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Bank of Japan

# Outlook for Economic Activity and Prices

April 2005

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

**[The Bank's View][1,2]**

**(Outlook for Economic Activity and Prices)**

Japan's economy remains on a recovery trend, although recently the economy has been pausing temporarily due partly to adjustments in production and inventories in IT-related sectors in the second half of 2004. As a result, economic activity in fiscal 2004 seemed to have deviated slightly below the projected outlook reported in the *Outlook for Economic Activity and Prices* (the Outlook Report) released in October 2004.

Looking forward, Japan's economic recovery is likely to gradually gather momentum from the middle of 2005 as the effects of adjustments in IT-related sectors diminish, and growth in fiscal 2005 is expected slightly to exceed the economy's potential growth rate. This is generally in line with the outlook presented in the October Outlook Report. Although at present there is considerable uncertainty, in fiscal 2006 the economy is expected to follow a sustainable growth path, albeit at a moderate pace. This economic outlook rests on the following underlying assumptions: that overseas economies remain on an expansionary trend; that firms' profits remain at high levels as they continue their efforts on various fronts; that increased corporate profits spread to a wider range of sectors through various channels; and that firms' cautious business stance allows excesses in, for example, business fixed investment or inventory investment to be avoided.

Overseas economies, particularly the United States and East Asia, are likely to remain on an expansionary trend. Against this background and with the international division of the production process within the East Asian region continuing to develop, Japan's exports are expected to continue to increase. Since inventory adjustments in IT-related sectors are likely to be completed around the middle of 2005, industrial production is expected to return to its upward trend thereafter. With production and sales set to increase against the background of the development of new high value-added products and services as well as further streamlining efforts by firms, corporate profits, although already at high levels, are likely to continue to trend upward at a moderate pace, despite pressure from the rise in crude oil prices and other commodity prices. Although the pace of increase in business

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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 April 28, 2005.

[2] The Bank of Japan announced that it would extend the projection period by one year in the April *Outlook for Economic Activity and Price*s. From this issue, the Bank will provide an outlook for the current and following fiscal years in the April as well as the October issues.

fixed investment is still contained compared with firms' cash flow, fixed investment is expected to follow an upward trend as adjustment pressure stemming from structural factors including excess capacity and debts eases. Household income is also likely to increase moderately reflecting improvement in supply and demand conditions in the labor market. In this situation, private consumption is expected to continue increasing moderately.

On the price front, as the output gap continues to narrow, domestic corporate goods prices have been increasing year on year since the beginning of 2004 reflecting the rise in commodity prices at home and abroad. The consumer price index (excluding fresh food, on a nationwide basis) has been declining slightly on a year-on-year basis partly due to the decline in rice prices and the reduction in electricity and telephone charges caused by intense competition accompanying deregulation. These developments in domestic corporate goods prices and consumer prices in fiscal 2004 were generally in line with the October outlook.

In fiscal 2005 and 2006, although domestic corporate goods prices will be sensitive to developments in commodity prices at home and abroad, they are likely to continue increasing, albeit at a slower pace than in the first half of 2004. In fiscal 2005, domestic corporate goods prices are likely to deviate above the projections given in the October outlook due mainly to the rise in crude oil prices. Consumer prices are unlikely to increase markedly since the rise in energy and materials prices is expected to be substantially offset by increases in corporate productivity. In fiscal 2005, developments in consumer prices are likely to deviate slightly below the projections in the October outlook. That is, consumer prices are likely to remain around zero percent on a year-on-year basis due partly to the fact that the effects of the decline in rice prices and the reduction in electricity and telephone charges are expected to remain for a while. In fiscal 2006, consumer prices are expected to increase on a year-on-year basis as the effects of these temporary factors fall off.

**(Positive and Negative Deviations)**

The following factors could cause economic activity to deviate either above or below the projections given in the above outlook.

The first factor is developments in energy and materials prices. Crude oil prices have risen again reflecting expectations of expanding global demand. Recently, crude oil prices have been recording historically high levels. There has also been some increase in the prices of various materials, particularly of steel plates and nonferrous metals. If energy and materials prices remain at high levels, the global economy may be adversely affected via declines in corporate profits and households' real purchasing power.

The second factor is developments in the U.S. and Chinese economies. In the outlook, the U.S. and East Asian economies, particularly the Chinese economy, are assumed to continue growing at around their current pace. Japan's exports could deviate from the projected outlook, either positively or negatively, depending on developments in these economies. Looking ahead, if, with energy prices rising and the output gap narrowing, inflationary pressures were to build in the U.S. economy, the subsequent changes in the monetary policy stance could trigger a U.S. and hence a global economic slowdown. If this situation materializes, attention should be paid to the risk of negative effects on the global economy, particularly on emerging economies, via capital flows and developments in financial markets. As for the Chinese economy, the government has made clear that it intends to contain the overheating of the economy and achieve a sustainable long-term economic expansion. The various structural problems remaining in the economy, however, mean that there is uncertainty about whether this can be achieved.

The third factor is developments in domestic private demand. The outlook is based on the assumption that firms' behavior is likely to remain cautious despite high corporate profits. In this situation, firms' spending, especially their business fixed investment, could deviate above the projected outlook if there is an increase in the economy's expected growth rate in the medium term, or if firms start to place less priority on reducing interest-bearing liabilities from their balance sheets. On the other hand, if firms' behavior becomes more cautious, this may constrain the growth of business fixed investment, employment, and wages.

As for price developments, there are factors that could cause deviations either above or below the projections of the outlook. If the factors, mentioned above, that cause economic activity to deviate were indeed to materialize, this would impact on prices. In addition, there are factors unique to prices that may cause either upward or downward deviation: a rise in crude oil and other commodity prices at home and abroad and the subsequent emergence of inflationary sentiment may cause upward deviation; meanwhile the intensification of competition among firms accompanying deregulation may cause downward deviation.

**(Conduct of Monetary Policy)**

Looking back at the Japanese economy since the 1990s, the emergence of nonperforming loans (NPLs) due to the bursting of the bubble reduced firms' and financial institutions' risk-taking ability and placed constraints on positive economic activity. In addition to the NPL problem, the tardiness of individual sectors of the economy in adapting to economic globalization, advances in IT, and other various economic changes caused a gradual decline in the potential growth rate of the economy. Since the latter half of the 1990s, negative shocks to the economy triggered anxiety about financial system stability, and this in turn tended to amplify the negative impact on the economy.

During the past decade or so, firms have not only made progress in adjusting their excessive production capacity, holdings of labor, and debts but have also raised their ability to develop new products and services offering high value-added. The fruits of these efforts are becoming evident in corporate profitability. Financial institutions have been making progress in disposing of NPLs and restoring their financial soundness. Against this background, blanket deposit insurance was fully lifted in April 2005. The financial system is becoming more stable and the risk that financial system problems could affect economic activity seems to have receded significantly.

More than four years have passed since the Bank adopted the quantitative easing policy. The framework of the quantitative easing policy is based on two key elements. The first element is the Bank's provision of ample liquidity to the money market so that the outstanding balance of current accounts at the Bank substantially exceeds the amount of required reserves. The second is the Bank's commitment to continue with this ample provision of liquidity until the year-on-year rate of change in the consumer price index (excluding fresh food, on a nationwide basis) registers zero percent or higher on a sustainable basis.

During the period of strong concerns about financial system stability, the Bank provided ample liquidity which met financial institutions' liquidity demand. This contributed greatly to stabilizing financial markets and maintaining an accommodative financial environment, thereby averting the risk of a contraction in economic activity caused by falling prices and decreases in corporate profits. At the same time, the commitment by the Bank caused market participants to expect interest rates to remain at zero for longer, and this in turn underpinned firms' profits and improved rates of return on investment by enabling firms to raise funds at low interest rates.

Anxiety about financial system stability has been subsiding. As a result, financial institutions are demanding less liquidity, as evidenced in undersubscription, where financial institutions' bids fall short of the Bank's offers, which has occurred frequently in the Bank's funds-supplying operations. Financial institutions have become more confident about raising funds under the quantitative easing framework, and an accommodative corporate financing environment has been maintained. The Bank's commitment to maintain the quantitative easing policy based on the consumer price index has allowed firms to continue to enjoy low funding costs even as the economy continues to recover. Positive effects on the economy, acting via interest rates, will strengthen as firms gradually become more confident about the economic outlook.

It is not certain whether or not there will be occasion to change the present framework of the quantitative easing policy during the projection period for this Outlook Report. However, assuming that the outlook's projections regarding economic activity and prices in fact materialize, it is likely that this possibility will gradually increase over the course of fiscal 2006. If upward pressure on prices continues to be to a large extent contained and the economy follows a sustainable and balanced growth path, this will likely give the Bank latitude in changing the policy framework and in conducting monetary policy thereafter.

**Forecasts of the Majority of Policy Board Members[3] and Actuals for Fiscal 2004**

(y/y % chg.)

| | Real GDP | Domestic CGPI | CPI (excluding fresh food) |
|---|---|---|---|
| Forecasts made in October 2004 | +3.4 to +3.7 [+3.6] | +1.4 to +1.5 [+1.5] | –0.2 to –0.1 [–0.2] |
| Actual | +1.6 | +1.5 | –0.2 |

**Forecasts of the Majority of Policy Board Members[3,4] for Fiscal 2005 and Fiscal 2006**

(y/y % chg.)

| | Real GDP | Domestic CGPI | CPI (excluding fresh food) |
|---|---|---|---|
| Fiscal 2005 | +1.2 to +1.6 [+1.3] | +0.8 to +1.0 [+0.8] | –0.1 to +0.1 [–0.1] |
| Forecasts made in October 2004 | +2.2 to +2.6 [+2.5] | +0.2 to +0.5 [+0.3] | –0.1 to +0.2 [+0.1] |
| Fiscal 2006 | +1.3 to +1.7 [+1.6] | +0.2 to +0.5 [+0.3] | +0.2 to +0.4 [+0.3] |

Notes: 1. Brackets indicate the median of the forecasts.

2. Policy Board members made forecasts for real GDP growth rates in the October Outlook Report using the fixed base-year method. At the time, they estimated that real GDP growth rates calculated using the fixed base-year method were slightly over 1 percent higher than if the current chain-linking method had been used. Hence, Policy Board members' median forecasts of real GDP growth rates would be equivalent to around 2.5 percent for fiscal 2004 and around 1.5 percent for fiscal 2005 in terms of the chain-linking method.

3. Actual real GDP for fiscal 2004 is calculated on the assumption that real GDP in the first quarter of 2005 equals that in the fourth quarter of 2004.

4. The forecasts of Policy Board members are based on the assumption that there will be no change in monetary policy.

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3 Forecasts of the majority of Policy Board members are the figures to which the individual members attach the highest probability and they are shown as a range, with the highest and lowest figures excluded. It should be noted that the range does not indicate the forecast errors.

4 The forecasts of all Policy Board members are as follows.

(y/y % chg.)

| | Real GDP | Domestic CGPI | CPI (excluding fresh food) |
|---|---|---|---|
| Fiscal 2005 | +1.1 to +1.8 | +0.7 to +1.0 | –0.1 to +0.1 |
| Forecasts made in October 2004 | +2.0 to +2.6 | +0.1 to +1.3 | –0.1 to +0.3 |
| Fiscal 2006 | +1.2 to +2.2 | +0.1 to +0.5 | +0.1 to +0.5 |

**[The Background]**

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

### (Economic Activity and Prices in Fiscal 2004)

Japan’s economy remained on a recovery trend despite somewhat weak movements mainly in production in the second half of fiscal 2004 due partly to adjustments in IT-related sectors (Charts 1 to 3). The pace of increase in exports became sluggish from the summer reflecting global adjustments in IT-related sectors, although overseas economies, particularly the United States and East Asia, remained on an expansionary trend. Industrial production weakened somewhat toward the end of the calendar year reflecting inventory adjustments in IT-related sectors, and business sentiment, especially among manufacturers, became slightly cautious. Exports started to show signs of picking up toward the fiscal year-end reflecting steady progress in global adjustments in IT-related sectors, and production stopped declining. There was considerable progress in resolving the excesses in production capacity, holdings of labor, and debts that have been a burden on the corporate sector since the bursting of the bubble. Thus, firms’ profitability ratio increased to a height last seen in the bubble period (Charts 4 to 6). According to the *Tankan* (Short-Term Economic Survey of Enterprises in Japan) diffusion index for production capacity, the gap between the number of firms perceiving “excessive capacity” and those perceiving “insufficient capacity” has declined considerably. The diffusion index for employment conditions indicated that the number of firms that perceived that they had insufficient holdings of labor slightly exceeded those that perceived that they had excessive holdings of labor for the first time since the November 1992 survey. Firms continued to reduce interest-bearing liabilities, and as a result, the number of listed firms with hardly any such liabilities rose considerably. Furthermore, firms raised their ability to develop new products and services offering high value-added. The fruits of these efforts were clearly reflected in their profitability: the ratio of current profits to sales recorded its highest level since the end of the 1980s. Against this background, business fixed investment increased, though moderately (Chart 7[1]). Although firms persisted with labor cost restraint, the employment situation and wages continued to improve reflecting progress in adjustments of excessive holdings of labor and the rise in corporate profits. In early 2004, the number of regular employees in the *Monthly Labour Survey* rose for the first time in approximately six years, and the number of full-time employees also increased on a year-on-year basis in early 2005 (Chart 8[1]). Nominal wages per worker stopped declining as a whole because special payments (bonuses) started to increase. Reflecting these developments in the employment situation and wages, household income clearly stopped declining over the course of the second half of fiscal 2004 (Chart 8[3]). Underpinned by the gradual diffusion of positive developments in the corporate sector to the household sector, private consumption basically remained steady, despite temporary effects from natural disasters, the lingering heat of summer, and the unusually warm winter. Housing investment was nearly flat and public investment followed a downtrend.

On the price front, the year-on-year rate of change in domestic corporate goods prices continued to increase from the beginning of 2004, and it rose temporarily above 2 percent (Chart 9[1]). This reflected the rise in commodity prices at home and abroad as the output gap continued to narrow. Consumer prices (excluding fresh food, on a nationwide basis) generally declined slightly on a year-on-year basis (Chart 9[3]). This was due mainly to the fact that, despite the moderate narrowing of the output gap, unit labor costs (labor costs per unit of output) and rice prices declined and intense competition accompanied by deregulation reduced electricity and telephone charges.

**(Outlook for Economic Activity in Fiscal 2005 and 2006)**

Looking forward, Japan's economic recovery is likely to gradually gather momentum from the middle of 2005 as the effects of adjustments in IT-related sectors diminish, and growth in fiscal 2005 is expected slightly to exceed the economy's potential growth rate.[5] Although at present there is considerable uncertainty, in fiscal 2006 the economy is expected to follow a sustainable growth path, albeit at a moderate pace. This economic outlook rests on the following underlying assumptions: that overseas economies remain on an expansionary trend; that firms' profits remain at high levels as they continue their efforts on various fronts; that increased corporate profits spread to a wider range of sectors through various channels; and that firm's cautious business stance allows excesses in, for example, business fixed investment or inventory investment to be avoided.

Overseas economies, particularly the United States and East Asia, are likely to remain on an expansionary trend. Against this background and as firms' allocative optimization efforts lead to further international division of the production process within the East Asian region, Japan's exports, along with imports, are expected to continue posting relatively high

[5] The potential growth rate of Japan's economy is estimated to be approximately 1 percent on the assumption that potential GDP is "the level of economic activity achieved if capital and labor are fully utilized under the existing economic structure."

growth.

Since inventory adjustments in IT-related sectors are likely to be completed around the middle of 2005, industrial production is expected to return to its upward trend thereafter. With production and sales set to increase against the background of the development of new high value-added products and services as well as further streamlining efforts by firms, corporate profits, although already at high levels, are likely to continue to trend upward at a moderate pace, despite pressure from the rise in crude oil prices and other commodity prices. Although the pace of increase in business fixed investment is still contained compared with firms' cash flow, fixed investment is expected to follow an upward trend as adjustment pressure stemming from structural factors including excess capacity and debts eases. Household income is also likely to increase moderately reflecting improvement in supply and demand conditions in the labor market. Although the household burden due to taxes and social security costs will increase, private consumption is expected to continue increasing moderately as the diffusion of positive developments in the corporate sector to the household sector via household income gradually becomes clearer.

In this situation, Japan's economy is expected to continue to recover. One of the features of the current economic recovery is that firms are cautious about increasing spending such as business fixed investment and inventory investment despite high corporate profits. This has resulted in a substantial increase in net corporate saving (Chart 7[2]). Two major factors have been behind this: firms, having experienced difficulties when concerns about financial system stability increased in the second half of the 1990s, have been placing priority on improving their financial positions; and, during the protracted period of low economic growth, firms' expectations for economic growth over the medium term declined. At the current juncture, it is difficult to see net saving in the corporate sector declining significantly within the next one or two years, and the pace of economic recovery is likely to remain moderate. On the other hand, firms' cautious attitude will also allow them to avoid accumulating excesses in capital stock, inventories, and labor, and hence in this situation, a relatively long period of economic growth, albeit at a moderate pace, can be expected. Thus, it is likely that Japan's economy will steadily recover at a relatively moderate pace, slightly faster than its potential growth rate, over the next one to two years.

**(Outlook for Prices in Fiscal 2005 and 2006)**

The output gap, which influences the underlying trend of prices, is likely to narrow steadily albeit at a moderate pace, as the economy recovers slightly faster than its potential growth rate (Chart 10). Prices of raw materials, such as crude oil and other commodity prices at home and abroad, continue to increase (Chart 11). Firms' drive to use more part-time and temporary workers, whose average wages are low, has placed downward pressure on prices by reducing average wages per worker. Recently, however, this tendency has been weakening, and as a result, the pace of decline in unit labor costs is likely to moderate (Charts 8[2] and 12).[6]

However, it is likely that the rise in energy and materials prices will continue to be substantially offset by increases in corporate productivity. Firms are also expected to continue to restrain labor costs as much as possible given their cautious business stance. Meanwhile, the consumer goods market is likely to remain competitive, as evidenced in the vigor with which large retail chains are opening new stores.

Against this background, in fiscal 2005 and 2006, although domestic corporate goods prices will be sensitive to developments in commodity prices at home and abroad, they are likely to continue increasing, albeit at a slower pace than in the first half of 2004. On the other hand, in fiscal 2005, the consumer price index (excluding fresh food, on a nationwide basis) is likely to remain around zero percent on a year-on-year basis due partly to the fact that the effects of the decline in rice prices and the reduction in electricity and telephone charges are expected to remain for a while. In fiscal 2006, consumer prices are expected to increase on a year-on-year basis as the effects of these temporary factors fall off.

Turning to households' and firms' expectations with regard to prices, the view that prices will decline has generally been fading since 2001-2002 (Chart 13).

**(Monetary and Financial Developments)**

Accommodative monetary conditions are likely to persist as the Bank continues to provide

[6] Unit labor costs increased slightly in the October–December quarter of 2004. This reflected the fact that labor productivity plunged temporarily due to sluggish real GDP growth. In the short term, unit labor costs may display this kind of temporary irregular fluctuation due to movements in real GDP growth. However, looking at the underlying trend, unit labor costs still seem to be on a declining trend at present.

ample liquidity.

Financial institutions have been making progress in disposing of NPLs and restoring their financial soundness (Chart 14). Banks are likely to continue relaxing their lending attitude. Clear increases in credit demand in the corporate sector are unlikely to start appearing for the time being since firms are continuing to repay debt to improve their financial positions. However, with the continued increase in business fixed investment suggesting more buoyant business activity, the pace of decline in credit demand is expected to slow gradually. Bank lending is therefore likely to continue declining, although the pace of decline is expected to decelerate. Meanwhile, the growth rate of the money stock is unlikely to accelerate conspicuously for the time being as firms continue to repay debt.

## 2. Positive and Negative Deviations

The following factors could cause economic activity to deviate either above or below the projections given in the above outlook.

### (Developments in energy and materials prices)

Crude oil prices have risen again reflecting expectations of expanding global demand. Recently, crude oil prices have been recording historically high levels. There has also been some increase in the prices of various materials, particularly of steel plates and nonferrous metals. In the outlook, energy and materials prices are projected to decline slightly on the presumption that the recent high levels are somewhat excessive.

Thus, it is also possible that, if energy and materials prices remain at high levels, the global economy may be adversely affected via declines in corporate profits and households’ real purchasing power.

### (Developments in the U.S. and Chinese economies)

In the outlook, the U.S. and East Asian economies, particularly the Chinese economy, are assumed to continue growing at around their current pace.

The U.S. economy continues to expand. Household spending and business fixed investment continue to increase, and the number of employees has been on an improving trend. As for East Asian economies, in China both domestic and external demand continue to expand strongly, while the NIEs and ASEAN economies have generally been recovering. Although the impact of the rise in energy prices has started to be felt, inflationary pressures in both U.S. and East Asian economies have been contained overall.

However, deviation either above or below the outlook’s projection of continued sustainable growth in overseas economies is possible depending on future developments. Looking ahead, if, with energy prices rising and the output gap narrowing, inflationary pressures were to build in the U.S. economy, the subsequent change in the monetary policy stance could trigger a U.S. and hence a global economic slowdown. If this situation materializes, attention should be paid to the risk of negative effects on the global economy, particularly on emerging economies, via capital flows and developments in financial markets. As for the Chinese economy, the government has made clear that it intends to contain the overheating of the economy and achieve a sustainable long-term economic expansion. The various structural problems remaining in the economy, however, mean that there is uncertainty about whether this can be achieved. Not only has fixed asset investment continued to increase at a relatively fast pace, but the risk of an infrastructural bottleneck arising, for example, from the paucity of the electricity supply, has also been pointed out, and these developments continue to require close monitoring.

In addition, large fluctuations in overseas financial and foreign exchange markets triggered by, for example, geopolitical risks or the U.S. “twin deficits,” could exert negative effects on the global economy.

**(Developments in Domestic Private Demand)**

The outlook is based on the assumption that net saving in the corporate sector are unlikely to decline significantly because firms, despite the increase in corporate profits, remain cautious about increasing spending, such as business fixed investment and inventory investment.

However, with corporate profits already at very high levels, adjustment pressures easing, and stock market pressure to raise firm value increasingly in evidence, firms may start to place less priority on reducing interest-bearing liabilities from their balance sheets. For example, firms may use their free cash flow, not to pay down debts, but to increase business fixed investment and financing for other investments or research aimed at increasing growth.

Alternatively, they may prefer to buy back their own stock or increase dividend payments. If firms become more positive as the economy's expected growth rate in the medium term increases, firms' spending, particularly business fixed investment, could deviate above the projected outlook. Furthermore, such positive developments are likely to translate, via rising stock prices and strengthening consumer confidence, into firmer private consumption. On the other hand, if firms' behavior becomes more cautious, this may constrain growth of business fixed investment, employment, and wages.

**(Developments in prices)**

For prices, as for economic activity above, there are factors that could cause deviation either above or below the projections of the outlook. If the factors, mentioned above, that cause economic activity to deviate were indeed to materialize, this would impact on prices. In addition, there are also factors unique to prices that may cause either upward or downward deviation: a rise in crude oil and other commodity prices at home and abroad and the subsequent emergence of inflationary sentiment may cause upward deviation; meanwhile intensification of competition among firms accompanying deregulation may cause downward deviation.[7]

## 3. Evaluation of Financial Environment

Since the adoption of the quantitative easing policy in March 2001, the Bank has been gradually raising the target balance of current accounts, taking due account of changes in economic and financial conditions, and providing ample liquidity by utilizing various instruments of money market operations. As a result, the outstanding balance of current accounts at the Bank has recently averaged around 33 trillion yen, which is substantially larger than the amount of required reserves of about 6 trillion yen (Charts 15[1] and [2]).

