April 27, 2021
Bank of Japan

Outlook for Economic Activity and Prices (April 2021)

The Bank's View[1]

Summary

- Although the level of Japan's economic activity, mainly in the face-to-face services sector, is expected to be lower than that prior to the pandemic for the time being, the economy is likely to recover, with the impact of the novel coronavirus (COVID-19) waning gradually and supported by an increase in external demand, accommodative financial conditions, and the government's economic measures. Thereafter, as the impact subsides, it is projected to continue growing with a virtuous cycle from income to spending intensifying.
- The year-on-year rate of change in the consumer price index (CPI, all items less fresh food) is likely to be slightly negative for the time being, mainly affected by COVID-19 and a reduction in mobile phone charges. Thereafter, it is expected to turn positive and then increase gradually, mainly on the back of economic activity continuing to improve and the effects of the reduction in mobile phone charges dissipating.
- Comparing the projections through fiscal 2022 with those presented in the previous *Outlook for Economic Activity and Prices* (Outlook Report), the projected growth rates are higher, mainly for fiscal 2022, on the back of stronger domestic and external demand. The projected rate of increase in the CPI for fiscal 2021 is lower due to the effects of the reduction in mobile phone charges, but that for fiscal 2022 is more or less unchanged.
- The outlook for economic activity and prices provided in this Outlook Report is highly unclear, since it could change depending on the consequences of COVID-19 and 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 in the middle 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 economic activity are skewed to the downside for the time being, mainly due to the impact of COVID-19, but are generally balanced for the middle of the projection period onward. Risks to prices are skewed to the downside.

[1] "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on April 26 and 27, 2021.

I. Current Situation of Economic Activity and Prices in Japan

Japan's economy has picked up as a trend, although it has remained in a severe situation due to the impact of COVID-19 at home and abroad. Overseas economies have recovered on the whole, albeit with variation across countries and regions. In this situation, exports and industrial production have continued to increase. In addition, corporate profits and business sentiment have improved on the whole. Business fixed investment has picked up, although weakness has been seen in some industries. The employment and income situation has remained weak due to the impact of COVID-19. A pick-up in private consumption has paused due to increased downward pressure 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, although weakness in firms' financial positions has been seen. 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 slightly negative, mainly affected by COVID-19 and the past decline in crude oil prices. Meanwhile, 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

Japan's economy is likely to recover, although the level of economic activity, mainly in the face-to-face services sector, is expected to be lower than that prior to the pandemic for the time being. That is, with the impact of COVID-19 waning gradually and the economy being supported by an increase in external demand, accommodative financial conditions, and the government's economic measures, a virtuous cycle from income to spending is expected to operate. Thereafter, as the impact subsides, the economy is projected to continue growing with the virtuous cycle intensifying.

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 in the middle of the projection period, due mainly to progress with vaccinations. 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 growing, albeit with variation across countries and regions, partly supported by aggressive macroeconomic policies taken mainly in advanced economies. In this situation, although the pace of increase in

Japan's goods exports is likely to decelerate for the time being, mainly for automobile-related goods, goods exports are projected to continue increasing firmly, supported by a global recovery in business fixed investment and an expansion in digital-related demand. Inbound tourism consumption, which is categorized under services exports, is expected to remain subdued while entry and travel restrictions continue but likely to recover thereafter.

An uptrend in business fixed investment is expected to become clear, mainly for machinery and digital-related investments, with improvement in corporate profits and supported by accommodative financial conditions and the government's economic measures, although construction investment by the face-to-face services sector is projected to remain weak.

Private consumption, mainly of face-to-face services, is likely to remain sluggish, being at a relatively low level for the time being due to the impact of COVID-19, but then it is expected to pick up again with the impact waning gradually and supported also by the government's economic measures. Thereafter, as the impact of COVID-19 subsides, an uptrend in private consumption, including that of face-to-face services, is projected to become evident with employee income improving. Employee income is likely to stop declining, reflecting improvement in corporate profits, and then increase moderately with a time lag following the recovery in domestic and external demand.

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 likely to increase clearly for fiscal 2021, mainly reflecting enhancement of the medical treatment system and the testing and vaccination system, but see a lowering in its level thereafter.

B. Baseline Scenario of the Outlook for Prices

The year-on-year rate of change in the CPI is likely to be slightly negative for the time being, mainly affected by COVID-19 and the reduction in mobile phone charges.[2] That said, the reduction is a temporary factor, and when its effects are excluded, the year-on-year rate of change in the CPI is expected to be steady. Although weakness in demand amid the situation of COVID-19 is projected to have an impact on prices, firms' price cuts that aim at stimulating demand have not been and are not likely to be observed

[2] The CPI forecasts in this Outlook Report are based on the current 2015-base index. The statistics authority that compiles the CPI has announced its plan to rebase the CPI to the base year of 2020 and retroactively revise its figures for the year-on-year rate of change from those for January 2021 onward, both in August 2021. With the rebasing, the reduction in mobile phone charges will have a larger impact than the current index, mainly because the weight of such charges in the CPI will rise. Therefore, the year-on-year rate of increase in the CPI is highly likely to be revised downward for the 2020-base index.

widely, given that one of the reasons for the decrease in demand is vigilance against COVID-19 and that there have been supply-side constraints and cost increases because of taking preventive measures against COVID-19. In addition, it is expected that the year-on-year rate of change in energy prices will turn positive on the back of a pick-up in crude oil prices since last autumn. Under these circumstances, medium- to long-term inflation expectations are likely to be more or less unchanged.

