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日本銀行
BANK OF JAPAN

Outlook for Economic Activity and Prices

January 2024

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

Outlook for Economic Activity and Prices (January 2024)

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, due to factors such as the effects, albeit waning, of a pass-through to consumer prices of cost increases led by the past rise in import prices and a waning of the effects of the government's economic measures pushing down CPI inflation of the previous year. As for fiscal 2025, the rate of increase is projected to decelerate owing to dissipation of these factors. 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. The likelihood of realizing this outlook has continued to gradually rise, although there remain high uncertainties over future developments.
- Comparing the projections with those presented in the previous *Outlook for Economic Activity and Prices* (Outlook Report), the projected real GDP growth rate is somewhat lower for fiscal 2023 and somewhat higher for fiscal 2024. The projected year-on-year rate of increase in the CPI (all items less fresh food) for fiscal 2024 is lower, mainly due to the effects of the recent decline in crude oil prices.
- 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 both economic activity and prices are generally balanced. 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 January 22 and 23, 2024.

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. Corporate profits and business sentiment have improved. In this situation, business fixed investment has been on a moderate increasing trend. The employment and income situation has improved moderately. Private consumption has continued to increase moderately, despite being affected by price rises. Housing investment has been relatively weak. Public investment has been more or less flat. Financial conditions have been accommodative. On the price front, the negative contribution of energy prices to the year-on-year rate of increase in the CPI (all items less fresh food) has been relatively large, partly due to the government's economic measures. That said, the rate of increase in the CPI has been in the range of 2.0-2.5 percent recently, mainly on the back of the fact that, despite waning, the effects of a pass-through to consumer prices of cost increases led by the past rise in import prices have remained, and services prices have increased moderately. 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 somewhat lower, mainly reflecting the actual data showing that the rate of change in business fixed investment has been lower than was previously projected. The projected growth rate for fiscal 2024 is somewhat higher.

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 (1) those to reduce the household burden of higher gasoline prices, electricity charges, and gas charges, (2) benefit payments to low-income households, and (3) cuts in income tax and inhabitant tax. 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, they are likely to return to an uptrend, mainly due to moderate growth in these economies, albeit with variation across countries and regions, and to a pick-up in global demand for IT-related goods. Meanwhile, inbound tourism demand, which is categorized under services exports, is expected to continue increasing. Corporate profits are likely to keep improving, 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 on an increasing trend, 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 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, due to factors such as the effects, albeit waning, of a pass-through to consumer prices of cost increases led by the past rise in import prices and a waning of the effects of the government's economic measures pushing down CPI inflation of the previous year. As for fiscal 2025, the rate of increase is projected to decelerate owing to dissipation of these factors. 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 2024 is lower, mainly due to the effects of the recent decline in crude oil prices.

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 and 2025, on the other hand, they are projected to push up the rates due to a waning of the effects of those measures pushing down CPI inflation of each

[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.

[3] Under a specific methodology, Japan's recent potential growth rate is estimated to be in the range of 0.5-1.0 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.

previous year.[4] 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 followed an improving trend. Based on the aforementioned outlook for economic activity, the gap is likely to widen moderately within positive territory 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 December 2023 *Tankan* (Short-Term Economic Survey of Enterprises in Japan) shows that the diffusion index (DI) for output prices is lower than a while ago but has remained at a high level, and that figures for firms' inflation outlook for general prices have declined somewhat for the short term but have remained at high levels for the medium to long term. 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, firms' behavior has shifted more toward raising wages and prices. Regarding the outlook, inflation expectations are expected to rise moderately toward the end of the projection period, with continued improvement in the output gap and changes in firms' wage- and price-setting behavior and in labor-management wage negotiations. Under these circumstances, a virtuous cycle between wages and prices is projected to intensify through achievement of wage increases that reflect price rises and through a pass-through of wage increases to selling prices.

Considering the above assessments, underlying CPI inflation is likely to increase gradually toward achieving the price stability target. Taking account, for example, of changes in firms' wage- and price-setting behavior and of the stance among labor and management toward wage negotiations, the likelihood of realizing this outlook has

[4] The Comprehensive Economic Measures to Completely Break Free from Deflation were decided by the Cabinet in November 2023. As part of these measures, the government decided to continue with measures to reduce the burden of higher gasoline prices through April 2024. It also decided that measures to reduce the burden of higher electricity and gas charges will remain effective for charges on these types of energy consumed through May 2024. Assuming that these measures to reduce those various burdens will not be extended and will be phased out, the year-on-year rates of increase in the CPI (all items less fresh food), mainly for fiscal 2024, will be pushed up by a waning of the effects of these measures pushing down CPI inflation of each previous year.

continued to gradually rise, although there remain high uncertainties over future developments.

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 inflationary pressure has remained on a global basis, inflation rates in the United States and Europe are lower than a while ago. In this situation, overseas central banks have continued to conduct tight monetary policy, but some have apparently signaled future policy interest rate reductions. 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. There is also a possibility that, if inflationary pressure wanes further, moves to reduce policy interest rates will strengthen and affect these economies. On the other hand, 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. While prices of grains and other commodities had declined on the whole -- albeit with fluctuations -- after reaching their peak around the middle of 2022, attention continues to be warranted on the risk that these prices 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 the effects of the pass-through of the past rise in import prices to consumer prices have been gradually waning, this pass-through could continue for longer than expected and lead prices to deviate upward from the baseline scenario, depending on how much upward pressure will be exerted by raw material costs and on how firms' inflation expectations will develop. 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 last 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 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.[5]

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 likelihood of realizing this outlook has continued to gradually rise, although there remain high uncertainties over future developments.

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 both economic activity and prices are generally balanced. 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.

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

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, 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.

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.

(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	+1.6 to +1.9 [+1.8]	+2.8 to +2.9 [+2.8]	+3.7 to +3.9 [+3.8]
Forecasts made in October 2023	+1.8 to +2.0 [+2.0]	+2.7 to +3.0 [+2.8]	+3.5 to +3.9 [+3.8]
Fiscal 2024	+1.0 to +1.2 [+1.2]	+2.2 to +2.5 [+2.4]	+1.6 to +2.1 [+1.9]
Forecasts made in October 2023	+0.9 to +1.4 [+1.0]	+2.7 to +3.1 [+2.8]	+1.6 to +2.1 [+1.9]
Fiscal 2025	+1.0 to +1.2 [+1.0]	+1.6 to +1.9 [+1.8]	+1.8 to +2.0 [+1.9]
Forecasts made in October 2023	+0.8 to +1.2 [+1.0]	+1.6 to +2.0 [+1.7]	+1.8 to +2.2 [+1.9]

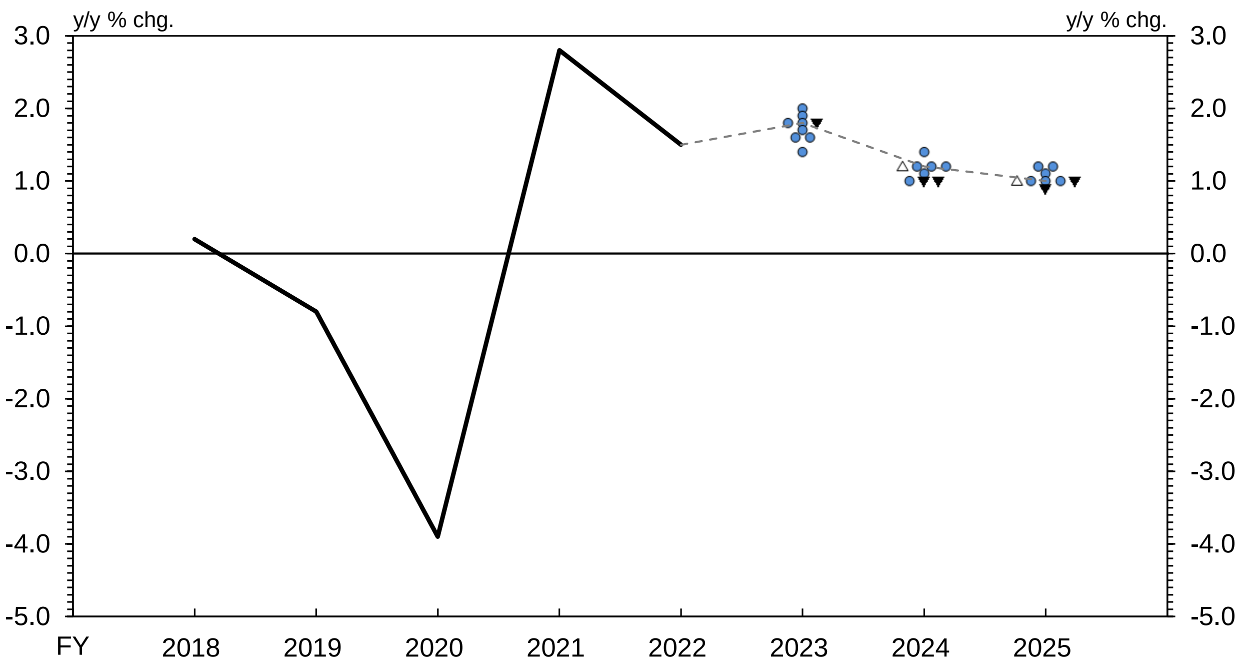
Notes: 1. Figures in brackets indicate the medians of the Policy Board members' forecasts (point estimates).

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.

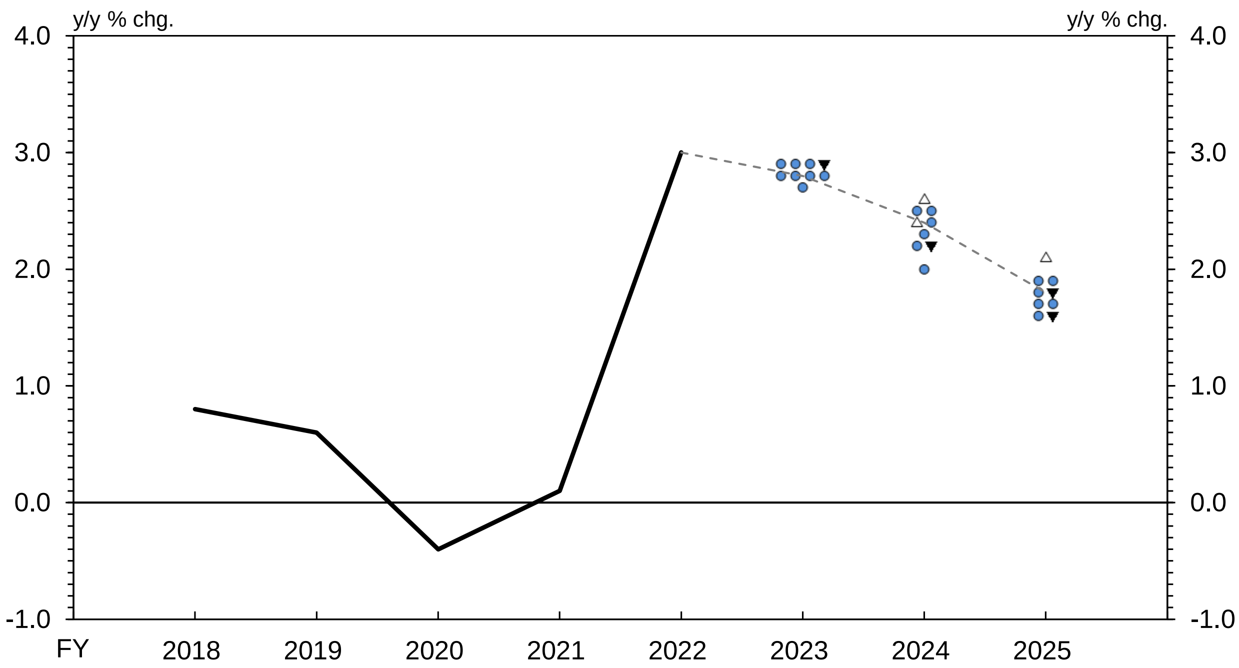
3. Each Policy Board member makes their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding the future conduct of policy.

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

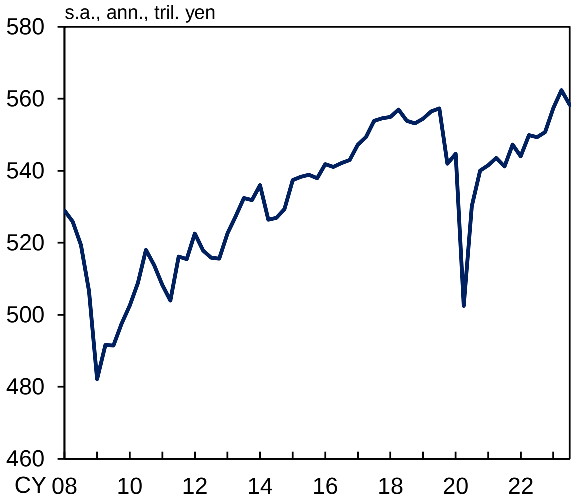
Japan's economy has recovered moderately.

Real GDP rose for three consecutive quarters, registering 0.9 percent on a quarter-on-quarter basis for the April-June quarter of 2023 and 3.6 percent on an annualized basis (Chart 1). It then decreased for the July-September quarter, registering minus 0.7 percent on a quarter-on-quarter basis and minus 2.9 percent on an annualized basis. Relative to the previous quarter, private consumption slightly declined and business fixed investment decreased. Meanwhile, net exports were unchanged and, owing to dissipation of the effects of large-scale projects, public investment was more or less flat. The output gap -- which captures the utilization of labor and capital -- remained on an improving trend, although it was slightly negative for the July-September quarter, which reflects the fact that the capacity utilization rate for the manufacturing industry declined somewhat (Chart 2).

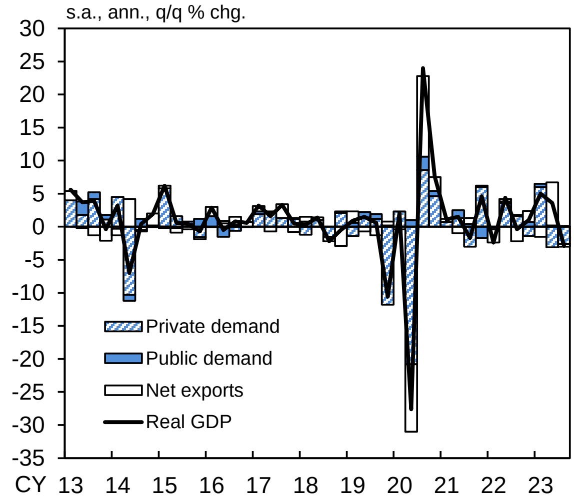
Monthly indicators and high-frequency data since then suggest that Japan's economy has continued on a recovery trend. In the corporate sector, although exports and production have been affected by a slowdown in the pace of

Chart 1: Real GDP

1. Level



2. Annualized Quarterly Growth Rate

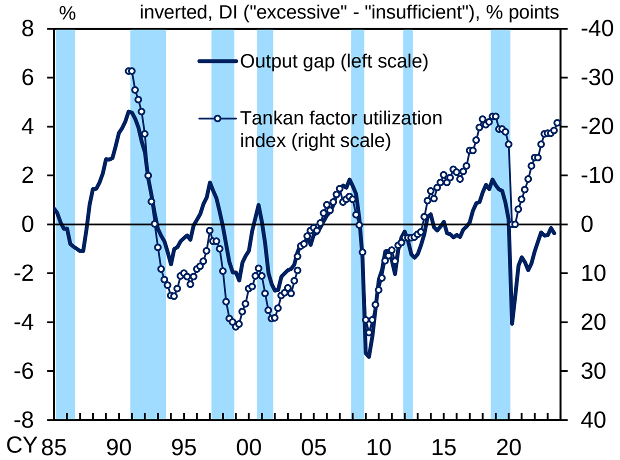


Source: Cabinet Office.

