April 27, 2020
Bank of Japan

Outlook for Economic Activity and Prices (April 2020)

The Bank's View[1]

Summary

- Japan's economy is likely to remain in a severe situation for the time being due to the impact of the spread of the novel coronavirus (COVID-19) at home and abroad. The year-on-year rate of change in the consumer price index (CPI, all items less fresh food) is expected to be somewhat weak for the time being, mainly affected by the spread of COVID-19 and the decline in crude oil prices.
- Thereafter, as the impact of the spread of COVID-19 wanes at home and abroad, Japan's economy is likely to improve, supported by accommodative financial conditions and the government's economic measures, as well as through the expected materialization of pent-up demand (i.e., demand that has been constrained) and a projected recovery in production from the decline brought about by the spread of COVID-19. The year-on-year rate of change in the CPI is likely to increase gradually. In this Outlook Report, the impact of the spread of COVID-19 is assumed to wane on a global basis through the second half of 2020.
- That said, future developments are extremely unclear, as they could change depending on the timing of the spread of COVID-19 subsiding and on the magnitude of the impact on domestic and overseas economies. The aforementioned outlook for economic activity and prices is based mainly on the assumption that, while the impact of the spread of COVID-19 remains, firms' and households' medium- to long-term growth expectations will not decline substantially and the smooth functioning of financial intermediation will be ensured with financial system stability being maintained, although this assumption entails high uncertainties.
- With regard to the risk balance, risks to both economic activity and prices are skewed to the downside, mainly due to the impact of COVID-19.

[1] "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on April 27, 2020.

I. Current Situation of Economic Activity and Prices in Japan

Japan's economy has been in an increasingly severe situation due to the impact of the spread of COVID-19 at home and abroad. Overseas economies have become depressed rapidly, reflecting the impact of the COVID-19 pandemic. In this situation, exports and industrial production have declined. Business sentiment has deteriorated, and the deceleration in the pace of increase in business fixed investment has become evident recently. With the growing impact of the spread of COVID-19, the employment and income situation has started to show some weakness, and private consumption has decreased significantly, mainly in services such as eating and drinking as well as accommodations. Meanwhile, housing investment has been more or less flat and public investment has increased moderately. Financial conditions have been accommodative on the whole but less so in terms of corporate financing, as seen in deterioration in firms' financial positions. 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. As for inflation expectations, relatively weak indicators have been observed.

II. Outlook for Economic Activity and Prices in Japan

A. Outlook for Economic Activity and Prices for the Time Being

Japan's economy is likely to remain in a severe situation for the time being due to the impact of the spread of COVID-19 at home and abroad.

The world currently is in a pandemic; the outbreak of COVID-19 was first identified in China and it spread rapidly worldwide, including to Asia, Europe, and the United States. Economic activity has been disrupted significantly as a result of preventive measures against the spread of COVID-19 taken by each country and region, such as restrictions on going outside and immigration/emigration, as well as orders to suspend business and production activities. Until the spread of COVID-19 subsides, economic activity is likely to remain constrained and thus overseas economies are expected to remain depressed.

In this situation, Japan's exports, including inbound tourism consumption, are likely to remain weak. Despite being supported by the government's economic measures, domestic demand, mainly in terms of private consumption, is expected to remain weak, with economic activity being constrained due to the impact of the spread of COVID-19.

The year-on-year rate of change in the CPI has been positive but is likely to be somewhat weak for the time being, mainly affected by the spread of COVID-19 and the decline in crude oil prices.

B. Outlook for Economic Activity and Prices from a Somewhat Long-Term Perspective

In this Outlook Report, while there are extremely high uncertainties over the outlook for economic activity from a somewhat long-term perspective, it is assumed that the impact of the spread of COVID-19 on the economy will wane on a global basis through the second half of 2020.[2]

Based on this assumption, the growth pace of overseas economies is likely to increase. This is because, from around the second half of 2020, pent-up demand and a recovery in production from the decline brought about by the spread of COVID-19 are expected to exert upward pressure on these economies, and the effects of aggressive macroeconomic policies taken by each country and region are likely to materialize.

