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BANK OF JAPAN

Outlook for Economic Activity and Prices

January 2021

(English translation prepared by the Bank's staff based on the Japanese original)

Outlook for Economic Activity and Prices (January 2021)

The Bank's View[1]

Summary

- Japan's economy is likely to follow an improving trend with 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. Specifically, downward pressure stemming from the impact of a resurgence of COVID-19 is likely to remain strong for the time being, particularly in face-to-face services consumption. 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 October Outlook Report, the projected growth rates are somewhat higher, mainly for fiscal 2021, reflecting the effects of the government's economic measures in particular. 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 the impact of COVID-19 will wane gradually and then almost subside toward the end of the projection period. It also is based on the premises that, while the impact 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.

[1] "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on January 20 and 21, 2021.

I. Current Situation of Economic Activity and Prices in Japan

Japan's economy has picked up as a trend, 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, although the impact of the resurgence of COVID-19 has been seen in part. In this situation, exports and industrial production have continued to increase. In addition, corporate profits and business sentiment deteriorated significantly but subsequently have improved gradually. Business fixed investment has stopped declining on the whole, albeit with variations across industries. The employment and income situation has remained weak due to the impact of COVID-19. Private consumption has picked up gradually as a trend, but downward pressure has increased recently on consumption of services, such as eating and drinking as well as accommodations. Housing investment has declined moderately. Public investment has continued to increase moderately. 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 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 the impact of COVID-19 waning gradually, is likely to follow an improving trend, supported by a recovery in external demand, 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. Specifically, downward pressure stemming from the impact of the resurgence of COVID-19 is likely to remain strong for the time being, particularly in face-to-face services consumption. 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 assumption that, while taking preventive measures against COVID-19 and improving economic activity simultaneously, the impact of COVID-19 will wane gradually and then 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 assumption 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. In addition, production activity of the manufacturing industry and trade are expected to follow an increasing trend, whereas the recovery is projected to be slow in the face-to-face services industry, which is susceptible to the impact of COVID-19. Thereafter, overseas economies are likely to continue improving toward the end of the projection period since the face-to-face services industry in particular is expected to see a marked recovery as the impact of COVID-19 almost subsides.

Japan's exports of goods are projected to increase for a wide range of goods, including capital goods and IT-related goods, mainly on the back of a global recovery in production activity, although the pace of increase is likely to decelerate, mainly for automobile-related goods, due to a peaking-out of pent-up demand. Inbound tourism consumption, which is categorized as services exports, is expected to remain subdued while entry restrictions in Japan and travel restrictions abroad continue but likely to recover thereafter along with a gradual easing in such restrictions.

Private consumption is likely to continue picking up as a trend, supported also by the government's economic measures. However, downward pressure, stemming mainly from the impact of the resurgence of COVID-19, is expected to remain strong for the time being, particularly in face-to-face services consumption. Thereafter, with the impact of COVID-19 waning gradually, 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 low levels of 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 pick up, mainly for machinery investment by the manufacturing industry that reflects a rise in exports and production, although construction investment by the face-to-face services industry is projected to continue declining. Thereafter, business fixed investment is expected to increase, supported by accommodative financial conditions, the government's economic measures, and improvement in corporate profits. Meanwhile, public investment is projected to steadily increase, reflecting progress such as 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. Government consumption is projected to continue increasing clearly toward fiscal 2021, mainly reflecting the enhancement of the medical treatment system as well as the testing and vaccination

system, both of which are under the additional economic measures.

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 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 2020 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. Under these circumstances, 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. Tension has eased in financial markets. Financing, mainly of firms, is likely to remain under stress for the time being with a moderate pace of economic improvement, but owing to the Bank's and the government's measures, as well as efforts made by private financial institutions, the Bank

[2] Based on specific assumptions, 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 0.1 percentage point for both fiscal 2021 and 2022. Major mobile phone carriers have made public new plans that include price cuts on charges, but this is not factored into the outlook for prices in this report since the impact of such plans could change depending on how they will be reflected in the CPI.

[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, "Introduction of a New Fund-Provisioning Measure to Support Financing Mainly of Small and Medium-Sized Firms" released on May 22, 2020, and "Statement on Monetary Policy" released on December 18, 2020, in which the Bank made decisions such as on the extension of the Special Program to Support Financing in Response to the Novel Coronavirus (COVID-19).

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.

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. It is highly unclear how the COVID-19 pandemic will evolve, and there is a possibility that downward pressure on economic activity will increase due to the spread of COVID-19. Meanwhile, although the impact of COVID-19 could subside earlier than expected if vaccines become widely available, the pace of distribution and the effects of the vaccines entail uncertainties.

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. These developments are likely to be encouraged by the government's measures to transform the economic structure toward the post-COVID-19 era and by accommodative financial conditions.

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. 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.

[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.

B. Risks to Prices

If the aforementioned risks to economic activity materialize, prices also are likely to be affected accordingly. In addition, it is necessary to pay attention to the following two risks that are specific to prices.

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 the impact of COVID-19 is likely to put downward pressure on prices of goods and services that are sensitive to economic activity. On the other hand, firms' price cuts that aim at stimulating demand have not been observed widely to date, given that one of the reasons for the current decrease in demand is vigilance against COVID-19 and that there have been supply-side constraints, such as limiting the number of customers to prevent infection, and cost increases due to preventive measures against COVID-19. 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.[5]

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

[5] 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."

magnitude of their impact on domestic and overseas economies. The outlook is based on the assumption that the impact of COVID-19 will wane gradually and then almost subside toward the end of the projection period. It also is based on the premises that, while the impact 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 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.

(Appendix)

Forecasts of the Majority of the Policy Board Members

y/y % chg.

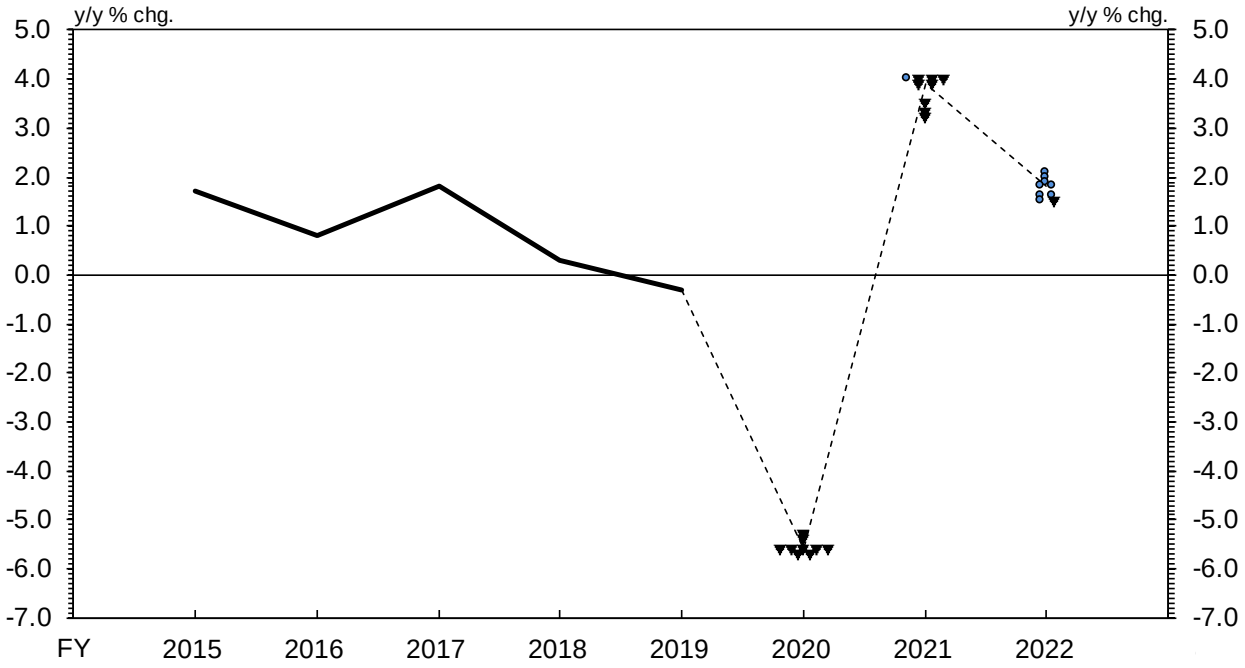
	Real GDP	CPI (all items less fresh food)	(Reference) Excluding the effects of the consumption tax hike and policies concerning the provision of free education
Fiscal 2020	-5.7 to -5.4 [-5.6]	-0.7 to -0.5 [-0.5]	-0.8 to -0.6 [-0.6]
Forecasts made in October 2020	-5.6 to -5.3 [-5.5]	-0.7 to -0.5 [-0.6]	-0.8 to -0.6 [-0.7]
Fiscal 2021	+3.3 to +4.0 [+3.9]	+0.3 to +0.5 [+0.5]	
Forecasts made in October 2020	+3.0 to +3.8 [+3.6]	+0.2 to +0.6 [+0.4]	
Fiscal 2022	+1.5 to +2.0 [+1.8]	+0.7 to +0.8 [+0.7]	
Forecasts made in October 2020	+1.5 to +1.8 [+1.6]	+0.4 to +0.7 [+0.7]	

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

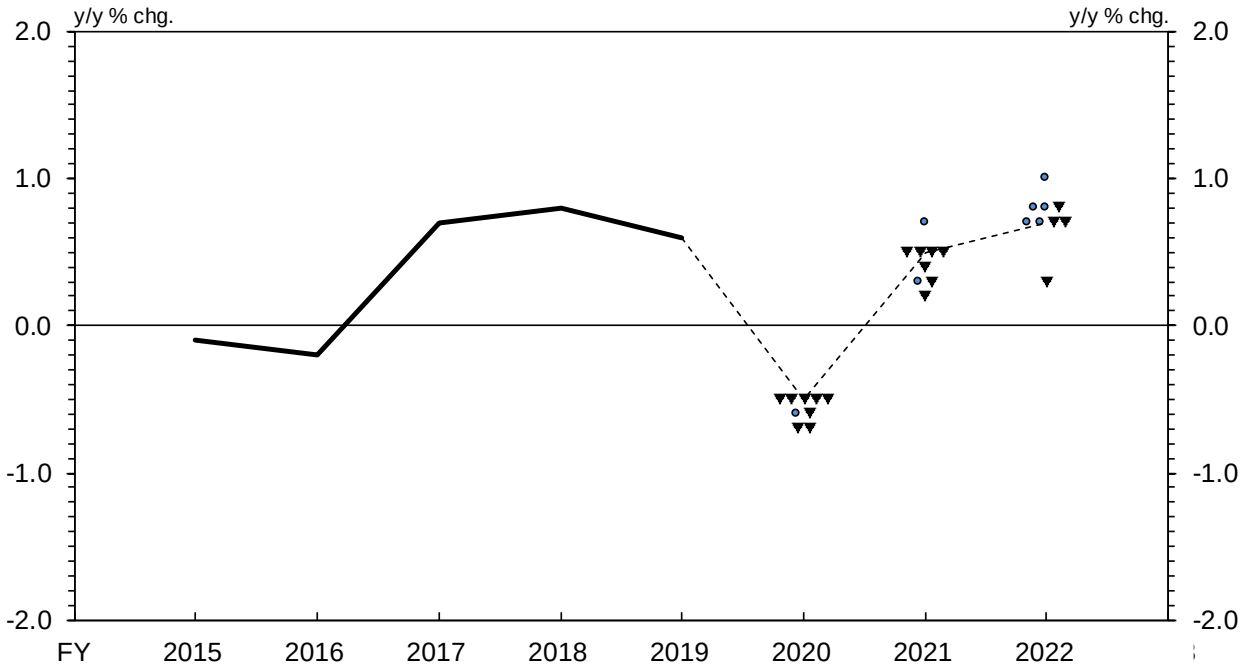
2. The forecasts of the majority of the Policy Board members are constructed as follows: each Policy Board member's forecast takes the form of a point estimate -- namely, the figure to which he or she attaches the highest probability of realization. These forecasts are then shown as a range, with the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

The Background[6]

I. Current Situation of Economic Activity and Its Outlook

A. Economic Developments

Japan's economy has picked up as a trend, although it has remained in a severe situation due to the impact of COVID-19 at home and abroad.

The real GDP growth rate for the April-June quarter of 2020 registered an extremely large decline, marking minus 8.3 percent on a quarter-on-quarter basis and minus 29.2 percent on an annualized basis (Chart 1). Thereafter, the rate turned to an increase for the July-September quarter, registering 5.3 percent on a quarter-on-quarter basis and 22.9 percent on an annualized basis. Looking at the breakdown, business fixed investment declined for two consequtive quarters, whereas exports and private consumption increased along with a resumption of economic activity at home and abroad.[7] Monthly indicators and high-frequency data since then suggest that, while global economic activity has picked up owing to the materialization of pent-up demand and policy effects, Japan's exports and industrial production have continued to increase clearly, not only for automobile-related goods but also for a wider range of goods, including capital goods and IT-related goods. Such a recovery in exports and production has led to a pick-up in machinery

Chart 1: Real GDP

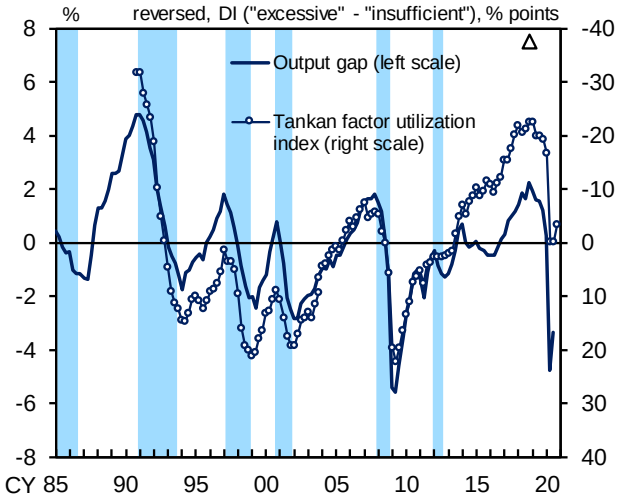
Source: Cabinet Office.

[6] "The Background" provides explanations of "The Bank's View" decided by the Policy Board at the Monetary Policy Meeting held on January 20 and 21, 2021.

[7] Box 1 makes a brief comparison of the pace of a pick-up in Japan's economy since the outbreak of COVID-19 with those in the United States and Europe.

investment, mainly by the manufacturing industry, through improvements in coporate profits and business sentiment. On the other hand, economic activity in the services industry leveled off around the summer season, mainly for face-to-face services, and then increased gradually until around the first half of November 2020, partly encouraged by the "Go To" campaign. However, there have been growing signs of stagnation again in the face-to-face services industry since the second half of November, due mainly to the resurgence of COVID-19, a resultant suspension of the "Go To Travel" campaign, and the reinstatement of the state of emergency. The output gap -- which captures the utilization of labor and capital -- became significantly negative for the April-June quarter for the first time since immediately after the Global Financial Crisis (GFC) but narrowed within negative territory for the July-September quarter, reflecting the resumption of economic activity. That for the October-December quarter seems to have continued improving, mainly for the manufacturing sector, reflecting increases in exports and production (Chart 2).

Chart 2: Output Gap



Source: Bank of Japan.
Notes: 1. The output gap is based on staff estimations.
2. The Tankan factor utilization index is calculated as the weighted average of the production capacity DI and the employment conditions DI for all enterprises. The capital and labor shares are used as weights. There is a discontinuity in the data in December 2003 due to a change in the survey framework.
3. Shaded areas indicate recession periods. The triangle shows the latest peak.

As for the outlook, Japan's economy, with the impact of COVID-19 waning gradually, is likely to follow an improving trend, supported by a recovery in external demand, accommodative financial conditions, and the government's

economic measures.[8] However, the pace of improvement is expected to be only moderate while vigilance against COVID-19 continues. Specifically, downward pressure stemming from the impact of the resurgence of COVID-19 is likely to remain strong for the time being, particularly in face-to-face services consumption. Thereafter, as the impact subsides globally, the economy is projected to keep improving further with overseas economies returning to a steady growth path.

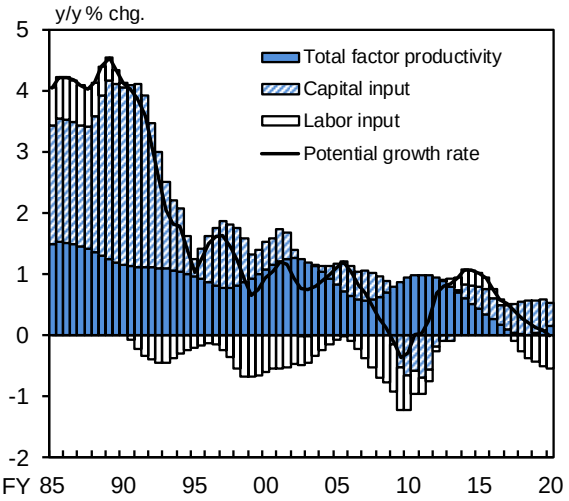
Specifically, goods exports are likely to increase for a wide range of goods, including capital goods and IT-related goods, mainly on the back of a global recovery in trade activity, although the pace of increase is projected to decelerate, mainly for automobile-related goods, due to a peaking-out of pent-up demand. On the other hand, inbound tourism demand, which is categorized as services exports, is expected to remain subdued as long as entry and travel restrictions continue but likely to recover thereafter along with a gradual easing in such restrictions. Private consumption is projected to continue picking up as a trend, supported also by the government's economic measures; however, downward pressure, stemming mainly from the impact of the resurgence of COVID-19, is expected to remain strong for the time being, particularly in face-to-face services consumption. With the impact of COVID-19 almost subsiding toward the

[8] On December 8, 2020, the Cabinet decided on the Comprehensive Economic Measures to Secure People's Lives and Livelihoods toward Relief and Hope, with a project size of around 73.6 trillion yen and fiscal spending of around 40.0 trillion yen. The outlook presented in this Outlook Report is based on the assumption that the third supplementary budget for fiscal 2020 and the initial budget for fiscal 2021 that are based on the comprehensive economic measures will be approved by the Diet and implemented, and will support economic activity accordingly.

end of the projection period, an uptrend in private consumption is likely to become evident gradually on the back of improvement in employee income. Although the employment adjustment subsidies, which were expanded in response to the current situation, and the measures to support financing are expected to provide support for employment, employee income is highly likely to remain on a downtrend for the time being, primarily for the face-to-face services industry, due mainly to a decrease in bonuses that reflects low levels of corporate profits. Thereafter, such income is likely to turn to an improving trend while lagging behind a recovery in domestic and external demand. Business fixed investment is projected to pick up, mainly for machinery investment by the manufacturing industry, due to increases in exports and production. Then, it is expected to increase, supported by accommodative financial conditions, the government's economic measures, and improvement in corporate profits. Meanwhile, public investment is likely to steadily increase, reflecting progress in construction related to restoration and reconstruction following natural disasters, as well as to building national resilience, which is included in the additional economic measures decided by the Cabinet in December 2020. Thereafter, it is expected to be at a relatively high level. Government consumption is projected to continue increasing clearly toward fiscal 2021. This mainly reflects, in addition to a pick-up in healthcare expenditure, the enhancement of the medical treatment system and the testing and vaccination system, both of which are under the additional economic measures.

Reflecting these developments in demand both at home and abroad, Japan's economic growth rate is expected to be significantly negative for fiscal 2020. However, supported by the additional economic measures and accommodative financial conditions, it is likely to mark a relatively large positive figure for fiscal 2021, when the impact of COVID-19 is expected to wane. The rate is expected to continue to register firm growth for fiscal 2022, mainly on the back of improvement in overseas economies. Compared with the previous projections in the October 2020 Outlook Report, the projected growth rates are somewhat higher, mainly for fiscal 2021, reflecting the effects of the additional economic measures in particular.

Chart 3: Potential Growth Rate



Source: Bank of Japan.
Note: Based on staff estimations. The benchmark year is 2011 for the SNA data used in calculating figures for capital input.

The potential growth rate seems to have declined to around 0 percent recently (Chart 3).[9] This is largely because total factor productivity (TFP) has declined, mainly due to preventive measures against COVID-19 and to labor hoarding, and working hours have been on a downtrend, mainly reflecting shorter operating hours. As for the outlook, the potential growth rate is expected to remain at around the current low level for the time being. As a background to this, the growth of capital stock is projected to continue decelerating, although, with the impact of COVID-19 waning, the downtrend in working hours is likely to become moderate gradually and the TFP growth rate is projected to turn to an uptrend. That said, the potential growth rate is expected to rise

[9] It should be noted that the potential growth rate is estimated using GDP with the new base year of 2015 and capital stock as a production factor with the previous base year of 2011. Thus, if the potential growth rate is recalculated using the *Quarterly Estimates of Net Capital Stocks of Fixed Assets* with the new base year that is to be released, the estimation results could be different.

moderately toward the end of the projection period. This is based on the projection that (1) the TFP growth rate will continue to increase moderately, reflecting adaptation to lifestyle changes that were caused by COVID-19, advancement in digital transformation, and a resultant improvement in efficiency of resource allocation, (2) the pace of decline in working hours will slow, and (3) the growth of capital stock will accelerate cyclically. However, there is a possibility that COVID-19 will bring about structural changes in people's working styles and firms' business processes, such as the widespread adoption of working from home and an acceleration in e-commerce, and these changes could lead to a trend that is different from the past one. Thus, the output gap and the potential growth rate, which are estimated based on a specific assumption regarding trends, should be interpreted with more latitude than usual. In addition, there are high uncertainties at this point over advancement in innovation by the corporate sector and flexible transfer of economic resources among sectors, both of which are assumed to bring about a future rise in the TFP growth rate.

Details of the outlook for each fiscal year are as follows. In the second half of fiscal 2020, the economy is expected to continue picking up, mainly for the manufacturing industry, although downward pressure stemming from the resurgence of COVID-19 is expected to remain strong, particularly in the face-to-face services industry. Goods exports are likely to decelerate, due mainly to a peaking-out of pent-up demand for automobile-related goods, but remain on an increasing trend, particularly for capital goods and IT-related goods. Business fixed investment is

projected to pick up gradually on the whole; construction investment by the face-to-face services industry is likely to continue decreasing, whereas machinery investment by the manufacturing industry is expected to increase, reflecting positive effects of exports. On the other hand, private consumption is highly likely to show growing signs of deceleration in the short run, since it is projected that private consumption will be pushed down from the income side due to a decline in winter bonuses and that face-to-face services consumption will remain somewhat weak, reflecting the spread of COVID-19 since the end of 2020 and the declaration of a state of emergency after the turn of 2021. Inbound tourism demand also is likely to remain stagnant for the time being with entry restrictions being maintained. Meanwhile, public investment is expected to continue increasing steadily due to expansion such as in construction related to restoration and reconstruction following natural disasters, as well as to building national resilience. In addition, government consumption is likely to follow an uptrend, mainly reflecting the enhancement of the medical treatment system as well as the testing and vaccination system.