[6] "The Background" provides explanations of "The Bank's View" decided by the Policy Board at the Monetary Policy Meeting held on January 22 and 23, 2024.

recovery in overseas economies, they have been more or less flat. Corporate profits and business sentiment have improved. In this situation, business fixed investment has been on a moderate increasing trend, and the business fixed investment plans for fiscal 2023 in the December 2023 *Tankan* indicate that investment is expected to see a clear rise. In the household sector, the employment and income situation has improved moderately. Under these circumstances, private consumption has continued to increase moderately, 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.

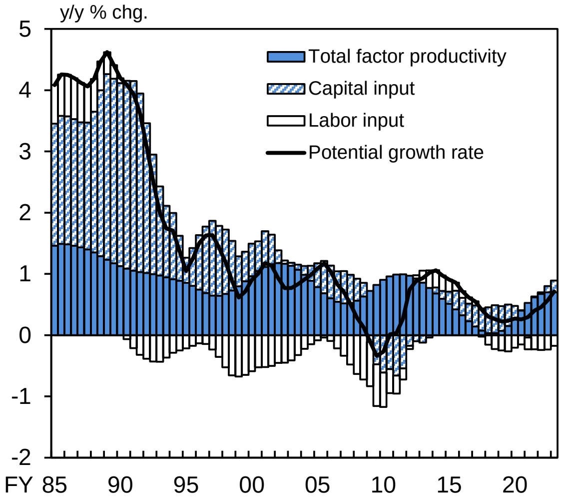
Japan's economy is likely to continue recovering moderately for the time being, supported by the materialization of pent-up demand, as well as by factors such as accommodative financial conditions and the government's economic measures, although it is expected to be under downward pressure stemming from 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

[7] The government formulated additional measures toward overcoming price increases in March 2023 and the Comprehensive Economic Measures to Completely Break Free from Deflation in November. 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.

Outlook Report, the projected real GDP growth rate for fiscal 2023 is somewhat lower, mainly reflecting the actual data showing that the rate of change in business fixed investment has been lower than was previously projected. The projected growth rate for fiscal 2024 is somewhat higher.

The potential growth rate seems to have been in the range of 0.5-1.0 percent recently with a moderate increase in the growth rate of total factor productivity (TFP), although a downtrend in working hours reflecting working-style reforms, for example, has continued (Chart 3). 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) TFP will continue to grow, 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 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,

Chart 3: Potential Growth Rate



Source: Bank of Japan.
Note: Figures are staff estimates.

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 despite being affected by the slowdown, mainly because IT-related demand is likely to head toward a pick-up. Inbound tourism demand, which is categorized under services exports, is expected to keep increasing. With corporate profits improving, business fixed investment is projected to continue on an increasing trend, 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 will likely occur due to the effects of the government's economic measures and 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 due to factors such as pent-up demand, which is partly supported by household savings that had accumulated as a result of pandemic-related restrictions. 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, Japan's economy is expected to continue growing at a pace above its potential growth rate, partly due to the effects of the government's economic measures, 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 expected to continue on an increasing trend, 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. Moreover, factors such as cuts in income tax and inhabitant tax by the government are projected to push up disposable income. In this situation, private consumption is likely to continue increasing moderately, although pent-up demand is projected to 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.

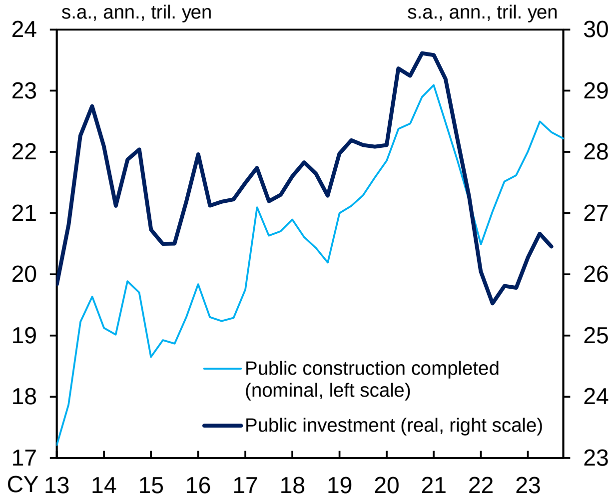
In fiscal 2025, although pent-up demand is expected to diminish, domestic and external demand is projected to continue increasing. Goods exports are likely to increase moderately, with overseas economies continuing to grow. Inbound tourism demand is projected to keep increasing. Business fixed investment 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 been more or less flat (Chart 4). While construction based on the government's economic measures, including construction related to building national resilience, has progressed, the amount of public construction completed -- a coincident indicator of public investment -- has been more or less flat, partly due to dissipation of the effects of large-scale projects. The value of public works contracted and orders received for public construction -- both of which are leading indicators of public investment -- declined, mainly due to the dissipation of the effects of large-scale projects; subsequently, they have been more or less flat.

Chart 4: Public Investment



Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Note: The figure for 2023/Q4 is the October-November average.

As for the outlook, public investment is likely to see a slight lowering in its level for the time being, mainly due to the 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 November 2023 also include efforts to implement the acceleration measures.

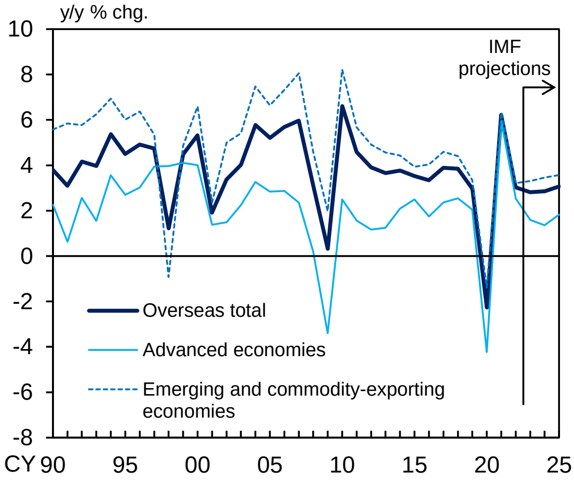
uptrend in healthcare and nursing care expenditures.

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. Emerging and commodity-exporting economies other than China have improved moderately on the whole, as signs of a pick-up have been seen in exports. Among those in Asia, which are closely related to Japan's economy, the ASEAN economies have improved moderately, as domestic demand has continued to improve and exports have started to bottom out. The NIEs economies have also improved moderately, on the back of a pick-up in exports, mainly led by IT-related goods, although the pace of improvement in domestic demand has decelerated.[9] 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 are lower than a while ago; figures for the manufacturing industry have been somewhat below 50 (Chart 6). The world

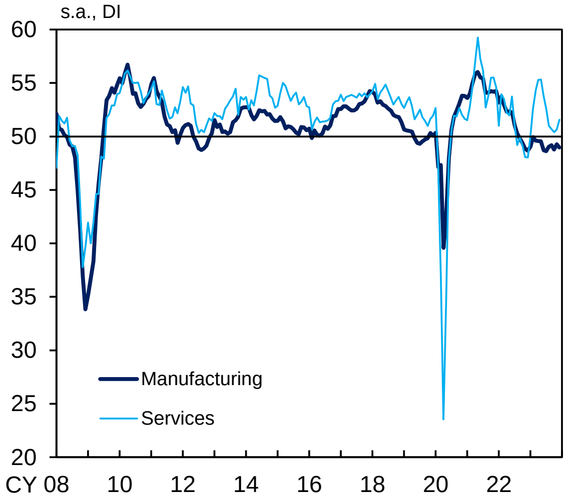
[9] Box 1 examines the recent pick-up in global IT-related demand and its background.

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.

Chart 6: Global PMI



Source: Copyright © 2024 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.

trade volume has started to bottom out despite being affected by the slowdown in the pace of recovery in overseas economies, mainly because inventory adjustments for intermediate and IT-related goods have progressed (Chart 7).

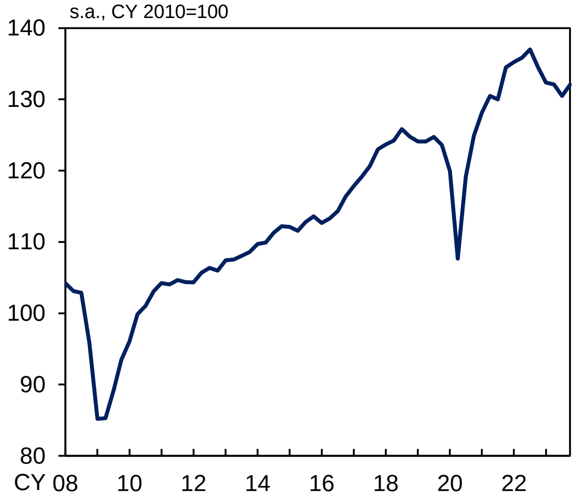
As for the outlook, the pace of recovery in overseas economies is projected to remain slow for the time being. By region, the U.S. economy is likely to continue to be firm. The Chinese economy is projected to gradually move out of its slowing phase due to policy support. European economies are expected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

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

Exports and Imports

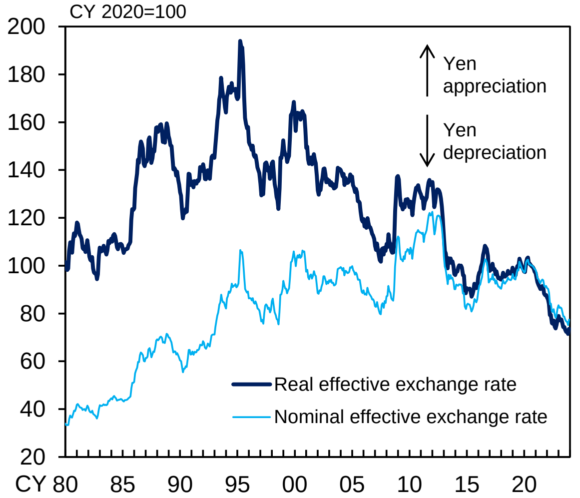
Although exports have been affected by the slowdown in the pace of recovery in overseas economies, they have been more or less flat (Chart 9). By region, exports to the U.S. economy have been on an uptrend, mainly led by automobile-related goods (Chart 10). Those to European and other economies have been at high levels, also mainly led by automobile-related goods. Exports to the Chinese economy have bottomed out. Those to the NIEs, the ASEAN economies, and some other Asian economies have also bottomed out, against the background of progress in global adjustments for IT-related

Chart 7: World Trade Volume



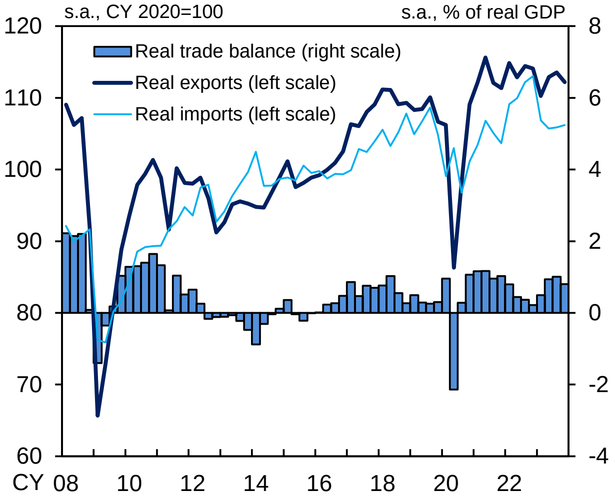
Source: CPB Netherlands Bureau for Economic Policy Analysis.
Note: Figures for the world trade volume are those for world real imports. The figure for 2023/Q4 is that for October.

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.

Chart 9: Real Exports and Imports



Sources: Bank of Japan; Ministry of Finance; Cabinet Office.
Note: Based on staff calculations. Figures for 2023/Q4 are October-November averages.

goods. By goods, exports of automobile-related goods have been on an uptrend, with supply-side constraints for semiconductors used in automobiles generally having dissipated (Chart 11). Exports of capital goods overall have been more or less flat, mainly because they have been supported by high levels of order backlogs and exports of semiconductor production equipment have bottomed out. Exports of IT-related goods have bottomed 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.

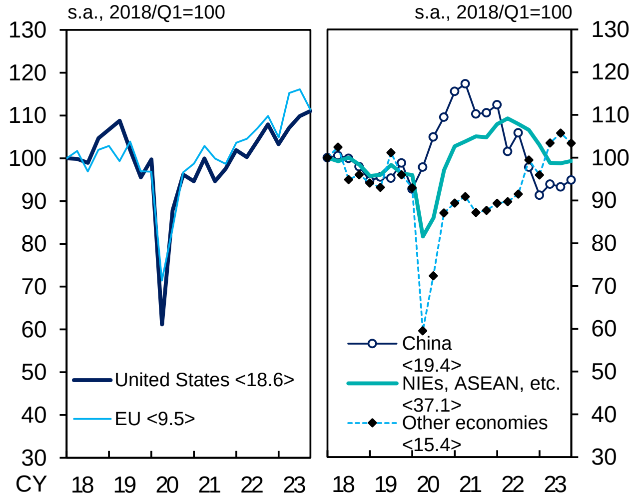
Exports are projected to be more or less flat for the time being with the pace of recovery in overseas economies remaining slow. Subsequently, as these economies grow moderately, albeit with variation across countries and regions, exports are likely to return to an uptrend.

Imports have been more or less flat, albeit with fluctuations (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.

External Balance

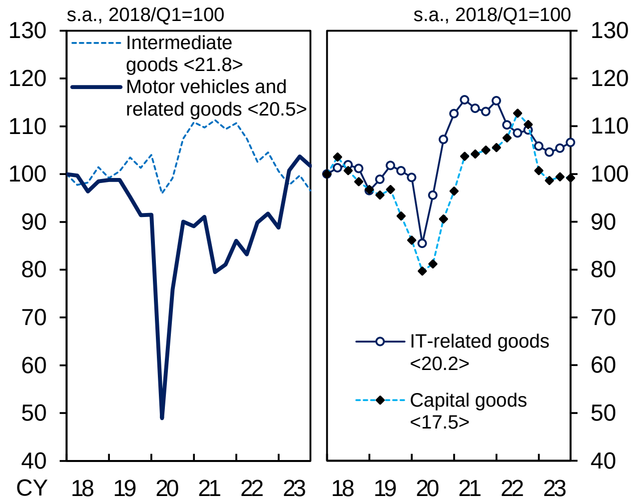
The nominal current account surplus has been at a high level (Chart 12). The trade balance deficit has been small, marking a clear decrease compared to a while ago. Despite a surplus in the travel balance, which reflects a recovery in inbound tourism demand (Chart 13), the services

Chart 10: Real Exports by Region



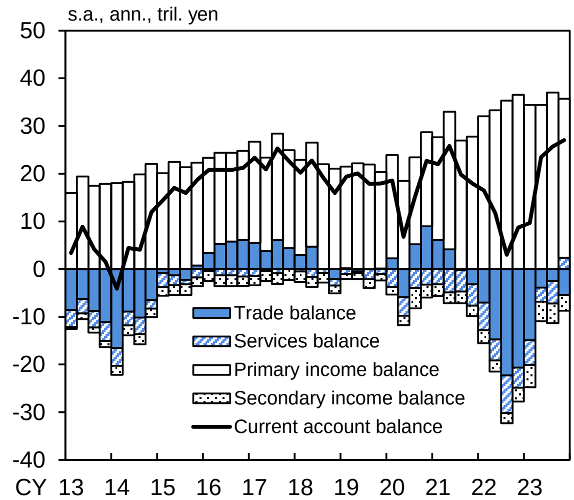
Sources: Bank of Japan; Ministry of Finance.
Notes: 1. Based on staff calculations. Figures in angular brackets show the share of each country or region in Japan's total exports in 2022. Figures for 2023/Q4 are October-November averages.
2. Figures for the EU exclude those for the United Kingdom for 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. Figures for 2023/Q4 are October-November averages.

