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May 1, 2007
Bank of Japan

Outlook for Economic Activity and Prices

April 2007

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

[The Bank's View][1]

(Outlook for Economic Activity and Prices)

Japan's economy is expanding moderately. Economic activity in fiscal 2006 seems to have been generally in line with the projection in the October 2006 *Outlook for Economic Activity and Prices* (hereafter the Outlook Report), although the pace of improvement in the household sector has been somewhat slow relative to the strength in the corporate sector.[2]

From fiscal 2007 through fiscal 2008, the economy is likely to continue its sustained expansion with a virtuous circle of production, income, and spending in place. The year-on-year rate of growth in real GDP is likely to register around 2 percent, somewhat higher than the potential growth rate, for both fiscal 2007 and fiscal 2008.

The outlook rests on the following underlying assumptions and mechanisms. First, exports are likely to remain on the increase, reflecting the continuing expansion of overseas economies. The U.S. economy is likely to realize a soft landing, moving onto a sustainable growth path, although the pace of economic growth has recently been decelerating due mainly to ongoing adjustments in the housing market. Taken as a whole, overseas economies are expected to keep expanding, with momentum being gained across a wide range of economies. Second, strong corporate performance is likely to continue. With corporate profits continuing to be high, business fixed investment is likely to keep rising. However, in view of the capital stock cycle, the rate of growth in business fixed investment will likely fall gradually, since firms continue to be strict in their evaluation of investment profitability. Third, it is expected that the positive influence of the strength in the corporate sector will continue to feed through into the household sector slowly but steadily. Although firms, attentive to global competition and their greater exposure to the discipline of the capital market, are expected to continue to restrain labor costs, it is assumed that upward pressure on wages will increase gradually as labor market conditions

[1] The text of "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on April 27, 2007.

[2] The year-on-year growth rate for fiscal 2006 was pushed down by 0.3 percentage point due to a lower carry-over effect from fiscal 2005, as a result of the annual revision of the GDP data for fiscal 2005, which took place in December 2006.

tighten further through increases in the number of employees. In addition, strength in the corporate sector should filter through into the household sector via various other channels, for example, increased dividends. Against this backdrop, private consumption is likely to follow a moderate upward trend. And fourth, the extremely accommodative financial conditions are likely to continue to support private demand. The lending attitude of financial institutions has been positive, and the level of short-term interest rates has been very low relative to economic activity and price conditions.

Given this economic outlook, the environment surrounding prices can be summarized as follows. First, a higher level of resource utilization, namely in production capacity and labor, is being observed, and this is likely to rise further going forward. Estimates of the output gap suggest that supply and demand conditions will continue to tighten. Second, unit labor costs (labor costs per unit of output), although currently still declining, are likely to stop falling and start showing modest increases, reflecting gradual rises in wages. And third, the results of various surveys suggest that although inflation expectations in the private sector have shifted down due mainly to past falls in the prices of petroleum products, prices in general are still expected to increase moderately.

Looking at indices for inflation, the domestic corporate goods price index (CGPI) in fiscal 2006 was somewhat lower than the previous projection in October, reflecting declines in international commodity prices. As for the outlook, the CGPI is likely to maintain its upward trend, although this will be subject to future developments in prices of crude oil and other commodities as well as foreign exchange rates.

Movements in the consumer price index (CPI, excluding fresh food) are currently somewhat weaker than previously projected, mainly due to the fall in crude oil prices. Going forward, the year-on-year rate of change in the CPI is likely to be around 0 percent in the short run depending on developments in crude oil prices, but is expected gradually to rise in the longer run. To be specific, the rate of increase is projected to be slightly above 0 percent in fiscal 2007 and around 0.5 percent in fiscal 2008.

(Positive and Negative Deviations)

The outlook described above is the most likely projection based on the underlying assumptions and mechanisms mentioned earlier. It should be noted that the outlook is subject to the following upside and downside risks.

The first risk concerns developments in the global economy. In the United States, ongoing adjustments in the housing market have not so far spilled over into the wider economy, as evidenced by continued firmness in private consumption. Business fixed investment is expected to maintain its gradual upward trend reflecting the high corporate profits, although some leading indicators have been weak recently. However, if adjustments in the housing market turn out to be greater than expected or business fixed investment weakens, this may cause growth to decelerate further. With regard to the U.S. price situation, as a result of higher resource utilization, namely in production capacity and labor, as well as other factors such as developments in crude oil prices, it is possible that inflationary pressures may not subside. In such a case, there is a risk that, for instance, the reaction of financial markets to this situation could adversely affect the U.S. and global economies. In China, the economy continues to expand strongly, and it is possible that the growth rate may exceed expectations during the projection period depending on developments in fixed asset investments and exports. The global economy may also be influenced by international commodity prices, such as crude oil prices, depending on how these develop.

The second risk concerns supply and demand conditions for IT-related goods. Recent rises in inventories of IT-related goods in Japan seem to have resulted mainly from specific factors concerning products for the domestic market. Demand for IT-related goods, on a global basis, seems set to remain on a steady upward trend. However, if expected global demand is revised significantly downward in response to, for instance, deceleration in the global economy, supply and demand conditions may deteriorate, since the pace of increase in the global supply of IT-related goods has been rapid. Even in such a case, however, enhanced strength in the Japanese corporate sector, namely improvements in corporate profitability and firms' financial positions, may act as a cushion minimizing the impact on the overall economy.

The third risk concerns possible larger swings in financial and economic activity based on optimistic assumptions regarding, for example, financial conditions. Japan's current economic circumstances are such as potentially to encourage assertive financial and economic activity, with the financial positions of both firms and financial institutions improving and real interest rates remaining very low. Moreover, recent developments in asset prices, as seen in the increasingly distinct upward trend for land prices in major cities, may also cause such activity to accelerate. In this situation, if greater assertiveness should be based on optimistic assumptions regarding future profitability, such as favorable assumptions concerning the expected growth rate, financing costs, foreign exchange rates, and asset prices, the result could well be a misallocation of resources in the long run as agents become over-extended in financial markets or pour funds and other resources into inefficient economic activities. Such behavior may push up economic growth and asset prices in the short run, but may lead to later downward adjustments and hamper the sustainability of economic growth.

Turning to the outlook for the inflation rate, it should be noted that there are uncertainties that could cause the rate to deviate either upward or downward from the projection. First, the sensitivity of prices to changes in the output gap seems to have declined due to factors such as the progress of economic globalization and deregulation, but the degree of decline is uncertain. In particular, if, despite continued economic expansion, wage growth were to remain low relative to the pace of productivity gains, downward pressure on prices would be expected to persist. On the other hand, greater upward pressure on prices is also a possibility if there is a significant change in inflation expectations or labor cost restraint by firms, following further, even moderate, increases in the utilization of resources such as production capacity and labor. And second, given factors such as geopolitical risks, considerable uncertainty surrounds developments in the prices of crude oil and other commodities, leaving the potential for movement in either direction.

(Conduct of Monetary Policy)

The Bank assesses the economic and price situation from two perspectives and then outlines its thinking on the future conduct of monetary policy, taking account of the "understanding of medium- to long-term price stability" (the level of inflation that each member of the

Policy Board understands, when conducting monetary policy, as being consistent with price stability over the medium to long term) (hereafter "understanding").

The "understanding" expressed in terms of the year-on-year rate of change in the CPI, takes the form of a range approximately between 0 and 2 percent, with most Policy Board members' median figures falling on one side or the other of 1 percent (see the Box).

The first perspective involves assessing the most likely outlook for economic activity and prices through fiscal 2008 with reference to the view of market participants regarding the future course of the policy interest rate -- a view that is incorporated in market interest rates. Examined from this perspective, Japan's economy is likely to continue its sustained expansion with a virtuous circle of production, income, and spending in place, as described earlier. The year-on-year rate of change in the CPI (excluding fresh food) is likely to be around 0 percent in the short run, but is expected gradually to rise in the longer run. Such developments can be regarded in line with the "understanding." In sum, Japan's economy is likely to realize sustainable growth under price stability.

The second perspective extends the time horizon and assesses the risks considered most relevant to the conduct of monetary policy, taking account of the cost incurred should risks materialize, even though the probability of such materialization may be low. From this perspective, it appears that, with the improved prospects for economic activity and prices, the stimulative effect of monetary policy may be further amplified. If, for instance, the expectation takes hold that interest rates will remain low for a long time regardless of developments in economic activity and prices, there is a medium- to long-term risk of larger swings and of inefficient allocation of resources as firms and financial institutions over-extend themselves. On the other hand, if the downside risks mentioned earlier should materialize, the improvement in the economic situation may stall. It is also possible that prices will continue not to rise despite the improvement in economic conditions. Nevertheless, the risk of the economy falling into a vicious circle of declining prices and deteriorating economic activity seems to have further decreased, since the strength of the corporate sector and robustness of the financial system have been enhanced.

Regarding the conduct of monetary policy since the termination of the quantitative easing policy in March 2006, the Bank has been gradually adjusting the level of interest rates in the light of developments in economic activity and prices. Adjustments were made in view of the outlook for the economy and prices, with the Bank judging that sustained economic growth would continue with a virtuous circle of production, income, and spending in place, and that consumer prices would be likely to increase moderately in the long run in line with the "understanding." With inflationary pressures weak, the pace of adjustment has been slow and the accommodative financial conditions ensuing from very low interest rates have been maintained. The Bank's basic thinking in this regard will remain the same in the conduct of future monetary policy. In sum, while confirming that the Japanese economy remains likely to follow a path of sustainable growth under price stability in light of the "understanding" and assessing relevant risk factors, the Bank will adjust the level of interest rates gradually in accordance with improvements in the economic and price situation.

(Box) Review of the "Understanding of Medium- to Long-Term Price Stability"

In March 2006, the Bank announced, in the publication of "The Bank's Thinking on Price Stability," that the "understanding of medium- to long-term price stability" (the level of inflation that each member of the Policy Board understands, when conducting monetary policy, as being consistent with price stability over the medium to long term) (hereafter "understanding") will be, in principle, reviewed annually. Since about a year has now passed since this announcement, a review has been conducted.

The results can be summarized in the three points given below.

1. Reaffirmation of the Bank's Basic Thinking on Price Stability

The basic understanding stated in "The Bank's Thinking on Price Stability" was reaffirmed as follows:

(1) Price stability is a state where various economic agents including households and firms may make decisions regarding such economic activities as consumption and investment without being concerned about the fluctuations in the general price level.

(2) Given that the effects of monetary policy take time to work through the economy and that the volatility of output may actually be amplified when attempts are made to absorb every short-term change in prices resulting from various shocks, the Bank should forecast developments in economic activity and prices from a sufficiently long-term viewpoint and strive to realize price stability over the medium to long term.

2. Points Considered in the Review of the "Understanding"

In examining the "understanding," the following points were considered: (1) measurement bias in the CPI; (2) the "safety margin" that acts as a buffer against the risk of falling into a vicious circle of declining prices and deteriorating economic activity; and (3) the level of inflation perceived by households and firms as consistent with price stability. As for the first point, it was judged that measurement bias remains insignificant even after taking account of last year's rebasing of the index. Regarding the second point, the "safety margin," the risk of the economy falling into a vicious circle of declining prices and deteriorating economic activity seems to have further decreased, since the strength of the corporate sector and robustness of the financial system have been enhanced. Finally, on the third point, the level of inflation perceived by households and firms as consistent with price stability is unlikely to have changed much, since changes in the inflation rate have been small.

3. Results of the Review of the "Understanding"

Based on the above considerations, it was agreed that the "understanding" should be expressed as follows:

> The "understanding," expressed in terms of the year-on-year rate of change in the CPI, takes the form of a range approximately between 0 and 2 percent, with most Policy Board members' median figures falling on one side or the other of 1 percent.

Forecasts of the Majority of Policy Board Members[3] and Actuals for Fiscal 2006

y/y % chg.

	Real GDP	Domestic CGPI	CPI (excluding fresh food)
Forecasts made in October 2006	+2.3 to +2.5 [+2.4]	+2.9 to +3.5 [+3.0]	+0.2 to +0.3 [+0.3]
Actual	+2.1	+2.8	+0.1

Forecasts of the Majority of Policy Board Members[3,4] for Fiscal 2007 and Fiscal 2008

y/y % chg.

	Real GDP	Domestic CGPI	CPI (excluding fresh food)
Fiscal 2007	+2.0 to +2.1 [+2.1]	+0.7 to +0.8 [+0.7]	0.0 to +0.2 [+0.1]
Forecasts made in October 2006	+1.9 to +2.4 [+2.1]	+1.1 to +1.5 [+1.2]	+0.4 to +0.5 [+0.5]
Fiscal 2008	+2.0 to +2.3 [+2.1]	+0.8 to +1.0 [+1.0]	+0.4 to +0.6 [+0.5]

Notes: 1. Figures in brackets indicate forecast medians.

2. "Actual" real GDP for fiscal 2006 is calculated on the assumption that real GDP in the first quarter of 2007 equals that in the fourth quarter of 2006.

3. Individual Policy Board members make the above forecasts with reference to the view of market participants regarding the future course of the policy interest rate -- a view that is incorporated in market interest rates.

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[3] The forecasts of the majority of 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. These forecasts are then shown as a range, with the highest and lowest figures excluded. It should be noted that the range does not indicate the forecast errors.

[4] The forecasts of all Policy Board members may be summarized as follows.

y/y % chg.

	Real GDP	Domestic CGPI	CPI (excluding fresh food)
Fiscal 2007	+1.9 to +2.5	+0.5 to +1.5	-0.1 to +0.2
Forecasts made in October 2006	+1.8 to +2.6	+1.0 to +1.7	+0.4 to +0.6
Fiscal 2008	+1.9 to +2.4	+0.7 to +1.2	+0.3 to +0.6

[The Background]

1. Economic Activity, Prices, and Monetary and Financial Developments

(Economic Activity and Prices in Fiscal 2006)

Japan's economy continued to expand moderately in fiscal 2006, with a virtuous circle of production, income, and spending in operation (Chart 1).[5] Real GDP growth for fiscal 2006 should turn out to be around 2 percent. This means that, in the four years since fiscal 2003, the economy will have been growing at around 2 percent, somewhat higher than the potential growth rate.[6]

Against the background of continuing expansion of overseas economies overall, exports continued to increase to a broader range of destinations, although those to the United States weakened somewhat in the second half of 2006 (Charts 2 and 3). Corporate profits recorded their fifth consecutive year of growth since fiscal 2002. Large manufacturers in particular made successive upward revisions to their profit estimates mainly due to growth in exports accompanied by the weaker yen (Chart 4). In this situation, business sentiment generally remained favorable, and business fixed investment continued to increase (Charts 5 and 6). Although growth in business fixed investment was becoming evident in a wider range of industries against the background of the prolonged economic expansion, the main contributors were manufacturers responding to higher global demand or international competition. Industrial production overall was on an upward trend on the back of continued increases in demand at home and abroad, although there was adjustment in production of electronic parts and devices toward the fiscal year-end (Chart 7).

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[5] According to Indexes of Business Conditions (Composite Indexes), the coincident index continues to show an improving trend, reflecting the sustained economic expansion. Based on the Cabinet Office's reference dates for business cycles, in November 2006 the duration of the current economic expansion seems to have exceeded that of the Izanagi boom (57 months during 1965-70) which until then had been the longest postwar phase of economic expansion.

[6] The Bank's estimate of the current potential growth rate is around 1.5 percent or somewhat higher, having risen moderately from a level of approximately 1 percent in fiscal 2003 through fiscal 2004. It should be noted, however, that these estimates of the potential growth rate and the output gap (the difference between actual GDP and potential output), which will be described later, need to be treated as approximations.

The positive influence of the strength in the corporate sector continued to feed through into the household sector slowly but steadily. Employee income stayed on a moderate upward trend, supported by increases in the number of employees (Chart 8).[7] In addition, high corporate profits also enhanced households' income through increased property income, such as dividends (Chart 9). The breakdown for nominal wages per worker indicated that although overtime payments and special payments maintained their increasing trend, regular payments were somewhat weak (Chart 8[2]). While the main factor behind the weakness was labor cost restraint by firms becoming more attentive to global competition, the effects from the retirement of baby-boomers, whose wage levels are relatively high, and a reduction in salaries of local government employees also played a part.[8] Growth in private consumption stalled temporarily due mainly to unfavorable weather conditions and consumers' reluctance to buy before the introduction of new products, but recently it resumed its upward movement. In fiscal 2006 as a whole, private consumption, mainly in outlays for services and durable consumer goods such as electrical appliances, remained on a moderate upward trend (Chart 10). Housing investment also increased moderately, albeit with some fluctuations.

With the continuing moderate economic expansion, resource utilization, namely in production capacity and labor, rose steadily (Chart 11). The *Tankan* (Short-Term Economic Survey of Enterprises in Japan) indicated that firms are facing the strongest constraints in terms of production capacity and employment levels in more than a decade, and estimates of the output gap indicated tighter supply and demand conditions.[9]

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[7] The Bank conducts research and analysis on regional economic conditions at its branches, and releases its assessment in the "Regional Economic Report" each quarter. The April 2007 Regional Economic Report provides the results of the Bank's detailed research on the employment and wage situation in each region. For a brief summary of the assessment of recent regional economic conditions, please refer to the Reference attached.

[8] Looking at the breakdown of government expenditure, compensation of employees, which represents salaries of government employees, can be seen to have declined for four consecutive years up to fiscal 2005 (the most recent year for which data are available). Moreover, according to the "Fact-finding Survey on Compensation of Local Government Employees" conducted by Ministry of Internal Affairs and Communications, the average monthly salaries of local government employees continued to show a year-on-year decline in fiscal 2006.

[9] The *Tankan* composite indicator is a weighted average of the diffusion indices of production capacity and employment conditions, where indices are weighted by capital and labor income shares

As for price developments, with resource utilization rising, the CGPI posted an annual increase of slightly below 3 percent in fiscal 2006 (Chart 12). This was partly influenced by higher prices of international commodities such as crude oil. More precisely, following the volatility in international commodity prices, the year-on-year growth of the CGPI accelerated in the first half of fiscal 2006 and then decelerated in the second half (Chart 13). The year-on-year rate of change in the CPI (excluding fresh food) indicated a positive trend. However, impacted, for instance, by changes in the prices of petroleum products, the rate of increase in the CPI edged up toward the summer and then declined to around 0 percent toward the fiscal year-end (Chart 14).

The overall picture of economic activity in fiscal 2006 was generally in line with the projection in the October 2006 Outlook Report, which envisaged that the economy would continue to expand at a pace somewhat higher than the potential growth rate. A closer look suggests, however, that developments in the corporate sector, mainly in corporate profits and business fixed investment, were strong, while the pace of improvement in the household sector in terms of wages and private consumption was relatively slow. Upward deviation of corporate profits and business fixed investment was attributable to vigor in the corporate sector led by increased exports in the manufacturing sector, which was supported by robust growth in overseas economies as economic globalization progressed. Meanwhile, wage growth was relatively weak due to factors such as persistent labor cost restraint by firms attentive to intensifying global competition, and this, coupled with adverse weather conditions and other temporary factors, pushed down private consumption, causing some downward deviation.

With regard to the price situation, both the CGPI and the CPI were somewhat lower than projected, mainly due to a drop in prices of international commodities such as crude oil. The downward deviation of the CPI was also influenced by wage growth and economic activity by households, such as private consumption, which were both somewhat weaker

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in the national accounts. The composite indicator showed that excesses in production capacity and employment levels had been dispelled by September 2005 and recent figures indicate increasing shortages (Chart 11[3]). Estimation of the GDP gap also indicated that operating levels have been higher than their historical averages in past economic cycles, and that the gap has been positive and expanding gradually, although these estimates are subject to a certain margin of error.

than expected.

(Outlook for Economic Activity in Fiscal 2007 and 2008)

From fiscal 2007 through fiscal 2008, Japan's economy is likely to continue its sustained expansion with domestic and external demand increasing and the positive influence of the strength in the corporate sector feeding through into the household sector slowly but steadily. The year-on-year rate of growth in real GDP is likely to continue to register around 2 percent, somewhat higher than the potential growth rate. The underlying mechanism for economic expansion is generally unchanged: although fiscal reform is likely to continue to exert downward pressure on economic activity, a virtuous circle operating between production, income, and spending is likely to be sustained on the back of generally favorable developments in overseas economies and the extremely accommodative financial environment in Japan.

In the corporate sector, business fixed investment should maintain its upward trend as exports are likely to continue rising and corporate profits remain high. Firms' business prospects and their plans for fiscal 2007, as indicated in the March *Tankan*, support this view: firms expect ratios of current profits to sales to post another historical high, as in fiscal 2006; meanwhile, their business fixed investment plans for fiscal 2007 are strong for initial estimates, anticipating relatively high investment growth in line with that in fiscal 2006 (Charts 4 and 6). The following economic situation is expected to remain basically unchanged in and after fiscal 2007: in the light of the ongoing progress of globalization, firms, mainly manufacturers, are seeking to reinforce their capacity to supply goods and services by raising investment in plant and equipment. In addition, increased corporate activity stimulated by growth in exports coupled with the accommodative financial conditions should help facilitate business fixed investment by nonmanufacturers. However, in view of the capital stock cycle, growth in business fixed investment will likely decelerate gradually as the economic expansion becomes more prolonged (Chart 15).

As for the household sector, with the strength in the corporate sector gradually translating into increased employee income, household spending should follow a moderate upward trend. Firms, attentive to global competition, are expected to continue to restrain wages.

The rate of growth in wages, however, is likely to increase gradually, as labor market conditions tighten with the lengthening of the economic expansion (Chart 16). In addition, high corporate profits should also contribute to the improvement of households' income in the form of increases in property income such as dividends (Chart 9). As a result, the growth rate of disposable income is likely to increase gradually, albeit moderately, even taking into account such factors as the abolition of the across-the-board income tax credits. In this situation, household spending is expected to follow a more solid increasing trend.

Considering these economic developments in terms of the IS balance, net exports (i.e., the current account surplus) are likely to keep increasing, mainly reflecting continuing high growth in overseas economies (Chart 17[1]). Looking at the internal balance, net saving in the domestic private sector should continue to decrease due mainly to the higher propensity of firms to invest as a result of the growth in exports. However, since fiscal reform is likely to achieve a decline in the fiscal deficit that exceeds the decrease in net saving in the domestic private sector, Japan's overall net saving (also equivalent to its current account surplus) should continue to expand moderately. Regarding Japan's balance of payments, the upward trend in the income balance is likely to be maintained due to increases in income from abroad such as interest income and dividend income, and this should increase corporate profits and households' property income, thereby enhancing growth in income and spending in the private sector (Chart 17[2]).

(Outlook for Prices in Fiscal 2007 and Fiscal 2008)

Looking at the environment surrounding future price developments, the utilization of resources such as production capacity and labor is likely to increase steadily because economic growth is expected to continue at a rate of around 2 percent, somewhat higher than the potential growth rate. The pace of the year-on-year decline in unit labor costs (labor costs per unit of output) is decelerating only very slowly, since wages per worker have remained almost flat reflecting factors such as labor cost restraint by firms (Chart 18[1]).[10] Looking forward, however, unit labor costs are likely to stop falling and start

[10] Among consumer prices, services prices have been flat for many years partly because the year-on-year rate of change in average hourly earnings in service-related industries has been around 0 percent on average (Chart 18[2]). The low CPI growth in Japan relative to that in the United States and Europe is mainly attributable to the difference in the rate of increase in services prices

showing modest increases, reflecting gradually increasing upward pressure on wages arising from tighter labor market conditions as the economic expansion becomes more prolonged.

Although such upward pressure on prices may to some extent be offset by intensified competition due to the progress of economic globalization, deregulation, and other factors, prices are expected to display a more definite upward trend. Survey results suggest that although inflation expectations in the private sector have shifted down due mainly to past falls in the prices of petroleum products, prices in general are still expected to increase moderately (Chart 19).

Based on the assessment above, it is likely that the year-on-year rate of change in the CGPI for fiscal 2007 and 2008 will be slightly below 1 percent, lower than in fiscal 2006 when rises in prices of international commodities such as crude oil pushed up the CGPI. The year-on-year rate of change in the CPI (excluding fresh food) is likely to be around 0 percent in the short run depending on developments in crude oil prices, but is expected gradually to rise in the longer run. To be specific, the rate of increase is projected to be slightly above 0 percent in fiscal 2007 and around 0.5 percent in fiscal 2008.

(Developments in Monetary Aggregates)

Regarding credit supply, the lending attitude of financial institutions has been positive as their risk-taking capacity has increased as a result of the easing of capital constraints. The issuing environment for CP and corporate bonds has been favorable. Such accommodative financial conditions are likely to be maintained (Chart 20). With regard to the demand for credit, firms' demand for external funds is increasing to cover the financing needed to accommodate dividend payments and stock buybacks, in addition to operating funds and fixed investment, although their cash flow remains at high levels on the back of high corporate profits. The upward trend in credit demand should continue and the year-on-year rate of change in the amount outstanding of lending by private banks is likely to remain positive going forward, as the economic expansion is sustained (Chart 21[1]).

The growth rate of the money stock (M_2+CDs) has recently been rising moderately, and the

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(Chart 18[3] and [4]).

year-on-year change is now at around 1 percent. The year-on-year rate of change in broadly-defined liquidity, which includes investment trusts and Japanese government bonds in addition to the money stock, has been slightly over 2 percent (Chart 21[2]). The recent moderate recovery in the growth of the money stock seems to be attributable to a slowdown in the shift of funds by households and firms from bank deposits to financial assets not included in the money stock, such as investment trusts and Japanese government bonds. Looking forward, however, if the stability of the financial system proves conductive to further diversification of financial assets, this may be expected to exert downward pressure on the growth of the money stock. Given this, the growth rate of the money stock is unlikely to accelerate markedly in the near future. However, taking underlying factors into consideration, these developments in the money stock seem compatible with sustainable economic growth under price stability.

2. Examining the Mechanism of Changes in Economic Activity and Prices

(Environment Surrounding Exports)

An important factor that underpins the virtuous circle of production, income, and spending is that Japan's exports remain on the increase against the background of the expansion of overseas economies (Chart 16[3]). Recent developments in Japan's exports show that goods in which Japanese firms have a competitive edge, particularly capital goods and automobiles, have been exported to an increasing number of countries. As a result, exports as a whole continue to increase steadily despite somewhat weak developments in exports to the United States (Chart 3). The outlook for economic activity and prices in this Outlook Report is based on the following view regarding overseas economies: although the pace of growth in the U.S. economy has been decelerating recently, the economy is likely to realize a soft landing and to move onto a sustainable growth path; and overseas economies as a whole are expected to keep expanding, with momentum being gained across a wide range of economies.[11] With these generally favorable developments in overseas economies coupled with the lagged effects of the lower yen in terms of the real effective

[11] These views are broadly shared by international organizations and private research institutes. For example, the *World Economic Outlook* released in April 2007 by the International Monetary Fund (IMF) forecasts that the global economy will expand strongly in 2007 and 2008, at a rate similar to the growth of about 5 percent recorded in the three years from 2004 to 2006.

exchange rate, Japan's exports are likely to continue to rise (Chart 22).

There are, however, some risks concerning developments in overseas economies. In China, the economy continues to expand strongly, and it is possible that the growth rate may exceed expectations depending on developments in fixed asset investments and exports in the run-up to the 2008 Olympic Games in Beijing. On the other hand, in the United States, in addition to somewhat growing uncertainty regarding developments in the housing market, some leading indicators for business fixed investment have been weak. So far, adjustments in the housing market have not spilled over into the wider economy as evidenced by continued firmness in private consumption. Business fixed investment is also expected to maintain its gradual upward trend, reflecting high corporate profits. However, if adjustments in the housing market turn out to be greater than expected or business fixed investment weakens, this may cause growth rates to decelerate further. With regard to the U.S. price situation, given that utilization of resources such as production capacity and labor remains high, inflation pressures may not subside, although much depends on developments in the prices of international commodities such as crude oil. If inflation pressures do not subside, there is a risk that, for instance, the reaction of financial markets could adversely affect the global economy.

Japan's exports will be considerably influenced by global supply and demand conditions for IT-related goods (Chart 23). Global demand for IT-related goods has so far been on a steady upward trend due partly to the rapid growth in emerging economies, such as the BRIC economies. However, the pace of increase in the global supply of IT-related goods has been rapid, and thus if downside risks to the outlook of the U.S. economy materialize, supply and demand conditions may deteriorate and Japan's exports may face downward pressure.[12] Potentially lower growth in exports risks sparking extensive production adjustments in the IT-related sector, since the domestic balance of inventories and shipments for electronic parts, particularly those related to cellular phones, has recently been slow to show improvement.

[12] There may be a risk that the global supply-demand balance of IT-related goods may be disturbed, for example, by the 2008 Olympic Games in Beijing. Demand for IT-related goods, particularly digital appliances, could surge before and plunge after the Olympic Games.

These developments in economies abroad and in supply and demand conditions for IT-related goods, coupled with developments in the yen exchange rate, may cause Japanese exports and production to deviate either upward or downward from their expected trajectory. Japanese business fixed investment may also be affected, as firms are factoring expanding external demand into their investment plans.

(Firms' Spending Behavior in the Globalized Economy)

The strong business fixed investment continues to be led by the manufacturing sector, although the nonmanufacturing sector has also started to step up its fixed investment (Chart 6). The acceleration in business fixed investment reflects the fact that, in the light of the ongoing progress of globalization, firms, mainly manufacturers, are seeking to reinforce their capacity to supply goods and services by raising investment in plant and equipment as they look to take advantage of profit opportunities in overseas markets (Chart 24). Firms, enjoying higher profits, have also become more inclined to return these profits to shareholders by increasing dividends or via stock buybacks (Charts 25 and 26). Such corporate behavior may be interpreted as meaning that firms, amid intensifying global competition and greater exposure to the discipline of the capital market, are becoming more concerned with increasing corporate value, minimizing labor costs as well as selling, general and administrative expenses while at the same time carrying out necessary investments and returning profits to shareholders.[13,14]

Since firms are very careful in choosing their investment projects, business fixed investment

[13] The ratio of fixed costs, such as labor costs, to sales tends to decline in a phase of economic recovery. In the current phase, the decline in the ratio has been considerably faster than in the past (Chart 25[1]). The rate of decline seems to have been affected by firms' greater exposure to the discipline of the capital market and by intensifying global competition. This observation is supported by analysis using the real wage gap, which is the rate of deviation of real wages from labor productivity. In industries with a larger negative real wage gap, the ratio of foreign shareholdings and the export ratio tend to be higher (Chart 26[1] and [2]). This suggests that the greater the exposure to the discipline of the capital market and to global competition, the stronger the restraint on wages.

[14] Increases in dividends and stock buybacks by firms are partly due to the accommodative financial conditions. With very low interest rates, if firms seek to further reduce their interest-bearing debts so as to lower their ratios of liabilities to capital then the cost of capital will increase. To avoid this firms are prompted to increase dividends and to buy back their own stocks.

as a whole has, despite recent acceleration, generally been kept within cash flow and the pace of increase in capital stock is moderate (Chart 6). Although the uptrend in business fixed investment is likely to continue, it is probable that firms will, based on careful evaluation of investment profitability, slow the pace of increase in their fixed investment as the growth in capital stock gradually accelerates.

However, given the extremely accommodative financial conditions, firms may further accelerate investment based on optimistic assumptions regarding future profitability, such as favorable expectations regarding the growth rate, financing costs, foreign exchange rates, and asset prices. An upturn in land prices has been more widely observed, particularly in major cities, and the pace of increase has been accelerating in some areas. These developments in asset prices may also cause private demand, including business fixed investment, to accelerate.

(The Employment and Income Situation and Households' Spending Behavior)

In the current expansion phase, which is characterized by the need to adjust to economic globalization, there exist structural factors acting to restrain wage growth.[15] Specifically, on the management side, greater attention to global competition has encouraged continued labor cost restraint; meanwhile, on the employee side, the rise of emerging economies with their significantly lower wage levels and past experience of a severe employment situation have tended to produce a preference for stable employment over wage increases (Chart 26).[16] Developments in fiscal reform, such as reductions both in public investment, generally a powerful stimulant for the labor-intensive nonmanufacturing sector, and in the salaries of local government employees, are also acting to constrain households' income. This situation is expected to continue for some time.

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[15] The actual increases in employee income in recent years have been significantly lower than the estimated increases in employee income induced from the increases in demand (Chart 16[3]). This may be due to the fact that, as a result of intensifying global competition, the positive impact of an increase in exports on employee income has become smaller.

