April 30, 2010
Bank of Japan

Outlook for Economic Activity and Prices
(April 2010)

The Bank's View[1]

The global economy has emerged from the sharp deterioration triggered by the financial crisis and has been on a recovery trend since the latter half of 2009. However, the global economy is not in the process of returning to its state prior to the crisis. It is becoming clear that a substantial change in the global economic structure is taking place and each economy faces new challenges to achieve more balanced sustainable growth. Specifically, the presence of emerging and commodity-exporting economies in the global economy is growing and economic activity in these economies has significantly affected fluctuations in commodity prices and the flow of global capital. In advanced economies, including Japan, the outstanding amount of public debt has risen to unprecedented levels as a result of large-scale fiscal spending. In addition, based on the experience of the financial crisis, discussions have proceeded regarding a review of financial regulation and supervision. Meanwhile, Japan -- where domestic demand is expected to decline against the backdrop of a low birth rate, population aging, and a shrinking population -- faces the critical challenge of raising real economic growth and productivity. Taking account of these medium- to long-term changes in, and challenges facing, the global economy and Japan's economy, both the Bank of Japan's baseline scenario of economic activity and prices in Japan over the coming two years as well as risks will be examined.

I. Outlook for Economic Activity

In the latter half of fiscal 2009, Japan's economy continued to pick up. Exports and production had been increasing against a backdrop of progress in inventory adjustments both at home and abroad as well as improvement in overseas economies -- in particular, fast

[1] The text of "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on April 30, 2010.

growth in emerging economies. The drop in business fixed investment started leveling out due to the recovery in corporate profits. Private consumption, notably durable goods consumption, picked up mainly due to the effects of policy measures. Meanwhile, public investment started to decline.

Japan's economy from fiscal 2010 through fiscal 2011 is likely to be on a recovery trend. The demand-boosting effects of various policy measures targeted at durable goods consumption are likely to gradually wane, and the measures are expected to be wound up in fiscal 2010. At the same time, though, Japan's exports are likely to continue increasing against the backdrop of strong growth in emerging and commodity-exporting economies, and business fixed investment is also likely to pick up with the recovery in corporate profits. Moreover, since improvements in the employment and income situation are likely to gradually become evident as corporate activity becomes more vibrant, the pace of increase in private consumption and housing investment is likely to accelerate. Taking these points into account, the growth rate of Japan's economy is expected to be at a level above the potential growth rate in fiscal 2010, and to accelerate in fiscal 2011.[2]

The key features of the outlook are as follows.

Overseas Economies

It is assumed that overseas economies will continue to recover, led mainly by strong growth in emerging and commodity-exporting economies. In the United States and Europe, production is picking up against the backdrop of progress in inventory adjustments and the increase in exports, although the unemployment rate has remained at an elevated level. The effects of demand-boosting policy measures in the United States and Europe are expected to wane, but if balance-sheet adjustments at financial institutions and in the household sector make steady progress, downward pressure on economic activity from the financial side will decline and on the whole the momentum for a self-sustaining recovery in private demand in the United States and Europe will likely strengthen gradually, albeit to varying degrees in the different countries. Meanwhile, emerging and

[2] Japan's potential growth rate during the projection period is estimated to be "around 0.5 percent." However, given that the potential growth rate is estimated based only on the latest available data, it is subject to a certain margin of error.

commodity-exporting economies have been achieving strong growth led by domestic demand, fueled -- in addition to the underlying strength of self-sustaining growth -- by the effects of the expansionary macroeconomic policies taken thus far and of large-scale monetary easing in advanced economies. In some of these economies, there are signs of overheating in asset prices, and general prices are also rising. While the Bank's baseline scenario assumes that the high growth in emerging and commodity-exporting economies will continue, whether this scenario will unfold depends largely on the appropriate conduct of macroeconomic policies in these economies.

The Corporate Sector

In the manufacturing sector, production has been increasing due to the rise in exports and the effects of various policy measures targeted at durable consumer goods. Corporate profits have been recovering due to such increases in production as well as firms' efforts to reduce fixed costs. In a situation where firms' medium- to long-term growth expectations about the global economy are expected to be maintained, production is likely to remain on an uptrend and corporate profits are likely to continue to recover. In addition to these developments, as financial conditions are likely to improve, business fixed investment is also expected to pick up. While it is possible that improvement in the nonmanufacturing sector and among small firms may lag behind due mainly to the continued pursuit of cost cutbacks in the manufacturing sector, the effects of the recovery among export-related manufacturers are likely to spill over gradually.