Short-term interest rates, including term rates such as FB and TB rates, have been at around zero percent as a result of ample liquidity provision by the Bank (Chart 15[3]). Looking at recent movements in more detail, FB and TB rates, already low, fell to a still lower level at

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[7] The base year for the CPI will be revised to 2005 in August 2006, and retroactive revision will be applied to year-on-year figures back as far as January 2006. The revised index will reflect changes in the price situation, such as structural changes in consumption, the emergence of new goods and services and the extent of their diffusion, and increased price diversification due to deregulation. The method of compiling the statistics will also be changed. Since it is difficult to quantify the impact of these changes at this juncture, the outlook for consumer prices for this Outlook Report is based on the 2000 base CPI.

the end of 2004, where they have since remained. At the semiannual book closings at the end of September 2004 and end of March 2005, when rates would have been likely to rise temporarily, these rates remained basically stable.[8]

Long-term interest rates continue to be stable. Their volatility has been at low levels (Chart 16).

The credit spread between short-term government securities and CP has generally been stable at low levels (Chart 17[1]). The credit spread between long-term government bonds and corporate bonds has been at a very low level partly because investors, faced with fewer investment alternatives, have displayed increased demand for corporate bonds (Chart 17[2]).

The issuing environment for corporate bonds and CP has continued to be favorable, and banks have been relaxing their lending attitude. The lending attitude of banks perceived by firms has continued to become more accommodative (Chart 18[1]). Average lending rates remain at low levels. Firms' financial positions have been on an improving trend (Chart 18[2]).

In this situation, the rate of decline in bank lending has been decelerating at a moderate pace (Chart 19[1]). The amounts outstanding of CP and corporate bonds issued have continued to be above the previous year's levels (Charts 19[2] and [3]). Firms have been active in equity finance.

The monetary base (the sum of currency in circulation and current account balances held at the Bank) has recently been increasing, by around 2 percent year on year, as the growth rate of banknotes in circulation, which make up almost 70 percent of the monetary base, has been slowing reflecting receding concerns over financial system stability (Chart 20[1]). The level of the monetary base compared with economic activity (that is, nominal GDP), however, remains at an extremely high level. The year-on-year growth rate of the money

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8 The current guideline for money market operations includes a contingency clause: "Should there be a risk of financial market instability, such as a surge in liquidity demand, the Bank will provide more liquidity irrespective of the above target." Until the end of March 2004, to avoid a temporary surge in interest rates, the Bank provided ample funds to the market at semiannual book closings by using the contingency clause so that the current account balances at the Bank exceeded the target. At the end of September 2004 and the end of March 2005, the current account balances at the Bank were within the target range, and interest rates rose very slightly.

stock remains around 2 percent (Chart 20[2]).

Firmness in stock prices since the end of 2004 reflected the expansionary trend in the global economy and the associated increase in corporate profits. Recently, they have declined slightly, as cautious views about the global economic outlook have emerged due partly to the surge in crude oil prices (Chart 21).

The yen appreciated temporarily against the U.S. dollar, partly reflecting growing concerns over the U.S. “twin deficits.” Recently, the yen has been generally stable within the range of 106–109 yen (Chart 22[1]). The real effective exchange rate has also been stable (Chart 22[2]).[9]

Land prices remain generally on a downtrend, but the pace of decline is slowing. By area, land prices of residential areas of central Tokyo increased on a year-on-year basis for the first time in 17 years, and the rate of decline in land prices in the three major metropolitan areas has slowed. In regional areas, however, land prices continue to experience substantial declines (Chart 23[1]). Looking at price movements for individual locations, prices of those near the top end of the market, which are considered to have high utility value are seen to have either stopped declining or to have started to increase (Charts 23[2] and [3]). At the top end of the rental market for office space in central Tokyo, the vacancy rate has been on a declining trend. On aggregate, however, the vacancy rate of office space remains at a high level and rent continues to trend downward.

Anxiety about financial system stability has been subsiding. As a result, financial institutions’ demand for liquidity is declining as evident in undersubscription, where bids fall short of the Bank’s offers, which has occurred frequently in the Bank’s funds-supplying operations (Box). Financial institutions have become more confident about raising funds under the quantitative easing framework, and an accommodative corporate financing environment has been maintained.

The Bank has made a commitment, unprecedented in the history of central banks, to continue with the quantitative easing policy until the year-on-year rate of change in the consumer price index (excluding fresh food, on a nationwide basis) registers zero percent or

[9] The real effective exchange rate is a weighted average of the yen’s real exchange rates versus major currencies. Real exchange rates are calculated from the nominal exchange rates and price indexes of the relevant countries.

higher on a sustainable basis. The Bank's commitment has allowed firms to continue to enjoy low funding costs even as the economy continues to recover. The positive impact on the economy, acting via interest rates, will strengthen as firms gradually become more confident about the economic outlook.

## (BOX) Undersubscription in the Bank's Funds-Supplying Operations

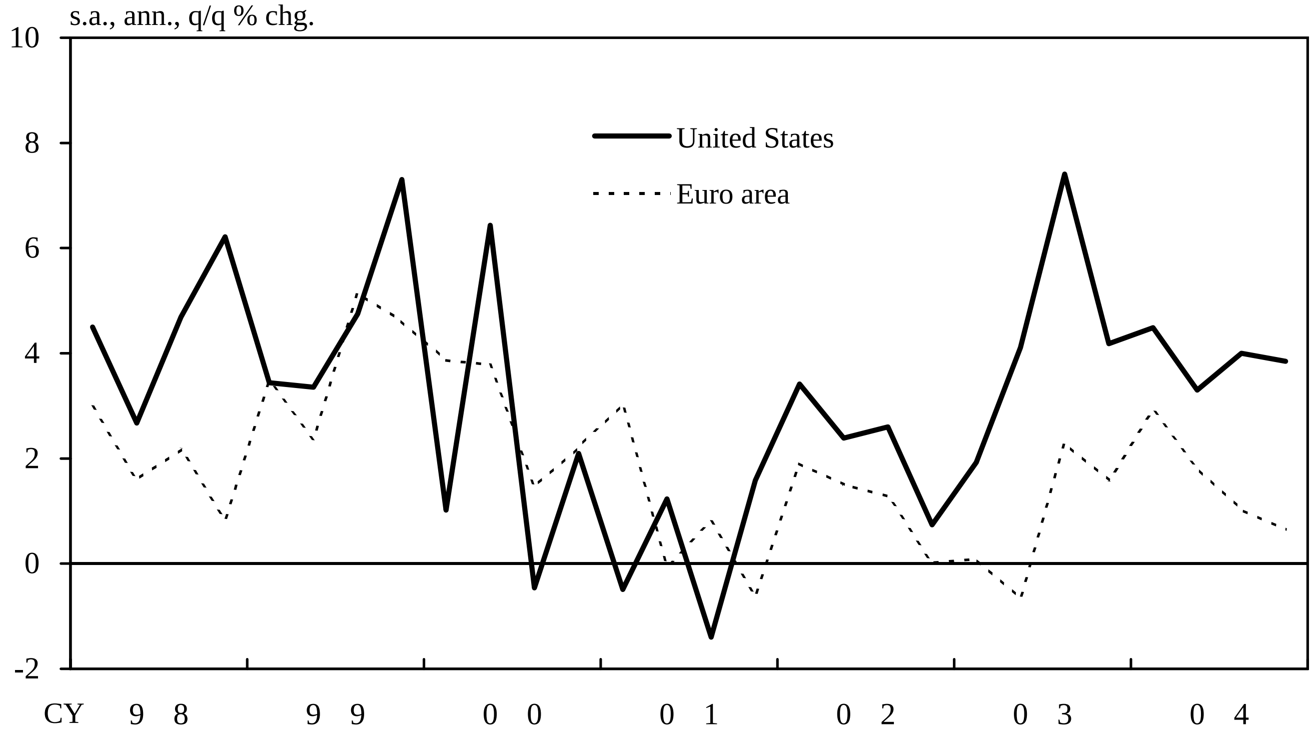
At the time of the partial removal of blanket deposit insurance in April 2002, a large shift of funds occurred because anxieties about Japan's financial system had not been completely dispelled. By types of financial institution, the amount outstanding of deposits at *shinkin* banks and credit cooperatives declined (Box Chart 1[1]). Also among types of deposits, there was a shift of funds from term deposits to ordinary deposits and other demand deposits, which continued to be fully covered (Box Chart 1[2]). With the full removal of blanket deposit insurance in April 2005, demand deposits, with the exception of payment and settlement deposits, were no longer given blanket protection. This time, however, there have so far been no shifts in funds between individual financial institutions either within the same or different bank categories.

As this shows, anxieties about the financial system have receded considerably. Financial institutions have become more confident about the availability of funds, which has led to a decline in liquidity demand. Against this background, since entering 2005, there has been frequent undersubscription in the Bank's funds-supplying operations where financial institutions' demand for funds has fallen short of the Bank's substantial offer through its market operations (Box Chart 2[1]).

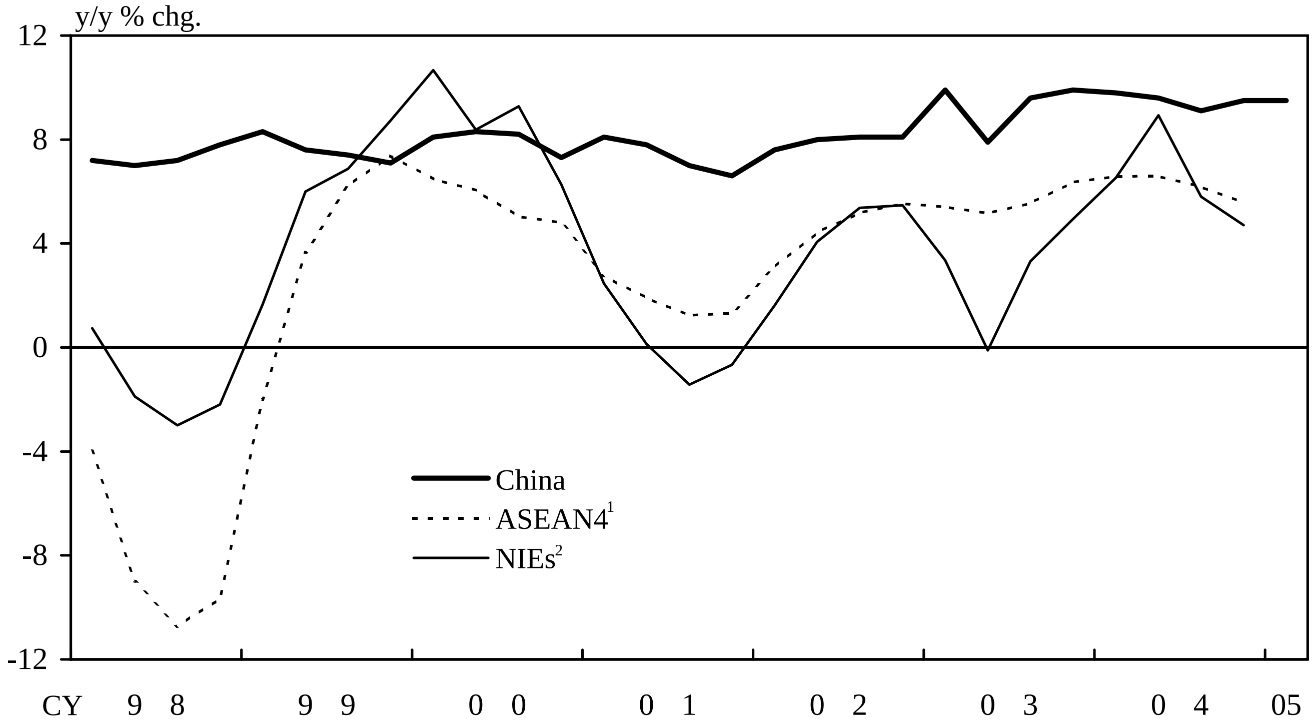
With financial institutions' liquidity demand declining, the Bank has been devising various means of conducting money market operations, such as extending the maturity of bill-purchasing operations, so as to maintain the target range of the outstanding balance of current accounts at the Bank (Box Chart 2[2]).

# Real GDP Growth Rates in Overseas Economies

(1) Real GDP Growth Rates in Advanced Economies




(2) Real GDP Growth Rates in East Asian Economies



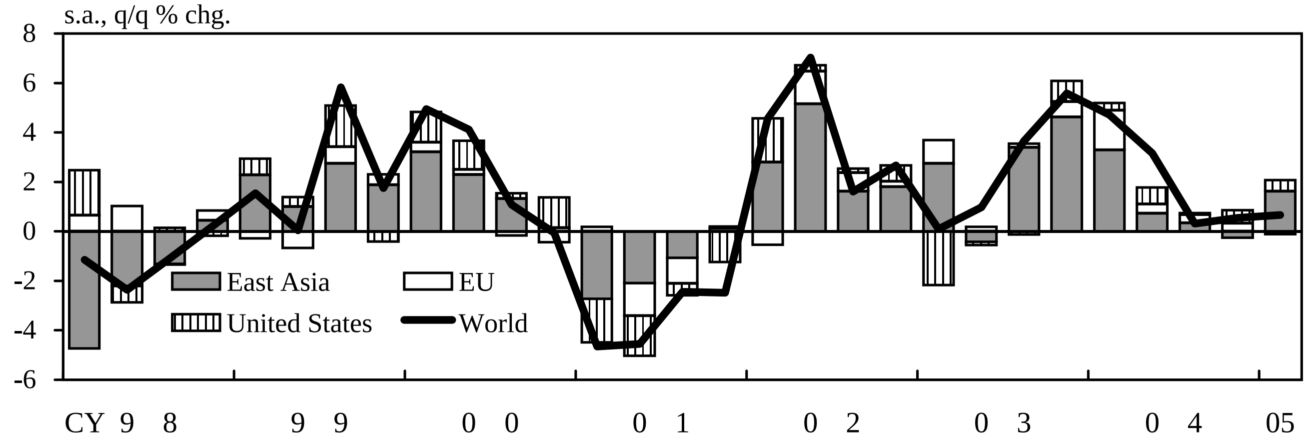

Notes:1. Data for ASEAN4: Thailand, Malaysia, the Philippines, and Indonesia.
2. Data for NIEs: South Korea, Taiwan, Hong Kong, and Singapore.

Sources: National governments; Central banks; European Commission.

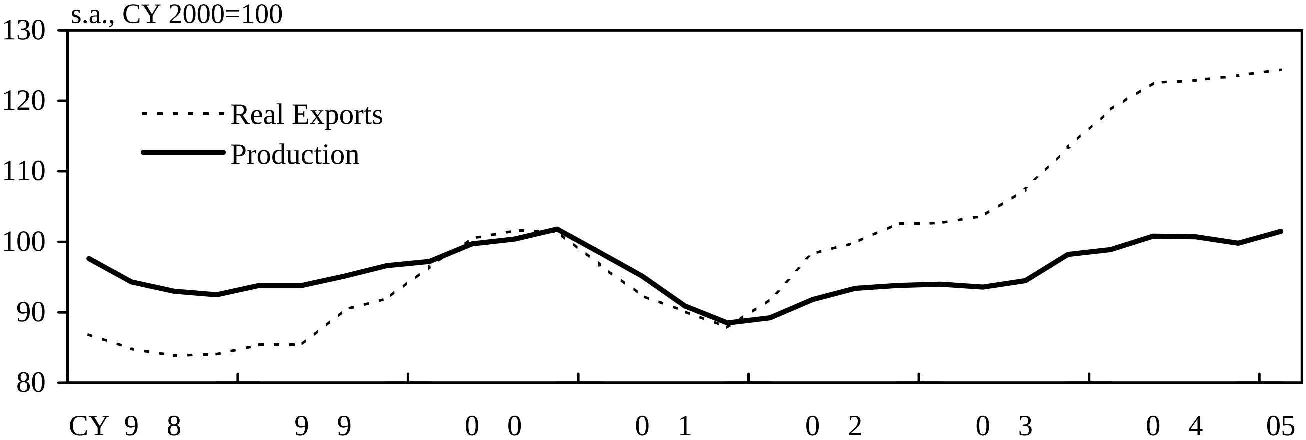
Chart 2

# Real Exports and Production

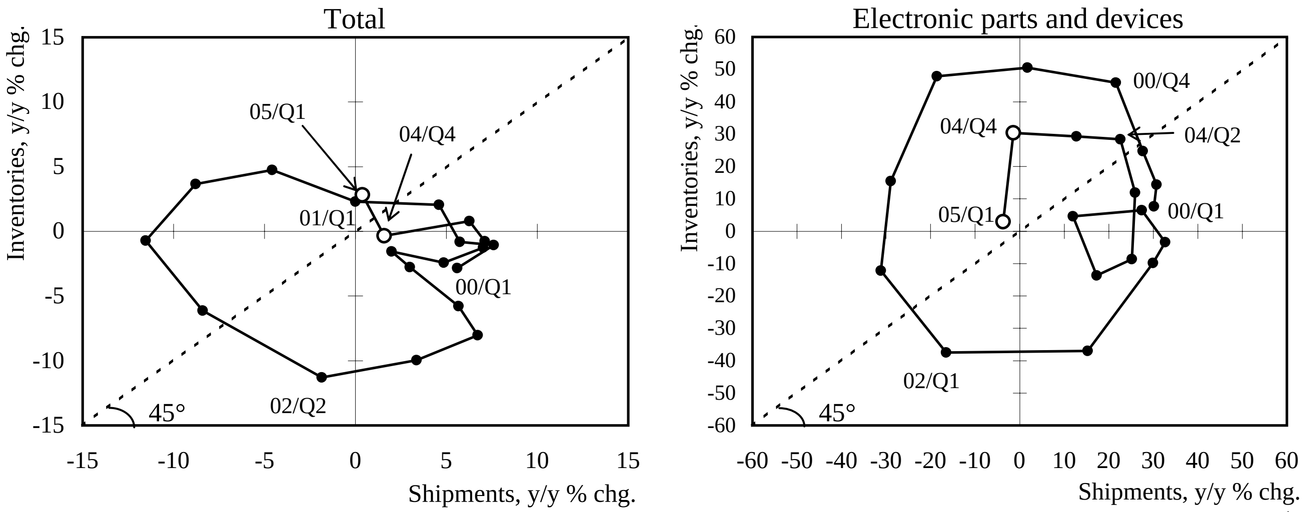
(1) Real Exports (Breakdown by Region)



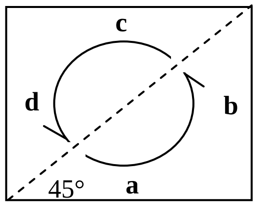

(2) Production




(3) Inventory Cycle



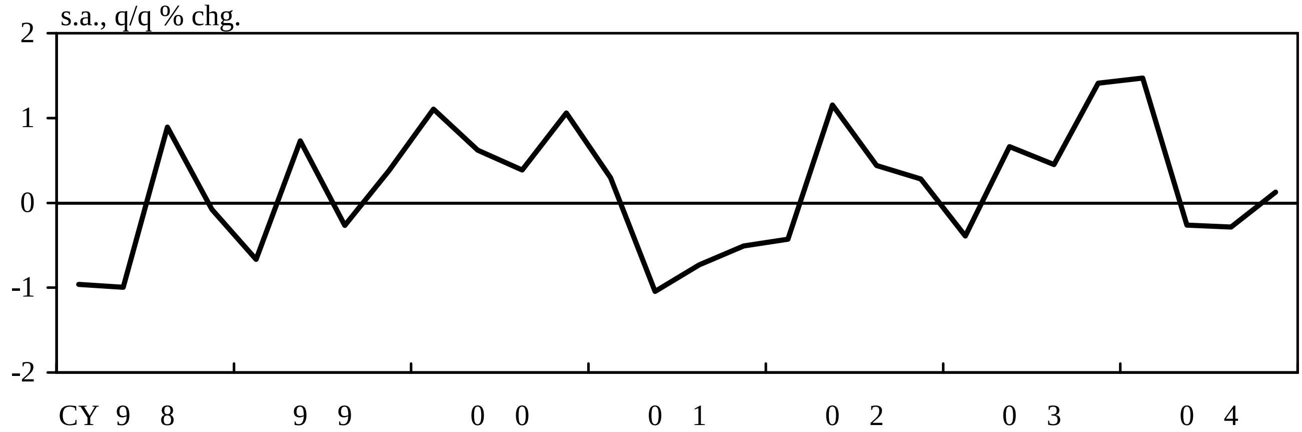

a Shipment recovery phase
b Intended inventory accumulation phase
c Unintended inventory accumulation phase
d Inventory adjustment phase



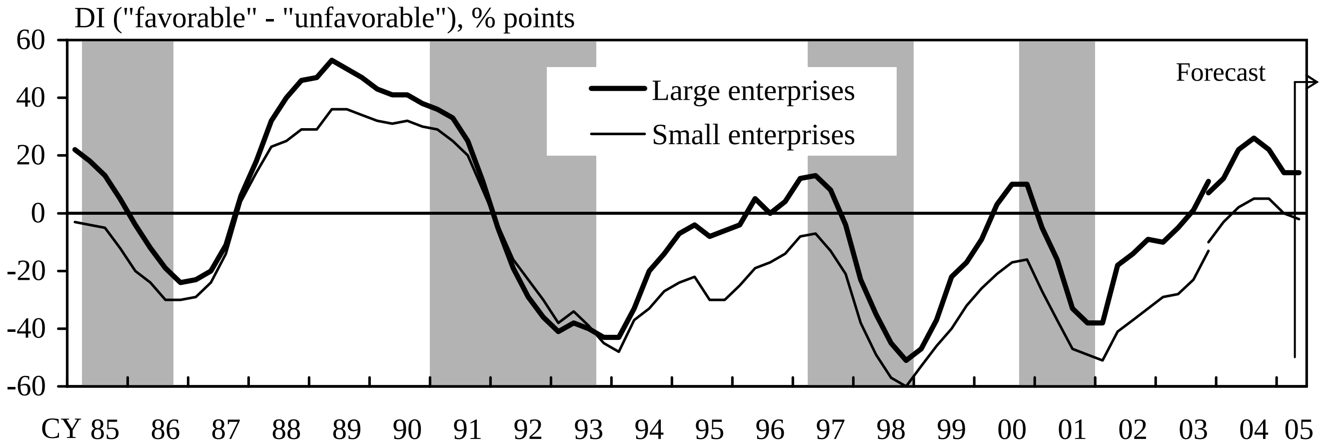

Sources: Ministry of Finance, "The Summary Report on Trade of Japan"; Bank of Japan, "Corporate Goods Price Index"; Ministry of Economy, Trade and Industry, "Indices of Industrial Production."

