April 27, 2017
Bank of Japan

Outlook for Economic Activity and Prices
(April 2017)

The Bank's View[1]

Summary

- Japan's economy is likely to continue expanding and maintain growth at a pace above its potential, mainly through fiscal 2018, on the back of highly accommodative financial conditions and the effects of the government's large-scale stimulus measures, with the growth rates in overseas economies increasing moderately. In fiscal 2019, the economy is expected to continue expanding, although the growth pace is projected to decelerate due to a cyclical slowdown in business fixed investment and the effects of the scheduled consumption tax hike.[2]

- The year-on-year rate of change in the consumer price index (CPI, all items less fresh food) is likely to continue on an uptrend and increase toward 2 percent, mainly on the back of an improvement in the output gap and a rise in medium- to long-term inflation expectations.

- Comparing the current projections through fiscal 2018 with the previous ones, the projected growth rates and the projected rates of increase in the CPI are more or less unchanged.

- 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 is maintained, but is not yet sufficiently firm, and thus developments in prices continue to warrant careful attention.

- 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 April 26 and 27, 2017.
[2] The April 2017 *Outlook for Economic Activity and Prices* (Outlook Report) assumes that the consumption tax will be raised to 10 percent in October 2019 and that a reduced tax rate will be applied to food and beverages -- excluding alcohol and dining-out -- and newspapers.

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

Japan's economy has been turning toward a moderate expansion. Overseas economies have continued to grow at a moderate pace, although emerging economies remain sluggish in part. In this situation, exports have been on an increasing trend. On the domestic demand side, business fixed investment has been on a moderate increasing trend with corporate profits and business sentiment improving in a wider range of industries. Private consumption has been resilient against the background of steady improvement in the employment and income situation. Meanwhile, housing investment and public investment have been more or less flat. Reflecting these increases in demand both at home and abroad, industrial production has been on an increasing trend, and labor market conditions have continued to tighten steadily. 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 about 0 percent. 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, Japan's economy is likely to continue its moderate expansion. Through fiscal 2018, 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 continue increasing moderately, supported by accommodative financial conditions, heightened growth expectations, and increases in Olympic Games-related demand. Private consumption is expected to follow a moderate increasing trend 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, the growth rates of overseas economies are expected to increase moderately as advanced economies continue growing steadily and a recovery in emerging economies takes hold gradually on the back of the steady growth in advanced economies and the effects of policy measures taken by emerging economies. Exports are expected to continue their moderate increasing trend on the back of the improvement in overseas economies. In fiscal 2019, the pace of expansion in Japan's economy is projected to decelerate, mainly due to a slowdown in domestic demand. Specifically, business fixed investment is likely to decelerate, mainly reflecting cyclical adjustments in capital stock after the prolonged economic expansion, as well as Olympic Games-related demand peaking out; household spending is likely to turn to a decline in the second half of the fiscal year due to the effects of the scheduled consumption tax hike.[3] Nevertheless, against the background that the increase in exports on the back of growth in overseas economies is expected to underpin the economy, the economy is expected to continue expanding, although the growth pace is projected to decelerate.

Reflecting this outlook, Japan's economy is likely to continue growing at a pace above its potential, mainly through fiscal 2018.[4] Comparing the current projections through fiscal 2018 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 throughout the projection period as the

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[3] The consumption tax hike scheduled to take place in October 2019 will affect the growth rates through the following two channels: (1) the front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike and (2) the effects of a decline in real income. The negative impact on the projected growth rate for fiscal 2019 is expected to be smaller than that on the rate for fiscal 2014, when the last consumption tax hike took place. However, it should be noted that the impact of the consumption tax hike is highly uncertain and varies depending, for example, on the income situation and price developments.

