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BANK OF JAPAN

Outlook for Economic Activity and Prices

January 2020

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

Outlook for Economic Activity and Prices (January 2020)

The Bank's View[1]

Summary

- Japan's economy is likely to continue on an expanding trend throughout the projection period -- that is, through fiscal 2021 -- as the impact of the slowdown in overseas economies on domestic demand is expected to be limited, although the effects of the slowdown are likely to remain for the time being. Although exports are projected to show some weakness for the time being, they are expected to be on a moderate increasing trend, with overseas economies growing moderately on the whole. Domestic demand also is likely to follow an uptrend, with a virtuous cycle from income to spending being maintained, mainly against the background of highly accommodative financial conditions and active government spending, although it has declined recently, due mainly to the effects of the consumption tax hike and natural disasters.
- The year-on-year rate of change in the consumer price index (CPI, all items less fresh food) is likely to increase gradually toward 2 percent, mainly on the back of the output gap remaining positive and medium- to long-term inflation expectations rising throughout the projection period, despite such effects as of the past decline in crude oil prices for the time being.
- Comparing the current projections with the previous ones, the projected growth rates are higher, mainly for fiscal 2020, reflecting the effects of the government's economic measures. The projected rates of increase in the CPI are more or less unchanged.
- With regard to the risk balance, risks to economic activity are skewed to the downside, particularly regarding developments in overseas economies. Risks to prices are skewed to the downside, mainly due to the downside risks to economic activity and uncertainties over developments in medium- to long-term inflation expectations. The momentum toward achieving the price stability target of 2 percent is maintained but is not yet sufficiently firm, and thus developments in prices continue to warrant careful attention.

[1] The text of "The Bank's View" -- the outlook for economic activity and prices as well as the Bank's thinking on the conduct of monetary policy, both of which are based on individual Policy Board members' views -- was decided by the Policy Board at the Monetary Policy Meeting held on January 20 and 21, 2020.

I. Current Situation of Economic Activity and Prices in Japan

Japan's economy has been on a moderate expanding trend, with a virtuous cycle from income to spending operating, although exports, production, and business sentiment have shown some weakness, mainly affected by the slowdown in overseas economies and natural disasters. Overseas economies have been growing moderately on the whole, although slowdowns have continued to be observed. In this situation, exports have continued to show some weakness, and industrial production has declined recently, due partly to the effects of natural disasters. On the other hand, with corporate profits staying at high levels on the whole, business fixed investment has continued on an increasing trend. Private consumption has been increasing moderately, albeit with fluctuations due to such effects as of the consumption tax hike, against the background of steady improvement in the employment and income situation. Housing investment has been more or less flat, and public investment has increased moderately. Meanwhile, labor market conditions have remained tight. Financial conditions are highly accommodative. On the price front, the year-on-year rate of change in the CPI (all items less fresh food, and the same hereafter) is at around 0.5 percent. Inflation expectations have been more or less unchanged.

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

A. Baseline Scenario of the Outlook for Economic Activity

With regard to the outlook, Japan's economy is likely to continue on an expanding trend throughout the projection period -- that is, through fiscal 2021 -- as the impact of the slowdown in overseas economies on domestic demand is expected to be limited, although the effects of the slowdown are likely to remain for the time being.

In a situation where the growth pace of overseas economies will take some time to pick up, exports are projected to show some weakness for the time being. However, overseas economies are expected to grow moderately on the whole, with the growth rates rising on the back of the materialization of the effects of macroeconomic policies in each country as well as a pick-up in the manufacturing sector due mainly to the global cycle for IT-related goods shifting toward a phase of improvement. Under these circumstances, Japan's exports are projected to return to their moderate increasing trend.

Although domestic demand has declined recently, due mainly to the effects of the consumption tax hike and natural disasters, it is likely to follow an uptrend, with a virtuous cycle from income to spending being maintained in both the corporate and household sectors, mainly against the background of highly accommodative financial conditions and active government spending. Business fixed investment -- mainly investment related to urban redevelopment projects, labor-saving investment to address labor shortage, and research and development (R&D) investment for growth areas -- is likely to continue increasing moderately amid accommodative financial conditions, although the pace of increase is expected to decelerate temporarily, mainly for manufacturing, due to the effects of the slowdown in overseas economies, and such factors as an accumulation of capital stock are projected to exert downward pressure from a somewhat longer-term perspective. Private consumption is expected to follow a moderate increasing trend with such effects as of the consumption tax hike waning gradually and the employment and income situation continuing to improve. Meanwhile, government spending is expected to increase steadily through fiscal 2020 due to expansion in expenditure such as for disaster-related restoration and reconstruction as well as national resilience, both of which reflect the government's economic measures, in addition to Olympic Games-related demand; government spending thereafter is likely to remain at a relatively high level. Thus, the impact of the slowdown in overseas economies on domestic demand is expected to be limited.

On this basis, although Japan's economy has grown at a slower pace than its potential recently, it is expected to see an acceleration in its growth pace thereafter.[2] Thus, on average, the economy is likely to continue growing at about the same pace as its potential or at a somewhat faster pace. Comparing the current projections with the previous ones, the projected growth rates are higher, mainly for fiscal 2020, reflecting the effects of the government's economic measures.

Looking at the financial conditions on which the above outlook is based, short- and long-term real interest rates are assumed to be in negative territory throughout the projection period as the Bank pursues "Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control."[3] Financial institutions' active lending attitudes, as well as favorable conditions for corporate bond and CP issuance, are likely to be maintained and support firms' and households' activities from the financial side. Thus, financial conditions are likely to remain highly accommodative.

Meanwhile, the potential growth rate is expected to follow a moderate uptrend throughout the projection period against the backdrop of the following continuing developments: progress in implementation of the government's growth strategy, including regulatory and institutional reforms as well as measures to strengthen productivity, which are part of the economic measures; an increase in labor participation by women and seniors under such strategy; and firms' fixed investment and efforts toward improving productivity. In addition,

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[2] Under a specific methodology, Japan's potential growth rate is estimated to be in the range of 0.5-1.0 percent recently. However, the estimate of the potential growth rate varies depending on the methodologies employed and could be revised as the sample period becomes longer over time. Thus, it should be regarded as being subject to a considerable margin of error.

[3] Individual Policy Board members make their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding future policy.

as the natural rate of interest increases together with the rise in the growth potential of Japan's economy, monetary easing effects are likely to be enhanced.

B. Baseline Scenario of the Outlook for Prices

The year-on-year rate of change in the CPI has been positive but has continued to show relatively weak developments compared to the economic expansion and tight labor market conditions.

This is basically because firms' cautious wage- and price-setting stance, as well as households' cautiousness toward price rises, have not yet clearly changed in a situation where the mindset and behavior based on the assumption that wages and prices will not increase easily have been deeply entrenched. Firms' efforts to absorb upward pressure of costs by raising productivity, the technological progress in recent years, and the high wage elasticity of labor supply also are contributing factors. In addition, the continued lackluster developments in administered prices and housing rent are likely to have affected the sluggishness in prices. It has been taking time to resolve these factors that have been delaying price rises, and the situation likely has continued in which the responsiveness of prices to the output gap, as well as inflation expectations that are strongly affected by the adaptive formation mechanism, do not rise easily.

With regard to the outlook, the year-on-year rate of change in the CPI is likely to increase gradually toward 2 percent, mainly on the back of the output gap remaining positive and medium- to long-term inflation expectations rising throughout the projection period, despite such effects as of the past decline in crude oil prices for the time being. Comparing the current projections with the previous ones, the projected rates of increase in the CPI are more or less unchanged.[4]

The mechanism through which the year-on-year rate of change in the CPI increases gradually toward 2 percent can be explained by the following factors that determine general price inflation. First, although the output gap -- which shows the utilization of labor and capital -- recently seems to have narrowed within positive territory due to such effects as of the slowdown in overseas economies and the consumption tax hike, it is likely to widen moderately thereafter through the end of the projection period, as the economic growth rate is expected to exceed its potential somewhat. Under such circumstances, further price rises are likely to be observed widely as households' tolerance of price rises

[4] Taking into account the actual CPI figures for October and November 2019, the effect of the October 2019 consumption tax hike on the year-on-year rate of change in the CPI (all items less fresh food) for October 2019 onward is estimated to be 1.0 percentage point; the effects for fiscal 2019 and 2020 are estimated to be 0.5 percentage point for each fiscal year. In addition, based on a specific assumption, the effects of policies concerning the provision of free education on the year-on-year rates of change in the CPI (all items less fresh food) for fiscal 2019 and 2020 are estimated to be around minus 0.3 percentage point and around minus 0.4 percentage point, respectively.

increases, mainly reflecting a rise in wage growth rates, and as firms' stance shifts toward further raising prices.

Second, medium- to long-term inflation expectations have remained more or less unchanged. As for the outlook, such expectations are likely to follow an increasing trend and gradually converge to 2 percent on the back of the following: (1) in terms of the adaptive component, a rise in the observed inflation rate is likely to push up inflation expectations, and (2) in terms of the forward-looking component, the Bank will pursue monetary easing through its strong commitment to achieving the price stability target, which will be effective in pushing up inflation expectations.[5]

Third, regarding import prices, the past decline in crude oil prices is likely to push down the CPI through the fall in energy prices for the time being. However, such downward pressure is projected to diminish gradually.

Meanwhile, the increase in labor participation by women and seniors, as well as firms' strengthening of efforts toward improving productivity, are expected to increase upward pressure on prices in the long term. Specifically, as the growth potential of the economy as a whole rises, reflecting such moves, firms' and households' spending behavior can be expected to become active.

III. Risks to Economic Activity and Prices

A. Risks to Economic Activity

The following four factors are upside and downside risks to the Bank's baseline scenario regarding the economy.

The first is developments in overseas economies. Specifically, the following are considered as risks: the consequences of protectionist moves and their effects; developments in emerging and commodity-exporting economies such as China; developments in global demand for IT-related goods; developments in the United Kingdom's exit from the European Union (EU) and their effects; geopolitical risks; and developments in global financial markets under these circumstances. Downside risks concerning overseas economies seem to be still significant, although they have decreased somewhat compared to a while ago, and it also is necessary to pay close attention to their impact on firms' and households' sentiment in Japan.

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[5] Medium- to long-term inflation expectations can be regarded as consisting of two components: a forward-looking component, in which inflation expectations converge to the price stability target set by the central bank, and a backward-looking, or adaptive, component that reflects the observed inflation rate. For details, see the Bank's *Comprehensive Assessment: Developments in Economic Activity and Prices as well as Policy Effects since the Introduction of Quantitative and Qualitative Monetary Easing (QQE)* released in September 2016.

The second risk is the effects of the consumption tax hike conducted in October 2019. Fluctuations in demand prior to and after the tax hike seem to have been constrained this time compared with those of the previous tax hike in April 2014, partly due to various measures implemented by the government. Although the impact of a decline in real income is expected to be smaller than that of the previous tax hike, it continues to warrant attention as it is likely to depend on consumer sentiment, the employment and income situation, and developments in prices.

Third, firms' and households' medium- to long-term growth expectations may be either raised or lowered depending on the following: efforts to address medium- to long-term issues such as the declining birthrate and aging population; developments in regulatory and institutional reforms, particularly in the labor market; innovation in the corporate sector; and the employment and income situation.

Fourth, in the event that confidence in fiscal sustainability in the medium to long term declines, the economy may deviate downward from the baseline scenario through increasing concerns regarding the future and the rises in long-term interest rates associated with them. On the other hand, there also is a possibility that the economy will deviate upward from the baseline scenario if confidence in the path toward fiscal consolidation strengthens and concerns regarding the future are alleviated.

B. Risks to Prices

As mentioned above, with regard to risks to economic activity, the downside risks concerning overseas economies in particular seem to be still significant. If these risks materialize, close attention should be paid to the possibility that prices also will be affected to some extent.

In addition, the specific factors that could exert upside and downside risks to prices are as follows. The first is developments in firms' and households' medium- to long-term inflation expectations. Although inflation expectations are likely to follow an increasing trend, there is a risk that a rise in such expectations will be delayed through the adaptive formation mechanism if it takes longer than projected for firms' stance to shift toward further raising wages and prices and actual inflation consequently remains relatively sluggish.

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

Third, developments in foreign exchange rates and international commodity prices going forward, as well as the extent to which such developments will spread to import prices and domestic prices, may lead prices to deviate either upward or downward from the baseline scenario.

IV. Conduct of Monetary Policy

In the context of the price stability target, the Bank assesses the aforementioned economic and price situation from two perspectives and then outlines its thinking on the future conduct of monetary policy.[6]

The first perspective involves an examination of the baseline scenario for the outlook. The year-on-year rate of change in the CPI is likely to increase gradually toward 2 percent. Although it is necessary to carefully examine the risks to economic activity and prices, the momentum toward achieving the price stability target of 2 percent appears to be maintained. This is because (1) firms' stance is expected to gradually shift toward further raising wages and prices with the output gap remaining positive, and (2) medium- to long-term inflation expectations have been more or less unchanged and are projected to rise gradually as further price rises come to be observed widely.

The second perspective involves an examination of the risks considered most relevant to the conduct of monetary policy. With regard to the outlook for economic activity, risks are skewed to the downside, particularly regarding developments in overseas economies. Regarding the outlook for prices, risks are skewed to the downside, mainly due to the downside risks to economic activity and uncertainties over developments in medium- to long-term inflation expectations. Although there has been no further increase in the possibility that the momentum toward achieving the price stability target will be lost, it is necessary to continue to pay close attention to the possibility. Examining financial imbalances from a longer-term perspective, there is no sign so far of excessively bullish expectations in asset markets or in the activities of financial institutions. However, prolonged downward pressure on financial institutions' profits, with the low interest rate environment and severe competition among financial institutions continuing, could create risks of a gradual pullback in financial intermediation and of destabilizing the financial system. Although these risks are judged as not significant at this point, mainly because financial institutions have sufficient capital bases, it is necessary to pay close attention to future developments.

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

[6] As for the examination from two perspectives in the context of the price stability target, see the Bank's statement released on January 22, 2013, entitled "The 'Price Stability Target' under the Framework for the Conduct of Monetary Policy."

for maintaining that target in a stable manner. It will continue expanding the monetary base until the year-on-year rate of increase in the observed CPI (all items less fresh food) exceeds 2 percent and stays above the target in a stable manner. As for the policy rates, the Bank expects short- and long-term interest rates to remain at their present or lower levels as long as it is necessary to pay close attention to the possibility that the momentum toward achieving the price stability target will be lost. It will examine the risks considered most relevant to the conduct of monetary policy and make policy adjustments as appropriate, taking account of developments in economic activity and prices as well as financial conditions, with a view to maintaining the momentum toward achieving the price stability target. In particular, in a situation where downside risks to economic activity and prices, mainly regarding developments in overseas economies, are significant, the Bank will not hesitate to take additional easing measures if there is a greater possibility that the momentum toward achieving the price stability target will be lost.

(Appendix)

Forecasts of the Majority of 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 2019	+0.8 to +0.9 [+0.8]	+0.6 to +0.7 [+0.6]	+0.4 to +0.5 [+0.4]
Forecasts made in October 2019	+0.6 to +0.7 [+0.6]	+0.6 to +0.8 [+0.7]	+0.4 to +0.6 [+0.5]
Fiscal 2020	+0.8 to +1.1 [+0.9]	+1.0 to +1.1 [+1.0]	+0.9 to +1.0 [+0.9]
Forecasts made in October 2019	+0.6 to +0.9 [+0.7]	+0.8 to +1.2 [+1.1]	+0.7 to +1.1 [+1.0]
Fiscal 2021	+1.0 to +1.3 [+1.1]	+1.2 to +1.6 [+1.4]	
Forecasts made in October 2019	+0.9 to +1.2 [+1.0]	+1.2 to +1.7 [+1.5]	

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

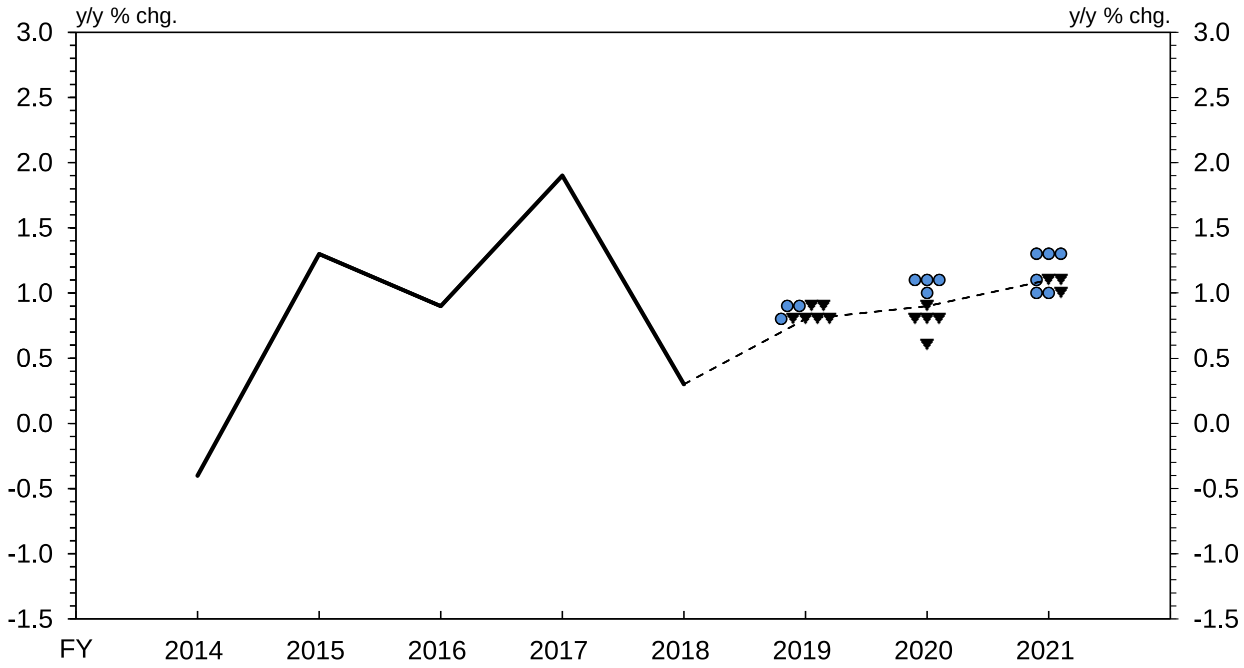
2. The forecasts of the majority of the Policy Board members are constructed as follows: each Policy Board member's forecast takes the form of a point estimate -- namely, the figure to which he or she attaches the highest probability of realization. These forecasts are then shown as a range, with the highest figure and the lowest figure excluded. The range does not indicate the forecast errors.

3. Individual Policy Board members make their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding future policy.

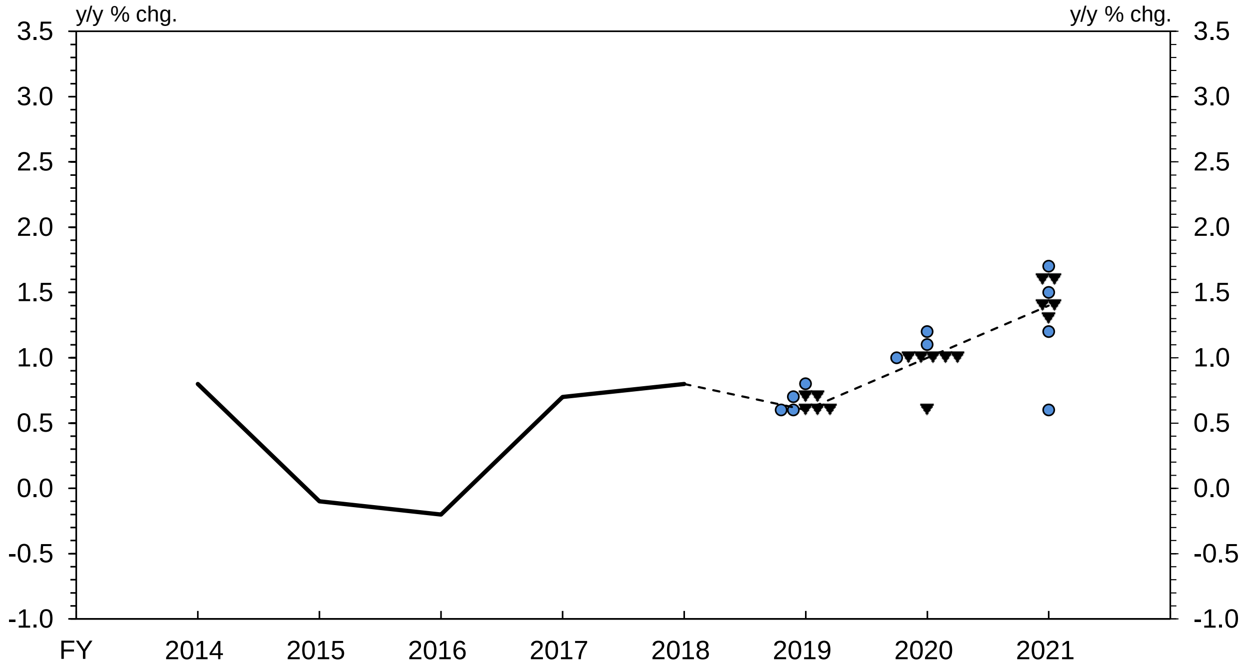
4. With regard to policies concerning the provision of free education, it is assumed that measures such as free higher education will be introduced in April 2020. Taking into account the actual CPI figures for October and November 2019, the direct effects of the October 2019 consumption tax hike on the CPI for fiscal 2019 and 2020 are estimated to be 0.5 percentage point for each fiscal year. In addition, based on a specific assumption, the direct effects of policies concerning the provision of free education on the CPI for fiscal 2019 and 2020 are estimated to be around minus 0.3 percentage point and around minus 0.4 percentage point, respectively.

