July 31, 2024
Bank of Japan

Outlook for Economic Activity and Prices (July 2024)

The Bank's View[1]

Summary

- Japan's economy is likely to keep growing at a pace above its potential growth rate, with overseas economies continuing to grow moderately and as a virtuous cycle from income to spending gradually intensifies against the background of factors such as accommodative financial conditions.
- The year-on-year rate of increase in the consumer price index (CPI, all items less fresh food) is likely to be at around 2.5 percent for fiscal 2024 and then be at around 2 percent for fiscal 2025 and 2026. While the effects of a pass-through to consumer prices of cost increases led by the past rise in import prices are expected to wane, the rate of increase is projected to be pushed up through fiscal 2025 by factors such as a dissipation of the effects of the government's measures pushing down CPI inflation. Meanwhile, underlying CPI inflation is expected to increase gradually, since it is projected that the output gap will improve and that medium- to long-term inflation expectations will rise with a virtuous cycle between wages and prices continuing to intensify. In the second half of the projection period, it is likely to be at a level that is generally consistent with the price stability target.
- 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 2024 is somewhat lower, mainly due to the impact of the statistical revision to the GDP figures for fiscal 2023. The projected year-on-year rate of increase in the CPI (all items less fresh food) for fiscal 2024 is lower, mainly because the government's measures will push down energy prices; on the other hand, that for fiscal 2025 is somewhat higher due to a dissipation of the effects of these measures.
- Concerning risks to the outlook, there remain 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. In particular, with firms' behavior shifting more toward raising wages and prices recently, exchange rate developments are, compared to the past, more likely to affect prices.
- With regard to the risk balance, risks to economic activity are skewed to the upside for fiscal 2025. Risks to prices are skewed to the upside for fiscal 2024 and 2025.

[1] "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on July 30 and 31, 2024.

I. Current Situation of Economic Activity and Prices in Japan

Japan's economy has recovered moderately, although some weakness has been seen in part. Overseas economies have grown moderately on the whole. Exports and industrial production have been more or less flat. Corporate profits have improved and business sentiment has stayed at a favorable level. In this situation, business fixed investment has been on a moderate increasing trend. The employment and income situation has improved moderately. Private consumption has been resilient despite the impact of price rises and other factors. Housing investment has been relatively weak. Public investment has been more or less flat. Financial conditions have been accommodative. On the price front, the year-on-year rate of increase in the CPI (all items less fresh food) has been at around 2.5 percent recently, as services prices have continued to rise moderately, reflecting factors such as wage increases, although the effects of a pass-through to consumer prices of cost increases led by the past rise in import prices have waned. Inflation expectations have risen moderately.

II. Baseline Scenario of the Outlook for Economic Activity and Prices in Japan[2]

A. Baseline Scenario of the Outlook for Economic Activity

Japan's economy is likely to keep growing at a pace above its potential growth rate, with overseas economies continuing to grow moderately and as a virtuous cycle from income to spending gradually intensifies against the background of factors such as accommodative financial conditions.

Comparing the projections with those presented in the previous Outlook Report, the projected real GDP growth rate for fiscal 2024 is somewhat lower, mainly due to the impact of the statistical revision to the GDP figures for fiscal 2023. The projected growth rates for fiscal 2025 onward are more or less unchanged.

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, for the time being, although private consumption is expected to be affected by the price rises, it is projected to increase moderately, mainly reflecting the rise in wage growth. Private consumption is also projected to be underpinned, for the time being, by the government's

[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.

initiatives such as the continuation of measures to reduce the household burden of higher gasoline prices, emergency measures against higher electricity and gas charges, and cuts in income tax and inhabitant tax.

In the corporate sector, exports and production are likely to return to an uptrend, mainly due to a pick-up in global demand for IT-related goods, as overseas economies continue to grow moderately. Meanwhile, inbound tourism demand, which is categorized under services exports, is expected to continue increasing. Corporate profits are likely to follow an improving trend with a moderate increase in domestic and external demand. In this situation, as accommodative financial conditions provide support, business fixed investment is likely to continue on an increasing trend, 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.

Meanwhile, public investment is expected to be more or less flat. Government consumption is expected to increase moderately in reflection of an uptrend in healthcare and nursing care expenditures.

