October 30, 2015
Bank of Japan

Outlook for Economic Activity and Prices
(October 2015)

The Bank's View[1]

Summary

- Japan's economy is likely to continue growing at a pace above its potential from fiscal 2015 through fiscal 2016. Thereafter, through fiscal 2017, the economy is projected to maintain its positive growth, although with a slowing in its pace to around a level somewhat below the potential growth rate. The slowdown is due mainly to (1) the effects of a front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike planned in April 2017 and (2) cyclical deceleration.[2]
- The year-on-year rate of change 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 about 0 percent for the time being and, as the underlying trend in inflation steadily rises and the effects of the decline in crude oil prices dissipate, accelerate toward 2 percent -- the price stability target.[3] Although the timing of reaching around 2 percent depends on developments in crude oil prices, it is projected to be around the second half of fiscal 2016, assuming that crude oil prices will rise moderately from the recent level. 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, the projected growth rate for fiscal 2015 is lower due to the flattening of exports against the background of the slowdown in emerging economies and to the sluggishness in private consumption reflecting in part bad weather, but the projections for fiscal 2016 and 2017 are more or less unchanged. The projected rates of increase in prices for fiscal 2015 and 2016 are lower due mainly to the effects of the decline in crude oil prices, but the projection for fiscal 2017 is more or less unchanged.
- As for the conduct of monetary policy, quantitative and qualitative monetary easing (QQE) has been exerting its intended effects. The Bank will continue with 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 30, 2015.

[2] The October 2015 *Outlook for Economic Activity and Prices* (Outlook Report) assumes that the consumption tax will rise to 10 percent in April 2017.

[3] Individual Policy Board members make their forecasts based on the following assumption about crude oil prices. Dubai crude oil prices are expected to rise moderately from the recent 50 U.S. dollars per barrel to the range of 60-65 dollars per barrel toward the end of the projection period. Under this assumption, the contribution of energy items to the year-on-year rate of change in the CPI (all items less fresh food) is estimated to be around minus 0.9 percentage point for fiscal 2015, and around minus 0.2 percentage point for fiscal 2016. More specifically, this negative contribution is expected to lessen from the turn of 2016, and in the second half of fiscal 2016, the contribution is estimated to be around 0 percentage point.

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, although exports and production have been affected by the slowdown in emerging economies. Overseas economies -- mainly advanced economies -- have continued to grow at a moderate pace, despite the slowdown in emerging economies. Exports and industrial production have recently been more or less flat, due mainly to the effects of the slowdown in emerging economies. On the domestic demand side, the corporate sector has maintained its positive investment stance, with profits having increased to their highest level historically. In the household sector, against the background of steady improvement in the employment and income situation, private consumption has been resilient and housing investment has been picking up.

Looking ahead, domestic demand is likely to follow an uptrend, with a virtuous cycle from income to spending being maintained in both the household and corporate sectors, and exports are expected to start increasing moderately on the back of emerging economies moving out of their deceleration phase. Thus, Japan's economy is likely to continue growing at a pace above its potential from fiscal 2015 through fiscal 2016.[4] Thereafter, through fiscal 2017, the economy is projected to maintain its positive growth, although with a slowing in its pace to around a level somewhat below the potential growth rate. The slowdown is due mainly to (1) the effects of a front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike planned in April 2017 and (2) cyclical deceleration.

The above projection assumes the following underlying developments.

First, as the Bank of Japan continues with 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,

[4] Japan's potential growth rate is estimated to be around 0.5 percent or lower recently under a specific methodology, and is expected to rise gradually toward the end of the projection period. However, the estimate of the potential growth rate varies depending on the methodologies employed and could be revised as the sample period becomes longer over time. Thus, it should be regarded as being subject to a considerable margin of error.

financial conditions are likely to remain accommodative and continue stimulating the economy.[5]

Second, overseas economies are expected to moderately increase their growth rates as it is likely that advanced economies will continue to see firm growth and emerging economies will move out of their deceleration phase on the back of the developments in advanced economies.

