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日本銀行
BANK OF JAPAN

Outlook for Economic Activity and Prices

July 2023

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

Outlook for Economic Activity and Prices (July 2023)

The Bank's View[1]

Summary

- Japan's economy is likely to continue recovering moderately for the time being, supported by factors such as the materialization of pent-up demand, although it is expected to be under downward pressure stemming from a slowdown in the pace of recovery in overseas economies. Thereafter, as a virtuous cycle from income to spending gradually intensifies, 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 decelerate, with a waning of the effects of a pass-through to consumer prices of cost increases led by the past rise in import prices. Thereafter, the rate of increase is projected to accelerate again moderately as the output gap improves and as medium- to long-term inflation expectations and wage growth rise, accompanied by changes in factors such as firms' wage- and price-setting behavior.
- Comparing the projections with those presented in the previous *Outlook for Economic Activity and Prices* (Outlook Report), the projected real GDP growth rates are more or less unchanged. The projected year-on-year rate of increase in the CPI (all items less fresh food) for fiscal 2023 is significantly higher, mainly due to the fact that cost increases led by the past rise in import prices have been passed on to consumer prices to a greater extent than expected. The projected rates of increase in this CPI for fiscal 2024 and 2025 are more or less unchanged.
- Concerning risks to the outlook, there are extremely high uncertainties for Japan's economic activity and prices, including developments in overseas economic activity and prices, developments in commodity prices, and domestic firms' wage- and price-setting behavior. Under these circumstances, 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 2023 but are generally balanced thereafter. Risks to prices are skewed to the upside for fiscal 2023 and 2024.

[1] "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on July 27 and 28, 2023.

I. Current Situation of Economic Activity and Prices in Japan

Japan's economy has recovered moderately. The pace of recovery in overseas economies has slowed. Although exports and industrial production have been affected by the developments in overseas economies, they have been more or less flat, supported by a waning of the effects of supply-side constraints. Corporate profits have been at high levels on the whole, and business sentiment has improved moderately. In this situation, business fixed investment has increased moderately. The employment and income situation has improved moderately. Private consumption has increased steadily at a moderate pace, despite being affected by price rises. Housing investment has been relatively weak. Public investment has increased moderately. Financial conditions have been accommodative. On the price front, the year-on-year rate of increase in the CPI (all items less fresh food) is slower than a while ago, mainly due to the effects of pushing down energy prices from the government's economic measures, but it has been in the range of 3.0-3.5 percent recently owing to the effects of a pass-through to consumer prices of cost increases led by the past rise in import prices. Inflation expectations have shown some upward movements again.

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

A. Baseline Scenario of the Outlook for Economic Activity

For the time being, Japan's economy is likely to continue recovering moderately, supported by the materialization of pent-up demand, as well as by factors such as accommodative financial conditions and the government's economic measures, although it is expected to be under downward pressure stemming from a slowdown in the pace of recovery in overseas economies.

In the household sector, employment is likely to rise on the back of a recovery in economic activity. In addition, the rate of increase in nominal wages per employee is expected to accelerate as it gradually reflects the results of this year's annual spring labor-management wage negotiations, which show that the wage growth rate agreed in the negotiations was significantly higher than in the previous year, reflecting tightening labor market conditions and price rises. Due to these factors, employee income is projected to continue increasing. In this situation, although private consumption is expected to be affected by price rises, it is projected to continue increasing moderately. This is because pent-up demand is likely to materialize, partly supported by household savings that had accumulated as a result of pandemic-related restrictions, and because factors such as improvement in consumer sentiment, which mainly reflects a rise in wage growth, are expected to provide support. Private consumption is also likely to be underpinned by the government's measures, such as those to reduce the household burden of higher gasoline prices, electricity charges, and gas charges.

In the corporate sector, exports and production are projected to be affected by the slowdown in the pace of recovery in overseas economies resulting mainly from the impact of global inflationary pressure and policy interest rate hikes by central banks. However, they are likely to be more or less flat due to factors such as a waning of the effects of supply-side constraints. Meanwhile, inbound tourism demand, which is categorized under services exports, is expected to continue increasing. With economic activity continuing to recover, corporate profits are likely to remain at high levels on the whole, partly due to a waning of the impact of past high raw material costs and to progress in the pass-through of cost increases to selling prices. In this situation, as accommodative financial conditions provide support and the effects of supply-side constraints wane, business fixed investment is expected to continue increasing, including investment to address labor shortages, digital-related investment, research and development (R&D) investment related to growth areas and decarbonization, and investment associated with strengthening supply chains.

Regarding the outlook for Japan's economy after these developments, it is projected to continue growing at a pace above its potential growth rate as a virtuous cycle from income to spending gradually intensifies in the overall economy. That said, the pace of growth is highly likely to decelerate gradually toward the end of the projection period 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.

In the household sector, employment is projected to continue rising, but the pace of increase is likely to moderate gradually. This is because it will become more difficult for labor supply to increase, with labor force participation of women and seniors having advanced to a high degree thus far. That said, these developments will lead to an increased tightening of labor market conditions during the course of the economic recovery. In this situation, wage growth is expected to increase as a trend, partly reflecting price rises, and employee income is projected to continue increasing. Supported by the rise in employee income, private consumption is expected to keep increasing, although the pace of increase is likely to decelerate as the materialization of pent-up demand slows and the positive contribution of the government's various measures wanes.

In the corporate sector, exports and production are likely to return to an uptrend 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 keep waning. In this situation, with support from accommodative financial conditions, business fixed investment is projected to continue increasing. Toward the end of the projection period, it is expected to be under cyclical adjustment pressure stemming from the accumulation of capital stock, but investment to address labor shortages and investment that is not necessarily responsive to the business cycle, such as that related to decarbonization, are likely to increase steadily.

Meanwhile, public investment is likely to keep increasing moderately for the time being, partly due to the effects of large-scale projects. Thereafter, although these effects are projected to gradually dissipate, public investment is expected to be more or less flat, with expenditure related to building national resilience continuing. Government consumption is expected to decline temporarily in reflection of developments in expenditure related to COVID-19 and then gradually increase in reflection of an uptrend in healthcare and nursing care expenditures.

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 follow an improving trend along with the economic recovery.

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 decelerate, with a waning of the effects of the pass-through to consumer prices of cost increases led by the past rise in import prices. Thereafter, the rate of increase is projected to accelerate again moderately as the output gap improves and as medium- to long-term inflation expectations and wage growth rise, accompanied by changes in factors such as firms' wage- and price-setting behavior.

Comparing the projections with those presented in the previous Outlook Report, the projected year-on-year rate of increase in the CPI (all items less fresh food) for fiscal 2023

[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 significantly higher, mainly due to the fact that cost increases led by the past rise in import prices have been passed on to consumer prices to a greater extent than expected.

The outlook for the CPI (all items less fresh food) depends on the assumptions regarding crude oil prices and the government's economic measures. Crude oil prices are assumed to decline moderately toward the end of the projection period with reference, for example, to developments in futures markets. The government's measures to reduce the household burden of higher electricity and 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 -- the year-on-year rate of change is projected to be at around 3 percent for fiscal 2023 and then be in the range of 1.5-2.0 percent for fiscal 2024 and 2025.

The main factors that determine inflation rates are assessed as follows. The output gap, which captures the utilization of labor and capital, has been slightly negative. Based on the aforementioned outlook for economic activity, the gap is likely to turn positive around the middle of fiscal 2023 and expand moderately toward the end of the projection period, albeit at a gradually slowing pace. 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. 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 shown some upward movements again. The June 2023 *Tankan* (Short-Term Economic Survey of Enterprises in Japan) shows that the diffusion index (DI) for output prices has been at a high level, and firms' inflation outlook for general prices has also been at a high level, not only for the short term but also for the medium to long term. In addition, the wage growth rate agreed in the annual spring labor-management wage negotiations this year was significantly higher than in the previous year, including base pay. Given that the formation of inflation expectations in Japan is largely adaptive, the increase in inflation seen thus far has brought about a rise in households' and firms' medium- to long-term inflation expectations. In this situation, signs of change have been seen in firms' wage- and price-setting behavior. Regarding the outlook, even as actual inflation decelerates, inflation expectations are likely to rise moderately toward the end of the projection period, with improvement in the output gap and changes in firms' wage- and price-setting behavior and in labor-management wage negotiations. This will likely 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, the main upside and downside risks that require attention are as follows.

The first is developments in overseas economic activity and prices and in global financial and capital markets. Although inflation rates in the United States and Europe 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. 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, albeit at a moderate pace. That said, vigilance against the risk of inflation rates staying elevated through wage increases 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 the continuing impact of policy interest rate hikes, there is also a risk that global financial conditions will tighten further, mainly through adjustments in asset prices, fluctuations in foreign exchange markets, changes in financial institutions' lending positions, and capital outflows from emerging economies, and that this will eventually lead to overseas economies deviating downward from the baseline scenario. Taking these risks 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. Meanwhile, regarding the Chinese economy, there are high uncertainties surrounding the future pace of pick-up, as adjustment pressure has remained in the labor and real estate markets.

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, downward pressure on overseas economies, particularly the euro area, could heighten. In addition, although prices of commodities, including grains, have declined on the whole after reaching their peak around the middle of last year, there are extremely high uncertainties regarding the outlook, such as over geopolitical factors -- particularly the situation surrounding Ukraine -- and the effects of efforts by countries around the world toward addressing climate change. 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. It is expected in the baseline scenario that the terms of trade will improve, but if they were to deteriorate again, this could squeeze corporate profits and households' real income and 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.

The third factor considered from a somewhat long-term perspective is firms' and households' medium- to long-term growth expectations. It is expected that factors such as moves toward digitalization, which reflect the experience of COVID-19 and intensifying labor shortages, and progress on efforts with a view to decarbonization and on labor market reform will change Japan's economic structure and people's working styles. Furthermore, 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 up or down.

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' wage- and price-setting behavior, which could exert either upward or downward pressure on prices. In the current inflationary phase, with Japan's economy following a recovery trend and against the backdrop of high raw material costs, many firms have raised prices while giving consideration to price setting by competitors, and these moves have continued to spread. Depending on how much upward pressure will be exerted by raw material costs and on how firms' inflation expectations will develop, the pass-through to consumer prices could continue for longer than expected and lead prices to deviate upward from the baseline scenario. In addition, with labor market conditions tightening, it is possible that firms will further shift their wage-setting behavior toward raising wages, in view of factors such as recruitment and retention. Under these circumstances, there is a possibility that both wages and prices will deviate upward from the baseline scenario to a greater extent than can be explained by changes in the output gap, as moves to reflect not only price developments in wage setting but also wage developments in price setting become more widespread than expected. On the other hand, with prices of commodities, including grains, declining on the whole, medium- to long-term inflation expectations could decline through the mechanism of adaptive inflation expectations formation, and this could affect firms' price-setting behavior. In addition, although the wage growth rate agreed in the annual spring labor-management wage negotiations this year was significantly higher than in the previous year, if the behavior and mindset based on the assumption that prices and wages will not increase easily remain deeply entrenched, there is a risk that moves to increase wages will not strengthen as much as expected from next year and prices will deviate downward from the baseline scenario.

The second risk is future developments in foreign exchange rates and international commodity prices, as well as the extent to which such developments will spread to import prices and domestic prices. This risk may lead prices to deviate either upward or downward from the baseline scenario. There are high uncertainties over, for example, the outlook for the global economy, and this could lead to significant fluctuations in international commodity prices. Including the possibility of inflation rates staying elevated on a global basis and of fluctuations in foreign exchange markets, 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 increase in the CPI is likely to decelerate, with a waning of the effects of a pass-through to consumer prices of cost increases led by the past rise in import prices. Thereafter, the rate of increase is projected to accelerate again moderately. Although it will take time, toward the end of the projection period, 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 are extremely high uncertainties for Japan's economic activity and prices, including developments in overseas economic activity and prices, developments in commodity prices, and domestic firms' wage- and price-setting behavior. Under these circumstances, 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 2023 but are generally balanced thereafter. Risks to prices are skewed to the upside for fiscal 2023 and 2024. 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 Japanese financial institutions have sufficient capital bases.

[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."

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, with extremely high uncertainties surrounding economies and financial markets at home and abroad, the Bank will patiently continue with monetary easing while nimbly responding to developments in economic activity and prices as well as financial conditions. By doing so, it will aim to achieve the price stability target of 2 percent in a sustainable and stable manner, accompanied by wage increases.

The Bank will continue with QQE with Yield Curve Control, aiming to achieve the price stability target, as long as it is necessary for maintaining that target in a stable manner. It will continue expanding the monetary base until the year-on-year rate of increase in the observed CPI (all items less fresh food) exceeds 2 percent and stays above the target in a stable manner. The Bank will continue to maintain the stability of financing, mainly of firms, and financial markets, and will not hesitate to take additional easing measures if necessary.

(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 2023	+1.2 to +1.5 [+1.3]	+2.4 to +2.7 [+2.5]	+3.1 to +3.3 [+3.2]
Forecasts made in April 2023	+1.1 to +1.5 [+1.4]	+1.7 to +2.0 [+1.8]	+2.5 to +2.7 [+2.5]
Fiscal 2024	+1.0 to +1.3 [+1.2]	+1.8 to +2.2 [+1.9]	+1.5 to +2.0 [+1.7]
Forecasts made in April 2023	+1.0 to +1.3 [+1.2]	+1.8 to +2.1 [+2.0]	+1.5 to +1.8 [+1.7]
Fiscal 2025	+1.0 to +1.2 [+1.0]	+1.6 to +2.0 [+1.6]	+1.8 to +2.2 [+1.8]
Forecasts made in April 2023	+1.0 to +1.1 [+1.0]	+1.6 to +1.9 [+1.6]	+1.8 to +2.0 [+1.8]

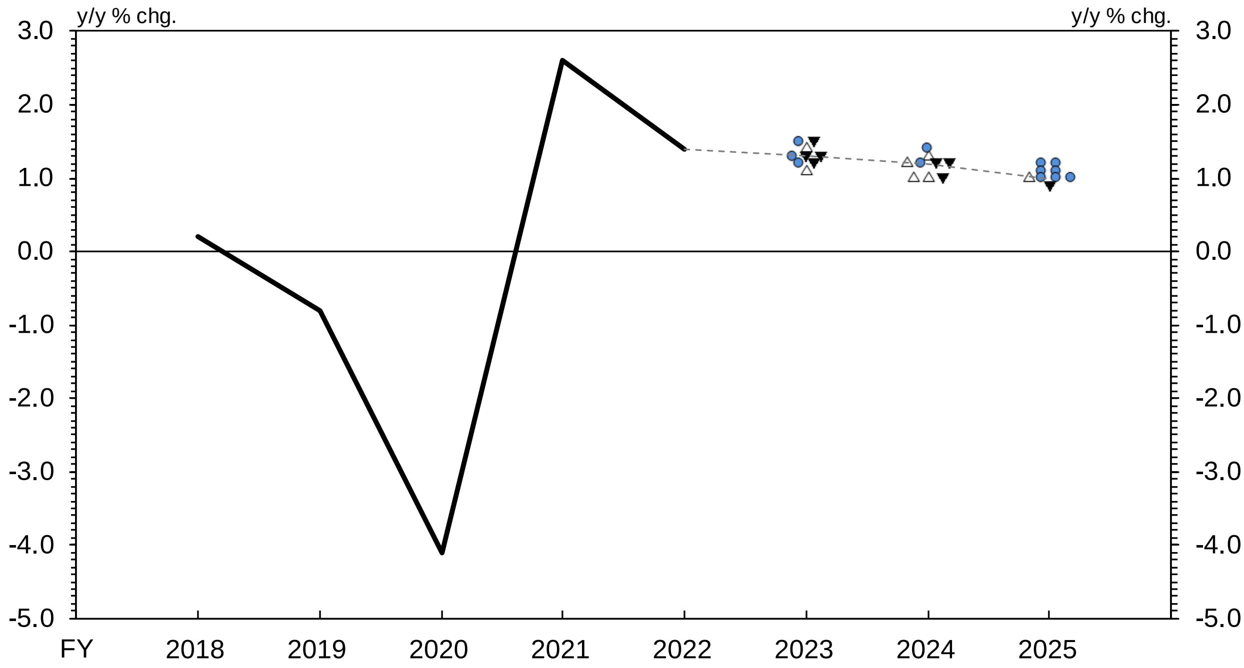
Notes: 1. Figures in brackets indicate the medians of the Policy Board members' forecasts (point estimates).

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.

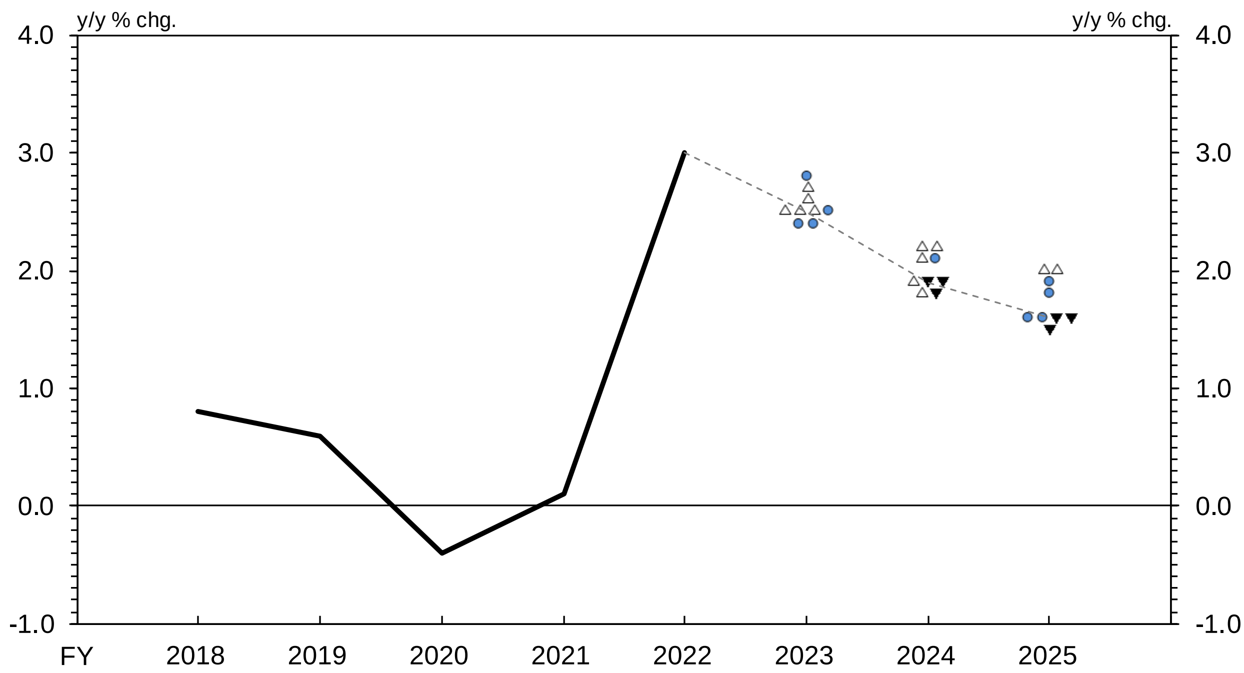
3. Each Policy Board member makes their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding the future conduct of policy.