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 at around 2.5 percent for fiscal 2024 and then be at around 2 percent for fiscal 2025 and 2026. While the effects of a pass-through to consumer prices of cost increases led by the past rise in import prices are expected to wane, the rate of increase is projected to be pushed up through fiscal 2025 by factors such as a dissipation of the effects of the government's measures pushing down CPI inflation. Meanwhile, underlying CPI inflation is expected to increase gradually, since it is projected that the output gap will improve and that medium- to long-term inflation expectations will rise with a virtuous cycle between wages and prices continuing to intensify. In the second half of the projection period, it is likely to be at a level that is generally consistent with the price stability target.

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

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 2024 is lower, mainly due to the effects of the government's measures to reduce the household burden of higher gasoline prices and its emergency measures against higher electricity and gas charges; on the other hand, that for fiscal 2025 is somewhat higher due to a dissipation of the effects of these measures. The projected rate of increase in this CPI for fiscal 2026 is more or less unchanged.

The outlook for the CPI (all items less fresh food) depends on the assumptions regarding crude oil prices and the government's 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 had pushed down the year-on-year rates of change in the CPI (all items less fresh food) up through fiscal 2023. For fiscal 2024 and 2025, the phasing out of these measures is projected to push up the rates. 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.

The main factors that determine underlying inflation are assessed as follows. The output gap, which captures the utilization of labor and capital, has followed an improving trend, albeit with fluctuations. Based on the aforementioned outlook for economic activity, the gap is likely to widen moderately within positive territory toward the end of the projection period. Meanwhile, labor market conditions are expected to tighten to a greater extent than can be explained by the changes in the output gap, 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 June 2024 *Tankan* (Short-Term Economic Survey of Enterprises in Japan) shows that firms' inflation outlook for general prices has increased moderately. 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. Firms' behavior has shifted more toward raising wages and prices, and firm wage increases that were higher than those seen in the previous year were achieved in this year's annual spring labor-management wage negotiations. In addition, moves to reflect wage increases in selling prices have been strengthening. Regarding the outlook, inflation expectations are expected to rise moderately, with continued improvement in the output gap and changes in firms' wage- and price-setting behavior. Under these circumstances, the virtuous cycle between wages and prices is projected to keep intensifying through achievement of wage increases that reflect price rises and through a pass-through of wage increases to selling prices.

Considering the above assessments, underlying CPI inflation is expected to increase gradually, mainly reflecting the improvement in the output gap and the rise in medium- to long-term inflation expectations; in the second half of the projection period, it is likely to be at a level that is generally consistent with the price stability target. That said, there remain uncertainties regarding this outlook, and it is necessary to carefully monitor factors such as firms' wage- and price-setting behavior.

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 <u>developments in overseas economic activity and prices and in global financial and capital markets</u>. Inflation rates in the United States and Europe have followed a declining trend, albeit with fluctuations, and some central banks have started to slightly lower their policy interest rates. That said, inflationary pressure has remained on a global basis and there is a risk of tight monetary policy being prolonged. Moreover, there are uncertainties over how past policy interest rate hikes by overseas central banks will affect their real economies and financial systems. 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 factors such as the course of the situation surrounding Ukraine and the Middle East, downward pressure on overseas economies 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, and it is necessary to pay attention to how inventory adjustment pressure on some goods will affect overseas economic activity and prices.

The second risk is <u>developments in import prices, particularly those of commodities, including grains</u>. Attention continues to be warranted on the risk that prices of grains and other commodities 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, households' defensive attitudes toward spending could strengthen further, and this could 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 the impact of various changes in the environment surrounding Japan on firms' and households' medium- to long-term growth expectations and on Japan's potential growth rate. It is expected that factors such as the experience of COVID-19, 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. Intensifying labor shortages -- which are partly due to demographic changes -- could accelerate labor-saving investment, such as for digitalization. On the other hand, if such a substitution of labor with capital does not sufficiently progress, there is a risk that supply-side constraints in some industries will push down the growth rate. Furthermore, the heightened geopolitical risks could change the trend of globalization, which has supported the growth of the global economy to date.

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. While firms' behavior has shifted more toward raising wages and prices, there remain uncertainties over the extent to which moves to reflect wage developments in selling prices will become widespread. It is expected in the baseline scenario that the virtuous cycle between wages and prices will continue to intensify. However, given that firms, especially small and medium-sized firms, have continued to report that it has been difficult to pass on their employees' higher wages to their selling prices, the rise in selling prices could be limited. Since the behavior and mindset based on the assumption that wages and prices will not increase easily have taken hold in Japanese society for a prolonged period, it is necessary to pay close attention to whether moves to pass on increases in wages and other costs to selling prices will weaken with the waning of the effects of the pass-through to consumer prices of cost increases led by the past rise in import prices. On the other hand, moves to reflect wages in selling prices could strengthen to a greater extent than expected, and upward pressure on wages could intensify with labor market conditions tightening. In this situation, there is also a possibility that both wages and prices will deviate upward from the baseline scenario, accompanied by a rise in medium- to long-term inflation expectations.