[16] This observation is supported by the fact that labor unions have demanded small wage increases in recent years, resulting in minimal gaps between the wage increases demanded and those agreed upon (Chart 26[3]).

However, further tightening of labor market conditions seems inevitable in the future, since the working-age population has been declining and, in line with the continuing economic expansion, the number of employees is likely to keep increasing by somewhat over 1 percent each year (Chart 16[1] and [2]). This should gradually exert upward pressure on wages, whose growth has been sluggish, and will likely lead gradually to a more firmly established uptrend in households' income. In fact, wages for temporary and part-time workers are rising, and an increasing number of firms are planning to raise their starting salaries for new graduates. This spring's wage negotiations show not only that labor unions demanded slightly larger wage increases than hitherto, but that firms' management tended to accommodate them, at least to a certain extent.[17]

The flow of income from the corporate sector to the household sector is likely to grow steadily stronger via increases, for example, in property income as well as in employee income. Property income, which is part of disposable income, has increased since fiscal 2004 (Chart 9). This is attributable to increased dividends, not only because firms have become more inclined to return profits to shareholders, but also because households, faced with a low interest rate environment, have been increasing their investments in, for instance, investment trusts. Given these developments, the growth rate of disposable income is likely to increase gradually, while remaining moderate, and thus the uptrend in household spending should become more firmly established.

(Environment Surrounding Price Changes)

During the current phase of economic expansion, the rise in consumer prices has proved sluggish despite high resource utilization. It seems that economic developments in the course of globalization have had a considerable effect on price movements. More specifically, upward pressure on prices seems to have been contained as firms, amid global competition, have increased wage restraint despite tight labor market conditions and have sought to raise productivity. Compared with the corporate sector, the pace of improvement in the household sector, as seen, for example, in consumption expenditure, has been relatively slow. In consumption-related industries, mainly retailing and services, the rise

[17] Moreover, although the retirement of baby boomers generates downward pressure on wages per worker, it may exert upward pressure on households' income via their receipt of retirement benefits.

in resource utilization has in fact been slower than the all-industries average, as indicated by firms' perceptions of employment levels and production capacity in the *Tankan*. This also seems to have contributed to the sluggishness of consumer prices (Chart 27).[18]

As for the outlook, the sensitivity of prices and wages to changes in resource utilization at the macro level is likely to remain relatively low in Japan, due mainly to economic globalization and deregulation. As a result, upward pressure on prices and wages is not expected to increase noticeably.[19] Nevertheless, prices are expected to display a more definite upward trend as the economic expansion becomes more prolonged and supply and demand conditions tighten steadily. The rate of increase in consumer prices -- including in services prices, which have been sluggish to date -- is likely to accelerate, albeit gradually and with a time lag, as supply and demand conditions in consumption-related industries continue to improve moderately, and developments in wages will also exert upward pressure on prices.[20]

However, the timing and the pace of increase in prices and wages are subject to a certain margin of error, because of uncertainties that could cause the sensitivity of prices and wages to changes in resource utilization to move in either direction.[21] If sensitivity to changes in resource utilization is not as weak as assumed, prices may rise by more than expected. On the other hand, if the sensitivity of prices to changes in resource utilization is weaker than assumed, prices will not easily respond even if economic activity is stronger than expected. In this latter case, at the point when prices finally respond and start to increase, the economy may already have seriously overheated. If this were to happen, swings in

[18] In contrast, the decline in consumer prices in the 1990s was contained partly by the slower pace of deterioration in supply and demand conditions in consumption-related industries relative to the all-industries average. The strength of the household sector in the 1990s seemed to have been supported by increased public investment and tax cuts, whereas the currently slow pace of improvement in the household sector seems partly attributable to the effects of fiscal reform.

[19] The decline in the sensitivity of prices and wages to changes in the utilization of domestic resources is observed not only in Japan, but globally.

[20] Wages, the dominant cost borne by the labor-intensive services sector, are adjusted only gradually. For this reason, changes in supply and demand conditions in the services sector tend to influence prices with a long time lag (Chart 27[5]).

[21] In particular, the length of the time lag before changes in supply and demand conditions start to influence wages and prices is more uncertain in the services sector than in the goods sector, and this makes the outlook for wages and prices all the more uncertain (Chart 27[2] to [5]).

economic activity could eventually be larger, reflecting an excessive build-up of capital stock and its subsequent adjustment.

Changes in prices of international commodities, such as crude oil, also affect overall price developments, as they did in fiscal 2006 (Chart 13). If crude oil prices rise in a situation where supply and demand conditions have tightened further and upward pressure on wages has increased, prices should rise by more than expected. On the other hand, it should be noted that while a decline in crude oil prices acts to contain upward pressure on prices, it also supports corporate profits and households' real income by improving the terms of trade, which in turn contributes to a tightening of supply and demand conditions.

(Developments in Financial Markets)

Turning to developments in financial markets since the publication of the October 2006 Outlook Report, the uncollateralized overnight call rate was at around 0.25 percent until the change in the guideline for money market operations in February 2007, and since then it has been at around 0.5 percent. Interest rates on term instruments have increased somewhat (Chart 28). As for Euroyen futures rates and various implied forward rates, those on instruments with nearby contract months have strengthened while those on instruments with distant contract months (those with starting dates six or more months ahead) remained at about the same level after the policy change in February as before (Chart 29). Long-term interest rates have been more or less unchanged (Chart 30). The stimulative effects stemming from the current level of short-term interest rates on economic activity appear to have been strong relative to the state of economic activity and prices (Chart 31).

Credit spreads between CP and short-term government securities have remained low, and spreads between corporate bonds and long-term government bonds have also remained low (Chart 32). Lending rates have generally been at extremely low levels, although recently short-term rates have been rising moderately (Chart 20[3]).

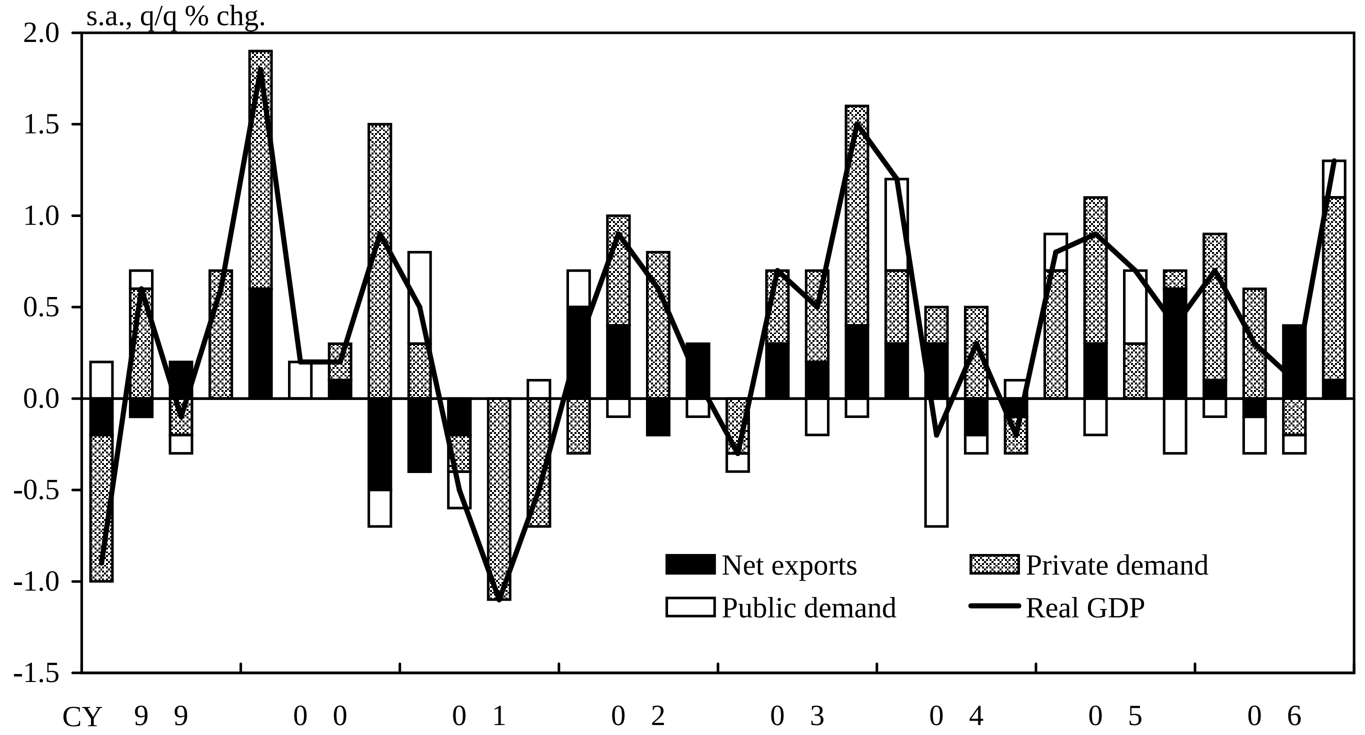
After the publication of the October 2006 Outlook Report, stock prices rose substantially to be followed by a fall in late February, and they have been somewhat unstable since then. Similar developments in stock prices have been seen worldwide. Factors behind these global developments include the modification of investors' attitudes toward risk in the wake of the plunge in Chinese stock prices, and the reemergence of uncertainty about future developments in the U.S. economy (Chart 33). The fundamentals of the global economy, however, remain strong, and global stock prices have been recovering recently.

The exchange rate of the yen appreciated from the end of February through March after declining against both the U.S. dollar and the euro, mainly reflecting pressure to sell the yen in the face of interest rate differentials between the Japanese and overseas markets. Recently, however, the yen has been on a declining trend again as a whole (Chart 34).

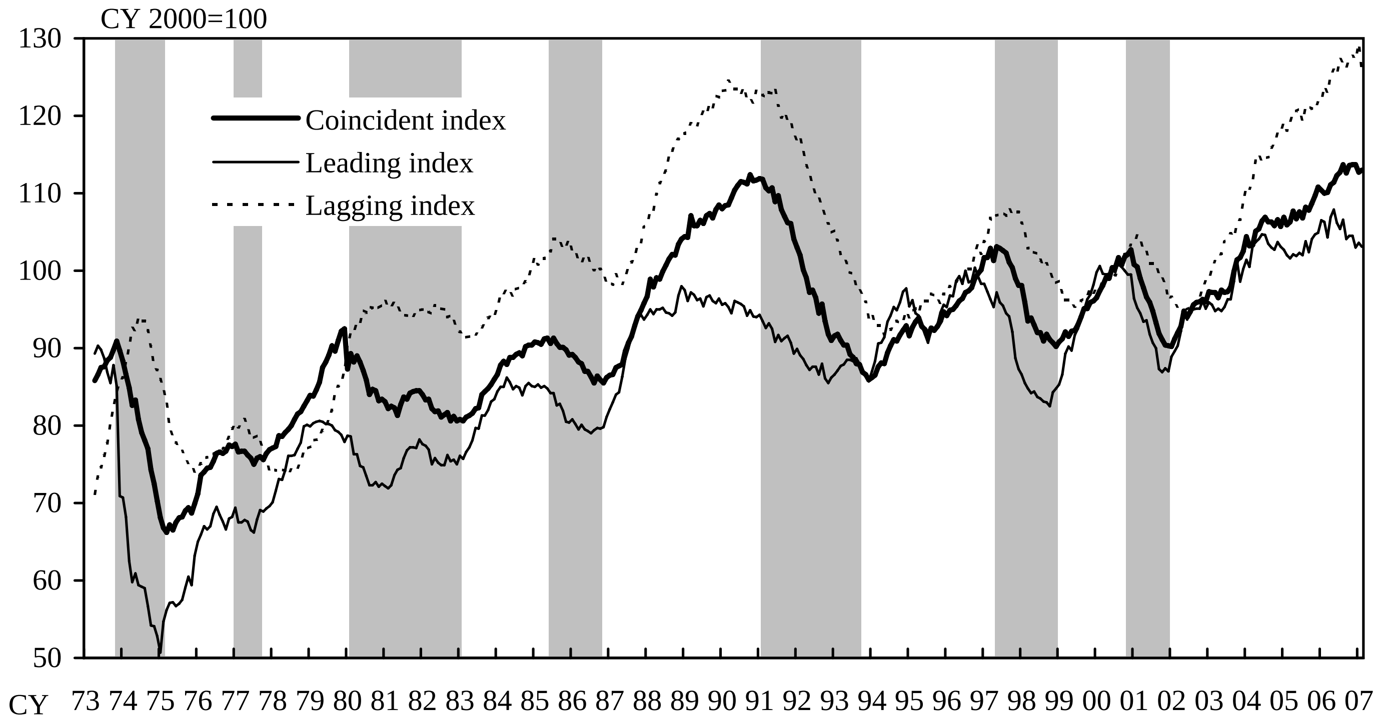
Land prices have clearly been on an upward trend in major metropolitan areas, whereas in regional areas they have been declining, although at a slower rate (Chart 35). According to the Land Price Publication, the nationwide averages for both residential and commercial land (as of January 1, 2007) registered year-on-year increases, albeit marginal increases, for the first time in 16 years. In the three major metropolitan areas (Tokyo, Osaka, and Nagoya), the rate of increase for commercial land prices in particular has risen against the backdrop of firm demand for office space. As for regional areas, although land prices, particularly commercial land prices, have started to rise in an increasing number of central cities within the regions, neither residential nor commercial land prices have stopped falling on the whole, although their rates of decline are slowing.

Real GDP and Indexes of Business Conditions

(1) Real GDP



(2) Indexes of Business Conditions (Composite Indexes)

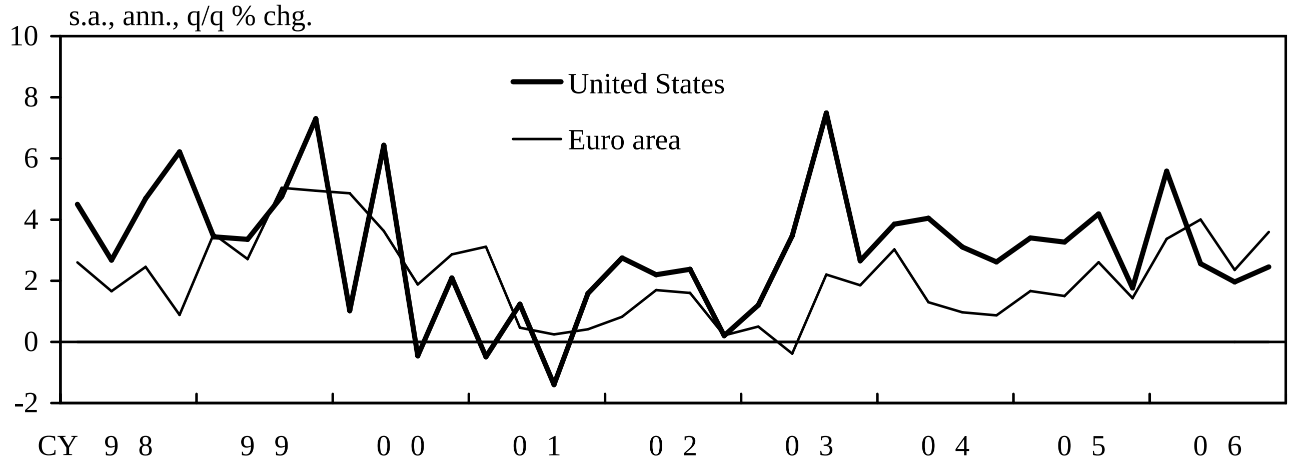


Note: Shaded areas indicate recession periods.

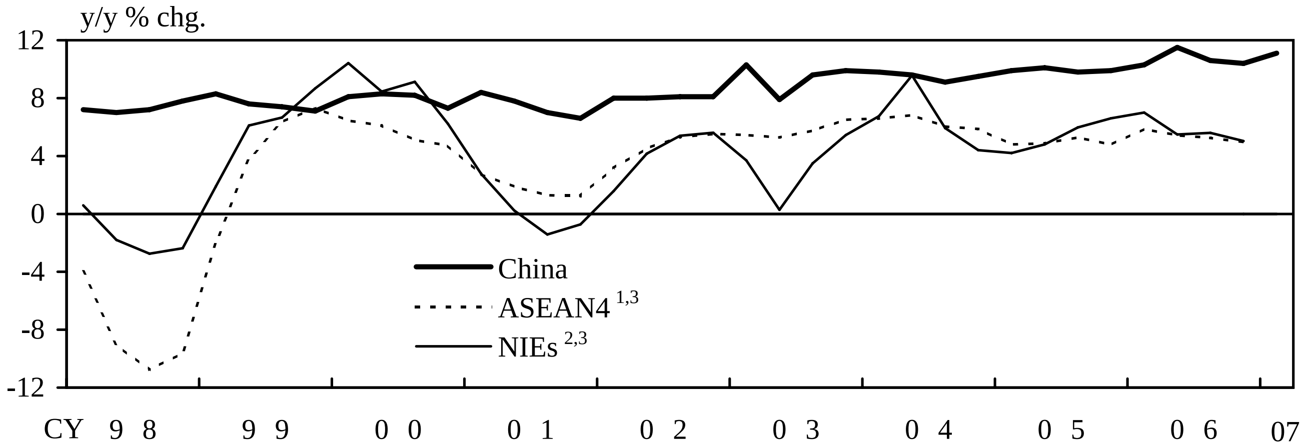
Source: Cabinet Office, "National Accounts," "Indexes of Business Conditions."

Real GDP Growth Rates in Overseas Economies

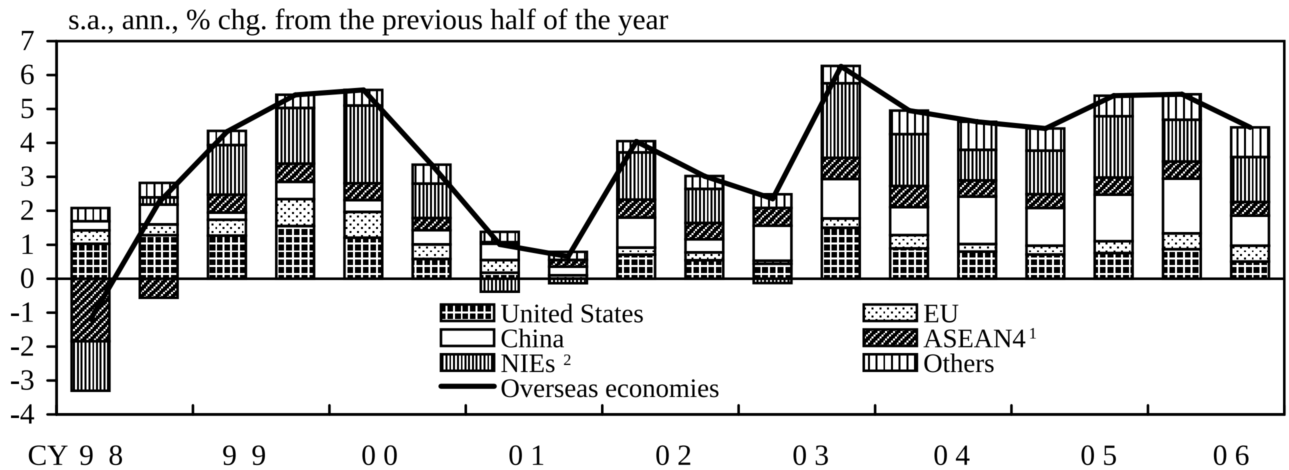
(1) Real GDP Growth Rates in Advanced Economies



(2) Real GDP Growth Rates in East Asian Economies



(3) Real GDP Growth Rates in Overseas Economies[3]

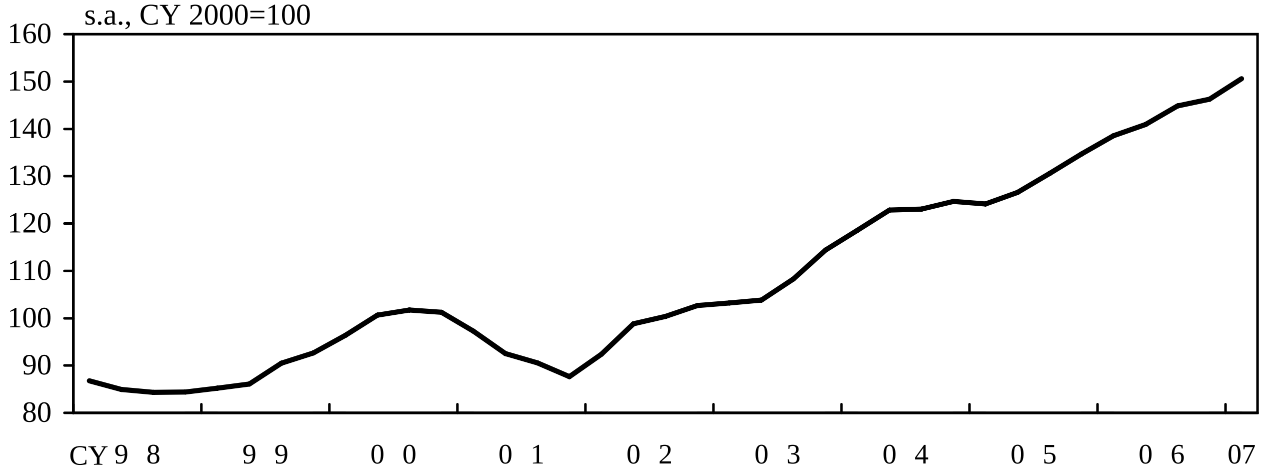


Notes: 1. Data for ASEAN4: Thailand, Malaysia, the Philippines, and Indonesia.
2. Data for NIEs: South Korea, Taiwan, Hong Kong, and Singapore.
3. Calculated as the average of real GDP weighted by value of exports from Japan to each economy.

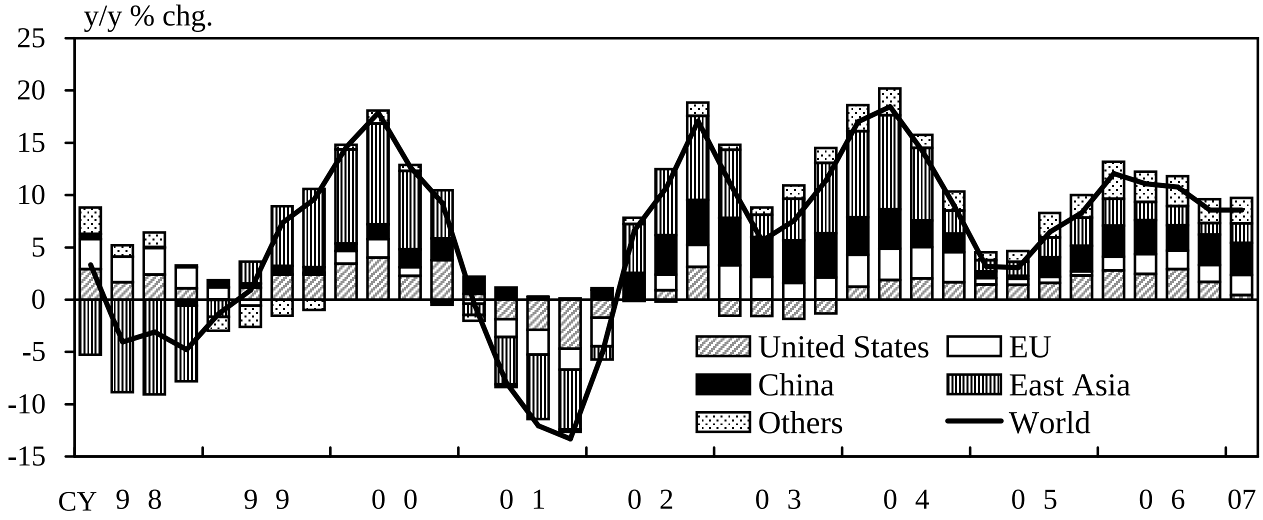
Sources: National governments; central banks; European Commission.

Exports

(1) Real Exports

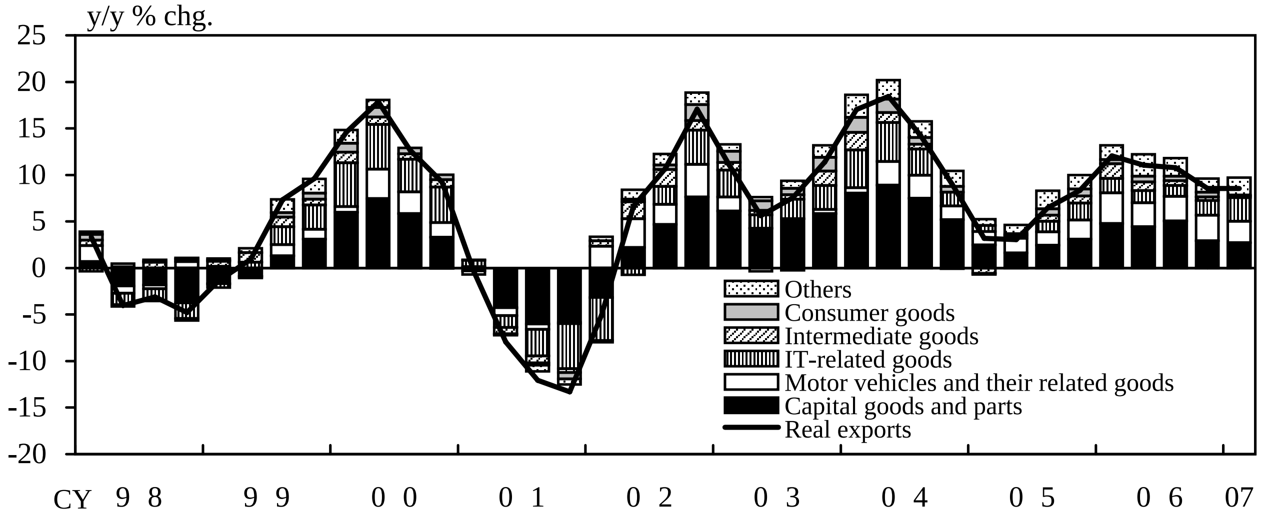


(2) Real Exports (Breakdown by Region)



Note: Data for East Asia: NIEs and ASEAN4.

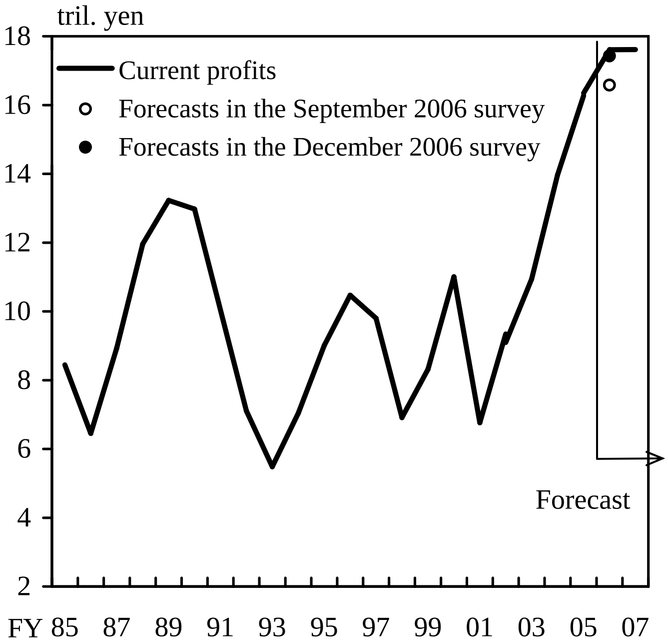
(3) Real Exports (Breakdown by Goods)



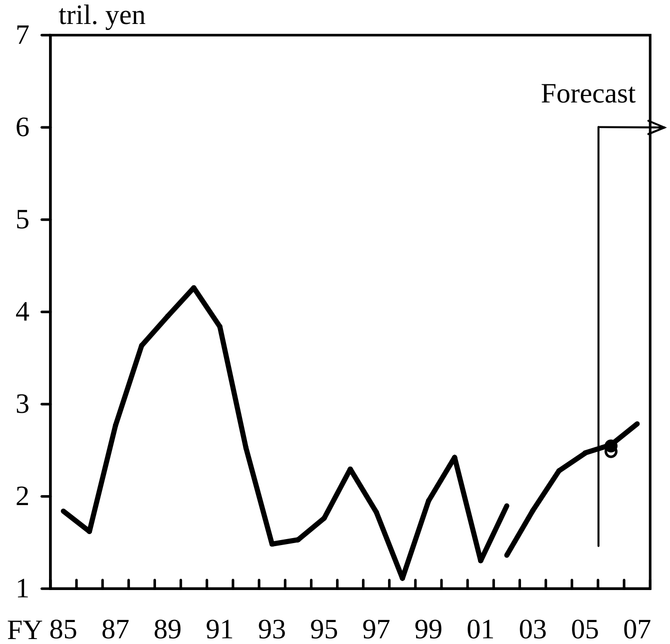
Sources: Ministry of Finance, "The Summary Report on Trade of Japan";
Bank of Japan, "Corporate Goods Price Index."

Current Profits

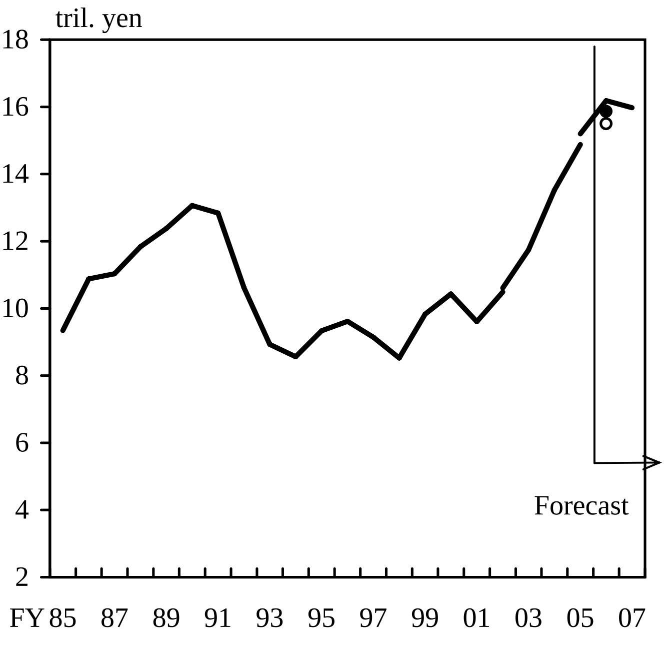
(1) Large Manufacturing Enterprises



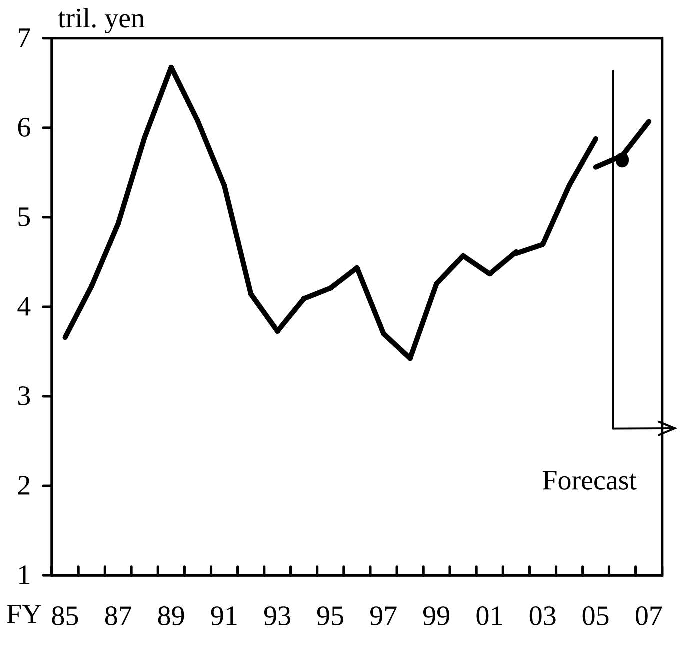
(2) Small Manufacturing Enterprises



(3) Large Nonmanufacturing Enterprises



(4) Small Nonmanufacturing Enterprises



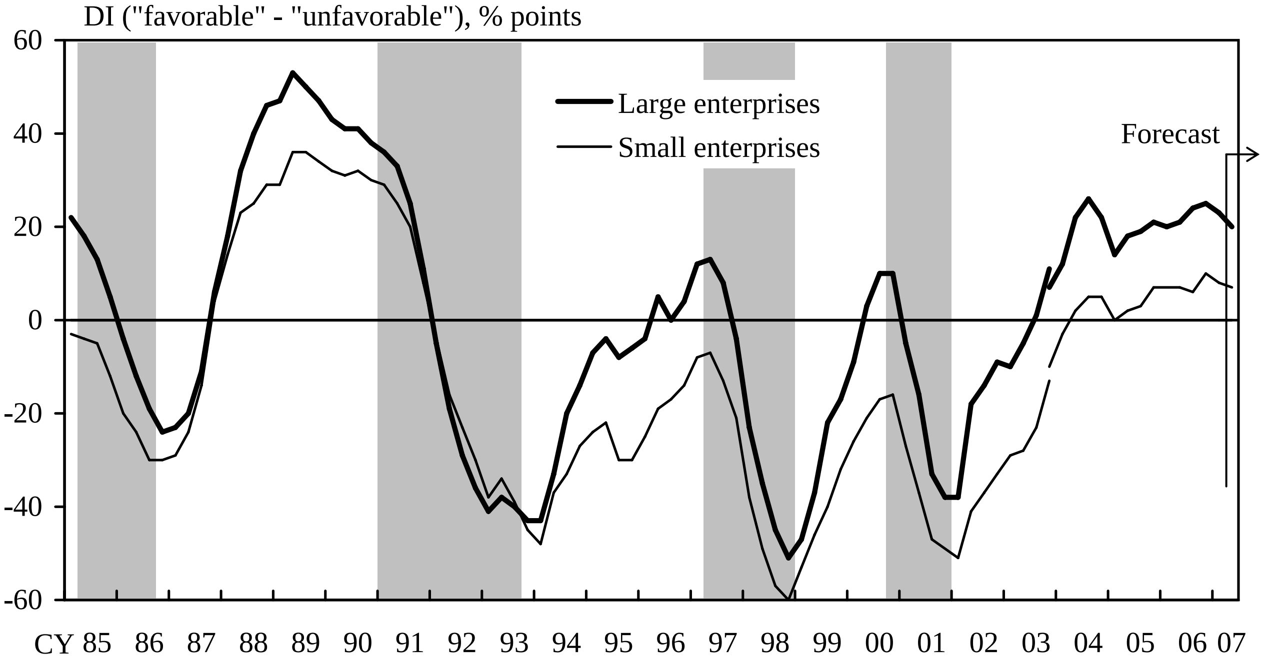
Notes: 1. In the March 2004 survey, the *Tankan* underwent major revisions, including the addition of new sample enterprises to the survey. In the March 2007 survey, regular revisions were made to the sample enterprises. The data show some discontinuities coincided with these timings.

