April 30, 2014
Bank of Japan

Outlook for Economic Activity and Prices (April 2014)

The Bank's View[1]

Summary

- From fiscal 2014 through fiscal 2016, Japan's economy is likely to continue growing at a pace above its potential as a trend, while it will be affected by the front-loaded increase and subsequent decline in demand prior to and after the two rounds of consumption tax hikes.
- The year-on-year rate of increase in the consumer price index (CPI, for all items less fresh food and excluding the direct effects of the consumption tax hikes) is likely to be around 1¼ percent for some time, follow a rising trend again from the second half of this fiscal year, and reach around 2 percent around the middle of the projection period. Thereafter, Japan's economy is expected to gradually shift to a growth path that sustains such inflation in a stable manner.
- Comparing the current projections with the previous ones, while the growth rate for fiscal 2014 is somewhat lower, due mainly to a delay in export recovery, the projected rates of increase in prices are more or less unchanged as (1) continued firm domestic demand, which tends to have large stimulative effects on employment, has tightened labor supply and demand conditions, and this situation is expected to be reinforced, and (2) a rise in medium- to long-term inflation expectations seems to have started to influence actual wage and price settings.
- In the context of the price stability target, the Bank of Japan examined the aforementioned baseline scenario (the first perspective) and upside and downside risks to the baseline scenario (the second perspective).[2] As for the conduct of monetary policy, quantitative and qualitative monetary easing (QQE) has been exerting its intended effects. The Bank will continue with the QQE, aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner. It will examine both upside and downside risks to economic activity and prices, and make adjustments as appropriate.

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[1] The text of "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on April 30, 2014.

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

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

A. Outlook for Economic Activity

Japan's economy has continued to recover moderately as a trend, albeit with some fluctuations due to the consumption tax hike. While exports have been somewhat weak, as domestic demand has been firm, a virtuous cycle of economic activity has been operating steadily. As domestic demand tends to have large stimulative effects on employment, the tightening trend in labor supply and demand conditions is becoming more apparent, as largely envisioned, despite a downward revision in the growth rate in fiscal 2013.

Looking ahead, as domestic demand is likely to maintain firmness and exports are expected to increase, albeit moderately, a virtuous cycle among production, income, and spending is likely to be maintained. Therefore, the economy is likely to continue growing at a pace above its potential as a trend, while it will be affected by the front-loaded increase and subsequent decline in demand prior to and after the two rounds of consumption tax hikes.[3]

The above projection assumes the following underlying developments.

First, as the Bank of Japan steadily pursues the QQE, financial conditions are likely to become more accommodative.[4] Namely, under the QQE, upward pressure on nominal long-term interest rates has been contained while inflation expectations have been rising on the whole, and thus real interest rates have continued to decline. The amount outstanding of bank lending has been increasing moderately. Stimulative effects of such

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[3] Japan's potential growth rate -- under a certain methodology -- is estimated to be "around 0.5 percent" recently, and is expected to rise gradually toward the end of the projection period. However, it should be noted that estimates of the potential growth rate are subject to a considerable margin of error as they rely on the specific methodology employed and could change as more data for the relevant period become available.

[4] Individual Policy Board members make their forecasts assuming the effects of past policy decisions and with reference to views incorporated in financial markets regarding future policy. Specifically, markets have factored in that short-term interest rates will continue to be effectively 0 percent throughout the projection period. While markets have been forecasting that long-term interest rates will hover at low levels throughout the projection period, this reflects the fact that market participants' forecasts for prices are lower than those presented in the *Outlook for Economic Activity and Prices* (Outlook Report). Each Policy Board member assumes the future path of long-term interest rates based on such market views, taking into account the difference in the forecasts for prices.

accommodative financial conditions on private demand are likely to strengthen as economic activity improves.

