

Outlook for Economic Activity and Prices (October 2023)

The Bank's View¹

Summary

- Japan's economy is likely to continue recovering moderately for the time being, supported by factors such as the materialization of pent-up demand, although it is expected to be under downward pressure stemming from a slowdown in the pace of recovery in overseas economies. Thereafter, as a virtuous cycle from income to spending gradually intensifies, Japan's economy is projected to continue growing at a pace above its potential growth rate.
 - The year-on-year rate of increase in the consumer price index (CPI, all items less fresh food) is likely to be above 2 percent through fiscal 2024, mainly due to the remaining effects of a pass-through to consumer prices of cost increases led by the past rise in import prices and the effects of the recent rise in crude oil prices. As for fiscal 2025, the rate of increase in the CPI is projected to decelerate owing to dissipation of these effects. Meanwhile, toward the end of the projection period, underlying CPI inflation is likely to increase gradually toward achieving the price stability target, as the output gap turns positive and as medium- to long-term inflation expectations and wage growth rise.
 - Comparing the projections with those presented in the previous *Outlook for Economic Activity and Prices* (Outlook Report), the projected real GDP growth rate for fiscal 2023 is higher. The projected year-on-year rate of increase in the CPI (all items less fresh food) for fiscal 2023 is somewhat higher, mainly because, while the government's economic measures will push down energy prices, cost increases have been passed on to consumer prices to a greater extent than expected. The projected rate of increase in this CPI for fiscal 2024 is significantly higher, mainly due to the effects of the recent rise in crude oil prices and to a waning of the effects of the economic measures pushing down energy prices of the previous year.
 - Concerning risks to the outlook, there are extremely high uncertainties surrounding Japan's economic activity and prices, including developments in overseas economic activity and prices, developments in commodity prices, and domestic firms' wage- and price-setting behavior. Under these circumstances, 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 generally balanced for fiscal 2023 and 2024 but are skewed to the downside for fiscal 2025. Risks to prices are skewed to the upside for fiscal 2023. In terms of prices, it should be noted that, mainly due to the experience of prolonged low growth and deflation, the behavior and mindset based on the assumption that wages and prices will not increase easily have taken hold in society. Considering this, it is important to closely monitor whether a virtuous cycle between wages and prices will intensify.
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¹ "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on October 30 and 31, 2023.

I. Current Situation of Economic Activity and Prices in Japan

Japan's economy has recovered moderately. The pace of recovery in overseas economies has slowed. Although exports and industrial production have been affected by the developments in overseas economies, they have been more or less flat, supported by a waning of the effects of supply-side constraints. Corporate profits have been at high levels on the whole, and business sentiment has improved moderately. In this situation, business fixed investment has increased moderately. The employment and income situation has improved moderately. Private consumption has increased steadily at a moderate pace, despite being affected by price rises. Housing investment has been relatively weak. Public investment has increased moderately. Financial conditions have been accommodative. On the price front, the year-on-year rate of increase in the CPI (all items less fresh food) is slower than a while ago, mainly due to the effects of pushing down energy prices from the government's economic measures, but it has been in the range of 2.5-3.0 percent recently owing to the effects of a pass-through to consumer prices of cost increases led by the past rise in import prices. Inflation expectations have risen moderately.

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

A. Baseline Scenario of the Outlook for Economic Activity

Japan's economy is likely to continue recovering moderately for the time being, supported by the materialization of pent-up demand, as well as by factors such as accommodative financial conditions and the government's economic measures, although it is expected to be under downward pressure stemming from a slowdown in the pace of recovery in overseas economies. Thereafter, pent-up demand and the effects of the economic measures are projected to wane, but Japan's economy is expected to continue growing at a pace above its potential growth rate as a virtuous cycle from income to spending gradually intensifies in the overall economy.

Comparing the projections with those presented in the previous Outlook Report, the projected real GDP growth rate for fiscal 2023 is higher. This reflects the actual data showing that the growth rate thus far has been higher than was previously projected, mainly due to a decline in imports.