2. Figures for FY 2006 in the September and December 2006 surveys are calculated by multiplying those for FY 2005 (which are based on new samples from the March 2007 survey) by each year-on-year expected growth rate.

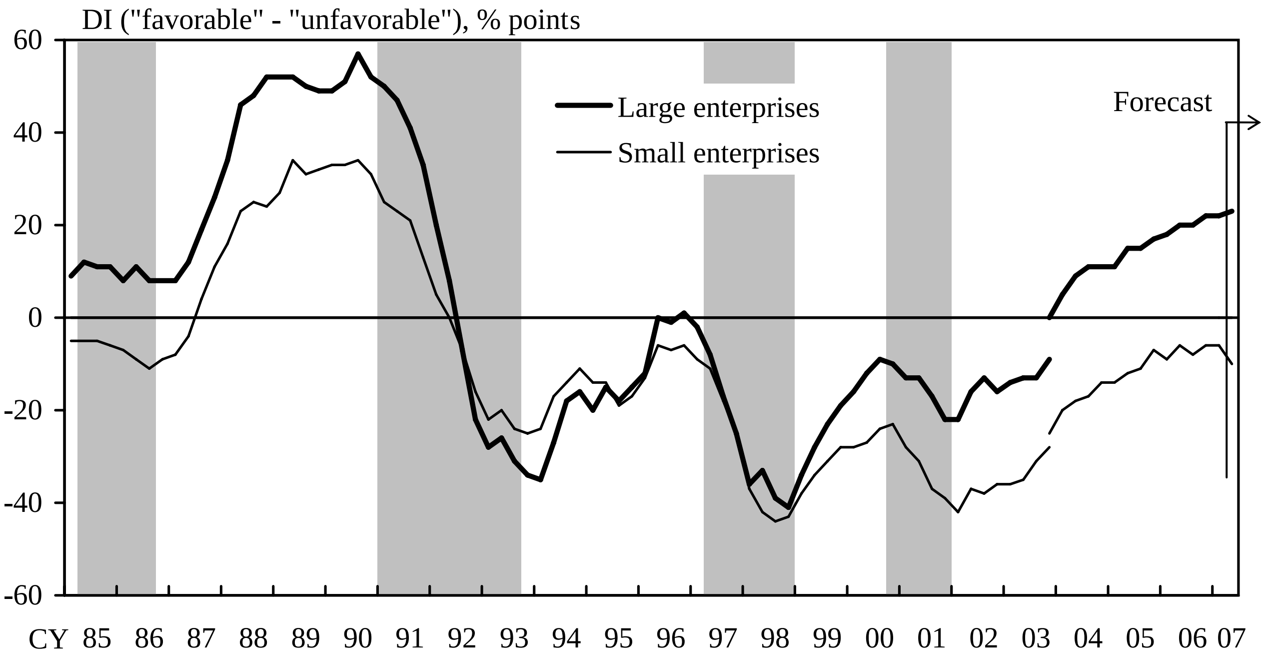
Source: Bank of Japan, "*Tankan*, Short-Term Economic Survey of Enterprises in Japan."

Business Conditions

(1) Manufacturing



(2) Nonmanufacturing



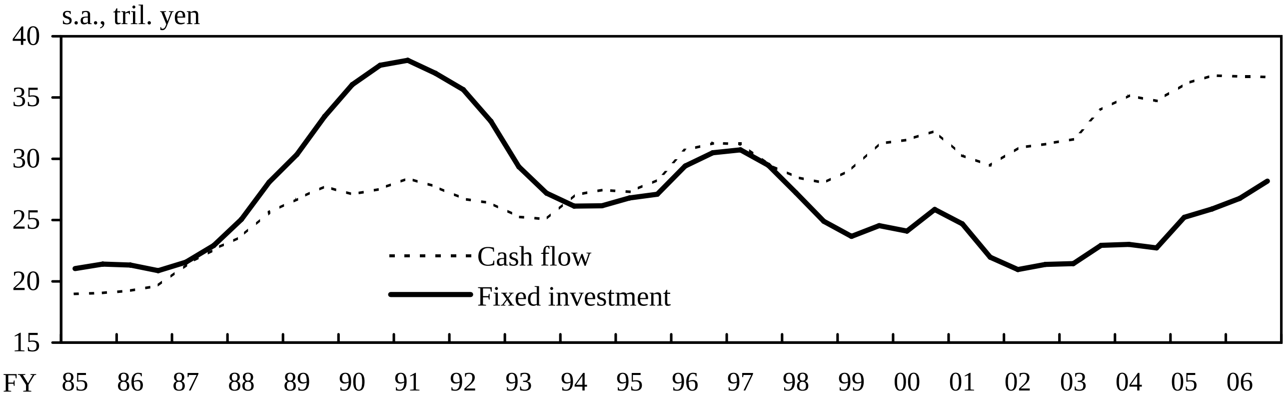
Notes: 1. The *Tankan* has been revised from the March 2004 survey. Figures based on the previous data sets are up to the December 2003 survey. Figures on a new basis are from the December 2003 survey.
2. Shaded areas indicate recession periods.

Source: Bank of Japan, "*Tankan*, Short-Term Economic Survey of Enterprises in Japan."

Fixed Investment

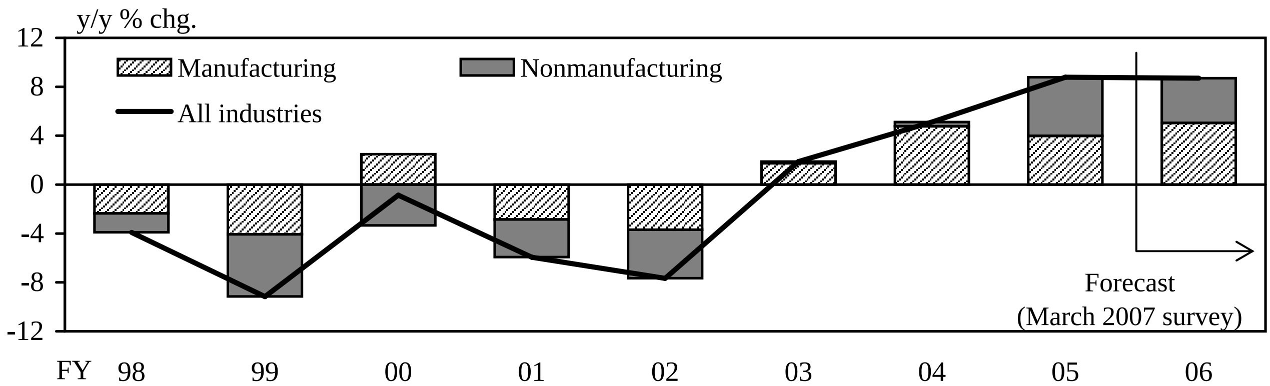
(1) Fixed Investment and Cash Flow

(*Financial Statements Statistics of Corporations by Industry, Quarterly,* All Enterprises)



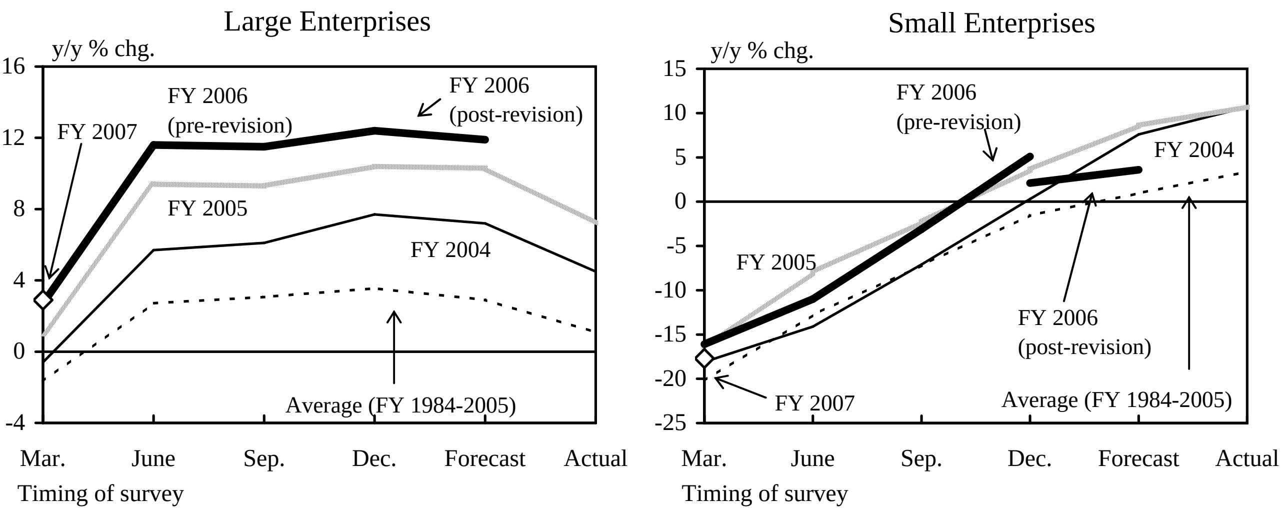
Notes: 1. Figures are adjusted for sample changes.
Cash flow = current profits/2 + depreciation expense
2. Figures for the second half of FY 2006 are calculated on the assumption that the year-on-year growth rates of 2007/Q1 are the same as those of 2006/Q4.

(2) Fixed Investment Plans as Surveyed (*Tankan,* All Enterprises)



Note: Figures up to FY 2002 include land purchasing expenses and exclude software investment.
Figures from FY 2003 exclude land purchasing expenses and include software investment.

(3) Developments of Fixed Investment Plans (*Tankan,* All Industries)

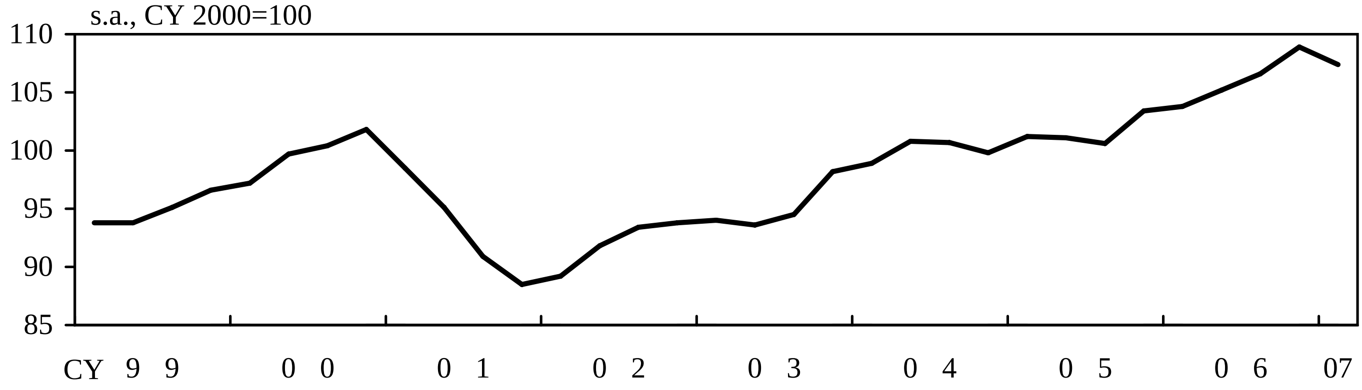


Note: In the March 2007 survey, regular revisions were made to the sample enterprises.

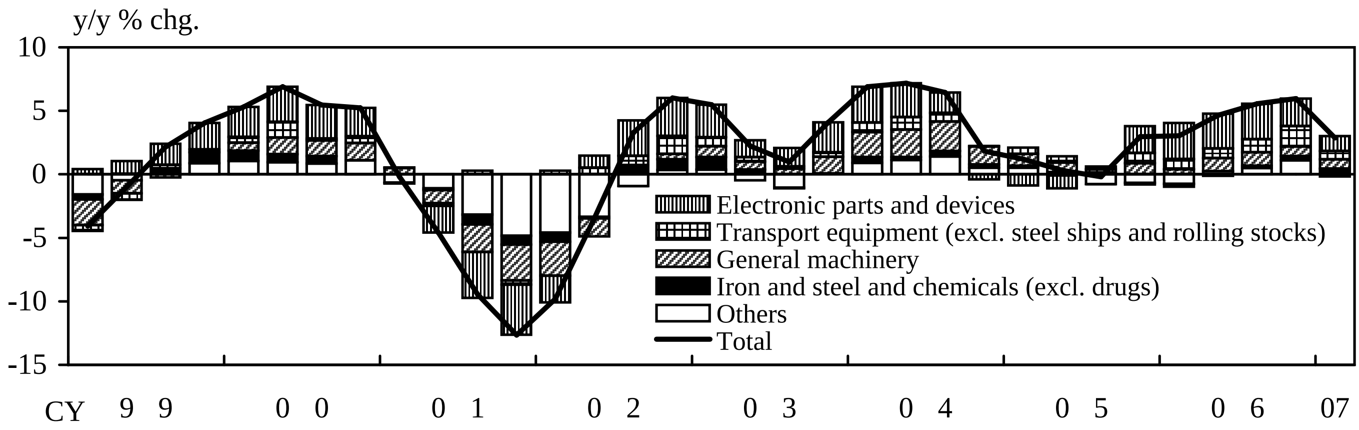
Sources: Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Quarterly";
Bank of Japan, "*Tankan,* Short-Term Economic Survey of Enterprises in Japan."

Production

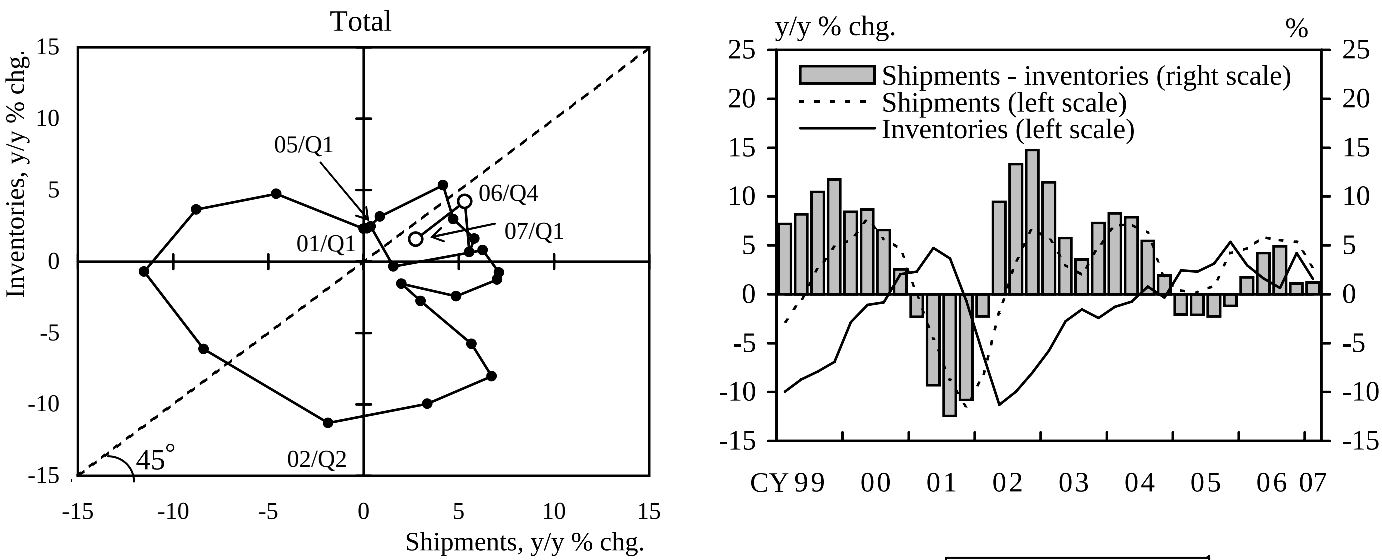
(1) Production



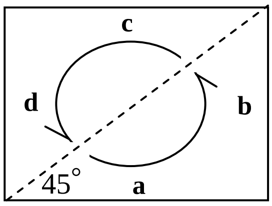
(2) Production (Breakdown by Industry)



(3) Inventory Cycle



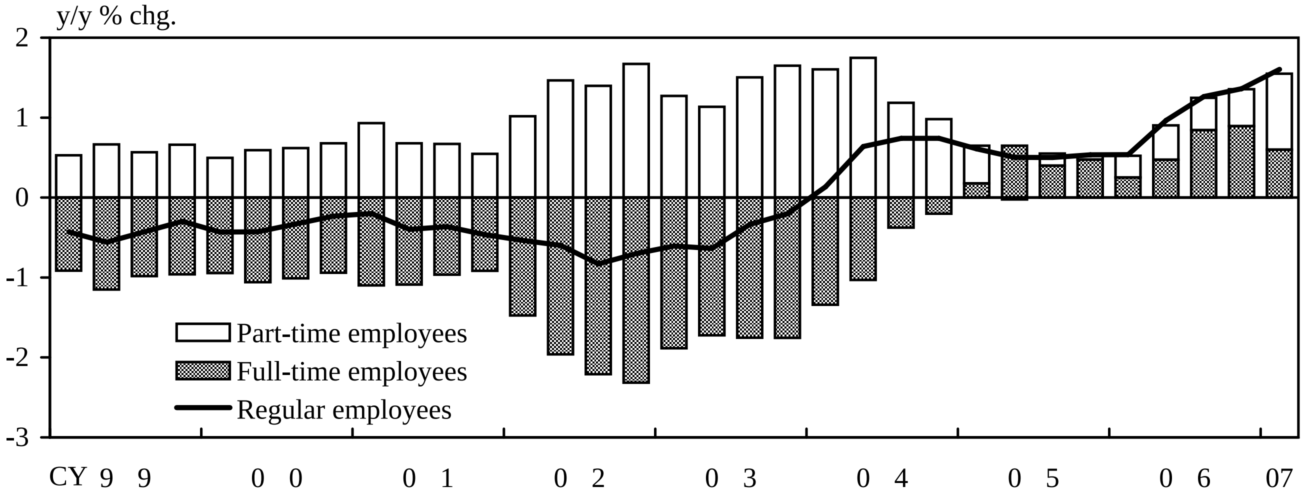
a Shipment recovery phase
b Intended inventory accumulation phase
c Unintended inventory accumulation phase
d Inventory adjustment phase



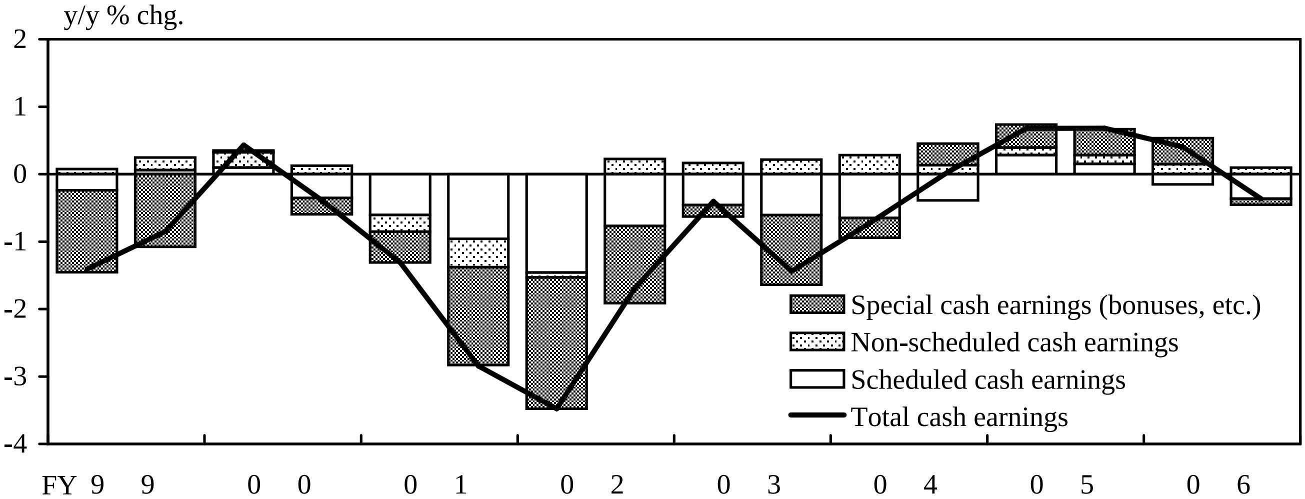
Source: Ministry of Economy, Trade and Industry, "Indices of Industrial Production."

Labor Market Conditions

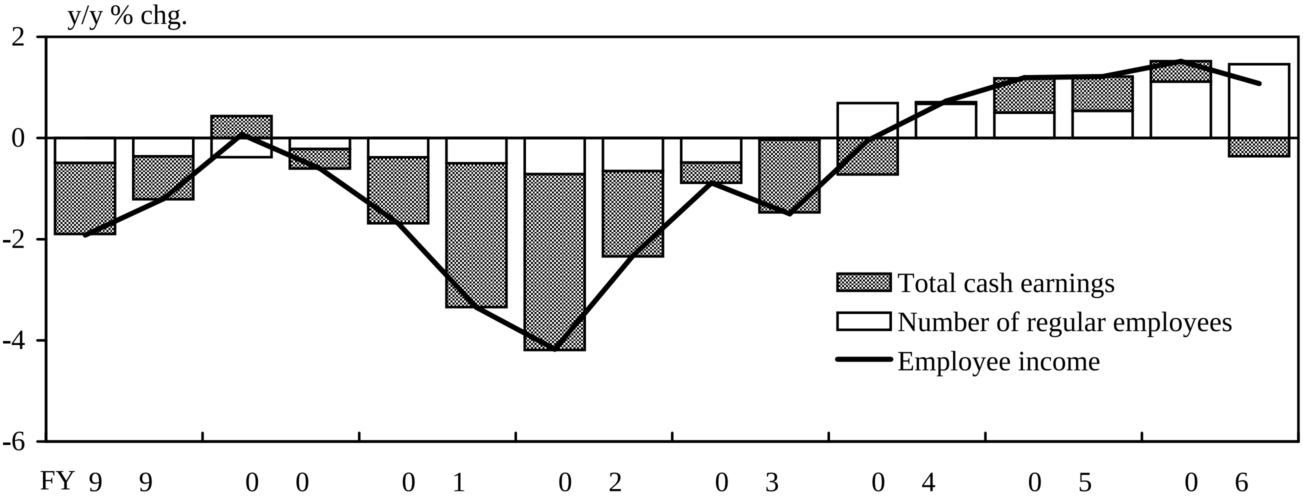
(1) Number of Regular Employees[1,2]



(2) Total Cash Earnings[1,3]



(3) Employee Income[1,3]

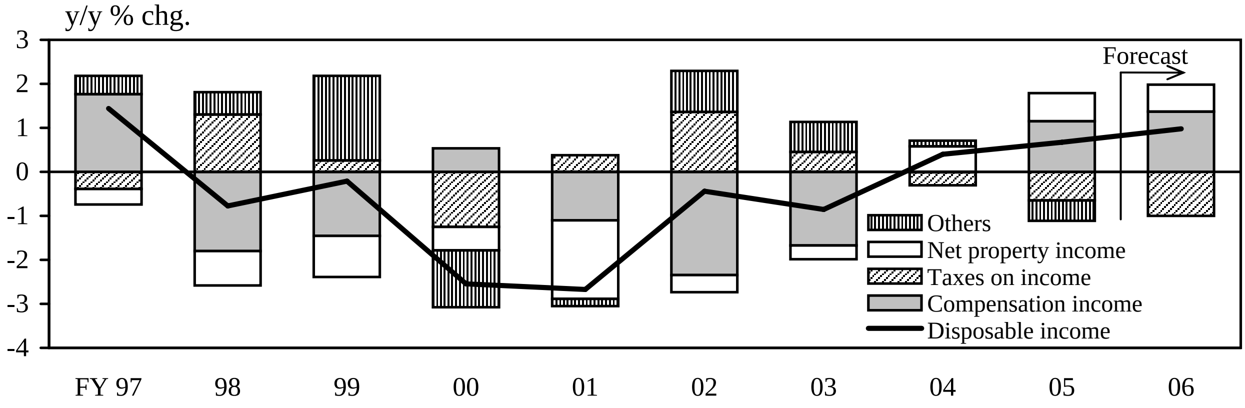


Notes: 1. Data are for establishments with at least 5 employees.
2. Figures for 2007/Q1 are those of January-February averages.
3. Figures for the second half of FY 2006 are those of October 2006-February 2007 averages.

Source: Ministry of Health, Labour and Welfare, "Monthly Labour Survey."

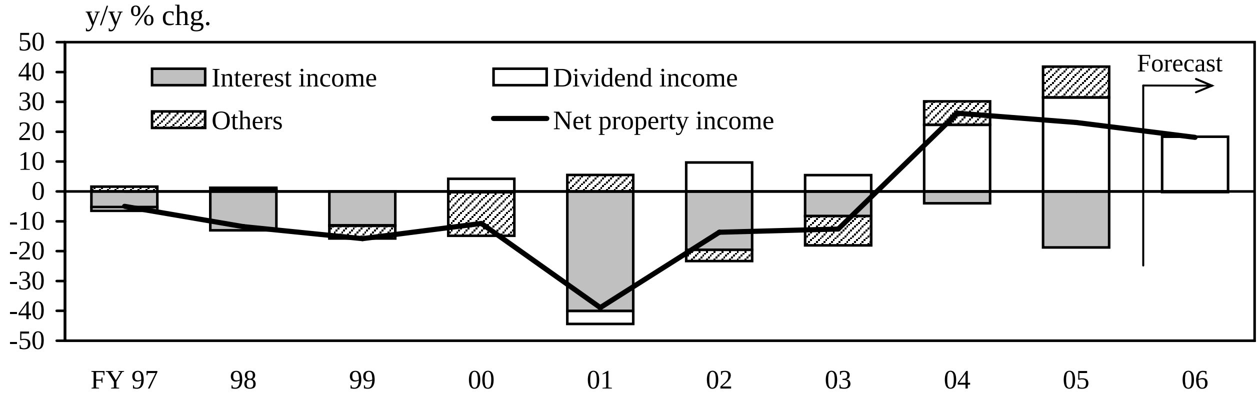
Households' Income

(1) Disposable Income



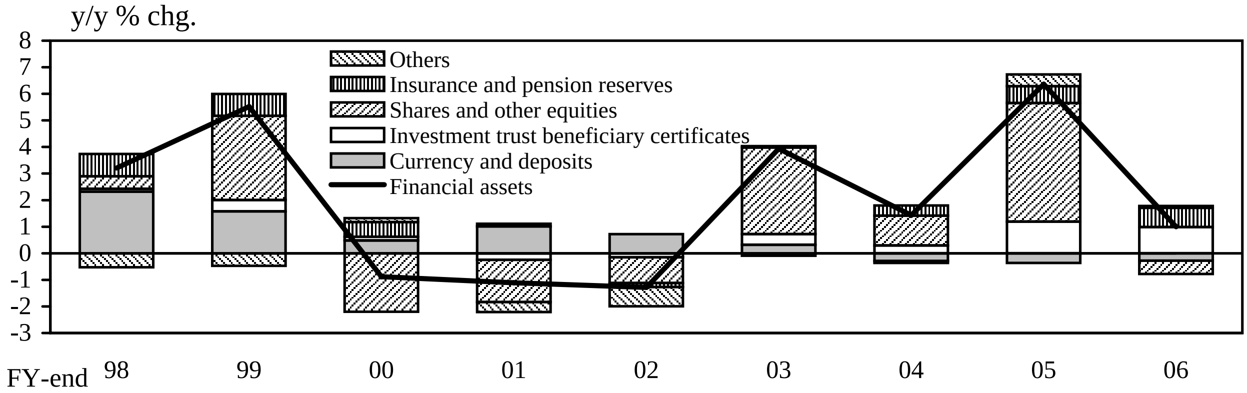
Note: The figure for compensation of employees in FY2006 is that of the year-on-year average for 2006/Q2-Q4. The figure for taxes on income in FY2006 is estimated based on the national budget, reflecting the supplementary budget, for FY2006. With regard to the estimation of net property income in FY2006, see the note for chart (2). The figure for others in FY2006 is assumed to be the same as in FY2005.

(2) Net Property Income



Note: The figure for interest income in FY2006 is estimated as the year-on-year change in outstanding amount of deposit from the end of CY2005 to the end of CY2006. The figure for dividend income in FY2006 is estimated as the year-on-year change in dividend paid in 2006 by enterprises, excluding financial institutions and nonbanks, with April-March accounting period listed on the 1st section of Tokyo Stock Exchange (the year end dividends in March 2006 plus the midterm dividends in September 2006). Figures for other items in FY2006 are assumed to be the same as in FY2005.

