October 31, 2014
Bank of Japan

Outlook for Economic Activity and Prices
(October 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 consumption tax hikes.[2]
- 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 at around the current level for the time being, and subsequently accelerate gradually and reach around 2 percent around the middle of the projection period; that is, in or around fiscal 2015. Thereafter, Japan's economy is expected to shift to a growth path that sustains such inflation in a stable manner.
- Comparing the current projections with the previous ones, the growth rate for fiscal 2014 is somewhat lower due mainly to the effects of the decline in demand following the front-loaded increase and to relatively weak exports. The projected rate of increase in prices for fiscal 2015 is somewhat lower due mainly to a decline in international commodity prices, but that for fiscal 2016 is more or less unchanged.
- 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).[3] 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 October 31, 2014.

[2] The October 2014 *Outlook for Economic Activity and Prices* (Outlook Report) assumes, as with the past Outlook Reports, that the consumption tax -- after having risen to 8 percent in April 2014 -- will rise to 10 percent in October 2015.

[3] 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, entitled "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, although some weakness, particularly on the production side, has been observed due mainly to the effects of the decline in demand following the front-loaded increase prior to the consumption tax hike. The growth rate in the April-June quarter of 2014 was substantially negative, reflecting in part the large effects of the decline in demand, mainly in durable goods such as automobiles, and somewhat weak developments in exports. In addition, the effects of irregular weather during this past summer have also exerted temporary downward pressure on private consumption. However, excluding the fluctuations in the front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike, Japan's economy has continued to grow at a pace above its potential.[4] Moreover, since the current economic recovery is led by domestic demand, which tends to have large stimulative effects on employment, an increase in employment and a tightening in labor market conditions have been developing steadily.

Looking ahead, as domestic demand is likely to maintain firmness, exports are expected to head for a moderate increase, and a virtuous cycle from income to spending is likely to be maintained in both the household and corporate sectors. Therefore, the economy is likely to continue growing at a pace above its potential as a trend, while it will be affected by a front-loaded increase and subsequent decline in demand prior to and after the consumption tax hikes.

The above projection assumes the following underlying developments.

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[4] Japan's potential growth rate -- under a certain methodology -- is estimated to be "around 0.5 percent or lower" 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.

First, as the Bank of Japan steadily pursues the QQE expanded on October 31, 2014,[5] financial conditions are likely to become more accommodative.[6] 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 been declining. The amount outstanding of bank lending has been increasing moderately. Stimulative effects of such 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 growth supported by a virtuous cycle originating from household spending. The European economy is expected to maintain its moderate recovery, supported mainly by the resilience in private consumption and an increase in exports, although the adjustment pressure associated with the debt problem remains and a downtrend in the inflation rate has been observed. The Chinese economy is likely to continue to see generally stable growth, albeit at a slightly slower pace, as authorities carry out policy measures to support economic activity while progressing with structural reforms. Other emerging and commodity-exporting economies are expected to moderately increase their growth rates as positive effects of recovery in advanced economies spread and domestic demand picks up, reflecting accommodative financial conditions, although there are differences across countries and regions.

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[5] See the Bank's statement released on October 31, 2014, entitled "Expansion of the Quantitative and Qualitative Monetary Easing."

[6] Individual Policy Board members make their forecasts assuming the effects of past policy decisions, including the measures decided on October 31, 2014, 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 market participants' forecasts for prices, which are lower than those presented in the 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.

Third, public investment has been hovering at a high level, reflecting a boost from economic stimulus, but is expected to turn to a moderate downtrend in the second half of fiscal 2014.

Fourth, firms' and households' medium- to long-term growth expectations and potential growth rates 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, in the second half of fiscal 2014, as for private consumption, the effects of the decline in demand following the front-loaded increase prior to the consumption tax hike are likely to remain for the time being but are expected to wane gradually, and it is expected to remain resilient with the employment and income situation continuing to improve steadily.[7] With an improvement in corporate profits and effects of monetary easing continuing to provide a boost, business fixed investment is projected to increase steadily. This increase also reflects a rise in the need for investment, such as (1) renewal investment to replace capital stock that has become outdated as a result of restrained investment for many years; (2) investment in labor-saving machinery and equipment, reflecting the tightening in labor market conditions; and (3) investment to reestablish the domestic bases of business, partly in response to developments in foreign exchange rates. Meanwhile, exports are expected to head for a moderate increase as overseas economies recover, and partly because of foreign exchange rate developments. In this situation, industrial production is expected to resume its moderate increase with the progress in inventory adjustments.

