Not to be released until 2:00 p.m. Japan Standard Time on Thursday, November 1, 2007.

November 1, 2007
Bank of Japan

Outlook for Economic Activity and Prices

October 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 the first half of fiscal 2007 seems to have been generally in line with the projection in the April 2007 *Outlook for Economic Activity and Prices* (hereafter the Outlook Report). The pace of improvement in the household sector, however, has remained slow relative to the strength in the corporate sector.

From the second half of fiscal 2007 through fiscal 2008, the economy is likely to continue its sustained expansion, although there are uncertainties regarding overseas economies and global financial markets. A virtuous circle of growth in production, income, and spending is expected to remain in place. The rate of real GDP growth in fiscal 2007 and fiscal 2008 is likely to register around 2 percent on average, somewhat higher than the potential growth rate. The growth rate will be somewhat lower in fiscal 2007 and somewhat higher in fiscal 2008 due to a swing in housing investment.[2]

The outlook rests on the following underlying assumptions and mechanisms. First, exports are likely to remain on the increase, reflecting continuing expansion of overseas economies. Although the slowdown in U.S. economic growth could be protracted due mainly to the correction in the housing market, growth in other overseas economies is likely to remain high. Thus, overseas economies, taken as a whole, are likely to keep expanding. Second, strong corporate performance is expected to continue. Business fixed investment is likely to keep rising, supported by high corporate profits. However, since capital investment continued to increase at a rapid pace for the last several years, the rate of growth is likely to be lower than it was up until fiscal 2006. 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. With the number of employees increasing, employee

[1] The text of "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on October 31, 2007.

[2] With the enforcement of the revised Building Standard Law in June 2007, applications for building permits became subject to a more stringent review. As a result of this procedural change, delays in the submission of applications for building permits and construction starts have been evident.

income is expected to rise moderately, and the positive effects via various other channels, for example, increased dividends, are likely to continue. Wages have been somewhat weak, reflecting labor cost restraint by firms, especially small firms, in the face of greater exposure to global competition and capital market discipline, and increased materials prices. The change in the composition of the workforce due to the retirement of the high-salaried baby-boomer generation and increases in part-time workers have also contributed to the weakness in wages. However, with a further tightening of labor market conditions, upward pressure on wages is expected to increase gradually. 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 adverse effects of the U.S. subprime mortgage problem and the consequent volatility in global financial markets on Japanese financial conditions have been limited: the lending attitude of financial institutions has been positive; and the issuing environment for CP and corporate bonds has continued to be favorable. 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 labor and production capacity, 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 along with gradual rises in wages. And third, the results of various surveys on inflation expectations continue to suggest that prices are expected to increase moderately.

Looking at indices for inflation, the domestic corporate goods price index (CGPI) in the first half of fiscal 2007 was higher than the previous projection in April, mainly reflecting rises in international commodity prices. As for the outlook, the CGPI is likely to maintain its upward trend,[3] although this will be subject to future developments in prices of crude oil and other commodities as well as foreign exchange rates.

---

[3] This outlook is based on the 2000-base CGPI. From the December 2007 publication, the Bank will change the base year for the CGPI from the current 2000 base to the 2005 base. This base-year change is likely to lower the year-on-year rate of increase in the index.

Developments in the consumer price index (CPI, excluding fresh food) have been generally in line with the previous projection, and the year-on-year rate of change has been around 0 percent. Fierce competition due partly to progress in deregulation has not allowed firms at the retail level to pass cost increases from higher materials prices on to consumers to the extent that has been possible at the wholesale level. Going forward, 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. The rate of increase is projected to be around 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 overseas economies. In the United States, the economy is likely to realize a soft landing and move onto a sustainable growth path, even though the correction in the housing market is continuing. Business fixed investment and private consumption are continuing their moderate upward trend, although the pace of increase is decelerating. If, however, the housing correction intensifies or the negative effects of the disruptions in financial markets become unexpectedly widespread, private consumption and business fixed investment may fall below expectations through negative wealth effects, the credit tightening, and deterioration in business and consumer sentiment, and this may lead to further deceleration in growth of the U.S. economy. The European economy is likely to continue to expand, but possible adverse effects on financial conditions of global financial market disruptions may pose a downside risk. If these risks related to the U.S. and European economies were to materialize and have significant adverse effects, growth in other parts of the world may be hampered and this could cause global economic growth to be weaker than expected.

At the same time, it is also possible that inflationary pressures in the United States may not subside as a result of higher resource utilization as well as other factors such as developments in crude oil prices. In China, the economy continues to expand strongly.

However, with signs of overheating, especially in fixed asset investment, the economic growth rate and the inflation rate may exceed expectations. The strong growth of the global economy and geopolitical risks, among other factors, are causing crude oil and other international commodity prices to remain elevated, and the global economy and the price situation may also be affected depending on future developments in these prices.

If overseas economies and global financial markets should follow the disruptive course mentioned above, Japan's economy may be adversely influenced through, for example, changes in exports and imports, corporate profits, and financial market conditions.

Meanwhile, in Japan, adjustments are progressing gradually in inventories of IT-related goods, which have been high relative to shipments since last year. However, if growth in overseas economies decelerates more than expected, supply and demand conditions for IT-related goods may deteriorate because their global supply has been increasing at a rapid pace.

The second risk concerns possible larger swings in financial and economic activity under continuing accommodative financial conditions. As mentioned earlier, Japanese financial conditions are likely to remain extremely accommodative, despite the U.S. subprime mortgage problem and the consequent volatility in global financial markets. 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, developments in asset prices, such as 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 sales and profits, 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 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 the factors restraining wage growth were to remain strong, 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. And second, 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").[4]

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 growth in 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

[4] The "understanding" reviewed in April 2007, 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.

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. The recent volatility in global financial markets could be regarded as an example of laxity in risk evaluation under the continued benign global economic and financial environment being reversed by market forces of self-correction. On the other hand, with uncertainties regarding overseas economies and global financial markets as referred to earlier, a significant change in their situation may adversely affect Japan's economy. 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, the Bank's basic thinking has been that (1) given the extremely accommodative financial conditions, the level of interest rates is to be raised if Japan's economy is to follow a path of sustainable growth under price stability, and (2) the pace of increase in interest rates should be determined in accordance with improvements in the economic and price situation without any predetermined view. Weak inflationary pressures have given the Bank latitude in conducting monetary policy. The actual interest rate adjustments have therefore been slow based on a thorough assessment, under the two perspectives, of the future path of the economy and prices and its likelihood, as well as both upside and downside risks. 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.

Forecasts of the Majority of Policy Board Members[5,6]

y/y % chg.

	Real GDP	Domestic CGPI	CPI (excluding fresh food)
Fiscal 2007	+1.7 to +1.8 [+1.8]	+1.9 to +2.1 [+2.0]	0.0 to +0.1 [0.0]
Forecasts made in April 2007	+2.0 to +2.1 [+2.1]	+0.7 to +0.8 [+0.7]	0.0 to +0.2 [+0.1]
Fiscal 2008	+1.9 to +2.3 [+2.1]	+0.9 to +1.2 [+1.0]	+0.2 to +0.4 [+0.4]
Forecasts made in April 2007	+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. 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.

[5] 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.

[6] 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	+1.7 to +2.0	+1.8 to +2.2	0.0 to +0.1
Forecasts made in April 2007	+1.9 to +2.5	+0.5 to +1.5	-0.1 to +0.2
Fiscal 2008	+1.9 to +2.4	+0.8 to +1.5	+0.2 to +0.5
Forecasts made in April 2007	+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 the First Half of Fiscal 2007

Japan's economy continued to expand moderately in the first half of fiscal 2007, with a virtuous circle of growth in production, income, and spending in place (Chart 1).[7,8]

Exports to the United States were somewhat weak, but the overall exports continued to increase to a broader range of destinations as overseas economies taken as a whole kept growing (Charts 2 and 3). Corporate profits remained high, and business sentiment was generally favorable, although some cautiousness was reported in certain sectors (Charts 4 and 5). In this situation, business fixed investment continued to increase, albeit with some deceleration (Chart 6). The September *Tankan* (Short-Term Economic Survey of Enterprises in Japan) indicated that steady growth in business fixed investment would continue in fiscal 2007, although the pace of increase would slow somewhat relative to fiscal 2006. Industrial production posted a robust gain in the July-September quarter, ascending from the level where it had stayed from early 2007, against the background of continued increases in demand at home and abroad as well as progress in inventory adjustments in electronic parts and devices (Chart 7).

The positive influence of the strength in the corporate sector continued to feed through moderately into the household sector. Nominal wages per worker were somewhat weak due to labor cost restraint by firms, facing fierce competition at home and abroad and coping with increased materials costs. The retirement of the high-salaried baby-boomer

---

[7] According to Indexes of Business Conditions (Composite Indexes), the coincident index remained at around the same level in the first half of 2007, as production was virtually flat. However, in the summer the index rose, reflecting an increase in production. Based on the Cabinet Office's reference dates for business cycles, the economic expansion seems to have been continuing after November 2006 when it exceeded the Izanagi boom, the longest postwar economic expansion (57 months during 1965-70).

[8] The Bank conducts research and analysis on regional economic conditions at its branches, and releases its assessment in the "Regional Economic Report." For a brief summary of the assessment of recent regional economic conditions, please refer to the Reference attached.

generation also contributed to the weakness in nominal wages. However, as firms were increasingly feeling a shortage of labor, the number of employees increased and accordingly employee income stayed on a moderate upward trend (Chart 8). In addition, high corporate profits, mainly at large firms, also enhanced household income through increased property income, such as dividends.[9] In this situation, private consumption, mainly in outlays for services and durable consumer goods such as electrical appliances, had been firm, although it had been susceptible to weather conditions (Chart 9). Consumer confidence remained favorable on the whole, although occasionally dampened by rises in gasoline prices. Housing investment decreased significantly in the summer, affected by the introduction of the revised Building Standard Law in June (Chart 10).

As the economy continued to expand moderately, resource utilization, namely in labor and production capacity, remained at high levels (Chart 11). The *Tankan* indicated that firms had been facing the strongest constraints in terms of employment levels and production capacity in more than a decade, and estimates of the output gap suggested that high resource utilization was continuing.[10]

Regarding the price situation, firms, with high levels of resource utilization, continued to pass through cost increases into the prices of goods and services at the wholesale level, as shown by rises in both the domestic corporate goods price index (CGPI) and the corporate service price index (CSPI) (Chart 12). At the retail level, however, firms were still reluctant to increase prices given the fierce competition, although some had passed on cost increases to consumers. In this situation, the year-on-year rate of change in the consumer

---

[9] According to *The Nihon Keizai Shimbun*, the total value of stock buybacks and midterm dividend payments made in the first half of fiscal 2007 by listed firms seems to have posted a record high, approximately 5,500 billion yen, up around 20 percent from the same period in fiscal 2006.

[10] 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 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 marginal shortages (Chart 11[3]). Estimates of the output gap (or the GDP gap) also indicated that operating levels have continued to be somewhat higher than their historical averages in past economic cycles. It should be noted, however, that these estimates of the output gap as well as the potential growth rate, which will be described later, need to be treated as approximations because they are subject to a certain margin of error pertaining to the extraction of trends of production factors such as labor input.

price index (CPI, excluding fresh food) stayed at around 0 percent (Chart 13).

In the April 2007 Outlook Report, it was projected that from fiscal 2007 through fiscal 2008, Japan's economy would be likely to continue its sustained expansion with the positive influence of the strength in the corporate sector feeding through into the household sector slowly but steadily. Economic activity after the release of the April 2007 Outlook Report was generally in line with the projection: the economy continued to expand moderately, although the flow of income from the corporate sector to the household sector was somewhat weak, particularly that from small firms. As for price developments, the year-on-year rate of change in the CGPI was higher than projected mainly due to rises in prices of crude oil and other international commodities (Chart 14). Meanwhile, developments in the CPI (excluding fresh food) were generally in line with the projection, and the year-on-year rate of change in the CPI had been around 0 percent.

Outlook for Economic Activity through Fiscal 2008

From the second half of 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 moderately. The year-on-year rate of growth in real GDP, on average, is likely to be somewhat higher than the potential growth rate.[11] This outlook rests on the assumption that, although there are uncertainties due mainly to the U.S. subprime mortgage problem, overseas economies, taken as a whole, are likely to keep expanding, since sustained growth in East Asia and other emerging economies should offset a protracted slowdown in the U.S. economy.[12] The basic view is that favorable conditions overseas and the extremely accommodative financial environment in Japan will likely sustain a virtuous circle of growth in production, income, and spending, even with fiscal consolidation exerting downward pressure on economic activity.

---

[11] 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.

[12] This view is broadly shared by international organizations and private research institutes. For example, the *World Economic Outlook* released in October 2007 by the International Monetary Fund (IMF) forecasts that the global economy will continue to expand at a rate of about 5 percent in 2007 and 2008, although the IMF made a downward revision to the growth projection due mainly to the slowdown in the U.S. economy.

In the corporate sector, exports are likely to remain on the increase, reflecting continued growth in overseas economies and higher demand for IT-related goods. In this situation, firms are expected to continue 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. Such increased corporate activity stimulated by growth in exports, coupled with the accommodative financial conditions, is likely to facilitate business fixed investment even among industries targeting the domestic market. However, since business fixed investment continued to increase at a rapid pace for the last several years and the level of capital investment is already high, the pace of growth will likely decelerate gradually (Chart 15).

As for the household sector, household spending is likely to follow a moderate upward trend, with gradual increases in household income resulting from high corporate profits. Labor cost restraint by firms is likely to be persistent due to fierce competition at home and abroad as well as higher materials prices. However, if, reflecting continued economic expansion, the number of employees increases at around the current pace, labor market conditions will likely tighten further and upward pressure on wages is expected to increase over time. In addition, high corporate profits should continue to contribute to the improvement of household income in the form of increases in property income such as dividends (Chart 16[1]). As a result, the growth rate of disposable income is likely to increase moderately, even taking into account a possible increase in the fiscal burden on the household sector. In this situation, household spending is expected to follow a more solid increasing trend. Housing investment, however, seems likely to decrease significantly in fiscal 2007 due to the introduction of the revised Building Standard Law, and this should bring a reactionary increase in fiscal 2008 (Chart 10).

Regarding Japan's balance of payments, the income balance and the balance of services are likely to continue improving, reflecting increases in income from business activities abroad, namely direct investment income and royalties and license fees, and portfolio investment income such as interest income and dividend income (Charts 16[2] and [3]). This should increase corporate profits and households' property income, thereby enhancing growth in income and spending in the private sector.[13]

In terms of real GDP, a decrease in housing investment is expected to lower the growth rate for fiscal 2007 to the 1.5-2.0 percent range, and push up the growth rate for fiscal 2008 to the 2.0-2.5 percent range. On average, however, the rate of real GDP growth is likely to continue to register around 2 percent, somewhat higher than the potential growth rate.

Outlook for Prices through Fiscal 2008

Looking at the environment surrounding future price developments, the utilization of resources, particularly labor, is likely to increase steadily, albeit gradually, because economic growth is expected to continue at a rate somewhat higher than the potential growth rate. Unit labor costs (labor costs per unit of output) are still declining, reflecting labor cost restraint by firms. Looking forward, however, unit labor costs are likely to stop falling, as tighter labor market conditions are expected to gradually increase upward pressure on wages (Chart 17).[14] Under these circumstances, more firms are likely to gradually pass on cost increases, including those from past rises in materials prices, at the retail level in addition to the wholesale level, although this may be offset to some extent by persistent competitive pressure (Chart 18). Survey results on inflation expectations continue to suggest that prices are 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 will be around 2 percent and that for fiscal 2008 will be around 1 percent, mainly reflecting the continued rises in prices of international commodities. 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, reflecting tighter labor market conditions and increased pass-through of higher costs into goods and services prices at the retail level. The rate of increase in the CPI (excluding fresh food) is projected

---

[13] An increase in household income stemming from foreign currency-denominated assets (for example, investment trusts) is recorded as an increase in the "portfolio investment income" under income in the balance of payments statistics.

[14] Services prices, which have a large weight in the CPI, have stayed at around the same level for many years partly because the year-on-year rate of change in average hourly wages in service-related industries has been around 0 percent on average (Chart 17[3]). The rate of change, however, will likely rise gradually going forward.

to be around 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. The issuing environment for CP and corporate bonds has been favorable. Such accommodative financial conditions are likely to be maintained (Chart 20). On the demand side, firms' cash outflow for dividend payments and stock buybacks as well as operating funds and fixed investment has been increasing. However, firms' cash inflow remains sufficient on the back of high corporate profits, and demand for funds in certain industries such as finance companies has weakened. As a result, the pace of increase in the amount outstanding of lending by private banks has been modest. Going forward, the upward trend in credit demand should continue, as the economic expansion is sustained. Increases in lending by private banks, however, are expected to remain modest, since firms' cash flow will likely remain high (Chart 21[1]).

The year-on-year rate of growth in the money stock (M_2+CDs) has been around 2 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 around 3-4 percent (Chart 21[2]).

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

Developments in Overseas Economies and Their Impact on Japan's Exports and Production

An important factor that underpins a virtuous circle of growth in production, income, and spending is that Japan's exports remain on the increase against the background of the expansion of overseas economies. Overseas economies taken as a whole are expected to continue expanding, even though there are uncertainties especially regarding future developments in the U.S. economy. On the U.S. economy, it is assumed that, even though the slowdown in economic growth could be protracted due mainly to the correction in the housing market, the economy is likely to manage a soft landing, avoiding a downturn and gradually moving onto a sustainable growth path. Given that global economic growth is supported by a more diverse range of countries than in the past, another assumption is that continued high growth in emerging economies, such as the East Asian economies, will support world growth.[15]

The geographical diversification of global economic growth is evident from the smaller contribution by the U.S. economy to the expansion of the world economy and from the increasing number of economies recording positive growth (Charts 2[2] and [3]). In this situation, the contribution of the United States to Japanese export growth has been decreasing markedly in recent years, and at the same time, the types of goods exported have become more diverse reflecting the growth in various economies with demand for different types of goods (Chart 3). Taking IT-related goods -- which significantly influence Japanese exports -- as an example, the diversification in the destination of final products, in addition to the diversification in the type of IT products, has helped to stabilize global supply and demand conditions for these goods throughout the current phase of expansion (Chart 22). It seems that these changes in the structure of the global economy and of Japanese exports have contributed to stabilizing Japan's overall production, with the co-movement of production across industries decreasing, as suggested by desynchronization of cyclical patterns in the production of IT-related and materials industries (Chart 23).

The changes described above may cushion the possible negative effects of a U.S. economic slowdown on Japan's economy. However, if the U.S. economy undergoes a significant adjustment, which could seriously dampen economies in East Asia and other regions or could cause disturbances in global financial markets such as large swings in foreign exchange rates, then it is possible that Japan's economy will be significantly affected (Chart 24). As for IT-related goods, whose domestic balance of inventories and shipments has recently been improving, unexpected developments such as a substantial slowdown in U.S.

---

15 Since the end of the 1980s, the global economy has experienced two sharp slowdowns: the first in 1998 during the East Asian currency crisis, and the second in 2001 during the bursting of the IT bubble (Chart 2[1]). In the current economic phase, shocks that are equivalent -- in terms of the scale and the strength in knock-on effects -- to those that hit the global economy in the above two cases have not occurred, at least up to now. In addition to the above-mentioned case in 2001, U.S. and European economies decelerated significantly in 1991, but the adverse impact on global economic growth was limited since the deceleration was largely offset by the strong growth in Asian economies at the time.

consumption may result in an imbalance in global supply and demand, partly because the global supply of IT-related goods has been increasing rapidly in anticipation of stronger demand relating to the 2008 Olympic Games in Beijing.

There are also upside risks to the outlook for the global economy. The Chinese economy seems to have been overheating, and both the economy and prices may deviate upward from the expected path. Moreover, if the pace of U.S. economic growth picks up earlier than expected, this, together with further rises in the prices of international commodities, may increase inflation pressures and long-term interest rates on a global basis.

In any case, these developments in economies abroad, coupled with developments in the yen's exchange rate, may cause Japanese exports and production to deviate either upward or downward from their expected trajectory.

Firms' Profits and Spending Behavior

Profits earned by Japanese firms, whose exports and production continue to be on an uptrend, have been increasing due in part to rises in income from their business activities abroad (for example, dividends and royalties and license fees).[16] The growth stimulus for Japan from the global economy is likely to remain intact (Charts 6 and 16[1]); in this process, the strength in the global economy will generate profit growth for Japanese firms, which will in turn bring about increases in business fixed investment and higher returns to shareholders (in the form of dividends and stock buybacks), and also lead to increases in employee income, although so far such increases have been modest.

Meanwhile, the pace of improvement in small firms' profits is slower than that of large firms, and it has been somewhat sluggish recently (Chart 25). This reflects a situation where small firms cannot pass on increases in materials prices to their customers because growth in demand for goods and services they provide is relatively slow due to progress in

[16] Parent firms receive income from their overseas subsidiaries. Such income includes royalties and license fees, which are classified as "industrial processes, franchises, etc." under services in the balance of payments statistics, and stock dividends classified as "direct investment income" under income (Chart 16[3]).

economic globalization and fiscal consolidation.[17] Although the deterioration in small firms' terms of trade may exert some downward pressure on their business fixed investment, the uptrend in capital investment is expected to continue given that profits have generally been at high levels and banks' lending attitude has been positive.[18]

As for business fixed investment, part of which aims at increasing capacity to supply products to growing overseas markets, attention should also be paid to risks associated with developments in overseas economies. With firms being disciplined in their investment activity at present, there does not seem to be an excessive build-up of business fixed investment that could result in a substantial adjustment later on, and therefore business fixed investment does not appear to be particularly vulnerable to various shocks (Chart 15). However, if there are shocks that seriously damage the growth prospects of external demand or if heightened uncertainty about future developments in external demand continues for a long time, downside risks to business fixed investment may materialize.[19]

On the other hand, given the extremely accommodative financial conditions, firms may further accelerate investment based on optimistic assumptions regarding the expected growth rate, financing costs, foreign exchange rates, and asset prices, including land prices.

The Employment and Income Situation and Households' Spending Behavior

As labor market conditions have continued to tighten as evidenced by the declining unemployment rate, the hourly wages of part-time workers have been rising (Chart 26[3]).

---

[17] An analysis of recent developments in profits earned by small firms shows that, with sales sluggish, increases in the cost of intermediate goods (materials costs) have had a negative effect on profits, but this has been offset by labor cost restraint (Chart 25[1]).

[18] In the June 2007 *Tankan*, the year-on-year rate of increase in small firms' business fixed investment plans for the current fiscal year was slightly lower than the average of the growth rate of investment plans recorded in the same period in *Tankan* reports of past years, partly because the rate was calculated based on the actual investment made in fiscal 2006, which turned out to be considerably higher than the previous plans. In the September *Tankan*, however, the investment plans were revised upward, as in the past (Chart 6[3]).

[19] When uncertainty about the future heightens, the option value of postponing a fixed investment increases and may exceed the discounted present value of the expected return from the investment, since fixed investment involves sunk costs. In real option theory, so long as the option value remains high, even an investment project that offers high yields is not implemented.

The growth of overall wages per worker, however, has not been on an uptrend yet (Chart 8[2]). Factors behind this include the following: (1) persistent labor cost restraint by firms, which have been facing fierce competition at home and abroad; (2) fiscal consolidation, including a reduction in salaries of local government employees; and (3) the change in the composition of the workforce due to the retirement of the high-salaried baby-boomer generation and an increase in part-time workers. These factors, together with the sluggish growth in profits due partly to the above-mentioned higher materials prices, seem to restrain wages per worker particularly at small firms (Chart 27). This situation is unlikely to change in the near future.

However, with the working-age population declining, if the number of employees increases at the current pace of somewhat more than 1 percent each year reflecting continued economic expansion, labor market conditions are likely to tighten further (Charts 26[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 employee income.

In addition to employee income, property income has also become a key component of household income, as households have gradually diversified the types of financial assets in which they invest. Factors behind this include changes in people's attitude toward investment activity and deregulation in the financial industry. In this situation, increases in corporate profits can augment household income by means of increased dividends and stock buybacks, as well as higher stock prices (Chart 16). Given these points, even factoring in a possible increase in the fiscal burden households have to bear, the growth rate of disposable income is likely to increase moderately, and thus the uptrend in household spending should become firmly established.

There is, however, high uncertainty regarding to what extent and when the tightening of labor market conditions will push up wages. This is because it is difficult to accurately predict to what extent firms' labor cost restraint will subside and how large the impact is of changes in the age composition of the workforce and in the form of employment. If the growth in employee income weakens and household spending falls below expectations, the growth of Japan's economy may deviate downward from the expected trajectory given that business fixed investment is beginning to enter a phase of cyclical slowdown. Meanwhile, wages and employee income may deviate upward if firms become more inclined to increase employment with the aim of aggressively exploiting profit opportunities.

Environment Surrounding Price Changes

During the current phase of economic expansion, the rise in consumer prices has proved sluggish despite high resource utilization. The sluggishness is partly because firms in the distribution and services industries have made various efforts to restrain sales prices in the face of the slow recovery of private consumption and intensified competition among firms amid economic globalization and deregulation (Chart 28).[20]

Firms are likely to continue their cost reduction efforts to respond to intensified competition at the retail level. As a result, as projected in the previous Outlook Report, upward pressure on prices and wages is not expected to increase noticeably. The utilization of resources is, however, expected to continue rising steadily, albeit at a moderate pace, if Japan's economy continues to expand. In fact, the increase in hourly wages of part-time workers, who have been employed widely in the distribution and services industries, has been accelerating gradually. At the same time, more firms, especially major food manufacturers, have announced an increase in prices, and purchasing costs at retailers are likely to keep increasing. Even if cost increases are absorbed to some extent by firms' efforts, it is reasonable to expect that higher costs will be passed through into retail prices, albeit gradually.[21] Hence, the year-on-year rate of change in the CPI (excluding fresh food) is expected gradually to rise.

However, future developments in prices could deviate either upward or downward because

---

[20] According to the *Tankan*, there was no significant gap between the level of the diffusion index for output prices and that for input prices in the retail sector until around 1990. However, since the mid-1990s, when competition became more intense and the so-called price destruction and distribution revolution occurred, the level of the diffusion index for output prices has been lower than that for input prices (Chart 28[2]). This is largely attributable to the constant efforts made by firms in the distribution industry to restrain output prices by reducing the costs of intermediate inputs and labor. Similar developments in the diffusion indexes have been observed in the services industry since 1990, and the gap has been expanding.

[21] Among the items in the basket of the CPI (excluding fresh food), items whose prices have risen outnumbered those whose prices have declined in recent months.

of a number of factors. These include (1) deviation of the economic situation from the projected scenario, (2) the sensitivity of prices to changes in resource utilization, and (3) developments in the prices of commodities such as crude oil and the pace at which firms pass on cost increases.[22] For instance, as prices of daily necessities such as food have been rising worldwide, more Japanese firms may pass through cost increases into retail prices. And this, coupled with increases in inflation expectations, may cause prices to deviate upward from the projection. On the other hand, if firms continue to restrain the pass-through of cost increases into sales prices longer than assumed through their cost-saving efforts and productivity improvements, prices may not easily respond to a sustained expansion of the economy. In this latter case, at the point when prices finally respond and start to increase, the economy may already have seriously overheated and the price formation of various assets may have been distorted in some way. If this were to happen, swings in economic activity could eventually be larger, reflecting excessive financial and economic activity and its subsequent adjustment.

Effects of the Disturbances in Global Financial Markets

In global financial markets, large swings have been observed since this summer stemming from increased concerns over the U.S. subprime mortgage problem. In the United States and Europe, the functioning of markets for securitized products, such as collateralized debt obligations (CDOs) and asset-backed commercial paper (ABCP), has deteriorated. As the securitization and resale of financial assets became difficult, leveraged buyout (LBO) and merger and acquisition (M&A) activity became stagnant, because financial institutions were trying to avoid the accumulation of risk assets on their own balance sheets. Yield spreads between corporate bonds and government securities have widened, but the issuance of corporate bonds has continued. In money markets, demand for liquidity has become stronger among financial institutions for purposes such as backup financing for ABCP programs. Rises in overnight rates have generally been restrained as a result of the provision of funds by central banks, while some difficulties have been observed in the trading of term instruments. Although the functioning of global financial markets has improved to some degree, the overall situation remains unstable.

[22] There is considerable uncertainty particularly in the services sector, compared with the goods sector, regarding when a change in supply-demand conditions affects wages and prices, and this makes future developments in wages and prices uncertain.

Turning to Japan's financial market, there have so far been only limited effects stemming from the U.S. subprime mortgage problem and the subsequent volatility in overseas financial markets, and the financial conditions have continued to be extremely accommodative. The lending attitude of financial institutions has remained positive. Yield spreads of CP and corporate bonds against government securities widened somewhat in the summer, but have been more or less unchanged since then, and the size of the widening has been smaller than in the United States and Europe (Chart 29). Lending rates have stayed at extremely low levels, although they are rising gradually (Chart 20[3]).

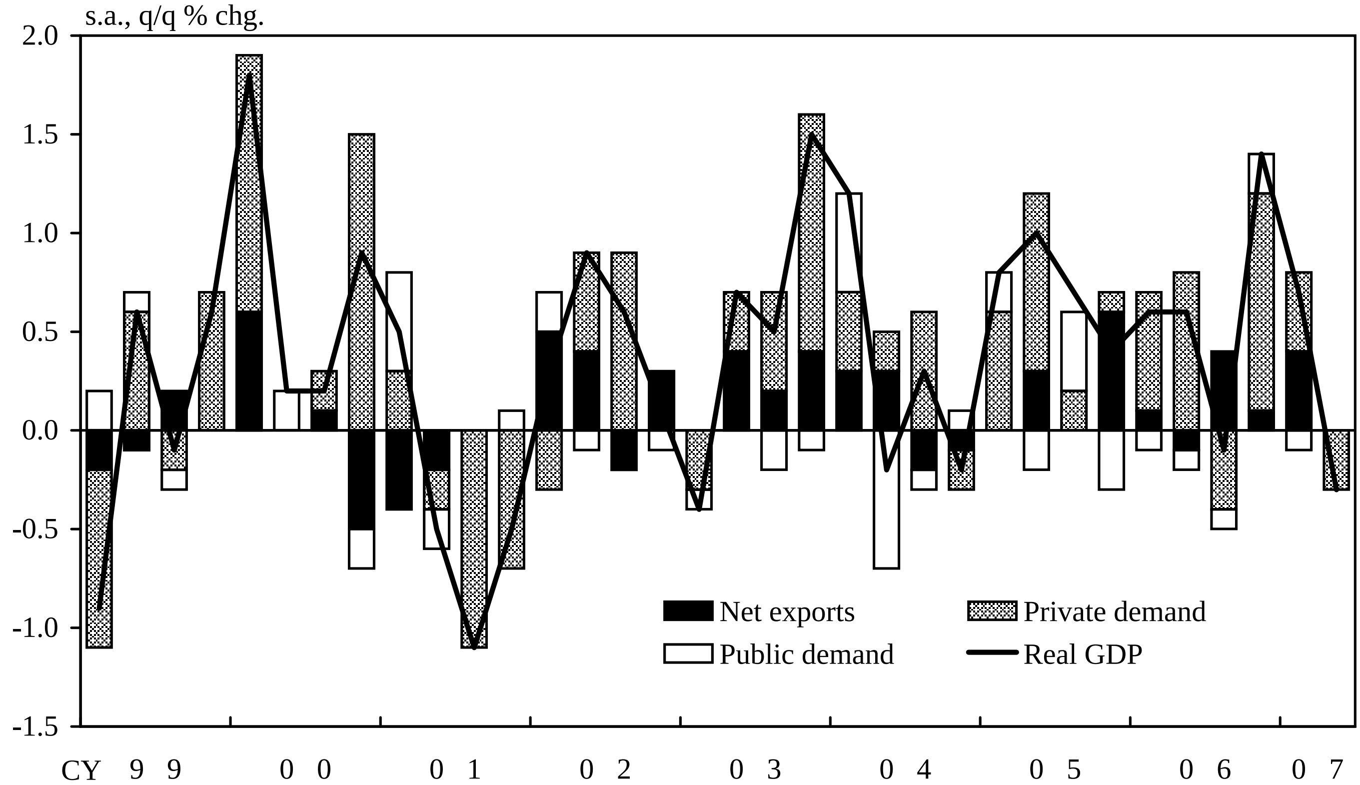
The money market has remained calm. The uncollateralized overnight call rate has been at around 0.5 percent, and interest rates on term instruments have been stable (Chart 30). Euroyen futures rates and various implied forward rates rose through the summer, but have declined since then (Chart 31). The 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 32).

