January 21, 2021

Bank of Japan

Outlook for Economic Activity and Prices (January 2021)

The Bank's View[1]

Summary

- Japan's economy is likely to follow an improving trend with the impact of the novel coronavirus (COVID-19) waning gradually, but the pace is expected to be only moderate while vigilance against COVID-19 continues. Specifically, downward pressure stemming from the impact of a resurgence of COVID-19 is likely to remain strong for the time being, particularly in face-to-face services consumption. Thereafter, as the impact subsides globally, the economy is projected to keep improving further with overseas economies returning to a steady growth path.
- The year-on-year rate of change in the consumer price index (CPI, all items less fresh food) is likely to be negative for the time being, mainly affected by COVID-19, the past decline in crude oil prices, and the "Go To Travel" campaign. Thereafter, it is expected to turn positive and then increase gradually, since downward pressure on prices is projected to wane gradually along with economic improvement and the effects of such factors as the decline in crude oil prices are likely to dissipate.
- Compared with the previous projections in the October Outlook Report, the projected growth rates are somewhat higher, mainly for fiscal 2021, reflecting the effects of the government's economic measures in particular. The projected rates of increase in the CPI are more or less unchanged.
- The outlook for economic activity and prices provided in this Outlook Report is extremely unclear, since it could change depending on the consequences of COVID-19 and the magnitude of their impact on domestic and overseas economies. The outlook is based on the assumption that the impact of COVID-19 will wane gradually and then almost subside toward the end of the projection period. It also is based on the premises that, while the impact remains, firms' and households' medium- to long-term growth expectations will not decline substantially and the smooth functioning of financial intermediation will be ensured with financial system stability being maintained. However, the assumption and premises entail high uncertainties.
- With regard to the risk balance, risks to both economic activity and prices are skewed to the downside, mainly due to the impact of COVID-19.

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

I. Current Situation of Economic Activity and Prices in Japan

Japan's economy has picked up as a trend, although it has remained in a severe situation due to the impact of COVID-19 at home and abroad. Overseas economies also have picked up, although the impact of the resurgence of COVID-19 has been seen in part. In this situation, exports and industrial production have continued to increase. In addition, corporate profits and business sentiment deteriorated significantly but subsequently have improved gradually. Business fixed investment has stopped declining on the whole, albeit with variations across industries. The employment and income situation has remained weak due to the impact of COVID-19. Private consumption has picked up gradually as a trend, but downward pressure has increased recently on consumption of services, such as eating and drinking as well as accommodations. Housing investment has declined moderately. Public investment has continued to increase moderately. Financial conditions have been accommodative on the whole but those for corporate financing have remained less so, as seen in weakness in firms' financial positions. On the price front, the year-on-year rate of change in the CPI (all items less fresh food, and the same hereafter) has been negative, mainly affected by COVID-19, the past decline in crude oil prices, and the "Go To Travel" campaign. Inflation expectations have weakened somewhat.

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

A. Baseline Scenario of the Outlook for Economic Activity

Japan's economy, with the impact of COVID-19 waning gradually, is likely to follow an improving trend, supported by a recovery in external demand, accommodative financial conditions, and the government's economic measures. However, the pace of improvement is expected to be only moderate while vigilance against COVID-19 continues. Specifically, downward pressure stemming from the impact of the resurgence of COVID-19 is likely to remain strong for the time being, particularly in face-to-face services consumption. Thereafter, as the impact subsides globally, the economy is projected to keep improving further with overseas economies returning to a steady growth path.

This baseline scenario is based on the assumption that, while taking preventive measures against COVID-19 and improving economic activity simultaneously, the impact of COVID-19 will wane gradually and then almost subside toward the end of the projection period. The outlook also is based on the premises that, in Japan, while the impact of COVID-19 remains, firms' and households' medium- to long-term growth expectations will not decline substantially and the smooth functioning of financial intermediation will be ensured with financial system stability being maintained.

Looking at the outlook for economic activity based on the assumption and premises in more detail, overseas economies are likely to continue improving, partly supported by aggressive macroeconomic policies, but the pace is expected to be only moderate while vigilance against COVID-19 continues. In addition, production activity of the manufacturing industry and trade are expected to follow an increasing trend, whereas the recovery is projected to be slow in the face-to-face services industry, which is susceptible to the impact of COVID-19. Thereafter, overseas economies are likely to continue improving toward the end of the projection period since the face-to-face services industry in particular is expected to see a marked recovery as the impact of COVID-19 almost subsides.

