

April 30, 2009

Bank of Japan

**Outlook for Economic Activity and Prices**  
**(April 2009)**

**[The Bank's View]<sup>1</sup>**

Economic conditions around the world have deteriorated simultaneously and sharply since the autumn of 2008 with the intensification of the turmoil in the U.S. and European financial systems and in global financial markets.<sup>2</sup> Recently, signs of a leveling out of economic activity are beginning to be seen globally against the backdrop of progress in inventory adjustments, and authorities in countries around the world are planning, or have already begun, to implement large-scale policy measures, which are expected to bear fruit in the near future. It is still not certain, however, whether these developments will lead to a steady recovery of the world economy. Projections regarding the world economy need to take into account how the restructuring of the U.S. and European financial systems is likely to proceed and how rapidly demand around the world, including that in emerging economies, is likely to recover. Due consideration has been paid to the uncertainties surrounding these issues in assessing the baseline scenario as well as risks to the outlook for Japan's economic activity and prices as detailed below. Meanwhile, possible spreading of the new type of influenza and its influence on economic activity need to be monitored carefully.

**I. Outlook for Economic Activity**

Economic conditions in Japan have deteriorated significantly. The economic growth rate for fiscal 2008 seems likely to have deviated substantially downward from the interim assessment conducted in January. In the corporate sector, exports have decreased

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<sup>1</sup> The text of "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on April 30, 2009.

<sup>2</sup> Since the autumn of 2008, forecasts of the real GDP growth rate by the Bank of Japan, international organizations, and private research firms have all been revised substantially downward at a rapid pace (Appendix Chart).

significantly due to a sharp downturn in overseas economies, and business fixed investment has also declined substantially, reflecting the deterioration in corporate profits and financial conditions. In the household sector, private consumption has weakened against the backdrop of the deterioration in consumer sentiment and in the employment and income situation.

The outlook for Japan's economy from fiscal 2009 through fiscal 2010 is likely to greatly depend on developments in overseas economies and global financial markets. In the first half of fiscal 2009, it is expected that, while domestic private demand will continue to weaken, the pace of decline in exports and production will decelerate as inventory adjustments make progress both at home and abroad.<sup>3</sup> Therefore, the pace of deterioration in economic conditions will likely moderate gradually and start to level out. It is expected that, from the latter half of fiscal 2009 onward, global financial markets will regain stability and overseas economies start recovering, supported by the positive effects of policy actions taken in various countries and by the gradual adjustment of various excesses in financial and economic activity that had accumulated until around the mid-2000s. Japan's economy is also expected to recover gradually, and return to a growth rate above its potential in the latter half of the projection period, supported partly by the positive effects of measures to stabilize the financial system and of fiscal and monetary policy measures, in addition to a recovery in overseas economies and improvements in conditions in global financial markets.<sup>4</sup>

The key features of the outlook are as follows.

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<sup>3</sup> In fiscal 2008, quarter-on-quarter real GDP growth rates declined substantially in the latter half of the year. Consequently, fiscal 2009 will have started from an extremely low level of real GDP, and the growth rate for fiscal 2009 will be substantially negative even if Japan's economy levels out some time in fiscal 2009. It should be noted that when fluctuations in economic activity are extremely large, quarter-on-quarter growth rates (annualized basis) may differ substantially from the growth rate for the fiscal year.

<sup>4</sup> Mainly reflecting the declines in the growth of capital stock due to the significant deterioration in economic conditions, Japan's potential growth rate is judged to have declined from the level previously estimated. The Bank's estimate of the potential growth rate during the current projection period is "around 1 percent" compared to "around 1.5 percent or somewhat higher" estimated in the October 2008 *Outlook for Economic Activity and Prices*.

## **A. Overseas Economies**

With the adverse feedback loop operating between financial and economic activity, overseas economic conditions are likely to continue deteriorating for the immediate future. In the United States, housing prices have declined sharply, adjustments in households' balance sheets are continuing, and lending attitudes of financial institutions remain tight. The employment situation and corporate profits are also deteriorating sharply. The resultant weakening in economic activity is having a negative impact on financial institutions' profits through increased credit costs. Economic conditions in Europe are also likely to continue deteriorating due to a decrease in exports and tight financial conditions. In emerging and commodity-exporting economies, growth rates are likely to remain low.

