April 28, 2022

Bank of Japan

Outlook for Economic Activity and Prices (April 2022)

The Bank's View[1]

Summary

- Japan's economy is likely to recover, with the impact of the novel coronavirus (COVID-19) and supply-side constraints waning and with support from an increase in external demand, accommodative financial conditions, and the government's economic measures, although it is expected to be under downward pressure stemming from a rise in commodity prices due to factors such as the situation surrounding Ukraine. Thereafter, as the negative impact of high commodity prices wanes and a virtuous cycle from income to spending intensifies gradually, Japan's economy is projected to continue growing, albeit more slowly, at a pace above its potential growth rate.
- The year-on-year rate of change in the consumer price index (CPI, all items less fresh food) is likely to increase temporarily to around 2 percent -- due to the impact of a significant rise in energy prices -- in fiscal 2022, when the effects of a reduction in mobile phone charges dissipate. Thereafter, however, the rate of increase is expected to decelerate because the positive contribution of the rise in energy prices to the CPI is likely to wane. Meanwhile, in terms of inflation excluding energy, for which prices fluctuate significantly, the year-on-year rate of change in the CPI (all items less fresh food and energy) is expected to moderately increase in positive territory on the back of improvement in the output gap and rises in medium- to long-term inflation expectations and wage inflation, and partly also of a pass-through of raw material cost increases to food in particular.
- Comparing the projections through fiscal 2023 with those presented in the previous *Outlook for Economic Activity and Prices* (Outlook Report), the projected growth rates for fiscal 2021 and 2022 are lower due to the effects of such factors as a resurgence of COVID-19, the rise in commodity prices, and a slowdown in overseas economies. However, the projected growth rate for fiscal 2023 is higher, partly owing to a rebound from the lower projection in the previous year. The projected rate of increase in the CPI for fiscal 2022 is significantly higher, mainly reflecting the impact of the rise in energy prices.
- Concerning risks to the outlook, the course of COVID-19, including variants, and its impact on domestic and overseas economies continue to warrant attention. In addition, there are extremely high uncertainties over developments in the situation surrounding Ukraine and the associated developments in commodity prices, global financial and capital markets, and overseas economies.
- With regard to the risk balance, risks to economic activity are skewed to the downside for the time being, mainly due to the impact of COVID-19 and the situation surrounding Ukraine, but are generally balanced thereafter. Risks to prices are skewed to the upside for the time being, mainly reflecting uncertainties over energy prices, but are generally balanced thereafter.

[1] "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on April 27 and 28, 2022.

I. Current Situation of Economic Activity and Prices in Japan

Japan's economy has picked up as a trend, although some weakness has been seen in part, mainly due to the impact of COVID-19 and the rise in commodity prices. Overseas economies have recovered on the whole, albeit with variation across countries and regions. In this situation, exports and industrial production have continued to increase as a trend, despite the remaining effects of supply-side constraints. Corporate profits have improved on the whole, but business sentiment has seen a pause in its improvement recently, mainly due to the impact of COVID-19 and the rise in commodity prices. Business fixed investment has picked up, although weakness has been seen in some industries. The employment and income situation has remained relatively weak on the whole, although improvement has been seen in some parts. Private consumption has started picking up again, with downward pressure stemming from COVID-19, particularly on services consumption, waning. Housing investment has been more or less flat. Public investment has been relatively weak, albeit at a high level. Financial conditions have been accommodative on the whole, although weakness in firms' financial positions has remained in some segments. On the price front, the year-on-year rate of change in the CPI (all items less fresh food), despite being affected by the reduction in mobile phone charges, has been in the range of 0.5-1.0 percent, reflecting price rises in energy and other items. Meanwhile, inflation expectations, particularly short-term ones, have risen.

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

A. Baseline Scenario of the Outlook for Economic Activity

<u>From the beginning to the middle of the projection period</u>, Japan's economy is likely to recover, with the impact of COVID-19 and supply-side constraints waning and with support from an increase in external demand, accommodative financial conditions, and the government's economic measures, although it is expected to be under downward pressure stemming from the rise in commodity prices.

