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Bank of Japan

# **Outlook for Economic Activity and Prices**

October 2005

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

**[The Bank's View]<sup>1</sup>**

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

Japan's economy continues to recover, having emerged from the temporary pause that began in the second half of 2004. Compared with the projection in the April 2005 *Outlook for Economic Activity and Prices* (the April outlook), overall economic activity has been more robust, because higher-than-expected domestic private demand has more than offset slightly lower-than-expected exports. The adjustments in production and inventory in IT-related sectors, which triggered the economy's temporary pause, appear to have run their course.

From the second half of fiscal 2005 through fiscal 2006, Japan's economy is likely to experience a sustained period of expansion at a pace slightly above its potential. This economic outlook rests on the following underlying assumptions and mechanisms. First, exports are likely to remain on the increase reflecting the continuing expansion of overseas economies. Second, the corporate sector is likely to continue to show strength. Corporate profits continue to increase, on top of three consecutive years of growth, and business fixed investment is likely to continue increasing as firms have mostly completed adjustments in excess production capacity and debt. Third, strong corporate performance is positively influencing the household sector via increases in wages and employment, as well as increases in dividends and stock prices. Against this backdrop, private consumption is expected to recover steadily. Finally, the extremely accommodative financial conditions are likely to support private demand. Firms' financing conditions have eased substantially, reflecting financial institutions' more active lending stance and the increased variety of financing channels available to firms. The accommodative financial conditions seem to be contributing to the increases in business fixed investment by small- and medium-sized enterprises (SMEs) and housing investment.

However, firms are still generally cautious in building up stocks of, for example, fixed capital, in view of the protracted period of low economic growth following the bursting of the bubble. While firms are beginning to make more efficient use of cash flow—not only paying off debts but also increasing capital investments and financing strategic

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<sup>1</sup> The text of "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on October 31, 2005.

partnerships—they still appear cautious about accelerating inventory and capital investments in response to increases in sales and production. As a result of such corporate behavior, economic recovery is likely to remain moderate, but at the same time the recovery is likely to be sustained as excessive build-up of stocks is being avoided.

Given this economic outlook, the environment influencing prices is likely to change gradually. The output gap is likely to continue narrowing moderately under the path of economic developments described above. Capacity constraints as perceived by firms in terms of capital stock and employment are currently at the strongest level in more than a decade. The decline in unit labor costs is likely to slow along with increases in wages, despite the fact that the rise in productivity would still tend to hold them down. Meanwhile, firms and households are gradually shifting up their expectations for inflation.

Regarding specific indices for inflation, the domestic corporate goods price index has deviated above the April outlook, recording relatively large increases on a year-on-year basis, due to rising prices of crude oil and other commodities. The index is likely to record a relatively large increase in fiscal 2005 and will probably continue increasing in fiscal 2006, albeit at a slower pace, with a caveat that the actual outcome will depend heavily on developments in crude oil and other commodity markets.

The consumer price index (excluding fresh food, on a nationwide basis) has generally moved in line with the April outlook, declining slightly on a year-on-year basis, reflecting persistent effects of special factors such as the decline in rice prices and the reduction in electricity and telephone charges. As the effects of these factors fall off, the year-on-year changes in the consumer price index will likely turn to zero percent or a slight increase toward the end of 2005. Thereafter, the year-on-year changes are expected to remain positive, in view of the gradually narrowing output gap and the weakening downward pressures from unit labor costs. This means that the year-on-year rate of change in the consumer price index is likely to be around zero percent in fiscal 2005 and a positive figure in fiscal 2006.

#### **(Positive and Negative Deviations)**

The outlook described above rests on the underlying assumptions and mechanisms mentioned earlier. It should be noted that there are following upside and downside risks to the outlook in the coming months.

The first is the path of crude oil prices. Crude oil prices have surged since 2004 and have recently recorded historical highs. One of the primary factors of this surge is increased global demand, reflecting developments such as high growth in emerging economies, and to that extent, high crude oil prices may be compatible with the expansion of the global economy. However, if crude oil prices rise further, due to, for example, supply-side constraints, the global economy may be adversely affected by a decline in real purchasing power in non-oil-producing countries, or rising concerns over increasing inflationary pressures worldwide with a concomitant rise in interest rates.

The second factor is the path of the global economy, including U.S. economic developments. In the United States, inflationary expectations have generally been contained, with the Federal Reserve continuing to raise the federal funds rate target at a measured pace. Financial conditions in the United States have remained accommodative, as evidenced by relatively low and stable long-term interest rates and historically tight credit spreads. The favorable financial conditions have supported buoyant spending by households, as house prices climbed higher. This, in turn, has supported economic expansion. Should this cycle be disrupted, due to, for example, unexpected changes in monetary accommodation in light of rising inflationary expectations, not only growth in the United States would slow, but the global economy could also be adversely affected, perhaps via a shift in the international flow of funds.

In the case of a major external shock, for example, an unexpected slowdown of overseas economies, economic growth in Japan may slow, notwithstanding the recent strength in domestic private demand.

The third factor is the path of domestic private demand. The outlook rests on the assumption that corporate behavior will generally remain cautious. However, firms are increasingly enjoying an improvement in the investment climate, with a high level of return on assets comparable to that recorded during the bubble economy period, and with high capital ratios resulting from repayment of debt and the extremely low cost of corporate debt. Meanwhile, the stimulative effects of low interest rates are being amplified as the economy continues to recover. If firms become more confident about the economic outlook, they may embark on more active investment programs. If there are also stronger positive influences from the corporate sector to households via increases in employee income and dividend payments, household spending may increase. These developments would entail

an acceleration of economic recovery.

As for price developments, there are both upside and downside risks to the outlook. The risks to real economic activity, mentioned above, would correspondingly impact prices, if they ever materialize. In addition, there are risks unique to prices. First is the uncertainty over developments in the prices of crude oil and other commodities. Depending on the direction of their fluctuations, general price levels may deviate either upward or downward. Second, although it appears that the impact of economic activity on prices has recently been weakening, a sustained narrowing of the output gap may cause a greater-than-anticipated increase in inflationary expectations. This can prompt firms to pass increases in costs, including past increases, onto sales prices, thus causing prices to deviate upward. Finally, the intensification of competition among firms, reflecting, for example, further deregulation, may cause downward deviation in prices.

#### **(Conduct of Monetary Policy)**

The Bank has been providing extremely ample liquidity under the quantitative easing policy. The two pillars of the quantitative easing policy are: 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; and 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.

When there were strong concerns over the stability of the financial system, the ample provision of liquidity by the Bank, which met financial institutions' liquidity demand, stabilized financial markets and maintained accommodative financial conditions, and contributed to averting a contraction in economic activity. In financial markets, the Bank's ample provision of liquidity pushed short-term interest rates to practically zero percent. Longer-term interest rates have stably remained at low levels because the commitment by the Bank has led the market to expect that short-term interest rates will remain at zero percent when prices continue to decline slightly. Recently, however, concerns about financial system stability have subsided substantially. At the same time, with more market participants expecting that prices will stop declining and start rising, there is a shortening of the duration of the quantitative easing policy as expected by market participants. As a result, the policy commitment is gradually losing its influence on the

formation of longer-term interest rates. Thus the stimulative effects of the quantitative easing policy on economic activity and prices are increasingly coinciding with the effects of short-term interest rates being at practically zero percent.

In the money market, where the Bank conducts its market operations, precautionary demand for liquidity has declined substantially, reflecting diminishing concerns over financial system stability. When demand for liquidity is extremely weak, measures adopted by the Bank in its market operations may, in some instances, hinder the natural formation of the yield curve and the efficient functioning of markets, even if the measures may enable the Bank to maintain a target balance of current accounts. Taking this into consideration, since May 2005, the Bank has allowed the outstanding balance of current accounts to fall temporarily short of the target range when demand for funds is judged to be extremely weak. Recently, with the improvement in the economic outlook, financial institutions are more actively bidding in the Bank's longer-maturity funds-supplying operations. Consequently, the maturity of funds-supplying operations, which has lengthened substantially since the beginning of 2005, may now be shortened without jeopardizing the Bank's ability to maintain the outstanding balance of current accounts within the target range. These developments are, to some extent, contributing to the reinvigoration of natural mechanisms for price formation in financial markets, which reflect underlying conditions of the economy and prices.

Assuming that developments would follow the projection described in this Outlook Report, the possibility of a departure from the present monetary policy framework is likely to increase over the course of fiscal 2006. Such a change would mean a reduction in the outstanding balance of current accounts toward a level in line with required reserves, and a shift in the main operating target for money market operations from the outstanding balance of current accounts to short-term interest rates. In reducing the outstanding balance of current accounts, the Bank will need to monitor financial market conditions carefully, because the quantitative easing policy has been in place for a long period of time. However, with strengthening expectations that prices will start rising, the effects of the quantitative easing policy are increasingly coinciding with the effects of short-term interest rates being at practically zero percent. Thus a change of the policy framework itself does not imply an abrupt change in terms of effects of policy. Conceptually, the course of monetary policy after the change of the framework will be a period of very low short-term interest rates followed by a gradual adjustment to a level consistent with economic activity and price developments.

The change of the policy framework as well as the level and time-path of short-term interest rates thereafter will depend on future developments in economic activity and prices as well as financial conditions. If it is judged that upward pressure on prices continues to be contained and the economy follows a sustainable and balanced growth path, this is likely to give the Bank latitude in conducting monetary policy through the entire process.

Given that the change of the current policy framework, as with the introduction of the quantitative easing policy, is unprecedented, it is essential to ensure that financial markets are able to perform pricing function smoothly, reflecting underlying conditions of the economy and prices. In order to realize sustainable economic growth and stable prices, the Bank will clearly explain its assessment of economic activity and prices as well as the thinking behind the conduct of monetary policy, and will endeavor to stabilize market expectations, while taking measures in an appropriate and timely manner in response to economic and financial developments.

### Forecasts of the Majority of Policy Board Members<sup>2,3</sup>

y/y % chg.

	Real GDP	Domestic CGPI	CPI (excluding fresh food)
Fiscal 2005	+2.2 to +2.5 [+2.2]	+1.6 to +1.8 [+1.7]	0.0 to +0.1 [+0.1]
Forecasts made in April 2005	+1.2 to +1.6 [+1.3]	+0.8 to +1.0 [+0.8]	-0.1 to +0.1 [-0.1]
Fiscal 2006	+1.6 to +2.2 [+1.8]	+0.5 to +0.8 [+0.6]	+0.4 to +0.6 [+0.5]
Forecasts made in April 2005	+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. The forecasts of Policy Board members are based on the assumption that there will be no change in monetary policy.

<sup>2</sup> 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.

<sup>3</sup> The forecasts of all Policy Board members are as follows.

y/y % chg.

	Real GDP	Domestic CGPI	CPI (excluding fresh food)
Fiscal 2005	+2.0 to +2.7	+1.6 to +2.0	0.0 to +0.1
Forecasts made in April 2005	+1.1 to +1.8	+0.7 to +1.0	-0.1 to +0.1
Fiscal 2006	+1.3 to +2.4	+0.4 to +1.0	+0.4 to +0.6
Forecasts made in April 2005	+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 the First Half of Fiscal 2005)

Japan's economy continued to recover, having emerged from the temporary pause that began in the second half of 2004. Growth in exports, particularly those to China, slowed temporarily, but with continued expansion of overseas economies, exports eventually increased moderately reflecting the completion of adjustments in IT-related sectors and the recovery in exports to China (Charts 1 and 2). Industrial production was on an uptrend with some fluctuations as adjustments progressed in production and inventory in IT-related sectors (Chart 3).<sup>4</sup> Despite the surge in energy and raw materials prices, in particular crude oil prices, corporate profits remained at high levels, reflecting increasing domestic and external demand.<sup>5</sup> The ratio of current profits to sales for large firms has already exceeded the peak recorded at the end of the 1980s during the bubble economy period and the ratio for small firms has been around the two peaks marked after the bursting of the bubble (Chart 4[1]). Business sentiment, which was slightly cautious in the second half of 2004, has recovered moderately since the start of 2005 albeit with differences between industries, firms of various sizes, and areas (Chart 5[2]).

In this situation, business fixed investment continued increasing partly due to the fact that firms have mostly completed adjustments in excess production capacity and debt (Chart 6). As for the employment situation, the *Tankan* (Short-Term Economic Survey of Enterprises in Japan) headline diffusion index for employment conditions indicated that the number of firms perceiving their holdings of labor as insufficient slightly exceeded the number perceiving them as excessive, and the number of regular employees continued to rise at a moderate pace (Chart 7[1]). A breakdown by type of employee showed that, whereas the

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<sup>4</sup> Industrial production has shown large fluctuations, increasing substantially in the January–March quarter of 2005 and decreasing in the April–June and July–September quarters. This has been mainly due to anomalous statistical fluctuations in the figures for steel ships and drugs. Production, after adjustment for the effects of these fluctuations, has been increasing relatively steadily albeit at a moderate pace.

<sup>5</sup> A breakdown of factors behind recent developments in large manufacturers' corporate profits showed that the "price factor" was placing downward pressure on them, reflecting the rise in input prices, particularly crude oil prices. On the other hand, the "quantity factor" was acting largely as upward pressure. This quantity factor is broadly defined and includes not only an increase in the volume of products sold but also development of high value-added products and cutting down on the amount of raw materials inputted (Chart 4[2]).

pace of increase in the number of part-time employees decelerated, the number of full-time employees started to increase year on year from the beginning of 2005 (Chart 7[2]). Regular compensation started to increase very slightly partly due to a deceleration in the pace of increase in the number of part-time employees, whose wages are lower than those of full-time employees. Summer bonuses in 2005 rose, as did winter bonuses in 2004, reflecting high corporate profits. As a result, employee income was on a moderate uptrend (Chart 7[3]). With strong corporate performance positively influencing the household sector, private consumption remained steady with some fluctuations (Chart 8). Meanwhile, housing investment, particularly in housing for sale and for rent, has shown some increases. On the other hand, public investment was basically on a downtrend, although there were underpinning factors such as an increase in construction following natural disasters.

On the price front, as the output gap continued narrowing moderately, the year-on-year rate of increase in domestic corporate goods prices continued to be 1–2 percent partly due to the rise in crude oil prices and other commodity prices (Chart 9[1]). The consumer price index (excluding fresh food, on a nationwide basis), however, declined slightly overall, despite the fact that the output gap continued narrowing moderately and prices of petroleum products such as gasoline rose (Chart 9[3]). This was because there was still downward pressure on the index from special factors that persisted since the end of 2004, such as the decline in rice prices and the reduction in electricity and telephone charges.

In the April Outlook Report, the Bank's outlook for economic activity in fiscal 2005 was: "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." In comparison with this outlook, overall economic activity has been more robust because higher-than-expected domestic private demand components, such as private consumption and business fixed investment, have more than offset slightly lower-than-expected exports, particularly to China. As for prices, domestic corporate goods prices deviated above the April outlook, mainly due to higher-than-expected crude oil prices. Consumer prices, on the other hand, generally moved in line with the April outlook, although the effects of high crude oil prices were slightly larger than expected.

### **(Outlook for Economic Activity through Fiscal 2006)**

From the second half of fiscal 2005 through fiscal 2006, Japan's economy is likely to

experience a sustained period of expansion at a pace slightly above its potential. Since growth in the first half of fiscal 2005 seems to have been relatively high, the growth rate for the whole of the fiscal year is expected to be slightly above 2.0 percent. The growth rate in fiscal 2006 is expected to be 1.5–2.0 percent, continuing to exceed the potential growth rate.<sup>6</sup>

This economic outlook rests on the following underlying assumptions and mechanisms: that overseas economies continue to expand; that the corporate sector continues to show strength despite high crude oil prices; that strong corporate performance continues to positively influence the household sector; and that the extremely accommodative financial conditions support private demand.

Overseas economies, particularly the U.S. economy and East Asian economies, are expected to remain on an expansionary trend. Although the growth of the U.S. economy is expected to slow temporarily due to the effects of the hurricanes, it is expected to basically continue to expand at a pace around its potential growth rate, because private consumption and business fixed investment are likely to grow steadily and there is likely to be reconstruction-related demand. As for the Chinese economy, with its continued high growth, the pressure on firms to cut down on inventories and restrain investments is likely to gradually diminish. Against this backdrop, Japanese exports are likely to remain on the increase.

Following the completion of inventory adjustments in IT-related sectors, industrial production is likely to continue increasing, reflecting the continued increase in exports and the solid basis for recovery in domestic demand. In materials industries such as iron and steel, chemicals, and paper and pulp, there have been recent inventory adjustments, particularly in general-purpose goods. However, given that these adjustments are small as a whole and demand for high value-added products is strong, the effects of inventory

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<sup>6</sup> Bearing in mind that a certain margin of error should be allowed for when estimating the potential growth rate, the Bank estimated it by the following method. Output is determined via an aggregate production function made up of the following three variables: (1) the capital input, or the amount of the available capital stock actually being used; (2) the labor input, defined as the number of workers multiplied by the number of hours worked; and (3) total factor productivity (TFP), which captures the efficiency with which GDP is produced. Potential output, defined as the level of economic activity that would be reached assuming that labor and capital resources are used to their fullest potential within the existing economic structure, is obtained from the interrelations between these variables. The annual rate of change in potential output, that is the potential growth rate, for Japan's economy is estimated to be approximately 1 percent. For details, refer to the Bank's research paper "The Output Gap and the Potential Growth Rate" released in May 2003.

adjustments on overall production seem likely to be limited.

Corporate profits are likely to remain at high levels, despite the upward pressure on costs from increased prices of crude oil and other commodities. This is because in addition to diversification in terms of the types of energy used and changes in the industrial structure, firms are making efforts to develop high value-added products and services and to cut down on the amount of raw materials inputted, and profits received from overseas affiliates are increasing.<sup>7</sup> These high levels of corporate profits or of cash flow may cushion external shocks.

With generally favorable conditions for corporate profits being maintained, firms have almost resolved the excess in production capacity, employment, and debt that has been a burden on the corporate sector since the bursting of the bubble. In addition, with increasing pressures from the stock market to raise corporate value, firms are beginning to make more efficient use of cash flow by not only paying off debts but also increasing capital investments and financing strategic partnerships (Box). Considering these factors, business fixed investment is likely to continue increasing steadily.

Employee income is likely to increase moderately as the number of employees and wages both increase with the continued improvement in supply and demand conditions in the labor market. Although the burden of taxes and social security on households is expected to increase in the near future, private consumption is expected to continue to recover steadily albeit at a moderate pace.<sup>8</sup> This is because positive influences from the corporate sector to the household sector are expected to continue via increases not only in employee income but also in dividend payments and stock prices, underpinning consumer sentiment.

Given the situation described above, Japan's economy is likely to continue recovering steadily, but the pace of recovery is unlikely to accelerate conspicuously for the time being. Firms are still generally cautious, although they are becoming more active than before.

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<sup>7</sup> By analyzing recent developments in corporate profits with information obtained from the *Financial Statements Statistics of Corporations by Industry*, increases have been confirmed in both "interests received," which includes dividend payments from affiliates, and "other non-operating revenue," which includes technical assistance fees, and royalties and license fees. One of the factors behind these increases is the fact that firms, particularly manufacturers, have been further expanding their overseas business in the past several years, and this development seems to have brought profits to the parent firms, with a slight time lag.

<sup>8</sup> In the period through fiscal 2006, the across-the-board tax credit is expected to be reduced, and premiums for social security such as those for pension insurance and nursing insurance are expected to rise.

Improvement in business sentiment is only moderate relative to firms' profits (Charts 4 and 5). Business fixed investment is increasing steadily but is still being significantly restrained relative to the level of cash flow (Chart 10[1]). As for the employment situation, the ratio of part-time to regular employees has clearly peaked out, reflecting the fact that firms have been reducing their emphasis on restraining labor costs. However, firms continue to convert part of their fixed labor costs into variable costs by increasing the number of dispatched workers (Chart 10[2]). As a result of such corporate behavior, the economic recovery is likely to remain moderate, but at the same time the recovery is likely to be sustained as excessive build-up of stocks is being avoided.

### **(Outlook for Prices through Fiscal 2006)**

Given this economic outlook, the environment influencing prices is likely to change gradually. The output gap is likely to continue narrowing moderately, as the economy continues to recover at a pace slightly above its potential (Chart 11).<sup>9</sup> Prices of raw materials, such as crude oil and other commodities, are generally expected to remain at high levels (Chart 12). The decline in unit labor costs (labor costs per unit of output) is likely to slow along with the increases in wages, despite the fact that the rise in productivity would still tend to hold them down (Chart 10[3]). As for firms' and households' expectations regarding prices, their inflationary expectations are increasing, as deflationary expectations are generally dissipating after being strong in 2001 through 2002 (Chart 13). These various factors are likely to cause price changes to become positive on a year-on-year basis.

However, the output gap is likely to narrow only moderately. Unit labor costs are unlikely to start to show a clear increase in the near future with firms' spending cautious. Intense competition in the consumer goods market is likely to continue for a while.

Against this backdrop, domestic corporate goods prices in fiscal 2005 are likely to increase by 1–2 percent as a whole reflecting high crude oil prices to date. Although domestic

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<sup>9</sup> The diffusion index for production capacity (based on all industries and firm sizes) in the September *Tankan* indicated that the gap between the number of firms perceiving "excessive capacity" and the number perceiving "insufficient capacity" has declined considerably and the figure showed the former exceeding the latter by only 2 percentage points. The diffusion index for employment conditions (based on all industries and firm sizes) indicated that the number of firms perceiving their holdings of labor as insufficient slightly exceeded the number perceiving them as excessive and the figure showed the former exceeding the latter by 2 percentage points. As a result, the weighted average of these indexes, where the weights are the capital and labor income shares in the national accounts, showed that excessiveness had dissolved, with this measure reaching a level last recorded in the early 1990s (Chart 11[1]).

corporate goods prices will depend heavily on developments in commodity markets, they are likely to continue increasing slightly in fiscal 2006 as the output gap is likely to continue narrowing and the rise in crude oil prices is likely to be passed on in domestic corporate goods prices to a moderate extent. For the rest of fiscal 2005, the year-on-year changes in the consumer price index (excluding fresh food, on a nationwide basis) will likely turn to zero percent or a slight increase toward the end of 2005, and the index is projected to increase at a faster pace in the January–March quarter of 2006. These developments in prices are due to the following: upward pressure from the rise in petroleum products is likely to continue for the time being, while downward pressure from the decline in rice prices and the reduction in electricity and telephone charges is likely to subside. This outlook is based on the assumptions that crude oil prices are likely to stop rising and upward pressure from the rise in petroleum products is likely to weaken gradually. Even with these assumptions, as the output gap continues narrowing moderately and the pace of decline in unit labor costs slows, the year-on-year changes in the consumer price index are expected to remain positive. On average, the year-on-year rate of change in the consumer price index is likely to be around zero percent in fiscal 2005 and a positive figure in fiscal 2006.<sup>10</sup>

#### **(Monetary and Financial Developments)**

Accommodative monetary conditions are likely to be maintained as financial institutions' lending attitude continues to be positive under an increasingly stable financial system. In the meantime, corporate financing needs have not increased conspicuously, in view of ample cash flow from high profits. Firms continue to restructure their balance sheets making use of cash flow to pay off their debts, although such efforts have lately become considerably less noticeable. In this environment, the increase in bank lending is likely to be only moderate for the time being.

