January 18, 2023
Bank of Japan

Outlook for Economic Activity and Prices (January 2023)

The Bank's View[1]

Summary

- Japan's economy is likely to recover toward the middle of the projection period, with the impact of the novel coronavirus (COVID-19) and supply-side constraints waning, although it is expected to be under downward pressure stemming from high commodity prices and slowdowns in overseas economies. Thereafter, as a virtuous cycle from income to spending intensifies gradually, Japan's economy is projected to continue growing at a pace above its potential growth rate.
- The year-on-year rate of increase in the consumer price index (CPI, all items less fresh food) is likely to be relatively high in the short run due to the effects of a pass-through to consumer prices of cost increases led by a rise in import prices. The rate of increase is then expected to decelerate toward the middle of fiscal 2023 due to a waning of these effects, as well as to the effects of pushing down energy prices from the government's economic measures. Thereafter, it is projected to accelerate again moderately on the back of improvement in the output gap, rises in medium- to long-term inflation expectations and in wage growth, and a waning of the effects of the economic measures pushing down energy prices toward the middle of fiscal 2023.
- Comparing the projections with those presented in the previous *Outlook for Economic Activity and Prices* (Outlook Report), the projected growth rates for fiscal 2022 and 2023 are somewhat lower, mainly due to overseas economies deviating downward from the previous baseline scenario, although the government's economic measures are likely to make a positive contribution to the growth rates. The projected growth rate for fiscal 2024 is somewhat lower due to a waning of the effects of those measures pushing up the economy of the previous year. The projected rates of increase in the CPI for fiscal 2022 and 2023 are more or less unchanged, as effects such as those of a pass-through to consumer prices of cost increases led by a rise in import prices are likely to offset the effects of pushing down energy prices from the economic measures. The projected rate of increase in the CPI for fiscal 2024 is somewhat higher due to a waning of the effects of those measures pushing down energy prices of the previous year.
- Concerning risks to the outlook, there remain extremely high uncertainties for Japan's economy, including the following: developments in overseas economic activity and prices; developments in the situation surrounding Ukraine and in commodity prices; and the course of COVID-19 at home and abroad and its impact. In this situation, it is necessary to pay due attention to developments in financial and foreign exchange markets and their impact on Japan's economic activity and prices.
- With regard to the risk balance, risks to economic activity are skewed to the downside for fiscal 2022 and 2023 but are generally balanced for fiscal 2024. Risks to prices are skewed to the upside.

[1] "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on January 17 and 18, 2023.

I. Current Situation of Economic Activity and Prices in Japan

Japan's economy, despite being affected by factors such as high commodity prices, has picked up as the resumption of economic activity has progressed while public health has been protected from COVID-19. The pace of recovery in overseas economies has slowed. Exports and industrial production have increased as a trend, with the effects of supply-side constraints waning. Corporate profits have been at high levels on the whole, and business sentiment has been more or less unchanged. In this situation, business fixed investment has increased moderately. The employment and income situation has improved moderately on the whole. Private consumption has increased moderately, despite being affected by COVID-19. Housing investment has been relatively weak. Public investment has been more or less flat. 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) has been in the range of 3.5-4.0 percent due to rises in prices of such items as energy, food, and durable goods. Meanwhile, inflation expectations have risen.

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

A. Baseline Scenario of the Outlook for Economic Activity

Toward the middle of the projection period, Japan's economy is likely to recover, with the impact of COVID-19 and supply-side constraints waning and with support from accommodative financial conditions and the government's economic measures, although it is expected to be under downward pressure stemming from high commodity prices and slowdowns in overseas economies.

