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日本銀行
BANK OF JAPAN

Outlook for Economic Activity and Prices

January 2023

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

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.

From the middle of the projection period, 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 developments in overseas economic activity and prices and in global financial and capital markets. 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]

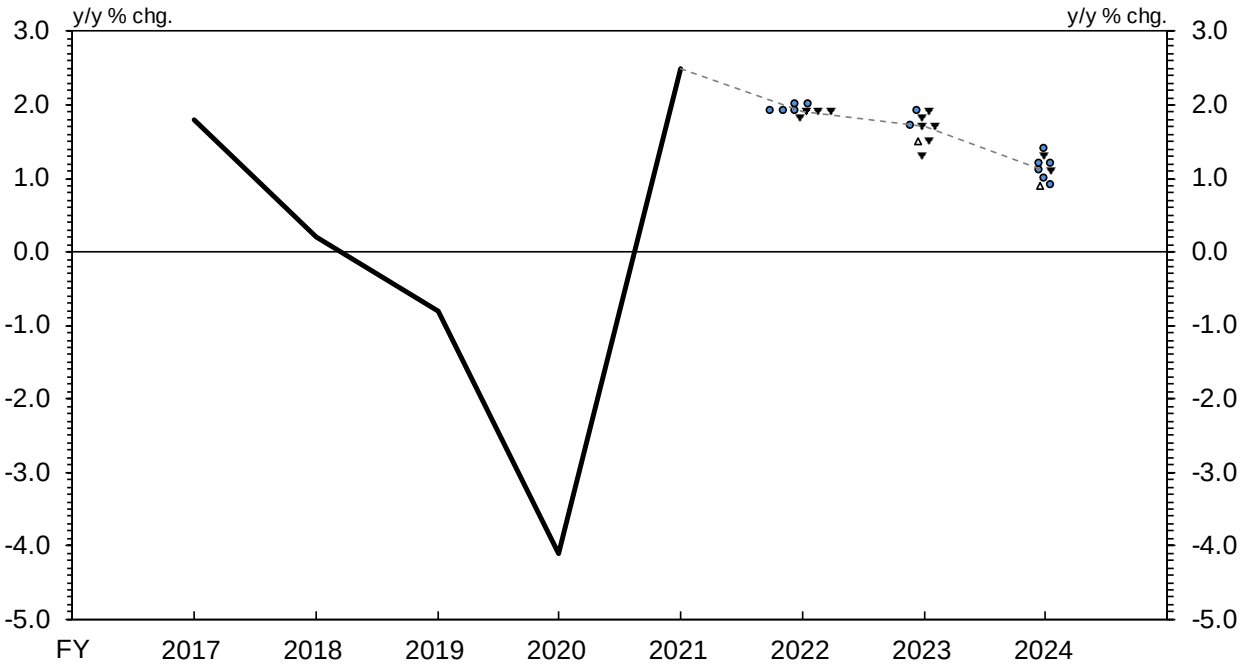
Notes: 1. Figures in brackets indicate the medians of the Policy Board members' forecasts (point estimates).

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.

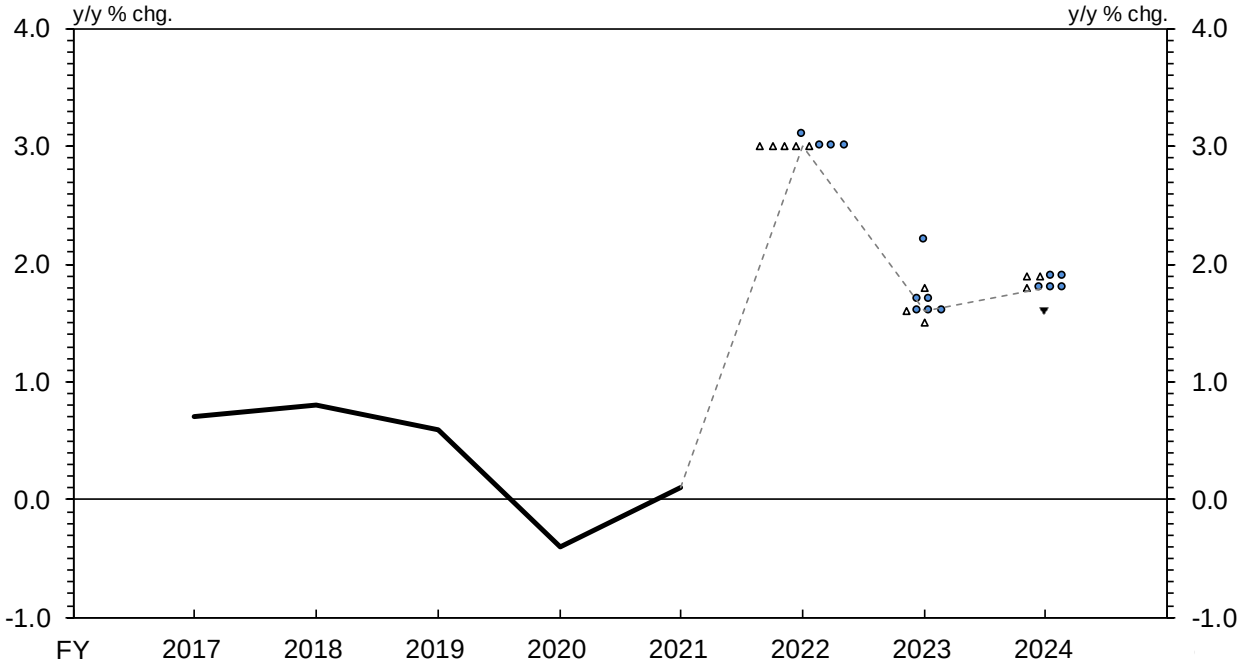
3. Each Policy Board member makes their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding the future conduct of policy.

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."

The Background[5]

I. Current Situation of Economic Activity and Its Outlook

A. Economic Developments

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.

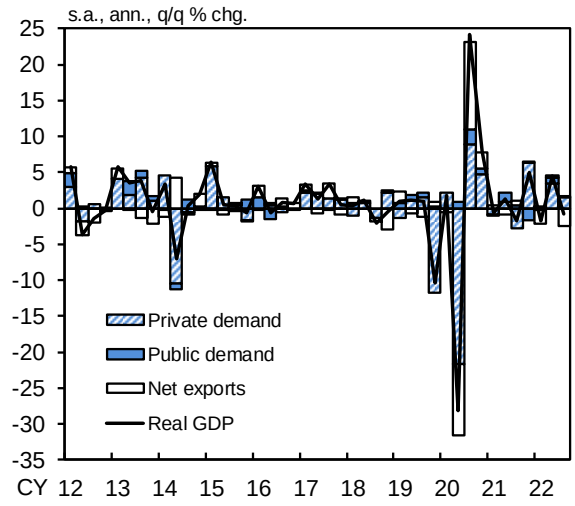
Real GDP increased clearly for the April-June quarter of 2022, registering 1.1 percent on a quarter-on-quarter basis and 4.5 percent on an annualized basis (Chart 1). It then decreased slightly for the July-September quarter, registering minus 0.2 percent on a quarter-on-quarter basis and minus 0.8 percent on an annualized basis. The decrease was mainly due to the surge in imports of services caused by temporary factors. Looking at final demand, exports and business fixed investment increased, mainly on the back of a waning of supply-side constraints, and private consumption increased slightly, despite being affected by the spread of COVID-19 last summer. With this pick-up in the economy, the output gap -- which captures the utilization of labor and capital -- for the July-September quarter was negative but improved from the previous quarter (Chart 2).

Monthly indicators and high-frequency data since then suggest that Japan's economy has continued to pick up. In the corporate sector,

Chart 1: Real GDP

1. Level

2. Annualized Quarterly Growth Rate

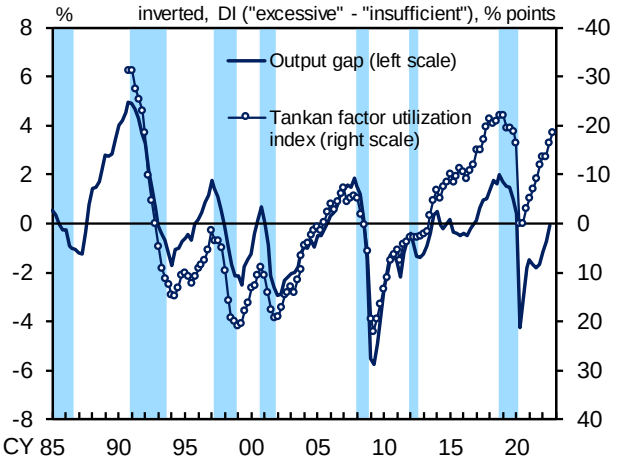


Source: Cabinet Office.

[5] "The Background" provides explanations of "The Bank's View" decided by the Policy Board at the Monetary Policy Meeting held on January 17 and 18, 2023.

exports have increased as a trend, with the effects of supply-side constraints waning. While corporate profits have remained at high levels on the whole despite being affected by high commodity prices, business sentiment has been more or less unchanged. In this situation, business fixed investment has increased moderately, and the business fixed investment plan for fiscal 2022 in the December 2022 *Tankan* indicates that investment is expected to see a clear rise. In the household sector, private consumption has increased moderately, partly owing to the effects of the government's domestic travel discount program, as the resumption of consumption activities has progressed while public health has been protected. The employment and income situation has improved moderately on the whole, as labor market conditions have tightened while the economy has continued to pick up, as just described.

Chart 2: Output Gap



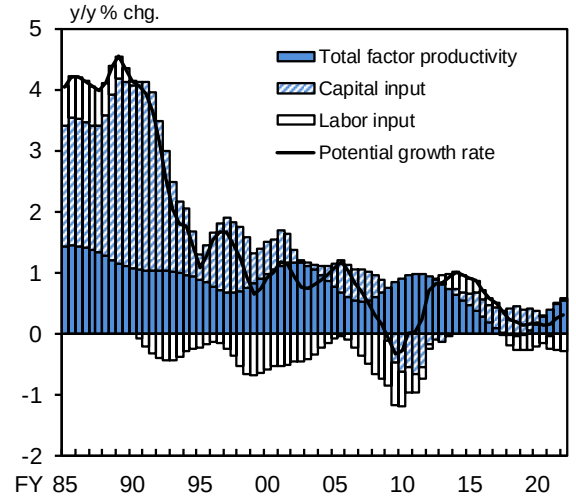
Source: Bank of Japan.
Notes: 1. Figures for the output gap are staff estimates.
2. The *Tankan* factor utilization index is calculated as the weighted average of the production capacity DI and the employment conditions DI for all industries and enterprises. The capital and labor shares are used as weights.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

Japan's economy is likely to recover toward the middle of the projection period, 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 the slowdowns in overseas economies. [6] Thereafter, the economy is projected to continue growing at a pace above its

[6] The government formulated the Comprehensive Emergency Measures to Counter Soaring Crude Oil and Other Prices under the COVID-19 Pandemic in April 2022 and the Comprehensive Economic Measures for Overcoming Price Increases and Revitalizing the Economy in October. The implementation of the budget based on these measures is expected to mainly push up government consumption and private consumption, and thereby support economic activity.

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. Comparing the projections with those presented in the previous 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 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.

Chart 3: Potential Growth Rate



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

The potential growth rate seems to have been in the range of 0.0-0.5 percent recently (Chart 3). This is because, although the growth rate of total factor productivity (TFP) has increased slightly, working hours have continued on a downtrend, reflecting working-style reforms, and growth in capital stock has decelerated as a result of past declines in business fixed investment. As for the outlook, the potential growth rate is expected to rise moderately. This is based on the projection that (1) the TFP growth rate will increase moderately, mainly on the back of advances in digitalization and investment in human capital and a resultant improvement in efficiency of resource allocation, (2) the pace of decline in working hours will slow with the effects of working-style reforms diminishing, and (3) growth in capital stock will accelerate cyclically. These developments are likely to be encouraged by the

government's various measures and by accommodative financial conditions. However, in terms of labor, it is highly uncertain what kind of working style will take hold going forward, given the experience of the pandemic and with demographic changes. In addition, in the corporate sector, there remain high uncertainties over the extent of advancement and sustainability of innovation and sectoral reallocation of production factors, both of which aim at adapting to the post-pandemic economic and industrial structures, including efforts toward digitalization and addressing climate change. It is also possible that the heightened geopolitical risks and other factors will have a significant impact on corporate behavior. Under these circumstances, the output gap and the potential growth rate, which are estimated based on a specific assumption regarding trends, should be interpreted with some latitude.

Details of the outlook for each fiscal year are as follows. In the second half of fiscal 2022, Japan's economy is likely to recover. This is because, although the economy is expected to be under downward pressure stemming from high commodity prices and the slowdowns in overseas economies, it is projected that the impact of COVID-19 on services consumption will wane and the effects of supply-side constraints will ease. Another reason is that accommodative financial conditions and the government's economic measures are likely to provide support. Specifically, while goods exports are likely to be affected by the slowdowns in overseas economies, they are expected to remain on an uptrend, with support from a waning of supply-side constraints and high levels of order

backlogs for automobiles and capital goods. Inbound tourism demand, which is categorized under services exports, is projected to increase, mainly in reflection of the government's relaxation of entry restrictions. In the household sector, employee income is likely to continue increasing moderately on the back of a continued increase in employment and an increase in wage growth, particularly for part-time employees. In this situation, private consumption is expected to be pushed down by deterioration in real income due to price rises. However, it is projected to continue increasing 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. With corporate profits being at high levels on the whole, business fixed investment is expected to continue increasing on the back of accommodative financial conditions and the waning of supply-side constraints. Overall government spending is projected to decrease somewhat. This is because, although expenditure related to COVID-19 is expected to remain at a high level, due in part to the formulation of economic measures, public investment is likely to decrease, given that the implementation of the fiscal 2022 budget for it was front-loaded in the first half of the fiscal year.

In fiscal 2023, the growth rate of Japan's economy is projected to remain relatively high,

partly supported by accommodative financial conditions and the government's economic measures. However, with the remaining effects of the slowdowns in overseas economies, it is likely to decelerate somewhat, mainly reflecting slower materialization of pent-up demand. Japan's goods exports are projected to remain on an uptrend as the effects of supply-side constraints dissipate, although such exports will likely continue to be affected by the slowdowns in overseas economies. Inbound tourism demand is projected to keep increasing. Business fixed investment is expected to continue increasing, including investment to address labor shortage, digital-related investment, investment related to growth areas and decarbonization, and investment associated with strengthening supply chains. In the household sector, employee income is likely to continue rising. This is because, reflecting tightening labor market conditions and price rises, wage growth is expected to rise not only for part-time employees but also full-time employees. In addition, downward pressure on households' real income stemming from high prices is projected to ease on the back of a waning of the effects of a pass-through to consumer prices of cost increases led by a rise in import prices, as well as the government's various measures. In this situation, private consumption is also expected to keep increasing as it is projected that pent-up demand will continue to materialize, albeit more slowly. Although progress in construction related to building national resilience and an uptrend in healthcare and nursing care expenditures are likely to provide support, government spending is expected to decline, reflecting a reduction in expenditure related to COVID-19.

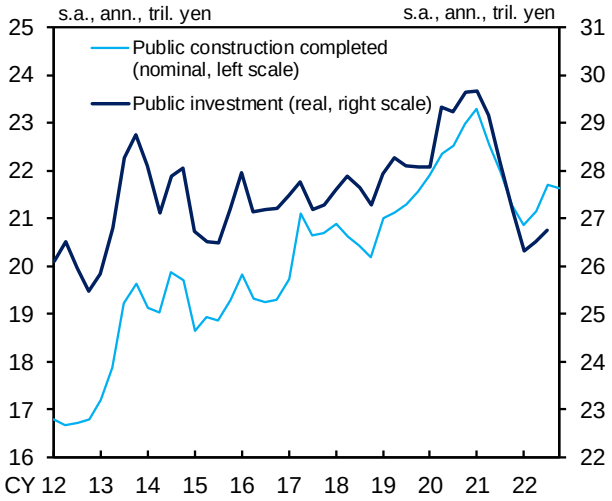
In fiscal 2024, the pace of economic growth is likely to decelerate, mainly due to a waning of pent-up demand and of the effects of the government's economic measures pushing up the economy of the previous year. However, Japan's economy is expected to continue growing at a pace somewhat above its potential growth rate, with accommodative financial conditions being maintained. Goods exports are likely to increase moderately on the back of a pick-up in overseas economies. Inbound tourism demand is projected to keep increasing. Business fixed investment is also expected to continue increasing, although it is likely to see deceleration in the pace of increase due to adjustment pressure stemming from the accumulation of capital stock. Although pent-up demand is likely to wane and a waning of the effects of the government's economic measures pushing down prices of the previous year is expected to push down real income through price rises, private consumption is projected to continue increasing steadily as employee income continues to improve. Government spending is expected to turn to a moderate increase on the back of progress in construction related to building national resilience and of an uptrend in healthcare and nursing care expenditures.

B. Developments in Major Expenditure Items and Their Background

Government Spending

Public investment has been more or less flat (Chart 4). The amount of public construction completed -- a coincident indicator -- has been more or less flat with progress in construction based on the government's economic measures, including construction related to building national resilience. After increasing due to the effects of the front-loaded implementation of the budget for public investment, the value of public works contracted and orders received for public construction -- both of which are leading indicators -- have turned to a decrease.

Chart 4: Public Investment



Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Note: The figure for 2022/Q4 is that for October.