Meanwhile, as concerns over financial system stability have receded substantially,

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<sup>10</sup> This outlook for consumer prices is based on the 2000 based CPI. The base year for the CPI will be revised to 2005 in August 2006, and year-on-year figures back as far as January 2006 will be revised retroactively. The year-on-year rate of increase in consumer prices based on the 2005 based CPI is likely to be revised slightly downward from that obtained using the current 2000 based CPI. The extent of downward revision for the year-on-year rate is not clear yet because the specifics of the 2005 based CPI have not been announced, but the revision is not likely to be as large as the 0.26 percentage point decline which was the extent of the revision in consumer prices when the base year was changed from 1995 to 2000 and new items such as personal computers were covered.

households and firms have become increasingly interested in holding financial assets other than bank deposits. Financial institutions, in order to enhance their profitability, are adopting business strategies of offering services tailored to specific needs of their customers, by providing products other than deposits, for example selling investment trusts at bank counters. These developments are likely to cause a shift of funds from bank deposits to financial assets such as investment trusts and Japanese government bonds specifically designed for individual investors. Based on the business strategy of financial institutions and the asset allocation by households and firms, the growth rate of the money stock ( $M_2$ +CDs), which has been exceeding that of nominal GDP in recent years, is unlikely to accelerate conspicuously for the time being although the economy is expanding at a rate faster than its potential growth rate.

## **2. Positive and Negative Deviations**

The outlook described above rests on the underlying assumptions and mechanisms mentioned earlier. It should be noted that there are following upside and downside risks to the outlook in the coming months.

### **(Developments in Crude Oil Prices)**

Crude oil prices have surged since 2004, reflecting expectations of expanding global demand, and have recently recorded historical highs. In the outlook, crude oil prices are expected to remain generally at around the present high levels.

The rise in crude oil prices risks a slowdown of the global economy through a decline in real purchasing power in non-oil-producing countries, but the global economy has been expanding steadily and this risk has hardly materialized. The reasons for this are as follows. First, one of the primary factors of this surge is increased global demand, reflecting developments such as high growth in emerging economies, and there is little influence from supply-side constraints. Second, the rise in crude oil prices means transfers of income to oil-producing countries. This will increase their real purchasing power, and eventually exports of non-oil-producing countries. Finally, the rise in crude oil prices has not shifted the trend of consumer prices upward or engendered inflationary expectations. Thus monetary policy has not been tightened aggressively.

If crude oil prices rise further, due to, for example, supply-side constraints, the above

situation may change. The global economy may be adversely affected by a decline in real purchasing power in non-oil-producing countries, or rising concerns over increasing inflationary pressures worldwide with a concomitant rise in interest rates.

### **(Developments in Overseas Economies)**

In the U.S. economy and other advanced economies, the accommodative financial conditions are being maintained partly due to the appropriate conduct of monetary policy. In the outlook, it is assumed that such financial conditions will continue.

The accommodative financial conditions in advanced economies together with the rise in asset prices seem to be underpinning spending by firms and households. In the United States, inflationary expectations have generally been contained, with the Federal Reserve continuing to raise the federal funds rate target at a measured pace amounting to 2.75 percentage points in total. Financial conditions in the United States have remained accommodative, as evidenced by relatively low and stable long-term interest rates and historically tight credit spreads. The favorable financial conditions have supported buoyant spending by households, as house prices climbed higher. This, in turn, has supported economic expansion.

However, there is no guarantee for the sustainability of the current environment in advanced economies, where long-term interest rates remain at low levels alongside continued economic expansion. Should this cycle be disrupted, due to, for example, unexpected changes in monetary accommodation in light of rising inflationary expectations, not only growth in advanced economies would slow, but the global economy could also be adversely affected, perhaps via a shift in the international flow of funds.

In the case of a major external shock, for example, an unexpected slowdown of overseas economies, economic growth in Japan may slow, notwithstanding the recent strength in domestic private demand.

### **(Developments in Domestic Private Demand)**

As described earlier, firms are beginning to make more efficient use of cash flow. They are not only paying off debts, but are also increasing capital investments, financing strategic partnerships, and increasing outlays for research and development, in order to increase



corporate value. Nevertheless, they still appear cautious about accelerating inventory and capital investments in response to increases in sales and production. The outlook is based on the assumption that firms will remain cautious about increasing spending for the time being.

However, firms are increasingly enjoying an improvement in the investment climate, with a high level of return on assets comparable to that recorded during the bubble economy period, and with high capital ratios resulting from repayment of debt and the extremely low cost of corporate debt. Meanwhile, the stimulative effects of low interest rates are being amplified as the economy continues to recover. If firms become more confident about the economic outlook, they may embark on more active investment programs. A high level of cash flow may prompt firms to increase the number of employees and wages, to conduct share buybacks, or increase dividend payments. If there are also stronger positive influences from the corporate sector to households via increases in employee income and dividend payments, household spending may increase. These developments would entail an acceleration of economic recovery.

### **(Developments in Prices)**

As for price developments, there are both upside and downside risks to the outlook. The risks to real economic activity, mentioned above, would correspondingly impact prices, if they ever materialize. In addition, there are risks unique to prices. First is the uncertainty over developments in the prices of crude oil and other commodities. Depending on the direction of their fluctuations, general price levels may deviate either upward or downward. Second, although it appears that the impact of economic activity on prices has recently been weakening, a sustained narrowing of the output gap may cause a greater-than-anticipated increase in inflationary expectations. This can prompt firms to pass increases in costs, including past increases, onto sales prices, thus causing prices to deviate upward. Finally, the intensification of competition among firms, reflecting, for example, further deregulation, may cause downward deviation in prices.

### **3. Evaluation of the Financial Environment**

Since the adoption of the quantitative easing policy in March 2001, the Bank has gradually raised the target balance of current accounts, taking due account of financial and economic

developments.<sup>11</sup> Currently, even as the demand for liquidity from financial institutions has weakened reflecting receding concerns over the stability of the financial system, the Bank continues to make a full effort in providing funds, while giving due consideration to the effects on the functioning of the markets. The outstanding balance of current accounts at the Bank has generally been around 30–35 trillion yen, which substantially exceeds the amount of required reserves of about 6 trillion yen (Chart 14[1]).<sup>12</sup>

Short-term interest rates, including fixed-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[1]). A more detailed look reveals that TB rates, particularly those maturing beyond the end of March 2006, are rising somewhat, reflecting improvements in economic outlook and the ensuing strengthening of market expectations regarding the end of the quantitative easing policy. The level of real short-term interest rates, calculated by subtracting fluctuations in prices from nominal short-term interest rates, has declined. Together with improvements in corporate profitability, this decline appears to have strengthened the stimulative effects of monetary easing on economic activity (Chart 15[2]). Long-term interest rates generally remain stable, in light of price developments, although they have shown slight rises very recently, reflecting improvements in the economic outlook (Chart 16).

Credit spreads between short-term government securities and CP have been stable at low levels. Credit spreads between long-term government bonds and corporate bonds have also been at low levels against the backdrop of increased demand for corporate bonds from investors, who have few attractive investment alternatives (Chart 17).

Banks' lending attitude is becoming more positive and this is confirmed in the survey of borrower firms. Firms' perception of the availability of financing has been on an improving trend, reflecting the improvement in their cash flows and financial institutions'

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<sup>11</sup> The current guideline for money market operations is as follows: "The Bank of Japan will conduct money market operations, aiming at the outstanding balance of current accounts held at the Bank at around 30 to 35 trillion yen. 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. When it is judged that liquidity demand is exceptionally weak considering such factors as responses of financial institutions to the Bank's funds-supplying operations, there may be cases where the balance of current accounts falls short of the target."

<sup>12</sup> At the Monetary Policy Meeting on May 19 and 20, 2005, the following sentence was added to the guideline for money market operations: "When it is judged that liquidity demand is exceptionally weak considering such factors as responses of financial institutions to the Bank's funds-supplying operations, there may be cases where the balance of current accounts falls short of the target." After the meeting in May, the outstanding balance of current accounts actually fell short of 30 trillion yen on the following six business days: June 2 and 3; July 29; and August 3, 4, and 5.

lending attitude (Chart 18). In this environment, bank lending has been decreasing. Bank lending, excluding the effects of marketing of loan assets and disposal of nonperforming loans, declined continuously from October 1998 when figures started to be released, but it has been increasing on a year-on-year basis since August 2005 (Chart 19[1]). The money stock ( $M_2$ +CDs) is increasing by around 2 percent year on year recently. The level of the money stock compared with economic activity (nominal GDP) remains extremely high (Chart 19[2]).

The monetary base (the sum of currency in circulation and current account balances held at the Bank) has recently been increasing by 1–2 percent year on year, partly because the growth rate of banknotes in circulation, which makes up almost 70 percent of the monetary base, has been slowing against the backdrop of receding concerns about financial system stability (Chart 20). The Bank's balance sheet at the end of fiscal 2004 compared with the end of fiscal 2000, soon after it adopted the quantitative easing policy, has increased by about 35 trillion yen, from about 115 to 150 trillion yen (Chart 14[2]).

Stock prices declined slightly in the early spring of 2005, as cautious views on the global economic outlook emerged along with the surge in crude oil prices. However, stock prices remain on an uptrend, led by firms in industries related to domestic demand and banks, reflecting stronger interest from foreign investors as well as the expansionary trend of the global economy and the strength in Japanese corporate profits (Chart 21).

The yen continued to depreciate against the U.S. dollar, in spite of the more positive outlook for the Japanese economy, factoring in expectations of widening interest rate differentials between Japan and the United States. Recently, the yen has been traded in the range of 113–116 yen against the U.S. dollar (Chart 22[1]). The real effective exchange rate has generally been stable (Chart 22[3]).<sup>13</sup>

The rate of decline slowed for the price of land in both residential and commercial areas, reflecting the progress in adjustments since the bursting of the bubble (Chart 23). According to the *Prefectural Land Price Survey* in 2005, which indicates land prices at representative locations surveyed as of July 1, 2005, land prices in the 23 wards of Tokyo increased on a year-on-year basis for the first time since 1990, and the rate of decline in

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<sup>13</sup> 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.

land prices in the three major metropolitan areas has slowed substantially. In other areas, the slowing was less noticeable. The decline in the weighted averages of published land prices is generally coming to a halt.<sup>14</sup> Meanwhile, in the rental market for office space, the vacancy rate has been on a downtrend and the decline in rent is coming to a halt.

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<sup>14</sup> The weighted averages of published land prices are the rates of change in published land prices per square meter at individual locations surveyed as of January 1, 2005, weighted by the value of land (published land prices multiplied by the area of the land) in the previous year.

**(BOX) Changes in Corporate Behavior as Seen from Cash Flow<sup>15</sup>**

Looking at recent corporate behavior from the perspective of cash flow, changes are becoming evident, although there are slight variations between firms with different credit ratings. There is a general tendency to increase investments that will bring in future profits and to return surplus cash to shareholders, in contrast to the past emphasis on reducing interest-bearing liabilities from their balance sheets and lowering the ratio of liabilities to capital.

According to listed firms' consolidated cash flow statements for fiscal 2004, operating cash flow was unchanged from the previous year. Although profits before taxes continued to increase, the pickup in corporate activity resulted in an offsetting increase in working capital (classified as "others," and declining up until the previous year). Investing cash flow increased conspicuously, reflecting developments such as increasing business fixed investment. As a result, the surplus of operating cash flow over investing cash flow narrowed slightly. A breakdown of financing cash flow, which captures changes in firms' financing activities in relation to its financial surplus, indicated that the net repayment of interest-bearing liabilities had declined and that returns of surplus cash to shareholders through share buybacks or dividend payments were increasing (Box Chart 1).

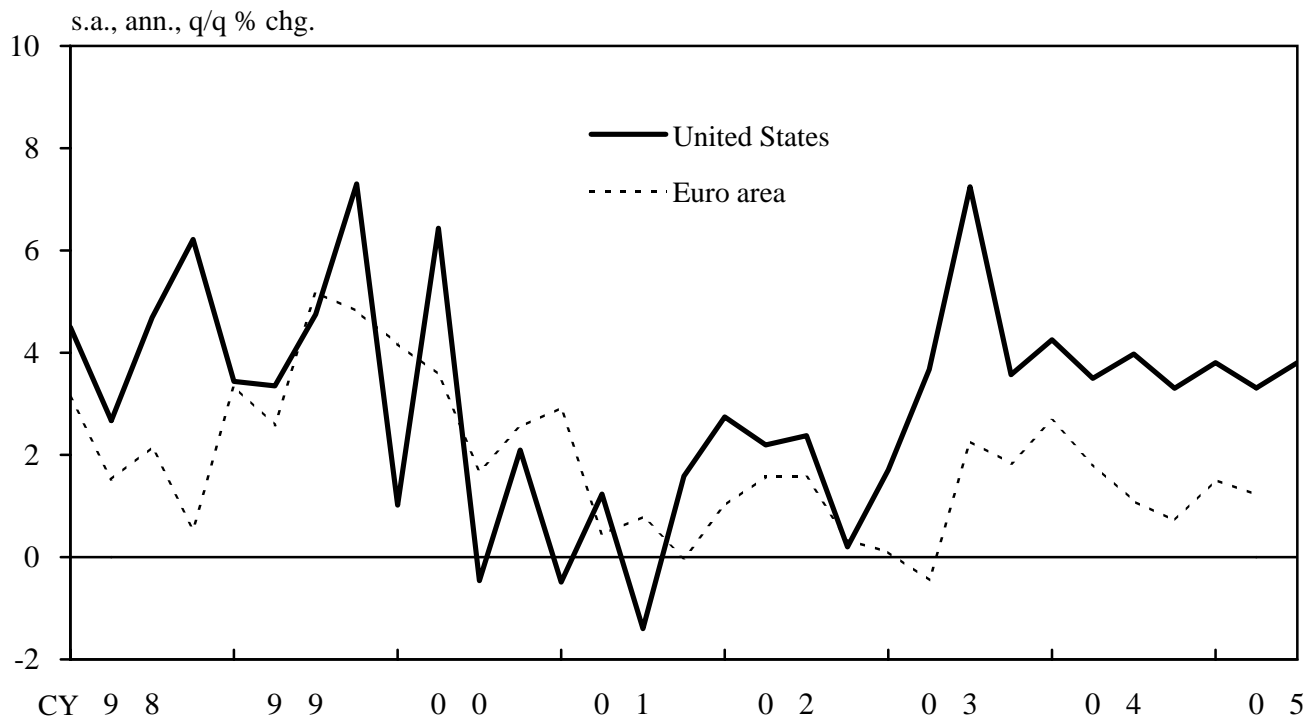
Looking at financing cash flow according to firms' credit ratings, it was revealed that BBB rated firms, which are regarded as barely investment grade, used more than 60 percent of operating cash flow to repay their interest-bearing liabilities. On the other hand, at firms with an A rating, the net repayment of interest-bearing liabilities decreased in fiscal 2004, and a greater proportion of increased profits were spent for investment. Firms with an AA or AAA rating are returning more surplus cash to shareholders and at the same time they have also been starting to record net borrowing of interest-bearing liabilities since fiscal 2003. This means that financing activities at some firms are beginning to result in increased leverage (i.e., debt-equity ratio) (Box Chart 2).

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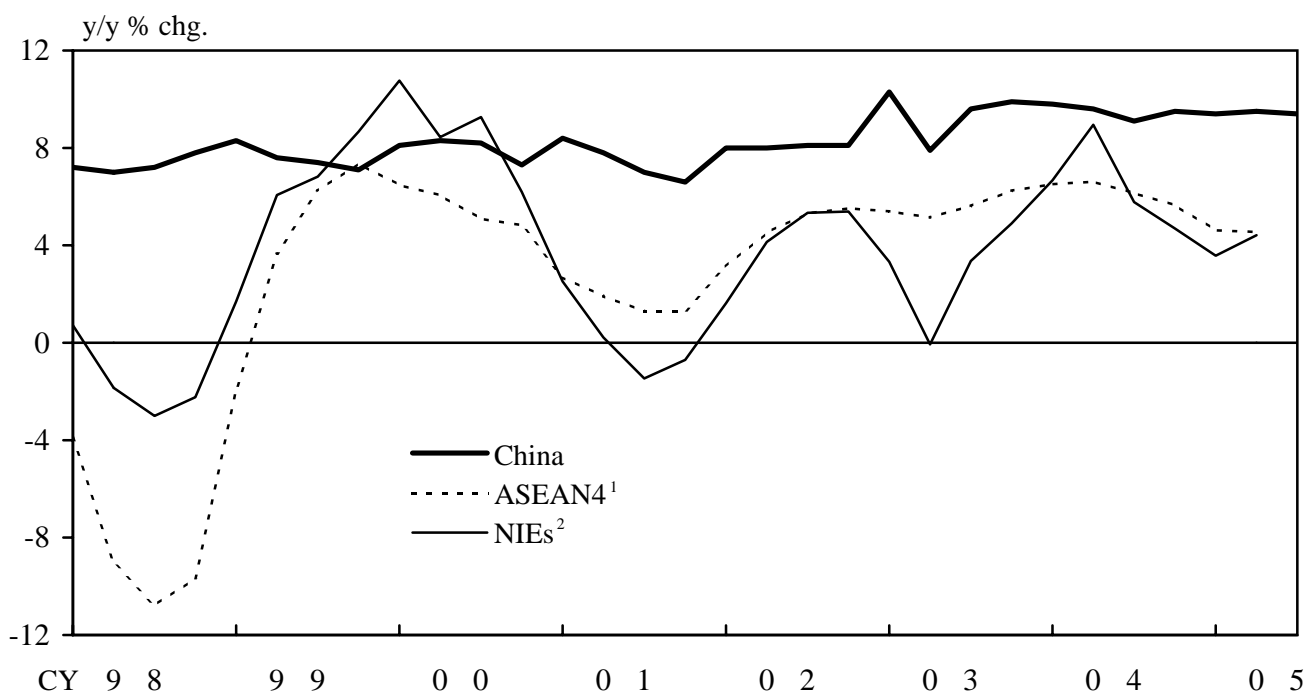
<sup>15</sup> For details, refer to the Bank's forthcoming research paper "The Improvement in Corporate Earnings and Its Implications for the Japanese Economy."

## Real GDP Growth Rates in Overseas Economies

### (1) Real GDP Growth Rates in Advanced Economies



### (2) Real GDP Growth Rates in East Asian Economies



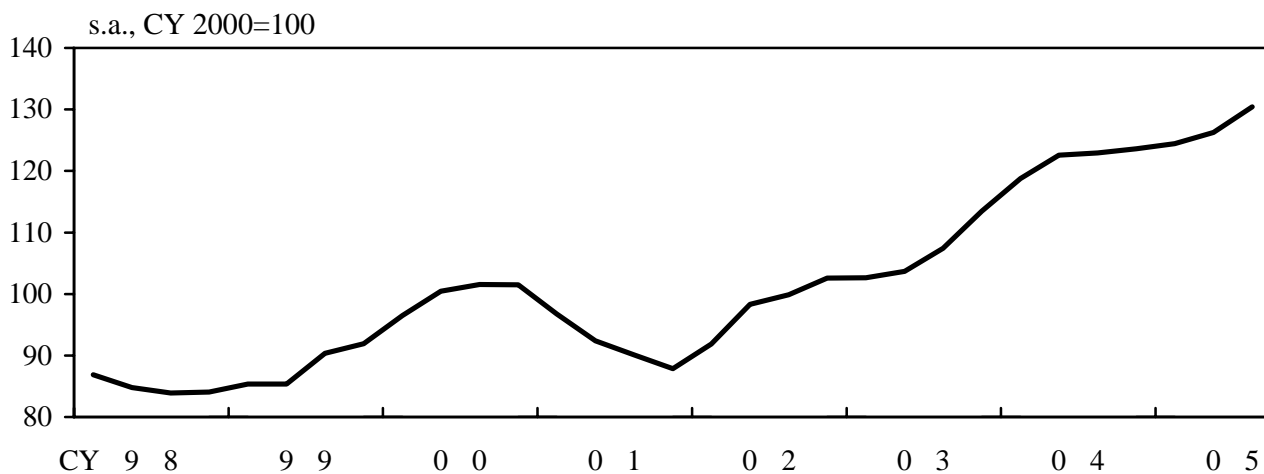
Notes: 1. Data for ASEAN4: Thailand, Malaysia, the Philippines, and Indonesia.

2. Data for NIEs: South Korea, Taiwan, Hong Kong, and Singapore.

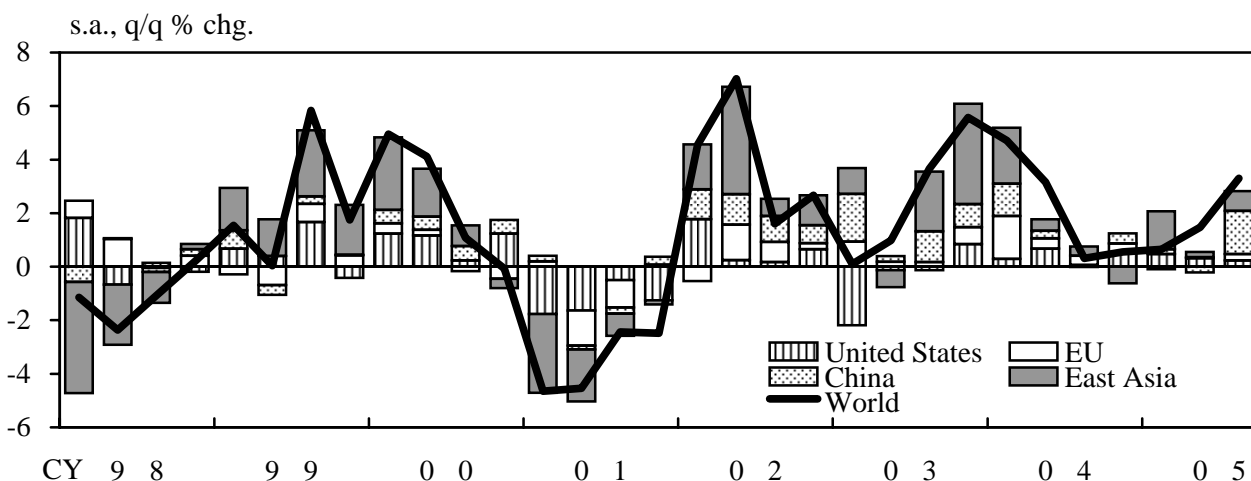
Sources: National governments; central banks; European Commission.