(3) Financial Assets

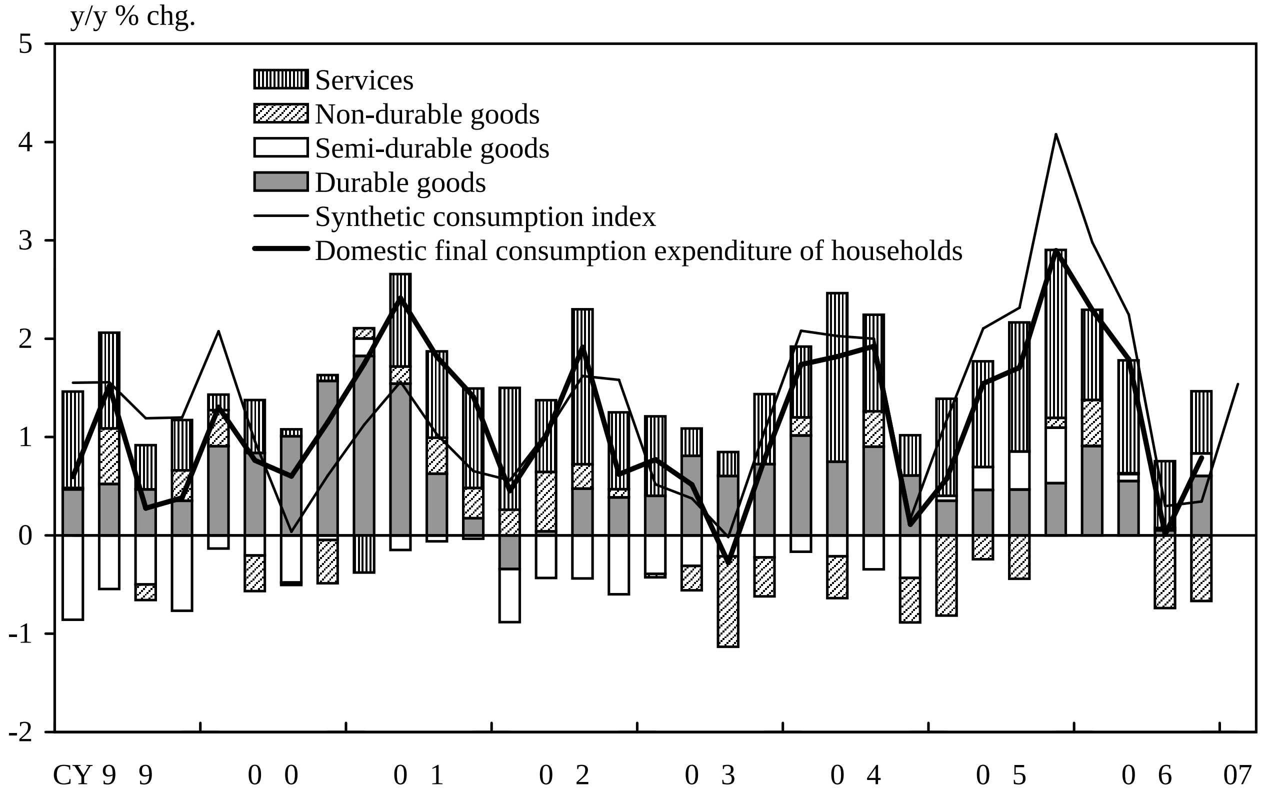


Note: Figures for FY2006 are those at the end of 2006/Q4.

Sources: Cabinet Office, "National Accounts"; Bank of Japan, "Flow of Funds Accounts"; Nikkei Financial QUEST.

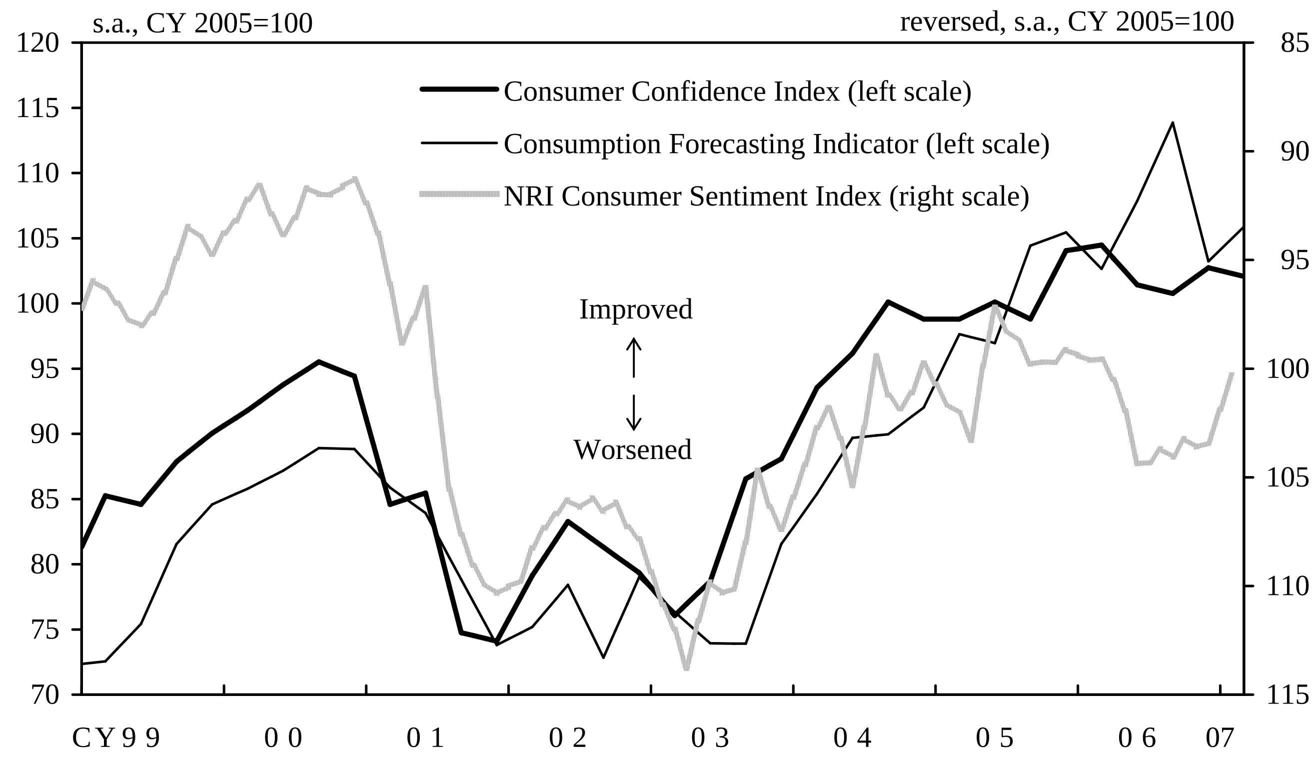
Private Consumption

(1) Breakdown of Domestic Final Consumption Expenditure of Households



Note: Figure of the synthetic consumption index for 2007/Q1 is the January-February average.

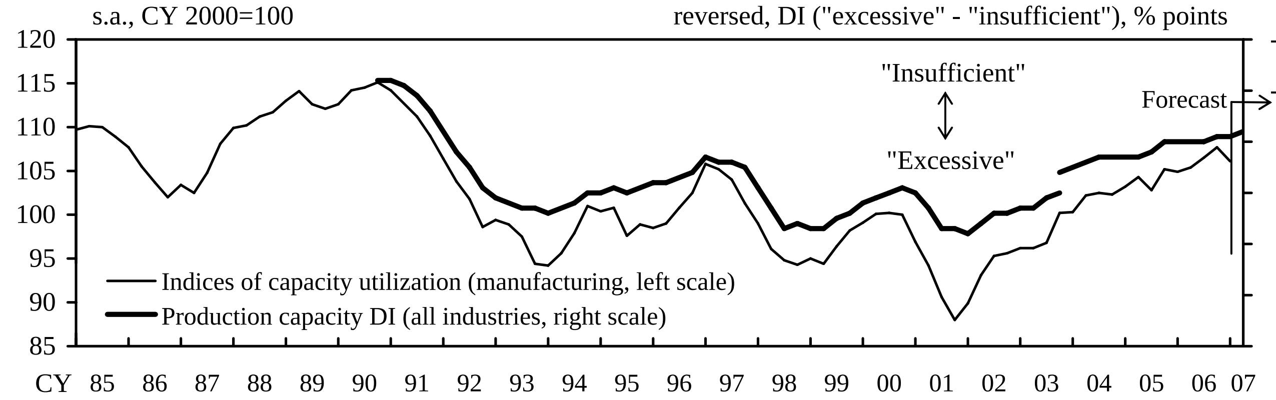
(2) Consumer Confidence



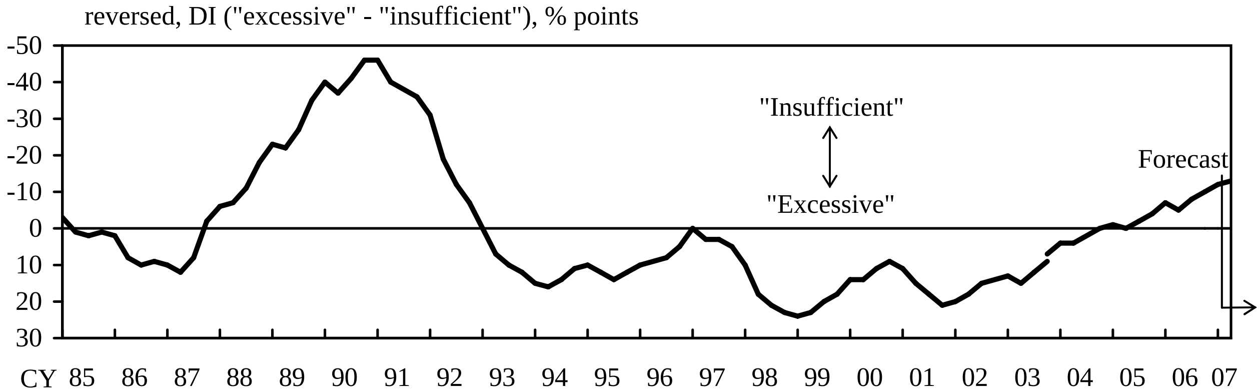
Sources: Cabinet Office, "National Accounts," "Consumer Confidence Survey,"
"Synthetic Consumption Index"; Nikkei Inc., "Consumption Forecasting Indicator";
Nippon Research Institute (NRI), "Consumer Sentiment Survey."

Resource Utilization

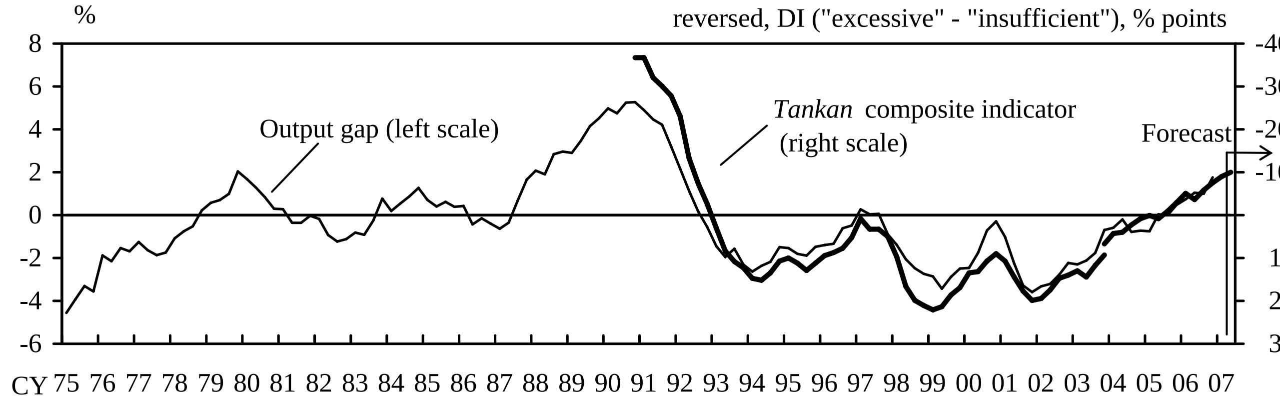
(1) Production Capacity DI (*Tankan*) and Indices of Capacity Utilization[1,2]



(2) Employment Conditions DI (*Tankan*)[1]



(3) *Tankan* Composite Indicator and Output Gap[1,3]

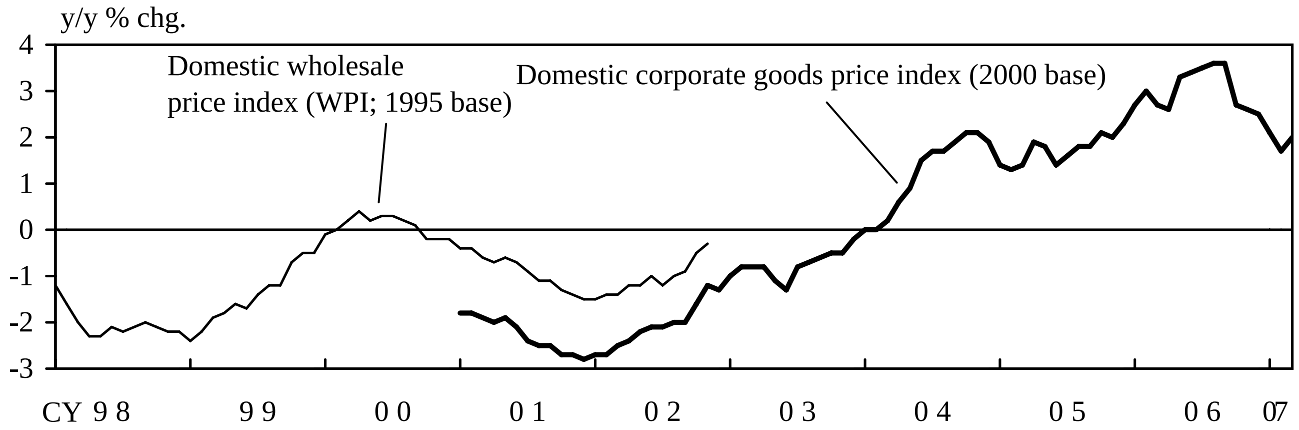


Notes: 1. Production capacity DI and employment conditions DI are based on all enterprises.
The *Tankan* has been revised from the March 2004 survey. Figures based on the previous data sets are up to the December 2003 survey. Figures on a new basis are from the December 2003 survey.
2. Figure of indices of capacity utilization for 2007/Q1 is the January-February average.
3. The *Tankan* composite indicator is calculated as the average of the diffusion indices of production capacity and employment conditions, weighted by capital and labor shares in the national accounts (FY 1990-2005 average).
The output gap is estimated by the Research and Statistics Department, Bank of Japan.

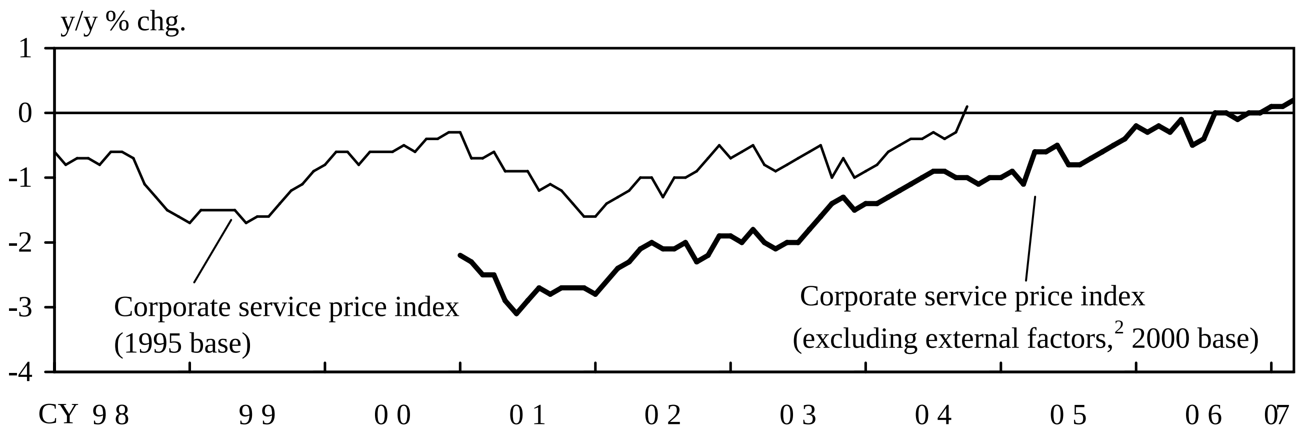
Sources: Cabinet Office, "National Accounts"; Cabinet Office and Ministry of Finance, "Business Outlook Survey";
Ministry of Internal Affairs and Communications, "Labour Force Survey";
Ministry of Health, Labour and Welfare, "Monthly Labour Survey," "Report on Employment Service";
Ministry of Economy, Trade and Industry, "Indices of Industrial Production";
Bank of Japan, "*Tankan*, Short-Term Economic Survey of Enterprises in Japan," etc.

Prices

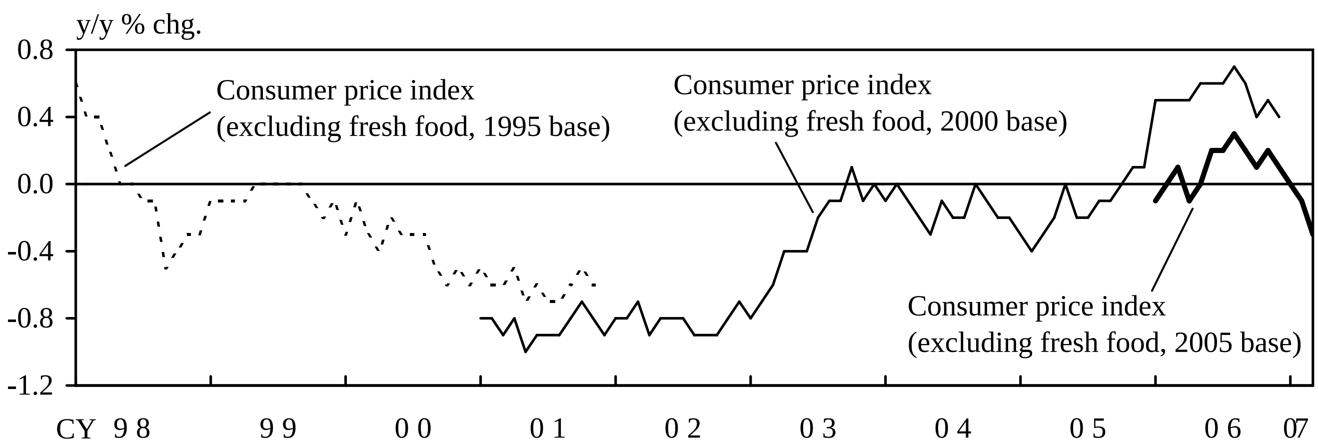
(1) Domestic Corporate Goods Price Index[1]



(2) Corporate Service Price Index[1]



(3) Consumer Price Index[1]

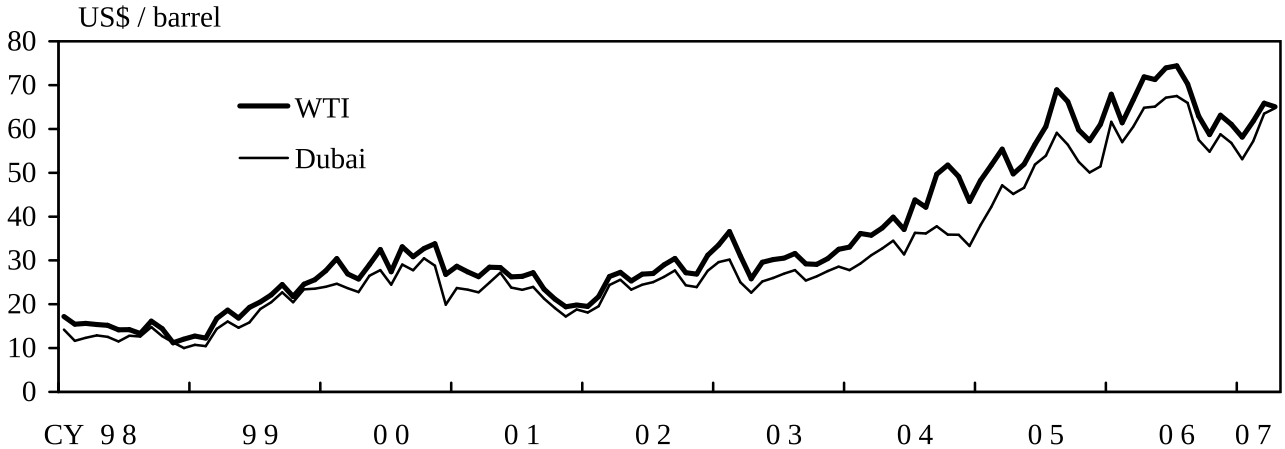


Notes: 1. Adjusted to exclude the effects of changes in consumption tax rate.
2. External factors: international air passenger transportation, ocean liner, ocean tramper, ocean tanker, oceangoing ship chartering services, and international air freight.

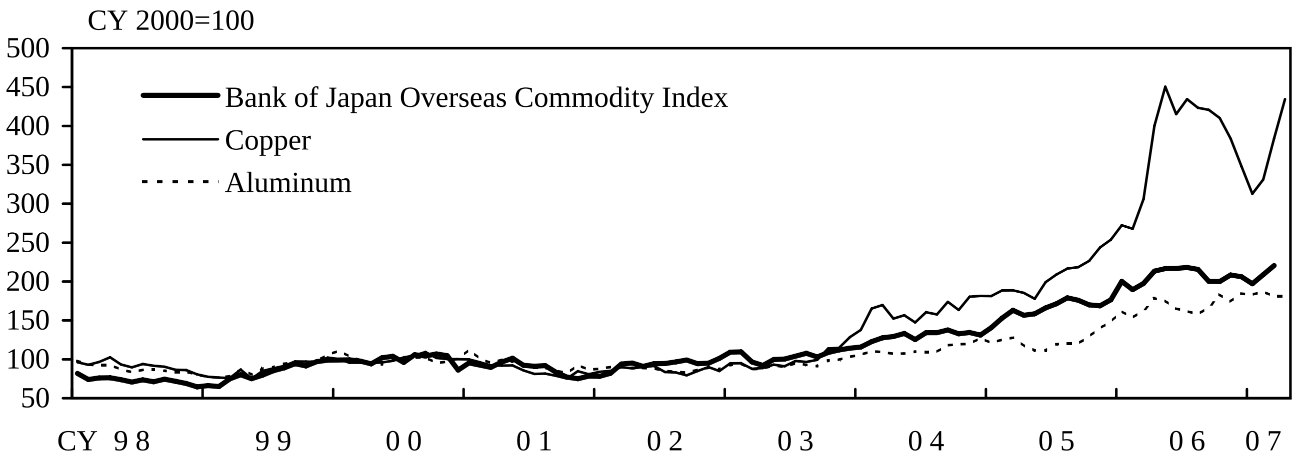
Sources: Ministry of Internal Affairs and Communications, "Consumer Price Index"; Bank of Japan, "Corporate Goods Price Index," "Wholesale Price Indexes," "Corporate Service Price Index."

Commodity Prices

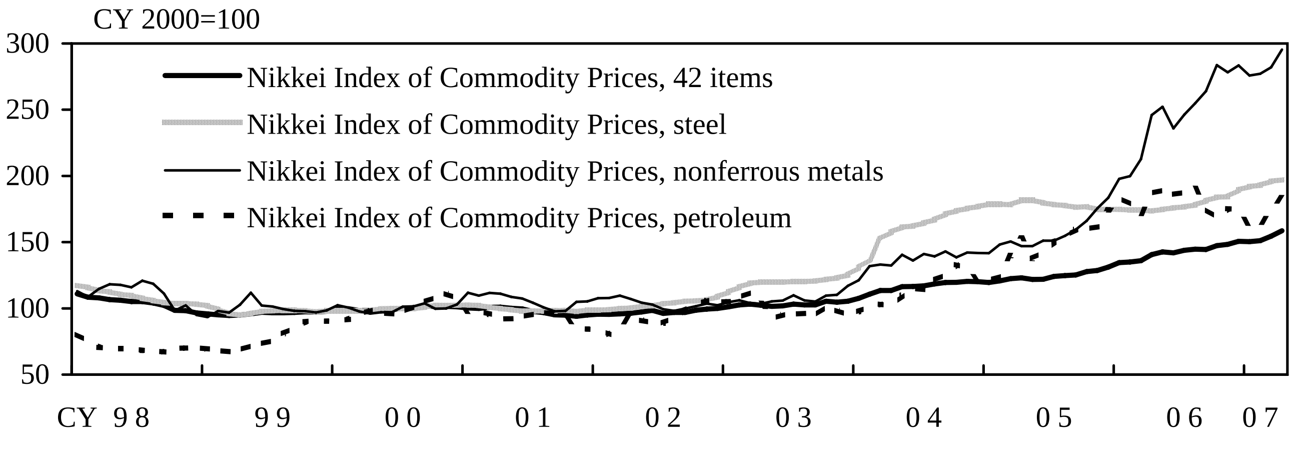
(1) Oil Prices[1,2]



(2) International Commodity Prices[1,2]



(3) Domestic Commodity Prices[1,2,3]

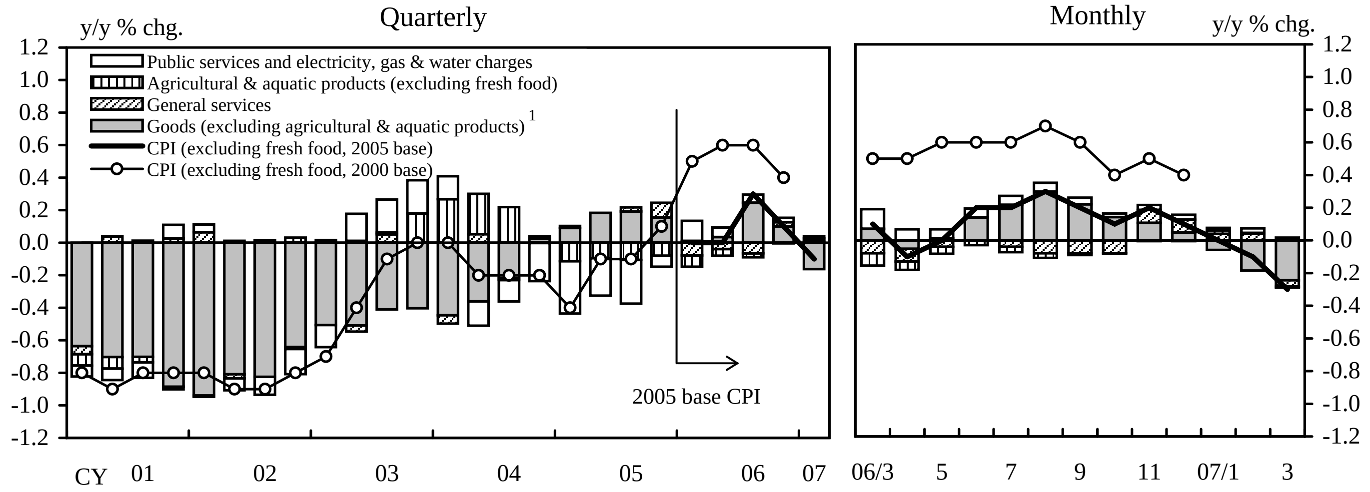


Notes: 1. Data are at end of month.
2. Figures for April 2007 are the latest available data.
3. Steel: steel bars, H sections, steel plates, etc. Nonferrous metals: unwrought copper, unwrought aluminum, etc. Petroleum: gasoline, kerosene, gas oil, fuel oil C.

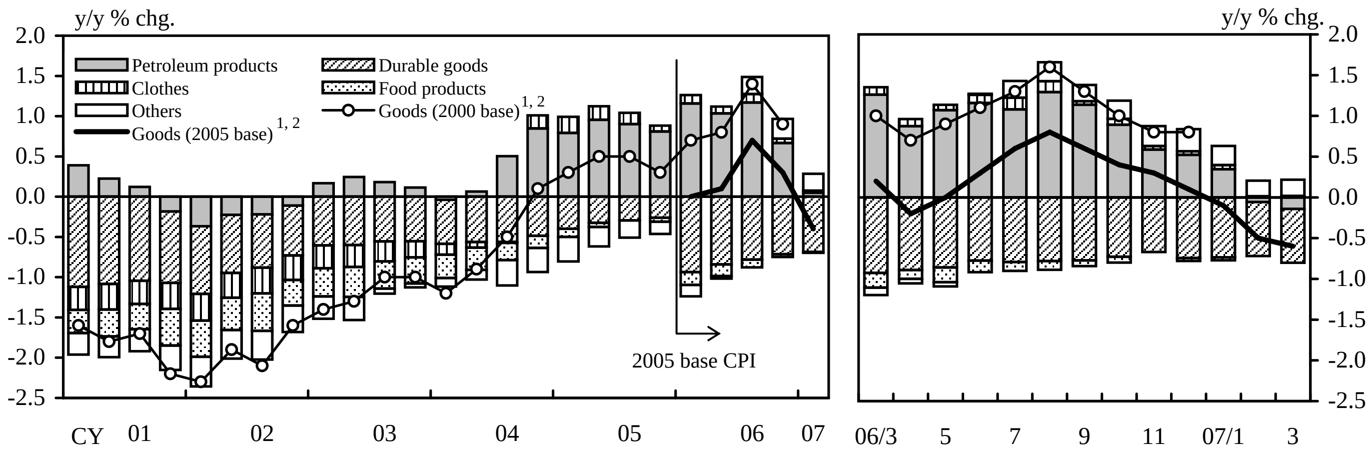
Sources: Bank of Japan; *Nihon Keizai Shimbun*, etc.

Consumer Price Index

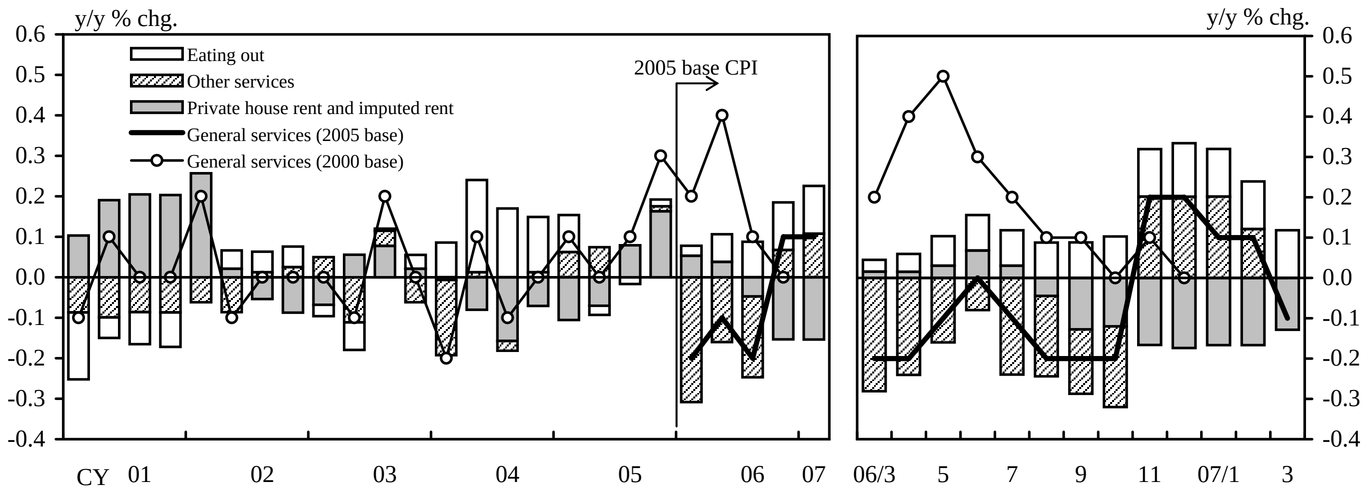
(1) Consumer Price Index (Excluding Fresh Food)



(2) Goods (Excluding Agricultural & Aquatic Products)[1]



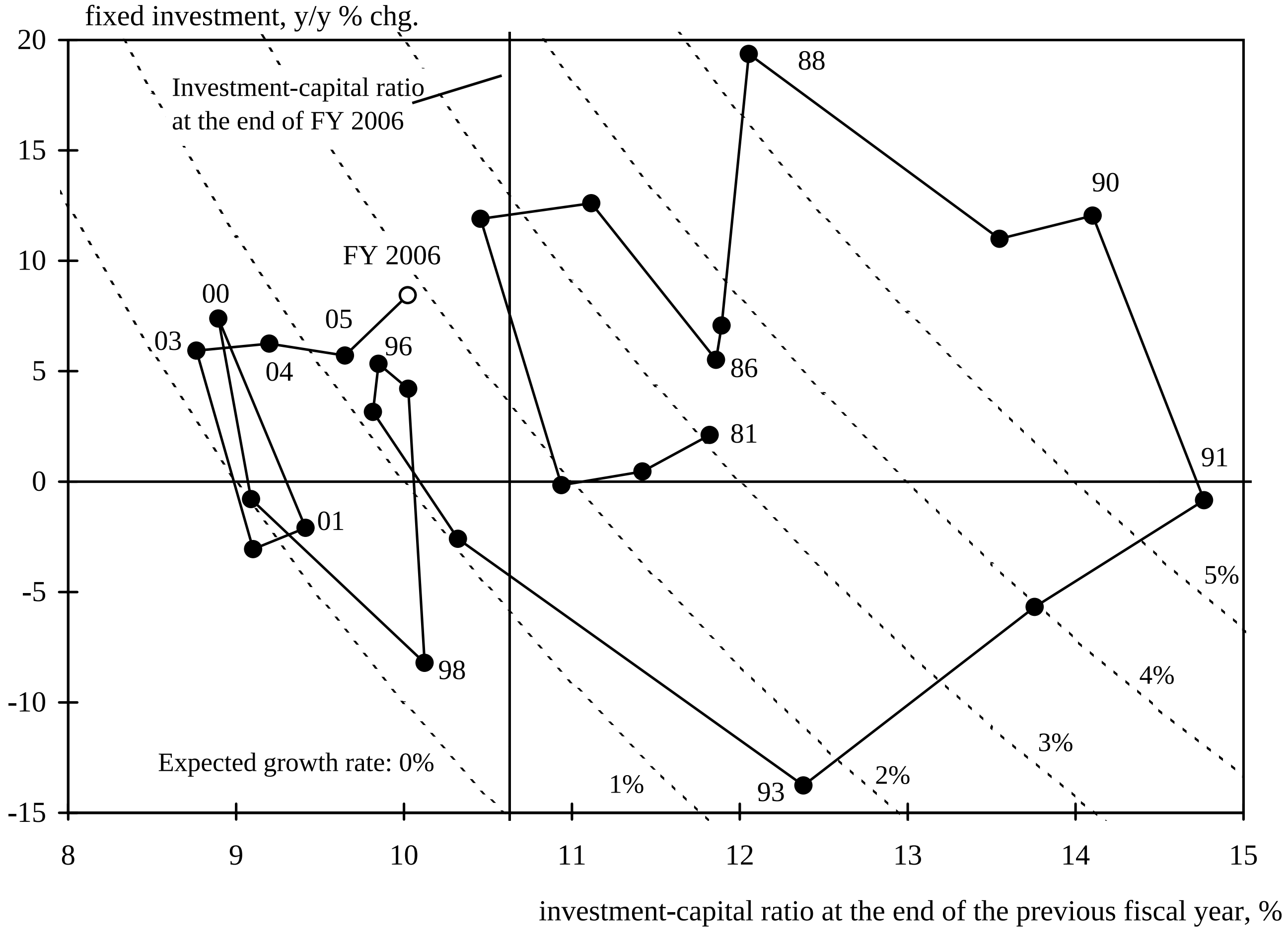
(3) General Services



Notes: 1. The items are basically the same as the definition published by the Ministry of Internal Affairs and Communications. However, electricity, gas & water charges are excluded from goods.
2. Excluding agricultural & aquatic products.

