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日本銀行
BANK OF JAPAN

Outlook for Economic Activity and Prices

July 2024

(English translation prepared by the Bank's staff based on the Japanese original)

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 developments in overseas economic activity and prices and in global financial and capital markets. 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 developments in import prices, particularly those of commodities, including grains. 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 <u>the conduct of monetary policy</u>, 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]

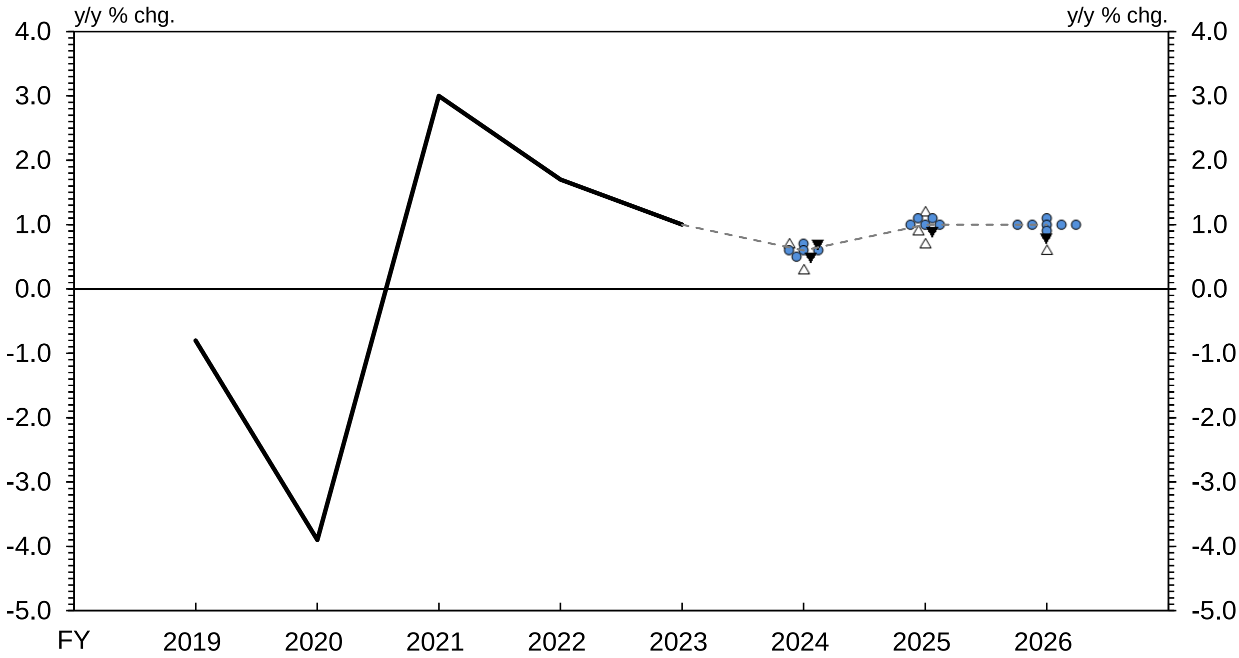
Notes: 1. Figures in brackets indicate the medians of the Policy Board members' forecasts (point estimates).

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.

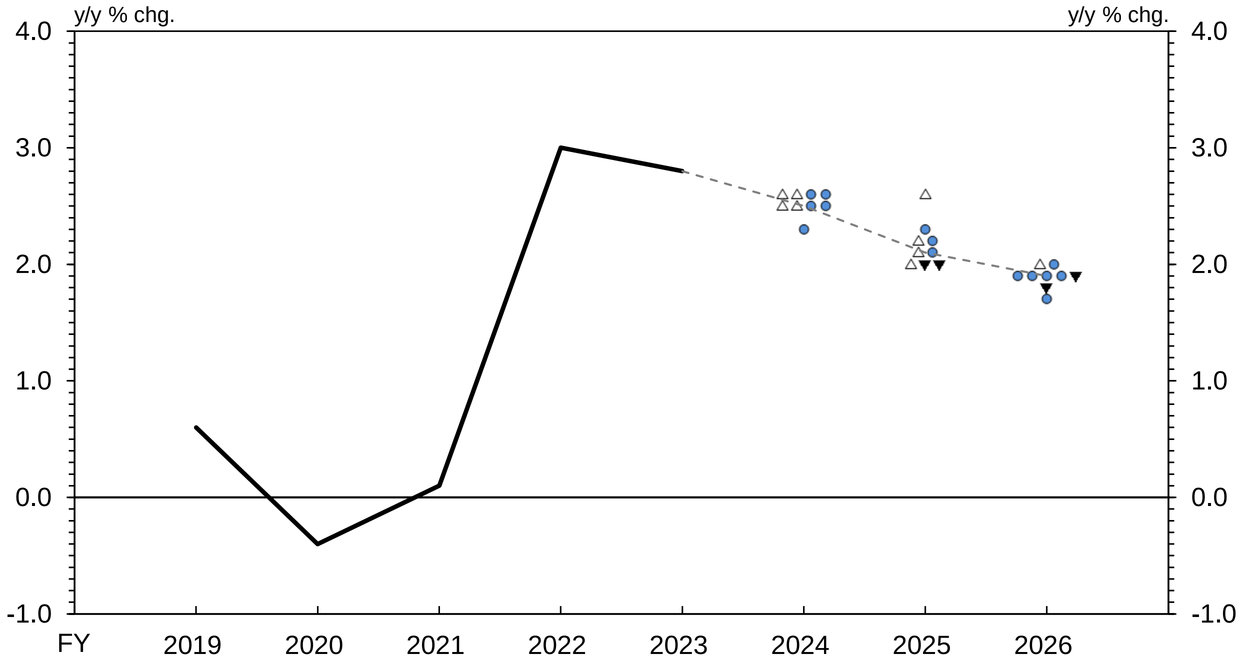
3. Each Policy Board member makes their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding the future conduct of policy.

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."

The Background[5]

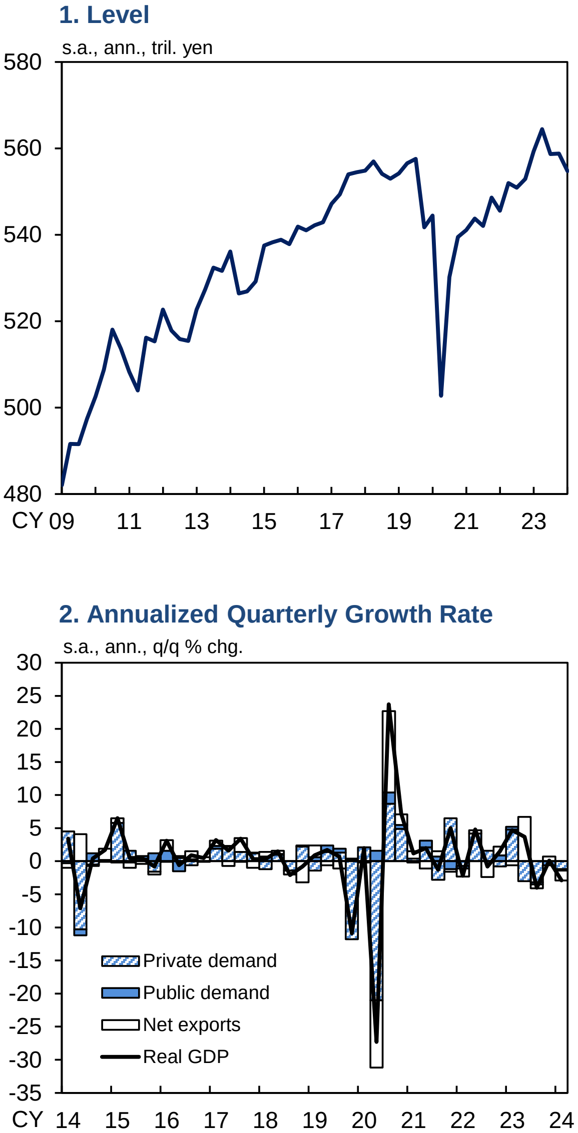
I. Current Situation of Economic Activity and Its Outlook

A. Economic Developments

Japan's economy has recovered moderately, although some weakness has been seen in part.

The real GDP growth rate for the October-December quarter of 2023 was 0.0 percent on a quarter-on-quarter basis and 0.1 percent on an annualized basis (Chart 1). It then registered minus 0.7 percent on a quarter-on-quarter basis and minus 2.9 percent on an annualized basis for the January-March quarter of 2024, resulting in negative growth for the first time in two quarters. This is mainly because private consumption and exports decreased, partly due to the effects of a suspension of production and shipment at some automakers. In addition, business fixed investment declined somewhat following the relatively high growth in the previous quarter. The output gap -- which captures the utilization of labor and capital -- became slightly negative in the January-March quarter, mainly because the capacity utilization rate for the manufacturing industry declined due to the effects of the suspension of production and shipment at some automakers (Chart 2).

Chart 1: Real GDP



Source: Cabinet Office.

Monthly indicators and high-frequency data since then suggest that Japan's economy has

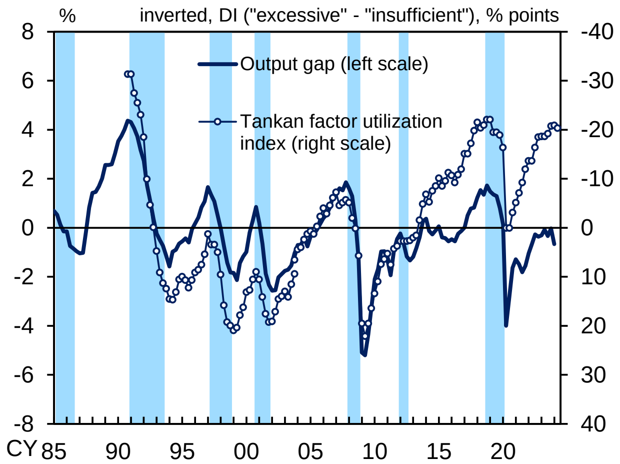
[5] "The Background" provides explanations of "The Bank's View" decided by the Policy Board at the Monetary Policy Meeting held on July 30 and 31, 2024.

continued on a recovery trend, although some weakness has been seen in part. In the corporate sector, exports and 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. Business fixed investment plans (in nominal terms) in the June 2024 *Tankan* indicate that the year-on-year rate of change in investment for fiscal 2023 was significantly positive and that the rate of change in planned investment for fiscal 2024 is clearly positive. In the household sector, the employment and income situation has improved moderately. Under these circumstances, private consumption has been resilient despite the impact of price rises and other factors.

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. This is mainly because the carry-over effect from the previous year on GDP growth for fiscal 2024 has become smaller due to the retroactive revision in the *Quick Estimate of Construction Investment*.

The potential growth rate seems to have been in the range of 0.5-1.0 percent recently, with a moderate increase in the growth rate of total factor productivity (TFP), although the downtrend

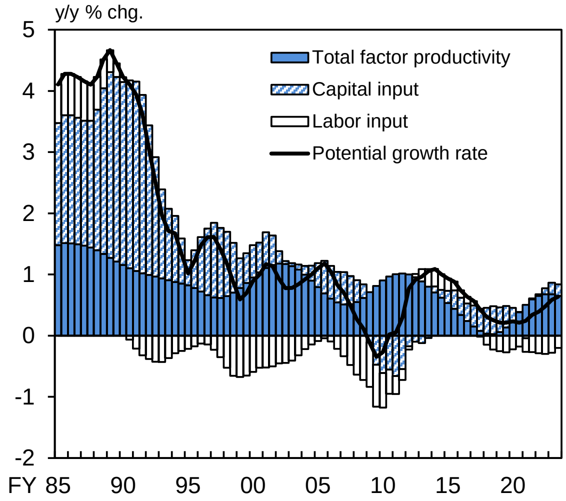
Chart 2: Output Gap



Source: Bank of Japan.
Notes: 1. Figures for the output gap are staff estimates.
2. The *Tankan* factor utilization index is calculated as the weighted average of the production capacity DI and the employment conditions DI for all industries and enterprises. The capital and labor shares are used as weights. There is a discontinuity in the data for December 2003 due to a change in the survey framework.
3. Shaded areas denote recession periods.

in working hours reflecting working-style reforms, for example, has continued (Chart 3). As for the outlook, the potential growth rate is expected to rise moderately. This is based on the projection that, although there will be less room for the number of employed persons to increase, (1) TFP will continue to grow, mainly on the back of advances in digitalization and a resulting improvement in efficiency of resource allocation, as well as an expansion in investment in human capital, (2) the decline in working hours will come to a halt in reflection of the diminishing effects of working-style reforms, and (3) growth in capital stock will accelerate. These developments are likely to be encouraged by the government's various measures and by accommodative financial conditions.[6]

Chart 3: Potential Growth Rate



Source: Bank of Japan.
Note: Figures are staff estimates.

Details of the outlook for each fiscal year are as follows. In fiscal 2024, Japan's economy is expected to continue recovering moderately, partly due to the effects of the government's economic measures, with overseas economies growing moderately and accommodative financial conditions being maintained. Goods exports are likely to see a moderate increase, as overseas economies grow moderately. Inbound tourism

[6] However, the output gap and the potential growth rate, which are estimated based on a specific assumption regarding trends, should be interpreted with some latitude. For example, in terms of labor, it is highly uncertain what kind of working style will take hold going forward -- including among women and seniors -- given the experience of COVID-19, that of wage and price increases, and with demographic changes. In addition, in the corporate sector, it is expected that factors such as moves toward digitalization, which reflect the experience of COVID-19 and labor shortages, and progress on efforts with a view to decarbonization will change Japan's economic and industrial structures; however, there remain high uncertainties over the extent of advancement and sustainability of innovation and sectoral reallocation of production factors, both of which aim at adapting to changes in the economic and industrial structures.

demand is projected to keep increasing. Business fixed investment is expected to continue on an increasing trend, mainly on the back of accommodative financial conditions. In the household sector, nominal employee income is likely to keep increasing. This is because employment is likely to rise on the back of an increase in domestic and external demand, and wage growth is expected to remain relatively high in reflection of the results of this year's annual spring labor-management wage negotiations. Moreover, the government's initiatives, such as measures to reduce the household burden of higher energy prices and cuts in income tax and inhabitant tax, are projected to push up disposable income. In this situation, private consumption is expected to increase moderately, despite being affected by high prices.

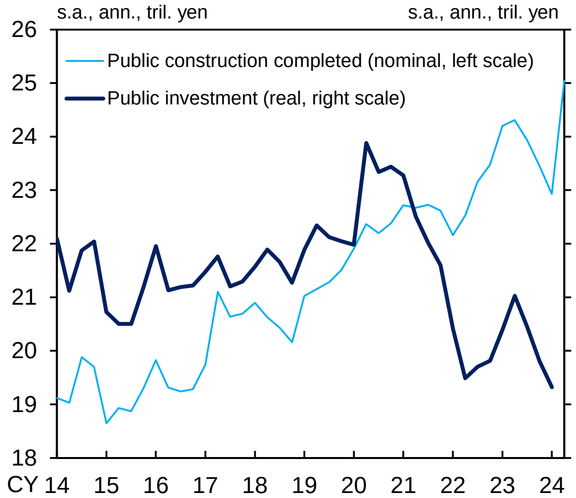
In fiscal 2025 and 2026, Japan's economy is expected to grow at a pace above its potential growth rate, with domestic and external demand rising. Goods exports are likely to increase moderately, with overseas economies continuing to grow. Inbound tourism demand is projected to keep increasing. Business fixed investment is also expected to continue increasing, mainly for investment to address labor shortages, digital-related investment, investment related to growth areas and decarbonization, and investment associated with strengthening supply chains. In the household sector, nominal employee income is likely to keep rising steadily. This is because wage growth is expected to remain relatively high as the linkage between wages and prices strengthens further, although it will gradually become more difficult for labor supply to increase, with labor force participation of women and seniors having advanced to a high degree thus far. In this situation, private consumption is projected to continue increasing moderately.

B. Developments in Major Expenditure Items and Their Background

Government Spending

Public investment has generally been more or less flat, albeit with fluctuations (Chart 4). While construction based on the government's economic measures, including construction related to building national resilience, has progressed, the amount of public construction completed -- a coincident indicator of public investment -- has generally been more or less flat, albeit with fluctuations. The value of public works contracted and orders received for public construction -- both of which are leading indicators of public investment -- also have generally been more or less flat, albeit with fluctuations.

