November 1, 2016

Bank of Japan

Outlook for Economic Activity and Prices (October 2016)

The Bank's View[1]

Summary

- Japan's economy is likely to continue growing at a pace above its potential through the projection period -- that is, through fiscal 2018 -- on the back of highly accommodative financial conditions and the effects of the government's large-scale stimulus measures, as well as the recovery in overseas economies.

- The year-on-year rate of change in the consumer price index (CPI, all items less fresh food) is likely to be slightly negative or about 0 percent for the time being, and as the aggregate supply and demand balance (the output gap) improves and medium- to long-term inflation expectations rise, it is expected to increase toward 2 percent in the second half of the projection period.

- With regard to the risk balance, risks to both economic activity and prices are skewed to the downside. On the price front, the momentum toward achieving the price stability target of 2 percent seems to be maintained, but is somewhat weaker than the previous outlook, and thus developments in prices warrant careful attention going forward.

- As for the conduct of monetary policy, the Bank will continue with "Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control," 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 continue expanding the monetary base until the year-on-year rate of increase in the observed CPI (all items less fresh food) exceeds 2 percent and stays above the target in a stable manner. The Bank will make policy adjustments as appropriate, taking account of developments in economic activity and prices as well as financial conditions, with a view to maintaining the momentum toward achieving the price stability target.

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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 and November 1, 2016.

I. The Current Situation of Economic Activity and Prices in Japan

Japan's economy has continued its moderate recovery trend, although exports and production have been sluggish due mainly to the effects of the slowdown in emerging economies. Overseas economies have continued to grow at a moderate pace, but the pace of growth has somewhat decelerated mainly in emerging economies. In this situation, exports have been more or less flat. On the domestic demand side, business fixed investment has been on a moderate increasing trend as corporate profits have been at high levels. Against the background of steady improvement in the employment and income situation, private consumption has been resilient, although relatively weak developments have been seen in some indicators. Housing investment has continued picking up, and the decline in public investment has leveled off. Reflecting these developments in demand both at home and abroad, industrial production has continued to be more or less flat. Business sentiment has generally stayed at a favorable level. Financial conditions are highly accommodative. On the price front, the year-on-year rate of change in the CPI (all items less fresh food, and the same hereafter) has been slightly negative. Inflation expectations have remained in a weakening phase.

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

A. Baseline Scenario of the Outlook for Economic Activity

With regard to the outlook, although sluggishness is expected to remain in exports and production for some time, Japan's economy is likely to expand moderately thereafter. Domestic demand is likely to follow an uptrend, with a virtuous cycle from income to spending being maintained in both the corporate and household sectors, on the back of highly accommodative financial conditions and fiscal spending through the government's large-scale stimulus measures. Business fixed investment is likely to maintain its moderate increasing trend, supported by accommodative financial conditions, heightened growth expectations, and increases in Olympic Games-related demand. Private consumption is expected to increase moderately as employee income continues to improve. Public investment is projected to increase through fiscal 2017, due mainly to the positive effects resulting from a set of stimulus measures, and thereafter remain at a relatively high level with Olympic Games-related demand. Meanwhile, although overseas economies are projected to remain slightly subdued for some time, they are expected to gradually increase their growth rates as advanced economies continue growing steadily and emerging economies move out of their deceleration phase, on the back of the steady growth in advanced economies and the effects of policy measures taken by emerging economies. Against this background, exports are expected to start increasing moderately.

Reflecting this outlook, Japan's economy is likely to continue growing at a pace above its potential through the projection period -- that is, through fiscal 2018.[2] Comparing the current projections with the previous ones, the projected growth rates are more or less unchanged.

Looking at the financial conditions assumed in the above outlook, short- and long-term real interest rates are expected to be in negative territory through the projection period as the Bank pursues "QQE with Yield Curve Control."[3] Financial institutions' proactive lending attitudes as well as favorable conditions for corporate bonds and CP issuance are both likely to be maintained and support firms' and households' activities from the financial side. Thus, financial conditions are likely to remain highly accommodative.[4]

The potential growth rate is expected to follow a moderate uptrend through the projection period against the backdrop of the following: 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;

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[2] Japan's potential growth rate is estimated to be in the range of 0.0-0.5 percent under a specific methodology. 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.

