October 28, 2022

Bank of Japan

Outlook for Economic Activity and Prices (October 2022)

The Bank's View[1]

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 high commodity prices and slowdowns in overseas economies. 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. The rate of increase is then expected to decelerate toward the middle of fiscal 2023 because the contribution of such price rises to this CPI is likely to wane. Thereafter, it is projected to accelerate again moderately 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 rates are somewhat lower, mainly for fiscal 2022, due to the effects of the spread of COVID-19 this summer and of slowdowns in overseas economies. The projected rates of increase in the CPI are higher, mainly for fiscal 2022, due to the effects of a pass-through to consumer prices of cost increases led by a rise in import prices.
- Concerning risks to the outlook, there remain extremely high uncertainties for Japan's economy, including the following: developments in overseas economic activity and prices; developments in the situation surrounding Ukraine and in commodity prices; and the course of COVID-19 at home and abroad and its impact. 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. Risks to prices are skewed to the upside.

[1] "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on October 27 and 28, 2022.

I. Current Situation of Economic Activity and Prices in Japan

Japan's economy, despite being affected by factors such as high commodity prices, has picked up as the resumption of economic activity has progressed while public health has been protected from COVID-19. Overseas economies have recovered moderately on the whole, but slowdowns have been observed, mainly in advanced economies. Exports and industrial production have increased as a trend, with the effects of supply-side constraints waning. 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. Private consumption has increased moderately, despite being affected by COVID-19. Housing investment has been relatively weak. Public investment has been more or less flat. 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 3 percent due to rises in prices of such items as energy, food, and durable goods. 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

<u>Toward the middle of the projection period</u>, Japan's economy is likely to recover, with the impact of COVID-19 and supply-side constraints waning and with support from accommodative financial conditions and the government's economic measures, although it is expected to be under downward pressure stemming from high commodity prices and slowdowns in overseas economies.

Slowdowns have been observed in overseas economies, with inflationary pressure exerted on a global basis and central banks thereby continuing to raise policy interest rates. In addition, although prices of commodities such as crude oil and grains (e.g., wheat) have turned to a decline on the whole, past rises in these prices have brought about an outflow of income from (i.e., trading losses for) Japan, which relies on imports for most of these commodities, and have put downward pressure on households' real income and corporate profits through rises in energy and food prices. Japan's economy is projected to be under such downward pressure stemming from the slowdowns in overseas economies and the outflow of income, but is likely to recover because a self-sustaining increase in demand, including pent-up demand, is projected to continue with the impact of COVID-19 and supply-side constraints waning. Moreover, the government's various measures are expected to mitigate the negative impact on income.

In the household sector, regarding the employment situation, the number of regular employees is expected to continue increasing, and a rise in that of non-regular employees is likely to become evident with a recovery in the face-to-face services sector. In addition, wage growth is expected to increase, reflecting improvement in labor market conditions. Due to these factors, employee income is projected to continue increasing moderately. 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 had accumulated as a result of pandemic-related restrictions, as the resumption of consumption activities progresses further while public health is being protected. In the corporate sector, although overseas economies, particularly advanced economies, are projected to slow, exports and production are likely to remain on an uptrend with the effects of supply-side constraints waning and with support from high levels of order backlogs for automobiles and capital goods. Inbound tourism demand, which is categorized under services exports, is also expected to increase, mainly in reflection of the government's relaxation of entry restrictions. Although high raw material costs 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. This will likely occur due to continued improvement in economic activity on the back of the materialization of pent-up demand, for example, and also partly due to 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, public investment is projected to be more or less flat, with expenditure related to building national resilience continuing. Government consumption is expected to decline gradually in reflection of developments in expenditure related to COVID-19.

<u>From the middle of the projection period</u>, 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 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 increase moderately with overseas economies picking up. Inbound tourism demand is expected to continue increasing. Corporate profits are likely to follow an improving trend since domestic and external demand is expected to increase and downward pressure stemming from high raw material costs 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. The rate of increase is then expected to decelerate toward the middle of fiscal 2023 because the contribution of such price rises to this CPI is likely to wane. Thereafter, it is projected to accelerate again moderately on the back of improvement in the output gap and rises in medium- to long-term inflation expectations and in wage growth. Looking at the projected developments in this CPI by fiscal year, the rate of change is expected to be relatively high at around 3 percent for fiscal 2022 and then be at around 1.5 percent for fiscal 2023 and fiscal 2024. Meanwhile, reflecting price developments in such items as food and durable goods, the year-on-year rate of change in the CPI (all items less fresh food and energy) is likely to see similar developments to those in the rate of change in the CPI (all items less fresh food), albeit with comparatively smaller range of fluctuations.

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

[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.

