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November 1, 2013
Bank of Japan

Outlook for Economic Activity and Prices

October 2013

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

The Bank's View[1]

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

A. Outlook for Economic Activity

Japan's economy has been recovering moderately. On the demand side, while exports have been picking up at a somewhat slower pace, domestic demand, notably private consumption, has been firm. Reflecting such domestic and external demand, on the production side, the pace of increase in industrial production has remained moderate while activity in the nonmanufacturing sector, including services and construction, has been somewhat strong.

Looking ahead, while domestic demand is likely to maintain firmness as external demand is expected to increase, albeit moderately, a virtuous cycle among production, income, and spending is likely to be maintained. Therefore, while the economy will be affected by the front-loaded increase and subsequent decline in demand prior to and after the two scheduled consumption tax hikes, it is likely to continue growing at a pace above its potential, as a trend.[2]

The above projection assumes the following underlying developments.

First, as the Bank of Japan steadily pursues quantitative and qualitative monetary easing (QQE), financial conditions are likely to become more accommodative. Namely, under the QQE, upward pressure on nominal long-term interest rates has been contained while inflation expectations have been rising on the whole, and thus real interest rates are trending downward. The year-on-year rate of change in the amount outstanding of bank lending has been rising moderately. Stimulative effects of such accommodative financial conditions on private demand are likely to strengthen as economic activity improves.

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[1] The text of "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on October 31, 2013.

[2] Japan's potential growth rate -- under a certain methodology -- is estimated to be "around 0.5 percent" on average during the projection period, and is expected to rise gradually toward the end of the projection period. However, it should be noted that estimates of the potential growth rate are subject to a considerable margin of error as they rely on the specific methodology employed and could change as more data for the relevant period become available.

Second, while overseas economies have been somewhat weaker than anticipated at the time of the *Outlook for Economic Activity and Prices* (Outlook Report) in April 2013, they are expected to pick up gradually -- particularly the advanced economies -- on the assumption that global financial markets remain generally stable. Looking at respective major countries and regions, the U.S. economy is expected to gradually accelerate its pace of recovery, mainly as accommodative financial conditions will be maintained and the fiscal drag will gradually fade. While adjustment pressure associated with the European debt problem is likely to remain, the European economy is expected to gradually pick up, supported mainly by an improvement in households' and firms' sentiment. The Chinese economy is likely to maintain stable growth at around the current pace as authorities carry out policy measures to underpin economic activity while progressing with structural reforms. By contrast, growth in other emerging and commodity-exporting economies will likely continue to lack momentum for the time being, due partly to a tightening trend in financial conditions.

Third, public investment is expected to continue hovering at a high level through the first half of fiscal 2014, mainly reflecting an anticipated additional boost from new economic measures scheduled to be formulated as well as the effects of various past economic measures.

Fourth, firms' and households' medium- to long-term growth expectations are expected to rise moderately, due mainly to the government's regulatory and institutional reforms, various anticipated tax reduction measures for businesses, and firms' tapping of domestic and external demand.

Given these assumptions, to elaborate on economic activity during the projection period, <u>in the second half of fiscal 2013</u> exports and industrial production are expected to increase, albeit moderately, as overseas economies head toward a pick-up while the lagged effects of past foreign exchange developments provide underlying support. Against such a backdrop, a pick-up in business fixed investment will become further pronounced, reflecting an improvement in corporate profits, and private consumption is also expected to remain resilient, underpinned by an improvement in the employment and income situation. In addition, as a front-loaded increase in demand prior to the consumption tax hike will take place for private consumption and housing investment, it is projected that the growth rate for the second half of fiscal 2013 will be significantly elevated.[3] The growth rate for <u>fiscal 2014</u> will slow substantially compared with the previous fiscal year, as there will be a decline in demand from the front-loaded increase in demand prior to the consumption tax hike, mainly in the first half. Nevertheless, the growth in exports is expected to accelerate as a pick-up in overseas economies becomes evident, and business fixed investment will likely continue to increase firmly, partly due to monetary easing and the effects of various tax reduction measures for businesses. Owing to these developments, the economy will likely continue growing at a pace above its potential. Also, <u>for fiscal 2015</u>, while fluctuations in demand stemming from the scheduled second consumption tax hike are anticipated, a virtuous cycle among production, income, and spending will be maintained and the economy is expected to continue growing at a pace above its potential. Comparing the current projection with that in the July 2013 interim assessment, the growth rates are expected to be more or less unchanged.

B. Outlook for Prices

The year-on-year rate of increase in the consumer price index (CPI, for all items less fresh food, and the same hereafter) has been expanding of late, and recently has been in the range of 0.5-1.0 percent.

Examining major factors that determine inflation rates into the future, first, the <u>aggregate supply and demand balance</u> is expected to follow a moderate improving trend, albeit with some swings due to the scheduled consumption tax hikes, causing excess demand over supply to expand toward the latter half of the projection period. Meanwhile, a tightening of labor supply and demand conditions is expected to become evident, and nominal wages are likely to see gradual upward pressure. Second, <u>medium- to long-term inflation expectations</u> are likely to continue on a rising trend under the QQE, partly supported by a rise in the observed inflation rate, gradually converging to around 2 percent -- the price

[3] The effects of the consumption tax hikes on the economic growth rate for each fiscal year are estimated as follows: an increase of around 0.3 percentage point for fiscal 2013, a decrease of around 0.7 percentage point for fiscal 2014, and an increase of around 0.2 percentage point for fiscal 2015. However, it should be noted that these estimates are subject to considerable uncertainty given that they depend partly on income conditions and price developments at each point in time, and therefore are subject to a considerable margin of error.

stability target. Such a rise in inflation expectations is expected to gradually carry through to the price and wage formation of economic entities including firms and households. Third, import prices are expected to exert upward pressure for the time being, reflecting developments in international commodity prices and foreign exchange rates.

Based on the above, the outlook for the year-on-year rate of change in the CPI (excluding the direct effects of the consumption tax hikes) is as follows.[4] It is expected to follow a rising trend, reflecting factors such as the improvement in the aggregate supply and demand balance, as well as the rise in medium- to long-term inflation expectations, and it is likely to reach around 2 percent -- the price stability target -- toward the latter half of the projection period. Comparing the current projection with that in the July 2013 interim assessment, the projected rates of change in the CPI are more or less unchanged.

II. Upside and Downside Risks

A. Risks to Economic Activity

The following are upside and downside risks to the Bank's aforementioned baseline scenario regarding the economy. First, there is uncertainty regarding developments in overseas economies. The pace of recovery in the U.S. economy may become faster or slower depending on developments such as the effects of new energy sources and consequences of the fiscal problem. As for the European economy, amid remaining sluggishness for the time being, attention should continue to be paid mainly to future developments in the debt problem. As for the Chinese economy, uncertainty is high with respect to effects of the structural problems of excess production capacity and excess debt. Other emerging and commodity-exporting economies, some of which are facing structural problems such as current account deficits, warrant attention together with developments in the global financial markets.

Second is developments in households' employment and income situations. As mentioned earlier, economic recovery has so far been led by firm domestic demand, mainly private

[4] The effects of the two scheduled consumption tax hikes on prices can be mechanically estimated by assuming that the rise in the consumption taxes will be fully passed on for all currently taxable items. On this basis, the CPI will be pushed up by 2.0 percentage points in fiscal 2014 and 1.3 percentage points in the second half of fiscal 2015 (0.7 percentage point for fiscal 2015 as a whole).

consumption. For domestic demand to continue to maintain its firmness in the future, it is important to maintain a virtuous cycle whereby improvement in the employment and income situation supports consumption. In this regard, close attention should be paid to whether wages will be increased, reflecting a tightening of labor supply and demand conditions and a rise in inflation expectations, when there is an improvement in corporate profits on the one hand but a continued severe competitive environment surrounding firms on the other hand.

Third is the effects of the consumption tax hikes. Consumption tax is an indirect tax that is imposed broadly on consumption in general, and the hikes will have adverse effects on households' real disposable income. However, forces to mitigate adverse effects on consumption to some extent could be at work, partly because (1) various economic measures are scheduled to be taken by the government, (2) the tax hikes seem to have already been factored in substantially among households, and (3) the rate hikes are expected to have the effect of alleviating households' future concerns over the fiscal condition and the social security system. Attention should be paid to the effects of consumption tax hikes as they may differ depending on income conditions and developments in prices at each point in time, including the magnitude of the front-loaded increase and subsequent decline in demand prior to and after the tax hikes.

Fourth, firms' and households' medium- to long-term growth expectations may be either raised or lowered depending on future developments in regulatory and institutional reforms as well as tax reforms, innovation in the corporate sector, and the income situation in the household sector. In addition, from a somewhat longer-term perspective, some positive effects from the hosting of the Tokyo 2020 Summer Olympic Games might be expected.

Fifth, in the event that confidence in fiscal sustainability in the medium to long term declines, the economy may deviate downward from the baseline scenario through increases in people's concerns regarding the future, and rises in long-term interest rates that are unwarranted by economic fundamental conditions. On the other hand, there is also a possibility that the economy will deviate upward from the baseline scenario if confidence in the path toward fiscal consolidation strengthens and people's concerns regarding the future are alleviated.

B. Risks to Prices

The following are upside and downside risks specific to prices. The first concerns the high uncertainty regarding developments in firms' and households' medium- to long-term inflation expectations. While there is a possibility that people's inflation expectations may not readily rise in reflection of the moderate decline in prices and wages observed in the past, there is also a possibility that they will rise relatively quickly with a rise in observed inflation and wages. Furthermore, effects on these expectations of a price increase associated with the consumption tax hikes in items across the board warrant attention.

Second, there is uncertainty regarding the responsiveness of prices to the aggregate supply and demand balance. Attention needs to be paid to whether firms will raise prices and wages in accordance with the extent to which the supply and demand balances in goods and services as well as employment tighten under a highly competitive environment sustained over time.

Third, there continues to be high uncertainty regarding developments in import prices, reflecting fluctuations in international commodity prices and foreign exchange rates, and the extent to which such developments are passed on to domestic prices.

III. Conduct of Monetary Policy

In the context of the price stability target, the Bank assesses the aforementioned economic and price situation from two perspectives and then outlines its thinking on the future conduct of monetary policy.[5]

The first perspective concerns an examination of the baseline scenario for the outlook. Japan's economy is judged as likely to achieve around 2 percent inflation and return to a sustainable growth path toward the latter half of the projection period.

The second perspective involves an examination of the risks considered most relevant to the conduct of monetary policy. With regard to the baseline scenario for economic activity, upside and downside risks can be assessed as being balanced, although uncertainty remains high, including that regarding developments in overseas economies. Risks on the price

[5] See the Bank's statement released on January 22, 2013, titled "The 'Price Stability Target' under the Framework for the Conduct of Monetary Policy."

front also can be assessed as being largely balanced, although considerable uncertainty surrounds developments in medium- to long-term inflation expectations. Examining financial imbalances from a longer-term perspective, there is no sign at this point of excessively bullish expectations in asset markets or in the activities of financial institutions. Nevertheless, due attention needs to be paid to the fact that financial institutions' holdings of government bonds have remained at an elevated level while the amount outstanding of government debt has shown a cumulative increase.[6]

As for the future conduct of monetary policy, under the QQE favorable developments have been widely seen, such as an improvement in the real economy and financial markets, as well as people's sentiment and expectations, and Japan's economy has been following the path toward achieving the 2 percent price stability target as expected. The Bank will continue with the QQE, aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner. It will examine both upside and downside risks to economic activity and prices, and make adjustments as appropriate.

[6] For more details, see the October 2013 issue of the Bank's *Financial System Report*.

(Appendix)

Forecasts of the Majority of Policy Board Members

y/y % chg.

	Real GDP	CPI (all items less fresh food)	Excluding the effects of the consumption tax hikes
Fiscal 2013	+2.6 to +3.0 [+2.7]	+0.6 to +1.0 [+0.7]	
Forecasts made in July 2013	+2.5 to +3.0 [+2.8]	+0.5 to +0.8 [+0.6]	
Fiscal 2014	+0.9 to +1.5 [+1.5]	+2.8 to +3.6 [+3.3]	+0.8 to +1.6 [+1.3]
Forecasts made in July 2013	+0.8 to +1.5 [+1.3]	+2.7 to +3.6 [+3.3]	+0.7 to +1.6 [+1.3]
Fiscal 2015	+1.3 to +1.8 [+1.5]	+1.6 to +2.9 [+2.6]	+0.9 to +2.2 [+1.9]
Forecasts made in July 2013	+1.3 to +1.9 [+1.5]	+1.6 to +2.9 [+2.6]	+0.9 to +2.2 [+1.9]

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

2. The forecasts of the majority of the Policy Board members are constructed as follows: each Policy Board member's forecast takes the form of a point estimate -- namely, the figure to which he or she attaches the highest probability of realization. These forecasts are then shown as a range, with the highest figure and the lowest figure excluded. The range does not indicate the forecast errors.

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

4. The scheduled consumption tax hikes for April 2014 and October 2015 -- to 8 percent and 10 percent, respectively -- are incorporated in the forecasts. In terms of the outlook for the CPI, individual Policy Board members make their forecasts based on figures excluding the direct effects of the consumption tax hikes.

5. The forecasts for the CPI for fiscal 2014 and fiscal 2015 that incorporate the direct effects of the consumption tax hikes are constructed as follows. First, the contribution to prices from each tax hike is mechanically computed on the assumption that the tax increase will be fully passed on for all taxable items. The CPI for fiscal 2014 and fiscal 2015 will be pushed up by 2.0 percentage points and 0.7 percentage point, respectively. Second, these figures are added to the forecasts made by the Policy Board members.

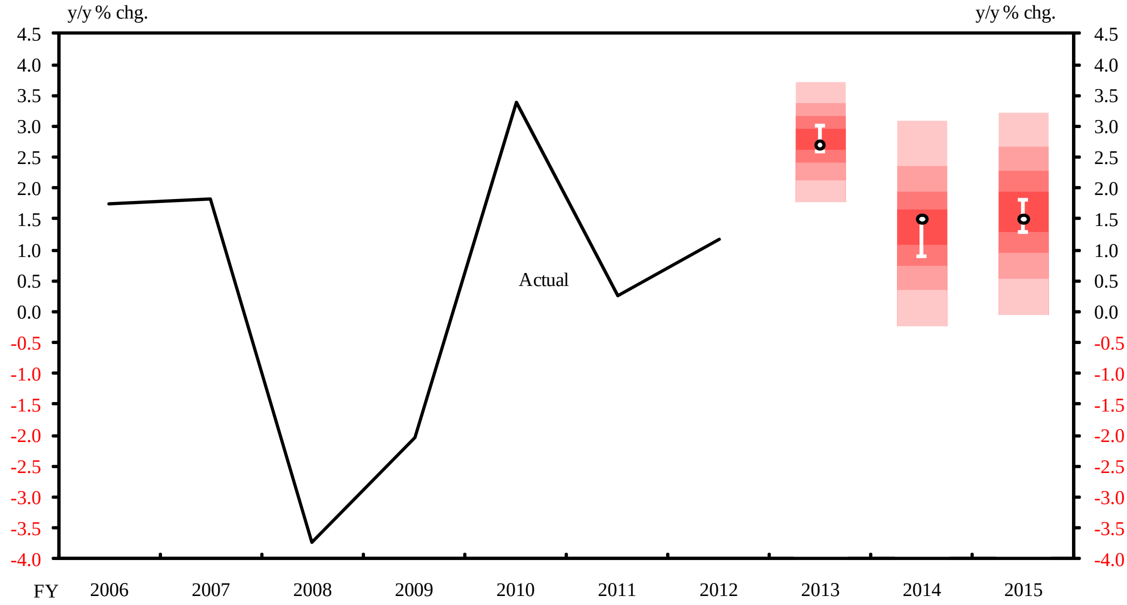
6. The ranges shown below include the forecasts of all Policy Board members.

y/y % chg.

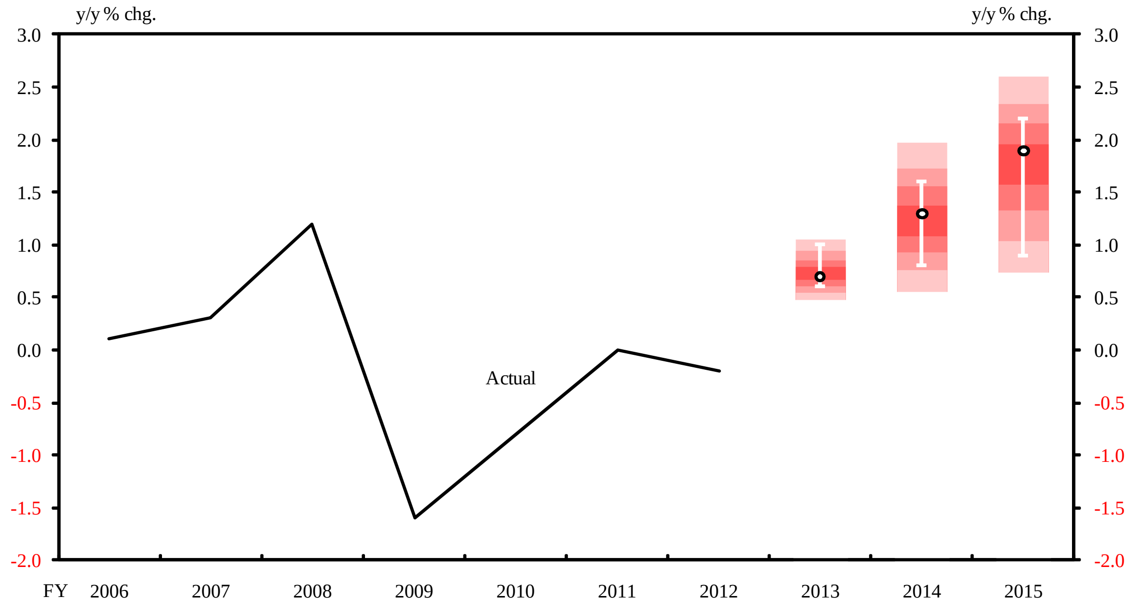
	Real GDP	CPI (all items less fresh food)	Excluding the effects of the consumption tax hikes
Fiscal 2013	+2.6 to +3.0	+0.6 to +1.0	
Forecasts made in July 2013	+2.3 to +3.0	+0.4 to +1.0	
Fiscal 2014	+0.5 to +1.6	+2.6 to +3.7	+0.6 to +1.7
Forecasts made in July 2013	+0.4 to +1.5	+2.6 to +3.7	+0.6 to +1.7
Fiscal 2015	+1.2 to +2.0	+1.4 to +2.9	+0.7 to +2.2
Forecasts made in July 2013	+1.2 to +2.1	+1.4 to +3.0	+0.7 to +2.3

Forecast Distribution Charts of Policy Board Members

(1) Real GDP



(2) CPI (All Items Less Fresh Food)



Notes: 1. Based on the aggregated probability distributions (i.e., the Risk Balance Charts) compiled from the distributions of individual Policy Board members, the Forecast Distribution Charts are compiled as follows. First, upper and lower 10 percentiles of the aggregated distributions are trimmed and second, colors indicated below are used to show the respective percentiles of those distributions.

Upper 40% to lower 40%	Upper 30 to 40% & lower 30 to 40%	Upper 20 to 30% & lower 20 to 30%	Upper 10 to 20% & lower 10 to 20%

2. For the process of compilation of the Risk Balance Charts, see the box on page 9 of the April 2008 *Outlook for Economic Activity and Prices* .

3. The circles in the bar charts indicate the median of the Policy Board members' forecasts (point estimates). The vertical lines in the bar charts indicate the range of the forecasts of the majority of Policy Board members.

4. The forecast for the CPI excludes the direct effects of the scheduled consumption tax hikes.

The Background

I. Economic and Price Developments in the First Half of Fiscal 2013

Economic Activity

Looking back at Japan's economy during the period leading up to the present, economic activity had stopped weakening after the turn of the year. The economy then returned to a moderate recovery path around mid-2013 against the background that domestic demand remained resilient, partly due to the effects of monetary easing and various economic measures, and that overseas economies were gradually heading toward a pick-up (Chart 1).

Specifically, overseas economies as a whole are gradually heading toward a pick-up, although a lackluster performance is partly seen (Charts 2 and 3). The U.S. economy is recovering moderately against the backdrop of firm private demand. The European economy had been receding slowly; however, it has recently stopped weakening and is heading toward a pick-up. The Chinese economy has been stabilizing, although its pace of growth is somewhat slower than some time ago. Meanwhile, in some of the emerging economies other than China and commodity-exporting economies, signs of weakness have been observed.

On the back of signs of overseas economies picking up, exports have generally been picking up as well, partly supported by developments in foreign exchange rates (Chart 4). Business fixed investment as a whole has been picking up, as corporate profits and business sentiment are improving; in addition to the resilience in business fixed investment in the nonmanufacturing sector, positive developments have started to be seen in that in the manufacturing sector (Charts 5 and 6). Public investment has continued to increase, as positive effects of various economic measures have come to take hold fully (Chart 7 [1] and [2]). With regard to housing investment, the number of housing starts -- a leading indicator of housing investment -- has seen a rise in its level since spring 2013, and actual construction has recently been increasing (Chart 7 [3]). Private consumption has remained resilient, reflecting an improving trend in consumer sentiment from a somewhat long-term perspective as well as signs of improvement seen recently in the employment and income situation (Charts 8 and 9). Reflecting such developments in domestic and external demand, industrial production has been increasing moderately (Chart 10 [1] and [2]).

Looking at the features of recent economic developments from each demand component of the GDP, as the growth rates of overseas economies have not risen clearly, exports have been picking up at a somewhat slower pace. As for business fixed investment, although it has been picking up on the whole, the recovery in the manufacturing sector still shows a lackluster performance (Chart 11). By contrast, private consumption and government spending have marked a clear increase, thereby leading the recovery of the overall economy. Reflecting this situation, an improvement in activity in the nonmanufacturing sector, including services and construction, has been more evident than that in production in the manufacturing sector (Chart 10 [3]).

Looking at indicators for capturing utilization of labor and production capacity against the background of such economic developments, the weighted average of the *Tankan* (Short-Term Economic Survey of Enterprises in Japan) diffusion indices (DIs) of production capacity and employment conditions, as well as the estimated output gap, have continued to improve moderately (Chart 12).

Prices

On the price front, the year-on-year rate of change in the domestic corporate goods price index (CGPI) turned positive at the start of fiscal 2013, reflecting developments in international commodity prices and foreign exchange rates; thereafter, its rate of increase has been widening moderately (Chart 13 [1]). The year-on-year rate of decline in the corporate services price index (CSPI, excluding international transportation) has been narrowing, partly reflecting an improvement in corporate profits, and has recently been around 0 percent (Chart 13 [2]). With regard to the CPI, the year-on-year rate of change turned negative at the start of fiscal 2013 due to the reversal of the previous year's developments in the prices of energy-related and durable goods (Chart 14 [1]). Thereafter, prices of energy-related items such as petroleum products and electricity costs have been rising again, reflecting movements in crude oil prices and foreign exchange rates. On top of this, in a situation of resilient private consumption, partly because cost increases have been passed on to selling prices, signs of improvement have gradually spread among prices for durable goods, food products, and other goods -- all of which are classified in the category of goods (less agricultural, aquatic, and livestock products) -- as well as those for the "meals outside the home" category -- a category of general services (Chart 15). Thus, the year-on-year rate of change in the CPI has turned positive and recently been in the range of 0.5-1.0 percent. Turning to the trimmed mean[7] and the Laspeyres chain-weighted index,[8] as well as the private consumption deflator -- all of which are regarded as indicators for capturing trend changes in the CPI -- improvements in these indicators, after having paused once since mid-2012, have recently resumed (Chart 14 [2]). An indicator that represents the difference between the share of items in the CPI for which prices have risen from the previous year and that for which prices have declined has recently been improving relatively clearly (Chart 16 [1]). The year-on-year rate of change in the unit prices in the *Family Income and Expenditure Survey* has been on a rising trend (Chart 16 [2]).

Meanwhile, the rate of decline in land prices has slowed gradually. In metropolitan areas, land prices have started rising, albeit marginally. By contrast, in nonmetropolitan areas they have continued to decline. Looking at the *Land Price Survey by Prefectural Governments* for 2013 (as of July 1), in the three major metropolitan areas (Tokyo, Osaka, and Nagoya), the rate of change in commercial land prices has turned positive on a year-on-year basis, while residential land prices have generally stopped declining. In nonmetropolitan areas, the year-on-year rate of change in both commercial and residential land prices has been negative, but the rate of decline has been narrowing (Chart 17).

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[7] The 10 percent trimmed mean is obtained by rearranging year-on-year rates of individual price changes in ascending order, excluding items corresponding to both the upper and lower 10 percent tails of weights and then taking weighted averages of the remaining items. This essentially eliminates the effects of large relative price fluctuations.

[8] The Laspeyres chain-weighted index is released as a reference for CPI. It is compiled as follows: (1) aggregates are produced after updating the weights of items of the base year and resetting the index level of individual items to 100 every year, and then (2) multiplying the previous year's chain-weighted index by the aggregated year-on-year figures obtained from the above calculation. Disregarding such factors as adopting and terminating items and revising model formulae, this is virtually equivalent to compiling an index in which the base year is updated every year.

II. Financial Developments

Financial Conditions

Financial conditions are accommodative.

Under the QQE introduced in April 2013, the Bank has been purchasing long-term government bonds and other financial assets so that the monetary base will increase at an annual pace of about 60-70 trillion yen. In this situation, the monetary base has been increasing substantially and its year-on-year growth rate has also been rising (Chart 18). Going forward, the Bank will continue to conduct money market operations so that the monetary base will increase at the aforementioned pace under the QQE.[9]

Firms' funding costs have been hovering at low levels. The issuance spread for CP has been low, with the spread of some CP that widened having narrowed again, in reflection of improvement in business conditions (Chart 19 [1]). The issuance spread for corporate bonds has been low overall, although there has been issuance of some bonds -- such as that of electric power company bonds -- at relatively high issuance rates (Chart 19 [2]). The average interest rates on new loans and discounts for both the short and long terms have been at historic low levels (Chart 20 [1]). In these circumstances, interest payments by firms have been at sufficiently low levels in relation to their profits (Chart 20 [2]).

With regard to the availability of funds for firms, financial institutions' lending attitudes -- as perceived by large as well as small firms -- have been on an improving trend, and the levels of various DIs have been above the average for the period since 2000 (Chart 21 [1]). The financial positions of large as well as small firms have recovered on the whole. The levels of various DIs have also been above the average for the period since 2000, and those of small firms have generally recovered to levels seen around 2006 (Chart 21 [2]).

Domestic demand for working capital by firms has continued to rise, due in part to increased costs of raw materials and fuel. There has also been an increase in demand for

[9] Under this guideline, the monetary base is expected to reach 200 trillion yen at end-2013 and 270 trillion yen at end-2014.

funds in sectors where there are prospects for high growth, such as the medical and nursing business, and demand for funds associated with corporate takeover activities as well as gaining interests in natural resources, reflecting firms' strategic efforts to strengthen their global businesses. In this situation, the year-on-year rate of increase in the amount outstanding of bank lending has risen moderately, and has recently been in the range of 2.0-2.5 percent (Chart 22 [1]). The year-on-year rate of change in the aggregate amount outstanding of CP and corporate bonds continued to be positive, but was slightly negative in September (Chart 22 [2]). Looking at CP and corporate bonds separately, the year-on-year rate of change in the amount outstanding of corporate bonds has been positive and that of CP has been negative, partly against a background of the previous year's shift from corporate bonds to CP.

The year-on-year rate of increase in the money stock (M2) has been rising, mainly reflecting an increase in bank lending, to the recent range of 3.5-4.0 percent (Chart 23 [1]). The ratio of money stock to nominal GDP has been rising moderately (Chart 23 [2]).

Developments in Financial Markets

In global financial markets, with backstop measures including the European Stability Mechanism (ESM) and the European Central Bank's Outright Monetary Transactions (OMTs) being in place and progress in establishing a single banking supervisory mechanism being made, the tail risk that the European debt problem might cause financial market turmoil and a significant global economic downturn has been subdued. Meanwhile, as for U.S. monetary policy, there has been broad speculation among investors, including rising anticipation of a scale-down in asset purchases by the Federal Reserve (Fed) as the employment situation has continued to improve. In phases in which anticipation of the Fed's scale-down in its asset purchases has strengthened, long-term interest rates in the United States and Europe have risen and capital outflow from emerging economies has progressed: the global financial markets have been sensitive to investors' speculation on U.S. monetary policy.

Looking at respective financial markets, U.S. and European stock prices have been on a moderate uptrend as the U.S. and European economies have been improving (Chart 24 [1]). By contrast, in emerging economies, against a backdrop of anticipation of the Fed's scale-down in its asset purchases, exchange rates against the U.S. dollar had fallen and stock prices had declined, mainly in current account deficit countries. However, partly because such anticipation has recently subsided compared with some time ago, exchange rates against the U.S. dollar and stock prices have been bouncing back (Charts 24 [1] and 27 [2]). As economic conditions improved, long-term interest rates in the United States and Germany rose substantially on anticipation of the Fed's scale-down in its asset purchases. Recently, however, while this anticipation has been subsiding compared with some time ago, there has been somewhat of a reverse in the rise in the interest rates (Chart 25 [1]). Meanwhile, foreign currency funding conditions have remained stable. The LIBOR-OIS spread in the U.S. dollar and euro has also remained stable at low levels (Chart 26 [2]).

Looking at financial markets in Japan, short-term interest rates -- including those on term instruments with longer maturities -- have been kept low as the Bank continues to provide ample liquidity (Chart 26 [1]). Credit spreads on interbank transactions have remained stable as the balance sheets of Japanese financial institutions have maintained their soundness (Chart 26 [2]).

Long-term interest rates temporarily rose as market participants became cautious in response to heightened volatility, and in light of a rise in the U.S. long-term interest rates. However, these have been stable in the face of a substantial rise in long-term interest rates in the United States and Germany, mainly due to flexible market operations by the Bank as it made progress in its purchases of long-term government bonds, and have recently been around 0.6 percent (Chart 25 [1]).

Stock prices substantially rose from end-2012 through May 2013 and, while there was a subsequent phase of adjustment reflecting investors' profit-taking, they have been on a rising trend, partly reflecting improving expectations for corporate profits (Chart 24 [1]). In the Japan real estate investment trust (J-REIT) market, prices rose substantially after end-2012 against the background of an improving outlook for conditions in the business office market, and subsequently declined after entering fiscal 2013 due mainly to concern over deterioration in supply and demand conditions, reflecting announcements of large-scale new listings, as well as a decline in REIT prices overseas; they have been picking up somewhat recently (Chart 24 [2]).

In foreign exchange markets, the yen continued to depreciate against the U.S. dollar through the beginning of fiscal 2013, and thereafter has generally leveled off to the range of 95-105 yen (Chart 27). The yen has continued to depreciate moderately against the euro as uncertainty over the European situation has subsided.

III. The Outlook for Economic Activity and Prices from the Second Half of Fiscal 2013 to Fiscal 2015

The Outlook for Economic Activity and Prices

Regarding the outlook for Japan's economy, while the economy will be affected by the front-loaded increase and subsequent decline in demand prior to and after the two scheduled consumption tax hikes, it is likely to continue growing at a pace above its potential, as a trend, as a virtuous cycle keeps operating.[10]

More specifically, in the second half of fiscal 2013, an improvement in external demand will gradually become evident while domestic demand remains firm. Public investment is likely to increase for the time being and thereafter reach a plateau at a high level. Exports and industrial production are expected to increase moderately as overseas economies pick up. Against such a backdrop, a pick-up in business fixed investment will become further pronounced as moves to undertake postponed maintenance and replacement spread in tandem with continued improvement in corporate profits. Private consumption is expected to maintain its resilience, underpinned by an improvement in the employment and income situation. In this way, a virtuous cycle will operate more clearly both in the corporate and household sectors. In addition, as a considerable front-loaded increase in demand -- particularly in private consumption -- prior to the first round of the consumption tax hike is

[10] As with the Outlook Report in April 2013, this report assumes that the consumption tax will rise to 8 percent in April 2014 and 10 percent in October 2015.

anticipated, the growth rate in the second half of fiscal 2013 will be somewhat higher even than that in the first half; consequently, the overall growth rate for fiscal 2013 is projected to be significantly elevated.[11]

From fiscal 2014 toward fiscal 2015, while affected by fluctuations in demand stemming from the scheduled consumption tax hikes, the economy is expected to continue growing at a pace above its potential, as a trend. As for fiscal 2014, on the assumption that the scheduled economic measures with a total amount of 5 trillion yen will be implemented, public investment is expected to continue to hover at a high level in the first half of 2014 and thereafter be on a gradual downtrend. Exports are likely to see an increase in their pace of growth as a pick-up in overseas economies gradually becomes evident. Domestic private demand, notably business fixed investment, will likely continue to exhibit steady developments, as a trend. This is because the effects of monetary easing will further strengthen as positive income formation continues and growth expectations gradually rise, due partly to economic entities' efforts to strengthen growth potential. Various tax reduction measures for businesses to be implemented as part of the economic policy package will also have a positive impact on business fixed investment. Meanwhile, as for private consumption, while various tax burdens will exert downward pressure on real disposable income, a considerable decline in demand following a front-loaded increase

[11] The consumption tax hikes will affect the economy mainly by generating a front-loaded increase and subsequent decline in demand prior to and after the tax hikes (an intertemporal substitution effect). Specifically, in the second half of fiscal 2013, a front-loaded increase in demand prior to the first tax hike is expected to occur; in the first half of fiscal 2014, the growth rate is likely to decelerate markedly due to the subsequent decline. In fiscal 2015, a front-loaded increase in the first half of that year and subsequent decline in the second half -- prior to and after the second tax hike -- are also expected to take place. However, such a swing in demand in the second round is unlikely to be large, taking account of the fact that (1) the extent of the consumption tax hike in the second round is smaller than the first round and (2) a considerable part of the front-loaded increase in demand will take place prior to the first round. The effect of the tax hikes on the economic growth rate for each fiscal year is estimated as follows: an increase of around 0.3 percentage point for fiscal 2013, a decrease of around 0.7 percentage point for fiscal 2014, and an increase of around 0.2 percentage point for fiscal 2015. However, it should be noted that these estimates are subject to considerable uncertainty given that they depend partly on income conditions and price developments at each point in time, and therefore are subject to a considerable margin of error. For more details on the effects of the consumption tax hikes on the economy, see Box 3 of the Outlook Report in October 2012.

prior to the consumption tax hike is expected, mainly in the first half of fiscal 2014. Nevertheless, it is likely to remain resilient as a trend, supported by an improvement in the employment and income situation.

As for fiscal 2015, public investment will follow a downtrend and business fixed investment will also gradually enter a cyclical slowdown as capital stock becomes sufficient. Nevertheless, the economy is projected to continue growing at a pace above its potential as overseas economies restore a pace of growth more or less comparable to the long-term average and, on the domestic front, as the effects of monetary easing and various tax reductions for businesses strengthen in light of a further rise in growth expectations.

Expressing the outlook in terms of the annual real GDP growth rate, this is projected to be slightly below 3.0 percent for fiscal 2013 and around 1.5 percent for fiscal 2014 and fiscal 2015 -- above the potential growth rate, which is considered to be around 0.5 percent. Comparing the current projection with that in the July 2013 interim assessment, the growth rates are expected to be more or less unchanged.

The outlook for prices -- excluding the direct effects of the consumption tax hikes -- is as follows.[12] The year-on-year rate of change in the CPI is expected to gradually rise from 0.5 percent to 1 percent, and is likely to reach around 1 percent during the second half of fiscal 2013. Thereafter, while the positive impetus from energy-related items (petroleum product prices and electricity costs) that has contributed thus far to lifting overall prices will shrink, the improvement in the aggregate supply and demand balance will continue, in which circumstance medium- to long-term inflation expectations will rise. Thus, the year-on-year rate of change in the CPI is expected to follow a rising trend and is likely to reach around 2 percent -- the price stability target -- toward the latter half of the projection period. Comparing the current projection with that in the July 2013 interim assessment, the projected rates of change in the CPI are more or less unchanged.

[12] The effects of the two scheduled consumption tax hikes on prices can be mechanically estimated by assuming that the rise in the consumption taxes will be fully passed on for all currently taxable items. On this basis, the CPI will be pushed up by 2.0 percentage points in fiscal 2014 and 1.3 percentage points in the second half of fiscal 2015 (0.7 percentage point for fiscal 2015 as a whole). See Box 5 of the Outlook Report in October 2012 for effects of the consumption tax hikes on prices.

The following provides supplementary details on the assumptions and underlying mechanism of the outlook for economic activity and prices.

Government Spending

Public investment has continued to increase, primarily because the effects of the supplementary budget for fiscal 2012 under the emergency economic measures, the budget for fiscal 2013 with prioritized allocation for public investment, and the increased budget for reconstruction-related spending have all come to take hold fully (Chart 7 [1] and [2]). As for the outlook, given that the positive impacts, mainly of the emergency economic measures, have already materialized to a considerable degree, public investment will be on an increasing trend for the time being and thereafter become more or less flat at a high level. After entering fiscal 2014, public investment will likely continue to be at a high level for some time on the assumption that the effects of new economic measures scheduled to be implemented will materialize from the beginning of fiscal 2014. Thereafter, through the latter half of the projection period, public investment is expected to start decreasing. Nonetheless, it is expected to remain at a reasonable level against the background of higher demand for maintenance and replacement of social infrastructure. Meanwhile, the level of the amount outstanding of government liabilities as a percentage of nominal GDP has already been high and is likely to increase further, mainly due to the increase in social security-related spending as a result of the aging population, even after an increase in tax revenue stemming from the consumption tax hikes and economic recovery has been taken into consideration (Chart 28).

Overseas Economies

As for the outlook, overseas economies, mainly the advanced economies, are expected to gradually pick up, assuming that global financial markets remain generally stable. In terms of growth rates, overseas economies as a whole are expected to grow at a somewhat slower pace than they used to before the Lehman shock, because of the still-existing effect of the bursting of the global credit bubble. Nonetheless, toward the latter half of the projection period, the growth rate is expected to return to more or less the past long-term averages (Chart 3 [1]).[13] By major country and region, the U.S. economy is expected to see a gradual acceleration in the pace of its recovery, led by private demand, partly as the fiscal drag on the economy fades gradually. The European economy is expected to gradually head toward a pick-up against the backdrop of an improvement in economic entities' sentiment and a recovery in exports. The Chinese economy is expected to maintain stable growth, albeit with a somewhat lower growth rate than some time ago, as domestic demand remains firm. Emerging economies other than China and commodity-exporting economies, some of which are exhibiting weakness, will likely continue to lack growth momentum for the time being; however, from a somewhat long-term perspective, their growth rates are likely to start picking up again with an improvement in the advanced economies, mainly the U.S. economy.

The outlook for overseas economies, however, entails significant uncertainties, both on the upside and downside. Although the European economy is expected to gradually head toward a pick-up, the pace of that pick-up is likely to be only quite moderate, and the consequences of the European debt problem and developments toward ensuring the soundness of the financial system continue to warrant vigilance. The Chinese economy is expected to continue to experience stable growth at around the current pace, partly thanks to the government's measures to underpin the economy, but there is still high uncertainty associated with the problem of excess production capacity, mainly in the manufacturing sector, and effects stemming from excess debt. The U.S. economy may post higher-than-expected growth, mainly due to the positive impact of new energy sources. By contrast, depending on the consequences of the fiscal problem, financial markets and the sentiment of economic entities can be negatively affected, and therefore the economy may register lower-than-expected growth. Meanwhile, there is also high uncertainty over

[13] Looking at the weighted averages of real GDP growth rates of respective economies and regions -- released by the International Monetary Fund (IMF) in October 2013 -- by value of exports from Japan, the growth rates of overseas economies are projected to accelerate moderately to the same pace as the past long-term average, registering 3.4 percent in 2013, 4.1 percent in 2014, and 4.3 percent in 2015 (Chart 3 [1]). Nonetheless, because the after-effect of the bursting of the global credit bubble remains, the growth rate is likely to remain somewhat subdued even at the end of the projection period, compared with the pre-Lehman shock period. The average growth rate for the past 33 years -- from 1980 through 2012 -- was 4.1 percent and that for the 5 years before the Lehman shock (i.e., 2003-07) was 5.3 percent.

future developments in emerging economies other than China and in commodity-exporting economies, such as their efforts to tackle structural reforms and the responses of the global financial markets to such reforms.

Exports and Imports

Exports have generally been picking up as overseas economies have been gradually heading toward a pick-up, with past movements in foreign exchange rates giving support with some time lag.

Looking at the developments in real exports by region, as the U.S. economy has recovered moderately, exports to the United States have trended upward, particularly in motor vehicles and their related goods, assisted partly by the effects of foreign exchange rate movements since the end of last year (Chart 4 [2]). Exports to the European Union, which continued to decline during the last fiscal year, have shown some signs of bottoming out and picking up after entering this fiscal year, reflecting developments in the European economy. Looking at exports to East Asia, those to China have been gradually picking up on the whole as the effects of the bilateral relationship between Japan and China have dissipated -- mainly in motor vehicles and their related goods -- and improvements have been observed in some IT-related goods. Exports to NIEs have also seen somewhat of a pick-up on the back of a completion of inventory adjustment in the IT-related sector and an increase in demand for parts for new smartphone products. By contrast, exports to ASEAN have continued to decline. By goods, exports of motor vehicles and their related goods have been increasing and exports of capital goods and parts, as well as of IT-related goods, have been gradually bottoming out and picking up moderately (Chart 4 [3]).

As explained, exports as a whole have been picking up at a somewhat slower pace. This is partly due to the fact that a pick-up in capital goods and parts, in which Japan maintains a comparative advantage, is still sluggish (Chart 29 [1][a]). Exports of capital goods and parts declined substantially in the second half of 2012, to which several factors appear to have contributed. First, heightened uncertainty stemming from the European debt problem and the "fiscal cliff" problem in the United States led to global restraints on investment.

And second, against the backdrop of excess capacity in Asia, notably China, supply and demand conditions have loosened. Looking at developments since the start of fiscal 2013 until recently, downward pressure associated with the first factor has improved to some extent, as evidenced by a recovery in semiconductor production equipment as well as an improvement in business sentiment and a pick-up in capital goods orders in the United States (Chart 29 [1][b] and [2][a]). However, there does not seem to be much improvement in the second factor given the low capacity utilization rate shown in the Chinese business survey (Chart 29 [2][b]).

As for the outlook, exports are expected to increase moderately against the background of a pick-up in overseas economies. Meanwhile, in the foreign exchange market, the yen has continued to hover at a depreciated level registered before the Lehman shock, and this development will likely continue to support exports (Chart 3 [2]).

The pace of increase in exports going forward, however, is likely to be somewhat subdued relative to what would be implied by the growth rates of overseas economies overall and the level of foreign exchange rates. This is because factors that restrain exports are likely to remain, such as (1) the investment adjustment pressure, as mentioned earlier, stemming from the excess capacity problem in emerging economies, notably China, (2) the restrained investment stance and lackluster recovery in consumption on durable goods around the globe after the collapse of the credit bubble, and (3) the effects of a further shift of production overseas. Japan's exports in the period leading up to the Lehman shock increased substantially, mainly in capital goods and parts as well as motor vehicles and their related goods, in which Japan has a comparative advantage (Chart 4 [1]). During the credit bubble, exports of these goods substantially exceeded the past trends, notably in advanced economies, and thus the subsequent decline was significant in return. Recent demand for these goods clearly remains lower than that prior to the Lehman shock (Chart 30 [1] and [2]). In addition, the manufacturing sector as a whole, including transportation equipment, has been expanding local procurement in tandem with an increasing trend in the ratio of overseas production, mainly in emerging economies, and this will also serve to restrain the growth in exports (Chart 30 [3]).[14]

On the other hand, there are signs that real imports have been heading toward an increase again (Chart 4 [1]). Going forward, while the movements in foreign exchange rates might work as factors to restrain some imports, real imports are projected to register a moderate increase in tandem with the development in industrial production as domestic demand remains firm.