As for the outlook, although public investment is likely to decrease for the time being due to a decline following the front-loaded implementation of the budget, it is then projected to be more or less flat, with expenditure related to building national resilience continuing. [7] Government consumption is likely to remain at a high level as a result of expenditure related to COVID-19, such as regarding vaccination. Thereafter, it is projected to see a temporary lowering in its level due to the reduction in such expenditure. Toward the end of the projection period, however, government consumption is likely to return to an

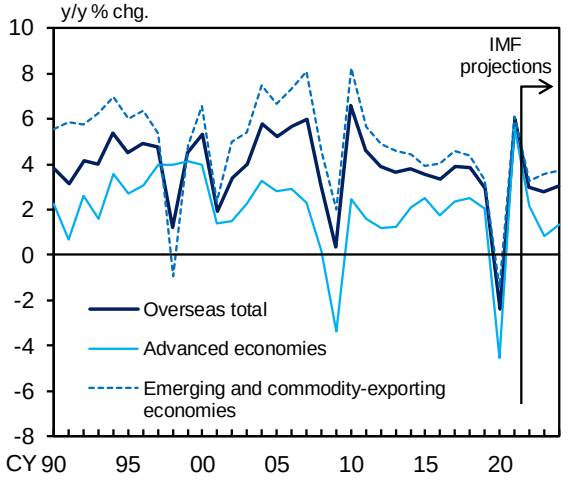
[7] The five-year acceleration measures for building national resilience with a project size of about 15 trillion yen were decided by the Cabinet in December 2020. In these measures, public investment projects for disaster prevention, disaster mitigation, and building national resilience are to be implemented intensively over five years from fiscal 2021 through fiscal 2025. The government's economic measures decided by the Cabinet in October 2022 also include efforts to implement the acceleration measures.

increasing trend, reflecting an uptrend in healthcare and nursing care expenditures.

Overseas Economies

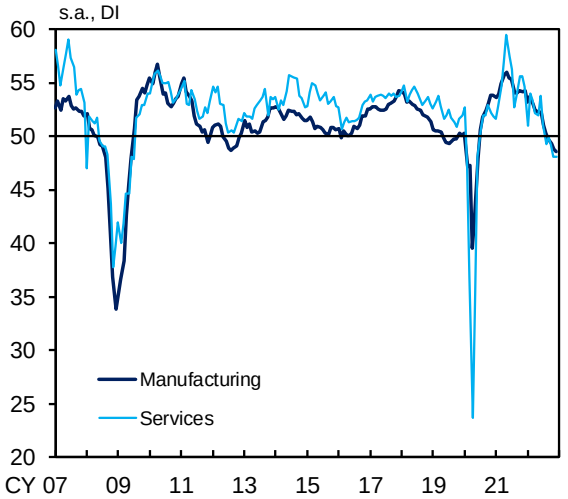
The pace of recovery in overseas economies has slowed (Chart 5). By region, the U.S. economy has remained on a slowing trend, in reflection of price rises and continued policy interest rate hikes, although firmness has been seen in private consumption. European economies have recovered moderately, but slowdowns have been observed as these economies have continued to be affected by the situation surrounding Ukraine. With adjustments continuing to be made in its real estate market, the Chinese economy has slowed, reflecting the impact of the spread of COVID-19 in the country. Emerging and commodity-exporting economies other than China have picked up on the whole, albeit with weakness seen in part. Among those in Asia, which are closely related to Japan's economy, the NIEs and the ASEAN economies have recovered on the whole because domestic demand has continued to improve with progress in the resumption of economic activity, although some weakness has been observed in exports, particularly of IT-related goods. Looking at the Global PMI to see the current situation for the global economy, figures for both the manufacturing and services industries have declined and been somewhat below 50, the break-even point between improvement and deterioration in business conditions (Chart 6). The world trade volume has been on an uptrend despite being affected by such slowdowns in overseas economies, on the back of factors such as a waning of supply-side constraints (Chart 7).

Chart 5: Overseas Economies



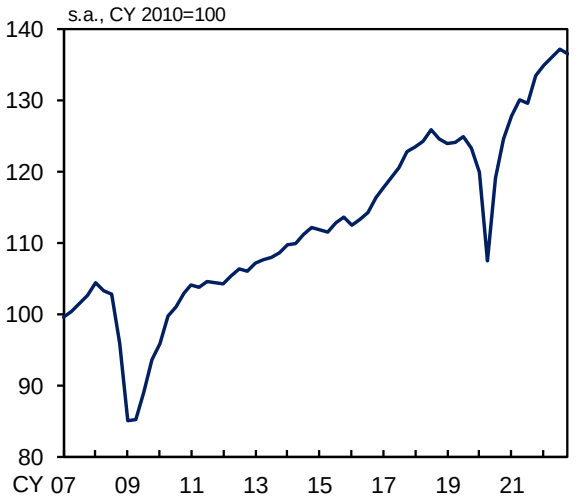
Sources: IMF; Ministry of Finance.
Note: Figures are the weighted averages of real GDP growth rates using countries' share in Japan's exports as weights. The real GDP growth rates are compiled by the IMF, and the rates from 2022 onward are its projections in the October 2022 *World Economic Outlook* (WEO). Figures for advanced economies are those for the United States, the euro area, and the United Kingdom. Figures for emerging and commodity-exporting economies are those for the rest of the world.

Chart 6: Global PMI



Source: Copyright © 2023 by S&P Global Market Intelligence, a division of S&P Global Inc. All rights reserved.
Note: Figures for manufacturing are the J.P.Morgan Global Manufacturing PMI. Figures for services are the J.P.Morgan Global Services Business Activity Index.

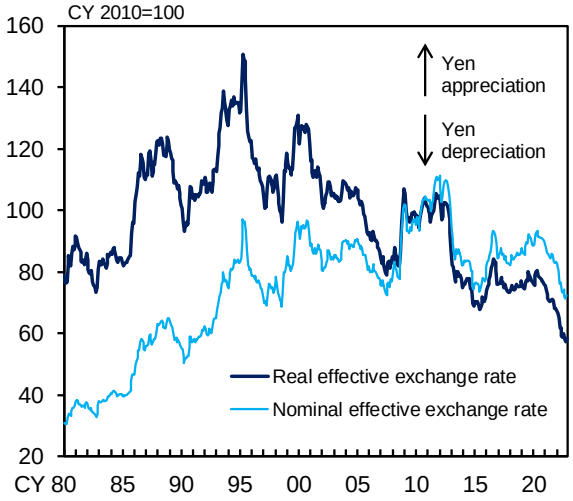
Chart 7: World Trade Volume



Source: CPB Netherlands Bureau for Economic Policy Analysis.
Note: Figures for the world trade volume are those for world real imports. The figure for 2022/Q4 is that for October.

As for the outlook, although the effects of supply-side constraints are likely to wane, overseas economies are expected to slow toward the middle of the projection period, albeit with variation across countries and regions. This will likely occur in reflection of the situation surrounding Ukraine and the impact of COVID-19 in China, in addition to inflationary pressure exerted on a global basis and policy interest rate hikes by overseas central banks. By region, the U.S. economy is expected to slow due to a decline in real disposable income stemming from price rises and the impact of policy interest rate hikes. European economies are also likely to slow, reflecting the situation surrounding Ukraine and the impact of policy interest rate hikes. The Chinese economy is projected to gradually head toward a pick-up as the resumption of economic activity progresses while public health is being protected. However, its pace of growth is expected to become moderate, partly due to adjustment pressure remaining on the employment and income side and in the real estate market. The paces of improvement in emerging and commodity-exporting economies other than China are likely to decelerate gradually, partly in reflection of external demand slowing, although the resumption of economic activity is expected to underpin domestic demand.

Chart 8: Effective Exchange Rates



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

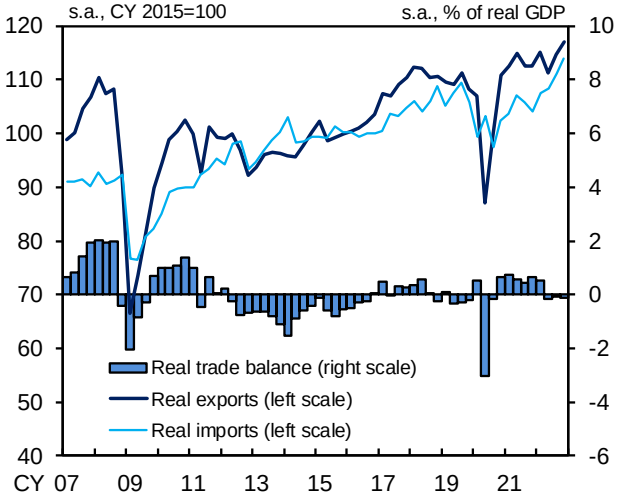
In sum, overseas economies are projected to slow toward the middle of the projection period; however, downward pressure on them is likely to ease in steps thereafter as inflation rates decline gradually, mainly reflecting policy interest rate hikes by central banks. For this reason, overseas economies are likely to pick up, particularly in advanced economies. In addition, growth in

emerging economies is also projected to accelerate gradually, partly because adjustment pressure in China is expected to wane in steps, owing to factors such as progress in the resumption of economic activity while public health is being protected, and because improvement in advanced economies and the Chinese economy is likely to spread to emerging and commodity-exporting economies other than China.

Exports and Imports

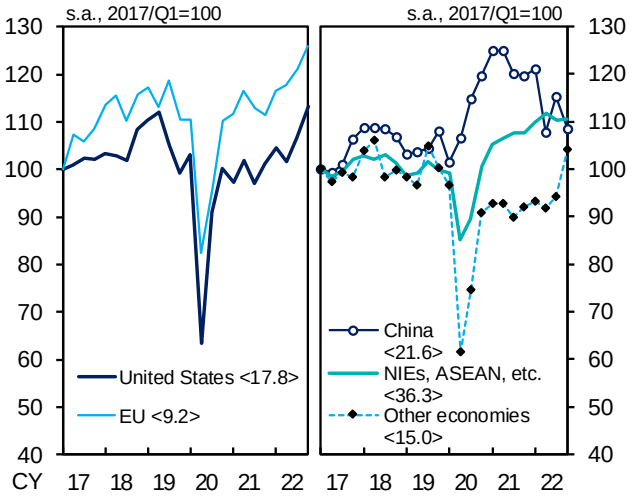
Exports have increased as a trend, with the effects of supply-side constraints waning (Chart 9). By region, exports to advanced economies have increased, mainly for automobile-related and capital goods, also with the effects of supply-side constraints waning (Chart 10). As for exports to emerging economies, those to China have been somewhat weak, particularly for intermediate and IT-related goods. While exports to the NIEs, the ASEAN economies, and some other Asian economies have remained at high levels for capital goods (e.g., semiconductor production equipment), they have been weak for intermediate and IT-related goods. By goods, exports of automobile-related goods have increased moderately, as the tightness in global supply and demand conditions for semiconductors used in automobiles has gradually eased on the whole (Chart 11). Exports of capital goods have increased, supported by high levels of order backlogs, although orders for semiconductor production equipment, for example, have seen a pause. In contrast, exports of IT-related goods have been somewhat weak on the whole, albeit with fluctuations, with stronger adjustment pressure on electronic parts such as

Chart 9: Real Exports and Imports



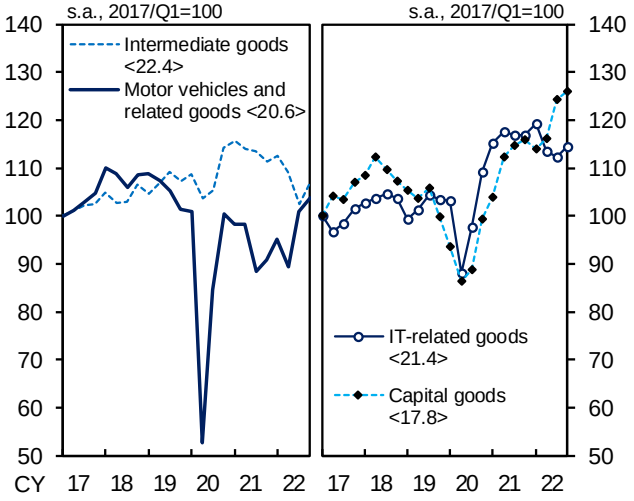
Sources: Bank of Japan; Ministry of Finance; Cabinet Office.
Note: Based on staff calculations. Figures for 2022/Q4 are October-November averages.

Chart 10: 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 2021. Figures for 2022/Q4 are October-November averages.
2. Figures for the EU exclude those for the United Kingdom for the entire period.

Chart 11: 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 2021. Figures for 2022/Q4 are October-November averages.

semiconductors for smartphones and for personal computers, although demand for automobile-related goods has been firm. Exports of intermediate goods have been on a downtrend against the background of the slowdown in the Chinese economy and weakness in global demand for IT-related goods.

Exports are likely to follow an uptrend toward the middle of the projection period, supported by the waning of supply-side constraints and high levels of order backlogs for automobiles and capital goods, although they are expected to be affected by the slowdowns in overseas economies. Thereafter, as overseas economies pick up, exports are projected to increase moderately.

Meanwhile, Japan's share of exports in the world trade volume has been at a low level recently, mainly because the effects of supply-side constraints on Japan's exports of automobiles have remained (Chart 12). As such temporary factors dissipate, Japan's share of exports is likely to increase gradually.

Imports have continued to increase, reflecting a pick-up in domestic demand (Chart 9). They are expected to follow a moderate uptrend on the back of developments in induced demand due to increases in domestic demand and exports.

External Balance

The nominal current account balance has improved somewhat recently, mainly reflecting a decline in import prices and improvement in the

Chart 12: Japan's Share of Exports in World Trade Volume

Source: CPB Netherlands Bureau for Economic Policy Analysis.
Note: Japan's share of exports in world trade volume is obtained by dividing Japan's real exports by world real imports (2010 prices). The figure for 2022/Q4 is that for October.

travel balance, after its surplus had continued to decrease significantly, owing to factors such as the impact of high commodity prices (Chart 13). Although the trade balance has also improved somewhat recently, mainly on the back of the decline in import prices, it has continued to register a significant deficit. The services balance deficit has decreased despite a continued increasing trend in payments for digital-related services, mainly because the travel balance has improved due to an increase in inbound tourism demand (Chart 14).[8] Meanwhile, the surplus in the primary income balance has remained at a high level.

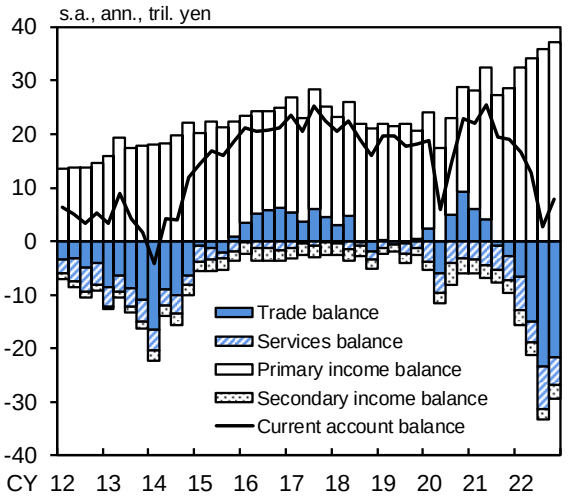
The nominal current account balance is likely to follow a moderate improving trend. This is based on the projection that (1) the surplus in the primary income balance will be at a high level, (2) the trade deficit will decline moderately due to factors such as an increase in goods exports, and (3) the deficit in the services balance will decrease due to the recovery in inbound tourism demand. In terms of the savings-investment balance, overall excess savings in Japan's economy are projected to remain at a low level in the short run but thereafter follow a moderate expanding trend, because the fiscal balance is likely to improve at a pace that somewhat exceeds the pace of decline in excess savings in the private sector (Chart 15).

Industrial Production

Industrial production has increased as a trend, with the effects of supply-side constraints waning

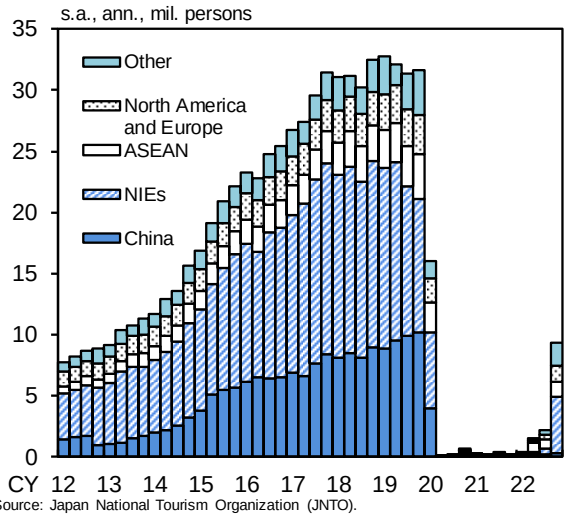
[8] Box 1 outlines recent developments in inbound tourism demand.

Chart 13: Current Account



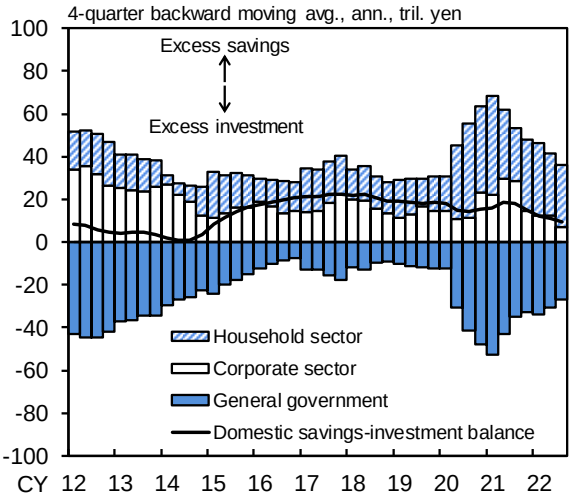
Source: Ministry of Finance and Bank of Japan.
Note: Figures for 2022/Q4 are October-November averages.

Chart 14: Number of Inbound Visitors



Source: Japan National Tourism Organization (JNTO).
Note: Figures for North America and Europe are those for the United States, Canada, the United Kingdom, France, and Germany. Figures for 2022/Q4 are October-November averages.

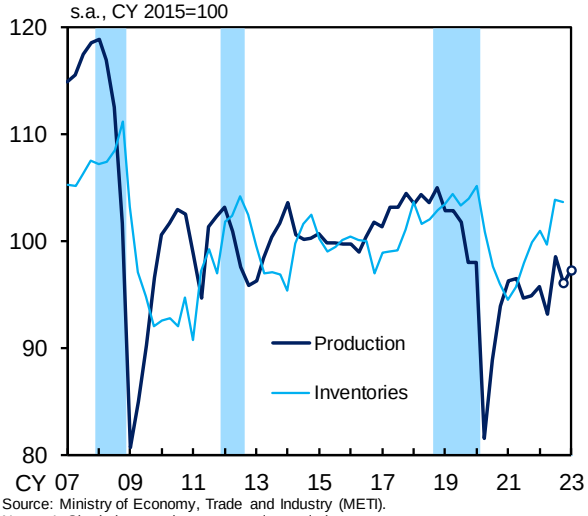
Chart 15: Savings-Investment Balance



Source: Bank of Japan.

