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BANK OF JAPAN

Outlook for Economic Activity and Prices

October 2023

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

Outlook for Economic Activity and Prices (October 2023)

The Bank's View[1]

Summary

- Japan's economy is likely to continue recovering moderately for the time being, supported by factors such as the materialization of pent-up demand, although it is expected to be under downward pressure stemming from a slowdown in the pace of recovery in overseas economies. Thereafter, as a virtuous cycle from income to spending gradually intensifies, Japan's economy is projected to continue growing at a pace above its potential growth rate.
- The year-on-year rate of increase in the consumer price index (CPI, all items less fresh food) is likely to be above 2 percent through fiscal 2024, mainly due to the remaining effects of a pass-through to consumer prices of cost increases led by the past rise in import prices and the effects of the recent rise in crude oil prices. As for fiscal 2025, the rate of increase in the CPI is projected to decelerate owing to dissipation of these effects. Meanwhile, toward the end of the projection period, underlying CPI inflation is likely to increase gradually toward achieving the price stability target, as the output gap turns positive and as medium- to long-term inflation expectations and wage growth rise.
- Comparing the projections with those presented in the previous *Outlook for Economic Activity and Prices* (Outlook Report), the projected real GDP growth rate for fiscal 2023 is higher. The projected year-on-year rate of increase in the CPI (all items less fresh food) for fiscal 2023 is somewhat higher, mainly because, while the government's economic measures will push down energy prices, cost increases have been passed on to consumer prices to a greater extent than expected. The projected rate of increase in this CPI for fiscal 2024 is significantly higher, mainly due to the effects of the recent rise in crude oil prices and to a waning of the effects of the economic measures pushing down energy prices of the previous year.
- Concerning risks to the outlook, there are extremely high uncertainties surrounding Japan's economic activity and prices, including developments in overseas economic activity and prices, developments in commodity prices, and domestic firms' wage- and price-setting behavior. Under these circumstances, it is necessary to pay due attention to developments in financial and foreign exchange markets and their impact on Japan's economic activity and prices.
- With regard to the risk balance, risks to economic activity are generally balanced for fiscal 2023 and 2024 but are skewed to the downside for fiscal 2025. Risks to prices are skewed to the upside for fiscal 2023. In terms of prices, it should be noted that, mainly due to the experience of prolonged low growth and deflation, the behavior and mindset based on the assumption that wages and prices will not increase easily have taken hold in society. Considering this, it is important to closely monitor whether a virtuous cycle between wages and prices will intensify.

[1] "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on October 30 and 31, 2023.

I. Current Situation of Economic Activity and Prices in Japan

Japan's economy has recovered moderately. The pace of recovery in overseas economies has slowed. Although exports and industrial production have been affected by the developments in overseas economies, they have been more or less flat, supported by a waning of the effects of supply-side constraints. Corporate profits have been at high levels on the whole, and business sentiment has improved moderately. In this situation, business fixed investment has increased moderately. The employment and income situation has improved moderately. Private consumption has increased steadily at a moderate pace, despite being affected by price rises. Housing investment has been relatively weak. Public investment has increased moderately. Financial conditions have been accommodative. On the price front, the year-on-year rate of increase in the CPI (all items less fresh food) is slower than a while ago, mainly due to the effects of pushing down energy prices from the government's economic measures, but it has been in the range of 2.5-3.0 percent recently owing to the effects of a pass-through to consumer prices of cost increases led by the past rise in import prices. Inflation expectations have risen moderately.

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

A. Baseline Scenario of the Outlook for Economic Activity

Japan's economy is likely to continue recovering moderately for the time being, supported by the materialization of pent-up demand, as well as by factors such as accommodative financial conditions and the government's economic measures, although it is expected to be under downward pressure stemming from a slowdown in the pace of recovery in overseas economies. Thereafter, pent-up demand and the effects of the economic measures are projected to wane, but Japan's economy is expected to continue growing at a pace above its potential growth rate as a virtuous cycle from income to spending gradually intensifies in the overall economy.

Comparing the projections with those presented in the previous Outlook Report, the projected real GDP growth rate for fiscal 2023 is higher. This reflects the actual data showing that the growth rate thus far has been higher than was previously projected, mainly due to a decline in imports.

In the household sector, employment is likely to continue rising, but the pace of increase is projected to moderate gradually. This is because it will become more difficult for labor supply to increase, with labor force participation of women and seniors having advanced to a high degree thus far. That said, these developments will lead to an increased tightening of labor market conditions during the course of the economic recovery. In this situation, wage growth is expected to increase as a trend, partly reflecting price rises, and employee income is projected to continue increasing. Against this backdrop, although private consumption is expected to be affected by the price rises, it is projected to keep increasing moderately for the time being. This is because pent-up demand is likely to materialize, partly supported by household savings that had accumulated as a result of pandemic-related restrictions, and because factors such as improvement in consumer sentiment, which mainly reflects the rise in wage growth, are expected to provide support. Private consumption is also projected to be underpinned by the government's measures, such as those to reduce the household burden of higher gasoline prices, electricity charges, and gas charges. Thereafter, although private consumption is likely to be affected by a slowdown in the materialization of pent-up demand and a waning of the positive contribution of the government's various measures, it is expected to keep increasing moderately, supported by the rise in employee income.

In the corporate sector, exports and production are projected to be more or less flat for the time being, affected by the slowdown in the pace of recovery in overseas economies. Subsequently, as these economies grow moderately, albeit with variation across countries and regions, exports and production are likely to return to an uptrend. Meanwhile, inbound tourism demand, which is categorized under services exports, is expected to continue increasing. Corporate profits are likely to follow an improving trend, as it is projected that they will be pushed up for the time being by factors such as progress in the pass-through of past high raw material costs to selling prices, and thereafter by a moderate increase in domestic and external demand. In this situation, as accommodative financial conditions provide support, business fixed investment is likely to continue increasing, including investment to address labor shortages, digital-related investment, research and development (R&D) investment related to growth areas and decarbonization, and investment associated with strengthening supply chains. Toward the end of the projection period, it is expected to be under cyclical adjustment pressure stemming from the accumulation of capital stock, but investment to address labor shortages and investment that is not necessarily responsive to the business cycle, such as that related to decarbonization, are likely to increase steadily.

Meanwhile, public investment is expected to be more or less flat, with expenditure related to building national resilience continuing. Government consumption is expected to decline temporarily in reflection of developments in expenditure related to COVID-19, and then gradually increase in reflection of an uptrend in healthcare and nursing care expenditures.

Looking at the financial conditions on which the above outlook is based, it is expected that they will remain accommodative as the Bank pursues Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control, and that this will support an increase in private demand.[2] That is, the environment for external funding, such as bank borrowing and the issuance of CP and corporate bonds, is projected to remain accommodative. In

[2] 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.

this situation, firms' financial positions are likely to follow an improving trend along with the economic recovery.

The potential growth rate is expected to rise moderately.[3] This is mainly because productivity is likely to increase due to advances in digitalization and investment in human capital, and because capital stock growth is projected to accelerate due to a rise in business fixed investment. These developments are likely to be encouraged by the government's various measures and by accommodative financial conditions.

B. Baseline Scenario of the Outlook for Prices

The year-on-year rate of increase in the CPI (all items less fresh food) is likely to be above 2 percent through fiscal 2024, mainly due to the remaining effects of a pass-through to consumer prices of cost increases led by the past rise in import prices and the effects of the recent rise in crude oil prices. As for fiscal 2025, the rate of increase in the CPI is projected to decelerate owing to dissipation of these effects. Meanwhile, toward the end of the projection period, underlying CPI inflation is likely to increase gradually toward achieving the price stability target, as the output gap turns positive and as medium- to long-term inflation expectations and wage growth rise.

Comparing the projections with those presented in the previous Outlook Report, the projected year-on-year rate of increase in the CPI (all items less fresh food) for fiscal 2023 is somewhat higher. This is mainly because, while the extension of the government's measures to reduce the household burden of higher gasoline prices, electricity charges, and gas charges will push down year-on-year CPI inflation, cost increases led by the past rise in import prices have been passed on to consumer prices to a greater extent than expected. The projected rate of increase in this CPI for fiscal 2024 is significantly higher. This is mainly due to the effects of the recent rise in crude oil prices as well as to a waning of the effects of the extended measures pushing down year-on-year CPI inflation for fiscal 2023.

The outlook for the CPI (all items less fresh food) depends on the assumptions regarding crude oil prices and the government's economic measures. Crude oil prices are assumed to decline moderately toward the end of the projection period with reference, for example, to developments in futures markets. The government's measures to reduce the household burden of higher gasoline prices, electricity charges, and gas charges are expected to push down the year-on-year rate of change in the CPI (all items less fresh food) for fiscal 2023. For fiscal 2024, on the other hand, they are projected to push up the rate due to a

[3] Under a specific methodology, Japan's recent potential growth rate is estimated to be at around 0.5 percent. However, the rate should be interpreted with considerable latitude. This is because the estimate is subject to change depending on the methodologies employed and could be revised as the sample period becomes longer over time. In addition, there are particularly high uncertainties in the current phase over how COVID-19 will affect the trends in productivity or labor supply.

waning of the effects of those measures pushing down CPI inflation of the previous year. In this regard, looking at the CPI (all items less fresh food and energy) -- which is not directly affected by fluctuations in energy prices -- the year-on-year rate of increase is likely to decelerate, due to a gradual waning of the effects of the pass-through to consumer prices of cost increases led by the past rise in import prices, and subsequently be at around 2 percent toward the end of the projection period.

The main factors that determine underlying inflation are assessed as follows. The output gap, which captures the utilization of labor and capital, has been at around 0 percent. Based on the aforementioned outlook for economic activity, the gap is likely to turn positive and expand moderately toward the end of the projection period, albeit at a gradually slowing pace. Under these circumstances, labor market conditions are expected to tighten, partly due to a deceleration in the pace of increase in labor force participation of women and seniors, and upward pressure on wages is projected to intensify. This is likely to put upward pressure on personnel expenses on the cost side and contribute to an increase in households' purchasing power.

Medium- to long-term inflation expectations have risen moderately. The September 2023 *Tankan* (Short-Term Economic Survey of Enterprises in Japan) shows that the diffusion index (DI) for output prices has been at a high level, and firms' inflation outlook for general prices has also been at a high level, not only for the short term but also for the medium to long term. In addition, the wage growth rate agreed in the annual spring labor-management wage negotiations this year was significantly higher than in the previous year, including base pay. Given that the formation of inflation expectations in Japan is largely adaptive, the increase in inflation seen thus far has brought about a rise in households' and firms' medium- to long-term inflation expectations. In this situation, some aspects of firms' behavior have begun to shift more toward raising wages and prices. Regarding the outlook, even as actual inflation decelerates, inflation expectations are expected to rise moderately toward the end of the projection period, with the output gap turning positive and changes in firms' wage- and price-setting behavior and in labor-management wage negotiations. This will likely lead to a sustained rise in prices accompanied by wage increases.

Considering the above assessments, although it is necessary to pay attention to the extremely high uncertainties surrounding the outlook, underlying CPI inflation is likely to increase gradually toward achieving the price stability target.

III. Risks to Economic Activity and Prices

A. Risks to Economic Activity

Regarding the aforementioned baseline scenario of the outlook for economic activity, the main upside and downside risks that require attention are as follows.

The first is developments in overseas economic activity and prices and in global financial and capital markets. Although inflation rates in the United States and Europe are lower than a while ago, inflationary pressure has remained on a global basis. In this situation, overseas central banks have continued to conduct tight monetary policy. On this point, it is expected in the baseline scenario that inflation rates around the world will decline gradually and that overseas economies will continue to grow moderately, albeit with variation across countries and regions. That said, there is a risk of inflation rates staying elevated through wage increases, mainly in advanced economies. In addition, since the policy interest rate hikes by overseas central banks to date have been rapid, there are high uncertainties over how these hikes will affect their real economies and financial systems with a time lag. Taking these risks into account, it is necessary to pay due attention to developments in financial and foreign exchange markets and their impact on Japan's economic activity and prices. Meanwhile, depending on the course of the situation surrounding Ukraine, downward pressure on overseas economies, particularly the euro area, could heighten. In addition, regarding the Chinese economy, there are high uncertainties surrounding the future pace of pick-up, as adjustment pressure has remained in the labor and real estate markets.

The second risk is developments in import prices, particularly those of commodities, including grains. Although prices of grains and other commodities had declined on the whole after reaching their peak around the middle of last year, energy prices, such as for crude oil, have risen recently. Attention is warranted on the risk that prices of commodities, including grains, will fluctuate significantly due to geopolitical factors, such as those concerning Ukraine and the Middle East. Furthermore, in the medium to long term, there are extremely high uncertainties surrounding, for example, efforts by countries around the world toward addressing climate change. Given that Japan is an importer of commodities such as energy and grains (e.g., wheat), a rise in these prices due to supply factors puts greater downward pressure on the economy through an increase in import costs, as this rise is not accompanied by an expansion in external demand or an increase in exports. If the terms of trade were to deteriorate again, this could squeeze corporate profits and households' real income, leading business fixed investment and private consumption to deviate downward from the baseline scenario through more cautious spending behavior of firms and households. Moreover, with progress in the pass-through of the rise in import prices to consumer prices, if wage increases were to be limited, this could further strengthen households' defensive attitudes toward spending and push down the economy. On the other hand, if prices of commodities, including grains, decline, the economy could deviate upward.

The third risk considered from a somewhat long-term perspective is firms' and households' medium- to long-term growth expectations. It is expected that factors such as moves toward digitalization, which reflect the experience of COVID-19 and intensifying labor shortages, and progress on efforts with a view to decarbonization and on labor market reform will change Japan's economic structure and people's working styles. Furthermore, the heightened geopolitical risks could change the trend of globalization, which has supported the growth of the global economy to date. Depending on how firms and households react to these changes, their medium- to long-term growth expectations, the potential growth rate, and the output gap could go either up or down.

B. Risks to Prices

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

The first is high uncertainties over firms' wage- and price-setting behavior, which could exert either upward or downward pressure on prices. In the current inflationary phase, with Japan's economy following a recovery trend and against the backdrop of high raw material costs, many firms have raised prices while giving consideration to price setting by competitors. While a fair degree of progress seems to have already been made in the pass-through of the past rise in import prices to consumer prices, depending on how much upward pressure will be exerted by raw material costs and on how firms' inflation expectations will develop, this pass-through could continue for longer than expected and lead prices to deviate upward from the baseline scenario. In addition, with labor market conditions tightening, it is possible that firms will further shift their wage-setting behavior toward raising wages, in view of factors such as recruitment and retention. Under these circumstances, there is a possibility that both wages and prices will deviate upward from the baseline scenario to a greater extent than can be explained by changes in the output gap, as moves to reflect not only price developments in wage setting but also wage developments in price setting become more widespread than expected. On the other hand, with inflation decelerating, medium- to long-term inflation expectations could decline through the mechanism of adaptive inflation expectations formation, and this could affect firms' price-setting behavior. In addition, although the wage growth rate agreed in the annual spring labor-management wage negotiations this year was significantly higher than in the previous year, if the behavior and mindset based on the assumption that wages and prices will not increase easily remain deeply entrenched, there is a risk that moves to increase wages will not strengthen as much as expected from next year and prices will deviate downward from the baseline scenario.

The second risk 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. This risk may lead prices to deviate either upward or downward from the baseline scenario. There are high uncertainties over, for example, the outlook for the global economy, and this could lead to significant fluctuations in international commodity prices. Including the possibility of inflation rates staying elevated on a global basis and of fluctuations in foreign exchange markets, how these factors will affect Japan's prices requires due 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.[4]

The first perspective involves an examination of the baseline scenario of the outlook. The year-on-year rate of increase in the CPI is likely to be above 2 percent through fiscal 2024 and then decelerate in fiscal 2025. Meanwhile, toward the end of the projection period, underlying CPI inflation is expected to increase gradually toward achieving the price stability target, as the output gap turns positive and as medium- to long-term inflation expectations and wage growth rise.

The second perspective involves an examination of the risks considered most relevant to the conduct of monetary policy. There are extremely high uncertainties, both upside and downside, surrounding Japan's economic activity and prices, and it is necessary to pay due attention to developments in financial and foreign exchange markets and their impact on economic activity and prices. With regard to the risk balance, risks to economic activity are generally balanced for fiscal 2023 and 2024 but are skewed to the downside for fiscal 2025. Risks to prices are skewed to the upside for fiscal 2023. In terms of prices, it should be noted that, mainly due to the experience of prolonged low growth and deflation, the behavior and mindset based on the assumption that wages and prices will not increase easily have taken hold in society. Considering this, it is important to closely monitor whether a virtuous cycle between wages and prices will intensify.

Examining risks on the financial side, overheating has not been seen in asset markets and financial institutions' credit activities. Japan's financial system has maintained stability on the whole. Although attention is warranted on, for example, the impact of the tightening of global financial conditions, the financial system is likely to remain highly robust on the whole, even in the case of an adjustment in the real economy at home and abroad and in global financial markets, mainly because Japanese financial institutions have sufficient capital bases. When examining financial imbalances from a longer-term perspective, if downward pressure on financial institutions' profits, such as from low interest rates, the declining population, and excess savings in the corporate sector, becomes prolonged, this could create a risk of a gradual pullback in financial intermediation. On the other hand,

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

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, it is necessary to pay close attention to future developments.[5]

As for the conduct of monetary policy, with extremely high uncertainties surrounding economies and financial markets at home and abroad, the Bank will patiently continue with monetary easing while nimbly responding to developments in economic activity and prices as well as financial conditions. By doing so, it will aim to achieve the price stability target of 2 percent in a sustainable and stable manner, accompanied by wage increases.

The Bank will continue with QQE with Yield Curve Control, aiming to achieve the price stability target, 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 maintain the stability of financing, mainly of firms, and financial markets, and will not hesitate to take additional easing measures if necessary.

[5] For details, see the Bank's *Financial System Report* (October 2023).

(Appendix)

Forecasts of the Majority of the Policy Board Members

y/y % chg.

	Real GDP	CPI (all items less fresh food)	(Reference) CPI (all items less fresh food and energy)
Fiscal 2023	+1.8 to +2.0 [+2.0]	+2.7 to +3.0 [+2.8]	+3.5 to +3.9 [+3.8]
Forecasts made in July 2023	+1.2 to +1.5 [+1.3]	+2.4 to +2.7 [+2.5]	+3.1 to +3.3 [+3.2]
Fiscal 2024	+0.9 to +1.4 [+1.0]	+2.7 to +3.1 [+2.8]	+1.6 to +2.1 [+1.9]
Forecasts made in July 2023	+1.0 to +1.3 [+1.2]	+1.8 to +2.2 [+1.9]	+1.5 to +2.0 [+1.7]
Fiscal 2025	+0.8 to +1.2 [+1.0]	+1.6 to +2.0 [+1.7]	+1.8 to +2.2 [+1.9]
Forecasts made in July 2023	+1.0 to +1.2 [+1.0]	+1.6 to +2.0 [+1.6]	+1.8 to +2.2 [+1.8]

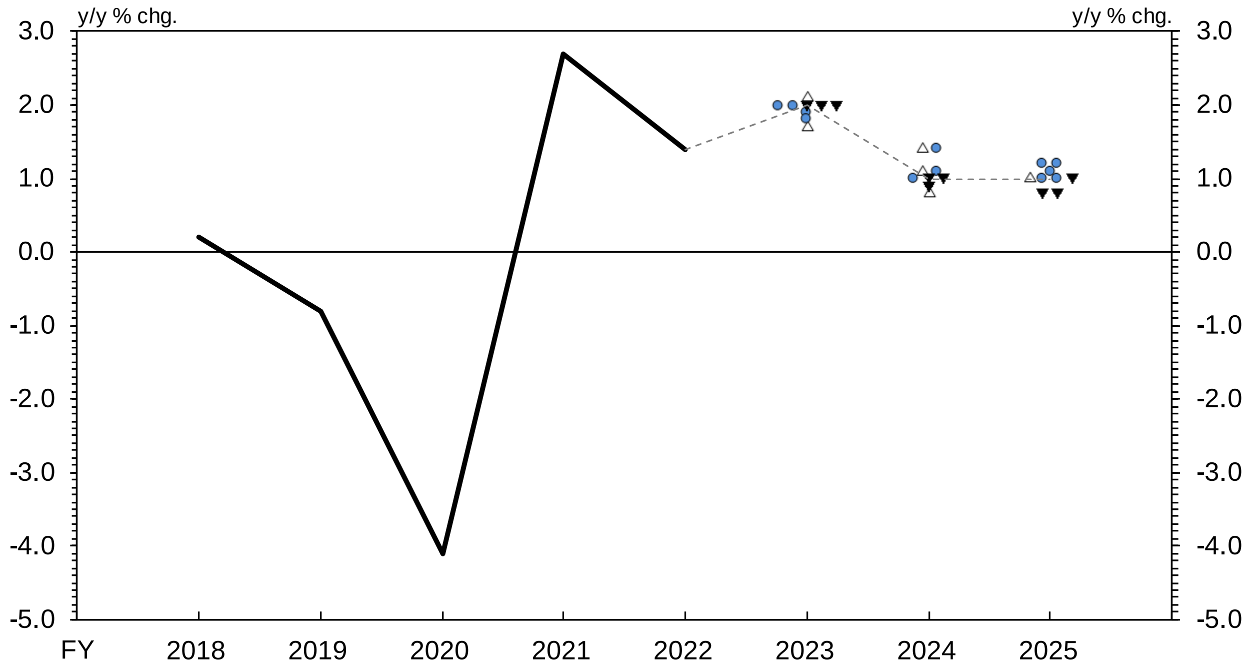
Notes: 1. Figures in brackets indicate the medians of the Policy Board members' forecasts (point estimates).