Recently, however, signs of a leveling out of the world economy have begun to appear, as inventories worldwide are being adjusted and policy measures in China are starting to have an effect. Further ahead, from the latter half of fiscal 2009 onward, it is expected that the adjustment of various excesses in financial and economic activity that had accumulated until around the mid-2000s will make progress, and the positive effects of policy actions either implemented or being planned in various countries will gradually materialize. Overseas economies taken as a whole are therefore expected to start recovering.

## **B. The Corporate Sector**

In the corporate sector, the terms of trade are expected to improve as the effects of the decline in commodity prices since the summer of 2008 gradually feed through. However, weak profits and the substantially depressed level of capacity utilization in the manufacturing sector will likely continue for the time being due to the deterioration in overseas economic conditions and the impact of the earlier appreciation of the yen. Such developments are also expected to adversely affect profits in the nonmanufacturing sector. Under these circumstances, business fixed investment is likely to continue decreasing in coming quarters. However, assuming that firms' expectations of medium- to long-term growth in global demand are not seriously dampened, growth in business fixed investment is expected to pick up gradually along with the recovery in exports and corporate profits.

### **C. The Household Sector**

Private consumption is likely to weaken in coming quarters, reflecting the deterioration of the employment and income situation. Overtime hours worked have already decreased substantially, and adjustments in the number of non-regular employees are in progress. Going forward, given the likelihood of these developments leading to a substantial reduction in bonus payments and the curtailment of hiring of new graduates, the employment and income situation is likely to increase in severity in coming quarters. Further ahead, it is expected that real income will be boosted by the decline in the prices of consumer goods and services, and consumer sentiment will be underpinned by the expectation of positive effects resulting from various policy measures. However, the recovery in private consumption will likely remain sluggish during the projection period, given that improvements in the employment and income situation tend to lag behind any recovery in corporate profits.

### **D. Financial Conditions**

The tightness in corporate financing conditions in Japan has eased somewhat relative to the latter half of calendar 2008, as seen in better issuing conditions in the CP and corporate bond markets. However, given the deterioration in corporate profits, the situation as a whole remains severe as an increasing number of firms are reporting that their financial positions are weak and lending attitudes of financial institutions are tight. In the first half of fiscal 2009, with respect to firms' demand for funds, their needs for operating funds will likely decline gradually against the backdrop of progress in inventory adjustments and declines in materials costs. Concerning the supply of funds, it is expected that improvements in the issuing conditions for CP and corporate bonds and increases in bank lending will continue due partly to the positive effects of various policy measures and continued low interest rates. The tightness in corporate financing, therefore, is likely to ease gradually. However, firms' concerns over their funding capability will likely persist, given that corporate profits will continue to be sluggish for some time and financial institutions and investors therefore remain cautious about taking on corporate credit risks.

Further ahead, it is expected that from the latter half of fiscal 2009 onward, economic activity and corporate profits will gradually pick up as global financial markets regain

stability. Under these circumstances, financial conditions will likely gradually decrease in severity as the stability of Japan's financial system and financial markets is enhanced due partly to the positive effects of the various policy measures and, as a result, financial institutions' lending attitudes become favorable and investors' risk-taking capabilities improve. It is expected that these improvements in financial conditions will support the recovery of economic activity in the latter half of the projection period.

## **II. Outlook for Prices**

Given this economic outlook, the environment surrounding prices can be summarized as follows. The current level of resource utilization, in terms of labor and production capacity, is substantially below its historical average and the negative output gap seems very large. Going forward, resource utilization is projected to recover gradually as the economy begins to recover, but the output gap is expected to remain negative even in the latter half of the projection period. Unit labor costs (labor costs per unit of output) are likely to be on a downtrend, after a temporary rise reflecting the sharp drop in production. Meanwhile, judging from developments in indicators such as long-term interest rates, medium- to long-term inflation expectations appear to be generally unchanged. In addition, commodity prices are projected to rise gradually as the world economy begins to recover.

Looking at price indices, the domestic corporate goods price index (CGPI) is expected to decline sharply in fiscal 2009 due to the earlier fall in commodity prices as well as the deterioration in demand conditions. The CGPI is projected to continue declining in fiscal 2010 due to the persistence of the negative output gap, but the rate of decline is likely to moderate against the backdrop of a moderate rise in commodity prices.