Since the release of the April 2007 Outlook Report, long-term interest rates, stock prices, and foreign exchange rates have been strongly influenced by developments in overseas financial markets. Long-term interest rates had been rising but have declined since July following the decline in U.S. and European long-term interest rates (Chart 33). Stock prices continued to rise but fell sharply this summer in response to declines in U.S. and European stock prices and the appreciation of the yen. They have since risen, reflecting the rise in U.S. and European stock prices (Chart 34). The yen had been depreciating against both the U.S. dollar and the euro, mainly reflecting pressure to sell the yen in the face of interest rate differentials, but since this summer, it has tended to appreciate as the global reassessment of risks proceeded (Chart 35).

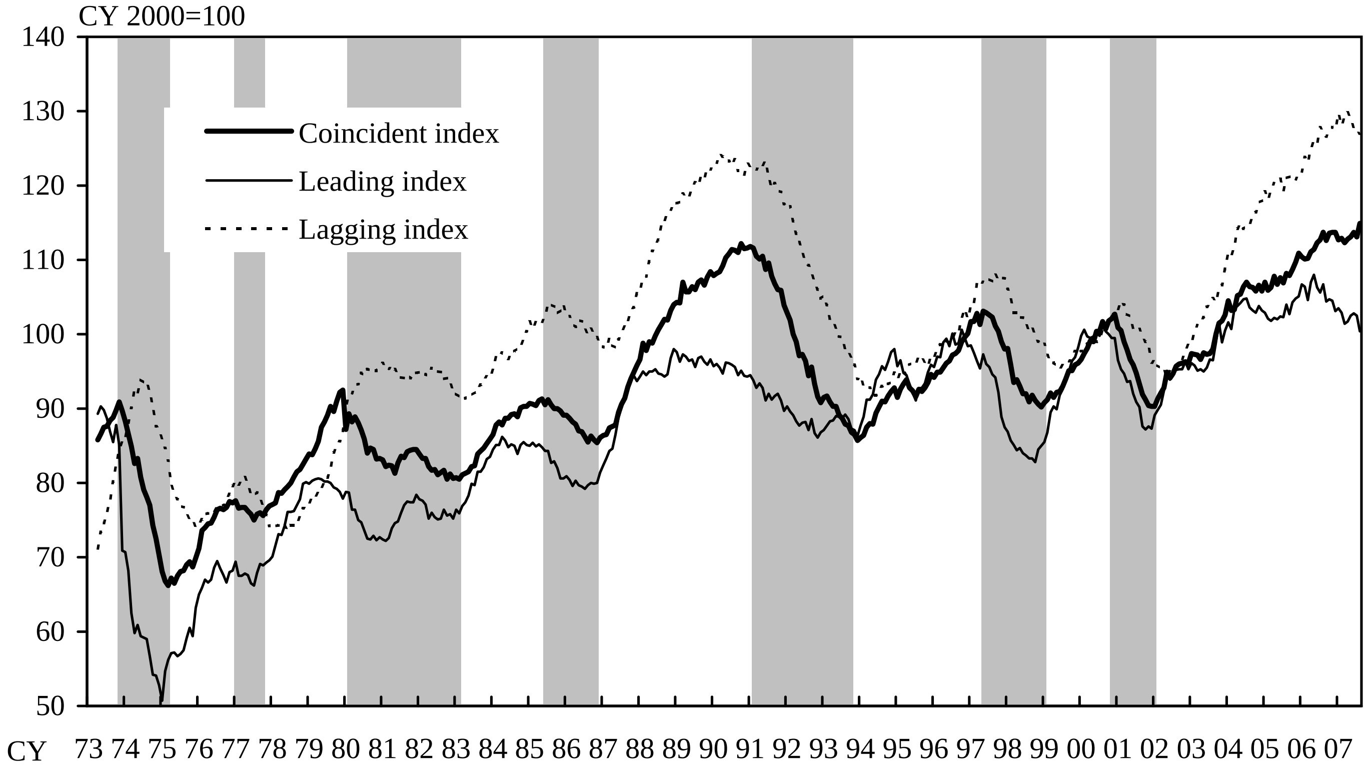
According to the Prefectural Land Price Survey in 2007, which indicates land prices at representative locations surveyed as of July 1, 2007, the nationwide average for commercial land has registered a year-on-year increase for the first time in 16 years, and the rate of decline for residential land has continued to slow (Chart 36). In the three major metropolitan areas (Tokyo, Osaka, and Nagoya), the rate of increase for commercial land prices has risen against the backdrop of firm demand for office space, and the upward trend in residential land prices has also become more evident. As for regional areas, commercial land prices have risen in central cities. However, residential and commercial land prices in regional areas taken as a whole have continued to fall, although their rates of decline are slowing.

Real GDP and Indexes of Business Conditions

(1) Real GDP



(2) Indexes of Business Conditions (Composite Indexes)

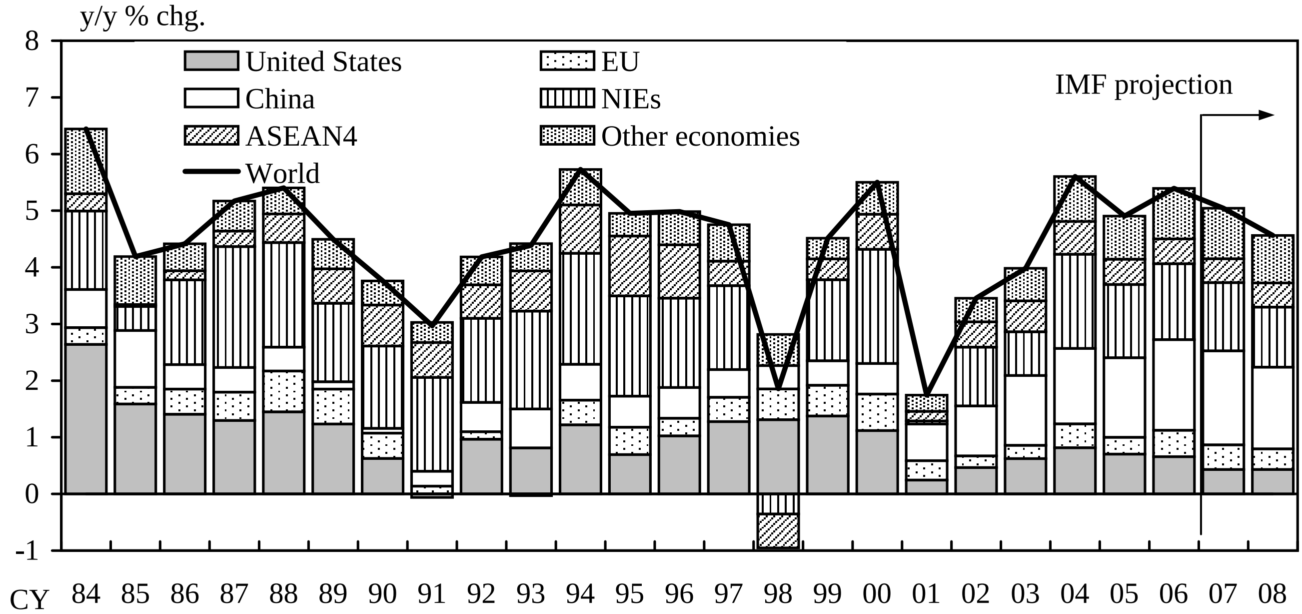


Note: Shaded areas indicate recession periods.

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

Overseas Economies

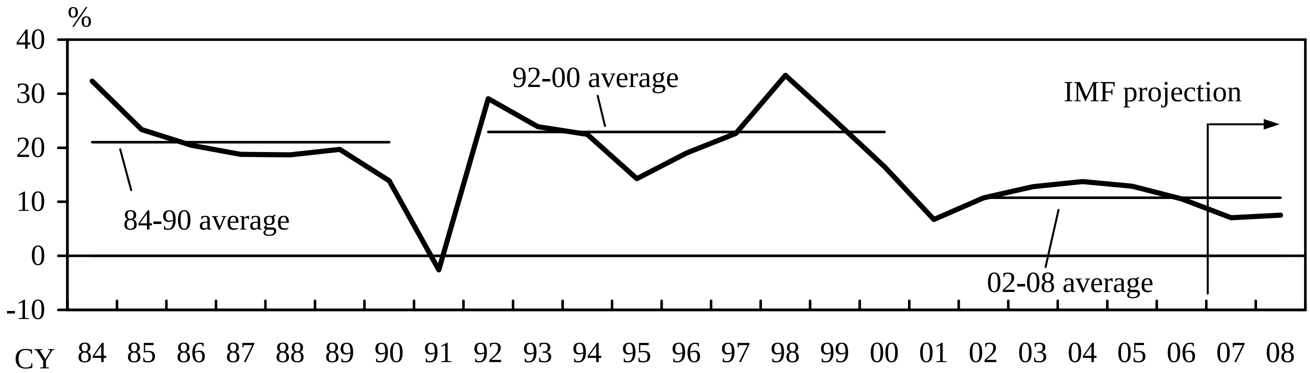
(1) Real GDP Growth Rates in Overseas Economies



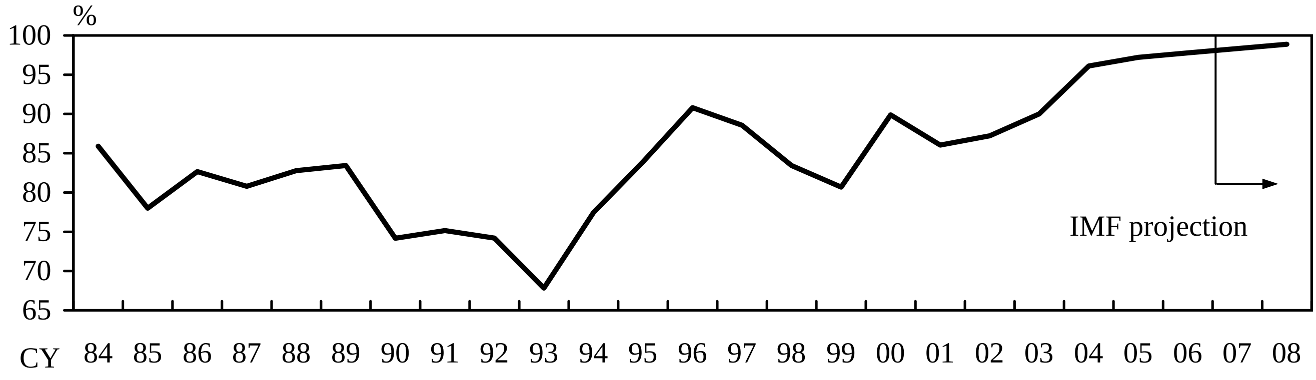
Notes: 1. Growth rates in overseas economies are calculated as the weighted average of real GDP weighted by value of exports from Japan to each economy. For 2007 and 2008, they are calculated using IMF projection of real GDP and value of exports from Japan in 2006.

2. Data for ASEAN4: Thailand, Malaysia, Indonesia, and the Philippines. Data for NIEs: South Korea, Hong Kong, Taiwan, and Singapore.

(2) Contribution of the U.S. Economy to World Economic Growth



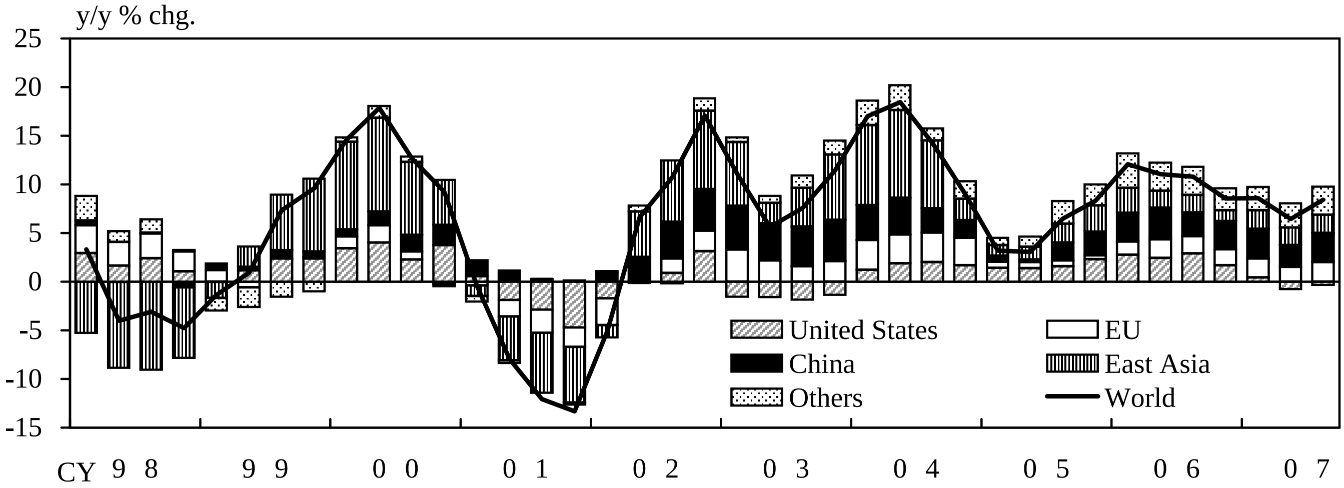
(3) Percentage Share of the Number of Economies Recording Positive Growth



Sources: IMF, "World Economic Outlook"; Ministry of Finance, "The Summary Report on Trade of Japan."

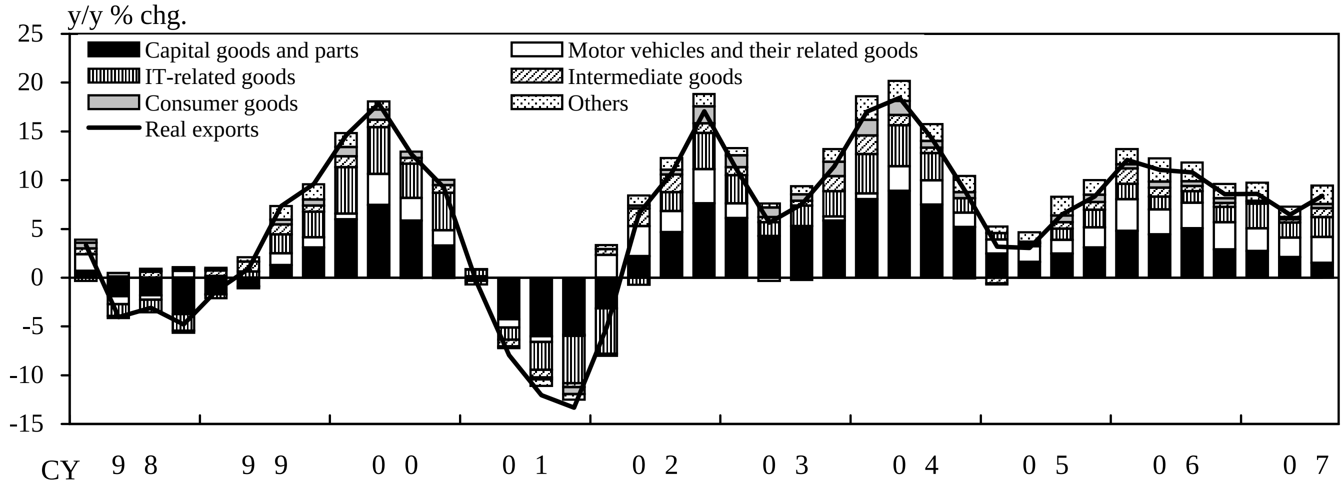
Exports

(1) Real Exports (Breakdown by Region)



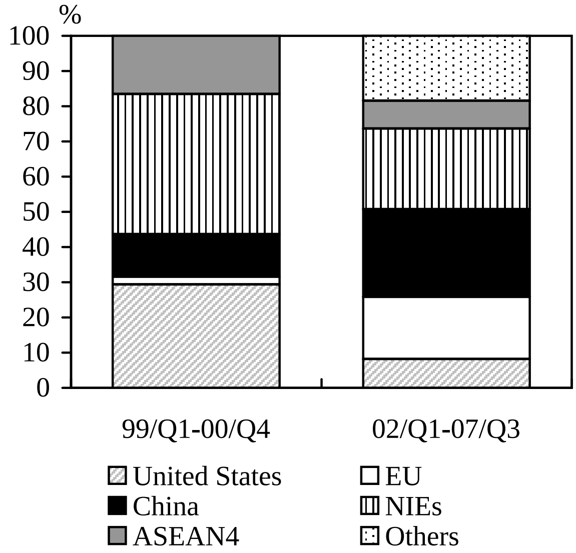
Note: Data for East Asia: NIEs and ASEAN4.

(2) Real Exports (Breakdown by Goods)

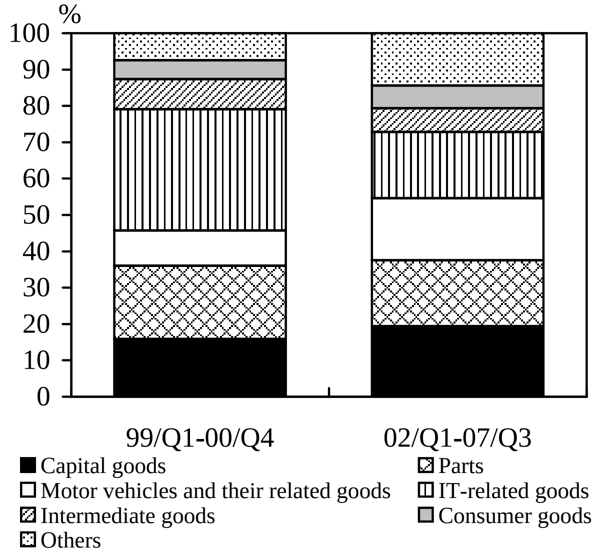


(3) Breakdown of Export Growth

(a) By Region



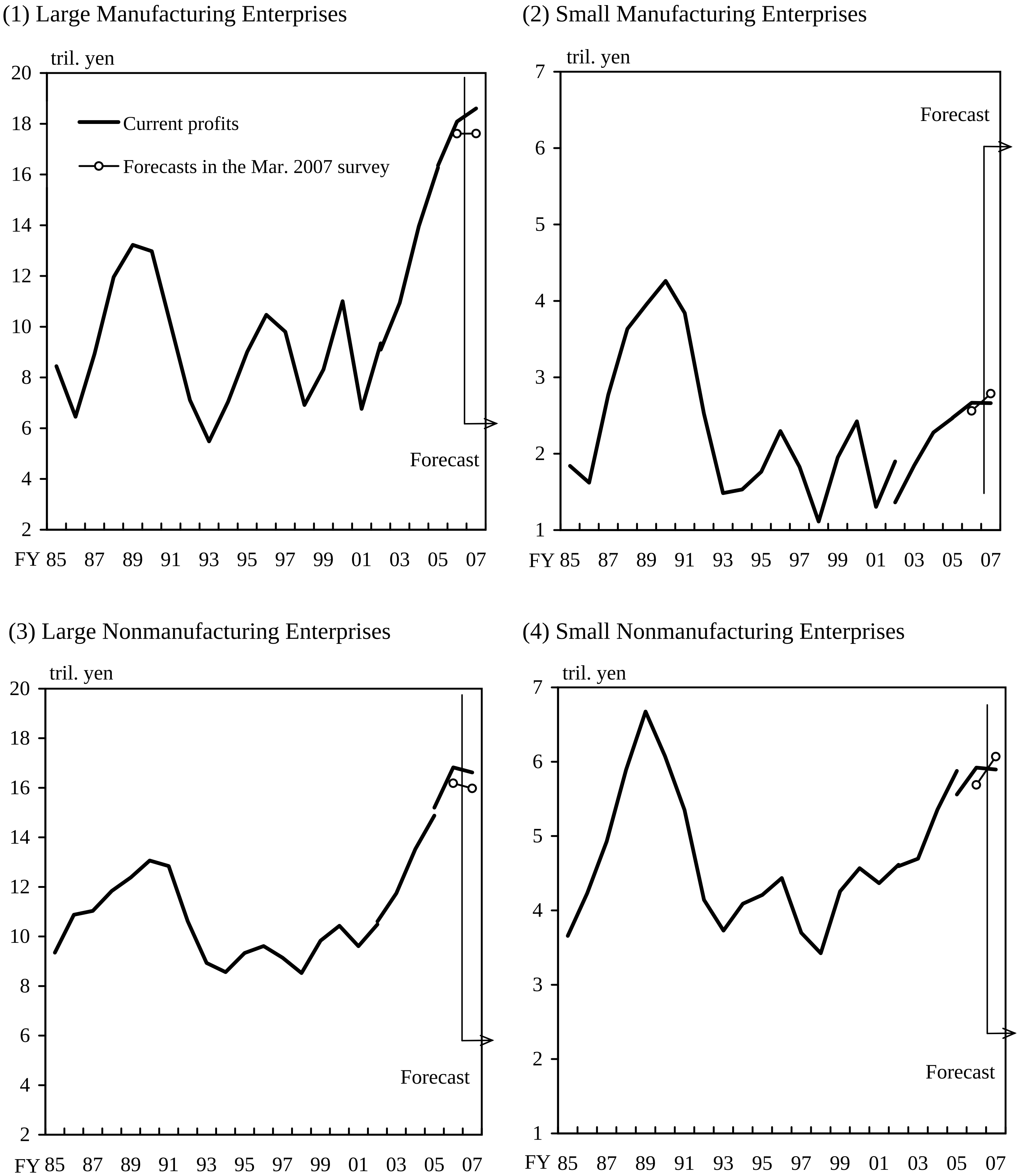
(b) By Goods



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

Chart 4

Current Profits

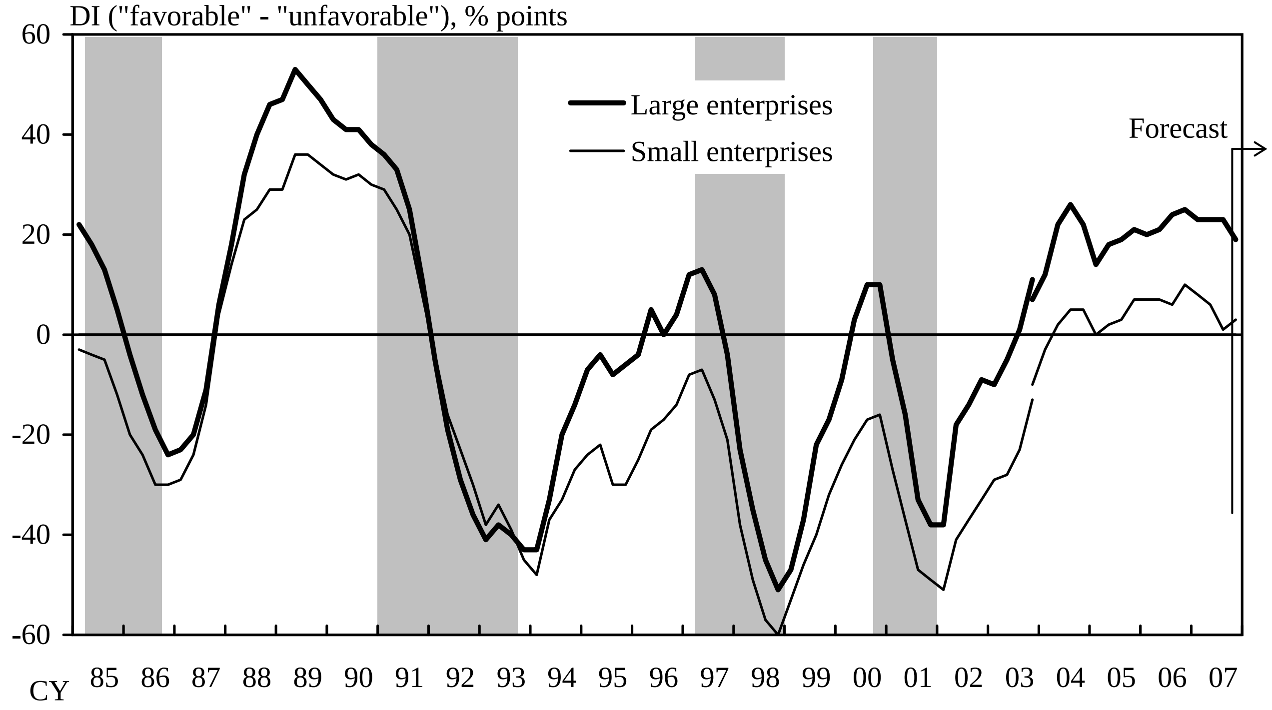


Note: In the March 2004 survey, the *Tankan* underwent major revisions, including the addition of new sample enterprises to the survey. In the March 2007 survey, regular revisions were made to the sample enterprises. The data show some discontinuities coincided with these timings.

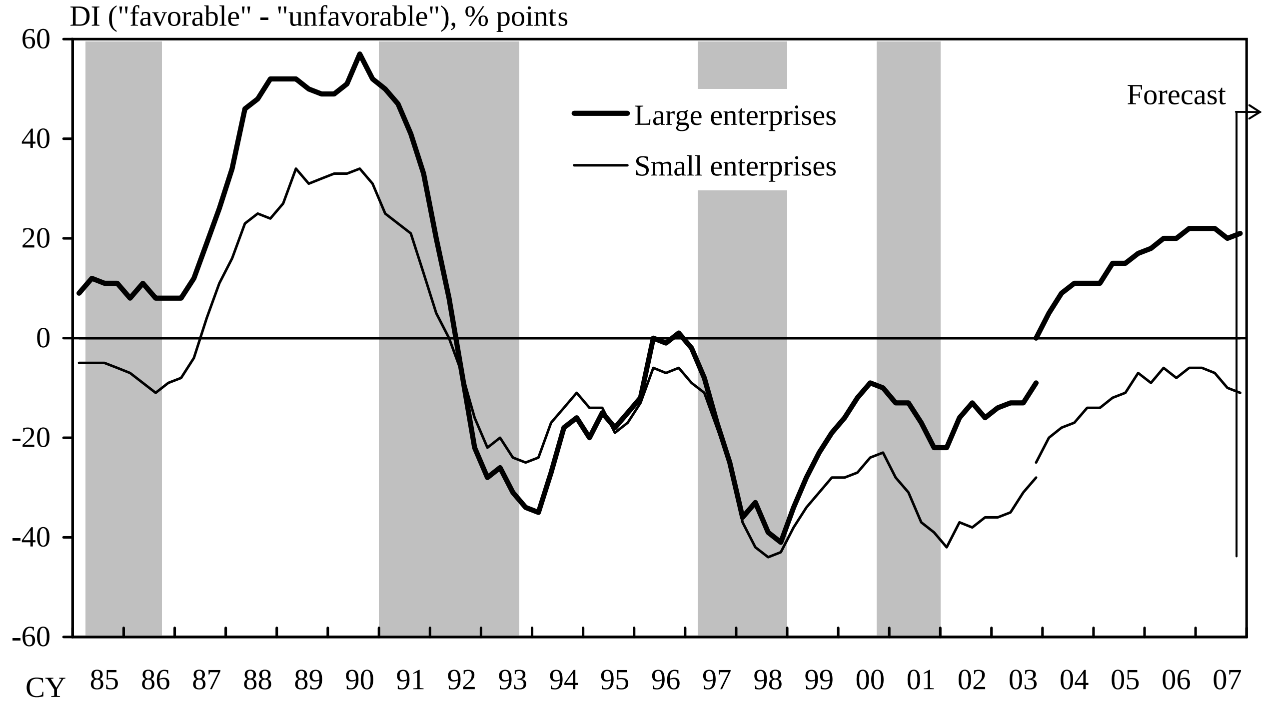
Source: Bank of Japan, "*Tankan,* Short-Term Economic Survey of Enterprises in Japan."

Business Conditions

(1) Manufacturing



(2) Nonmanufacturing



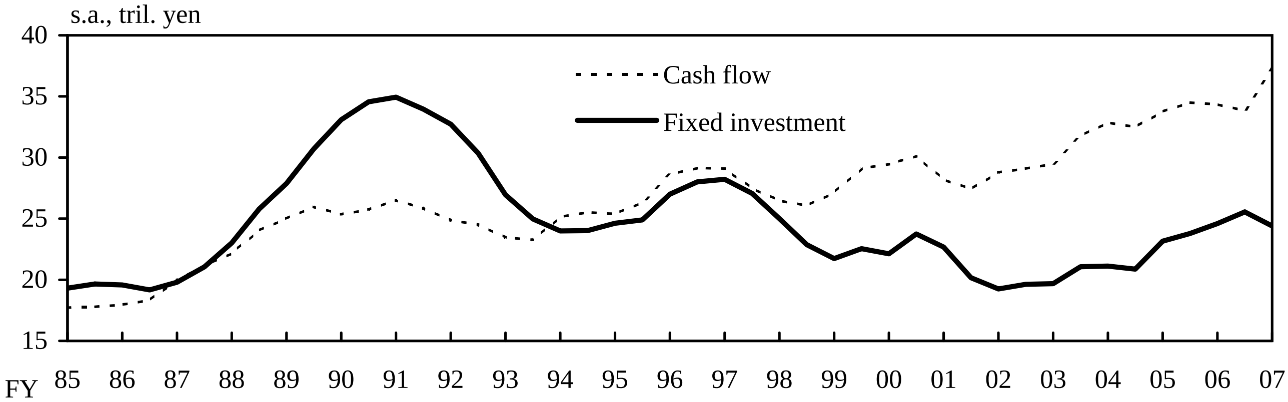
Notes: 1. The *Tankan* has been revised from the March 2004 survey. Figures based on the previous data sets are up to the December 2003 survey. Figures on a new basis are from the December 2003 survey.
2. Shaded areas indicate recession periods.