In fiscal 2021, as the impact of COVID-19 wanes at home and abroad and the growth rates of overseas economies rise, an improving trend in Japan's economy is expected to become evident, partly supported by the additional economic measures and accommodative financial conditions. Exports are likely to follow an uptrend for a wide range of goods on the back of improvement in overseas economies, although the pace is expected to decelerate from that seen in the second half of fiscal 2020. With the impact

of COVID-19 waning, private consumption is likely to increase, albeit only moderately, supported also by a pick-up in employee income, the government's demand stimulus measures, and Olympic Games-related demand. Business fixed investment is expected to increase, although construction investment, such as for commercial facilities and hotels, is likely to remain at a low level. This is because, with corporate profits improving, business fixed investment is projected to be pushed up by an undertaking of postponed investment projects and an increase in digital-related investment such as to set up systems for contactless services. Meanwhile, with regard to government spending, owing to the additional economic measures, public investment in construction related to building national resilience is likely to increase steadily and government consumption is expected to continue showing a clear increase, mainly reflecting the enhancement of the medical treatment system as well as the testing and vaccination system, in addition to a pick-up in healthcare expenditure.

In fiscal 2022, the economy is expected to continue growing firmly, with demand at home and abroad increasing in a well-balanced manner. Exports are likely to continue increasing clearly, reflecting improvement in overseas economies. In this situation, corporate profits are expected to follow their improving trend and business fixed investment is likely to continue increasing, mainly for digital-related investment as well as research and development (R&D) investment for growth such as in areas related to the environment. Private consumption is expected to continue increasing while vigilance against COVID-19 by seniors wanes along with the impact subsiding

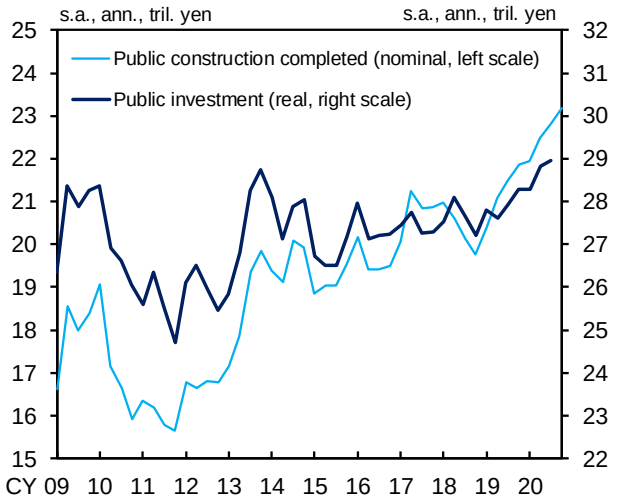
and as a virtuous cycle from income to spending operates. Meanwhile, although an increase in public investment in construction related to building national resilience is projected to serve as support, government spending is likely to turn to a decline on the whole since government consumption is expected to decrease, mainly due to a peaking-out of spending related to COVID-19.

B. Developments in Major Expenditure Items and Their Background

Government Spending

Public investment has continued to increase moderately (Chart 4). The amount of public construction completed, which is a coincident indicator, has continued to increase moderately since early 2019. The value of public works contracted, as well as orders received for public construction, both of which are leading indicators, have been on a moderate uptrend, albeit with fluctuations, reflecting such progress as in construction related to restoration and reconstruction following natural disasters, as well as to building national resilience. As for the outlook, public investment is expected to continue increasing steadily for the time being due to the progress in the aforementioned infrastructure-related construction. Then, it is likely to continue increasing steadily, supported by construction of Olympic Games-related temporary facilities and that related to building national resilience with the aim of taking measures, mainly to control flooding and address decaying infrastructures.[10] Public investment thereafter is projected to be at a relatively high level. Government consumption is expected to continue increasing clearly toward fiscal 2021, mainly reflecting the enhancement of the medical treatment system as well as the testing and vaccination system, both of which are under the

Chart 4: Public Investment



Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Note: The figure for 2020/Q4 is the October-November average.

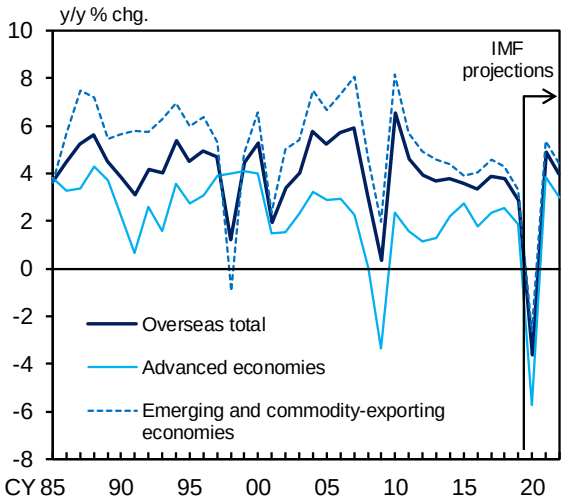
[10] Given the expiration of the three-year emergency response plan for disaster prevention, disaster mitigation, and building national resilience at the end of fiscal 2020, a new plan for building national resilience with a targeted period from fiscal 2021 through 2025 and a project size of about 15 trillion yen was decided by the Cabinet in December 2020. In reflection of this plan, public works to push forward with disaster prevention, disaster mitigation, and building national resilience have been incorporated into the third supplementary budget for fiscal 2020 as major measures.

additional economic measures.

Overseas Economies

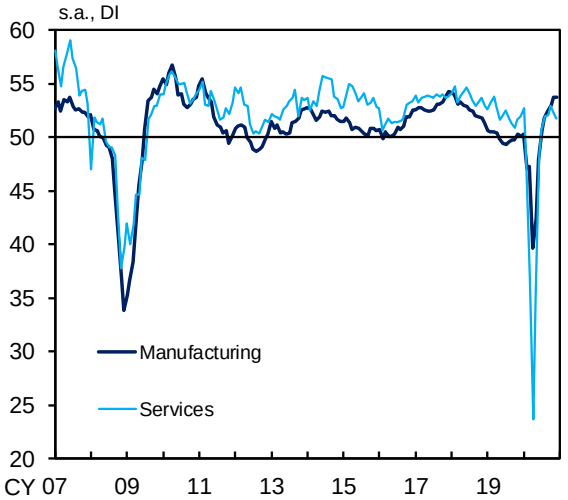
Overseas economies have picked up, although the impact of the resurgence of COVID-19 has been seen in part (Chart 5). With economic activity resuming, the growth rates in many economies for the July-September quarter of 2020 became significantly positive, on the back of increases such as in goods consumption and digital-related business fixed investment. Thereafter, the confirmed new cases of COVID-19 have surged and the stricter public health measures have taken effect in the United States and Europe. However, business sentiment globally has maintained its clear improving trend both for the manufacturing and services industries, as respective countries generally have been addressing the spread of COVID-19 while taking care of economic activity at the same time (Chart 6). On a global basis, the production level of the manufacturing industry and the trade volume have continued to increase firmly and almost recovered to the level seen around early 2020.[11] Looking at developments by major region, the Chinese economy has continued to recover. The U.S. economy has picked up. Emerging and commodity-exporting economies other than China have picked up from a state of depression. On the other hand, European economies have been pushed down by the resurgence of COVID-19, mainly for the services industry.

Chart 5: Overseas Economies



Sources: IMF; Ministry of Finance.
Note: Figures are the weighted averages of real GDP growth rates using countries' share in Japan's exports as weights. Annual GDP growth rates are from the "World Economic Outlook (WEO)" as of October 2020. Advanced economies consist of the United States, the euro area, and the United Kingdom. Emerging and commodity-exporting economies consist of the rest of the world economy.

Chart 6: Global PMI

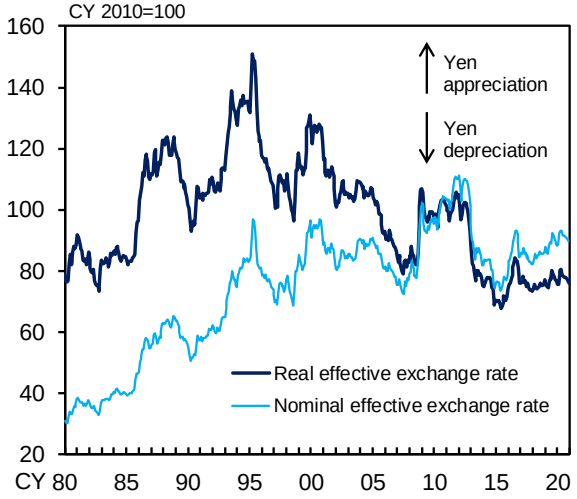


Source: IHS Markit (© and database right IHS Markit Ltd 2021. All rights reserved.).
Note: Figures for manufacturing are the "J.P.Morgan Global Manufacturing PMI." Figures for services are the "J.P.Morgan Global Services Business Activity Index."

[11] With regard to the impact of a resurgence of COVID-19 since last autumn on the U.S. and European economies, see Box 2.

As for the outlook, overseas economies are likely to improve, partly supported by aggressive macroeconomic policies taken by each country and region. That said, it is highly likely that the pace will be only moderate and vary across areas for the time being, partly due to the impact of the resurgence of COVID-19, mainly in the United States and Europe. Toward the end of the projection period, the stimulus effects of macroeconomic policies are projected to dissipate but overseas economies are likely to continue growing. This is because the pick-up in services consumption, which has been notably slow to recover, is expected to become evident gradually with the impact of COVID-19 almost subsiding, due partly to the distribution of vaccines.

Chart 7: Effective Exchange Rates

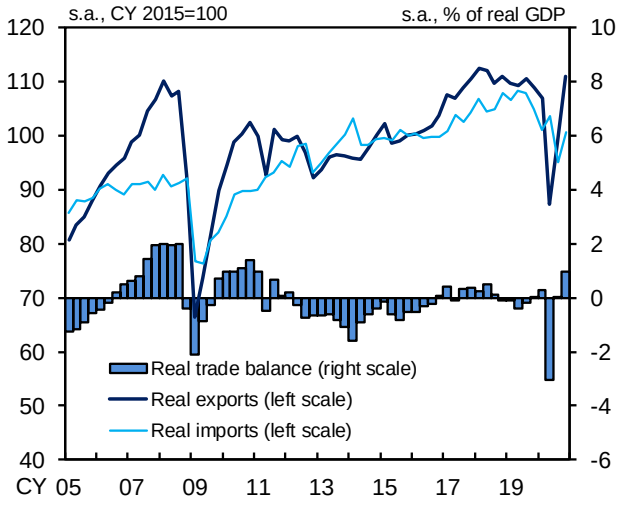


Source: BIS.
Note: Figures are based on the broad index of the "Effective Exchange Rate." Those prior to 1994 are calculated using the narrow index.

Exports and Imports

Exports have continued to increase clearly, reflecting a pick-up in overseas economies (Chart 8). By region, exports to advanced economies have continued to increase clearly, supported by a recovery in automobile sales and restocking of inventories, as well as steady machinery investment and digital-related demand (Chart 9). Regarding exports to emerging economies, those to China have increased firmly and those to other countries and regions, which showed a delay in a pick-up on the whole, have turned to an increase recently. By goods, exports of automobile-related goods have continued to increase clearly, reflecting a global recovery in automobile sales that has been supported by the materialization of pent-up demand (Chart 10). With firm exports of parts for data centers, those related to personal computers, and those for on-board equipment for motor vehicles, an uptrend in IT-related exports has been evident recently, also reflecting a rise in

Chart 8: Real Exports and Real Imports

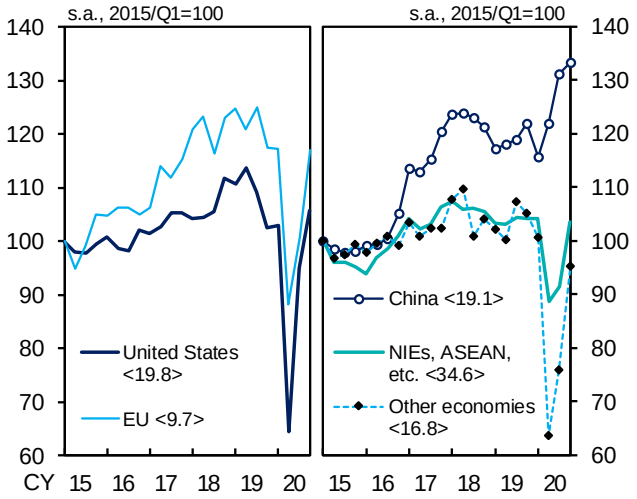


Sources: Bank of Japan; Ministry of Finance; Cabinet Office.
Note: Based on staff calculations. Figures for 2020/Q4 are October-November averages.

demand for parts related to new models of smartphones. Exports of capital goods declined, mainly for metalworking machinery, as well as construction and mining machinery, but have turned to an increase recently due to a global recovery in production activity and demand for machinery investment. Exports of intermediate goods declined temporarily around last spring but have increased of late, mainly for chemicals such as plastics to Asia.

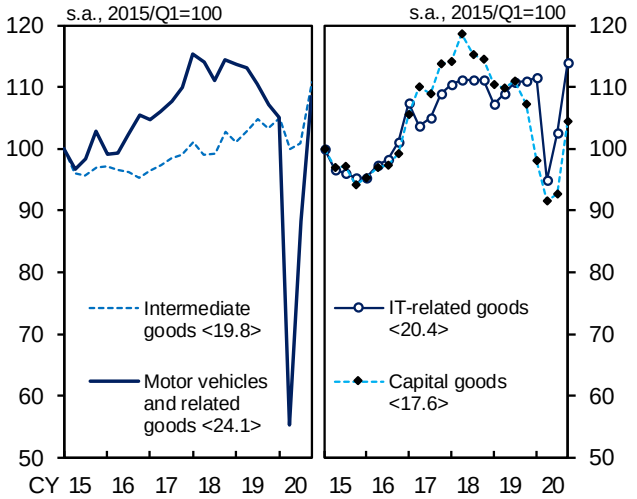
The pace of increase in exports is expected to decelerate for the time being, mainly for automobile-related goods, due to a peaking-out of pent-up demand. However, exports are likely to continue increasing for a wider range of goods, such as capital goods and IT-related goods, supported by a global recovery in demand for business fixed investment and steady IT-related demand. By goods, although exports of automobile-related goods are likely to slow their pace of increase due to a peaking-out of pent-up demand and the end of the inventory-restocking phase, they are expected to remain on an uptrend, backed by a global increase in demand for automobiles. IT-related exports are likely to continue increasing firmly on the back of continuing firm demand for parts for data centers, those related to personal computers, and those for on-board equipment for motor vehicles, as well as increasing demand for parts for 5G-related equipment. Capital goods exports also are likely to continue increasing, reflecting a global recovery in demand for business fixed investment.

Chart 9: Real Exports by Region



Sources: Bank of Japan; Ministry of Finance.
Notes: 1. Based on staff calculations. Figures in angular brackets show the share of each country or region in Japan's total exports in 2019.
Figures for 2020/Q4 are October-November averages.
2. "EU" does not include the United Kingdom for the entire period.

Chart 10: Real Exports by Type of Goods

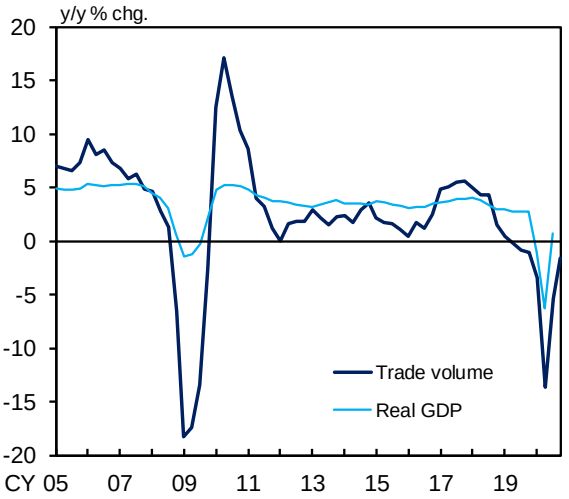


Sources: Bank of Japan; Ministry of Finance.
Note: Based on staff calculations. Figures in angular brackets show the share of each type of goods in Japan's total exports in 2019.
Figures for 2020/Q4 are October-November averages.

Looking at the world trade volume, which has a crucial impact on developments in Japan's exports, it declined considerably around last spring but has recovered along with the resumption of economic activity (Chart 11).[12] As for the outlook, it is likely to continue increasing as spending on goods, such as durable goods consumption and business fixed investment, and production in the manufacturing industry are expected to follow an uptrend globally. Japan's share of exports in world trade decreased significantly, reflecting a plunge in exports of automobile-related goods, of which Japan's share in particular is large (Chart 12). However, it has recovered to date to the pre-pandemic level, along with a recovery in exports of automobile-related goods and capital goods. As for the outlook, Japan's share of exports is expected to remain more or less flat with Japan's competitiveness of exports being maintained, mainly for automobile-related goods and capital goods. Based on the aforementioned outlook for the world trade volume and Japan's share of exports, Japan's exports are likely to continue increasing at almost the same pace as the world trade volume on average throughout the projection period.

Imports have started to pick up, reflecting domestic economic activity (Chart 8). They are expected to follow a moderate uptrend, on the back of developments in induced demand due to increases in domestic demand and exports.

Chart 11: World Trade Volume and Real GDP of the World Economy



Sources: CPB Netherlands Bureau for Economic Policy Analysis; IMF, etc.
Notes: 1. Figures for the trade volume are those for real imports.
The figure for 2020/Q4 is the percentage change from the October-December 2019 average to October 2020.
2. Real GDP of the world economy is based on staff calculations using GDP shares of world total GDP from the IMF as weights.

Chart 12: Japan's Share of Exports in World Trade

Source: CPB Netherlands Bureau for Economic Policy Analysis.
Note: Japan's share of exports in world trade is obtained by dividing Japan's real exports by world real imports (2010 prices). The figure for 2020/Q4 is that for October.

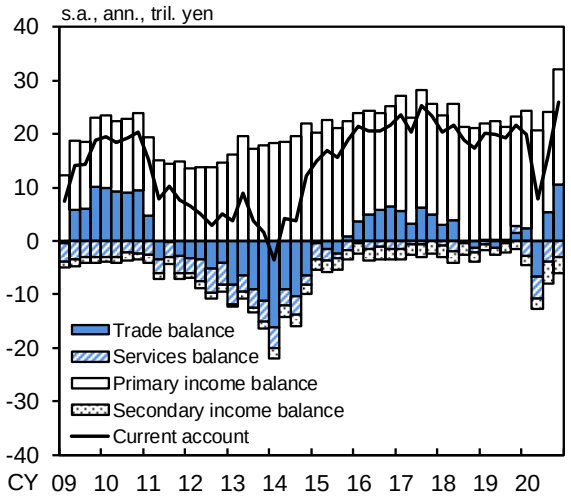
[12] The world trade volume is calculated by adding up real imports in each country.

External Balance

The nominal current account surplus declined around last spring, mainly due to deterioration in the trade balance, but subsequently has been on a clear expanding trend, mainly for the trade balance (Chart 13). Looking at the breakdown of developments in the current account balance, the nominal trade balance marked a relatively large deficit around last spring but subsequently has turned positive and seen an increase in its surplus, reflecting a steady rise in exports. On the other hand, the services balance has continued to register a deficit, reflecting deterioration in the travel balance, as described later. A surplus in the primary income balance decreased temporarily, reflecting developments in direct investment income, but then has expanded again. Looking at these developments in the current account balance in terms of the savings-investment balance, overall excess savings in Japan's economy declined temporarily for the April-June quarter of 2020, with the expansion in the fiscal deficit due to the conduct of economic measures exceeding that in excess savings in the private sector (Chart 14). However, subsequently, overall excess savings have expanded, reflecting improvement in the fiscal balance.

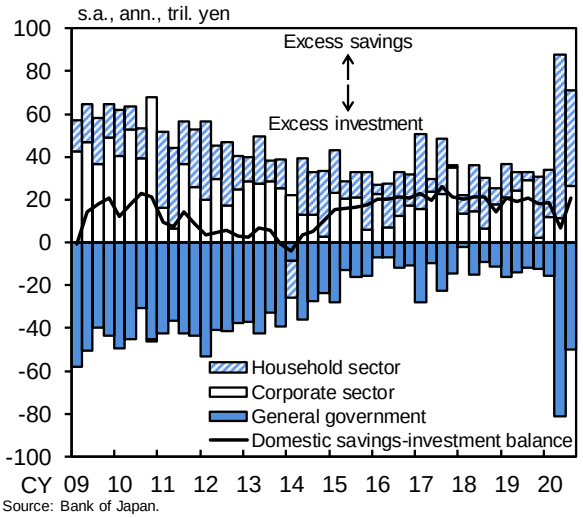
Meanwhile, as entry and travel restrictions remain in place to contain the spread of COVID-19, there is still almost no inbound visitors (Chart 15). As a result of these developments, travel receipts have been at significantly low levels. Although travel payment also has decreased due to a smaller number of departures stemming from travel restrictions, the net travel balance has remained at a deteriorated level since the impact of the

Chart 13: Current Account



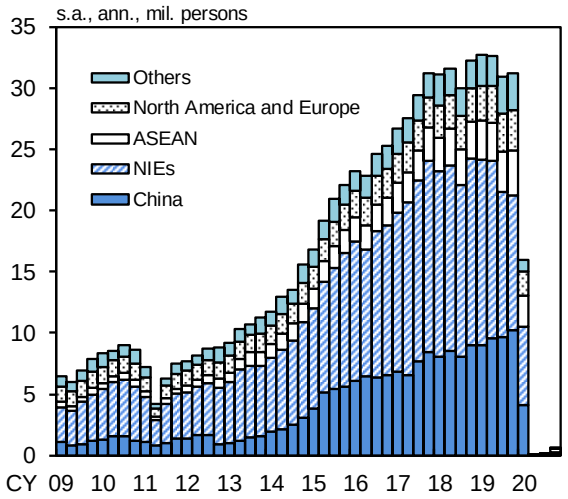
Source: Ministry of Finance and Bank of Japan.
Note: Figures for 2020/Q4 are October-November averages.

Chart 14: Savings-Investment Balance



Source: Bank of Japan.

Chart 15: Number of Inbound Visitors



Source: Japan National Tourism Organization (JNTO).
Note: North America and Europe consist of the United States, Canada, the United Kingdom, France, and Germany.

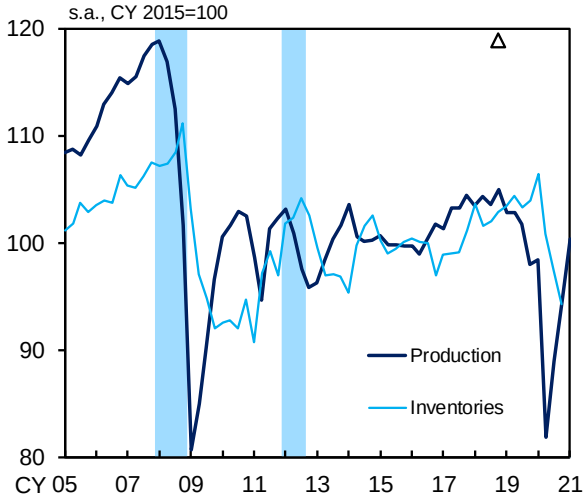
decline in receipts has been larger than that in payment.