Chart 4: Public Investment



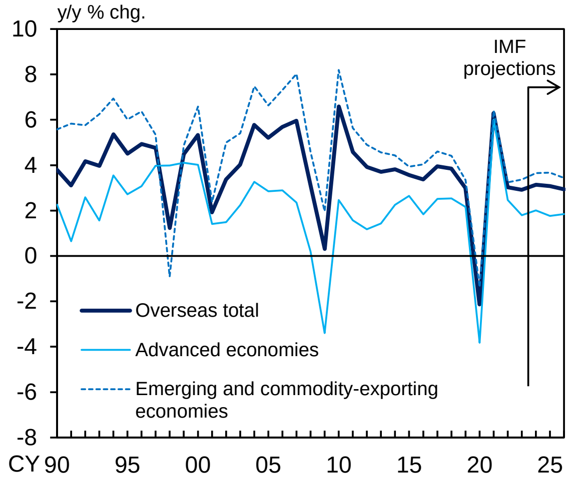
Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Note: The figure for 2024/Q2 is the April-May average.

As for the outlook, public investment is likely to be more or less flat.[7] Government consumption is projected to continue increasing moderately, reflecting an uptrend in healthcare and nursing care expenditures.

Overseas Economies

Overseas economies have grown moderately on the whole (Chart 5). By region, the U.S. economy has grown moderately, mainly led by private consumption, although it has been affected by

Chart 5: Overseas Economies



Sources: IMF; Ministry of Finance.
Note: Figures are the weighted averages of real GDP growth rates using countries' share in Japan's exports as weights. The real GDP growth rates are compiled by the IMF, and the rates from 2024 onward are its projections in the April 2024 *World Economic Outlook* (WEO) and the July 2024 WEO *Update*. Figures for advanced economies are those for the United States, the euro area, and the United Kingdom. Figures for emerging and commodity-exporting economies are those for the rest of the world.

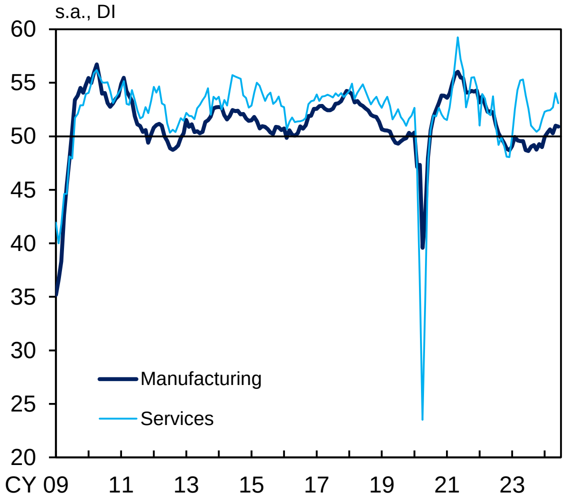
[7] The five-year acceleration measures for building national resilience with a project size of about 15 trillion yen were decided by the Cabinet in December 2020. In these measures, public investment projects for disaster prevention, disaster mitigation, and building national resilience are to be implemented intensively over five years from fiscal 2021 through fiscal 2025. The government's economic measures decided by the Cabinet in November 2023 also include efforts to implement the acceleration measures.

past policy interest rate hikes. European economies have started to bottom out. The Chinese economy has improved moderately, partly due to government support, despite continued effects of adjustments in the real estate market. Emerging and commodity-exporting economies other than China have improved moderately on the whole, as signs of a pick-up have been seen in exports. Among those in Asia, which are closely related to Japan's economy, the ASEAN economies have improved moderately, as domestic demand has continued to improve and exports have bottomed out. The NIEs economies also have improved moderately on the back of a pick-up in exports, mainly led by IT-related goods, although the pace of improvement in domestic demand has decelerated.

Looking at the Global PMI to see the current situation for the global economy, figures for the services industry have been clearly above 50, the break-even point between improvement and deterioration in business conditions; figures for the manufacturing industry have been somewhat above 50 (Chart 6).

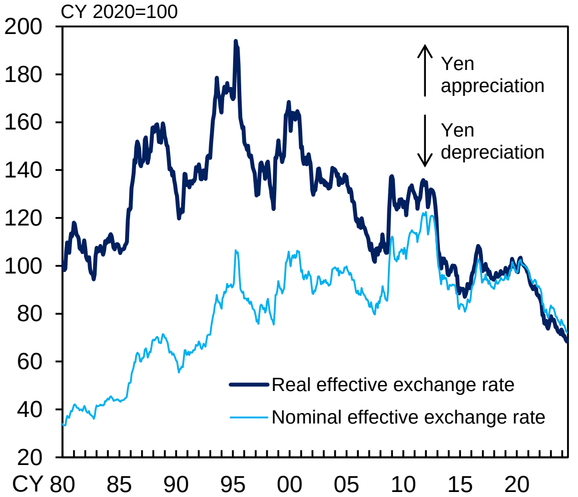
As for the outlook, overseas economies are projected to keep growing moderately. Looking at developments by region for the time being, the U.S. economy is likely to continue growing moderately. European economies are expected to pick up moderately. The Chinese economy is projected to grow moderately as the effects of policy measures emerge, although adjustment pressure in the real estate market is likely to remain. Emerging and commodity-exporting economies other than China are likely to continue

Chart 6: Global PMI



Source: Copyright © 2024 by S&P Global Market Intelligence, a division of S&P Global Inc. All rights reserved.
Note: Figures for manufacturing are the J.P.Morgan Global Manufacturing PMI. Figures for services are the J.P.Morgan Global Services Business Activity Index.

Chart 7: Effective Exchange Rates



Source: BIS.
Note: Figures are based on the broad effective exchange rate indices. Figures prior to 1994 are calculated using the narrow indices.

improving moderately with external demand picking up.

Exports and Imports

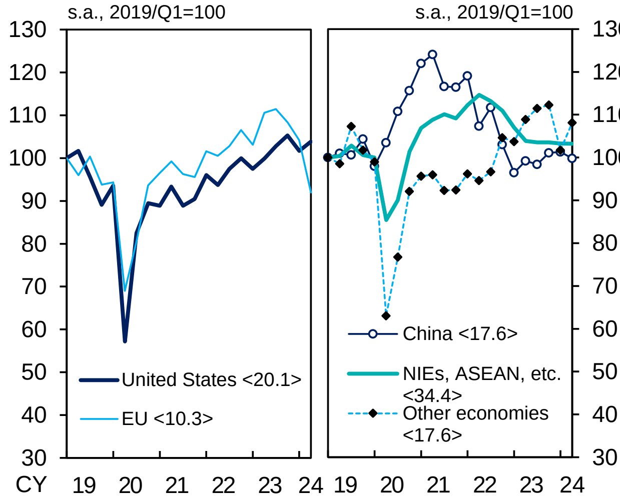
Exports have been more or less flat (Chart 8). By region, exports to the U.S. economy have been at relatively high levels, albeit with fluctuations (Chart 9). Those to European economies have decreased recently, particularly of automobiles and capital goods. Exports to the Chinese economy have continued on a moderate pick-up trend, with an increase in exports of semiconductor production equipment and other goods. Exports to the NIEs, the ASEAN economies, and some other Asian economies have bottomed out against the background of progress in global adjustments for IT-related goods. By goods, exports of automobile-related goods have increased slightly, as the effects of the suspension of production and shipment at some automakers have been dissipating (Chart 10). Exports of capital goods have been more or less flat when fluctuations are smoothed out. Exports of IT-related goods have bottomed out against the background of the progress in global adjustments for IT-related goods. Meanwhile, exports of intermediate goods have been at relatively low levels, mainly due to a deterioration in supply and demand conditions in global markets.

As overseas economies continue to grow moderately, exports are projected to return to an uptrend, mainly due to a pick-up in global demand for IT-related goods.

Chart 8: Real Exports and Imports

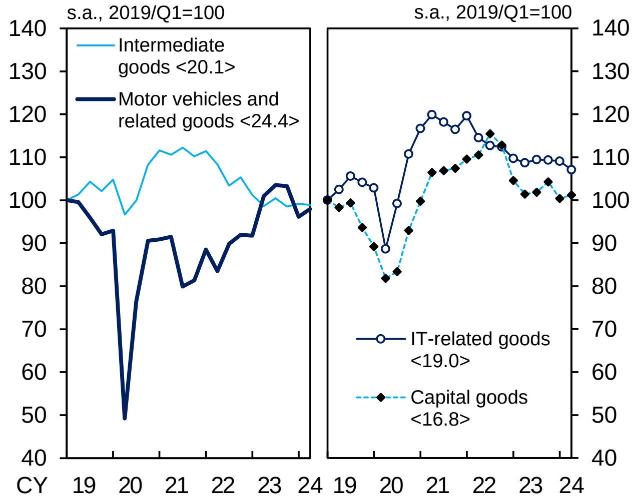
Sources: Bank of Japan; Ministry of Finance; Cabinet Office.
Note: Based on staff calculations.

Chart 9: Real Exports by Region



Sources: Bank of Japan; Ministry of Finance.
Notes: 1. Based on staff calculations. Figures in angular brackets show the share of each country or region in Japan's total exports in 2023.
2. Figures for the EU exclude those for the United Kingdom for the entire period.

Chart 10: Real Exports by Type of Goods



Sources: Bank of Japan; Ministry of Finance.
Note: Based on staff calculations. Figures in angular brackets show the share of each type of goods in Japan's total exports in 2023.

Imports have picked up (Chart 8). They are expected to follow a moderate uptrend on the back of developments in demand induced by increases in domestic demand and exports.

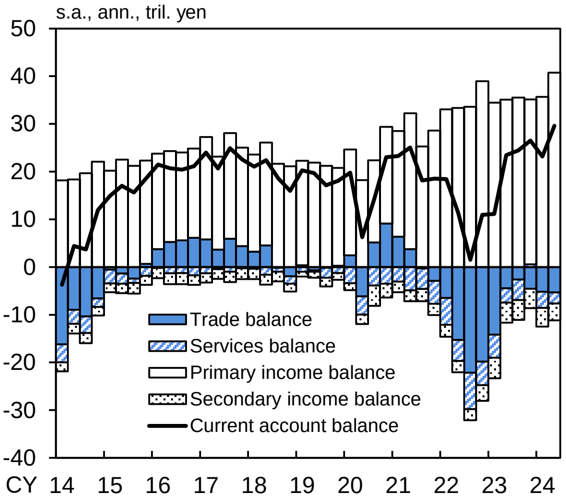
External Balance

The nominal current account surplus has been at a high level (Chart 11). The trade balance deficit has been small, marking a clear decrease compared to a while ago. Despite a surplus in the travel balance -- which reflects an increase in inbound tourism demand due to factors such as a rise in the number of inbound visitors (Chart 12) -- the services balance has remained on a slight deficit trend, as payments for digital-related services have been at high levels, albeit with fluctuations. Meanwhile, the primary income balance surplus has remained at a high level.

The nominal current account balance is likely to follow a moderate improving trend. This is based on the projection that the primary income balance surplus will increase moderately, and that the trade balance deficit will decline moderately due to factors such as an increase in goods exports. Meanwhile, the services balance is expected to be more or less unchanged: while the rise in inbound tourism demand will make a positive contribution, the increase in payments for digital-related services will make a negative contribution.

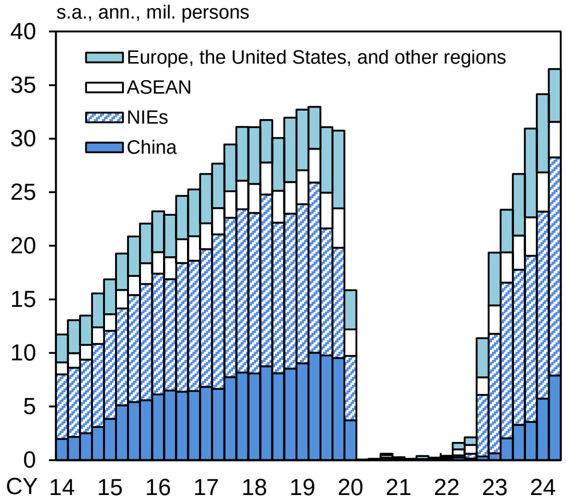
In terms of the savings-investment balance, overall excess savings in Japan's economy are projected to follow a moderate expanding trend, because the fiscal balance is likely to improve at a

Chart 11: Current Account



Source: Ministry of Finance and Bank of Japan.
Note: Figures for 2024/Q2 are April-May averages.

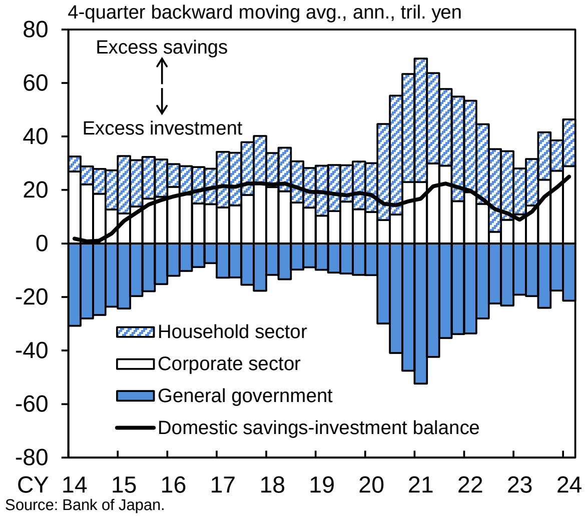
Chart 12: Number of Inbound Visitors



Source: Japan National Tourism Organization (JNTO).
Note: Figures for Europe, the United States, and other regions include seasonal adjustment errors.

pace that somewhat exceeds the pace of decline in excess savings in the private sector (Chart 13).

Chart 13: Savings-Investment Balance

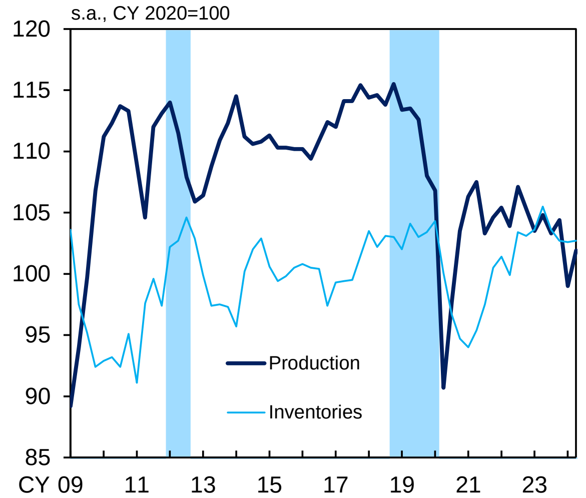


Source: Bank of Japan.

Industrial Production

Industrial production has been more or less flat (Chart 14). By major industry, production of "transport equipment" has increased, as the effects of the suspension of production and shipment at some automakers have been dissipating. Production of "electrical machinery, and information and communication electronics equipment" has picked up somewhat, as the impact of the production decline in automobiles has been dissipating. Despite a pause in demand for construction machinery and other items, production of "general-purpose, production, and business-oriented machinery" has been more or less flat, reflecting signs of a pick-up in production of semiconductor production equipment. Production of "electronic parts and devices" has picked up with progress in inventory adjustments. Meanwhile, production of "chemicals (excluding medicine)" has been at a low level, mainly due to a deterioration in supply and demand conditions in global markets.

Chart 14: Industrial Production



Source: Ministry of Economy, Trade and Industry.
Note: Shaded areas denote recession periods.

Industrial production is projected to return to an uptrend, reflecting a pick-up in global demand for IT-related goods and other developments in domestic and external demand.

Corporate Profits

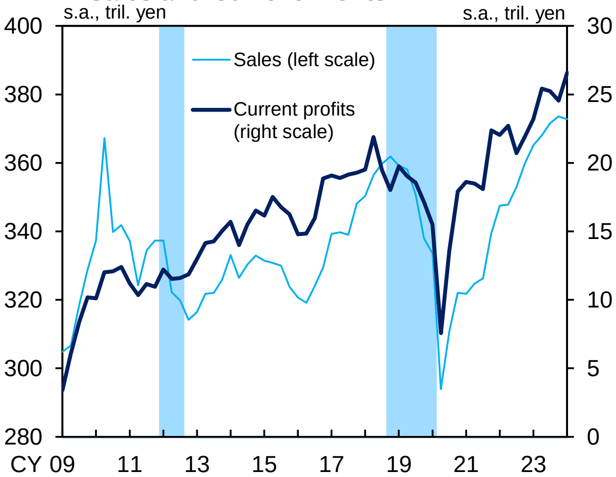
Corporate profits have improved. According to the *Financial Statements Statistics of Corporations by Industry, Quarterly*, current profits for all industries and enterprises for the January-March quarter of

2024 rose from the previous quarter, reaching the highest level since the April-June quarter of 1985, from when comparable data are available (Chart 15). This mainly reflects progress in the pass-through of cost increases to selling prices and the increase in non-operating profits due to the yen's depreciation. By industry and firm size, current profits of large manufacturers have increased, despite the effects of the suspension of production and shipment at some automakers, mainly reflecting the progress in the pass-through of cost increases to selling prices and the yen's depreciation. Current profits of small and medium-sized manufacturers have decreased, reflecting factors such as the effects of the suspension of production and shipment at some automakers. As for nonmanufacturers, current profits of large firms have decreased, mainly because profitability in the electric and gas utilities industry has deteriorated due to developments in fuel prices. Current profits of small and medium-sized nonmanufacturers have increased, mainly reflecting a rise in sales -- including those to inbound tourists -- in the retail trade and services industries.