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

Chart 6

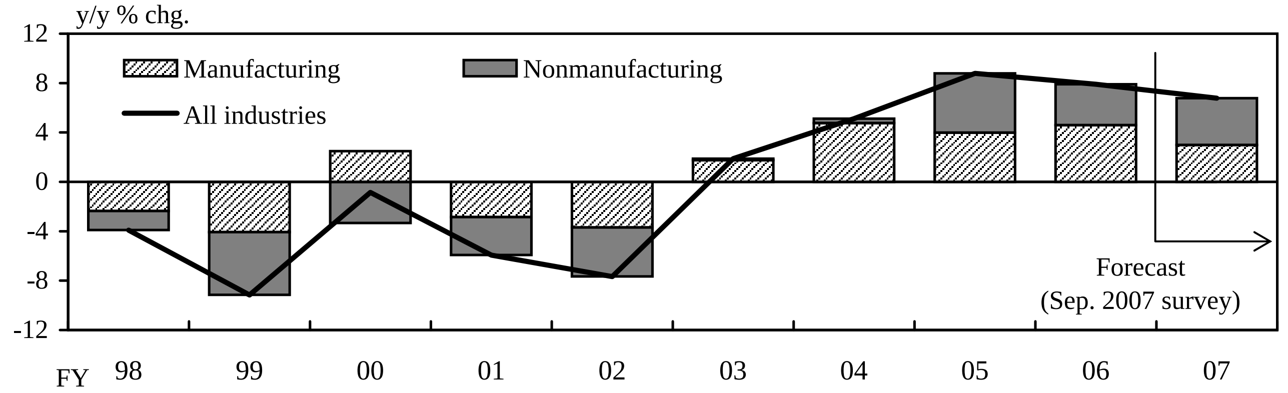
Fixed Investment

(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 first half of FY 2007 are calculated on the assumption that the year-on-year growth rates of 2007/Q3 are the same as those of 2007/Q2.

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

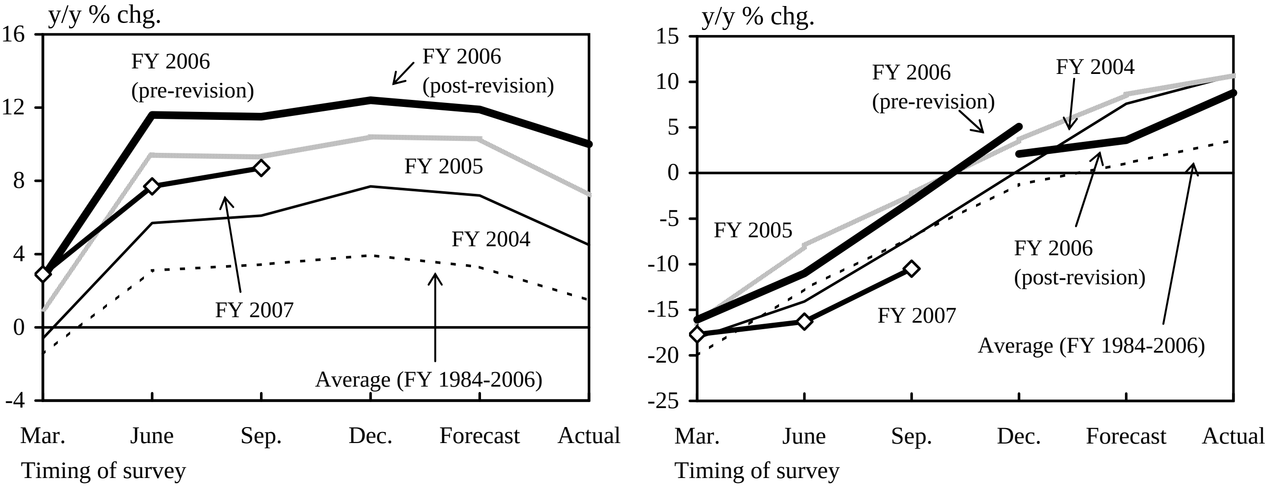


Note: Figures up to FY 2002 include land purchasing expenses and exclude software investment.
Figures from FY 2003 exclude land purchasing expenses and include software investment.

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

(a) Large Enterprises

(b) Small Enterprises

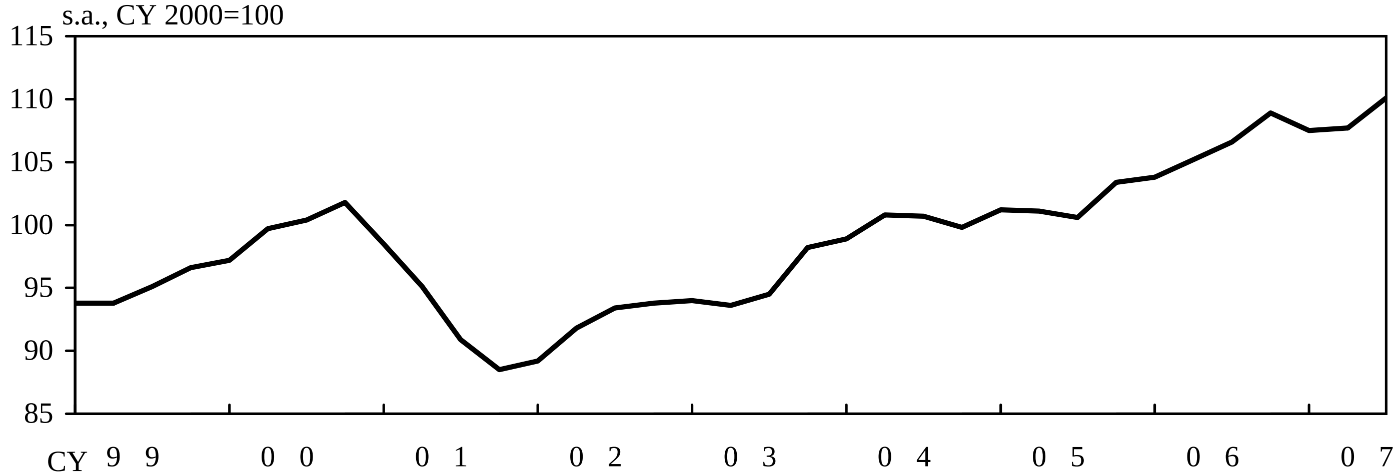


Note: In the March 2007 survey, regular revisions were made to the sample enterprises.

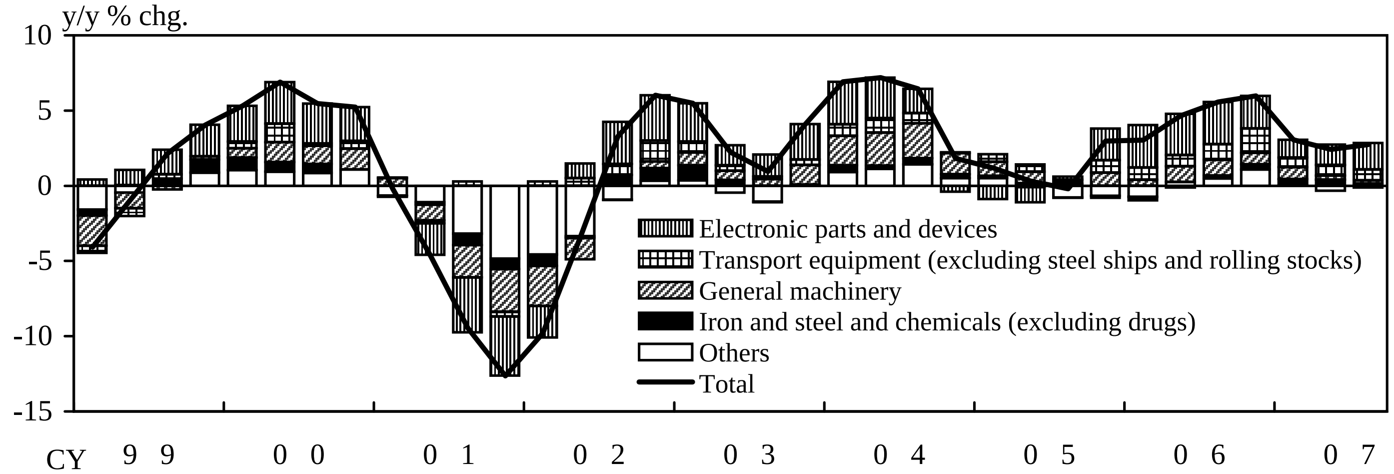
Sources: Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Quarterly"; Bank of Japan, "*Tankan*, Short-Term Economic Survey of Enterprises in Japan."

Production

(1) Production

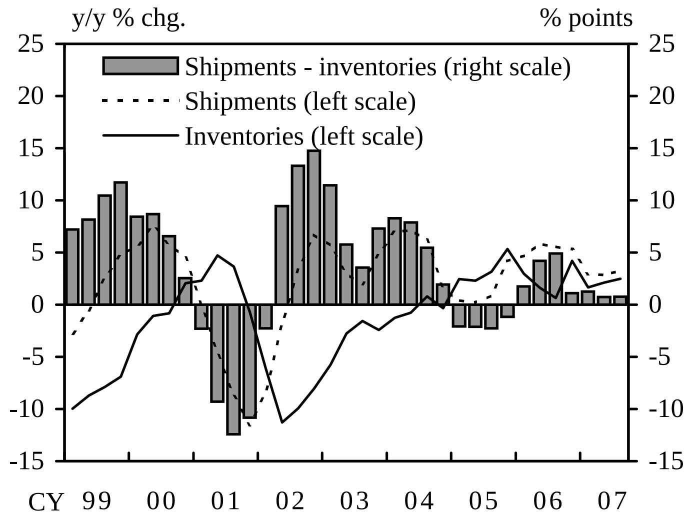


(2) Production (Breakdown by Industry)

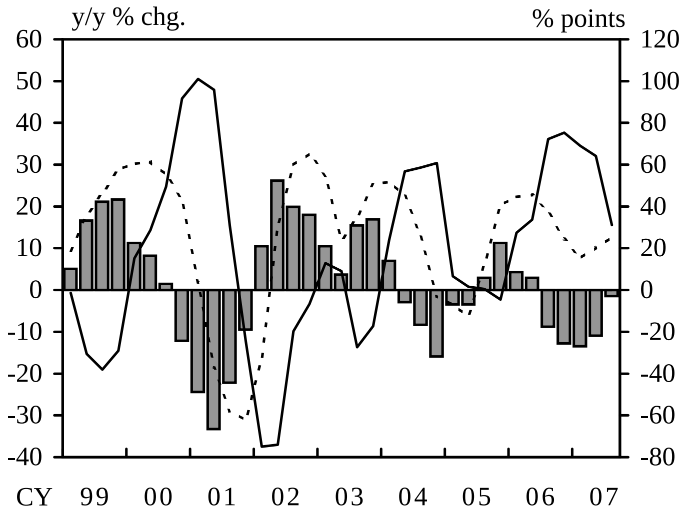


(3) Inventory Cycle

(a) Total



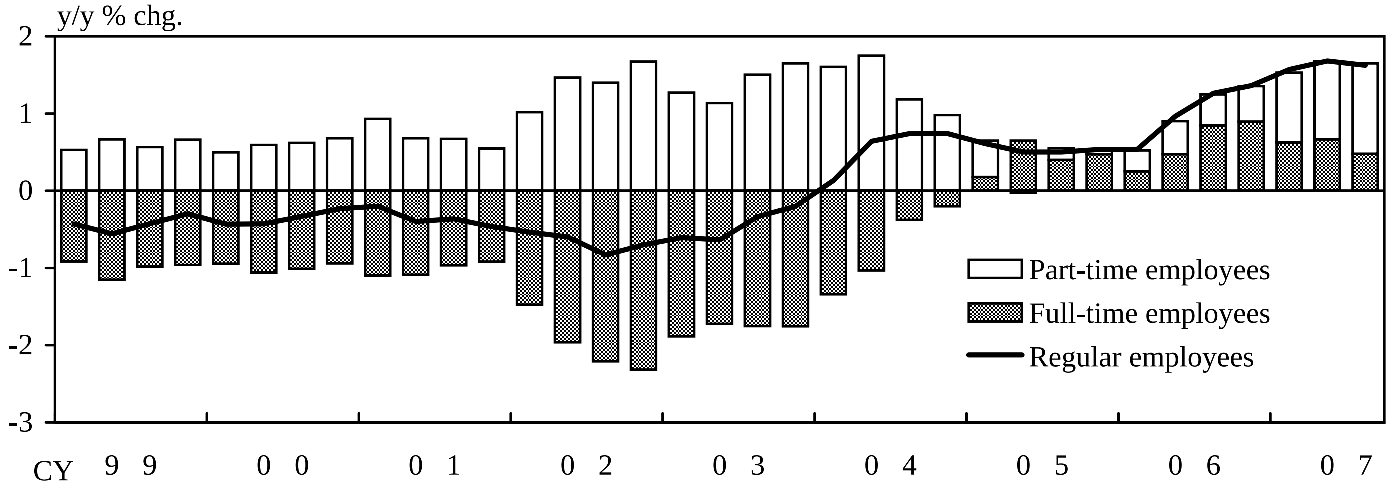
(b) Electronic Parts and Devices



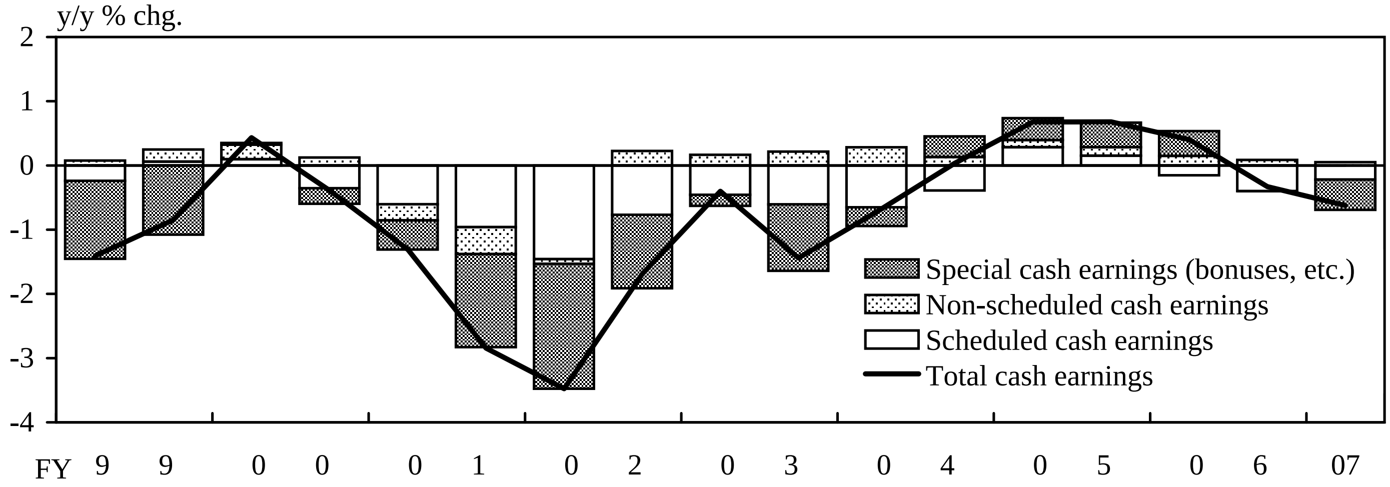
Source: Ministry of Economy, Trade and Industry, "Indices of Industrial Production."

Labor Market Conditions

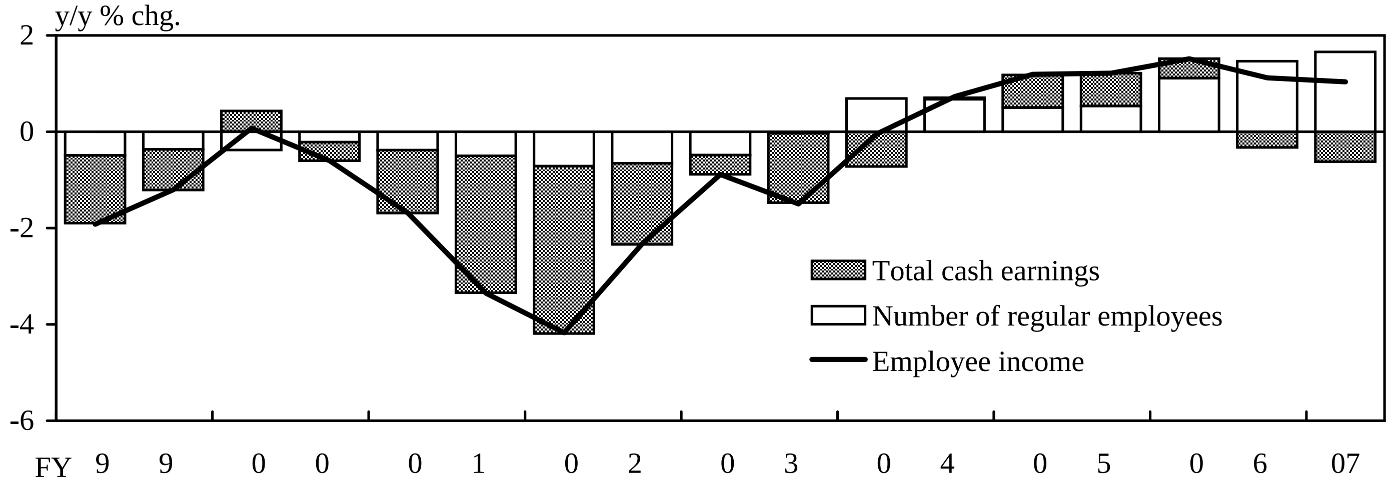
(1) Number of Regular Employees[1,2]



(2) Total Cash Earnings[1,3]



(3) Employee Income[1,3]

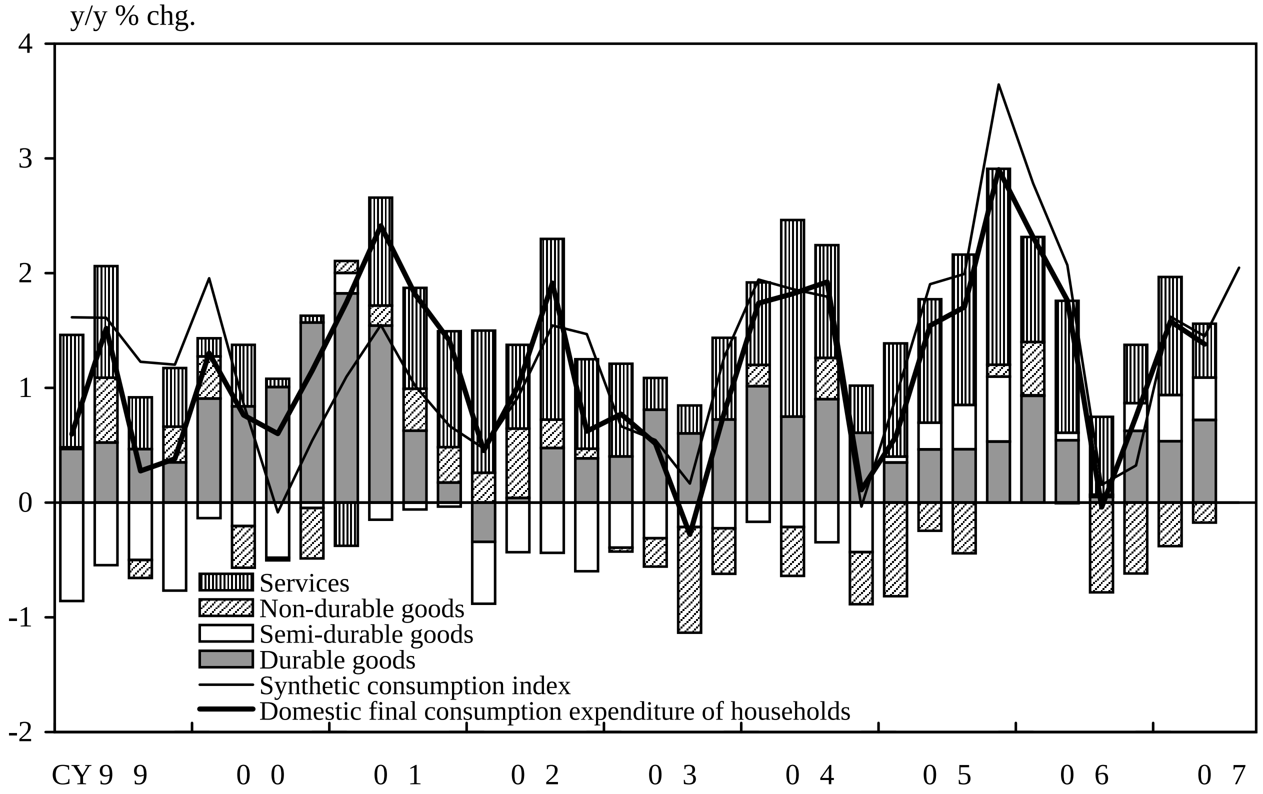


Notes: 1. Data are for establishments with at least 5 employees.
2. Figures for 2007/Q3 are those of the July-August average.
3. Figures for the first half of FY 2007 are those of the April-August average.

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

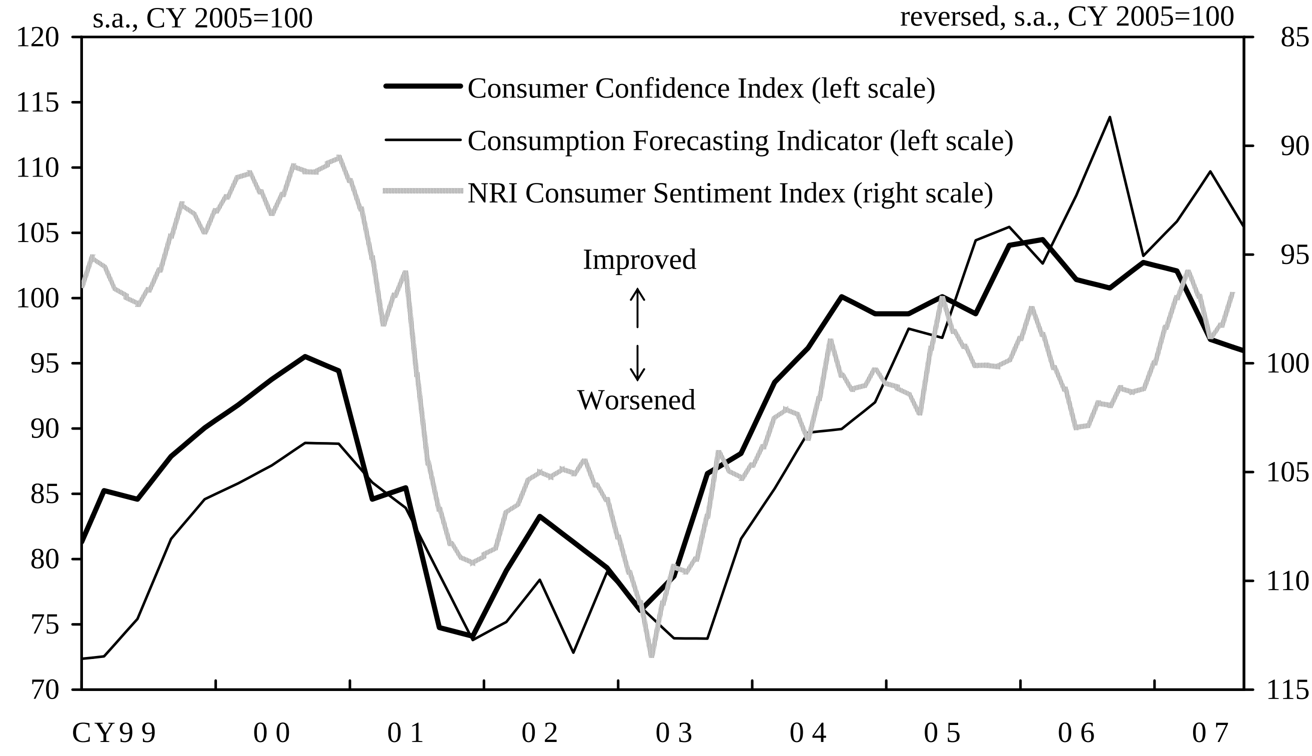
Private Consumption

(1) Breakdown of Domestic Final Consumption Expenditure of Households



Note: Figure of the synthetic consumption index for 2007/Q3 is the July-August average.

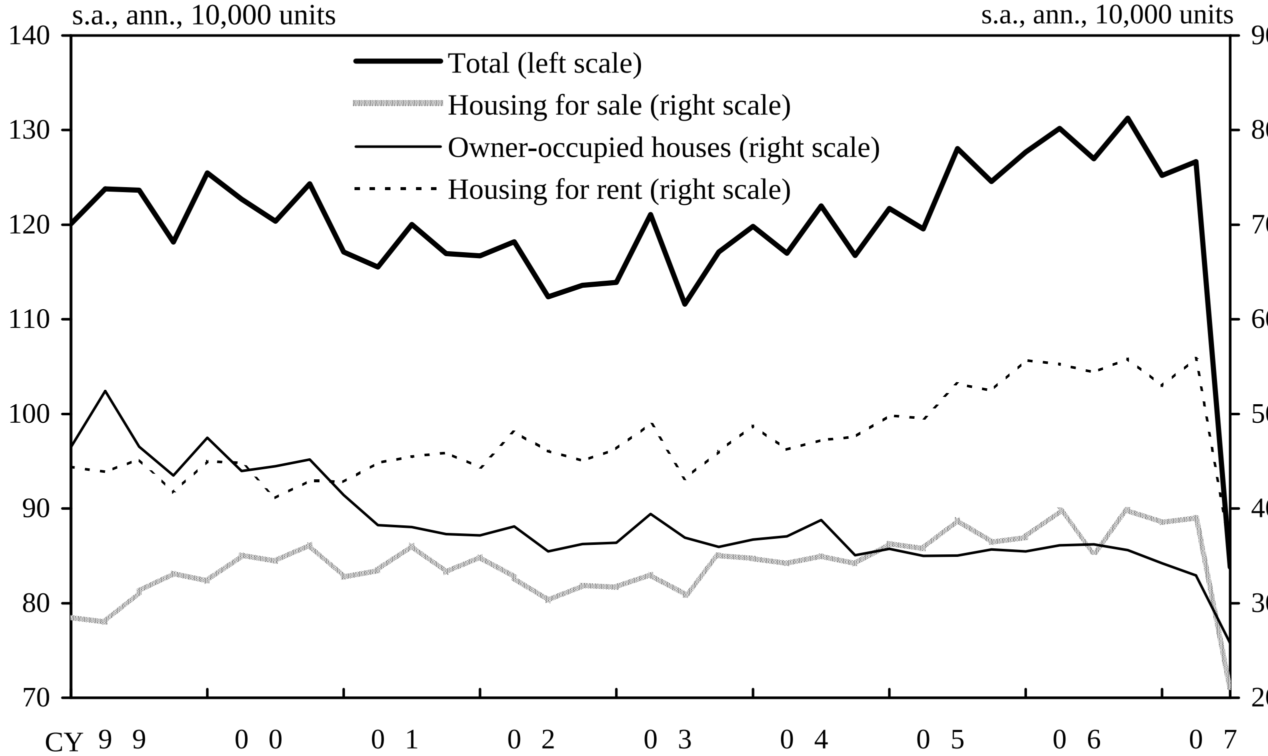
(2) Consumer Confidence



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

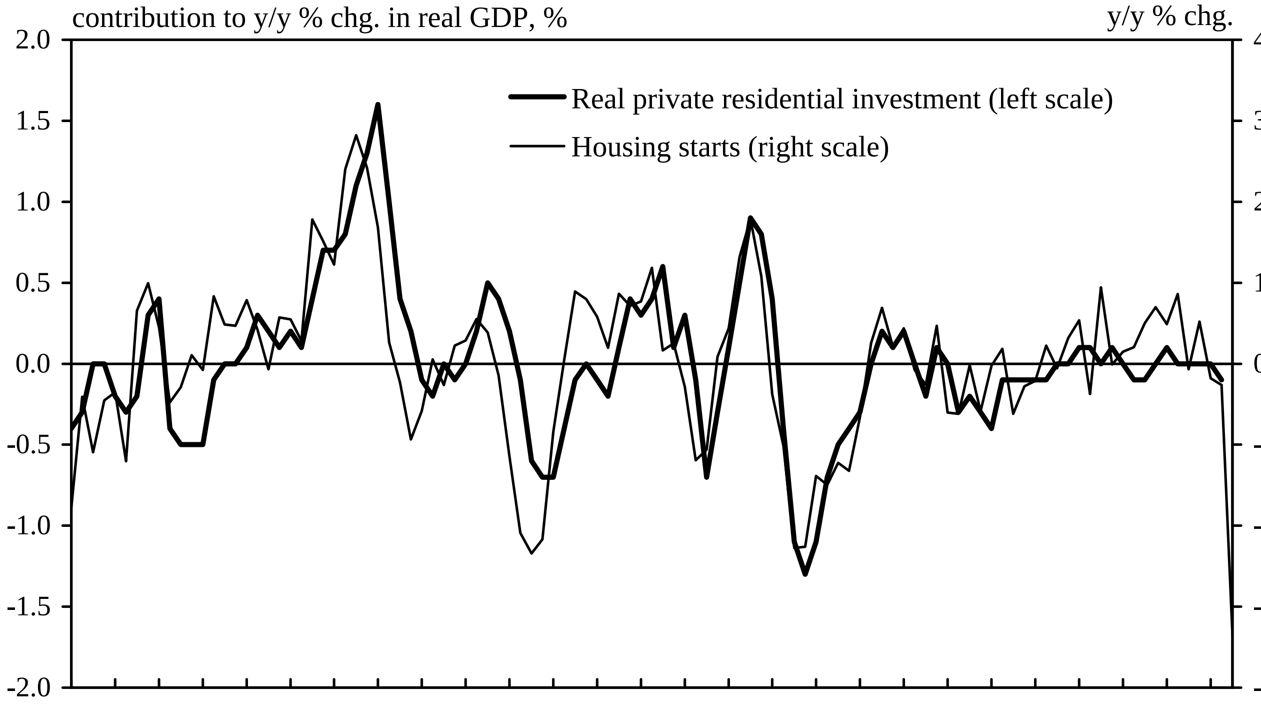
Housing Investment

(1) Housing Starts



Note: Figures for 2007/Q3 are those of the July-August average.

(2) Housing Starts and Contribution of Housing Investment to Change in GDP

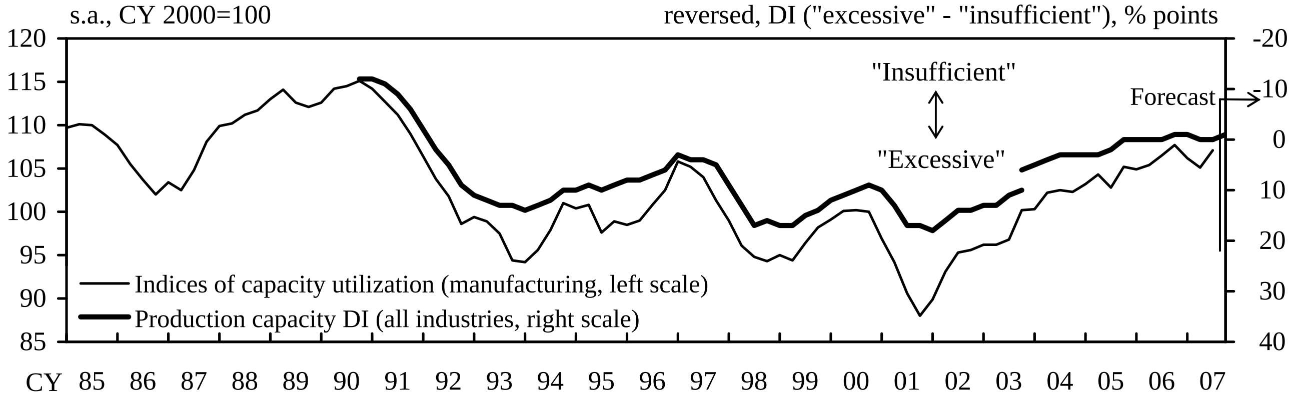


Note: Figure of housing starts for 2007/Q3 is the July-August average.