## Exports

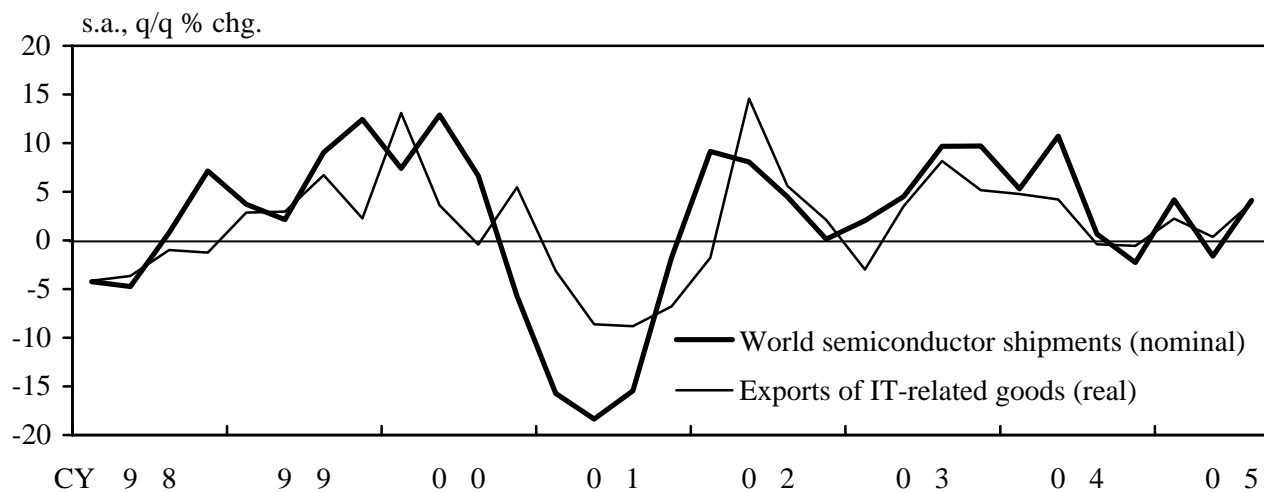
(1) Real Exports



(2) Real Exports (Breakdown by Region)



(3) World Semiconductor Shipments and Exports of IT-Related Goods

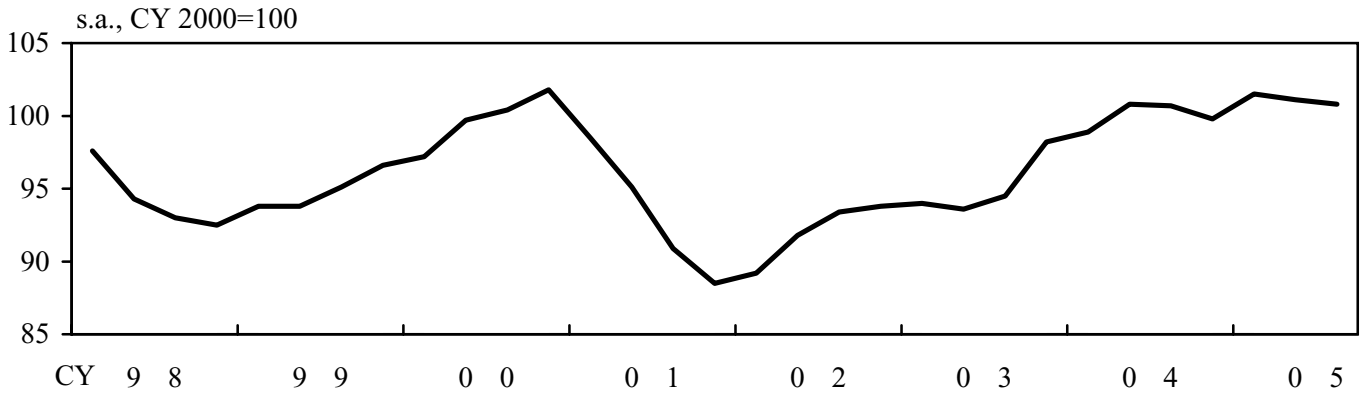


Sources: Ministry of Finance, "The Summary Report on Trade of Japan";

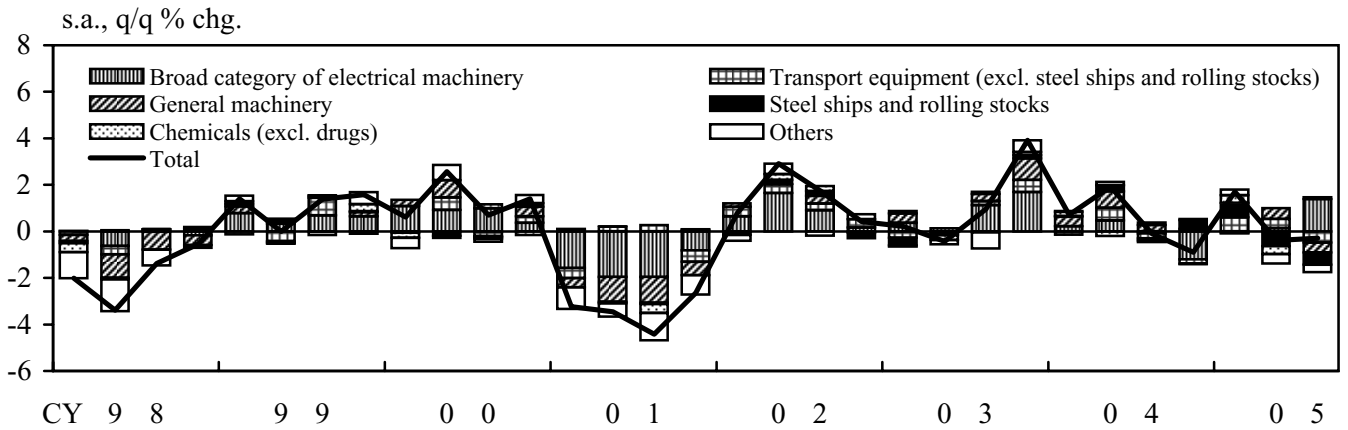
Bank of Japan, "Corporate Goods Price Index"; World Semiconductor Trade Statistics (WSTS).

# Production

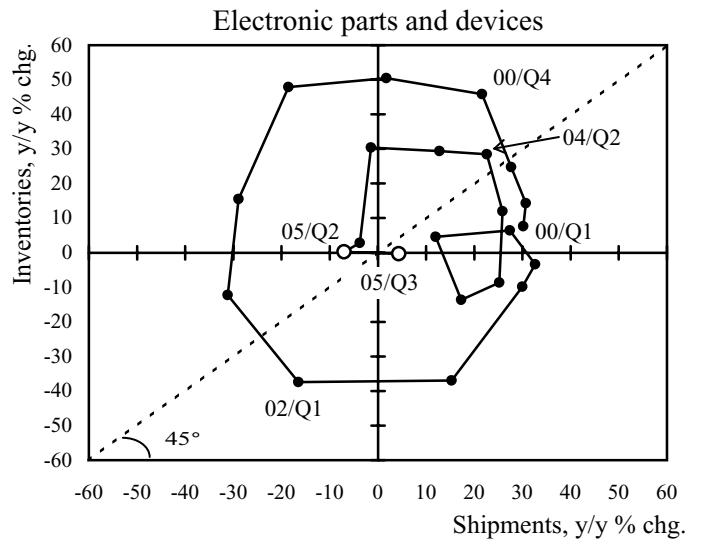
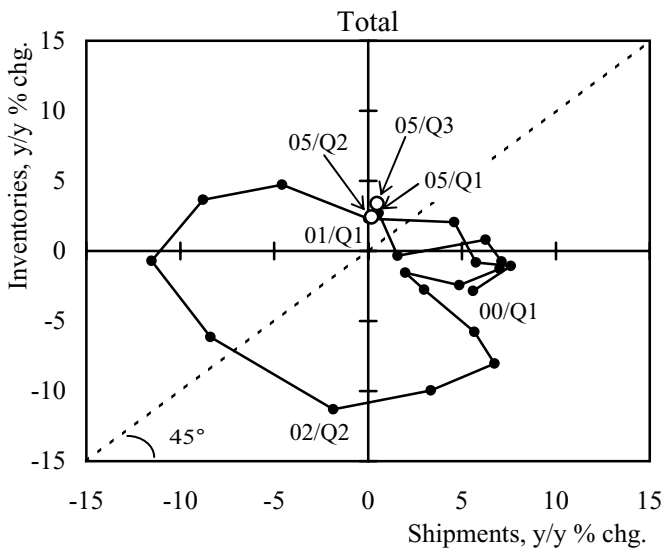
(1) Production



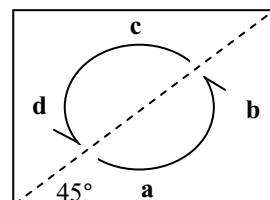
(2) Production (Breakdown by Industry)



(3) Inventory Cycle



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

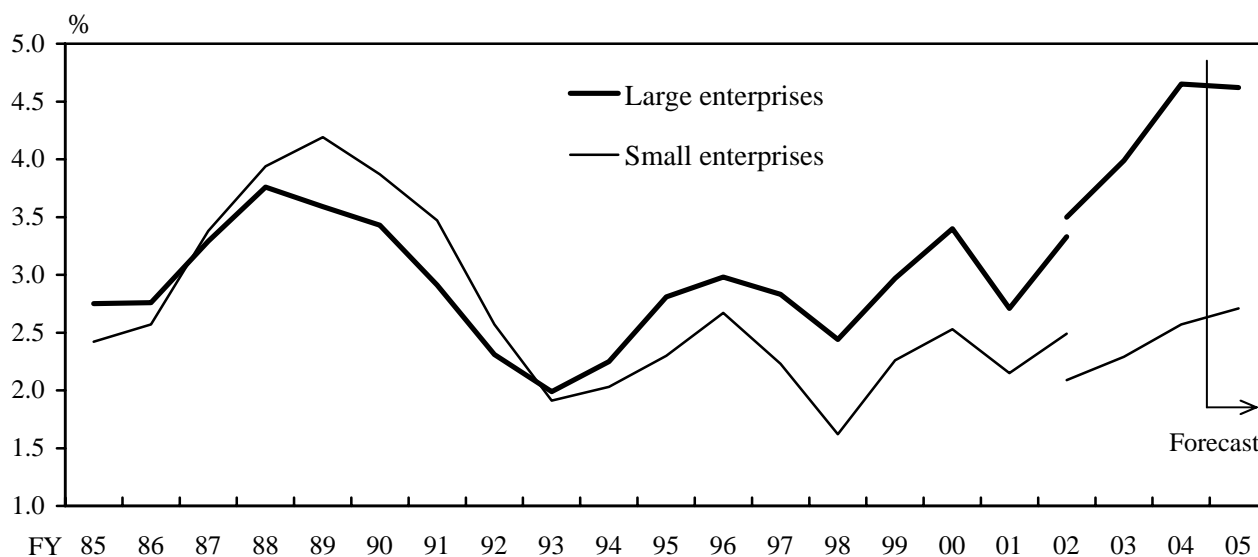


Source: Ministry of Economy, Trade and Industry, "Indices of Industrial Production."



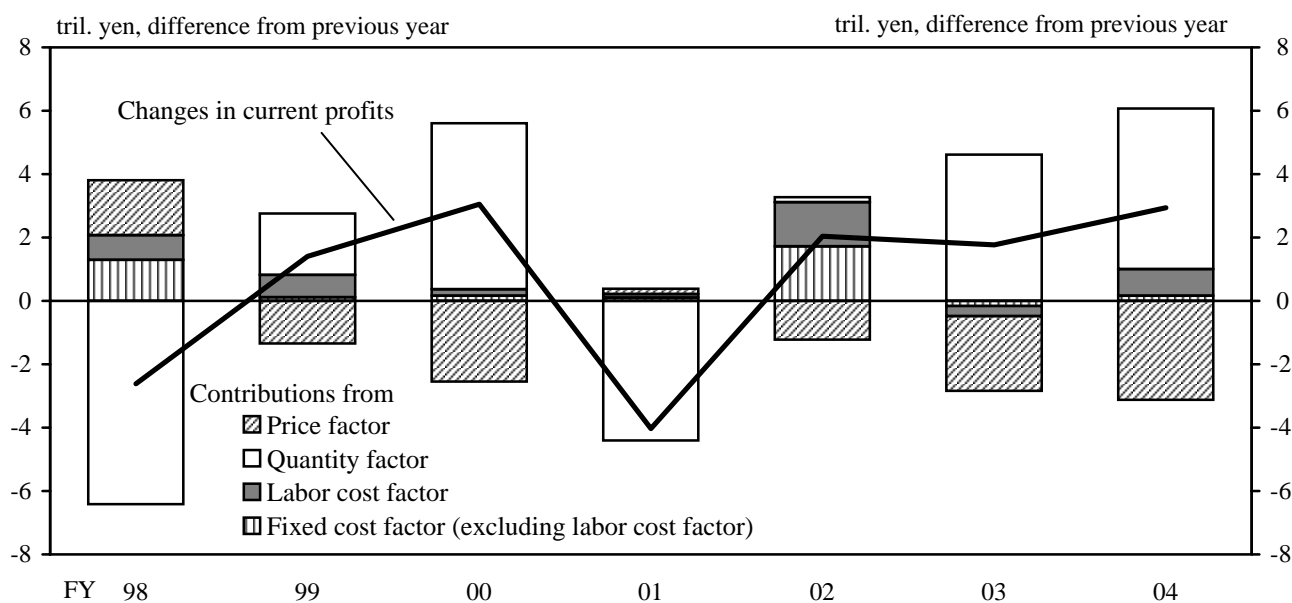
## Corporate Profits

### (1) Ratio of Current Profits to Sales (*Tankan*)



Note: Data are based on all industries. 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.

### (2) Factors Contributing to Changes in Current Profits at Large Manufacturing Enterprises



Notes:

1. Prices, quantities and other factors affect current profits as follows:

$$\pi = P_O Q_O - P_I Q_I - LC - FC$$

$\pi$ : current profits,  $P_O$ : output price,  $Q_O$ : sales quantity,  $P_I$ : input price,  $Q_I$ : input quantity, LC: labor cost,

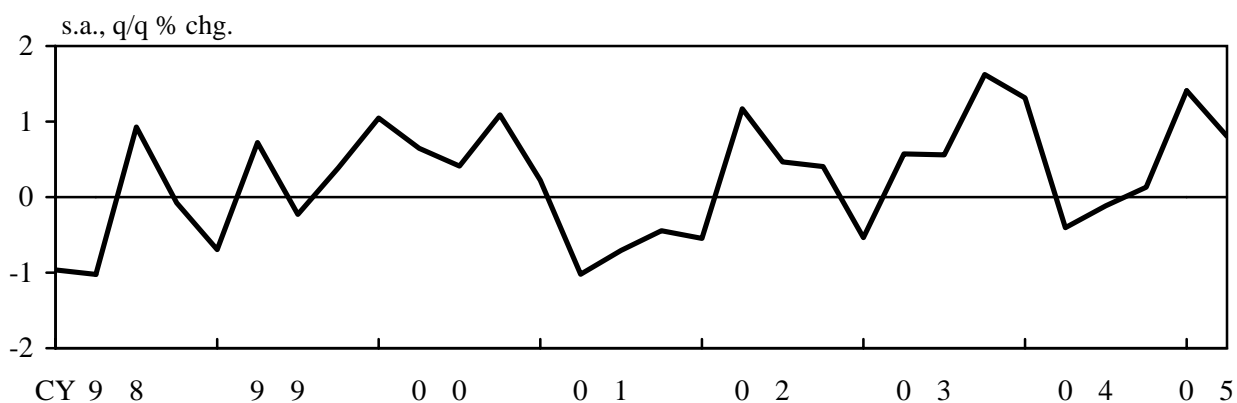
FC: fixed cost excluding labor cost (the sum of depreciation and amortization expenses, net non-operating expenses, and selling and general administrative expenses  $\times 0.7$ )

- Taking the total differentiation of the equation, changes in current profits may be attributed to contributions from changes in each factor mentioned above.
- "Price factor" refers to the contributions from changes in  $P_O$  and  $P_I$ .
- "Quantity factor" refers to the contributions from changes in  $Q_O$  and  $Q_I$ .

Sources: Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Annually"; Bank of Japan, "*Tankan*, Short-Term Economic Survey of Enterprises in Japan," "Input-Output Price Index of the Manufacturing Industry by Sector."

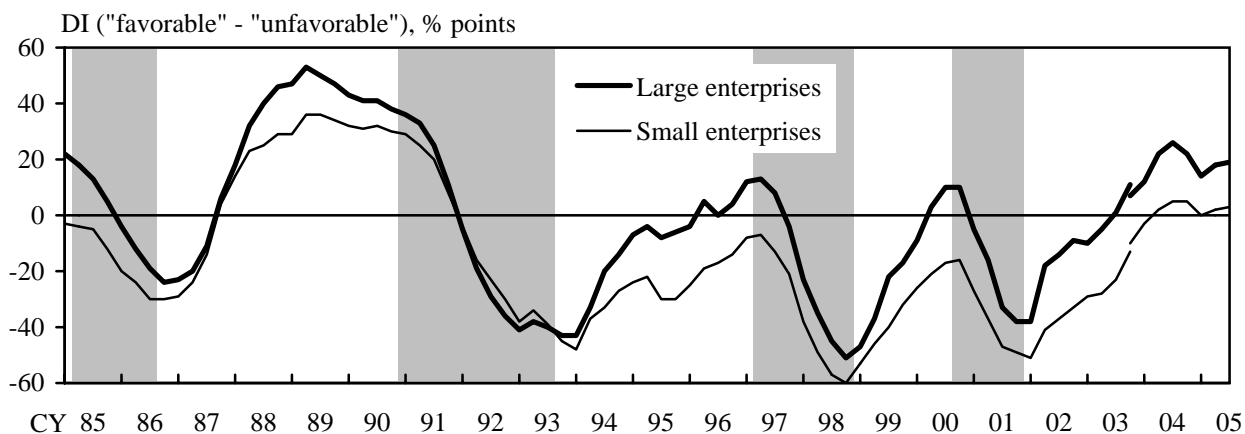
## Real GDP and Business Conditions

### (1) Real GDP

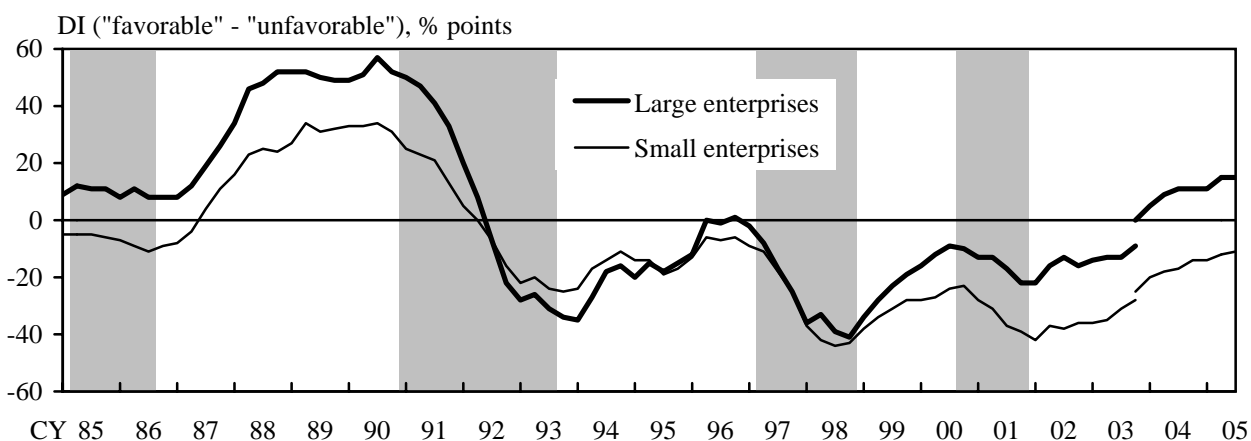


### (2) Business Conditions<sup>1,2</sup>

<Manufacturing>



<Nonmanufacturing>



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

2. Shaded areas indicate recession periods.

Sources: Cabinet Office, "National Accounts";

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

## Debts and Fixed Investment of Firms

### (1) Ratio of Net Debts to Sales

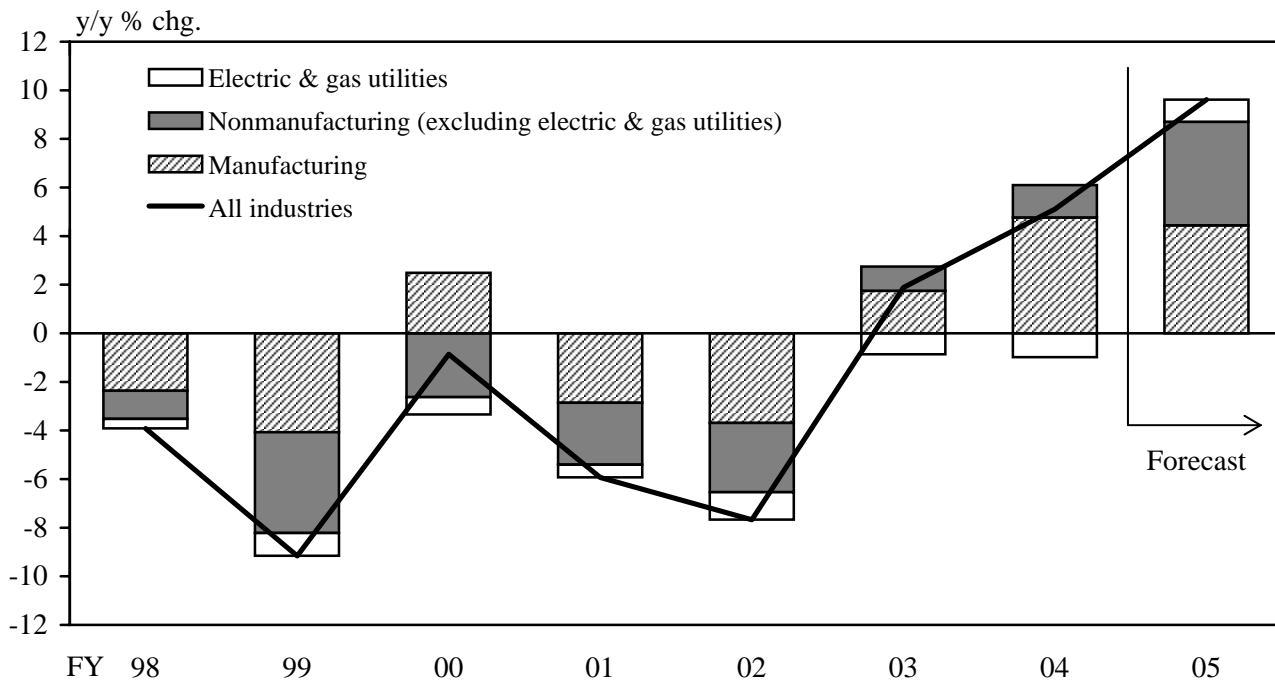


Notes: 1. Figures for FY 2005 are those of April-June.

