

Not to be released until 2:00 p.m.
Japan Standard Time on
Thursday, July 16, 2020.



Outlook for Economic Activity and Prices

July 2020



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

Please contact the Bank of Japan at the address below in advance to request permission when reproducing or copying the content of this document for commercial purposes.

Secretariat of the Policy Board, Bank of Japan
P.O. Box 30, Nihonbashi, Tokyo 103-8660, Japan

Please credit the source when quoting, reproducing, or copying the content of this document.

Outlook for Economic Activity and Prices (July 2020)

The Bank's View¹

Summary

- Japan's economy is likely to improve gradually from the second half of this year with economic activity resuming, but the pace is expected to be only moderate while the impact of the novel coronavirus (COVID-19) remains worldwide. Thereafter, as the impact subsides globally, the economy is projected to keep improving further with overseas economies returning to a steady growth path.
 - The year-on-year rate of change in the consumer price index (CPI, all items less fresh food) is likely to be negative for the time being, mainly affected by COVID-19 and the past decline in crude oil prices. Thereafter, it is expected to turn positive and then increase gradually, since downward pressure on prices is projected to wane gradually along with economic improvement and the effects of the decline in crude oil prices are likely to dissipate.
 - The projected growth rates and projected rates of increase in the CPI in this Outlook Report are broadly within the range of the forecasts in the previous report.
 - The outlook for economic activity and prices provided in this Outlook Report is extremely unclear, since it could change depending on the consequences of COVID-19 and the magnitude of their impact on domestic and overseas economies. It is based mainly on the assumptions that a second wave of COVID-19 will not occur on a large scale and that, while the impact of COVID-19 remains, firms' and households' medium- to long-term growth expectations will not decline substantially and the smooth functioning of financial intermediation will be ensured with financial system stability being maintained. However, these assumptions entail high uncertainties.
 - With regard to the risk balance, risks to both economic activity and prices are skewed to the downside, mainly due to the impact of COVID-19.
-

¹ "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on July 14 and 15, 2020.

I. Current Situation of Economic Activity and Prices in Japan

Japan's economy has been in an extremely severe situation with the impact of COVID-19 remaining at home and abroad, although economic activity has resumed gradually. Overseas economies have been depressed significantly, reflecting the impact of the COVID-19 pandemic, although they have shown signs of heading toward a pick-up. In this situation, exports and industrial production have declined substantially. Corporate profits and business sentiment have deteriorated, and business fixed investment has been more or less flat. With the continuing impact of COVID-19, the employment and income situation has been weak. Although private consumption has decreased significantly, mainly in services such as eating and drinking as well as accommodations, it has shown signs of a pick-up recently. Housing investment has declined moderately. Meanwhile, public investment has increased moderately. Financial conditions have been accommodative on the whole but those for corporate financing have remained less so, as seen in deterioration in firms' financial positions. On the price front, the year-on-year rate of change in the CPI (all items less fresh food, and the same hereafter) is at around 0 percent, mainly affected by the decline in crude oil prices. Inflation expectations have weakened somewhat.

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

A. Baseline Scenario of the Outlook for Economic Activity

Japan's economy, with economic activity resuming, is likely to improve gradually from the second half of this year through the materialization of pent-up demand and supported by accommodative financial conditions and the government's economic measures. However, the pace of improvement is expected to be only moderate while the impact of COVID-19 remains worldwide. Thereafter, as the impact subsides globally, the economy is projected to keep improving further with overseas economies returning to a steady growth path.

The COVID-19 pandemic has had a considerable impact on the global economy, along with the conduct of strict public health measures such as restrictions on going outside and suspension of business and production activities. A phased lifting of these measures has begun, mainly in countries where the spread of COVID-19 has almost subsided, but economic activities of firms and households have remained constrained due to vigilance against COVID-19. In this Outlook Report, which is based on the assumption that a second wave of COVID-19 will not occur on a large scale, it is expected that, until COVID-19 subsides globally, precautionary efforts made voluntarily by firms and households will continue to act as a force constraining economic activity, although it will

wane gradually.²

Based on this assumption, as the impact of COVID-19 wanes, overseas economies are likely to recover from being depressed significantly, partly supported by aggressive macroeconomic policies, but the pace is expected to be only moderate. Japan's exports are likely to increase gradually along with a recovery in overseas economies but remain constrained for the time being. Inbound tourism consumption is expected to remain subdued while entry restrictions continue.

Domestic demand is likely to see an increase in its level as the impact of COVID-19 wanes, but be only at a low level while it remains. Specifically, along with a resumption of economic activity, household spending such as private consumption is expected to pick up from a significant decline through the materialization of pent-up demand as well as supported by the government's economic measures and accommodative financial conditions. However, the spending is likely to remain constrained while people continue to be vigilant against COVID-19. Business spending, such as business fixed investment, is expected to decrease, mainly in industries affected strongly by substantial declines in exports and consumption. Thereafter, it is likely to pick up as the impact of COVID-19 wanes.

Meanwhile, it is expected that the government's economic measures and accommodative financial conditions will contribute to sustaining businesses and retaining employees, thereby preventing firms' and households' medium- to long-term growth expectations in Japan from declining substantially. Thus, as the impact of COVID-19 subsides globally thereafter, it is likely that exports will continue to increase on the back of growth in overseas economies and that household and business spending will return to a stable increasing trend.

B. Baseline Scenario of the Outlook for Prices

The year-on-year rate of change in the CPI is likely to be negative for the time being, mainly affected by COVID-19 and the past decline in crude oil prices. With economic activity remaining at a low level due to the impact of COVID-19, it is expected that prices of goods and services that are sensitive to economic activity will be pushed down. Crude oil prices, which declined significantly compared to a while ago, are projected to push down the CPI through energy prices. Under these circumstances, medium- to long-term

² According to the global economic outlook released by various international organizations, it is assumed, as a baseline scenario, that the economy will recover from the second half of 2020 after being pushed down significantly in the first half of the year by the rapid spread of COVID-19. In that scenario, which is based on the assumption that a second wave of COVID-19 will not occur on a large scale, an economic recovery is expected to be only moderate since preventive measures, including voluntary ones, are likely to continue to be taken until the COVID-19 pandemic subsides due to medical breakthroughs such as development of effective medicines and vaccines.

inflation expectations are likely to continue weakening somewhat.

Thereafter, downward pressure on prices is projected to wane gradually along with economic improvement. In addition, the effects of the decline in energy prices are likely to dissipate. Under these circumstances, the year-on-year rate of change in the CPI is expected to turn positive and then increase gradually. Medium- to long-term inflation expectations also are expected to rise again.

C. Financial Conditions

Looking at the financial conditions on which the above outlook is based, corporate financing has been under stress, mainly against the background of a decline in sales that reflects constrained economic activity due to the spread of COVID-19. In response to this situation, the Bank, while pursuing "Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control," has conducted various powerful monetary easing measures since March with a view to supporting financing, mainly of firms, and maintaining stability in financial markets.³ In addition, the government has conducted various measures to support financing, mainly of firms, through programs that provide loans guaranteed by the credit guarantee corporations and that provide quasi-capital funds. In this situation, along with active efforts made by private financial institutions, the environment for external funding, such as bank borrowing and the issuance of CP and corporate bonds, has remained accommodative. Owing to the Bank's and the government's measures, as well as efforts made by private financial institutions together with those measures, it is expected that financial conditions will remain accommodative and further downward pressure on the real economy from the financial side will be avoided.⁴

III. Risks to Economic Activity and Prices

A. Risks to Economic Activity

Regarding the baseline scenario of the outlook for economic activity, it is necessary to pay attention to the following three upside and downside risks in particular until the impact of COVID-19 subsides.

The first is the impact of COVID-19 on domestic and overseas economies. There are extremely high uncertainties over the consequences of COVID-19 and the magnitude of their impact on domestic and overseas economies. Until effective medicines and vaccines

³ See "Enhancement of Monetary Easing in Light of the Impact of the Outbreak of the Novel Coronavirus (COVID-19)" released on March 16, 2020, "Enhancement of Monetary Easing" released on April 27, 2020, and "Introduction of a New Fund-Provisioning Measure to Support Financing Mainly of Small and Medium-Sized Firms" released on May 22, 2020.

⁴ 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.

are developed, it is highly unclear how the COVID-19 pandemic will evolve and how long it will take for it to subside. In particular, if a second wave of COVID-19 occurs on a large scale, economic activity is likely to be constrained significantly again. In addition, households' and firms' behavior at home and abroad is also uncertain, with people continuing to voluntarily make precautionary efforts until COVID-19 subsides.

The second risk is firms' and households' medium- to long-term growth expectations. If such expectations decline due to a shock caused by COVID-19 that pushes down the economy considerably, there is a risk that firms' and households' appetite for spending will not increase easily even after COVID-19 subsides. On the other hand, medium- to long-term growth expectations could increase if the issue of COVID-19 leads to, for example, active use of information and communication technology to prevent infection and an undertaking of investment to meet new demand, thereby having positive effects on economic activity such as further innovation.

The third risk is developments in the financial system. Although it is under severe stress due to the impact of COVID-19, the Bank and the government have taken measures aggressively, with a view to supporting financing, mainly of firms, and maintaining stability in financial markets. In addition, financial institutions have considerable resilience in terms of both capital and liquidity. In this situation, the financial system has maintained stability on the whole. However, if COVID-19 has a larger impact than expected, there is a risk that deterioration in the real economy will affect financial system stability, thereby exerting further downward pressure on the real economy. Although this risk is judged as not significant at this point, it is necessary to pay close attention to future developments.

B. Risks to Prices

If the aforementioned risks to economic activity materialize, prices also are likely to be affected accordingly.

Risks that are specific to prices are as follows. The first is uncertainties over firms' price-setting behavior amid the impact of COVID-19 on both the demand and supply sides of economic activity. A decrease in demand due to constrained economic activity is likely to push down prices of goods and services that are sensitive to economic activity. On the other hand, there are uncertainties over how firms set prices if economic activity is constrained also from the supply side, such as by limiting the number of customers to prevent infection. In addition, it is unclear how these circumstances will affect prices from a macro perspective.

The second is that 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, may lead prices to deviate either upward or downward from the baseline scenario. In particular, since crude oil prices have been highly volatile, it is

necessary to pay attention to the effects on the CPI exerted through energy 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.⁵

The first perspective involves an examination of the baseline scenario for the outlook. The year-on-year rate of change in the CPI is likely to increase gradually toward achieving the price stability target, although it will take time. For the time being, prices are expected to be pushed down with economic activity remaining at a low level due to the impact of COVID-19, and medium- to long-term inflation expectations also are likely to weaken somewhat. Thereafter, prices are expected to increase gradually since downward pressure on them is projected to wane gradually along with economic improvement. In addition, medium- to long-term inflation expectations also are likely to rise again.

The second perspective involves an examination of the risks considered most relevant to the conduct of monetary policy. The outlook for economic activity and prices is extremely unclear, since it could change depending on the consequences of COVID-19 and the magnitude of their impact on domestic and overseas economies. This outlook is based mainly on the assumptions that a second wave of COVID-19 will not occur on a large scale and that, while the impact of COVID-19 remains, firms' and households' medium- to long-term growth expectations will not decline substantially and the smooth functioning of financial intermediation will be ensured with financial system stability being maintained. However, these assumptions entail high uncertainties. With regard to the risk balance, risks to both economic activity and prices are skewed to the downside, mainly due to the impact of COVID-19. When examining financial imbalances from a longer-term perspective, prolonged downward pressure on financial institutions' profits could create a risk of a gradual pullback in financial intermediation, given the existing factors -- such as the prolonged low interest rate environment, the declining population, and excess savings in the corporate sector -- as well as the recent impact of COVID-19. 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, mainly because financial institutions have sufficient capital bases, it is necessary to pay close attention to future developments.

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

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."

for maintaining that target in a stable manner. It will continue expanding the monetary base until the year-on-year rate of increase in the observed CPI (all items less fresh food) exceeds 2 percent and stays above the target in a stable manner.

The Bank will continue to support financing, mainly of firms, and maintain stability in financial markets through (1) the Special Program to Support Financing in Response to the Novel Coronavirus (COVID-19), (2) an ample provision of yen and foreign currency funds without setting upper limits mainly by purchasing Japanese government bonds (JGBs) and conducting the U.S. dollar funds-supplying operations, and (3) active purchases of exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs).

For the time being, the Bank will closely monitor the impact of COVID-19 and will not hesitate to take additional easing measures if necessary, and also it expects short- and long-term policy interest rates to remain at their present or lower levels.

Forecasts of the Majority of the Policy Board Members

y/y % chg.

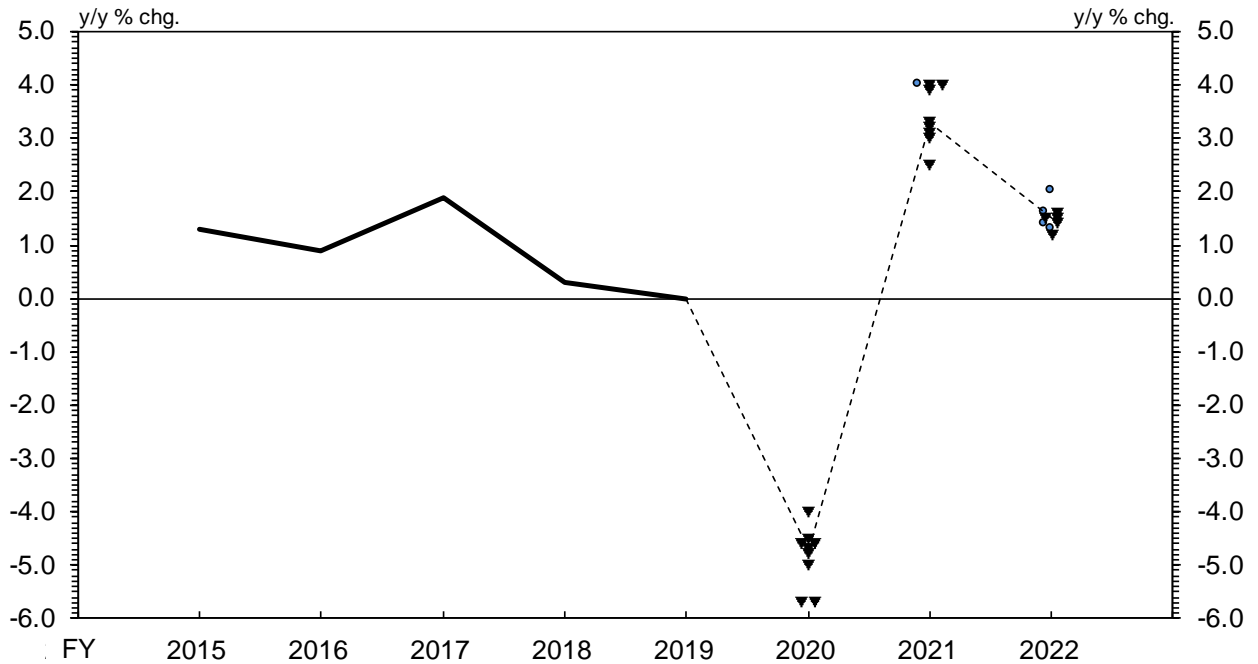
	Real GDP	CPI (all items less fresh food)	(Reference) Excluding the effects of the consumption tax hike and policies concerning the provision of free education
Fiscal 2020	-5.7 to -4.5 [-4.7]	-0.6 to -0.4 [-0.5]	-0.7 to -0.5 [-0.6]
Forecasts made in April 2020	-5.0 to -3.0	-0.7 to -0.3	-0.8 to -0.4
Fiscal 2021	+3.0 to +4.0 [+3.3]	+0.2 to +0.5 [+0.3]	
Forecasts made in April 2020	+2.8 to +3.9	0.0 to +0.7	
Fiscal 2022	+1.3 to +1.6 [+1.5]	+0.5 to +0.8 [+0.7]	
Forecasts made in April 2020	+0.8 to +1.6	+0.4 to +1.0	

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

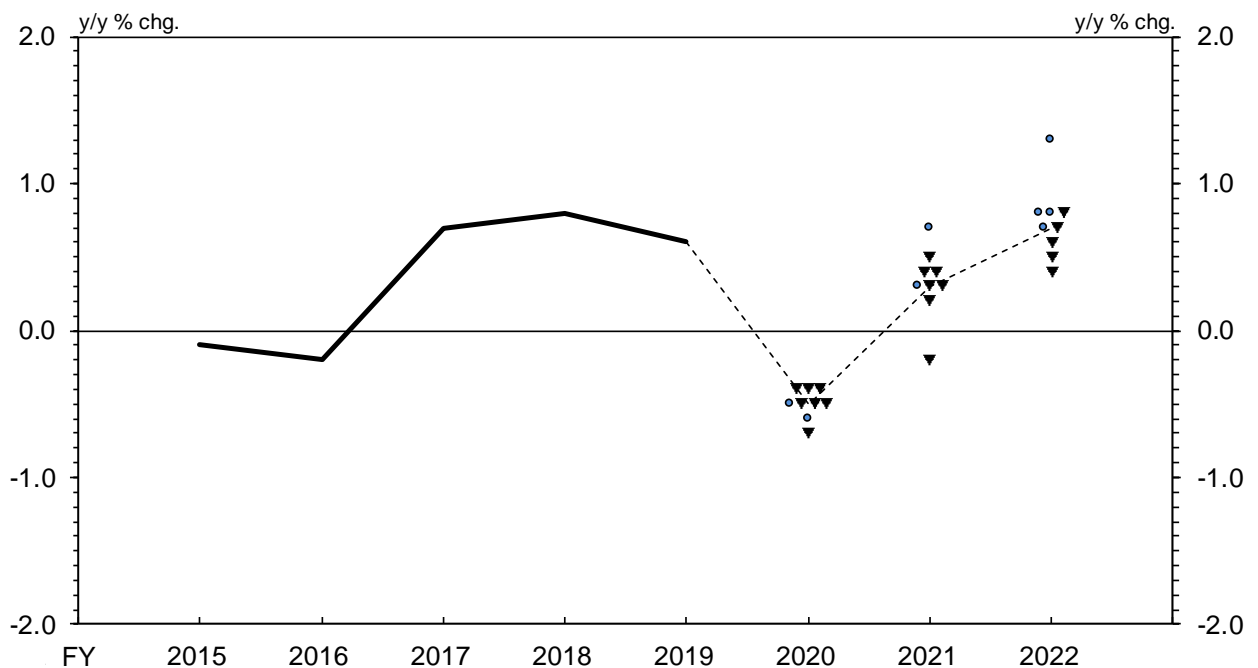
2. The forecasts of the majority of the Policy Board members are constructed as follows: each Policy Board member's forecast takes the form of a point estimate -- namely, the figure to which he or she attaches the highest probability of realization. These forecasts are then shown as a range, with the highest figure and the lowest figure excluded. The range does not indicate the forecast errors.
3. In the April Outlook Report, each Policy Board member made their forecasts as a range and submitted two figures (i.e., the highest and lowest figures) within the range of 1.0 percentage point at most. The forecasts of the majority of the Policy Board members were shown as a range excluding four figures -- namely, the two highest figures and two lowest figures among the forecasts of the nine members. Thus, it should be noted that the definition of the forecasts of the majority of the Policy Board members in the April Outlook Report is different from that in the July Outlook Report.
4. 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.
5. The direct effects of the October 2019 consumption tax hike on the CPI for fiscal 2020 are estimated to be 0.5 percentage point. In addition, based on a specific assumption, the direct effects of policies concerning the provision of free education on the CPI for fiscal 2020 are estimated to be around minus 0.4 percentage point.

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 he or she attaches 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."

3. The CPI figure for fiscal 2015 excludes the direct effects of the April 2014 consumption tax hike.

The Background⁶

I. Current Situation of Economic Activity and Its Outlook

A. Economic Developments

Japan's economy has been in an extremely severe situation with the impact of COVID-19 remaining at home and abroad, although economic activity has resumed gradually.

The real GDP growth rate for the January-March quarter of 2020 registered negative growth for two consecutive quarters, marking minus 0.6 percent on a quarter-on-quarter basis and minus 2.2 percent on an annualized basis (Chart 1). This is attributable to the fact that components such as private consumption and exports declined, due mainly to the impact of the spread of COVID-19. Since April, COVID-19 has brought about a considerable decline in aggregate demand through the following three channels: (1) a decline in goods exports reflecting a depression in overseas economies; (2) a decline in inbound tourism demand (i.e., services exports); and (3) a decline in domestic private consumption, due mainly to self-restraint from going outside and business restrictions. In reflection of the decline in aggregate demand, labor demand has weakened significantly. The unemployment rate and active job openings-to-applicants ratio have deteriorated, and the number of employed persons has turned to a clear decline (Charts 2 and 3). Under these circumstances, the output gap -- which captures the utilization of labor and capital -- narrowed

Chart 1: Real GDP

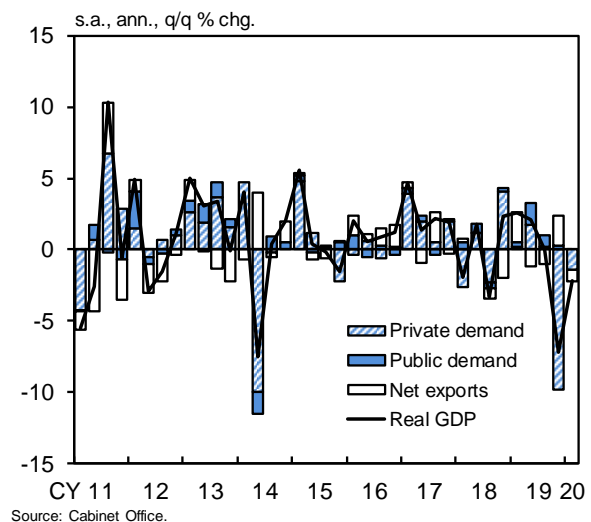
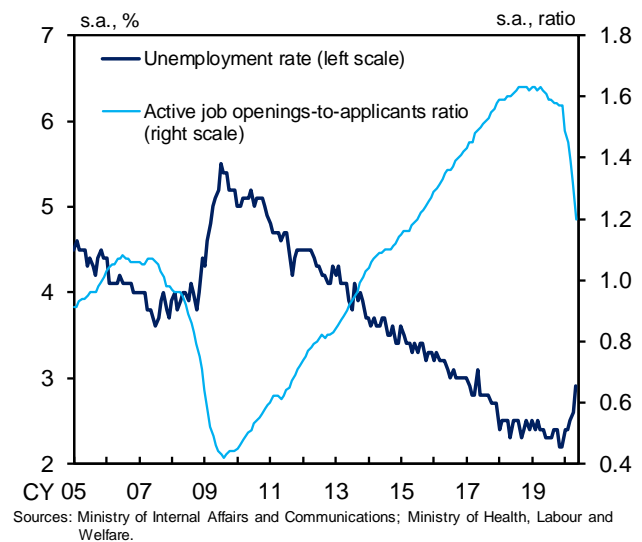


Chart 2: Labor Market Conditions

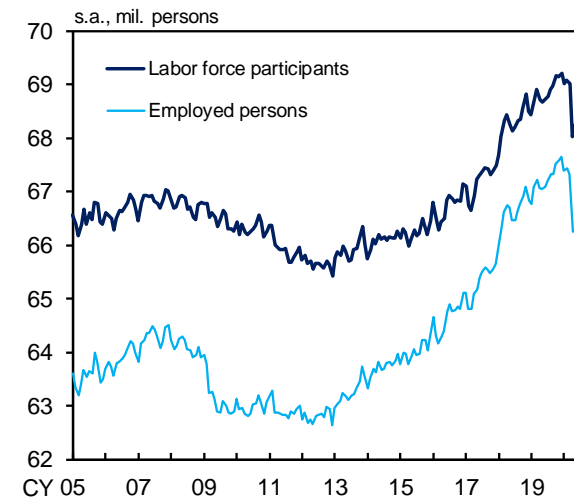


⁶ "The Background" provides explanations of "The Bank's View" decided by the Policy Board at the Monetary Policy Meeting held on July 14 and 15, 2020.

within positive territory for the January-March quarter, reaching almost 0 percent (Chart 4). The gap seems to have continued to narrow and become significantly negative for the April-June quarter, given the deterioration in the diffusion indices (DIs) related to employment and business fixed investment in the June 2020 *Tankan* (Short-Term Economic Survey of Enterprises in Japan).