The nominal current account surplus is expected to follow a moderate expanding trend, on the back of improvements in the trade balance and the primary income balance that reflect a recovery in overseas economies.

Industrial Production

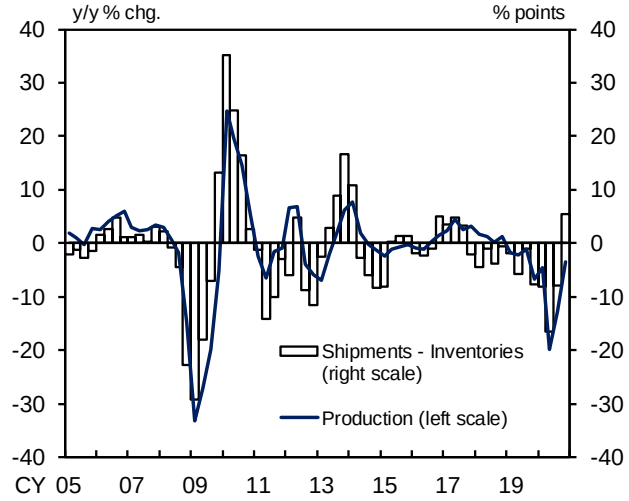
Industrial production has continued to increase (Chart 16). By major industry, transport equipment production has remained on an uptrend, albeit at a slower pace, on the back of a global recovery in automobile sales and restocking of inventories by automakers at home and abroad. Such developments have spread to related industries such as materials. For example, production of iron and steel, as well as nonferrous metals, has increased. Production of machinery (i.e., "general-purpose, production, and business-oriented machinery" in the *Indices of Industrial Production*) also has picked up on the back of a recovery in demand for machinery investment at home and abroad. Production of electronic parts and devices has continued to pick up, supported by an increase in demand for parts for data centers, those related to personal computers, those for on-board equipment for motor vehicles, and those related to new models of smartphones. Meanwhile, the shipments-inventories balance (i.e., the year-on-year rate of change in shipments minus that in inventories) has improved clearly of late since an increase in shipments and progress in inventory adjustments have been observed at the

Chart 16: Industrial Production



Source: Ministry of Economy, Trade and Industry (METI).
Notes: 1. Shaded areas indicate recession periods. The triangle shows the latest peak.
2. The production figures for 2020/Q4 and 2021/Q1 are calculated based on METI projections for December 2020 and January 2021. The inventories figure for 2020/Q4 is that for November.

Chart 17: Shipments-Inventories Balance



Source: Ministry of Economy, Trade and Industry.
Note: The production figure and the shipments figure for 2020/Q4 are October-November averages. The inventories figure for 2020/Q4 is that for November.

same time across a wide range of industries (Chart 17).

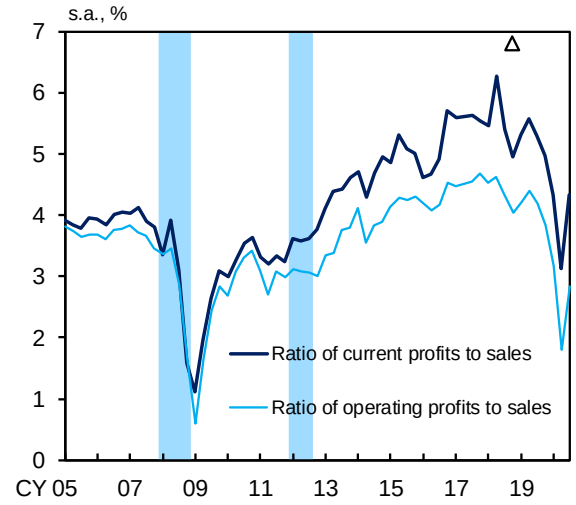
Industrial production is likely to decelerate its pace of increase in the short run due to a peaking-out of pent-up demand for automobiles. However, it is expected to continue increasing, mainly supported by a global recovery in demand for business fixed investment and steady digital-related demand.

Corporate Profits

Corporate profits deteriorated substantially but subsequently have improved gradually. According to the *Financial Statements Statistics of Corporations by Industry, Quarterly* (FSSC), the ratios of profits to sales for all industries and enterprises declined significantly for the April-June quarter of 2020, reflecting a depression in economic activity, but have picked up for the July-September quarter along with the resumption of economic activity (Chart 18). Looking at current profits by firm size, a relatively large improvement has been observed in small and medium-sized firms in the manufacturing and nonmanufacturing industries, both of which showed a significant decline for the April-June quarter. This is attributable to an increase in non-operating profits owing to various measures to support firms, such as the employment adjustment subsidies and subsidies for sustaining businesses, in addition to improvement in operating profits.

As with corporate profits, business sentiment deteriorated significantly but subsequently has

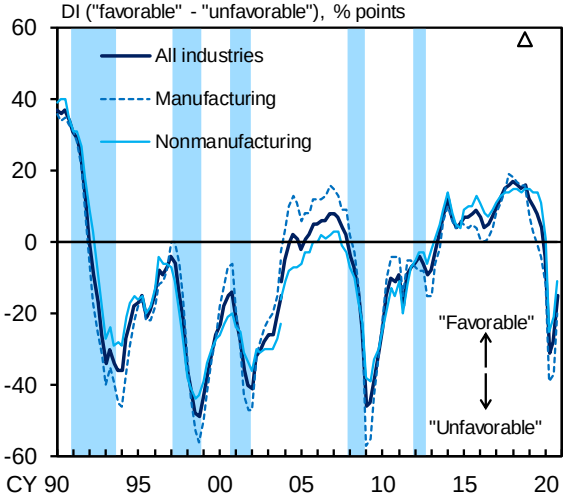
Chart 18: Corporate Profits



Source: Ministry of Finance.
Notes: 1. Based on the "Financial Statements Statistics of Corporations by Industry, Quarterly." Excluding "finance and insurance."
2. Figures from 2009/Q2 exclude "pure holding companies."
3. Shaded areas indicate recession periods. The triangle shows the latest peak.

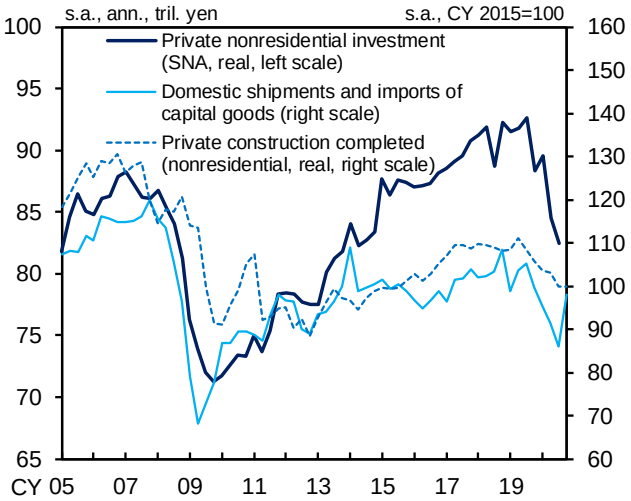
improved gradually. According to the December 2020 *Tankan* (Short-Term Economic Survey of Enterprises in Japan), the diffusion index (DI) for business conditions for all industries and enterprises has improved for two consecutive quarters, although it has remained at a low level (Chart 19). By industry, the DI for the manufacturing industry has improved clearly, with a recovery in automobiles spreading widely to the related industries. With overall economic activity picking up, the DI for the nonmanufacturing industry also has improved for a wide range of industries, backed by the government's demand stimulus measures. As for the outlook, the business conditions DI for the manufacturing industry is likely to continue improving, albeit to a small degree, whereas the DI for the nonmanufacturing industry suggests that business sentiment of firms, particularly small ones, is expected to be cautious, due to the impact of the resurgence of COVID-19 since November 2020.

Chart 19: Business Conditions



Source: Bank of Japan.
Notes: 1. Based on the *Tankan*. All enterprises. There is a discontinuity in the data in December 2003 due to a change in the survey framework.
2. Shaded areas indicate recession periods. The triangle shows the latest peak.

Chart 20: Coincident Indicators of Business Fixed Investment



Sources: Cabinet Office; Ministry of Economy, Trade and Industry; Ministry of Land, Infrastructure, Transport and Tourism.
Notes: 1. Figures for 2020/Q4 are October-November averages.
2. Real private construction completed is based on staff calculations using price indices in the "Construction Cost Deflators."

Corporate profits are likely to follow an improving trend on the whole, reflecting a recovery in domestic and overseas demand, although there will be variations across industries for the time being; for example, the impact of COVID-19 is expected to continue pushing down the face-to-face services industry in particular.

Business Fixed Investment

Business fixed investment has stopped declining on the whole, albeit with variations across industries (Chart 20). The aggregate supply of capital goods -- a coincident indicator of machinery investment -- continued to decline due

to a decrease in corporate profits and to increasing uncertainties over the future, both of which were brought about by the impact of COVID-19. However, it has picked up recently, reflecting increases in exports and production. On the other hand, with large-scale Olympic Games-related construction having almost completed, private construction completed (nonresidential) -- a coincident indicator of construction investment -- has remained on a moderate declining trend due to the materialization of the effects of a decrease in construction of stores and accommodation facilities mainly by the eating and drinking as well as accommodation industries.

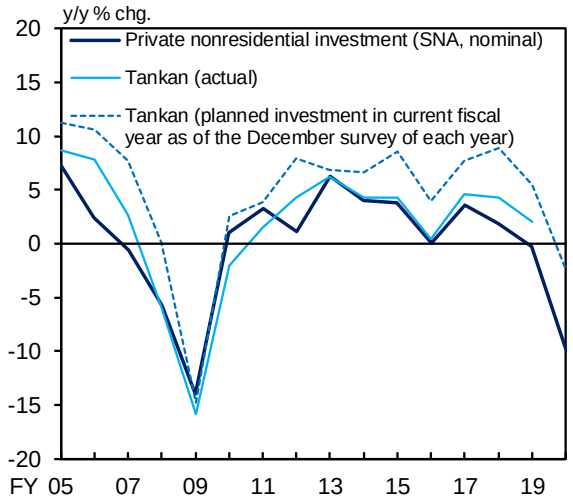
Chart 21: Leading Indicators of Business Fixed Investment

Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Notes: 1. Volatile orders: orders for ships and orders from electric power companies.
2. Figures for 2020/Q4 are October-November averages.

Machinery orders -- a leading indicator of machinery investment -- remained on a downtrend, but a pick-up, mainly for the manufacturing industry, has become evident, reflecting increases in exports and production (Chart 21). On the other hand, construction starts (in terms of planned expenses for private and nonresidential construction) -- a leading indicator of construction investment -- has remained on a declining trend. This is largely attributable to a decrease in construction of stores and accommodation facilities mainly by the eating and drinking as well as accommodation industries, which have been affected by COVID-19. However, construction of warehouses, such as logistics facilities, has continued to increase on the back of expansion in e-commerce. Meanwhile, looking at the business fixed investment plan for this fiscal year in the *Tankan*, business fixed investment (on the basis close to GDP definition; business fixed investment -- including software and R&D investments, but excluding land purchasing

expenses -- in all industries and enterprises including financial institutions) has been revised downward for two consecutive quarters, mainly for the materials as well as transport and postal activities industries, and become negative on a year-on-year basis, albeit marginally, for the first time in a December survey since fiscal 2009 (Chart 22). However, the capital stock adjustment seems to be not as significant as that seen after the GFC, since accommodative financial conditions have been maintained on the back of the Bank's and the government's aggressive measures to support financing and of financial institutions' efforts together with those measures.[13]

Chart 22: Planned and Actual Business Fixed Investment



Sources: Bank of Japan; Cabinet Office.
Notes: 1. The *Tankan* figures include software and R&D investments and exclude land purchasing expenses (R&D investment is not included before the March 2017 survey). The figures are for all industries including financial institutions.
2. The figure for private nonresidential investment for fiscal 2020 is the 2020/Q2-Q3 average.

As for the outlook, business fixed investment is likely to pick up, mainly for machinery investment by the manufacturing industry, reflecting a recovery in exports and production, although construction investment by the face-to-face services industry is expected to remain weak for the time being. Thereafter, with the impact of COVID-19 waning, an uptrend in business fixed investment is likely to become evident, supported by accommodative financial conditions, the government's economic measures, and improvement in corporate profits. Specifically, it is expected to be led mainly by (1) machinery investment by the manufacturing industry, which has already increased, (2) digital-related investment including that related to e-commerce as well as environment-related investment, and (3) R&D investment for growth areas.

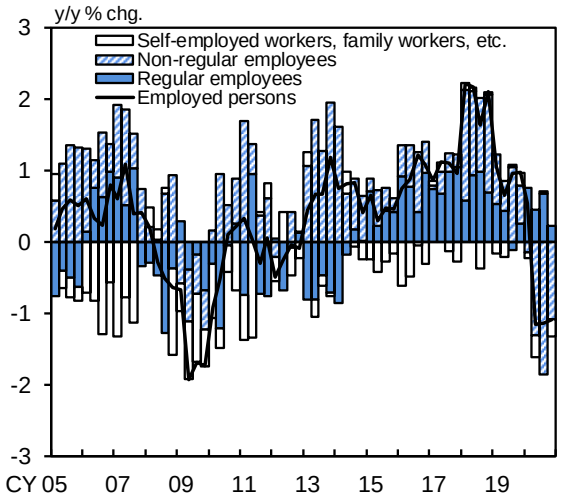
[13] Box 3 outlines characteristics of firms' behavior during the COVID-19 era in terms of both business fixed investment and employment, taking into account the effects of support from the policy responses.

Employment and Income Situation

The employment and income situation has remained weak due to the impact of COVID-19.

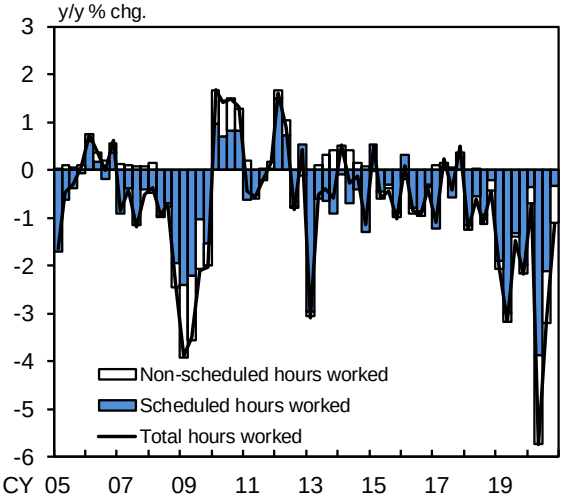
The year-on-year rate of change in the number of employed persons has continued to register a negative figure of slightly more than minus 1 percent, when fluctuations are smoothed out, mainly due to a decrease in non-regular employees in the face-to-face services industry (Chart 23). However, the decline in the number of employed persons has been constrained compared with that in the level of economic activity. This is mainly because the employment adjustment subsidies, which were expanded in response to the current situation, have somewhat halted job cuts, and because bankruptcies of firms have been mitigated under the Bank's and the government's measures to support financing. The year-on-year rate of change in total hours worked per employee has been on an uptrend in negative territory on the whole, albeit with fluctuations that are due mainly to the number of weekdays, although relatively large negative growth is still seen in some industries, such as accommodations as well as eating and drinking, that have been affected strongly by COVID-19 (Chart 24). With regard to labor market conditions, the labor force participation rate declined around last spring because some seniors, women, and student part-time workers were out of the labor market due to the effects of the declaration of a state of emergency and school closures. However, since they have continued to return to the labor market, the labor force participation rate has increased, almost recovering recently to the level seen around the end of 2019 (Chart 25). The unemployment rate has been on a moderate

Chart 23: Number of Employed Persons



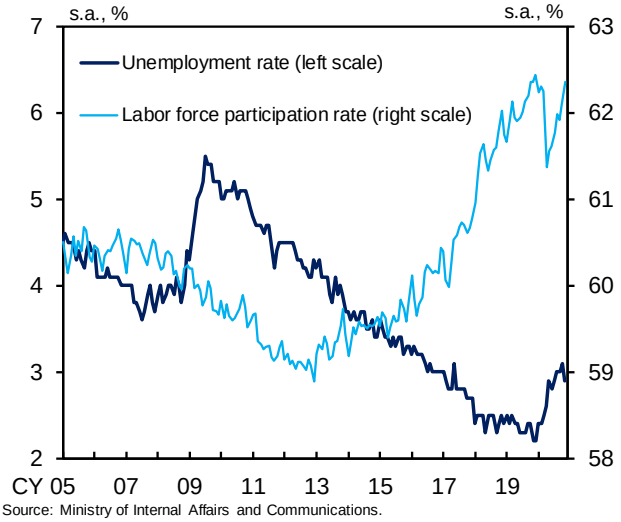
Source: Ministry of Internal Affairs and Communications.
Note: "Self-employed workers, family workers, etc." includes executives of companies or corporations. Figures prior to 2014 are based on the "detailed tabulation" in the "Labour Force Survey." Figures for 2020/Q4 are October-November averages.

Chart 24: Hours Worked



Source: Ministry of Health, Labour and Welfare.
Note: Figures for 2020/Q4 are October-November averages.

Chart 25: Unemployment Rate and Labor Force Participation Rate



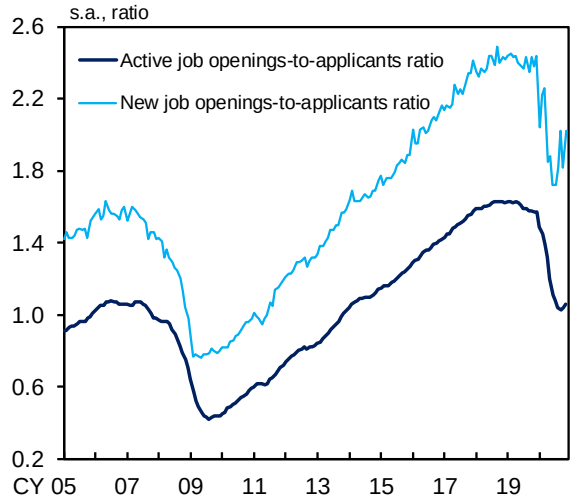
Source: Ministry of Internal Affairs and Communications.

increasing trend since last spring, being at around 3 percent of late. The active job openings-to-applicants ratio continued to decline clearly but has stopped doing so recently at a level slightly above 1, mainly due to an increase in job openings that reflects a pick-up in economic activity (Chart 26).

As for the outlook, policy responses such as the employment adjustment subsidies and measures to support financing are likely to continue supporting employment, but it is expected that employment adjustment pressure will continue to be exerted to a certain degree, mainly on non-regular employees in industries such as accommodations, eating and drinking, as well as services for individuals, all of which are largely affected by a decline in demand due to COVID-19. From the middle of the projection period, with the impact of COVID-19 waning, the number of employed persons is likely to return to a moderate increasing trend as labor absorption is expected to progress to a certain degree, mainly in industries with labor shortage, such as construction, as well as medical and welfare services.

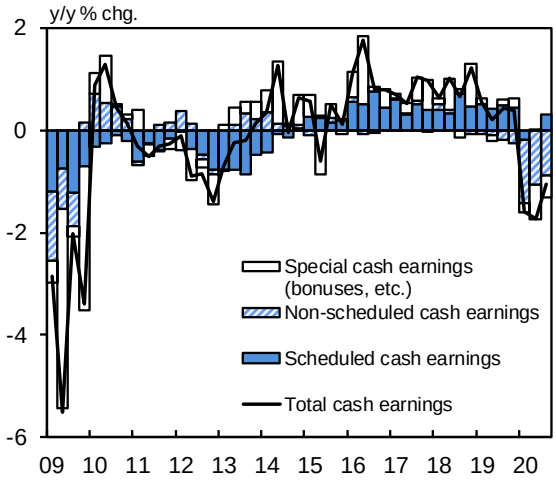
On the wage side, total cash earnings per employee have declined, mainly due to a decrease in non-scheduled cash earnings (Chart 27). [14] The year-on-year rate of change in scheduled cash earnings has been slightly positive on the whole (Chart 28). A decline in the share of part-time employees has contributed

Chart 26: Job Openings-to-Applicants Ratio



Source: Ministry of Health, Labour and Welfare.

Chart 27: Nominal Wages

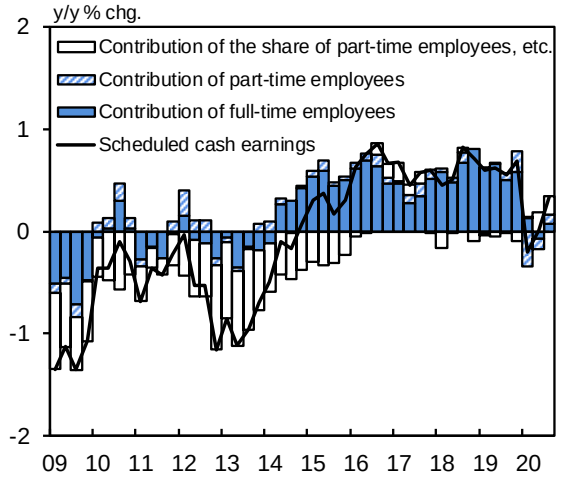


Source: Ministry of Health, Labour and Welfare.
Notes: 1. Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February.
2. Figures from 2016/Q1 are based on continuing observations following the sample revisions.

[14] Wages in the *Monthly Labour Survey* are assessed on the basis of continuing observations, which are less affected by the sample revisions.

positively to the rate, while the rates of change in scheduled cash earnings for both full-time and part-time employees have been at around 0 percent, reflecting decreases in the numbers of working days and hours.[15] With underlying downward pressure stemming from a decline in non-scheduled hours worked that has been brought about by working-style reforms, non-scheduled cash earnings have continued their downtrend, also due to the impact of COVID-19. Meanwhile, the year-on-year rate of change in special cash earnings has been clearly negative, reflecting deterioration in business performance.

Chart 28: Scheduled Cash Earnings



Source: Ministry of Health, Labour and Welfare.
Notes: 1. Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February.
2. Figures from 2016/Q1 are based on continuing observations following the sample revisions.

With regard to the outlook for wages, in the short run, scheduled cash earnings of full-time employees are expected to be underpinned by the base pay increases, which were decided before the pandemic. However, downward pressure on such earnings is likely to increase gradually as deterioration in business performance and a decline in prices are expected to be reflected with some time lag. The rate of change in non-scheduled cash earnings is likely to be negative for the time being due to the effects of shortened working hours. However, it is expected to remain on an increasing trend in negative territory with economic activity improving. The rate of change in special cash earnings (bonuses), which lags behind corporate profits for about half a year, is highly likely to decline further within negative territory in the second half of the

[15] The Labor Standards Act stipulates that employers shall pay to their employees allowances for absence from work that are equivalent to 60 percent or more of the employees' average wages. Thus, an increase in the number of "employed persons not at work" and days absent from work will put downward pressure on scheduled cash earnings.

fiscal year -- when a significant deterioration in business performance for the first half of fiscal 2020 will be reflected in winter bonuses -- but turn positive in the second half of the projection period. Under these circumstances, the year-on-year rate of change in total cash earnings per employee is projected to register relatively large negative growth for the time being. However, thereafter, it is likely to gradually start bottoming out with the impact of COVID-19 waning and increase moderately in positive territory toward the end of the projection period.