(Chart 16). By major industry, production of "transport equipment" has been on a moderate uptrend, as the tightness in global supply and demand conditions for semiconductors used in automobiles has gradually eased on the whole. Production of "electrical machinery, and information and communication electronics equipment" has increased for on-board equipment for motor vehicles. That for personal computers and peripheral devices has also increased, partly due to renewal demand in view of the end to support for some operating systems. Supported by order backlogs, production of "general-purpose, production, and business-oriented machinery" has been at a high level, albeit with fluctuations stemming from orders related to large-scale projects. On the other hand, with stronger adjustment pressure, particularly on memory for smartphones and personal computers, production of "electronic parts and devices" has continued to decrease significantly despite firm demand for those related to automobiles. While inventories of "chemicals (excluding medicine)" have been at relatively high levels, their production has been relatively weak, reflecting the slowdown in the Chinese economy and weakness in global demand for IT-related goods.

Chart 16: Industrial Production



Source: Ministry of Economy, Trade and Industry (METI).
Notes: 1. Shaded areas denote recession periods.
2. Figures denoted by the round markers are calculated based on METI projections for December 2022 and January 2023. The inventories figure for 2022/Q4 is that for November.

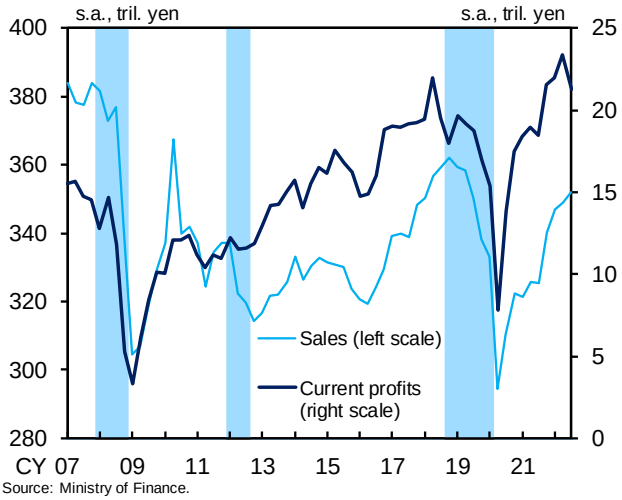
Industrial production is likely to follow an uptrend toward the middle of the projection period, supported by the waning of supply-side constraints and high levels of order backlogs for automobiles and capital goods, although it is expected to be affected by the slowdowns in overseas economies. Thereafter, production is projected to increase moderately on the back of a rise in domestic and external demand.

Corporate Profits

Corporate profits have been at high levels on the whole. According to the *Financial Statements Statistics of Corporations by Industry, Quarterly* (FSSC), current profits for all industries and enterprises for the July-September quarter of 2022 declined slightly from the previous quarter, although they continued to be at high levels (Chart 17[1]). In detail, while current profits have been pushed up by the waning of the effects of supply-side constraints and by an increase in dividend receipts, mainly from overseas subsidiaries reflecting the past depreciation of the yen, they have been pushed down by factors such as deterioration in the terms of trade resulting from a rise in input prices and lower inventory valuation due to a recent decline in commodity prices (Chart 17[2]). By industry and firm size, current profits of large manufacturers in the processing industry have risen on the back of increased sales that partly reflect the waning of supply-side constraints. However, current profits of large manufacturers as a whole have declined slightly from the peak level marked in the previous quarter, mainly due to lower inventory valuation in the basic materials industry that reflects the decline in commodity prices. Current profits of small and medium-sized manufacturers have been more or less flat because, despite an increase in sales, the extent to which they pass on cost increases to selling prices has been limited compared with large manufacturers. As for nonmanufacturers, current profits of large firms have registered a relatively significant decline. This is due to a deficit in the electric and gas utilities industry against the background of higher fuel costs and to the fact that, after recording high levels in the previous quarter, current profits for industries such as wholesale decreased owing to

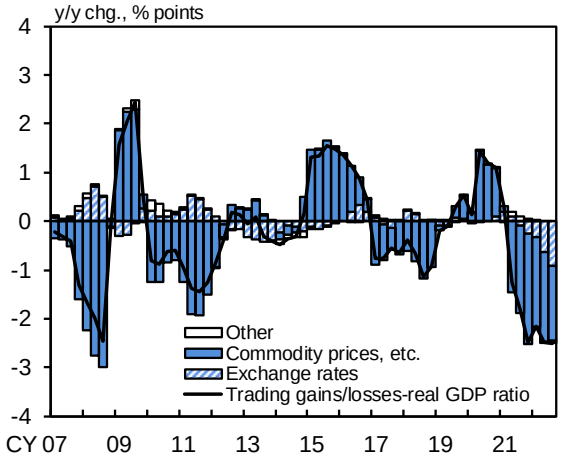
Chart 17: Indicators Related to Corporate Profits

1. Sales and Current Profits



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

2. Contribution to Changes in Trading Gains and Losses

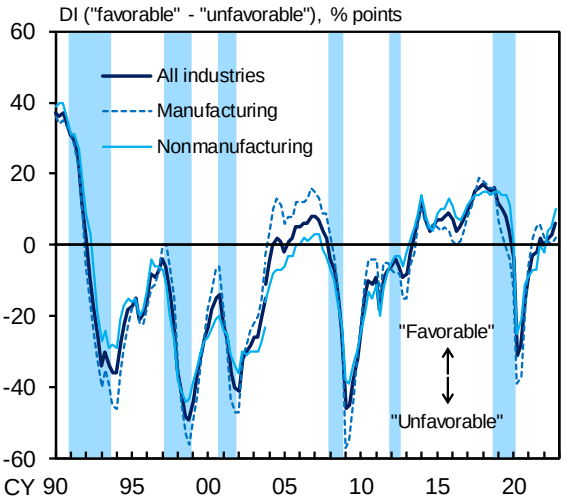


Sources: Cabinet Office; Bank of Japan.
Notes: 1. The contribution of changes in commodity prices, etc. is calculated using changes in export/import price indexes on a contract currency basis. The contribution of changes in exchange rates is calculated using the difference between export/import price indexes on a yen basis and those on a contract currency basis. "Other" is the contribution of other factors such as changes in quantities.
2. Trading gains/losses = (Nominal net exports / Weighted average of export and import deflators) – Real net exports

the decline in commodity prices. Current profits of small and medium-sized nonmanufacturers have continued to register a slight decline due to deterioration in the terms of trade.

Business sentiment has been more or less unchanged on the whole. According to the *Tankan*, the DI for business conditions for all industries and enterprises improved slightly for the December survey, particularly for nonmanufacturing (Chart 18). By industry, despite being affected by high raw material costs and adjustment pressure on IT-related goods, the DI for manufacturing has been more or less flat, mainly due to the waning of the effects of supply-side constraints and to progress in the pass-through of cost increases to selling prices. The DIs for production machinery and electrical machinery (large enterprises) have deteriorated slightly, with stronger adjustment pressure on semiconductor memory and other items, while those for motor vehicles (large enterprises) and other related industries have improved as the tightness in global supply and demand conditions for semiconductors used in automobiles has eased gradually. In the meantime, continued high raw material costs have pushed down the DIs for chemicals and other industries, while progress in the pass-through of cost increases has pushed up the DIs for industries such as those of food and beverages and of processed metals. The DI for nonmanufacturing has continued to improve as the resumption of economic activity has progressed while public health has been protected and as cost increases have been passed on to selling prices. The DIs for private consumption-related industries such as those of accommodations as well as eating and drinking

Chart 18: Business Conditions



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

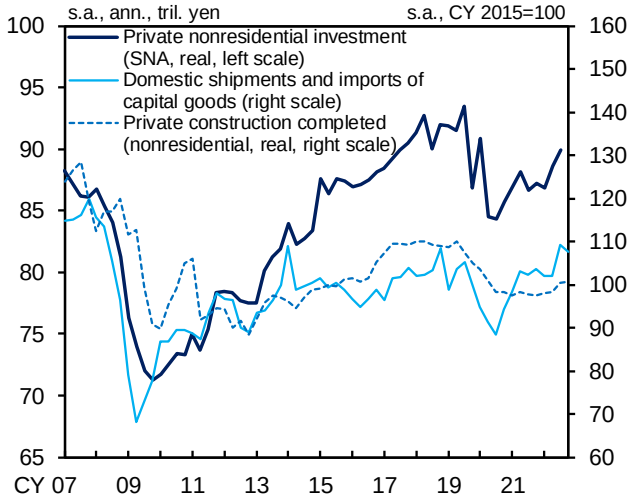
services and of retail have improved due to the increase in private consumption boosted by the government's domestic travel discount program, as well as to a hike in selling prices. However, the DI for future business conditions for manufacturing has deteriorated, due to concern over slowdowns in overseas economies, while that for nonmanufacturing has deteriorated as well, due to concern over high prices and the impact of the spread of COVID-19. Meanwhile, according to various surveys, business sentiment for small and medium-sized firms, including smaller ones that are not covered by the *Tankan*, has been more or less flat. This is because, although such sentiment has continued to be pushed down by high costs, it has been underpinned by factors such as a pick-up in domestic demand.

Regarding the outlook for corporate profits, they are expected to be at high levels on the whole for the time being, partly due to a recovery in Japan's economy, although they are likely to be affected by cost increases resulting mainly from high commodity prices and by the slowdowns in overseas economies. Thereafter, as the effects of deterioration in the terms of trade stemming from the rise in commodity prices wane gradually, corporate profits are projected to improve, reflecting a recovery in the level of economic activity.

Business Fixed Investment

Business fixed investment has increased moderately (Chart 19). With the effects of supply-side constraints waning, the aggregate supply of capital goods -- a coincident indicator of

Chart 19: Coincident Indicators of Business Fixed Investment

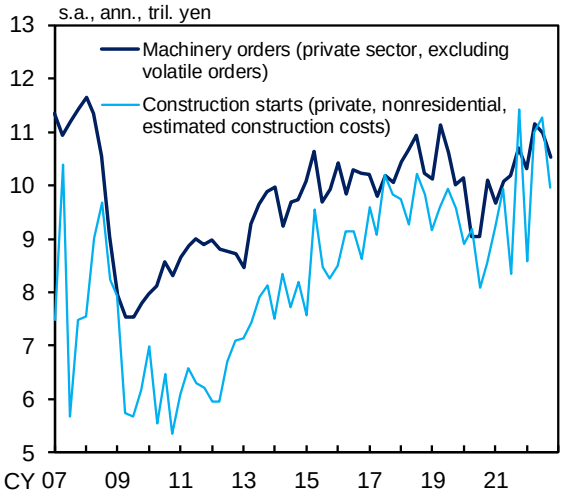


Sources: Cabinet Office; Ministry of Economy, Trade and Industry; Ministry of Land, Infrastructure, Transport and Tourism.
Notes: 1. The figure for domestic shipments and imports of capital goods for 2022/Q4 is the October-November average. The figure for private construction completed for 2022/Q4 is that for October.
2. Figures for real private construction completed are based on staff calculations using the construction cost deflators.

machinery investment -- has increased, albeit with fluctuations, mainly led by digital- and labor saving-related investments. Private construction completed (nonresidential) -- a coincident indicator of construction investment -- has increased moderately, mainly due to a rise in construction of logistics facilities on the back of an expansion in e-commerce and to progress in urban redevelopment projects.

Machinery orders -- a leading indicator of machinery investment -- have increased, albeit with fluctuations (Chart 20). By industry, orders by the manufacturing industry have been on an uptrend on the whole, mainly led by "general-purpose, production, and business-oriented machinery," reflecting factors such as projections that digital-related demand will increase in the medium to long term, although electrical machinery orders have seen a pause against the backdrop of adjustment pressure on semiconductor memory and other items. Orders by the nonmanufacturing industry have been more or less flat, supported by digital-related and labor-saving investments. Construction starts (in terms of planned expenses for private and nonresidential construction) -- a leading indicator of construction investment -- have increased, albeit with fluctuations. This is due to an uptrend in construction of logistics and other facilities and to progress in urban redevelopment projects. Looking at the business fixed investment plan in the December *Tankan*, business fixed investment (on the basis close to GDP definition; business fixed investment -- including software and R&D investments but excluding land purchasing expenses -- for all industries and enterprises including financial institutions) for fiscal 2022

Chart 20: Leading Indicators of Business Fixed Investment

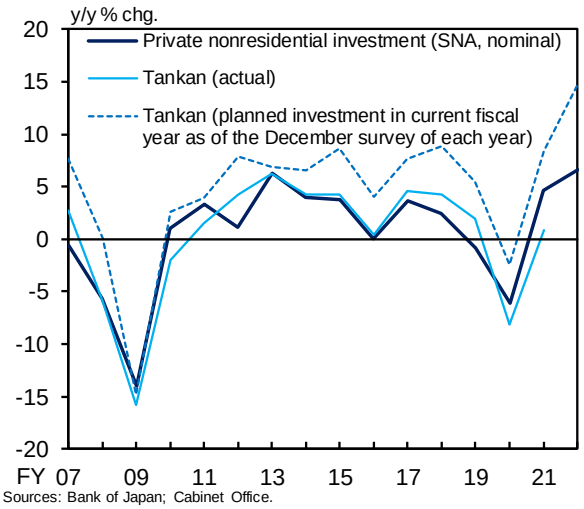


Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Notes: 1. Volatile orders are orders for ships and orders from electric power companies.
2. Figures for 2022/Q4 are October-November averages.

shows a year-on-year rate of increase of 14.7 percent (Chart 21). As with the previous survey in September, plans for a significant increase in business fixed investment have been maintained for both the manufacturing and nonmanufacturing industries.

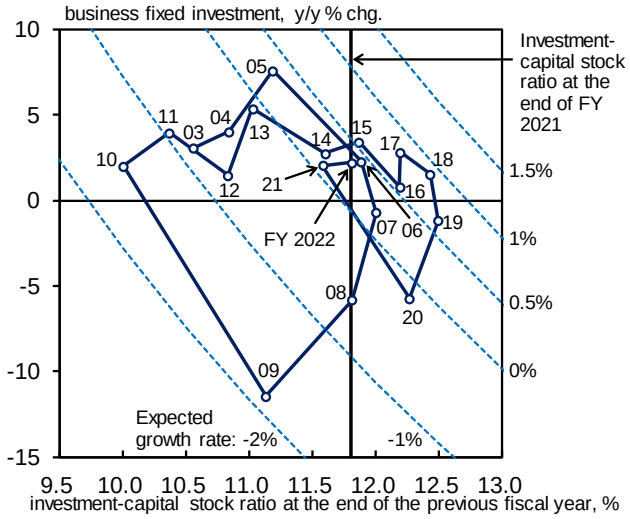
With regard to the outlook, as corporate profits remain at high levels on the whole, business fixed investment is expected to continue increasing, mainly on the back of accommodative financial conditions. Toward the end of the projection period, business fixed investment is expected to continue increasing, partly due to an increase in medium- to long-term investment, although the pace of increase is projected to slow, reflecting cyclical adjustment pressure stemming from the accumulation of capital stock (Chart 22). Specifically, investment that is projected to be undertaken during the projection period includes (1) investment induced by the increase in domestic and external demand, (2) IT-related investment to address labor shortage and digitalize business activities, (3) construction investment in logistics facilities, resulting from the expanding e-commerce, and in offices and commercial facilities due to redevelopment projects, (4) investment for growth areas and to address environmental issues, such as toward decarbonization, and (5) semiconductor-related investment that is mainly aimed at strengthening supply chains and that also reflects government support.

Chart 21: Planned and Actual Business Fixed Investment



Sources: Bank of Japan; Cabinet Office.
Notes: 1. The *Tankan* figures include software and R&D investments and exclude land purchasing expenses. R&D investment is not included before the March 2017 survey. The figures are for all industries including financial institutions.
2. The figure for private nonresidential investment for fiscal 2022 is the 2022/Q2-Q3 average.

Chart 22: 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. The figure for fiscal 2022 is the 2022/Q2-Q3 average.

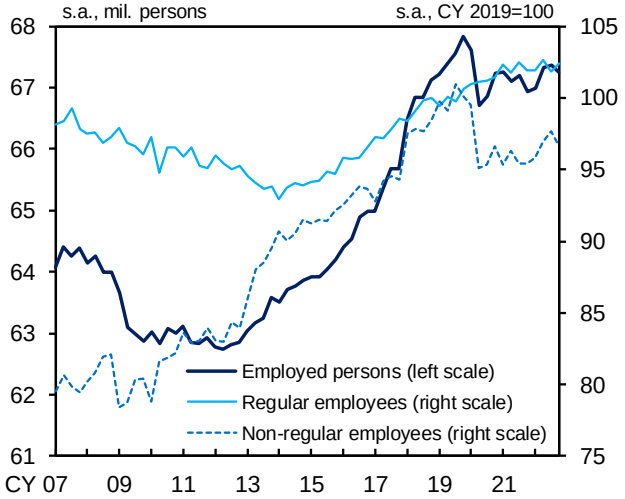
Employment and Income Situation

The employment and income situation has improved moderately on the whole.

Regarding the number of employed persons, that of regular employees has followed a moderate uptrend, mainly in the medical, healthcare, and welfare services industry as well as the information and communications industry, both of which have faced a severe labor shortage (Chart 23). When fluctuations are smoothed out, the number of non-regular employees has also followed a moderate uptrend, mainly in the face-to-face services industry and the medical, healthcare, and welfare services industry. Total hours worked per employee have been more or less flat, when fluctuations due to the number of weekdays are smoothed out. With regard to labor market conditions, the unemployment rate has been at around 2.5 percent (Chart 24).[9] The active job openings-to-applicants ratio has risen moderately, as the number of job offerings for regular employees has been firm in industries with labor shortage and as that for part-time employees has increased, including in the face-to-face services industry (Chart 25). Meanwhile, the labor force participation rate has been on a moderate uptrend, particularly for women, when fluctuations are smoothed out (Chart 24).

