

Outlook for Economic Activity and Prices (July 2022)

The Bank's View¹

Summary

- Japan's economy is likely to recover toward the middle of the projection period, with the impact of the novel coronavirus (COVID-19) and supply-side constraints waning, although it is expected to be under downward pressure stemming from a rise in commodity prices due to factors such as the situation surrounding Ukraine. Thereafter, as a virtuous cycle from income to spending intensifies gradually, Japan's economy is projected to continue growing at a pace above its potential growth rate.
 - The year-on-year rate of change in the consumer price index (CPI, all items less fresh food) is likely to increase toward the end of this year due to rises in prices of such items as energy, food, and durable goods. Thereafter, the rate of increase is expected to decelerate because the positive contribution of the rise in energy prices to the CPI is likely to wane. Meanwhile, in terms of inflation excluding energy, for which prices fluctuate significantly, the year-on-year rate of change in the CPI (all items less fresh food and energy) is expected to increase moderately in positive territory on the back of improvement in the output gap and rises in medium- to long-term inflation expectations and in wage growth.
 - Comparing the projections with those presented in the previous *Outlook for Economic Activity and Prices* (Outlook Report), the projected growth rate for fiscal 2022 is lower due to the effects of such factors as a slowdown in overseas economies and intensification of supply-side constraints. However, the projected growth rates thereafter are somewhat higher, partly owing to a rebound from the lower projection for fiscal 2022. The projected rates of increase in the CPI are higher, mainly for the near term, reflecting the impact of a rise in import prices and of a pass-through of that rise to consumer prices.
 - Concerning risks to the outlook, there remain extremely high uncertainties for Japan's economy, including the course of COVID-19 at home and abroad and its impact, developments in the situation surrounding Ukraine, and developments in commodity prices and in overseas economic activity and prices. In this situation, it is necessary to pay due attention to developments in financial and foreign exchange markets and their impact on Japan's economic activity and prices.
 - With regard to the risk balance, risks to economic activity are skewed to the downside for the time being but are generally balanced thereafter. Risks to prices are skewed to the upside for the time being but are generally balanced thereafter.
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¹ "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on July 20 and 21, 2022.

I. Current Situation of Economic Activity and Prices in Japan

Japan's economy has picked up with the impact of COVID-19 waning, despite being affected by factors such as a rise in commodity prices. Overseas economies have recovered on the whole, albeit with some weakness seen in part. Exports have continued to increase as a trend, but they have been affected by supply-side constraints, and industrial production has been under strong downward pressure due to the effects of such constraints. Corporate profits have been at high levels on the whole, and business sentiment has been more or less unchanged. In this situation, business fixed investment has picked up, although weakness has been seen in some industries. The employment and income situation has improved moderately on the whole, although some weakness has been seen in part. Private consumption has increased moderately, particularly for services consumption, with the impact of COVID-19 waning. Housing investment has been more or less flat. Public investment has been relatively weak. Financial conditions have been accommodative on the whole, although weakness in firms' financial positions has remained in some segments. On the price front, the year-on-year rate of change in the CPI (all items less fresh food) has been at around 2 percent, mainly due to rises in energy and food prices. Meanwhile, inflation expectations have risen.

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

A. Baseline Scenario of the Outlook for Economic Activity

Toward the middle of the projection period, Japan's economy is likely to recover, with the impact of COVID-19 and supply-side constraints waning and with support from an increase in external demand, accommodative financial conditions, and the government's economic measures, although it is expected to be under downward pressure stemming from the rise in commodity prices.

Prices of commodities, such as crude oil, natural gas, coal, and grains (e.g., wheat), have remained high, mainly reflecting heightened supply concerns as a result of Russia's invasion of Ukraine. Since Japan relies on imports for most of these commodities, rises in these prices bring about an outflow of income from Japan (i.e., trading losses), and put downward pressure on households' real income and corporate profits through rises in energy and food prices. That said, with the government's various measures mitigating the negative impact on income, a self-sustaining increase in demand, including pent-up demand, is projected to continue on the back of a waning of the impact of COVID-19 and supply-side constraints. For this reason, the economy is likely to recover. In the household sector, employee income is projected to continue increasing moderately on the back of a rise in the number of non-regular employees associated with a recovery in the face-to-face services sector and of an increase in wage growth that reflects improvement in labor market conditions. In this situation, although private consumption is expected to