[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. Specifically, each Policy Board member makes an assumption about the future path of short- and long-term interest rates based on their market rates, with the difference in the outlook for prices between that presented in the *Outlook for Economic Activity and Prices* (Outlook Report) and that of market participants in mind.

[4] As for financial developments, see the Bank's *Financial System Report* (October 2016).

and steady progress in overcoming of deflation. Along with this, the natural rate of interest is projected to rise, thereby enhancing monetary easing effects.

B. Baseline Scenario of the Outlook for Prices

The outlook for prices is as follows. The year-on-year rate of change in the CPI is likely to be slightly negative or about 0 percent for the time being, due to the effects of the decline in energy prices, and as the output gap improves and medium- to long-term inflation expectations rise, it is expected to increase toward 2 percent in the second half of the projection period. Comparing the current projections with the previous ones, the projected rate of increase in the CPI is somewhat lower, mainly due to medium- to long-term inflation expectations having remained in a weakening phase. The timing of the year-on-year rate of change in the CPI reaching around 2 percent will likely be at the end of the projection period -- that is, around fiscal 2018.

The background to these projections is as follows. First, medium- to long-term inflation expectations can be regarded as consisting of two components: a forward-looking component, in which inflation expectations converge to the price stability target set by the central bank, and a backward-looking, or adaptive, component that reflects the observed inflation rate.[5] Medium- to long-term inflation expectations have remained in a weakening phase since summer 2015 as the adaptive component has played a large role in their formation, with the observed inflation rate being about 0 percent or slightly negative. As for the outlook, based on the aforementioned projections, firms' price-setting stance is expected to revert to raising prices as private consumption is expected to head toward a moderate increase, and their wage-setting stance is likely to shift toward raising wages driven by the tightening of labor market conditions. Against this backdrop, because of the following two factors, medium- to long-term inflation expectations are likely to follow an increasing trend and gradually converge to around 2 percent: (1) in terms of the adaptive component, the observed inflation rate is expected to rise, mainly due to the dissipation of the downward pressure of energy prices going forward, and (2) in terms of the forward-looking component,

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[5] With regard to the mechanism of inflation expectation formation, see the Bank's *Comprehensive Assessment: Developments in Economic Activity and Prices as well as Policy Effects since the Introduction of Quantitative and Qualitative Monetary Easing (QQE)* released in September 2016.

the Bank will pursue monetary easing through its strong commitment to achieving the price stability target.

Second, the output gap, which shows the utilization of labor and capital, is more or less unchanged, as the tightening of labor market conditions has continued while an improvement in manufacturers' capacity utilization rates has been delayed, mainly against the background of the slowdown in emerging economies. Going forward, due in part to the effects resulting from the set of stimulus measures, the tightening of labor market conditions is likely to continue, and capacity utilization rates are expected to increase again as exports and production pick up. Against this backdrop, the output gap is expected to move into positive territory through the end of fiscal 2016 and widen further within that territory.

Third, through import prices, the past decline in international commodity prices including crude oil prices will exert downward pressure on consumer prices for the time being, but the effects of such pressure are expected to wane. The impact of foreign exchange rates on consumer prices through import prices is likely to restrain upward pressure on prices, due in part to the appreciation of the yen since the turn of the year.

III. Upside and Downside Risks to Economic Activity and Prices

A. Upside and Downside 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. Specifically, the following are considered as risks: developments in emerging and commodity-exporting economies, particularly China; developments in the U.S. economy and the impact of its monetary policy on global financial markets; the consequences stemming from the United Kingdom's vote to leave the European Union (EU) and their effects; prospects regarding the European debt problem, including the financial sector; and geopolitical risks.

Second, firms' and households' medium- to long-term growth expectations may be either raised or lowered depending on the following: efforts to address medium- to long-term issues such as the aging population; developments in regulatory and institutional reforms, particularly in the labor market; innovation in the corporate sector; and the employment and income situation.

Third, 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 the rises in long-term interest rates associated with them. 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 concerns regarding the future are alleviated.

B. Upside and Downside Risks to Prices

Other than risks to economic activity, the specific 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. Amid the considerable uncertainties surrounding the economic outlook, mainly for overseas economies, there is a risk that firms' price- and wage-setting stance will remain cautious, strongly affected by developments in the observed inflation rate. In this context, how the labor-management wage negotiations next spring develop warrants particular attention.