Second, overseas economies are expected to moderately increase their growth rates as advanced economies continue to see firm recovery and its positive effects gradually spread to emerging economies. Looking at major countries and regions, the U.S. economy is expected to gradually accelerate its pace of recovery, as the fiscal drag will fade and an improvement in the employment and income situation will become evident. While adjustment pressure associated with the European debt problem is likely to remain, the European economy is expected to move from a pick-up to a moderate recovery, supported mainly by an improvement in households' and firms' sentiment. The Chinese economy is likely to continue to see stable growth, albeit at a slightly slower pace, as authorities carry out policy measures to support economic activity while progressing with structural reforms. Meanwhile, other emerging and commodity-exporting economies will likely continue to lack growth momentum for the time being, but they are expected to gradually increase their growth rates due to positive effects of recovery in advanced economies, on the assumption that global financial markets remain generally stable.

Third, public investment is expected to continue hovering at a high level through the first half of fiscal 2014, reflecting a boost from economic stimulus, and thereafter gradually turn to a moderate downtrend.

Fourth, firms' and households' medium- to long-term growth expectations are expected to rise moderately, against the backdrop of progress in the government's growth strategy, including regulatory and institutional reforms, an increase in labor participation by women and the elderly under such strategy, and firms' initiatives toward improving productivity and their tapping of potential domestic and external demand.

Given these assumptions, to elaborate on economic activity during the projection period, <u>in fiscal 2014</u>, the growth rate for the April-June quarter is expected to temporarily decline, mainly in private consumption, including durable goods, due to effects of the subsequent decline in demand following the front-loaded increase prior to the consumption tax hike.[5] However, private consumption is expected to maintain its resilience as a trend, underpinned by an improvement in the employment and income situation. Therefore, the effects of the subsequent decline in demand following the front-loaded increase prior to the consumption tax hike will likely dissipate from summer. In the meantime, exports are expected to start increasing, albeit moderately, as the growth rates of advanced economies will likely increase while temporary downside factors that dragged down exports -- seen at the end of fiscal 2013 -- diminish. These factors include (1) firms' stance of placing priority on domestic shipments in response to the front-loaded increase in demand and (2) the unusually severe winter weather in the United States. Business fixed investment is also expected to follow a moderate uptrend due mainly to an improvement in corporate profits, a rise in the capacity utilization rate, and effects of monetary easing. Owing to these developments in domestic and external demand, the economy is expected to return to a growth path that is above its potential from summer.

As for fiscal 2015 through fiscal 2016, a virtuous cycle of economic activity will be maintained -- supported by (1) a firm increase in domestic private demand reflecting accommodative financial conditions and heightened growth expectations, as well as (2) an increase in exports due to an improvement in overseas economies -- and the economy is expected to continue growing at a pace above its potential, while fluctuations in demand stemming from the scheduled second consumption tax hike are anticipated. Comparing the current projection for growth rates up through fiscal 2015 with that in the January 2014 interim assessment, while the growth rate for fiscal 2014 is somewhat lower, that for fiscal 2015 is more or less unchanged.

[5] The effects of the two rounds of consumption tax hikes on the economic growth rate for each fiscal year are quantitatively estimated as follows: an increase of around 0.3 percentage point for fiscal 2013, a decrease of around 0.7 percentage point for fiscal 2014, an increase of around 0.2 percentage point for fiscal 2015, and about 0 percentage point for fiscal 2016. However, it should be noted that these estimates are subject to considerable uncertainty given that they depend partly on income conditions and price developments at each point in time, and therefore are subject to a considerable margin of error.

B. Outlook for Prices

The year-on-year rate of increase in the CPI (for all items less fresh food, and the same hereafter) has been expanding, and recently has been around 1¼ percent.

Examining major factors that determine inflation rates into the future, first, the aggregate supply and demand balance (output gap, and the same hereafter), which shows the utilization of labor and capital, has been improving mainly on the labor front, reflecting firm domestic demand, which tends to have large stimulative effects on employment.[6] It appears to have reached around the past long-term average of about 0 percent. Specifically, the tightening trend in the labor supply and demand conditions is steadily becoming more apparent, with the unemployment rate gradually approaching a structural unemployment rate that is deemed to be around 3.5 percent, and a sense of capital shortage has been strengthening, mainly in the nonmanufacturing sector.[7] As for the outlook, accompanied by some swings due to effects of the consumption tax hikes, a trend in which the output gap will be positive (in excess demand) is likely to take root in the second half of fiscal 2014, and thereafter the gap is expected to move further into excess demand territory. In this situation, upward pressure on wages and prices due to the tightening of supply and demand conditions is likely to steadily increase.