be under downward pressure from the real income side due to price rises, it is projected to continue increasing. This is mainly because pent-up demand is likely to materialize, supported by household savings that have accumulated as a result of pandemic-related restrictions, as the resumption of consumption activities progresses while public health is being protected. In the corporate sector, exports and production are likely to increase, mainly for automobile- and digital-related goods, due in part to a waning of the effects of supply-side constraints. This is based on the projection that overseas economies will continue recovering on the whole, despite downward pressure from factors such as the situation surrounding Ukraine. Although raw material cost increases are projected to exert downward pressure, corporate profits are likely to remain at high levels on the whole, albeit with variation across industries and firm sizes, on the back of an increase in domestic and external demand and partly also of the yen's depreciation. In this situation, an uptrend in business fixed investment is expected to become clear as accommodative financial conditions provide support and supply-side constraints wane. Meanwhile, government spending is expected to be more or less flat on the whole.

From the middle of the projection period, Japan's economy is projected to continue growing at a pace above its potential growth rate as a virtuous cycle from income to spending intensifies gradually in the overall economy. That said, the pace of growth is highly likely to decelerate gradually because the positive contribution of the materialization of pent-up demand is projected to wane.

In the household sector, employee income is likely to continue increasing on the back of a moderate rise in the number of employees associated with improvement in economic activity and of an increase in wage growth that reflects tightening labor market conditions and price rises. Supported by this increase in employee income, private consumption is expected to keep increasing steadily, although the materialization of pent-up demand is likely to slow. In the corporate sector, exports and production are likely to continue increasing moderately because it is projected that the effects of supply-side constraints, such as on semiconductors, will dissipate, with overseas economies continuing to grow at a moderate pace. Inbound tourism demand, which is categorized under services exports, is expected to increase. Corporate profits are likely to follow an improving trend since domestic and external demand is expected to keep increasing and downward pressure stemming from raw material cost increases is likely to wane gradually. In this situation, with support from accommodative financial conditions, business fixed investment is expected to continue increasing, including investment to address labor shortage, digital-related investment, and research and development (R&D) investment related to growth areas and decarbonization.

Looking at the financial conditions on which the above outlook is based, it is expected that they will remain accommodative as the Bank pursues Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control, and that this will support an increase in

private demand.² That is, the environment for external funding, such as bank borrowing and the issuance of CP and corporate bonds, is projected to remain accommodative. In this situation, firms' financial positions are likely to continue on an improving trend along with an economic recovery.

Meanwhile, the potential growth rate is expected to rise moderately.³ This is mainly because productivity is likely to increase due to advances in digitalization and investment in human capital, and because capital stock growth is projected to accelerate due to a rise in business fixed investment. These developments are likely to be encouraged by the government's various measures and by accommodative financial conditions.

B. Baseline Scenario of the Outlook for Prices

The year-on-year rate of change in the CPI (all items less fresh food) is likely to increase toward the end of this year due to rises in prices of such items as energy, food, and durable goods. Thereafter, the rate of increase is expected to decelerate because the positive contribution of the rise in energy prices to the CPI is likely to wane. Meanwhile, in terms of inflation excluding energy, for which prices fluctuate significantly, the year-on-year rate of change in the CPI (all items less fresh food and energy) is expected to increase moderately in positive territory on the back of improvement in the output gap and rises in medium- to long-term inflation expectations and in wage growth.

The main factors that determine inflation rates are assessed as follows. The output gap, which captures the utilization of labor and capital, has been slightly negative. With Japan's economy following a growth path that outpaces its potential growth rate, the gap is projected to turn positive around the second half of fiscal 2022 and then continue to expand moderately. Under these circumstances, labor market conditions are expected to tighten, partly due to a deceleration in the pace of increase in labor force participation of women and seniors, and upward pressure on wages is projected to intensify gradually. This is likely to put upward pressure on personnel expenses on the cost side and contribute to an increase in households' purchasing power.

Medium- to long-term inflation expectations have risen, albeit at a moderate pace relative to short-term ones. The June 2022 *Tankan* (Short-Term Economic Survey of Enterprises in Japan) shows that the diffusion index (DI) for output prices has increased clearly of late and firms' inflation outlook for general prices has been at a high level, not only for the short term but also for the medium to long term. Given that the formation of inflation

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 Under a specific methodology, Japan's recent potential growth rate is estimated to be in the range of 0.0-0.5 percent. However, the rate should be interpreted with considerable latitude. This is because the estimate is subject to change depending on the methodologies employed and could be revised as the sample period becomes longer over time. In addition, there are particularly high uncertainties in the current phase over how COVID-19 will affect the trends in productivity or labor supply.

expectations in Japan is largely adaptive, an increase in actual inflation is expected to bring about a rise in households' and firms' medium- to long-term inflation expectations and, through changes in firms' price- and wage-setting stance and in labor-management wage negotiations, lead to a sustained rise in prices accompanied by wage increases.