2. Net debts = financial debts (corporate bonds + long-term and short-term borrowings + bills discounted) - cash and deposits

3. Based on *Financial Statements Statistics of Corporations by Industry, Quarterly*.

### (2) Business Fixed Investment Plans as Surveyed (*Tankan*)

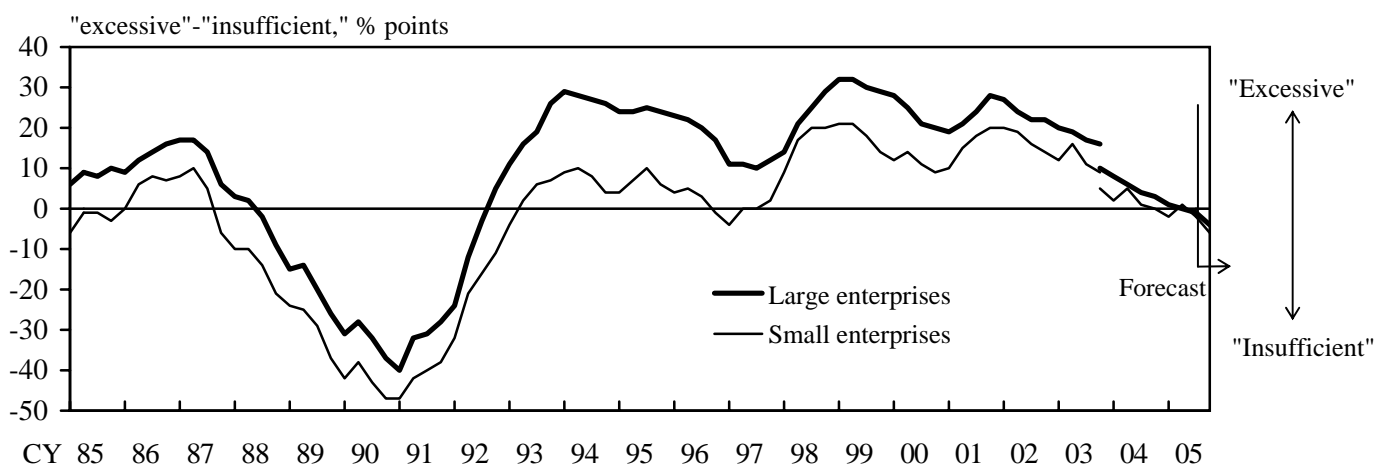


Note: Figures up to the FY 2002 survey include land purchasing expenses and exclude software investment. Figures from the FY 2003 survey exclude land purchasing expenses and include software investment.

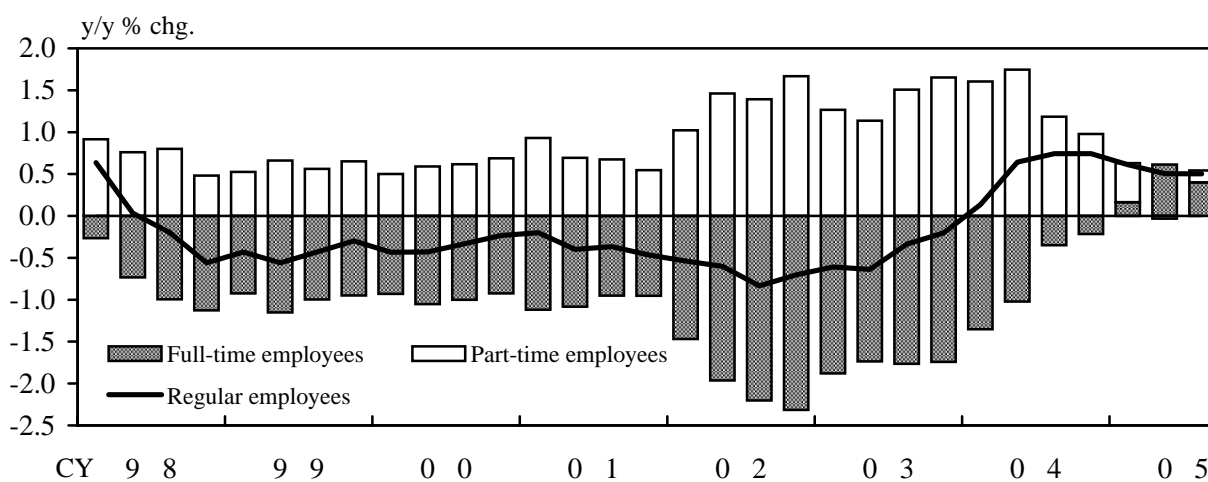
Sources: Ministry of Finance, "Financial Statement Statistics of Corporations by Industry, Quarterly"; Bank of Japan, "*Tankan*, Short-Term Economic Survey of Enterprises in Japan."

## Labor Market Conditions

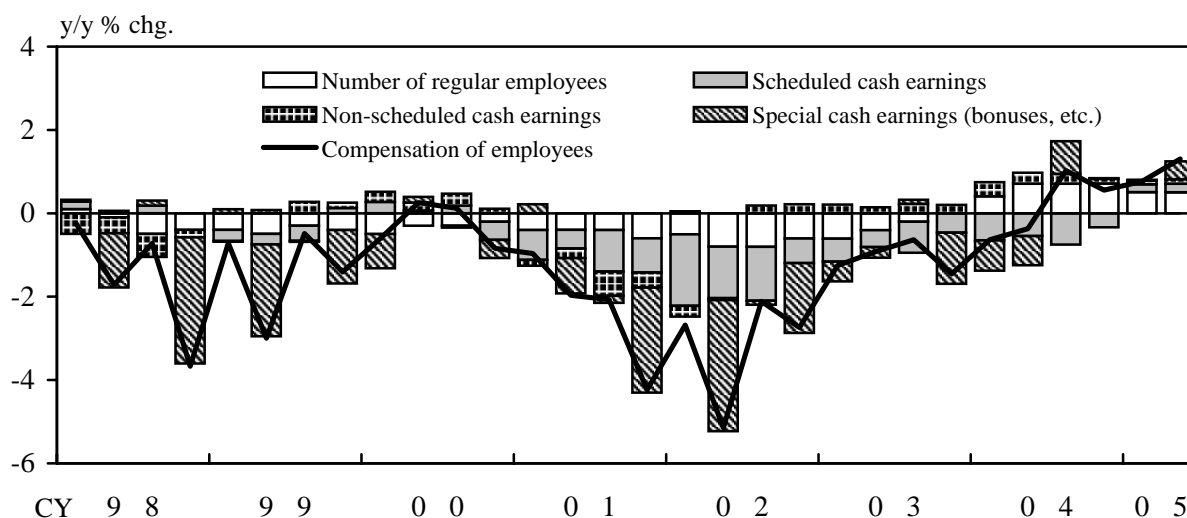
### (1) Employment DI<sup>1</sup>



### (2) Number of Regular Employees<sup>2,3</sup>



### (3) Breakdown of Compensation<sup>2,4</sup>



Notes: 1. Employment DI is that of all industries. 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. Data are for establishments with at least 5 employees.

3. Figures for 2005/Q3 are those of July-August averages.

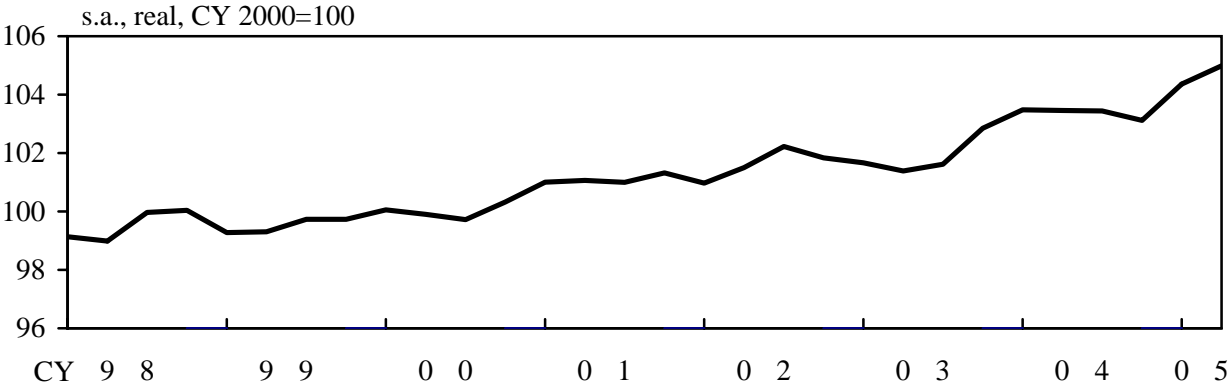
4. Q1=Mar.-May, Q2=June-Aug., Q3=Sep.-Nov., Q4=Dec.-Feb.

Sources: Ministry of Health, Labour and Welfare, "Monthly Labour Survey";

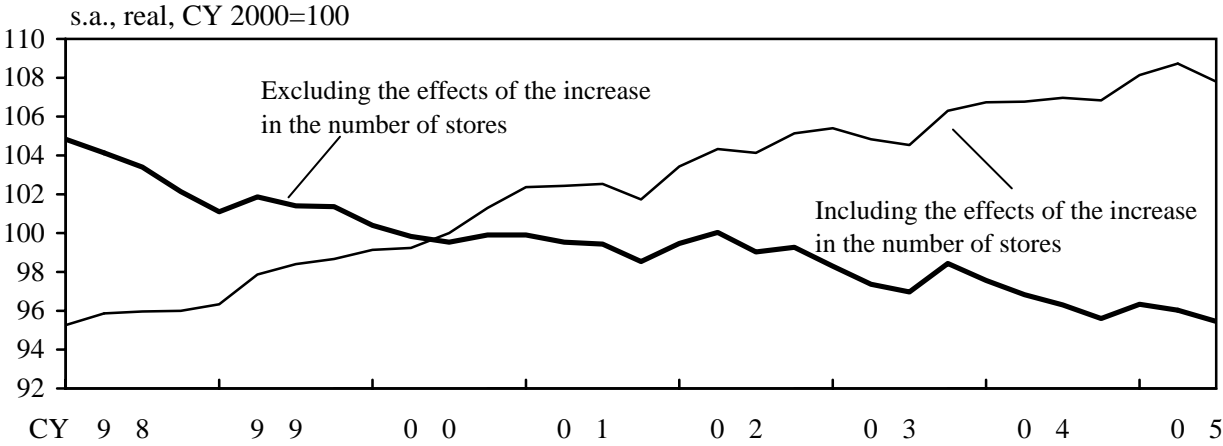
Bank of Japan, "*Tankan*, Short-Term Economic Survey of Enterprises in Japan."

# Private Consumption

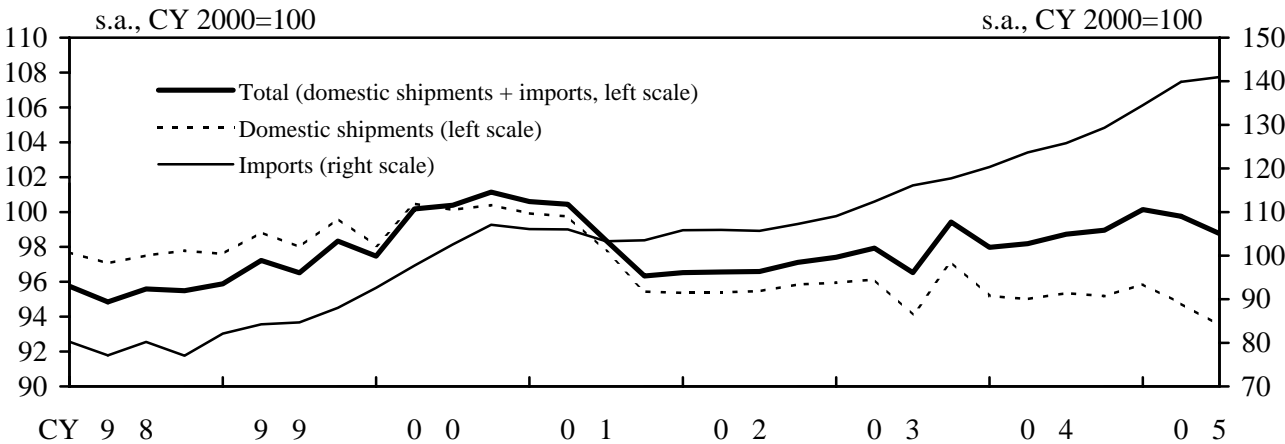
(1) GDP Private Consumption



(2) Indices of Aggregated Sales<sup>1,3</sup>



(3) Aggregate Supply of Consumer Goods<sup>2</sup>

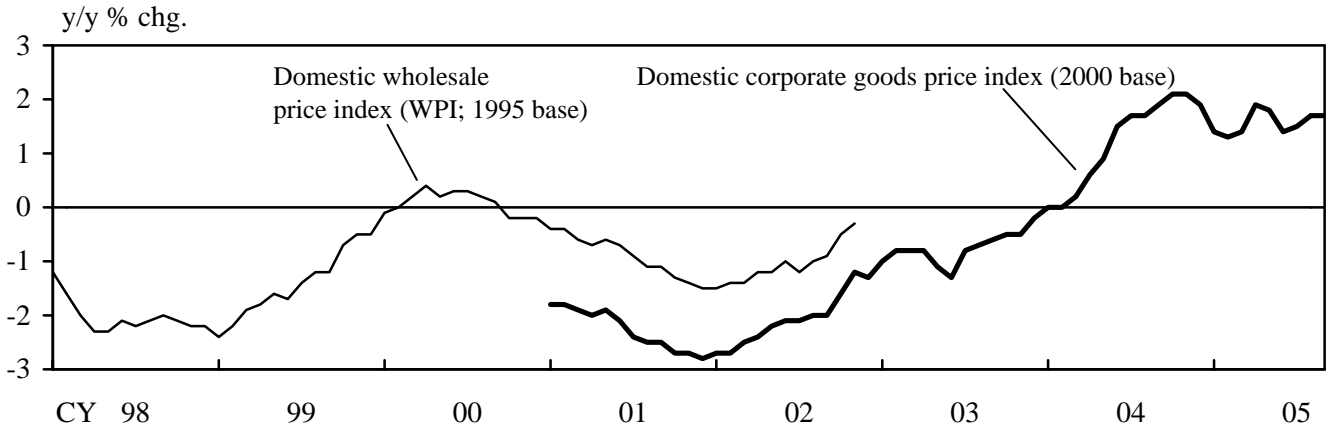


- Notes: 1. Indices of aggregated sales are the weighted sum of sales at department stores and supermarkets; new passenger-car registrations; sales of household electrical appliances; outlays for travel; and sales of food service industry. In addition, the index "including the effects of the increase in the number of stores" includes sales at convenience stores.
2. Aggregate supply of consumer goods is calculated by the Bank of Japan using shipments of consumer goods in *Indices of Industrial Production* and real exports and imports of consumer goods.
3. Data for 2005/Q3 figures of the indices of aggregated sales are those of July-August averages.

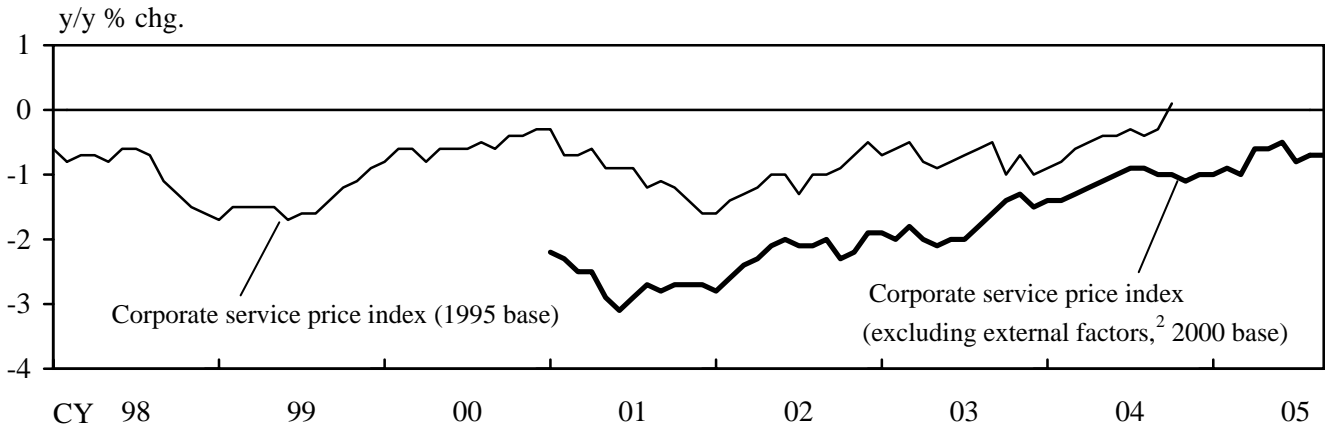
Sources: Ministry of Economy, Trade and Industry, "Indices of Industrial Production," "Indices of Industrial Domestic Shipments and Imports"; Ministry of Finance, "The Summary Report on Trade of Japan"; Cabinet Office, "National Accounts"; Bank of Japan, "Indices of Aggregated Sales," "Corporate Goods Price Index."

# Prices

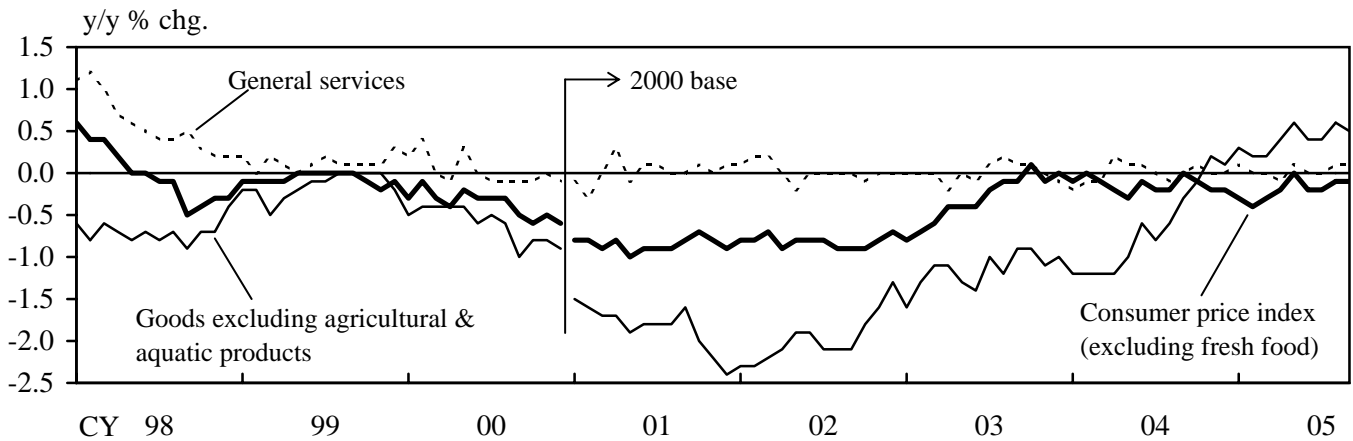
(1) Domestic Corporate Goods Price Index<sup>1</sup>



(2) Corporate Service Price Index<sup>1</sup>



(3) Consumer Price Index<sup>1,3</sup>



Notes: 1. Adjusted to exclude the effects of changes in consumption tax rate.

2. External factors: international air passenger transportation, ocean liner, ocean tramper, ocean tanker, oceangoing ship chartering services, and international air freight.

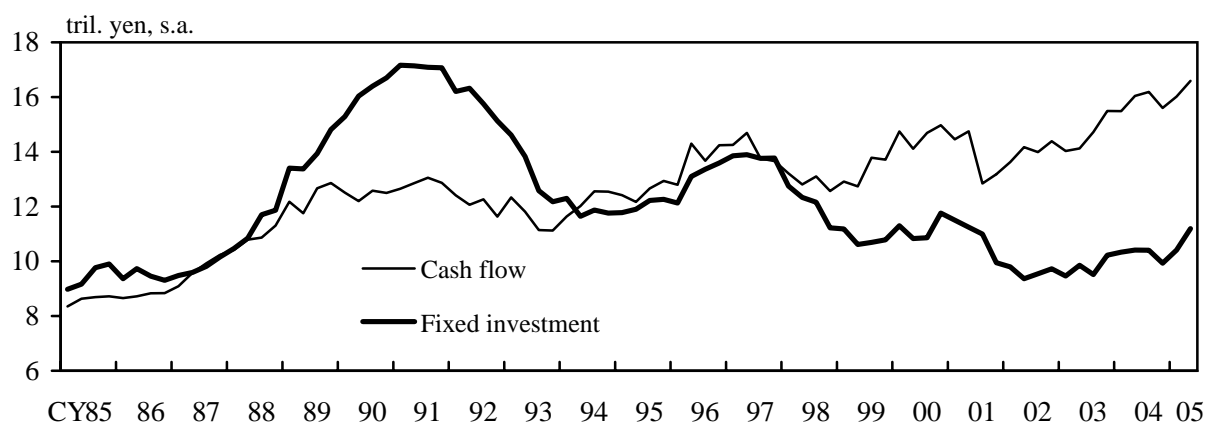
3. Figures of consumer price index for 1998-2000 are 1995 base.

Sources: Ministry of Internal Affairs and Communications, "Consumer Price Index";

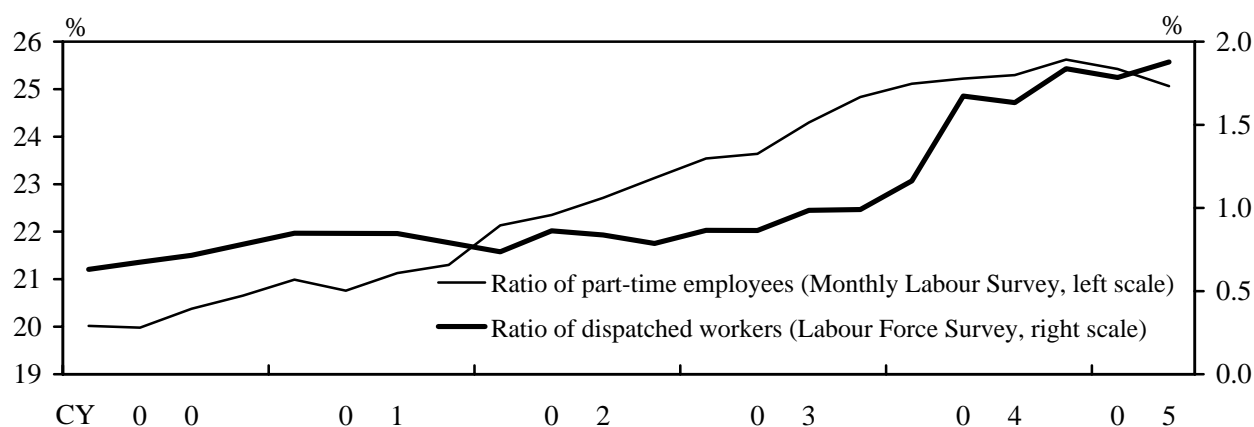
Bank of Japan, "Corporate Goods Price Index," "Wholesale Price Indexes," "Corporate Service Price Index."

## Firms' Stance on Investment and Employment

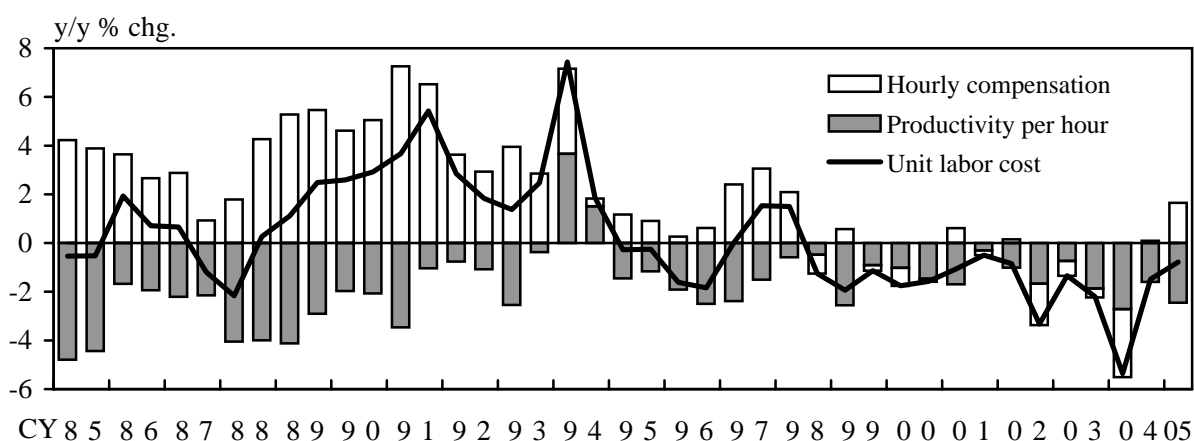
### (1) Cash Flow and Fixed Investment<sup>1</sup>



### (2) Ratio of Part-Time Employees and Ratio of Dispatched Workers<sup>2, 3</sup>



### (3) Unit Labor Cost<sup>4</sup>



Notes: 1. Cash flow = current profits / 2 + depreciation expense

2. Ratio of part-time employees = number of part-time employees / number of regular employees

Ratio of dispatched workers = number of dispatched workers from temporary labor agencies / number of employees

3. For 2000 and 2001, when the dispatched worker data are available only semiannually in February and August, figures are plotted only for Q1 and Q3, and the data for intervening quarters are linearly interpolated.

