January 18, 2022

Bank of Japan

Outlook for Economic Activity and Prices (January 2022)

The Bank's View[1]

Summary

- Japan's economy is likely to recover as downward pressure stemming from the novel coronavirus (COVID-19) on services consumption and the effects of supply-side constraints wane, while being supported by an increase in external demand, accommodative financial conditions, and the government's economic measures. Thereafter, 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 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 in positive territory for the time being, albeit with fluctuations, on the back of a rise in energy prices, a moderate pass-through of raw material cost increases, and dissipation of the effects of a reduction in mobile phone charges. Thereafter, although the positive contribution of the rise in energy prices is projected to wane, the rate of increase in the CPI is expected to stay at around 1 percent toward the end of the projection period, due to the underlying inflationary pressure stemming mainly from 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 lower due to the effects of supply-side constraints, but that for fiscal 2022 is higher, mainly on the back of the effects of the government's economic measures and a recovery in production to catch up with demand. The projected rate of increase in the CPI for fiscal 2022 is somewhat higher, mainly reflecting a rise in commodity prices and the pass-through of that rise to consumer prices.
- Concerning risks to the outlook, the course of COVID-19, including variants, and its impact on domestic and overseas economies continue to warrant attention. In addition, there are high uncertainties over future developments in overseas economies given the effects of supply-side constraints, as well as in commodity prices and their impact on economic activity and prices.
- 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 thereafter. Risks to prices are generally balanced.

[1] "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on January 17 and 18, 2022.

I. Current Situation of Economic Activity and Prices in Japan

A pick-up in Japan's economy has become evident as the impact of COVID-19 at home and abroad has waned gradually. 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 the remaining effects of supply-side constraints. 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 relatively weak on the whole, although improvement has been seen in some parts. A pick-up in private consumption has become evident, with downward pressure stemming from COVID-19, particularly on services consumption, waning. Housing investment has picked up. Public investment has been relatively weak, albeit at a high level. 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), despite being affected by the reduction in mobile phone charges, has been slightly positive, reflecting price rises of energy and other items. Meanwhile, inflation expectations have risen moderately.

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 is likely to recover as downward pressure stemming from COVID-19 on services consumption and the effects of supply-side constraints wane, while being supported by the increase in external demand, accommodative financial conditions, and the government's economic measures. In the corporate sector, exports and production are expected to increase firmly, supported by steady external demand, as the effects of supply-side constraints wane. In this situation, a virtuous cycle is projected to continue operating, in which improvement in corporate profits leads to a rise in business fixed investment. In the household sector, with vigilance against COVID-19 and the effects of supply-side constraints on automobiles waning, private consumption is likely to recover, particularly for face-to-face services and durable goods.

Thereafter, 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. In this situation, Japan's economy is projected to see an acceleration in its growth pace, mainly due to the effects of the government's economic measures and of the recovery in production to catch up with demand. Toward the end of the projection period, the economy is likely to continue growing, albeit slower, at a pace above its potential growth rate.

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, Japan's exports of goods, mainly automobile-related ones, are expected to increase clearly for the time being as supply-side constraints on parts wane. Thereafter, they are projected to continue increasing on the back of firm expansion in global demand, including 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 is 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 the rise in 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 as well as for research and development (R&D) investment related to decarbonization -- supported by improvement in corporate profits, accommodative financial conditions, and the government's economic measures, although weakness is projected to remain for the time being in investment by the face-to-face services sector.

Private consumption, despite being restrained for the time being, mainly through vigilance against COVID-19, is expected to recover, supported by the materialization of pent-up demand, such as for services, and by the government's economic measures, as the resumption of consumption activities progresses while public health is being protected, mainly due to the widespread vaccinations. Thereafter, private consumption is projected to continue increasing at a slower but moderate pace, 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 be at a relatively high level, reflecting progress such as in construction related to building national resilience. Government consumption is likely to increase, mainly reflecting a pick-up in healthcare expenditure and enhancement of the COVID-19 vaccination and medical treatment systems, but see a lowering in its level thereafter due to a reduction in expenditure related to COVID-19.