III. Risks to Economic Activity and Prices

A. Risks to Economic Activity

Regarding the aforementioned baseline scenario of the outlook for economic activity, there are extremely high uncertainties, including the course of COVID-19 at home and abroad and its impact, developments in the situation surrounding Ukraine, and developments in commodity prices and in overseas economic activity and prices. Specifically, it is necessary to pay attention to the following upside and downside risks.

The first is how COVID-19 at home and abroad will affect private consumption and firms' export and production activities. If vigilance against COVID-19 persists in Japan, particularly among seniors, there is a risk that upward pressure from pent-up demand will weaken by more than expected and private consumption will deviate downward from the baseline scenario. On the other hand, if vigilance against COVID-19 lessens significantly, household savings that have accumulated as a result of pandemic-related restrictions could be withdrawn by more than expected and private consumption could be pushed up. In the meantime, if COVID-19 resurges at home and abroad while the global semiconductor shortage continues, this could lead supply-side constraints to become prolonged and amplified through, for example, supply-chain disruptions. If this happens, Japan's exports and production could be pushed down and the adverse impact could even spill over to goods consumption and business fixed investment.

The second factor is developments in the situation surrounding Ukraine and the associated developments in prices of commodities, including grains. Depending on the course of this situation, overseas economies, particularly the euro area, could deviate downward from the baseline scenario. In addition, there is a risk that prices of commodities, including grains, will rise or remain high for a prolonged period. Given that Japan is a commodity importer, a rise in these prices due to supply factors puts greater downward pressure on the economy through an increase in import costs, as this rise is not accompanied by an expansion in external demand or an increase in exports. For this reason, if prices of commodities, including grains, remain high and this results in prolonged deterioration in the terms of trade, wage increases will not catch up with overall price rises and Japan's economy could deviate downward from the baseline scenario. On the other hand, if these prices decline significantly, the economy could deviate upward. On this point, in the baseline scenario, commodity prices are assumed to decline moderately on the whole from the recent high levels toward the end of the projection

period with reference, for example, to developments in futures markets. However, there are extremely high uncertainties, such as over geopolitical factors -- particularly the situation surrounding Ukraine -- and global efforts toward addressing climate change.

The third factor is developments in overseas economic activity and prices and in global financial and capital markets. Amid a continued rise in inflation, mainly in advanced economies, central banks have accelerated the pace of interest rate hikes, and moves to tighten monetary policy, including a reduction in monetary accommodation, are projected to continue for the time being. While it is expected in the baseline scenario that inflation rates will decline and overseas economies will continue to grow at a moderate pace, there is concern in global financial and capital markets over whether it is possible to contain inflation and maintain economic growth simultaneously. Under these circumstances, there is a risk that global financial conditions will tighten further through adjustments in asset prices, fluctuations in foreign exchange markets, and capital outflows from emerging economies, and that this will eventually lead to overseas economies deviating downward from the baseline scenario. Taking this risk into account, it is necessary to pay due attention to developments in financial and foreign exchange markets and their impact on Japan's economic activity and prices.

The fourth factor considered from a somewhat long-term perspective is firms' and households' medium- to long-term growth expectations. It is expected that efforts with a view to the post-COVID-19 era, digitalization, and decarbonization will change Japan's economic structure and people's working styles. In addition, the heightened geopolitical risks could change the trend of globalization, which has supported the growth of the global economy to date. Depending on how households and firms react to these changes, their medium- to long-term growth expectations, the potential growth rate, and the output gap could go either upward or downward.

B. Risks to Prices

If the aforementioned risks to economic activity materialize, prices also are likely to be affected. In addition, it is necessary to pay attention to the following two risks that are specific to prices.

The first is high uncertainties over firms' price- and wage-setting behavior, which could exert either upward or downward pressure on prices. Depending on the degree of upward pressure from raw material costs and on developments in firms' inflation expectations, the pass-through of cost increases could accelerate by more than expected and lead prices to deviate upward from the baseline scenario. On the other hand, given that, in Japan, the behavior and mindset based on the assumption that prices and wages will not increase easily are deeply entrenched, there is a risk that moves to increase wages will not strengthen and prices will deviate downward from the baseline scenario.