Japan's economy also is expected to improve as the impact of the spread of COVID-19 wanes at home and abroad. Exports are likely to head toward an increase again with the growth pace of overseas economies rising. In addition, domestic demand is expected to turn toward a pick-up and then increase, supported by accommodative financial conditions and the government's economic measures, as well as through the expected materialization of pent-up demand.

As for prices, with the economy improving in such a manner, the year-on-year rate of change in the CPI is likely to increase gradually.

C. Financial Conditions

Looking at the financial conditions on which the above outlook is based, global financial and capital markets have been unstable and corporate financing has been affected globally, both reflecting the spread of COVID-19. That said, the government and central bank of each country and region have been making responses aggressively, with a view to maintaining stability in financial markets and ensuring smooth corporate financing. In Japan, the government has implemented various measures to support corporate financing. While pursuing "Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control," the Bank has implemented various powerful monetary easing measures since March with a view to ensuring smooth financing, such as of firms, and maintaining

[2] According to the baseline scenario in the April 2020 *World Economic Outlook* released by the International Monetary Fund (IMF), it is assumed that the pandemic will fade in the second half of 2020 and containment measures taken by each country and region will be lifted gradually. The outlook for economic activity and prices presented in this Outlook Report generally is based on the same assumption.

stability in financial markets.[3] In this situation, it is expected that financial conditions will remain accommodative and further downward pressure on the real economy from the financial side will be avoided.[4]

III. Risks to Economic Activity and Prices

The outlook for economic activity and prices is extremely unclear, as it could change depending on the timing of the spread of COVID-19 subsiding and on the magnitude of the impact on domestic and overseas economies. In addition, the aforementioned outlook is based mainly on the assumption that, while the impact of the spread of COVID-19 remains, firms' and households' medium- to long-term growth expectations will not decline substantially and the smooth functioning of financial intermediation will be ensured with financial system stability being maintained, although this assumption entails high uncertainties. Major upside and downside risks to economic activity and prices are as follows. With regard to the risk balance, risks to both economic activity and prices are skewed to the downside, mainly due to the impact of COVID-19.

Regarding the outlook for economic activity, it is necessary to pay attention to the following three risks in particular until the impact of the spread of COVID-19 subsides.

The first is <u>the impact of the spread of COVID-19 on domestic and overseas economies</u>. There are high uncertainties regarding the consequences of the spread of COVID-19, the timing of the spread subsiding, and the magnitude of its impact on domestic and overseas economies until the spread subsides. As it is difficult at this point to envisage when effective medicines and vaccines can be developed, it is highly unclear how long it will take for the spread of COVID-19 to subside. In addition, with regard to preventive measures against this spread, such as stay-at-home orders or requests, it is difficult to predict the magnitude of their impact on the economy. Moreover, there are high uncertainties over the pace of economic improvement after the spread of COVID-19 subsides.

The second risk is <u>firms' and households' medium- to long-term growth expectations</u>. If such expectations decline, triggered mainly by the spread of COVID-19 becoming prolonged, there is a risk that their appetite for spending will not increase easily even after the spread subsides. On the other hand, medium- to long-term growth expectations could increase if the issue of COVID-19 leads to an active use of various types of information

[3] See "Enhancement of Monetary Easing in Light of the Impact of the Outbreak of the Novel Coronavirus (COVID-19)" released on March 16, 2020 and "Enhancement of Monetary Easing" released on April 27, 2020.

[4] Each Policy Board member makes their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding the future conduct of policy.

and communication technology in the face of the restrictions on going outside, thereby having positive effects on the field of digital technology, such as further innovation.