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. In addition, with firms' behavior shifting more toward raising wages and prices recently, exchange rate developments are, compared to the past, more likely to affect prices.

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 at around 2.5 percent for fiscal 2024 and then be at around 2 percent for fiscal 2025 and 2026. Meanwhile, underlying CPI inflation is expected to increase gradually, since it is projected that the output gap will improve and that medium- to long-term inflation expectations will rise with the virtuous cycle between wages and prices continuing to intensify. In the second half of the projection period, it is likely to be at a level that is generally consistent with the price stability target.

The second perspective involves an examination of the risks considered most relevant to the conduct of monetary policy. There remain 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 skewed to the upside for fiscal 2025. Risks to prices are skewed to the upside for fiscal 2024 and 2025.

Examining risks on the financial side, overheating has generally not been seen in asset markets and financial institutions' credit activities, although a somewhat rapid rise in stock prices was seen for a time and valuations of some properties seem to have been relatively high in the real estate market. Japan's financial system has maintained stability on the whole. In addition, even in the case of an adjustment in the real economy at home and

[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."

abroad and in global financial markets, the financial system is likely to remain highly robust on the whole, mainly because Japanese financial institutions have sufficient capital bases. Moreover, financial institutions' resilience to rises in yen interest rates has headed toward improvement, mainly reflecting their portfolio rebalancing in securities investment. 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.

As for the conduct of monetary policy, while it will depend on developments in economic activity and prices as well as financial conditions going forward, given that real interest rates are at significantly low levels, if the aforementioned outlook for economic activity and prices will be realized, the Bank will accordingly continue to raise the policy interest rate and adjust the degree of monetary accommodation. With the price stability target of 2 percent, it will conduct monetary policy as appropriate, in response to developments in economic activity and prices as well as financial conditions, from the perspective of sustainable and stable achievement of the target.

(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 2024	+0.5 to +0.7 [+0.6]	+2.5 to +2.6 [+2.5]	+1.8 to +2.0 [+1.9]
Forecasts made in April 2024	+0.7 to +1.0 [+0.8]	+2.6 to +3.0 [+2.8]	+1.7 to +2.1 [+1.9]
Fiscal 2025	+0.9 to +1.1 [+1.0]	+2.0 to +2.3 [+2.1]	+1.8 to +2.0 [+1.9]
Forecasts made in April 2024	+0.8 to +1.1 [+1.0]	+1.7 to +2.1 [+1.9]	+1.8 to +2.0 [+1.9]
Fiscal 2026	+0.8 to +1.0 [+1.0]	+1.8 to +2.0 [+1.9]	+1.9 to +2.2 [+2.1]
Forecasts made in April 2024	+0.8 to +1.0 [+1.0]	+1.6 to +2.0 [+1.9]	+1.9 to +2.1 [+2.1]