In the household sector, employment is likely to continue rising, but the pace of increase is projected to moderate gradually. This is because it will become more difficult for labor supply to increase, with labor force participation of women and seniors having advanced to a high degree thus far. That said, these developments will lead to an increased tightening of labor market conditions during the course of the economic recovery. In this situation, wage growth is expected to increase as a trend, partly reflecting price rises, and employee income is projected to continue increasing. Against this backdrop, although

private consumption is expected to be affected by the price rises, it is projected to keep increasing moderately for the time being. This is because pent-up demand is likely to materialize, partly supported by household savings that had accumulated as a result of pandemic-related restrictions, and because factors such as improvement in consumer sentiment, which mainly reflects the rise in wage growth, are expected to provide support. Private consumption is also projected to be underpinned by the government's measures, such as those to reduce the household burden of higher gasoline prices, electricity charges, and gas charges. Thereafter, although private consumption is likely to be affected by a slowdown in the materialization of pent-up demand and a waning of the positive contribution of the government's various measures, it is expected to keep increasing moderately, supported by the rise in employee income.

In the corporate sector, exports and production are projected to be more or less flat for the time being, affected by the slowdown in the pace of recovery in overseas economies. Subsequently, as these economies grow moderately, albeit with variation across countries and regions, exports and production are likely to return to an uptrend. Meanwhile, inbound tourism demand, which is categorized under services exports, is expected to continue increasing. Corporate profits are likely to follow an improving trend, as it is projected that they will be pushed up for the time being by factors such as progress in the pass-through of past high raw material costs to selling prices, and thereafter by a moderate increase in domestic and external demand. In this situation, as accommodative financial conditions provide support, business fixed investment is likely to continue increasing, including investment to address labor shortages, digital-related investment, research and development (R&D) investment related to growth areas and decarbonization, and investment associated with strengthening supply chains. Toward the end of the projection period, it is expected to be under cyclical adjustment pressure stemming from the accumulation of capital stock, but investment to address labor shortages and investment that is not necessarily responsive to the business cycle, such as that related to decarbonization, are likely to increase steadily.

Meanwhile, public investment is expected to be more or less flat, with expenditure related to building national resilience continuing. Government consumption is expected to decline temporarily in reflection of developments in expenditure related to COVID-19, and then gradually increase in reflection of an uptrend in healthcare and nursing care expenditures.

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

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.

this situation, firms' financial positions are likely to follow an improving trend along with the economic recovery.

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 increase in the CPI (all items less fresh food) is likely to be above 2 percent through fiscal 2024, mainly due to the remaining effects of a pass-through to consumer prices of cost increases led by the past rise in import prices and the effects of the recent rise in crude oil prices. As for fiscal 2025, the rate of increase in the CPI is projected to decelerate owing to dissipation of these effects. Meanwhile, toward the end of the projection period, underlying CPI inflation is likely to increase gradually toward achieving the price stability target, as the output gap turns positive and as medium- to long-term inflation expectations and wage growth rise.

Comparing the projections with those presented in the previous Outlook Report, the projected year-on-year rate of increase in the CPI (all items less fresh food) for fiscal 2023 is somewhat higher. This is mainly because, while the extension of the government's measures to reduce the household burden of higher gasoline prices, electricity charges, and gas charges will push down year-on-year CPI inflation, cost increases led by the past rise in import prices have been passed on to consumer prices to a greater extent than expected. The projected rate of increase in this CPI for fiscal 2024 is significantly higher. This is mainly due to the effects of the recent rise in crude oil prices as well as to a waning of the effects of the extended measures pushing down year-on-year CPI inflation for fiscal 2023.

The outlook for the CPI (all items less fresh food) depends on the assumptions regarding crude oil prices and the government's economic measures. Crude oil prices are assumed to decline moderately toward the end of the projection period with reference, for example, to developments in futures markets. The government's measures to reduce the household burden of higher gasoline prices, electricity charges, and gas charges are expected to push down the year-on-year rate of change in the CPI (all items less fresh food) for fiscal 2023. For fiscal 2024, on the other hand, they are projected to push up the rate due to a

³ Under a specific methodology, Japan's recent potential growth rate is estimated to be at around 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.

waning of the effects of those measures pushing down CPI inflation of the previous year. In this regard, looking at the CPI (all items less fresh food and energy) -- which is not directly affected by fluctuations in energy prices -- the year-on-year rate of increase is likely to decelerate, due to a gradual waning of the effects of the pass-through to consumer prices of cost increases led by the past rise in import prices, and subsequently be at around 2 percent toward the end of the projection period.

