October 27, 2011
Bank of Japan

Outlook for Economic Activity and Prices
(October 2011)

The Bank's View[1]

I. Introduction

This October 2011 issue of the *Outlook for Economic Activity and Prices* (Outlook Report) presents the outlook for Japan's economy through fiscal 2013. The Outlook Report first provides a description of developments in global financial markets and overseas economies that are affecting trends in Japan's economy, followed by the Bank of Japan's assessment of the nation's financial environment. Next, the scenario considered to be the most likely by the Bank -- its baseline scenario -- is described, and upside and downside risks associated with the scenario are examined. Lastly, a summary of the Bank's basic thinking on the conduct of monetary policy is provided.

II. Global Financial Markets and Overseas Economies

Strains in global financial markets have intensified since this summer, mainly reflecting concern about the sovereign debt problem in Europe. Although actions have been initiated recently to promote financial system stability, including ratification of the decision to increase the capacity and flexibility of the European Financial Stability Facility (EFSF) by 17 eurozone nations, financial market strains continue in light of remaining uncertainty about the implementation of such measures. The government bond yields have remained high in countries experiencing serious fiscal concern, such as Greece. Stock prices for European banks with significant exposure to the government bonds of concern have declined sharply, and short-term interest rates in the euro interbank markets have shown a distinct rise. The financial strains have started to affect the real economy through a tightening of financial institutions' lending attitude and a rise in lending rates, as well as a

[1] The text of "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on October 27, 2011.

decline in business and household sentiment. Furthermore, in countries with serious fiscal concerns, additional fiscal austerity measures have been a drag on the economy in the short run. As such, in Europe a negative feedback loop among fiscal balances, the financial system, and the real economy is now in effect and uncertainty concerning the outlook for financial developments and economic activity has become elevated. In the United States, concern over an economic slowdown has intensified as a series of softer-than-expected economic indicators were released, and uncertainty regarding market prospects increased due to the fiscal debt ceiling problem and the downgrading of the credit rating for U.S. government bonds.

In such an environment, global investors have increasingly become risk averse. Stock prices have continued to be highly volatile around the globe, and credit spreads such as those on corporate bonds have widened in the U.S. and European markets. International commodity prices have also declined on the whole. Correspondingly, demand for assets perceived as safe has increased. The yields on U.S. and German government bonds have declined to historical lows. In the foreign exchange market, on the perception that it is a relatively safe currency, the yen has appreciated, together with the U.S. dollar and Swiss franc, mainly against the currencies of emerging and commodity-exporting economies.

Looking at developments in overseas economies with the situation described above in mind, after continuing strong growth led by emerging and commodity-exporting economies, the pace of growth has moderated since the spring of 2011, especially in advanced economies. By region, the underlying pace of recovery in the U.S. economy has remained quite modest against the background of the prolonged adjustment in excessive household debt and the housing markets as well as slow recovery in employment, although the slowdown in the spring partly reflected temporary factors such as high gasoline prices and the effect of the earthquake in Japan. European economies -- especially Germany, where exports are flourishing -- continued to recover gradually on the whole, but the pace has clearly slowed as a result of an aggravated financial environment caused by the sovereign debt problem and a deterioration in business and household sentiment. On the other hand, emerging and commodity-exporting economies have generally continued to see relatively strong growth -- against the background in which the autonomous positive feedback loop among production, income, and expenditure has basically been maintained -- although the pace has moderated somewhat due to waning real purchasing power caused by inflation, the effect of monetary tightening, and a slowdown in advanced economies. Inflationary pressures have not been sufficiently contained in many emerging and commodity-exporting economies.

In the Bank's baseline scenario, the growth pace of overseas economies, especially that of advanced economies, is likely to remain slow for the time being against a backdrop of continued global financial market strains, but is expected to subsequently pick up led by emerging and commodity-exporting economies. Therefore, for the projection period on the whole, the growth rates of overseas economies are projected to be relatively high.[2] Looking at developments by country and region, the pace of growth in the U.S. economy is likely to remain modest despite the support from accommodative financial conditions reflecting the persistent strains from balance-sheet repair. In European economies, the effect of the sovereign debt problem will continue to weigh on economic activity for the time being, restraining economic recovery. Regarding emerging and commodity-exporting economies, as a gradual receding of inflationary pressure restores the real purchasing power of households, these economies are likely to achieve relatively strong growth, although some slowdown will continue in many economies for the time being. It should be noted, however, that the above projections are made based on the assumption that financial market shocks with possible significant impacts on economic activity are successfully avoided. Such an assumption is supported by the stance of policymakers, as the Group of 20 (G-20) communiqué of the Finance Ministers and Central Bank Governors meeting held in Paris in mid-October 2011 clearly states that they remain committed to taking all necessary actions to preserve the stability of banking systems and financial markets.