External and Saving-Investment Balances

The trade balance, after having recorded an increase in the deficit through fiscal 2012, has continued to show a deficit of a similar size in fiscal 2013 (Chart 31 [1]). Factors contributing to the deficit are (1) only a moderate pick-up in exports as well as (2) a continued high level of imports on nominal terms due both to imports of fuels as a result of resilient domestic demand and the continued shutdown of nuclear power plants, and to a rise in import prices that partly reflects the movements in foreign exchange rates.[15] However, as for the services balance, the deficit has recently been narrowing, due partly to an increasing trend in receipts in the travel balance that reflects an increase in the number of foreign visitors to Japan. Also, as for the income balance, the surplus has been further expanding on the back of the accumulation of foreign assets, while currency movements in foreign exchange rates since the end of last year have also been a factor leading to an increase in value in yen terms. Therefore, for the current account balance as a whole, its surplus has remained intact. As for the outlook, trade deficits are expected to narrow as a trend, partly against the background of an increase in exports due to a pick-up in overseas economies, and the services balance is also likely to see a narrowing trend in its deficit. In addition, the income balance is expected to widen its surplus moderately as a trend;

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[14] However, even if there is no material change in firms' tendency to expand overseas production and local procurement, it is possible that this trend will become somewhat moderate given that the yen has depreciated compared with the past.

[15] In a phase of yen depreciation, there will be some time lag for the export volume to increase after the depreciation; thus, the deficit in the trade balance is expected to widen temporarily due to a rise in import prices and then start moving toward a narrowing (i.e., the J-curve effects). The large trade deficit to date could have been affected by such effects.

accordingly, the current account surplus is expected to widen at a mild pace.

Looking at a domestic saving-investment balance that conceptually corresponds to a current account balance, domestic excess saving as a whole is expected to widen moderately throughout the projection period (Chart 31 [2]). This is because the deficit in the general government is expected to narrow, partly due to an increase in tax revenue as a result of the consumption tax hikes, and the pace of its narrowing will be somewhat faster than the moderate pace at which excess saving in the private sector will narrow.

The Environment Surrounding Corporate Profits and Business Fixed Investment

Corporate profits have improved both in the manufacturing and nonmanufacturing sectors (Chart 32). As for the outlook, they are projected to continue improving against the background of firm domestic demand, supported by a moderate increase in exports and movements in foreign exchange rates, while factors such as a rise in electricity prices exert downward pressure on profits.[16] However, toward the end of the projection period, the pace of growth in corporate profits is expected to gradually slow down as the distribution of profits to households through a rise in wages progresses.

Business fixed investment has been picking up on the whole, and that in the manufacturing sector, which had lagged to date, has also shown signs of improvement (Chart 6 [2]). As for the outlook, business fixed investment is expected to continue increasing moderately, as a trend, on account of improvements in corporate profits and monetary easing effects. The underlying mechanism behind this outlook can be summarized as follows.

First, the effects of the QQE are expected to underpin business fixed investment during the projection period. In the context of investment profitability, the extent of monetary easing stimulus to investment is projected to strengthen, reflecting both a rise in the rate of return on capital due to economic recovery and a decline in real interest rates, partly in reflection of a rise in inflation expectations (Chart 33 [1]). In addition, the effects of various tax

[16] Looking at corporate profits, the increase in current profits clearly has been exceeding that of operating profits (Chart 6 [1]). This could be partly attributable to an increase in dividend receipts from overseas subsidiaries, which is partly due to the movements in foreign exchange rates.

reductions for businesses to be implemented as part of the economic policy package are likely to support business fixed investment through a decline in capital costs and an improvement in cash flows.

Second, given that the level of business fixed investment has still been low, as it has only just entered a recovery phase following the period of a plunge after the Lehman shock and the earthquake disaster, the cyclical position of the economy is such that pent-up demand can well be expected to emerge when the level of economic activity increases further and corporate profits continue to improve. Reflecting the past restrained investment stance, in cases where capital stock -- mainly in the manufacturing sector -- has declined on the whole and existing equipment has aged, potential demand for maintenance and replacement is likely to be considerable (Chart 33 [2] and [3]). On this point, when assessed from the viewpoint of the capital stock cycle, the growth rate of business fixed investment is expected to be relatively high for the time being even if firms' expected growth rates remain at around 0.5 percent (Chart 34 [1]). The ratios of business fixed investment to nominal GDP and to cash flow remain relatively low viewed from a longer-term perspective, suggesting that there is ample room for business fixed investment to increase (Chart 35 [1] and [2]). Therefore, as exports and industrial production increase and the level of the capacity utilization rate recovers, business fixed investment is likely to head toward a moderate increase (Chart 33 [4]). In fact, the September *Tankan* presented steady business fixed investment plans for fiscal 2013 (Chart 34 [2]).

Third, firms' medium- to long-term growth expectations are likely to rise moderately on the back of efforts to strengthen competitiveness and growth potential; on the part of the government, these efforts include regulatory and institutional reforms and implementation of various anticipated tax reduction measures for businesses, and on the part of firms, further business restructuring. While the aforementioned cyclical boost is likely to gradually become moderate toward the end of the projection period as capital stock becomes sufficient, a heightening of growth expectations is likely to contribute to mitigating the decelerating pressure of business fixed investment as a result of capital stock accumulation. Considered from the viewpoint of the ratio of business fixed investment to capital stock, as the potential growth rate rises very moderately toward the latter half of the projection period, business fixed investment is expected to gradually increase to a level consistent with the potential growth rate (Chart 35 [3]).[17]

The Employment and Income Situation

As for the employment and income situation, labor supply and demand conditions have been on a steady, albeit moderate, improving trend on the whole, as labor demand in the nonmanufacturing sector has been increasing in reflection of resilient domestic demand and that in the manufacturing sector has finally been showing positive developments against the backdrop of a pick-up in exports and industrial production (Chart 9). The amount of labor input (i.e., [number of employees] times [number of hours worked]) has recently been increasing moderately, due mainly to growth in the number of employees (Chart 36 [1]). Meanwhile, looking at developments in the labor force participation rate, while a shift in demographics due to aging continues to exert downward pressure as a trend, the downtrend in the participation rate up to now has come to a halt, partly because an increase in labor participation by women and the elderly has caused a slight rise recently (Chart 36 [2]). The potential pool of labor supply appears to be declining, with the proportion of "persons who wish to work and are able to take up employment immediately, but have not been searching for a job because they see no prospect of finding a suitable one (discouraged workers)" in the non-labor force reaching a historic low. In such a situation, the sense of a labor shortage on the side of firms has become heightened in association with an increase in economic activity, leading to further utilization of the labor force of women and the elderly (Charts 9 [1] and 36 [3]).

Such improvement in labor supply and demand conditions has started to affect nominal wages. The year-on-year rate of change in nominal wages per full-time employee has become slightly positive due to an increase in non-scheduled cash earnings and in summer bonuses, the latter for the first time in three years, and the year-on-year rate of increase in hourly wages per part-time employee has inched up gradually (Chart 37 [2]). Meanwhile, scheduled cash earnings per employee as a whole have still been negative year on year, and this is attributable to an uptrend in the proportion of part-time employees and, more recently,

[17] See Footnote 20 for developments in the potential growth rate.

to a further shortening in hours worked by part-time employees as female and elderly workers, as mentioned earlier, have been increasingly utilized (Chart 37 [1]). This development in average wages has taken place in parallel with the improvement in labor supply and demand conditions and the increase in the number of employees, and the income situation as a whole has been gradually improving, as seen in employee income -- the number of employees times wages per employee -- having turned positive on a year-on-year basis (Chart 9 [4]).

Going forward, labor supply and demand conditions are likely to stay on an improving trend and the unemployment rate is expected to remain on a moderate declining trend (Chart 9 [3]).[18] In this situation, nominal wages are expected to be put under upward pressure gradually (Chart 37 [3]). In particular, toward the latter half of the projection period, reflecting the effects of tighter supply and demand conditions in the labor market and the rise in inflation expectations, wages will likely show a clear uptrend, with an increase in scheduled cash earnings, including base pay.

Under these circumstances, employee income is expected to edge up gradually during the projection period. The labor share is expected to trend downward at a mild pace as the economy continues to recover; however, it is projected to stop declining toward the latter half of the projection period to around a level slightly above the average for 2004-07, the latter half of the previous economic expansion phase (Chart 37 [4]).[19]

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[18] In Chart 9 [3], aggregate supply and demand in the labor market is judged as being in equilibrium on the whole when the unemployment rate (i.e., the rate reflecting the portion of the labor force that is without jobs) is equal to the vacancy rate (i.e., the rate reflecting the portion of job positions remaining vacant). The unemployment rate in such a situation is regarded here as the structural unemployment rate. In Japan, however, there has been a statistical tendency for the unemployment rate to consistently exceed the vacancy rate, and it should be noted that the structural unemployment rate estimated in this way should be treated with some caution.

[19] During the period between 2004 and 2007, deregulation in the labor market led to a sharp increase in nonregular employment -- mainly temporary workers -- and thereby exerted downward pressure on wages. In contrast, downward pressure caused by these factors is considered to be less pronounced in the current phase.

Households' Spending Behavior

Private consumption has remained resilient. With buoyant consumption by the elderly -- notably, the baby-boomer generation -- providing underlying support, an improvement in consumer sentiment as well as wealth effects from an increase in the value of financial assets, reflecting a rise in stock prices and foreign exchange rate developments, appear to have boosted private consumption since the beginning of the year (Chart 38 [4]). Currently, as the boosting effects since the beginning of the year -- while still in place -- have lessened, the aforementioned improvement in the employment and income situation has been increasing in importance as a supporting factor behind the resilience of private consumption.

Regarding the outlook for throughout the projection period, private consumption is expected to be on a moderate increasing trend on the whole, albeit with fluctuations caused by the consumption tax hikes. This outlook owes to several factors. First, consumption by the elderly is likely to support consumption as a whole on a sustainable basis, both from the demand side (i.e., a higher propensity to consume among the baby-boomer generation) and from the supply side (i.e., firms' capturing of the elderly's new demand) (Chart 38 [3]). Second, as mentioned earlier, an improvement in employee income, which is expected to become increasingly evident, will support consumption, mainly by the workers' households. Nonetheless, growth in nominal disposable income is projected to remain moderate due to tax rises and a higher burden of social security-related payments; moreover, the consumption tax hikes and electricity price rise are likely to push down real income (Chart 38 [1]). As a result, with consumption by the elderly likely to remain firm, as mentioned earlier, private consumption is basically expected to stay somewhat stronger relative to household income, and the propensity to consume will inch up very gradually over the projection period (Chart 38 [2]).

Housing investment has increased (Chart 7 [3]). This is due not only to the front-loaded increase in demand prior to the consumption tax hikes, but also to anticipation of a rise in real estate prices and interest rates and the materialization, in light of improvement in the employment and income situation, of pent-up demand that was held down substantially after the Lehman shock. As for the outlook, housing investment is expected to be resilient as a trend, albeit with fluctuations resulting from the consumption tax hikes, assisted in part by the reconstruction of disaster-stricken homes and by monetary easing effects.

The Environment surrounding Prices

In assessing the outlook for prices, the main factors that determine inflation rates are examined. First, the aggregate supply and demand balance has continued its moderate improving trend (Chart 39 [1]). Going forward, the balance is expected to follow a moderate improving trend during the projection period, reflecting the economy's continued growth at a pace above its potential, albeit with fluctuations resulting from the consumption tax hikes.[20] On this basis, the aggregate supply and demand balance is likely to turn positive (i.e., there will be excess demand) around the middle of the projection period, and the balance is expected to move further into excess demand territory toward the latter half of the projection period.

Second, based on market indicators and the results of various surveys, medium- to long-term inflation expectations appear to be rising on the whole. A survey result obtained from bond market participants indicates that inflation expectations have started rising since end-2012. Break-even inflation rates -- calculated as the yield spreads between the fixed-rate bonds and inflation-indexed bonds -- remain on a rising trend from a somewhat

[20] Japan's potential growth rate had temporarily dropped to around 0 percent, partly due to a decline in the growth rate of capital stock reflecting the economic plunge after the Lehman shock (Chart 39 [2]). Since then, the rate has been picking up somewhat against the background of a gradual recovery in economic activity. Based on a standard production function approach, Japan's potential growth rate is estimated to be "around 0.5 percent" on average during the projection period, and is expected to rise gradually toward the end of the projection period due to such factors as capital accumulation. However, it should be noted that estimates of the potential growth rate are subject to a considerable margin of error, as they greatly depend on the specific methodology employed and could change as more data for the relevant period become available.

long-term perspective.[21,22] A survey conducted for economists points to a rise in medium- to long-term inflation expectations (Chart 40). Various survey results on household views also show a rise in inflation expectations in the short to medium term (Chart 41). As for the outlook, under the Bank's QQE, the medium- to long-term inflation expectations are likely to continue on a rising trend, gradually converging to around 2 percent -- the price stability target. While the economy is expected to continue to improve on a sustainable basis, the observed inflation rate is projected to rise, and this should also contribute to such development.

Third, import prices have been rising compared with some time ago, reflecting international commodity prices and movements in foreign exchange rates (Chart 42). As for the outlook, they are projected to generally follow a very moderate uptrend in tandem with a pick-up in overseas economies.

Taking the above into account, as for the outlook for prices -- excluding the direct effects of the consumption tax hikes -- the year-on-year rate of increase in the CGPI is expected to widen for the time being, mainly due to the effects of developments in foreign exchange rates since the end of last year, and continue to rise moderately thereafter as overseas economies and the supply and demand conditions for products improve. The year-on-year rate of change in the CPI is expected to gradually rise from 0.5 percent to 1 percent, and is likely to reach around 1 percent during the second half of fiscal 2013. Thereafter, while the positive impetus from energy-related items (petroleum product prices and electricity costs) that has contributed thus far to lifting overall prices will shrink, the improvement in the aggregate supply and demand balance will continue, in which circumstance medium- to

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21 However, the market liquidity of inflation-indexed bonds has continued to be at a low level, with the latest market size of inflation-indexed bonds at around 3.5 trillion yen, and the share of inflation-indexed bonds in the amount outstanding of Japanese government bonds (JGBs) issued below 1 percent. Therefore, due attention to the interpretation of changes in break-even inflation rates is necessary, as these are likely to be affected not only by changes in market participants' inflation expectations but also by changes in the liquidity risk premium of inflation-indexed bonds to a non-negligible degree.

22 It should be noted that break-even inflation rates and some survey indicators of inflation expectations include the effects of the consumption tax hikes, and therefore due attention to the interpretation of these indicators is also necessary.

long-term inflation expectations will rise. Thus, the year-on-year rate of change in the CPI is expected to follow a rising trend and is likely to reach around 2 percent -- the price stability target -- toward the latter half of the projection period.[23]

Considering the outlook for prices in light of their relationship with the aggregate supply and demand balance -- depicted by the so-called Phillips curve -- the year-on-year rate of change in the CPI is projected to rise in line with the historically observed positive correlation as the supply and demand balance improves; at the same time, the Phillips curve itself is projected to gradually shift upward due to the rise in inflation expectations (Chart 43). Looking at indicators that capture trend changes in the CPI, such as the trimmed mean and the indicator representing the difference between the share of items for which prices have risen and that for which prices have declined, they exhibited muted responses to the output gap in the previous economic recovery period, from 2003 to around 2007, but such divergence has not been seen recently (Chart 44). At the time, "negative price shocks" that did not directly result from developments in the aggregate supply and demand balance, such as deregulation of temporary staffing and a low-pricing strategy utilizing imported goods, seemed to have put downward pressure on prices. By contrast, in the current phase -- taking into consideration such factors as wage increases in emerging economies and foreign exchange movements, developments on the labor regulation front, and changes in firms' price-setting behavior -- it is assumed that such negative price shocks as seen previously will not occur. Nevertheless, given that Japan's economy has been mired in deflation for nearly 15 years, there is a high degree of uncertainty associated with (1) the responsiveness of prices to the aggregate supply and demand balance (i.e., the slope of the Phillips curve) and (2) developments in firms' and households' medium- to long-term inflation expectations (i.e., the extent to which the Phillips curve will shift upward), and due attention needs to be paid to whether the CPI will rise as expected.

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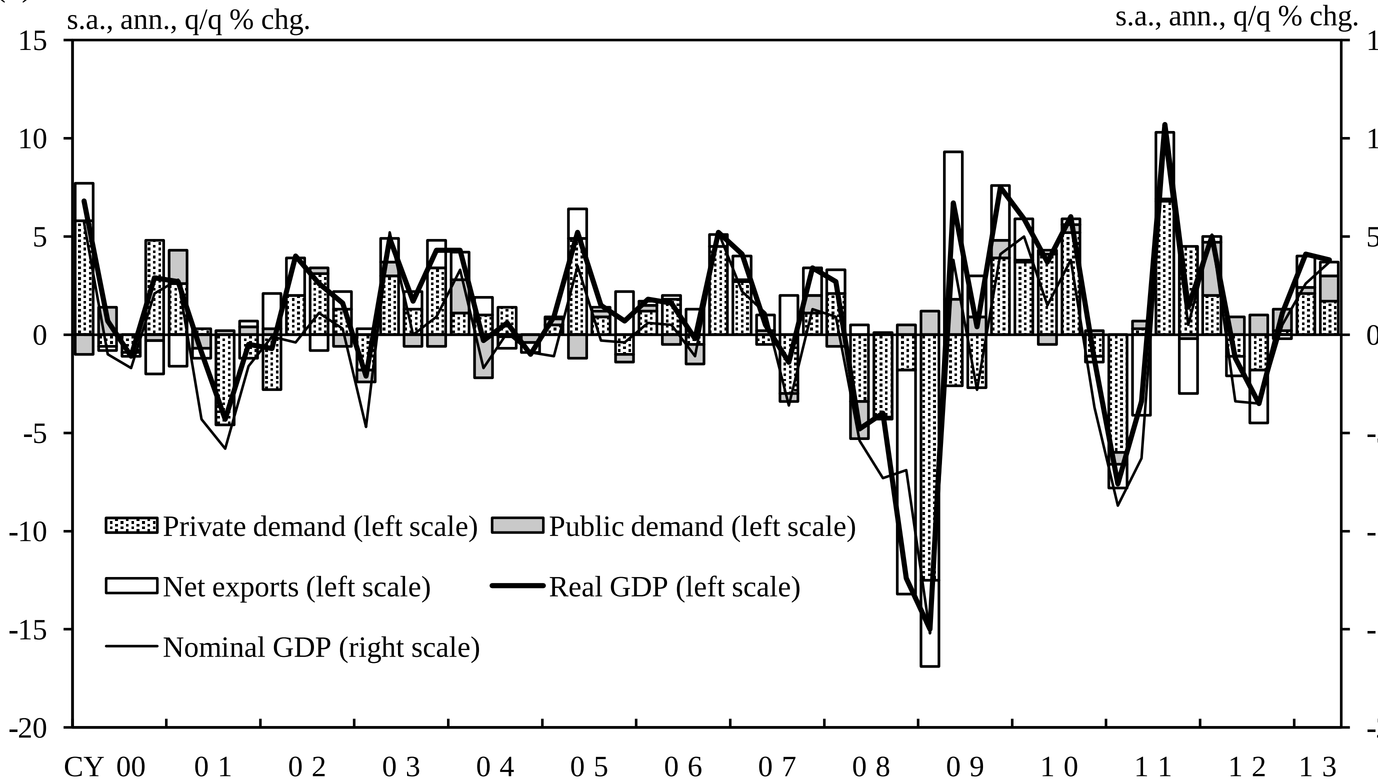
[23] The year-on-year rate of change in the chain-weighted CPI (see Footnote 8) tended to be lower than that in the standard fixed-weighted CPI, and the gap became larger as more time passed from the base year. However, with regard to the latest weighted index (the base year for which is currently 2010), the gap between the chain-weighted CPI and the fixed-weighted CPI is expected to remain relatively small. This is because the weights of some items such as TVs -- for which prices tend to fall faster, and thus tend to generate a gap between the chain-weighted index and the fixed-weighted index -- have been declining since 2011, and the paces of the price falls themselves have become relatively small compared with some time ago.

Meanwhile, in terms of the relations between prices and nominal wages, a stable correlation is observed between the CPI and hourly wages -- namely, from a long-term perspective, they move almost in parallel to each other (Chart 45). In the aforementioned outlook, the rate of increase in the CPI is projected to pick up gradually while hourly wages are expected to rise moderately, reflecting the tightening of labor supply and demand conditions and the rise in people's inflation expectations.

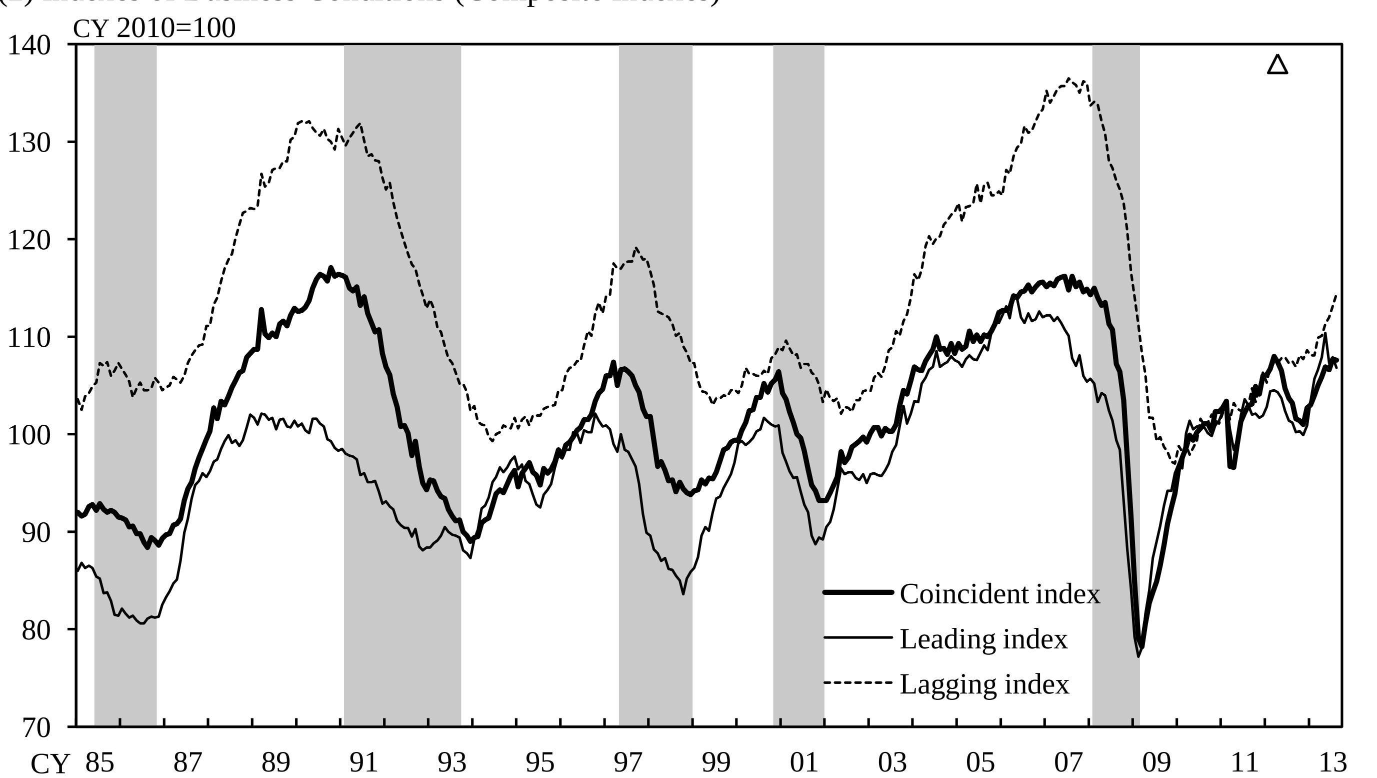
Charts

GDP and Indexes of Business Conditions

(1) GDP



(2) Indexes of Business Conditions (Composite Indexes)

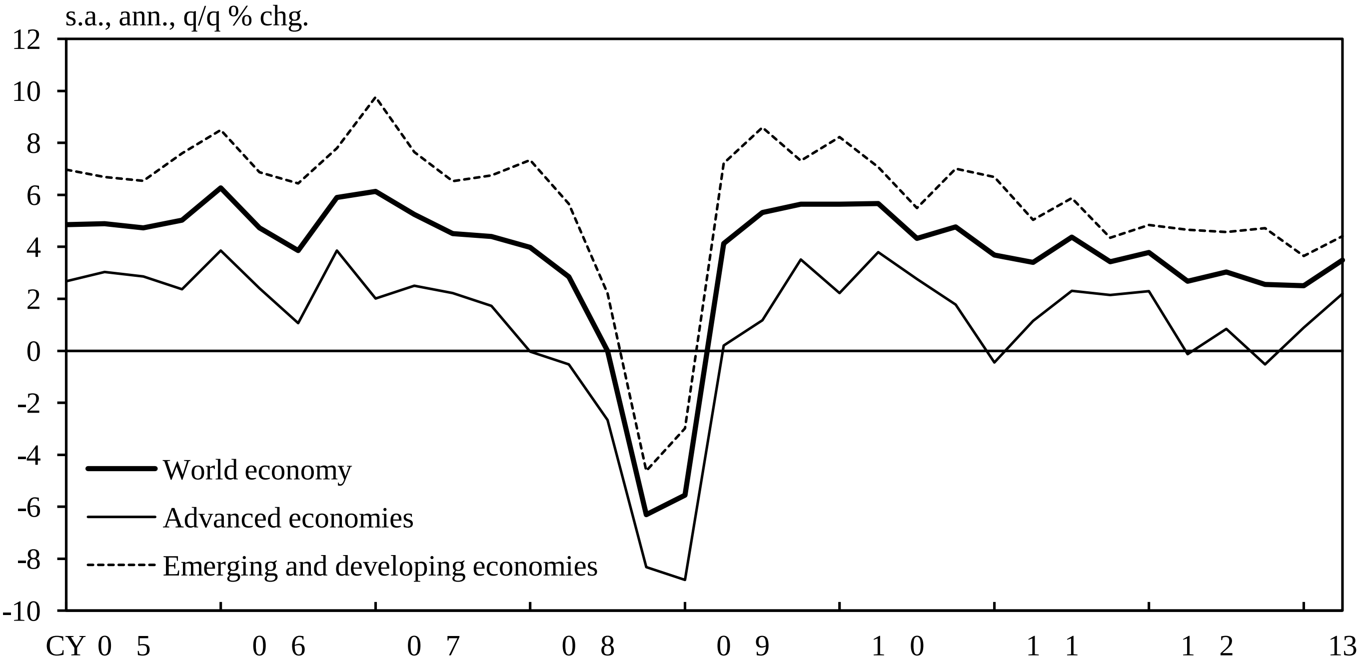


Note: Shaded areas indicate recession periods. Triangle shows the latest peak.

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

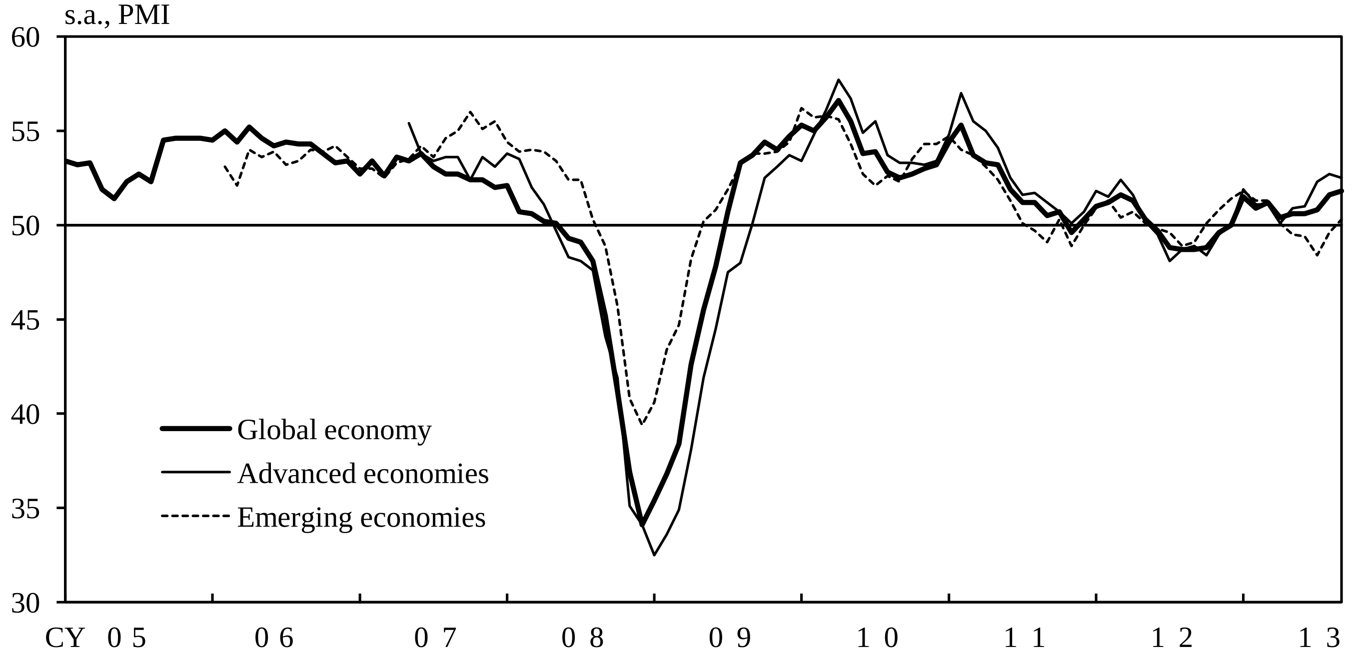
World Economy

(1) Real GDP Growth Rates of the World Economy



Notes: 1. Figures are calculated using GDP based on purchasing power parity (PPP) shares of the world total from the IMF.
2. The world economy covers 189 countries. The advanced economies are the United States, the euro area (17 countries), the United Kingdom, and Japan. The emerging and developing economies include the rest of the world economy.
3. Includes estimated quarterly growth rates based on historical annual data on real GDP growth rates.

(2) Business Confidence (Manufacturing)

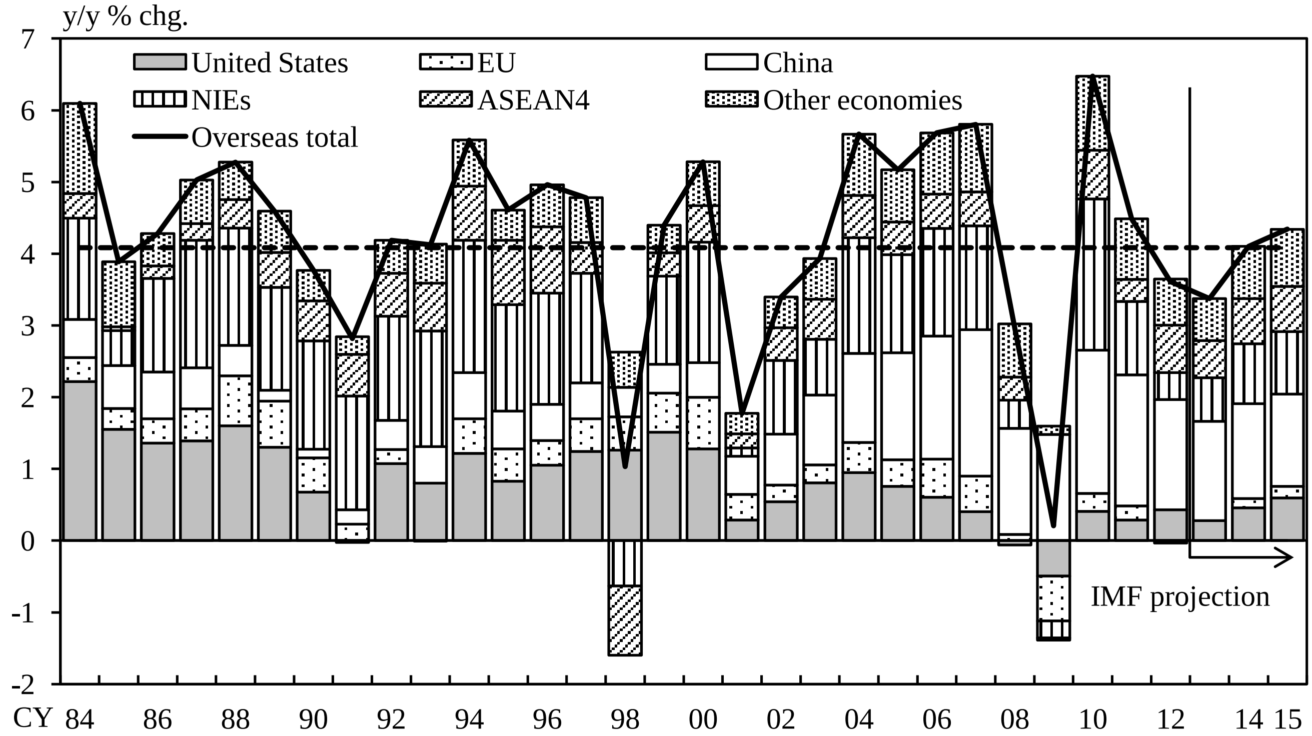


Notes: 1. Figures for the global economy are from the Markit PMI. Figures for the advanced economies and the emerging economies are calculated using the Markit PMI and GDP based on PPP shares of the world total from the IMF.
2. The advanced economies are the United States, the euro area, the United Kingdom, and Japan. The emerging economies are China, South Korea, Taiwan, Singapore, India, Australia, Russia, Turkey, Poland, the Czech Republic, and Brazil.
3. A reading of 50 on the PMI generally indicates a turning point between economic expansion and downturn.

Sources: IMF, "World Economic Outlook"; Markit (© and database right Markit Economics Ltd 2013. All rights reserved.), etc.

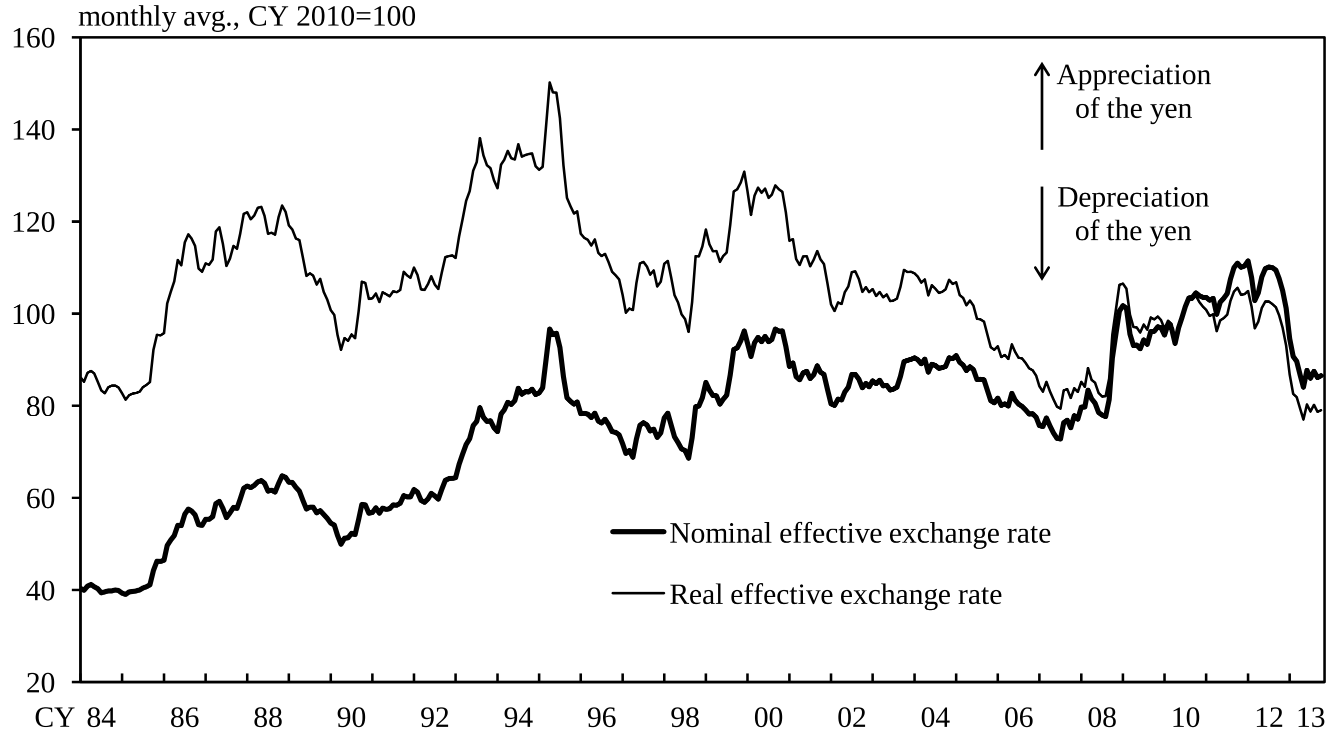
Overseas Economies and Exchange Rates

(1) Real GDP Growth Rates of Overseas Economies



Note: Figures for the overseas total are the weighted averages of real GDP growth rates by value of exports from Japan to each economy. The broken line indicates the average of 1980-2012 (4.1 percent).

(2) Effective Exchange Rates of the Yen

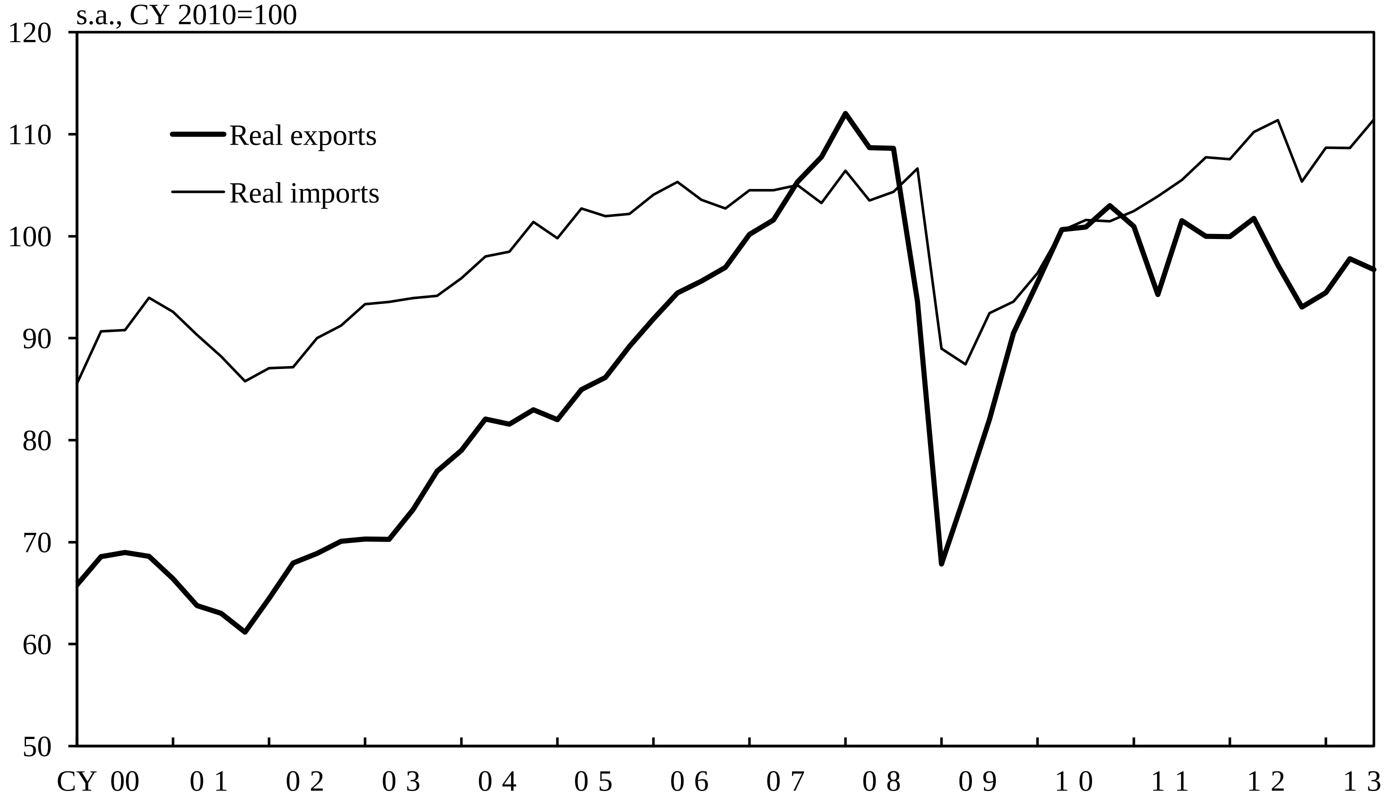


Note: Figures are based on the broad indices of the BIS effective exchange rates, and those prior to 1994 are calculated using the narrow indices. Figures for October 2013 are calculated using the Bank of Japan's nominal effective exchange rate of the yen.

Sources: IMF, "World Economic Outlook"; Ministry of Finance, "Trade Statistics"; Bank for International Settlements (BIS); Bank of Japan.

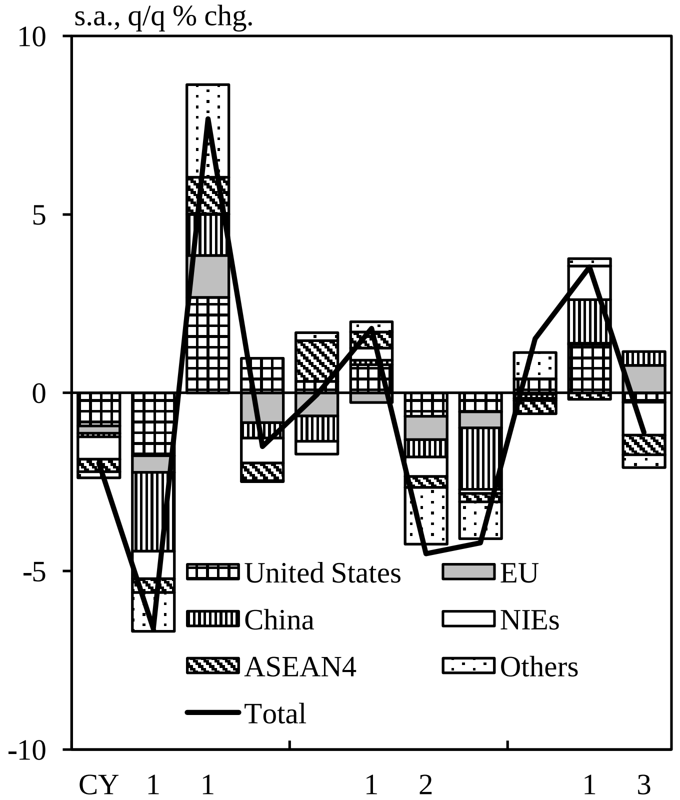
Exports and Imports

(1) Real Exports and Real Imports

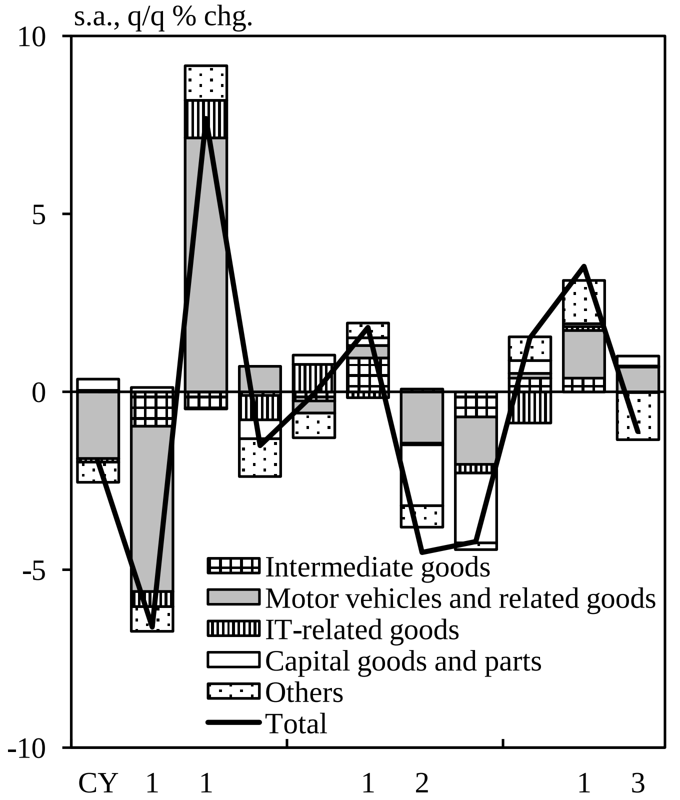


Note: Figures are seasonally adjusted by X-12-ARIMA. The same method applies to the charts below.