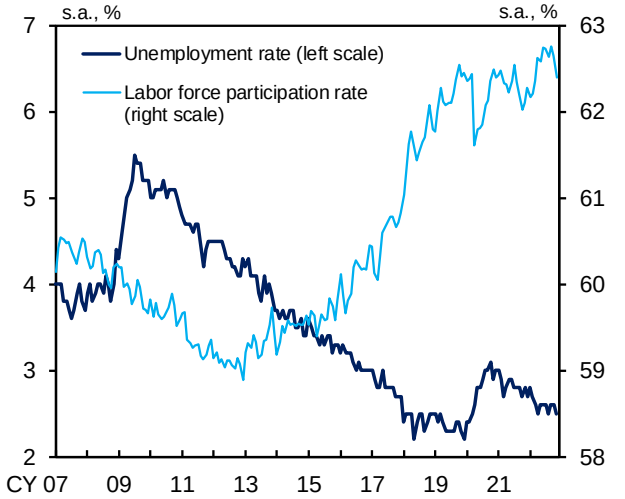
With regard to the outlook for the number of employees, regular employees are likely to continue increasing, mainly in industries with labor shortage, such as medical, healthcare, and welfare services, information and communications, and construction. Non-regular employees, such as in the face-to-face services industry, are also likely to continue increasing as the impact of

Chart 23: Number of Employed Persons



Source: Ministry of Internal Affairs and Communications.
Note: Figures for regular employees and non-regular employees prior to 2013 are based on the "detailed tabulation" in the *Labour Force Survey*. Figures for 2022/Q4 are October-November averages.

Chart 24: Unemployment Rate and Labor Force Participation Rate



Source: Ministry of Internal Affairs and Communications.

Chart 25: Job Openings-to-Applicants Ratio

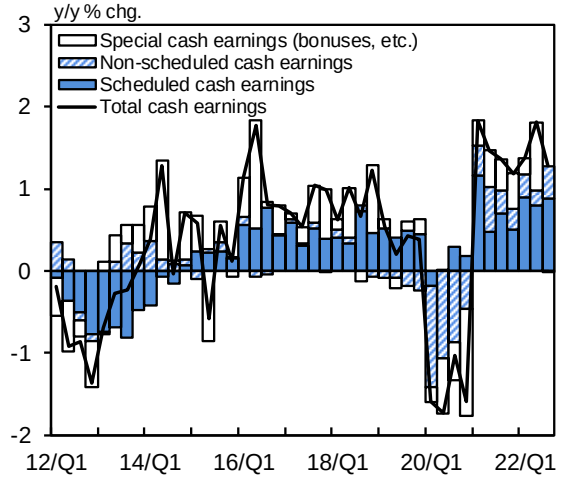
Source: Ministry of Health, Labour and Welfare.

[9] Box 2 outlines the current situation and outlook for labor market conditions.

COVID-19 wanes. Toward the end of the projection period, however, with the economic growth rate slowing, the pace of increase in the number of employees is projected to decelerate, partly because it will become more difficult for labor supply to increase, reflecting factors such as demographic changes. Under these circumstances, the unemployment rate is expected to follow a moderate declining trend on the back of a recovery in economic activity.

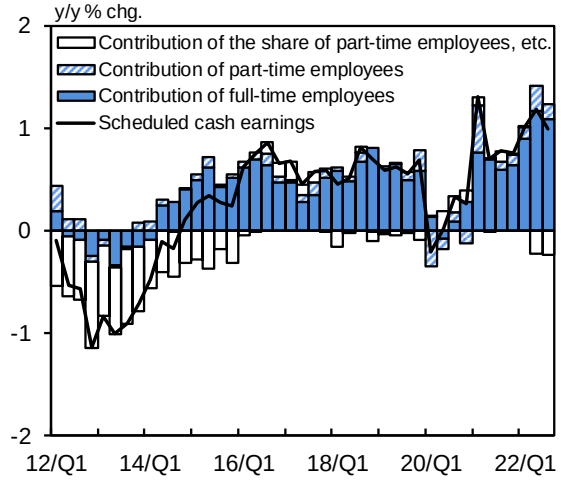
On the wage side, total cash earnings per employee have increased moderately, reflecting a pick-up in overall economic activity (Chart 26).[10] The year-on-year rate of change in scheduled cash earnings has continued to increase moderately (Chart 27). Looking at the breakdown, that for full-time employees has been in the range of 1.0-1.5 percent, with concern over labor shortage continuing. The year-on-year rate of change in hourly scheduled cash earnings for part-time employees has risen to around 2 percent recently, as labor market conditions have tightened and minimum wages have been raised.[11] Non-scheduled cash earnings have increased in reflection of improvement in economic activity, and their year-on-year rate of change has registered a relatively large positive figure. Special cash earnings (bonuses) have

Chart 26: Nominal Wages



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

Chart 27: Decomposition of Developments in Scheduled Cash Earnings



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

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

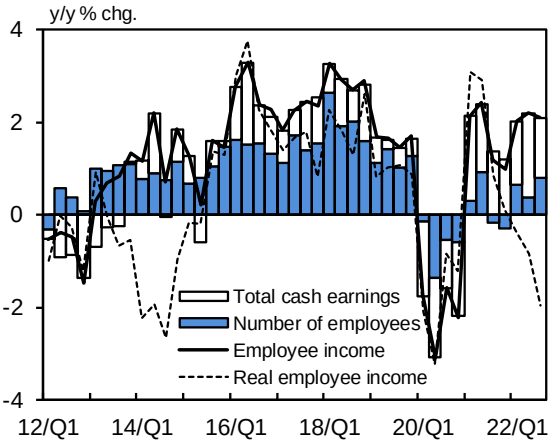
[11] It has been difficult to capture the trend of the year-on-year rate of change in hourly scheduled cash earnings for part-time employees from the *Monthly Labour Survey*, due to the effects of employment adjustment subsidies. In this regard, the year-on-year rate of change in part-time wages at the time of recruitment has recently accelerated to around 3 percent (for details, see Box 3).

continued on an uptrend, reflecting high levels of corporate profits.

With regard to the outlook for wages, scheduled cash earnings are expected to continue increasing as there are likely to be higher wage increases resulting from labor-management wage negotiations, mainly on the back of a tightening of labor market conditions and price rises.[12] Despite the declining trend in non-scheduled hours worked, mainly brought about by progress with working-style reforms, non-scheduled cash earnings are likely to increase moderately, reflecting improvement in economic activity. Special cash earnings (bonuses) are likely to increase, with corporate profits following an improving trend.[13] Taking all of these factors into account, the rate of increase in total cash earnings per employee is projected to accelerate.

In light of the aforementioned employment and wage conditions, employee income has improved in nominal terms, but in real terms, its year-on-year rate of decline has accelerated, reflecting price rises (Chart 28). With regard to the outlook, nominal employee income is likely to continue increasing along with economic improvement. In real terms, the year-on-year rate of change in employee income is projected to be negative toward the middle of the projection period, reflecting price rises. Thereafter, however,

Chart 28: Employee Income



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

[12] Box 3 examines the outlook for wages in Japan, taking its labor market structure into account.

[13] Lump-sum payments in response to price rises, or the so-called inflation allowances, are expected to be included in special cash earnings in many cases for statistical purposes.

it is likely to turn to a moderate increase as wage growth accelerates and inflation declines.

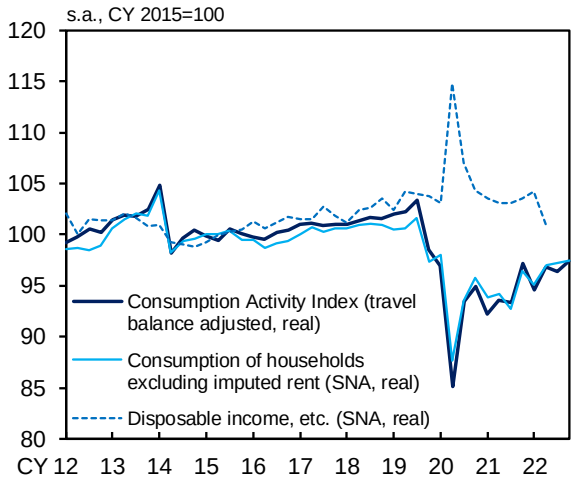
Household Spending

Private consumption has increased moderately, despite being affected by COVID-19.

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 -- turned out to be more or less flat for the July-September quarter of 2022, despite being affected by the COVID-19 resurgence (Charts 29 and 30). [14] It then increased for the October-November period relative to the July-September quarter, mainly for services consumption, as the resumption of consumption activities has progressed while public health has been protected, and as the government's domestic travel discount program has made a positive contribution. Based on various sources, such as high-frequency indicators, statistics published by industry organizations, and anecdotal information from firms, it seems that private consumption subsequently has been on a moderate uptrend, although prices have kept rising and the number of confirmed new cases of COVID-19 has followed an increasing trend (Chart 31).

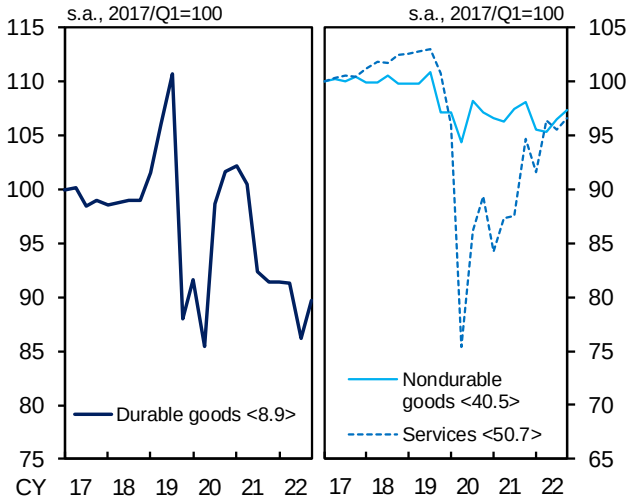
[14] Regarding the CAI, see the Bank's research paper "Revision of the Consumption Activity Index to Capture Recent Changes in Consumption Patterns" released in July 2021.

Chart 29: Private Consumption



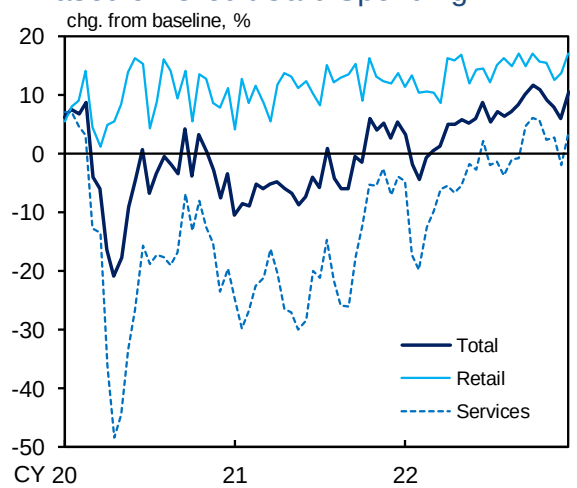
Sources: Bank of Japan; Cabinet Office, etc.
Notes: 1. Figures for the Consumption Activity Index (CAI) are based on staff calculations. The CAI figures (travel balance adjusted) exclude inbound tourism consumption and include outbound tourism consumption. The figure for 2022/Q4 is the October-November average.
2. The figure for consumption of households excluding imputed rent for 2022/Q4 is based on staff calculations using the Synthetic Consumption Index for October.
3. "Disposable income, etc." consists of disposable income and adjustment for the change in pension entitlements (using annual and quarterly estimates). Real values are obtained using the deflator of consumption of households.

Chart 30: Consumption Activity Index (CAI, Real)



Sources: Bank of Japan, etc.
Notes: 1. Based on staff calculations. Figures in angular brackets show the weights in the CAI. Figures for 2022/Q4 are October-November averages.
2. Nondurable goods include goods classified as semi-durable goods in the SNA.

Chart 31: Consumption Developments Based on Credit Card Spending

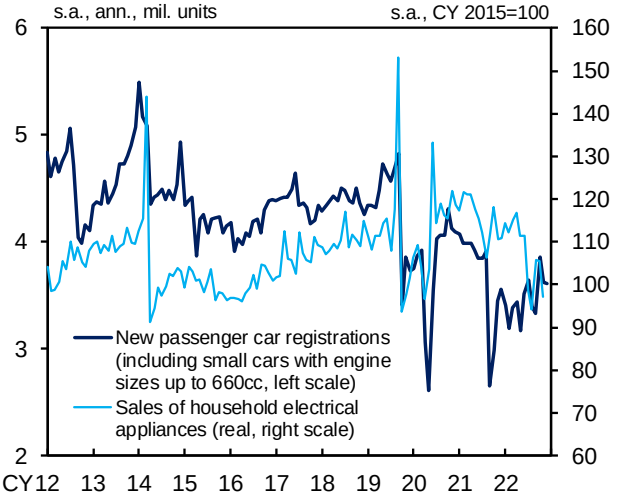


Source: Nowcast Inc./ JCB, Co., Ltd., "JCB Consumption NOW."
Notes: 1. Figures are from the reference series in *JCB Consumption NOW*, which take changes in the number of consumers into account. Figures for the total and for services exclude telecommunications and are based on staff calculations.
2.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

By type, albeit with fluctuations that mainly result from weather conditions, consumption of durable goods has picked up moderately, mainly due to the waning of supply-side constraints (Chart 32). Specifically, the number of new passenger car registrations has picked up moderately, albeit with fluctuations, as the tightness in global supply and demand conditions for semiconductors used in automobiles has eased gradually. Sales of household electrical appliances declined for November, mainly for seasonal items such as air conditioners, due to relatively higher temperatures than in normal years. Thereafter, however, it seems that these sales have increased slightly, partly due to temperature declines. When fluctuations are smoothed out, consumption of nondurable goods has increased, mainly for clothes, although some effects of high prices have been seen for items such as beverages and food.

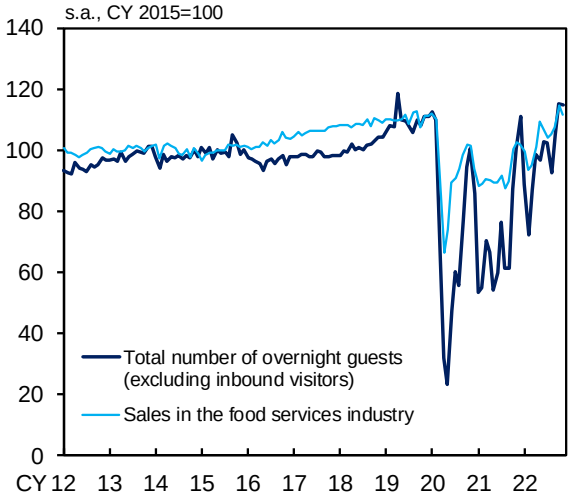
Services consumption has increased, underpinned by the government's domestic travel discount program, as the resumption of consumption activities has progressed while public health has been protected (Charts 31, 33, and 34). Despite being affected by COVID-19, dining-out -- including at *izakaya* (Japanese-style bars) -- has increased, mainly led by that of small groups. Domestic travel has increased not only for short but also long distances, partly due to the positive contribution of the domestic travel discount program. Meanwhile, overseas travel has remained at a low level, although it has continued to increase moderately.

Chart 32: Consumption of Durable Goods



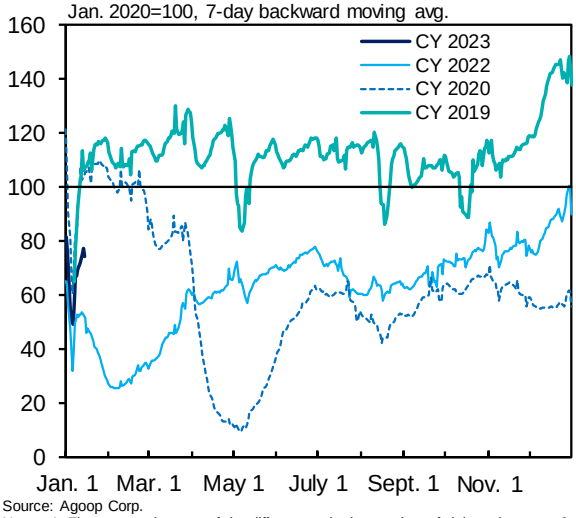
Sources: Japan Automobile Dealers Association; Japan Light Motor Vehicle and Motorcycle Association; Ministry of Economy, Trade and Industry; Ministry of Internal Affairs and Communications.
Note: Figures for real sales of household electrical appliances are based on staff calculations using the retail sales index of machinery and equipment in the *Current Survey of Commerce* and the price index of related items in the CPI.

Chart 33: Consumption of Services



Sources: Japan Tourism Agency; Japan Foodservice Association, "Market Trend Survey of the Food Services Industry."

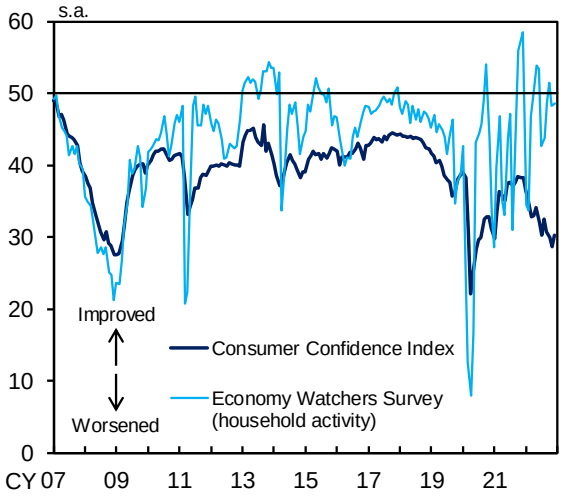
Chart 34: Mobility Trends in Downtown Areas



Source: Agoop Corp.
Notes: 1. Figures are the sum of the differences in the number of visitors between 9 p.m. and 4 a.m. on the following day in 53 downtown areas.
2. The latest figure is the average for January 9-15.