[2] According to the projections for global economic growth (calculated as the aggregate of purchasing-power-parity weighted GDP growth projections for individual countries or regions) released by the International Monetary Fund in September 2011, the growth rates, especially those for advanced economies, were revised downward from the projections made in June. The global economy, however, is still expected to grow by 4.0 percent both in 2011 and 2012, and accelerate by 4.5 percent in 2013. For reference, the average growth rate during the 30 years since 1980 was 3.3 percent.

III. Japan's Financial Environment

Japan's financial conditions have continued to ease as the Bank has pursued powerful monetary easing. Market interest rates, including longer-term ones, have remained at extremely low levels, and firms' funding costs have declined moderately. Issuing conditions for CP have remained favorable with the exception of a brief period after the quake. In the corporate bond market, new issuances temporarily paused in the face of some widening of credit spreads soon after the quake, but issuing conditions thereafter have remained favorable except for electric power companies, which face difficulties with new issuance due to uncertainty concerning their business environment. Firms have continued to view financial institutions' lending attitudes as being on an improving trend. The financial positions of firms have continued to recover after an increase in the number of firms, especially small and medium-sized ones, experiencing weakness after the quake. Despite some differences depending on the size of firms, financial institutions' lending attitudes and the financial positions of firms have been on an improving trend on the whole and have recovered to the same levels as the average for the period since 2000, or somewhat better than the average. As such, the financial environment surrounding firms has continued to ease. Looking at funding in the corporate sector, for bank lending the year-on-year rate of decline has been gradually slowing and the outstanding amount has almost recovered to the previous year's level recently. The amounts outstanding of both corporate bonds and CP have exceeded their prior-year levels.

In the global financial market turmoil, there are marked differences between the financial environment in Japan as described above and that in the United States and Europe. For example, the LIBOR-OIS spread -- a proxy for strains in the interbank market -- has continued to widen for the U.S. dollar and the euro since this summer but has remained stable for the yen. Credit spreads on corporate bonds have been widening noticeably in the U.S. and European markets but have remained stable at low levels in Japan, as described. One of the background items to such differences is the fact that Japan's financial institutions do not hold a large amount of government bonds issued by the European countries at the center of the sovereign debt problem. Second, the total amount of risks held by Japan's financial institutions is also generally restrained relative to their capital levels, which they have endeavored to strengthen. In fact, financial institutions' credit cost ratios and nonperforming-loan ratios have been low in comparison to those in the United States and Europe, and funding liquidity risk including that in foreign currency has been also restrained. Third, the corporate sector holds relatively ample on-hand liquidity and there are no signs of a rush for additional liquidity funding, even in the face of the disturbance in global financial and capital markets. Fourth, the Bank has also been contributing to the easing of financial conditions by providing massive liquidity and purchasing risk assets such as CP, corporate bonds, exchange-traded funds (ETFs), and Japanese real estate investment trusts (J-REITs) under the comprehensive monetary easing framework.

The easing trend in financial conditions will likely continue as the effects of the Bank's significant monetary easing spread further, and this is expected to support momentum toward a self-sustained recovery in domestic private demand. Stability in the financial environment will also be supported by the fact that Japan's financial system has gained reasonable robustness against a sharp economic downturn and a stock price plunge. Given the increasing global linkages of financial markets, however, Japan's financial environment is not immune from negative global developments. In practice, increasing risk aversion by global investors has been affecting Japan's financial markets in some areas since the summer, as evidenced by the yen's appreciation and stock price declines. It is necessary to maintain vigilance with regard to the possibility that further deterioration in global financial market conditions will affect Japan's financial system, and consequently the financial environment, through declines in stock and bond prices induced by the linkages between foreign and domestic financial markets as well as a deterioration in financial institutions' funding environment.[3]

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

A. Outlook for Economic Activity

On the basis of the aforementioned developments in overseas economies and the financial environment at home and abroad, the following examines the scenario for Japan's economy that the Bank considers to be the most likely -- that is, the baseline scenario.