4. Unit labor cost = compensation of employees / real GDP

Productivity per hour = real GDP / (number of employees × hours at work)

Hourly compensation = compensation of employees / (number of employees × hours at work)

Number of employees is based on the "Labour Force Survey," hours at work on the "Monthly Labour Survey" basis and all remaining data are based on "National Accounts."

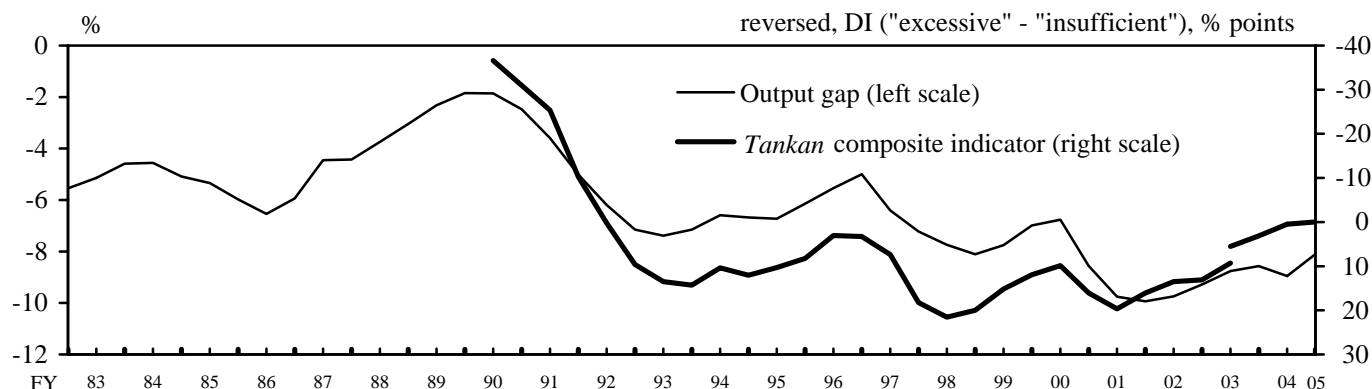
Sources: Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Quarterly";

Cabinet Office, "National Accounts"; Ministry of Health, Labour and Welfare, "Monthly Labour Survey";

Ministry of Internal Affairs and Communications, "Labour Force Survey."

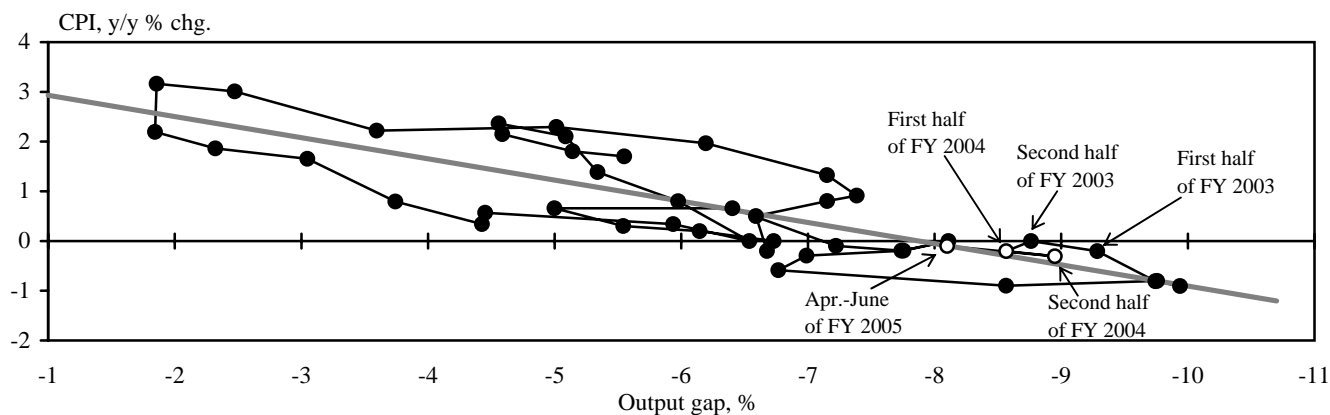
## Output Gap and Consumer Price Index

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



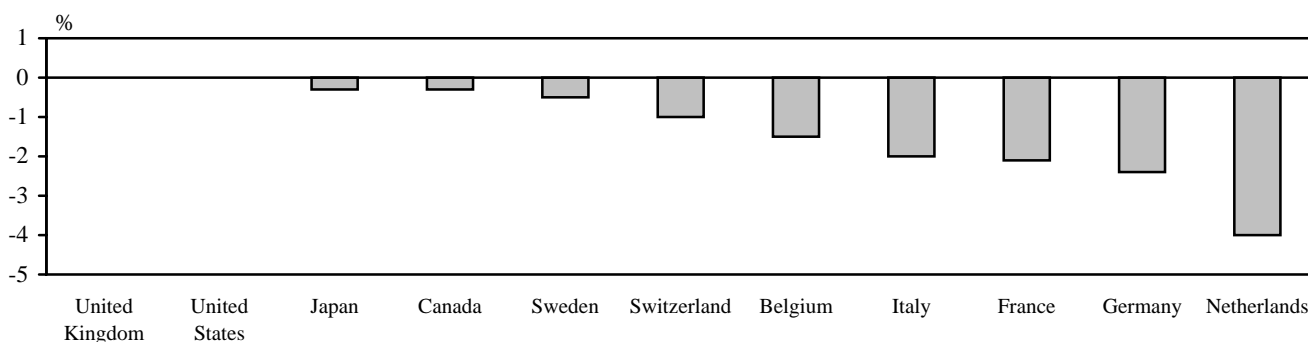
- Notes: 1. Output gap is calculated as the wedge between actual and maximum outputs which are attainable by the maximum usage of capital stock and employment (estimation by the Research and Statistics Department of the Bank of Japan). These estimates always take negative values. On the other hand, international organizations, for example the OECD, 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 first half of FY 2005 is the April-June 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 income 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 (Excluding Fresh Food)



Note: White circles indicate data after FY 2004.

### (3) Output Gap of Major Countries (As of CY 2005, Estimated by OECD)

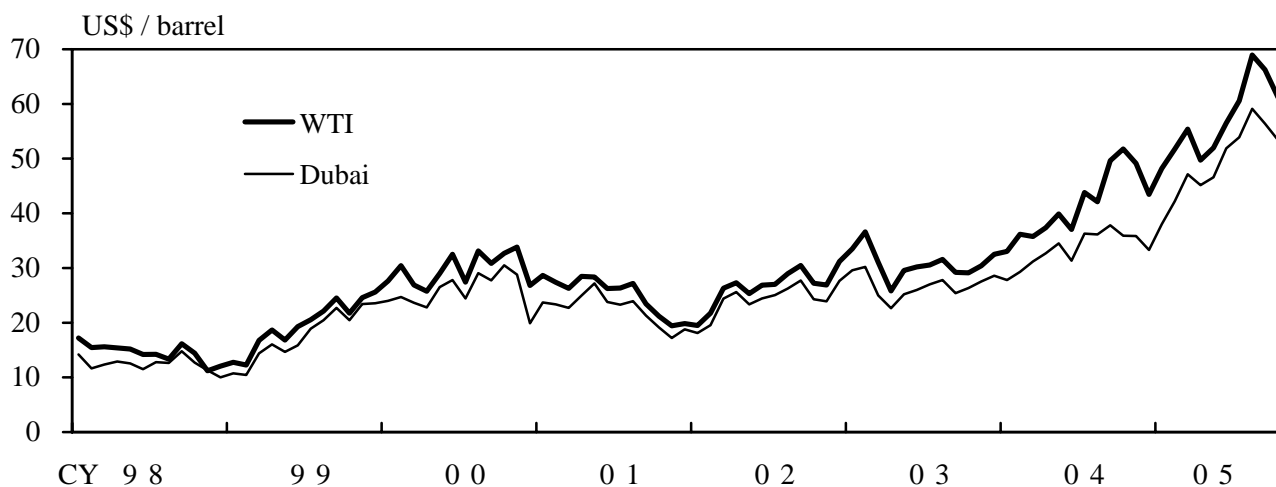


Sources: Cabinet Office, "National Accounts," "Capital Stock of Private Enterprises Statistics"; Ministry of Economy, Trade and Industry, "Indices of Industrial Production"; Ministry of Health, Labour and Welfare, "Monthly Labour Survey"; Ministry of Internal Affairs and Communications, "Consumer Price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

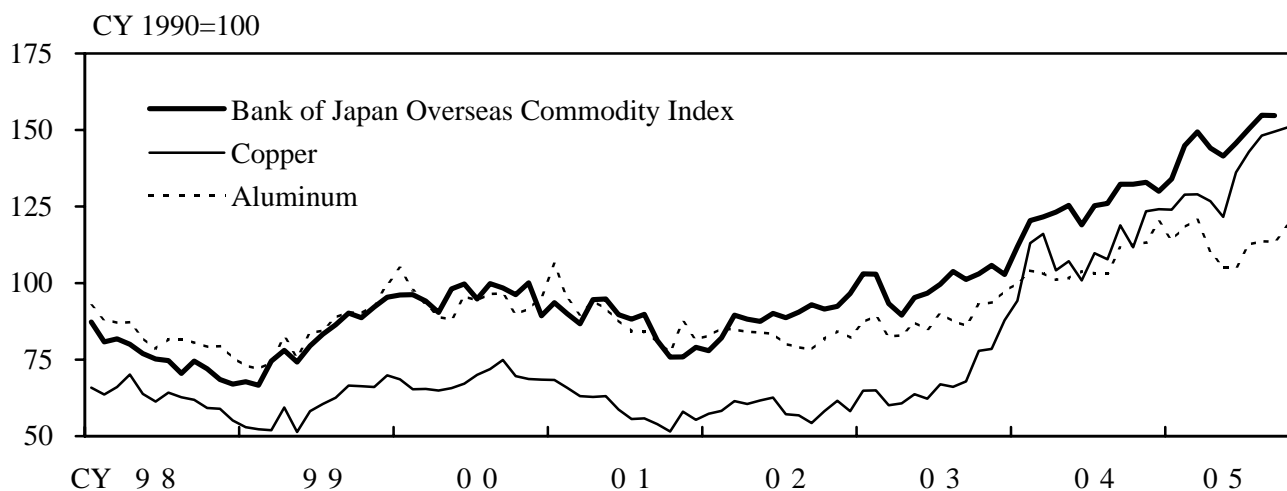


## Commodity Prices

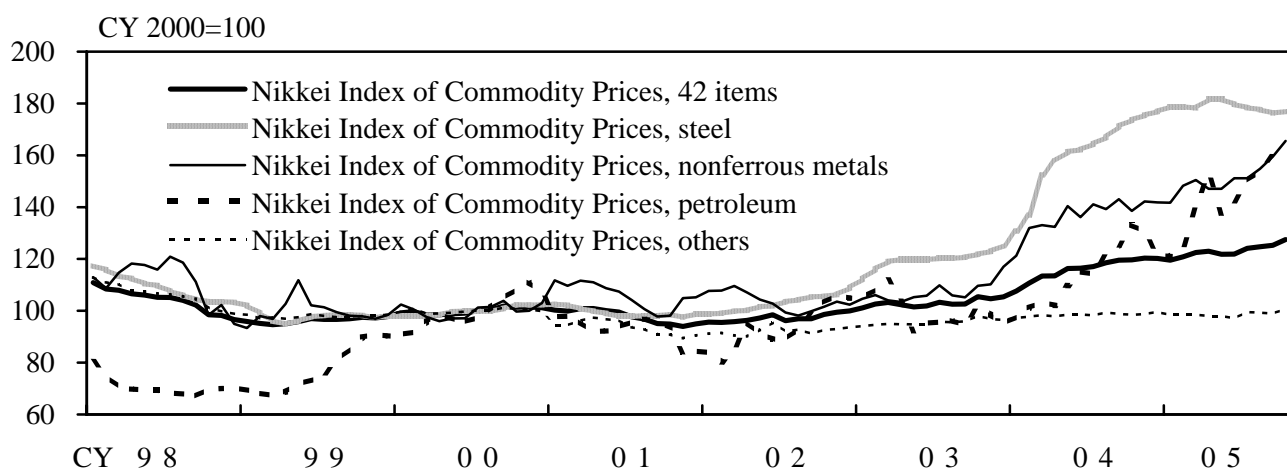
### (1) Oil Prices<sup>1,2</sup>



### (2) International Commodity Prices<sup>1,2</sup>



### (3) Domestic Commodity Prices<sup>1,2,3</sup>



Notes: 1. Data are at end of month.

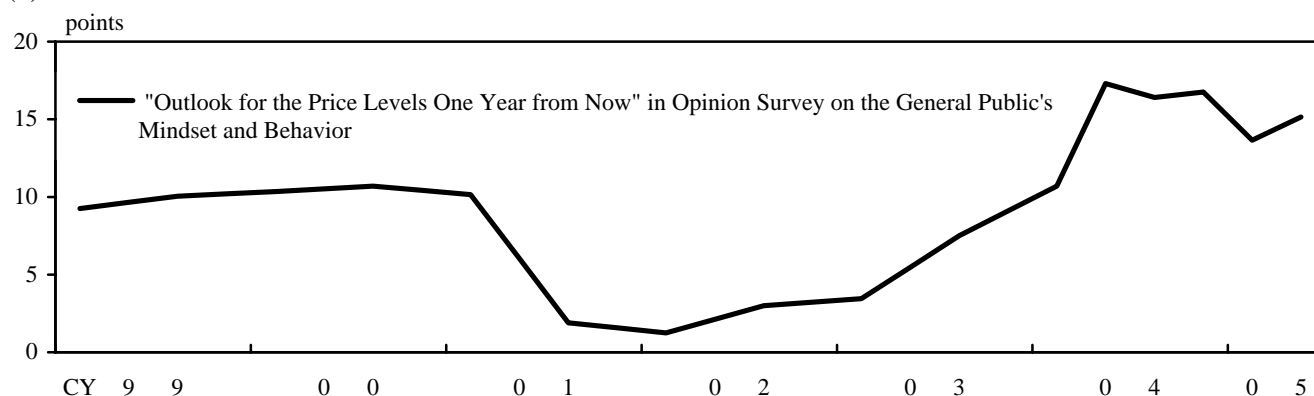
2. Figures for October 2005 are the latest available data.

3. Steel: steel bars, H sections, steel plates, etc. Nonferrous metals: unwrought copper, unwrought aluminum, etc. Petroleum: gasoline, kerosene, gas oil, fuel oil C.

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

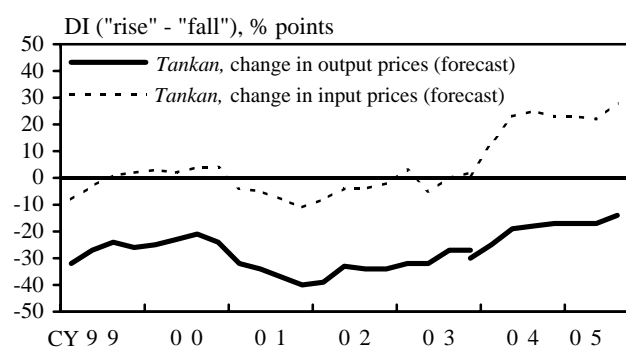
## Outlook for Prices

### (1) Households



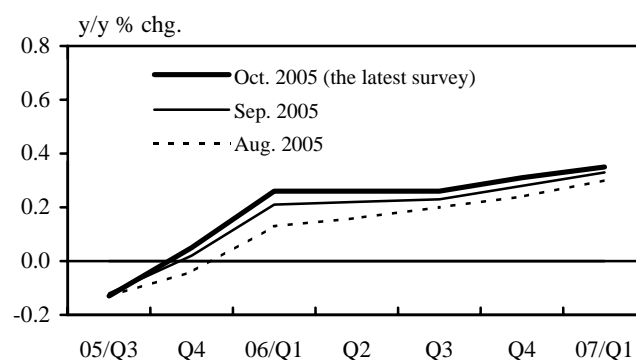
Note: The share of respondents is multiplied by the following points according to the type of answer, and the results are totaled:  
 1 point for respondents answering prices will "go up significantly"; 0.5 point for those answering "go up slightly";  
 -0.5 point for those answering "go down slightly"; and -1 point for those answering "go down significantly."

### (2) Firms



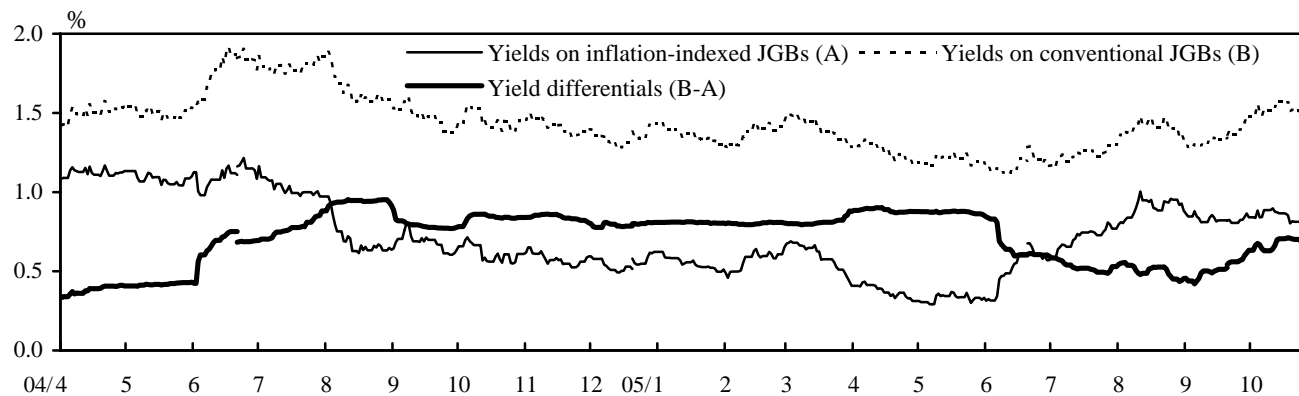
Notes: 1. All enterprises. The forecast period is one quarter ahead.  
 2. The *Tankan* has been revised from the March 2004 survey.  
 Figures based on the previous data sets are up to the December 2003 survey. Figures on a new basis are from the December 2003 survey.

### (3) Economists (ESP Forecast)



Note: Figures are the averages of the consumer price index excluding fresh food forecasted by 38 economic research institutions and economists.

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

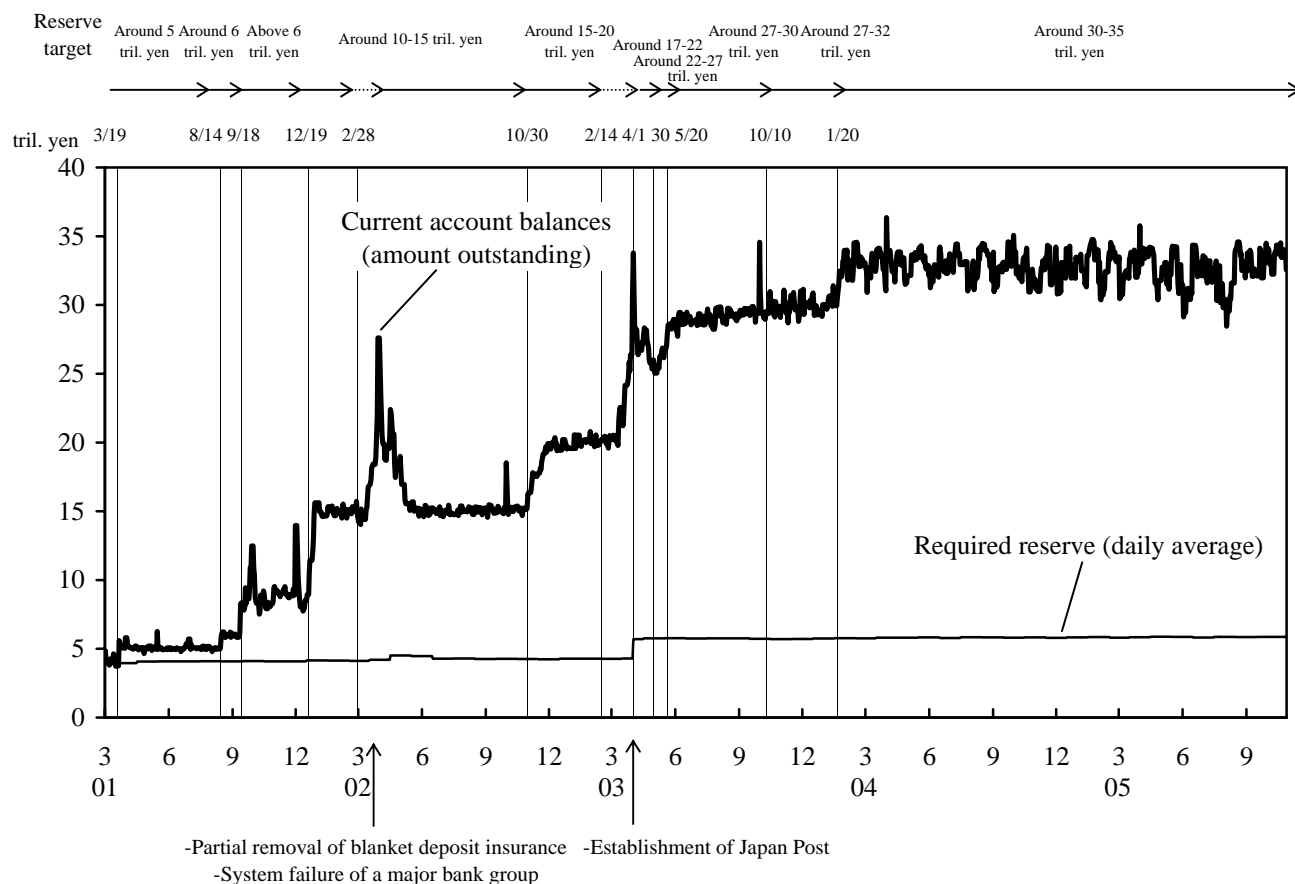


Notes: 1. Yields on inflation-indexed JGBs are those for the current issue, and yields on conventional JGBs are those for 10-year JGBs issued in the same month as the corresponding inflation-indexed JGBs (connected at issue date of conventional JGBs).  
 2. Inflation-indexed JGBs are indexed to the consumer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

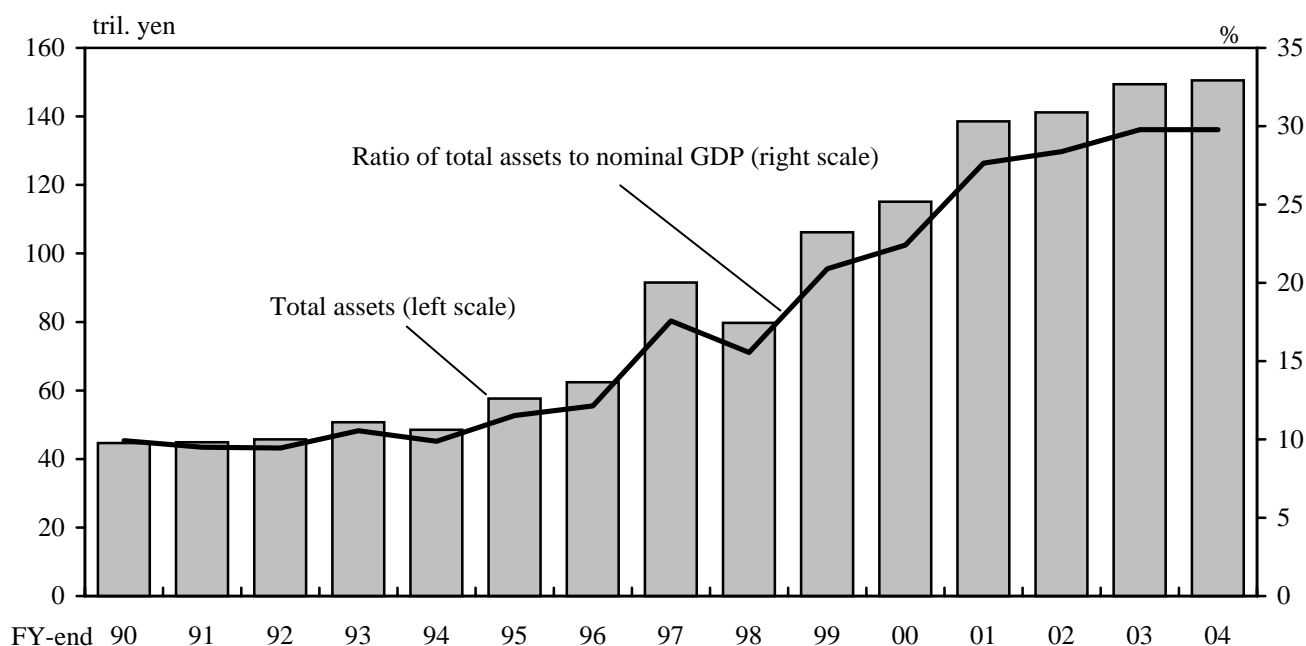
Sources: Bank of Japan, "Opinion Survey on the General Public's Mindset and Behavior," "*Tankan*, Short-Term Economic Survey of Enterprises in Japan"; Economic Planning Association, "ESP Forecast"; Japan Securities Dealers Association; Bloomberg.

