July 15, 2020
Bank of Japan

# Outlook for Economic Activity and Prices (July 2020)

## The Bank's View[1]


### Summary

- Japan's economy is likely to improve gradually from the second half of this year with economic activity resuming, but the pace is expected to be only moderate while the impact of the novel coronavirus (COVID-19) remains worldwide. Thereafter, as the impact subsides globally, the economy is projected to keep improving further with overseas economies returning to a steady growth path.
- The year-on-year rate of change in the consumer price index (CPI, all items less fresh food) is likely to be negative for the time being, mainly affected by COVID-19 and the past decline in crude oil prices. Thereafter, it is expected to turn positive and then increase gradually, since downward pressure on prices is projected to wane gradually along with economic improvement and the effects of the decline in crude oil prices are likely to dissipate.
- The projected growth rates and projected rates of increase in the CPI in this Outlook Report are broadly within the range of the forecasts in the previous report.
- The outlook for economic activity and prices provided in this Outlook Report is extremely unclear, since it could change depending on the consequences of COVID-19 and the magnitude of their impact on domestic and overseas economies. It is based mainly on the assumptions that a second wave of COVID-19 will not occur on a large scale and that, while the impact of COVID-19 remains, firms' and households' medium- to long-term growth expectations will not decline substantially and the smooth functioning of financial intermediation will be ensured with financial system stability being maintained. However, these assumptions entail high uncertainties.
- With regard to the risk balance, risks to both economic activity and prices are skewed to the downside, mainly due to the impact of COVID-19.


[1] "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on July 14 and 15, 2020.

## I. Current Situation of Economic Activity and Prices in Japan

Japan's economy has been in an extremely severe situation with the impact of COVID-19 remaining at home and abroad, although economic activity has resumed gradually. Overseas economies have been depressed significantly, reflecting the impact of the COVID-19 pandemic, although they have shown signs of heading toward a pick-up. In this situation, exports and industrial production have declined substantially. Corporate profits and business sentiment have deteriorated, and business fixed investment has been more or less flat. With the continuing impact of COVID-19, the employment and income situation has been weak. Although private consumption has decreased significantly, mainly in services such as eating and drinking as well as accommodations, it has shown signs of a pick-up recently. Housing investment has declined moderately. Meanwhile, public investment has increased moderately. Financial conditions have been accommodative on the whole but those for corporate financing have remained less so, as seen in deterioration in firms' financial positions. On the price front, the year-on-year rate of change in the CPI (all items less fresh food, and the same hereafter) is at around 0 percent, mainly affected by the decline in crude oil prices. Inflation expectations have weakened somewhat.

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

### A. Baseline Scenario of the Outlook for Economic Activity

Japan's economy, with economic activity resuming, is likely to improve gradually from the second half of this year through the materialization of pent-up demand and supported by accommodative financial conditions and the government's economic measures. However, the pace of improvement is expected to be only moderate while the impact of COVID-19 remains worldwide. Thereafter, as the impact subsides globally, the economy is projected to keep improving further with overseas economies returning to a steady growth path.

The COVID-19 pandemic has had a considerable impact on the global economy, along with the conduct of strict public health measures such as restrictions on going outside and suspension of business and production activities. A phased lifting of these measures has begun, mainly in countries where the spread of COVID-19 has almost subsided, but economic activities of firms and households have remained constrained due to vigilance against COVID-19. In this Outlook Report, which is based on the assumption that a second wave of COVID-19 will not occur on a large scale, it is expected that, until COVID-19 subsides globally, precautionary efforts made voluntarily by firms and households will continue to act as a force constraining economic activity, although it will wane gradually.[2]

Based on this assumption, as the impact of COVID-19 wanes, overseas economies are likely to recover from being depressed significantly, partly supported by aggressive macroeconomic policies, but the pace is expected to be only moderate. Japan's exports are likely to increase gradually along with a recovery in overseas economies but remain constrained for the time being. Inbound tourism consumption is expected to remain subdued while entry restrictions continue.

Domestic demand is likely to see an increase in its level as the impact of COVID-19 wanes, but be only at a low level while it remains. Specifically, along with a resumption of economic activity, household spending such as private consumption is expected to pick up from a significant decline through the materialization of pent-up demand as well as supported by the government's economic measures and accommodative financial conditions. However, the spending is likely to remain constrained while people continue to be vigilant against COVID-19. Business spending, such as business fixed investment, is expected to decrease, mainly in industries affected strongly by substantial declines in exports and consumption. Thereafter, it is likely to pick up as the impact of COVID-19 wanes.