# Real GDP and Business Conditions

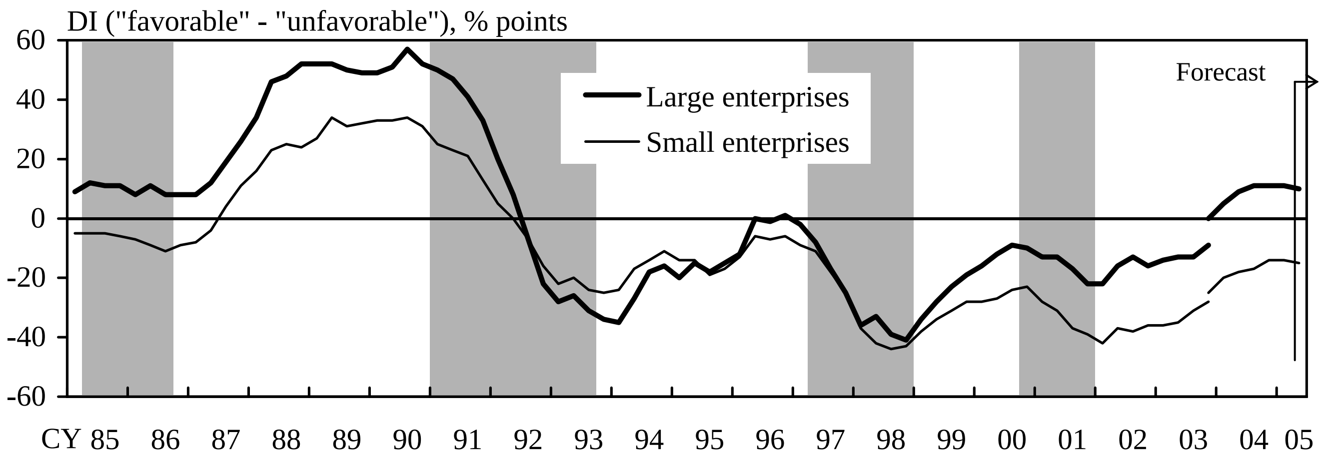
(1) Real GDP




(2) Business Conditions in Manufacturing[1, 2]




(3) Business Conditions in Nonmanufacturing[1, 2]



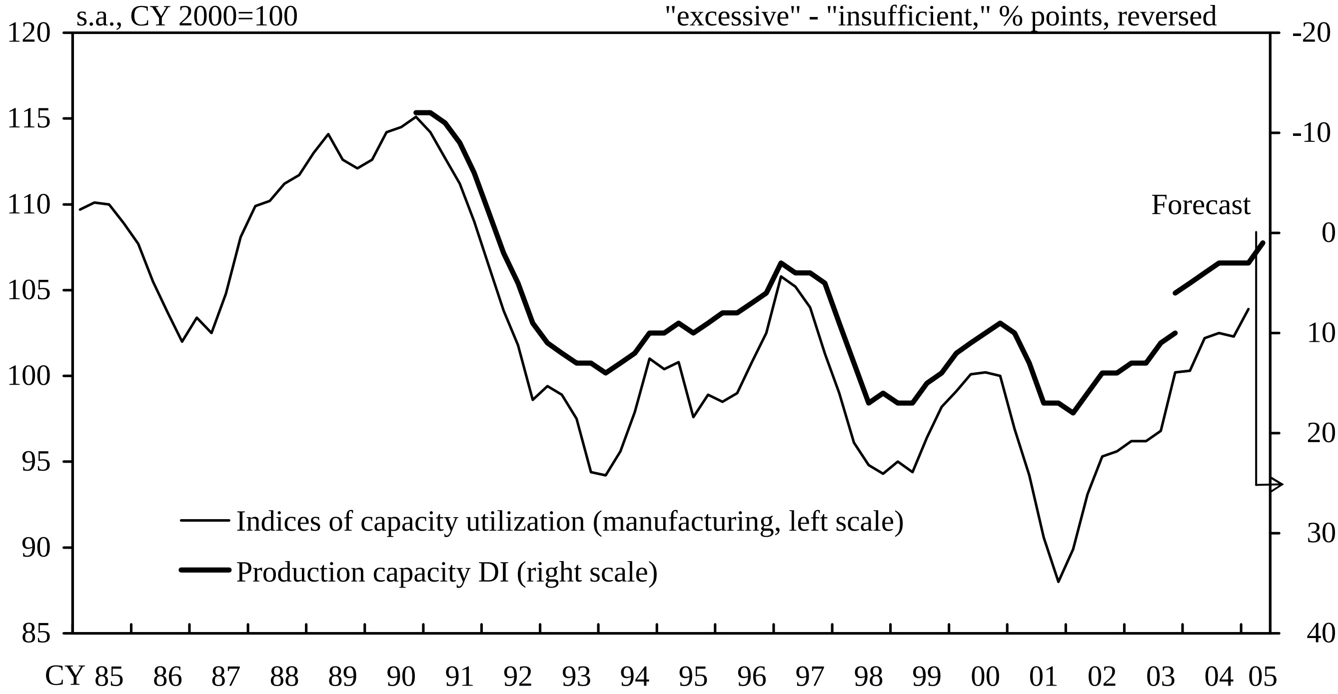

Notes: 1. The *Tankan* has been revised from the March 2004 survey. Figures based on the previous data sets are up to the December 2003 survey. Figures on a new basis are from the December 2003 survey.

2. Shaded areas indicate recession periods.

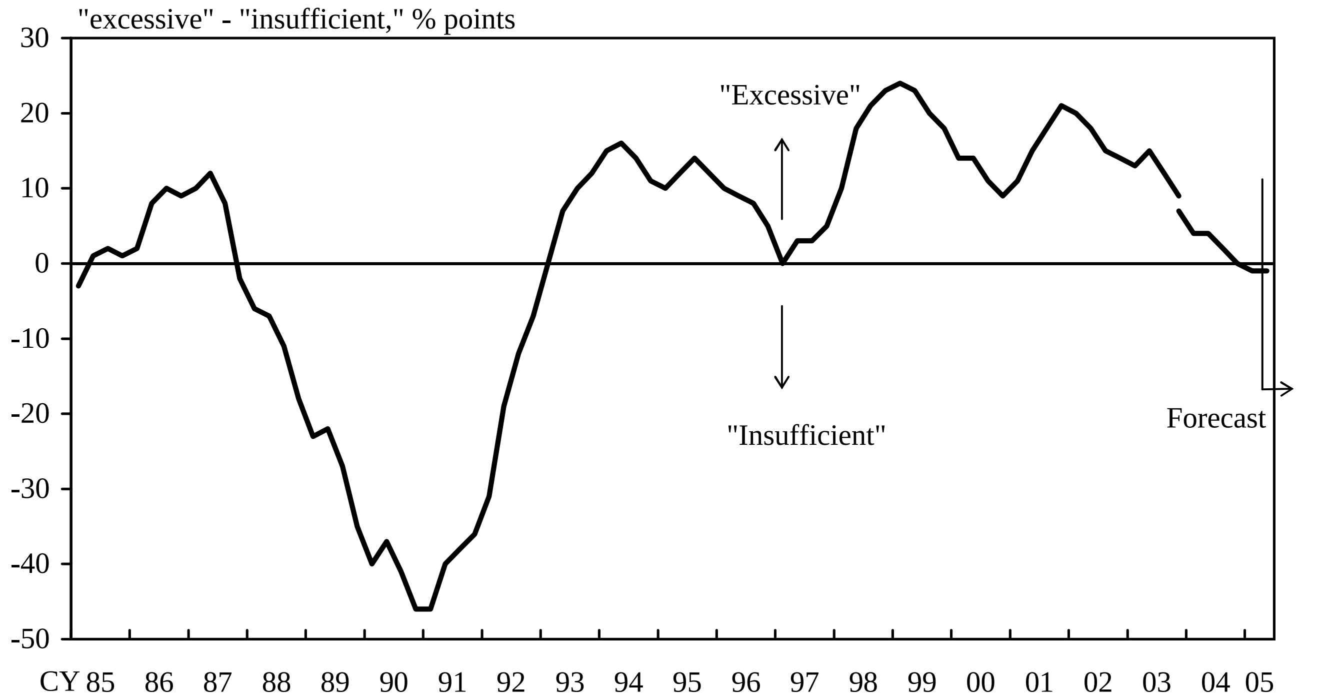
Sources: Cabinet Office, "National Accounts";
Bank of Japan, "*Tankan* - Short-Term Economic Survey of Enterprises in Japan."

# Firms' Perception of Production Capacity and Holdings of Labor

(1) Production Capacity DI[1, 2, 3]




(2) Employment DI[1, 2]

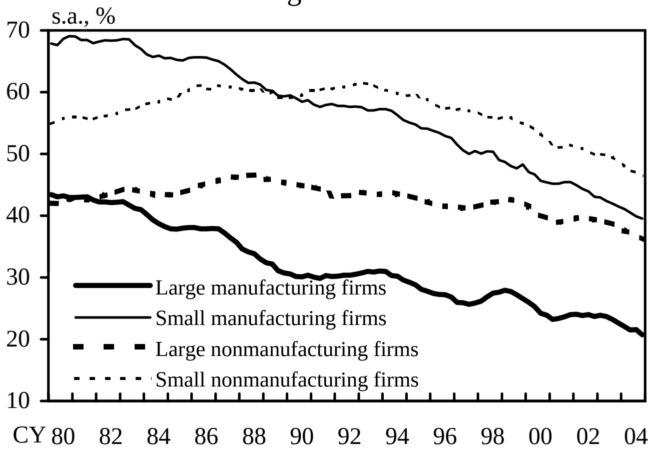


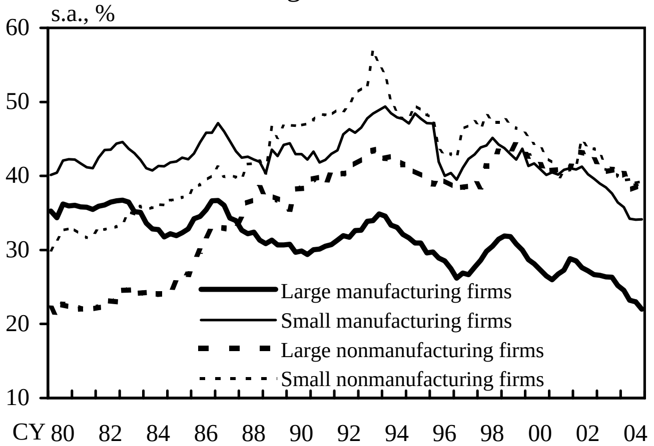

Notes:1. Production capacity DI and employment DI are those of all enterprises.
2. The *Tankan* has been revised from the March 2004 survey. Figures based on the previous data sets are up to the December 2003 survey. Figures on a new basis are from the December 2003 survey.
3. The figure for capacity utilization in 2005/Q1 is the average of January and February.

Sources: Ministry of Economy, Trade and Industry, "Indices of Industrial Production"; Bank of Japan, "*Tankan* - Short-Term Economic Survey of Enterprises in Japan."

# Interest-Bearing Liabilities of Firms

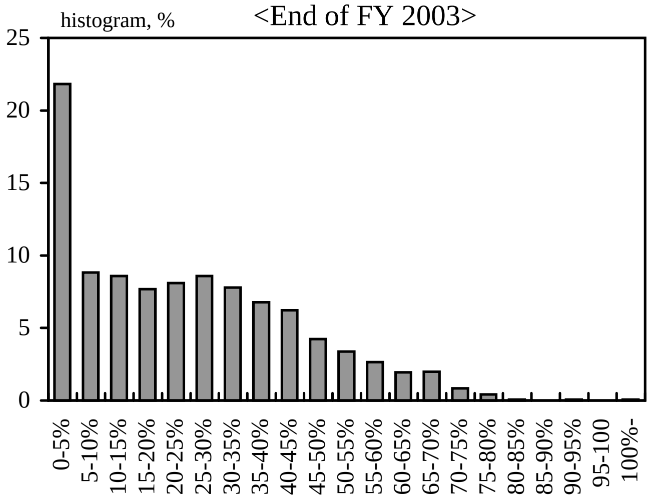
## (1) Ratio of Interest-Bearing Liabilities of Firms

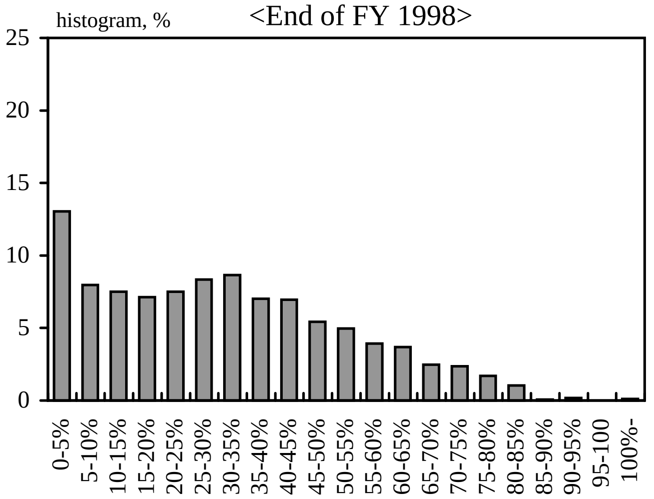


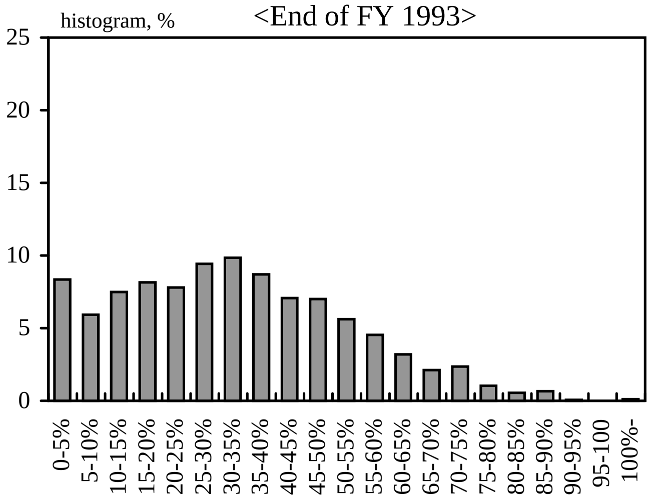



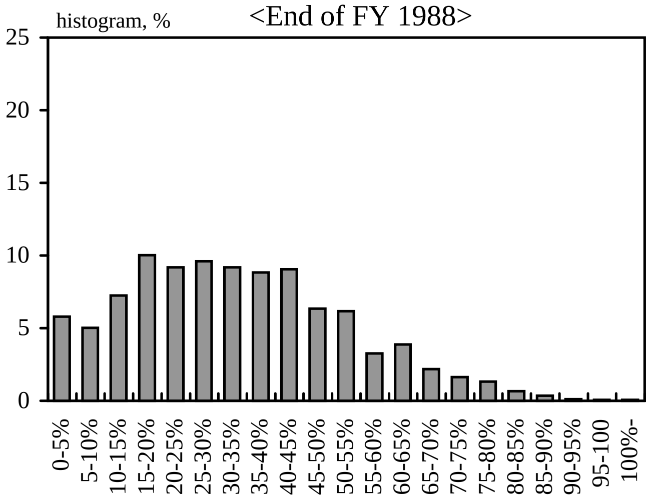

Notes:1. Interest-bearing liabilities = corporate bonds + long-term and short-term borrowings + bills discounted.
2. Electric and gas industries are excluded from large nonmanufacturing firms.
3. Sales are annualized.

## (2) Distribution of Ratio of Interest-Bearing Liabilities to Assets of Firms



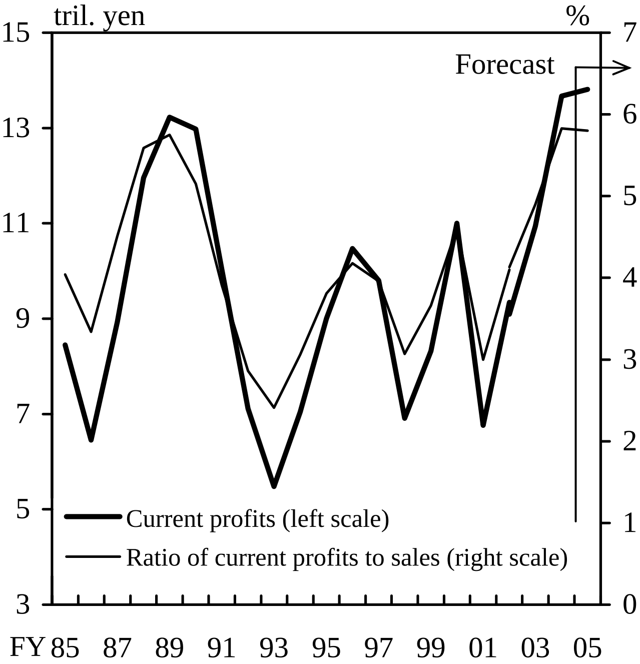




Notes:1. Interest-bearing liabilities = CP + corporate bonds + convertible bonds + long-term and short-term borrowings + employee saving deposits + bills discounted.
2. Data of 1655 companies (excluding financial institutions) listed on the Tokyo Stock Exchange First and Second sections whose data have been available on a continuous basis since FY 1988.

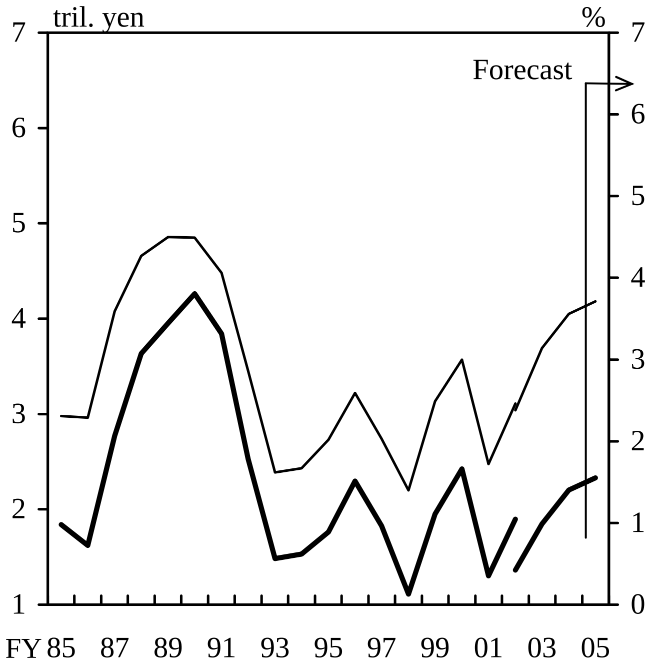
Sources: Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Quarterly"; Financial Statements of firms.

# Current Profits

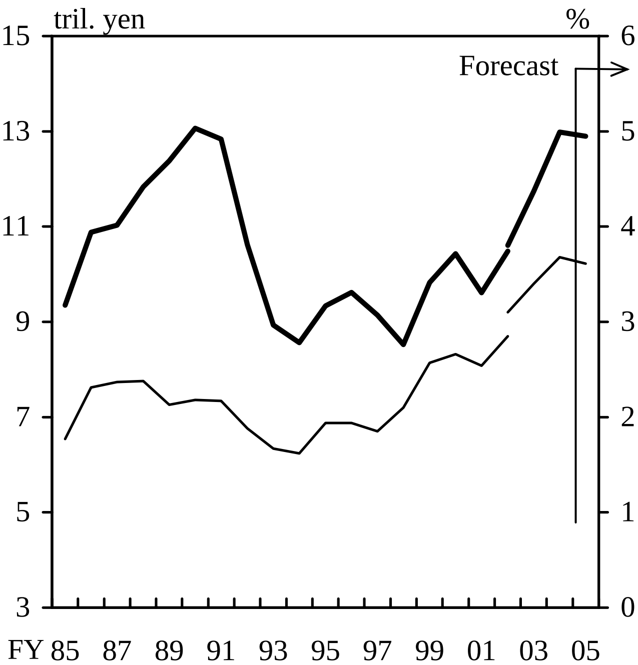
(1) Large Manufacturing Enterprises



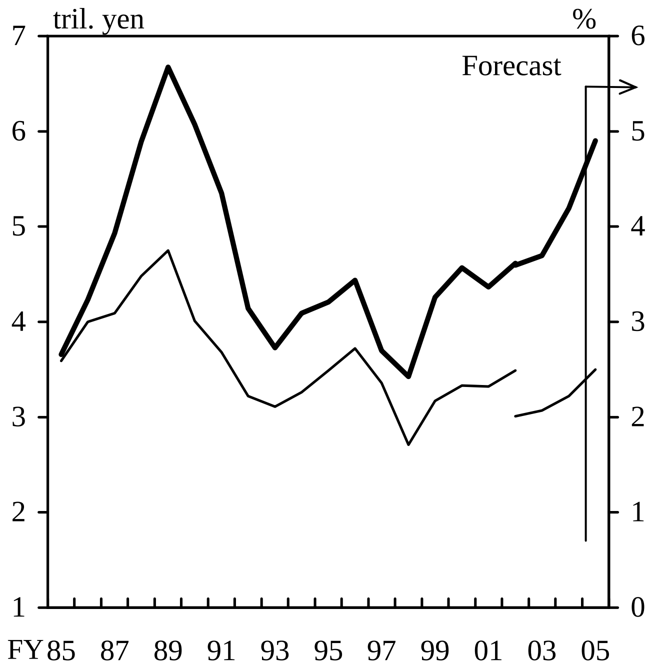

(2) Small Manufacturing Enterprises




(3) Large Nonmanufacturing Enterprises




(4) Small Nonmanufacturing Enterprises

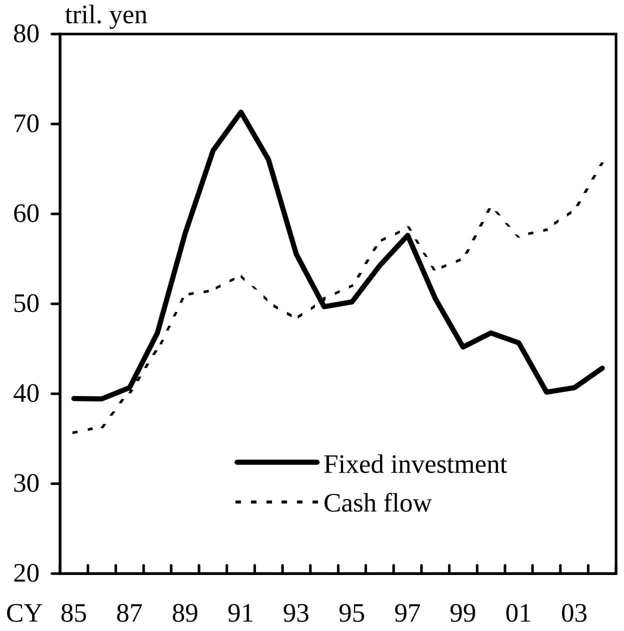



Notes: 1. Large enterprises (pre-revision): 1,000 employees or more.
Small enterprises (pre-revision): 50-299 employees (for manufacturing), 20-99 employees (for wholesaling), 20-49 employees (for retailing, services, and leasing), 50-299 employees (for other industries).
Large enterprises (post-revision): capital of 1 billion yen or more.
Small enterprises (post-revision): capital of from 20 million yen to less than 100 million yen.
2. The *Tankan* has been revised from the March 2004 survey. Figures based on the previous data sets are up to FY 2002. Figures on a new basis are from FY 2002.
3. Data for FY 2004 are provisional figures.

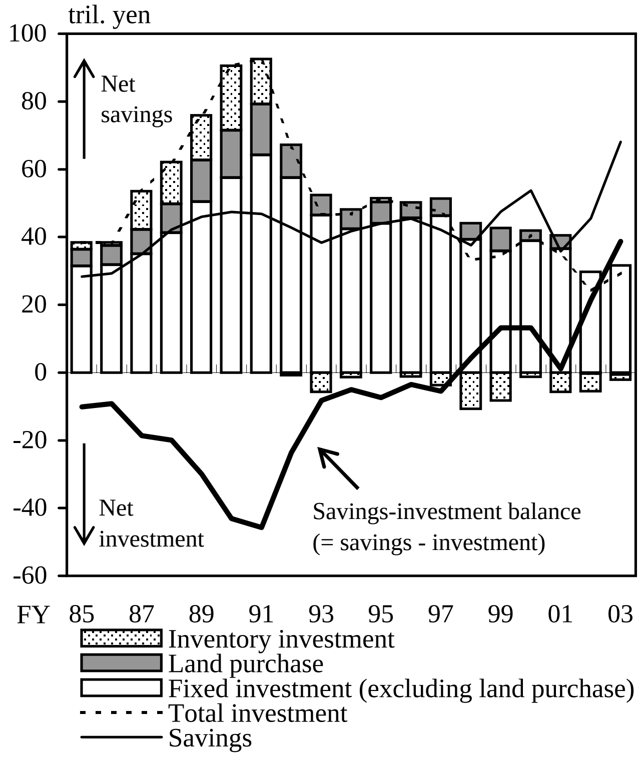
Source: Bank of Japan, "*Tankan* - Short-Term Economic Survey of Enterprises in Japan."