In the household sector, regarding the employment situation, the number of regular employees is expected to continue increasing, and a rise in that of non-regular employees is likely to become evident with a recovery in the face-to-face services sector. In addition, wage growth is expected to increase, reflecting tightening labor market conditions and price rises. Due to these factors, employee income is projected to continue increasing moderately. In this situation, although private consumption is expected to be under downward pressure from the real income side due to price rises, it is projected to continue increasing. This is mainly because pent-up demand is likely to materialize, supported by household savings that had accumulated as a result of pandemic-related restrictions, as the resumption of consumption activities progresses further while public health is being protected. Private consumption is also likely to be underpinned by the government's measures to reduce the household burden of higher gasoline prices, electricity charges, and manufactured and piped gas charges, and by its domestic travel discount program. In the corporate sector, although overseas economies are projected to slow, mainly due to the impact of global inflationary pressure and policy interest rate hikes by central banks, exports and production are likely to remain on an uptrend with the effects of supply-side constraints waning and with support from high levels of order backlogs for automobiles and capital goods. Inbound tourism demand, which is categorized under services exports, is also expected to increase, mainly in reflection of the government's relaxation of entry restrictions. Although high raw material costs 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. This will likely occur due to continued improvement in economic activity on the back of factors such as the materialization of pent-up demand. In this situation, as accommodative financial conditions provide support and supply-side constraints wane, business fixed investment is expected to continue increasing, including investment to address labor shortage, digital-related investment, research and development (R&D) investment related to growth areas and decarbonization, and investment associated with strengthening supply chains. Meanwhile, public investment is projected to be more or less flat, with expenditure related to building national resilience continuing. Government consumption is expected to decline gradually in reflection of developments in expenditure related to COVID-19.

<u>From the middle of the projection period</u>, Japan's economy is projected to continue growing at a pace above its potential growth rate as a virtuous cycle from income to spending intensifies gradually in the overall economy. That said, the pace of growth is highly likely to decelerate due to a waning of the contribution from the materialization of pent-up demand, as well as to a waning of the effects of the government's economic measures pushing up the economy of the previous year.

In the household sector, employee income is likely to continue increasing on the back of a moderate rise in the number of employees associated with improvement in economic activity and of an increase in wage growth that reflects tightening labor market conditions and price rises. Supported by this increase in employee 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 increase moderately with overseas economies picking up. Inbound tourism demand is expected to continue increasing. Corporate profits are likely to follow an improving trend since domestic and external demand is expected to increase and downward pressure stemming from high raw material costs is likely to wane gradually. In this situation, with support from accommodative financial conditions, business fixed investment is expected to continue increasing.

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 this situation, firms' financial positions 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 a rise in business fixed investment. These developments are likely to be encouraged by the government's various measures and by accommodative financial conditions.

B. Baseline Scenario of the Outlook for Prices

The year-on-year rate of increase in the CPI (all items less fresh food) is likely to be relatively high in the short run due to the effects of a pass-through to consumer prices of cost increases led by a rise in import prices. The rate of increase is then expected to decelerate toward the middle of fiscal 2023 due to a waning of these effects, as well as to the effects of pushing down energy prices from the government's economic measures. Thereafter, it is projected to accelerate again moderately on the back of improvement in the output gap, rises in medium- to long-term inflation expectations and in wage growth, and a waning of the effects of the economic measures pushing down energy prices toward the middle of fiscal 2023. The government's measures to reduce the household burden of higher gasoline prices, electricity charges, and manufactured and piped gas charges are expected to push down the year-on-year rate of change in the CPI (all items less fresh food), mainly for the first half of fiscal 2023. For fiscal 2024, on the other hand, they are likely to push up the rate due to a waning of the effects of those measures pushing down CPI inflation of the previous year. In this regard, looking at the CPI (all items less fresh food and energy) -- which is not directly affected by fluctuations in energy prices, such as in gasoline prices, electricity charges, and manufactured and piped gas charges -- the year-on-year rate of change is projected to be at around 2 percent for fiscal 2022, in the range of 1.5-2.0 percent for fiscal 2023, and at around 1.5 percent for fiscal 2024.

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

[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 in the range of 0.0-0.5 percent. However, the rate should be interpreted with considerable latitude. This is because the estimate is subject to change depending on the methodologies employed and could be revised as the sample period becomes longer over time. In addition, there are particularly high uncertainties in the current phase over how COVID-19 will affect the trends in productivity or labor supply.

is projected to turn 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 put upward pressure on personnel expenses on the cost side and contribute to an increase in households' purchasing power.