The third risk is developments in the financial system. Although it is under severe stress due to the impact of the spread of COVID-19, the Bank and the government have been taking measures aggressively, with a view to ensuring smooth financing, such as of firms, and maintaining stability in financial markets. In addition, financial institutions have considerable resilience in terms of both capital and liquidity. In this situation, the financial system has maintained stability on the whole.[5] However, if the impact of the spread of COVID-19 lasts longer than expected, there is a risk that deterioration in the real economy will affect financial system stability, thereby exerting further downward pressure on the real economy. Although this risk is judged as not significant at this point, it is necessary to pay close attention to future developments.

If the aforementioned risks to economic activity materialize, prices also are likely to be affected accordingly. In addition, it is necessary to pay attention to developments in international commodity prices, including those of crude oil, and to the effects of future fluctuations in foreign exchange rates on prices.

[5] For details, see the Bank's *Financial System Report* (April 2020).

(Appendix)

Forecasts of the Majority of the 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	-0.4 to -0.1	+0.6	+0.4
Forecasts made in January 2020	+0.8 to +0.9	+0.6 to +0.7	+0.4 to +0.5
Fiscal 2020	-5.0 to -3.0	-0.7 to -0.3	-0.8 to -0.4
Forecasts made in January 2020	+0.8 to +1.1	+1.0 to +1.1	+0.9 to +1.0
Fiscal 2021	+2.8 to +3.9	0.0 to +0.7	
Forecasts made in January 2020	+1.0 to +1.3	+1.2 to +1.6	
Fiscal 2022	+0.8 to +1.6	+0.4 to +1.0	

Notes: 1. Given that there are higher uncertainties regarding the outlook, in the April Outlook Report, each Policy Board member made their forecasts as a range and submitted two figures (i.e., the highest and lowest figures) within the range of 1.0 percentage point at most. The forecasts of the majority of the Policy Board members are shown as a range excluding four figures -- namely, the two highest figures and two lowest figures among the forecasts of the nine members. (If a member submits the same forecast figure for the highest and lowest figures, it is counted as two separate figures.) In the January Outlook Report, the forecasts of the majority of the Policy Board members also were shown as a range, excluding the highest and lowest figures, but each member's forecasts took the form of point estimates. Thus, it should be noted that the definition of the forecasts of the majority of the Policy Board members in the January Outlook Report is different from that in the April Outlook Report.

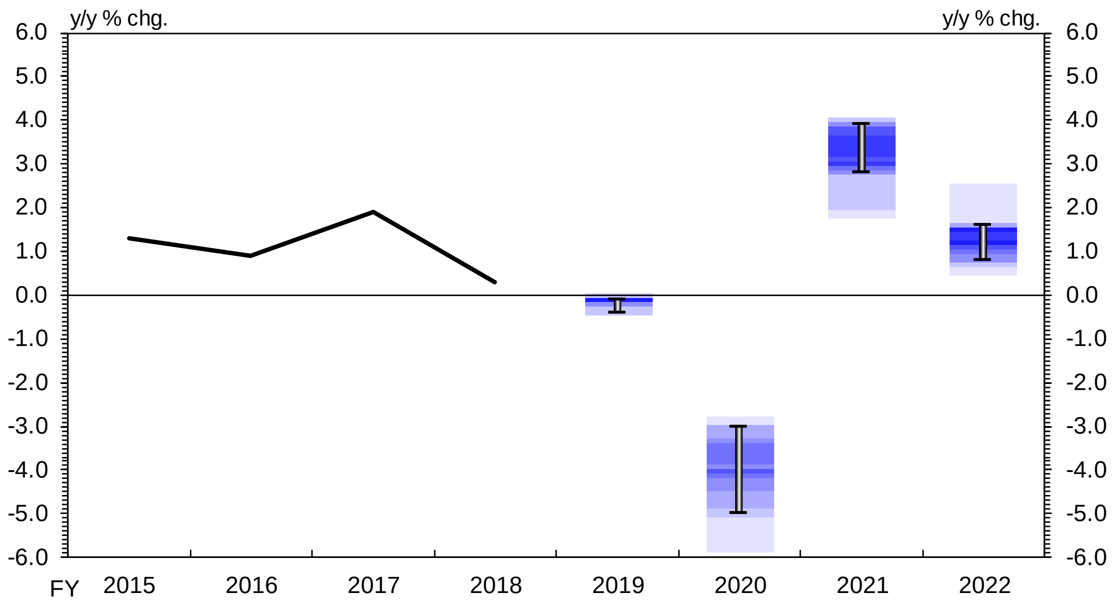
2. Each Policy Board member makes their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding the future conduct of policy.

