

October 30, 2009

Bank of Japan

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

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

The global economy has been gradually emerging from a grave situation of panicked contraction of economic and financial activity induced by the financial crisis that broke out in the autumn of 2008. Global financial markets have been improving, and the global economy has picked up. However, the stabilization of global financial markets and the global economy to date has largely been achieved through the effects of large-scale policy measures by public authorities around the world as well as progress in various adjustment processes in the private sector. The outlook for the global economy will hinge, among other things, on the possible consequences of balance-sheet adjustments in the United States and Europe and developments in emerging economies, which have been contributing significantly to the current recovery in the global economy. The uncertainty involved in these factors remains high, although it has decreased somewhat. Against this backdrop, in considering the outlook for economic activity and prices, the baseline scenario and various risk factors should be carefully examined.

**I. Outlook for Economic Activity**

In the first half of fiscal 2009, Japan's economy headed toward a pick-up following the rapid and substantial deterioration in the second half of fiscal 2008. Exports and production rose considerably against the backdrop of progress in inventory adjustments both at home and abroad as well as a recovery in overseas economies, especially emerging economies. Public investment continued to rise as the government's economic policy measures were implemented. However, business fixed investment continued to decline substantially, reflecting mainly the severe corporate profit situation and low capacity

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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 October 30, 2009.

utilization. Private consumption remained generally weak amid the increasingly severe employment and income situation, although there were signs of a pick-up in durable goods consumption largely owing to the effects of various policy measures.

As with other advanced economies, the outlook for Japan's economy from the second half of fiscal 2009 through fiscal 2011 is likely to continue to hinge greatly on developments in the global economy. Japan's economy has started to pick up, and in the second half of fiscal 2009 it is likely to improve gradually on the back of improvements in overseas economies as well as the effects of economic policy measures. While Japan's economy is expected to remain on a recovery trend in fiscal 2010, the pace of improvement is likely to be moderate until around the middle of fiscal 2010. This is because the pace of recovery of the global economy is likely to remain moderate and also because, in Japan, pressures to adjust employment and wages are likely to remain, while effects of demand-boosting policy measures wane. Thereafter, as balance-sheet adjustments in the United States and Europe make fair progress, improvements in the corporate sector originating from exports are likely to spill over to the household sector. Therefore, in fiscal 2011 the growth rate of Japan's economy is likely to reach a level clearly above the potential growth rate.<sup>2</sup>

The key features of the outlook are as follows.

### *Overseas Economies*

It is assumed that overseas economies will recover moderately on the whole. In the second half of fiscal 2009, U.S. and European economies are expected to improve on the back of demand-boosting policy measures and progress in inventory adjustments. Emerging and commodity-exporting economies are likely to maintain high growth. Economic stimulus measures are likely to have stronger effects in these economies because balance-sheet problems in these economies are relatively minor to start with and growth is

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<sup>2</sup> According to the latest estimate using available data, Japan's potential growth rate appears to have declined from the level previously estimated, mainly reflecting the decline in the growth of capital stock due mainly to the significant deterioration in economic conditions. The Bank of Japan estimates that the potential growth rate during the current projection period has declined to "around 0.5 percent" from the "around 1 percent" estimated in the April 2009 *Outlook for Economic Activity and Prices*. It should be noted that, when fluctuations in economic activity are large as at present, estimates of the potential growth rate should be interpreted with care.

likely to be boosted by the effects of capital inflows and a recovery in exports to advanced economies. While the global economic recovery might temporarily lose momentum sometime in fiscal 2010 reflecting the waning effects of demand-boosting policy measures in each country, it is unlikely that the recovery trend of the global economy will come to a halt, for the following reasons. First, authorities in the United States and Europe are taking a stance of supporting the economic recovery through macroeconomic policies. And second, domestic demand is potentially strong in emerging economies. Therefore, the growth rate of the global economy is expected to gradually rise through fiscal 2011. Nevertheless, it is most likely that the pace of economic recovery will remain modest on the whole as the global economy is in a recovery process while adjustments are made to various excesses that had accumulated until around the mid-2000s, and the effects of balance-sheet adjustments in the United States and Europe, in particular, are likely to persist.