Medium- to long-term inflation expectations have risen, albeit at a moderate pace relative to short-term ones. The December 2022 *Tankan* (Short-Term Economic Survey of Enterprises in Japan) shows that the diffusion index (DI) for output prices has increased and firms' inflation outlook for general prices has been at a high level, not only for the short term but also for the medium to long term. Given that the formation of inflation expectations in Japan is largely adaptive, an increase in actual inflation is expected to bring about a rise in households' and firms' medium- to long-term inflation expectations and, through changes in firms' price- and wage-setting behavior and in labor-management wage negotiations, lead to a sustained rise in prices accompanied by wage increases.

III. Risks to Economic Activity and Prices

A. Risks to Economic Activity

Regarding the aforementioned baseline scenario of the outlook for economic activity, there are extremely high uncertainties, including the following: developments in overseas economic activity and prices; developments in the situation surrounding Ukraine and in commodity prices; and the course of COVID-19 at home and abroad and its impact. Specifically, it is necessary to pay attention to the following upside and downside risks.

The first is <u>developments in overseas economic activity and prices and in global financial and capital markets</u>. Although inflation rates, such as in the United States, are lower than a while ago, inflationary pressure has remained on a global basis. In this situation, overseas central banks have continued to raise their policy interest rates, and such moves are projected to continue for the time being. On this point, it is expected in the baseline scenario that inflation rates around the world will decline gradually and that overseas economies will continue to grow moderately, albeit at a decelerating pace. That said, vigilance against a wage-price spiral has remained high, mainly in advanced economies. In addition, there is concern in global financial and capital markets over whether it is possible to contain inflation and maintain economic growth simultaneously. With central banks continuing to make policy interest rate hikes, there is a risk that global financial conditions will tighten further through adjustments in asset prices, fluctuations in foreign exchange markets, and capital outflows from emerging economies, and that this will eventually lead to overseas economies deviating downward from the baseline scenario.

Taking this risk into account, it is necessary to pay due attention to developments in financial and foreign exchange markets and their impact on Japan's economic activity and prices.

The second factor is developments in the situation surrounding Ukraine and the associated developments in prices of commodities, including grains. Depending on the course of this situation, overseas economies, particularly the euro area, could be pushed down further. In addition, although prices of commodities, including grains, have declined on the whole after reaching their peak around the middle of last year, they could rise again depending on, for example, developments in the situation surrounding Ukraine. Given that Japan is an importer of commodities such as energy and grains (e.g., wheat), a rise in these prices due to supply factors puts greater downward pressure on the economy through an increase in import costs, as this rise is not accompanied by an expansion in external demand or an increase in exports. Such deterioration in the terms of trade squeezes corporate profits and households' real income, and this could lead business fixed investment and private consumption to deviate downward from the baseline scenario through more cautious spending behavior of firms and households. On the other hand, if prices of commodities, including grains, see a clearer downtrend, the economy could deviate upward. On this point, in the baseline scenario, commodity prices are assumed to decline moderately on the whole toward the end of the projection period with reference, for example, to developments in futures markets. However, there are extremely high uncertainties, such as over geopolitical factors -- particularly the situation surrounding Ukraine -- and global efforts toward addressing climate change.

The third factor is how COVID-19 at home and abroad will affect private consumption and firms' export and production activities. Although COVID-19 has resurged in Japan since last autumn, private consumption has increased moderately thus far -- supported by pent-up demand, especially for services consumption -- and the resumption of consumption activities has progressed steadily while public health has been protected. That said, depending on the course of COVID-19, upward pressure from pent-up demand could weaken by more than expected. On the other hand, if vigilance against COVID-19 lessens significantly, household savings that had 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, supply-side constraints have remained in part, and if COVID-19 resurges at home and abroad in this situation, such constraints could intensify again through, for example, 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 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. In addition, the heightened geopolitical risks could change the trend of globalization, which has supported the growth of the global economy to date. Depending on how firms and households react to these 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. 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. Recently, against the backdrop of high raw material costs, price hikes have been widely observed even among firms that had taken a cautious stance toward changing their selling prices, while their pricing decisions have been made in consideration of price setting by competitors. Depending on how much upward pressure will be exerted by raw material costs and on how firms' inflation expectations will develop, the pass-through of cost increases could accelerate by more than expected and lead prices to deviate upward from the baseline scenario. In addition, there is a possibility that wages and prices will rise by more than expected as more firms reflect price developments in wage setting through labor-management wage negotiations. On the other hand, there is a risk that moves to increase wages will not strengthen as much as expected and prices will deviate downward from the baseline scenario, with the deeply entrenched behavior and mindset based on the assumption that prices and wages will not increase easily.

