April 27, 2018

Bank of Japan

Outlook for Economic Activity and Prices (April 2018)

The Bank's View[1]

Summary

- Japan's economy is likely to continue growing at a pace above its potential in fiscal 2018, mainly against the background of highly accommodative financial conditions and the underpinnings through government spending, with overseas economies continuing to grow firmly. From fiscal 2019 through fiscal 2020, the economy is expected to continue on an expanding trend supported by external demand, 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) has continued to show relatively weak developments when excluding the effects of energy prices compared to the economic expansion and the labor market tightening, mainly against the background that firms' wage- and price-setting stance has remained cautious. Nonetheless, medium- to long-term inflation expectations are projected to rise as firms' stance gradually shifts toward raising wages and prices with an improvement in the output gap continuing. As a consequence, the year-on-year rate of change in the CPI is likely to continue on an uptrend and increase toward 2 percent.
- Comparing the current projections through fiscal 2019 with the previous ones, the projected growth rates are somewhat higher and the projected rates of increase in the CPI are more or less unchanged.
- With regard to the risk balance, upside and downside risks to economic activity are generally balanced in fiscal 2018, but risks are skewed to the downside for fiscal 2019 onward. Risks to prices are skewed to the downside. On the price front, the momentum toward achieving the price stability target of 2 percent is maintained as the output gap is expected to continue improving and medium- to long-term inflation expectations are projected to rise gradually; however, the momentum 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.

[1] The text of "The Bank's View" -- the outlook for economic activity and prices as well as the Bank's thinking on the conduct of monetary policy, both of which are based on individual Policy Board members' views -- was decided by the Policy Board at the Monetary Policy Meeting held on April 26 and 27, 2018.

[2] The April 2018 *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. It also factors in policies concerning the provision of free education based on information available at this point.

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

Japan's economy is expanding moderately, with a virtuous cycle from income to spending operating. Overseas economies have continued to grow firmly on the whole. In this situation, exports have been on an increasing trend. On the domestic demand side, business fixed investment has continued on an increasing trend with corporate profits and business sentiment maintaining their improving trend. Private consumption has been increasing moderately, albeit with fluctuations, against the background of steady improvement in the employment and income situation. Housing investment has been weakening somewhat. Meanwhile, public investment has been more or less flat, remaining at a relatively high level. 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) is around 1 percent. Inflation expectations have been more or less unchanged.

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. In 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, mainly against the background of highly accommodative financial conditions and the underpinnings through government spending. Business fixed investment is likely to continue increasing amid accommodative financial conditions, led mainly by investment intended for domestic capacity expansion in line with the economic expansion, Olympic Games-related investment, and labor-saving investment to address the labor shortage. Private consumption is also expected to follow a moderate increasing trend as the employment and income situation continues to improve. Public investment is expected to remain at a relatively high level, mainly reflecting the supplementary budget for fiscal 2017 and Olympic Games-related demand, although the positive effects resulting from the government's past stimulus measures are likely to diminish moderately. Exports are expected to continue their moderate increasing trend on the back of the firm growth in overseas economies. On this basis, the economy is likely to continue growing at a pace above its potential in fiscal 2018.[3]

In fiscal 2019 and fiscal 2020, Japan's economy is expected to continue on an expanding trend supported by external demand, although the growth pace is projected to decelerate, reflecting a slowdown in domestic demand. Specifically, the pace of increase in private consumption is projected to be moderate in fiscal 2019 and fiscal 2020, mainly because it is likely to temporarily turn to a decline due to the effects of the scheduled consumption tax hike in October 2019.[4] On the other hand, exports are projected to maintain their increasing trend on the back of the firm growth in overseas economies. Meanwhile, the pace of increase in business fixed investment is likely to decelerate gradually through fiscal 2020, mainly reflecting cyclical adjustments in capital stock after the prolonged economic expansion, as well as Olympic Games-related demand peaking out; however, the deceleration is expected to be moderate, due partly to growing demand for fixed investment stemming from the increase in exports.