The main factors that determine underlying inflation are assessed as follows. The output gap, which captures the utilization of labor and capital, has been at around 0 percent. Based on the aforementioned outlook for economic activity, the gap is likely to turn positive and expand moderately toward the end of the projection period, albeit at a gradually slowing pace. 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. 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 moderately. The September 2023 *Tankan* (Short-Term Economic Survey of Enterprises in Japan) shows that the diffusion index (DI) for output prices has been at a high level, and firms' inflation outlook for general prices has also been at a high level, not only for the short term but also for the medium to long term. In addition, the wage growth rate agreed in the annual spring labor-management wage negotiations this year was significantly higher than in the previous year, including base pay. Given that the formation of inflation expectations in Japan is largely adaptive, the increase in inflation seen thus far has brought about a rise in households' and firms' medium- to long-term inflation expectations. In this situation, some aspects of firms' behavior have begun to shift more toward raising wages and prices. Regarding the outlook, even as actual inflation decelerates, inflation expectations are expected to rise moderately toward the end of the projection period, with the output gap turning positive and changes in firms' wage- and price-setting behavior and in labor-management wage negotiations. This will likely lead to a sustained rise in prices accompanied by wage increases.

Considering the above assessments, although it is necessary to pay attention to the extremely high uncertainties surrounding the outlook, underlying CPI inflation is likely to increase gradually toward achieving the price stability target.

III. Risks to Economic Activity and Prices

A. Risks to Economic Activity

Regarding the aforementioned baseline scenario of the outlook for economic activity, the main upside and downside risks that require attention are as follows.

The first is developments in overseas economic activity and prices and in global financial and capital markets. Although inflation rates in the United States and Europe are lower than a while ago, inflationary pressure has remained on a global basis. In this situation, overseas central banks have continued to conduct tight monetary policy. 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 with variation across countries and regions. That said, there is a risk of inflation rates staying elevated through wage increases, mainly in advanced economies. In addition, since the policy interest rate hikes by overseas central banks to date have been rapid, there are high uncertainties over how these hikes will affect their real economies and financial systems with a time lag. Taking these risks 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. Meanwhile, depending on the course of the situation surrounding Ukraine, downward pressure on overseas economies, particularly the euro area, could heighten. In addition, regarding the Chinese economy, there are high uncertainties surrounding the future pace of pick-up, as adjustment pressure has remained in the labor and real estate markets.

The second risk is developments in import prices, particularly those of commodities, including grains. Although prices of grains and other commodities had declined on the whole after reaching their peak around the middle of last year, energy prices, such as for crude oil, have risen recently. Attention is warranted on the risk that prices of commodities, including grains, will fluctuate significantly due to geopolitical factors, such as those concerning Ukraine and the Middle East. Furthermore, in the medium to long term, there are extremely high uncertainties surrounding, for example, efforts by countries around the world toward addressing climate change. Given that Japan is an importer of commodities such as energy and grains (e.g., wheat), 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. If the terms of trade were to deteriorate again, this could squeeze corporate profits and households' real income, leading business fixed investment and private consumption to deviate downward from the baseline scenario through more cautious spending behavior of firms and households. Moreover, with progress in the pass-through of the rise in import prices to consumer prices, if wage increases were to be limited, this could further strengthen households' defensive attitudes toward spending and push down the economy. On the other hand, if prices of commodities, including grains, decline, the economy could deviate upward.

The third risk considered from a somewhat long-term perspective is firms' and households' medium- to long-term growth expectations. It is expected that factors such as moves toward digitalization, which reflect the experience of COVID-19 and intensifying

labor shortages, and progress on efforts with a view to decarbonization and on labor market reform will change Japan's economic structure and people's working styles. Furthermore, the heightened geopolitical risks could change the trend of globalization, which has supported the growth of the global economy to date. Depending on how firms and households react to these changes, their medium- to long-term growth expectations, the potential growth rate, and the output gap could go either up or down.

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' wage- and price-setting behavior, which could exert either upward or downward pressure on prices. In the current inflationary phase, with Japan's economy following a recovery trend and against the backdrop of high raw material costs, many firms have raised prices while giving consideration to price setting by competitors. While a fair degree of progress seems to have already been made in the pass-through of the past rise in import prices to consumer prices, depending on how much upward pressure will be exerted by raw material costs and on how firms' inflation expectations will develop, this pass-through could continue for longer than expected and lead prices to deviate upward from the baseline scenario. In addition, with labor market conditions tightening, it is possible that firms will further shift their wage-setting behavior toward raising wages, in view of factors such as recruitment and retention. Under these circumstances, there is a possibility that both wages and prices will deviate upward from the baseline scenario to a greater extent than can be explained by changes in the output gap, as moves to reflect not only price developments in wage setting but also wage developments in price setting become more widespread than expected. On the other hand, with inflation decelerating, medium- to long-term inflation expectations could decline through the mechanism of adaptive inflation expectations formation, and this could affect firms' price-setting behavior. In addition, although the wage growth rate agreed in the annual spring labor-management wage negotiations this year was significantly higher than in the previous year, if the behavior and mindset based on the assumption that wages and prices will not increase easily remain deeply entrenched, there is a risk that moves to increase wages will not strengthen as much as expected from next year 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. There are high uncertainties over, for example, the outlook for the global economy, and this could lead to significant fluctuations in