Thereafter, the year-on-year rate of change in the CPI is expected to turn positive and then increase gradually, mainly on the back of economic activity continuing to improve and the effects of the reduction in mobile phone charges dissipating. 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 the impact of COVID-19 with a view to supporting financing, mainly of firms, and maintaining stability in financial markets.[3] The government has conducted various measures to support financing, mainly of firms. Private financial institutions have actively fulfilled the functioning of financial intermediation. In this situation, although weakness in firms' financial positions has been seen, the environment for external funding, such as bank borrowing and the issuance of CP and corporate bonds, has remained accommodative. Owing to the continuation of powerful monetary easing by the Bank, the government's measures, and efforts made by private financial institutions, the Bank 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.

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[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, "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), and "Further Effective and Sustainable Monetary Easing" released on March 19, 2021.

[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.

The first is the impact of COVID-19 on domestic and overseas economies. There are high uncertainties over the consequences of COVID-19 and their impact on domestic and overseas economies. As the baseline scenario, it is assumed that the impact of COVID-19 will subside, mainly due to the vaccine rollout. However, the pace of such rollout and the effects of the vaccines entail uncertainties, and thus there is a risk that downward pressure on economic activity will increase. In addition, it is also uncertain how the varying paces of the vaccine rollout across countries and regions will affect global economic activity. On the other hand, with economic measures conducted particularly in advanced economies, such as those in response to the impact of COVID-19, the pace of recovery in domestic and overseas economies could be faster than expected.

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.[5] 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. 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. As the baseline scenario of the outlook for prices, firms' price cuts that aim at stimulating

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

demand have not been and are not likely to be observed widely, as described earlier. That said, including this aspect, firms' price-setting behavior entails uncertainties.

The second is future developments in foreign exchange rates, international commodity prices, and import prices, as well as the effects of such developments on 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.[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 achieving the price stability target, although it will take time. For the time being, weakness in demand amid the situation of COVID-19 is expected to have an impact on prices, and medium- to long-term inflation expectations are likely to be more or less unchanged. Thereafter, prices are expected to increase gradually since upward pressure on them is projected to intensify at a gradual pace with the economy continuing to improve. 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 highly unclear, since it could change depending on the consequences of COVID-19 and 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 in the middle 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 economic activity are skewed to the downside for the time being, mainly due to the impact of COVID-19, but are generally balanced for the middle of the projection period onward. Risks to prices are skewed to the downside. Looking at the current situation from the perspective of financial imbalances, the aggregate credit relative to the size of the economy has been increasing at a pace significantly above the past trend. This is because financial institutions have responded to demand for working capital, mainly by firms, which has increased due to the

[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."

impact of COVID-19, and the increase in the aggregate credit therefore does not seem to show overheating of financial activities. On this basis, 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) purchases of exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) with upper limits of about 12 trillion yen and about 180 billion yen, respectively, on annual paces of increase in their amounts outstanding.

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

(Appendix)

Forecasts of the Majority of the Policy Board Members

y/y % chg.

	Real GDP	CPI (all items less fresh food)
Fiscal 2020	-5.0 to -4.9 [-4.9]	-0.4
Forecasts made in January 2021	-5.7 to -5.4 [-5.6]	-0.7 to -0.5 [-0.5]
Fiscal 2021	+3.6 to +4.4 [+4.0]	0.0 to +0.2 [+0.1]
Forecasts made in January 2021	+3.3 to +4.0 [+3.9]	+0.3 to +0.5 [+0.5]
Fiscal 2022	+2.1 to +2.5 [+2.4]	+0.5 to +0.9 [+0.8]
Forecasts made in January 2021	+1.5 to +2.0 [+1.8]	+0.7 to +0.8 [+0.7]
Fiscal 2023	+1.2 to +1.5 [+1.3]	+0.7 to +1.0 [+1.0]