Comparing the current projections through fiscal 2019 with the previous ones, the projected growth rates are somewhat higher, mainly reflecting the firm growth in overseas economies.

Looking at the financial conditions on which the above outlook is based, short- and long-term real interest rates are assumed to be in negative territory throughout the projection period as the 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

[3] Under a specific methodology, Japan's potential growth rate is estimated to be in the range of 0.5-1.0 percent. 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.

[4] The consumption tax hike scheduled to take place in October 2019 will affect the GDP 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. Although it is subject to considerable uncertainties, the negative impact on the growth rates is expected to be smaller than that on the rate for fiscal 2014, when the last consumption tax hike took place.

[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.

in labor participation by women and seniors under such strategy; and firms' continued efforts toward improving productivity. 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

Although the year-on-year rate of increase in the CPI has been accelerating gradually, it has continued to show relatively weak developments compared to the economic expansion and the labor market tightening, remaining at around 0.5 percent excluding the effects of energy prices.

This is attributable to the fact that the mindset and behavior based on the assumption that wages and prices will not increase easily have been deeply entrenched among firms and households. Firms have been making efforts to absorb a rise in labor costs by increasing labor-saving investment and streamlining their business process, while limiting wage increases -- which correspond to the labor shortage -- mainly to part-time employees. As suggested by these developments, firms' wage- and price-setting stance has remained cautious despite the steady tightening of labor market conditions and the high levels of corporate profits. However, the upward pressure on prices stemming from the rise in firms' costs has been increasing, partly due to a continued clear uptrend in hourly scheduled cash earnings of part-time employees and a rise in input prices.

With regard to the outlook, the year-on-year rate of change in the CPI 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 2019 with the previous ones, the projected rates of increase in the CPI are more or less unchanged.[6]

The mechanism through which the year-on-year rate of change in the CPI increases toward 2 percent can be explained by the following factors that determine inflation rates. First, <u>the output gap</u> -- which shows the utilization of labor and capital -- has widened steadily within positive territory on the back of the steady tightening of labor market conditions and a rise in capital utilization rates. Going forward, as the economy continues its moderate expansion, the output gap is expected to widen further within positive territory in fiscal 2018 and remain substantially positive in fiscal 2019 and fiscal 2020.

[6] Assuming that the rise in the consumption tax will be fully passed on to prices of taxable items, excluding those to which a reduced tax rate will be applied, the effect 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 and fiscal 2020 is estimated to be 0.5 percentage point for each year. It also is assumed that the effects of policies concerning the provision of free education will not be reflected in the CPI, as statistical treatment of these effects is not yet decided.

Second, medium- to long-term inflation expectations have been more or less unchanged recently, after having remained in a weakening phase since summer 2015. As for the outlook, such expectations are likely to follow an increasing trend and gradually converge to around 2 percent on the back of the following: (1) in terms of the adaptive component, with the improvement in the output gap, firms' stance is likely to gradually shift toward raising wages and prices and the observed inflation rate is expected to rise steadily, 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]

Regarding import prices, the past pick-up in crude oil prices has pushed up energy prices in the CPI, but this effect is likely to wane moderately.

III. Risks to Economic Activity and Prices

A. Risks to Economic Activity

The following four factors are upside and downside risks to the Bank's baseline scenario regarding the economy.

The first is developments in overseas economies. 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; and geopolitical risks.

The second risk is the effects of the consumption tax hike scheduled to take place in October 2019. It is likely that the effects of the front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike and of the decline in real income will depend 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 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.

[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.

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 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. 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 a risk that a rise in such expectations will lag behind if it takes time for firms' stance to shift toward raising wages and prices and inflation consequently remains relatively sluggish.