international commodity prices. Including the possibility of inflation rates staying elevated on a global basis and of fluctuations in foreign exchange markets, 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. The year-on-year rate of increase in the CPI is likely to be above 2 percent through fiscal 2024 and then decelerate in fiscal 2025. Meanwhile, toward the end of the projection period, underlying CPI inflation is expected to increase gradually toward achieving the price stability target, as the output gap turns positive and as medium- to long-term inflation expectations and wage growth rise.

The second perspective involves an examination of the risks considered most relevant to the conduct of monetary policy. There are extremely high uncertainties, both upside and downside, surrounding Japan's economic activity and prices, and it is necessary to pay due attention to developments in financial and foreign exchange markets and their impact on economic activity and prices. With regard to the risk balance, risks to economic activity are generally balanced for fiscal 2023 and 2024 but are skewed to the downside for fiscal 2025. Risks to prices are skewed to the upside for fiscal 2023. In terms of prices, it should be noted that, mainly due to the experience of prolonged low growth and deflation, the behavior and mindset based on the assumption that wages and prices will not increase easily have taken hold in society. Considering this, it is important to closely monitor whether a virtuous cycle between wages and prices will intensify.

Examining risks 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 Japanese 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,

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."

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, with extremely high uncertainties surrounding economies and financial markets at home and abroad, the Bank will patiently continue with monetary easing while nimbly responding to developments in economic activity and prices as well as financial conditions. By doing so, it will aim to achieve the price stability target of 2 percent in a sustainable and stable manner, accompanied by wage increases.

The Bank will continue with QQE with Yield Curve Control, aiming to achieve the price stability target, 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 continue to maintain the stability of financing, mainly of firms, and financial markets, and will not hesitate to take additional easing measures if necessary.

⁵ For details, see the Bank's *Financial System Report* (October 2023).

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 2023	+1.8 to +2.0 [+2.0]	+2.7 to +3.0 [+2.8]	+3.5 to +3.9 [+3.8]
Forecasts made in July 2023	+1.2 to +1.5 [+1.3]	+2.4 to +2.7 [+2.5]	+3.1 to +3.3 [+3.2]
Fiscal 2024	+0.9 to +1.4 [+1.0]	+2.7 to +3.1 [+2.8]	+1.6 to +2.1 [+1.9]
Forecasts made in July 2023	+1.0 to +1.3 [+1.2]	+1.8 to +2.2 [+1.9]	+1.5 to +2.0 [+1.7]
Fiscal 2025	+0.8 to +1.2 [+1.0]	+1.6 to +2.0 [+1.7]	+1.8 to +2.2 [+1.9]
Forecasts made in July 2023	+1.0 to +1.2 [+1.0]	+1.6 to +2.0 [+1.6]	+1.8 to +2.2 [+1.8]