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

Private consumption is likely to continue picking up as a trend, supported also by the government's economic measures. However, downward pressure, stemming mainly from the impact of the resurgence of COVID-19, is expected to remain strong for the time being, particularly in face-to-face services consumption. Thereafter, with the impact of COVID-19 waning gradually, an uptrend in private consumption is likely to become evident gradually, supported also by improvement in employee income. Although the government's economic measures and accommodative financial conditions are expected to support employment, the employment and income situation is projected to be under downward pressure for the time being against the background of low levels of corporate profits and worsening labor market conditions. The employment and income situation is likely to turn to an improving trend thereafter, with domestic and external demand recovering.

Business fixed investment is expected to pick up, mainly for machinery investment by the manufacturing industry that reflects a rise in exports and production, although construction investment by the face-to-face services industry is projected to continue declining. Thereafter, business fixed investment is expected to increase, supported by accommodative financial conditions, the government's economic measures, and improvement in corporate profits. Meanwhile, public investment is projected to steadily increase, reflecting progress such as in construction related to restoration and reconstruction following natural disasters, as well as to building national resilience. Thereafter, it is expected to be at a relatively high level. Government consumption is projected to continue increasing clearly toward fiscal 2021, mainly reflecting the enhancement of the medical treatment system as well as the testing and vaccination system, both of which are under the additional economic measures.

B. Baseline Scenario of the Outlook for Prices

The year-on-year rate of change in the CPI is likely to be negative for the time being, mainly affected by COVID-19, the past decline in crude oil prices, and the "Go To Travel" campaign.[2] With economic activity remaining at a low level due to the impact of COVID-19, it is expected that prices of goods and services that are sensitive to economic activity will be pushed down. The past decline in crude oil prices also is projected to push down the CPI through energy prices. Under these circumstances, medium- to long-term inflation expectations are likely to continue weakening somewhat.

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

C. Financial Conditions

The Bank has pursued "Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control." It also has conducted various powerful monetary easing measures since March 2020 in response to COVID-19 with a view to supporting financing, mainly of firms, and maintaining stability in financial markets.[3] In addition, the government has conducted various measures to support financing, mainly of firms, through programs that provide loans guaranteed by the credit guarantee corporations and also quasi-capital funds. Under these circumstances, private financial institutions have actively fulfilled the functioning of financial intermediation. In this situation, although firms' financial positions have been weak, the environment for external funding, such as bank borrowing and the issuance of CP and corporate bonds, has remained accommodative. Tension has eased in financial markets. Financing, mainly of firms, is likely to remain under stress for the time being with a moderate pace of economic improvement, but owing to the Bank's and the government's measures, as well as efforts made by private financial institutions, the Bank

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[2] Based on specific assumptions, the direct effects of the "Go To Travel" campaign on the CPI are estimated to be minus 0.2 percentage point for fiscal 2020 and 0.1 percentage point for both fiscal 2021 and 2022. Major mobile phone carriers have made public new plans that include price cuts on charges, but this is not factored into the outlook for prices in this report since the impact of such plans could change depending on how they will be reflected in the CPI.

[3] See "Enhancement of Monetary Easing in Light of the Impact of the Outbreak of the Novel Coronavirus (COVID-19)" released on March 16, 2020, "Enhancement of Monetary Easing" released on April 27, 2020, "Introduction of a New Fund-Provisioning Measure to Support Financing Mainly of Small and Medium-Sized Firms" released on May 22, 2020, and "Statement on Monetary Policy" released on December 18, 2020, in which the Bank made decisions such as on the extension of the Special Program to Support Financing in Response to the Novel Coronavirus (COVID-19).

considers that financial conditions will remain accommodative and further downward pressure on the real economy from the financial side will be avoided.[4]

III. Risks to Economic Activity and Prices

A. Risks to Economic Activity

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

The first is the impact of COVID-19 on domestic and overseas economies. There are extremely high uncertainties over the consequences of COVID-19 and the magnitude of their impact on domestic and overseas economies. It is highly unclear how the COVID-19 pandemic will evolve, and there is a possibility that downward pressure on economic activity will increase due to the spread of COVID-19. Meanwhile, although the impact of COVID-19 could subside earlier than expected if vaccines become widely available, the pace of distribution and the effects of the vaccines entail uncertainties.

