

Outlook for Economic Activity and Prices (January 2019)

The Bank's View¹

Summary

- Japan's economy is likely to continue on an expanding trend throughout the projection period -- that is, through fiscal 2020 -- mainly against the background of highly accommodative financial conditions and the underpinnings through government spending, with overseas economies continuing to grow firmly on the whole, despite being affected by a cyclical slowdown in business fixed investment and the scheduled consumption tax hike.²
 - The year-on-year rate of change in the consumer price index (CPI, all items less fresh food) has been positive but has continued to show relatively weak developments compared to the economic expansion and the labor market tightening. This is mainly attributable to (1) such factors as firms' cautious wage- and price-setting stance not having changed clearly yet in a situation where the mindset and behavior based on the assumption that wages and prices will not increase easily have been deeply entrenched and (2) firms' moves toward raising productivity as well as the technological progress in recent years. While it has been taking time to resolve these factors that have been delaying price rises, medium- to long-term inflation expectations have been more or less unchanged. Nonetheless, with the output gap remaining positive, firms' stance gradually will shift toward further raising wages and prices and households' tolerance of price rises will increase. In this situation, further price rises are likely to be observed widely and then medium- to long-term inflation expectations are projected to rise gradually. As a consequence, the year-on-year rate of change in the CPI is likely to increase gradually toward 2 percent.
 - Comparing the current projections with the previous ones, the projected growth rate for fiscal 2018 is lower, but the projections for fiscal 2019 and 2020 are more or less unchanged. The projected rates of increase in the CPI are lower, mainly for fiscal 2019, due primarily to the decline in crude oil prices.
 - With regard to the risk balance, risks to both economic activity and prices are skewed to the downside. On the price front, the momentum toward achieving the price stability target of 2 percent is maintained but is not yet sufficiently firm, and thus developments in prices continue to warrant careful attention.
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¹ The text of "The Bank's View" -- the outlook for economic activity and prices as well as the Bank's thinking on the conduct of monetary policy, both of which are based on individual Policy Board members' views -- was decided by the Policy Board at the Monetary Policy Meeting held on January 22 and 23, 2019.

² The January 2019 *Outlook for Economic Activity and Prices* (Outlook Report) assumes that the consumption tax will be raised to 10 percent in October 2019 and that a reduced tax rate will be applied to food and beverages -- excluding alcohol and dining-out -- and newspapers.

I. Current Situation of Economic Activity and Prices in Japan

Japan's economy is expanding moderately, with a virtuous cycle from income to spending operating. Overseas economies have continued to grow firmly on the whole. In this situation, exports have been on an increasing trend. On the domestic demand side, business fixed investment has continued on an increasing trend, with corporate profits having been at high levels and business sentiment staying at a favorable level. Private consumption has been increasing moderately, albeit with fluctuations, against the background of steady improvement in the employment and income situation. Meanwhile, housing investment has been more or less flat. Public investment also has been more or less flat, remaining at a relatively high level. Reflecting these increases in demand both at home and abroad, industrial production has been on an increasing trend, and labor market conditions have continued to tighten steadily. Financial conditions are highly accommodative. On the price front, the year-on-year rate of change in the CPI (all items less fresh food, and the same hereafter) is in the range of 0.5-1.0 percent. Inflation expectations have been more or less unchanged.

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

A. Baseline Scenario of the Outlook for Economic Activity

With regard to the outlook, Japan's economy is likely to continue on an expanding trend throughout the projection period -- that is, through fiscal 2020. Overseas economies are expected to continue growing firmly on the whole, with domestic demand in both the advanced and emerging economies remaining firm, although various developments of late warrant attention, such as the trade friction between the United States and China. Under these circumstances, Japan's exports are projected to continue their moderate increasing trend. Domestic demand is likely to follow an uptrend, with a virtuous cycle from income to spending being maintained in both the corporate and household sectors, mainly against the background of highly accommodative financial conditions and the underpinnings through government spending, despite being affected by a cyclical slowdown in business fixed investment and the scheduled consumption tax hike. Business fixed investment -- such as that intended for domestic capacity expansion in line with the economic expansion, that related to urban redevelopment projects, and labor-saving investment to address labor shortage -- is likely to continue increasing amid accommodative financial conditions. Through fiscal 2020, the pace of increase in business fixed investment is projected to decelerate gradually, mainly reflecting cyclical adjustments in capital stock after the prolonged economic expansion, as well as Olympic Games-related demand peaking out; however, fixed investment is likely to maintain an increasing trend, due partly to demand for such investment underpinned by the increase in exports. Private consumption is also expected to follow a moderate increasing trend as

the employment and income situation continues to improve and the government implements countermeasures for the scheduled consumption tax hike in October 2019, although it is likely to be pushed down for some time due to the effects of the hike.³ Meanwhile, public investment is expected to increase reflecting Olympic Games-related demand, the implementation of the supplementary budgets in response to natural disasters, and expansion in expenditure such as for national resilience.