The year-on-year rate of decline in the consumer price index (CPI) for all items excluding fresh food is expected to accelerate through the middle of fiscal 2009, reflecting the decline in the prices of petroleum products, the stabilization of food prices, and the deterioration in aggregate demand conditions. Thereafter, however, assuming that medium- to long-term inflation expectations remain stable, the rate of decline in the CPI (excluding fresh food) is likely to moderate as the effects of the changes in the prices of petroleum products and food abate. Nevertheless, the rate of change in the CPI (excluding fresh food) is projected to

remain negative in fiscal 2010 given the persistence of the negative output gap and continued weak developments in wages.

### **III. Upside and Downside Risks**

The outlook above, considered the most likely projection by the Bank, is subject to both upside and downside risks with regard to economic activity and prices, and these require close attention especially when the outlook for economic activity and prices is extremely uncertain, as at present.

The following upside and downside risks bear upon the outlook for economic activity.

The first risk concerns the outcome of the adverse feedback loop operating globally between financial and economic activity. Since the autumn of 2008, the financial turmoil has been affecting not only the United States and Europe but also emerging and commodity-exporting economies, thereby leading to a global intensification of the adverse feedback loop between financial and economic activity. Should declines in asset prices and the downturn in economic activity continue despite the various policy measures being taken, the adverse feedback loop may worsen and result in a further weakening of overseas economies or a delay in the timing of their recovery. Even when strains in financial markets have eased, there is a possibility that financial institutions and investors will continue to maintain their cautious risk-taking stance and thereby restrain economic activity. Furthermore, should economic recovery in countries around the world be delayed, attention needs to be paid to a possible increase in protectionist actions triggered by such a delay since this may reduce the volume of trade and financial transactions, thereby exerting further downward pressure on the world economy.

In the United States, although some improvements have been observed in financial markets, the markets taken as a whole continue to be under great stress and labor market conditions are deteriorating rapidly. If the adverse feedback loop between financial and economic activity should intensify, reflecting a continued decline in asset prices and an increase in impaired assets, the economy may become weaker than assumed. In Western Europe, the adverse feedback loop may worsen, as in the United States, due to the deterioration in economic activity. Furthermore, a weakening of European emerging economies, which are

major trading partners of Western European economies and whose share of Western European financial institutions' lending has been large, may exert further downward pressure on European economies as a whole. Many emerging and commodity-exporting economies have experienced a sharp drop in exports and an outflow of funds. Their economic downturn may lead to a further increase in the outflow of funds, and this may exert further downward pressure on economic activity.

The second risk concerns the impact of various policy measures being implemented around the globe. At present, many countries, including Japan, have taken measures to stabilize their financial systems and introduced stimulative fiscal and monetary policy measures. Specifically, the key issues are whether the United States and Europe can make progress in restoring confidence in their financial systems and whether the measures taken by countries around the world can succeed in underpinning global demand. The effects of these measures on domestic demand have already started to be observed in some countries such as China, and some improvements have been observed in financial markets in various countries. It should be noted, however, that many of the measures announced by countries around the world have only been planned or have only just begun to be implemented. Therefore, there are both upside and downside risks to the outcome of these measures and to their impact on the economies of these countries.

The third risk concerns firms' medium- to long-term expectations of future growth. In this outlook, it is assumed that firms' medium- to long-term expectations of global demand will not decline greatly despite the current significant downturn in the economy, and thus that business fixed investment will recover at a moderate pace as adjustments in overseas economies progress. However, if the adjustments in overseas economies should deepen further or become prolonged, firms' medium- to long-term growth expectations may decline further, causing the projections, especially those concerning business fixed investment, to deviate downward. There is also a risk that a decline in firms' medium- to long-term growth expectations may affect the employment and income situation, and ultimately restrain household spending through a decline in permanent income.

The fourth risk concerns developments in financial conditions in Japan. There is a possibility that, if increased strains in global financial markets have a larger negative impact

on Japanese financial markets, or if the stability of the financial system is impaired by increased credit risks reflecting continued sluggishness in corporate performance, pressures acting to depress the economy from the financial side may become more marked, thereby intensifying the adverse feedback loop between financial and economic activity. On the other hand, from a longer-term perspective, attention should continue to be paid to the risk that prolonged accommodative financial conditions together with a gradual rise in the economic growth rate may lead to larger swings in financial and economic activity as well as in prices.