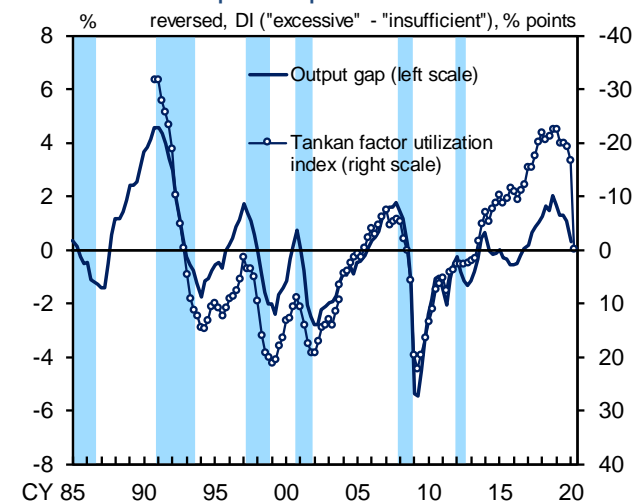
With regard to the outlook, Japan's economy is likely to remain in a severe situation for the time being due to the impact of COVID-19 at home and abroad. Subsequently, with a phased resumption of economic activity, the economy is likely to improve gradually from the second half of this year through the materialization of pent-up demand and supported by accommodative financial conditions and the government's economic measures.⁷ Specifically, with regard to goods exports, a significant decline has been observed recently, mainly for automobile-related goods. However, such exports are expected to stop declining and turn to a pick-up in the second half of this year. Thereafter, as the impact of COVID-19 wanes worldwide, goods exports are likely to increase, supported also by the materialization of pent-up demand and a recovery in production. Inbound tourism demand, which is a component of services exports, is expected to

Chart 3: Labor Force Participation and Employment



Source: Ministry of Internal Affairs and Communications.

Chart 4: Output Gap



Source: Bank of Japan.

Notes: 1. The output gap is based on staff estimations.

2. The Tankan factor utilization index is calculated as the weighted average of the production capacity DI and the employment conditions DI for all enterprises. The capital and labor shares are used as weights. There is a discontinuity in the data in December 2003 due to a change in the survey framework.

3. Shaded areas indicate recession periods.

⁷ Based on the Emergency Economic Measures to Cope with the Novel Coronavirus (COVID-19) -- with a project size of around 117.1 trillion yen and fiscal spending of around 48.4 trillion yen -- decided by the Cabinet in April 2020, the first supplementary budget for fiscal 2020 was approved by the Diet. In reflection of the expansion in the areas where the state of emergency was declared and the period of that state being prolonged, the second supplementary budget -- with a project size of around 117.1 trillion yen and fiscal spending of around 72.7 trillion yen -- also was approved by the Diet.

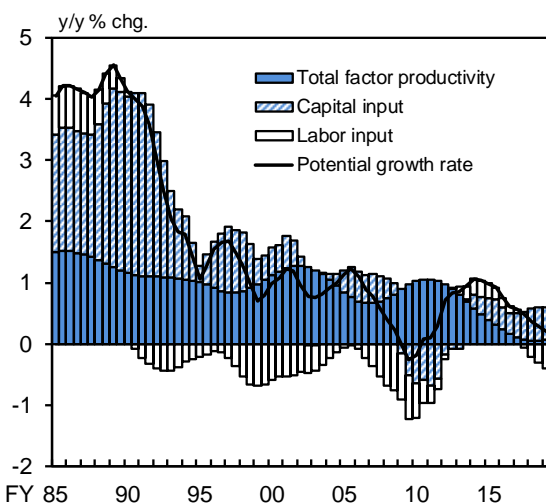
remain subdued while entry restrictions continue. Private consumption decreased significantly in the April-June quarter, affected by the declaration of a state of emergency. It is projected to pick up from that bottom, but the pace will likely be quite moderate due to vigilance against COVID-19 and the need to ensure social distancing. The employment and income situation is projected to remain under downward pressure for the time being, reflecting weak labor demand stemming from a decline in domestic and overseas demand. However, the employment adjustment subsidies, which have been expanded in response to the current situation, are expected to halt job cuts, and income support measures such as special cash payments are likely to underpin disposable income. Business fixed investment is expected to turn to a downtrend against the background of a decline in corporate profits and increasing uncertainties over the future. However, with financial conditions remaining accommodative owing to the Bank's and the government's measures to support financing, mainly of firms, as well as efforts made by financial institutions together with those measures, it is unlikely that adjustments in capital stock will be significant, since many medium- to long-term investment projects will continue to be undertaken. Thus, business fixed investment is expected to increase again after the impact of COVID-19 subsides. Meanwhile, government spending is projected to steadily increase reflecting the progress in construction related to restoration and reconstruction following natural disasters, as well as to national resilience. Thereafter, it is expected to be at a relatively high level.

From a somewhat long-term perspective, as the impact of COVID-19 subsides globally, Japan's economy is projected to keep improving further with overseas economies returning to a steady growth path.

Reflecting these developments in demand both at home and abroad, Japan's economic growth rate is expected to register significant negative growth for fiscal 2020; however, the economy is likely to mark relatively high growth for fiscal 2021, due partly to the materialization of pent-up demand and the hosting of the Olympic Games, and then continue to grow firmly for fiscal 2022 on the back of an improvement in overseas economies.

Meanwhile, the potential growth rate is likely to decline in the short run. This is because the following is projected: (1) a decline in total factor productivity (TFP), mainly due to measures against COVID-19 and to labor hoarding; (2) a downtrend in working hours due to temporary store closures and shorter operating hours; and (3) a deceleration in growth of capital stock reflecting a decline in business fixed investment (Chart 5). Thereafter, the potential growth rate is expected to be at a low level for a while but rise moderately toward the end of the projection period. This is based on the projection that, (1) while the TFP growth rate will turn to a moderate increase due to adaptation to a "new lifestyle," advances in digital transformation, and a resultant improvement in efficiency of resource allocation, (2) working hours will stop declining, and (3) the growth of capital stock will accelerate cyclically. However, there is a possibility that COVID-19 will bring about a structural change in people's

Chart 5: Potential Growth Rate



Source: Bank of Japan.
Note: Based on staff estimations.

working styles and firms' business processes that does not follow the past trend, and thus the output gap and the potential growth rate, which are estimated based on a specific assumption regarding trends, should be interpreted with more latitude than usual.

Details of the outlook for each fiscal year are as follows. In fiscal 2020, the economic growth rate is likely to decline significantly in the April-June quarter due to the impact of COVID-19 at home and abroad, and then pick up moderately through the second half of the fiscal year. Exports, mainly of automobile-related goods, have declined significantly of late due to a substantial decrease in overseas demand and a resultant increase in inventory adjustments. However, they are expected to pick up moderately through the second half of the fiscal year on the back of the progress in inventory adjustments and a rise in overseas demand that reflects the resumption of economic activity. Meanwhile, inbound tourism demand, which is a component of services exports, is likely to remain subdued for a while, reflecting a significant decline in the number of inbound visitors due to entry restriction measures. Private consumption seems to have decreased significantly in the April-June quarter, mainly in services such as eating and drinking as well as accommodations, reflecting self-restraint from going outside and business restrictions under the declaration of a state of emergency. Thereafter, with businesses reopening, it is expected to pick up through the second half of the fiscal year, backed by income support measures such as special cash payments. However, it seems inevitable that the pace of a pick-up in private consumption will be only moderate given that

people will continue to be vigilant against COVID-19 and to ensure social distancing. Business fixed investment is likely to turn to a downtrend, with an increasing number of non-urgent projects, mainly regarding machinery investment, being postponed due to the decline in corporate profits and increasing uncertainties over the future. Meanwhile, although expenditure on temporary facilities accompanying the hosting of the Olympic Games has been postponed to fiscal 2021, government spending is expected to continue increasing moderately due to expansion such as in construction related to restoration and reconstruction following natural disasters, as well as to national resilience.

In fiscal 2021, as the impact of COVID-19 wanes worldwide and the growth rates of overseas economies rise clearly, an improving trend in Japan's economy is expected to become evident. This is likely to be supported by accommodative financial conditions, the effects of various demand stimulus measures, the materialization of pent-up demand, and an improvement in sentiment that reflects the hosting of the Olympic Games. Amid a recovery in overseas economies, exports are expected to increase firmly, supported by the materialization of pent-up demand and the recovery in production. As the impact of COVID-19 continues to wane, private consumption is likely to increase moderately, supported by a pick-up in employee income, the effects of various demand stimulus measures, and Olympic Games-related demand. With corporate profits improving, business fixed investment is expected to increase, albeit with some time lag, pushed up by undertaking postponed investment projects and an increase in

IT-related investment to set up teleworking systems and remote services. Meanwhile, government spending is likely to be at a high level on the back of disaster-related reconstruction, river flood control projects, infrastructure enhancements, and Olympic Games-related expenditure.

In fiscal 2022, the economy is expected to continue growing firmly, led by increases in exports and business fixed investment that reflect an improvement in overseas economies. Exports are likely to continue increasing clearly, reflecting an improvement in overseas economies. In this situation, corporate profits are expected to follow their improving trend. Regarding business fixed investment, machinery investment is likely to see an acceleration in its growth pace, and IT-related investment as well as research and development (R&D) investment for growth areas also are likely to continue increasing. Private consumption is expected to continue increasing moderately, with a virtuous cycle from income to spending operating. Meanwhile, although Olympic Games-related expenditure will have been completed, government spending is likely to be at a high level, due partly to demand for maintenance and replacement of decaying infrastructures.

B. Developments in Major Expenditure Items and Their Background

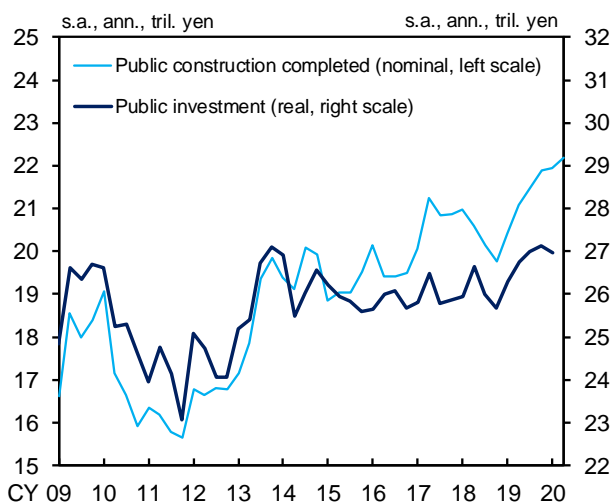
Government Spending

Public investment has increased moderately (Chart 6). The amount of public construction completed, which is a coincident indicator, has followed its moderate uptrend since early 2019. The value of public works contracted, as well as orders received for public construction, both of which are leading indicators, have been on a moderate uptrend, albeit with fluctuations, reflecting the progress in construction related to restoration and reconstruction following natural disasters, as well as to national resilience.⁸ As for the outlook, public investment is expected to increase steadily, reflecting the progress in infrastructure-related construction, and then be at a relatively high level from fiscal 2021 onward, mainly supported by Olympic Games- and infrastructure-related construction.⁹

Overseas Economies

Overseas economies have been depressed significantly, reflecting the impact of the COVID-19 pandemic, although they have shown

Chart 6: Public Investment



Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Note: The figure for 2020/Q2 is that for April.

⁸ In view of the three-year emergency response plan for disaster prevention, disaster mitigation, and building national resilience decided by the Cabinet in December 2018 -- with a total project size of around 7 trillion yen -- measures to maintain functions, such as of important infrastructure, are to be implemented intensively over three years from fiscal 2018 through fiscal 2020.

⁹ It is assumed that public investment will be pushed up by the Comprehensive Economic Measures to Create a Future with Security and Growth -- with a project size of around 26.0 trillion yen and fiscal spending of around 13.2 trillion yen -- which was decided by the Cabinet in December 2019, mainly led by construction related to restoration and reconstruction following natural disasters as well as to flood control.

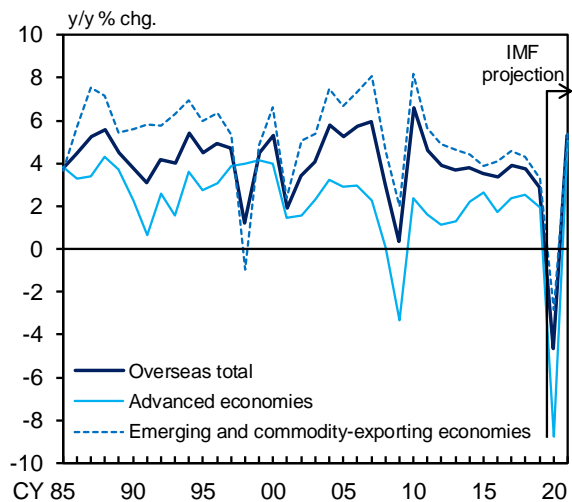
signs of heading toward a pick-up (Chart 7).¹⁰ Economic activity resumed first in China, where the spread of COVID-19 subsided earlier than any other places. Subsequently, resumption has been observed in European countries and the United States, since the strict public health measures, such as restrictions on going outside and suspension in business and production activities, have been lifted gradually, mainly in areas where the spread has almost subsided. The Global PMI shows that business sentiment has shown signs of heading toward a pick-up recently, reflecting the resumption of economic activity (Chart 8). That said, private consumption and business fixed investment have been depressed significantly in many economies due to vigilance against COVID-19, a global deterioration in the employment situation, and a decline in corporate profits.

Looking at developments by major region, the Chinese economy has picked up due to the emergence of the effects of aggressive macroeconomic policies and the materialization of pent-up demand. The U.S. and European economies have been depressed significantly, although there have been some signs of heading toward a pick-up. Emerging and commodity-exporting economies other than China have plunged with COVID-19 continuing to spread.

With regard to the outlook, as the impact of COVID-19 wanes, overseas economies are likely

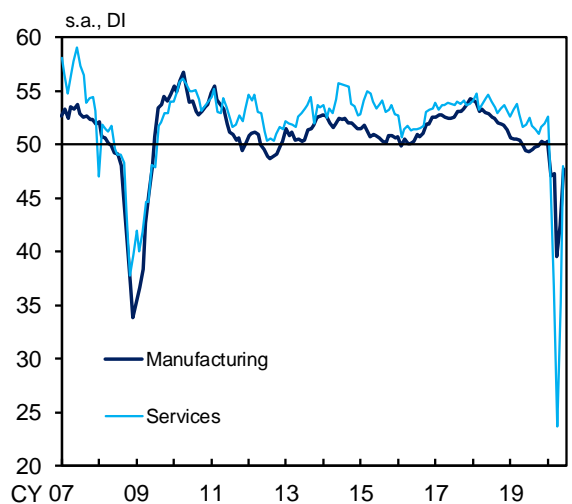
¹⁰ With regard to the impact of COVID-19 on developments in overseas economies, see Box 1.

Chart 7: Overseas Economies



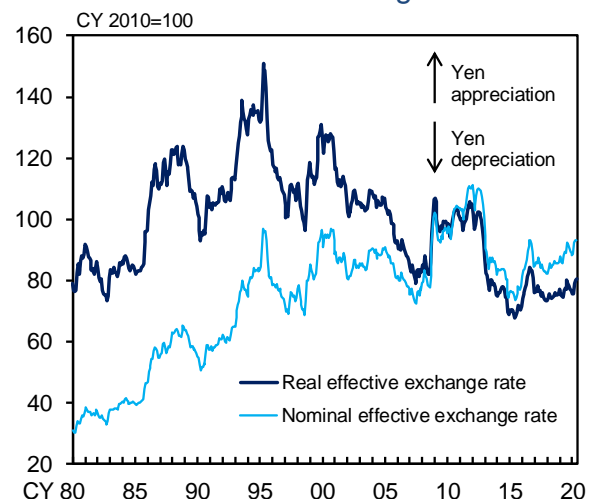
Sources: IMF; Ministry of Finance.
 Note: Figures are the weighted averages of real GDP growth rates using countries' share in Japan's exports as weights. Annual GDP growth rates are from the "World Economic Outlook (WEO)" as of April 2020 and the "WEO update" as of June 2020. Advanced economies consist of the United States, the euro area, and the United Kingdom. Emerging and commodity-exporting economies consist of the rest of the world economy.

Chart 8: Global PMI



Source: IHS Markit (© and database right IHS Markit Ltd 2020. 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 9: Effective Exchange Rates



Source: BIS.
 Note: Figures are based on the broad index of the "Effective Exchange Rate." Those prior to 1994 are calculated using the narrow index.

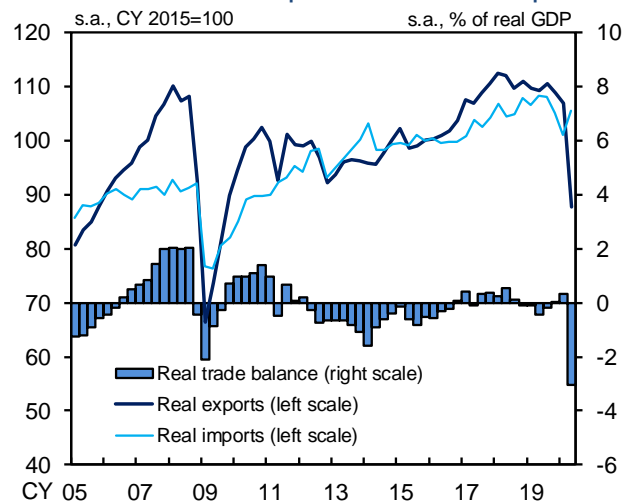
to recover from being depressed significantly, pushed up by the materialization of pent-up demand and the recovery in production, as well as supported by aggressive macroeconomic policies taken by each country and region. That said, the pace of recovery is expected to be only moderate since precautionary efforts made voluntarily by firms and households will continue to act as a force constraining economic activity.

There are extremely high uncertainties over the outlook for overseas economies, since it could change depending on the consequences of COVID-19 and the magnitude of their impact on those economies. In fact, the number of confirmed cases is still increasing in emerging economies, such as Central and South America as well as India, and in the United States.

Exports and Imports

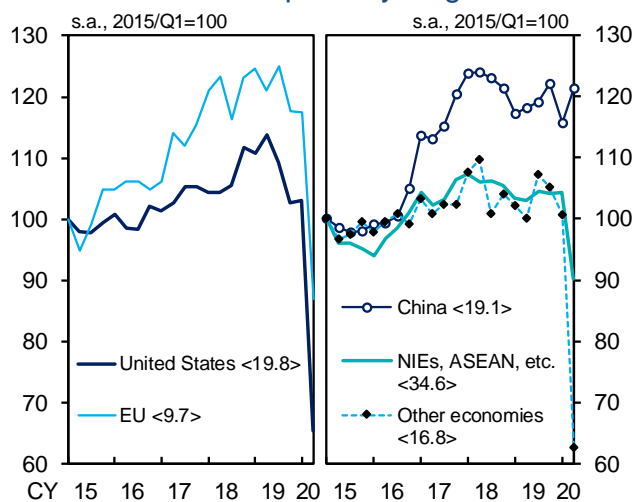
Exports have declined substantially with overseas economies being depressed significantly (Chart 10). By region, exports to advanced economies such as the United States and the European Union (EU) have declined substantially, mainly for automobile-related goods, with the impact of strict public health measures taken by each economy remaining (Chart 11). Regarding exports to emerging economies, those to China have picked up, whereas those to the NIEs and the ASEAN countries as well as other regions have decreased significantly. By goods, exports of automobile-related goods have declined substantially against the background of a rapid decline in global automobile sales, mainly in the United States and Europe, and of the resultant inventory adjustments (Chart 12). Exports of

Chart 10: Real Exports and Real Imports



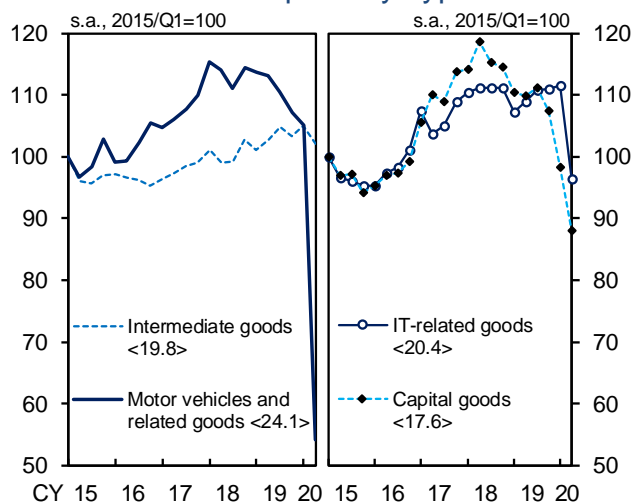
Sources: Bank of Japan; Ministry of Finance; Cabinet Office.
Note: Based on staff calculations. Figures for 2020/Q2 are April-May averages.

Chart 11: 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 2019. Figures for 2020/Q2 are April-May averages.
2. "EU" does not include the United Kingdom for the entire period.

Chart 12: 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 2019. Figures for 2020/Q2 are April-May averages.

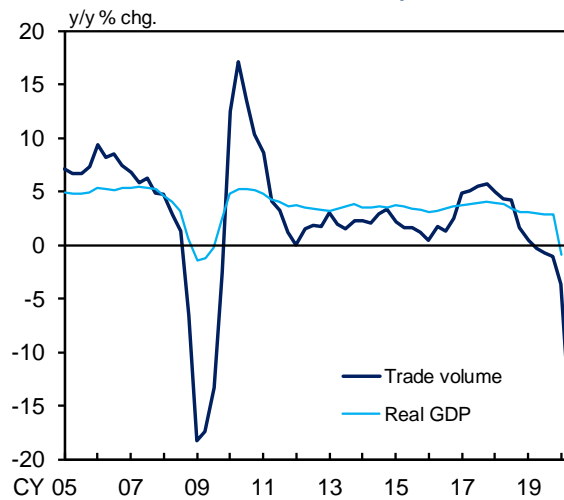
capital goods have continued to decline clearly, mainly for metalworking machinery and construction machines, reflecting a global postponement of business fixed investment, although they have been firm for semiconductor production equipment. On the other hand, IT-related exports have declined recently, mainly for parts for on-board equipment for motor vehicles and parts for smartphones, but the decline has been relatively small, supported by firm developments in parts for data centers and in those related to personal computers. Exports of intermediate goods have been more or less flat, with an increase in exports of chemicals to China offset by a decline in those of iron and steel, mainly to the NIEs and the ASEAN countries.

It is likely that exports will be at low levels for the time being, mainly for automobile-related goods, but will stop declining and then head toward a pick-up as the impact of COVID-19 wanes worldwide. By goods, exports of automobile-related goods are expected to be at low levels for the time being but start picking up gradually, reflecting a recovery in automobile sales in the United States and China, as well as progress in the inventory adjustments. Capital goods exports are likely to remain on their downtrend for a while, mainly for machine tools for automobile-related goods and construction machines for the resources industry. The uptrend in IT-related exports is likely to become evident gradually on the back of continuing firm demand for parts for data centers and for those related to personal computers, as well as increasing demand for parts for 5G-related equipment.