Third, public investment is expected to follow a moderate downtrend from the current relatively high level, and thereafter level off toward the end of the projection period.

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

Given these assumptions, economic activity during the projection period can be elaborated on as follows. For fiscal 2015 through fiscal 2016, exports are expected to remain more or less flat for the time being, and after that they are likely to increase moderately as emerging economies are expected to move out of their deceleration phase and given support from past foreign exchange rate developments. With record profits seen at Japanese firms and monetary accommodation continuing to provide a boost, business fixed investment is projected to continue increasing, additionally supported by firms' positive stance on domestic investment. Private consumption is projected to rise moderately, led by continued steady improvement in the employment situation and a resultant increase in

[5] Individual Policy Board members make their forecasts taking into account 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. Markets also have been forecasting that long-term interest rates will hover at low levels throughout the projection period, although the market participants' outlook for prices behind such forecasts is lower than that presented in the Outlook Report. Each Policy Board member makes an assumption about the future path of long-term interest rates based on such market views, taking into account the difference in the forecasts for prices.

wages, and by the positive effects of the decline in energy prices through raising real income.[6] Reflecting these developments in demand both at home and abroad, industrial production is expected to remain more or less flat for the time being, and after that it is likely to increase moderately.

Through fiscal 2017, the economy is likely to be affected by the front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike scheduled to take place in April 2017, and the pace of increase in business fixed investment is likely to decline, reflecting a cycle in the accumulation of capital stock. However, exports are projected to continue increasing moderately owing to overseas economic growth, and domestic private demand is likely to be resilient, supported by accommodative financial conditions and heightened growth expectations. Meanwhile, Japan's potential growth rate is expected to follow a moderate increasing trend through the projection period, pushing up the economy's growth in the medium to long term. Reflecting these developments, the economy is projected to maintain its positive growth in fiscal 2017, although with a slowing in its pace to around a level somewhat below the potential growth rate.

Comparing the current projections with those in the July 2015 interim assessment, the projected growth rate for fiscal 2015 is lower due to the flattening of exports against the background of the slowdown in emerging economies and to the sluggishness in private consumption reflecting in part bad weather, but the projections for fiscal 2016 and 2017 are more or less unchanged.

B. Outlook for Prices

The year-on-year rate of change in the CPI for all items less fresh food has been about 0 percent, due to the effects of the decline in energy prices, but the underlying trend in

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[6] 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 0.5 percentage point for fiscal 2013, a decrease of around 1.2 percentage points for fiscal 2014, an increase of around 0.3 percentage point for fiscal 2015, an increase of around 0.3 percentage point for fiscal 2016, and a decrease of around 0.8 percentage point for fiscal 2017. It should be noted that the effects of the consumption tax hikes are considerably uncertain, given that they depend partly on income conditions and price developments at each point in time, and therefore these estimates are subject to a considerable margin of error.

inflation has steadily been improving, as indicated, for example, by the year-on-year rate of change in the CPI for all items less fresh food and energy, which exceeds 1 percent.

Major factors that determine inflation rates into the future are evaluated as follows. First, the aggregate supply and demand balance (the output gap), which shows the utilization of labor and capital, has steadily followed an improving trend driven mainly by labor market developments, albeit under some downward pressure partly from the flattening of exports against the background of the slowdown in emerging economies.[7] Specifically, the tightening trend in labor market conditions has continued, with the unemployment rate declining moderately to the range of 3.0-3.5 percent.[8] Capacity utilization rates also seem to be on an uptrend amid a situation of Japan's economy continuing to recover moderately, while affected by adverse developments including the flattening of exports. Looking ahead, the output gap is likely to turn positive (in excess demand) toward the end of fiscal 2015, and move further into positive territory in fiscal 2016; thus, upward pressure on wages and prices due to the tightening of supply and demand conditions is likely to steadily increase. In fiscal 2017, the output gap is projected to be more or less unchanged in positive territory.