Meanwhile, it is expected that the government's economic measures and accommodative financial conditions will contribute to sustaining businesses and retaining employees, thereby preventing firms' and households' medium- to long-term growth expectations in Japan from declining substantially. Thus, as the impact of COVID-19 subsides globally thereafter, it is likely that exports will continue to increase on the back of growth in overseas economies and that household and business spending will return to a stable increasing trend.

## B. Baseline Scenario of the Outlook for Prices

The year-on-year rate of change in the CPI is likely to be negative for the time being, mainly affected by COVID-19 and the past decline in crude oil prices. With economic activity remaining at a low level due to the impact of COVID-19, it is expected that prices of goods and services that are sensitive to economic activity will be pushed down. Crude oil prices, which declined significantly compared to a while ago, are projected to push down the CPI through energy prices. Under these circumstances, medium- to long-term

[2] According to the global economic outlook released by various international organizations, it is assumed, as a baseline scenario, that the economy will recover from the second half of 2020 after being pushed down significantly in the first half of the year by the rapid spread of COVID-19. In that scenario, which is based on the assumption that a second wave of COVID-19 will not occur on a large scale, an economic recovery is expected to be only moderate since preventive measures, including voluntary ones, are likely to continue to be taken until the COVID-19 pandemic subsides due to medical breakthroughs such as development of effective medicines and vaccines.

inflation expectations are likely to continue weakening somewhat.

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

### C. Financial Conditions

Looking at the financial conditions on which the above outlook is based, corporate financing has been under stress, mainly against the background of a decline in sales that reflects constrained economic activity due to the spread of COVID-19. In response to this situation, the Bank, while pursuing "Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control," has conducted various powerful monetary easing measures since March with a view to supporting financing, mainly of firms, and maintaining stability in financial markets.[3] In addition, the government has conducted various measures to support financing, mainly of firms, through programs that provide loans guaranteed by the credit guarantee corporations and that provide quasi-capital funds. In this situation, along with active efforts made by private financial institutions, the environment for external funding, such as bank borrowing and the issuance of CP and corporate bonds, has remained accommodative. Owing to the Bank's and the government's measures, as well as efforts made by private financial institutions together with those measures, it is expected that financial conditions will remain accommodative and further downward pressure on the real economy from the financial side will be avoided.[4]

## III. Risks to Economic Activity and Prices

### A. Risks to Economic Activity

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

The first is the <u>impact of COVID-19 on domestic and overseas economies</u>. There are extremely high uncertainties over the consequences of COVID-19 and the magnitude of their impact on domestic and overseas economies. Until effective medicines and vaccines

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

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

are developed, it is highly unclear how the COVID-19 pandemic will evolve and how long it will take for it to subside. In particular, if a second wave of COVID-19 occurs on a large scale, economic activity is likely to be constrained significantly again. In addition, households' and firms' behavior at home and abroad is also uncertain, with people continuing to voluntarily make precautionary efforts until COVID-19 subsides.

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

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

## B. Risks to Prices

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

Risks that are specific to prices are as follows. The first is uncertainties over firms' price-setting behavior amid the impact of COVID-19 on both the demand and supply sides of economic activity. A decrease in demand due to constrained economic activity is likely to push down prices of goods and services that are sensitive to economic activity. On the other hand, there are uncertainties over how firms set prices if economic activity is constrained also from the supply side, such as by limiting the number of customers to prevent infection. In addition, it is unclear how these circumstances will affect prices from a macro perspective.

The second is that future developments in foreign exchange rates and international commodity prices, as well as the extent to which such developments will spread to import prices and domestic prices, may lead prices to deviate either upward or downward from the baseline scenario. In particular, since crude oil prices have been highly volatile, it is necessary to pay attention to the effects on the CPI exerted through energy prices.

## IV. Conduct of Monetary Policy

In the context of the price stability target, the Bank assesses the aforementioned economic and price situation from two perspectives and then outlines its thinking on the future conduct of monetary policy.[5]

The first perspective involves an examination of the baseline scenario for the outlook. The year-on-year rate of change in the CPI is likely to increase gradually toward achieving the price stability target, although it will take time. For the time being, prices are expected to be pushed down with economic activity remiaining at a low level due to the impact of COVID-19, and medium- to long-term inflation expectations also are likely to weaken somewhat. Thereafter, prices are expected to increase gradually since downward pressure on them is projected to wane gradually along with economic improvement. In addition, medium- to long-term inflation expectations also are likely to rise again.