Business sentiment has stayed at a favorable level. The June *Tankan* shows that the diffusion index (DI) for business conditions has remained at a favorable level (Chart 16). By industry, the DI for manufacturing has been more or less flat. The DIs for "pulp and paper" and "ceramics, stone, and clay" have improved, reflecting the progress in the pass-through of cost increases to selling prices. The DIs for textiles (large enterprises) and chemicals also have improved, since profits have increased with the yen's depreciation. On the other hand, the DIs for "iron and steel" and "food

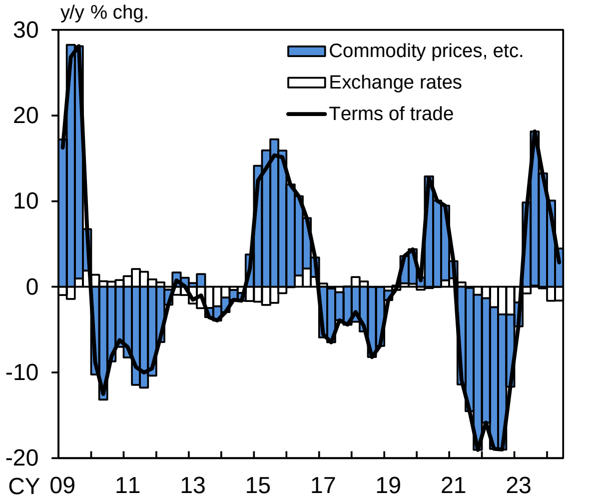
Chart 15: Indicators Related to Corporate Profits

1. Sales and Current Profits



Source: Ministry of Finance.
Notes: 1. Based on the *Financial Statements Statistics of Corporations by Industry, Quarterly*. Excluding "finance and insurance."
2. Figures from 2009/Q2 onward exclude pure holding companies.
3. Shaded areas denote recession periods.

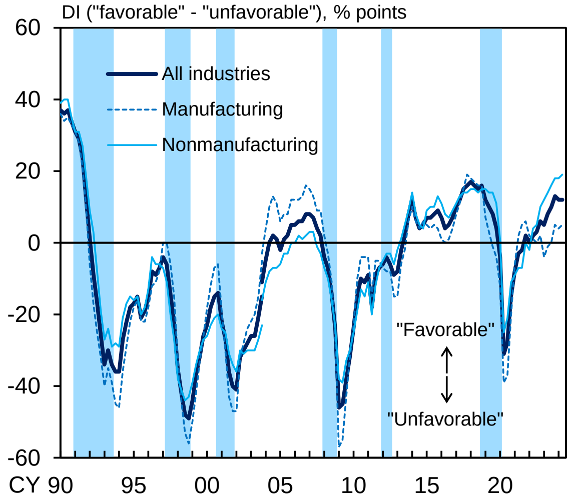
2. Contribution to Changes in Terms of Trade



Source: Bank of Japan.
Notes: 1. The contribution of changes in commodity prices, etc. is calculated using changes in export/import price indexes on a contract currency basis. The contribution of changes in exchange rates is calculated using the difference between export/import price indexes on a yen basis and those on a contract currency basis.
2. Terms of trade = Export price index on a yen basis / Import price index on a yen basis

and beverages" (large enterprises) have deteriorated, reflecting a rise in raw material prices. In addition, the DI for motor vehicles (large enterprises) has deteriorated somewhat due to the effects of the suspension of production and shipment at some automakers. With regard to nonmanufacturing, the DIs have been more or less flat. The DI for transport and postal activities has improved, reflecting the progress in the pass-through of cost increases to selling prices and a rise in inbound tourism demand. On the other hand, the DIs for "services for individuals" (large enterprises) and "accommodations as well as eating and drinking services" have deteriorated, reflecting labor shortages and a rise in personnel expenses. In addition, consumers' increased thriftiness due to price hikes has made a negative contribution to the DI for retail trade.

Chart 16: Business Conditions



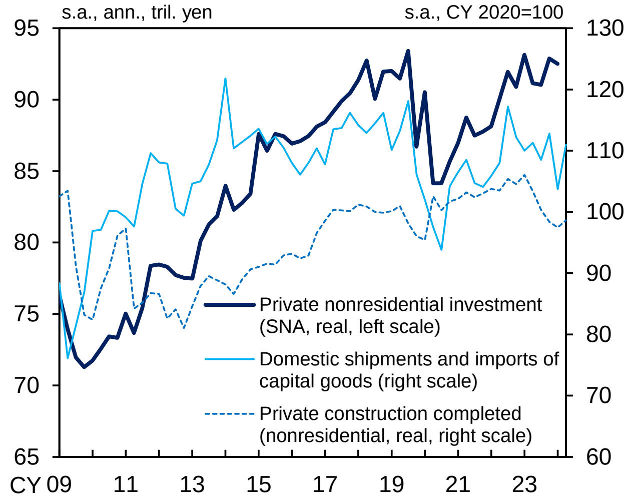
Source: Bank of Japan.
Notes: 1. Based on the *Tankan*. All enterprises. There is a discontinuity in the data for December 2003 due to a change in the survey framework.
2. Shaded areas denote recession periods.

Regarding the outlook, with a moderate rise in domestic and external demand, corporate profits are likely to follow an improving trend, partly due to the progress in the pass-through of cost increases to selling prices.

Business Fixed Investment

Business fixed investment has been on a moderate increasing trend (Chart 17). The aggregate supply of capital goods -- a coincident indicator of machinery investment -- has risen recently, partly because investment in semiconductor production equipment has increased and the effects of the suspension of production and shipment at some automakers have been dissipating. Although moves to postpone investment have been observed against the background of factors such as high

Chart 17: Coincident Indicators of Business Fixed Investment

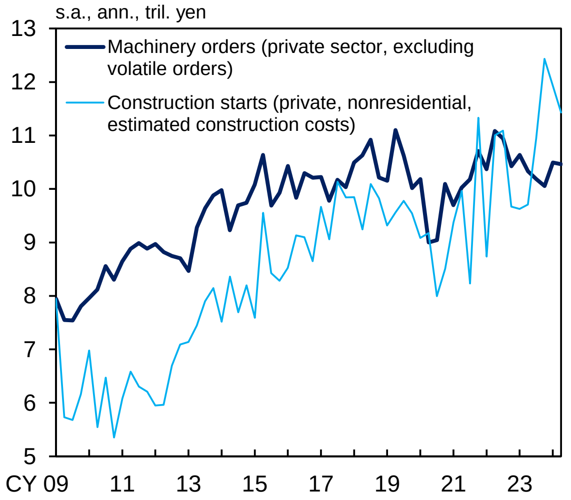


Sources: Cabinet Office; Ministry of Economy, Trade and Industry; Ministry of Land, Infrastructure, Transport and Tourism.
Notes: 1. The figure for private construction completed for 2024/Q2 is the April-May average.
2. Figures for real private construction completed are based on staff calculations using the construction cost deflators.

construction material prices, private construction completed (nonresidential) -- a coincident indicator of construction investment -- has been flat recently, as there has been progress in, for example, construction of logistics facilities and urban redevelopment projects.

Machinery orders -- a leading indicator of machinery investment -- have remained at relatively high levels, although they have seen a lowering in their levels compared to a while ago (Chart 18). By industry, although orders by the manufacturing industry overall have been pushed down by the dissipation of the effects of large-scale projects in some industries, orders by the "electrical machinery" and "information and communication electronics equipment" industries have been on an uptrend against the background of the progress in global adjustments for IT-related goods. Orders from the nonmanufacturing industry have increased moderately, albeit with fluctuations stemming from large-scale projects, as digital- and labor saving-related investments have followed an uptrend. Construction starts (in terms of planned expenses for private and nonresidential construction) -- a leading indicator of construction investment -- have been on an uptrend recently, partly due to the establishment of new factories and the extension of existing ones, as construction of logistics facilities and redevelopment projects have continued. Looking at the business fixed investment plans (in nominal terms) in the June *Tankan*, business fixed investment (on the basis close to GDP definition; business fixed investment -- including software and R&D investments but excluding land purchasing expenses -- for all industries and

Chart 18: Leading Indicators of Business Fixed Investment

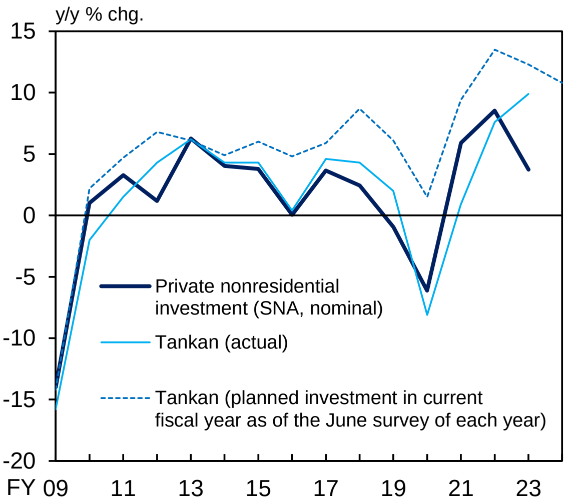


Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Notes: 1. Volatile orders are orders for ships and orders from electric power companies.
2. Figures for 2024/Q2 are April-May averages.

enterprises including financial institutions) registered a year-on-year rate of increase of 9.9 percent for fiscal 2023 (Chart 19). The rates of change in both manufacturing and nonmanufacturing industries for fiscal 2023 were significantly positive. In addition, the reported rate for fiscal 2024 of 10.8 percent indicates a relatively high increase compared with past June *Tankan* surveys.

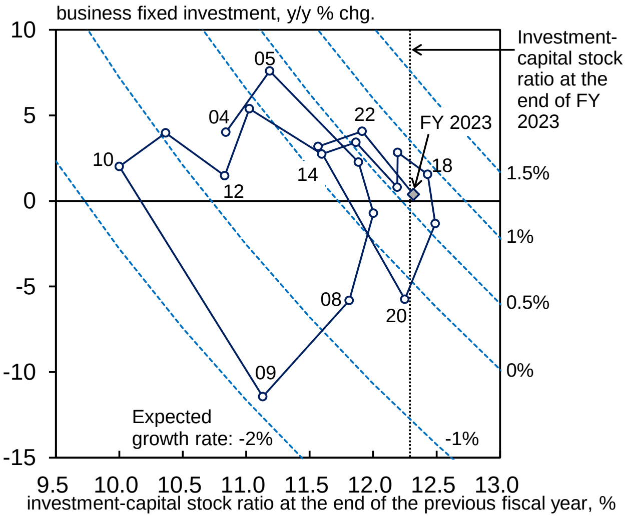
Business fixed investment is expected to continue on an increasing trend, mainly on the back of accommodative financial conditions, as corporate profits follow an improving trend. Specifically, investment that is expected to be undertaken during the projection period includes (1) investment induced by the increase in domestic and external demand; (2) labor-saving and efficiency-improving investment to address labor shortages and IT-related investment to digitalize business activities; (3) construction investment in logistics facilities, resulting from expanding e-commerce, and in offices and commercial facilities due to redevelopment projects; (4) investment in growth areas and to address environmental issues, such as decarbonization; and (5) semiconductor-related investment that is mainly aimed at strengthening supply chains and that also reflects government support. Regarding investment related to growth areas, such as digitalization and semiconductors, capital accumulation in these areas tends to be moderate due to a relatively small existing capital stock and to short depreciation periods reflecting rapid advances in technology (Chart 20).

Chart 19: Planned and Actual Business Fixed Investment



Sources: Bank of Japan; Cabinet Office.
Note: The *Tankan* figures include software and R&D investments and exclude land purchasing expenses. R&D investment is not included before the March 2017 survey. The figures are for all industries including financial institutions.

Chart 20: Capital Stock Cycles



Source: Cabinet Office.
Note: Each broken line represents the combination of the rate of change in business fixed investment and the investment-capital stock ratio at a certain expected growth rate.

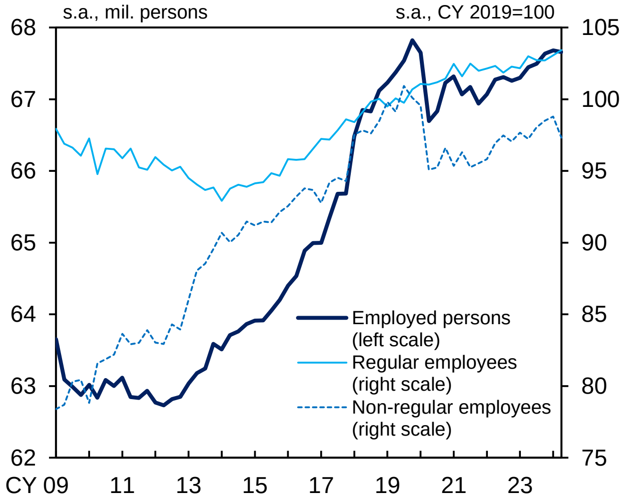
Employment and Income Situation

The employment and income situation has improved moderately.

Regarding the number of employed persons, that of regular employees has been on a moderate uptrend, albeit with fluctuations, mainly in the information and communications industry, which has faced a severe labor shortage (Chart 21). The number of non-regular employees has also been on a moderate uptrend, albeit with fluctuations, mainly in the wholesale and retail trade as well as the face-to-face services industries. With regard to labor market conditions, the unemployment rate has been at a low level (Chart 22). The active job openings-to-applicants ratio, despite some fluctuations, has been more or less flat (Chart 23). Meanwhile, the labor force participation rate has been on a moderate uptrend, particularly for women, when fluctuations are smoothed out (Chart 22).

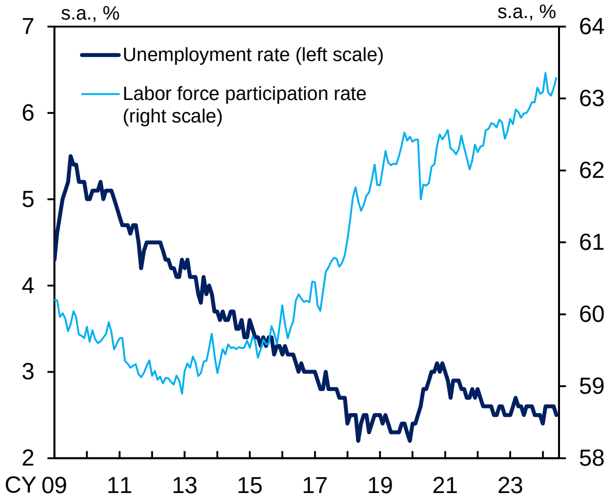
With regard to the outlook for the number of employees, regular employees are likely to increase moderately, mainly in industries with labor shortages, such as the information and communications industry. Non-regular employees, mainly in the face-to-face services industry, are expected to keep increasing along with the rise in domestic and external demand. However, the pace of increase in the number of overall employees is projected to decelerate, partly because it will become more difficult for labor supply to increase, reflecting factors such as demographic changes, with labor force participation of women and seniors having advanced to a high degree thus far. Under these

Chart 21: Number of Employed Persons



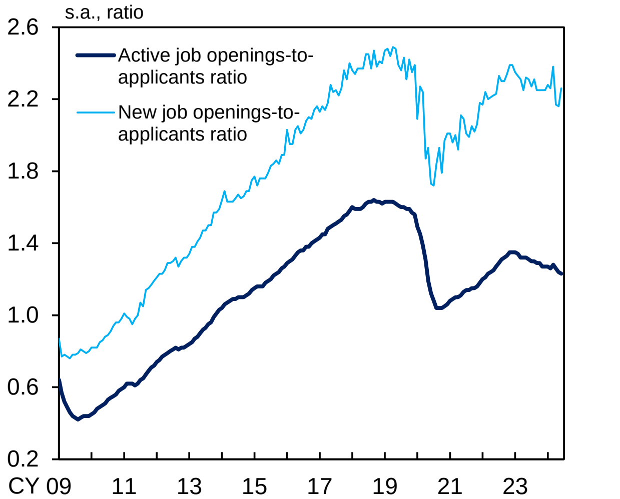
Source: Ministry of Internal Affairs and Communications.
Note: Figures for regular employees and non-regular employees prior to 2013 are based on the "detailed tabulation" in the *Labour Force Survey*.

Chart 22: Unemployment Rate and Labor Force Participation Rate



Source: Ministry of Internal Affairs and Communications.