(2) Real Exports by Region



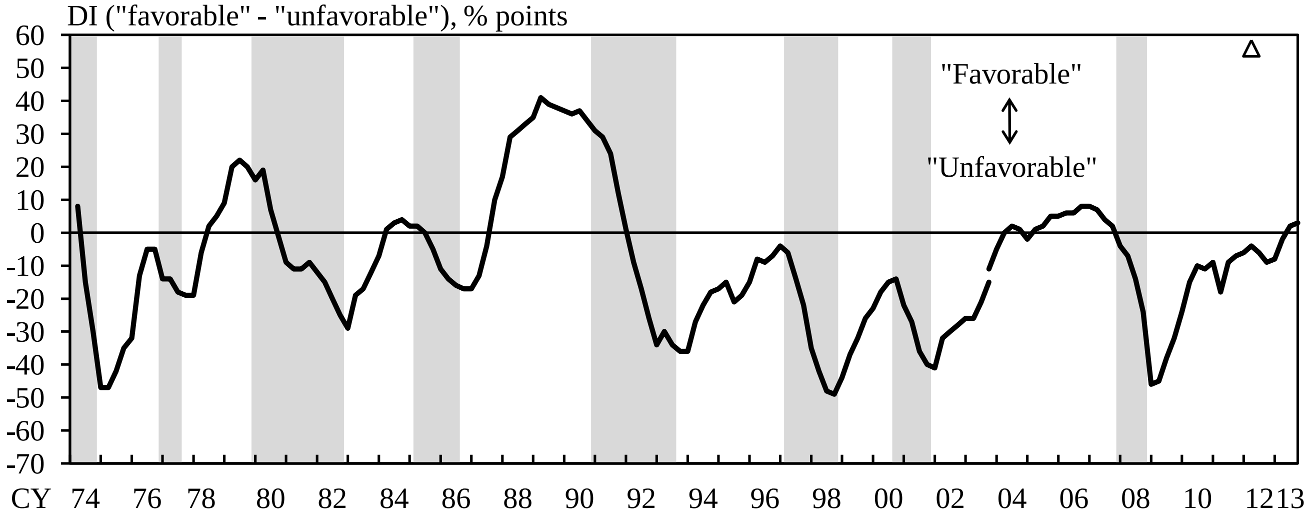
(3) Real Exports by Goods



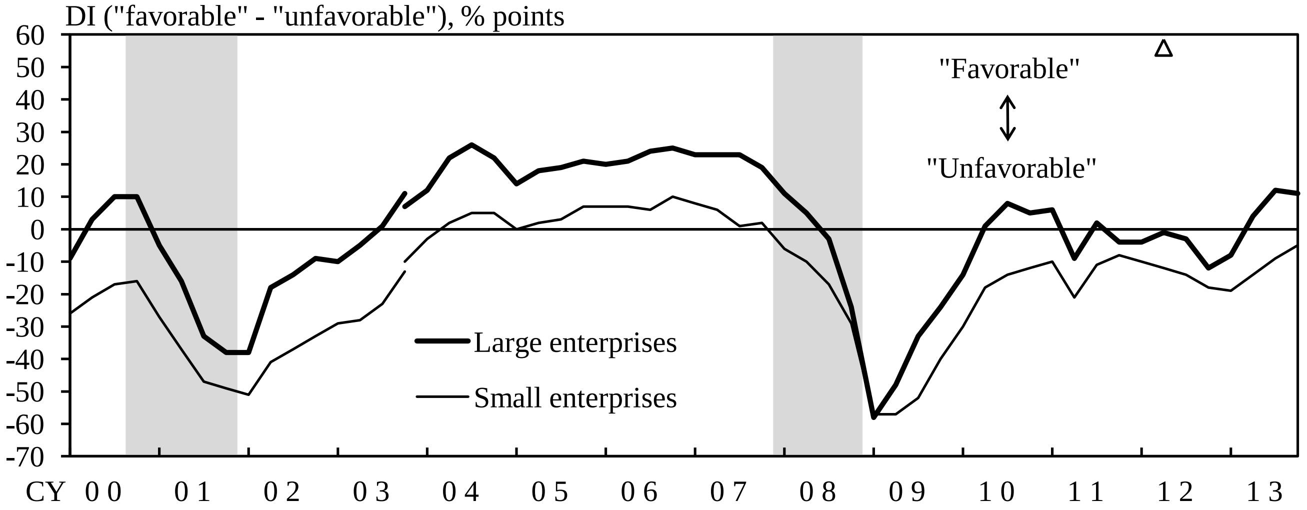
Sources: Ministry of Finance, "Trade Statistics"; Bank of Japan, "Corporate Goods Price Index."

Business Conditions

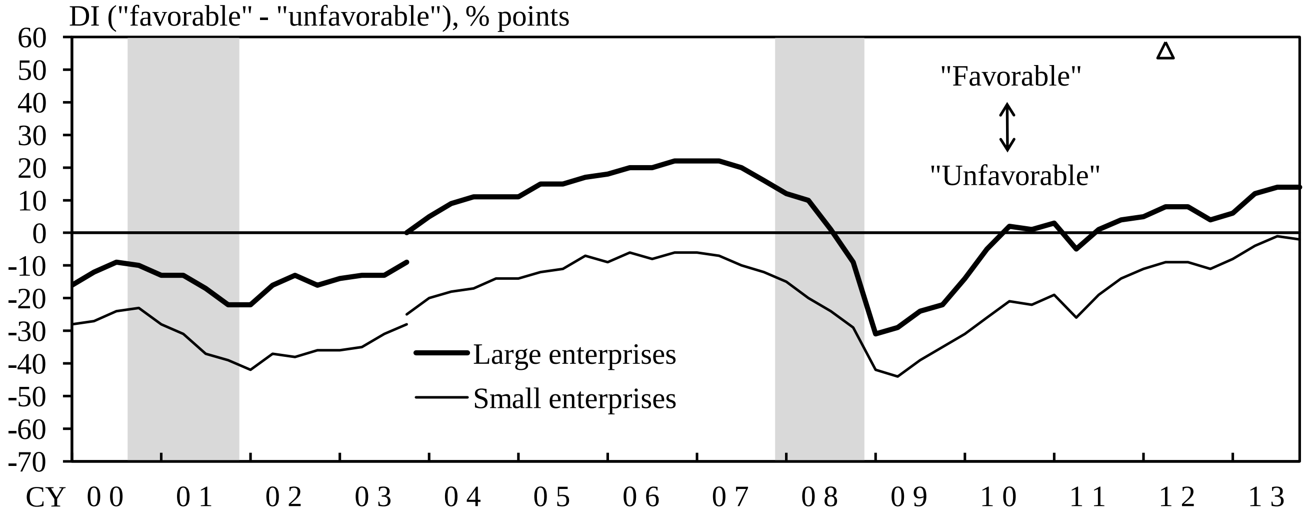
(1) All Industries and Enterprises



(2) Manufacturing



(3) Nonmanufacturing



Notes: 1. The "Tankan" was revised from the March 2004 survey. Figures up to the December 2003 survey are based on the previous data sets. Figures from the December 2003 survey are on the new basis. Figures for 2013/Q4 are the forecasts in the September 2013 survey.

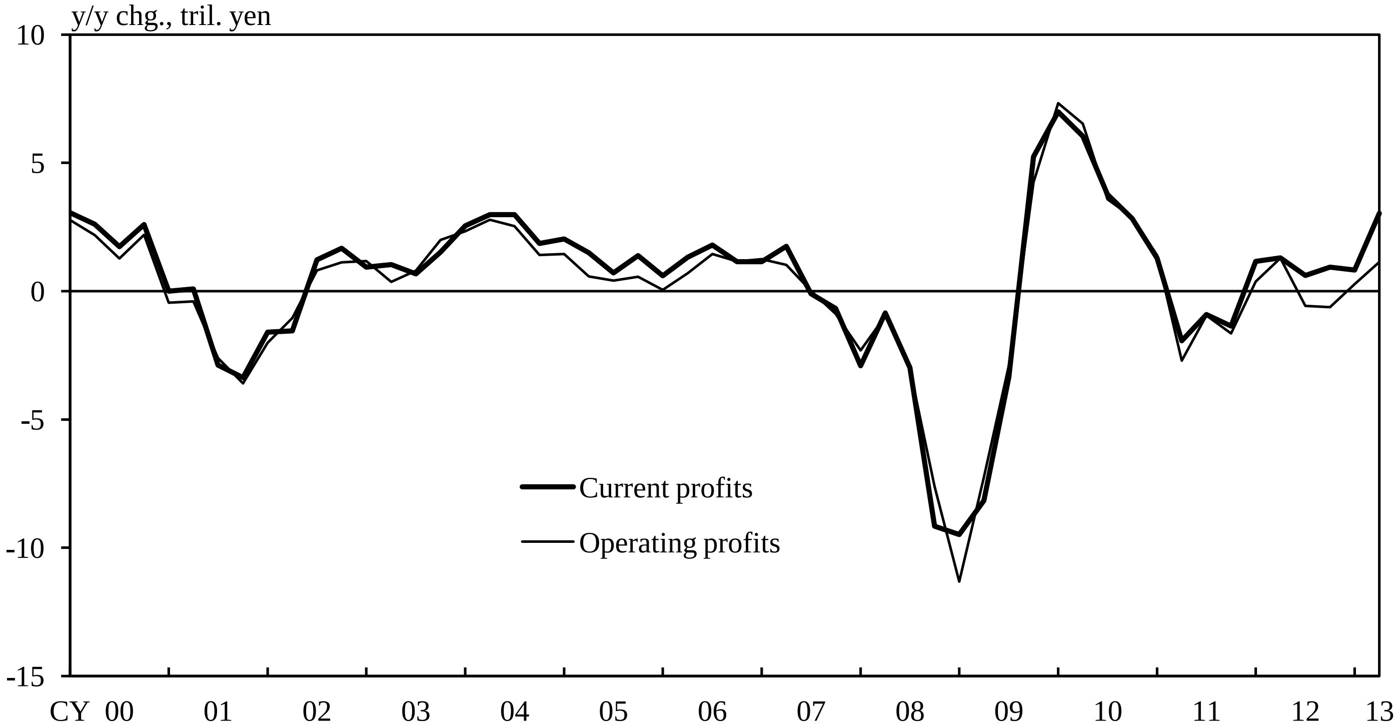
2. Shaded areas indicate recession periods. Triangles show the latest peaks.

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

Chart 6

Corporate Profits and Fixed Investment

(1) Corporate Profits



Note: Taken from the "Financial Statements Statistics of Corporations by Industry, Quarterly." Figures are based on all enterprises except finance and insurance.

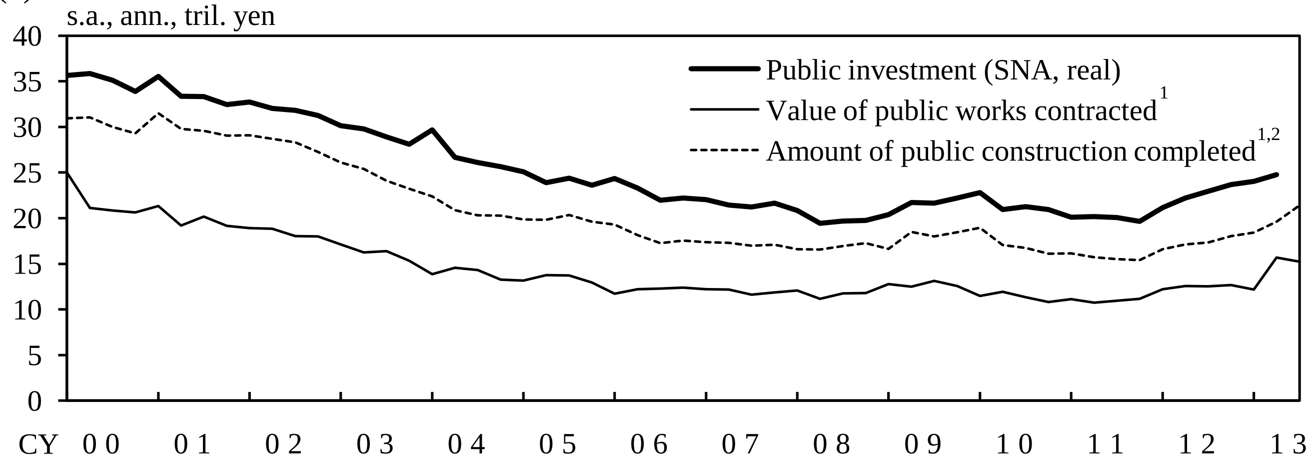
(2) Fixed Investment

Note: Taken from the "National Accounts." The figure represents real private non-residential investment.

Sources: Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Quarterly"; Cabinet Office, "National Accounts."

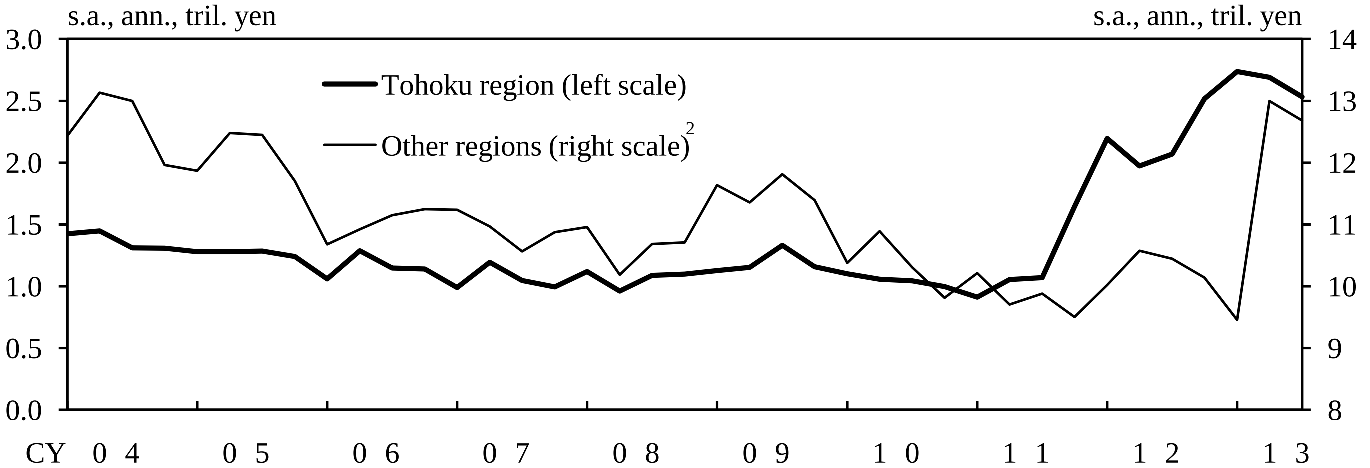
Public Investment and Housing Investment

(1) Indicators of Public Investment



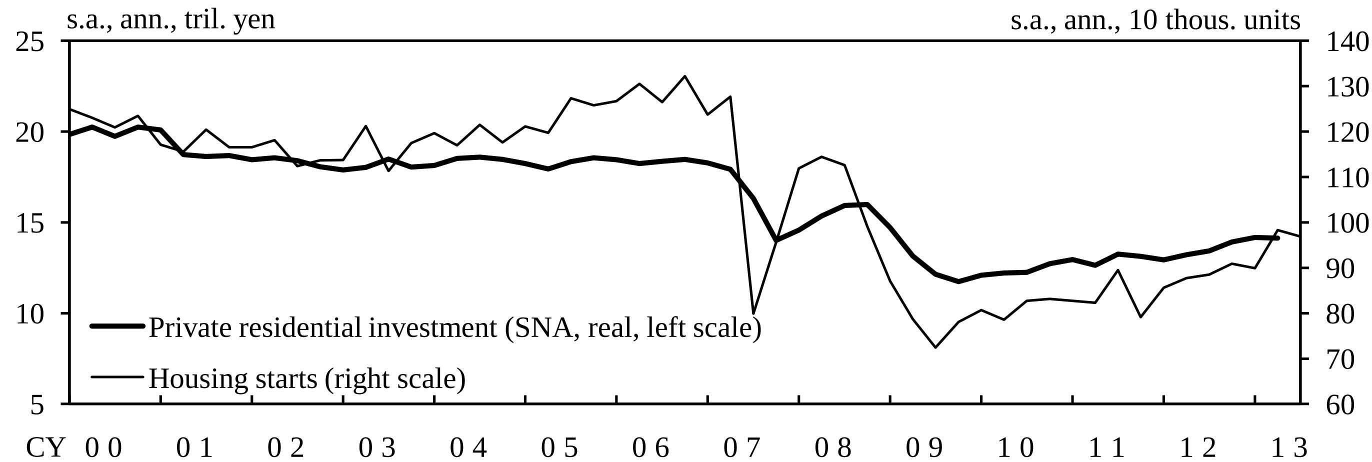
Notes: 1. Figures are seasonally adjusted by X-12-ARIMA.
2. The figure for 2013/Q3 is the July-August average.

(2) Value of Public Works Contracted by Region[1]



Notes: 1. Figures are seasonally adjusted by X-12-ARIMA.
2. The value of public works contracted described in Chart (1) minus that of the Tohoku region.

(3) Housing Starts and Private Residential Investment

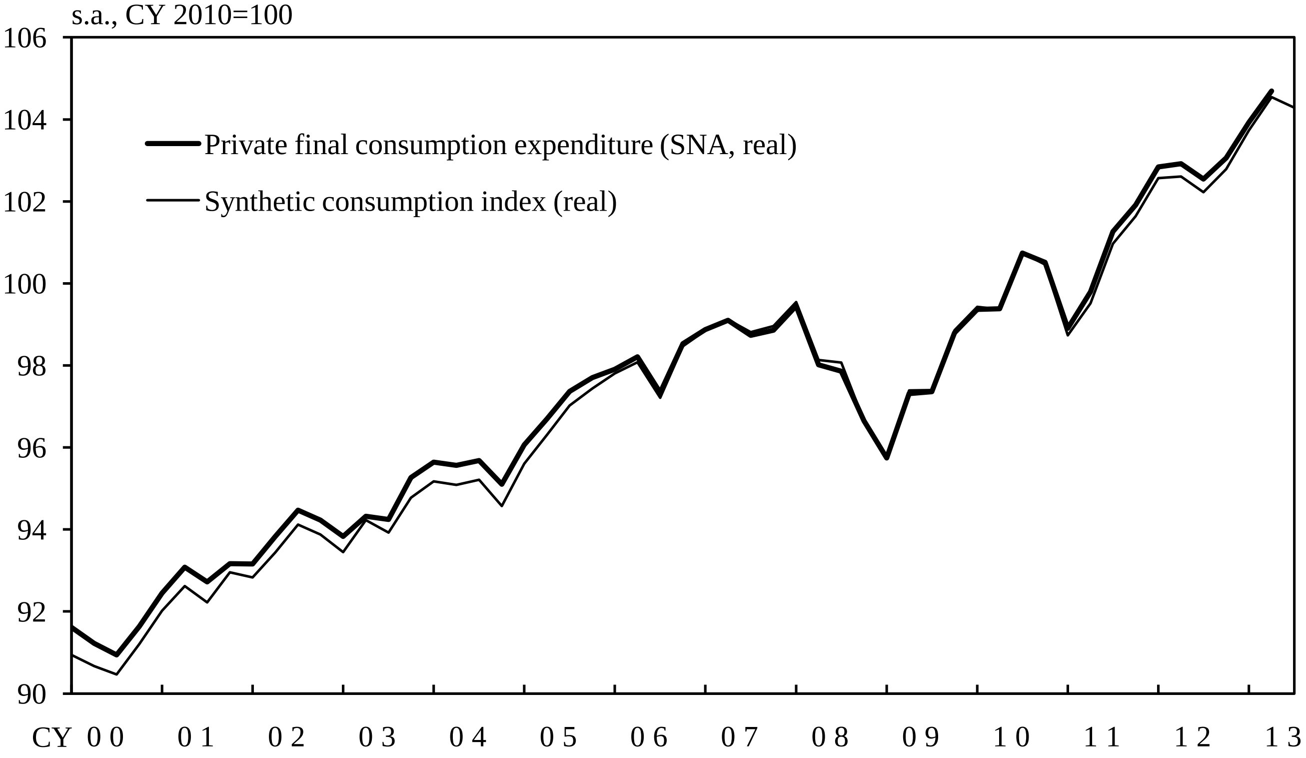


Note: The figure for housing starts for 2013/Q3 is the July-August average.

Sources: Cabinet Office, "National Accounts"; East Japan Construction Surety, etc., "Public Works Prepayment Surety Statistics"; Ministry of Land, Infrastructure, Transport and Tourism, "Integrated Statistics on Construction Works," "Statistics on Building Construction Starts."

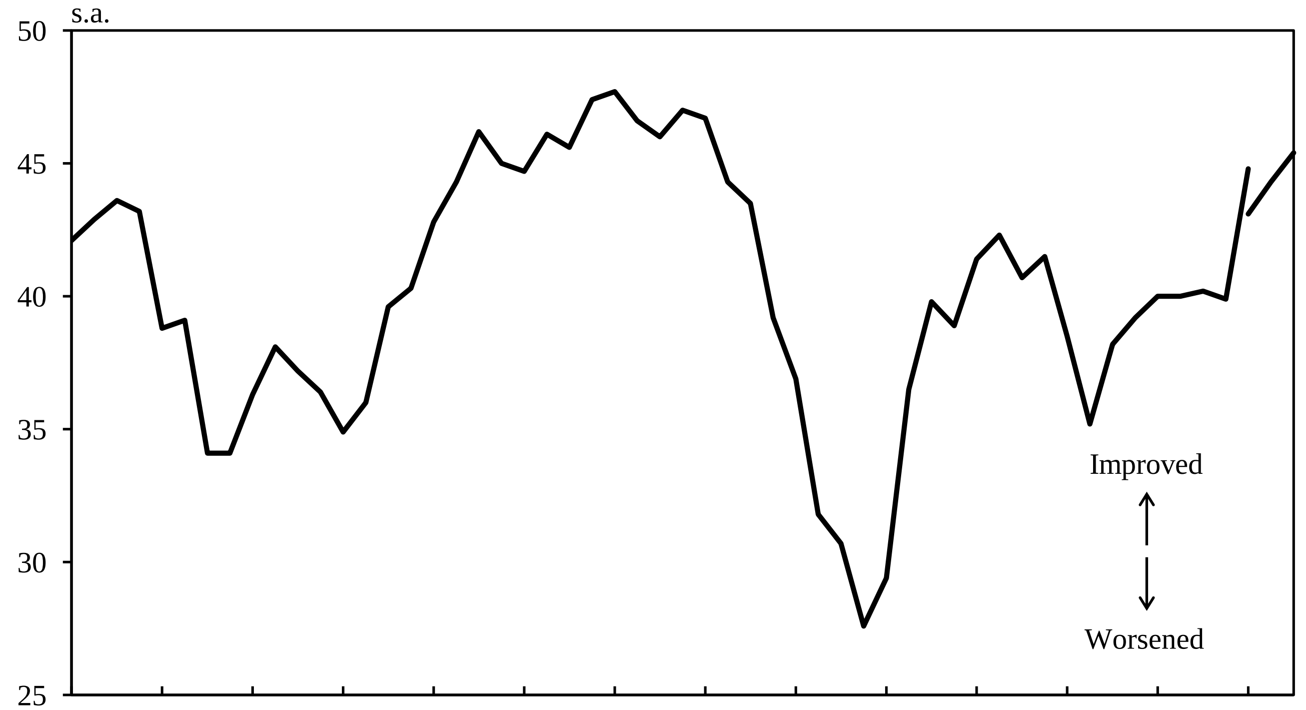
Private Consumption

(1) Private Final Consumption Expenditure and Synthetic Consumption Index



Note: The figure for the synthetic consumption index for 2013/Q3 is the July-August average.

(2) Consumer Confidence Index

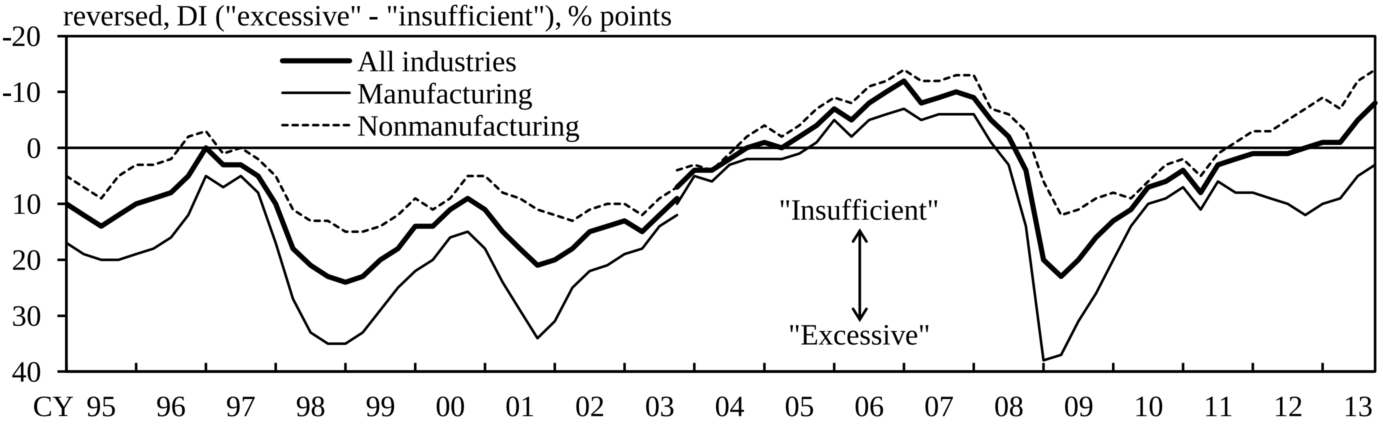


Note: In April 2013, the Cabinet Office changed the method for conducting the Consumer Confidence Survey to a postal method, along with some other changes. For this reason, there is a discontinuity between data up to March 2013, which were obtained from the survey on a visit-and-leave method, and those thereafter. The figure for 2013/Q1 on the postal-method basis is obtained from an examination survey.

Source: Cabinet Office, "National Accounts," "Synthetic Consumption Index," "Consumer Confidence Survey."

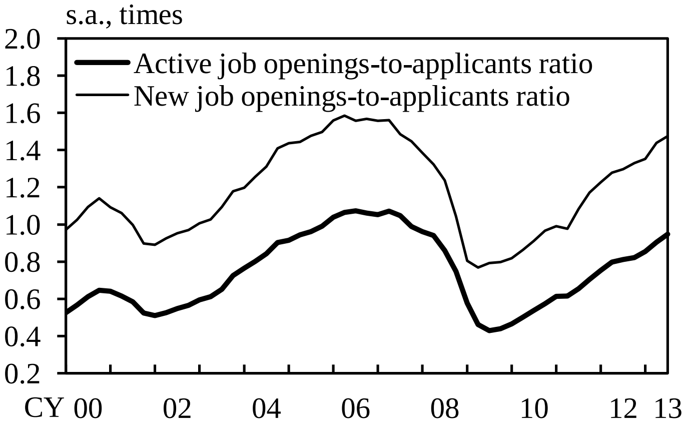
Employment and Income Situation

(1) Employment Conditions DI



Note: Data from the "Tankan" are based on enterprises of all sizes. The "Tankan" was revised from the March 2004 survey. Figures up to the December 2003 survey are based on the previous data sets. Figures from the December 2003 survey are on the new basis. Figures for 2013/Q4 are the forecasts in the September 2013 survey.

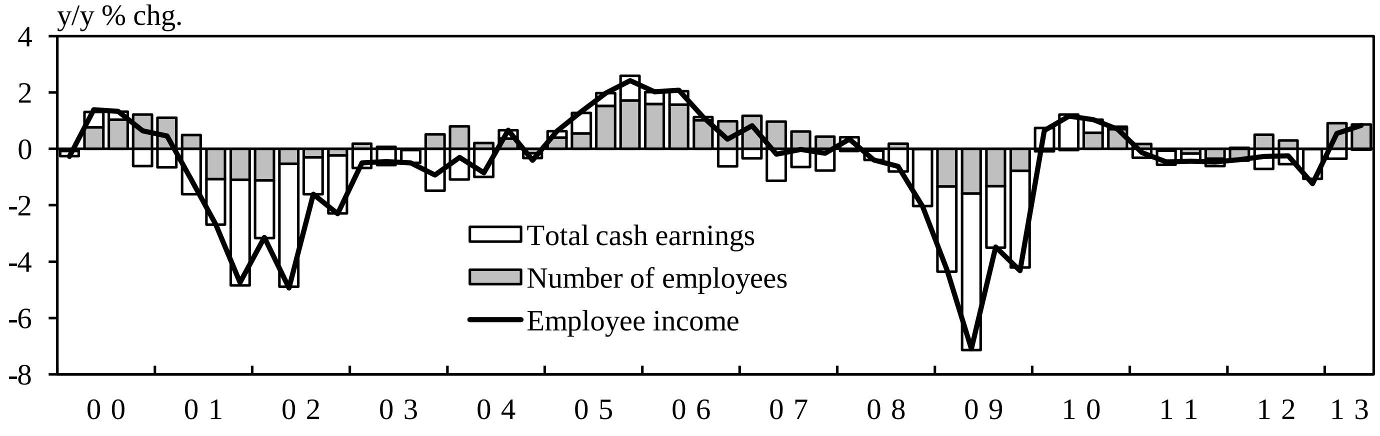
(2) Job Openings-to-Applicants Ratio



(3) Unemployment Rate

Note: The structural unemployment rate is defined as the level of the unemployment rate where the number of vacancies equals that of the unemployed, given the empirical relationship between job vacancies and unemployment (estimation by the Research and Statistics Department, Bank of Japan). It captures frictional unemployment and unemployment caused by the mismatch between supply and demand in the labor market.

(4) Breakdown of Employee Income

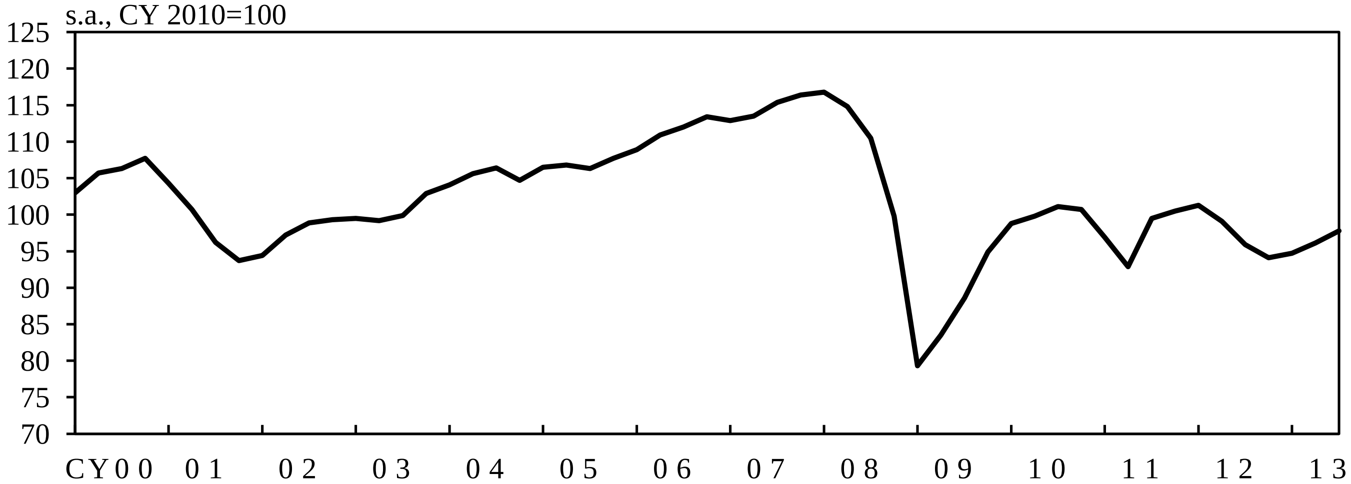


Note: Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February.
Employee income = number of employees (Labour Force Survey) × total cash earnings

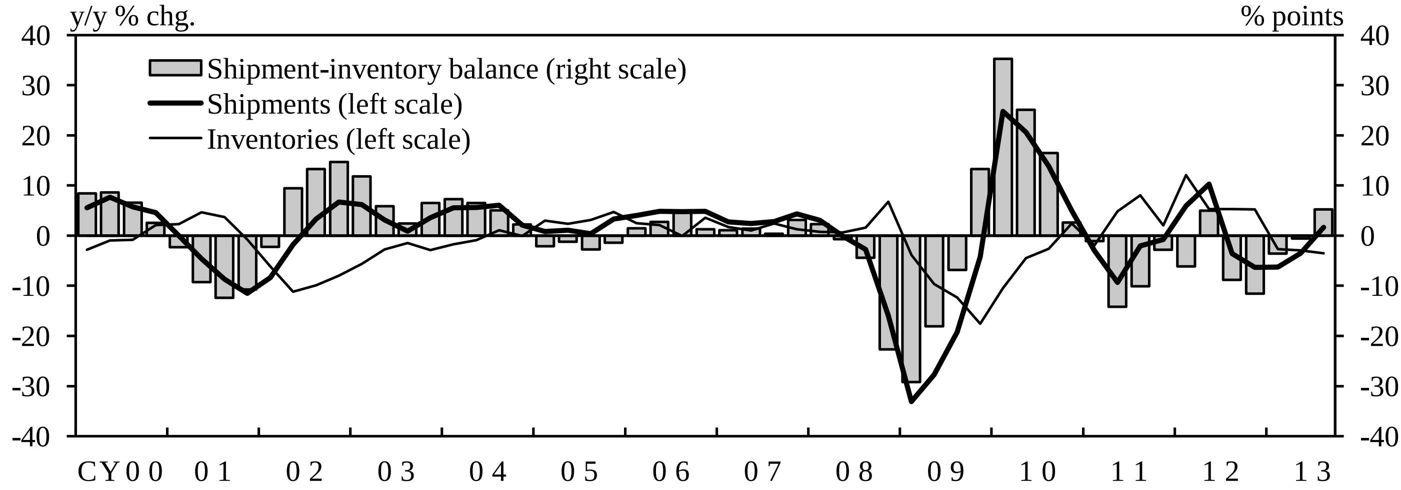
Sources: Bank of Japan, "*Tankan*, Short-Term Economic Survey of Enterprises in Japan";
Ministry of Health, Labour and Welfare, "Monthly Labour Survey," "Report on Employment Service";
Ministry of Internal Affairs and Communications, "Labour Force Survey."

Industrial Production and All Industry Activity

(1) Industrial Production

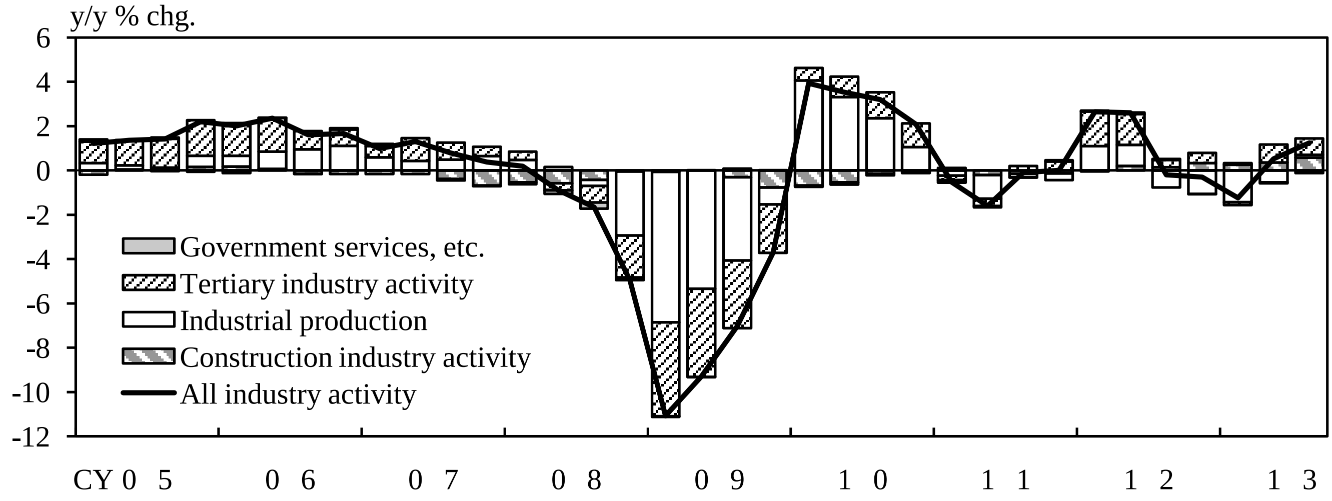


(2) Shipment-Inventory Balance (Mining and Manufacturing)



Note: Shipment-inventory balance = shipments (y/y % chg.) - inventories (y/y % chg.)

(3) All Industry Activity

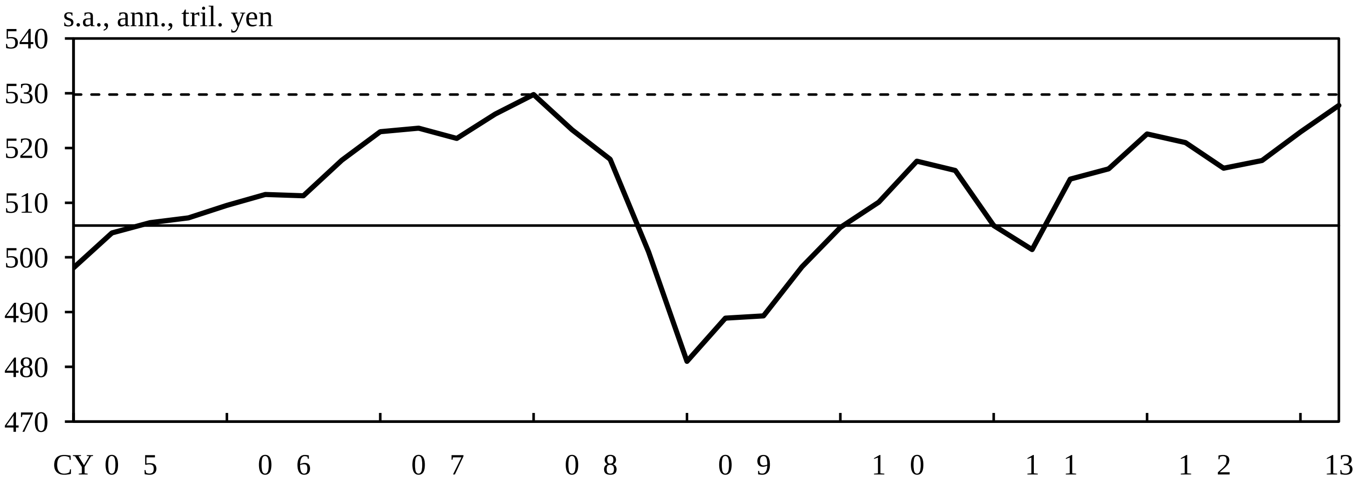


Note: Figures for 2013/Q3 are July-August averages.

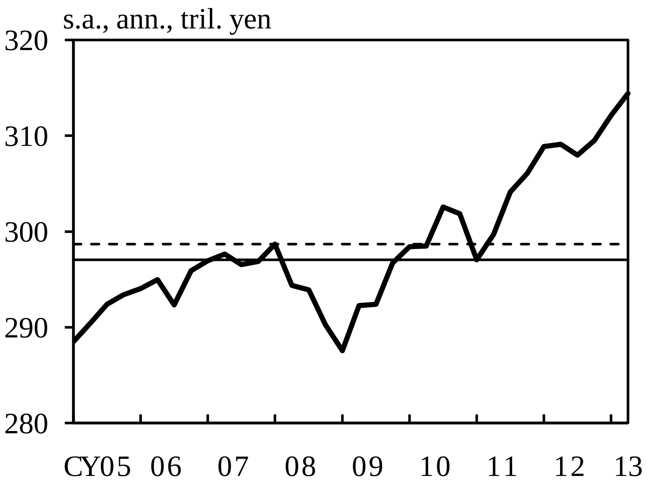
Source: Ministry of Economy, Trade and Industry, "Indices of Industrial Production,"
"Indices of All Industry Activity."

Real GDP and Its Components

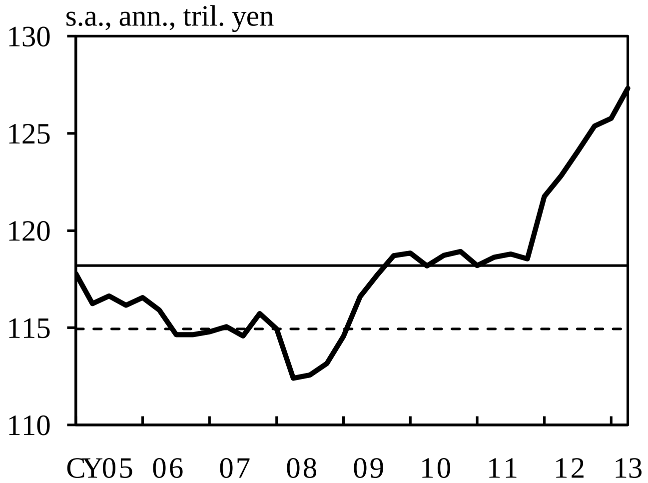
(1) Real GDP



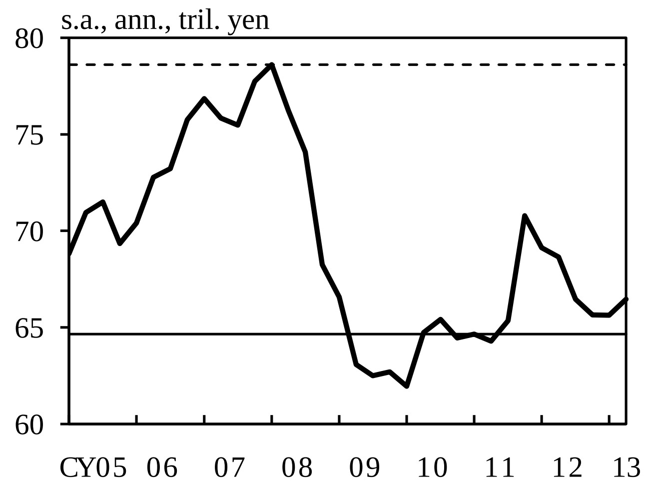
(2) Private Consumption



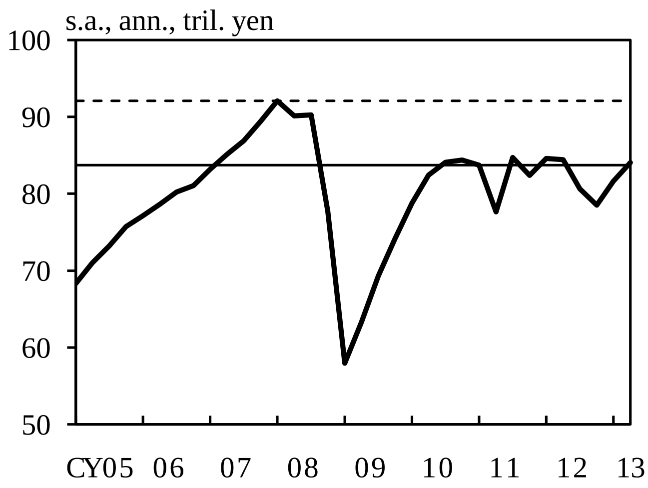
(3) Public Demand



(4) Private Non-Residential Investment



(5) Exports

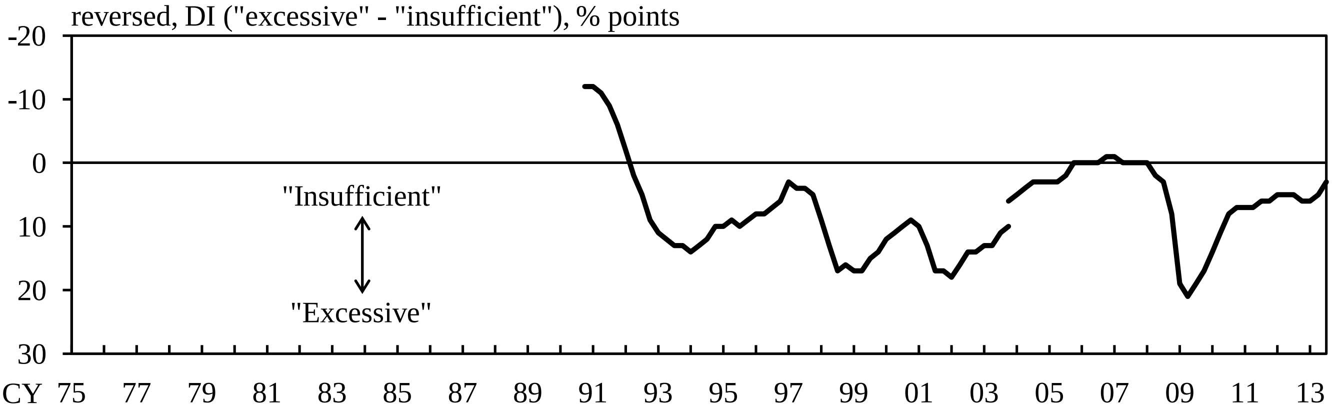


Note: In each chart, the broken line indicates the level for 2008/Q1, when real GDP recorded its peak just before the Lehman shock. The thin solid line indicates that of 2011/Q1, when the Great East Japan Earthquake occurred.