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 in positive territory for the time being. That is, albeit with fluctuations due to temporary factors such as the "Go To Travel" campaign, the increase in the CPI is expected to be brought about by the rise in energy prices, the moderate pass-through of raw material cost increases on the back of improvement in the output gap, and dissipation of the effects of last year's reduction in mobile phone charges.

Thereafter, while the positive contribution of the rise in energy prices to the CPI is likely to wane, the underlying inflationary pressure is projected to increase, mainly on the back of improvement in the output gap and the rise in medium- to long-term inflation expectations. The year-on-year rate of increase in the CPI therefore is expected to stay at around 1 percent toward the end of the projection period.

The output gap, which captures the utilization of labor and capital, has been negative recently. However, it is projected to turn positive around the first half of fiscal 2022 with the economy returning to a growth path that outpaces its potential growth rate, and then continue to expand moderately. 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. Since the onset of the pandemic in March 2020, it also has supported financing, mainly of firms, under the Special Program to Support Financing in Response to the Novel Coronavirus (COVID-19). The government has also conducted various measures to support financing, mainly of firms. Private financial institutions have actively fulfilled the functioning of financial intermediation. In this situation, firms' financial

[2] Under a specific methodology, Japan's recent potential growth rate is estimated to be 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 particularly high uncertainties in the current phase over how COVID-19 will affect the trends in productivity or labor supply.

positions have continued to improve on the whole due to a pick-up in economic activity, although weakness has remained in financial positions of firms in industries that are susceptible to the impact of COVID-19, as well as small and medium-sized ones.

As the Bank pursues QQE with Yield Curve Control, it is expected that financial conditions will remain accommodative and that this will support an increase in private demand.[3] That is, the environment for external funding, such as bank borrowing and the issuance of CP and corporate bonds, is projected to remain accommodative. In addition, backed by the Bank's measures to support financing, the government's measures, and efforts made by private financial institutions, firms' financial positions -- including those of small and medium-sized ones, for which weakness has remained to date -- are likely to continue on an improving trend along with an economic recovery.

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 <u>impact of COVID-19 on private consumption as well as on firms' export and production activities</u>. If people's vigilance against COVID-19 entrenches due, for example, to the spread of highly contagious variants, there is a risk that private consumption will be pushed down. In addition, in a case where COVID-19 cases surge in areas such as Asia, which is closely related to Japan's economy, with global supply-demand conditions of digital-related goods such as semiconductors remaining tight, export and production activities of Japanese firms could also be pushed down through supply-chain disruptions. On the other hand, if people's vigilance against COVID-19 lessens significantly with the widespread vaccinations and the rollout of antiviral medicines, economic activity could be pushed up through, for example, a larger-than-expected increase in pent-up demand for services consumption.

The second factor is <u>developments in overseas economies</u>. If supply-side constraints that mainly stem from the stagnation of logistics and labor shortage become prolonged or amplified in advanced economies such as the United States, there is a risk that the growth rates of overseas economies will deviate downward from the baseline scenario. In addition, signs of a slowdown in the Chinese economy could become clearer due, for example, to the effects of adjustments in its real estate sector, with the medium- to long-term growth potential declining gradually. Furthermore, there is a risk that overseas economies, particularly emerging economies, will deviate downward from the baseline

[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.

scenario if global financial conditions tighten by more than expected amid concern in global financial markets over steps taken by advanced economies toward reducing monetary accommodation on the back of elevated inflation rates. 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 in the respective economies due to various restrictions during the COVID-19 pandemic.

The third factor is developments in commodity prices. Due to a global surge in demand brought about by progress with the resumption of economic activity, commodity prices have been hovering at a high level for a prolonged period, with supply factors, including a decline in capital investment related to fossil fuels against the background of efforts toward decarbonization, also being taken into consideration. As described earlier, corporate profits in Japan basically are projected to continue on an improving trend on the back of the recovery in domestic and external demand, despite being affected by deterioration in the terms of trade that reflects the rise in commodity prices. That said, if the rise in commodity prices becomes prolonged or is not smoothly passed on to selling prices, Japan's economic recovery trend could be negatively affected, mainly through deterioration in corporate profits.