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[3] For more details on the assessment of the financial system stability in Japan, see the October 2011 issue of the Bank's *Financial System Report*.

Japan's economic activity plunged after the Great East Japan Earthquake, mainly on the production and export side. Production activity declined sharply due to supply-side constraints caused by damage to production facilities and disruptions in supply chains, which resulted in a plunge in exports. Domestic private demand has also been weak, partly due to a deterioration in business and household sentiment that reflected uncertainty concerning the economic outlook and the effect of the nuclear power plant accident.

Many firms have made serious efforts and come up with various ideas to overcome the quake-induced difficulties. They have carried out production at alternative sites and secured alternative suppliers while restoring damaged facilities. The resolution of supply-side constraints has progressed at a faster pace than originally anticipated. There is still uncertainty regarding the supply and demand of electric power, which rests primarily on the prospect of resuming operation of nuclear power plants after regular inspections. Nevertheless, despite the initial pressing concern that a possible power shortage this summer might seriously constrain economic activity, such a situation was avoided thanks to electric power companies' emergency measures to strengthen supply capacity, as well as firms' and households' efforts to conserve electricity and level out demand. As a result, production and exports have already been restored to the level registered before the quake-induced plunge.[4] Domestic private demand such as business fixed investment and private consumption has been also picking up on improvement in business and household sentiment.

As described above, during the period between the time of the quake until this summer, the pace of economic recovery had been determined by the pace of resolving supply-side constraints. However, as the supply-side constraints imposed by the disaster have now almost been resolved, the demand-side developments have become increasingly important. With this point in mind, the economic outlook for Japan can be described as follows.

[4] After the revision to seasonal adjustments reflecting unusually large fluctuations following the Lehman shock, the published industrial production index is considered to have some bias, showing higher growth rates for the October-December and January-March quarters and lower rates for the April-June and July-September quarters. Therefore, the actual level of production in the July-September quarter is considered to be higher than as read in the statistics.

Although an adverse effect from a slowdown in overseas economies and the appreciation of the yen will continue for the time being, Japan's economy is expected to return to a moderate recovery path because the pace of recovery in overseas economies will subsequently pick up and the demand related to reconstruction after the earthquake disaster will gradually materialize. In the second half of fiscal 2011, a slowdown in overseas economies and the appreciation of the yen will have an adverse effect on the economy, especially on the export and production front, while reconstruction-related demand associated with the restoration of capital stock will gradually materialize in a variety of channels, such as public investment, business fixed investment, housing investment, and consumption of durable consumer goods. In fiscal 2012, as the growth rates of overseas economies gradually pick up, Japan's economy is projected to register a relatively high rate of growth supported by the transmission mechanism by which the strength in exports and production feeds through into income and spending. In addition, the support from reconstruction-related demand is likely to continue throughout the fiscal year. In fiscal 2013, the economy is expected to grow at a pace above its potential, led by robust demand from overseas economies, especially emerging and commodity-exporting economies, although the growth rate is expected to be lower than that in fiscal 2012 because the contribution from reconstruction-related demand will gradually diminish.[5] The growth rates for fiscal 2011 and 2012 are expected to be somewhat lower than the projection in the July 2011 interim assessment because of the effects of a slowdown in overseas economies and the appreciation of the yen. Somewhat detailed explanations of the outlook broken down by the corporate and household sectors are as follows.