The second risk is future developments in foreign exchange rates and international commodity prices, as well as the extent to which such developments will spread to import prices and domestic prices. This risk may lead prices to deviate either upward or downward from the baseline scenario. Fluctuations in international commodity prices have been significant, reflecting high uncertainties over, for example, developments in the situation surrounding Ukraine, while globally elevated inflation rates and sharp fluctuations in foreign exchange markets have been observed. How these factors will affect Japan's prices requires due attention.

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.⁴

The first perspective involves an examination of the baseline scenario of the outlook. Although it will take time, the year-on-year rate of change in the CPI is likely to increase gradually as an underlying trend toward achieving the price stability target, mainly on the back of improvement in the output gap and rises in medium- to long-term inflation expectations and in wage growth.

The second perspective involves an examination of the risks considered most relevant to the conduct of monetary policy. Concerning risks to the outlook, there remain extremely high uncertainties for Japan's economy, including the course of COVID-19 at home and abroad and its impact, developments in the situation surrounding Ukraine, and developments in commodity prices and in overseas economic activity and prices. In this situation, it is necessary to pay due attention to developments in financial and foreign exchange markets and their impact on Japan's economic activity and prices. With regard to the risk balance, risks to economic activity are skewed to the downside for the time being but are generally balanced thereafter. Risks to prices are skewed to the upside for the time being but are generally balanced thereafter. On the financial side, overheating has not been seen in asset markets and financial institutions' credit activities. Japan's financial system has maintained stability on the whole. Even in the case of an adjustment in the real economy and global financial markets, the financial system is likely to remain highly robust on the whole, mainly because financial institutions have sufficient capital bases. When examining financial imbalances from a longer-term perspective, if downward pressure on financial institutions' profits, such as from low interest rates, the declining population, and excess savings in the corporate sector, becomes prolonged, this could create a risk of a gradual pullback in financial intermediation. On the other hand, under

⁴ 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."

these circumstances, the vulnerability of the financial system could increase, mainly due to the search for yield behavior. Although these risks are judged as not significant at this point, 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.

For the time being, while closely monitoring the impact of COVID-19, the Bank will support financing, mainly of firms, and maintain stability in financial markets, and will not hesitate to take additional easing measures if necessary; it also expects short- and long-term policy interest rates to remain at their present or lower levels.

Forecasts of the Majority of the Policy Board Members

y/y % chg.

	Real GDP	CPI (all items less fresh food)	(Reference) CPI (all items less fresh food and energy)
Fiscal 2022	+2.2 to +2.5 [+2.4]	+2.2 to +2.4 [+2.3]	+1.2 to +1.4 [+1.3]
Forecasts made in April 2022	+2.6 to +3.0 [+2.9]	+1.8 to +2.0 [+1.9]	+0.8 to +1.0 [+0.9]
Fiscal 2023	+1.7 to +2.1 [+2.0]	+1.2 to +1.5 [+1.4]	+1.2 to +1.4 [+1.4]
Forecasts made in April 2022	+1.5 to +2.1 [+1.9]	+0.9 to +1.3 [+1.1]	+1.1 to +1.3 [+1.2]
Fiscal 2024	+1.1 to +1.5 [+1.3]	+1.1 to +1.5 [+1.3]	+1.4 to +1.7 [+1.5]
Forecasts made in April 2022	+1.1 to +1.3 [+1.1]	+1.0 to +1.3 [+1.1]	+1.2 to +1.5 [+1.5]