The second factor is the fact that there are items for which prices are not particularly responsive to the output gap. There is a particular concern about the continued dull responses of administered prices and some services prices, even amid the tightening of labor market conditions. In addition, a decline in housing rent has accelerated recently, possibly constraining CPI inflation by more than projected.

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

IV. 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.[6]

The first perspective concerns an examination of the baseline scenario for the outlook. The year-on-year rate of change in the CPI is likely to increase toward 2 percent in the second half of the projection period. The momentum toward achieving the price stability target seems to be maintained, but is somewhat weaker than the previous outlook, and thus developments in prices warrant careful attention going forward.

The second perspective involves an examination of the risks considered most relevant to the conduct of monetary policy. With regard to the outlook for economic activity, risks are skewed to the downside, particularly those regarding developments in overseas economies. With regard to the outlook for prices, risks are skewed to the downside, especially those concerning overseas economies and developments in medium- to long-term inflation expectations. Examining financial imbalances from a longer-term perspective, there is no sign so far of excessively bullish expectations in asset markets or in the activities of financial institutions. Furthermore, prolonged downward pressure on financial institutions' profits under the continued low interest rate environment could create risks of a gradual pullback in financial intermediation and of destabilizing the financial system. However, at this point, these risks are judged as not significant, mainly because financial institutions have sufficient capital bases.

As for the conduct of monetary policy, the Bank will continue with "QQE with Yield Curve Control," 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 continue expanding the monetary base until the year-on-year rate of increase in the observed CPI (all items less fresh food) exceeds 2 percent and stays above the target in a stable manner. The Bank will make policy adjustments as appropriate, taking account of developments in economic activity and prices

[6] 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."

as well as financial conditions, with a view to maintaining the momentum toward achieving the price stability target.

(Appendix)

Forecasts of the Majority of Policy Board Members

y/y % chg.

	Real GDP	CPI (all items less fresh food)
Fiscal 2016	+0.8 to +1.0 [+1.0]	-0.3 to -0.1 [-0.1]
Forecasts made in July 2016	+0.8 to +1.0 [+1.0]	0.0 to +0.3 [+0.1]
Fiscal 2017	+1.0 to +1.5 [+1.3]	+0.6 to +1.6 [+1.5]
Forecasts made in July 2016	+1.0 to +1.5 [+1.3]	+0.8 to +1.8 [+1.7]
Fiscal 2018	+0.8 to +1.0 [+0.9]	+0.9 to +1.9 [+1.7]
Forecasts made in July 2016	+0.8 to +1.0 [+0.9]	+1.0 to +2.0 [+1.9]

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.

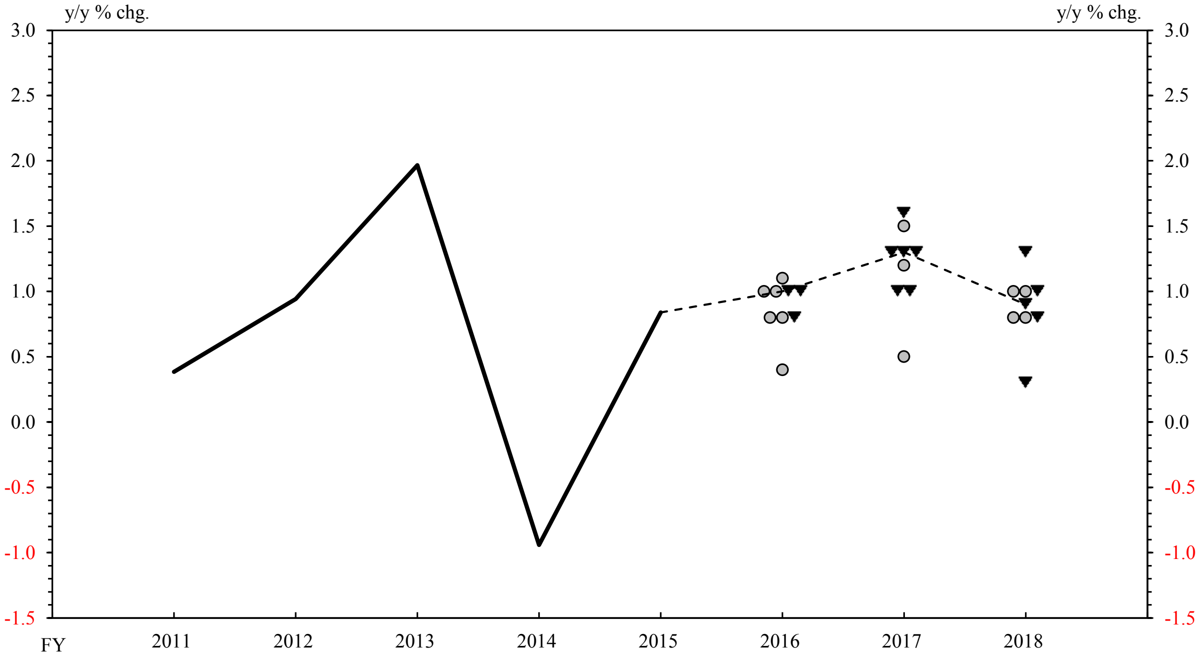
3. Individual Policy Board members make their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding future policy. Specifically, each Policy Board member makes an assumption about the future path of short- and long-term interest rates based on their market rates, with the difference in the outlook for prices between that presented in the Outlook Report and that of market participants in mind.