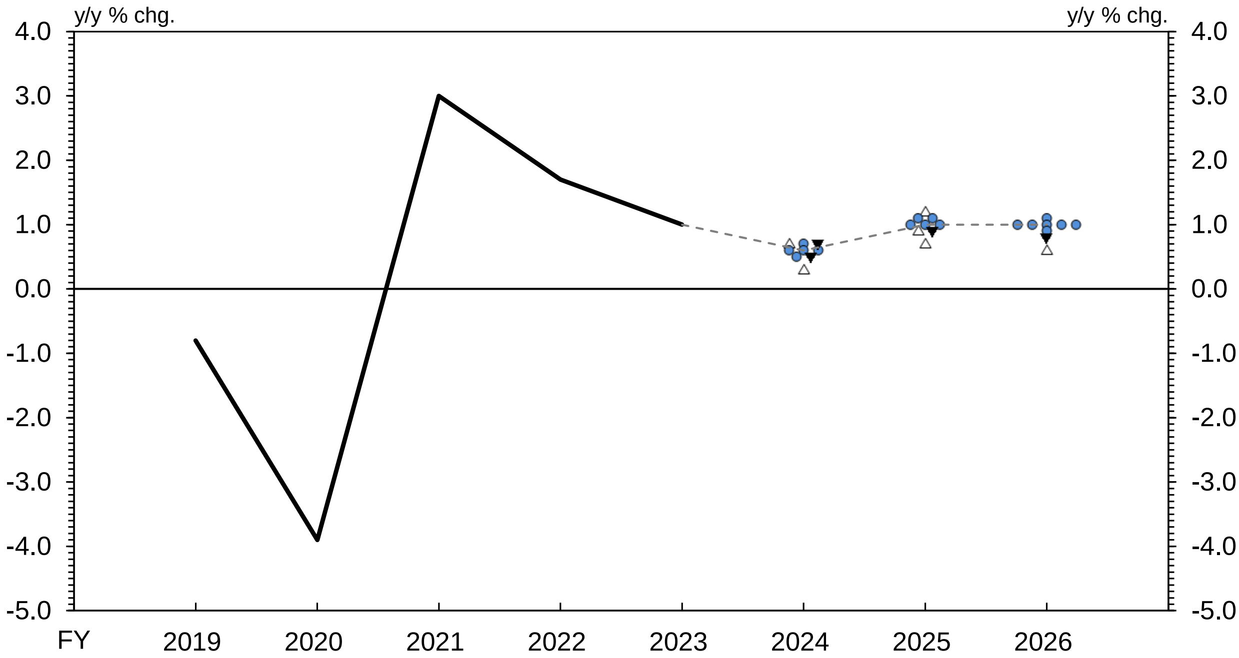
Notes: 1. Figures in brackets indicate the medians of the Policy Board members' forecasts (point estimates).

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.

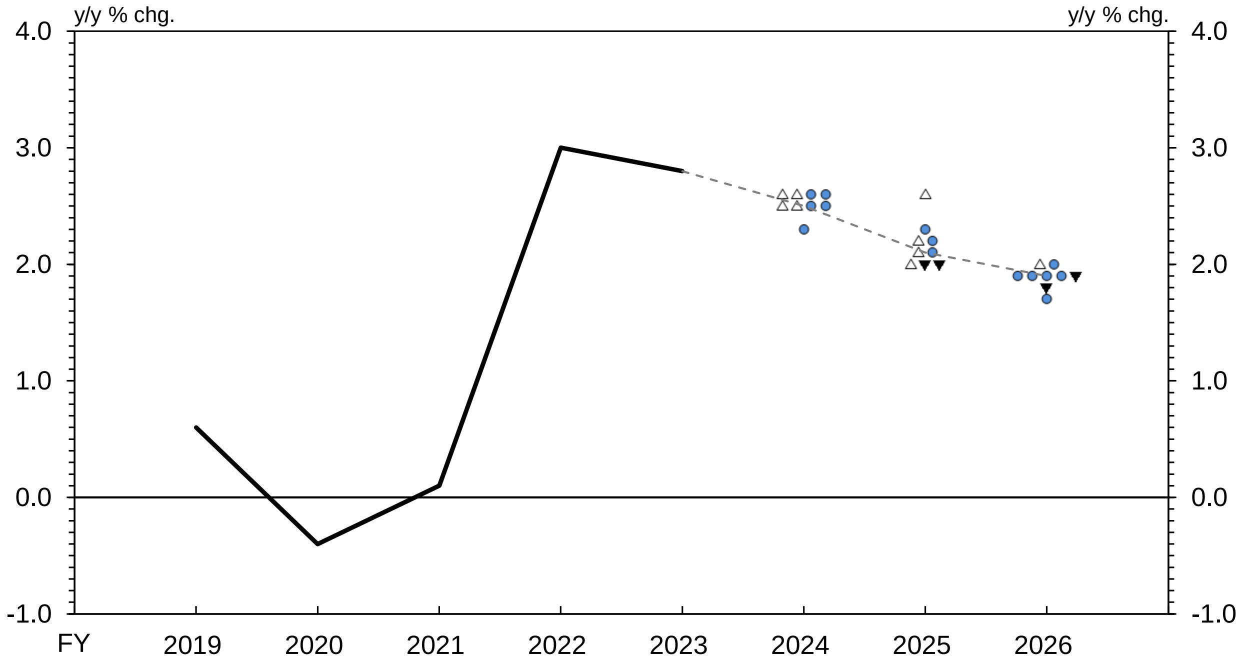
3. Each Policy Board member makes their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding the future conduct of policy.

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."