Not to be released until 2:00 p.m. Japan Standard Time on Monday, November 1, 2004.

November 1, 2004
Bank of Japan

Outlook for Economic Activity and Prices

October 2004

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

[The Bank's View][1]

(Outlook for Economic Activity and Prices)

Japan's economy continues to recover. As exports and production continue to be on an uptrend, albeit at a slightly slower pace, corporate profits are increasing, and this has led to an increase in business fixed investment. Household consumption continues to hold up well reflecting the improvement in the employment situation and consumer sentiment. Thus, economic activity is deviating above the "Outlook for Fiscal 2004" described in the *Outlook for Economic Activity and Prices* released in April 2004. Developments in domestic corporate goods prices are deviating above the "Outlook for Fiscal 2004," while those in consumer prices are generally in line with it.

Looking forward, Japan's economy is expected to continue recovering and gradually move to a sustainable growth path. Though overseas economies are expected to grow at a somewhat slower pace due to the rise in crude oil prices and inventory adjustment in IT-related goods, they are likely to continue expanding. Under such circumstances, Japan's exports are likely to continue increasing, albeit at a slower pace. The ongoing inventory adjustment in IT-related goods is expected to be small. Production in the materials industry is at high levels reflecting the increase in demand. Thus, industrial production is expected to continue an uptrend given the low levels of inventory in the manufacturing industry as a whole. Profits of firms both large and small in a wide range of industries are likely to continue increasing as firms have reduced costs and strengthened their financial position. Moreover, structural adjustment pressure stemming from excess capacity and debt has been easing. Against this background, business fixed investment is expected to continue increasing. While firms are expected to continue restraining labor costs, household income is likely to start increasing gradually since corporate profits are increasing and the extent of excess labor perceived by firms is continuing to ease. Household consumption is expected to continue increasing gradually.

Domestic corporate goods prices are likely to continue rising in fiscal 2004 reflecting higher crude oil prices and the tightening of supply-demand conditions for materials. In fiscal 2005, the pace of the rise is likely to become moderate if crude oil prices do not rise

[1] The text of "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on October 29, 2004.

significantly. Meanwhile, consumer prices are unlikely to rise for the time being due partly to the increase in productivity and the restraint on labor costs by firms, though the output gap is continuing to narrow in line with the economic recovery. The year-on-year change in the consumer price index (CPI; excluding fresh food, on a nationwide basis) is likely to continue declining slightly due partly to the fall in rice prices year on year in the second half of fiscal 2004. In fiscal 2005, the CPI is expected to increase slightly on a year-on-year basis reflecting continued improvement in the output gap. It should be noted that the forecasts for prices are subject to some uncertainty as future developments in prices may be influenced by changes in various factors, such as crude oil prices, productivity, and labor costs.

(Positive and Negative Deviations)

The following factors could make the economy deviate either above or below the *Outlook for Economic Activity and Prices* through fiscal 2005 (the Outlook).

The first factor is the developments in overseas economies. There is a possibility that the U.S. and East Asian economies, particularly the Chinese economy, could make the global economy deviate below the Outlook, and reduce Japan's exports. A further rise in crude oil prices, which are already at high levels, could cause the global economy, especially oil importing economies, to deviate below the Outlook through a decline in corporate profits and in households' real purchasing power. Since demand for IT-related goods tends to be volatile, adjustment in both production and inventory may become severe if final demand declines more than anticipated.

The second factor is the developments in domestic private demand. Greater-than-expected fluctuations in crude oil prices and global demand for IT-related goods could influence not only Japan's exports through the change in overseas economies as described earlier but also business fixed investment and other domestic private demand. If firms continue to restrain labor costs persistently, delayed improvement in household income could cause household consumption to deviate below the Outlook. On the other hand, if bullish sentiment about the economic outlook becomes widespread among firms and households against the background of the increase in productivity and progress in structural adjustments, business fixed investment and household consumption may deviate above the Outlook.

The third factor is the developments in domestic financial and foreign exchange markets.

While financial markets reflect the developments in economic activity and prices in the medium to long term, they may fluctuate due to various factors in the short term. Depending on the extent and direction of market developments, the economy could deviate either above or below the Outlook.

The fourth factor is the nonperforming loan (NPL) problem and financial system developments. Considerable progress has been made in the resolution of the NPL problem, and concerns over financial system stability have been subsiding. Though financial system problems warrant continued monitoring given the upcoming removal of blanket deposit insurance in April 2005, concerns that they could affect economic activity through corporate finance are receding.

(Conduct of Monetary Policy)

Currently, firms have been striving to increase profitability by articulating their business strategy, reducing costs, and strengthening their financial positions. Their efforts have been bearing fruits. Financial institutions have been making progress in disposing of their NPLs. The government on its part has been backing the private sector efforts toward revitalization through deregulation and reforms in the areas of financial infrastructure, tax system, and public expenditure. The Bank of Japan has been continuing with aggressive monetary easing. If various economic agents continue their efforts and the economic recovery gathers further momentum, there will be a stronger possibility of achieving sustainable growth and overcoming deflation.

In such circumstances, the Bank is firmly committed to continue with the quantitative easing policy until the year-on-year rate of change in the CPI (excluding fresh food, on a nationwide basis) registers zero percent or higher on a sustainable basis. The positive effect of the commitment through interest rates on the economy will strengthen as corporate profits increase along with the economic recovery.

Under the current Outlook, it is not certain whether or not the occasion will arise during fiscal 2005 to change the present monetary policy framework of using the current account balances at the Bank as the main operating target. The way the central bank conducts monetary policy depends on future developments in economic activity and prices. If higher productivity and other factors continue to contain to a large extent upward pressure on prices as the economy follows a sustainable and balanced growth path, this will likely give the Bank latitude in conducting monetary policy.

The Bank will take appropriate measures in a flexible manner in response to changes in economic and financial developments, while endeavoring to offer a lucid explanation about the assessment of economic activity and prices as well as the thinking behind the conduct of monetary policy. The Bank will continue to enhance its communication with market participants so that they will be better able to judge and predict the future conduct of monetary policy.

Forecasts of the Majority of Policy Board Members[2]

(y/y % chg.)

	Real GDP	Domestic CGPI	CPI (excluding fresh food)
Fiscal 2004	+3.4 to +3.7 [+3.6]	+1.4 to +1.5 [+1.5]	–0.2 to –0.1 [–0.2]
Forecasts made in April 2004	+3.0 to +3.2 [+3.1]	+0.1 to +0.3 [+0.2]	–0.2 to –0.1 [–0.2]
Fiscal 2005	+2.2 to +2.6 [+2.5]	+0.2 to +0.5 [+0.3]	–0.1 to +0.2 [+0.1]

Notes: 1. Brackets indicate 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.

[2] Forecasts of the majority of Policy Board members are shown as a range, with the highest and lowest figures excluded. The forecasts of all Policy Board members are as follows.

(y/y % chg.)

	Real GDP	Domestic CGPI	CPI (excluding fresh food)
Fiscal 2004	+3.2 to +3.7	+1.4 to +1.8	–0.2 to –0.1
Forecasts made in April 2004	+2.9 to +3.5	+0.1 to +0.5	–0.2 to +0.5
Fiscal 2005	+2.0 to +2.6	+0.1 to +1.3	–0.1 to +0.3

[The Background]

1. Economic Activity, Prices, and Financial Developments

(Economic Activity and Prices in the First Half of Fiscal 2004)

Japan's economy, which had entered a recovery phase from the second half of 2003, continued to recover. From the second half of 2003 through the first half of 2004, exports grew sharply and production continued to increase as the growth rates of overseas economies accelerated. Thereafter, exports and production maintained their upward trend, albeit at a slower pace, reflecting the slight slowdown in growth of overseas economies (Charts 1 and 2). In this situation, corporate profits and business sentiment improved to around the highest levels since the bursting of asset price bubbles (Charts 3 and 4). Business fixed investment continued to increase. Construction starts began to show a clear uptrend partly due to the favorable effect stemming from low land prices (Charts 5 and 6). Positive effects of the increase in production and corporate profits were observed in the employment situation, as evidenced by the decline in the unemployment rate and the increase in the number of employees. Household income, though coming close to a halt, yet showed no clear signs of an increase as firms continued to restrain labor costs by the use of temporary workers (Chart 7). Household consumption held up well due partly to improvement in consumer sentiment.

Domestic corporate goods prices increased 1.8 percent year on year in September 2004 due to the rise in commodity prices at home and abroad as well as improvement in supply-demand conditions (Chart 8). Consumer prices (excluding fresh food, on a nationwide basis), on the other hand, continued a slight downtrend on a year-on-year basis reflecting the fact that the effect of temporary factors, which raised prices in the previous year, gradually fell off.[3] Although commodity prices rose, consumer prices did not increase except for some components such as gasoline prices. The decline in consumer prices in the rapidly growing economy seemed to be due mainly to the fact that intense competition among firms persisted and unit labor costs (labor costs per output) continued to decline reflecting the increase in productivity and the restraint on labor costs (Charts 9 and

[3] Temporary factors include the increase in medical treatment costs in April 2003 and tobacco tax in July 2003. As one year has passed since the increase, the effects on prices year on year fell off. The year-on-year rate of increase in rice prices, which began in the autumn of 2003, has been slowing as rice harvested in 2004 starts to come on the market.

10).[4]

Expectations for lower prices were diminishing among households and firms (Chart 11).

In the "Outlook for Fiscal 2004" described in the *Outlook for Economic Activity and Prices* released in April 2004, the economy was expected to continue its recovery, gradually gathering momentum with the increase in production and corporate profits. Economic activity since April 2004 has deviated above the "Outlook for Fiscal 2004." Domestic corporate goods prices deviated above the "Outlook for Fiscal 2004" due to the greater-than-expected rise in commodity prices both at home and abroad, whereas consumer prices were more or less in line with it.

(Outlook for Economic Activity through Fiscal 2005)

During the second half of fiscal 2004 and fiscal 2005, Japan's economy is expected to continue its recovery since overseas economies are likely to continue expanding and structural adjustment pressure on the economy is likely to ease, though the pace of increase in production is expected to remain moderate due partly to inventory adjustment in IT-related goods.

Overseas economies, the United States and China in particular, are expected to continue expanding, though at a more moderate pace than the high growth rate to date, partly due to the rise in crude oil prices. The ongoing inventory adjustment in IT-related goods is likely to be small because the market for digital appliances is still growing and production is being curtailed to prevent accumulation of excessive inventories. As a result, exports and production are likely to continue an upward trend, albeit with some fluctuations. Business fixed investment is likely to continue increasing in not only export related but also domestic demand related areas, given that corporate profits are increasing and structural adjustment pressure from excessive capacity and debt is easing. While firms are likely to continue restraining labor costs, household income is expected to start rising gradually since corporate profits are increasing and the extent of excessive labor perceived by firms is easing. Household consumption is likely to increase gradually.