The Household Sector

With regard to the employment situation, signs of improvement have become more pronounced than before, as seen in the fact that non-scheduled hours worked have been increasing and the ratio of job offers to applicants has risen moderately. Under these circumstances, private consumption, notably durable goods consumption, is picking up mainly due to the effects of various policy measures. As these measures are expected to be wound up in fiscal 2010, the pace of recovery in private consumption is likely to temporarily slow somewhat. Nevertheless, the effects of the increase in production are beginning to spill over gradually into the employment and income situation. Stock prices have also been rising against the backdrop of the recovery in corporate profits. As corporate activity becomes more vibrant, the recovery in employment is likely to become more pronounced and wages are also likely to show signs of improvement. Given these developments, the momentum for a self-sustaining recovery in private consumption is likely to build gradually. Moreover, housing investment is likely to recover moderately against the backdrop of improvements in the employment and income situation.

Financial Environment

The functioning of Japanese financial markets, which had declined considerably due to the global financial crisis, has improved substantially in 2009, and the constraints imposed by financial developments on economic activity vanished gradually. Recently, financial conditions have shown increasing signs of easing. Specifically, with the overnight call rate remaining at an extremely low level and interest rates on term instruments declining moderately, firms' funding costs, such as bank lending rates, have been on a downtrend. Issuing conditions for CP and corporate bonds have remained favorable, and even those for low-rated corporate bonds have shown signs of improvement. Financial institutions' lending stance has generally eased. Therefore, firms as a whole regard the situation as improving, although many firms still see financial institutions' lending attitudes as severe. As for the outlook, with Japan's financial system remaining stable on the whole, circumstances regarding firms' funding are likely to continue improving. The recovery in corporate profits and economic activity amplifies the stimulative effects of low interest rates, and, coupled with the improvement in funding conditions for firms, is expected to provide a boost for a self-sustaining recovery in domestic private demand. Meanwhile, as for credit demand, firms' demand for external funds is likely to remain weak due in part to the fact that firms have accumulated ample on-hand liquidity, in addition to the increase in cash flow in line with the recovery in corporate profits. Under these circumstances, it is likely that firms' financial positions will continue to improve, and bank lending and the amount of outstanding CP decrease, until a recovery in business fixed investment is well underway. Meanwhile, financial conditions surrounding small firms are likely to continue showing signs of easing, although some tightness may remain stemming from the fact that improvements in their performance tend to lag behind those of large firms.

II. Outlook for Prices

The year-on-year rate of decline in the consumer price index (CPI) for all items excluding fresh food accelerated toward the summer of 2009, due mainly to the effects of the drop in commodity prices following the surge in 2008. Since then, with the effects of the commodity prices gradually waning, the year-on-year rate of decline in the CPI (excluding fresh food) has started to moderate.

The outlook for the environment for prices can be summarized as follows. First, resource utilization of labor and production capacity, which reflects the aggregate supply and demand balance of goods and services, is projected to improve gradually as the economy follows a recovery trend. Second, unit labor costs (labor costs per unit of output) are likely to remain on a downtrend as a result of efforts by firms to restrain wages, but the pace of decline is likely to slow in the latter half of the projection period when a recovery in employment and wages is projected. 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 and are assumed to remain stable throughout the projection period. Commodity prices have continuously been on a rise recently, albeit with some swings, due mainly to strong growth in emerging and commodity-exporting economies. Commodity prices are assumed to rise moderately on the back of the continuation of strong growth in emerging and commodity-exporting economies.

As for the outlook for prices in terms of price indices, the domestic corporate goods price index (CGPI) is expected to be positive on a year-on-year basis from fiscal 2010 onward due mainly to the improvement in the aggregate supply and demand balance and to developments in commodity prices.