Source: Cabinet Office, "National Accounts."

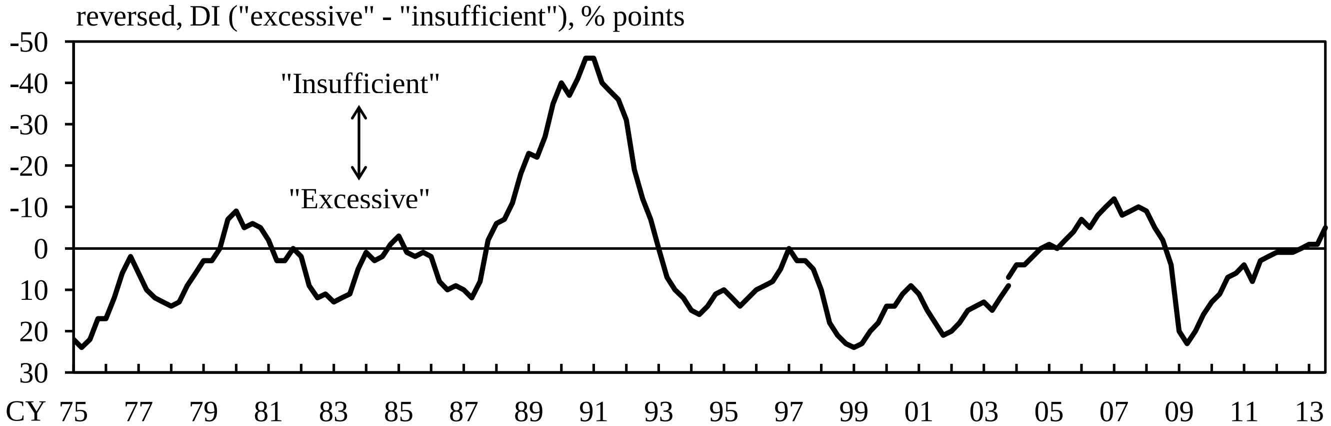
Resource Utilization

(1) Production Capacity DI

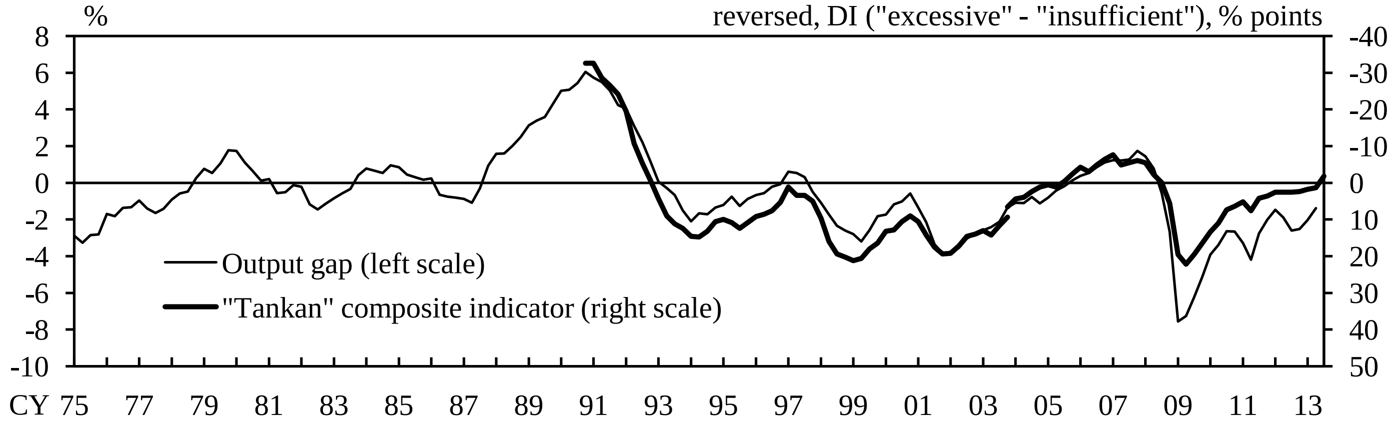


Notes: 1. Figures for the DI are based on all enterprises. The same definition applies to the charts below.
2. The "Tankan" was revised from the March 2004 survey. Figures up to the December 2003 survey are based on the previous data sets. Figures from the December 2003 survey are on the new basis. The same definition applies to the charts below.

(2) Employment Conditions DI



(3) *Tankan* Composite Indicator and Output Gap



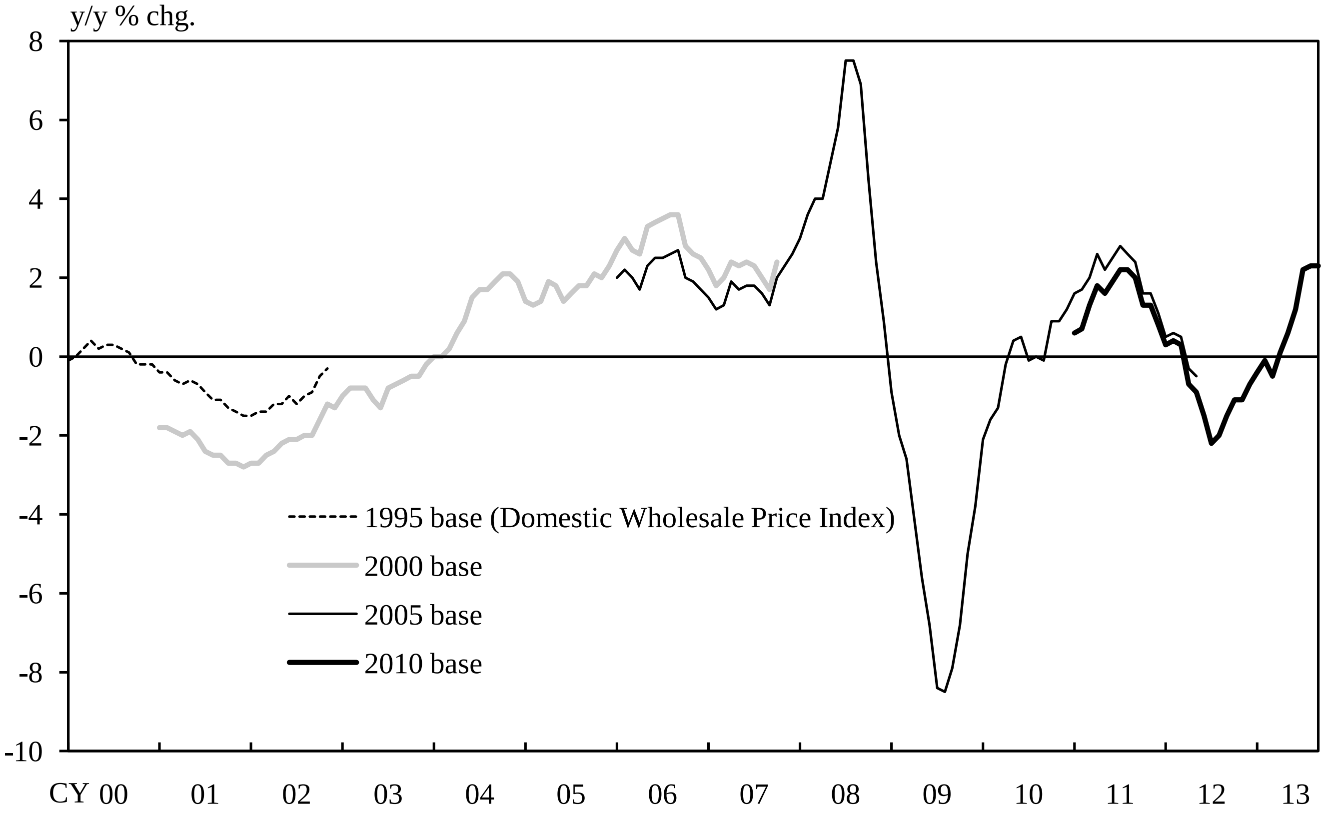
Note: Figures for the "Tankan" composite indicator are weighted averages of the production capacity DI and employment conditions DI. The fiscal 1990-2011 averages of capital and labor shares in the "National Accounts" are used as the weight. The output gap is estimated by the Research and Statistics Department, Bank of Japan. For the estimation procedures, see "The New Estimates of Output Gap and Potential Growth Rate," Bank of Japan Review Series, 2006-E-3.

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

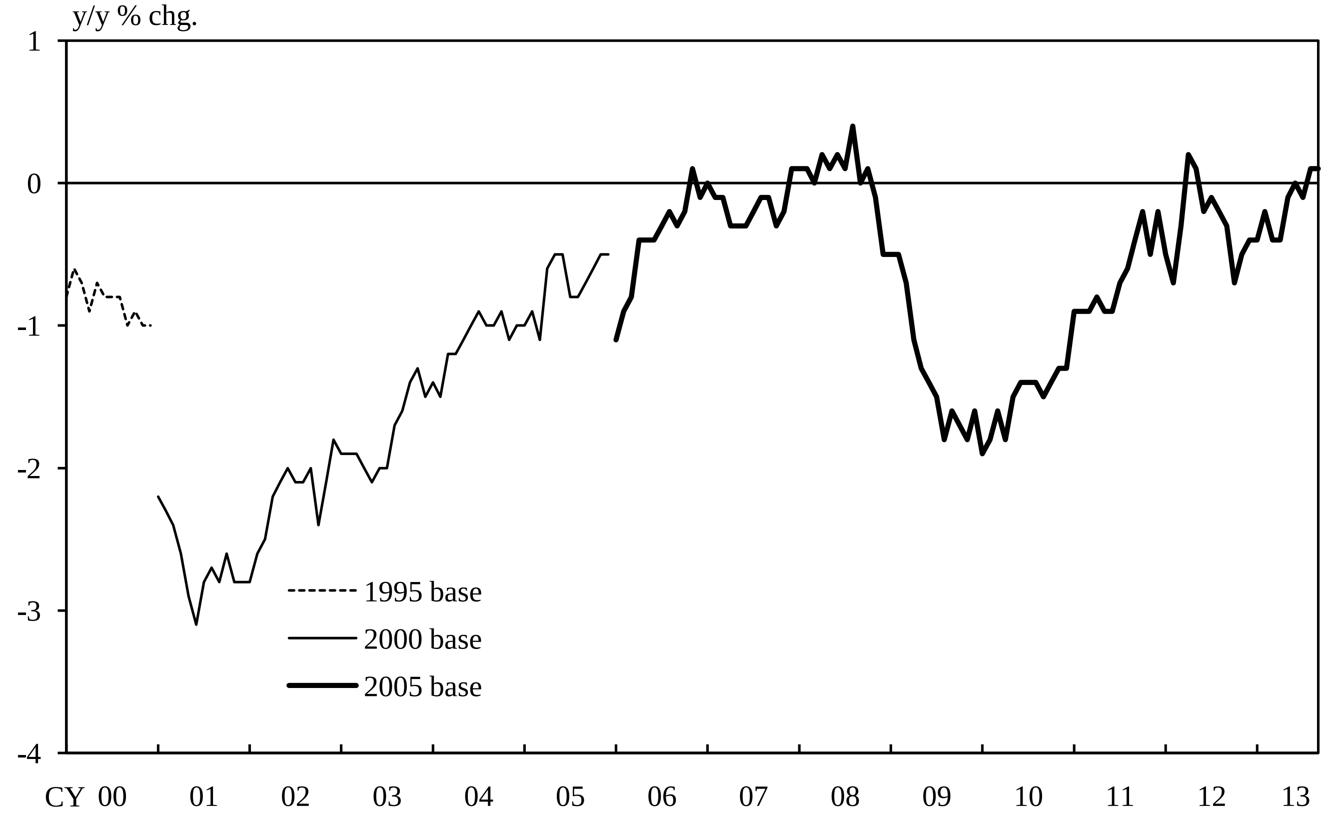
Chart 13

Domestic Corporate Goods Prices and Corporate Services Prices

(1) Domestic Corporate Goods Price Index



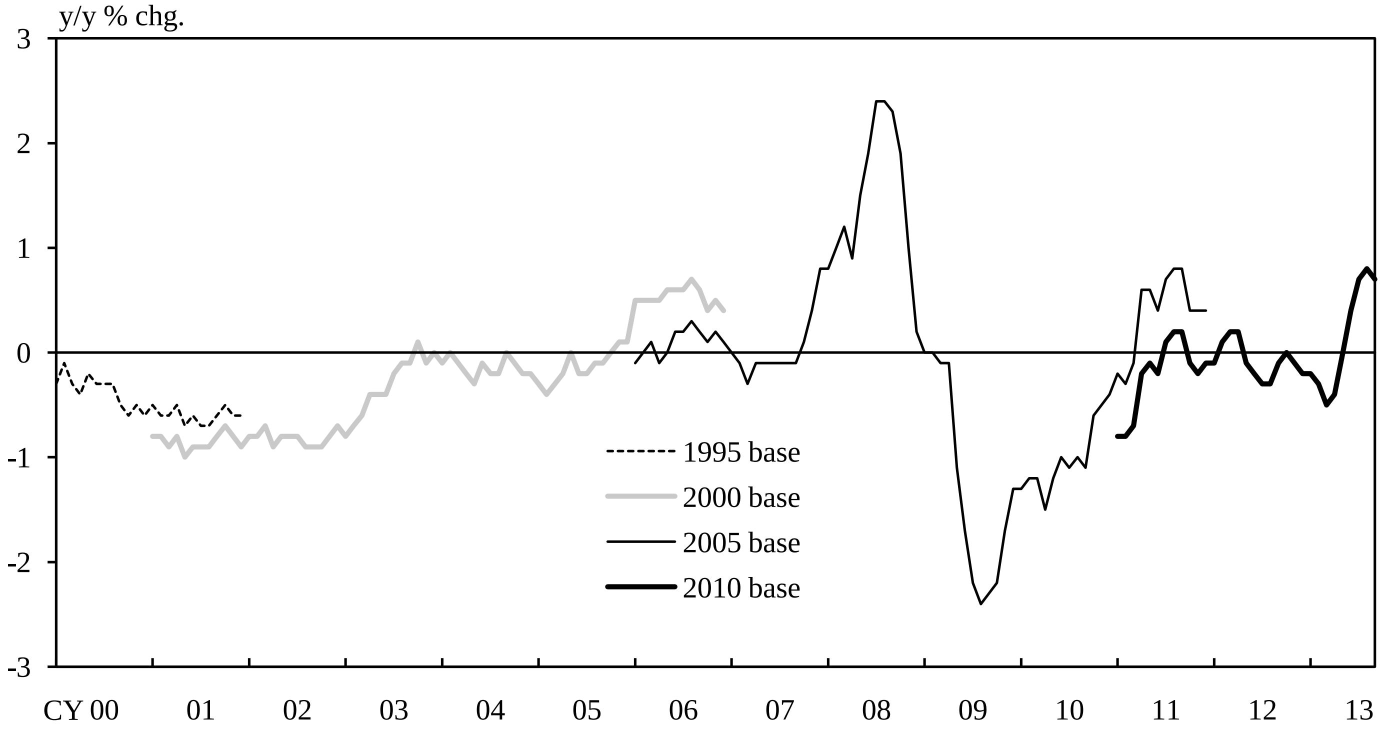
(2) Corporate Services Price Index (Excluding International Transportation)



Source: Bank of Japan, "Corporate Goods Price Index," "Wholesale Price Index," "Corporate Services Price Index."

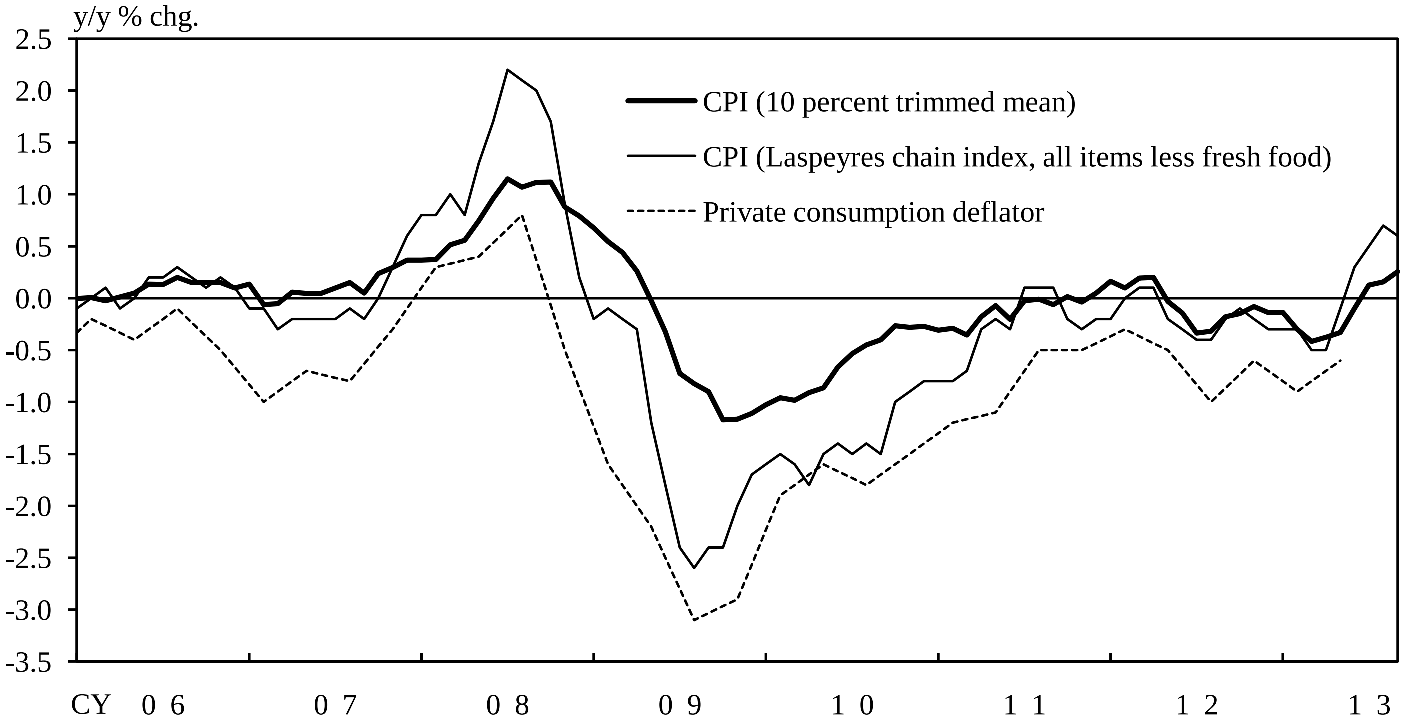
Consumer Price Index (1)

(1) Consumer Price Index



Note: All items less fresh food.

(2) Trimmed Mean, Laspeyres Chain Index, and Private Consumption Deflator



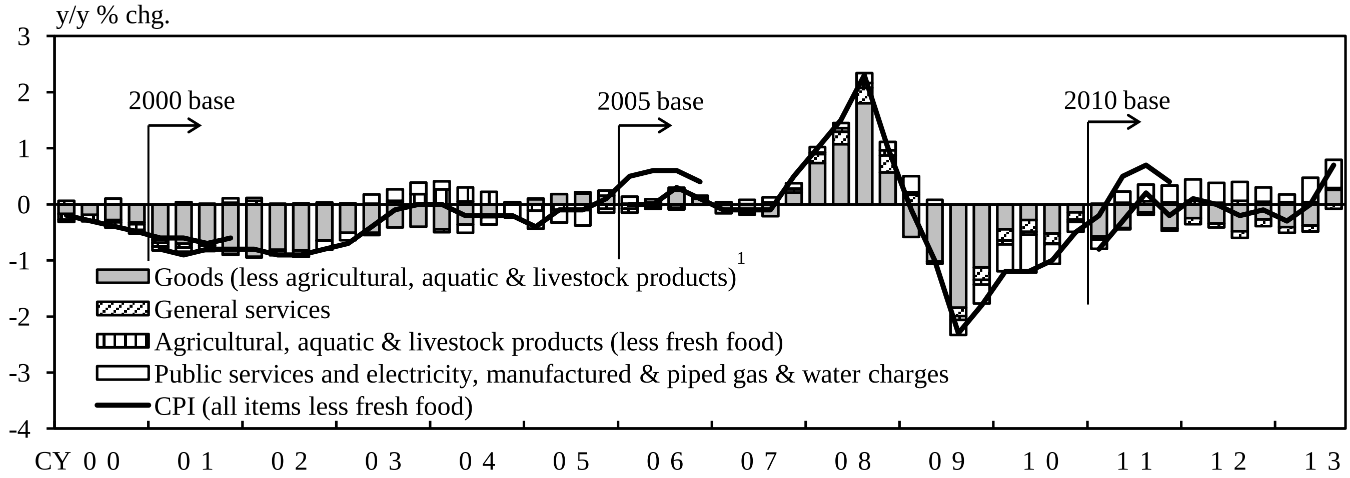
Notes: 1. Figures for the 10 percent trimmed mean are weighted averages of items; these items are obtained by rearranging year-on-year rates of price change in ascending order and then excluding items in both the upper and lower 10 percent tails by weight.

2. Figures for the Laspeyres chain index for 2006 are the year-on-year rates for the fixed-base method. The year-on-year figures for the Laspeyres chain index up to 2010 are on the 2005 base, and those from 2011 onward are on the 2010 base.

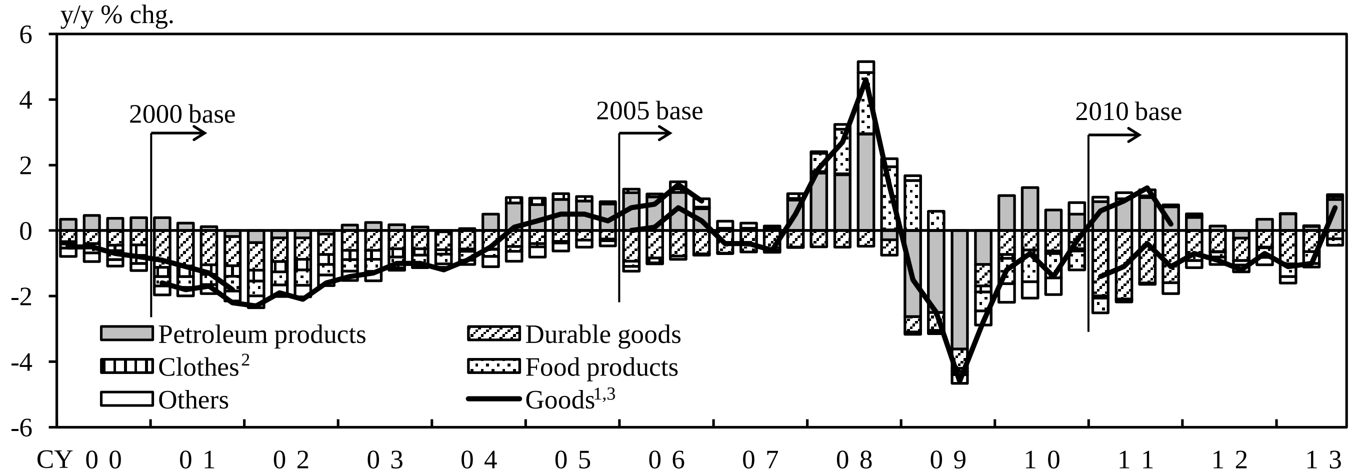
Sources: Ministry of Internal Affairs and Communications, "Consumer Price Index"; Cabinet Office, "National Accounts."

Consumer Price Index (2)

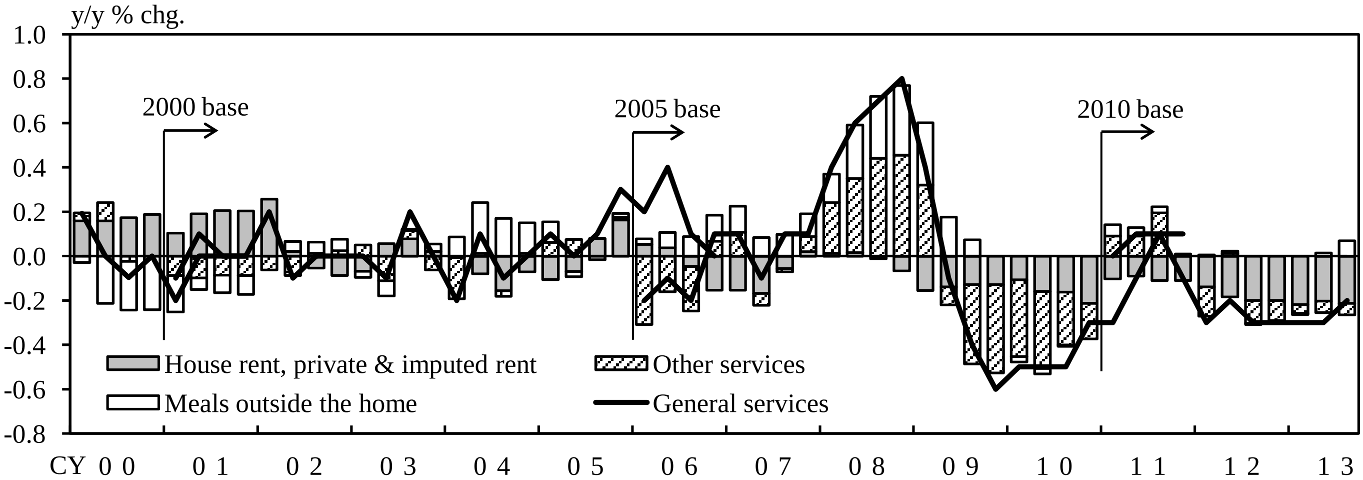
(1) Consumer Price Index (All Items Less Fresh Food)



(2) Goods (Less Agricultural, Aquatic & Livestock Products)[1]



(3) General Services

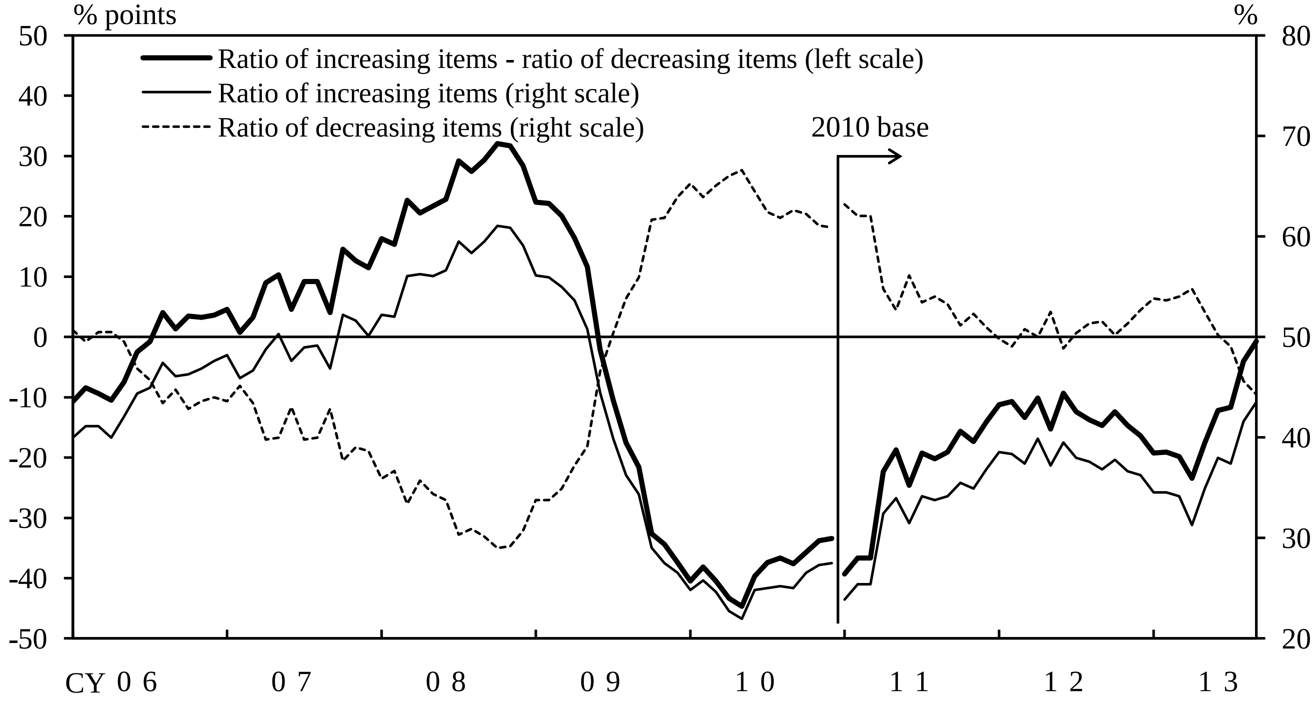


Notes: 1. The items are basically the same as those defined by the Ministry of Internal Affairs and Communications. However, electricity, manufactured & piped gas & water charges are excluded from goods.
2. Including shirts, sweaters & underwear.
3. Less agricultural, aquatic & livestock products.
4. The year-on-year rates of change, other than those of the CPI (all items less fresh food) and general services, are calculated using published indices.

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

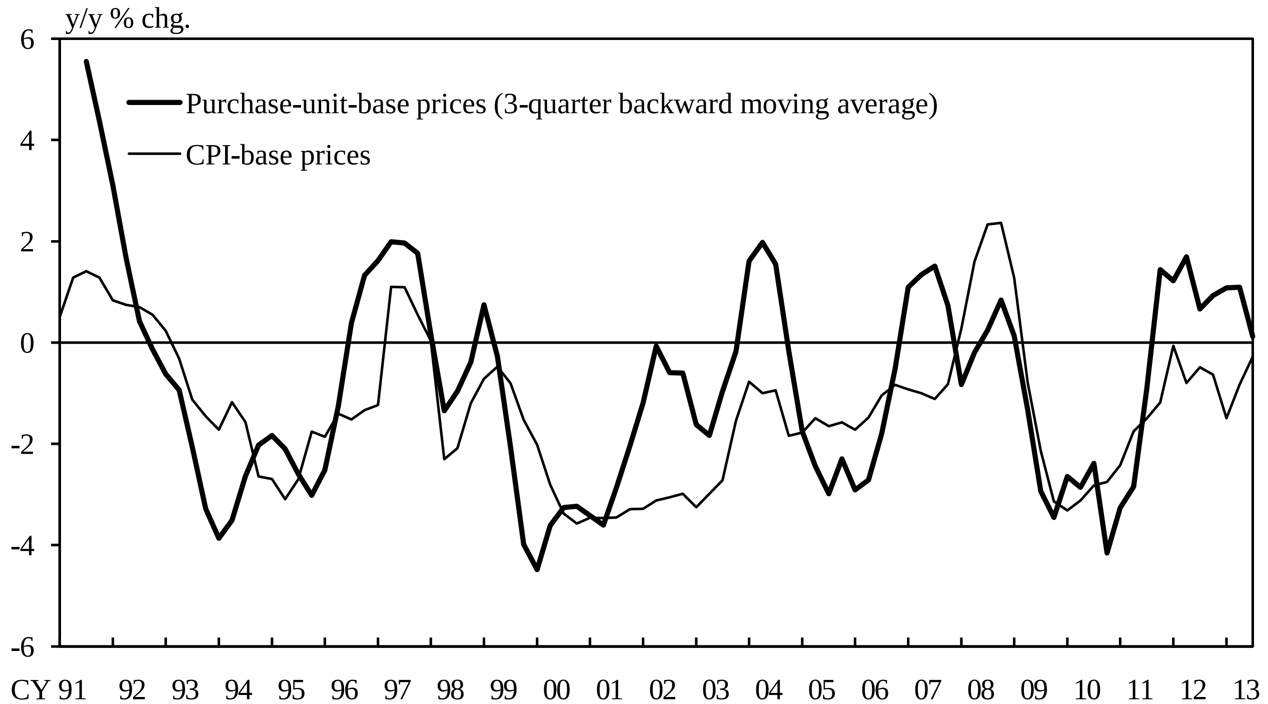
Consumer Price Index (3)

(1) Ratio of Increasing and Decreasing Items



Note: Proportion of items whose year-on-year rates of price change increased/decreased. All items less fresh food.

(2) Purchase-Unit-Base Prices (Family Income and Expenditure Survey)



Notes: 1. Figures are the weighted averages of the items of food products, agricultural, aquatic & livestock products (less fresh food), clothes, durable goods, and other goods that are continuously available in both the CPI and the "Family Income and Expenditure Survey."

2. Definitions of the items are basically the same as those published by the Ministry of Internal Affairs and Communications.

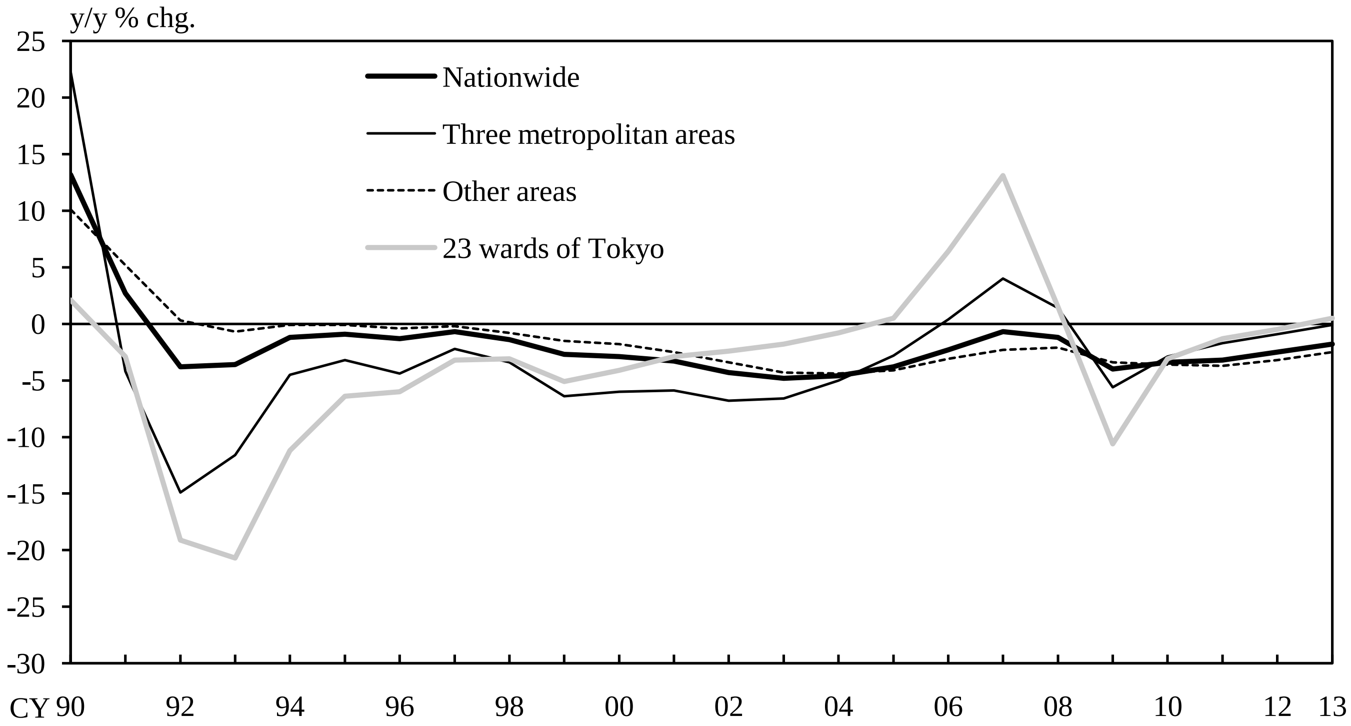
3. Other goods exclude clothes (including shirts, sweaters & underwear); food products; agricultural, aquatic & livestock products; durable goods; petroleum products; and electricity, manufactured & piped gas & water charges.

4. Figures for 2013/Q3 are July-August averages.

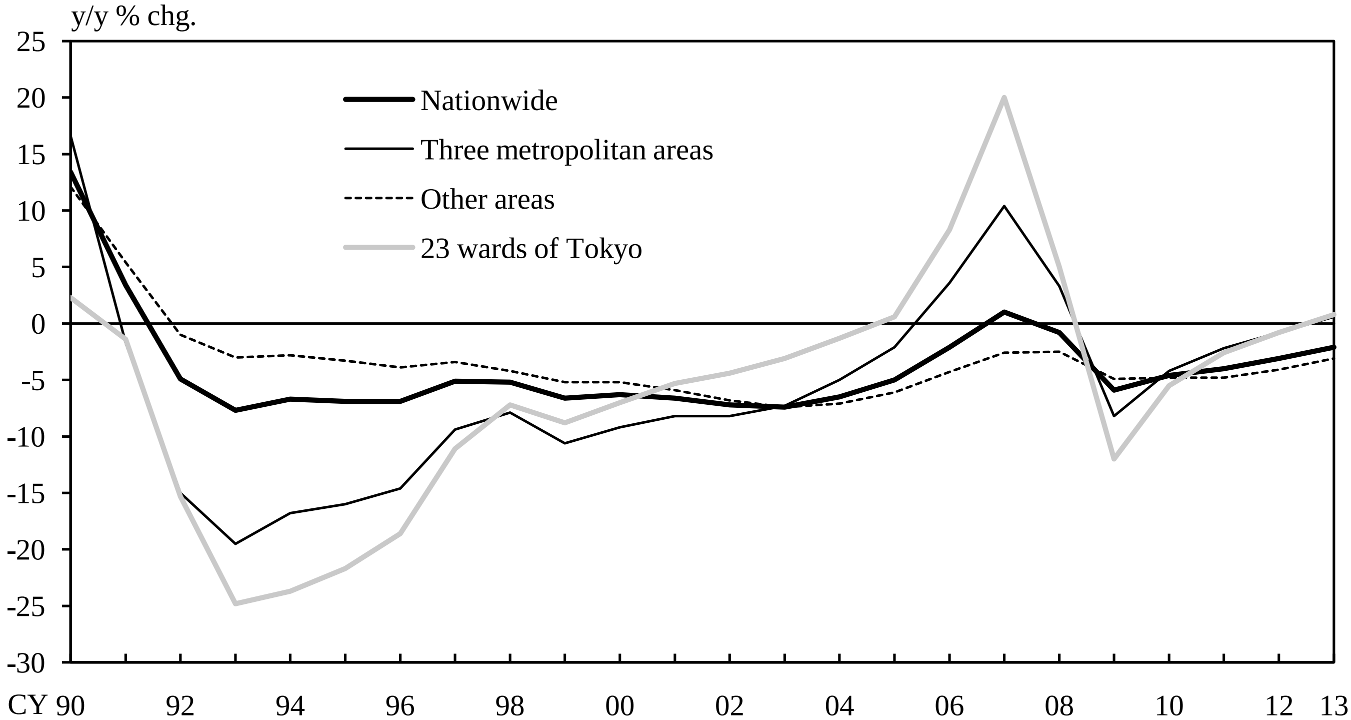
Source: Ministry of Internal Affairs and Communications, "Consumer Price Index," "Family Income and Expenditure Survey."

Land Prices

(1) Residential Land



(2) Commercial Land



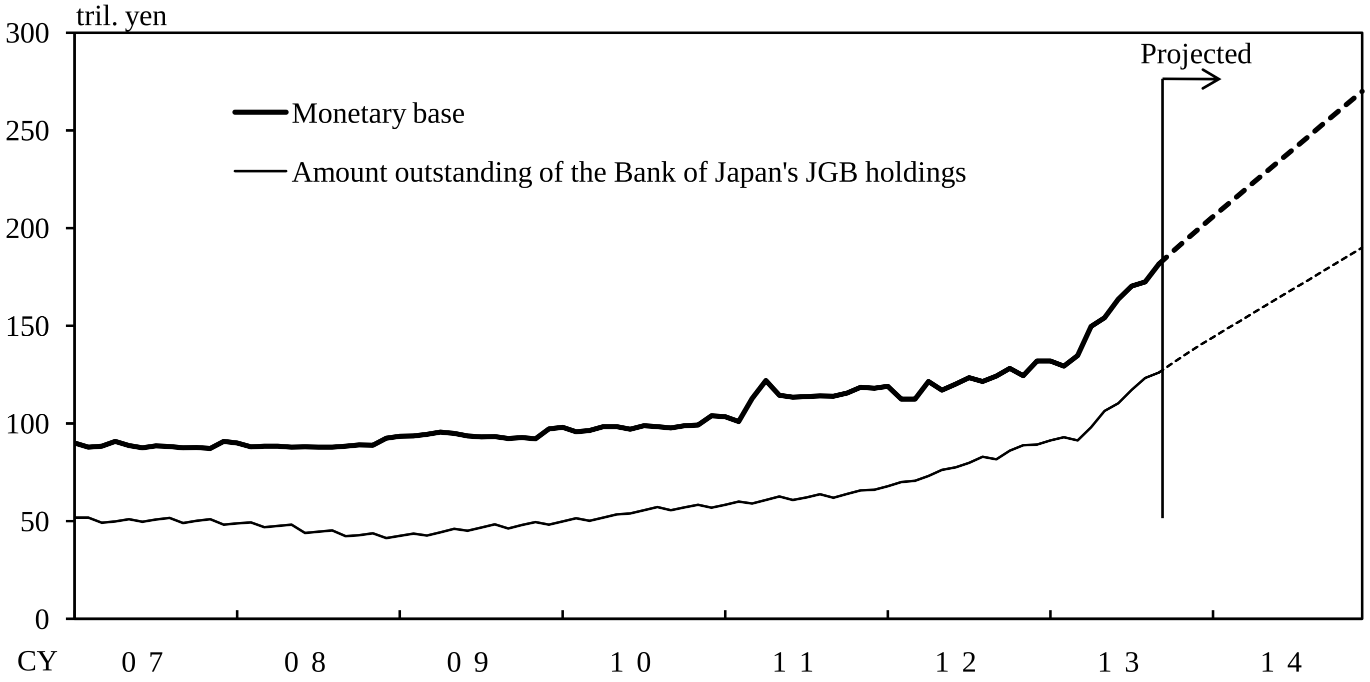
Notes: 1. Figures are as of July 1.

2. Three metropolitan areas: the Tokyo area (Tokyo, Kanagawa, Saitama, Chiba, and Ibaraki prefectures), the Osaka area (Osaka, Hyogo, Kyoto, and Nara prefectures), and the Nagoya area (Aichi and Mie prefectures). Other areas: other than the three metropolitan areas.

Source: Ministry of Land, Infrastructure, Transport and Tourism, "Land Price Survey by Prefectural Governments."

