

Outlook for Economic Activity and Prices

(January 2017)

The Bank's View¹

Summary

- Japan's economy is likely to continue growing at a pace above its potential through the projection period -- that is, through fiscal 2018 -- on the back of highly accommodative financial conditions and the effects of the government's large-scale stimulus measures, with the growth rates in overseas economies increasing moderately.
- The year-on-year rate of change in the consumer price index (CPI, all items less fresh food) is likely to increase from about 0 percent and become slightly positive, reflecting developments in energy prices. Thereafter, it is expected to increase toward 2 percent as the aggregate supply and demand balance (the output gap) improves and medium- to long-term inflation expectations rise.
- Comparing the current projections with the previous ones, the projected growth rates are somewhat higher, mainly reflecting improvement in overseas economies and the yen's depreciation. The projected rates of increase in the CPI are more or less unchanged.
- With regard to the risk balance, risks to both economic activity and prices are skewed to the downside. On the price front, the momentum toward achieving the price stability target of 2 percent is maintained, but is not yet sufficiently firm, and thus developments in prices continue to warrant careful attention.
- As for the conduct of monetary policy, the Bank will continue with "Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control," aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner. It will continue expanding the monetary base until the year-on-year rate of increase in the observed CPI (all items less fresh food) exceeds 2 percent and stays above the target in a stable manner. The Bank will make policy adjustments as appropriate, taking account of developments in economic activity and prices as well as financial conditions, with a view to maintaining the momentum toward achieving the price stability target.

¹ The text of "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on January 30 and 31, 2017.

I. The Current Situation of Economic Activity and Prices in Japan

Japan's economy has continued its moderate recovery trend. Overseas economies have continued to grow at a moderate pace, although emerging economies remain sluggish in part. In this situation, exports have picked up. On the domestic demand side, business fixed investment has been on a moderate increasing trend as corporate profits have been at high levels and business sentiment has improved somewhat. Against the background of steady improvement in the employment and income situation, private consumption has been resilient, and housing investment has continued its pick-up. Meanwhile, public investment has been more or less flat. Reflecting these moderate increases in demand both at home and abroad and the progress in inventory adjustments, industrial production has picked up. Financial conditions are highly accommodative. On the price front, the year-on-year rate of change in the CPI (all items less fresh food, and the same hereafter) has been about 0 percent. Inflation expectations have remained in a weakening phase.

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

A. Baseline Scenario of the Outlook for Economic Activity

With regard to the outlook, Japan's economy is likely to turn to a moderate expansion. Domestic demand is likely to follow an uptrend, with a virtuous cycle from income to spending being maintained in both the corporate and household sectors, on the back of highly accommodative financial conditions and fiscal spending through the government's large-scale stimulus measures. Business fixed investment is likely to maintain its moderate increasing trend, supported by accommodative financial conditions, heightened growth expectations, and increases in Olympic Games-related demand. Private consumption is expected to continue increasing moderately as employee income continues to improve. Public investment is projected to increase through fiscal 2017, due mainly to the positive effects resulting from a set of stimulus measures, and thereafter remain at a relatively high level with Olympic Games-related demand. Meanwhile, the growth rates of overseas economies are expected to increase moderately as advanced economies continue growing steadily and a recovery in emerging economies takes hold gradually on the back of the steady growth in advanced economies and the effects of policy measures taken by emerging

economies. Exports are expected to follow a moderate increasing trend on the back of the improvement in overseas economies.

Reflecting this outlook, Japan's economy is likely to continue growing at a pace above its potential through the projection period -- that is, through fiscal 2018.² Comparing the current projections with the previous ones, the projected growth rates are somewhat higher, mainly reflecting improvement in overseas economies and the yen's depreciation, in addition to an upward revision to the GDP due to the comprehensive revision to GDP statistics.

Looking at the financial conditions assumed in the above outlook, short- and long-term real interest rates are expected to be in negative territory through the projection period as the Bank pursues "QQE with Yield Curve Control."³ Financial institutions' proactive lending attitudes as well as favorable conditions for corporate bonds and CP issuance are both likely to be maintained and support firms' and households' activities from the financial side. Thus, financial conditions are likely to remain highly accommodative.