# BOJ Current Account Balances and the BOJ's Balance Sheet

## (1) BOJ Current Account Balances



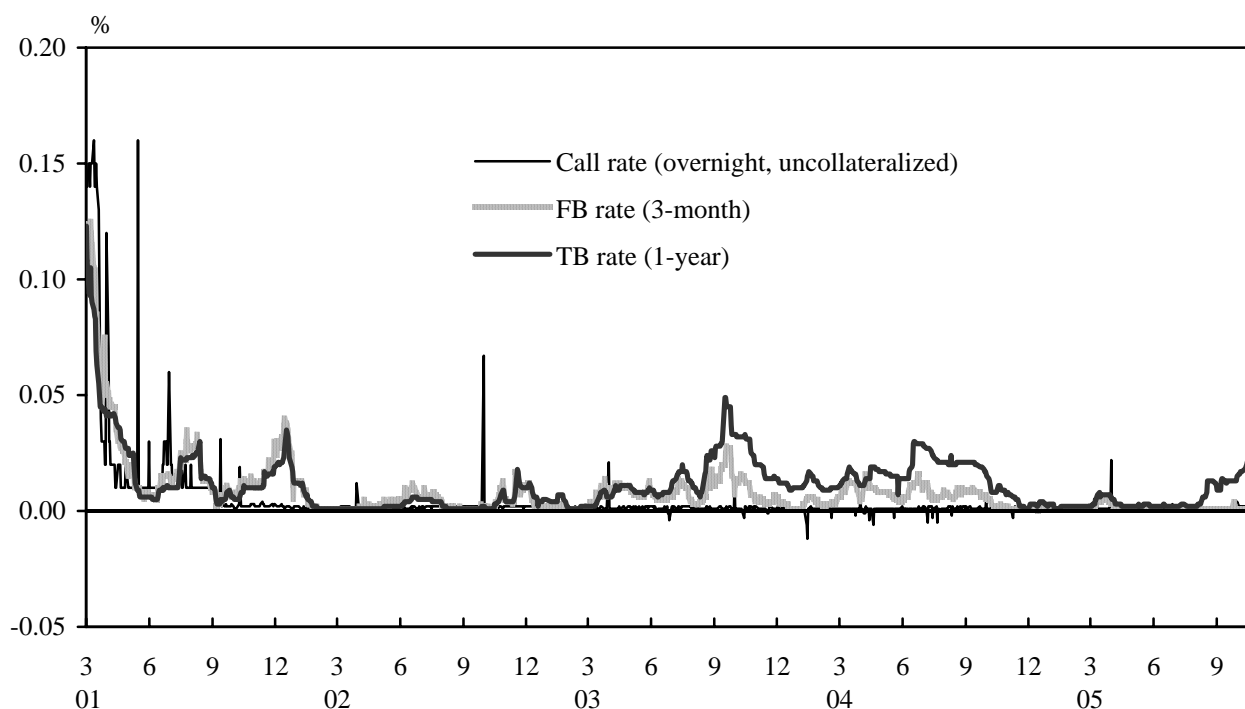
## (2) Size of the Balance Sheet of the Bank of Japan



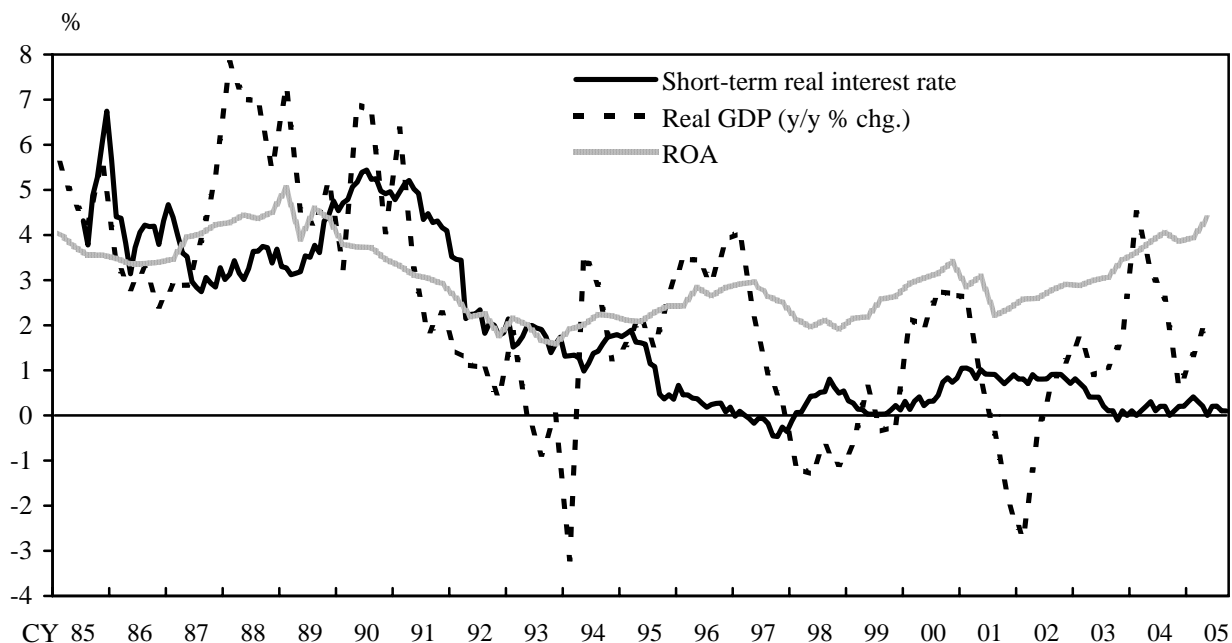
Sources: Cabinet Office, "National Accounts"; Bank of Japan.

## Short-Term Interest Rates

### (1) Short-Term Interest Rates



### (2) Short-Term Real Interest Rate and Economic Activities

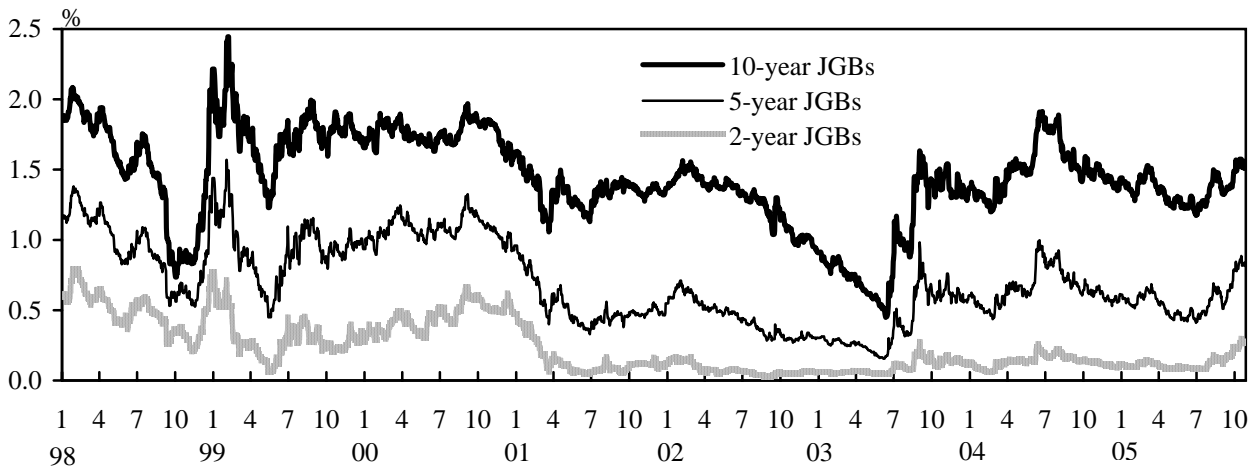


- Notes: 1. Real interest rate = call rate (overnight, uncollateralized, monthly average) - y/y % chg. in the consumer price index (excluding fresh food)  
 2. Figures for real GDP after 1995 are based on the chain-linking method and those before 1994 on the fixed base-year method.  
 3. ROA = current profits / total assets. Figures for ROA are seasonally adjusted by X-11.  
 4. Quarterly data (real GDP and ROA) are supplemented with linear interpolation.

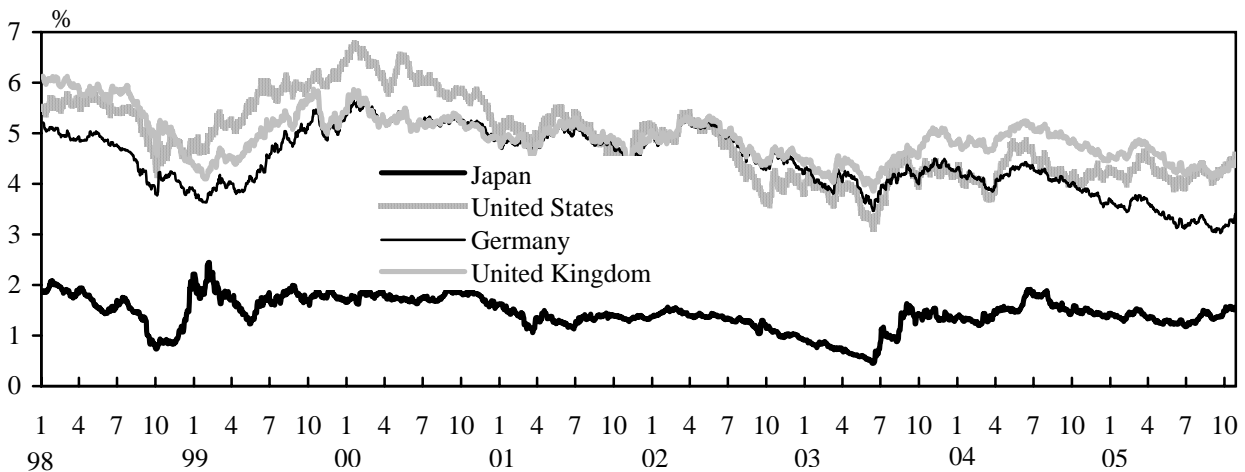
Sources: Cabinet Office, "National Accounts"; Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Quarterly"; Ministry of Internal Affairs and Communications, "Consumer Price Index"; Bank of Japan; Bloomberg.

## Long-Term Interest Rates

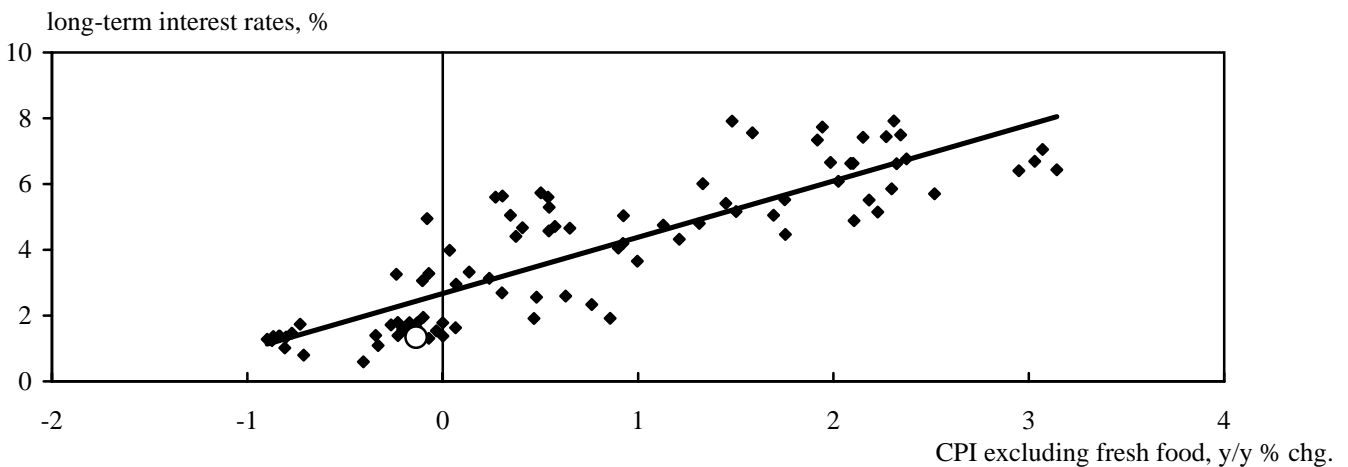
(1) Government Bond Yields



(2) Major Countries (10-Year Government Bond Yields)



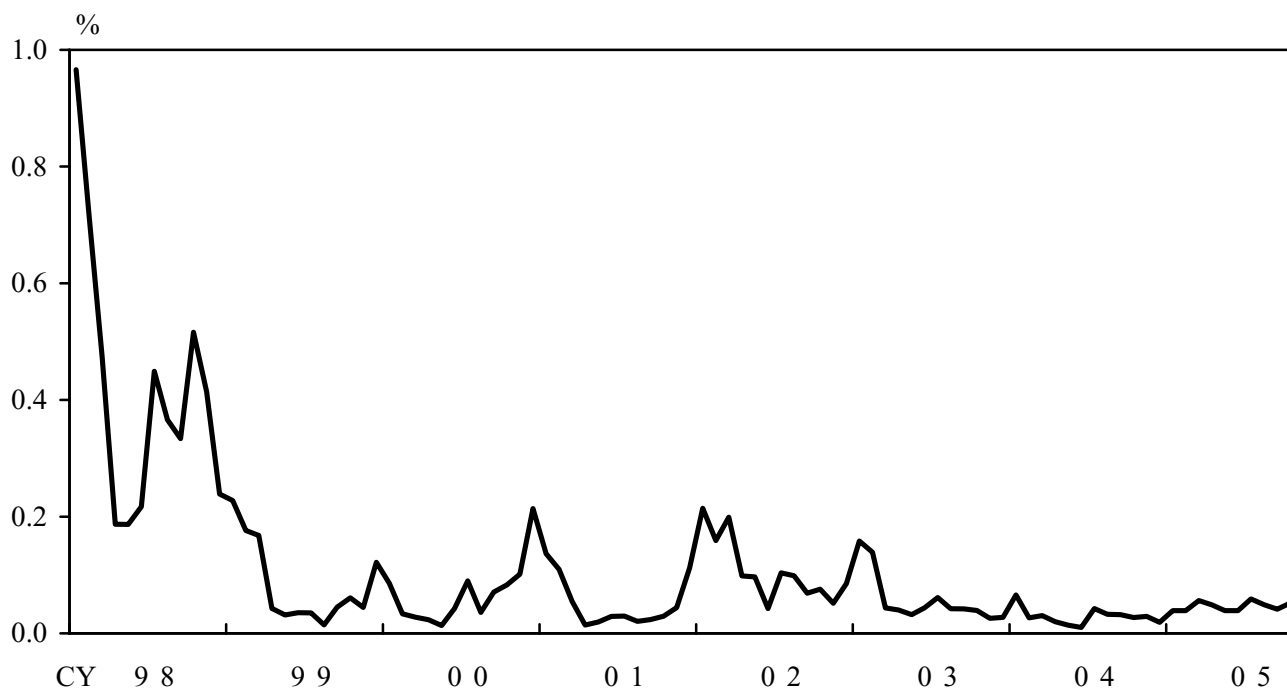
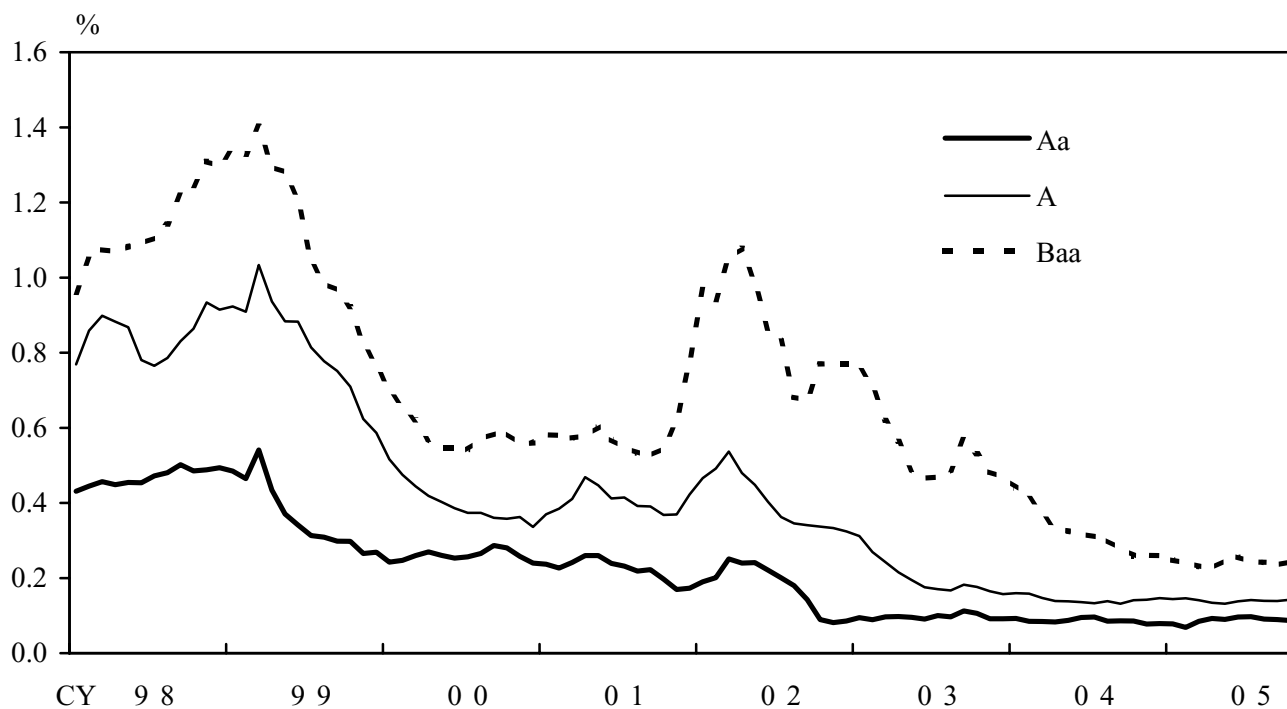
(3) Long-Term Interest Rates and Change in the Consumer Price Index



- Notes: 1. Long-term interest rates are 10-year JGB yields.  
 2. CPI is adjusted to exclude the effects of the changes in consumption tax rate.  
 3. The sample period is 1983/Q1-2005/Q3. The white circle indicates the latest data.

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

## Credit Spread

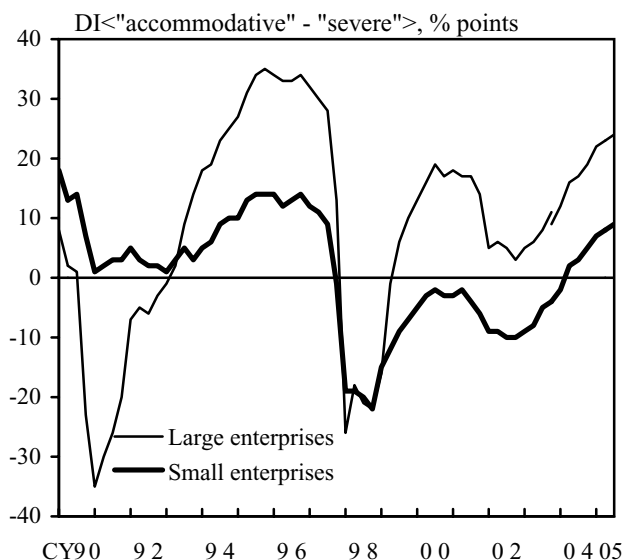
(1) Commercial Paper (3-Month)<sup>1,2,3</sup>(2) Corporate Bonds (5-Year)<sup>3,4,5</sup>

- 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 October 2005 are the averages up to the latest available data.  
 4. The spread for corporate bonds is the corporate bond yield minus the government bond yield.  
 5. The indicated ratings of corporate bonds are of Moody's.