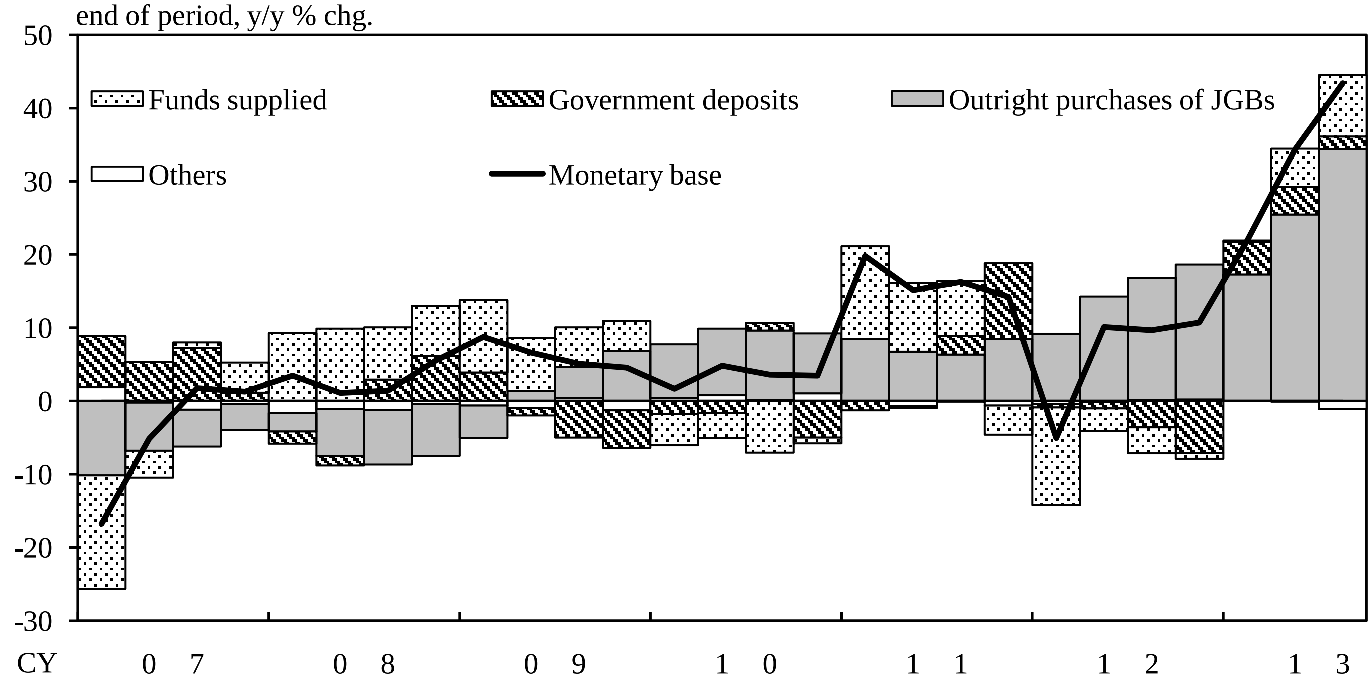
Monetary Base and JGB Purchases

(1) Expansion in the Monetary Base and JGB Holdings



Note: Actual figures for the monetary base are monthly average data. Projected figures for the monetary base and all figures for the amount outstanding of the Bank of Japan's JGB holdings are end-of-month data.

(2) Year-on-Year Percentage Change in the Monetary Base



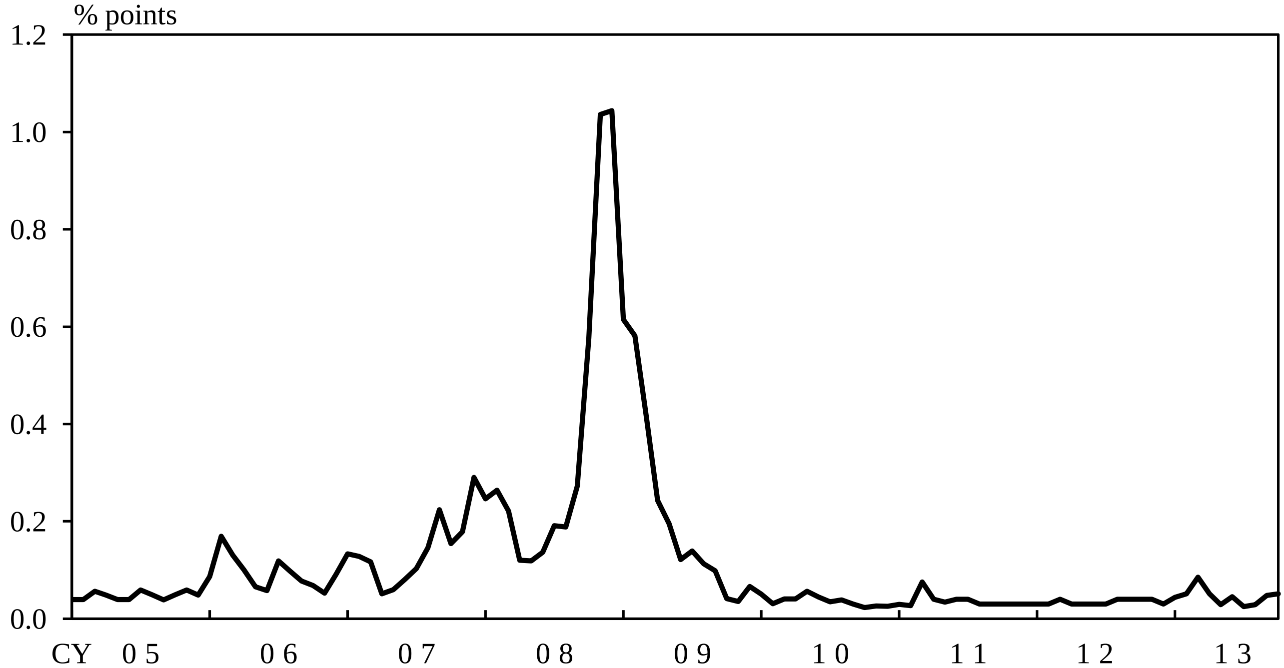
Notes: 1. Funds supplied are calculated by adding the amounts outstanding of (1) assets purchased through market operations (excluding outright purchases of JGBs), (2) funds-supplying operations against pooled collateral, and (3) the Loan Support Program, etc.

2. Government deposits mainly include sales of JGBs to the government under repurchase agreements and T-Bills underwritten by the Bank of Japan.

Source: Bank of Japan, "Monetary Base and the Bank of Japan's Transactions," "Monetary Base," "Bank of Japan Accounts."

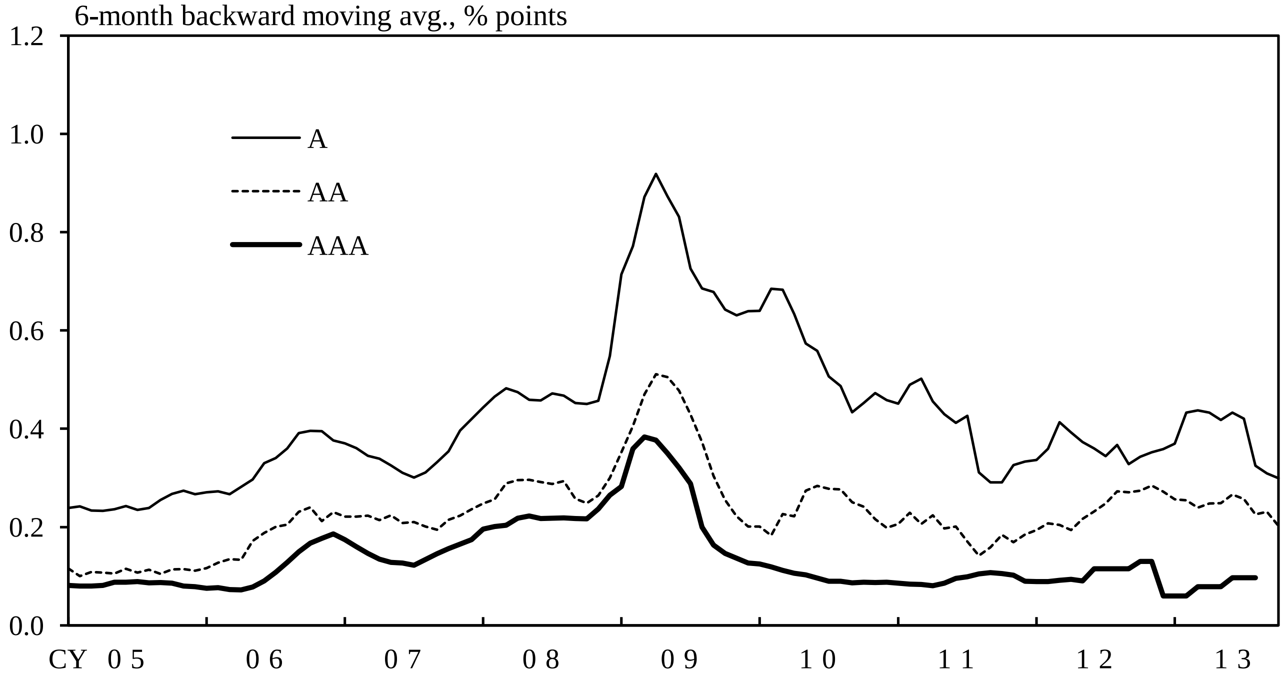
Spreads for CP and Corporate Bonds

(1) Issuance Spreads for CP



Note: Figures up to September 2009 are the average issuance rate of CP (3-month, rated a-1 or higher) minus the yield on T-Bills (3-month). Figures from October 2009 are the average issuance rate of CP (3-month, rated a-1) minus the yield on T-Bills (3-month).

(2) Issuance Spreads for Corporate Bonds by Securities Rating

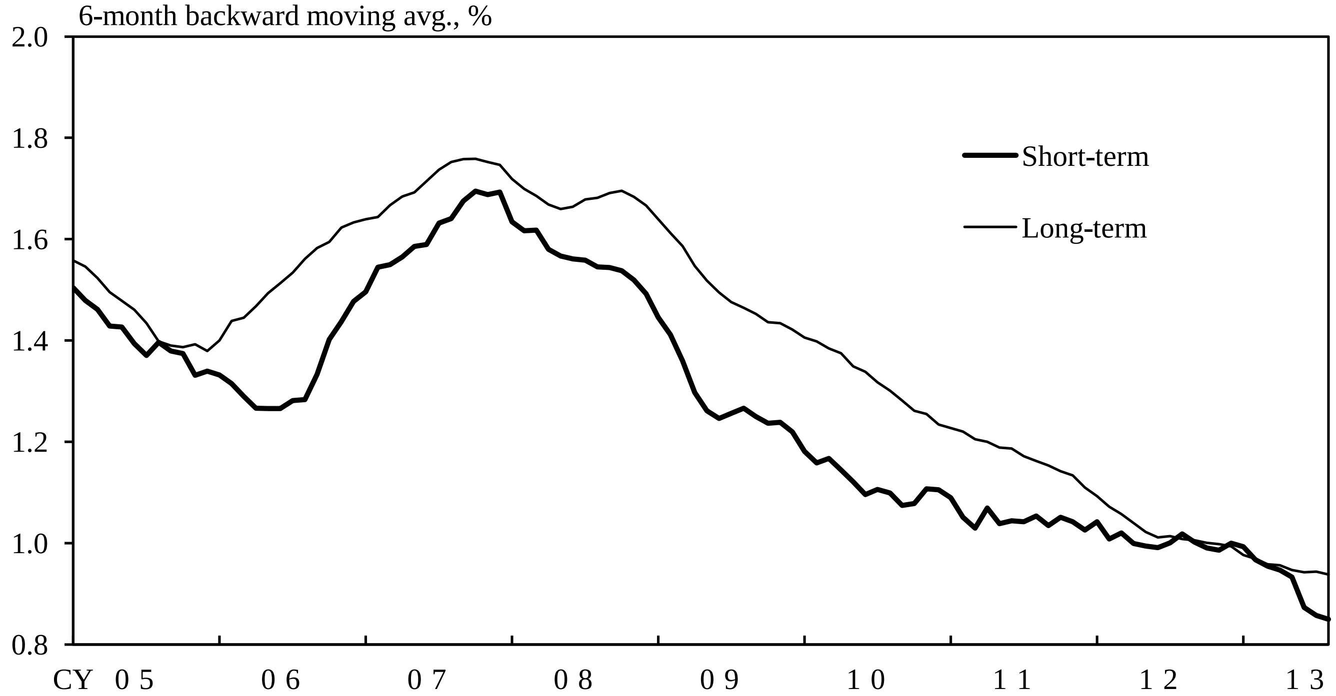


Notes: 1. The issuance spreads for corporate bonds are the issuance rate of these bonds minus the government bond yield.
2. Figures are the average of all maturities issued in domestic markets, based on the launch date.
3. Bonds issued by banks and securities companies, etc., are excluded.
4. Bonds are classified by the highest ratings among Moody's, S&P, R&I, and JCR.
5. No AAA bonds were issued from April to October 2013.

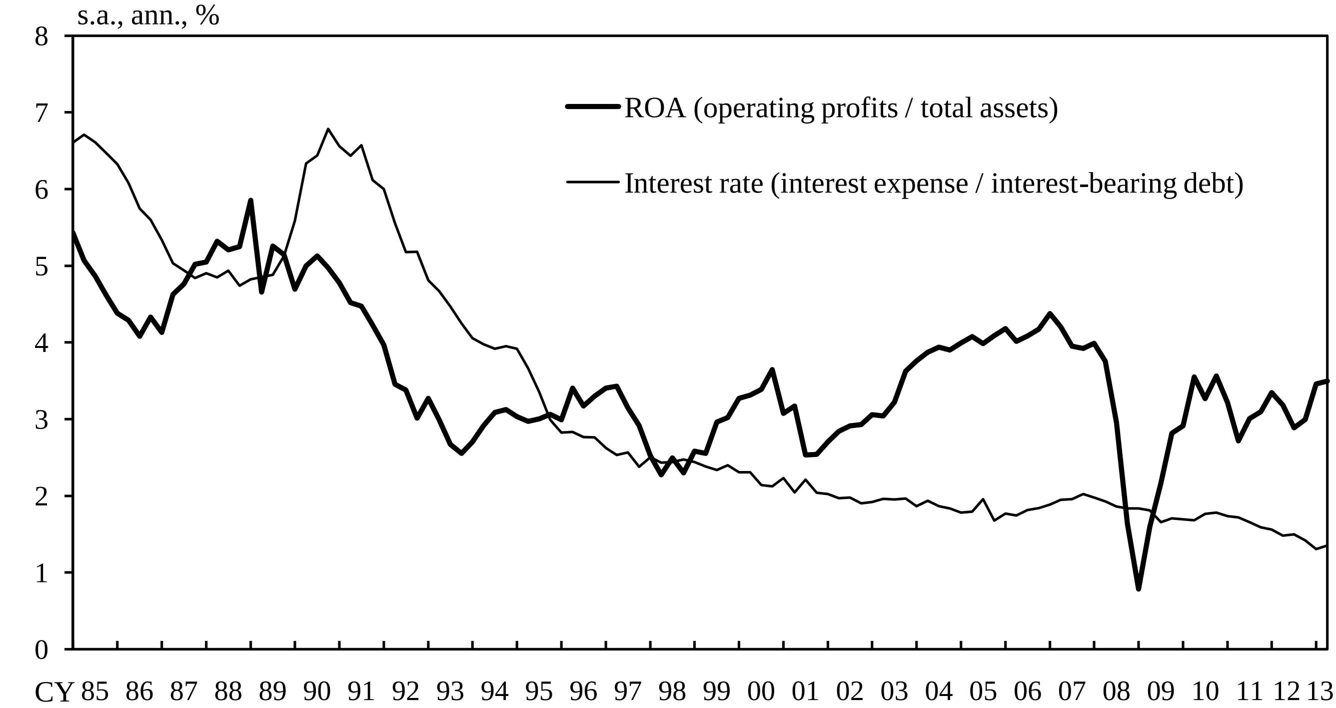
Sources: Bank of Japan, "Average Yields on Newly Issued Domestic Commercial Paper";
Japan Securities Depository Center; Capital Eye, Ltd.; I-N Information Systems; Bloomberg.

Bank Lending Rates

(1) Average Contract Interest Rates on New Loans and Discounts



(2) ROA and Interest Rate



Notes: 1. Figures are taken from the "Financial Statements Statistics of Corporations by Industry, Quarterly," and are the total for all-size enterprises and all industries. Finance and insurance are excluded.

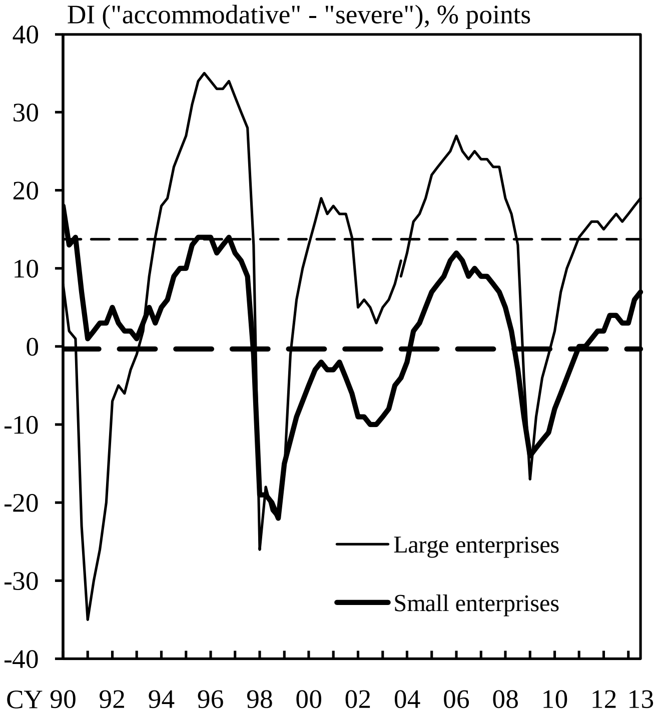
2. Interest-bearing debt is the sum of long- and short-term borrowings, corporate bonds, and bills receivable discounted outstanding.

Sources: Bank of Japan, "Average Contract Interest Rates on Loans and Discounts";
Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Quarterly."

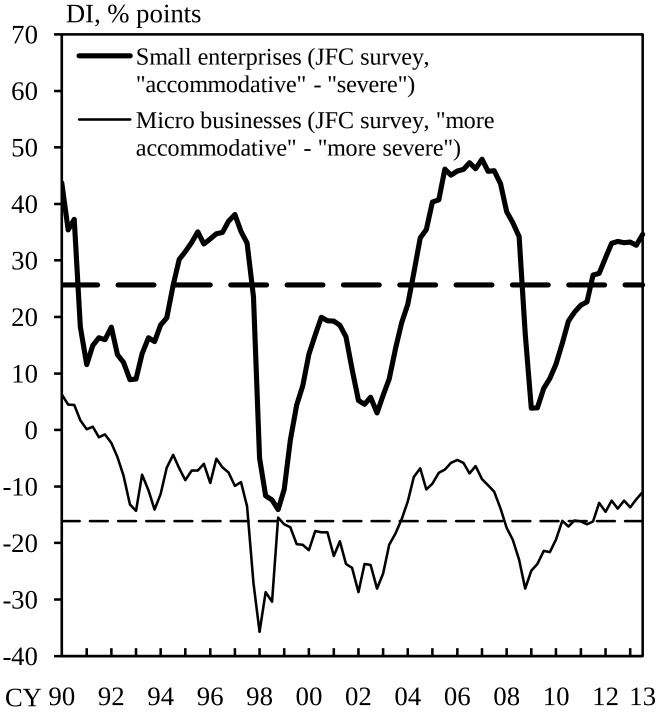
Corporate Finance-Related Indicators

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

(a) *Tankan* [1]

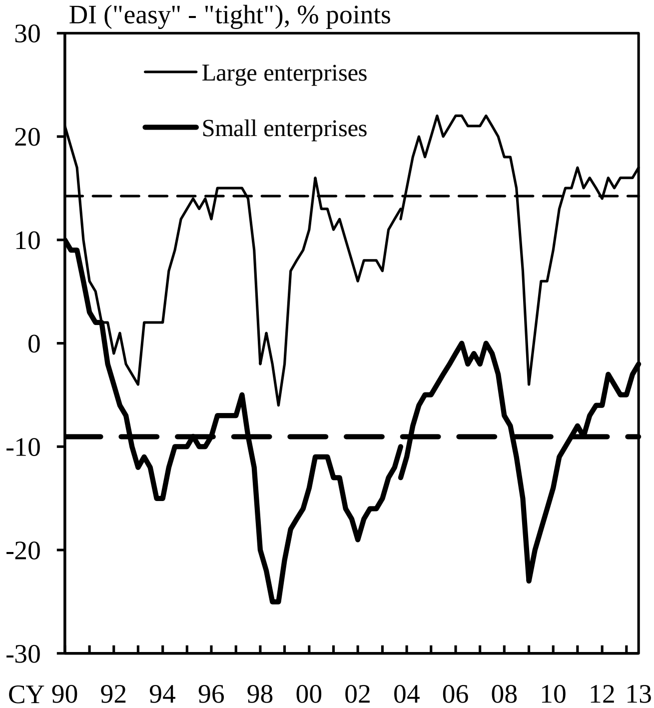


(b) Other Surveys

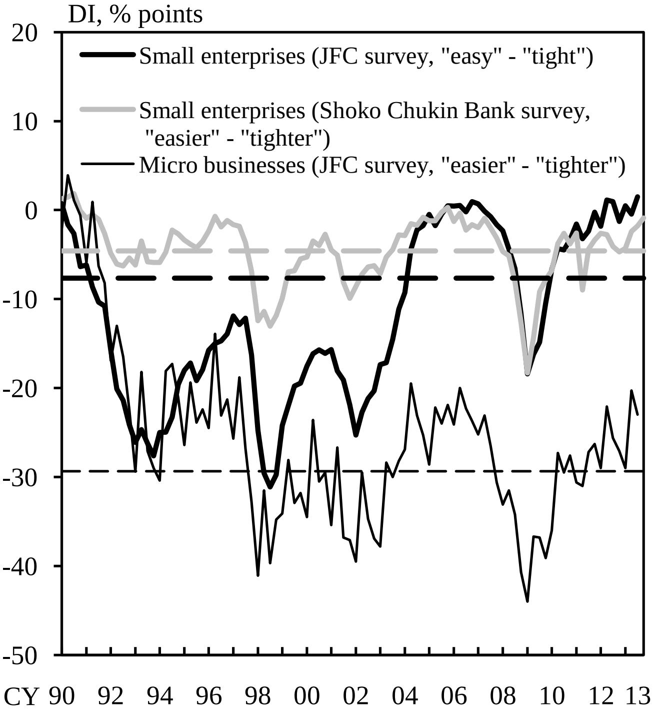


(2) Financial Position

(a) *Tankan* [1]



(b) Other Surveys [2]

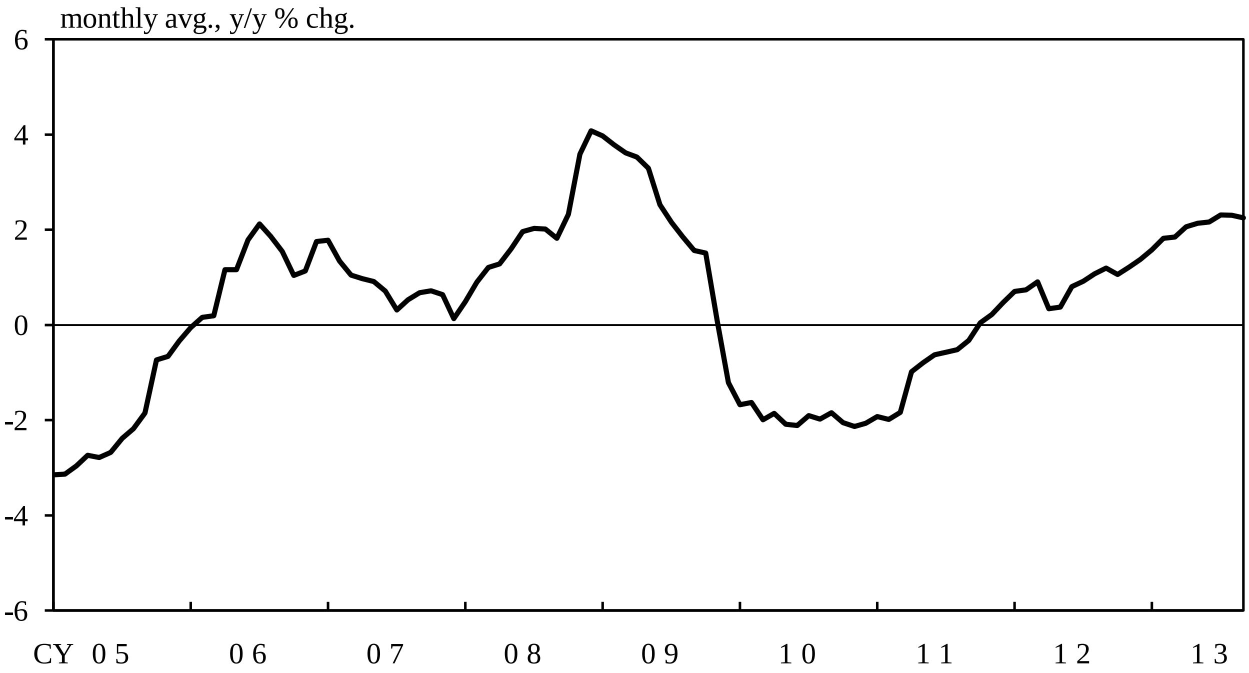


Notes: 1. Data from the "Tankan" are based on all industries. The "Tankan" was revised from the March 2004 survey. Figures up to the December 2003 survey are based on the previous data sets. Figures from the December 2003 survey are on the new basis. Broken lines are the averages since 2000.
2. The figure for the Shoko Chukin Bank survey for 2013/Q4 is that of October.

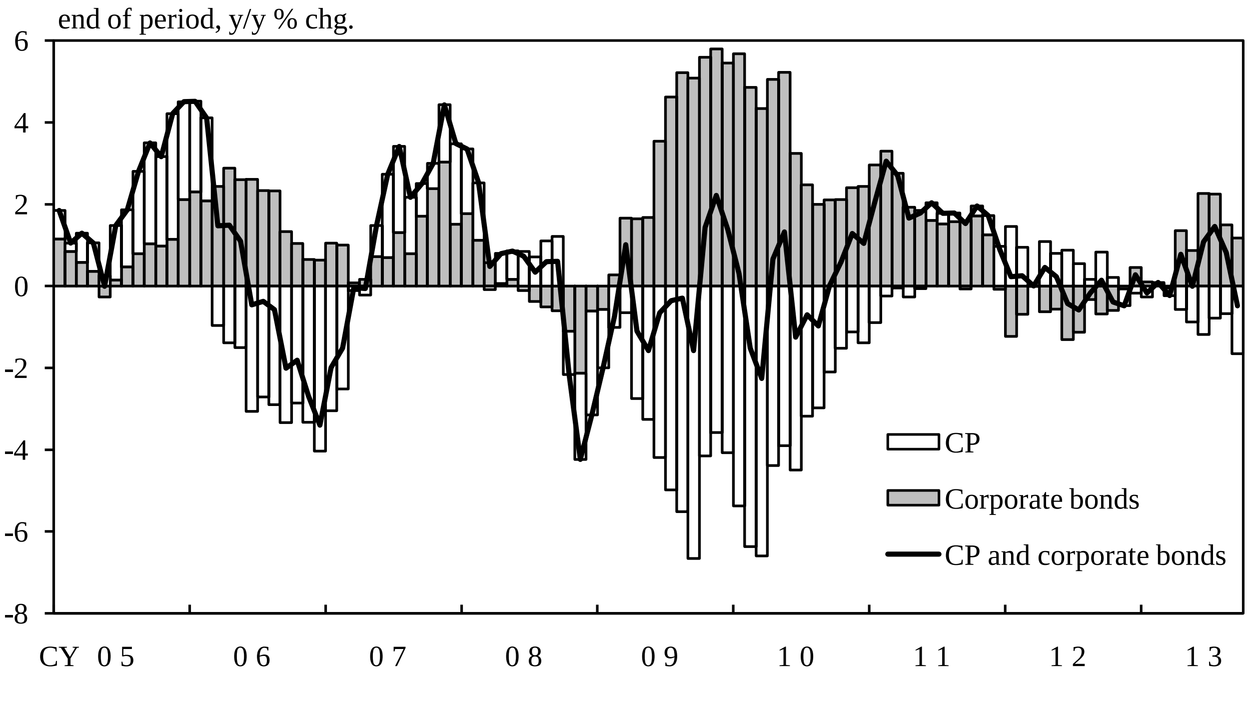
Sources: Bank of Japan, "*Tankan*, Short-Term Economic Survey of Enterprises in Japan";
Shoko Chukin Bank, Ltd., "Business Survey Index for Small and Medium-Sized Businesses";
Japan Finance Corporation (JFC), "Monthly Survey of Small Businesses in Japan," "Quarterly Survey of Small Businesses in Japan (For Micro Businesses)."

Amount Outstanding of Bank Lending, CP, and Corporate Bonds

(1) Lending by Domestic Commercial Banks (Total of Major and Regional Banks)



(2) Amount Outstanding of CP and Corporate Bonds



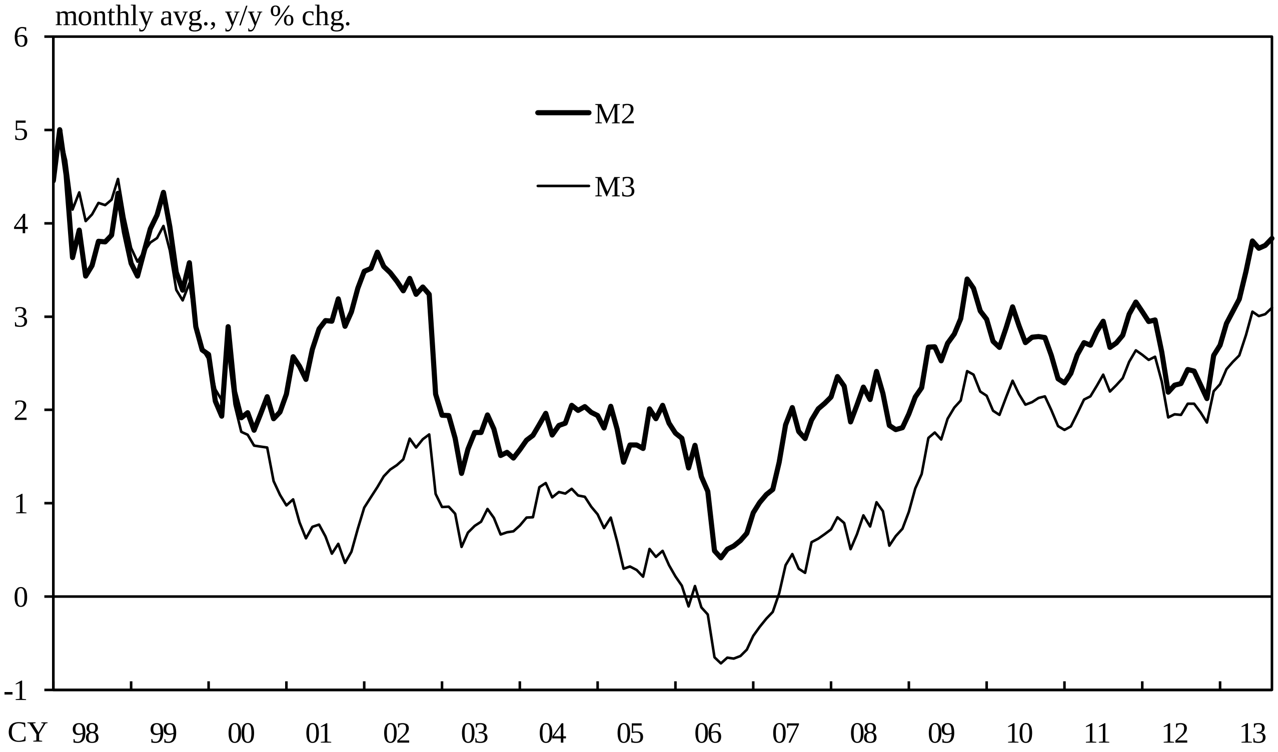
Notes: 1. Figures for CP are those of short-term corporate bonds registered under the book-entry transfer system. Those issued by banks, securities companies, and others such as foreign corporations are excluded; ABCP is included. Figures up to March 2008 are those compiled by the Bank of Japan.

2. Figures for corporate bonds are calculated based on the sum of straight bonds issued in both domestic and overseas markets. Bonds issued by banks are included. Domestic bonds are those registered by the book-entry transfer system. The series is spliced at April 2008 with the one published by the Japan Securities Dealers Association.

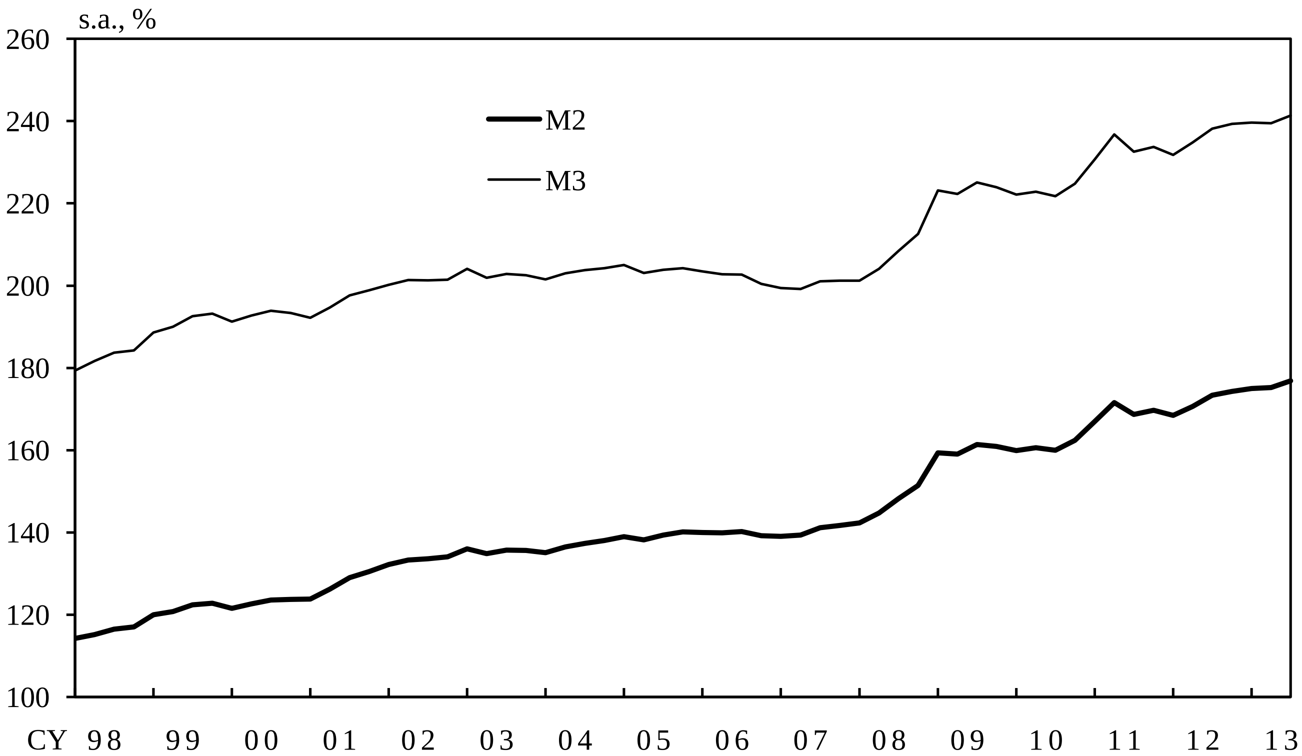
Sources: Bank of Japan, "Principal Figures of Financial Institutions"; Japan Securities Depository Center; Japan Securities Dealers Association; I-N Information Systems.

Money Stock

(1) Changes from a Year Earlier



(2) Ratio of Money Stock to Nominal GDP

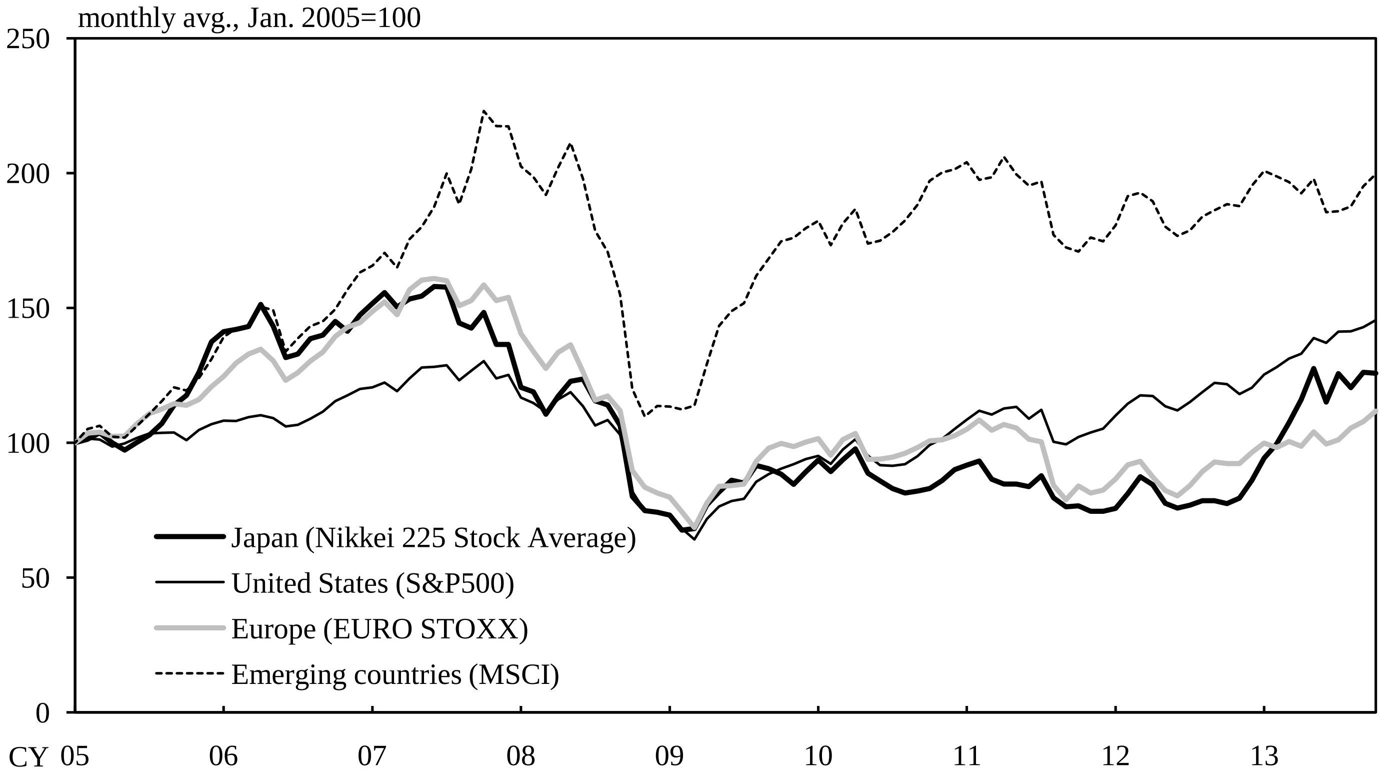


Notes: 1. Figures for M2 up to March 2003 are the former series of the figures for M2+CDs.
2. Figures for M3 up to March 2003 are the former series of the figures for M3+CDs minus the figures for pecuniary trusts.
3. The figure for nominal GDP in 2013/Q3 is assumed to be unchanged from the previous quarter.

Sources: Bank of Japan, "Money Stock"; Cabinet Office, "National Accounts."

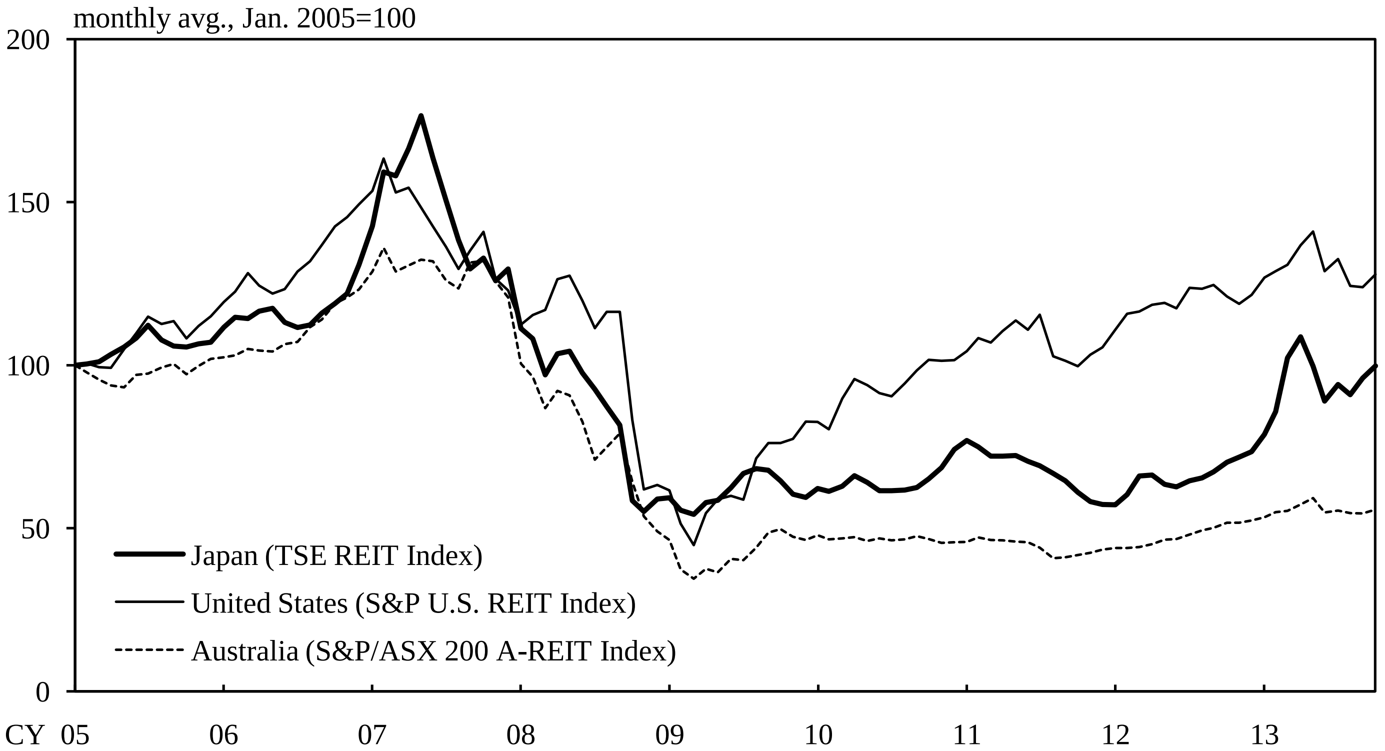
Stock Prices and REIT Prices

(1) Selected Stock Prices



Note: Figures for emerging countries are from the MSCI Emerging Markets Index denominated in the local currencies.

(2) Selected REIT Indexes

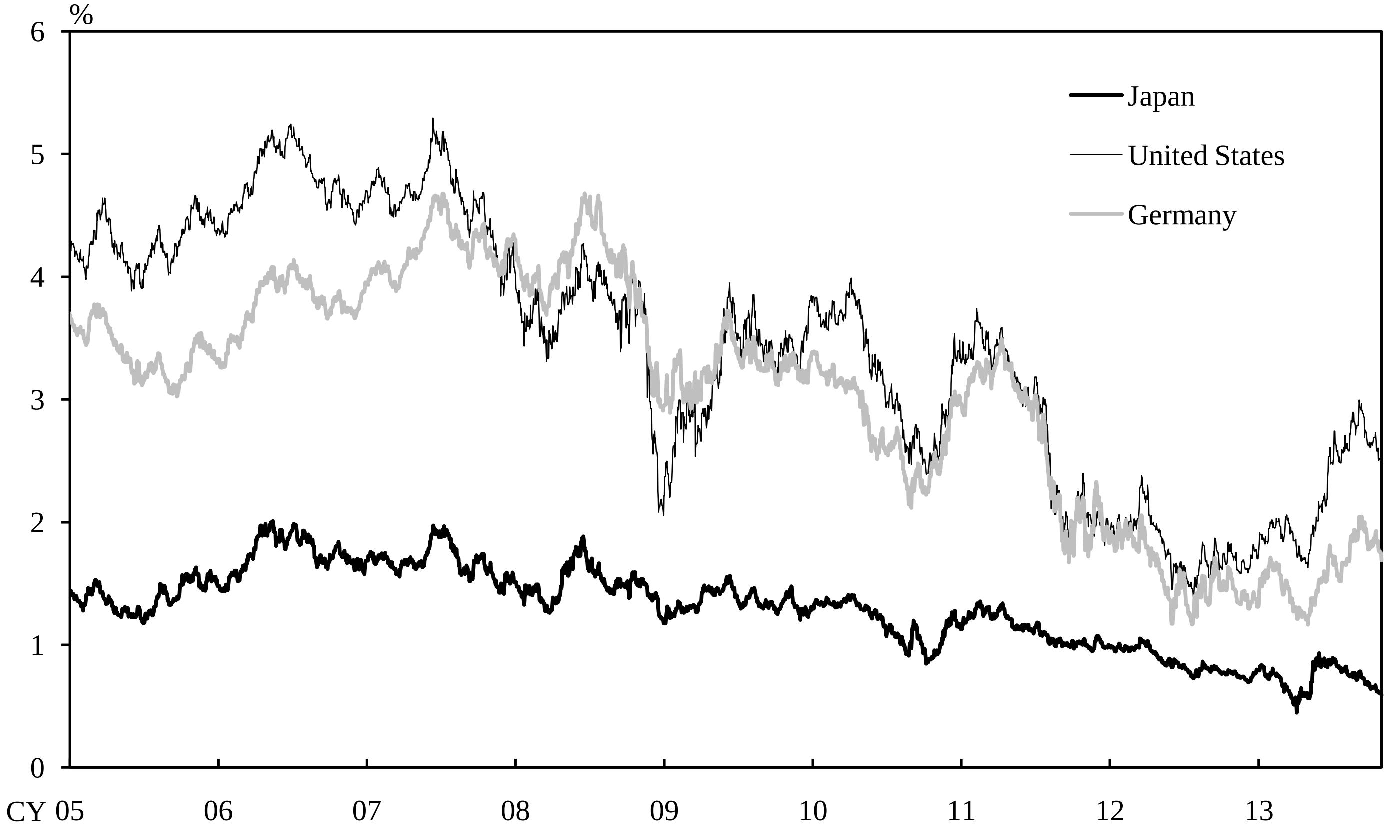


Source: Bloomberg.