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

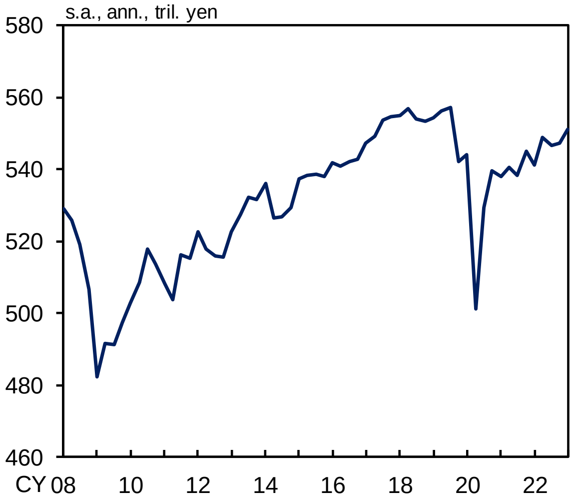
A. Economic Developments

Japan's economy has recovered moderately.

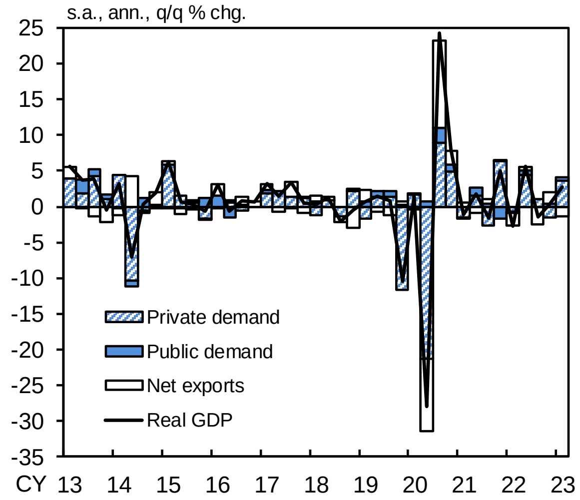
Real GDP was flat for the October-December quarter of 2022, registering 0.1 percent on a quarter-on-quarter basis and 0.4 percent on an annualized basis (Chart 1). It then rose for the January-March quarter of 2023, registering 0.7 percent on a quarter-on-quarter basis and 2.7 percent on an annualized basis. Although exports declined, mainly due to the effects of issues at some production sites for automobiles, private consumption increased with the impact of COVID-19 waning, and business fixed investment also rose. In addition, the positive contribution of public investment to GDP growth increased. Meanwhile, inventory investment, particularly for work-in-progress inventories, made a relatively large positive contribution and pushed up GDP growth temporarily. The output gap -- which captures the utilization of labor and capital -- for the January-March quarter was more or less unchanged from the previous quarter (Chart 2). This is mainly because the capacity utilization rate for the manufacturing industry declined in reflection of the decrease in exports, while labor market conditions continued on an improving trend.

Chart 1: Real GDP

1. Level



2. Annualized Quarterly Growth Rate

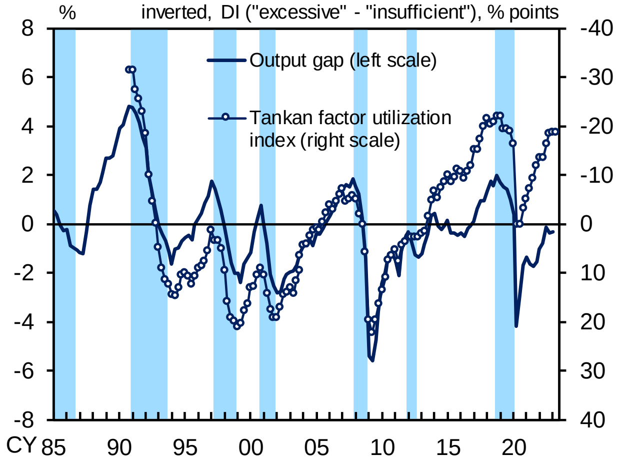


Source: Cabinet Office.

[5] "The Background" provides explanations of "The Bank's View" decided by the Policy Board at the Monetary Policy Meeting held on July 27 and 28, 2023.

Monthly indicators and high-frequency data since then suggest that Japan's economy has continued on a recovery trend. In the corporate sector, although exports and production have been affected by a slowdown in the pace of recovery in overseas economies, they have been more or less flat, supported by a waning of the effects of supply-side constraints. Corporate profits have remained at high levels on the whole, and business sentiment has improved moderately. In this situation, business fixed investment has increased moderately. The business fixed investment plans in the June 2023 *Tankan* indicate that the year-on-year rate of change in investment for fiscal 2022 was significantly positive and that the rate of change in planned investment for fiscal 2023 is clearly positive. In the household sector, the employment and income situation has improved moderately, and an uptrend in nominal employee income has gradually become clear. In this situation, private consumption has increased steadily at a moderate pace, despite being affected by price rises. In sum, although Japan's economy has been affected by the slowdown in the pace of recovery in overseas economies, a virtuous cycle from income to spending has been operating in both the corporate and household sectors.

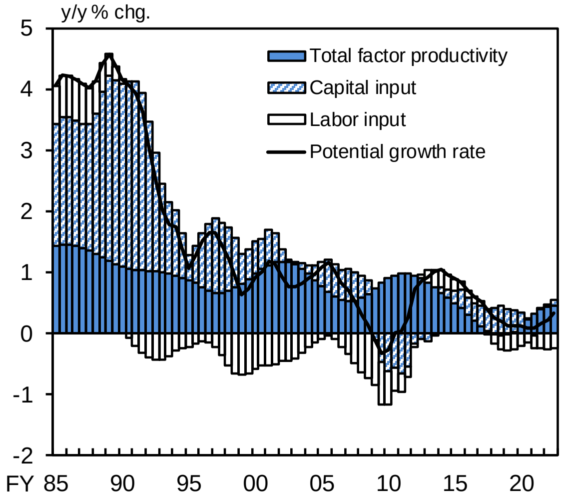
Chart 2: Output Gap



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 continue recovering moderately for the time being, supported by the materialization of pent-up demand, as well as by factors such as accommodative financial conditions and the government's economic measures, although it is expected to be under downward pressure stemming from the slowdown in the pace of recovery in overseas economies.[6] Thereafter, with overseas economies gradually picking up, Japan's economy is projected to continue growing at a pace above its potential growth rate as the virtuous cycle from income to spending gradually intensifies in the overall economy. That said, the pace of growth is highly likely to decelerate gradually toward the end of the projection period 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. Comparing the projections through fiscal 2025 with those presented in the previous Outlook Report, all projected growth rates are more or less unchanged.

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, although there will be less room for the number of employed persons to increase, (1) the TFP growth rate will increase moderately, mainly on the back of advances in digitalization and a

[6] The government formulated the Comprehensive Emergency Measures to Counter Soaring Crude Oil and Other Prices under the COVID-19 Pandemic in April 2022, the Comprehensive Economic Measures for Overcoming Price Increases and Revitalizing the Economy in October 2022, and additional measures toward overcoming price increases in March 2023. 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.

resulting improvement in efficiency of resource allocation, as well as an expansion in investment in human capital, (2) the decline in working hours will come to a halt in reflection of the diminishing effects of working-style reforms, and (3) growth in capital stock will accelerate. 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 COVID-19 and with demographic changes. In addition, in the corporate sector, it is expected that factors such as moves toward digitalization, which reflect the experience of COVID-19 and labor shortages, and progress on efforts with a view to decarbonization will change Japan's economic and industrial structures; however, 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 changes in the economic and industrial structures. 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 fiscal 2023, Japan's economy is likely to continue recovering moderately for the time being, supported by the materialization of pent-up demand, as well as by factors such as accommodative financial conditions and the government's economic measures, although the impact of the slowdown in the pace of recovery in overseas economies is expected to exert downward pressure on Japan's economy. Although goods exports are projected to be affected by the slowdown in the pace of recovery in overseas economies, they are likely to be more or less flat for the time being, due to factors such as the waning of the effects of supply-side constraints. Thereafter, goods exports are likely to return to an uptrend in steps with overseas economies gradually picking up. Inbound tourism demand, which is categorized under services exports, is projected to keep increasing as travel demand recovers globally. Business fixed investment is also expected to continue increasing, with corporate profits improving on the whole and with the materialization of demand for investment that had been postponed during the pandemic. In the household sector, employment is likely to rise on the back of a recovery in economic activity. In addition, nominal wage growth is expected to accelerate as it gradually reflects the results of this year's annual spring labor-management wage negotiations, which show that the wage growth rate agreed in the negotiations was significantly higher than in the previous year, reflecting tightening labor market conditions and price rises. Due to these factors, nominal employee income is likely to continue rising. Moreover, downward pressure on households' real income stemming from high prices is projected to ease gradually, since it is expected that the effects of pushing down energy prices from the government's economic measures will continue for the time being, and that there will be a waning of the effects of a pass-through to consumer prices of cost increases led by the past rise in import prices. In this situation, private consumption is projected to continue increasing moderately. This is because pent-up demand is likely to materialize, partly supported by household savings that had accumulated as a result of pandemic-related restrictions, and because factors such as improvement in consumer sentiment, which mainly reflects a rise in wage growth, are expected to provide support. Government spending is expected to decline, reflecting a reduction in expenditure related to COVID-19, although it is likely to be supported by progress in construction related to building national resilience and by an uptrend in healthcare and nursing care expenditures.

In fiscal 2024, although the effects of the government's economic measures are likely to wane, Japan's economy is expected to continue growing at a pace above its potential growth rate, with overseas economies picking up and accommodative financial conditions being maintained. Goods exports are likely to increase moderately on the back of the pick-up in overseas economies. Inbound tourism demand is projected to keep increasing. Business fixed investment is also expected to continue increasing, including investment to address labor shortages, digital-related investment, investment related to growth areas and decarbonization, and investment associated with strengthening supply chains. In the household sector, nominal employee income is likely to continue increasing steadily. This is because wage growth is expected to remain relatively high, although it will gradually become more difficult for labor supply to increase, with labor force participation of women and seniors having advanced to a high degree thus far. In this situation, private consumption is likely to continue increasing moderately, although it is projected that a waning of the effects of the government's economic measures pushing down prices of the previous year will push down real income through price rises, and that pent-up demand will gradually wane. Government spending is expected to turn to a moderate increase on the back of progress in construction related to building national resilience and an uptrend in healthcare and nursing care expenditures.

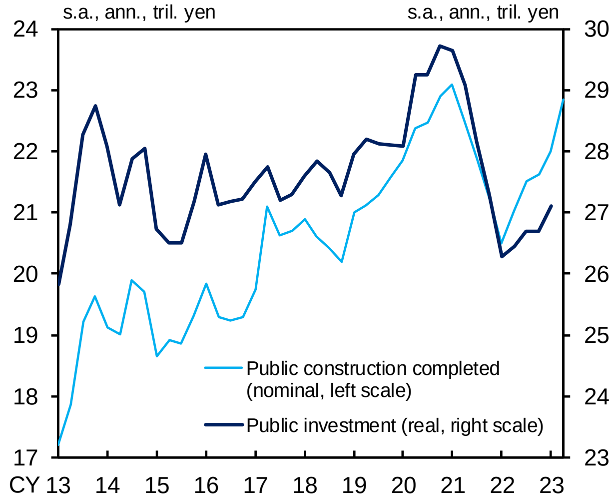
In fiscal 2025, although domestic and external demand is expected to continue increasing, the growth pace of Japan's economy is likely to slow somewhat, mainly because pent-up demand is expected to diminish. Goods exports are likely to increase moderately, with overseas economies continuing to grow. Inbound tourism demand is projected to keep increasing. Business fixed investment is also expected to continue increasing, mainly for investment to address labor shortages and investment related to growth areas and decarbonization; however, the pace of increase is projected to slow somewhat, partly because it is likely to be pushed down by adjustment pressure on capital stock. Although pent-up demand is likely to diminish, private consumption is projected to continue increasing moderately, with the income situation continuing to improve, supported by wage increases. Government spending is expected to keep increasing moderately on the back of an uptrend in healthcare and nursing care expenditures.

B. Developments in Major Expenditure Items and Their Background

Government Spending

Public investment has increased moderately (Chart 4). With progress in construction based on the government's economic measures, including construction related to building national resilience, the amount of public construction completed -- a coincident indicator of public investment -- has increased. Recently, the effects of large-scale projects have also made a positive contribution. The value of public works contracted and orders received for public construction -- both of which are leading indicators of public investment -- saw relatively significant increases, mainly due to a concentration of large-scale projects, and then have decreased somewhat.

Chart 4: Public Investment



Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Note: The figure for 2023/Q2 is the April-May average.

As for the outlook, public investment is likely to keep increasing moderately for the time being, partly due to the effects of large-scale projects.[7] Thereafter, although these effects are projected to gradually dissipate, public investment is expected to be more or less flat, with expenditure related to building national resilience continuing. Government consumption is projected to see a temporary lowering in its level due to a reduction in expenditure related to COVID-19, such as regarding vaccination. Thereafter, however, government consumption is likely to return to an

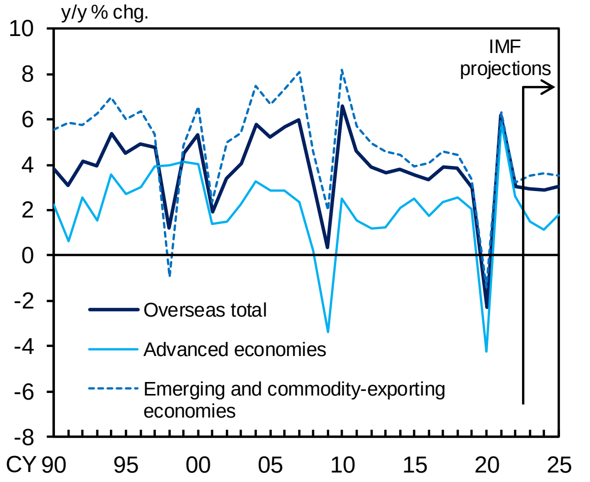
[7] The five-year acceleration measures for building national resilience with a project size of about 15 trillion yen were decided by the Cabinet in December 2020. In these measures, public investment projects for disaster prevention, disaster mitigation, and building national resilience are to be implemented 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 continued policy interest rate hikes, but firmness has continued to be seen in private consumption, particularly for services. European economies have kept slowing moderately, despite concern over energy supply easing compared to a while ago, as they have continued to be affected by the situation surrounding Ukraine. The pace of pick-up in the Chinese economy has slowed, mainly owing to the effects of a slowdown in external demand and adjustments in the real estate market, although services consumption has been firm as the normalization of economic activity has progressed. The pace of improvement in emerging and commodity-exporting economies other than China has slowed on the whole; although domestic demand has continued to improve moderately in these economies, exports have slowed, particularly of IT-related goods. Among those in Asia, which are closely related to Japan's economy, the ASEAN economies have continued to improve, particularly in domestic demand, whereas in the NIEs economies, the pace of improvement in domestic demand has decelerated, while there has been a slowdown in exports, particularly of IT-related goods. Looking at the Global PMI to see the current situation for the global economy, figures for the services industry have been above 50 -- the break-even point between improvement and deterioration in business conditions -- as pent-up demand has remained since the resumption of economic

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 2023 onward are its projections in the April 2023 *World Economic Outlook* (WEO) and the July 2023 WEO *Update*. 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.

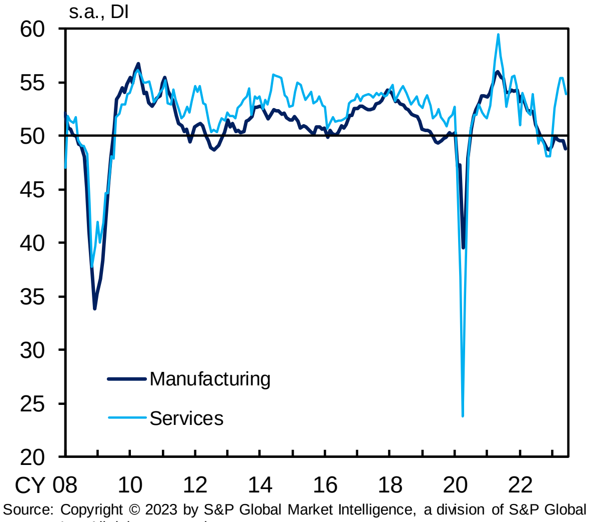
activity, while figures for the manufacturing industry have been around 50 (Chart 6). The world trade volume has decreased, reflecting a decline in energy imports in Europe, where inventories of natural gas have been at high levels due to mild winter weather, in addition to the effects of the slowdown in the pace of recovery in overseas economies and inventory adjustments in IT-related goods (Chart 7).

As for the outlook, the pace of recovery in overseas economies is projected to remain slow for the time being, with inflationary pressure remaining on a global basis and the continuing impact of policy interest rate hikes by central banks. By region, the U.S. and European economies are expected to remain on a slowing trend. On the other hand, the Chinese economy is projected to continue picking up, partly with policy support, although adjustment pressure is expected to remain on the employment and income side and in the real estate market. The pace of improvement in emerging and commodity-exporting economies other than China is likely to continue slowing, partly in reflection of external demand slowing, although the resumption of economic activity is expected to underpin domestic demand.

Thereafter, overseas economies are projected to pick up gradually.[8] This will likely occur as inflation rates decline, due primarily to dissipation of the impact of past high commodity prices and to the effects of policy interest rate hikes by central banks.

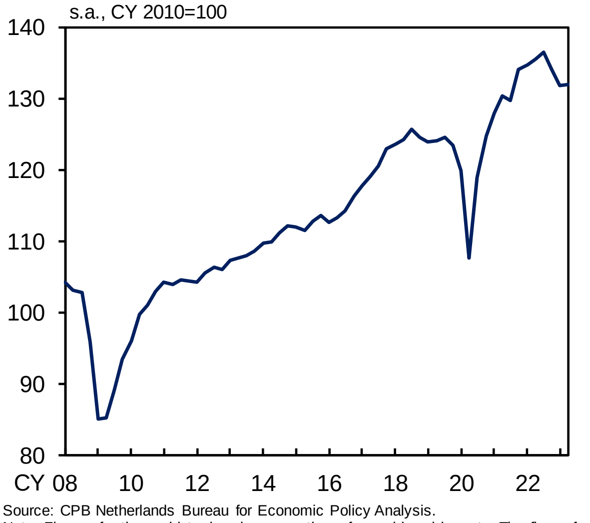
[8] Box 1 outlines uncertainties regarding the pace of recovery in overseas economies.

