Japan's Balance of Payments for 2005

August 2006

International Department
Bank of Japan

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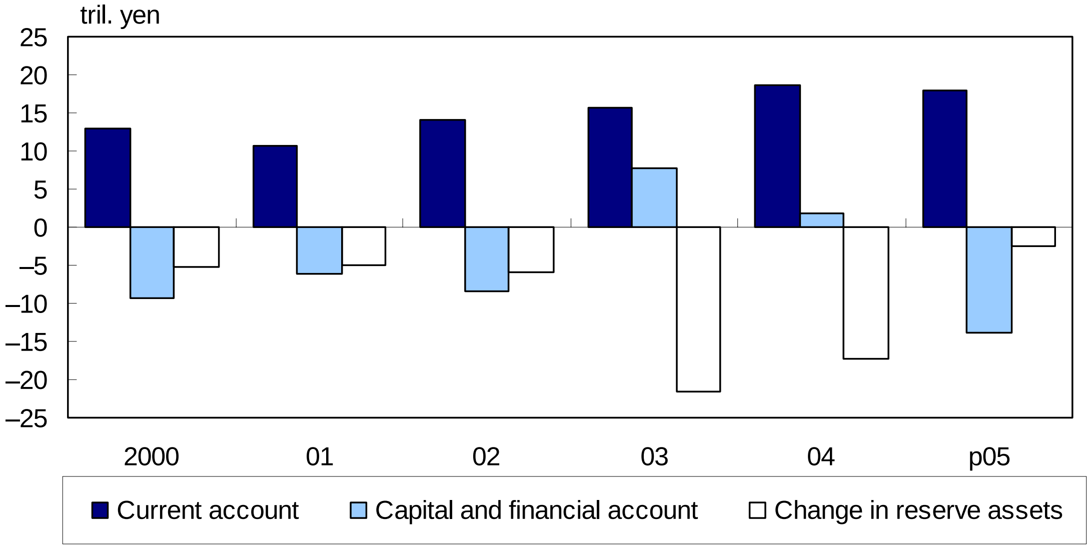
I. Summary[1]

A. Overview

- Japan's balance of payments (BOP) in 2005 recorded a current account surplus of 18.0 trillion yen, a small decrease from the surplus of 18.6 trillion yen in 2004. The capital and financial account turned from a net inflow of 1.7 trillion yen in 2004 to a net outflow of 14.0 trillion yen in 2005.[2] Reserve assets increased by 2.5 trillion yen, which was a smaller increase than the one recorded in 2004 (17.3 trillion yen). Highlights of developments in the BOP are as follows.

Figure 1: Balance of Payments



B. Highlights of Japan's BOP for 2005

1. A decrease in the surplus in the balance of goods

The surplus in the balance of goods decreased for the first time since 2001. An increase in exports, in particular to Asia and the United States, was more than offset by a sharp increase in imports, reflecting higher prices for mineral fuels (crude oil and partly refined oil).

2. An increase in the surplus in the balance of income

The surplus in the balance of income increased for the third consecutive year. Principal contributing factors were an increase in portfolio investment income reflecting an increase in outstanding amounts of outward investment in bonds and notes, and higher U.S. interest rates. As a result, the surplus in the balance of income

[1] Data for the whole of 2005, the second half of 2005, and the fourth quarter of 2005, as well as the figures and the tables are preliminary unless otherwise stated. Annual, semiannual, and quarterly data in this report, including the figures and the tables, are on a calendar-year basis unless otherwise stated.
[2] Figures until 2004 reflect changes made in the recording method of sea freight fares.

exceeded the surplus in the balance of goods for the first time since 1985, the first year for which comparable historical time series data are available.

3. A shift to net outflow in the capital and financial account

The capital and financial account recorded a net outflow for the first time in three years, and the level of outflow was the highest since 1998. This was mainly due to an increase in net outflow of direct investment, an increase in outward portfolio investment (outward investment in bonds and notes), and a shift to net outflow in other investment (repayment of funds brought in for conversion to the yen).

Table 1: Japan's Balance of Payments

bil. yen

	2003	2004	p2005	Changes from the previous year	Highlights
Current account	15,766.8	18,618.4	18,047.9	–570.5	Decrease in the surplus, mainly due to increased imports
Goods and services[1]	8,355.3	10,196.1	7,602.7	–2,593.5	Decrease in the surplus, mainly due to increased imports
Goods	11,976.8	13,902.2	10,350.2	–3,552.0	Sharp increase in imports due to higher mineral fuel prices
Exports	51,934.2	58,295.1	62,633.1	+4,338.0	
Imports	39,957.5	44,392.8	52,282.9	+7,890.0	
Services	–3,621.5	–3,706.1	–2,747.5	+958.6	Other services turned to surplus
Income	8,281.2	9,273.1	11,359.5	+2,086.4	Increase in portfolio investment income
Current transfers	–869.7	–850.9	–914.3	–63.4	Increase in tax payments to oil producing countries
Capital and financial account[2]	7,734.1	1,737.0	–13,957.5	–15,694.5	
Of which: Outward direct investment	–3,338.9	–3,348.7	–5,049.7	–1,701.0	Active outward direct investment
Inward direct investment	733.2	845.6	318.1	–527.5	Increase in both inward investment and withdrawal
Outward portfolio investment[3]	–18,396.1	–20,020.1	–23,657.3	–3,637.2	Increase in net purchases due to the purchase of long-term bonds by investment trusts such as monthly-distribution-type funds that invest in foreign bonds
Equity securities	–686.6	–3,290.3	–2,543.9	+746.4	
Bonds and notes	–18,392.7	–17,399.0	–22,110.7	–4,711.7	
Money market instruments	683.2	669.2	997.2	+328.1	
Inward portfolio investment[3]	9,532.9	21,899.3	20,345.0	–1,554.3	Decrease in net purchases (inflow) due to the redemption (outflow) of money market instruments purchased in the previous year and the increase in purchases of equities and bonds and notes (including inflation-indexed JGBs)
Equity securities	9,838.6	10,595.8	13,955.2	+3,359.3	
Bonds and notes	–1,645.8	6,409.0	7,247.3	+838.3	
Money market instruments	1,340.1	4,894.4	–857.5	–5,751.9	
Financial derivatives	607.4	259.0	–765.2	–1,024.2	Increase in payments related to margin trading in stock futures
Other investment[3]	19,006.3	2,649.3	–4,785.4	–7,434.7	Repayment of funds converted to yen by foreign banks
Changes in reserve assets[4]	–21,528.8	–17,267.5	–2,456.2	+14,811.2	No foreign exchange operations during 2005
Errors and omissions	–1,972.2	–3,087.9	–1,634.2	+1,453.7	
Ratio of current account to nominal GDP (%)	3.2	3.8	3.6		

Notes: 1. Goods and services reflect changes made in the method of recording sea freight fares.
2. Negative figures represent capital outflow.
3. Figures for portfolio investment and other investment exclude securities lending transactions.
4. Negative figures in "Changes in reserve assets" represent increase in reserve assets.

II. Current Account

A. Summary

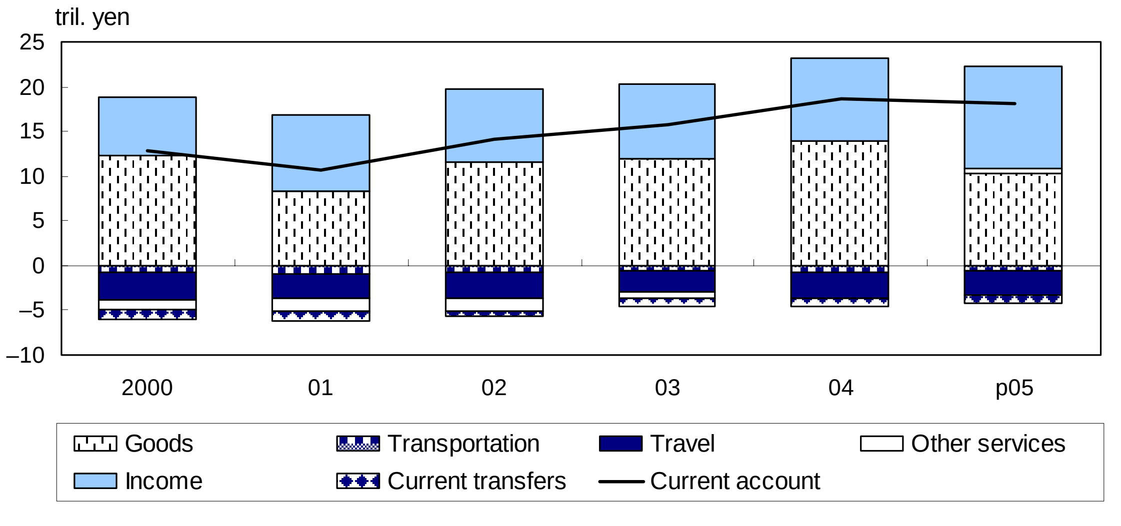
- The current account surplus decreased slightly year on year. Although the balance of income and the balance of services contributed to increasing the current account surplus, this was more than offset by the decrease in the surplus in the balance of goods.

Table 2: Developments in the Current Account

bil. yen

	2004	p2005	Changes from the previous year
Cuurent account	18,618.4	18,047.9	–570.5
Goods and services	10,196.1	7,602.7	–2,593.5
Goods	13,902.2	10,350.2	–3,552.0
Exports	58,295.1	62,633.1	+4,338.0
Imports	44,392.8	52,282.9	+7,890.0
Services	–3,706.1	–2,747.5	+958.6
Transportation	–748.3	–502.0	+246.2
Travel	–2,918.9	–2,775.6	+143.3
Other services	–39.0	530.0	+569.0
Income	9,273.1	11,359.5	+2,086.4
Current transfers	–850.9	–914.3	–63.4

Figure 2: Developments in the Current Account



B. Developments in the Main Components

1. Goods

The balance of goods in 2005 registered a surplus of 10,350.2 billion yen, decreasing by 3,552.0 billion yen or 25.5 percent from the previous year.

a. Exports[3]

- On a customs-clearance basis, exports posted the fourth consecutive year-on-year increase. By region, exports to Asia and the United States largely contributed to the total increase. By product, exports of motor vehicles (mainly to the United States), other machinery, and raw materials such as iron and steel (mainly to Asia) accounted for a large part of the overall increase.

Table 3: Contribution to Overall Export Growth by Region (Customs-Clearance Basis)

y/y % chg.

	Overall exports	United States	European Union	Asia	Of which: NIEs	ASEAN	China	Middle East
2004	+12.1	+0.6	+1.7	+7.9	+4.2	+1.5	+2.5	+0.1
2005	+7.3	+1.8	+0.1	+3.5	+1.4	+0.7	+1.4	+0.4

Source: Ministry of Finance, "Trade Statistics of Japan."

[3] Figures for exports and imports are on a customs-clearance basis. Exports (credit in goods) are recorded in the BOP based on the change of ownership principle, whereby export occurs at the transfer of ownership of goods between residents and nonresidents. Specifically, figures are compiled by deducting the amount of re-exports/imports (the parts of a transaction that do not involve transfer of ownership) and other figures from customs-clearance figures (recorded when goods cross the customs frontier). Major differences between the two statistics are as follows.

	Merchandise Trade Statistics	Balance of Payments Statistics
Price quoted	Exports: FOB Imports: CIF	Exports: FOB Imports: FOB
Coverage	Goods that have crossed the customs frontier of the reporting economy	Goods whose ownership has been transferred between residents and nonresidents
Time of recording	Exports: When the ship or the aircraft carrying the goods leaves the port Imports: When imported goods are officially recognized	When the ownership is transferred

FOB stands for “free on board” and CIF for “cost, insurance and freight.” On an FOB basis, the price of goods at the border of the exporting country is recorded. On a CIF basis, freight charges and insurance premiums are recorded in addition to the price of goods.

Table 4: Contribution to Overall Export Growth by Item (Customs-Clearance Basis)

y/y % chg.

		2004	2005	Major factors
Value of overall exports		+12.1	+7.3	Increased exports of motor vehicles to the United States and chemicals to Asia
Motor vehicle-related goods		+1.1	+1.6	
	Motor vehicles	+0.6	+1.2	Brisk sales in the United States due to buoyant economy
	Parts for motor vehicles	+0.5	+0.4	Increased exports mainly to Asia
Raw materials		+2.5	+2.2	
	Of which: Chemicals	+1.3	+1.0	Increased demand in Asia and pass-through of higher raw material prices
	Iron and steel products	+0.8	+0.8	Prices higher due to strong market and shift to higher grade steel, but decrease in volume
IT-related goods		+0.5	–0.4	
	Semiconductors and other electronic parts	+0.6	+0.0	Unchanged from the previous year as inventory adjustment in the first half of the year ended in the second half
	Office machines	–0.0	–0.3	Exports decrease due to a shift to overseas production by Japanese companies
	Telecommunication apparatus	–0.0	–0.1	Exports marginally decrease as exports to the European Union decline
Other machinery		+3.8	+1.3	
	Of which: Scientific, medical, and optical instruments	+0.8	+0.0	Increased exports to Asia cancelled out by decreased exports to the United States and the European Union
	Metalworking machinery	+0.3	+0.3	Increased exports led by increased demand in China
Other exports		+4.3	+2.7	

Note: Figures for office machines for 2005 represent the sum of data for computers and computer-related parts.
Source: Ministry of Finance, "Trade Statistics of Japan."

b. Imports

- On a customs-clearance basis, imports increased by 7.9 trillion yen year-on-year. This exceeded the year-on-year increase in exports which amounted to 4.3 trillion yen. By region, imports from the Middle East and Asia posted substantial growth, with the former reflecting the sharp rise in mineral fuel (crude oil) prices. By product, the largest rise in imports was seen in mineral fuels.

Table 5: Contribution to Overall Import Growth by Region (Customs-Clearance Basis)

y/y % chg.

	Overall imports	United States	European Union	Asia	Of which: NIEs	ASEAN	China	Middle East
2004	+10.9	–0.1	+1.1	+5.6	+1.2	+1.2	+3.3	+1.9
p2005	+15.6	+0.6	+0.4	+6.2	+1.1	+1.4	+3.6	+5.8

Source: Ministry of Finance, "Trade Statistics of Japan."

Table 6: Contribution to Overall Import Growth by Item (Customs-Clearance Basis)

y/y % chg.

	2004	p2005	Major factors
Value of overall imports	+10.9	+15.6	Increased imports due to sharp rise in crude oil prices
Mineral fuels	+3.0	+7.9	
Of which: Crude oil and partly refined oil	+1.7	+5.6	Sharp rise in crude oil prices while import volume slightly decreased
Petroleum products	+0.4	+0.6	
Coal	+0.8	+0.8	Sharp rise in coal prices due to strong Chinese demand and volume unchanged
IT-related goods	+0.9	+0.3	
Semiconductors and other electronic parts	+0.6	+0.2	Increased imports from Asia
Office machines	+0.3	+0.1	Increased imports from Asia due to growing domestic demand and shift to overseas production
Telecommunications apparatus	+0.0	+0.1	
Textiles	+0.3	+0.4	Rise in prices but volume unchanged
Aircraft	–0.1	+0.2	Increased imports from the United States
Chemicals	+0.8	+1.0	Increased imports mainly from the United States and the European Union due to growing domestic demand reflecting economic recovery
Foodstuff	+0.4	+0.5	Increased imports mainly from the United States and Asia
Other imports	+4.1	+7.4	Increased imports of scientific and optical instruments. Rise in the price of steel and a slight increase in volume

Notes: 1. Figures for office machines for 2005 represent the sum of data for computers and computer-related parts.
2. Figures for textiles for 2005 represent the sum of data for textile yarns, textiles and apparel, and ancillary products.

Source: Ministry of Finance, "Trade Statistics of Japan."

2. Services

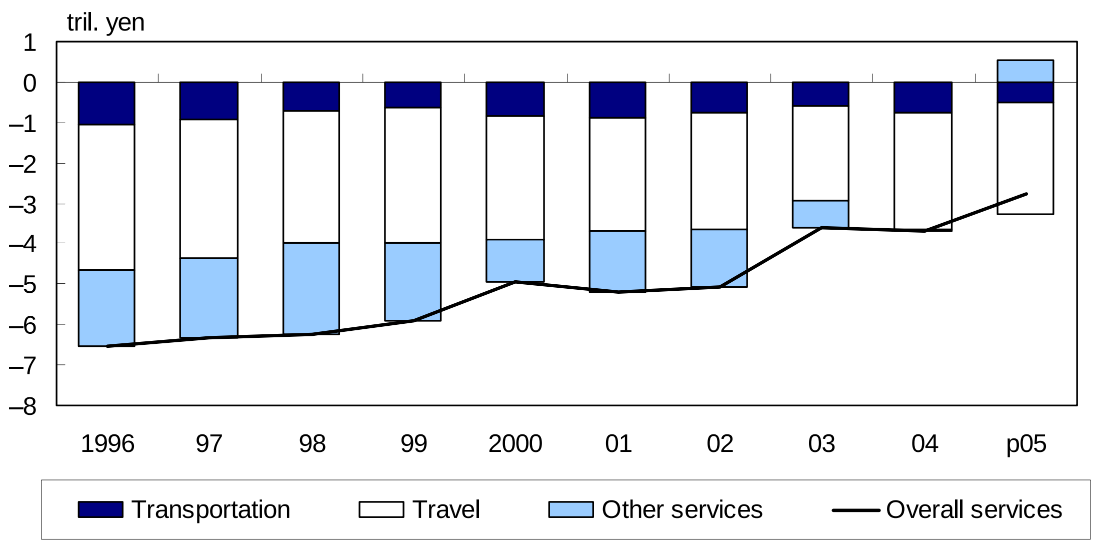
- The deficit in the balance of trade in services for 2005 decreased to 2,747.5 billion yen, declining by 958.6 billion yen or 25.9 percent from 2004. The following factors played a role. First, the balance of trade in other services registered the first surplus since 1996, the earliest year for which comparable historical time series data are available. Second, the deficits in the balance of travel and transportation decreased.

Table 7: Balance of Trade in Services

bil. yen

	2004	p2005	Changes from the previous year	Major factors
Services	–3,706.1	–2,747.5	+958.6	
Transportation	–748.3	–502.0	+246.2	Increased credits in sea transportation
Travel	–2,918.9	–2,775.6	+143.3	Increased credits due to increase in foreign visitors
Other services	–39.0	530.0	+569.0	Increased credits in merchanting and other trade-related services

Figure 3: Developments in Services



a. Transportation

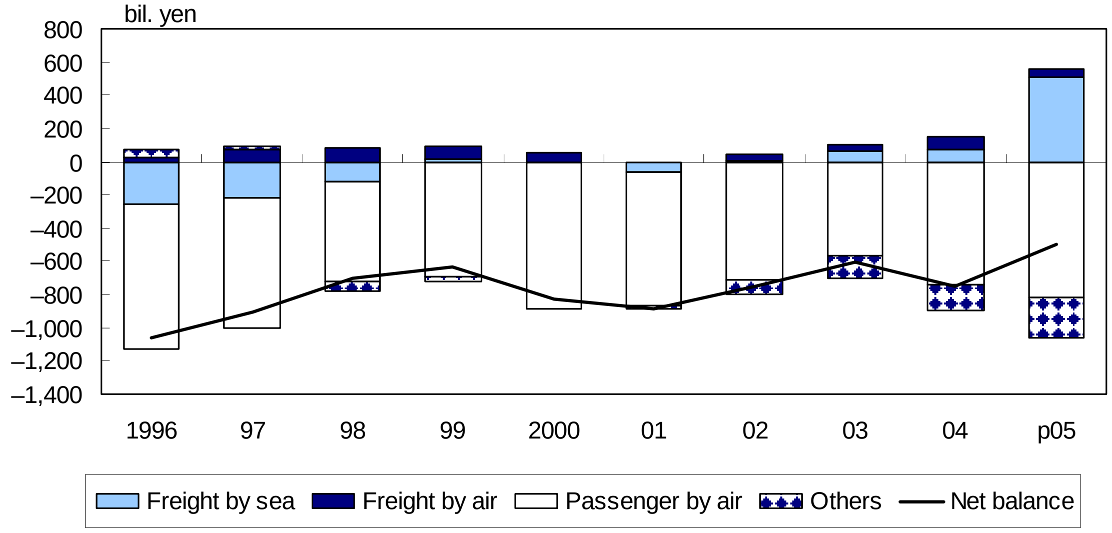
- The deficit in the balance of transportation decreased to 502.0 billion yen, declining by 246.2 billion yen or 32.9 percent from 2004. While rising oil prices and upward adjustments in fuel surcharges resulted in an increase in debits in air transport, this was outweighed by an increase in credit in sea freight from cross trade.

Table 8: Balance of Transportation

bil. yen

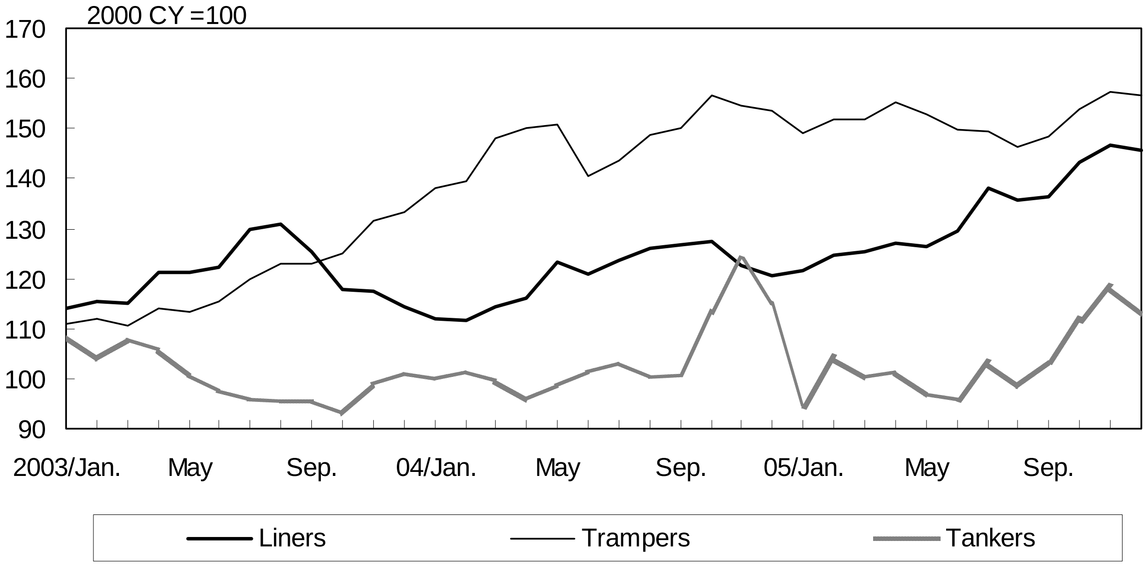
	2004	p2005	Changes from the previous year	Major factors
Transportation	–748.3	–502.0	+246.2	Deficit decreases due to the increase in credit for sea transport
Sea transport	–373.0	–54.6	+318.4	Sea freight credit from cross trade increased due to increase in freight fares and cross trade increased due to strong movement of cargo from Asia to Europe and United States
Passenger	0.4	0.1	–0.2	
Credit	0.9	1.7	+0.8	
Debit	0.5	1.6	+1.1	
Freight	77.8	510.8	+433.0	
Credit	2,102.5	2,496.3	+393.8	
Debit	2,024.8	1,985.6	–39.2	
Air transport	–370.4	–441.6	–71.3	Air transport debit increased mainly due to the upward adjustments in fuel surcharge following the rise in oil prices
Passenger	–740.8	–823.1	–82.3	
Credit	332.1	342.2	+10.1	
Debit	1,072.9	1,165.3	+92.4	
Freight	69.4	44.2	–25.2	
Credit	332.9	331.7	–1.2	
Debit	263.5	287.5	+24.0	

Figure 4: Developments in Transportation



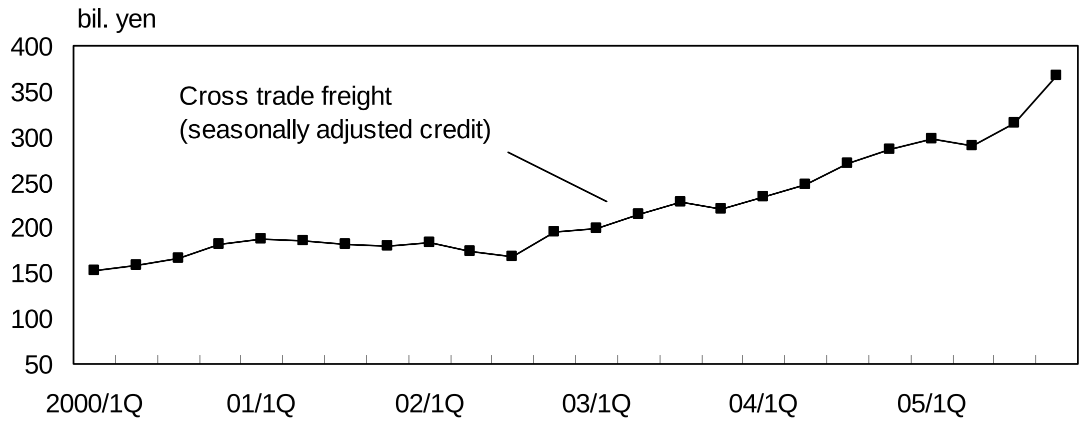
Note: "Others" includes "passenger by sea," "other sea transport," "other air transport," and "other transport."