Turning to the outlook for inflation, it should be noted that there are also considerable uncertainties attending inflation that could cause it to deviate either upward or downward from the projection. If any of the above-mentioned upside or downside risks affecting the level of economic activity should materialize, prices may be expected to respond accordingly. There are also the following risks that are specific to prices. The first of these concerns changes in the medium- to long-term inflation expectations of households and the price-setting behavior of firms. Demand conditions in Japan are likely to remain slack, and to continue to exert downward pressure on prices. Under these circumstances, should firms and households expect a continued decline in prices, the decline in prices may accelerate along with the decline in wages. The second risk concerns developments in import prices. Considerable uncertainty surrounds developments in prices of commodities such as crude oil, leaving potential for movement in either direction. In the short run, there is a risk of commodity prices falling, reflecting the weaker-than-expected world economy. On the other hand, in the longer run, should the current extremely stimulative economic measures be maintained amid a recovery of the world economy, commodity prices may rise more than expected. Fluctuations in foreign exchange rates can also affect consumer prices not only by influencing the level of economic activity but also through changes in import prices.

#### **IV. Conduct of Monetary Policy**

To realize sustainable growth with price stability, the Bank assesses the economic and price situation from two perspectives and then outlines its thinking on the future conduct of monetary policy, taking account of the "understanding of medium- to long-term price stability" -- that is, the level of inflation that each member of the Policy Board understands,

when conducting monetary policy, as being consistent with price stability over the medium to long term.<sup>5</sup>

The first perspective involves assessing the most likely outlook for economic activity and prices through fiscal 2010. As noted earlier, economic conditions are likely to continue deteriorating in coming months but gradually level out thereafter, and the growth rate is expected, from the latter half of fiscal 2009, to recover at a moderate pace. The year-on-year rate of change in the CPI (excluding fresh food) is likely to record a somewhat large decline through the middle of fiscal 2009, but the rate of decline is expected to moderate gradually thereafter. If these developments continue, there are prospects for the economy to return to a sustainable growth path with price stability in the longer run.

The second perspective assesses the risks considered most relevant to the conduct of monetary policy, including risks that have a longer time horizon than the first perspective. In the area of economic activity, those that demand attention are the continued high downside risks to the economy stemming from future developments in the global financial and economic situation, changes in medium- to long-term growth expectations, and financial conditions in Japan. Regarding the outlook for prices, there is a possibility that inflation will decline more than expected, if the downside risks to the economy materialize or medium- to long-term inflation expectations decline. On the other hand, in the medium to long run, should the current extremely stimulative economic measures be maintained amid a recovery of the world economy, the rate of inflation in Japan might rise higher than projected due, for example, to a further rise in commodity prices.

Based on the examination from the two perspectives described above, there are prospects for Japan's economy to return to a sustainable growth path with price stability in the longer run. However, attention should be paid to the downside risks to economic activity and prices for the time being.

The ongoing global financial crisis and the current sharp drop in economic activity appear

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<sup>5</sup> The "understanding of medium- to long-term price stability" -- reviewed annually in principle and expressed in terms of the year-on-year rate of change in the CPI -- was reviewed in April 2009 and falls in the range approximately between 0 and 2 percent, with most Policy Board members' median figures at around 1 percent.

to have occurred during the process of the unwinding of various excesses in financial and economic activity that had accumulated until around the mid-2000s. The adjustment of these excesses is indispensable for the world economy to achieve a full-fledged recovery, and this is likely to take some time. In this situation, economic policies should prevent economic activity from deteriorating further and continue to correct the excesses as smoothly as possible. To achieve these aims, measures from two standpoints -- the provision of various safety nets, and the prevention of a sharp drop in demand -- are crucially important. Governments and central banks in countries around the globe, including Japan, have been taking various measures from these standpoints.

In order to support the economy from the monetary policy side, the Bank has taken various steps since last autumn, which can be divided into three main areas: reductions in the policy interest rate; measures to ensure stability in financial markets; and steps to facilitate corporate financing. In addition, to secure the stability of the financial system, the Bank resumed its purchases of stocks held by banks, and also decided to provide subordinated loans to banks. The Bank, paying attention for the time being to the downside risks to economic activity and prices, will continue to exert its utmost efforts as the central bank to facilitate the return of Japan's economy to a sustainable growth path with price stability.