[4] In the April 2017 Outlook Report, the estimation method of Japan's potential growth rate and the output gap has been revised, given (1) the comprehensive revision to GDP statistics and (2) the revised capital stock data that reflect such revision. Under the new method, the potential growth rate is estimated to be in the range of 0.5-1.0 percent, revised upward from being in the range of 0.0-0.5 percent, as an increase in research and development investment in recent years and a rise in productivity are newly factored in. The output gap is estimated to be almost the same level as that based on the previous base year GDP statistics, since the utilization of production factors is evaluated as mostly unchanged. However, the estimates of both the potential growth rate and the output gap vary depending on the methodologies employed and could be revised as the sample period becomes longer over time. Thus, they should be subject to a considerable margin of error. For details, see "The Background" section of this Outlook Report.

Bank pursues "QQE with Yield Curve Control."[5] 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.

The potential growth rate is expected to follow a moderate uptrend throughout 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; and firms' continued efforts toward improving productivity and discovering potential domestic and external demand. 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

With regard to developments in the year-on-year rate of change in the CPI since the previous Outlook Report, prices of some consumer durable goods as well as services have shown somewhat weak developments in recent months. As for the outlook, however, it is likely to continue on an uptrend and increase toward 2 percent, mainly on the back of the improvement in the output gap and the rise in medium- to long-term inflation expectations. Comparing the current projections through fiscal 2018 with the previous ones, the projected rates of increase in the CPI are more or less unchanged. The timing of the year-on-year rate of change in the CPI reaching around 2 percent will likely be around the middle of the projection period -- that is, around fiscal 2018.[6] Thereafter, the rate of change is expected to remain at around 2 percent.

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

[6] By assuming that the rise in the consumption tax will be fully passed on to taxable items excluding those to which a reduced tax rate will be applied, the effects of the October 2019 consumption tax hike on the year-on-year rate of change in the CPI (all items less fresh food) for October 2019 onward is estimated to be 1.0 percentage point; the effect for fiscal 2019 is thus estimated to be half that, at 0.5 percentage point.

The background to these projections is as follows. First, medium- to long-term inflation expectations have remained in a weakening phase. Various market indicators and survey results indicate that medium- to long-term inflation expectations have not yet picked up clearly on the whole, although some of them show a rise in such expectations. As for the outlook, however, 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 as the output gap improves, also backed in part by developments in energy prices, and (2) in terms of the forward-looking component, the Bank will pursue monetary easing through its strong commitment to achieving the price stability target.[7]

Second, with regard to the output gap, which shows the utilization of labor and capital, after having been more or less unchanged at around 0 percent, it improved recently, turning positive at the end of 2016. In particular, the tightening of labor market conditions is becoming even more evident, as evidenced by the active job openings-to-applicants ratio approaching the peak level observed during the "asset bubble" period, and by the unemployment rate having declined to the range of 2.5-3.0 percent. In this situation, wages are rising moderately, as seen in the fact that many firms -- including small and medium-sized firms -- are expected to raise their base pay for the fourth consecutive year. Going forward, the output gap is expected to widen further within positive territory. This is likely to be supported by the further tightening of labor market conditions, due in part to the effects resulting from the set of stimulus measures becoming evident, in addition to an improvement in capacity utilization rates brought about by an increase in exports and production. Under such circumstances, a virtuous cycle between a moderate rise in the inflation rate and wage increases is likely to operate.

Third, regarding import prices, a pick-up in international commodity prices including crude oil prices since last spring is expected to push up the year-on-year rate of change in energy

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[7] 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. For details, 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.

prices in the CPI for fiscal 2017, but this effect is likely to wane gradually. As for the impact of foreign exchange rates on consumer prices through import prices, the past yen depreciation is likely to increase upward pressure on prices, mainly in fiscal 2017.

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 <u>developments in overseas economies</u>. Specifically, the following are considered as risks: the U.S. economic policies and their impact on global financial markets; developments in emerging and commodity-exporting economies; negotiations on the United Kingdom's exit from the European Union (EU) and their effects; prospects regarding the European debt problem, including the financial sector; and geopolitical risks. If these risks were to materialize, they could exert downward pressure on economic activity. On the other hand, as market participants and economic entities factor them in to a certain extent, the economy could deviate upward from the baseline scenario depending on how they play out.