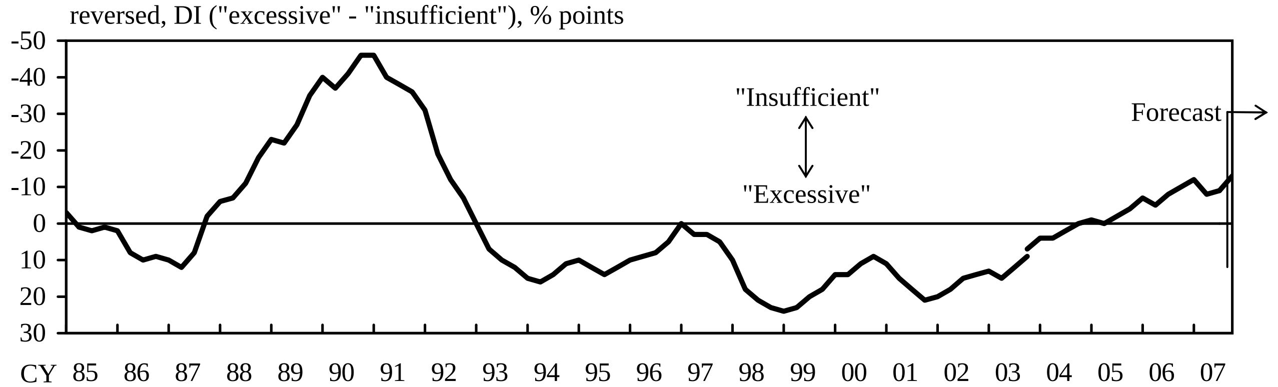
Sources: Ministry of Land, Infrastructure and Transport, "Statistics on Building Construction Starts"; Cabinet Office, "National Accounts."

Resource Utilization

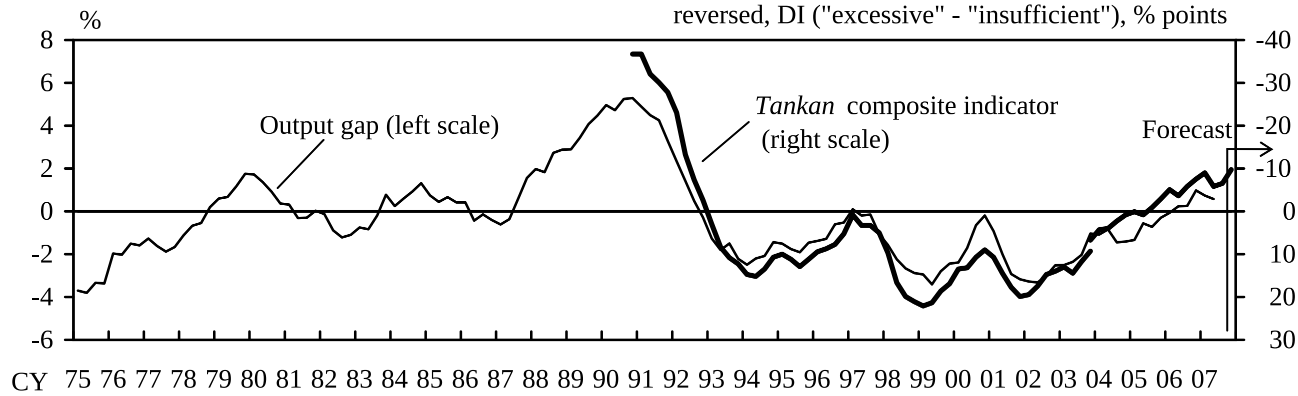
(1) Production Capacity DI (*Tankan*) and Indices of Capacity Utilization[1,2]



(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-size 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/Q3 is that of the July-August average.

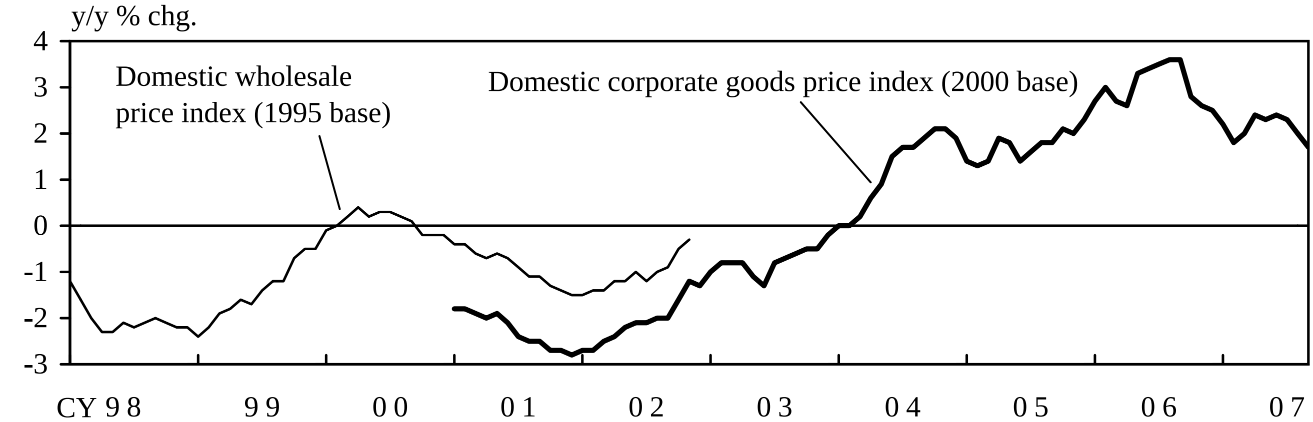
3. The *Tankan* composite indicator is calculated as the average of the diffusion indices of production capacity and employment conditions, weighted by capital and labor shares in the national accounts (FY 1990-2005 average). The output gap is estimated by the Research and Statistics Department, Bank 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.

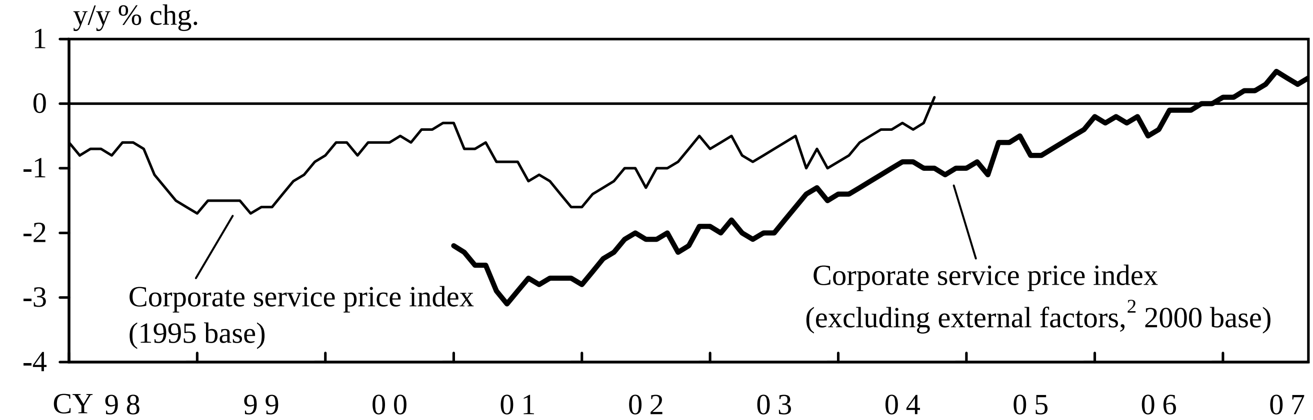
Chart 12

Prices

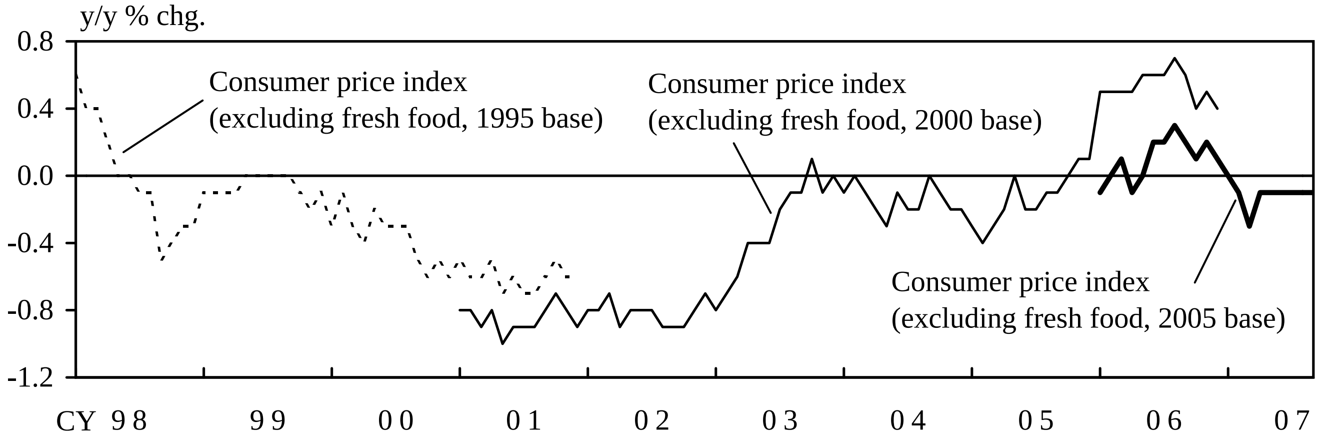
(1) Domestic Corporate Goods Price Index[1]



(2) Corporate Service Price Index[1]



(3) Consumer Price Index[1]

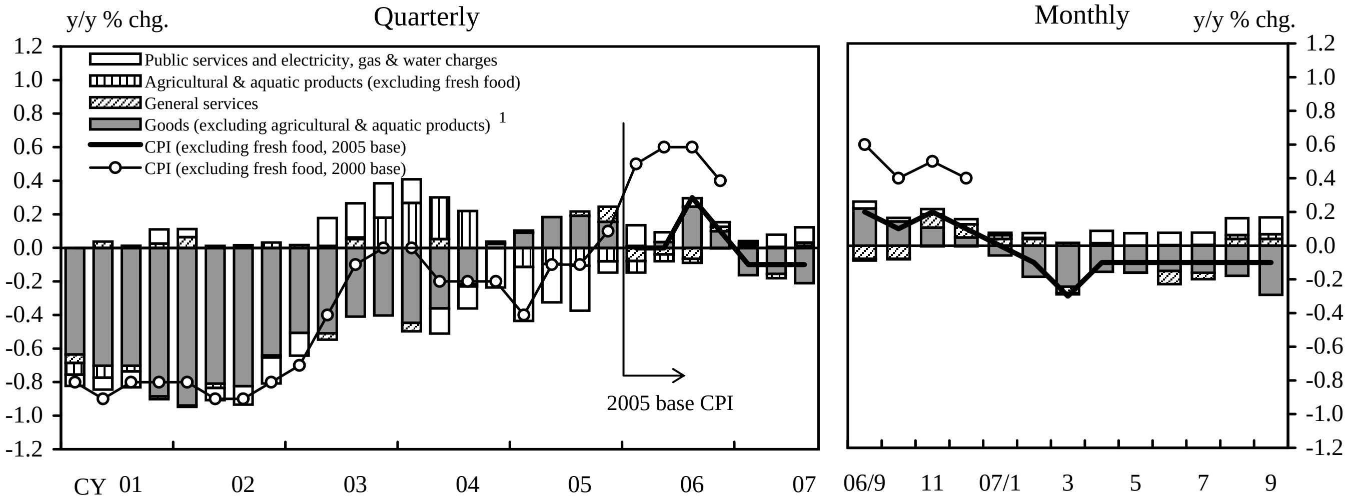


Notes: 1. Adjusted to exclude the effects of changes in consumption tax rate.
2. External factors: international air passenger transportation, ocean liner, ocean tramper, ocean tanker, oceangoing ship chartering services, and international air freight transportation.

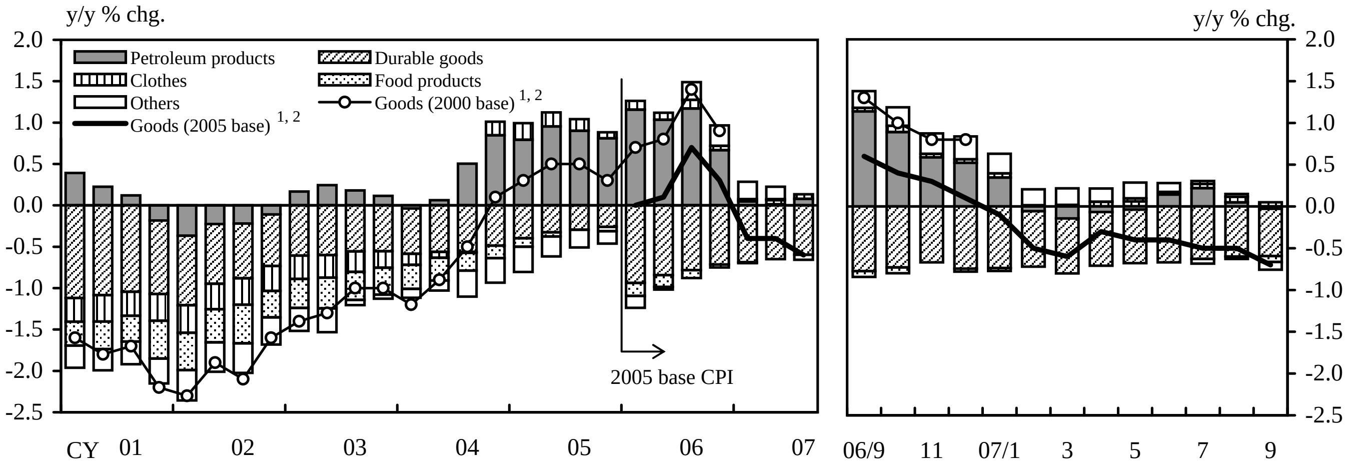
Sources: Ministry of Internal Affairs and Communications, "Consumer Price Index"; Bank of Japan, "Corporate Goods Price Index," "Wholesale Price Index," "Corporate Service Price Index."

Consumer Price Index

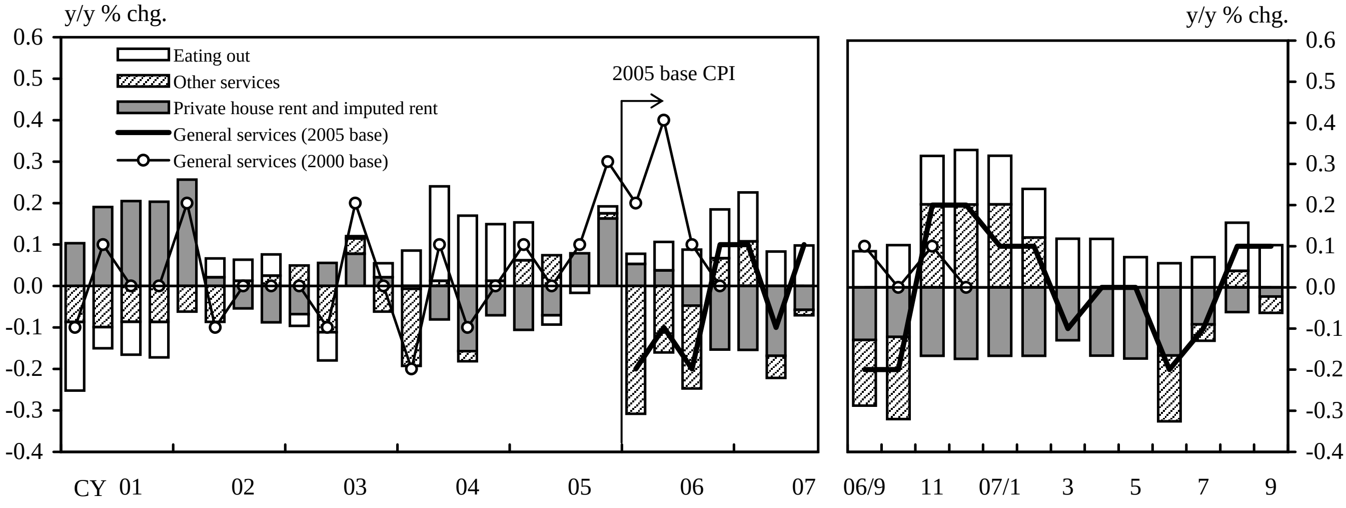
(1) Consumer Price Index (Excluding Fresh Food)



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



(3) General Services

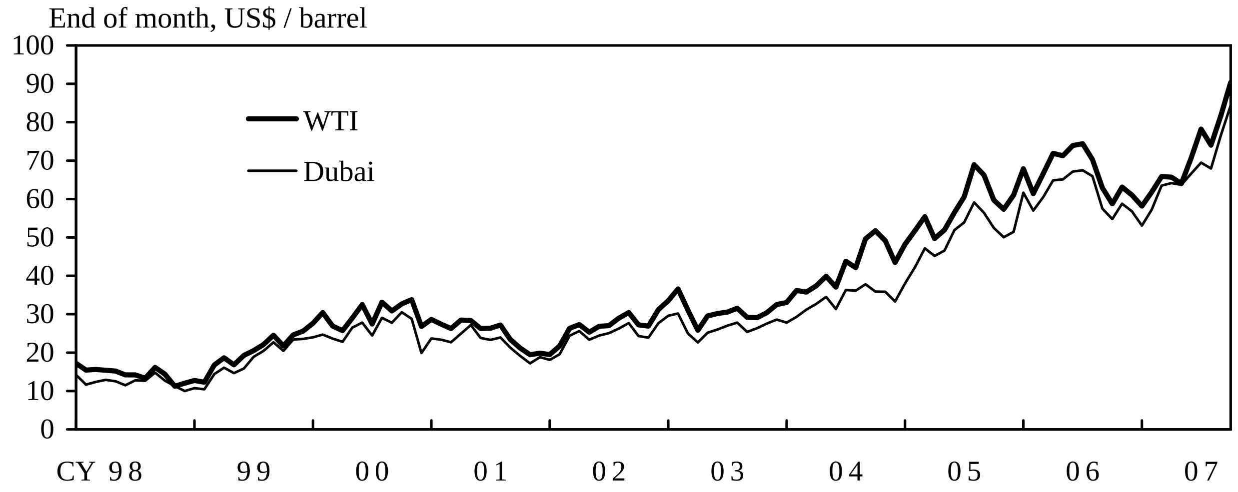


Notes: 1. The items are basically the same as the definition published by the Ministry of Internal Affairs and Communications. However, electricity, gas & water charges are excluded from goods.
2. Excluding agricultural & aquatic products.

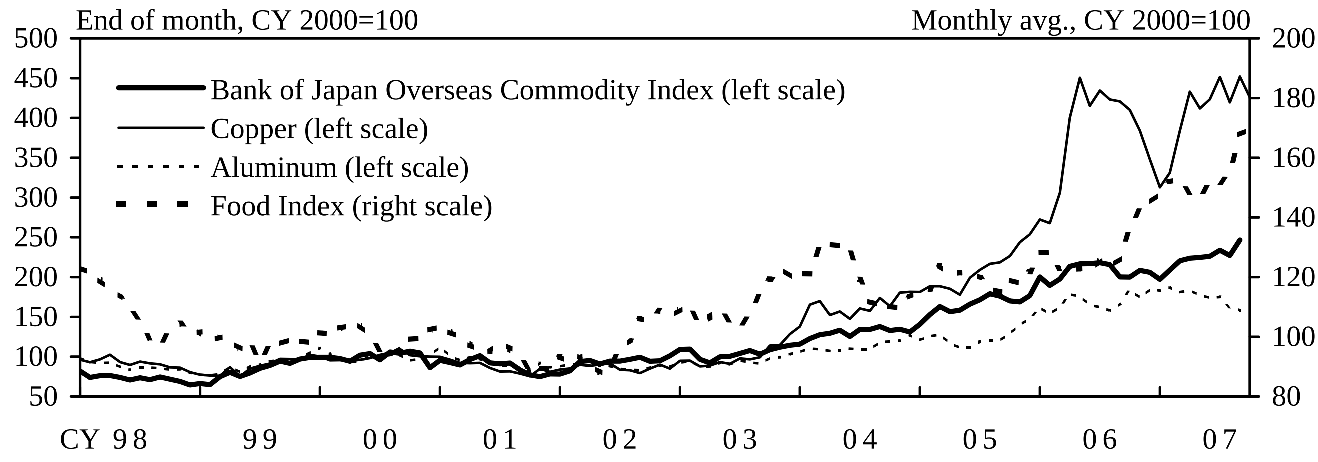
Source: Ministry of Internal Affairs and Communications, "Consumer Price Index."

Commodity Prices

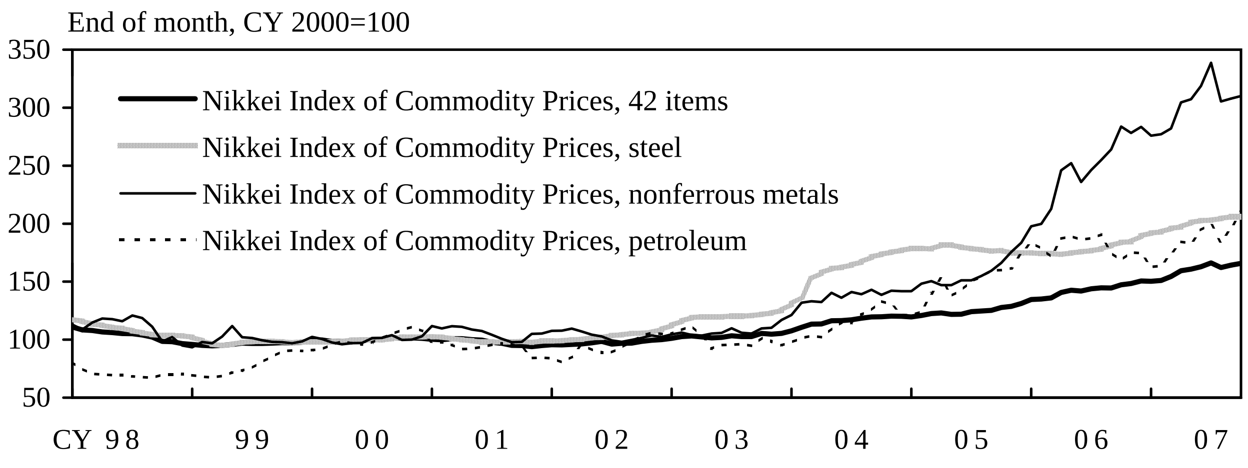
(1) Oil Prices[1]



(2) International Commodity Prices[1,2]



(3) Domestic Commodity Prices[1,3]

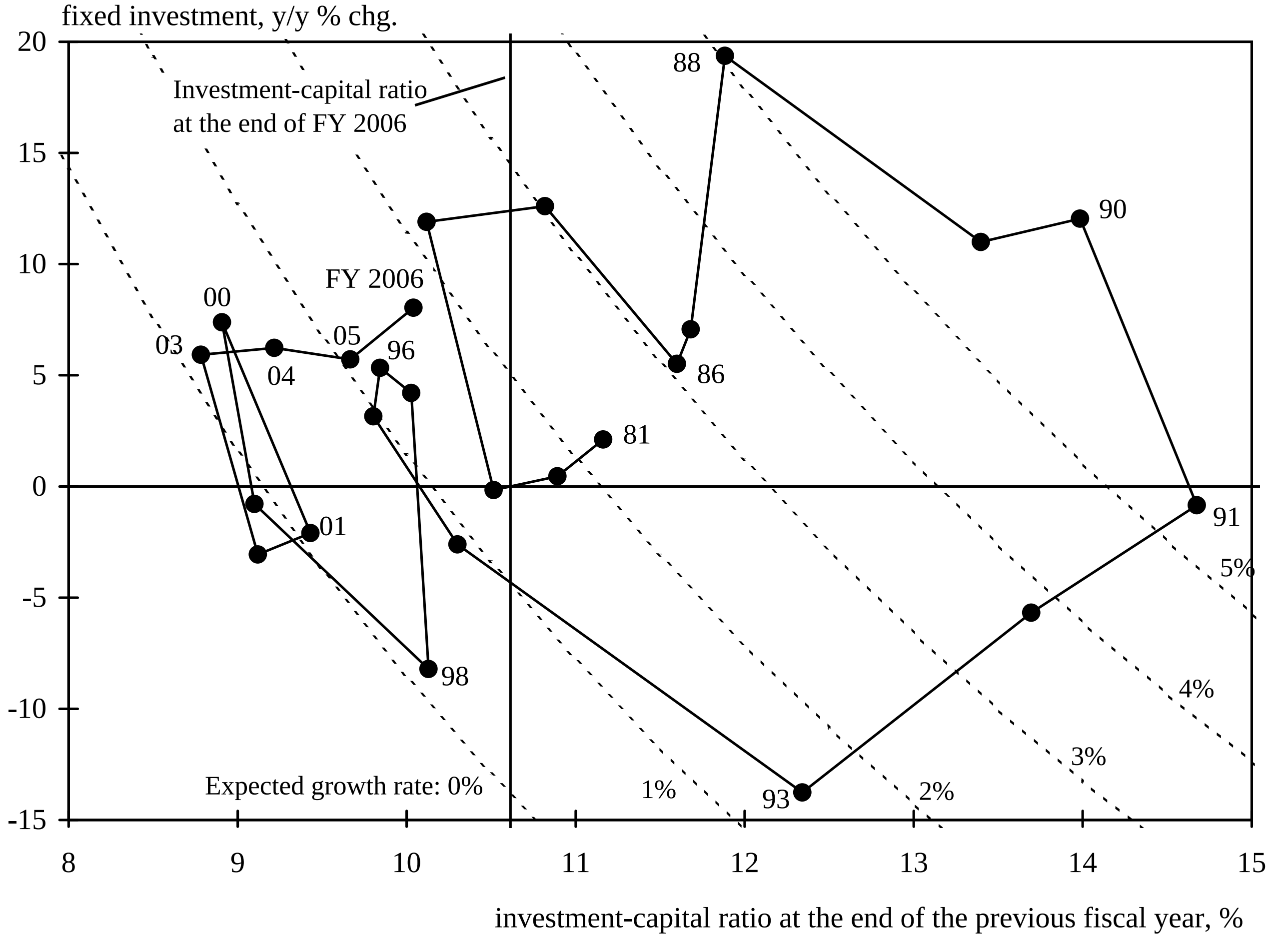


Notes: 1. Figures for October 2007 are the latest available data.
2. The Food Index is the weighted average of prices of six selected items (wheat, soybeans, corn, sugar, coffee, live cattle) in overseas commodity markets. The weights are based on the value of imports in 2000 reported in "Japan Exports & Imports."
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; Japan Tariff Association, "Japan Exports & Imports"; *The Nihon Keizai Shimbun* , etc.

Chart 15

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.

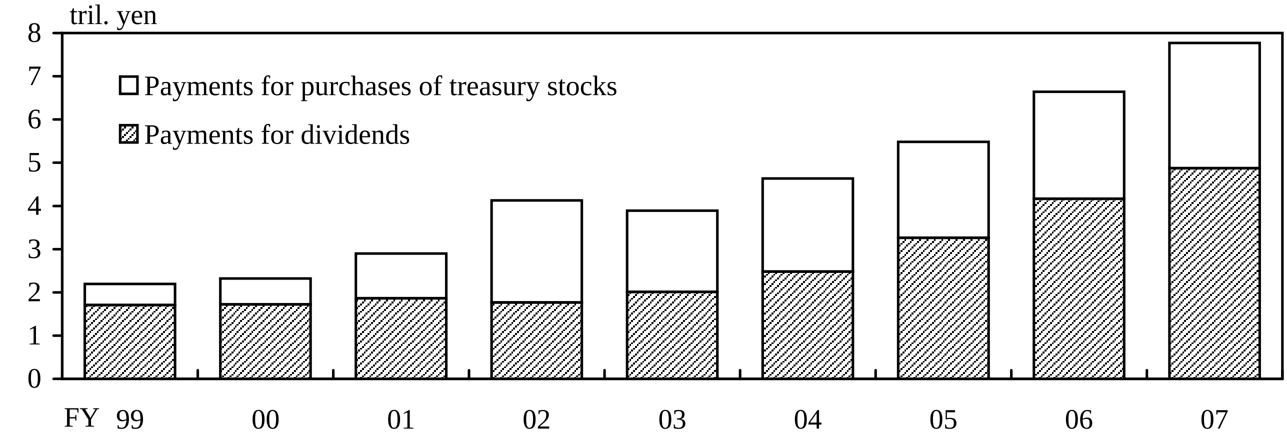
   Year-on-year rate of change of fixed investment (y-axis) × investment-capital ratio at the end of the previous fiscal year (x-axis) = expected growth rate + trend of capital coefficient + depreciation rate

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.

Sources: Cabinet Office, "National Accounts," "Annual Report on Gross Capital Stock of Private Enterprises," "Preliminary Quarterly Estimates of Gross Capital Stock of Private Enterprises"; Ministry of Economy, Trade and Industry, "Census of Manufactures"; Research Institute of Economy, Trade and Industry, "Japan Industrial Productivity Database 2006."