Chart 25

Nominal Benchmark Yields

(1) 10-Year Government Bond Yields in Selected Advanced Economies

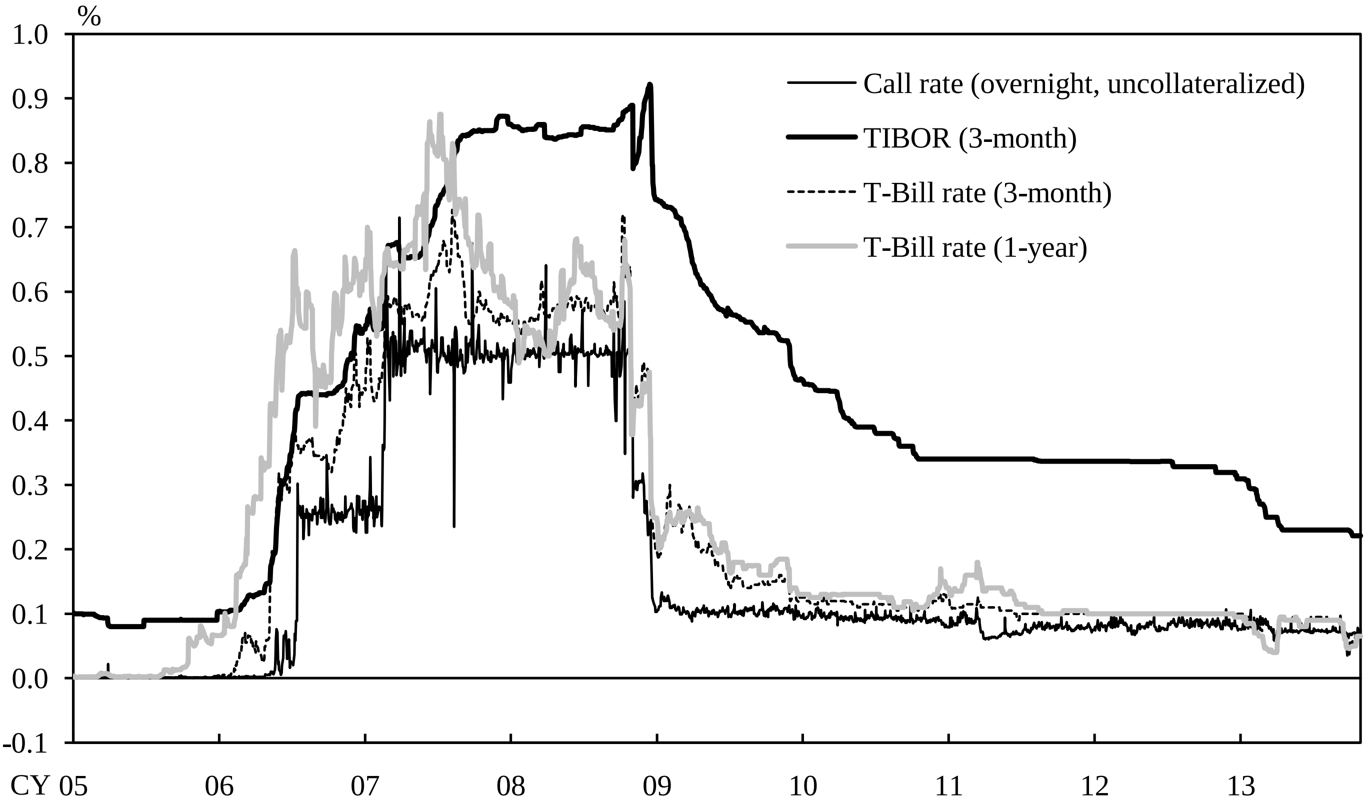


(2) Japanese Government Bond Yields

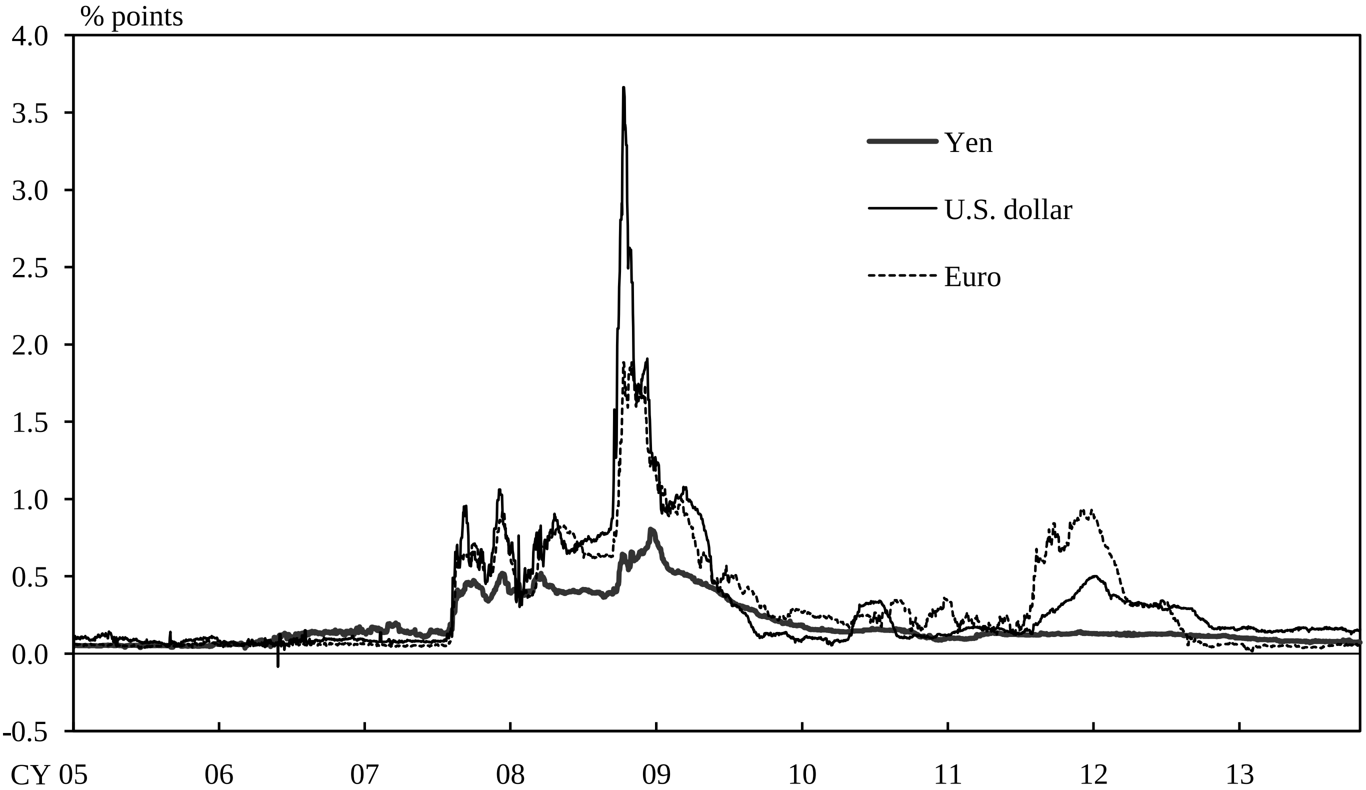
Source: Bloomberg.

Money Market Rates

(1) Short-Term Interest Rates



(2) Credit Spreads for Yen-, Dollar-, and Euro-Denominated Term Instruments

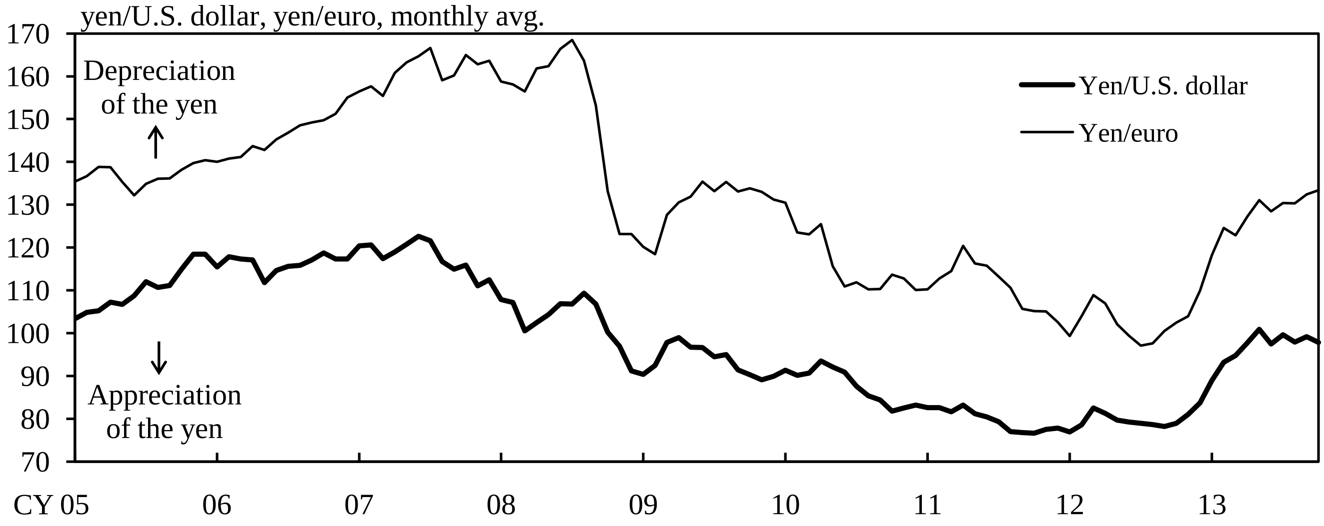


Note: The credit spreads for term instruments are LIBOR (3-month) minus yields on overnight index swaps (3-month).

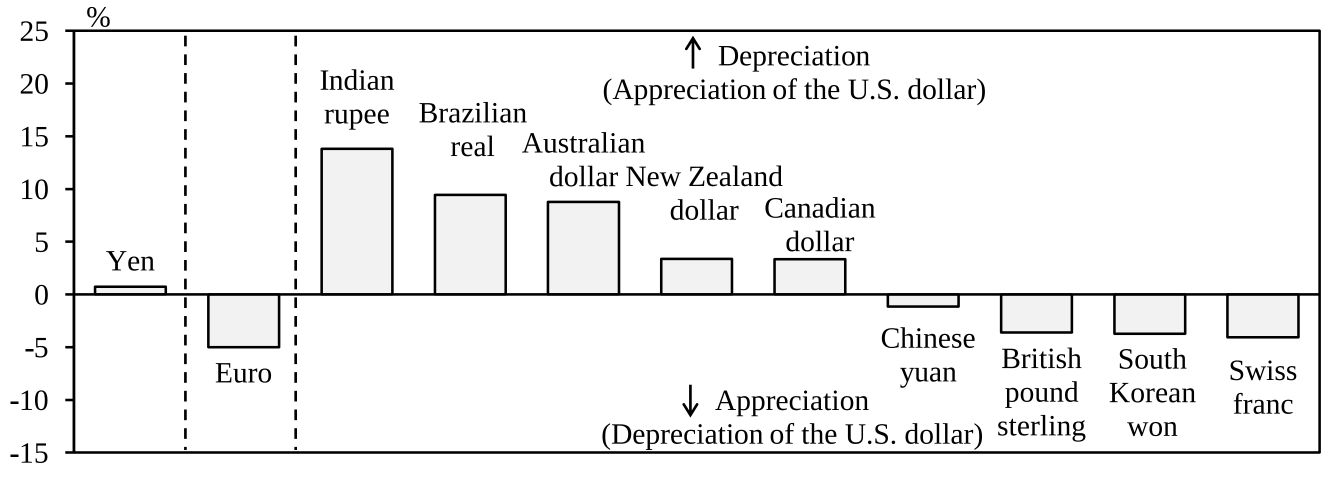
Sources: Bank of Japan; Bloomberg.

Exchange Rates

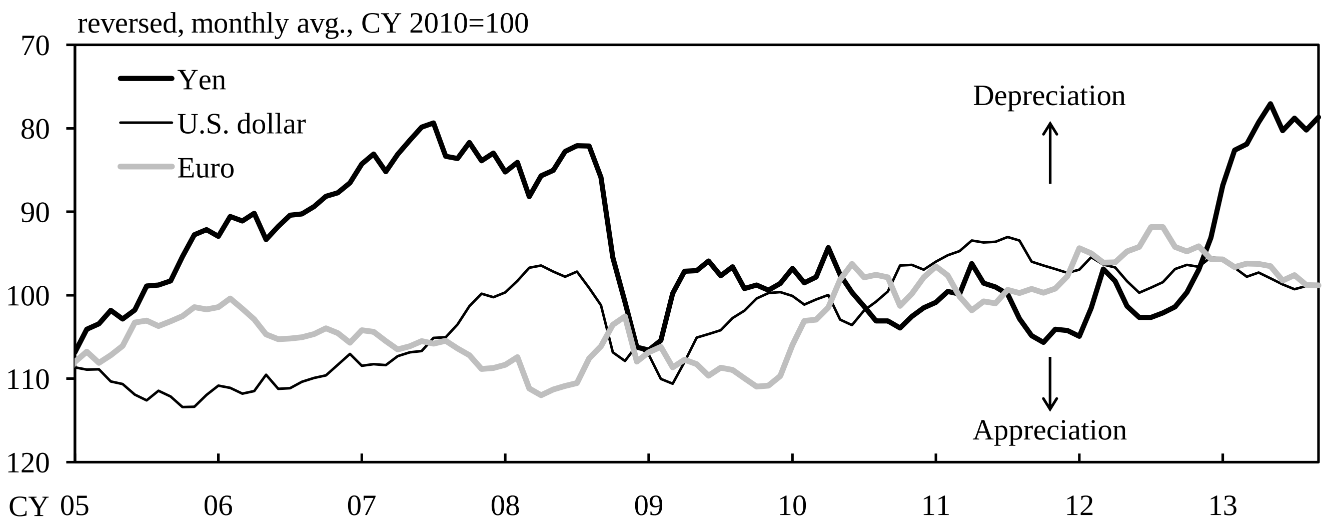
(1) Yen/U.S. Dollar and Yen/Euro



(2) Rates of Change in Selected Currencies against the U.S. Dollar (Since the End of April 2013)



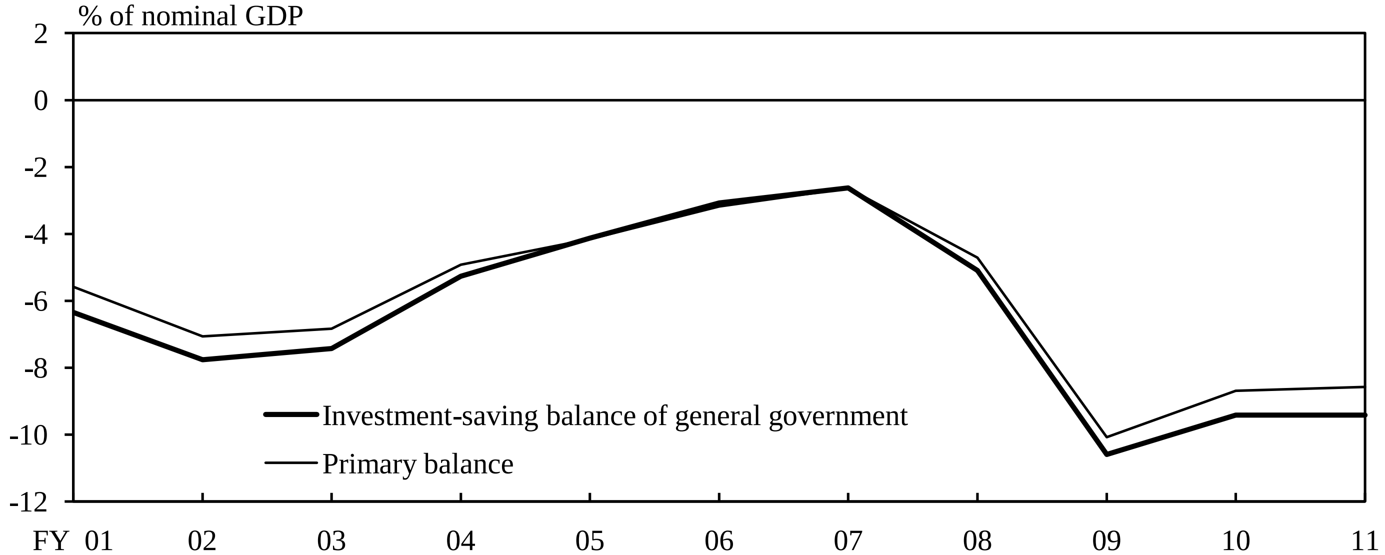
(3) Real Effective Exchange Rates



Note: The real effective exchange rates are based on the broad indices of the BIS effective exchange rate.
Sources: Bank for International Settlements (BIS); Bloomberg.

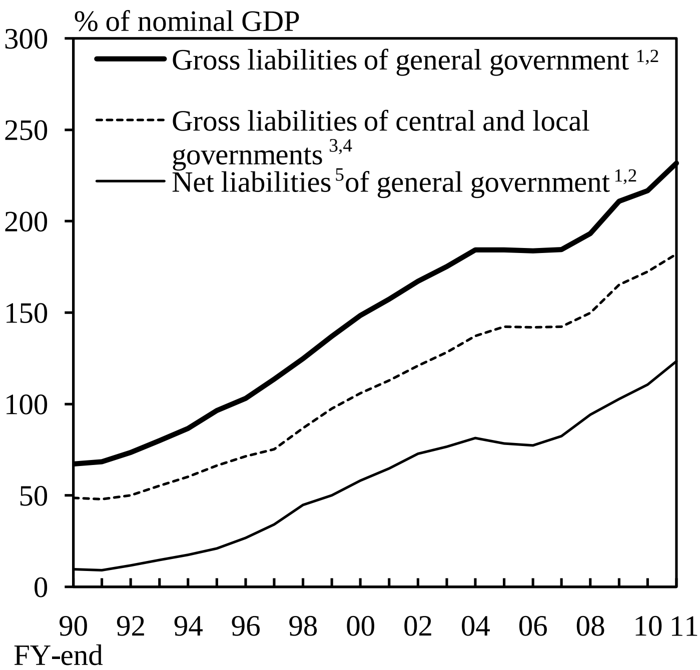
Government Liabilities

(1) Fiscal Balance



Note: The following factors are excluded from the investment-saving balance of the general government: (1) redemption of JGBs held by the Deposit Insurance Corporation of Japan (fiscal 2001 and 2002); (2) transfer of assets and liabilities of the Japan Expressway Holding and Debt Repayment Agency to the general account (fiscal 2008); (3) transfer of reserves in the special account for the Fiscal Investment and Loan Program (public financial institutions) to the special account for the government debt consolidation fund of the general government (fiscal 2006 and 2008); (4) transfer of reserves in the special account for the Fiscal Investment and Loan Program to the general account of the general government (fiscal 2008-11); and (5) transfer of assets of the Japan Railway Construction, Transport and Technology Agency to the general account of the general government (fiscal 2011).

(2) Government Liabilities in Japan



(3) Government Liabilities of the G7 Countries[1,6]

% of nominal GDP

	Fiscal balance	Gross liabilities	Net liabilities[5]
Japan	-9.9	219.1	135.9
United States	-8.7	106.3	87.1
Germany	0.2	89.2	50.9
United Kingdom	-6.5	103.9	70.9
Italy	-2.9	140.2	112.9
France	-4.9	109.7	70.7
Canada	-3.2	85.5	34.5

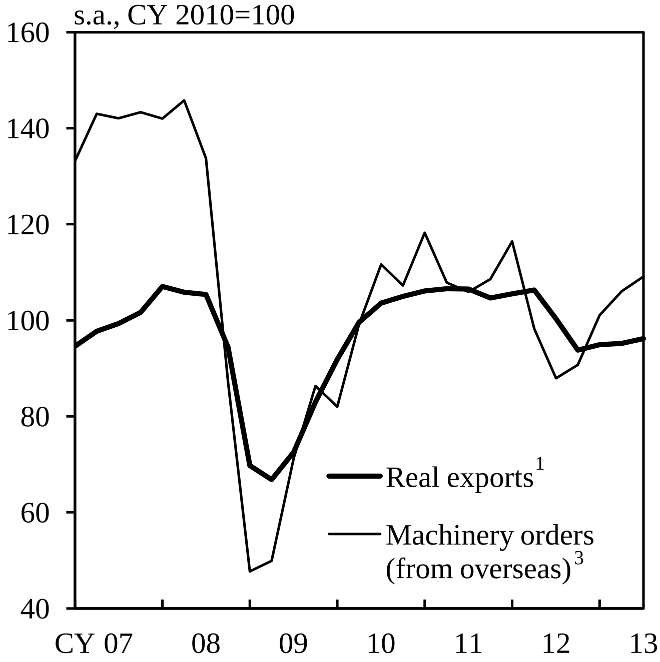
Notes: 1. General government consists of the central government, local governments, and social security funds.
2. Figures up through fiscal 1993 are on the 2000 base. From fiscal 1994, they are on the 2005 base.
3. Figures up through fiscal 2000 are on the 2000 base. From fiscal 2001, they are on the 2005 base.
4. Outstanding debt reported in "Economic and Fiscal Projections for Medium to Long Term Analysis (August 2013)."
5. Gross liabilities minus financial assets.
6. Fiscal balance and government liabilities (of the general government) are the OECD projections in CY 2012.

Sources: Cabinet Office, "National Accounts," "Economic and Fiscal Projections for Medium to Long Term Analysis"; OECD, "Economic Outlook," etc.

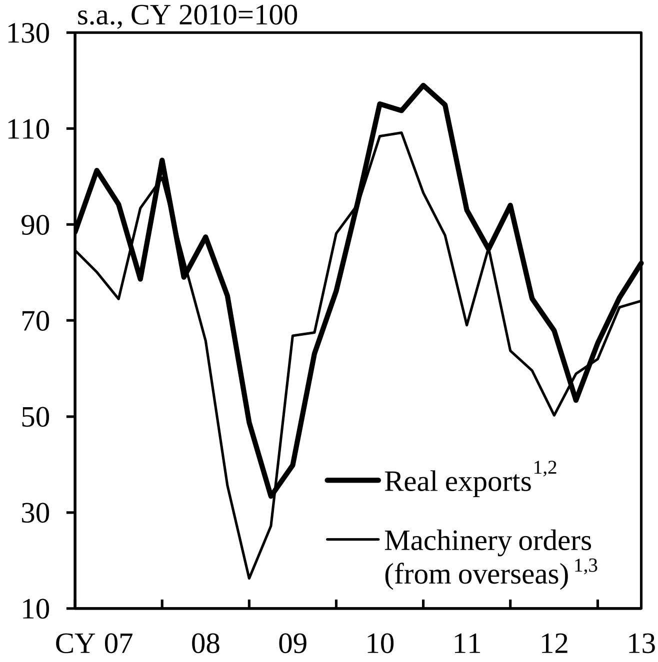
Exports of Capital Goods

(1) Exports of Capital Goods and Parts, and Machinery Orders (from Overseas)

(a) Capital Goods and Parts (Total)



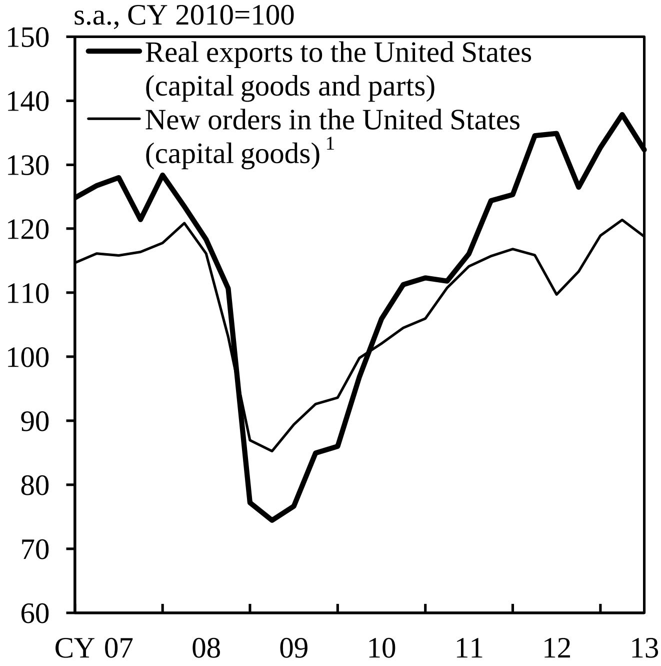
(b) Of Which: Semiconductor Making Equipments



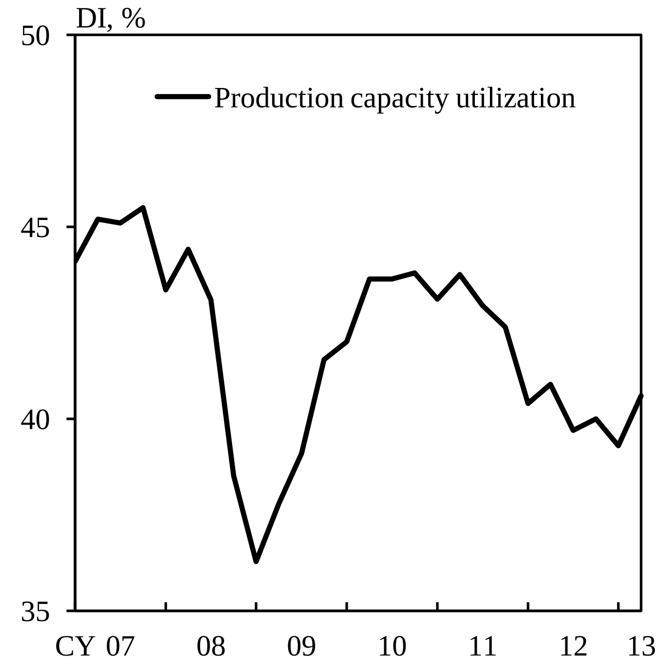
Notes: 1. Figures are seasonally adjusted by X-12-ARIMA.
2. Figures include parts and accessories, etc.
3. Figures for 2013/Q3 are July-August averages.

(2) Environment Surrounding Exports of Capital Goods

(a) Exports of Capital Goods and Parts to the United States, and New Orders for Capital Goods in the United States



(b) Business Survey of 5,000 Enterprises[2] (by the People's Bank of China)

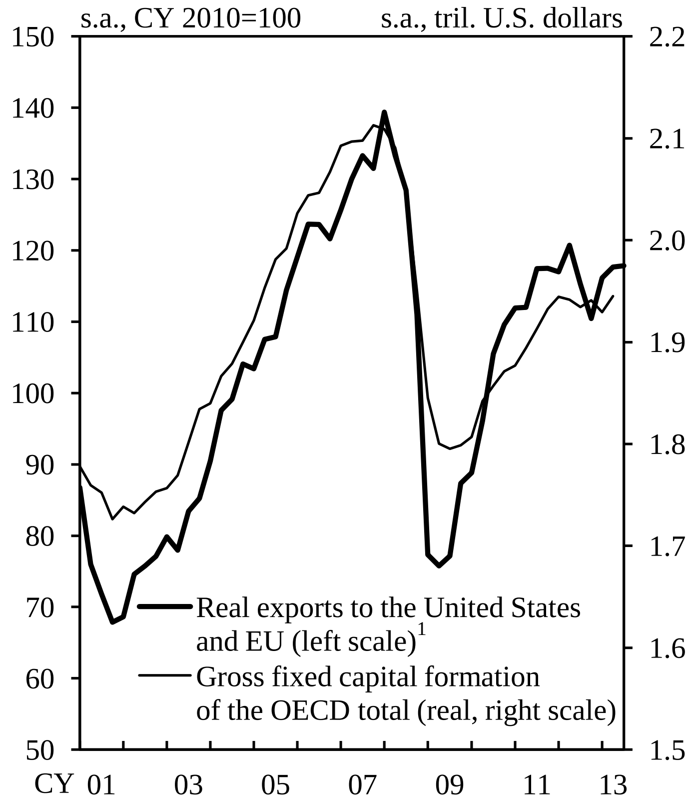


Notes: 1. Nondefense capital goods excluding aircrafts.
2. The DIs are calculated based on the proportion of two answers regarding utilization rate: "too high" and "too low." The range of the indices is 0-100 percent.

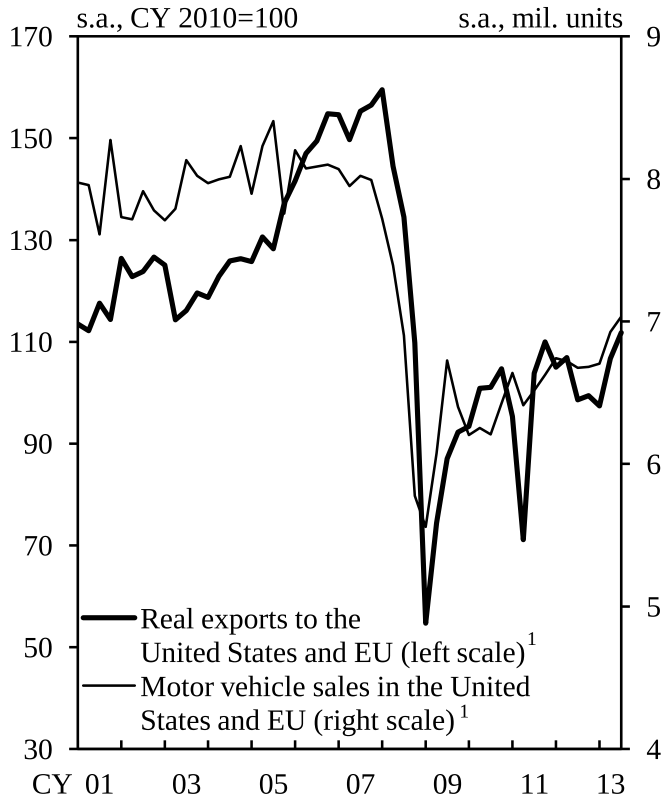
Sources: Cabinet Office, "Orders Received for Machinery"; Ministry of Finance, "Trade Statistics"; Bank of Japan, "Corporate Goods Price Index"; CEIC.

Environment Surrounding Exports

(1) Exports of Capital Goods and Parts, and Global Business Fixed Investment

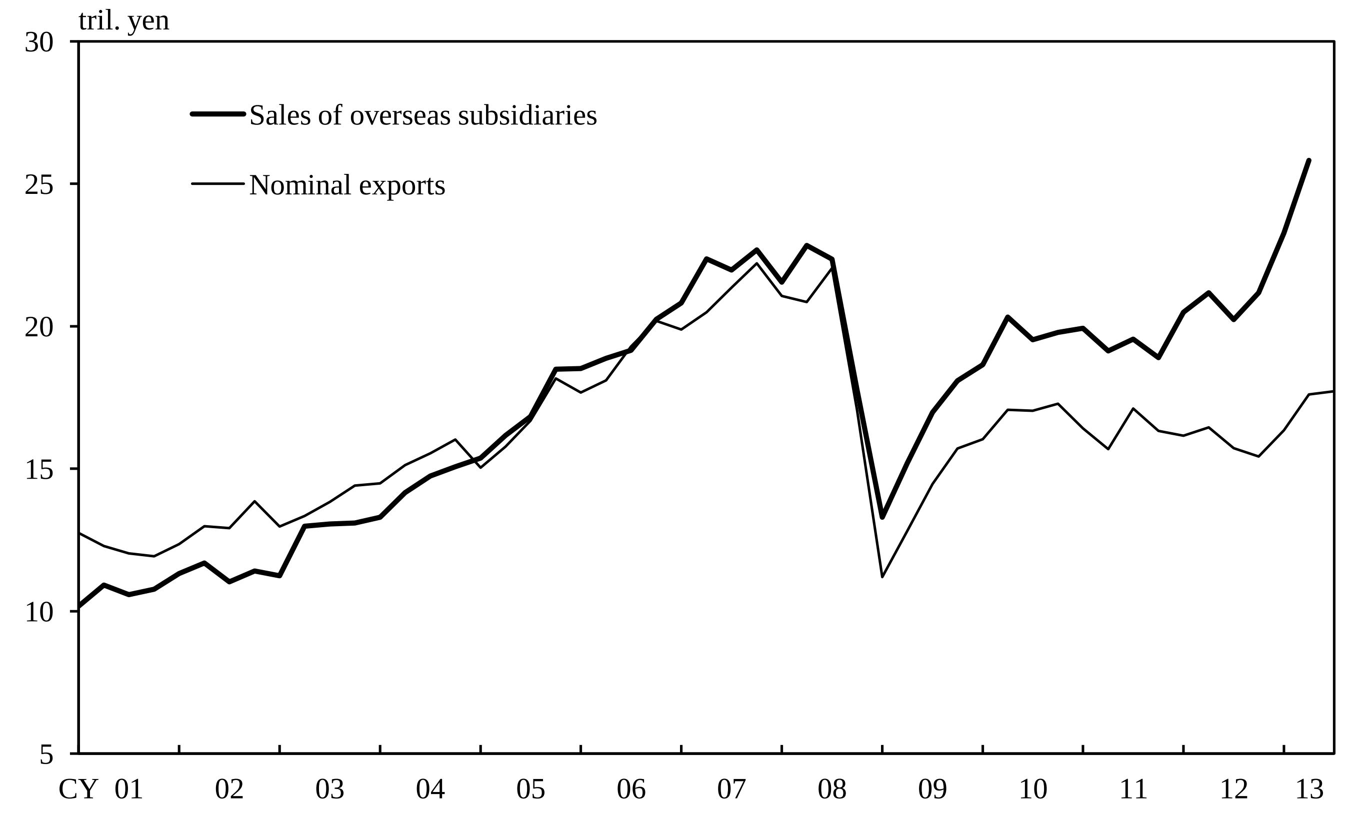


(2) Exports of Motor Vehicles and Related Goods, and Motor Vehicle Sales



Note: 1. Figures are seasonally adjusted by X-12-ARIMA.

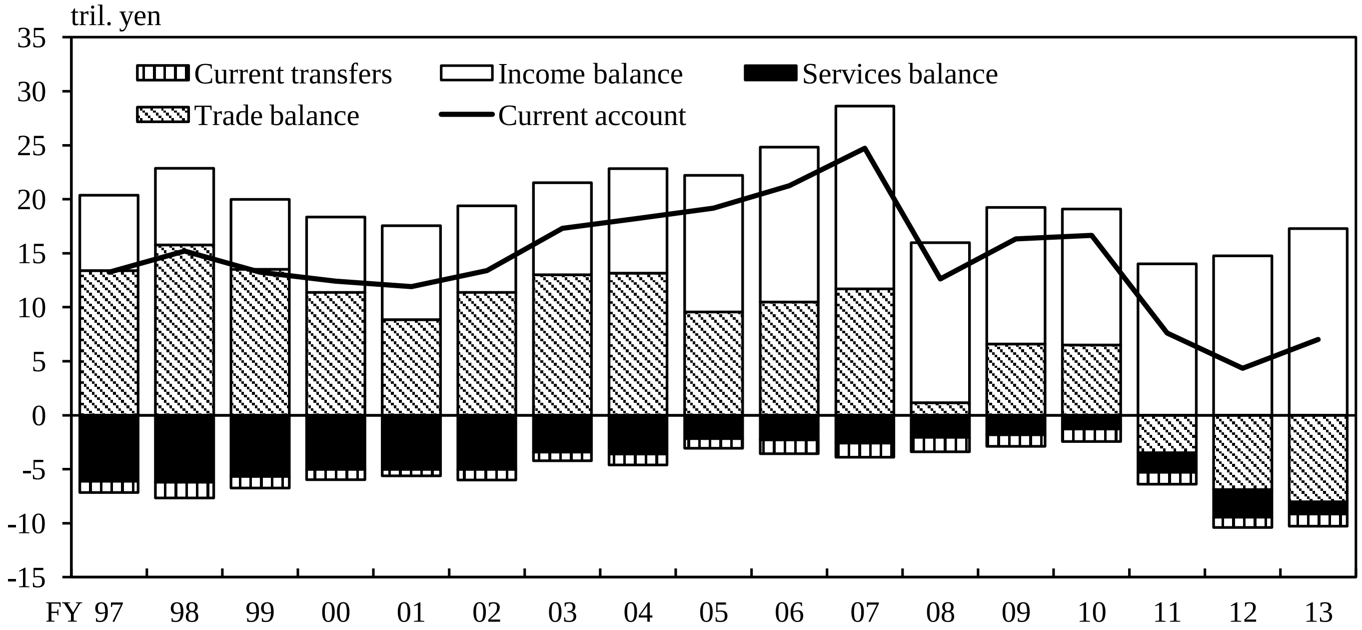
(3) Sales of Overseas Subsidiaries (Manufacturing) and Exports



Sources: Ministry of Finance, "Trade Statistics"; Bank of Japan, "Corporate Goods Price Index"; OECD; BEA; ACEA; Ministry of Economy, Trade and Industry, "Quarterly Survey of Overseas Subsidiaries."

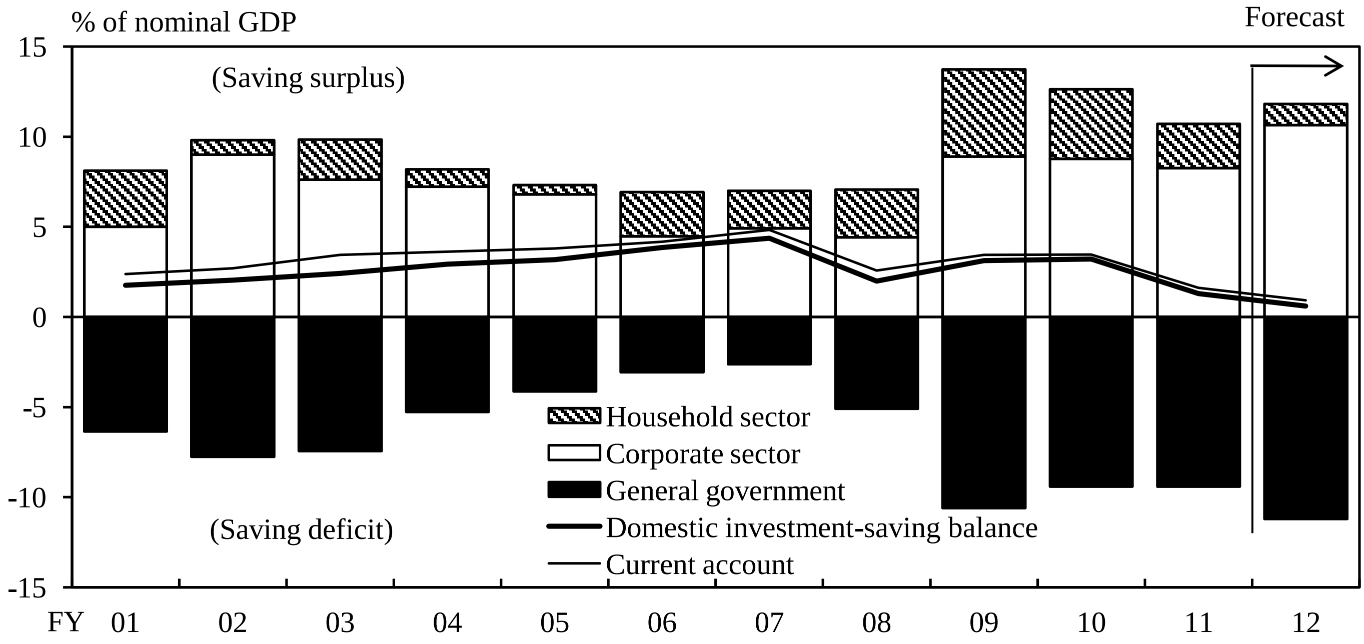
Current Account and Investment-Saving Balance

(1) Current Account



Note: Figures for fiscal 2013 are April-August averages in terms of annual amount.

(2) Investment-Saving Balance



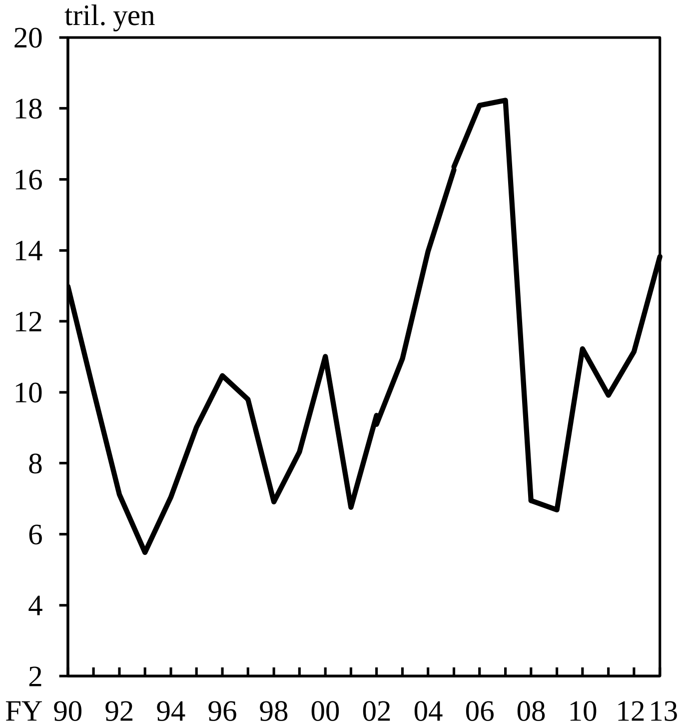
Notes: 1. The same factors described in Chart 28 (1) are excluded.
2. The figure for the investment-saving balance of the general government for fiscal 2012 is based on the "Economic and Fiscal Projections for Medium to Long Term Analysis (August 2013)." The figure for the balance of the household sector is estimated by subtracting private consumption expenditure and private residential investment from personal disposable income, which is calculated using the nominal disposable income in Chart 38 (1). The figure for the balance of the corporate sector is the residue.
3. The domestic investment-saving balance for fiscal 2012 is estimated by subtracting +0.3 percentage point (the difference between the domestic investment-saving balance and the current account in fiscal 2011) from the current account.

Sources: Cabinet Office, "National Accounts," "Economic and Fiscal Projections for Medium to Long Term Analysis"; Ministry of Finance and Bank of Japan, "Balance of Payments."

