

Outlook for Economic Activity and Prices (October 2021)

The Bank's View¹

Summary

- The outlook for Japan's economy is that, for the time being, downward pressure stemming from the novel coronavirus (COVID-19) is likely to remain on services consumption, and exports and production are expected to decelerate temporarily due to supply-side constraints. Thereafter, however, with the impact of COVID-19 waning gradually, mainly due to the widespread vaccinations, the economy is likely to recover, supported by an increase in external demand, accommodative financial conditions, and the government's economic measures. From the middle of the projection period, as a virtuous cycle from income to spending intensifies in the overall economy, including the household sector, Japan's economy is projected to continue growing at a pace, albeit slower, above its potential growth rate.
 - The year-on-year rate of change in the consumer price index (CPI, all items less fresh food) is likely to increase moderately in positive territory for the time being, reflecting a rise in energy prices. Thereafter, albeit with fluctuations due to temporary factors, it is projected to increase gradually as a trend, mainly on the back of improvement in the output gap and a rise in medium- to long-term inflation expectations.
 - Comparing the projections with those presented in the previous *Outlook for Economic Activity and Prices* (Outlook Report), the projected growth rate for fiscal 2021 is somewhat lower, mainly for exports and private consumption, but that for fiscal 2022 is somewhat higher. The projected rate of increase in the CPI for fiscal 2021 is lower, mainly due to the effects of the rebasing of the index.
 - Concerning risks to the outlook, the course of COVID-19 and its impact on domestic and overseas economies continue to warrant attention. In particular, there are high uncertainties over whether the resumption of economic activity can progress smoothly while public health is being protected. Attention also should be paid to a risk that the effects of supply-side constraints seen in some areas will be amplified or prolonged.
 - With regard to the risk balance, risks to economic activity are skewed to the downside for the time being, mainly due to the impact of COVID-19, but are generally balanced for the middle of the projection period onward. Risks to prices are skewed to the downside.
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¹ "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on October 27 and 28, 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 have recovered on the whole, albeit with variation across countries and regions. In this situation, exports and industrial production have continued to increase as a trend, despite being weak recently due to the effects of supply-side constraints seen in some areas. In addition, corporate profits and business sentiment have continued to improve on the whole. Business fixed investment has picked up, although weakness has been seen in some industries. The employment and income situation has remained weak due to the impact of COVID-19. Private consumption has shown signs of a pick-up recently, although downward pressure has remained strong, particularly on services consumption, mainly due to vigilance against COVID-19. Housing investment has picked up. Public investment has been more or less flat. Financial conditions have been accommodative on the whole, although weakness in firms' financial positions has remained in some segments. 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 at around 0 percent, mainly due to the rise in energy prices, despite being affected by COVID-19 and a reduction in mobile phone charges. Meanwhile, inflation expectations have picked up.

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

A. Baseline Scenario of the Outlook for Economic Activity

The outlook for Japan's economy is that, for the time being, downward pressure stemming from COVID-19 is likely to remain on services consumption, and exports and production are expected to decelerate temporarily due to supply-side constraints. Thereafter, however, with the impact of COVID-19 waning gradually, mainly due to the widespread vaccinations, the economy is likely to recover, supported by the increase in external demand, accommodative financial conditions, and the government's economic measures. In the corporate sector, a virtuous cycle is projected to continue operating, in which increases in exports and production that reflect steady external demand lead to a rise in business fixed investment, mainly through improvement in profits. In the household sector, it is highly likely that overall private consumption will pick up again because downward pressure on the face-to-face services sector is expected to gradually wane as the resumption of consumption activities progresses while public health is being protected, mainly due to the widespread vaccinations. Therefore, with improvement spreading from the corporate sector to the household sector, the recovery trend in the overall economy is projected to become pronounced.

From the middle of the projection period, although the pace of economic growth is likely to decelerate somewhat, mainly reflecting a peaking-out of pent-up demand at home and

abroad, the economy is projected to continue growing at a pace above its potential growth rate because the virtuous cycle from income to spending is expected to intensify in the overall economy, including the household sector, supported by accommodative financial conditions, for example.