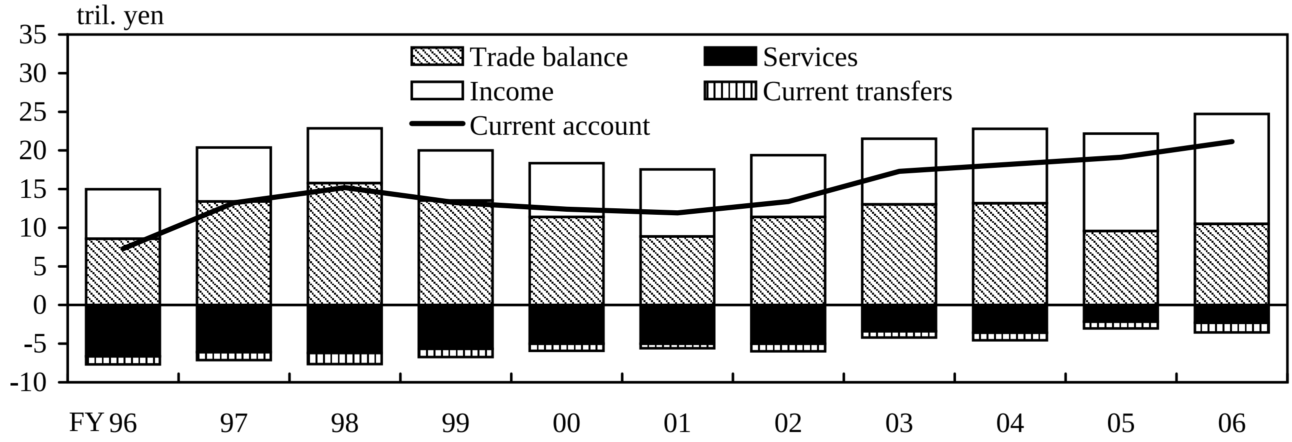
Increasing Variety of Income Channels

(1) Return to Stockholders of Firms

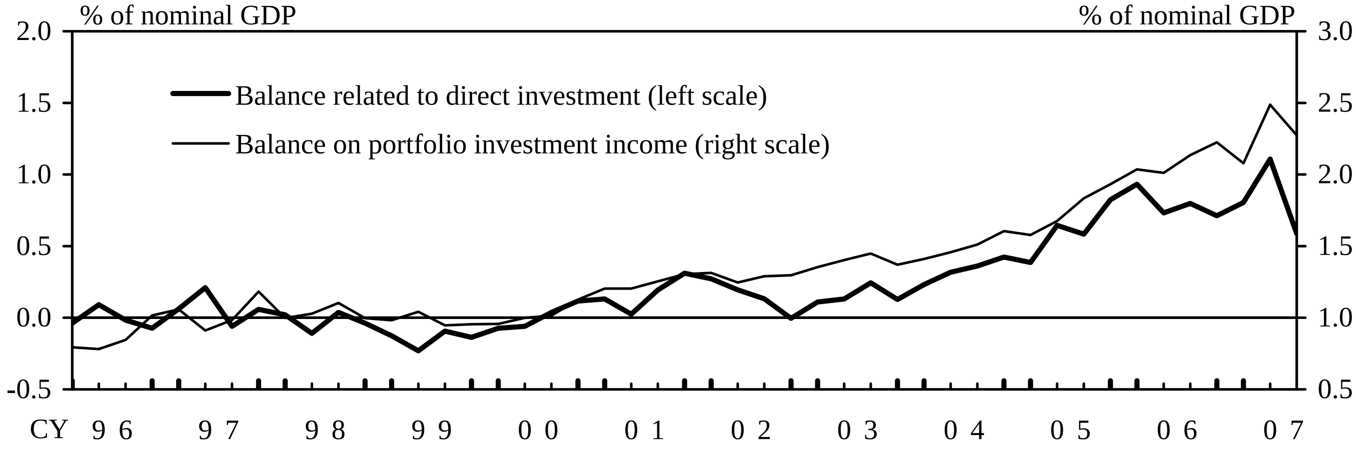


Note: Data are for 1,035 firms (excluding financial institutions, insurance companies, and electric and gas utility firms) listed on the Tokyo Stock Exchange First Section which have continuously disclosed consolidated statements of cash flows since FY 1999. Data in FY 2007 are calculated using the growth rates in the first half of FY 2007 estimated by *The Nihon Keizai Shimbun.*

(2) Current Account



(3) Balance Related to Direct Investment and Balance on Portfolio Investment Income

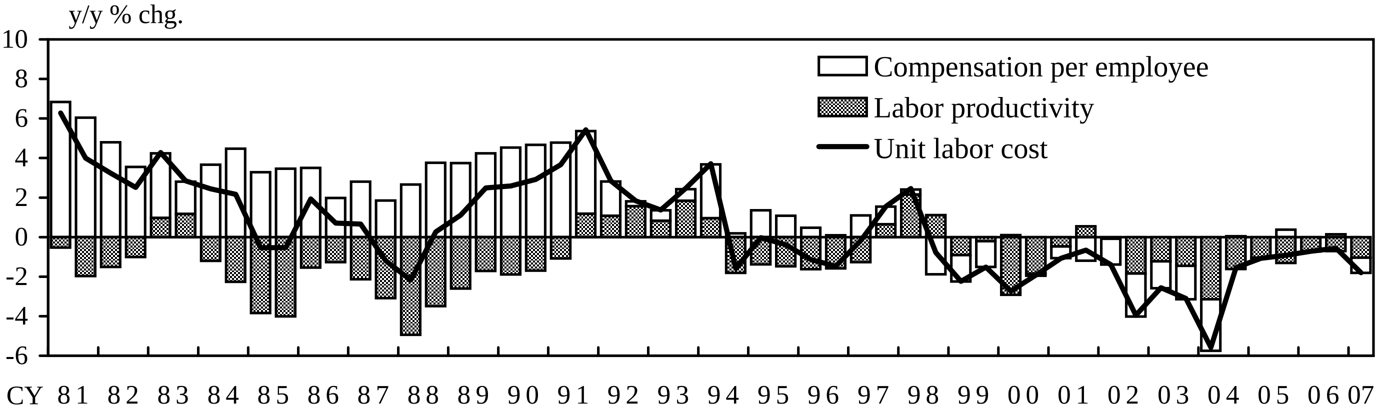


Note: Balance related to direct investment is the sum of net income of individual items that are considered to fluctuate along with the development of overseas operations by Japanese firms (direct investment, merchanting and other trade-related services, industrial processes and franchises, and miscellaneous business, professional, and technical services). Figures for 2007/Q3 are the July-August averages (using nominal GDP in 2007/Q2).

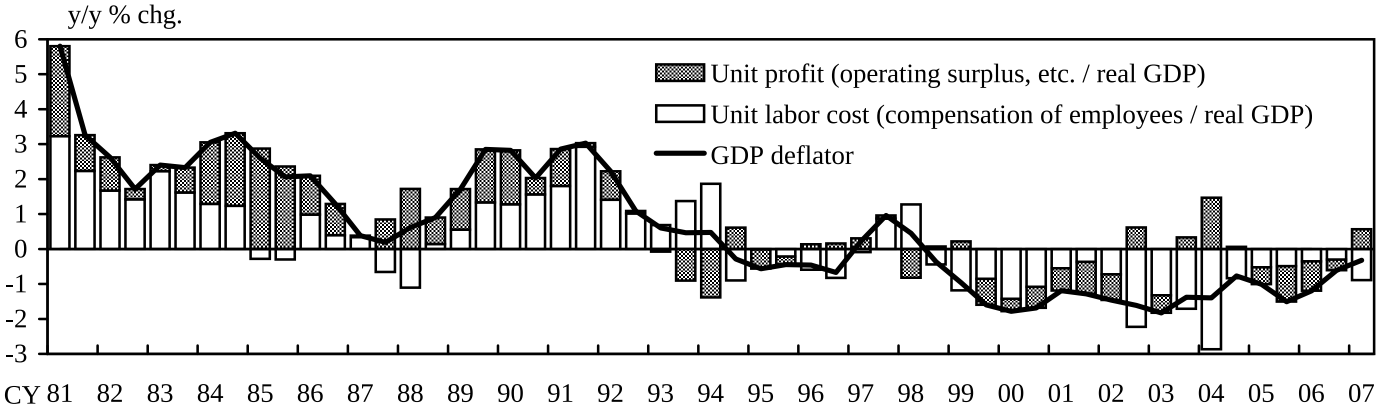
Sources: Cabinet Office, "National Accounts"; Bank of Japan, "Balance of Payments"; Nikkei Financial QUEST; *The Nihon Keizai Shimbun.*

Unit Labor Cost

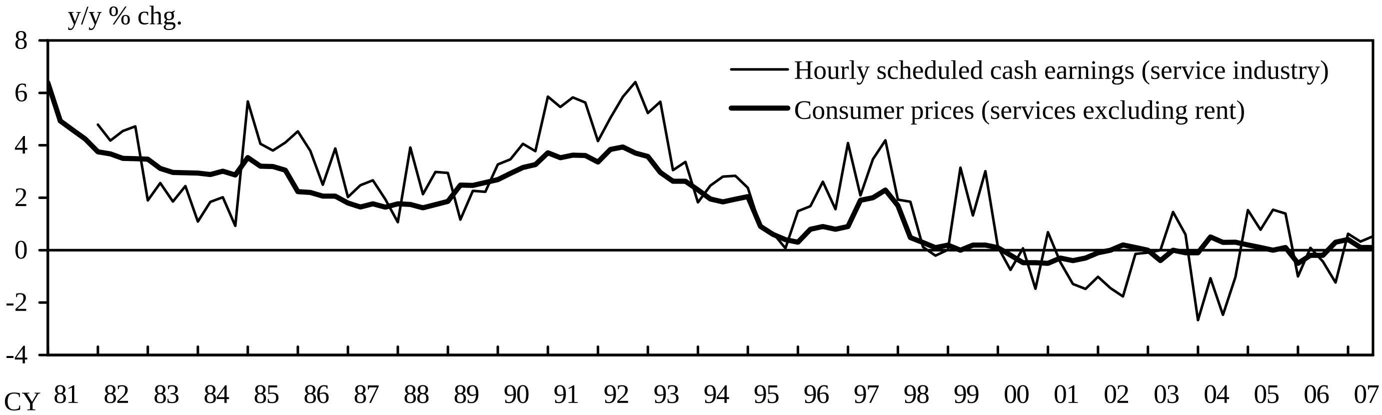
(1) Unit Labor Cost[1]



(2) Decomposition of GDP Deflator in Terms of Distribution[1,2]



(3) Service Prices and Wages[3,4]

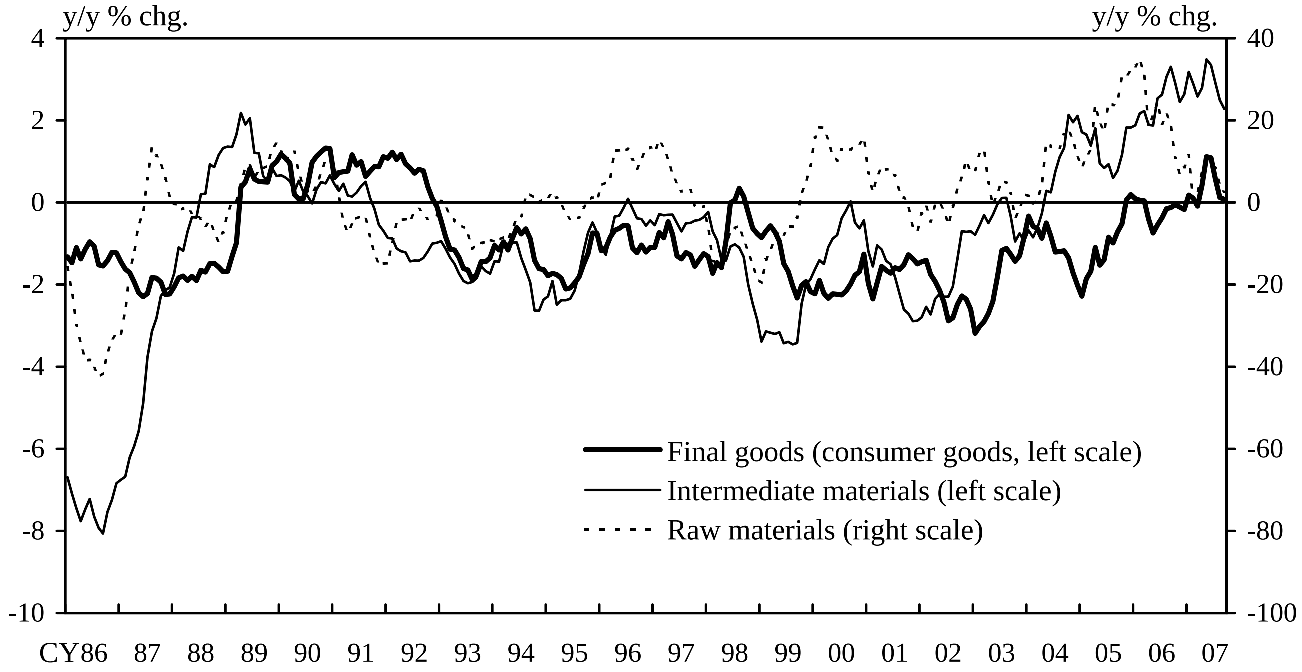


Notes: 1. Up to 1994, fixed-based series are used (base year=1995). From 1995, chain-linked series are used (base year=2000).
2. Operating surplus, etc., includes (i) operating surplus and mixed income, (ii) consumption of fixed capital, (iii) taxes on production and imports, (iv) subsidies, and (v) statistical discrepancy.
3. Figure of hourly scheduled cash earnings for 2007/Q3 is the July-August average.
4. 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."

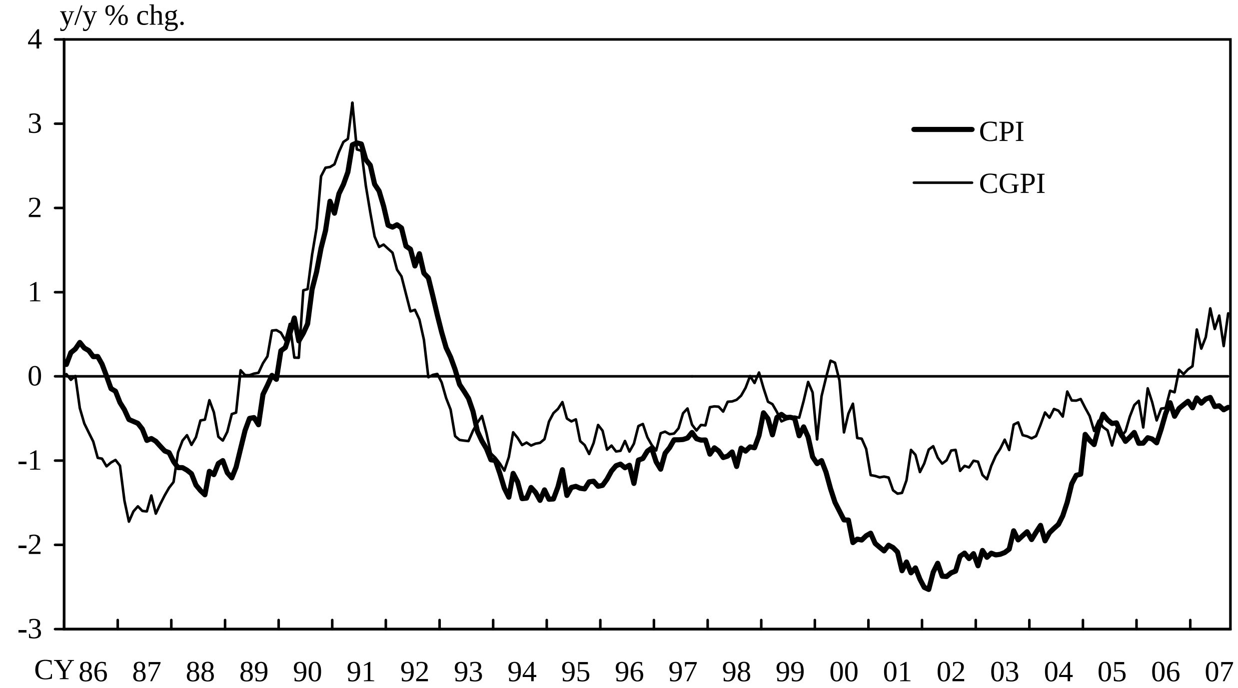
Price Developments by Stage of Demand

(1) CGPI by Stage of Demand and Use (Domestic Goods and Imports)



Notes: 1. Figures of the CGPI for CY 1986-1999 are those of the WPI.
2. Figures for intermediate materials are the weighted averages of "group" level indexes based on the weights of consumer goods.
3. Petroleum & coal products are excluded from intermediate materials and final goods.

(2) CGPI Consumer Goods and the CPI



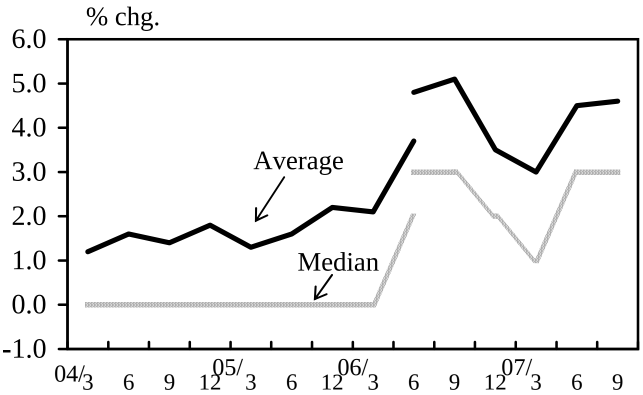
Notes: 1. Figures of the CGPI for CY 1986-1999 are those of the WPI.
2. Figures are the weighted averages of common goods for the CPI and CGPI based on the weights in the CPI (base year=2005). However, omitted goods, newly included goods in the 2000 base and 2005 base, agricultural & aquatic products, petroleum & coal products and tobacco are excluded from the figures.

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

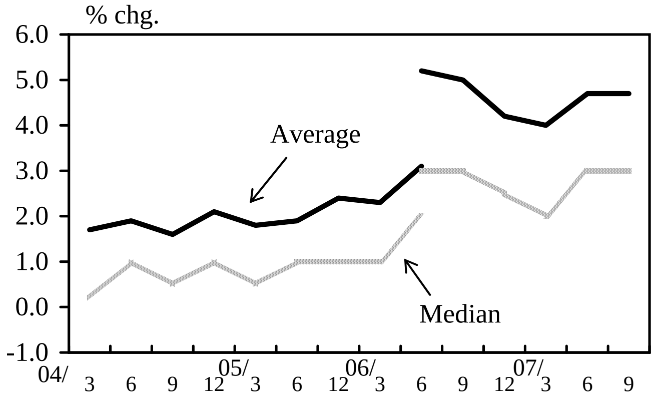
Outlook for Prices

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

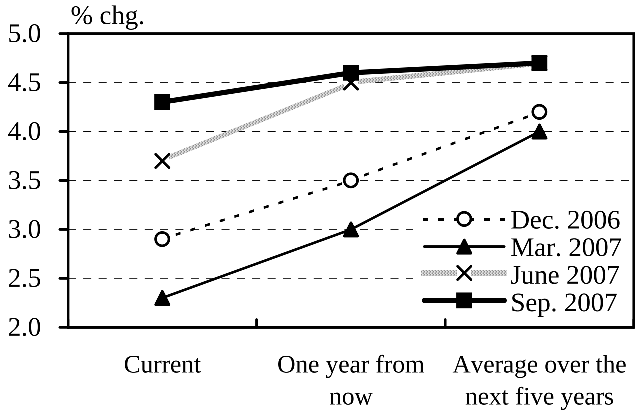
(a) Changes in the Price Levels One Year from Now



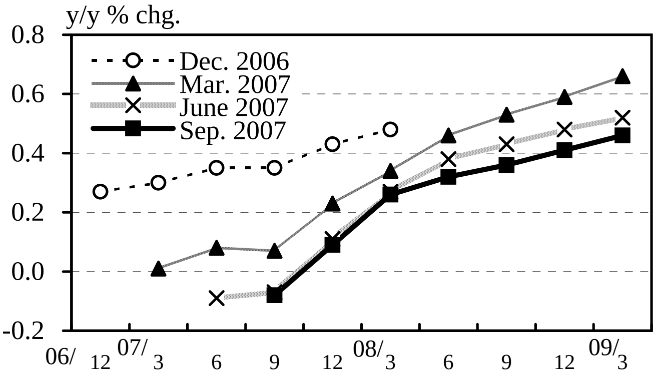
(b) Changes in the Price Levels per Year on Average over the Next Five Years



(c) Perception of Current Inflation Rate and Outlook for Future Inflation Rates (Average)

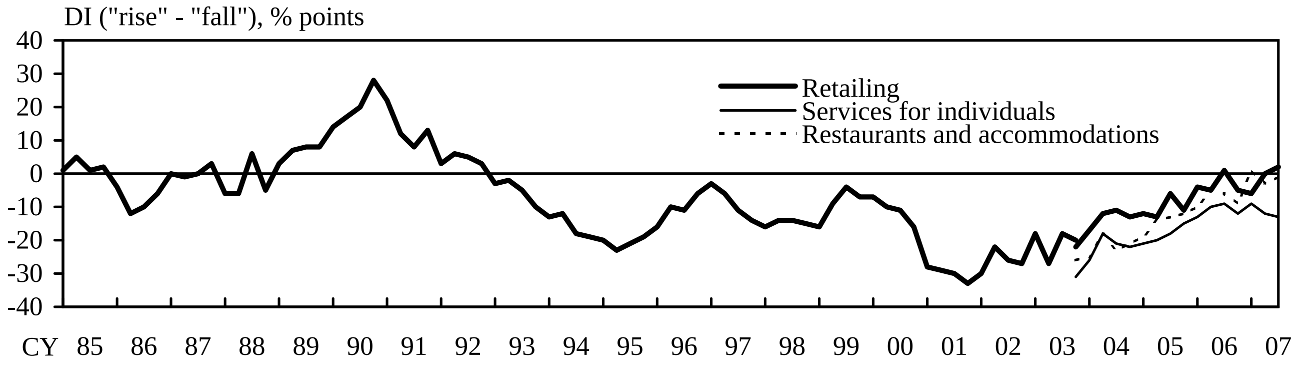


(2) Economists (ESP Forecast)



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])

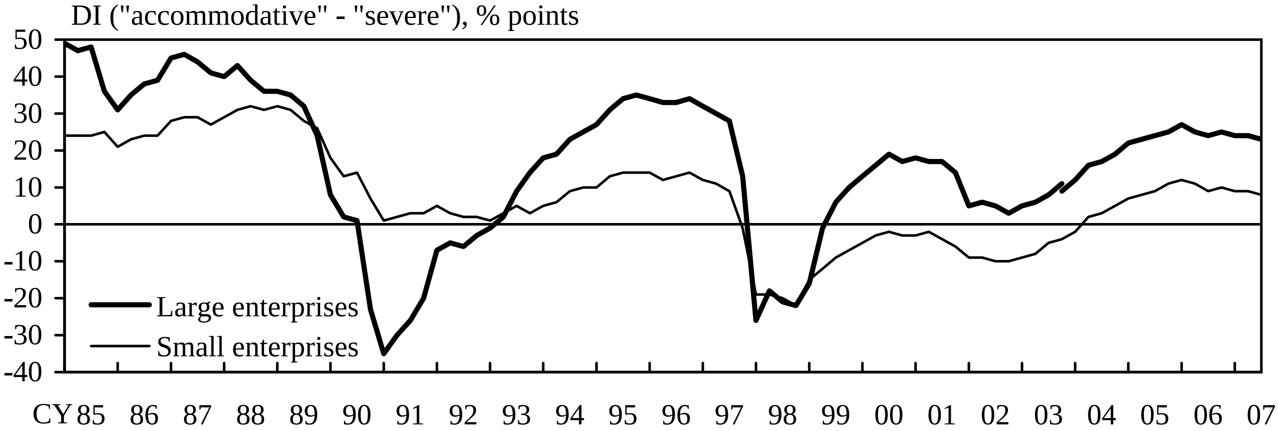


Notes: 1. All-size enterprises.
2. The *Tankan* has been revised from the March 2004 survey. Figures based on the previous data sets are up to the December 2003 survey. Figures on a new basis are from the December 2003 survey.

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

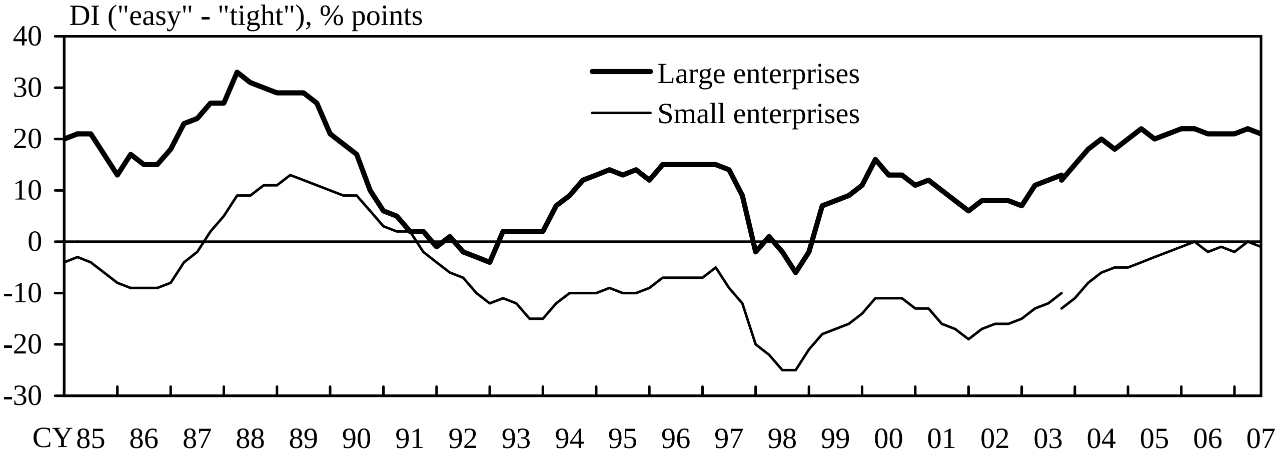
Corporate Finance

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



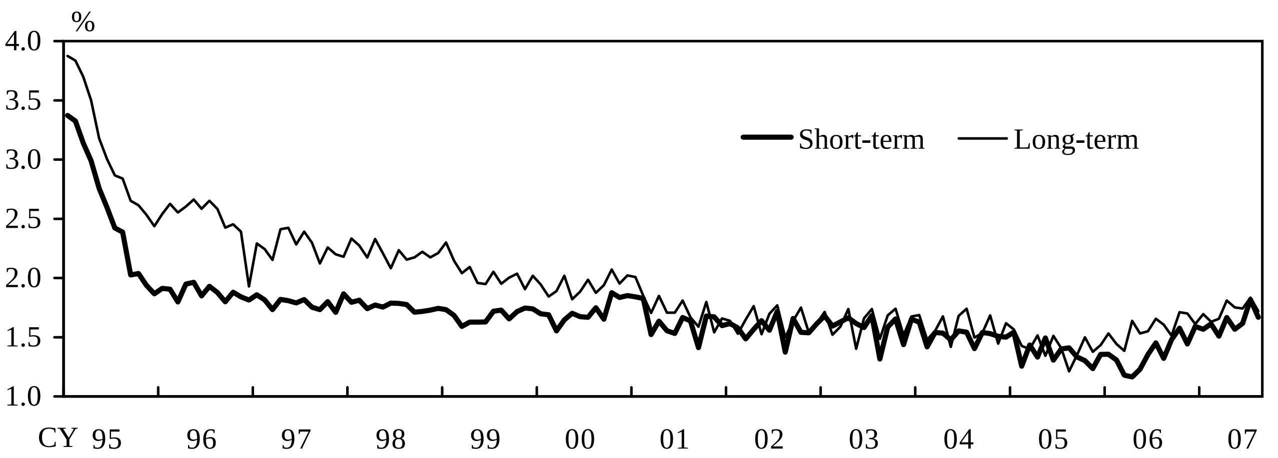
Note: The *Tankan* has been revised from the March 2004 survey. Figures based on the previous data sets are up to the December 2003 survey. Figures on a new basis are from the December 2003 survey.

(2) Financial Position of Firms (*Tankan*, All Industries)



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.

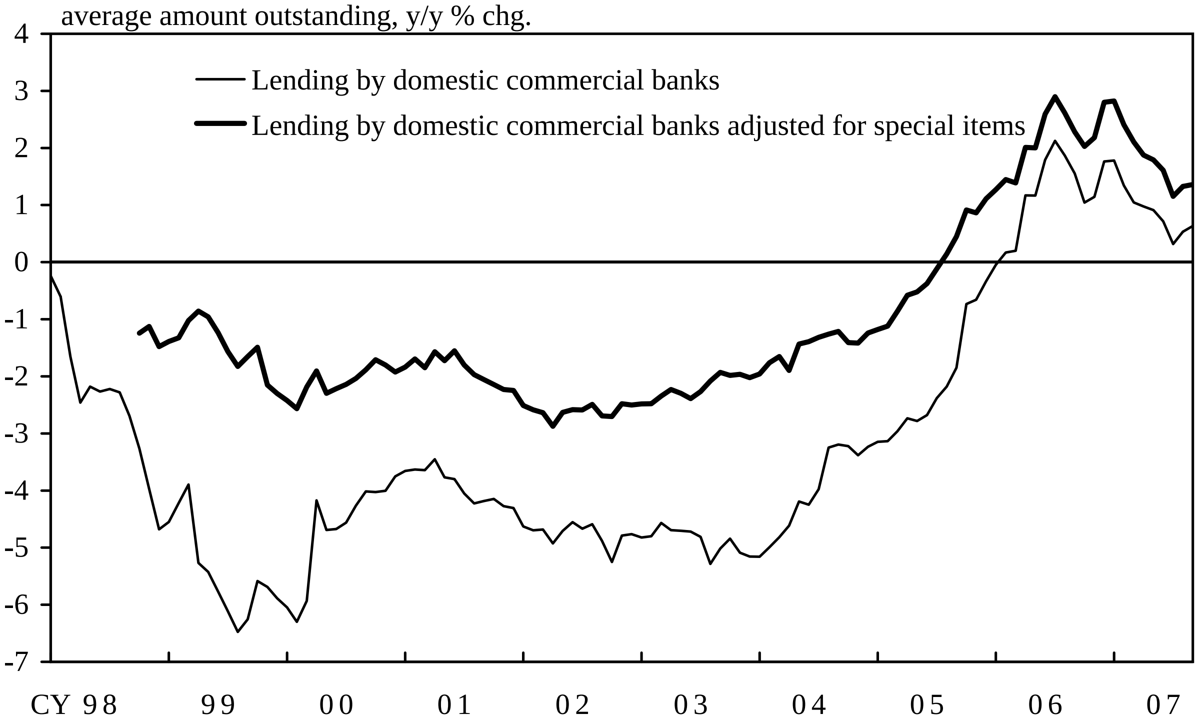
(3) Average Contracted Interest Rates on New Loans and Discounts



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

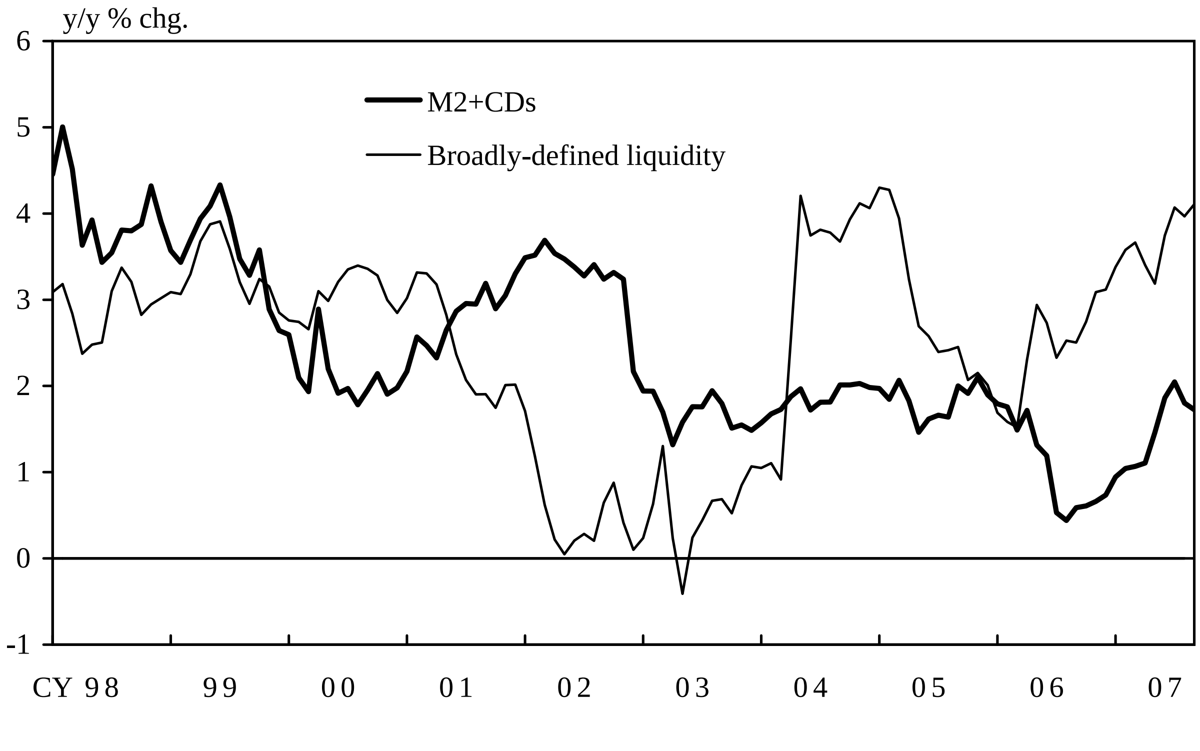
Bank Lending and Money Stock

(1) Lending by Domestic Commercial Banks



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

(2) Money Stock

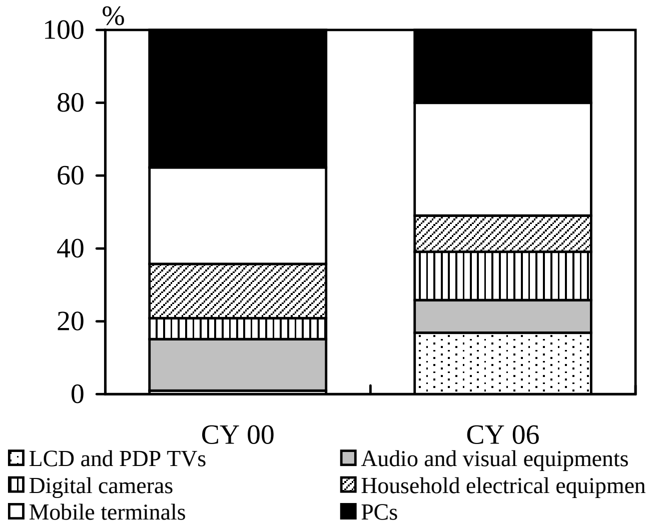


Source: Bank of Japan, "Principal Figures of Financial Institutions," "Money Stock."

