July 30, 2019
Bank of Japan

Outlook for Economic Activity and Prices (July 2019)

The Bank's View[1]

Summary

- Japan's economy is likely to continue on an expanding trend throughout the projection period -- that is, through fiscal 2021 -- despite being affected by the slowdown in overseas economies for the time being.[2] Although exports are projected to show some weakness for the time being, they are expected to be on a moderate increasing trend, with overseas economies growing moderately on the whole. Domestic demand also is likely to follow an uptrend, mainly against the background of highly accommodative financial conditions and the underpinnings through government spending, despite being affected by such factors as the scheduled consumption tax hike.
- The year-on-year rate of change in the consumer price index (CPI, all items less fresh food) has been positive but has continued to show relatively weak developments compared to the economic expansion and tight labor market conditions. Medium- to long-term inflation expectations have been more or less unchanged. Nonetheless, with the output gap remaining positive, firms' stance gradually will shift toward further raising wages and prices, and households' tolerance of price rises will increase. In this situation, further price rises are likely to be observed widely and then medium- to long-term inflation expectations are projected to rise gradually. As a consequence, the year-on-year rate of change in the CPI is likely to increase gradually toward 2 percent.
- Comparing the current projections with the previous ones, both 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 economic activity are skewed to the downside, particularly regarding developments in overseas economies. Risks to prices are skewed to the downside, mainly due to the downside risks to economic activity and uncertainties over developments in medium- to long-term inflation expectations. 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.

[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 July 29 and 30, 2019.

[2] The July 2019 *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. Current Situation of Economic Activity and Prices in Japan

Japan's economy has been on a moderate expanding trend, with a virtuous cycle from income to spending operating, although exports, production, and business sentiment have been affected by the slowdown in overseas economies. Overseas economies have been growing moderately on the whole, although slowdowns have been observed. In this situation, exports have shown some weakness. On the other hand, with corporate profits staying at high levels on the whole, business fixed investment has continued on an increasing trend. Private consumption has been increasing moderately against the background of steady improvement in the employment and income situation, and an increase in demand prior to the scheduled consumption tax hike has started to be seen in part, albeit to a marginal extent compared with that of the previous tax hike. Housing investment and public investment have been more or less flat. Although exports have shown some weakness, industrial production also has been more or less flat, reflecting the increase in domestic demand, and labor market conditions have remained tight. 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 at around 0.5 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 on an expanding trend throughout the projection period -- that is, through fiscal 2021 -- despite being affected by the slowdown in overseas economies for the time being.

Specifically, as for the outlook for Japan's economy for the time being, exports are projected to show some weakness and business fixed investment also is likely to decelerate somewhat, both reflecting the effects of the slowdown in overseas economies. However, private consumption is expected to continue increasing as the employment and income situation continues to improve, and also partly because of the increase in demand prior to the scheduled consumption tax hike in October 2019. Public investment also is likely to increase, reflecting Olympic Games-related demand, the implementation of the supplementary budgets in response to natural disasters, and expansion in expenditure such as for national resilience.

Thereafter, overseas economies are expected to grow moderately on the whole with the growth rates rising somewhat, partly backed by the materialization of the effects of stimulus measures, such as in China, and the progress in global adjustments in IT-related goods. Under these circumstances, Japan's exports are projected to return to their moderate increasing trend. 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, despite being affected by such factors as the scheduled consumption tax hike. Business fixed investment -- such as that intended for domestic capacity expansion in line with the economic expansion, that related to urban redevelopment projects, and labor-saving investment to address labor shortage -- is likely to increase moderately amid accommodative financial conditions, despite downward pressure resulting mainly from cyclical adjustments in capital stock accompanying the prolonged economic expansion. Private consumption also is expected to follow a moderate increasing trend as the employment and income situation continues to improve and the government implements countermeasures for the scheduled consumption tax hike, although it is likely to be pushed down for some time due to the effects of the hike.[3] Meanwhile, public investment is expected to continue increasing through fiscal 2020 and thereafter maintain a relatively high level in fiscal 2021.

On this basis, Japan's economy is likely to continue growing at about the same pace as its potential on average.[4] Comparing the current projections with the previous ones, the projected growth rates are more or less unchanged.

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 "Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control."[5] Financial institutions' active lending attitudes, as well as favorable conditions for corporate bond and CP issuance, are likely to be maintained and support firms' and households' activities from the financial side. Thus, financial conditions are likely to remain highly accommodative.

Meanwhile, 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 seniors under such strategy; and firms' continued efforts toward improving productivity. In addition, as the natural rate of interest

[3] 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) a decline in real income. Although it is subject to uncertainties, the negative impact on the growth rates is expected to be smaller than that of the previous tax hike in fiscal 2014.