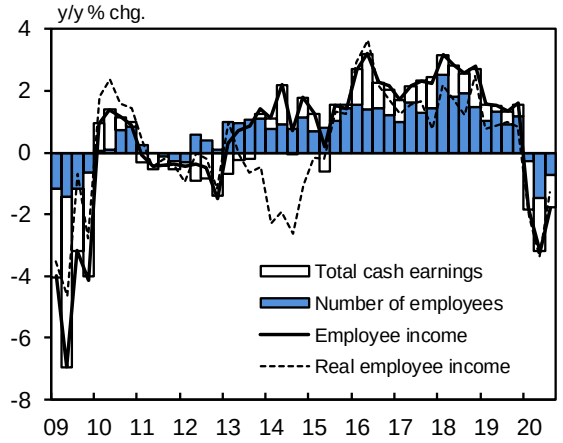
In light of the aforementioned employment and wage conditions, employee income has declined (Chart 29). It is projected to continue declining clearly for the time being, but thereafter is likely to return to a moderate increasing trend while lagging somewhat behind economic improvement. The labor share has been at a relatively high level, even compared with the past phases of economic downturn, since labor hoarding by firms and wage stickiness have been particularly strong amid a decline in the level of economic activity (Chart 30). As for the outlook, however, the share is likely to follow a moderate decreasing trend along with economic improvement.

Household Spending

Private consumption has picked up gradually as a trend, but downward pressure has increased recently on consumption of services, such as eating and drinking as well as accommodations.

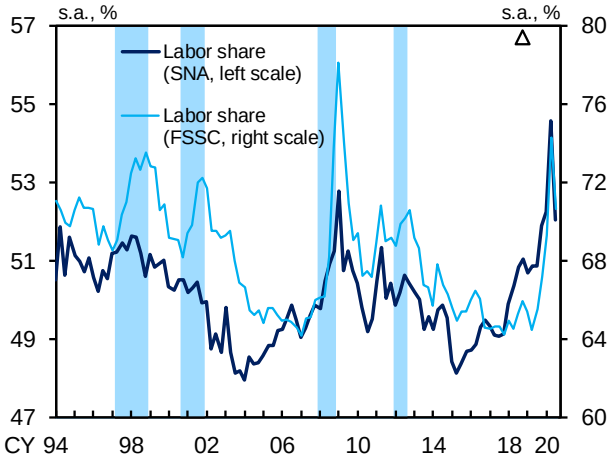
The Consumption Activity Index (CAI, travel balance adjusted) -- which is calculated by

Chart 29: Employee Income



Sources: Ministry of Health, Labour and Welfare; Ministry of Internal Affairs and Communications.
Notes: 1. Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February.
2. Employee income = total cash earnings ("Monthly Labour Survey") × number of employees ("Labour Force Survey")
3. Figures from 2016/Q1 are based on continuing observations following the sample revisions of the "Monthly Labour Survey."
4. Real employee income is based on staff calculations using the CPI (less imputed rent).

Chart 30: Labor Share

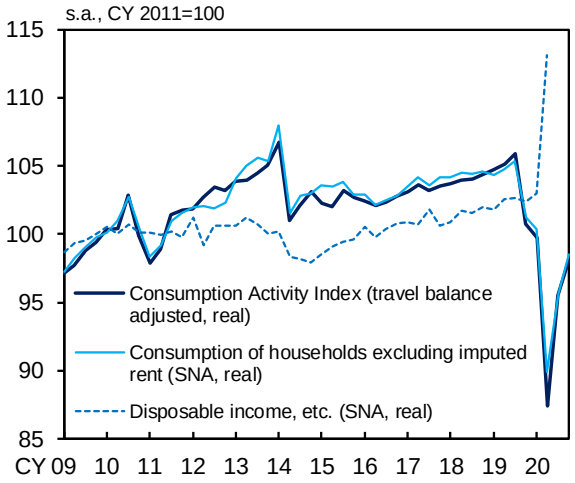


Sources: Cabinet Office; Ministry of Finance.
Notes: 1. Labor share (SNA) = compensation of employees / nominal GDP × 100
2. The labor share (FSSC) is based on the "Financial Statements Statistics of Corporations by Industry, Quarterly (FSSC)" and excludes "finance and insurance." Figures from 2009/Q2 exclude "pure holding companies."
3. Labor share (FSSC) = personnel expenses / (operating profits + personnel expenses + depreciation expenses) × 100
4. Shaded areas indicate recession periods. The triangle shows the latest peak.

combining various sales and supply-side statistics from the viewpoint of gauging Japan's consumption activity in a comprehensive manner -- declined significantly for the April-June quarter of 2020. [16] However, the CAI for the July-September quarter turned to a pick-up, mainly due to the effects of reopening of businesses and special cash payments, and that for the October-November period became positive relative to the previous quarter, partly encouraged by the "Go To" campaign (Charts 31 and 32). That said, based on various sources, such as high-frequency indicators, statistics published by industry organizations, and anecdotal information from firms, downward pressure on services consumption has increased since the second half of November. This development mainly reflects the resurgence of COVID-19, a resultant suspension of the "Go To Travel" campaign, and the declaration of a state of emergency after the turn of 2021. Thus, overall private consumption seems to have shown growing signs of deceleration.[17]

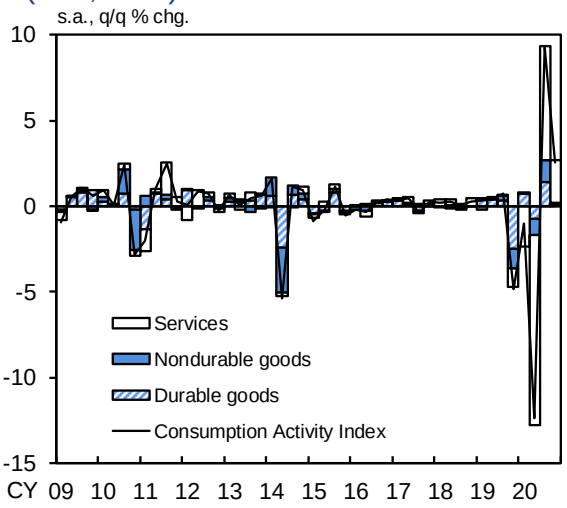
Looking at private consumption by type, durable goods showed a relatively large decrease around last spring, but have continued picking up thereafter, partly supported by the provision of special cash payments and the materialization of pent-up demand (Chart 33). Specifically, automobile sales declined substantially around last spring but have increased thereafter on the back of a recovery in the number of customers,

Chart 31: Private Consumption



Sources: Bank of Japan; Cabinet Office, etc.
Notes: 1. The Consumption Activity Index is based on staff calculations. Figures for the Consumption Activity Index (travel balance adjusted) exclude inbound tourism consumption and include outbound tourism consumption. The figure for 2020/Q4 is the October-November average.
2. The figure for consumption of households excluding imputed rent for 2020/Q4 is based on staff calculations using the "Synthetic Consumption Index" (November).
3. "Disposable income, etc." consists of disposable income and "adjustment for the change in pension entitlements" (using annual and quarterly estimates). Real values are obtained using the deflator of consumption of households.

Chart 32: Consumption Activity Index (CAI, Real)



Sources: Bank of Japan, etc.
Notes: 1. Based on staff calculations. The Consumption Activity Index is adjusted for the travel balance. Figures for the components are not adjusted for the travel balance. Figures for 2020/Q4 are October-November averages.
2. Nondurable goods include goods classified as "semi-durable goods" in the SNA.

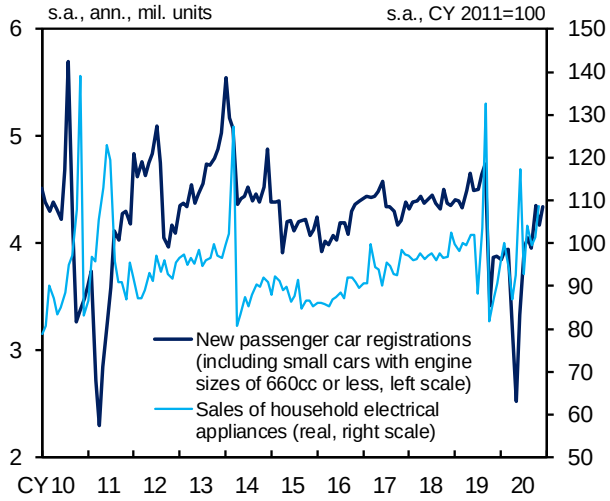
[16] Regarding the CAI, see the Bank's research paper "Revision of the Consumption Activity Index to Address the 2008 SNA and Improve Accuracy" published in April 2018.

[17] Box 4 outlines developments in private consumption to date during the resurgence of COVID-19, using high-frequency data as well.

measures to support sales by some automakers, and the effects of the introduction of new car models. Sales of household electrical appliances have remained firm on the back of an increase in demand for personal computers, televisions, and white goods due to people spending more time at home. However, the rate of increase has decelerated since the effects of the special cash payments, which had pushed up sales, have peaked out. Nondurable goods have picked up from the decline seen around last spring. Food and daily necessities have remained firm on the back of the expansion in stay-at-home consumption, albeit with some fluctuations depending on the situation with COVID-19. On the other hand, although clothes have picked up from the decline seen around last spring, they have remained at a relatively low level with such factors as a decrease in opportunities for going out continuing to push down sales.

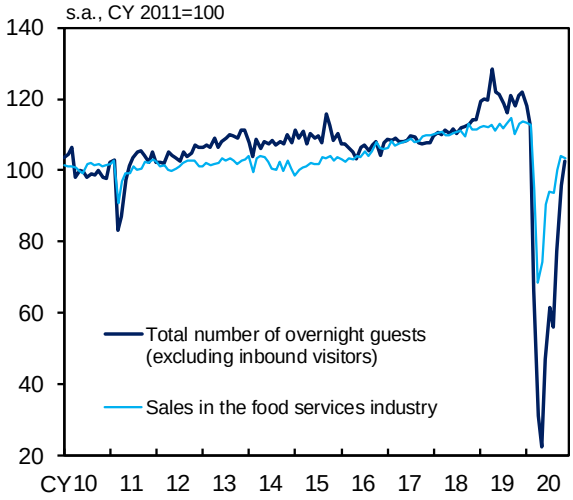
Services consumption picked up gradually, partly encouraged by the "Go To" campaign. However, it seems to have declined of late, mainly for face-to-face services, due to the resurgence of COVID-19 and the reinstatement of the state of emergency (Chart 34). Dining-out increased gradually, partly due to the effects of demand stimulus measures such as the "Go To Eat" campaign. However, it seems to have declined significantly since the second half of November for dining at *izakaya* (Japanese-style bars) and restaurants in the evening in particular, mainly reflecting the resurgence of COVID-19 and resultant requests for business hour cuts. A pick-up trend in domestic travel became evident, partly due to travel to and from Tokyo being added to the "Go To Travel" campaign last autumn.

Chart 33: Consumption of Durable Goods



Sources: Japan Automobile Dealers Association; Japan Light Motor Vehicle and Motorcycle Association; Ministry of Economy, Trade and Industry; Ministry of Internal Affairs and Communications.
Note: Figures for real sales of household electrical appliances are based on staff calculations using the retail sales index of machinery and equipment in the "Current Survey of Commerce" and the price index of related items in the CPI.

Chart 34: Consumption of Services



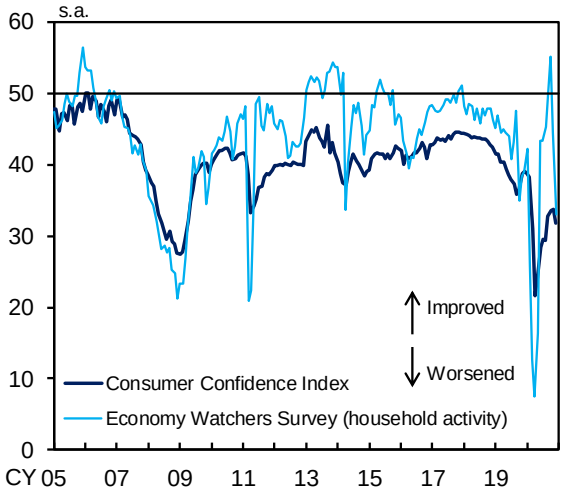
Sources: Japan Tourism Agency; Japan Foodservice Association, "Market Trend Survey of the Food Services Industry."
Note: Figures for the "total number of overnight guests (excluding inbound visitors)" in 2010 are calculated using those of accommodation facilities with more than nine employees.

However, domestic travel seems to have declined considerably since the second half of November, mainly due to the impact of the resurgence of COVID-19 and a resultant suspension of the "Go To Travel" campaign. Meanwhile, there is still almost no overseas travel due to continued travel restrictions.

Looking at confidence indicators related to private consumption, the Consumer Confidence Index and the DI of the *Economy Watchers Survey* followed an improving trend after bottoming out in April 2020 but turned to deterioration at the end of the year, reflecting the resurgence of COVID-19 (Chart 35).

In the outlook, private consumption is likely to show growing signs of deceleration for the time being. This is based on the projection that it will be pushed down from the income side due to a decline in winter bonuses and that face-to-face services consumption will remain somewhat weak, reflecting the resurgence of COVID-19 since the end of 2020 and the declaration of a state of emergency after the turn of 2021. Thereafter, with the impact of COVID-19 waning, private consumption is likely to continue picking up, partly supported by the government's demand stimulus measures. That said, the pace of improvement is highly likely to be quite moderate, mainly for face-to-face services consumption. This is because, as long as vigilance against COVID-19 continues, (1) on the demand side, the cautious stance on spending is likely to continue, mainly by seniors, and (2) on the supply side, a decline in the operation rates, mainly for dining-out and services for individuals, is inevitable. With the

Chart 35: Confidence Indicators Related to Private Consumption



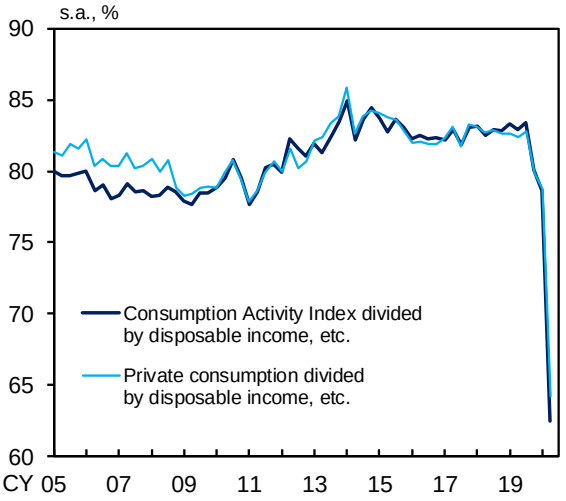
Source: Cabinet Office.
Note: Figures for the "Economy Watchers Survey" are those for the current economic conditions DI.

impact of COVID-19 almost subsiding toward the end of the projection period, the increasing trend in private consumption is likely to become evident gradually, partly supported by improvement in employee income.

The propensity to consume seems to have increased somewhat recently after a significant decline that reflected a sharp drop in private consumption and an increase in disposable income brought about by various measures to support income (Chart 36). As for the outlook, the propensity is likely to increase as the degree of COVID-19 constraining consumption activity is expected to lessen. However, it is highly likely to remain at a somewhat low level compared with the past average even at the end of the projection period, mainly due to uncertainties over future developments in the income situation.

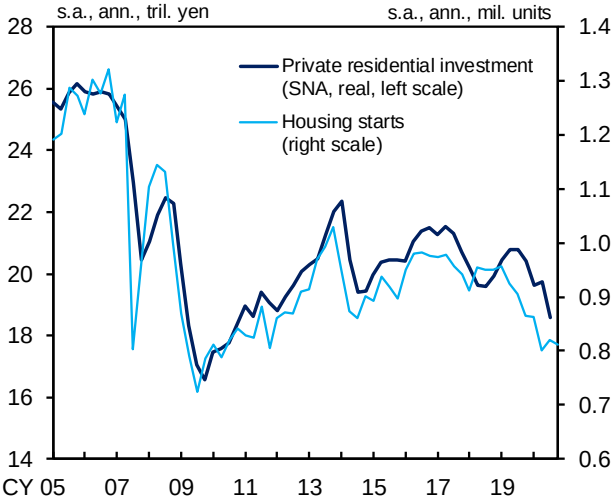
Housing investment has declined moderately (Chart 37). The number of housing starts -- a leading indicator of housing investment -- declined due to the effects of the consumption tax hike and COVID-19, but the decline is coming to a stop recently. As for the outlook, housing investment is likely to continue decreasing moderately in the short run. However, it is expected to gradually turn to a pick-up, partly supported by accommodative financial conditions, and continue to be more or less flat toward the end of the projection period.

Chart 36: Average Propensity to Consume



Sources: Bank of Japan; Cabinet Office, etc.
Notes: 1. The Consumption Activity Index is adjusted for the travel balance. Based on staff calculations.
2. Private consumption is consumption of households excluding imputed rent.
3. "Disposable income, etc." consists of disposable income and "adjustment for the change in pension entitlements" (using annual and quarterly estimates).

Chart 37: Housing Investment



Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Note: The figure for 2020/Q4 is the October-November average.

II. Current Situation of Prices and Their Outlook

Developments in Prices

The rate of change in the producer price index (PPI, adjusted for the effects of seasonal changes in electricity rates) has been more or less flat on a quarter-on-quarter basis, reflecting developments in international commodity prices (Chart 38). The year-on-year rate of decline in the services producer price index (SPPI, excluding international transportation) has decelerated moderately as a trend, mainly due to a pick-up in advertising demand and a recovery in real estate rents.

The year-on-year rate of change in the CPI (all items less fresh food) has been negative, mainly affected by COVID-19, the past decline in crude oil prices, and a decrease in hotel charges through the "Go To Travel" campaign (Charts 38 and 39).[18] That in the CPI (all items less fresh

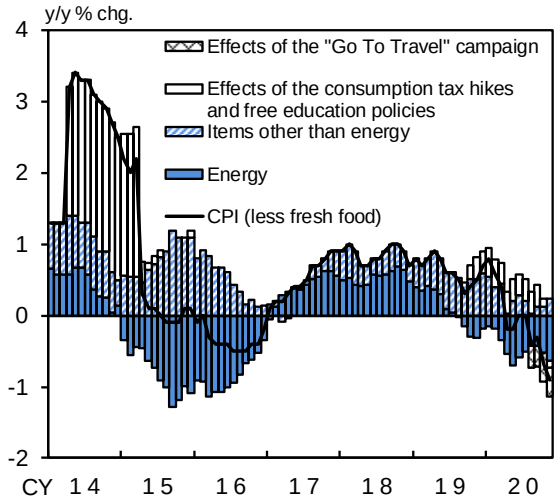
Chart 38: Inflation Indicators

y/y % chg.

	20/Q1	20/Q2	20/Q3	20/Q4
Consumer Price Index (CPI)				
Less fresh food	0.6	-0.1	-0.2	-0.8
Adjusted figure	0.2	-0.4	-0.3	-0.4
Less fresh food and energy	0.7	0.4	0.1	-0.3
Adjusted figure	0.4	0.2	0.2	0.2
Producer Price Index (q/q % chg.)	-0.4	-2.4	0.6	0.1
Services Producer Price Index	0.1	-1.1	-0.6	-0.3
GDP deflator	0.9	1.4	1.2	
Domestic demand deflator	0.8	-0.0	0.2	

Sources: Ministry of Internal Affairs and Communications; Bank of Japan; Cabinet Office.
Notes: 1. Adjusted figures exclude the effects of the consumption tax hike, policies concerning the provision of free education, and the "Go To Travel" campaign, which covers a portion of domestic travel expenses. The figures from 2020/Q2 onward are based on staff estimations, and exclude the effects of measures such as free higher education introduced in April 2020.
2. Figures for the Producer Price Index are adjusted for the hike in electric power charges during the summer season.
3. Figures for the Services Producer Price Index exclude international transportation.
4. Figures for the Producer Price Index and the Services Producer Price Index exclude the effects of the consumption tax hike.
5. Figures for the CPI and the Services Producer Price Index for 2020/Q4 are October-November averages.

Chart 39: CPI (less fresh food)



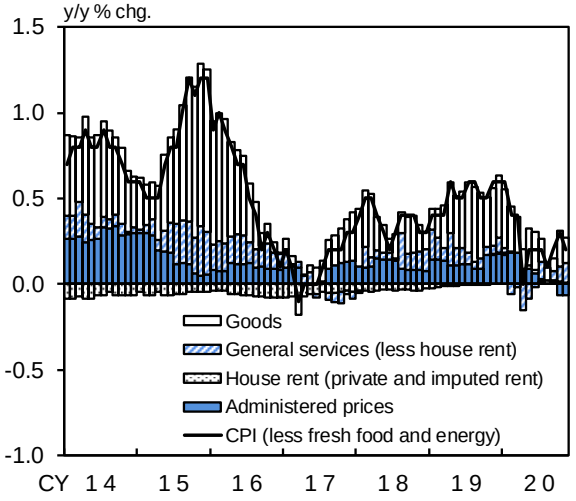
Source: Ministry of Internal Affairs and Communications.
Notes: 1. Energy consists of petroleum products, electricity, and gas, manufactured & piped.
2. Figures for the "effects of the consumption tax hikes and free education policies" from April 2020 onward are based on staff estimations, and include the effects of measures such as free higher education introduced in April 2020.

[18] The "Go To Travel" campaign offers up to a 35 percent discount for domestic travel, with a maximum of 14 thousand yen per person per night, on fees for registered accommodation facilities. Based on the campaign period that has been announced at this point and the effects on the actual CPI estimated by the Statistics Bureau of Japan, the Bank estimates in the January 2021 Outlook Report that this campaign will push down both the year-on-year rate of change in the CPI (all items less fresh food) and that in the CPI (all items less fresh food and energy) by around 0.3 to 0.4 percentage point from August 2020 through June 2021 (excluding January and February 2021, when the campaign will be suspended). On the other hand, it is assumed that the CPI will be pushed up by 0.3 to 0.4 percentage point from August 2021 through June 2022 (excluding January and February 2022), due to a dissipation of the effects of the campaign. Looking at the CPI by fiscal year, the effects of the campaign on the year-on-year rates of change in both the CPI (all items less fresh food) and the CPI (all items less fresh food and energy) are estimated to be around minus 0.2 percentage point for fiscal 2020 and around 0.1 percentage point for both fiscal 2021 and 2022. These contributions could change if the system of the campaign is reviewed or some adjustments to the campaign, such as

food and energy) also has declined compared with a while ago, partly due to the effects of the "Go To Travel" campaign, and has been slightly negative recently. The year-on-year rate of change in the CPI (all items less fresh food and energy, excluding the effects of temporary factors of the consumption tax hikes, policies concerning the provision of free education, and the "Go To Travel" campaign) has been slightly positive (Chart 40). Looking at the breakdown of developments in this CPI, although price rises in daily necessities have exerted upward pressure, the year-on-year rate of change in goods has been on a moderate declining trend in positive territory, which is largely attributable to deceleration in the rate of increase in food products that are sensitive to economic activity. The rate of change in general services has been slightly positive on the whole; (1) although the rate of increase in dining-out has decelerated, (2) housework-related services, such as services related to housing repairs and maintenance, have maintained their positive trend, and (3) the rate of change in hotel charges (excluding the effects of the "Go To Travel" campaign) has turned positive. Meanwhile, administered prices have turned to a slight negative figure recently due to a decline in airfare and a reduction in or exemption for school lunch charges, in addition to a dissipation of the effects of fire insurance premiums and accident insurance premiums, both of which were raised in the previous year.