---

[4] Unit labor costs are calculated by dividing the compensation of employees by real GDP. The rise in productivity and the decline in calculated unit labor costs will be larger to the extent of upward bias of real GDP as described in footnote 5. Thus, it should be noted that the actual decline in unit labor costs for the past year or two may have been smaller than the calculated value.

Given the above situation, Japan's economy is expected to continue growing at a rate slightly above its potential as both external and domestic private demand increase. Looking at growth rates for each fiscal year, fiscal 2004 is likely to record high growth on annual average due to the base effect that high growth in the latter half of fiscal 2003 boosted the level of economic activity in the early part of fiscal 2004. Fiscal 2005 is likely to post a slower growth rate closer to the economy's potential growth rate.[5]

(Outlook for Prices through Fiscal 2005)

The output gap, which influences the underlying trend of prices, is likely to narrow steadily reflecting the economic recovery (Charts 12 and 13).[6] The rise in crude oil and other commodity prices at home and abroad is likely to exert upward pressure on prices of raw materials and intermediate goods at least for the time being. However, the effect of higher prices of raw materials and intermediate goods is likely to be offset to a large extent by the reduction in unit labor costs due to the increase in productivity and the restraint on labor costs through the active use of part-time workers and outsourcing in the corporate sector. In the situation where the pace of recovery in household consumption is still unlikely to accelerate, firms are likely to set prices of their goods and services under the severe competition thanks to the effect of various deregulatory measures. Thus, upward pressure on prices of consumer goods and services is likely to be contained.

Given the above situation, domestic corporate goods prices, which consist solely of goods and have the heavy weighting of raw materials and intermediate goods, are likely to continue rising for some time. The pace of increase is expected to slow through fiscal 2005 as long as crude oil prices do not rise significantly.

---

[5] As was described in the *Outlook and Risk Assessment of the Economy and Prices* in October 2003, the GDP deflator, which is the Paasche index, tends to decline at a faster pace than the Laspeyres price index. This is partly because the Paasche index, unlike the Laspeyres index, reflects changes in product weighting, and heavy weighting tends to be given to the products that experience significant price declines and improvements in quality, and also because the difference between the Paasche index and the Laspeyres index widens as the year to calculate the index moves away from the base year. The recent GDP deflator may have a downward bias due mainly to the fact that 1995 is the base year and that the weighting of IT-related goods is increasing. Thus, the calculated value of real GDP growth could have an upward bias to the extent that the deflator has a downward bias. Given this possibility, the potential growth rate is considered to be around 2 percent. To remove such a bias, the Cabinet Office has announced that it will work toward an early introduction of the chain index method which requires the base year to be revised more frequently.

[6] Generally, the output gap will narrow if the real GDP growth rate exceeds the potential growth rate

Consumer prices in fiscal 2004 are expected to decline slightly year on year due partly to the fall in rice prices. In fiscal 2005, consumer prices are expected to post a small rise year on year reflecting continued improvement in the output gap.

The outlook for prices depends on a variety of factors, such as changes in crude oil prices, the output gap, and unit labor costs. Unit labor costs, which have been declining, are expected to increase eventually, but the extent of the decline and the timing of a turnaround are uncertain at present because they depend on the sustainability of the current productivity growth and the room for firms to further restrain labor costs through the use of temporary workers. It should be noted that the forecasts for prices are subject to some uncertainty.

(Financial Developments)

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

Banks are generally expected to continue easing their lending attitude, though they are likely to remain cautious about making loans to borrowers with low creditworthiness. Credit demand in the corporate sector is unlikely for the time being to show a clear turnaround to an increase as firms continue to repay debt to improve their balance sheets (Chart 14), though the pace of decline in credit demand is expected to slow gradually against the background that business activity is becoming more buoyant as seen in the continued increase in business fixed investment. In this situation, bank lending is likely to continue declining, albeit at a moderate pace. The growth rate of the money stock is expected to increase with the expansion of economic activity, though it is unlikely to accelerate conspicuously for the time being.

2. Positive and Negative Deviations

(Developments in Overseas Economies)

In the Outlook, overseas economies are expected to continue expanding, though at a more

---

mentioned in footnote 5 above.

moderate pace than the high growth rate to date.

The U.S. economy seems to be maintaining its momentum for expansion. Corporate profits and business fixed investment are continuing to increase, while growth of consumer outlays has been slowing and since the early spring of 2004 the pace of increase in the number of employees has been decelerating. East Asian economies, particularly the Chinese economy, are likely to continue high growth.

Developments in crude oil prices and demand for IT-related goods require attention. A further rise in crude oil prices, which are already at high levels, could cause the global economy to deviate below the path assumed in the Outlook through declines in corporate profits and in households' real purchasing power (Chart 15). Inventory adjustment in IT-related goods is assumed to be small in the Outlook, but it may become severe if final demand falls. Changes in demand for IT-related goods are expected to exert a large impact on the global economy, especially the U.S. and East Asian economies, as their production process has become increasingly internationally linked.

In China, measures by the public authorities to contain overheating of the economy are taking effect, as evidenced by the halt of acceleration in the growth rate of fixed asset investment. However, close monitoring is required as the economy is still somewhat overheated.

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

(Developments in Domestic Private Demand)

A further rise in crude oil prices and developments in demand for IT-related goods may influence Japan's economy not only through changes in overseas economies but also through their impact on business fixed investment and other domestic private demand. It should be noted that the direct effect of higher crude oil prices on Japan's economy is expected to be relatively small given its high energy efficiency.[7]

---

[7] Heavy crude oil of the Middle East accounts for a large portion of Japan's imports of crude oil. Dubai crude oil prices, which are the benchmark price for heavy crude oil, have been rising less than

In the Outlook, household consumption is expected to increase gradually as the recovery of the corporate sector spreads to the household sector. This is against the background that corporate profits are increasing and the employment situation is improving, though firms continue to restrain labor costs. If firms' restraints on labor costs are stronger than expected, improvement in household income may be delayed, and the pace of increase in household consumption, which has held up due to higher propensity to consume reflecting improved consumer sentiment, may decelerate.

Meanwhile, if bullish sentiment about the economic outlook becomes widespread among firms and households against the background of higher productivity and progress in structural adjustments, business fixed investment will expand further, and household consumption will increase at a faster pace than household income.

(Developments in Financial and Foreign Exchange Markets)

While financial markets reflect developments in economic activity and prices in the medium to long term, they may fluctuate due to various factors in the short term. Changes in stock prices, long-term interest rates, and foreign exchange rates, depending on their extent and direction, could make the economy deviate either above or below the Outlook.

Stock prices are continuing to be firm amid the economic recovery. Large fluctuations in stock prices affect the spending behaviors of firms and households through changes in their sentiment as well as changes in corporate profits and capital positions. Though stocks held by banks have declined, changes in the value of stocks they hold could still affect their lending attitude.

Long-term interest rates are recently at around 1.5 percent. The amount outstanding of government securities in Japan is the largest among industrialized countries, and banks hold a large portion of these securities. If long-term interest rates fluctuate more than economic activity and prices warrant, they could affect economic activity through changes in firms' funding costs and banks' profitability.

---

those of the North Sea Brent and the West Texas Intermediate. For this reason, it is considered that the direct effect of higher crude oil prices on Japan's economic activity and prices has been relatively small.

In the foreign exchange market, the yen was at around 110 yen against the U.S. dollar from the beginning of fiscal 2004. Recently, however, the yen has been appreciating slightly. Changes in foreign exchange rates could influence the economy through exports and imports as well as corporate profits.

(Disposal of NPLs and Financial System Developments)

Considerable progress has been made in the resolution of the NPL problem, which has long been a burden to Japan's economy, and concerns over financial system stability have been subsiding. Given this assessment, the Outlook assumes that accommodative conditions in corporate funding are expected to continue.

Financial system fragility has tended to amplify a recession, which has been observed since the bursting of asset price bubbles. Such concern has receded due to increased soundness of the financial system (Chart 16). Developments in the financial system, nevertheless, warrant continued monitoring in view of the removal of blanket deposit insurance in April 2005.

3. Evaluation of Financial Environment and Conduct of Monetary Policy

Since the adoption of quantitative easing in March 2001, the Bank has been 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 (Chart 17). As a result, the outstanding balance of current accounts at the Bank has been at around 33 trillion yen on average, which is substantially larger than the required reserves of about 6 trillion yen (Charts 18[1] and [2]).

Short-term interest rates, including term rates, have been at around zero percent as a result of ample liquidity provision by the Bank (Chart 18[3]).

Short-term interest rate futures have been generally stable at low levels, though they temporarily increased slightly in the early summer of 2004 (Chart 19).

Long-term interest rates rose through the middle of 2004 reflecting stronger expectations for economic recovery, but declined thereafter as the growth rates of the domestic and overseas economies fell slightly. Recently, they are at around 1.5 percent. Volatility of long-term interest rates has been at low levels (Chart 20).

The credit spread between short-term government securities and CP has generally been stable at low levels under the quantitative easing policy. The credit spread between long-term government bonds and corporate bonds has been at low levels as well. The spread of corporate bonds with low credit ratings is still trending further downward (Chart 21).

The overall condition in corporate finance has become more accommodative except for firms with low creditworthiness. While firms continue reducing debt, the pace of decline in credit demand has slowed reflecting the increase in business activity as seen in larger business fixed investment.

Banks have continued easing their lending attitude, although they remain cautious in making loans to borrowers with low creditworthiness. The lending attitude of banks perceived by firms, including small firms, has continued to become more accommodative (Chart 22). Average lending rates remain at low levels. The funding environment for firms in CP and bond markets is generally favorable. Firms have been active in equity finance.

Under such circumstances, the amount outstanding of CP and corporate bond issuance has been larger than a year ago, and the rate of decline in bank lending has continued to follow a decelerating trend (Chart 23).

The monetary base (the sum of currency in circulation and current account balances held at the Bank) has been increasing 4 to 5 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. The ratio of the monetary base to nominal GDP, however, remains at extremely high levels (Chart 24). The year-on-year growth rate of the money stock is recently around 2 percent (Chart 25).

Japanese stock prices rose substantially from the middle of 2003 through the spring of 2004 reflecting improvement in business sentiment, and declined slightly as U.S. stock prices fell. They have basically remained firm as corporate profits continue to increase (Chart 26).

The yen appreciated from the autumn of 2003 partly reflecting growing concerns over the U.S. twin deficits, and from the spring of 2004, it was virtually unchanged at around 110 yen against the U.S. dollar. Recently, the yen has been appreciating slightly (Chart 27).

Commercial and residential land prices remain generally on a downtrend. In the three metropolitan areas (Tokyo, Osaka, and Nagoya), however, the pace of decline is slowing (Chart 28). Land prices have started to rise in central Tokyo and some parts of other metropolitan areas, and the decline in property prices in prime locations in regional centers is coming to a halt.