Policy Board Members' Forecasts and Risk Assessments

(1) Real GDP



(2) CPI (All Items Less Fresh Food)



Notes: 1. Solid lines show actual figures, while dotted lines show the medians of the Policy Board members' forecasts (point estimates).

2. The locations of ●, △, and ▼ in the charts indicate the figures for each Policy Board member's forecasts to which he or she attaches the highest probability. The risk balance assessed by each Policy Board member is shown by the following shapes: ● indicates that a member assesses "upside and downside risks as being generally balanced," △ indicates that a member assesses "risks are skewed to the upside," and ▼ indicates that a member assesses "risks are skewed to the downside."

3. The CPI figures for fiscal 2014 and 2015 exclude the direct effects of the consumption tax hike in April 2014.

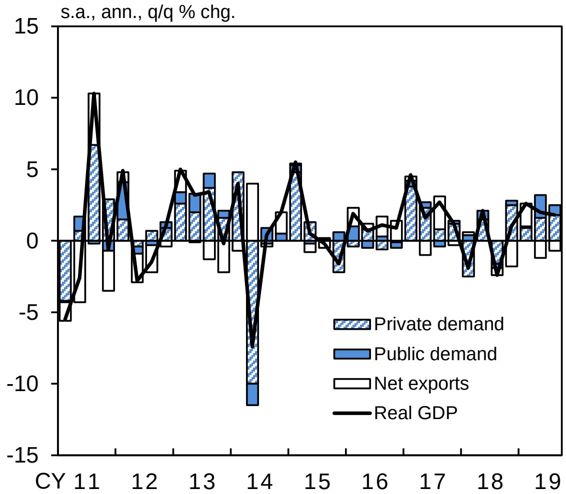
The Background[7]

I. Current Situation of Economic Activity and Its Outlook

A. Economic Developments

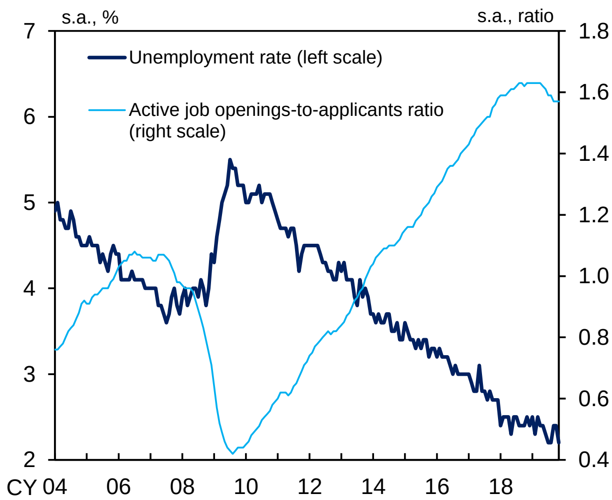
Looking back at Japan's economy since the October 2019 Outlook Report, the real GDP growth rate for the July-September quarter of 2019 registered positive growth for four consecutive quarters, marking 0.4 percent on a quarter-on-quarter basis and 1.8 percent on an annualized basis (Chart 1). This was underpinned by an increase in domestic demand such as business fixed investment and private consumption, although external demand made a negative contribution, reflecting the effects of the slowdown in overseas economies. In this situation, the number of employed persons has followed an uptrend and labor market conditions, as seen in the unemployment rate and active job openings-to-applicants ratio, have remained tight (Charts 2 and 3). The output gap -- which captures the utilization of labor and capital -- for the July-September quarter has remained substantially positive at around the same level as the April-June quarter (Chart 4). Indicators since October suggest that exports, production, and business sentiment have shown some weakness, affected by the slowdown in overseas economies, the consumption tax hike, and natural disasters. Domestic demand has maintained an uptrend, mainly in terms of business fixed investment and government spending, although such effects as of the tax hike and natural disasters recently have been observed, mainly in durable goods

Chart 1: Real GDP



Source: Cabinet Office.

Chart 2: Labor Market Conditions



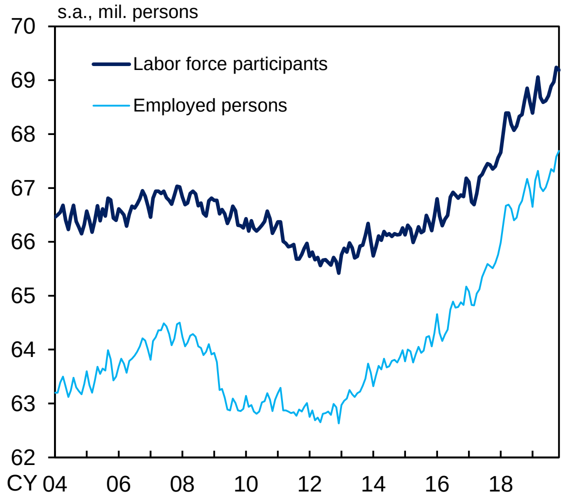
Sources: Ministry of Internal Affairs and Communications; Ministry of Health, Labour and Welfare.

[7] "The Background" provides explanations of "The Bank's View" decided by the Policy Board of the Bank of Japan at the Monetary Policy Meeting held on January 20 and 21, 2020.

consumption. Thus, Japan's economy is judged as having been on a moderate expanding trend with a virtuous cycle from income to spending being maintained.

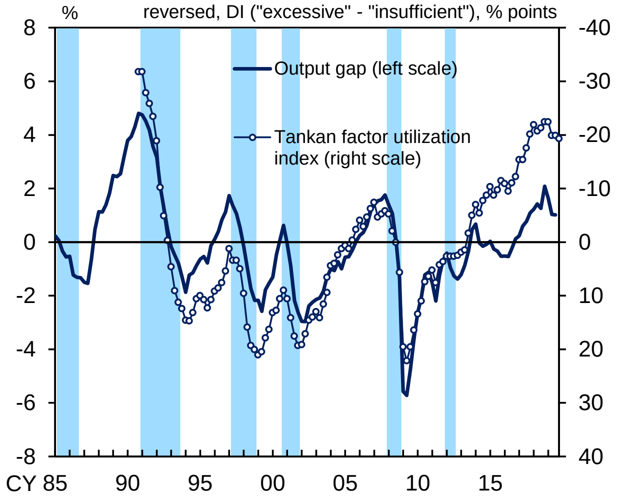
With regard to the outlook, Japan's economy is likely to maintain an expanding trend as domestic demand is expected to follow an uptrend with a virtuous cycle from income to spending continuing to operate, supported by synergetic stimulus effects brought about by highly accommodative financial conditions and active government spending, although the effects of the slowdown in overseas economies are likely to remain for the time being.[8] Specifically, government spending is expected to increase steadily through fiscal 2020 due to expansion such as in construction related to restoration and reconstruction following natural disasters as well as to national resilience, which reflects the economic measures decided by the Cabinet at the end of last year, in addition to Olympic Games-related demand; government spending thereafter is likely to remain at a relatively high level. Although exports are likely to show some weakness for the time being due to the effects of the slowdown in overseas economies, they are projected to return to their moderate increasing trend thereafter, with the growth pace of overseas economies picking up. Business fixed investment -- mainly construction investment related to urban redevelopment projects and that aimed at meeting inbound tourism demand, labor-saving investment to address labor shortage, as well as software and R&D investments for growth areas -- is likely to continue increasing moderately, supported by

Chart 3: Labor Force Participation and Employment



Source: Ministry of Internal Affairs and Communications.

Chart 4: Output Gap

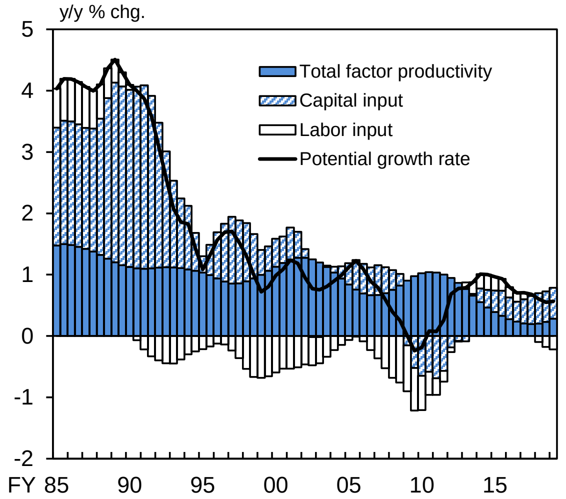


Source: Bank of Japan.
Notes: 1. The output gap is based on staff estimations.
2. The Tankan factor utilization index is calculated as the weighted average of the production capacity DI and the employment conditions DI for all enterprises. The capital and labor shares are used as weights. There is a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

[8] See Box 1 for synergetic stimulus effects brought about by a policy mix of monetary easing and fiscal expansion.

highly accommodative financial conditions, although its pace of increase, mainly in machinery investment by manufacturers, is projected to decelerate temporarily, reflecting the effects of the slowdown in overseas economies. Private consumption is expected to maintain an increasing trend, albeit at a moderate pace, on the back of the improvement in the employment and income situation, with such effects as of the tax hike remaining for the time being but dissipating gradually.[9] Reflecting these developments in demand both at home and abroad, Japan's economic growth rate is expected to decline temporarily in the October-December quarter of 2019, but thereafter accelerate gradually through the end of the projection period. Thus, the economy is likely to continue growing at about the same pace as its potential or at a somewhat faster pace, when fluctuations are smoothed out (Chart 5).

Chart 5: Potential Growth Rate



Source: Bank of Japan.
Note: Based on staff estimations.

[9] The consumption tax hike conducted in October 2019 will have some impact on the GDP growth rates, mainly due to changes in household spending, through the following two channels: (1) fluctuations in demand prior to and after the tax hike and (2) a decline in real income. At present, the negative impact of the tax hike on the growth rates for fiscal 2019 and 2020 is expected to be smaller than that of the previous tax hike in fiscal 2014. This is mainly due to the following: (1) as the tax hike was conducted in the middle of fiscal 2019, there are the technical factors of fluctuations in demand prior to and after the hike offsetting each other during that fiscal year -- although they will push down the growth rate for fiscal 2020 -- and of the effects of the decline in real income being dispersed over fiscal 2019 and 2020; (2) the increase in the consumption tax rate was smaller than that of the previous tax hike and the reduced tax rate was applied to some items; (3) free education was introduced, and various measures to reduce the household burden of the tax hike and to smooth out demand were implemented; and (4) before the previous tax hike in April 2014, it was likely that a front-loaded increase in demand was seen not only in view of that hike but also in anticipation of the second round of the tax hike, which was supposed to take place in October 2015. Although fluctuations in demand prior to and after the tax hike this time seem to be constrained compared to those of the previous tax hike on the whole, considerable uncertainties remain depending on developments in consumer sentiment, as the effects of the decline in real income tend to appear gradually over time.

Comparing the current projections with the previous ones, the projected growth rates are higher, mainly for fiscal 2020, reflecting the effects of the government's economic measures.

The potential growth rate is expected to follow a moderate uptrend throughout the projection period against the backdrop of the following continuing developments: progress in implementation of the government's growth strategy, including regulatory and institutional reforms as well as measures to strengthen productivity, which are part of the economic measures; an increase in labor participation by women and seniors under such strategy; a rise in business fixed investment aimed at saving labor as well as research and development; and firms' efforts toward improving productivity.

Details of the outlook for each fiscal year are as follows. Through the end of fiscal 2019, the economic growth rate is expected to pick up from a decline in the October-December quarter of 2019 with the effects of the tax hike and natural disasters dissipating, although the effects of the slowdown in overseas economies are likely to remain. Exports, mainly of automobile-related goods and capital goods, are projected to show some weakness. Private consumption is likely to pick up from a decline at the end of last year as the effects of a reactionary decline to the increase in demand prior to the tax hike are expected to dissipate, underpinned by various measures implemented to support households accompanying the tax hike. On the other hand, business fixed investment is expected to maintain an uptrend, supported by steadiness in construction investment as well as in software and R&D investments, although it is projected to decelerate temporarily, due mainly to the decline in machinery investment by manufacturers. Government spending is likely to continue increasing moderately, mainly in construction related to restoration and reconstruction following natural disasters as well as to national resilience.

In fiscal 2020, the economy is likely to grow at a pace that exceeds its potential somewhat, as the economic measures are expected to stimulate economic activity with the growth pace of overseas economies picking up and the effects of the tax hike waning. Government spending is likely to increase steadily as expenditure on temporary facilities accompanying the hosting of the Olympic Games is expected to be made in the first half of the fiscal year and construction related to restoration and reconstruction following natural disasters, which is part of the economic measures, is projected to make progress. Exports are expected to return to a moderate uptrend, amid the recovery in global production and trade activity of the manufacturing sector, mainly for IT-related goods. Business fixed investment is likely to continue on a moderate uptrend, since machinery investment by manufacturers is expected to gradually pick up with construction investment as well as software and R&D investments remaining steady, despite being under adjustment pressure stemming from the accumulation of capital stock. With regard to private consumption and housing investment, their uptrend is likely to become evident gradually, as downward pressure stemming from the reactionary decline in demand after the tax hike and the decline in real income is expected to wane further through the second half of fiscal 2020, although the effects of those declines are projected to remain to some extent in the first half.

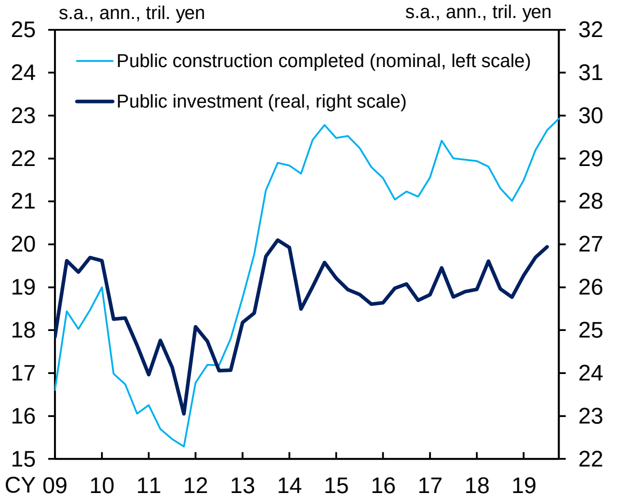
In fiscal 2021, the economic growth rate is likely to continue exceeding its potential somewhat due to a rise in the growth rates of overseas economies and a dissipation of the effects of the tax hike, while continuing to be underpinned by the effects of the government's economic measures. Government spending is likely to maintain a high level, mainly led by disaster-related reconstruction, river flood control projects, and infrastructure enhancements, all of which reflect the economic measures, although Olympic Games-related expenditure will have been completed. With the effects of the tax hike dissipating, household spending, such as private consumption and housing investment, is projected to increase clearly, supported by a rise in disposable income. Exports are projected to continue their moderate increasing trend on the back of the rise in the growth rates of overseas economies. Business fixed investment also is likely to maintain its moderate uptrend, as software and R&D investments for growth areas and labor-saving investment to address labor shortage are expected to be steady, despite being under adjustment pressure stemming from the accumulation of capital stock.

B. Developments in Major Expenditure Items and Their Background

Government Spending

Public investment has increased moderately (Chart 6). 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 the progress in construction related to restoration and reconstruction following natural disasters as well as to national resilience.[10] As for the outlook, public investment is expected to increase steadily through fiscal 2020 due to expansion such as in construction related to restoration and reconstruction following natural disasters as well as to national resilience, which reflects the latest economic measures, in addition to the progress in construction of temporary facilities for the Olympic Games; government spending thereafter is likely to remain at a relatively high level.[11]

Chart 6: Public Investment



Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Note: The figure for 2019/Q4 is that for October.

Overseas Economies

Overseas economies have been growing moderately on the whole, although slowdowns

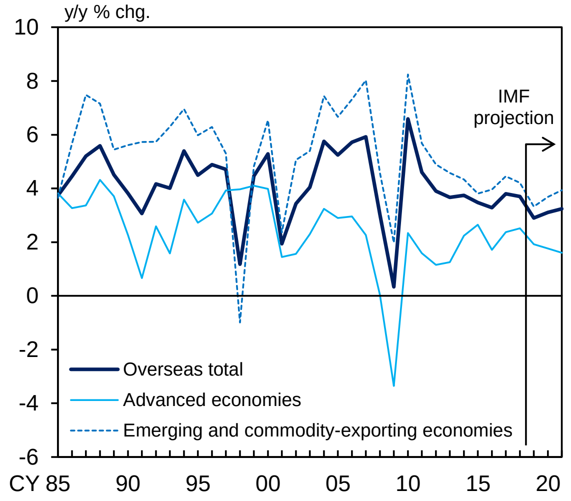
[10] In view of the three-year emergency response plan for disaster prevention, disaster mitigation, and building national resilience decided by the Cabinet on December 14, 2018 -- with a total project size of around 7 trillion yen -- measures to maintain functions, such as of important infrastructure, are to be implemented intensively over three years from fiscal 2018 through fiscal 2020.

[11] The Comprehensive Economic Measures to Create a Future with Security and Growth -- with a project size of around 26.0 trillion yen and fiscal spending of around 13.2 trillion yen -- was decided by the Cabinet on December 5, 2019. This Outlook Report assumes that the supplementary budget for fiscal 2019 and the initial budget for fiscal 2020 will be enacted and implemented, and that public investment is expected to be pushed up, mainly led by construction related to restoration and reconstruction following natural disasters as well as to flood control.

have continued to be observed (Chart 7). The Global Manufacturing PMI shows that business sentiment of manufacturing firms continued to decline from the second half of 2018, but it has bottomed out and currently is heading toward a pick-up, mainly on the back of the cycle for IT-related goods shifting toward a phase of improvement and the progress in the U.S.-China trade negotiations (Chart 8). In this situation, signs of bottoming out have been observed in the manufacturing sector's production and trade activity, which continued to show some weakness. Meanwhile, the nonmanufacturing sector has remained steady on a global basis, supported by an increase in private consumption that reflects the favorable employment and income situation, and the impact of the manufacturing sector has been limited.

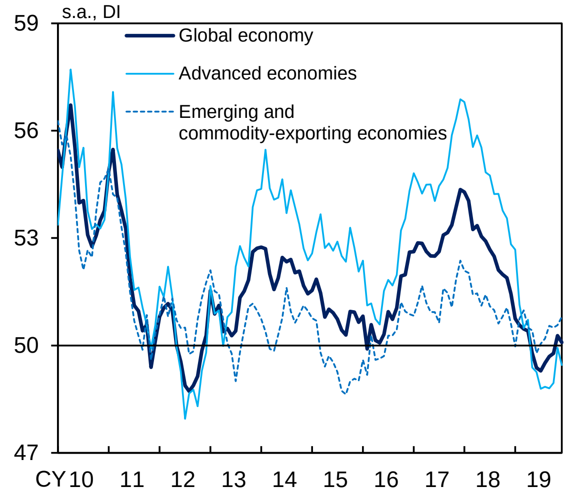
Looking at developments by major region, the U.S. economy has expanded moderately, supported by an increase in private consumption that mainly reflects the favorable employment and income situation, although some weakness has been seen in the manufacturing sector. The European economy has remained in the deceleration phase, mainly due to adjustments in the manufacturing sector. The Chinese economy has continued to see stable growth on the whole, but weakness has remained in the manufacturing sector. Other emerging and commodity-exporting economies have maintained their moderate recovery trend on the whole, but such effects as of weak exports to China have exerted downward pressure on the NIEs and the ASEAN economies.

Chart 7: 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 2019 and the "WEO update" as of January 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 8: Global Manufacturing PMI

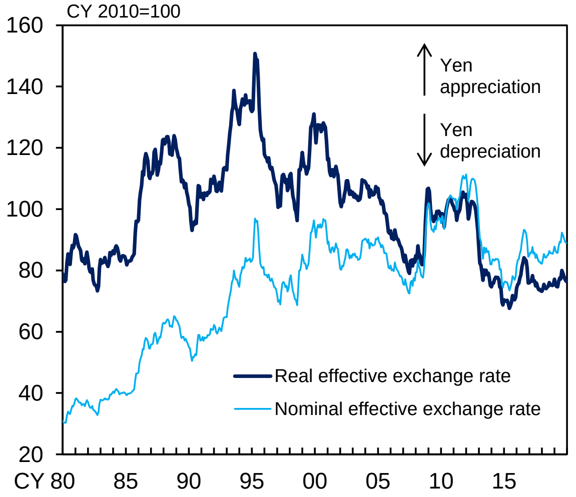


Sources: IHS Markit (© and database right IHS Markit Ltd 2020. All rights reserved.), etc.
Note: Figures for the global economy are the "J.P. Morgan Global Manufacturing PMI." Figures for advanced economies as well as emerging and commodity-exporting economies are calculated as the weighted averages of the Manufacturing PMI using GDP shares of world total GDP from the IMF as weights. Advanced economies consist of the United States, the euro area, the United Kingdom, and Japan. Emerging and commodity-exporting economies consist of 20 countries and regions, such as China, South Korea, Taiwan, Russia, and Brazil.

In terms of the outlook, although overseas economies are likely to remain in the deceleration phase for the time being, mainly in the manufacturing sector, their growth rates are projected to rise moderately thereafter on the back of the materialization of the effects of macroeconomic policies in each country and a pick-up in the manufacturing sector that mainly results from the cycle for IT-related goods shifting toward a phase of improvement.