[7] Taking into account the magnitude of the front-loaded increase in demand prior to the consumption tax hike in April 2014 and possible effects of the tax hike through a decline in real income, 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 0.4 percentage point for fiscal 2013, a decrease of around 0.9 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.

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 growing 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 projections for growth rates up through fiscal 2016 with those in the July 2014 interim assessment, while the growth rate for fiscal 2014 is somewhat lower due mainly to the effects of the decline in demand following the front-loaded increase and relatively weak exports, those for fiscal 2015 and fiscal 2016 are more or less unchanged.

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 around 1¼ percent recently.

Examining major factors that determine inflation rates into the future, first, the aggregate supply and demand balance (the output gap), which shows the utilization of labor and capital, has steadily continued its improving trend, mainly on the labor front, as firm domestic demand -- which tends to have large stimulative effects on employment -- has led to an increase in employment despite being affected by the front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike.[8] Specifically, the tightening trend in labor market conditions is steadily becoming more apparent, with the unemployment rate hovering around the structural unemployment rate, which is deemed to be around 3.5 percent, and the broadly-defined unemployment rates -- counting as unemployed, for example, those people who currently are not looking for work but indicate

[8] There are two approaches to estimating the output gap: (1) estimate potential GDP and then measure its difference with actual GDP; and (2) 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.

their willingness to work -- continuing to be on a declining trend.[9] Firms seem to be regarding the decline in demand following the front-loaded increase as temporary, and are maintaining their positive hiring stance. In this situation, wages have continued to improve, as seen in the fact that scheduled cash earnings turned to a clear increase. Moreover, more firms have faced a capital shortage, mainly in nonmanufacturing. Therefore, 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 be rising on the whole from a somewhat longer-term perspective. Such developments in inflation expectations seem to have been influencing actual wage and price settings. For example, a rise in the inflation rate, in addition to corporate performance, has been taken into account in the annual labor-management wage negotiations, and rises in base pay were revived at many firms for the first time in many years. Among firms, a shift in firms' price-setting strategy has been seen, from a low-price strategy to one of raising sales prices while increasing value added. Looking ahead, as the Bank pursues the QQE and the observed inflation rate rises, medium- to long-term inflation expectations are also likely to follow an increasing trend and gradually converge to around 2 percent -- the price stability target.

Third, as for import prices, while recent developments in foreign exchange rates will exert upward pressure on consumer prices, a decline in international commodity prices, including crude oil prices, will exert downward pressure on consumer prices for the time being.

[9] 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*. However, it should be noted that the estimated structural unemployment rate tends to change over time. Moreover, the broadly-defined unemployment rates are calculated by counting as unemployed those people who are defined as being not in the labor force because they have stopped looking for work but are potentially willing to work, and those who are currently employed part time but want and are available to work longer than they do at present.

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.[10] It is likely to be at around the current level for the time being, and subsequently accelerate gradually and reach around 2 percent -- the price stability target -- around the middle of the projection period; that is, in or around fiscal 2015. 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 projections up through fiscal 2016 with those in the July 2014 interim assessment, the projected rate of increase in the CPI for fiscal 2015 is somewhat lower due mainly to the decline in international commodity prices, but that for fiscal 2016 is 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. The continuing lack of momentum in exports has been due to the sluggishness in overseas economies, particularly emerging economies, and to weakness in investment activity globally. In addition, exports have been affected by structural factors such as an increase in Japanese manufacturers' shifting of production sites to overseas. Risks to future developments in overseas economies include the pace of recovery in the U.S. economy and its effects on the global financial markets, the prospects regarding the debt problem and the risk of low inflation rates being protracted in Europe, the progress in structural adjustments in emerging economies, and geopolitical risks. As for Japanese firms' production share at home and abroad going forward, there is high uncertainty associated with the effects of foreign exchange rates and the pace of shifting production sites overseas. However, it should be noted that, although firms' expansion of overseas

[10] 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.

production could contribute to restraining exports, it could have positive effects on the economy through increasing dividends from subsidiary companies, thereby pushing up corporate profits.

The second risk is the effects of the consumption tax hikes. The effects of the decline in demand following the first round of consumption tax hikes in April 2014 and of the decline in real income remain, and they warrant continued examination. How the scheduled second round of consumption tax hikes in October 2015 will affect the economy may differ depending on consumer sentiment, the employment and income situation, and developments in prices at that 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. The baseline scenario assumes that, amid a rise in observed price and wage inflation, people's inflation expectations will rise further. However, the pace at which they will rise is subject to uncertainty over developments in observed prices and to what extent they will affect inflation expectations. On this point, how developments in prices in the past fiscal year and the outlook for prices will be taken into consideration in the wage negotiations between management and labor toward the next fiscal year is of importance. Recently, somewhat weak developments in demand following the consumption tax hike and a substantial decline in crude oil prices have been exerting downward pressure on prices. If such downward pressure on prices remains, there is a risk that an improvement in inflation expectations might be delayed.