Prices of commodities, such as crude oil, natural gas, and coal, and prices of grains, such as wheat, have seen a significant rise recently, mainly reflecting heightened supply concerns as a result of Russia's invasion of Ukraine. Since Japan relies on imports for most of these commodities, rises in these prices bring about an outflow of income from Japan (i.e., trading losses), and put downward pressure on households' real income and corporate profits through rises in energy and food prices. That said, the government's measures against oil price hikes and the accumulation of household savings that has resulted from pandemic-related restrictions are expected to mitigate downward pressure on income and the consequent negative impact on spending. In addition, a self-sustaining increase in demand, including pent-up demand, is projected to continue in both the household and corporate sectors with the impact of COVID-19 and supply-side constraints waning. For these reasons, the economy is likely to continue recovering. Specifically, in the household sector, private consumption is projected to recover, particularly led by the materialization of pent-up demand, as the situation with COVID-19 improves and as the resumption of consumption activities progresses while public health is being protected, mainly due to the widespread vaccinations and the rollout of antiviral medicines. In the corporate sector, exports and production are likely to increase, mainly for automobile-related goods, for which the effects of supply-side constraints are expected to wane, and for digital-related goods, which have seen an expansion in global demand. This is based on the projection that overseas economies will continue recovering on the whole, despite downward pressure from the situation surrounding Ukraine. Although raw material cost increases are projected to exert downward pressure, corporate profits are likely to remain at high levels on the whole, albeit with variation across industries and firm sizes, on the back of an increase in domestic and external demand and partly also of the yen's depreciation. In this situation, an uptrend in business fixed investment is expected to become clear as accommodative financial conditions provide support and supply-side constraints wane, although weakness is projected to remain for the time being in investment by the face-to-face services sector. Meanwhile, government spending is expected to be at a high level on the whole since it is projected that expenditure related to COVID-19 will continue, reflecting the government's past economic measures.

From the middle of the projection period, Japan's economy is projected to continue growing at a pace above its potential growth rate, as the negative impact of high commodity prices wanes and a virtuous cycle from income to spending intensifies gradually in the overall economy. That said, the pace of growth is highly likely to decelerate because the positive contribution of the materialization of pent-up demand is projected to wane.

In the household sector, employee income is likely to continue increasing moderately on the back of a rise in the number of non-regular employees associated with a recovery in the face-to-face services sector and of an increase in wage inflation that mainly reflects tightening labor market conditions and price rises. Due to this increase in employee income and a decline in downward pressure from rises in energy and food prices on real income, private consumption is expected to keep increasing steadily, although the materialization of pent-up demand is likely to slow. In the corporate sector, exports and production are likely to continue increasing moderately because it is projected that the growth in overseas economies, albeit decelerating, will stay at around the long-term average and that the effects of supply-side constraints, such as on semiconductors, will dissipate. Corporate profits are likely to return to an improving trend since domestic and external demand is expected to keep increasing and downward pressure stemming from raw material cost increases is likely to wane gradually. In this situation, with support from accommodative financial conditions, business fixed investment is expected to continue increasing, including investment to address labor shortage, digital-related investment, and research and development (R&D) investment related to growth areas and decarbonization.

Looking at the financial conditions on which the above outlook is based, it is expected that they will remain accommodative as the Bank pursues Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control, and that this will support an increase in private demand.[2] That is, the environment for external funding, such as bank borrowing and the issuance of CP and corporate bonds, is projected to remain accommodative. In addition, backed by the Bank's measures to support financing, the government's measures, and efforts made by private financial institutions, firms' financial positions -- including those of small and medium-sized ones, for which weakness has remained to date -- are likely to continue on an improving trend along with an economic recovery.

Meanwhile, the potential growth rate is expected to rise moderately.[3] This is mainly because productivity is likely to increase due to advances in digitalization and investment in human capital, and because capital stock growth is projected to accelerate due to the rise in business fixed investment. These developments are likely to be encouraged by the government's measures to transform the economic structure toward the post-COVID-19 era and by accommodative financial conditions.