Source: Ministry of Internal Affairs and Communications, "Consumer Price Index."

Capital Stock Cycle



1. Capital stock cycle in the chart shows the relationship between the investment-capital ratio and the year-on-year rate of change of fixed investment.

2. As two variables have the following relation, a hyperbolic curve can be drawn for a given expected growth rate.

   Year-on-year rate of change of fixed investment (y-axis) × investment-capital ratio at the end of the previous fiscal year (x-axis) = expected growth rate + trend of capital coefficient + depreciation rate

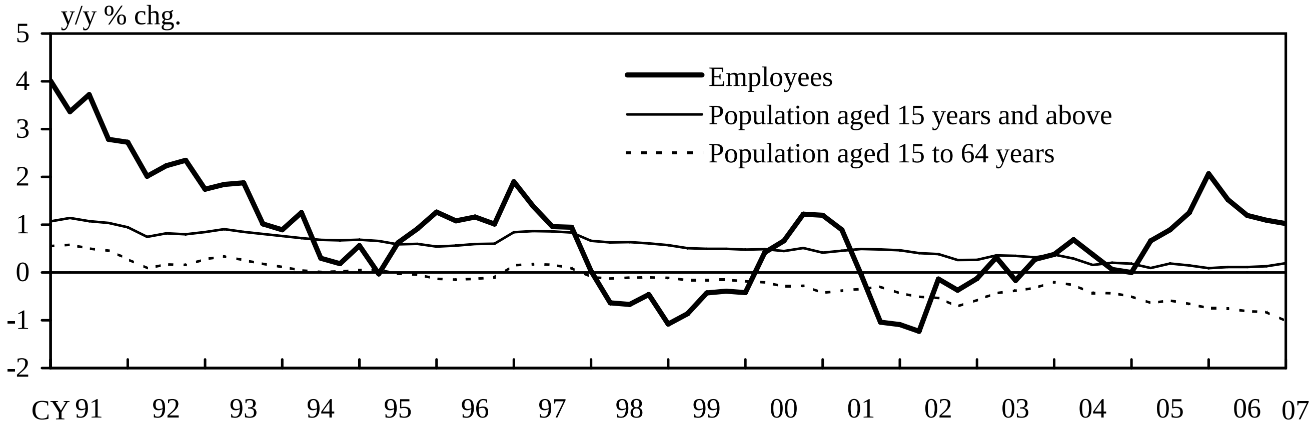
3. The phase of fixed investment at a certain time can be evaluated in relation to the hyperbolic curve corresponding to the expected growth rate at that time.

Note: Fixed investment in FY 2006 is calculated on the assumption that the investment growth rate in 2007/Q1 is the average of those of 2006/Q2-Q4.

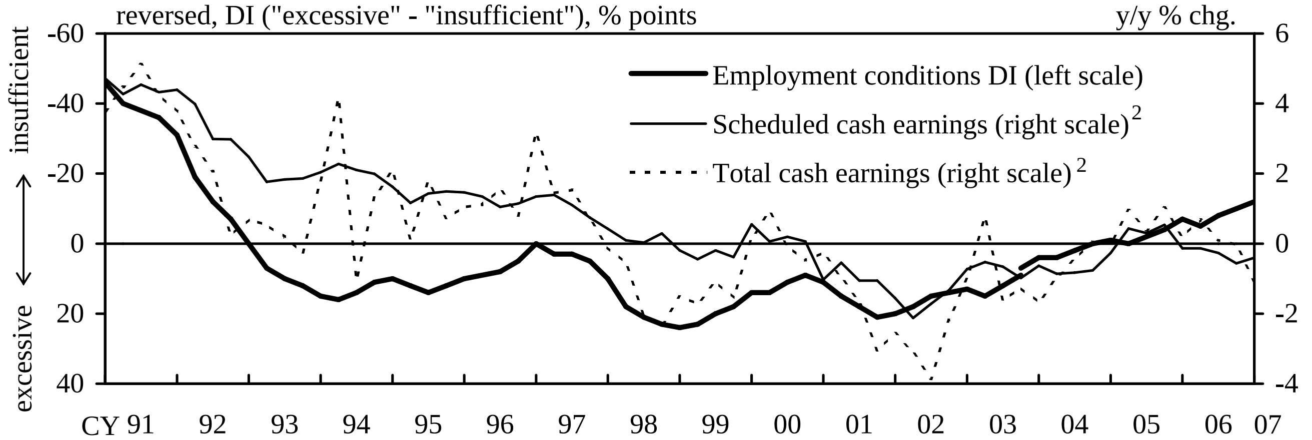
Sources: Cabinet Office, "National Accounts," "Sectoral Productivity and Economic Growth: 1970-1998"; Ministry of Economy, Trade and Industry, "Census of Manufactures."

Labor Market and Wages

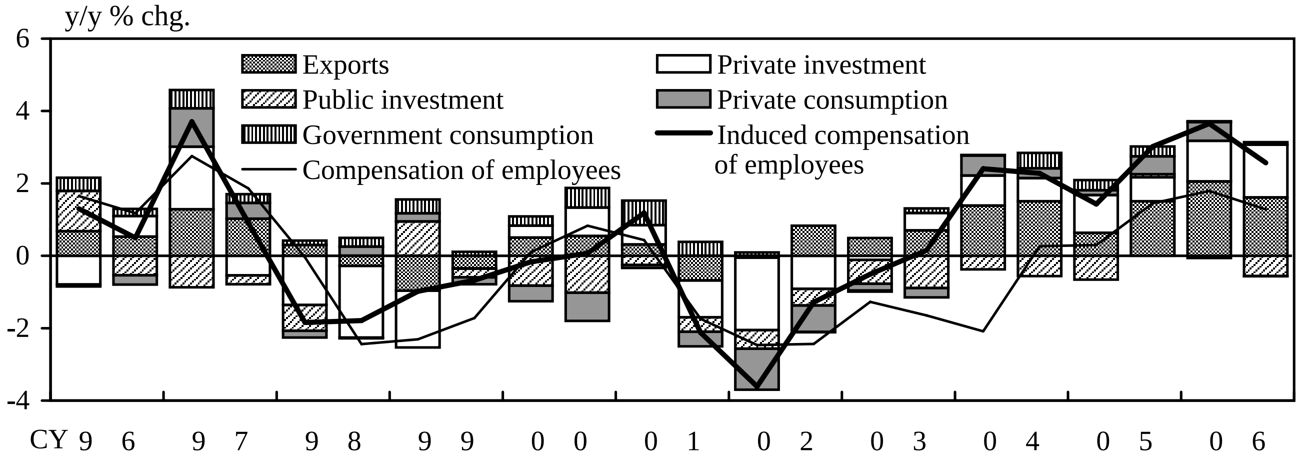
(1) Number of Employees and Population of Aged 15 Years and Above



(2) Employment Conditions DI and Wages[1]



(3) Induced Compensation of Employees[3]

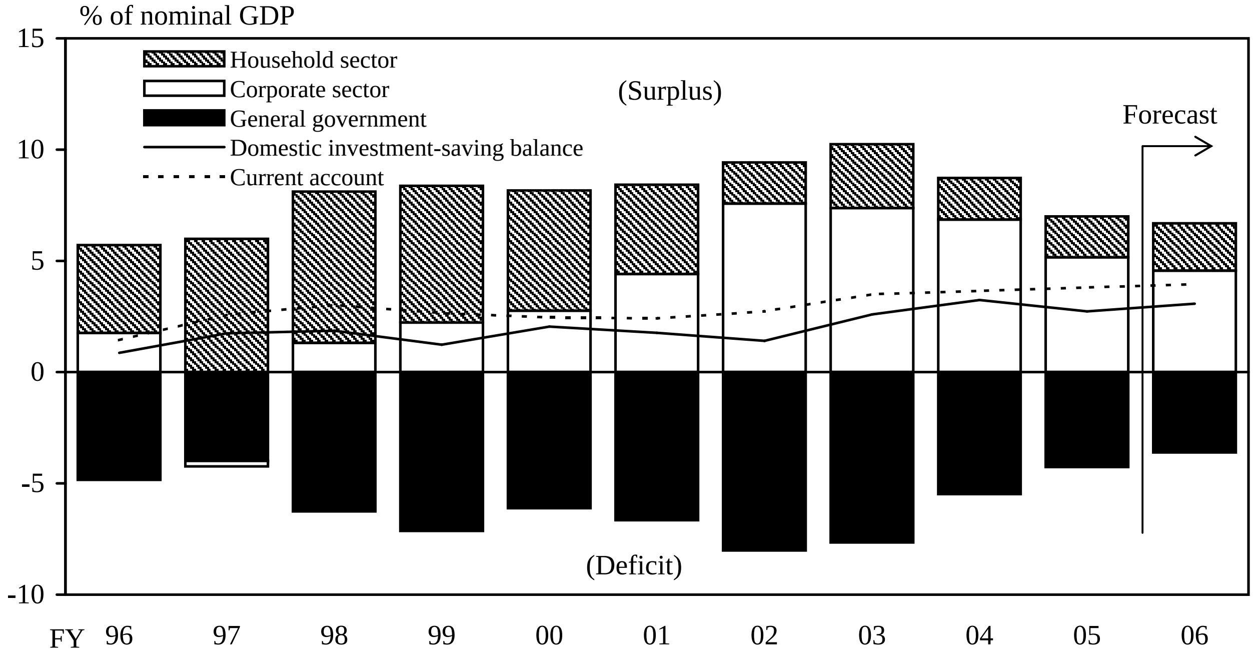


Notes: 1. Figures for 2007/Q1 are those of January-February averages.
2. Data are for establishments with at least 5 employees.
3. Induced compensation of employees is compensation induced by final demand.
It is assumed that figures of induced compensation coefficients after 2002 are constant at the level for 2002.

Sources: Ministry of Health, Labour and Welfare, "Monthly Labour Survey";
Ministry of Internal Affairs and Communications, "Labour Force Survey";
Bank of Japan, "*Tankan* , Short-Term Economic Survey of Enterprises in Japan";
Cabinet Office, "National Accounts," "Input-Output Table, 1993 SNA."

Investment-Saving Balance

(1) Investment-Saving Balance

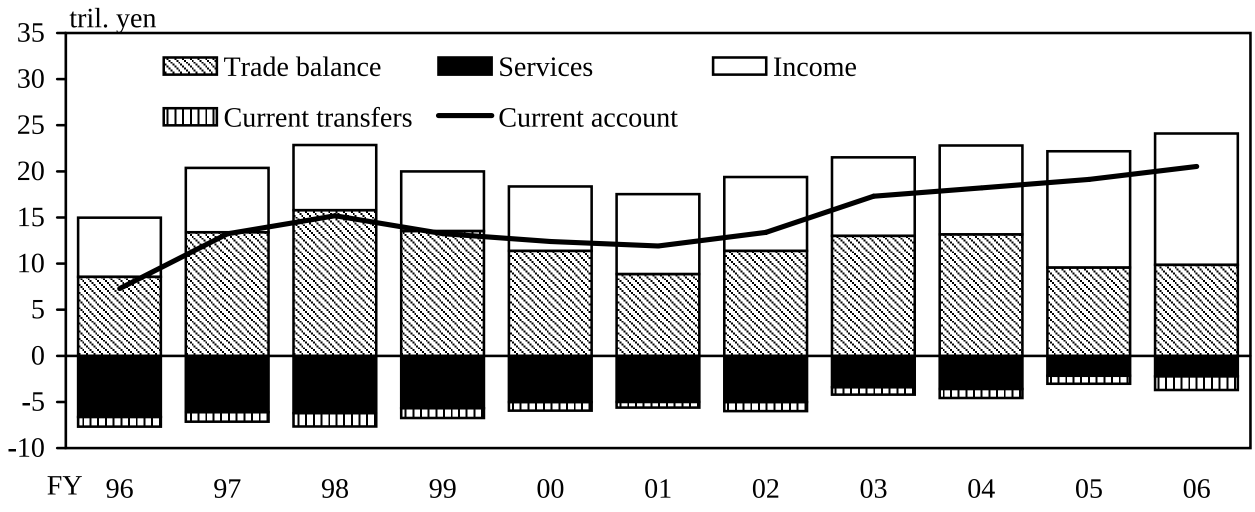


Notes: 1. The following factors are excluded from the domestic investment-saving balance: (1) redemption of JGBs held by the Deposit Insurance Corporation of Japan; (2) transfer of Japan National Railways' long-term debt and cumulative debt of the National Forestry Project (state-owned forests and fields) to general accounts (general government); and (3) transfer of assets and liabilities of Japan Expressway Holding and Debt Repayment Agency to the general government.

2. Figures for the current account, nominal GDP, private final consumption expenditure, and private housing investment in FY 2006 are those of the year-on-year average from April to December 2006. The domestic investment-saving balance in FY 2006 is estimated by subtracting 0.9 percentage point (the average difference between the domestic investment-saving balance and current account during FY 1996-2005) from the current account.

3. The figure for the investment-saving balance of the general government in FY 2006 is based on the "Course and Strategy for the Japanese Economy." The Figure for the balance of the household sector is estimated by subtracting private final consumption expenditure and private housing investment from personal disposable income in Chart 9. The figure for the balance of the corporate sector is the residue.

(2) Current Account

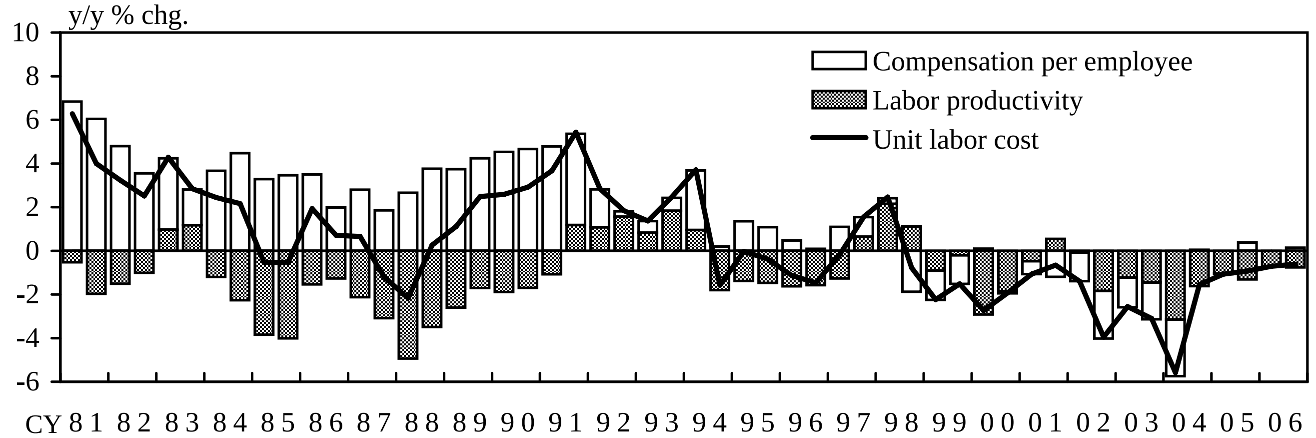


Note: Figures for FY 2006 are those of the year-on-year average from April 2006 to February 2007.

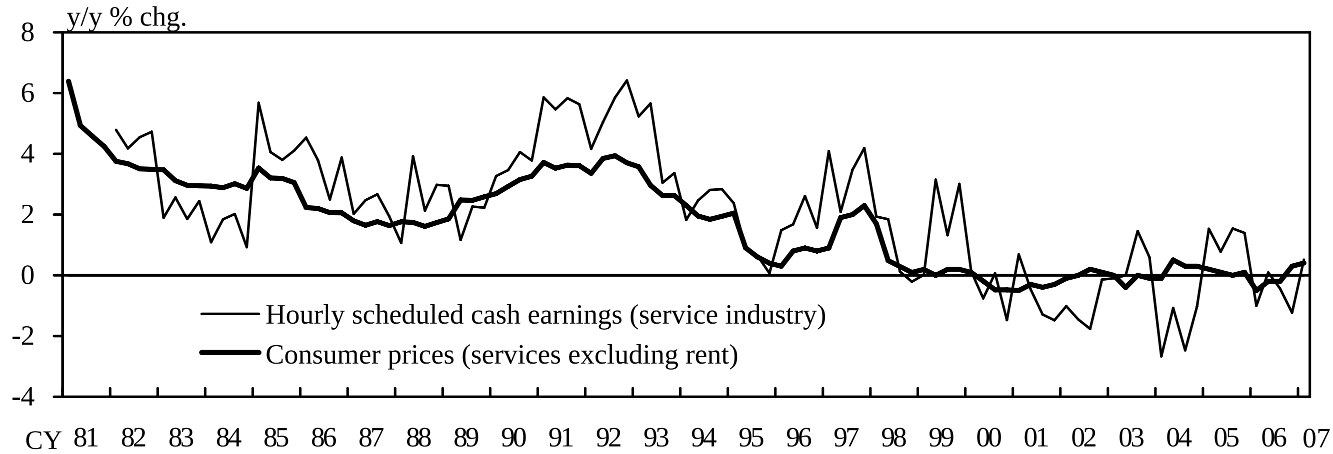
Sources: Cabinet Office, "National Accounts,""Course and Strategy for the Japanese Economy"; Bank of Japan, "Balance of Payments."

Unit Labor Cost

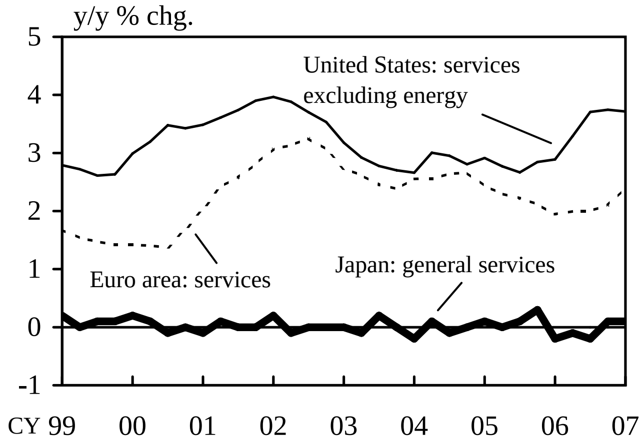
(1) Unit Labor Cost[1]



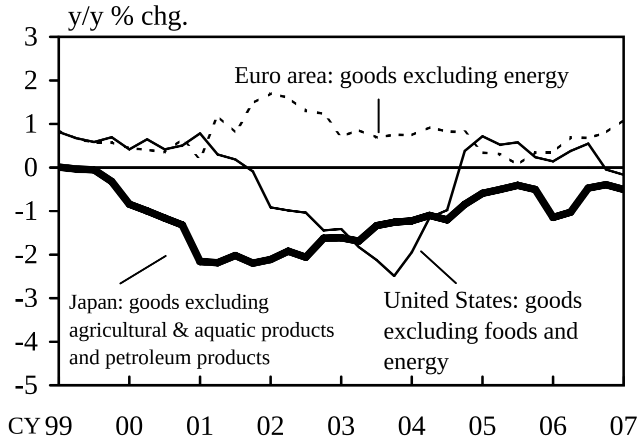
(2) Service Prices and Wages[2,3]



(3) Service Prices



(4) Goods Prices



Notes: 1. Before 1994, fixed-based series are used (base year = 1995). After 1995, chain-linked series are used (base year = 2000).

2. Figure of hourly scheduled cash earnings for 2007/Q1 is the January-February average.

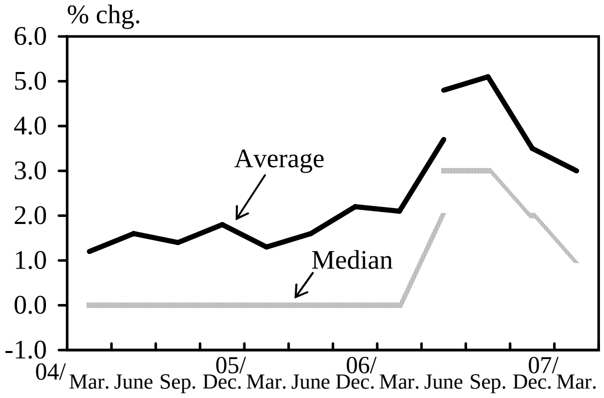
3. Wages are the sum of "eating and drinking places" and "services" of the previous industrial classification. From 2001, they are the sum of "eating and drinking places", "accommodations" and "miscellaneous education, learning support" and "services" of the new industrial classification. Data are for establishments with at least 30 employees.

Sources: Ministry of Health, Labour and Welfare, "Monthly Labour Survey"; Ministry of Internal Affairs and Communications, "Labour Force Survey", "Consumer Price Index"; Cabinet Office, "National Accounts"; Bureau of Labor Statistics; Eurostat.

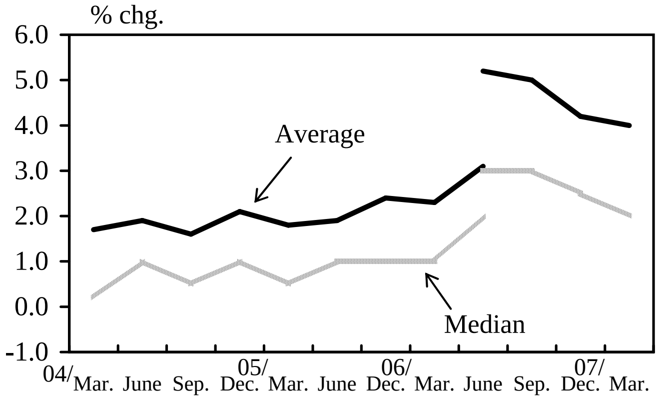
Outlook for Prices

(1) Households (Opinion Survey on the General Public's Views and Behavior)

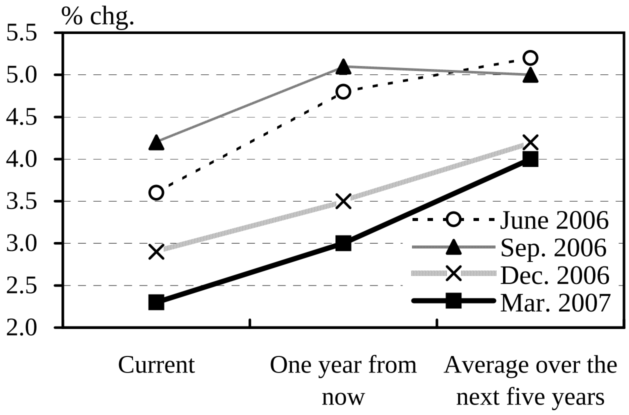
<Changes in the Price Levels One Year from Now>



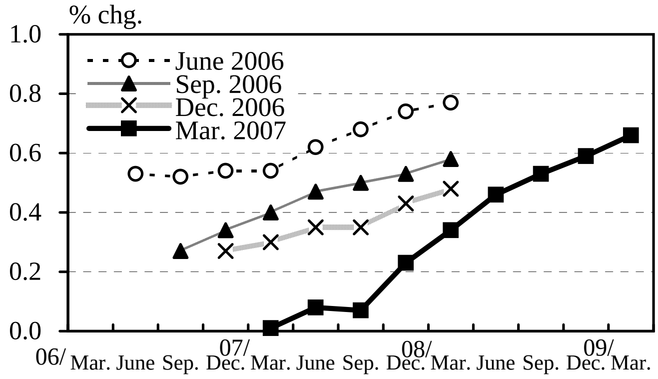
<Changes in the Price Levels per Year on Average over the Next Five Years>



<Perception of Current Inflation Rate and Outlook for Future Inflation Rates [Average]>



(2) Economists (ESP Forecast)



Note: Figures for (1) are calculated by excluding 0.5 percent of the highest and the lowest figures, respectively. The survey was not conducted in September 2005. The survey method was changed in September 2006. A preliminary survey was conducted under the new method in June 2006.

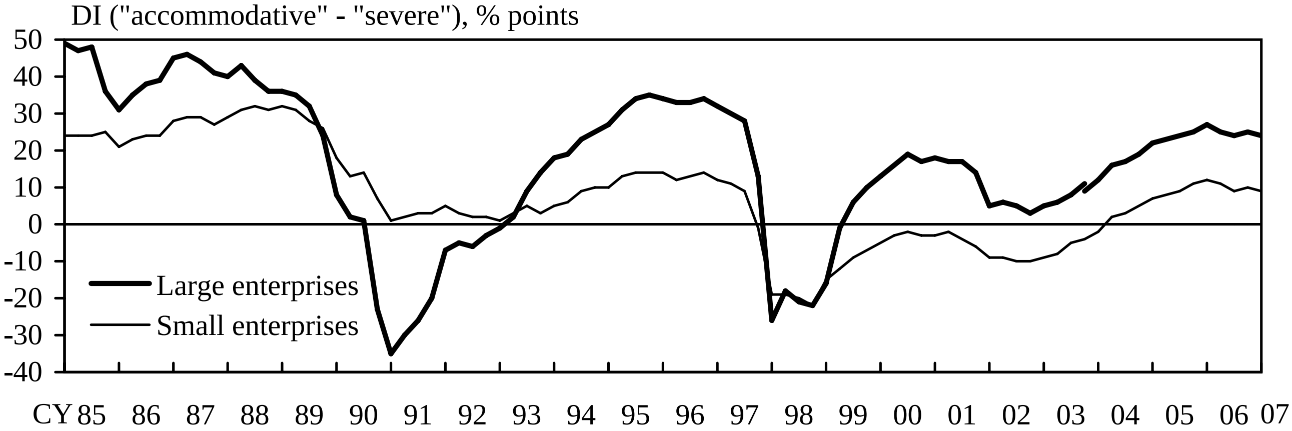
(3) Firms (*Tankan* , Change in Output Prices [Forecast One Quarter Ahead])

Notes: 1. All-size enterprises.
2. The *Tankan* has been revised from the March 2004 survey. Figures based on the previous data sets are up to the December 2003 survey. Figures on a new basis are from the December 2003 survey.

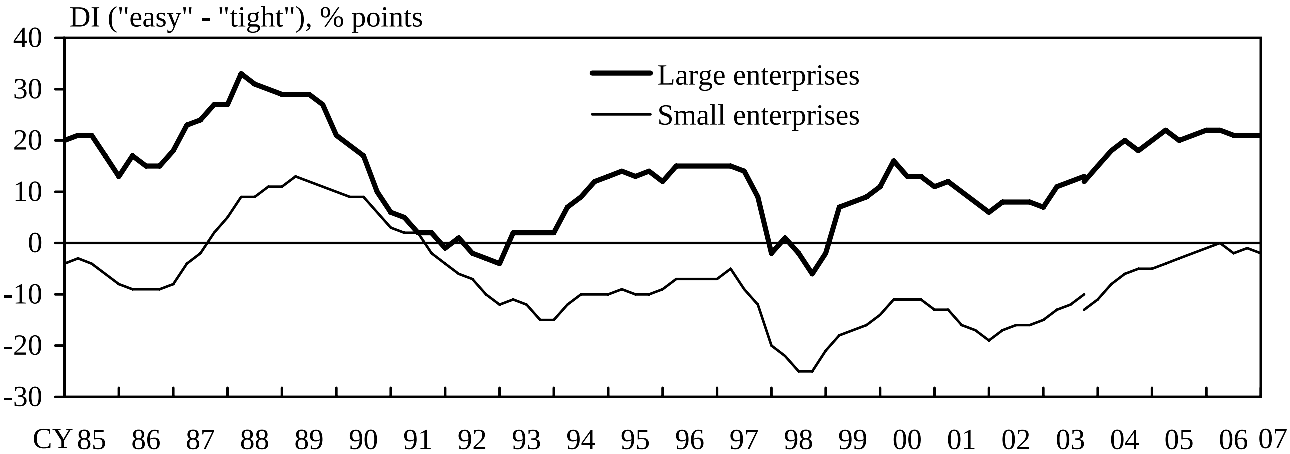
Source: Bank of Japan, "Opinion Survey on the General Public's Mindset and Behavior," "*Tankan* , Short-Term Economic Survey of Enterprises in Japan"; Economic Planning Association, "ESP Forecast."

Corporate Finance

(1) Lending Attitude of Financial Institutions as Perceived by Firms (*Tankan*)

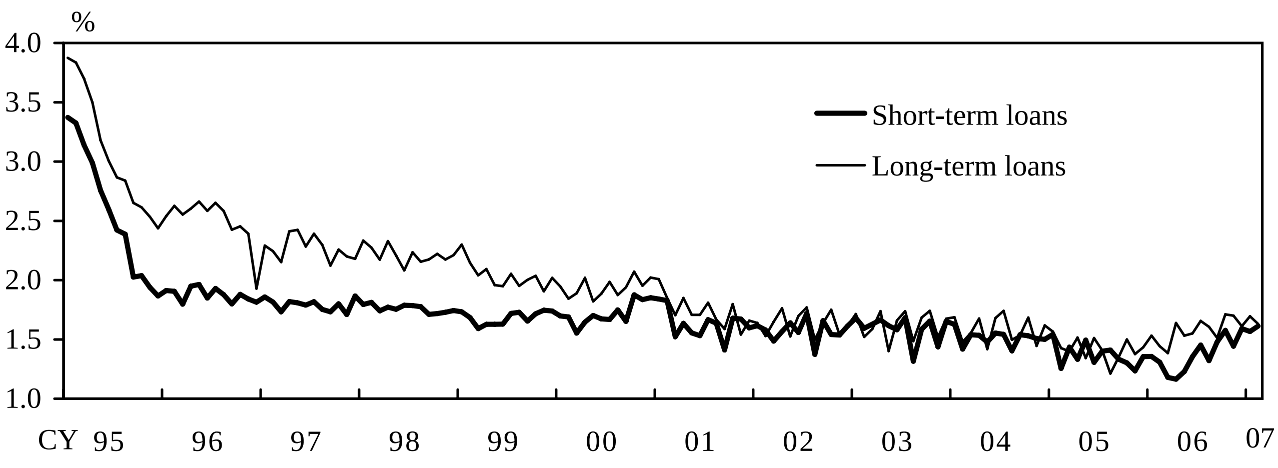


(2) Financial Position of Firms (*Tankan*)



Note: The *Tankan* has been revised from the March 2004 survey. Figures based on the previous data sets are up to the December 2003 survey. Figures on a new basis are from the December 2003 survey.