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 September 2022 *Tankan* (Short-Term Economic Survey of Enterprises in Japan) shows that the diffusion index (DI) for output prices has increased further 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 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 behavior 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 following: developments in overseas economic activity and prices; developments in the situation surrounding Ukraine and in commodity prices; and the course of COVID-19 at home and abroad and its impact. Specifically, it is necessary to pay attention to the following upside and downside risks.

The first is <u>developments in overseas economic activity and prices and in global financial and capital markets</u>. Amid ongoing inflationary pressure on a global basis, central banks have raised policy interest rates rapidly, and moves to tighten monetary policy, including a reduction in monetary accommodation, are projected to continue for the time being. On this point, it is expected in the baseline scenario that inflation rates around the world will decline gradually and that overseas economies will continue to grow moderately, albeit at a decelerating pace. That said, vigilance against a wage-price spiral has heightened, mainly in advanced economies. In addition, there is concern in global financial and capital markets over whether it is possible to contain inflation and maintain economic growth simultaneously. With central banks continuing to make rapid policy interest rate hikes, 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 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 be pushed down further. In addition, although prices of commodities, including grains, have declined compared with a while ago, they could rise again depending on, for example, developments in the situation surrounding Ukraine. 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. Such deterioration in the terms of trade squeezes corporate profits and households' real income, and this could lead business fixed investment and private consumption to deviate downward from the baseline scenario through more cautious spending behavior of firms and households. On the other hand, if prices of commodities, including grains, see a clearer downtrend, the economy could deviate upward. On this point, in the baseline scenario, commodity prices are assumed to decline moderately on the whole 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 how COVID-19 at home and abroad will affect private consumption and firms' export and production activities. COVID-19 resurged in Japan this summer, but its impact on the economy has remained small relative to past phases of COVID-19 surges, and the resumption of consumption activities has progressed steadily while public health has been protected. That said, depending on the course of COVID-19, upward pressure from pent-up demand could weaken by more than expected. On the other hand, if vigilance against COVID-19 lessens significantly, household savings that had 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, supply-side constraints have remained in part, and if COVID-19 resurges at home and abroad in this situation, such constraints could intensify again 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 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. Recently, against the backdrop of high raw material costs, price hikes have been widely observed even among firms that had taken a cautious stance toward changing their selling prices, while their pricing decisions have been made in consideration of price setting by competitors. Depending on how much upward pressure will be exerted by raw material costs and on how firms' inflation expectations will develop, the pass-through of cost increases could accelerate by more than expected and lead prices to deviate upward from the baseline scenario. In addition, there is a possibility that wages and prices will rise by more than expected as more firms reflect price developments in wage setting through labor-management wage negotiations. 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 inflation rates have remained high on a global basis and foreign exchange markets have fluctuated sharply. 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]

[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."

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 following: developments in overseas economic activity and prices; developments in the situation surrounding Ukraine and in commodity prices; and the course of COVID-19 at home and abroad and its impact. 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. Risks to prices are skewed to the upside. 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. Although attention is warranted on, for example, the impact of the tightening of global financial conditions, the financial system is likely to remain highly robust on the whole even in the case of an adjustment in the real economy at home and abroad and in global financial markets, 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 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.[5]

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.

[5] For details, see the Bank's *Financial System Report* (October 2022).

(Appendix)

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	+1.8 to +2.1 [+2.0]	+2.8 to +2.9 [+2.9]	+1.8 to +1.9 [+1.8]
Forecasts made in July 2022	+2.2 to +2.5 [+2.4]	+2.2 to +2.4 [+2.3]	+1.2 to +1.4 [+1.3]
Fiscal 2023	+1.5 to +2.0 [+1.9]	+1.5 to +1.8 [+1.6]	+1.5 to +1.8 [+1.6]
Forecasts made in July 2022	+1.7 to +2.1 [+2.0]	+1.2 to +1.5 [+1.4]	+1.2 to +1.4 [+1.4]
Fiscal 2024	+1.3 to +1.6 [+1.5]	+1.5 to +1.9 [+1.6]	+1.5 to +1.8 [+1.6]
Forecasts made in July 2022	+1.1 to +1.5 [+1.3]	+1.1 to +1.5 [+1.3]	+1.4 to +1.7 [+1.5]