Regarding the corporate sector, exports and production are expected to continue increasing against a background of robust demand from overseas, especially emerging and commodity-exporting economies. For the time being, although a slowdown in overseas economies and the appreciation of the yen will continue to be a drag, exports and production are most likely to remain on an increasing trend because manufacturers -- automakers in particular -- will restore the level of inventory abroad, which sharply

[5] Japan's potential growth rate during the projection period is estimated to be "around 0.5 percent" based on a standard production function approach. However, estimates of the potential growth rate are subject to a considerable margin of error as they greatly depend on the specific methodology employed and could change as more data for the relevant period become available.

declined after the earthquake, and work off an accumulated backlog of domestic orders. Demand related to reconstruction after the earthquake is also expected to increase gradually from both the private sector, including fixed investment and housing investment, and the public sector. Against this background, corporate profits are expected to continue recovering gradually. As evident in firms' annual business plans, business fixed investment is also likely to keep increasing gradually against the background of a recovery in corporate profits and global and domestic demand.[6] In this regard, partly as a result of the yen's appreciation, firms are expected to strengthen their investment overseas. Although this has substituted for investment in Japan to some extent in the past, an expansion of overseas investment has often been pursued as a strategic move by firms to capture rising local demand overseas more effectively. At the same time, firms have made efforts to differentiate the role of domestic offices and factories from that of overseas production sites by shifting to more value-added activities. As for the outlook, although due attention needs to be paid to the possibility that domestic fixed investment and employment will be affected by a rapid shift of companies to overseas, the basic expectation is that overseas investment and domestic investment will increase by complementing each other. In addition, domestic business fixed investment will likely be supported by various needs arising from the earthquake such as repair and rebuilding of damaged facilities, as well as strengthening of their capacity for resistance to earthquakes and work to develop business continuity, including data backups.

As for the employment and income environment surrounding the household sector, despite a plunge in economic activity, a significant employment adjustment was avoided partly due to the relaxation of conditions for receiving employment adjustment subsidies. Working hours were also shortened after the plunge but have been recovering, especially in the manufacturing sector, with the recovery in economic activity led by production. Wage developments have been somewhat weak against a backdrop of deterioration in corporate profits due to the earthquake. Summer bonuses showed negative year-on-year growth, especially at small and medium-sized firms. As for the outlook, recovery in economic

[6] According to the September 2011 *Tankan* (Short-Term Economic Survey of Enterprises in Japan), the domestic business fixed investment plan for fiscal 2011 is expected to exceed the previous year's level as it has been revised upward for the second half of fiscal 2011.

activity will gradually spread to the employment and income environment. In consideration of the time lag, however, an increasing trend in employment and wages will become evident only in fiscal 2012 and thereafter. In such an employment and income environment, private consumption weakened due to an economic plunge and deterioration in sentiment caused by the earthquake, but has been recovering on the whole. With regard to the outlook, private consumption is expected to gradually become more firm against a backdrop of gradual recovery in the employment and income environment. In the meantime, backed by low interest rates and a rise in the demand related to reconstruction, housing investment will likely continue increasing moderately throughout the projection period.

B. Outlook for Prices

Based on the above projections for economic activity, the following examines the outlook for price developments. Looking at the underlying trend of the consumer price index (CPI) for all items less fresh food, the year-on-year rate of decline has continued to slow consistently since around the end of 2009 with a gradual improvement in the aggregate supply and demand balance, and is currently at around 0 percent.[7]

Regarding the outlook for the environment surrounding prices, the state of utilization of employment and production capacity, which reflects the aggregate supply and demand balance of goods and services, is expected to continue improving gradually with the economy's moderate recovery trend. According to the survey targeted at households and firms and at economists, medium- to long-term inflation expectations have not significantly changed so far and are expected to remain stable throughout the projection period. According to the surveys of market participants and economists, the expected rate of inflation in the medium to long term has been stable in recent years, at around 1.0 percent,

[7] In August, the base year of the CPI was changed to 2010 and year-on-year rates of change for all items less fresh food as far back as January 2011 were revised retroactively. Taking the average for the period from January to July 2011, the year-on-year rate of change in the CPI for all items less fresh food was revised downward by about 0.6 percentage point. The downward revision was mainly due to resetting of the index levels for durable consumer goods, which had significantly declined on the 2005 base. As a result of the resetting, a decline in the prices of those goods on the total CPI index has a larger impact.

and has not changed notably even after the downward revision of the CPI due to the base-year change. International commodity prices, which recently softened reflecting the global economic slowdown, are expected to increase moderately over the relatively long term led by food and energy prices. Such an increase is backed by the continued high growth in emerging economies that seek vigorously to raise their basic living standards in terms of housing, food, and clothing.