On this basis, Japan's economy is likely to continue growing at about the same pace as its potential.⁴ Comparing the current projections with the previous ones, the projected growth rate for fiscal 2018 is lower, due mainly to the effects of last summer's natural disasters, but the projections for fiscal 2019 and 2020 are more or less unchanged.

Looking at the financial conditions on which the above outlook is based, short- and long-term real interest rates are assumed to be in negative territory throughout the projection period as the Bank pursues "Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control."⁵ Financial institutions' active lending attitudes, as well as favorable conditions for corporate bonds and CP issuance, are both likely to be maintained and support firms' and households' activities from the financial side. Thus, financial conditions are likely to remain highly accommodative.

Meanwhile, the potential growth rate is expected to follow a moderate uptrend throughout the projection period against the backdrop of the following: progress in implementation of the government's growth strategy, including regulatory and institutional reforms; an increase in labor participation by women and seniors under such strategy; and firms' continued efforts toward improving productivity.

B. Baseline Scenario of the Outlook for Prices

The year-on-year rate of change in the CPI has been positive but has continued to show relatively weak developments compared to the economic expansion and the labor market tightening.

This is basically because the mindset and behavior based on the assumption that wages and prices will not increase easily have been deeply entrenched, due mainly to the

³ The consumption tax hike scheduled to take place in October 2019 will affect the GDP growth rates through the following two channels: (1) the front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike and (2) a decline in real income. Although it is subject to uncertainties, the negative impact on the growth rates is expected to be smaller than that on the rate for fiscal 2014, when the last consumption tax hike took place.

⁴ Under a specific methodology, Japan's potential growth rate is estimated to be in the range of 0.5-1.0 percent recently. However, the estimate of the potential growth rate varies depending on the methodologies employed and could be revised as the sample period becomes longer over time. Thus, it should be regarded as being subject to a considerable margin of error.

⁵ Individual Policy Board members make their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding future policy.

experience of prolonged low growth and deflation, and firms' cautious wage- and price-setting stance as well as households' cautiousness toward price rises have not yet clearly changed. In addition, the large room to raise productivity, mainly in the nonmanufacturing sector, the technological progress in recent years, and the high wage elasticity of labor supply among women and seniors have allowed firms to maintain their cautious stance toward raising prices, even amid the economic expansion. Furthermore, such factors as technological progress have further intensified competition in some areas. The continued lackluster developments in administered prices and housing rent also are likely to have affected the sluggishness in prices. It has been taking time to resolve these factors that have been delaying price rises, and the situation likely has continued in which the responsiveness of prices to the output gap, as well as inflation expectations that are strongly affected by the adaptive formation mechanism, do not rise easily. In addition, reflecting the decline in crude oil prices since last autumn, upward pressure of energy prices on the year-on-year rate of change in the CPI has been diminishing recently.

With regard to the outlook, the year-on-year rate of change in the CPI is likely to increase gradually toward 2 percent, mainly on the back of the output gap remaining positive and medium- to long-term inflation expectations rising. Comparing the current projections with the previous ones, the projected rates of increase in the CPI are lower, mainly for fiscal 2019, due primarily to the decline in crude oil prices.⁶

The mechanism through which the year-on-year rate of change in the CPI increases gradually toward 2 percent can be explained by the following factors that determine general price inflation. First, the output gap -- which shows the utilization of labor and capital -- has widened within positive territory on average against the background of the steady tightening of labor market conditions and a rise in capital utilization rates. As for the outlook, it is expected to remain substantially positive. Under such circumstances, further price rises are likely to be observed widely as households' tolerance of price rises increases, mainly reflecting a rise in wage growth rates, and firms' stance shifts toward further raising prices.