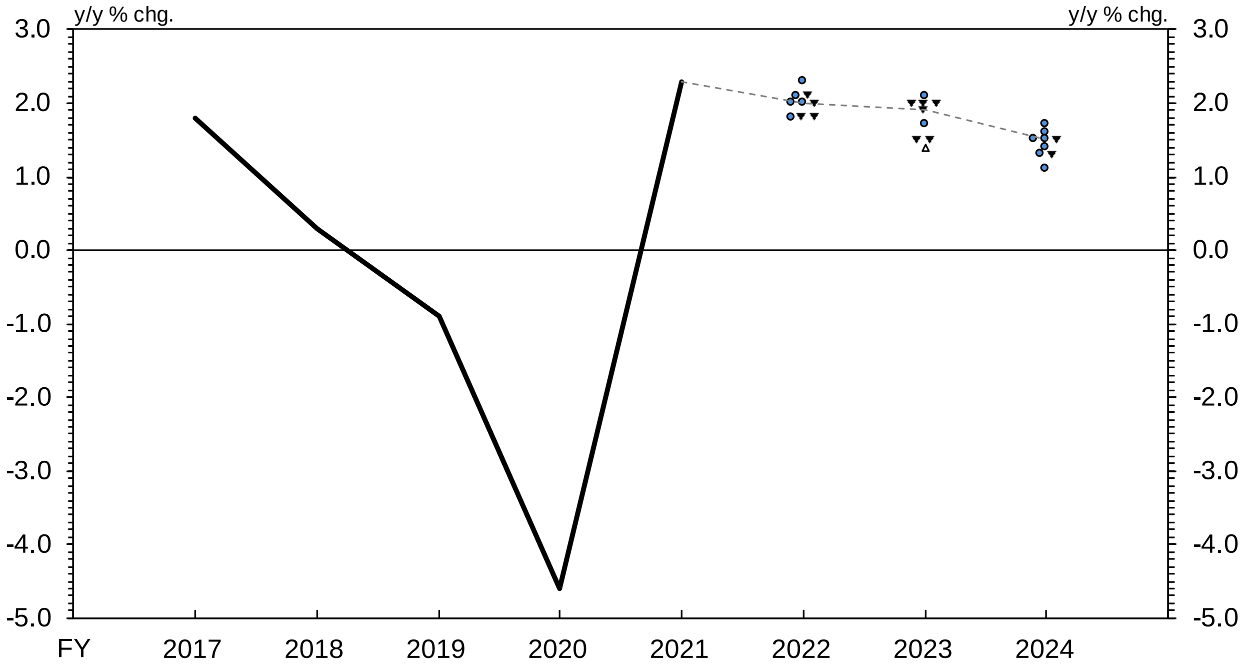
Notes: 1. Figures in brackets indicate the medians of the Policy Board members' forecasts (point estimates).

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.

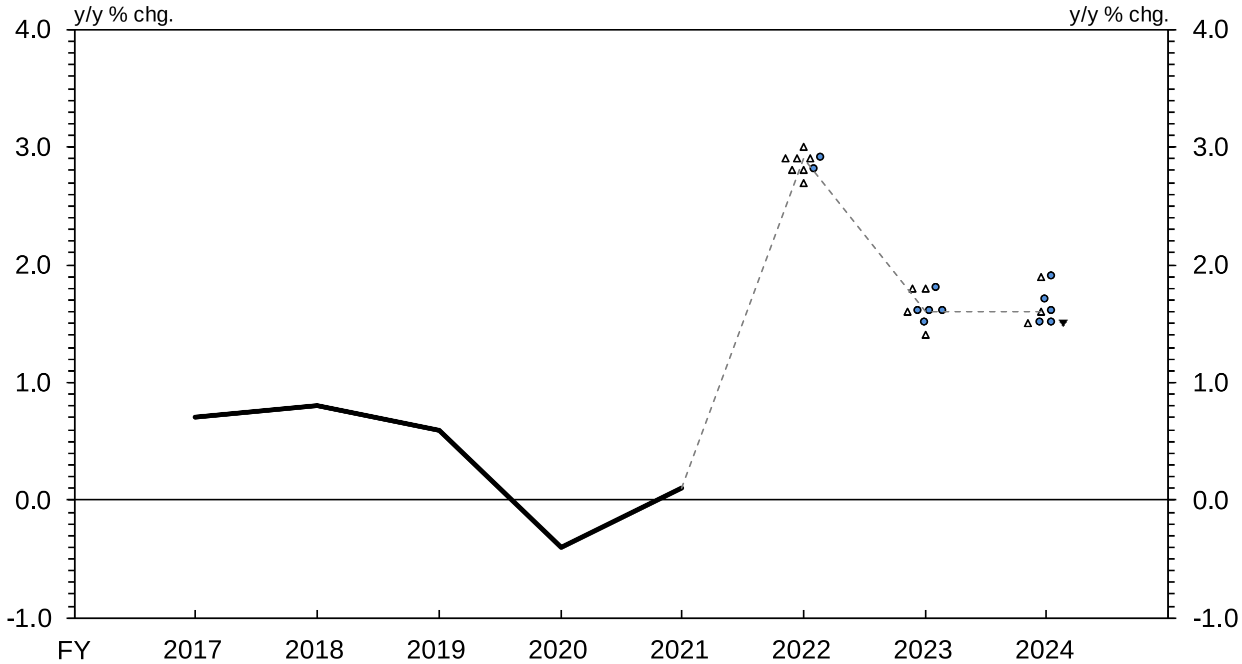
3. Each Policy Board member makes their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding the future conduct of policy.

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."