As for the outlook for prices on the basis of the aforementioned environment, the domestic corporate goods price index (CGPI) is expected to continue rising moderately on an annual basis throughout the projection period, reflecting a moderate increase in international commodity prices and the improvement in the aggregate supply and demand balance. With such an improvement in the balance and stable medium- to long-term inflation expectations, the year-on-year rate of change in the CPI will remain at around 0 percent for the time being but will gradually rise to around 0.5 percent toward the latter half of the projection period.

V. Upside and Downside Risks

A. Risks to Economic Activity

The aforementioned outlook is the scenario the Bank considers to be the most likely, in other words, its baseline scenario. The following upside and downside risks concerning the outlook for economic activity warrant attention.

The first risk concerns developments in global financial markets, especially those related to the sovereign debt problem in Europe. Given high uncertainty regarding the possible outcome of the sovereign debt problem in Europe, including its impact on the global economy, there is a possibility that global investors' risk-averse behavior will further intensify in financial and foreign exchange markets. If this results in further appreciation of the yen and a stock price fall, such events could cause Japan's growth outlook to deviate downward partly through a deterioration in business and household sentiment. Furthermore, given that a rise in the outstanding amount of sovereign debt not only in peripheral European countries but also in many of the advanced economies has been a source of instability in global financial markets, there is a possibility that financial markets will find the fiscal restructuring efforts in Japan to be insufficient. If this were to happen, it could have an adverse impact on economic activity through a rise in long-term interest rates and a fall in stock prices.

The second risk, which is related to the first one, concerns uncertainty about developments in overseas economies. Looking at advanced economies, balance-sheet repair has continued to be a drag on U.S. economic growth, making it difficult to gain upward momentum and creating vulnerability to downside risks. Against the background of the continuing slump in housing prices, the slow pace of recovery in employment, and the limited room for further monetary and fiscal stimulus, due attention is warranted to the risk that the slowdown in the U.S. economy will be prolonged beyond the expectation. As for European economies, due attention needs to be paid to the possibility that a negative feedback loop among fiscal balances, the financial system, and the real economy will intensify, triggered by the sovereign debt problem. In many emerging and commodity-exporting economies, there remains a high degree of uncertainty about whether price stability and economic growth can be realized at the same time. If inflationary pressure persists despite monetary tightening, downside risk to the growth outlook warrants attention.

With regard to the outlook for global financial markets and overseas economies, there is also a possibility that further progress being made in initiatives to tackle the aforementioned problems in Europe -- such as fiscal reconstruction, and measures to restore financial system stability and structural reforms -- will result in a receding of global investors' risk aversion and a decrease in uncertainty concerning the global economic outlook. In such a case, the global economy, and consequently Japan's economy, could achieve stronger growth through improvement in business and household sentiment.

Third, there is uncertainty with regard to the demand related to reconstruction after the earthquake disaster. In disaster areas, replacement demand for damaged durable consumer goods such as autos and home appliances has already seen somewhat of an increase. Various activities aiming at reconstruction are ongoing, including removal of debris and construction of temporary housing. However, the restoration of capital stock such as infrastructure, business facilities, and housing has been carried out only on a limited scale both in the public and private sectors.

These kinds of reconstruction-related demand are expected to gradually expand into a full-scale operation as reconstruction plans, including a long-term vision for the recreation of local communities, become more concrete and the supplementary budget is executed. However, it is still necessary to allow for a wide margin when projecting the scale and timing of reconstruction-related demand, as well as its impact on economic activity, because these depend on several factors including how quickly the reconstruction plan will become more concrete and whether the long-term vision of regional economies can be developed to enable a virtuous cycle of private demand work.

Fourth, there is uncertainty with regard to firms' and households' medium- to long-term growth expectations. Although these are expected to be maintained in a baseline scenario, possible changes warrant due attention. Japan's economy, which had already faced a declining trend in growth rates partly reflecting a rapid aging of its society, was confronted with additional challenges by the earthquake such as uncertainty regarding the supply and demand of electric power and steady progress in reconstruction. If it should therefore turn out to be difficult to overcome such challenges or further yen appreciation continues to suppress corporate profits as well as the employment and income environment -- or if new domestic production activity does not emerge to compensate for a shift of production to overseas -- then firms' and households' medium- to long-term growth expectations will decline and the growth outlook for the projection period is more likely to worsen.