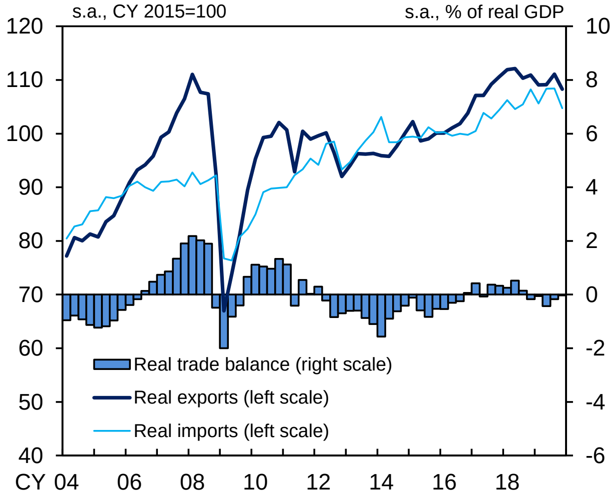
By major region, the U.S. economy is expected to maintain its moderate expansion, although the effects of the U.S.-China trade friction are likely to remain for the time being. The European economy is projected to gradually move out of its deceleration phase, reflecting the pick-up in the manufacturing sector. The Chinese economy is likely to broadly follow a stable growth path with authorities implementing macroeconomic policies in an incremental manner, despite being affected to some extent by the trade friction with the United States and measures to push forward with deleveraging. The growth rates of other emerging and commodity-exporting economies are likely to increase on the whole, reflecting a dissipation of downward pressure in some economies and the materialization of the effects of macroeconomic policies in each country.

Chart 9: 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.

Chart 10: Real Exports and Real Imports

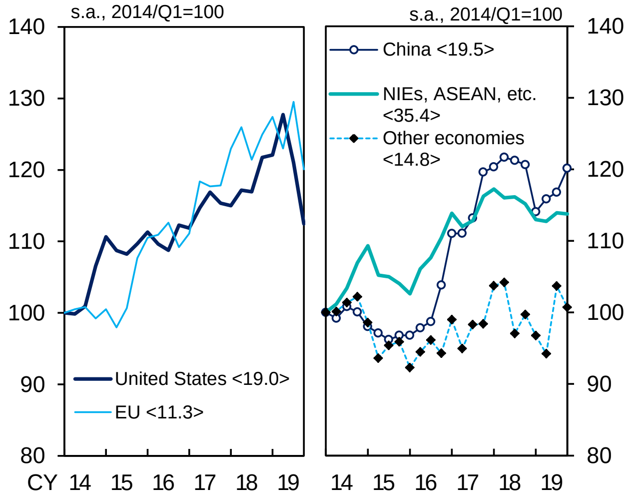


Sources: Bank of Japan; Ministry of Finance; Cabinet Office.
Note: Based on staff calculations. Figures for 2019/Q4 are October-November averages.

Exports and Imports

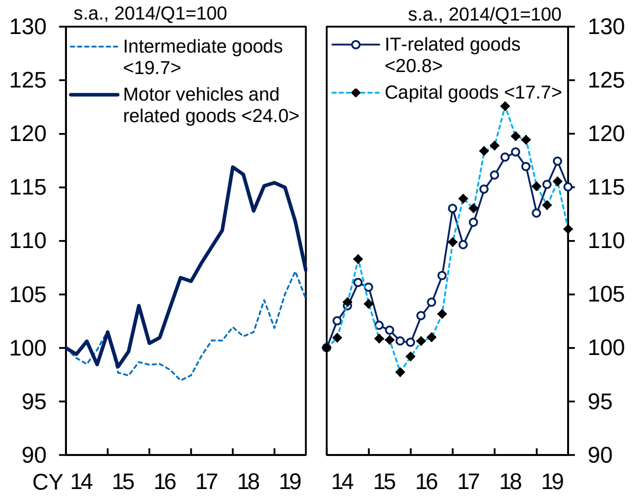
Exports have continued to show some weakness (Chart 10). By region, although exports to advanced economies such as the United States and the EU were on an increasing trend through the middle of last year, they recently have declined clearly, mainly for automobile-related goods and capital goods exports (Chart 11). Those to emerging economies, such as China as well as the NIEs and the ASEAN economies, have continued to show some weakness on the whole, although IT-related exports, for example, have been on an uptrend. By goods, automobile-related exports have registered a relatively large decline amid weak global automobile sales, partly reflecting the shift of production sites to overseas (Chart 12).[12] Excluding an increase in semiconductor production equipment and the temporary contribution of ships that show large fluctuations, exports of capital goods have remained somewhat weak, reflecting the slowdown in business fixed investment in emerging economies such as China. On the other hand, IT-related exports have been on an uptrend, mainly for parts for new smartphones and data centers, as the global cycle for IT-related goods has shifted toward a phase of improvement on the back of the progress in inventory adjustments. Meanwhile, exports of intermediate goods have been on a moderate uptrend, mainly regarding cosmetics and pharmaceuticals, but the pace of increase recently has decelerated, pushed down by declines in chemicals as well as iron and steel that are exported to Asia.

Chart 11: Real Exports by Region



Sources: Bank of Japan; Ministry of Finance.
Note: Based on staff calculations. Figures in angular brackets show the share of each country or region in Japan's total exports in 2018.
Figures for 2019/Q4 are October-November averages.

Chart 12: 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 2018.
Figures for 2019/Q4 are October-November averages.

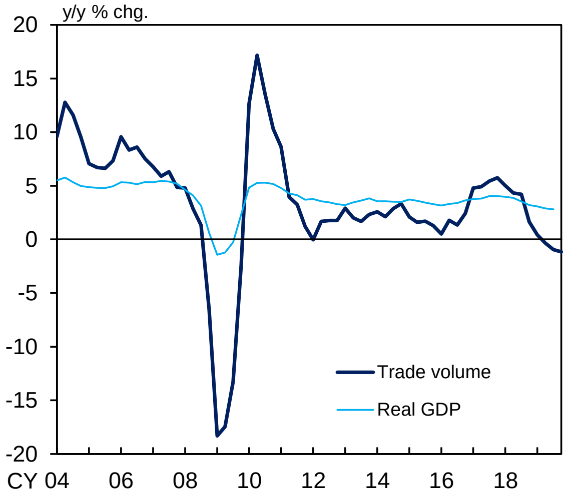
Exports are projected to still show some weakness for the time being, mainly in automobile-related goods and capital goods, although IT-related exports are likely to maintain an uptrend. Thereafter, exports are expected to return to their moderate increasing trend. This is

[12] Box 2 examines the current situation of and outlook for exports by type of goods; namely, IT-related goods, capital goods, and automobile-related goods.

based on the projection that, as the growth rates of overseas economies rise, (1) the world trade volume will increase moderately and (2) Japan's share of exports in world trade also will pick up, reflecting recovery in exports of automobile-related goods and capital goods (Charts 13 and 14).[13]

The pace of increase in the world trade volume has been clearly below world economic growth, and recently has been slightly negative on an annual basis. As for the outlook, although the pace is expected to remain somewhat weak -- below world economic growth -- for the time being, it will likely bottom out with the improvement in the business sentiment of manufacturing firms on a global basis, and then gradually head to a pick-up. Thereafter, the pace of increase in the world trade volume is expected to accelerate and return to around the same level as that of world economic growth -- that is, the world trade volume to world GDP ratio is likely to bottom out and then be more or less unchanged. This is based on the projection that, (1) as the cycle for IT-related goods will continue shifting toward a phase of improvement, (2) downward pressure on automobile sales, stemming from stricter environmental regulations and a tightening of financial conditions, will wane, and (3) business fixed investment, which has been postponed because of high uncertainties, will recover gradually. On the other hand, Japan's share of exports in world trade is expected to decline for the time being, reflecting weakness in automobile-related goods and capital goods, in which Japan has a comparative advantage, but

Chart 13: 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 2019/Q4 is the percentage change from the October-December 2018 average to October 2019.
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 14: 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 2019/Q4 is that for October.

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

pick up gradually thereafter on the back of a recovery in global demand for business fixed investment and in global automobile sales.

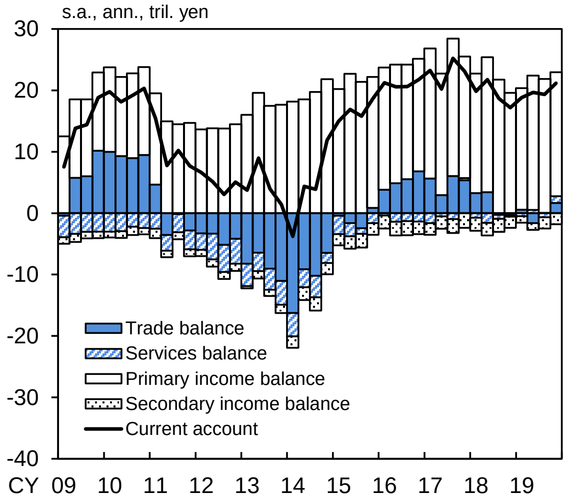
Imports have been on a moderate uptrend on average, although the effects of the reactionary decline to the increase in demand prior to the consumption tax hike have been observed (Chart 10). Going forward, they are expected to follow an uptrend, reflecting the increase in domestic demand; however, the pace is projected to remain only moderate, mainly against the background of a decline in imports of raw materials that reflects an improvement in energy efficiency.

External Balance

The nominal current account surplus has been more or less flat (Chart 15). Looking at the breakdown of developments in the current account balance, the nominal trade balance also has been more or less flat, at around zero, with weakness in exports and the effects of the past decline in crude oil prices offsetting each other. The services balance has been at around that level as well. On the other hand, the primary income balance has maintained a relatively large surplus.

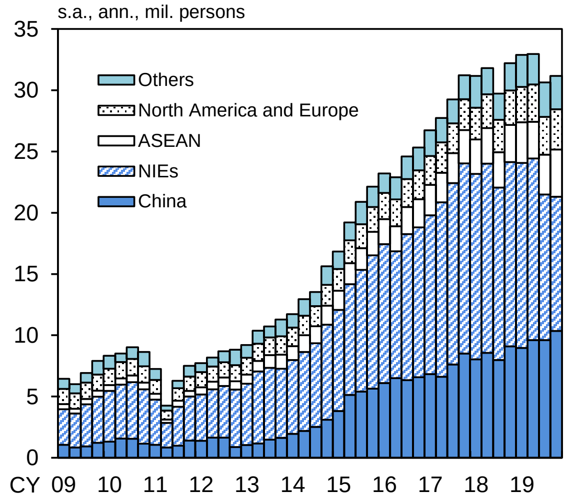
Meanwhile, the number of inbound visitors, which contributes to travel receipts in the services balance, has been on an increasing trend from a long-term perspective. However, it has been more or less flat since the middle of last year, pushed down by a decline in visitors from some Asian economies (Chart 16).

Chart 15: Current Account



Source: Ministry of Finance and Bank of Japan.
Note: Figures for 2019/Q4 are October-November averages.

Chart 16: 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.

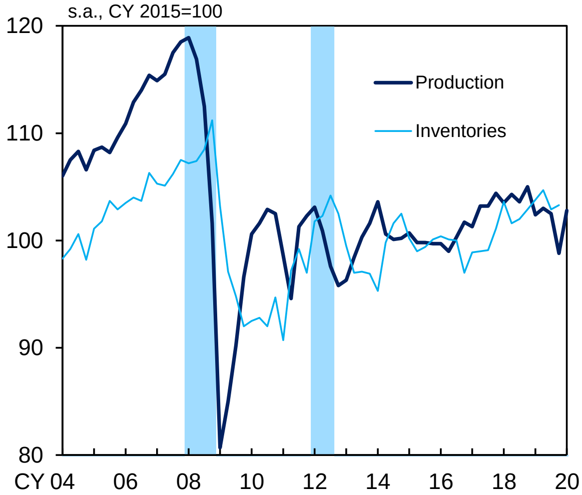
Going forward, the nominal current account surplus will likely increase moderately, mainly on the back of (1) an improving trend in the trade balance, due mainly to the increase in exports, and (2) an increase in travel receipts supported by the rise in inbound visitors.

In terms of the saving-investment balance, this outlook for the current account surplus is in line with the projected moderate expansion in excess saving in Japan's economy as a whole that reflects a declining trend in the fiscal deficit. Excess investment in the general government is projected to follow a moderate decreasing trend, as an increase in tax revenue, mainly from the consumption tax, is likely to somewhat exceed a rise in fiscal spending that primarily reflects the economic measures. Meanwhile, excess saving in both the household and corporate sectors is projected to be more or less flat.

Industrial Production

Industrial production has declined recently, due partly to the effects of natural disasters, with continued slowdowns in overseas economies (Chart 17). By major industry, transport equipment production recently has declined clearly. This is mainly attributable to weak automobile sales abroad, the shift of production sites to overseas, and the effects of supply constraints due mainly to natural disasters. The production decline in transport equipment also has led to one in relevant industries such as iron and steel, as well as nonferrous metals. The production of machinery (i.e., "general-purpose, production, and business-oriented machinery" in the *Indices of Industrial Production*) also has declined to a

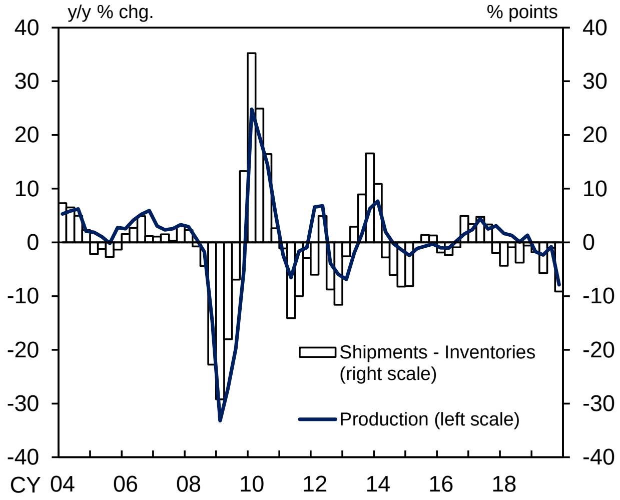
Chart 17: Industrial Production



Source: Ministry of Economy, Trade and Industry (METI).
Notes: 1. Shaded areas indicate recession periods.
2. The production figures for 2019/Q4 and 2020/Q1 are calculated based on METI projections for December 2019 and January 2020. The inventories figure for 2019/Q4 is that for November.

relatively large degree, pushed down partly by supply constraints due to natural disasters amid exports of capital goods remaining weak. On the other hand, the production of electronic parts and devices has picked up on the back of an increase in overseas demand for parts for new smartphones and data centers. Meanwhile, the shipments-inventories balance (i.e., the year-on-year rate of change in shipments minus that in inventories) has deteriorated, mainly for capital goods and production goods (Chart 18).

Chart 18: Shipments-Inventories Balance



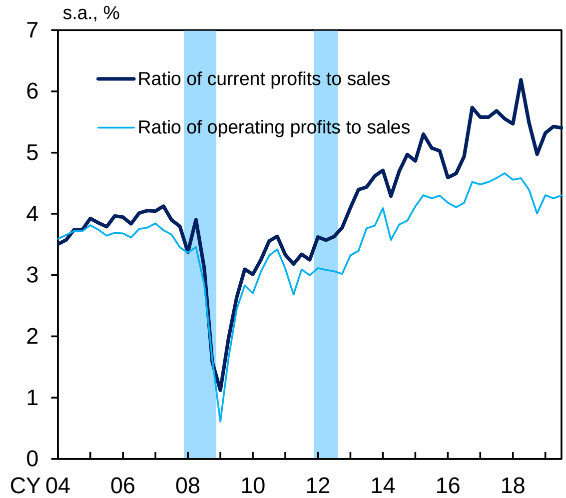
Source: Ministry of Economy, Trade and Industry.
Note: The production figure and the shipments figure for 2019/Q4 are October-November averages. The inventories figure for 2019/Q4 is that for November.

Industrial production is projected to turn to a moderate increase. This is based on the projection that the effects of the consumption tax hike will wane and IT-related exports will follow an uptrend for the time being, while an acceleration in production that more than offsets the impact of natural disasters will exert upward pressure.

Corporate Profits

Corporate profits have been at high levels on the whole, albeit with some weakness observed in part. According to the *Financial Statements Statistics of Corporations by Industry, Quarterly* (FSSC), the ratios of profits to sales for all industries and enterprises have remained at high levels, supported by an increase in domestic demand, although their levels have become lower reflecting the effects of the slowdown in overseas economies (Chart 19).

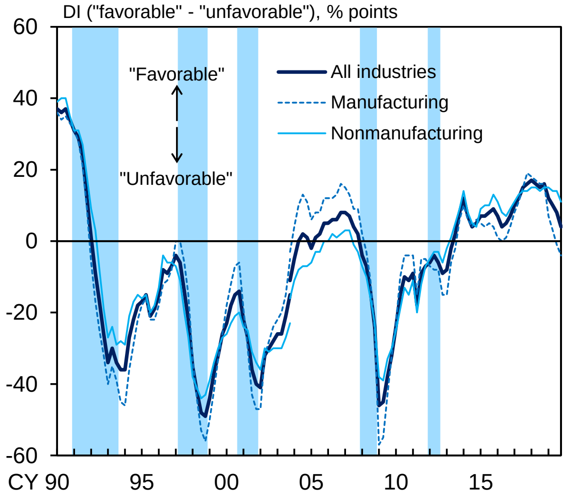
Chart 19: Corporate Profits



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.

With regard to business sentiment, while the manufacturing sector clearly has become cautious due to the effects of the slowdown in overseas economies, the nonmanufacturing sector has stayed at a favorable level on the whole, reflecting an increasing trend in domestic demand. According to the diffusion index (DI) for business conditions in the December 2019 *Tankan* (Short-Term Economic Survey of Enterprises in Japan), that for all industries and enterprises has remained positive, despite deteriorating for four consecutive quarters (Chart 20). The DI for the manufacturing sector has deteriorated in a wide range of industries -- including automobiles, general-purpose, production, and business-oriented machinery, as well as iron and steel -- mainly affected by the slowdown in overseas economies and natural disasters. On the other hand, the DI for the nonmanufacturing sector has remained at a historically favorable level, supported by increases in construction investment and public investment, although it has deteriorated somewhat due to the effects of the consumption tax hike and natural disasters.

Chart 20: Business Conditions



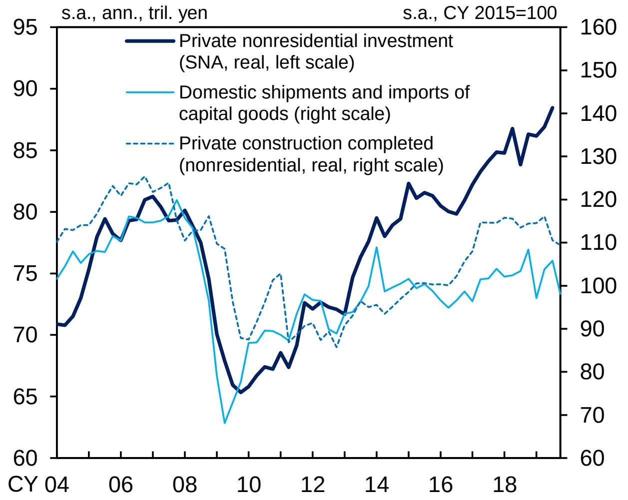
Source: Bank of Japan.
Notes: 1. Based on the *Tankan*. All enterprises. There is a discontinuity in the data in December 2003 due to a change in the survey framework.
2. Shaded areas indicate recession periods.

Corporate profits are projected to maintain their high levels on the whole, supported by firmness in the nonmanufacturing sector, such as the services industry as well as the construction and real estate industries, although downward pressure on profits -- particularly in the manufacturing sector -- is likely to remain for the time being, mainly reflecting the effects of the slowdown in overseas economies and the tax hike. Thereafter, they are expected to follow a moderate improving trend, mainly due to a rise in the sales volume that reflects a pick-up in overseas economies, the dissipation of the effects of the tax hike, and the effects of the economic measures.

Business Fixed Investment

Business fixed investment has continued on an increasing trend (Chart 21). The aggregate supply of capital goods -- a coincident indicator of machinery investment -- has been more or less flat recently, mainly due to the effects of the slowdown in overseas economies. Private construction completed (nonresidential) -- a coincident indicator of construction investment -- has maintained its moderate uptrend from a somewhat longer-term perspective, although its pace of increase has decelerated, partly due to a peak-out of Olympic Games-related demand.

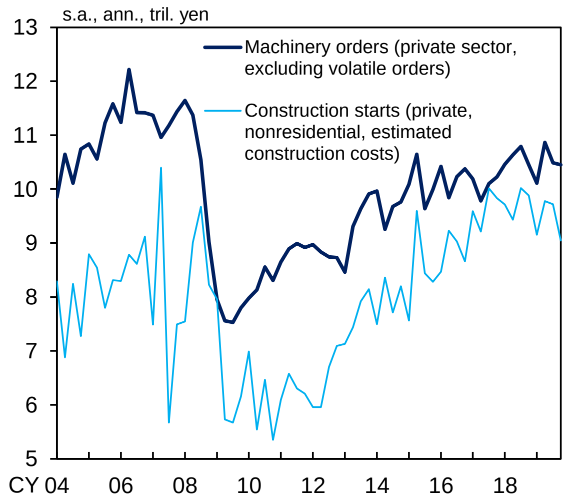
Chart 21: Coincident Indicators of Business Fixed Investment



Sources: Cabinet Office; Ministry of Economy, Trade and Industry; Ministry of Land, Infrastructure, Transport and Tourism.
Notes: 1. The figure for domestic shipments and imports of capital goods for 2019/Q4 is the October-November average. The figure for private construction completed for 2019/Q4 is that for October.
2. Real private construction completed is based on staff calculations using price indices in the "Construction Cost Deflators."