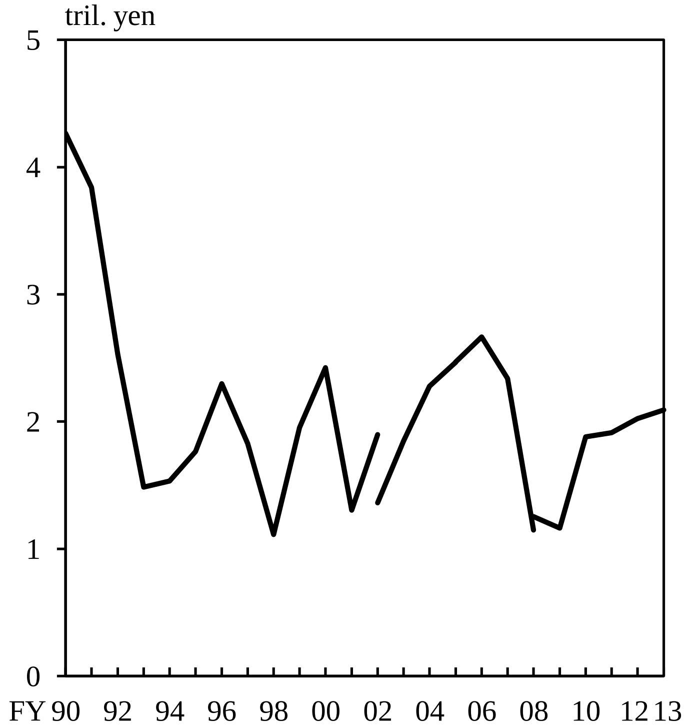
Chart 32

Corporate Profits

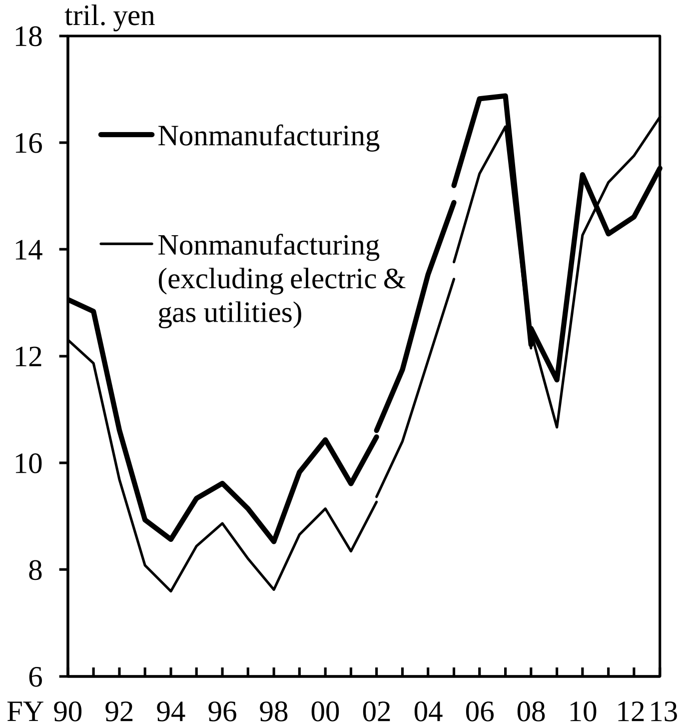
(1) Large Manufacturing Enterprises



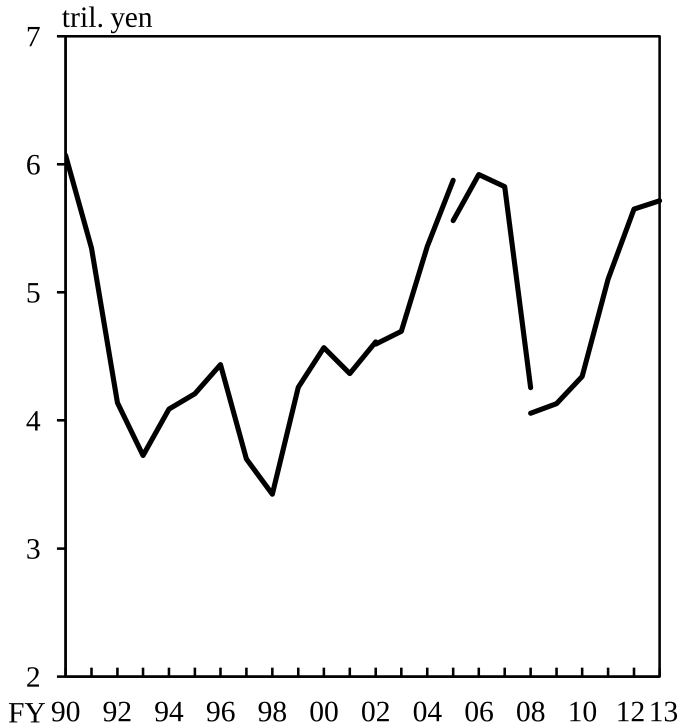
(2) Small Manufacturing Enterprises



(3) Large Nonmanufacturing Enterprises



(4) Small Nonmanufacturing Enterprises

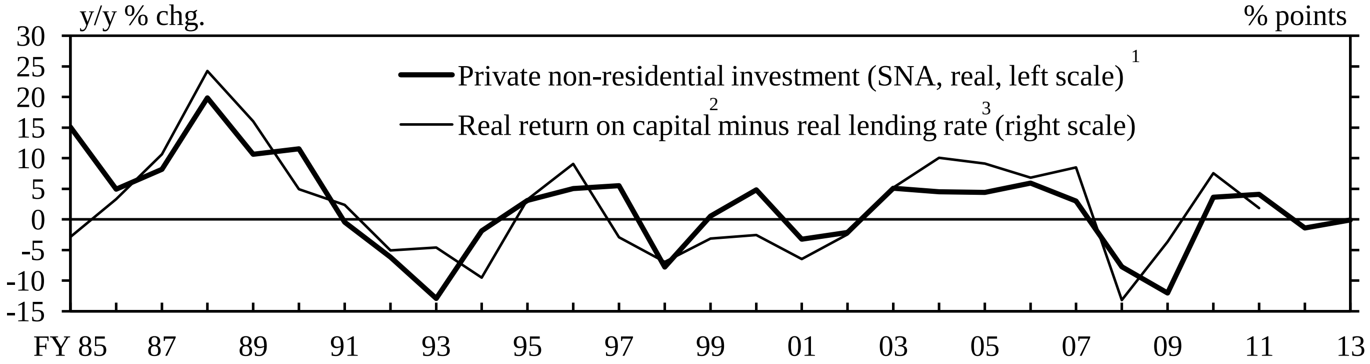


Notes: 1. Based on current profits. Figures for fiscal 2013 are the forecasts in the September 2013 survey.
2. In the March 2004 survey, the "Tankan" underwent major revisions, including the addition of new sample enterprises to the survey. In the March 2007 and March 2010 surveys, regular revisions were made to the sample enterprises. The data show some discontinuities that coincided with these timings.

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

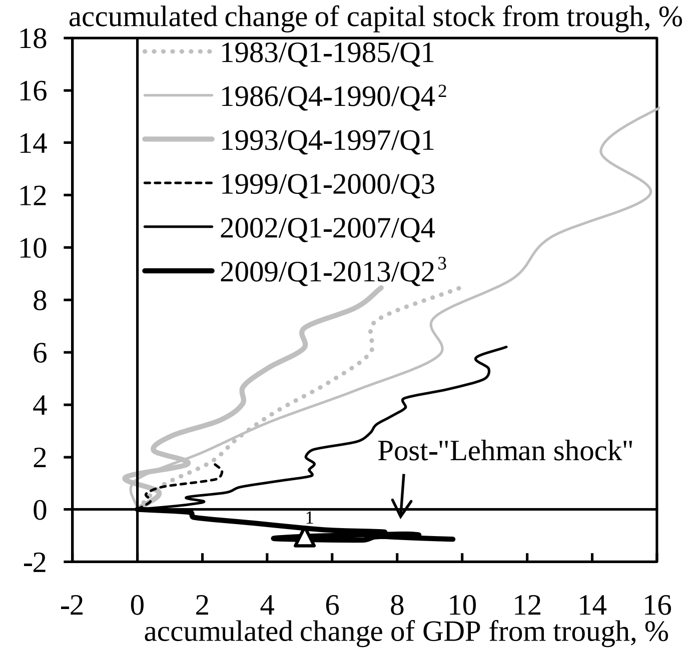
Factors Supporting Business Fixed Investment

(1) Profitability of Investment and Business Fixed Investment

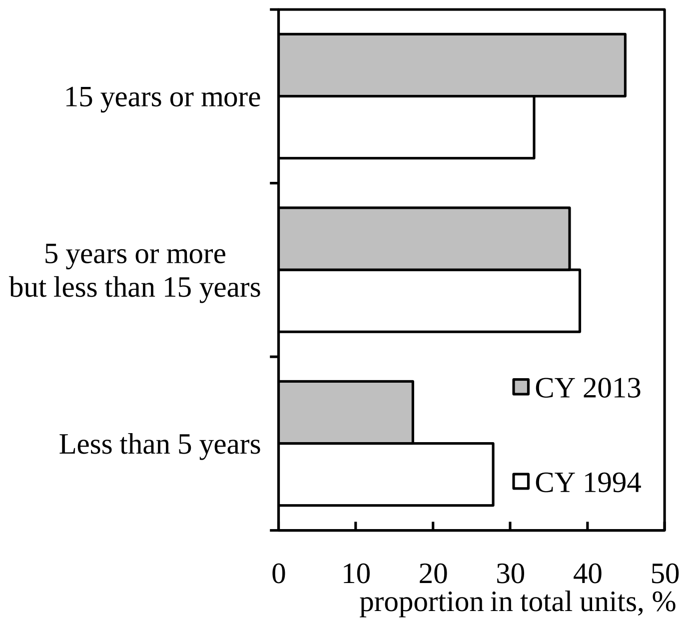


Notes: 1. The figure for fiscal 2013 is that of 2013/Q2.
2. Real return on capital = real operating surplus / real capital stock × 100
3. Real lending rate = long-term prime lending rate - domestic demand deflator (y/y % chg., 1 year ahead)

(2) Business Cycle and Capital Stock

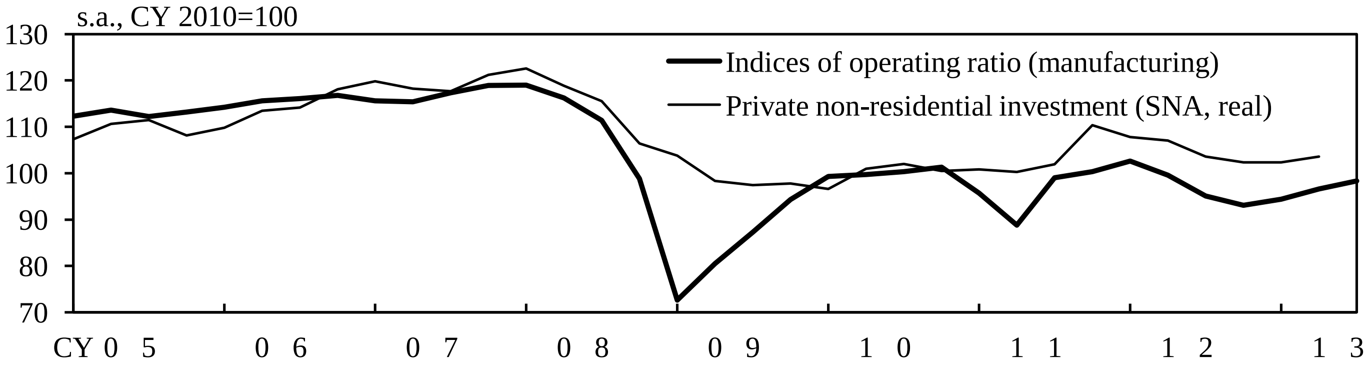


(3) Holding Periods of Production Facilities (Manufacturing)



Notes: 1. The triangle indicates the occurrence of the Great East Japan Earthquake.
2. The cumulative increase of GDP and capital stock from the trough reached 25 percent for the recovery phase starting from November 1986.
3. The provisional date for the peak of the business cycle starting from March 2009 is April 2012.

(4) Operating Ratio (Manufacturing) and Business Fixed Investment

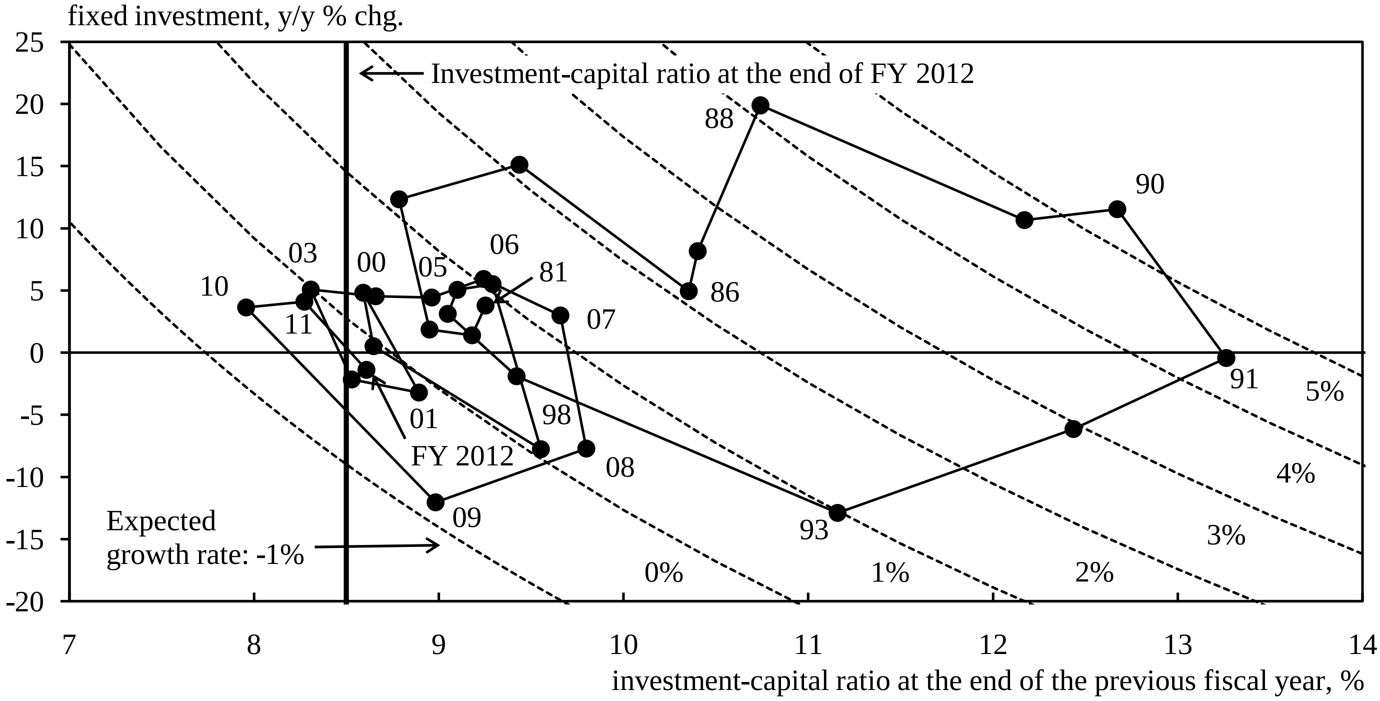


Note: The figure for 2013/Q3 is the July-August average.

Sources: Cabinet Office, "National Accounts"; Ministry of Economy, Trade and Industry, "Indices of Industrial Production," etc.

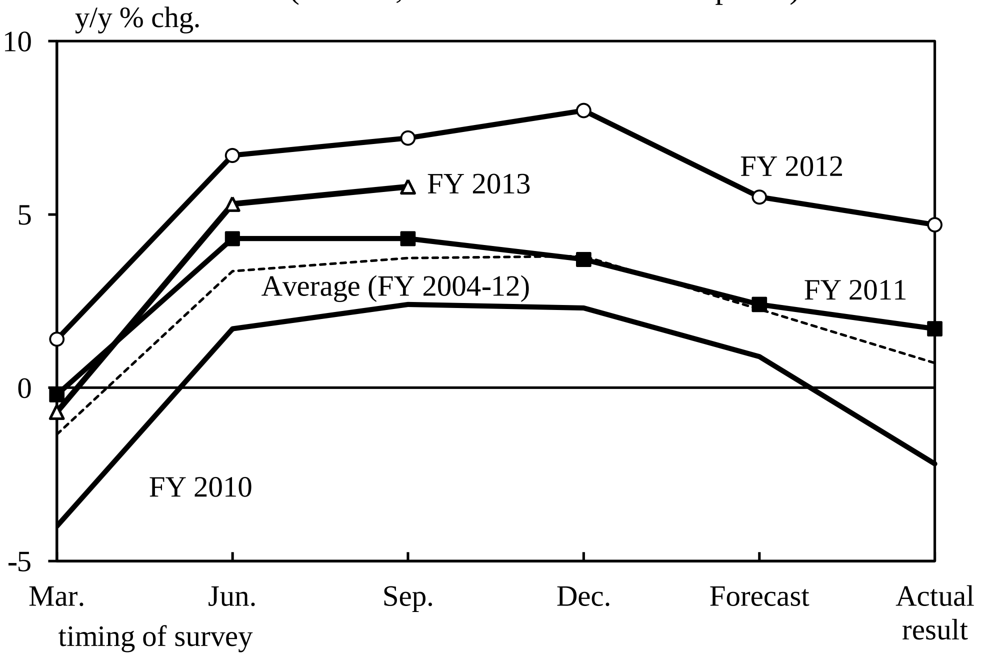
Capital Stock Cycles and Business Fixed Investment Plans

(1) Capital Stock Cycles



1. Capital stock cycles in the chart show the relationship between the investment-capital ratio and the year-on-year rate of change in fixed investment.
2. As these variables have the following relation, a hyperbolic curve can be drawn for a given expected growth rate.
   Year-on-year rate of change in fixed investment (y-axis) × investment-capital ratio at the end of the previous fiscal year (x-axis) = expected growth rate + trend growth rate of capital coefficient + depreciation rate
3. The phase of fixed investment at a certain time can be evaluated in relation to the hyperbolic curve corresponding to the expected growth rate at that time.

(2) Business Fixed Investment Plans (*Tankan*, All Industries and Enterprises)

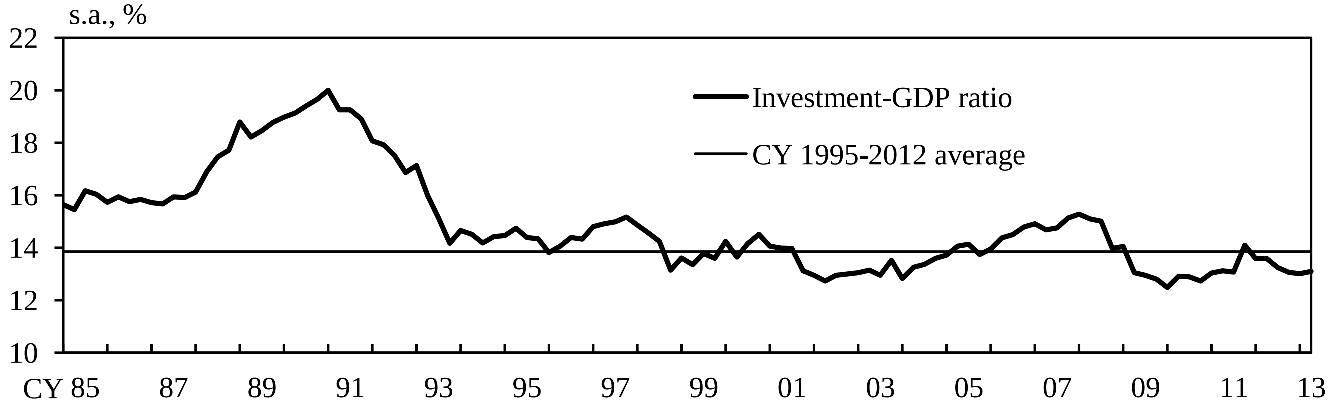


Note: Includes software investment and excludes land purchasing expenses.

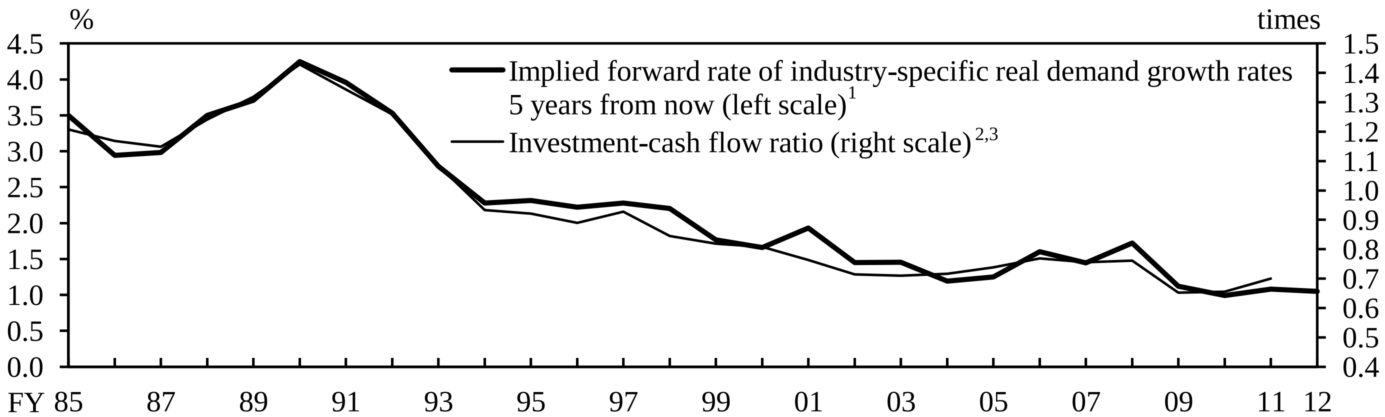
Sources: Cabinet Office, "National Accounts";
Research Institute of Economy, Trade and Industry, "Japan Industrial Productivity Database";
Bank of Japan, "*Tankan*, Short-Term Economic Survey of Enterprises in Japan."

Business Fixed Investment

(1) Investment-GDP Ratio (Nominal)

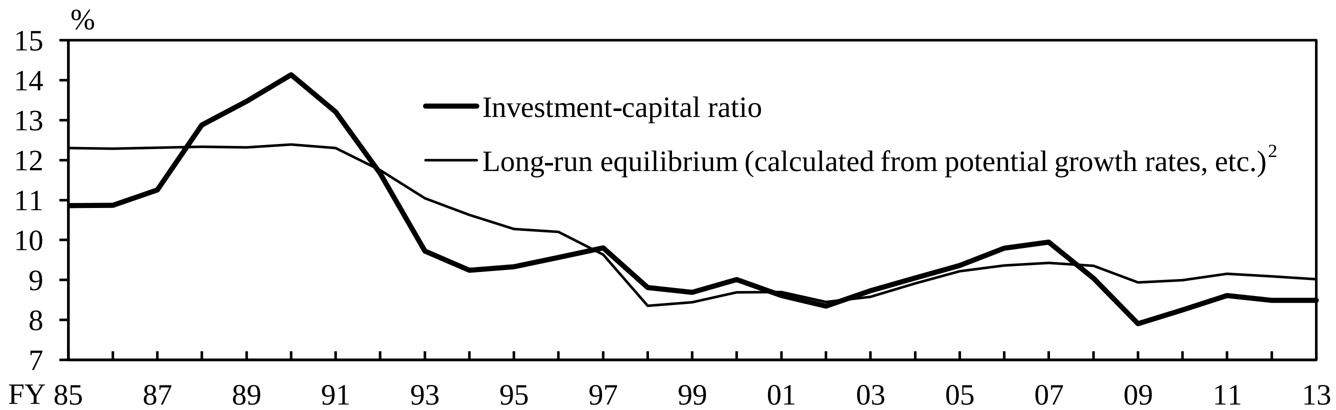


(2) Cash Flow and Business Fixed Investment



Notes: 1. Calculated using the "Annual Survey of Corporate Behavior." The survey period is January or February in each fiscal year.
2. Taken from the "National Accounts."
3. Cash flow = consumption of fixed capital + (operating surplus + net property income) / 2
Figures up through fiscal 1993 are on the 2000 base.

(3) Investment-Capital Ratio (I_t / K_{t-1})[1]

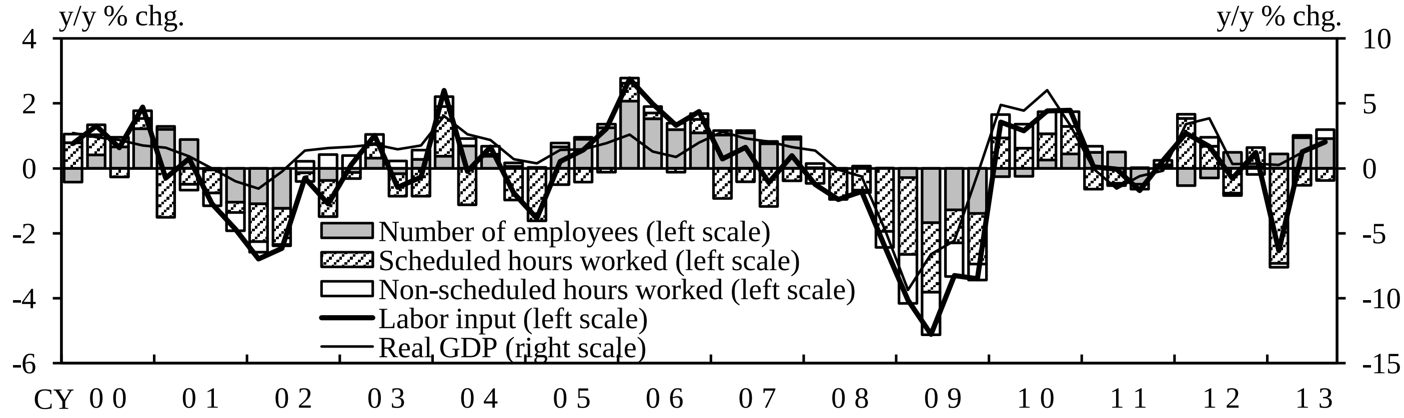


Notes: 1. Figures for fiscal 2013 are those of 2013/Q2.
2. $(I_t / I_{t-1})\cdot(I / K)_{t-1}$ = expected growth rate + trend growth rate of capital coefficient + depreciation rate (see the explanation in Chart 34). The investment-capital ratio consistent with the potential growth rate can be expressed as I_t / K_{t-1} = potential growth rate + trend growth rate of capital coefficient + depreciation rate. The long-run equilibrium is calculated using this equation.

Sources: Cabinet Office, "National Accounts," "Annual Survey of Corporate Behavior";
Research Institute of Economy, Trade and Industry, "Japan Industrial Productivity Database," etc.

Labor Supply and Demand

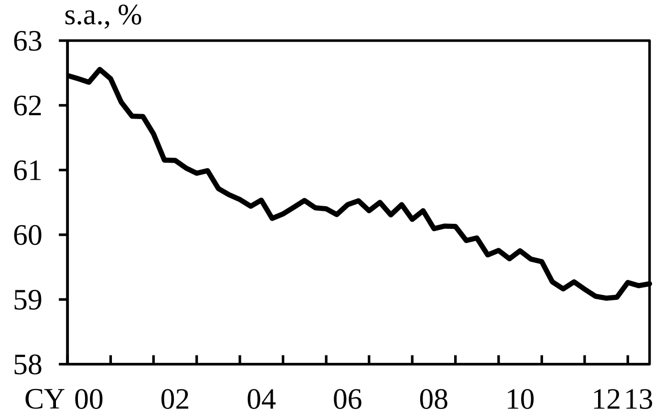
(1) Labor Input and Real GDP



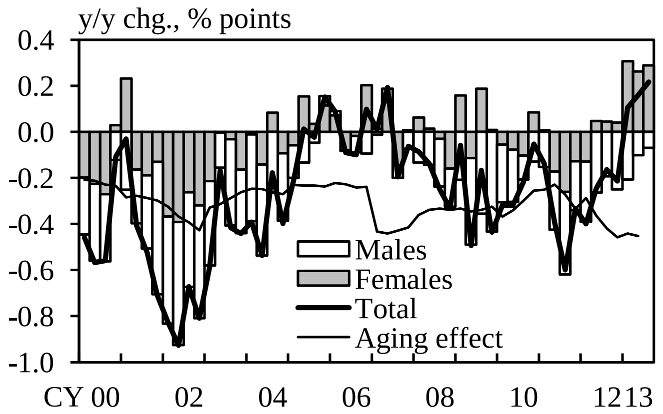
Note: Figures for 2013/Q3 are July-August averages. Labor input = number of employees (Labour Force Survey) × total hours worked (scheduled hours worked + non-scheduled hours worked)

(2) Labor Force Participation Rate

(a) Level[1]

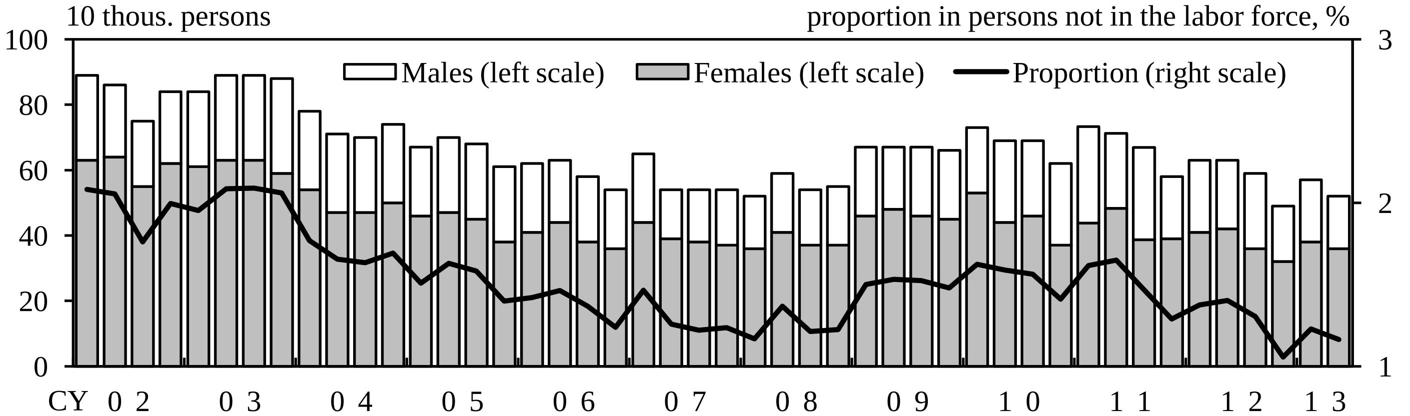


(b) Change from Previous Year[2]



Notes: 1. Labor force participation rate = labor force / population of 15 years old or more × 100
Figures are seasonally adjusted by X-12-ARIMA.
2. Figures for the total are calculated as weighted averages of the year-on-year change for males and females. The aging effect illustrates downward pressures on the labor force participation rate due to the increase in the number of elderly people whose participation in the labor market is low. This effect is obtained by regressing the labor participation rate by age on variables such as age dummies.

(3) Discouraged Workers

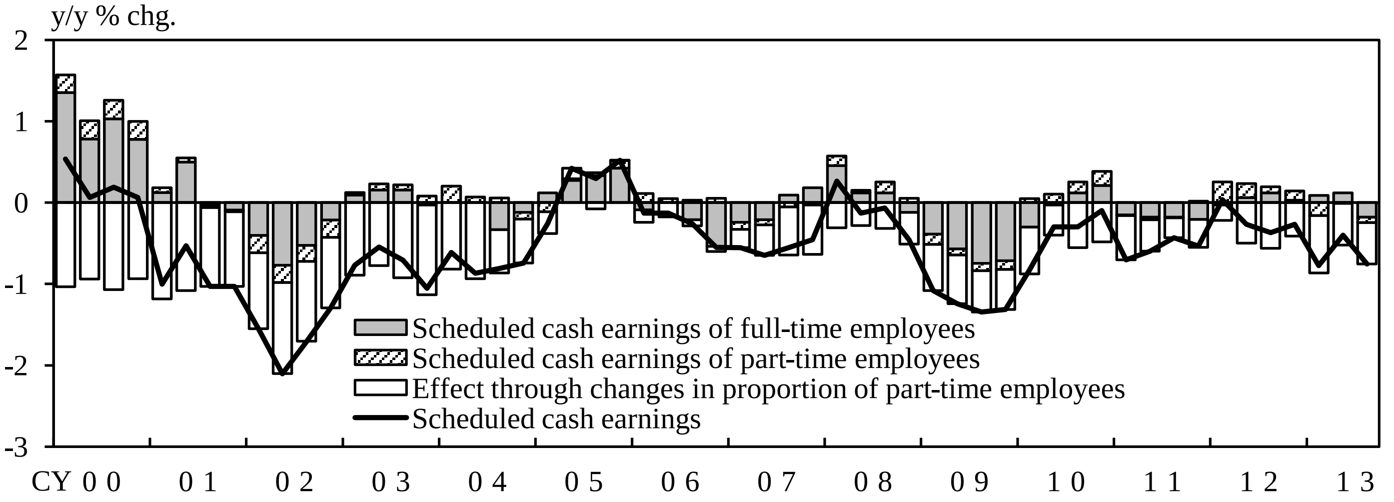


Note: Discouraged workers are persons not in the labor force who wish to work and are able to take up a job immediately, but who are not looking for a job as there is no prospect of finding one. Figures for 2011/Q1-Q3 are estimated values.

Sources: Cabinet Office, "National Accounts"; Ministry of Internal Affairs and Communications, "Labour Force Survey"; Ministry of Health, Labour and Welfare, "Monthly Labour Survey."

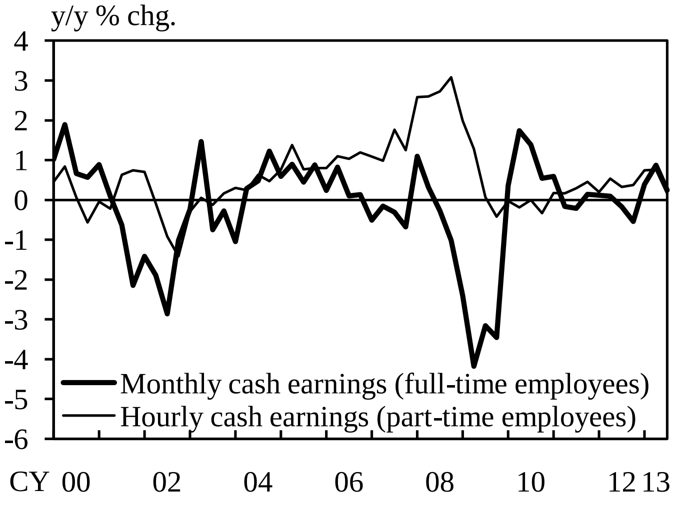
Wages

(1) Breakdown of Scheduled Cash Earnings

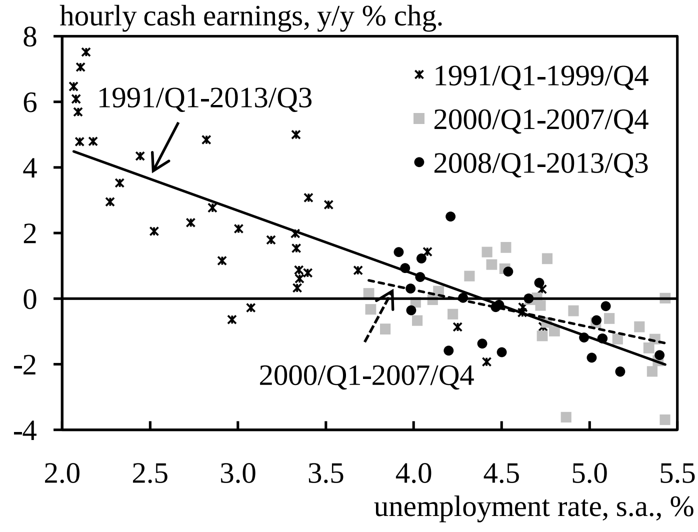


Note: Figures for 2013/Q3 are July-August averages. The same definition applies to Charts (2) and (3).

(2) Cash Earnings by Type of Worker



(3) Unemployment Rate and Hourly Cash Earnings



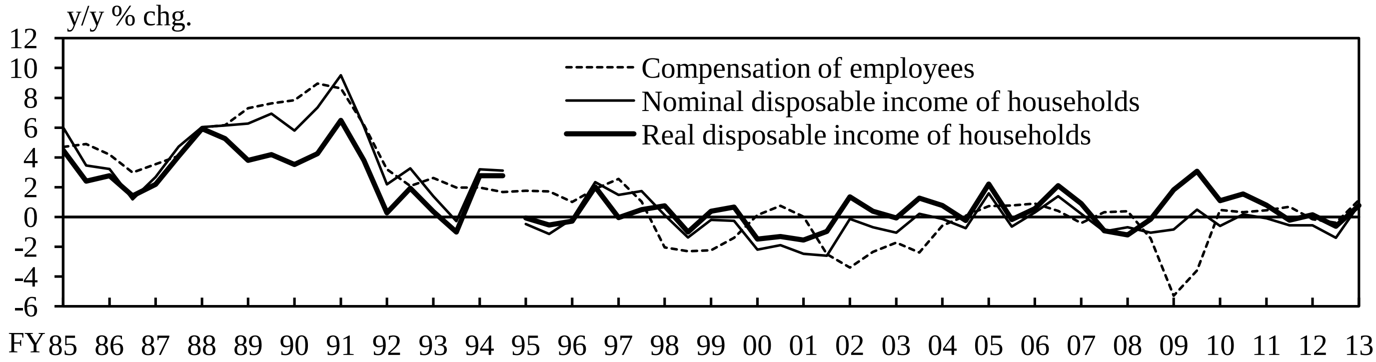
(4) Labor Share

Note: Labor share = compensation of employees / nominal GDP × 100

Sources: Cabinet Office, "National Accounts"; Ministry of Internal Affairs and Communications, "Labour Force Survey"; Ministry of Health, Labour and Welfare, "Monthly Labour Survey."

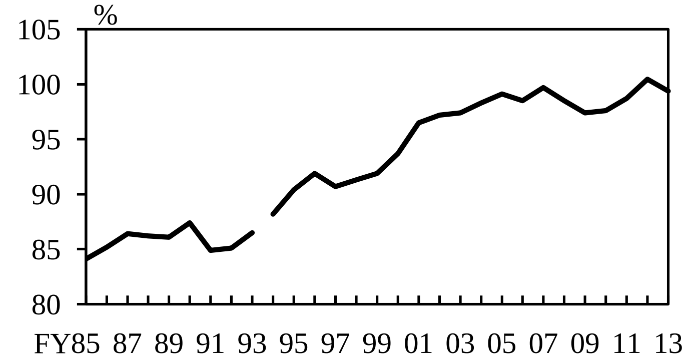
Environment Surrounding Private Consumption

(1) Compensation of Employees and Disposable Income of Households

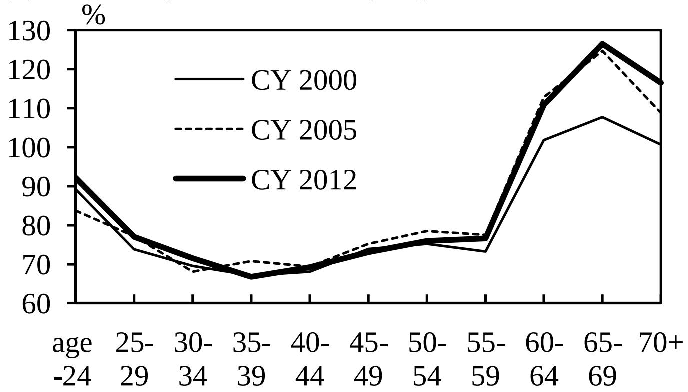


Notes: 1. The figure for compensation of employees for the first half of fiscal 2013 is the year-on-year rate of change in 2013/Q2.
2. Figures for disposable income of households up through fiscal 1994 are on the 2000 base. From fiscal 1995, they are on the 2005 base.
3. Figures for fiscal 2012 and 2013 are estimated by the Research and Statistics Department, Bank of Japan. They include estimated transfers of income from the government to households through the economic policy packages. The same procedure applies to Chart (2).

(2) Propensity to Consume[1]



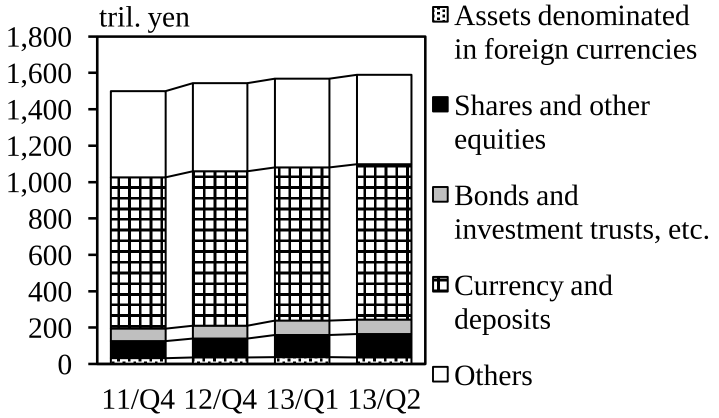
(3) Propensity to Consume by Age[2]



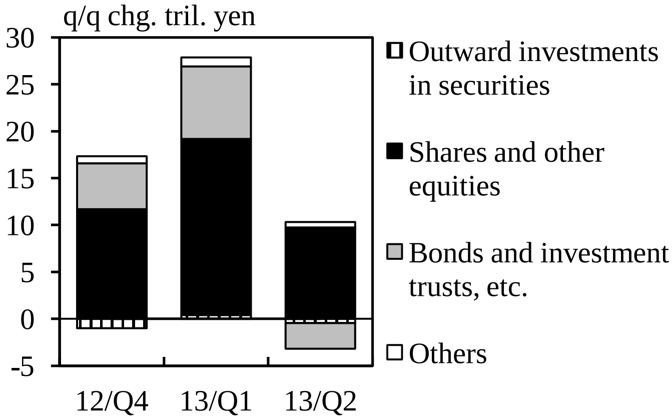
Notes: 1. Figures are on a "National Accounts" basis. They are on the 2000 base up through fiscal 1993 and on the 2005 base from fiscal 1994 onward.
2. Figures are on a "Family Income and Expenditure Survey" basis. Calculated by using consumption expenditure and disposable income that are the weighted averages of workers' households and no-occupation households.

(4) Financial Assets Held by Households

(a) Amount Outstanding



(b) Changes from Fluctuation in Market Value

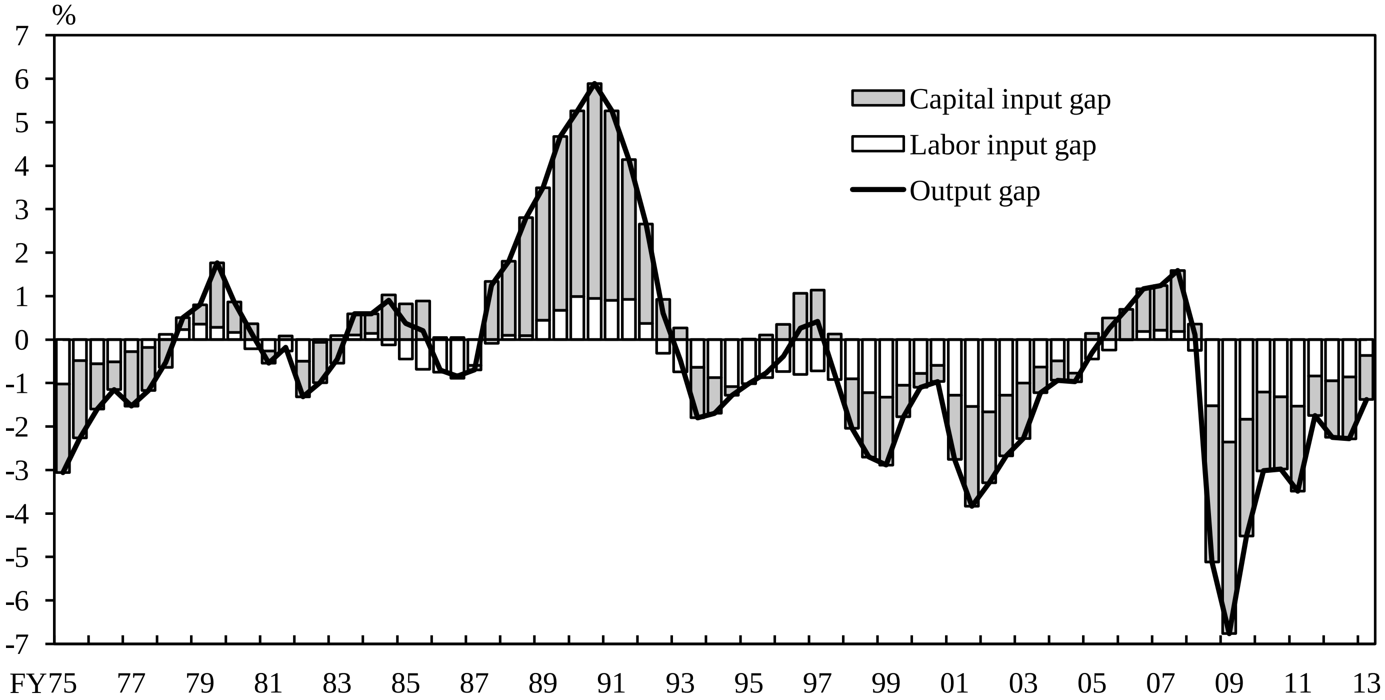


Notes: 1. Figures for bonds and investment trusts, etc. in Chart (4) (a) exclude investment trusts denominated in foreign currencies. Figures for currency and deposits exclude foreign currency deposits.
2. Figures for Chart (4) (b) are on a "Flow of Funds Accounts (Reconciliation Table)" basis.