### ***The Corporate Sector***

In the manufacturing sector, exports and production have been increasing because of the progress in global inventory adjustments and stronger demand induced by various policy measures. However, the level of production is still low due mainly to the earlier plunge in production. While the pace of increase in production might temporarily slow as the effects of inventory adjustments and of demand-boosting policy measures at home and abroad wane, the rising trend of production is expected to continue as long as the moderate recovery trend of the global economy continues. In the absence of a substantial decline in firms' expectations of medium- to long-term growth of global demand, business fixed investment is also expected to recover gradually with the increase in production and recovery in corporate profits. In contrast, recovery in the nonmanufacturing sector and for small firms is likely to lag behind that in the manufacturing sector, since the pursuit of cost cutbacks in the manufacturing sector will put downward pressure on demand, and the household sector will face a severe situation, as will be discussed below.

### ***The Household Sector***

Private consumption, while likely to continue to show signs of recovery with regard to consumer durable goods due to the effects of various policy measures, will probably remain generally weak amid the severe employment and income situation. Recently, against the

backdrop of increased exports and production, there have been changes in some employment indicators, such as an increase in non-scheduled hours worked and a leveling out of the ratio of new job offers to applicants. However, the slack in the labor market is likely to continue for some time, and the severe situation for wages, particularly for bonus payments, will continue. Since improvements in the employment and income situation tend to lag behind any recovery in corporate profits, it is highly likely that a sustainable recovery in private consumption will be in sight in the latter half of the projection period.

### ***Financial Environment***

The financial environment has been increasingly showing signs of improvement, as indicated by the fact that issuing conditions in the CP and corporate bond markets have been improving markedly and financial institutions' lending attitudes have been becoming less severe. Looking ahead, as Japan's financial system has remained robust when compared with the situation in the United States and Europe, the conditions surrounding corporate financing, such as the lending attitudes of financial institutions, are expected to continue to improve. Meanwhile, in terms of the demand for funds, the accumulation of on-hand liquidity, which had surged from the second half of fiscal 2008, has receded and demand for funds for business fixed investment is expected to be on a declining trend. Against the backdrop of a decline in the demand for funds, it is likely that firms' financial positions will improve while the amount of fund-raising by firms both through bank loans and CP issuance declines. This is particularly the case for bank loans, the outstanding balance of which had increased markedly as bank loans became a substitute means of raising funds when the issuance of CP and corporate bonds became difficult in the second half of fiscal 2008. Therefore, as CP and corporate bond markets improve, bank lending is likely to become sluggish. Meanwhile, for some nonmanufacturing firms and small firms, the financial environment will remain severe, as improvements in their performance tend to lag those of manufacturing firms and large firms. From fiscal 2010 onward, in addition to improved funding conditions for firms, the stimulative effects of low interest rates on the back of the recovery in corporate profits will likely increase. This improvement in the financial environment as a whole is expected to support the self-sustained recovery in private demand.

## **II. Outlook for Prices**

Given the economic outlook described above, the environment surrounding the outlook for prices can be summarized as follows. First, resource utilization of labor and production capacity, which reflects the supply and demand balance of goods and services, is projected to recover gradually as the economy improves. However, since the decline in the level of resource utilization at the beginning of fiscal 2009, which is the starting point of the projection, was extraordinarily large, the level of utilization of labor and production capacity is likely to approach gradually the historical average toward the end of the projection period. Second, unit labor costs (labor costs per unit of output) are likely to be on a downtrend as a result of efforts by firms to restrain wages. Meanwhile, judging from developments in long-term interest rates and the results of various surveys targeted at households and firms, medium- to long-term inflation expectations have been generally unchanged. In addition, while commodity prices have been on a rise from the turn of the year until recently, they are projected to remain more or less unchanged, since the pace of growth of the global economy is likely to remain modest.

As for the outlook for prices in terms of price indices, while the domestic corporate goods price index (CGPI) is expected to continue declining on a year-on-year basis in the second half of fiscal 2009 due to the deterioration in the aggregate supply and demand balance, the pace of decline will likely slow down reflecting developments in commodity prices. The rate of decline in the CGPI is likely to gradually moderate from fiscal 2010 onward as the slack in the economy dissipates.