The second factor is the fact that there are items for which prices are not particularly responsive to the output gap. There is concern about the continued dull responses of administered prices, some services prices, and housing rent, which may continue to constrain the acceleration of CPI inflation. In addition, with regard to goods and services that are difficult to differentiate, their prices may also constrain the acceleration of CPI inflation if competition among firms intensifies further, due mainly to changes in the distribution system and deregulation.

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 likely to increase toward 2 percent. Although it is necessary to carefully examine the fact that firms' wage- and price-setting stance has

[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."

remained cautious, the momentum toward achieving the price stability target of 2 percent appears to be maintained. This is because (1) firms' stance is likely to gradually shift toward raising wages and prices with the steady improvement in the output gap, and (2) medium- to long-term inflation expectations have been more or less unchanged recently and such expectations are projected to rise steadily as further price rises come to be observed widely.

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, upside and downside risks are generally balanced in fiscal 2018, but risks are skewed to the downside for fiscal 2019 onward. Regarding the outlook for prices, risks are skewed to the downside, especially 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 2018).

(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 2017	+1.8 to +1.9 [+1.9]	+0.7	
Forecasts made in January 2018	+1.8 to +2.0 [+1.9]	+0.7 to +1.0 [+0.8]	
Fiscal 2018	+1.4 to +1.7 [+1.6]	+1.2 to +1.3 [+1.3]	
Forecasts made in January 2018	+1.3 to +1.5 [+1.4]	+1.3 to +1.6 [+1.4]	
Fiscal 2019	+0.7 to +0.9 [+0.8]	+2.0 to +2.3 [+2.3]	+1.5 to +1.8 [+1.8]
Forecasts made in January 2018	+0.7 to +0.9 [+0.7]	+2.0 to +2.5 [+2.3]	+1.5 to +2.0 [+1.8]
Fiscal 2020	+0.6 to +1.0 [+0.8]	+2.0 to +2.3 [+2.3]	+1.5 to +1.8 [+1.8]

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.

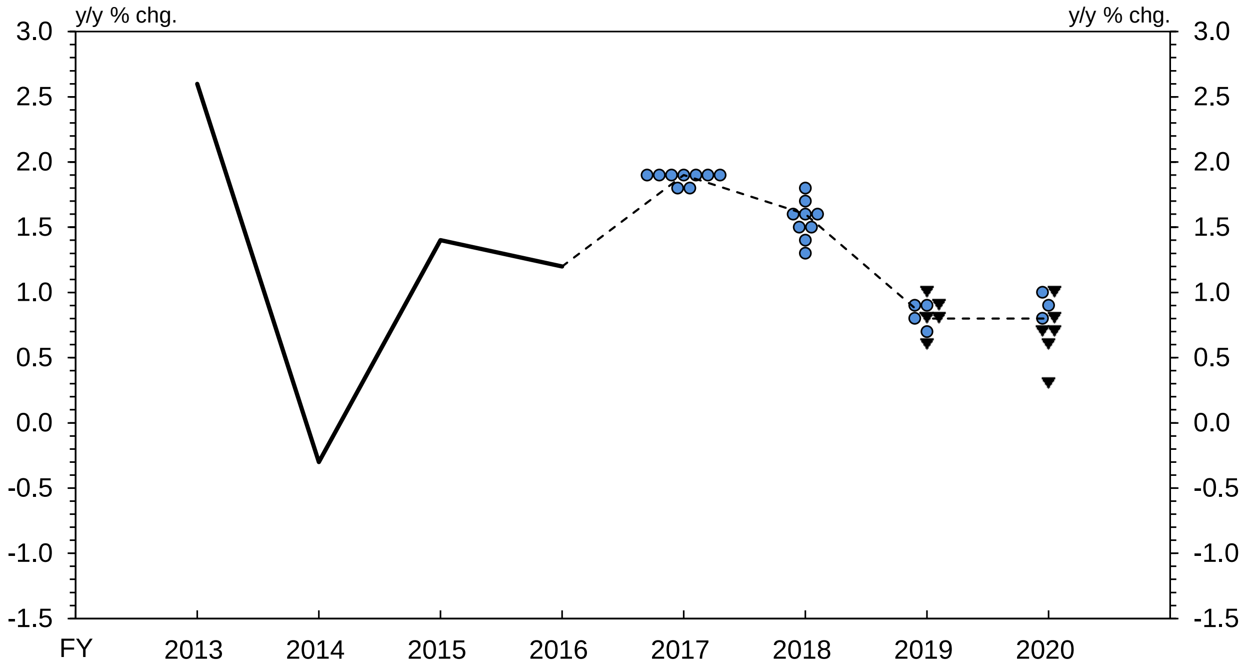
3. Individual Policy Board members make their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding future policy. Specifically, each Policy Board member makes an assumption about the future path of short- and long-term 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 and fiscal 2020 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 for each year. Second, this figure is added to the forecasts made by the Policy Board members. While it is assumed that the effects of policies concerning the provision of free education will not be reflected in the CPI as statistical treatment of these effects is not yet decided, the effects of such policies are factored in by individual Policy Board members for their forecasts of the real GDP growth rates, based on information available at this point.