3. The direct effects of the October 2019 consumption tax hike on the CPI for fiscal 2019 and 2020 are estimated to be 0.5 percentage point for each fiscal 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 2020 are estimated to be around minus 0.3 percentage point and around minus 0.4 percentage point, respectively.

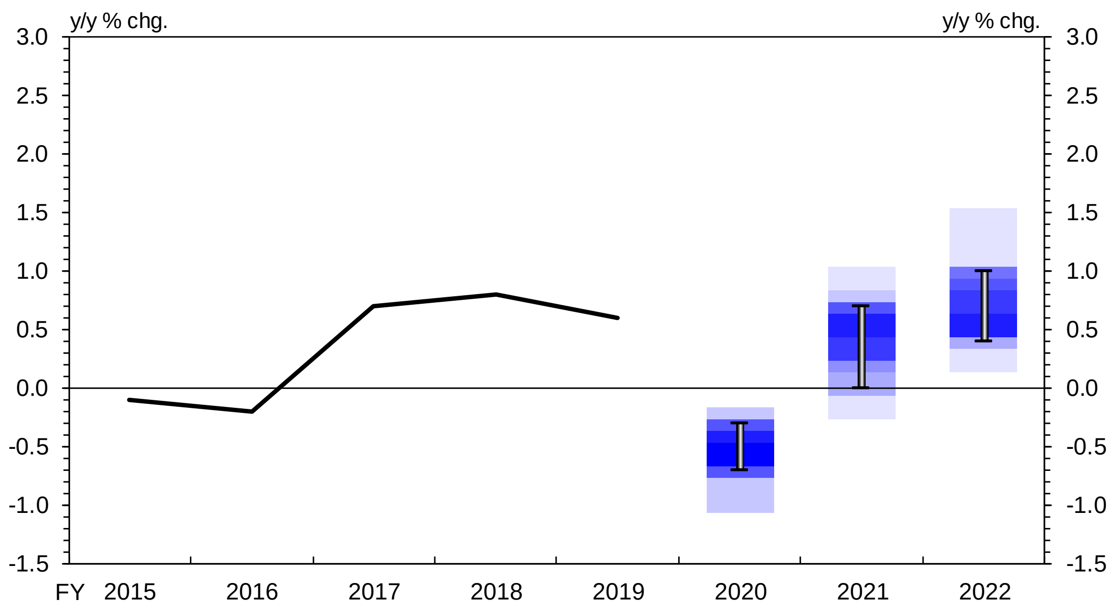
4. The CPI (all items less fresh food) for fiscal 2019 is an actual figure.

Policy Board Members' Forecasts for Economic Activity and Prices

(1) Real GDP



(2) CPI (All Items Less Fresh Food)



Notes: 1. The solid lines represent actual figures. Shaded areas, which correspond to the color-coded distribution below, indicate the number of the Policy Board members who forecasted the same figure. (Figures are shown in units of 0.1 percentage point.) The vertical lines indicate the forecasts of the majority of the Policy Board members.

member(s)

0	1	2	3	4	5	6	7	8	9

2. The CPI figure for fiscal 2015 excludes the direct effects of the April 2014 consumption tax hike.