Looking at the outlook for exports relative to the world trade volume, they are likely to increase. This is based on the projection that (1) the world trade volume will return to its uptrend and (2) Japan's share of exports in world trade also will pick up, reflecting a recovery in exports of automobile-related goods and capital goods (Charts 13 and 14).¹¹ The growth in the world trade volume is expected to remain negative on an annual basis for the time being due to the impact of COVID-19, but will likely stop declining, reflecting a recovery in production activity of manufacturing firms on a global basis, and then head toward a pick-up gradually. Thereafter, the growth in the world trade volume is expected to accelerate. This is based on the projection that (1) IT-related exports will be firm as a trend, (2) downward pressure on automobile sales, stemming from the impact of COVID-19, will wane, and (3) business fixed investment, which had been postponed because of high uncertainties, will be undertaken gradually. On the other hand, Japan's share of exports in world trade is likely to be at a low level for the time being, reflecting declines in automobile-related goods and capital goods, in which Japan has a comparative advantage, but pick up thereafter on the back of a recovery in global demand for business fixed investment and in global automobile sales.

Imports decreased in the January-March quarter due to the impact of the spread of COVID-19 in China, but have picked up recently, mainly for consumer goods -- such as personal computers, mobile phones, and masks -- reflecting a

Chart 13: World Trade Volume and Real GDP of the World Economy



Sources: CPB Netherlands Bureau for Economic Policy Analysis; IMF, etc.
 Notes: 1. Figures for the trade volume are those for real imports.
 The figure for 2020/Q2 is the percentage change from the April-June 2019 average to April 2020.
 2. Real GDP of the world economy is based on staff calculations using GDP shares of world total GDP from the IMF as weights.

Chart 14: Japan's Share of Exports in World Trade



Source: CPB Netherlands Bureau for Economic Policy Analysis.
 Note: Japan's share of exports in world trade is obtained by dividing Japan's real exports by world real imports (2010 prices). The figure for 2020/Q2 is that for April.

¹¹ The world trade volume is calculated by adding up real imports in each country.

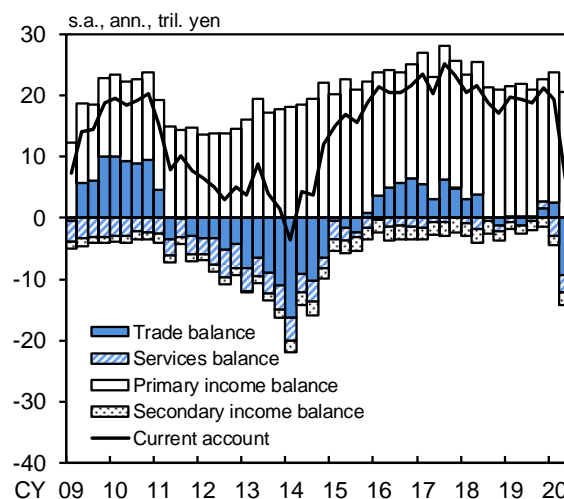
resumption of production activity in China (Chart 10). Imports are likely to be under downward pressure stemming from weak production activity in Japan for the time being, but an uptrend is expected to become evident thereafter, reflecting the resumption of domestic economic activity.

External Balance

The nominal current account surplus has declined (Chart 15). Looking at the breakdown of developments in the current account balance, the nominal trade balance has marked a relatively large deficit, due mainly to a significant decline in goods exports. The services balance also has marked a deficit, reflecting a significant deterioration in the travel balance that is due to a decline in inbound tourism demand. On the other hand, the primary income balance has maintained a relatively large surplus, supported mainly by the interest income from past securities investment.

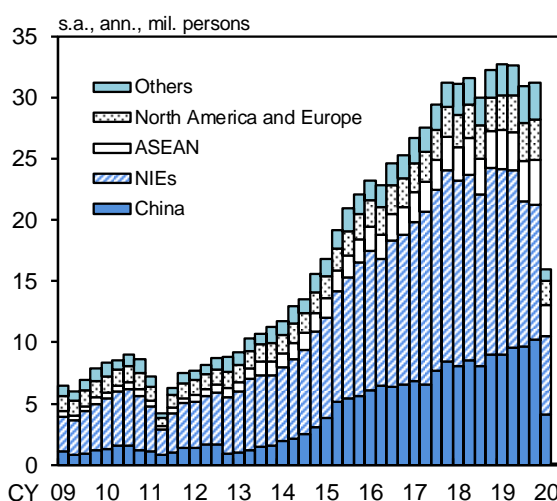
Meanwhile, the number of inbound visitors (on a seasonally adjusted annualized basis) recently has dropped sharply from last year's level, which exceeded 30 million, to roughly tens of thousands, mainly as a result of the tightening of entry restriction measures that reflects the COVID-19 pandemic (Chart 16). As a result of these developments, travel receipts have declined significantly. Although travel payment has decreased due to a smaller number of departures that is attributable to the tightening of travel restrictions, the net travel balance has deteriorated since the impact of the decline in receipts is larger than that in payment.

Chart 15: Current Account



Source: Ministry of Finance and Bank of Japan.
Note: Figures for 2020/Q2 are April-May averages.

Chart 16: Number of Inbound Visitors



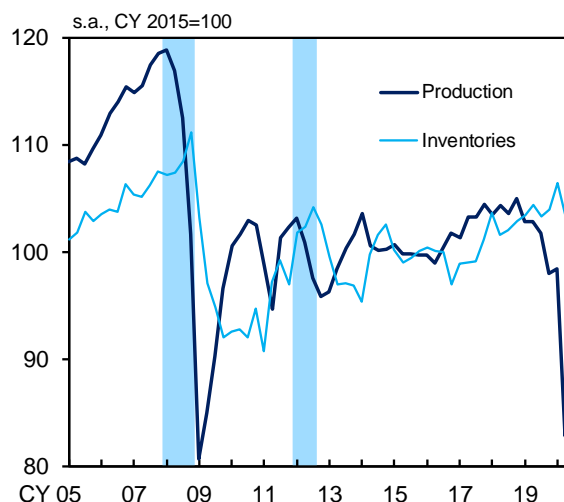
Source: Japan National Tourism Organization (JNTO).
Note: North America and Europe consist of the United States, Canada, the United Kingdom, France, and Germany. Figures for 2020/Q2 are April-May averages.

Industrial Production

Industrial production has declined substantially amid a considerable decline in exports (Chart 17). By major industry, transport equipment production has decreased significantly. This is attributable to a substantial decline in production of parts related to automobiles that reflects a rapid decline in global automobile sales and the resultant inventory adjustments, as well as to a decline in production of parts related to aircraft. The production decline in transport equipment also has led to a significant decline in relevant industries such as iron and steel, as well as nonferrous metals. Although the production of semiconductor production equipment has remained firm, that of machinery (i.e., "general-purpose, production, and business-oriented machinery" in the *Indices of Industrial Production*) has declined, mainly for construction machines and metalworking machinery. On the other hand, a decline in the production of electronic parts and devices has been relatively small, since demand for parts for data centers and for those related to personal computers has increased firmly while the production of parts for on-board equipment for motor vehicles and parts for smartphones has declined. Meanwhile, the shipments-inventories balance (i.e., the year-on-year rate of change in shipments minus that in inventories) recently has deteriorated to a relatively large degree, due mainly to developments in transport equipment production (Chart 18).

Industrial production is likely to be at a low level for the time being, due to a depression in overseas economies stemming from the impact of COVID-19 and to inventory adjustments. However,

Chart 17: Industrial Production



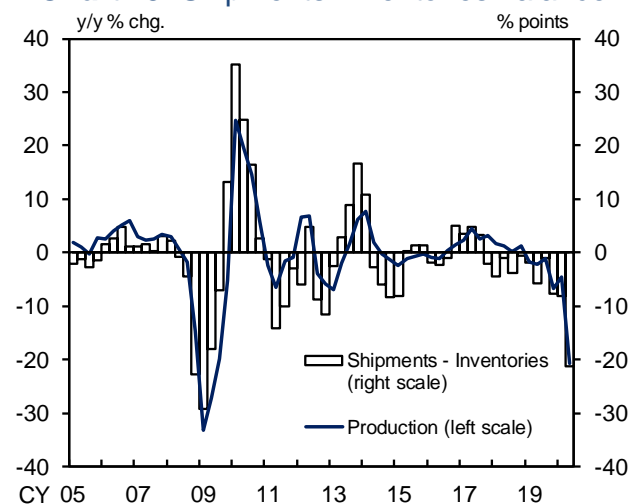
Source: Ministry of Economy, Trade and Industry (METI).

Notes: 1. Shaded areas indicate recession periods.

2. The production figures for 2020/Q2 and Q3 are calculated based on METI projections for June and July 2020.

The inventories figure for 2020/Q2 is that for May.

Chart 18: Shipments-Inventories Balance



Source: Ministry of Economy, Trade and Industry.

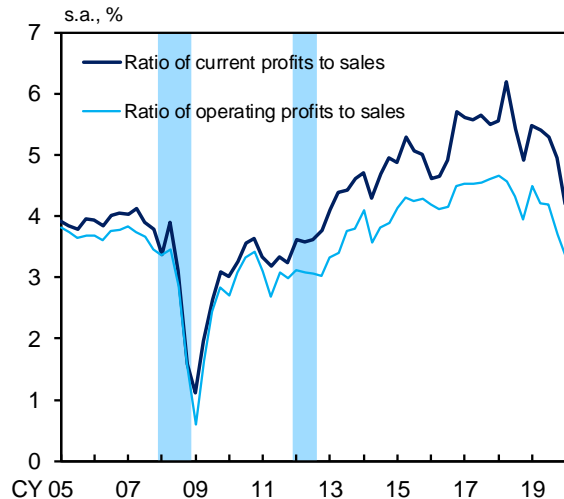
Note: The production figure and the shipments figure for 2020/Q2 are April-May averages. The inventories figure for 2020/Q2 is that for May.

it is expected to bottom out and then head toward a pick-up as the impact of COVID-19 wanes worldwide and inventory adjustment progresses. Thereafter, with overseas economies continuing to grow steadily, the uptrend in industrial production is expected to become evident gradually, supported by the materialization of pent-up demand and the recovery in production from the decline brought about by COVID-19.

Corporate Profits

Corporate profits have deteriorated due to the impact of COVID-19. According to the *Financial Statements Statistics of Corporations by Industry, Quarterly* (FSSC), the ratios of profits to sales for all industries and enterprises declined from last year, reflecting the effects of the slowdown in overseas economies and the consumption tax hike, and the downtrend became evident for the January-March quarter, pushed down also by the impact of COVID-19 (Chart 19).¹² Recently, corporate profits have been supported by an improvement in the terms of trade due to the decline in crude oil prices and by various income support measures. However, since the impact of the sales decline due to decreases mainly in exports and private consumption is large, corporate profits seem to have declined significantly, also taking into account deterioration in business sentiment, as described below.

Chart 19: Corporate 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 exclude "pure holding companies."
 3. Shaded areas indicate recession periods.

¹² As for the FSSC, since the response rate for the January-March survey declined due to the impact of COVID-19, the Ministry of Finance extended the deadline of the survey by around 2 months and accordingly decided to release the revised figures on July 27, 2020.

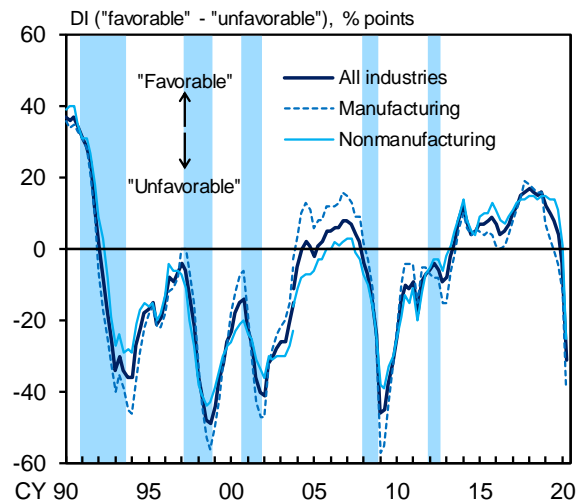
Business sentiment has deteriorated, reflecting a decline in domestic and overseas demand. According to the DI for business conditions in the June 2020 *Tankan*, that for all industries and enterprises has declined substantially in negative territory, reflecting the impact of COVID-19 (Chart 20). By industry, the DI for the manufacturing sector has continued to deteriorate significantly in a wide range of industries, mainly for automobiles as well as iron and steel. With regard to the DI for the nonmanufacturing sector, those for accommodations, eating and drinking services, as well as services for individuals have continued to deteriorate significantly, mainly against the background of self-restraint from going outside and holding events, as well as of business restrictions.

Corporate profits are likely to be under strong downward pressure for the time being due to the impact of COVID-19. Thereafter, however, with the impact waning worldwide, they are expected to gradually return to their improving trend, reflecting a recovery in domestic and overseas demand supported also by the materialization of pent-up demand.

Business Fixed Investment

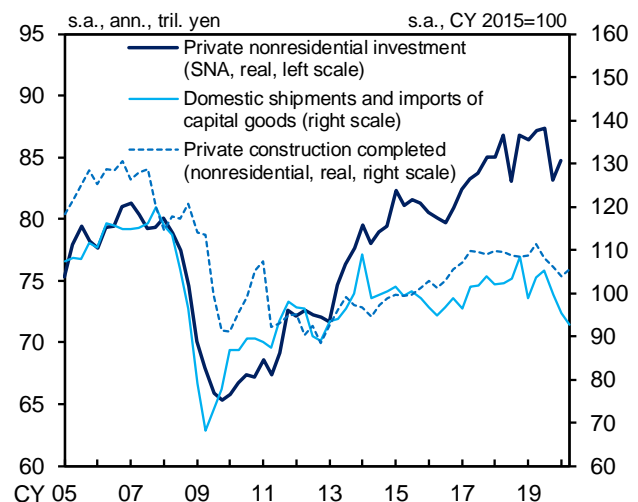
Business fixed investment has been more or less flat (Chart 21). Excluding IT-related goods, such as personal computers, that have been firm, mainly reflecting an increase in working from home, the aggregate supply of capital goods -- a coincident indicator of machinery investment -- has shown some weakness on the whole due to a rapid decline in exports and increasing uncertainties over the future. Private construction

Chart 20: Business Conditions



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

Chart 21: Coincident Indicators of Business Fixed Investment



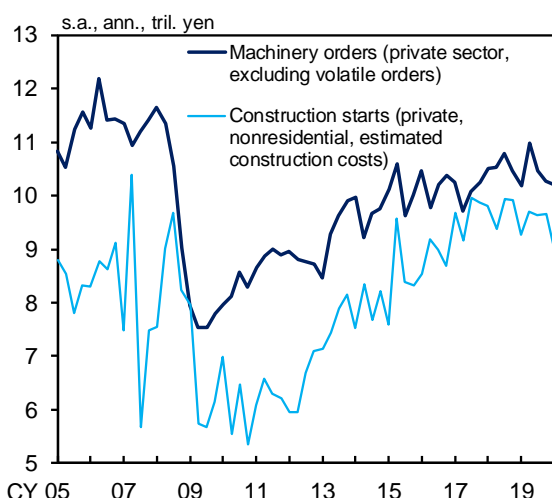
Sources: Cabinet Office; Ministry of Economy, Trade and Industry; Ministry of Land, Infrastructure, Transport and Tourism.
Notes: 1. The figure for domestic shipments and imports of capital goods for 2020/Q2 is the April-May average. The figure for private construction completed for 2020/Q2 is that for April.
2. Real private construction completed is based on staff calculations using price indices in the "Construction Cost Deflators."

completed (nonresidential) -- a coincident indicator of construction investment -- has been more or less flat, albeit remaining at a high level.

A declining trend in machinery orders -- a leading indicator of machinery investment -- has become evident recently, pushed down by a decline in the growth rates of overseas economies since last year and an increase in uncertainties due to COVID-19 (Chart 22). Construction starts (in terms of planned expenses for private and nonresidential construction) -- a leading indicator of construction investment -- have been more or less flat on the whole, since the number of factories and stores has decreased while that of warehouses, such as logistics facilities, has increased. Looking at the business fixed investment plan 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 -- in all industries and enterprises including financial institutions and holding companies, etc.) is expected to remain positive on an annual basis for fiscal 2020. However, the rate of increase was the lowest since fiscal 2009 among past figures for the June surveys (Chart 23).

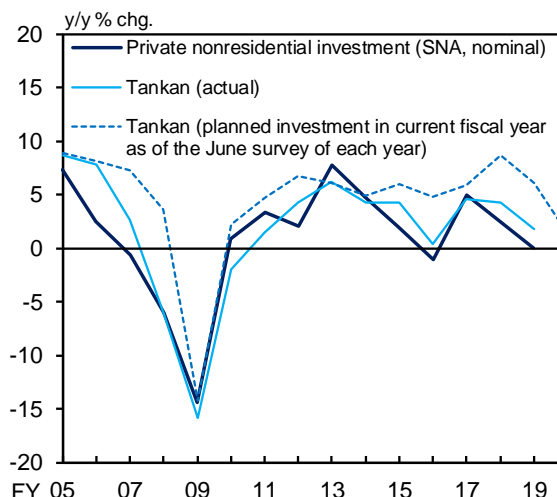
As for the outlook, with downward pressure on corporate profits remaining and uncertainties over COVID-19 continuing to be high, business fixed investment is likely to turn to a downtrend, mainly for automobiles -- which are affected largely by a global decline in demand -- and for eating and drinking services as well as accommodations -- of which financial positions have deteriorated due to

Chart 22: Leading Indicators of Business Fixed Investment



Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Notes: 1. Volatile orders: orders for ships and orders from electric power companies.
2. Figures for 2020/Q2 are April-May averages.

Chart 23: 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 until the December 2016 survey). The figures are for all industries including financial institutions and holding companies, etc. (figures up to the March 2020 survey exclude holding companies, etc.).

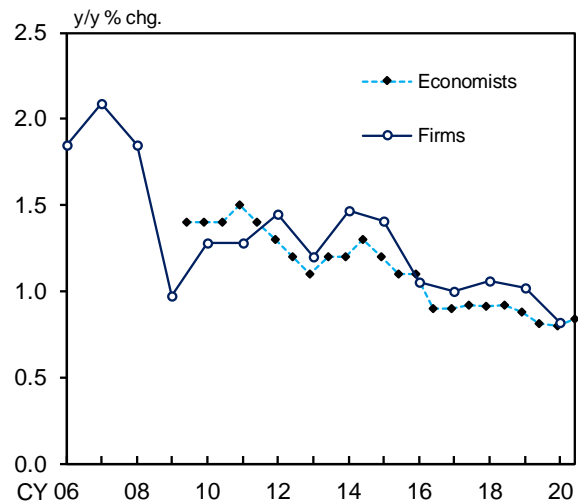
the effects of a decline in domestic services consumption. That said, it is assumed that an adjustment in capital stock will not be as significant as what was observed at the time of the global financial crisis. This is because many of the medium- to long-term projects, such as R&D and IT-related investments, are likely to continue to be undertaken, while it is expected that accommodative financial conditions will be maintained owing to aggressive measures to support financing taken by the Bank and the government, thereby preventing firms' growth expectations from declining substantially (Charts 24 and 25).¹³ From a somewhat long-term perspective, with the impact of COVID-19 waning worldwide, business fixed investment is likely to return to a moderate uptrend, with some time lag from an improvement in corporate profits. Specifically, it is expected to be led mainly by (1) IT-investment that is related to telework and remote services, (2) construction investment in logistics facilities reflecting an expansion in e-commerce, and (3) software and R&D investments for growth areas.

Employment and Income Situation

With the continuing impact of COVID-19, the employment and income situation has been weak.

On the employment side, labor demand has weakened significantly due to the impact of COVID-19. According to the *Labour Force Survey*, the year-on-year rate of change in the number of

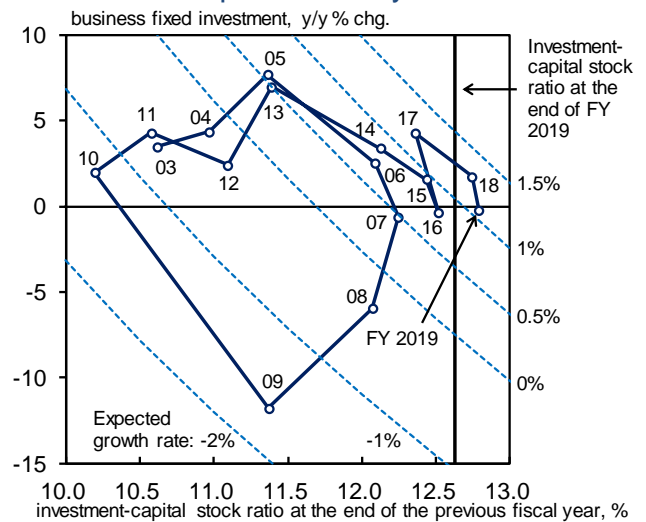
Chart 24: Medium- to Long-Term Real GDP Growth Forecasts



Sources: Cabinet Office; JCER, "ESP Forecast Survey."

- Notes: 1. The horizontal axis represents the time the surveys were conducted.
 2. The forecasts of economists are taken from the "ESP Forecast Survey" and are the averages of the 2-to-6-year-ahead growth rate forecasts in the June and December surveys of each year. The latest figure is for June 2020.
 3. The forecasts of firms are the fiscal year averages of firms' forecasts for the next five years in the "Annual Survey of Corporate Behavior" conducted in January of each year. Figures are for listed firms in all industries.

Chart 25: Capital Stock Cycles



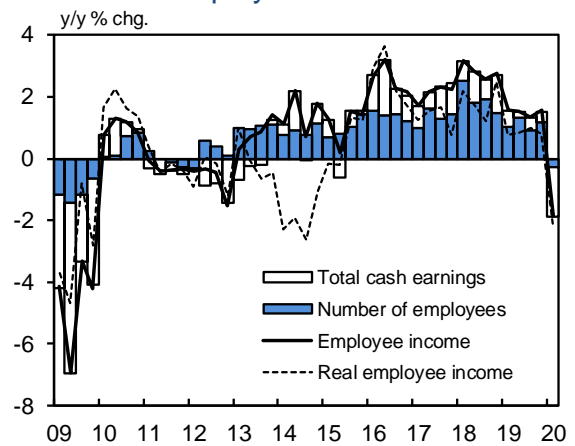
Source: Cabinet Office.

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.

¹³ See Box 2 for features of firms' behavior that has been affected by COVID-19.

employees has been negative recently for the first time since the end of 2012 due to a clear decline mainly in the number of non-regular employees such as part-time and temporary workers (Chart 26). The rate of decline in the number of employed persons for the April-May period has accelerated, which reflects a decrease in the number of not only employees but also self-employed and family workers. With regard to labor market conditions, the active job openings-to-applicants ratio has declined clearly, reflecting a significant decrease in job openings (Chart 2). The employment conditions DI in the *Tankan* shows that the perception of labor shortage has diminished substantially on the whole, as seen in the DIs for accommodations as well as eating and drinking services having turned to a net "excessive." Reflecting these developments, the unemployment rate has risen to around 3 percent recently, but the rise has been constrained compared with the decline in the number of employed persons. This is because those who lost their jobs have refrained from seeking new ones due to vigilance against COVID-19 and the effects of school closures, thereby being temporarily out of the labor force. Thus, the labor force participation rate has declined recently, mainly for seniors and women (Chart 27). Meanwhile, looking at the number of employed persons in detail, the number of employed persons whose working hours were zero in the last week of each month (i.e., "employed persons not at work") spiked for the April-May period. This indicates that potential employment adjustments have remained strong (Chart 28).

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 are based on continuing observations following the sample revisions of the "Monthly Labour Survey."