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.

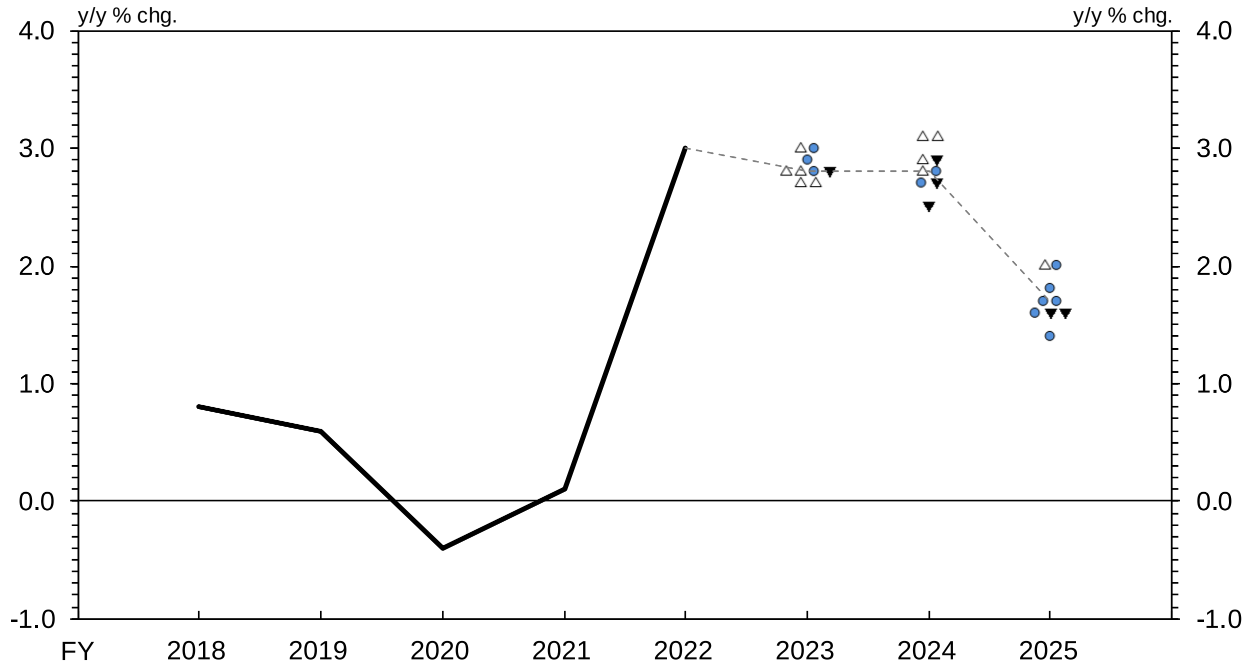
3. Each Policy Board member makes their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding the future conduct of policy.

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."

The Background[6]

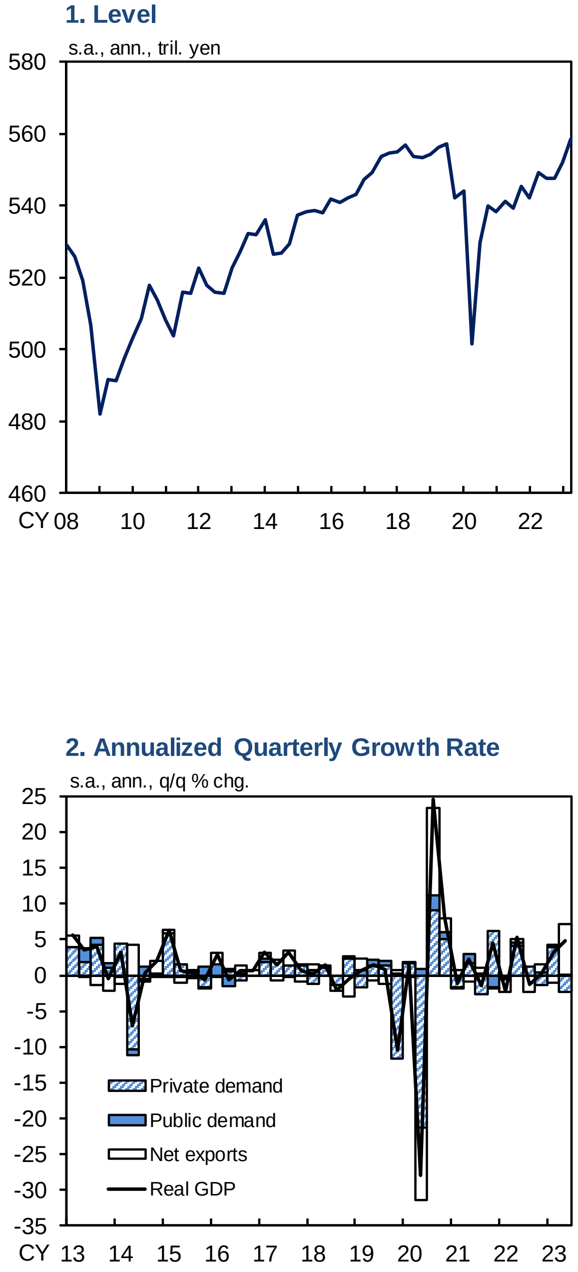
I. Current Situation of Economic Activity and Its Outlook

A. Economic Developments

Japan's economy has recovered moderately.

Real GDP rose for the January-March quarter of 2023, registering 0.8 percent on a quarter-on-quarter basis and 3.2 percent on an annualized basis (Chart 1). It then increased significantly for the April-June quarter, registering 1.2 percent on a quarter-on-quarter basis and 4.8 percent on an annualized basis. Net exports saw a substantial rise, since exports increased due to a waning of supply-side constraints and imports decreased significantly owing to temporary factors. Meanwhile, private consumption and business fixed investment saw declines, but it seems that these respectively are mainly attributable to irregular weather and a decline following the increase in the previous quarter that was due to large-scale projects. Taking account of this, as well as sources such as various monthly indicators, it is likely that private consumption and business fixed investment remained on an uptrend. The output gap -- which captures the utilization of labor and capital -- for the April-June quarter narrowed somewhat within negative territory from the previous quarter, improving to around 0 percent (Chart 2). This is mainly because the capacity utilization rates for the manufacturing and nonmanufacturing industries improved due to the recovery in economic activity.

Chart 1: Real GDP

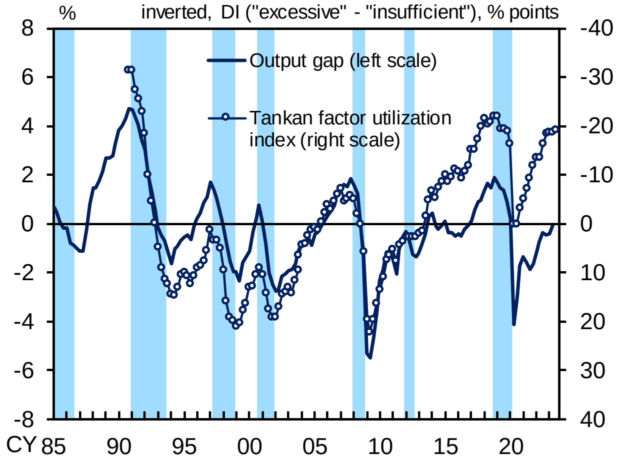


Source: Cabinet Office.

[6] "The Background" provides explanations of "The Bank's View" decided by the Policy Board at the Monetary Policy Meeting held on October 30 and 31, 2023.

Monthly indicators and high-frequency data since then suggest that Japan's economy has continued on a recovery trend. In the corporate sector, although exports and production have been affected by a slowdown in the pace of recovery in overseas economies, they have been more or less flat, supported by a waning of the effects of supply-side constraints. Corporate profits have remained at high levels on the whole, and business sentiment has improved moderately. In this situation, business fixed investment has increased moderately, and the business fixed investment plans for fiscal 2023 in the September 2023 *Tankan* indicate that investment is expected to see a clear rise. In the household sector, the employment and income situation has improved moderately. In particular, nominal employee income has followed an uptrend, reflecting the results of this year's annual spring labor-management wage negotiations. In this situation, private consumption has increased steadily at a moderate pace, despite being affected by price rises. In sum, although Japan's economy has been affected by the slowdown in the pace of recovery in overseas economies, a virtuous cycle from income to spending has been operating in both the corporate and household sectors.

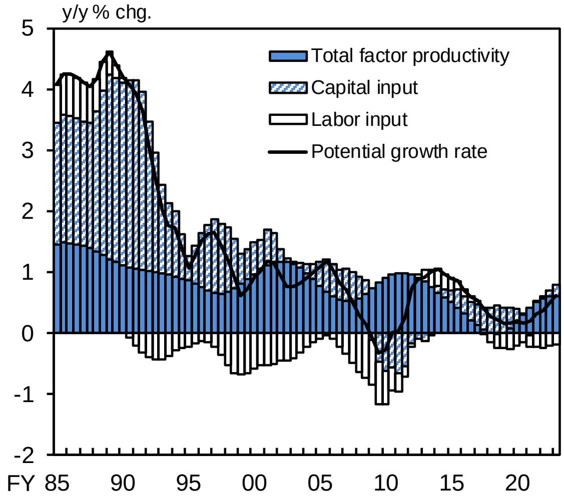
Chart 2: Output Gap



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

Japan's economy is likely to continue recovering moderately for the time being, supported by the materialization of pent-up demand, as well as by factors such as accommodative financial conditions and the government's economic measures, although it is expected to be under downward pressure stemming from the slowdown in the pace of recovery in overseas economies.[7] Thereafter, pent-up demand and the effects of the economic measures are projected to wane, but Japan's economy is expected to continue growing at a pace above its potential growth rate as the virtuous cycle from income to spending gradually intensifies in the overall economy. Comparing the projections with those presented in the previous Outlook Report, the projected real GDP growth rate for fiscal 2023 is higher. This reflects the actual data showing that the growth rate thus far has been higher than was previously projected, mainly due to a decline in imports.

Chart 3: Potential Growth Rate



Source: Bank of Japan.
Note: Figures are staff estimates. Figures for the first half of fiscal 2023 are those for 2023/Q2.

The potential growth rate seems to have been at around 0.5 percent recently (Chart 3). This is because, although the growth rate of total factor productivity (TFP) has increased slightly, working hours have continued on a downtrend, reflecting working-style reforms, and growth in capital stock has decelerated as a result of past declines in business fixed investment. As for the outlook, the potential growth rate is expected to rise moderately. This is based on the projection that, although there will be less room for the number of employed persons to increase, (1) the TFP growth rate will increase moderately, mainly on the back of advances in digitalization and a resulting improvement in efficiency of resource allocation, as well as an expansion in investment in human capital, (2) the decline in working hours will come to a halt in reflection of the diminishing effects of working-style reforms, and (3) growth in

[7] The government formulated the Comprehensive Economic Measures for Overcoming Price Increases and Revitalizing the Economy in October 2022 and additional measures toward overcoming price increases in March 2023. The implementation of the budget based on these measures is expected to mainly push up government consumption and private consumption, and thereby support economic activity.

capital stock will accelerate. These developments are likely to be encouraged by the government's various measures and by accommodative financial conditions. However, in terms of labor, it is highly uncertain what kind of working style will take hold going forward, given the experience of COVID-19 and with demographic changes. In addition, in the corporate sector, it is expected that factors such as moves toward digitalization, which reflect the experience of COVID-19 and labor shortages, and progress on efforts with a view to decarbonization will change Japan's economic and industrial structures; however, there remain high uncertainties over the extent of advancement and sustainability of innovation and sectoral reallocation of production factors, both of which aim at adapting to changes in the economic and industrial structures. It is also possible that the heightened geopolitical risks and other factors will have a significant impact on corporate behavior. Under these circumstances, the output gap and the potential growth rate, which are estimated based on a specific assumption regarding trends, should be interpreted with some latitude.

Details of the outlook for each fiscal year are as follows. In the second half of fiscal 2023, Japan's economy is likely to continue recovering moderately, supported by the materialization of pent-up demand, as well as by factors such as accommodative financial conditions and the government's economic measures, although the impact of the slowdown in the pace of recovery in overseas economies is expected to exert downward pressure on Japan's economy. Goods exports are projected to be more or less flat for the time being with the pace of recovery in overseas economies remaining slow. Inbound tourism demand, which is categorized under services exports, is expected to keep increasing. With corporate profits improving on the whole, business fixed investment is also projected to continue increasing, mainly on the back of accommodative financial conditions. In the household sector, employment is likely to rise on the back of a recovery in economic activity and wage growth is expected to remain relatively high. Due to these factors, nominal employee income is likely to keep rising. Moreover, downward pressure on households' real income stemming from high prices is expected to ease. This is because the effects of pushing down energy prices from the government's economic measures are projected to continue, although they will likely diminish, and because it is expected that there will be a waning of the effects of a pass-through to consumer prices of cost increases led by the past rise in import prices. Against this backdrop, private consumption is projected to keep increasing moderately. This is because pent-up demand is likely to materialize, partly supported by household savings that had accumulated as a result of pandemic-related restrictions, and because factors such as improvement in consumer sentiment, which mainly reflects a rise in wage growth, are expected to provide support. Government spending is expected to decline, reflecting a reduction in expenditure related to COVID-19, although it is likely to be supported by progress in construction related to building national resilience and by an uptrend in healthcare and nursing care expenditures.

In fiscal 2024, although the effects of the government's economic measures are likely to wane, Japan's economy is expected to continue growing at a pace above its potential growth rate, with overseas economies growing moderately and accommodative financial conditions being maintained. As overseas economies grow moderately, albeit with variation across countries and regions, goods exports are likely to see a moderate increase. Inbound tourism demand is projected to keep increasing. Business fixed investment is also expected to continue increasing, including investment to address labor shortages, digital-related investment, investment related to growth areas and decarbonization, and investment associated with strengthening supply chains. In the household sector, nominal employee income is likely to continue increasing steadily. This is because wage growth is expected to remain relatively high, although it will gradually become more difficult for labor supply to increase, with labor force participation of women and seniors having advanced to a high degree thus far. In this situation, private consumption is likely to continue increasing moderately, although it is projected that a waning of the effects of the government's economic measures pushing down prices of the previous year will push down real income through price rises, and that pent-up demand will gradually wane. Government spending is expected to turn to a moderate increase on the back of progress in construction related to building national resilience and an uptrend in healthcare and nursing care expenditures.

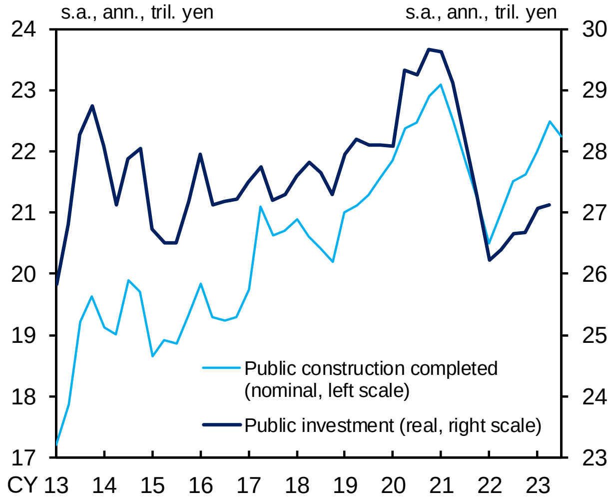
In fiscal 2025, although pent-up demand is expected to diminish, domestic and external demand is projected to continue increasing. Goods exports are likely to increase moderately, with overseas economies continuing to grow. Inbound tourism demand is projected to keep increasing. Business fixed investment is also expected to continue increasing, mainly for investment to address labor shortages and investment related to growth areas and decarbonization; however, the pace of increase is projected to slow somewhat, partly because it is likely to be pushed down by adjustment pressure on capital stock. Although pent-up demand is likely to diminish, private consumption is projected to continue increasing moderately, with the income situation continuing to improve, supported by wage increases. Government spending is expected to keep increasing moderately on the back of an uptrend in healthcare and nursing care expenditures.

B. Developments in Major Expenditure Items and Their Background

Government Spending

Public investment has increased moderately (Chart 4). With progress in construction based on the government's economic measures, including construction related to building national resilience, the amount of public construction completed -- a coincident indicator of public investment -- has been on an uptrend. The effects of large-scale projects have also made a positive contribution. The value of public works contracted and orders received for public construction -- both of which are leading indicators of public investment -- saw relatively significant increases, mainly due to a concentration of large-scale projects; subsequently, they have decreased somewhat.

Chart 4: Public Investment



Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Note: The figure for 2023/Q3 is the July-August average.

As for the outlook, public investment is likely to see a slight lowering in its level for the time being, partly due to gradual dissipation of the effects of large-scale projects. Subsequently, public investment is expected to be more or less flat, with expenditure related to building national resilience continuing.[8] Government consumption is projected to see a temporary lowering in its level due to a reduction in expenditure related to COVID-19, such as regarding vaccination. Thereafter, however, government consumption is likely to return to an increasing trend, reflecting an

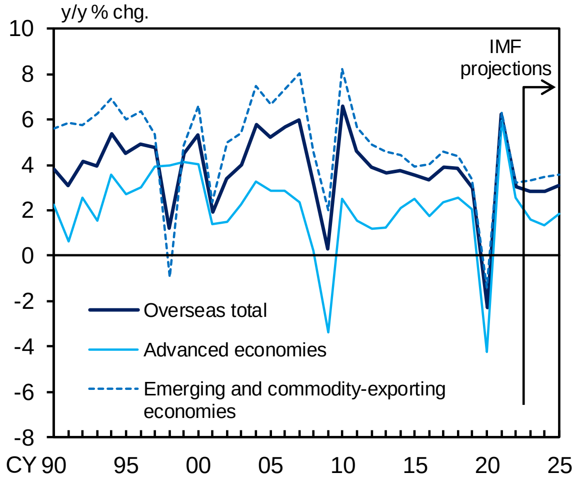
[8] The five-year acceleration measures for building national resilience with a project size of about 15 trillion yen were decided by the Cabinet in December 2020. In these measures, public investment projects for disaster prevention, disaster mitigation, and building national resilience are to be implemented intensively over five years from fiscal 2021 through fiscal 2025. The government's economic measures decided by the Cabinet in October 2022 also include efforts to implement the acceleration measures.

uptrend in healthcare and nursing care expenditures.

Overseas Economies

The pace of recovery in overseas economies has slowed (Chart 5). By region, the U.S. economy has been firm, mainly led by private consumption, although it has been affected by policy interest rate hikes. European economies have kept slowing moderately as they have continued to be affected by factors such as policy interest rate hikes. The Chinese economy has remained on a moderate slowing trend, mainly owing to the effects of a slowdown in external demand and adjustments in the real estate market, but signs of a pick-up have been observed in some aspects, such as private consumption. The pace of improvement in emerging and commodity-exporting economies other than China has slowed on the whole; although domestic demand has continued to improve moderately in these economies, exports have slowed. Among those in Asia, which are closely related to Japan's economy, the ASEAN economies have recovered on the whole; while exports have slowed, domestic demand has continued to improve as inflation has decelerated. In the NIEs economies, although exports of IT-related goods have shown signs of bottoming out, overall exports have continued to slow, particularly exports related to basic materials, and the pace of improvement in domestic demand has decelerated. Looking at the Global PMI to see the current situation for the global economy, figures for the services industry have been somewhat above 50 -- the break-even point between improvement and deterioration in business conditions -- but have declined slightly to date; figures for the manufacturing industry

Chart 5: 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. The real GDP growth rates are compiled by the IMF, and the rates from 2023 onward are its projections in the October 2023 *World Economic Outlook* (WEO). Figures for advanced economies are those for the United States, the euro area, and the United Kingdom. Figures for emerging and commodity-exporting economies are those for the rest of the world.

have been somewhat below 50 (Chart 6). The world trade volume has decreased, reflecting the effects of the slowdown in the pace of recovery in overseas economies and inventory adjustments in IT-related goods (Chart 7).