Looking at confidence indicators related to private consumption, the Consumer Confidence Index has been on a deteriorating trend, particularly in terms of consumer perception of "overall livelihood," with attention being given to price rises (Chart 35). The current economic conditions DI (household activity-related) of the *Economy Watchers Survey* -- which asks firms for their views on the direction of the economy -- was more or less flat for December 2022. This is because, while a positive contribution to the DI was made by an increase in tourism demand that mainly reflects the easing of COVID-19 border controls and the domestic travel discount program, there was concern over the impact of price rises and the effects of the COVID-19 resurgence were observed in part.

Chart 35: Confidence Indicators Related to Private Consumption



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

Regarding the outlook, 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. Thereafter, although the materialization of pent-up demand is likely to be moderate in pace, private consumption is expected to continue increasing steadily as employee income keeps improving and downward pressure stemming from high

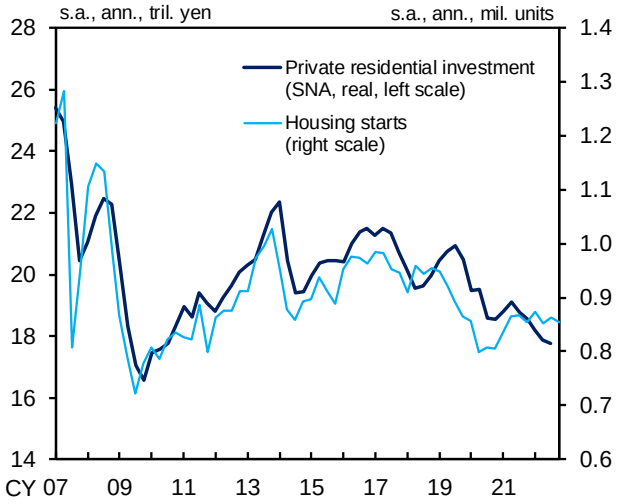
prices wanes. The propensity to consume is likely to follow an uptrend with the impact of COVID-19 waning (Chart 36). It is expected to somewhat exceed the average level seen prior to the pandemic, partly due to the withdrawals of household savings that had accumulated as a result of pandemic-related restrictions.

Housing investment has been relatively weak, mainly due to a rise in housing prices (Chart 37). Specifically, the number of housing starts -- a leading indicator of housing investment -- has been more or less flat on the whole, but that for owned houses -- for which prices per house are high -- has remained somewhat weak. Housing investment is likely to remain relatively weak toward the middle of the projection period. This is because, although accommodative financial conditions are expected to provide support, the rise in housing prices is projected to weigh on housing investment. Thereafter, when fluctuations are smoothed out, such investment is expected to follow a moderate declining trend toward the end of the projection period, reflecting demographic developments.

Chart 36: Average Propensity to Consume

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

Chart 37: Housing Investment



Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Note: The figure for 2022/Q4 is the October-November average.

II. Current Situation of Prices and Their Outlook

Developments in Prices

Reflecting past developments in international commodity prices and foreign exchange rate developments, the quarter-on-quarter rate of change in the producer price index (PPI, adjusted for the effects of seasonal changes in electricity rates) has continued to be relatively high (Chart 38). The year-on-year rate of increase in the services producer price index (SPPI, excluding international transportation) has been in the range of 1.0-1.5 percent, mainly on the back of a pick-up in economic activity and a rise in personnel expenses, with the impact of COVID-19 waning.

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 (Chart 39). The rate of increase in the CPI (all items less fresh food and energy, excluding temporary factors such as the effects of the government's domestic travel discount program) has accelerated significantly, reflecting a pass-through to selling prices of increases in costs such as of raw materials (Chart 40).[15]

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 temporary

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

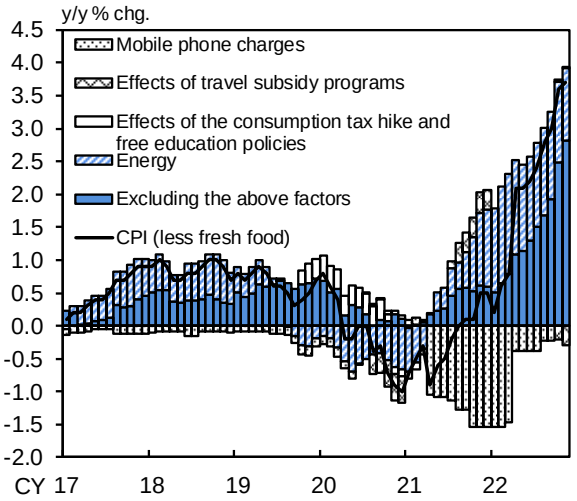
Chart 38: Inflation Indicators

y/y % chg.

	22/Q1	22/Q2	22/Q3	22/Q4
Consumer Price Index (CPI)				
Less fresh food	0.6	2.1	2.7	3.6
Excluding temporary factors	2.1	2.6	3.1	3.9
Less fresh food and energy	-0.9	0.9	1.5	2.7
Excluding temporary factors	0.7	1.3	1.9	2.9
Producer Price Index (q/q % chg.)	2.0	2.9	1.8	2.7
Services Producer Price Index	0.9	1.3	1.4	1.4
GDP Deflator	0.4	-0.2	-0.3	
Domestic demand deflator	2.6	2.8	3.2	

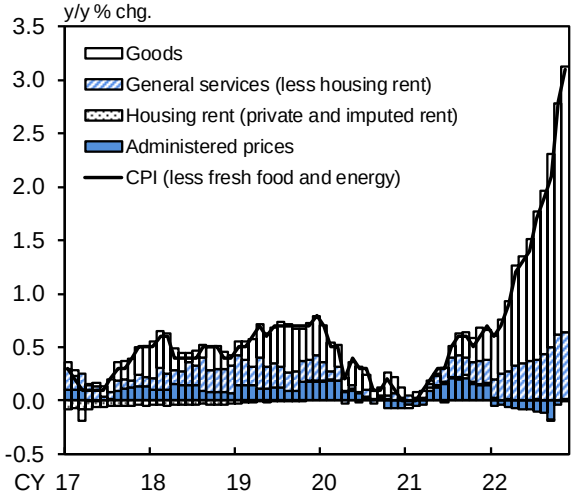
Sources: Ministry of Internal Affairs and Communications; Bank of Japan; Cabinet Office.
Notes: 1. Figures for the producer price index (PPI) are adjusted for the hike in electric power charges during the summer season. Figures for the services producer price index (SPPI) exclude international transportation.
2. The CPI figures excluding temporary factors are staff estimates and exclude mobile phone charges and the effects of travel subsidy programs.
3. Figures for the CPI and the SPPI for 2022/Q4 are October-November averages.

Chart 39: CPI (Less Fresh Food)



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

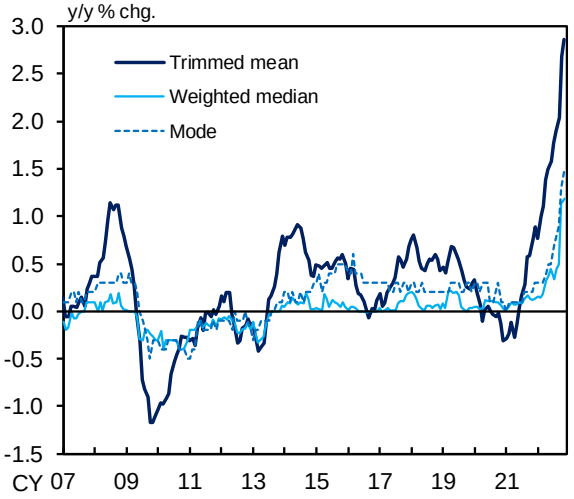
Chart 40: CPI (Excluding Temporary Factors)



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

factors), the rate of increase in goods prices has continued to accelerate, and that in general services prices has accelerated. The year-on-year rate of change in administered prices has been at around 0 percent. The rate of increase in goods prices has continued to accelerate as the pass-through of cost increases to selling prices has intensified for a wide range of items, especially food, daily necessities, and durable goods. The rate of increase in general services prices has accelerated against the backdrop of an intensified pass-through of raw material costs, mainly for dining-out and housework-related services (e.g., services related to housing repairs and maintenance). Although water and sewerage charges for some local governments have declined somewhat, the year-on-year rate of change in administered prices has been at around 0 percent in reflection of a hike in fire and earthquake insurance premiums.

Chart 41: Various Measures of Core Inflation



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

The indicators for capturing the underlying trend in the CPI have exhibited the following developments (Chart 41).[16] The trimmed mean of the year-on-year rate of change in the CPI has increased to around 3 percent due to price hikes in a wide range of goods and services. Similarly, the mode and the weighted median, which are

[16] The trimmed mean is calculated by excluding items that belong to a certain percentage of the upper and lower tails of the price change distribution (10 percent of each tail) in order to eliminate the effects of large relative price changes. The mode is the inflation rate with the highest density in the price change distribution. The weighted median is the average of the inflation rates of the items at around the 50 percentile point of the cumulative distribution in terms of weight. All three indicators are calculated using data for each CPI item that excludes the effects of the consumption tax hikes, policies concerning the provision of free education, and travel subsidy programs.

less susceptible to developments in certain CPI items, have risen. Looking at the year-on-year price changes across all CPI items (less fresh food), the share of price-increasing items minus the share of price-decreasing items has continued to increase in positive territory because costs such as of raw materials have been passed on to a wide range of goods and services prices (Chart 42).

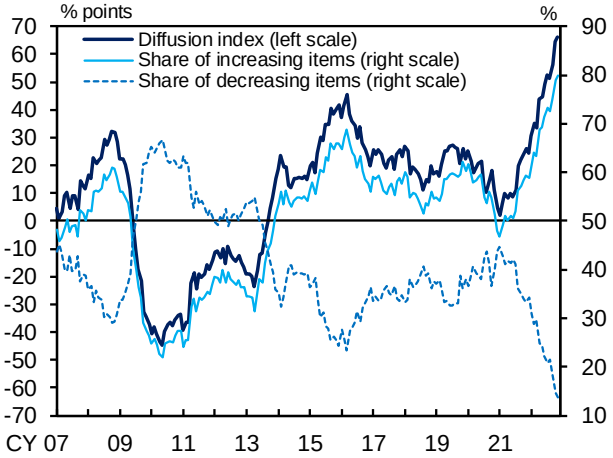
Meanwhile, the year-on-year rate of change in the domestic demand deflator has been at around 3 percent (Chart 38). By component, the private consumption deflator has been in the range of 2.5-3.0 percent on a year-on-year basis, and deflators such as for business fixed investment have increased clearly, reflecting rises in material and other prices. On the other hand, the year-on-year rate of change in the GDP deflator has been in the range of 0.0 to minus 0.5 percent, pushed down by an increase in the import deflator in reflection of developments in crude oil prices, for example.

Environment Surrounding Prices

In the outlook for prices, the main factors that determine inflation rates are assessed as follows. First, the output gap is projected to turn positive around the second half of fiscal 2022 with the economy following a growth path that outpaces its potential growth rate (Charts 2 and 43). Thereafter, the output gap is likely to continue to expand moderately.

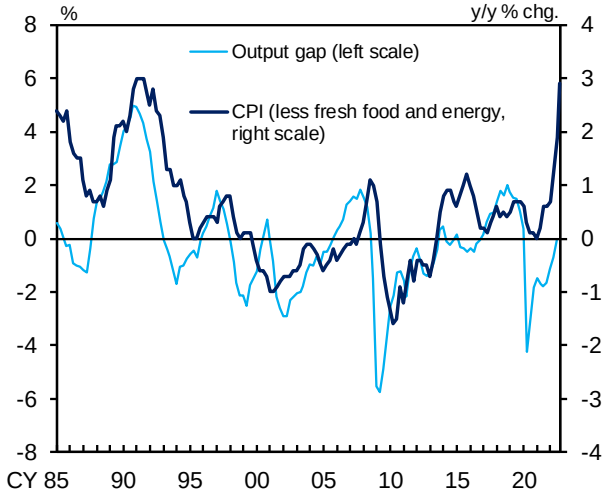
Second, medium- to long-term inflation expectations have risen, albeit at a moderate

Chart 42: Diffusion Index of Price Changes



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

Chart 43: Inflation Rate and Output Gap



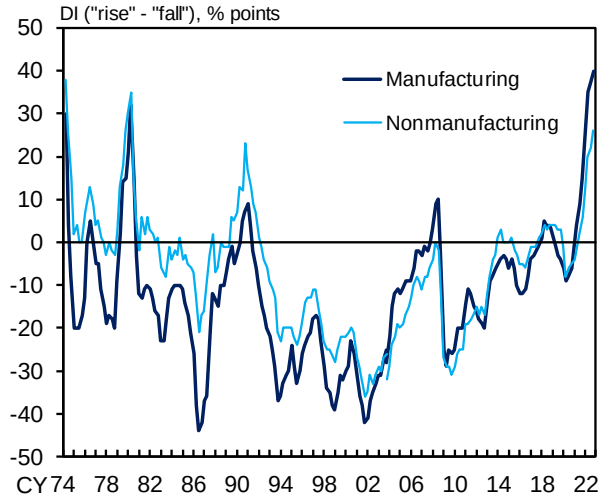
Sources: Ministry of Internal Affairs and Communications; Bank of Japan.
Notes: 1. The CPI figures are staff estimates and exclude mobile phone charges and the effects of the consumption tax hikes, policies concerning the provision of free education, and travel subsidy programs. The figure for 2022/Q4 is the October-November average.
2. Figures for the output gap are staff estimates.

pace relative to short-term ones. The December 2022 *Tankan* shows that the output prices DI has increased (Chart 44). It also shows that 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 (Chart 45). 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.

Third, the year-on-year rate of increase in import prices has decelerated recently owing to price declines in such items as crude oil that reflect concern over a global economic slowdown, and to a pause in the rapid depreciation of the yen (Chart 46[1]). Nevertheless, upward pressure of costs led by past rises in import prices has continued to be passed on to selling prices at the midstream to downstream stages of supply chains, and this has been a factor pushing up the CPI (Chart 46[2]). Although the upward pressure on the CPI is expected to wane gradually, the pass-through of cost increases is projected to continue for a wide range of goods and services prices in the short run given, for example, that the degree of cost increases in the recent past has been larger than those in previous phases.

Meanwhile, energy prices (e.g., gasoline prices and electricity charges) are likely to fluctuate owing to developments in import prices, such as for crude oil, as well as to the effects of the

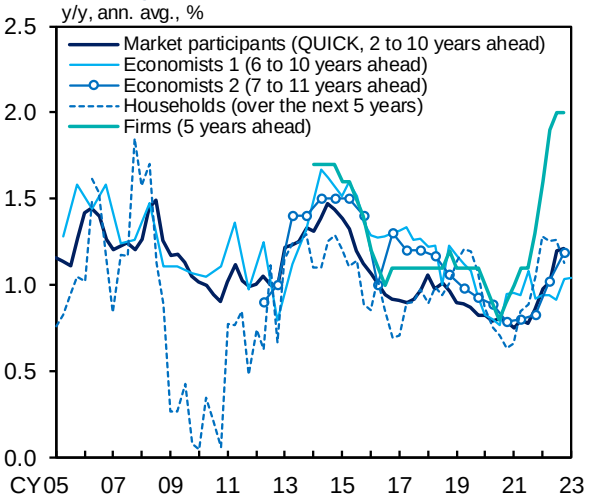
Chart 44: Output Prices



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

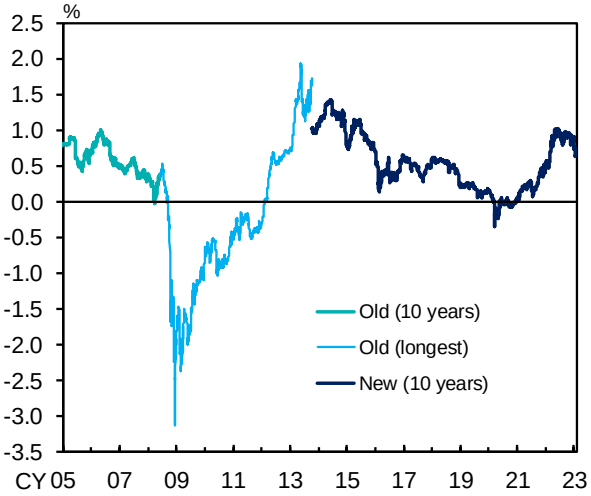
Chart 45: Inflation Expectations

1. Survey



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

2. BEI

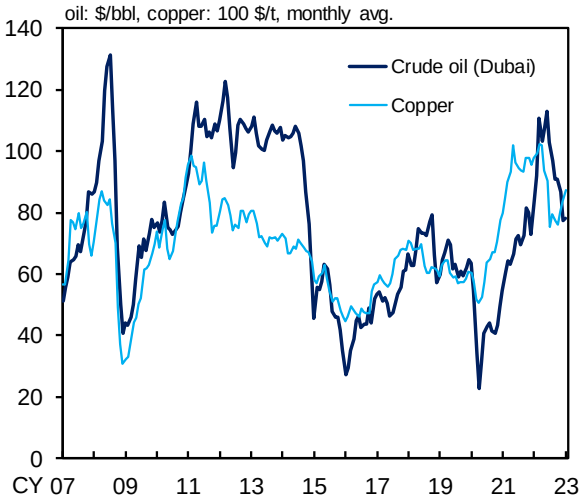


Source: Bloomberg.
Note: The BEI (break-even inflation) rate is the yield spread between fixed-rate coupon-bearing JGBs and inflation-indexed JGBs. Inflation-indexed JGBs issued since October 2013 are designated as "new," while the rest are designated as "old." Figures for "old (longest)" are calculated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

government's measures and of changes in regulated rates. Specifically, the year-on-year rate of change in energy prices is projected to decline clearly for a while, since prices of petroleum products have been curbed by the effects of the government's gasoline subsidies and, at the end of fiscal 2022, the government will implement the measures to reduce the household burden of higher electricity charges and of higher manufactured and piped gas charges.[17] From the beginning of fiscal 2023, upward pressure will be exerted on energy prices if the hikes in regulated electricity rates that power companies are currently applying for are approved by the government. However, as the effects of the government's measures to respond to soaring energy prices are expected to outweigh such upward pressure, the year-on-year rate of change in energy prices is likely to turn negative toward the middle of fiscal 2023. Thereafter, assuming that the government's various measures will be scaled back, the rate of change in energy prices is highly likely to turn positive and accelerate clearly through the first half of fiscal 2024, partly due to a waning of the effects of the measures to respond to soaring energy prices pushing down such prices of the previous year.