4. Real employee income is based on staff calculations using the CPI (less imputed rent).

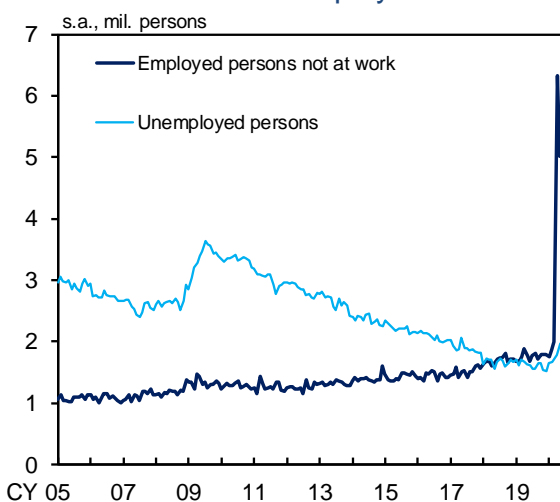
Chart 27: Labor Force Participation Rate



Source: Ministry of Internal Affairs and Communications.

Note: The figure for 2020/Q2 is the April-May average.

Chart 28: Number of Employed Persons not at Work and Unemployed Persons

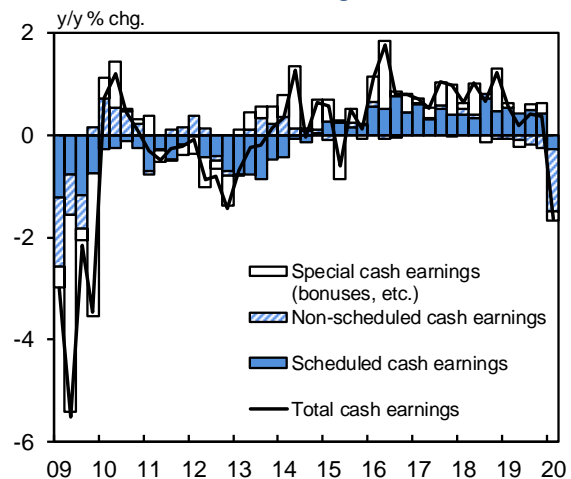


Source: Ministry of Internal Affairs and Communications.

As for the outlook, the number of employees is expected to follow a decreasing trend for the time being with employment adjustments remaining, mainly in the services industry, such as eating and drinking as well as accommodations, and in the automobile industry, both of which are largely affected by a decrease in demand. That said, the decline in the number of employees will likely be constrained compared with the depressed economic activity. This is because the employment adjustment subsidies, which have been expanded in response to the current situation, are expected to somewhat halt job cuts, and because the Bank's and the government's measures to support financing are expected to help prevent firms from going bankrupt and discontinuing their businesses. From a somewhat long-term perspective, the number of employees is likely to stop declining and turn to a pick-up as the impact of COVID-19 wanes, partly supported by the government's measures to stimulate demand.

On the wage side, the year-on-year rate of change in total cash earnings per employee has shown a relatively large decline recently, pushed down by the rate of decline in non-scheduled cash earnings having accelerated and the rate of change in scheduled cash earnings having turned negative (Chart 29).¹⁴ Looking at developments in nominal wages in detail, the year-on-year rate of change in scheduled cash earnings of full-time employees, which had been positive thus far, has turned slightly negative, pushed down by an increasing number of "employed persons not at

Chart 29: Nominal Wages



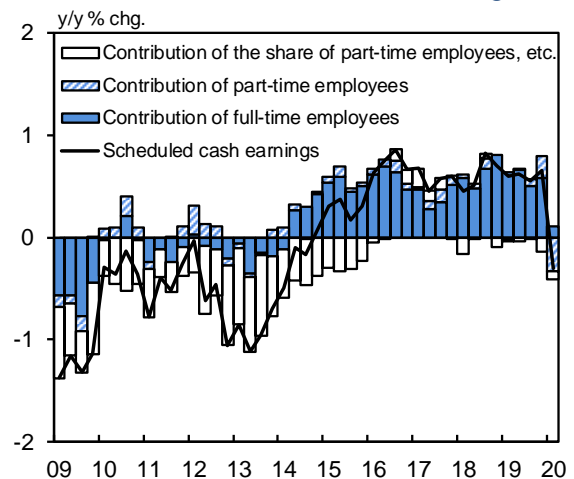
Source: Ministry of Health, Labour and Welfare.
 Notes: 1. Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February.
 2. Figures from 2016/Q1 are based on continuing observations following the sample revisions.

¹⁴ Wages in the *Monthly Labour Survey* are assessed on the basis of continuing observations, which are less affected by the sample revisions.

work" (Chart 30).¹⁵ That in scheduled cash earnings of part-time employees also has been clearly negative, mainly reflecting a significant decline in working hours. In addition to the underlying downward pressure brought about by working-style reforms, non-scheduled hours worked have declined recently due to the impact of COVID-19, leading to a significant decline in non-scheduled cash earnings.

With regard to the outlook for wages, scheduled cash earnings of full-time employees are likely to be pushed down by the number of "employed persons not at work" remaining high, although the year-on-year rate of change in base pay was positive as a result of this year's annual spring labor-management wage negotiations. In addition, scheduled cash earnings of part-time employees are projected to decline, since deterioration in labor market conditions and the decline in working hours are expected to exert downward pressure. The rate of change in special cash earnings (bonuses) also will likely register relatively large negative growth for the time being, in line with deterioration in corporate profits with some time lag. Under this situation, the year-on-year rate of change in total cash earnings per employee is projected to be clearly negative on the whole for the time being. Thereafter, it is likely to return to a moderate increasing trend, on the back of a tightening of labor market conditions and improvement in corporate profits, both reflecting an economic improvement.

Chart 30: 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 are based on continuing observations following the sample revisions.

¹⁵ The Labor Standards Act stipulates that employers shall pay to their employees allowances for absence from work that are equivalent to 60 percent or more of the employees' average wages. If the amount of allowance is less than the average wage, the year-on-year rate of change in scheduled cash earnings will be pushed down accordingly.

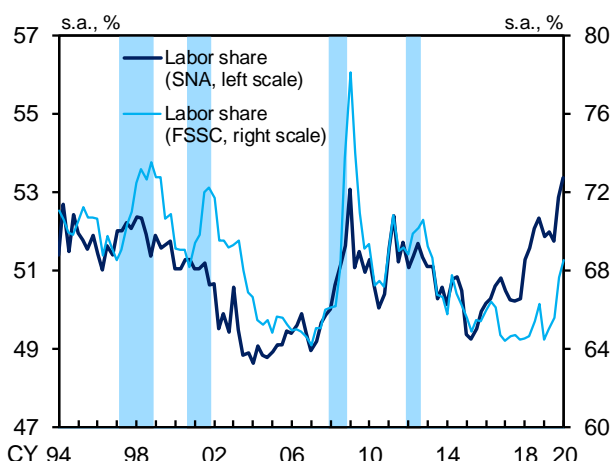
In light of the aforementioned employment and wage conditions, employee income is projected to decline clearly for the time being. Thereafter, it is likely to return to a moderate increasing trend, reflecting an economic improvement. The labor share has risen significantly of late, due to labor hoarding by firms and wage stickiness. As for the outlook, however, the share is likely to turn to a moderate decreasing trend, with the growth in nominal GDP rising (Chart 31).

Household Spending

Private consumption decreased significantly, mainly in services such as eating and drinking as well as accommodations, but has shown signs of a pick-up recently.

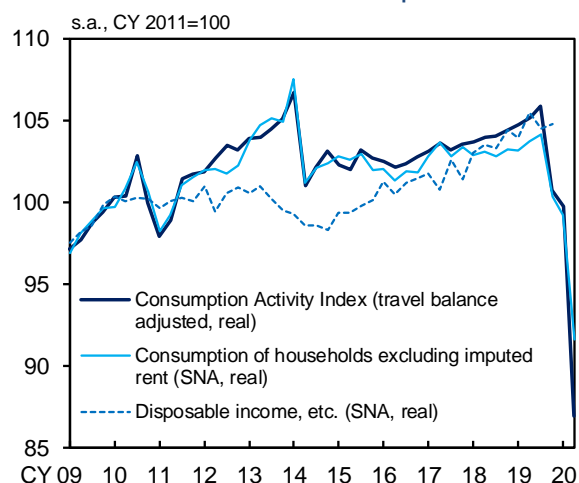
The Consumption Activity Index (CAI, travel balance adjusted) -- which is calculated by combining various sales and supply-side statistics from the viewpoint of gauging Japan's consumption activity in a comprehensive manner -- declined significantly for the October-December quarter of 2019 due to the effects of the consumption tax hike and natural disasters.¹⁶ Subsequently, the CAI for the January-March quarter of 2020 registered a decline for two consecutive quarters due to the impact of COVID-19. That for the April-May period declined further, reflecting the effects of the declaration of a state of emergency and the expansion in the areas where it was declared (Charts 32 and 33). Based on various sources, such as

Chart 31: Labor Share



Sources: Cabinet Office; Ministry of Finance.
 Notes: 1. Labor share (SNA) = compensation of employees / nominal GDP × 100
 2. The labor share (FSSC) is based on the "Financial Statements Statistics of Corporations by Industry, Quarterly (FSSC)" and excludes "finance and insurance." Figures from 2009/Q2 exclude "pure holding companies."
 3. Labor share (FSSC) = personnel expenses / (operating profits + personnel expenses + depreciation expenses) × 100
 4. Shaded areas indicate recession periods.

Chart 32: Private Consumption



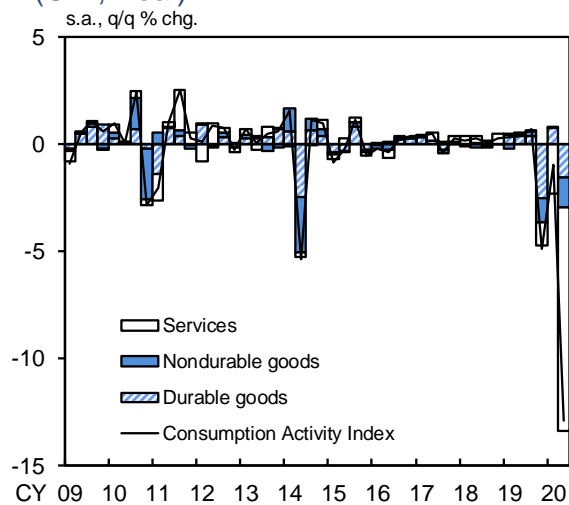
Sources: Bank of Japan; Cabinet Office, etc.
 Notes: 1. The Consumption Activity Index is based on staff calculations. Figures for the Consumption Activity Index (travel balance adjusted) exclude inbound tourism consumption and include outbound tourism consumption. The figure for 2020/Q2 is the April-May average.
 2. The figure for consumption of households excluding imputed rent for 2020/Q2 is based on staff calculations using the "Synthetic Consumption Index" (April).
 3. "Disposable income, etc." consists of disposable income and "adjustment for the change in pension entitlements." Real values are obtained using the deflator of consumption of households.

¹⁶ Regarding the CAI, see the Bank's research paper "Revision of the Consumption Activity Index to Address the 2008 SNA and Improve Accuracy" published in April 2018.

high-frequency indicators, statistics published by industry organizations, and anecdotal information from firms, although consumption activities are still at a low level, it seems to be gradually heading toward a pick-up from June along with the resumption of economic activity.¹⁷

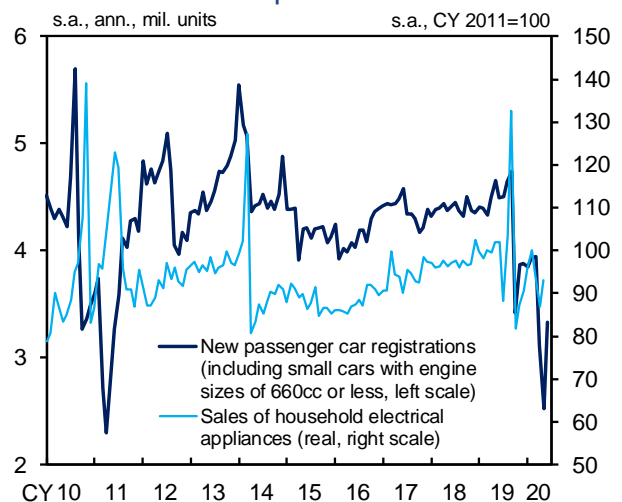
Looking at private consumption by type, durable goods increased temporarily for the January-March quarter since the effects of the consumption tax hike and natural disasters waned. However, they decreased again for the April-May period due to the intensifying effects of temporary store closures and self-restraint from going outside (Chart 34). Specifically, automobile sales declined substantially, mainly reflecting the effects of a decline in the number of customers visiting dealerships and supply-side constraints on imported parts, both of which are due to the impact of COVID-19. However, the sales have started to pick up recently. Sales of household electrical appliances declined through April due to the effects of shorter operating hours of stores and temporary closures. To date, however, they have picked up, mainly led by personal computers, televisions, and white goods, on the back of store businesses normalizing gradually. With regard to nondurable goods, the rates of increase in food and daily necessities have decelerated, due partly to the shift to dining-out. On the other hand, clothes have picked up in reflection of businesses reopening, although they declined mainly against the background of fewer people going outside and of temporary store closures. Services consumption has declined substantially, mainly

Chart 33: Consumption Activity Index (CAI, Real)



Sources: Bank of Japan, etc.
 Notes: 1. Based on staff calculations. The Consumption Activity Index is adjusted for the travel balance. Figures for the components are not adjusted for the travel balance. Figures for 2020/Q2 are April-May averages.
 2. Nondurable goods include goods classified as "semi-durable goods" in the SNA.

Chart 34: Consumption of Durable Goods



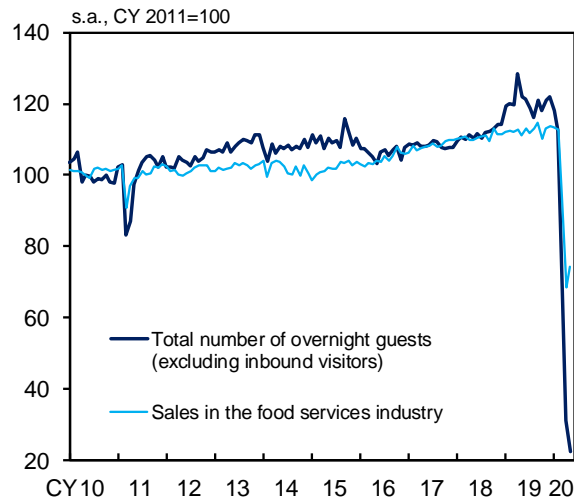
Sources: Japan Automobile Dealers Association; Japan Light Motor Vehicle and Motorcycle Association; Ministry of Economy, Trade and Industry; Ministry of Internal Affairs and Communications.

Note: Figures for real sales of household electrical appliances are based on staff calculations using the retail sales index of machinery and equipment in the "Current Survey of Commerce" and the price index of related items in the CPI.

¹⁷ Box 3 outlines the impact of COVID-19 on developments in private consumption to date, using high-frequency data.

for selective expenditures of services such as dining-out and accommodations (Chart 35). This reflects self-restraint from going outside, temporary store closures, and shorter operating hours, all of which are due to the impact of COVID-19. With regard to dining-out, fast food has been supported mainly by demand for take-out and delivery services, and the number of diners seems to have somewhat picked up recently with the state of emergency lifted. However, *izakaya* (Japanese-style bars) and chain restaurants have remained at low levels. Both overseas and domestic travel have remained weak to a considerable degree with the continuing impact of COVID-19.

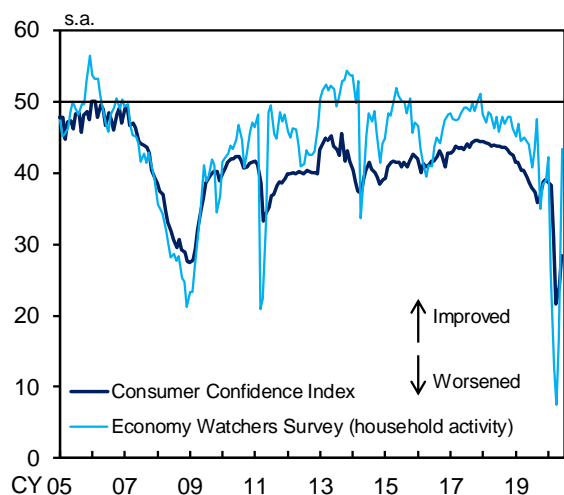
Chart 35: Consumption of Services



Sources: Japan Tourism Agency; Japan Foodservice Association, "Market Trend Survey of the Food Services Industry."
 Note: Figures for the "total number of overnight guests (excluding inbound visitors)" in 2010 are calculated using those of accommodation facilities with more than nine employees.

Looking at confidence indicators related to private consumption, the Consumer Confidence Index and the DI of the *Economy Watchers Survey* deteriorated significantly in April due to the impact of COVID-19 but have turned to a pick-up since May, reflecting a lift of the state of emergency (Chart 36).

Chart 36: Confidence Indicators Related to Private Consumption



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

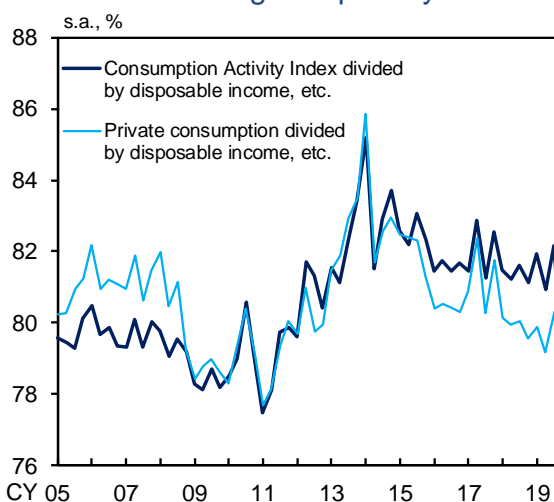
In the outlook, private consumption is likely to remain at a low level for the time being, mainly for services consumption. However, along with a phased reopening of businesses, it is expected to pick up moderately, supported by various income support measures. A variety of demand stimulus measures also are projected to encourage the materialization of pent-up demand, mainly for dining-out and travel, with the impact of COVID-19 waning. That said, the pace of a pick-up in private consumption will likely be quite moderate, mainly because (1) the operation rates, mainly for dining-out and services for individuals,

will be lower than before due to the need to ensure social distancing, and (2) people will continue to avoid crowds due to vigilance against COVID-19. If households and firms adapt to a "new lifestyle" and new goods and services are innovated, the increasing trend in private consumption is likely to become evident gradually, partly supported by an improvement in the employment and income situation.

The propensity to consume is expected to show a significant decline temporarily, reflecting (1) a sharp drop in private consumption and (2) an increase in disposable income due to various income support measures. Thereafter, the propensity is likely to recover as economic activity normalizes. However, it will likely remain at a somewhat low level compared with the past average, mainly due to a rise in concern over future developments (Chart 37).

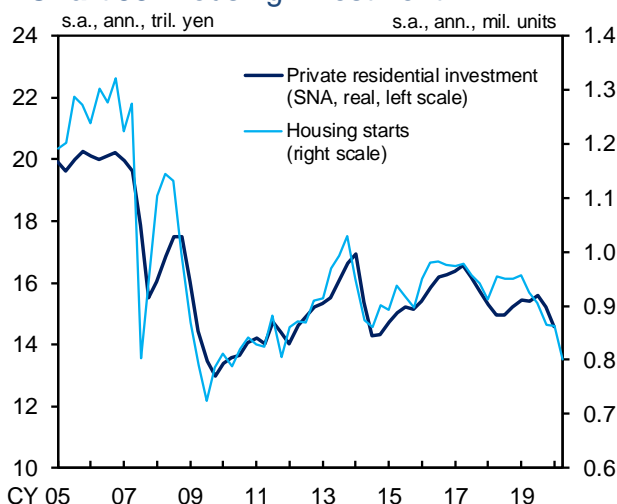
Housing investment has decreased moderately (Chart 38). The number of housing starts -- a leading indicator of housing investment -- has declined recently due to the effects of the consumption tax hike and COVID-19. As for the outlook, housing investment is likely to continue decreasing moderately for the time being, partly due to weakness in the employment and income situation and increasing uncertainties over the future. However, it is expected to bottom out thereafter and then turn to a pick-up, supported by an improvement in the employment and income situation and accommodative financial conditions.

Chart 37: Average Propensity to Consume



Sources: Bank of Japan; Cabinet Office, etc.
 Notes: 1. The Consumption Activity Index is adjusted for the travel balance. Based on staff calculations.
 2. Private consumption is consumption of households excluding imputed rent.
 3. "Disposable income, etc." consists of disposable income and "adjustment for the change in pension entitlements."

Chart 38: Housing Investment



Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
 Note: The figure for 2020/Q2 is the April-May average.

II. Current Situation of Prices and Their Outlook

Developments in Prices

The rate of change in the producer price index (PPI, adjusted for the effects of seasonal changes in electricity rates) has declined significantly on a quarter-on-quarter basis, reflecting developments in international commodity prices and foreign exchange rates (Chart 39). The year-on-year rate of change in the services producer price index (SPPI, excluding international transportation) has registered relatively large negative growth, such as for advertising services, hotels, as well as sales space and hotel rental (Chart 39). This is mainly against the background of increasing pressure stemming from cost cuts in response to deterioration in corporate profits and of the effects of a decrease in demand for travel as well as eating and drinking because of the impact of COVID-19.

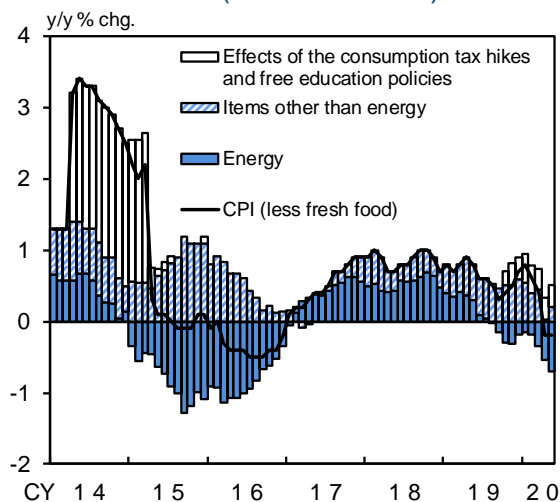
The year-on-year rate of change in the CPI (all items less fresh food) has decelerated recently, mainly due to the effects of the decline in energy prices, and is at around 0 percent (Charts 39 and 40). On the other hand, that in the CPI (all items less fresh food and energy) has been in the range of 0.0-0.5 percent recently, albeit with fluctuations. Looking at the breakdown of developments in the year-on-year rate of change in the CPI (all items less fresh food and energy, excluding the effects of the consumption tax hikes and policies concerning the provision of free education), the rate of change in general services has been negative and the rate of increase in administered prices has narrowed (Chart 41). By item, the rate of decline has been relatively large in some items

Chart 39: Inflation Indicators

	y/y % chg.			
	19/Q3	19/Q4	20/Q1	20/Q2
Consumer Price Index (CPI)				
Less fresh food	0.5	0.6	0.6	-0.2
Adjusted figure		0.2	0.2	-0.5
Less fresh food and energy	0.6	0.8	0.7	0.3
Adjusted figure		0.6	0.4	0.1
Producer Price Index (q/q % chg.)	-0.9	-0.1	-0.4	-2.4
Services Producer Price Index	0.5	0.4	0.2	-1.0
GDP deflator				
Domestic demand deflator	0.2	0.7	0.7	

Sources: Ministry of Internal Affairs and Communications; Bank of Japan; Cabinet Office.
 Notes: 1. Adjusted figures exclude the effects of the consumption tax hike and policies concerning the provision of free education. The figures from 2020/Q2 onward are based on staff estimations, and exclude the effects of measures such as free higher education introduced in April 2020.
 2. Figures for the Producer Price Index are adjusted for the hike in electric power charges during the summer season.
 3. Figures for the Services Producer Price Index exclude international transportation.
 4. Figures for the Producer Price Index and the Services Producer Price Index exclude the effects of the consumption tax hike.
 5. Figures for the CPI and the Services Producer Price Index for 2020/Q2 are April-May averages.