The second risk is future developments in foreign exchange rates and international commodity prices, as well as the extent to which such developments will spread to import prices and domestic prices. This risk may lead prices to deviate either upward or downward from the baseline scenario. Fluctuations in international commodity prices have been significant, reflecting high uncertainties over, for example, developments in the situation surrounding Ukraine, while inflation rates have remained high on a global basis and foreign exchange markets have fluctuated sharply. How these factors will affect Japan's prices requires due 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. The year-on-year rate of change in the CPI has been above 2 percent. The rate of increase, however, is expected to decelerate to a level below 2 percent toward the middle of fiscal 2023. Although it will take time, underlying CPI inflation is likely to increase gradually 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 in wage growth.

The second perspective involves an examination of the risks considered most relevant to the conduct of monetary policy. Concerning risks to the outlook, there remain extremely high uncertainties for Japan's economy, including the following: developments in overseas economic activity and prices; developments in the situation surrounding Ukraine and in commodity prices; and the course of COVID-19 at home and abroad and its impact. In this situation, it is necessary to pay due attention to developments in financial and foreign exchange markets and their impact on Japan's economic activity and prices. With regard to the risk balance, risks to economic activity are skewed to the downside for fiscal 2022 and 2023 but are generally balanced for fiscal 2024. Risks to prices are skewed to the upside. 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. Although attention is warranted on, for example, the impact of the tightening of global financial conditions, the financial system is likely to remain highly robust on the whole even in the case of an adjustment in the real economy at home and abroad and in global financial markets, 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.

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

[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."

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.

(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 2022	+1.9 to +2.0 [+1.9]	+3.0 to +3.0 [+3.0]	+2.1 to +2.1 [+2.1]
Forecasts made in October 2022	+1.8 to +2.1 [+2.0]	+2.8 to +2.9 [+2.9]	+1.8 to +1.9 [+1.8]
Fiscal 2023	+1.5 to +1.9 [+1.7]	+1.6 to +1.8 [+1.6]	+1.7 to +1.9 [+1.8]
Forecasts made in October 2022	+1.5 to +2.0 [+1.9]	+1.5 to +1.8 [+1.6]	+1.5 to +1.8 [+1.6]
Fiscal 2024	+0.9 to +1.3 [+1.1]	+1.8 to +1.9 [+1.8]	+1.5 to +1.8 [+1.6]
Forecasts made in October 2022	+1.3 to +1.6 [+1.5]	+1.5 to +1.9 [+1.6]	+1.5 to +1.8 [+1.6]

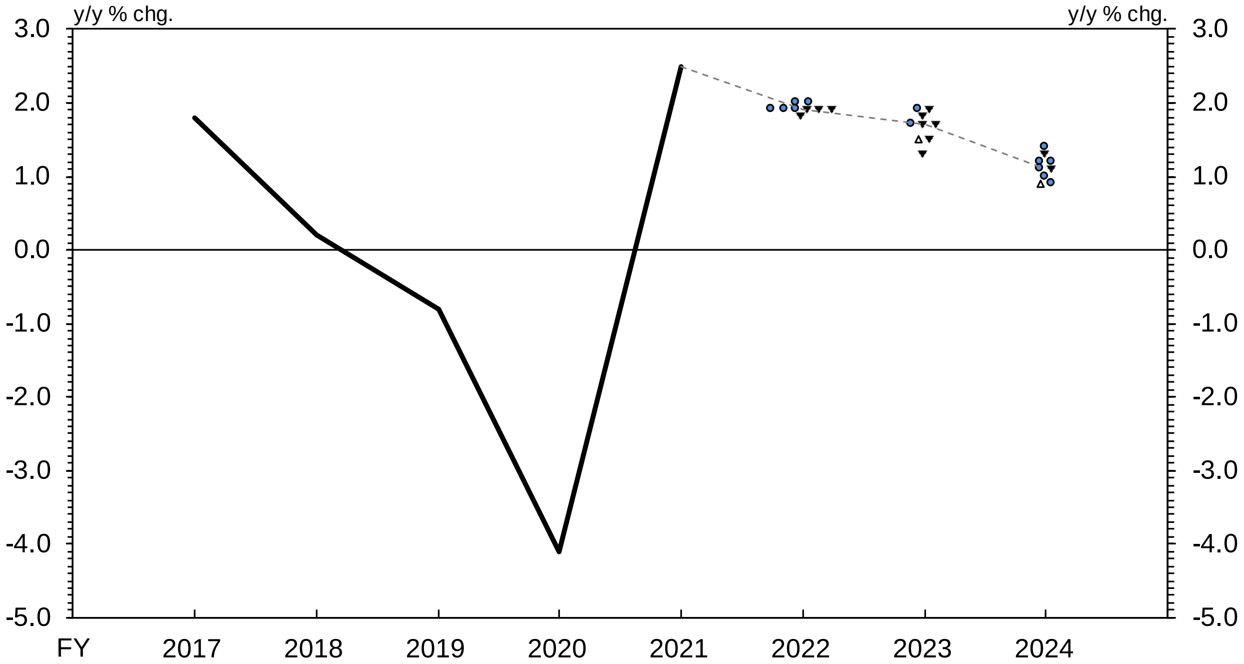
Notes: 1. Figures in brackets indicate the medians of the Policy Board members' forecasts (point estimates).