The Bank has made a commitment to continue with the quantitative easing policy until the year-on-year rate of change in the CPI (excluding fresh food, on a nationwide basis) registers zero percent or higher on a sustainable basis, and clarified this commitment in October 2003. The Bank’s commitment has contributed to stabilizing expectations about the future trajectory of interest rates amid the continued economic recovery, enabling firms to enjoy low funding costs. As returns on investment increase along with the economic recovery, net returns are expected to rise gradually. Thus, the positive effect of the commitment through interest rates on the economy will strengthen as corporate profits increase along with the economic recovery.

(BOX) International Comparison of Developments in Prices and Wages in the Recent Recovery Phase

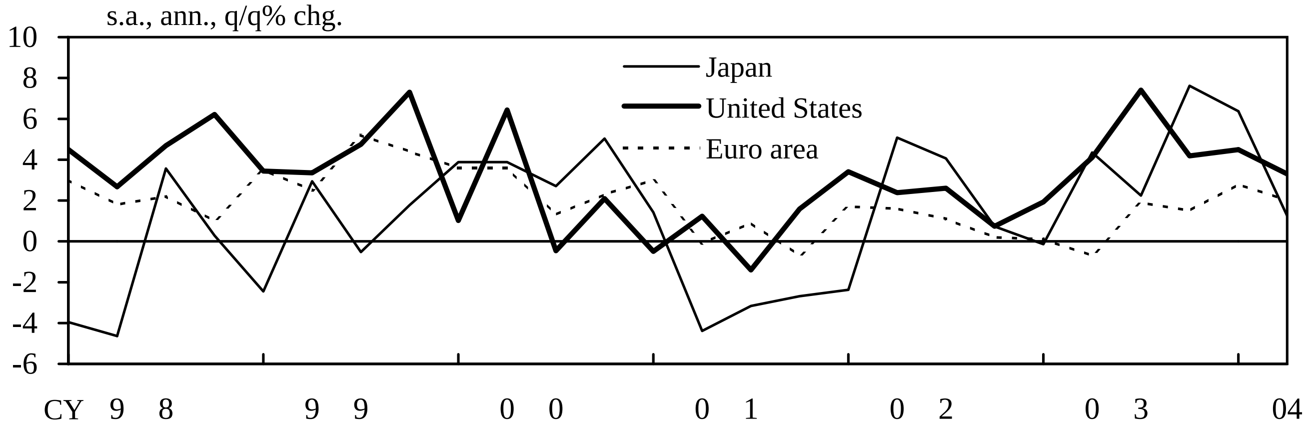
Japan's economy hit bottom in the January–March quarter of 2002, and since then it has been recovering at a pace, faster than that of the euro area and almost equivalent to that of the United States (Chart 1[1] of Box). Despite high economic growth, consumer prices have not risen, and such divergence between growth rates and inflation is the salient feature of the recent economic recovery in Japan (Chart 1[2] of Box). A similar divergence has been observed in other economies, and it is the most conspicuous in Japan where the CPI is continuing a slight downtrend on a year-on-year basis (Chart 2 of Box).

While nominal wages, which generally tend to move with the CPI, have increased about 2 to 3 percent year on year in the United States and the euro area, they have been on a downtrend with some fluctuations in Japan (Chart 3[1] of Box).

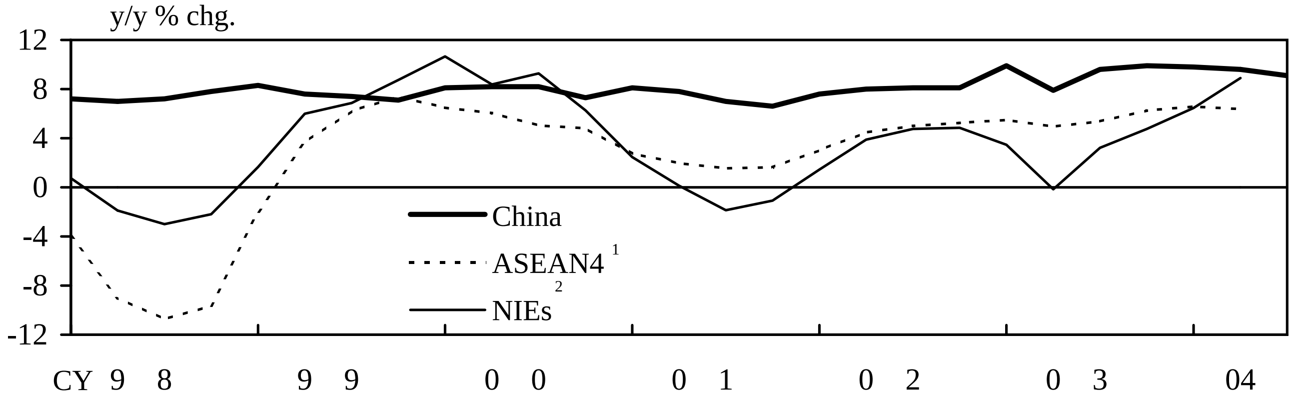
Though the difference between Japan on one hand and the United States and the euro area on the other is reduced significantly in terms of real wages adjusted for price fluctuations, the year-on-year growth rate of real wages are still lower in Japan (Chart 3[2] of Box). Flexibility of nominal wages seems to have contributed to the economic recovery through improvement in corporate profits.

Real GDP Growth Rates in Overseas Economies

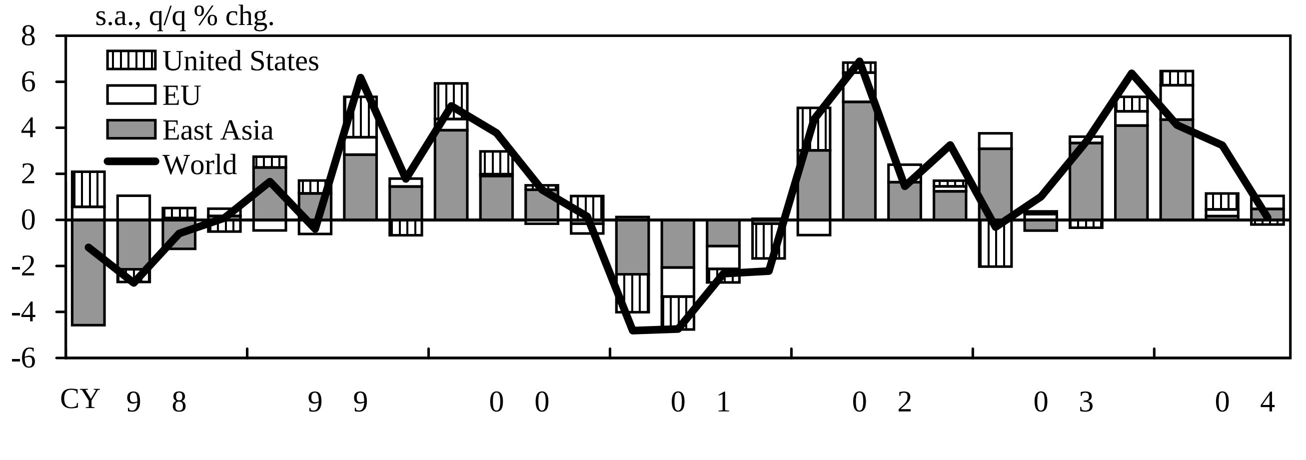
(1) Real GDP Growth Rates in Advanced Economies



(2) Real GDP Growth Rates in East Asian Economies



(3) Real Exports (Breakdown by Region)

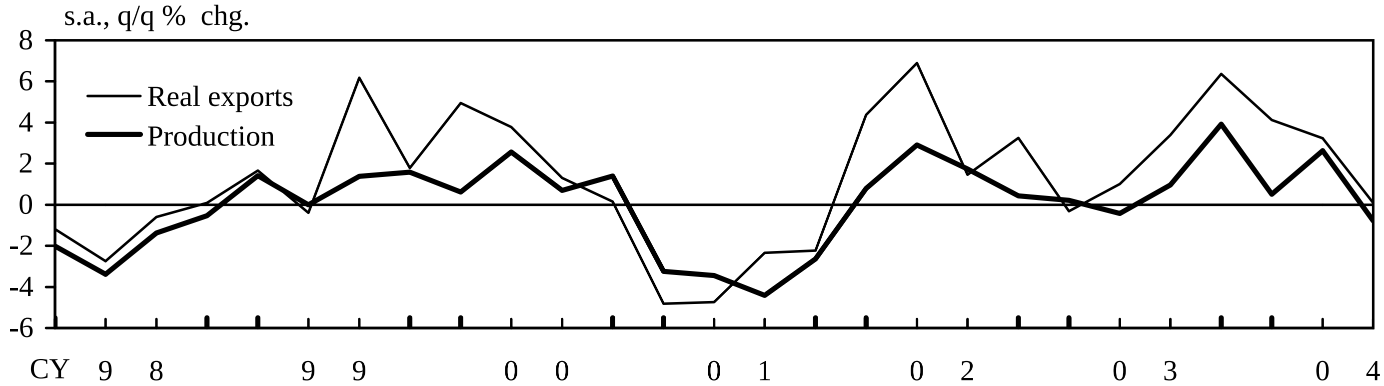


Notes: 1. Data for ASEAN4: Thailand, Malaysia, the Philippines, and Indonesia.
2. Data for NIEs: South Korea, Taiwan, Hong Kong, and Singapore.

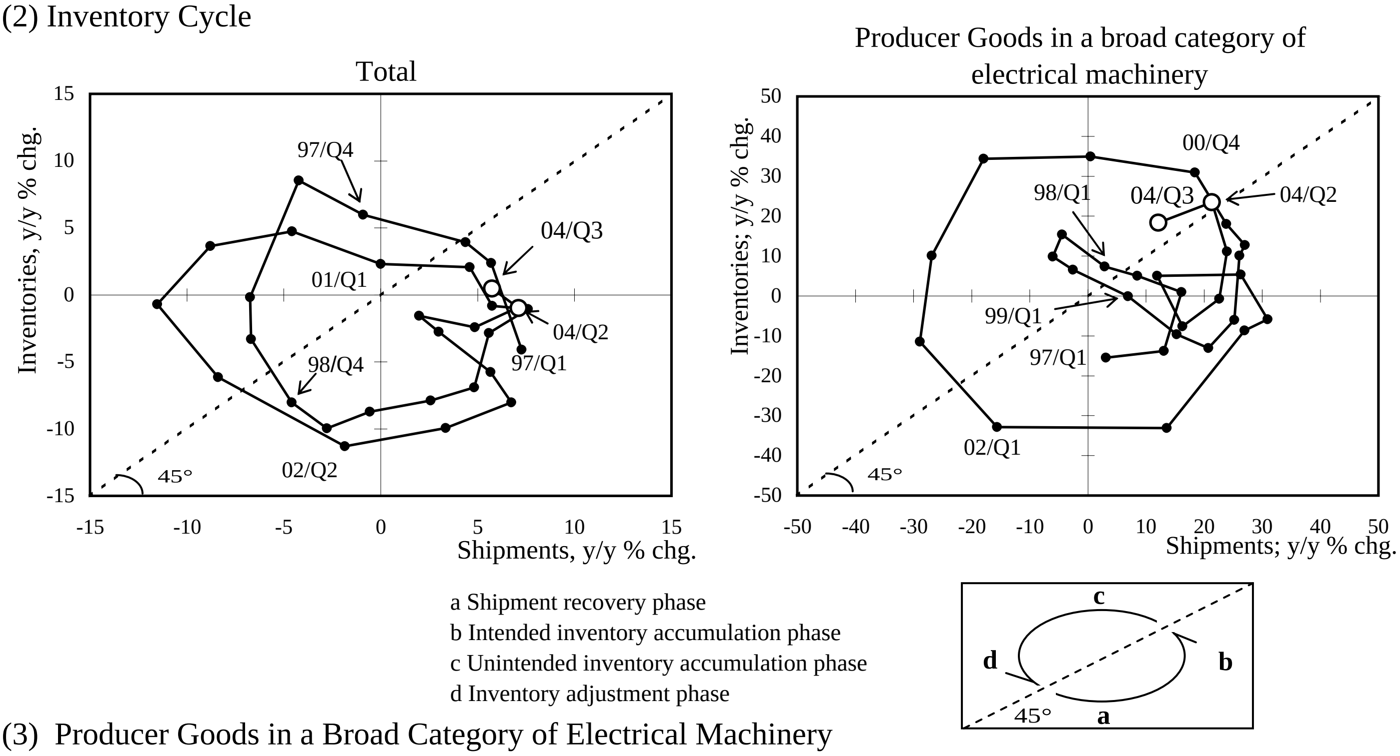
Sources: National governments; central banks; European Commission; Ministry of Finance, "The Summary Report on Trade of Japan"; Bank of Japan, "Corporate Goods Price Index."