The fourth factor considered from a somewhat long-term perspective is firms' and households' medium- to long-term growth expectations. It is expected that efforts with a view to the post-COVID-19 era, digitalization, and decarbonization will change Japan's economic structure and people's working styles. Depending on how households and firms react to such changes, their medium- to long-term growth expectations, the potential growth rate, and the output gap could go either upward or downward.

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 high uncertainties over firms' price-setting behavior, which could exert either upward or downward pressure on prices. In the baseline scenario of the outlook for prices, as described earlier, it is projected that firms' price-setting stance will gradually become active and the pass-through of raw material cost increases will progress moderately, with continuing improvement in the output gap. That said, depending on the degree of upward pressure from raw material costs and on developments in firms' inflation expectations, the pass-through of cost increases to selling prices could accelerate by more than expected and lead prices to deviate upward from the baseline scenario. On the other hand, given that, in Japan, the behavior and mindset based on the assumption that prices will not increase easily are deeply entrenched mainly among firms, there is 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, and that prices will deviate downward from the baseline scenario.

The second risk is <u>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</u>. 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 <u>first perspective</u> 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 <u>second perspective</u> 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, including variants, and its impact on domestic and overseas economies continue to warrant attention. In addition, there are high uncertainties over future developments in overseas economies given the effects of supply-side constraints, as well as in commodity prices and their impact on economic activity and prices. 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 thereafter. Risks to prices are generally balanced. 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 pandemic. 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

[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."

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.

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) 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.

(Appendix)

Forecasts of the Majority of the Policy Board Members

y/y % chg.

	Real GDP	CPI (all items less fresh food)
Fiscal 2021	+2.7 to +2.9 [+2.8]	0.0 to +0.1 [0.0]
Forecasts made in October 2021	+3.0 to +3.6 [+3.4]	0.0 to +0.2 [0.0]
Fiscal 2022	+3.3 to +4.1 [+3.8]	+1.0 to +1.2 [+1.1]
Forecasts made in October 2021	+2.7 to +3.0 [+2.9]	+0.8 to +1.0 [+0.9]
Fiscal 2023	+1.0 to +1.4 [+1.1]	+1.0 to +1.3 [+1.1]
Forecasts made in October 2021	+1.2 to +1.4 [+1.3]	+0.9 to +1.2 [+1.0]

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

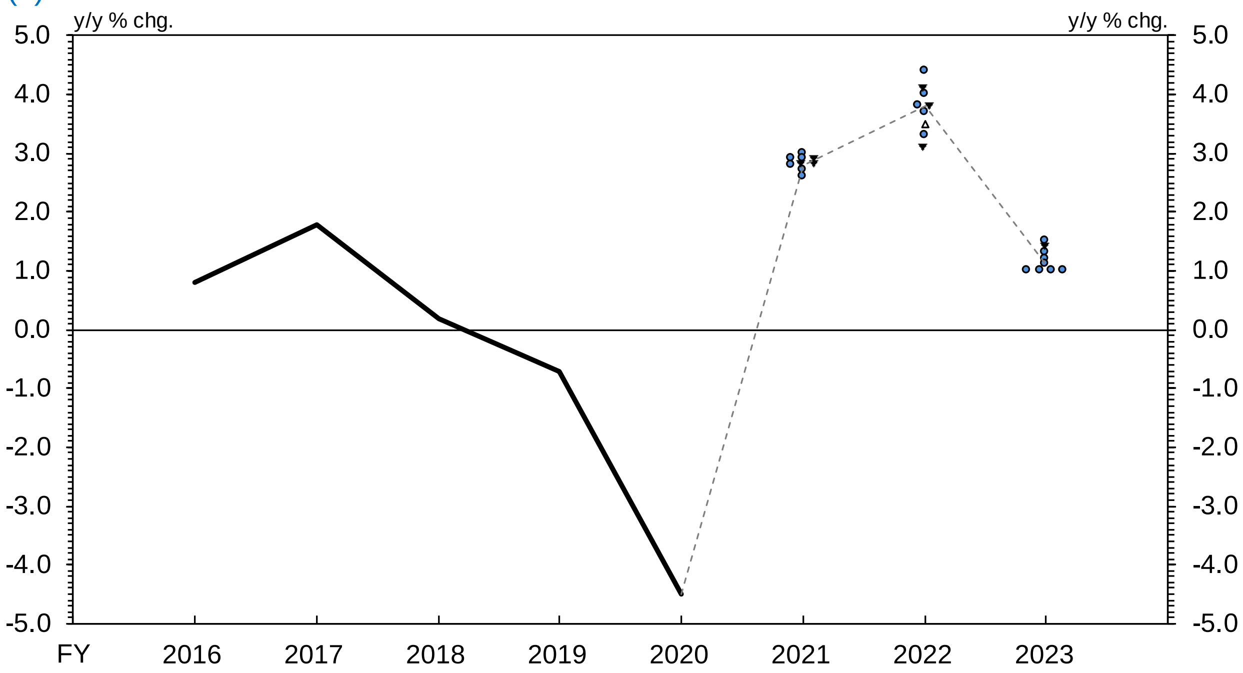
2. The forecasts of the majority of the Policy Board members are constructed as follows: each Policy Board member's forecast takes the form of a point estimate -- namely, the figure to which they attach the highest probability of realization. These forecasts are then shown as a range, with the highest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