4. Dubai crude oil prices are expected to rise moderately from the recent 50 U.S. dollars per barrel to the range of 55-60 dollars per barrel toward the end of the projection period; that is, fiscal 2018. 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 approximately minus 0.6 percentage point for fiscal 2016. More specifically, the contribution is expected to lessen through the second half of fiscal 2016 and reach around 0 percentage point in early 2017.

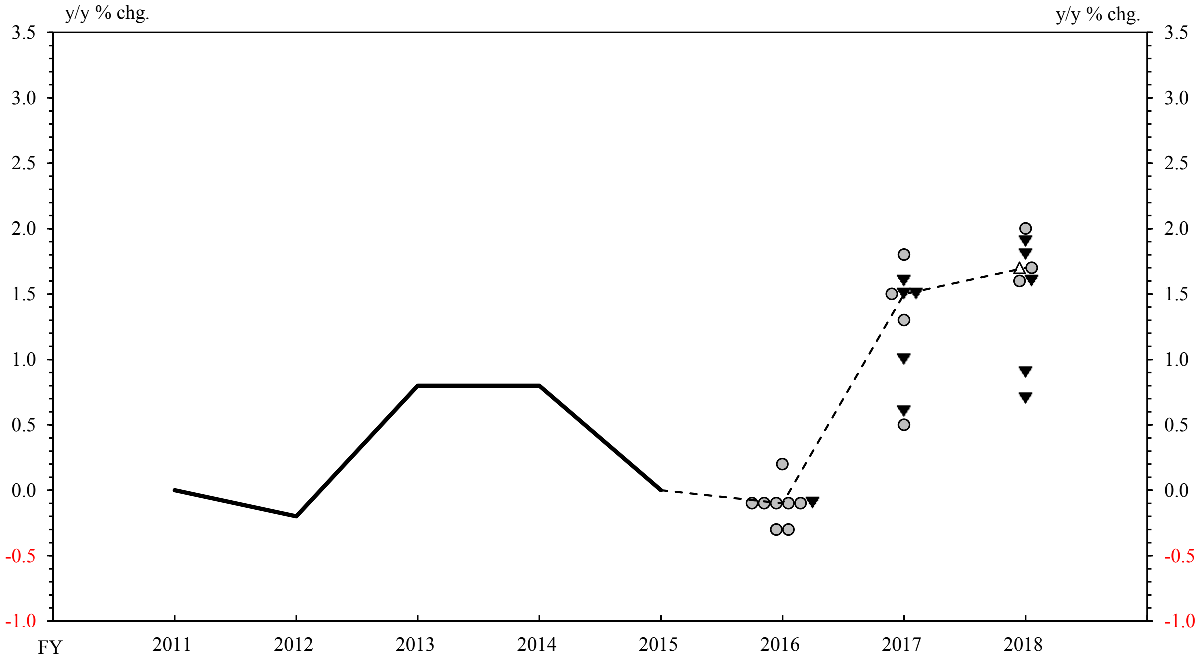
5. Individual Policy Board members' forecasts are based on the assumption that the consumption tax will be raised to 10 percent in October 2019.

Policy Board Members' Forecasts and Risk Assessments

(1) Real GDP



(2) CPI (All Items Less Fresh Food)



Notes: 1. Solid lines show actual figures, while dotted lines show the medians of the Policy Board members' forecasts (point estimates).

2. 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."

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