Looking at the outlook for economic activity in more detail, as the impact of COVID-19 wanes gradually, overseas economies are likely to continue growing, albeit with variation across countries and regions, supported by aggressive macroeconomic policies taken mainly in advanced economies. In this situation, although Japan's exports of goods, mainly automobile-related ones, are expected to decelerate temporarily due to the effects of supply-side constraints, they are projected to continue increasing as a trend on the back of firm expansion in global demand, particularly for digital-related goods. Inbound tourism consumption, which is categorized under services exports, is expected to remain subdued while entry and travel restrictions continue but likely to recover thereafter.

Corporate profits are projected to continue on an improving trend on the back of a recovery in domestic and external demand, despite being affected by deterioration in the terms of trade that reflects a rise in international commodity prices and by supply-side constraints. In this situation, an uptrend in business fixed investment is expected to become clear, mainly for machinery and digital-related investments, supported by improvement in corporate profits, accommodative financial conditions, and the government's economic measures, although investment by the face-to-face services sector is projected to remain weak for the time being.

Private consumption, despite being restrained for the time being, mainly by vigilance against COVID-19, is expected to pick up again, supported by the materialization of pent-up demand, such as for services, as the resumption of consumption activities progresses while public health is being protected, mainly due to the widespread vaccinations. Thereafter, as the impact of COVID-19 subsides gradually, an uptrend in private consumption is projected to become evident, supported by improvement in employee income. Employee income is likely to increase moderately on the back of a rise in the number of employees that reflects the recovery in domestic and external demand and of wage increases in industries with acute labor shortage.

Public investment is projected to steadily increase, reflecting progress such as in construction related to building national resilience. Thereafter, it is expected to be at a relatively high level. Government consumption is likely to increase clearly for fiscal 2021, mainly reflecting a pick-up in healthcare expenditure and enhancement of the testing and vaccination systems and the medical treatment system, but see a lowering in its level thereafter.

Meanwhile, the potential growth rate is expected to rise moderately, mainly on the back of an increase in productivity due to advances in digitalization and of an acceleration in

capital stock growth due to the rise in business fixed investment.² 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.

B. Baseline Scenario of the Outlook for Prices

The year-on-year rate of change in the CPI is likely to increase moderately in positive territory for the time being. That is, although the rate is projected to continue to be pushed down relatively significantly by the reduction in mobile phone charges, it is expected to increase toward around the end of 2021, mainly due to the rise in energy prices reflecting the rise in crude oil prices, and also because of a rebound in hotel charges from last year's decline brought about by the "Go To Travel" campaign. When various temporary factors are excluded, the year-on-year rate of change in the CPI is likely to remain steady and continue to show a moderate increase in positive territory.

Thereafter, albeit with fluctuations due to temporary factors, such as deceleration in the rise in energy prices and dissipation of the effects of the rebound in hotel charges and of the reduction in mobile phone charges, the year-on-year rate of change in the CPI is expected to increase gradually as a trend, mainly on the back of improvement in the output gap and the rise in medium- to long-term inflation expectations. Although the output gap -- which captures the utilization of labor and capital -- has been negative recently, it is projected to turn positive with the economy returning to a growth path that outpaces its potential growth rate, and continue to expand moderately from the middle of the projection period. Under these circumstances, as households' tolerance of price rises improves moderately, mainly reflecting an increase in wage inflation, and as firms' price-setting stance gradually becomes active, the pass-through of cost increases and a rise in selling prices are likely to become widely observed. In addition, the increase in actual inflation is expected to lead to a rise in households' and firms' medium- to long-term inflation expectations through the adaptive formation mechanism and thereby encourage further price rises.