The potential growth rate is expected to follow a moderate uptrend through the projection period against the backdrop of the following: progress in implementation of the government's growth strategy, including regulatory and institutional reforms; an increase in labor participation by women and the elderly under such strategy; firms' continued efforts toward improving productivity and discovering potential domestic and external demand; and steady progress in overcoming of deflation. Along with this, the natural rate of interest is projected to rise, thereby enhancing monetary easing effects.

² Under a specific methodology, Japan's potential growth rate is estimated to be around 0.5 percent, revised upward from being in the range of 0.0-0.5 percent due to the comprehensive revision to GDP statistics. However, the estimate of the potential growth rate varies depending on the methodologies employed and could be revised as the sample period becomes longer over time. Thus, it should be regarded as being subject to a considerable margin of error.

³ Individual Policy Board members make their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding future policy. Specifically, each Policy Board member makes an assumption about the future path of short- and long-term interest rates based on their market rates, with the difference in the outlook for prices between that presented in the *Outlook for Economic Activity and Prices* (Outlook Report) and that of market participants in mind.

B. Baseline Scenario of the Outlook for Prices

The outlook for prices is as follows. The year-on-year rate of change in the CPI is likely to increase from about 0 percent and become slightly positive, reflecting developments in energy prices. Thereafter, it is expected to increase toward 2 percent as the output gap improves and medium- to long-term inflation expectations rise. Comparing the current projections with the previous ones, the projected rates of increase in the CPI are more or less unchanged. The timing of the year-on-year rate of change in the CPI reaching around 2 percent will likely be at the end of the projection period -- that is, around fiscal 2018.

The background to these projections is as follows. First, medium- to long-term inflation expectations have remained in a weakening phase as the adaptive component has played a large role in their formation, reflecting the observed inflation rate having been slightly negative.⁴ However, various market indicators and survey results indicate that medium- to long-term inflation expectations have stopped declining on the whole, and some of them show a rise in such expectations. As for the outlook, based on the aforementioned projections, firms' price-setting stance is expected to revert to raising prices as private consumption is expected to continue increasing moderately, and their wage-setting stance is likely to shift toward raising wages driven by the tightening of labor market conditions. Against this backdrop, because of the following two factors, medium- to long-term inflation expectations are likely to follow an increasing trend and gradually converge to around 2 percent: (1) in terms of the adaptive component, the observed inflation rate is expected to rise, mainly reflecting energy prices starting to push up prices and the recent yen depreciation, and (2) in terms of the forward-looking component, the Bank will pursue monetary easing through its strong commitment to achieving the price stability target.

Second, the output gap, which shows the utilization of labor and capital, had been more or less unchanged at around 0 percent as the tightening of labor market conditions continued, but it has shown some improvement recently. Going forward, the output gap is expected to

⁴ Medium- to long-term inflation expectations can be regarded as consisting of two components: a forward-looking component, in which inflation expectations converge to the price stability target set by the central bank, and a backward-looking, or adaptive, component that reflects the observed inflation rate. For details, see the Bank's *Comprehensive Assessment: Developments in Economic Activity and Prices as well as Policy Effects since the Introduction of Quantitative and Qualitative Monetary Easing (QQE)* released in September 2016.

move into positive territory toward the end of fiscal 2016 and widen further within that territory. This is likely to be supported by the continued tightening of labor market conditions, due in part to the effects resulting from the set of stimulus measures becoming evident, in addition to an improvement in capacity utilization rates brought about by a pick-up in exports and production.

Third, regarding import prices, the effects of the past decline in international commodity prices including crude oil prices -- which had been exerting downward pressure on consumer prices -- are likely to largely dissipate through the end of fiscal 2016. Thereafter, a pick-up in international commodity prices is expected to push up consumer prices. As for the impact of foreign exchange rates on consumer prices through import prices, amid a gradual waning of downward pressure stemming from the past yen appreciation, the recent yen depreciation is likely to increase upward pressure on prices after the turn of fiscal 2017.