Figure 5: Sea Freight Fares (Corporate Service Price Index)



Note: All indices are on the yen basis. Figures for December 2005 are preliminary.
Source: Bank of Japan, "Corporate Service Price Index."

Figure 6: Developments in Cross Trade Freight (credit)



b. Travel

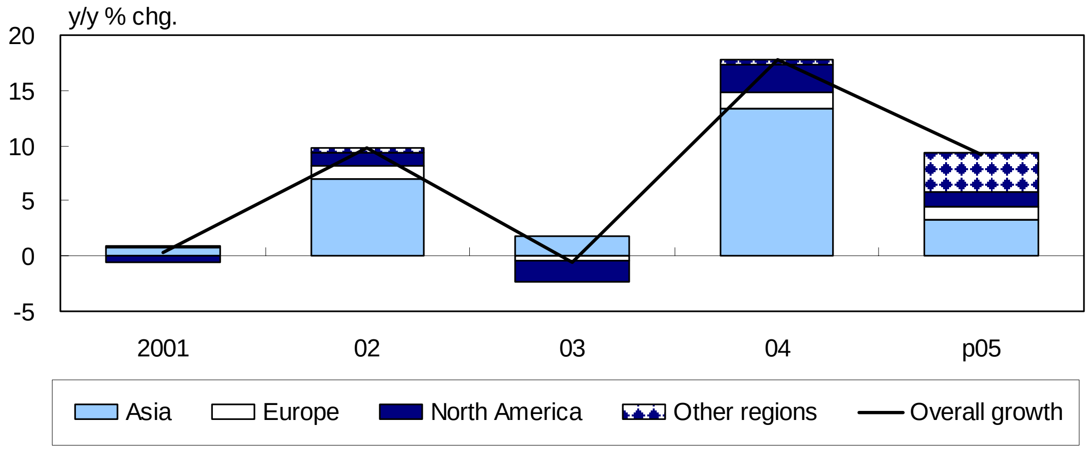
- The deficit in the balance of travel decreased to 2,775.6 billion yen, declining by 143.3 billion yen or 4.9 percent from 2004. This represented the first decrease in the travel deficit since 2003 when debits decreased as a result of the drop in the number of Japanese travelers abroad in response to the SARS epidemic. The decreased deficit in the balance of travel in 2005 was due to increased credit as a result of growth in the number of foreign visitors. The following factors have played a role: (1) the Visit Japan Campaign (Reference 1); (2) deregulation of visa acquisition and introduction of permanent visa exemptions (Reference 2); and, (3) the Aichi World Exposition.

Table 9: Balance of Travel

bil. yen

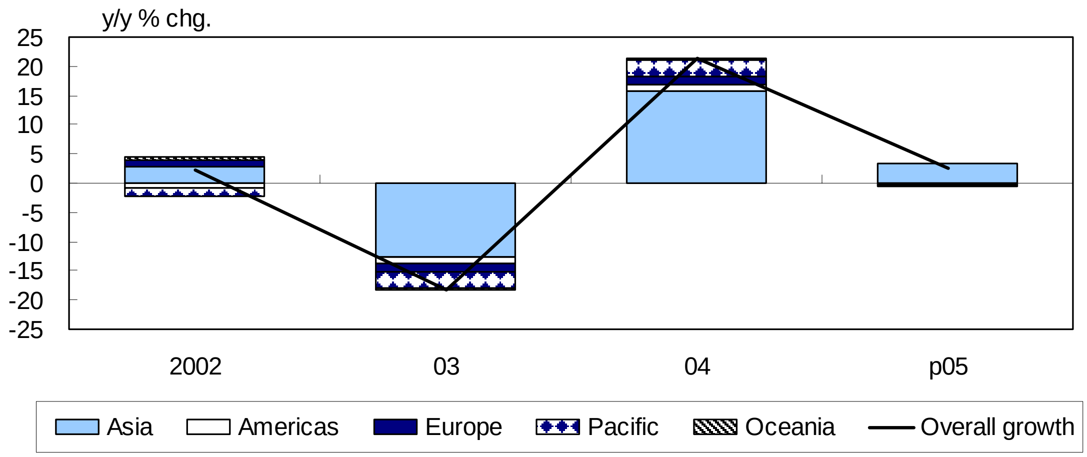
	2004	p2005	Changes from the previous year
Travel	–2,918.9	–2,775.6	+143.3
Credit	1,219.2	1,361.1	+141.9
Debit	4,138.0	4,136.6	–1.4

Figure 7: Developments in the Number of Foreign Visitors



Note: Figures for 2005 represent the year-on-year change for January through October 2005.
Source: Japan National Tourist Organization (JNTO), "Visitor Arrivals and Japanese Overseas Travelers."

Figure 8: Developments in the Number of Japanese Overseas Travelers



Note: Figures for 2005 represent the year-on-year change for January through October 2005.
Source: Ministry of Land, Infrastructure and Transport, "Provisional Statistical Report on Air Transport."

[Reference 1] Visit Japan Campaign

• April 2003: Campaign headquarters was established and the Visit Japan Campaign was launched.

- The Visit Japan Campaign is part of the "Inbound Tourism Initiatives of Japan" that aims to attract foreign visitors to Japan and was announced at a cabinet meeting on December 2002.
- The goal of the campaign is to increase the number of foreign visitors to 10 million by 2010.

• During fiscal 2005, Japan received seven million foreign visitors (up by 14 percent from 2004).

- In addition to some Asian countries (South Korea, Taiwan, China, and Hong Kong), the United States and Europe (United Kingdom, Germany, and France), in fiscal 2005, Australia, Canada, Thailand and Singapore were chosen as new target countries.
- Campaign activities include the participation in tourism exhibits in various countries, media-based promotions (TV programs and newspaper ads focusing on Japan), and promotions to travel companies.

Source: Visit Japan Campaign (http://www.vjc.jp).

[Reference 2] Deregulation of visa acquisition and visa exemption measures for foreign visitors

• China: Eligibility for the issuance of group tourist visas increased from five provinces and three cities (Guangdong, Jiangsu, Zhejiang, Shandong, Liaoning, Beijing, Shanghai, and Tianjin) to the whole of China.

• Short-stay visa exemptions for visitors from South Korea and Taiwan were made permanent.
Short-stay visa exemptions for Taiwanese and South Korean visitors were initially introduced on a temporary basis for the period between March and September 2005, but were later made permanent.

c. Other services

- The balance of trade in other services turned to a surplus of 530.0 billion yen in 2005, marking an increase of 569.0 billion yen from 2004. The turnaround was mainly due to the increase in credits in merchanting and other trade-related services as well as royalties and license fees.

  - For an analysis of the increase in credit in merchanting, see Box 1, "Developments in Production and Distribution Networks in East Asia from the Perspective of Merchanting."
  - The increase in credit of royalties and license fees was mainly due to the increase in credit of industrial property rights. For the breakdown by region and trends, see Box 2, "Breakdown of Royalties and License Fees by region."

Table 10: Balance of Other Services

bil. yen

	2004	p2005	Changes from the previous year	Major factors
Other services	–39.0	530.0	+569.0	Balance of trade in other services turned positive mainly due to increased credit for merchanting and other trade-related services as well as royalties and license fees
Credit	5,859.0	6,681.6	+822.6	
Debit	5,898.0	6,151.6	+253.6	
Royalties and license fees	223.1	316.3	+93.2	Credit increased due to rise in royalties resulting from strong overseas sales by Japanese motor vehicle and electric machinery manufacturers
Credit	1,697.5	1,933.9	+236.4	
Debit	1,474.4	1,617.6	+143.2	
Insurance services	–256.3	–111.2	+145.1	Deficit decreased mainly due to receipt of reinsurance payments for typhoon damage sustained in 2004
Credit	115.8	95.7	–20.1	
Debit	372.2	207.0	–165.2	
Financial services	189.8	259.2	+69.4	Credit increased mainly due to increase in M&A fees and brokage commission for stocks
Credit	476.7	559.0	+82.3	
Debit	286.9	299.8	+12.8	
Personal, cultural, and recreational services	–109.1	–112.1	–3.0	Basically unchanged from previous year
Credit	7.8	10.7	+2.8	
Debit	116.9	122.8	+5.9	
Construction services	223.2	235.0	+11.8	Decrease both in the Asia-related credit and debit
Credit	742.7	703.1	–39.6	
Debit	519.5	468.1	–51.4	
Government services n.i.e.	126.7	69.5	–57.2	Basically unchanged from the previous year
Credit	289.5	251.3	–38.2	
Debit	162.8	181.8	+19.0	
Other business services	–294.2	42.3	+336.4	
Miscellaneous business, professional, and technical services	–1,042.5	–1,185.1	–142.7	Debit increased due to increased R&D payments by motor vehicle and electric machinery manufacturers to the United States and Europe
Credit	985.7	1,006.0	+20.2	
Debit	2,028.2	2,191.1	+162.9	
Merchanting and other trade-related services	657.5	1,098.5	+441.0	Credit increased due to active merchanting of audio-visual apparatus, computer game equipment, and petroleum-related products (transactions of goods without passing through Japanese customs)
Credit	1,268.0	1,801.1	+533.2	
Debit	610.4	702.6	+92.1	

Figure 9: Developments in Credit of Other Services

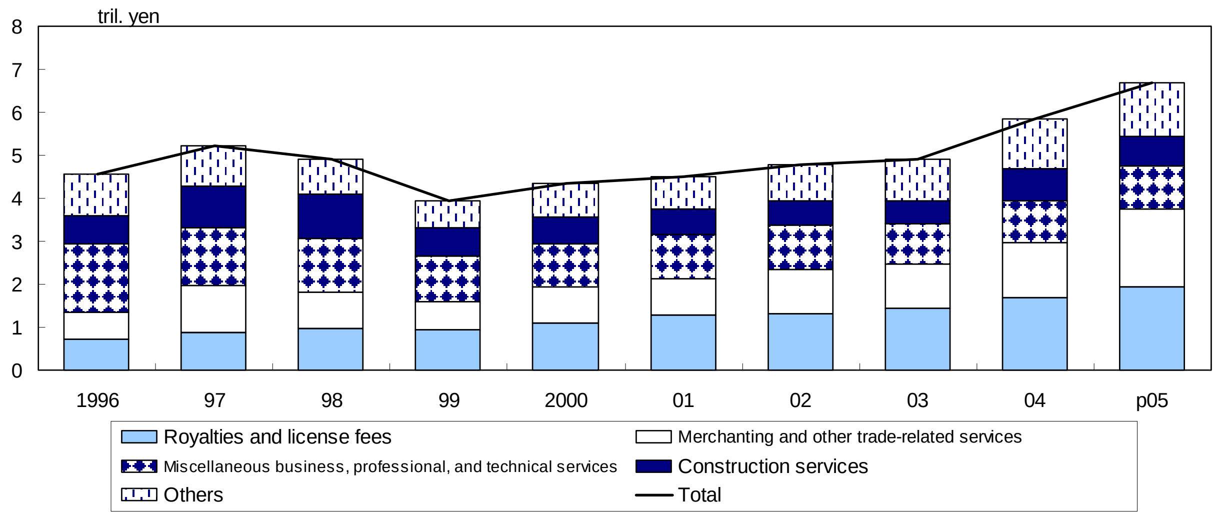
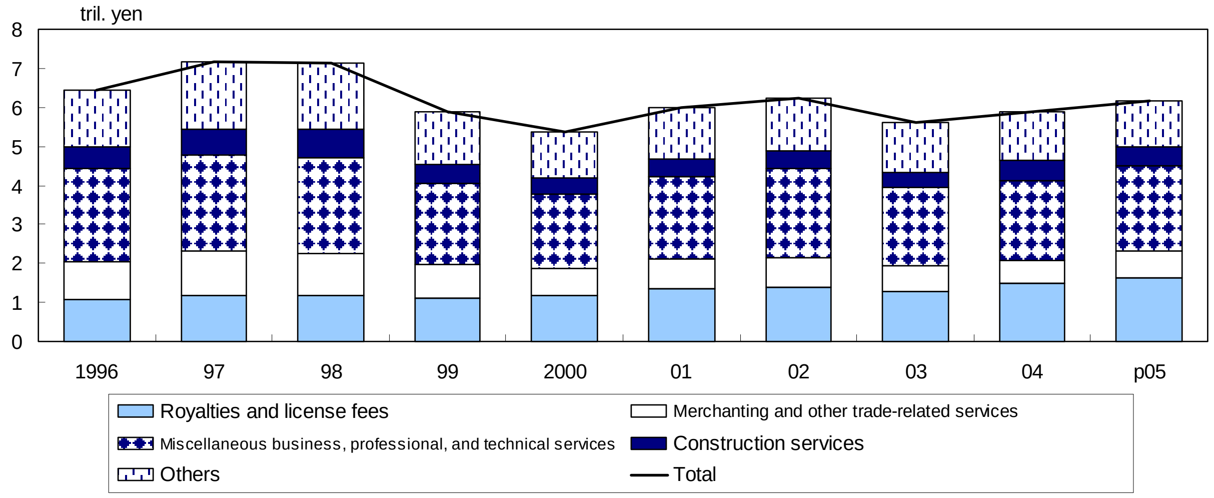


Figure 10: Developments in Debit of Other Services



3. Income

- The balance of income recorded a surplus of 11,359.5 billion yen, increasing by 2,086.4 billion yen or 22.5 percent from 2004. This marked a new record high for the second consecutive year and is a result of the following trends. First, portfolio investment income rose due to an increase in credit of interest on bonds and notes springing from the accumulation of outward portfolio investment and the rise in foreign interest rates. Second, direct investment income climbed thanks to an increase in credit of reinvested earnings[4] reflecting the strong performance of the foreign subsidiaries of Japanese companies.

[4] In the BOP statistics, the increase in retained earnings of overseas subsidiaries in each accounting period is recorded both under credits in the income account and under assets in the direct investment account. This convention is based on the assumption that the profit accruing to the parent company in Japan are distributed as dividends and are reinvested in the subsidiary by the parent company.

- On the direct investment income account, both credit and debit for dividends and distributed branch profits increased. The increase in credit reflects the strong performance of the foreign subsidiaries of Japanese companies. On the other hand, the increase in debit reflects large-scale dividend payments by the subsidiaries of American companies in Japan taking advantage of the tax reduction on repatriated earnings for U.S. multinationals under the American Jobs Creation Act of 2004.

Table 11: Balance of Income

bil. yen

	2004	p2005	Changes from the previous year	Major factors
Income	9,273.1	11,359.5	+2,086.4	
Direct investment income	1,367.4	2,291.9	+924.5	Credit of reinvested earnings increased due to the strong performance of Japanese companies' foreign subsidiaries
Dividends and distributed branch profits	898.7	959.6	+60.9	
Credit	1,330.9	1,786.8	+455.8	
Debit	432.3	827.2	+394.9	
Reinvested earnings	434.8 <816.9>	1,274.7	+839.9 <+457.8>	
Credit	645.2 <1,027.0>	1,461.6	+816.5 <+434.6>	
Debit	210.4	186.9	–23.4	
Portfolio investment income	7,430.4	8,600.7	+1,170.3	Interest income on bonds and notes increased due to the accumulation of outward portfolio investment and a rise in foreign interest rates
Bonds and notes	6,411.3	7,338.1	+926.8	
Credit	7,125.7	8,106.8	+981.2	
Debit	714.4	768.7	+54.3	
Other investment income	487.4	481.0	–6.4	Interest payments on bank lending and borrowing increased due to the rise in U.S. interest rates
Credit	1,392.5	1,686.8	+294.2	
Debit	905.1	1,205.8	+300.6	

Note: The foreign exchange conversion method for credits of reinvested earnings was revised, taking effect from January 2005. The estimated figures for 2004 of reinvested earnings using the new method are shown in parentheses.

Figure 11: Developments in Income

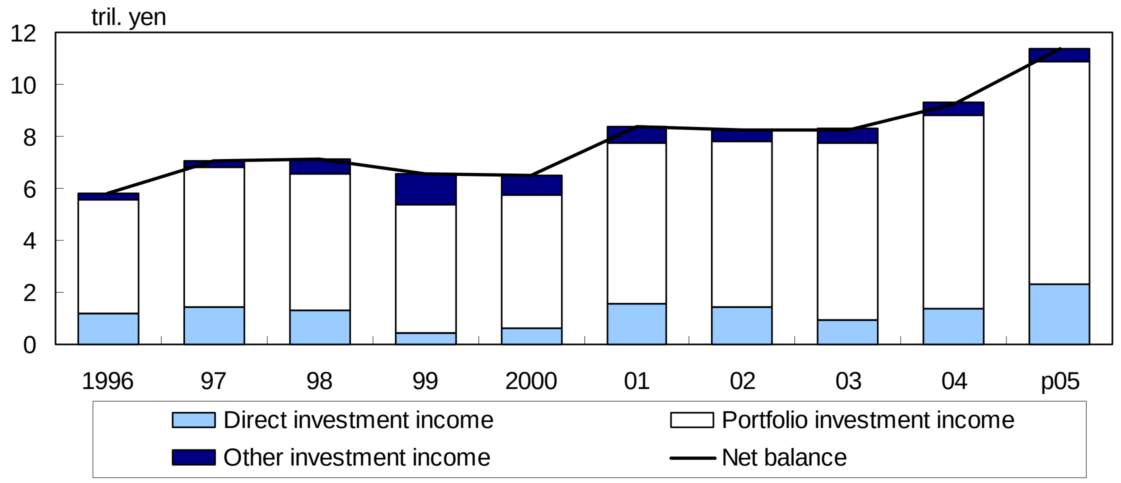


Figure 12: Developments in Direct Investment Income (Net)

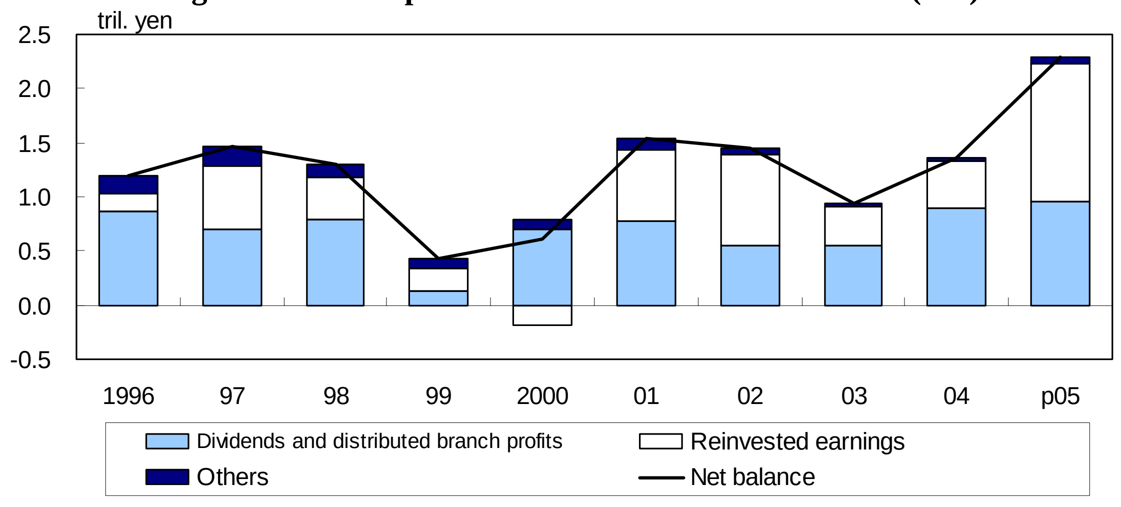
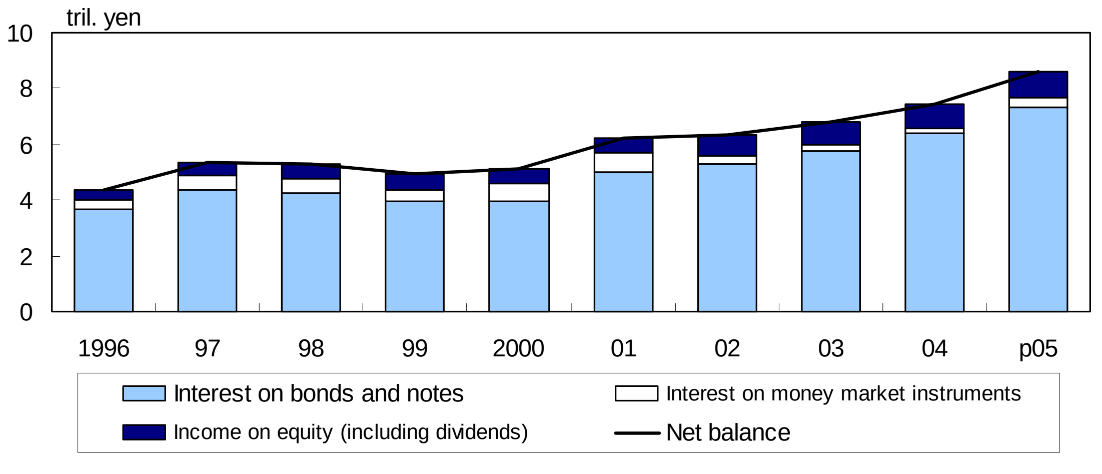


Figure 13: Developments in Portfolio Investment Income (Net)



4. Current transfers

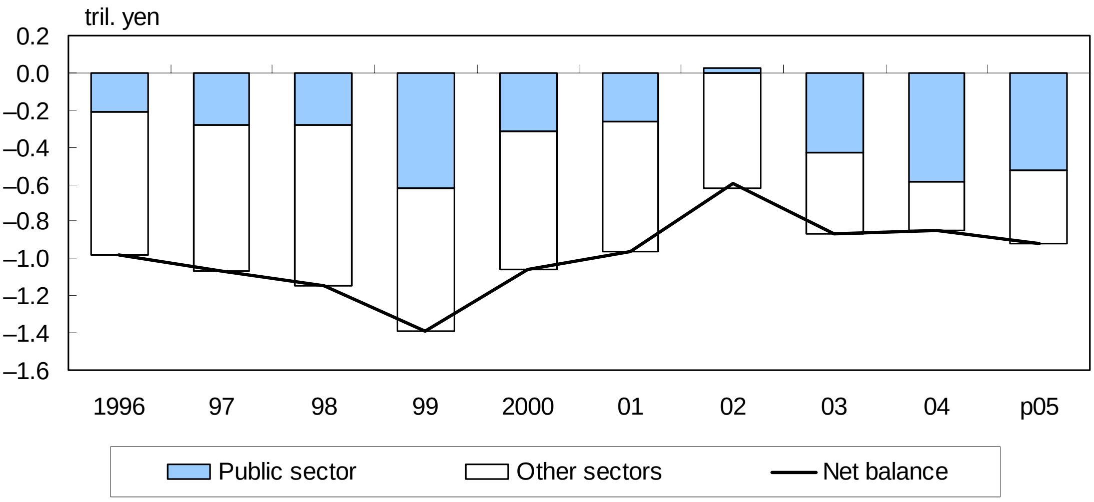
- The deficit in the balance of current transfers rose to 914.3 billion yen, an increase of 63.4 billion yen or 7.5 percent from 2004. While the deficit in the public sector decreased, this was outweighed by the increase in the deficit in other sectors.