Chart 23: Job Openings-to-Applicants Ratio



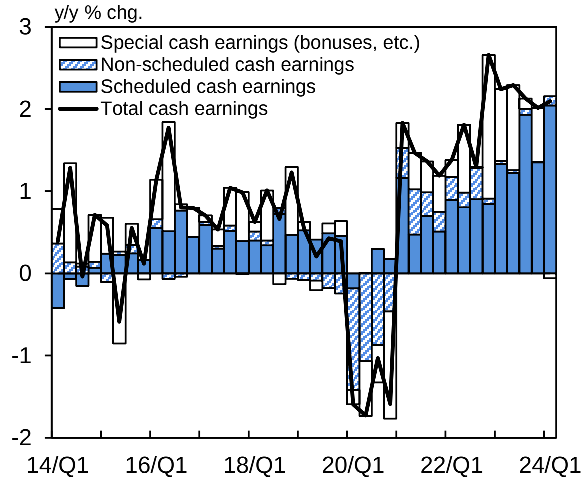
Source: Ministry of Health, Labour and Welfare.

circumstances, the unemployment rate is expected to follow a moderate declining trend.

On the wage side, the year-on-year rate of change in nominal wages per employee has increased clearly, reflecting the recovery in economic activity and the results of this year's annual spring labor-management wage negotiations (Chart 24).[8,9] Looking at the breakdown, the rate of increase in scheduled cash earnings has accelerated clearly (Chart 25). Specifically, the rate of increase for full-time employees has accelerated to the range of 2.5-3.0 percent as their scheduled cash earnings have gradually reflected the results of the annual spring labor-management wage negotiations, in which the wage growth rate (the rate of base pay increase) significantly exceeded last year's high rate. The year-on-year rate of increase in hourly scheduled cash earnings for part-time employees has continued to show high growth recently in the range of 3.5-4.0 percent, as labor market conditions have remained tight and minimum wages have been raised. Non-scheduled cash earnings have increased moderately. The year-on-year rate of change in special cash earnings (bonuses) has continued on a moderate uptrend, reflecting the improvement in corporate profits.

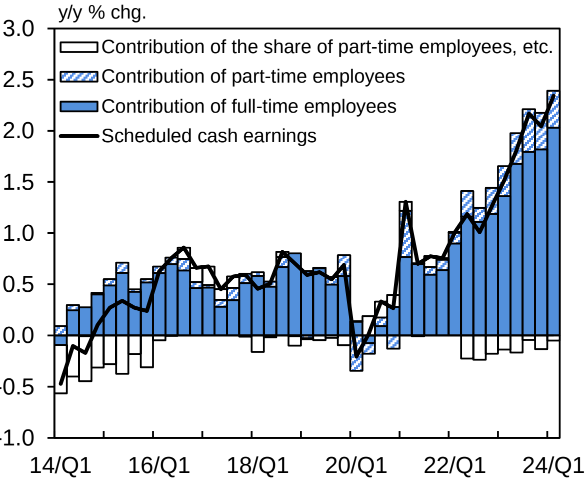
With regard to the outlook for wages, the rate of increase in scheduled cash earnings is likely to accelerate further through this summer, reflecting

Chart 24: Nominal Wages



Source: Ministry of Health, Labour and Welfare.
Notes: 1. Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February.
2. Figures from 2016/Q1 onward are based on continuing observations following the sample revisions.

Chart 25: Decomposition of Developments in Scheduled Cash Earnings



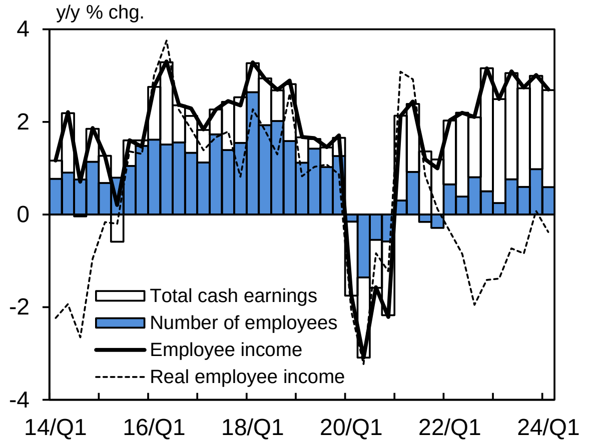
Source: Ministry of Health, Labour and Welfare.
Notes: 1. Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February.
2. Figures from 2016/Q1 onward are based on continuing observations following the sample revisions.

[8] Wages in the *Monthly Labour Survey* are assessed on the basis of continuing observations, which are less susceptible to fluctuations due to sample revisions.

[9] Box 1 outlines developments in the annual spring labor-management wage negotiations this year.

the results of this spring's labor-management wage negotiations. These earnings are projected to continue increasing firmly from fiscal 2025, in reflection of price rises and with labor market conditions continuing to be tight, due in part to a slowdown in the pace of increase in labor force participation of women and seniors. Non-scheduled cash earnings are expected to increase moderately, reflecting the rise in domestic and external demand. Special cash earnings (bonuses) are likely to keep rising with corporate profits following an improving trend. Taking all of these factors into account, the rate of change in nominal wages per employee is projected to continue increasing clearly.

Chart 26: Employee Income



Sources: Ministry of Health, Labour and Welfare; Ministry of Internal Affairs and Communications.

Notes: 1. Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February.
2. Employee income = Total cash earnings (*Monthly Labour Survey*) × Number of employees (*Labour Force Survey*)
3. Figures from 2016/Q1 onward are based on continuing observations following the sample revisions of the *Monthly Labour Survey*.
4. Figures for real employee income are based on staff calculations using the CPI (less imputed rent).

In light of the aforementioned employment and wage conditions, employee income has improved clearly in nominal terms (Chart 26). In real terms, the year-on-year rate of decline in employee income has remained on a slowing trend due to the combination of a decline in inflation and an improvement in nominal income. With regard to the outlook, nominal employee income is likely to continue to see a clear increase in reflection of an acceleration in nominal wage growth. Under these circumstances, the year-on-year rate of change in real employee income is likely to gradually turn positive despite the effects of energy prices.

Household Spending

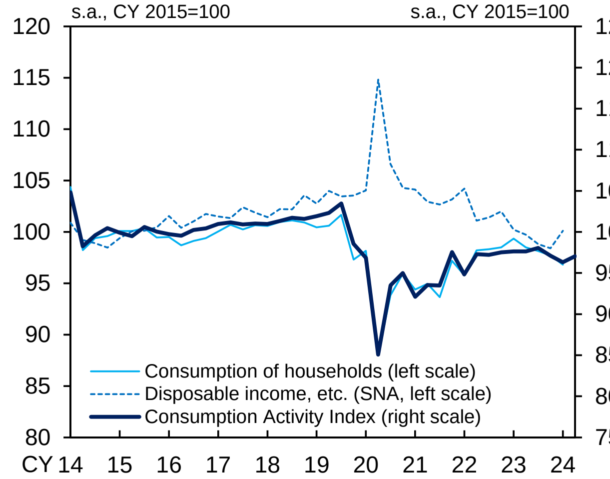
Private consumption has been resilient despite the impact of price rises and other factors.

The Consumption Activity Index (CAI, travel balance-adjusted) -- which is calculated by combining various sales and supply-side statistics from the viewpoint of gauging Japan's consumption activity in a comprehensive manner -- increased slightly on average for the April-May period of 2024 relative to the January-March quarter, as automobile sales picked up (Charts 27 and 28).[10] Looking at subsequent developments in private consumption from various sources, such as high-frequency indicators, statistics published by industry organizations, and anecdotal information from firms, consumption seems to have been resilient despite being affected by price rises, partly due to the improvement in the income situation (Chart 29).

By type, consumption of durable goods has picked up recently, as automakers that had suspended production and shipment have gradually resumed their activities (Chart 28). Specifically, the number of new passenger cars sold has increased after it decreased significantly for the January-March quarter due to factors such as the effects of the suspension of production and shipment at some automakers. Sales of household electrical appliances appear to have picked up moderately recently, as those of air conditioners have been favorable, reflecting high temperatures.

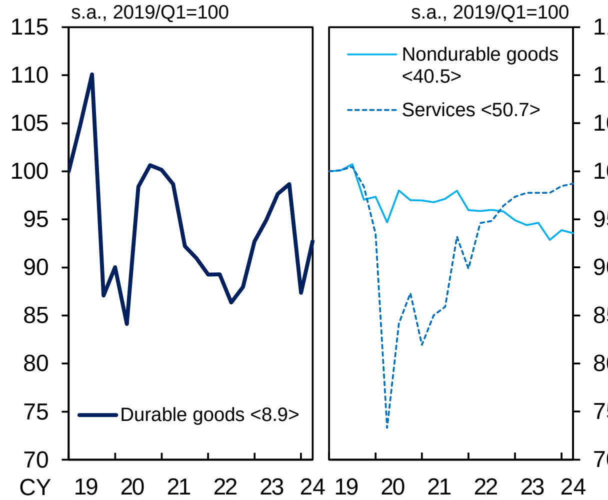
Nondurable goods (e.g., "beverages and food" and "clothes") have followed a decreasing trend, mainly reflecting the impact of high prices. Sales

Chart 27: Real Private Consumption



Sources: Bank of Japan; Cabinet Office, etc.
Notes: 1. Figures for the Consumption Activity Index (CAI) are based on staff calculations. The CAI figures are travel balance adjusted; i.e., they exclude inbound tourism consumption and include outbound tourism consumption. The figure for 2024/Q2 is the April-May average.
2. Figures for consumption of households exclude imputed rent.
3. "Disposable income, etc." consists of disposable income and adjustment for the change in pension entitlements, and real values are obtained using the deflator of consumption of households.

Chart 28: Consumption Activity Index (CAI, Real)



Sources: Bank of Japan, etc.
Notes: 1. Based on staff calculations. Figures in angular brackets show the weights in the CAI. Figures for 2024/Q2 are April-May averages.
2. Nondurable goods include goods classified as semi-durable goods in the SNA.

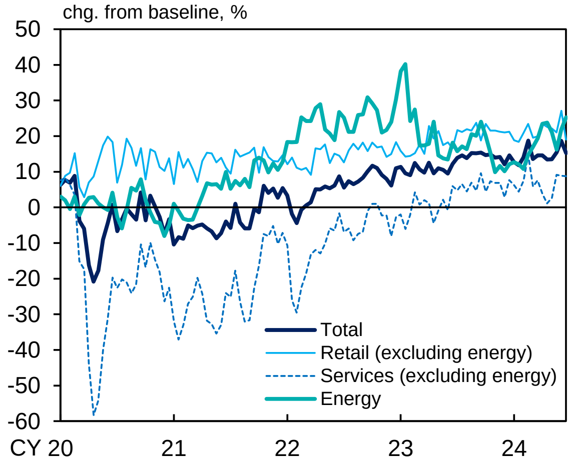
[10] Regarding the CAI, see the Bank's research paper "Revision of the Consumption Activity Index to Capture Recent Changes in Consumption Patterns" released in July 2021.

of beverages and food at supermarkets and other stores have been more or less flat, albeit with fluctuations; in real terms, they appear to have declined moderately. However, there are indications that sales of beverages have increased recently, reflecting high temperatures. In addition, at department stores, consumption of high-end goods by the wealthy has remained favorable, partly due to the rise in stock prices in the meantime.

Services consumption has increased moderately as a trend, although the pace of increase has slowed (Charts 28 and 29). Dining-out has also been on a moderate increasing trend, despite a slowdown in the pace of increase due to the impact of high prices, the effects of changes in consumers' lifestyles, and constraints on operating hours and the number of restaurants. Domestic travel has been at a relatively high level, reflecting a recovery in travel demand. Overseas travel has seen a pause in the recovery, with relatively high travel costs.

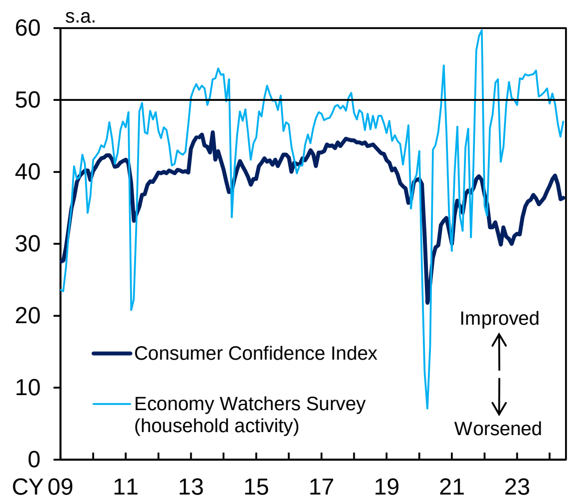
Looking at confidence indicators related to private consumption, the Consumer Confidence Index -- which asks consumers for their views on the outlook -- had continued to improve, mainly reflecting expectations for an increase in nominal income; however, it has recently deteriorated somewhat compared to a while ago, reflecting concern over higher prices due to such factors as the yen's depreciation (Chart 30). The *Economy Watchers Survey* -- which asks firms for their views on the direction of the economy -- shows that the current economic conditions DI (household activity-related) has been below the

Chart 29: Consumption Developments Based on Credit Card Spending



Source: Nowcast Inc./ JCB, Co., Ltd., "JCB Consumption NOW."
Notes: 1. Figures are from the reference series in *JCB Consumption NOW*, which take changes in the number of consumers into account. The baseline is the average for the corresponding half of the month for fiscal 2016 through fiscal 2018.
2. Figures for the total and for services exclude telecommunications, and figures for energy consist of those for fuel, electricity, gas, heat supply, and water. Based on staff calculations.

Chart 30: Confidence Indicators Related to Private Consumption



Source: Cabinet Office.
Note: Figures for the *Economy Watchers Survey* are those for the current economic conditions DI.

threshold value of 50 recently, mainly reflecting higher input costs due to such factors as the yen's depreciation, as well as an increase in consumers' thriftiness owing to higher prices.

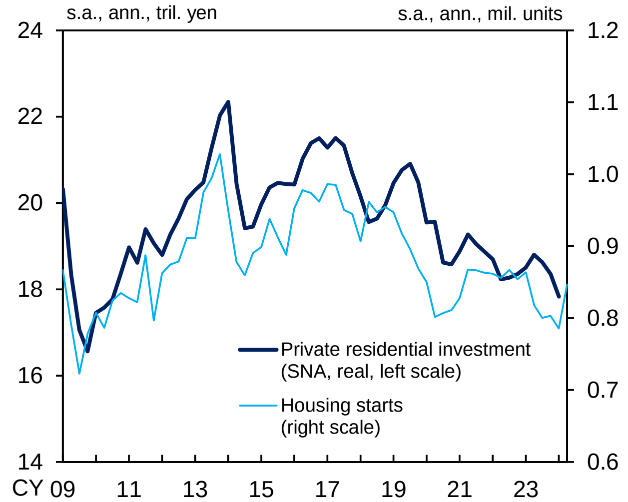
Regarding the outlook, for the time being, although private consumption is expected to be affected by price rises, it is projected to increase moderately, partly due to the effects of the government's economic measures (e. g., cuts in income tax and inhabitant tax) and with nominal employee income continuing to improve. Thereafter, private consumption is projected to continue increasing moderately as employee income keeps improving. The propensity to consume is likely to gradually return to the average level seen before the pandemic, albeit with fluctuations due to the effects of the economic measures (Chart 31).

Housing investment has been relatively weak (Chart 32). The number of housing starts -- a leading indicator of housing investment -- has followed a downtrend that reflects a rise in housing prices. Housing investment is likely to follow a moderate declining trend in reflection of the rise in housing prices and demographic developments, although accommodative financial conditions are expected to provide support.

Chart 31: Average Propensity to Consume

Source: Cabinet Office.
Note: Average propensity to consume = Consumption of households / Disposable income, etc. "Disposable income, etc." consists of disposable income and adjustment for the change in pension entitlements.

Chart 32: Housing Investment



Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Note: The figure for 2024/Q2 is the April-May average.

II. Current Situation of Prices and Their Outlook

Developments in Prices

The quarter-on-quarter rate of change in the producer price index (PPI, adjusted for the effects of seasonal changes in electricity rates) has risen (Chart 33). This reflects factors such as moves to pass on increases in raw material costs, personnel expenses, and other costs to prices, as well as a scaling back of the government's measures to reduce the household burden of higher electricity and gas charges. The year-on-year rate of increase in the services producer price index (SPPI, excluding international transportation) has remained relatively high at around 3 percent recently, mainly on the back of the rise in personnel expenses.