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

[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.

increases together with the rise in the growth potential of Japan's economy, monetary easing effects are likely to be enhanced.

B. Baseline Scenario of the Outlook for Prices

The year-on-year rate of change in the CPI has been positive but has continued to show relatively weak developments compared to the economic expansion and tight labor market conditions.

This is basically because firms' cautious wage- and price-setting stance, as well as households' cautiousness toward price rises, have not yet clearly changed in a situation where the mindset and behavior based on the assumption that wages and prices will not increase easily have been deeply entrenched. Firms' efforts to absorb upward pressure of costs on prices by raising productivity, the technological progress in recent years, and the high wage elasticity of labor supply also are contributing factors. In addition, the continued lackluster developments in administered prices and housing rent are likely to have affected the sluggishness in prices. It has been taking time to resolve these factors that have been delaying price rises, and the situation likely has continued in which the responsiveness of prices to the output gap, as well as inflation expectations that are strongly affected by the adaptive formation mechanism, do not rise easily.

With regard to the outlook, the year-on-year rate of change in the CPI is likely to increase gradually toward 2 percent, mainly on the back of the output gap remaining positive and medium- to long-term inflation expectations rising. Comparing the current projections 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 gradually toward 2 percent can be explained by the following factors that determine general price inflation. First, the output gap -- which shows the utilization of labor and capital -- has been substantially positive, reflecting tight labor market conditions and high levels of capital utilization rates, and is expected to remain so. Under such circumstances, further price rises are likely to be observed widely as households' tolerance of price rises increases, mainly reflecting a rise in wage growth rates, and firms' stance shifts toward further raising prices.

[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. In addition, based on a specific assumption using information available at this point, the effects of policies concerning the provision of free education on the year-on-year rate of change in the CPI (all items less fresh food) for fiscal 2019 and fiscal 2020 are estimated to be minus 0.3 percentage point and minus 0.4 percentage point, respectively.

Second, medium- to long-term inflation expectations have been more or less unchanged recently. As for the outlook, such expectations are likely to follow an increasing trend and gradually converge to 2 percent on the back of the following: (1) in terms of the adaptive component, a rise in the observed inflation rate is likely to push up inflation expectations, 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, which will be effective in pushing up inflation expectations.[7]

Third, regarding import prices, the past decline in crude oil prices is likely to exert downward presure on the CPI through energy prices for the time being.

Meanwhile, the recent increase in labor participation by women and seniors, as well as firms' strengthening of efforts to absorb upward pressure of costs on prices by raising productivity, are expected to increase upward pressure on prices in the long term. Specifically, as the growth potential of the economy as a whole rises, reflecting such moves, firms' and households' spending behavior can be expected to become active.

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. macroeconomic policies and their impact on global financial markets; the consequences of protectionist moves and their effects; developments in emerging and commodity-exporting economies such as China, including the effects of the two aforementioned factors; developments in global adjustments in IT-related goods; negotiations on the United Kingdom's exit from the European Union (EU) and their effects; and geopolitical risks. Downside risks concerning overseas economies are likely to remain significant, and uncertainties regarding the effects of protectionist moves in particular have been heightening. It also is necessary to pay close attention to the impact of such downside risks on firms' and households' sentiment in Japan.

The second risk is the effects of the consumption tax hike scheduled to take place in October 2019. These are likely to depend on consumer sentiment, the employment and income situation, and developments in prices.

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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.

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 declining birthrate and aging population; developments in regulatory and institutional reforms, particularly in the labor market; innovation in the corporate sector; and the employment and income situation.

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 also is 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

As mentioned above, with regard to risks to economic activity, the downside risks concerning overseas economies in particular are significant. If these risks materialize, there is a possibility that prices also will be affected to some extent. In addition, the specific factors that could exert upside and downside risks to prices are as follows. The first 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 be delayed through the adaptive formation mechanism if it takes longer than projected for firms' stance to shift toward further raising wages and prices and actual inflation consequently remains relatively sluggish.

The second factor is the responsiveness of prices to the output gap. If firms' efforts to absorb upward pressure of costs on prices by raising productivity continue for a long time, or competition among firms intensifies further, due partly to the technological progress in recent years and changes in the distribution system, downward pressure on prices stemming from these factors may last longer than expected. In addition, the lackluster developments in administered prices and housing rent also may continue to constrain the rise in CPI inflation for a long period.