The second concerns developments in the output gap, particularly in labor market conditions. The baseline scenario assumes that, on the labor supply side, the recent increase in labor participation by the elderly and women and recent movements in firms to convert part-time employees into regular ones will continue to some extent, but uncertainty is associated with this assumption. In particular, given that the broadly-defined unemployment rates have been at low levels in addition to the standard unemployment rate, the degree of labor shortage may rise further.

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. On this point, there is high uncertainty as to how developments in consumption after the tax hike will affect firms' price-setting behavior.

Fourth, developments in import prices, reflecting fluctuations in international commodity prices and foreign exchange rates, as well as the extent to which such developments will spread to domestic prices, may lead prices to deviate either upward or downward from the baseline scenario.

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 -- that is, in or around fiscal 2015 -- 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 and the effects of the consumption tax hikes. With regard to the baseline scenario for prices, there is considerable uncertainty, mainly in developments in medium- to long-term inflation expectations, and there are substantial downside risks. 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.[11] 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 have been on a gradual declining trend.

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.

[11] For more details, see the October 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 2014	+0.2 to +0.7 [+0.5]	+3.1 to +3.4 [+3.2]	+1.1 to +1.4 [+1.2]
Forecasts made in July 2014	+0.6 to +1.3 [+1.0]	+3.2 to +3.5 [+3.3]	+1.2 to +1.5 [+1.3]
Fiscal 2015	+1.2 to +1.7 [+1.5]	+1.8 to +2.6 [+2.4]	+1.1 to +1.9 [+1.7]
Forecasts made in July 2014	+1.2 to +1.6 [+1.5]	+1.9 to +2.8 [+2.6]	+1.2 to +2.1 [+1.9]
Fiscal 2016	+1.0 to +1.4 [+1.2]	+1.9 to +3.0 [+2.8]	+1.2 to +2.3 [+2.1]
Forecasts made in July 2014	+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, including the measures decided on October 31, 2014, 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.

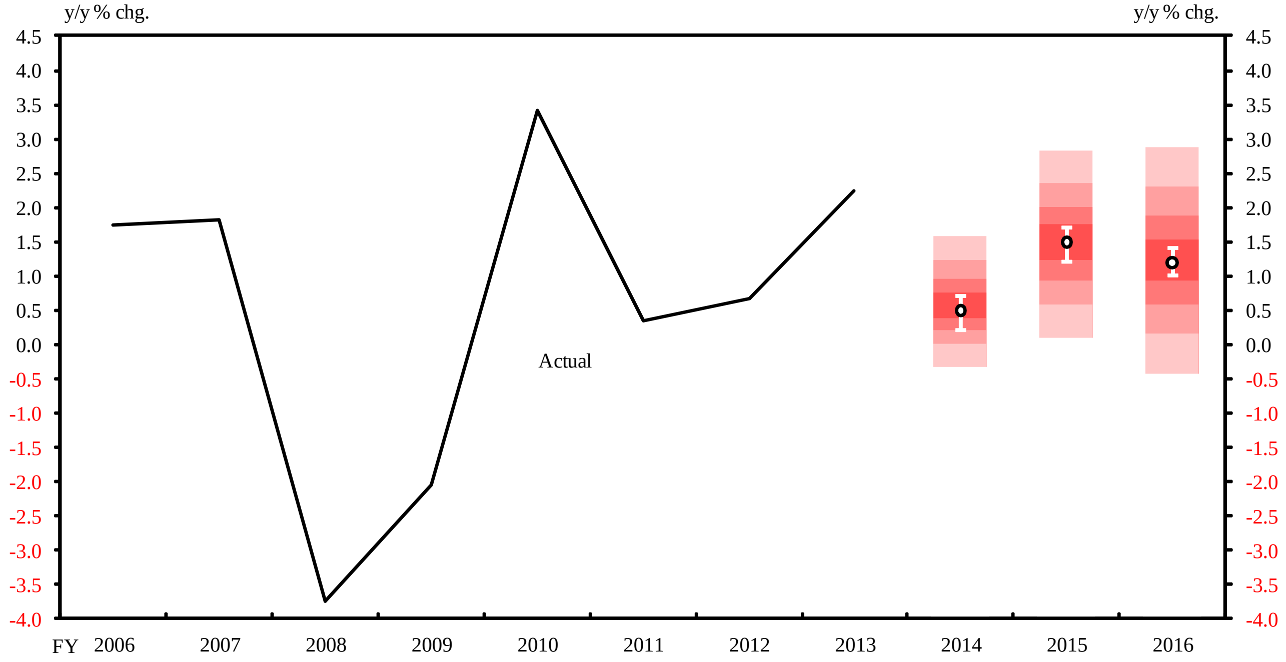
6. The ranges shown below include the forecasts of all Policy Board members.

y/y % chg.