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 the impact of COVID-19 with a view to supporting financing, mainly of firms, and maintaining stability in financial markets. The government has

² Under a specific methodology, Japan's recent potential growth rate is estimated to be at around 0 percent or marginally positive. However, the rate should be interpreted with considerable latitude. This is because the estimate is subject to change depending on the methodologies employed and could be revised as the sample period becomes longer over time. In addition, there are high uncertainties in the current phase over how COVID-19 will affect the trends in productivity or labor supply.

conducted various measures to support financing, mainly of firms. Private financial institutions have actively fulfilled the functioning of financial intermediation. In this situation, although firms' financial positions have improved on the whole, mainly due to a pick-up in economic activity, weakness has remained, particularly for firms in industries facing subdued sales due to the impact of COVID-19, as well as small and medium-sized ones. The environment for external funding, such as bank borrowing and the issuance of CP and corporate bonds, has remained accommodative. On the back of financial system stability being maintained, the Bank considers that financial conditions will remain accommodative owing to the continuation of powerful monetary easing by the Bank, the government's measures, and efforts made by private financial institutions, and that this will support an increase in private demand.³

III. Risks to Economic Activity and Prices

A. Risks to Economic Activity

Regarding the upside and downside risks to the aforementioned baseline scenario of the outlook for economic activity, it is necessary to pay attention to the following factors.

The first is the impact of COVID-19 on consumption activities. There are high uncertainties over the course of COVID-19 and its impact on the economy, or more specifically regarding people's vigilance against COVID-19 and its impact on consumption activities. If their vigilance entrenches due, for example, to the spread of highly contagious variants, there is a risk that economic activity will deviate downward from the baseline scenario. On the other hand, economic activity could improve by more than expected because if, for example, public health is protected and people's vigilance lessens significantly with the widespread vaccinations and the rollout of antiviral medicines, pent-up demand for services consumption will materialize relatively early.

The second factor is the effects of supply-side constraints. Mainly due to a rapid recovery in advanced economies, such as the United States, and to the effects of the resurgence of COVID-19 in Asia, supply-side constraints have been seen globally, including the semiconductor shortage, the stagnation of logistics such as in marine transport, and parts procurement difficulties reflecting supply-chain disruptions. As the impact of COVID-19 wanes, demand imbalances and production and shipping bottlenecks are likely to head toward a resolution. However, if the effects of supply-side constraints are prolonged or amplified by more than expected, there is a risk that economic activity will deviate further downward from the baseline scenario, particularly in the first half of the projection period.

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.

The third factor is developments in overseas economies. The growth rates of overseas economies are projected to decelerate gradually toward the end of the projection period, mainly reflecting further normalization of those economies and the peaking-out of economic stimulus measures taken in advanced economies. However, there is a risk that overseas economies, particularly emerging economies, will deviate downward from the baseline scenario if global financial conditions tighten by more than expected amid concern in global financial markets over firms' debt problems in certain industries within some emerging economies and over steps toward reducing monetary accommodation in advanced economies. On the other hand, overseas economies, mainly for consumption activities, could be pushed up through, for example, rapid spending of household savings that have accumulated significantly across economies due to various restrictions during the COVID-19 pandemic.

The fourth factor considered from a somewhat long-term perspective is firms' and households' medium- to long-term growth expectations. While it is likely that the economic structure and working style will be transformed toward the post-COVID-19 era, digitalization will see further advances, and efforts to address climate change will proceed, there are uncertainties over whether these developments raise or lower such expectations.

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. In the baseline scenario of the outlook for prices, as described earlier, it is projected that firms' price-setting stance will gradually become active with continuing improvement in the output gap. That said, given, for example, that the entrenched mechanism of adaptive inflation expectations formation in Japan is complex and sticky, firms' price-setting behavior in the future entails uncertainties, including a risk that the pass-through of cost increases to selling prices, particularly to downstream or consumer prices, which are closer to final demand, will not progress.

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. Thus, it is necessary to continue paying attention to them.

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.⁴

The first perspective involves an examination of the baseline scenario of the outlook. Although it will take time, the year-on-year rate of change in the CPI is likely to increase gradually toward achieving the price stability target, mainly on the back of improvement in the output gap and the rise in medium- to long-term inflation expectations.