Machinery orders -- a leading indicator of machinery investment -- continued on an increasing trend through mid-2019, but the uptrend has paused recently, mainly because of the manufacturing sector, against the background of the prolonged slowdown in overseas economies (Chart 22). On the other hand, construction starts (in terms of planned expenses for private and nonresidential construction) -- a leading indicator of construction investment -- have continued on an uptrend, albeit with fluctuations that depend on whether there is large-scale construction. These developments suggest that the positive business fixed investment stance has been maintained on the whole, despite weak machinery investment by manufacturers. On this point, according to the December *Tankan*, business fixed investment is expected to maintain its firm increase for fiscal 2019, slightly exceeding the past average as of the December survey (Chart 23). Business fixed investment (on the basis close to GDP definition; business fixed investment -- including software and R&D investments, but excluding land

Chart 22: Leading Indicators of Business Fixed Investment



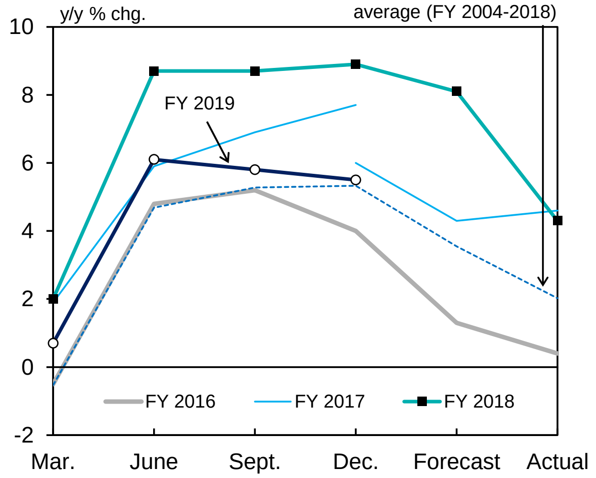
Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Notes: 1. Volatile orders: orders for ships and orders from electric power companies.
2. Figures for 2019/Q4 are October-November averages.

purchasing expenses -- in all industries and enterprises including financial institutions) is expected to see a year-on-year rate of increase of 5.5 percent in fiscal 2019, following a rise in fiscal 2018.[14]

With regard to the outlook, business fixed investment is likely to decelerate temporarily for the time being, mainly for machinery investment by manufacturers, due to the effects of the slowdown in overseas economies. However, it is expected to increase moderately from a somewhat longer-term perspective, mainly on the back of (1) an improvement in corporate profits, (2) highly stimulative financial conditions, such as low interest rates and accommodative lending attitudes, (3) the effects of the economic measures, and (4) moderate improvement in growth expectations. Specifically, an increase is likely to continue to be seen in such items as (1) construction investment related to urban redevelopment projects and inbound tourism demand, (2) investment aimed at improving efficiency and saving labor in order to deal mainly with labor shortage, and (3) software and R&D investments for growth areas.

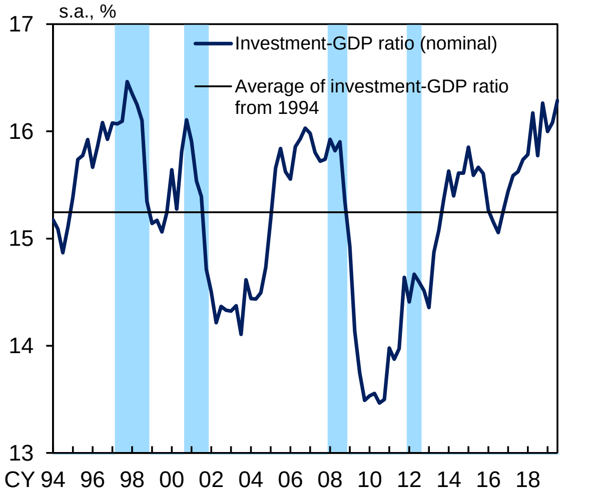
The nominal investment-GDP ratio is expected to maintain its high level on the basis of the aforementioned outlook for business fixed investment (Chart 24). Given that the ratio already has reached a level around the peaks observed in the investment cycles since the burst of the bubble, pressure stemming from cyclical

Chart 23: Developments in Business Fixed Investment Plans



Source: Bank of Japan.
Notes: 1. Based on the *Tankan*. All industries including financial institutions.
2. Including software and R&D investment and excluding land purchasing expenses (R&D investment is not included until the December 2016 survey).
3. There is a discontinuity in the data in December 2017 due to a change in the survey sample.

Chart 24: Investment-GDP Ratio (Nominal)



Source: Cabinet Office.
Note: Shaded areas indicate recession periods.

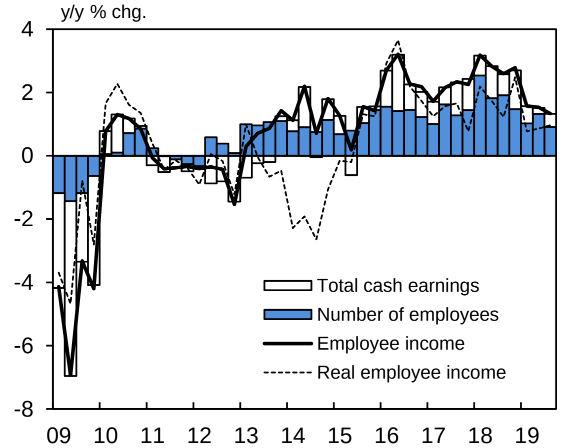
[14] Box 3 examines the reasons why business fixed investment has remained steady on the whole despite the slowdown in overseas economies.

adjustments in capital stock is likely to gradually bring about deceleration in business fixed investment. However, since the weight of software and R&D investments, which are less likely to be linked directly to an expansion in production capacity, within business fixed investment has been showing a trend rise, an increase in pressure stemming from capital stock adjustments will likely be limited for the time being.

Employment and Income Situation

Supply-demand conditions in the labor market have remained tight and employee income has increased.[15] On the employment side, the *Labour Force Survey*-based number of employees has continued to increase steadily (Chart 25). Against this backdrop, the unemployment rate has remained at around the lowest level observed in the current economic expansion phase, being in the range of 2.0-2.5 percent recently (Chart 2). The active job openings-to-applicants ratio has remained at a high level that exceeds the peak marked during the bubble period, although it has declined slightly since end-2018 due to the effects of the slowdown in overseas economies. The employment conditions DI in the *Tankan* shows that a perception of labor shortage has remained quite strong, mainly for the nonmanufacturing sector. Meanwhile, although an uptrend in the labor force participation rate paused temporarily, the rate has started to rise again recently, mainly

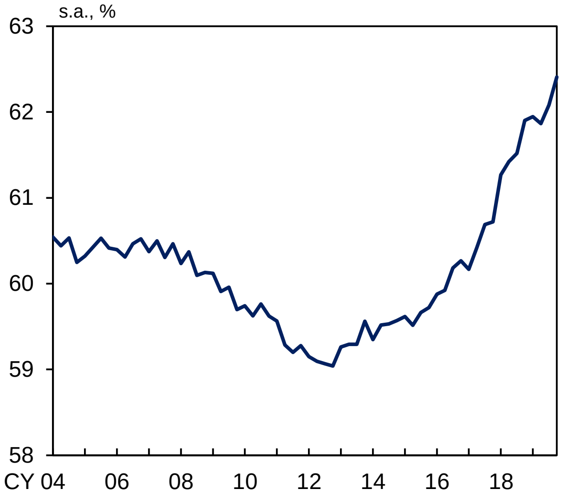
Chart 25: Employee Income



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 for establishments in Tokyo with 500 or more employees for 2013/Q1-2019/Q1 in the "Monthly Labour Survey" are corrected data based on sample observations. Figures from 2019/Q2 onward are for all such establishments.
4. Figures from 2016/Q1 are based on continuing observations following the sample revisions of the "Monthly Labour Survey."
5. Real employee income is based on staff calculations using the CPI (less imputed rent).

Chart 26: Labor Force Participation Rate



Source: Ministry of Internal Affairs and Communications.
Note: The figure for 2019/Q4 is the October-November average.

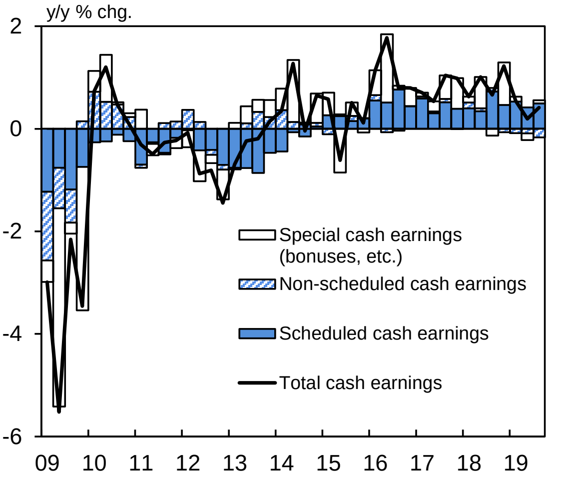
[15] From the June 2019 *Monthly Labour Survey*, the Ministry of Health, Labour and Welfare started to release figures for establishments in Tokyo with 500 or more employees based on all such establishments. As for figures used in the charts in this Outlook Report, those taken from the June 2019 survey onward are for all establishments and those taken from the surveys conducted through May 2019 are corrected data based on sample observations where such data are available.

for women (Chart 26). As for the outlook, with the economy continuing on an expanding trend, the supply-demand conditions in the labor market will likely remain tight as the number of employees is expected to keep increasing.

On the wage side, while growth in total cash earnings per employee has decelerated somewhat, due mainly to a weak rise in bonuses, such earnings have continued to increase moderately, mainly led by scheduled cash earnings (Chart 27).[16] However, wage increases have remained relatively weak compared to tight labor market conditions, mainly reflecting the experience of protracted employment adjustments in the past and the high wage elasticity of labor supply in recent years, mainly among women and seniors.[17]

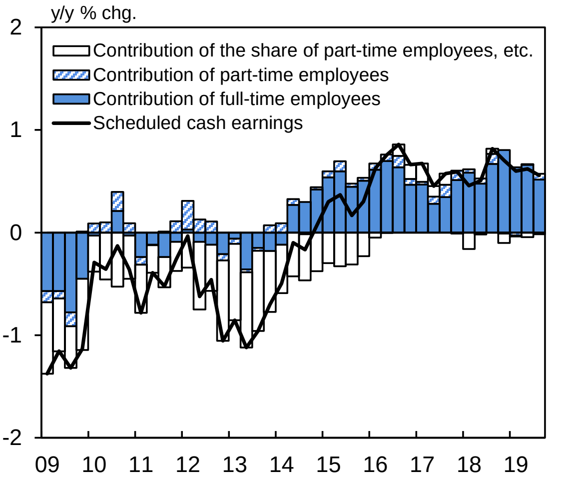
Looking at developments in nominal wages in detail, scheduled cash earnings as a whole have continued to increase moderately, mainly due to a rise in wages of full-time employees (Chart 28). The year-on-year rate of increase in scheduled cash earnings of full-time employees has been at around 0.5-1.0 percent (Chart 29). That in hourly scheduled cash earnings of part-time employees -- which are sensitive to labor market conditions -- has continued to register relatively high growth in the range of 2.5-3.0 percent, partly affected by an increase in minimum wages. On the other hand, amid the underlying downward pressure

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 for establishments in Tokyo with 500 or more employees for 2013/Q1-2019/Q1 are corrected data based on sample observations. Figures from 2019/Q2 onward are for all such establishments.
3. Figures from 2016/Q1 are based on continuing observations following the sample revisions.

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 for establishments in Tokyo with 500 or more employees for 2013/Q1-2019/Q1 are corrected data based on sample observations. Figures from 2019/Q2 onward are for all such establishments.
3. Figures from 2016/Q1 are based on continuing observations following the sample revisions.

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

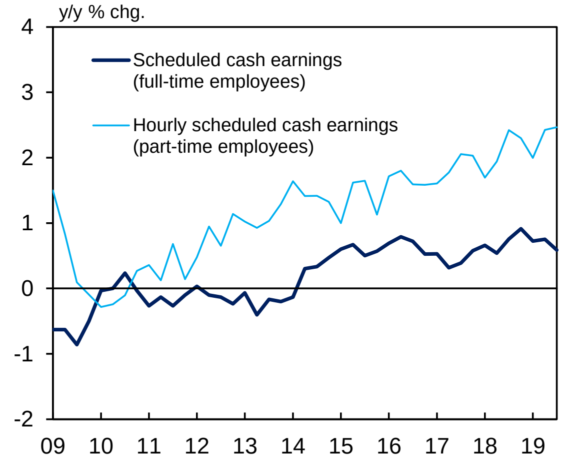
[17] With regard to the relationship between an increase in the labor supply of women and seniors and wage developments, see Box 1 in the July 2018 Outlook Report.

stemming from a decrease in non-scheduled hours worked brought about by working-style reforms, non-scheduled cash earnings have been on a moderate declining trend, mainly in the manufacturing sector, due in part to a decline in production activity that results from the slowdown in overseas economies. Growth in special cash earnings has decelerated recently, reflecting a weak rise in bonuses that resulted from slow growth in corporate profits.

With regard to the outlook for wages, the pace of increase in scheduled cash earnings of full-time employees is expected to accelerate moderately with the inflation rate in the previous fiscal year rising and an improvement in labor productivity becoming more evident. The rate of increase in hourly scheduled cash earnings of part-time employees is also likely to accelerate steadily in response to tight labor market conditions and an increase in minimum wages. Under this situation, overall employees' hourly cash earnings are projected to increase moderately at almost the same pace as labor productivity growth in nominal terms.

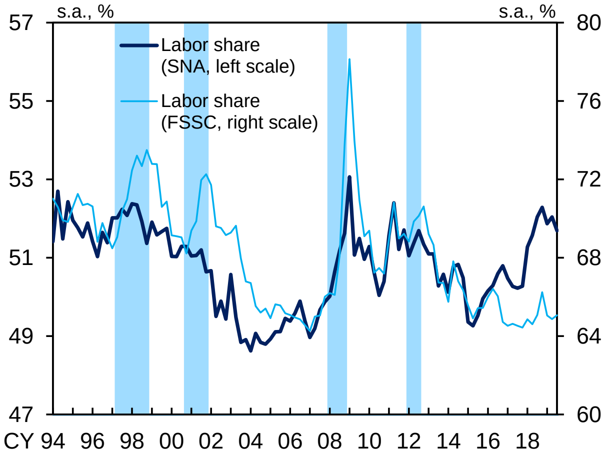
In light of the aforementioned employment and wage conditions, employee income is likely to increase steadily, and the pace is expected to be about the same as the nominal GDP growth rate. As a result, the labor share is projected to remain generally at around the current level, albeit with fluctuations (Chart 30).

Chart 29: Wages of Full-Time and Part-Time Employees



Source: Ministry of Health, Labour and Welfare.
Notes: 1. Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February.
2. Figures for establishments in Tokyo with 500 or more employees for 2013/Q1-2019/Q1 are corrected data based on sample observations. Figures from 2019/Q2 onward are for all such establishments.
3. Figures from 2016/Q1 are based on continuing observations following the sample revisions.

Chart 30: Labor Share

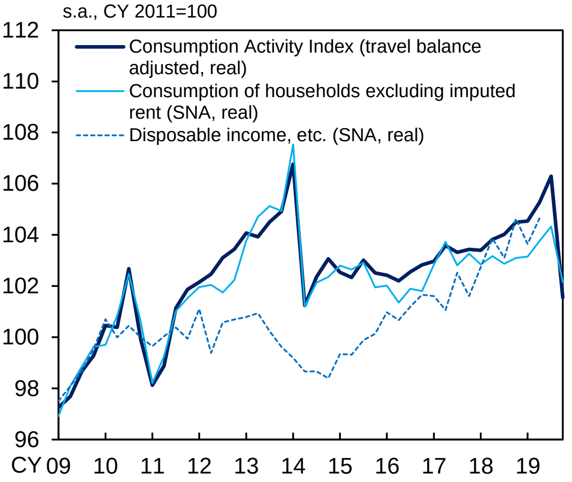


Sources: Cabinet Office; Ministry of Finance.
Notes: 1. Labor share (SNA) = compensation of employees / nominal GDP ×100
2. The labor share (FSSC) is based on the "Financial Statements Statistics of Corporations by Industry, Quarterly (FSSC)" and excludes "finance and insurance." Figures from 2009/Q2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

Household Spending

Private consumption has been increasing moderately, albeit with fluctuations due to such effects as of the consumption tax hike, against the background of steady improvement in the employment and income situation.[18] The Consumption Activity Index (CAI, travel balance adjusted) -- which is calculated by combining various sales and supply-side statistics from the viewpoint of gauging Japan's consumption activity in a comprehensive manner -- has shown a relatively significant decline recently, mainly due to the reactionary decline to the increase in demand prior to the tax hike and the effects of natural disasters (Charts 31 and 32).[19]

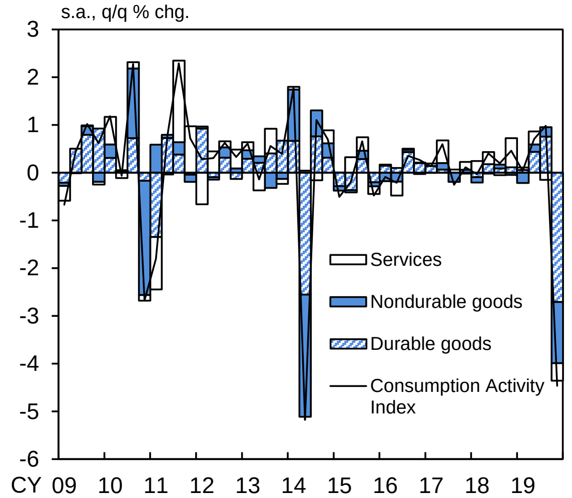
Chart 31: Private Consumption



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 2019/Q4 is the October-November average.
2. The figure for consumption of households excluding imputed rent for 2019/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.

Looking at private consumption by type, durable goods recently have declined clearly, mainly reflecting the reactionary decline to the increase in demand prior to the tax hike and the effects of natural disasters (Chart 33). Specifically, sales of automobiles have shown a relatively large decline, affected by such factors as supply constraints due to natural disasters. Sales of household electrical appliances declined temporarily, reflecting the reactionary decline to the increase in demand prior to the tax hike and temporary store closures due to natural disasters, but have been picking up

Chart 32: Consumption Activity Index (CAI, Real)



Sources: Bank of Japan, etc.
Notes: 1. The Consumption Activity Index is adjusted for the travel balance. Based on staff calculations. Figures for the components are not adjusted for the travel balance. Figures for 2019/Q4 are October-November averages.
2. Nondurable goods include goods classified as "semi-durable goods" in the SNA.

[18] Box 4 compares developments in household spending after the latest consumption tax hike with those after the previous tax hike in April 2014. Looking at consumption of goods as a whole, the increase in demand prior to the tax hike and the reactionary decline have been observed to a certain degree this time as well, mainly in durable goods, but it can be assessed that the degree of fluctuation has been constrained on the whole compared to that of the previous tax hike. The degree of fluctuation in housing investment this time also appears to be constrained on the whole compared to that of the previous tax hike.

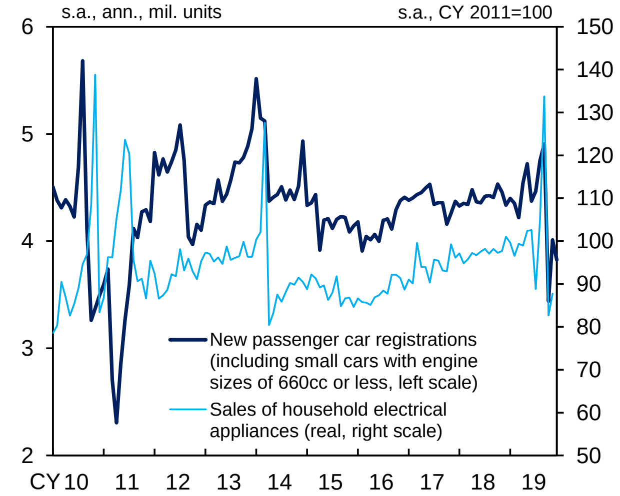
[19] Regarding the CAI, see the Bank's research paper "Revision of the Consumption Activity Index to Address the 2008 SNA and Improve Accuracy" published in April 2018.

gradually to date. Nondurable goods have registered a reactionary decline to the increase in demand prior to the tax hike, albeit to a small extent compared to durable goods. On the other hand, services consumption has maintained its moderate increasing trend, reflecting a trend rise in communications and medical care. Dining-out also has maintained its moderate uptrend, led mainly by fast food, despite being affected by the tax hike and irregular weather (Chart 34). Travel has bottomed out recently, although it decreased, due partly to the effects of natural disasters, while the reactionary decline to the increase in demand observed during the long holiday period from end-April through early May last year has become prolonged.

Looking at confidence indicators related to private consumption, the Consumer Confidence Index deteriorated from end-2018 due to such concern as over the tax hike, but it has picked up since October 2019, partly reflecting the effects of the reduced tax rate and various support measures for households (Chart 35). The *Economy Watchers Survey* also suggests that consumer confidence has picked up recently, although such effects as of the unusually warm winter have exerted downward pressure.