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

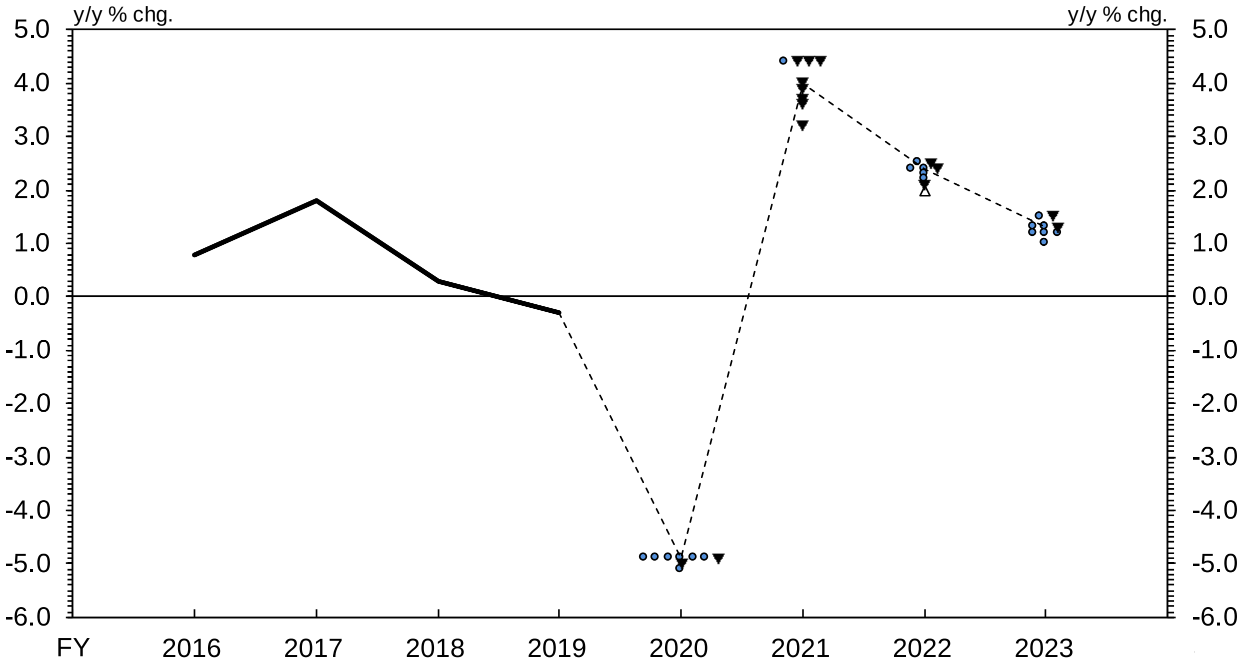
2. The forecasts of the majority of the Policy Board members are constructed as follows: each Policy Board member's forecast takes the form of a point estimate -- namely, the figure to which they attach the highest probability of realization. These forecasts are then shown as a range, with the highest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

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

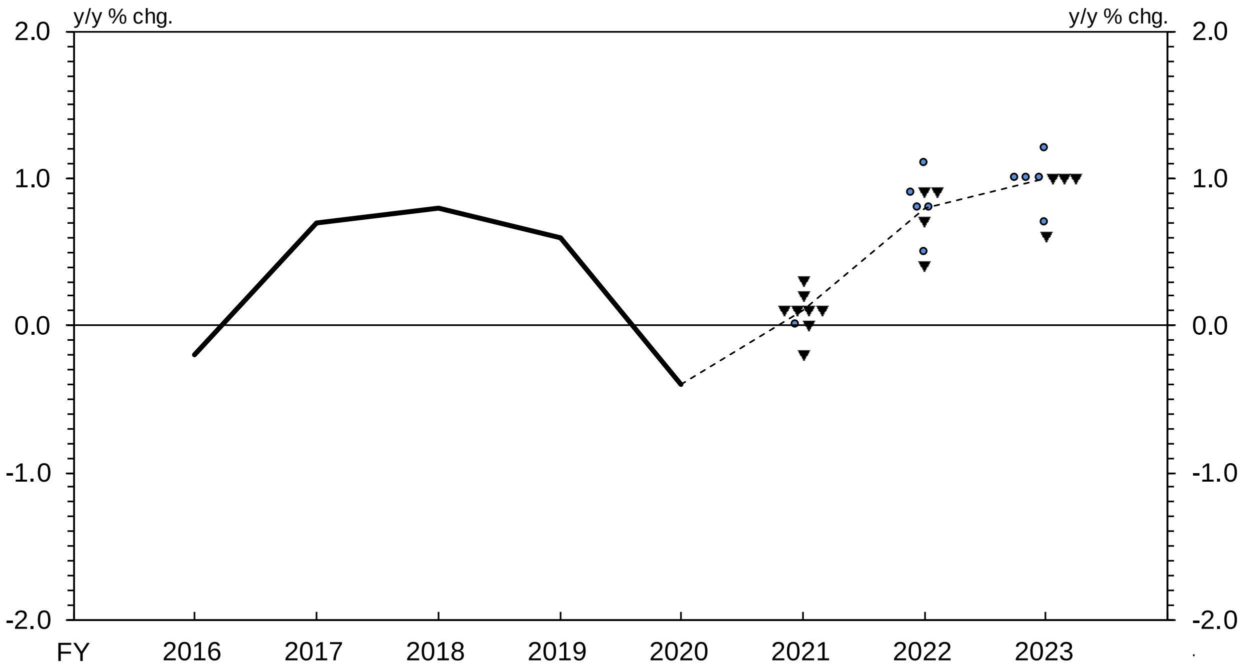
4. The CPI (all items less fresh food) for fiscal 2020 is an actual figure.

Policy Board Members' Forecasts and Risk Assessments

(1) Real GDP



(2) CPI (All Items Less Fresh Food)



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

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