Second, <u>firms' and households' medium- to long-term growth expectations</u> 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 <u>fiscal sustainability in the medium to long term</u> 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. Although inflation expectations are likely to follow an increasing trend, there is uncertainty regarding the momentum to push up inflation expectations through the "adaptive expectation formation mechanism" given that the observed inflation rate has been somewhat weak recently. Therefore, there is a risk that firms' price- and wage-setting stance will be more cautious than the baseline scenario.

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, some services prices, and housing rent, which might continue to constrain the acceleration of CPI inflation.

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.[8]

The first perspective concerns an examination of the baseline scenario for the outlook. The year-on-year rate of change in the CPI is expected to increase toward 2 percent. The momentum toward achieving the price stability target is maintained, but is not yet sufficiently firm, and thus developments in prices continue to warrant careful attention.

[8] 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."

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 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.[9]

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

[9] For details, see the Bank's *Financial System Report* (April 2017).

(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 hike
Fiscal 2016	+1.4 to +1.4 [+1.4]	-0.3	
Forecasts made in January 2017	+1.2 to +1.5 [+1.4]	-0.2 to -0.1 [-0.2]	
Fiscal 2017	+1.4 to +1.6 [+1.6]	+0.6 to +1.6 [+1.4]	
Forecasts made in January 2017	+1.3 to +1.6 [+1.5]	+0.8 to +1.6 [+1.5]	
Fiscal 2018	+1.1 to +1.3 [+1.3]	+0.8 to +1.9 [+1.7]	
Forecasts made in January 2017	+1.0 to +1.2 [+1.1]	+0.9 to +1.9 [+1.7]	
Fiscal 2019	+0.6 to +0.7 [+0.7]	+1.4 to +2.5 [+2.4]	+0.9 to +2.0 [+1.9]

Notes: 1. Figures in brackets indicate the medians 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.

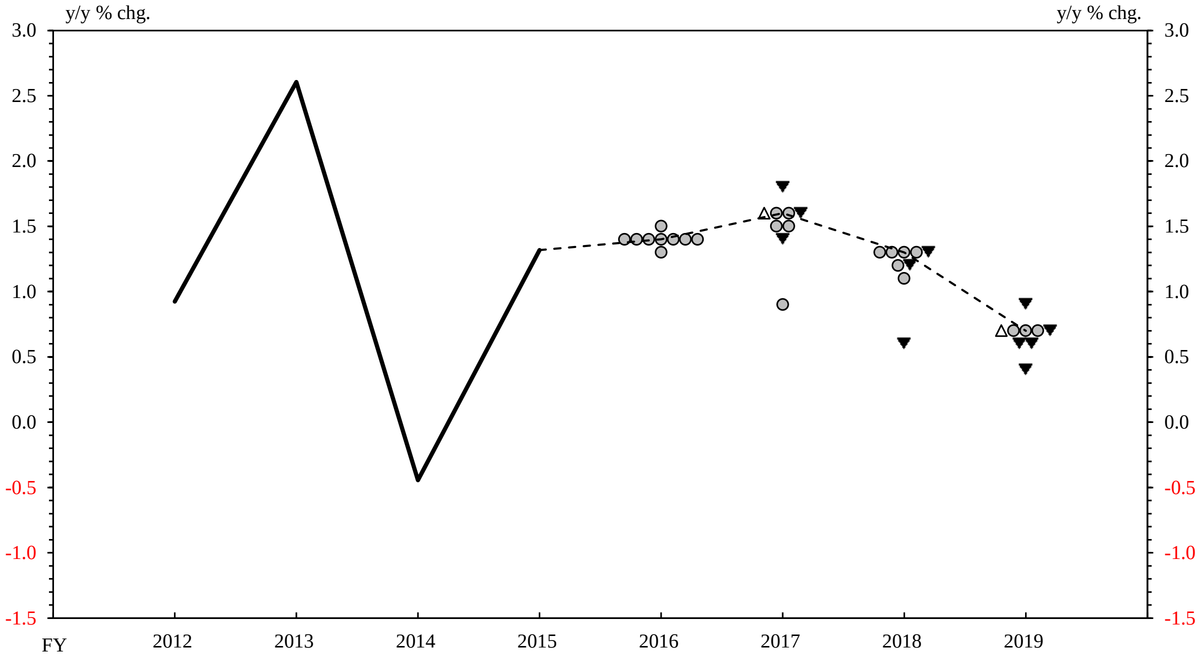
3. Individual Policy Board members make their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding future policy. Specifically, each Policy Board member makes an assumption about the future path of short- and long-term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