Under the assumption that medium- to long-term inflation expectations remain stable, the year-on-year rate of decline in the CPI (excluding fresh food) is expected to slow as the aggregate supply and demand balance gradually improves, and there are prospects that the rate of change in the CPI could enter positive territory in fiscal 2011.[3]

III. Upside and Downside Risks

The outlook described above is the scenario considered to be the most likely by the Bank. As upside and downside risks concerning the outlook, the following risks warrant attention.

The first risk concerns developments in emerging and commodity-exporting economies. These economies have continued to achieve strong growth led by domestic demand mainly as a result of the effects of expansionary macroeconomic policies in addition to the underlying strength of self-sustaining growth. Moreover, the improvement in global financial markets and continuation of large-scale monetary easing in advanced countries have increased capital inflows to emerging and commodity-exporting economies, which also seems to have been supporting economic activity in these economies. Commodity prices have also been on a rising trend against the backdrop of the growth in emerging and commodity-exporting economies. If economic conditions in emerging and commodity-exporting economies turn out to be stronger than expected, this could become an upside risk for Japan's economy through the increase in exports it would generate. However, there is a certain risk that, depending on the future conduct of macroeconomic policy in these economies, economic activity might overheat. In this case, Japan's exports could rise even further. At the same time, the worsening in the terms of trade associated with a rise in commodity prices could also pose a downside risk for private domestic demand in Japan. Moreover, if a sharp unwinding of excessive economic and financial activity takes place in emerging and commodity-exporting economies, there are risks of a substantial plunge in asset prices and of deep adjustments in economic activity in these economies.

The second risk concerns developments in advanced economies. As balance-sheet adjustments continue in the U.S. and European economies, bank lending has been sluggish. If credit intermediation does not operate smoothly for a protracted period, downward

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[3] The CPI for fiscal 2010 excludes the effects of the introduction of subsidies for high school tuition fees, a factor that will substantially lower the year-on-year rate of change in the CPI for the year. In assessing the trend change in prices, it is deemed appropriate to exclude such one-off factors that will disappear in twelve months.

pressure on economic activity from the financial side could continue. Moreover, attention should be paid to the potential consequences and impact of any possible changes in the various policy measures implemented in advanced economies, including Japan. If expansionary macroeconomic policies are modified while the momentum for a self-sustaining recovery in private demand remains weak, there is a risk that economic activity may turn out to be weaker than expected, depending on the way such changes are undertaken or their extent. Meanwhile, if accommodative financial conditions are maintained for a prolonged period as a self-sustaining recovery in private demand gains momentum, this could lead to larger swings in economic activity and prices. Moreover, it should be noted that if public support measures are maintained for longer than necessary, productivity growth in the economy as a whole might be hampered due to the retention of resources in inefficient areas.

The third risk concerns various international financial developments. Advanced economies around the world, including Japan, have implemented large-scale fiscal policies. As a result, the outstanding amount of public debt has been rising. Under these circumstances, depending on the market's evaluation of the outlook for public finances in the medium to long term, there is a risk that downward pressure on the economy might arise through adverse effects on financial markets, such as substantial fluctuations in long-term interest rates. Economic activity could also be affected by future regulation and supervision of the financial sector through financial institutions' and financial markets' response. Moreover, there is a risk that the possible consequences of balance-sheet adjustments in the United States and Europe as well as developments in emerging and commodity-exporting economies could cause substantial fluctuations in global financial markets.

The fourth risk concerns firms' medium- to long-term expectations for future economic growth. In this outlook, it is assumed that firms' medium- to long-term expectations for global economic growth remain unchanged and that business fixed investment will pick up at a moderate pace as overseas economies recover. Recently, in order to actively capture demand from emerging and commodity-exporting economies, firms, particularly large firms, have started to work on the development of products aimed at these economies and, in view of the international division of labor, to specialize in high-value-added products. If such moves accelerate, firms' medium- to long-term growth expectations could rise, and economic activity, particularly exports and business fixed investment, could turn out to be stronger than expected. However, if efforts to address various medium- to long-term issues, such as the need to increase the productivity of the economy as a whole, make little progress, there is a risk that expectations for growth in domestic demand could decline further. In this case, there is a risk that investment in and lending to emerging economies could increase but business fixed investment in Japan could be restrained, particularly at domestic demand-related firms, and household spending could decline through heightened anxiety about the outlook for employment and income.