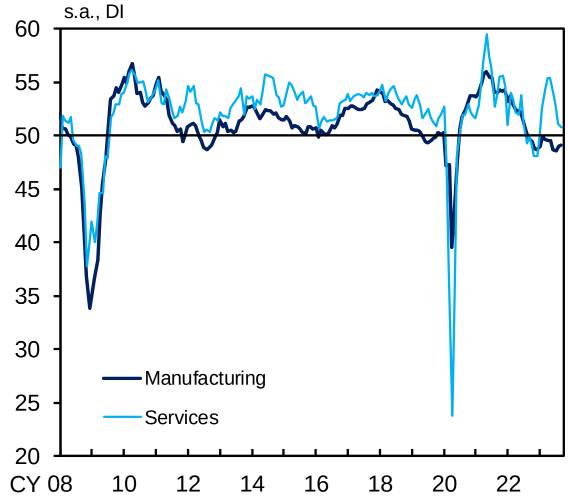
As for the outlook, the pace of recovery in overseas economies is projected to remain slow for the time being. By region, the U.S. economy is likely to continue to be firm. The Chinese economy is projected to gradually move out of its slowing phase due to policy support. European economies are expected to remain on a slowing trend. The pace of improvement in emerging and commodity-exporting economies other than China is likely to continue slowing, mainly led by external demand.

Thereafter, overseas economies are projected to grow moderately, albeit with variation across countries and regions.

Exports and Imports

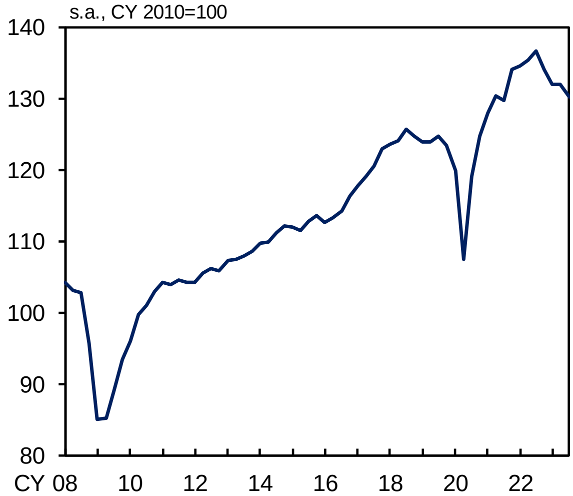
Although exports have been affected by the slowdown in the pace of recovery in overseas economies, they have been more or less flat, supported by the waning of the effects of supply-side constraints (Chart 9). By region, exports to advanced economies have been on an uptrend, mainly led by automobile-related goods (Chart 10). As for exports to emerging economies, those to China have bottomed out as the normalization of the country's economic activity has progressed. Exports to the NIEs, the ASEAN economies, and some other Asian economies have started to bottom out against the

Chart 6: Global PMI



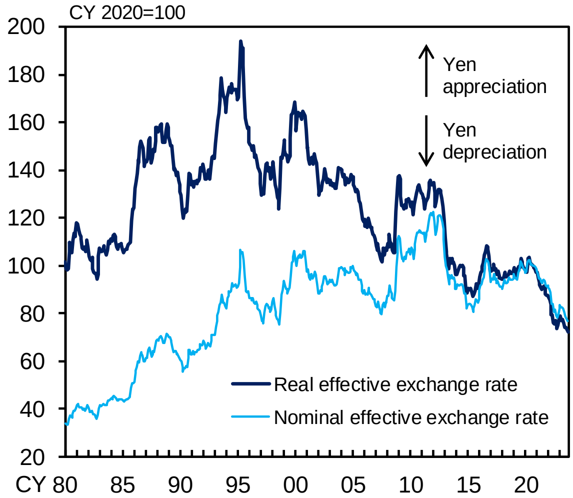
Source: Copyright © 2023 by S&P Global Market Intelligence, a division of S&P Global Inc. All rights reserved.
Note: Figures for manufacturing are the J.P.Morgan Global Manufacturing PMI. Figures for services are the J.P.Morgan Global Services Business Activity Index.

Chart 7: World Trade Volume



Source: CPB Netherlands Bureau for Economic Policy Analysis.
Note: Figures for the world trade volume are those for world real imports. The figure for 2023/Q3 is the July-August average.

Chart 8: Effective Exchange Rates



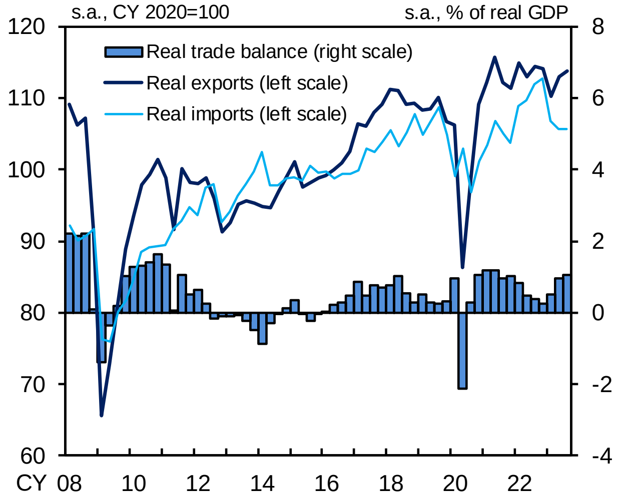
Source: BIS.
Note: Figures are based on the broad effective exchange rate indices. Figures prior to 1994 are calculated using the narrow indices.

background of progress in global adjustments for IT-related goods. By goods, exports of automobile-related goods have continued on an uptrend, with supply-side constraints for semiconductors used in automobiles almost having dissipated (Chart 11). Although exports of semiconductor production equipment have seen a lowering in their levels compared to a while ago, those of capital goods overall have been more or less flat, as they have been supported by high levels of order backlogs. Exports of IT-related goods have started to bottom out with progress in adjustments for electronic parts, such as semiconductors. Meanwhile, those of intermediate goods have been at relatively low levels, mainly reflecting weakness in the Chinese real estate market.

Exports are projected to be more or less flat for the time being with the pace of recovery in overseas economies remaining slow. Subsequently, as these economies grow moderately, albeit with variation across countries and regions, exports are likely to return to an uptrend.

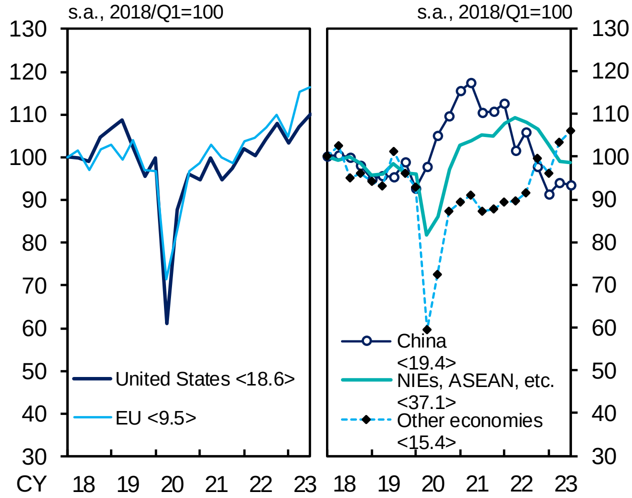
Imports have been more or less flat, albeit with fluctuations, after seeing a lowering in their levels compared to a while ago due to a waning of the effects of vaccine imports pushing up overall imports (Chart 9). They are expected to follow a moderate uptrend on the back of developments in demand induced by increases in domestic demand and exports.

Chart 9: Real Exports and Imports



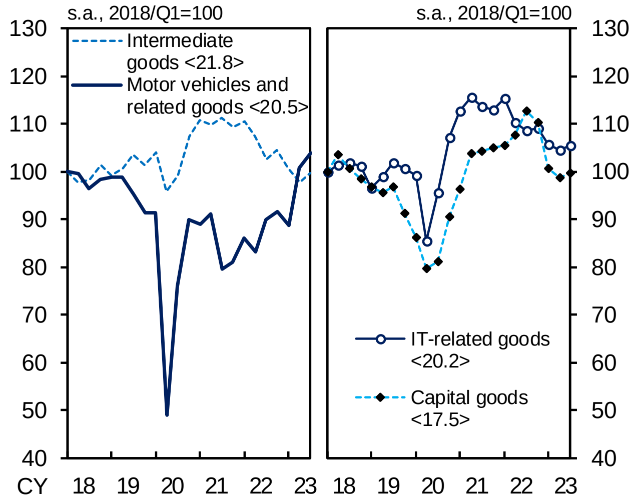
Sources: Bank of Japan; Ministry of Finance; Cabinet Office.
Note: Based on staff calculations.

Chart 10: Real Exports by Region



Sources: Bank of Japan; Ministry of Finance.
Notes: 1. Based on staff calculations. Figures in angular brackets show the share of each country or region in Japan's total exports in 2022.
2. Figures for the EU exclude those for the United Kingdom for the entire period.

Chart 11: Real Exports by Type of Goods

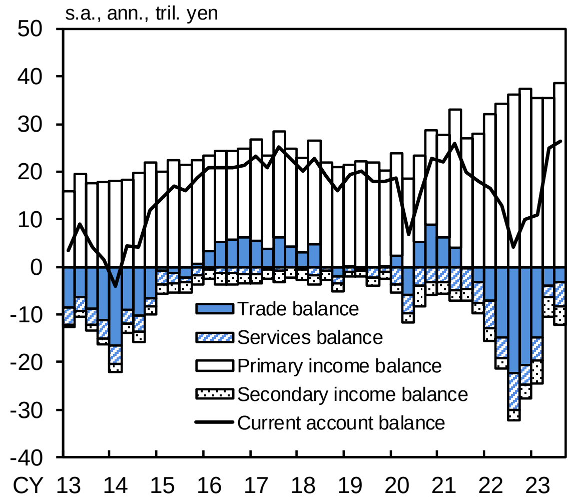


Sources: Bank of Japan; Ministry of Finance.
Note: Based on staff calculations. Figures in angular brackets show the share of each type of goods in Japan's total exports in 2022.

External Balance

The nominal current account balance has seen clear improvement (Chart 12). The trade balance deficit has decreased clearly, mainly reflecting an increase in exports. The services balance deficit has been on a moderate declining trend, albeit with fluctuations stemming from payments for digital-related services. This is mainly because the travel balance has improved due to an increase in inbound tourism demand (Chart 13). Meanwhile, the primary income balance surplus has remained at a high level.

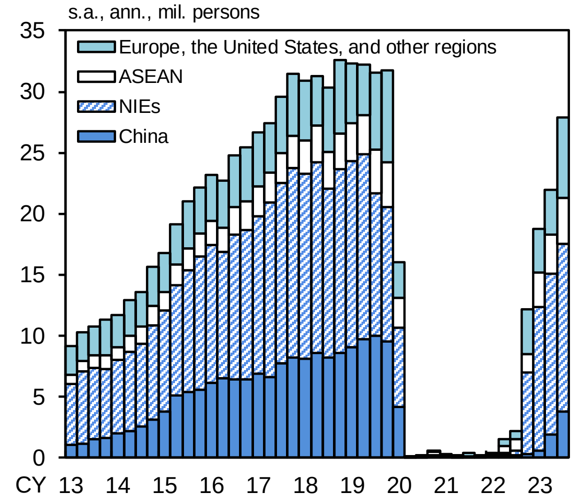
Chart 12: Current Account



Source: Ministry of Finance and Bank of Japan.
Note: Figures for 2023/Q3 are July-August averages.

The nominal current account balance is likely to follow a moderate improving trend. This is based on the projection that (1) the primary income balance surplus will increase moderately, (2) the trade balance deficit will decline moderately due to factors such as an increase in goods exports, and (3) the services balance deficit will decrease due to the increase in inbound tourism demand. In terms of the savings-investment balance, overall excess savings in Japan's economy are projected to follow a moderate expanding trend, because the fiscal balance is likely to improve at a pace that somewhat exceeds the pace of decline in excess savings in the private sector (Chart 14).

Chart 13: Number of Inbound Visitors

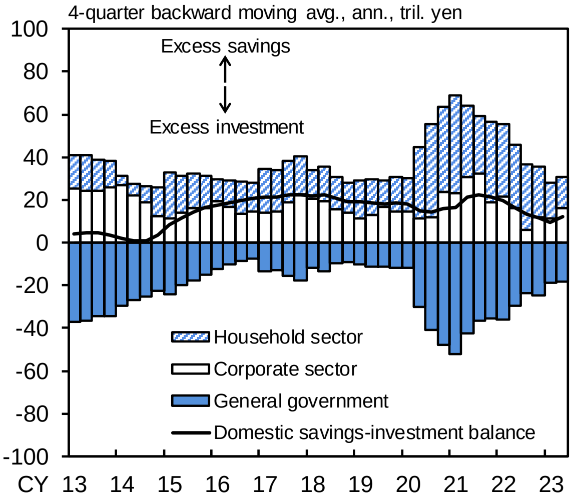


Source: Japan National Tourism Organization (JNTO).
Note: Figures for Europe, the United States, and other regions include seasonal adjustment errors.

Industrial Production

Although industrial production has been affected by the slowdown in the pace of recovery in overseas economies, it has been more or less flat, supported by the waning of the effects of supply-side constraints (Chart 15). By major industry, production of "transport equipment" has been on an uptrend, with supply-side constraints for semiconductors used in automobiles almost

Chart 14: Savings-Investment Balance



Source: Bank of Japan.

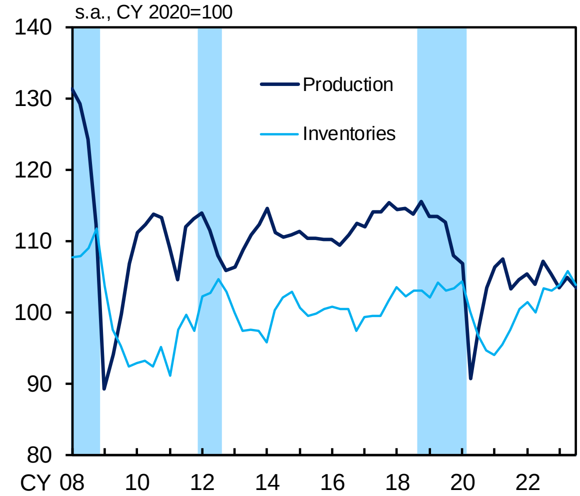
having dissipated. Although production of semiconductor production equipment has seen a lowering in its level compared to a while ago, that of "general-purpose, production, and business-oriented machinery" overall has been more or less flat, as it has been supported by high levels of order backlogs. Production of "electrical machinery, and information and communication electronics equipment" has also been more or less flat, mainly because production of white goods has declined while that of on-board equipment for motor vehicles has been on an uptrend. Production of "electronic parts and devices" has started to bottom out with progress in inventory adjustments. Meanwhile, production of "chemicals (excluding medicine)" has been on a downtrend, mainly reflecting weakness in the Chinese real estate market.

Industrial production is projected to be more or less flat for the time being with the pace of recovery in overseas economies remaining slow. Subsequently, as these economies grow moderately, albeit with variation across countries and regions, it is likely to return to an uptrend.

Corporate Profits

Corporate profits have been at high levels on the whole. According to the *Financial Statements Statistics of Corporations by Industry, Quarterly*, current profits for all industries and enterprises for the April-June quarter of 2023 increased for two consecutive quarters (Chart 16). Operating profits have been pushed up by a recovery in automobile production stemming from the waning of supply-side constraints, in addition to a decline in import prices and progress in the pass-through of

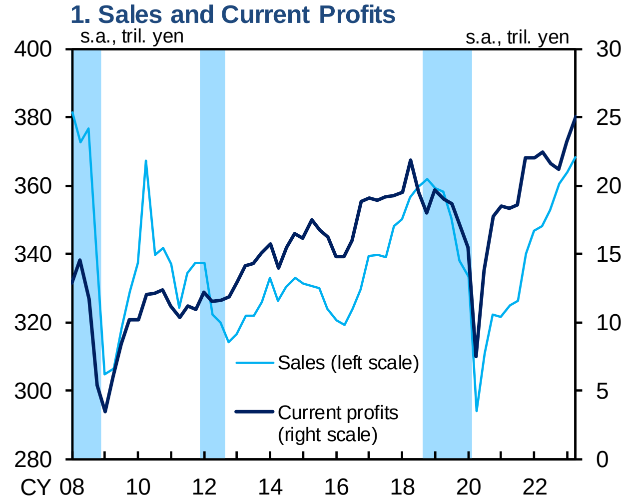
Chart 15: Industrial Production



Source: Ministry of Economy, Trade and Industry.
Note: Shaded areas denote recession periods.

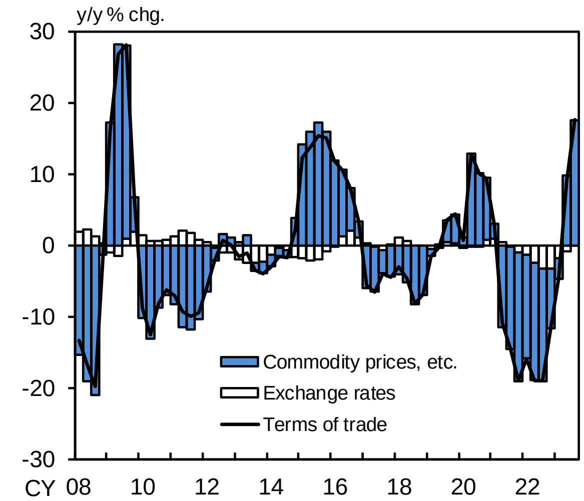
Chart 16: Indicators Related to Corporate Profits

1. Sales and Current 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 onward exclude pure holding companies.
3. Shaded areas denote recession periods.

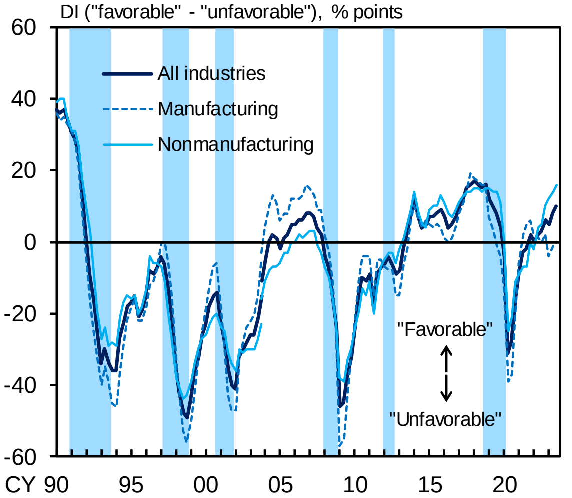
2. Contribution to Changes in Terms of Trade



Source: Bank of Japan.
Notes: 1. The contribution of changes in commodity prices, etc. is calculated using changes in export/import price indexes on a contract currency basis. The contribution of changes in exchange rates is calculated using the difference between export/import price indexes on a yen basis and those on a contract currency basis.
2. Terms of trade = Export price index on a yen basis / Import price index on a yen basis

cost increases to selling prices. Moreover, non-operating profits have been pushed up by foreign exchange gains due to the yen's depreciation and by an increase in interest received from overseas. By industry and firm size, current profits of large manufacturers have increased, particularly for the transportation equipment industry, where supply-side constraints have waned. Current profits of large food manufacturers have been pushed up by the progress in the pass-through of cost increases to selling prices. Current profits of small and medium-sized manufacturers have also risen for the transportation equipment industry in particular. As for nonmanufacturers, current profits of large firms have increased, mainly due to the impact of selling price hikes, particularly for electric power companies, and a rise in travel demand in the transportation industry. Those of small and medium-sized nonmanufacturers have declined slightly on the whole, but such profits for the retail trade and other industries have increased, reflecting the progress in the pass-through of cost increases to selling prices.

Chart 17: Business Conditions



Source: Bank of Japan.