Chart 6: Global PMI



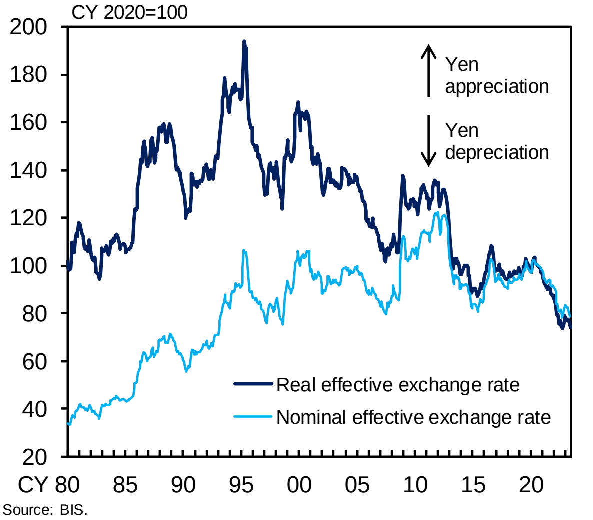
Source: Copyright © 2023 by S&P Global Market Intelligence, a division of S&P Global Inc. All rights reserved.
Note: Figures for manufacturing are the J.P.Morgan Global Manufacturing PMI. Figures for services are the J.P.Morgan Global Services Business Activity Index.

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 2023/Q2 is the April-May average.

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.

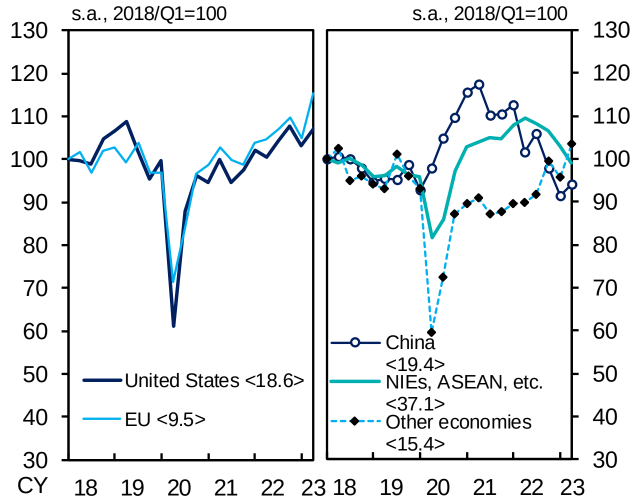
Exports and Imports

Although exports have been affected by the slowdown in the pace of recovery in overseas economies, they have been more or less flat, supported by the waning of the effects of supply-side constraints (Chart 9). By region, exports to advanced economies have been on an uptrend, mainly led by automobile-related goods, on the back of the waning of the effects of supply-side constraints (Chart 10). As for exports to emerging economies, those to China have bottomed out as the normalization of the country's economic activity has progressed. Exports to the NIEs, the ASEAN economies, and some other Asian economies have been relatively weak, against the background of weakness in global demand for IT-related goods. By goods, exports of automobile-related goods have increased clearly, with the waning of supply-side constraints for semiconductors used in automobiles gradually becoming evident and the effects of issues at some production sites dissipating (Chart 11). Despite being supported by high levels of order backlogs, exports of capital goods are at relatively lower levels than a while ago. This mainly reflects the fact that exports of semiconductor production equipment have declined due to major semiconductor manufacturers postponing business fixed investment. Exports of IT-related goods have been relatively weak, with adjustment pressure remaining on electronic parts, such as semiconductors mainly for smartphones and personal computers, although those of on-board equipment for motor vehicles have been firm. Exports of intermediate goods also have continued to be relatively weak against the background of weakness in global demand for IT-related goods.

Chart 9: Real Exports and Imports

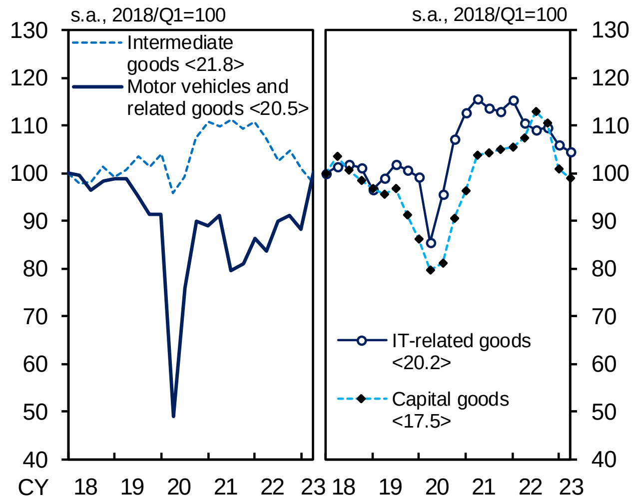
Sources: Bank of Japan; Ministry of Finance; Cabinet Office.
Note: Based on staff calculations.

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 2022.
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 2022.

Although exports are projected to be affected by the slowdown in the pace of recovery in overseas economies, they are expected to be more or less flat for the time being due to factors such as the waning of the effects of supply-side constraints. Thereafter, exports are likely to return to an uptrend with overseas economies gradually picking up.

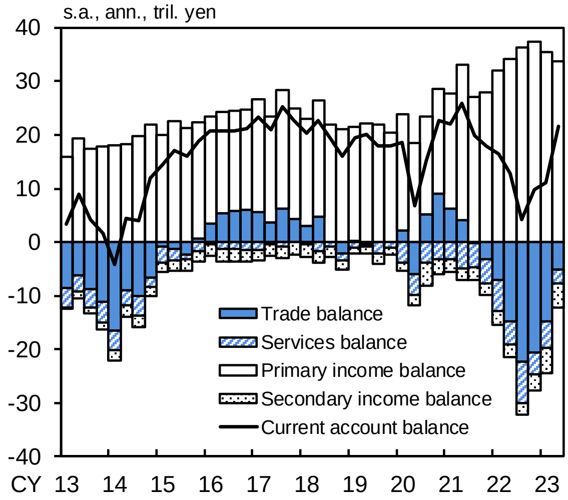
Imports have been more or less flat generally, albeit with fluctuations stemming from factors such as imports of vaccines (Chart 9). They are expected to follow a moderate uptrend on the back of developments in demand induced by increases in domestic demand and exports.

External Balance

The nominal current account balance has been on an improving trend (Chart 12). The trade balance deficit has decreased clearly, mainly on the back of a decline in import prices. The services balance deficit has decreased recently because the travel balance has been on an improving trend due to an increase in inbound tourism demand, and because payments for digital-related services have decreased somewhat, partly due to temporary factors (Chart 13). Meanwhile, the primary income balance surplus has remained at a high level.

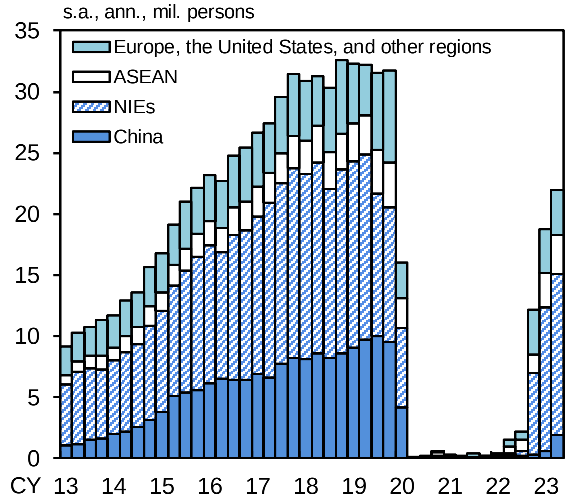
The nominal current account balance is likely to follow a moderate improving trend. This is based on the projection that (1) the primary income balance surplus will increase moderately, (2) the trade balance deficit will decline moderately due to factors such as an increase in goods exports,

Chart 12: Current Account



Source: Ministry of Finance and Bank of Japan.
Note: Figures for 2023/Q2 are April-May averages.

Chart 13: Number of Inbound Visitors



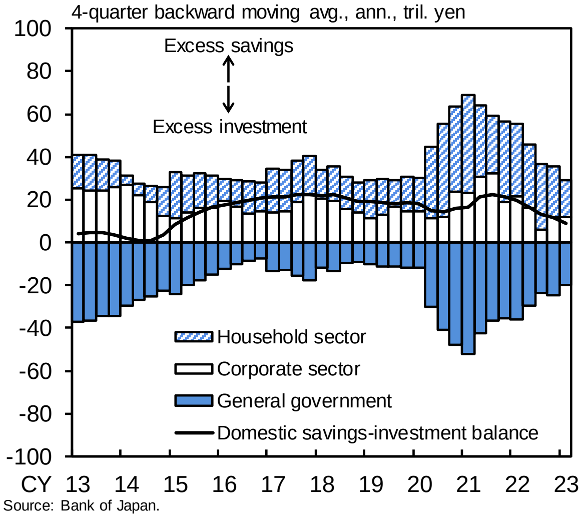
Source: Japan National Tourism Organization (JNTO).
Note: Figures for Europe, the United States, and other regions include seasonal adjustment errors.

and (3) the services balance will improve due to the increase in inbound tourism demand. In terms of the savings-investment balance, overall excess savings in Japan's economy are projected to 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 14).

Industrial Production

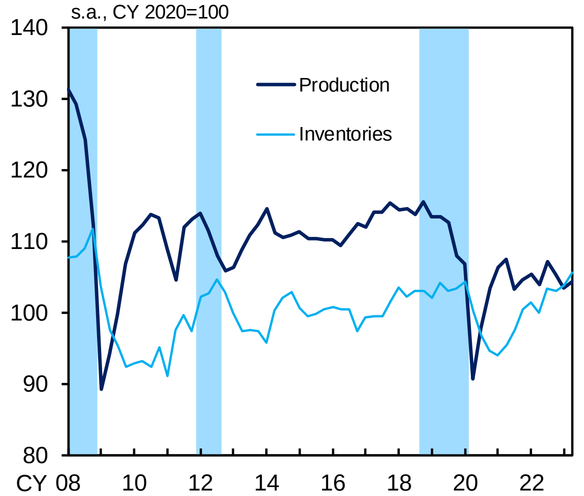
Although industrial production has been affected by the slowdown in the pace of recovery in overseas economies, it has been more or less flat, supported by the waning of the effects of supply-side constraints (Chart 15). By major industry, production of "transport equipment" has increased clearly, with the waning of supply-side constraints for semiconductors used in automobiles gradually becoming evident and the effects of issues at some production sites dissipating. Production of "electrical machinery, and information and communication electronics equipment" has been on an uptrend, mainly for on-board equipment for motor vehicles. On the other hand, despite being supported by high levels of order backlogs, production of "general-purpose, production, and business-oriented machinery" is at a relatively lower level than a while ago, mainly due to a decline in production of semiconductor production equipment. Production of "electronic parts and devices" has remained relatively weak when fluctuations are smoothed out. Production of "chemicals (excluding medicine)" also has been relatively weak, mainly reflecting weakness in global demand for IT-related goods.

Chart 14: Savings-Investment Balance



Source: Bank of Japan.

Chart 15: Industrial Production



Source: Ministry of Economy, Trade and Industry.
Notes: 1. Shaded areas denote recession periods.
2. The production figure for 2023/Q2 is the April-May average. The inventories figure for 2023/Q2 is that for May.

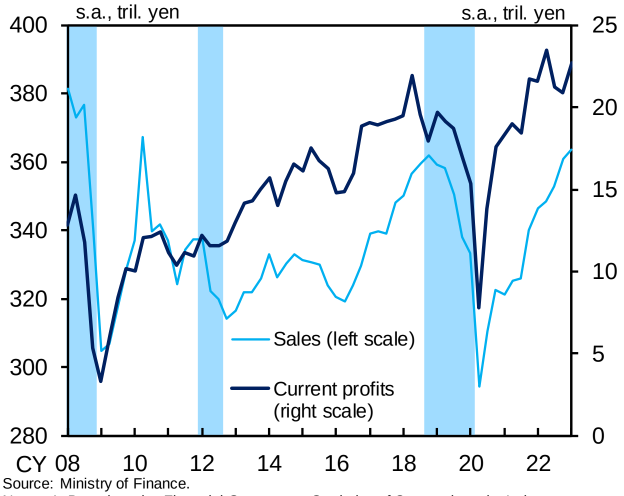
Although industrial production is projected to be affected by the slowdown in the pace of recovery in overseas economies, it is expected to be more or less flat for the time being due to factors such as the waning of the effects of supply-side constraints. Thereafter, production is likely to return to an uptrend with overseas economies gradually picking up.

Corporate Profits

Corporate profits have been at high levels on the whole. According to the *Financial Statements Statistics of Corporations by Industry, Quarterly*, current profits for all industries and enterprises for the January-March quarter of 2023 increased, particularly for nonmanufacturers, reflecting factors such as a recovery in economic activity and hikes in selling prices (Chart 16). By industry and firm size, although operating profits of large manufacturers have declined slightly, their current profits have seen a small increase, reflecting the fact that their non-operating profits improved from the previous quarter -- when they incurred, for example, foreign exchange losses. Current profits of small and medium-sized manufacturers have decreased, mainly because the weakness in global demand for IT-related goods has affected various industries. As for nonmanufacturers, current profits of large firms in the shipping industry have decreased, reflecting a decline in ocean freight rates, but those of large nonmanufacturers overall have risen. This is mainly because current profits of large firms in the electric and gas utilities industry have increased significantly in reflection of a decline in fuel prices. Current profits of small and medium-sized nonmanufacturers have continued to rise, mainly because those for the services industry (e.g.,

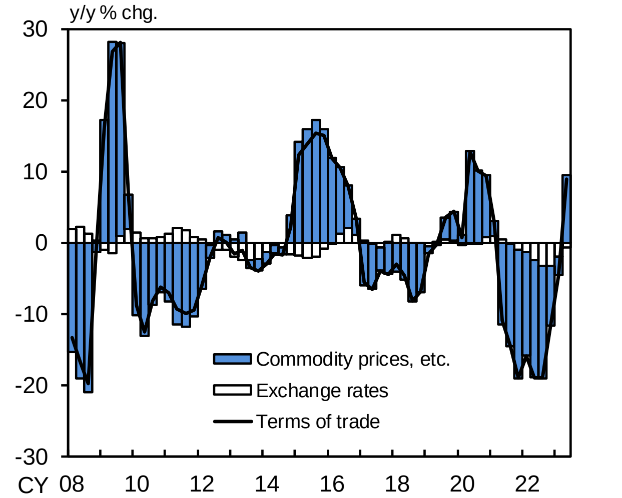
Chart 16: Indicators Related to Corporate Profits

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 Terms of Trade

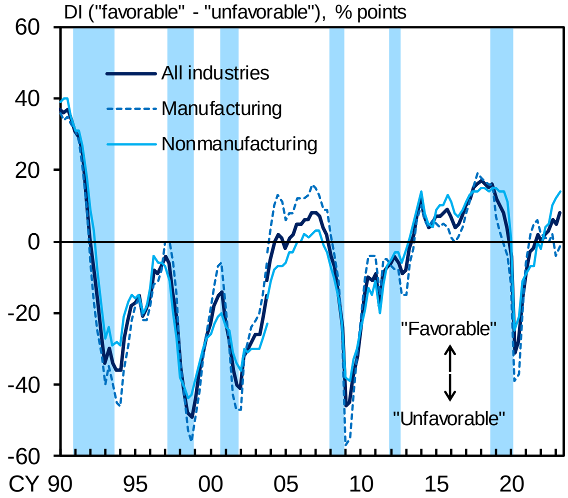


Source: Bank of Japan.
Notes: 1. The contribution of changes in commodity prices, etc. is calculated using changes in export/import price indexes on a contract currency basis. The contribution of changes in exchange rates is calculated using the difference between export/import price indexes on a yen basis and those on a contract currency basis.
2. Terms of trade = Export price index on a yen basis / Import price index on a yen basis

eating and drinking services) have increased, with economic activity continuing to recover and a pass-through of cost increases to selling prices progressing.

Business sentiment has improved moderately. According to the June *Tankan*, the DI for business conditions for all enterprises has continued to improve for nonmanufacturing and has turned toward improvement for manufacturing (Chart 17). Although the slowdown in the pace of recovery in overseas economies and adjustment pressure on IT-related goods have continued to draw attention in the manufacturing industry, the DI for manufacturing has improved for large firms in particular, owing to the waning of the effects of supply-side constraints, a pause in high raw material costs, and progress in the pass-through of cost increases to selling prices. Looking at industries where the DIs have improved, (1) that for transportation machinery has done so due to the waning of supply-side constraints for semiconductors used in automobiles, (2) the pause in high raw material costs has pushed up the DIs for basic materials industries, and (3) the progress in the pass-through of cost increases to selling prices has also pushed up the DIs for a wide range of industries, such as those for food and beverages and for pulp and paper. On the other hand, such DIs as those for large firms in the chemicals industry and for firms in the electrical machinery industry have deteriorated, mainly in reflection of the slowdown in the pace of recovery in overseas economies and continued adjustment pressure on IT-related goods. The DI for nonmanufacturing has continued to improve, particularly for private consumption-related industries. This is due to the recovery in economic

Chart 17: 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.

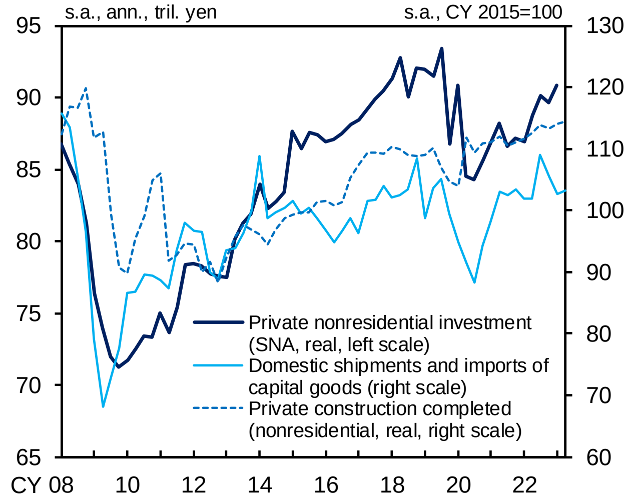
activity, which reflects a waning of the impact of COVID-19, and to the progress in the pass-through of cost increases to selling prices. In particular, the DI for the accommodations as well as eating and drinking services industry has improved significantly, due not only to these factors but also to a rise in inbound tourism demand.

Regarding the outlook for corporate profits, with economic activity continuing to recover, they are expected to remain at high levels on the whole for the time being, partly due to a waning of the impact of past high raw material costs and to the progress in the pass-through of cost increases to selling prices. Thereafter, corporate profits are projected 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 keep waning.