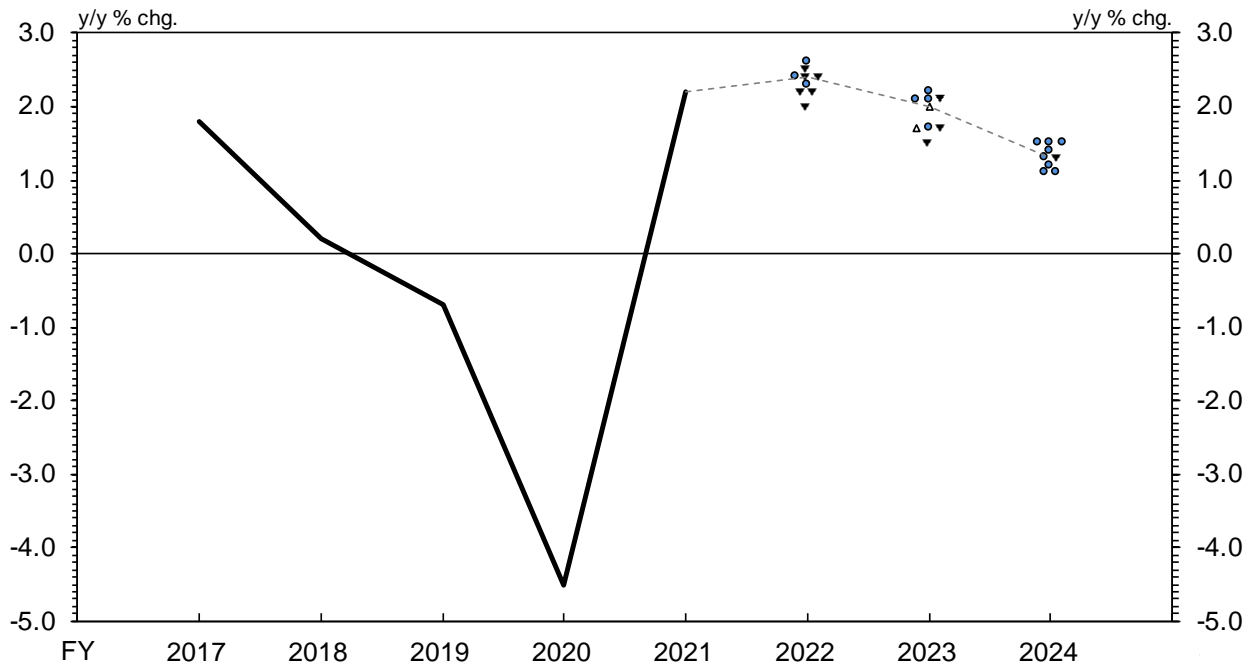
Notes: 1. Figures in brackets indicate the medians of the Policy Board members' forecasts (point estimates).

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 they attach 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.

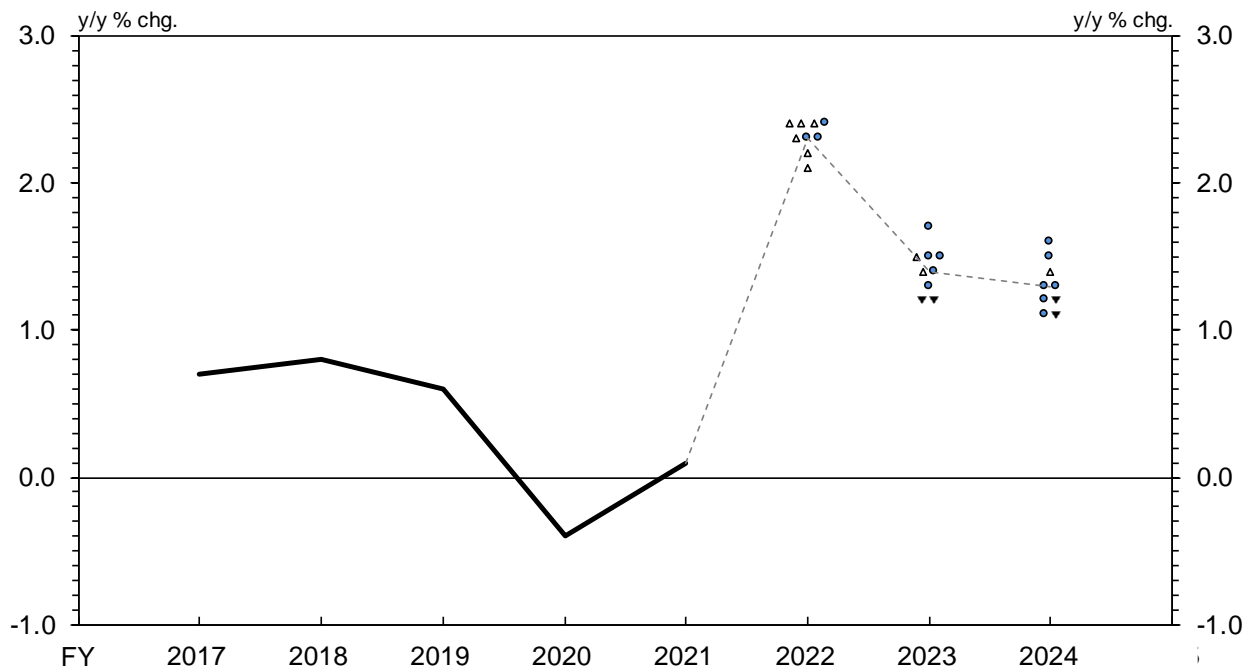
3. Each Policy Board member makes their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding the future conduct of policy.

Policy Board Members' Forecasts and Risk Assessments

(1) Real GDP



(2) CPI (All Items Less Fresh Food)



Notes: 1. The solid lines show actual figures, while the 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 they attach 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."