# Business Investment Activity

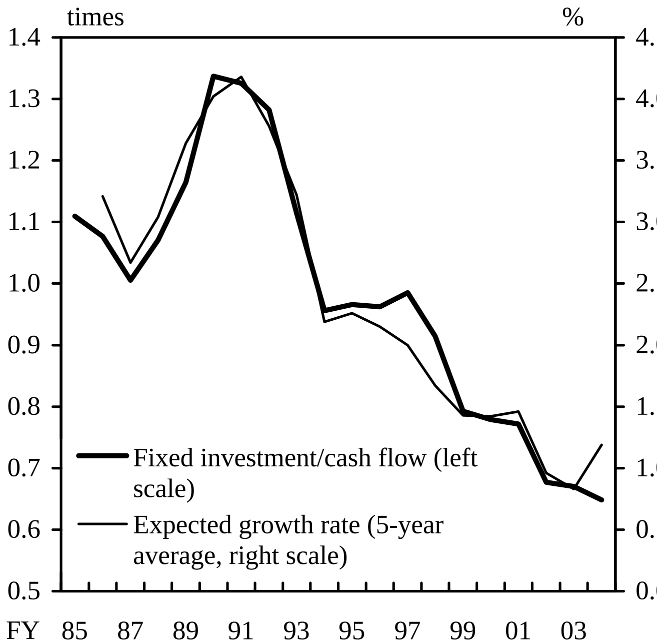
(1) Fixed Investment and Cash Flow[1]



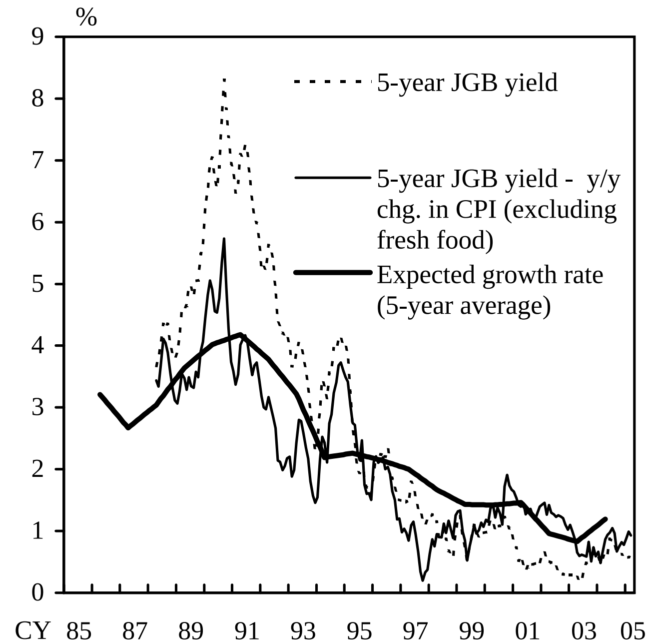

(2) Savings-Investment Balance of Corporate Sector[2]




(3) Fixed Investment and Expected Growth Rate[1]




(4) Expected Growth Rate and JGB Yield[3]



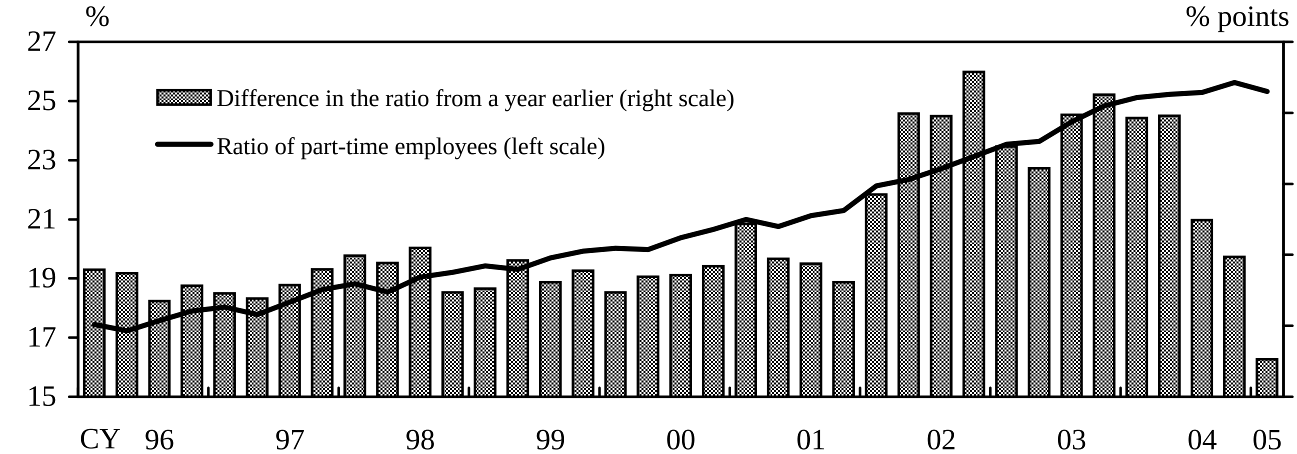

Notes: 1. Sample change adjusted.
Cash flow = current profits/2 + depreciation expense.
2. Savings = changes in total capital - (changes in capital stock + changes in capital surplus) + depreciation expense.
3. Expected growth rates are plotted at the beginning of each projection period.

Sources: Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Quarterly," "Financial Statements Statistics of Corporations by Industry, Yearly"; Cabinet Office, "Annual Survey of Corporate Behavior"; Ministry of Internal Affairs and Communications, "Consumer Price Index"; Bloomberg.

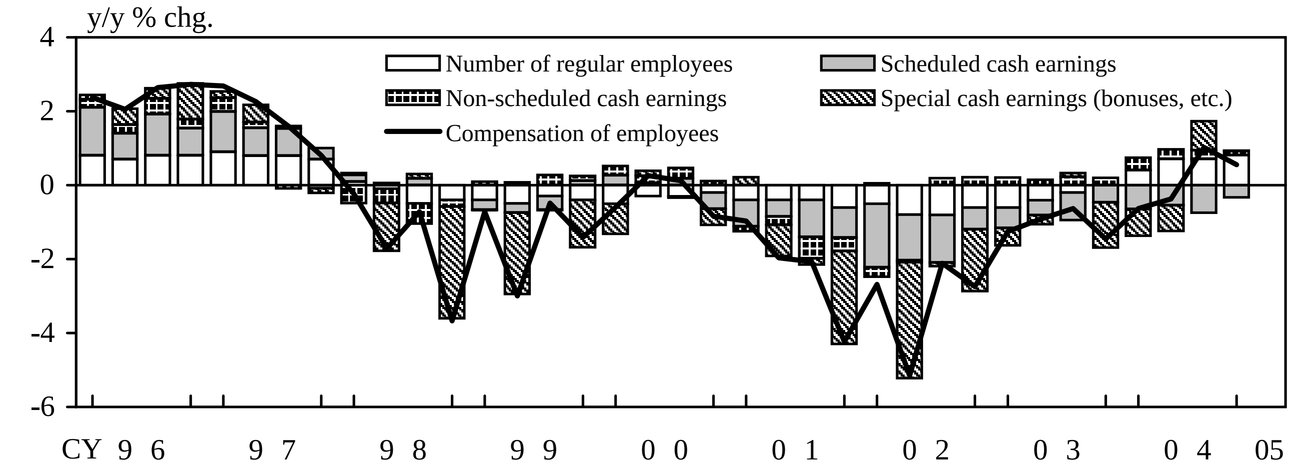
# Labor Market Conditions

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


(2) Ratio of Part-Time Employees[1, 2, 3]




(3) Breakdown of Compensation[2, 4]

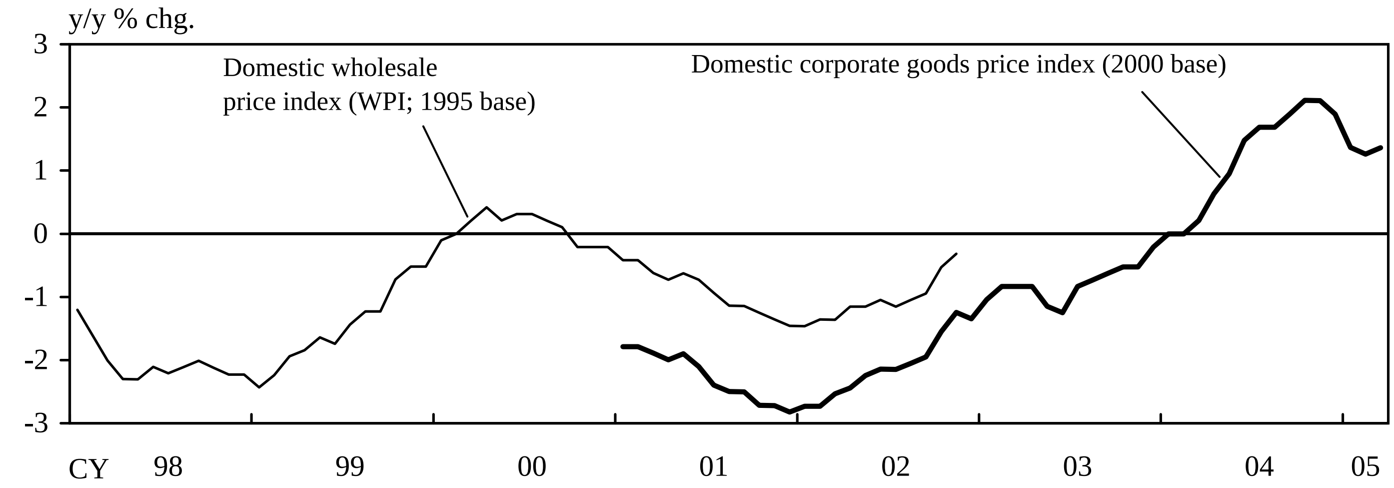



Notes:1. Figures for 2005/Q1 are those of Jan.-Feb. averages.
2. Data are for establishments with at least 5 employees.
3. Ratio of part-time employees = number of part-time employees/number of regular employees. Part-time employees work fewer hours in a day or fewer days in a week.
4. Q1=Mar.-May, Q2=Jun.-Aug., Q3=Sep.-Nov., Q4=Dec.-Feb.

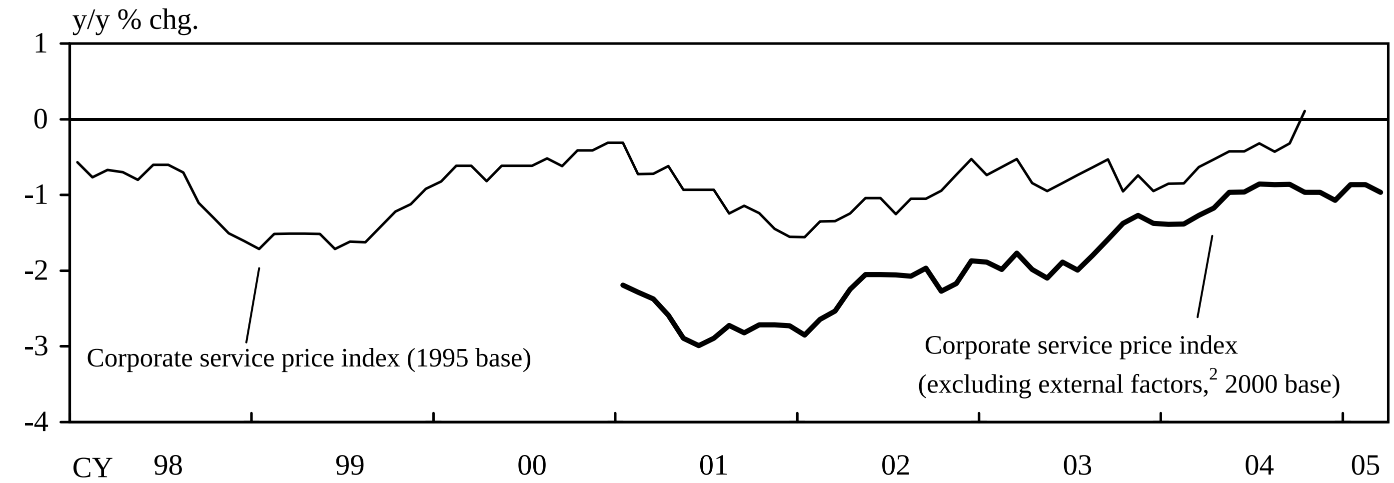
Source: Ministry of Health, Labour and Welfare, "Monthly Labour Survey."

# Prices[1]

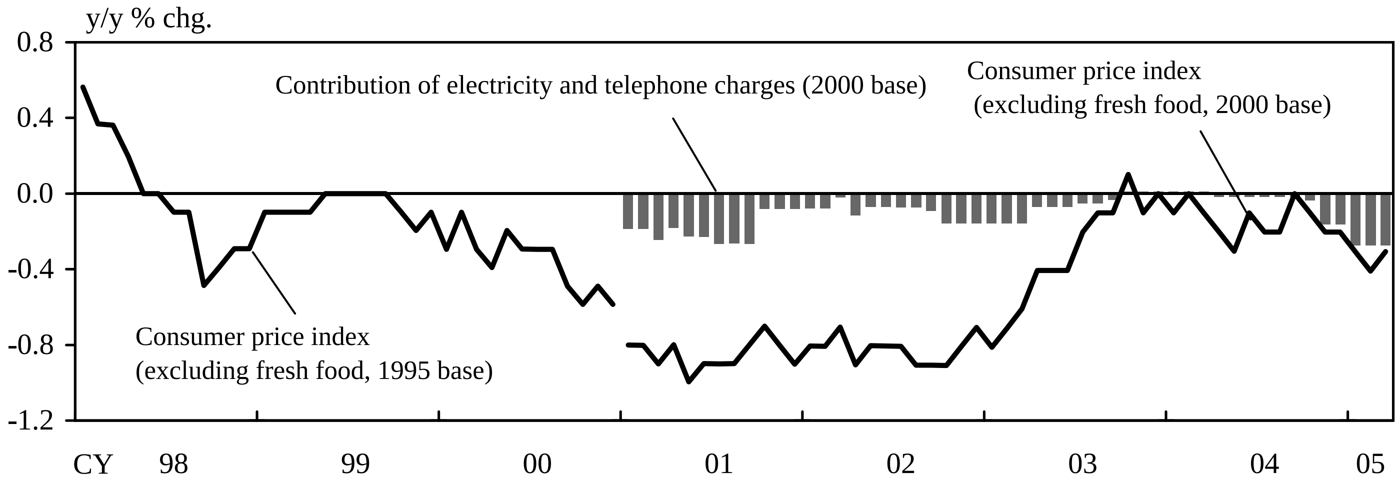
(1) Domestic Corporate Goods Price Index




(2) Corporate Service Price Index




(3) Consumer Price Index

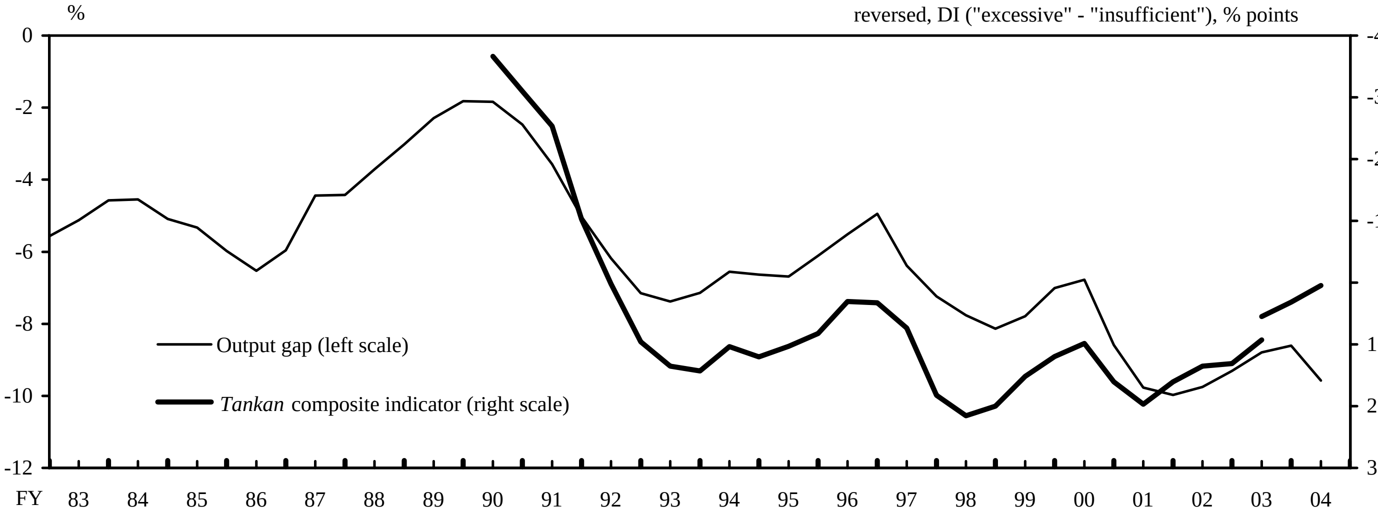



Notes:1. Adjusted to exclude the effects of changes in consumption tax rate.
2. External factors comprise international air passenger transportation, ocean liner, ocean tramper, ocean tanker, oceangoing ship chartering services, and international air freight.

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

# Output Gap and Consumer Price Index

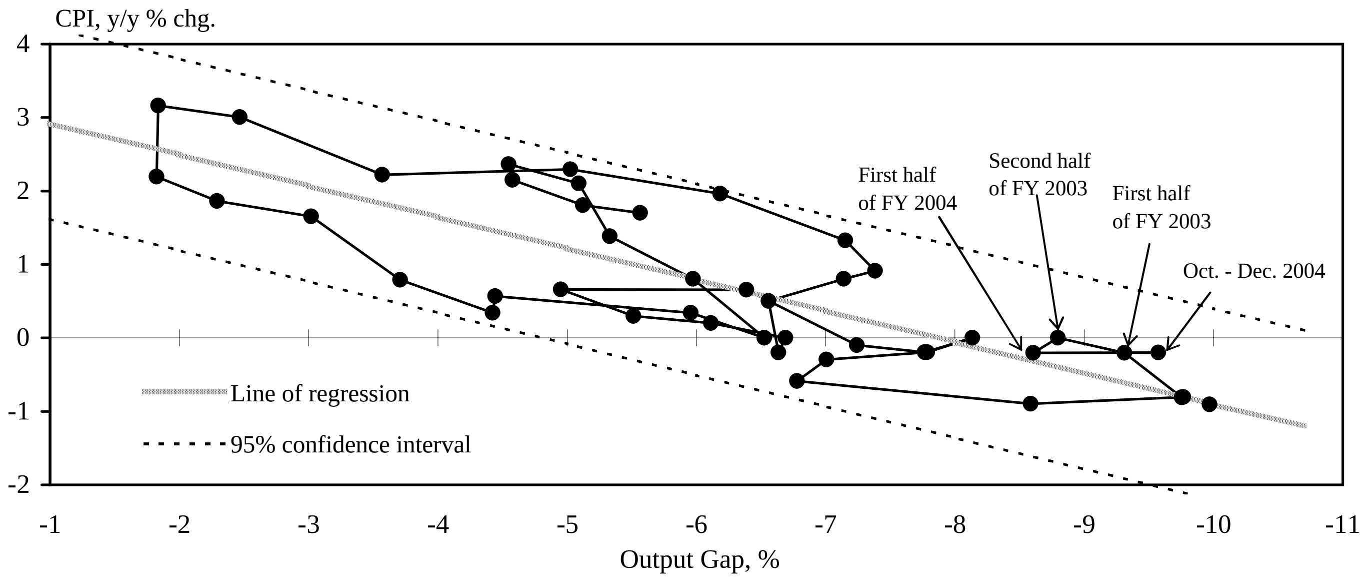
## (1) Indicators Related to Supply-Demand Conditions




Notes:1. Output gap is calculated as the wedge between actual and maximum outputs which are attainable by the maximum usage of capital stock and employment (estimation by the Research and Statistics Department of the Bank of Japan). These estimates always take negative values. On the other hand, international organizations often calculate the output gap as the wedge between actual and maximum outputs which are sustainable in the medium term with stable inflation. In such cases, the output gap can take both positive or negative values. Due to these differences in definition, the levels of different output gaps are not comparable directly. Figure for the second half of FY 2004 is the October-December average.

2. The *Tankan* composite indicator aims at constructing a series similar to the output gap directly from the *Tankan* survey data that show firms' judgment of excessiveness as to the number of employees and the production capacity. It is calculated as the average of the diffusion indices of production capacity and employment conditions, weighted by capital and labor shares in the national accounts (FY 1990 - FY 2003 average). The survey coverage for the production capacity DI was limited to the manufacturing industry before 1990/Q3. For this reason, the figures are calculated for the period from 1990/Q4, when the survey was extended to include the nonmanufacturing industry. Due to a change in the sample, there is a discontinuity as of the December 2003 survey.

## (2) Output Gap and Consumer Price Index




Notes:1. Estimation: Rate of change in CPI (excluding fresh food) = 3.35 + 0.43 × output gap
(11.02) (9.02)

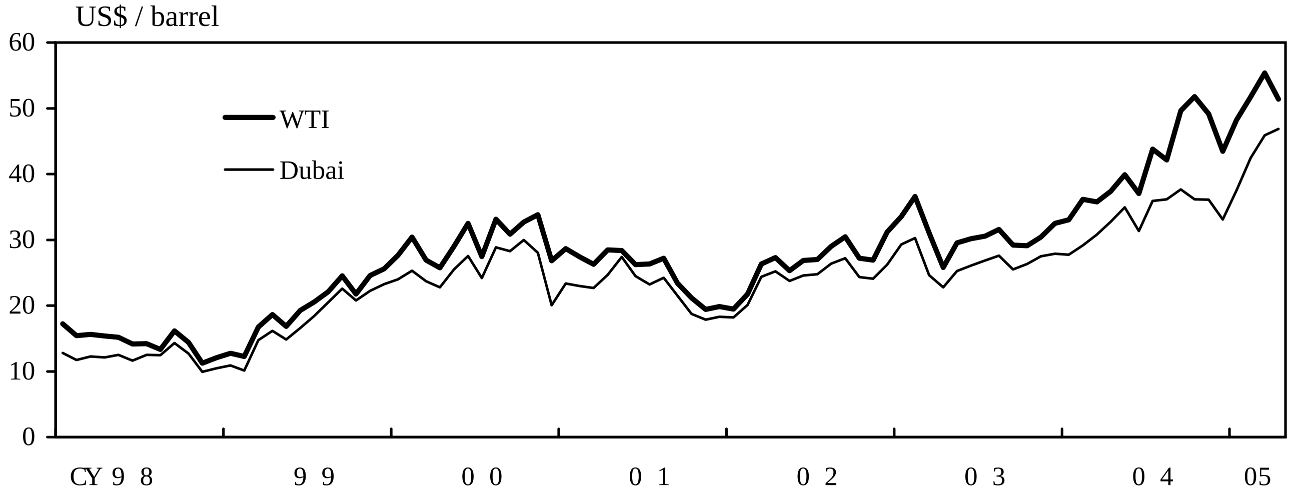
Sample: 1983 to the first half of 2004 (fiscal half-years), $R^2$=0.66, Standard error = 0.65, t-values in parentheses.

2. The CPI is adjusted to exclude the effects of changes in consumption tax rate. Figures until FY 2000 are on the 1995 base.