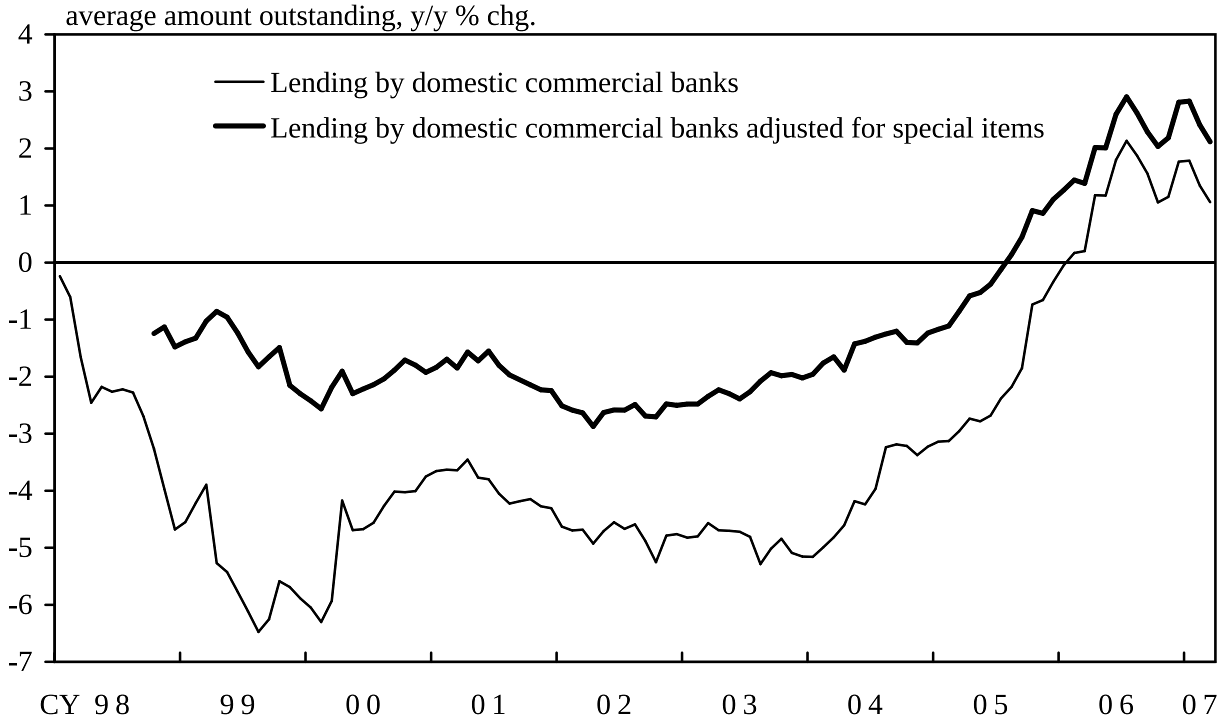
(3) Average Contracted Interest Rates on New Loans and Discounts



Source: Bank of Japan, "*Tankan*, Short-Term Economic Survey of Enterprises in Japan," "Average Contracted Interest Rates on Loans and Discounts."

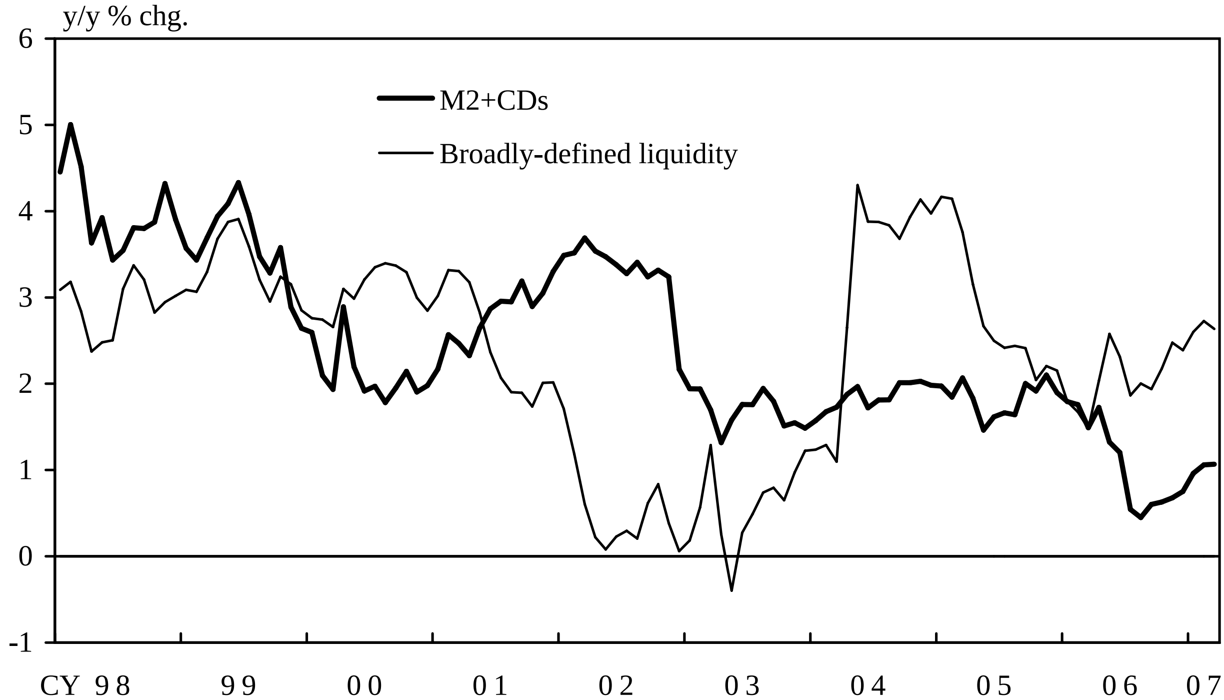
Bank Lending and Money Stock

(1) Lending by Domestic Commercial Banks



Note: Adjusted figures exclude fluctuations from liquidations of loans, loan write-offs, etc.

(2) Money Stock

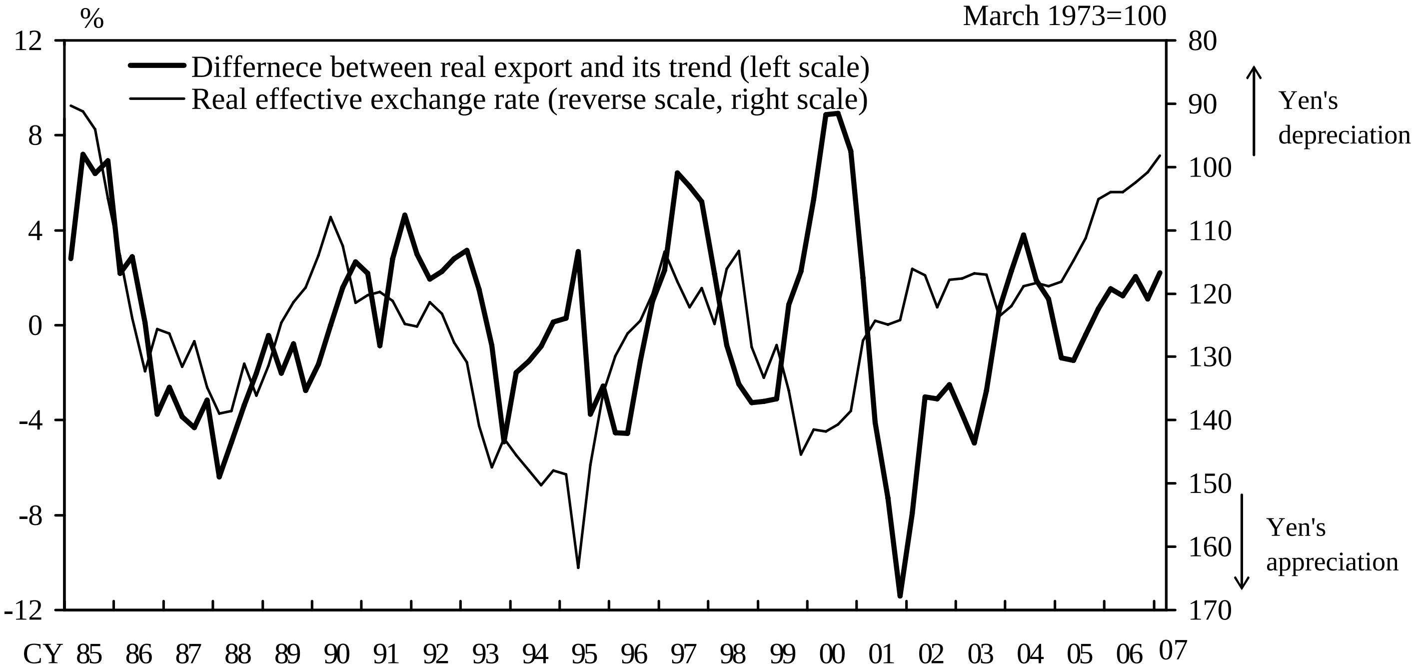


Source: Bank of Japan, "Principal Figures of Financial Institutions," "Money Stock."

Chart 22

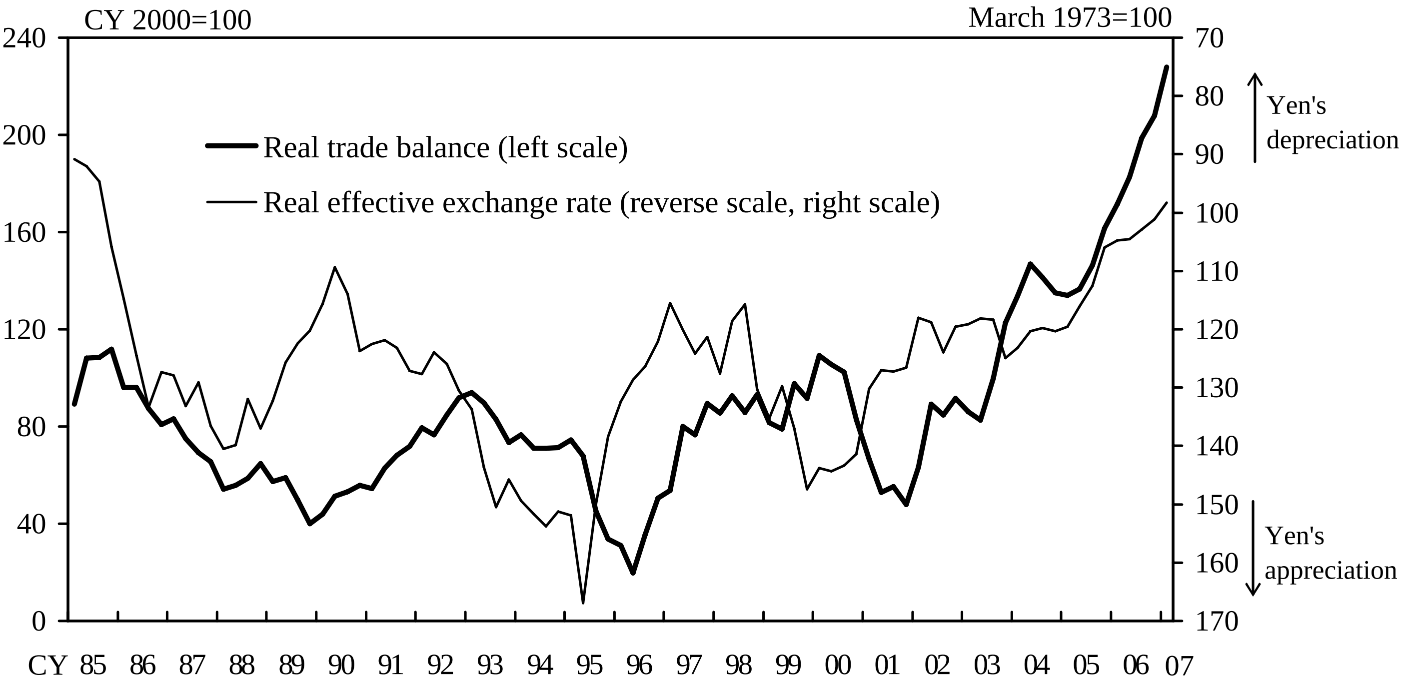
Real Trade Balance and Exchange Rate

(1) Real Exports and Real Effective Exchange Rate



Notes: 1. Real export trend is calculated by applying the HP filter.
2. The real effective exchange rate is a weighted average of the yen's real exchange rates against 15 currencies that have a large share among Japanese total exports.

(2) Real Trade Balance and Real Effective Exchange Rate

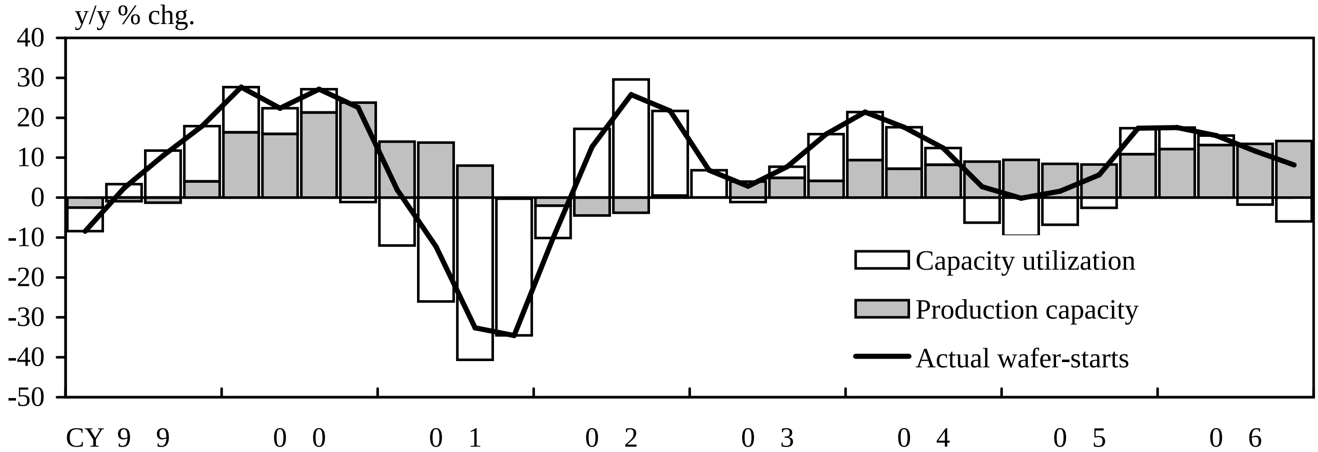


Note: The real effective exchange rate is a weighted average of the real export effective exchange rate and the real import effective exchange rate.

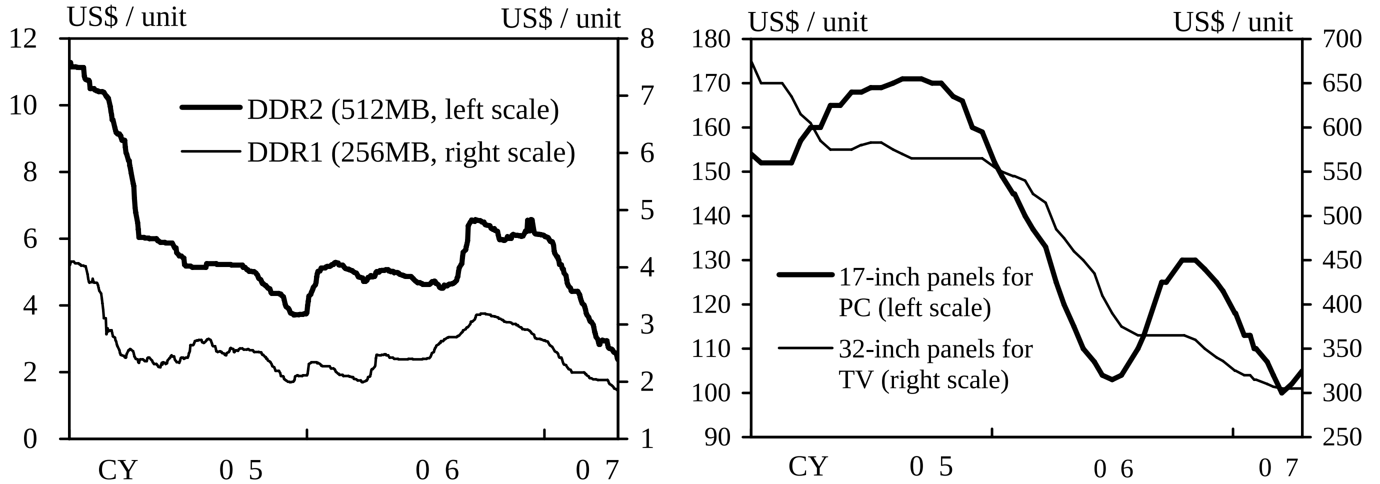
Source: Bank of Japan, "Real Exports and Real Imports," "Effective Exchange Rate.

Developments in the IT-Related Sectors

(1) Global Semiconductors

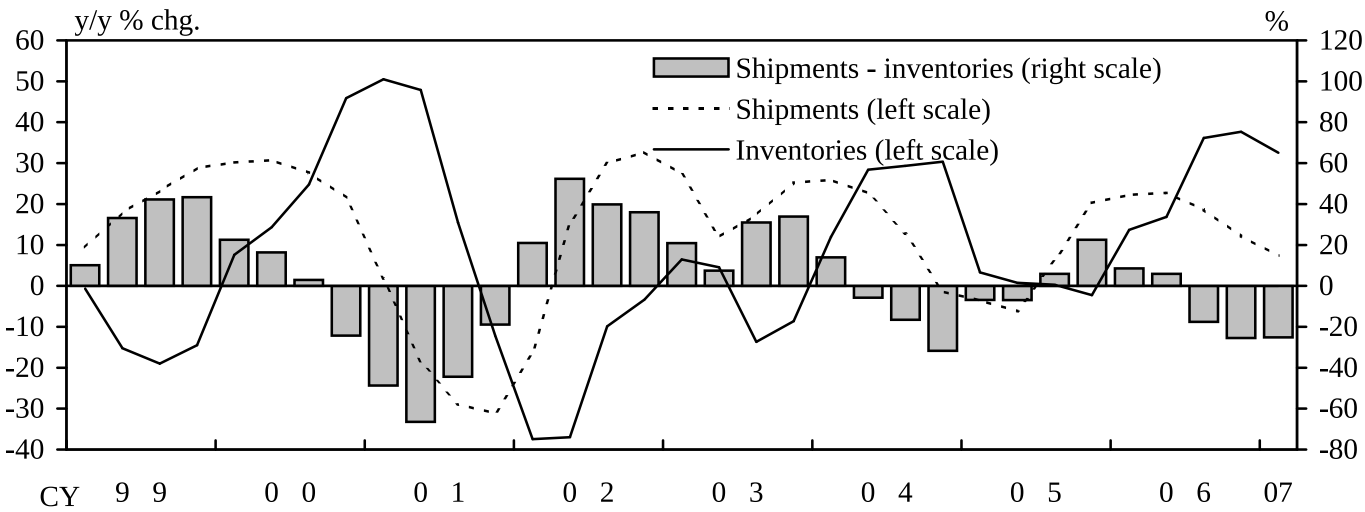


(2) DRAM Prices and LCD Panel Prices



Note: Figures for DRAMs and panels are up to April 26 and April 20, respectively.

(3) Electronic Parts and Devices

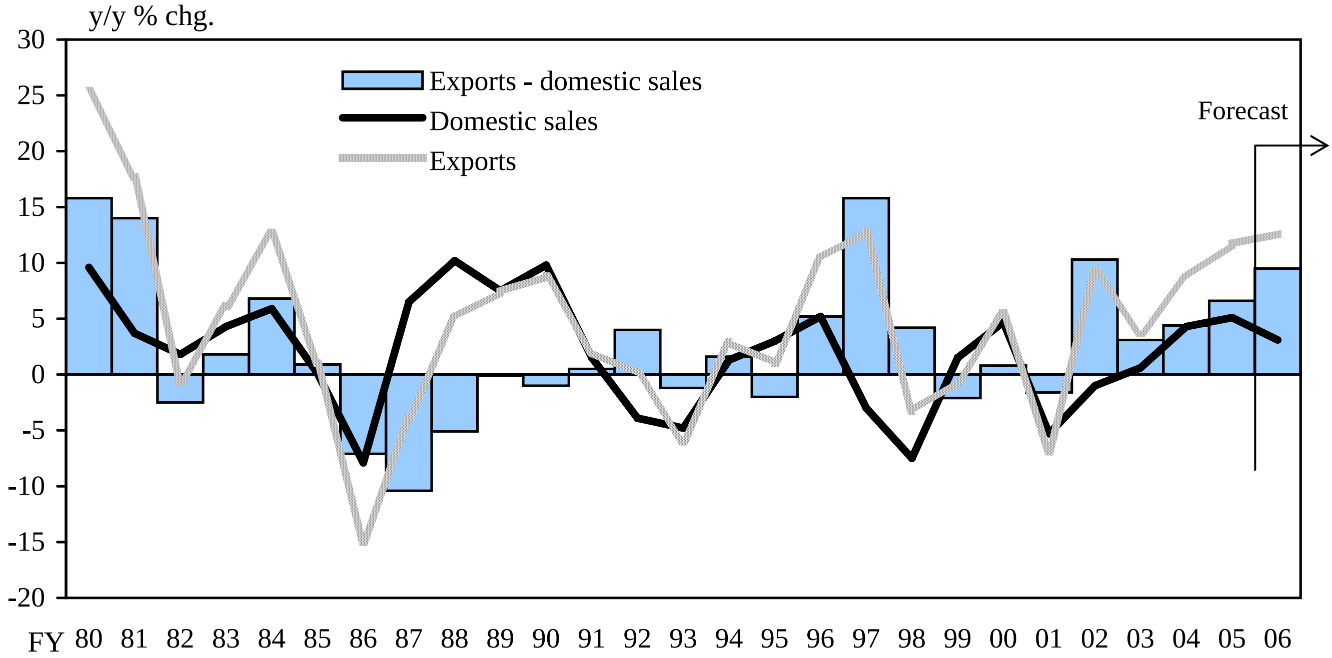


Sources: Ministry of Economy, Trade and Industry, "Indices of Industrial Production"; SICAS, "Semiconductor International Capacity Statistics"; Bloomberg.

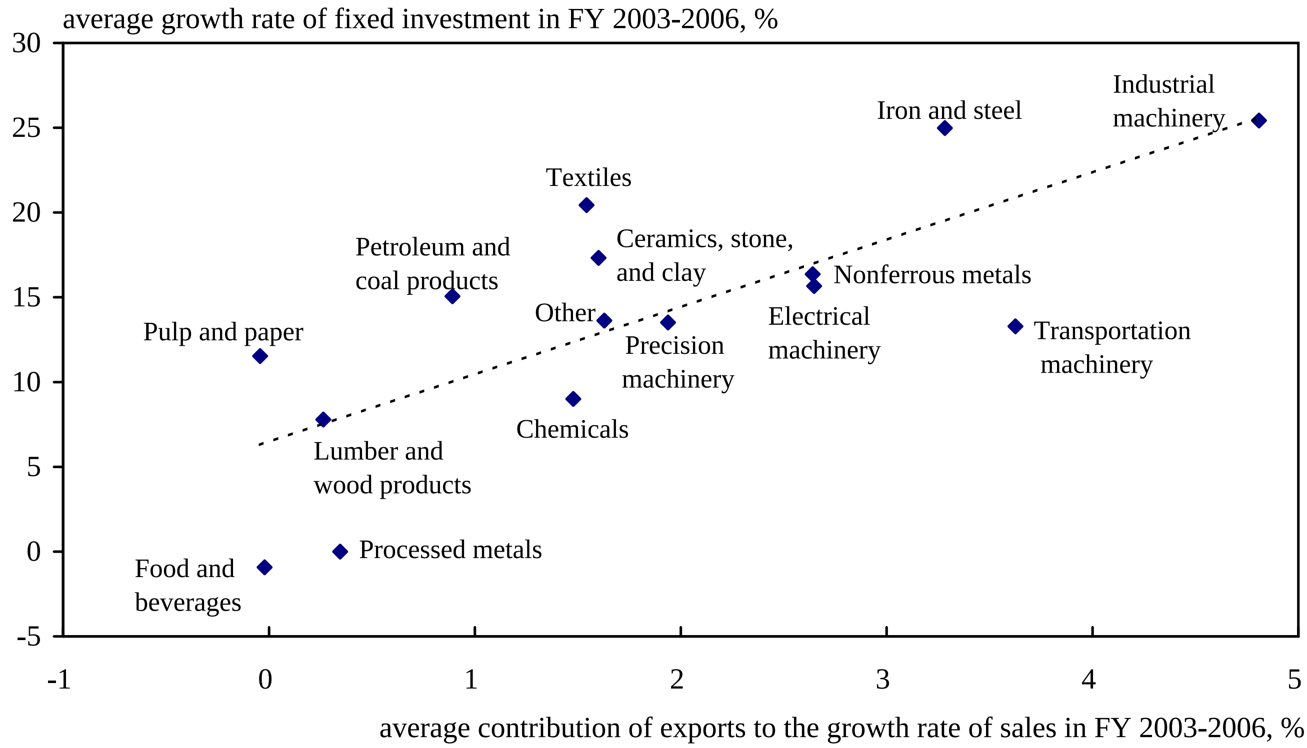
Chart 24

Relationship between Exports and Fixed Investment

(1) Domestic Sales and Exports of Large Manufacturing Enterprises



(2) Relationship between Exports and Fixed Investment of Large Manufacturing Enterprises

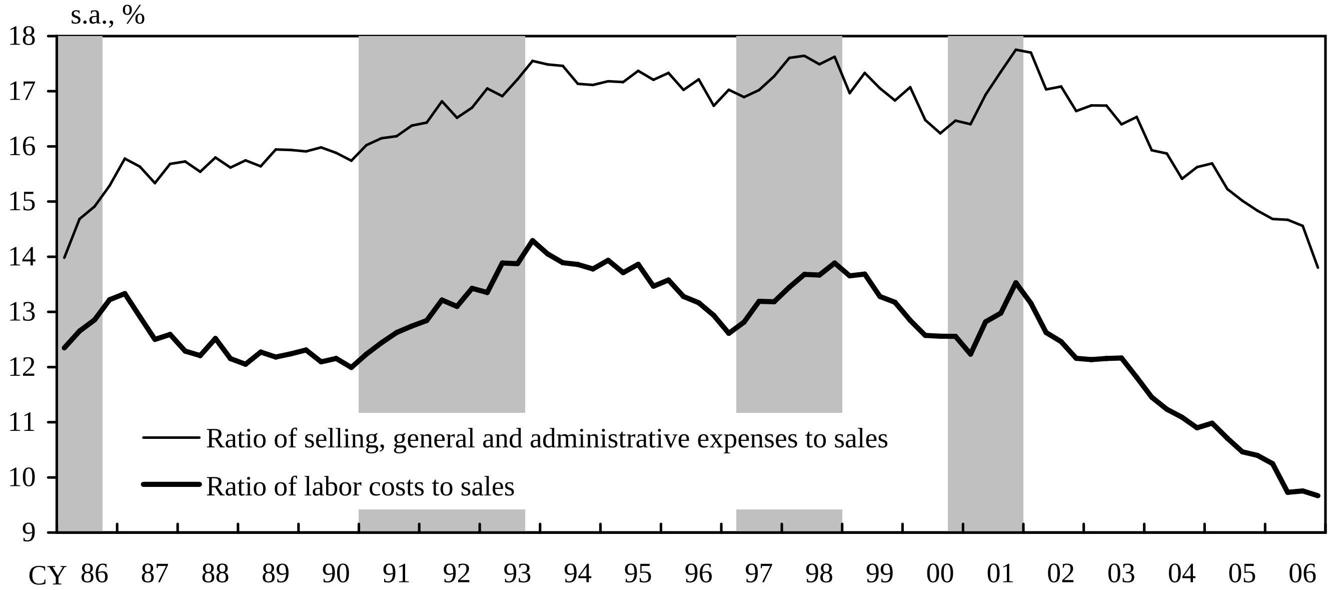


Note: Figures for FY 2006 are forecasts in the March 2007 survey.

Source: Bank of Japan, "*Tankan*, Short-Term Economic Survey of Enterprises in Japan."

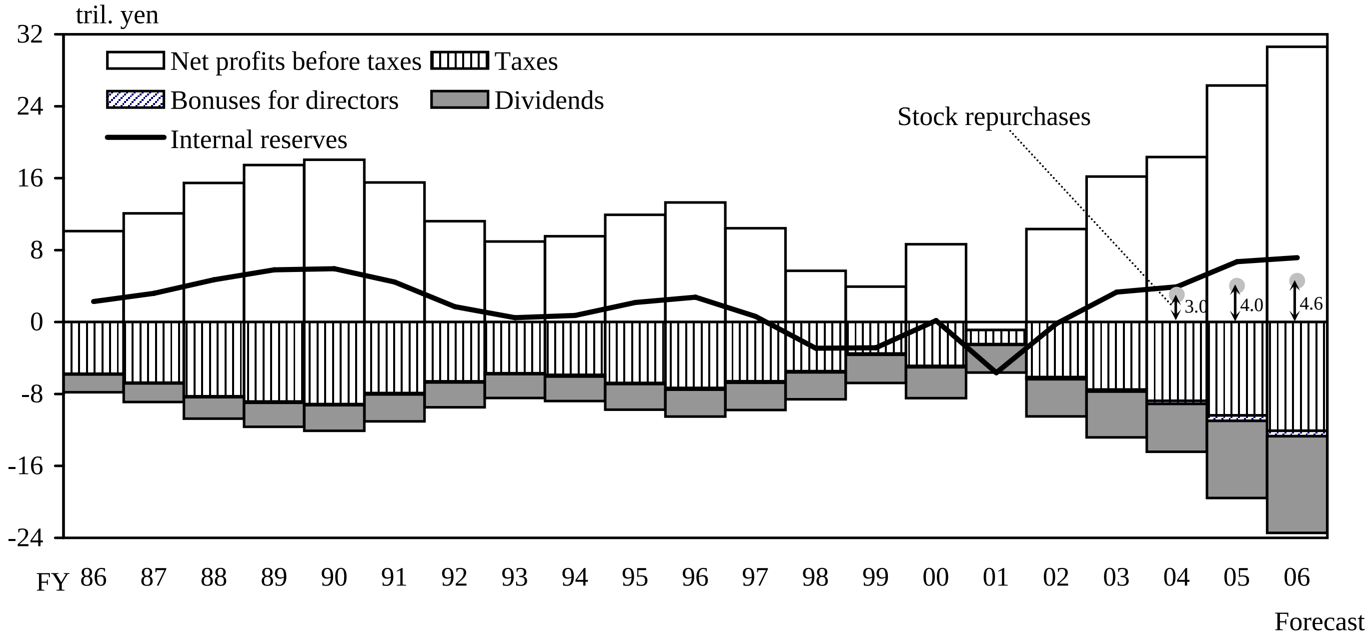
Cost Saving and Profits Appropriation

(1) Labor Costs and Selling, General and Administrative Expenses (Large Manufacturing Enterprises)



Note: Shaded areas indicate recession periods.

(2) Profits Appropriation (Large Enterprises)



Notes: 1. Internal reserves = net profits before taxes - taxes - bonuses for directors - dividends.

2. Net profits before taxes in FY 2006 are calculated by multiplying those in FY 2005 by the year-on-year expected growth rate of the net profits in the March 2007 *Tankan* survey.

3. Taxes after FY 2004 include corporate tax adjustments. Taxes in FY 2006 are calculated by multiplying those in FY 2005 by the year-on-year expected growth rate of the net profits on the March 2007 *Tankan* survey.