Chart 40: CPI (less fresh food)



Source: Ministry of Internal Affairs and Communications.
 Notes: 1. Energy consists of petroleum products, electricity, and gas, manufactured & piped.
 2. Figures for the "effects of the consumption tax hikes and free education policies" from April 2020 onward are based on staff estimations, and include the effects of measures such as free higher education introduced in April 2020.

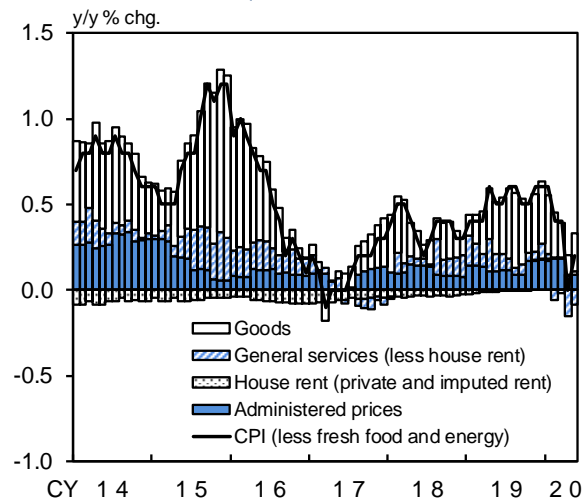
that have been affected strongly by COVID-19, such as those related to travel. That said, at least for now, a reduction in prices that aims at stimulating demand does not seem to be observed for a wider range of items.¹⁸

The year-on-year rate of change in the GDP deflator has been at around 1 percent on the whole due to a rise in the domestic demand deflator and to a decrease in the import deflator stemming from the decline in crude oil prices (Chart 39). The year-on-year rate of change in the domestic demand deflator has been in the range of 0.5-1.0 percent, mainly led by the private consumption deflator that is partly affected by the tax hike.

Environment surrounding Prices

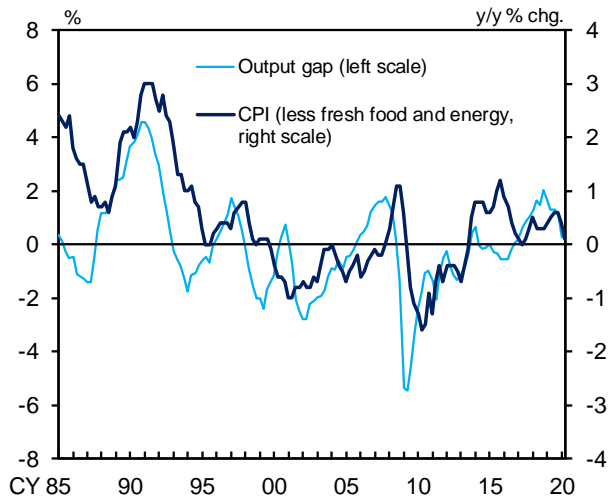
In the outlook for prices, the main factors that determine inflation rates are assessed as follows. First, the output gap is likely to deteriorate clearly and register a relatively large negative figure for the time being, mainly because of a rise in the unemployment rate, a decline in working hours, and a decrease in capital utilization rates, all of which are due to the impact of COVID-19 (Charts 4 and 42). Thereafter, as the impact of COVID-19 wanes, the output gap is projected to continue improving and return to a positive trend since the economic growth rate is expected to exceed its potential.

Chart 41: CPI (less fresh food and energy)



Source: Ministry of Internal Affairs and Communications.
 Notes: 1. Administered prices (less energy) consist of "public services" and "water charges."
 2. The CPI figures exclude the effects of the consumption tax hikes and policies concerning the provision of free education. The figures from April 2020 onward are based on staff estimations, and exclude the effects of measures such as free higher education introduced in April 2020.

Chart 42: Inflation Rate and Output Gap



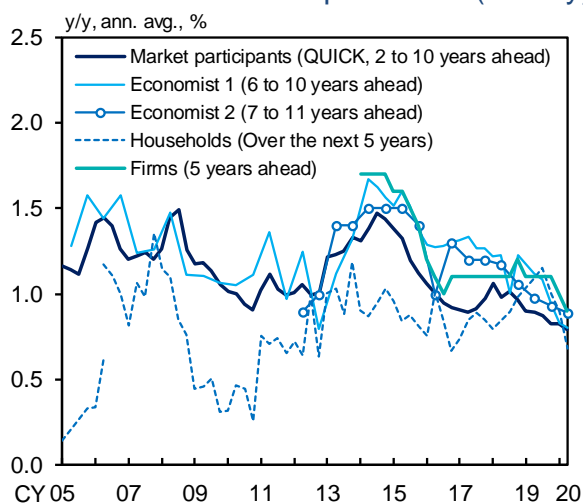
Sources: Ministry of Internal Affairs and Communications; Bank of Japan.
 Notes: 1. The CPI figures exclude the effects of the consumption tax hikes and policies concerning the provision of free education. The figures from 2020/Q2 onward are based on staff estimations, and exclude the effects of measures such as free higher education introduced in April 2020. The figure for 2020/Q2 is the April-May average.
 2. The output gap is based on staff estimations.

¹⁸ Box 4 analyzes features of recent developments in prices under the impact of COVID-19.

Second, medium- to long-term inflation expectations have weakened somewhat (Charts 43 and 44). With regard to the outlook, such expectations are likely to continue to do so for the time being, since actual inflation that includes the effects of the decline in energy prices is expected to be negative, as described below. Thereafter, however, as the economy improves, such expectations are projected to rise again on the back of an increase in actual prices and the Bank pursuing monetary easing through its strong commitment to achieving the price stability target.

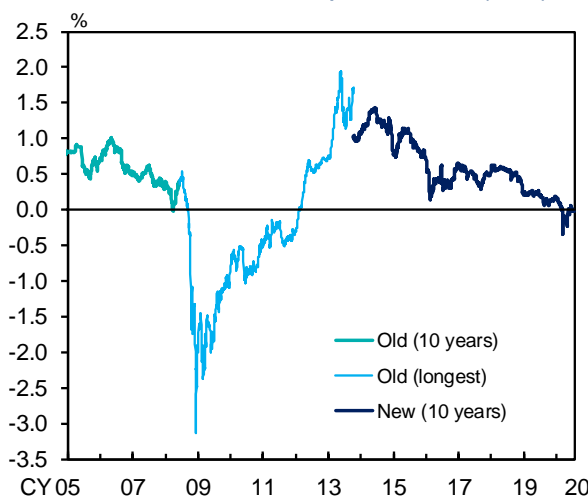
The third factor is developments in import prices. The CPI is likely to be pushed down by the past significant decline in crude oil prices, first through a decline in prices for petroleum products for the time being, and thereafter through declines, mainly in electricity charges, with some time lag (Chart 45). That said, the effects of downward pressure on the CPI are expected to wane gradually from a somewhat long-term perspective.

Chart 43: Inflation Expectations (Survey)



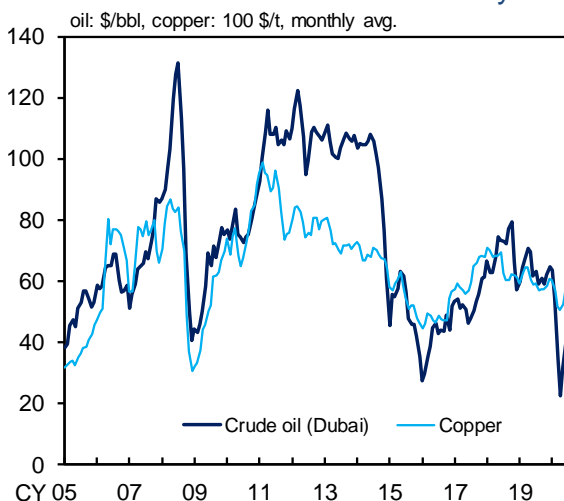
Sources: Bank of Japan; QUICK, "QUICK Monthly Market Survey (Bonds)"; JCER, "ESP Forecast"; Consensus Economics Inc., "Consensus Forecasts."
 Notes: 1. Figures for the economist 1 are from the "Consensus Forecasts." Figures for the economist 2 are from the "ESP Forecast."
 2. Figures for households are from the "Opinion Survey on the General Public's Views and Behavior," estimated using the modified Carlson-Parkin method.
 3. Figures for firms are "Outlook for General Prices (*Tankan*, all industries and enterprises, average)."

Chart 44: Inflation Expectations (BEI)



Source: Bloomberg.
 Note: BEI (break-even inflation) rates are yield spreads 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.

Chart 45: International Commodity Prices



Sources: Nikkei Inc.; Bloomberg.

Outlook for Prices

The year-on-year rate of increase in the CPI (all items less fresh food and energy) is likely to decelerate within positive territory for the time being. In detail, (1) the rates of decline in charges for hotels and package tours to overseas are expected to accelerate in the short run, reflecting a fall in travel demand at home and abroad. In addition, (2) the rates of increase in the CPI items that are sensitive to economic activity, such as food products, durable goods, clothes, and dining-out, will likely decelerate gradually, albeit with some time lag. Moreover, (3) mobile phone-related prices (i.e., prices of and charges for mobile phones) are projected to continue to show some weakness, reflecting an intensifying competitiveness in the industry.¹⁹

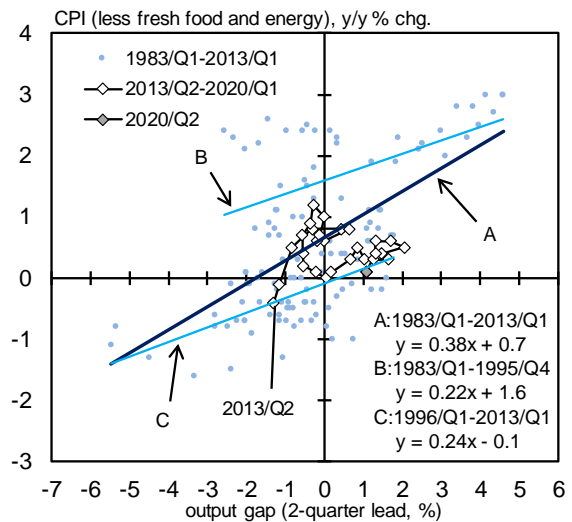
As for the outlook from a somewhat long-term perspective, the year-on-year rate of increase in the CPI (all items less fresh food and energy) is expected to accelerate gradually. This is based on the projection that, with the impact of COVID-19 waning and the output gap improving, the rates of change in the CPI items, such as charges for hotels and services related to culture and recreation, are expected to turn to an increase on the back of demand stimulus measures under the government's economic measures and of the hosting of the Olympic Games. Thereafter, the year-on-year rate of increase in the CPI (all items less fresh food and energy) is likely to accelerate further through the end of the projection period with (1) the output gap continuing to improve and (2) medium- to long-term inflation expectations

¹⁹ The waning effects of the consumption tax hike also are likely to push down the year-on-year rate of change in the CPI.

rising through both the adaptive and the forward-looking expectation formation mechanisms (Chart 46).

Under these circumstances, the year-on-year rate of change in the CPI (all items less fresh food) is likely to be negative for the time being, mainly because the rate of decline in energy prices is expected to accelerate, such as for electricity as well as manufactured and piped gas charges, reflecting the past significant decline in crude oil prices. Thereafter, the year-on-year rate of change in the CPI (all items less fresh food) is likely to turn positive and accelerate gradually through the end of the projection period, since the effects of the decline in energy prices are expected to wane and the year-on-year rate of increase in the CPI (all items less fresh food and energy) is projected to accelerate.

Chart 46: Phillips Curve



Sources: Ministry of Internal Affairs and Communications; Bank of Japan.
 Notes: 1. The CPI figures exclude the effects of the consumption tax hikes and policies concerning the provision of free education. The figures from 2020/Q2 onward are based on staff estimations, and exclude the effects of measures such as free higher education introduced in April 2020. The figure for 2020/Q2 is the April-May average.
 2. The output gap is based on staff estimations.

III. Financial Developments in Japan

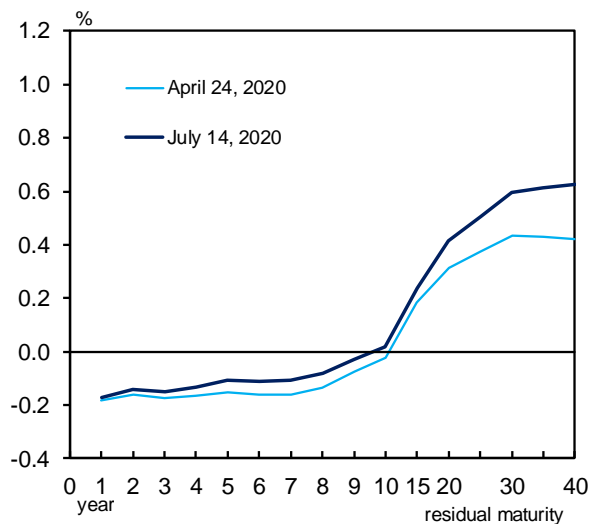
Financial Conditions

Financial conditions have been accommodative on the whole but those for corporate financing have remained less so, as seen in deterioration in firms' financial positions.²⁰

Under "QQE with Yield Curve Control," the yield curve for JGBs has been in line with the current guideline for market operations, in which the short-term policy interest rate is set at minus 0.1 percent and the target level of 10-year JGB yields is around zero percent (Chart 47). That is, the yields for relatively short maturities have been in slightly negative territory and the 10-year JGB yields have been at around 0 percent. As a background to this, the Bank has conducted further active purchases of both JGBs and treasury discount bills (T-Bills) with a view to maintaining stability in the bond market and stabilizing the entire yield curve at a low level, taking into account the impact on the market of the increase in the amount of issuance of JGBs and T-Bills in response to the government's emergency economic measures. Meanwhile, the 20-year JGB yields have been in the range of 0.0-0.5 percent.

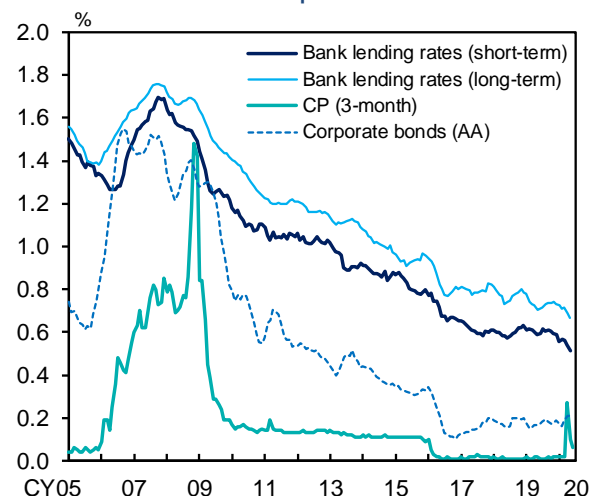
Firms' funding costs have been hovering at low levels, with issuance rates in the market -- which rose mainly for CP -- turning to a decline, partly due to the effects of the Bank's monetary easing measures (Chart 48). Issuance rates for CP

Chart 47: Yield Curves



Source: Bloomberg.

Chart 48: 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 to September 2009 are the averages for CP (3-month, rated a-1 or higher). Those from October 2009 are the averages for CP (3-month, rated a-1).

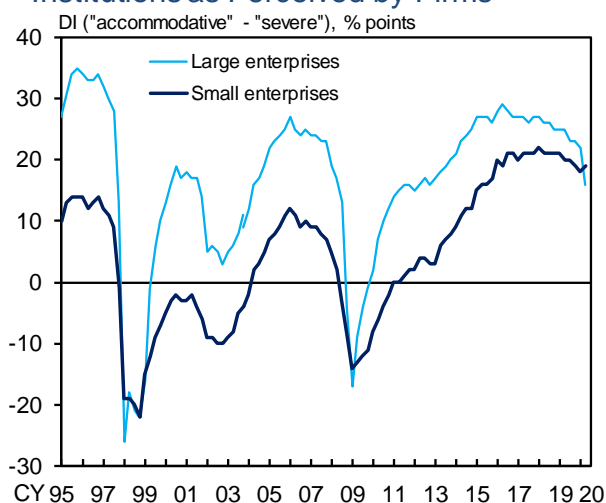
2. Figures for issuance yields for corporate bonds are the averages for domestically issued bonds launched on a particular date. Bonds issued by banks and securities companies, etc., are excluded.

3. Figures for bank lending rates and issuance yields for corporate bonds show 6-month backward moving averages.

²⁰ See Box 5 for Japan's financial conditions under the impact of COVID-19 and responses made by the Bank and the government to support financing, mainly of firms.

showed a significant rise in April, but declined after the Bank announced that it would increase purchases of CP and have been at low levels recently. Meanwhile, the DI for issuance conditions for CP in the June *Tankan* has declined, since the proportion of firms answering that such conditions are "easy" decreased, due partly to a temporary rise in the issuance rates. Issuance rates for corporate bonds, which had risen somewhat, have declined to date, and are at extremely low levels. Meanwhile, lending rates (the average interest rates on new loans and discounts) have been at around historical low levels.

Chart 49: Lending Attitude 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 in December 2003 due to a change in the survey framework.

With regard to the availability of funds for firms, 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 49). Specifically, the proportion of firms answering that financial institutions' lending attitudes are "severe" has remained small for both large and small firms. Meanwhile, although the DI for large firms has declined somewhat against the background of a smaller proportion perceiving their attitudes as "accommodative," that for small firms has increased marginally. As a background against these developments, there have been various measures taken by the Bank and the government to support financing, mainly of firms, as well as efforts made by financial institutions together with those measures. On the other hand, with regard to corporate financing, the DI for firms' financial positions in the *Tankan* has deteriorated regardless of firm size, mainly reflecting a decline in sales due to the impact of COVID-19 (Chart 50).

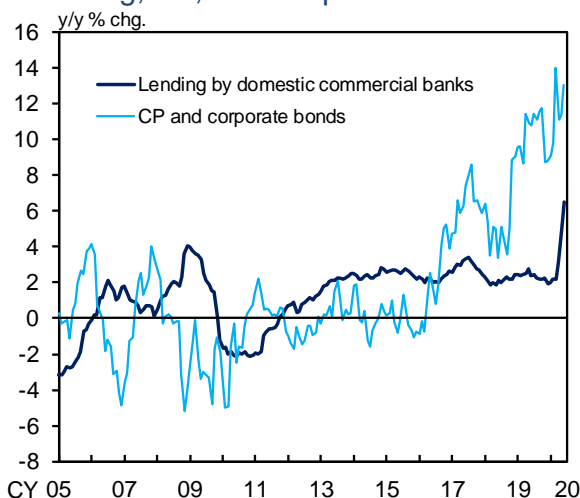
Chart 50: Financial Position



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

Firms' demand for funds has increased, mainly reflecting a decline in sales and the need to secure funds, both of which are due to the impact of COVID-19. Under these circumstances, the year-on-year rate of increase in the amount outstanding of bank lending has been at around 6.5 percent, registering the highest increase in about 30 years (Chart 51). That in the aggregate amount outstanding of CP and corporate bonds has been at a relatively high level that exceeds 10 percent, mainly due to active funding through direct financing.

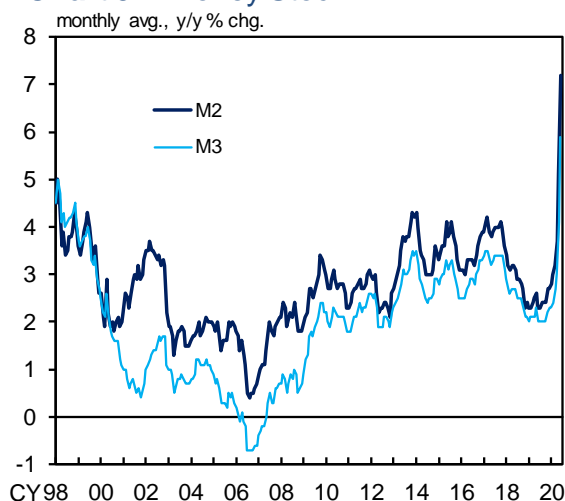
Chart 51: Amount Outstanding of Bank Lending, CP, and Corporate Bonds



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 period.

The year-on-year rate of increase in the monetary base has been at around 6 percent, and its amount outstanding as of end-June was 565 trillion yen, of which the ratio to nominal GDP was 103 percent.²¹ The year-on-year rate of increase in the money stock (M2) has been in the range of 7.0-7.5 percent, pushed up mainly by an increase in bank lending and fiscal factors (Chart 52).

Chart 52: Money Stock



Source: Bank of Japan.

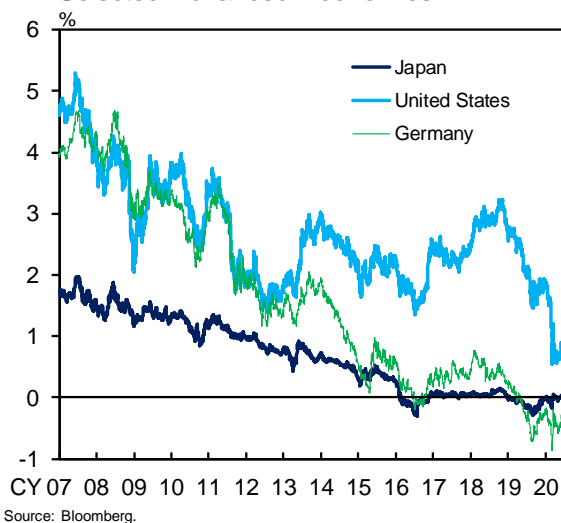
²¹ It is assumed that the figure for nominal GDP is unchanged from the January-March quarter of 2020.

Developments in Financial Markets

With regard to developments in global financial markets, tension has abated due to aggressive fiscal and monetary policies taken in each country and region, as well as to signs of a resumption of economic activity, mainly in advanced economies. Stock prices have increased in many countries and regions. Long-term interest rates rose temporarily on the back of an improvement in market sentiment and an increase in the issuance of government bonds due to an expansion in fiscal spending. However, they have been more or less flat, mainly against the background of the central bank of each country and region having conducted aggressive purchases of government bonds while pursuing monetary easing. That said, the markets have remained nervous, as seen in the volatility of stock prices staying relatively high amid a situation of developments in domestic and overseas economies being highly unclear.

Yields on 10-year government bonds in the United States increased temporarily, mainly on the back of a resumption of economic activity, economic indicators that reflect it, and an increase in issuance of government bonds. However, the yields have been more or less flat, due mainly to the purchases of government bonds by the Federal Reserve and increased speculation that policy interest rates will remain low for a prolonged period (Chart 53). Yields on 10-year government bonds in Germany increased temporarily, mainly reflecting the resumption of economic activity and speculation over an increase in issuance of government bonds, but have been more or less flat with the European Central Bank (ECB) purchasing government bonds.