Table 12: Balance of Current Transfers

bil. yen

	2004	p2005	Changes from the previous year	Major Factors
Current transfers	–850.9	–914.3	–63.4	
Public sector	–586.9	–521.4	+65.5	Debit decreased due to decline in contribution to international organizations
Credit	19.1	37.4	+18.3	
Debit	606.0	558.8	–47.2	
Other sectors	–263.9	–392.9	–129.0	Debit increased due to rise in tax payments to oil producing countries and increase in large compensation payments
Credit	727.2	926.8	+199.6	
Debit	991.2	1,319.7	+328.5	

Figure 14: Developments in Current Transfers



III. Capital and Financial Account[5]

A. Summary

- The capital and financial account turned to a net outflow of 14.0 trillion yen, the first outflow in three years. The following factors have contributed to this development. Net direct investment outflow rose by 2.2 trillion yen from the previous year; portfolio investment turned from a net inflow in 2004 to a net outflow in 2005 for a 5.2 trillion yen change from the previous year; and other investment also turned from a net inflow in 2004 to a net outflow in 2005 for a 7.4 trillion yen change from the previous year.

Table 13: Capital and Financial Account[1]

bil. yen

	2004			p2005		
		Assets (outward investment)	Liabilities (inward investment)		Assets (outward investment)	Liabilities (inward investment)
Current account	18,618.4			18,047.9		
Capital and financial account	1,737.0			–13,957.5		
Financial account	2,250.4			–13,587.0		
Direct investment	–2,503.2	–3,348.7	845.6	–4,731.6	–5,049.7	318.1
Portfolio investment[2]	1,879.2	–20,020.1	21,899.3	–3,312.3	–23,657.3	20,345.0
Equity securities	7,305.5	–3,290.3	10,595.8	11,411.3	–2,543.9	13,955.2
Bonds and notes	–10,990.0	–17,399.0	6,409.0	–14,863.4	–22,110.7	7,247.3
Money market instruments	5,563.6	669.2	4,894.4	139.8	997.2	–857.5
Financial derivatives	259.0	6,106.1	–5,847.1	–765.2	25,882.9	–26,648.1
Other investment	2,649.3	–3,885.6	6,534.9	–4,785.4	–8,142.4	3,357.0
Interoffice account transactions of banks	4,454.8	831.1	3,623.6	–4,121.7	–2,738.5	–1,383.3
Capital account	–513.4			–370.5		
Changes in reserve assets	–17,267.5			–2,456.2		
Errors and omissions	–3,087.9			–1,634.2		

Notes: 1. Negative figures show capital outflow. Capital outflow of assets means an outward investment by residents and an increase in reserve assets, whereas capital outflow of liabilities means the withdrawal of inward investment by nonresidents.

2. Figures exclude securities lending transactions. Figures for securities lending transactions are not included in the analysis in this article unless otherwise noted. The reason is that such transactions are large and volatile and therefore, if included in the portfolio investment and other investment items of the capital and financial account, might prevent an accurate understanding of securities transactions and loans.

[5] This account includes outward investment and loans by residents, withdrawals of inward investment and loans by nonresidents, and changes in reserve assets.

B. Developments in the Main Components

1. Direct investment

- Outward direct investment by residents[6] increased for the second consecutive year. Led by high levels of acquisitions and capital participations in Asia and North America for expansion of overseas businesses, net direct investment outflows grew by 50.8 percent to 5.0 trillion yen, the highest level since 1990, when net outflow reached 7.4 trillion yen. Inward direct investment[7] by nonresidents recorded a net inflow of 318.1 billion yen, a drop of approximately 60 percent from the previous year. This decline was the result of large-scale withdrawals in such industries as financial services, pharmaceuticals, and motor vehicles. In fact, there was a net outflow in inward direct investment during the second half of the year, primarily because of such large-scale withdrawals during this period, representing the first net outflow in inward direct investment on a semiannual basis since the first half of 2000.

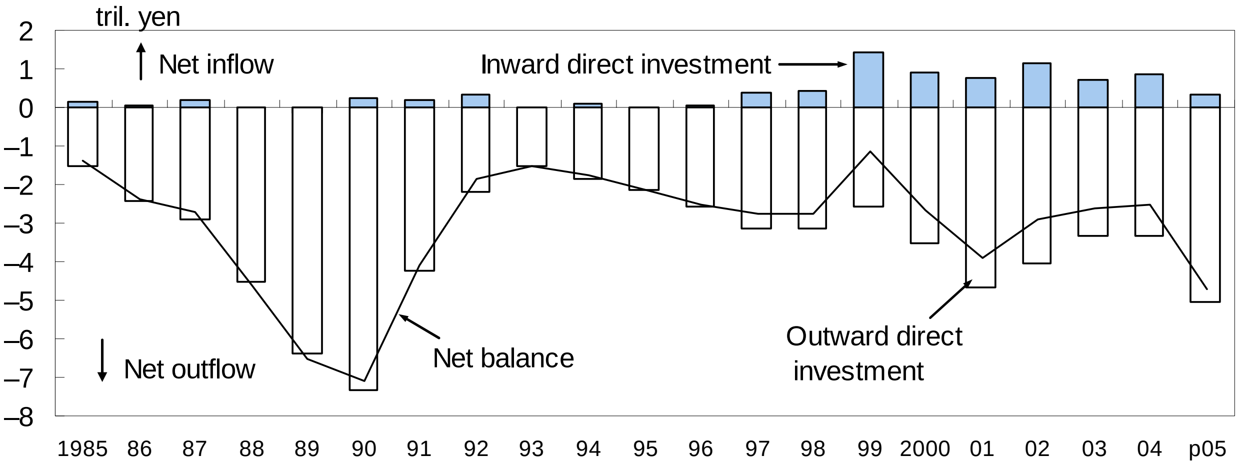
  - For an analysis of trends in direct investment, see Box 3, "Publication of Direct Investment Statistics by Industry and by Region," and Box 4, "Classification of Foreign Direct Investment by Type of Investment."

Table 14: Outward and Inward Direct Investment

	2003		2004		p2005		2005 Jan.-June		p2005 July-Dec.	
	Value (bil. yen)	Percentage changes from a year earlier	Value (bil. yen)	Percentage changes from a year earlier	Value (bil. yen)	Percentage changes from a year earlier	Value (bil. yen)	Percentage changes from a year earlier	Value (bil. yen)	Percentage changes from a year earlier
Outward direct investment	–3,338.9	–17.5	–3,348.7	+0.3	–5,049.7	+50.8	–1,931.5	+34.4	–3,118.2	+63.1
Inward direct investment	733.2	–36.7	845.6	+15.3	318.1	–62.4	487.9	–13.7	–169.8	Turned to net outflow
Inward/outward (%)	22.0%		25.3%		6.3%		25.3%		–5.4%	

[6] Outward direct investment refers to direct investments by Japanese investors in foreign corporations (with a paid-in capital ratio of 10 percent or more), such as initial capitalizations, capital increases, loan capital (excluding loans between financial companies), and reinvested earnings.
[7] Inward direct investment refers to direct investments by foreign investors in Japanese corporations (with a paid-in equity ratio of 10 percent or more), such as initial capitalizations, capital increases, loan capital (excluding loans between financial companies), and reinvested earnings.

Figure 15: Developments in Outward and Inward Direct Investment



a. Outward direct investment (assets)

- Looking at patterns in outward direct investment in 2005, the following three types dominated: (1) acquisitions and capital participation with the aim of entering foreign markets and expanding profit opportunities in the wholesale and retail, finance and insurance, and telecommunications sectors; (2) capital increases in subsidiaries in the finance and insurance sector and the chemical industry with the aim of expanding overseas businesses; and (3) investments in corporate-type investment trusts[8] as investment vehicles by Japanese financial institutions and precision machinery companies.

  - Regarding disinvestments by Japanese companies (negative outward direct investment), instances of borrowing by parent companies from foreign subsidiaries[9] for use in domestic investment could be observed in the telecommunications and precision machinery industries.

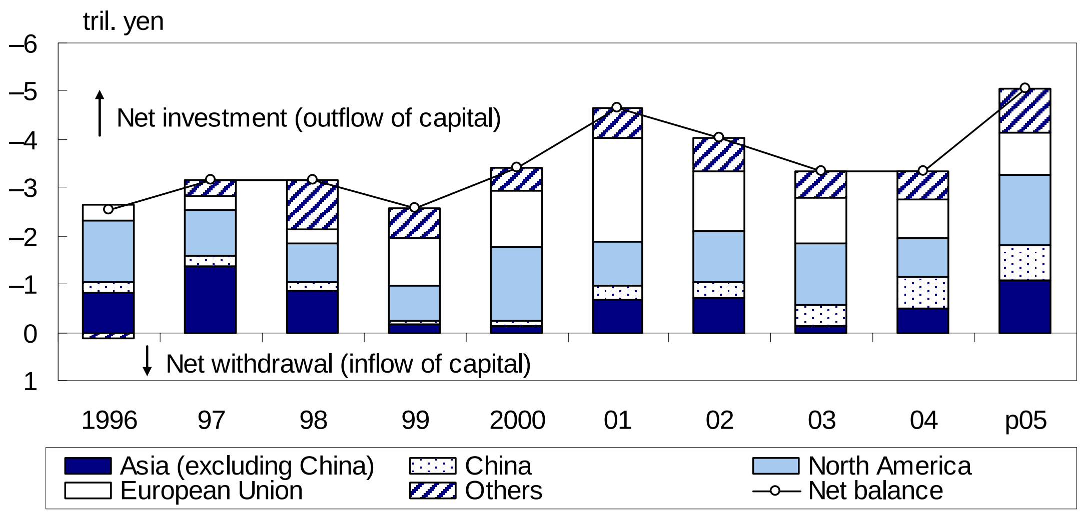
Breakdown by region

- Looking at outward direct investment by region, outflows to Asia (including China), amounting to 1,796.6 billion yen, and to North America, amounting to 1,468.2 billion yen, stand out in particular. The net direct investment outflows to Asia (including China) represent a sharp increase of 57.4 percent from 2004. Contributing factors were: (1) the continued high level of investment in China, led by the electric machinery and motor vehicle industries, which have been establishing new production facilities and expanding existing ones; (2) acquisitions by finance and insurance companies with the aim of expanding business operations in Asia (excluding China); and (3) equity participation in a South Korean telecommunications company. Investment in North America also rose sharply,

[8] Investments in corporate-type investment trusts are recorded as direct investment in the BOP statistics if they reach 10 percent or more of the trusts' equity.
[9] Loans received by a parent company in Japan from its foreign subsidiary are assumed to offset outward direct investments (assets) made by the parent company and are reported under assets as disinvestment (inflow). (The reverse applies when these loans are repaid).

increasing by 79.2 percent from 2004. Underlying this jump are an active level of investment in the motor vehicle and electric machinery industries as well as large-scale capital injections in retail subsidiaries for the acquisition of local firms. Investment in the European Union (EU) amounted to 863.7 billion yen, representing an increase in net outflows of only 9.0 percent due to large-scale borrowing (i.e., inflows) from subsidiary holding companies in Europe. Investment activity in other regions registered a sharp increase in net outflows of 54.6 percent, resulting from the underwriting of a large-scale capital increase by a Japanese insurance company seeking to expand its business operations in Latin America and from the establishment and purchase of corporate-type investment trusts in the Cayman Islands by Japanese financial institutions.

Figure 16: Outward Direct Investment (By Region)



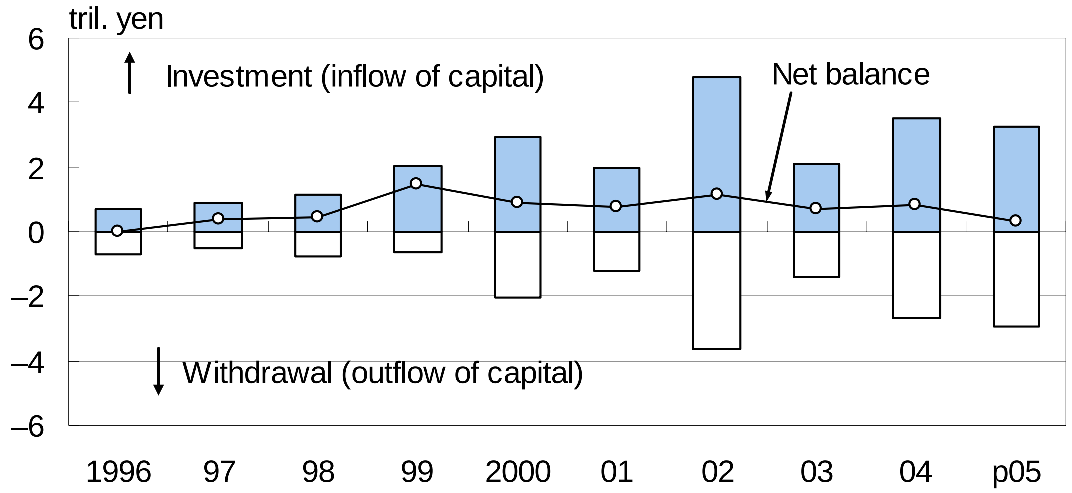
b. Inward direct investment (liabilities)

- Inward direct investment has fluctuated in the 1 trillion-yen range since 1997 for the following reasons: (1) full-fledged response to global industry consolidation and the intensification of competition; (2) the growing number of foreign-affiliated companies seeking to expand their business in Japan; and (3) the fact that an increasing number of Japanese companies are willing to accept foreign capital participation as part of their operational and financial restructuring efforts. In 2005, inward direct investment posted a net inflow of 318.1 billion yen, the lowest level to be recorded since 1996 (24.8 billion yen), despite large-scale investment in transportation, retailing, and other industries. These, however, were offset by the partial withdrawal of capital invested in subsidiaries in Japan (such as financial institutions) whose corporate value had increased, and by large-scale withdrawals related to the transfer of shares in existing subsidiaries in Japan to a Japanese holding company.

  - The above observations are based on net inward direct investment, which is the balance of investments implemented and amounts withdrawn. On a gross basis, investment into Japan (inflow of capital) during 2005 amounted to 3.3 trillion

yen, the third highest level ever recorded (following the 4.8 trillion yen in 2002 and the 3.5 trillion yen in 2004). Thus, although slightly down from 2004, gross inflows in 2005 remained relatively high. Net inflows, on the other hand, contracted because withdrawals increased slightly.

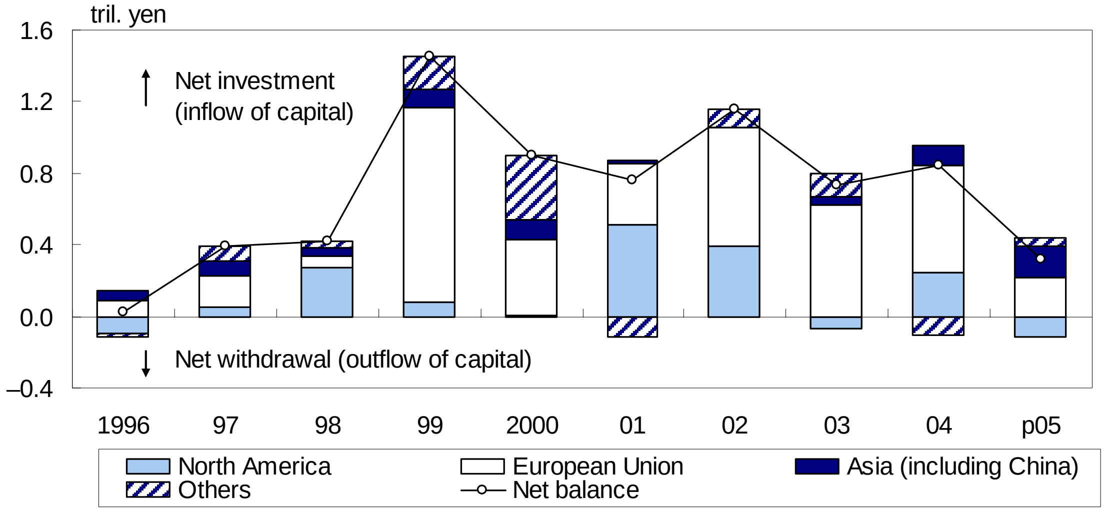
Figure 17: Inward Direct Investment



Breakdown by region

- Looking at inward direct investment by region in 2005, inflows from the EU, amounting to 217.3 billion yen, and from Asia (including China), amounting to 179.7 billion yen accounted for the largest shares. Net inflows from Asia increased sharply, by 66.7 percent from 2004, because a Hong Kong securities company undertook a large-scale capital injection in a company newly established in Japan for the purpose of transforming its Japanese branch office operations into a Japanese corporation. On the other hand, net investment inflows from the EU declined dramatically, decreasing by 63.9 percent from a year earlier. Inflows such as a large-scale capital increase in a Japanese transportation subsidiary to improve its financial condition were largely offset by large-scale withdrawals, such as the sale of a Japanese bank to investors in Japan by a U.S. investment fund through its Belgian holding company, and the sharp drop in investment in the telecommunications sector when compared with 2004. Investment from North America turned to a net outflow of 117.8 billion yen in 2005 as a U.S. motor vehicle manufacturer withdrew from its investment, selling its shares in a Japanese subsidiary and dissolving its capital alliances as part of a wider restructuring program. In contrast, investment from other regions turned positive in 2005. Although there were large outflows of capital as, for example, shares in existing subsidiaries in Japan were transferred to a Japanese holding company, this was more than offset by the large-scale capital increase by a U.S. retailer, acting through its Swiss holding company, aimed at strengthening the financial condition of its subsidiary in Japan.

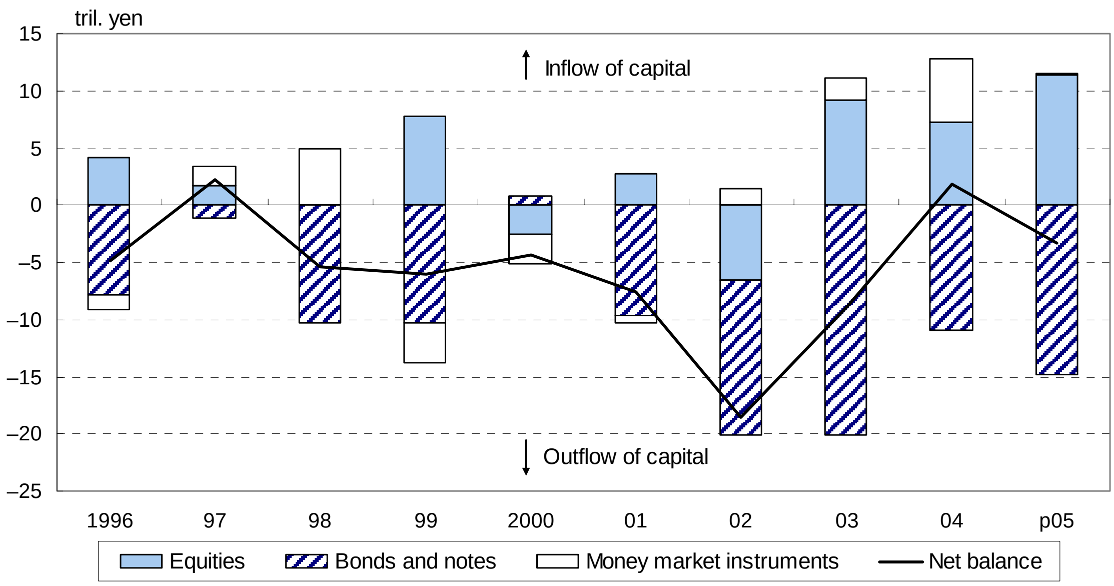
Figure 18: Inward Direct Investment (By Region)



2. Portfolio investment (excluding securities lending)

- Portfolio investment turned to a net outflow of 3.3 trillion yen in 2005 from a net inflow of 1.9 trillion yen in 2004. Underlying this reversal is both an increase in net purchases (outflow) in outward portfolio investment, and a decrease in net purchases (inflow) in inward portfolio investment.

Figure 19: Developments in Portfolio Investment (Net)

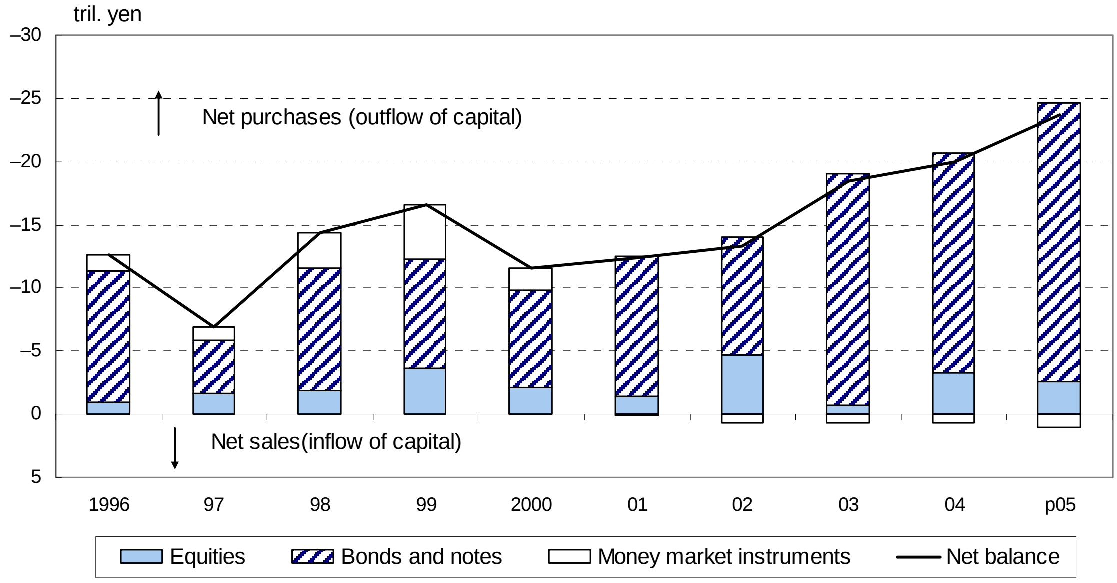


a. Outward portfolio investment (assets)

- Net purchases (outflow) of outward portfolio investment continued to increase in 2005 to 23.7 trillion yen from 20.0 trillion yen in 2004, marking the second consecutive year in which net purchases exceeded 20 trillion yen. While net purchases of foreign equities decreased slightly, this was more than offset by a sharp increase in net purchases of foreign bonds and notes.

  - See Box 5, "Outward Portfolio Investment by the Household and the Non-financial Sector in 2005."

Figure 20: Developments in Outward Portfolio Investment



(1) Outward investment in equities (assets)

- While remaining at high levels, net purchases (outflow) of outward investment in equities decreased to 2.5 trillion yen from 3.3 trillion yen in 2004.