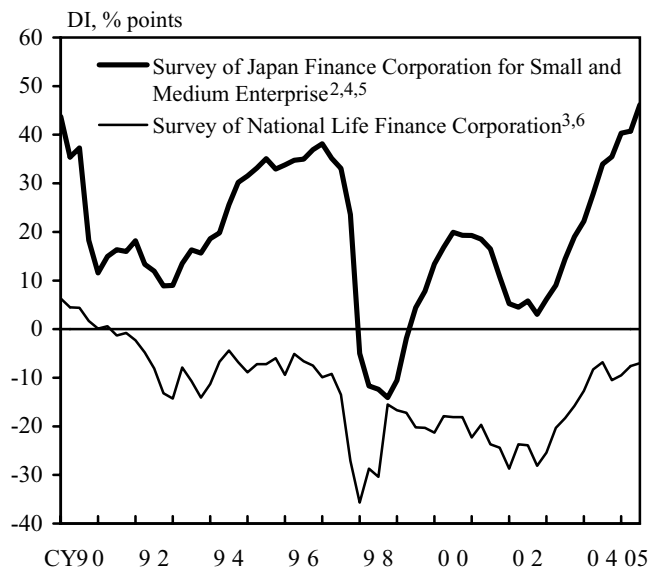
# Lending Attitude of Financial Institutions and Financial Position of Firms

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

<Tankan<sup>1</sup>>

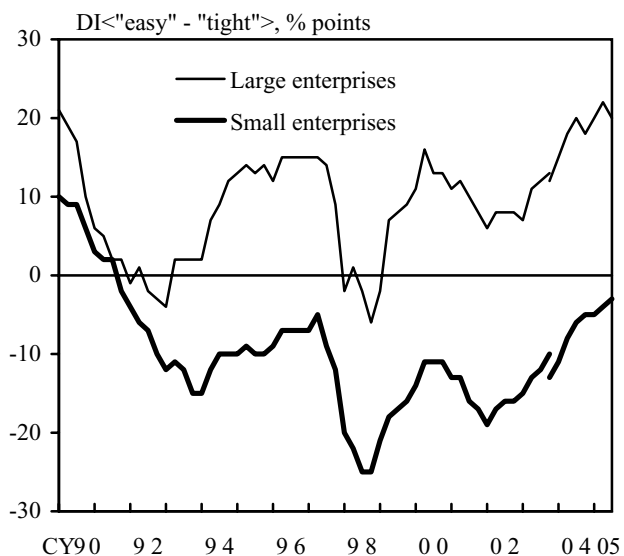


<Other Surveys>

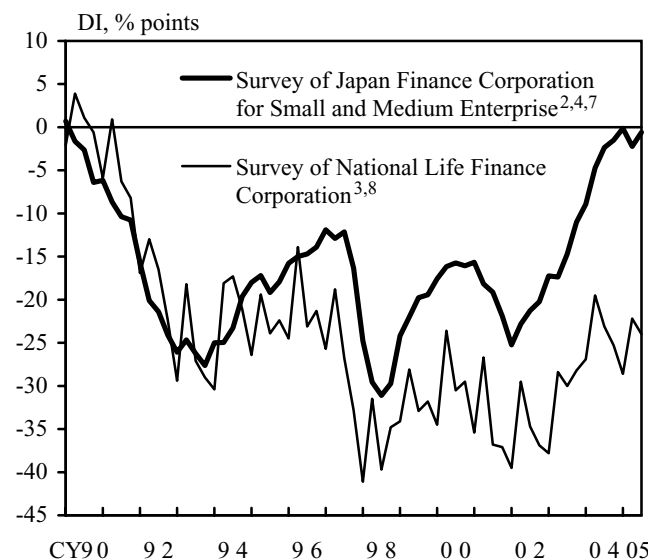


## (2) Financial Position of Firms

<Tankan<sup>1</sup>>



<Other Surveys>



Notes: 1. Data are based on all industries. 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. Data are based on the customers of Japan Finance Corporation for Small and Medium Enterprise, which are small and medium enterprises with stockholders' equity of 300 million yen or less, or with 300 or fewer employees in principle.

3. Data are based on the customers of National Life Finance Corporation, almost 90% of which are enterprises with 9 or fewer employees.

4. Figures are quarterly averages of monthly data.

5. DI of "accommodative" - "severe."

6. DI of "more accommodative" - "more severe."

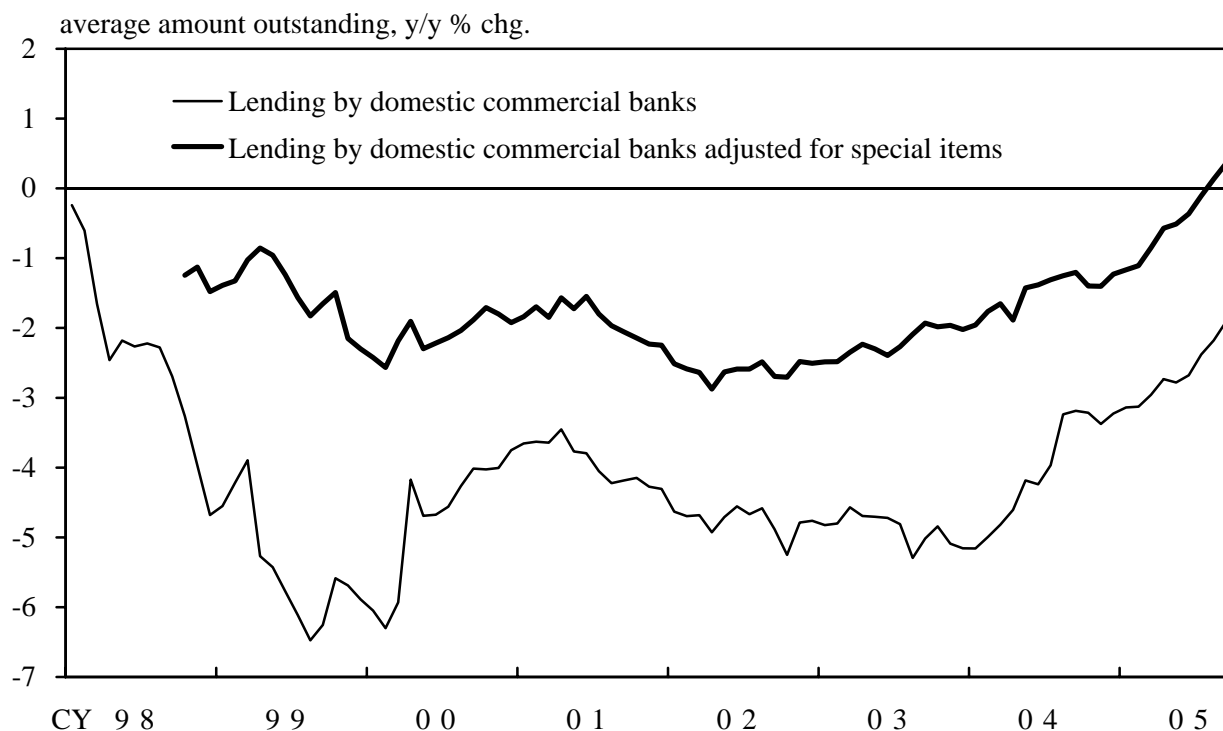
7. DI of "easy" - "tight."

8. DI of "easier" - "tighter."

Sources: Bank of Japan, "*Tankan*, Short-Term Economic Survey of Enterprises in Japan"; Japan Finance Corporation for Small and Medium Enterprise, "Monthly Survey of Small Businesses in Japan"; National Life Finance Corporation, "Quarterly Survey of Small Businesses in Japan."

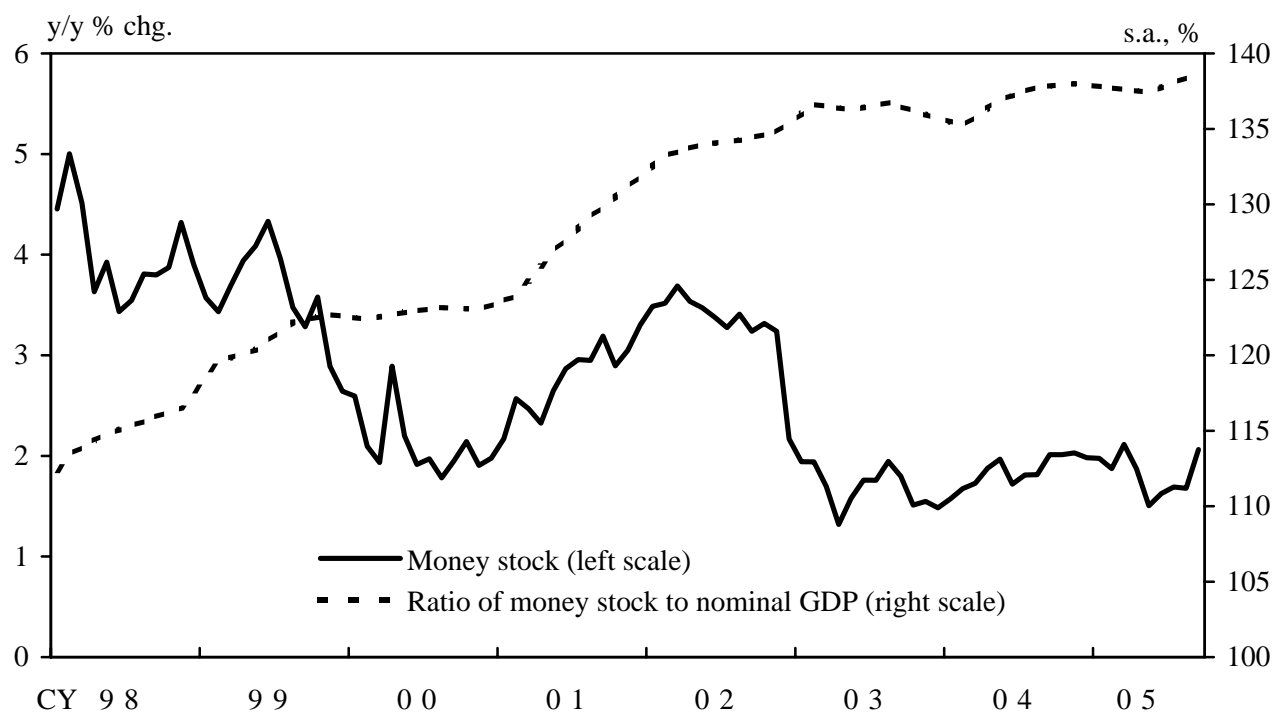
## Bank Lending and Money Stock

### (1) Lending by Domestic Commercial Banks



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

### (2) Money Stock (M<sub>2</sub>+CDs)



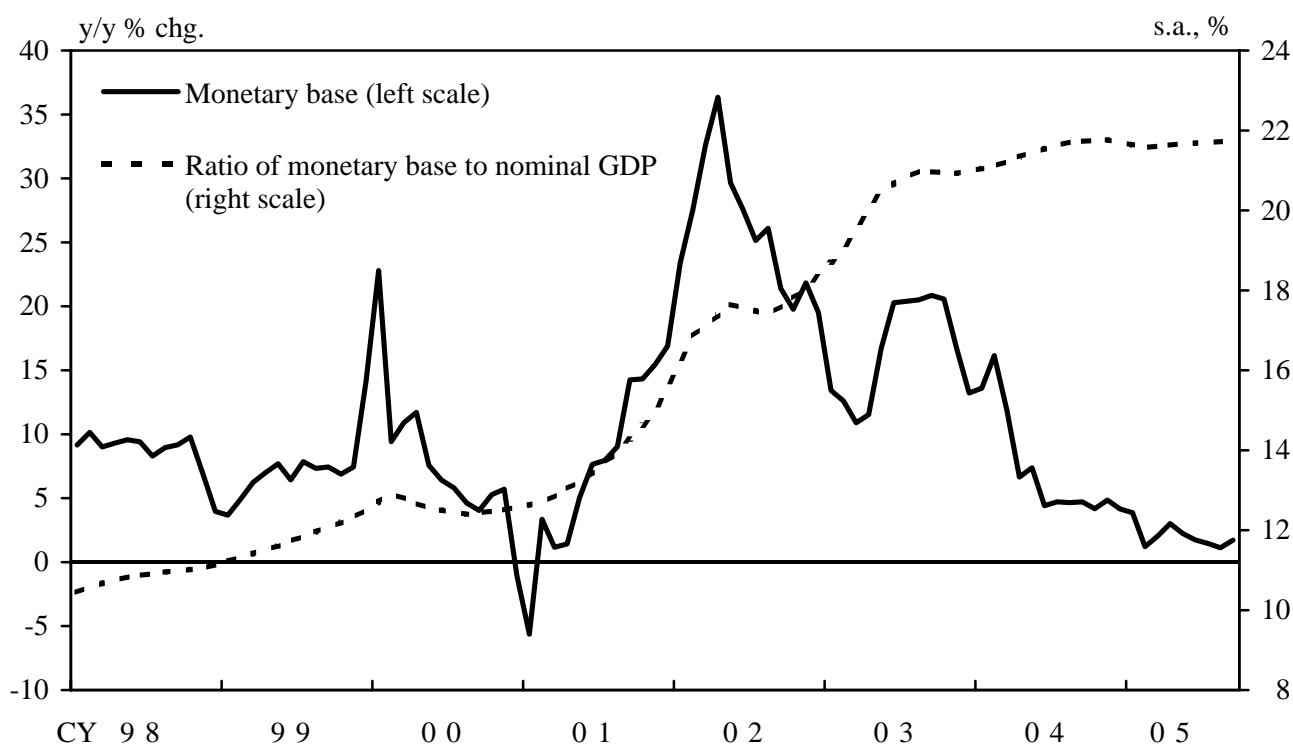
Note: Figure for nominal GDP in 2005/Q3 is assumed to be unchanged from the previous quarter.

Sources: Cabinet Office, "National Accounts"; Bank of Japan, "Principal Figures of Financial Institutions," "Money Stock."



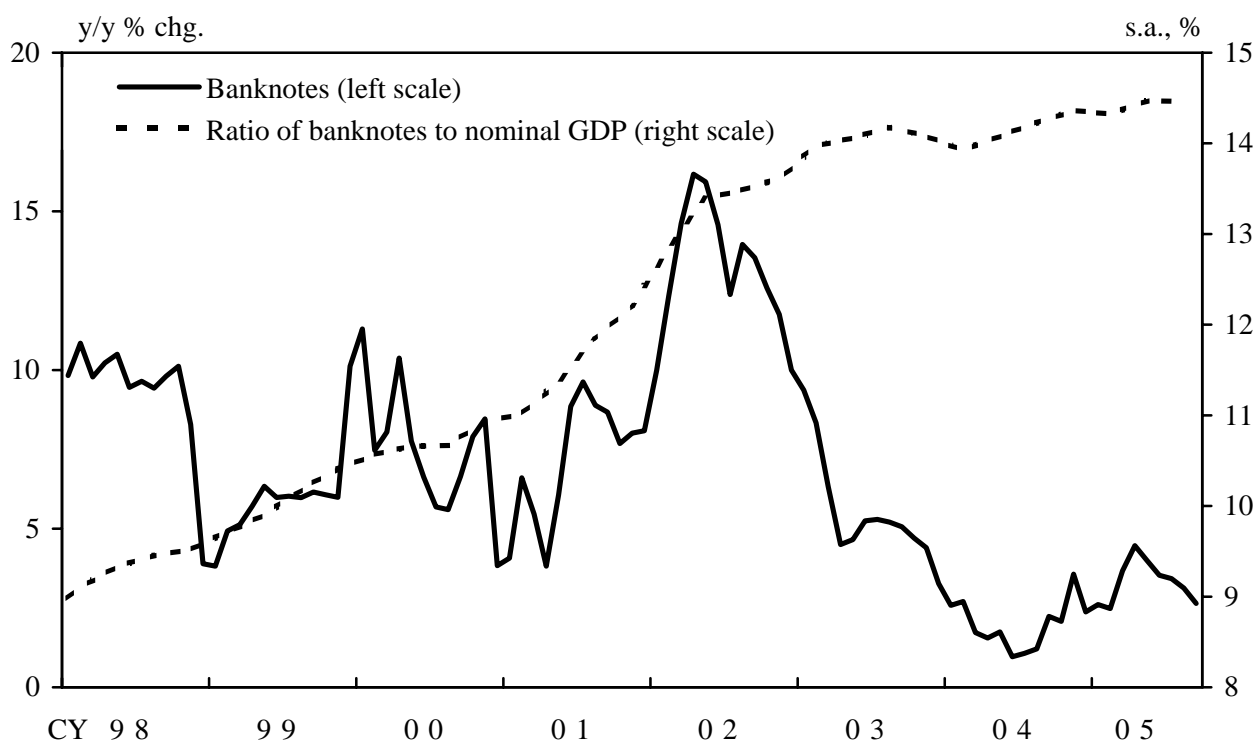
## Monetary Base and Banknotes

### (1) 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/Q3 is assumed to be unchanged from the previous quarter.

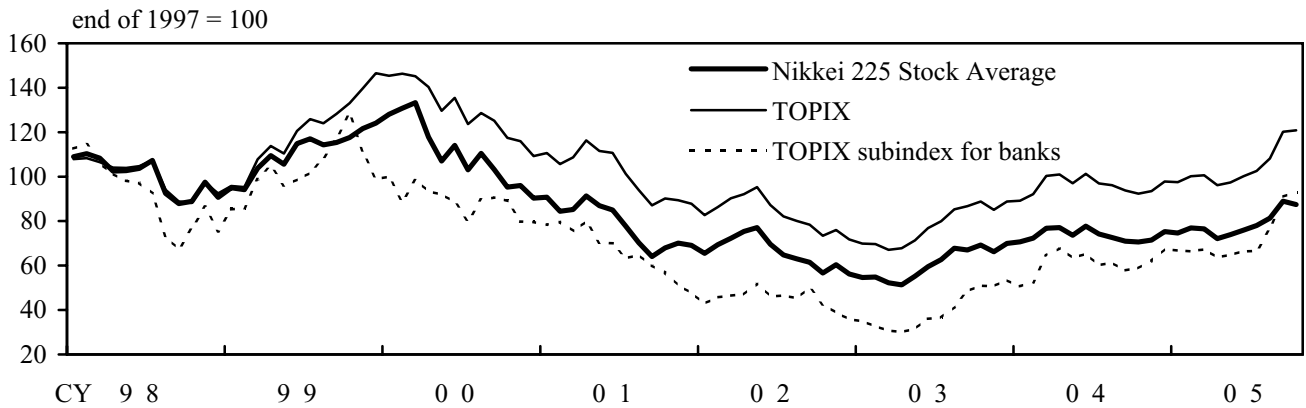
### (2) Banknotes



Note: Figure for nominal GDP in 2005/Q3 is assumed to be unchanged from the previous quarter.

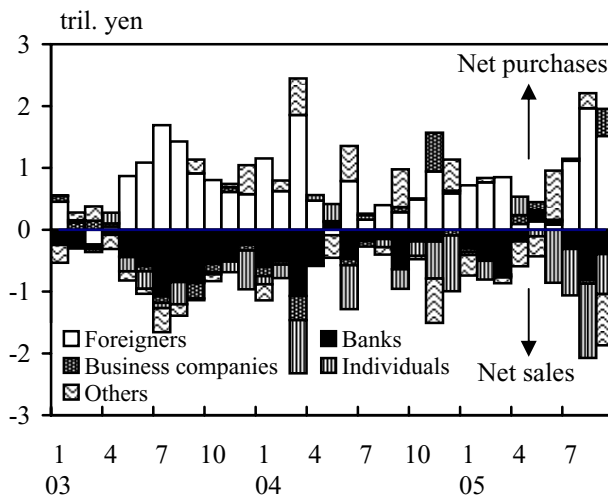
## Stock Prices

### (1) Stock Prices



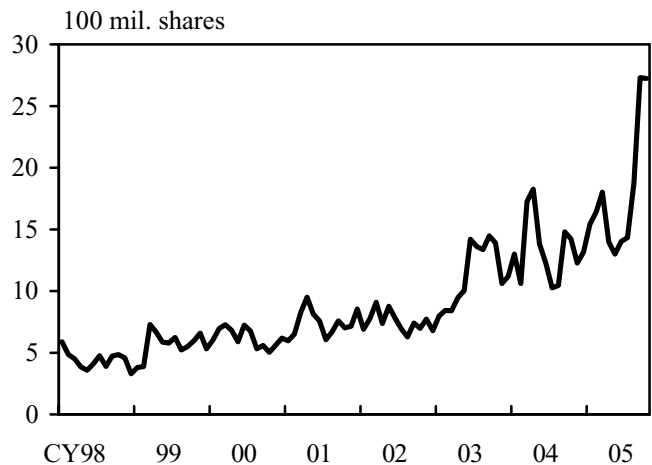
Note: Data are at end of month. Figures for October 2005 are the latest available data.

### (2) Trading Volume by Investor Type



Note: Figures are the sum of the first and second sections of the Tokyo, Osaka, and Nagoya stock exchanges.

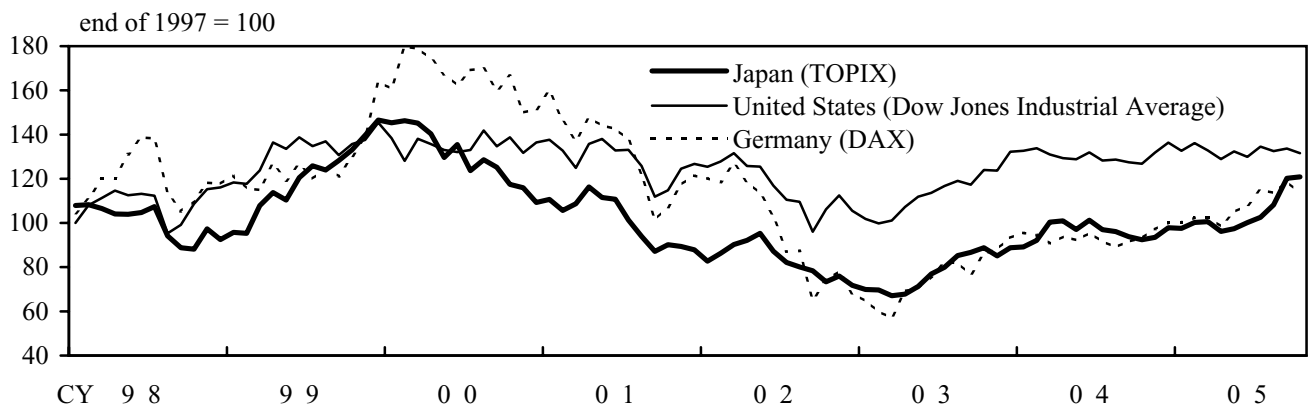
### (3) Trading Volume



Notes: 1. Data are monthly average. Figure for October 2005 is the average up to the latest available data.