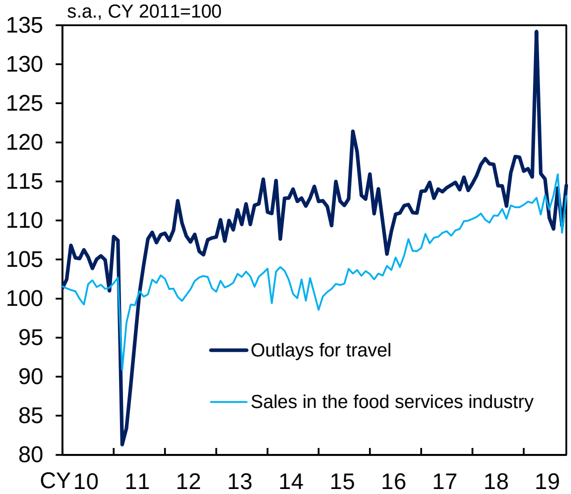
In the outlook, downward pressure on private consumption stemming from the reactionary decline to the increase in demand prior to the tax hike and the decrease in real income is likely to remain for the time being but wane gradually, underpinned by various support measures for households and an improvement in the employment and income situation. The decline in

Chart 33: Consumption of Durable Goods



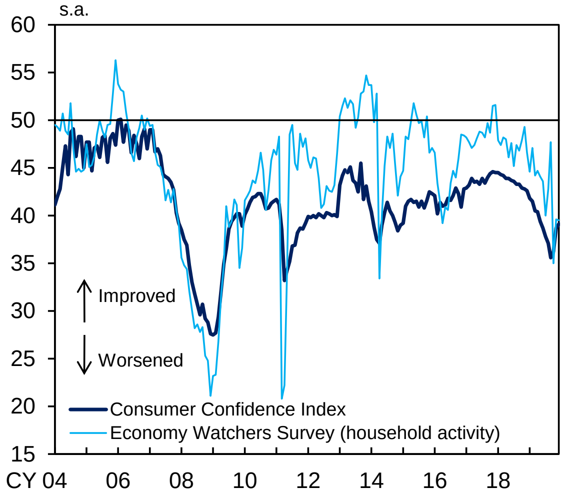
Sources: Japan Automobile Dealers Association; Japan Light Motor Vehicle and Motorcycle Association; Ministry of Economy, Trade and Industry; Ministry of Internal Affairs and Communications.
Note: Figures for real sales of household electrical appliances are based on staff calculations using the retail 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 outlays for travel exclude those by foreign travelers.

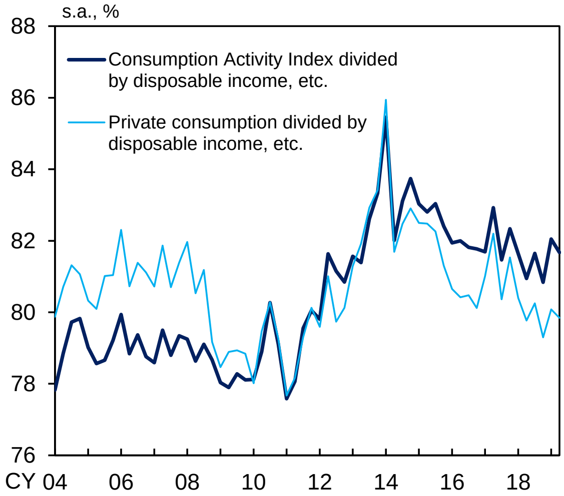
Chart 35: Confidence Indicators Related to Private Consumption



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

private consumption is likely to be limited compared with that of the previous tax hike as the degree of increase in demand prior to the hike this time has been constrained on the whole and the increase in the net burden on households is smaller. Thus, an uptrend in private consumption itself is likely to be maintained. Thereafter, private consumption is expected to continue on a moderate increasing trend, supported by the increase in employee income and by the wealth effects stemming from a rise in stock prices. The propensity to consume is projected to be more or less flat, albeit with fluctuations resulting from the tax hike (Chart 36).

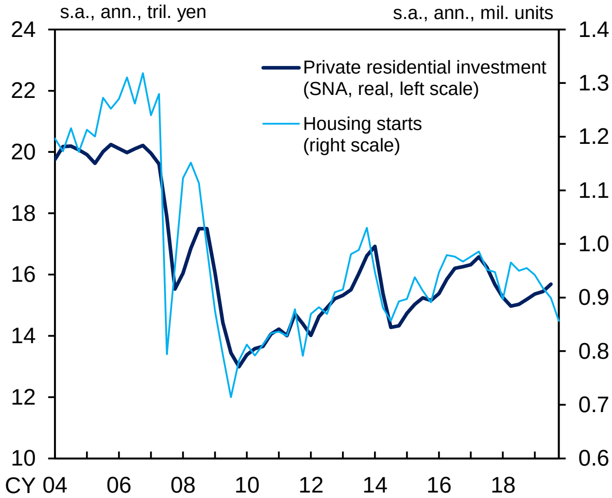
Chart 36: Average Propensity to Consume



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).

Housing investment has been more or less flat (Chart 37). Looking at the number of housing starts -- a leading indicator of housing investment -- owned houses have registered a reactionary decline to the increase in demand prior to the tax hike, albeit to a small extent compared with that of the previous tax hike. Detached houses built for sale have been more or less flat, albeit with fluctuations that depend on whether there are large-scale properties. Housing for rent has continued on a downtrend against the background of waning demand for tax saving and asset management as well as cautious lending attitudes of financial institutions.

Chart 37: Housing Investment



Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Note: The figure for 2019/Q4 is the October-November average.

As for the outlook, although housing investment is projected to decline temporarily in the short run due to the effects of the tax hike, it is expected to remain more or less flat when fluctuations are smoothed out, underpinned by an improvement in the employment and income situation, low housing loan rates, and various support measures introduced accompanying the tax hike.

II. Current Situation of Prices and Their Outlook

Developments in Prices

The rate of decline in the producer price index (PPI, adjusted for the effects of seasonal changes in electricity rates) has decelerated on a quarter-on-quarter basis, reflecting developments in international commodity prices and foreign exchange rates (Chart 38). The year-on-year rate of increase in the services producer price index (SPPI, excluding international transportation) has decelerated since the end of 2018, being at around 0.5 percent recently, due to pressure stemming from cost cuts in response to slow growth in corporate profits, although price rises that reflect increases in personnel expenses and distribution costs have been seen (Chart 38).[20]

The year-on-year rate of change in the CPI (all items less fresh food and energy) is in the range of 0.5-1.0 percent and that in the CPI (all items less fresh food) is at around 0.5 percent (Charts 38 and 40). Regarding the indicators for capturing the underlying trend in the CPI that exclude the effects of the consumption tax hikes and policies concerning the provision of free education, developments are as follows (Chart 41). The rate of change in the trimmed mean has been in the range of 0.0-0.5 percent recently.[21] While the mode has been in the range of 0.0-0.5 percent,

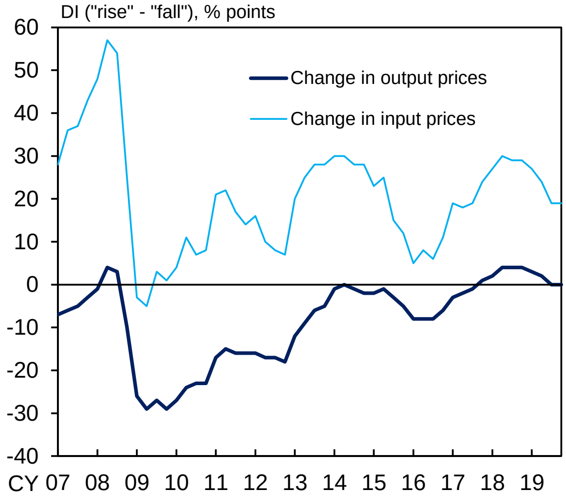
Chart 38: Inflation Indicators

y/y % chg.

	19/Q1	19/Q2	19/Q3	19/Q4
Consumer Price Index (CPI)				
Less fresh food	0.8	0.8	0.5	0.5
Adjusted figure				0.2
Less fresh food and energy	0.4	0.5	0.6	0.7
Adjusted figure				0.5
Producer Price Index (q/q % chg.)	-0.8	0.4	-0.9	-0.1
Services Producer Price Index	1.1	0.9	0.5	0.4
GDP deflator	0.1	0.4	0.6	
Domestic demand deflator	0.3	0.4	0.2	

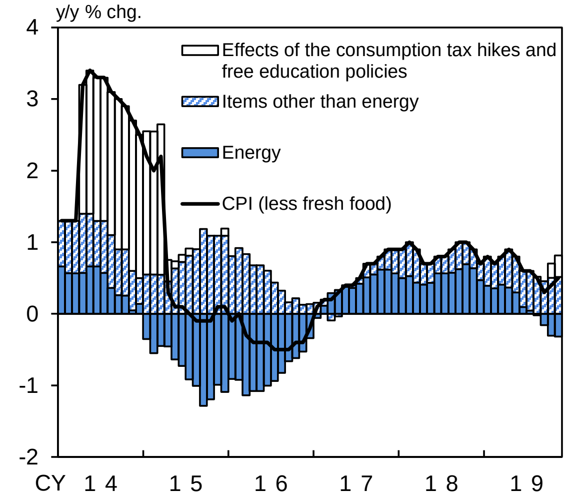
Sources: Ministry of Internal Affairs and Communications; Bank of Japan; Cabinet Office.
Notes: 1. Adjusted figures exclude the effects of the consumption tax hike and policies concerning the provision of free education.
2. Figures for the Producer Price Index are adjusted for the hike in electric power 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 2019/Q4 are October-November averages.

Chart 39: Changes in Prices



Source: Bank of Japan.
Note: Based on the *Tankan.* All enterprises.

Chart 40: CPI (less fresh food)



Source: Ministry of Internal Affairs and Communications.
Note: Energy consists of petroleum products, electricity, and gas, manufactured & piped.

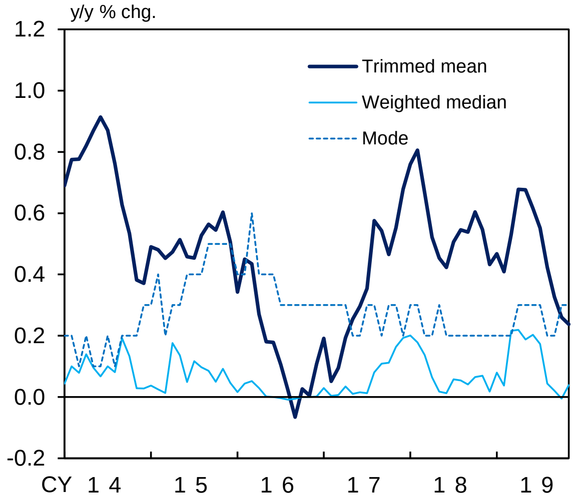
[20] Under these circumstances, with regard to both the input prices DI and the output prices DI in the *Tankan*, the net "rise" has decreased recently, mainly for the manufacturing sector, partly reflecting the past decline in commodity prices such as crude oil prices (Chart 39).

[21] The effects of large relative price fluctuations are eliminated by excluding items that belong to a certain percentage of the upper and lower tails of the price fluctuation distribution (10 percent of each tail in this report).

the weighted median has been at around 0 percent recently.[22]

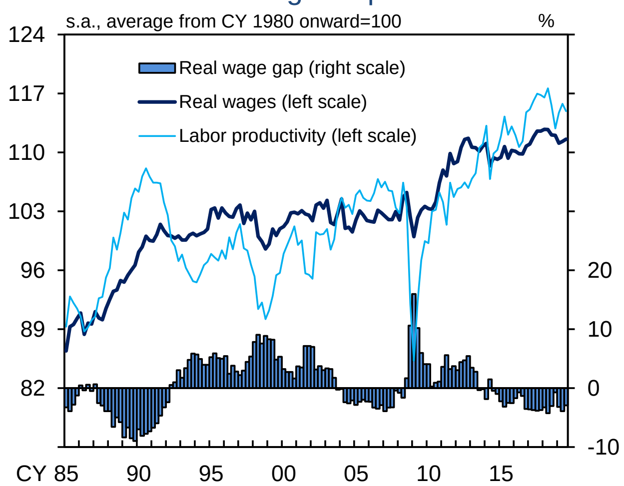
Compared to the economic expansion and tight labor market conditions, the trend inflationary pressure on the CPI has remained relatively weak. This basically has continued to be affected partly by the fact that the mindset and behavior based on the assumption that wages and prices will not increase easily have been deeply entrenched among firms and households, due mainly to the experience of prolonged low growth and deflation.[23] Under these circumstances, firms' cautious wage- and price-setting stance, as well as households' cautiousness toward price rises, have not yet clearly changed. Firms have been making efforts to absorb a rise in labor costs by increasing labor-saving investment and streamlining their business process while limiting wage increases -- which correspond to labor shortage -- mainly to part-time employees. As a result, the real wage gap, which is defined as the deviation of real wages from labor productivity, recently has been negative and has continued to contribute to pushing down price rises (Chart 42). In addition, the following factors have been

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 and policies concerning the provision of free education.

Chart 42: Real Wage Gap



Sources: Ministry of Finance; Cabinet Office.
Notes: 1. The real wage gap is defined as the deviation of real wages from labor productivity.
2. Real wages = personnel expenses / number of workers / GDP deflator
3. Labor productivity = (operating profits + personnel expenses + depreciation expenses) / number of workers / GDP deflator
4. Variables such as personnel expenses are based on the "Financial Statements Statistics of Corporations by Industry, Quarterly" and exclude "finance and insurance."
5. Figures from 2009/Q2 exclude "pure holding companies."

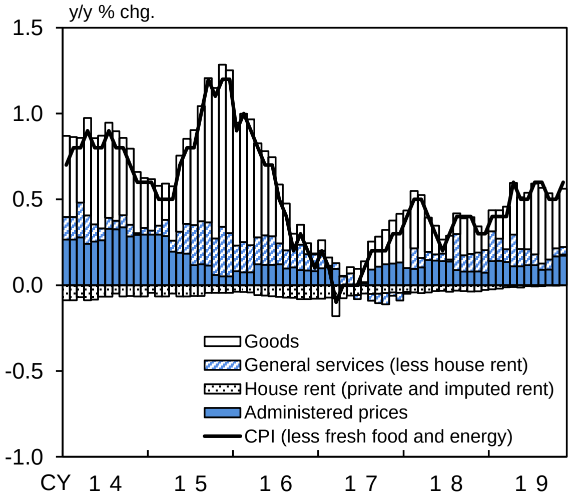
22 The mode is the inflation rate with the highest density in the price fluctuation distribution. The weighted median is the average of the inflation rates of the items at around the 50 percentile point of the cumulative distribution in terms of weight.

23 At the 8th conference co-hosted by the Center for Advanced Research in Finance (CARF) of the University of Tokyo and the Research and Statistics Department of the Bank of Japan held on April 15, 2019, many participants expressed the view that Japan's experience of prolonged deflation amid hysteresis in forming inflation expectations explains why the price stability target of 2 percent has not yet been achieved. For details, see the Bank's research paper "Report on the 8th Conference Co-Hosted by the Center for Advanced Research in Finance (CARF) of the University of Tokyo and the Research and Statistics Department of the Bank of Japan: Discussion over Inflation Dynamics in Recent Years Focusing on Japan's Experience" published in June 2019 (available only in Japanese).

constraining overall inflation: sectoral shocks such as declines in (1) prices, mainly at supermarkets, resulting from intensifying competition with other types of retail businesses and (2) prices of some items, including mobile-phone related prices, that have a large weight in the CPI; and the continued lackluster developments in administered prices and housing rent. It has been taking time to resolve these factors that have been delaying price rises. Nonetheless, in the face of upward pressure, such as of personnel expenses and distribution costs, firms' moves to raise their prices have been spreading of late, albeit at a gradual pace (Chart 43). In fact, looking at annual price changes across all CPI items (less fresh food, excluding the effects of the consumption tax hikes and policies concerning the provision of free education), the share of price-increasing items minus the share of price-decreasing items has maintained a relatively high level since the tax hike, reflecting moves to pass on rises in personnel expenses and distribution costs to prices (Chart 44).

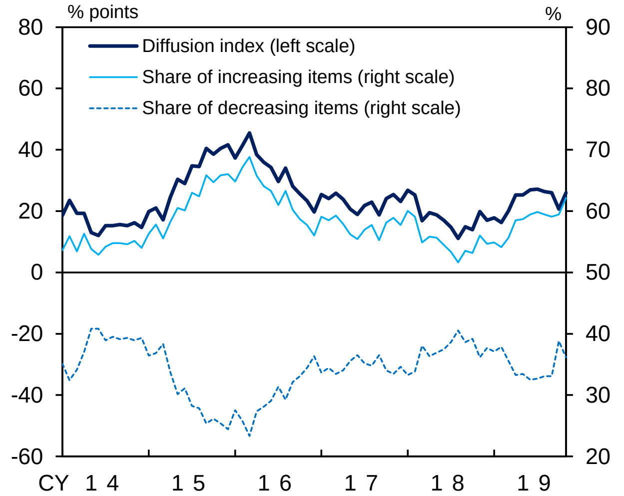
The year-on-year rate of change in the GDP deflator has been at around 0.5 percent on the whole against the background of the rise in the domestic demand deflator and the past decline in crude oil prices (Chart 38). The year-on-year rate of change in the domestic demand deflator has been in the range of 0.0-0.5 percent, mainly led by the private consumption deflator.

Chart 43: 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 and policies concerning the provision of free education.

Chart 44: Diffusion Index of Price Changes

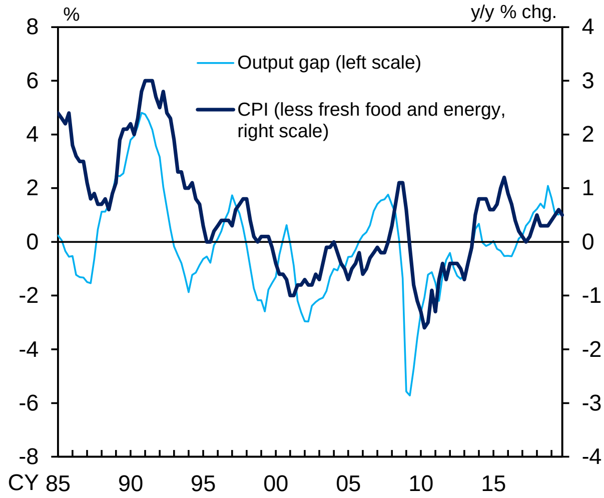


Sources: Bank of Japan; Ministry of Internal Affairs and Communications.
Note: The diffusion index is defined as the share of increasing items minus the share of decreasing items. The share of increasing/decreasing items is the share of items whose price indices increased/decreased from a year earlier. Based on staff calculations using the CPI (less fresh food) excluding the effects of the consumption tax hikes and policies concerning the provision of free education.

Environment surrounding Prices

In the outlook for prices, the main factors that determine inflation rates are assessed as follows. First, the output gap for the July-September quarter of 2019 has remained substantially positive at around the same level as the April-June quarter (Charts 4 and 45). Although the positive output gap seems to be narrowing of late due to such effects as of the slowdown in overseas economies and the consumption tax hike, it is likely to widen moderately thereafter through the end of the projection period as the economic growth rate is expected to exceed its potential somewhat.

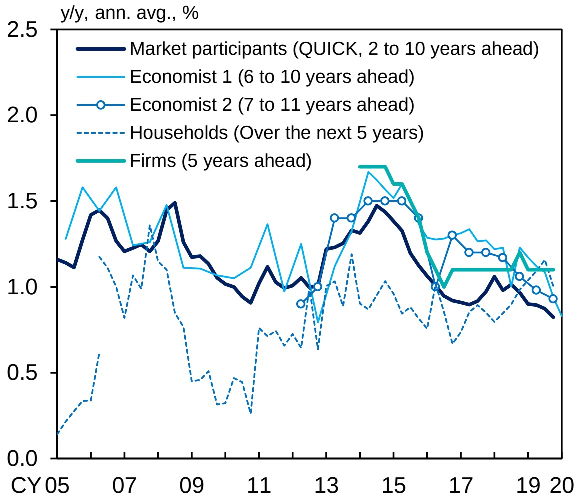
Chart 45: Inflation Rate and Output Gap



Sources: Ministry of Internal Affairs and Communications; Bank of Japan.
Notes: 1. The CPI figures exclude the effects of the consumption tax hikes and policies concerning the provision of free education.
The figure for 2019/Q4 is the October-November average.
2. The output gap is based on staff estimations.

Second, medium- to long-term inflation expectations have remained more or less unchanged (Charts 46 and 47). As for the outlook, such expectations are likely to follow an increasing trend and gradually converge to 2 percent on the back of the following: (1) in terms of the adaptive component, as further price rises come to be observed widely with the output gap remaining positive, inflation expectations are likely to be pushed up through a rise in the observed inflation rate, and (2) in terms of the forward-looking component, the Bank will pursue monetary easing through its strong commitment to achieving the price stability target, which will be effective in pushing up inflation expectations toward 2 percent.

Chart 46: 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)."