III. Upside and Downside Risks to Economic Activity and Prices

A. Upside and Downside Risks to Economic Activity

The following are upside and downside risks to the Bank's baseline scenario regarding the economy. First, there is uncertainty regarding developments in overseas economies. Specifically, the following are considered as risks: developments in the U.S. economy and the impact of its monetary policy on global financial markets; developments in emerging and commodity-exporting economies, particularly China; the consequences stemming from the United Kingdom's vote to leave the European Union (EU) and their effects; prospects regarding the European debt problem, including the financial sector; and geopolitical risks. If these risks were to materialize, they could exert downward pressure on economic activity. On the other hand, as market participants and economic entities factor them in to a certain extent, the economy could deviate upward from the baseline scenario depending on how they play out.

Second, firms' and households' medium- to long-term growth expectations may be either raised or lowered depending on the following: efforts to address medium- to long-term issues such as the aging population; developments in regulatory and institutional reforms,

particularly in the labor market; innovation in the corporate sector; and the employment and income situation.

Third, in the event that confidence in fiscal sustainability in the medium to long term declines, the economy may deviate downward from the baseline scenario through increasing concerns regarding the future and the rises in long-term interest rates associated with them. On the other hand, there is also a possibility that the economy will deviate upward from the baseline scenario if confidence in the path toward fiscal consolidation strengthens and concerns regarding the future are alleviated.

B. Upside and Downside Risks to Prices

Other than risks to economic activity, the specific factors that could exert upside and downside risks to prices are as follows. The first factor is developments in firms' and households' medium- to long-term inflation expectations. Amid the continued considerable uncertainties surrounding the economic outlook, mainly for overseas economies, there is a risk that firms' price- and wage-setting stance will remain cautious. In this context, how the labor-management wage negotiations this spring will develop warrants particular attention.

The second factor is the fact that there are items for which prices are not particularly responsive to the output gap. There is a particular concern about the continued dull responses of administered prices and some services prices, even amid the tightening of labor market conditions. In addition, a decline in housing rent has accelerated recently, possibly constraining CPI inflation by more than projected.

Third, developments in foreign exchange rates and international commodity prices going forward, as well as the extent to which such developments will spread to import prices and domestic prices, may lead prices to deviate either upward or downward from the baseline scenario.

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.⁵

The first perspective concerns an examination of the baseline scenario for the outlook. The year-on-year rate of change in the CPI is expected to increase toward 2 percent. The momentum toward achieving the price stability target is maintained, but is not yet sufficiently firm, and thus developments in prices continue to warrant careful attention.

The second perspective involves an examination of the risks considered most relevant to the conduct of monetary policy. With regard to the outlook for economic activity, risks are skewed to the downside, particularly those regarding developments in overseas economies. With regard to the outlook for prices, risks are skewed to the downside, especially those concerning overseas economies and developments in medium- to long-term inflation expectations. Examining financial imbalances from a longer-term perspective, there is no sign so far of excessively bullish expectations in asset markets or in the activities of financial institutions. Furthermore, prolonged downward pressure on financial institutions' profits under the continued low interest rate environment could create risks of a gradual pullback in financial intermediation and of destabilizing the financial system. However, at this point, these risks are judged as not significant, mainly because financial institutions have sufficient capital bases.

As for the conduct of monetary policy, the Bank will continue with "QQE with Yield Curve Control," aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner. It will continue expanding the monetary base until the year-on-year rate of increase in the observed CPI (all items less fresh food) exceeds 2 percent and stays above the target in a stable manner. The Bank will make policy adjustments as appropriate, taking account of developments in economic activity and prices as well as financial conditions, with a view to maintaining the momentum toward achieving the price stability target.

⁵ 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."

Forecasts of the Majority of Policy Board Members

y/y % chg.