Second, medium- to long-term inflation expectations appear to be rising on the whole from a somewhat longer-term perspective. In response to such developments in inflation expectations, firms' wage- and price-setting stance has clearly changed, particularly from the turn of the fiscal year. In the annual labor-management wage negotiations, movements

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[7] There are two approaches to estimating the output gap: (1) estimating potential GDP and then measuring its difference from actual GDP and (2) directly measuring 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.

[8] One measure used in assessing the degree of tightness in labor market conditions is the *structural unemployment rate*. In the labor market, there is always some mismatch between job openings and job applicants, and thus there is a certain number of unemployed even when the economy is booming. The unemployment rate at which no excess labor force is found, excluding the unemployment due to the mismatch, is called the structural unemployment rate. This rate is calculated to be in the range of 3.0-3.5 percent recently under a specific methodology. It should be noted that the estimated structural unemployment rate tends to change over time.

toward reflecting price developments as well as corporate performance and supply-demand conditions in the labor market on wages have been broadening, and the increase in wages including that in base pay this year was larger than last year at many firms. Firms' price-hiking behavior also has become widespread and sustained. These developments indicate the steady functioning of the mechanism in which inflation rises moderately accompanied by wage increases. Nevertheless, it should be noted that, given that firms have been seeing record profits and the unemployment rate has declined to the range of 3.0-3.5 percent, the pace of improvement in wages has been somewhat slow.

Looking ahead, as the Bank pursues 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. Against this backdrop, firms' wage- and price-setting stance is likely to shift further toward raising wages and prices.

Third, through import prices, while past 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.

Based on the above, the outlook for the year-on-year rate of change in the CPI (for all items less fresh food and excluding the direct effects of the consumption tax hikes, and the same hereafter) is as follows. It is likely to be about 0 percent for the time being and, as the underlying trend in inflation steadily rises and the effects of the decline in crude oil prices dissipate, accelerate toward 2 percent -- the price stability target. Although the timing of reaching around 2 percent depends on developments in crude oil prices, it is projected to be around the second half of fiscal 2016, assuming that crude oil prices will rise moderately from the recent level. Thereafter, the year-on-year rate of change in the CPI is likely to be around 2 percent on average.[9] Comparing the current projections with those in the July 2015 interim assessment, the projected rates of increase in the CPI for fiscal 2015 and 2016 are lower due mainly to the effects of the decline in crude oil prices, but the projection for fiscal 2017 is more or less unchanged.

[9] The effects of the scheduled consumption tax hike in April 2017 on prices can be mechanically estimated by assuming that the rise in the consumption tax will be fully passed on for all currently taxable items. On this basis, the year-on-year rate of change in the CPI will be pushed up by 1.3 percentage points in fiscal 2017.

II. Upside and Downside Risks

A. Risks to Economic Activity

The following are upside and downside risks to the Bank's baseline scenario regarding the economy. First, there is uncertainty regarding developments in overseas economies. Risks to future developments in overseas economies include the effects of the slowdown in emerging economies, particularly China, developments in the U.S. economy and the influences of its monetary policy response to them on the global financial markets, prospects regarding the European debt problem and the momentum of economic activity and prices in Europe, the effects of the decline in commodity prices, and geopolitical risks.

The second risk is the effects of the consumption tax hike scheduled to take place in April 2017. The effects on the economy of the front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike, as well as of the decline in real income, may differ depending on consumer sentiment, the employment and income situation, and developments in prices.

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 increasing 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 factor is developments in firms' and households' medium- to long-term inflation expectations. The baseline scenario assumes that, amid rises in observed inflation accompanied by wage increases, people's inflation expectations will rise further and gradually converge to around 2 percent -- the price stability target. However, the pace at which they will rise is subject to uncertainty over developments in observed prices and to the extent to which they will affect inflation expectations. On this point, there is a risk that the year-on-year rate of change in the CPI being about 0 percent for the time being, which owes to the effects of the decline in energy prices, might affect the pace of increase in inflation expectations. Regarding the relationship between wages and prices, the focal point is how rises in the underlying trend in inflation to date and the outlook for prices will be reflected in the annual labor-management wage negotiations toward fiscal 2016.