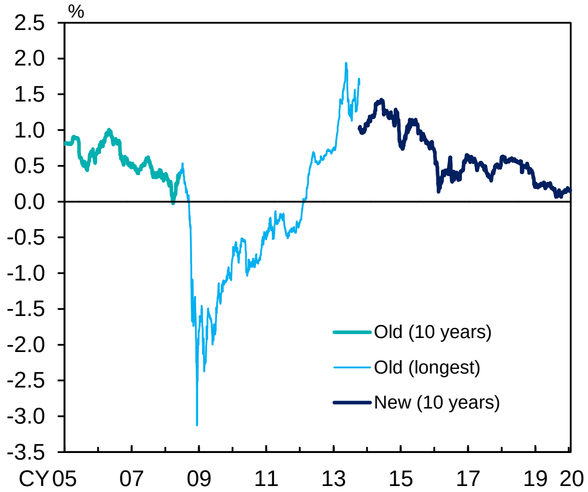
The third factor is developments in import prices. The past decline in crude oil prices is likely to push down the CPI through the decline in energy prices for the time being (Chart 48). However, such downward pressure is expected to diminish gradually, albeit with fluctuations.

Outlook for Prices

The outlook for the year-on-year rate of increase in the CPI (all items less fresh food and energy) in the short run is likely to be as follows. (1) Moves to pass on the increases in costs of raw materials and personnel expenses to prices of goods and services, such as food products, dining-out, and housework-related services, are expected to continue. In addition, (2) a pick-up in sales from a decline observed after the consumption tax hike will likely push up the prices of a wide range of items, mainly those of durable goods and clothes. Moreover, (3) a rise in the optional auto insurance premium has taken place since the start of this year. On the other hand, (4) mobile phone-related prices (i.e., prices of and charges for mobile phones) and travel-related prices (i.e., charges for package tours to overseas and for hotels) are expected to remain somewhat weak. On the back of these factors, the year-on-year rate of increase in the CPI (all items less fresh food and energy) is likely to accelerate in the short run, albeit marginally. Thereafter, as firms' stance shifts toward further raising wages and prices and households' tolerance of price rises increases with the output gap remaining positive, inflation expectations also are projected to rise gradually, and thus the year-on-year rate of change in the CPI (all items less fresh food and energy) is likely to increase gradually toward 2 percent.

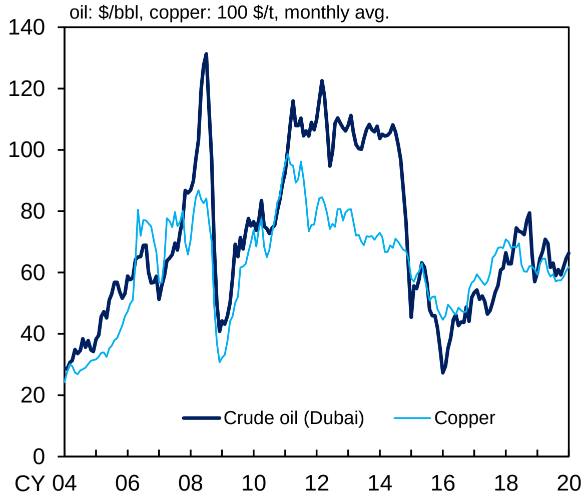
The year-on-year rate of increase in the CPI (all items less fresh food) is likely to accelerate at a moderate pace for the time being compared to the

Chart 47: 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 48: International Commodity Prices



Sources: Nikkei Inc.; Bloomberg.

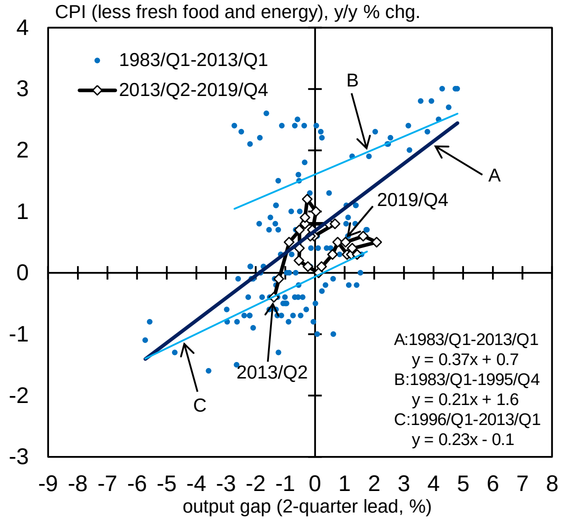
CPI (all items less fresh food and energy), as a decline in energy prices, such as of electricity, is expected to exert downward pressure. Thereafter, the rate of change is projected to increase gradually toward 2 percent as the CPI (all items less fresh food and energy) is expected to accelerate with the effects of the decline in energy prices diminishing.

Such projections are made based on the underlying scenario that, (1) with the output gap remaining positive, (2) the Phillips curve gradually will shift upward as inflation expectations rise through both the forward-looking and adaptive expectation formation mechanisms (Chart 49).

Comparing the current projections through fiscal 2021 with the previous ones, the projected rates of increase in the CPI (all items less fresh food) are more or less unchanged.

In the long run, real wages -- which are determined by the balance between prices and nominal wages -- will be consistent with labor productivity (Chart 42). Under the baseline scenario, the pace of increase in real wages is expected to accelerate gradually, catching up with the improvement in labor productivity. That is, with corporate profits remaining at high levels, the rate of increase in nominal wages is projected to outpace that in the CPI, reflecting tight labor market conditions. Such a rise in real wages is likely to push up consumption through an improvement in household real income and increase households' tolerance of price rises, thereby contributing to a rise in the CPI.

Chart 49: 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 and policies concerning the provision of free education.
The figure for 2019/Q4 is the October-November average.
2. The output gap is based on staff estimations.

III. Financial Developments in Japan

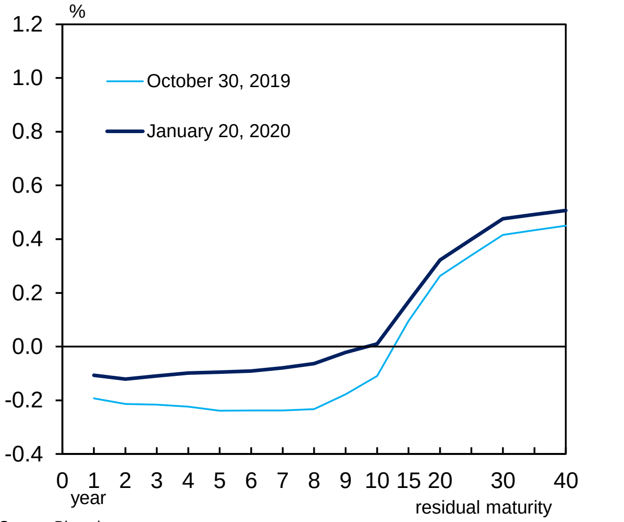
Financial Conditions

Financial conditions are highly accommodative.

Under "QQE with Yield Curve Control," the yield curve for Japanese government bonds (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 50). That is, the yields for relatively short maturities have been in slightly negative territory. The 10-year JGB yields have been at around 0 percent, although they bounced back temporarily along with the rises in U.S. and European interest rates that mainly reflected the progress in the U.S.-China trade negotiations and the United Kingdom's exit from the EU. Meanwhile, although the 20-year JGB yields bounced back temporarily along with the 10-year yields, they have been in the range of 0.0-0.5 percent.

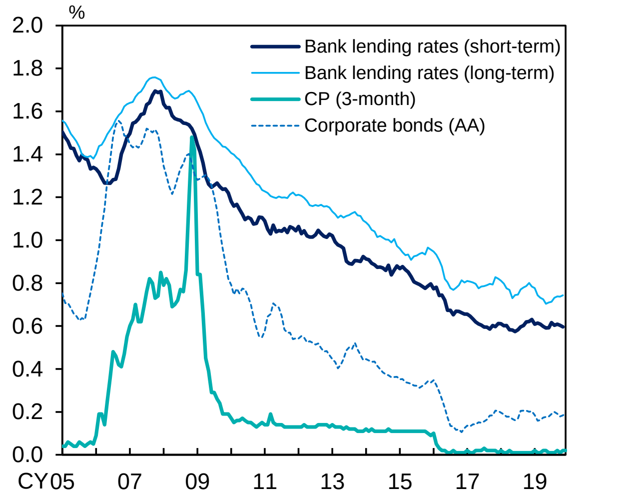
Firms' funding costs have been hovering at extremely low levels (Chart 51). Issuance rates for CP have remained at extremely low levels, and indices such as the DI in the *Tankan* suggest that conditions for its issuance have been favorable. Issuance rates for corporate bonds also have remained at extremely low levels. Meanwhile, lending rates (the average interest rates on new loans and discounts) have been at around historical low levels.

Chart 50: Yield Curves



Source: Bloomberg.

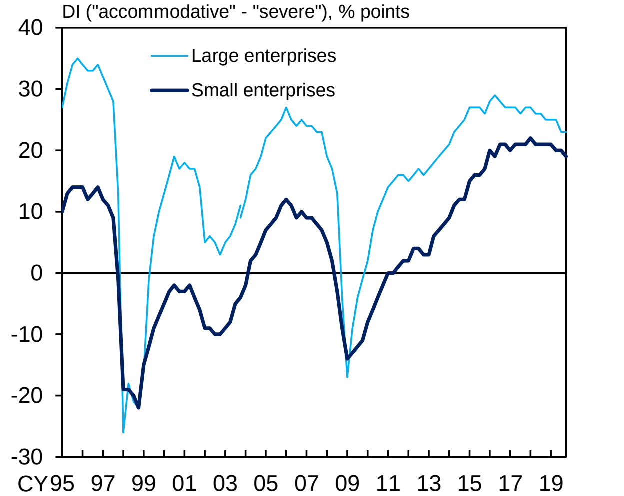
Chart 51: Bank Lending Rates and Issuance Yields for CP and Corporate Bonds



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.

Chart 52: Lending Attitude of Financial Institutions as Perceived by Firms



Source: Bank of Japan.

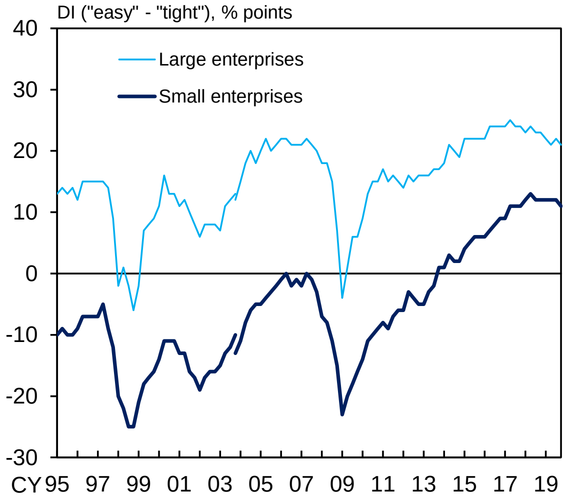
Note: Based on the *Tankan*. All industries. There is a discontinuity in the data in December 2003 due to a change in the survey framework.

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 their lending attitudes have been highly accommodative; the DI for large firms has been at a high level of around the peak in the mid-2000s, and that for small firms has been at a high level last seen at the end of the 1980s (Chart 52). Firms' financial positions have been favorable, as suggested by the DI for large firms in the *Tankan* having been at a high level of around the peak in the mid-2000s, and that for small firms having been at about the same high level seen around 1990 (Chart 53).

Demand for funds such as those for business fixed investment, as well as those related to mergers and acquisitions of firms, has increased. In these circumstances, the year-on-year rate of increase in the amount outstanding of bank lending has been at around 2 percent (Chart 54). That in the aggregate amount outstanding of CP and corporate bonds has been at a relatively high level of around 9 percent.

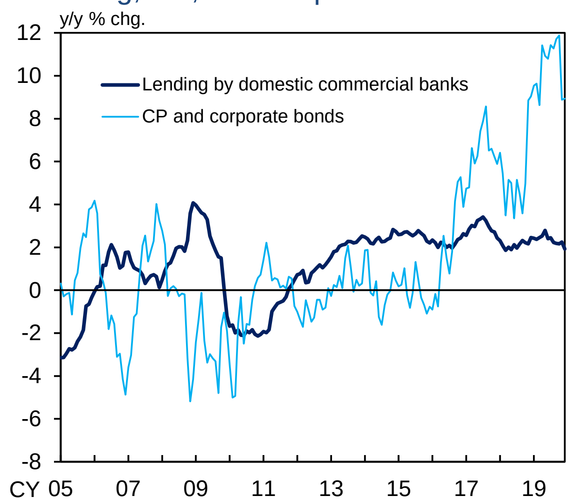
The year-on-year rate of increase in the monetary base has been in the range of 3.0-3.5 percent, and its amount outstanding as of end-December was 518 trillion yen, of which the ratio to nominal GDP was 93 percent.[24] The year-on-year rate of increase in the money stock (M2) has been in the range of 2.5-3.0 percent, partly reflecting an increase in bank lending (Chart 55).

Chart 53: Financial Position



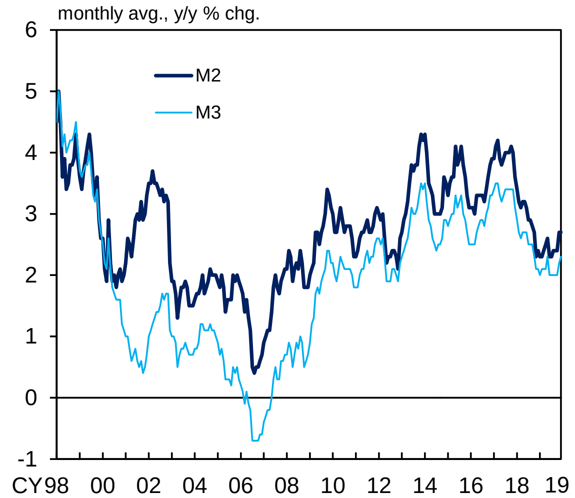
Source: Bank of Japan.
Note: Based on the *Tankan.* All industries. There is a discontinuity in the data in December 2003 due to a change in the survey framework.

Chart 54: 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.

Chart 55: Money Stock



Source: Bank of Japan.

[24] It is assumed that the figure for nominal GDP is unchanged from the July-September quarter of 2019.

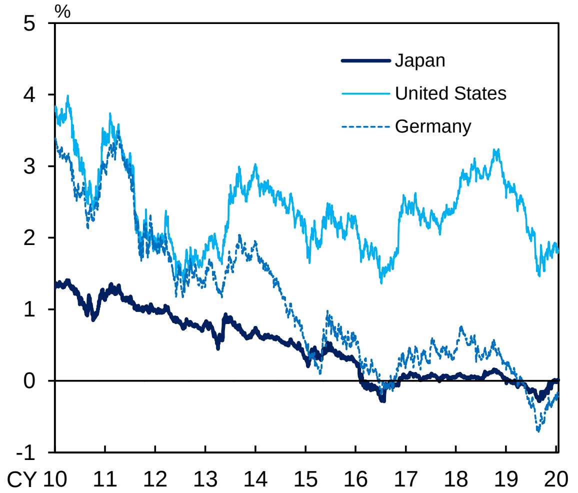
Developments in Financial Markets

With regard to developments in global financial markets, stock prices and long-term interest rates have risen in many economies on the back of an improvement in investors' risk sentiment that mainly reflects the progress in the U.S.-China trade negotiations and the United Kingdom's exit from the EU, although they fluctuated temporarily due to heightened geopolitical risks in the Middle East.

Yields on 10-year government bonds in the United States and Germany have risen, mainly reflecting the progress in the U.S.-China trade negotiations and the United Kingdom's exit from the EU (Chart 56). However, the rise has been constrained, partly because market expectations that financial conditions will remain accommodative for the time being have been maintained due to the Federal Reserve and the European Central Bank (ECB) having shifted their policy stance to monetary easing since around the middle of last year.

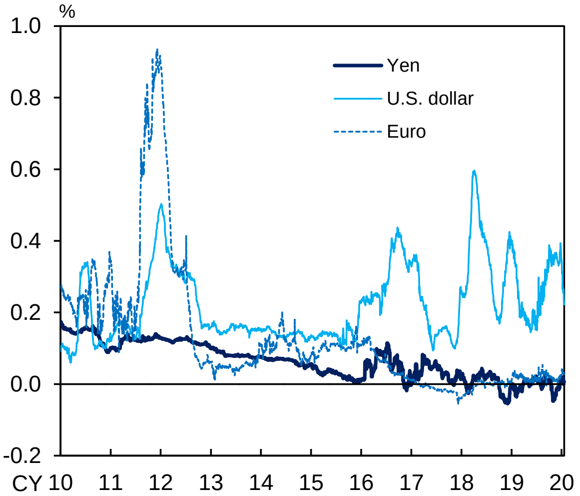
With regard to the LIBOR-OIS spreads for major currencies, those for the U.S. dollar remained wide, partly due to concern over the tight supply-demand conditions for funds at year-end, but have narrowed to date (Chart 57). Those for the euro and the yen have remained at low levels. Premiums for U.S. dollar funding through the dollar/yen foreign exchange swap market rose from end-September last year, partly against the background of transactions conducted in view of the year-end, but currently are declining (Chart 58).

Chart 56: 10-Year Government Bond Yields in Selected Advanced Economies



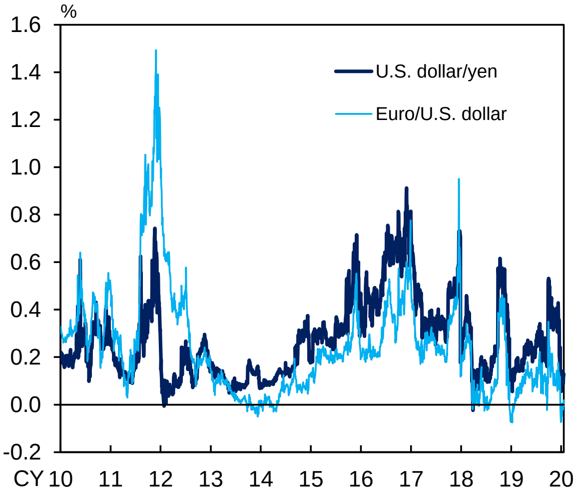
Source: Bloomberg.

Chart 57: LIBOR-OIS Spreads



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

Chart 58: Dollar Funding Premiums through Foreign Exchange Swaps



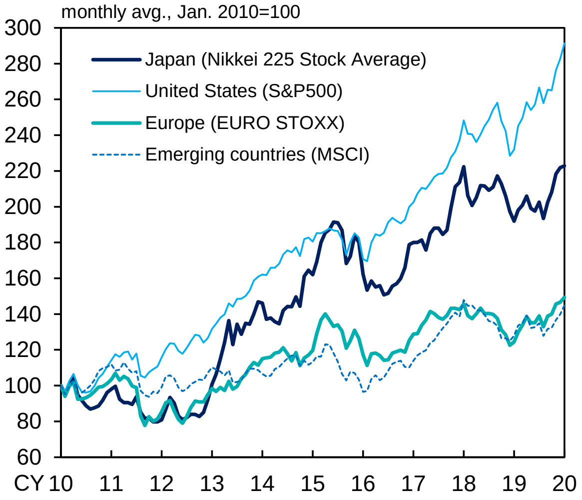
Source: Bloomberg.
Note: U.S. dollar funding rate from yen or euro minus 3-month dollar LIBOR.

Regarding the stock market, although stock prices in the United States fluctuated temporarily due to heightened geopolitical risks in the Middle East, they have risen, temporarily marking historical highs, on the back of an improvement in investors' risk sentiment that mainly reflects the progress in the U.S.-China trade negotiations and the United Kingdom's exit from the EU (Chart 59). Stock prices in Europe and Japan have moved in line with those in the United States.

In the Japan real estate investment trust (J-REIT) market, prices have fallen back, mainly in reflection of a rebound in long-term interest rates (Chart 60).

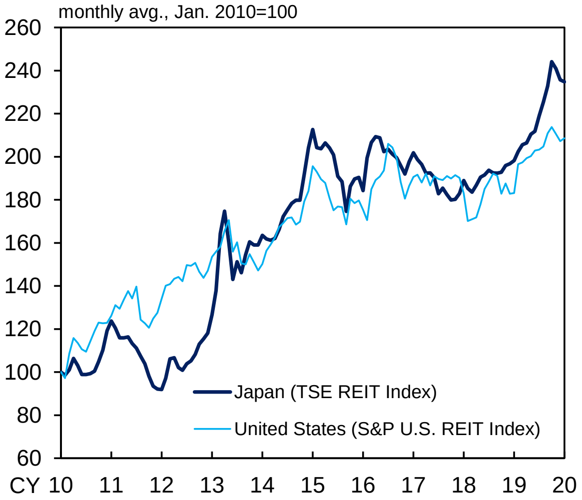
In foreign exchange markets, the yen has depreciated somewhat against the U.S. dollar and the euro, due mainly to the progress in the U.S.-China trade negotiations and the United Kingdom's exit from the EU, although it fluctuated temporarily due to heightened geopolitical risks in the Middle East (Chart 61). Meanwhile, the range of movement in the yen against the dollar in 2019 was the smallest since 1973, when a floating exchange rate regime was adopted.

Chart 59: Selected Stock Prices



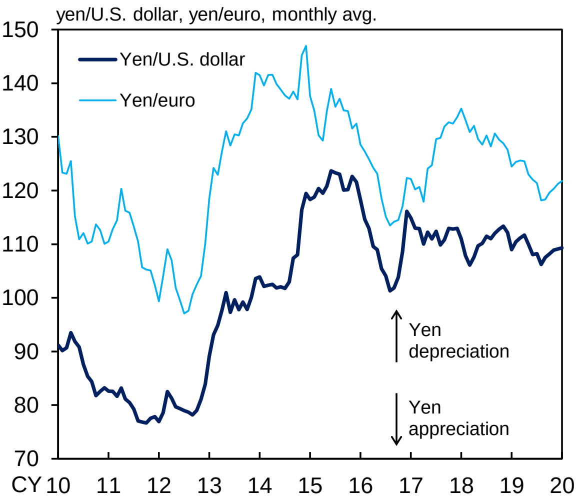
Source: Bloomberg.
Note: Figures for emerging countries are based on the MSCI Emerging Markets Index calculated in the local currencies.