The year-on-year rate of decline in the consumer price index (CPI) for all items excluding fresh food is expected to slow down significantly in the second half of fiscal 2009, reflecting the waning effects of the drop in the prices of petroleum products from a year before. From fiscal 2010 onward, with medium- to long-term inflation expectations likely to remain stable, the rate of decline in the CPI (excluding fresh food) is likely to continue to moderate as the aggregate supply and demand balance improves gradually. Nevertheless, the pace of decline in the CPI (excluding fresh food) is likely to slow down only modestly, given that, as described earlier, the recovery in the level of utilization of labor and production capacity is likely to be gradual and unit labor costs are likely to decline.

In an economy where prices continue to decline, whether the decline in prices will induce downward pressure on economic activity becomes a critical issue. Given that the pace of decline in prices is expected to slow down during the projection period, albeit modestly, and that the financial system and medium- to long-term inflation expectations are stable, it is unlikely that the decline in prices will induce downward pressure on economic activity.

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

While the outlook described above is the scenario considered to be the most likely by the Bank, uncertainty concerning the outlook, as mentioned previously, remains high, although such uncertainty has receded somewhat. The following upside and downside risks bear upon the outlook for economic activity.

The first risk concerns the possible consequences of balance-sheet adjustments in the United States and Europe. When debt increases substantially along with an excessive rise in asset prices, it is inevitable that during the ensuing adjustment process economic entities restrain spending in order to bring excessive debt ratios back to normal. In the past, in a number of cases including that of Japan, the scale and duration of the adjustment were greater than initially envisaged. It should be noted that the same may be the case for the balance-sheet adjustment process in the United States and Europe. In that case, it is possible that spending, especially in the household sector, might be restrained for a long period while excessive debt ratios are being corrected. The financial sector might not fulfill its credit intermediation function smoothly for a protracted period and thereby put downward pressure on economic activity for a considerable period. In addition, with the economy and the financial system still vulnerable, global financial markets and the global financial system might again become unstable if some sort of shock occurs. Should this be the case, Japan's financial markets and financial system would also be affected accordingly, leading to weaker-than-expected economic growth.

The second risk concerns developments in emerging and commodity-exporting economies. In China, the implementation of large-scale macroeconomic policies has led to high growth centered on domestic demand, and has been affecting neighboring Asian emerging economies and commodity-exporting economies. In addition, the improvement in global financial markets and large-scale monetary easing in advanced countries have increased

capital inflows to emerging and commodity-exporting countries, which also seems to have been supporting economic activity in these countries. If these developments further intensify, economic developments in emerging and commodity-exporting economies could become an upside risk factor for Japan's economy. On the other hand, there is also the risk that, as a result of foreign exchange and macroeconomic policies in these countries, their economies could overheat and commodity prices could rise. Such developments might put downward pressure on domestic private demand in Japan through a worsening of the terms of trade due to high commodity prices.

The third risk concerns future developments in the various policy measures taken by countries around the globe. Since the autumn of 2008, countries around the world, including Japan, have implemented large-scale fiscal and monetary policy measures as well as policies to restore financial system stability. As a result of these measures, global financial markets have been improving and the global economy has picked up. Future developments in these policy measures will have a substantial impact on the global economy. If the effects of public demand-boosting policy measures dissipate when the private sector is still fragile, this could lead to weaker-than-expected economic growth. In this case, protectionism might spread, and this might further exert downward pressure on the global economy through a decline in trade and financial transactions. On the other hand, attention should continue to be paid to the risk that an overly prolonged accommodative financial environment together with a rise in the economic growth rate might lead to larger swings in economic activity and prices. Moreover, if the public measures are maintained for longer than necessary, the productivity of the economy as a whole might decline through the retention of resources in inefficient areas. When confidence in fiscal discipline and the conduct of monetary policy declines amid increasing public debt, this might have adverse effects on financial markets, such as substantial fluctuations in long-term interest rates.

The fourth risk concerns firms' medium- to long-term expectations of future economic growth. In this outlook, it is assumed that firms' medium- to long-term expectations for global demand will remain unchanged, and that business fixed investment will recover at a moderate pace as overseas economies recover. However, if there is a decline in Japanese firms' medium- to long-term growth expectations, triggered for example by a decline in

overseas economies, it is possible that economic activity, particularly business fixed investment, will deviate downward from the projected growth path. If emerging economies are expected to maintain sustainable high growth while growth expectations for Japan fail to recover, there is also a risk that investment in and lending to emerging economies might increase but domestic investment might continue to be suppressed. In addition, a decline in firms' medium- to long-term growth expectations might lead to restrained household spending through heightened anxiety about the outlook for employment and income.