Chart 12: Current Account



Source: Ministry of Finance and Bank of Japan.
Note: Figures for 2023/Q4 are October-November averages.

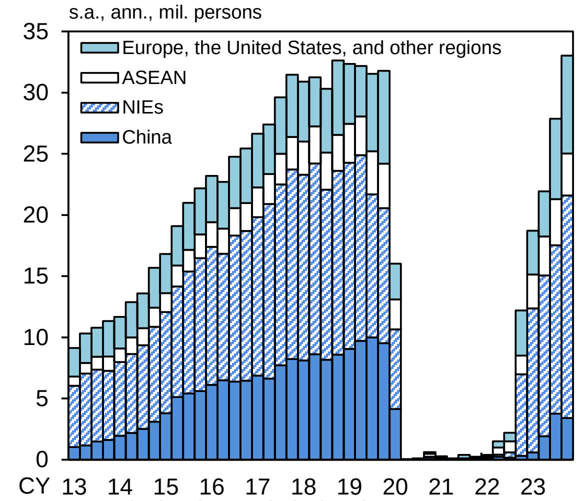
balance has remained on a slight deficit trend, as payments for digital-related services have been at high levels, albeit with fluctuations. Meanwhile, the primary income balance surplus has remained at a high level.

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 an 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).

Industrial Production

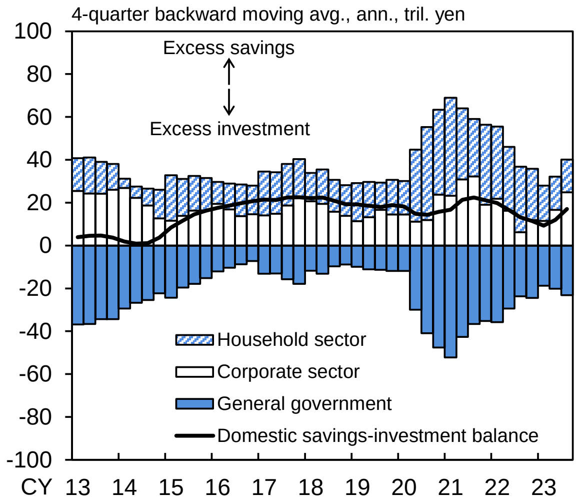
Although industrial production has been affected by the slowdown in the pace of recovery in overseas economies, it has been more or less flat (Chart 15). By major industry, production of "transport equipment" has been on an uptrend, with supply-side constraints for semiconductors used in automobiles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

Chart 13: Number of Inbound Visitors



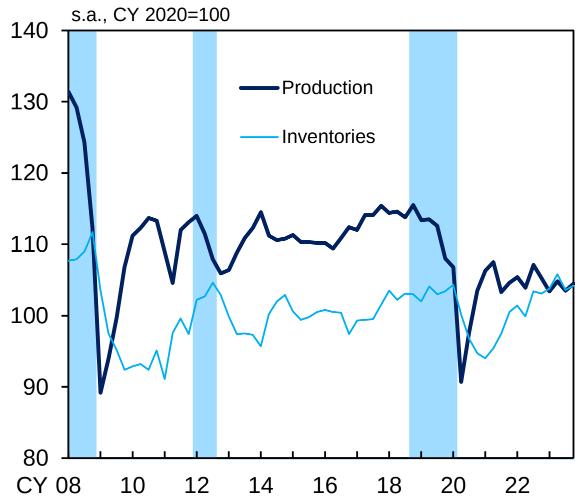
Source: Japan National Tourism Organization (JNTO).
Note: Figures for Europe, the United States, and other regions include seasonal adjustment errors.

Chart 14: Savings-Investment Balance



Source: Bank of Japan.

Chart 15: Industrial Production



Source: Ministry of Economy, Trade and Industry.
Notes: 1. Shaded areas denote recession periods.
2. The production figure for 2023/Q4 is the October-November average. The inventories figure for 2023/Q4 is that for November.

equipment" has also been more or less flat, mainly because production of white goods has picked up while that of lithium-ion batteries used in automobiles has been relatively weak. Production of "electronic parts and devices" has bottomed out with progress in inventory adjustments. Meanwhile, production of "chemicals (excluding medicine)" has been at a low level, mainly reflecting weakness in the Chinese real estate market.

Industrial production is projected to be more or less flat for the time being. Subsequently, it is likely to return to an uptrend, reflecting a pick-up in global demand for IT-related goods and other developments in domestic and external demand.

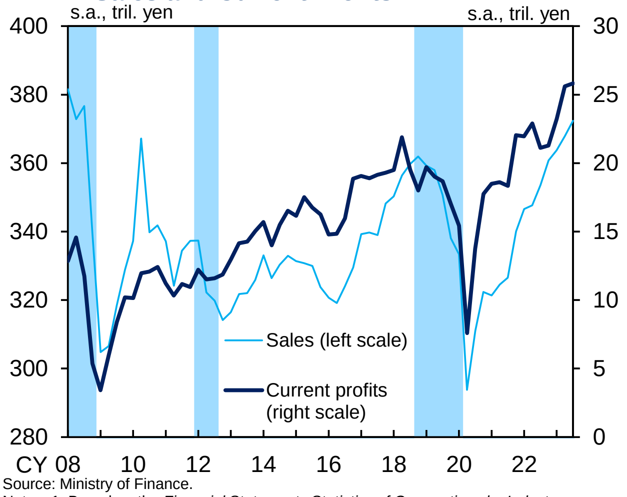
Corporate Profits

Corporate profits have improved. According to the *Financial Statements Statistics of Corporations by Industry, Quarterly* (FSSC), current profits for all industries and enterprises for the July-September quarter of 2023 increased for four consecutive quarters (Chart 16).[10] Operating profits have been pushed up mainly by progress in the pass-through of cost increases to selling prices, a recovery in the flow of people due to that in economic activity, and a recovery in automobile production stemming from a waning of supply-side constraints. 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, mainly due to a

[10] The FSSC figures here exclude "finance and insurance" and pure holding companies.

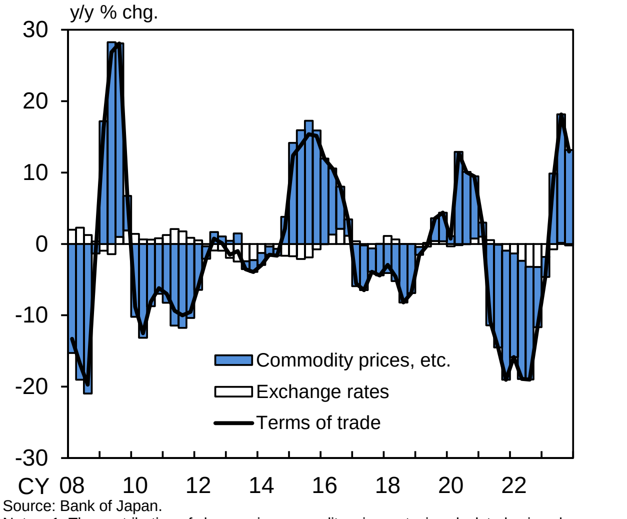
Chart 16: Indicators Related to Corporate Profits

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.

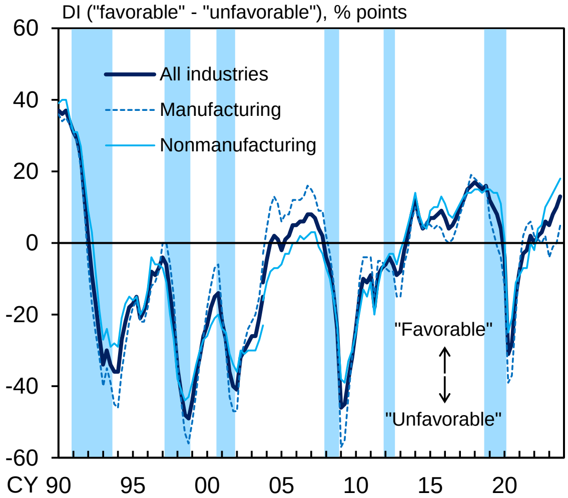
2. Contribution to Changes in Terms of Trade



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

rise in revenue for the transportation equipment industry, which reflects the recovery in automobile production stemming from the waning of supply-side constraints. Current profits of small and medium-sized manufacturers have also risen, mainly because of progress in the pass-through of cost increases to selling prices for food and other items. As for nonmanufacturers, current profits of large firms have increased, mainly due to a rise in revenue for the transportation industry, which reflects the recovery in the flow of people and in travel demand. Those of small and medium-sized nonmanufacturers have also increased, mainly owing to a rise in revenue for the retail trade industry, which reflects the recovery in the flow of people.

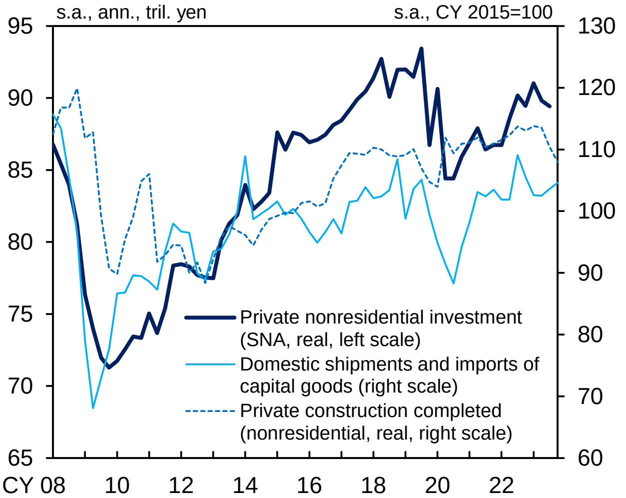
Chart 17: Business Conditions



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. According to the December *Tankan*, the DIs for business conditions have improved for all firm size categories in both manufacturing and nonmanufacturing (Chart 17). By industry, the DI for manufacturing has improved, particularly for small firms, which had seen a delay in improvement. This is mainly due to the progress in the pass-through of cost increases to selling prices and the recovery in automobile production. Looking at industries where the DIs have improved, that for transportation machinery has continued to do so due to a waning of the effects of supply-side constraints, and this has led to improvement in the DIs for relevant industries such as iron and steel, as well as nonferrous metals. In addition, the progress in the pass-through of cost increases to selling prices and a pause in high raw material costs have improved the DIs for basic materials (e.g., "pulp and paper" and "ceramics, stone, and clay") in particular. Turning to industries where the DIs have deteriorated, subdued demand for semiconductor-related investment has contributed to pushing down business conditions for some firms in business-oriented machinery, and the DI for lumber and wood products has deteriorated, reflecting weakness in housing starts. With regard to nonmanufacturing, the DIs have continued to improve for a wide range of industries, particularly those related to private consumption. This is due to the recovery in economic activity and to the progress in the pass-through of cost increases to selling prices. On the other hand, a rise in personnel expenses has contributed to deterioration in the DI for services for businesses.

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/Q4 are October-November averages.
2. Figures for real private construction completed are based on staff calculations using the construction cost deflators.

Regarding the outlook for corporate profits, they are likely to keep improving, 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.

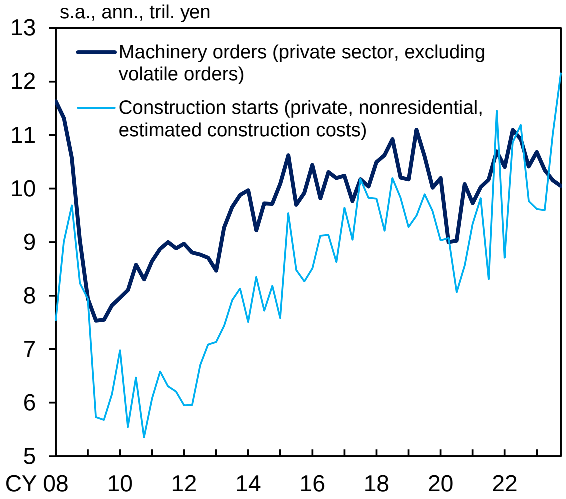
Business Fixed Investment

Business fixed investment has been on a moderate increasing trend (Chart 18). The aggregate supply of capital goods -- a coincident indicator of machinery investment -- has increased moderately, due to firm demand for digital- and labor saving-related capital goods, although investment in semiconductor production equipment is lower than a while ago. Despite progress in, for example, construction of logistics facilities and urban redevelopment projects, private construction completed (nonresidential) --

a coincident indicator of construction investment -- has been relatively weak recently, partly due to dissipation of the effects of large-scale projects, with moves to postpone investment being observed against the background of factors such as high construction material prices.

Machinery orders -- a leading indicator of machinery investment -- have remained at relatively high levels, although they have seen a lowering in their levels compared to a while ago (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" and "information and communication electronics equipment" industries have remained relatively weak and the effects of large-scale projects in some industries 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 mainly due to an uptrend in construction of logistics and other facilities and to establishment of new factories. Looking at the business fixed investment plans in the December *Tankan*, business fixed investment (on the basis close to GDP definition; business fixed investment -- including software and R&D investments but

Chart 19: Leading Indicators of Business Fixed Investment

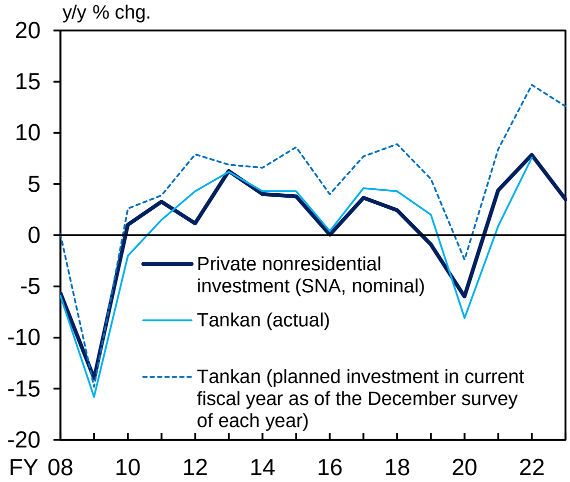


Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Notes: 1. Volatile orders are orders for ships and orders from electric power companies.
2. Figures for 2023/Q4 are October-November averages.

excluding land purchasing expenses -- for all industries and enterprises including financial institutions) shows a year-on-year rate of increase of 12.6 percent for fiscal 2023 (Chart 20). This indicates that, as with the previous survey in September, investment is likely to increase clearly. In sum, although some indicators have been relatively weak, firms have maintained an active stance toward business fixed investment.

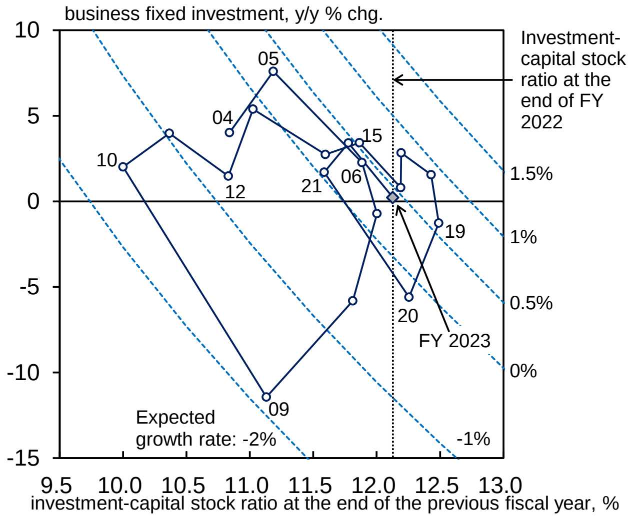
In this situation, business fixed investment is expected to continue on an increasing trend, mainly on the back of improvement in corporate profits and accommodative financial conditions. Toward the end of the projection period, such investment is projected to continue increasing, partly due to a rise 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 supply chains and that also reflects government support.

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 the 2023/Q2-Q3 average.

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 the 2023/Q2-Q3 average.