Second, medium- to long-term inflation expectations appear to have been rising on the whole, and such developments seem to have started to influence actual wage and price settings. For example, a rise in the inflation rate has been taken into account in the recent labor-management wage negotiations. In addition, a shift in firms' price-setting strategy,

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[6] There are two approaches to estimating the output gap: (a) estimate potential GDP and then measure its difference with actual GDP, and (b) directly measure the utilization of production factors (labor and capital). As the output gap in the Outlook Report has been estimated based on the latter approach, changes in the GDP growth rate do not have a one-to-one relationship with the expansion/narrowing of the output gap. It should be noted that estimates of the output gap could differ depending on the specific methodology employed and data used, and therefore they are subject to a considerable margin of error.

[7] In the labor market, there is always a mismatch to some extent between job openings and job applicants, and thus there is a certain number of unemployed even when the economy is booming. Given that there is such unemployment due to the mismatch, the unemployment rate that corresponds to a state in which excess labor force has disappeared is called the *structural unemployment rate*.

from a low-price strategy to one of raising sales prices while increasing value-added, has started to be seen. Looking ahead, as the Bank pursues the QQE and the observed inflation rate rises above 1 percent, medium- to long-term inflation expectations are likely to follow an increasing trend and gradually converge to around 2 percent -- the price stability target.

Third, as for import prices, upward pressure mainly from energy prices is likely to wane through around summer, reflecting developments in international commodity prices and foreign exchange rates.

Based on the above, the outlook for the year-on-year rate of increase in the CPI (excluding the direct effects of the consumption tax hikes) is as follows.[8] It is likely to be around 1¼ percent for some time, follow a rising trend again from the second half of this fiscal year, and reach around 2 percent -- the price stability target -- around the middle of the projection period. Thereafter, the year-on-year rate of increase in the CPI is likely to edge up as medium- to long-term inflation expectations will converge to around 2 percent and the output gap is expected to continue expanding in positive territory. Comparing the current projection up through fiscal 2015 with that in the January 2014 interim assessment, the projected rates of increase in the CPI are more or less unchanged.

II. Upside and Downside Risks

A. Risks to Economic Activity

The following are upside and downside risks to the Bank's aforementioned baseline scenario regarding the economy. First, there is uncertainty regarding developments in exports. While, basically, the recent weakness in exports has been due mainly to the sluggishness in emerging economies including ASEAN economies that have strong ties with Japan's economy, it is likely that effects of structural factors such as a spreading of the shift of Japanese manufacturers' production sites to overseas have also played a certain role.

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[8] The effects of the two rounds of consumption tax hikes on prices can be mechanically estimated by assuming that the rise in the consumption taxes will be fully passed on for all currently taxable items. On this basis, the year-on-year rate of increase in the CPI will be pushed up by 2.0 percentage points in fiscal 2014 and 1.3 percentage points in the second half of fiscal 2015 and the first half of fiscal 2016.

Therefore, depending on future developments in overseas economies -- such as in emerging economies, the prospects for the European debt problem, and the pace of recovery in the U.S. economy -- as well as the situation for Japanese firms' production share at home and abroad, exports may either deviate upward or downward.

The second risk is the effects of the consumption tax hikes. Consumption tax is an indirect tax that is imposed broadly on consumption in general, and the hikes will have adverse effects on households' real disposable income. However, forces to mitigate adverse effects on consumption to some extent could be at work, partly because (1) various economic measures are taken by the government, (2) the tax hikes seem to have already been factored in substantially among households, and (3) the rate hikes are expected to have the effect of alleviating households' future concerns over the fiscal condition and the social security system. Attention should be paid to the effects of consumption tax hikes on household spending as they may differ depending on consumer sentiment, the employment and income situation, and developments in prices at each point in time.

Third, firms' and households' medium- to long-term growth expectations may be either raised or lowered depending on future developments in regulatory and institutional reforms, innovation in the corporate sector, and the employment and income situation surrounding the household sector.