Production

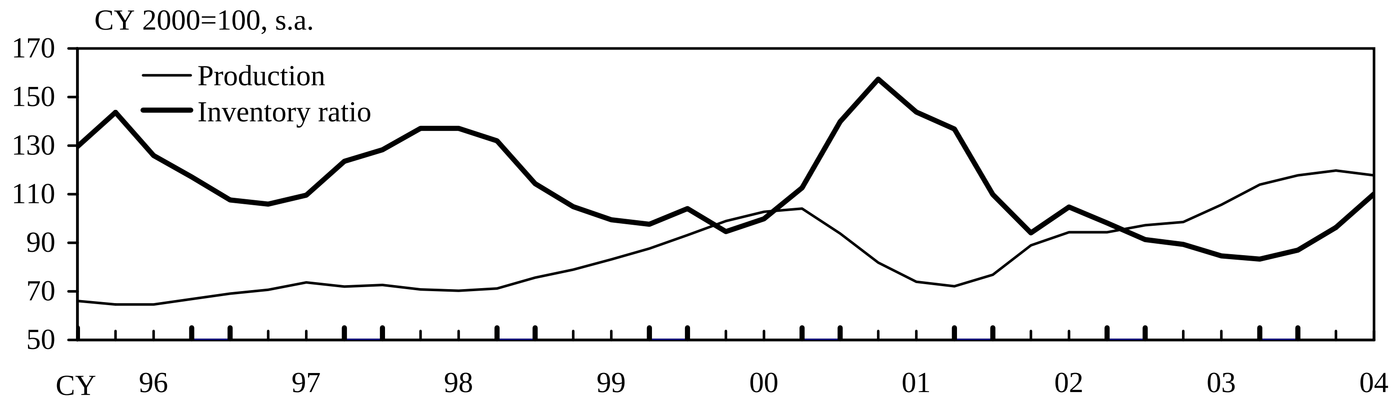
(1) Real Exports and Production



(2) Inventory Cycle

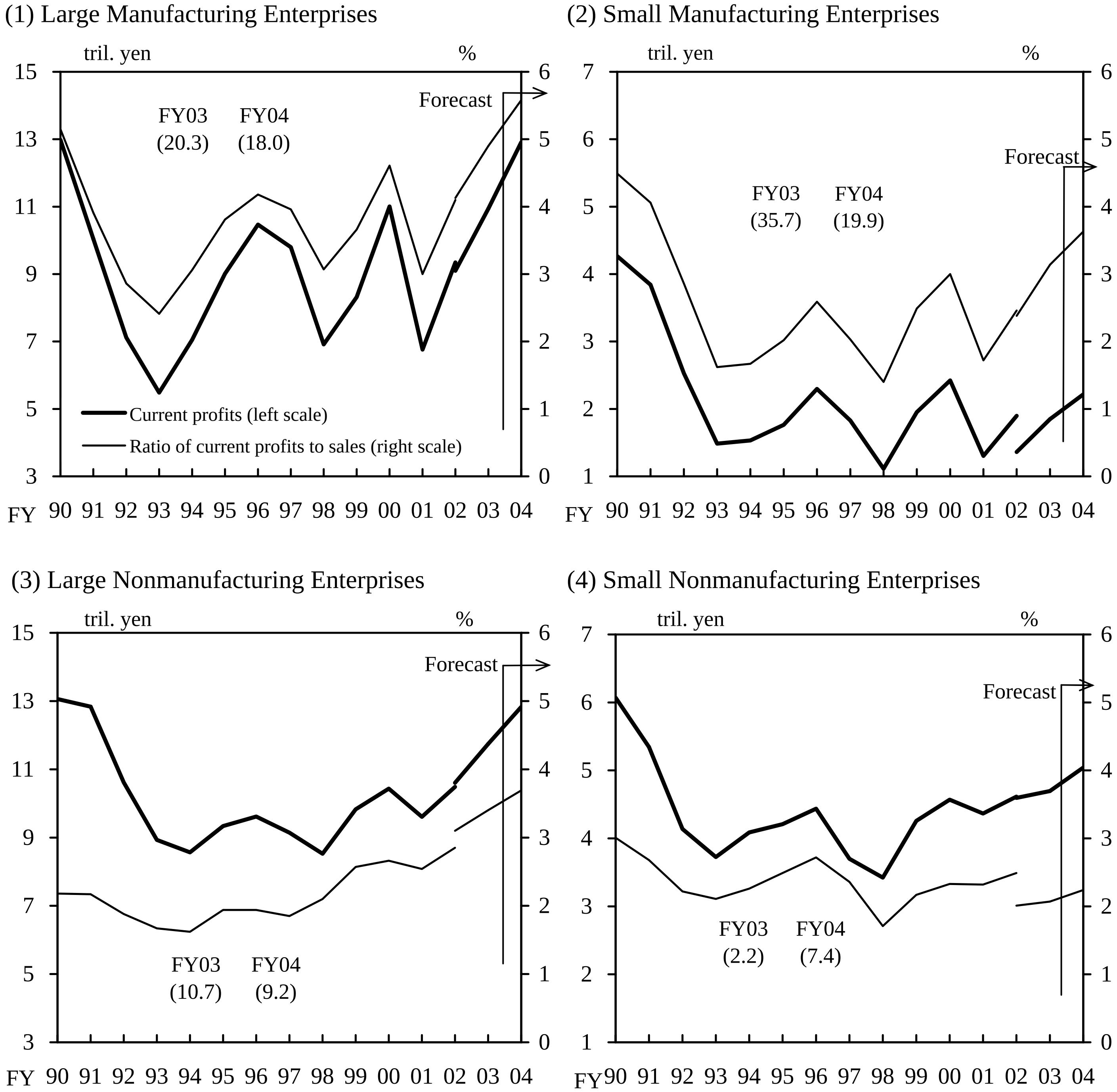


(3) Producer Goods in a Broad Category of Electrical Machinery



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."

Current Profits

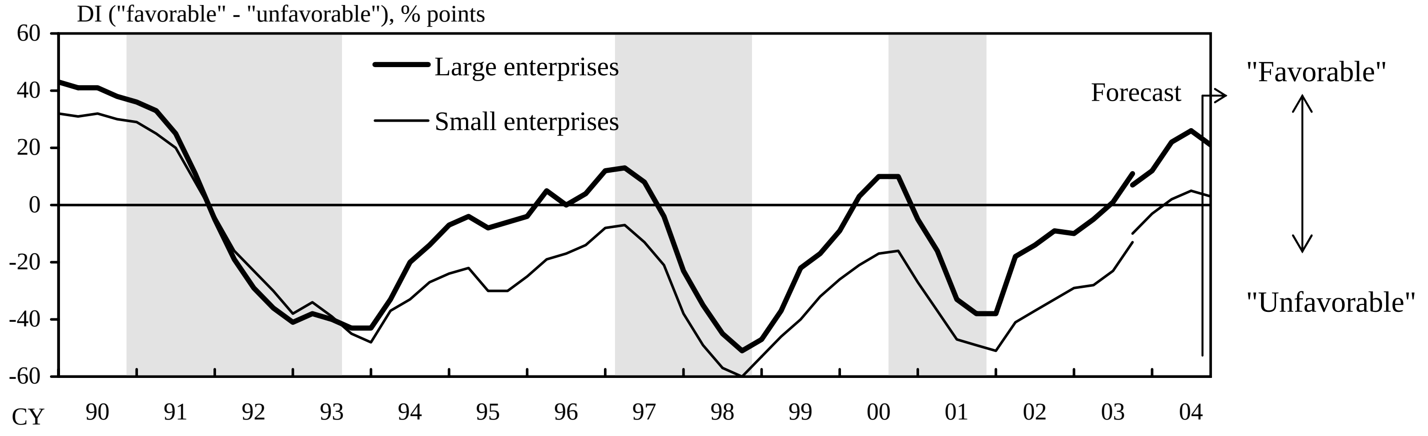


Notes: 1. Large enterprises (pre-revision): 1,000 employees or more
Small enterprises (pre-revision): 50-299 employees (for manufacturing), 20-99 employees (for wholesaling), 20-49 employees (for retailing, services, and leasing), 50-299 employees (for other industries)
Large enterprises (post-revision): capital of 1 billion yen or more
Small enterprises (post-revision): capital of from 20 million yen to less than 100 million yen
2. Parentheses indicate current profits (year-on-year percentage change). Post-revision.
3. The *Tankan* has been revised from the March 2004 survey. Figures up to FY2002 are based on the previous data sets. Figures from FY2002 are on a new basis.