Second, medium- to long-term inflation expectations have been more or less unchanged recently. As for the outlook, such expectations are likely to follow an increasing trend and gradually converge to 2 percent on the back of the following: (1) in terms of the adaptive component, a rise in the observed inflation rate is likely to push up inflation expectations,

⁶ Assuming that the rise in the consumption tax will be fully passed on to prices of taxable items, excluding those to which a reduced tax rate will be applied, the effect of the October 2019 consumption tax hike on the year-on-year rate of change in the CPI (all items less fresh food) for October 2019 onward is estimated to be 1.0 percentage point; the effect for fiscal 2019 and fiscal 2020 is estimated to be 0.5 percentage point for each year. In addition, based on a specific assumption using information available at this point, the effects of policies concerning the provision of free education on the year-on-year rate of change in the CPI (all items less fresh food) for fiscal 2019 and fiscal 2020 are estimated to be minus 0.3 percentage point and minus 0.4 percentage point, respectively.

and (2) in terms of the forward-looking component, the Bank will pursue monetary easing through its strong commitment to achieving the price stability target, which will be effective in pushing up inflation expectations.⁷

Third, regarding import prices, the past rise in crude oil prices had pushed up the CPI for fiscal 2018; however, crude oil prices have turned to a decline since last autumn and this is likely to push down the year-on-year rate of change in the CPI for fiscal 2019.

Meanwhile, the recent increase in labor participation by women and seniors, as well as firms' strengthening of efforts to absorb upward pressure of costs on prices by raising productivity, are expected to increase upward pressure on prices in the long term. Specifically, as the growth potential of the economy as a whole rises, reflecting such moves, firms' and households' spending behavior can be expected to become active. In addition, as the natural rate of interest increases together with the rise in the growth potential of Japan's economy, monetary easing effects are likely to be enhanced.

III. Risks to Economic Activity and Prices

A. Risks to Economic Activity

The following four factors are upside and downside risks to the Bank's baseline scenario regarding the economy.

The first is developments in overseas economies. Specifically, the following are considered as risks: the U.S. macroeconomic policies and their impact on global financial markets; the consequences of protectionist moves and their effects; developments in emerging and commodity-exporting economies including the effects of the two aforementioned factors; negotiations on the United Kingdom's exit from the European Union (EU) and their effects; and geopolitical risks. Such downside risks concerning overseas economies are likely to be heightening recently, and it also is necessary to pay close attention to their impact on firms' and households' sentiment in Japan.

The second risk is the effects of the consumption tax hike scheduled to take place in October 2019. These are likely to depend on consumer sentiment, the employment and income situation, and developments in prices.

Third, firms' and households' medium- to long-term growth expectations may be either raised or lowered depending on the following: efforts to address medium- to long-term issues such as the declining birthrate and aging population; developments in regulatory

⁷ Medium- to long-term inflation expectations can be regarded as consisting of two components: a forward-looking component, in which inflation expectations converge to the price stability target set by the central bank, and a backward-looking, or adaptive, component that reflects the observed inflation rate. For details, see the Bank's *Comprehensive Assessment: Developments in Economic Activity and Prices as well as Policy Effects since the Introduction of Quantitative and Qualitative Monetary Easing (QQE)* released in September 2016.

and institutional reforms, particularly in the labor market; innovation in the corporate sector; and the employment and income situation.

Fourth, in the event that confidence in fiscal sustainability in the medium to long term declines, the economy may deviate downward from the baseline scenario through increasing concerns regarding the future and the rises in long-term interest rates associated with them. On the other hand, there is also a possibility that the economy will deviate upward from the baseline scenario if confidence in the path toward fiscal consolidation strengthens and concerns regarding the future are alleviated.

B. Risks to Prices

Other than the effects of risks to economic activity, the specific factors that could exert upside and downside risks to prices are as follows. The first factor is developments in firms' and households' medium- to long-term inflation expectations. Although inflation expectations are likely to follow an increasing trend, there is a risk that a rise in such expectations will be delayed through the adaptive formation mechanism, if it takes longer than projected for firms' stance to shift toward further raising wages and prices and actual inflation consequently remains relatively sluggish.

The second factor is the responsiveness of prices to the output gap. If firms' efforts to absorb upward pressure of costs on prices by raising productivity continue for a long time, or competition among firms intensifies further, due partly to the technological progress in recent years and changes in the distribution system, downward pressure on prices stemming from these factors may last longer than expected. In addition, the lackluster developments in administered prices and housing rent also may continue to constrain the rise in CPI inflation for a long period.