Chart 33: Inflation Indicators

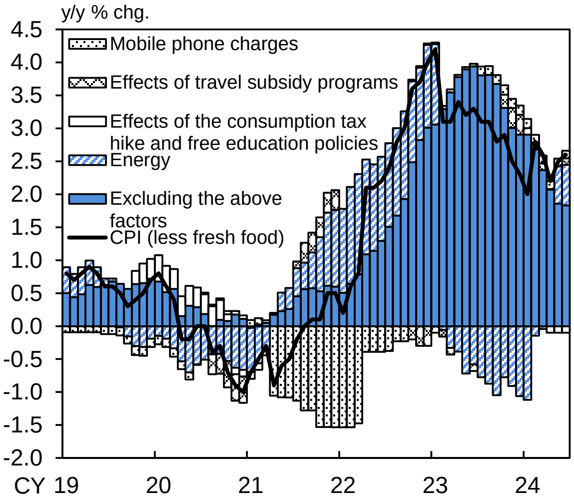
y/y % chg.

	23/Q3	23/Q4	24/Q1	24/Q2
Consumer Price Index (CPI)				
Less fresh food	3.0	2.5	2.5	2.4
Excluding temporary factors	2.9	2.1	2.3	2.4
Less fresh food and energy	4.3	3.8	3.2	2.2
Excluding temporary factors	4.2	3.4	3.0	2.1
Producer Price Index (q/q % chg.)	-0.1	0.3	0.6	1.4
Services Producer Price Index	2.5	2.7	2.4	2.8
GDP Deflator	5.2	3.9	3.4	
Domestic demand deflator	2.5	2.1	2.3	

Sources: Ministry of Internal Affairs and Communications; Bank of Japan; Cabinet Office.
Notes: 1. Figures for the producer price index (PPI) are adjusted for the hike in electric power charges during the summer season. Figures for the services producer price index (SPPI) exclude international transportation.
2. The CPI figures excluding temporary factors are staff estimates and exclude mobile phone charges and the effects of policies concerning the provision of free education and travel subsidy programs.

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 the pass-through to consumer prices of cost increases led by the past rise in import prices have waned (Chart 34).

Chart 34: CPI (Less Fresh Food)

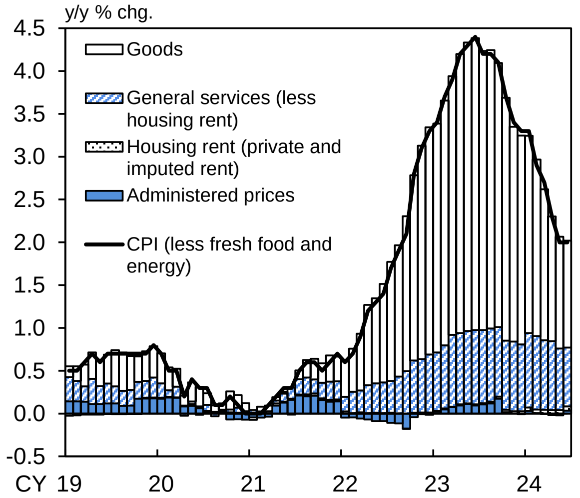


Source: Ministry of Internal Affairs and Communications.
Notes: 1. Figures for energy consist of those for petroleum products, electricity, and gas, manufactured & piped.
2. Figures for the "effects of the consumption tax hike and free education policies" from April 2020 onward are staff estimates and include the effects of measures such as free higher education.

The rate of increase in the CPI (all items less fresh food and energy, excluding temporary factors such as the effects of the government's domestic travel discount program) has remained on a decelerating trend, as the pressure on firms to pass on raw material cost increases to selling prices has waned compared to a while ago, although moves to pass on personnel expenses have been widely observed (Chart 35).[11] Specifically, as for goods, the rates of increase in prices of a wide range of items have continued to decelerate as the impact of the previous year's price hikes has dissipated and the pressure on firms to pass on raw material cost increases has waned compared to a while ago. With the waning of such pressure, the rate of increase in general services prices has decelerated slightly, particularly for items such as services related to housing repairs and maintenance, although moves to pass on personnel expenses to prices have been observed. Such moves to pass on personnel expenses have been spreading for items including domestic help, tutorial fees, lesson fees, and charges for massage.[12] The year-on-year rate of change in overall administered prices has been flat recently. This reflects offsetting factors -- while TV license charges have been reduced, exerting downward pressure together with other factors, auto insurance premiums and other prices have been raised and nursing care and medical fees have been revised.

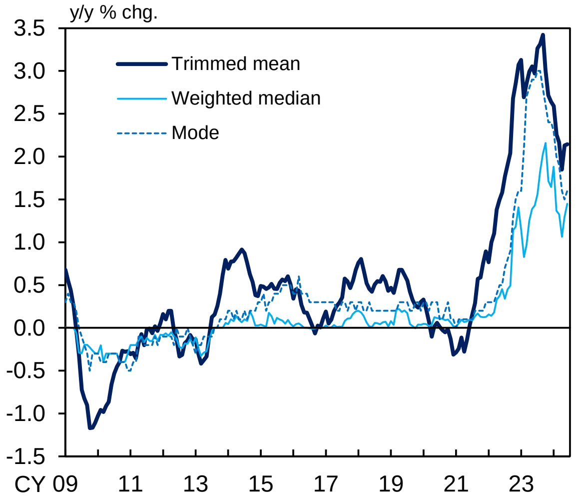
The indicators for capturing the underlying trend in the CPI have exhibited the following developments (Chart 36).[13,14,15] The trimmed

Chart 35: CPI (Excluding Temporary Factors)



Source: Ministry of Internal Affairs and Communications.
Notes: 1. Administered prices (less energy) consist of "public services" and "water charges."
2. The CPI figures are staff estimates and exclude mobile phone charges and the effects of the consumption tax hike, policies concerning the provision of free education, and travel subsidy programs.

Chart 36: Various Measures of Core Inflation



Sources: Bank of Japan; Ministry of Internal Affairs and Communications.
Note: Based on staff calculations using the CPI excluding the effects of the consumption tax hikes, policies concerning the provision of free education, and travel subsidy programs. The CPI figures from April 2020 onward are staff estimates and exclude the effects of measures such as free higher education.

[11] The CPI figures excluding temporary factors are calculated by excluding (1) the effects of the consumption tax hike and policies concerning the provision of free education, (2) the effects of travel subsidy programs, and (3) mobile phone charges from the CPI (all items less fresh food) and the CPI (all items less fresh food and energy).

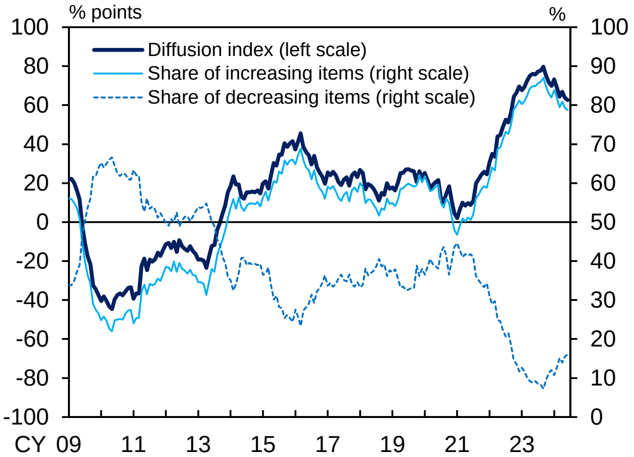
[12] Box 2 outlines services price revisions in April 2024.

[13] The trimmed mean is calculated by excluding items that belong to a certain percentage of the upper and lower tails of the price change distribution (10 percent of each tail) in order to eliminate the effects of large relative price changes. The mode is the inflation rate with the highest density in the price change distribution. The weighted median is the average of the inflation rates of the items at around the 50 percentile point of the

mean of the year-on-year rate of change in the CPI has been at around 2 percent as the impact of the previous year's price hikes has dissipated. The mode and the weighted median have been at around 1.5 percent. Looking at the year-on-year price changes across all CPI items (less fresh food), the share of items whose prices have increased minus the share of items whose prices have decreased has remained on a decreasing trend (Chart 37).

Meanwhile, the year-on-year rate of change in the domestic demand deflator has been in the range of 2.0-2.5 percent (Chart 33). By component, while the rate of increase in the private consumption deflator has continued to decelerate, the rates of increase in the business fixed investment deflator and other deflators have accelerated somewhat. The rate of change in the import deflator has turned positive, mainly reflecting the past rise in crude oil prices and the yen's depreciation. The year-on-year rate of increase in the GDP deflator has decelerated somewhat; specifically, the rate of change in the domestic demand deflator has been positive, while the rise in the import deflator has exerted downward pressure.

Chart 37: Diffusion Index of Price Changes



Sources: Bank of Japan; Ministry of Internal Affairs and Communications.
Note: The diffusion index is defined as the share of increasing items minus the share of decreasing items. The share of increasing/decreasing items is the share of items for which price indices increased/decreased from a year earlier. Based on staff calculations using the CPI (less fresh food) excluding the effects of the consumption tax hikes, policies concerning the provision of free education, and travel subsidy programs. The CPI figures from April 2020 onward are staff estimates and exclude the effects of measures such as free higher education.

cumulative distribution in terms of weight. Each indicator is calculated using data for each CPI item that excludes the effects of the consumption tax hikes, policies concerning the provision of free education, and travel subsidy programs.

[14] In this report, the mode is defined as the inflation rate with the highest density in the distribution that is estimated parametrically by fitting a normal inverse Gaussian distribution to the observed price change distribution in each period. It should be noted that, with dispersions of the observed distributions increasing, the fit of the normal inverse Gaussian distribution has deteriorated recently. Therefore, estimates of this mode should be interpreted with some latitude.

[15] See Box 2 for inflationary pressure stemming from the linkage between wages and prices, which has been explained in past Outlook Reports and other publications by the Bank.

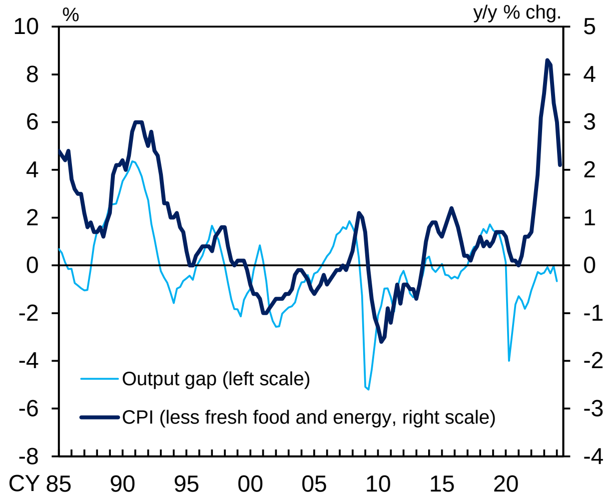
Environment Surrounding Prices

In the outlook for prices, the main factors that determine inflation rates are assessed as follows. First, the output gap is likely to continue to widen moderately within positive territory toward the end of the projection period (Charts 2 and 38).

Second, medium- to long-term inflation expectations have risen moderately (Chart 39). The June *Tankan* 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.

Third, the year-on-year rate of change in the import price index has risen recently, mainly reflecting the past rise in crude oil prices and the yen's depreciation (Charts 41 and 42). Looking at

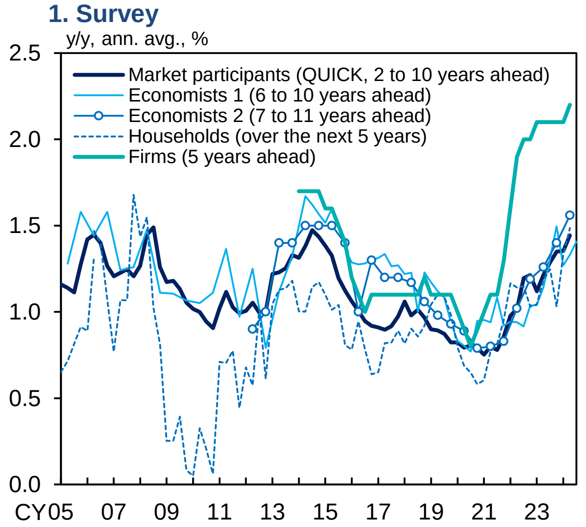
Chart 38: Inflation Rate and Output Gap



Sources: Ministry of Internal Affairs and Communications; Bank of Japan.
Notes: 1. The CPI figures are staff estimates and exclude mobile phone charges and the effects of the consumption tax hikes, policies concerning the provision of free education, and travel subsidy programs.
2. Figures for the output gap are staff estimates.

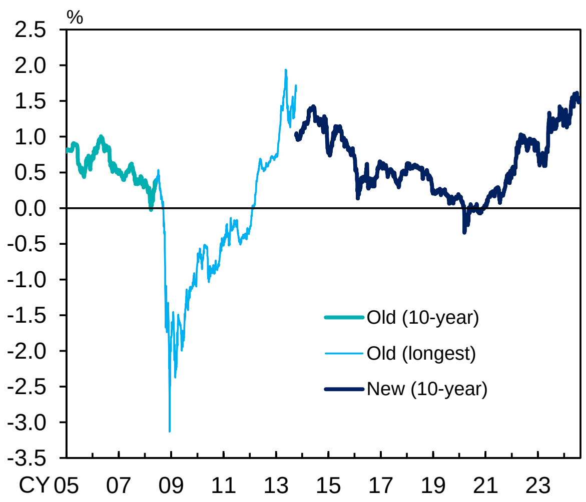
Chart 39: Inflation Expectations

1. Survey



Sources: Bank of Japan; QUICK, "QUICK Monthly Market Survey <Bonds>"; JCER, "ESP Forecast"; Consensus Economics Inc., "Consensus Forecasts."
Notes: 1. "Economists 1" shows the forecasts of economists in the *Consensus Forecasts*. "Economists 2" shows the forecasts of forecasters surveyed for the *ESP Forecast*.
2. Figures for households are from the *Opinion Survey on the General Public's Views and Behavior*, estimated using the modified Carlson-Parkin method for a 5-choice question.
3. Figures for firms show the inflation outlook of enterprises for general prices (all industries and enterprises, average) in the *Tankan*.

2. BEI



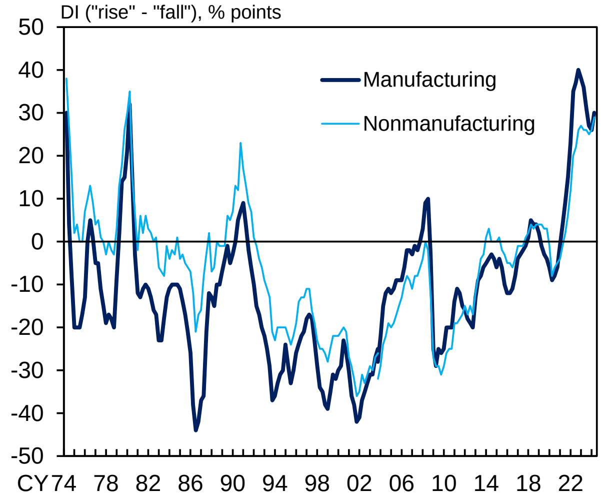
Source: Bloomberg.
Note: The BEI (break-even inflation) rate is the yield spread between fixed-rate coupon-bearing JGBs and inflation-indexed JGBs. Inflation-indexed JGBs issued since October 2013 are designated as "new," while the rest are designated as "old." Figures for "old (longest)" are calculated using yield data for issue No. 16 of inflation-indexed JGBs, which matured in June 2018.

the final demand-intermediate demand (FD-ID) price indexes, the index for stage 1 of the ID -- which shows developments in an upstream stage of the production process -- has increased recently, mainly reflecting the yen's depreciation and the past rise in crude oil prices (Chart 43). That for stage 2 of the ID has remained on a moderate uptrend. The indexes for stages 3 and 4 of the ID, which show developments in relatively downstream stages of the production process, have risen slightly recently, as there have been moves to pass on the increases in raw material costs, personnel expenses, and other costs to prices.

Meanwhile, the year-on-year rate of change in energy prices (e.g., gasoline prices and electricity charges) had remained negative due to the government's measures to reduce the household burden of higher gasoline prices, electricity charges, and gas charges.[16] However, it has turned positive, mainly reflecting the fact that discounts on electricity and gas charges have been reduced compared to the previous year and that the rate of renewable energy surcharges on electricity has been raised. As for the outlook, the rate of increase in energy prices is likely to

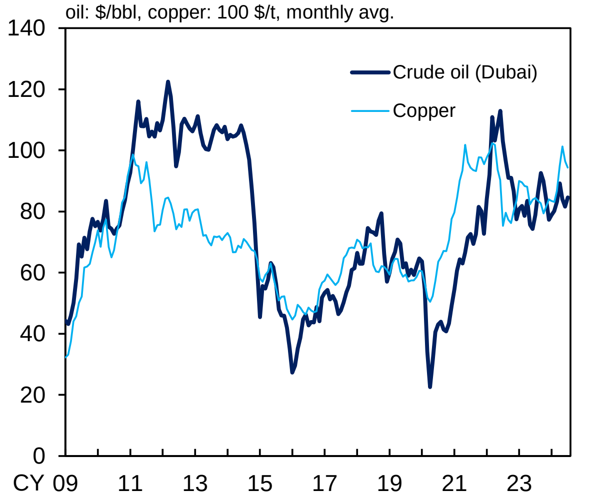
[16] Looking at the government's energy-related economic measures, with regard to gasoline subsidies, it has introduced a measure to provide subsidies to petroleum distributors and importers as funds to contain a sharp rise in their selling prices when the nationwide average for retail gasoline prices exceeds the benchmark price (168 yen per liter). With regard to electricity charges, through the government's measures to reduce the household burden, electricity charges were cut by 7 yen per kilowatt-hour (roughly a 20 percent discount per month for typical households) from February through September 2023, 3.5 yen per kilowatt-hour from October 2023 through May 2024, and 1.8 yen per kilowatt-hour in June (the months refer to the timing at which electricity charges were calculated). Regarding manufactured and piped gas charges, measures to reduce the household burden roughly similar to those for electricity charges were implemented.