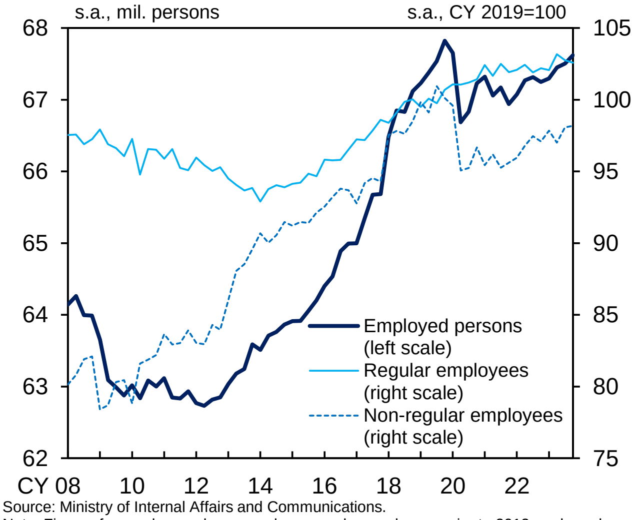
Employment and Income Situation

The employment and income situation has improved moderately.

Regarding the number of employed persons, that of regular employees has been on a moderate uptrend, 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 risen moderately, 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, partly reflecting the normalization of economic activity (Chart 24). Meanwhile, the labor force participation rate has been on a moderate uptrend, particularly for women, when fluctuations are smoothed out (Chart 23).

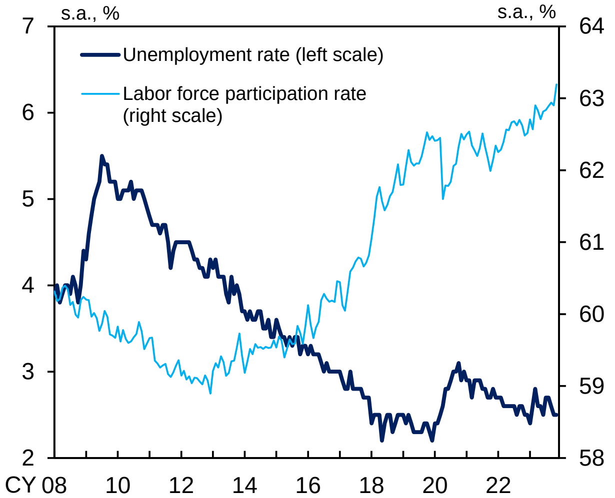
With regard to the outlook for the number of employees, regular employees are likely to increase moderately, mainly in industries with labor shortages, such as medical, healthcare, and welfare services, information and communications, and construction. Non-regular employees, mainly in the face-to-face services industry, are likely to continue increasing along with the recovery in economic activity. However, the pace of increase

Chart 22: Number of Employed Persons



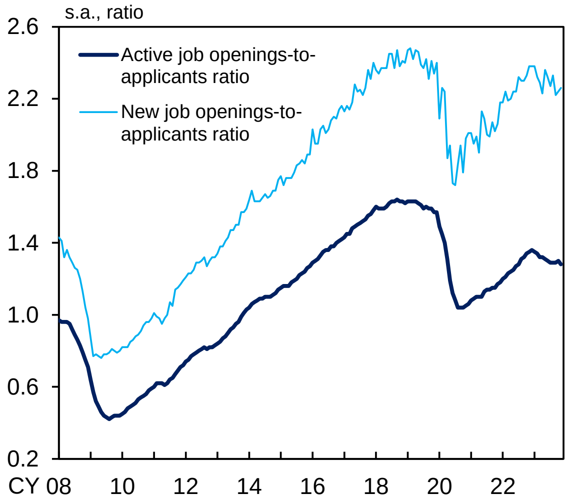
Source: Ministry of Internal Affairs and Communications.
Note: Figures for regular employees and non-regular employees prior to 2013 are based on the "detailed tabulation" in the *Labour Force Survey*. Figures for 2023/Q4 are October-November averages.

Chart 23: Unemployment Rate and Labor Force Participation Rate



Source: Ministry of Internal Affairs and Communications.

Chart 24: Job Openings-to-Applicants Ratio

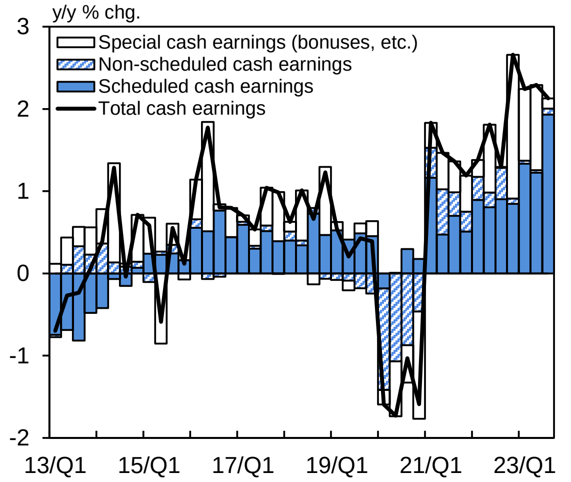


Source: Ministry of Health, Labour and Welfare.

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.

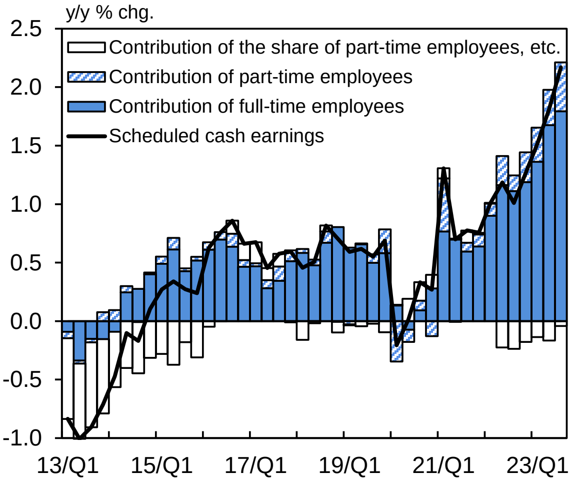
On the wage side, nominal wages per employee have increased moderately, reflecting the recovery in economic activity and the results of last year's annual spring labor-management wage negotiations (Chart 25).[11,12] The year-on-year rate of change in scheduled cash earnings has continued to increase moderately (Chart 26). Looking at the breakdown, the rate for full-time employees has accelerated to around 2 percent -- albeit with fluctuations that are due mainly to changes in working hours -- reflecting the results of last year's annual spring labor-management wage negotiations, which showed high wage growth. The year-on-year rate of increase in hourly scheduled cash earnings for part-time employees has accelerated to the range of 3.5-4.0 percent recently, as labor market conditions have remained tight and minimum wages have been raised. Non-scheduled cash earnings have continued to increase moderately in reflection of the recovery in economic activity. Special cash earnings (bonuses) have also kept rising moderately on the back of improvement in corporate profits.

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.

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

[12] Box 2 examines the current environment surrounding wages and firms' wage-setting behavior.

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 continuing to improve. Taking all of these factors into account, the rate of increase in nominal wages per employee is projected to gradually accelerate.

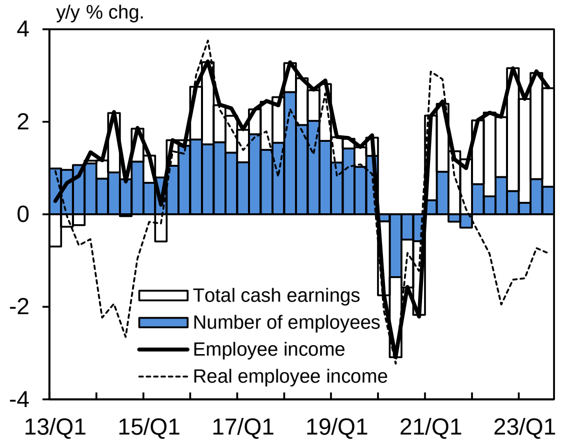
In light of the aforementioned employment and wage conditions, employee income has improved in nominal terms (Chart 27). In real terms, the year-on-year rate of change in employee income has been negative in reflection of price rises, but the rate of decline has remained on a slowing trend due to a combination 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.

Household Spending

Private consumption has continued to increase moderately, 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

Chart 27: Employee Income



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

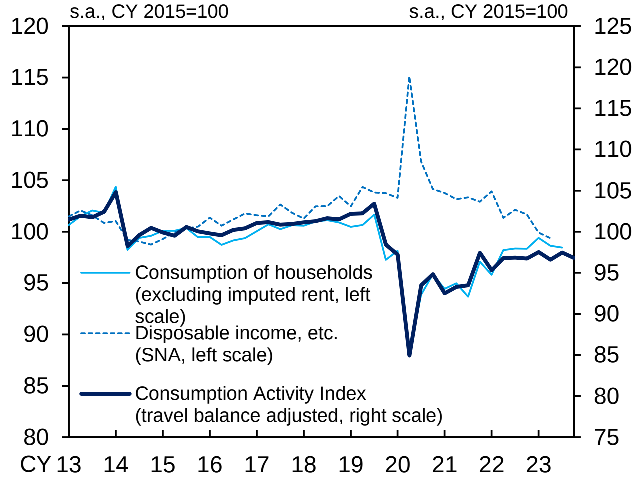
Notes: 1. Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February.
2. Employee income = Total cash earnings (*Monthly Labour Survey*) × Number of employees (*Labour Force Survey*)
3. Figures from 2016/Q1 onward are based on continuing observations following the sample revisions of the *Monthly Labour Survey*.
4. Figures for real employee income are based on staff calculations using the CPI (less imputed rent).

from the viewpoint of gauging Japan's consumption activity in a comprehensive manner -- declined slightly on average for the October-November period of 2023 relative to the July-September quarter (Charts 28 and 29).[13] This is the result of a combination of factors, such as the impact of price rises, dissipation of the positive effects of hot weather seen in the previous quarter, sluggish sales of autumn and winter clothes due to relatively higher temperatures than in normal years, and issues at some production sites. 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, although households' thriftiness that reflects price rises has grown, consumption seems to have continued on a moderate uptrend, partly supported by the improvement in the income situation (Chart 30). There is also a view that demand for dining-out and travel from late December through early January, as well as New Year sales, were firm.

By type, consumption of durable goods has been at a relatively high level (Chart 29). Specifically, the number of new passenger cars sold decreased for November 2023, affected by a production decline at an automaker due to issues at production sites for parts; however, it has been at a high level, with supply-side constraints for semiconductors used in automobiles generally having dissipated. Sales of household electrical appliances have remained weak, albeit with

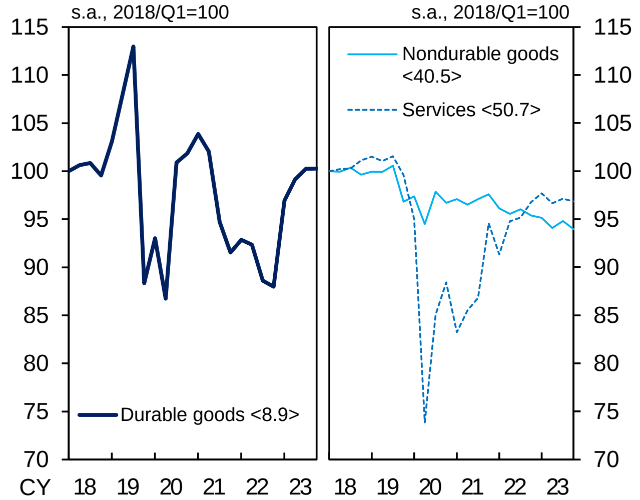
[13] Regarding the CAI, see the Bank's research paper "Revision of the Consumption Activity Index to Capture Recent Changes in Consumption Patterns" released in July 2021.

Chart 28: Real Private Consumption



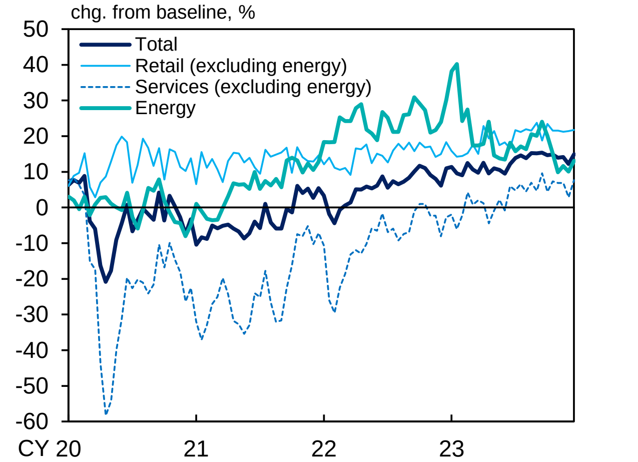
Sources: Bank of Japan; Cabinet Office, etc.
Notes: 1. Figures for the Consumption Activity Index (CAI) are based on staff calculations. The CAI figures (travel balance adjusted) exclude inbound tourism consumption and include outbound tourism consumption. The figure for 2023/Q4 is the October-November average.
2. "Disposable income, etc." consists of disposable income and adjustment for the change in pension entitlements (using annual and quarterly estimates), 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/Q4 are October-November averages.
2. Nondurable goods include goods classified as semi-durable goods in the SNA.

Chart 30: Consumption Developments Based on Credit Card Spending



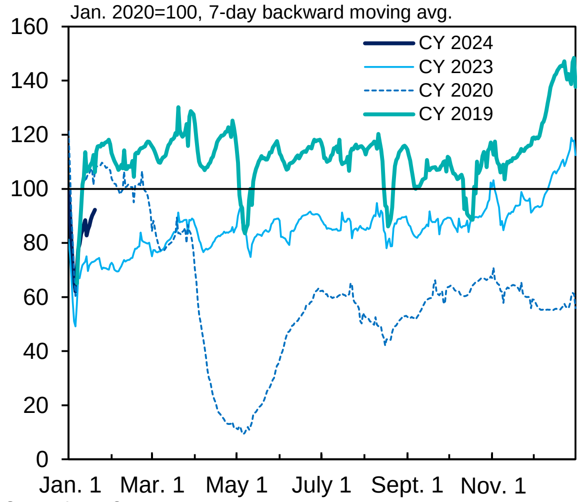
Source: Nowcast Inc./ JCB, Co., Ltd., "JCB Consumption NOW."
Notes: 1. Figures are from the reference series in *JCB Consumption NOW*, which take changes in the number of consumers into account. The baseline is the average for the corresponding half of the month for fiscal 2016 through fiscal 2018.
2. 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.

fluctuations; sales of air conditioners seem to have declined recently due to relatively high temperatures. Turning to nondurable goods, consumption of beverages and food, clothes, and other items has followed a decreasing trend, due to factors such as the impact of high prices, a decline caused by the dissipation of the positive effects of hot weather seen in the previous quarter, and the sluggish sales of autumn and winter clothes.

Services consumption has increased moderately as a trend in reflection of the recovery in the flow of people and the materialization of pent-up demand, although the pace of increase has slowed (Charts 29, 30, and 31). Despite being affected by factors such as price rises, dining-out has also been on a moderate increasing trend. Domestic travel has been at a relatively high level, reflecting a recovery in travel demand. Overseas travel has seen a pause in recovery recently.