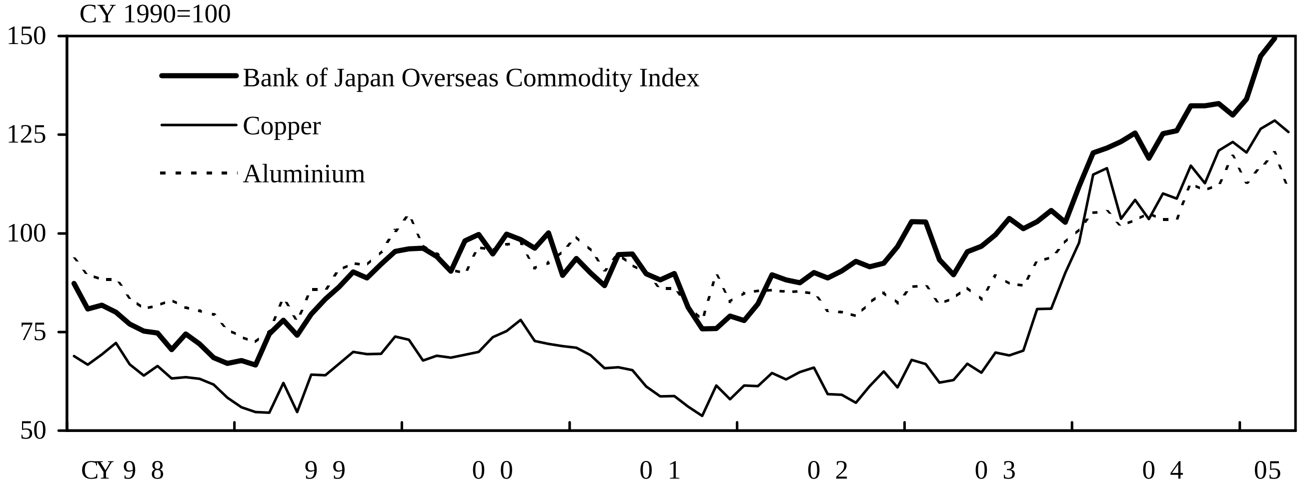
Sources: Cabinet Office, "National Accounts," "Capital Stock of Private Enterprises Statistics"; Ministry of Economy, Trade and Industry, "Indices of Industrial Production"; Ministry of Health, Labour and Welfare, "Monthly Labour Survey"; Ministry of Internal Affairs and Communications, "Consumer Price Index,"; Bank of Japan, "*Tankan* - Short-Term Economic Survey of Enterprises in Japan," etc.

# Commodity Prices

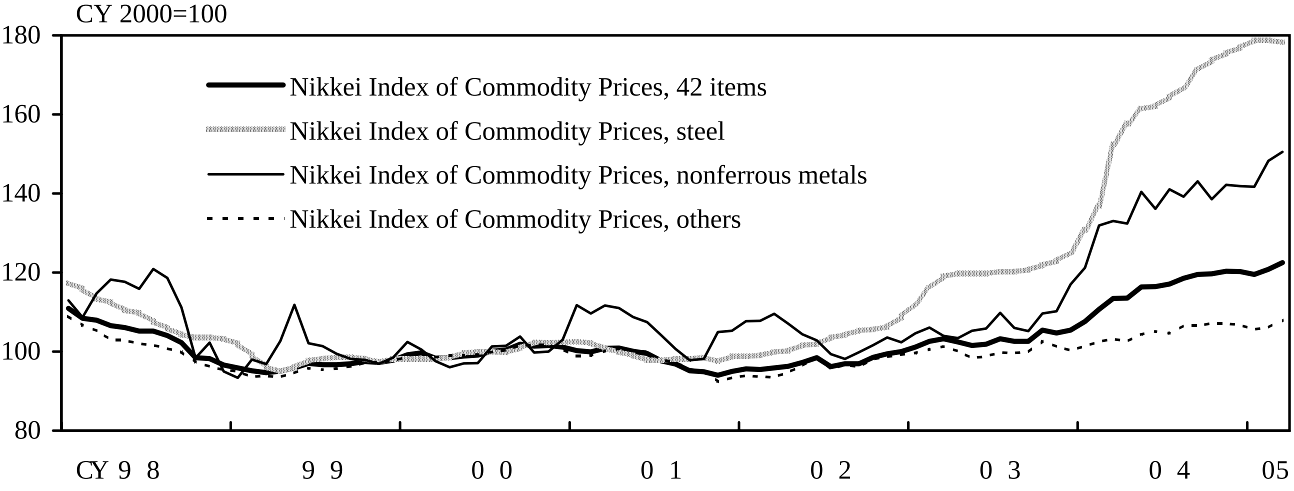
(1) Oil Prices[1, 2]




(2) International Commodity Prices[1, 2]




(3) Domestic Commodity Prices[1]



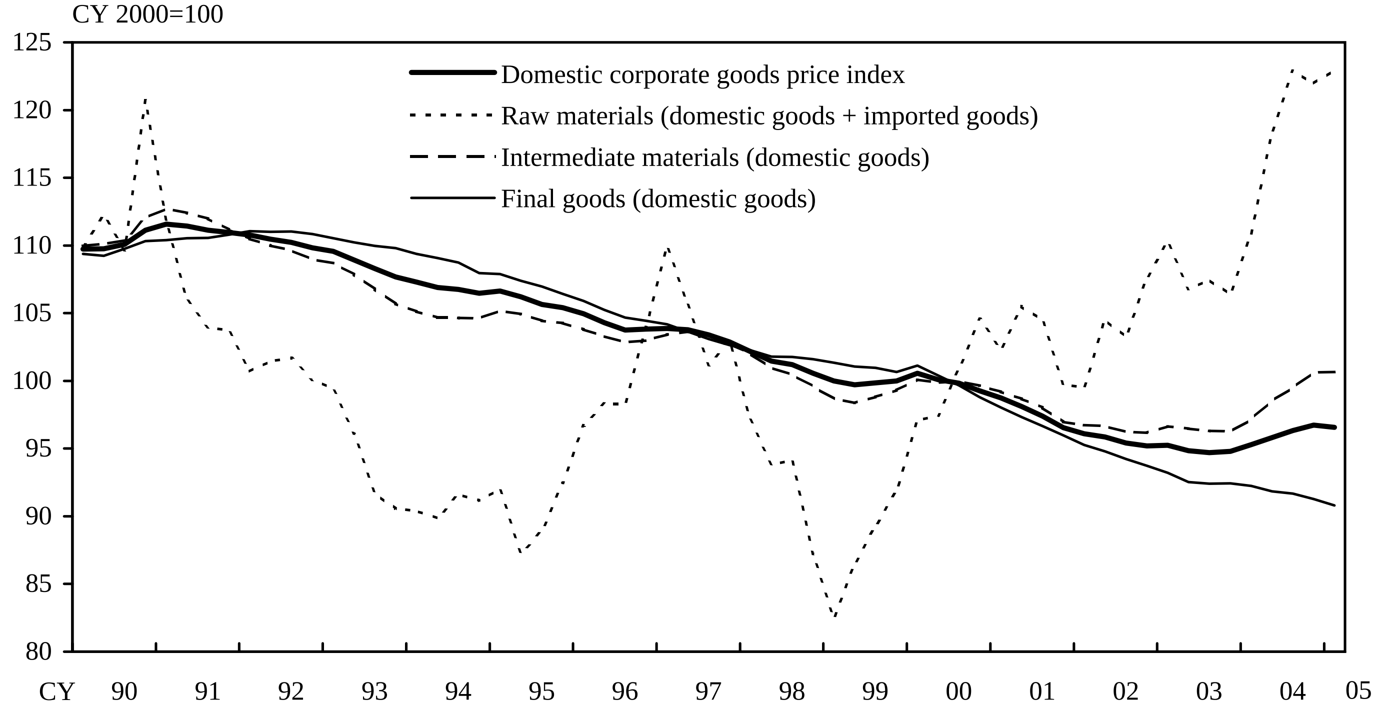

Notes:1. Data are at end of month.
2. Figures for April 2005 are the latest available data.

Sources: Bank of Japan; *Nihon Keizai Shimbun* ; Bloomberg.

Chart 12

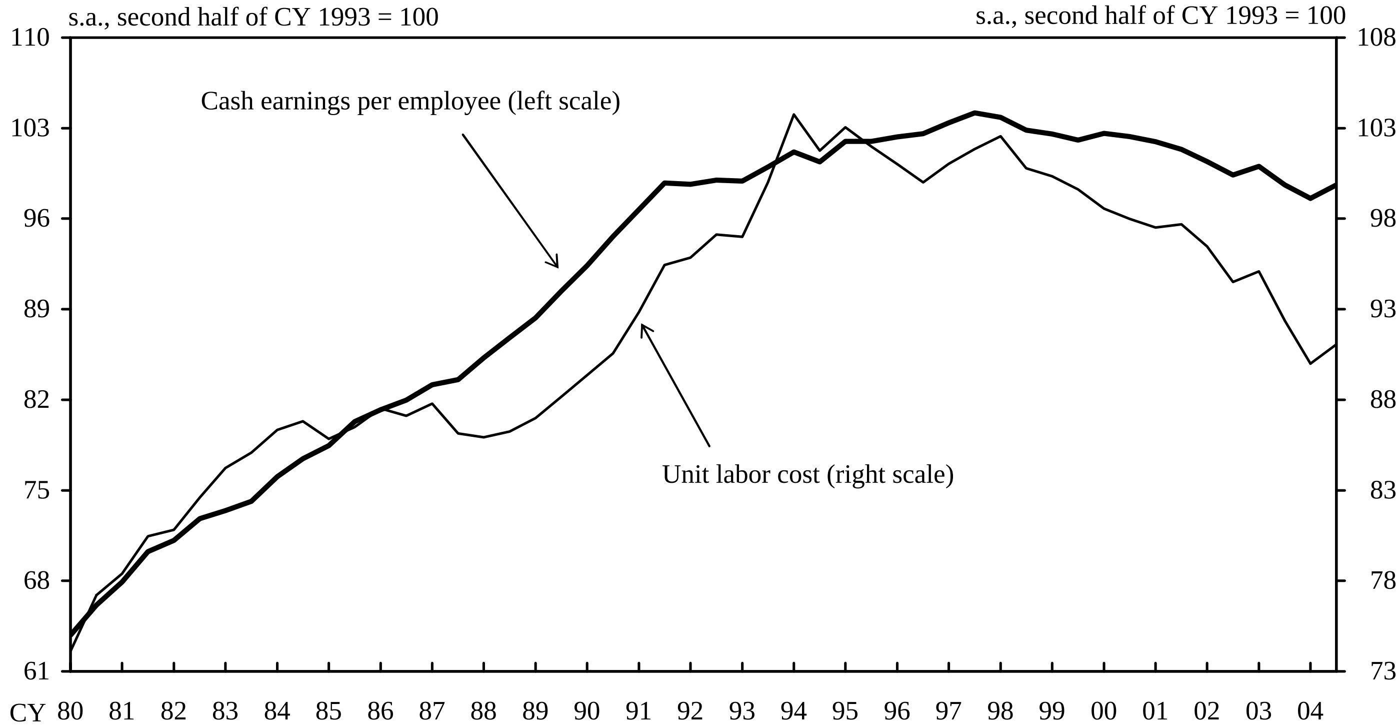
# Prices by Stage of Demand and Unit Labor Cost

## (1) Domestic Corporate Goods Price Index by Stage of Demand




Note: Data exclude the effects of changes in the consumption tax rate and hikes in electricity charges in the summer.

## (2) Cash Earnings per Employee and Unit Labor Cost

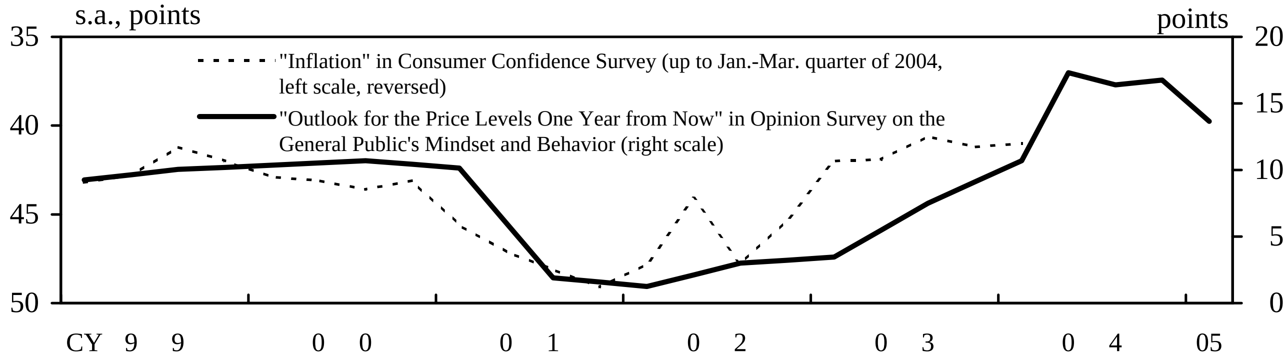



Notes:1. Unit labor cost = cash earnings per employee/labor productivity = compensation of employees/real GDP.
2. Cash earnings per employee = compensation of employees/number of employees (in "Labour Force Survey").

Sources: Cabinet Office, "National Accounts"; Ministry of Internal Affairs and Communications, "Labour Force Survey"; Bank of Japan, "Corporate Goods Price Index."

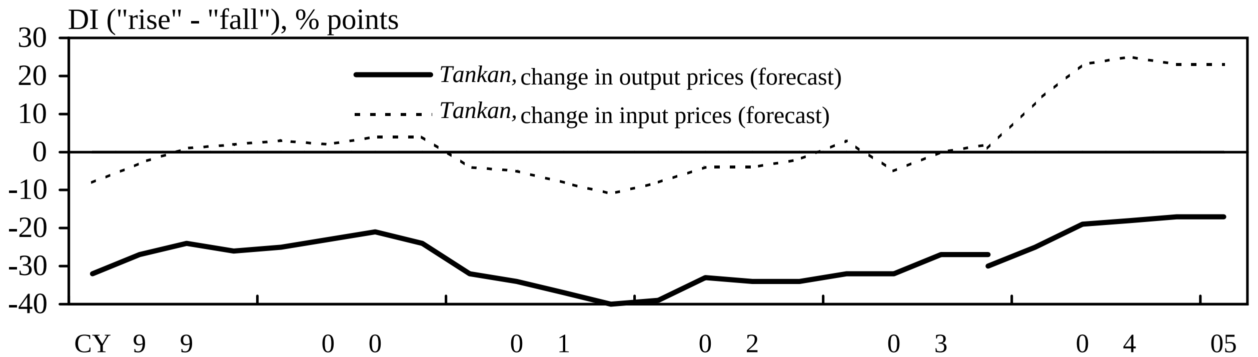
# Outlook for Prices

## (1) Households' Outlook for Prices



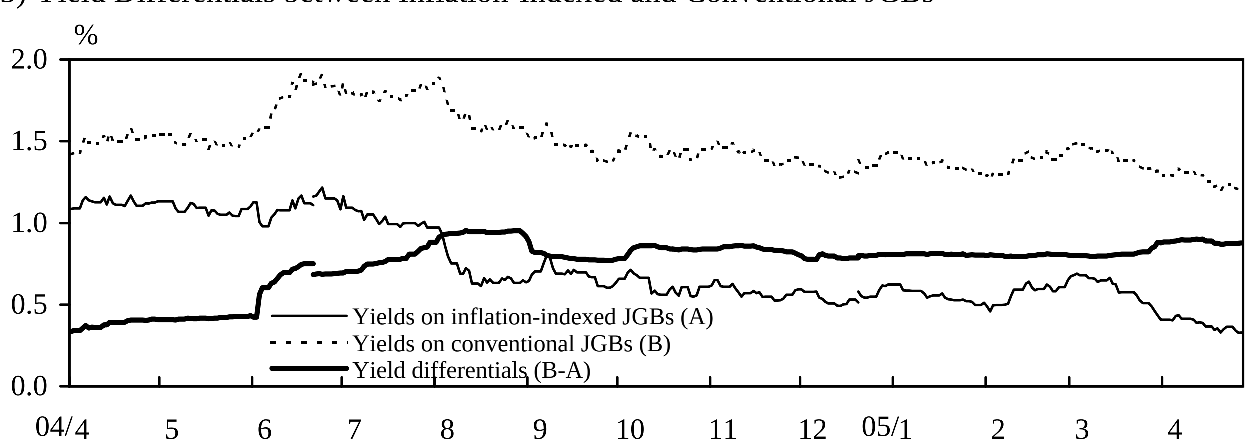

Note: The share of respondents is multiplied by the following points according to the type of answer, and the results are totaled.
For the question about the price levels one year from now compared with the present in the "Opinion Survey on the General Public's Mindset and Behavior": 1 point for respondents who answered prices will "go up significantly"; 0.5 point for those answering "go up slightly"; -0.5 point for those answering "go down slightly"; and -1 point for those answering "go down significantly."
For the question about the inflation rate in six months in the "Consumer Confidence Survey": 1 point for respondents who answered that the inflation rate will be "lower"; 0.75 point for those answering "slightly lower"; 0.5 point for those answering "unchanged"; 0.25 point for those answering "slightly higher"; and 0 point for those answering "higher."

## (2) Firms' Outlook for Prices




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

## (3) Yield Differentials between Inflation-Indexed and Conventional JGBs



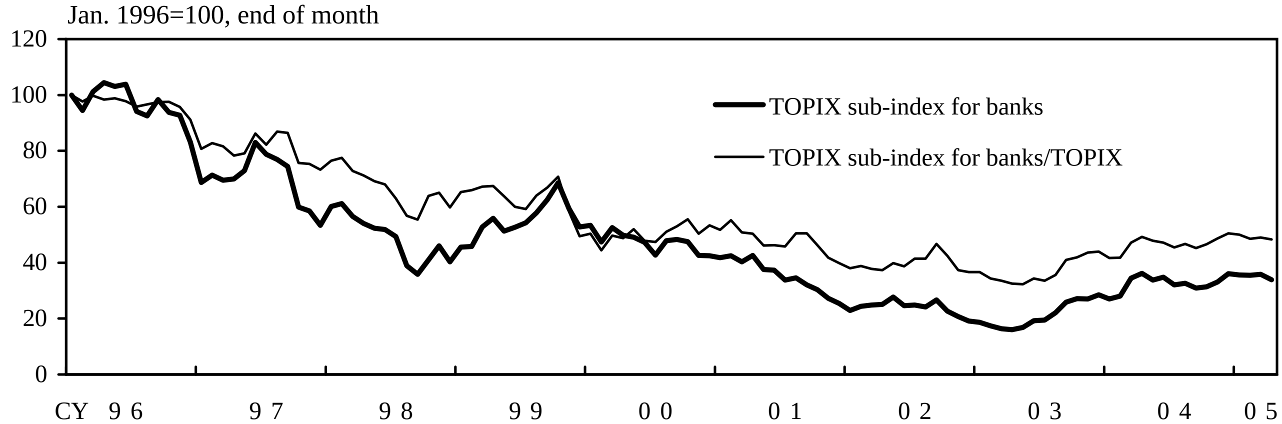

Notes:1. Yields on inflation-indexed JGBs are those for the current issue, and yields on conventional JGBs are those for 10-year JGBs issued in the same month as the corresponding inflation-indexed JGBs (connected at issue date of conventional JGBs).
2. Inflation-indexed JGBs are indexed to the Consumer Price Index excluding fresh food, on a nationwide basis.

Sources: Cabinet Office, "Consumer Confidence Survey"; Bank of Japan, "Opinion Survey on the General Public's Mindset and Behavior," "*Tankan* - Short-Term Economic Survey of Enterprises in Japan"; Japan Securities Dealers Association; Bloomberg.

Chart 14

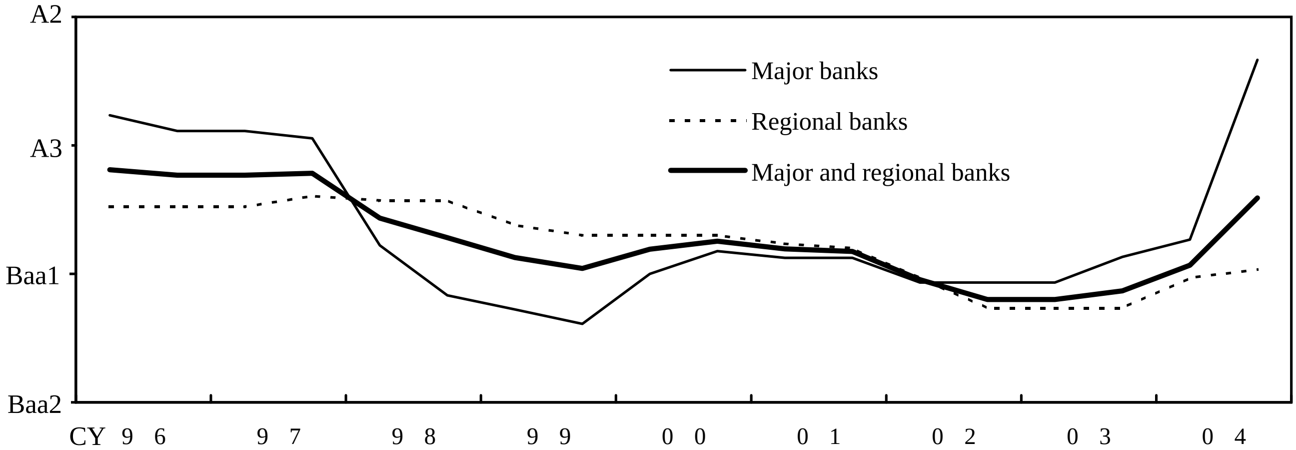
# Business Conditions in the Banking Sector

## (1) Stock Prices of the Banking Sector



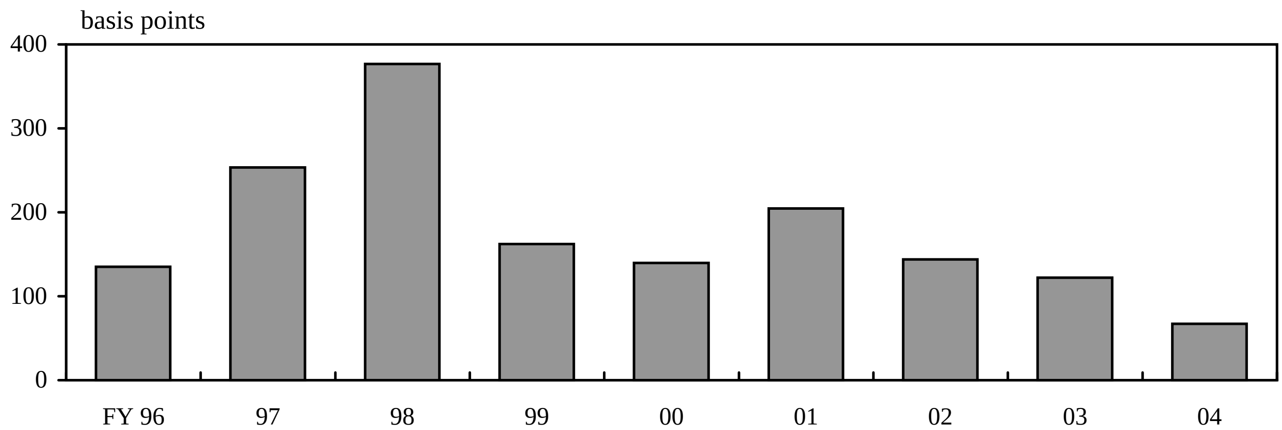

Note: Figures for April 2005 are the latest available data.

## (2) Rating of Japanese Banks




Notes: 1. Average of Long-term bank deposit ratings by Moody's (end of June and December).
2. Intervals between each rating are assumed to be the same.