Chart 60: Selected REIT Indices



Source: Bloomberg.

Chart 61: Yen/U.S. Dollar and Yen/Euro



Source: Bloomberg.

(Box 1) Policy Mix Effects

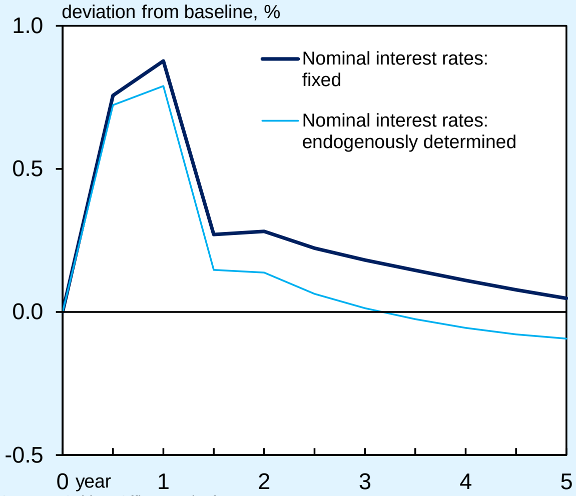
The baseline scenario in the January 2020 Outlook Report assumes that government spending will increase in response to the implementation of the economic measures decided by the Cabinet on December 5, 2019, with the Bank continuing with its current powerful monetary easing policy. Under these circumstances, domestic demand is expected to be underpinned by the synergistic economic stimulus effects of a so-called policy mix of monetary and fiscal measures.

Generally speaking, in the case where a government raises funds through increased issuance of government bonds and expands its spending, upward pressure on longer-term market rates will emerge and restrain private investment -- the so-called crowding-out -- and lessen the stimulative effects on economic activity. On the other hand, in the case where a central bank conducts monetary easing amid fiscal expansion, upward pressure on interest rates resulting from the issuance of government bonds will be contained, and fiscal expansion and monetary easing will synergistically act in a positive direction, resulting in stronger economic stimulus effects. The baseline scenario in this Outlook Report shows that domestic private demand sensitive to interest rates, such as business fixed investment, is likely to continue increasing steadily throughout the projection period, assuming that fiscal expansion will not create any "crowding-out" effects with the Bank continuing to pursue "QQE with Yield Curve Control."

Chart B1: Simulation of the Effects of an Increase in Public Investment

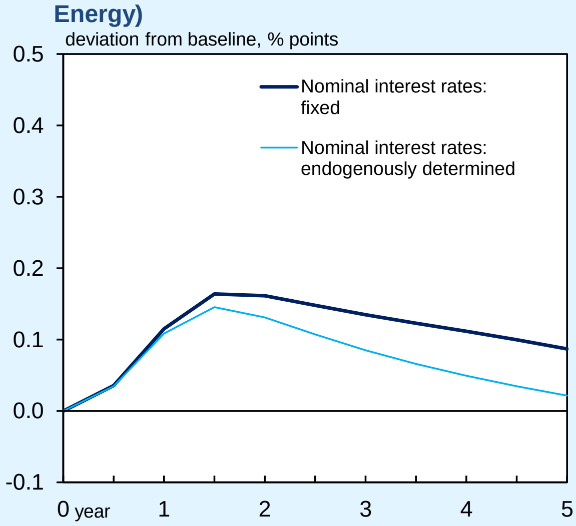
Case: Public investment increases by 1% of nominal GDP during the 1st year

1. Real GDP



Sources: Cabinet Office; Bank of Japan, etc.
Note: The simulation is based on Q-JEM, a macroeconomic model developed by the Bank of Japan. For details of the model, see "The Quarterly Japanese Economic Model (Q-JEM): 2019 version," Bank of Japan Working Paper Series (19-E-7), etc.

2. Annual Change in the CPI (Less Fresh Food and Energy)



Sources: Ministry of Internal Affairs and Communications; Bank of Japan, etc.
Note: The simulation is based on Q-JEM, a macroeconomic model developed by the Bank of Japan. For details of the model, see "The Quarterly Japanese Economic Model (Q-JEM): 2019 version," Bank of Japan Working Paper Series (19-E-7), etc.

To examine the economic stimulus effects of the policy mix, simulations have been carried out employing an increase in public investment using the Quarterly Japanese Economic Model (Q-JEM) developed by the Bank of Japan's Research and Statistics Department.[25] The simulations consider two cases: (1) nominal long-term interest rates are determined endogenously and fluctuate (interest rates rise and the yen appreciates) and (2) those rates are exogenously fixed. Regarding public investment, it is assumed that expenditure increases by 1 percent of nominal GDP in the first year.

The simulation results suggest that, in the case where nominal interest rates are fixed, the effects of pushing up GDP clearly will be large compared to the case where the rates are endogenously determined, since business fixed investment is not contained through crowding-out in the former case (Chart B1[1]).[26] Reflecting these developments in GDP, the effects of pushing up the CPI (all items less fresh food and energy) also will be somewhat larger in the case where nominal interest rates are fixed (Chart B1[2]).

However, these simulation results should be interpreted with some latitude as they are based on the average relationships in the past between

[25] While a similar simulation was conducted in Box 1 of the October 2016 Outlook Report, the results here differ somewhat, because more data have become available and the model specification has been changed. For details of the model, see theses such as "The Quarterly Japanese Economic Model (Q-JEM): 2019 version," *Bank of Japan Working Paper Series*, no.19-E-7, June 2019.

[26] Moreover, in the case where nominal interest rates are fixed, the appreciation of the yen that reflects a rise in interest rates is avoided and there is no decrease in exports. This also contributes to making the increase in GDP larger.

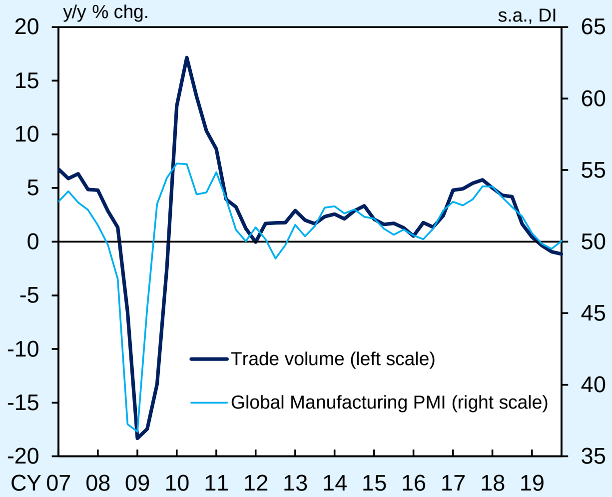
economic variables. In addition, attention needs to be paid to the fact that there are uncertainties to some extent regarding the actual timing of the enactment and implementation of the budget as well as progress with construction work in the construction industry, which is experiencing severe labor shortage.

(Box 2) Developments in and Outlook for Exports by Type of Goods

The Global Manufacturing PMI, which is highly correlated with the world trade volume, has stopped declining and currently is heading toward a pick-up (Chart B2-1). Given these developments in manufacturers' sentiment, there has been a rise in the likelihood that the year-on-year rate of change in world trade volume, which continued to decline from the second half of 2018, eventually will stop falling and head toward a pick-up. Although the recovery in global trade activity is expected to have positive effects on Japan's exports on the whole, some differences are likely to remain in the export environment for different types of goods. Specifically, although IT-related exports are expected to follow an increasing trend, exports of automobile-related goods and capital goods, in which Japan has a comparative advantage, will likely remain somewhat weak for the time being. This box summarizes the current situation of and outlook for Japan's exports by type of goods.

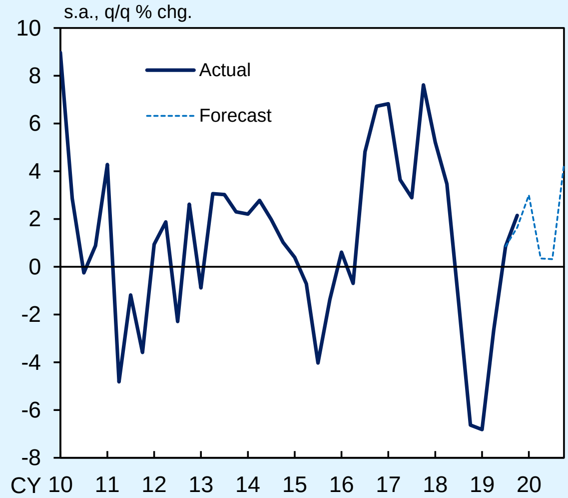
Japan's IT-related exports bottomed out in mid-2019 on the back of the global cycle for IT-related goods shifting toward a phase of improvement, and recently have turned to an uptrend, mainly led by parts for smartphones and data centers. The WSTS world semiconductor shipments started to increase in the second half of last year, and shipments of a wide range of relevant items such as memory and logic chips are likely to continue increasing in 2020 (Chart B2-2). These developments mainly reflect the fact that investment in parts for data centers, which fell temporarily in the first half of 2019, has been

Chart B2-1: World Trade Volume and Manufacturing PMI



Sources: CPB Netherlands Bureau for Economic Policy Analysis;
IHS Markit (© and database right IHS Markit Ltd 2020. All rights reserved.).
Notes: 1. Figures for the trade volume are those for real imports.
The figure for 2019/Q4 is the percentage change from the October-December 2018 average to October 2019.
2. Figures for the Global Manufacturing PMI are the "J.P. Morgan Global Manufacturing PMI."

Chart B2-2: World Semiconductor Shipments

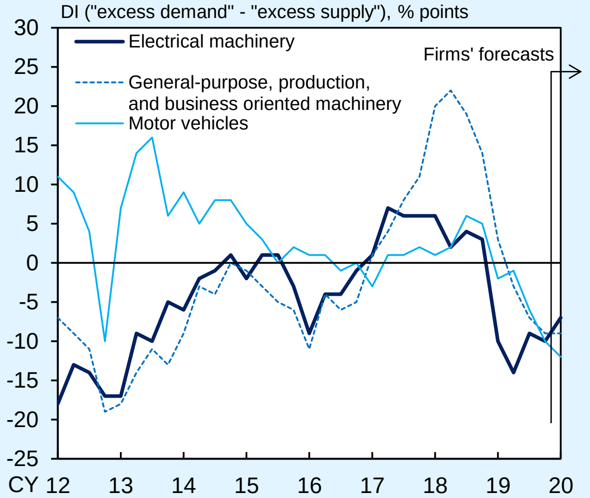


Notes: 1. Based on staff calculations using the WSTS data.
2. The actual figure for 2019/Q4 is the October-November average.

picking up on the back of rising demand for cloud services and expanding e-commerce. In addition, shipments of high-value-added parts related to smartphones are expected to increase as the introduction of 5G-compatible models is likely to expand gradually from 2020 onward. Under these circumstances, the DI for overseas supply and demand conditions for Japanese "electrical machinery" (large enterprises) recently has been picking up moderately, unlike the corresponding DIs for "motor vehicles" and for "general-purpose, production, and business oriented machinery" (Chart B2-3). Taking into account these developments, IT-related exports are expected to maintain their firm increasing trend, mainly led by parts related to 5G communication and data centers.

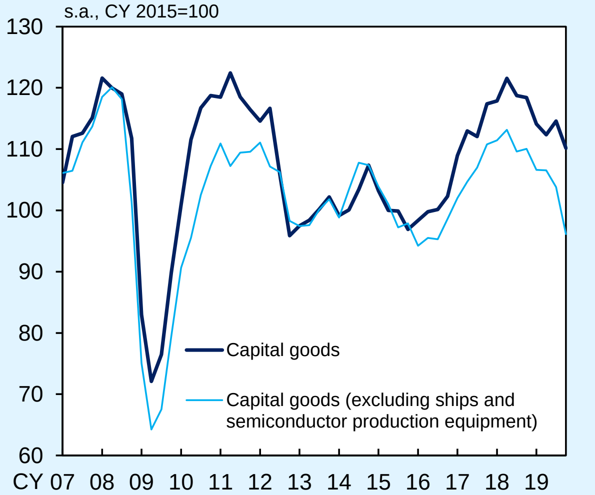
Next, exports of capital goods can be assessed as remaining somewhat weak when excluding an increase in semiconductor production equipment and the temporary contribution of ships that show large fluctuations (Chart B2-4). Such weak overseas demand for Japanese capital goods is attributable to the continued slowdown in business fixed investment observed mainly in the manufacturing sector in China as well as the NIEs and the ASEAN economies. In particular, looking at machine tool orders from overseas, a leading indicator of Japan's capital goods exports, the downtrend in such overseas demand has not come to a halt yet, which mainly reflects (1) weak global automobile production and (2) the postponement of business fixed investment around the world due to growing uncertainties (Chart B2-5). As for the outlook based on these developments, it is likely to still take some time for capital goods exports to start increasing, even

Chart B2-3: Overseas Demand and Supply Conditions



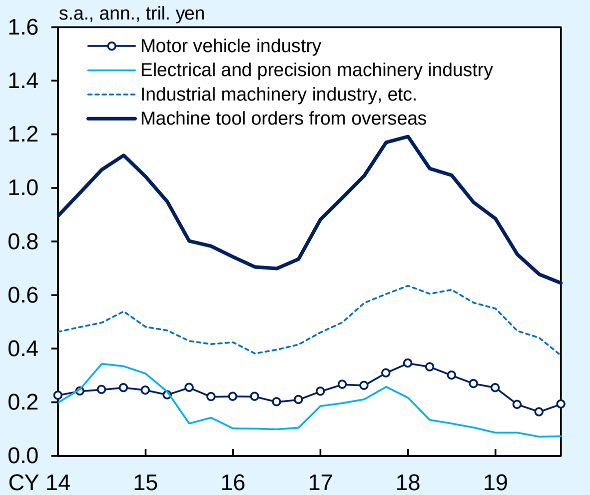
Source: Bank of Japan.
Note: Based on the *Tankan*. Large enterprises.

Chart B2-4: Real Exports of Capital Goods



Sources: Bank of Japan; Ministry of Finance.
Note: Based on staff calculations. Figures for 2019/Q4 are October-November averages.

Chart B2-5: Machine Tool Orders from Overseas

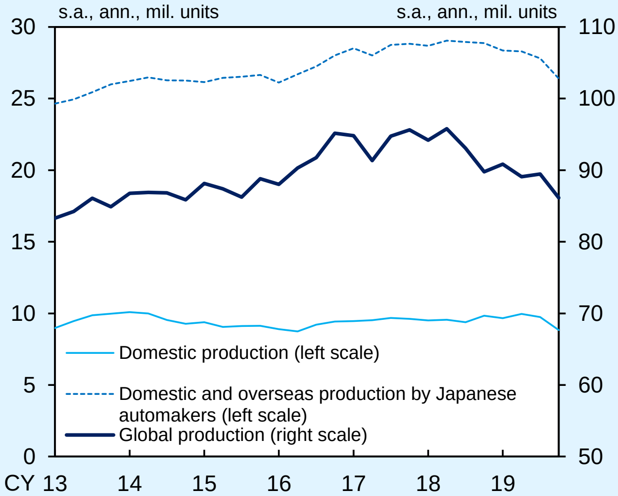


Source: Japan Machine Tool Builders' Association.
Notes: 1. Figures for "industrial machinery industry, etc." include orders from the primary metals industry and trading companies.
2. Figures for 2019/Q4 are October-November averages.

though they are expected to be underpinned by a rise in semiconductor production equipment for the time being. However, from a somewhat longer-term perspective, it is likely that the trade volume in capital goods gradually will head to a recovery and Japan's capital goods exports also will return to a moderate increasing trend if protectionist moves are prevented from becoming more intensified and global uncertainties turn to a declining trend.

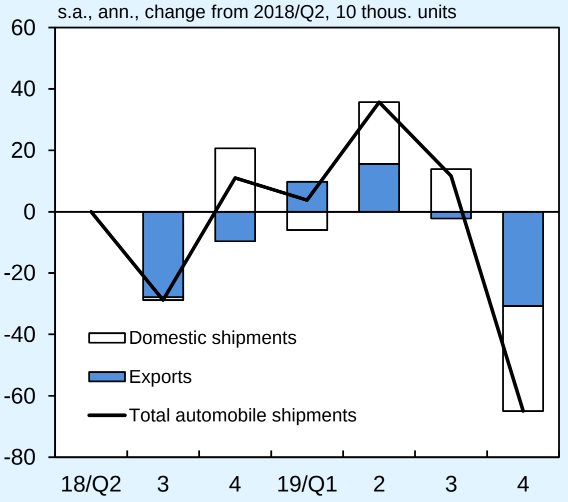
Meanwhile, Japan's automobile-related exports recently have seen a relatively large decline, partly reflecting the shift of production sites to overseas amid the continued weakness in global automobile sales. Looking at global automobile production numbers, a downtrend has been evident since 2018, reflecting (1) a decline in corporate demand due to a slowdown in business fixed investment, (2) the tightening of financial conditions in countries such as China and India, and (3) the stricter environmental regulations in Europe and China (Chart B2-6). Japan's exports of automobiles remained on an uptrend until around mid-2019 despite the continued weakness in global automobile sales. Thus, the reactionary decline since the second half of last year has been large. In addition, since supply constraints, such as supply chain disruptions caused by natural disasters, have occurred at the same time, domestic automobile production recently has seen a clear decline not only for exports but also for domestic sales (Chart B2-7). As for the outlook, automobile-related exports will likely remain somewhat weak for the time being as global automobile sales also are projected to remain weak, although a dissipation of the impact of the shift of production sites to overseas and a

Chart B2-6: Automobile Production



Source: MarkLines Co., Ltd.
Note: Based on automobile production in 37 countries and regions. Figures for 2019/Q4 are October-November averages.

Chart B2-7: Domestic Shipments and Exports of Automobiles



Notes: 1. Figures for 2019/Q4 are October-November averages.
2. Based on staff calculations using the data compiled by the Japan Automobile Manufacturers Association, Inc.

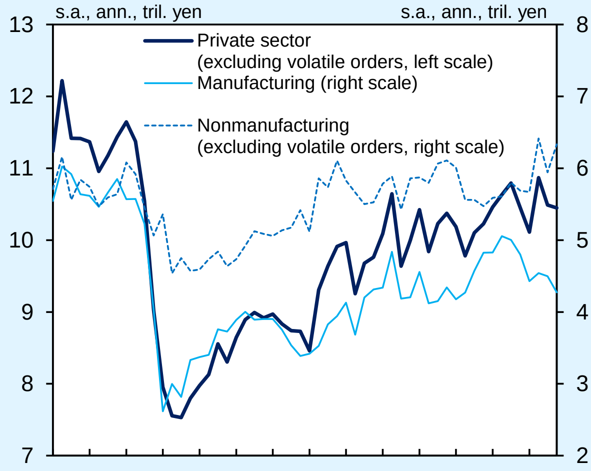
removal of supply constraints are expected to contribute to an increase in such exports. Thereafter, however, global automobile sales are expected to recover moderately, underpinned by a pick-up in corporate demand following a recovery in business fixed investment as well as by policy responses in emerging economies, with downward pressure stemming from stricter environmental regulations waning. Under these circumstances, automobile-related exports also are likely to gradually head toward a recovery.

(Box 3) Background to the Recent Steady Business Fixed Investment

Although exports, production, and business sentiment have shown some weakness, mainly affected by the slowdown in overseas economies and natural disasters, firms' positive fixed investment stance has been maintained on the whole. Under the circumstances, business fixed investment is expected to continue on a moderate increasing trend. This box examines such outlook by type of investment.

Looking at machinery orders, a leading indicator of machinery investment, the manufacturing sector has continued to show some weakness since end-2018 against the background of weak exports due to the slowdown in overseas economies (Chart B3-1). Looking at the manufacturing sector by industry, orders by "electrical machinery" have turned to a pick-up since around mid-2019, reflecting the global cycle for IT-related goods shifting toward a phase of improvement; on the other hand, those by "general-purpose, production, and business-oriented machinery," which account for the largest share of total machinery orders, have continued to decline clearly, reflecting weak demand for global business fixed investment. In addition, regarding orders by "automobiles, parts, and accessories," demand for such items as metal cutting machines has been somewhat weak recently due to a decrease in automobile-related exports. Looking at the deviations of machinery orders by the manufacturing sector and real exports from their trends, the correlation between the two is extremely high, which indicates that manufacturers -- in response to changes in

Chart B3-1: Machinery Orders

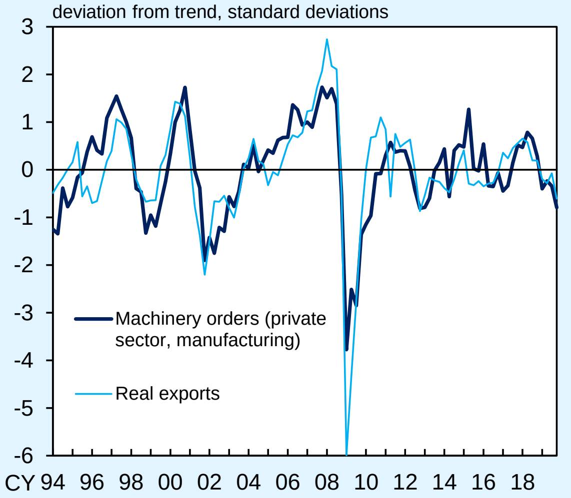


Source: Cabinet Office.
Notes: 1. Volatile orders: orders for ships and orders from electric power companies.
2. Figures for 2019/Q4 are October-November averages.

exports -- make adjustments to their orders for such items as metal cutting machines in a highly sensitive manner (Chart B3-2). Given these observations, the outlook for machinery investment by manufacturers is expected to remain somewhat weak for the time being until the effects of the slowdown in overseas economies wane and real exports begin to pick up.