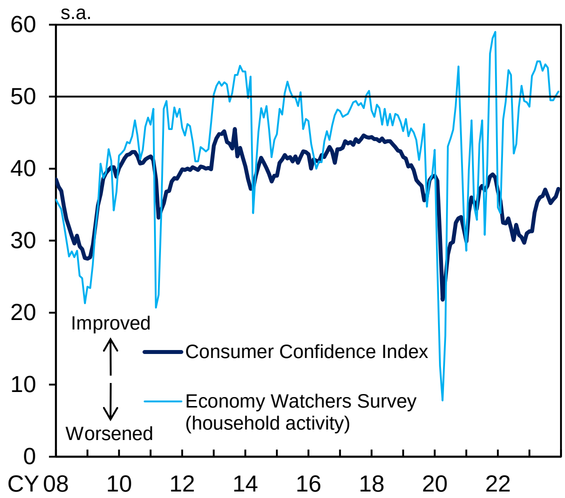
Looking at confidence indicators related to private consumption, the Consumer Confidence Index has improved again recently, particularly in terms of consumer perception of "overall livelihood," mainly because the pace of price rises has moderated compared to a while ago (Chart 32). The *Economy Watchers Survey* -- which asks firms for their views on the direction of the economy -- shows that the current economic conditions DI (household activity-related) has been somewhat above the threshold value of 50, mainly reflecting the materialization of pent-up demand and a rise in inbound tourism demand, although concern over the impact of price rises has contributed to pushing down the DI.

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 January 14-20.

Chart 32: Confidence Indicators Related to Private Consumption

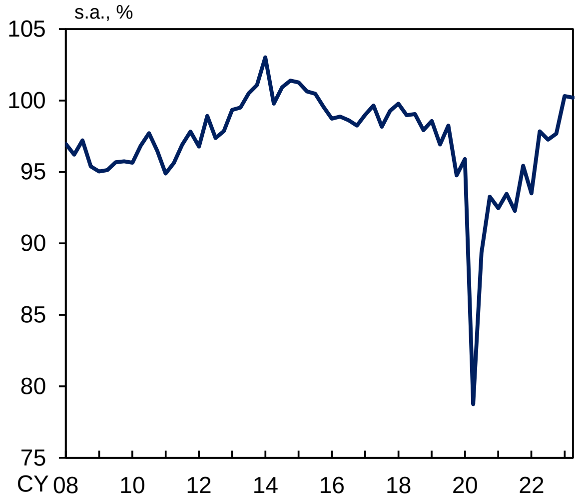


Source: Cabinet Office.
Note: Figures for the *Economy Watchers Survey* are those for the current economic conditions DI.

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 (1) those to reduce the household burden of higher gasoline prices, electricity charges, and gas charges, (2) benefit payments to low-income households, and (3) cuts in income tax and inhabitant tax. From the middle of the projection period, private consumption is expected to continue increasing moderately as employee income keeps improving. The propensity to consume is likely to first remain at 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). Thereafter, it is expected to gradually return to the average level seen before the pandemic.

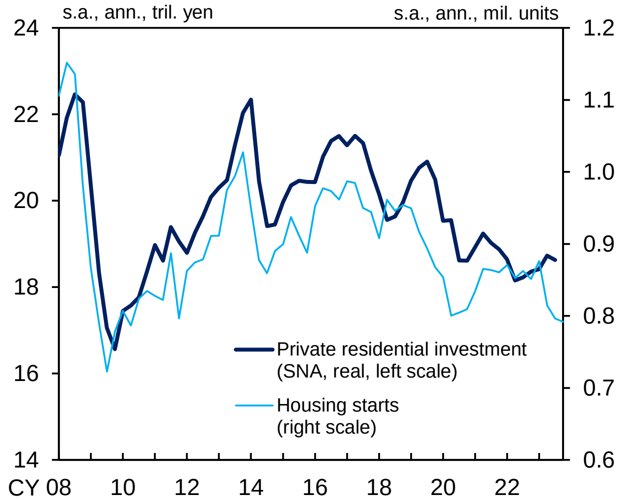
Housing investment has been relatively weak (Chart 34). The number of housing starts -- a leading indicator of housing investment -- has followed a downtrend that reflects a rise in housing prices. Housing investment is likely to follow a moderate declining trend in reflection of the rise in housing prices and demographic developments, although accommodative financial conditions are expected to provide support.

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 (using annual and quarterly estimates).

Chart 34: Housing Investment



Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Note: The figure for 2023/Q4 is the October-November average.

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 at around 0 percent (Chart 35). The year-on-year rate of increase in the services producer price index (SPPI, excluding international transportation) has remained on an accelerating trend, mainly on the back of the recovery in economic activity and a rise in personnel expenses.

Chart 35: Inflation Indicators

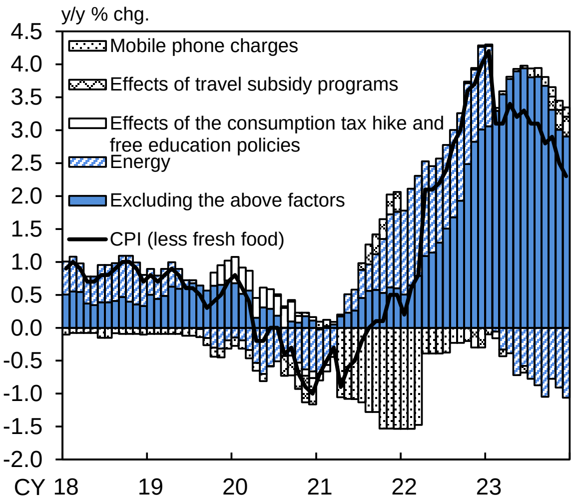
y/y % chg.

	23/Q1	23/Q2	23/Q3	23/Q4
Consumer Price Index (CPI)				
Less fresh food	3.5	3.3	3.0	2.5
Excluding temporary factors	3.6	3.3	2.9	2.1
Less fresh food and energy	3.5	4.2	4.3	3.8
Excluding temporary factors	3.6	4.3	4.2	3.4
Producer Price Index (q/q % chg.)	0.5	-0.2	-0.1	0.2
Services Producer Price Index	1.7	2.1	2.3	2.4
GDP Deflator	2.3	3.8	5.3	
Domestic demand deflator	3.2	2.7	2.6	

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.
3. The figure for the SPPI for 2023/Q4 is the October-November average.

The negative contribution of energy prices to the year-on-year rate of increase in the CPI (all items less fresh food) has been relatively large, partly due to the government's economic measures (Chart 36). That said, the rate of increase in the CPI has been in the range of 2.0-2.5 percent recently, mainly on the back of the fact that, despite waning, the effects of the pass-through to consumer prices of cost increases led by the past rise in import prices have remained, and services prices have increased moderately.

Chart 36: CPI (Less Fresh Food)



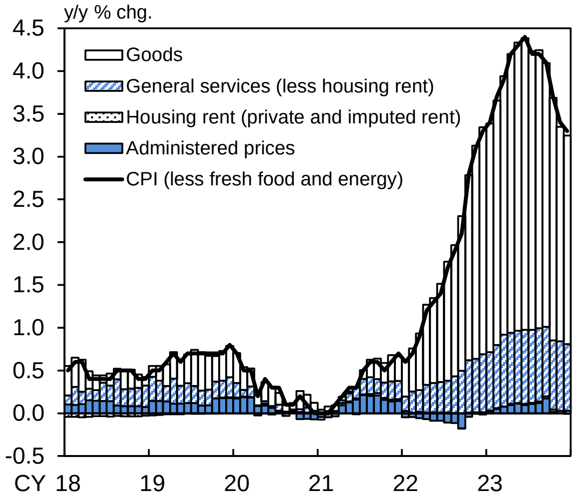
Source: Ministry of Internal Affairs and Communications.
Notes: 1. Figures for energy consist of those for petroleum products, electricity, and gas, manufactured & piped.
2. Figures for the "effects of the consumption tax hike and free education policies" from April 2020 onward are staff estimates and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

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 steadily, mainly because the impact of the previous year's price hikes has dissipated

(Chart 37).[14] Specifically, as for goods, the rates of increase in prices of a wide range of items have decelerated as the impact of the previous year's price hikes has dissipated. The rate of change in overall general services prices has been more or less flat. This is because, while the rate of increase for hotel charges has remained on an accelerating trend, the rates for items such as dining-out and housework-related services (e.g., services related to housing repairs and maintenance) have decelerated as the impact of the previous year's price hikes has dissipated. Although hikes in railway fares and other administered prices have been observed, the year-on-year rate of change in overall administered prices has been flat recently, mainly due to dissipation of the effects of the previous year's hikes in fire and earthquake insurance premiums.

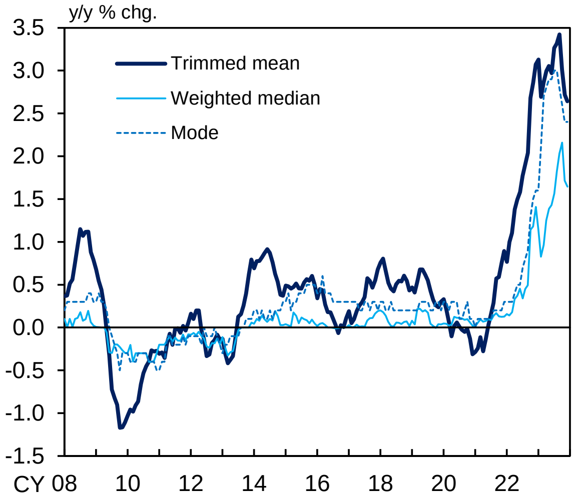
The indicators for capturing the underlying trend in the CPI have exhibited the following developments (Chart 38).[15,16] The trimmed mean

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.

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.

[14] 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).

[15] 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.

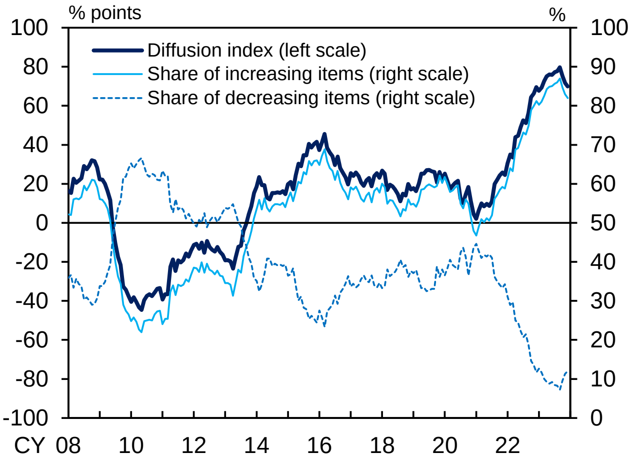
of the year-on-year rate of change in the CPI has been at around 2.5 percent as the impact of the previous year's price hikes has dissipated. The mode and the weighted median, which are less susceptible to developments in certain CPI items, have been at around 2.5 percent and around 1.5 percent, respectively. 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 decreased slightly (Chart 39).

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 in the range of 5.0-5.5 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 been negative, mainly reflecting a waning of the effects of past high crude oil prices.

Environment Surrounding Prices

In the outlook for prices, the main factors that determine inflation rates are assessed as follows.

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.

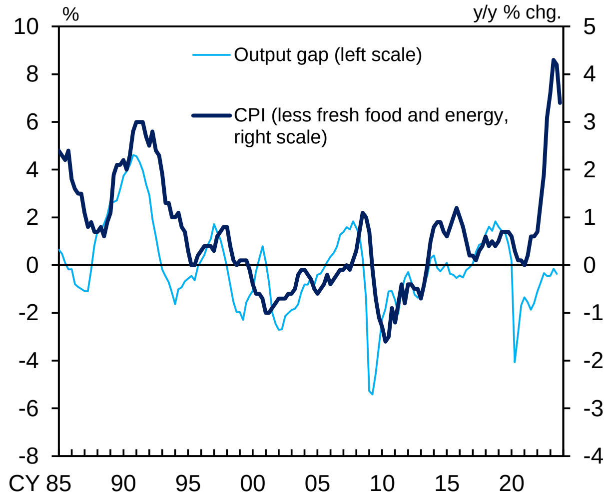
[16] In this report, the mode is defined as the inflation rate with the highest density in the distribution that is estimated parametrically by fitting a normal inverse Gaussian distribution to the observed price change distribution in each period. It should be noted that, with dispersions of the observed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

First, the output gap is projected to turn positive and continue to expand moderately toward the end of the projection period, albeit at a gradually slowing pace (Charts 2 and 40).

Second, medium- to long-term inflation expectations have risen moderately (Chart 41). The December 2023 *Tankan* shows that the output prices DI is lower than a while ago but has remained at a high level (Chart 42). It also shows that figures for firms' inflation outlook for general prices have declined somewhat for the short term but have remained at high levels for the medium to long term. 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, firms' behavior has shifted more toward raising wages and prices. Regarding the outlook, inflation expectations are expected to rise moderately toward the end of the projection period, with continued improvement in the output gap and changes in firms' wage- and price-setting behavior and in labor-management wage negotiations. Under these circumstances, a virtuous cycle between wages and prices is projected to intensify through achievement of wage increases that reflect price rises and through a pass-through of wage increases to selling prices.

Third, the year-on-year rate of change in the import price index has remained negative, mainly reflecting the fact that prices of many commodities, particularly crude oil, are relatively lower than a while ago (Charts 43 and 44).

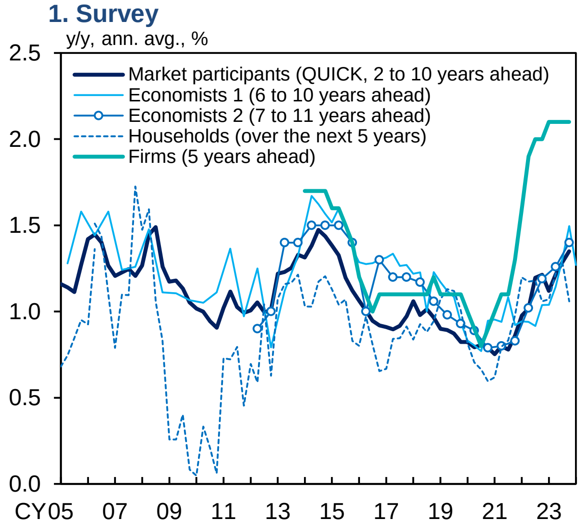
Chart 40: Inflation Rate and Output Gap



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.

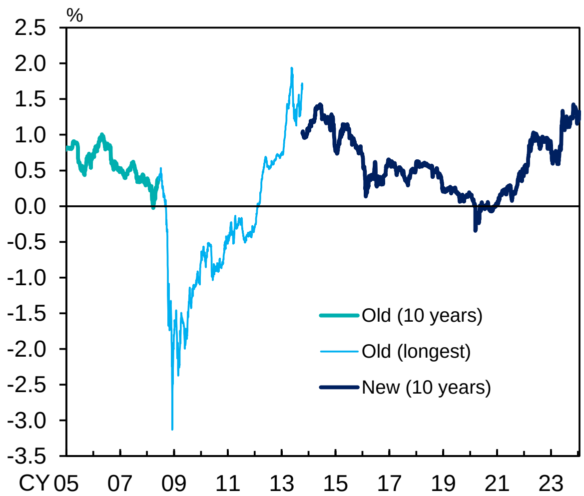
Chart 41: Inflation Expectations

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

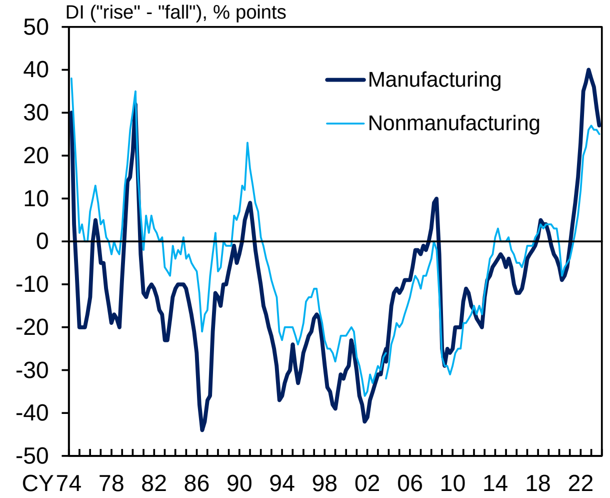


Source: Bloomberg.
Note: The BEI (break-even inflation) rate is the yield spread between fixed-rate coupon-bearing JGBs and inflation-indexed JGBs. Inflation-indexed JGBs issued since October 2013 are designated as "new," while the rest are designated as "old." Figures for "old (longest)" are calculated using yield data for issue No. 16 of inflation-indexed JGBs, which matured in June 2018.