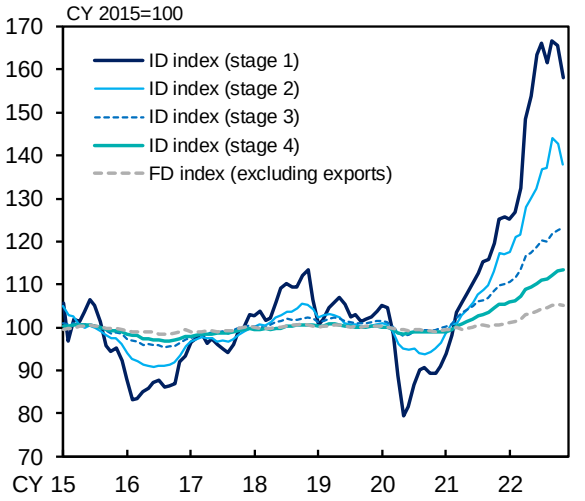
Chart 46: International Commodity Prices and FD-ID Price Indexes

1. International Commodity Prices



Sources: Nikkei Inc.; Bloomberg.

2. FD-ID Price Indexes (All Commodities)



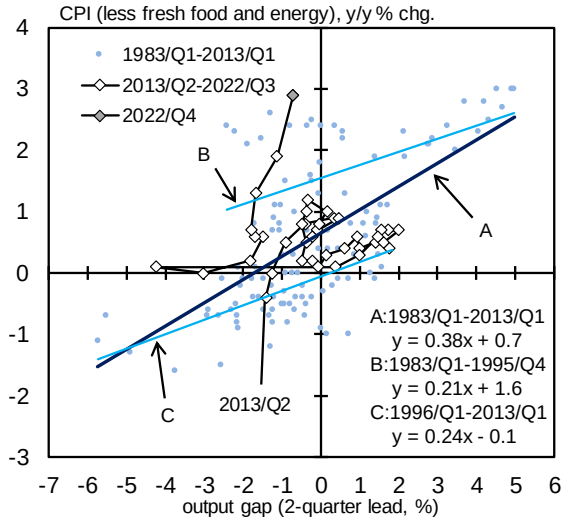
Source: Bank of Japan.

[17] With regard to gasoline subsidies, the government has introduced a measure to provide subsidies to petroleum distributors and importers as funds to contain a sharp rise in their selling prices when the nationwide average for retail gasoline prices exceeds the benchmark price (168 yen per liter). It has decided to continue with this measure until the end of May 2023 while lowering the upper limit of the subsidies. The government has announced that it will gradually scale back the gasoline subsidies from June. With regard to electricity charges, through its measures to reduce the household burden, electricity charges will be cut by 7 yen per kilowatt-hour (roughly a 20 percent discount per month for typical households) for the period from February through September 2023 and by 3.5 yen per kilowatt-hour for October. Regarding manufactured and piped gas charges, roughly similar measures to reduce the household burden have been introduced.

Outlook for Prices

Based on this underlying scenario, the year-on-year rate of change in the CPI (all items less fresh food and energy) is projected to increase for the time being as the pass-through of cost increases led by a rise in import prices is likely to continue for prices of items such as food, durable goods, and dining-out. The rate of increase is then expected to decelerate through the second half of fiscal 2023 because the contribution of these factors to this CPI is likely to wane. Thereafter, it is projected to accelerate again moderately on the back of continued improvement in the output gap and rises in medium- to long-term inflation expectations and in wage growth (Chart 47).

Chart 47: Phillips Curve



Sources: Ministry of Internal Affairs and Communications; Bank of Japan.
Notes: 1. The CPI figures are staff estimates and exclude mobile phone charges and the effects of the consumption tax hikes, policies concerning the provision of free education, and travel subsidy programs. The figure for 2022/Q4 is the October-November average.
2. Figures for the output gap are staff estimates.

On this basis, taking account of the aforementioned developments in energy prices, the year-on-year rate of increase in the CPI (all items less fresh food) is likely to be relatively high in the short run due to the effects of the 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 because it is projected that (1) the rate of change in energy prices will turn negative and (2) there will be a gradual waning of pressure on firms to pass on the cost increases led by the rise in import prices. Thereafter, the rate of increase in this CPI is projected to accelerate again moderately on the whole as (1) the rate of increase in energy prices accelerates clearly and (2) the rate of increase in the CPI (all items less fresh food and energy) also accelerates moderately.

III. Financial Developments in Japan

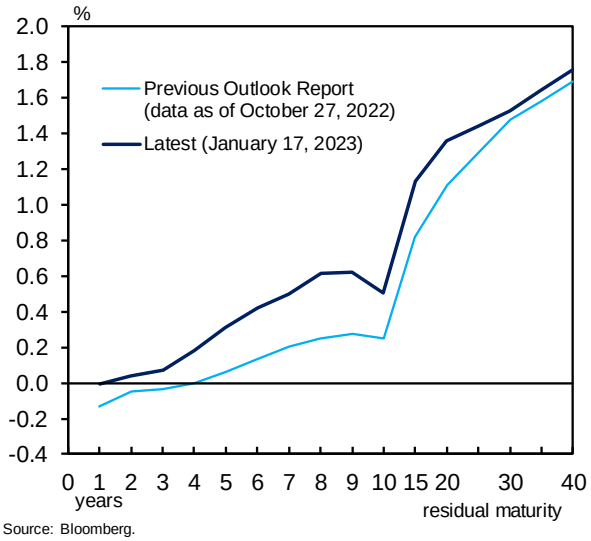
Financial Conditions

Financial conditions have been accommodative on the whole, although weakness in firms' financial positions has remained in some segments.

Under QQE with Yield Curve Control, the shape of the yield curve for Japanese government bonds (JGBs) has been consistent 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 48). At the Monetary Policy Meeting held in December 2022, the Bank decided to modify the conduct of yield curve control, given that the functioning of bond markets had deteriorated, particularly in terms of relative relationships among interest rates of bonds with different maturities and arbitrage relationships between spot and futures markets. As part of the decision, while significantly increasing the amount of JGB purchases, the Bank expanded the range of 10-year JGB yield fluctuations from the target level: from between around plus and minus 0.25 percentage points to between around plus and minus 0.5 percentage points.

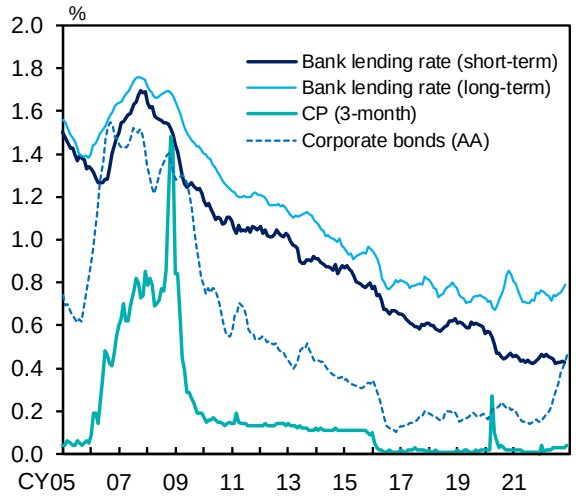
Firms' funding costs have been hovering at extremely low levels (Chart 49). Issuance rates for CP also have been at extremely low levels, as issuance conditions have remained favorable. The DI for issuance conditions for CP in the *Tankan* has continued to show net "easy" conditions, although the DI has declined due to an

Chart 48: Yield Curves



Source: Bloomberg.

Chart 49: Bank Lending Rates and Issuance Yields for CP and Corporate Bonds



Sources: Bank of Japan; Japan Securities Depository Center; Capital Eye; I-N Information Systems; Bloomberg.

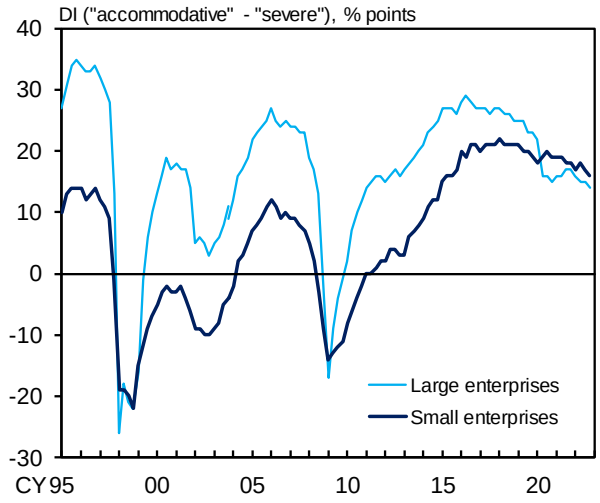
Notes: 1. Figures for issuance yields for CP up through September 2009 are the averages for CP (3-month, rated a-1 or higher). Those from October 2009 onward are the averages for CP (3-month, rated a-1).
2. Figures for issuance yields for corporate bonds are the averages for domestically issued bonds launched on a particular date. Bonds issued by banks and securities companies, etc. are excluded.
3. Figures for bank lending rates and issuance yields for corporate bonds are 6-month backward moving averages.

increase in demand for working capital in reflection of high commodity prices. In the corporate bond market, while issuance conditions have remained favorable on the whole, issuance spreads have widened and issuance rates have risen. Meanwhile, lending rates (the average interest rates on new loans and discounts) have been at around historical low levels.

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 50). The DI for firms' financial positions in the *Tankan* suggests that, although weakness has remained in some segments, the positions have continued on an improving trend, including for small firms, on the back of a pick-up in the economy (Chart 51). By industry, the DI for manufacturing has deteriorated slightly, mainly due to the effects of raw material cost increases, whereas that for nonmanufacturing has remained on an improving trend, mainly reflecting the effects of a pick-up in economic activity.

Regarding firms' demand for funds, demand for working capital has increased in reflection of the pick-up in economic activity and raw material cost increases. In this situation, the aggregate amount outstanding of CP and corporate bonds has increased at a pace of around 4 percent on a year-on-year basis (Chart 52). In addition, the year-on-year rate of increase in the amount outstanding of bank lending has been at around 3 percent.

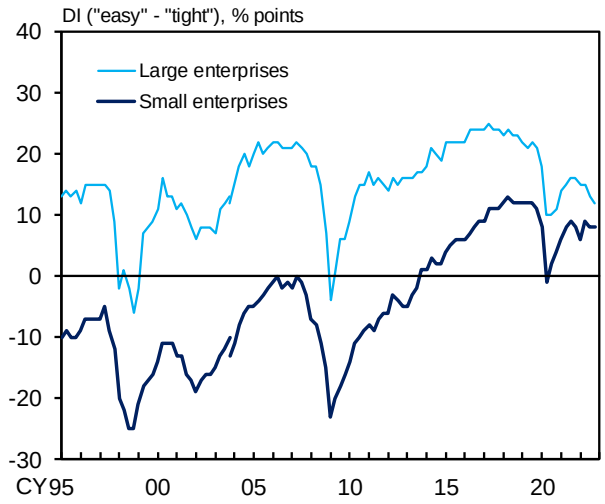
Chart 50: Lending Attitudes of Financial Institutions as Perceived by Firms



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

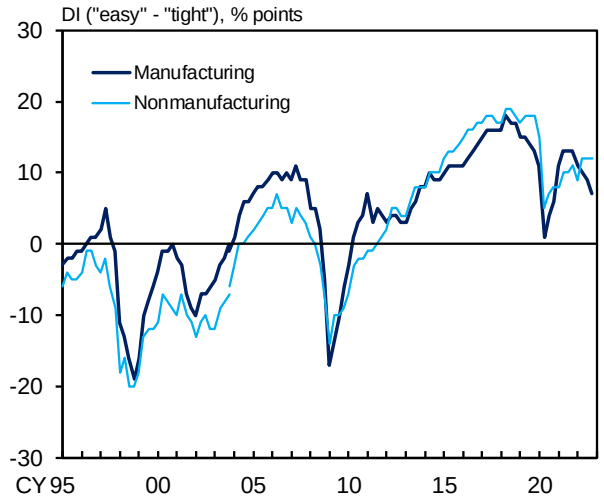
Chart 51: Firms' Financial Positions

1. By Firm Size



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

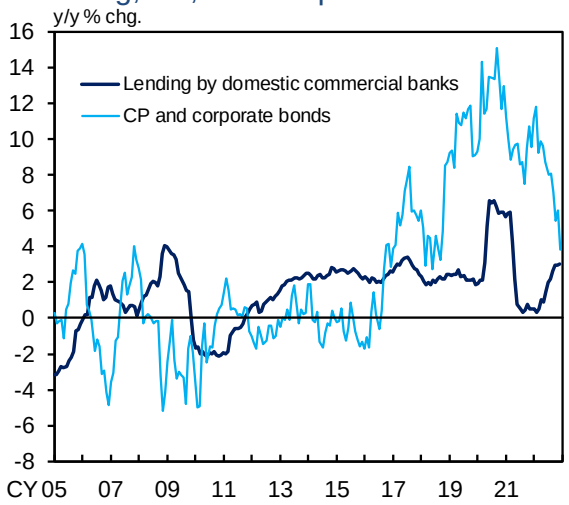
2. By Industry



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

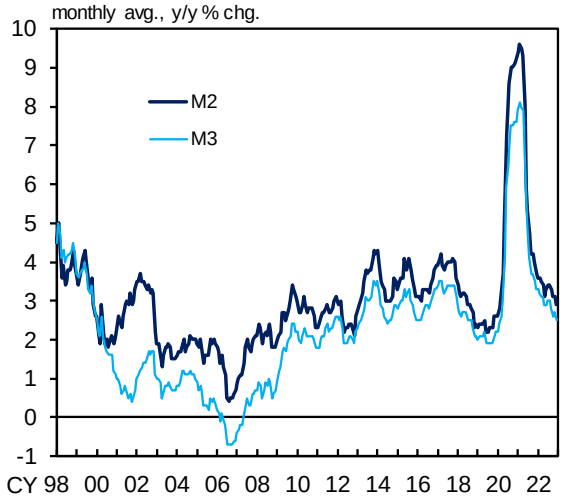
The year-on-year rate of change in the monetary base has been slightly negative due to a decline in the amount outstanding of funds provided through the Special Funds-Supplying Operations to Facilitate Financing in Response to the Novel Coronavirus (COVID-19). The amount outstanding of the monetary base was 632 trillion yen, of which the ratio to nominal GDP was 114 percent.[18] The year-on-year rate of change in the money stock (M2) has been at around 3 percent, mainly because fiscal spending has pushed it up and the amount outstanding of bank lending has increased (Chart 53).

Chart 52: Amounts Outstanding of Bank Lending, CP, and Corporate Bonds



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

Chart 53: Money Stock



Source: Bank of Japan.

[18] The amount outstanding of the monetary base is as of end-December 2022. Nominal GDP is the figure for the July-September quarter of 2022.

Developments in Financial Markets

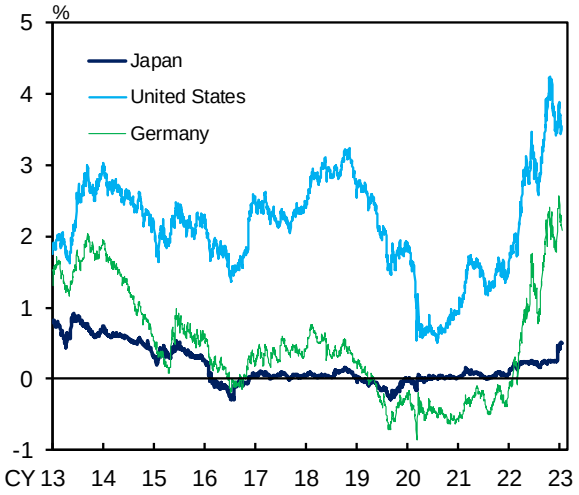
In global financial markets, market sentiment has remained cautious, as market attention has continued to be drawn to uncertainties surrounding monetary tightening by central banks in the United States and Europe and to a slowdown in the global economy.

Yields on 10-year government bonds in the United States have declined, mainly reflecting a deceleration in its inflation rate (Chart 54). Those in Europe have risen, mainly in reflection of the European Central Bank's communication to the public indicating its firm stance toward containing inflation.

Premiums for U.S. dollar funding through the dollar/yen foreign exchange swap market expanded temporarily due to a seasonal tightening of supply and demand conditions for this funding in view of the year-end (Chart 55). Recently, as such tightening dissipated after the beginning of 2023, these premiums have declined.

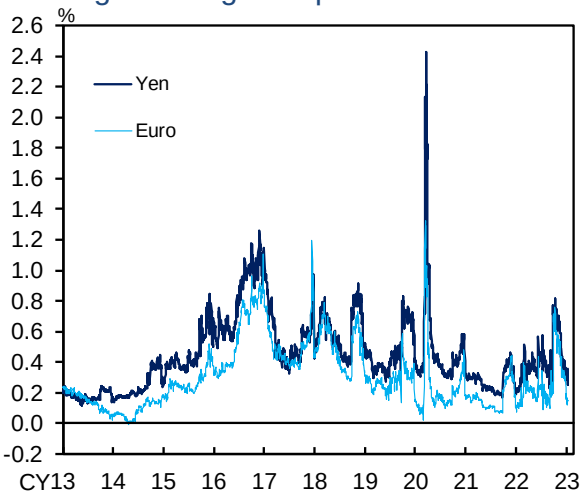
Stock prices in the United States and Europe rose, mainly reflecting a decline in U.S. long-term interest rates and diminished concern over the issue of energy supply in Europe this winter, and volatility in the market decreased (Charts 56 and 57). Stock prices in Japan rose along with those in the United States and then declined, mainly reflecting the yen's appreciation. Stock prices in emerging economies have risen, particularly in Asia, mainly due to market expectations for the stimulus effects that China's policy shift from the

Chart 54: 10-Year Government Bond Yields in Selected Advanced Economies



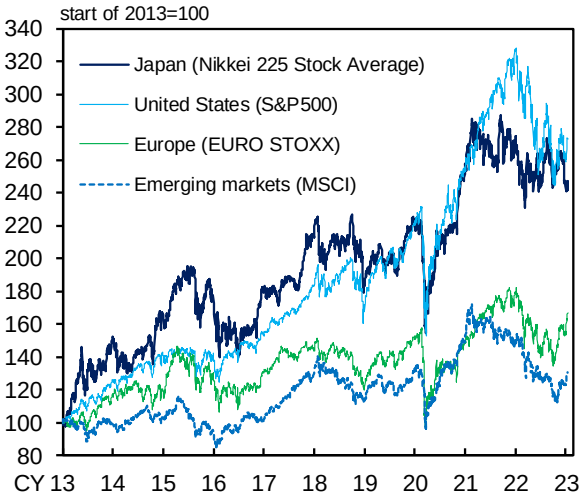
Source: Bloomberg.