Chart 40: Output Prices



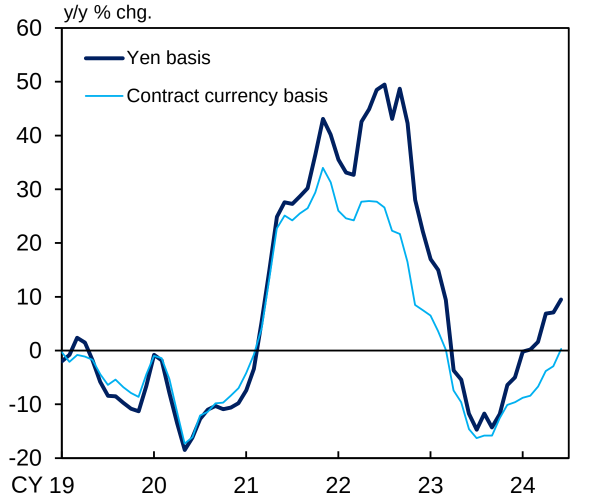
Source: Bank of Japan.
Note: Based on the *Tankan*. All enterprises. There is a discontinuity in the data for December 2003 due to a change in the survey framework.

Chart 41: International Commodity Prices



Sources: Nikkei Inc.; Bloomberg.

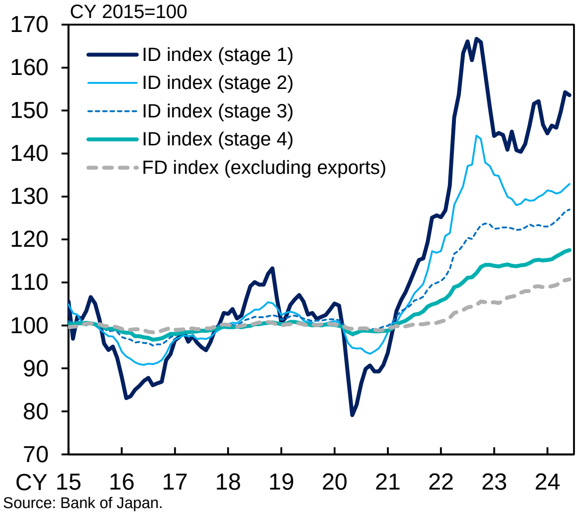
Chart 42: Import Price Index



Source: Bank of Japan.

accelerate temporarily with the discontinuation of the discounts on electricity and gas charges, but downward pressure is projected to be exerted again this summer by emergency measures against higher electricity and gas charges.[17] Thereafter, assuming that the government's measures to reduce the household burden of higher energy prices will be phased out toward the end of 2024, the rate of change in energy prices is highly likely to register a relatively large positive figure after the turn of 2025, due to a dissipation of the effects of these measures pushing down energy prices. After the impact of the rebound caused by the phasing out of the government's measures dissipates, the rate is projected to be slightly negative in light of developments in the futures market.

Chart 43: FD-ID Price Indexes (All Commodities)



Source: Bank of Japan.

Outlook for Prices

Based on this underlying scenario, the year-on-year rate of increase in the CPI (all items less fresh food and energy) 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. Subsequently, the rate of increase is expected to accelerate moderately and be at around 2 percent, as the output gap continues to improve and as medium- to long-term inflation expectations and wage growth rise, accompanied by changes in

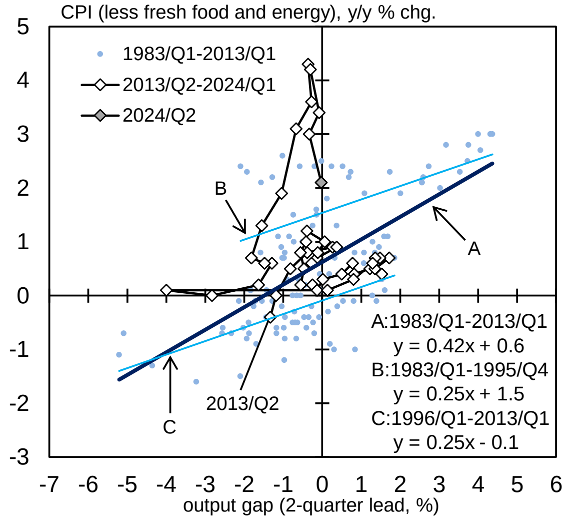
[17] The government announced that it would continue with its gasoline subsidies through the end of 2024. It discontinued the discounts on electricity charges at the end of June 2024, and will cut the charges by 4 yen per kilowatt-hour for September and October and by 2.5 yen per kilowatt-hour for November (the months refer to the timing at which the charges are calculated). Regarding manufactured and piped gas charges, measures to reduce the household burden roughly similar to those for electricity charges are planned to be implemented.

factors such as firms' wage- and price-setting behavior (Chart 44).

Taking account of the aforementioned developments in energy 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. In the first half of the projection period, the rate of increase is expected to be pushed up by factors such as a dissipation of the effects of the government's measures pushing down CPI inflation, while the effects of the pass-through to consumer prices of cost increases led by the past rise in import prices are likely to wane. Thereafter, the rate is projected to be at around 2 percent in reflection of the developments in the CPI for all items less fresh food and energy.

That said, there remain uncertainties over whether underlying inflation will increase with a stronger linkage between wages and prices. In particular, close attention is warranted on the degree to which moves to reflect wage developments in selling prices will become widespread. On the other hand, if such moves strengthen to a greater extent than expected or labor market conditions become tighter, there is 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.

Chart 44: Phillips Curve



Sources: Ministry of Internal Affairs and Communications; Bank of Japan.
Notes: 1. The CPI figures are staff estimates and exclude mobile phone charges and the effects of the consumption tax hikes, policies concerning the provision of free education, and travel subsidy programs.
2. Figures for the output gap are staff estimates.

III. Financial Developments in Japan

Financial Conditions

Financial conditions have been accommodative.

Looking at short-term interest rates, the uncollateralized overnight call rate has been in the range of 0 to 0.1 percent (Chart 45). Interest rates on term instruments have risen slightly.

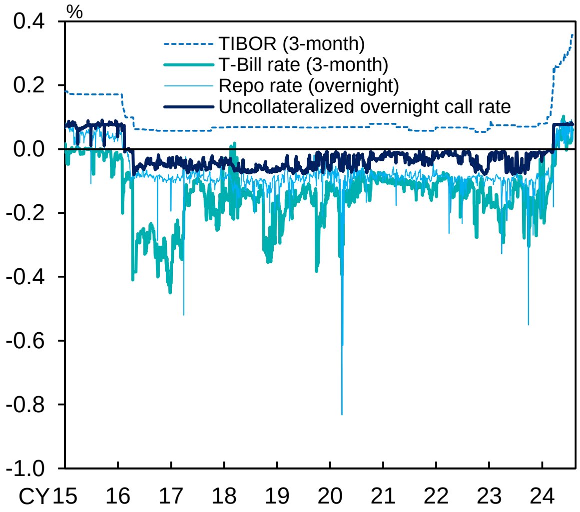
Real interest rates have been negative (Chart 46).[18]

Firms' funding costs have increased but have remained at low levels (Chart 47). Lending rates (the average interest rates on new loans and discounts) have risen, particularly for long-term loans, but have remained at low levels. Issuance rates for CP have been more or less flat. Those for corporate bonds have increased, albeit with fluctuations.

The DI in the *Tankan* for financial institutions' lending attitudes as perceived by firms suggests that such attitudes have remained accommodative on the whole (Chart 48). That for issuance conditions for CP has continued to show net "easy" conditions. As suggested by the latter, issuance conditions for CP and corporate bonds have been favorable. The DI for firms' financial positions in the *Tankan* suggests that they have been at favorable levels on the back of a recovery in economic activity and progress in the

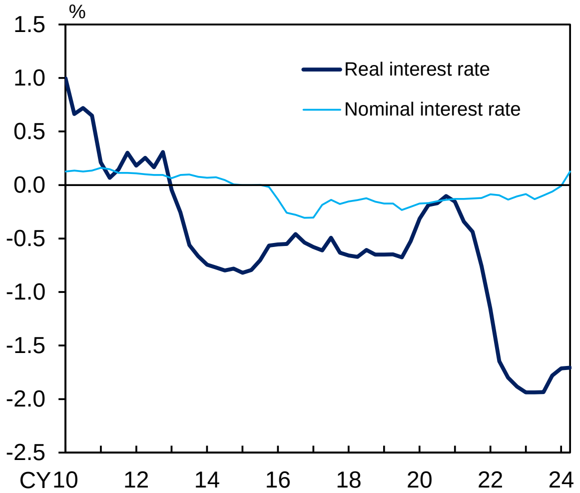
[18] See Box 5 of the April 2024 Outlook Report for an assessment of financial conditions in terms of real interest rates.

Chart 45: Short-term Interest Rates



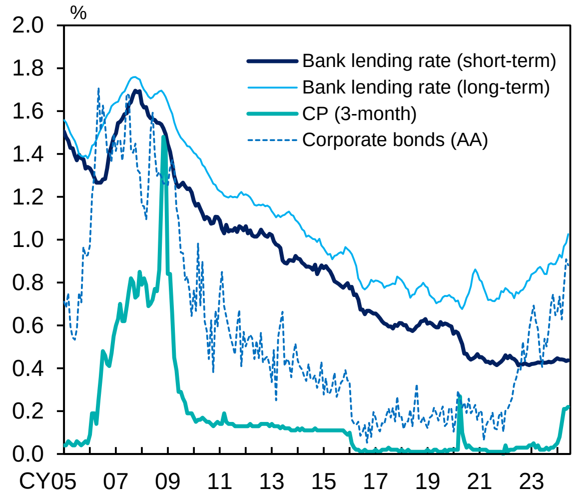
Sources: Bank of Japan; JBA TIBOR Administration; Bloomberg.
Note: Figures for repo rate are the *Tokyo Repo Rate*.

Chart 46: Real Interest Rate (1-Year)



Sources: Bank of Japan; QUICK, "QUICK Monthly Market Survey <Bonds>"; Consensus Economics Inc., "Consensus Forecasts"; Bloomberg.
Note: Figures for the real interest rate are calculated as government bond yields (1-year) minus the composite index of inflation expectations (staff estimates).

Chart 47: Bank Lending Rates and Issuance Yields for CP and Corporate Bonds

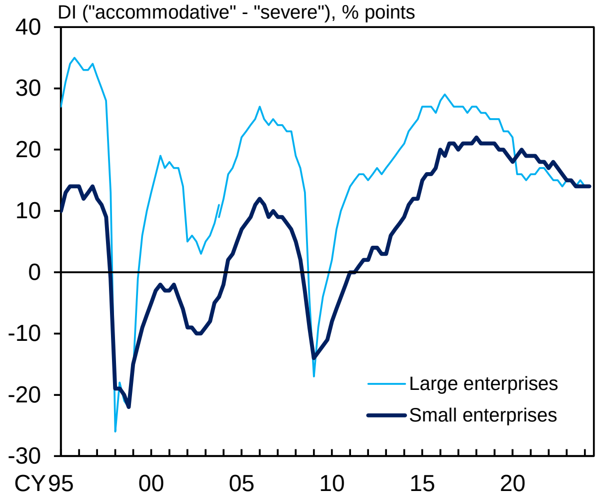


Sources: Bank of Japan; Japan Securities Depository Center; Capital Eye; I-N Information Systems; Bloomberg.
Notes: 1. Figures for issuance yields for CP up through September 2009 are the averages for CP (3-month, rated a-1 or higher). Those from October 2009 onward are the averages for CP (3-month, rated a-1).
2. Figures for issuance yields for corporate bonds are the averages for domestically issued bonds launched on a particular date. Bonds issued by banks and securities companies, etc. are excluded.
3. Figures for bank lending rates are 6-month backward moving averages.

pass-through of cost increases to selling prices (Chart 49).

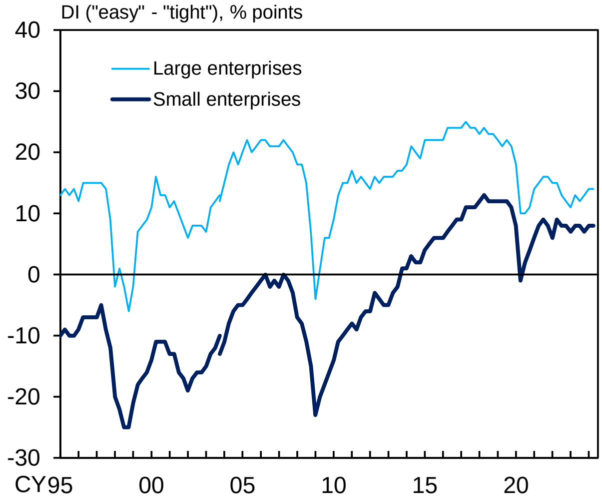
Firms' demand for funds has increased moderately on the back of, for example, the recovery in economic activity as well as mergers and acquisitions of firms. In this situation, the year-on-year rate of increase in the amount outstanding of bank lending has been at around 3.5 percent (Chart 50). That in the aggregate amount outstanding of CP and corporate bonds has been at around 2.5 percent.

Chart 48: Lending Attitudes of Financial Institutions as Perceived by Firms



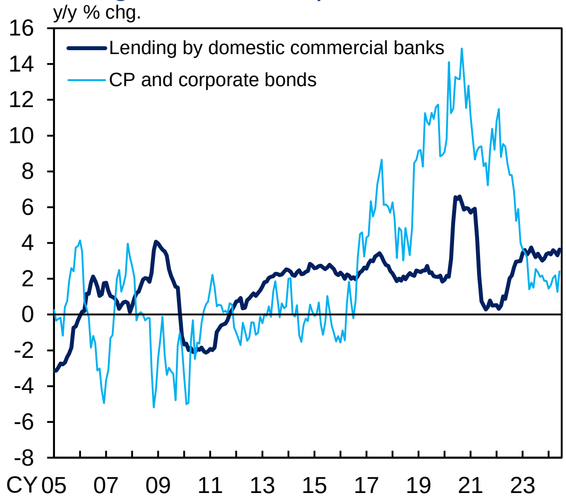
Source: Bank of Japan.
Note: Based on the *Tankan.* All industries. There is a discontinuity in the data for December 2003 due to a change in the survey framework.

Chart 49: Firms' Financial Positions



Source: Bank of Japan.
Note: Based on the *Tankan.* All industries. There is a discontinuity in the data for December 2003 due to a change in the survey framework.

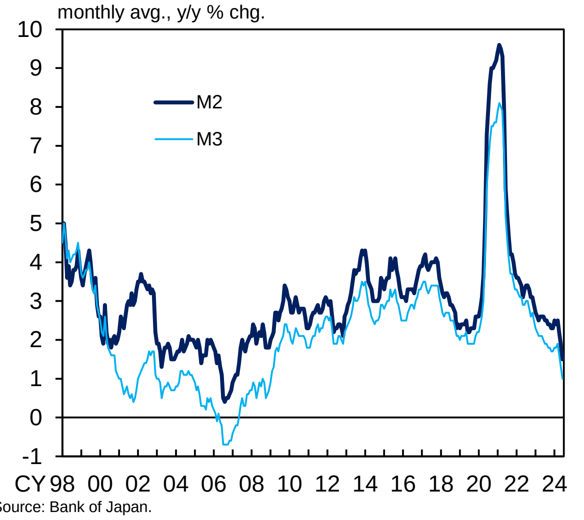
Chart 50: Amounts Outstanding of Bank Lending, CP, and Corporate Bonds



Sources: Bank of Japan; Japan Securities Depository Center; Japan Securities Dealers Association; I-N Information Systems.
Note: Figures for lending by domestic commercial banks are monthly averages. Figures for CP and corporate bonds are those at the end of the period.

The rate of change in the money stock (M2) has been at around 1.5 percent, as the amount outstanding of bank lending has continued to increase and fiscal spending has kept pushing the rate up (Chart 51).