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

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

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

B. Risks to Prices

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

The first is uncertainties over firms' price-setting behavior amid the impact of COVID-19 on both the demand and supply sides of economic activity. A decrease in demand due to the impact of COVID-19 is likely to put downward pressure on prices of goods and services that are sensitive to economic activity. On the other hand, firms' price cuts that aim at stimulating demand have not been observed widely to date, given that one of the reasons for the current decrease in demand is vigilance against COVID-19 and that there have been supply-side constraints, such as limiting the number of customers to prevent infection, and cost increases due to preventive measures against COVID-19. Under these circumstances, there are high uncertainties over how firms will set their prices and how this will affect general prices from a macro perspective.

The second is future developments in foreign exchange rates and international commodity prices, as well as the extent to which such developments will spread to import prices and domestic prices. These risks may lead prices to deviate either upward or downward from the baseline scenario, and thus continue to warrant attention.

IV. Conduct of Monetary Policy

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

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

The second perspective involves an examination of the risks considered most relevant to the conduct of monetary policy. The outlook for economic activity and prices is extremely unclear, since it could change depending on the consequences of COVID-19 and the

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

magnitude of their impact on domestic and overseas economies. The outlook is based on the assumption that the impact of COVID-19 will wane gradually and then almost subside toward the end of the projection period. It also is based on the premises that, while the impact remains, firms' and households' medium- to long-term growth expectations will not decline substantially and the smooth functioning of financial intermediation will be ensured with financial system stability being maintained. However, the assumption and premises entail high uncertainties. With regard to the risk balance, risks to both economic activity and prices are skewed to the downside, mainly due to the impact of COVID-19. When examining financial imbalances from a longer-term perspective, prolonged downward pressure on financial institutions' profits could create a risk of a gradual pullback in financial intermediation, given the existing factors -- such as the prolonged low interest rate environment, the declining population, and excess savings in the corporate sector -- as well as the recent impact of COVID-19. On the other hand, under these circumstances, the vulnerability of the financial system could increase, mainly due to the search for yield behavior. Although these risks are judged as not significant at this point, mainly because financial institutions have sufficient capital bases, it is necessary to pay close attention to future developments.

As for the conduct of monetary policy, the Bank will continue with "QQE with Yield Curve Control," aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner. It will continue expanding the monetary base until the year-on-year rate of increase in the observed CPI (all items less fresh food) exceeds 2 percent and stays above the target in a stable manner.

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

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

(Appendix)

Forecasts of the Majority of the Policy Board Members

y/y % chg.

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

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

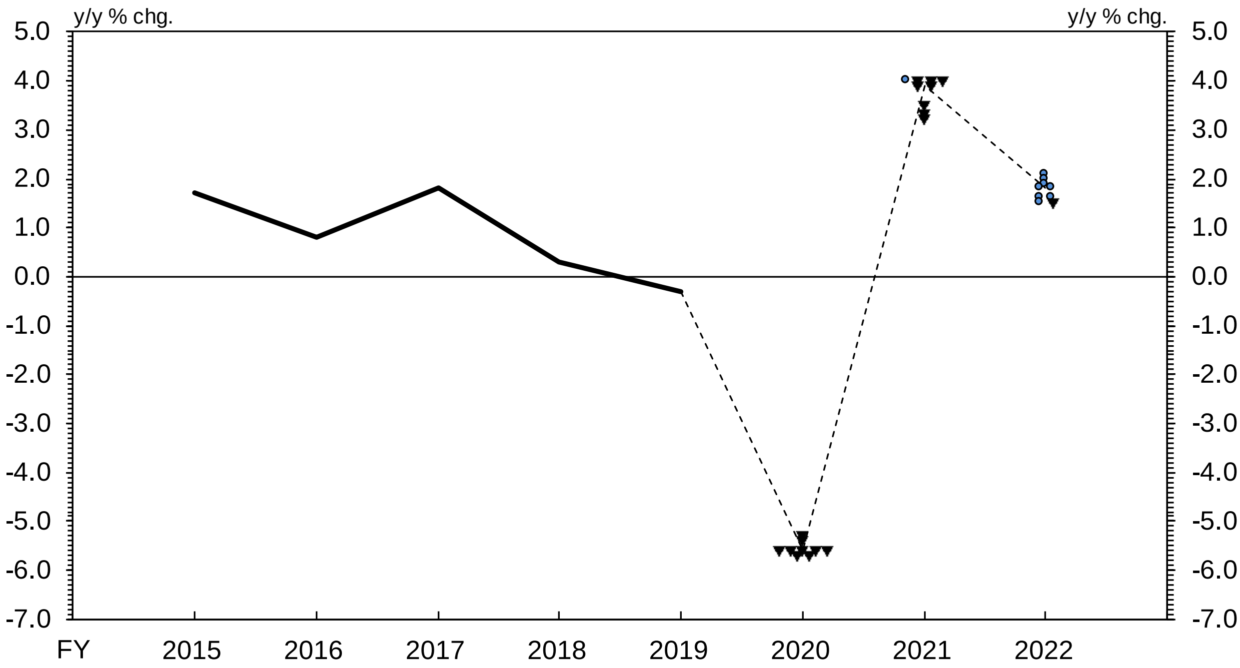
2. The forecasts of the majority of the Policy Board members are constructed as follows: each Policy Board member's forecast takes the form of a point estimate -- namely, the figure to which he or she attaches the highest probability of realization. These forecasts are then shown as a range, with the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