There are also 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 affected accordingly. There are also the following risk factors 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 recover, the pace of recovery is expected to be moderate. In these circumstances, should firms and households factor in the possibility of a continued decline in prices, the decline in actual prices and wages might accelerate. The second 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. Especially if growth in emerging and commodity-exporting economies turns out to be stronger than expected, 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 causing swings in economic activity but also through changes in import prices. The third 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 fluctuating substantially with structural changes in demand, it is possible that the supply capacity of the economy is 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 the latest available data, there is a risk of overestimating the downward pressure on prices in a period when the economy is on a recovery trend.

IV. Conduct of Monetary Policy

The Bank has been actively implementing monetary easing measures to support the economy from the financial side. Specifically, the Bank has lowered the policy rate to 0.1 percent and, to encourage a decline in longer-term interest rates, introduced in December 2009 fixed-rate funds-supplying operations against pooled collateral, and in March 2010 substantially increased the amount of funds to be provided through the operation. Through these measures, the overnight call rate has remained at an extremely low level and interest rates on term instruments and bank lending rates have been declining. Meanwhile, the stimulative effects of low interest rates have been amplified given the improvements in corporate profits and economic activity.

In what follows, the Bank's assessment of the economic and price situation from two perspectives and the outline of its thinking on the future conduct of monetary policy will be discussed.[4]

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 be on a recovery trend. Based on the assumption that medium- to long-term inflation expectations remain stable, the year-on-year rate of decline in the CPI (excluding fresh food) is expected to slow as the aggregate supply and demand balance improves gradually, and there are prospects that the rate of change in the CPI could enter positive territory in fiscal 2011. The economy is expected 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.

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[4] 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" (the "understanding") -- 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. The "understanding" was reviewed again this year, which showed that each Policy Board member's "understanding" falls in a positive range of 2 percent or lower, and the midpoints of most Policy Board members' "understanding" are around 1 percent.

In the area of economic activity, while there are some upside risks such as faster growth in emerging and commodity-exporting economies, there are also downside risks such as those related to international financial developments. 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, while there is also 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 environment. The Bank recognizes that Japan's economy faces the critical challenge of overcoming deflation and returning to a sustainable growth path with price stability. To this end, the Bank will continue to consistently make contributions as a central bank.

(Appendix 1)

Forecasts of the Majority of Policy Board Members

y/y % chg.

	Real GDP	Domestic CGPI	CPI (excluding fresh food)
Fiscal 2009	-2.2 to -2.1 [-2.2]	-5.2	-1.6
Forecasts made in January 2010	-2.5 to -2.5 [-2.5]	-5.3 to -5.2 [-5.3]	-1.5 to -1.5 [-1.5]
Fiscal 2010	+1.6 to +2.0 [+1.8]	+1.1 to +1.5 [+1.3]	-0.5 to -0.2 [-0.5]
Forecasts made in January 2010	+1.2 to +1.4 [+1.3]	-0.5 to -0.4 [-0.5]	-0.6 to -0.5 [-0.5]
Fiscal 2011	+2.0 to +2.2 [+2.0]	+0.5 to +0.8 [+0.7]	-0.1 to +0.2 [+0.1]
Forecasts made in January 2010	+1.7 to +2.4 [+2.1]	-0.5 to 0.0 [-0.4]	-0.3 to -0.1 [-0.2]

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

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. 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 real GDP figures for fiscal 2009 are Policy Board members' estimates. The figures for the domestic CGPI and the CPI (excluding fresh food) are actual values.

5. The CPI for fiscal 2010 excludes the effects of the introduction of subsidies for high school tuition fees, a factor that will substantially lower the year-on-year rate of change in the CPI for the year. This measure is estimated to lower the year-on-year rate of change in the CPI (excluding fresh food) by approximately 0.5 percentage points.