The second factor is 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 by firms to convert part-time employees into regular ones will continue to some extent, but there is uncertainty associated with this assumption, and depending on these developments, wages and prices could be affected.

The third factor is the responsiveness of inflation to the output gap. There is a risk that the pace of increase in inflation will deviate downward from the baseline scenario should firms become cautious in raising wages, reflecting uncertainties including future developments in overseas economies, or should consumers mount stronger resistance to an increase in sales prices under such circumstance. In addition, in the case of price rigidity of administered prices, some services prices, and rents for houses being more than expected, there is a possibility that the price rigidity will constrain the acceleration of CPI inflation.

Fourth, developments in import prices, reflecting fluctuations in international commodity prices such as crude oil 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.[10]

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 second half of fiscal 2016 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, risks are skewed to the downside, particularly those regarding developments in overseas economies. With regard to the baseline scenario for prices, there is considerable uncertainty, mainly in developments in medium- to long-term inflation expectations, and risks are skewed to the downside. 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 declining trend on the whole.

As for the conduct of monetary policy, QQE has been exerting its intended effects. The Bank will continue with 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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[10] 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."

[11] For more details, see the October 2015 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 2015	+0.8 to +1.4 [+1.2]	0.0 to +0.4 [+0.1]	
Forecasts made in July 2015	+1.5 to +1.9 [+1.7]	+0.3 to +1.0 [+0.7]	
Fiscal 2016	+1.2 to +1.6 [+1.4]	+0.8 to +1.5 [+1.4]	
Forecasts made in July 2015	+1.5 to +1.7 [+1.5]	+1.2 to +2.1 [+1.9]	
Fiscal 2017	+0.1 to +0.5 [+0.3]	+2.5 to +3.4 [+3.1]	+1.2 to +2.1 [+1.8]
Forecasts made in July 2015	+0.1 to +0.5 [+0.2]	+2.7 to +3.4 [+3.1]	+1.4 to +2.1 [+1.8]

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.

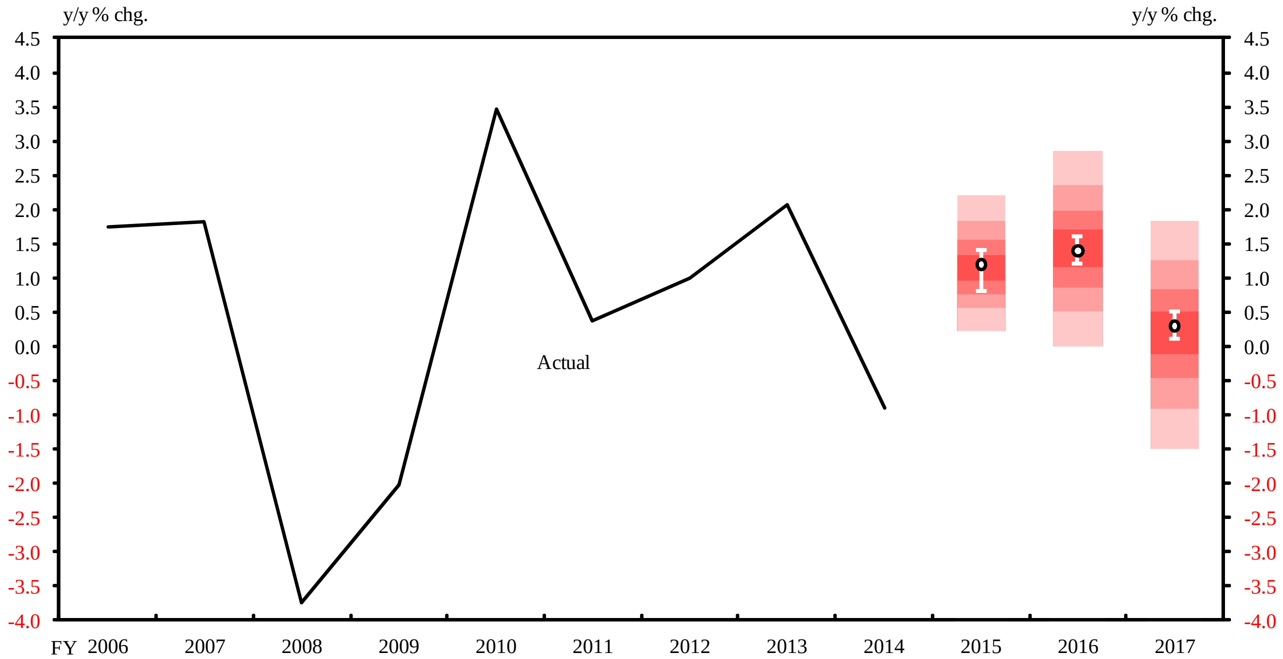
3. Individual Policy Board members make their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding future policy.