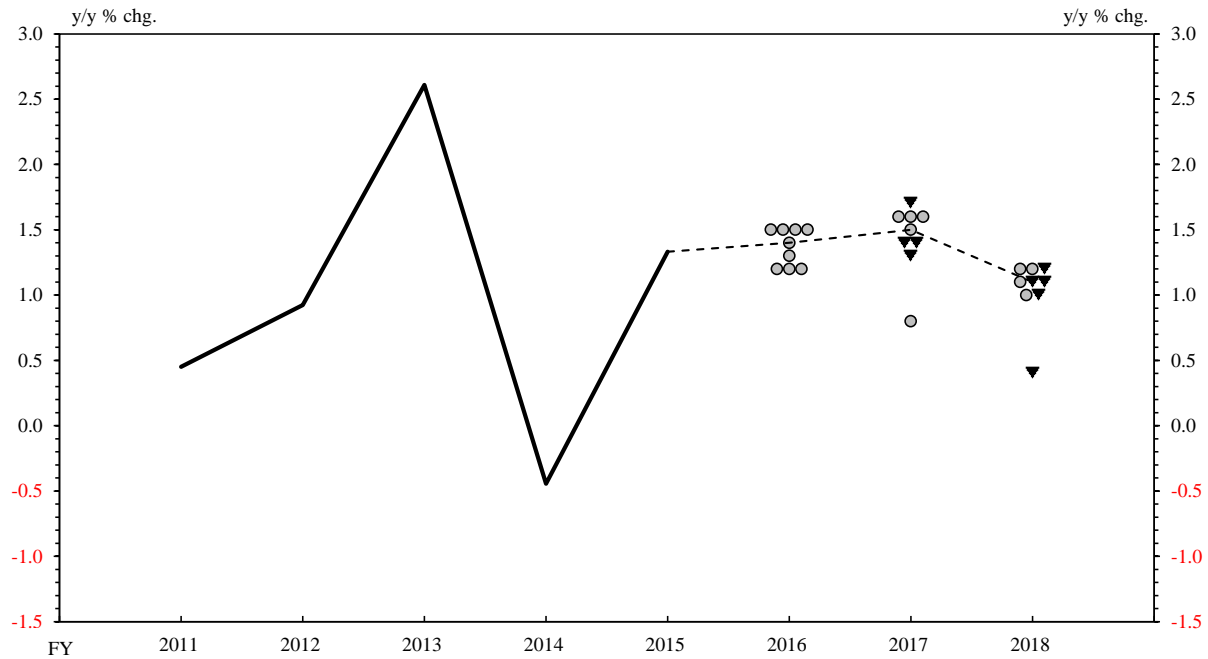
	Real GDP	CPI (all items less fresh food)
Fiscal 2016	+1.2 to +1.5 [+1.4]	-0.2 to -0.1 [-0.2]
Forecasts made in October 2016	+0.8 to +1.0 [+1.0]	-0.3 to -0.1 [-0.1]
Fiscal 2017	+1.3 to +1.6 [+1.5]	+0.8 to +1.6 [+1.5]
Forecasts made in October 2016	+1.0 to +1.5 [+1.3]	+0.6 to +1.6 [+1.5]
Fiscal 2018	+1.0 to +1.2 [+1.1]	+0.9 to +1.9 [+1.7]
Forecasts made in October 2016	+0.8 to +1.0 [+0.9]	+0.9 to +1.9 [+1.7]