## (3) Credit Cost Ratio (Major and Regional Banks)

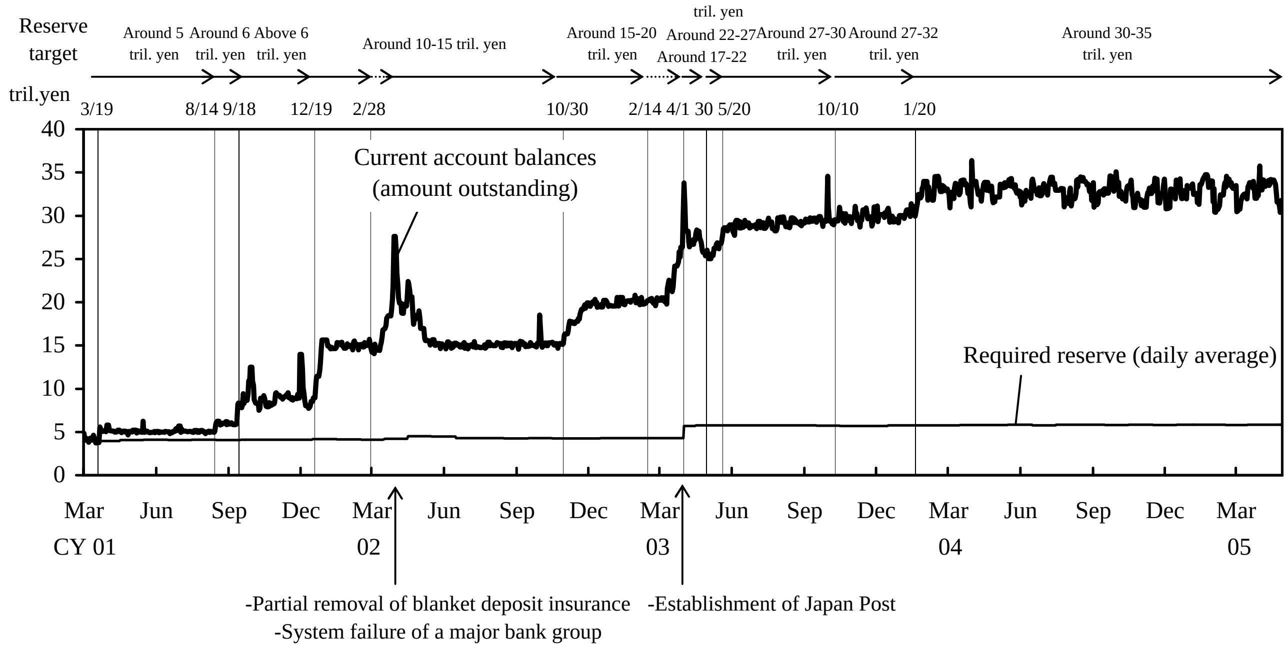



Notes: 1. Credit cost ratio is the ratio of credit cost (loan write-offs, net transfers to special loan-loss provisions, net transfers to allowances for possible loan losses, and losses from loan sales and others) to total loans outstanding.
2. The figure for FY 2004 is calculated by doubling the figure for the first half of FY 2004.

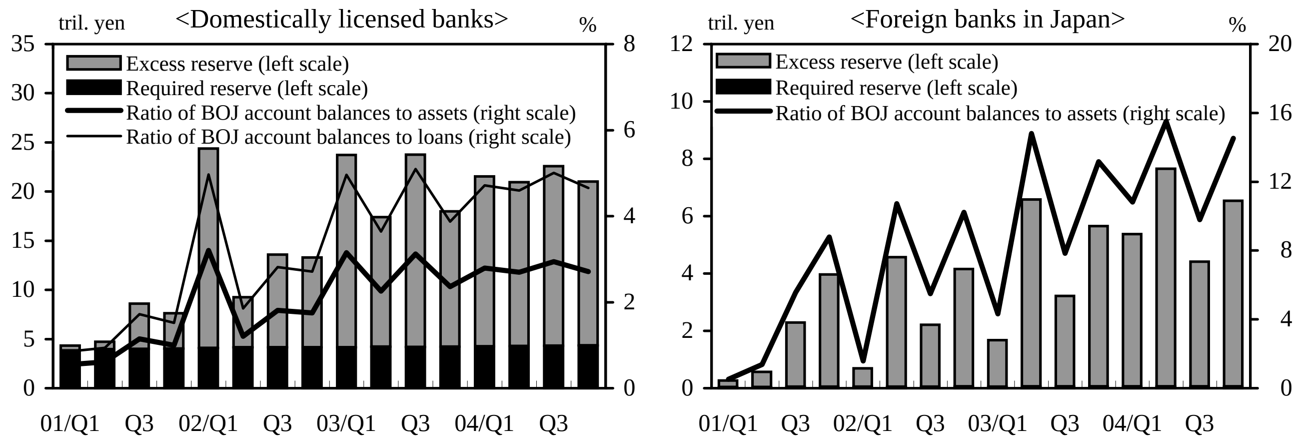
Sources: Bank of Japan; Moody's; Bloomberg.

# BOJ Current Account Balances and Money Market Rates

## (1) BOJ Current Account Balances

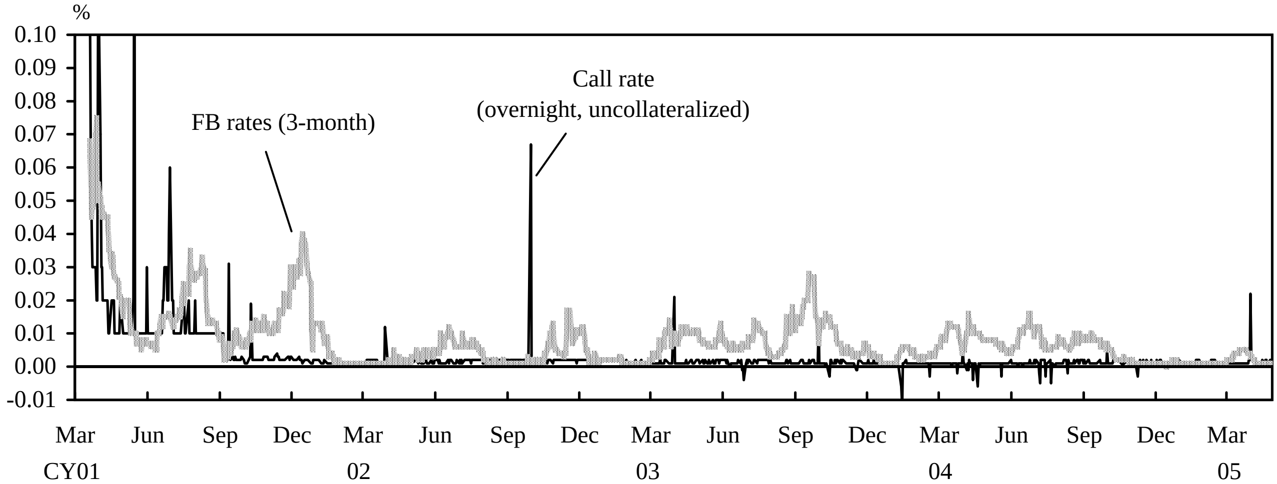



## (2) BOJ Current Account Balances of Domestically Licensed and Foreign Banks




Note: Data are at end of quarter.

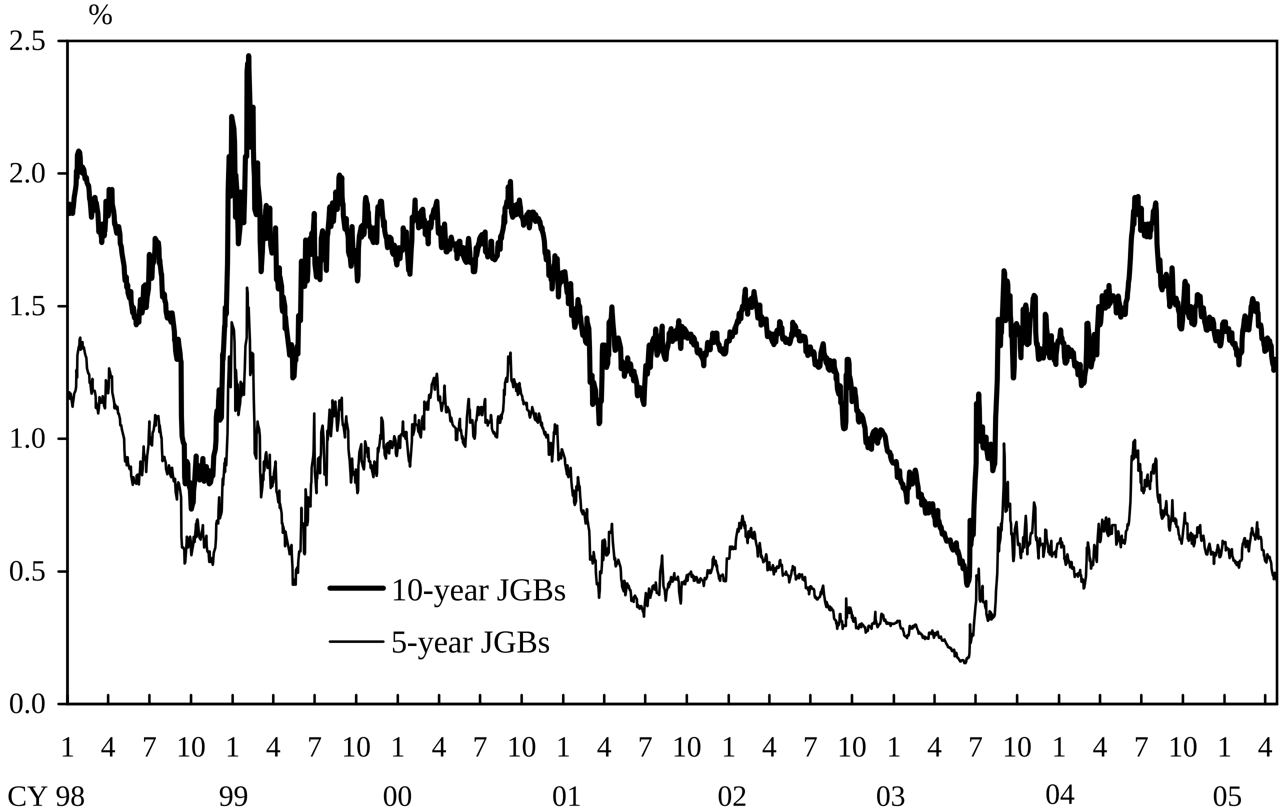
## (3) Money Market Rates



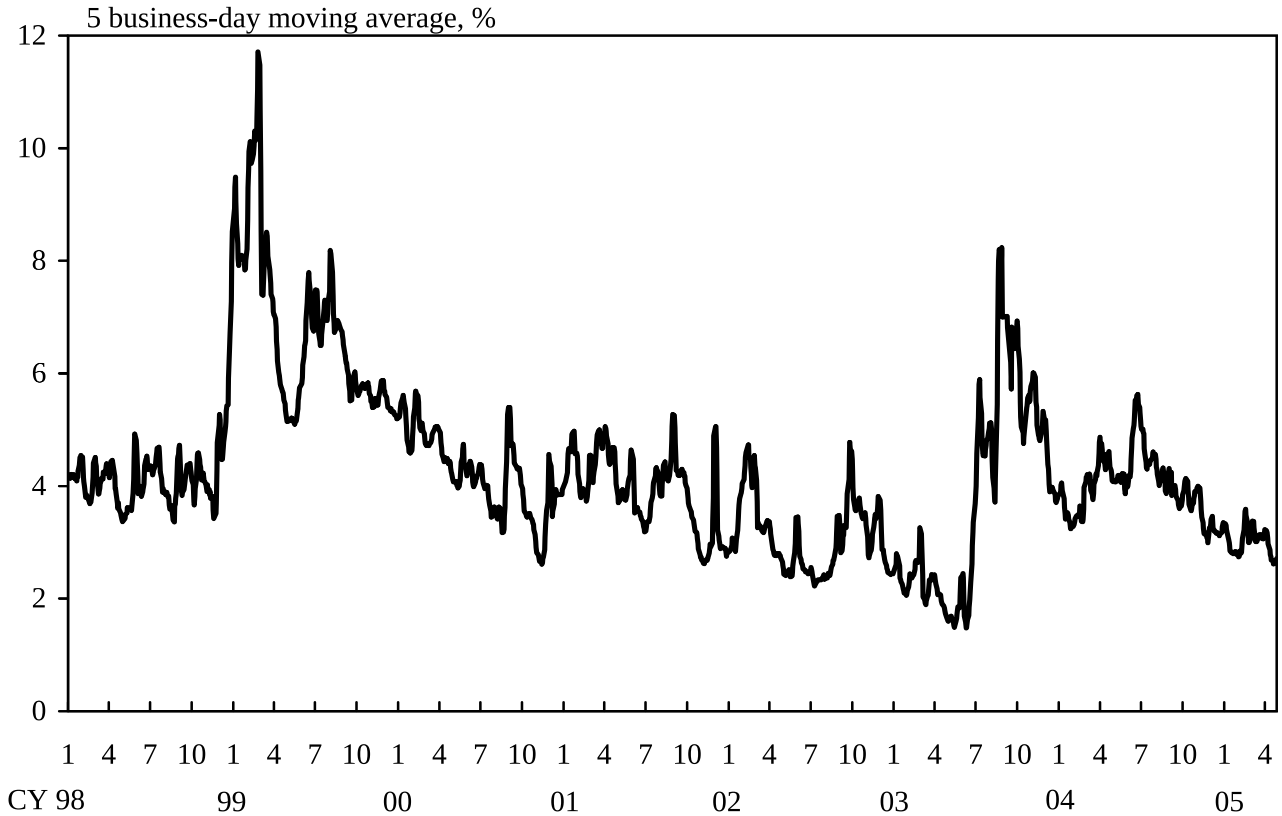

Sources: Bank of Japan; Bloomberg.

# Long-Term Interest Rates

(1) Long-Term Government Bond Yield



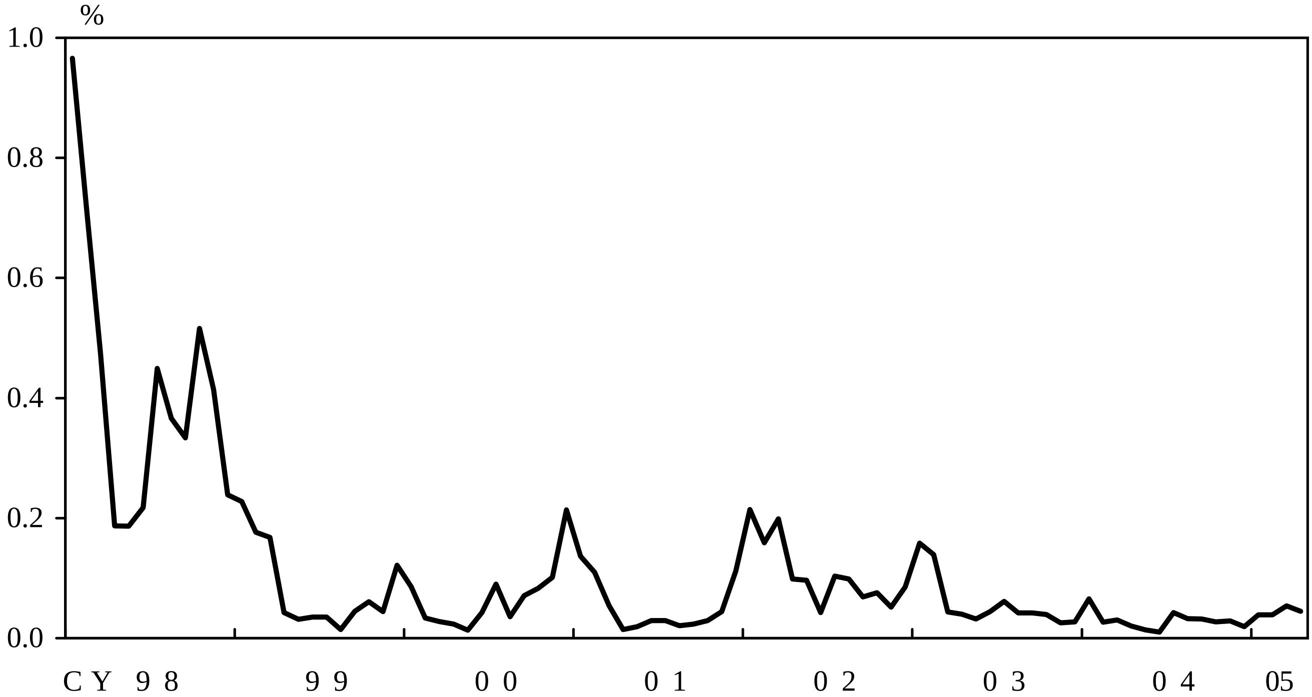

(2) Implied Volatility of 10-Year JGB Futures



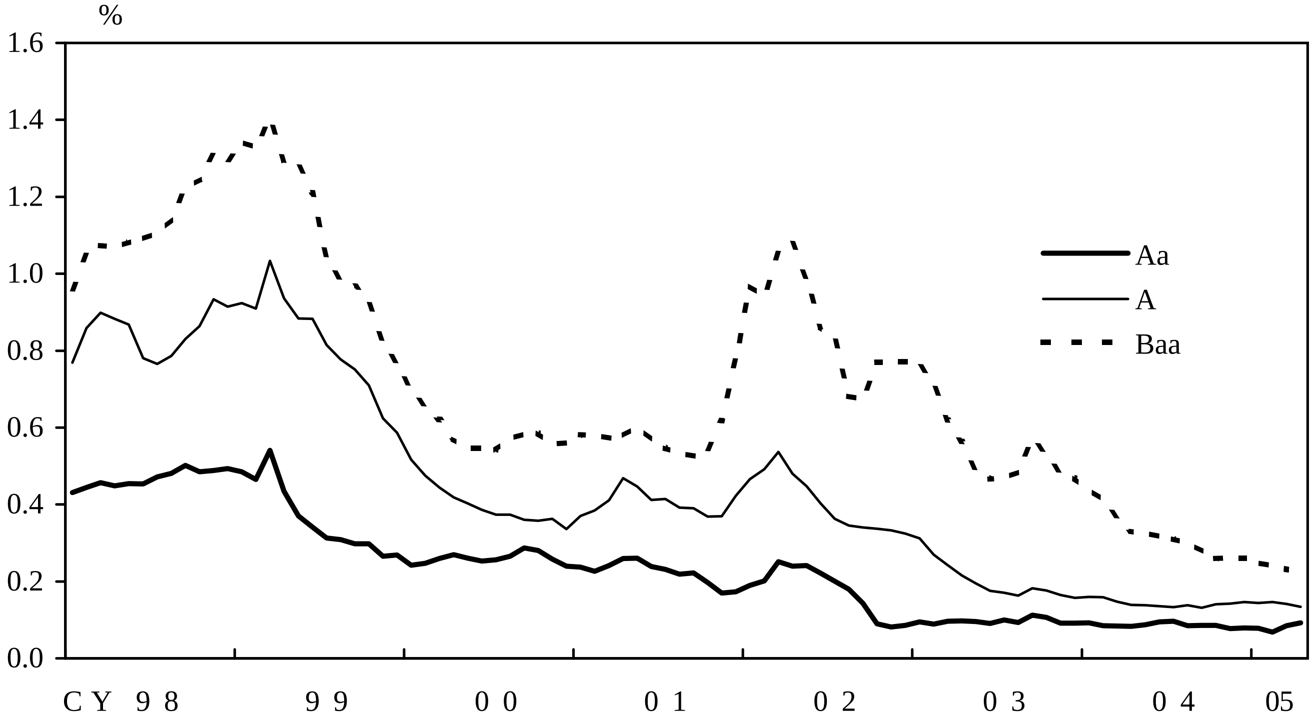

Source: Bloomberg.

# Credit Spread

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




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

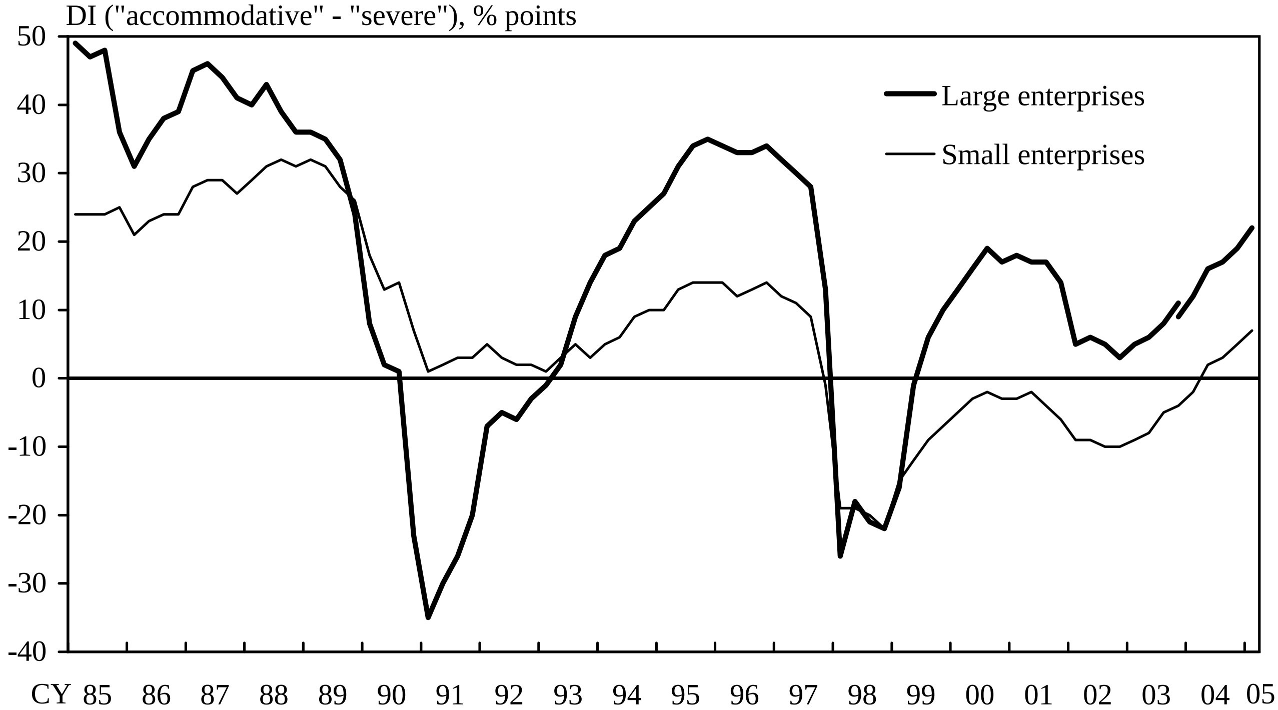



Notes: 1. The spread for CP is the average issuance rate of CP minus the FB/TB yield.
2. CP ratings are A-1 or above.
3. The spreads for both CP and corporate bonds in April 2005 are the averages up to the latest available data.
4. The spreads for corporate bonds are the corporate bond yield minus the government bond yield.
5. The indicated ratings of corporate bonds are of Moody's.