The second perspective involves an examination of the risks considered most relevant to the conduct of monetary policy. The outlook for economic activity and prices is extremely unclear, since it could change depending on the consequences of COVID-19 and the magnitude of their impact on domestic and overseas economies. This outlook is based mainly on the assumptions that a second wave of COVID-19 will not occur on a large scale and that, while the impact of COVID-19 remains, firms' and households' medium- to long-term growth expectations will not decline substantially and the smooth functioning of financial intermediation will be ensured with financial system stability being maintained. However, these assumptions entail high uncertainties. With regard to the risk balance, risks to both economic activity and prices are skewed to the downside, mainly due to the impact of COVID-19. When examining financial imbalances from a longer-term perspective, prolonged downward pressure on financial institutions' profits could create a risk of a gradual pullback in financial intermediation, given the existing factors -- such as the prolonged low interest rate environment, the declining population, and excess savings in the corporate sector -- as well as the recent impact of COVID-19. On the other hand, under these circumstances, the vulnerability of the financial system could increase, mainly due to the search for yield behavior. Although these risks are judged as not significant at this point, mainly because financial institutions have sufficient capital bases, it is necessary to pay close attention to future developments.

As for the conduct of monetary policy, the Bank will continue with "QQE with Yield Curve Control," aiming to achieve the price stability target of 2 percent, as long as it is necessary

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

for maintaining that target in a stable manner. It will continue expanding the monetary base until the year-on-year rate of increase in the observed CPI (all items less fresh food) exceeds 2 percent and stays above the target in a stable manner.

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

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

(Appendix)

## Forecasts of the Majority of the Policy Board Members

y/y % chg.

| | | Real GDP | CPI (all items less fresh food) | (Reference) Excluding the effects of the consumption tax hike and policies concerning the provision of free education |
|---|---|---|---|---|
| Fiscal 2020 | | -5.7 to -4.5 [-4.7] | -0.6 to -0.4 [-0.5] | -0.7 to -0.5 [-0.6] |
| | Forecasts made in April 2020 | -5.0 to -3.0 | -0.7 to -0.3 | -0.8 to -0.4 |
| Fiscal 2021 | | +3.0 to +4.0 [+3.3] | +0.2 to +0.5 [+0.3] | |
| | Forecasts made in April 2020 | +2.8 to +3.9 | 0.0 to +0.7 | |
| Fiscal 2022 | | +1.3 to +1.6 [+1.5] | +0.5 to +0.8 [+0.7] | |
| | Forecasts made in April 2020 | +0.8 to +1.6 | +0.4 to +1.0 | |

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

2. The forecasts of the majority of the Policy Board members are constructed as follows: each Policy Board member's forecast takes the form of a point estimate -- namely, the figure to which 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.

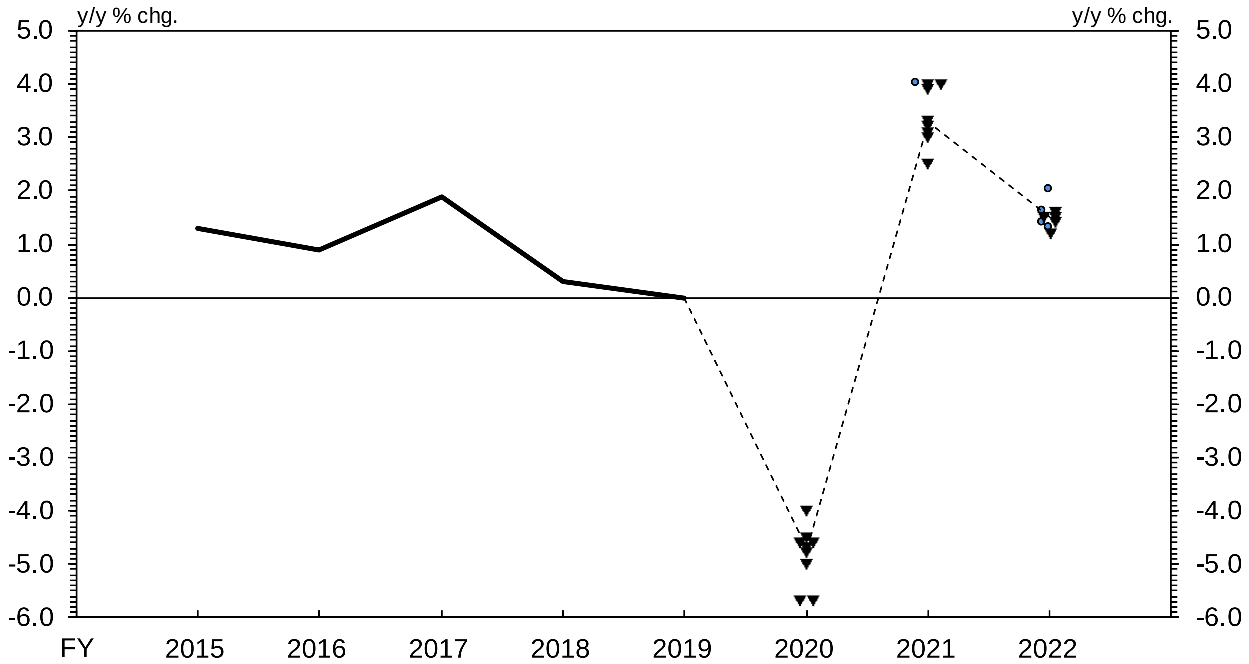
3. In the April Outlook Report, each Policy Board member made their forecasts as a range and submitted two figures (i.e., the highest and lowest figures) within the range of 1.0 percentage point at most. The forecasts of the majority of the Policy Board members were shown as a range excluding four figures -- namely, the two highest figures and two lowest figures among the forecasts of the nine members. Thus, it should be noted that the definition of the forecasts of the majority of the Policy Board members in the April Outlook Report is different from that in the July Outlook Report.