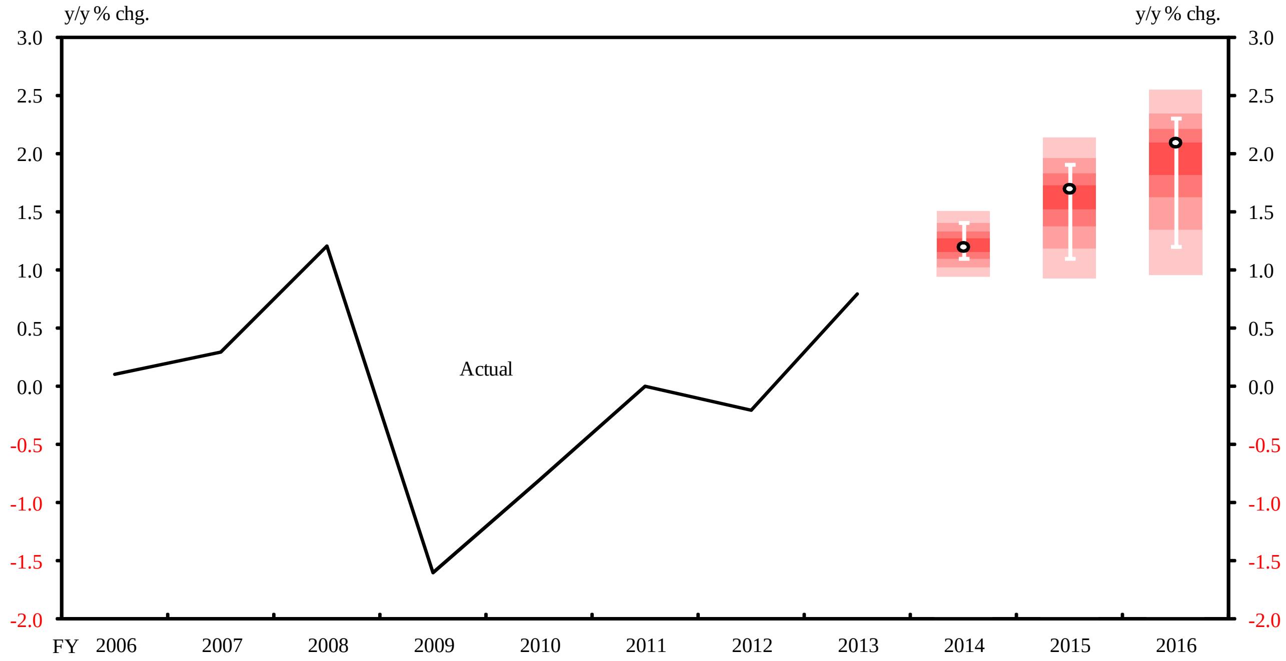
	Real GDP	CPI (all items less fresh food)	Excluding the effects of the consumption tax hikes
Fiscal 2014	+0.1 to +1.0	+3.0 to +3.4	+1.0 to +1.4
Forecasts made in July 2014	+0.5 to +1.3	+3.0 to +3.7	+1.0 to +1.7
Fiscal 2015	+0.8 to +1.8	+1.6 to +2.7	+0.9 to +2.0
Forecasts made in July 2014	+0.9 to +1.7	+1.7 to +2.8	+1.0 to +2.1
Fiscal 2016	+0.6 to +1.6	+1.6 to +3.0	+0.9 to +2.3
Forecasts made in July 2014	+0.7 to +1.6	+1.6 to +3.0	+0.9 to +2.3

Forecast Distribution Charts of Policy Board Members

(1) Real GDP



(2) CPI (All Items Less Fresh Food)



Notes: 1. The Forecast Distribution Charts are based on the aggregated probability distributions (i.e., the Risk Balance Charts) compiled from the distributions of individual policy board members, and constructed as follows. First, the upper and lower 10 percentiles of the aggregated distributions are trimmed. Second, the various percentiles of the aggregated distributions are color-coded as below.

Upper 40% to lower 40%	Upper 30% to 40% and lower 30% to 40%	Upper 20% to 30% and lower 20% to 30%	Upper 10% to 20% and 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.