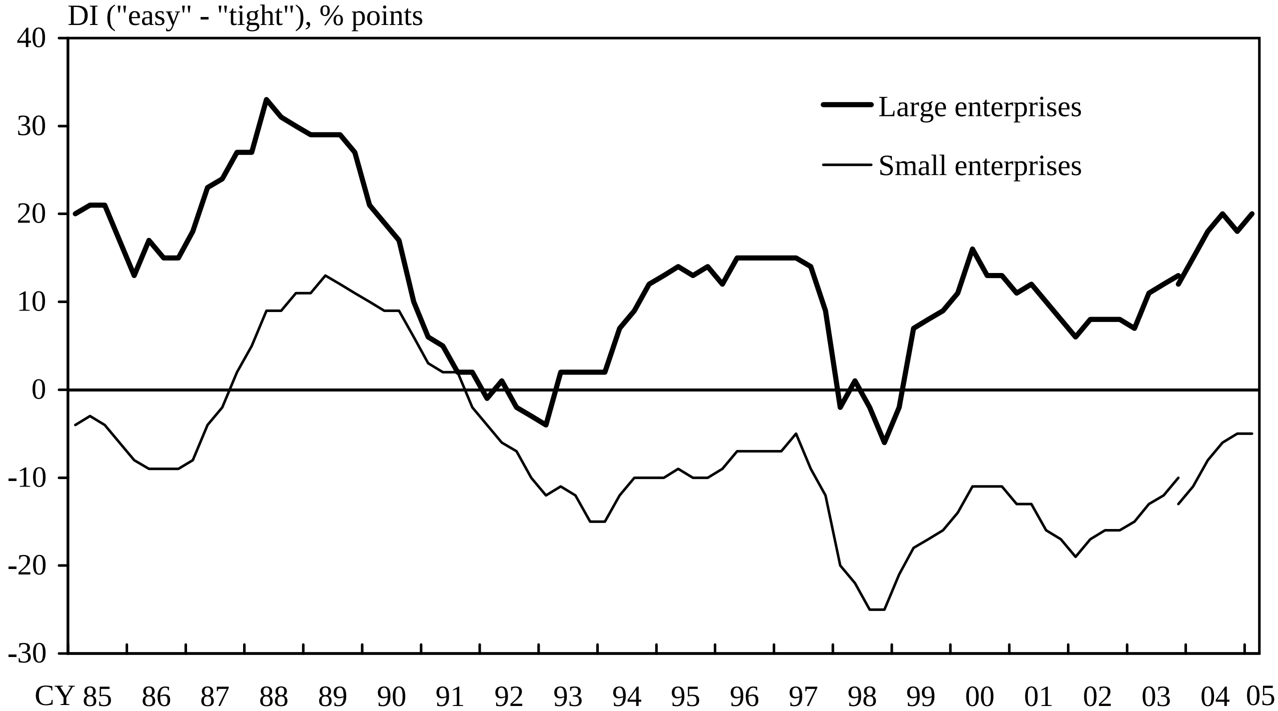
Sources: Bank of Japan; Japan Bond Trading Co., Ltd.; Japan Securities Dealers Association.

# Lending Attitude of Financial Institutions and Financial Positions of Firms

(1) Lending Attitude of Financial Institutions




(2) Financial Position of Firms

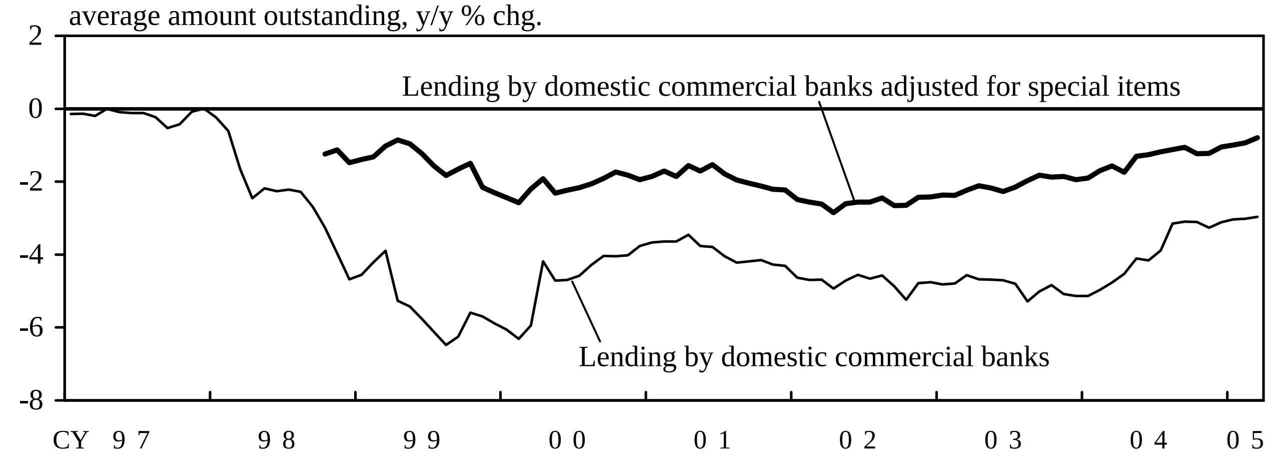



Note: The *Tankan* has been revised from the March 2004 survey. Figures based on the previous data sets are up to the December 2003 survey. Figures on a new basis are from the December 2003 survey.

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

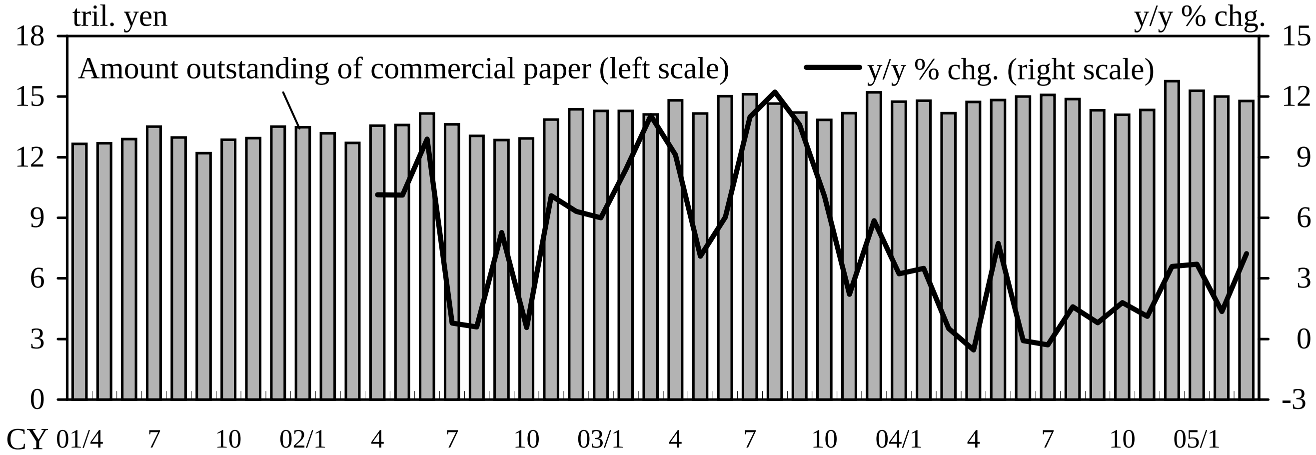
# Fund-Raising by Firms

(1) Lending by Domestic Commercial Banks



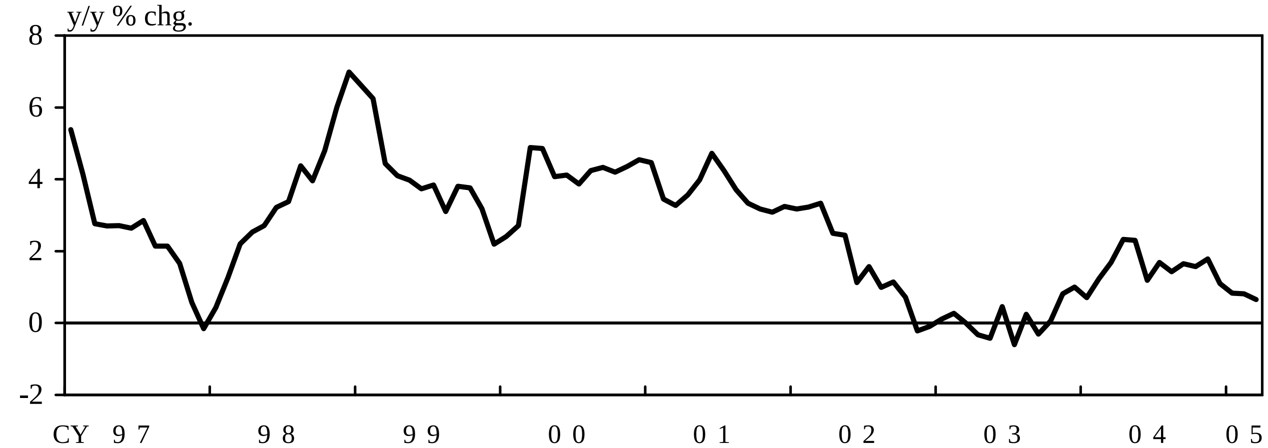

Note: Adjusted figures exclude fluctuations from liquidations of loans, loan write-offs, etc.

(2) Amount Outstanding of Commercial Paper




Note: Figures are those underwritten by financial institutions that hold current accounts at the Bank of Japan. Excludes those issued by banks. Data are at end of month.

(3) Amount Outstanding of Corporate Bonds (Changes from a Year Earlier)

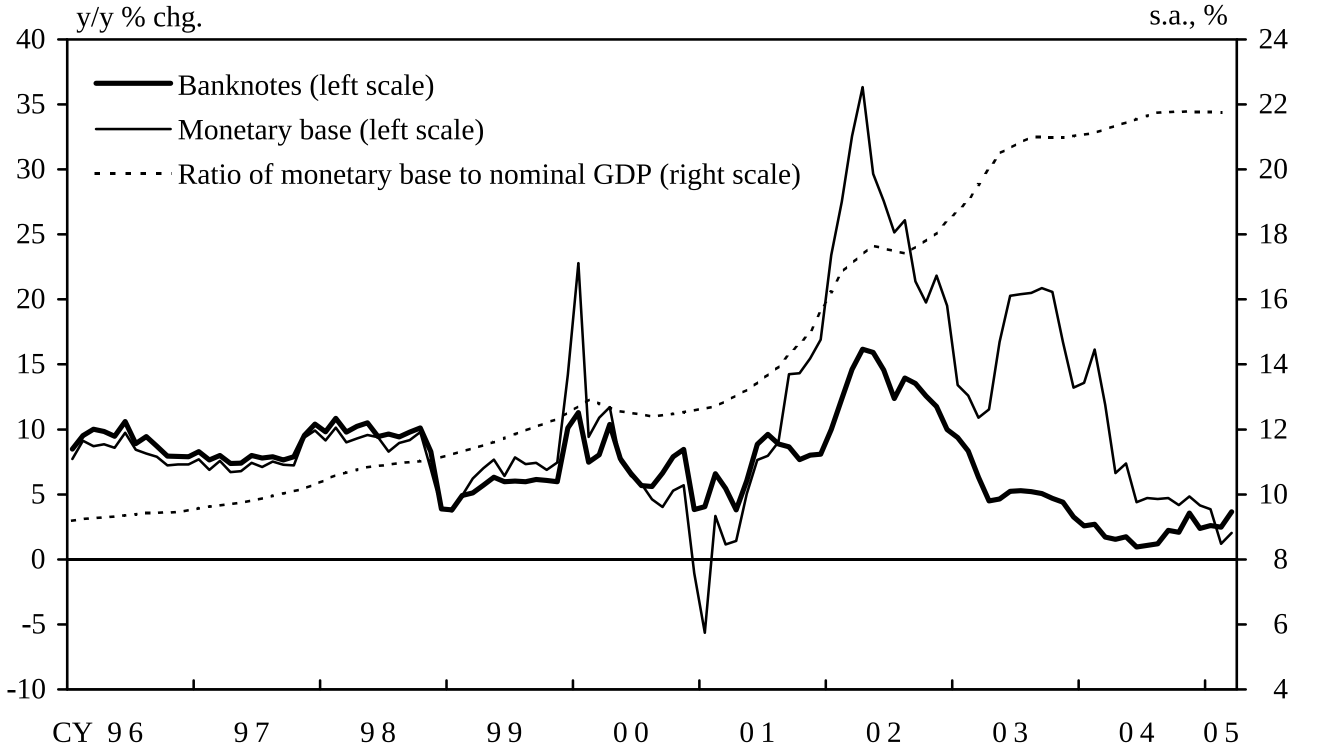



Note: The sum of straight bonds, convertible bonds, bonds with warrants, and asset-backed securities issued in both domestic and overseas markets. Bonds issued by banks are included. Data are at end of month.

Sources: Bank of Japan; Japan Securities Dealers Association; IN Information Center.

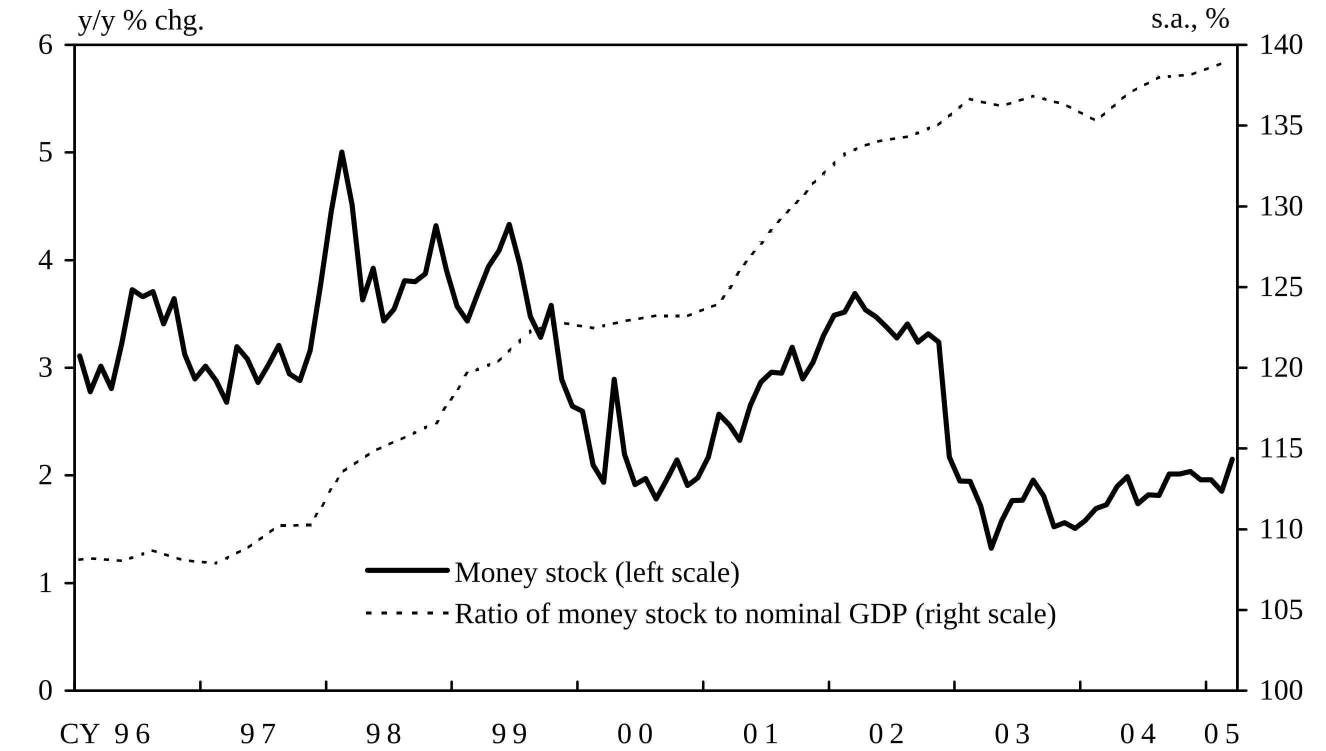
# Monetary Base and Money Stock

(1) Banknotes and Monetary Base




Notes: 1. Monetary base = currency in circulation (banknotes + coins) + current deposits at the Bank of Japan. Data for currency in circulation include holdings of financial institutions.
2. Figure for nominal GDP in 2005/Q1 is assumed to be unchanged from the previous quarter.

(2) Money Stock ($M_2$+CDs)

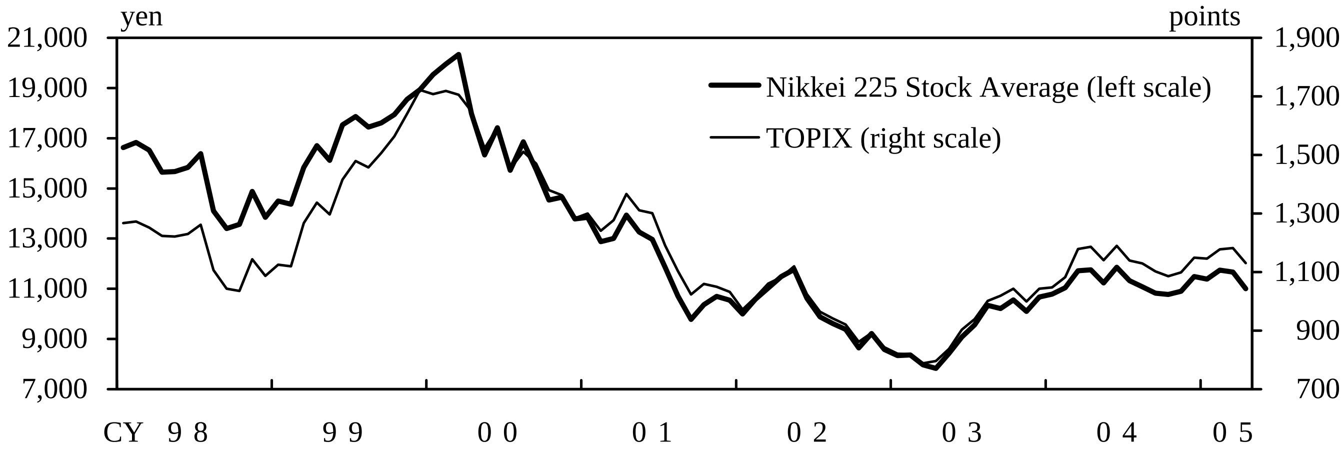



Note: Figure for nominal GDP in 2005/Q1 is assumed to be unchanged from the previous quarter.

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

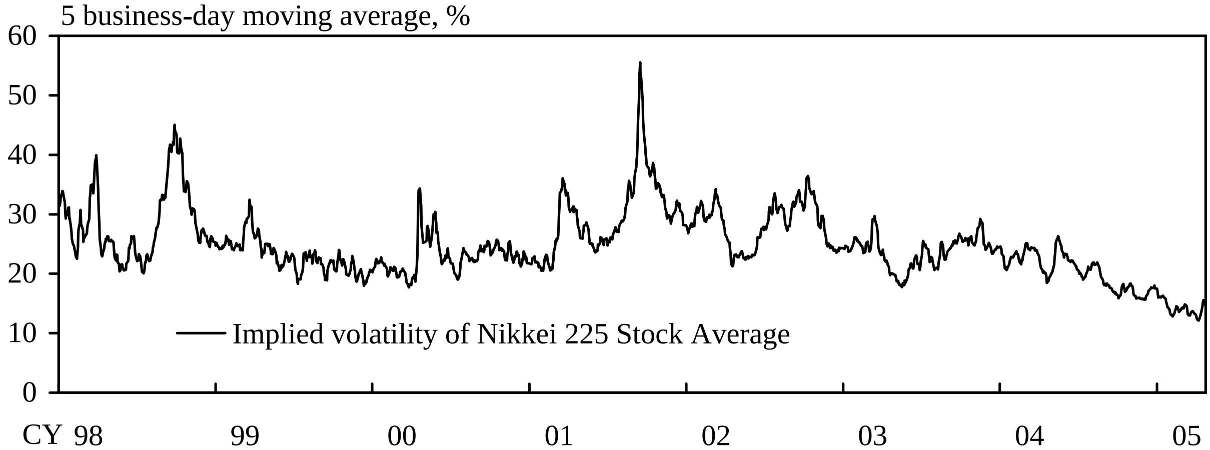
# Stock Prices

## (1) Japan

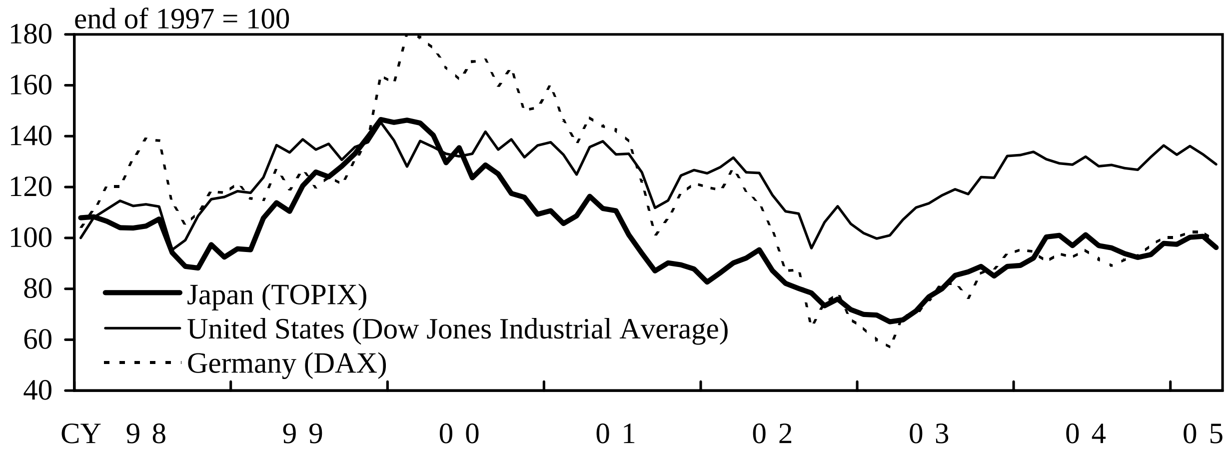



Note: Data are at end of month. Figures for April 2005 are the latest available data.

## (2) Implied Volatility




## (3) Major Countries

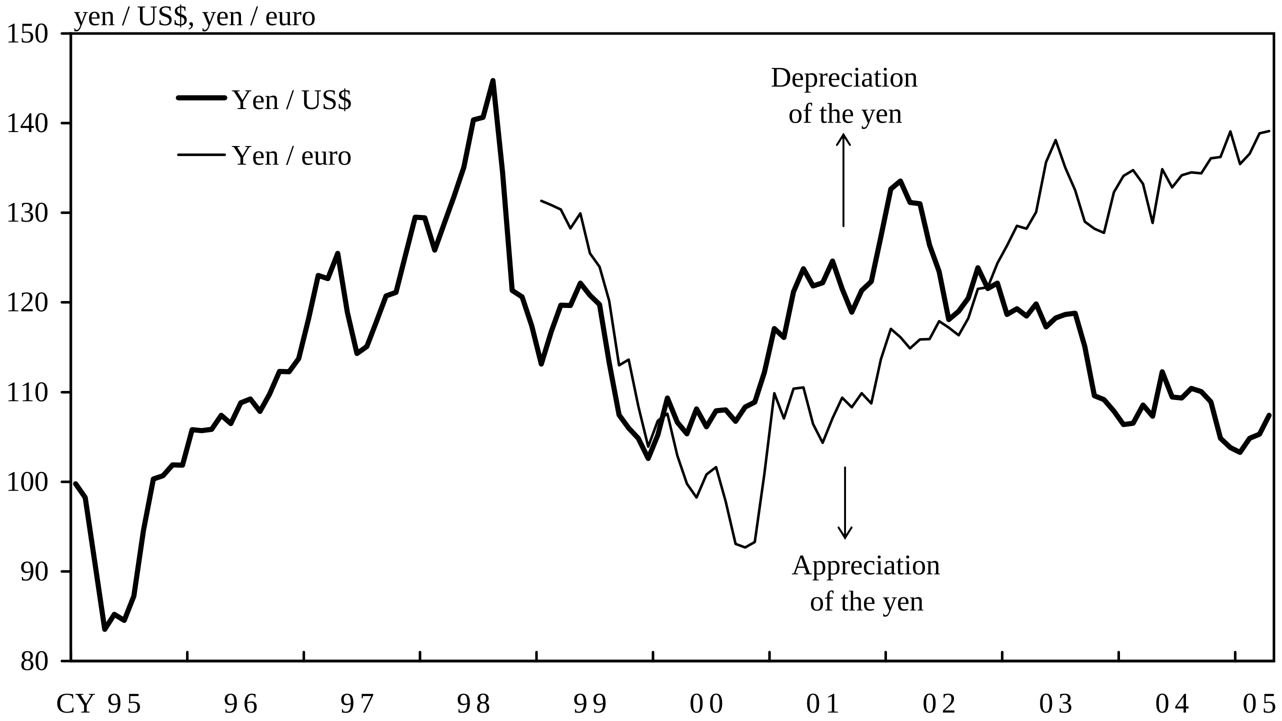



Note: Data are at end of month. Figures for April 2005 are the latest available data.