Chart 51: Money Stock

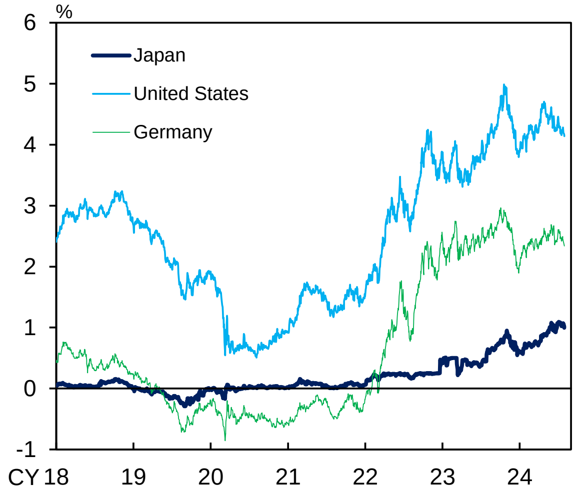


Source: Bank of Japan.

Developments in Financial Markets

In global financial markets, market sentiment became somewhat cautious for a time, reflecting heightened uncertainties regarding the political situation in Europe. However, long-term interest rates have declined, particularly in the United States, and stock prices in many economies have followed an uptrend.

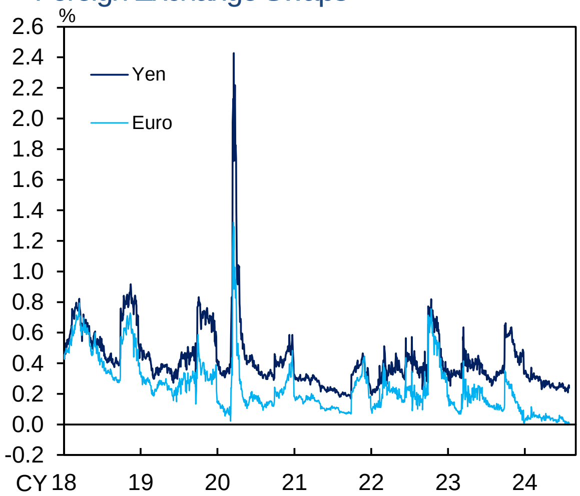
Chart 52: 10-Year Government Bond Yields in Selected Advanced Economies



Source: Bloomberg.

Yields on 10-year government bonds in the United States had continued to rise from the beginning of this year, due to speculation that the Federal Reserve's monetary tightening would be prolonged; however, yields have declined since the turn of May, as such speculation has waned compared to a while ago, reflecting factors such as the decline in the inflation rate (Chart 52). Yields on 10-year government bonds in Europe have decreased slightly, albeit with fluctuations, in line with developments in yields in the United States. Meanwhile, in Japan, yields on 10-year government bonds have increased, mainly against the background of market views on the Bank of Japan's future monetary policy, despite the impact of the decline in 10-year yields in the United States.

Chart 53: Dollar Funding Premiums through Foreign Exchange Swaps



Source: Bloomberg.
Notes: 1. U.S. dollar funding premiums are calculated as the difference between U.S. dollar fundings rates (3-month) in the dollar/yen or euro/dollar foreign exchange swap market and those in the money market.
2. The interest rates used for the calculation are as follows: for the yen, the OIS rate; for the euro, the EONIA-referencing OIS rate before October 4, 2019, and the €STR-referencing OIS rate thereafter; for the U.S. dollar, the OIS rate before January 3, 2019, and the SOFR thereafter.

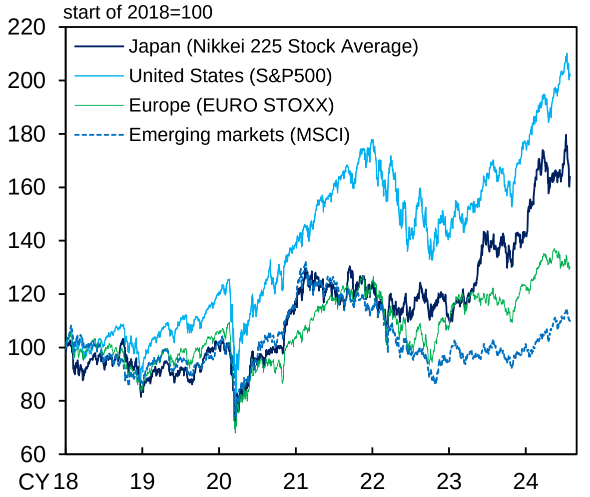
Premiums for U.S. dollar funding through the dollar/yen foreign exchange swap market have been at low levels on the whole (Chart 53).

Stock prices in the United States have increased, reflecting the decline in long-term interest rates and solid corporate results in the high-tech industry (Chart 54). While generally moving in line with those in the United States, stock prices in

Europe have been more or less flat, weighed down by uncertainties regarding the political situation. Stock prices in Japan had risen somewhat rapidly, mainly reflecting the increase in U.S. stock prices and solid corporate results, but have turned to a decline recently. Stock prices in emerging economies, particularly in Asia, have risen, driven by high-tech-related stocks.

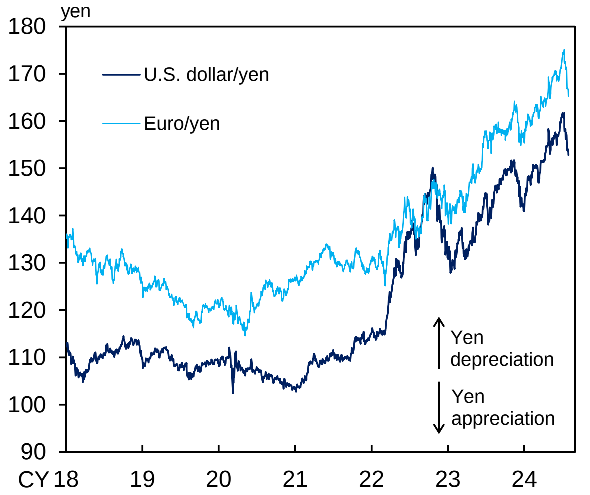
In foreign exchange markets, reflecting attention to factors such as the yield differential between Japan and the United States, the yen had depreciated against the U.S. dollar but recently has appreciated (Chart 55). The yen had also depreciated against the euro but recently has appreciated.

Chart 54: Selected Stock Price Indices



Source: Bloomberg.
Note: Figures for emerging markets are those for the MSCI Emerging Markets Index (local currency).

Chart 55: U.S. Dollar/Yen and Euro/Yen



Source: Bloomberg.

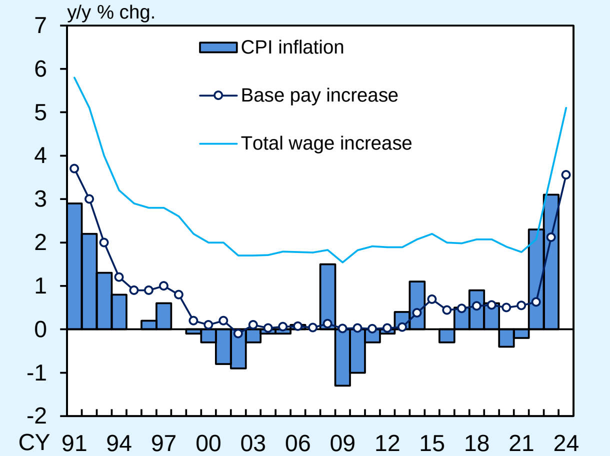
(Box 1) Review of the Annual Spring Labor-Management Wage Negotiations in 2024

In the annual spring labor-management wage negotiations this year, the rate of base pay increase further accelerated at many firms, indicating that moves to raise wages have spread to even more firms (Chart B1-1).[19] This box provides a brief review of the key features of this year's wage negotiations using the most recent data.

Among large firms, "leader firms," which have a large number of union members, implemented large base pay increases. Following in their footsteps, many other firms also raised wages considerably (Chart B1-2). The distribution of the rates of base pay increase at individual firms with labor unions that belong to the Japanese Trade Union Confederation (Rengo) -- which mainly consists of labor unions at large firms -- shows that in both the manufacturing and the nonmanufacturing industries (1) the tail on the left-hand side has clearly become thinner, including at around 0 percent, and (2) the distribution has visibly shifted to the right (Chart B1-3).

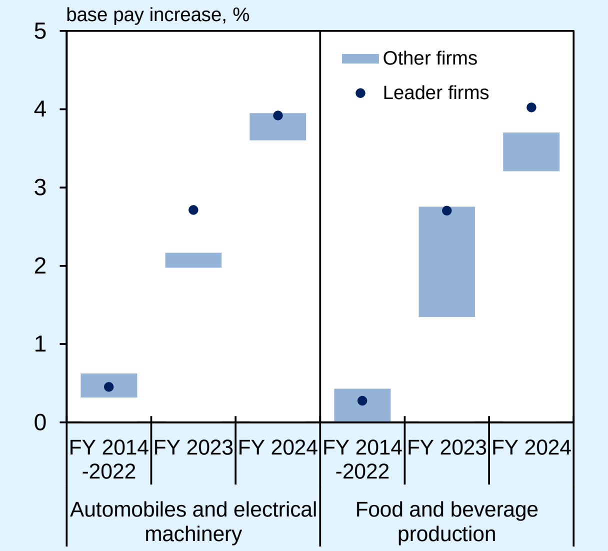
For small and medium-sized enterprises (SMEs), many of which do not have labor unions, the full picture of wage revisions is not yet clear. That

Chart B1-1: Results of Spring Wage Negotiations (Aggregation by Rengo)



Sources: Japanese Trade Union Confederation (Rengo); Central Labour Relations Commission; Ministry of Internal Affairs and Communications.
Notes: 1. Figures for CPI inflation are for all items less fresh food, excluding the effects of the consumption tax hikes, etc.
2. Figures for base pay and total wage increases from 1991 to 2013 are those published by the Central Labour Relations Commission, while those from 2014 to 2024 are figures released by Rengo.

Chart B1-2: Spillover of Wage Hikes from Leader Firms



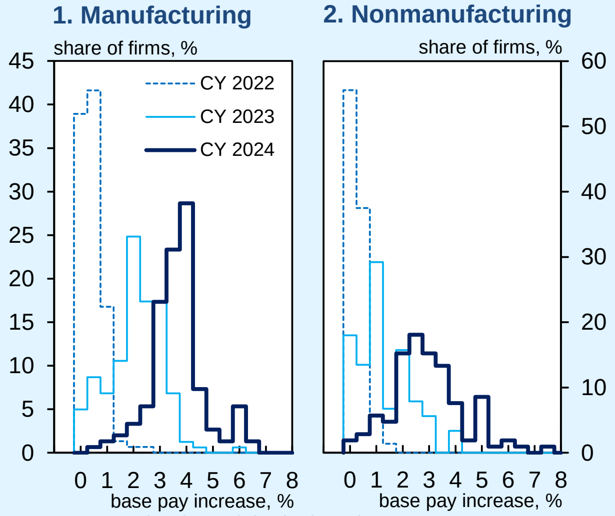
Source: Japanese Trade Union Confederation (Rengo).
Notes: 1. Figures for base pay increases are staff estimates based on Rengo's microdata on wage hikes and wage levels reported by its major labor unions.
2. Figures for leader firms in each sector are the averages of three firms with among the largest number of union members in that sector.
3. The blue bars show the 25th-75th percentile distributions of wage hikes at other firms.

[19] See also Box 2 of the April 2024 Outlook Report for developments in wage revisions of regular employees in labor unions that belong to the Japanese Trade Union Confederation. Meanwhile, for details on labor-management negotiations in 2023, see Box 1 of the April 2023 Outlook Report and Box 1 of the October 2023 Outlook Report.

said, some surveys of SMEs and other sources indicate that the positive wage-setting behavior of large firms is steadily spreading to SMEs. For example, using the results of a special survey conducted by the Ministry of Finance to compare the rates of base pay increase with the previous year shows that (1) while a certain fraction of SMEs have not yet increased base pay, the share of such firms has decreased from the previous year, and (2) the distribution of the rates of base pay increases at individual SMEs has shifted to the right, although the shift is not as pronounced as in the distribution for large firms (Chart B1-4). In this context, interviews conducted by the Bank's Head Office and branches with SMEs also suggest a spread of wage hikes across all regions, industries, and firm sizes, with many respondents saying that wage increases exceeded or were on par with those in the previous year.[20]

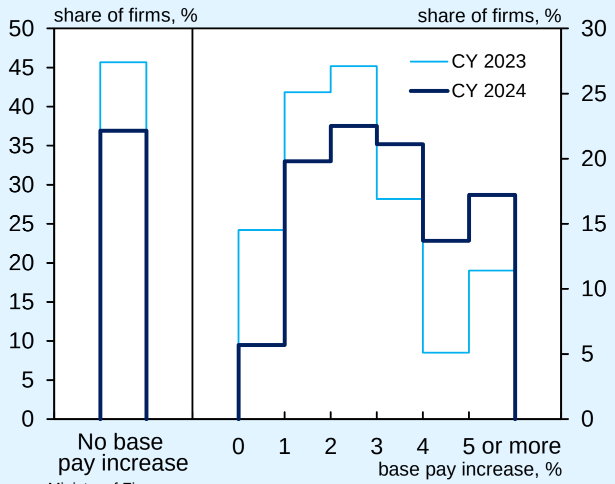
Going forward, whether firms' positive wage-setting behavior continues needs to be monitored closely. In this context, it is likely that, with labor market conditions becoming increasingly tight, wages are becoming more susceptible to upward pressure. For example, the growing market for job changers is likely to lead not only to higher wages for those looking to change jobs but also for existing employees as firms seek to retain workers. Moreover, in industries and firms where the differential between wages of full-time and part-time employees is small, increases in the minimum

Chart B1-3: Base Pay Increase Distribution, Large Firms



Source: Japanese Trade Union Confederation (Rengo).
Note: Figures for base pay increases are staff estimates based on Rengo's microdata on wage hikes and wage levels reported by its major labor unions.

Chart B1-4: Base Pay Increase Distribution, Small and Medium-Sized Firms



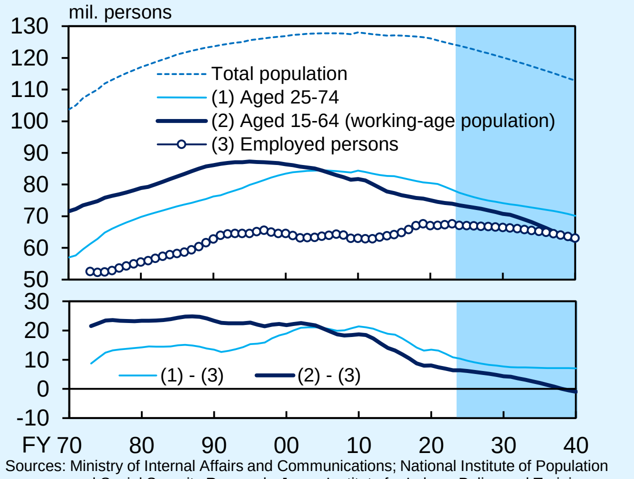
Source: Ministry of Finance.
Notes: 1. Based on the results of a special survey conducted by the Ministry of Finance. Small and medium-sized firms are firms with a capitalization of less than 1 billion yen.
2. The left-hand side of the chart shows the share of firms that did not raise base pay. The right-hand side shows the distributions of the rates of base pay increase for firms that raised base pay.

[20] See the annex paper to the Regional Economic Report, "Chiiki no chūken chūshō kigyō ni okeru chingin dōkō -- saikin no kigyō kōdō no henka wo chūshin ni" [Wage developments in regional SMEs: Focusing on changes in firms' behavior] released in July 2024 (available only in Japanese).

wage are likely to lead to wage increases not only for part-time employees but also for full-time employees.[21] Furthermore, from a somewhat medium- to long-term perspective, given the demographic outlook, the room for further increases in the labor supply is likely to gradually shrink, which will continue to push up wages through tightening labor market conditions (Chart B1-5).

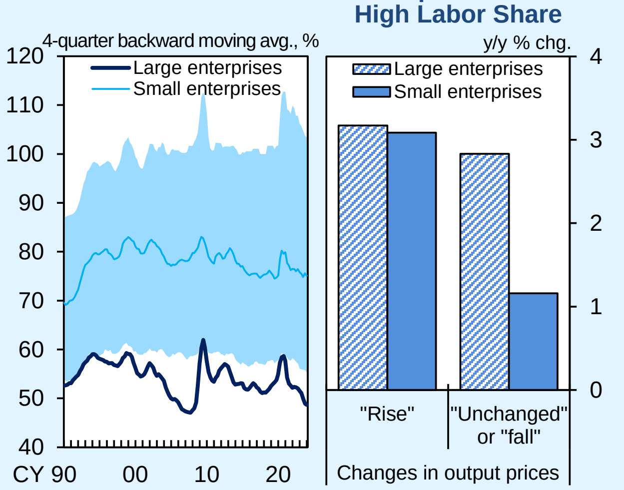
It should be noted, however, that the labor share at SMEs is higher than at large firms, and the pace of decline in the labor share is slower than at large firms, which may act to hold down wages. In this context, analysis of microdata from the *Tankan* and other sources shows that even SMEs with a high labor share have tended to implement relatively large wage increases in an environment in which profits can be expected to improve as a result of higher output prices (Chart B1-6). Going forward, whether firms, including SMEs, make further progress in passing on price increases and improving profits and this leads to sustained increases in wages warrants careful attention.