B. Baseline Scenario of the Outlook for Prices

The year-on-year rate of change in the CPI (all items less fresh food) is likely to increase temporarily to around 2 percent -- due to the impact of a significant rise in energy prices -- in fiscal 2022, when the effects of a reduction in mobile phone charges dissipate. Thereafter, however, the rate of increase is expected to decelerate because the positive contribution of the rise in energy prices to the CPI is likely to wane. Meanwhile, in terms of inflation excluding energy, for which prices fluctuate significantly, the year-on-year rate of change in the CPI (all items less fresh food and energy) is expected to moderately increase in positive territory on the back of improvement in the output gap and rises in medium- to long-term inflation expectations and wage inflation, and partly also of a pass-through of raw material cost increases to food in particular.

The main factors that determine inflation rates are assessed as follows. The output gap, which captures the utilization of labor and capital, has been negative recently. However, with Japan's economy following a growth path that outpaces its potential growth rate, it is

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

[3] Under a specific methodology, Japan's recent potential growth rate is estimated to be marginally positive. However, the rate should be interpreted with considerable latitude. This is because the estimate is subject to change depending on the methodologies employed and could be revised as the sample period becomes longer over time. In addition, there are particularly high uncertainties in the current phase over how COVID-19 will affect the trends in productivity or labor supply.

projected to turn clearly positive around the second half of fiscal 2022 and then continue to expand moderately. Under these circumstances, labor market conditions are expected to tighten, partly due to a deceleration in the pace of increase in labor force participation of women and seniors, and upward pressure on wages is projected to intensify gradually. This is likely to contribute to improvement in households' tolerance of price rises and, coupled with the tight supply and demand conditions for goods and services, lead to a rise in inflation.

Medium- to long-term inflation expectations have risen, albeit at a moderate pace relative to short-term ones. Firms' price-setting stance has become increasingly active as a result of upward pressure remaining on costs from preventive measures against COVID-19 and of the recent rise in commodity prices. It is therefore likely that the pass-through of cost increases and a rise in selling prices will become widely observed, particularly for goods. The increase in actual inflation is expected to lead to a further rise in households' and firms' medium- to long-term inflation expectations through the adaptive formation mechanism and, in turn, bring about a wider range of price rises, including for services, and an increase in wage inflation.

III. Risks to Economic Activity and Prices

A. Risks to Economic Activity

Regarding the aforementioned baseline scenario of the outlook for economic activity, it is necessary to pay particular attention to the following upside and downside risks, which are associated mainly with the course of COVID-19 and the situation surrounding Ukraine.

The first is the <u>impact of COVID-19 on private consumption as well as on firms' export and production activities</u>. There seems to be persistent vigilance against COVID-19 by Japanese households, particularly seniors, as evidenced by their behavior during the spread of the Omicron variant since the beginning of the year. If this tendency continues and people become less willing to go out, for example, due to factors such as the spread of highly contagious new variants, there is a risk that the materialization of pent-up demand will be delayed and private consumption will be pushed down. On the other hand, if people's vigilance against COVID-19 lessens significantly with the widespread vaccinations and the rollout of antiviral medicines, household savings that have accumulated as a result of pandemic-related restrictions could be withdrawn by more than expected and private consumption could be pushed up. In the meantime, with global supply and demand conditions for digital-related goods such as semiconductors remaining tight, there is a possibility that supply-side constraints become prolonged and amplified due, for example, to a resurgence of COVID-19 at home and abroad, the resultant strict public health measures in some countries and regions, and the consequent supply-chain disruptions. If this happens, Japan's exports and production could be pushed down and the adverse impact could even spill over to goods consumption and business fixed investment.

The second factor is developments in commodity prices. Commodity prices have risen on the back of an expansion in demand for commodities due to the global resumption of economic activity; these prices have recently been under increasing upward pressure even from the supply side due to heightened geopolitical risks concerning the situation surrounding Ukraine, in addition to the existing moves toward decarbonization. Since the rise in commodity prices due to supply factors is not accompanied by an expansion in external demand or an increase in exports, it puts greater downward pressure on economies of commodity importers like Japan through an increase in import costs. For this reason, if high commodity prices persist, Japan's economy could deviate downward from the baseline scenario through deterioration in the terms of trade. On the other hand, if these prices decline significantly on the back of, for example, an easing of geopolitical tensions, the economy could deviate upward through improvement in the terms of trade.