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

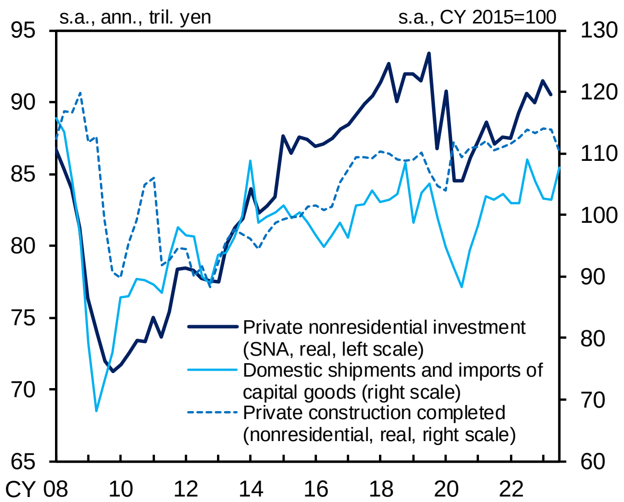
Business sentiment has improved moderately. According to the September *Tankan*, the DI for business conditions for all enterprises has continued to improve both for manufacturing and nonmanufacturing (Chart 17). By industry, although the slowdown in the pace of recovery in overseas economies and adjustment pressure on IT-related goods have continued to draw attention in the manufacturing industry, the DI for manufacturing has improved for large firms in particular. Looking at industries where the DIs have improved, (1) that for transportation machinery has done so due to the waning of the effects of supply-side constraints, (2) the DIs for basic materials (e.g., "lumber and wood products," "pulp and paper," and "ceramics, stone, and clay") have improved because of a pause in high raw material costs, and (3) the DI for food and beverages has done so due to the progress in the pass-through of cost increases to selling prices. Turning to industries where the DIs have deteriorated, those for industries such as production machinery, general-purpose machinery, and electrical machinery have been pushed down, mainly by the slowdown in the pace of recovery in overseas economies and by adjustments for IT-related goods. The DI for nonmanufacturing has improved, particularly for private consumption-related industries. This is due to the recovery in economic activity, which reflects a waning of the impact of COVID-19, and to the progress in the pass-through of cost increases to selling prices. The DI for the electric and gas utilities industry has improved significantly, reflecting a rise in profits due to selling price hikes.

Regarding the outlook for corporate profits, they are likely to follow an improving trend, as it is projected that they will be pushed up for the time being by factors such as progress in the pass-through of past high raw material costs to selling prices, and thereafter by a moderate increase in domestic and external demand.

Business Fixed Investment

Business fixed investment has increased moderately (Chart 18). The aggregate supply of capital goods -- a coincident indicator of machinery investment -- has increased recently,

Chart 18: Coincident Indicators of Business Fixed Investment

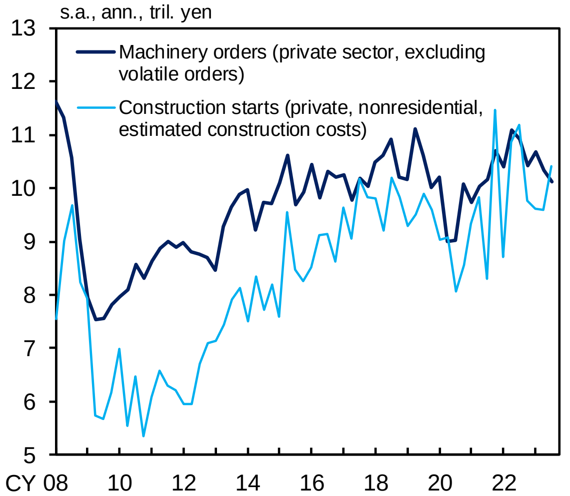


Sources: Cabinet Office; Ministry of Economy, Trade and Industry; Ministry of Land, Infrastructure, Transport and Tourism.

Notes: 1. Figures for 2023/Q3 are July-August averages.
2. Figures for real private construction completed are based on staff calculations using the construction cost deflators.

due to firm demand for digital- and labor saving-related capital goods, as well as to a rise in investment in ships, although investment in semiconductor production equipment is lower than a while ago. Private construction completed (nonresidential) -- a coincident indicator of construction investment -- has been on a moderate uptrend, mainly due to a rise in construction of logistics facilities on the back of an expansion in e-commerce and to progress in urban redevelopment projects.

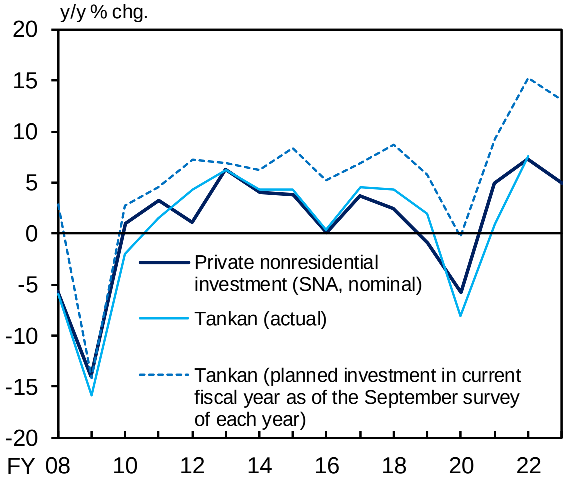
Chart 19: Leading Indicators of Business Fixed Investment



Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Notes: 1. Volatile orders are orders for ships and orders from electric power companies.
2. Figures for 2023/Q3 are July-August averages.

Machinery orders -- a leading indicator of machinery investment -- have remained at high levels, although they have seen a lowering in their levels due to factors such as dissipation of the effects of large-scale projects (Chart 19). By industry, orders by the automobile and "general-purpose, production, and business-oriented machinery" industries have been on an increasing trend. On the other hand, orders by the manufacturing industry overall have been pushed down as those by the "electrical machinery" industry have remained relatively weak and the effects of large-scale projects in some industries, which had continued since last year, have dissipated. With regard to orders by the nonmanufacturing industry, digital- and labor saving-related investments have followed an uptrend, albeit with fluctuations stemming from large-scale projects, and orders for projects that had been postponed due to COVID-19 have been seen in industries such as transportation. Construction starts (in terms of planned expenses for private and nonresidential construction) -- a leading indicator of construction investment -- have increased, albeit with fluctuations. This is due to an uptrend in construction of logistics and other facilities and to progress in urban redevelopment projects. Looking at the business fixed investment plans in the September *Tankan*, business fixed investment (on the basis close to GDP definition; business fixed investment -- including software and R&D investments but excluding land purchasing expenses -- for all industries and enterprises including financial institutions) shows a year-on-year rate of increase of 13.1 percent for fiscal 2023 (Chart 20). This indicates that, as with the previous survey in June, investment is likely to continue increasing clearly.

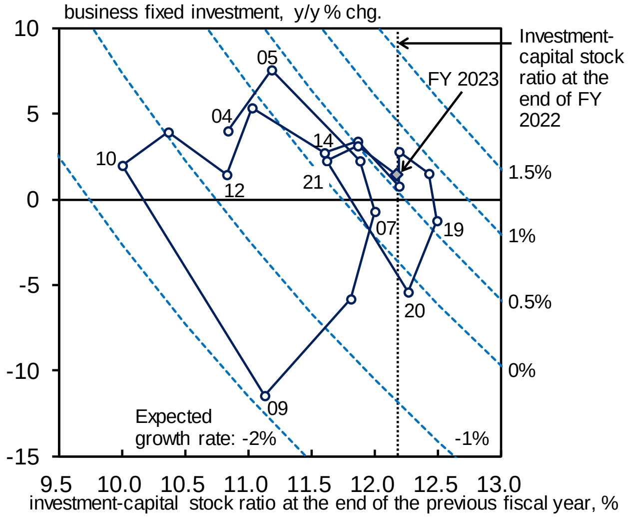
Chart 20: Planned and Actual Business Fixed Investment



Sources: Bank of Japan; Cabinet Office.
Notes: 1. The *Tankan* figures include software and R&D investments and exclude land purchasing expenses. R&D investment is not included before the March 2017 survey. The figures are for all industries including financial institutions.
2. The figure for private nonresidential investment for fiscal 2023 is that for 2023/Q2.

With regard to the outlook, as corporate profits improve, business fixed investment is expected to continue increasing, mainly on the back of accommodative financial conditions. Toward the end of the projection period, such investment is projected to continue increasing, partly due to a rise in investment that is not necessarily responsive to the business cycle, although the pace of increase is likely to slow, reflecting cyclical adjustment pressure stemming from the accumulation of capital stock (Chart 21). Specifically, investment that is expected to be undertaken during the projection period includes (1) investment induced by the increase in domestic and external demand; (2) labor-saving and efficiency-improving investment to address labor shortages and IT-related investment to digitalize business activities; (3) construction investment in logistics facilities, resulting from expanding e-commerce, and in offices and commercial facilities due to redevelopment projects; (4) investment in growth areas and to address environmental issues, such as decarbonization; and (5) semiconductor-related investment that is mainly aimed at strengthening

Chart 21: Capital Stock Cycles



Source: Cabinet Office.
Note: Each broken line represents the combination of the rate of change in business fixed investment and the investment-capital stock ratio at a certain expected growth rate. The figure for fiscal 2023 is that for 2023/Q2.

supply chains and that also reflects government support.

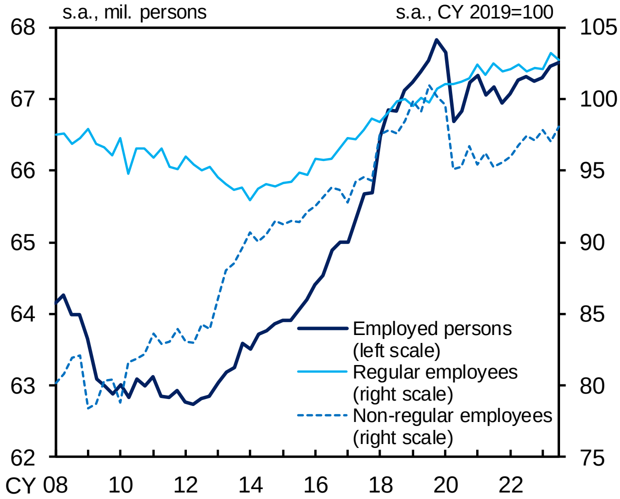
Employment and Income Situation

The employment and income situation has improved moderately.

Regarding the number of employed persons, that of regular employees has risen moderately, albeit with fluctuations, mainly in the medical, healthcare, and welfare services industry and in the information and communications industry, which have faced a severe labor shortage (Chart 22). With economic activity normalizing, the number of non-regular employees has been on a moderate uptrend, mainly in the wholesale and retail trade as well as the face-to-face services industries. Total hours worked per employee have been more or less flat when fluctuations due to the number of weekdays are smoothed out. With regard to labor market conditions, the unemployment rate has been at a low level (Chart 23). The active job openings-to-applicants ratio has been somewhat weak recently, despite being at a high level (Chart 24). This is mainly because the number of job applicants has increased along with the normalization of economic activity. Meanwhile, the labor force participation rate has been on a moderate uptrend, particularly for women, when fluctuations are smoothed out (Chart 23).

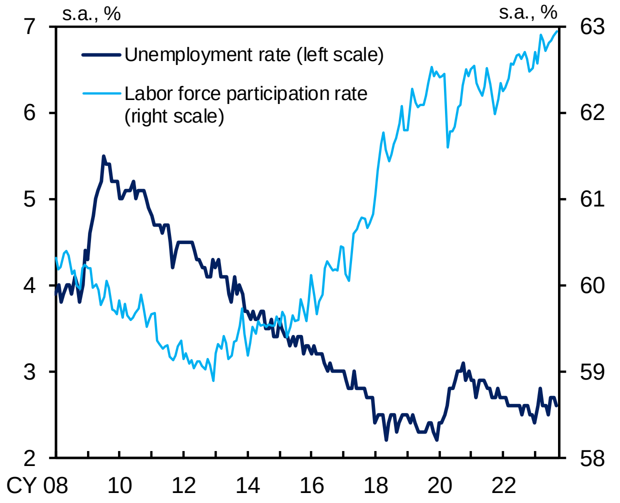
With regard to the outlook for the number of employees, regular employees are likely to increase moderately, mainly in industries with labor shortages, such as medical, healthcare, and

Chart 22: Number of Employed Persons



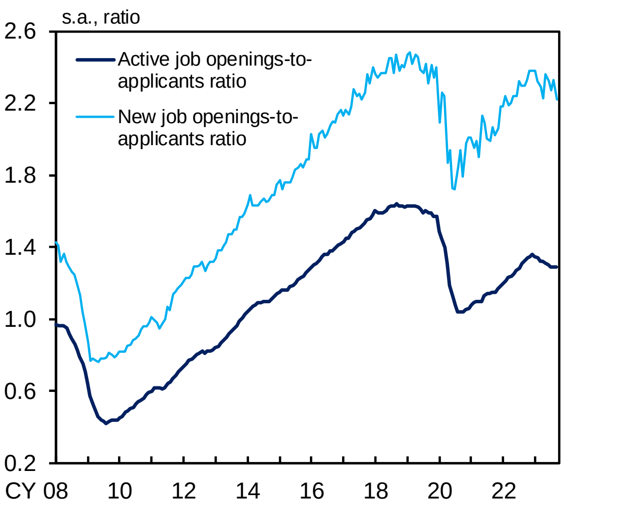
Source: Ministry of Internal Affairs and Communications.
Note: Figures for regular employees and non-regular employees prior to 2013 are based on the "detailed tabulation" in the *Labour Force Survey*.

Chart 23: Unemployment Rate and Labor Force Participation Rate



Source: Ministry of Internal Affairs and Communications.

Chart 24: Job Openings-to-Applicants Ratio

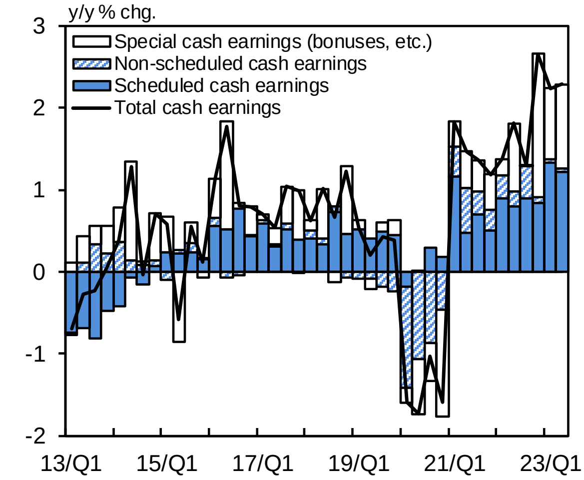


Source: Ministry of Health, Labour and Welfare.

welfare services, information and communications, and construction. Non-regular employees, such as in the face-to-face services industry, are likely to continue increasing along with a moderate increase in private consumption and a continuing rise in inbound tourism demand. However, the pace of increase in the number of overall employees is projected to decelerate, partly because it will become more difficult for labor supply to increase, reflecting factors such as demographic changes, with labor force participation of women and seniors having advanced to a high degree thus far. Under these circumstances, the unemployment rate is expected to follow a moderate declining trend on the back of the recovery in economic activity.

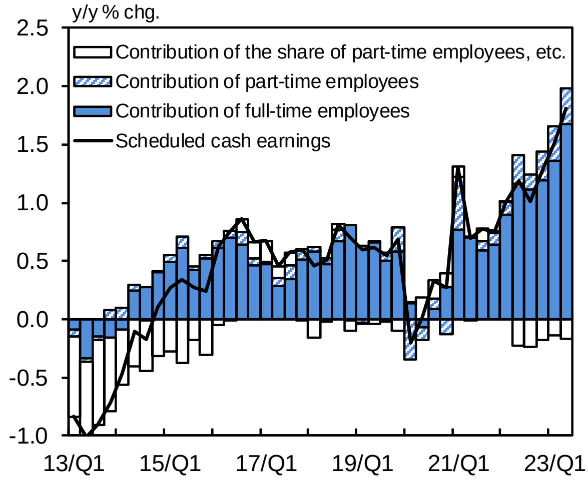
On the wage side, nominal wages per employee have increased moderately, reflecting the recovery in economic activity and the results of the annual spring labor-management wage negotiations (Chart 25).[9] The year-on-year rate of change in scheduled cash earnings has continued to increase moderately (Chart 26). Looking at the breakdown, the rate for full-time employees has accelerated to around 2 percent, reflecting the results of this year's annual spring labor-management wage negotiations, which show that the wage growth rate agreed in the negotiations was significantly higher than in the previous year.[10] The year-on-year rate of increase in hourly scheduled cash earnings for part-time employees has been at around 3 percent recently, as labor market conditions have

Chart 25: 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 from 2016/Q1 onward are based on continuing observations following the sample revisions.

Chart 26: Decomposition of Developments in 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 from 2016/Q1 onward are based on continuing observations following the sample revisions.

[9] Wages in the *Monthly Labour Survey* are assessed on the basis of continuing observations, which are less susceptible to fluctuations due to sample revisions.

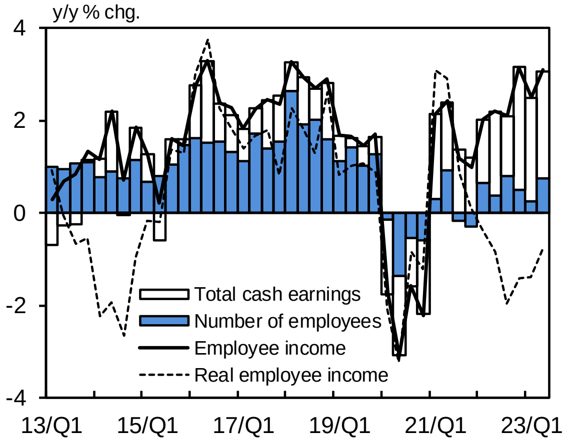
[10] Box 1 looks back on the annual spring labor-management wage negotiations in 2023.

remained tight. Non-scheduled cash earnings have continued to increase moderately in reflection of the recovery in economic activity. The year-on-year rate of change in special cash earnings (bonuses) has been clearly positive on the back of high levels of corporate profits.

With regard to the outlook for wages, the rate of increase in scheduled cash earnings is likely to continue increasing firmly, in reflection of price rises and with labor market conditions continuing to be tight. Non-scheduled cash earnings are expected to increase moderately, reflecting the recovery in economic activity. Special cash earnings (bonuses) are likely to keep rising with corporate profits following an improving trend. Taking all of these factors into account, the rate of increase in nominal wages per employee is projected to gradually accelerate.

In light of the aforementioned employment and wage conditions, employee income has improved in nominal terms (Chart 27). In real terms, the year-on-year rate of change in employee income has remained negative in reflection of price rises, but the rate of decline has slowed due to a combination of a decline in inflation and improvement in nominal income. With regard to the outlook, nominal employee income is likely to continue to see a clear increase in reflection of an acceleration in nominal wage growth. Under these circumstances, the year-on-year rate of decline in real employee income is projected to follow a decelerating trend. Thereafter, the rate of change is likely to gradually turn positive.

Chart 27: 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 from 2016/Q1 onward are based on continuing observations following the sample revisions of the *Monthly Labour Survey*.

4. Figures for real employee income are based on staff calculations using the CPI (less imputed rent).

Household Spending

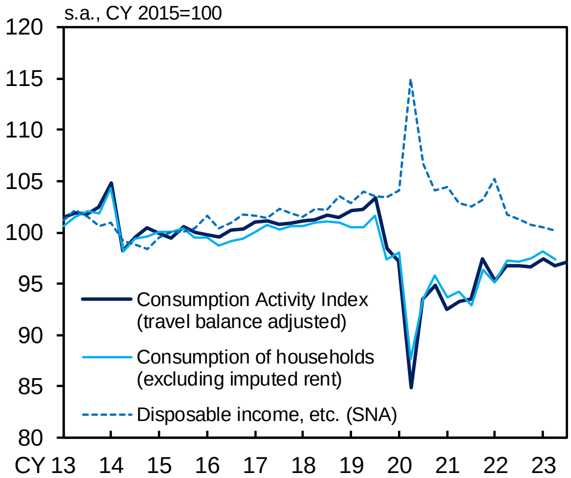
Private consumption has increased steadily at a moderate pace, despite being affected by price rises.

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 -- increased slightly on average for the July-August period of 2023 relative to the April-June quarter, despite being affected by price rises (Charts 28 and 29).[11] This is due to improvement in nominal employee income reflecting the results of the annual spring labor-management wage negotiations, the materialization of pent-up demand, and the impact of hot weather. Looking at subsequent developments in private consumption from various sources, such as high-frequency indicators, statistics published by industry organizations, and anecdotal information from firms, consumption seems to have continued on a moderate uptrend, partly supported by the improvement in the income situation (Chart 30).