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 increased slightly recently, reflecting the rise in crude oil prices last summer and the past depreciation of the yen (Chart 45). That for stage 2 of the ID has risen somewhat recently. On the other hand, 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 wane.[17]

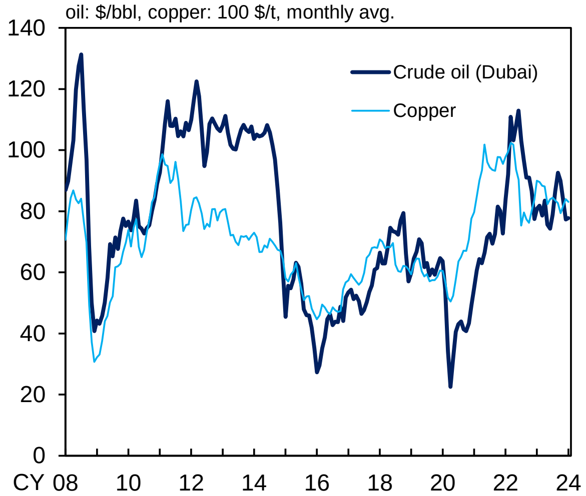
Meanwhile, the year-on-year rate of change in energy prices (e.g., gasoline prices and electricity charges) has remained negative. That in prices of petroleum products has been slightly positive, since gasoline subsidies, which have made a negative contribution to these prices, have been reduced compared to the previous year.[18] On the other hand, the rates of change in electricity and

Chart 42: Output Prices



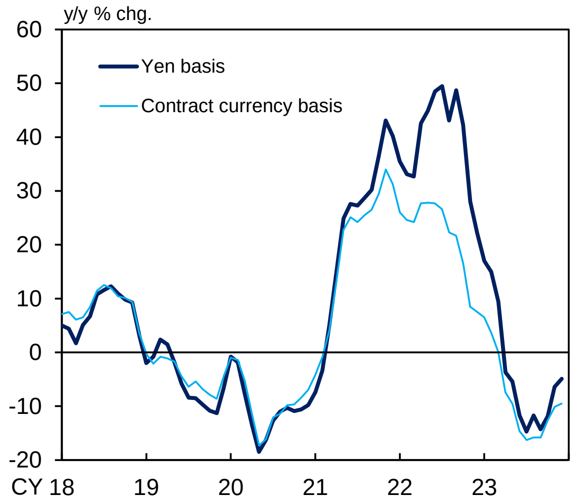
Source: Bank of Japan.
Note: Based on the *Tankan*. All enterprises. There is a discontinuity in the data for December 2003 due to a change in the survey framework.

Chart 43: International Commodity Prices



Sources: Nikkei Inc.; Bloomberg.

Chart 44: Import Price Index



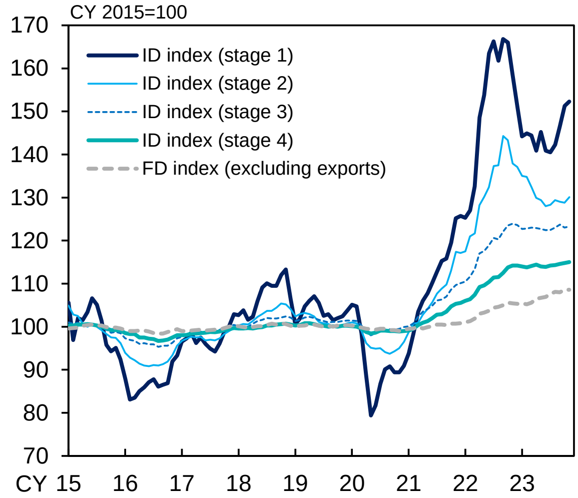
Source: Bank of Japan.

[17] Regarding recent developments surrounding the CPI, Box 3 assesses the current situation of (1) the upward pressure of costs led by the past rise in import prices and (2) moves to reflect wages in selling prices.

[18] 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 (the months refer to the timing at which electricity charges are calculated). Regarding manufactured and piped gas charges, roughly similar measures to reduce the household burden have been introduced.

gas charges have been negative in reflection of 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 remain negative in the short run. However, from February 2024 toward the beginning of fiscal 2024, the rate of decline is expected to decelerate to around 0 percent because it is projected that the effects of pushing down the rate of change from the government's measures introduced last year to reduce the household burden of higher electricity and gas charges will dissipate. Subsequently, assuming that the government's measures to reduce the household burden of higher energy prices will be phased out, 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's measures pushing down such prices of the previous year.[19] After the impact of the rebound caused by the phasing out of the government's measures dissipates, the rate is projected to be slightly negative in light of developments in the futures market.

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



Source: Bank of Japan.

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

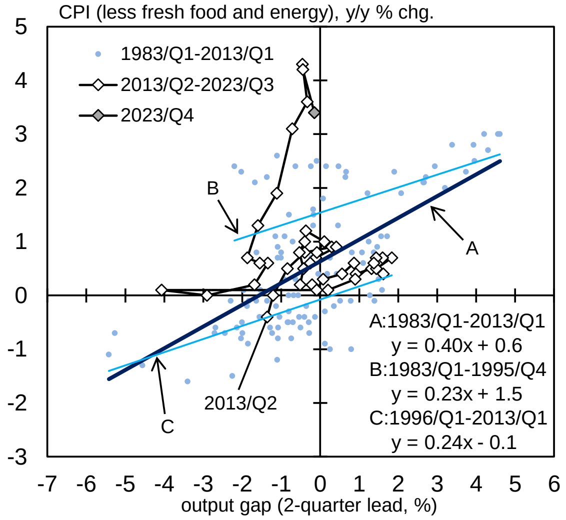
[19] As part of the economic measures decided by the Cabinet in November 2023, the government decided to continue with gasoline subsidies through April 2024. It also decided that measures to reduce the burden of higher electricity and gas charges will remain effective for charges on these types of energy consumed through May 2024 (the charges will be calculated in June).

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 factors such as the effects, albeit waning, of the pass-through to consumer prices of cost increases led by the past rise in import prices and a waning of the effects of the government's economic measures pushing down CPI inflation of the previous year. As for fiscal 2025, the rate of increase is projected to decelerate owing to dissipation of these factors.

It should be noted that there are extremely high uncertainties surrounding this outlook. Specifically, for the time being, there are high uncertainties over the pace at which the upward pressure on the CPI stemming from the rise in import prices will wane. Moreover, it is extremely unclear whether underlying inflation will increase with a stronger linkage between wages and prices.

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.

III. Financial Developments in Japan

Financial Conditions

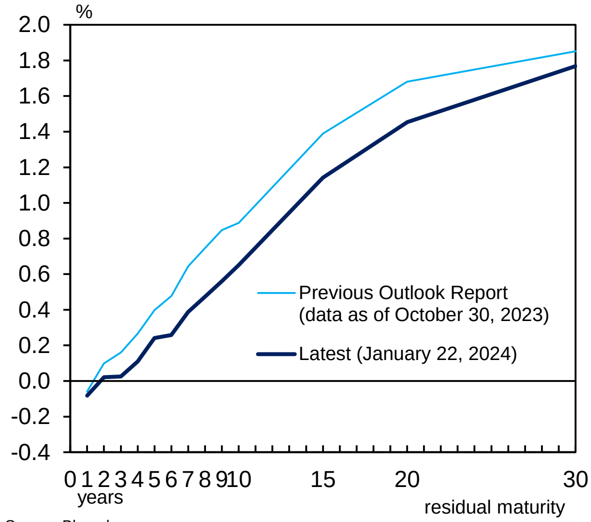
Financial conditions have been accommodative.

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 increase flexibility at the October 2023 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 remained at extremely low levels, with a pause in the rise in those for long-term loans. Issuance rates for CP have been at extremely low levels. The rise in issuance rates for corporate bonds has paused, reflecting developments in their base rate.

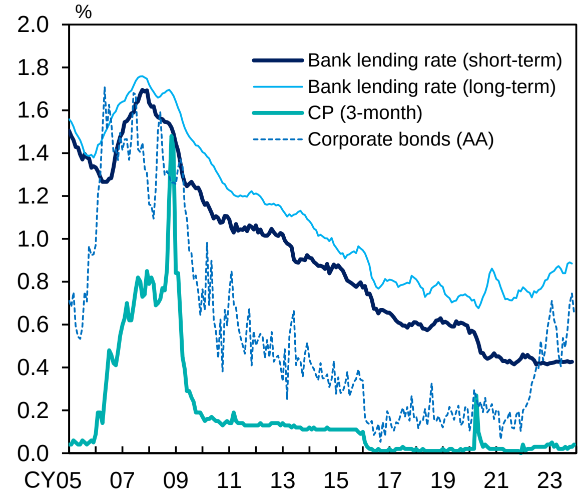
The DI in the *Tankan* for financial institutions' lending attitudes as perceived by firms suggests that such attitudes have remained accommodative on the whole (Chart 49). That for issuance conditions for CP has continued to show net "easy" conditions. As suggested by the latter, issuance conditions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

Chart 47: Yield Curves



Source: Bloomberg.

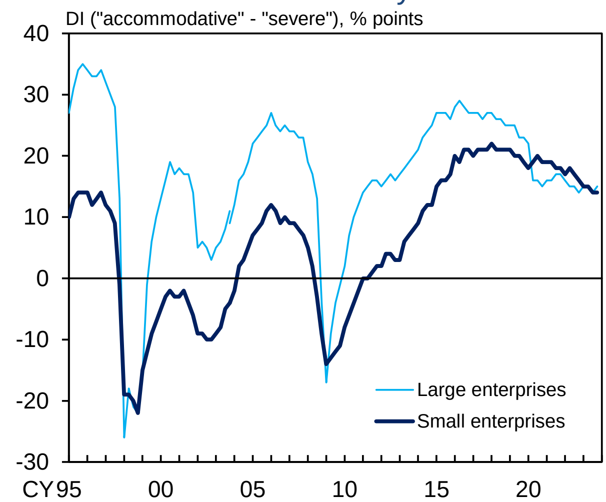
Chart 48: Bank Lending Rates and Issuance Yields for CP and Corporate Bonds



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.

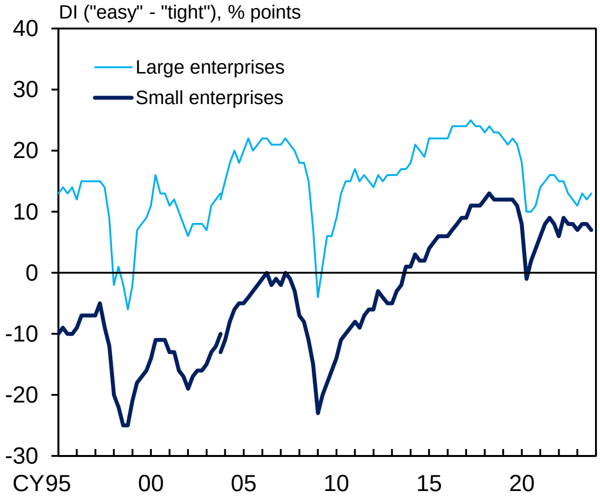
Note: Based on the *Tankan.* All industries. There is a discontinuity in the data for December 2003 due to a change in the survey framework.

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).

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 at around 3.5 percent (Chart 51). That in the aggregate amount outstanding of CP and corporate bonds has been at around 1.5 percent.

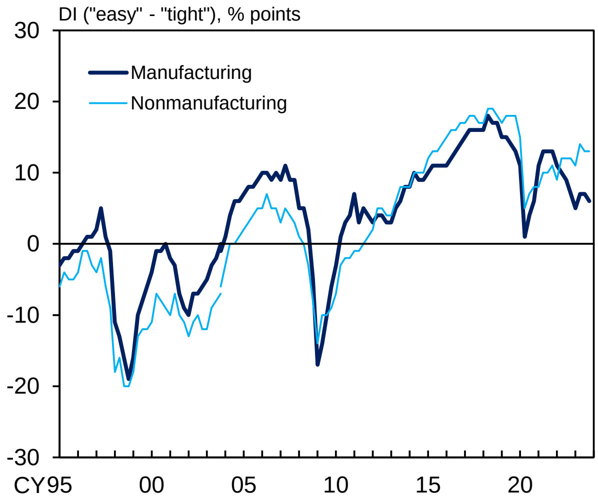
Chart 50: Firms' Financial Positions

1. By Firm Size



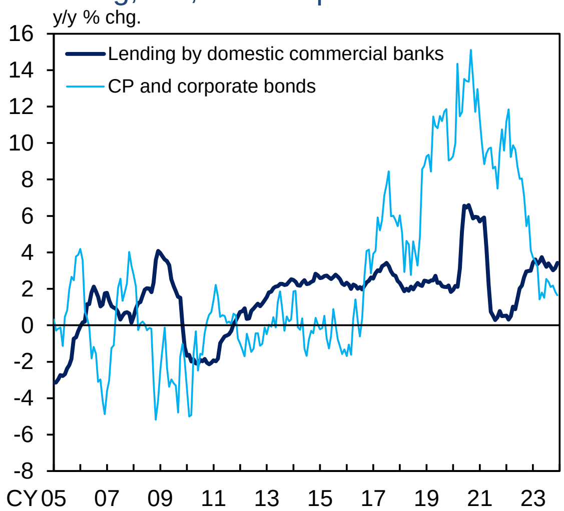
Source: Bank of Japan.
Note: Based on the *Tankan.* All industries. There is a discontinuity in the data for December 2003 due to a change in the survey framework.

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.

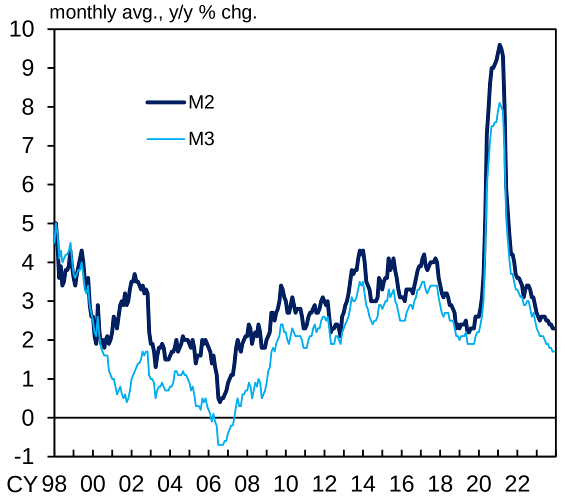
Chart 51: Amounts Outstanding of Bank Lending, CP, and Corporate Bonds



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.

The year-on-year rate of change in the monetary base has been at around 8 percent. The amount outstanding of the monetary base was 673 trillion yen, of which the ratio to nominal GDP was 113 percent.[20] The year-on-year rate of change in the money stock (M2) has been in the range of 2.0-2.5 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.

[20] The amount outstanding of the monetary base is as of end-December 2023. Nominal GDP is the figure for the July-September quarter of 2023.

Developments in Financial Markets

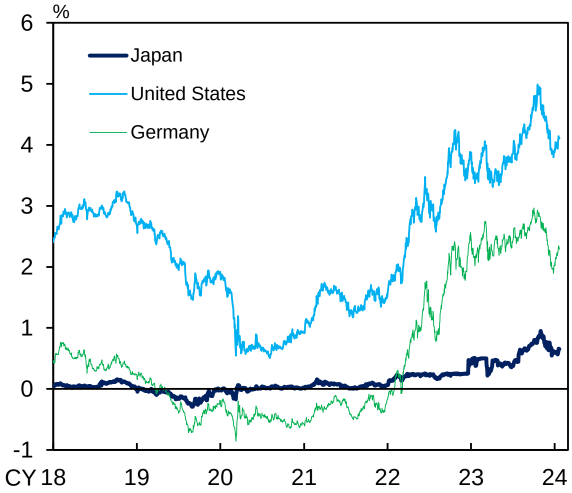
In global financial markets, attention has continued to be drawn to uncertainties over the outlook for the global economy. However, market sentiment has been at an improved level compared to a while ago, reflecting diminished concern over prolonged monetary tightening in the United States and Europe.