6. The range shown below includes the forecasts of all Policy Board members.

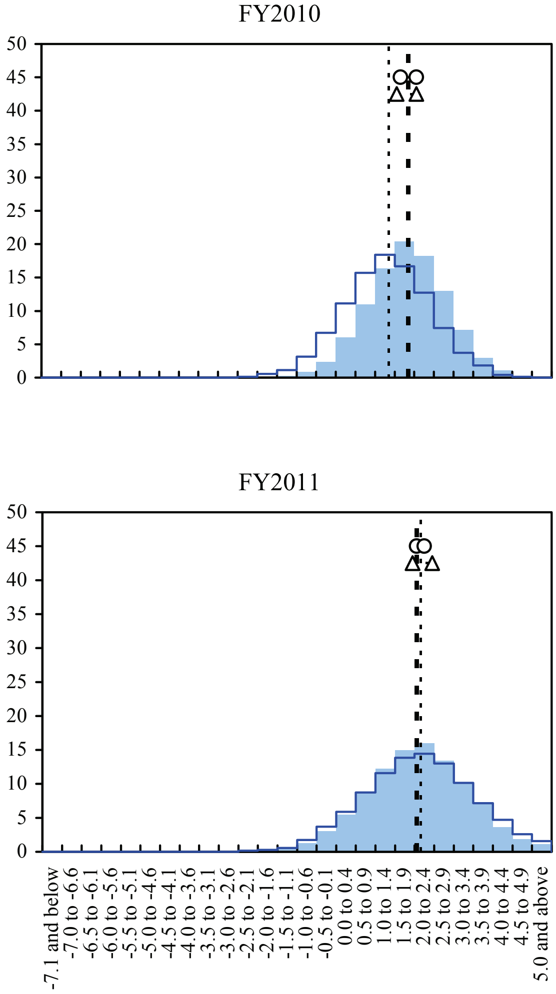
y/y % chg.

	Real GDP	Domestic CGPI	CPI (excluding fresh food)
Fiscal 2009	-2.2 to -2.0	-5.2	-1.6
Forecasts made in January 2010	-2.6 to -2.3	-5.5 to -5.0	-1.6 to -1.5
Fiscal 2010	+1.5 to +2.0	+1.0 to +1.6	-0.6 to -0.2
Forecasts made in January 2010	+1.0 to +1.5	-0.9 to -0.4	-0.7 to -0.4
Fiscal 2011	+1.9 to +2.4	+0.4 to +1.0	-0.1 to +0.3
Forecasts made in January 2010	+1.6 to +2.5	-0.5 to +0.2	-0.3 to 0.0

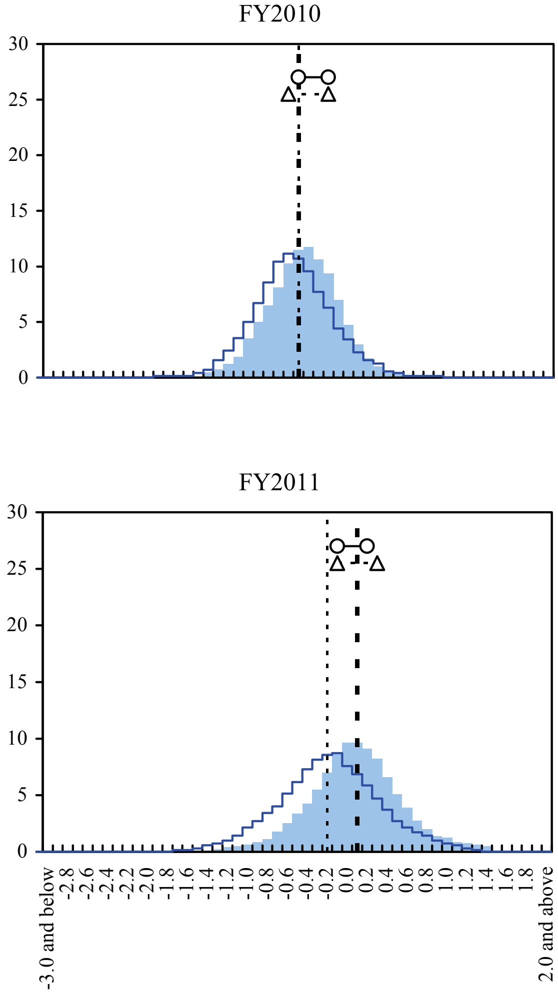
(Appendix 2)

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 2010, and solid lines represent those in January 2010.

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. △- - - -△ 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 2010.

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*.