On the other hand, if firms strengthen their capacity to explore global demand by expanding their business abroad, including that through mergers and acquisitions, and strengthen their capacity to create new goods and services that are highly original and more immune to price competition in domestic markets, medium- to long-term growth expectations could rise despite a rapidly aging population. If revitalization of local economies progresses on the back of reconstruction following the earthquake, or if prospects for achieving sustainability in the fiscal situation and social security system improve, then such positive effects could boost the medium- to long-term growth expectations. Efforts to address the challenge regarding the supply and demand of electric power may contribute to enhancing potential growth capacity through technological innovation and development of new business models.

B. Risks to Prices

There is also uncertainty regarding the outlook for prices, which could deviate either upward or downward from the projection. To begin with, if any of the aforementioned upside and downside risks to economic activity materialize, prices might be affected accordingly. There are also the following risks specific to prices. The first concerns firms' and households' medium- to long-term inflation expectations. Even in the case where economic activity follows the baseline scenario, it takes time before positive inflation is firmly established. In such an environment, there is a possibility that firms and households will have increased expectations that prices are unlikely to rise even in the medium to long term. If medium- to long-term inflation expectations decline, it becomes more likely that actual prices and wages will deviate downward from the projection.

The second risk concerns developments in import prices. Considerable uncertainty surrounds developments in primary commodities such as crude oil, with potential for movement in either direction. Global demand for foods and energy will increase on the back of strong growth in emerging economies that seek vigorously to raise their basic living standards in terms of housing, food, and clothing, while supply capacity for such primary products has limited room for further expansion, at least in the short run. Given such a supply and demand structure for primary commodities, an upward revision in the growth outlook for emerging economies could result in a sharp rise in international commodity prices. On the other hand, if downside risks to the global economic outlook materialize, intensified risk aversion by global investors could trigger an accelerated decline in international commodity prices. In addition, fluctuations in foreign exchange rates could also affect consumer prices to a certain extent directly through changes in import prices and indirectly through changes in economic activity.

VI. Conduct of Monetary Policy

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" (hereafter "understanding") -- that is, the level of inflation that each Policy Board member understands, when conducting monetary policy, as being consistent with price stability over the medium to long term. The current "understanding" shows that "on the basis of a year-on-year rate of change in the CPI, it falls in a positive range of 2 percent or lower, centering around 1 percent."

The first perspective involves assessing the baseline scenario of the outlook for economic activity and prices -- that is, the scenario considered to be the most likely -- through fiscal 2013. As noted earlier, although an adverse effect from a slowdown in overseas economies and the yen's appreciation will continue for the time being, Japan's economy is expected to return to a moderate recovery path because overseas economies will maintain relatively high growth, led by emerging and commodity-exporting economies, during the projection period on the whole, and the demand related to reconstruction after the earthquake disaster will gradually materialize. As for prices, the year-on-year rate of decline in the CPI has continued to slow consistently since around the end of 2009 and is currently at around 0 percent. Based on the projection taking into account the recent price developments as described above, with the improvement in the aggregate supply and demand balance and stable medium- to long-term inflation expectations, the year-on-year rate of change in the CPI will remain at around 0 percent for the time being but will gradually rise to around 0.5 percent toward the latter half of the projection period. Comprehensively assessing the outlook for economic activity and prices described above, the Bank expects that, although some more time will be needed to confirm that price stability is in sight on the basis of the "understanding," Japan's economy will eventually return to a sustainable growth path with price stability in the longer run.

The assessment from the second perspective examines the risks considered most relevant to the conduct of monetary policy, including risks that have a longer time horizon than the first perspective.[8] In the area of economic activity, the effect of balance-sheet repair on the U.S. economy still warrants attention. With regard to the sovereign debt problem in Europe, due attention needs to be paid to the possibility that a negative feedback loop among fiscal balances, the financial system, and the real economy will intensify. As for emerging and commodity-exporting economies, there remains a high degree of uncertainty about whether price stability and economic growth can be realized at the same time. There is a need to carefully examine how Japan's economy will be affected by the uncertainties regarding developments in overseas economies and ensuing disturbances in financial and foreign exchange markets. On the price front, considerable uncertainty surrounds the outlook for international commodity prices with potential for movement in either direction. There is also a risk that inflation rates will deviate downward from the projection as a result of a decline in medium- to long-term inflation expectations.