Next, construction starts, a leading indicator of construction investment, have continued on an uptrend without a significant drop even after the start of fiscal 2019, when Olympic Games-related demand seems to have peaked out (Chart 22). With regard to recent new construction projects such as office buildings, hotels, and commercial facilities that have supported this steady growth in construction investment, many projects appear to aim at rejuvenating vintage building stock, such as replacement of aging existing buildings, rather than constructing additional buildings. Estimating the vintage of the capital stock based on a certain assumption, that of buildings and structures has continued on an uptrend, reflecting the prolonged weakness in construction investment since the bubble burst (Chart B3-3). Under these circumstances, demand for replacing existing buildings built under the old earthquake resistance standards seems to have become evident in recent years, supported in part by highly accommodative financial conditions. Office building vacancy rates are extremely low, partly reflecting the fact that many recent urban redevelopment projects involve replacing existing buildings in good locations with high-performance buildings. Such increase in replacement demand also can be confirmed by a frequency spectrum

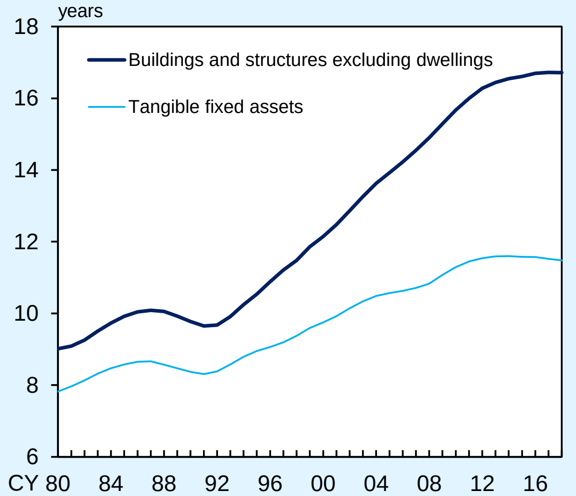
Chart B3-2: Machinery Orders and Real Exports



Sources: Cabinet Office; Bank of Japan; Ministry of Finance.
Note: Figures for 2019/Q4 are October-November averages.

Chart B3-3: Vintage of Fixed Capital Stock

(Calculation)
$V_t = ((V_{t-1}+1)(K_{t-1}-R_t) + I_t/2)/K_t$
V_t: Vintage, K_t: Capital stock
I_t: Investment
$R_t = K_{t-1} + I_t - K_t$: Scrapping of capital stock



Sources: Cabinet Office; Research Institute of Economy, Trade and Industry; Ministry of Internal Affairs and Communications.
Note: Based on the private sector. Figures are based on staff calculations using figures from the "1970 National Wealth Survey" as initial values and employing data from the SNA (as well as the "Japan Industrial Productivity Database" for the period before 1980). The initial value of "buildings and structures excluding dwellings" is the vintage of "buildings and fixtures" and "structures" in the "1970 National Wealth Survey" that is adjusted for the vintage of the dwellings estimated based on the "Housing and Land Survey."

decomposition of construction starts (Chart B3-4). This shows that the medium- to long-term (15- to 50-year) cycle, which seems to roughly correspond to the replacement cycle, has contributed to the uptrend in construction starts in recent years. As for the outlook, given the high vintage of building stock, there seems to remain reasonable potential replacement demand, which is likely to underpin construction investment for a long time on the back of highly stimulative financial conditions.

Meanwhile, software and R&D investments also have continued to increase steadily. The share of these investments in total business fixed investment has been on an uptrend from a long-term perspective, reaching about 30 percent since the 2010s (Chart B3-5). These software and R&D investments are (1) relatively less susceptible to short-term fluctuations in profits than, for example, machinery investment and (2) less likely to be linked directly to an expansion in production capacity and lead to an increase in pressure stemming from capital stock adjustments. Thus, the growing share of these investments in recent years seems to contribute to the recent steady business fixed investment as a whole.

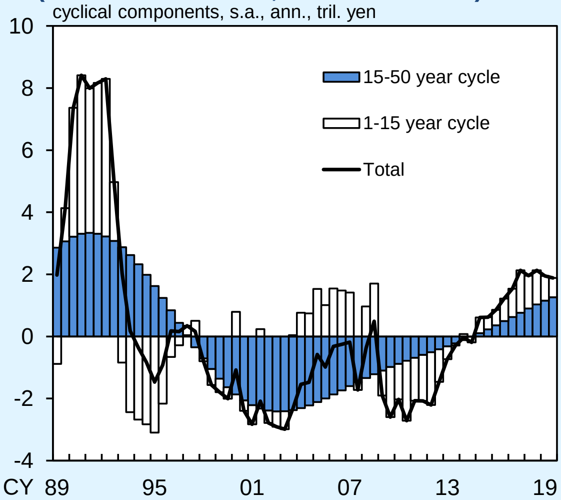
Although an increase in software investment thus far was mainly observed in labor-intensive nonmanufacturing industries with strong demand for improving efficiency and saving labor in a situation of acute labor shortage, aggressive IT investment recently seems to be increasing steadily across industries, including in manufacturing (Chart B3-6). Specifically, it is

Chart B3-4: Frequency Spectrum Decomposition of Construction Investment

1. Useful Life of Buildings

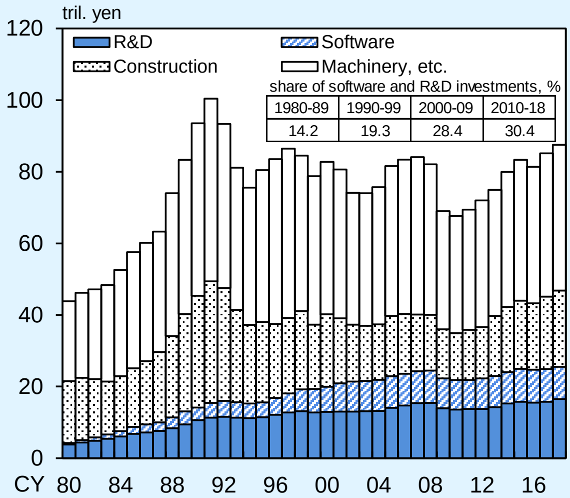
Wooden buildings, etc.	15-25 years approx.
Steel-frame reinforced concrete buildings, etc.	30-50 years approx.

2. Frequency Spectrum Decomposition (Construction Starts, Estimated Costs)



Sources: National Tax Agency; Ministry of Land, Infrastructure, Transport and Tourism.
Notes: 1. The useful life of buildings is based on useful life tables by the National Tax Agency.
2. The cycles are extracted by applying frequency spectrum decomposition to estimated construction costs of nonresidential buildings reported by private-sector builders. The estimation period is 1988/Q2-2019/Q4. Figures for 2019/Q4 are October-November averages.

Chart B3-5: Software and R&D Investments

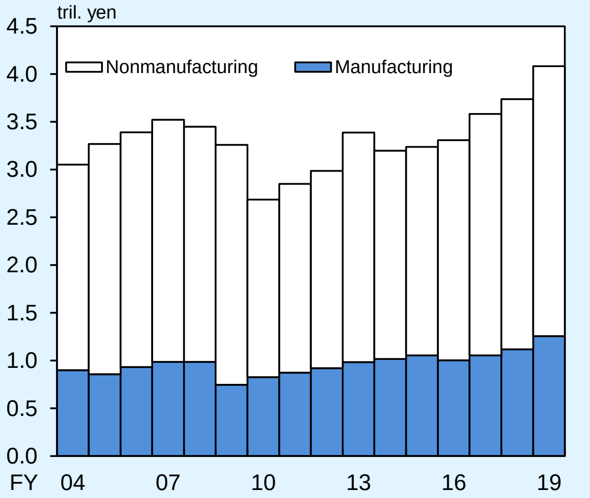


Source: Cabinet Office.
Note: The chart shows fixed capital formation other than "dwellings" in the private sector in the Cabinet Office's "Gross Fixed Capital Formation of Assets classified by Institutional Sectors and Economic Activities" in current prices.

noteworthy that firms not only have invested in robotic process automation (RPA) to save labor and raise productivity but also gradually are becoming active in investment related to big data, artificial intelligence (AI), and the Internet of Things (IoT), with the aim of creating new businesses, expanding sales channels, analyzing data, and promoting use for marketing (Chart B3-7).

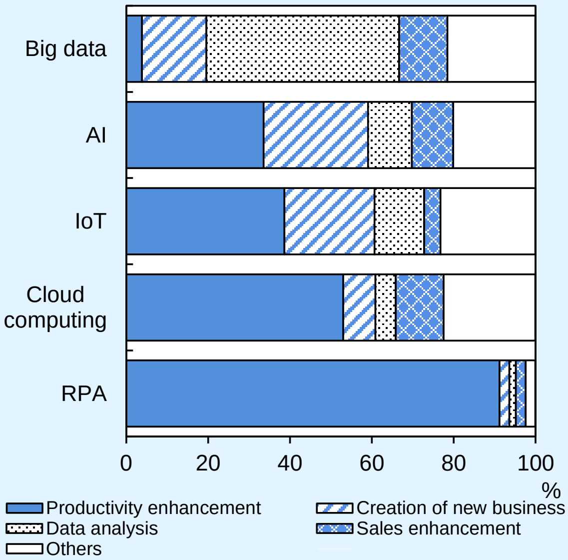
Taking into account these developments, business fixed investment is expected to remain steady overall as firm investments in construction as well as in software and research and development offset weak machinery investment by manufacturers. However, since some weakness has continued in exports and production -- particularly in automobile-related goods and capital goods, both of which have a large impact on Japan's economy -- due attention needs to be paid to the possibility that firms' investment stance may become cautious if profits in these sectors decline further.

Chart B3-6: Software Investment (*Tankan*)



Source: Bank of Japan.
Note: All enterprises. Figures for fiscal 2019 are adjusted based on average changes of comparable figures for fiscal 2004-2018 from planned investment in the December surveys to actual investment.

Chart B3-7: Firms' Use of Information Technology



Source: Japan Users Association of Information Systems.
Note: Survey for fiscal 2018. Figures for "cloud computing" are the weighted averages of the share of responses for "public cloud computing (IaaS, PaaS)" and "public cloud computing (SaaS)" in the survey.

(Box 4) Developments in Household Spending after the Consumption Tax Hike

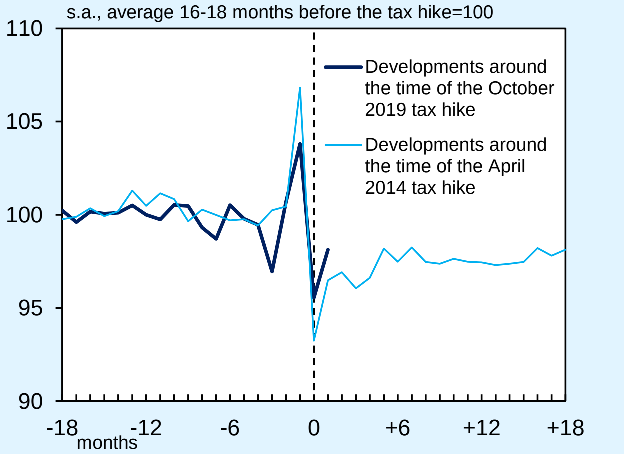
While the economic growth rate is pushed up before a consumption tax hike through an increase in the front-loaded purchases ahead of selling price rises, it is then pushed down after the tax hike as a result of a reactionary decline to the increase in demand and of a decrease in households' real disposable income due to overall price rises. Based on developments in various indicators so far, it appears that (1) the increase in demand prior to the tax hike and the reactionary decline to the increase have been constrained compared to those of the previous tax hike in April 2014, and (2) consumer sentiment after the tax hike has been picking up.

Starting with developments in nondurable goods as a whole, these have been firm compared to at the time of the previous tax hike as the decline in consumption of these goods after the tax hike has been constrained, partly reflecting the effects of various support measures for households (such as the reduced tax rate and point reward program for cashless payments) (Chart B4-1[1]). Similarly, sales at supermarkets and convenience stores, which mainly handle nondurable goods, have been picking up to date, although they dropped temporarily right after the tax hike, also reflecting the impact of Typhoon No. 19.

On the other hand, looking at developments in durable goods as a whole, even though the increase in demand prior to the tax hike generally was constrained compared to that of the previous tax hike, the degree of decline since last October

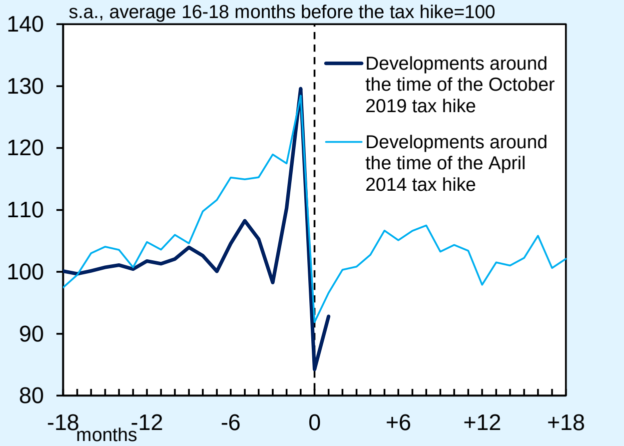
Chart B4-1: Consumption Activity Index (CAI, Real)

1. Nondurable Goods



Sources: Bank of Japan, etc.
Notes: 1. Month 0 is the month in which the consumption tax rate was raised -- namely, April 2014 or October 2019. Regarding developments around the time of the October 2019 tax hike, the latest figure is for November 2019. The CAI is based on staff calculations.
2. Nondurable goods include goods classified as "semi-durable goods" in the SNA.

2. Durable Goods (Automobiles + Household Electrical Appliances)

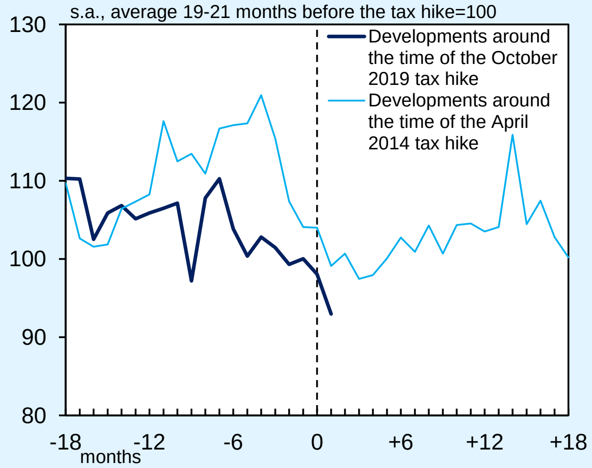


Sources: Bank of Japan, etc.
Note: Month 0 is the month in which the consumption tax rate was raised -- namely, April 2014 or October 2019. Regarding developments around the time of the October 2019 tax hike, the latest figure is for November 2019. The CAI is based on staff calculations.

has been somewhat large (Chart B4-1[2]). The weakness in durable goods consumption is largely attributable to the decline in automobile sales since last October (Chart 33). However, as the decline in automobile sales has been affected to some extent by natural disasters and supply constraints caused by automakers, it is necessary to wait a little longer for more data to accumulate in order to make a judgement on whether there has been a change in the trend in demand for automobiles.

Chart B4-2: Housing Starts

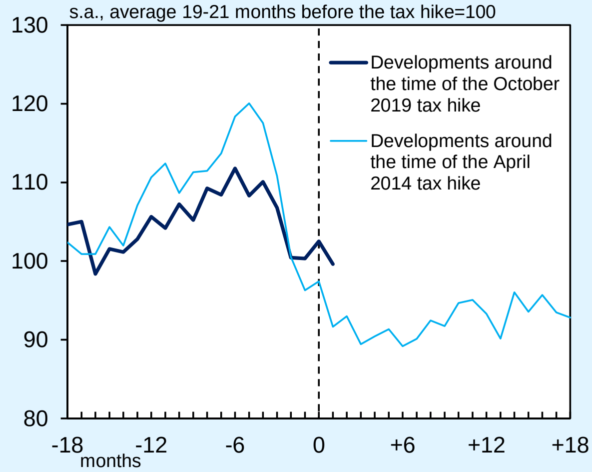
1. Overall



Source: Ministry of Land, Infrastructure, Transport and Tourism.
Note: Month 0 is the month in which the consumption tax rate was raised -- namely, April 2014 or October 2019. Regarding developments around the time of the October 2019 tax hike, the latest figure is for November 2019.

Looking at the number of housing starts, which is a leading indicator of housing investment, owned houses and detached houses built for sale increased through around last June due to the effects of the increase in demand prior to the tax hike, but there has been a reactionary decline to this increase in housing starts recently (Chart B4-2[2]).[27] However, the decline in housing starts after the tax hike has been constrained to a considerable degree compared to that of the previous tax hike, partly due to the effects of various housing-related support measures (such as the enhancement of housing loan tax deductions, the expansion of gift tax exemptions, and the introduction of the next-generation housing point reward program) (Chart B4-2[1]).

2. Owned Houses + Detached Houses Built for Sale



Source: Ministry of Land, Infrastructure, Transport and Tourism.
Notes: 1. Month 0 is the month in which the consumption tax rate was raised -- namely, April 2014 or October 2019. Regarding developments around the time of the October 2019 tax hike, the latest figure is for November 2019.
2. Figures for detached houses built for sale are based on staff calculations.

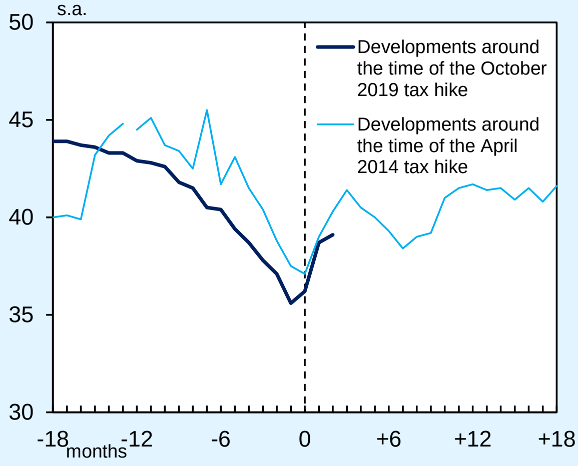
Unlike the reactionary decline to the increase in demand prior to the tax hike mentioned earlier,

[27] For housing, the old consumption tax rate of 8 percent was applied to contracts made before end-March 2019, even if the handover of the property was after the start of October 2019. For this reason, regarding orders received by housing developers, there was a rush to make contracts through March, and a reactionary decline to the increase has been observed since April. Such developments in orders have been reflected in housing starts with some time lag.

the impact of the decline in real income is likely to materialize gradually over time. Therefore, it is necessary to wait a little longer until more data become available to examine this impact. That said, the Consumer Confidence Index makes it possible to capture households' spending attitudes relatively early. Comparing developments in the index before and after the latest tax hike with those of the previous tax hike, consumer sentiment continued to be somewhat weak before the tax hike this time, mainly affected by the slowdown in overseas economies; however, it has been picking up after the tax hike, led by the category of "overall livelihood" in the Consumer Confidence Index, through which people's perception of real income can be captured (Chart B4-3). This improvement in consumer sentiment as seen mainly in "overall livelihood" seems to be consistent with the fact that the increase in the net burden on households due to the tax hike has been greatly constrained compared to that of the previous tax hike through support measures such as the reduced tax rate and an increase in welfare benefits for pensioners.

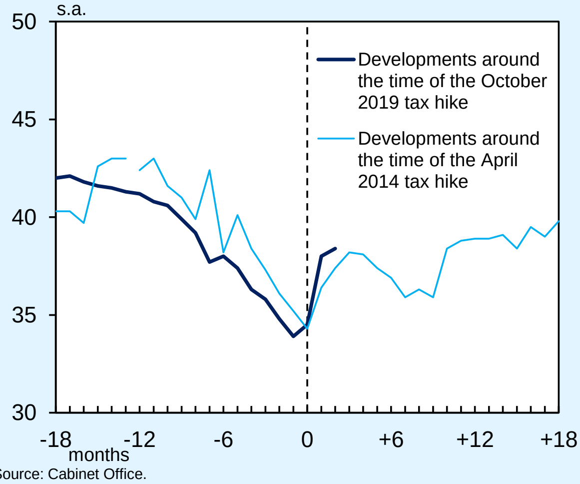
Chart B4-3: Consumer Sentiment

1. Consumer Confidence Index



Source: Cabinet Office.
Notes: 1. Month 0 is the month in which the consumption tax rate was raised -- namely, April 2014 or October 2019. Regarding developments around the time of the October 2019 tax hike, the latest figure is for December 2019.
2. There is a discontinuity in the data in April 2013 due to a change in the survey method.

2. Overall Livelihood (Consumer Confidence Index)



Source: Cabinet Office.
Notes: 1. Month 0 is the month in which the consumption tax rate was raised -- namely, April 2014 or October 2019. Regarding developments around the time of the October 2019 tax hike, the latest figure is for December 2019.
2. There is a discontinuity in the data in April 2013 due to a change in the survey method.