Figure 21: Developments in Outward Investment in Equities

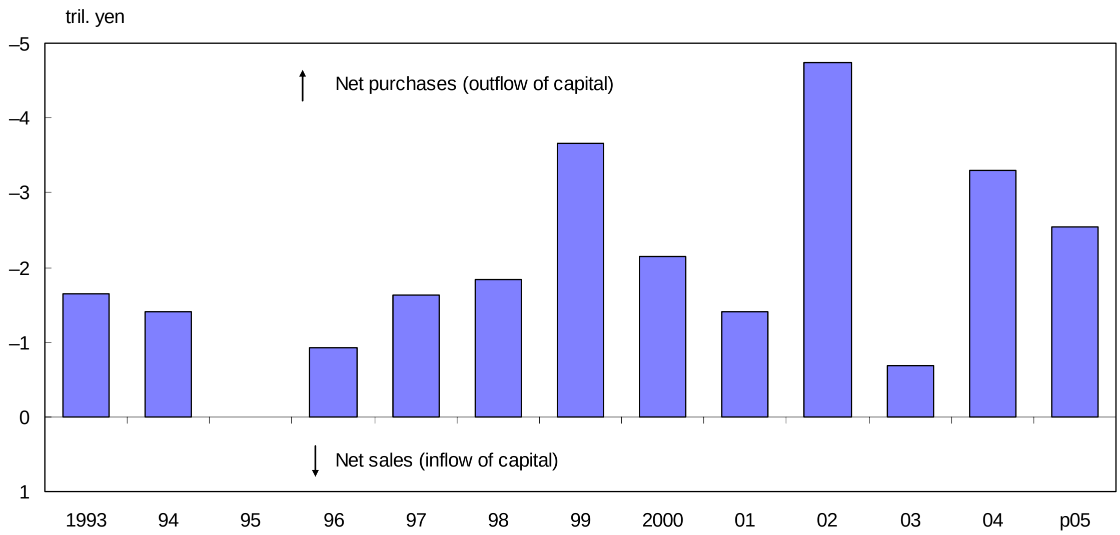
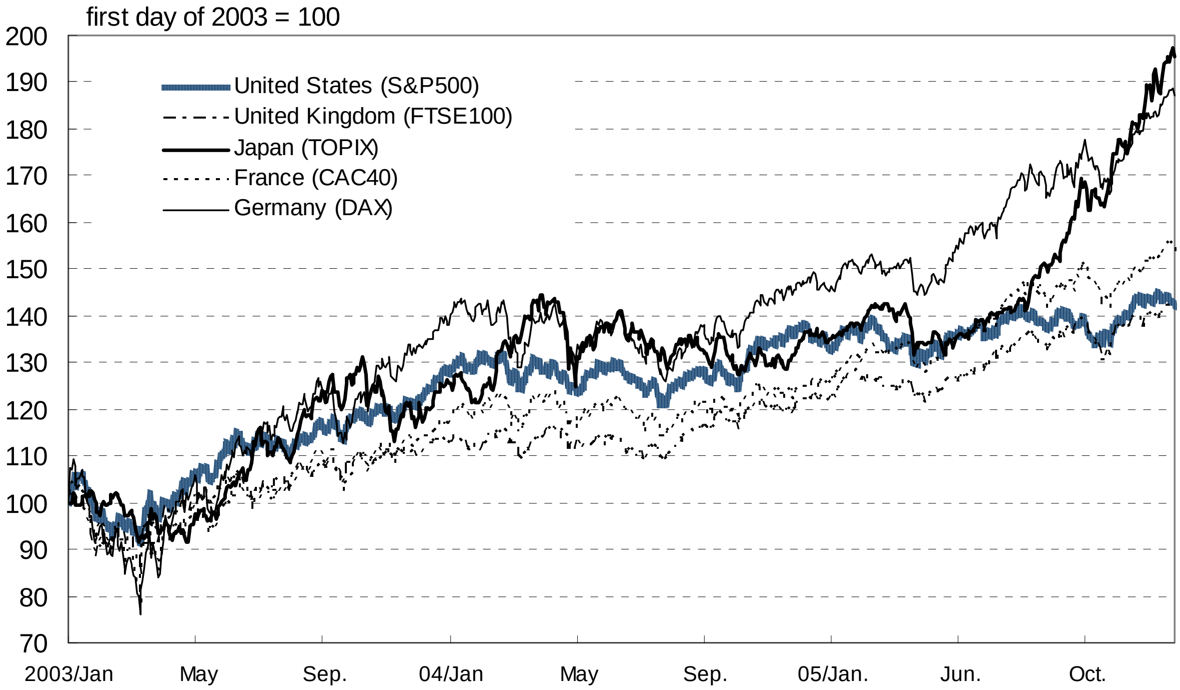


Figure 22: Stock Price Indices in Major Markets



Source: Bloomberg.

(a) Developments by investor category

Looking at developments by investor category, the most conspicuous feature in 2005 was the active level of investment by investment trusts. Reasons for the observed sharp increase is the establishment of developing country equities funds focusing on countries or regions such as India, Eastern Europe, and Russia, which resulted in a massive increase in investment in, for example, Indian and Russian equities. A large number of real estate investment trust (REIT) funds were also sold during 2005, resulting in a high level of purchases of foreign REITs, including REITs focusing on the United States and Australia. Moreover, with the flow of funds into global equities funds, acquisition of European and U.S. equities reached high levels.

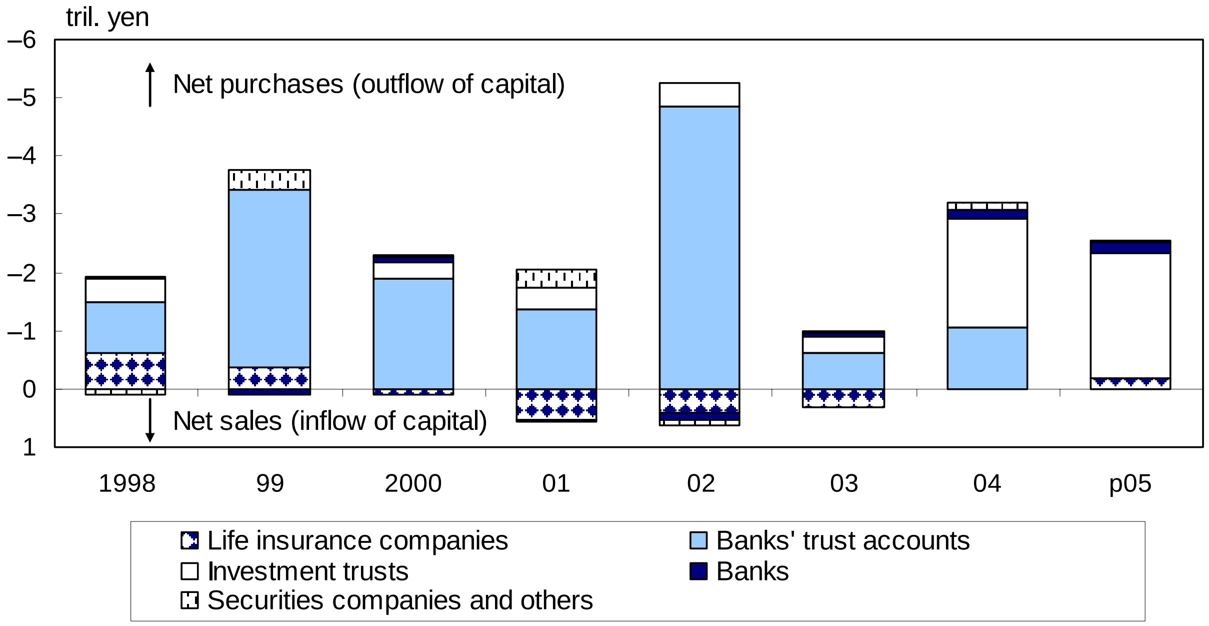
Net outward investment in equities by banks' trust accounts,[10] became slightly negative in 2005. While there was a steady flow of newly allocated funds from public pension funds throughout the year, there was considerable selling by corporate pension funds due to the termination of proxy management and profit taking.

Net purchases of foreign equities by banks increased in 2005. One reasons for this increase is that banks purchased beneficiary certificates of overseas funds which had loans to EU companies as underlying assets.

[10] The majority of outward portfolio investment by public pension funds is made by entrusting funds to investment management companies and banks' trust accounts. Thus, these are recorded as transactions under banks' trust accounts. The same holds true for corporate pension funds. However, in the case of corporate pension funds, some funds are entrusted to life insurance companies.

Life insurance companies recorded net purchases in 2005 as compared to net sales in 2004. This reversal reflects the increased weight assigned to U.S. and other foreign equities in life insurance companies' special accounts for the management of corporate pension funds.

Figure 23: Outward Investment in Equities (By Sector)



Note: Figures through 2004 are from "Securities Investment at Home and Abroad (settlement basis)." Figures for 2005 are based on balance of payments statistics: (1) "banks" comprises the sum of the bank accounts of banks and trust banks, and (2) "banks' trust accounts" comprises the sum of the trust accounts of banks and trust banks.

(b) Breakdown by region

Turning to outward investment in equities by region, net purchases of U.S. equities remained at approximately the same level as 2004. Important components were investments in U.S. REITs by REIT funds set up in Japan and in global equity funds.

Net purchases of European equities increased in 2005, driven by active purchasing of corporate-type investment trusts established in Luxembourg and other countries, as well as by acquisitions of shares of German and French companies.

Net purchases of Asian equities, on the other hand, decreased significantly. Although there was active purchasing of Indian equities due to the popularity of Indian equity funds, Chinese equity funds, which had registered high levels of purchasing until 2004, underwent extensive selling.

Net purchases of equities of other regions decreased. Although purchases of corporate-type investment trusts,[11] issued by special purpose companies (SPCs) established in overseas tax havens, by Japanese investors continued at a steady pace, purchases of preferred shares[12] issued by the SPCs of Japanese banks to boost their own-capital ratio, eased off a little from the high levels recorded in 2004.

Table 15: Outward Investment in Equities (By Region) [1, 2]

bil. yen

	2002	2003	2004	p2005	IIP [3] (end of 2004)
United States	–3,051.8	–169.0	–933.1	–961.9	18,344.9
EU countries [4]	–737.3	107.0	–551.4	–694.1	11,404.3
Of which: Germany	–58.5	–54.3	4.1	–55.4	1,061.4
France	–55.3	4.8	26.5	–73.0	1,540.9
United Kingdom	–441.1	82.3	–47.2	80.5	4,596.3
Luxembourg	41.1	48.3	–111.3	–283.8	614.1
Asia [5]	–92.5	–8.8	–328.5	–101.2	1,837.2
Cayman Islands	–411.5	–324.0	–742.3	–355.9	2,384.0
Others	–335.1	–283.8	–639.7	–430.8	4,001.3
Total	–4,628.2	–678.6	–3,195.0	–2,543.9	37,971.7

Notes: 1. Negative figures indicate net purchases (outflow of capital).
2. Figures through 2004 are from "Securities Investment at Home and Abroad (settlement basis)," while figures for 2005 are based on balance of payments statistics.
3. IIP stands for International Investment Position.
4. Figures through April 2004 are based on 15-country membership before the enlargement of the EU, while figures thereafter are based on the 25-country membership following the enlargement.
5. Flow figures through 2004 are the sum of figures for Hong Kong, South Korea, Thailand, Malaysia, and Singapore. India, China, and other countries are added to the figures for 2005. (The same applies to the IIP data at the end of 2004). Therefore, there is a discontinuity in the data between 2005 and preceding years.

(2) Outward investment in bonds and notes (assets)[13]

- Net purchases (outflow) of foreign bonds and notes increased to 22.1 trillion yen in 2005 from 17.4 trillion yen in 2004.

[11] Corporate-type investment trust securities and close-ended contract-type investment trust securities are included under "equities." Open-ended contract-type investment trust securities are classified under "bonds and notes."

[12] Purchases of a stake of less than 10 percent are recorded under portfolio investment. Purchases of a stake of 10 percent or more are recorded under direct investment.

[13] Investment in foreign bonds and notes by residents (assets) is the sum of sales and purchases by residents, and of issuance and redemption of bonds and notes issued in Japan by nonresidents.

Figure 24: Developments in Outward Investment in Bonds and Notes

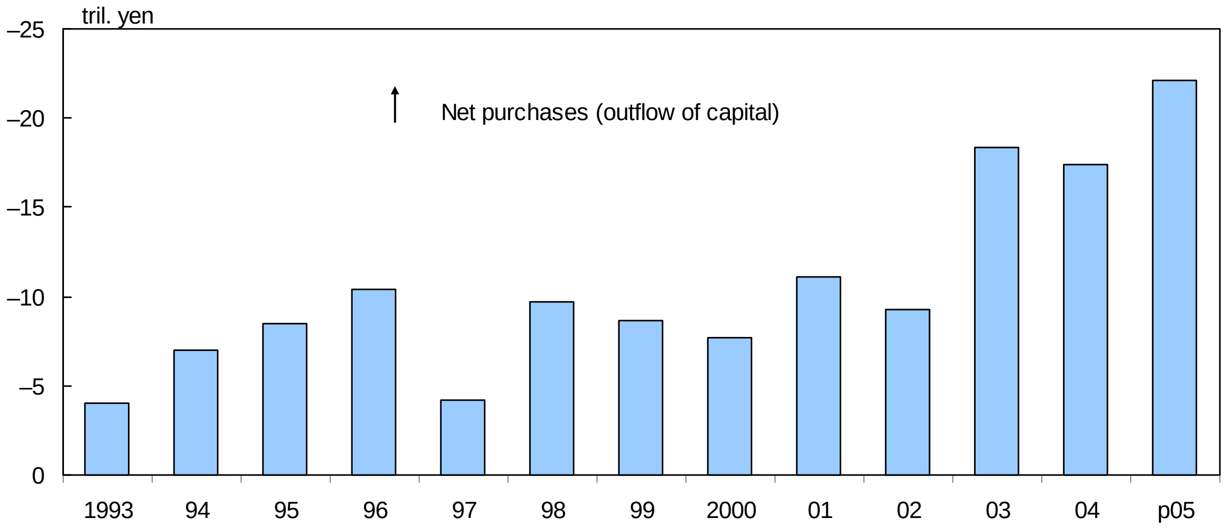
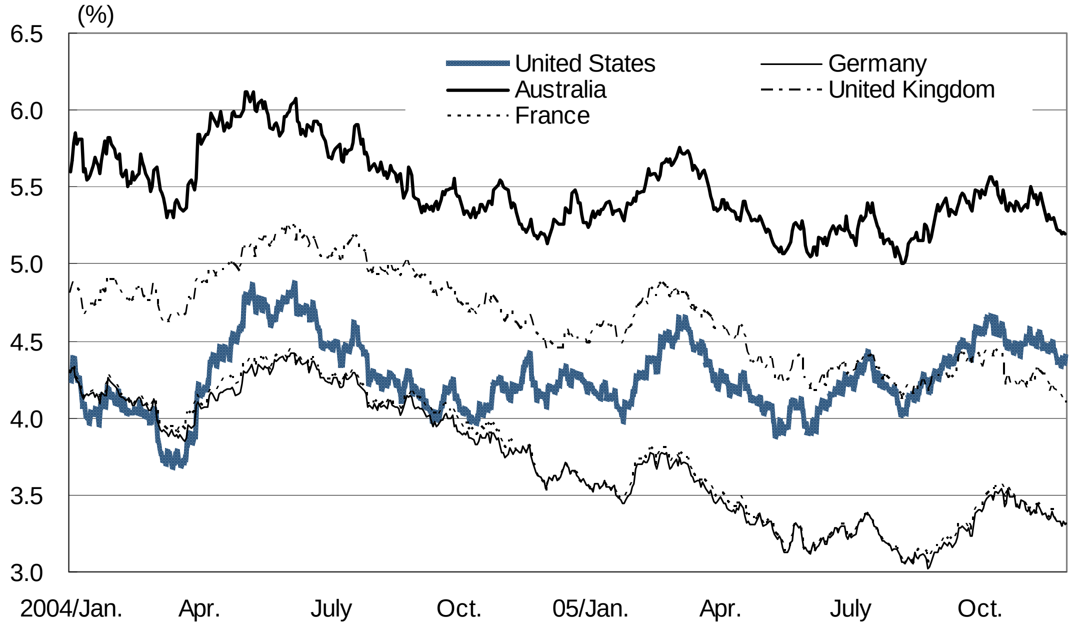


Figure 25: Long-Term Interest Rates in Major Markets (10-Year Government Bonds)



Source: Bloomberg.

(a) Developments by investor category

By investor category, the increase in net purchases of bonds and notes by banks' trust account was particularly noteworthy. Underlying this trend is the high flow of household funds into monthly-distribution-income type investment funds, which mainly invest in foreign bonds.

Net purchases by banks also increased. This was mainly because investors with a strong preference for higher yields increased their investment in U.S. and European bonds. Investment in U.S. government-sponsored enterprise (GSE) bonds[14] and private placement investment trusts were also buoyant.

Net purchases by life insurance companies decreased substantially from the previous year as purchases of foreign bonds and notes without an exchange-risk-hedge were outweighed by sales of exchange-risk-hedged foreign bonds and notes due to an increase in hedging costs.

Net purchases by banks' trust accounts increased from the previous year as purchases of foreign bonds with funds newly allocated by corporate and public pension funds continued.

Finally, net purchases by securities companies and others increased significantly due to the active purchasing of foreign bonds by individual investors.

Table 16: Outward Investment in Bonds and Notes (By Sector) [1, 2]

bil. yen

	2002	2003	2004	p2005
Life insurance companies	–1,082.8	–5,541.7	–2,949.7	–332.8
Banks' trust accounts	–1,167.9	34.7	–639.3	–2,598.4
Banks	–4,152.1	–5,101.0	–6,989.4	–7,567.6
Investment trusts	–763.3	–3,195.5	–3,387.7	–7,098.8
Public sector	1,983.9	887.6	275.1	37.0
Securities companies and others	–3,824.4	–4,702.9	–1,890.5	–4,550.2
Total	–8,815.5	–17,851.3	–15,581.5	–22,110.7

Notes: 1. Negative figures indicate net purchases (outflow of capital).
2. Figures through 2004 are from "Securities Investment at Home and Abroad (settlement basis)." Figures for 2005 are based on balance of payments statistics: (1) "banks" comprises the sum of the bank accounts of banks and trust banks, and (2) "banks' trust accounts" comprises the sum of the trust accounts of banks and trust banks.

(b) Breakdown by region

By region, net purchases of bonds and notes in the United States decreased slightly. Although banks continued to actively purchase U.S. bonds and notes and GSE bonds,

[14] Bonds issued by U.S. government-sponsored enterprises, such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).

life insurance companies liquidated their positions in exchange-risk-hedged foreign bonds due to higher hedging costs.

Net purchases of bonds and notes in Europe increased. This was primarily due to larger positions in European bonds taken during January-June 2005 when European bond prices rose.

Net purchases of bonds and notes in other regions rose as securities companies actively increased the underwriting of bonds issued by international organizations for sale to retail investors.[15]

Table 17: Outward Investment in Bonds and Notes (By Region) [1, 2]

bil. yen

	2002	2003	2004	p2005	IIP [3] (end of 2004)
United States	–3,690.3	–6,901.8	–6,388.1	–6,190.0	52,662.8
EU countries [4]	–1,588.8	–6,189.1	–2,971.9	–9,019.3	66,428.0
Of which: Germany	1,295.9	–1,882.7	650.5	–1,621.9	15,204.2
France	–518.4	–897.2	–1,055.1	–1,634.1	11,228.4
United Kingdom	645.6	–576.7	–1,063.4	–2,326.1	8,044.4
Asia [5]	106.6	128.7	–38.6	–195.0	1,151.0
Cayman Islands	–2,385.8	–2,005.4	–5,505.5	–4,068.2	24,425.7
Others	–1,257.2	–2,883.7	–677.4	–2,638.2	22,967.4
Total	–8,815.5	–17,851.3	–15,581.5	–22,110.7	167,634.9

Notes: 1. Negative figures indicate net purchases (outflow of capital).

2. Figures through 2004 are from "Securities Investment at Home and Abroad (settlement basis)," while figures for 2005 are based on balance of payments statistics.

3. IIP stands for International Investment Position.

4. Figures through April 2004 are based on 15-country membership before the enlargement of the EU, while figures for thereafter are based on the 25-country membership following the enlargement.

5. Flow figures through 2004 are the sum of figures for Hong Kong, South Korea, Thailand, Malaysia and Singapore. India, China and other countries are added to the figures for 2005 (The same applies to the IIP data at the end of 2004). Therefore, there is a discontinuity in the data between 2005 and preceding years.

(3) Outward investment in money market instruments (assets)

- Outward investment in money market instruments recorded net sales (inflow) for the fifth consecutive year, registering 997.2 billion yen in 2005 from 669.2 billion yen in

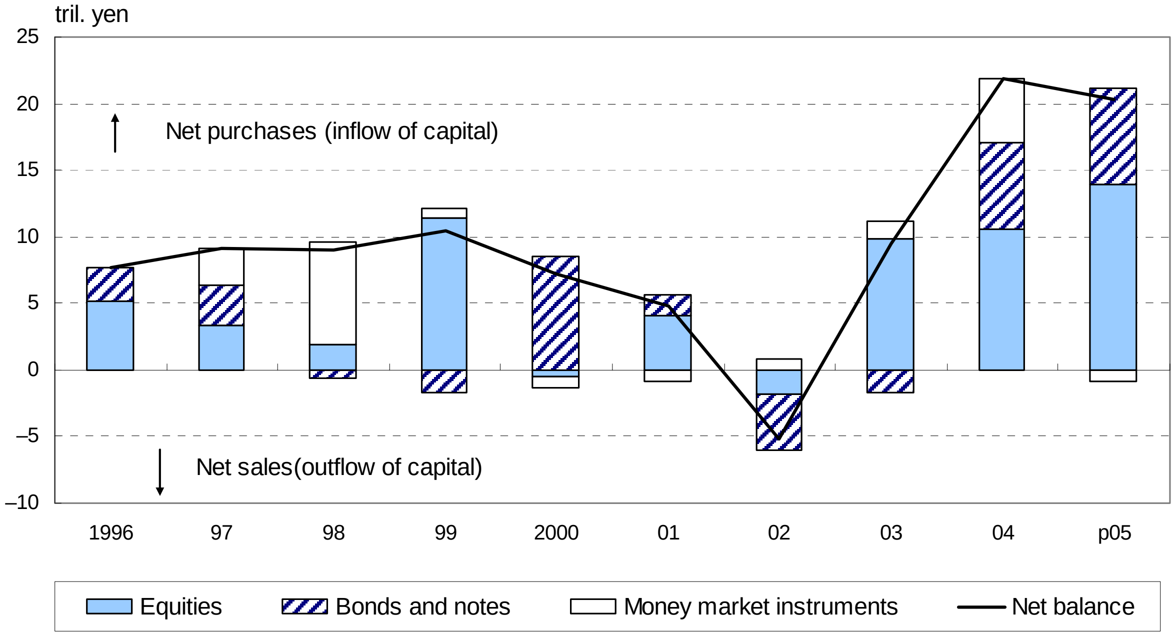
[15] In this report, international organizations, such as the IBRD, are categorized under "other regions." In the BOP statistics, regional classification is not applied to international organizations.

2004. This trend reflects a decrease in purchases by resident investors of *samurai* CP issued by Japanese corporations through their overseas affiliates.

b. Inward portfolio investment (liabilities)

- Inward portfolio investment continued to record large net purchases (inflow), although the amount decreased slightly to 20.3 trillion yen in 2005 from 21.9 trillion yen in 2004. Inward investment in equities and in bonds and notes continued sizable net purchases (inflow). However, inward investment in money market instruments shifted to net sales (outflow).

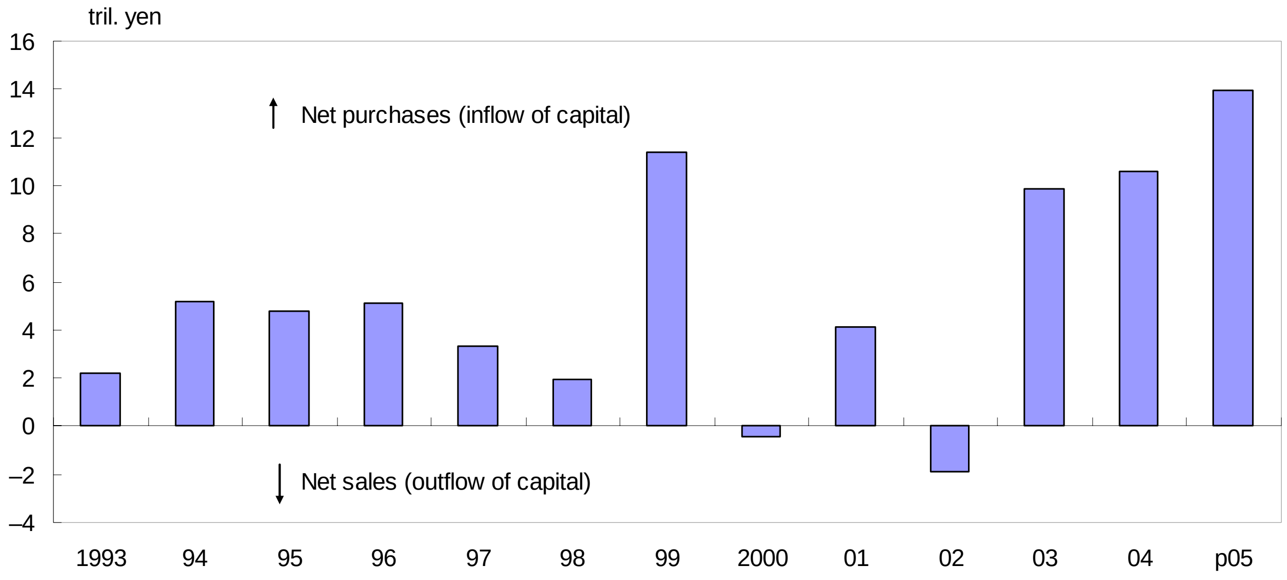
Figure 26: Inward Portfolio Investment (By Instruments)



(1) Inward investment in equities (liabilities)

- Net purchases (inflow) in inward investment in equities increased to 14.0 trillion yen in 2005 from 10.6 trillion yen in 2004. This recorded the highest level of net purchases in inward investment in equities since 1991, the earliest year for which comparable historical time series data are available. The high inflows reflect the growing popularity of Japanese equities among nonresident investors who are attracted by improving economic indicators and corporate performance.