4. Bonuses for directors in FY 2006 are calculated to be the same amount as those in FY 2005.

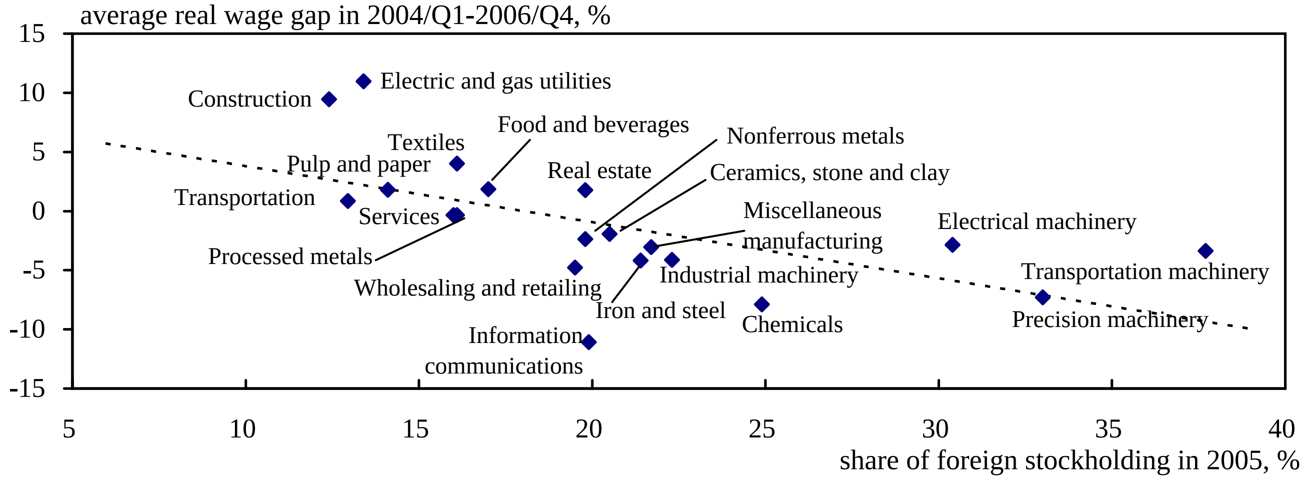
5. Dividends in FY 2006 are calculated by multiplying those in FY 2005 by the year-on-year growth rate of the dividends paid as a midterm dividend in FY 2006 by listed firms on the Tokyo Stock Exchange First Section which close the books at the end of March (excluding financial institutions and nonbanks).

6. Stock repurchases are for listed firms on the Tokyo Stock Exchange. Stock repurchases in FY 2006 are calculated by multiplying those in FY 2005 by the year-on-year growth rate of the stocks repurchased from April 2006 to February 2007.

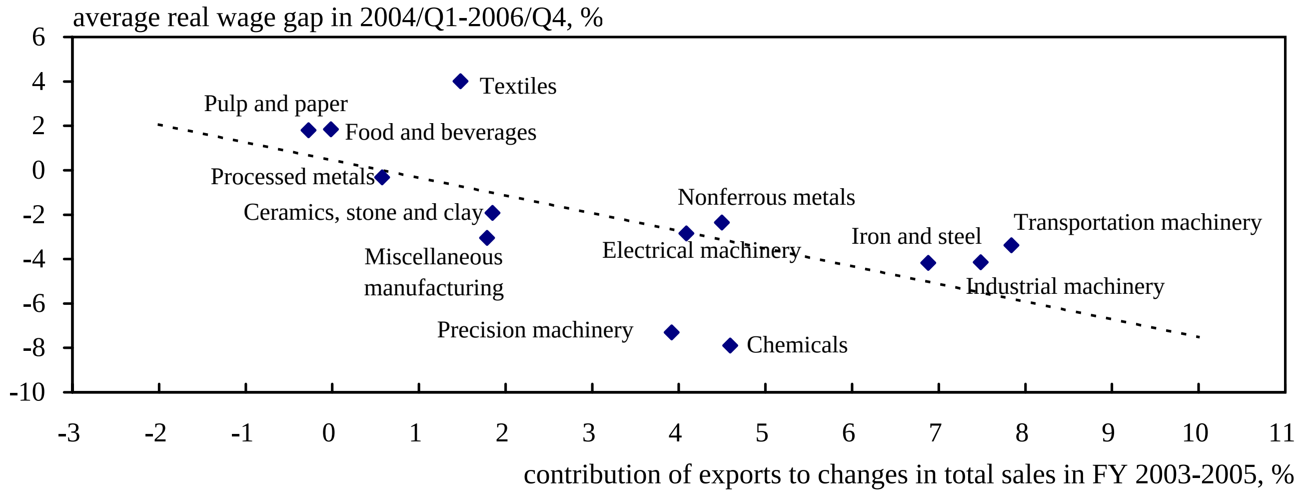
Sources: Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Quarterly," "Financial Statements Statistics of Corporations by Industry, Annually"; Nikkei Financial QUEST; Tokyo Stock Exchange, "State of Purchase and Dispose of Company's Own Share Certificates"; Bank of Japan, "*Tankan*, Short-Term Economic Survey of Enterprises in Japan."

Downward Pressure on Wages

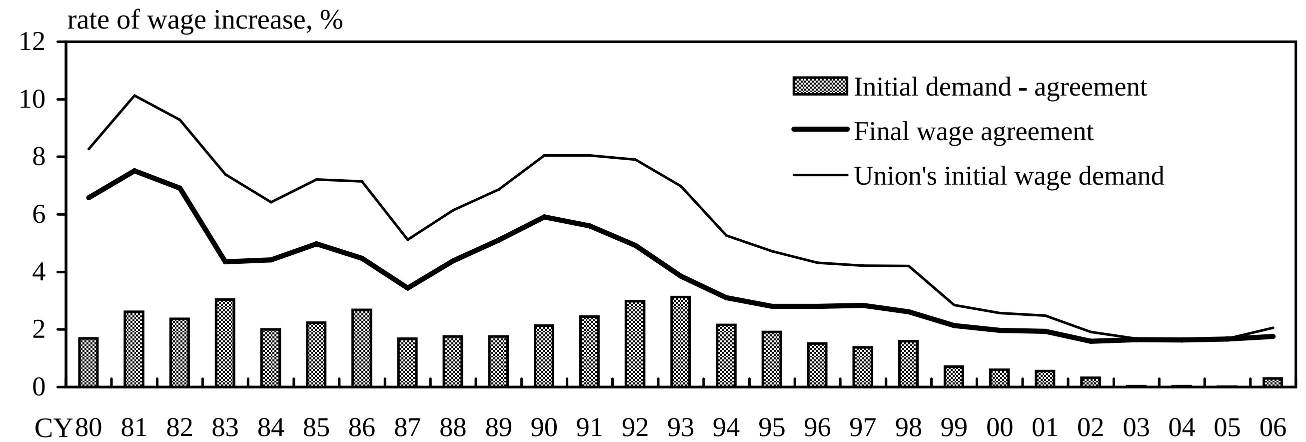
(1) Real Wage Gap and Share of Foreign Stockholding



(2) Real Wage Gap and Exports



(3) Wage Negotiation



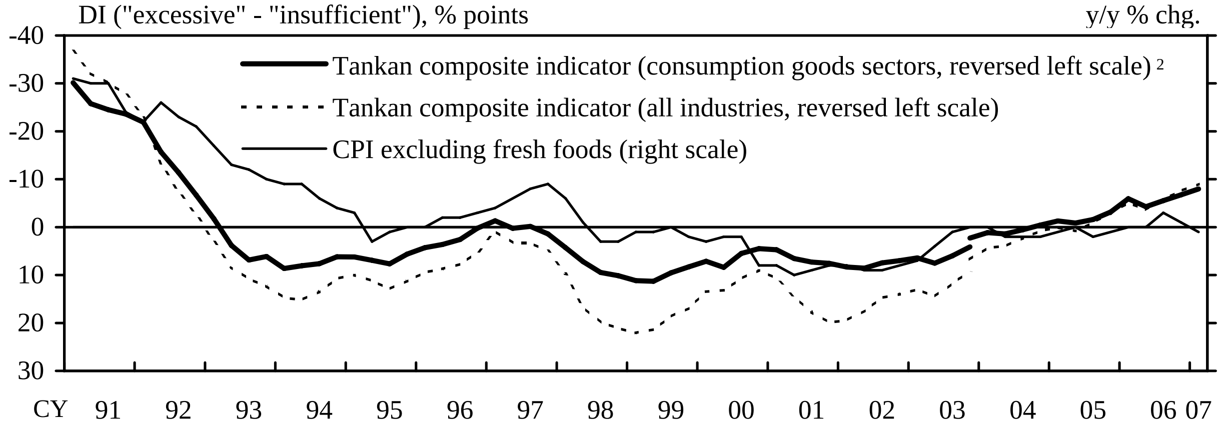
Notes: 1. Real wage gap is the deviation of real wages from their equilibrium level which is estimated from the long-run relationship between real wages and productivity.

2. Union's initial wage demand and fianl wage agreement are from Japan Business Federation "Labour Information." Due to the discontinuance of the union's initial wage demand in 2005, union's initial wage demand after 2005 is that of spring wage offensives released by the Ministry of Health, Labour and Welfare.

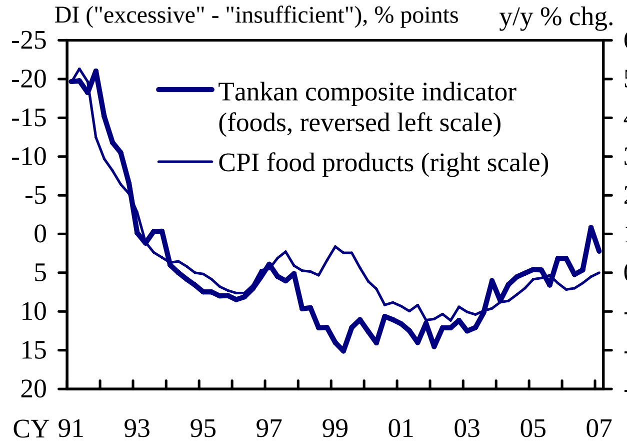
Sources: Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Quarterly"; Cabinet Office, "National Accounts"; Ministry of Health, Labour and Welfare, "Monthly Labour Survey" Japan Business Federation, "Labour Information"; Tokyo Stock Exchange, "Shareownership Survey" Bank of Japan, "*Tankan* , Short-Term Economic Survey of Enterprises in Japan."

Resource Utilization and CPI

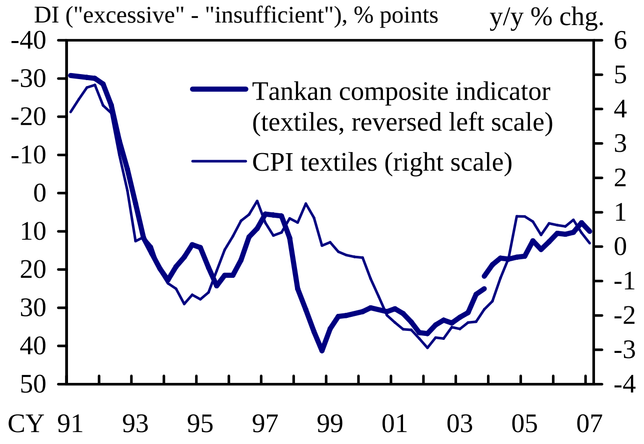
(1) *Tankan* Composite Indicator[1]



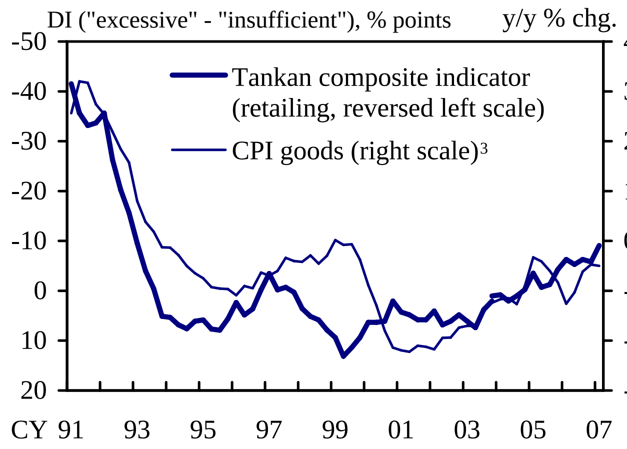
(2) Foods



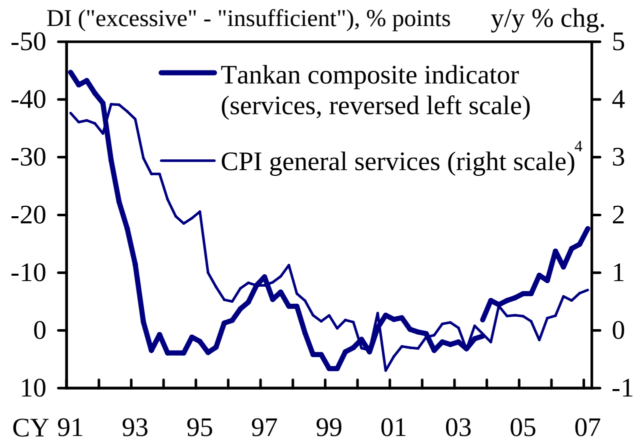
(3) Textiles



(4) Retailing



(5) Services

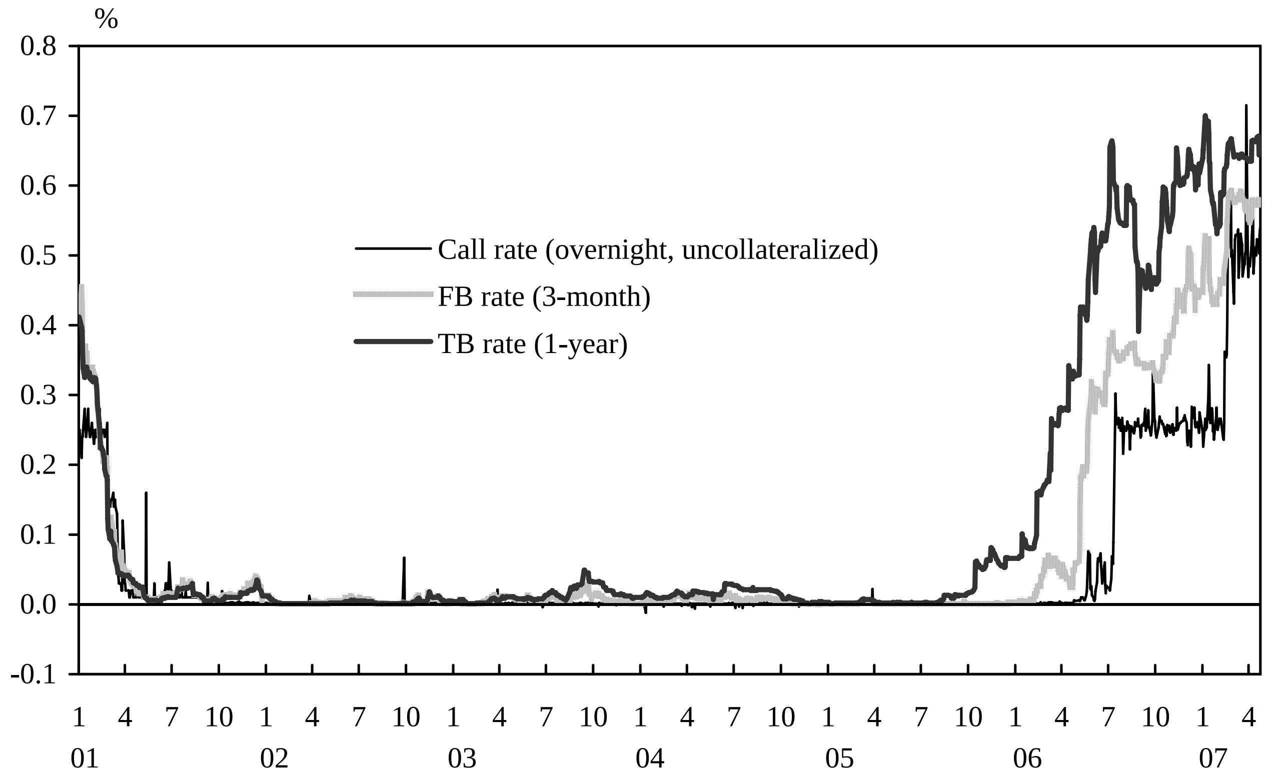


Notes: 1. The *Tankan* composite indicator is calculated as the average of the diffusion indices (all enterprises) of production capacity and employment conditions, weighted by capital and labor shares in the national accounts (FY 1990-2005 average).
2. The *Tankan* composite indicator of consumption goods sectors is calculated as the average of the sectoral indicators, weighted by sectoral shares in the private consumption in the Input-Output Table.
3. Excluding agricultural and aquatic products and petroleum products.
4. Excluding rent and mobile telephone charges.

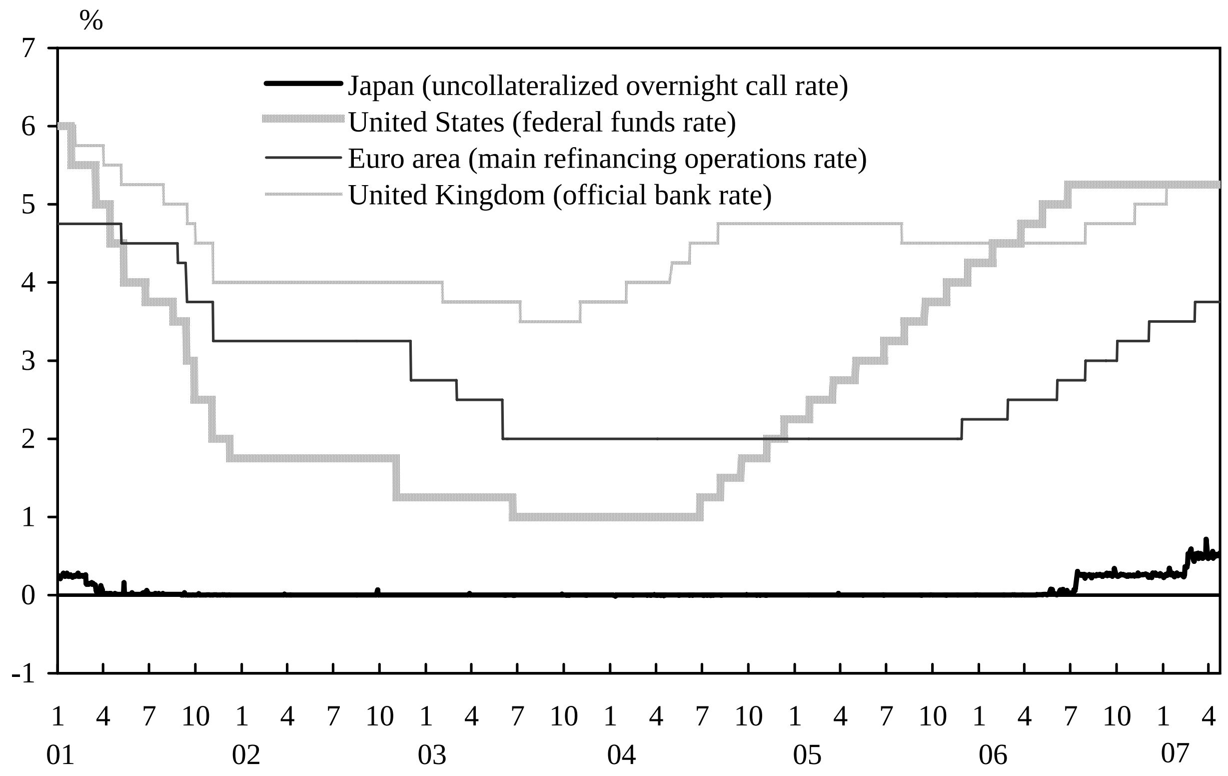
Sources: Ministry of Internal Affairs and Communications, "Consumer Price Index"; Bank of Japan, "*Tankan*, Short-Term Economic Survey of Enterprises in Japan"; Cabinet Office,"National Accounts,""Input-Output Table."

Short-Term Interest Rates

(1) Short-Term Interest Rates



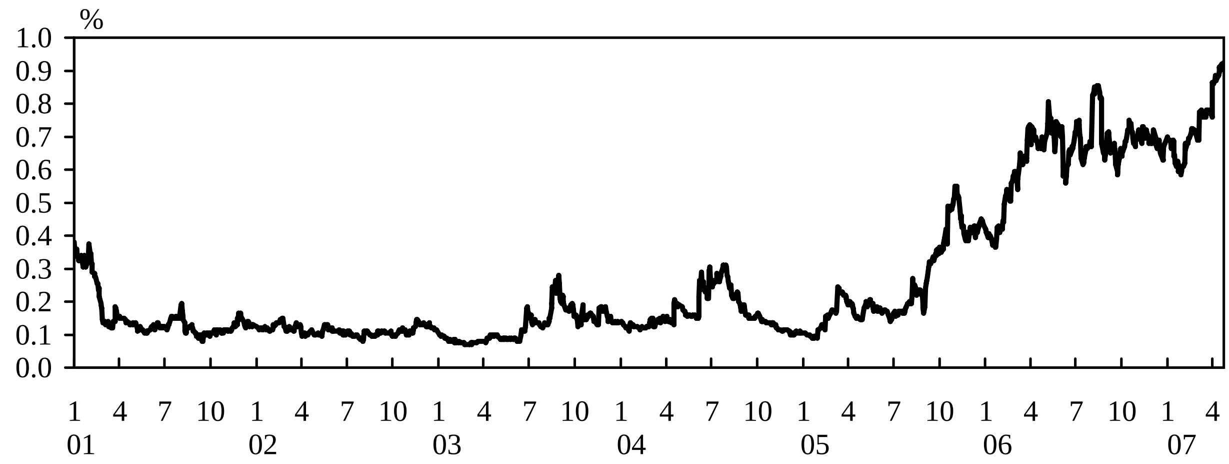
(2) Policy Interest Rates in Major Economies



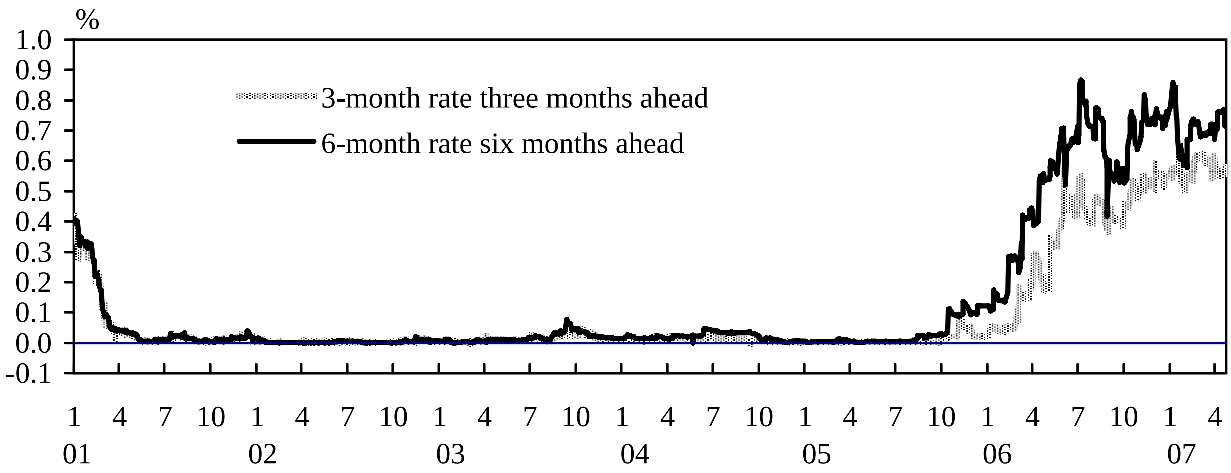
Sources: Bank of Japan; other central banks; Bloomberg.

Market Participants' Expectations on Interest Rates in the Future

(1) Euroyen Interest Rate Futures (3-Month, Leading Contract Months)

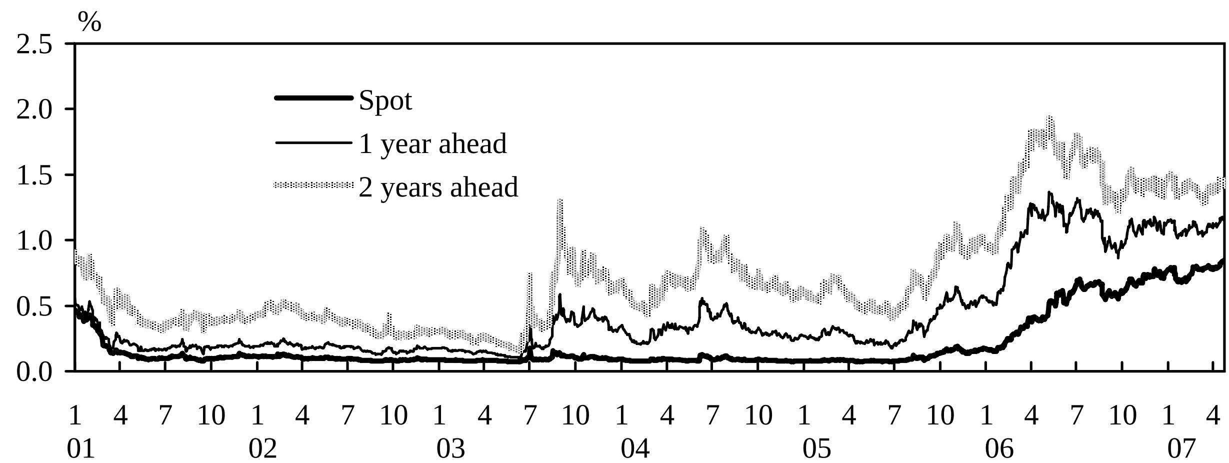


(2) Implied Forward Rates (3-Month, 6-Month)



Note: Calculated from the FB rate (3-month) and TB rates (6-month, 1-year).

(3) Implied Forward Rates (1-Year)

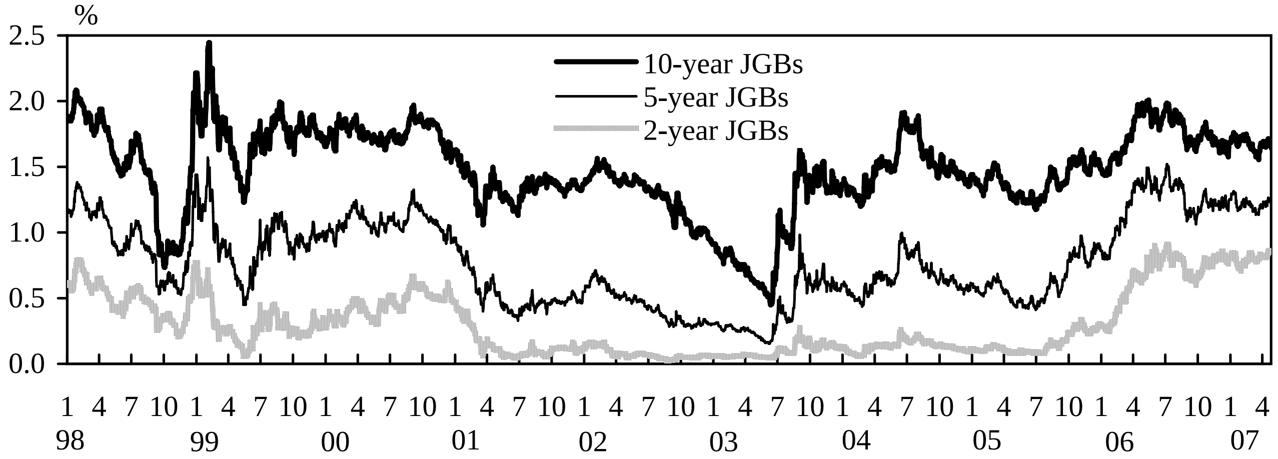


Note: Calculated from yen-yen swap rates.

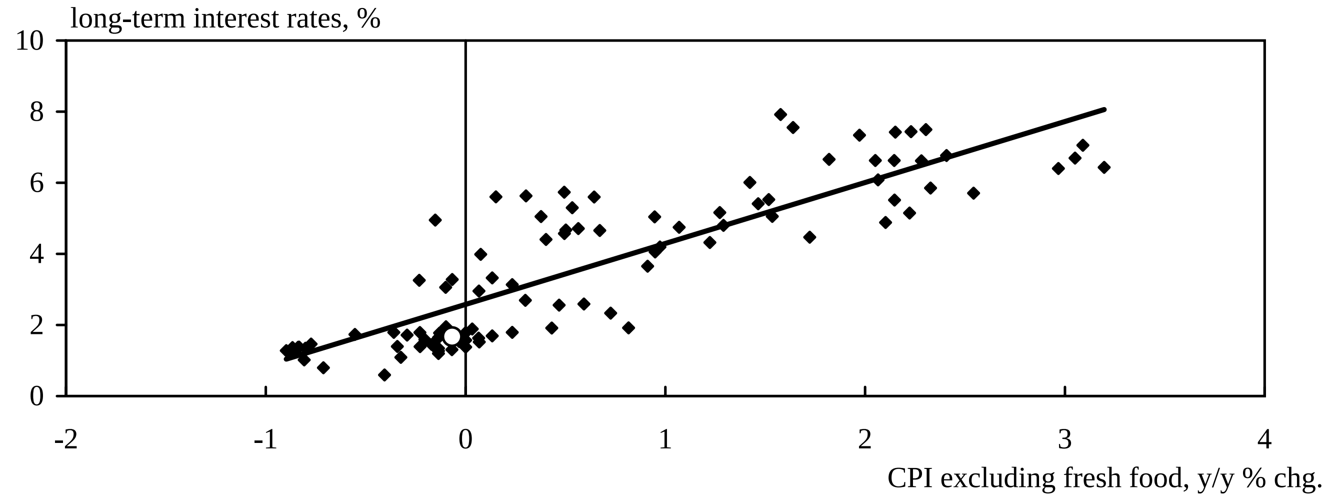
Sources: Tokyo Financial Exchange; Reuters; Bloomberg.

Long-Term Interest Rates

(1) Government Bond Yields

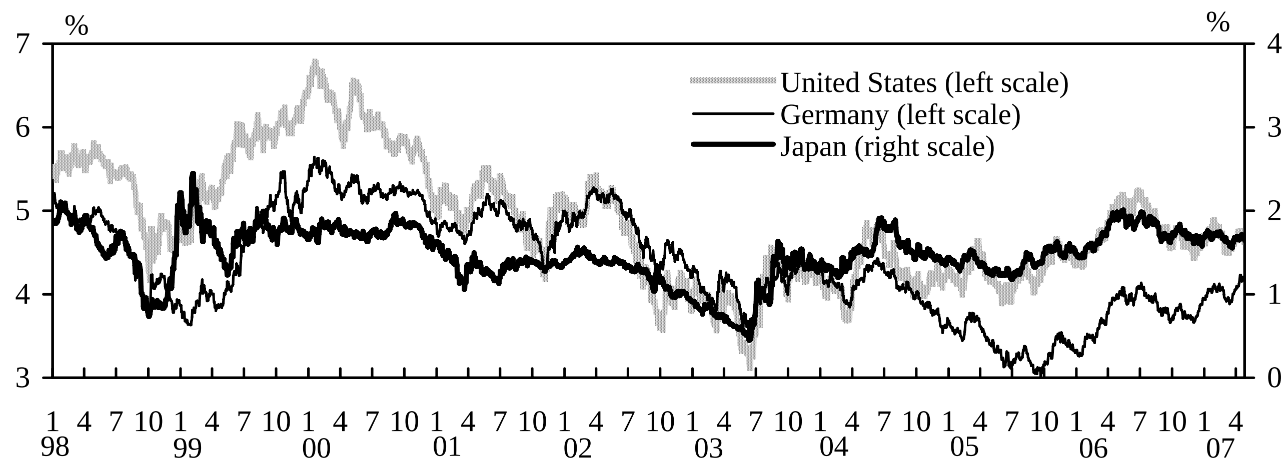


(2) Long-Term Interest Rates and Change in the Consumer Price Index



Notes: 1. Long-term interest rates are 10-year JGB yields.
2. CPI is adjusted to exclude the effects of the changes in consumption tax rate.
3. The sample period is 1983/Q3-2007/Q1. The white circle indicates the latest data.