Yields on 10-year government bonds in the United States and Europe had declined significantly through December 2023, with diminished concern over issues such as prolonged monetary tightening (Chart 53). Subsequently, the yields have risen somewhat in reflection of solid economic indicators. Those in Japan have declined.

Premiums for U.S. dollar funding through the dollar/yen foreign exchange swap market have declined since December, due to dissipation of the effects of pushing up the premiums from the seasonal tightening of supply and demand conditions for this funding in view of the year-end (Chart 54).

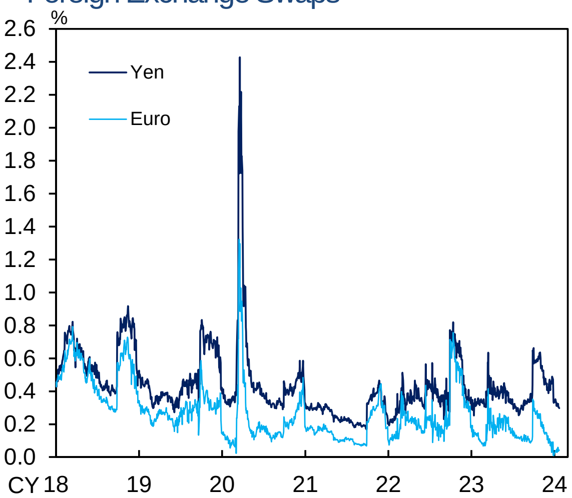
Stock prices in the United States and Europe have been more or less flat, after increasing substantially in reflection of the significant decreases in long-term interest rates (Chart 55). Those in Japan have risen considerably, mainly due to increases in U.S. and European stock prices and to expectations of an inflow of funds associated with the introduction of the new Nippon Individual Savings Account (NISA) program. Stock prices in emerging economies

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



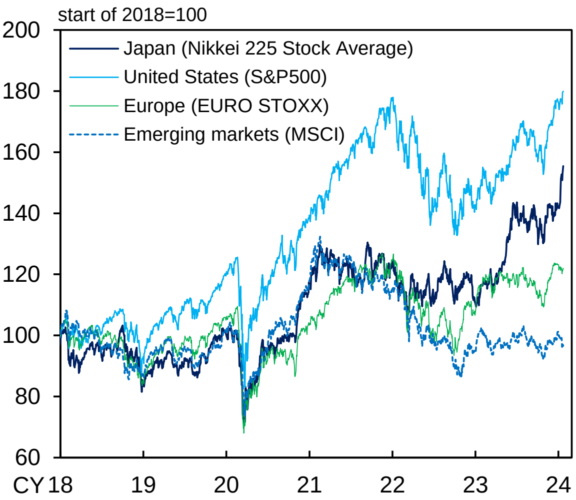
Source: Bloomberg.

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



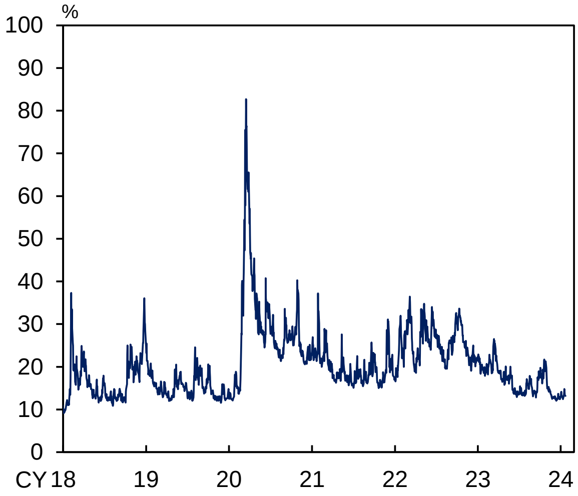
Source: Bloomberg.
Note: Figures for emerging markets are those for the MSCI Emerging Markets Index (local currency).

have slightly declined after seeing a rise, reflecting developments in U.S. and European interest rates.

Prices of Japan real estate investment trusts (J-REITs) have been more or less flat (Chart 57).

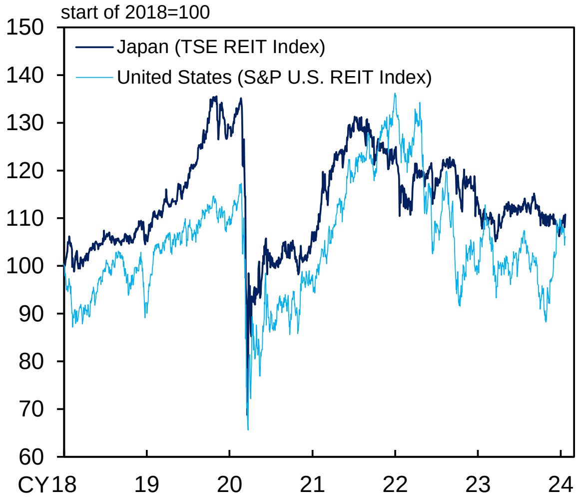
In foreign exchange markets, mainly because of developments in the yield differential between Japan and the United States, the yen had appreciated against the U.S. dollar but recently has depreciated (Chart 58). The yen had also appreciated against the euro but recently has depreciated.

Chart 56: Stock Market Volatility (VIX)



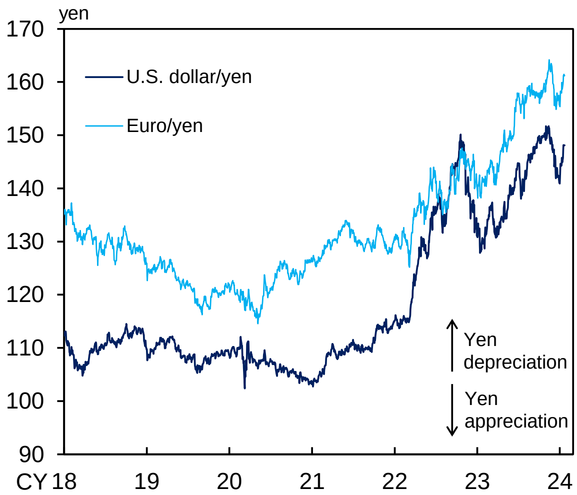
Source: Bloomberg.

Chart 57: Selected REIT Indices



Source: Bloomberg.

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



Source: Bloomberg.

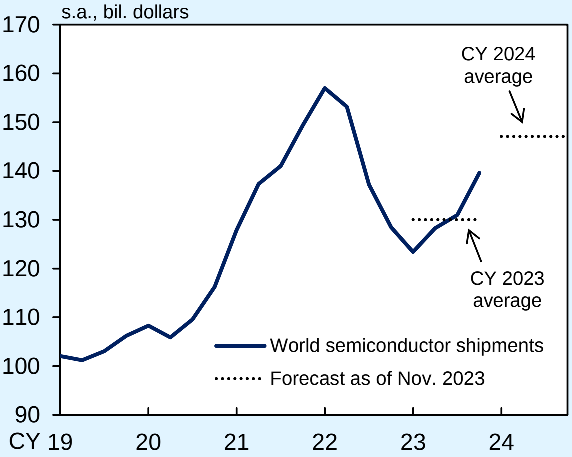
(Box 1) The Recent Pick-Up in Global IT-Related Demand and Its Background

Global IT-related demand continued to be weak from the second half of 2022, after increasing significantly due to factors such as restrictions on going outside and an expansion of remote work during the COVID-19 pandemic. However, it has picked up recently, as seen in semiconductor shipments turning to an increase (Chart B1-1).

This seems to be largely attributable to a fast-paced expansion of generative artificial intelligence (AI) services. Along with advances in the use of these services, there have been moves to actively invest in AI servers, and demand for high-performance semiconductors and other components installed in these servers has been growing rapidly. In fact, revenue of major semiconductor firms with strong AI links has recently increased markedly (Chart B1-2). Moreover, recent developments in IT-related goods production in Asia show that the NIEs, where many firms are engaged in manufacturing AI-related high-performance semiconductors, have seen a clear increase in production of IT-related goods, unlike the ASEAN countries, where firms tend to be engaged in the assembly and testing processes in manufacturing semiconductors that are more general-purpose (Chart B1-3).

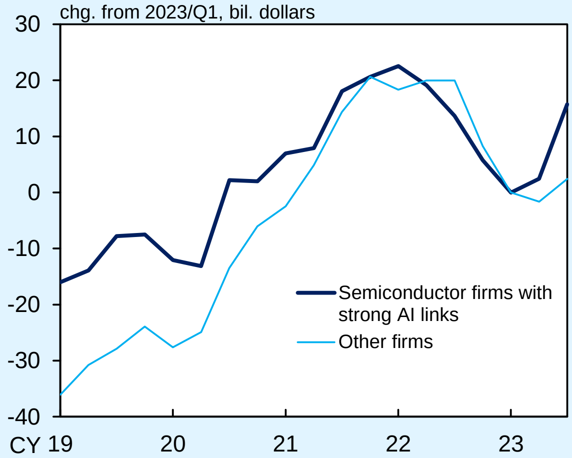
Meanwhile, inventory adjustments for other IT-related products have progressed on the whole, especially among assemblers of personal computers (PCs) and smartphones, although the adjustments have been protracted in some

Chart B1-1: World Semiconductor Demand (WSTS)



Notes: 1. Based on staff calculations using World Semiconductor Trade Statistics (WSTS) data.
2. The figure for 2023/Q4 is the October-November average.

Chart B1-2: Revenue of Major Semiconductor Firms



Source: S&P Global Market Intelligence.
Note: Semiconductor firms with strong AI links here consist of 4 major firms engaged in the design and manufacturing of semiconductors for AI servers, demand for which has been growing rapidly in recent years, while other firms are 46 other major semiconductor firms.

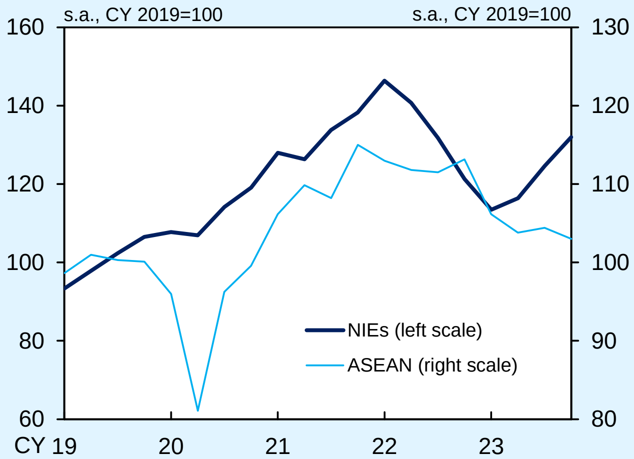
sectors (Chart B1-4). Under these circumstances, even when excluding firms with strong AI links, revenue of major semiconductor firms has bottomed out recently (Chart B1-2).

Regarding the outlook, participants in the semiconductor industry and relevant parties have expressed the view that global IT-related demand is likely to continue picking up, driven by the expansion of generative AI services (Chart B1-1). However, the following two points warrant attention.

First, the whole process of manufacturing AI-related high-performance semiconductors tends to be completed within a limited number of countries and regions, mainly for the purpose of preventing technology leaks and ensuring quality. Therefore, there are high uncertainties over whether the recovery in IT-related demand on the back of the expansion of generative AI services will widely spread across countries and regions.

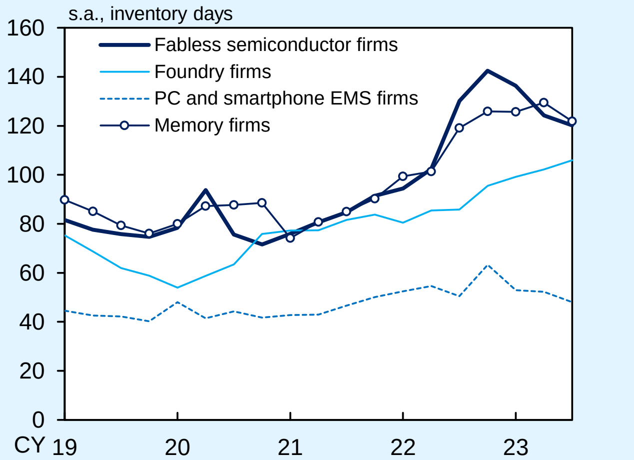
The second point concerns demand for products such as PCs and smartphones. The pace of recovery in this demand is expected to gradually increase due to factors including replacement demand for products purchased during the pandemic and the introduction of new products. That said, a full-fledged recovery in demand for products such as PCs and smartphones could take time owing to diminishing remote work-related demand and to a prolonged replacement cycle.

Chart B1-3: IT-Related Production in Asia



Sources: CEIC; IMF.
Notes: 1. Figures for 2023/Q4 are October-November averages.
2. Figures are the weighted averages of IT-related production indices for countries and regions in Asia using their shares in global GDP as weights. Figures for the NIEs are those for South Korea, Taiwan, and Singapore. Figures for ASEAN are those for Thailand, Malaysia, and the Philippines.

Chart B1-4: Inventories of IT-Related Firms



Source: S&P Global Market Intelligence.
Notes: 1. Fabless semiconductor firms here consist of 12 major firms engaged in the design and selling of logic ICs, foundry firms of 9 major foundries, PC and smartphone EMS (electronics manufacturing services) firms of 9 major EMS providers, and memory firms of 6 major firms engaged in memory production.
2. Inventory days are calculated by dividing the total end-of-period inventory by the total cost of goods sold, multiplied by 365.

It is necessary to closely monitor future developments in global IT-related demand, including developments in individual countries and regions, those in different final products, and how these developments will affect Japan's economy.

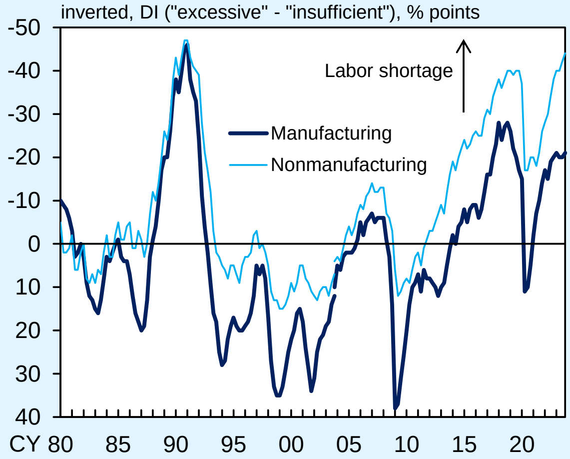
(Box 2) Current Environment Surrounding Wages and Firms' Wage-Setting Behavior

Looking at the current environment surrounding wages, labor market conditions have tightened further and corporate profits have improved and registered a historical high.

First, labor market conditions have tightened more relative to the past as the Japanese economy has continued to recover moderately. The employment conditions DI in the *Tankan* shows that an increasing number of firms has faced labor shortage, especially in nonmanufacturing, for which the DI has risen to a higher level than in the pre-pandemic period (Chart B2-1). In this situation, labor mobility seems to have been increasing gradually, as seen in, for example, the job markets rapidly growing for full-time workers looking for their next job. As a result, wages are highly likely to remain under upward pressure for the time being.[21] This outlook is underpinned, for example, by the fact that labor supply is widely expected to be constrained mainly by the aging population in the long run.