Diversification in IT-Related Goods

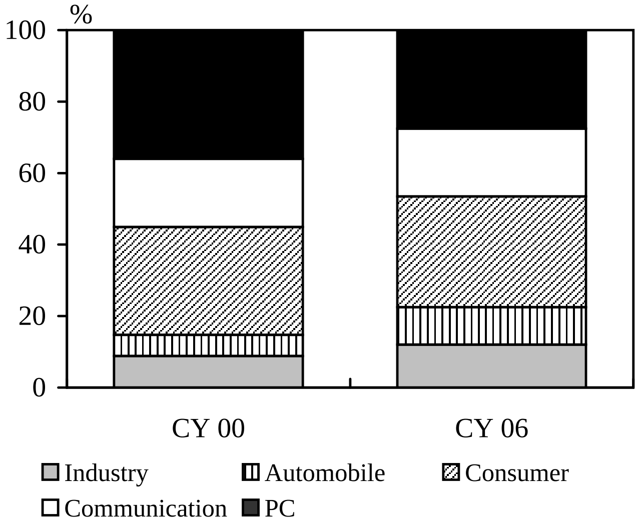
(1) Increasing Variety of IT-Related Goods

(a) Domestic Production of IT-Related Final Goods by Product



Note: Amount of domestic production.

(b) Semiconductors Shipments to Japan by Use

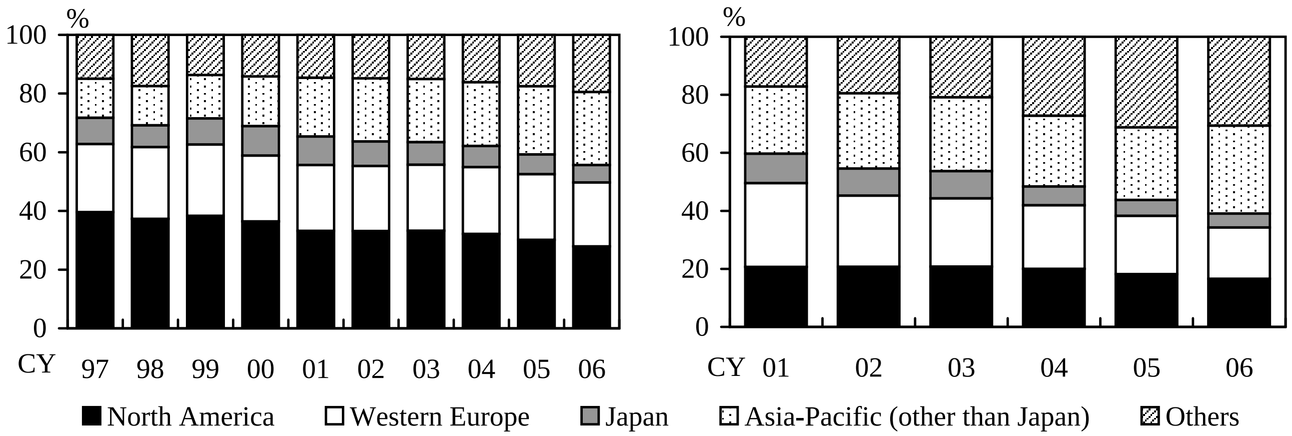


Note: Amount of domestic shipments and imports.

(2) Demand of Personal Computers and Mobile Terminals by Region

(a) Personal Computers

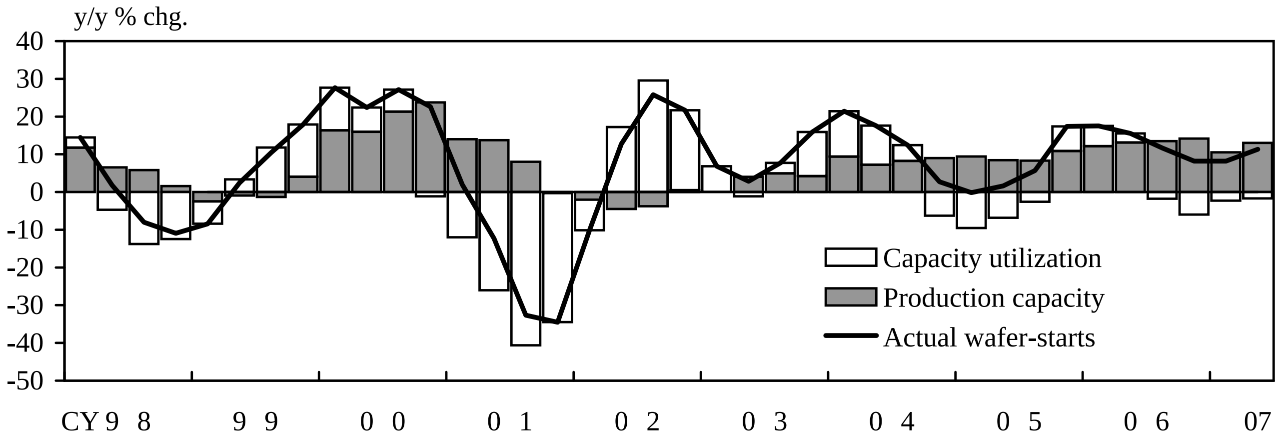
(b) Mobile Terminals



Note: Units of shipments (Gartner, May 2007).

Note: Units of sales to end users (Gartner, July 2007).

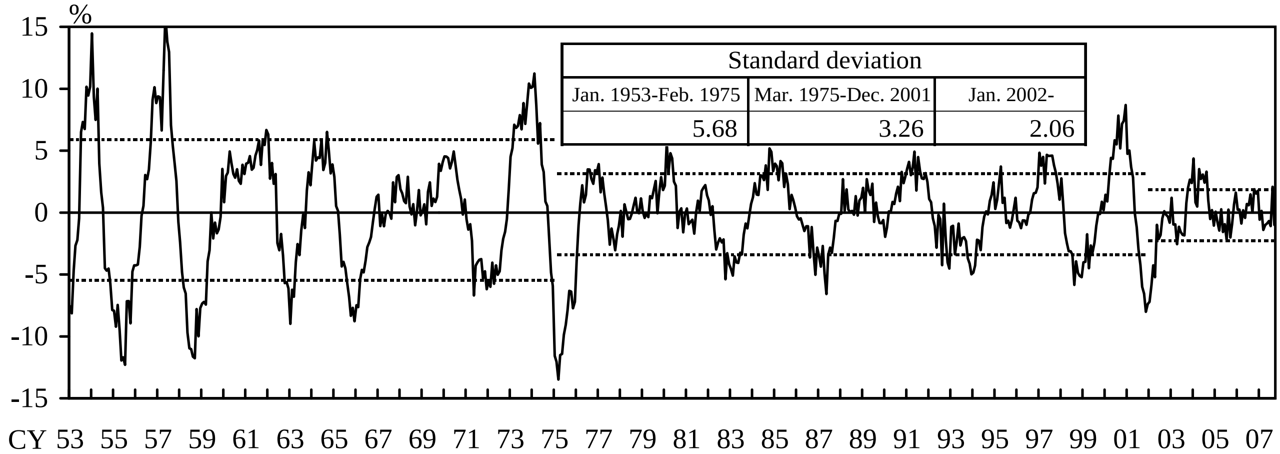
(3) Global Semiconductors



Sources: Ministry of Economy, Trade and Industry, "Current Survey of Production"; Gartner (GJ07352); WSTS (World Semiconductor Trade Statistics); SICAS, "Semiconductor International Capacity Statistics."

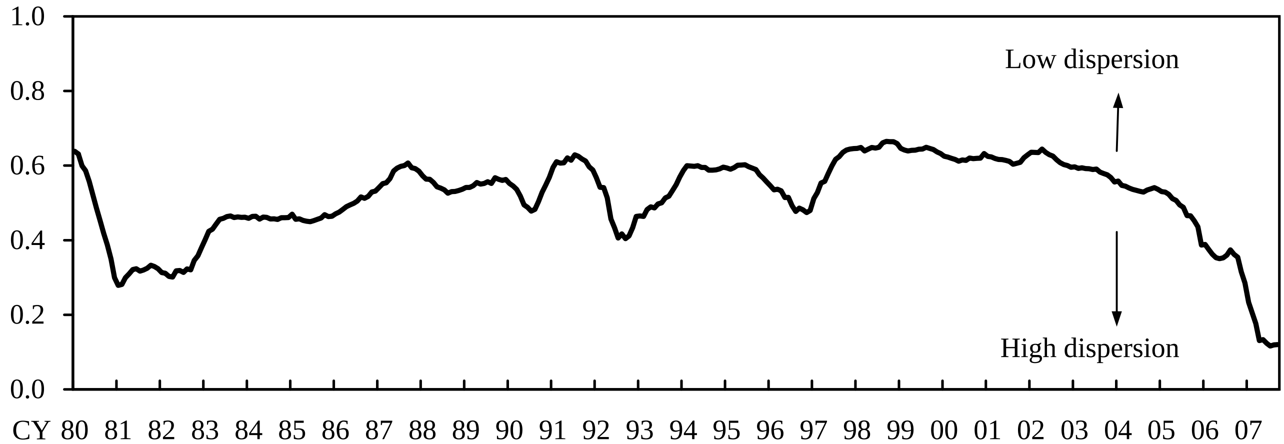
Movements in Production

(1) Cyclical Movements in Production



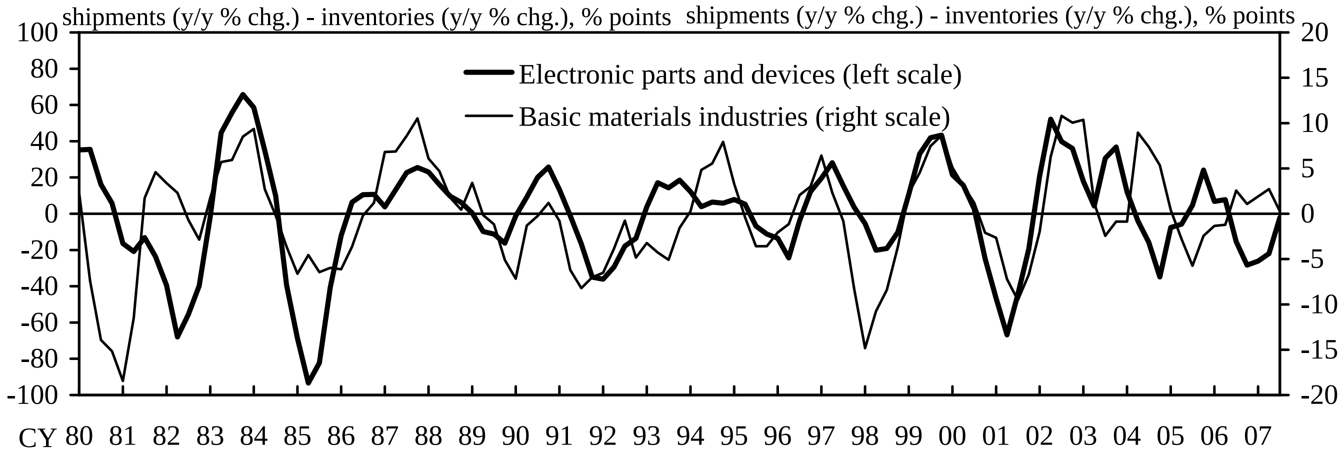
Note: Data are deviations from HP trend. Dotted lines indicate one standard deviation for each period.

(2) Dispersion of Production across Industries (Weighted Average of Correlation Coefficients)



Note: Data are the weighted average of inter-industry correlation coefficients of cyclical movements in each industry's production (60-month backward rolling), using as weights each industry's share of production, as in "Indices of Industrial Production."

(3) Shipment-Inventory Balance of Electronic Parts and Devices and Basic Materials Industries

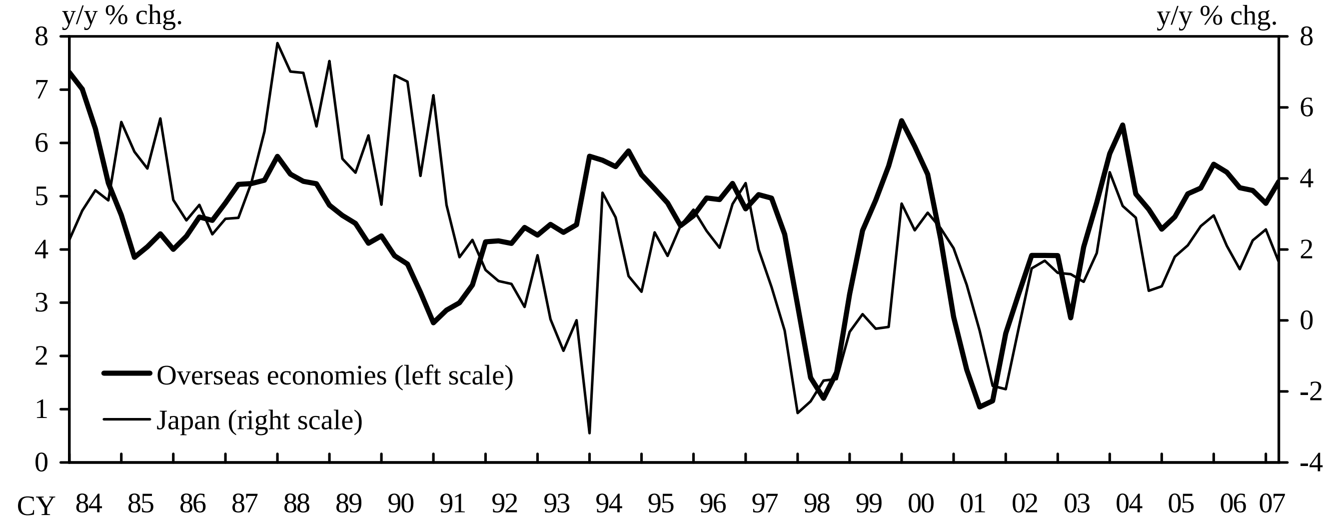


Note: Figures for electronic parts and devices up to 1998/Q4 are based on Electrical machinery of producer goods for manufacturing (1995 base). Basic materials industries: Textile machinery, Pulp, paper and paper products, Chemicals (excluding Drugs), Petroleum and coal products, Ceramics, stone and clay products, Iron and steel, and Non-ferrous materials.

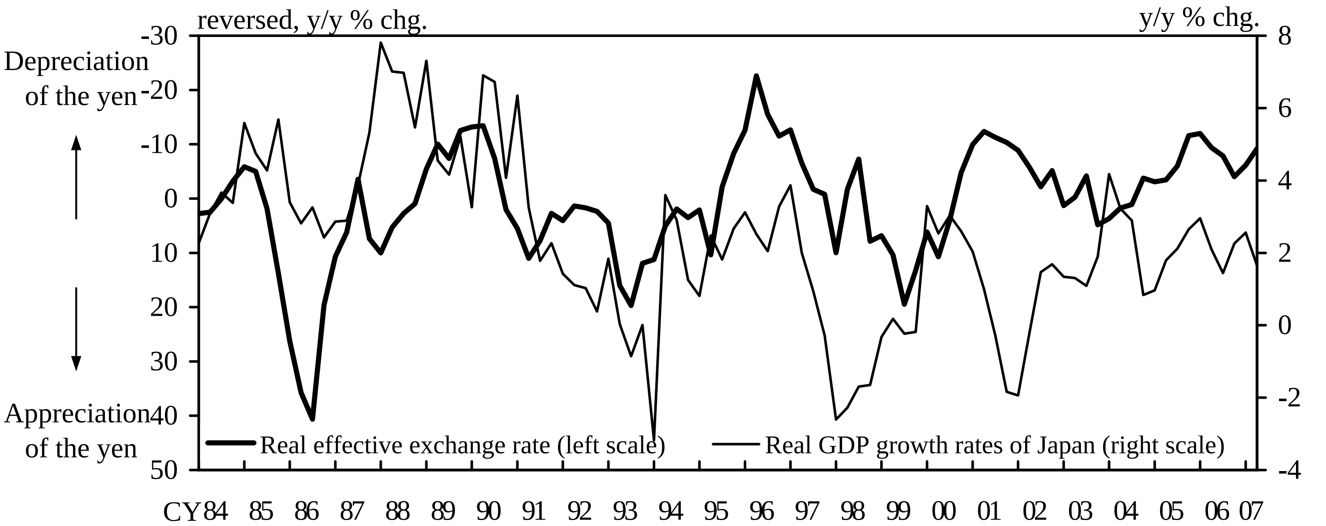
Source: Ministry of Economy, Trade and Industry, "Indices of Industrial Production."

Environment Surrounding Exports and Real GDP Growth Rates of Japan

(1) Real GDP Growth Rates in Overseas Economies and Japan



(2) Real Effective Exchange Rate and Real GDP Growth Rates of Japan



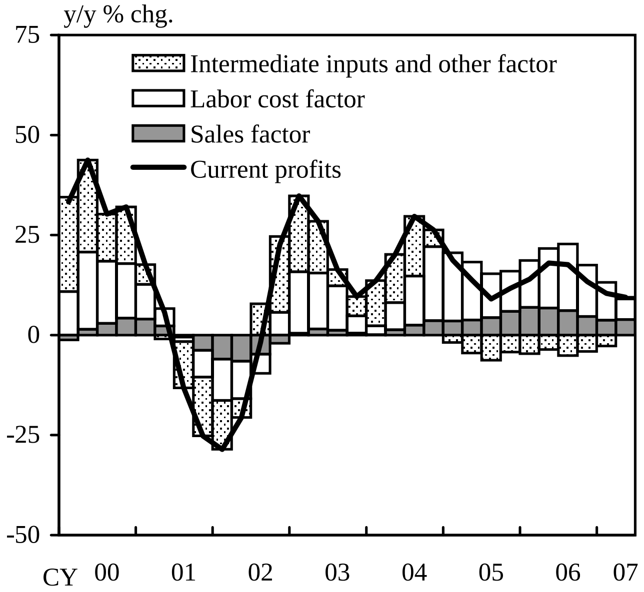
(3) World Semiconductor Shipments and Real GDP Growth Rates of Japan

Sources: Cabinet Office, "National Accounts"; Bank of Japan, "Effective Exchange Rate"; WSTS (World Semiconductor Trade Statistics), etc.

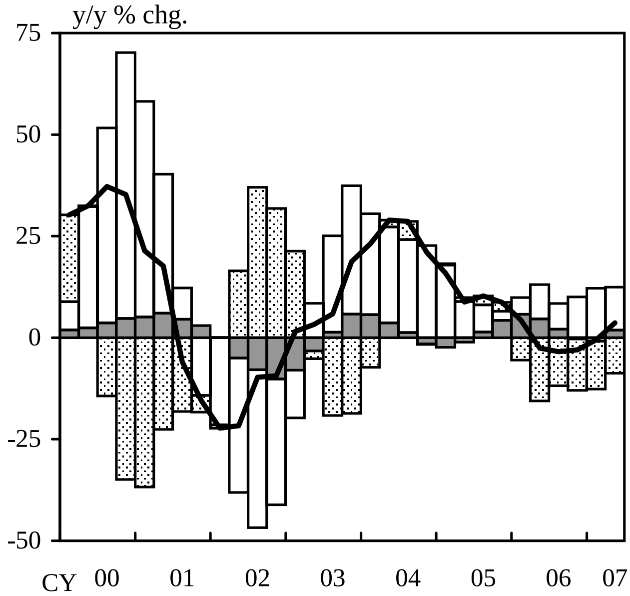
Corporate Profits by Size of Firms

(1) Corporate Profits by Size of Firms (All Industries)

(a) Large Firms



(b) Medium-Sized and Small Firms



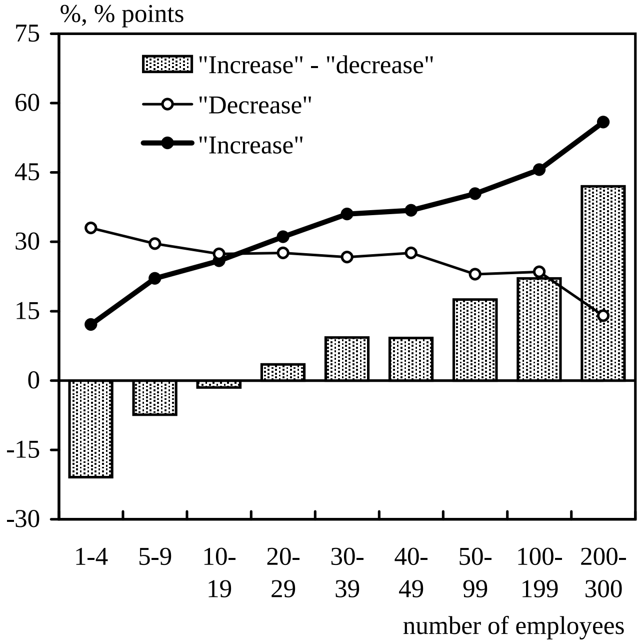
Notes: 1. On a "Financial Statements Statistics of Corporations by Industry, Quarterly" basis.

2. Figures are adjusted for sample change and seasonally adjusted by X-11. Three-month backward moving average. "Large firms" refers to firms with capital stock of 1 billion yen or more, and "Medium-sized and small firms" refers to firms with capital stock of 10 million yen or more but less than 1 billion yen.

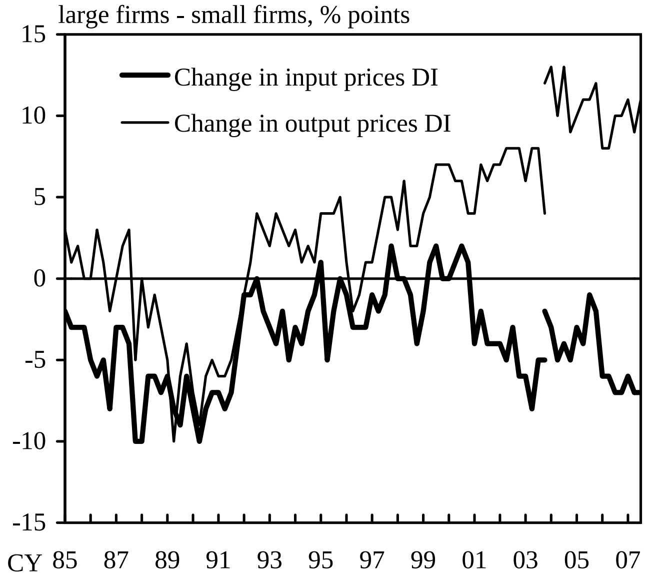
3. Contribution of each factor is calculated as follows (P_t: current profits, S_t: sales, L_t: labor cost, I_t: S_t-P_t-L_t).

$$(P_0-P_{-4})/P_{-4}=\underbrace{(S_0-S_{-4})/S_{-4}}_{\text{Sales factor}}\ \underbrace{-\ 1/P_{-4}\ \{(L_0/L_{-4}-S_0/S_{-4})L_{-4}\}}_{\text{Labor cost factor}}\ \underbrace{-\ 1/P_{-4}\ \{(I_0/I_{-4}-S_0/S_{-4})I_{-4}\}}_{\text{Intermediate inputs and other factor}}$$

(2) Sales of Small Firms in FY 2006



(3) Change in Input and Output Prices (*Tankan* , All Industries)



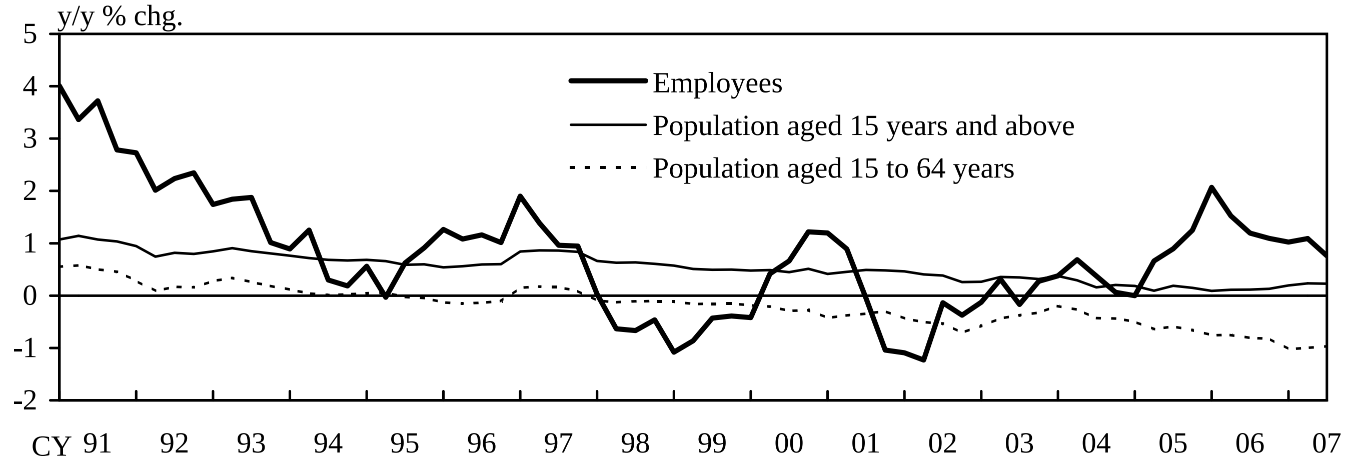
Notes: 1. (2) is based on the survey on financial reports of firms that close the fiscal year between October 2006 and September 2007. (Sample: 16,212 firms; survey period: early March, 2007)

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

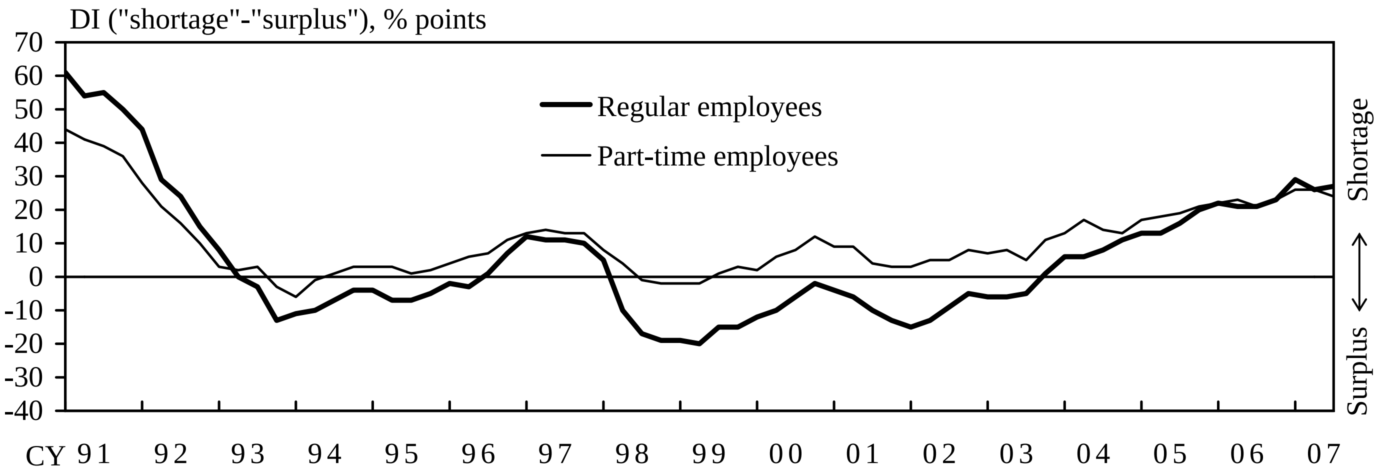
Sources: Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Quarterly";
Bank of Japan, "*Tankan*, Short-Term Economic Survey of Enterprises in Japan";
Shinkin Central Bank Research Institute.