The second perspective involves an examination of the risks considered most relevant to the conduct of monetary policy. Concerning risks to the outlook, the course of COVID-19 and its impact on domestic and overseas economies continue to warrant attention. In particular, there are high uncertainties over whether the resumption of economic activity can progress smoothly while public health is being protected. Attention also should be paid to the risk that the effects of supply-side constraints seen in some areas will be amplified or prolonged. With regard to the risk balance, risks to economic activity are skewed to the downside for the time being, mainly due to the impact of COVID-19, but are generally balanced for the middle of the projection period onward. Risks to prices are skewed to the downside. On the financial side, overheating has not been seen in asset markets and financial institutions' credit activities. Japan's financial system has maintained stability on the whole, despite the fact that COVID-19 has had a significant impact on economic and financial activity at home and abroad. In addition, even in the case of a future resurgence of COVID-19, the financial system is likely to remain highly robust on the whole, mainly because financial institutions have sufficient capital bases. 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, it is necessary to pay close attention to future developments.⁵

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

⁴ 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."

⁵ For details, see the Bank's *Financial System Report* (October 2021).

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) purchases of exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) with upper limits of about 12 trillion yen and about 180 billion yen, respectively, on annual paces of increase in their amounts outstanding.

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

Forecasts of the Majority of the Policy Board Members

y/y % chg.

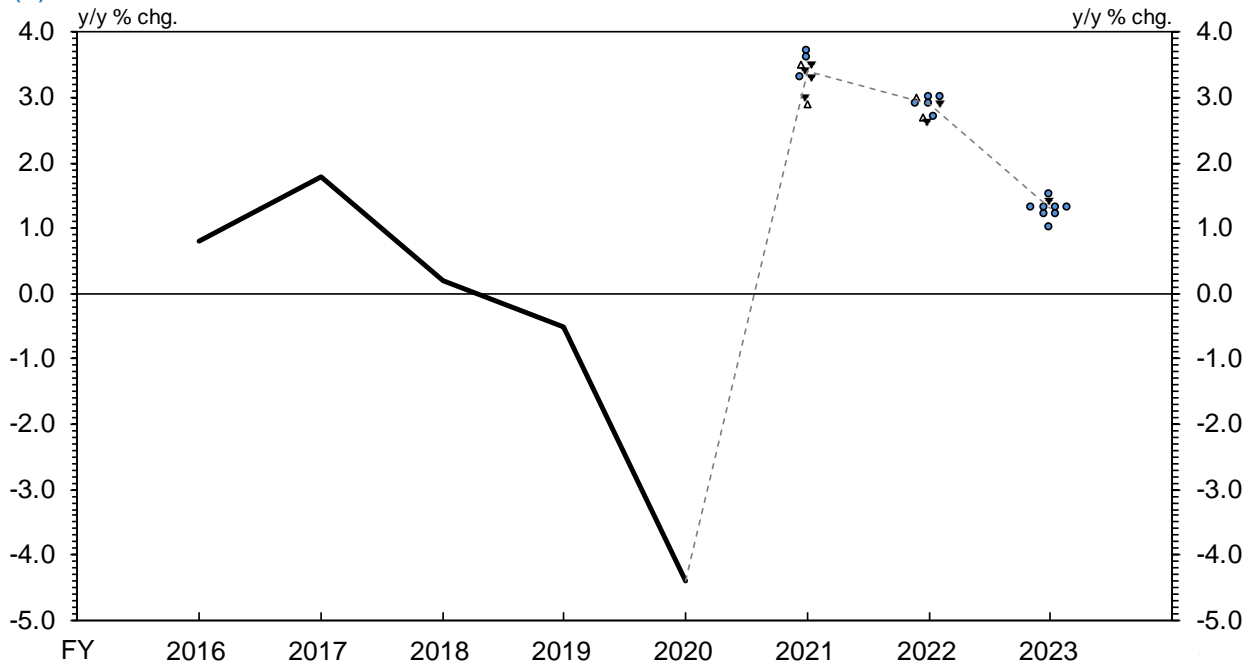
	Real GDP	CPI (all items less fresh food)
Fiscal 2021	+3.0 to +3.6 [+3.4]	0.0 to +0.2 [0.0]
Forecasts made in July 2021	+3.5 to +4.0 [+3.8]	+0.3 to +0.6 [+0.6]
Fiscal 2022	+2.7 to +3.0 [+2.9]	+0.8 to +1.0 [+0.9]
Forecasts made in July 2021	+2.6 to +2.9 [+2.7]	+0.8 to +1.0 [+0.9]
Fiscal 2023	+1.2 to +1.4 [+1.3]	+0.9 to +1.2 [+1.0]
Forecasts made in July 2021	+1.2 to +1.4 [+1.3]	+0.9 to +1.1 [+1.0]