The indicators for capturing the underlying trend in the CPI have exhibited the following

Chart 40: CPI (less fresh food and energy)



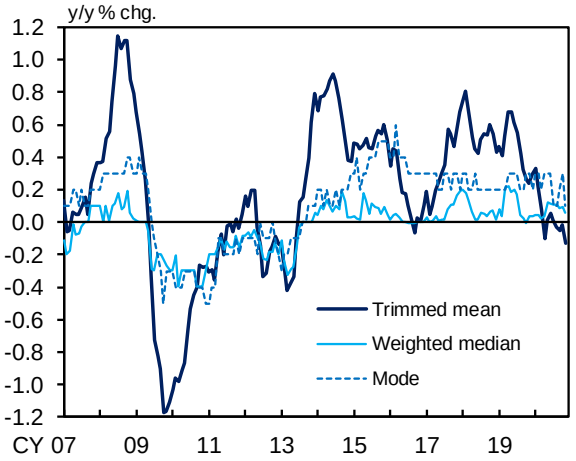
Source: Ministry of Internal Affairs and Communications.
Notes: 1. Administered prices (less energy) consist of "public services" and "water charges."
2. The CPI figures exclude the effects of the consumption tax hikes, policies concerning the provision of free education, and the "Go To Travel" campaign, which covers a portion of domestic travel expenses. The figures from April 2020 onward are based on staff estimations, and exclude the effects of measures such as free higher education introduced in April 2020.

suspension, are made in response to the COVID-19 situation.

developments (Chart 41).[19] The rate of change in the trimmed mean has remained at around 0 percent, although it has weakened somewhat due to declines in electricity as well as manufactured and piped gas charges, which have large weights in the CPI. On the other hand, the rate of change in the mode, which is less susceptible to developments in CPI items with large weights, has been positive in the range of 0.0-0.5 percent, albeit with fluctuations. Looking at annual price changes across all CPI items (less fresh food), the share of price-increasing items minus the share of price-decreasing items has maintained a net "increase," although it has been on a moderate declining trend, mainly because the number of price-increasing items has been decreasing as a trend, such as for food products that are sensitive to economic activity (Chart 42).

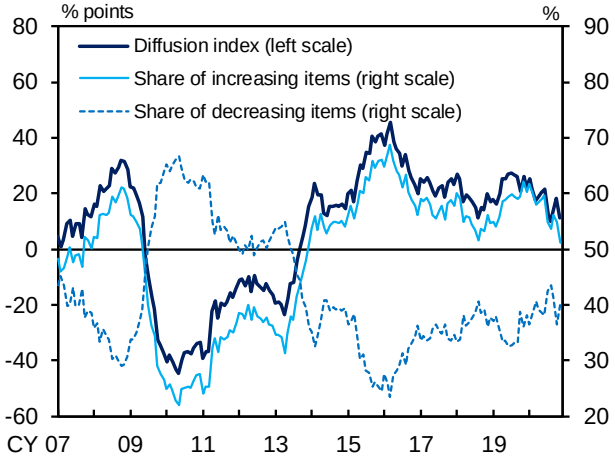
The year-on-year rate of change in the GDP deflator has been in the range of 1.0-1.5 percent recently, mainly due to a decrease in the import deflator stemming from the decline in crude oil prices (Chart 38). The year-on-year rate of change in the domestic demand deflator has been at around 0 percent with growth in the private consumption deflator decelerating gradually.

Chart 41: Various Measures of Core Inflation



Sources: Bank of Japan; Ministry of Internal Affairs and Communications.
Note: Based on staff calculations using the CPI excluding the effects of the consumption tax hikes, policies concerning the provision of free education, and the "Go To Travel" campaign, which covers a portion of domestic travel expenses. The CPI figures from April 2020 onward are based on staff estimations and exclude the effects of measures such as free higher education introduced in April 2020.

Chart 42: Diffusion Index of Price Changes



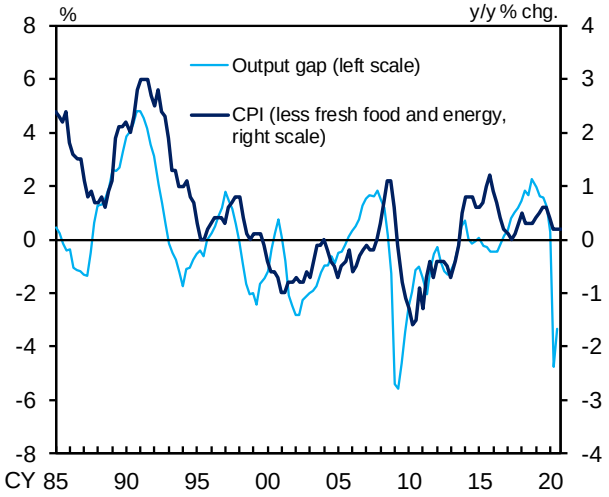
Sources: Bank of Japan; Ministry of Internal Affairs and Communications.
Note: The diffusion index is defined as the share of increasing items minus the share of decreasing items. The share of increasing/decreasing items is the share of items whose price indices increased/decreased from a year earlier. Based on staff calculations using the CPI (less fresh food) excluding the effects of the consumption tax hikes, policies concerning the provision of free education, and the "Go To Travel" campaign, which covers a portion of domestic travel expenses. The CPI figures from April 2020 onward are based on staff estimations and exclude the effects of measures such as free higher education introduced in April 2020.

[19] The trimmed mean is calculated by excluding items that belong to a certain percentage of the upper and lower tails of the price change distribution (10 percent of each tail) in order to eliminate the effects of large relative price changes. The mode is the inflation rate with the highest density in the price change distribution. The weighted median is the average of the inflation rates of the items at around the 50 percentile point of the cumulative distribution in terms of weight. All three indicators are calculated by using data for each CPI item that excludes the effects of the consumption tax hikes, policies concerning the provision of free education, and the "Go To Travel" campaign.

Environment surrounding Prices

In the outlook for prices, the main factors that determine inflation rates are assessed as follows. First, the output gap is likely to continue picking up, mainly for the manufacturing industry. However, for the time being, it is expected to register a relatively large negative figure, with the impact of COVID-19 exerting downward pressure on working hours and the capital utilization rate in the nonmanufacturing industry (Charts 2 and 43). Thereafter, with the impact of COVID-19 waning and the economy following a growth path above its potential from a macroeconomic perspective, an improving trend in the output gap is projected to become evident gradually, and the gap is likely to turn positive.

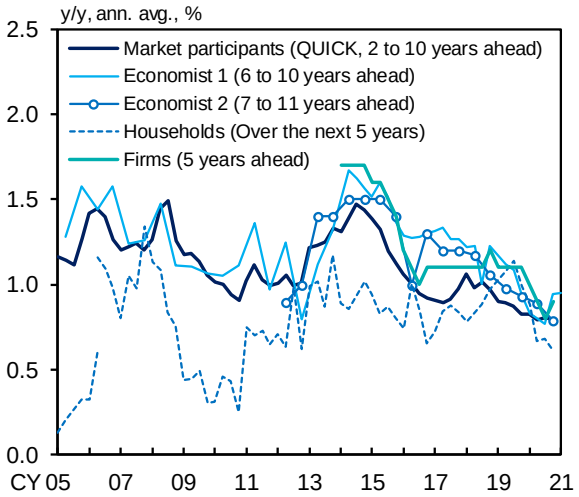
Chart 43: Inflation Rate and Output Gap



Sources: Ministry of Internal Affairs and Communications; Bank of Japan.
Notes: 1. The CPI figures exclude the effects of the consumption tax hikes, policies concerning the provision of free education, and the "Go To Travel" campaign, which covers a portion of domestic travel expenses. The figures from 2020/Q2 onward are based on staff estimations, and exclude the effects of measures such as free higher education introduced in April 2020.
The figure for 2020/Q4 is the October-November average.
2. The output gap is based on staff estimations.

Second, medium- to long-term inflation expectations have weakened somewhat (Charts 44 and 45). With regard to the outlook, such expectations are likely to continue to do so for the time being, since actual inflation that includes the effects of the decline in energy prices is expected to be negative, as described later. Thereafter, however, as the economy improves, such expectations are projected to rise again on the back of an increase in actual prices and the Bank pursuing monetary easing through its strong commitment to achieving the price stability target.

Chart 44: Inflation Expectations (Survey)



Sources: Bank of Japan; QUICK, "QUICK Monthly Market Survey (Bonds)"; JCER, "ESP Forecast"; Consensus Economics Inc., "Consensus Forecasts."
Notes: 1. Figures for the economist 1 are from the "Consensus Forecasts." Figures for the economist 2 are from the "ESP Forecast."
2. Figures for households are from the "Opinion Survey on the General Public's Views and Behavior," estimated using the modified Carlson-Parkin method.
3. Figures for firms are "Outlook for General Prices (*Tankan*, all industries and enterprises, average)."

The third factor is developments in import prices. The negative contribution of energy prices to the CPI (all items less fresh food) is likely to remain relatively large for the time being due to declines in electricity as well as manufactured and piped gas charges that reflect the past decline in crude oil prices. That said, such downward pressure is

projected to wane clearly toward the middle of fiscal 2021 (Chart 46).

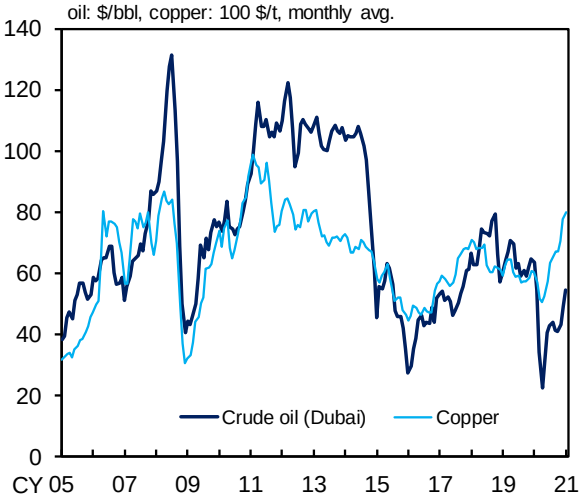
Outlook for Prices

Based on the recent developments in the indicators, as described earlier, downward pressure on prices of items that are sensitive to economic activity has increased gradually along with significant deterioration in the output gap due to the impact of COVID-19. That said, firms' price cuts that aim at stimulating demand have not been observed widely to date. As the background to this, in the current phase of the economic downturn, it seems that firms, mainly in the face-to-face services industry, which is confronted with a substantial decrease in demand, cannot readily make price cuts that would lead to a further deterioration in their profits. This is because they have inevitably been facing cost increases for taking preventive measures against COVID-19 and avoiding creating crowds -- for example, conducting temperature checks and disinfection steps or reducing the number of seats -- and the price elasticity of demand in the industry has decreased while consumers' vigilance against COVID-19 remains strong. In addition, since there are significant discounts, mainly through the "Go To" campaign, there is less need for firms to cut prices at their own expense, and this could be another reason for them not to make price cuts. Thus, regarding the outlook, although downward pressure on prices of the CPI items that are sensitive to economic activity is likely to increase with COVID-19 negatively affecting the income situation, such as in terms of a decline in winter bonuses, price cuts that aim at stimulating demand are not expected to be observed that widely and a decline in the

Chart 45: Inflation Expectations (BEI)

Source: Bloomberg.
Note: BEI (break-even inflation) rates are yield spreads between fixed-rate coupon-bearing JGBs and inflation-indexed JGBs. Inflation-indexed JGBs issued since October 2013 are designated as "new," while the rest are designated as "old." Figures for "old (longest)" are calculated using yield data for issue No. 16 of inflation-indexed JGBs, which matured in June 2018.

Chart 46: International Commodity Prices



Sources: Nikkei Inc.; Bloomberg.

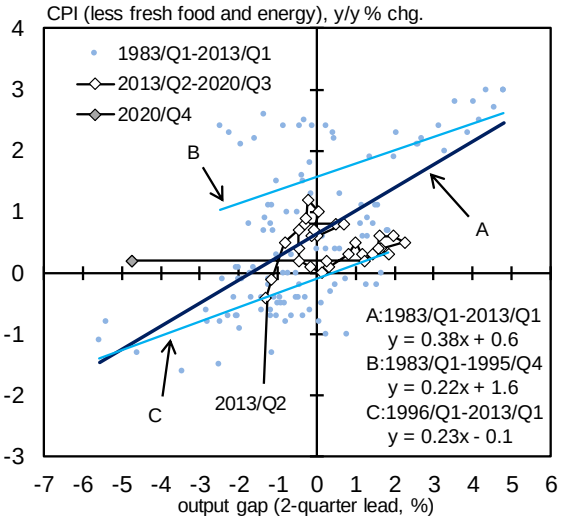
CPI (all items less fresh food and energy) is likely to be relatively small for the time being. Thereafter, the CPI is expected to turn to a moderate increase with the output gap continuing to improve on the back of the impact of COVID-19 waning gradually (Chart 43).

Based on this underlying scenario, the year-on-year rate of increase in the CPI (all items less fresh food and energy, excluding the effects of the consumption tax hikes, policies concerning the provision of free education, and the "Go To Travel" campaign) is likely to decline somewhat for the time being, to around 0 percent. In detail, (1) downward pressure is expected to remain on prices of the CPI items that are sensitive to economic activity, such as food products, durable goods, clothes, and dining-out, albeit with some time lag from deterioration in the output gap, and (2) travel-related services -- such as airfare and hotel charges -- for which demand has deteriorated significantly due to the direct impact of COVID-19, are likely to remain on a declining trend. In addition, (3) a reduction in the mandatory auto insurance premium and repricing of drugs, both of which are expected to take place in April 2021, are also projected to push down the CPI. With regard to mobile phone-related prices (i.e., prices of and charges for mobile phones), major carriers recently have successively announced new plans at a low price, and thus the CPI may be pushed down further for the time being depending on how they will be reflected in the CPI.[20]

[20] Such new plans are not factored into the outlook for prices in this Outlook Report since their impact could change depending on how they will be reflected in the CPI.

As for the outlook from a somewhat long-term perspective, the year-on-year rate of increase in the CPI (all items less fresh food and energy, excluding the effects of the consumption tax hikes, policies concerning the provision of free education, and the "Go To Travel" campaign) is expected to accelerate on the whole. This is based on the projection that, with the impact of COVID-19 waning and the output gap continuing to improve, upward pressure on prices of goods and services that are sensitive to economic activity will increase. Thereafter, the year-on-year rate of change in the CPI (all items less fresh food and energy) is likely to increase moderately toward the end of the projection period with (1) the output gap continuing to improve and (2) medium- to long-term inflation expectations rising through both the adaptive and the forward-looking expectation formation mechanisms (Chart 47).

Chart 47: Phillips Curve



Sources: Ministry of Internal Affairs and Communications; Bank of Japan.
Notes: 1. The CPI figures exclude the effects of the consumption tax hikes, policies concerning the provision of free education, and the "Go To Travel" campaign, which covers a portion of domestic travel expenses. The figures from 2020/Q2 onward are based on staff estimations, and exclude the effects of measures such as free higher education introduced in April 2020.
The figure for 2020/Q4 is the October-November average.
2. The output gap is based on staff estimations.

Under these circumstances, the year-on-year rate of change in the CPI (all items less fresh food) is likely to be at around the current negative level for the time being. This is because energy prices are expected to continue declining to a relatively large degree, such as for electricity as well as manufactured and piped gas charges, reflecting the past decline in crude oil prices and because a discount on hotel charges through the "Go To Travel" campaign also is likely to put downward pressure on the overall CPI during the campaign period. Thereafter, the year-on-year rate of change in the CPI (all items less fresh food) is likely to turn positive in the middle of the projection period and then accelerate, since (1) with the underlying upward pressure on prices rising gradually along with improvement in the output gap, (2) the effects of the decline in energy

prices are expected to wane and (3) hotel charges are projected to push up the overall CPI due to a dissipation of the effects of the "Go To Travel" campaign.

III. Financial Developments in Japan

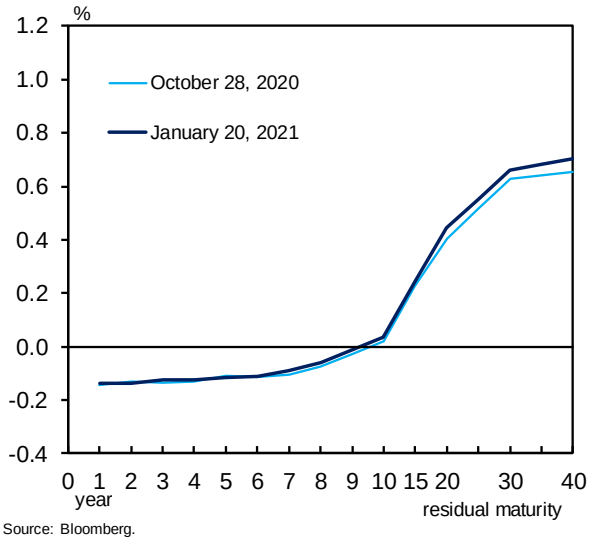
Financial Conditions

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.

Under "QQE with Yield Curve Control," the yield curve for JGBs has been in line with the current guideline for market operations, in which the short-term policy interest rate is set at minus 0.1 percent and the target level of 10-year JGB yields is around zero percent (Chart 48). That is, the yields for relatively short maturities have been in slightly negative territory and the 10-year JGB yields have been at around 0 percent as the Bank has purchased a necessary amount of both JGBs and treasury discount bills (T-Bills) without setting upper limits. Meanwhile, the 20-year JGB yields have been at around 0.5 percent.

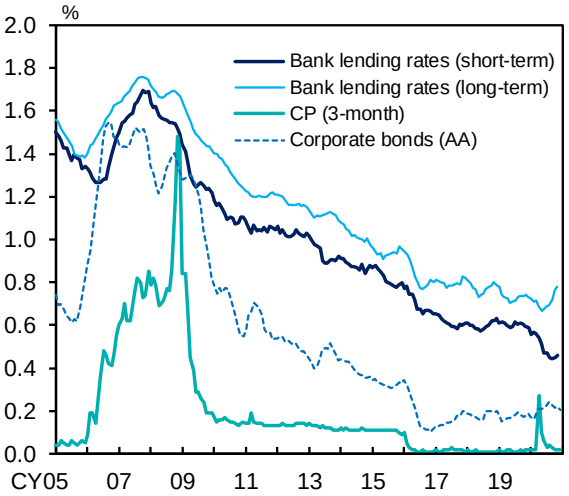
Firms' funding costs have been hovering at extremely low levels (Chart 49). Issuance rates for CP showed a significant rise in April 2020, but they declined after the Bank announced that it would increase purchases of CP and have been at extremely low levels. The DI for issuance conditions for CP in the *Tankan*, which declined temporarily, has continued to improve, mainly reflecting stabilized issuance rates. Issuance rates for corporate bonds rose somewhat in April 2020, but they declined thereafter and have been at extremely low levels. Meanwhile, lending rates (the average interest rates on new loans and discounts) have been at around historical low levels.

Chart 48: Yield Curves



Source: Bloomberg.

Chart 49: Bank Lending Rates and Issuance Yields for CP and Corporate Bonds



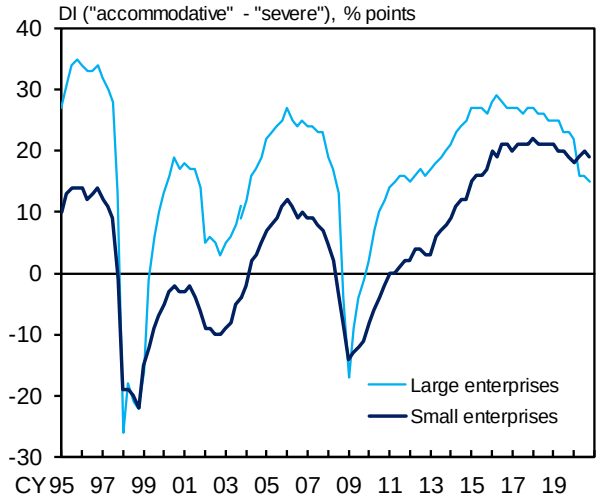
Sources: Bank of Japan; Japan Securities Depository Center; Capital Eye; I-N Information Systems; Bloomberg.

Notes: 1. Figures for issuance yields for CP up to September 2009 are the averages for CP (3-month, rated a-1 or higher). Those from October 2009 are the averages for CP (3-month, rated a-1).
2. Figures for issuance yields for corporate bonds are the averages for domestically issued bonds launched on a particular date. Bonds issued by banks and securities companies, etc., are excluded.
3. Figures for bank lending rates and issuance yields for corporate bonds show 6-month backward moving averages.

With regard to the availability of funds for firms, the DI in the *Tankan* for financial institutions' lending attitudes as perceived by firms suggests that such attitudes have remained accommodative on the whole (Chart 50). Although the DI for large firms has declined somewhat compared to a while ago, the proportion of firms answering that financial institutions' lending attitudes are "severe" has remained small for both large and small firms. As the background to these developments, there have been various measures taken by the Bank and the government to support financing, mainly of firms, as well as efforts made by financial institutions together with those measures. With regard to corporate financing, the DI for firms' financial positions in the *Tankan* has improved moderately for both large and small firms, as the economy has picked up and firms have made use of the loans provided based on the government's programs (Chart 51). However, firms' financial positions have not recovered to the pre-pandemic level and have remained weak.

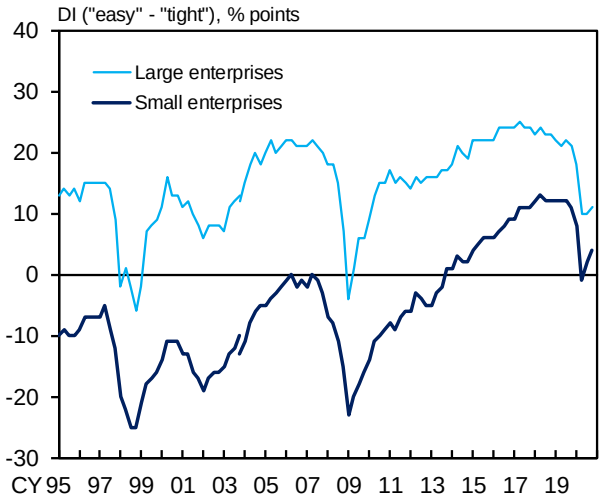
Firms' demand for funds that stem mainly from a decline in sales and a rise in precautionary demand has remained at a high level, although an increase in demand by large firms in particular has leveled off. Under these circumstances, the year-on-year rate of increase in the amount outstanding of bank lending has been at around 6 percent, registering the highest increase in about 30 years (Chart 52). The year-on-year rate of increase in the aggregate amount outstanding of CP and corporate bonds has been at a relatively high level that exceeds 10 percent, although the pace has slowed compared with a while ago.