Chart 55: Dollar Funding Premiums through Foreign Exchange Swaps



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

Chart 56: Selected Stock Price Indices



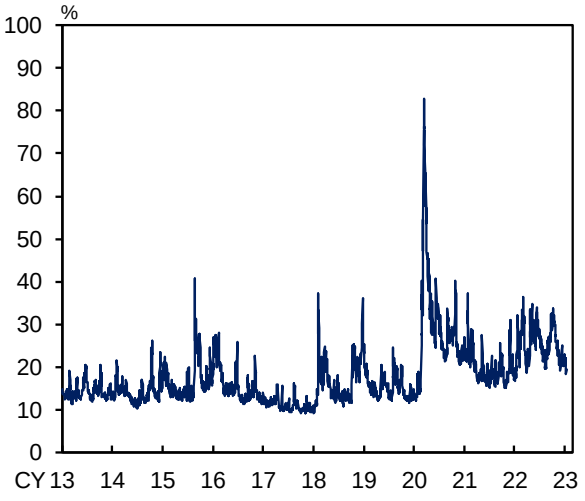
Source: Bloomberg.
Note: Figures for emerging markets are those for the MSCI Emerging Markets Index (local currency).

strict preventive measures against COVID-19 has on its economy.

Prices of Japan real estate investment trusts (J-REITs) have declined, mainly reflecting a rise in long-term interest rates (Chart 58).

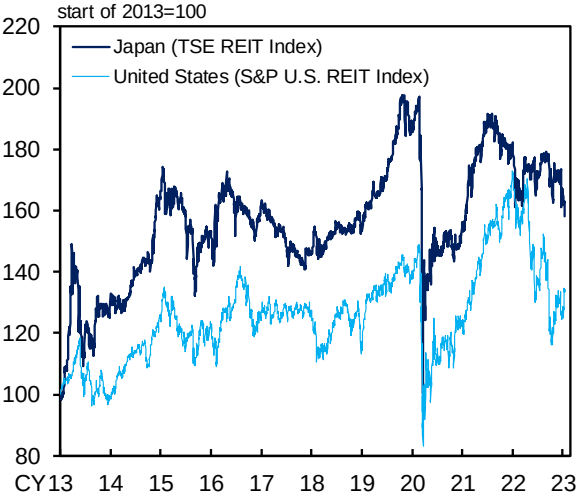
In foreign exchange markets, the yen has appreciated against the U.S. dollar, mainly on the back of a narrowing of the yield differential between Japan and the United States (Chart 59). Meanwhile, the yen has also appreciated against the euro.

Chart 57: Stock Market Volatility (VIX)



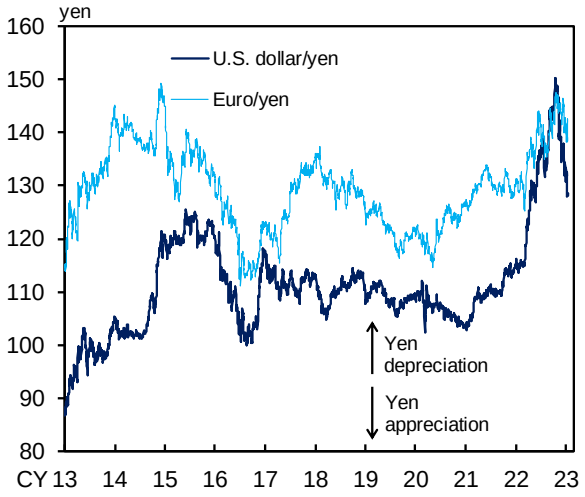
Source: Bloomberg.

Chart 58: Selected REIT Indices



Source: Bloomberg.

Chart 59: U.S. Dollar/Yen and Euro/Yen

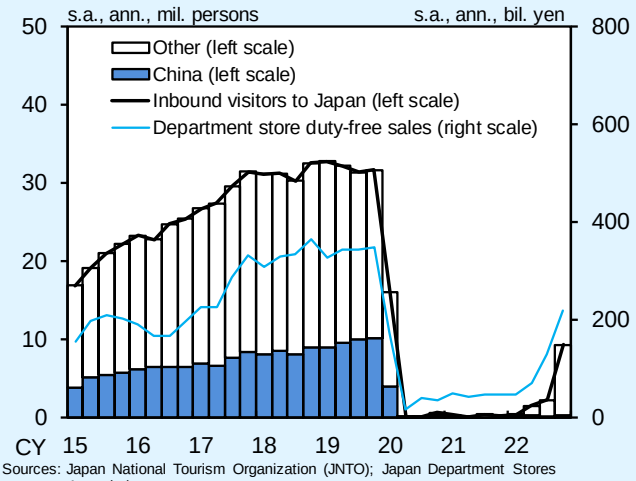


Source: Bloomberg.

(Box 1) Recent Developments in Inbound Tourism Demand

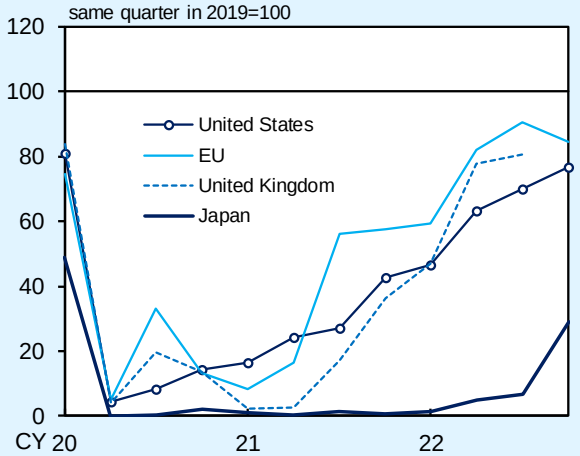
The number of inbound visitors to Japan had been at an extremely low level since the outbreak of COVID-19 but has turned to a clear increase, given the government's relaxation of entry restrictions in October 2022 (Chart B1-1). In addition, the expenditure per inbound visitor seems to be at a high level, considering that sales of duty-free goods at department stores have recovered more rapidly than the number of inbound visitors. Therefore, inbound visitors' consumption in Japan (i.e., inbound tourism demand) has picked up, supported by the recovery in both the number of inbound visitors and the expenditure per such visitor, and this has boosted Japan's economic recovery.

Chart B1-1: Number of Inbound Visitors to Japan and Duty-Free Sales



Sources: Japan National Tourism Organization (JNTO); Japan Department Stores Association.
Note: Figures for 2022/Q4 are October-November averages.

Chart B1-2: Number of Inbound Visitors to Major Regions



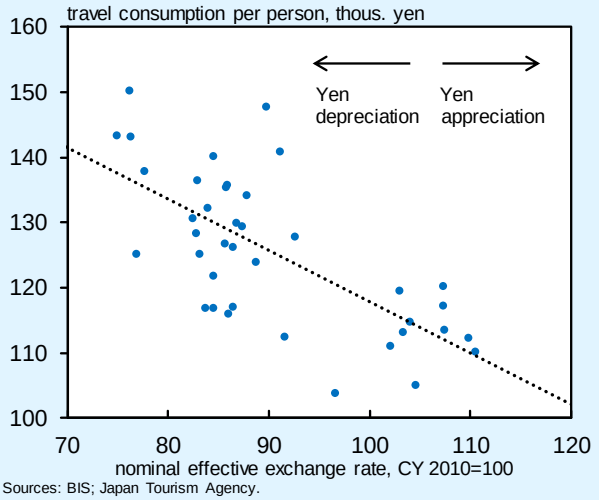
Sources: CEIC; Japan National Tourism Organization (JNTO).
Note: The figure for the United States for 2022/Q4 is that for October. Figures for the EU and Japan for 2022/Q4 are October-November averages. The figure for the United Kingdom for 2022/Q3 is the July-August average.

The outlook for inbound tourism demand is examined from the perspectives of the number of inbound visitors and the expenditure per such visitor. First, the number of inbound visitors is highly likely to follow a clear increasing trend for the time being. In fact, in countries where COVID-19 border controls were eased earlier than in Japan, the number of inbound visitors has been on an uptrend. In the United States and Europe in particular, the number has already recovered to a level close to that seen prior to the pandemic (Chart B1-2). However, the number of Chinese tourists -- which accounted for around 30 percent of the number of inbound visitors to Japan before the pandemic -- has remained at an extremely low level, and thus future developments warrant close monitoring. In addition, the pace of recovery in overseas economies has slowed

recently, and this may affect the number of inbound visitors to Japan.

Second, there seems to have been a moderate correlation between an increase in the expenditure per inbound visitor and a depreciation of the yen (Chart B1-3). The expenditure per such visitor is likely to be at a relatively high level for the time being, partly due to the past depreciation of the yen. It is expected that this, coupled with the rise in the number of inbound visitors, will lead to an increase in inbound tourism demand.

Chart B1-3: Exchange Rate and Inbound Visitor Spending



Sources: BIS; Japan Tourism Agency.
Note: The sample period is from 2010/Q2 to 2019/Q4. The broad-based nominal effective exchange rate is used.

(Box 2) Current Situation and Outlook for Labor Market Conditions

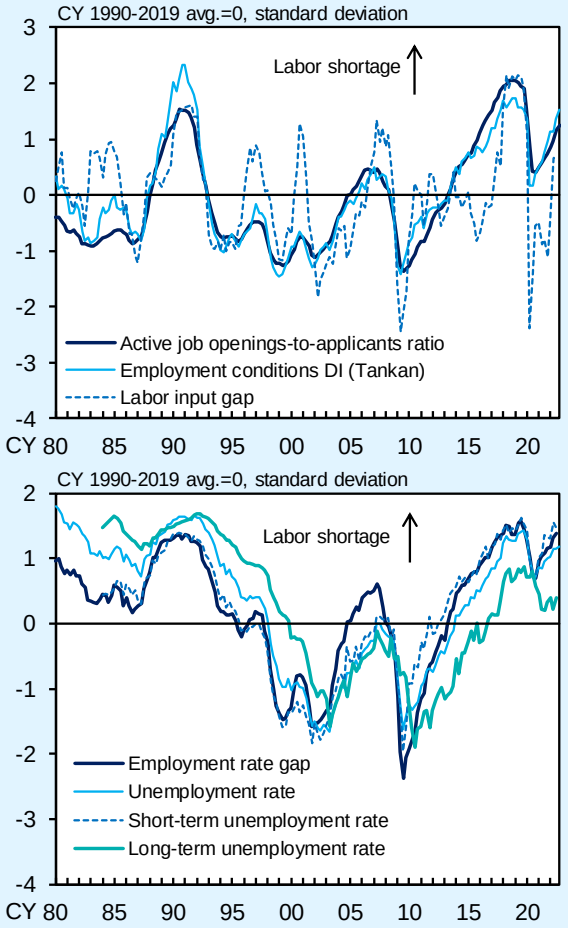
Labor market conditions have been tightening in Japan with economic activity continuing to improve. Looking at various measures of labor market conditions, some of them show that the degree of tightness has been close to the pre-pandemic level and to the peak during the bubble period at the end of the 1980s (Chart B2-1).[19]

The outlook for labor market conditions depends on how much labor demand will rise, reflecting improvement in economic activity, as well as on developments in labor supply. In this regard, looking at the 2010s, before the pandemic, while labor demand increased along with an economic recovery, the number of labor force participants rose on the labor supply side even amid a decreasing total population because labor force participation of seniors and women had advanced (Chart B2-2). This eased upward pressure on wages stemming from tight labor market conditions and supported economic growth. The following outlines whether an increase in labor supply as seen in the 2010s can be expected going forward.

First, the labor force participation rate for seniors, which had continued on an uptrend, has remained more or less flat recently, partly reflecting moves to temporarily put off participation in the labor market due to the pandemic (Chart B2-3). The

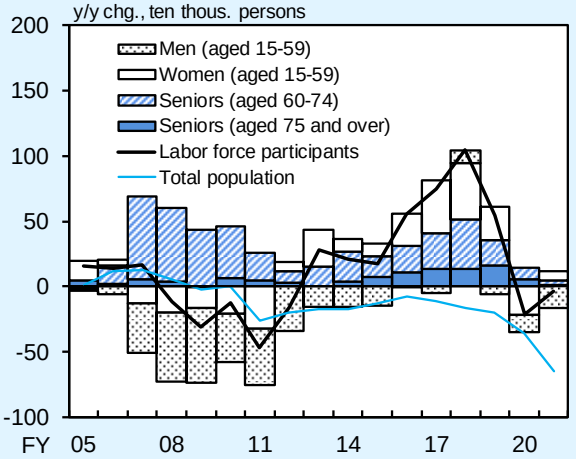
[19] For details on each measure, see Box 1 in the July 2017 Outlook Report.

Chart B2-1: Various Measures of Labor Market Conditions



Sources: Ministry of Health, Labour and Welfare; Bank of Japan; Ministry of Internal Affairs and Communications, etc.
Notes: 1. Figures for each measure of labor market conditions are normalized by the standard deviation from 1990 to 2019.
2. Figures for the active job openings-to-applicants ratio and the unemployment rate for 2022/Q4 are October-November averages.
3. The labor input gap and the employment rate gap are staff estimates.
4. Figures for the short- and long-term unemployment rates up through 2001 are on a semiannual or annual basis.

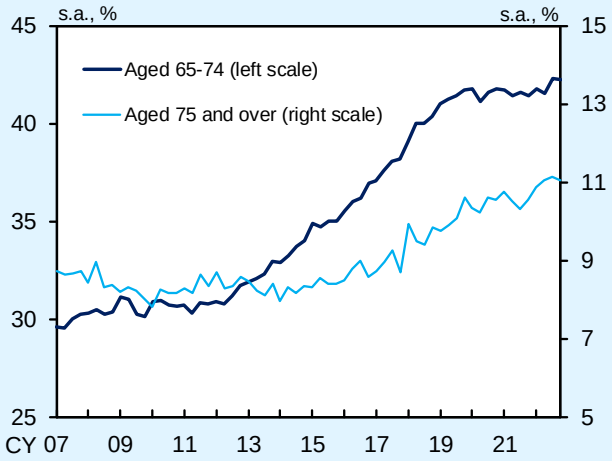
Chart B2-2: Labor Force Participants



Source: Ministry of Internal Affairs and Communications.
Note: Figures for labor force participants are staff estimates adjusted for gaps due to revisions of the benchmark population.

labor force participation rate for seniors aged 75 and over has been significantly lower than those aged between 65 and 74, and the so-called baby boomer generation (born between 1947 and 1949), which supported the increase in labor supply in the 2010s, has reached their mid-70s. Considering these factors, the pace of increase in labor force participation of seniors is projected to decelerate, as it is highly likely that the labor force participation rate for the baby boomer generation will decline (Chart B2-4).

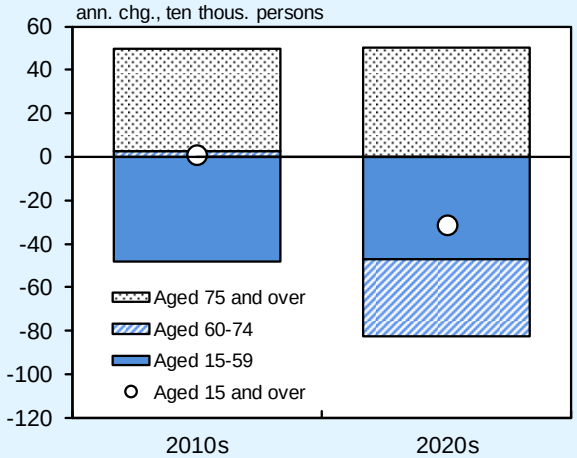
Chart B2-3: Labor Force Participation Rate of Seniors



Source: Ministry of Internal Affairs and Communications.
Note: Figures are staff estimates adjusted for gaps due to revisions of the benchmark population. Figures for 2022/Q4 are October-November averages.

Second, room for additional labor supply seems to have shrunk for women as well. Specifically, although a so-called M-shaped curve -- which indicates a low labor force participation rate for women in their child-bearing and child-rearing phases -- had been observed in Japan, it has started to flatten in recent years (Chart B2-5). The labor force participation rate for women in Japan has been comparable to those in the United States and Europe, as seen in the rate for women aged between 25 and 34 already exceeding those in the United States and Germany and rising to a level close to that in Sweden.

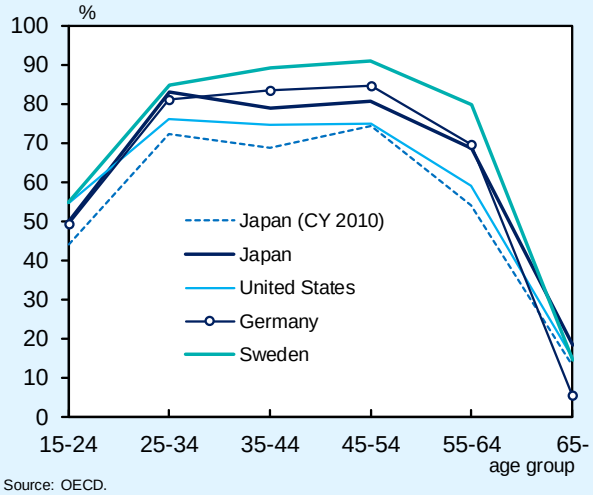
Chart B2-4: Change in Population by Age



Sources: Ministry of Internal Affairs and Communications; National Institute of Population and Social Security Research.
Note: Figures for the 2020s are calculated using forecasts for the period from 2020 to 2024.