4. The consumption tax hike scheduled to take place in October 2019 -- to 10 percent -- and the reduced tax rate to be applied to food and beverages -- excluding alcohol and dining-out -- and newspapers are 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 2019 that incorporate the direct effects of the consumption tax hike are constructed as follows. First, the contribution to prices from the tax hike is mechanically computed on the assumption that the tax increase will be fully passed on for taxable items. The CPI will be pushed up by 0.5 percentage point. Second, this figure is added to the forecasts made by the Policy Board members.

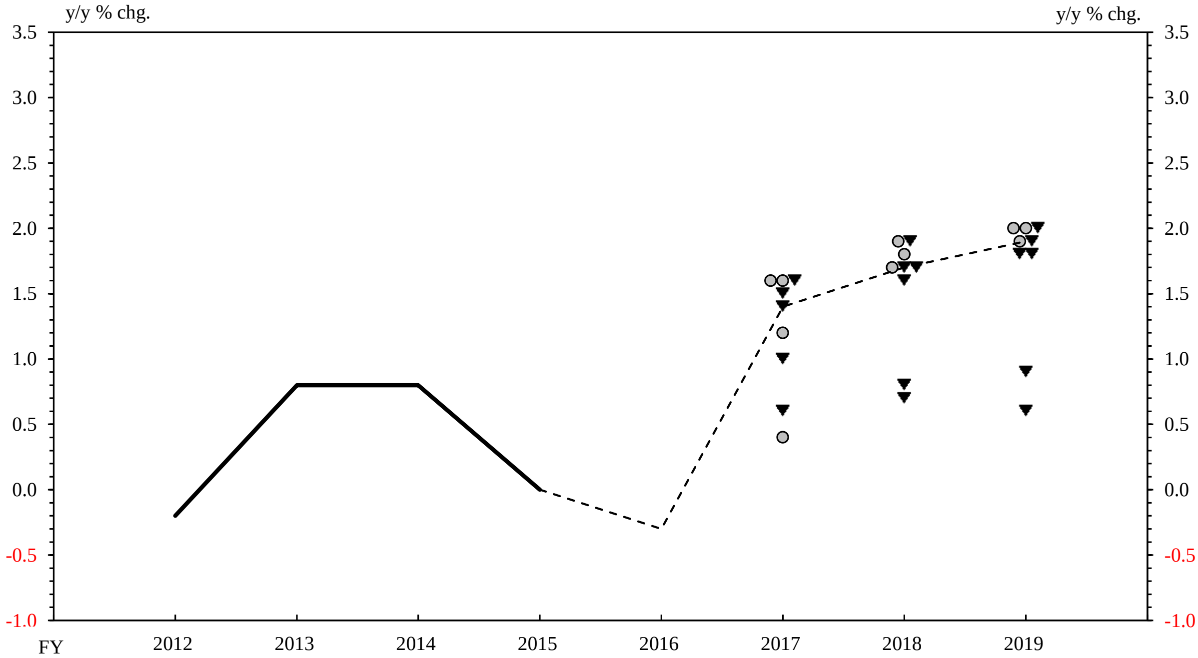
5. The CPI (all items less fresh food) for fiscal 2016 is computed based on the assumption that the year-on-year rate of increase for March is the same as that for February.

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). However, the CPI (all items less fresh food) for fiscal 2016 is computed based on the assumption that the year-on-year rate of increase for March is the same as that for February.

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.