Fourth, in the event that confidence in fiscal sustainability in the medium to long term declines, the economy may deviate downward from the baseline scenario through increases in people's concerns regarding the future and rises in long-term interest rates that are unwarranted by economic fundamental conditions. On the other hand, there is also a possibility that the economy will deviate upward from the baseline scenario if confidence in the path toward fiscal consolidation strengthens and people's concerns regarding the future are alleviated.

B. Risks to Prices

In case the aforementioned upside and downside risks to the economy materialize, it is likely that prices will also be affected to a certain degree. Other factors that could exert upside and downside risks to prices are as follows. The first concerns developments in firms' and households' medium- to long-term inflation expectations. While the baseline scenario assumes that, amid a rise in observed price and wage inflation, people's inflation expectations will rise further, attention should be paid to the pace at which they will rise. Furthermore, effects on people's expectations of price increases in a wide range of items associated with the consumption tax hikes warrant attention.

The second concerns developments in the output gap, particularly in labor supply and demand conditions. The baseline scenario assumes that, on the labor supply side, the recent increase in labor participation by the elderly and women will continue to some extent going forward, but uncertainty is associated with this assumption. In addition, even with the same economic growth rate, the degree of labor shortage in the economy as a whole may change depending on the balance between manufacturing and nonmanufacturing, for which the extent of labor intensity differs.

The third regards the responsiveness of inflation to the output gap. Attention needs to be paid to what extent firms will raise prices and wages as the output gap tightens.

Fourth, depending on developments in import prices, reflecting fluctuations in international commodity prices and foreign exchange rates, prices may either deviate upward or downward.

III. Conduct of Monetary Policy

In the context of the price stability target, the Bank assesses the aforementioned economic and price situation from two perspectives and then outlines its thinking on the future conduct of monetary policy.

The first perspective concerns an examination of the baseline scenario for the outlook. Japan's economy is judged as likely to achieve around 2 percent inflation around the middle of the projection period, and thereafter gradually shift to a growth path that sustains such inflation in a stable manner.

The second perspective involves an examination of the risks considered most relevant to the conduct of monetary policy. With regard to the baseline scenario for economic activity, upside and downside risks can be assessed as being balanced, although uncertainty remains high, including that regarding developments in exports. Risks on the price front also can be assessed as being largely balanced, although considerable uncertainty surrounds developments, mainly in medium- to long-term inflation expectations. Examining financial imbalances from a longer-term perspective, there is no sign at this point of excessively bullish expectations in asset markets or in the activities of financial institutions.[9] Nevertheless, in a situation where the amount outstanding of government debt has shown a cumulative increase, due attention needs to be paid to the fact that financial institutions' holdings of government bonds have remained at an elevated level, although they recently have been declining.

As for the conduct of monetary policy, the QQE has been exerting its intended effects. The Bank will continue with the QQE, aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner. It will examine both upside and downside risks to economic activity and prices, and make adjustments as appropriate.

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[9] For more details, see the April 2014 issue of the Bank's *Financial System Report*.

(Appendix)

Forecasts of the Majority of Policy Board Members

y/y % chg.

	Real GDP	CPI (all items less fresh food)	Excluding the effects of the consumption tax hikes
Fiscal 2013	+2.2 to +2.3 [+2.2]	+0.8	
Forecasts made in January 2014	+2.5 to +2.9 [+2.7]	+0.7 to +0.9 [+0.7]	
Fiscal 2014	+0.8 to +1.3 [+1.1]	+3.0 to +3.5 [+3.3]	+1.0 to +1.5 [+1.3]
Forecasts made in January 2014	+0.9 to +1.5 [+1.4]	+2.9 to +3.6 [+3.3]	+0.9 to +1.6 [+1.3]
Fiscal 2015	+1.2 to +1.5 [+1.5]	+1.9 to +2.8 [+2.6]	+1.2 to +2.1 [+1.9]
Forecasts made in January 2014	+1.2 to +1.8 [+1.5]	+1.7 to +2.9 [+2.6]	+1.0 to +2.2 [+1.9]
Fiscal 2016	+1.0 to +1.5 [+1.3]	+2.0 to +3.0 [+2.8]	+1.3 to +2.3 [+2.1]

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 assuming the effects of past policy decisions and with reference to views incorporated in financial markets regarding future policy.