Figure 27: Developments in Inward Investment in Equities



- A more detailed analysis of inward investment in equities during 2005 reveals the following pattern. From January through March 2005, monthly net purchases amounted to approximately one trillion yen, a response to the improving profitability of Japanese companies. Net purchases sagged during April through June as this dynamic fizzled out and concerns mounted that anti-Japan demonstrations in China would affect the performance of Japanese companies. However, a reversal was seen in July and inflows remained strong throughout the remainder of 2005, with monthly net purchases rising to the one trillion to two trillion yen range. Improved economic indicators and expectations of an end to deflation sustained the momentum of purchasing.

Figure 28: Developments in Inward Investment in Equities

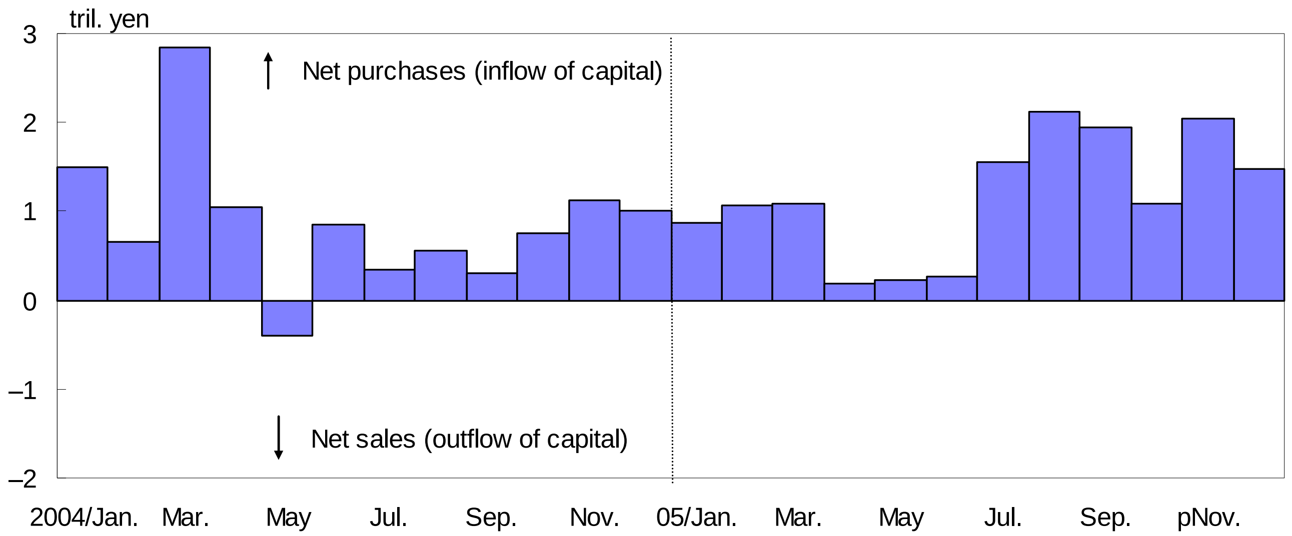
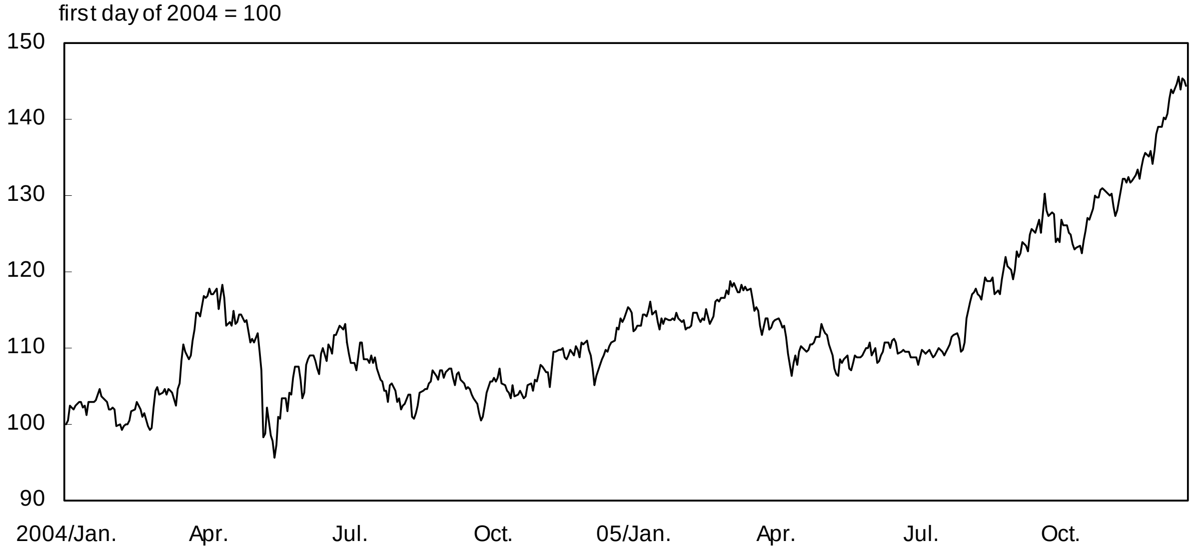


Figure 29: TOPIX (U.S. Dollar Basis)



Source: Bloomberg.

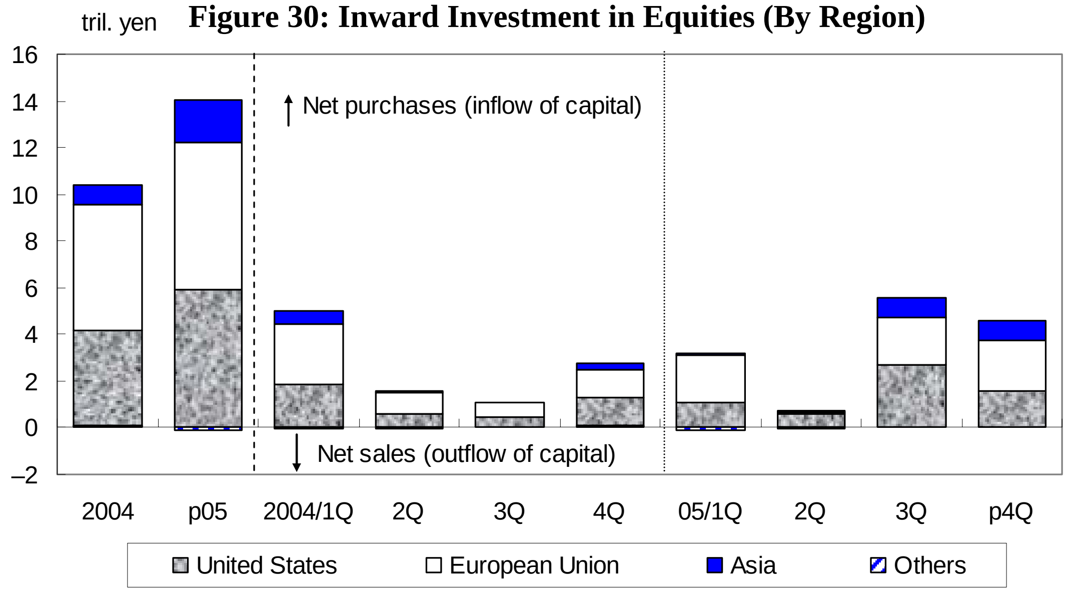
Breakdown by region

Net purchases of Japanese equities by U.S. investors accelerated beginning in the July-September quarter of 2005. This reflected the increased flow of funds into U.S. overseas investment funds and the active acquisition of Japanese equities by U.S. pension funds.

Net purchases by European investors decreased sharply in the April-June quarter. However, for 2005 as a whole, net purchases remained roughly on the same level as 2004.

- For an analysis of the purchases of Japanese equities by nonresident investors by industry, see Box 6, "Inward Investment in Equities by Foreign Investors by Industry in 2005."

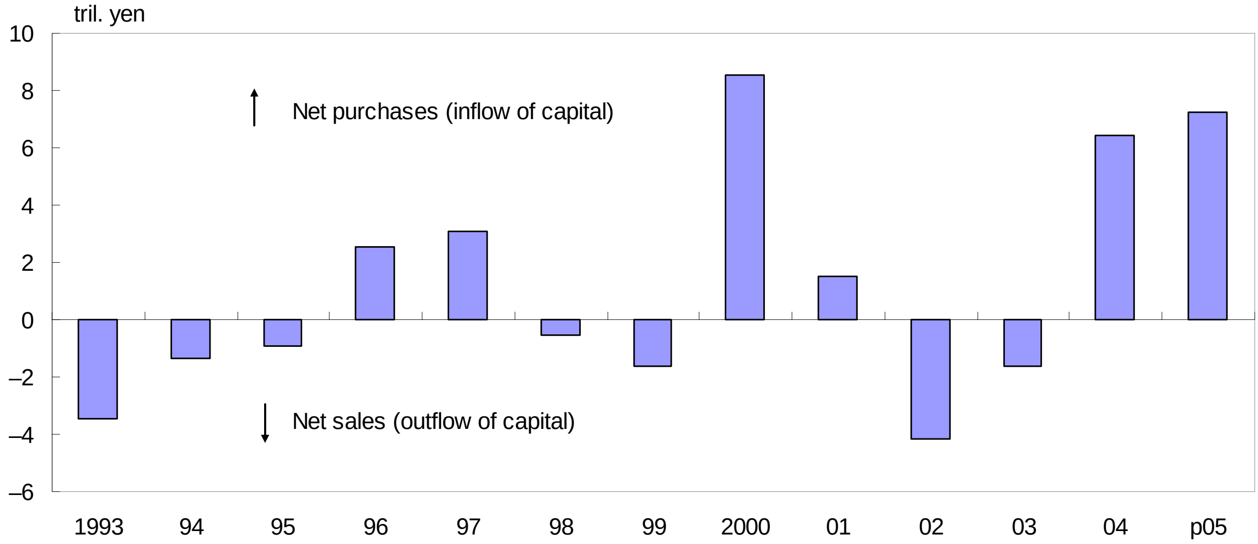
Figure 30: Inward Investment in Equities (By Region)



(2) Inward investment in bonds and notes (liabilities)

- Inward investment in bonds and notes continued to register sizeable net purchases (inflow), increasing to 7.2 trillion yen in 2005 from 6.4 trillion yen in 2004.

Figure 31: Developments in Inward Investment in Bonds and Notes



- A more detailed review of inward investment in bonds and notes during 2005 reveals the following. During the first half of 2005, hedge funds and foreign banks took on new arbitrage positions of JGB combining cash long of five- and ten-year bonds and futures sales as rising bond prices rendered bond futures relatively expensive in comparison to cash bonds. These arbitrage positions were closed as bond prices declined in the second half of the year. When swap spreads narrowed during this period, new arbitrage positions were taken combining cash long with swap payments of two- and five-year bonds. This resulted in the decrease in net sales in the third quarter and of net purchases in the fourth quarter. For the entire year, reflecting growing expectations of an end to deflation, foreign monetary authorities and European and U.S. pension funds actively purchased inflation-indexed bonds. In 2005, nonresident investors purchased roughly 1.4 trillion yen out of the total of roughly 1.5 trillion yen worth of inflation-indexed bonds issued.

Figure 32: Developments in Inward Investment in Bonds and Notes

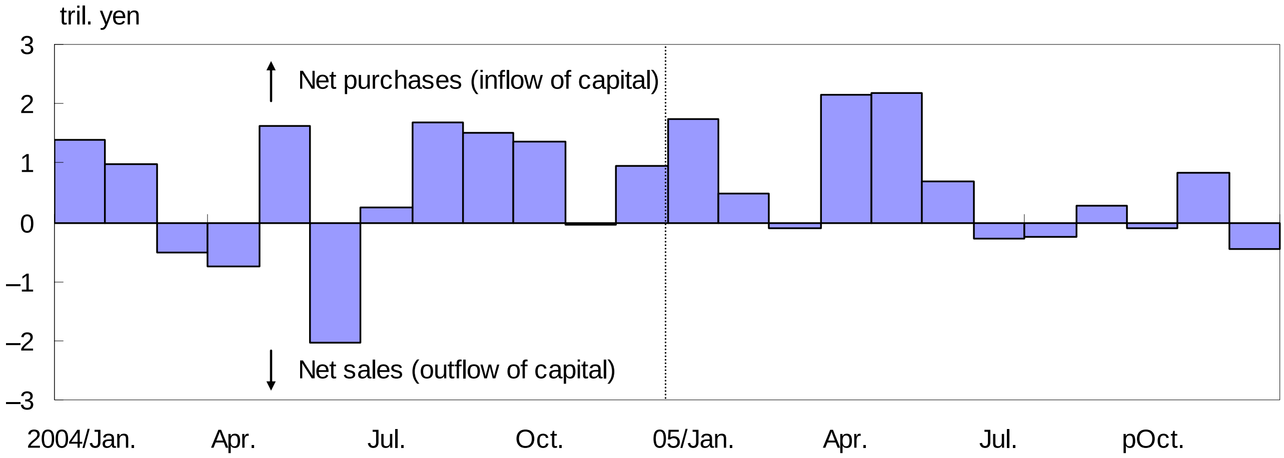
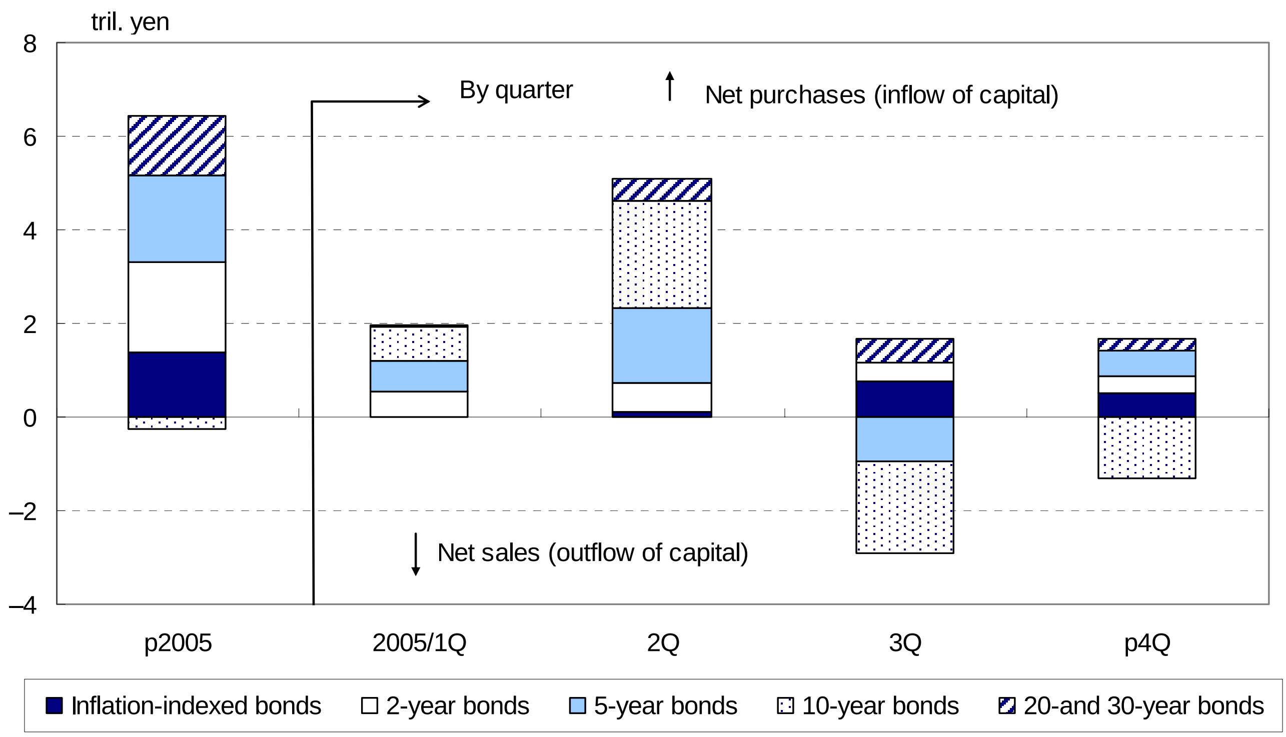


Figure 33: Purchases and Sales of Bonds and Notes by Issue

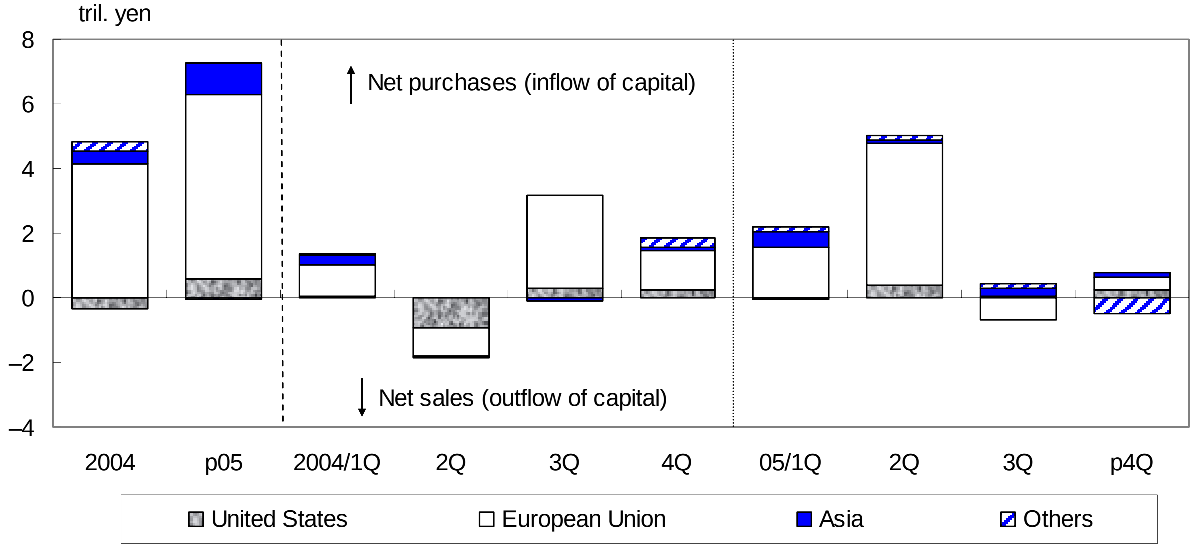


Breakdown by region

European and U.S. investors were large net purchasers during the first half of 2005 as they took on new arbitrage positions combining cash long and futures sales of JGBs. In the second half of the year, these positions were closed and new positions were taken on, involving cash long with swap payments of JGBs. As a result, net sales by European and U.S. investors remained essentially unchanged from the previous year.

Asian investors posted net purchases (inflow) exceeding the previous year's level, reflecting outright purchases of inflation-indexed bonds by the monetary authorities of some Asian countries.

Figure 34: Inward Investment in Bonds and Notes (By Region)

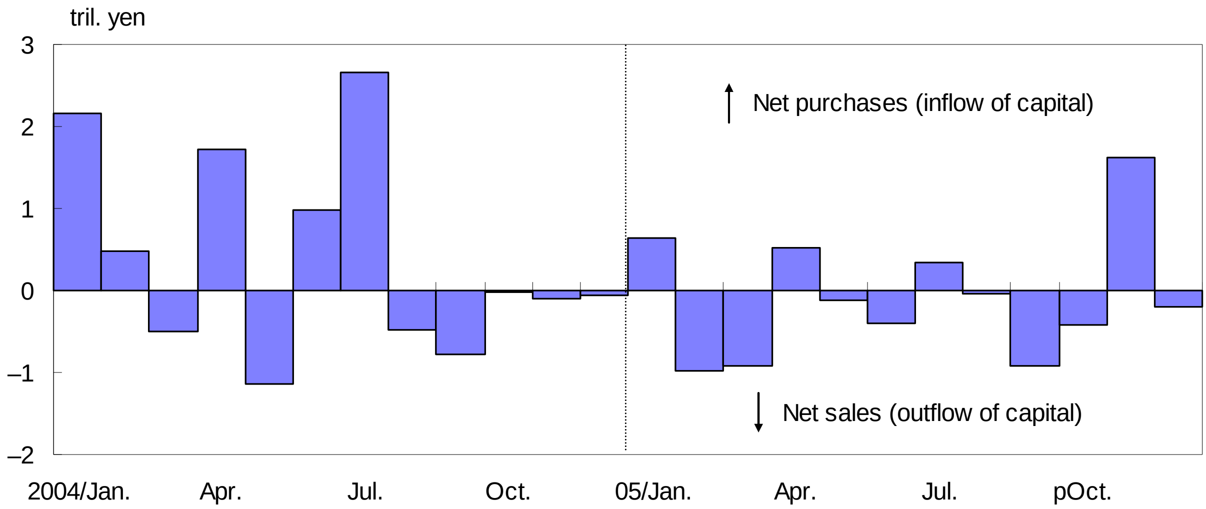


(3) Inward investment in money market instruments (liabilities)

- Inward investment in money market instruments turned to net sales (outflow) of 0.9 trillion yen in 2005, from net purchases (inflow) of 4.9 trillion yen in 2004.

  - While a large amount of money market instruments purchased in 2004 with yen funds at low cost came due, there were no new investments in 2005.

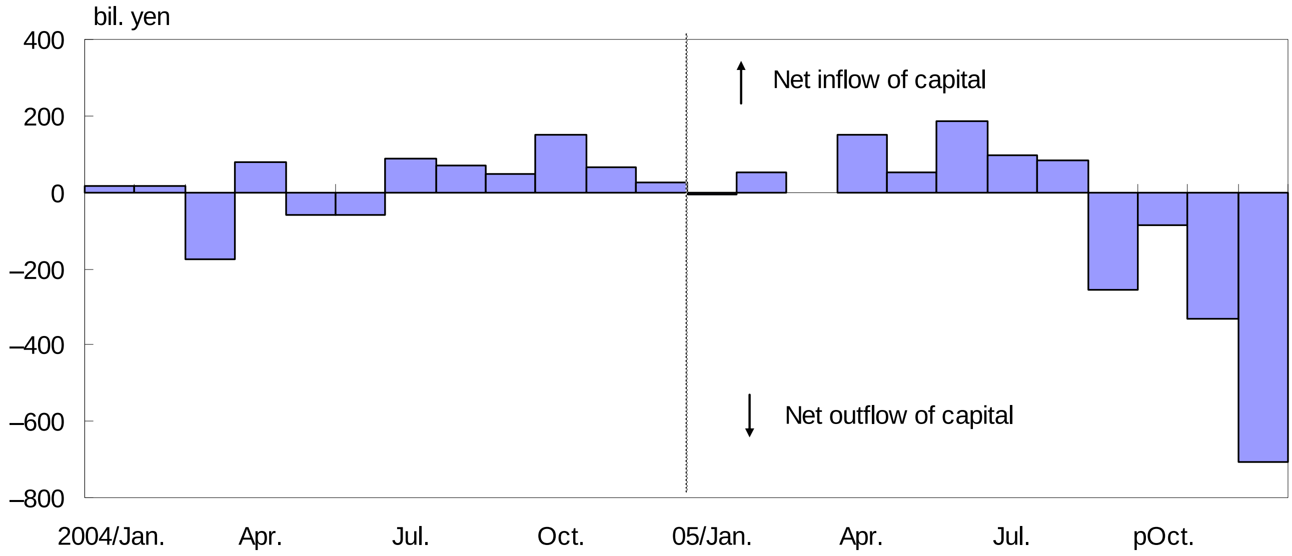
Figure 35: Developments in Inward Investment in Money Market Instruments



3. Financial derivatives

- Financial derivatives transactions turned to net outflow of 765.2 billion yen in 2005, from a net inflow of 259.0 billion yen in 2004. During the second half of the year, as Japanese stock prices rose rapidly, nonresident investors with long positions in Nikkei 225 futures and TOPIX futures realized capital gains. This resulted in sizeable net payments (outflow) to nonresident investors from resident counterparties, mainly securities companies.