There are also considerable uncertainties regarding the outlook for 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 materialize, prices may be expected to respond accordingly. There are also the following risk factors that are specific to prices. The first concerns firms' and households' medium- to long-term inflation expectations. While resource utilization of labor and production capacity is likely to improve, the pace of recovery is expected to be moderate. In these circumstances, should firms and households expect a continued decline in prices, the decline in actual prices and wages might accelerate. The second risk factor concerns the high uncertainty with respect to gauging the degree of slack in the economy or the state of utilization of labor and production capacity. When the economy is deteriorating substantially with structural changes in demand, it is possible that the supply capacity of the economy and the potential growth rate are also declining owing to obsolescence or a cutback in capital stock. In this case, if the degree of economic slack is estimated based on the output gap derived from past data, there is a risk of overestimating the downward pressure on prices. The third risk factor concerns developments in import prices. Considerable uncertainty surrounds developments in prices of primary commodities such as crude oil, leaving room for movement in either direction. On one hand, there is a risk of primary commodity prices falling as a result of a weaker-than-expected global economy. On the other hand, should the growth of emerging economies be stronger than expected or the current extremely stimulative economic measures be maintained, primary commodity prices might rise more than expected. Fluctuations in foreign exchange rates can also affect consumer prices to a certain extent, not only by influencing the swings in 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 into account 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>3</sup>

The first perspective involves assessing the most likely outlook for economic activity and prices through fiscal 2011. As noted earlier, the economy is likely to continue improving. The rate of year-on-year decline in the CPI (excluding fresh food) is likely to moderate gradually from the second half of fiscal 2009 onward. If these developments continue, there are prospects for the economy to return to a sustainable growth path with price stability in the longer term.

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, while there are some upside risks, such as economic developments in emerging and commodity-exporting economies, there are still downside risks, although somewhat diminished, with risk factors including the possible consequences of balance-sheet adjustments in the United States and Europe or potential changes in firms' medium- to long-term growth expectations. Regarding the outlook for prices, there is a possibility that inflation will rise more than expected due to a rise in commodity prices brought about by higher growth rates in emerging and commodity-exporting economies. On the other hand, there is a risk that the rate of inflation might decline due, for example, to a decline in medium- to long-term inflation expectations.

Based on the examination from the two perspectives described above, in the conduct of monetary policy the Bank will aim to maintain the extremely accommodative financial

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<sup>3</sup> The "understanding of medium- to long-term price stability," reviewed in April 2009, is expressed in terms of the year-on-year rate of change in the CPI and falls in the range approximately between 0 and 2 percent, with most Policy Board members' median figures at around 1 percent.

environment. The Bank will provide steady support for Japan's economy to return 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 2009	-3.3 to -3.2 [-3.2]	-5.3 to -5.0 [-5.2]	-1.5 to -1.5 [-1.5]
Forecasts made in July 2009	-3.7 to -3.0 [-3.4]	-6.0 to -5.8 [-5.9]	-1.5 to -1.2 [-1.3]
Fiscal 2010	+0.8 to +1.3 [+1.2]	-1.5 to -1.0 [-1.4]	-0.9 to -0.7 [-0.8]
Forecasts made in July 2009	+0.6 to +1.1 [+1.0]	-2.1 to -1.5 [-2.1]	-1.2 to -0.7 [-1.0]
Fiscal 2011	+1.6 to +2.4 [+2.1]	-1.0 to -0.3 [-0.7]	-0.7 to -0.4 [-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. 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.
4. The range shown below includes the forecasts of all Policy Board members.