Labor Market and Wages

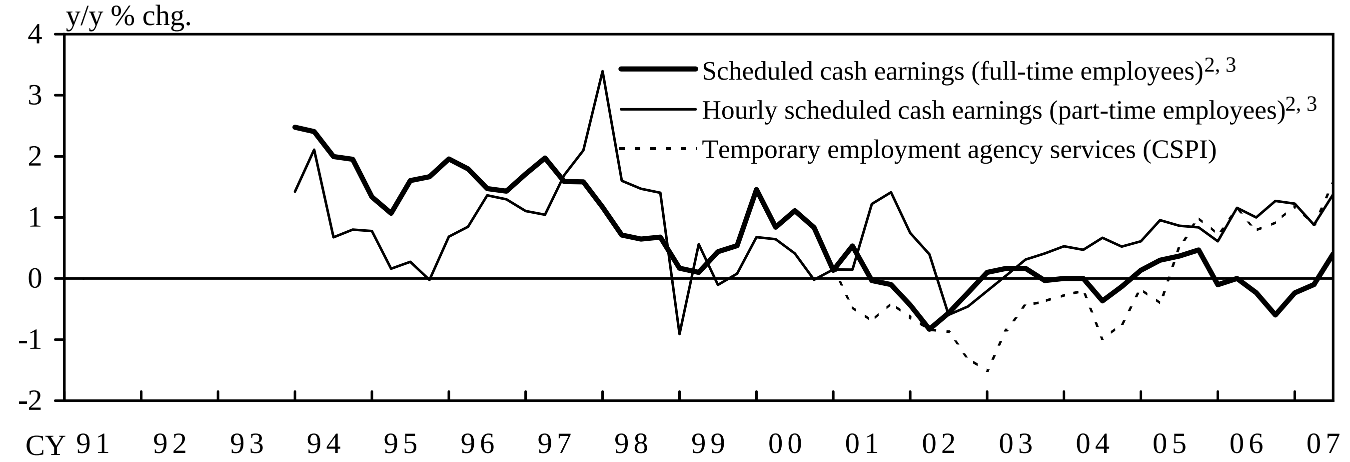
(1) Number of Employees and Population Aged 15 Years and Above



(2) Judgment on the Situation of Overs and Shorts of Workers (All Industries[1])



(3) Wages

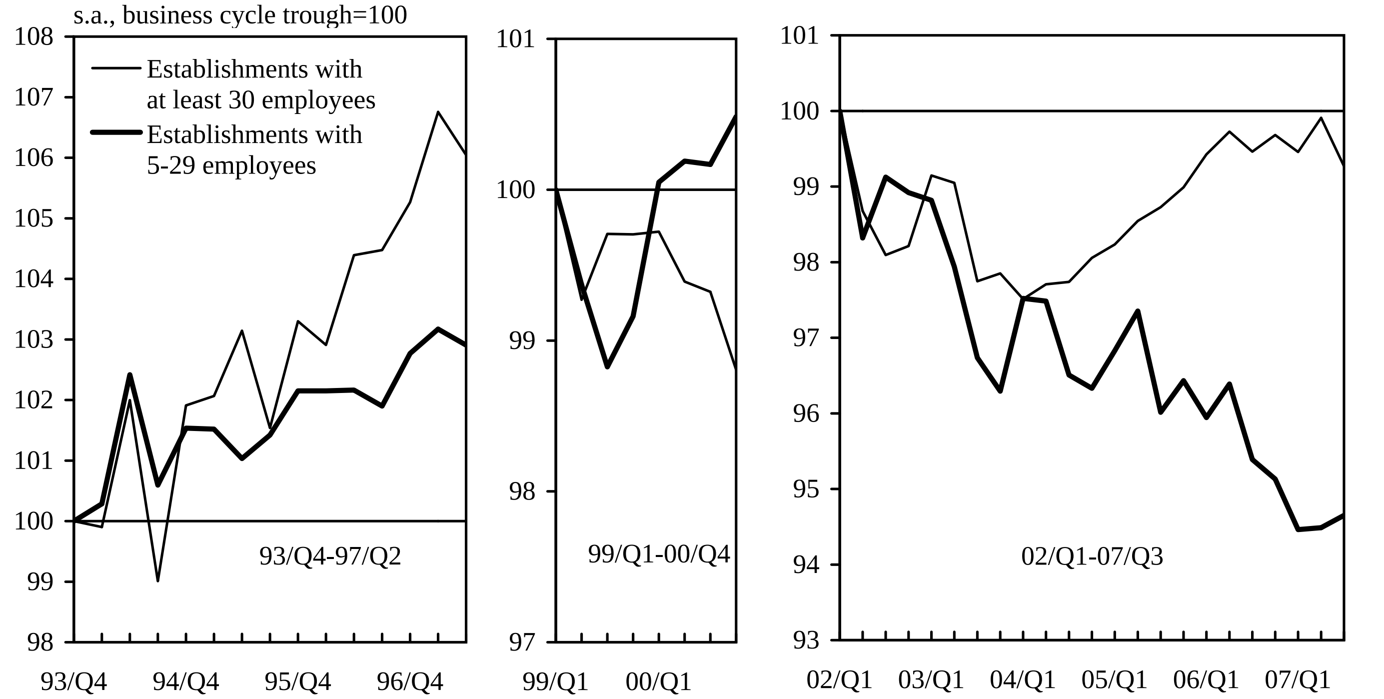


Notes: 1. Figures up to 1998 exclude "Finance and insurance" and "Real estate."
2. Data are for establishments with at least 5 employees.
3. Figures for 2007/Q3 are those of the July-August average.

Sources: Ministry of Health, Labour and Welfare, "Monthly Labour Survey," "Survey on Labour Economy Trend"; Ministry of Internal Affairs and Communications, "Labour Force Survey"; Bank of Japan, "Corporate Service Price Index."

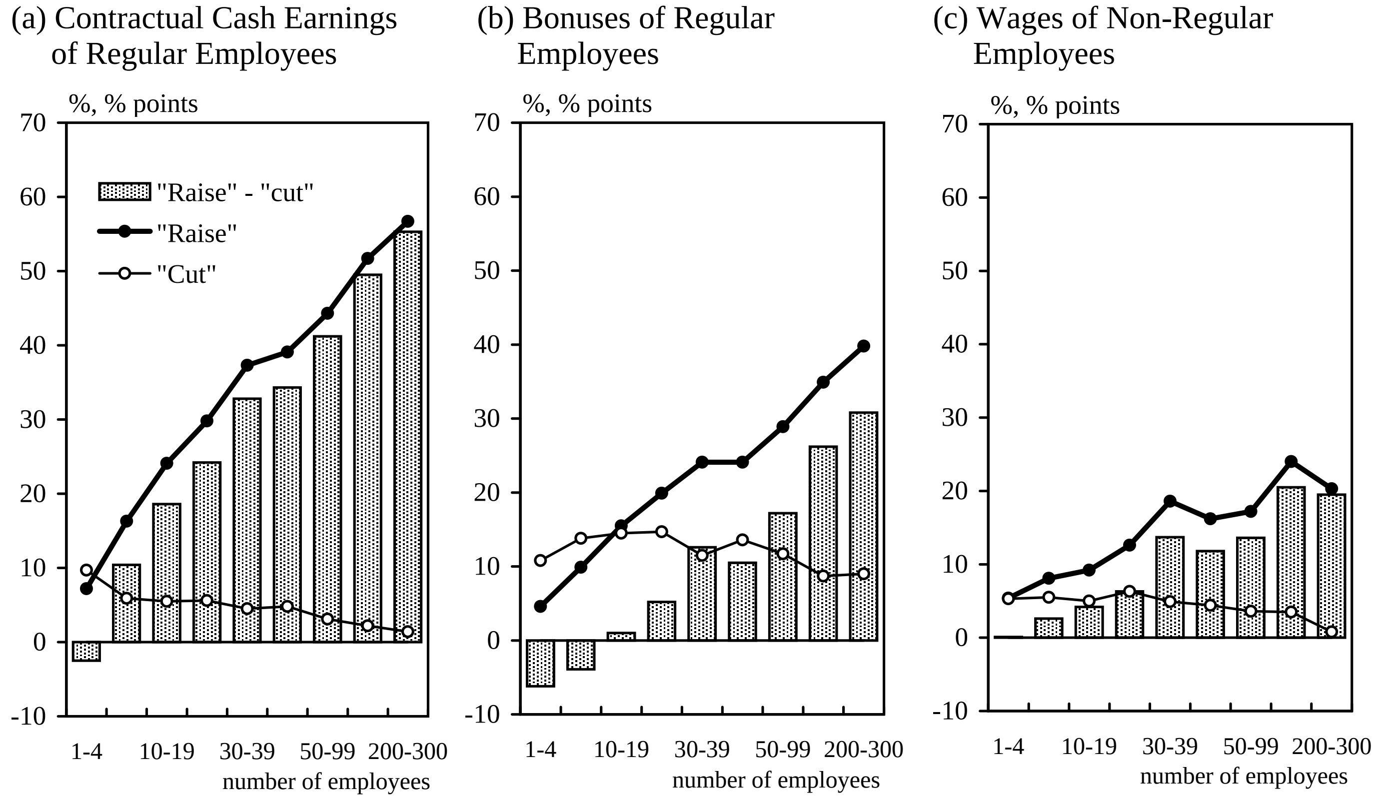
Wages by Size of Firms

(1) Total Cash Earnings in Economic Expansion Periods since the 1990s



Note: Figures for 2007/Q3 are the July-August averages.

(2) Wage Raise from a Year Earlier by Size of Firms

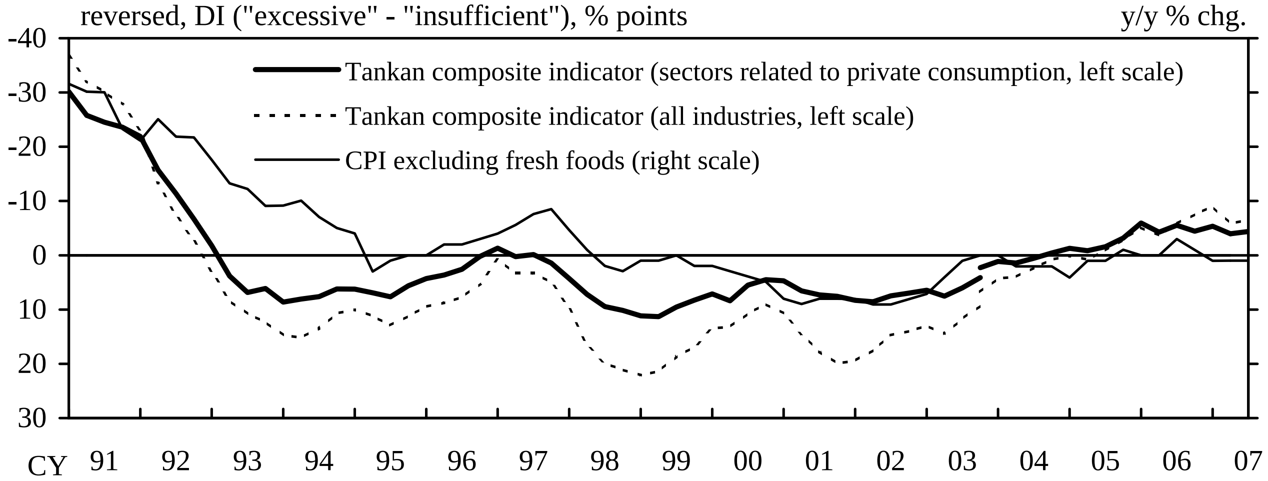


Note: Based on the research conducted by Shinkin Central Bank Research Institute.
Survey period: early June 2007
Sample: 15,918 firms

Sources: Ministry of Health, Labour and Welfare, "Monthly Labour Survey"; Shinkin Central Bank Research Institute.

Price Developments around Consumers

(1) CPI and Resource Utilization

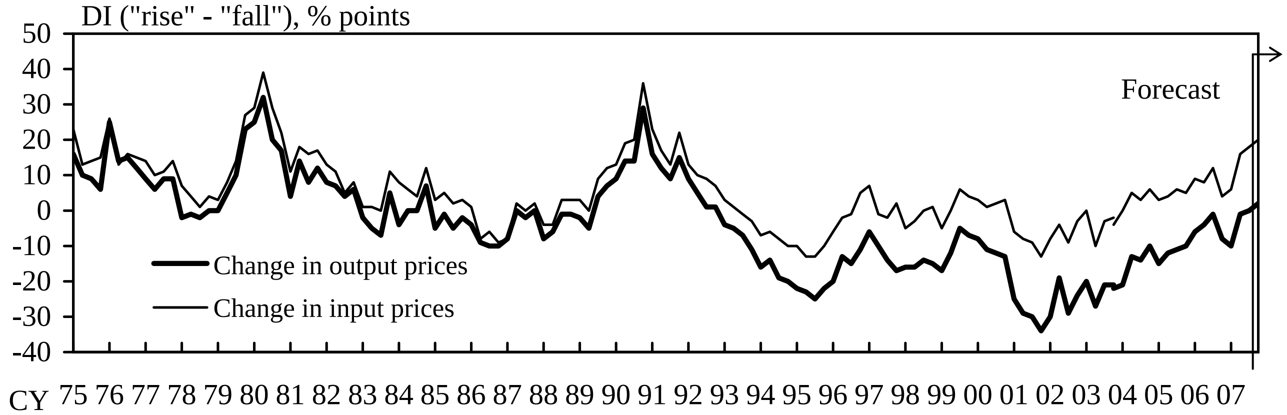


Notes: 1. The *Tankan* composite indicator is calculated as the average of the diffusion indices (all-size enterprises) of production capacity and employment conditions, weighted by capital and labor shares in the national accounts (FY 1990-2005 average).

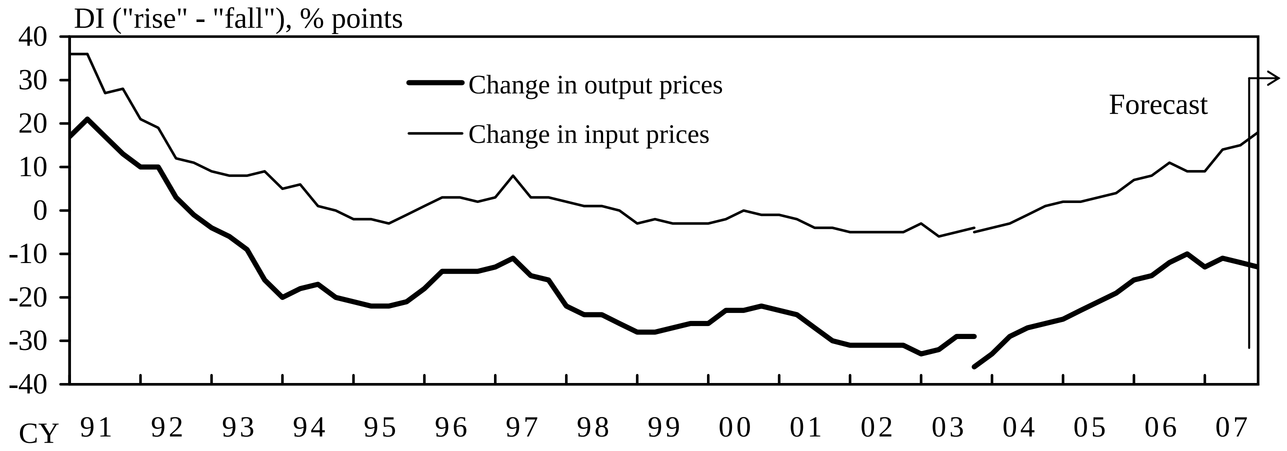
2. The *Tankan* composite indicator of sectors related to private consumption is calculated as the average of the sectoral indicators, weighted by sectoral shares in the private consumption in the CY 2000 Input-Output Table.

(2) Change in Output Price and Input Price

(a) Retailing



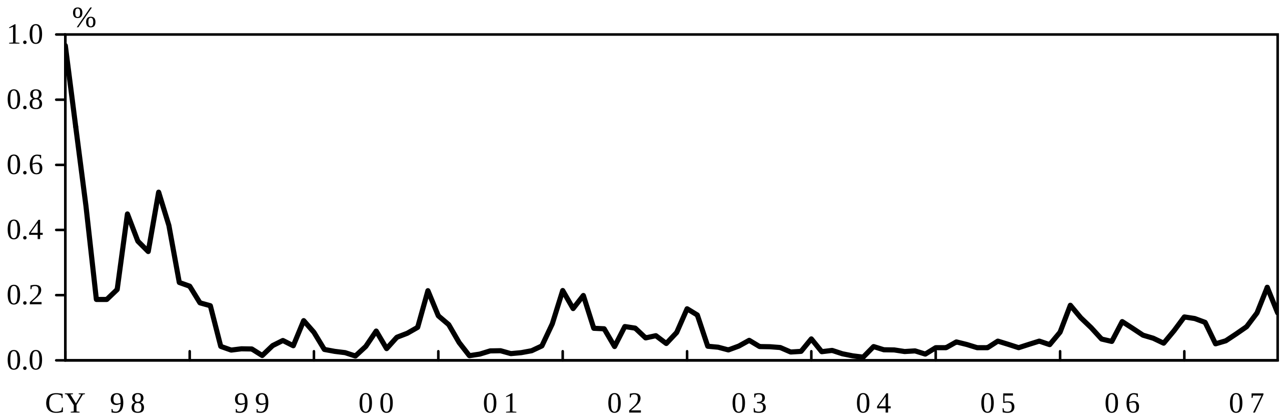
(b) Services



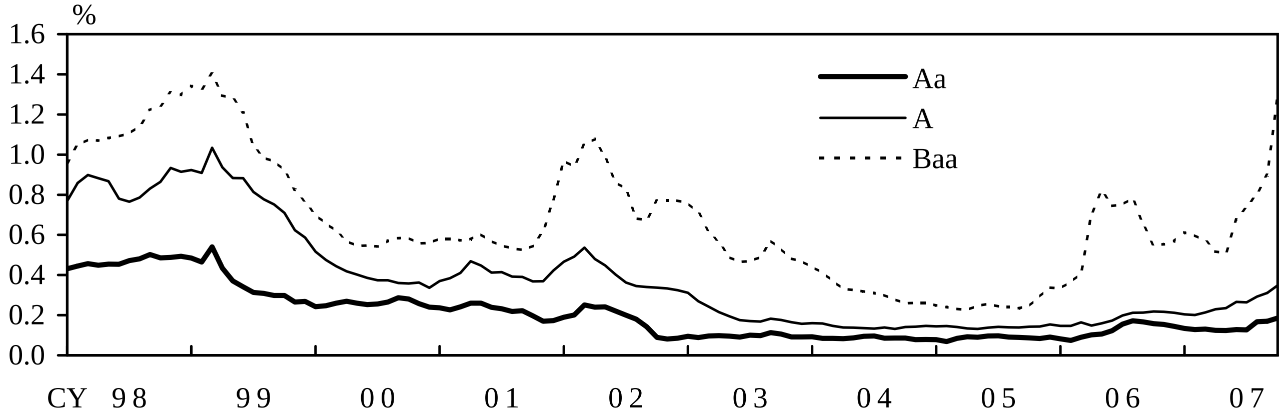
Sources: Bank of Japan, "*Tankan* , Short-Term Economic Survey of Enterprises in Japan"; Ministry of Internal Affairs and Communications, "Consumer Price Index," "Input-Output Table"; Cabinet Office, "National Accounts."

Credit Spread

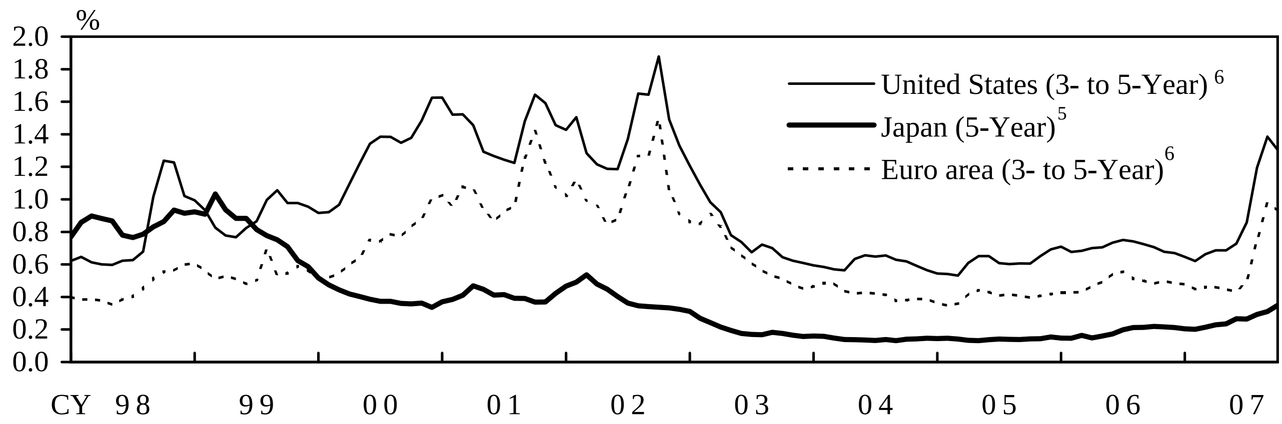
(1) Spread for Commercial Paper (3-Month)[1,2,3]



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



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

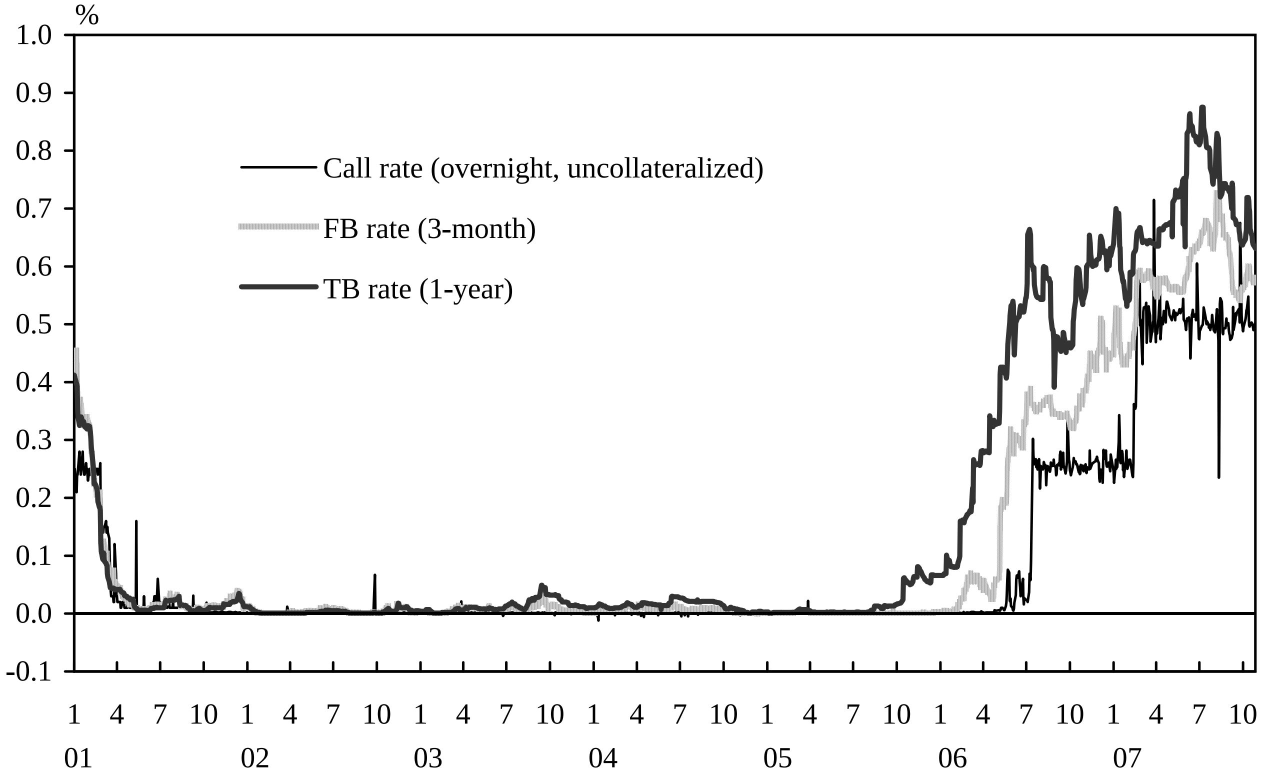


Notes: 1. The spread for CP is the average issuance rate of CP minus the TB/FB yield.
2. CP ratings are A-1 or above.
3. The spreads for both CP and corporate bonds in October 2007 are the averages up to the latest available data.
4. The spread for corporate bonds is the corporate bond yield minus the 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.

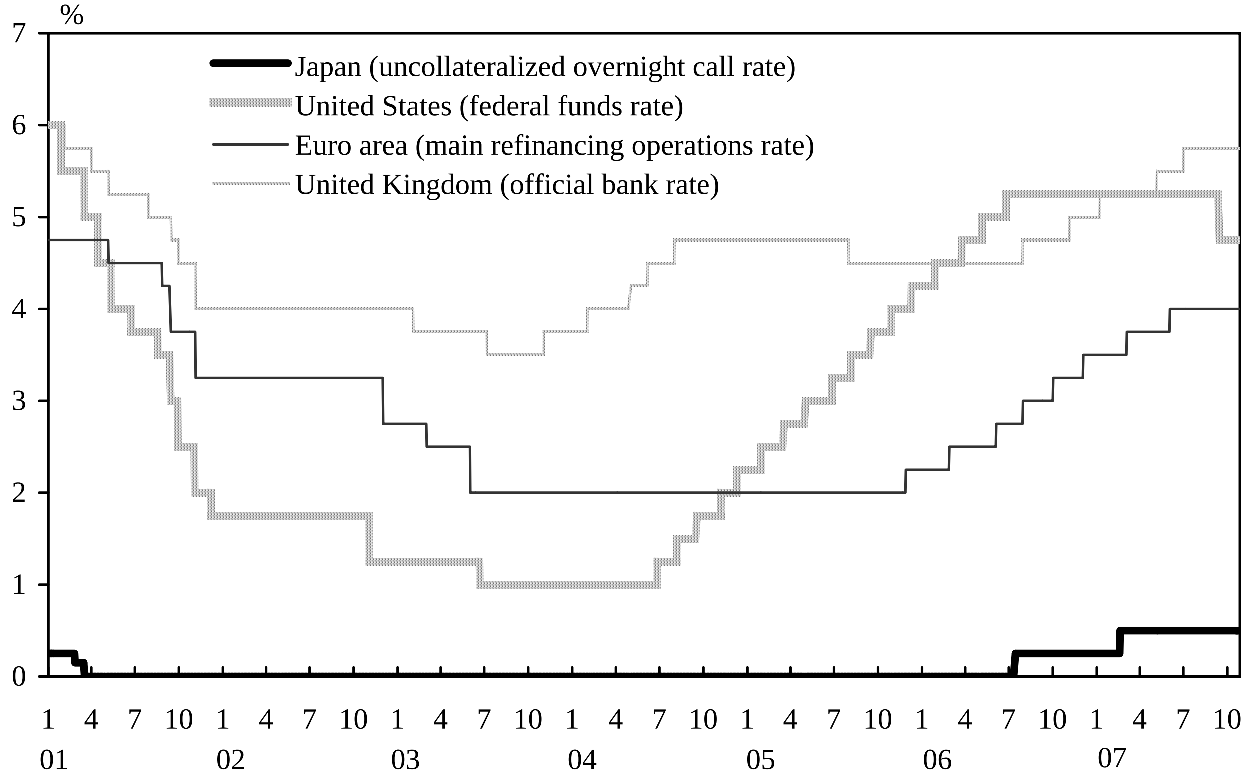
Sources: Bank of Japan; Japan Bond Trading Co., Ltd.; Japan Securities Dealers Association; Merrill Lynch.

Short-Term Interest Rates

(1) Short-Term Interest Rates



(2) Policy Interest Rates in Major Economies

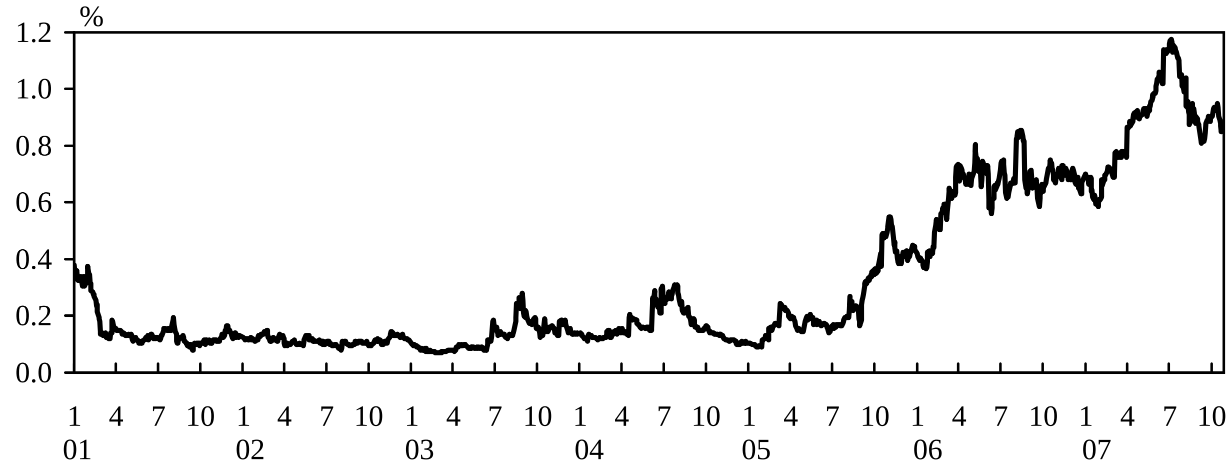


Note: The policy interest rate of Japan is considered zero percent while the operating target of money market operations was the outstanding balance of current accounts at the Bank.

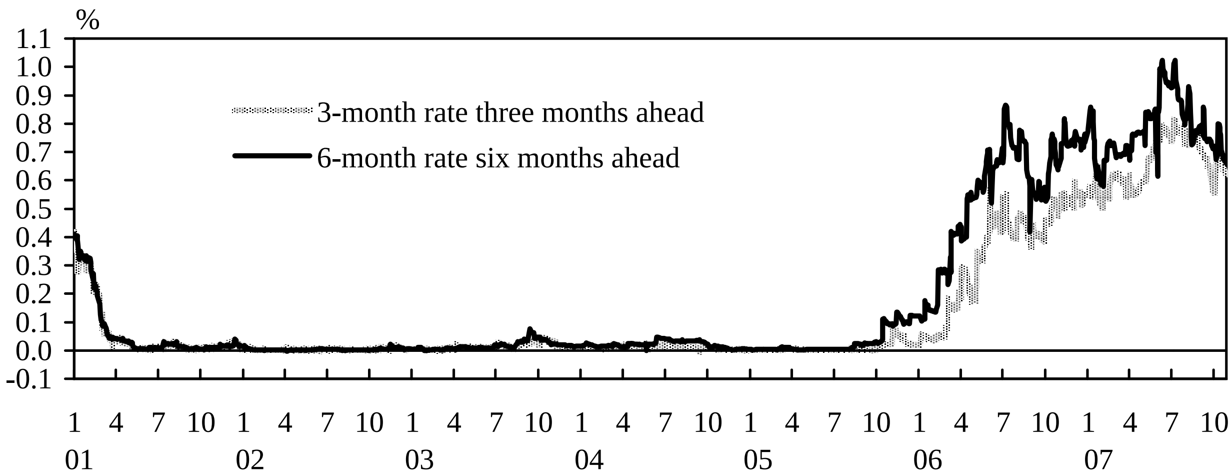
Sources: Bank of Japan; other central banks; Bloomberg.