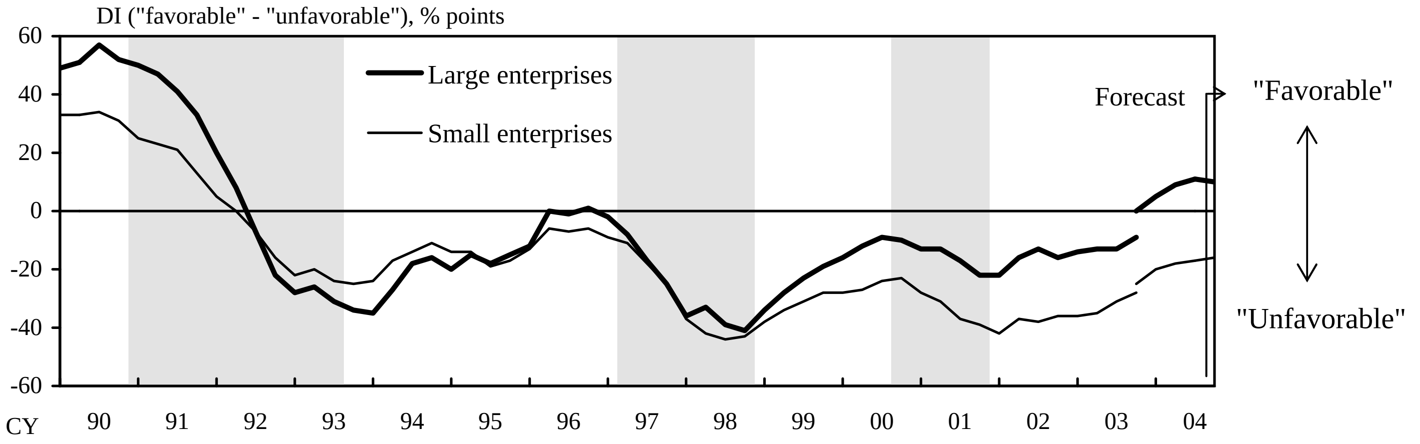
Source: Bank of Japan, "*Tankan* - Short-Term Economic Survey of Enterprises in Japan."

Business Conditions

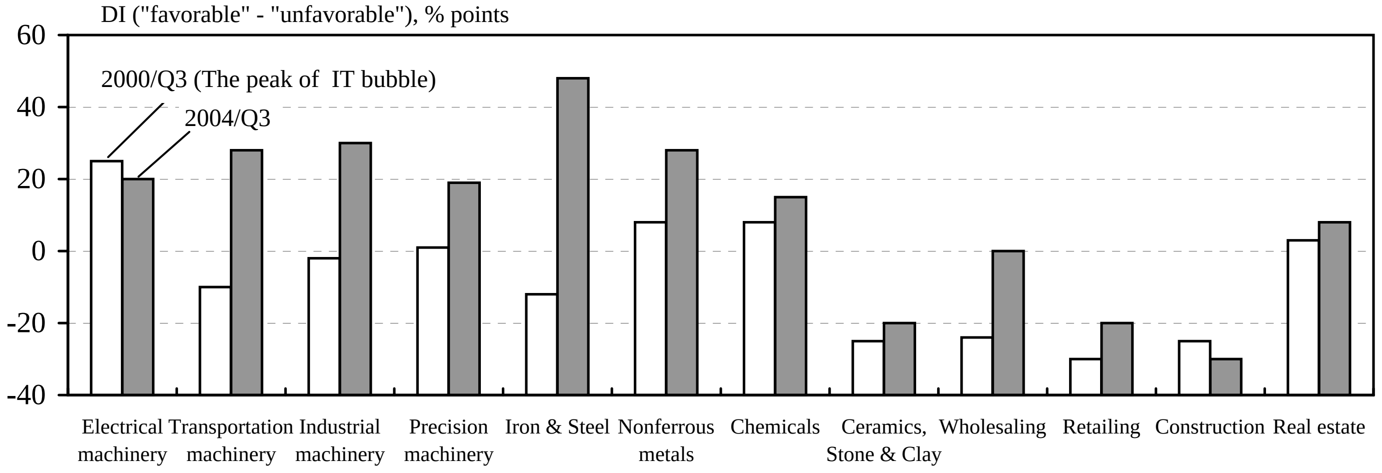
(1) Manufacturing



(2) Nonmanufacturing



(3) Business Conditions by Industries



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

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

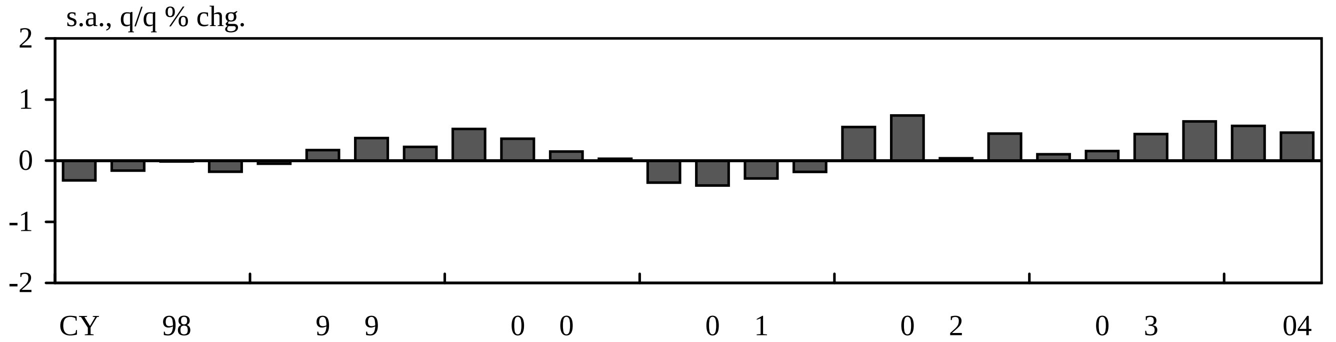
Chart 5

Real GDP

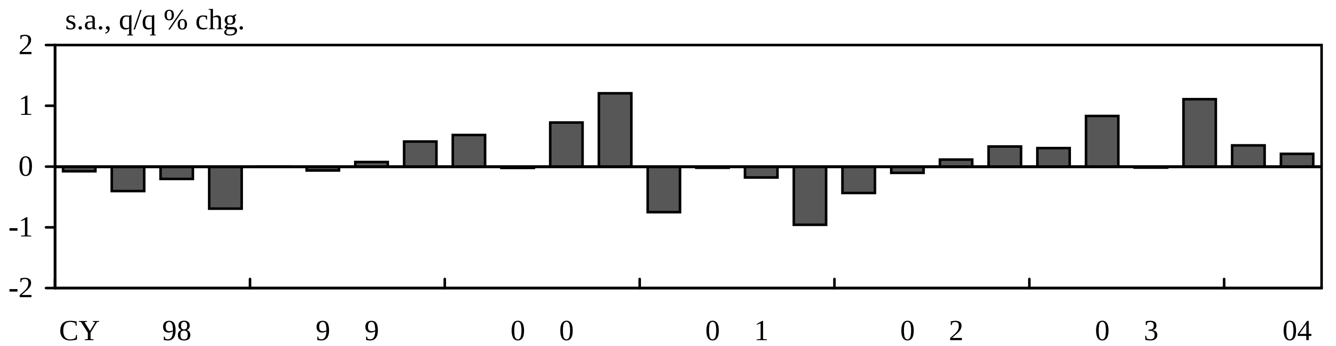
(1) Changes from the Previous Quarter

(2) Each Component's Contribution to Changes in Real GDP

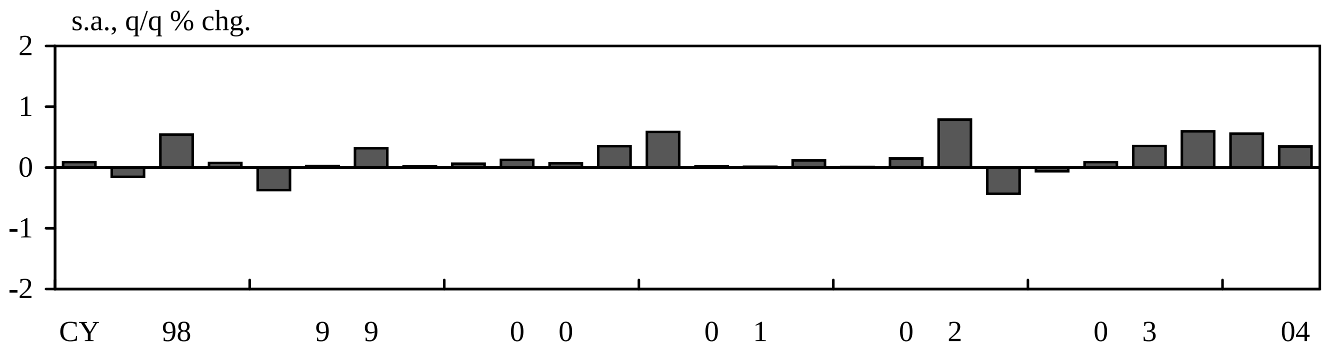
a. Exports



b. Private non-residential investment



c. Private consumption

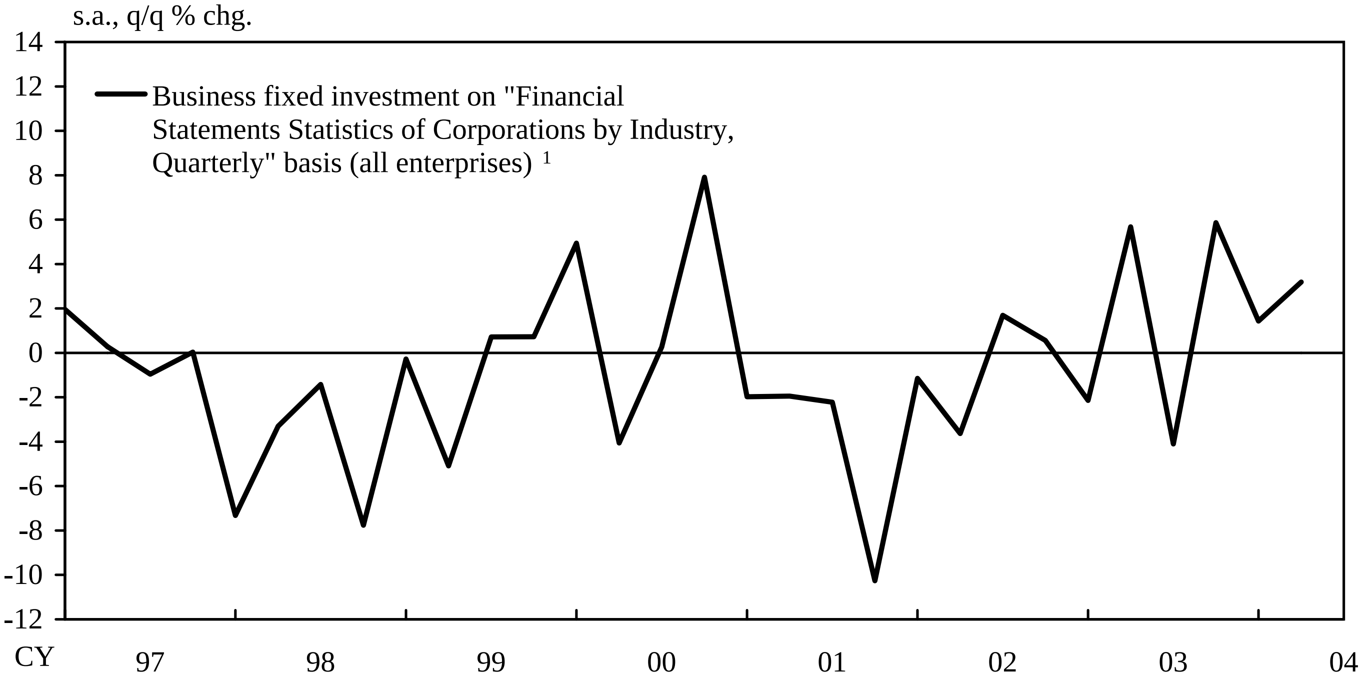


Source: Cabinet Office, "National Accounts."