Business Fixed Investment

Business fixed investment has increased moderately (Chart 18). With the effects of supply-side constraints waning, the aggregate supply of capital goods -- a coincident indicator of machinery investment -- has been on an uptrend, mainly led by digital- and labor saving-related investments, although it has decreased from the level recorded in the middle of last year, when investment in semiconductor production equipment surged. Private construction completed (nonresidential) -- a coincident indicator of construction investment -- has been on a moderate uptrend, mainly due to a rise in construction of logistics facilities on the back of an

Chart 18: Coincident Indicators of Business Fixed Investment

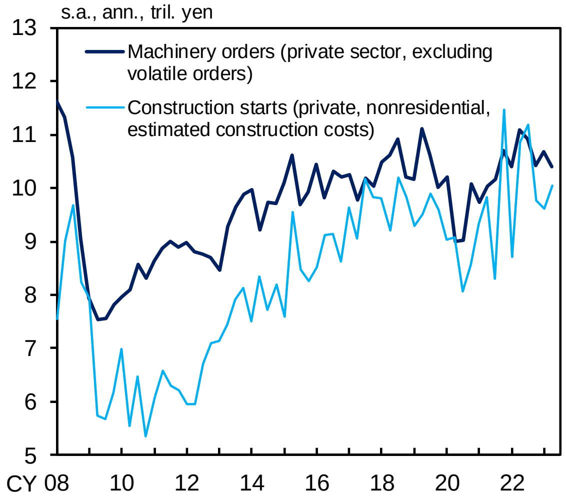


Sources: Cabinet Office; Ministry of Economy, Trade and Industry; Ministry of Land, Infrastructure, Transport and Tourism.
Notes: 1. Figures for 2023/Q2 are April-May averages.
2. Figures for real private construction completed are based on staff calculations using the construction cost deflators.

expansion in e-commerce and to progress in urban redevelopment projects.

Machinery orders -- a leading indicator of machinery investment -- have been more or less flat at high levels recently (Chart 19). By industry, orders by the automobile and "general-purpose, production, and business-oriented machinery" industries have been on an increasing trend, and those by the "electrical machinery" industry -- which had followed a decreasing trend, mainly reflecting production adjustments for semiconductor memory -- have started to bottom out. However, orders by the manufacturing industry overall have been pushed down as the effects of large-scale projects in some industries, which had continued since last year, have dissipated. With regard to orders by the nonmanufacturing industry, digital- and labor saving-related investments have followed an uptrend, albeit with fluctuations stemming from large-scale projects, and orders for projects that had been postponed due to COVID-19 have been seen in industries such as transportation. 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 plans in the June *Tankan*, business fixed investment (on the basis close to GDP definition; business fixed investment -- including software and R&D investments but excluding land purchasing expenses -- for all industries and enterprises including financial institutions) registered a significant year-on-year

Chart 19: Leading Indicators of Business Fixed Investment

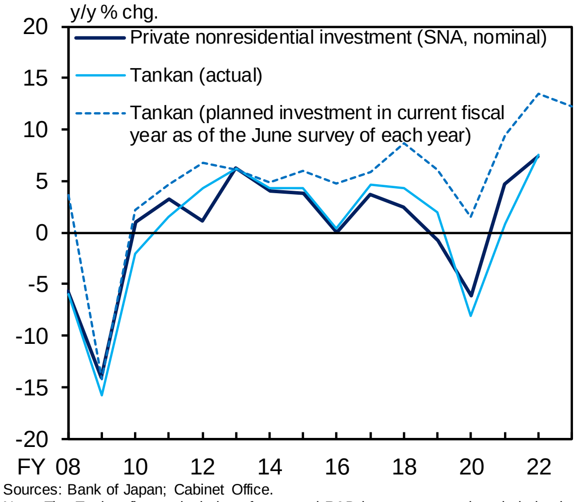


Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Notes: 1. Volatile orders are orders for ships and orders from electric power companies.
2. Figures for 2023/Q2 are April-May averages.

rate of increase of 7.6 percent for fiscal 2022 (Chart 20). The plan for fiscal 2023 shows that the year-on-year rate of increase in business fixed investment is expected to be at 12.3 percent and indicates that investment is likely to continue increasing clearly for both manufacturing and nonmanufacturing industries.

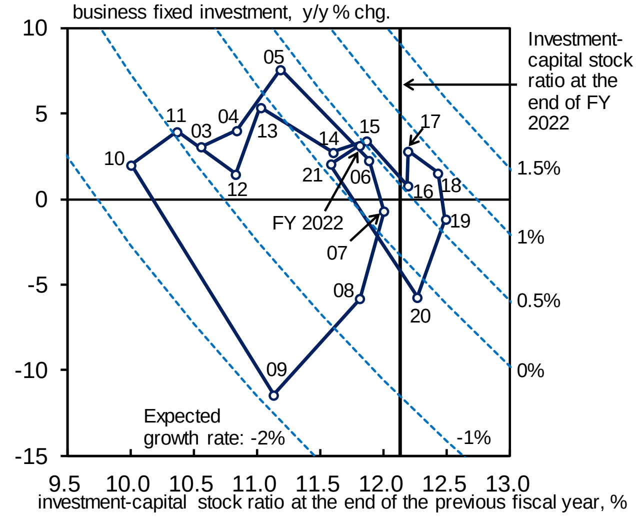
With regard to the outlook, as corporate profits improve, business fixed investment is expected to continue increasing, mainly on the back of accommodative financial conditions. Toward the end of the projection period, such investment is projected to continue increasing, partly due to a rise in investment that is not necessarily responsive to the business cycle, although the pace of increase is likely to slow, reflecting cyclical adjustment pressure stemming from the accumulation of capital stock (Chart 21). Specifically, investment that is expected to be undertaken during the projection period includes (1) investment induced by the increase in domestic and external demand; (2) labor-saving and efficiency-improving investment to address labor shortages and IT-related investment to digitalize business activities; (3) construction investment in logistics facilities, resulting from expanding e-commerce, and in offices and commercial facilities due to redevelopment projects; (4) investment in growth areas and to address environmental issues, such as decarbonization; and (5) semiconductor-related investment that is mainly aimed at strengthening supply chains and that also reflects government support.

Chart 20: Planned and Actual Business Fixed Investment



Sources: Bank of Japan; Cabinet Office.
Note: The *Tankan* figures include software and R&D investments and exclude land purchasing expenses. R&D investment is not included before the March 2017 survey. The figures are for all industries including financial institutions.

Chart 21: 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.

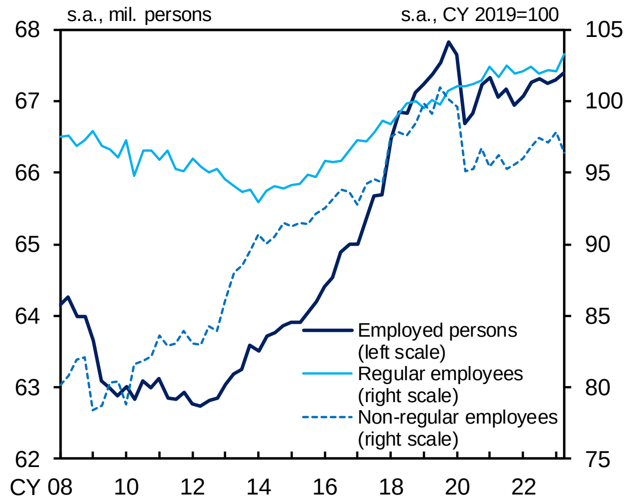
Employment and Income Situation

The employment and income situation has improved moderately.

Regarding the number of employed persons, that of regular employees has risen moderately, mainly in the medical, healthcare, and welfare services industry and in the information and communications industry, both of which have faced a severe labor shortage (Chart 22). When fluctuations are smoothed out, the number of non-regular employees has been on a moderate uptrend, mainly in industries such as face-to-face services. 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 23). The active job openings-to-applicants ratio has been more or less flat recently (Chart 24). This is mainly because the number of job offerings has been relatively weak in industries such as manufacturing, which had seen a temporary decline in production, and because the number of job applicants has increased, mainly in reflection of the impact of COVID-19 waning and an increase in job changes, which is due to improvement in the labor market. Meanwhile, the labor force participation rate has been on a moderate uptrend, particularly for women, when fluctuations are smoothed out (Chart 23).

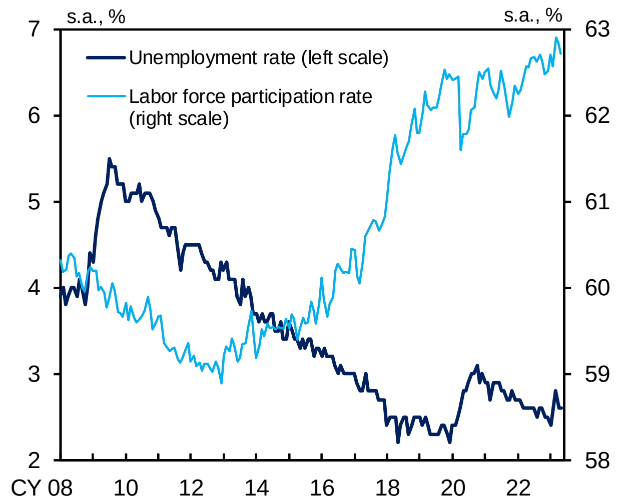
With regard to the outlook for the number of employees, regular employees are likely to continue increasing, mainly in industries with labor shortages, such as medical, healthcare, and

Chart 22: Number of Employed Persons



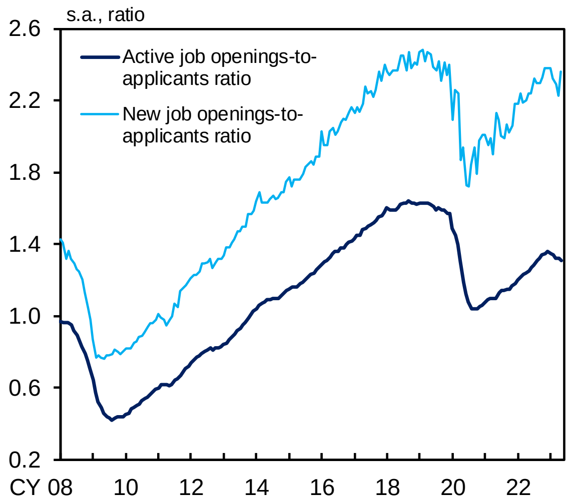
Source: Ministry of Internal Affairs and Communications.
Note: Figures for regular employees and non-regular employees prior to 2013 are based on the "detailed tabulation" in the *Labour Force Survey*. Figures for 2023/Q2 are April-May averages.

Chart 23: Unemployment Rate and Labor Force Participation Rate



Source: Ministry of Internal Affairs and Communications.

Chart 24: Job Openings-to-Applicants Ratio

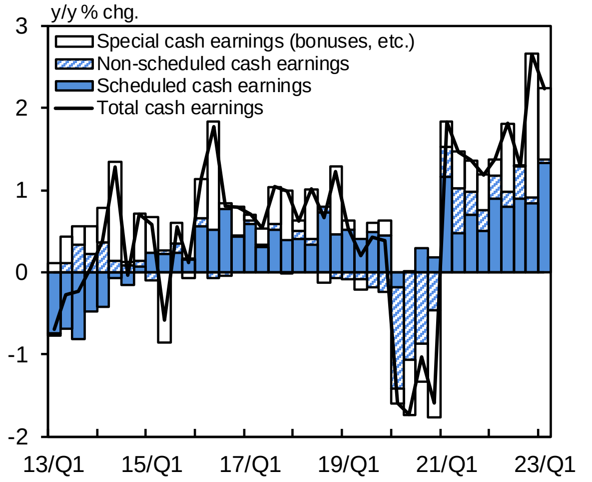


Source: Ministry of Health, Labour and Welfare.

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 along with a moderate increase in private consumption and a continuing rise in inbound tourism demand. However, the pace of increase in the number of overall employees is projected to decelerate, partly because it will become more difficult for labor supply to increase, reflecting factors such as demographic changes, with labor force participation of women and seniors having advanced to a high degree thus far. Under these circumstances, the unemployment rate is expected to follow a moderate declining trend on the back of the recovery in economic activity.

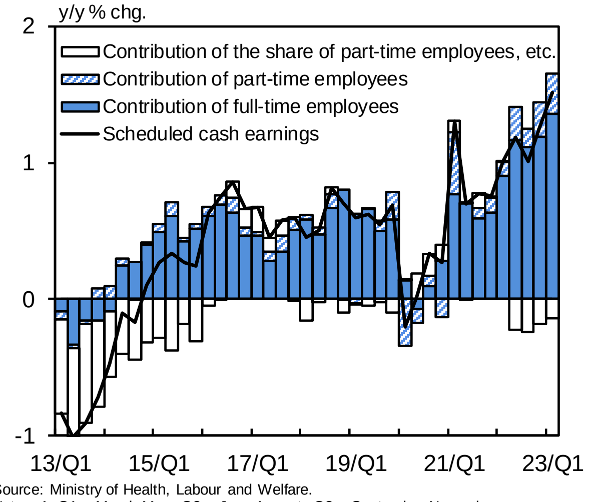
On the wage side, nominal wages per employee have increased moderately, reflecting the recovery in economic activity (Chart 25).[9] The year-on-year rate of change in scheduled cash earnings has continued to increase moderately (Chart 26). Looking at the breakdown, the rate for full-time employees has accelerated to around 2 percent, since it has started to gradually reflect the results of this year's annual spring labor-management wage negotiations, which show that the wage growth rate agreed in the negotiations was significantly higher than in the previous year. The year-on-year rate of change in hourly scheduled cash earnings for part-time employees has been in the range of 2.0-2.5 percent recently, as labor market conditions have tightened. Non-scheduled cash earnings have continued to increase in reflection of the recovery

Chart 25: 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 26: 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.

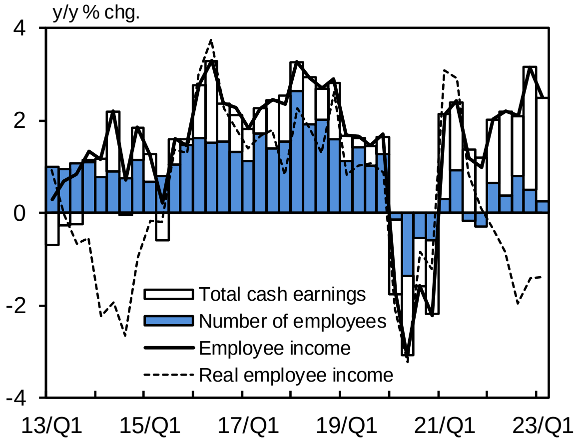
[9] Wages in the *Monthly Labour Survey* are assessed on the basis of continuing observations, which are less susceptible to fluctuations due to sample revisions.

in economic activity. Special cash earnings (bonuses) have kept increasing significantly for a wide range of industries and firm sizes. This seems to be attributable to lump-sum payments by some firms in response to price rises, or "inflation allowances," in addition to improvement in business performance.

With regard to the outlook for wages, the rate of increase in scheduled cash earnings is likely to accelerate further through this summer as it reflects the results of this spring's labor-management wage negotiations. These earnings are projected to continue increasing firmly thereafter, in reflection of price rises and with labor market conditions continuing to be tight. Non-scheduled cash earnings are likely to increase moderately, reflecting the recovery in economic activity. The rate of increase in special cash earnings (bonuses) is likely to remain relatively high, with corporate profits following an improving trend. Taking all of these factors into account, the rate of increase in nominal wages per employee is projected to accelerate.

In light of the aforementioned employment and wage conditions, employee income has improved in nominal terms (Chart 27). In real terms, the year-on-year rate of change in employee income has remained negative in reflection of price rises, but the rate of decline has somewhat slowed recently due to a combination of a decline in inflation and improvement in nominal income. With regard to the outlook, nominal employee income is likely to continue to see a clear increase in reflection of an acceleration in nominal wage growth. Under these circumstances, partly as

Chart 27: 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).

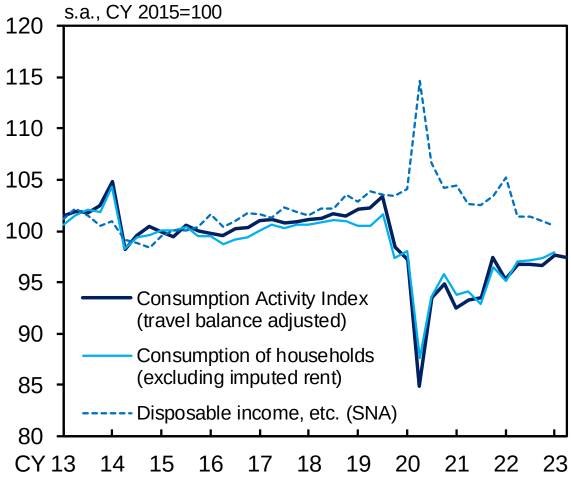
inflation declines, the year-on-year rate of decline in real employee income is projected to follow a decelerating trend. Thereafter, the rate of change is likely to gradually turn positive.

Household Spending

Private consumption has increased steadily at a moderate pace, despite being affected by price rises.

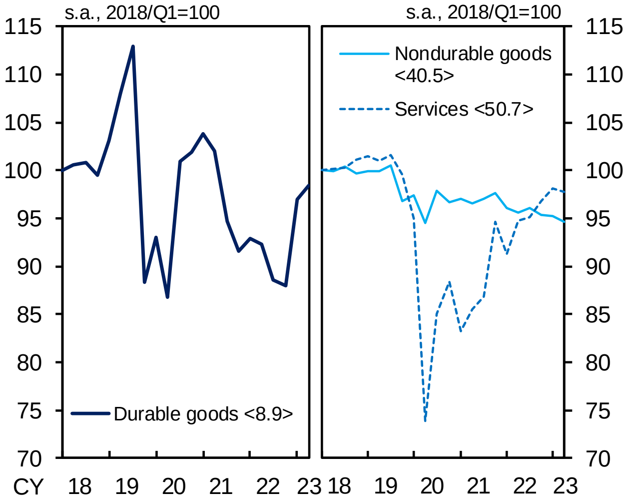
The Consumption Activity Index (CAI, travel balance adjusted) -- which is calculated by combining various sales and supply-side statistics from the viewpoint of gauging Japan's consumption activity in a comprehensive manner -- saw a relatively significant increase for the January-March quarter of 2023 and then was flat for the April-May period relative to that quarter (Charts 28 and 29).[10] Looking at subsequent developments in private consumption from various sources, such as high-frequency indicators, statistics published by industry organizations, and anecdotal information from firms, consumption seems to have continued on a moderate uptrend (Chart 30). This is mainly because, although private consumption has been affected by price rises, pent-up demand has materialized with the reclassification of COVID-19 as a Class V infectious disease under the Infectious Disease Control Law, and private consumption has been supported by improvement in consumer sentiment, which partly reflects the results of the annual spring labor-management wage negotiations.

Chart 28: Real Private Consumption



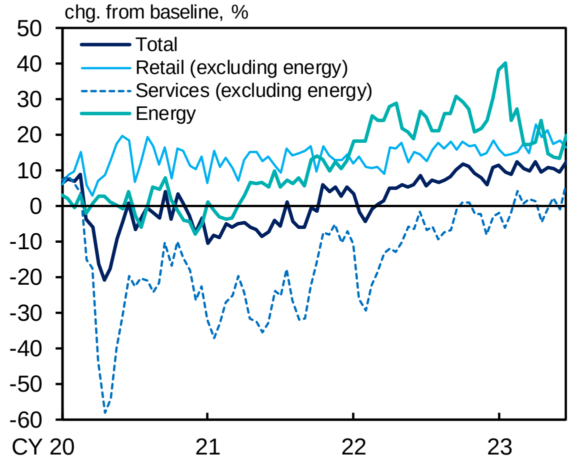
Sources: Bank of Japan; Cabinet Office, etc.
Notes: 1. Figures for the Consumption Activity Index (CAI) are based on staff calculations. The CAI figures (travel balance adjusted) exclude inbound tourism consumption and include outbound tourism consumption. The figure for 2023/Q2 is the April-May average.
2. "Disposable income, etc." consists of disposable income and adjustment for the change in pension entitlements, and real values are obtained using the deflator of consumption of households.