By type, consumption of durable goods has picked up, mainly on the back of the waning of supply-side constraints (Chart 29). Specifically, the number of new passenger cars sold has been at a high level, with supply-side constraints for semiconductors used in automobiles almost having dissipated. Sales of household electrical

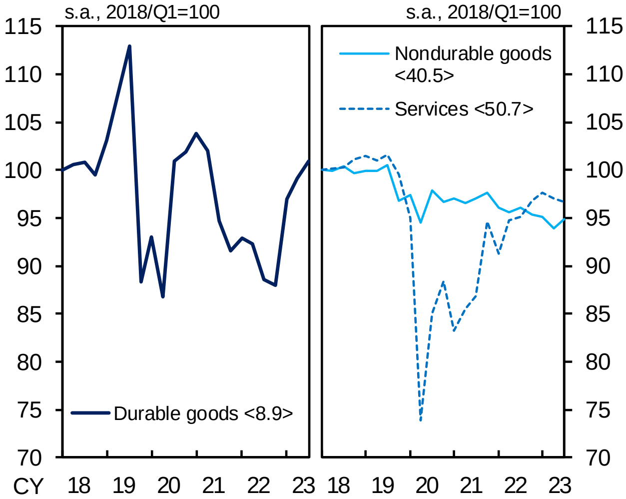
[11] Regarding the CAI, see the Bank's research paper "Revision of the Consumption Activity Index to Capture Recent Changes in Consumption Patterns" released in July 2021.

Chart 28: Real Private Consumption



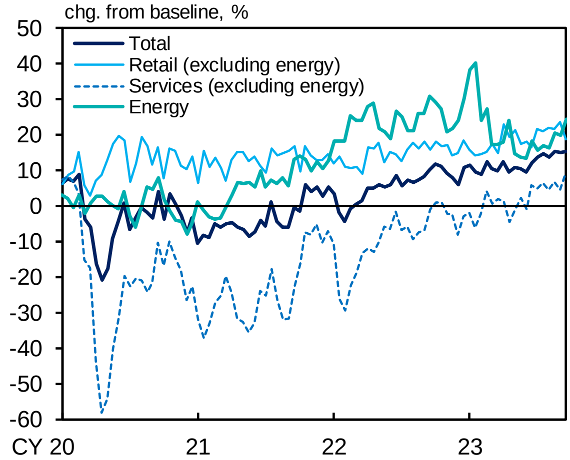
Sources: Bank of Japan; Cabinet Office, etc.
Notes: 1. Figures for the Consumption Activity Index (CAI) are based on staff calculations. The CAI figures (travel balance adjusted) exclude inbound tourism consumption and include outbound tourism consumption. The figure for 2023/Q3 is the July-August average.
2. "Disposable income, etc." consists of disposable income and adjustment for the change in pension entitlements, and real values are obtained using the deflator of consumption of households.

Chart 29: Consumption Activity Index (CAI, Real)



Sources: Bank of Japan, etc.
Notes: 1. Based on staff calculations. Figures in angular brackets show the weights in the CAI. Figures for 2023/Q3 are July-August averages.
2. Nondurable goods include goods classified as semi-durable goods in the SNA.

Chart 30: Consumption Developments Based on Credit Card Spending



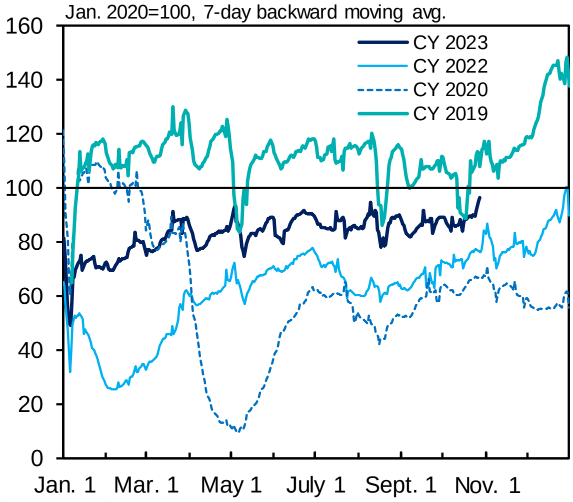
Source: Nowcast Inc./ JCB, Co., Ltd., "JCB Consumption NOW."
Notes: 1. Figures are from the reference series in *JCB Consumption NOW*, which take changes in the number of consumers into account. The baseline is the average for the corresponding half of the month for fiscal 2016 through fiscal 2018.
2. Figures for the total and for services exclude telecommunications, and figures for energy consist of those for fuel, electricity, gas, heat supply, and water. Based on staff calculations.

appliances have been at relatively low levels since demand for items such as televisions has been weak, but they increased this summer in reflection of favorable sales of air conditioners due to the hot weather. Turning to nondurable goods, despite being affected by high prices, consumption of beverages and food, clothes, and other items has been more or less flat, mainly on the back of an increased flow of people due to the recovery in economic activity.

Services consumption has increased moderately as a trend in reflection of the materialization of pent-up demand (Charts 29, 30, and 31). Despite being affected by price rises, dining-out has also been on a moderate increasing trend, since the number of visitors has risen at a wide range of restaurants, including *izakaya* (Japanese-style bars), which had been slow to recover. Domestic travel has followed an uptrend reflecting a recovery in travel demand. Overseas travel has remained at a low level but has continued to increase moderately.

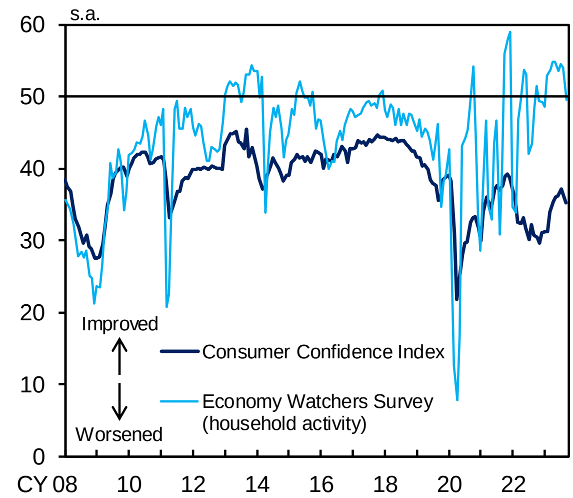
Looking at confidence indicators related to private consumption, the Consumer Confidence Index has remained at an improved level, mainly on the back of improvement in consumer perception of "income growth" (Chart 32). The *Economy Watchers Survey* -- which asks firms for their views on the direction of the economy -- shows that the current economic conditions DI (household activity-related) has continued to indicate improvement, albeit with fluctuations, mainly reflecting the materialization of pent-up demand and a rise in inbound tourism demand,

Chart 31: Mobility Trends in Downtown Areas



Source: Agoop Corp.
Notes: 1. Figures are the sum of the differences in the number of visitors between 9 p.m. and 4 a.m. on the following day in 53 downtown areas.
2. The latest figure is the average for October 22-28.

Chart 32: Confidence Indicators Related to Private Consumption



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

although concern over the impact of price rises has contributed to pushing down the DI.

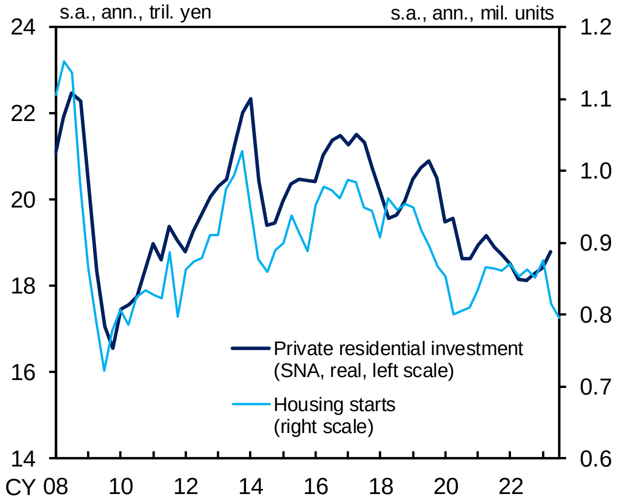
Regarding the outlook, although private consumption is expected to be affected by price rises, it is projected to keep increasing moderately, partly supported by household savings that had accumulated as a result of pandemic-related restrictions, with nominal employee income continuing to improve. Private consumption is also likely to be underpinned by the government's measures, such as those to reduce the household burden of higher gasoline prices, electricity charges, and gas charges, and government subsidies for those with low incomes. Although pent-up demand is likely to wane, private consumption is expected to continue increasing moderately from the middle of the projection period as employee income keeps improving. The propensity to consume is likely to first rise to a level that somewhat exceeds the average level seen before the pandemic, partly due to the withdrawals of household savings that had accumulated as a result of pandemic-related restrictions (Chart 33). From the middle of the projection period, it is expected to gradually return to the average level seen before the pandemic.

Housing investment has been relatively weak, mainly due to a rise in housing prices (Chart 34). Reflecting this rise, the number of housing starts -- a leading indicator of housing investment -- has followed a downtrend. Housing investment is likely to follow a moderate declining trend in reflection of the rise in housing prices and demographic developments, although

Chart 33: Average Propensity to Consume

Source: Cabinet Office.
Note: Average propensity to consume = Consumption of households / Disposable income, etc. "Disposable income, etc." consists of disposable income and adjustment for the change in pension entitlements.

Chart 34: Housing Investment



Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Note: The figure for 2023/Q3 is the July-August average.

accommodative financial conditions are expected to provide support.

II. Current Situation of Prices and Their Outlook

Developments in Prices

With the impact of past high commodity prices waning, the quarter-on-quarter rate of change in the producer price index (PPI, adjusted for the effects of seasonal changes in electricity rates) has been negative (Chart 35). The services producer price index (SPPI, excluding international transportation) has seen a greater year-on-year rate of increase, mainly on the back of the recovery in economic activity and a rise in personnel expenses.

The year-on-year rate of increase in the CPI (all items less fresh food) is slower than a while ago, mainly due to the effects of pushing down energy prices from the government's economic measures. However, it has been in the range of 2.5-3.0 percent recently owing to the effects of the pass-through to consumer prices of cost increases led by the past rise in import prices (Chart 36).

The rate of increase in the CPI (all items less fresh food and energy, excluding temporary factors such as the effects of the government's domestic travel discount program) has decelerated slightly (Chart 37).[12] This is mainly because, although raw material cost increases have continued to be passed on to selling prices,

[12] The CPI figures excluding temporary factors are calculated by excluding (1) the effects of the consumption tax hike and policies concerning the provision of free education, (2) the effects of travel subsidy programs, and (3) mobile phone charges from the CPI (all items less fresh food) and the CPI (all items less fresh food and energy).

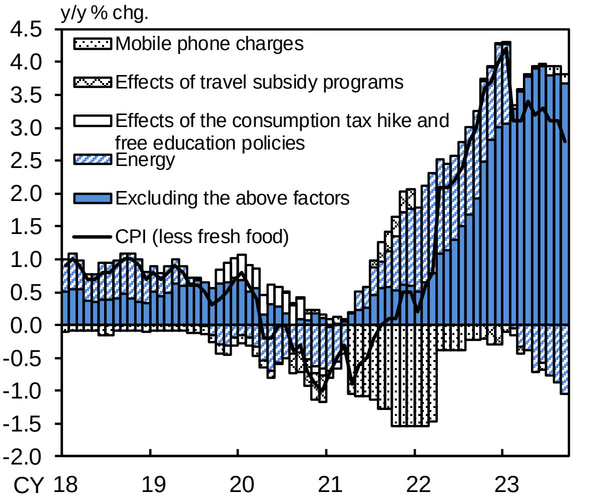
Chart 35: Inflation Indicators

y/y % chg.

	22/Q4	23/Q1	23/Q2	23/Q3
Consumer Price Index (CPI)				
Less fresh food	3.7	3.5	3.3	3.0
Excluding temporary factors	4.1	3.6	3.3	2.9
Less fresh food and energy	2.8	3.5	4.2	4.3
Excluding temporary factors	3.1	3.6	4.3	4.2
Producer Price Index (q/q % chg.)	2.8	0.5	-0.2	-0.3
Services Producer Price Index	1.4	1.7	2.1	2.3
GDP Deflator	1.2	2.0	3.5	
Domestic demand deflator	3.4	2.8	2.4	

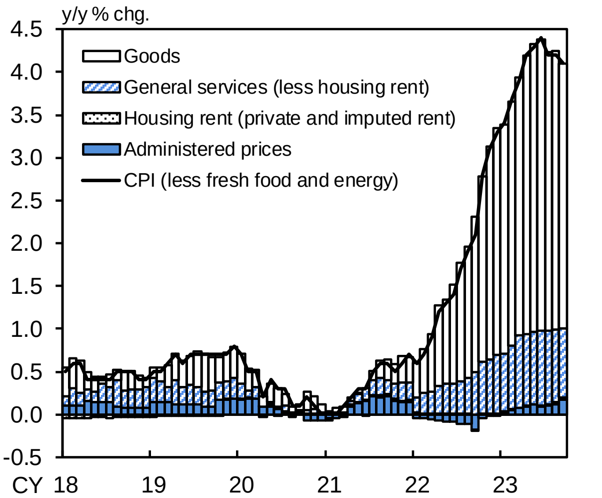
Sources: Ministry of Internal Affairs and Communications; Bank of Japan; Cabinet Office.
Notes: 1. Figures for the producer price index (PPI) are adjusted for the hike in electric power charges during the summer season. Figures for the services producer price index (SPPI) exclude international transportation.
2. The CPI figures excluding temporary factors are staff estimates and exclude mobile phone charges and the effects of travel subsidy programs.

Chart 36: CPI (Less Fresh Food)



Source: Ministry of Internal Affairs and Communications.
Notes: 1. Figures for energy consist of those for petroleum products, electricity, and gas, manufactured & piped.
2. Figures for the "effects of the consumption tax hike and free education policies" from April 2020 onward are staff estimates and include the effects of measures such as free higher education introduced in April 2020.

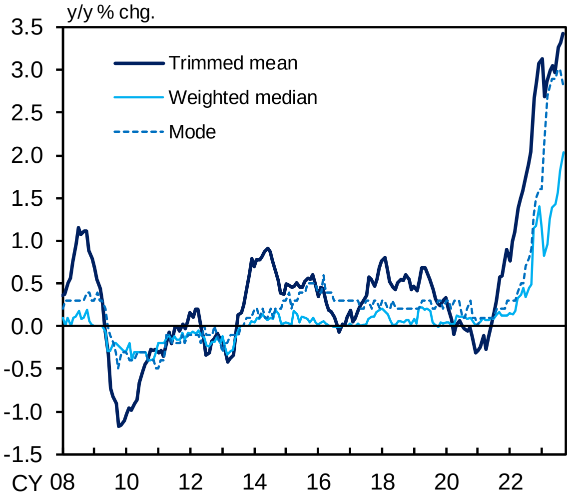
Chart 37: CPI (Excluding Temporary Factors)



Source: Ministry of Internal Affairs and Communications.
Notes: 1. Administered prices (less energy) consist of "public services" and "water charges."
2. The CPI figures are staff estimates and exclude mobile phone charges and the effects of the consumption tax hike, policies concerning the provision of free education, and travel subsidy programs.

the impact of the previous year's price hikes has dissipated. Specifically, although the pass-through of cost increases to selling prices has continued for food and daily necessities, the rate of increase in goods prices has decelerated slightly, mainly led by durable goods and by agricultural, aquatic, and livestock products. The rate of increase in general services prices has decelerated slightly -- particularly for dining-out and housework-related services (e.g., services related to housing repairs and maintenance), where dissipation of the impact of the previous year's price hikes has been observed -- although the rates for items such as hotel charges have remained on an accelerating trend. The year-on-year rate of increase in administered prices has remained on a moderate accelerating trend in reflection of hikes in, for example, fire and earthquake insurance premiums and railway fares.

Chart 38: 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, policies concerning the provision of free education, and travel subsidy programs. The CPI figures from April 2020 onward are staff estimates and exclude the effects of measures such as free higher education introduced in April 2020.

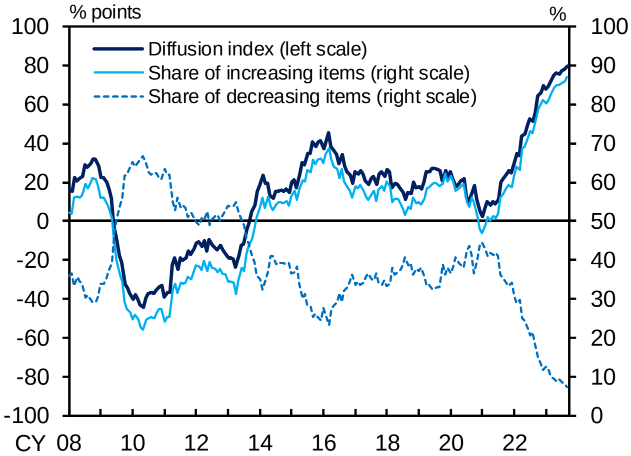
The indicators for capturing the underlying trend in the CPI have exhibited the following developments (Chart 38).[13,14] The trimmed mean

[13] The trimmed mean is calculated by excluding items that belong to a certain percentage of the upper and lower tails of the price change distribution (10 percent of each tail) in order to eliminate the effects of large relative price changes. The mode is the inflation rate with the highest density in the price change 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. All three indicators are calculated using data for each CPI item that excludes the effects of the consumption tax hikes, policies concerning the provision of free education, and travel subsidy programs.

[14] In this report, the mode is defined as the inflation rate with the highest density in the distribution that is estimated parametrically by fitting a normal inverse Gaussian distribution to the observed price change distribution in each period. It should be noted that, with dispersions of the observed distributions increasing, the fit of the normal inverse Gaussian distribution has deteriorated recently. Therefore, estimates of this mode should be interpreted with some latitude.

of the year-on-year rate of change in the CPI has been at around 3.5 percent, as price hikes have continued for a wide range of items. The mode and the weighted median, which are less susceptible to developments in certain CPI items, have been in the range of 2.5-3.0 percent and at around 2 percent, respectively. Looking at the year-on-year price changes across all CPI items (less fresh food), the share of price-increasing items minus the share of price-decreasing items has increased slightly as costs, such as of raw materials, have been passed on to a wide range of goods and services prices (Chart 39).

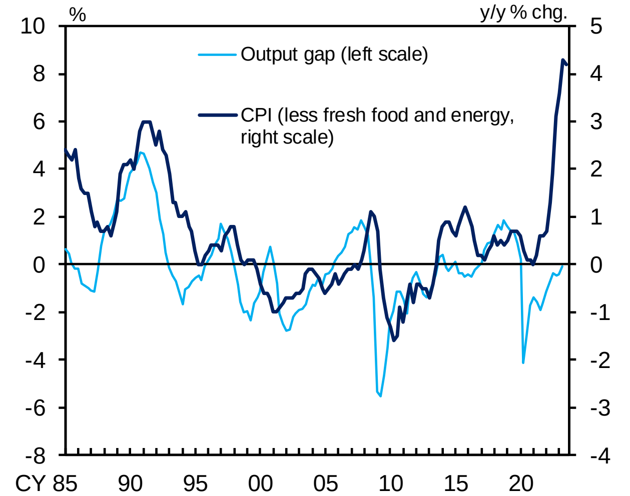
Chart 39: Diffusion Index of Price Changes



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 for which 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, policies concerning the provision of free education, and travel subsidy programs. The CPI figures from April 2020 onward are staff estimates and exclude the effects of measures such as free higher education introduced in April 2020.

Meanwhile, the year-on-year rate of change in the domestic demand deflator has been at around 2.5 percent (Chart 35). By component, the private consumption deflator has been at around 3 percent on a year-on-year basis. The rates of increase in such deflators as for business fixed investment have remained at high levels despite slowing somewhat. The year-on-year rate of change in the GDP deflator has been at around 3.5 percent recently; specifically, the rate of increase in the domestic demand deflator has remained relatively high despite slowing somewhat, while the rate of change in the import deflator has turned negative, mainly reflecting a waning of the effects of past high crude oil prices.

Chart 40: Inflation Rate and Output Gap



Sources: Ministry of Internal Affairs and Communications; Bank of Japan.
Notes: 1. The CPI figures are staff estimates and exclude mobile phone charges and the effects of the consumption tax hikes, policies concerning the provision of free education, and travel subsidy programs.
2. Figures for the output gap are staff estimates.