4. Dubai crude oil prices are expected to rise moderately from the recent 50 U.S. dollars per barrel to the range of 60-65 dollars per barrel toward the end of the projection period. Under this assumption, the contribution of energy items to the year-on-year rate of change in the CPI (all items less fresh food) is estimated to be around minus 0.9 percentage point for fiscal 2015, and around minus 0.2 percentage point for fiscal 2016. More specifically, this negative contribution is expected to lessen from the turn of 2016, and in the second half of fiscal 2016, the contribution is estimated to be around 0 percentage point.

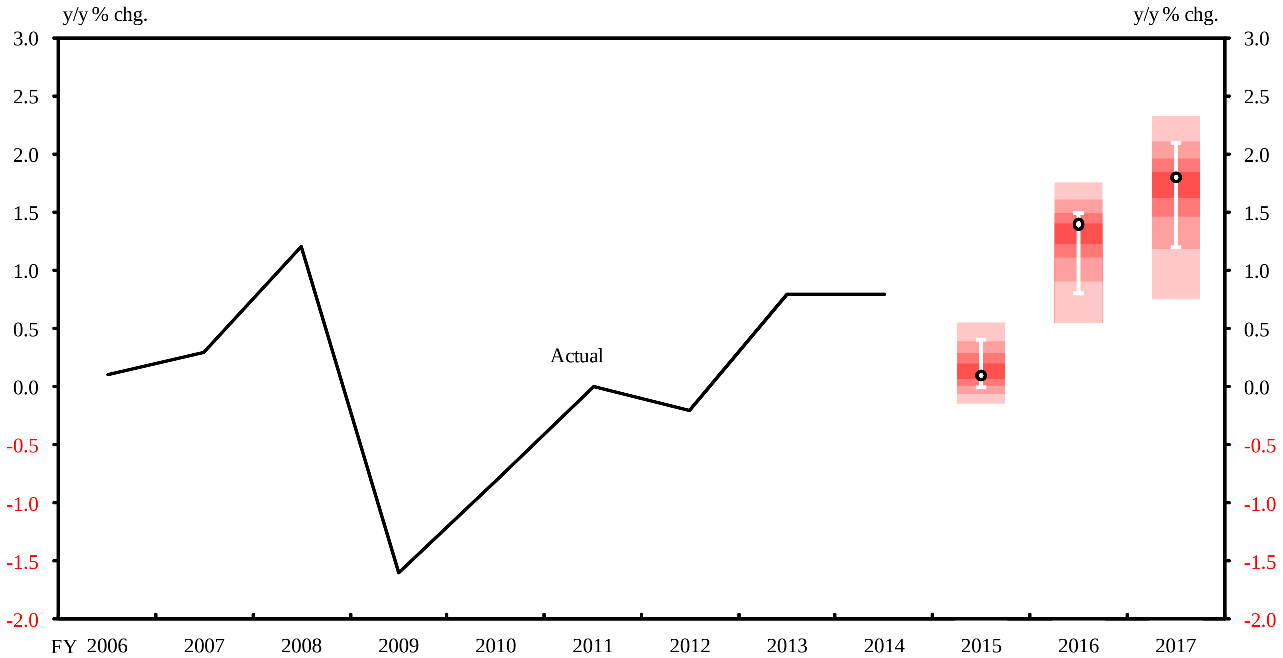
5. The consumption tax hike scheduled to take place in April 2017 -- to 10 percent -- is incorporated in the forecasts, but individual Policy Board members make their forecasts of the CPI based on figures excluding the direct effects of the consumption tax hike. The forecasts for the CPI for fiscal 2017 that incorporate the direct effects of the consumption tax hike 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 1.3 percentage points. Second, this figure is added to the forecasts made by the Policy Board members.