Chart 29: 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 2023/Q2 are April-May averages.
2. Nondurable goods include goods classified as semi-durable goods in the SNA.

Chart 30: Consumption Developments Based on Credit Card Spending

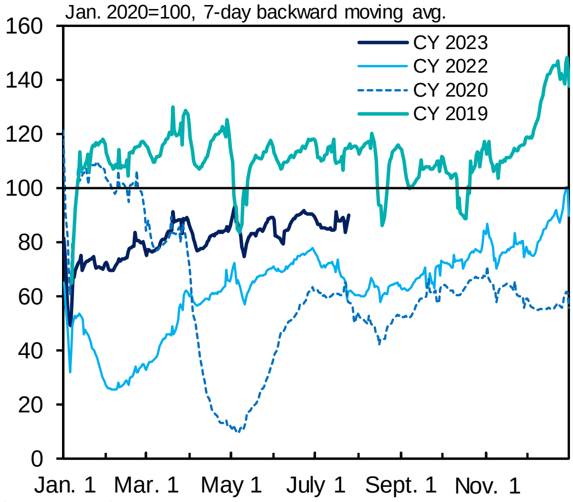


Source: Nowcast Inc./ JCB, Co., Ltd., "JCB Consumption NOW."
Notes: 1. Figures are from the reference series in *JCB Consumption NOW*, which take changes in the number of consumers into account. The baseline is the average for the corresponding half of the month for fiscal 2016 through fiscal 2018.
2.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

[10] 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.

By type, consumption of durable goods has picked up, mainly on the back of a waning of supply-side constraints (Chart 29). Specifically, the number of new passenger cars sold has risen significantly, with the waning of supply-side constraints for semiconductors used in automobiles gradually becoming evident. With regard to sales of household electrical appliances, smartphones and televisions have remained weak, but sales of air conditioners seem to have pushed up overall sales recently, reflecting temperature rises. Consumption of nondurable goods has seen relatively weak developments in beverages and food, clothes, and other items, partly due to the effects of high prices.

Chart 31: Mobility Trends in Downtown Areas



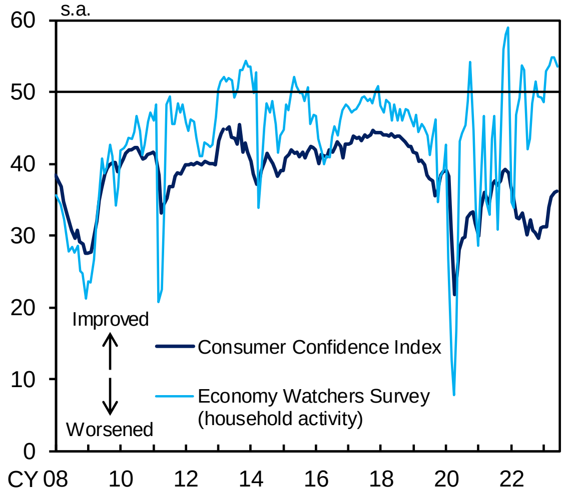
Source: Agoop Corp.
Notes: 1. Figures are the sum of the differences in the number of visitors between 9 p.m. and 4 a.m. on the following day in 53 downtown areas.
2. The latest figure is the average for July 19-25.

Services consumption has increased moderately in reflection of the materialization of pent-up demand (Charts 29, 30, and 31). Despite being affected by price rises, dining-out has been on a moderate increasing trend on the whole, since the number of visitors has increased at a wide range of restaurants, including *izakaya* (Japanese-style bars), which had been slow to recover. Domestic travel has followed an uptrend even as the effects of the government's domestic travel discount program have waned, as seen in a clear recovery in demand for long-distance travel, which had been at a low level during the pandemic. In addition, there is a view that demand for travel during summer vacation has been favorable. Overseas travel has remained at a low level but has continued to increase moderately.

Looking at confidence indicators related to private consumption, the Consumer Confidence Index has improved, mainly on the back of improvement in consumer perception of "employment" and "income growth" (Chart 32). The *Economy Watchers Survey* -- which asks firms for their views on the direction of the economy -- shows that the current economic conditions DI (household activity-related) has continued to indicate improvement, mainly reflecting the materialization of pent-up demand and a rise in inbound tourism demand, although concern over the impact of price rises has contributed to pushing down the DI.

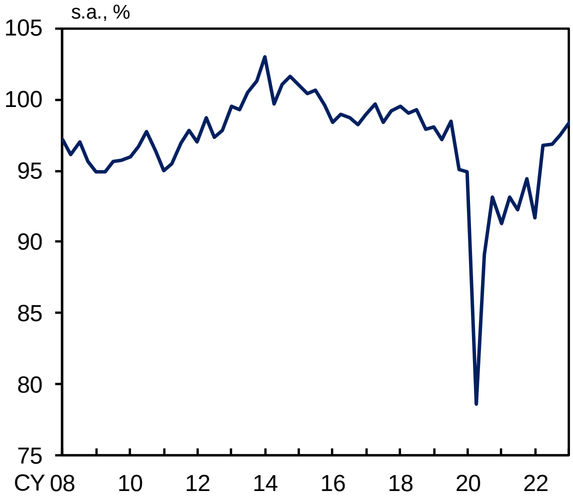
Regarding the outlook, although private consumption is expected to be affected by price rises, it is projected to continue increasing moderately, partly supported by household savings that had accumulated as a result of pandemic-related restrictions, with nominal employee income continuing to improve. Private consumption is also likely to be underpinned by the government's measures, such as those to reduce the household burden of higher gasoline prices, electricity charges, and gas charges, and government subsidies for those with low incomes. Although pent-up demand is likely to wane, private consumption is expected to continue increasing moderately from the middle of the projection period as employee income keeps improving. The propensity to consume is likely to first rise to a level that somewhat exceeds the average level seen before the pandemic, partly due to the withdrawals of household savings that had accumulated as a result of pandemic-related restrictions (Chart 33). From the middle of the projection period, it is expected to gradually return to the average level seen before the pandemic.

Chart 32: Confidence Indicators Related to Private Consumption



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

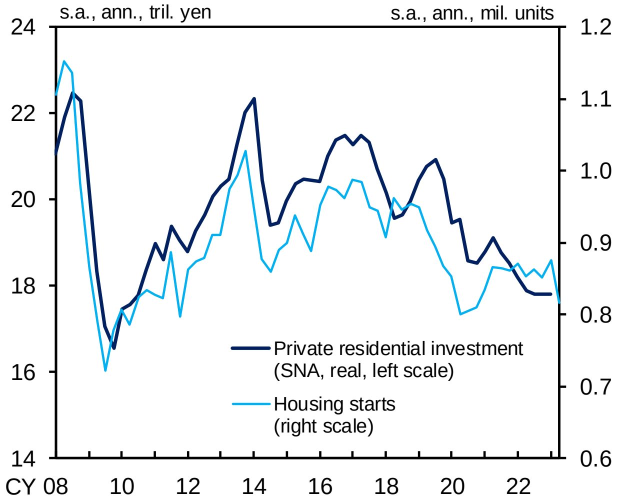
Chart 33: Average Propensity to Consume



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.

Housing investment has been relatively weak, mainly due to a rise in housing prices (Chart 34). 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 followed a downtrend. Housing investment is likely to follow a moderate declining trend in reflection of a rise in housing prices and demographic developments, although accommodative financial conditions are expected to provide support.

Chart 34: Housing Investment



Sources: Cabinet Office; Ministry of Land, Infrastructure, Transport and Tourism.
Note: The figure for 2023/Q2 is the April-May average.

II. Current Situation of Prices and Their Outlook

Developments in Prices

With the impact of past high commodity prices gradually waning, the quarter-on-quarter rate of change in the producer price index (PPI, adjusted for the effects of seasonal changes in electricity rates) has entered negative territory (Chart 35). The year-on-year rate of increase in the services producer price index (SPPI, excluding international transportation) has accelerated, mainly on the back of the recovery in economic activity and a rise in personnel expenses, registering around 2 percent recently.

The year-on-year rate of increase in the CPI (all items less fresh food) is slower than a while ago, mainly due to the effects of pushing down energy prices from the government's economic measures. However, it has been in the range of 3.0-3.5 percent recently owing to the effects of the pass-through to consumer prices of cost increases led by the past rise in import prices (Chart 36). 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 remained relatively high, with a continued pass-through to selling prices of increases in costs such as of raw materials (Chart 37).[11]

[11] 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).

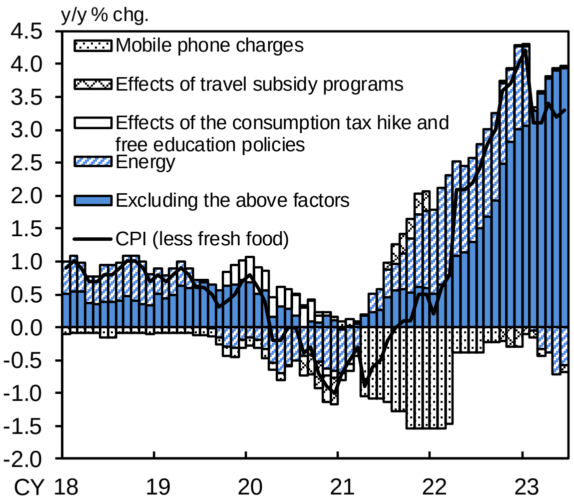
Chart 35: Inflation Indicators

y/y % chg.

	22/Q3	22/Q4	23/Q1	23/Q2
Consumer Price Index (CPI)				
Less fresh food	2.7	3.7	3.5	3.3
Excluding temporary factors	3.1	4.1	3.6	3.3
Less fresh food and energy	1.5	2.8	3.5	4.2
Excluding temporary factors	1.9	3.1	3.6	4.3
Producer Price Index (q/q % chg.)	1.8	2.9	0.6	-0.3
Services Producer Price Index	1.4	1.3	1.7	1.9
GDP Deflator	-0.4	1.2	2.0	
Domestic demand deflator	3.2	3.4	2.8	

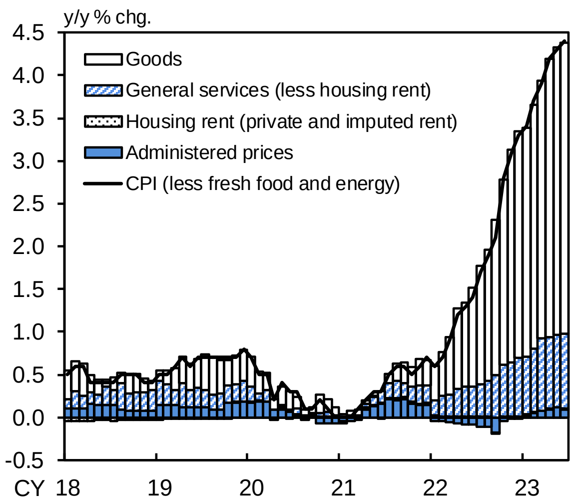
Sources: Ministry of Internal Affairs and Communications; Bank of Japan; Cabinet Office.
Notes: 1. Figures for the producer price index (PPI) are adjusted for the hike in electric power charges during the summer season. Figures for the services producer price index (SPPI) exclude international transportation.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

Chart 36: 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.

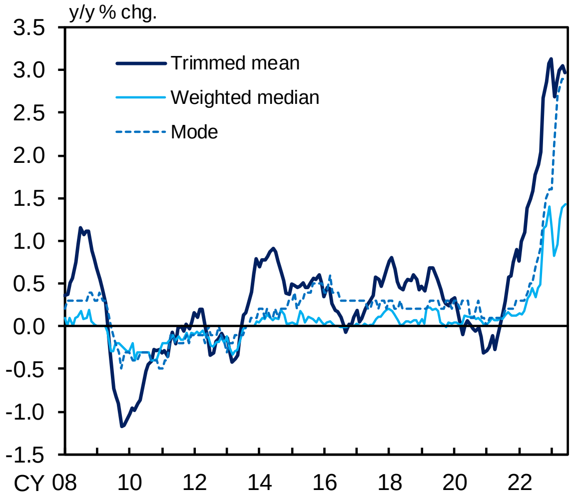
Chart 37: CPI (Excluding Temporary Factors)



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.

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 factors), the rate of increase in goods prices has accelerated, albeit slightly, as the pass-through of cost increases to selling prices has continued for a wide range of items. Specifically, the rates of increase for food and daily necessities have stayed on an accelerating trend, while the rates of increase for durable goods and for agricultural, aquatic, and livestock products have decelerated moderately. The rate of increase in general services prices has accelerated moderately on the whole, as those for items such as hotel charges have remained on an accelerating trend while those for dining-out and housework-related services (e.g., services related to housing repairs and maintenance) have decelerated somewhat. The year-on-year rate of increase in administered prices has remained on a moderate accelerating trend in reflection of hikes in, for example, fire and earthquake insurance premiums and railway fares.

Chart 38: 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 38).[12,13] The trimmed mean

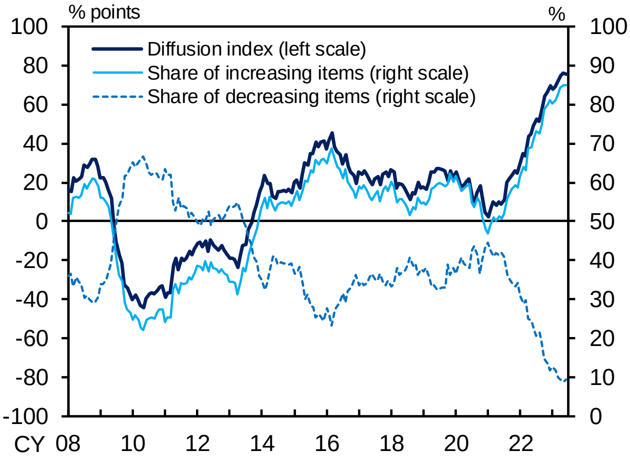
[12] The trimmed mean is calculated by excluding items that belong to a certain percentage of the upper and lower tails of the price change distribution (10 percent of each tail) in order to eliminate the effects of large relative price changes. The mode is the inflation rate with the highest density 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.

[13] In this report, the mode is defined as the inflation rate with the highest density in the distribution that is estimated parametrically by fitting a normal inverse Gaussian distribution to the observed price change distribution in each period. It should be noted that,

of the year-on-year rate of change in the CPI has been at around 3 percent recently. The weighted median, which is less susceptible to developments in certain CPI items, has been at around 1.5 percent. 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 been at a high level as costs, such as of raw materials, have been passed on to a wide range of goods and services prices (Chart 39).

Meanwhile, the year-on-year rate of change in the domestic demand deflator has been in the range of 2.5-3.0 percent (Chart 35). By component, the private consumption deflator has been at around 3 percent on a year-on-year basis. The rates of increase in such deflators as for business fixed investment have remained at high levels despite slowing somewhat. The year-on-year rate of change in the GDP deflator has been at around 2 percent recently; specifically, the rate of increase in the domestic demand deflator has remained relatively high despite slowing somewhat, while the rate of increase in the import deflator has slowed in reflection of developments in crude oil prices, for example.

Chart 39: 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.

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 middle of fiscal 2023 and then

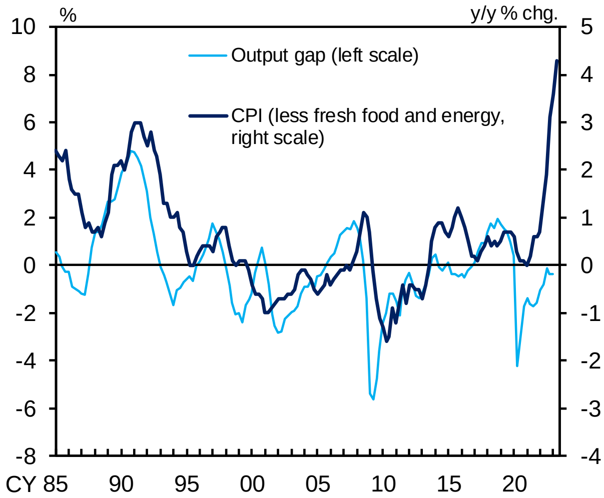
with dispersions of the observed distributions increasing, the fit of the normal inverse Gaussian distribution has deteriorated recently. Therefore, estimates of this mode should be interpreted with some latitude.

continue to expand moderately, albeit at a gradually slowing pace (Charts 2 and 40).

Second, medium- to long-term inflation expectations have shown some upward movements again (Chart 41). The June *Tankan* shows that the output prices DI has been at a high level (Chart 42). It also shows that firms' inflation outlook for general prices has also been at a high level, not only for the short term but also for the medium to long term. In addition, as mentioned earlier, the wage growth rate agreed in the annual spring labor-management wage negotiations this year was significantly higher than in the previous year, including base pay. Given that the formation of inflation expectations in Japan is largely adaptive, the increase in inflation seen thus far has brought about a rise in households' and firms' medium- to long-term inflation expectations. In this situation, signs of change have been seen in firms' wage- and price-setting behavior. Regarding the outlook, inflation expectations are likely to rise moderately toward the end of the projection period, with improvement in the output gap and changes in firms' wage- and price-setting behavior and in labor-management wage negotiations. This will likely lead to a sustained rise in prices accompanied by wage increases.

Third, the year-on-year rate of change in the import price index has been negative recently, reflecting, for example, relatively lower prices than a while ago, such as of crude oil, with these lower prices resulting partly from the slowdown in the pace of recovery in the global economy (Charts 43 and 44). Looking at the final demand-intermediate demand (FD-ID) price

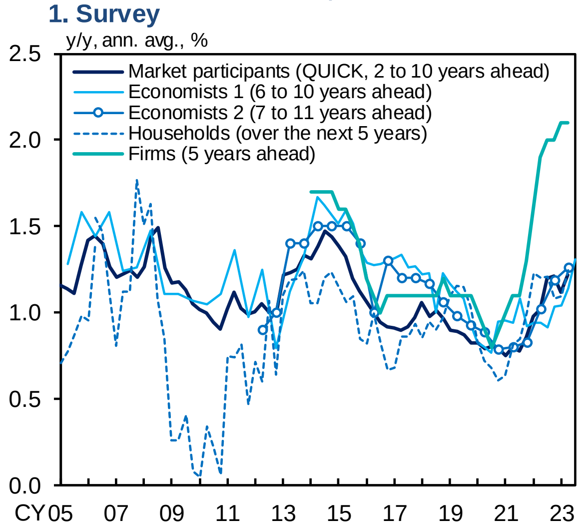
Chart 40: Inflation Rate and Output Gap



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.
2. Figures for the output gap are staff estimates.