The third factor is developments in global financial and capital markets and in overseas economies. Amid concern in these markets over acceleration in the pace of reduction in monetary accommodation -- mainly for advanced economies facing a continued rise in inflation -- global financial conditions could tighten by more than expected through, for example, adjustments in risk asset prices and capital outflows from emerging economies. If this occurs, there is a risk that overseas economies will deviate downward from the baseline scenario. Furthermore, depending on the course of the situation surrounding Ukraine, overseas economies, particularly the euro area, which has strong economic relations with Russia and Ukraine, could be pushed down through the channels of a reduction in trade, in addition to a rise in commodity prices and amplification of supply-side constraints. Meanwhile, signs of a slowdown in the Chinese economy could become clearer due, for example, to adjustments in its real estate sector, with the medium- to long-term growth potential declining gradually.

The fourth factor considered from a somewhat long-term perspective is firms' and households' medium- to long-term growth expectations. It is expected that efforts with a view to the post-COVID-19 era, digitalization, and decarbonization will change Japan's economic structure and people's working styles. Depending on how households and firms react to such changes, their medium- to long-term growth expectations, the potential growth rate, and the output gap could go either upward or downward.

B. Risks to Prices

If the aforementioned risks to economic activity materialize, prices also are likely to be affected accordingly. In addition, it is necessary to pay attention to the following two risks that are specific to prices.

The first is high uncertainties over firms' price- and wage-setting behavior, which could exert either upward or downward pressure on prices. Depending on the degree of upward pressure from raw material costs and on developments in firms' inflation expectations, the pass-through of cost increases to selling prices could accelerate by more than expected and lead prices to deviate upward from the baseline scenario. On the other hand, given that, in Japan, the behavior and mindset based on the assumption that prices and wages will not increase easily are deeply entrenched, there is a risk that moves to increase wages will not strengthen, households' tolerance of price rises will be slow to improve, and prices will deviate downward from the baseline scenario.

The second risk is future developments in foreign exchange rates and international commodity prices, as well as the extent to which such developments will spread to import prices and domestic prices. These risks may lead prices to deviate either upward or downward from the baseline scenario. In particular, due to high uncertainties over the course of the situation surrounding Ukraine, fluctuations in international commodity prices have been significant recently. In this situation, the impact on overall prices through energy and food prices warrants attention.

IV. Conduct of Monetary Policy

In the context of the price stability target, the Bank assesses the aforementioned economic and price situation from two perspectives and then outlines its thinking on the future conduct of monetary policy.[4]

The first perspective involves an examination of the baseline scenario of the outlook. Although it will take time, the year-on-year rate of change in the CPI is likely to increase gradually as an underlying trend toward achieving the price stability target, mainly on the back of improvement in the output gap and rises in medium- to long-term inflation expectations and wage inflation.

The second perspective involves an examination of the risks considered most relevant to the conduct of monetary policy. Concerning risks to the outlook, the course of COVID-19, including variants, and its impact on domestic and overseas economies continue to warrant attention. In addition, there are extremely high uncertainties over developments in the situation surrounding Ukraine and the associated developments in commodity prices, global financial and capital markets, and overseas economies. With regard to the risk balance, risks to economic activity are skewed to the downside for the time being, mainly due to the impact of COVID-19 and the situation surrounding Ukraine, but are generally balanced thereafter. Risks to prices are skewed to the upside for the time being, mainly

[4] As for the examination from two perspectives in the context of the price stability target, see the Bank's statement released on January 22, 2013, entitled "The 'Price Stability Target' under the Framework for the Conduct of Monetary Policy."

reflecting uncertainties over energy prices, but are generally balanced thereafter. On the financial side, overheating has not been seen in asset markets and financial institutions' credit activities. Japan's financial system has maintained stability on the whole, despite the pandemic. Even in the case of an adjustment in the real economy and global financial markets, the financial system is likely to remain highly robust on the whole, mainly because financial institutions have sufficient capital bases. When examining financial imbalances from a longer-term perspective, if downward pressure on financial institutions' profits, such as from low interest rates, the declining population, and excess savings in the corporate sector, becomes prolonged, this could create a risk of a gradual pullback in financial intermediation. On the other hand, under these circumstances, the vulnerability of the financial system could increase, mainly due to the search for yield behavior. Although these risks are judged as not significant at this point, it is necessary to pay close attention to future developments.[5]

As for the conduct of monetary policy, the Bank will continue with QQE with Yield Curve Control, aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner. It will continue expanding the monetary base until the year-on-year rate of increase in the observed CPI (all items less fresh food) exceeds 2 percent and stays above the target in a stable manner.