2. Figures are for the Tokyo Stock Exchange First Section.

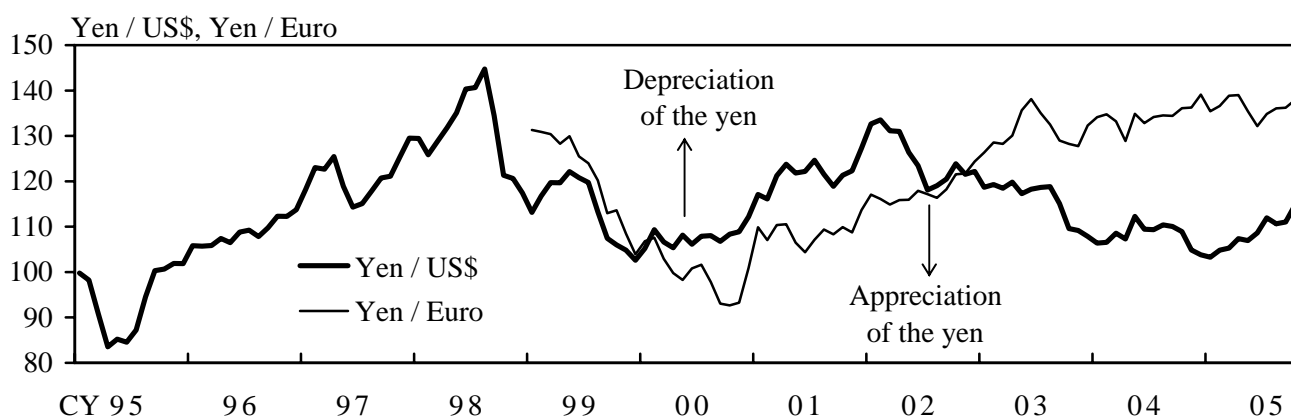
### (4) Major Countries



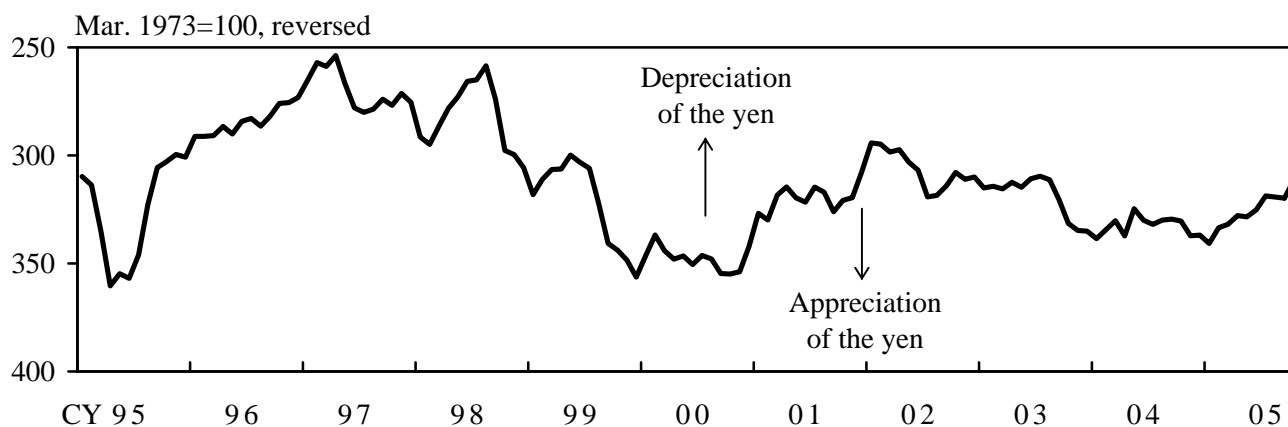
Note: Data are at end of month. Figures for October 2005 are the latest available data.

## Exchange Rates

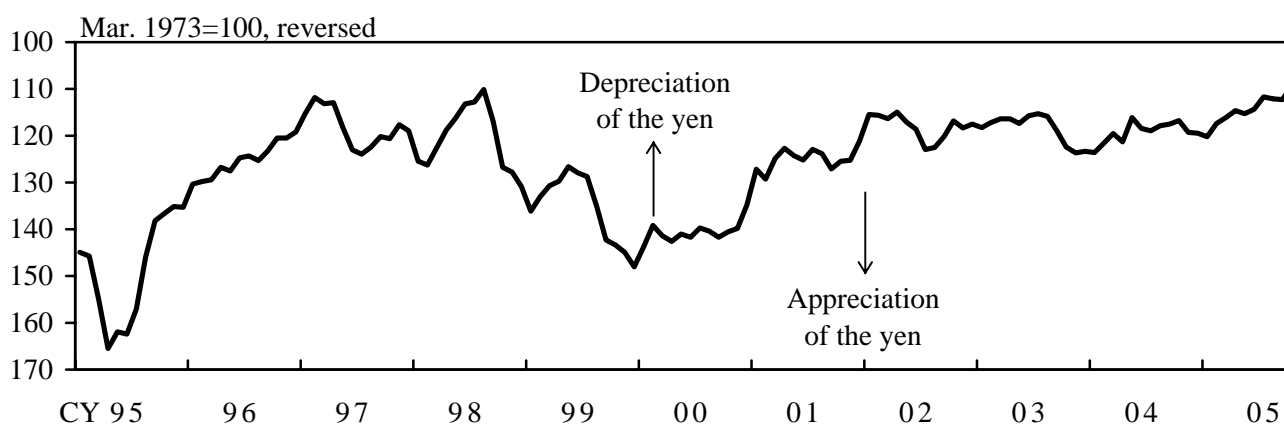
(1) Yen / US\$ and Yen / Euro<sup>1</sup>



(2) Nominal Effective Exchange Rate<sup>1,2</sup>



(3) Real Effective Exchange Rate<sup>1,2,3</sup>



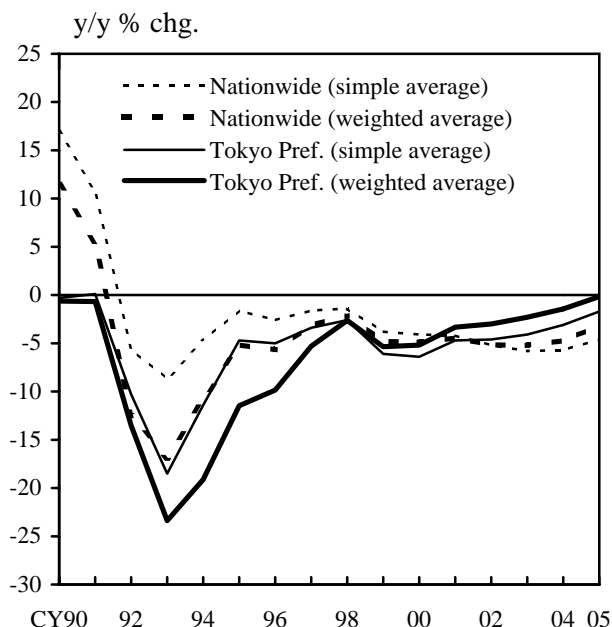
- Notes: 1. Monthly average. Figures for October 2005 are averages up to the latest available data.  
 2. The nominal and real effective exchange rates are set against 15 currencies that have a large share among Japanese total exports.  
 3. The real effective exchange rate is a weighted average of the yen's real exchange rates which are calculated from the nominal exchange rates and price indexes of the relevant countries.

Source: Bank of Japan.

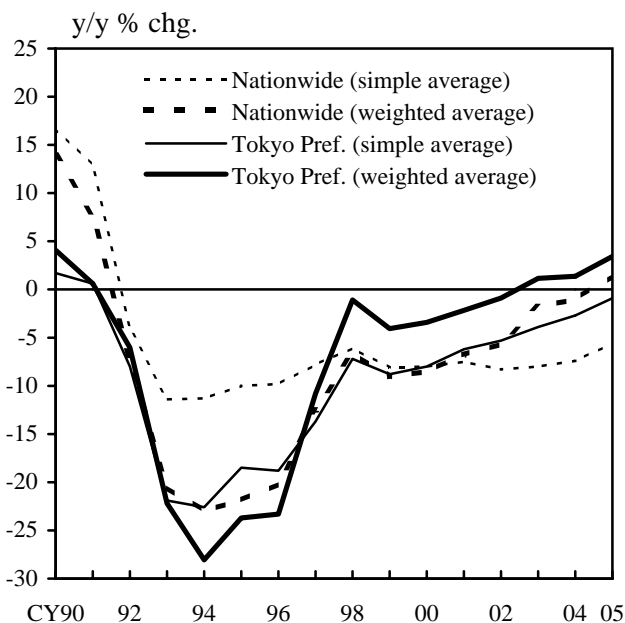
# Land Prices

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

<Residential Land>



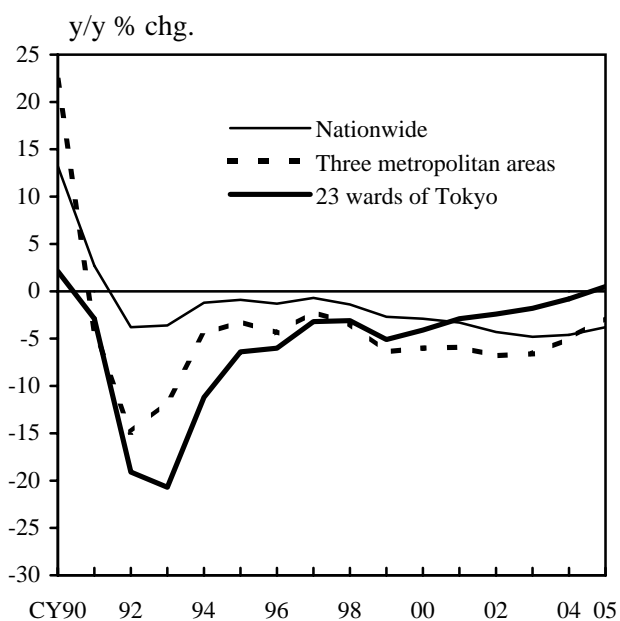
<Commercial Land>



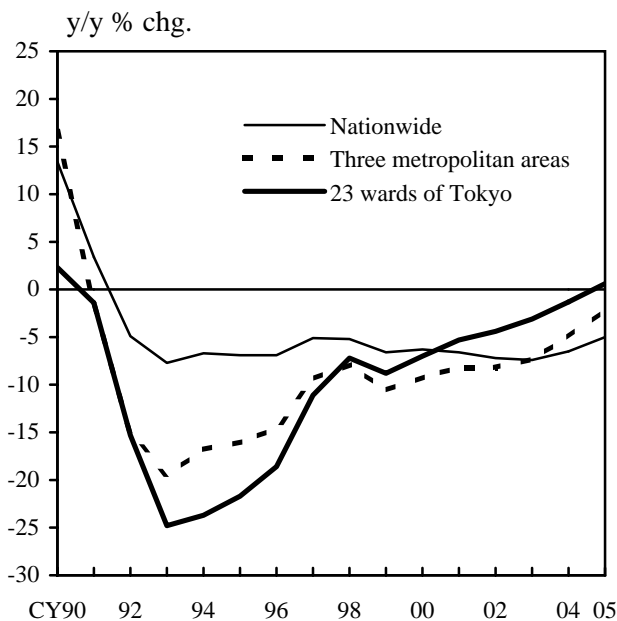
Note: Average land prices released by Ministry of Land, Infrastructure and Transport are simple averages of the rates of change in land prices per square meter at individual locations surveyed. Weighted averages are calculated by the Bank of Japan. The weights are derived from the value of land (individual land prices multiplied by the area of the land) in the previous year.

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

<Residential Land>



<Commercial Land>

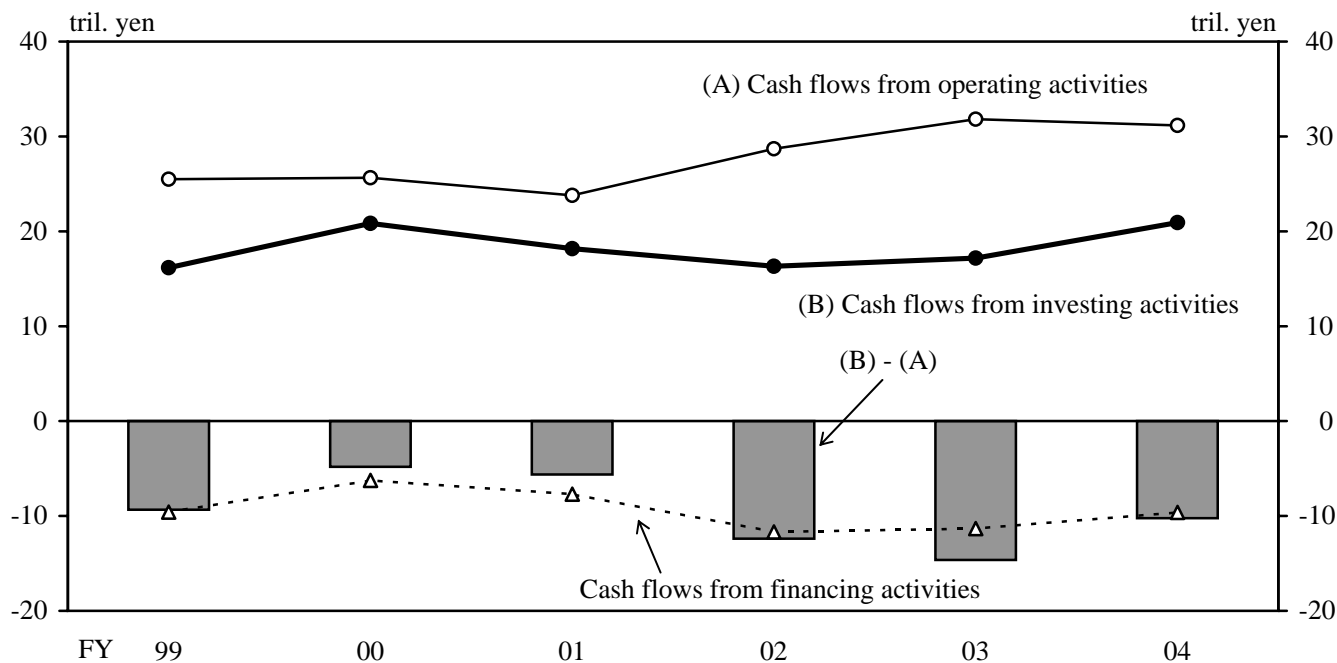


Note: Three metropolitan areas: simple average of the Tokyo area (Tokyo, Kanagawa, Saitama, Chiba, and Ibaraki prefectures), the Osaka area (Osaka, Hyogo, Kyoto, and Nara prefectures), and the Nagoya area (Aichi and Mie prefectures).

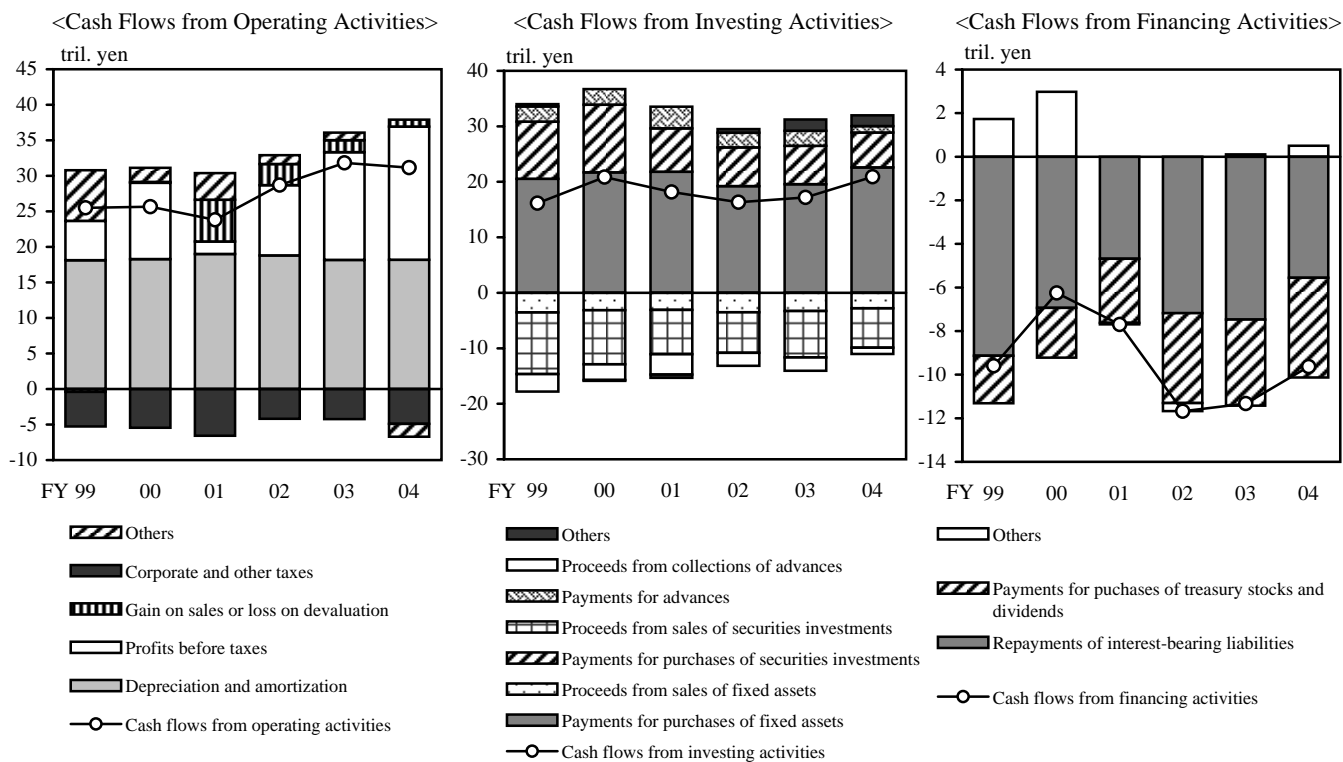
Sources: Ministry of Land, Infrastructure and Transport, "Land Price Publication," "Prefectural Land Price Survey."

## Cash Flows of Firms

### (1) Overview of Cash Flows



### (2) Content of Cash Flows

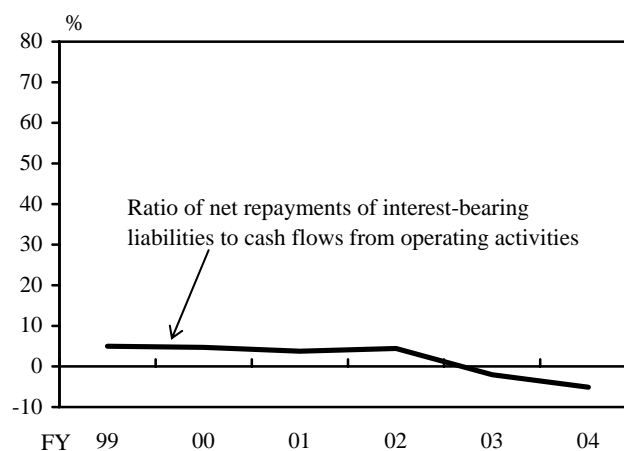
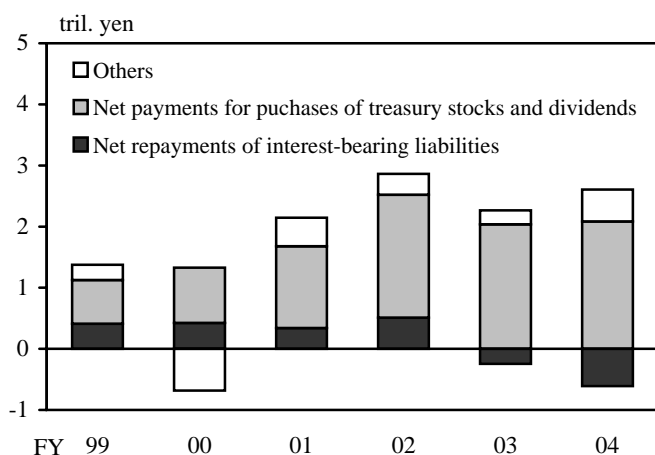


Note: Data are for 1,072 firms (excluding financial institutions, nonbanks, and electric and gas utility firms), listed on the Tokyo Stock Exchange First Section, which have continuously disclosed consolidated statements of cash flows since FY 1999.

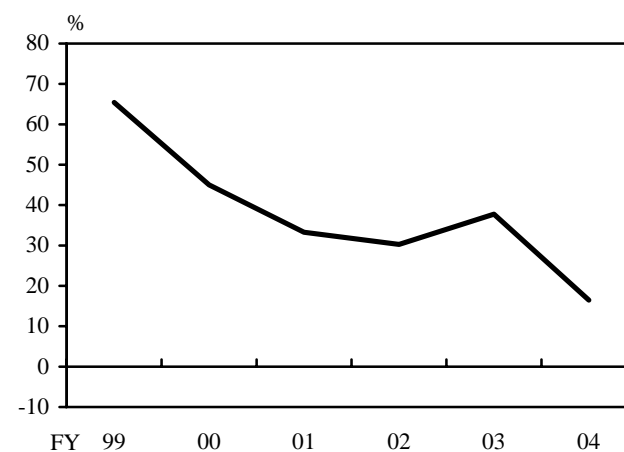
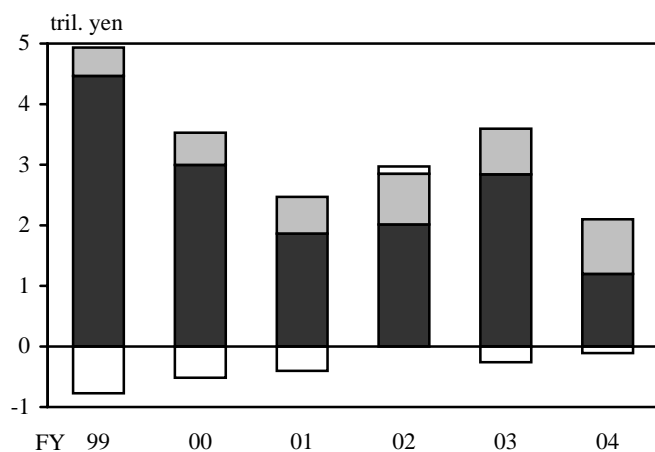
Source: Nikkei Financial QUEST.

## Comparison of Cash Flows by Ratings

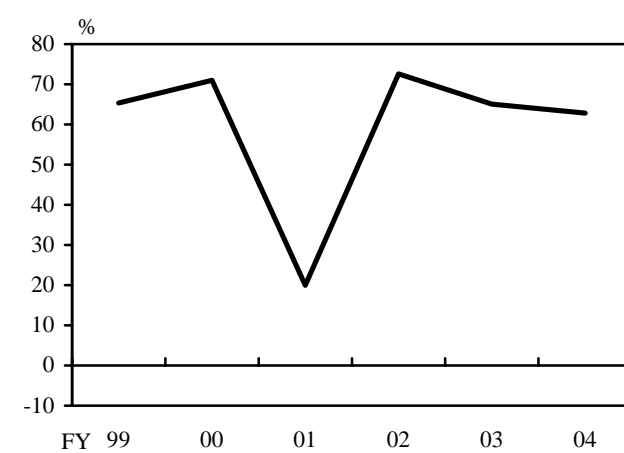
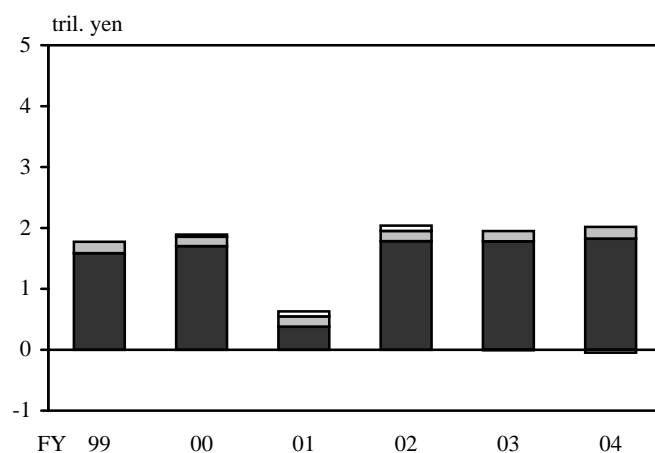
### (1) Rating AA or AAA (49 Firms)



### (2) Rating A (151 Firms)



### (3) Rating BBB (127 Firms)



Note: Data are for 342 firms (excluding financial institutions, nonbanks, and electric and gas utility firms), listed on the Tokyo Stock Exchange First Section, which have continuously disclosed consolidated statements of cash flows since FY 1999 and received ratings from Rating and Investment Information, Inc. at the end of July 2005. Those enterprises are classified by their ratings at the end of FY 2004.