Chart 50: Lending Attitude of Financial Institutions as Perceived by Firms



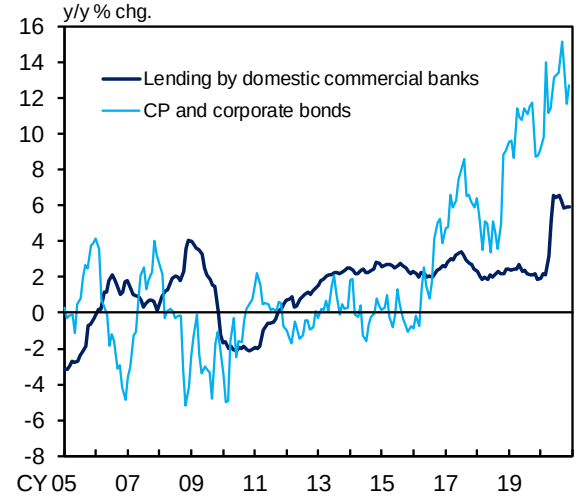
Source: Bank of Japan.
Note: Based on the *Tankan*. All industries. There is a discontinuity in the data in December 2003 due to a change in the survey framework.

Chart 51: Financial Position



Source: Bank of Japan.
Note: Based on the *Tankan*. All industries. There is a discontinuity in the data in December 2003 due to a change in the survey framework.

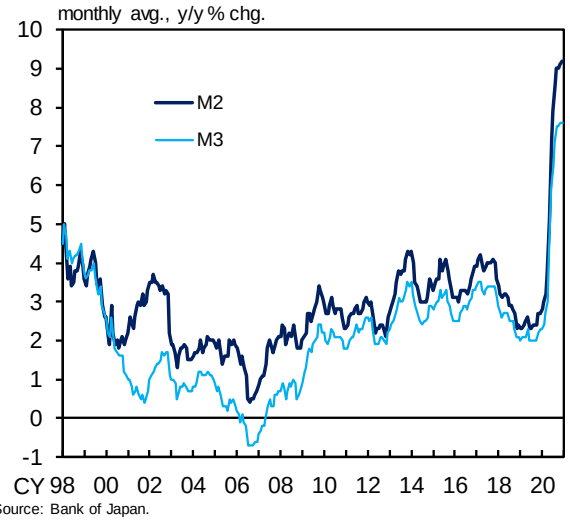
Chart 52: Amount Outstanding of Bank Lending, CP, and Corporate Bonds



Sources: Bank of Japan; Japan Securities Depository Center; Japan Securities Dealers Association; I-N Information Systems.
Note: Figures for lending by domestic commercial banks are monthly averages. Figures for CP and corporate bonds are those at the end of period.

The year-on-year rate of increase in the monetary base has been in the range of 18.0-18.5 percent, and its amount outstanding as of end-December was 618 trillion yen, of which the ratio to nominal GDP was 115 percent.[21] The year-on-year rate of increase in the money stock (M2) has been in the range of 9.0-9.5 percent, mainly due to increases in fiscal spending and bank lending (Chart 53).

Chart 53: Money Stock



Source: Bank of Japan.

[21] It is assumed that the figure for nominal GDP is unchanged from the July-September quarter of 2020.

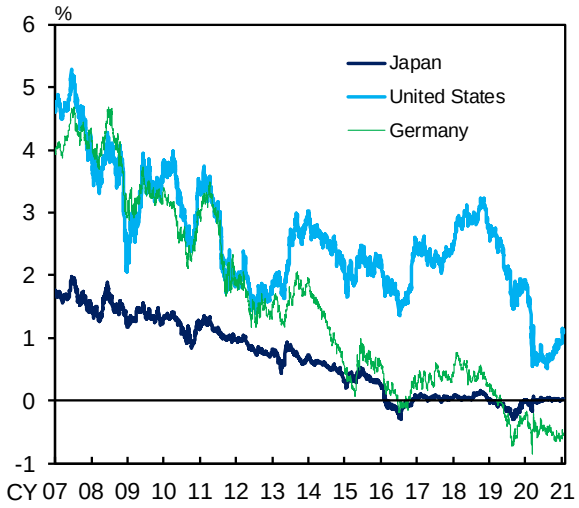
Developments in Financial Markets

With regard to developments in global financial markets, market sentiment has improved, partly reflecting positive developments in vaccines and expectations for additional economic measures in the United States. In this situation, prices of risk assets such as stocks have risen. That said, volatility in stock markets has remained somewhat higher than the pre-pandemic level with lingering concern over various uncertainties, including the COVID-19 situation.

Yields on 10-year government bonds in the United States have been at low levels due to the Federal Reserve's purchases of government bonds. However, the yields have risen, mainly due to positive developments in vaccines and expectations for additional economic measures (Chart 54). Yields on 10-year government bonds in Germany declined temporarily, reflecting the resurgence of COVID-19 and the European Central Bank (ECB) having increased the amount and extended the duration of the asset purchasing program conducted in response to the COVID-19 pandemic. However, the yields have increased slightly of late, along with those in the United States.

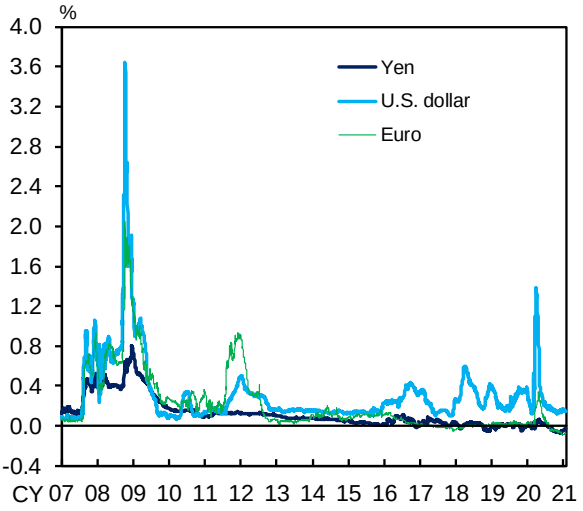
With regard to the LIBOR-OIS spreads for major currencies, those for the U.S. dollar, the euro, and the yen have been more or less flat at low levels (Chart 55). Premiums for U.S. dollar funding through the dollar/yen foreign exchange swap market fluctuated temporarily, reflecting transactions conducted in view of the year-end. That said, they have been at low levels as the U.S. dollar funds-supplying operations conducted by

Chart 54: 10-Year Government Bond Yields in Selected Advanced Economies



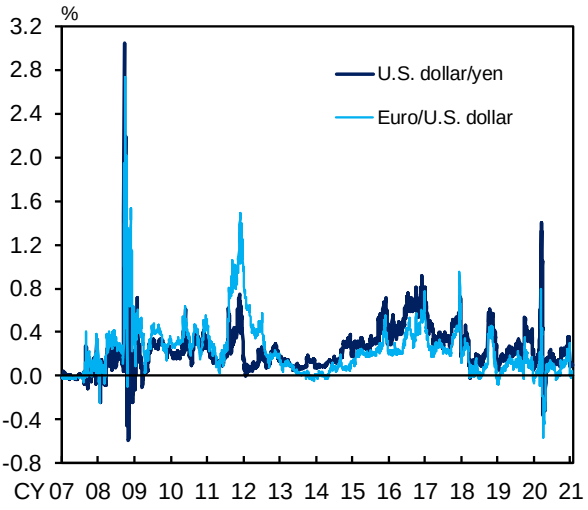
Source: Bloomberg.

Chart 55: LIBOR-OIS Spreads



Source: Bloomberg.
Note: LIBOR-OIS spreads are LIBOR (3-month) minus yields on overnight index swaps (3-month).

Chart 56: Dollar Funding Premiums through Foreign Exchange Swaps



Source: Bloomberg.
Note: U.S. dollar funding rate from yen or euro minus 3-month dollar LIBOR.

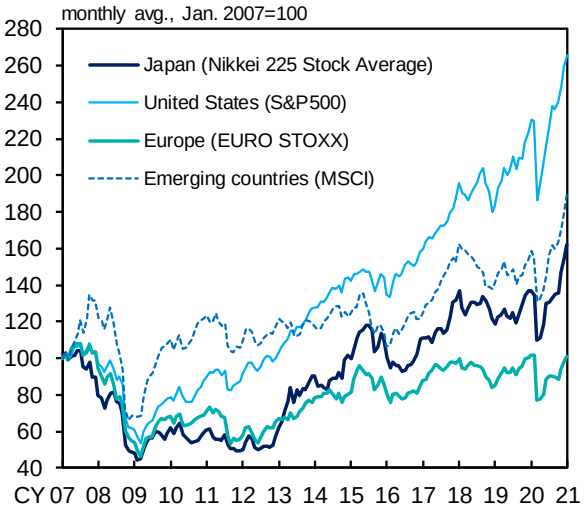
the central bank of each country and region, including the Bank of Japan, have been functioning as a backstop (Chart 56).

Stock prices in Japan, the United States, and Europe have risen with improvement in market sentiment that partly reflects positive developments in vaccines and expectations for additional economic measures in the United States (Chart 57). They also have been supported by increasing expectations for a recovery in business performance. U.S. stock prices have been at record high levels.

In the J-REIT market, prices have risen for retail and office REITs in particular, partly due to positive developments in vaccines (Chart 58).

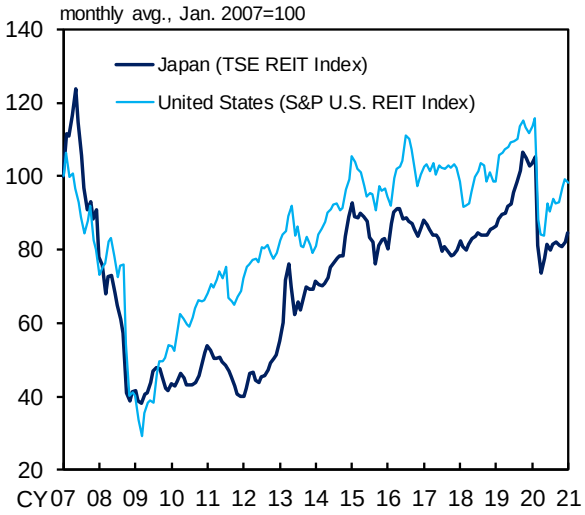
In foreign exchange markets, both the U.S. dollar and the yen have depreciated against a wide range of currencies as market sentiment improved. Meanwhile, the yen appreciated against the U.S. dollar due to a relatively strong dollar-selling bias, but subsequently has depreciated in reflection of a rise in U.S. interest rates (Chart 59). The yen has depreciated against the euro.

Chart 57: Selected Stock Prices



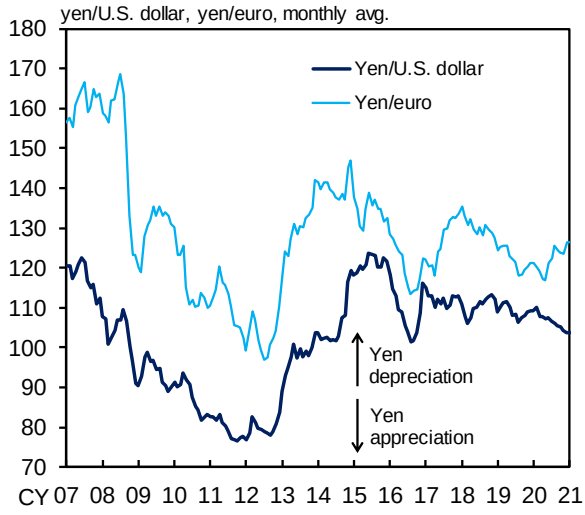
Source: Bloomberg.
Note: Figures for emerging countries are based on the MSCI Emerging Markets Index calculated in the local currencies.

Chart 58: Selected REIT Indices



Source: Bloomberg.

Chart 59: Yen/U.S. Dollar and Yen/Euro

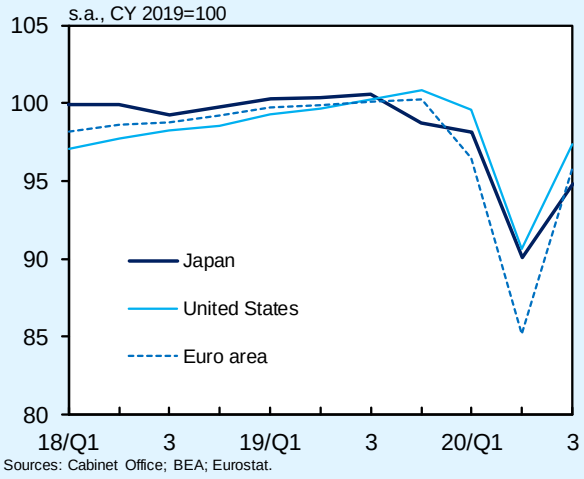


Source: Bloomberg.

(Box 1) Pace of a Pick-Up in the Level of Economic Activity to Date: Comparison between Japan, the United States, and Europe

This box provides an overview of the pace of a pick-up to date in Japan's economy compared with the U.S. and European economies, mainly by focusing on GDP data. It should be noted that descriptions in this box are solely the findings from assessments and examinations available at the moment, since they are based on data that cover a short time period -- namely, about a quarter beginning after economic activity became depressed significantly in early spring last year.

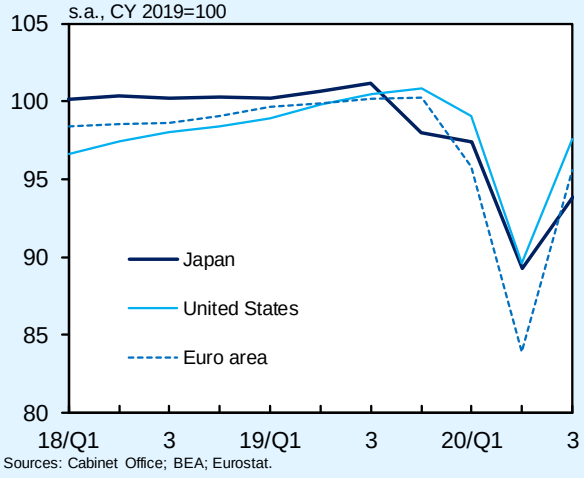
Chart B1-1: Real GDP



Sources: Cabinet Office; BEA; Eurostat.

Real GDP for Japan, the United States, and the euro area saw common developments in that they declined significantly for the April-June quarter of 2020 due to the effects of lockdowns or the declaration of a state of emergency, and then picked up for the July-September quarter in reflection of a resumption of economic activity (Chart B1-1). That said, a detailed look shows that, in terms of the degree of recovery to the pre-pandemic level (the 2019 average), Japan's real GDP has recovered to a level lower than that of the United States and to about the same level as that of the euro area, for which the decline for the April-June quarter was larger compared with Japan.

Chart B1-2: Real Private Consumption



Sources: Cabinet Office; BEA; Eurostat.

A comparison by demand component shows that Japan's domestic demand components, such as private consumption, housing investment, and business fixed investment, have been relatively weak to date compared with those of the United

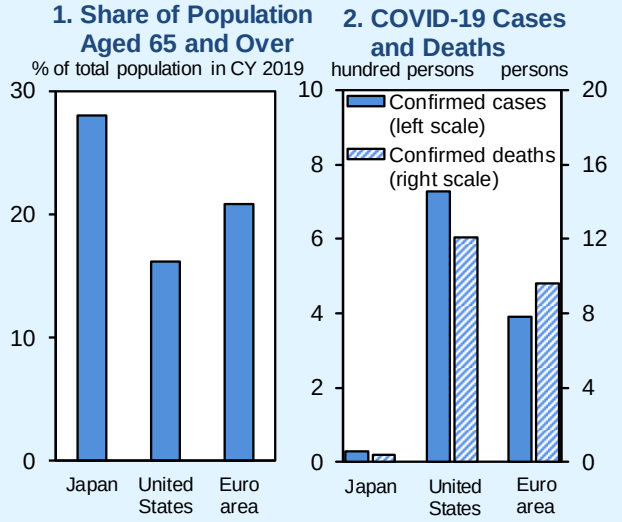
States in particular (Charts B1-2 and B1-8).

The relative weakness in private consumption in Japan could be attributable to the fact that the population share of seniors, who are considered to be at greater risk of severe illness from COVID-19, is higher in Japan than in the United States and Europe (Chart B1-3[1]). With regard to services consumption -- which is most susceptible to the impact of COVID-19 -- developments for the first half of fiscal 2020 show that, on average, the degree of decline in Japan was almost the same as that in the United States and Europe, both of which have faced a more severe spread of COVID-19 and taken stricter public health measures (Charts B1-3[2], B1-4, and B1-5[2]). In Japan, consumption of senior households -- for which the head is aged 65 years and over -- accounts for around 35 percent of selective services consumption, and the relatively weak services consumption seems largely attributable to the fact that these households have voluntarily constrained spending activity on face-to-face services that involve going out and contacting with others due to strong vigilance against COVID-19.[22]

In addition, even though an expansion in disposable income in Japan -- partly supported by a provision of special cash payments -- has been relatively large compared with that in Europe and has been at a level comparable to that in the United States, goods consumption in Japan has been relatively weak compared with that in those

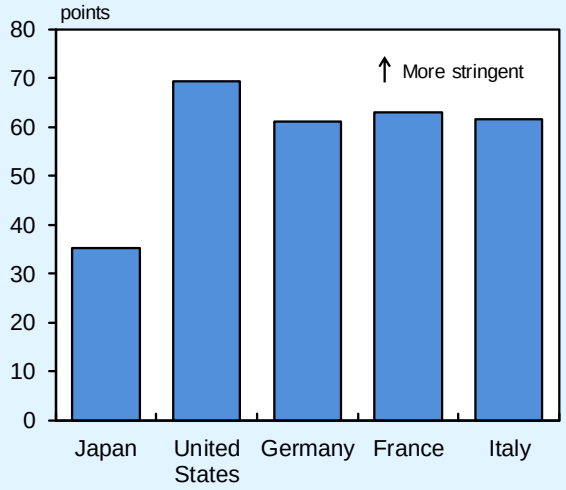
[22] With regard to senior households' cautiousness toward consumption, see Box 4 in the October 2020 Outlook Report.

Chart B1-3: Population Share of Seniors and COVID-19 Cases and Deaths



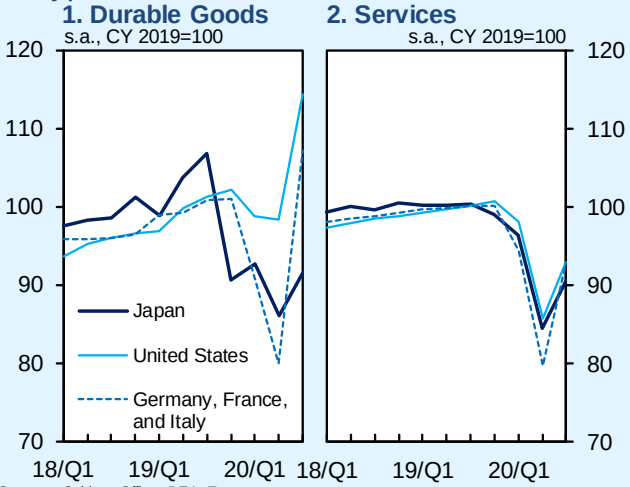
Sources: World Bank; WHO.
Note: Figures for confirmed cases and confirmed deaths are cumulative numbers per 10,000 population (as of January 20, 2021). Calculated using data released by the WHO and population data for 2019 released by the World Bank.

Chart B1-4: Stringency Index (April-September 2020 Averages)



Source: Oxford COVID-19 Government Response Tracker.
Note: Figures are based on preventive measures taken by governments such as school closures and travel restrictions.

Chart B1-5: Real Private Consumption by Type



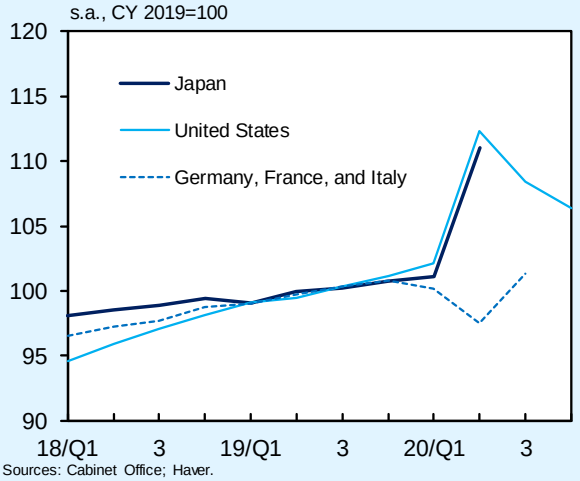
Sources: Cabinet Office; BEA; Eurostat.

economies (Chart B1-6). In particular, developments in durable goods consumption for the July-September quarter, during which economic activities resumed, indicate that pent-up demand in Japan has not materialized as strongly as that in the United States and Europe (Chart B1-5[1]). In Japan, increases in teleworking-related demand and goods consumption using e-commerce may be smaller than those seen in the United States and Europe, and this could be a reason for less evident materialization of pent-up demand for durable goods consumption. It also should be taken into account that the underlying trend in Japan's durable goods consumption has been difficult to gauge due to the front-loaded increase and subsequent decline in demand prior to and after the October 2019 consumption tax hike.

On the other hand, partly supported by firm exports to China -- which have a large share in Japan's exports -- a decrease in Japan's exports around last spring was smaller and a subsequent increase has been evident compared with the United States and Europe (Chart B1-7). Such developments in Japan's overall exports in the current phase are quite different from the time of the GFC, indicating that exports and production of Japan's manufacturing sector have been recovering steadily without lagging behind a global increase in trade volume.

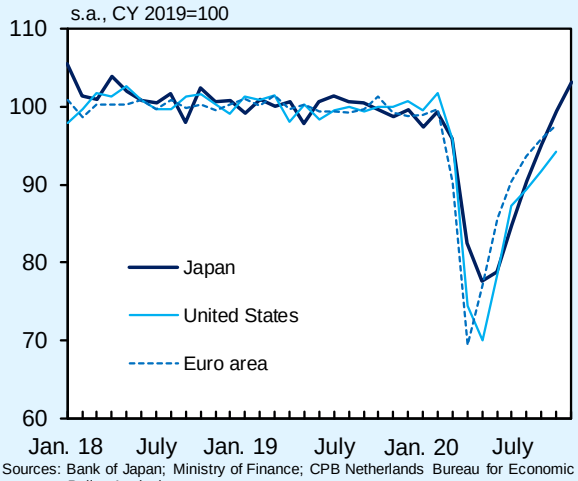
Lastly, turning to business fixed investment, the degree of decline for the April-June quarter was smaller in Japan than in the United States and Europe; for the July-September quarter, however, such investment in the United States and Europe

Chart B1-6: Nominal Disposable Income



Sources: Cabinet Office; Haver.
Notes: 1. Figures for Japan are calculated using annual and quarterly estimates.
2. The figure for the United States for 2020/Q4 is the October-November average.