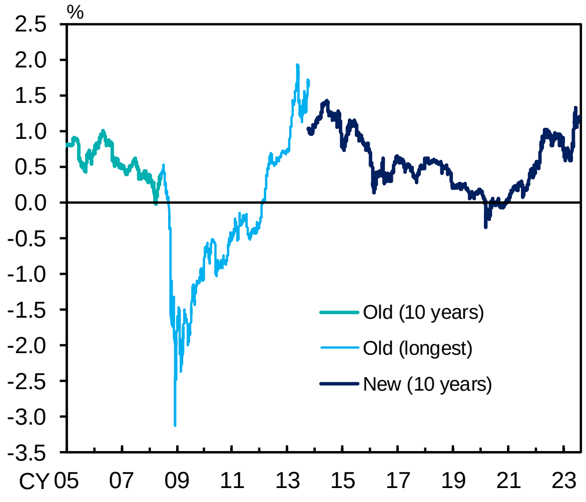
Chart 41: Inflation Expectations

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.

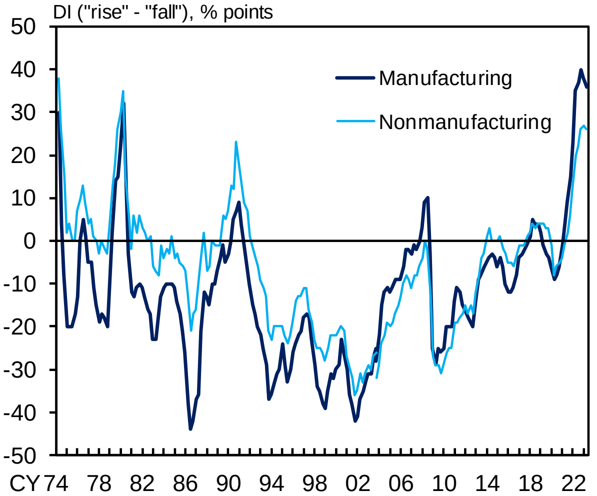
indexes, the indexes for stages 1 and 2 of the ID, which show developments in upstream stages of the production process, have been on a downtrend as a decline in imported goods prices has fed through to these indexes. In addition, the indexes for stages 3 and 4 of the ID, which show developments in midstream and downstream stages of the production process, have been more or less flat, reflecting a waning of upward pressure of costs from the upstream stages (Chart 45). Given these developments, the upward pressure on the CPI stemming from the past rise in import prices is expected to gradually wane.[14]

Meanwhile, the year-on-year rate of decline in energy prices (e.g., gasoline prices and electricity charges) has been on an accelerating trend. This is because, while the rate of change has been pushed up by the hikes in regulated electricity rates by power companies, it has been pushed down by recent developments in commodity prices, the government's measures to reduce the household burden of higher electricity and gas charges, and its revision to the rate of renewable energy surcharges on electricity.[15] As for the

[14] Box 2 examines the current situation of and future issues regarding the upward pressure of costs led by the rise in import prices. Box 3 compares price developments in Japan, the United States, and Europe.

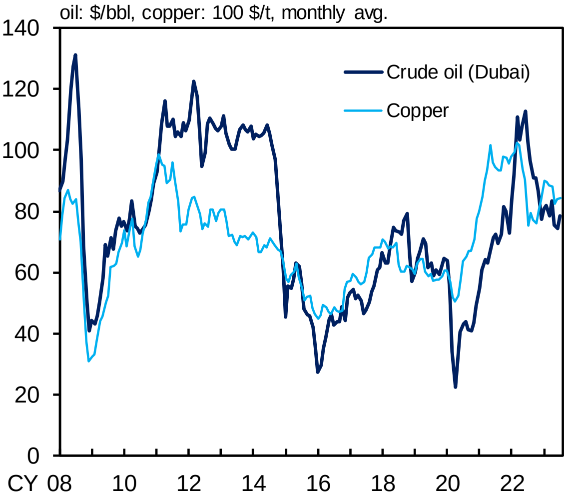
[15] Looking at the government's energy-related economic measures, with regard to gasoline subsidies, it has introduced a measure to provide subsidies to petroleum distributors and importers as funds to contain a sharp rise in their selling prices when the nationwide average for retail gasoline prices exceeds the benchmark price (168 yen per liter). Starting from June 2023, the government has gradually lowered the gasoline subsidy rate applied when the nationwide average exceeds the benchmark by no more than 25 yen per liter, and will terminate the overall subsidies at the end of September. 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

Chart 42: 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 43: International Commodity Prices



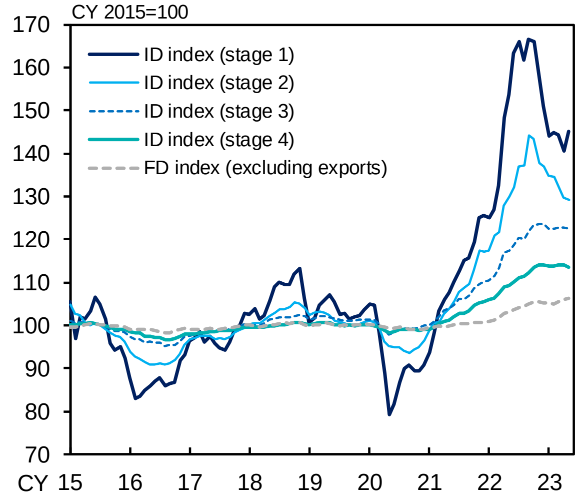
Sources: Nikkei Inc.; Bloomberg.

Chart 44: Import Price Index

Source: Bank of Japan.

outlook, the year-on-year rate of decline in energy prices is likely to first moderately accelerate toward the middle of fiscal 2023. This is based on the projection that, although the rate of change in these prices will be pushed up by a gradual scaling back of gasoline subsidies, it will continue to be pushed down by the measures to reduce the household burden of higher electricity and gas charges, and the effects of the past decline in commodity prices will be reflected in these charges with a lag. Assuming that the government's measures to reduce the household burden of higher electricity and gas charges will be scaled back gradually, the year-on-year rate of change in energy prices is then highly likely to turn positive and accelerate clearly, mainly due to a waning of the effects of the government measures pushing down such prices of the previous year. Thereafter, the rate of increase is expected to decelerate rapidly as the impact of the rebound caused by the phasing out of the government measures diminishes. Subsequently, in light of developments in the futures market, the rate of change is projected to remain slightly negative toward the end of the projection period.

Chart 45: FD-ID Price Indexes (All Commodities)



Source: Bank of Japan.

Outlook for Prices

Based on this underlying scenario, the year-on-year rate of increase in the CPI (all items less fresh food and energy) is likely to decelerate for a while, with a gradual waning of the effects of the cost increases led by the past rise in import prices. The rate of increase is then projected to accelerate again moderately toward the end of the projection period, as the output gap continues

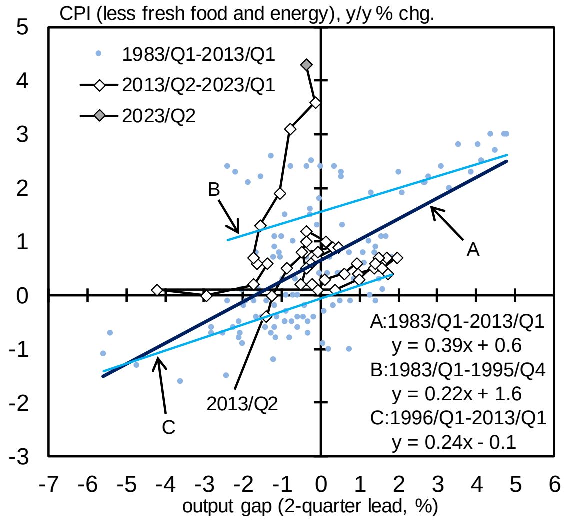
period from February through September 2023 and by 3.5 yen per kilowatt-hour for October. Regarding manufactured and piped gas charges, roughly similar measures to reduce the household burden have been introduced.

to improve and as medium- to long-term inflation expectations and wage growth rise, accompanied by changes in factors such as firms' wage- and price- setting behavior (Chart 46).

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 decelerate toward around the end of 2023, because it is projected that (1) energy prices will make a negative contribution to the rate and (2) there will be a gradual waning of pressure on firms to pass on the cost increases led by the past rise in import prices. Thereafter, the rate of increase in this CPI is projected to accelerate, as (1) the deceleration in the rate of increase in the CPI (all items less fresh food and energy) gradually comes to a halt and as (2) the rate of increase in energy prices accelerates clearly, mainly due to the waning of the effects of the government's various measures pushing down such prices of the previous year. Regarding the outlook after these developments, the rate of increase in the CPI (all items less fresh food) is expected to decelerate for a while as the impact of the rebound in energy prices caused by the phasing out of the government measures diminishes. Toward the end of the projection period, however, the rate of increase in this CPI is likely to accelerate again moderately, with that in the CPI (all items less fresh food and energy) accelerating moderately.

It should be noted that there are high uncertainties over the pace and timing of a decline in inflation, as well as over price developments after the upward pressure of costs

Chart 46: 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.
2. Figures for the output gap are staff estimates.

wanes and the pass-through of cost increases to consumer prices moderates. This is because the degree of cost increases in the recent past has been large and signs of change have been seen in firms' price-setting stance.

III. Financial Developments in Japan

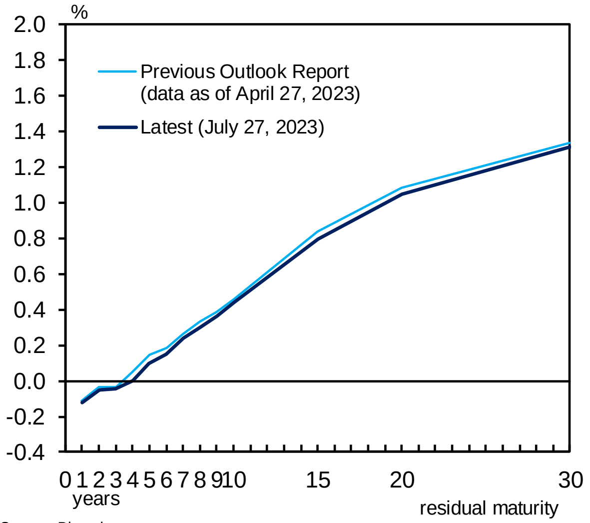
Financial Conditions

Financial conditions have been accommodative.

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 47). Specifically, the Bank has conducted market operations nimbly; as part of this, it has purchased a necessary amount of JGBs without setting an upper limit, including through fixed-rate purchase operations for consecutive days. Under these circumstances, the yields for relatively short maturities have been in slightly negative territory, and the 10-year JGB yields have been in the range of around plus and minus 0.5 percentage points from 0 percent.

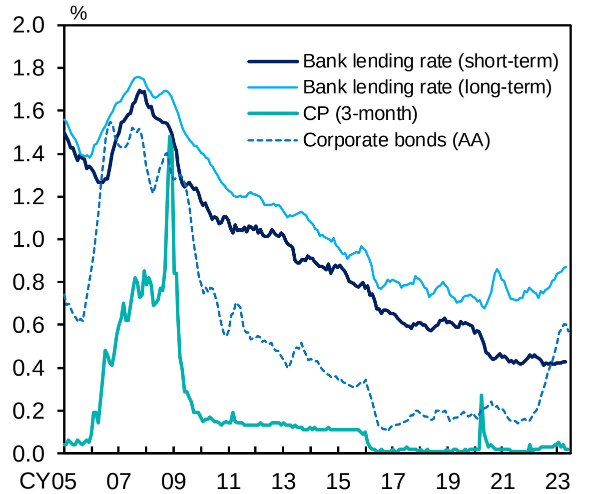
Firms' funding costs have been hovering at extremely low levels (Chart 48). Issuance rates for CP have been at extremely low levels, as issuance conditions have remained favorable. The DI for issuance conditions for CP in the *Tankan* has continued to show net "easy" conditions, as supply and demand conditions have improved due to factors such as subdued issuance by energy-related and other firms. In the corporate bond market, issuance conditions have been favorable on the whole; with supply and demand conditions showing some improvement, issuance spreads have narrowed somewhat and issuance of long-term bonds has picked up. Meanwhile, lending rates (the average interest

Chart 47: Yield Curves



Source: Bloomberg.

Chart 48: Bank Lending Rates and Issuance Yields for CP and Corporate Bonds



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

Notes: 1. Figures for issuance yields for CP up 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.

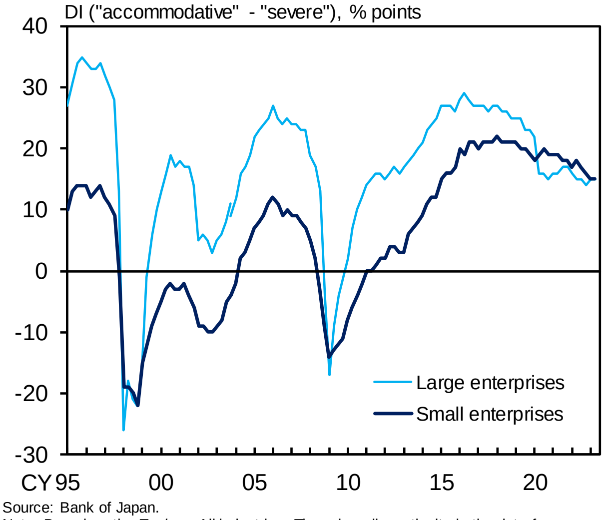
rates on new loans and discounts) have been at extremely low levels for short-term loans and discounts, while they have increased somewhat for long-term loans.

The DI in the *Tankan* for financial institutions' lending attitudes as perceived by firms suggests that such attitudes have remained accommodative on the whole (Chart 49). The DI for firms' financial positions in the *Tankan* suggests that the positions have improved on the back of a recovery in economic activity (Chart 50). By industry, with progress in the pass-through of cost increases to selling prices, the DI for manufacturing has improved, partly due to a waning of the effects of supply-side constraints, and that for nonmanufacturing has continued to improve, mainly because of increases in private consumption and inbound tourism demand.

Firms' demand for funds has increased moderately on the back of the recovery in economic activity and past high raw material costs. In this situation, the year-on-year rate of increase in the amount outstanding of bank lending has been at around 3.5 percent (Chart 51). That in the aggregate amount outstanding of CP and corporate bonds has continued to decelerate, registering around 1.5 percent, mainly because of subdued issuance by energy-related firms.

The year-on-year rate of decline in the monetary base has decelerated due to a waning of the effects of a decline in the amount outstanding of funds provided through the Special Funds-Supplying Operations to Facilitate

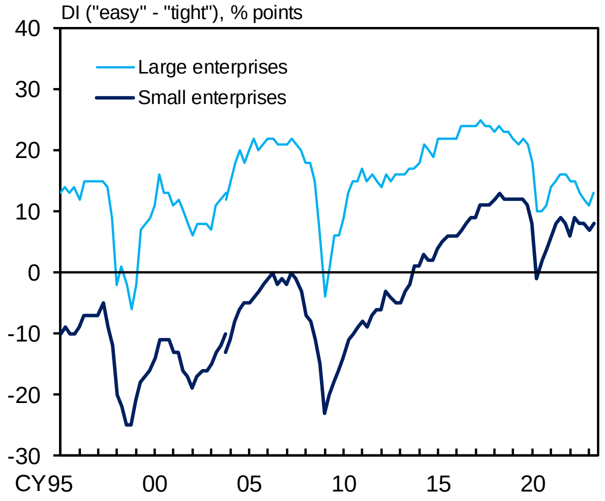
Chart 49: Lending Attitudes of Financial Institutions as Perceived by Firms



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.

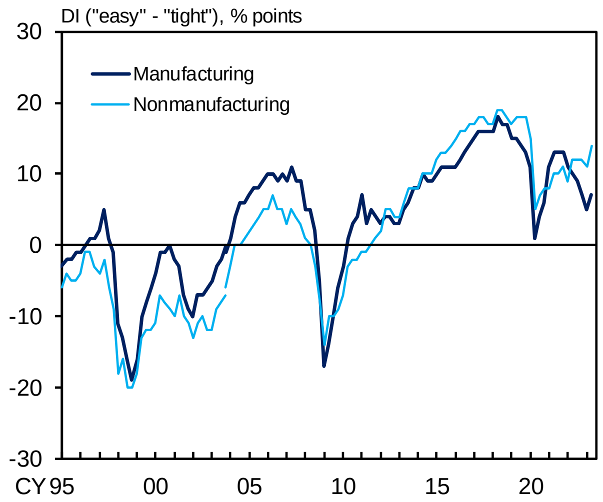
Chart 50: Firms' Financial Positions

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.

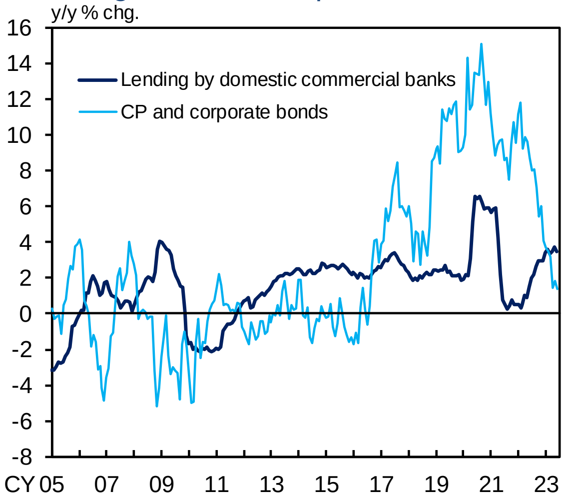
2. By Industry



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.

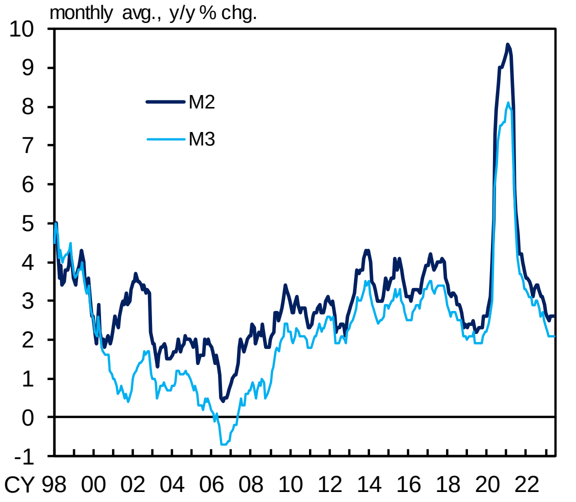
Financing in Response to the Novel Coronavirus (COVID-19). The amount outstanding of the monetary base was 671 trillion yen, of which the ratio to nominal GDP was 117 percent.[16] The year-on-year rate of change in the money stock (M2) has been at around 2.5 percent, as the amount outstanding of bank lending has continued to increase and fiscal spending has kept pushing the rate up (Chart 52).

Chart 51: 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 52: Money Stock



Source: Bank of Japan.

[16] The amount outstanding of the monetary base is as of end-June 2023. Nominal GDP is the figure for the January-March quarter of 2023.

Developments in Financial Markets

In global financial markets, attention has continued to be drawn to uncertainties over the U.S. and European monetary policies, as well as the outlook for the global economy. However, market sentiment has improved, mainly reflecting solid economic indicators in the United States and a decline in its inflation rate.