Chart B1-5: Labor Input



Sources: Ministry of Internal Affairs and Communications; National Institute of Population and Social Security Research; Japan Institute for Labour Policy and Training.
Note: The shaded areas denote projection periods. The population projections are by the National Institute of Population and Social Security Research. The projection for the number of employed persons is calculated based on projections by the Japan Institute for Labour Policy and Training.

Chart B1-6: Labor Share and Wage Increases



Sources: Ministry of Finance; Bank of Japan.
Notes: 1. Large enterprises are enterprises with a capitalization of 1 billion yen or more. In the left-hand chart, small enterprises are enterprises with a capitalization of 10 million yen or more but less than 100 million yen. In the right-hand chart, small enterprises are enterprises with a capitalization of 20 million yen or more but less than 100 million yen.
2. In the left-hand chart, the shaded area denotes the 25th-75th percentile distribution for small enterprises, based on staff calculations using microdata from the *Financial Statements Statistics of Corporations by Industry, Quarterly*. Figures exclude "finance and insurance" and those for 2009/Q2 onward also exclude pure holding companies.
3. In the right-hand chart, figures show the year-on-year percentage changes in labor costs per employee in 2023/Q4. Figures are the medians of wage increases at enterprises with a high labor share and are calculated by matching microdata for enterprises that responded to both the survey for the *Financial Statements Statistics of Corporations by Industry, Quarterly* (wage increases) and the *Tankan* survey (the output prices DI). Enterprises with a high labor share are enterprises whose labor share falls into the top 50 percent in their size group.

[21] The government has indicated that it intends to raise the minimum wage to 1,500 yen per hour (national weighted average) by the mid-2030s. At SMEs and in accommodations services and eating and drinking services, the differential between wages of full-time and part-time employees tends to be small (see Box 2 of the April 2024 Outlook Report).

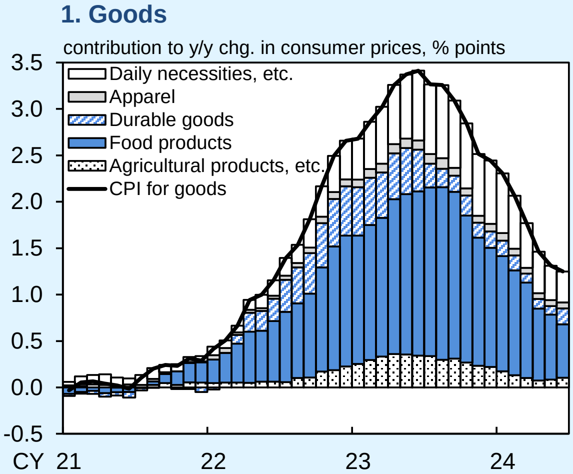
(Box 2) Developments in Services Prices: The Spread of Beginning-of-the-Period Price Hikes

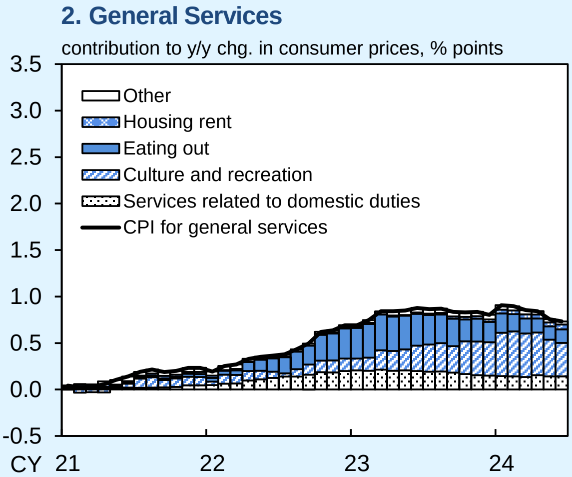
The year-on-year rate of change in the consumer price index (CPI, all items less fresh food and energy) shows that goods price inflation decelerated considerably due to a further waning of upward pressure on costs led by the past rise in import prices (Chart B2-1[1]). Under these circumstances, in terms of how the gradual rise in wages affects future price developments, the key factor is developments in the prices of services, where labor costs account for a high share of selling prices. Services prices in Japan are often revised in April and October at the beginning of each period. Price developments in April 2024 warranted attention as they were considered to indicate whether spillovers from wages to prices will strengthen further going forward (Chart B2-2).

While the year-on-year rate of change in services prices has remained more or less unchanged on the whole, the rate of increase for items susceptible to the impact of changes in import prices (such as dining out and housing repair and maintenance) has been following a decreasing trend. On the other hand, the rate of increase for items susceptible to labor costs (such as culture and recreational services) has been gradually rising (Chart B2-1[2]). The following takes a closer look at services price revisions in April 2024 and shows that a spread of price changes was observed.

Starting with individual items, there were widespread moves to pass on higher labor costs

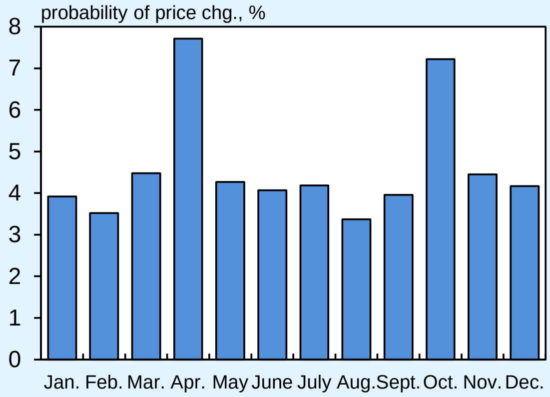
Chart B2-1: CPIs for Goods and Services





Source: Ministry of Internal Affairs and Communications.
Notes: 1. Figures for goods exclude petroleum products. Figures for "agricultural products, etc." include aquatic and livestock products.
2. Figures for services related to domestic duties include services related to housing repairs and maintenance.
3. Figures are the contribution to changes in the CPI (less fresh food and energy). Figures are staff estimates and exclude mobile phone charges and the effects of the consumption tax hike, policies concerning the provision of free education, and travel subsidy programs.

Chart B2-2: Month When Price Changes Take Place (General Services)



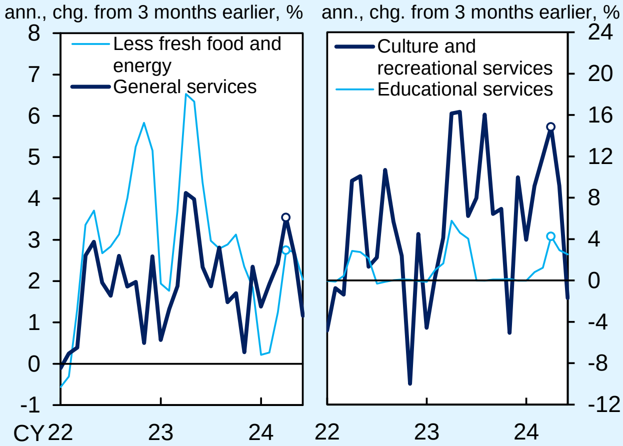
Source: Ministry of Internal Affairs and Communications.
Note: Figures are staff estimates and show the probability of change in prices of items corresponding to those in the CPI for general services in each month, based on the estimation results of a probit model using microdata from the *Retail Price Survey*. The estimation period is from January 2022 to December 2023.

to selling prices, particularly for items that are susceptible to labor costs, such as lesson fees for English conversation and other schools (services related to culture and recreation), cram school fees for junior high and high school students (services related to education), charges for domestic help and automotive maintenance charges (services related to domestic duties), and charges for massage (services related to medical care and welfare). Looking at the rate of price changes relative to three months earlier makes it clear that the rate of price increases, especially for culture and recreational services and education-related services, has accelerated markedly (Chart B2-3).

Next, the distribution of price changes by item shows that the peak of the distribution has shifted from close to 0 to close to 2 percent, indicating a change in price-setting behavior in the services sector as a whole (Chart B2-4). To get a more detailed grasp, the distribution is divided into items with a high and with a low ratio of labor costs to total costs. This shows that the distribution of items with a low labor cost ratio (such as dining out) -- prices of which had been rising at a high rate due to the effects of past upward pressure on costs -- has shifted to the left, while the distribution of items with a high labor cost ratio (such as lesson fees) has clearly shifted to the right (Chart B2-5).

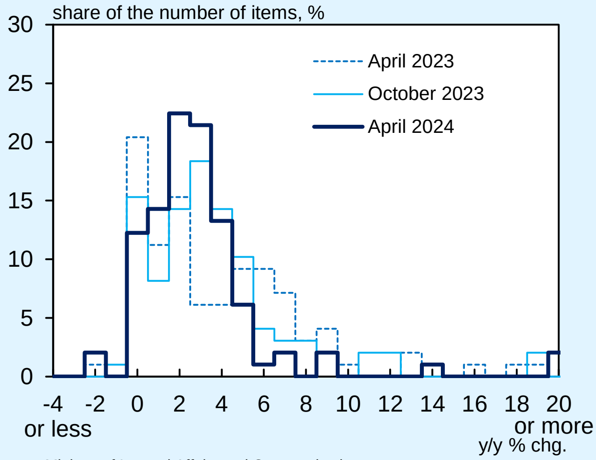
The widespread trend to raise services prices amid rising labor costs can also be confirmed from other perspectives. Using microdata from the *Tankan* to extract firms that had been cautious in changing their output prices for many years and

Chart B2-3: CPI Momentum



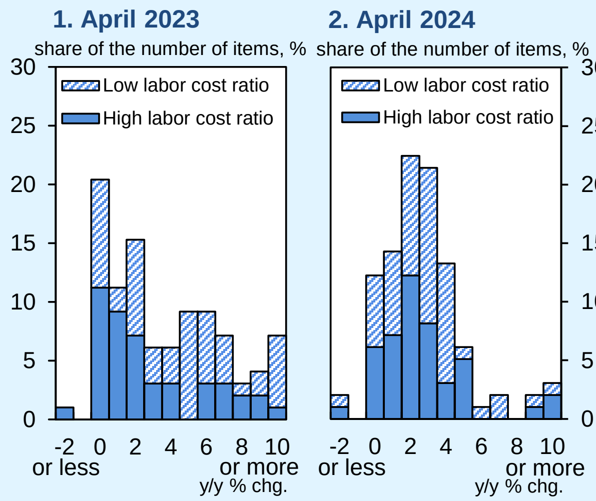
Source: Ministry of Internal Affairs and Communications.
Note: Figures are staff estimates and exclude mobile phone charges and the effects of policies concerning the provision of free education and travel subsidy programs. Figures denoted by the round markers are for April 2024.

Chart B2-4: Price Change Distribution of General Services, Total



Source: Ministry of Internal Affairs and Communications.
Note: Figures show the CPI for general services (less housing rent). Figures are staff estimates and exclude the effects of policies concerning the provision of free education and the effects of travel subsidy programs.

Chart B2-5: Price Change Distribution of General Services, Breakdown



Source: Ministry of Internal Affairs and Communications.
Notes: 1. Figures show the CPI for general services (less housing rent). Figures are staff estimates and exclude the effects of policies concerning the provision of free education and the effects of travel subsidy programs.
2. CPI items are matched to the items in the *2015 Input-Output Tables for Japan* and grouped in terms of the share of "wages and salaries" and other labor costs in the domestic output of those items. Figures for items with a high (low) labor cost ratio are for items that fall into the top (bottom) 50 percent in general services (less housing rent).

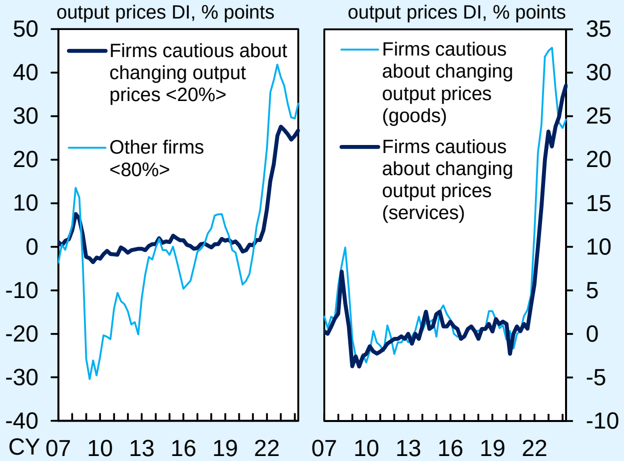
examining their price-setting behavior for goods and services separately shows that, in the case of goods, such firms have been actively revising prices since 2021 against the background of growing cost-push pressure led by the rise in import prices (Chart B2-6). On the other hand, with regard to services prices, changes in these firms' price-setting behavior thus far had been relatively moderate compared to goods prices, but price revisions have recently been gaining momentum. In this situation, "low-volatility items," "wage factors," and "the trend component in the CPI for services," which indicate how the linkage between wages and prices affects price developments -- indicators that were presented, for example, in past Outlook Reports -- have all been on a moderately increasing trend (Chart B2-7).[22]

Going forward, it is necessary to continue to examine from a broad perspective whether changes in firms' price-setting behavior spread further. In particular, heading into the next period of price revisions, (1) whether the high level of wage hikes seen in this year's annual spring labor-management wage negotiations will be reflected in selling prices, particularly for services, (2) whether more firms will set selling prices in anticipation of future wage increases, and (3) whether the continuation of these trends will lead to a further strengthening of the linkage between wages and prices, needs to be examined carefully in conjunction with firms' wage-setting behavior.[23]

[22] For details, see "Recent Developments in the Linkage between Wages and Prices," *Bank of Japan Review Series*, no. 24-E-2, May 2024.

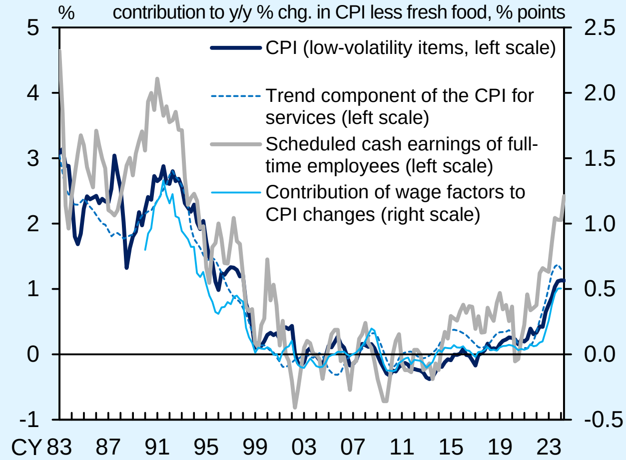
[23] For details on the 2024 spring labor-management wage negotiations, see Box 1 of this report and Box 2 of the April 2024 Outlook Report.

Chart B2-6: Change in Firms' Price-Setting Stance



Source: Bank of Japan.
Note: Based on the *Tankan* (all enterprises). Figures for firms cautious about changing output prices are for firms that for at least about 95 percent of the period from 1991 to 2019 replied that their output prices were "unchanged." In the left-hand chart, figures in angular brackets show the share in all firms. In the right-hand chart, figures for "firms cautious about changing output prices (goods)" are for manufacturing firms, while those for "firms cautious about changing output prices (services)" are for nonmanufacturing firms.

Chart B2-7: CPI and Scheduled Cash Earnings



Sources: Ministry of Internal Affairs and Communications; Ministry of Health, Labour and Welfare; Bank of Japan.
Notes: 1. Figures for low-volatility CPI items and scheduled cash earnings of full-time employees are year-on-year percentage changes, while those for the trend component of the CPI for services are the 6-quarter backward moving averages of annualized quarter-on-quarter percentage changes. Figures for scheduled cash earnings of full-time employees before 1994 are those for regular employees. Moreover, figures from 2016 onward are based on continuing observations following the sample revisions.
2. Figures for the contribution of wage factors to CPI changes are based on the relationship between the CPI and wages, estimated using a 4-variable VAR model comprising import prices (yen basis), the output gap, wages (scheduled cash earnings of full-time employees), and price indices for low-, medium-, and high-volatility items in the CPI. The estimates are obtained using 20-year rolling regressions for low-, medium-, and high-volatility CPI items.
3. Figures for the trend component of the CPI for services are the composite of the sector-specific price trend for services and the common trend in services prices and wages. The figures are estimated using category-level services prices and industry-level scheduled cash earnings.