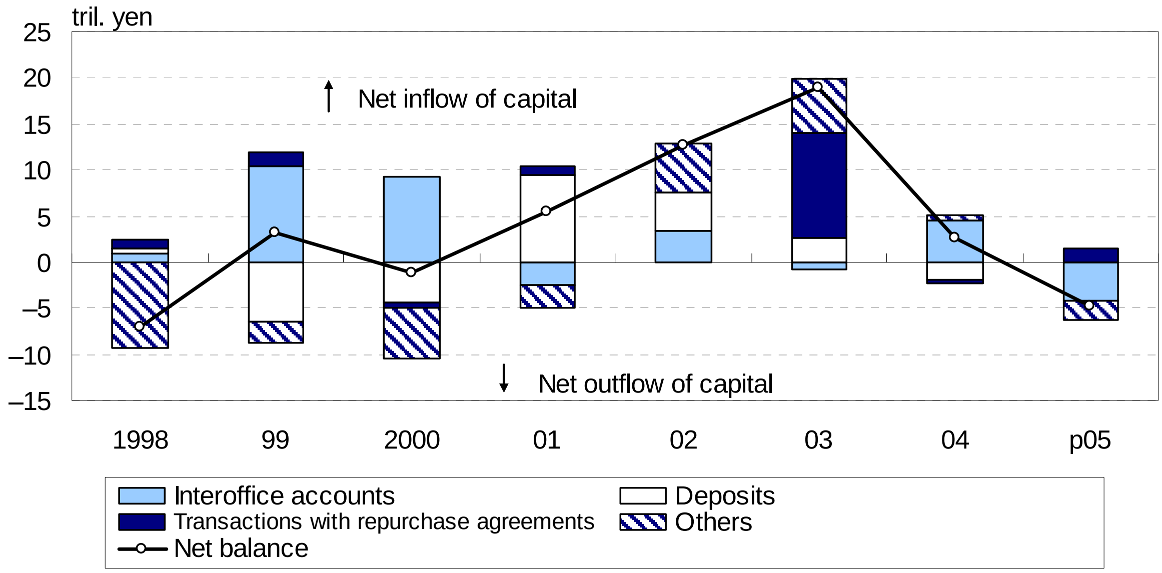
Figure 36: Developments in Financial Derivatives



4. Other investment (excluding securities lending)

- In 2005, the balance on other investment turned to net outflow for the first time in five years, amounting to a net outflow of 4.8 trillion yen, from a net inflow of 2.6 trillion yen in 2004.

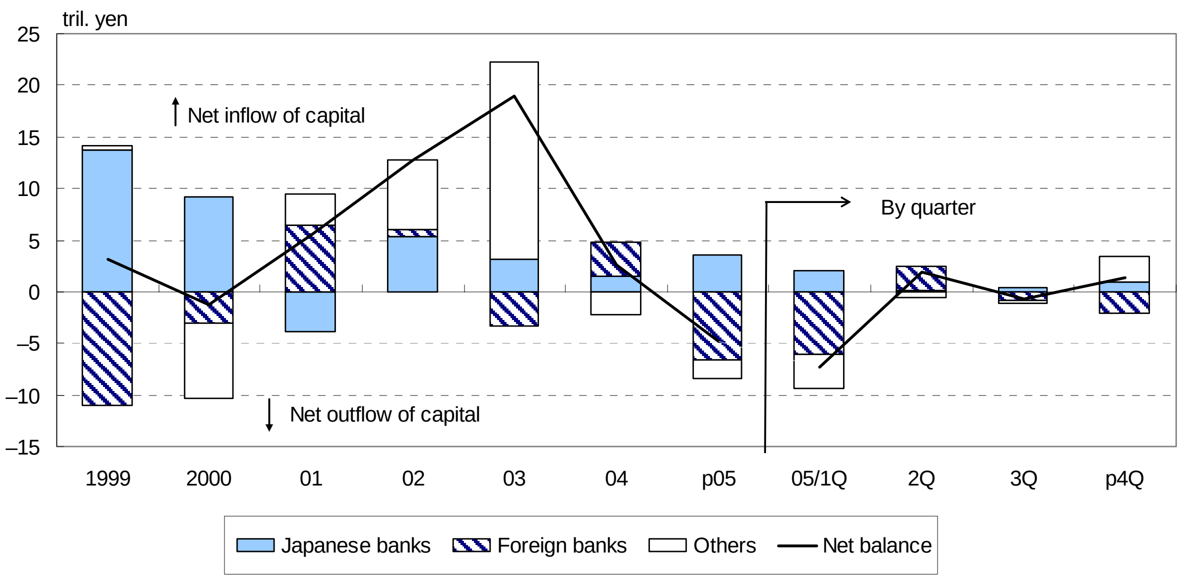
Figure 37: Developments in Other Investment (By Item)



- In 2005, foreign banks accounted for a large net outflow. When the negative cost of funding yen narrowed early in the year, foreign currencies that had been taken in through interoffice accounts for conversion to yen were repaid in large volumes.

- In contrast, net inflows accounted for by Japanese banks increased. This was primarily because some Japanese banks actively utilized foreign-currency funding for investment in foreign bonds and notes during the second half of the year.

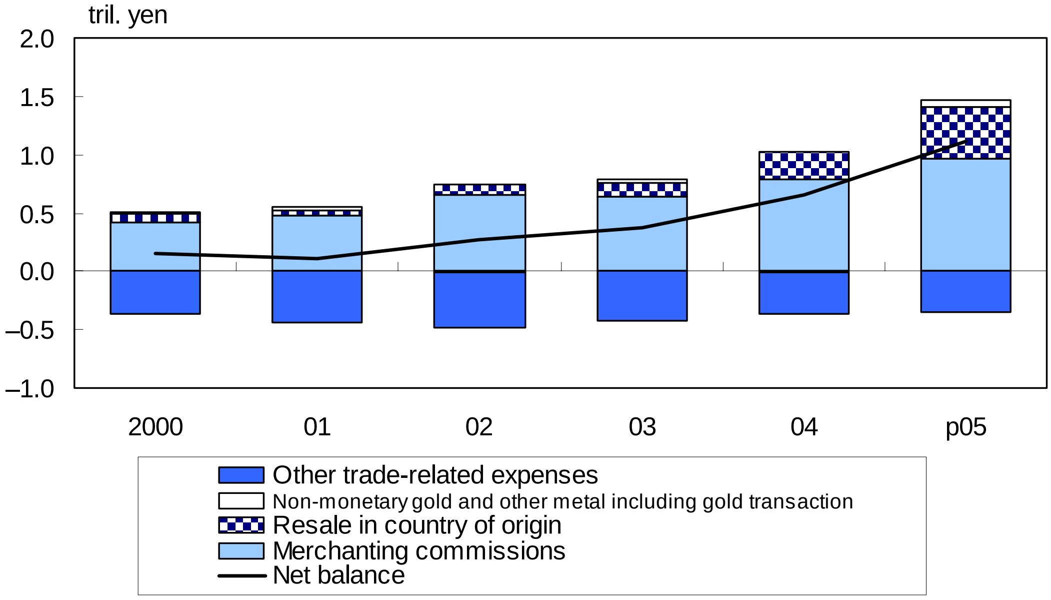
Figure 38: Other Investment (By Sector)



Box 1: Developments in Production and Distribution Networks in East Asia from the Perspective of Merchanting

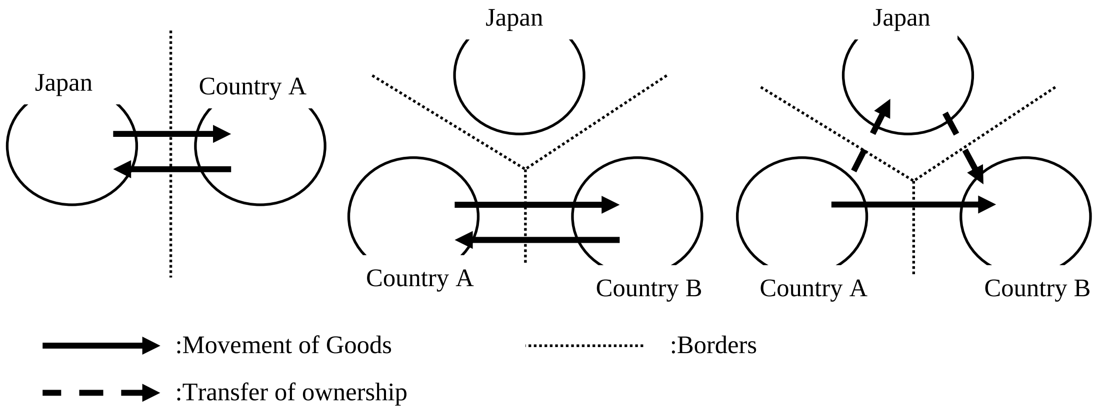
- "Merchanting and other trade-related services" a component of the balance of trade in other services, recorded a significant increase in credit in 2005. Among the sub-components "merchanting commissions" occupied the largest share and showed a significant increase.

Figure 1 for Box 1: Merchanting and Other Trade-Related Services



- Merchanting differs from cross-border transactions of goods between residents and nonresidents (import and export: Figure 2-A for Box 1), or transactions between nonresidents (Figure 2-B for Box 1). Merchanting covers the purchase of goods by residents from nonresidents (transfer of ownership) that are then resold to other nonresidents without crossing Japan's borders (Figure 2-C for Box 1).

Figure 2-A for Box 1: **Figure 2-B for Box 1 :** **Figure 2-C for Box 1:**



In the Balance of Payments Statistics, merchanting is not treated as a series of import/export transactions. Instead, the difference between the value of goods when

purchased and when sold (net balance on transactions) is treated as a services provided by traders. "Merchanting commissions" correspond to the value of these services rendered.

- In 2005, on a gross basis, sales in merchanting transactions amounted to 9.9 trillion yen, equivalent to 15.8 percent of Japan's exports (62.6 trillion yen). A breakdown by country (Figures 3-1 and 3-2 for Box 1) reveals the following patterns in Japanese companies' cross trade.

Figure 3-1 for Box 1: Merchanting Purchases

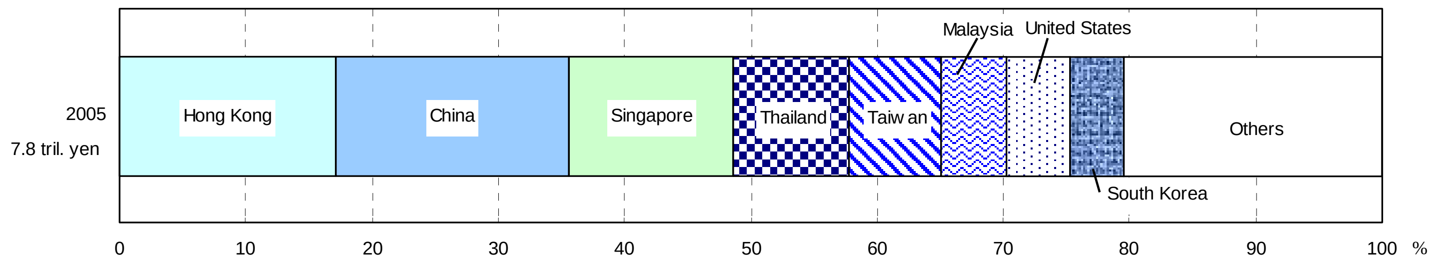
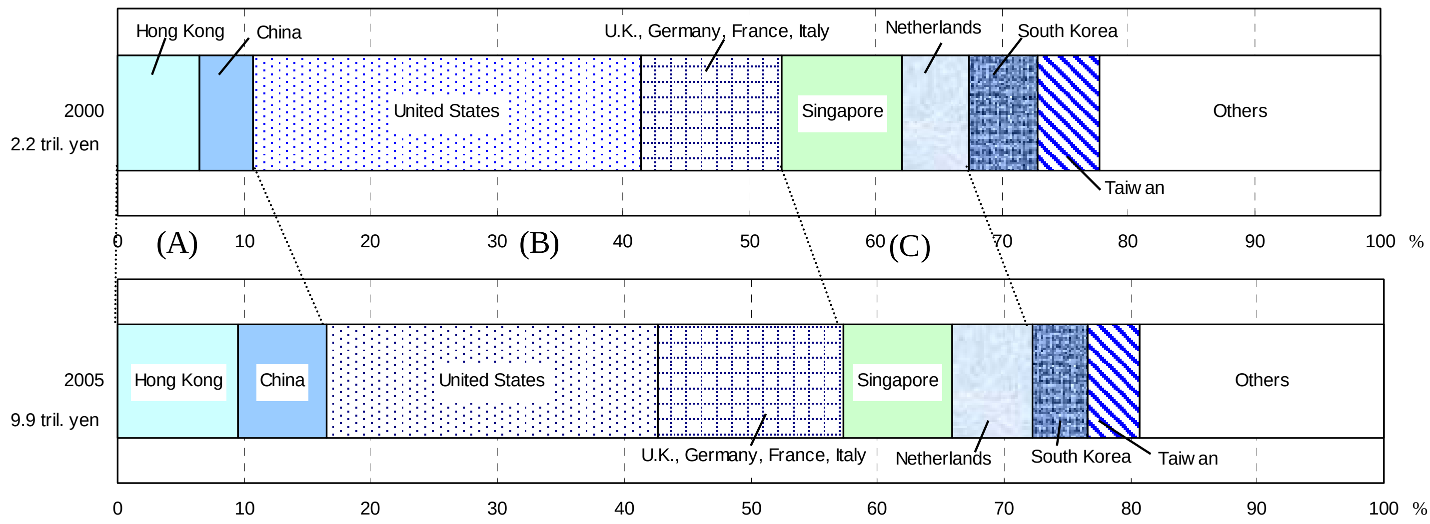


Figure 3-2 for Box 1: Merchanting Sales



Source: Compiled by the Bank of Japan.

1. The main portion of Japan's cross trade consists of the purchase of goods from manufacturing centers in Asia (Figure 3-1 for Box 1) and the resale to consumption centers in the United States and Western Europe (Section (B) of Figure 3-2 for Box 1).

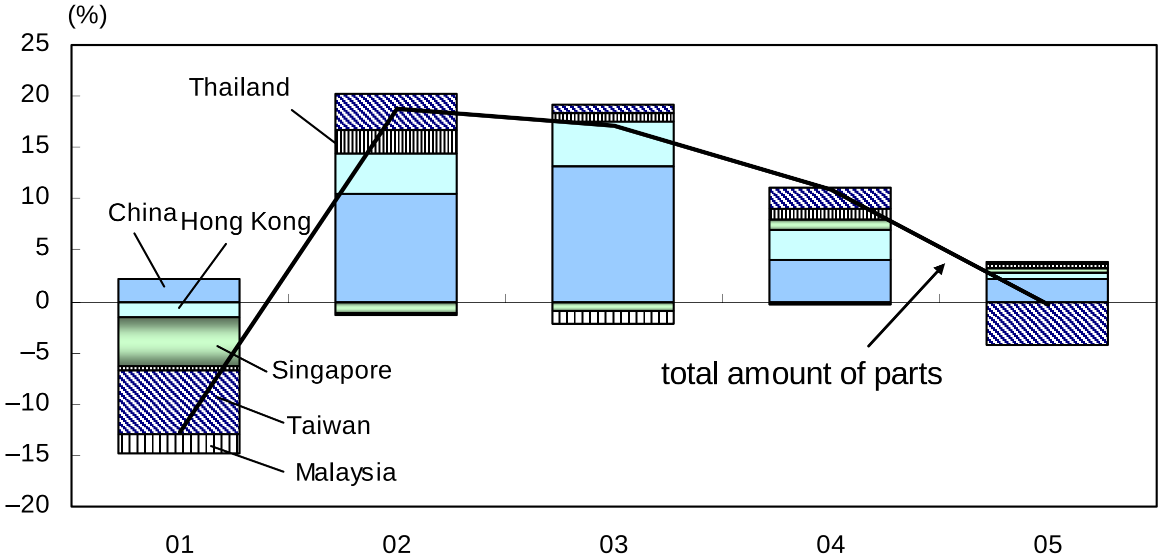
Transactions by item in cross trade are not recognized in the Balance of Payments Statistics, nor do they appear in customs statistics because they are not subject to customs clearance procedures in Japan. However, shipping companies report that a significant portion of goods transported in cross trade between Asia and the United States, and between Asia and Europe consists of consumer electronics and other electronic products, sundry goods, and furniture.

- Japan's cross trade also contains a substantial volume of resale to Singapore and the Netherlands (section(C) of Figure 3-2 for Box 1), which function as relay points in trade with Asian and European countries, respectively. No significant change in this structure is observed between 2000 and 2005.

2. A significant change that has taken place between 2000 and 2005 is that China's and Hong Kong's role as buyers in Japan's cross trade has gained in importance (Section (A) of Figure 3-2 for Box 1).

The following trends are likely to have contributed to this change. In recent years, manufacturing production in China has continued to accelerate, while the growth in exports of electronic parts and components from Japan to Hong Kong and China has slowed down (Figure 4 for Box 1). It appears that some of the parts and components exported from Japan to China and Hong Kong are being substituted by parts exported from Southeast Asia and other production bases. If these transactions are being arranged by Japanese companies, this will result in an increase in resales to Hong Kong and China. In fact, major Japanese manufacturers are trading parts and intermediate goods differentiated by the degree of processing among their cross-border networks of production and distribution, which is actively contributing to the international division of processing in East Asia. This development is particularly notable in the machinery industry.

Figure 4 for Box 1: Year-on-Year Growth in the Value of Exports of Parts and Components to East Asia (Parts for Computers, Electronic Circuits, Audio-Visual Apparatus, Semiconductors, and Motor Vehicles)



Source: Trade Statistics of Japan.

- The statistics on merchanting by country can be interpreted to suggest that production and distribution in East Asia are organized not only within individual countries, but instead shape cross-boarder networks spanning a number of countries.

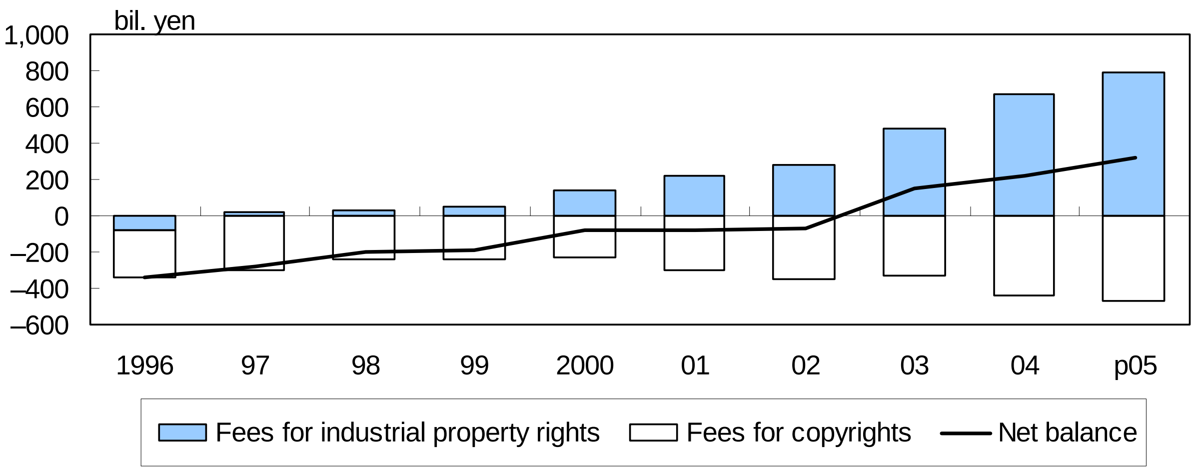
- It should be noted that "resale in country of origin" in Figure 1 for Box 1 differs from transactions related to "merchanting commissions." Specifically, "resale in country of origin" records the difference in the purchase and sales value of intermediate goods bought locally and then sold again locally by a Japanese company in China. Here, too, the weight of credit from China is increasing, rising to 2.9 percent in 2005 from 0.7 percent in 2000. However, the volume of this trade is equivalent to only 30 percent of that of the volume of merchanting. In 2005, resale in country of origin amounted to 197.4 billion yen as compared to merchanting sales of 692.6 billion yen.

Box 2: Breakdown of Royalties and License Fees by Region

- In the Balance of Payments Statistics, "royalties and license fees" constitutes one of the components of the balance of trade in "other services."[1] "Royalties and license fees," in turn, consist of "fees for industrial processes, franchises etc." (hereafter "fees for industrial property rights") and "fees for copyrights." The former includes payments accruing from industrial property (patents etc.), mining rights, and technical know-how. The latter is calculated by subtracting the amount of "fees for industrial processes, franchises, etc." from the total amount of "royalties and license fees."

- "Royalties and license fees" have shown a growing surplus since 2003 (Figure 1 for Box 2) as a result of the growing surplus in "fees for industrial property rights." On the other hand, "fees for copyrights" have shown a growing deficit in recent years, which is primarily due to payments of software licensing fees.

Figure 1 for Box 2: Developments in Royalties and License Fees



- A breakdown of "fees for industrial property rights" by region reveals the following:

1. Japan's balance in "fees for industrial property rights" with Asia has consistently been in surplus. Balances with North America and the European Union turned from deficit to surplus in 2002 and 2004, respectively.

2. While transactions with North America and the European Union include both credit and debit, transactions with Asia primarily consist of credit.

3. Credit in 2005 increased for all regions: North America, Asia, and the European Union. Credit from North America have been increasing every year since 1996

[1] In 2005, "royalties and license fees" account for 29 percent of the credit and 26 percent of the debit for other services.

when the current methodology (IMF, Balance of Payments Manual, Fifth Edition) was adopted.