Taking account of these factors, it is highly likely that labor market conditions will tighten further as labor demand is expected to rise due to an economic recovery and as labor supply is unlikely to increase to the extent that it did in the 2010s. That said, uncertainties regarding this outlook, both upside and downside, are high.

Chart B2-5: Labor Force Participation Rate of Women (CY 2021)



Source: OECD.

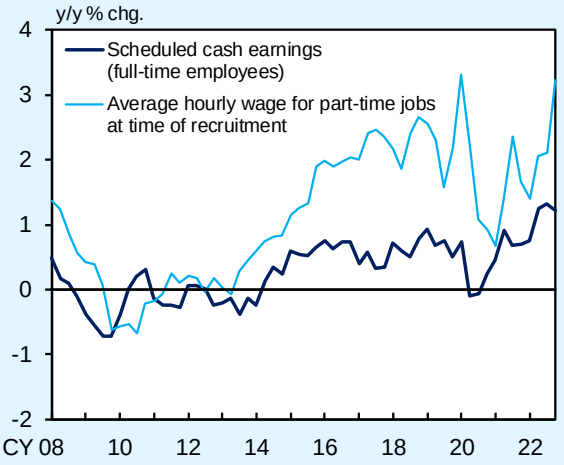
Specifically, labor demand is projected to be affected by factors such as the pace of economic

recovery, which depends partly on the degree of pent-up demand. On the labor supply side, although the labor force participation rate for women has risen to some extent, as mentioned earlier, the total hours worked per female employee have remained low compared with those per male employee. Considering that labor market reform has progressed and government measures such as those to support employment have been enhanced since the 2010s, there still seems to be room for labor supply of women to increase in the form of a rise in the number of working hours. In addition, labor supply in such industries as face-to-face services (e.g., accommodations as well as eating and drinking services) is susceptible to whether the number of foreign workers, for which the growth rate has decreased since the outbreak of COVID-19, will recover. It is necessary to pay close attention to developments in labor supply, since it is an important factor that affects wage developments.

(Box 3) Dual Structure in the Labor Market and the Outlook for Wages

Wage growth in Japan has continued to be sluggish since the second half of the 1990s. However, different developments between wages of regular employees (full-time employees) and those of non-regular employees (part-time employees) have been seen behind the overall sluggishness: when labor market conditions tightened notably in the second half of the 2010s, growth in wages of part-time employees accelerated, while that in full-time employees' scheduled cash earnings remained modest (Chart B3-1).

Chart B3-1: Scheduled Cash Earnings



Sources: Ministry of Health, Labour and Welfare; Recruit Co., Ltd., "Report on Average Hourly Wages for Part-Time Jobs at Time of Recruitment" (available only in Japanese).
Notes: 1. Figures for scheduled cash earnings from 2016/Q1 onward are based on continuing observations following the sample revisions. Figures for the average hourly wage for part-time jobs at the time of recruitment are for the three largest metropolitan areas (the Tokyo metropolitan, Tokai, and Kansai areas).
2. Figures for 2022/Q4 are October-November averages.

This difference in wage developments between regular and non-regular employees is mainly attributable to (1) variance between the two in terms of job mobility and the degree to which a tightening of labor market conditions affects wages, and (2) the fact that for regular employees, both labor and management have tended to prioritize employment stability over wage increases, partly because of the experience of severe employment adjustments in the past.[20] Taking this dual structure of the labor market into account, it is projected in this Outlook Report that wage growth will accelerate gradually, albeit at a moderate pace.[21]

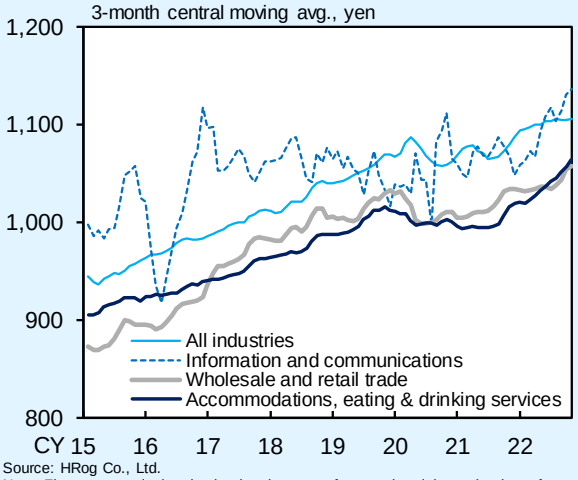
[20] For the dual structure of Japan's labor market and its impact on wages, see also Box 1 in the July 2018 Outlook Report.

[21] At the Bank of Japan's workshop on "Issues Surrounding Price Developments during the COVID-19 Pandemic" held in November 2022, wage developments and the link between wages and prices in Japan were discussed, taking account of the characteristics of Japan's labor market, such as its dual structure. For a summary of the workshop, see the Bank's research paper "The Wage Formation Mechanism in Japan: Summary of the Third Workshop on 'Issues Surrounding Price Developments during the COVID-19 Pandemic,'" forthcoming in English.

Starting with wages of part-time employees, the growth rate is expected to accelerate clearly, reflecting a tightening of labor market conditions. In the face-to-face services industry -- such as accommodations as well as eating and drinking services -- where the resumption of economic activity has started to become full-fledged, hourly wages have seen a clear rise recently in reflection of labor market conditions (Chart B3-2). Regarding the outlook, wages of part-time employees are likely to increase to a greater extent than before, since labor market conditions are expected to tighten from both the demand and supply sides and hence labor shortages are projected to intensify, as pointed out in Box 2. On this point, a survey suggests that the "reservation wage" of non-workers has risen recently, partly due to the effects of an increase in minimum wages (Chart B3-3).[22]

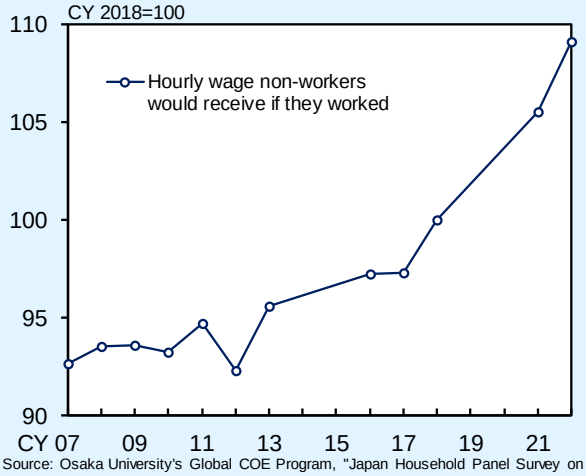
Such upward pressure on wages against the backdrop of the tightening of labor market conditions has spilled over to scheduled cash earnings of some full-time employees. Specifically, signs of change reflecting recent labor market conditions and other factors have been seen in wages in segments where the job mobility of full-time employees is considered to be relatively high, such as in certain industries including face-to-face services, at small and medium-sized firms, and among younger employees.

Chart B3-2: Hourly Wage for Part-Time Jobs at Time of Recruitment



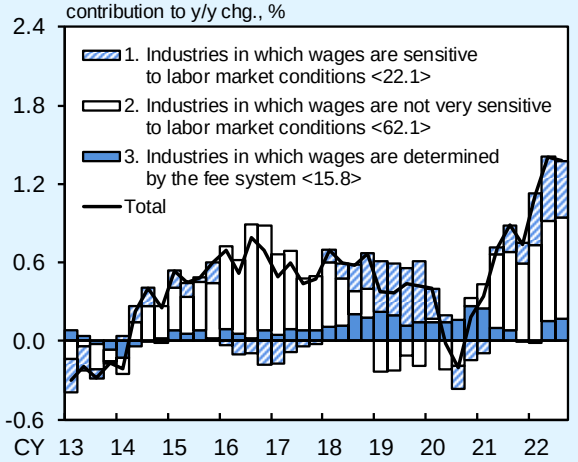
Source: HRog Co., Ltd.
Note: Figures are calculated using hourly wages for part-time jobs at the time of recruitment, posted on major private job-search services. Job offers paying 3,000 yen an hour or more are excluded.

Chart B3-3: "Reservation Wages"



Source: Osaka University's Global COE Program, "Japan Household Panel Survey on Consumer Preferences and Satisfaction."
Note: Figures are staff estimates using data from the survey by Osaka University and trimming the data at the 3rd and 97th percentiles.

Chart B3-4: Scheduled Cash Earnings of Full-Time Employees

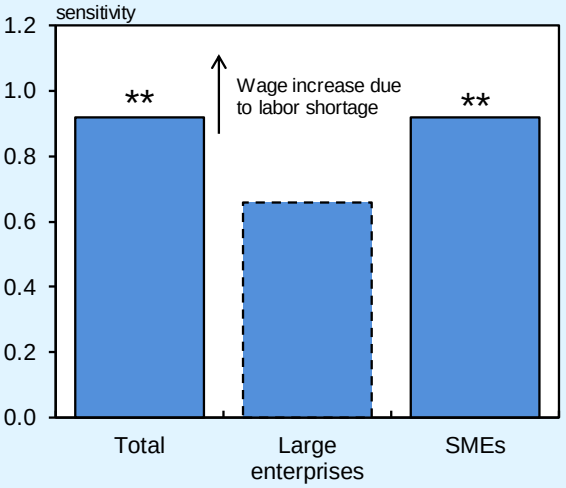


Sources: Ministry of Health, Labour and Welfare; Ministry of Internal Affairs and Communications.
Note: Group 3 comprises the medical, health care, and welfare services industries. Group 1 consists of industries in which wages are highly correlated with the unemployment rate (industries for which the correlation coefficient for the period from 2016 to 2019 is minus 0.25 or smaller). Group 2 comprises all other industries. Figures are estimated adjusting for the impact of sample replacement. The figures in angular brackets show the shares in the total number of full-time employees in 2021.

[22] The reservation wage is the wage level above which non-workers would accept a job and below which they would not. For Chart B3-3, non-workers' answers to the following question in Osaka University's *Japan Household Panel Survey on Consumer Preferences and Satisfaction* are used as a proxy variable for the reservation wage: "If you were working, what do you estimate you would be making per hour?"

First, developments by industry are examined. Year-on-year changes in scheduled cash earnings of full-time employees are divided into those in (1) industries in which wages are relatively sensitive to macro-level labor market conditions, (2) industries in which wages are not very sensitive to macro-level labor market conditions, and (3) industries in which wages tend to be determined by the fee system (medical, health care, and welfare services industries) (Chart B3-4).[23] The results show that wages in industries that are sensitive to labor market conditions, such as face-to-face services, have seen a relatively significant increase recently.

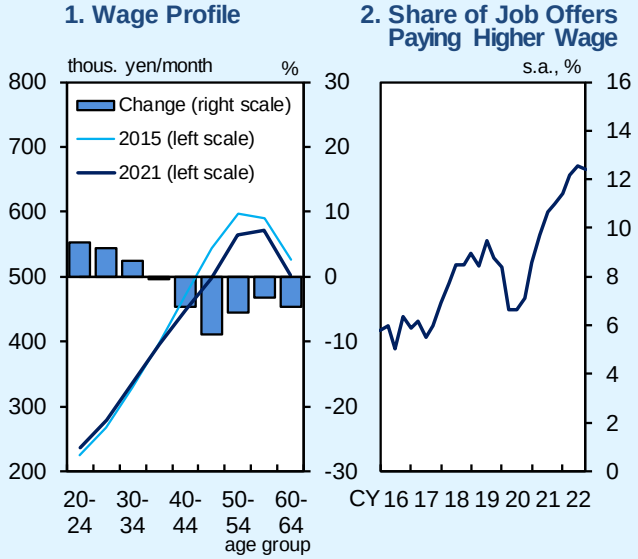
Chart B3-5: Sensitivity of Wages to Labor Shortages by Firm Size



Sources: Ministry of Health, Labour and Welfare; Bank of Japan; Ministry of Internal Affairs and Communications.
Note: The dependent variable is the year-on-year rate of change in scheduled cash earnings of full-time employees in the *Basic Survey on Wage Structure*. Explanatory variables include the following: a dummy for firms reporting "insufficient employment" in the *Tankan*; inflation expectations (five years ahead), also from the *Tankan*; the rate of change in the CPI (all items less fresh food, excluding the effects of the consumption tax hikes, etc.) in the previous year; and real labor productivity growth. The estimation period is from fiscal 2014 to 2021. The bars marked with ** show that the results are statistically significant at the 5 percent level, while the broken line means that the result is not statistically significant.

Next, the impact of labor market conditions on wages is examined by firm size. Matching microdata from the *Tankan* and the *Basic Survey on Wage Structure*, released by the Ministry of Health, Labour and Welfare, and looking at the relationship between each firm's assessment of employment conditions and its rate of change in wages shows that for large firms, labor market conditions have had no statistically significant impact on wages, while for small and medium-sized firms, a tightening of labor market

Chart B3-6: Wages at Large Enterprises



Sources: Ministry of Health, Labour and Welfare; HRog Co., Ltd.
Notes: 1. In the left-hand chart, figures are calculated using the scheduled cash earnings of regular employees with an undergraduate or graduate degree working for a private enterprise with 1,000 or more employees.
2. In the right-hand chart, figures are the share of job offers for regular employees posted on major private job-search services paying a higher wage than in the previous year. Job offers are examined by establishment, job type, etc.

[23] The analysis is conducted as follows. First, after adjusting for gaps resulting from sample revisions in the *Monthly Labour Survey*, industries in which wages are closely linked to medical and nursing care fees, such as hospitals and nursing care services, are selected. All other industries are then divided into two groups based on the degree of sensitivity to macro-level labor market conditions. Namely, industries in which the correlation coefficient between the unemployment rate and industry-level scheduled cash earnings is greater than minus 0.25 are regarded as "industries in which wages are not very sensitive to labor market conditions" (e.g., manufacturing), and industries in which the correlation coefficient is minus 0.25 or smaller are regarded as "industries in which wages are sensitive to labor market conditions" (e.g., face-to-face services).

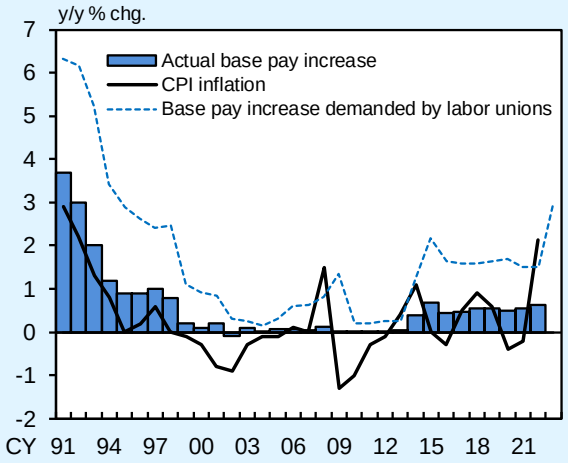
conditions has tended to push up wages (Chart B3-5).

Furthermore, the wage profile by age has flattened in recent years. Even at large firms, wages of younger employees, for which there is a large labor shortage and whose job mobility is considered to be relatively high, have risen, albeit slightly. In terms of offered wages in the market where regular employees search for a new job, more firms have raised their wage levels in response to the growing labor shortage (Chart B3-6).

Thus, moves toward raising wages have been observed recently, even for regular employees. Going forward, in order for wage increases to become full-fledged from a macroeconomic perspective, a broad-based rise in wages is needed, including for segments where job mobility is relatively low.

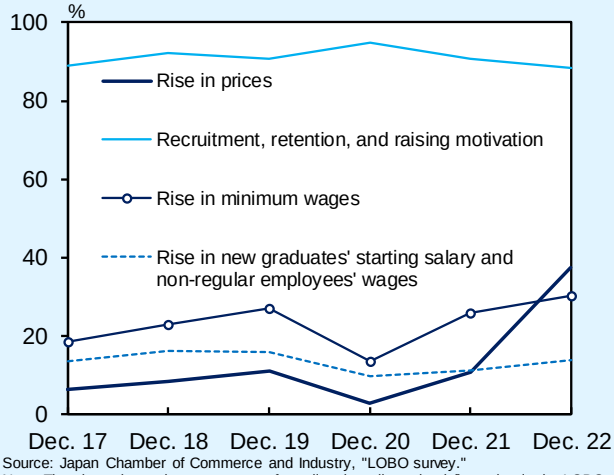
On this point, wage increases, including base pay increases, demanded by labor unions for the annual spring labor-management wage negotiations this year have become higher, and the outcome of these negotiations warrants close attention (Chart B3-7). A recent survey shows that the number of firms pointing to price rises as a reason for their wage increases has risen (Chart B3-8). With labor market conditions tightening, as examined in Box 2, it is necessary to pay close attention to the extent to which recent price rises will be reflected in wages through the labor-management wage negotiations.

Chart B3-7: Prices and Wage Negotiations



Sources: Japanese Trade Union Confederation (Rengo); Central Labour Relations Commission; Ministry of Internal Affairs and Communications.
Notes: 1. Figures for CPI inflation are for all items less fresh food, excluding the effects of the consumption tax hikes, etc. The figure for 2022 is the January-November average.
2. Figures for actual base pay increase from 1991 to 2013 are those published by the Central Labour Relations Commission, while those from 2014 to 2022 are figures released by Rengo. Figures for the base pay increase demanded by labor unions before 2023 are calculated by subtracting seniority-related wage increases from the total increase in wages demanded. The figure for 2023 is from Rengo's policy for the spring 2023 wage negotiations.

Chart B3-8: Reasons for Wage Increase



Source: Japan Chamber of Commerce and Industry, "LOBO survey."
Note: The chart shows the percentage of small and medium-sized firms that in the LOBO survey cited each reason as one for increasing the scheduled cash earnings of regular employees.