For the time being, while closely monitoring the impact of COVID-19, the Bank will support financing, mainly of firms, and maintain stability in financial markets, and will not hesitate to take additional easing measures if necessary; it also expects short- and long-term policy interest rates to remain at their present or lower levels.

[5] For details, see the Bank's *Financial System Report* (April 2022).

(Appendix)

Forecasts of the Majority of the Policy Board Members

y/y % chg.

	Real GDP	CPI (all items less fresh food)	(Reference) CPI (all items less fresh food and energy)
Fiscal 2021	+2.0 to +2.2 [+2.1]	+0.1	-0.8
Forecasts made in January 2022	+2.7 to +2.9 [+2.8]	0.0 to +0.1 [0.0]	-
Fiscal 2022	+2.6 to +3.0 [+2.9]	+1.8 to +2.0 [+1.9]	+0.8 to +1.0 [+0.9]
Forecasts made in January 2022	+3.3 to +4.1 [+3.8]	+1.0 to +1.2 [+1.1]	-
Fiscal 2023	+1.5 to +2.1 [+1.9]	+0.9 to +1.3 [+1.1]	+1.1 to +1.3 [+1.2]
Forecasts made in January 2022	+1.0 to +1.4 [+1.1]	+1.0 to +1.3 [+1.1]	-
Fiscal 2024	+1.1 to +1.3 [+1.1]	+1.0 to +1.3 [+1.1]	+1.2 to +1.5 [+1.5]

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

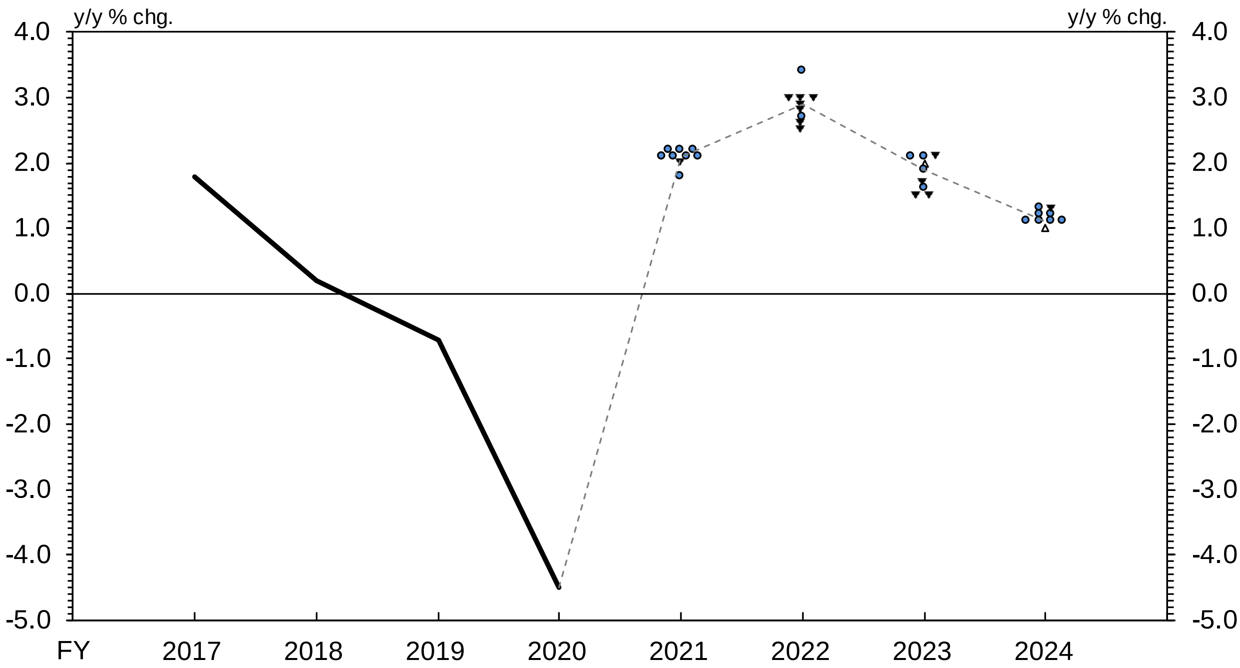
2. The forecasts of the majority of the Policy Board members are constructed as follows: each Policy Board member's forecast takes the form of a point estimate -- namely, the figure to which they attach the highest probability of realization. These forecasts are then shown as a range, with the highest figure and the lowest figure excluded. The range does not indicate the forecast errors.