The Bank has been pursuing its comprehensive monetary easing policy introduced in October 2010 mainly through the purchase of financial assets under the Asset Purchase Program, which has been repeatedly expanded in size on a significant scale. In addition, the Bank has made it clear that it will continue the virtually zero interest policy until it judges that price stability is in sight on the basis of the "understanding," on condition that no problem is identified in examining risk factors, including the accumulation of financial imbalances.

As for the future conduct of monetary policy, the Bank -- in order for Japan's economy to overcome deflation and return to a sustainable growth path with price stability, and based on the examination from the two perspectives described above -- will continue to consistently make its utmost contributions as the central bank through the three-pronged approach of pursuing powerful monetary easing consisting of comprehensive monetary easing, ensuring financial market stability, and providing support to strengthen the foundations for economic growth.

Japan's economy faces not only a short-term and cyclical problem of recovery from a

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[8] For example, the Bank examines risk factors that will significantly impact economic activity and prices when they materialize, although the probability of such risks arising is low.

plunge in demand after the Lehman shock. More fundamentally, a long-term and structural problem -- namely, a decline in medium- to long-term growth expectations -- is of greater significance. Japan has confronted the fundamental challenge of a declining trend in growth rates reflecting a rapidly aging society and stagnant growth in labor productivity. In addition, Japan's economy faces a new challenge of reconstruction after the earthquake disaster. With the highest government debt level in terms of GDP among advanced countries, Japan also needs to present a clear medium-term roadmap for fiscal restructuring in order to maintain market participants' confidence. In order to respond to these challenges and form the basis for future economic development, it is important for the government, the central bank, financial institutions, and business firms to continue making efforts in their respective roles to strengthen sustainable economic potential in the medium to long term, with a correct understanding of the aforementioned situation of the economy.

(Appendix 1)

Forecasts of the Majority of Policy Board Members

y/y % chg.

	Real GDP	Domestic CGPI	CPI (all items less fresh food)
Fiscal 2011	+0.2 to +0.4 [+0.3]	+1.7 to +2.0 [+1.8]	0.0 to 0.0 [0.0]
Forecasts made in July 2011	+0.2 to +0.6 [+0.4]	+2.2 to +2.5 [+2.4]	+0.6 to +0.8 [+0.7]
Fiscal 2012	+2.1 to +2.4 [+2.2]	+0.1 to +0.3 [+0.2]	0.0 to +0.2 [+0.1]
Forecasts made in July 2011	+2.5 to +3.0 [+2.9]	+0.5 to +0.9 [+0.6]	+0.6 to +0.7 [+0.7]
Fiscal 2013	+1.3 to +1.6 [+1.5]	+0.7 to +0.9 [+0.8]	+0.4 to +0.6 [+0.5]

Notes: 1. Figures in brackets indicate the median 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 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 base year for the CPI was changed from 2005 to 2010. Revisions from the previous CPI forecast largely reflect this base-year change.

5. CPI using the Chain-weighted Index Formula has also been released as a reference. Based on this chain-weighted index, the year-on-year rate of change in the CPI around fiscal 2013 may be slightly lower than the above forecasts based on the Fix-weighted Index Formula.

6. The ranges shown below include the forecasts of all Policy Board members.

y/y % chg.