(Appendix 1)

**Forecasts of the Majority of Policy Board Members**

y/y % chg.

	Real GDP	Domestic CGPI	CPI (excluding fresh food)
Fiscal 2008	-3.2 to -3.1 [-3.2]	+3.3	+1.2
Forecasts made in January 2009	-2.0 to -1.7 [-1.8]	+3.0 to +3.2 [+3.1]	+1.1 to +1.2 [+1.2]
Fiscal 2009	-3.7 to -3.0 [-3.1]	-7.6 to -6.9 [-7.5]	-1.6 to -1.4 [-1.5]
Forecasts made in January 2009	-2.5 to -1.9 [-2.0]	-7.0 to -6.0 [-6.4]	-1.2 to -0.9 [-1.1]
Fiscal 2010	+0.8 to +1.5 [+1.2]	-2.4 to -1.4 [-1.8]	-1.1 to -0.8 [-1.0]
Forecasts made in January 2009	+1.3 to +1.8 [+1.5]	-1.5 to -0.8 [-0.9]	-0.6 to 0.0 [-0.4]

- Notes: 1. Figures in brackets indicate forecast medians.
2. The forecasts of the majority of Policy Board members are constructed as follows: each Policy Board member's forecast takes the form of a point estimate, namely, the figure to which he or she attaches the highest probability of realization. These forecasts are then shown as a range, with the highest figure and the lowest figure excluded. It should be noted that the range does not indicate the forecast errors.
3. In the past, real GDP for the fiscal year just ended was calculated on the assumption that the level of real GDP in the January-March quarter equaled that in the October-December quarter. This time, the Bank decided to post Policy Board members' forecasts of real GDP for fiscal 2008 taking account of developments in economic data in the January-March quarter of 2009. Note, however, that the domestic CGPI for fiscal 2008 is the actual figure, and the CPI (excluding fresh food) for fiscal 2008 is calculated on the assumption that the year-on-year rate of change in the CPI for March 2009 equals that in February.
4. Individual Policy Board members make their forecasts with reference to the view of market participants regarding the future course of the policy interest rate -- a view that is incorporated in market interest rates.
5. The range shown below includes the forecasts of all Policy Board members.

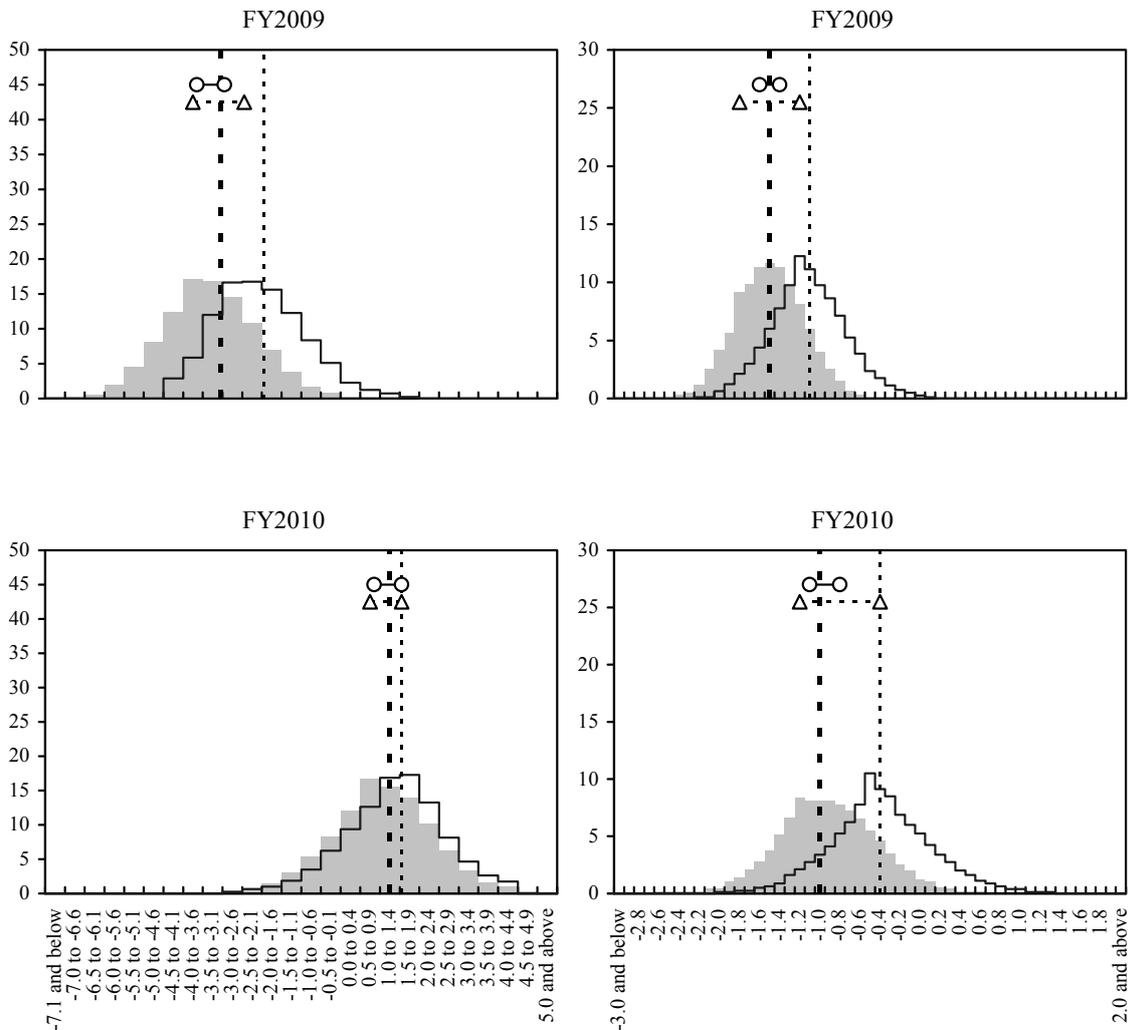
y/y % chg.