Forecast Distribution Charts of Policy Board Members

(1) Real GDP



(2) CPI (All Items Less Fresh Food)



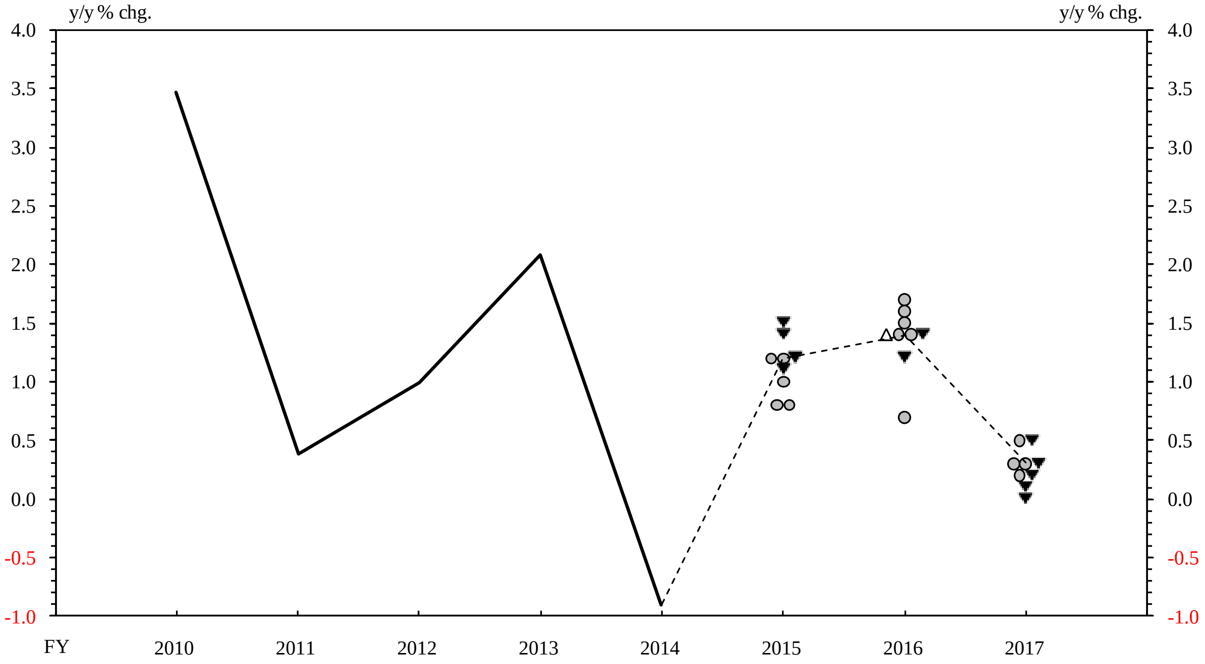
Notes: 1. The Forecast Distribution Charts are based on the aggregated probability distributions (i.e., the Risk Balance Charts) compiled from the distributions of individual Policy Board members, and constructed as follows. First, the upper and lower 10 percentiles of the aggregated distributions are 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%