Chart B1-7: Real Exports

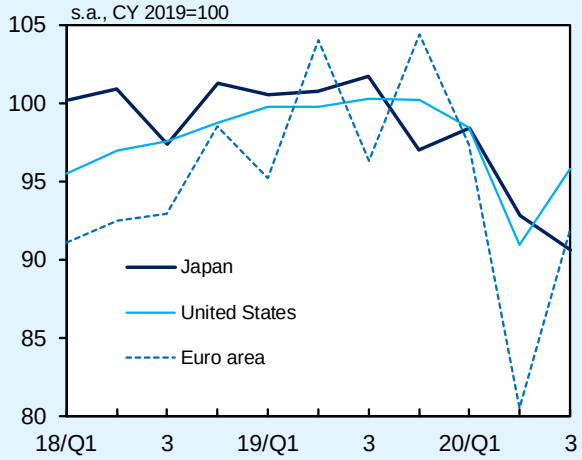


Sources: Bank of Japan; Ministry of Finance; CPB Netherlands Bureau for Economic Policy Analysis.
Note: Figures for the euro area include trade within the area.

turned to an increase, whereas that in Japan registered a decline for two consecutive quarters (Chart B1-8). On this point, there is a possibility that, due in part to the difference in the extent of the spread of COVID-19, Japanese firms thus far may not have been as active as European and U.S. firms in making digital or teleworking-related investments to respond to the situation during the COVID-19 era (Charts B1-3[2] and B1-9). That said, the weakness in Japan's business fixed investment relative to the United States and Europe might be merely due to some time lag given that, as described in the main text of the January 2021 Outlook Report, Japan's machinery investment already has picked up recently in reflection of a steady increase in exports and production.

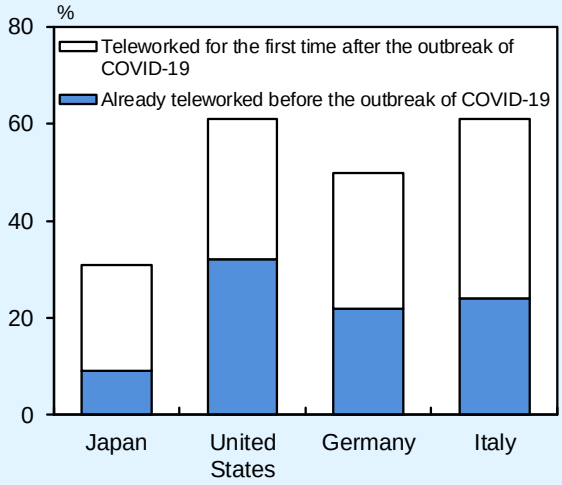
As mentioned at the beginning of this box, the above descriptions are based on actual data that cover a short time period. From a somewhat long-term perspective, there is likely to be a gap between Japan's economic growth rate and that of the United States and Europe due to the aforementioned factors and Japan's potential growth rate being lower than that of these economies, mainly reflecting the effects of demographic changes. In considering the growth pace of Japan's economy from a medium- to long-term perspective, it is necessary to pay close attention to whether progress will be made in the corporate sector's innovation to adapt to new circumstances and in transfer of economic resources among industries.

Chart B1-8: Real Business Fixed Investment



Sources: Cabinet Office; BEA; Eurostat.
Note: Figures for the euro area are those for gross fixed capital formation excluding housing investment.

Chart B1-9: Rate of Teleworkers by Country

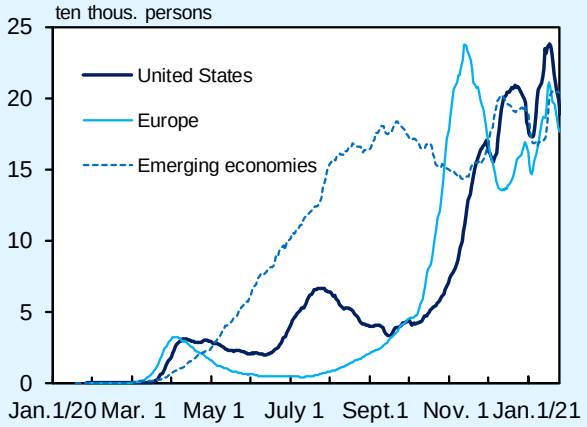


Source: Nomura Research Institute, "Global Survey Comparing Living Conditions During the Covid-19 Pandemic" (July 2020).
Note: Figures are prepared by the Bank's staff based on the online survey by Nomura Research Institute. The number of survey responses is 2,060 for each country.

(Box 2) Impact of a Resurgence of COVID-19 since Autumn 2020 on the U.S. and European Economies

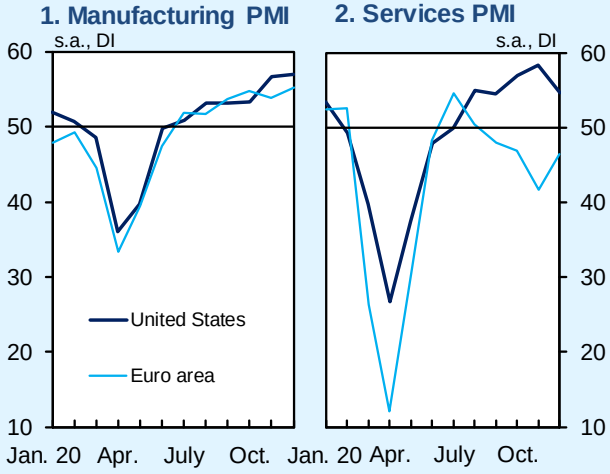
Since last autumn, the number of confirmed new cases of COVID-19 has clearly resurged in the United States and Europe (Chart B2-1). However, business sentiment suggests that downward pressure on economic activity has thus far been milder than last spring (Chart B2-2). This box summarizes the impact of a resurgence of COVID-19 since last autumn on the U.S. and European economies, using high-frequency data as well.

Chart B2-1: Confirmed New Cases of COVID-19 in Major Economies



Source: CEIC.
Note: Figures for the United States, Taiwan, and Hong Kong are from the CDC, the Taiwan Ministry of Health and Welfare, and the Hong Kong Centre for Health Protection, Department of Health, respectively. All other figures are from the WHO. Figures for Europe are the sum of figures for the EU and the United Kingdom. Figures for emerging economies are the sum of figures for India, South Africa, Russia, Turkey, and major economies in the NIEs, ASEAN, Latin America, and the Middle East. Figures show 7-day backward moving averages. The latest figures are for January 19.

Chart B2-2: PMI for the United States and the Euro Area



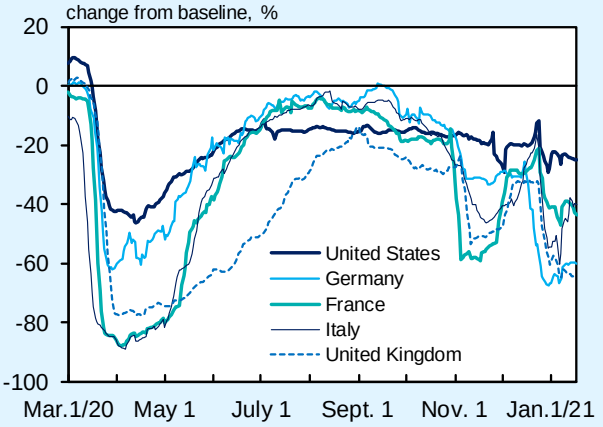
Source: IHS Markit (© and database right IHS Markit Ltd 2021. All rights reserved.).
Note: Figures for the services PMI are the "Services Business Activity Index."

In response to the rapid increase in the number of confirmed new cases, European countries reinstated public health measures, including restrictions on going outside and on restaurant and retail store businesses, from late October last year, and the number of people visiting such places as retail stores and entertainment facilities decreased again (Chart B2-3). However, these countries have been trying to strike a balance between such restrictions and sustaining economic activities; for example, (1) unlike last spring, economic activities, mainly of the manufacturing and construction industries, are being maintained, and (2) measures are revised flexibly and in a timely manner depending on the COVID-19 situation. In addition, many European countries have taken into consideration securing corporate financing and household income; as with last spring, together with the tightening of public health measures, they have introduced additional fiscal support measures such as the extension of salary compensation under short-time work schemes and the provision of

subsidies to firms. Under these circumstances, the impact of the resurgence of COVID-19 has been concentrated in the face-to-face services industry (Chart B2-2). This also is confirmed by high-frequency data; while the face-to-face services industry, such as eating and drinking, accommodations, and tourism, has been under downward pressure, electricity consumption -- a proxy for the level of activity in the economy as a whole, including the manufacturing industry -- has recovered to the previous year's level since last December, after dropping again in November (Chart B2-4). Thus, although European economies have been under downward pressure since last autumn, mainly in the services industry, they do not seem to have declined to the same extent as last spring.

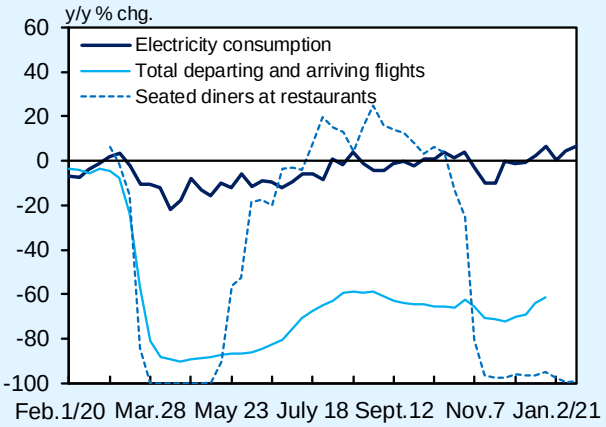
In the United States, some states and cities have also tightened public health measures since November 2020, including restrictions on going outside and banning restaurants and other establishments from operating at night. However, compared with Europe, the decline in the number of people going outside has remained small, since the tightening of measures has been limited to certain areas and types of business (Chart B2-3). Despite the rising trend in the number of confirmed new cases, business sentiment in both the manufacturing and services industries has continued to improve clearly (Chart B2-2). This is partly because, under the prolonged low interest rate environment, housing investment has increased, mainly reflecting a demand shift from rented houses in urban areas to owned houses in the suburbs, and machinery investment related to digitalization in particular has expanded (Chart B2-5). Looking at high-frequency data on

Chart B2-3: Mobility Trends in the United States and Europe



Source: Google LLC *"Google COVID-19 Community Mobility Reports."* https://www.google.com/covid19/mobility/. Accessed: January 21, 2021.
Notes: 1. Figures show 7-day backward moving averages of the percentage change in visits to places categorized as "retail and recreation" in the report released by Google.
2. The baseline is the median on the corresponding day of the week during the 5-week period from January 3 to February 6, 2020. The latest figures are for January 17.

Chart B2-4: Economic Activity Indicators for the Euro Area

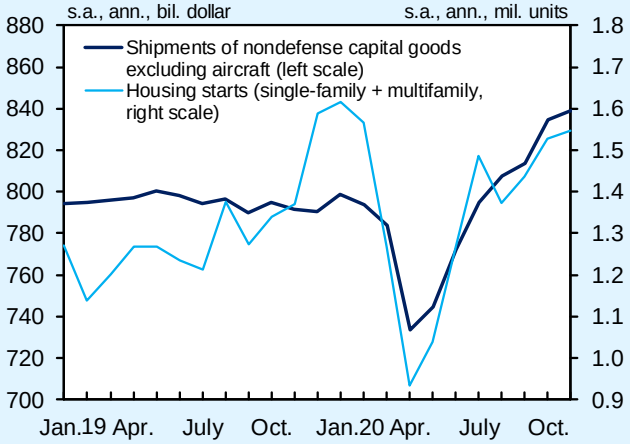


Sources: Bloomberg; EUROCONTROL; OpenTable.
Notes: 1. The horizontal axis shows the ending date of each week.
2. Figures for electricity consumption are the simple average for Germany, France, Italy, and Spain. The latest figure is for the week of January 10 to 16, 2021.
3. Figures for total departing and arriving flights are the simple average for the main airports in Germany, France, Italy, and Spain. The latest figure is for the week of December 20 to 26, 2020.
4. Figures for seated diners at restaurants are based on the number of those who dined on the premises at restaurants in Germany participating in the OpenTable online network. The latest figure is for the week of January 10 to 16, 2021.

indicators of private consumption to date, overall consumption seems to have remained on a moderate improving trend; while downward pressure on consumption of face-to-face services, such as eating and drinking as well as accommodations, has increased somewhat, goods consumption has been firm (Chart B2-6). The United States also decided to introduce additional economic measures at the end of December, including ones to support small and medium-sized firms and provide cash payments to households, thereby securing corporate financing and household income amid a situation of the resurgence of COVID-19. Against this backdrop, the U.S. economy has remained on an improving trend.

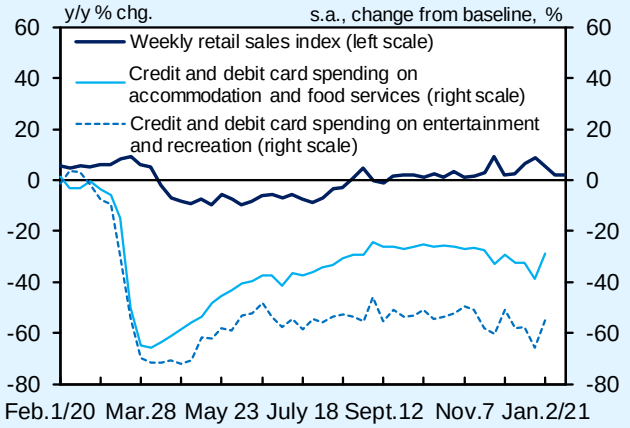
Thus, the U.S. and European economies have been less affected so far by the resurgence of COVID-19 compared with last spring. Although the face-to-face services industry is likely to remain under downward pressure for the time being, the growth rates are expected to increase thereafter, partly owing to fiscal support, as further progress is expected to be made in simultaneously taking preventive measures against COVID-19 and improving economic activity. However, there remain extremely high uncertainties over this outlook. Some positive developments toward leading the pandemic to subside have been seen recently, such as the start of vaccinations in various countries, but the effects of vaccines and the pace of distribution are still unclear. For the time being, it is necessary to continue to closely monitor the consequences of the resurgence of COVID-19 in respective countries and the impact on economic activity.

Chart B2-5: Machinery Investment and Housing Investment in the United States



Source: Haver.

Chart B2-6: Private Consumption-Related Indicators for the United States



Sources: Haver; Opportunity Insights.
Notes: 1. The horizontal axis shows the ending date of each week.
2. Figures for the weekly retail sales index are the "Johnson Redbook Index." The latest figure is for the week of January 10 to 16, 2021.
3. Figures for credit and debit card spending are from Opportunity Insights. The baseline is the average for the period from January 4 to 31, 2020. The latest figures are for the week of December 28, 2020 to January 3, 2021.

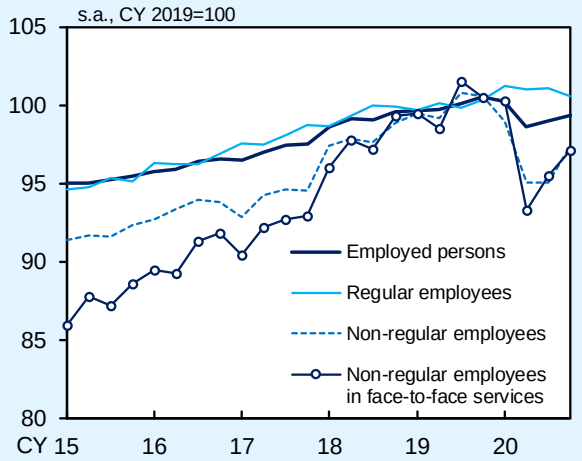
(Box 3) Extent of Transmission of the COVID-19 Shock across Employment and Business Fixed Investment

The impact of COVID-19 on Japan's economy has been extremely large, as seen in a substantial decline in its GDP for the April-June quarter of 2020, and widespread across the economy regardless of sector. That said, taking a detailed look at a pick-up in the economy since the July-September quarter, it can be pointed out as a characteristic of the COVID-19 shock that its impact is uneven across sectors and attributes. From this viewpoint, this box examines the extent of transmission of the COVID-19 shock across employment and business fixed investment.

A characteristic of the COVID-19 pandemic is that the face-to-face services industry in particular, such as accommodations as well as eating and drinking, has been affected directly, thereby generating a substantial decline in demand and a rise in operating costs -- although this was not the case around last spring, when economic activities were widely constrained regardless of sector under the state of emergency. On this basis, the variation in the impact of the COVID-19 shock across sectors seems to have become clearer, since (1) the transmission of the shock in the overall economy through a cycle from income to spending has been constrained to some extent on the back of large-scale and swift policy responses from the fiscal and monetary sides, and (2) steady exports and production in Japan due to a global recovery in trade activity and firm goods consumption have become evident. In fact, as for the employment situation, contrary to firm

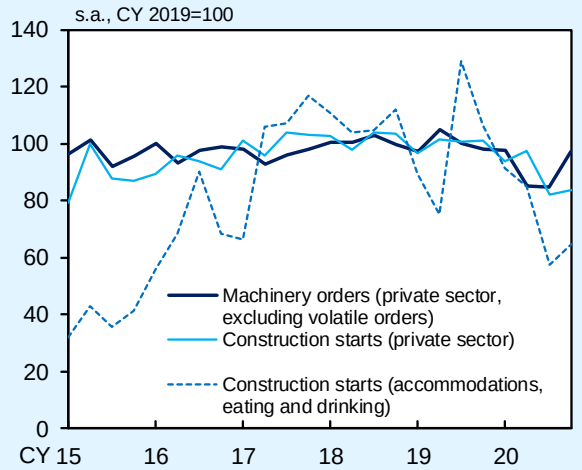
Chart B3-1: Employment and Business Fixed Investment by Sector

1. Number of Employed Persons



Source: Ministry of Internal Affairs and Communications.
Notes: 1. Face-to-face services consist of "accommodations, eating and drinking," "living-related services and amusement," "education, learning support," and "medical, health care and welfare."
2. Figures for 2020/Q4 are October-November averages.

2. Indicators of Business Fixed Investment

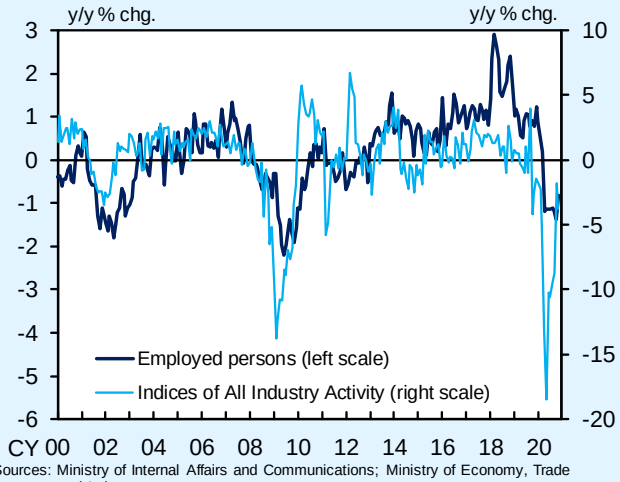


Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Notes: 1. Volatile orders: orders for ships and orders from electric power companies.
2. Figures for construction starts are estimated costs of nonresidential construction.
3. Figures for 2020/Q4 are October-November averages.

developments in the number of regular employees, the number of non-regular employees has declined, mainly in the face-to-face services industry (Chart B3-1[1]). Even when looking at the breakdown of business fixed investment, while machinery investment has picked up, construction investment in the accommodations as well as eating and drinking services industry has shown particularly notable weakness (Chart B3-1[2]).

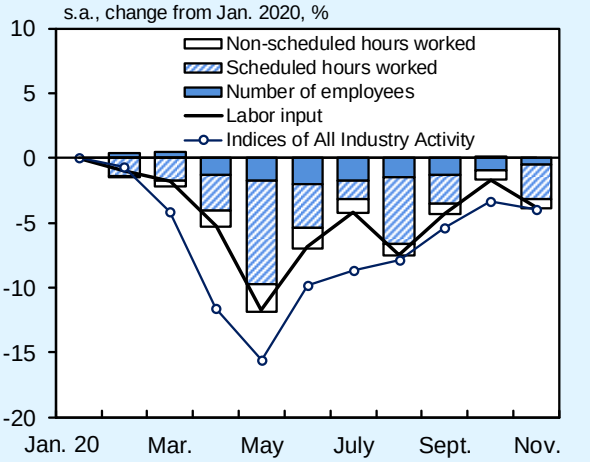
Taking a detailed look at the employment situation, despite the fact that the degree of decline in economic activity (in terms of the *Indices of All Industry Activity*) in the current phase has exceeded that following the bursting of the IT bubble and that at the time of the GFC, the rate of decline in the number of employed persons has been small compared with these past phases of economic downturn (Chart B3-2). On the other hand, labor input -- which consists of not only the number of employees but also the number of working hours per employee -- shows that, in the current phase, fairly large adjustments have been made, mainly though substantial reductions in scheduled hours worked (Chart B3-3). This indicates that firms have responded to a rapid drop in demand for their products or services by prioritizing temporary closures of businesses (i.e., reductions in working days) and reductions in working hours per day while hoarding a majority of their employees, partly through making active use of employment adjustment subsidies, which were expanded in response to the current situation. Although labor hoarding during an economic downturn is a characteristic among Japanese firms, if the expanded subsidies were unavailable for them, they would have been highly likely to have decided on larger-scale job cuts,

Chart B3-2: All Industry Activity and Number of Employed Persons



Sources: Ministry of Internal Affairs and Communications; Ministry of Economy, Trade and Industry.
Note: Figures for the "Indices of All Industry Activity" from August 2020 onward are calculated using the growth rate of the weighted average of the "Indices of Industrial Production" and the "Indices of Tertiary Industry Activity."

Chart B3-3: All Industry Activity and Labor Input

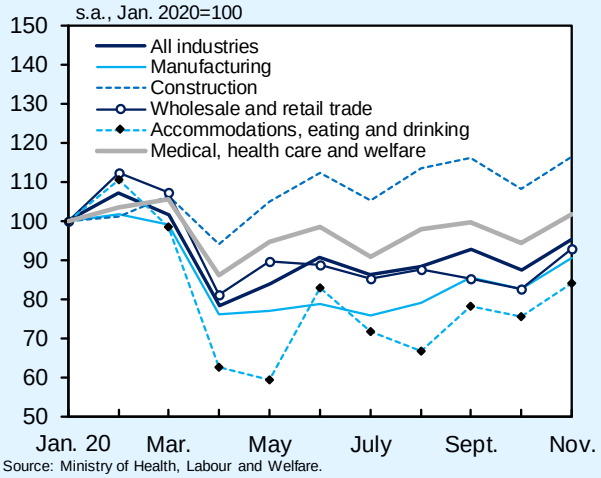


Sources: Ministry of Internal Affairs and Communications; Ministry of Health, Labour and Welfare; Ministry of Economy, Trade and Industry.
Note: Figures for the "Indices of All Industry Activity" from August 2020 onward are calculated using the growth rate of the weighted average of the "Indices of Industrial Production" and the "Indices of Tertiary Industry Activity."

reductions in the number of new graduates recruited, and stopping contract extensions for fixed-term employees. If this were the case, the degree of decline in overall wages and income should have been larger than that of the actual declines brought about by fewer working days and hours. The actual declines refer to those in scheduled cash earnings (i.e., the portion of expected earnings during normal times that was not covered by leave allowances) and in non-scheduled cash earnings. As a result, further downward pressure should have been put on private consumption. In other words, the positive contribution of employment adjustment subsidies and other measures to support firms and employment can be gauged by the extent to which the negative impact that should have emerged was mitigated.