Table 1 for Box 2: Industrial Property Rights by Region (Level, Net)

bil. yen

	Total			Asia			North America			European Union		
	credit	debit	net	credit	debit	net	credit	debit	net	credit	debit	net
1996	677.6	760.9	–83.3	292.8	16.4	276.5	257.2	549.3	–292.1	97.5	165.7	–68.2
97	790.9	771.0	19.9	303.0	23.2	279.7	343.2	553.0	–209.8	110.3	164.3	–54.0
98	871.4	839.3	32.1	266.8	82.2	184.6	409.7	568.0	–158.3	151.8	157.9	–6.2
99	871.1	821.4	49.6	232.4	99.1	133.3	471.4	534.1	–62.6	131.0	153.8	–22.7
2000	1,043.0	900.8	142.2	299.3	59.9	239.5	543.8	605.1	–61.3	159.4	184.1	–24.7
01	1,198.3	979.6	218.7	298.0	27.6	270.4	617.0	676.4	–59.4	224.8	231.9	–7.1
02	1,232.0	955.1	276.9	309.2	30.0	279.2	689.0	614.2	74.8	167.7	253.5	–85.7
03	1,342.1	859.0	483.1	340.3	19.5	320.8	737.1	590.9	146.2	187.7	209.2	–21.5
04	1,599.2	933.1	666.2	427.8	23.9	404.0	831.6	626.1	205.5	252.3	243.9	8.4
p05	1,832.6	1,045.8	786.7	520.2	33.5	486.7	903.1	775.3	127.8	290.1	224.8	65.3

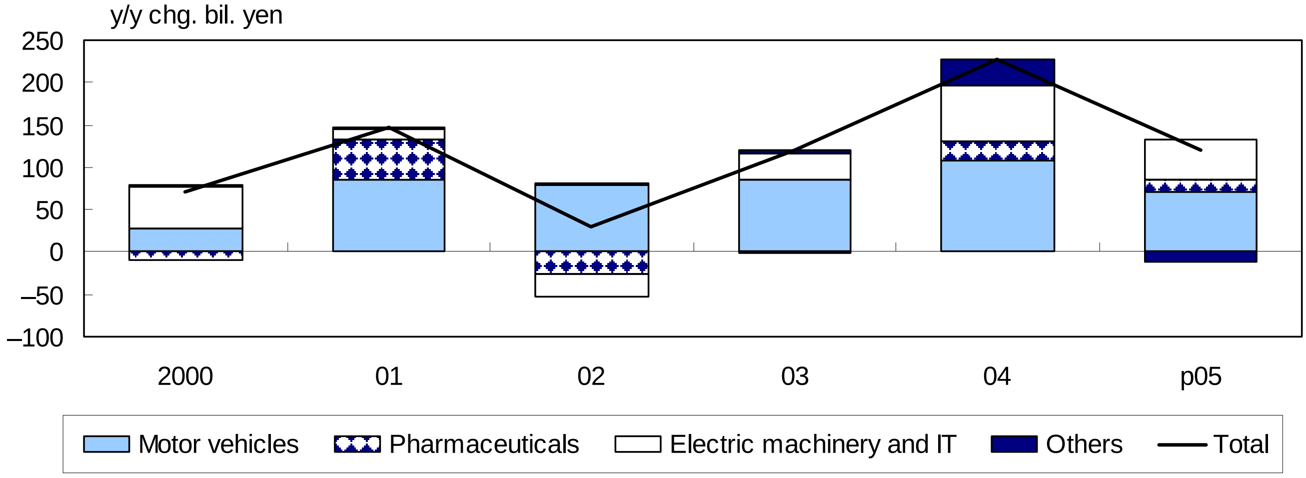
Note: Regional figures for 2005 are computed using year-on-year changes for the first through third quarter of 2005 to estimate the fourth quarter of 2005.

- The increase in credit of "fees for industrial property rights" was due to the increase in royalty credit resulting from the expansion of Japanese firms' overseas production and the expansion of the global economy.

  - The amount of royalty payments are frequently calculated by multiplying the amount of overseas production or sales by a given rate.

  - An analysis of "fees for industrial property rights" by industry shows that motor vehicles account for a considerable portion of credit (Figure 2 for Box 2). According to the Japan Automobile Manufacturers Association, year-on-year growth of overseas production by Japanese motor vehicle manufacturers came to 13.8 percent in 2004 and 8.8 percent in 2005 (year-on-year increase for the January – September period).

Figure 2 for Box 2: Credit for Industrial Property Rights, etc. (By Industry)



Note: Data are obtained by selecting and tallying large payments of one billion yen or more from reports submitted to the Bank of Japan. Therefore, these figures differ from those published in the Balance of Payments Statistics.

- Any continued increase in overseas production by Japanese manufacturers will be reflected in "fees for industrial property rights" in the Balance of Payments Statistics.

Box 3: Publication of Direct Investment Statistics by Industry and by Region

- Before the revision of balance of payments-related statistics, there were two sets of similar but differently defined statistics:[2] the direct investment statistics of the Balance of Payments Statistics, and "Foreign Direct Investment" statistics. As part of the revision,[3] which took effect in January 2005, the "Foreign Direct Investment" statistics were discontinued with the release in fiscal 2004, and were merged with the Balance of Payments Statistics. Since 2005, a breakdown of direct investment by country, region, and industry is being released on a quarterly basis as part of the revised Balance of Payments Statistics.

  - In the past, Balance of Payments Statistics did not include a breakdown of direct investment by industry and only provided a semi-annual breakdown by country and region covering 32 countries. The revised Balance of Payments statistics thus offer the following improvements to further promote user convenience.

    [1] The "Foreign Direct Investment" statistics, published on a semi-annual basis, provided a breakdown of direct investment by country, region, and industry, covering all countries and regions for which investments had been reported (withdrawals were not included). In the revised Balance of Payments Statistics, a breakdown by country, region, and industry of direct investment data (including withdrawals) are disseminated on a quarterly basis.

    [2] The breakdown by industry used in the "Foreign Direct Investment" statistics (17 industries for outward and 14 industries for inward investment) was expanded based on the "Standard Industrial Classification for Japan," the UN "International Standard Industrial Classification," and with reference to past investment trends and now covers a total of 22 industries for both outward and inward direct investment, consisting of 12 manufacturing industries and 10 non-manufacturing industries.

- The tables below show the outward and inward direct investment data by industry and region for the first to third quarter of 2005.

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[2] The former, in principle, is based on the IMF *Balance of Payments Manual* (Fifth Edition), which defines the international standards for balance of payments statistics. The latter is based on Japan's own standards. There are significant differences in definitions between the two, particularly with regard to the treatment of withdrawals and reinvested earnings.

[3] For details, see "Revision of Balance of Payments Related Statistics" (released on December 30, 2004 on the Bank of Japan website (http://www.boj.or.jp/en/index.htm).

Table 1 for Box 3: Outward Direct Investment by Foreign Subsidiaries' Industry and Region

bil. yen

	Finance and insurance	Transportation equipment	General, electrical, and precision machinery	Chemicals and pharmaceuticals	Wholesale and retail	Total (including other industries)
World	–841.1	–685.4	–567.9	–224.4	–147.0	–3,383.1
Asia	–217.3	–152.4	–273.6	–79.9	–54.8	–1,157.2
Of which: P.R. China	–37.8	–79.5	–137.8	–49.6	–37.4	–504.1
North America	–5.5	–365.2	–166.3	–67.4	–56.6	–802.4
EU	–145.6	–58.4	–112.0	–65.7	0.3	–684.2
Central and South America	–412.3	–59.6	–4.5	–4.2	12.5	–579.8
Oceania	11.7	–29.2	3.3	–0.4	–31.1	–85.6
Other regions	–72.1	–20.6	–14.8	–6.8	–17.3	–73.9

Notes: 1. Negative figures indicate net investment (outflow of capital).
2. Holding companies are classified by the industry of affiliated enterprises.

Table 2 for Box 3: Inward Direct Investment by Foreign Parent Companies' Region and Japanese Subsidiaries' Industry

bil. yen

	Transportation	Finance and insurance	Wholesale and retail	Transportation equipment	Communications	Total (including other industries)
World	219.0	186.7	76.3	59.5	57.0	756.8
EU	203.5	63.0	–8.8	53.5	0.4	350.9
North America	–0.1	108.4	68.5	2.6	67.0	291.2
Central and South America	13.3	15.7	–0.2	–0.4	–9.4	69.8
Asia	–0.3	7.1	1.0	X	0.3	23.4
Oceania	–	–11.9	–	–	–	–13.8
Other regions	2.6	4.4	15.8	3.8	–1.3	35.3

Notes: 1. Negative figures indicate net withdrawals (outflow of capital).
2. Data items for which less than three reports are available are marked with an "X" to maintain confidentiality. When there are no reports, they are indicated by "–."
3. Holding companies are classified by the industry of affiliated enterprises.

- As direct investment data are now broken down into smaller categories, the number of reports for each item can become very small, leading to the possibility that information on the transactions of individual companies may be revealed. To prevent this, data items for which less than three reports are available are not disclosed in the breakdowns by region/country and industry in the Balance of Payments Statistics.

Box 4: Classification of Foreign Direct Investment by Type of Investment

- Since 2005, foreign direct investment data are available on a quarterly basis, broken down by region/country and industry (see Box 3). Based on these data, it is possible to gauge the magnitude of investment flows by country and industry.

  In addition, it is also useful to clarify the type of foreign direct investment. As mentioned earlier, outward direct investment activity involving corporate acquisition and equity participation (generally referred to as M&A) for the purpose of expanding existing businesses was brisk in 2005. However, existing classifications of foreign direct investment data provide no quantitative information on the extent of such investment. This problem could be resolved if foreign direct investment were to be classified by the type of investment. Furthermore, such a classification would allow an examination of rates of return on foreign direct investment and of the impact on a host country's economy (e.g., job creation) by the type of investment.

- Foreign direct investment can be divided into two major types of investment: M&A investment and greenfield investment. Generally, M&A investment refers to the acquisition of, equity participation in, or merger with an existing company, while greenfield investment refers to the establishment of a new company without transferring of business from existing companies.[4] One possible approach to classify an investment is to consider how the invested capital is used by the ultimate investee enterprise (see Table 1 for Box 4). This method allows for the following classification. Greenfield-type investment can be defined as investment that increases the tangible fixed assets (e.g., factories, equipment) of the ultimate investee enterprise. M&A-type investment can be defined as investment that does not increase tangible fixed assets, such as the acquisition of shares. On the other hand, investment for financial restructuring can be defined as investment that does not increase the total asset base of the ultimate investee enterprise.

Table 1 for Box 4: Definitions for the Classification of Foreign Direct Investment by Investment Type

<table>
<tr><th>Components</th><th colspan="2">Definition</th></tr>
<tr><td>(a) Initial M&A-type investment</td><td rowspan="2">It is a first-time investment by a direct investor in a direct investment enterprise, and…</td><td>...the invested capital is used for the acquisition of shares issued by an existing enterprise.</td></tr>
<tr><td>(b) Initial greenfield-type investment</td><td>...the invested capital is used for the acquisition of shares issued by a newly established enterprise.</td></tr>
<tr><td>(c) Additional M&A-type investment</td><td rowspan="3">It is not a first-time investment by a direct investor in a direct investment enterprise, and…</td><td>...the invested capital is not used for the acquisition of tangible fixed assets of an enterprise (or, it is used for the acquisition of shares already issued by an existing enterprise).</td></tr>
<tr><td>(d) Additional greenfield-type investment</td><td>...the invested capital is used for the acquisition of tangible fixed assets of an enterprise.</td></tr>
<tr><td>(e) Investment for financial restructuring</td><td>...the invested capital does not increase the asset base of the enterprise and is used for debt repayment.</td></tr>
</table>

Note: These definitions assume that the target enterprise is the ultimate investee enterprise.

4 Kyoji Fukao and Tomofumi Amano, *Tainichi chokusetu toshi to nihon keizai* (Inward Direct Investment and the Japanese Economy), Nihon Keizai Shimbun, Inc. (2004).

- Categories (a) and (c) can be grouped into M&A-type investment, while categories (b) and (d) can be grouped into greenfield-type investment; and categories (a) and (b) can be grouped into initial investment, while categories (c) and (d) can be grouped into additional investment.

- In addition to above categories, investments in corporate-type investment trusts and acquisition of non-voting shares issued by SPEs, (i.e., preferred stocks etc.) are included in foreign direct investment.

(1) Summary of Classification Results

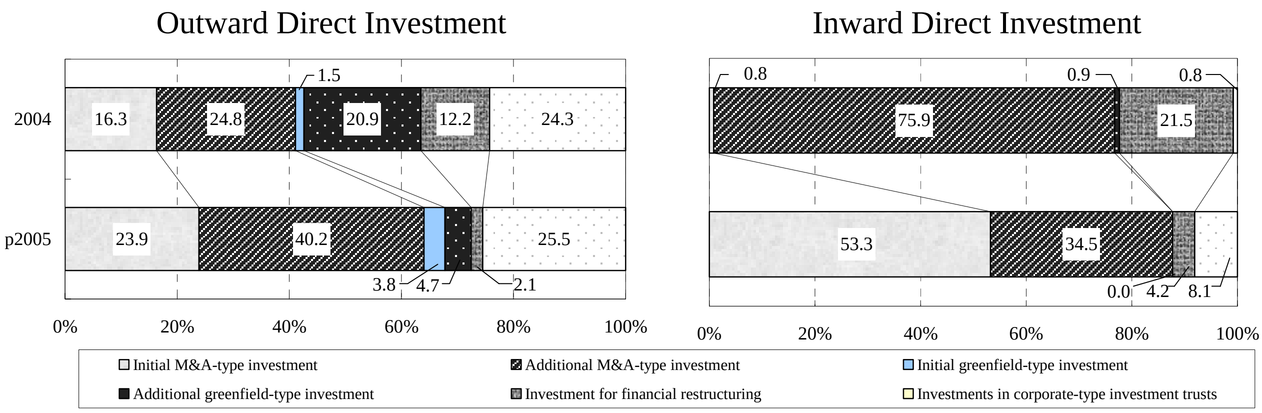
- Applying the above classification to foreign direct investment data (realized investments worth 10 billion yen or more) as determined by whether or not the investment results in increase of tangible fixed assets yields the following patterns (percentages are based on transaction values).

  - It should be noted that because surveys do not cover all investments, the results should be interpreted with a degree of range.

    [1] M&A-type investment accounts for a high share of both outward (approximately 40-60 percent) and inward (approximately 80-90 percent) direct investment. In 2005, the share of initial M&A-type investment in inward direct investment showed a particularly large increase.

    [2] Greenfield-type investment accounts for only a very small proportion of inward direct investment, but makes up about 10-20 percent of outward direct investment.

Figure 1 for Box 4: Foreign Direct Investment by Type of Investment (transactions of 10 billion yen or more)



Note: Share of cases investigated in total equity capital investment (on a transaction value basis).

Outward investment: 2004: 28.8 percent; 2005: 38.0 percent

Inward investment: 2004: 63.9 percent; 2005: 39.2 percent

(2) About the classification methodology

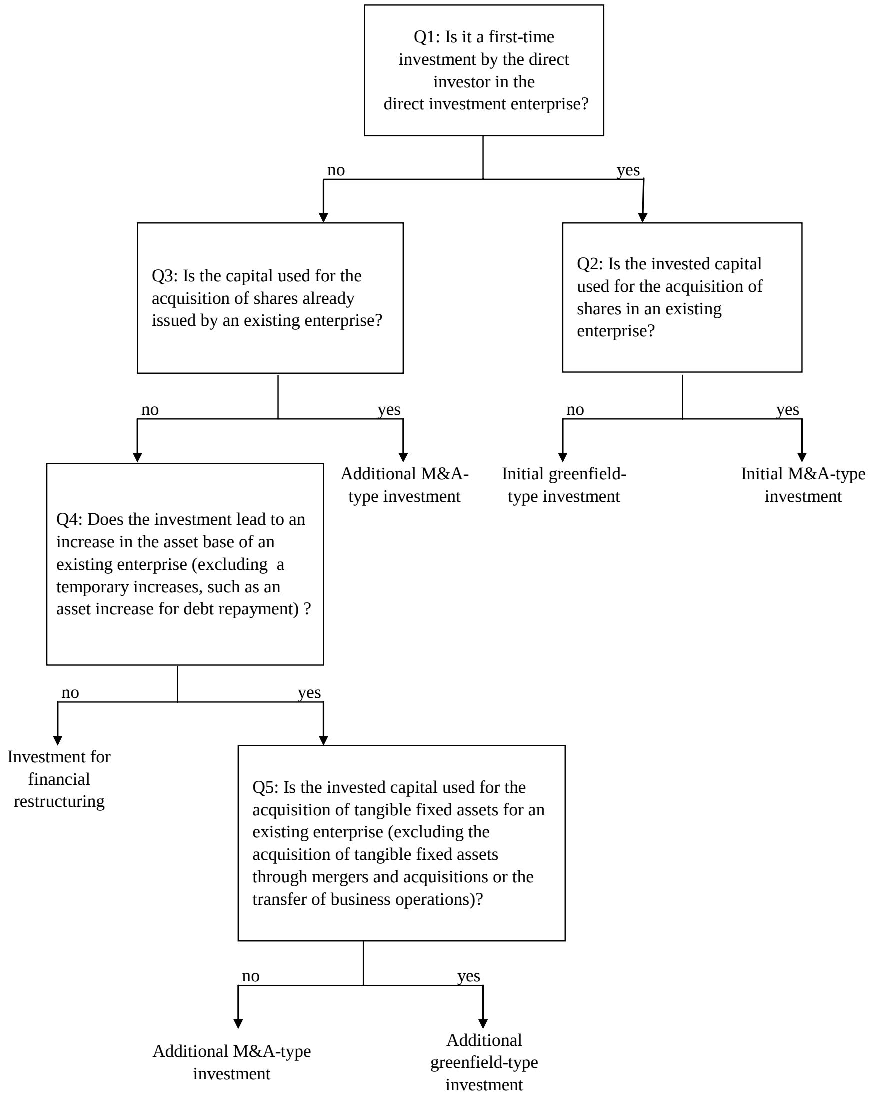
- Most previous surveys on foreign direct investment have primarily focused on initial investment and were designed to identify M&A investment. For this reason, when analyzing the economic impact of outward and inward direct investment (such as on job creation), it was not possible to undertake comparisons that included additional M&A-type and greenfield-type investments. Moreover, the specific methods of classification contained various practical problems, such as the classification of investment by "investors' aims." In contrast, the methodology described above has the following advantages (see Figure 2 for Box 4 for a classification flow chart):

  [1] It covers a wider range of investments, including not only initial investment but also additional investment that accounts for a substantial part of overall foreign direct investment.

  [2] In addition to M&A-type investment, greenfield-type investment is defined and identified.

  [3] The methodology makes it possible not only to analyze the relationship between a direct investor and a direct investment enterprise, but also to determine the purpose for which the ultimate investee enterprise, which may be an affiliate of the enterprise in which the investment takes place, uses the capital. Thus, investment that appear to be M&A-type investment can be appropriately classified as greenfield-type investment if it involves an increase in tangible fixed assets.

Figure 2 for Box 4: Flow Chart to Classify Foreign Direct Investment by Type of Investment



Q1: Distinguishes initial and additional investment.

Q2: Classifies initial investment into initial M&A-type investment (the acquisition of shares of an existing company) and initial greenfield-type investment (the acquisition of shares of a newly established company).

Q3: Classifies additional investment into additional M&A-type investment (the acquisition of outstanding shares) and other types of investment.

Q4: Classifies investment that is not additional M&A investment under Q3 above into investment for financial restructuring (investment that does not increase total assets, e.g., debt repayments) and other types of investment.

Q5: Classifies investment that is not for financial restructuring under Q4 above into additional greenfield-type investment (the acquisition of tangible fixed assets for the enterprise that is the ultimate investee enterprise) and additional M&A-type investment.

Note: These definitions assume that the target enterprise is the ultimate investee enterprise.

- Corporate-type investment trusts and acquisition of non-voting shares issued by SPEs can be classified by their legal properties and are separated from other investments before the classification according to the above chart is applied. All other investments are classified using the above chart.

Box 5: Outward Portfolio Investment by the Household and the Non-financial Sector in 2005

- In 2005, Japanese retail investors seeking higher yields actively engaged in outward portfolio investment. Looking at investment by component, a conspicuous feature is that investment in products with high currency risk and large price movements, such as unhedged global sovereign bonds, emerging market funds, structured bonds and the like registered an increase.

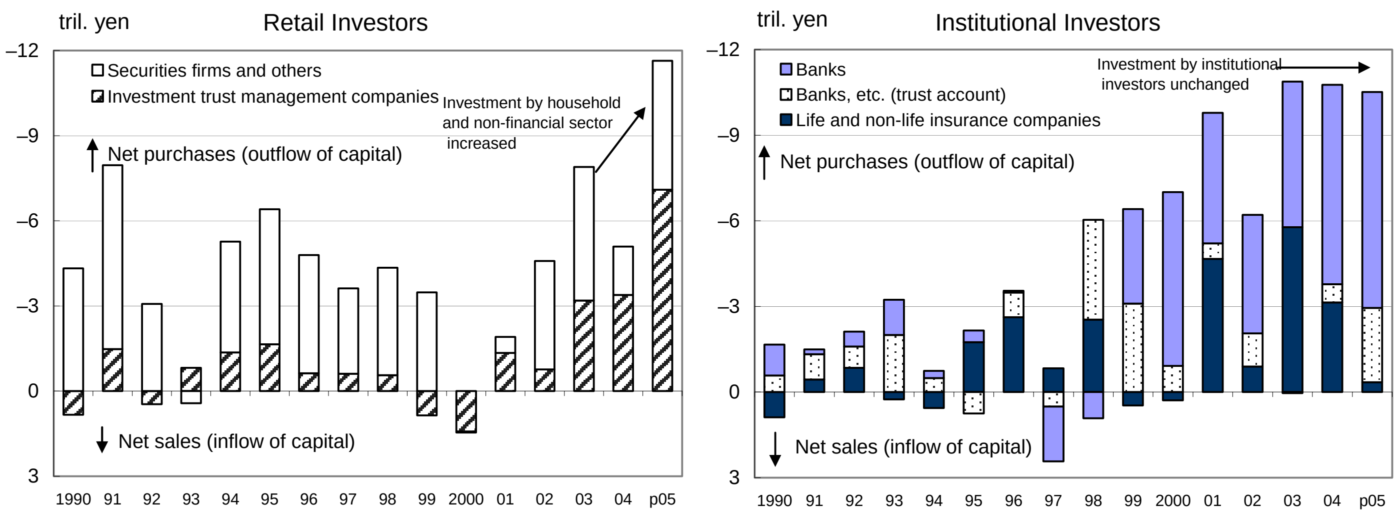
(1) Outward investment in bonds and notes

- A review of outward investment in bonds and notes by investor category in 2005 shows that net acquisitions by Japanese institutional investors (banks, trust banks, and life and non-life insurance companies) remained essentially unchanged from the previous year. Net acquisitions by Japanese retail investors, such as households and non-financial corporations, meanwhile, increased substantially from 2004 to reach 11.6 trillion yen.[5] This exceeded net acquisitions by institutional investors in 2005, which came to 10.5 trillion yen. The following three salient features can be identified.

  - Investment trust management companies are placed in the category of retail investors because the household sector is the principal buyer of investment trusts.

[5] In the Balance of Payments Statistics, outward portfolio investments executed by nonresidents (acquisitions of securities) are indicated with a minus sign, while withdrawals of outward portfolio investment (sale of securities) are indicated without a sign. However, in the text of this Box, amounts of securities acquired and sold are both indicated without a sign in order to avoid confusion between increases and decreases.

Figure 1 for Box 5: Outward Investment in Bonds and Notes by Investor Category[6]



[1] Capital flows into monthly-distribution-income type global sovereign bond funds.

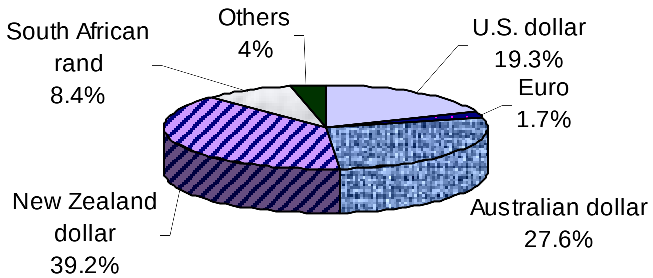
Investment in foreign bonds and notes by "investment trust management companies" increased sharply, to 7.1 trillion yen in 2005 from 3.4 trillion yen in 2004. This increase reflects a stronger preference shown, primarily by the household sector, for receiving interest earned on sovereign bonds in the form of monthly payouts of dividends over averting a potential decrease in the original principal caused by foreign exchange fluctuations.

[2] Investment in high interest-rate foreign currency bonds (mainly Oceanian currencies)

Purchases of newly-issued foreign bonds by securities companies for the purpose of targeting sales to retail investors remained at high levels, increasing to 2.1 trillion yen in 2005 from 2.0 trillion yen in 2004. A breakdown of purchased bonds by currency shows that roughly 70 percent are denominated in high interest-rate currencies (New Zealand and Australian dollars). The credit risk of such bonds is limited because they mainly consist of bonds and notes issued by highly-rated international organizations. At the same time, the interest they pay is high. It would appear that for these reasons, retail investors showed a preference for these bonds regardless of the risk associated with exchange-rate fluctuations.

6 Based on "Securities Investment at Home and Abroad" through 2004, and Balance of Payments Statistics beginning in 2005.