	Real GDP	Domestic CGPI	CPI (excluding fresh food)
Fiscal 2008	-3.2 to -3.0	--	--
Forecasts made in January 2009	-2.0 to -1.6	+2.8 to +3.2	+1.0 to +1.2
Fiscal 2009	-3.8 to -2.5	-7.8 to -6.8	-1.8 to -1.2
Forecasts made in January 2009	-2.8 to -1.8	-7.0 to -5.0	-1.3 to -0.8
Fiscal 2010	+0.7 to +1.5	-2.6 to -1.3	-1.2 to -0.4
Forecasts made in January 2009	+1.2 to +2.0	-1.8 to -0.5	-0.7 to 0.0

### Risk Balance Charts

(1) Real GDP

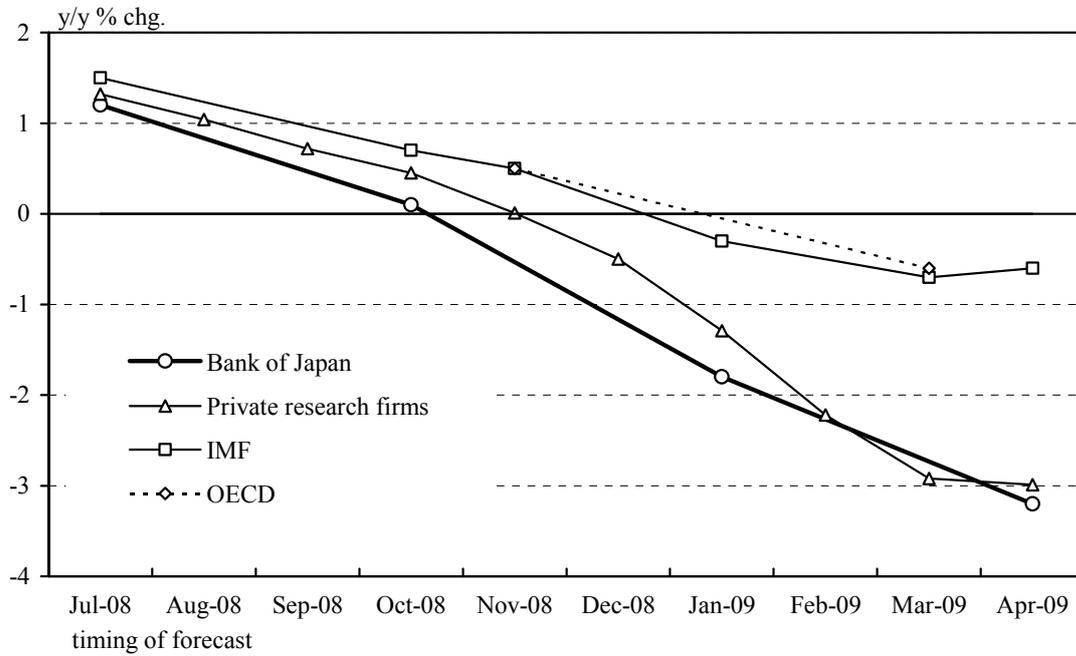
(2) CPI (Excluding Fresh Food)