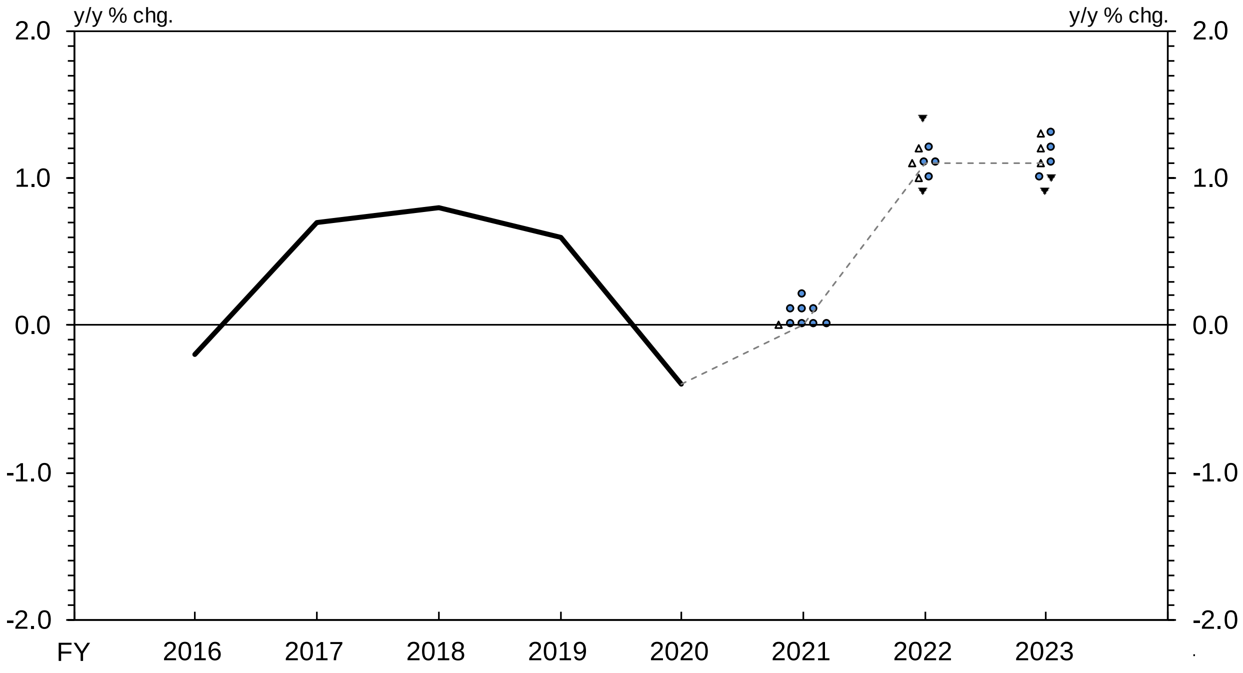
4. The reduction in mobile phone charges by major carriers conducted in spring 2021 is estimated to directly push down the CPI for fiscal 2021 by around 1.1 percentage points.

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."