Environment Surrounding Prices

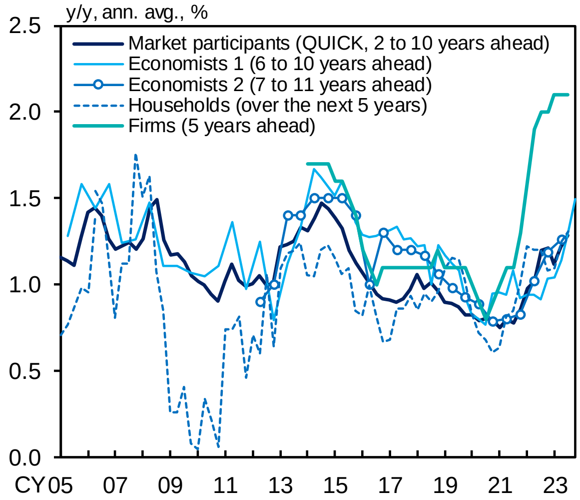
In the outlook for prices, the main factors that determine inflation rates are assessed as follows. First, the output gap is projected to turn positive around the middle of fiscal 2023 and then continue to expand moderately, albeit at a gradually slowing pace (Charts 2 and 40).

Second, medium- to long-term inflation expectations have risen moderately (Chart 41). The September *Tankan* shows that the output prices DI has been at a high level (Chart 42). It also shows that firms' inflation outlook for general prices has been at a high level, not only for the short term but also for the medium to long term. In addition, the wage growth rate agreed in the annual spring labor-management wage negotiations this year was significantly higher than in the previous year, including base pay. Given that the formation of inflation expectations in Japan is largely adaptive, the increase in inflation seen thus far has brought about a rise in households' and firms' medium- to long-term inflation expectations. In this situation, some aspects of firms' behavior have begun to shift more toward raising wages and prices. Regarding the outlook, even as actual inflation decelerates, inflation expectations are expected to rise moderately toward the end of the projection period, with the output gap turning positive and changes in firms' wage- and price-setting behavior and in labor-management wage negotiations. This will likely lead to a sustained rise in prices accompanied by wage increases.

Third, the year-on-year rate of change in the import price index has remained clearly negative (Charts 43 and 44). Regarding commodity prices, many of them are relatively lower than a while ago, although crude oil prices have risen and the yen's depreciation has contributed to pushing up commodity prices in yen terms. Looking at the final demand-intermediate demand (FD-ID) price indexes, the index for stage 1 of the ID -- which shows developments in an upstream stage of the production process -- has risen somewhat

Chart 41: Inflation Expectations

1. Survey



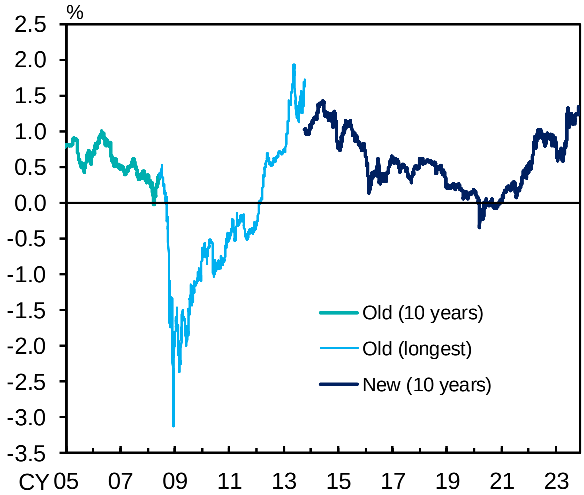
Sources: Bank of Japan; QUICK, "QUICK Monthly Market Survey <Bonds>"; JCER, "ESP Forecast"; Consensus Economics Inc., "Consensus Forecasts."

Notes: 1. "Economists 1" shows the forecasts of economists in the *Consensus Forecasts*. "Economists 2" shows the forecasts of forecasters surveyed for 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 for a 5-choice question.

3. Figures for firms show the inflation outlook of enterprises for general prices (all industries and enterprises, average) in the *Tankan*.

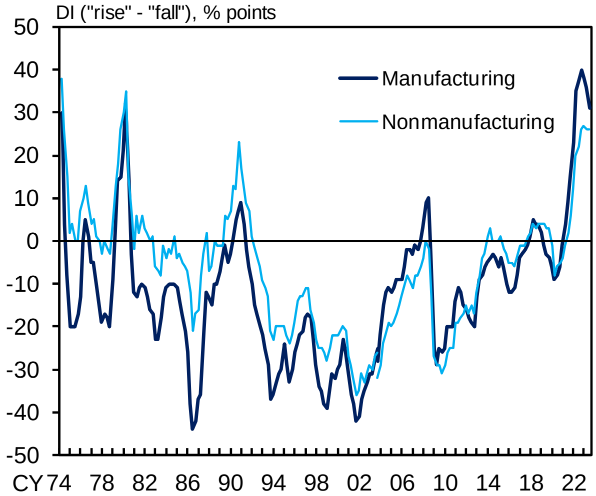
2. BEI



Source: Bloomberg.

Note: The BEI (break-even inflation) rate is the yield spread 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 42: Output Prices



Source: Bank of Japan.

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

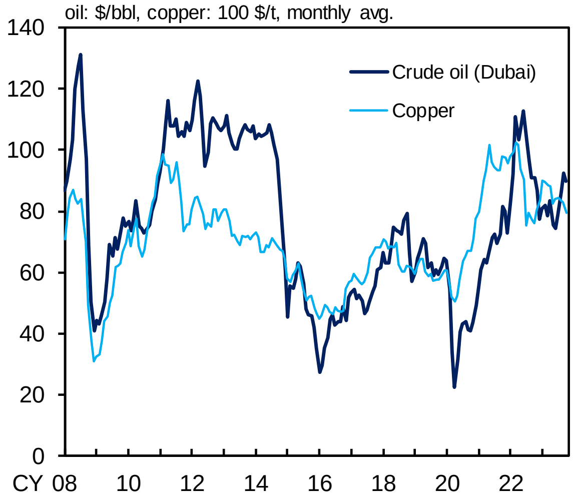
recently, partly owing to a rebound in crude oil prices, but is relatively lower than a while ago in reflection of developments in import prices (Chart 45). That for stage 2 of the ID has been more or less flat recently, mainly reflecting a pause in the decline in selling prices at the upstream stage. The indexes for stages 3 and 4 of the ID, which show developments in relatively downstream stages of the production process, have remained more or less flat. Given these developments, the upward pressure on the CPI stemming from the past rise in import prices is expected to gradually wane.[15]

Meanwhile, the year-on-year rate of decline in energy prices (e.g., gasoline prices and electricity charges) has been on an accelerating trend. The rate of change in prices of petroleum products has been slightly positive, since gasoline subsidies, which have made a negative contribution to these prices, have been reduced compared to the previous year.[16] On the other

[15] Box 2 examines the current situation of and future issues regarding the upward pressure of costs led by the rise in import prices.

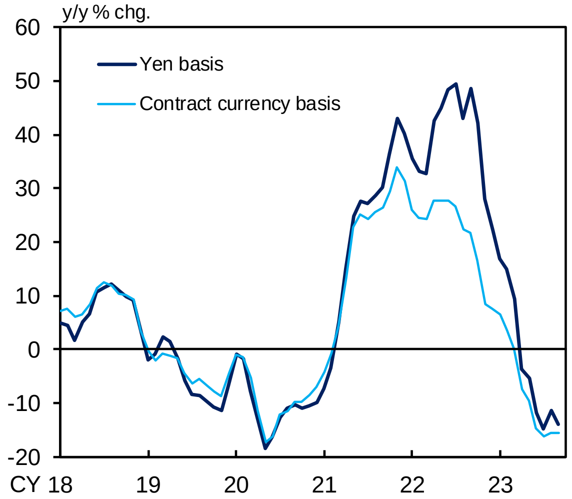
[16] Looking at the government's energy-related economic measures, with regard to gasoline subsidies, it has introduced a measure to provide subsidies to petroleum distributors and importers as funds to contain a sharp rise in their selling prices when the nationwide average for retail gasoline prices exceeds the benchmark price (168 yen per liter). After gradually reducing the subsidies from January 2023, the government revised the measure and expanded the subsidies in early September, in response to crude oil prices rising again. With regard to electricity charges, through its measures to reduce the household burden, electricity charges were cut by 7 yen per kilowatt-hour (roughly a 20 percent discount per month for typical households) for the period from February through September 2023, and have been cut by 3.5 yen per kilowatt-hour since October. Regarding manufactured and piped gas charges, roughly similar measures to reduce the household burden have been introduced. In the provisional economic measures that the government is currently formulating, it has announced its policy to continue with the above measures to reduce the household burden until next spring.

Chart 43: International Commodity Prices



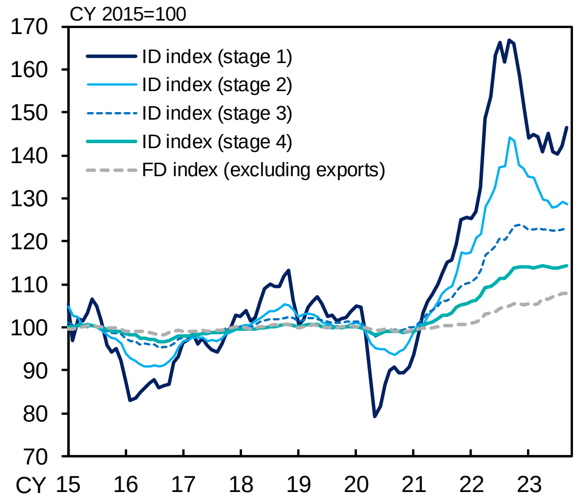
Sources: Nikkei Inc.; Bloomberg.

Chart 44: Import Price Index



Source: Bank of Japan.

Chart 45: FD-ID Price Indexes (All Commodities)



Source: Bank of Japan.

hand, the rates of decrease in electricity and gas charges have accelerated in reflection of the past decline in commodity prices, the government's measures to reduce the household burden of higher energy prices, and its revision to the rate of renewable energy surcharges on electricity. As for the outlook, the year-on-year rate of change in energy prices is likely to be negative for the time being. This is based on the projection that it will continue to be pushed down by the government's measures to reduce the household burden of higher energy prices, and that the effects of the past decline in commodity prices will be reflected in electricity and gas charges with a lag. As for fiscal 2024, assuming that those government measures will be terminated around the end of fiscal 2023, the year-on-year rate of change in energy prices is highly likely to register a relatively large positive figure, mainly due to a waning of the effects of the government measures pushing down such prices of the previous year. Thereafter, in light of developments in the futures market, the rate is projected to remain slightly negative through fiscal 2025, as the impact of the rebound caused by the phasing out of the government measures dissipates.

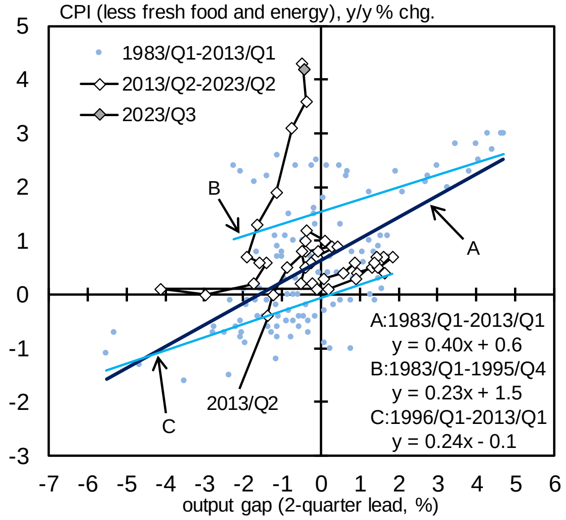
Outlook for Prices

Based on this underlying scenario, the year-on-year rate of increase in the CPI (all items less fresh food and energy) is likely to decelerate, due to a gradual waning of the effects of the pass-through to consumer prices of cost increases led by the past rise in import prices. Subsequently, the rate of increase is expected to be at around 2 percent toward the end of the projection period, as the output gap continues to improve and as medium- to long-term inflation expectations and wage growth rise, accompanied by changes in factors such as firms' wage- and price-setting behavior (Chart 46).

Taking account of the aforementioned developments in energy prices, the year-on-year rate of increase in the CPI (all items less fresh food) is likely to be above 2 percent through fiscal 2024, due to (1) the remaining effects of the pass-through to consumer prices of cost increases led by the past rise in import prices, (2) the effects of the recent rise in crude oil prices, and (3) the rebound caused by the phasing out of the government's measures to reduce the household burden of higher energy prices. As for fiscal 2025, the rate of increase in this CPI is projected to decelerate, since it is expected that there will be dissipation in the effects of the rise in crude oil prices and in the rebound caused by the phasing out of the government measures.

It should be noted that there are extremely high uncertainties surrounding this outlook. Specifically, there seem to be high uncertainties over the pace at which the upward pressure on the CPI stemming from the rise in import prices will wane and over whether underlying inflation will increase with a stronger linkage between wages and prices.[17]

Chart 46: Phillips Curve



Sources: Ministry of Internal Affairs and Communications; Bank of Japan.
Notes: 1. The CPI figures are staff estimates and exclude mobile phone charges and the effects of the consumption tax hikes, policies concerning the provision of free education, and travel subsidy programs.
2. Figures for the output gap are staff estimates.

[17] Box 3 examines the current situation of and future issues regarding firms' wage- and price-setting behavior.

III. Financial Developments in Japan

Financial Conditions

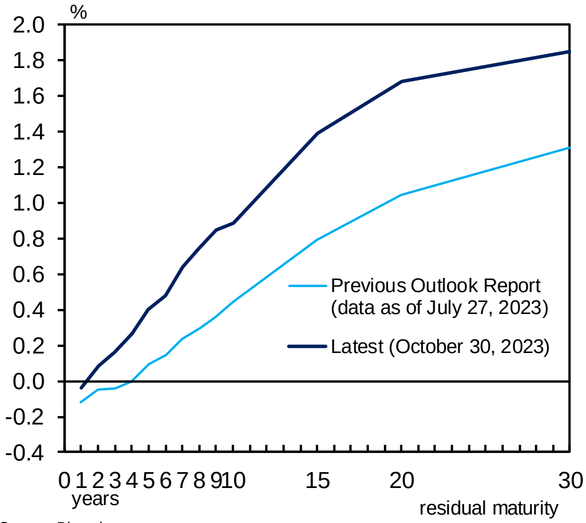
Financial conditions have been accommodative.

Under the framework of QQE with Yield Curve Control, the Bank has conducted market operations nimbly in accordance with the guideline for conduct of yield curve control, for which it decided to allow greater flexibility at the July Monetary Policy Meeting. In this situation, the shape of the yield curve for Japanese government bonds (JGBs) has been consistent 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 47).

Firms' funding costs have been hovering at extremely low levels (Chart 48). Lending rates (the average interest rates on new loans and discounts) have been at extremely low levels for short-term loans and discounts, while the rise in lending rates has paused for long-term loans. Issuance rates for CP have also been at extremely low levels. Issuance rates for corporate bonds have risen somewhat, reflecting an increase in their base rate.

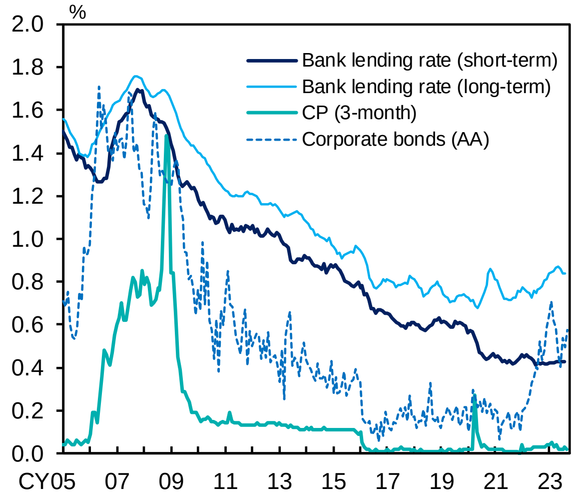
The DI in the *Tankan* for financial institutions' lending attitudes as perceived by firms suggests that such attitudes have remained accommodative on the whole (Chart 49). That for issuance conditions for CP has continued to show net "easy" conditions. As suggested by the latter, issuance conditions for CP and corporate bonds

Chart 47: Yield Curves



Source: Bloomberg.

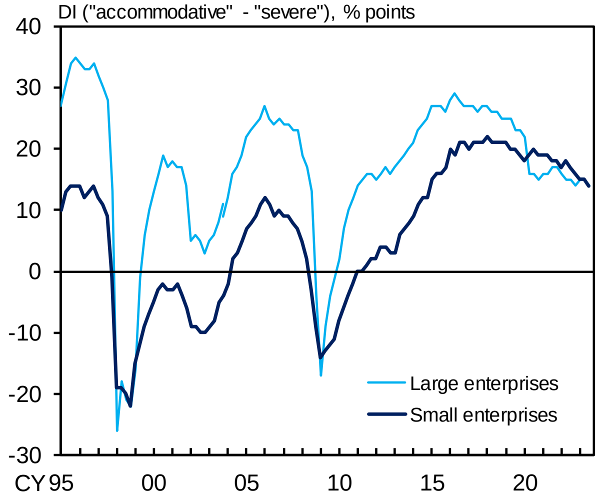
Chart 48: Bank Lending Rates and Issuance Yields for CP and Corporate Bonds



Sources: Bank of Japan; Japan Securities Depository Center; Capital Eye; I-N Information Systems; Bloomberg.

Notes: 1. Figures for issuance yields for CP up through September 2009 are the averages for CP (3-month, rated a-1 or higher). Those from October 2009 onward 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 are 6-month backward moving averages.

Chart 49: Lending Attitudes 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 for December 2003 due to a change in the survey framework.

have been favorable. The DI for firms' financial positions in the *Tankan* suggests that they have been at favorable levels on the back of a recovery in economic activity and progress in the pass-through of cost increases to selling prices (Chart 50). By industry, despite being affected by a slowdown in the pace of recovery in overseas economies, the DI for manufacturing has been flat, supported by a waning of the effects of supply-side constraints and the progress in the pass-through of cost increases. That for nonmanufacturing has continued on an improving trend on the back of the progress in this pass-through, in addition to increases in private consumption and inbound tourism demand.

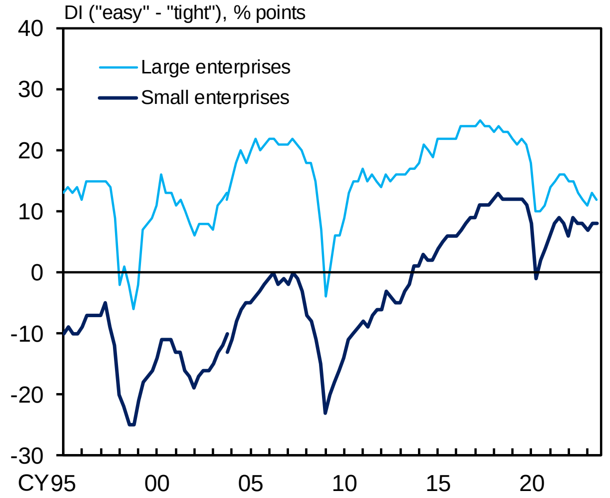
With a high level of demand for working capital stemming from past high raw material costs, firms' demand for funds has increased moderately on the back of, for example, the recovery in economic activity as well as mergers and acquisitions of firms. In this situation, the year-on-year rate of increase in the amount outstanding of bank lending has been in the range of 3.0-3.5 percent (Chart 51). That in the aggregate amount outstanding of CP and corporate bonds has been at around 2 percent.

The year-on-year rate of change in the monetary base has been at around 5.5 percent. The amount outstanding of the monetary base was 673 trillion yen, of which the ratio to nominal GDP was 114 percent.[18] The year-on-year rate of change in the money stock (M2) has been at

[18] The amount outstanding of the monetary base is as of end-September 2023. Nominal GDP is the figure for the April-June quarter of 2023.

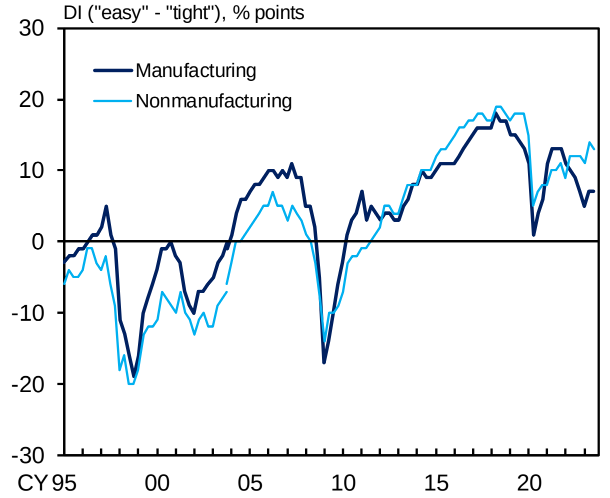
Chart 50: Firms' Financial Positions

1. By Firm Size



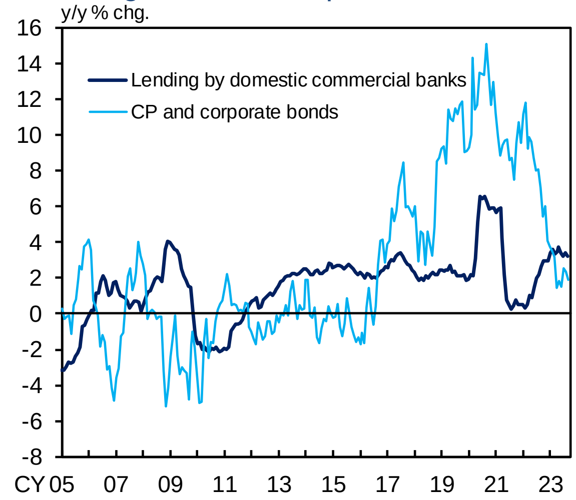
Source: Bank of Japan.
Note: Based on the *Tankan*. All industries. There is a discontinuity in the data for December 2003 due to a change in the survey framework.