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 involves an examination of the baseline scenario for the outlook. The year-on-year rate of change in the CPI is likely to increase gradually toward 2 percent. Although it is necessary to carefully examine the risks to economic activity and prices, the momentum toward achieving the price stability target of 2 percent appears to be maintained. This is because (1) firms' stance is expected to gradually shift toward further raising wages and prices with the output gap remaining positive, and (2) medium- to long-term inflation expectations have been more or less unchanged and are projected to rise gradually 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, risks are skewed to the downside, particularly regarding developments in overseas economies. Regarding the outlook for prices, risks are skewed to the downside, mainly due to the downside risks to economic activity and uncertainties over 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. However, prolonged downward pressure on financial institutions' profits, with the low interest rate environment and severe competition among financial institutions continuing, could create risks of a gradual pullback in financial intermediation and of destabilizing the financial system. Although these risks are judged as not significant at this point, mainly because financial institutions have sufficient capital bases, it is necessary to pay close attention to future developments.

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. As for policy rates, the Bank intends to maintain the current extremely low levels of short- and long-term interest rates for an extended period of time, at least through around spring 2020, taking into account uncertainties regarding economic activity and prices including developments in overseas economies and the effects of the scheduled consumption tax hike. It will examine the risks considered most relevant to the conduct of monetary policy and make

[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."

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. In particular, in a situation where downside risks to economic activity and prices, mainly regarding developments in overseas economies, are significant, the Bank will not hesitate to take additional easing measures if there is a greater possibility that the momentum toward achieving the price stability target will be lost.

(Appendix)

Forecasts of the Majority of Policy Board Members

y/y % chg.

	Real GDP	CPI (all items less fresh food)	(Reference) Excluding the effects of the consumption tax hike and policies concerning the provision of free education
Fiscal 2019	+0.6 to +0.9 [+0.7]	+0.8 to +1.1 [+1.0]	+0.6 to +0.9 [+0.8]
Forecasts made in April 2019	+0.7 to +0.9 [+0.8]	+0.9 to +1.2 [+1.1]	+0.7 to +1.0 [+0.9]
Fiscal 2020	+0.8 to +1.0 [+0.9]	+1.1 to +1.4 [+1.3]	+1.0 to +1.3 [+1.2]
Forecasts made in April 2019	+0.8 to +1.1 [+0.9]	+1.2 to +1.5 [+1.4]	+1.1 to +1.4 [+1.3]
Fiscal 2021	+0.9 to +1.2 [+1.1]	+1.3 to +1.7 [+1.6]	
Forecasts made in April 2019	+0.9 to +1.2 [+1.2]	+1.4 to +1.7 [+1.6]	

Notes: 1. Figures in brackets indicate the medians of the Policy Board members' forecasts (point estimates).

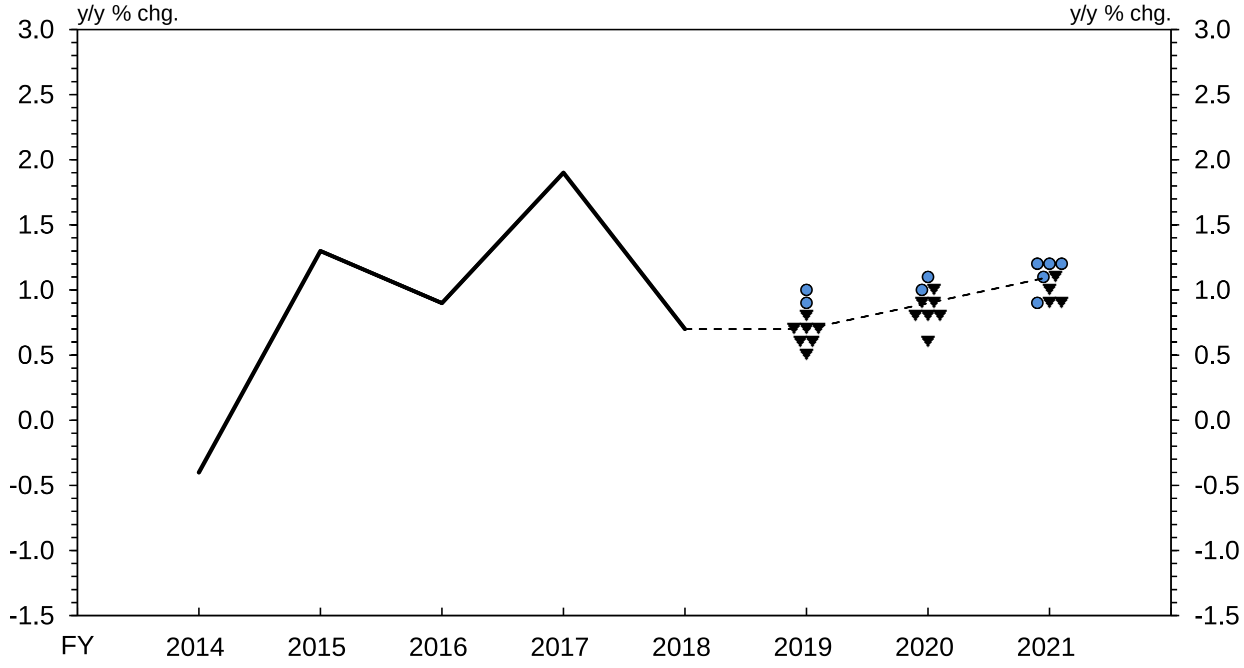
2. The forecasts of the majority of the Policy Board members are constructed as follows: each Policy Board member's forecast takes the form of a point estimate -- namely, the figure to which he or she attaches the highest probability of realization. These forecasts are then shown as a range, with the 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.