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

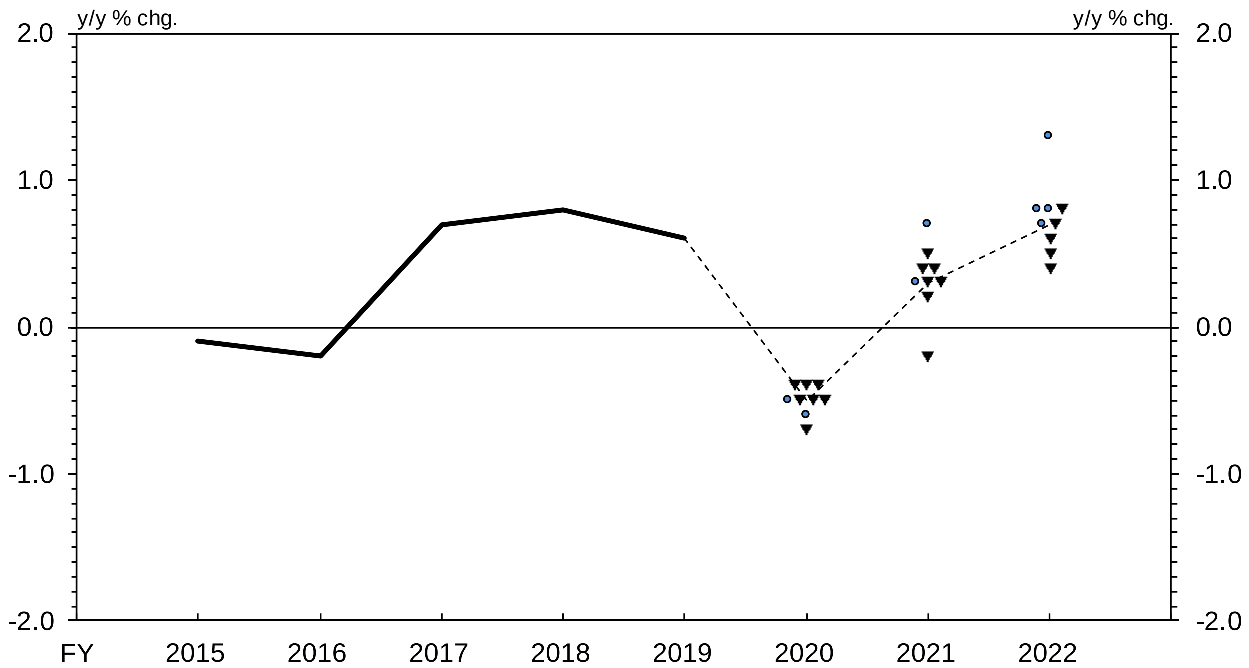
5. The direct effects of the October 2019 consumption tax hike on the CPI for fiscal 2020 are estimated to be 0.5 percentage point. In addition, based on a specific assumption, the direct effects of policies concerning the provision of free education on the CPI for fiscal 2020 are estimated to be around minus 0.4 percentage point.

## Policy Board Members' Forecasts and Risk Assessments

### (1) Real GDP




### (2) CPI (All Items Less Fresh Food)




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

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

3. The CPI figure for fiscal 2015 excludes the direct effects of the April 2014 consumption tax hike.