Second, corporate profits have improved due to progress in the pass-through of cost increases to output prices and the depreciation of the yen, in addition to a recovery in economic activity. According to the *Financial Statements Statistics of Corporations by Industry, Quarterly*, current profits based on all industries and enterprises have risen

Chart B2-1: Employment Conditions DI

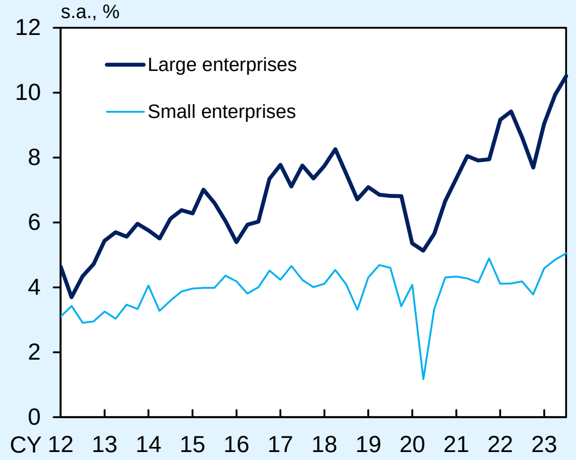


Source: Bank of Japan.
Note: Based on the *Tankan*. All enterprises. There is a discontinuity in the data for December 2003 due to a change in the survey framework.

[21] See Box 2 of the January 2023 Outlook Report for discussion on the outlook for labor market conditions.

in four consecutive quarters, reaching the highest level since the April-June quarter of 1985, from when comparable data are available (Charts 16 and B2-2). In this situation, labor share has been declining recently (Chart B2-3).[22] As for the outlook, corporate profits are likely to continue improving as the pass-through of past high raw material costs to output prices will progress for the time being, and thereafter domestic and external demand will increase moderately.

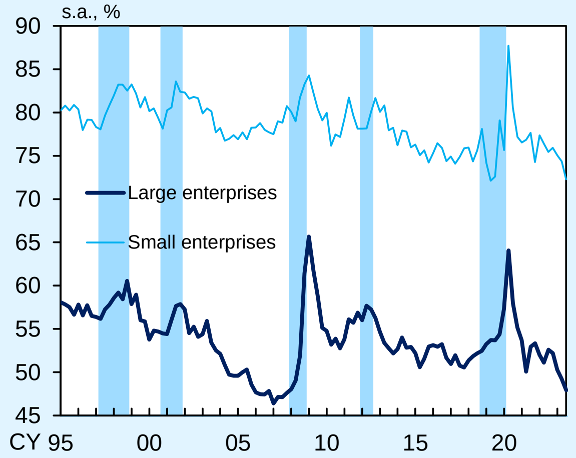
Chart B2-2: Ratio of Current Profits to Sales



Source: Ministry of Finance.
Note: Based on the *Financial Statements Statistics of Corporations by Industry, Quarterly*. Large enterprises are enterprises with a capitalization of 1 billion yen or more, while small enterprises are enterprises with a capitalization of 10 million yen or more but less than 100 million yen. Excluding "finance and insurance" and pure holding companies.

The extent of improvement in corporate profits varies depending on factors such as the firm size and industry. Consequently, there is a possibility, for example, that it will not be easy for firms with a low level of corporate profits and a high level of labor share to increase distribution to employees through wage increases. That being said, analyzing matched microdata for enterprises that responded to both the survey for the *Financial Statements Statistics of Corporations by Industry, Quarterly* and the *Tankan* survey shows that, in an environment where the perception of labor shortage is accelerating and an improvement in profits through rises in output prices is seen, firms tend to carry out relatively high wage increases, even if they have a higher labor share (Chart B2-4).[23] Going forward, corporate profits are expected to increase further and firms' wage-setting behavior is expected to change as labor market conditions continue to tighten and firms' active price-setting behavior takes hold.

Chart B2-3: Labor Share



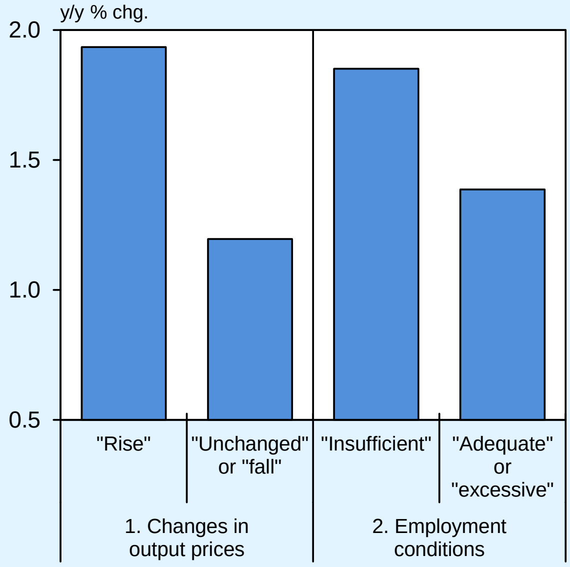
Source: Ministry of Finance.
Notes: 1. Based on the *Financial Statements Statistics of Corporations by Industry, Quarterly*. Excluding "finance and insurance."
2. Figures from 2009/Q2 onward exclude pure holding companies.
3. Shaded areas denote recession periods.

[22] Labor share generally moves in a countercyclical manner (in the opposite direction) to economic fluctuations, as wages, which is the numerator, tend to fluctuate less relative to the added value, which is the denominator.

[23] See Box 1 of the October 2023 Outlook Report for details of the annual spring labor-management wage negotiations in 2023.

In view of the annual spring labor-management wage negotiations in 2024, the Japanese Trade Union Confederation (Rengo) and some industrial unions have stated that they aim to achieve a larger increase in base pay than in 2023.[24] Although a majority of firms have not determined their stance toward this year's wage negotiations at this point, some firms, mainly among large enterprises, have already announced larger base pay increases than in 2023. The course of the wage negotiations warrants attention as labor market conditions have continued to tighten and corporate profits have been improving.

Chart B2-4: Wage Increases at Enterprises with a High Labor Share



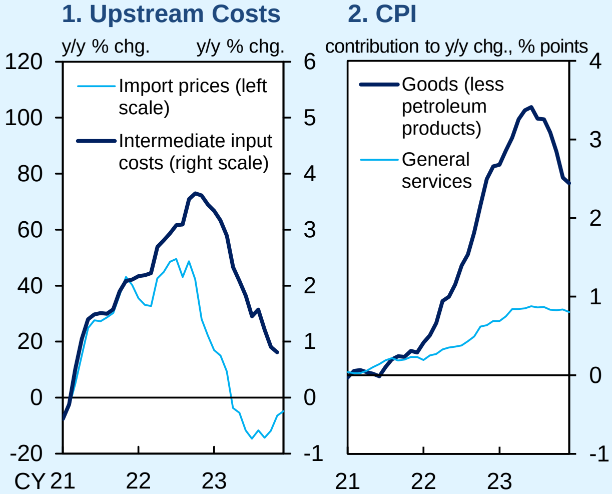
Sources: Ministry of Finance; Bank of Japan.
Note: Wage increases here are the year-on-year percentage changes in labor costs per employee in 2023/Q2. Figures are the medians of wage increases at enterprises with a high labor share and are calculated by matching microdata for enterprises that responded to both the survey for the *Financial Statements Statistics of Corporations by Industry, Quarterly* (wage increases) and the *Tankan* survey (the output prices DI and the employment conditions DI). Enterprises with a high labor share are enterprises whose labor share falls into the top 50 percent in their size group and industry.

[24] The Rengo has set the following wage increase targets for the annual spring labor-management wage negotiations in 2024: more than 3 percent for base pay and more than 5 percent for wages including seniority- and performance-related wages (for the spring 2023 wage negotiations, the targets were respectively around 3 percent and around 5 percent).

(Box 3) Recent Developments Surrounding the CPI: Upward Pressure of Costs Led by a Rise in Import Prices and Current Assessment of the Linkage between Wages and Prices

The year-on-year rate of increase in the CPI (all items less fresh food and energy) has decelerated recently (Chart 37). Looking at the environment surrounding the CPI, the year-on-year rate of change in import prices has remained negative as international commodity prices have been at lower levels than a while ago (Chart B3-1). The final demand-intermediate demand (FD-ID) price indexes indicate that waning of upward pressure of costs has spread steadily from the upstream to the downstream stages of supply chains in business-to-business (B to B) transactions (Chart 45). Reflecting these developments, the pace of increase in input costs (intermediate input costs) faced by firms that conduct business-to-consumer (B to C) transactions has further decelerated and the year-on-year rate of increase in goods prices, which has been susceptible to the impact of import prices, has been slowing.

Chart B3-1: Inflation Indicators



Sources: Ministry of Internal Affairs and Communications; Bank of Japan.
Notes: 1. Figures for import prices are on a yen basis. 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 or the services producer price index and then taking the weighted average using consumption expenditure shares as weights.
2. In the right-hand chart, figures show 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.

As shown above, upward pressure of costs led by past rises in import prices has been decreasing gradually.[25] In this situation, whether the linkage between wages and prices -- in particular, firms' behavior of reflecting wage increases in selling prices -- would strengthen and an active wage- and price-setting behavior would spread among

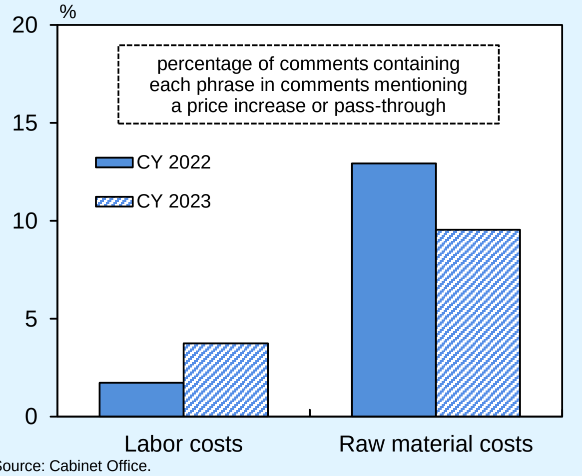
[25] International commodity prices have been stable on the whole, but developments differ across items and it is necessary to carefully monitor their impact on the CPI. For example, crude oil prices rose again in summer 2023; such rises could exert upward pressure on the CPI again with a time lag, and this warrants attention.

firms has become increasingly important when considering the outlook for price developments.[26] An assessment of the current situation of the linkage between wages and prices is described below.

First, while many firms have maintained the view that "it is now possible to pass fluctuations in raw material costs on to selling prices, but it is difficult to pass labor costs on to selling prices," moves to raise prices to obtain the source of wage increases have been spreading gradually, mainly among face-to-face services for which demand has recovered. On this point, firms' comments in the *Economy Watchers Survey* show that the number of firms that identified labor costs as one of the reasons for price increases has increased slightly (Chart B3-2).

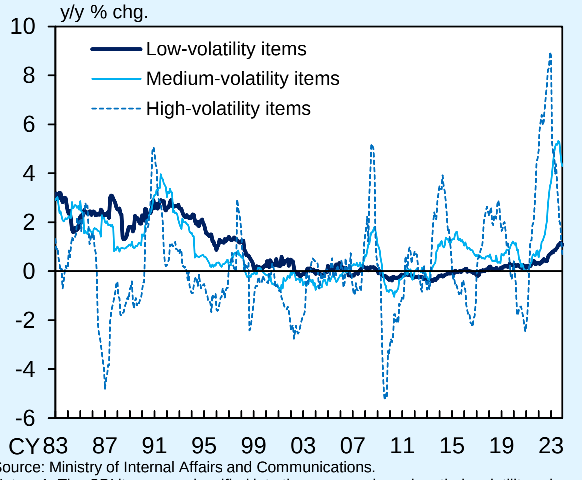
Next, a quantitative analysis using time-series data shows that moves to reflect wages in selling prices have been spreading, albeit moderately. In Chart B3-3, the CPI items are classified into three groups, according to the degree of price volatility. The chart shows that even the prices of "low-volatility items," which had shown little sign of movements, have been rising moderately to date. Moreover, a look at three indicators; namely, (1) "low-volatility items" of this analysis, (2) the contribution of wage factors to CPI changes, estimated by using the relationship of price developments by the degree of price volatility, import prices, the output gap, and wages, and (3) the trend in services prices -- where labor costs

Chart B3-2: Text Analysis of the *Economy Watchers Survey*



Source: Cabinet Office.
Notes: 1. Figures are calculated using comments regarding current economic conditions.
2. Figures for CY 2022 and CY 2023 are those for July-December 2022 and July-December 2023, respectively.
3. Figures for labor costs are for comments that contain the phrases "*jinken-hi*" or "*rōmu-hi*" in Japanese, while those for raw material costs are for comments that contain "*genzairyō*" or "*genryō*."

Chart B3-3: CPI Items by Degree of Price Volatility



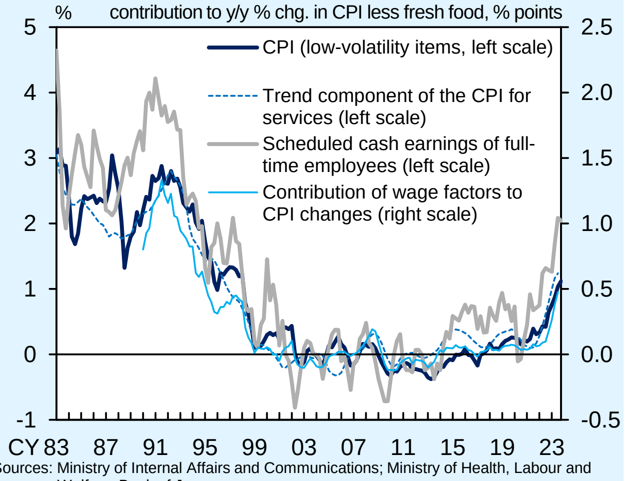
Source: Ministry of Internal Affairs and Communications.
Notes: 1. The CPI items are classified into three groups based on their volatility using long-term time-series data for the CPI (less fresh food).
2. The CPI figures are staff estimates and exclude mobile phone charges and the effects of the consumption tax hikes, travel subsidy programs, policies concerning the provision of free education, etc.

[26] See also Box 3 of the 2023 October Outlook Report for the linkage between wages and prices.

account for a high share of selling prices -- shows that all of them have been increasing moderately to date after remaining at around 0 percent for a long time (Chart B3-4).[27]

As explained, positive developments have been spreading gradually in firms' wage- and price-setting behavior. It is important to determine whether the linkage between wages and prices would strengthen by continuously conducting qualitative analyses, such as interviews with firms, carefully, as well as by carrying out quantitative analyses from various standpoints.

Chart B3-4: CPI and Scheduled Cash Earnings



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

Notes: 1. Figures for low-volatility CPI items and scheduled cash earnings of full-time employees are year-on-year percentage changes, while those for the trend component of the CPI for services are the 6-quarter backward moving averages of annualized quarter-on-quarter percentage changes.

2. Figures for scheduled cash earnings of full-time employees before 1994 are those for regular employees. Moreover, figures from 2016/Q1 onward are based on continuing observations following the sample revisions. The figure for 2023/Q4 is the October-November average.

3. Figures for the contribution of wage factors to CPI changes are based on the relationship between the CPI and wages, estimated using a 4-variable VAR model comprising import prices (yen basis), the output gap, wages (scheduled cash earnings of full-time employees), and price indices for low-, medium-, and high-volatility items in the CPI. The estimates are obtained using 20-year rolling regressions for low-, medium-, and high-volatility CPI items.

4. Figures for the trend component of the CPI for services are the composite of the sector-specific price trend for services and the common trend in services prices and wages. The figures are estimated using category-level services prices and industry-level scheduled cash earnings. The approach is based on Kiley (2023) and Stock and Watson (2016).

[27] The approach is based on the following prior studies:

Kiley, M. T., "The Role of Wages in Trend Inflation: Back to the 1980s?" Finance and Economics Discussion Series (Washington: Board of Governors of the Federal Reserve System), no. 2023-022 (2023).

Stock, J. H. and M. W. Watson, "Core Inflation and Trend Inflation," *The Review of Economics and Statistics* 98, no. 4 (2016): 770-784.