Chart 53: 10-Year Government Bond Yields in Selected Advanced Economies

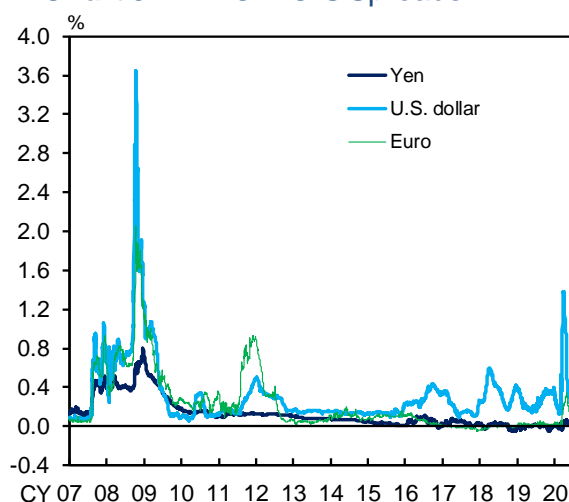


With regard to the LIBOR-OIS spreads for major currencies, those for the U.S. dollar have narrowed, mainly because prime money market funds (MMFs) -- the major providers of U.S. dollars -- have been providing more funds compared to a while ago (Chart 54). The LIBOR-OIS spreads for the euro also have narrowed somewhat. Meanwhile, those for the yen have remained at low levels. Partly due to the provision of a large amount of U.S. dollars through the U.S. dollar funds-supplying operations conducted by the central bank of each country and region, including the Bank of Japan, premiums for U.S. dollar funding through the dollar/yen foreign exchange swap market have declined and been at relatively low levels recently (Chart 55).

Regarding the stock market, stock prices in the United States have risen on the back of aggressive fiscal and monetary policies taken in each country and region and an improvement in investors' risk sentiment that reflects signs of a resumption of economic activity, mainly in advanced economies (Chart 56). That said, the market has remained nervous; U.S. stock prices declined temporarily to a relatively large degree, due mainly to vigilance against a resurgence of COVID-19, and volatility in the market has been relatively high. Stock prices in Europe and Japan have moved in line with those in the United States.

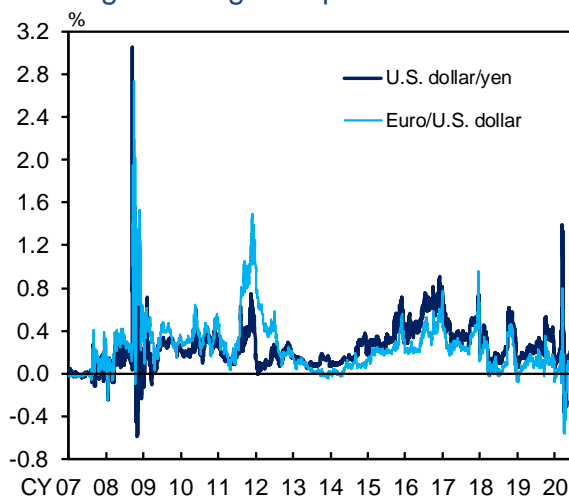
In the J-REIT market, prices have increased somewhat due to an improvement in investors' risk sentiment that reflects signs of a resumption of economic activity (Chart 57). That said, the

Chart 54: LIBOR-OIS Spreads



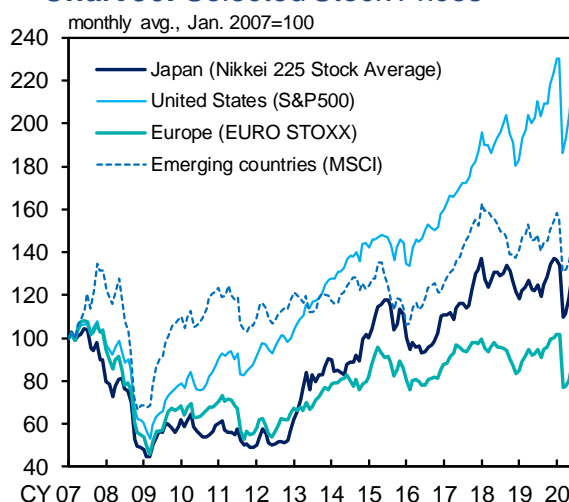
Source: Bloomberg.
Note: LIBOR-OIS spreads are LIBOR (3-month) minus yields on overnight index swaps (3-month).

Chart 55: Dollar Funding Premiums through Foreign Exchange Swaps



Source: Bloomberg.
Note: U.S. dollar funding rate from yen or euro minus 3-month dollar LIBOR.

Chart 56: Selected Stock Prices

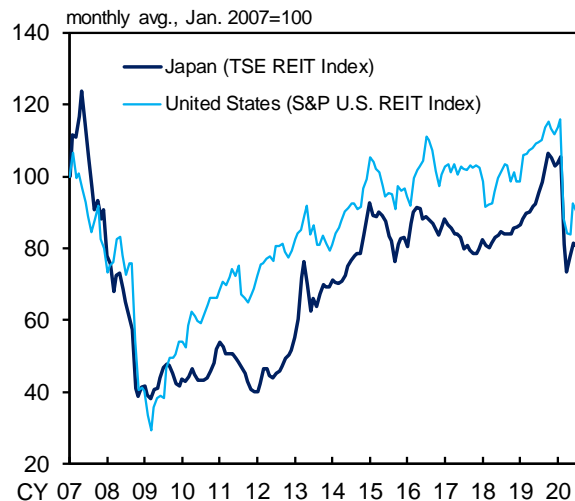


Source: Bloomberg.
Note: Figures for emerging countries are based on the MSCI Emerging Markets Index calculated in the local currencies.

pace of increase has been moderate, due partly to cautious views regarding the impact of COVID-19, such as on hotels and commercial facilities.

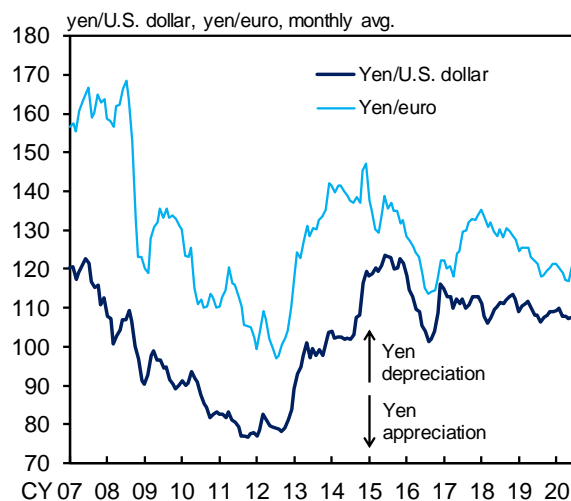
In foreign exchange markets, the yen has been more or less flat against the U.S. dollar (Chart 58). It has depreciated against the euro, albeit with fluctuations, mainly reflecting increasing expectations that economic activity will be supported by fiscal and monetary policies in the Euro area.

Chart 57: Selected REIT Indices



Source: Bloomberg.

Chart 58: Yen/U.S. Dollar and Yen/Euro



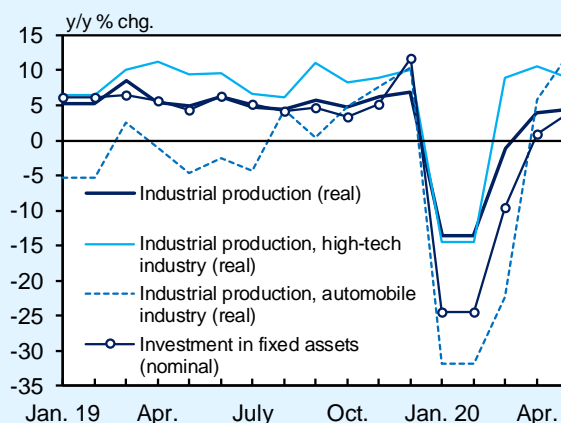
Source: Bloomberg.

(Box 1) Developments in Overseas Economies under the COVID-19 Pandemic

Although economic activity has started to resume, mainly in countries where the spread of COVID-19 has almost subsided, overseas economies have been depressed significantly with the impact of COVID-19 remaining. This box examines developments in overseas economies under the pandemic, looking first at those in China thus far, where the economy has been picking up, and then turning to those in Europe and the United States.

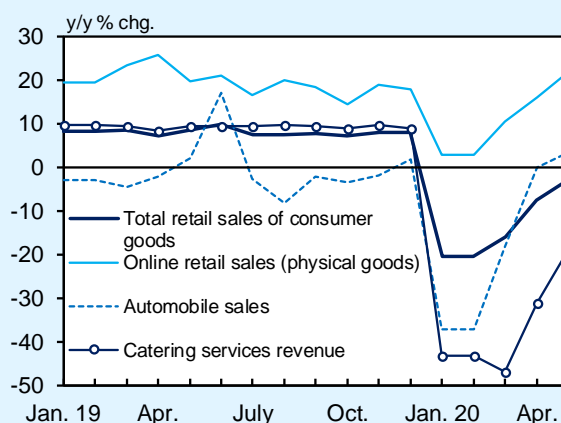
In China, economic activity plunged from late January due to the impact of the spread of COVID-19. Subsequently, however, there has been progress in the resumption of economic activity, and the economy has been picking up with the spread subsiding domestically. Industrial production recently has recovered to above last year's level, mainly led by the high-tech and automobile-related industries, as supply constraints such as labor shortage and supply chain disruptions eased, and partly reflecting the recovery in production from the decline brought about by COVID-19 (Chart B1-1). Investment in fixed assets also has recovered to above last year's level, supported by aggressive macroeconomic policies by the Chinese authorities, including their efforts to speed up the implementation of key infrastructure projects. Retail sales have been recovering to last year's level due to favorable online sales and the materialization of pent-up demand, although the recovery in eating and drinking services has been lagging somewhat behind, mainly due to voluntary efforts made by firms and households to

Chart B1-1: China's Industrial Production and Investment in Fixed Assets



Source: CEIC.
Note: Based on staff calculations.

Chart B1-2: China's Nominal Retail Sales of Consumer Goods



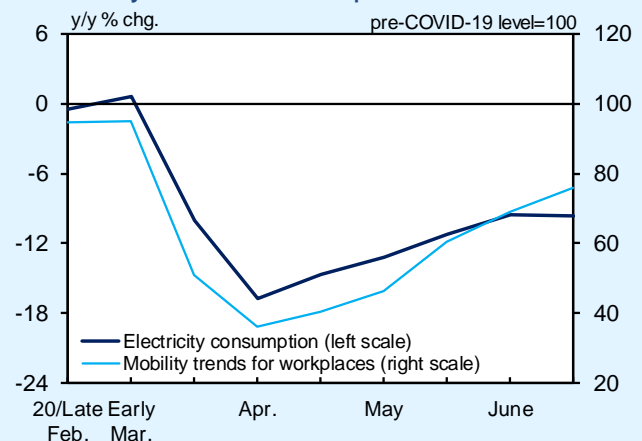
Source: CEIC.
Note: Based on staff calculations. Figures for automobile sales are based on the aggregate for enterprises (units) with revenues above certain threshold amounts only.

prevent infections (Chart B1-2).

Turning to Europe, economic activity was depressed significantly from mid-March, as seen in electricity consumption falling substantially below last year's level, mainly affected by the spread of COVID-19 and the resultant closure of workplaces and restrictions on going outside (Chart B1-3). Subsequently, with COVID-19 subsiding, economic activity has been showing signs of heading toward a pick-up, as seen in a deceleration in the year-on-year rate of decline in electricity consumption as strict public health measures have been eased. Under these circumstances, there have been signs that the employment situation will stop deteriorating. In Germany, France, and Italy, the number of firms applying for subsidies for short-time work increased sharply through April but has decreased significantly since May (Chart B1-4).

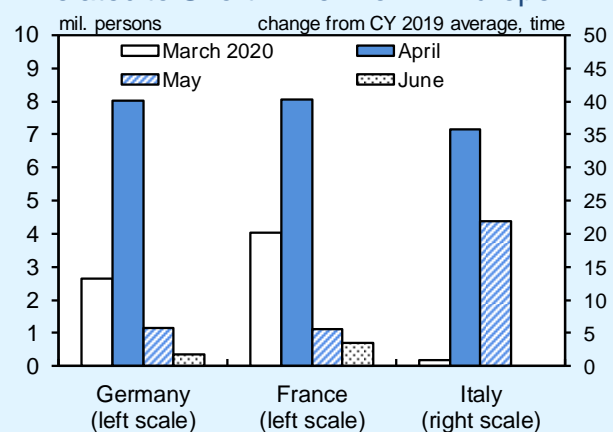
In the United States, economic activity was depressed significantly from mid-March, affected by the spread of COVID-19 and strict public health measures, as indicated, for example, by the Weekly Economic Index (WEI) released by the Federal Reserve Banks -- which aggregates high-frequency data on various economic activities -- falling well below last year's level (Chart B1-5). In terms of employment, the unemployment rate for April has risen to the highest level since 1940 (Chart B1-6). Subsequently, although COVID-19 has not yet subsided in the United States as a whole, automobile sales and consumption of services such as eating and drinking have turned to an increase, mainly on the back of the easing of strict

Chart B1-3: Electricity Consumption and Mobility Trends in Europe



Sources: Bloomberg; Google LLC "Google COVID-19 Community Mobility Reports". <https://www.google.com/covid19/mobility/> Accessed: July 15, 2020.
 Notes: 1. The chart shows the simple averages for Germany, France, Italy, Spain, and the United Kingdom.
 2. Figures for mobility trends for workplaces refer to the aggregate number of persons going to their workplace. The median value for the corresponding days of the week for the period from January 3 to February 6 (i.e., before the outbreak of COVID-19) is used for reference and set to 100.

Chart B1-4: Labor Market Indicators Related to Short-Time Work in Europe

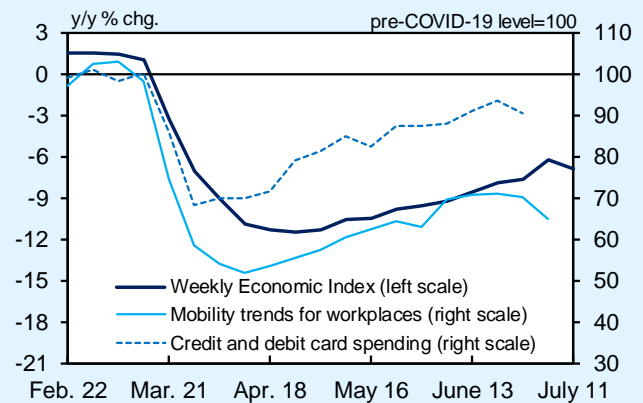


Sources: Haver; DARES.
 Note: Figures for Germany and France are the notifications of short-time workers. Figures for Italy are the number of authorized hours under the main short-time work scheme, the Wages Guarantee Fund. The latest figure for Italy is that for May 2020.

public health measures and U.S. government cash payments to households. Under these circumstances, the rate of decline in the amount of card transactions related to consumer spending has slowed, and economic activity, as seen in the WEI, has been improving. On the employment side, with support from the U.S. government's Paycheck Protection Program continuing, the number of employees has increased since May on the back of progress in the resumption of economic activity, and the unemployment rate has turned to a decline.

Thus, there are signs of a pick-up in Europe and the United States, but the level of economic activities is still clearly below that seen before the outbreak of COVID-19. It should be noted that it will take time for overseas economies to recover to the level seen before the outbreak, partly because precautionary efforts made voluntarily by firms and households will continue to act as a force constraining economic activity. In addition, as seen in the number of confirmed cases still increasing in emerging economies -- such as Central and South America as well as India -- and in the United States, there are extremely high uncertainties over the consequences of COVID-19 and the magnitude of their impact on overseas economies, and thus close attention should continue to be paid.

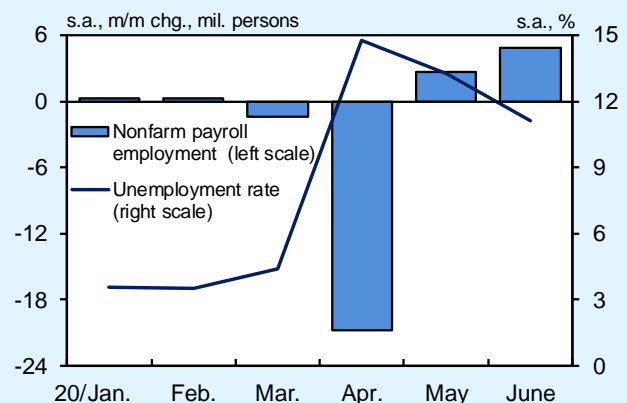
Chart B1-5: High-Frequency Indicators for the United States



Sources: Haver; Opportunity Insights; Google LLC "Google COVID-19 Community Mobility Reports". <https://www.google.com/covid19/mobility/> Accessed: July 15, 2020.

Notes: 1. Figures for mobility trends for workplaces refer to the aggregate number of persons going to their workplace. The median value for the corresponding days of the week for the period from January 3 to February 6 (i.e., before the outbreak of COVID-19) is used for reference and set to 100.
2. Figures for credit and debit card spending are seasonally adjusted. The average for the period from January 4 to 31 (i.e., before the outbreak of COVID-19) is used for reference and set to 100.

Chart B1-6: Labor Market Indicators for the United States



Source: Haver.

(Box 2) Firms' Behavior Affected by COVID-19

This box outlines the recent changes in firms' behavior due to the impact of COVID-19 by examining firms' stance on business fixed investment and employment.

The business fixed investment plan for fiscal 2020 shows that the investment has been relatively steady for both large firms as well as small and medium-sized firms despite facing a significant decline in their profits (Chart 23). This is largely attributable to the fact that downward pressure from the financial side has not intensified. Such pressure has been constrained by (1) financial conditions of firms, especially large ones, becoming more sound since the global financial crisis and (2) the Bank's and the government's measures to support financing, as well as active efforts made by financial institutions together with those measures.

Since the global financial crisis, firms in Japan have continued to avert risks and prioritize improvement in their financial positions. Specifically, they have increased their capital adequacy ratios by actively repaying their loans (Chart B2-1). For firms that have made their repayments, they also have increased the on-hand liquidity ratios, mainly by saving a large amount of their profits in the form of cash and deposits (Chart B2-2). As a result, in Japan, there seems to be a considerable number of firms, mainly large ones, that have adequate financial capacity to undertake necessary investment for growth areas even when they are faced with

Chart B2-1: Earned Surplus and Interest-Bearing Debt

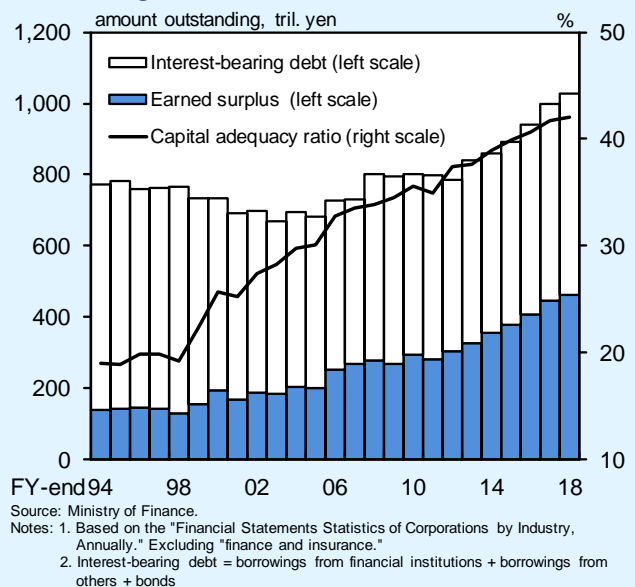
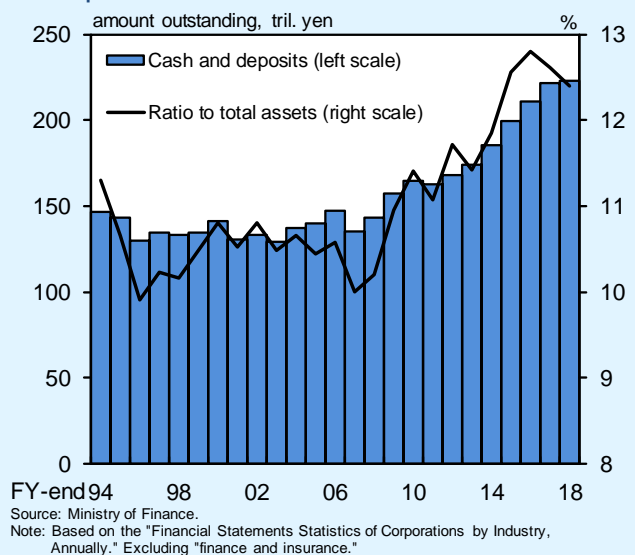


Chart B2-2: Developments in Cash and Deposits



unexpected severe stress, as in the current situation.

Compared with large firms, the financial capacities of small and medium-sized firms are limited. That said, mainly through effectively interest-free and unsecured loans, financial institutions have been actively responding to meet firms' increasing demand for funds, and this seems to have eased, to a certain degree, pressure that reduces business fixed investment by small and medium-sized firms. In fact, looking at the DI in the *Tankan* for financial institutions' lending attitudes -- that is highly correlated to business fixed investment reported in the *Financial Statements Statistics of Corporations by Industry, Quarterly*, mainly for small and medium-sized firms -- it has maintained its considerably accommodative level compared with at the time of the global financial crisis (Chart B2-3). The active lending stance of financial institutions seems to have supported business fixed investment conducted mainly by small and medium-sized firms, many of which have limited access to capital markets and are facing liquidity constraints. The correlation between the DI for financial institutions' lending attitudes and business fixed investment can be examined by using a simple vector auto-regression (VAR) model consisting of the following five variables: (1) the macroeconomic uncertainty index, (2) the *Indices of Industrial Production*, (3) TOPIX, (4) the DI for financial institutions' lending attitudes, and (5) business fixed investment.²² The results suggest that the deterioration in the DI has a

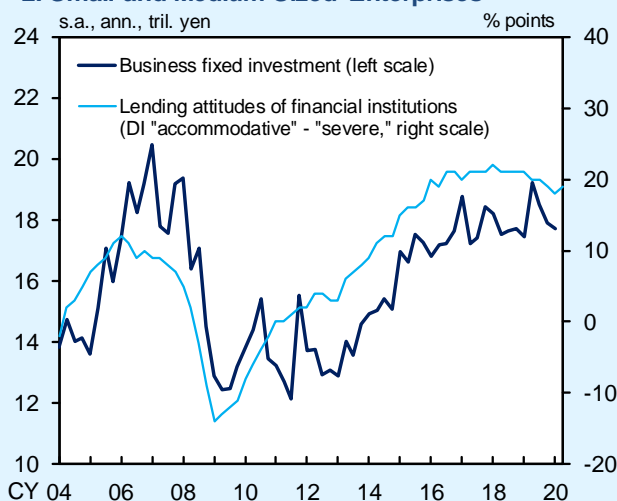
Chart B2-3: Lending Attitudes of Financial Institutions and Business Fixed Investment

1. Large Enterprises



Sources: Ministry of Finance; Bank of Japan.
Notes: 1. Figures for business fixed investment are based on the "Financial Statements Statistics of Corporations by Industry, Quarterly," excluding software investment, and are for all industries excluding "finance and insurance" and "goods rental and leasing." Large enterprises are defined as enterprises with a capitalization of 1 billion yen or more.
2. Figures for the lending attitudes of financial institutions are based on the *Tankan* and are for large enterprises.

2. Small and Medium-Sized Enterprises



Sources: Ministry of Finance; Bank of Japan.
Notes: 1. Figures for business fixed investment are based on the "Financial Statements Statistics of Corporations by Industry, Quarterly," excluding software investment, and are for all industries excluding "finance and insurance" and "goods rental and leasing." Small and medium-sized enterprises are defined as enterprises with a capitalization of less than 1 billion yen.
2. Figures for the lending attitudes of financial institutions are based on the *Tankan* and are for small enterprises.