Chart 6

Indicators for Business Fixed Investment

(1) Coincident Indicator



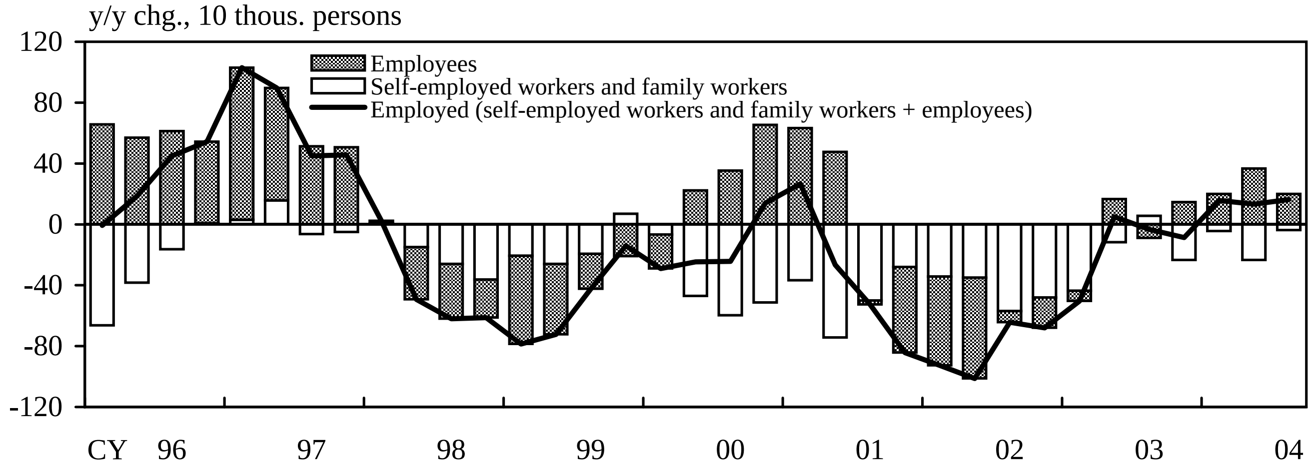
(2) Leading Indicators

Notes: 1. Sample change adjusted.
2. All industries. Excluding shipbuilding and orders from electric power companies.
3. All industries.
4. Figures for 2004/Q3 are July-August averages in terms of quarterly amount.

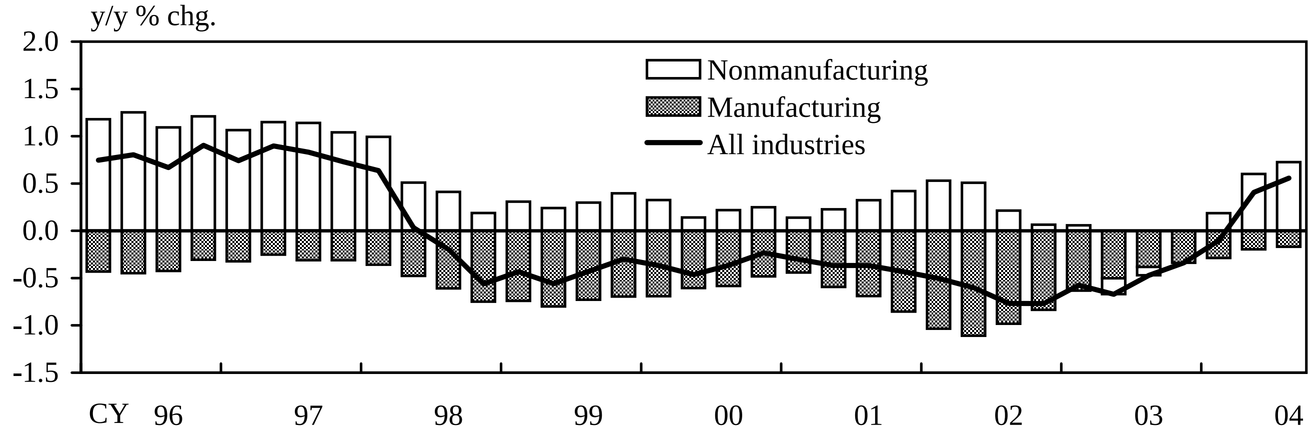
Sources: Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Quarterly";
Cabinet Office, "Machinery Orders Statistics";
Ministry of Land, Infrastructure and Transport, "Statistics on Building Construction Starts."

Labor Market Conditions

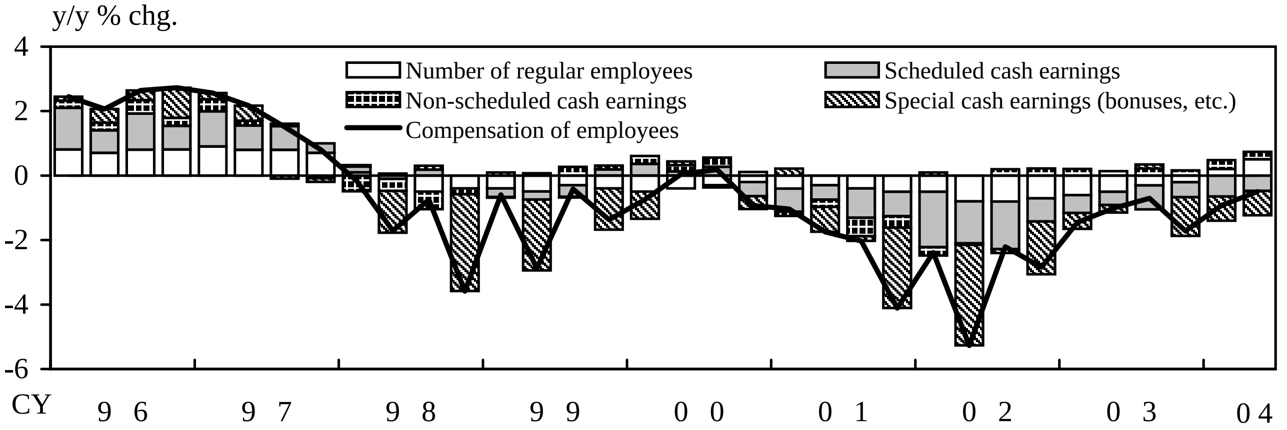
(1) Number of Employed (Labour Force Survey)



(2) Number of Regular Employees[1,2] (Monthly Labour Survey)



(3) Breakdown of Compensation[2,3] (Monthly Labour Survey)



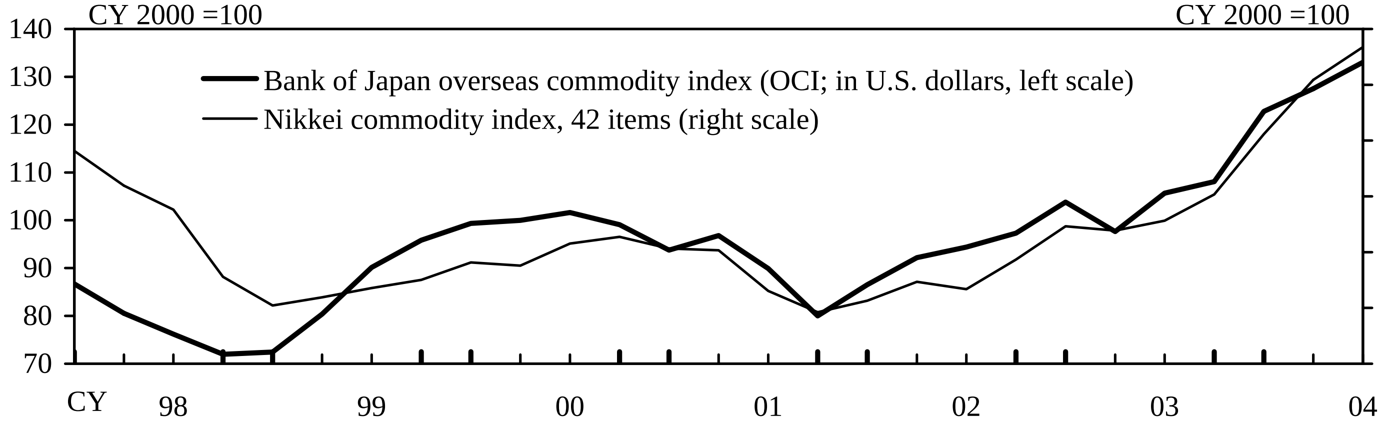
Notes:1. Figures for 2004/Q3 are those of July-August averages.
2. Data are for establishments with at least 5 employees.
3. Q1= Mar.-May, Q2= Jun.-Aug., Q3=Sep.-Nov., Q4= Dec.-Feb.