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

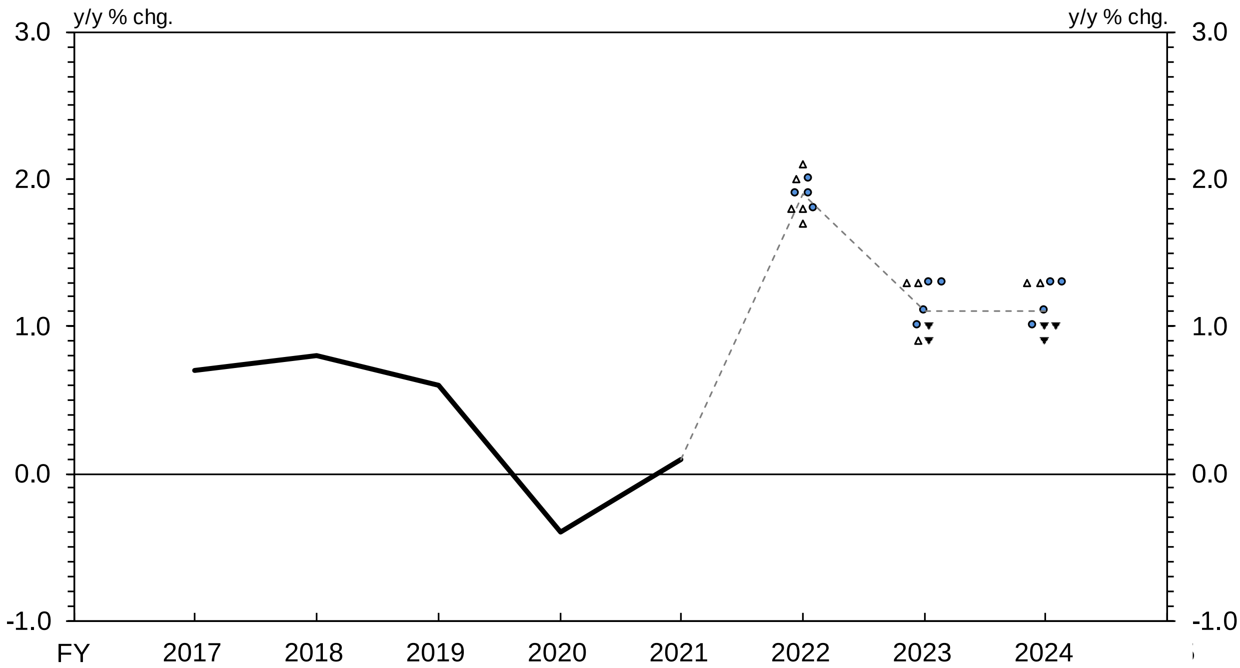
4. The CPI figures for fiscal 2021 are actual values.

Policy Board Members' Forecasts and Risk Assessments

(1) Real GDP



(2) CPI (All Items Less Fresh Food)



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

2. The locations of ●, △, and ▼ in the charts indicate the figures for each Policy Board member's forecasts to which they attach the highest probability. The risk balance assessed by each Policy Board member is shown by the following shapes: ● indicates that a member assesses "upside and downside risks as being generally balanced," △ indicates that a member assesses "risks are skewed to the upside," and ▼ indicates that a member assesses "risks are skewed to the downside."