4. The consumption tax hike in April 2014 -- to 8 percent -- and the one scheduled for October 2015 -- to 10 percent -- are incorporated in the forecasts. In terms of the outlook for the CPI, individual Policy Board members make their forecasts based on figures excluding the direct effects of the consumption tax hikes.

5. The forecasts for the CPI that incorporate the direct effects of the consumption tax hikes are constructed as follows. First, the contribution to prices from each tax hike is mechanically computed on the assumption that the tax increase will be fully passed on for all taxable items. The CPI will be pushed up by 2.0 percentage points for fiscal 2014 and by 0.7 percentage point for fiscal 2015 and fiscal 2016, respectively. Second, these figures are added to the forecasts made by the Policy Board members.

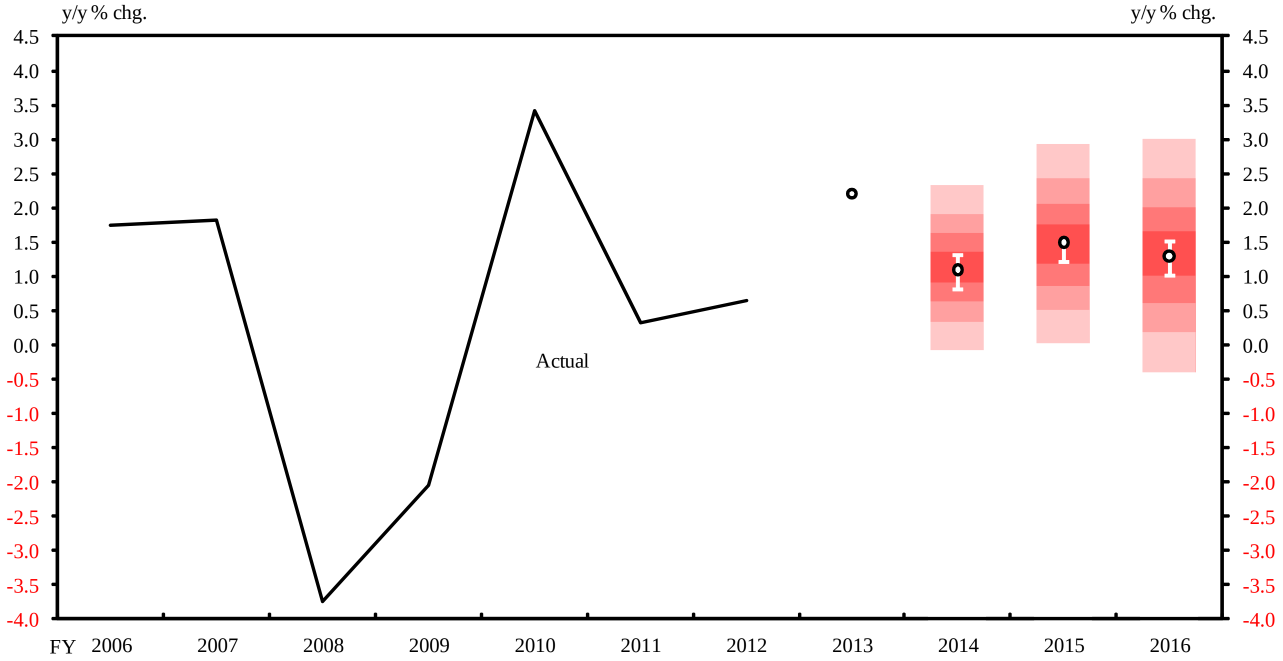
6. The ranges shown below include the forecasts of all Policy Board members.

y/y % chg.