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

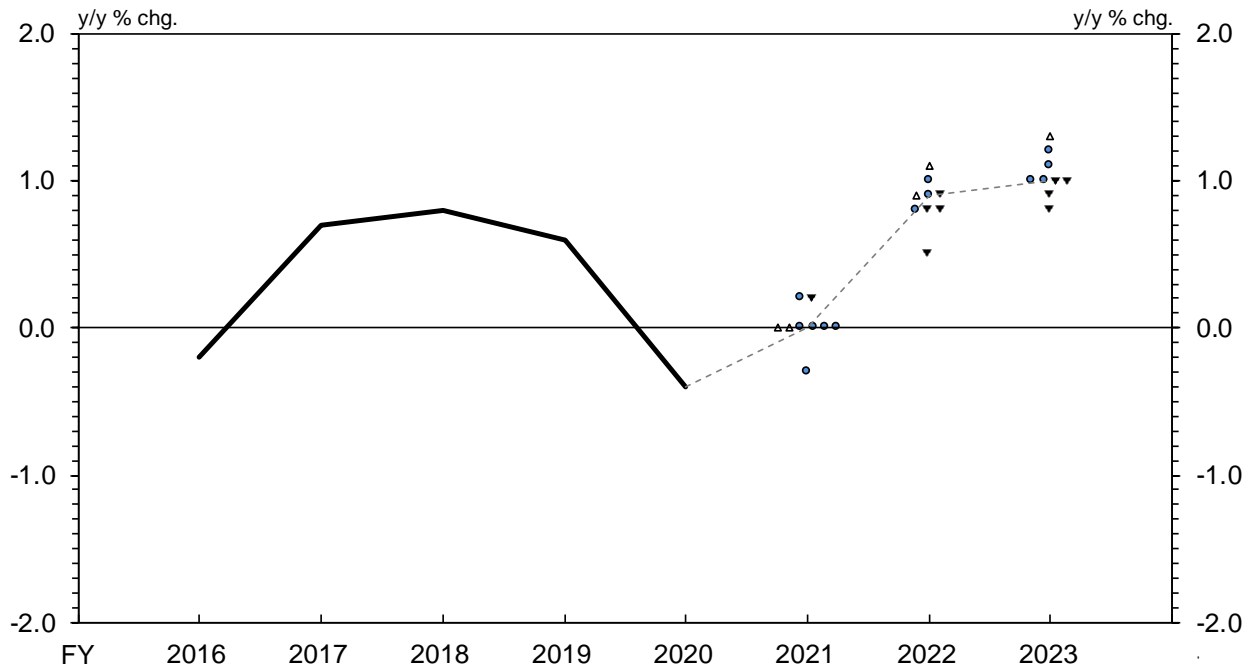
2. The forecasts of the majority of the Policy Board members are constructed as follows: each Policy Board member's forecast takes the form of a point estimate -- namely, the figure to which they attach the highest probability of realization. These forecasts are then shown as a range, with the highest 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 reduction in mobile phone charges by major carriers conducted in spring 2021 is estimated to directly push down the CPI for fiscal 2021 by around 1.1 percentage points.
5. In August 2021, the base year of the CPI was changed from 2015 to 2020, and figures for the year-on-year rate of change from January 2021 onward were retroactively revised. Accordingly, the year-on-year rate of change in the CPI for all items excluding fresh food for the April-June quarter of 2021 was revised downward by around 0.7 percentage points; namely, from around 0.1 percent (2015-base) to minus 0.6 percent (2020-base). This is mainly because the negative contribution of mobile phone charges to the CPI expanded from around 0.6 percentage points to around 1.1 percentage points. The changes to the CPI forecasts in this Outlook Report from the previous ones are largely attributable to the rebasing of the CPI.

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 they attach 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."