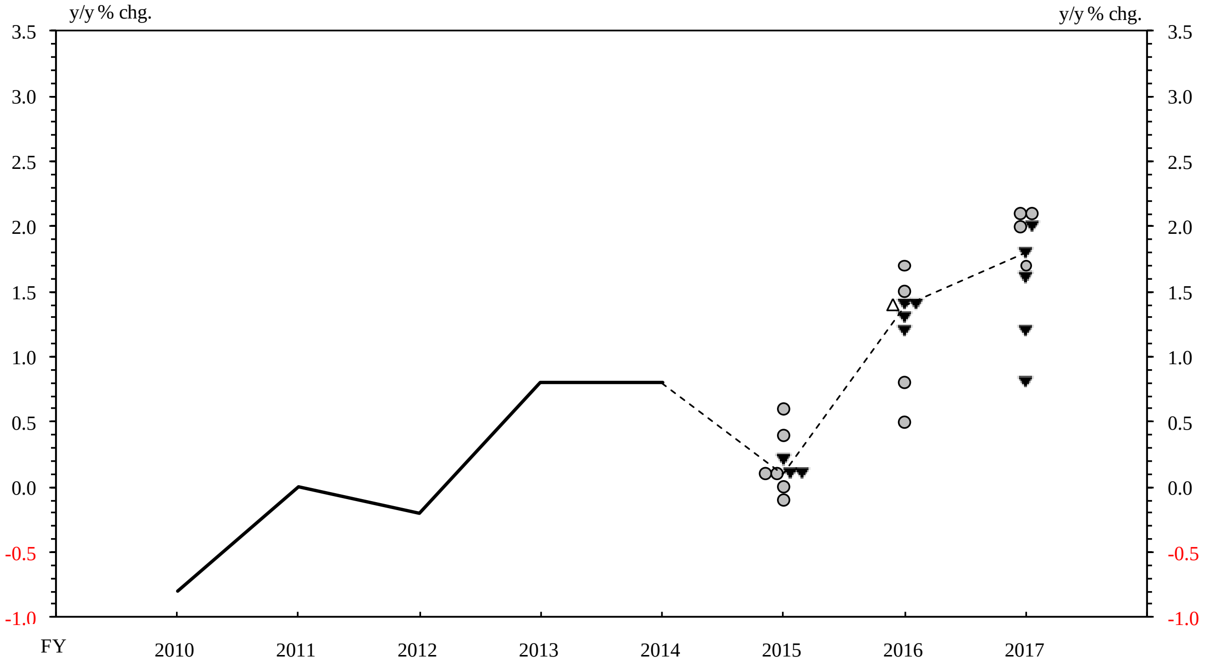
2. For the process of compilation of the Risk Balance Charts, see the box on page 9 of the April 2008 *Outlook for Economic Activity and Prices* .
3. The circles in the bar charts indicate the median of the Policy Board members' forecasts (point estimates). The vertical lines indicate the range of the forecasts of the majority of Policy Board members.
4. Figures for the CPI exclude the direct effects of the consumption tax hikes.

Policy Board Members' Forecasts and Risk Assessments

(1) Real GDP



(2) CPI (All Items Less Fresh Food)



Notes: 1. The Bank of Japan announced on June 19, 2015 in the "New Framework for Monetary Policy Meetings" that it would release from January 2016 the Policy Board Members' Forecasts and Risk Assessments, in replacement of the Forecast Distribution Charts of Policy Board Members. In this Outlook Report, the Bank released the former earlier than planned in order to enable a comparison between this release and future releases.

2. Solid lines show actual figures, while dotted lines show the medians of the Policy Board members' forecasts (point estimates).

3. The locations of ○, △, and ▼ in the charts indicate the figures for each Policy Board member's forecasts to which he or she attaches the highest probability. The risk balance assessed by each Policy Board member is shown by the following shapes: ○ indicates that a member assesses "upside and downside risks as being generally balanced," △ indicates that a member assesses "risks are skewed to the upside," and ▼ indicates that a member assesses "risks are skewed to the downside."

4. Figures for the CPI exclude the direct effects of the consumption tax hikes.