Third, developments in foreign exchange rates and international commodity prices going forward, as well as the extent to which such developments will spread to import prices and domestic prices, may lead prices to deviate either upward or downward from the baseline scenario.

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.⁸

⁸ 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."

The first perspective involves an examination of the baseline scenario for the outlook. The year-on-year rate of change in the CPI is likely to increase gradually toward 2 percent. Although it is necessary to carefully examine the risks to economic activity and prices, the momentum toward achieving the price stability target of 2 percent appears to be maintained. This is because (1) firms' stance is likely to gradually shift toward further raising wages and prices with the output gap remaining positive, and (2) medium- to long-term inflation expectations have been more or less unchanged and are projected to rise gradually as further price rises come to be observed widely.

The second perspective involves an examination of the risks considered most relevant to the conduct of monetary policy. With regard to the outlook for economic activity, risks are skewed to the downside, particularly regarding developments in overseas economies. Regarding the outlook for prices, risks are skewed to the downside, especially concerning developments in medium- to long-term inflation expectations. Examining financial imbalances from a longer-term perspective, there is no sign so far of excessively bullish expectations in asset markets or in the activities of financial institutions. However, prolonged downward pressure on financial institutions' profits, with the low interest rate environment and severe competition among financial institutions continuing, could create risks of a gradual pullback in financial intermediation and of destabilizing the financial system. Although these risks are judged as not significant at this point, mainly because financial institutions have sufficient capital bases, it is necessary to pay close attention to future developments.

As for the conduct of monetary policy, the Bank will continue with "QQE with Yield Curve Control," aiming to achieve the price stability target of 2 percent, as long as it is necessary 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. As for policy rates, the Bank intends to maintain the current extremely low levels of short- and long-term interest rates for an extended period of time, taking into account uncertainties regarding economic activity and prices including the effects of the consumption tax hike scheduled to take place in October 2019. It will examine the risks considered most relevant to the conduct of monetary policy and make policy adjustments as appropriate, taking account of developments in economic activity and prices as well as financial conditions, with a view to maintaining the momentum toward achieving the price stability target.

Forecasts of the Majority of Policy Board Members

y/y % chg.

	Real GDP	CPI (all items less fresh food)	(Reference) Excluding the effects of the consumption tax hike and policies concerning the provision of free education
Fiscal 2018	+0.9 to +1.0 [+0.9]	+0.8 to +0.9 [+0.8]	
Forecasts made in October 2018	+1.3 to +1.5 [+1.4]	+0.9 to +1.0 [+0.9]	
Fiscal 2019	+0.7 to +1.0 [+0.9]	+1.0 to +1.3 [+1.1]	+0.8 to +1.1 [+0.9]
Forecasts made in October 2018	+0.8 to +0.9 [+0.8]	+1.5 to +1.7 [+1.6]	+1.3 to +1.5 [+1.4]
Fiscal 2020	+0.7 to +1.0 [+1.0]	+1.3 to +1.5 [+1.5]	+1.2 to +1.4 [+1.4]
Forecasts made in October 2018	+0.6 to +0.9 [+0.8]	+1.5 to +1.7 [+1.6]	+1.4 to +1.6 [+1.5]

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

2. The forecasts of the majority of the Policy Board members are constructed as follows: each Policy Board member's forecast takes the form of a point estimate -- namely, the figure to which he or she attaches the highest probability of realization. These forecasts are then shown as a range, with the highest figure and the lowest figure excluded. The range does not indicate the forecast errors.
3. Individual Policy Board members make their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding future policy.
4. The forecasts assume the following: (1) the consumption tax will be raised to 10 percent in October 2019 and a reduced tax rate will be applied to food and beverages -- excluding alcohol and dining out -- and newspapers, and (2) with regard to policies concerning the provision of free education, free early childhood education and such measures as free higher education will be introduced in October 2019 and April 2020, respectively. Assuming that the rise in the consumption tax will be fully passed on to prices of taxable items, the direct effect of the tax hike on the CPI for fiscal 2019 and fiscal 2020 is estimated to be 0.5 percentage point for each year. In addition, based on a specific assumption using information available at this point, the direct effects of policies concerning the provision of free education on the CPI for fiscal 2019 and fiscal 2020 are estimated to be minus 0.3 percentage point and minus 0.4 percentage point, respectively.