2. By Industry



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

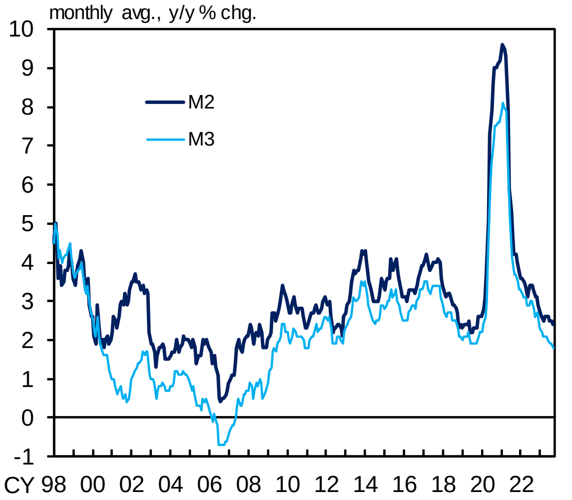
Chart 51: Amounts Outstanding of Bank Lending, CP, and Corporate Bonds



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 the period.

around 2.5 percent, as the amount outstanding of bank lending has continued to increase and fiscal spending has kept pushing the rate up (Chart 52).

Chart 52: Money Stock



Source: Bank of Japan.

Developments in Financial Markets

In global financial markets, market sentiment has become cautious as attention has been drawn to uncertainties over the U.S. and European monetary policies, as well as the outlook for the global economy.

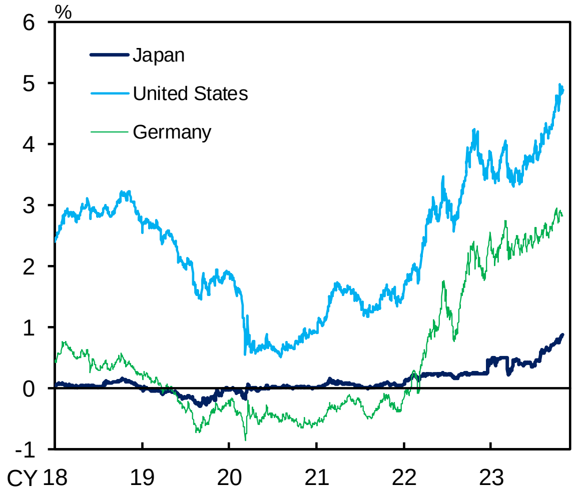
Yields on 10-year government bonds have risen significantly in the United States with market participants expecting prolonged monetary tightening (Chart 53). These yields have risen in Europe, as well as in Japan.

Premiums for U.S. dollar funding through the dollar/yen foreign exchange swap market have expanded since the end of September, mainly due to transactions conducted in view of the year-end (Chart 54).

Stock prices in the United States have declined against the background of a rise in long-term interest rates, and the volatility of these prices has increased (Charts 55 and 56). Stock prices in Europe have decreased due to a rise in long-term interest rates and a slowdown in the Chinese economy, as well as to heightened geopolitical risks in the Middle East. Those in Japan have declined, in line with decreases in U.S. and European stock prices, albeit with fluctuations. Stock prices in emerging economies have also declined, mainly due to rises in U.S. and European interest rates.

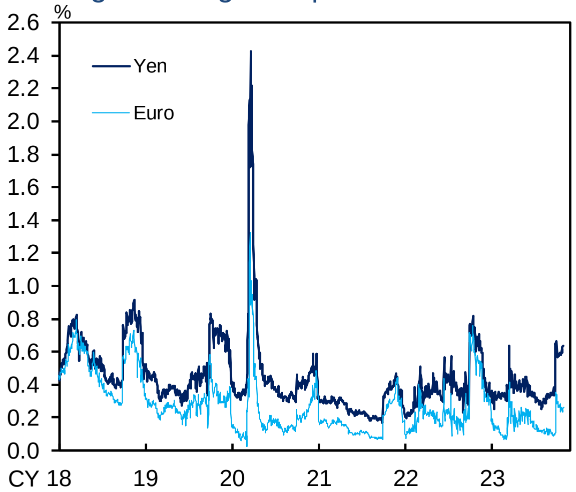
Prices of Japan real estate investment trusts (J-REITs) have decreased (Chart 57).

Chart 53: 10-Year Government Bond Yields in Selected Advanced Economies



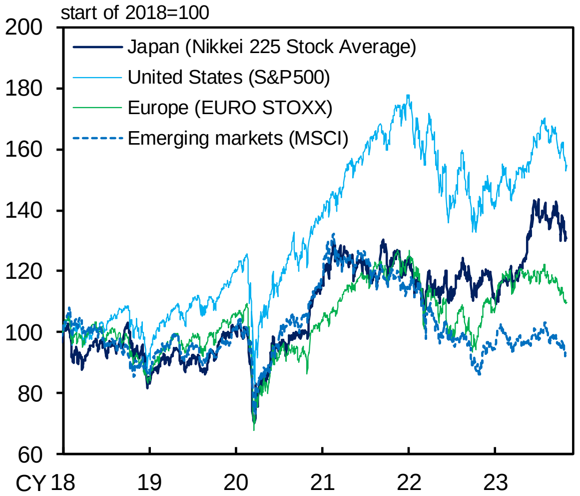
Source: Bloomberg.

Chart 54: Dollar Funding Premiums through Foreign Exchange Swaps



Source: Bloomberg.
Notes: 1. U.S. dollar funding premiums are calculated as the difference between U.S. dollar fundings rates (3-month) in the dollar/yen or euro/dollar foreign exchange swap market and those in the money market.
2. The interest rates used for the calculation are as follows: for the yen, the OIS rate; for the euro, the EONIA-referencing OIS rate before October 4, 2019, and the €STR-referencing OIS rate thereafter; for the U.S. dollar, the OIS rate before January 3, 2019, and the SOFR thereafter.

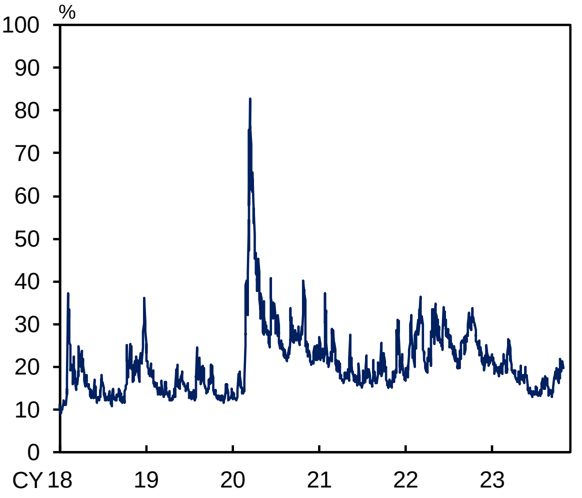
Chart 55: Selected Stock Price Indices



Source: Bloomberg.
Note: Figures for emerging markets are those for the MSCI Emerging Markets Index (local currency).

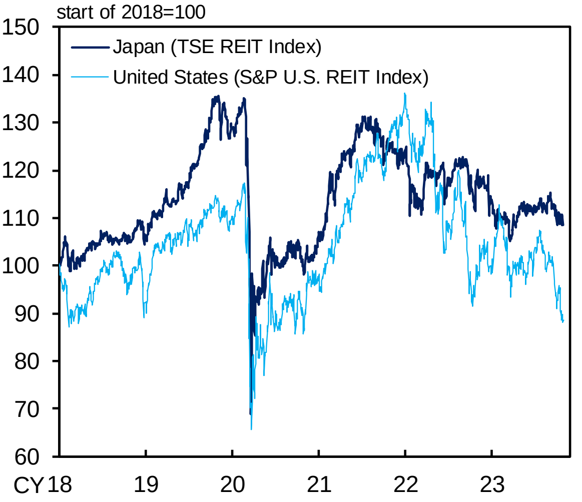
In foreign exchange markets, the yen has depreciated against the U.S. dollar, mainly because of developments in the yield differential between Japan and the United States (Chart 58). The yen has also depreciated against the euro.

Chart 56: Stock Market Volatility (VIX)



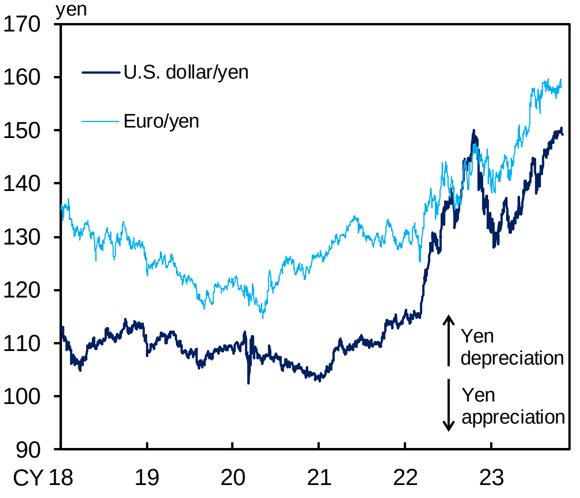
Source: Bloomberg.

Chart 57: Selected REIT Indices



Source: Bloomberg.

Chart 58: U.S. Dollar/Yen and Euro/Yen

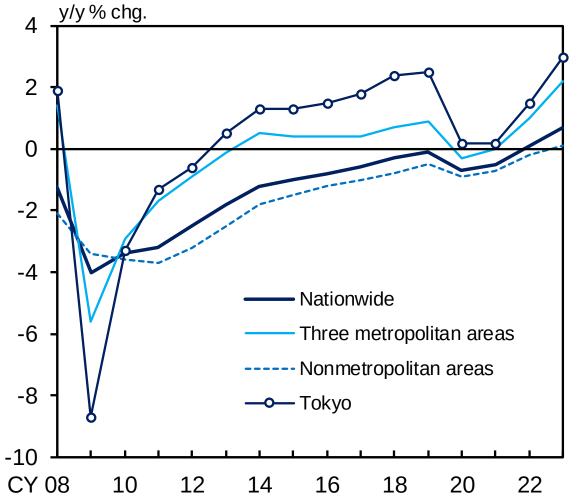


Source: Bloomberg.

Land Prices

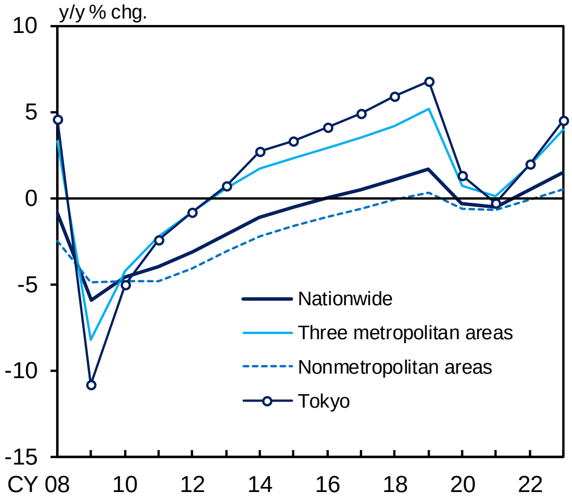
Land prices have increased in reflection of the economic recovery. According to the *Land Price Research by Prefectural Governments* for 2023 (as of July 1), the year-on-year rates of increase in both residential and commercial land prices have accelerated (Charts 59 and 60). In the three major metropolitan areas (Tokyo, Osaka, and Nagoya), the year-on-year rates of increase in both residential and commercial land prices have accelerated. In nonmetropolitan areas, the rates of change in these prices have turned positive.

Chart 59: Residential Land Prices



Source: Ministry of Land, Infrastructure, Transport and Tourism.
Notes: 1. Based on the *Land Price Research by Prefectural Governments*. Figures are as of July 1.
2. The three metropolitan areas are the Tokyo area (Tokyo, Kanagawa, Saitama, Chiba, and Ibaraki prefectures), the Osaka area (Osaka, Hyogo, Kyoto, and Nara prefectures), and the Nagoya area (Aichi and Mie prefectures). Nonmetropolitan areas are areas other than the three metropolitan areas.

Chart 60: Commercial Land Prices



Source: Ministry of Land, Infrastructure, Transport and Tourism.
Notes: 1. Based on the *Land Price Research by Prefectural Governments*. Figures are as of July 1.
2. The three metropolitan areas are the Tokyo area (Tokyo, Kanagawa, Saitama, Chiba, and Ibaraki prefectures), the Osaka area (Osaka, Hyogo, Kyoto, and Nara prefectures), and the Nagoya area (Aichi and Mie prefectures). Nonmetropolitan areas are areas other than the three metropolitan areas.

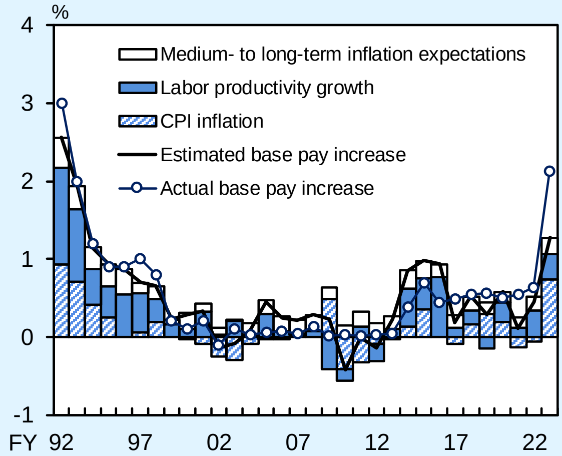
(Box 1) Reflection on Annual Spring Labor-Management Wage Negotiations in 2023

In the annual spring labor-management wage negotiations in 2023, relatively high base pay increases were achieved at many firms. Estimating a simple base pay function using long-term time-series data shows that the actual base pay increase this year is far larger than the estimated value. This suggests that firms' wage-setting behavior has shifted more toward raising wages (Chart B1-1).

For individual firms having labor unions that belong to the Japanese Trade Union Confederation (Rengo) -- which mainly consists of labor unions of large firms -- the distribution of the rates of base pay increase shows that, first and foremost, base pay increases at many firms were not achieved, and the observed rates of increase were concentrated in the range of 0-1 around 2015 and last year, when relatively higher base pay increases were realized on the whole, although not as high as the increases this spring (Chart B1-2). On the other hand, a wider range of firms in both the manufacturing and nonmanufacturing industries simultaneously conducted high levels of base pay increases this spring.

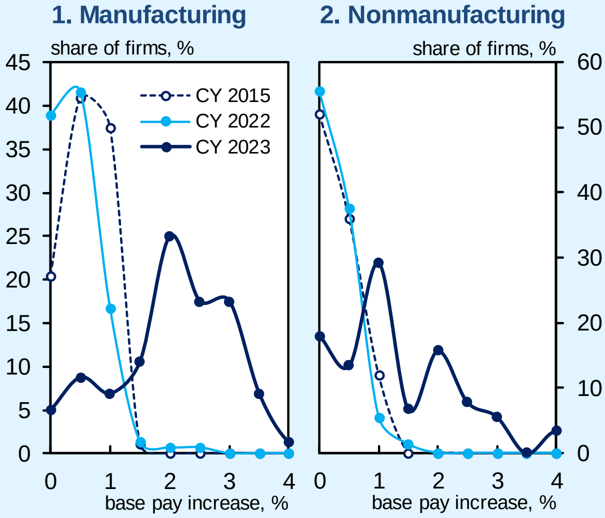
Looking back on it in detail, "leader firms," which have a large number of union members, conducted high levels of base pay increases and many other firms followed suit (Chart B1-3). Some surveys and other sources show that a wide

Chart B1-1: Base Pay Increase



Sources: Central Labour Relations Commission; Japanese Trade Union Confederation (Rengo); Ministry of Internal Affairs and Communications, etc.
Notes: 1. Figures for CPI inflation are for all items less fresh food, excluding the effects of the consumption tax hikes, etc. Figures for actual base pay increases from fiscal 1992 to 2013 are those published by the Central Labour Relations Commission, while those from fiscal 2014 to 2023 are figures released by Rengo.
2. The wage growth function for the estimation of base pay increases is specified as shown below. Estimation period: FY 1992-2022. *** indicates that the coefficient estimates are statistically significant at the 1 percent level.
Base pay increase = 0.32*** × CPI inflation (t-1)
+ 0.24*** × Nominal labor productivity growth (t-1)
+ 0.15*** × Medium- to long-term inflation expectations (t-1)

Chart B1-2: Base Pay Increase Distribution



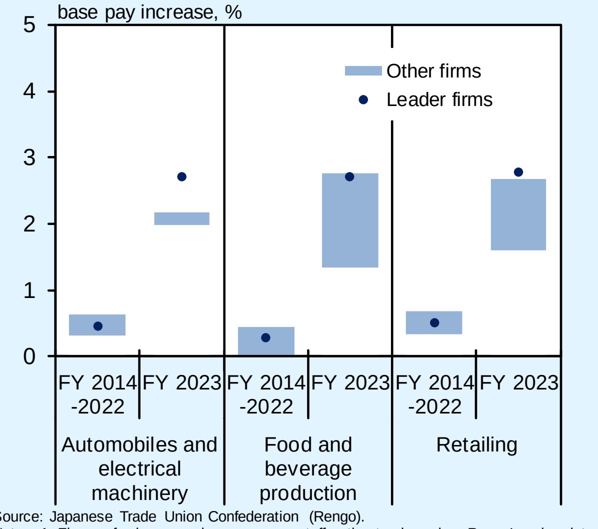
Source: Japanese Trade Union Confederation (Rengo).
Note: Figures for base pay increases are staff estimates based on Rengo's microdata on wage hikes and wage levels reported by its major labor unions.

range of SMEs also implemented base pay increases.[19]

Possible factors behind such active base pay increases by many firms are a rise in the inflation rate and intensifying labor shortages at a macroeconomic level that are partly due to the declining birthrate and aging population. Labor shortages have been evident especially among workers who are younger or highly skilled. Driven by the developments among these workers, the job market for regular employees, who were considered to have low mobility and to be recruited and retained without putting high pressure on firms to raise wages, has expanded rapidly in recent years (Chart B1-4).

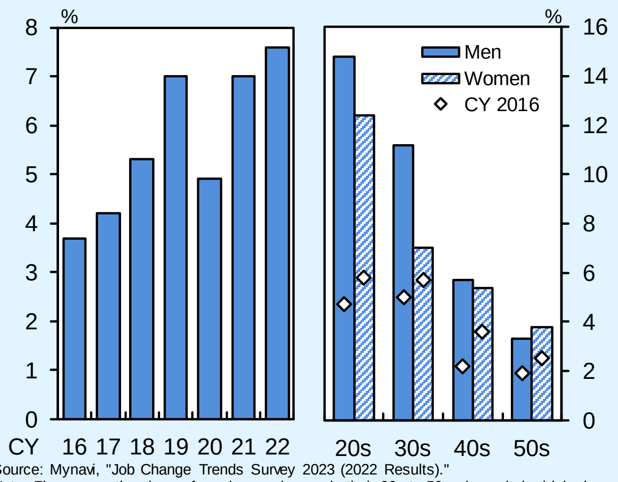
Such intensifying labor shortages have been spreading even to firms that are considered to have advantages in recruiting and retaining workers -- which seem to include many leader firms -- and it is likely that this has resulted in these firms shifting their wage-setting behavior more toward raising wages. In fact, an analysis of microdata from the *Tankan* surveys indicates that labor shortages have recently intensified rapidly, including among firms that did not experience such shortages even when macro-level labor market conditions became tight (Chart B1-5).

Chart B1-3: Spillover of Wage Hikes from Leader Firms



Source: Japanese Trade Union Confederation (Rengo).
Notes: 1. Figures for base pay increases are staff estimates based on Rengo's microdata on wage hikes and wage levels reported by its major labor unions.
2. Figures for leader firms in each sector are the averages of three firms with among the largest number of union members in that sector.
3. The blue bars show the 25th-75th percentile distributions of wage hikes at other firms.