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

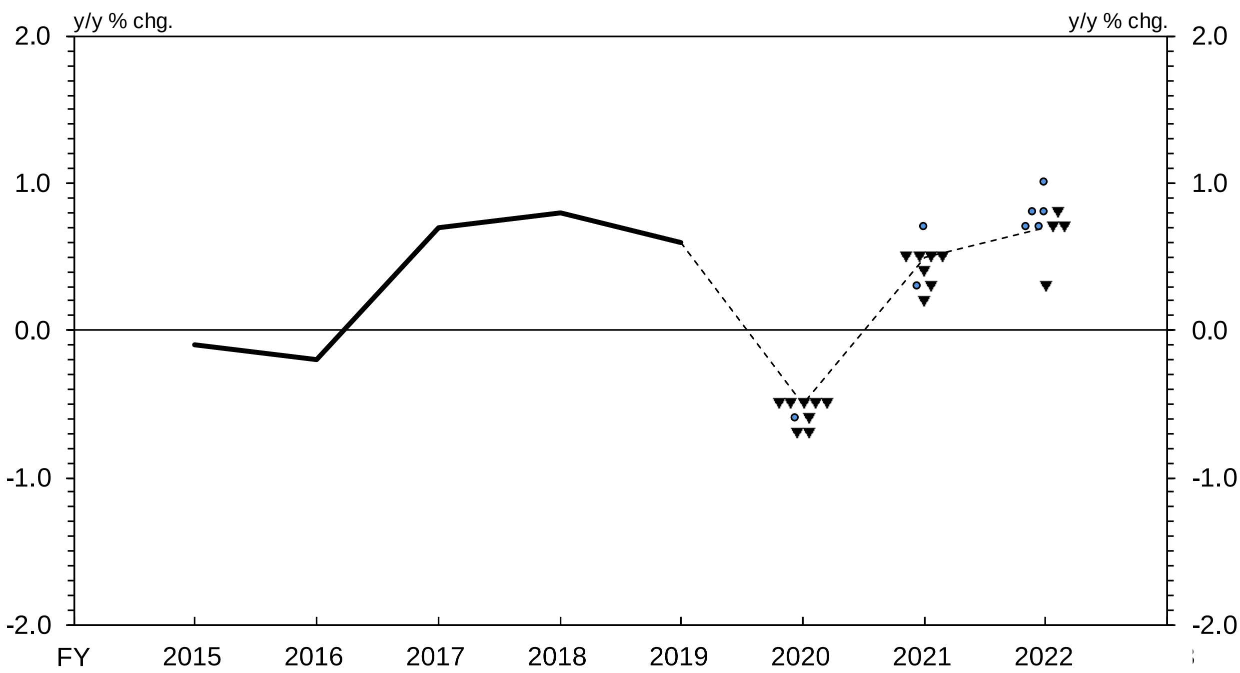
4. The direct effects of the October 2019 consumption tax hike on the CPI for fiscal 2020 are estimated to be 0.5 percentage point. In addition, based on a specific assumption, the direct effects of policies concerning the provision of free education on the CPI for fiscal 2020 are estimated to be around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

Policy Board Members' Forecasts and Risk Assessments

(1) Real GDP



(2) CPI (All Items Less Fresh Food)



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

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

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