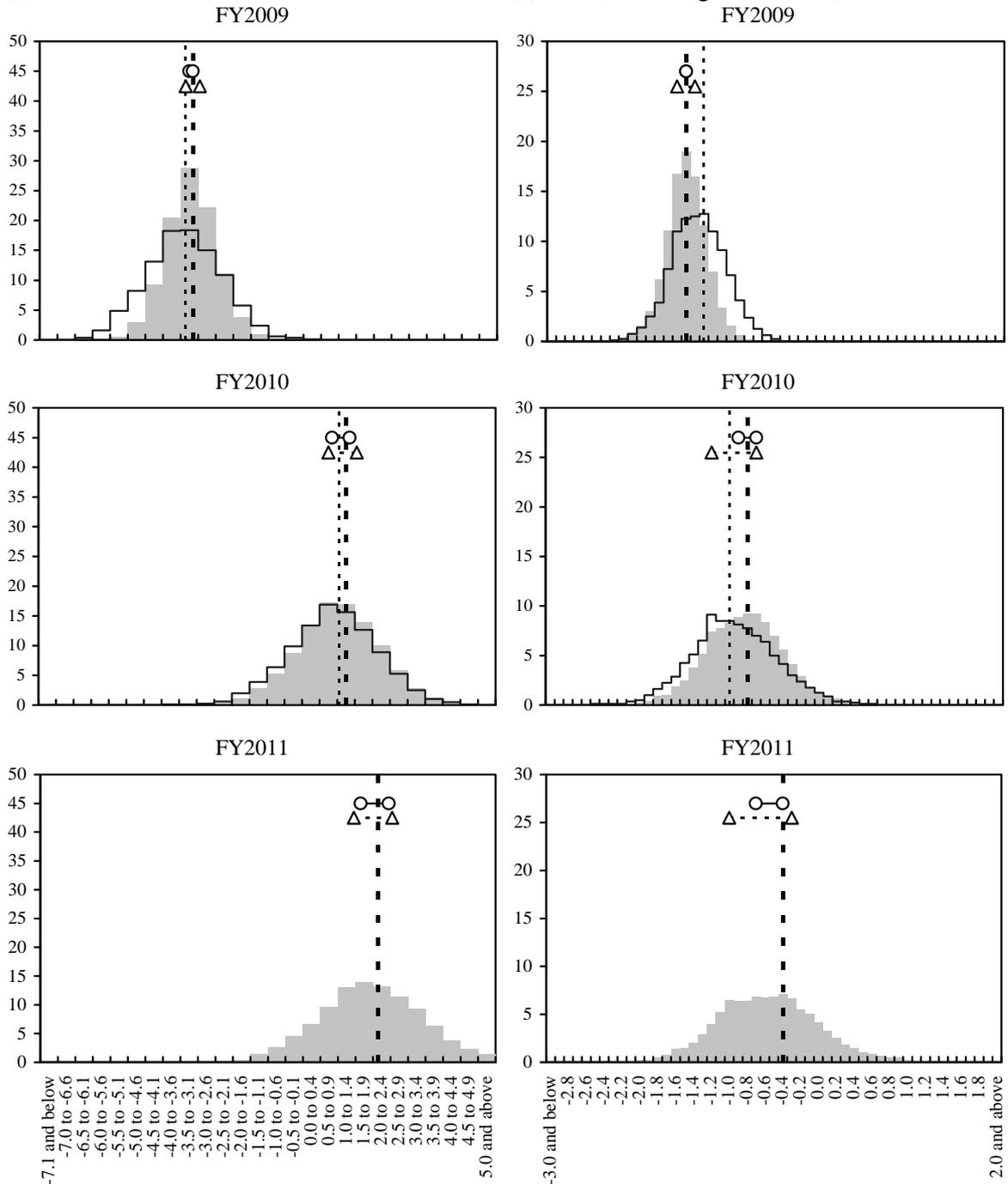
y/y % chg.

	Real GDP	Domestic CGPI	CPI (excluding fresh food)
Fiscal 2009	-3.4 to -3.0	-5.4 to -5.0	-1.6 to -1.4
Forecasts made in July 2009	-3.8 to -3.0	-6.2 to -5.7	-1.6 to -1.2
Fiscal 2010	+0.7 to +1.5	-1.5 to -0.9	-1.2 to -0.7
Forecasts made in July 2009	+0.5 to +1.5	-2.1 to -1.4	-1.2 to -0.6
Fiscal 2011	+1.4 to +2.5	-1.1 to +0.2	-1.0 to -0.3

### 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 October 2009, and solid lines represent those in July 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 July 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*.