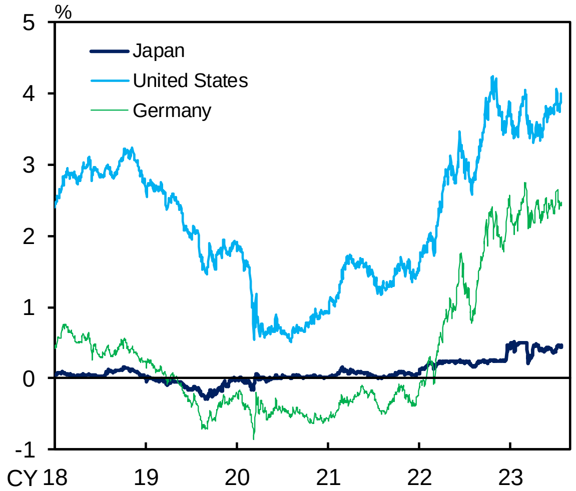
Yields on 10-year government bonds in the United States had risen, mainly on the back of solid economic indicators (Chart 53). Subsequently, the yields have declined somewhat, reflecting the decline in the inflation rate. Those in Europe have been more or less flat.

Premiums for U.S. dollar funding through the dollar/yen foreign exchange swap market have been at low levels (Chart 54).

Stock prices in the United States have risen significantly due to solid economic indicators and market expectations for a spread of new technologies, as well as to the decline in the inflation rate (Chart 55). Meanwhile, the volatility of these prices has declined (Chart 56). Stock prices in Europe have been more or less flat. Those in Japan have increased significantly due to high levels of corporate profits, as well as to the yen's depreciation. Stock prices in emerging economies have risen.

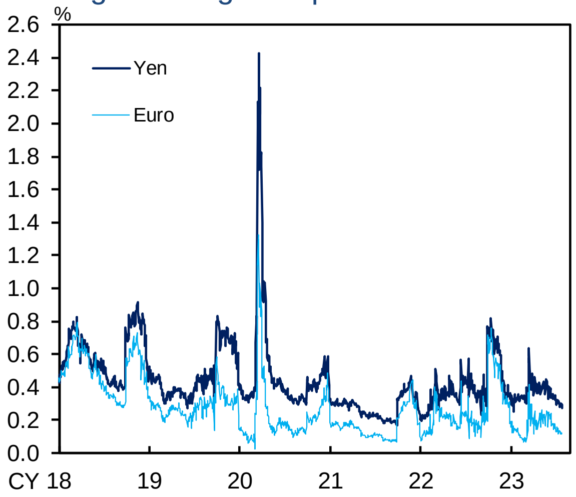
Prices of Japan real estate investment trusts (J-REITs) have risen somewhat (Chart 57).

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



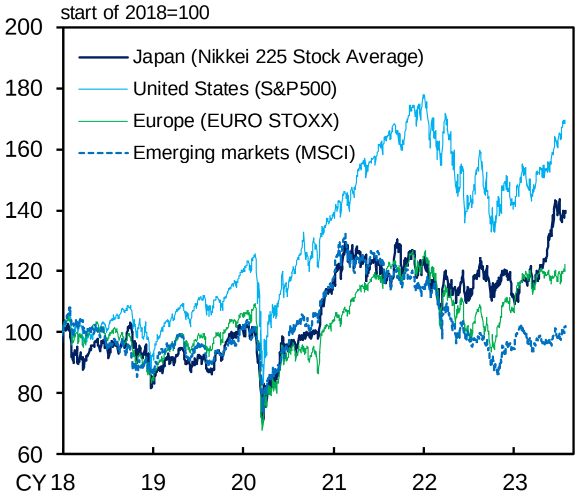
Source: Bloomberg.

Chart 54: 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.

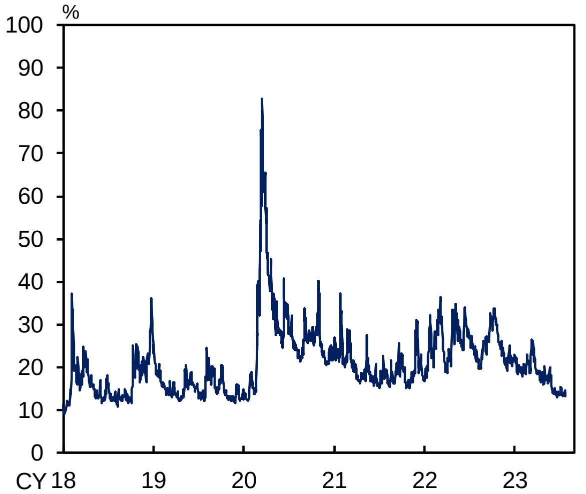
Chart 55: Selected Stock Price Indices



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

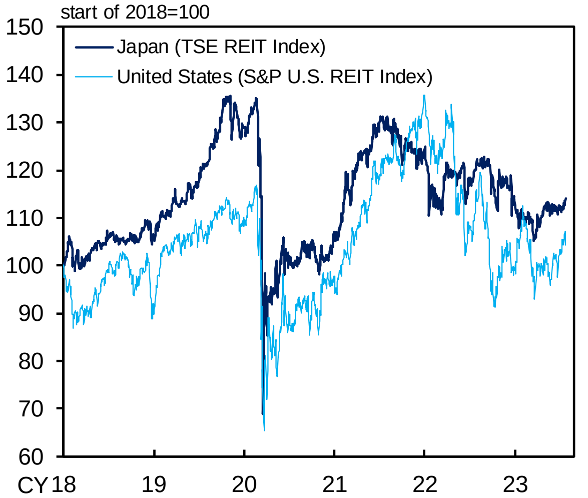
In foreign exchange markets, the yen had depreciated against the U.S. dollar, mainly because of developments in the yield differential between Japan and the United States (Chart 58). Subsequently, it has appreciated somewhat. The yen has depreciated against the euro.

Chart 56: Stock Market Volatility (VIX)



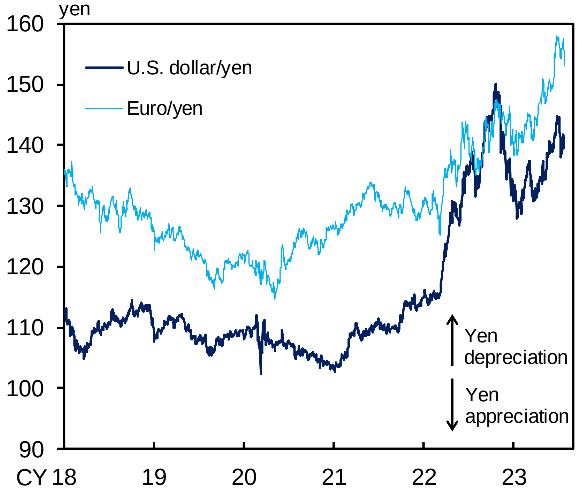
Source: Bloomberg.

Chart 57: Selected REIT Indices



Source: Bloomberg.

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



Source: Bloomberg.

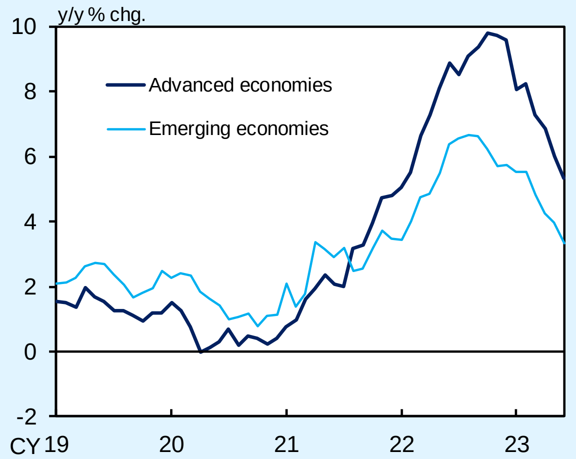
(Box 1) Uncertainties regarding the Pace of Recovery in Overseas Economies

Although the pace of recovery in overseas economies is projected to remain slow for the time being, they are likely to pick up gradually thereafter. However, there are extremely high uncertainties surrounding them, and downside risks have remained a particular concern. Among these risks, the following factors warrant special attention.

The first is uncertainties over price developments and policy interest rate hikes by overseas central banks. Developments in inflation, which have exerted downward pressure on overseas economies, show a clear deceleration in both advanced and emerging economies after inflation reached its peak in the second half of last year, mainly reflecting a decline in energy prices and a waning of supply-side constraints (Chart B1-1). However, inflation rates are still high, especially in advanced economies, and vigilance against the risk of these rates staying elevated through wage increases has been strong in some countries and regions. It is necessary to pay attention to the possibility of overseas economies slowing further if it takes time for inflation rates to be contained and policy interest rates are raised by more than market participants expect.

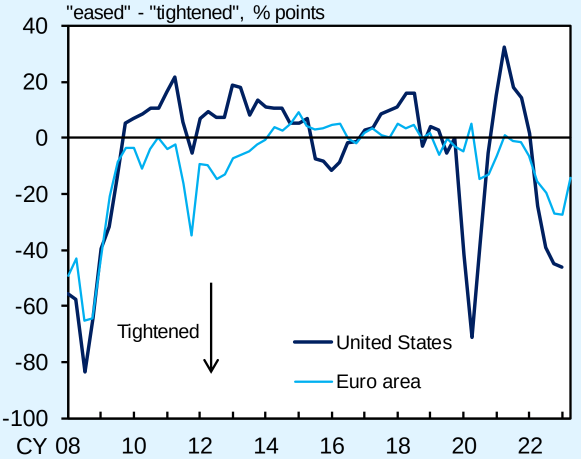
Second, attention also needs to be paid to the possibility that the functioning of financial intermediation will decline as credit risks materialize. In the United States and Europe, banks' lending standards have clearly tightened since last year (Chart B1-2). After the failures of

Chart B1-1: Inflation Rates in Advanced and Emerging Economies



Sources: Haver; CEIC.
Note: Figures for advanced economies are the median year-on-year rates of change in consumer prices for 17 economies, including the United States and European countries. Figures for emerging economies are the median year-on-year rates of change in consumer prices for 12 economies in Asia (excluding China) and Latin America.

Chart B1-2: Lending Attitudes of U.S. and European Financial Institutions



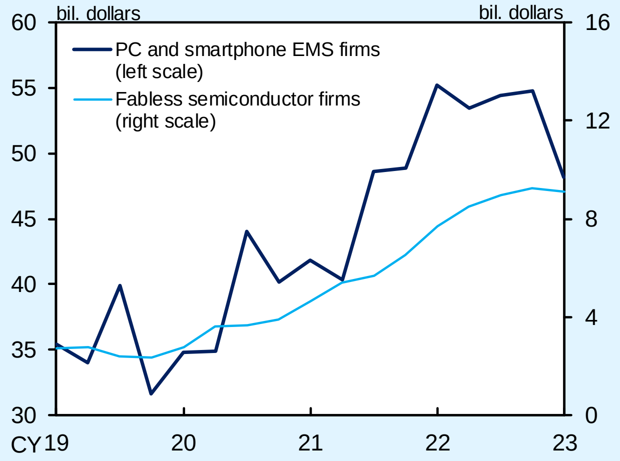
Sources: FRB, "Senior Loan Officer Opinion Survey on Bank Lending Practices"; ECB, "The Euro Area Bank Lending Survey."
Note: Figures are the percentage of financial institutions responding that they had eased standards for loans minus the percentage responding that they had tightened standards. Figures for the United States are for loans to large and middle-market firms, while those for the euro area are for loans to firms overall.

some financial institutions in these economies this spring, an acceleration in the tightening of lending standards due to this has been avoided. However, as has been of concern with regard to, for example, commercial real estate lending in the United States, there is a risk that a materialization of credit risks will trigger a further tightening of lending standards coupled with a deterioration in banks' balance sheets.

The third factor concerns developments in IT-related demand. Developments in IT-related firms' inventories show that, while inventories are still at high levels, progress with adjustments seems to have begun gradually, especially for products close to final demand (Chart B1-3). Meanwhile, South Korean and Taiwanese IT-related exports have started to bottom out (Chart B1-4). Given these developments, it is highly likely that IT-related demand will head toward a pick-up after bottoming out as inventory adjustments gradually progress. In this regard, anecdotal information from firms indicates that IT-related demand will pick up gradually in the second half of this year. However, if final demand continues to be weak due to, for example, the impact of continued inflation and policy interest rate hikes, the pace of the pick-up could turn out to be slow.

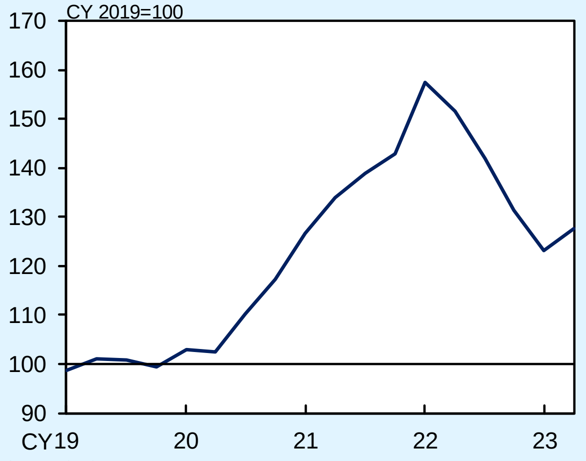
Fourth, there is a risk of a delay in the recovery of the Chinese economy due to prolonged adjustments in the real estate market, as well as on the employment and income side. Looking at the Chinese real estate market, lending to the real estate industry has shown signs of bottoming out -- partly due to government support measures --

Chart B1-3: Inventories of IT-Related Firms



Source: S&P Global Market Intelligence.
Notes: 1. Figures for PC and smartphone EMS (electronics manufacturing services) firms are for six major EMS providers.
2. Figures for fabless semiconductor firms are for two major firms that mainly design and sell logic ICs for smartphones.

Chart B1-4: South Korean and Taiwanese IT-Related Exports

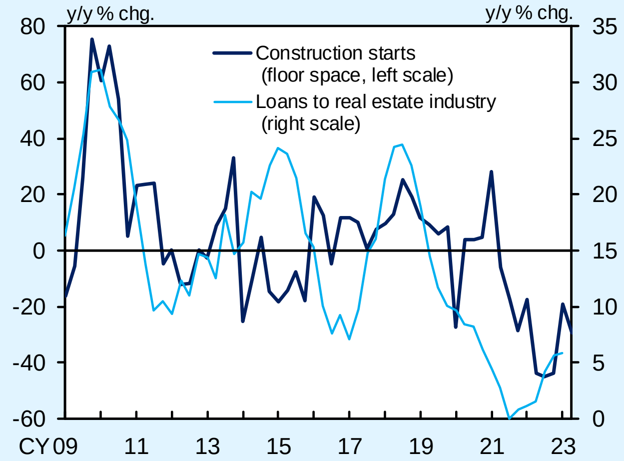


Source: CEIC.
Note: Figures are for nominal exports in U.S. dollar terms.

and there is less concern over developers' financial positions than a while ago (Chart B1-5). However, construction starts have remained weak. Since the real estate industry accounts for a large share of economic activity in China, if adjustments in this industry prolong, this is likely to push down the Chinese economy to a certain degree. Moreover, in the labor market, the increase in youth unemployment has not come to a halt despite the resumption of economic activity, suggesting that adjustment pressure has remained (Chart B1-6). In this context, attention needs to be paid to the risk that it will take a relatively long time for the employment and income situation to improve.

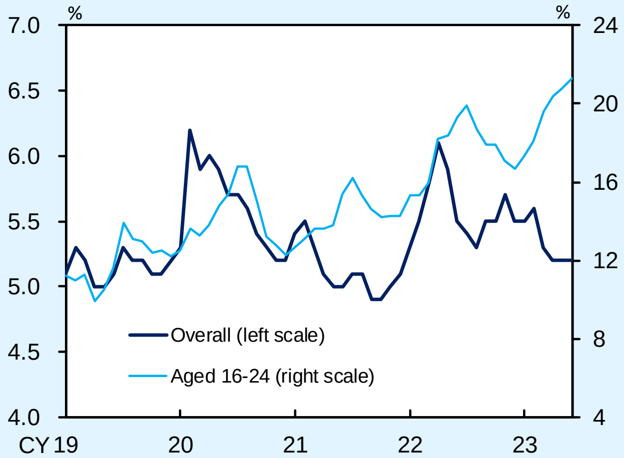
Lastly, it is necessary to keep in mind factors such as the impact of the situation surrounding Ukraine and the prolonged U.S.-China tension. For the time being, close monitoring is required as to whether these various downside risks will materialize.

Chart B1-5: Construction Starts and Bank Loans to Real Estate Industry in China



Source: CEIC.

Chart B1-6: Surveyed Urban Unemployment Rate in China



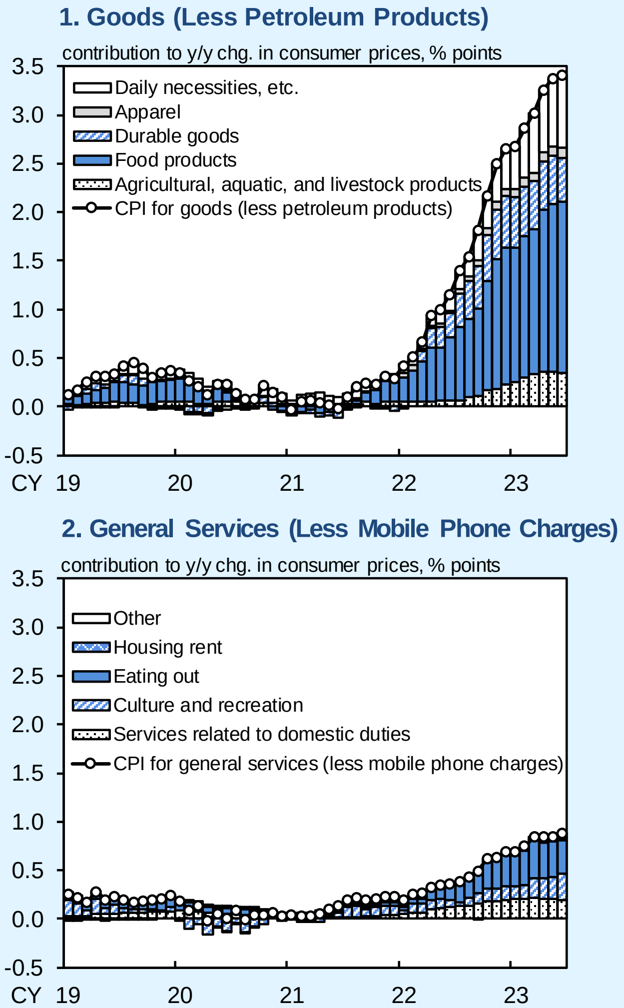
Source: CEIC.