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

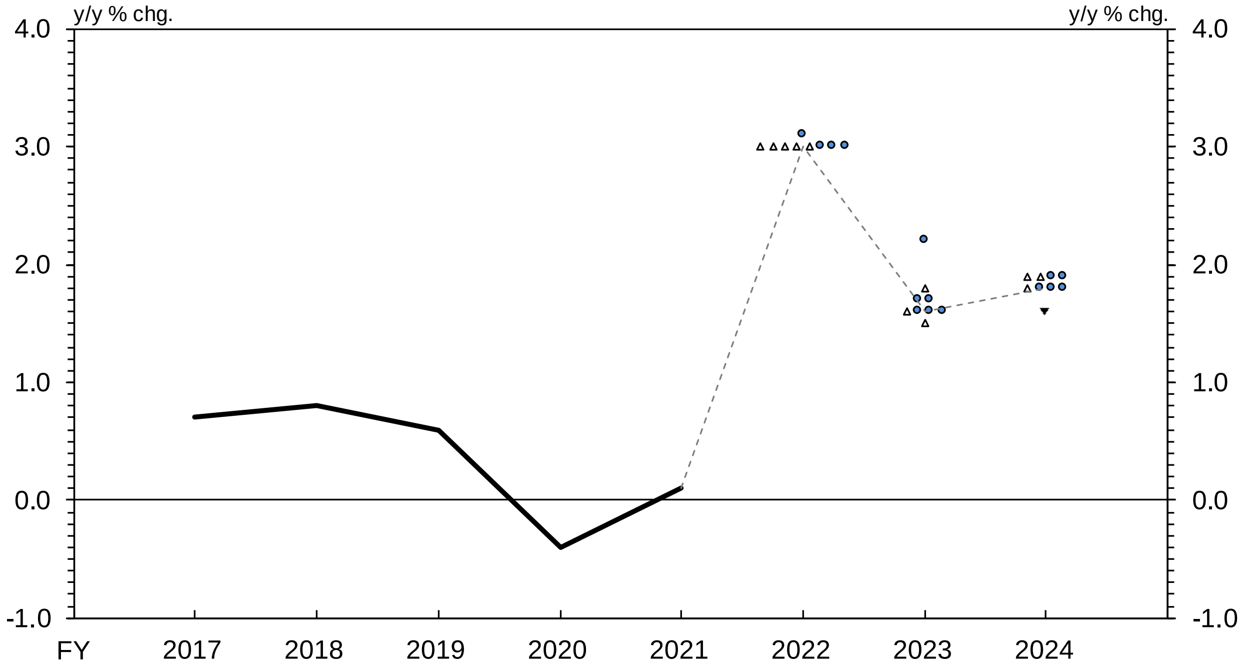
3. Each Policy Board member makes their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding the future conduct of policy.

Policy Board Members' Forecasts and Risk Assessments

(1) Real GDP



(2) CPI (All Items Less Fresh Food)



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

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