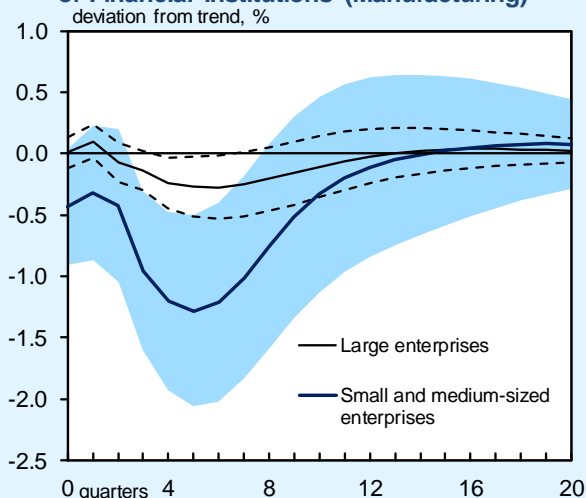
²² The macroeconomic uncertainty index is based on staff calculations by aggregating the variance of forecast errors of the time-series models related to various macroeconomic indicators.

statistically significant negative impact on business fixed investment by small and medium-sized firms, and the impact could be much larger than that on large firms (Chart B2-4). The net "accommodative" for the DI for financial institutions' lending attitudes as perceived by small and medium-sized firms in the June *Tankan* has been roughly at the same level as last quarter, which indicates that it is unlikely that business fixed investment by those firms will be pushed down from the financial side.

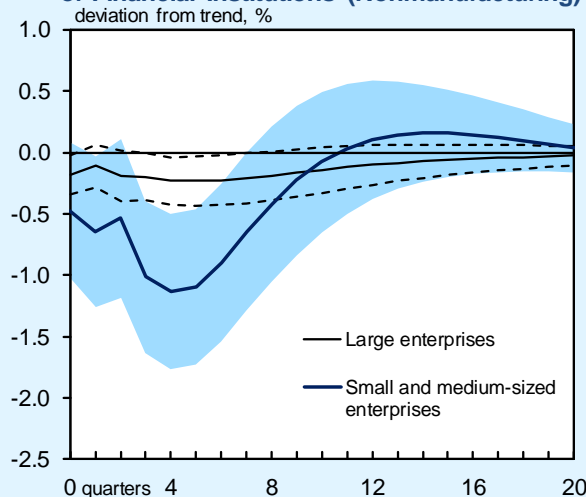
Looking at the employment side, firms' stance on employment has receded significantly due to the impact of COVID-19, but the degree of deterioration in that stance has been somewhat limited thus far compared with the pace of depression in economic activity. Due to the impact of COVID-19, the employment conditions DI in the *Tankan* shows that the perception of labor shortage has diminished and the unemployment rate has been under upward pressure. However, at this point, both the DI and the unemployment rate have not deteriorated as much as they did at the time of the global financial crisis (Chart B2-5). By industry, the DIs for accommodations as well as eating and drinking services, both of which have been directly affected by COVID-19, have turned to a significant net "excessive" to date. However, the DIs for many of the other industries, including construction as well as transport and postal activities, have remained a net "insufficient" (Chart B2-6). Firms seem to be somehow trying to retain their employees mainly through furloughs, while making active use of employment adjustment subsidies, which have been expanded significantly as part of the government's current

Chart B2-4: Financial Conditions and Business Fixed Investment

1. Response of Business Fixed Investment to a Negative 1% Point Shock to Lending Attitudes of Financial Institutions (Manufacturing)



2. Response of Business Fixed Investment to a Negative 1% Point Shock to Lending Attitudes of Financial Institutions (Nonmanufacturing)



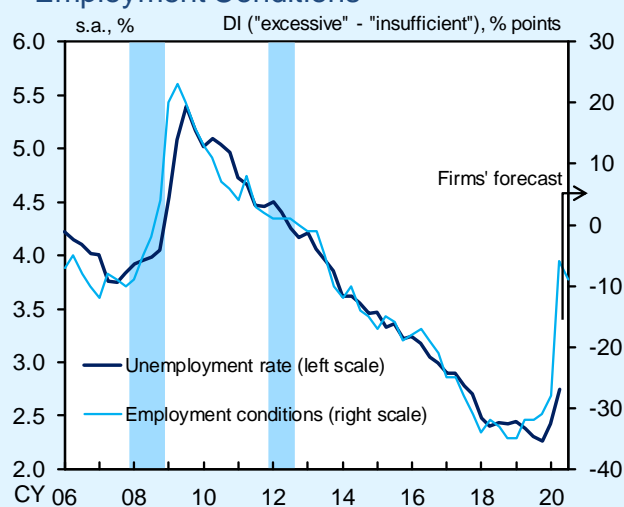
Sources: Ministry of Economy, Trade and Industry; Bloomberg; Ministry of Finance; Bank of Japan, etc.

Notes: 1. The VAR model (three-period lag) is estimated using the following five variables: Macroeconomic Uncertainty Index, IIP, TOPIX, the DI for lending attitudes of financial institutions (*Tankan*), business fixed investment ("Financial Statements Statistics of Corporations by Industry, Quarterly"). The estimation period is 1994/Q1-2020/Q1. Shocks are identified by Cholesky decomposition, where variables are ordered as above.
2. The shaded area and the broken lines indicate the 90 percentile bands.

economic measures, and of the financing support by financial institutions (Chart B2-7). This is probably against the background of (1) the prolonged labor shortage that continued to constrain business activities before the outbreak of COVID-19 and (2) the projection that the declining trend in the working-age population will continue in the long run.

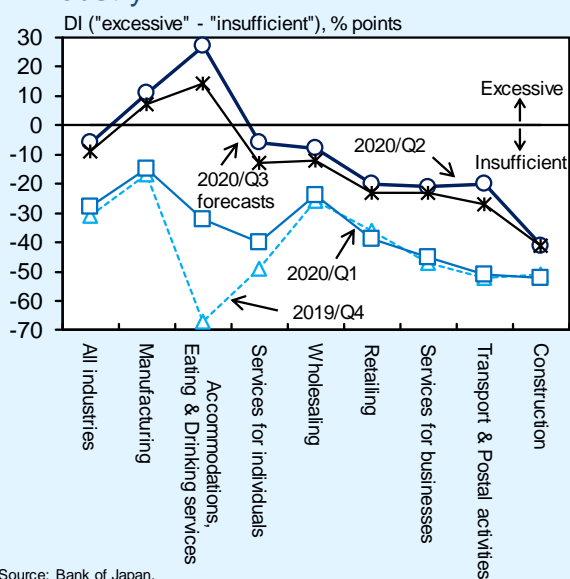
It is necessary to pay attention to the point that the aforementioned firms' stance on business fixed investment and employment could change substantially depending on developments in COVID-19. In particular, firms' stance on spending has a risk of becoming extremely cautious if the following happens, mainly reflecting the occurrence of a second wave of COVID-19 on a large scale: medium- to long-term growth expectations decline significantly as the impact of COVID-19 expands or lasts by more than expected, and financial conditions tighten, triggered by, for example, fluctuations in the global financial and capital markets.

Chart B2-5: Unemployment Rate and Employment Conditions



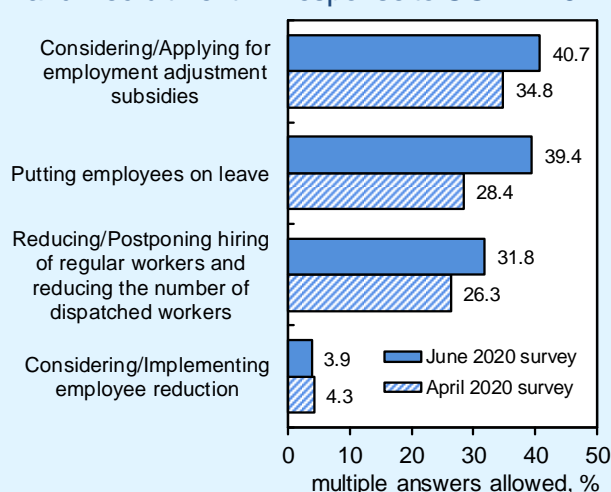
Sources: Ministry of Internal Affairs and Communications; Bank of Japan.
 Notes: 1. The figure for the unemployment rate for 2020/Q2 is the April-May average.
 2. Figures for employment conditions are based on the *Tankan* and are for all enterprises.
 3. Shaded areas indicate recession periods.

Chart B2-6: Employment Conditions by Industry



Source: Bank of Japan.
 Note: Figures are based on the *Tankan* and are for all enterprises.

Chart B2-7: Measures Related to Employment and Recruitment in Response to COVID-19



Source: Japan Chamber of Commerce and Industry, "LOBO survey."
 Notes: 1. Figures are for firms who responded that their business was affected due to the outbreak of COVID-19.
 2. The survey period of the April 2020 survey was from April 14 to 20 and that of the June 2020 survey from June 15 to 19.

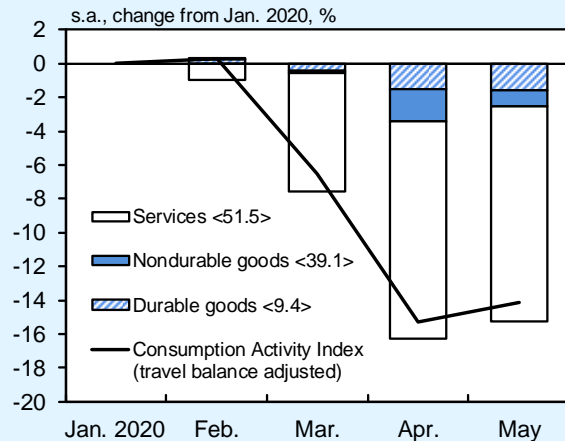
(Box 3) Impact of COVID-19 on Private Consumption

This box provides an overview of the impact of COVID-19 on developments in private consumption to date, using high-frequency data.

Looking back at developments in the Consumption Activity Index (CAI) from January this year -- that is, before the impact of COVID-19 materialized -- through May shows that a downward trend was already evident for March and the CAI declined further for the April-May period due to the impact of the declaration of a state of emergency, registering a substantial fall of about 15 percent compared with January (Chart B3-1). By type, services consumption saw the largest decrease, since self-restraint from going outside and temporary store closures led directly to the decline in sales, and this decrease in services consumption accounts for about 80 to 90 percent of the decline in private consumption that has happened since January. Goods consumption registered a considerable decline for the April-May period compared with January. This is attributable to a significant impact of the sales decline in automobiles and clothes due to the decrease in the number of customers visiting dealerships and stores, although the steady demand for food and daily necessities that reflects people spending more time at home has underpinned goods consumption to a certain extent (Chart B3-2).

Looking at the breakdown of services consumption, there has been a notable decline in selective expenditures for services that are considered non-urgent, such as dining-out,

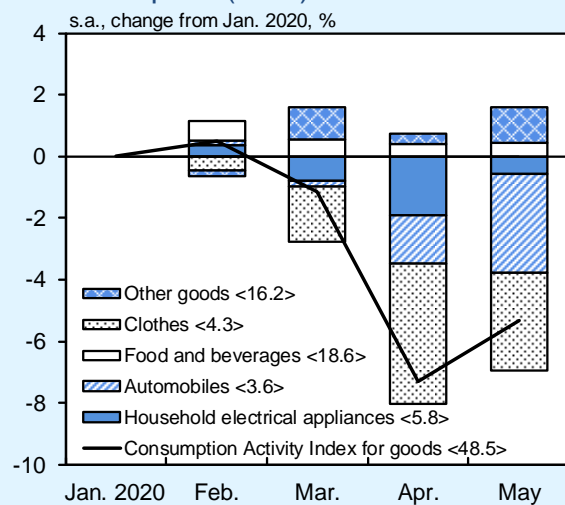
Chart B3-1: Developments in the Consumption Activity Index (Real)



Sources: Bank of Japan, etc.

- Notes: 1. Based on staff calculations. Figures for the Consumption Activity Index (travel balance adjusted) exclude inbound tourism consumption and include outbound tourism consumption. Figures for the components are not adjusted for the travel balance.
 2. Nondurable goods include goods classified as "semi-durable goods" in the SNA.
 3. Figures in angular brackets show the weights in the Consumption Activity Index.

Chart B3-2: Developments in Goods Consumption (Real)



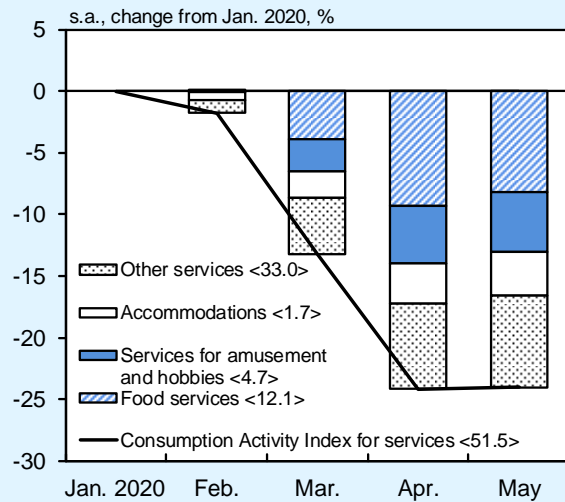
Sources: Bank of Japan, etc.

- Notes: 1. Based on staff calculations. Figures are not adjusted for the travel balance.
 2. Figures in angular brackets show the weights in the Consumption Activity Index.

entertainment, and accommodations (Chart B3-3). On a daily basis, mobility trends for "retail and recreation" based on smartphone location data by Google are quite similar to developments in selective expenditures for services in the *Family Income and Expenditure Survey*.²³ This suggests that the decrease in people going outside due to self-restraint has directly led to a decline in selective expenditures for services (Chart B3-4). Consumption of services other than those classified as selective expenditures (categorized as "other services" in Chart B3-3) has also decreased considerably, mainly for spending on medical services, ceremonial occasions, and cram schools. This indicates that people's vigilance against COVID-19 has exerted strong downward pressure not only on selective expenditures for services but also on the overall consumption of face-to-face services, including fundamental expenditures for services.

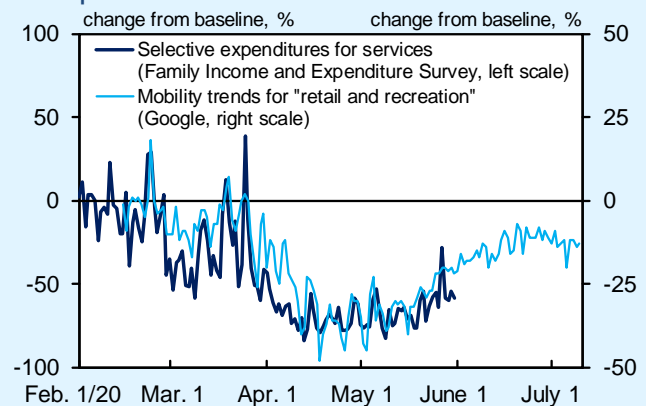
Thus, the spread of COVID-19 has brought about a significant decline in private consumption on the whole. At the same time, however, it has led to the creation of demand for new goods and services in some areas despite precautionary efforts by firms and households. For example, in terms of dining-out, demand for take-out and delivery services has expanded rapidly of late amid the situation of stricter self-restraint from going outside. On this point, fast food, which has its advantage in take-out and delivery services, has been relatively firm since March, although dining-out as a whole has dropped considerably

Chart B3-3: Developments in Services Consumption (Real)



Sources: Bank of Japan, etc.
 Notes: 1. Based on staff calculations. Figures are not adjusted for the travel balance.
 2. Figures in angular brackets show the weights in the Consumption Activity Index.

Chart B3-4: Mobility Trends and Selective Expenditures for Services



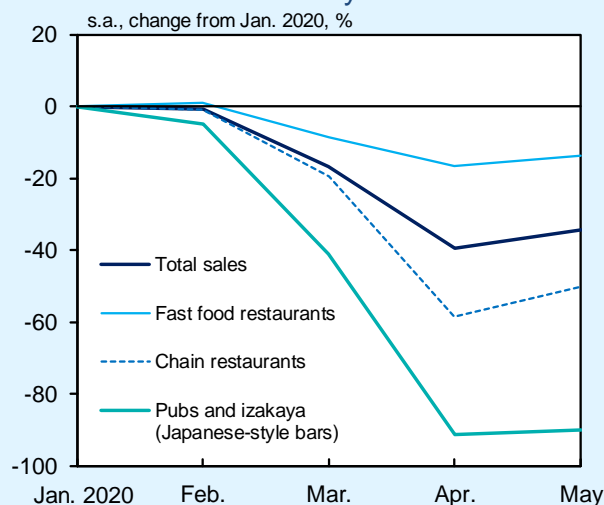
Sources: Ministry of Internal Affairs and Communications; Google LLC "Google COVID-19 Community Mobility Reports".
<https://www.google.com/covid19/mobility/> Accessed: July 15, 2020.
 Notes: 1. The baseline is the median on the corresponding day of the week during the 5-week period from January 3 to February 6, 2020.
 2. Figures for selective expenditures for services are the sum of expenditure on public transportation, recreational services (accommodation services, etc.), and meals outside the home. The latest figure is for May 31.
 3. Figures for mobility trends for "retail and recreation" are mobility trends for places such as restaurants, shopping centers, and theme parks. The latest figure is for July 10.

²³ Google releases changes in mobility by type of place for each country and region. "Retail and recreation" includes places such as restaurants, cafes, shopping centers, theme parks, museums, libraries, and movie theaters. Grocery stores and drugstores are included in a category labeled "grocery and pharmacy."

(Chart B3-5). In addition, the rapid expansion in teleworking and in taking online classes from home has led to an increase in demand for personal computers for home-use. The fact that people are spending more time at home also has led to an increase in demand for televisions and white goods such as high-performance air conditioners. As a result, although sales of household electrical appliances fell in April due to temporary store closures and shorter operating hours, they have picked up to date, led by personal computers, televisions, and white goods (Chart B3-6).

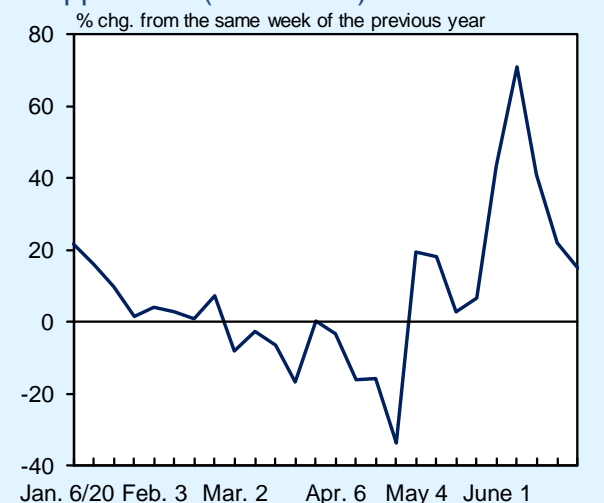
Although sufficient hard data for developments from June to date are not yet available, various sources, such as high-frequency indicators, statistics published by industry organizations, and anecdotal information from firms, suggest that it is highly likely that consumption activities have been heading toward a pick-up moderately on the whole. In particular, the number of people going out, which is strongly correlated with developments in selective expenditure for services, has picked up moderately since the second half of May, when the state of emergency was lifted gradually, and downward pressure on services consumption seems to have eased to date. However, amid a situation of vigilance against COVID-19 persisting, the nighttime population of selected downtown areas -- which has high correlation with developments in dining at restaurants in the evening and in *izakaya* (Japanese-style bars) that comprise services consumption of dining-out -- has been fairly slow to return to the previous level (Chart B3-7). In this situation, the pace of a pick-up in domestic travel, in particular long-distance travel, also seems to

Chart B3-5: Developments in Sales in the Food Services Industry



Source: Japan Foodservice Association, "Market Trend Survey of the Food Services Industry."
 Note: Based on staff calculations using data compiled by the Japan Foodservice Association.

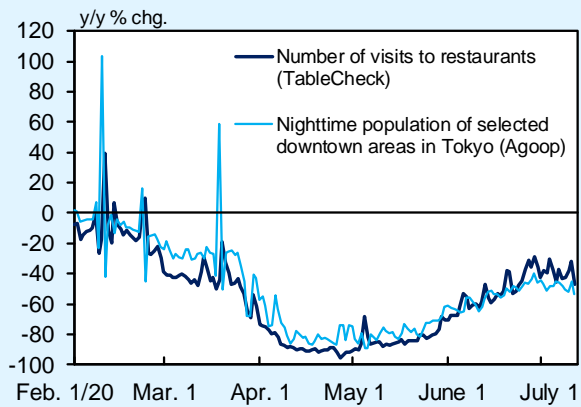
Chart B3-6: Sales of Household Electrical Appliances (METI POS)



Source: Ministry of Economy, Trade and Industry (METI).
 Note: The horizontal axis shows the starting date of each week. The latest figure is for the week of June 29 to July 5.

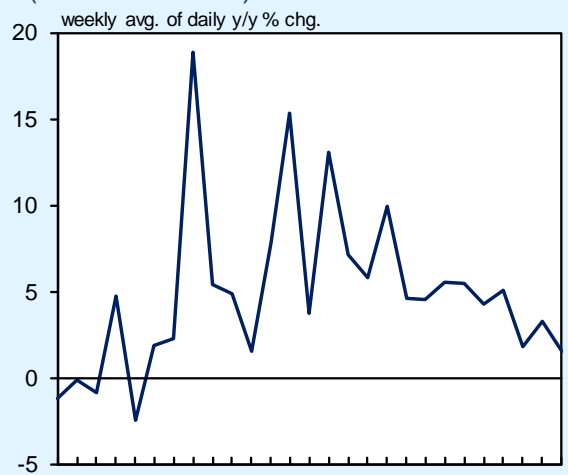
have been considerably slow, mainly reflecting requests for self-restraint from travelling across prefectures that continued until June 18. On the other hand, regarding goods consumption, (1) sales of household electrical appliances have picked up to date, partly due to the provision of special cash payments, and (2) clothing sales also have picked up with businesses reopening gradually (Chart B3-6). However, (3) growth in demand for food and daily necessities, which make up a large share of consumption, has slowed, partly due to the shift to dining-out (Chart B3-8). Thus, the overall increase in goods consumption seems to have been only small.

Chart B3-7: Number of Visits to Restaurants



Sources: TableCheck Inc.; Agoop Corp.
 Notes: 1. Figures for the number of visits to restaurants show the number of visits per restaurant, and are for about 4,500 restaurants that have installed the reservation and customer management system for restaurants provided by TableCheck Inc. The latest figure is for July 12.
 2. Figures for the nighttime population of selected downtown areas in Tokyo show the aggregate population between 20h-24h within a 500 m radius centered on Ginza, Shinjuku, and Roppongi stations. The figures for 2019 are estimated using data for the aggregate population within the 900 m x 900 m square areas centered around the same stations. The latest figure is for July 12.

Chart B3-8: Sales at Supermarkets (Nikkei CPINow)



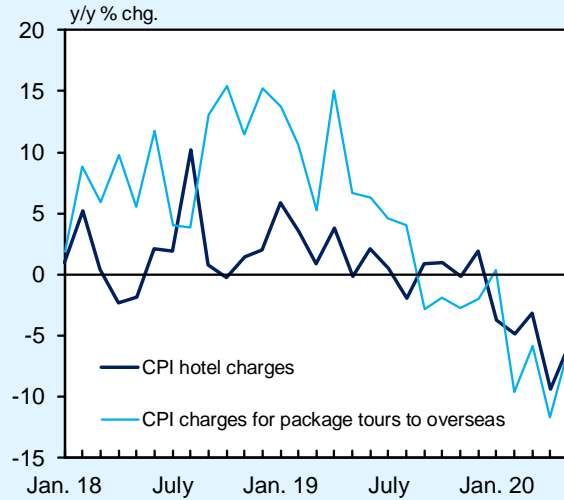
Source: NOWCAST, Inc.
 Note: The horizontal axis shows the starting date of each week. The latest figure is for the week of July 7 to 13.