That said, as mentioned earlier, employment adjustments, mainly of non-regular employees, have remained in the face-to-face services industry, which has been affected by COVID-19 more than any other industry. On the other hand, with large-scale employment adjustments in the overall economy being avoided, positive developments have been observed in part of the labor market, as seen in an increase in new job openings in industries where corporate activities had long been constrained by labor shortage, such as construction, medical, health care, and welfare services, as well as wholesale and retail trade (Chart B3-4). If workers leaving the face-to-face services industry -- where employment opportunities have decreased due to the impact of COVID-19 -- are gradually absorbed by other industries that have continued to face structural labor shortage, this will constrain

Chart B3-4: Number of New Job Openings by Industry

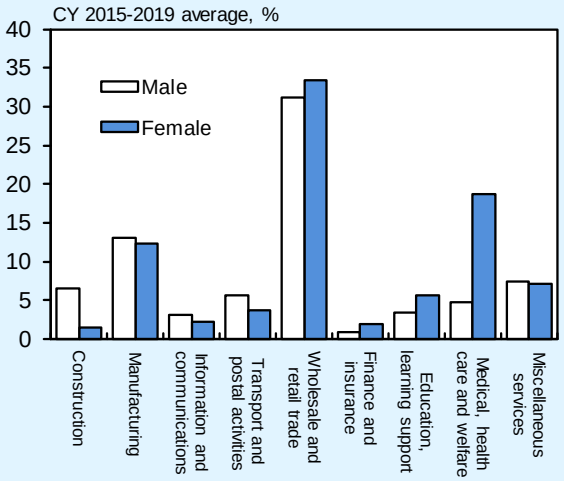


Source: Ministry of Health, Labour and Welfare.

upward pressure on the unemployment rate. In this regard, as pointed out in the October 2020 Outlook Report, the following developments have been observed: in industries that have been under strong pressure to reduce employment due to the impact of COVID-19, such as accommodations as well as eating and drinking, a relatively high ratio of workers have moved to other industries, due partly to a high proportion of non-regular employees in such industries; there has been a notable number of cases where female workers in particular have moved to the wholesale and retail trade industry or the medical, health care, and welfare services industry (Chart B3-5). Such employment reallocation from the face-to-face services industry to industries with labor shortage is expected to ease the worsening of labor market conditions to some extent.

Turning to business fixed investment, adjustment pressure on capital stock has remained small compared with the deterioration in economic activity. This seems largely attributable to the fact that business fixed investment has been supported from the financial side, mainly through active efforts by financial institutions. In addition, such efforts have been encouraged by the Bank's and the government's measures to support financing. In this regard, the DI in the *Tankan* for financial institutions' lending attitudes as perceived by firms suggests that their attitudes have remained accommodative, mainly in terms of those perceived by small firms (Chart B3-6). This DI usually has a strong correlation with the business conditions DI and tends to show severer attitudes in the phase of an economic downturn, but in the current phase, it is clearly deviating from developments in the business conditions DI,

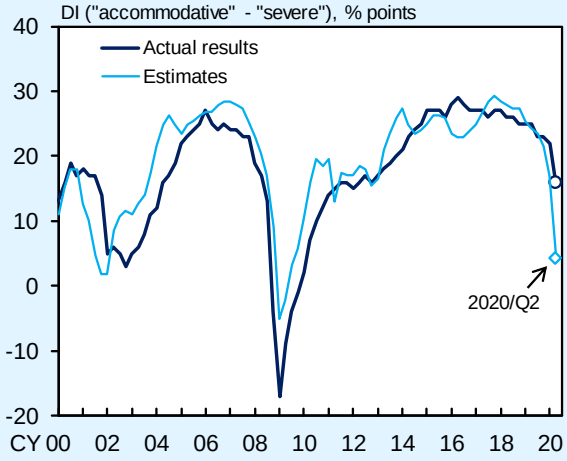
Chart B3-5: Industries to Which Employed Persons in Face-to-Face Services Moved



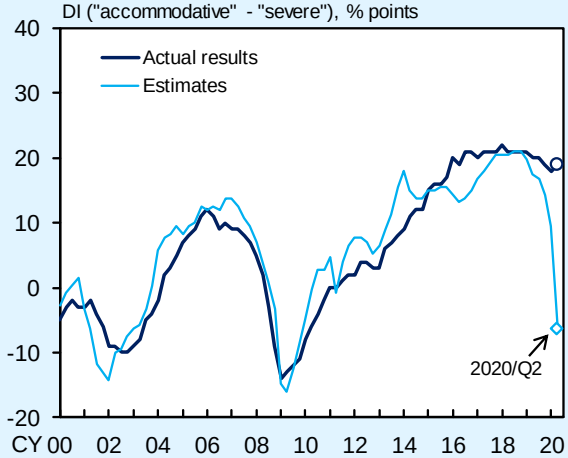
Source: Ministry of Internal Affairs and Communications.
Notes: 1. Figures are calculated using data for employed persons who changed jobs in the past year.
2. Face-to-face services consist of "accommodations, eating and drinking" and "living-related services and amusement." Figures exclude those who changed jobs within face-to-face services.

Chart B3-6: Lending Attitudes of Financial Institutions

1. Large Enterprises



2. Small Enterprises

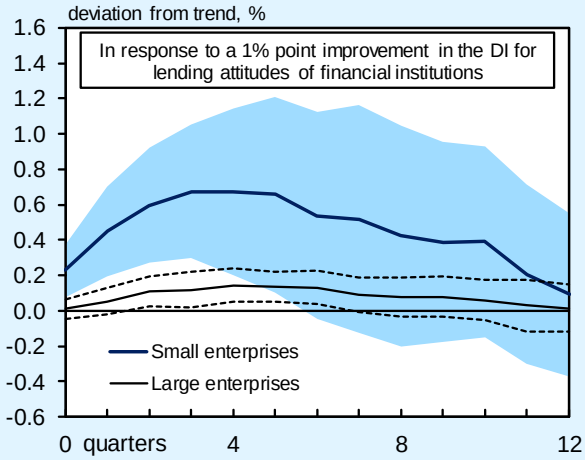


Source: Bank of Japan.
Notes: 1. Based on the *Tankan*. All industries.
2. The estimates are obtained by regressing the DI for lending attitudes of financial institutions on the business conditions DI.

which has remained at a low level.

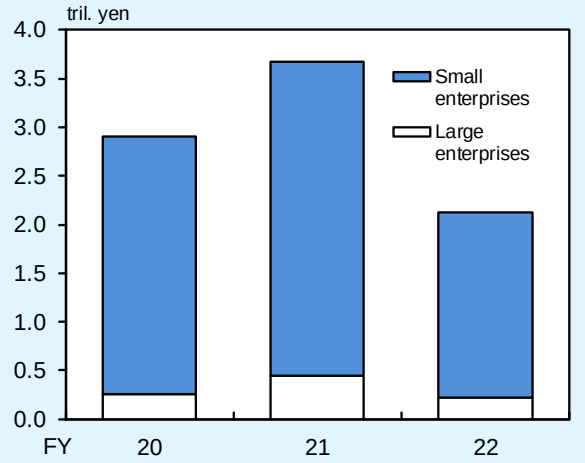
The contribution of such accommodative lending attitudes to supporting business fixed investment can be estimated by using a local projection model for the amount of business fixed investment by firm size, using the following four explanatory variables: (1) the DI in the *Tankan* for financial institutions' lending attitudes; (2) TOPIX; (3) the Macroeconomic Uncertainty Index; and (4) GDP.[23] The estimation results indicate that improvement in the lending attitude DI is statistically significant in terms of pushing up business fixed investment, and such positive effects are particularly large among small firms (Chart B3-7). In addition, by using the estimation results of this model, a calculation was made of how the lending attitudes that have remained accommodative in the current phase will have effects on business fixed investment.[24] The result suggests that improvement in the lending attitude DI will push up the amount of business fixed investment, mainly by small firms, and the overall amount will increase over three years by around 3 trillion yen (around 6 percentage points) on an annual average basis (Chart B3-8). That said, these estimation results should be interpreted with some latitude as they depend on the estimation model.

Chart B3-7: Impact of Lending Attitudes on Business Fixed Investment



Sources: Cabinet Office; Bloomberg; Ministry of Finance; Bank of Japan, etc.
Note: Estimated using the local projection method by size of enterprise. Explanatory variables include lagged dependent variables, the TOPIX, the Macroeconomic Uncertainty Index, and GDP. The shaded area and the broken lines indicate the 95 percentile bands. The estimation period is 1994/Q1-2020/Q1. Figures for business fixed investment are based on the "Financial Statements Statistics of Corporations by Industry, Quarterly." Excluding "finance and insurance."

Chart B3-8: Amount of Increase in Business Fixed Investment



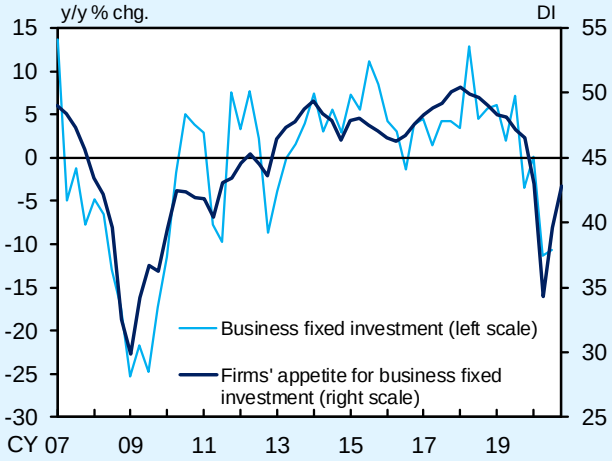
Sources: Cabinet Office; Bloomberg; Ministry of Finance; Bank of Japan, etc.
Note: Figures are estimated using the trend in 2020/Q1 and the deviation from the trend. The deviation from the trend is calculated as the response of business fixed investment to a shock to the DI for lending attitudes of financial institutions in 2020/Q2. The difference between the actual result and the estimate obtained by regressing the DI for lending attitudes on the business conditions DI is regarded as the shock.

[23] The Macroeconomic Uncertainty Index is calculated by aggregating the variance of forecast errors of the time-series models related to various macroeconomic indicators. For details on the calculation method, see "Characteristics of Uncertainty Indices in the Macroeconomy," *Bank of Japan Working Paper Series*, no. 20-E-6, October 2020.

[24] In the calculation, by firm size, the following was regarded as an "additional positive shock to lending attitudes": the difference in level between the actual result of the DI for financial institutions' lending attitudes for June 2020 and such DI estimated from its past correlation with the business conditions DI.

With accommodative financial conditions being maintained and the heightening of macroeconomic adjustment pressure on capital stock being avoided, the sectors where business fixed investment has continued declining significantly have been limited to the face-to-face services industry and some sectors of the transportation industry. In addition, since machinery investment in the manufacturing industry has picked up clearly on the back of a recovery in exports and production, there seems to have been a rise in the likelihood that overall business fixed investment will turn to a pick-up, mainly led by machinery investment and digital investment aimed at responding to COVID-19. In fact, an indicator of firms' appetite for business fixed investment -- for which survey respondents mainly consist of small and medium-sized firms -- shows that such appetite has turned to a clear improvement recently (Chart B3-9).

Chart B3-9: Firms' Appetite for Business Fixed Investment



Sources: Ministry of Finance; Teikoku Databank, Ltd.
Note: Figures for business fixed investment are based on the "Financial Statements Statistics of Corporations by Industry, Quarterly." Excluding "finance and insurance."

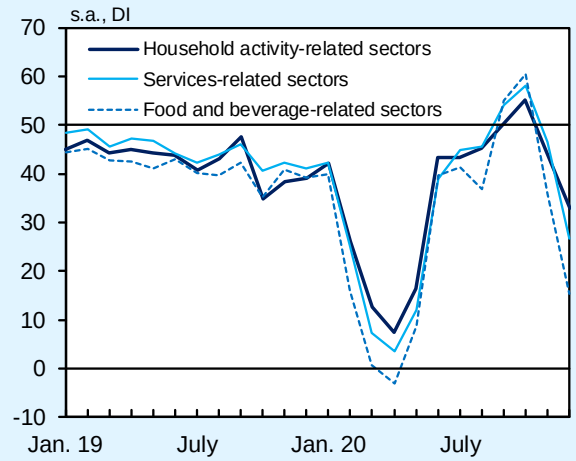
(Box 4) Developments in Private Consumption since a Resurgence of COVID-19

This box examines developments in private consumption up to the latest possible period amid a resurgence of COVID-19 since November 2020 while making use of high-frequency data and anecdotal information from firms.

With regard to face-to-face services consumption, which has been susceptible to the impact of COVID-19, that for dining out and travel in particular has picked up through around mid-November, partly encouraged by the "Go To" campaign. However, subsequently, downward pressure on such consumption has increased, mainly due to the resurgence of COVID-19, a resultant suspension of the "Go To Travel" campaign, and the reinstatement of the state of emergency.

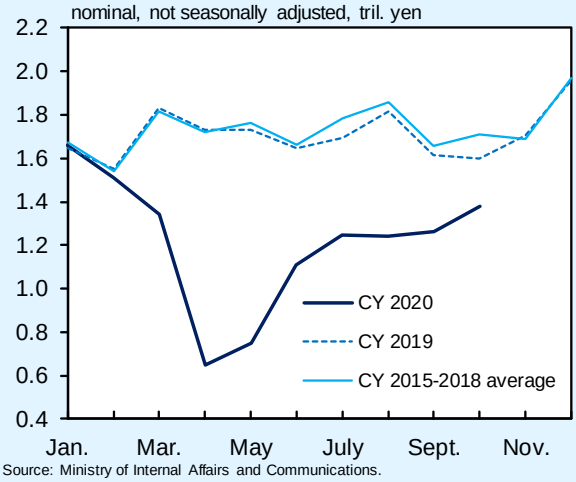
Looking at developments through the end of 2020 in the current economic conditions DI (household activity-related) of the *Economy Watchers Survey*, it continued to improve from the bottom hit in April and exceeded 50 for the September-October period; however, it has deteriorated markedly for two consecutive months since November, mainly for food and beverage-related sectors and services-related sectors including those related to leisure facilities as well as travel and transportation (Chart B4-1). As a seasonal feature, consumption for October through December has a particularly large weight in that for the whole year, and this is especially the case for December, when consumption is stimulated by such factors

Chart B4-1: Economy Watchers Survey



Source: Cabinet Office.
Note: Figures are for the current economic conditions DI.

Chart B4-2: Seasonality in Sales at Restaurants

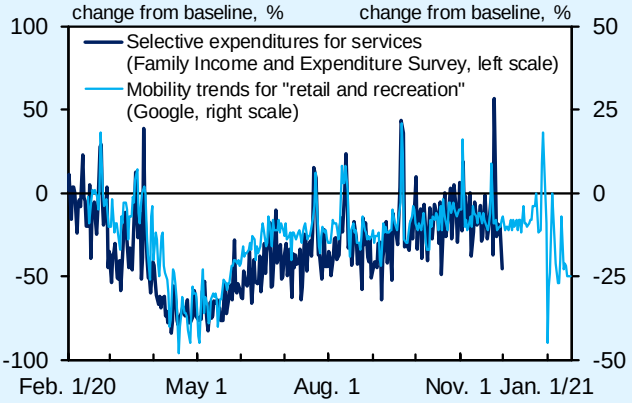


Source: Ministry of Internal Affairs and Communications.

as demand for visiting hometowns, year-end sales, and demand for year-end parties (Chart B4-2). Due to the fact that the number of people going outside was constrained and events were restricted during the peak season at year-end, the resurgence of COVID-19 may have had a larger impact on sales at restaurants and travel agencies, as well as on their business sentiment.

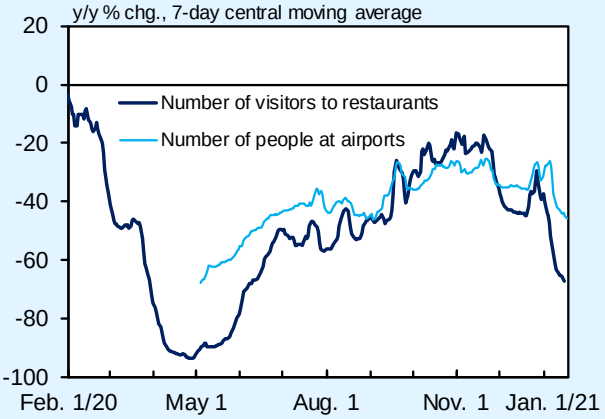
Downward pressure on dining out and travel seems to have increased since the turn of January 2021, with the continuing increase in the number of confirmed cases and in response to the declaration of a state of emergency by the government. Looking at high-frequency data that provide location tracking information, mobility trends for "retail and recreation" -- which have high correlation with selective expenditures for services -- were on a downtrend from the second half of November, when fluctuations are smoothed out, and have plunged since the turn of this year with the reinstatement of the state of emergency (Chart B4-3). The year-on-year rate of change in the number of visitors to restaurants declined markedly in negative territory for December, reflecting requests for business hour cuts and self-restraint from having year-end parties, and has further decelerated since the turn of January due to the reinstatement of the state of emergency (Chart B4-4). The number of people at major airports, which is said to reflect developments in domestic travel, has continued to decrease, with the ongoing suspension of the "Go To Travel" campaign. In interviews with firms, some have said that the year-on-year rate of change in the transaction value of domestic travel for January has declined further in negative territory.

Chart B4-3: Mobility Trends and Selective Expenditures for Services



Sources: Ministry of Internal Affairs and Communications;
Google LLC *"Google COVID-19 Community Mobility Reports."*
https://www.google.com/covid19/mobility/. Accessed: January 21, 2021.
Notes: 1. The baseline is the median on the corresponding day of the week during the 5-week period from January 3 to February 6, 2020.
2. Figures for selective expenditures for services are the sum of expenditure on public transportation, recreational services (accommodation services, etc.), and meals outside the home. The latest figure is for November 30.
3. Figures for mobility trends for "retail and recreation" are mobility trends for places such as restaurants, shopping centers, and theme parks. The latest figure is for January 17.

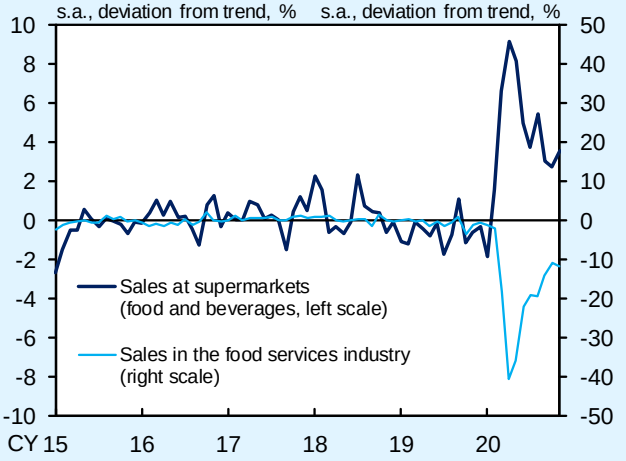
Chart B4-4: Number of People Going Out as Indicated by High-Frequency Data



Sources: TableCheck Inc.; NTT DOCOMO, Inc.
Notes: 1. Figures for the number of visitors to restaurants show the number of visitors per restaurant, and are for about 5,200 restaurants that have installed the reservation and customer management system for restaurants provided by TableCheck Inc. The latest figure is the average for January 12-18.
2. Figures for the number of people at airports are the averages for New Chitose Airport, Haneda Airport (the average of Terminals 1 and 2), Osaka International Airport, Fukuoka Airport, and Naha Airport. The latest figure is the average for January 14-20. Figures are adjusted for differences between weekdays and weekends/holidays.

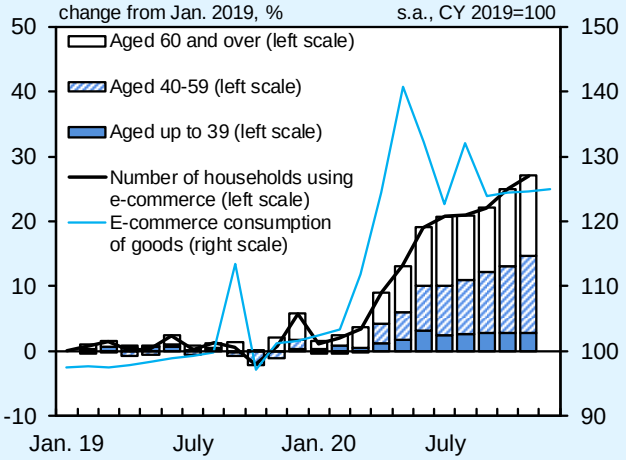
While face-to-face services consumption has been stagnant, as mentioned above, goods consumption seems to have remained steady on the whole, supported by an expansion in online consumption and an increase in stay-at-home consumption, despite being pushed down by a decrease in winter bonuses. In this regard, a clear negative correlation has been seen since the outbreak of COVID-19 last year between sales of food and beverages at supermarkets and sales in the food services industry (Chart B4-5). When demand for dining-out services declines in reflection of the spread of COVID-19, demand for goods for eating at home increases and, in terms of overall consumption, this eases to some extent downward pressure stemming from the impact of COVID-19. Such steady demand for goods seems to have been also supported by an accelerating shift to e-commerce since the outbreak. In fact, looking at a consumption indicator based on credit card transaction data, online consumption of goods has increased significantly since last spring (Chart B4-6). In addition, with regard to households using e-commerce, their number -- including senior households, for which the proportion of users had been low -- has been on a clear increasing trend, indicating that e-commerce users have become more diverse.

Chart B4-5: Sales of Food and Beverages and Sales in the Food Services Industry



Sources: Ministry of Economy, Trade and Industry; Japan Foodservice Association, "Market Trend Survey of the Food Services Industry."
Note: The trend is a linear trend from January 2015 to December 2019.

Chart B4-6: E-Commerce Consumption



Sources: Ministry of Internal Affairs and Communications; NOWCAST, Inc./ JCB, Co., Ltd., "JCB Consumption NOW."
Notes: 1. Figures for the number of households using e-commerce are the number of households ordering over the Internet. Figures are for two-or-more-person households and compiled by the age of the household head.
2. Figures for e-commerce consumption of goods are from the reference series in "JCB Consumption NOW," which take changes in the number of consumers into account. Seasonally adjusted based on staff calculations.