Figure 2 for Box 5: Currency Weights of Bonds Purchased by Securities Companies for Retail Sales during 2005



<Reference: Yield on 5-Year Bond>

	Average during 2005
New Zealand	6.0%
Australia	5.3%
United States	4.0%
Germany	2.8%

Source: Bloomberg.

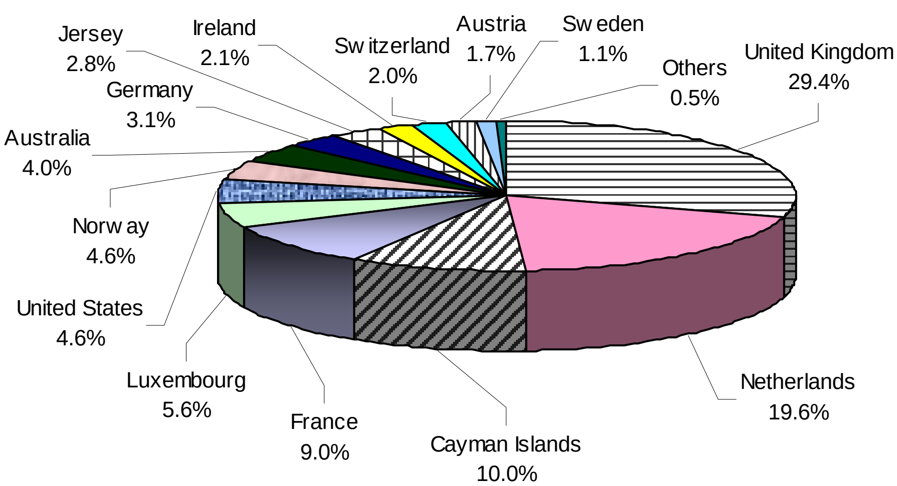
Note: Figures are based on gross purchases, tallied by the Bank of Japan.

[3] Investment in foreign structured bonds

Acquisitions of foreign industrial bonds (corporate bonds, securitized products, etc.) by Japanese securities companies, individuals etc. increased markedly, totaling 3.2 trillion yen in 2005. A breakdown by currency of these industrial bonds purchased by those investors indicates that a large portion is denominated in the Japanese yen. By country of residence of issuer, the United Kingdom, the Netherlands, the Cayman Islands, and Luxembourg accounted for a large share. Most of these are yen-denominated structured bonds issued by overseas subsidiaries or by SPCs, and are linked to foreign exchange rates and domestic stock prices. Primary purchasers are wealthy individuals and non-financial corporations aiming to raise their investment returns.

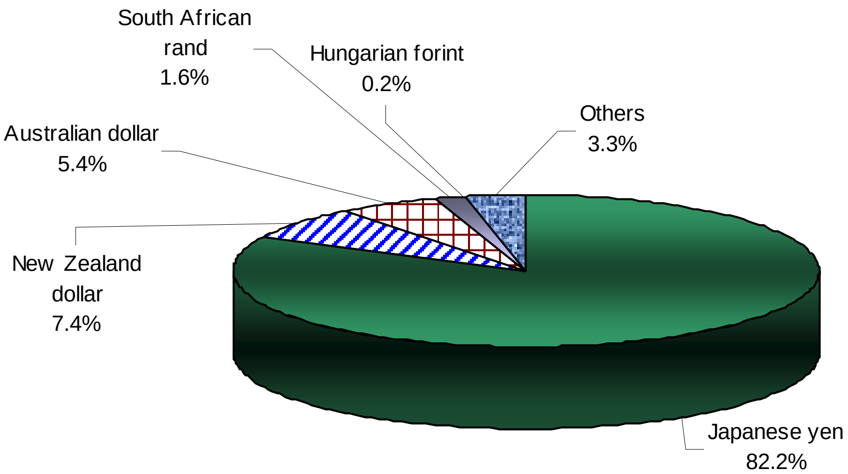
Figure 3 for Box 5: Investment in Industrial Bonds by Individuals and Non-financial Corporations during 2005

Breakdown by Country of Non-resident Issuer



Note: Figures are on a net basis (acquisitions minus sales), tallied by the Bank of Japan.

Breakdown by Currency of Denomination



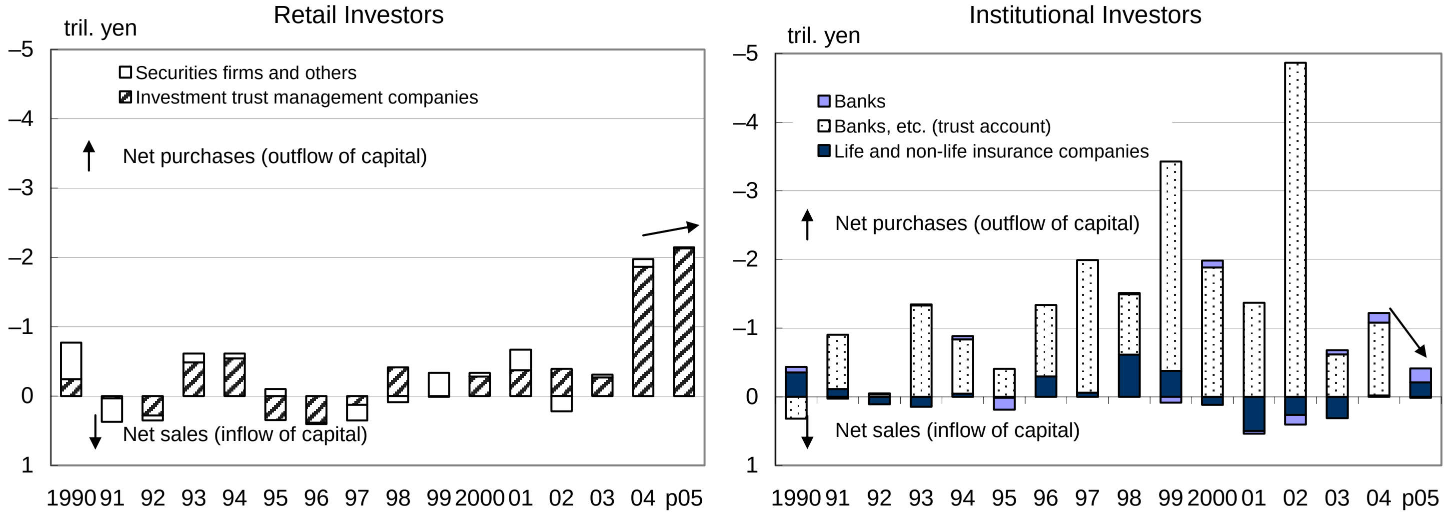
Note: Figures are on a net basis (acquisitions minus sales), tallied by the Bank of Japan.

(2) Outward investment in equities

- A review of outward investment in equities by investor category indicates that acquisitions of foreign equities by Japanese institutional investors decreased to 0.4 trillion yen in 2005 from 1.2 trillion yen in 2004. In contrast, acquisitions by retail investors increased to 2.1 trillion Japanese yen in 2005 from 2.0 trillion in 2004. This reflected the flow of funds from the household sector into investment trusts.

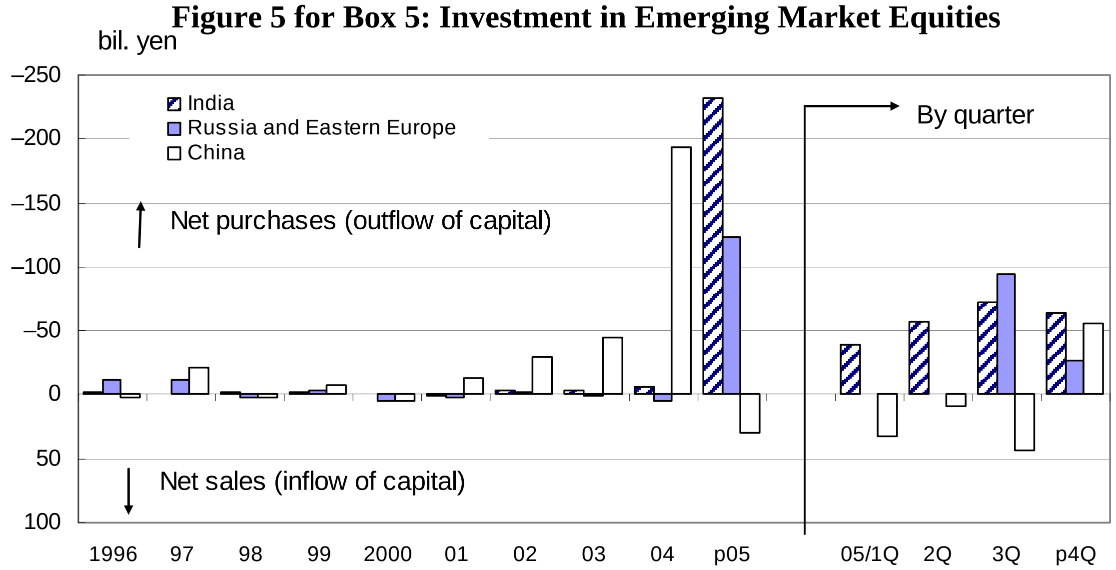
  - Capital flows into investment trusts might include the flow of surplus funds of small and medium sized financial institutions into private placement investment funds. Therefore, it should be noted that these figures do not necessarily reflect only investment by the non-financial sector (including the household sector).

Figure 4 for Box 5: Outward Investment in Equities by Investor Category[7]



A regional breakdown of foreign equities increasingly purchased by investment trust management companies reveals that acquisitions of emerging market equities, which were small in the past registered particularly large increases in 2005 as well as in 2004. While Chinese equities were sold as stock markets in the country stagnated, investment in Indian, Russian, and Eastern European equities increased in response to increasing stock prices in each market. Purchases of overseas REITs, which are classified as "equities," are also believed to have been high. This can be surmised from the growth of foreign REITs, whose outstanding assets increased to 1.1 trillion yen as of year-end 2005 from 0.5 trillion yen as of year-end 2004 (estimated by the Bank of Japan based on statistics published by the Investment Trusts Association, Japan). The increase may reflect the preference of household sector and other investors for rising market prices of U.S. REITs.

Figure 5 for Box 5: Investment in Emerging Market Equities



Note: Figures represent net acquisitions by resident investors, with the largest part accounted for by investment trust management companies.

[7] Based on "Securities Investment at Home and Abroad" through 2004, and Balance of Payments Statistics beginning in 2005.

<Reference>

Breakdown of Assets (Equities) in Investment Trusts

bil. yen

	Year-end 2004	Year-end 2005
U.S. dollar	932.4	1,548.5
Hong Kong dollar	690.6	527.7
Indian rupee	6.8	296.8
Euro	115.4	214.9
U.K. pound	85.0	166.6
Chinese yuan	0.0	13.6
Total (including other currencies)	2,032.3	3,241.2

Note: Chinese stocks denominated in the Hong Kong dollar are included under the Hong Kong dollar.
Source: Investment Trusts Association, Japan

Table 1 for Box 5: Prices in Foreign Markets

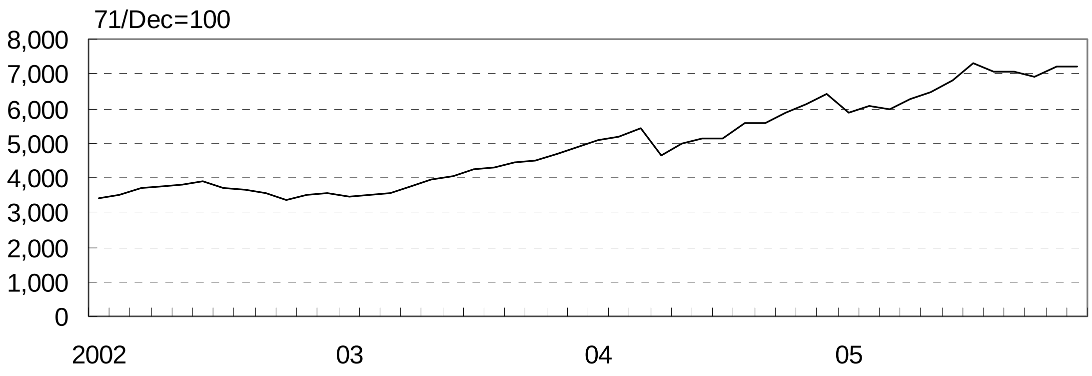
Rate of Increase of Stock Prices in Major Emerging Markets

(%)

	2003	2004	2005
India (SENSEX30)	72.2	11.6	40.7
Russia (RTS)	58.0	8.3	83.3
Czech (PX50)	49.5	75.9	48.3
Poland (WIG)	34.5	51.6	42.4
China (Shanghai B)	-2.0	-28.7	-17.6

Note: Percentage change during each year.
Source: Bloomberg.

Performance Index of U.S. REITs



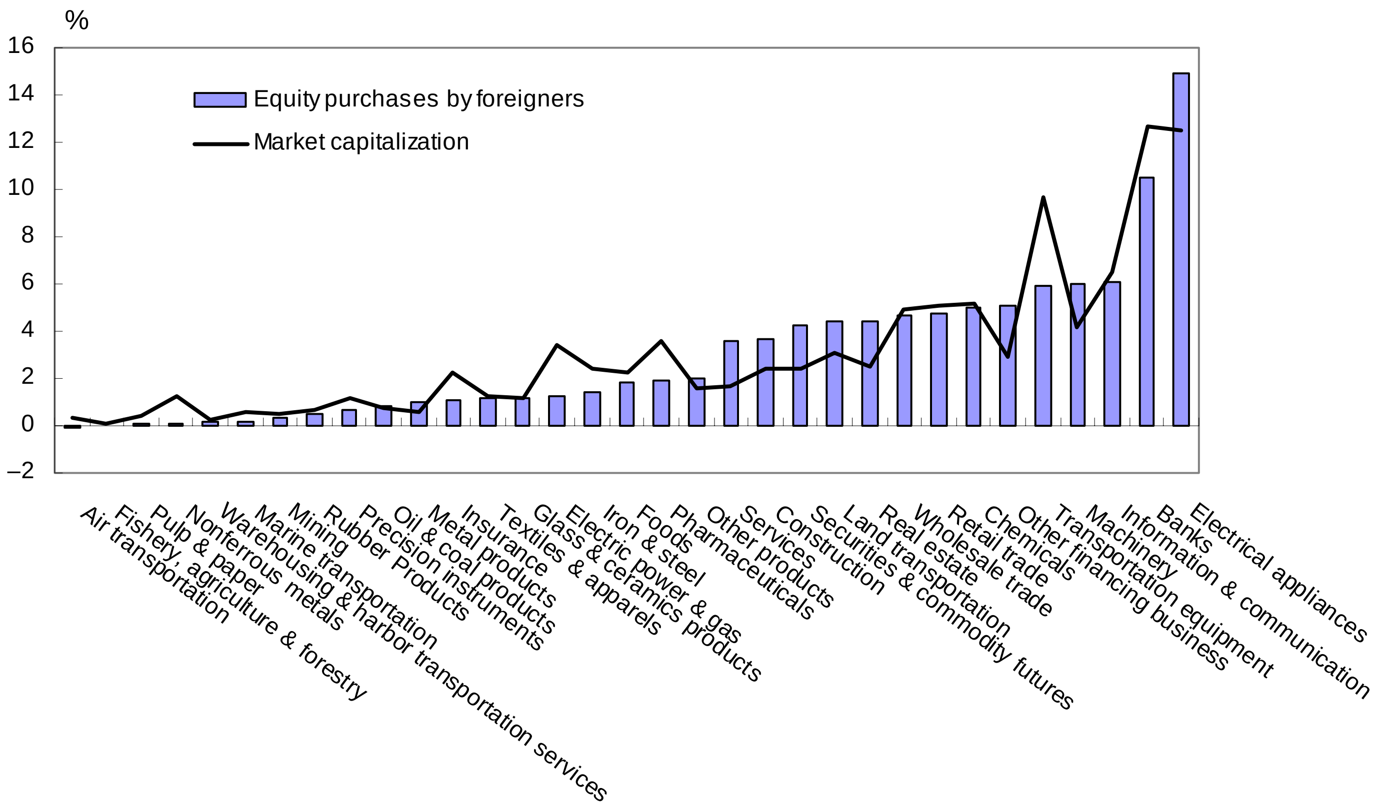
Source: National Association of Real Estate Investment Trusts.

- As seen above, purchases by Japanese retail investors of foreign securities with expected high returns that involved some risk posted an increase. In addition to the continued low level of domestic interest rates, the increase in these investments could have been influenced by the following factors: (1) the household sector's capacity to bear risk has increased due to the improved employment and income situation; (2) as "baby boomers" reach retirement and receive their retirement benefit, there is a growing incentive for investment in assets; and (3) Japanese banks have shifted their retail strategies to emphasize commission income and have strengthened their marketing of investment trusts at bank branches.

Box 6: Inward Investment in Equities by Foreign Investors by Industry in 2005

- Inward investment in equities by foreigners posted a sharp increase, jumping by 3.4 trillion yen to 14.0 trillion yen. Foreign investors acquired a broad range of Japanese equities during 2005. Comparing the industry distribution of inward investment in equities and of market capitalization on the First Section of the Tokyo Stock Exchange reveals that both distributions were relatively similar, suggesting that foreigners were "buying into Japan," rather than only a few selected industries (Figure 1 for Box 6).

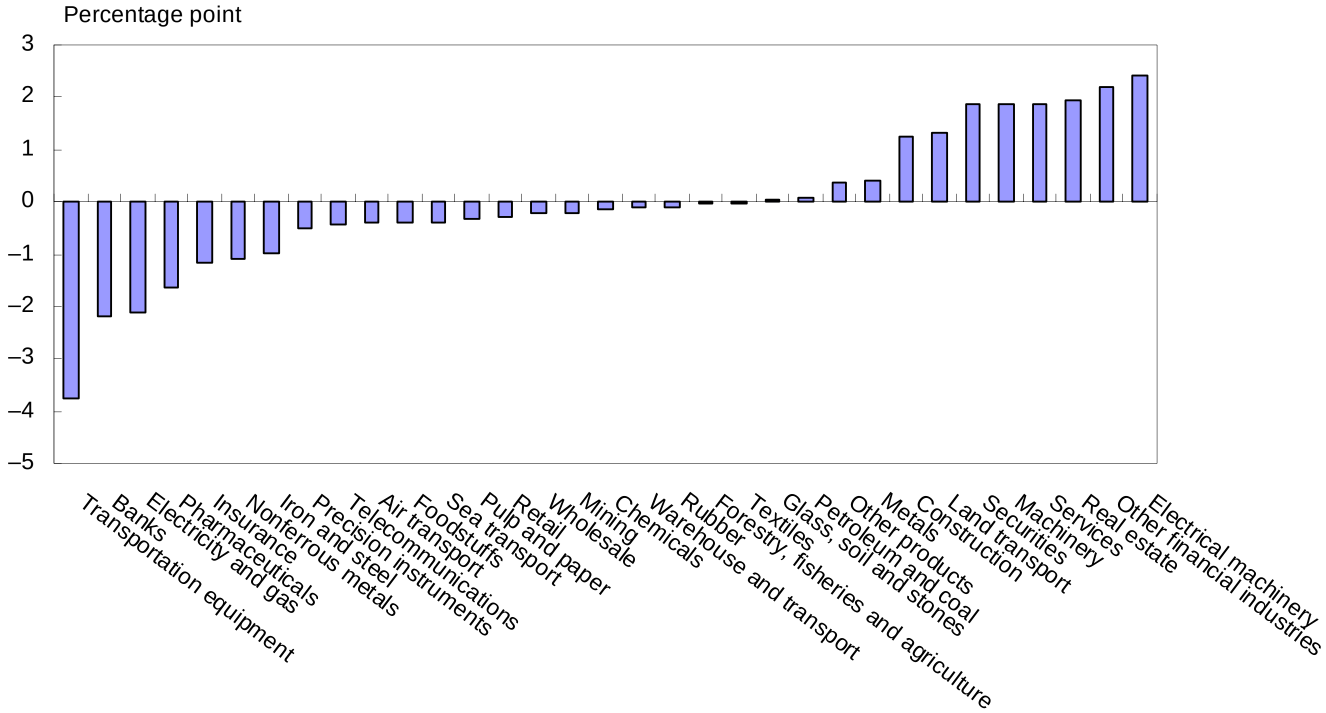
Figure 1 for Box 6: Equity Purchases and Market Capitalization by Industry



Note: Figures indicate the percentage shares.

- A more detailed picture of investment behavior can be obtained by examining the differentials between the weight of an industry in equity purchases by foreigners and market capitalization. This comparison suggests that foreign investors prefer to invest in the following sectors: the electrical machinery and machinery industry, selected because an improvement in corporate performances is expected; the construction and real estate industry, selected because of progress in the disposal of nonperforming loans and the bottoming out of land prices; and, securities companies, selected because of the higher level of stock transactions (Figure 2 for Box 6). In the case of transportation equipment and banks, while the value of purchases was relatively high, the weight of such purchases stood below the market capitalization weights.

Figure 2 for Box 6: Industry Preferences of Foreign Investors as Indicated by Equity Purchases in Comparison with Market Capitalization



Note: Figures are calculated by subtracting the percentage share of the market capitalization from that of equity purchases.

- A review of investment behavior by quarter shows that inward investment in equities was particularly active in the July-September quarter. During this period, purchases of equities of banks and machinery companies exceeded the percentage share of their market capitalization and their stock prices rose faster than the TOPIX. Purchases of banking sector shares leveled off in the October-December quarter, while purchases of machinery, electrical machinery and retail sector shares exceeded the market capitalization weights during this period, indicating a cyclical trend in investment (Table 1 for Box 6).

Table 1 for Box 6: Quarterly Inward Investment in Equities by Industry

	Market caputalization weight at end-December	1st quarter			2nd quarter			3rd quarter			p4th quarter		
		Net purchases (bil. yen)	Acquisition weight (%)	Rise in stock prices (%)	Net purchases (bil. yen)	Acquisition weight (%)	Rise in stock prices (%)	Net purchases (bil. yen)	Acquisition weight (%)	Rise in stock prices (%)	Net purchases (bil. yen)	Acquisition weight (%)	Rise in stock prices (%)
Chemicals	**5.2**	65.8	(2.2)	<3.4>	92.0	(13.3)	<0.9>	267.8	(4.8)	<13.0>	273.3	(6.0)	<59.8>
Machinery	**4.2**	192.7	(6.5)	<8.5>	29.7	(4.3)	<2.2>	286.1	(5.1)	<26.8>	326.2	(7.1)	<21.0>
Electrical machinery	**12.5**	576.7	(19.5)	<0.9>	–0.8	(–0.1)	<–0.0>	664.6	(11.8)	<7.2>	826.9	(18.1)	<18.3>
Transportation equipment	**9.7**	144.9	(4.9)	<–0.9>	92.8	(13.4)	<–0.3>	266.7	(4.7)	<24.6>	320.9	(7.0)	<12.3>
Telecommunications	**6.5**	170.1	(5.7)	<–1.1>	188.9	(27.2)	<–4.6>	227.5	(4.0)	<15.1>	253.6	(5.5)	<8.2>
Wholesale	**4.9**	56.4	(1.9)	<6.3>	74.4	(10.7)	<2.3>	423.4	(7.5)	<28.3>	92.7	(2.0)	<30.7>
Retail	**5.1**	107.7	(3.6)	<3.2>	–72.1	(–10.4)	<–1.9>	283.2	(5.0)	<21.9>	340.7	(7.5)	<30.5>
Banks	**12.7**	213.0	(7.2)	<–0.4>	–7.3	(–1.1)	<–1.3>	915.7	(16.3)	<37.0>	328.8	(7.2)	<17.1>
All industries/TOPIX average (including other industries)		2,963.1	(100.0)	<2.8>	693.7	(100.0)	<–0.4>	5,634.2	(100.0)	<20.0>	4,571.1	(100.0)	<16.8>

• Left column: Net purchases by foreign investors.
• Middle column: Purchase weights by industry (%).
• Right column: Rise in the TOPIX (%).
* Major industries with market capitalization ratio (First Section, Tokyo Stock Exchange) exceeding 4 percent as of end-December.