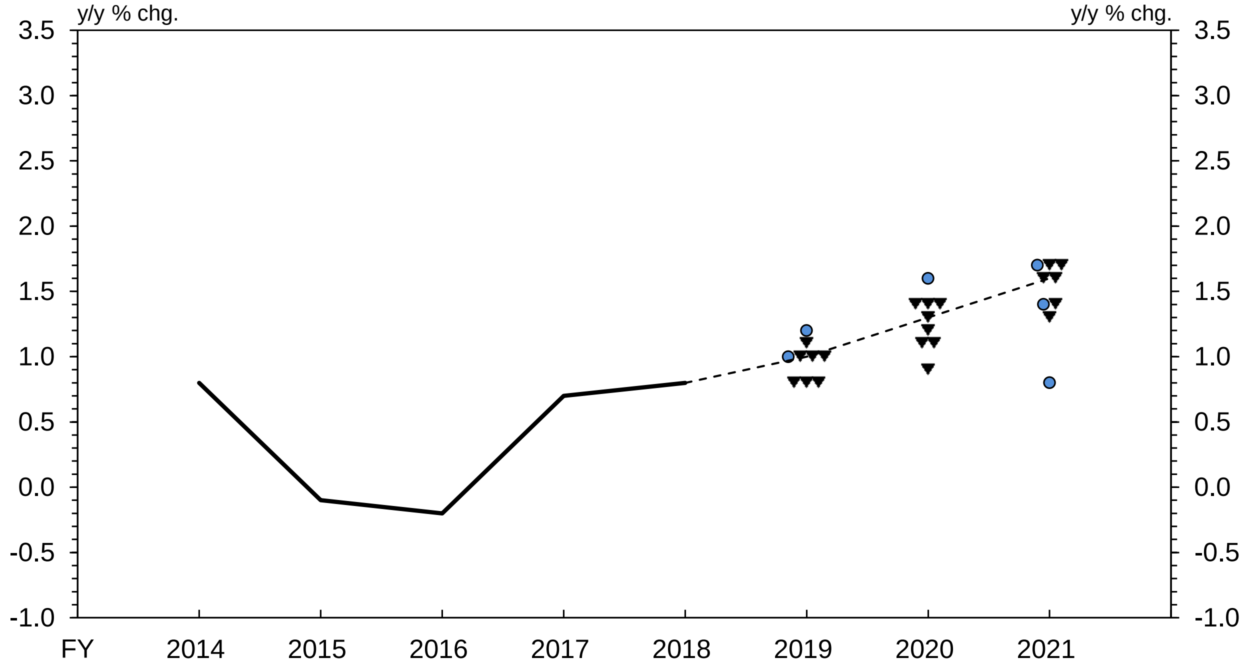
4. The forecasts assume the following: (1) the consumption tax will be raised to 10 percent in October 2019 and a reduced tax rate will be applied to food and beverages -- excluding alcohol and dining out -- and newspapers, and (2) with regard to policies concerning the provision of free education, free early childhood education and such measures as free higher education will be introduced in October 2019 and April 2020, respectively. Assuming that the rise in the consumption tax will be fully passed on to prices of taxable items, the direct effect of the tax hike on the CPI for fiscal 2019 and fiscal 2020 is estimated to be 0.5 percentage point for each year. In addition, based on a specific assumption using information available at this point, the direct effects of policies concerning the provision of free education on the CPI for fiscal 2019 and fiscal 2020 are estimated to be minus 0.3 percentage point and minus 0.4 percentage point, respectively.

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. The CPI figures for fiscal 2014 and fiscal 2015 exclude the direct effects of the consumption tax hike in April 2014.