(Box 4) Impact of COVID-19 on Price Changes

This box examines the impact of COVID-19 on recent price developments, while focusing on the differences in price changes by item.

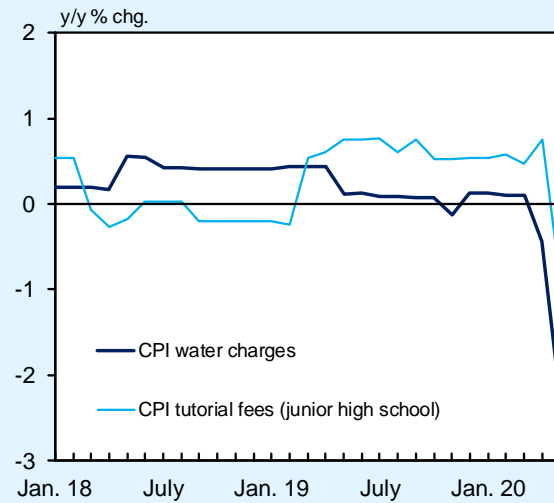
The year-on-year rate of change in the CPI (all items less fresh food) for January this year, which was before the outbreak of COVID-19, was 0.8 percent and that for May was minus 0.2 percent, indicating a decline of 1.0 percentage point (Chart 40). The decline in the CPI was largely attributable to the decline in energy prices, such as those of petroleum products (i.e., gasoline), pushing down the CPI by about 0.6 percentage point. It also was affected by a decline in the items that have relatively large weights in the CPI, mainly reflecting the direct impact of COVID-19 (Chart B4-1). Such items include (1) travel-related services such as charges for hotels and for package tours to overseas, (2) water charges, which declined due to a reduction and exemption by the local governments for those who have difficulty paying them, and (3) tutorial fees, which declined reflecting an introduction of online classes.²⁴

Chart B4-1: Price Changes by Item
1. Hotel Charges and Charges for Package Tours to Overseas



Source: Ministry of Internal Affairs and Communications.
Note: The CPI figures exclude the effects of the consumption tax hike.

2. Water Charges and Tutorial Fees

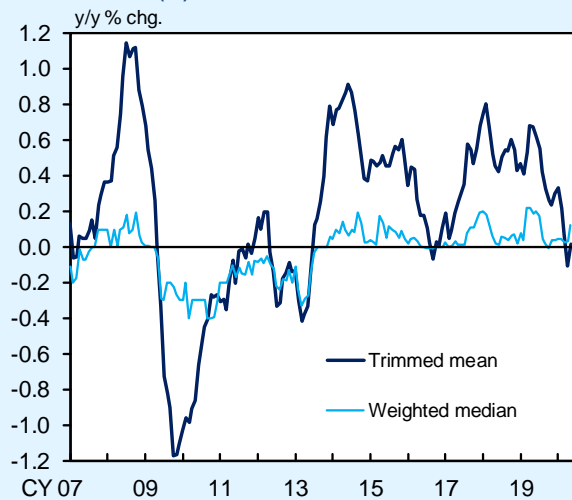


Source: Ministry of Internal Affairs and Communications.
Note: The CPI figures exclude the effects of the consumption tax hike.

²⁴ The decline in the CPI from April also is attributable to the provision of free higher education and a reduction in the mandatory auto insurance premium, both of which were decided before the outbreak of COVID-19.

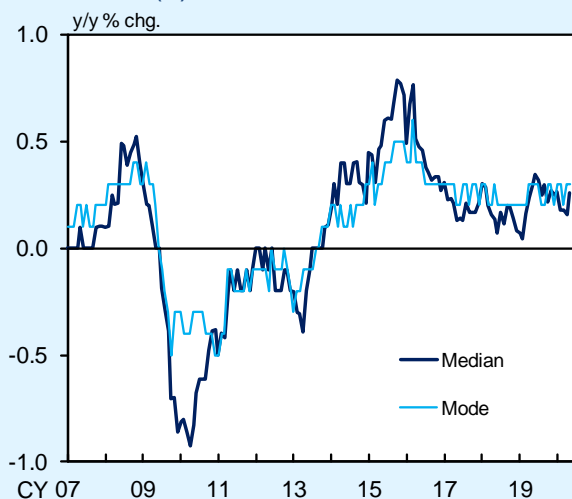
Various core indicators for capturing the underlying trend in the CPI show the following developments.²⁵ The rate of increase in the trimmed mean, which is relatively susceptible to changes in prices of items that have large weights in the CPI, has decelerated, mainly reflecting developments in the aforementioned items (Chart B4-2).²⁶ On the other hand, the rates of increase in the median and the mode, which are less susceptible to developments in prices of items with large weights since these indicators are calculated by treating the effects of each CPI item equally, have been in the range of 0.0-0.5 percent recently, suggesting that there has been no particular change in the underlying trend (Chart B4-3).²⁷ The share of price-increasing items minus the share of price-decreasing items has maintained its relatively high level thus far, and the share of price-decreasing items alone has not risen significantly (Chart B4-4).

Chart B4-2: Measures of Underlying Inflation (1)



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 and policies concerning the provision of free education. The CPI figures from April 2020 onward are based on staff estimations and exclude the effects of measures such as free higher education introduced in April 2020.

Chart B4-3: Measures of Underlying Inflation (2)



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 and policies concerning the provision of free education. The CPI figures from April 2020 onward are based on staff estimations and exclude the effects of measures such as free higher education introduced in April 2020.

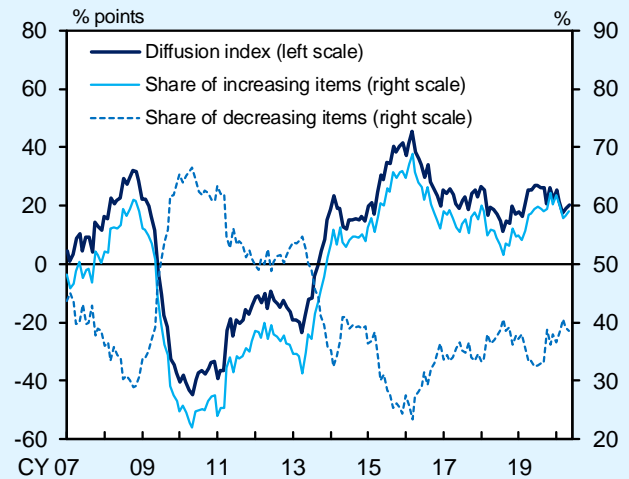
²⁵ The examinations of the following indicators are based on the CPI excluding the effects of the consumption tax hikes and policies concerning the provision of free education.

²⁶ 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 weighted median is the average of the inflation rates of the items at around the 50 percentile point of the cumulative distribution in terms of weight.

²⁷ The median is the average of the inflation rates of the items of the price change distribution. The mode is the inflation rate with the highest density in the price change distribution.

Looking at the price change distribution based on the weight of each item, the items for which prices have seen large declines have increased their share to some extent lately, reflecting the aforementioned declines in prices of certain items due to the impact of COVID-19 (Chart B4-5[1]). On the other hand, the distribution based on the number of items shows that there has been no significant change in the shape since the start of this year to date (Chart B4-5[2]). Thus, the shapes of these distributions imply that the decline in the year-on-year rate of change in the CPI to date can be explained mostly by the decline in prices of some items that are affected strongly by COVID-19.

Chart B4-4: Diffusion Index of Price Changes

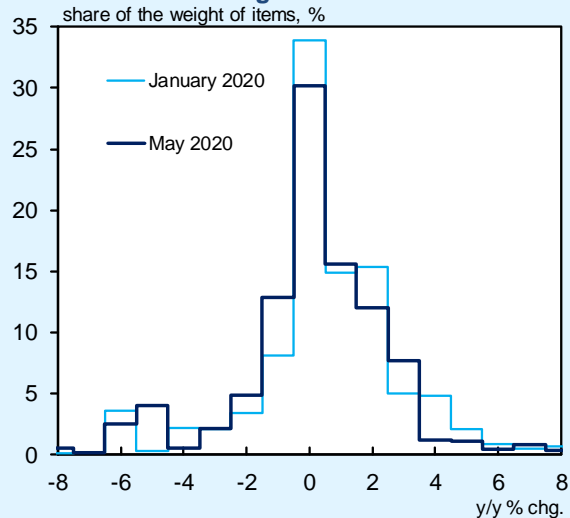


Sources: Bank of Japan; Ministry of Internal Affairs and Communications.
 Note: The diffusion index is defined as the share of increasing items minus the share of decreasing items. The share of increasing/decreasing items is the share of items whose price indices increased/decreased from a year earlier.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

Although firms reduced their prices to stimulate demand during the deflationary period in the past, such price-setting behavior is not observed widely at this point. The following can be considered as factors behind this. The first factor is that, despite a rapid depression in overseas economies, there has not been a sudden appreciation of the yen, and thus downward pressure on prices of durable goods and food products, which are sensitive to developments in the foreign exchange rates, has not intensified significantly (Chart B4-6). These developments are contrary to those observed immediately after the global financial crisis, when the declines in prices of these items pushed down the overall CPI due to a sudden appreciation of the yen. Second, since the government's large-scale income support measures have firmly supported households' disposable income, their preference to cut back on spending has not increased as much as it did during the deflationary period in the past. A third factor is that, under the "new lifestyle," a decline in

Chart B4-5: Price Change Distribution

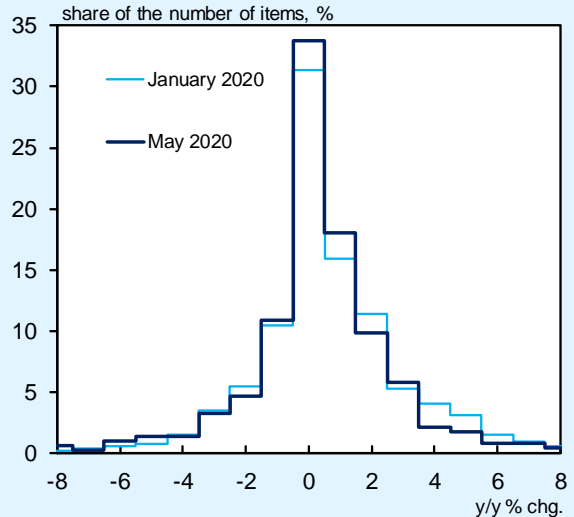
1. Based on the Weight of Items



Source: Ministry of Internal Affairs and Communications.
 Note: Based on staff calculations using the CPI less fresh food, energy and house rent (private and imputed rent) excluding the effects of the consumption tax hike and policies concerning the provision of free education. The figure for May 2020 is based on staff estimations and excludes the effects of measures such as free higher education introduced in April 2020.

productivity (i.e., a decline in customers to which services can be provided with the same input) is inevitable for firms in the services industry, such as dining-out as well as culture and recreation, in view of avoiding crowds, and thus those firms cannot reduce their prices for the purpose of stimulating demand. Since developments in the CPI slightly lag behind the business cycle, it is necessary to wait a little longer until more data become available to examine these factors.

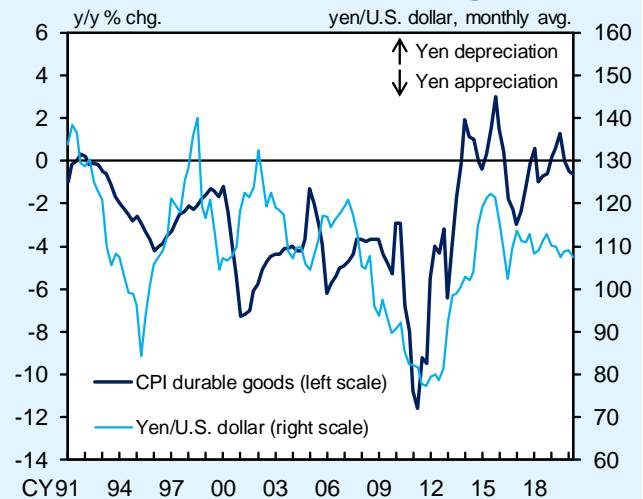
2. Based on the Number of Items



Source: Ministry of Internal Affairs and Communications.
 Note: Based on staff calculations using the CPI less fresh food, energy and house rent (private and imputed rent) excluding the effects of the consumption tax hike and policies concerning the provision of free education. The figure for May 2020 is based on staff estimations and excludes the effects of measures such as free higher education introduced in April 2020.

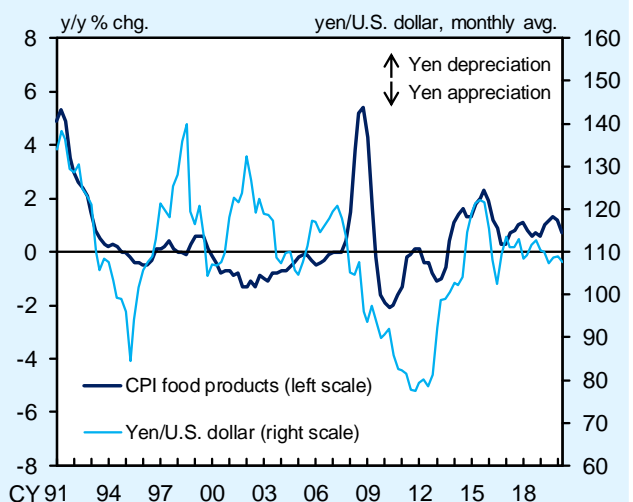
Chart B4-6: Inflation Rate and Exchange Rate

1. Durable Goods Prices and Exchange Rate



Sources: Ministry of Internal Affairs and Communications; Bloomberg.
 Note: The CPI figures exclude the effects of the consumption tax hikes. The figure for 2020/Q2 is the April-May average.

2. Food Products Prices and Exchange Rate



Sources: Ministry of Internal Affairs and Communications; Bloomberg.
 Note: The CPI figures exclude the effects of the consumption tax hikes. The figure for 2020/Q2 is the April-May average.

(Box 5) Japan's Financial Conditions under the Impact of COVID-19

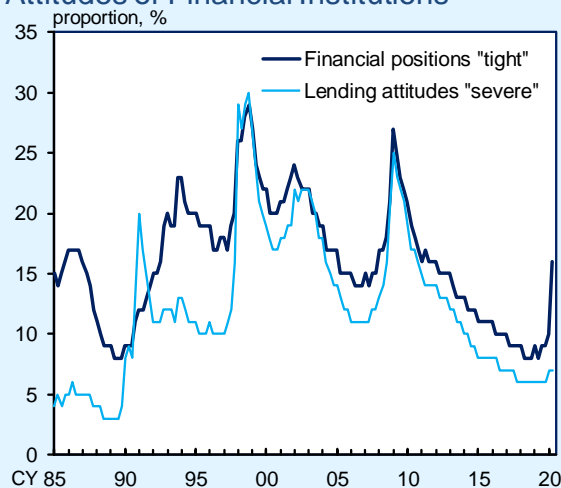
COVID-19 has been exerting stress on financing such as of firms, mainly through a decline in sales due to constrained economic activity. In this situation, the Bank, in cooperation with the government, has actively made responses to support financing, mainly of firms. This box examines developments in Japan's financial conditions under the impact of COVID-19, as well as the policy effects.

Financial positions, mainly of firms, have deteriorated in Japan, regardless of firm size, due mainly to the sales decline that reflects the impact of COVID-19 (Chart 50). In response to this situation, the government and the Bank have taken aggressive measures to support financing, mainly of firms (Chart B5-1). The government has provided effectively interest-free and unsecured loans mainly to small and medium-sized firms through government-affiliated and private financial institutions. It also has provided crisis response loans to medium-sized and large firms through government-affiliated financial institutions. Since this March, with regard to the Special Program to Support Financing in Response to the Novel Coronavirus (COVID-19), the Bank has increased purchases of CP and corporate bonds as well as established and strengthened the Special Funds-Supplying Operations to Facilitate Financing in Response to the Novel Coronavirus (COVID-19), which is a new measure to encourage lending by financial institutions. This operation includes a scheme in which the Bank provides funds to private financial institutions on favorable terms for the loans that they make to small and medium-sized firms as well as sole

Chart B5-1: Major Measures to Support Corporate Financing

Japanese Government	<ul style="list-style-type: none"> -- Provision of effectively interest-free and unsecured loans to SMEs mainly through JFC and private financial institutions -- Provision of crisis response loans to medium-sized and large companies through DBJ and the Shoko Chukin Bank -- Programs by the credit guarantee corporations such as the Safety Net Guarantees Nos.4 and 5 and the Crisis-Related Guarantee -- Equity support mainly through subordinated loans and capital injections
Bank of Japan <Special Program>	<ul style="list-style-type: none"> -- Special Funds-Supplying Operations in response to COVID-19 <ol style="list-style-type: none"> 1. Fund-provisioning against private debt pledged as collateral 2. Fund-provisioning against eligible loans such as interest-free and unsecured loans based on the aforementioned government's measure -- Increase in purchases of CP and corporate bonds

Chart B5-2: Firms' Financial Positions and Their Perceptions of Lending Attitudes of Financial Institutions



Source: Bank of Japan.
Note: Based on the *Tankan*. All enterprises.

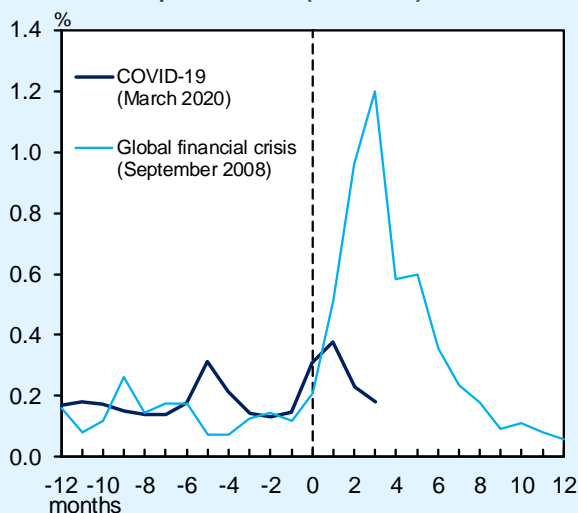
proprietors, mainly by making use of the government's programs to support financing. In cooperation with the government's measures, this serves to encourage active efforts by private financial institutions.

Under these various measures taken by the Bank and the government, financial institutions' lending attitudes have remained at their accommodative levels (Charts B5-2 and 49). What is unique to the current situation in particular is that, compared with the past phase of being under stress, there is a smaller proportion of firms answering that financial institutions' lending attitudes are "severe." In fact, the year-on-year rate of increase in bank lending has been at around 6.5 percent, registering the highest growth in about 30 years. In addition, issuance spreads for CP and corporate bonds expanded temporarily but have narrowed of late, suggesting that issuance conditions have remained favorable, even when compared with those under the global financial crisis (Chart B5-3). Under these circumstances, funding by the private sector has maintained its high growth, with the amounts outstanding of bank lending, CP, and corporate bonds all contributing to the increase (Chart B5-4). The DI for financial positions of small and medium-sized firms, which had deteriorated rapidly compared with the past shocks, has shown a rise in negative territory recently (Chart B5-5).

Thus, on the back of various measures taken by the Bank and the government, the environment for external funding has remained accommodative, and thus the liquidity has been supported from the financial side. In addition, the

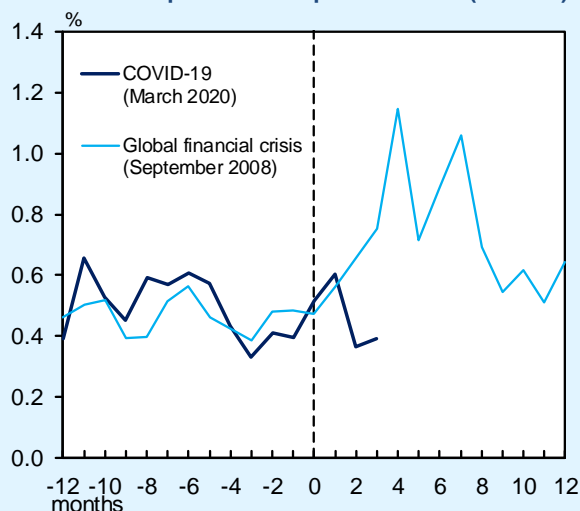
Chart B5-3: Domestic Funding Environment

1. Issuance Spread for CP (Rated a-1)



Sources: Bank of Japan; Japan Securities Depository Center; Bloomberg.
 Notes: 1. The issuance spread is calculated as the issuance yield for CP minus the yield on 3-month T-Bills.
 2. Month 0 is indicated in the legend for each event.

2. Issuance Spread for Corporate Bonds (Rated A)

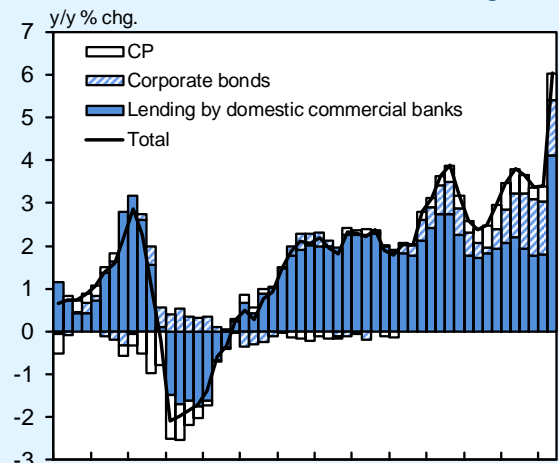


Sources: Capital Eye; I-N Information Systems.
 Notes: 1. The issuance spread is calculated as the issuance yield for corporate bonds minus the yield on JGBs with the same maturity.
 2. Month 0 is indicated in the legend for each event.

government has conducted support measures that take into account the solvency problem. Specifically, it has enhanced programs that provide loans guaranteed by the credit guarantee corporations and established programs to supply capital and quasi-capital funds through government-affiliated financial institutions and some entities (Chart B5-1).

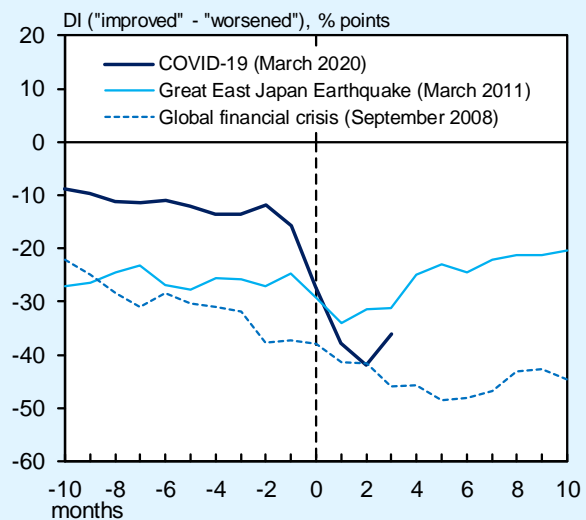
That said, there are extremely high uncertainties over the consequences of COVID-19 and their impact on the economy. If COVID-19 has a larger impact than expected, there is a risk that deterioration in the real economy will affect financial system stability, thereby exerting further downward pressure on the real economy. This risk is judged as not significant at this point, since (1) financial institutions have considerable resilience in terms of both capital and liquidity, (2) firms have maintained robust financial bases on the whole, and (3) the Bank and the government have made policy responses. However, it is necessary to pay close attention to future developments.

Chart B5-4: Private Sector Funding



Sources: Bank of Japan; Japan Securities Depository Center; Japan Securities Dealers Association; HN Information Systems.
 Note: Figures for lending by domestic commercial banks include those for lending to local governments.

Chart B5-5: Financial Positions of Small and Medium-Sized Firms



Source: Japan Chamber of Commerce and Industry.
 Notes: 1. Based on the LOBO survey. The survey includes sole proprietors.
 2. Month 0 is indicated in the legend for each event.