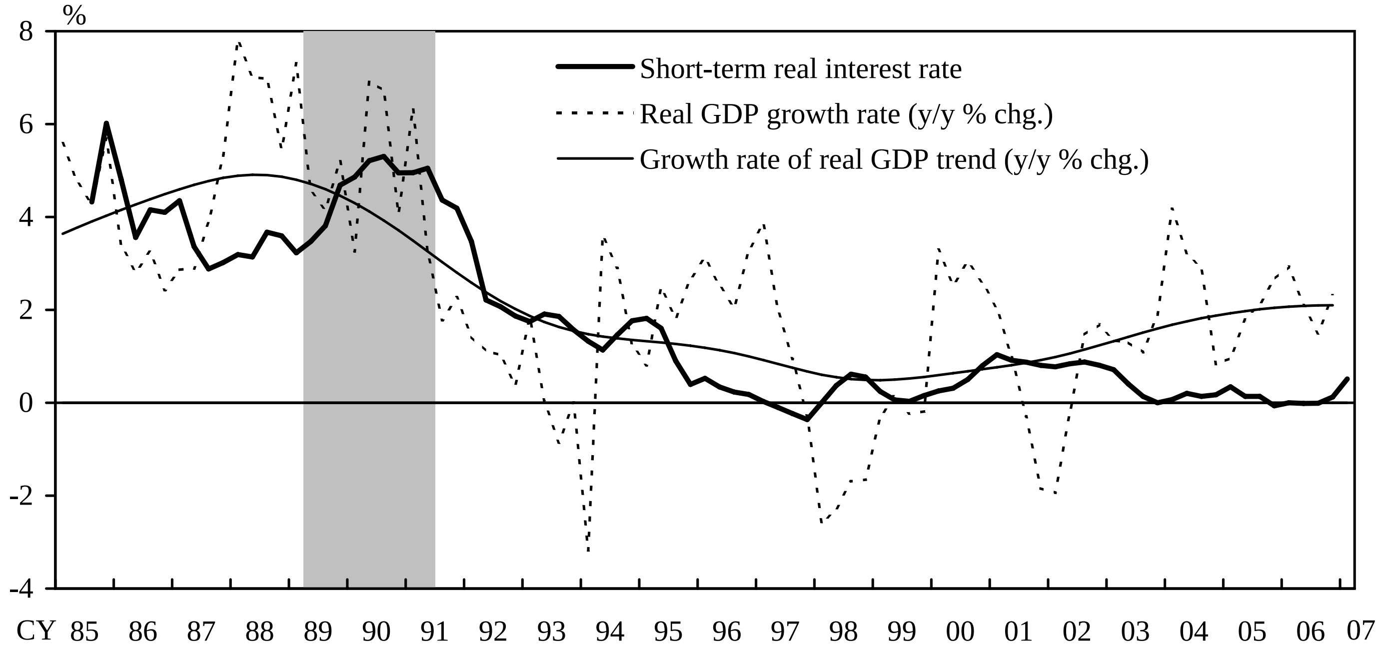
(3) Long-Term Interest Rates in Major Countries (10-Year Government Bond Yields)



Sources: Ministry of Internal Affairs and Communications, "Consumer Price Index"; Japan Bond Trading Co., Ltd.; Bloomberg.

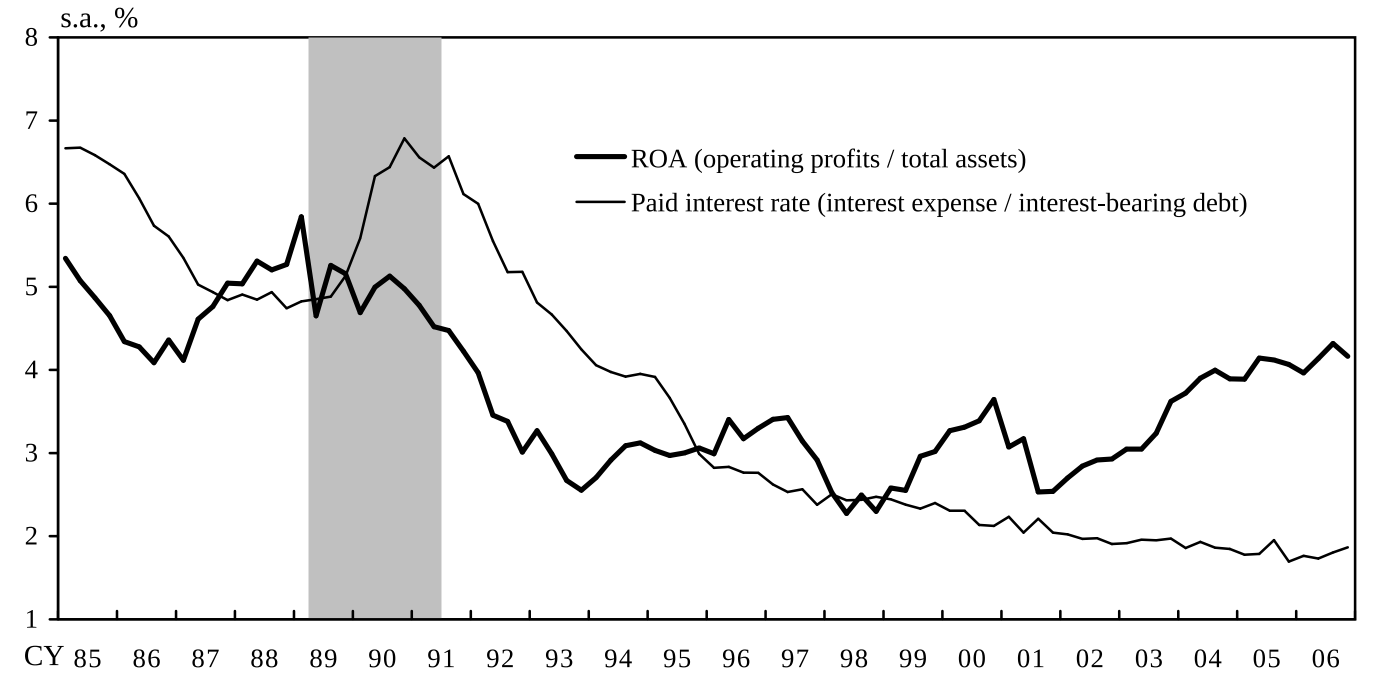
Interest Rates and Economic Activity

(1) Short-Term Real Interest Rate and Real GDP Growth Rate



Notes: 1. Short-term real interest rate = call rate (overnight, uncollateralized) - y/y % chg. in the consumer price index (excluding fresh food)
2. Real GDP trend is calculated by applying the HP filter.
3. Shaded area indicates the phase of rises in the policy interest rate (May 1989-June 1991).

(2) ROA and Paid Interest Rate
(*Financial Statements Statistics of Corporations by Industry, Quarterly,* All Enterprises)

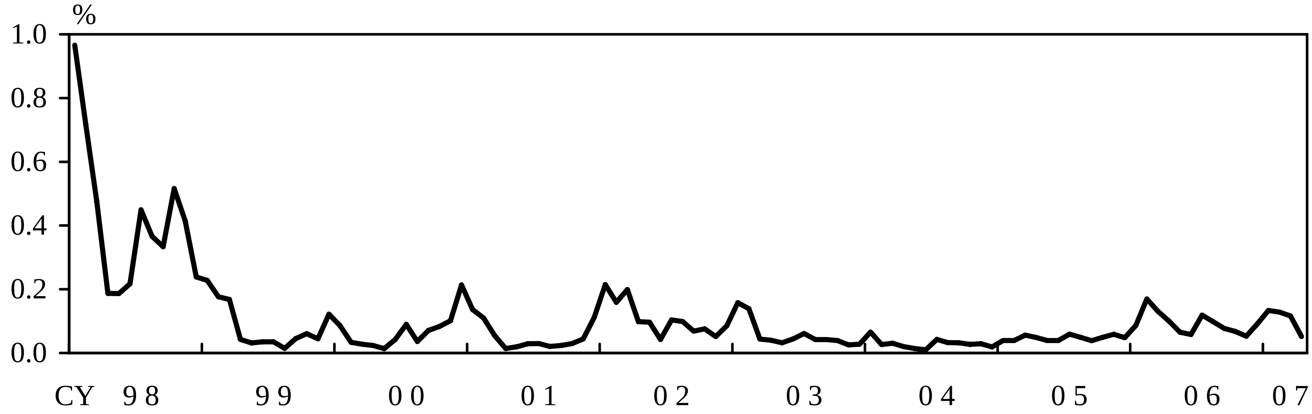


Notes: 1. Interest-bearing debt = long- and short-term borrowings + corporate bonds + bills receivable discounted outstanding
2. Shaded area indicates the phase of rises in the policy interest rate (May 1989-June 1991).

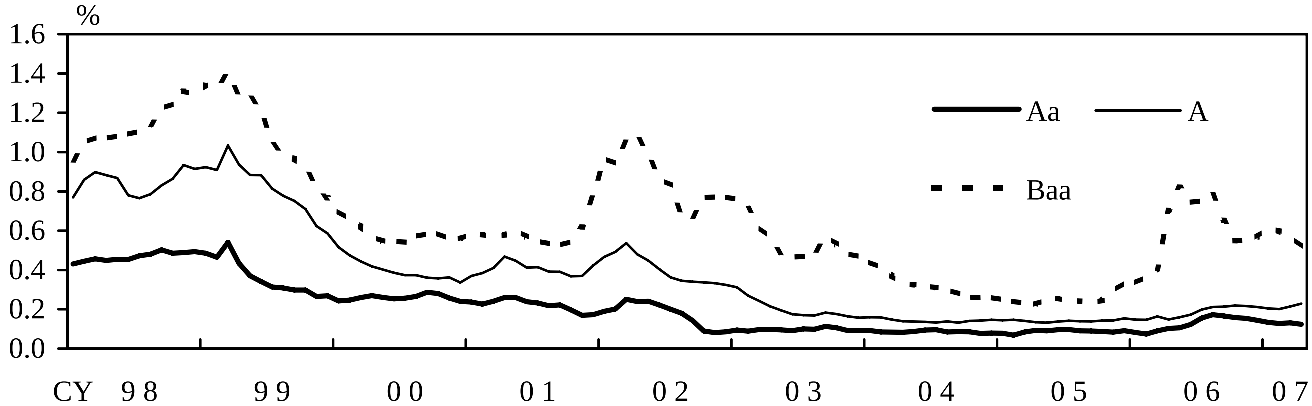
Sources: Cabinet Office, "National Accounts"; Ministry of Internal Affairs and Communications, "Consumer Price Index"; Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Quarterly"; Bank of Japan.

Credit Spread

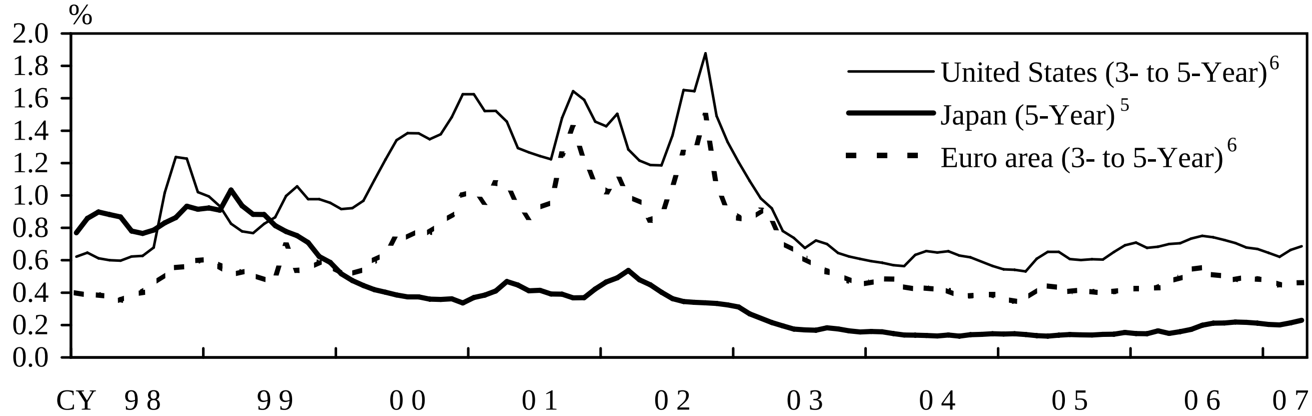
(1) Spread for Commercial Paper (3-Month)[1,2,3]



(2) Spread for Corporate Bonds (5-Year)[3,4,5]



(3) Spread for Corporate Bonds in Major Economies (A-Rated)[3,4]

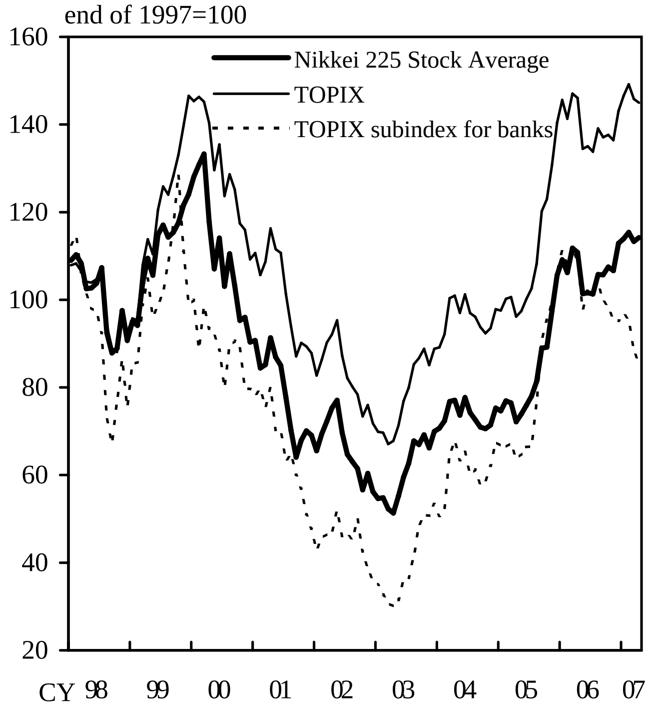


Notes: 1. The spread for CP is the average issuance rate of CP minus the FB yield.
2. CP ratings are A-1 or above.
3. The spreads for both CP and corporate bonds in April 2007 are the averages up to the latest available data.
4. The spread for corporate bonds is the corporate bond yield minus the government bond yield.
5. The indicated ratings of corporate bonds are of Moody's.
6. The indicated rating of corporate bonds is of Moody's and S&P.

Sources: Bank of Japan; Japan Bond Trading Co., Ltd.; Japan Securities Dealers Association; Merrill Lynch.

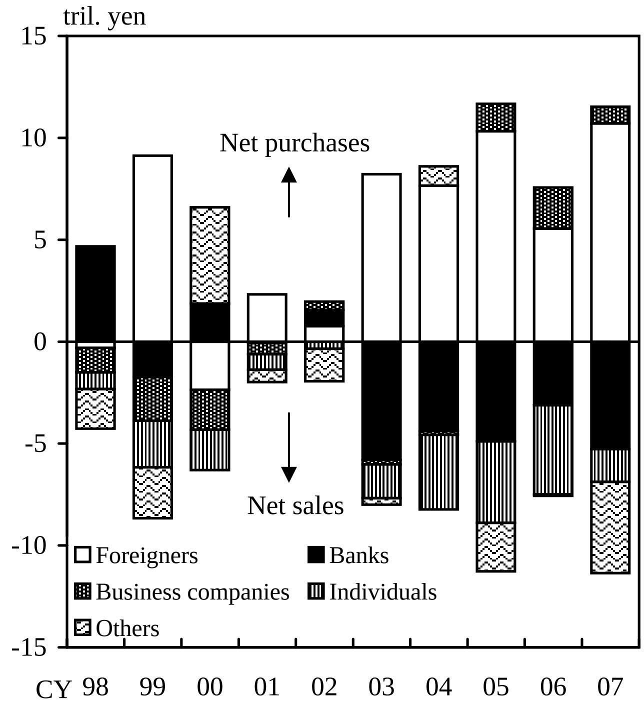
Stock Prices

(1) Stock Prices



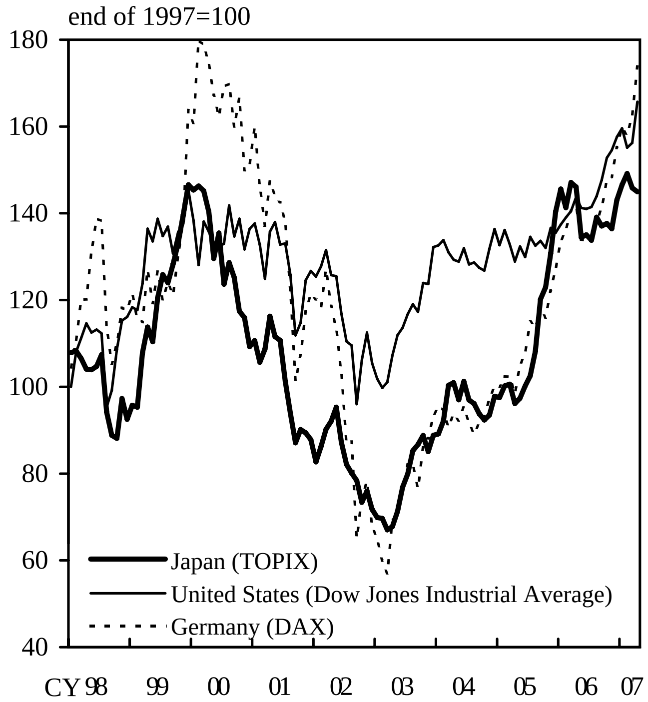
Note: Data are at end of month. Figures for April 2007 are the latest available data.

(2) Trading Volume by Investor Type



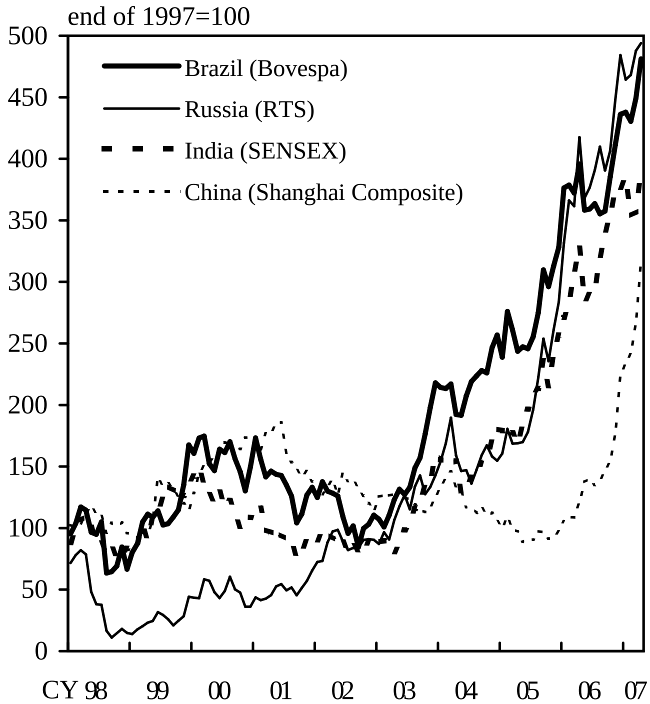
Notes: 1. Figures are the sum of the first and second sections of the Tokyo, Osaka, and Nagoya stock exchanges.
2. Figures for 2007 are those of January-March in terms of annual amount.

(3) Stock Prices in Major Countries



Note: Data are at end of month. Figures for April 2007 are the latest available data.

(4) Stock Prices in the BRIC Economies

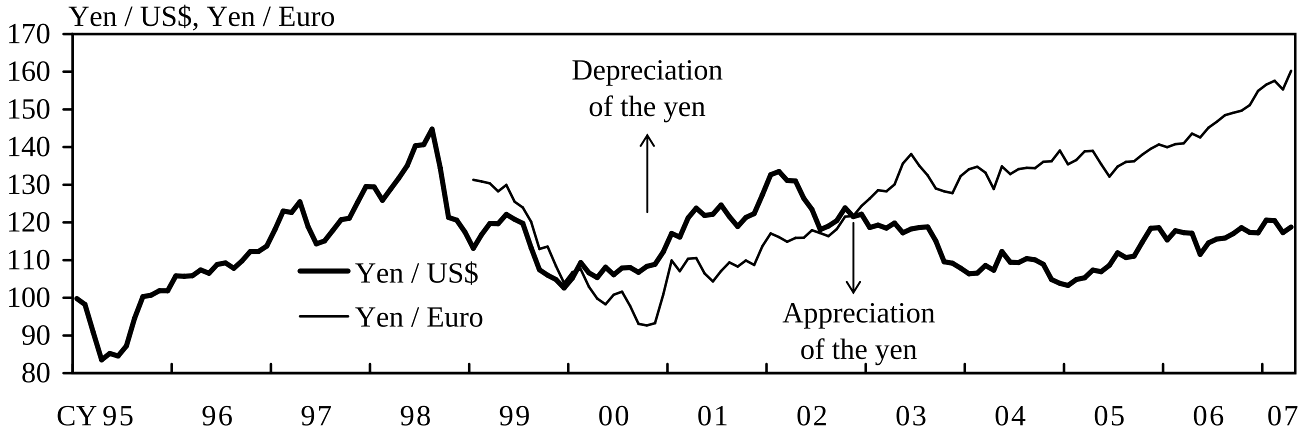


Note: Data are at end of month. Figures for April 2007 are the latest available data.

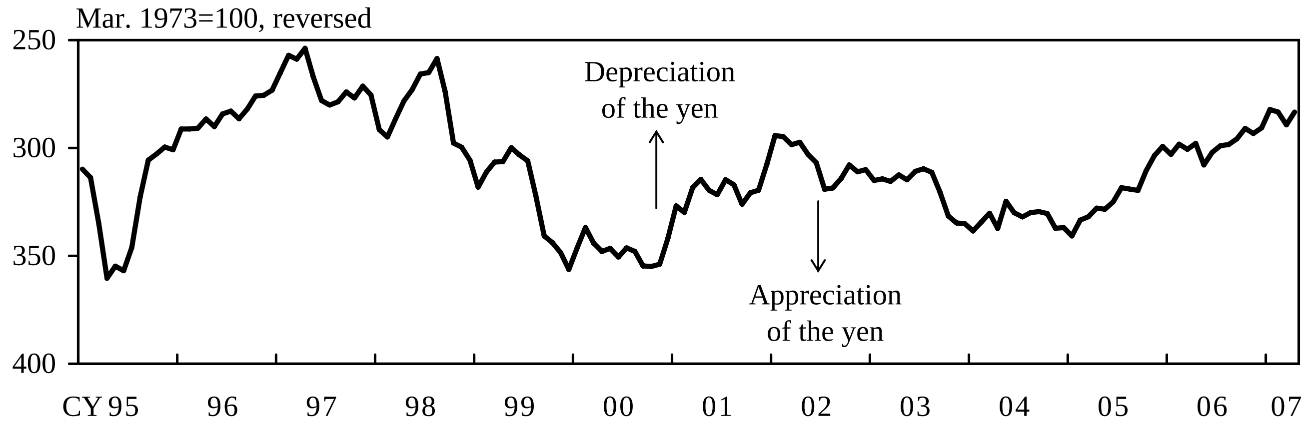
Sources: *Nihon Keizai Shimbun* ; Tokyo Stock Exchange; Bloomberg.

Exchange Rates

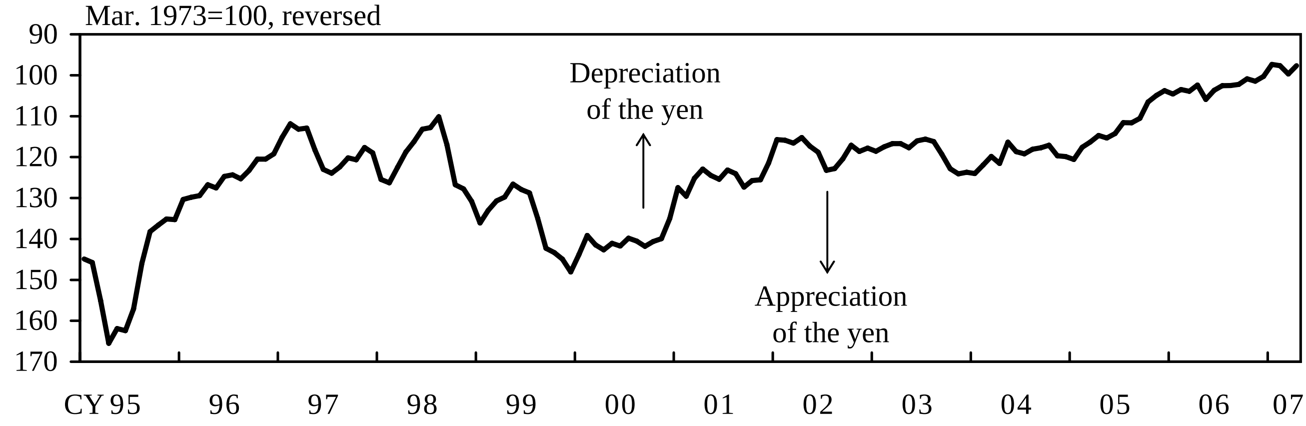
(1) Yen / US$ and Yen / Euro[1]



(2) Nominal Effective Exchange Rate[1,2]



(3) Real Effective Exchange Rate[1,3]



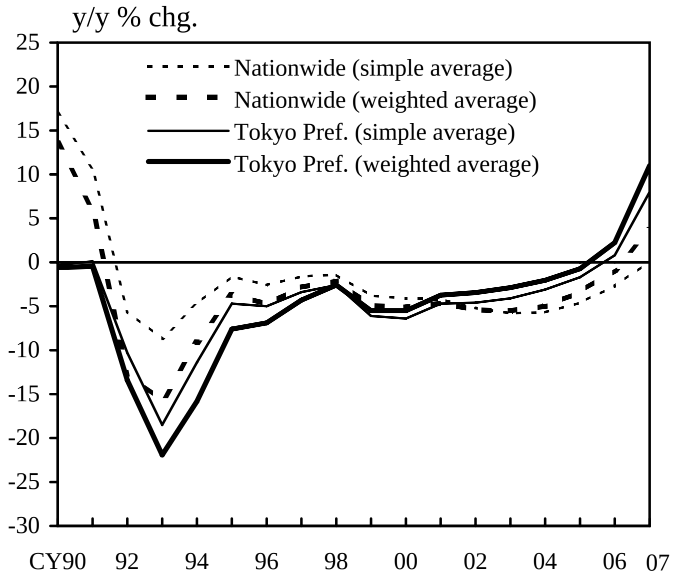
Notes: 1. Monthly average. Figures for April 2007 are averages up to the latest available data.
2. The nominal effective exchange rate is a weighted average of the yen's exchange rates against 15 currencies that have a large share among Japanese total exports.
3. The real effective exchange rate is a weighted average of the yen's real exchange rates against 15 currencies that have a large share among Japanese total exports. The yen's real exchange rates are calculated from the nominal exchange rates and price indexes of the relevant countries.

Source: Bank of Japan.

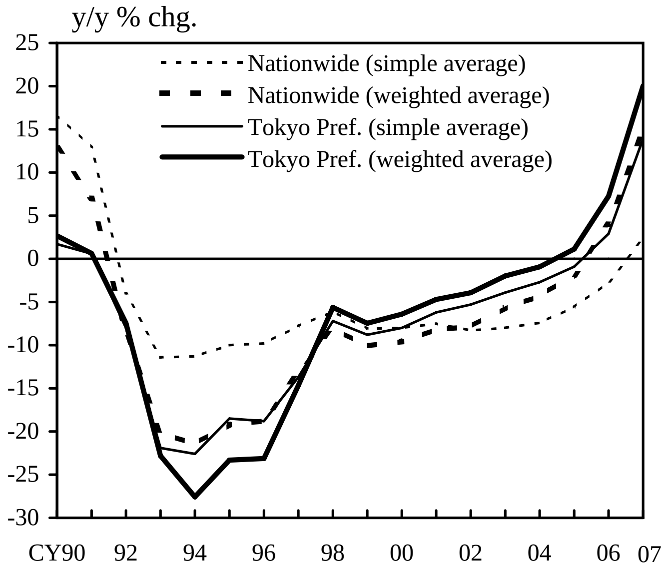
Land Prices

(1) Land Price Publication (As of January 1)

<Residential Land>



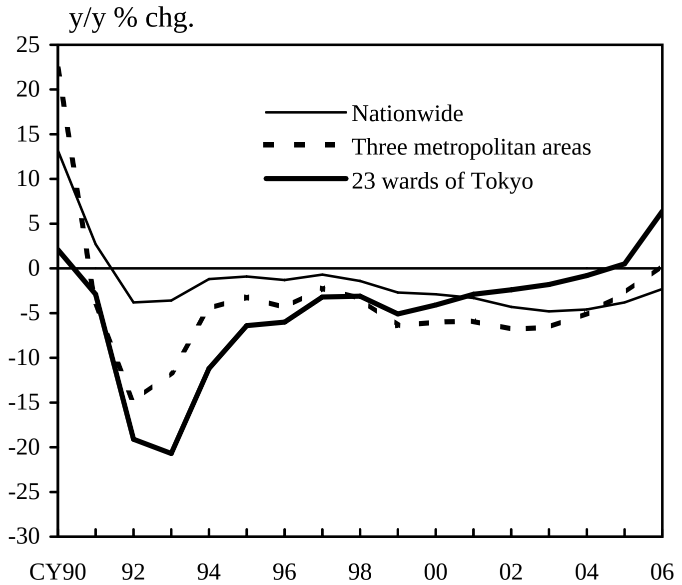
<Commercial Land>



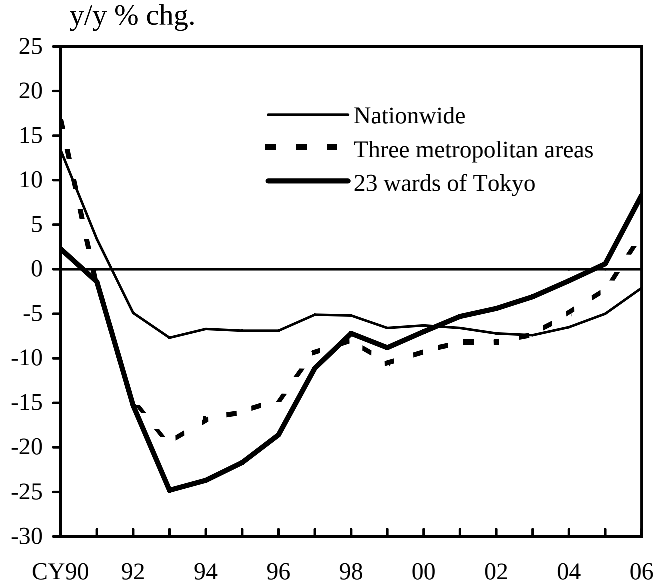
Note: Average land prices released by the Ministry of Land, Infrastructure and Transport are simple averages of the rates of change in land prices per square meter at individual locations surveyed. Weighted averages are calculated by the Bank of Japan, averaging the rates of change in land prices weighted by the level of land prices per square meter at individual locations surveyed in the previous year. The rate of changes in the weighted average is equal to that in the sum of land prices at individual locations surveyed. However, as "Land Price Publication" is a sample survey, the rate of changes in the weighted average is not generally equal to that in the total value of land.

(2) Prefectural Land Price Survey (As of July 1)

<Residential Land>



<Commercial Land>



Note: Three metropolitan areas: simple average of the Tokyo area (Tokyo, Kanagawa, Saitama, Chiba, and Ibaraki prefectures), the Osaka area (Osaka, Hyogo, Kyoto, and Nara prefectures), and the Nagoya area (Aichi and Mie prefectures).

Source: Ministry of Land, Infrastructure and Transport, "Land Price Publication," "Prefectural Land Price Survey."

Reference

Economic Assessment by Region (Regional Economic Report)

Region	Assessment in April 2007	Revision of assessment from January to April	Assessment in January 2007
Hokkaido	The economy is picking up gradually.	Unchanged	The economy is picking up gradually.
Tohoku	The economy continues to recover gradually.	Unchanged	The economy continues to recover gradually.
Hokuriku	The economy continues to recover.	Unchanged	The economy is recovering steadily.
Kanto-Koshinetsu	The economy is expanding gradually.	Unchanged	The economy is expanding gradually.
Tokai	The economy is expanding.	Unchanged	The economy is expanding.
Kinki	The economy continues to expand.	Unchanged	The economy continues to expand.
Chugoku	The economy continues to recover as a whole.	Unchanged	The economy continues to recover as a whole.
Shikoku	The economy continues to pick up gradually.	Unchanged	The economy continues to pick up gradually.
Kyushu-Okinawa	The economy continues to recover.	Unchanged	The economy continues to recover.

Note: The Regional Economic Report (summary) is available on the Bank of Japan's web site,
http://www.boj.or.jp/en/type/ronbun/chiiki_rep/chiiki0704.htm

Source: Bank of Japan, "Regional Economic Report (summary) April 2007."