Chart B1-4: Job-Switching Rates among Regular Employees

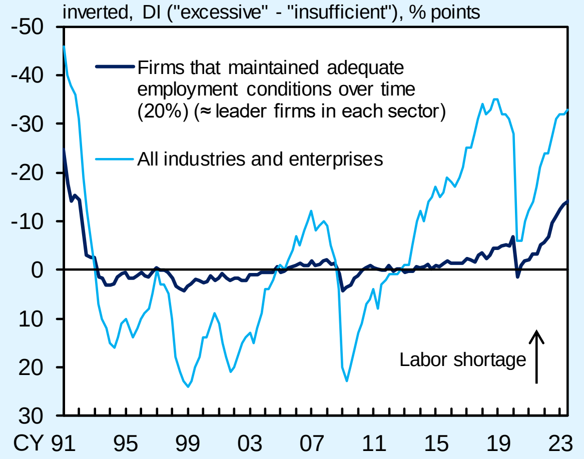


Source: Mynavi, "Job Change Trends Survey 2023 (2022 Results)."
Note: Figures are the share of regular employees in their 20s to 50s who switched jobs in the past year.

[19] For example, a survey released by Tokyo Shoko Research Ltd. in August 2023 and the LOBO survey (May 2023), which is conducted by the Japan Chamber of Commerce and Industry -- both of which mainly cover SMEs -- show that the percentage of firms that raised or would raise base pay went up significantly from last year.

As explained, it is likely that many firms simultaneously shifted their wage-setting behavior more toward raising wages at the annual spring labor-management wage negotiations in 2023, triggered by a rise in consumer prices that was led by an increase in import prices, as shortages of regular employees became acute for many firms, including leader firms in each sector. It is necessary to pay close attention to what extent wages will rise, given that labor shortages at a macroeconomic level are projected to continue, partly due to the declining birthrate and aging population.

Chart B1-5: Employment Conditions



Source: Bank of Japan.
Note: Based on the *Tankan*. Figures for "firms that maintained adequate employment conditions over time" are for firms that for at least about 90 percent of the period from 1991 to 2019 replied that their employment conditions were "adequate."

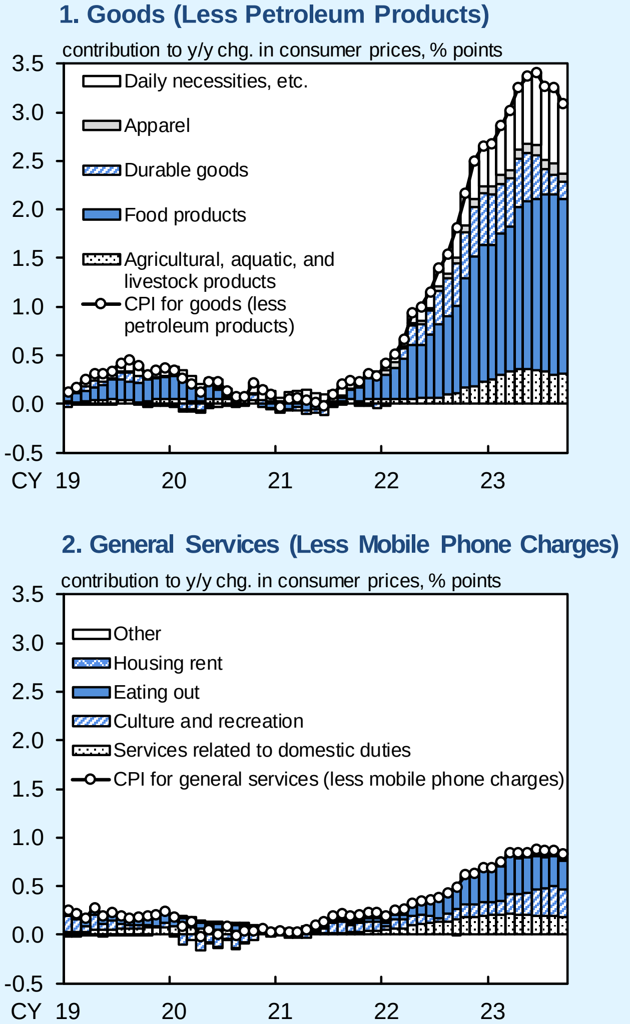
(Box 2) Firms' Outlook for Costs and Cost Pass-Through

The year-on-year rate of change in the CPI (all items less fresh food and energy) has continued to show relatively high growth, although the pace of increase has decelerated (Chart 37). Price rises have continued to be noticeable, mainly for food and daily necessities that use a large proportion of imported raw materials. This suggests that firms have continued to pass on past cost increases to prices, even with the year-on-year rate of change in import prices being negative since this spring (Chart B2-1).

One of the possible reasons for this is that firms have not fully reflected the actual developments in input costs in producing their outlook for costs, partly because of extremely large fluctuations in import prices since last year. In this regard, firms' outlook for costs at the time of making their annual plans is estimated for each sector, using their actual business plans and other data. The results show that firms in sectors such as food and daily necessities, which experienced large increases in costs last fiscal year, projected that cost increases would continue at relatively high rates for this fiscal year as well (Chart B2-2). Such outlook for high costs at the time of making annual plans has likely contributed to firms' prolonged moves to pass on cost increases to prices of items such as food and daily necessities, even with somewhat stable import prices.

However, upward pressure of raw material costs has already started to dissipate in a wide range of transaction stages of supply chains, reflecting

Chart B2-1: CPIs for Goods and Services

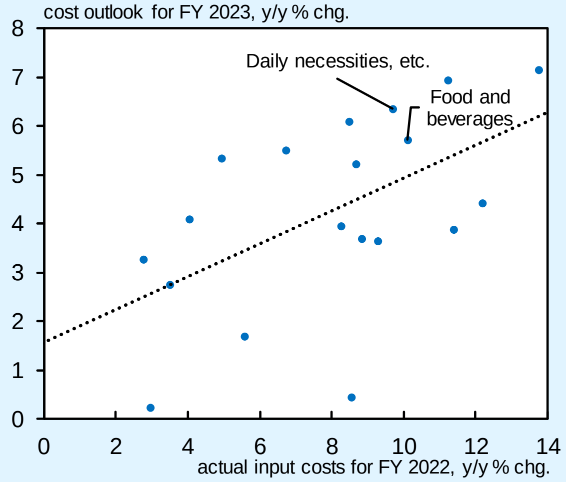


Source: Ministry of Internal Affairs and Communications.
Notes: 1. Figures are the contribution to changes in the CPI (less fresh food and energy). Figures are staff estimates and exclude mobile phone charges and the effects of the consumption tax hike, policies concerning the provision of free education, and travel subsidy programs.
2. Figures for services related to domestic duties include services related to housing repairs and maintenance.

stable import prices. Looking at the final demand-intermediate demand (FD-ID) price indexes, the indexes for stages 3 and 4 of the ID -- relatively downstream stages of the production process -- suggest that upward pressure of costs at these stages has waned. In addition, the rates of change in these indexes compared to three months earlier, which indicate short-term inflation momentum, have been at around 0 percent recently (Chart B2-3). In this situation, the growth rate of intermediate input costs, which are input costs for firms that conduct business-to-consumer transactions, has also decelerated clearly (Chart B2-4).[20] Considering these factors, as firms' outlook for costs will become stable, it is likely that the effects of cost pass-through, led by the past increase in import prices, will wane gradually, although they will remain in the short run.

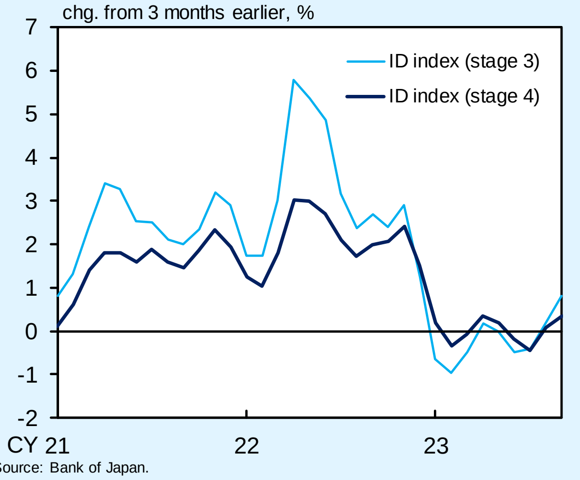
While crude oil prices have risen recently, prices of metals and grains have been stable to this point. If this situation continues, a significant rise in costs in a wide range of sectors -- such as that seen last fiscal year -- will likely be avoided, although it is necessary to continue to pay close attention to future developments in prices of commodities, including grains. In addition, given that cost structures differ among sectors, close monitoring is required on the effects of cost fluctuations on prices.

Chart B2-2: Firms' Cost Outlook



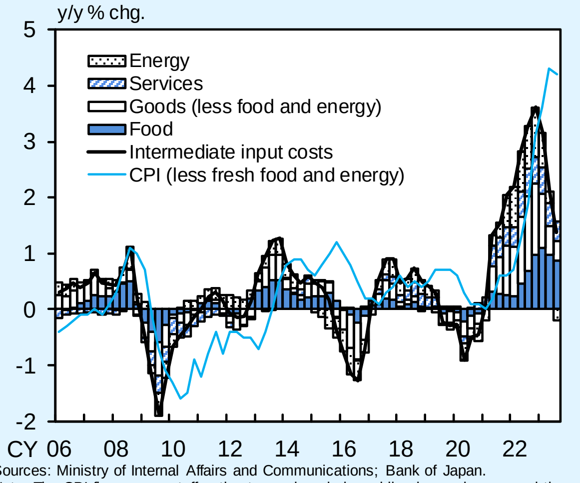
Sources: Ministry of Internal Affairs and Communications; Ministry of Health, Labour and Welfare; Bank of Japan; Nikkei NEEDS-Financial QUEST.
Notes: 1. Actual input costs for fiscal 2022 are the sum of intermediate input costs and wage costs.
2. Figures for the cost outlook for fiscal 2023 are first calculated at the firm level using figures for firms' outlook for output prices in the *Tankan* and listed firms' outlook for cost of sales ratios estimated from their business plans such as operating profits, etc. The figures are then aggregated at the industry level using firms' sales as weights.

Chart B2-3: FD-ID Price Indexes (All Commodities)



Source: Bank of Japan.

Chart B2-4: Intermediate Input Costs



Sources: Ministry of Internal Affairs and Communications; Bank of Japan.
Note: The CPI figures are staff estimates and exclude mobile phone charges and the effects of the consumption tax hikes, policies concerning the provision of free education, and travel subsidy programs. Intermediate input costs are calculated by multiplying the intermediate input ratio of each sector in the *2015 Input-Output Tables for Japan* by price data from the corporate goods price index (CGPI) or the services producer price index (SPPI) and then taking the weighted average using consumption expenditure shares as weights.

[20] To measure the intermediate input costs for the production of consumer goods and services, excluding fresh food and energy, the intermediate input cost index is estimated based on the transaction structure in the input-output tables. For details, see Box 3 in the April 2022 Outlook Report.

(Box 3) Linkage between Wages and Prices: Current Situation and Future Issues

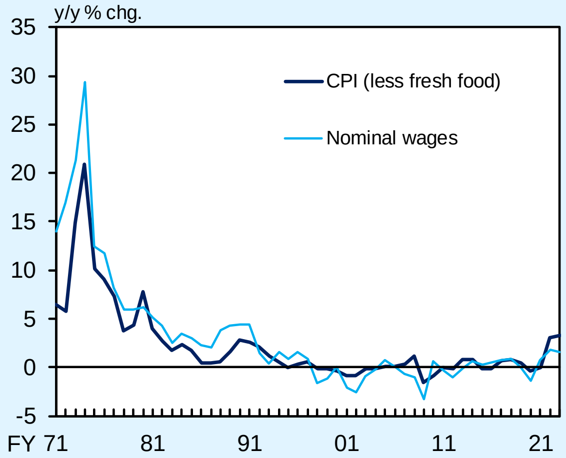
While the year-on-year rates of change in wages and prices had both been hovering at around 0 percent since the 2000s, they have been rising recently (Chart B3-1). In order to achieve stable inflation, it is important that wages and prices interact and gradually push each other up. This box assesses the current state of the link between wages and prices and provides an overview of issues going forward.

First, regarding spillovers from prices to wages, as shown in Box 1, price rises were reflected in wages in the annual spring labor-management wage negotiations in 2023. It is necessary to monitor whether this development will continue, including in the annual spring labor-management wage negotiations from next year onward.

Second, with regard to spillovers from wages to prices, developments in services prices -- where labor costs account for a high share of output prices -- are particularly important.[21]

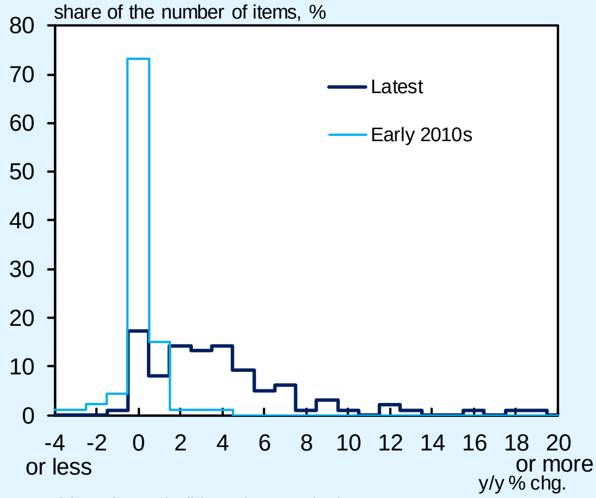
A look at the distribution of changes in services prices by item shows that the distribution overall has shifted to the right (Chart B3-2). However, this is partly because of the fact that prices of many service items, such as dining out and services related to housing repairs and maintenance, have been rising due to the strong impact of the past

Chart B3-1: Developments in Wages and Prices



Sources: Ministry of Internal Affairs and Communications; Ministry of Health, Labour and Welfare.
Notes: 1. The CPI figures are staff estimates and exclude the effects of the consumption tax hikes, policies concerning the provision of free education, and travel subsidy programs. Figures for nominal wages are for establishments with 30 or more employees up through fiscal 1990, and with 5 or more employees from fiscal 1991 onward.
2. Figures for fiscal 2023 are April-August averages.

Chart B3-2: Price Change Distribution (General Services)



Source: Ministry of Internal Affairs and Communications.
Notes: 1. Figures show the CPI for general services (less housing rent).
2. Figures for the early 2010s are as of June 2012 and the latest figures are as of September 2023.

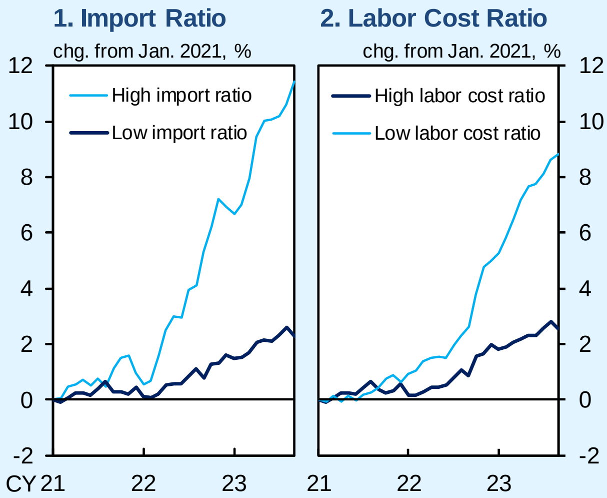
[21] For differences in the cost structure of output prices by industry, see Box 2 of the April 2023 Outlook Report.

rise in import prices. In this regard, price rises have been relatively slower for items with a low ratio of import costs to total costs and those with a high ratio of labor costs to total costs (Chart B3-3). In order for prices across a wide range of items to increase in a well-balanced manner once the impact of higher import prices has dissipated, moves to reflect actual wage increases in prices as well as forward-looking price-setting behavior in anticipation of factors such as future rises in wage costs will need to spread. In this respect, while many firms, when asked whether they have been able to reflect a wide range of costs, including wages, in their selling prices, point out that it has been difficult to pass on costs other than raw material costs to this point, some have started to say that they have raised prices to secure funds for future wage increases (Chart B3-4).

Econometric methods to examine the linkage between wages and prices show that, in Japan, wages have not responded in a statistically significant way to increases in prices and vice versa for a long time, but this situation may be changing (Chart B3-5). Starting with spillovers from prices to wages, the latest elasticity has increased in a statistically significant way, although it has not reached the level of the early 1990s, when inflation was stable. On the other hand, with regard to spillovers from wages to prices, although the elasticity itself has risen, no statistically significant change is observed at this point.[22] Attention needs to be paid to whether the

[22] Chart B3-5 shows the estimation results using a time-varying parameter VAR model. On this point, conducting a rolling estimation with similar variables using a local projection method has led to almost the same results.

Chart B3-3: CPI by Cost Structure



Source: Ministry of Internal Affairs and Communications.
Notes: 1. Based on staff calculations using the CPI excluding fresh food, energy, mobile phone charges, and imputed rent.
2. CPI items are matched to the items in the *2015 Input-Output Tables for Japan* and grouped in terms of their "total imports coefficient" or the share of "wages and salaries" and other labor costs in the domestic output of those items. Figures in the chart are the weighted averages of the items grouped in the top (bottom) 25 percent.

Chart B3-4: Interview Responses by Firms

Firms experiencing difficulty in passing on higher labor costs to output prices

-- We have been forced to pass on increases in raw material costs to our output prices and have continued to raise prices. On the other hand, we have absorbed higher labor costs by raising productivity and have not passed them on to output prices (eating and drinking).

-- Further output price hikes could lead to a decline in demand. Given the ongoing labor shortages, we intend to continue raising wages from next spring onward but plan to keep prices unchanged (hotel).

-- Although upward pressure on labor costs has continued, since we are concerned about losing customers, we do not plan to pass on higher labor costs to output prices (services for individuals).

Firms making progress in passing on higher labor costs to output prices

-- We plan to raise wages next fiscal year. In light of this, we have raised prices for the first time since our establishment (services for individuals).

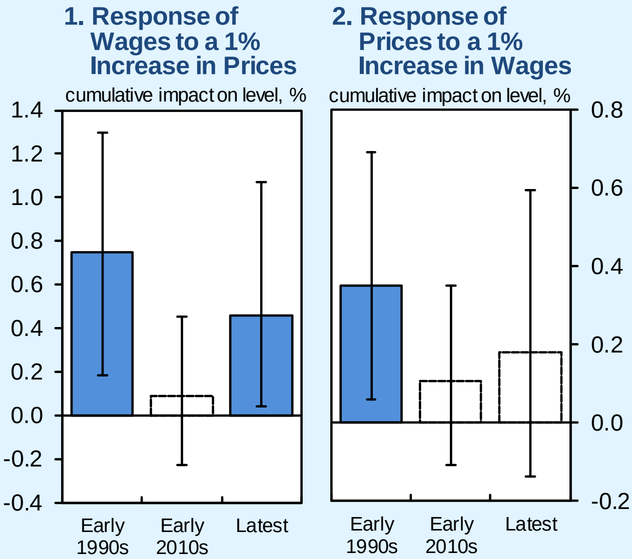
-- In response to rising electricity charges as well as higher labor costs partly due to the effects of the increase in minimum wages this fall, we have raised output prices (pharmacy).

Source: Interviews by the Bank of Japan.
Note: The industry of the interviewee is shown in parentheses.

above-mentioned changes in price-setting behavior that are starting to be seen among some firms will spread.

As described above, a gradually increasing number of firms have been changing their behavior, albeit slowly, which is based on the assumption that wages and prices will not increase easily and has been observed in Japan for many years. As the economy continues to recover, it is necessary to closely monitor whether the linkage between wages and prices will strengthen further.

Chart B3-5: Linkage between Wages and Prices



Sources: Ministry of Internal Affairs and Communications; Cabinet Office; Ministry of Health, Labour and Welfare; Bank of Japan.

Notes: 1. Figures show the estimation results of a time-varying parameter VAR model consisting of the output gap, nominal wages, and the CPI (less fresh food). Import prices are added as an exogenous control variable. The CPI figures are staff estimates and exclude temporary factors.

2. Figures are 4-quarter cumulative impulse responses. The bands indicate the 75 percent confidence intervals, while the broken lines indicate that the results are not statistically significant.

3. Figures for the early 1990s are as of 1991/Q2, those for the early 2010s are as of 2012/Q2, and the latest figures are as of 2023/Q2.