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

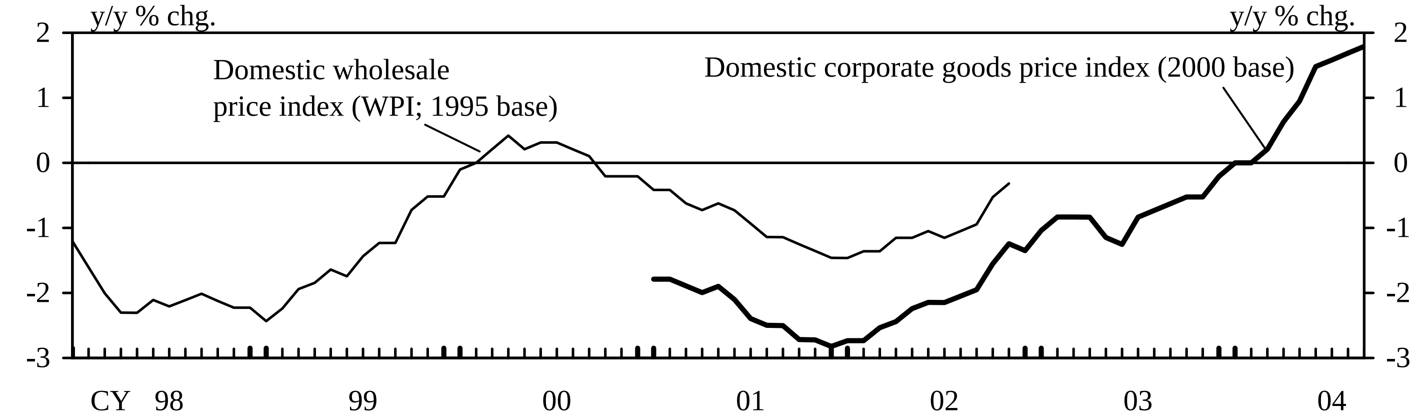
Chart 8

Prices

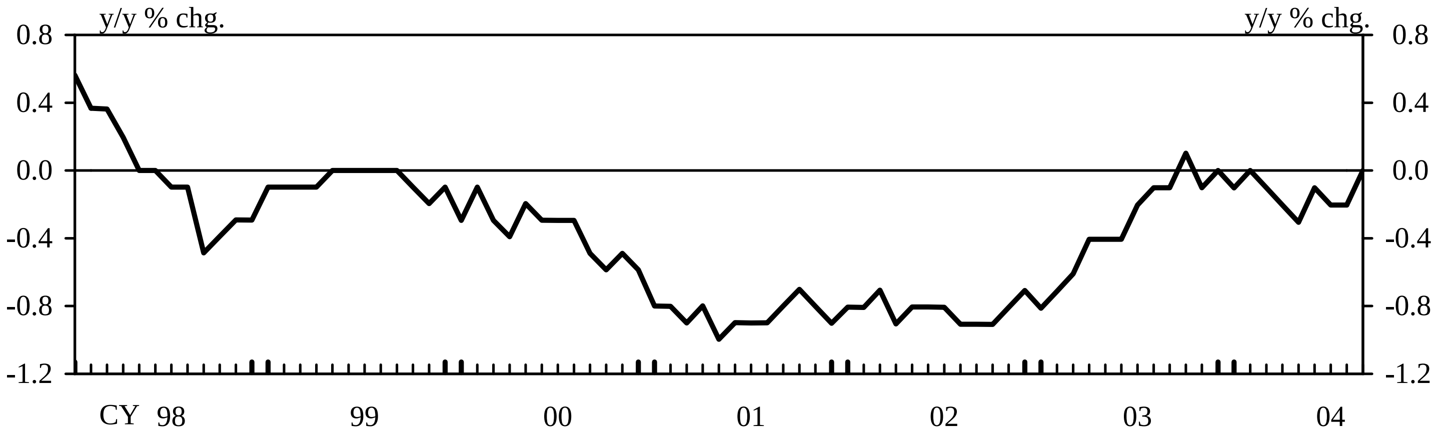
(1) Commodity Prices



(2) Domestic Corporate Goods Price Index



(3) Consumer Price Index (CPI; excluding fresh food)

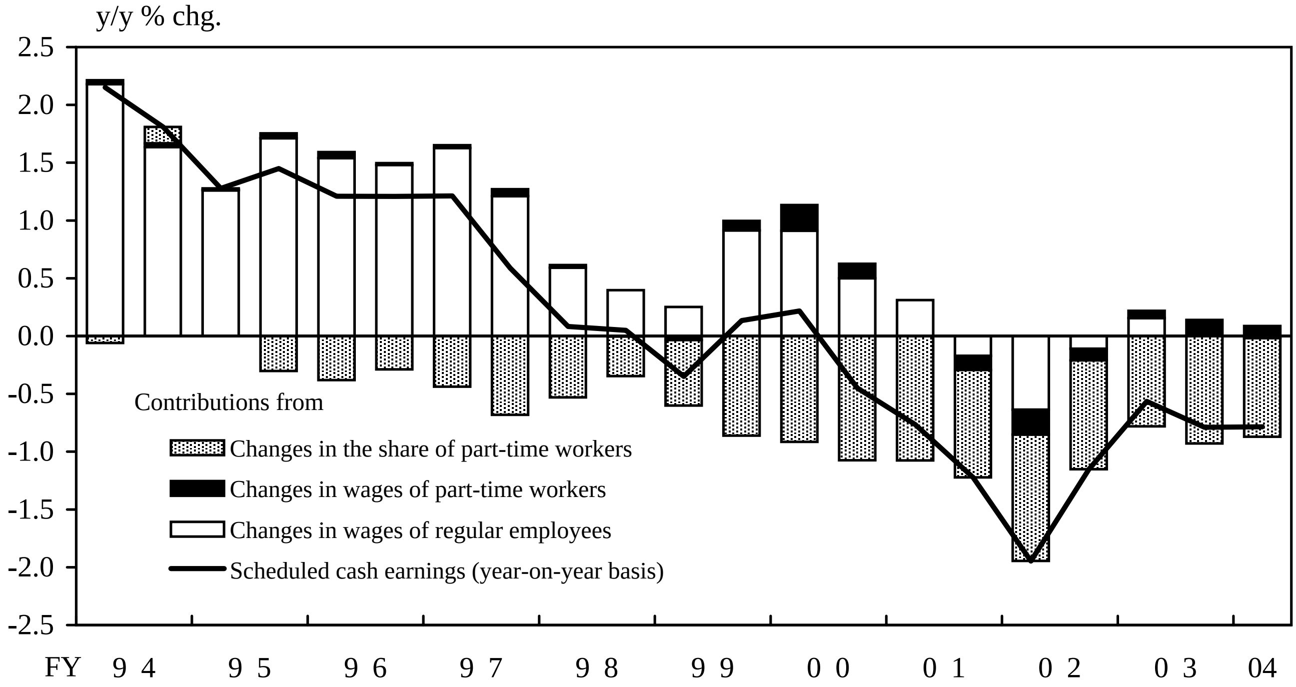


Notes: 1. Quarterly data for the OCI and the Nikkei commodity index, 42 items, are calculated from their respective end-month figures.
2. The WPI and the CPI are adjusted to exclude the effects of the consumption tax hike in April 1997.
3. The CPI before December 2000 is on the 1995 base.

Sources: Ministry of Internal Affairs and Communications, "Consumer Price Index"; Nihon Keizai Shimbun, Inc., "Nikkei Commodity Price Index"; Bank of Japan, "Bank of Japan Overseas Commodity Index," "Corporate Goods Price Index," "Wholesale Price Indexes."

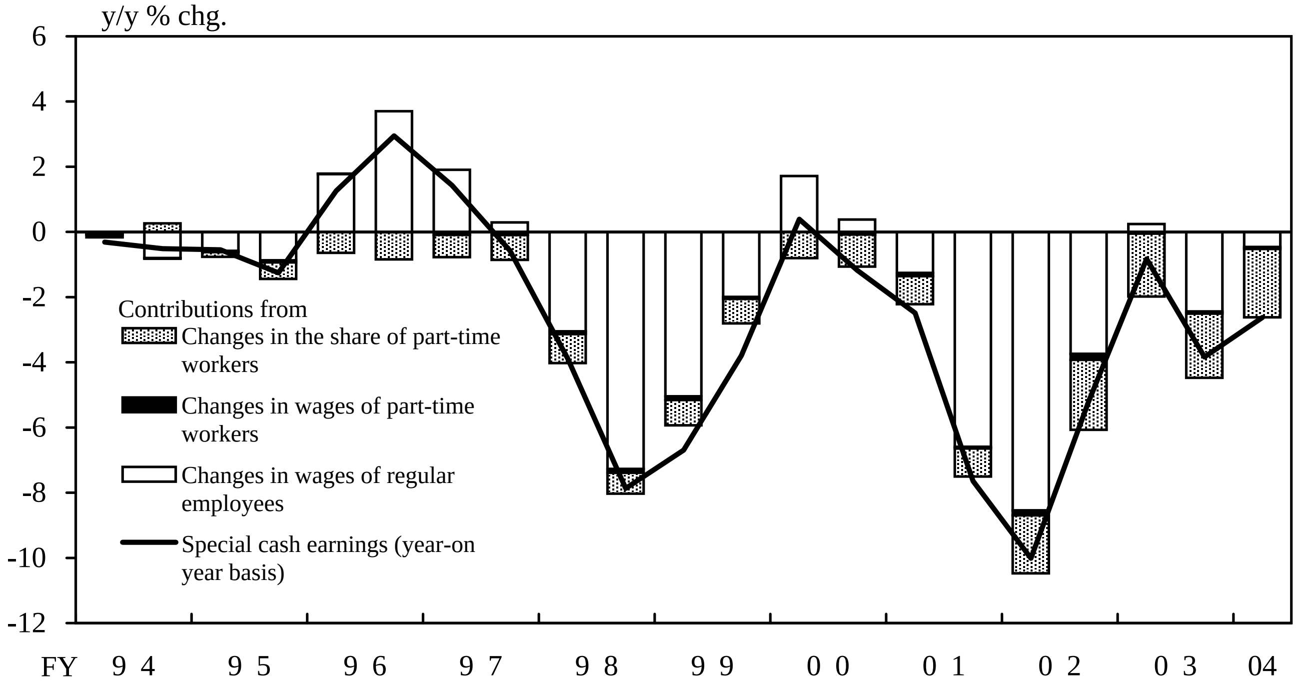
Nominal Wages per Employee

(1) Scheduled Cash Earnings[1,2]



Notes: 1. Data are for establishments with at least 5 employees.
2. Figures for the first half of FY2004 are April-August averages.

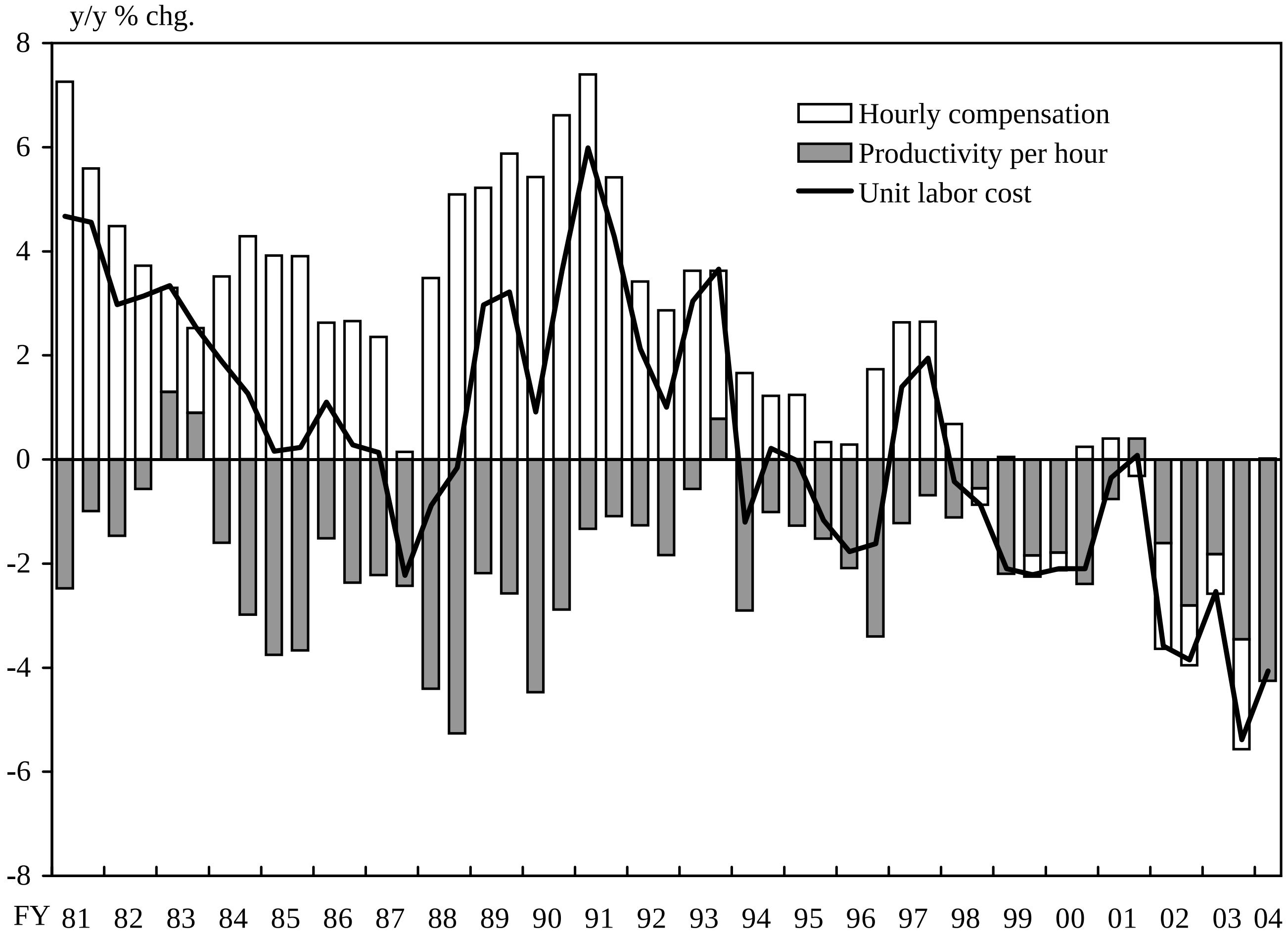
(2) Special Cash Earnings (Bonuses, etc.)[1,2]