Market Participants' Expectations on Interest Rates in the Future

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

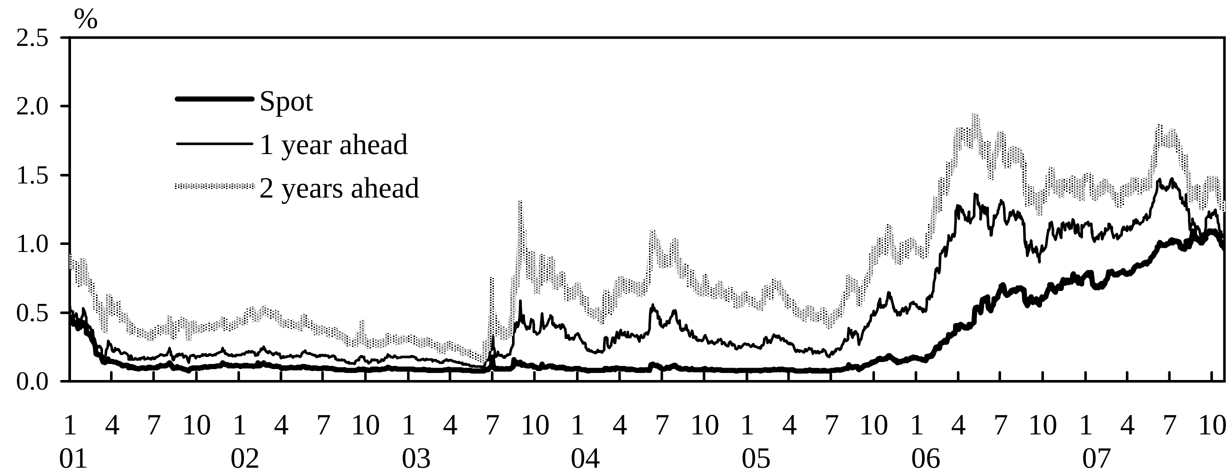


(2) Implied Forward Rates (3-Month, 6-Month)



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

(3) Implied Forward Rates (1-Year)

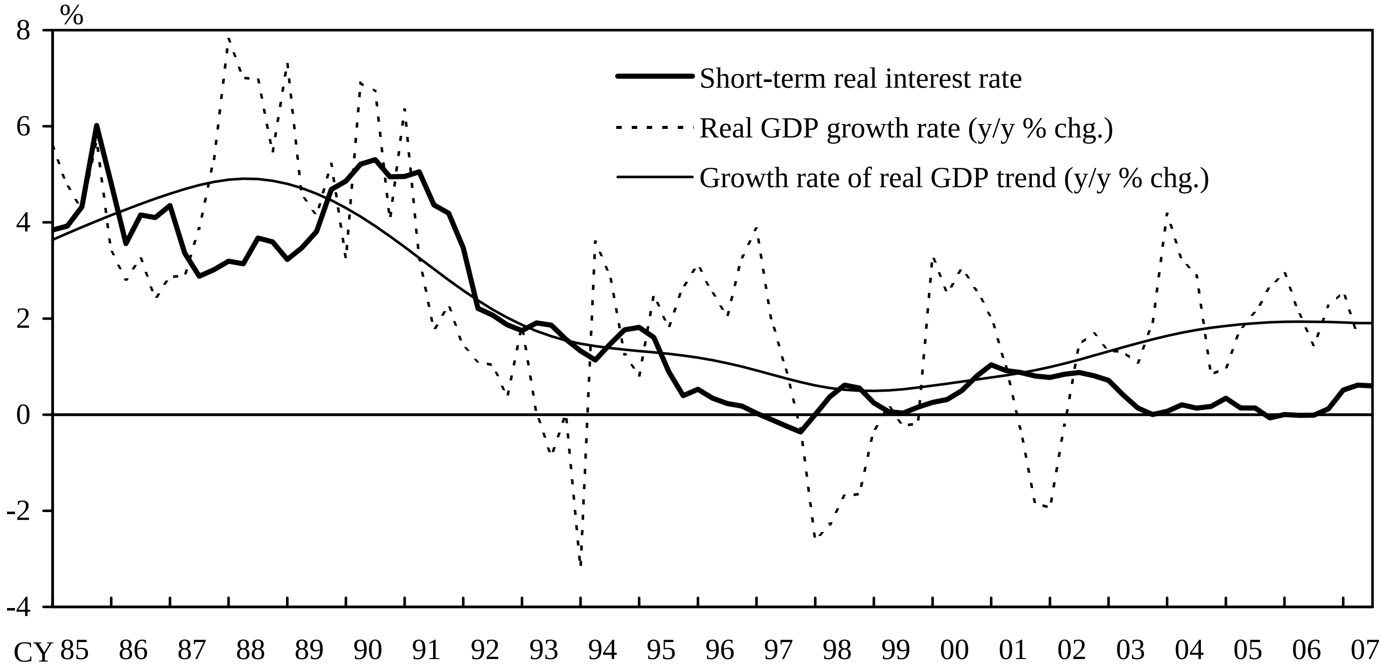


Note: Calculated from yen-yen swap rates.

Sources: Tokyo Financial Exchange; Reuters; Bloomberg.

Interest Rates and Economic Activity

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

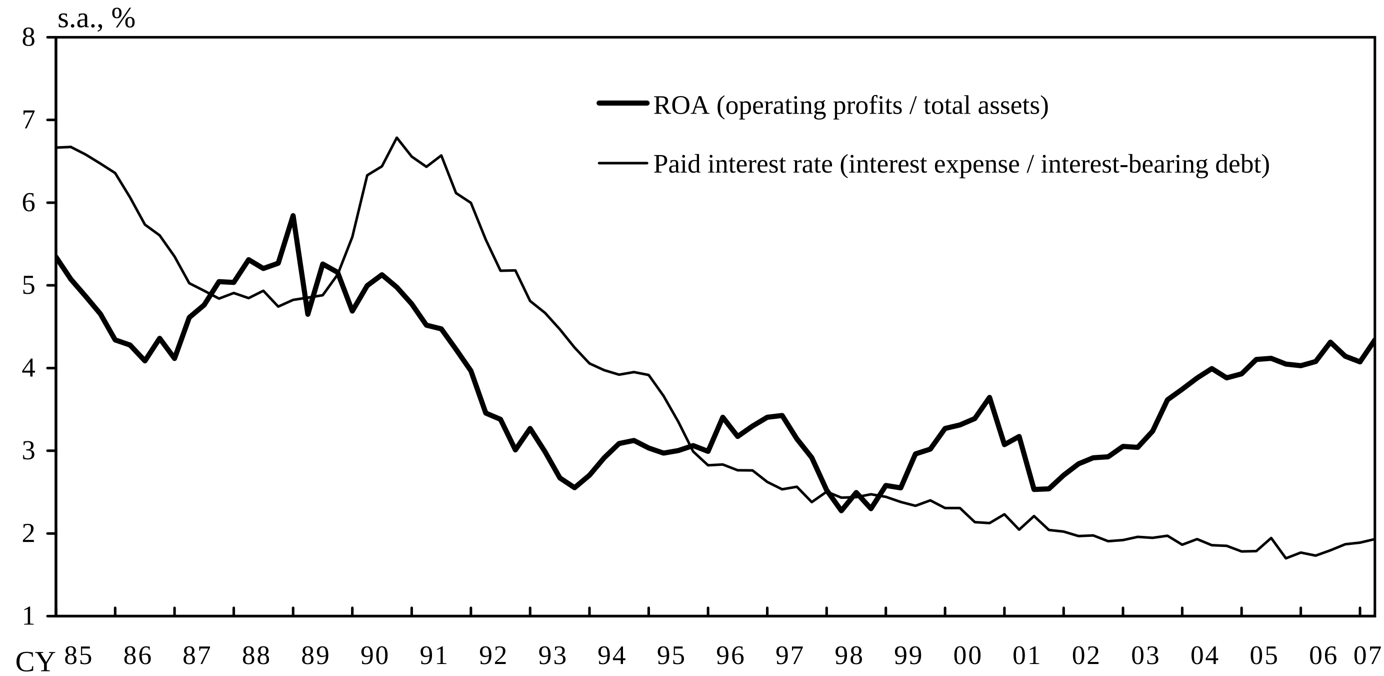


Notes: 1. Short-term real interest rate = call rate (overnight, uncollateralized) - y/y % chg. in the consumer price index (excluding fresh food)

2. Real GDP trend is calculated by applying the HP filter.

(2) ROA and Paid Interest Rate

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

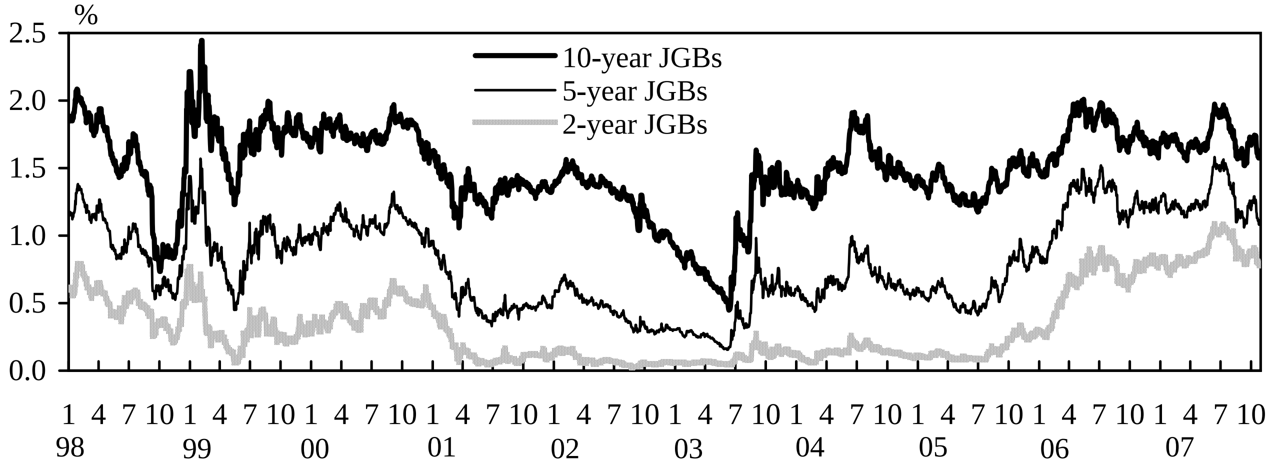


Note: Interest-bearing debt = long- and short-term borrowings + corporate bonds + bills receivable discounted outstanding

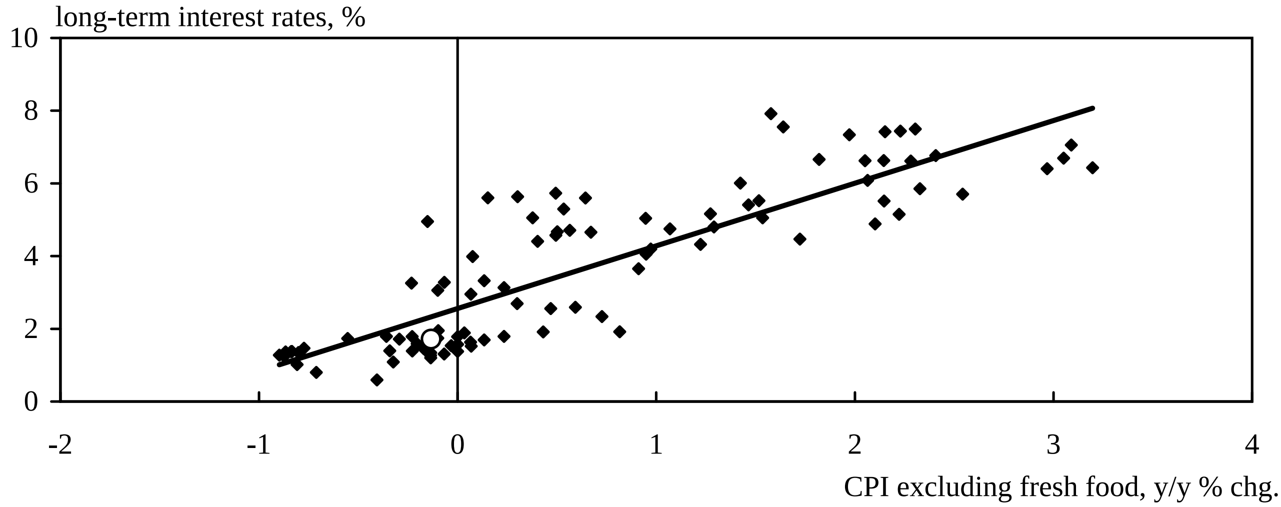
Sources: Cabinet Office, "National Accounts"; Ministry of Internal Affairs and Communications, "Consumer Price Index"; Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Quarterly"; Bank of Japan.

Long-Term Interest Rates

(1) Government Bond Yields

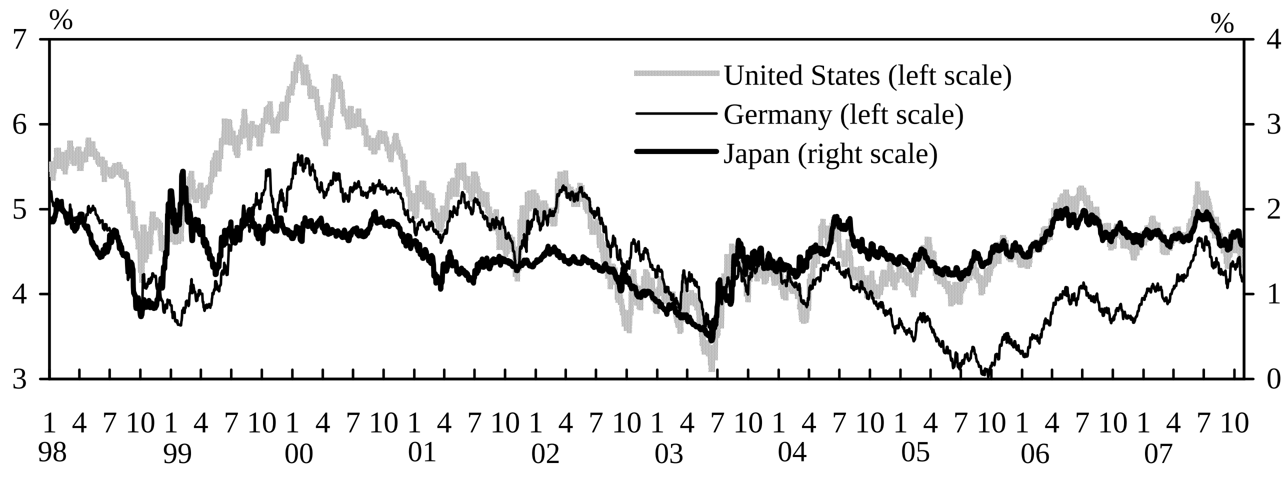


(2) Long-Term Interest Rates and Change in the Consumer Price Index



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

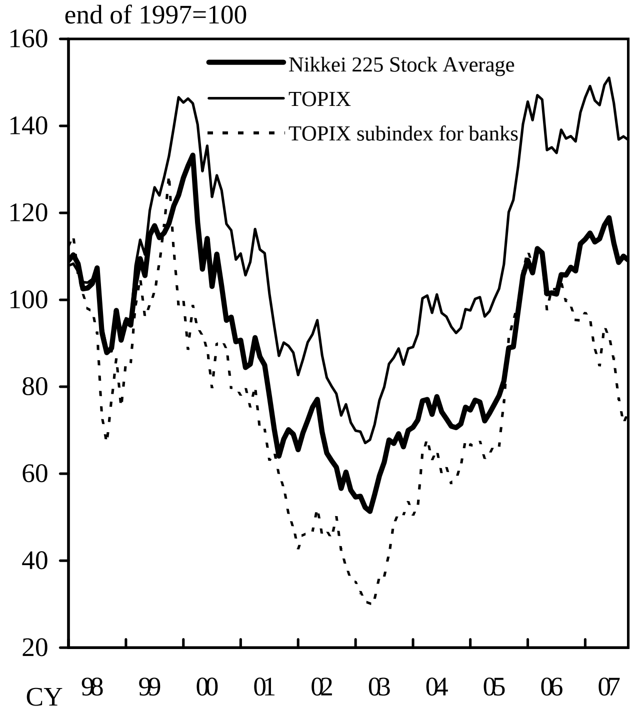
(3) Long-Term Interest Rates in Major Countries (10-Year Government Bond Yields)



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

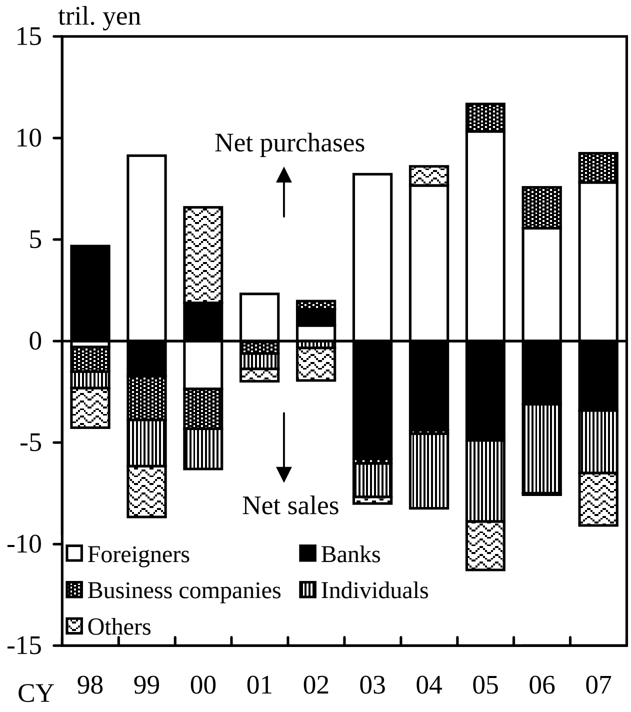
Stock Prices

(1) Stock Prices



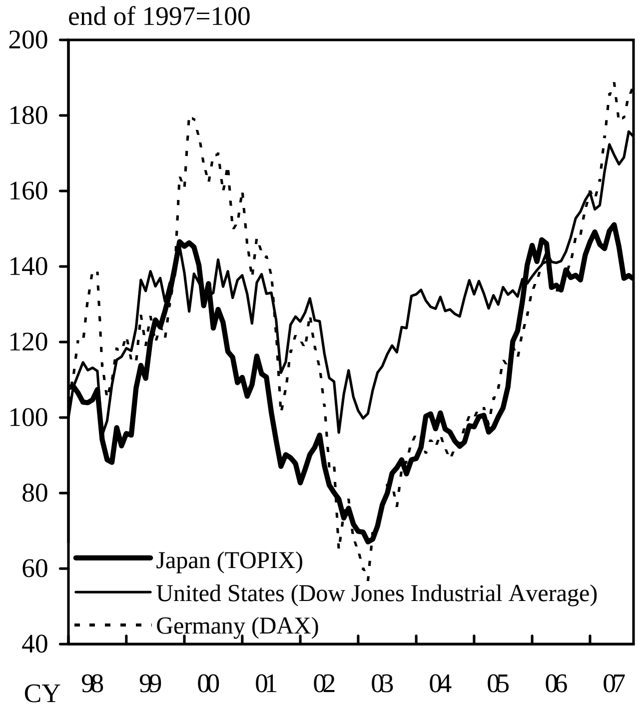
Note: Data are at end of month. Figures for October 2007 are the latest available data.

(2) Trading Volume by Investor Type



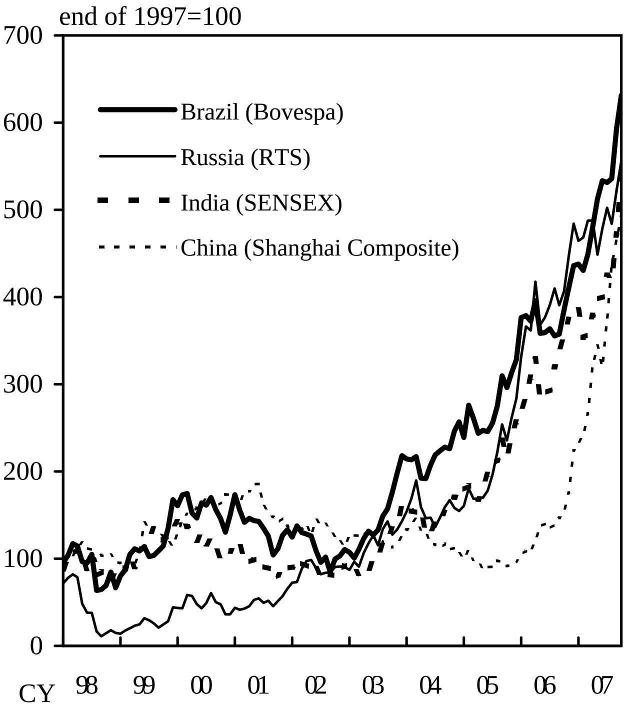
Notes: 1. Figures are the sum of the first and second sections of the Tokyo, Osaka, and Nagoya stock exchanges.
2. Figures for 2007 are those of January-September in terms of annual amount.

(3) Stock Prices in Major Countries



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

(4) Stock Prices in the BRIC Economies

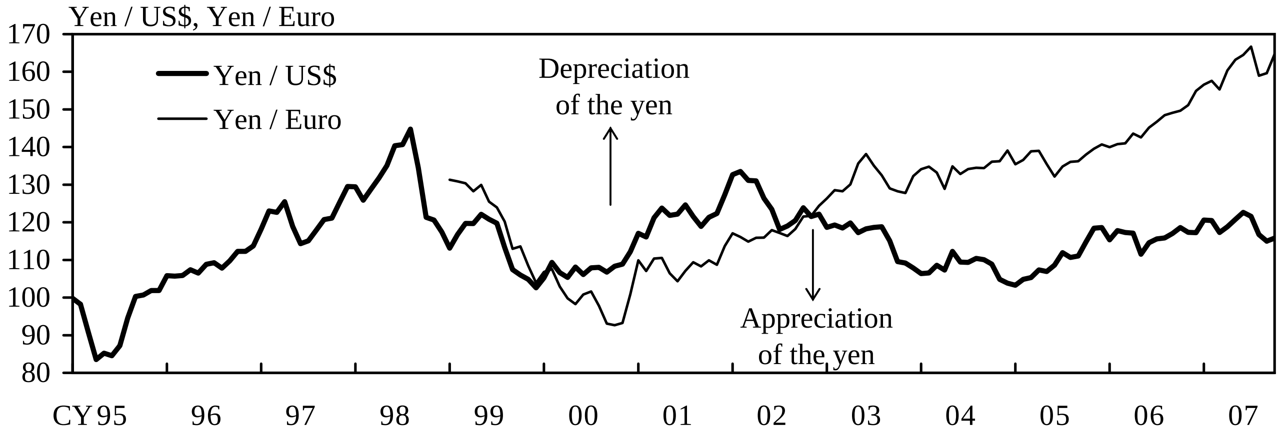


Note: Data are at end of month. Figures for October 2007 are the latest available data.

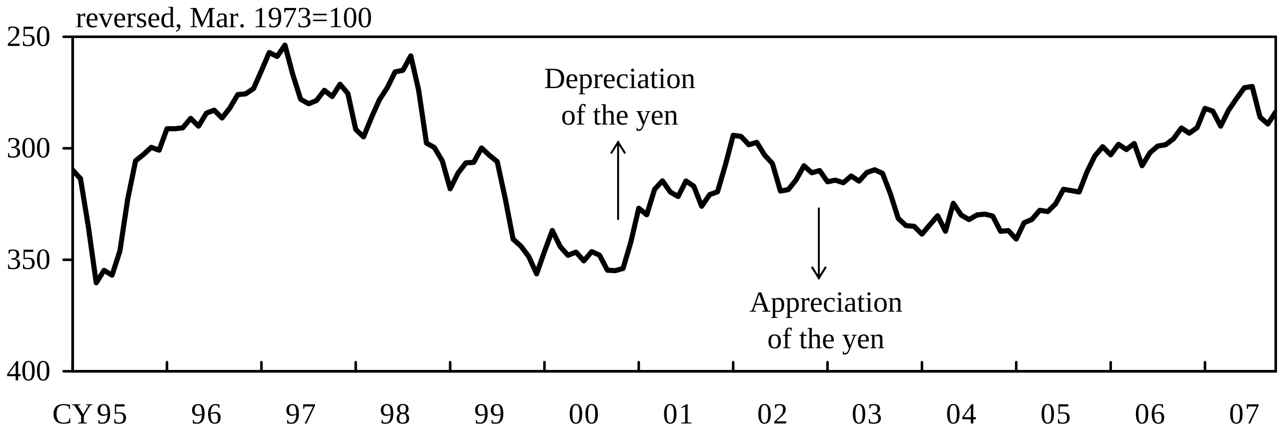
Sources: *The Nihon Keizai Shimbun* ; Tokyo Stock Exchange; Bloomberg.

Exchange Rates

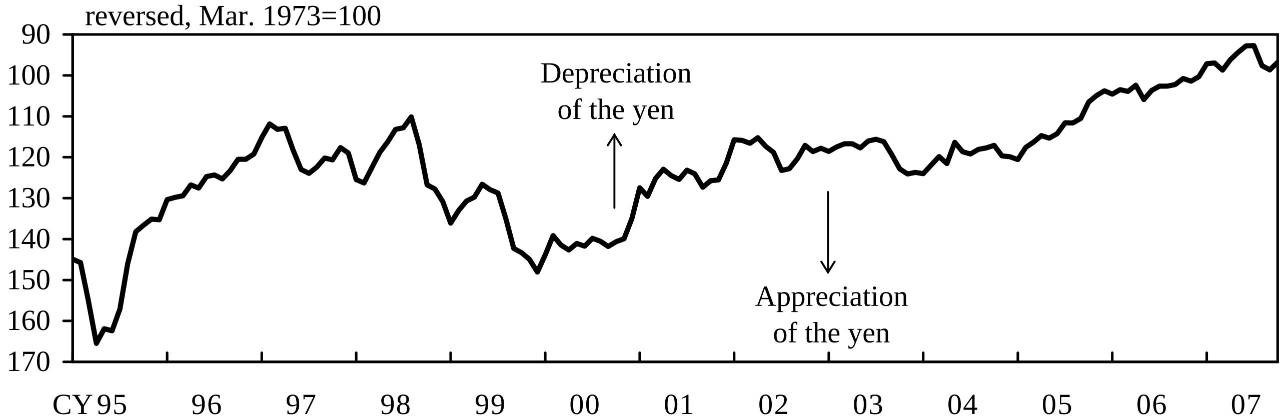
(1) Yen / US$ and Yen / Euro



(2) Nominal Effective Exchange Rate[2]



(3) Real Effective Exchange Rate[3]



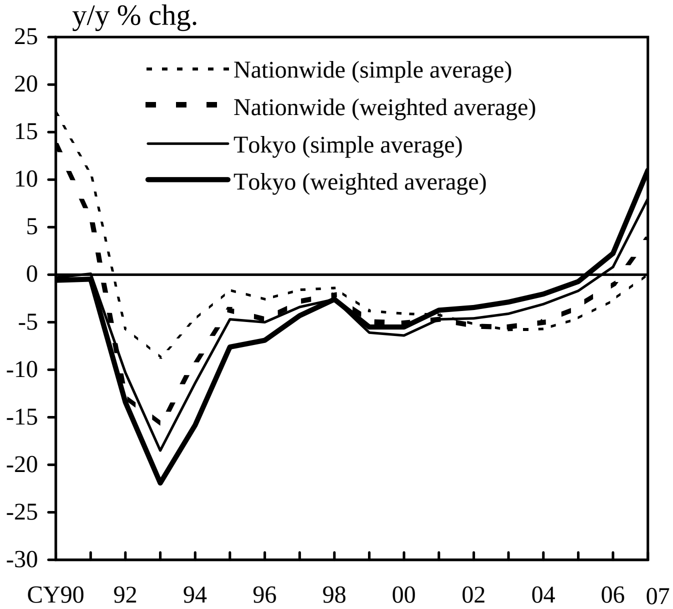
Notes: 1. Monthly average. Figures for October 2007 are averages up to the latest available data.
2. The nominal effective exchange rate is a weighted average of the yen's exchange rates against 15 currencies that have a large share among Japanese total exports.
3. The real effective exchange rate is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

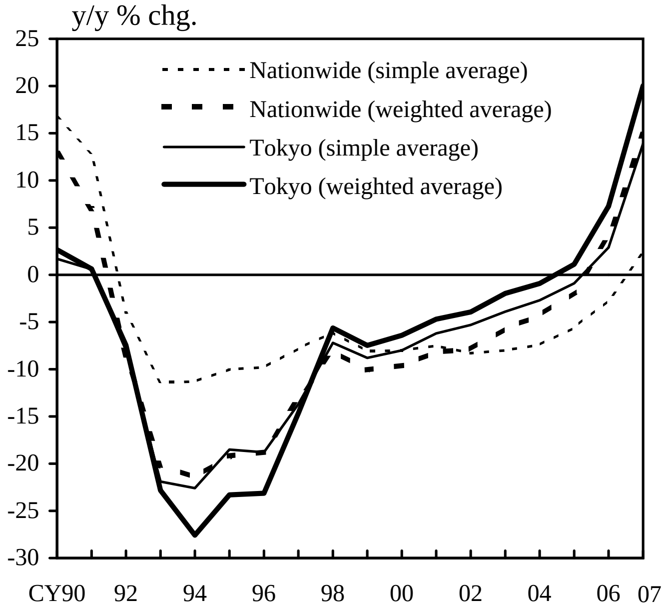
Land Prices

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

(a) Residential Land



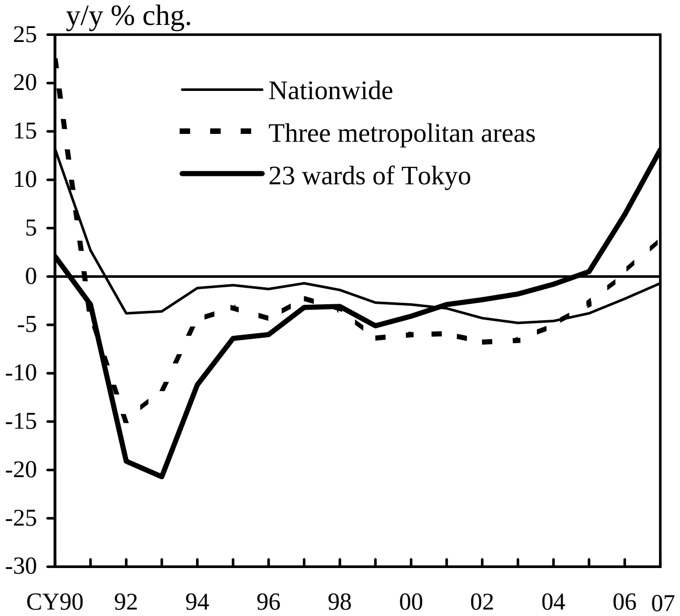
(b) Commercial Land



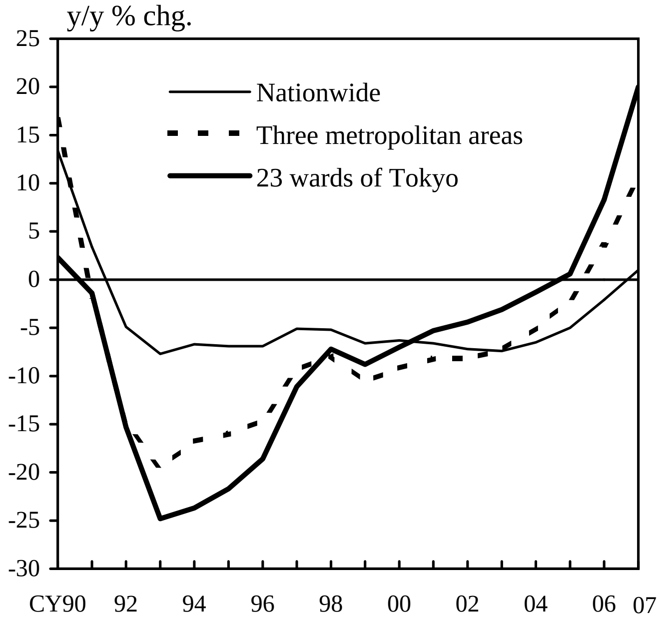
Note: Average land prices released by the Ministry of Land, Infrastructure and Transport are simple averages of the rates of change in land prices per square meter at individual locations surveyed. Weighted averages are calculated by the Bank of Japan, averaging the rates of change in land prices weighted by the level of land prices per square meter at individual locations surveyed in the previous year.

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

(a) Residential Land



(b) Commercial Land



Note: Three metropolitan areas: 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 October 2007	Revision of assessment from July to October	Assessment in July 2007
Hokkaido	Economic activity is flat.	Slightly downward	The economy is picking up gradually.
Tohoku	The economy continues to recover steadily, albeit gradually.	Unchanged	The economy continues to recover steadily, albeit gradually.
Hokuriku	The economy is recovering gradually.	Unchanged	The economy is recovering gradually.
Kanto-Koshinetsu	The economy is expanding gradually.	Unchanged	The economy is expanding gradually.
Tokai	The economy is expanding gradually.	Unchanged	The economy is expanding gradually.
Kinki	The economy is expanding gradually.	Slightly downward	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 gradually.	Slightly downward	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/chiiki0710.htm).

Source: Bank of Japan, "Regional Economic Report (Summary) October 2007."