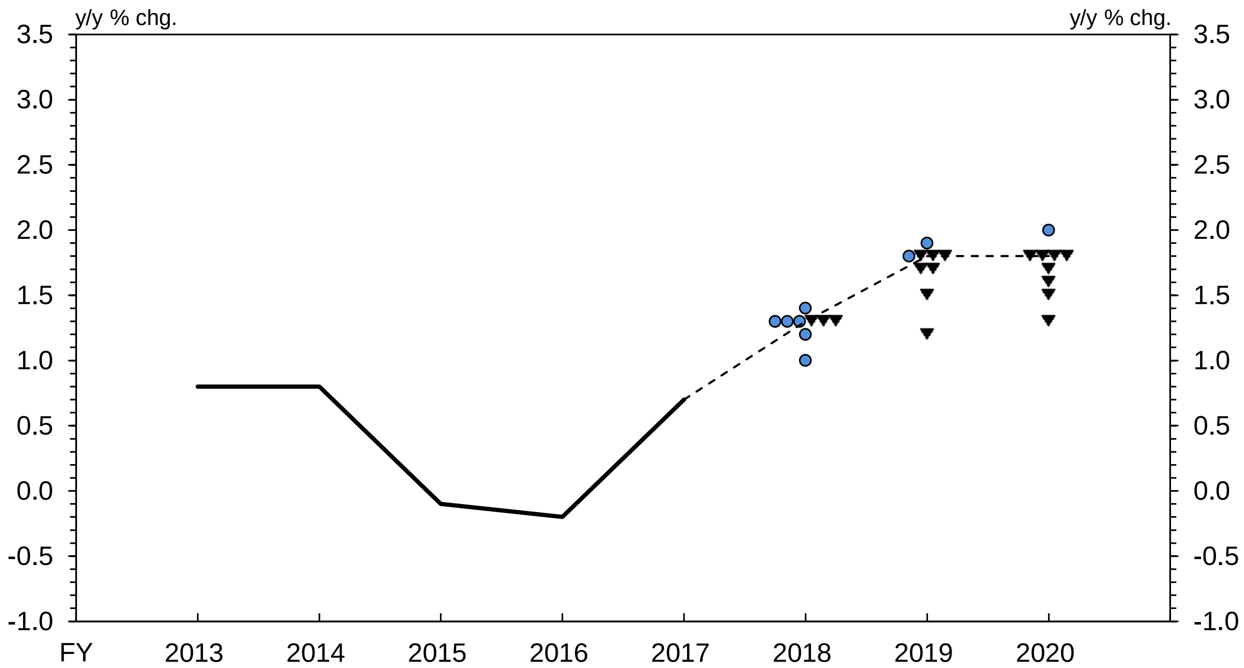
5. The CPI (all items less fresh food) for fiscal 2017 is an actual figure.

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.