Sources: Cabinet Office, "National Accounts"; Ministry of Internal Affairs and Communications, "Family Income and Expenditure Survey"; Bank of Japan, "Flow of Funds Accounts," etc.

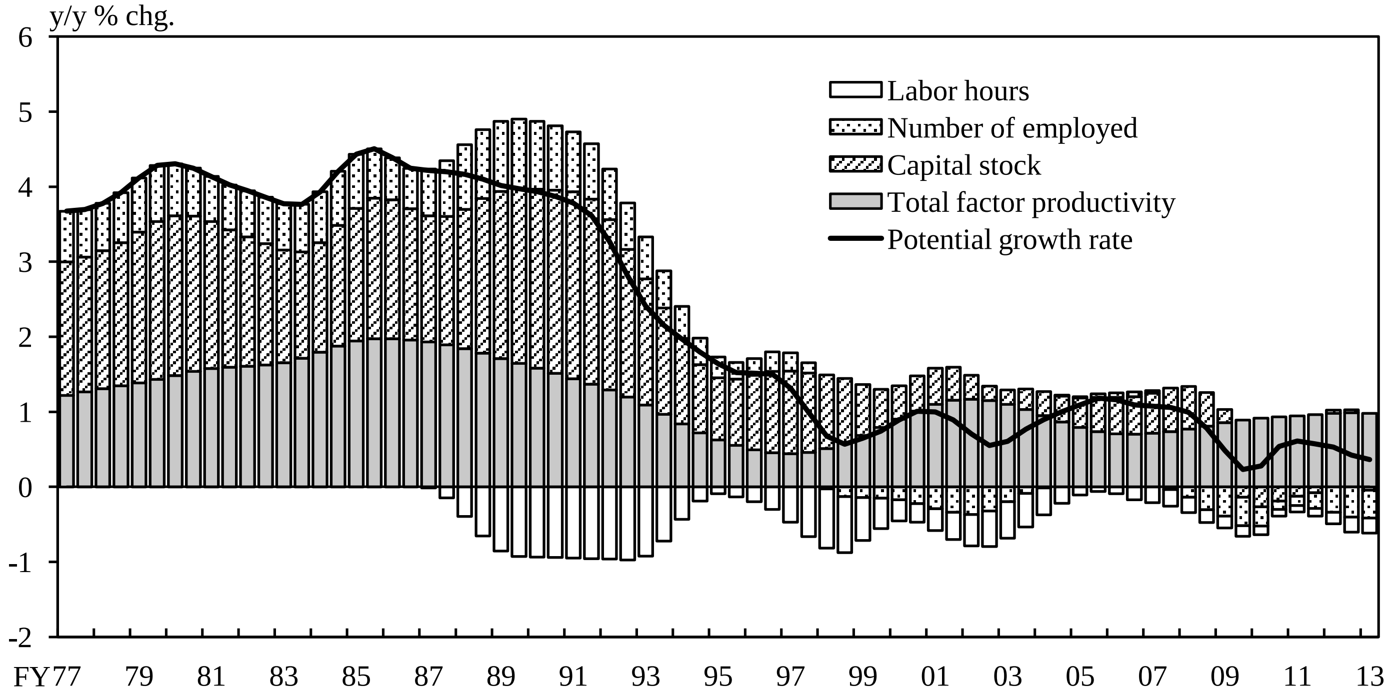
Output Gap and Potential Growth Rate

(1) Output Gap



Notes: 1. The output gap and the potential growth rate are estimated by the Research and Statistics Department, Bank of Japan. For the estimation procedures, see "The New Estimates of Output Gap and Potential Growth Rate," Bank of Japan Review Series, 2006-E-3. The same definition applies to the chart below.
2. Figures for the first half of fiscal 2013 are those of 2013/Q2. The same rule applies to the chart below.

(2) Potential Growth Rate

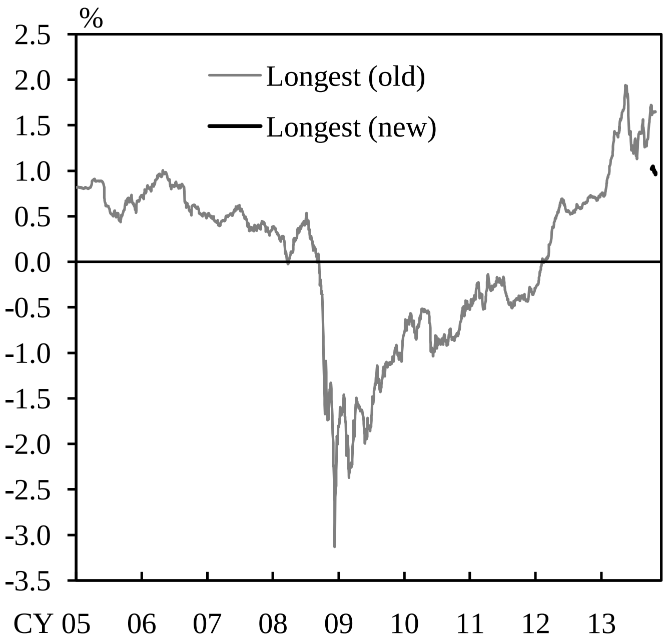


Sources: Cabinet Office, "National Accounts"; Ministry of Internal Affairs and Communications, "Labour Force Survey"; Ministry of Health, Labour and Welfare, "Monthly Labour Survey," "Report on Employment Service"; Ministry of Economy, Trade and Industry, "Indices of Industrial Production"; Bank of Japan,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

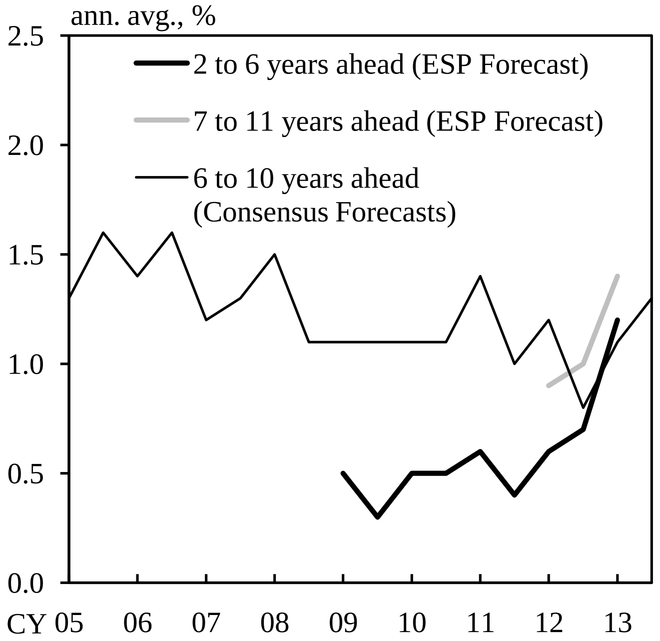
Chart 40

Inflation Expectations (1)

(1) Market Participants
(BEI for Inflation-Indexed JGBs)



(2) Economists

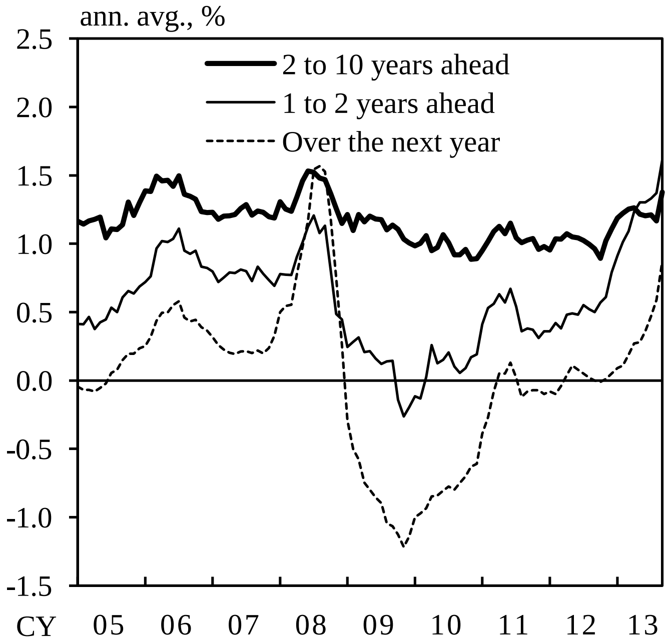


Notes: 1. BEI (break-even inflation) rates in Chart (1) are yield spreads between fixed-rate coupon-bearing JGBs and inflation-indexed JGBs. Inflation-indexed JGBs issued since October 2013 are designated as "new," while the rest of them are designated as "old." Figures for "longest" are calculated using yield data for the inflation-indexed JGBs that have the longest maturity at each period, which currently correspond to those maturing in June 2018 for "old" and September 2023 for "new."

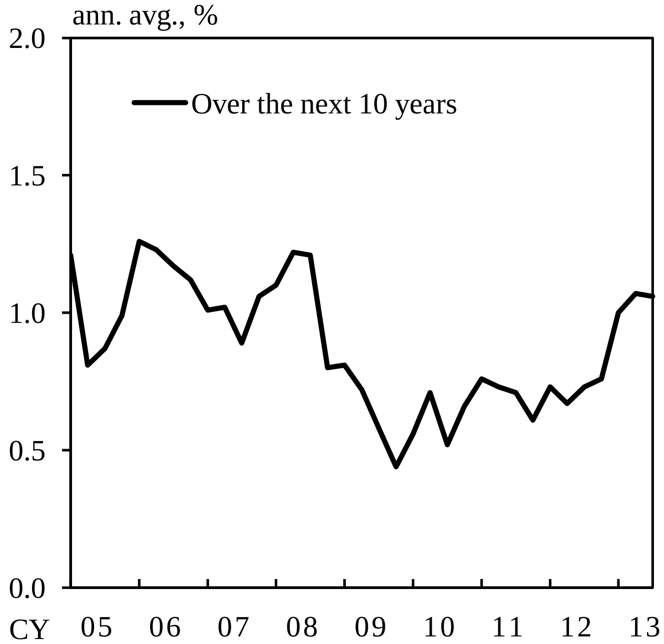
2. Figures for the ESP Forecast in Chart (2) exclude the effects of the scheduled consumption tax hikes.

(3) Market Participants

<Quick Bond Monthly Survey>



<Survey by Mizuho Securities>



Note: From the September 2013 survey, the Quick Bond Monthly Survey has asked respondents to include the effects of the scheduled consumption tax hikes. Figures for the survey by Mizuho Securities exclude the effects of the scheduled consumption tax hikes.

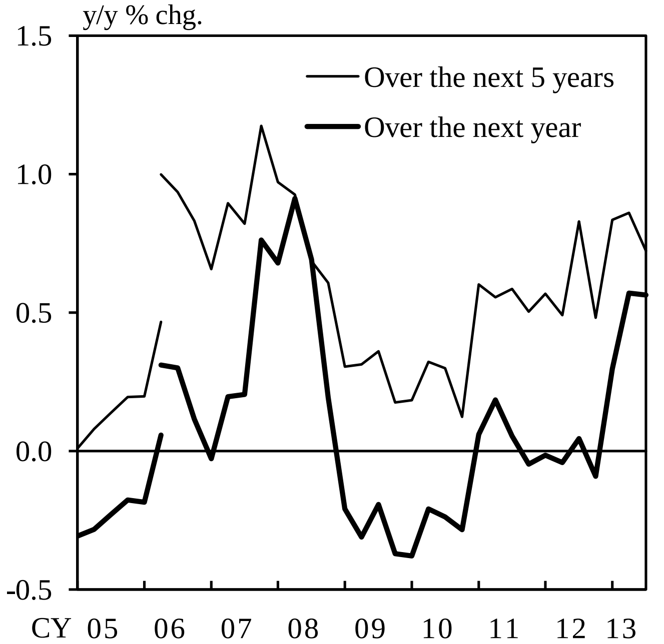
Sources: Consensus Economics Inc., "Consensus Forecasts"; JCER, "ESP Forecast"; QUICK, "Quick Bond Monthly Survey"; Mizuho Securities, "Investor Survey"; Bloomberg.

Chart 41

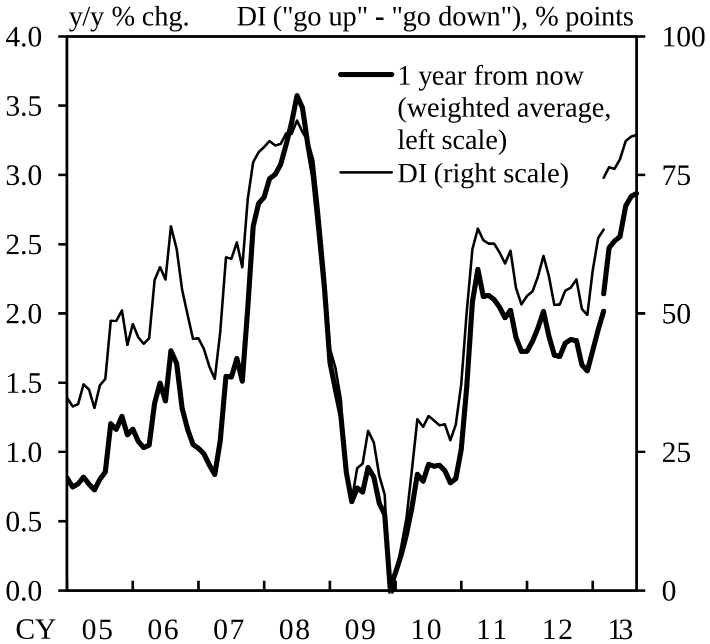
Inflation Expectations (2)

(1) Households

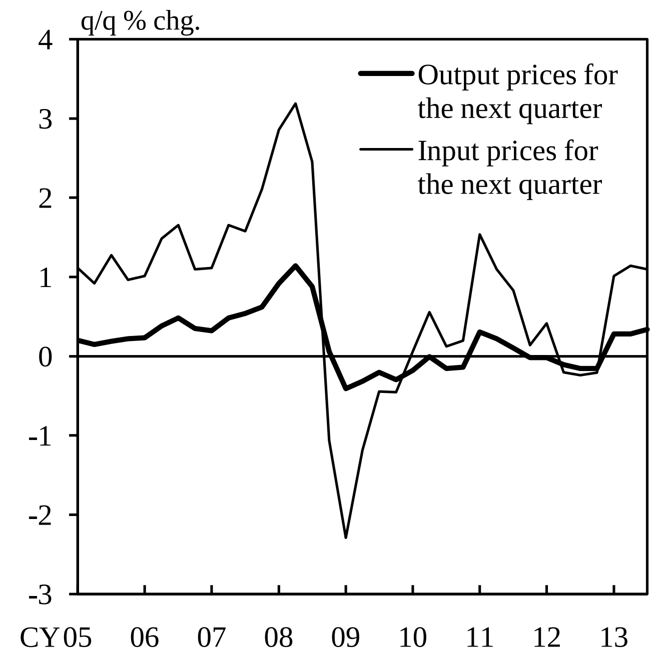
<Opinion Survey on the General Public's Views and Behavior>[1, 2]



<Consumer Confidence Survey>[3, 4]

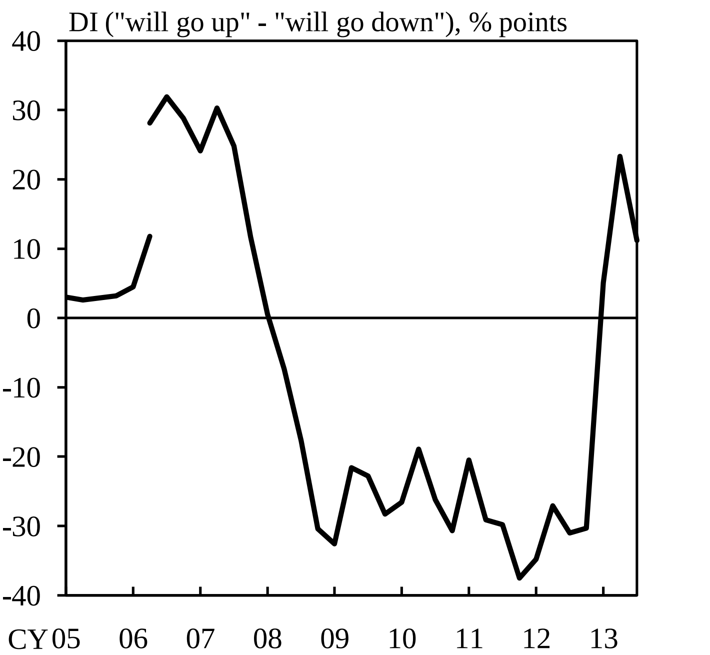


(2) Enterprises (*Tankan*)[1]



(Reference) Household Expectations for Land Prices

<Opinion Survey on the General Public's Views and Behavior>



Notes: 1. Figures are estimated using the modified Carlson-Parkin method. For details, see "On Inflation Expectations," Bank of Japan Review Series, 2008-J-15 (available in Japanese only).

2. From the June 2013 survey, the Opinion Survey has asked respondents to exclude the effects of the scheduled consumption tax hikes.

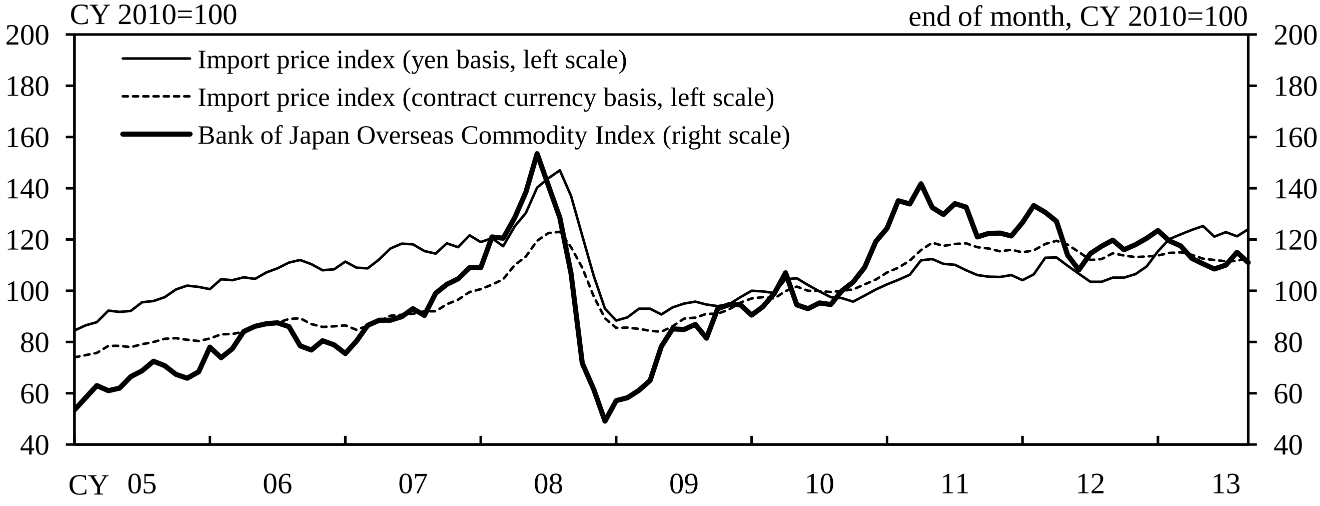
3. Figures are for all households.

4. The weighted average is calculated based on the following assumption: survey responses chosen by households as their expected inflation rates -- "-5% or below," "from -5% to -2%," "from -2% to 0%," "from 0% to +2%," "from +2% to +5%," and "+5% or above" -- indicate inflation rates of -5%, -3.5%, -1%, +1%, +3.5%, and +5%, respectively.

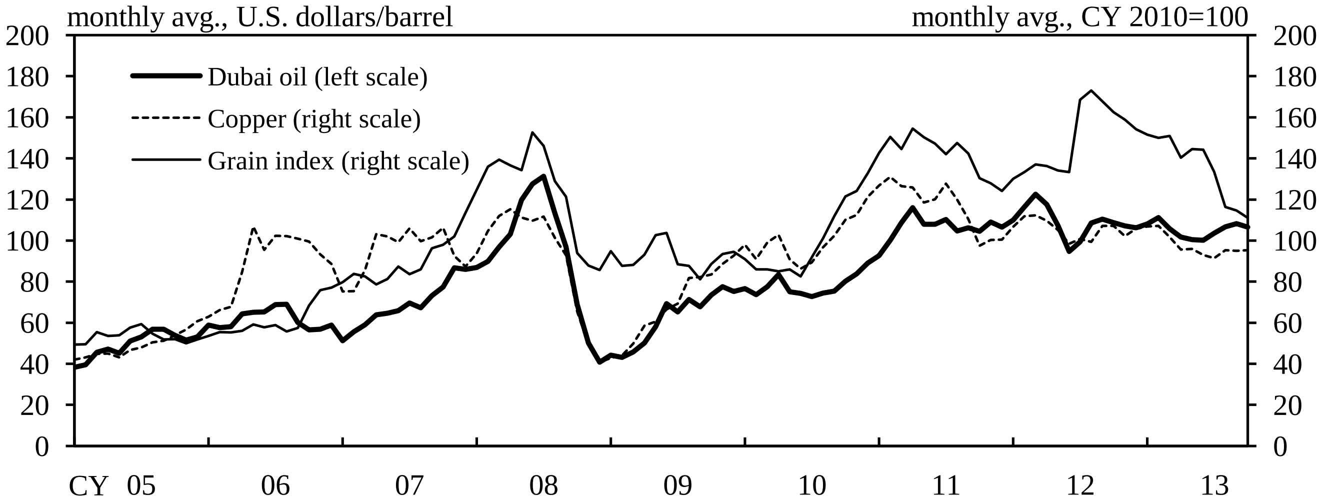
Sources: Bank of Japan, "*Tankan,* Short-Term Economic Survey of Enterprises in Japan," "Opinion Survey on the General Public's Views and Behavior," "Corporate Goods Price Index"; Ministry of Internal Affairs and Communications, "Consumer Price Index"; Cabinet Office, "Consumer Confidence Survey."

Import Prices and International Commodity Prices

(1) Import Price Index and Overseas Commodity Index

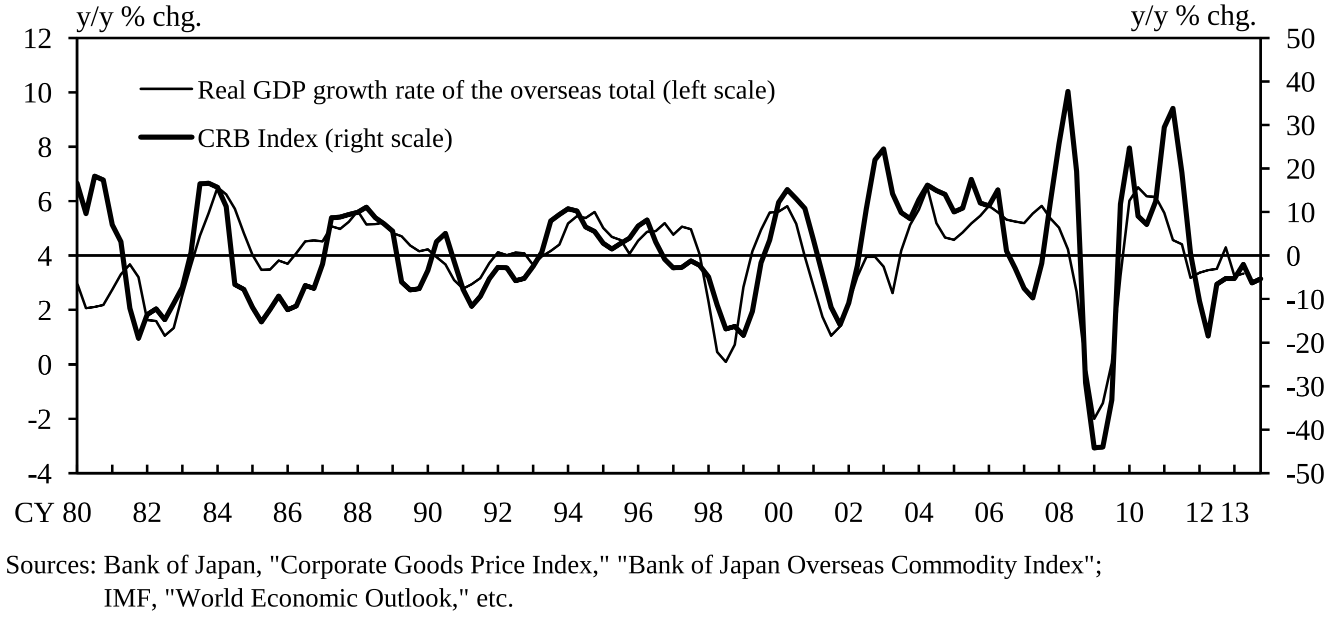


(2) Oil, Nonferrous Metal and Grain Prices



Note: The grain index is the weighted average of prices of three selected items (wheat, soybeans, and corn) in overseas commodity markets. The weights are based on the value of imports in the Trade Statistics of Japan.

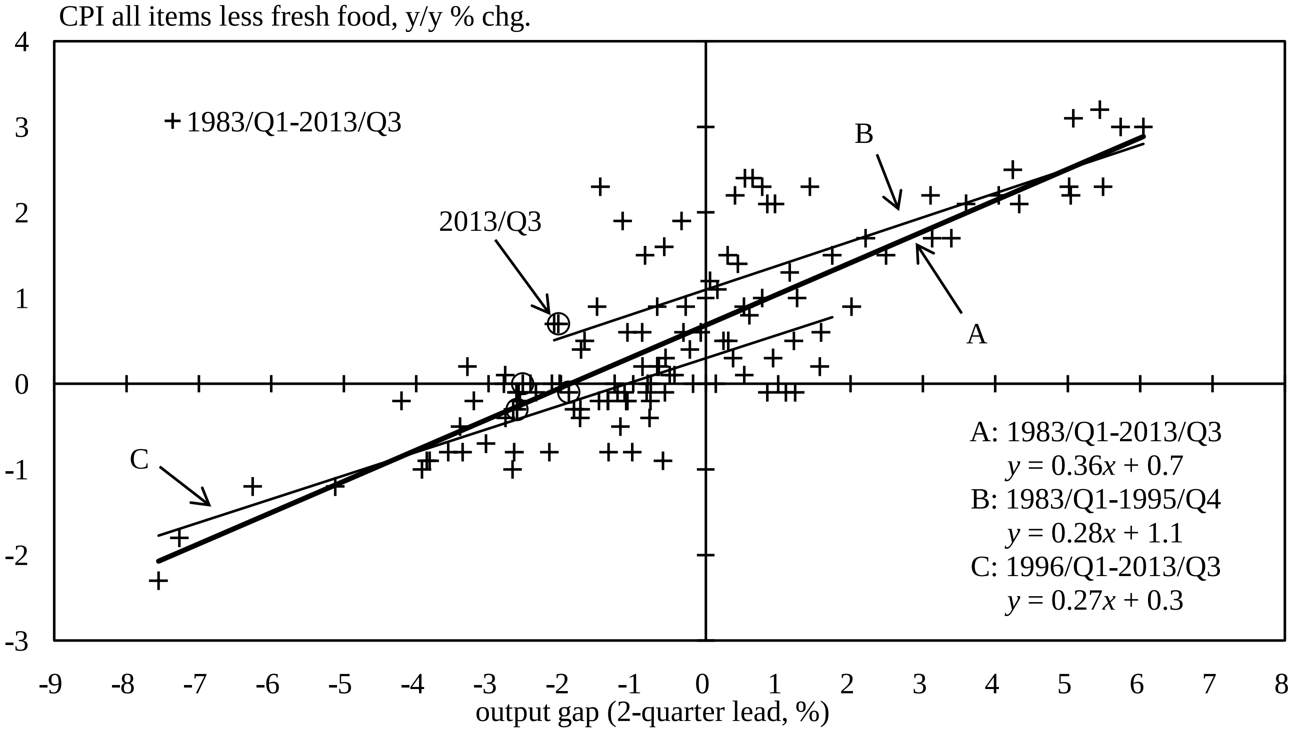
(3) International Commodity Prices and Overseas Economies



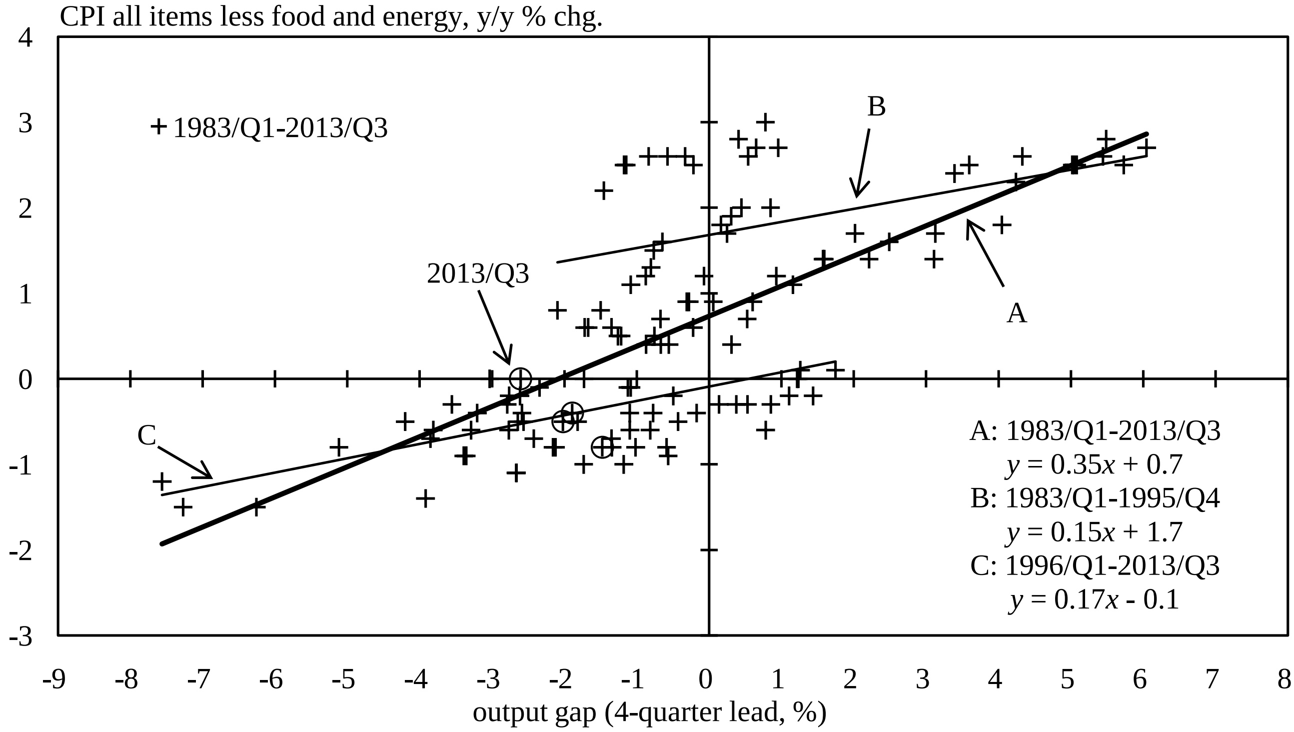
Sources: Bank of Japan, "Corporate Goods Price Index," "Bank of Japan Overseas Commodity Index"; IMF, "World Economic Outlook," etc.

Output Gap and Inflation Rate (1)

(1) Phillips Curve (CPI All Items Less Fresh Food)



(2) Phillips Curve (CPI All Items Less Food and Energy)

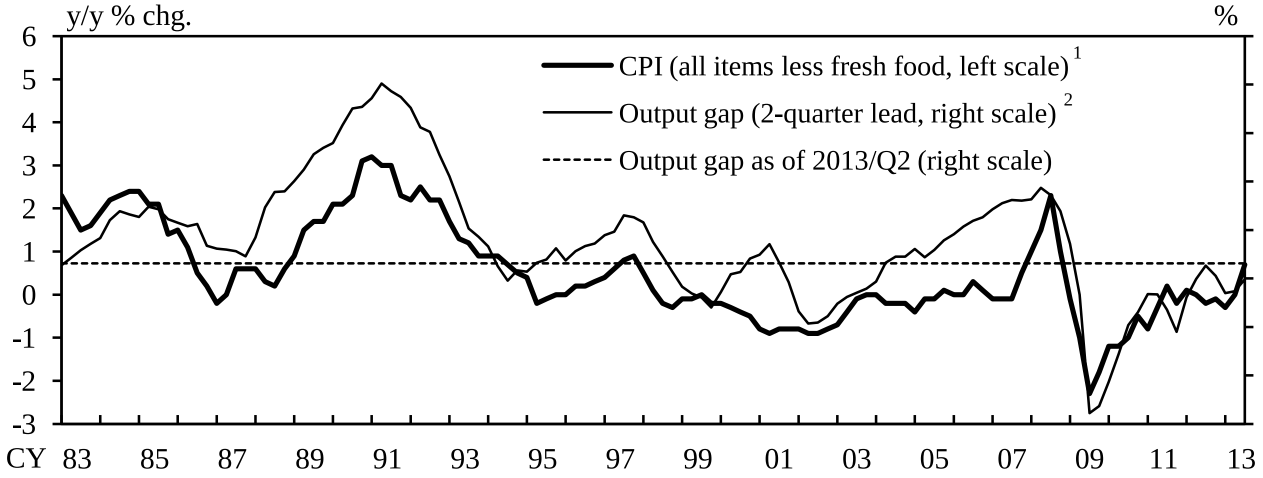


Notes: 1. The circled marks are the latest four positions.
2. Figures for the CPI are adjusted to exclude the effect of changes in the consumption tax rate.
3. The output gap is estimated by the Research and Statistics Department, Bank of Japan. For the estimation procedures, see "The New Estimates of Output Gap and Potential Growth Rate," Bank of Japan Review Series, 2006-E-3.
4. The number of lags is chosen so that the cross-correlation between the output gap and the CPI is maximized.

Sources: Ministry of Internal Affairs and Communications, "Consumer Price Index"; Cabinet Office, "National Accounts," etc.

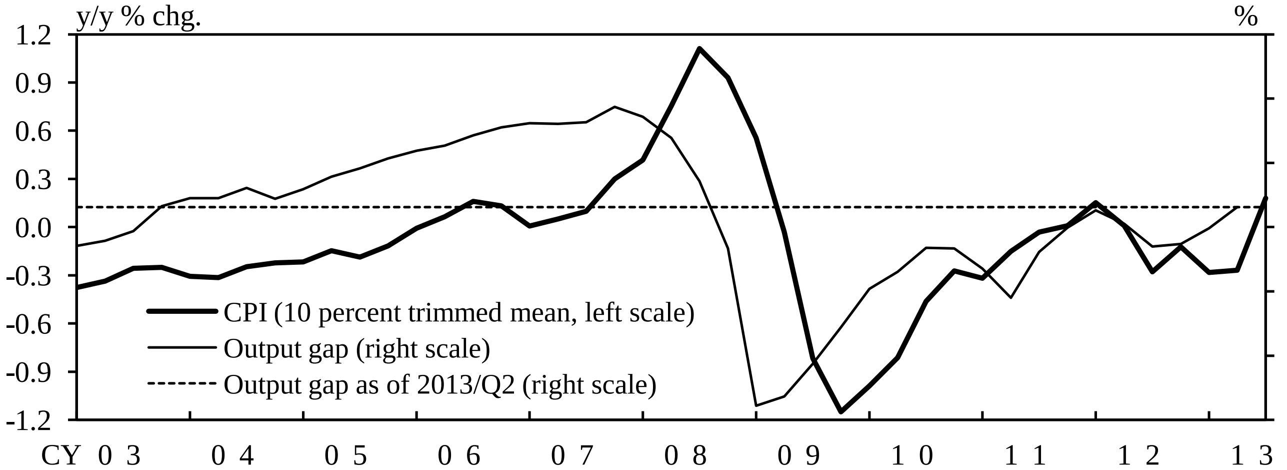
Output Gap and Inflation Rate (2)

(1) Output Gap and CPI (All Items Less Fresh Food)



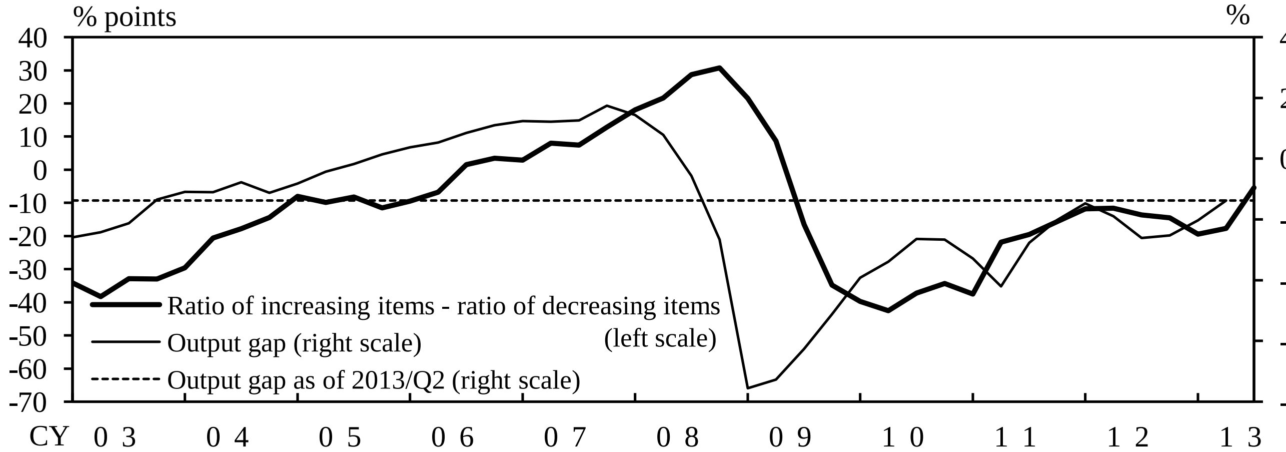
Notes: 1. Figures for the CPI are adjusted to exclude the effect of changes in the consumption tax rate.
2. The output gap is estimated by the Research and Statistics Department, Bank of Japan. For the estimation procedures, see "The New Estimates of Output Gap and Potential Growth Rate," Bank of Japan Review Series, 2006-E-3. The same definition applies to the charts below.

(2) Output Gap and Trimmed Mean CPI



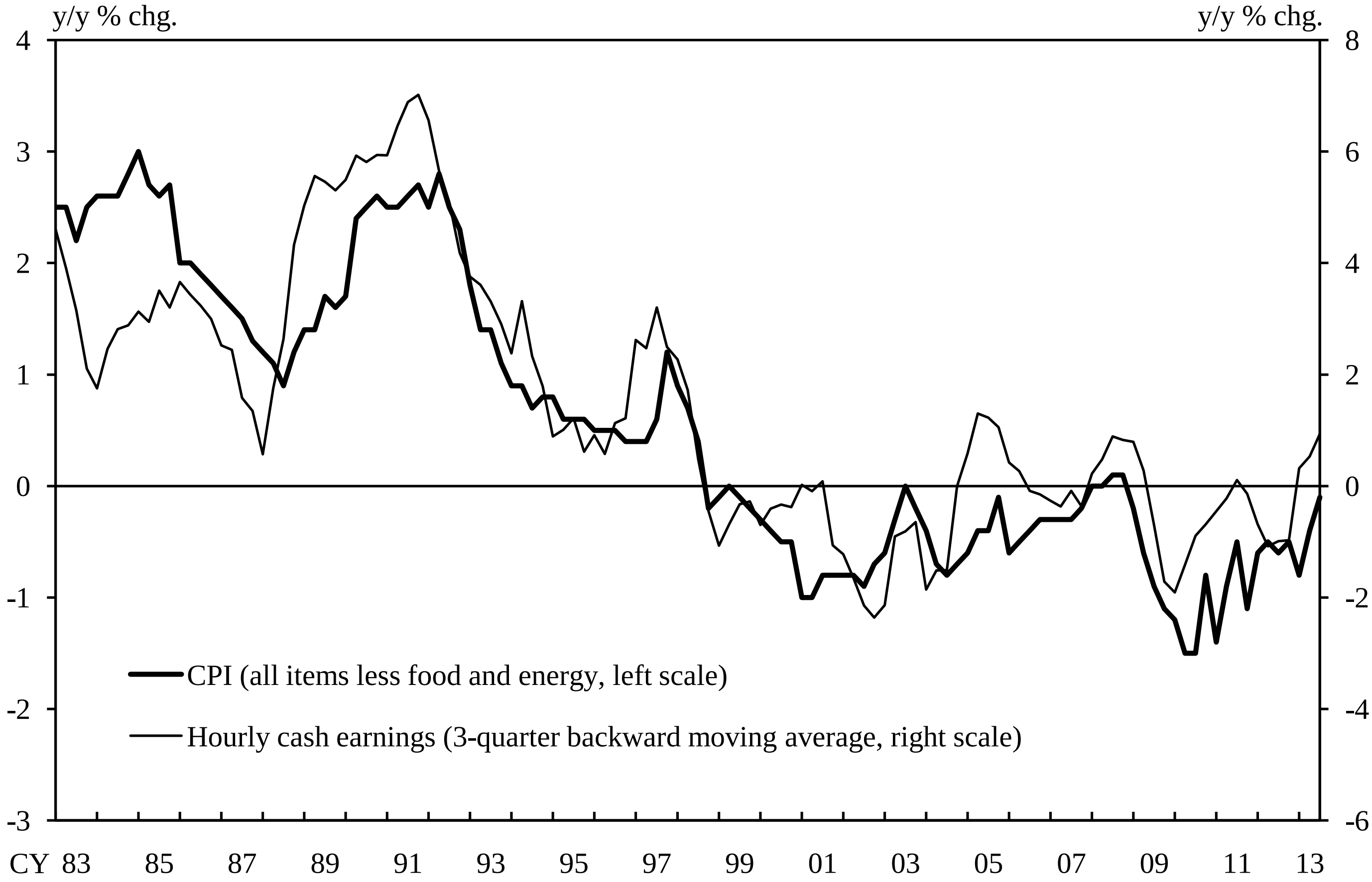
Note: Figures for the 10 percent trimmed mean are weighted averages of items; these items are obtained by rearranging year-on-year rates of price change in ascending order and then excluding items in both the upper and lower 10 percent tails by weight.

(3) Output Gap and Ratio of Increasing and Decreasing Items in CPI



Note: Proportion of items whose year-on-year rates of price change increased/decreased. All items less fresh food.
Sources: Ministry of Internal Affairs and Communications, "Consumer Price Index";
Cabinet Office, "National Accounts," etc.

Prices and Wages



Notes: 1. Figures for 2013/Q3 are July-August averages.
2. Figures for the CPI are adjusted to exclude the effect of changes in the consumption tax rate.
3. Figures for hourly cash earnings up through 1990/Q4 are those for establishments with 30 or more employees.

Sources: Ministry of Internal Affairs and Communications, "Consumer Price Index"; Ministry of Health, Labour and Welfare, "Monthly Labour Survey."

Reference

Economic Assessment by Region (Regional Economic Report)

Region	Assessment in July 2013	Changes from the previous assessment	Assessment in October 2013
Hokkaido	The economy has been picking up.	↗	The economy has begun to recover moderately.
Tohoku	The economy has begun to recover.	↗	The economy has been recovering.
Hokuriku	The economy has been picking up.	↗	The economy has been picking up steadily.
Kanto-Koshinetsu	The economy has been picking up.	↗	The economy has been recovering moderately.
Tokai	The economy has been picking up.	↗	The economy has been recovering moderately.
Kinki	The economy has been picking up moderately.	↗	The economy has been recovering moderately.
Chugoku	The economy has been picking up moderately as a whole.	↗	The economy has been recovering moderately as a whole.
Shikoku	The economy has begun to pick up.	↗	The economy has begun to recover moderately.
Kyushu-Okinawa	The economy has been picking up.	↗	The economy has been recovering moderately.

Note: The Regional Economic Report (summary) is available on the Bank of Japan's web site (http://www.boj.or.jp/en/research/brp/rer/rer131021.htm/).

Source: Bank of Japan, "Regional Economic Report (Summary) October 2013."