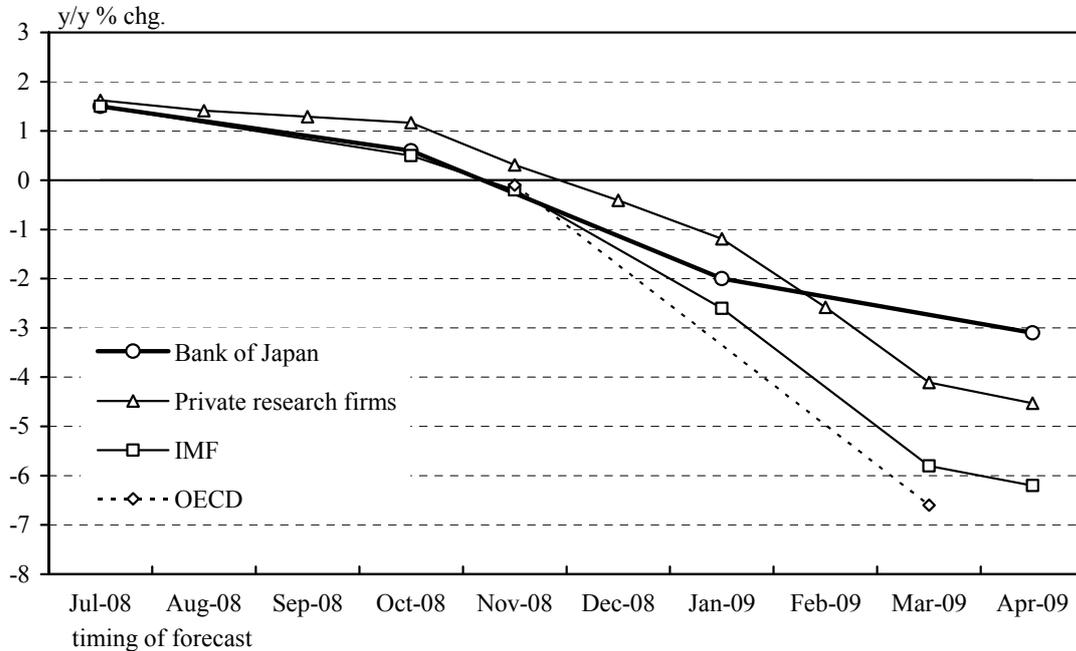
- Notes: 1. Vertical axes in the charts represent probability (%), while horizontal axes represent the year-on-year percentage changes in the respective indicators. Bar charts represent the probability distributions in April 2009, and solid lines represent those in January 2009.
2. Vertical dashed heavy lines indicate the median of the Policy Board members' forecasts (point estimates).  
○—○ indicates the range of the forecasts of the majority of Policy Board members. Δ—Δ indicates the range of the forecasts of all Policy Board members.
3. Vertical dashed thin lines indicate the median of the Policy Board members' forecasts (point estimates) in January 2009.
4. For the process of compilation of the Risk Balance Charts, see the box on page 9 of the April 2008 *Outlook for Economic Activity and Prices*.

### Revisions of Real GDP Growth Forecasts

(1) FY 2008



(2) FY 2009



Notes: 1. Figures for the Bank of Japan indicate forecast medians of Policy Board members.  
2. Figures for private research firms are those of the ESP Forecast.  
3. Figures for the IMF and the OECD are on a calendar-year basis.

Sources: Bank of Japan; Economic Planning Association, "ESP Forecast"; IMF, "World Economic Outlook"; OECD, "Economic Outlook," etc.