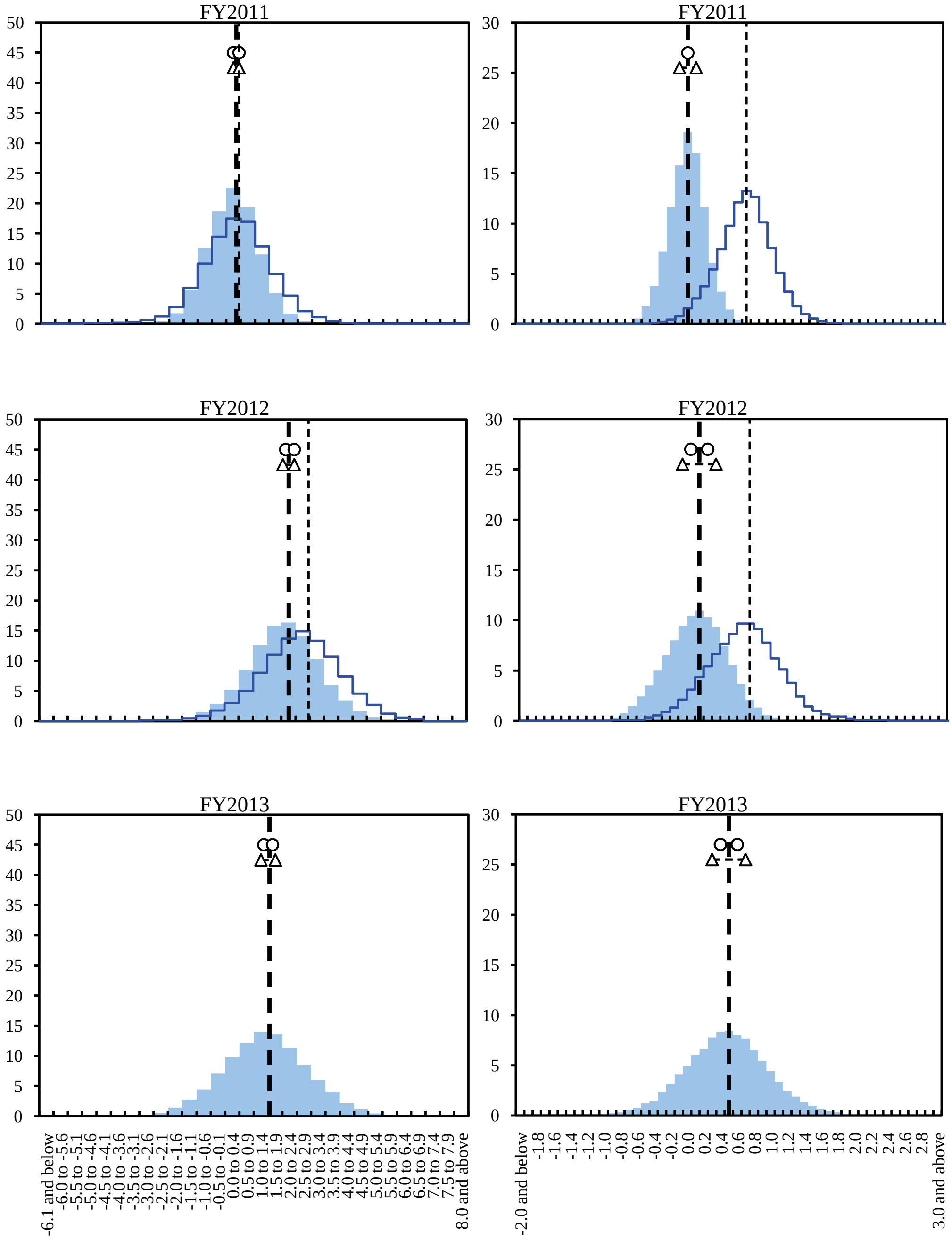
	Real GDP	Domestic CGPI	CPI (all items less fresh food)
Fiscal 2011	+0.2 to +0.4	+1.7 to +2.1	-0.1 to +0.1
Forecasts made in July 2011	+0.2 to +0.6	+2.2 to +2.6	+0.5 to +0.8
Fiscal 2012	+2.0 to +2.4	+0.1 to +0.4	-0.1 to +0.3
Forecasts made in July 2011	+2.5 to +3.0	+0.3 to +1.0	+0.4 to +0.8
Fiscal 2013	+1.2 to +1.7	+0.6 to +1.0	+0.3 to +0.7

(Appendix 2)

Risk Balance Charts

(1) Real GDP

(2) CPI (All Items Less 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 2011, and solid lines represent those in July 2011.

2. Vertical dashed heavy lines indicate the median of the Policy Board members' forecasts (point estimates). O——O 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 2011.

4. The base year for the CPI was changed from 2005 to 2010. Revisions from the previous CPI forecast largely reflect this base-year change.

5. 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.*