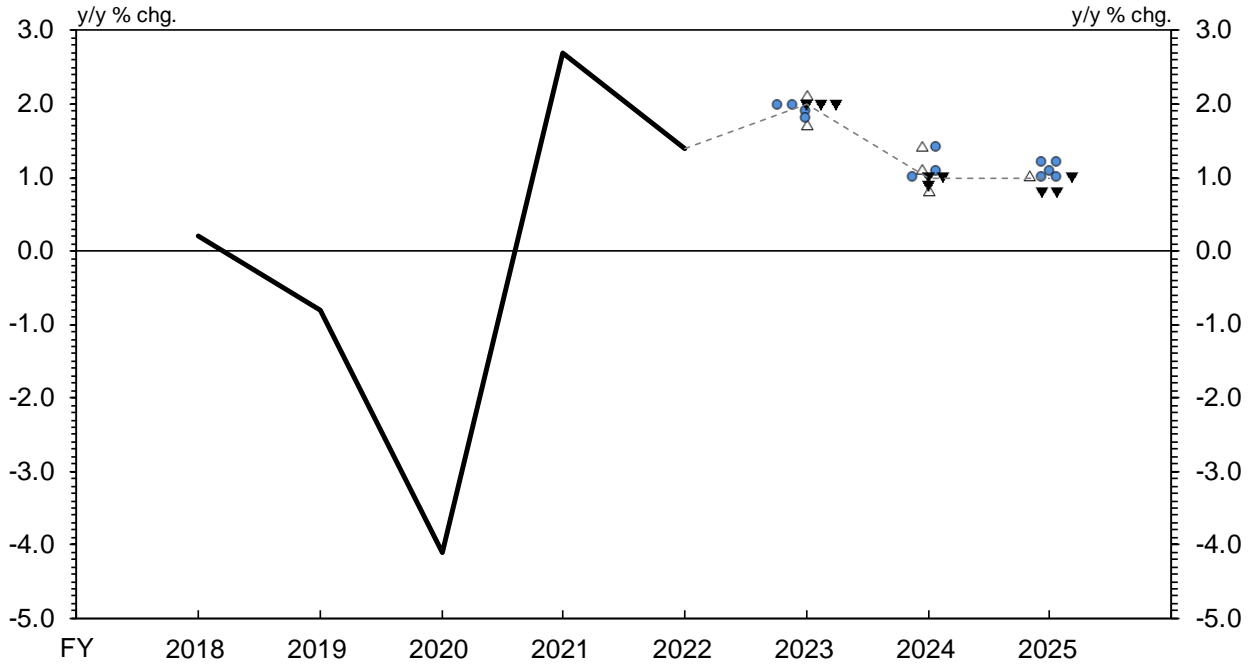
Notes: 1. Figures in brackets indicate the medians of the Policy Board members' forecasts (point estimates).

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 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.

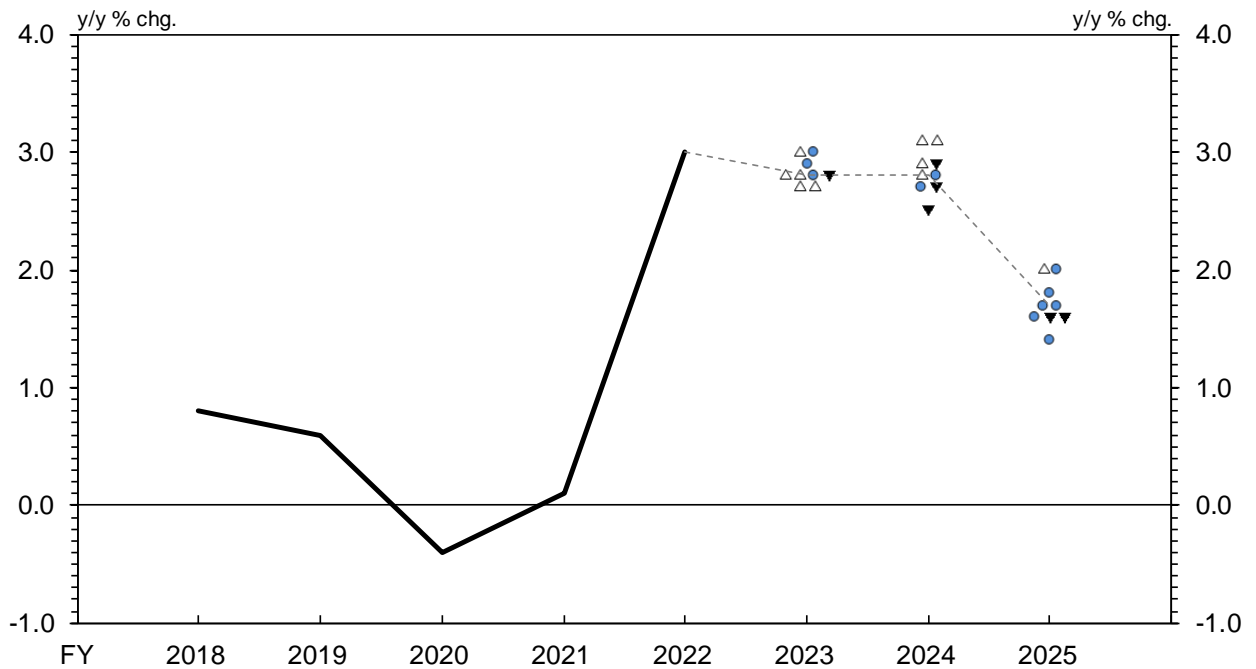
3. Each Policy Board member makes their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding the future conduct of policy.

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."