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

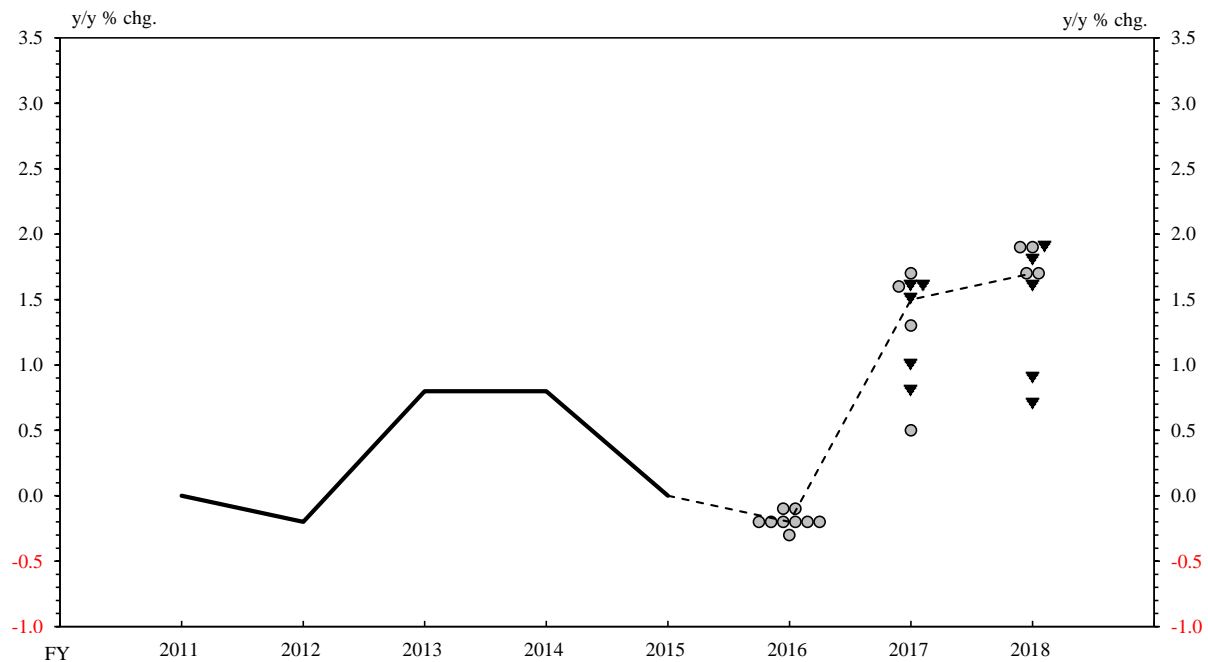
2. The forecasts of the majority of the Policy Board members are constructed as follows: each Policy Board member's forecast takes the form of a point estimate -- namely, the figure to which he or she attaches the highest probability of realization. These forecasts are then shown as a range, with the highest figure and the lowest figure excluded. The range does not indicate the forecast errors.
3. Individual Policy Board members make their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding future policy. Specifically, each Policy Board member makes an assumption about the future path of short- and long-term interest rates based on their market rates, with the difference in the outlook for prices between that presented in the Outlook Report and that of market participants in mind.
4. From the January 2015 interim assessment through the October 2016 Outlook Report, each Policy Board member made their forecasts based on the same assumption about crude oil prices due to the fact that such prices had been exerting a considerable impact on consumer prices. In this January 2017 Outlook Report, each member has made an assumption about crude oil prices individually in making their forecasts in light of the fact that the contribution of energy items to the year-on-year rate of change in the CPI (all items less fresh food) has lessened. The contribution is estimated to be approximately minus 0.6 percentage point for fiscal 2016 and reach around 0 percentage point in early 2017, becoming slightly positive thereafter.
5. Individual Policy Board members' forecasts are based on the assumption that the consumption tax will be raised to 10 percent in October 2019.

Policy Board Members' Forecasts and Risk Assessments

(1) Real GDP



(2) CPI (All Items Less Fresh Food)



Notes: 1. Solid lines show actual figures, while dotted lines show the medians of the Policy Board members' forecasts (point estimates).

2. The locations of \circ , Δ , and \blacktriangledown in the charts indicate the figures for each Policy Board member's forecasts to which he or she attaches the highest probability. The risk balance assessed by each Policy Board member is shown by the following shapes: \circ indicates that a member assesses "upside and downside risks as being generally balanced," Δ indicates that a member assesses "risks are skewed to the upside," and \blacktriangledown indicates that a member assesses "risks are skewed to the downside."

3. Figures for the CPI exclude the direct effects of the consumption tax hikes.