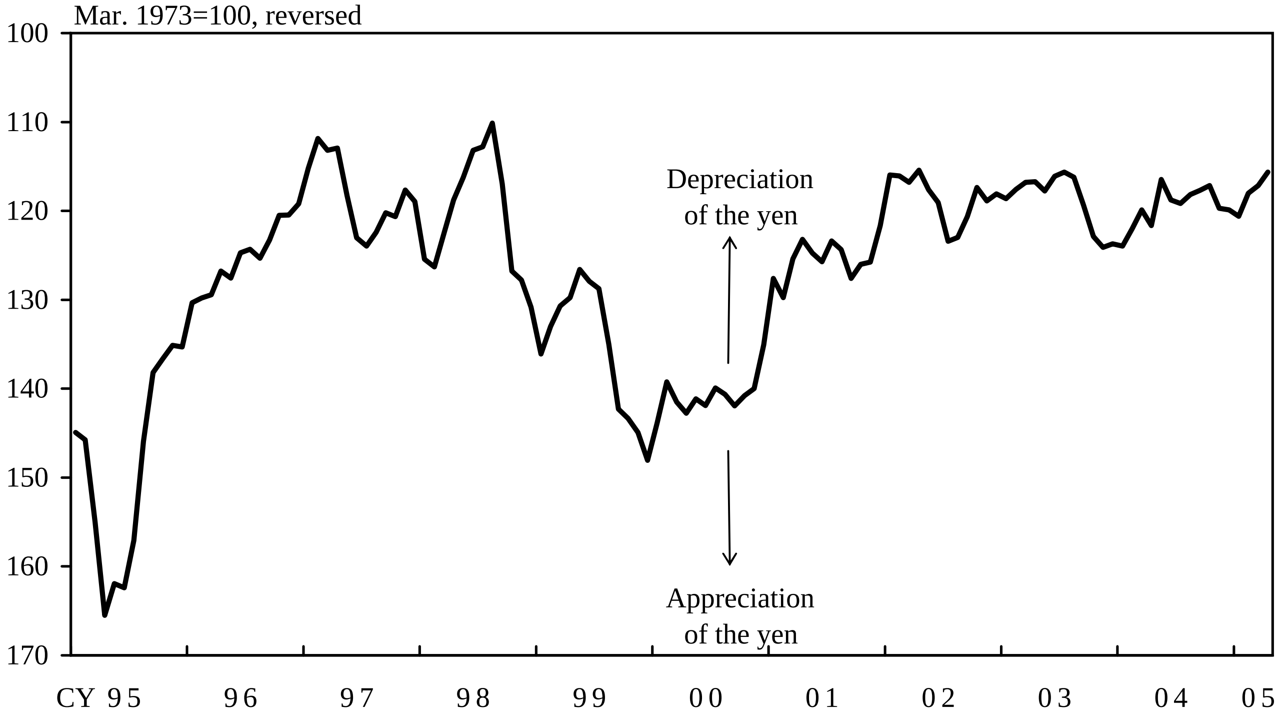
Sources: *Nihon Keizai Shimbun* ; Tokyo Stock Exchange; Bloomberg.

# Exchange Rates

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




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

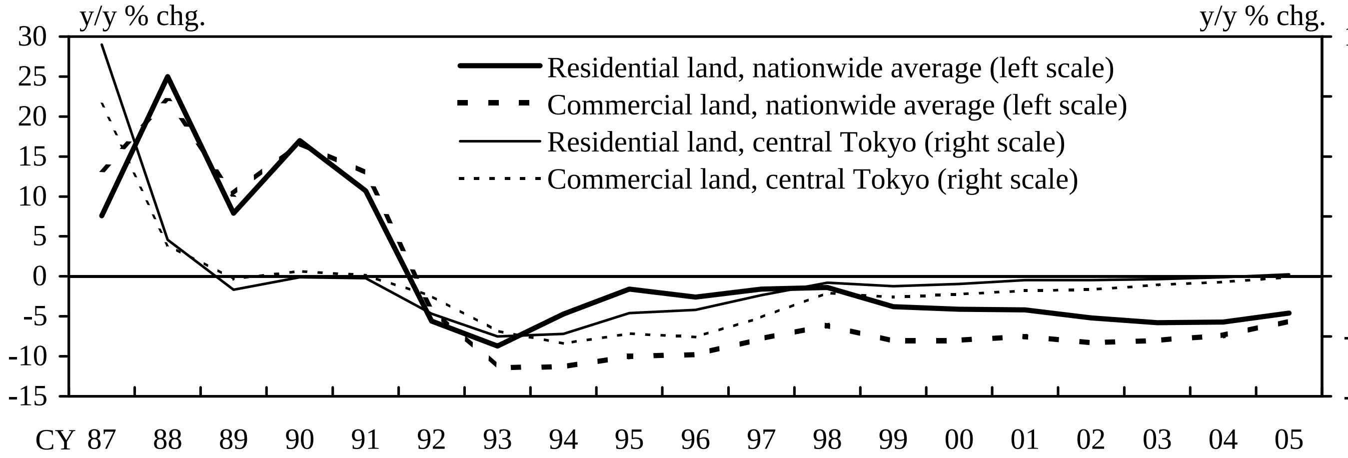



Notes: 1. Monthly average. Figures for April 2005 are averages up to the latest available data.
2. The real effective exchange rate is set against 15 currencies that have a large share among Japanese total exports. Producer price indices (PPI) or wholesale price indices (WPI) are used to deflate the nominal exchange rates.

Source: Bank of Japan.

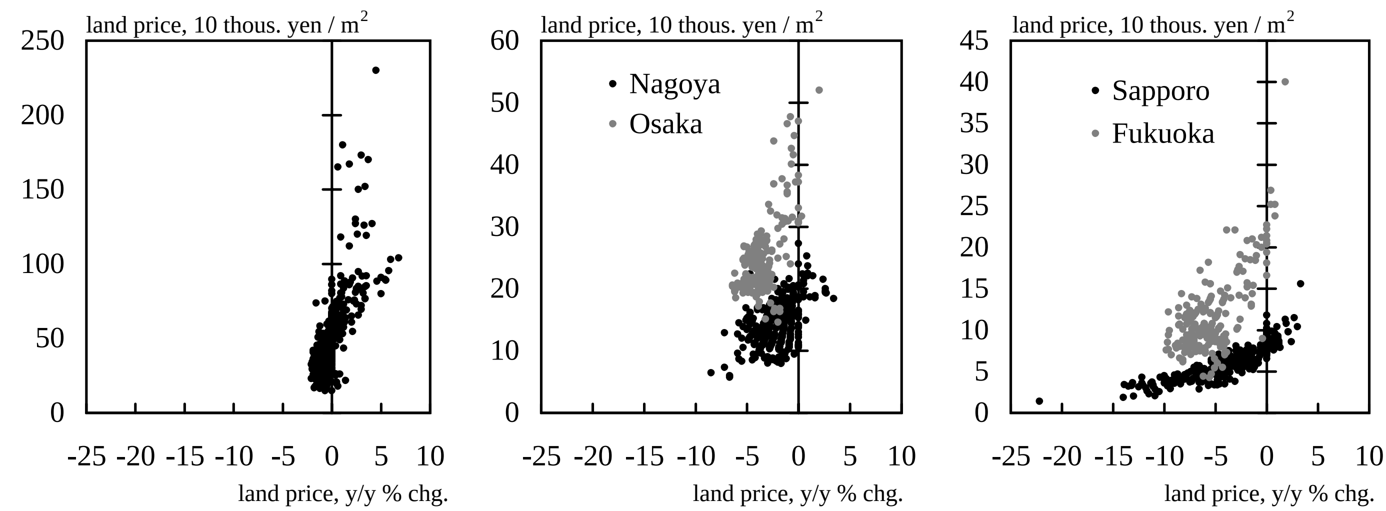
# Land Prices

## (1) Nationwide Average and Central Tokyo

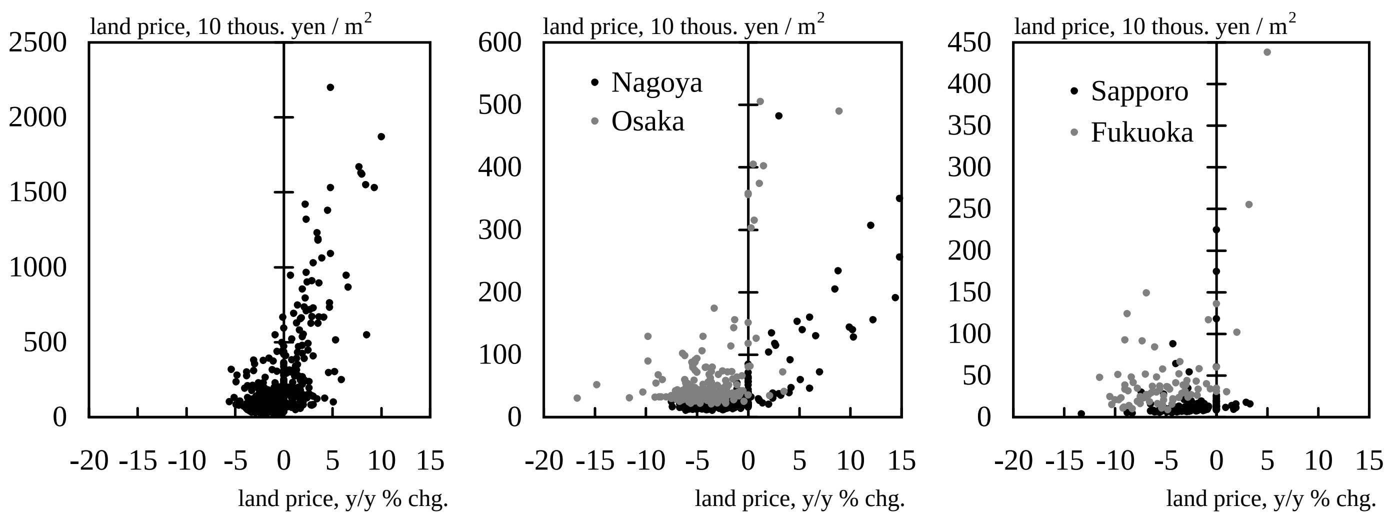



Note: Central Tokyo: average of eight wards in central Tokyo, including Chiyoda, Chuo, and Minato Wards.

## (2) Residential Land



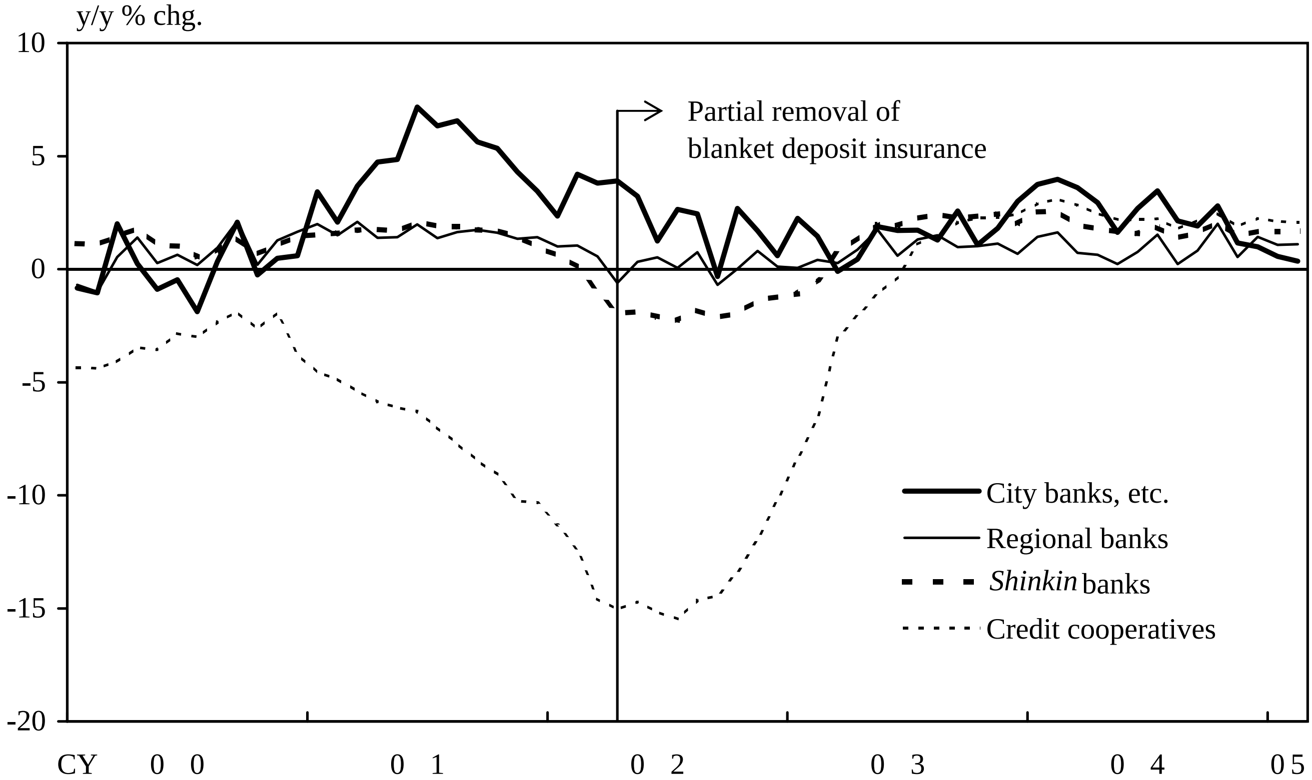

## (3) Commercial Land




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

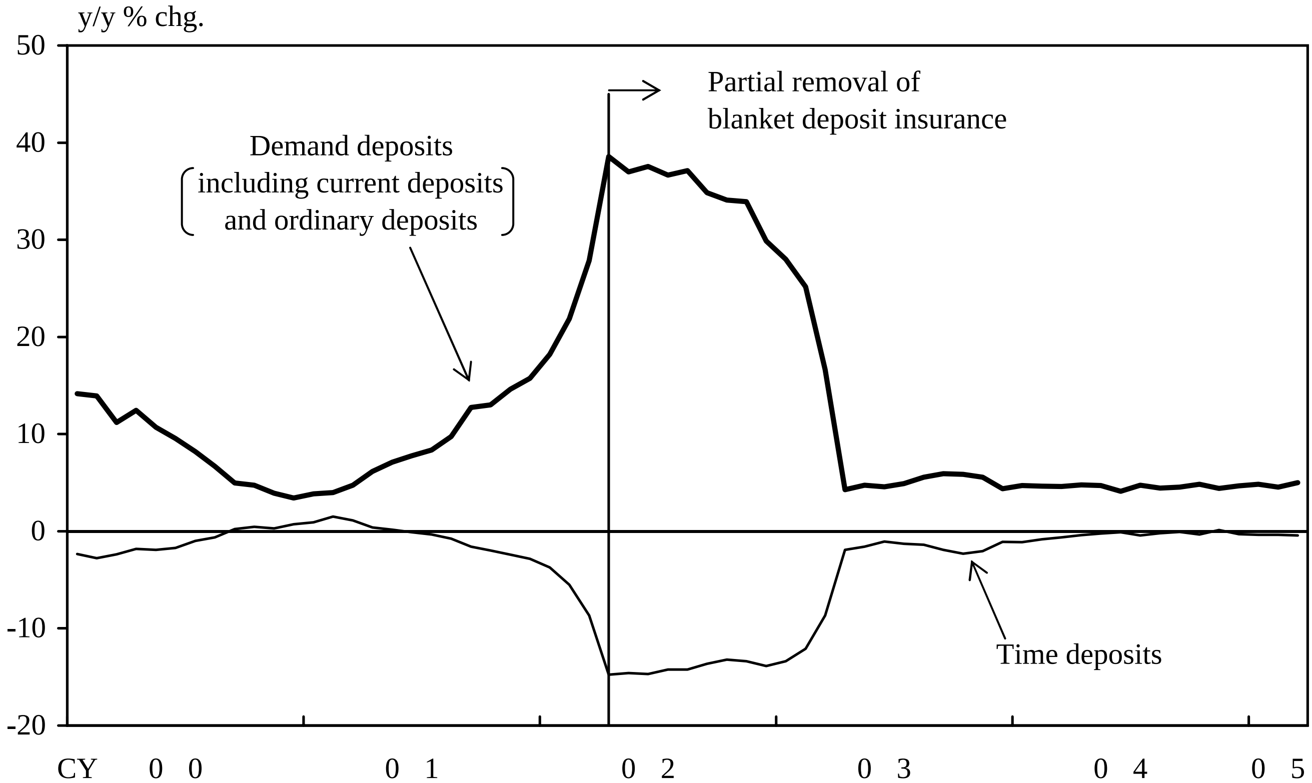
# Developments in Deposits before and after the Removal of Blanket Deposit Insurance

(1) Amount Outstanding of Deposits by Sector




Note: "City banks, etc." refers to domestically licensed banks excluding regional banks.

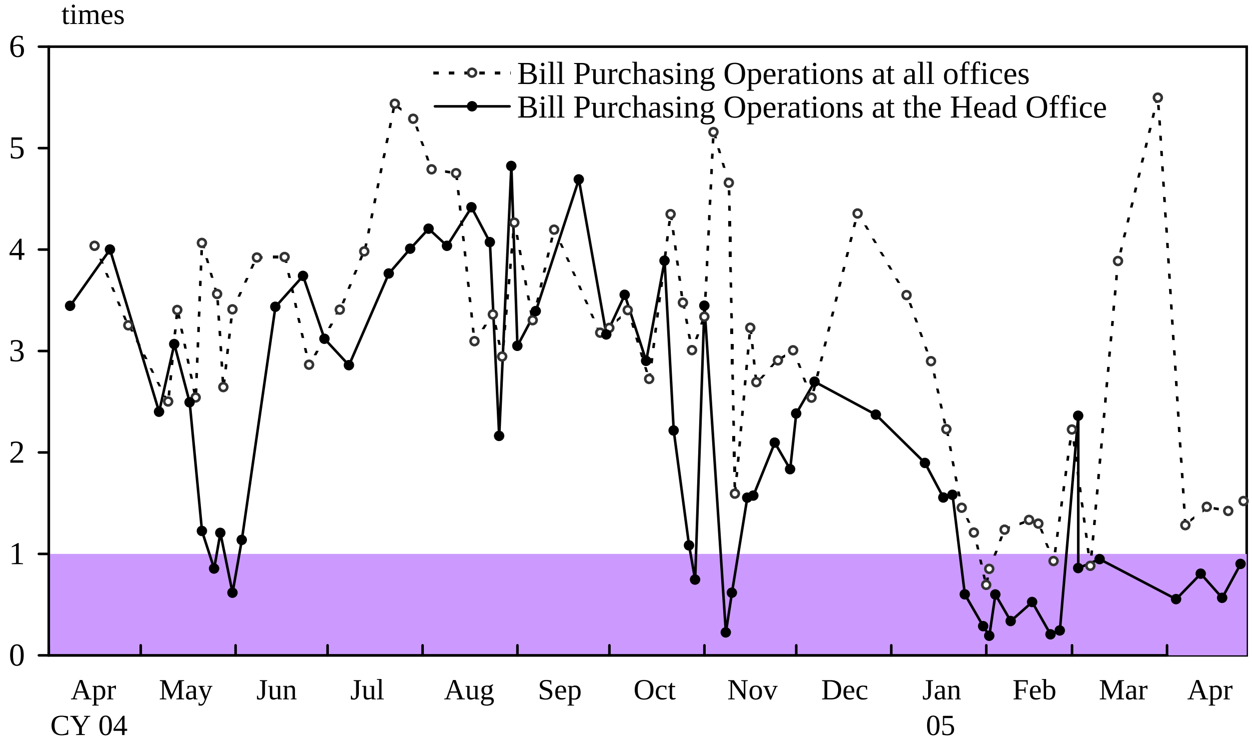
(2) Amount Outstanding of Deposits by Type




Source: Bank of Japan.

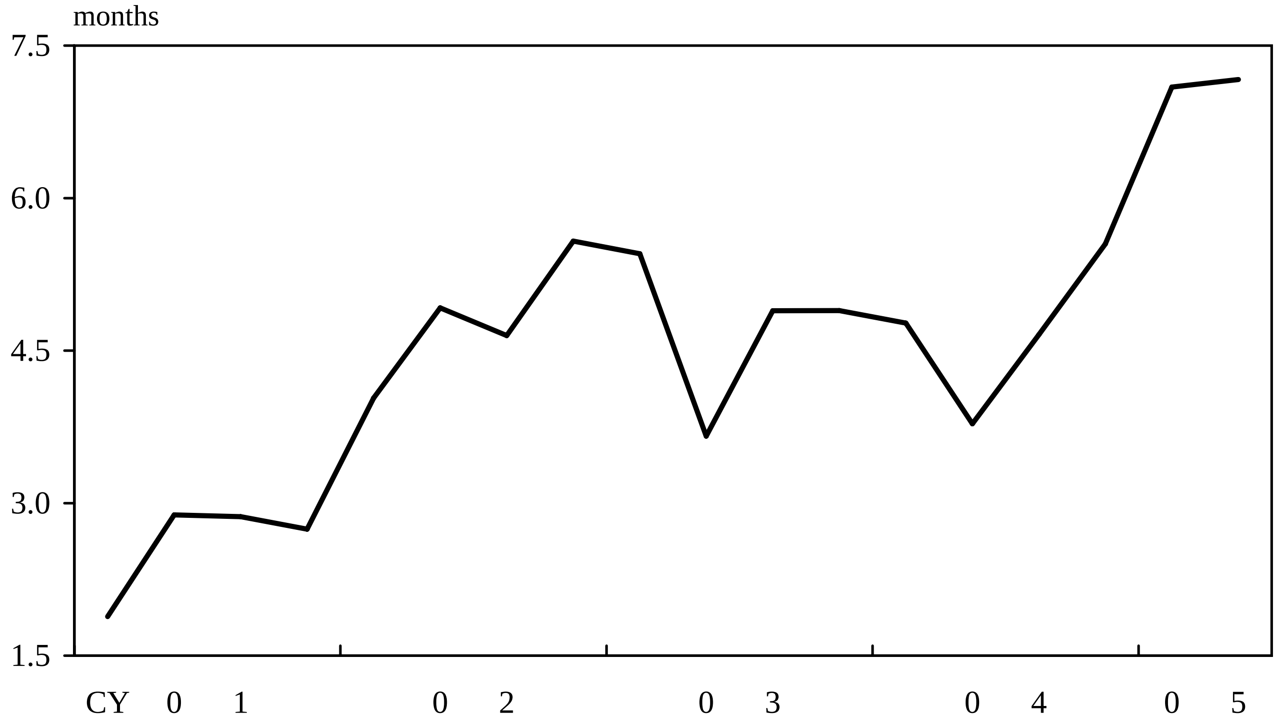
# Funds-Supplying Operations

(1) Bid-to-Cover Ratio (Bill-Purchasing Operations)




Note: Based on the dates of offers.

(2) Maturity of Bill-Purchasing Operations




Note: Figures are the amount-weighted average of the maturities of bill-purchasing operations offered during each quarter.

Source: Bank of Japan.