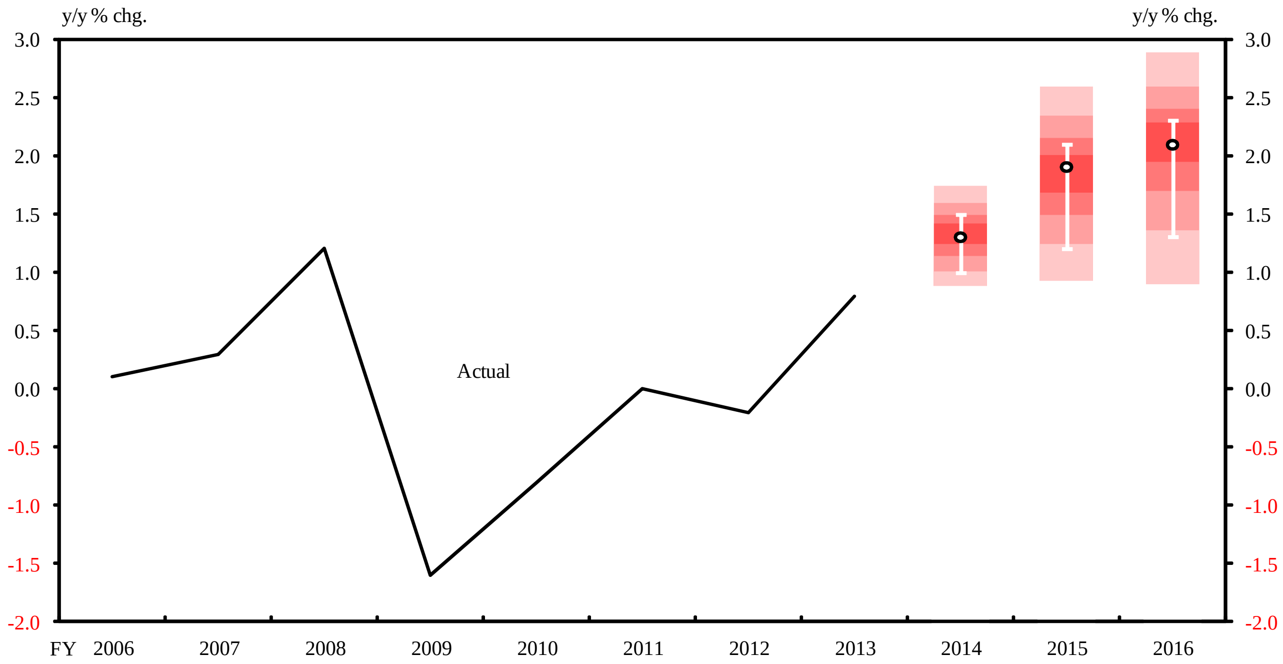
	Real GDP	CPI (all items less fresh food)	Excluding the effects of the consumption tax hikes
Fiscal 2013	+2.2 to +2.5	+0.8	
Forecasts made in January 2014	+2.5 to +3.0	+0.7 to +0.9	
Fiscal 2014	+0.5 to +1.4	+2.9 to +3.7	+0.9 to +1.7
Forecasts made in January 2014	+0.6 to +1.6	+2.7 to +3.7	+0.7 to +1.7
Fiscal 2015	+1.0 to +1.8	+1.5 to +2.8	+0.8 to +2.1
Forecasts made in January 2014	+1.2 to +2.0	+1.5 to +2.9	+0.8 to +2.2
Fiscal 2016	+0.8 to +1.6	+1.4 to +3.0	+0.7 to +2.3

Forecast Distribution Charts of Policy Board Members

(1) Real GDP



(2) CPI (All Items Less Fresh Food)



Notes: 1. Based on the aggregated probability distributions (i.e., the Risk Balance Charts) compiled from the distributions of individual Policy Board members, the Forecast Distribution Charts are compiled as follows. First, upper and lower 10 percentiles of the aggregated distributions are trimmed and second, colors indicated below are used to show the respective percentiles of those distributions.

Upper 40% to lower 40%	Upper 30 to 40% & lower 30 to 40%	Upper 20 to 30% & lower 20 to 30%	Upper 10 to 20% & lower 10 to 20%

2. 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* .

3. The circles in the bar charts indicate the median of the Policy Board members' forecasts (point estimates). The vertical lines in the bar charts indicate the range of the forecasts of the majority of Policy Board members.

4. The forecast for the CPI excludes the direct effects of the scheduled consumption tax hikes.