(Box 2) Upward Pressure of Costs Led by a Rise in Import Prices and the CPI

The year-on-year rate of change in the CPI (all items less fresh food and energy) has been following an uptrend. Looking at its developments separately for goods and services shows that the rise in prices of goods, mainly food and daily necessities, has been remarkable, and it seems that upward pressure of costs led by past rises in import prices has continued to be passed on to selling prices (Chart B2-1). This box examines the current situation of and future issues regarding such upward pressure of costs and firms' price-setting behavior in response.

First, looking at import prices to examine the current situation of the upward pressure of costs, the year-on-year rate of change has turned negative as international commodity prices have been lower than a while ago (Chart 44). The effects of such waning of upward pressure of costs stemming from past rises in import prices have gradually spread from the upstream to the downstream stages of supply chains in business-to-business (B to B) transactions. Second, the final demand-intermediate demand (FD-ID) price indexes indicate that the year-on-year rates of change in the indexes for stages 1 and 2 of the ID, which show developments in selling prices at the upstream stages, have been negative (Chart 45). Meanwhile, the indexes for stages 3 and 4 of the ID, which are relatively downstream stages, have been affected by these developments in the

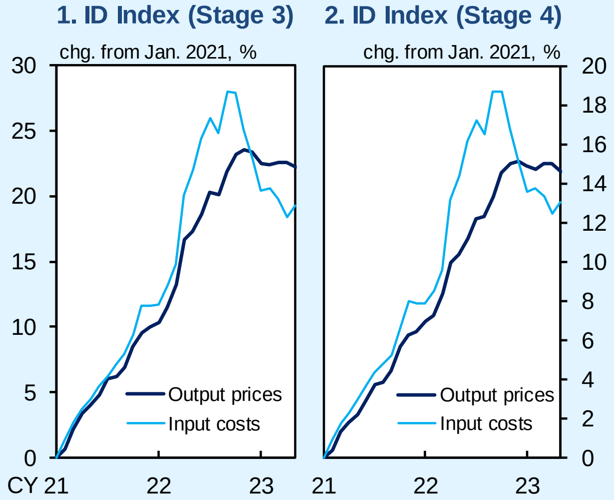
Chart B2-1: CPIs for Goods and Services



Source: Ministry of Internal Affairs and Communications.
Notes: 1. Figures are the contribution to changes in the CPI (less fresh food and energy). 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.
2. Figures for services related to domestic duties include services related to housing repairs and maintenance.

upstream stages.[17] A closer look at these indexes shows that (1) firms at stages 3 and 4 could only partially pass on a rapid increase in input costs to selling prices toward the second half of 2022, and thereafter, (2) while input costs have turned to a decline, past cost increases have continued to be passed on to selling prices, and thus such prices have been more or less flat (Chart B2-2).[18] Reflecting these developments, the pace of increase in input costs (intermediate input costs) faced by firms that conduct business-to-consumer (B to C) transactions has decelerated (Chart B2-3).[19]

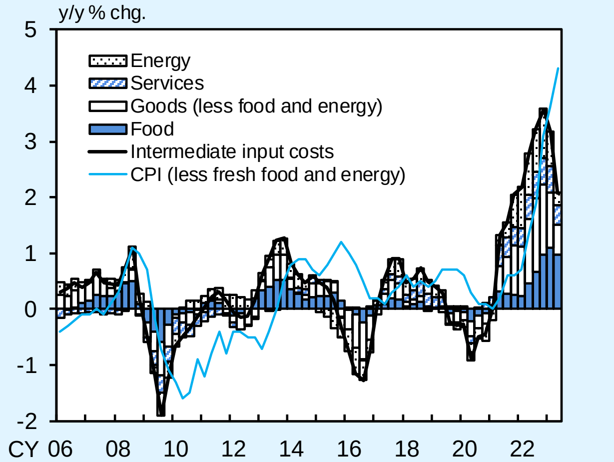
Chart B2-2: Business-to-Business Prices



Sources: Ministry of Internal Affairs and Communications; Bank of Japan.
Note: Figures for input costs are estimates of firms' costs of inputs such as raw materials at the upstream stages using the *2015 Input-Output Tables for Japan*. Figures for output prices are the ID indexes for stages 3 and 4, respectively, indicating the selling prices to each stage.

As explained, the effects of the waning of upward pressure of costs led by past rises in import prices have started to gradually spread to B to C transactions, albeit with a time lag, through transactions at each stage of supply chains. Therefore, it is quite likely that the upward pressure on the CPI led by past rises in import prices will wane.

Chart B2-3: Intermediate Input Costs



Sources: Ministry of Internal Affairs and Communications; Bank of Japan.
Note: 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. Intermediate input costs are calculated by multiplying the intermediate input ratio of each sector in the *2015 Input-Output Tables for Japan* by price data from the corporate goods price index (CGPI) or the services producer price index (SPPI) and then taking the weighted average using consumption expenditure shares as weights.

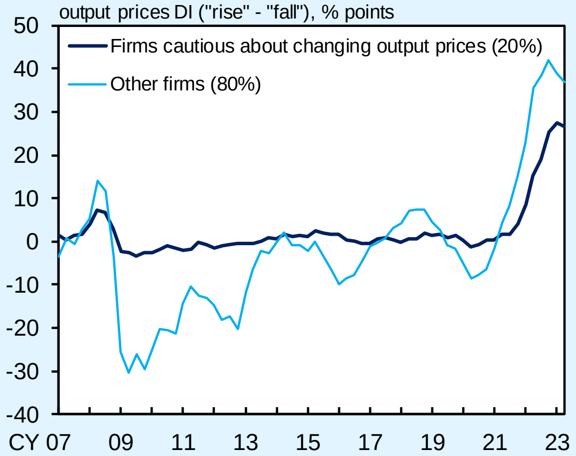
[17] In the FD-ID price indexes, stage 3 includes goods and services that are close to final demand, such as motor vehicle parts, integrated circuits, and air transport, while stage 4 includes final demand goods such as passenger motor cars and machine tools, as well as services such as hotels. For details, see "Explanation of Final Demand-Intermediate Demand price indexes (FD-ID price indexes)," released by the Research and Statistics Department of the Bank of Japan in June 2022.

[18] As input costs are estimated here based on macroeconomic statistics, the figures should be interpreted with considerable latitude. The extent of cost pass-through has likely varied considerably across individual items and firms.

[19] To measure the intermediate input costs for the production of consumer goods and services, excluding fresh food and energy, the intermediate input cost index is estimated based on the transaction structure in the input-output tables. For details, see Box 3 in the April 2022 Outlook Report.

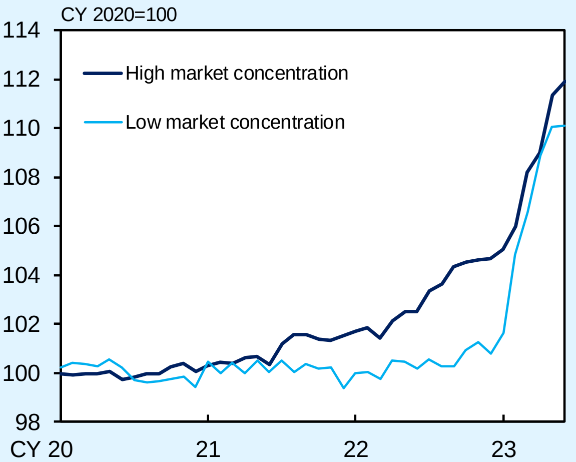
However, as has been pointed out, it warrants attention that, since last summer, moves to raise selling prices have been spreading rapidly even to industries and firms that were cautious about raising prices in the past (Chart B2-4). In addition, recently, price rises are spreading to items for which a pass-through of cost increases has been contained even during the current period of inflation, mainly because of fierce competition among firms amid a situation of low market concentration (Chart B2-5). The background to such changes in firms' behavior is that (1) final demand has been firm, partly supported by pent-up demand, despite price rises, and (2) as many firms have had no choice but to consider raising prices in the face of the upward pressure of costs, it has become less difficult, in terms of competition, for firms to pass on cost increases to their selling prices.[20] It is necessary to continue paying close attention to whether the pass-through of cost increases becomes more prolonged or intensifies with firms shifting their price-setting stance further toward raising prices.

Chart B2-4: Change in Firms' Price-Setting Stance



Source: Bank of Japan.
Note: Based on the *Tankan* (all industries and enterprises). Figures for "firms cautious about changing output prices" are for firms that for at least about 95 percent of the period from 1991 to 2019 replied that their output prices were "unchanged."

Chart B2-5: Market Concentration and Prices of Daily Necessities



Sources: Ministry of Internal Affairs and Communications; Japan Fair Trade Commission.
Note: Daily necessities that fall into the top 50 percent in terms of the Herfindahl-Hirschman Index are defined as items with a high market concentration and vice versa. Figures in the chart are the weighted averages of these selected CPI items.

[20] Regarding nonlinear change in firms' price-setting behavior in the current phase, see the following: Box 3 in the October 2022 Outlook Report, and "Firms' Recent Price-Setting Stance: Evidence from the *Tankan*," *Bank of Japan Review Series*, no. 23-E-2, February 2023.

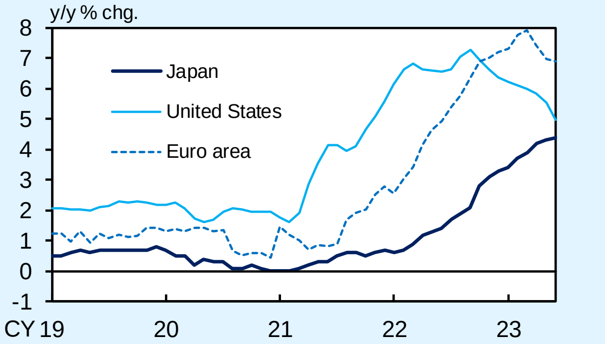
(Box 3) Features of and Reasons for Price Rises in the Current Phase: Comparison with the United States and Europe

The year-on-year rates of change in the CPI have risen globally in the current phase (Chart B3-1). Against this background, this box provides an overview of the differences in price rises in the United States, Europe, and Japan.

First, the distribution of the year-on-year rates of change in prices for individual items constituting the CPI is examined in order to gain a detailed understanding of the features of recent price rises. The number of items for which prices have risen significantly by more than 5 percent has increased in all three economies, and it is these items that have been driving the overall increase in the price indexes. This is in line with the fact that many core indicators of the CPI, such as the trimmed mean, have been at high levels in all three economies. On the other hand, a closer look at the price change distribution shows that, in Japan, the peak of the distribution has remained around 0 percent, mainly due to services, although the height of the peak is now much lower than before. In contrast, in the United States and Europe, the peak of the distribution itself has clearly shifted to the right as prices of a wide range of goods and services have risen (Chart B3-2).

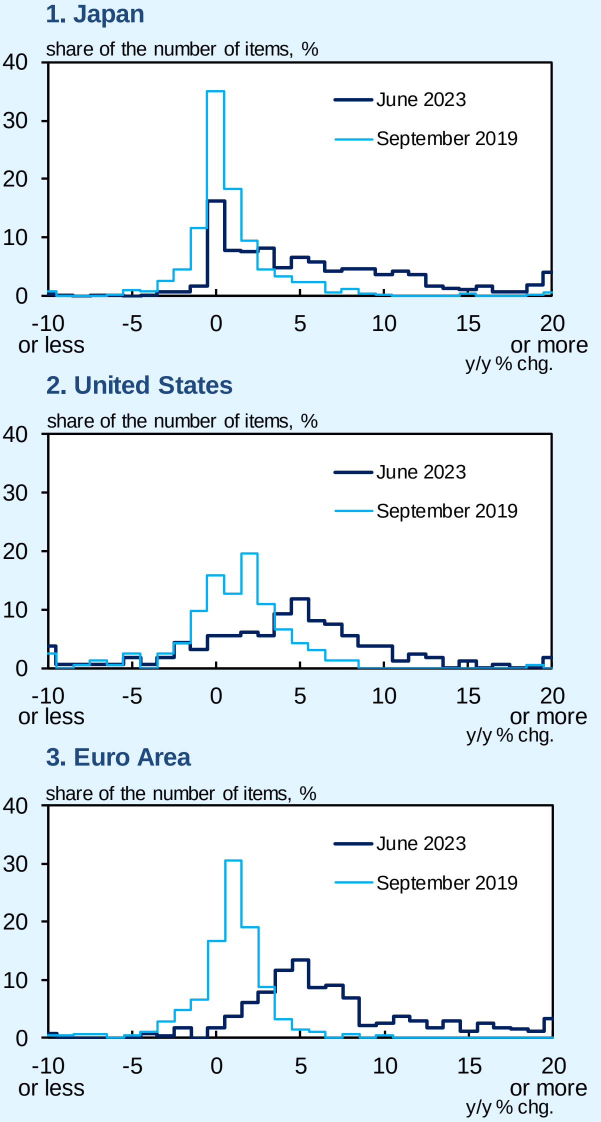
The reason why the peak of the price change distribution for Japan has not shifted, unlike in the United States and Europe, is that, in Japan, price increases have largely been due to upward pressure of costs led by a rise in import prices,

Chart B3-1: Consumer Prices in Japan, the United States, and Europe



Sources: Ministry of Internal Affairs and Communications; BLS; Eurostat.
Note: Figures for Japan are staff estimates based on the CPI (less fresh food and energy) and exclude mobile phone charges and the effects of the consumption tax hike, policies concerning the provision of free education, and travel subsidy programs. Those for the United States and the euro area are for the CPI (less energy).

Chart B3-2: Price Change Distribution (CPI)



Sources: Ministry of Internal Affairs and Communications; BLS; Eurostat.
Note: Figures for Japan are for the CPI (less fresh food and energy). Those for the United States and the euro area are for the CPI (less energy).

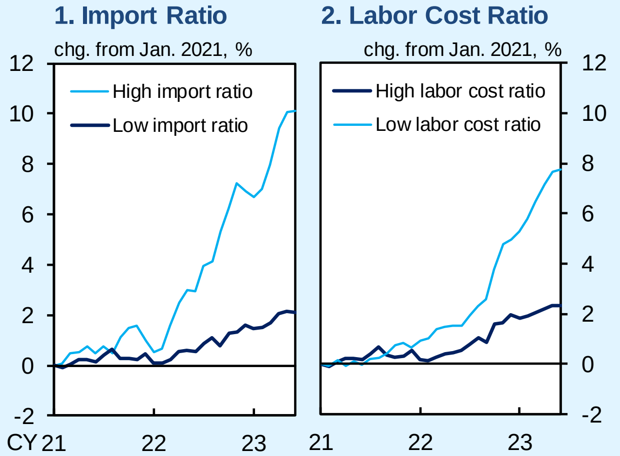
and the rates of increase have been limited for items that are not very susceptible to import prices. In fact, the pace of increase in prices has been relatively slower for CPI items with a low ratio of import costs to total costs (Chart B3-3 [1]). In addition, items with a high ratio of labor costs to total costs have seen a relatively slower increase in their prices (Chart B3-3 [2]).

These are also borne out by developments in the GDP deflator, which measures the change in prices of value-added in the domestic economy and excludes the impact of changes in import prices (Chart B3-4). Decomposing changes in the GDP deflator into changes in labor costs per unit of real GDP (unit labor costs), corporate profits per unit of real GDP (unit profits), and other factors shows that, (1) in the United States, prices have been pushed up by rapidly growing unit labor costs due to large increases in wages, while (2) in Europe, prices have been pushed up by a relatively large increase in unit profits as firms have increased their profit margins.

In Japan, on the other hand, the increase in the GDP deflator has been quite limited compared to the United States and Europe, and increases in unit labor costs and unit profits have not been observed. This suggests that price rises in Japan have been mainly attributable to the upward pressure of costs led by the rise in import prices.

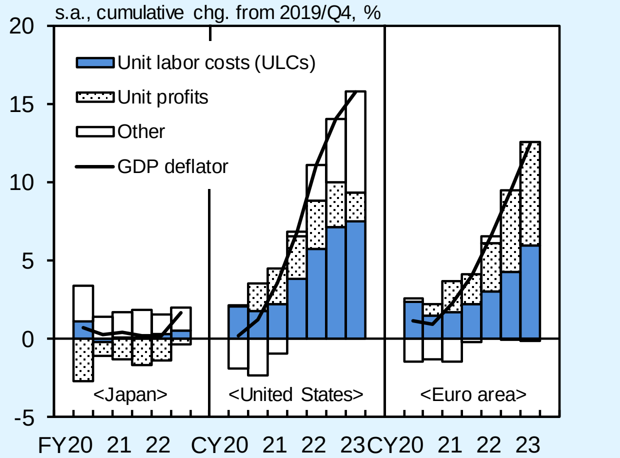
That said, declines in Japan's GDP deflator were observed in past phases of rising import prices, reflecting moves to make up for the accompanying cost increases by restraining

Chart B3-3: CPI by Cost Structure



Source: Ministry of Internal Affairs and Communications.
Notes: 1. Based on staff calculations using the CPI excluding fresh food, energy, mobile phone charges, and imputed rent.
2. CPI items are matched to the items in the *2015 Input-Output Tables for Japan* and grouped in terms of their "total imports coefficient" or the share of "wages and salaries" and other labor costs in the domestic output of those items. Figures in the chart are the weighted averages of the items grouped in the top (bottom) 25 percent.

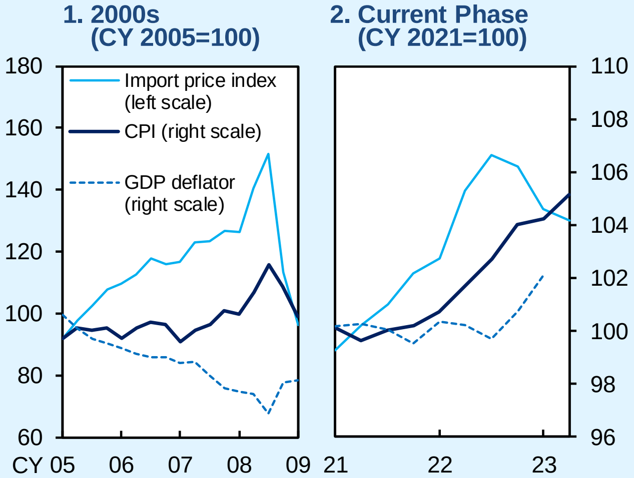
Chart B3-4: GDP Deflators in Japan, the United States, and Europe



Sources: Cabinet Office; BEA; Eurostat.
Note: Figures for the United States and the euro area for the first half of 2023 are those for 2023/Q1.

wages and profits. On the other hand, the GDP deflator has been flat or even rising moderately during the current phase due to progress in the pass-through of cost increases to selling prices, as noted in Box 2 (Chart B3-5). Thus, there are different aspects to Japanese firms' price-setting stance from that in the past and, as seen in this year's annual spring labor-management wage negotiations, firms have been taking a more positive stance in setting wages recently.[21] Going forward, how such factors will affect price developments warrants careful attention.

Chart B3-5: Comparison of Cost Increase Phases



Sources: Bank of Japan; Ministry of Internal Affairs and Communications; Cabinet Office.
Note: Figures for the import price index are on a yen basis. The CPI figures exclude fresh food. Figures for the GDP deflator are seasonally adjusted.

[21] For the linkage between wages and prices, see Box 2 in the April 2023 Outlook Report.