Notes: 1. Data are for establishments with at least 5 employees.
2. The first half of the fiscal year refers to the June-August period, and the second half refers to the November-January period, during which special cash earnings for summer and winter are paid.

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

Unit Labor Cost

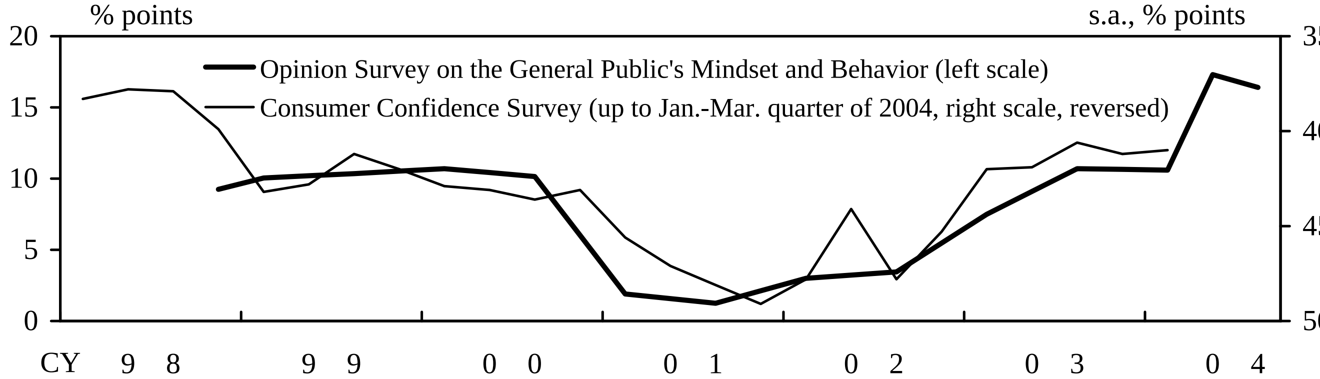


Notes: 1.Unit labor cost = compensation of employees/real GDP.
Productivity per hour = Real GDP/(number of employees [in"Labour Force Survey"]×hours at work [in"Monthly Labour Survey"]).
Hourly compensation = compensation of employees/(number of employees [in"Labour Force Survey"] ×hours at work [in"Monthly Labour Survey"]).
2.Figures for first half of FY2004 are those of 2004/Q2.
3.Data of hours at work (in"Monthly Labour Survey") are for establishments with at least 5 employees since 1990/Q1. Those before 1989/Q4 are retroactively calculated with year-to-year growth rates of data for establishments with at least 30 employees.

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

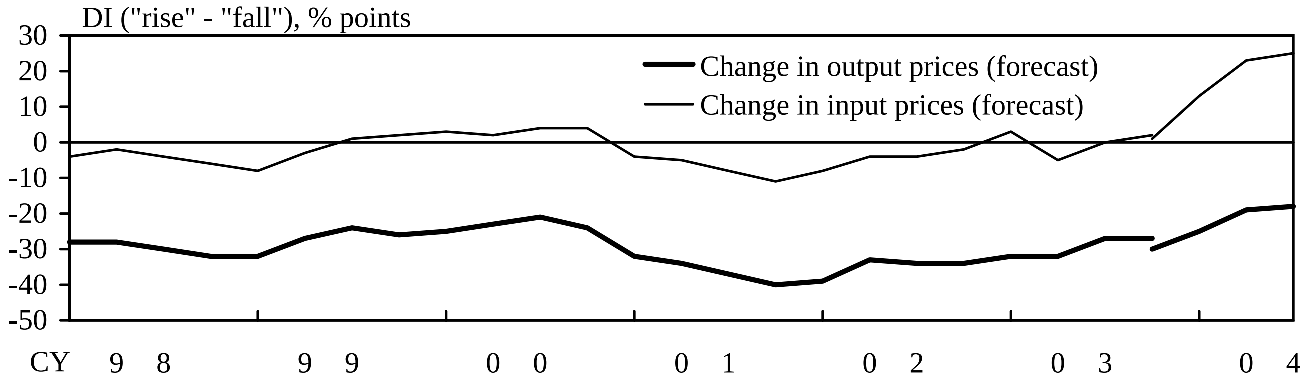
Outlook for Prices

(1) Households' Outlook for Prices

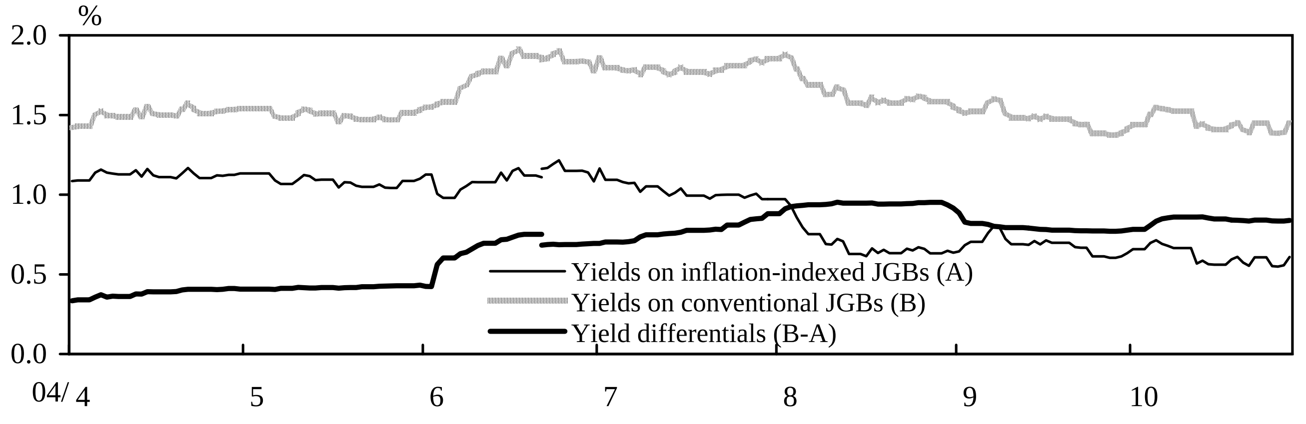


Note: The share of respondents is multiplied by the following points according to the type of answer, and the results are totaled.
For the question about the price levels one year from now compared with the present in the "Opinion Survey on the General Public's Mindset and Behavior": 1 point for respondents 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



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



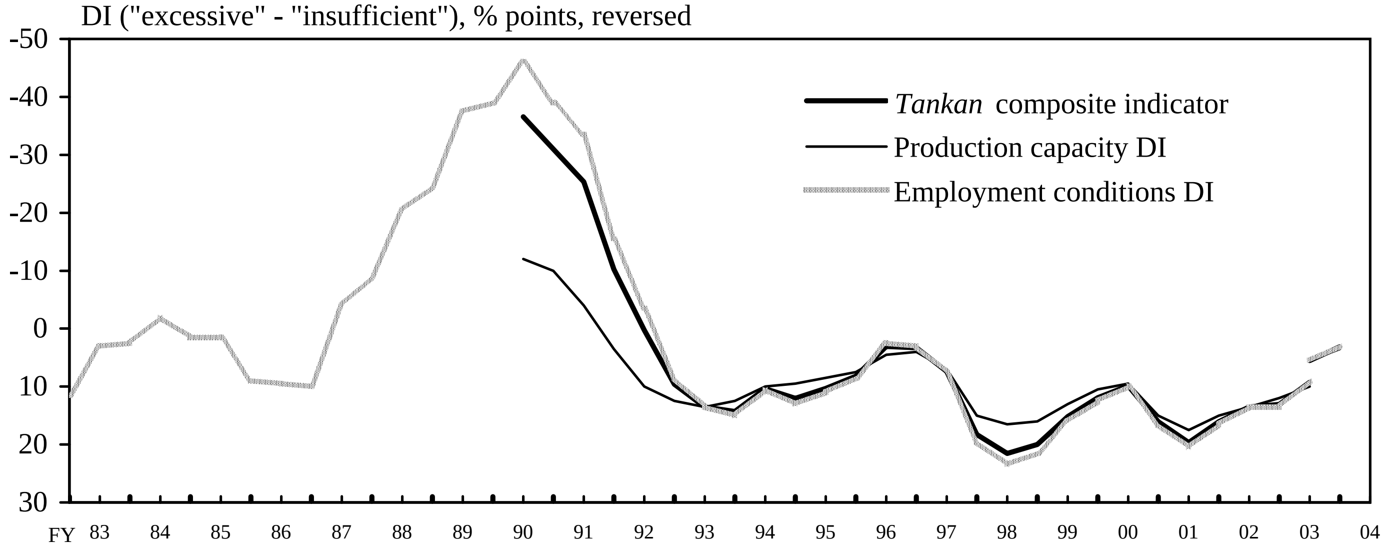
Note: Yields on inflation-indexed JGBs are those for the current issue, and yields on conventional JGBs are those for 10-year JGBs issued in the same month as the corresponding inflation-indexed JGBs.

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

Indicators Related to Supply-Demand Conditions

(1) Output Gap[1]

(2) *Tankan* Composite Indicator[2]

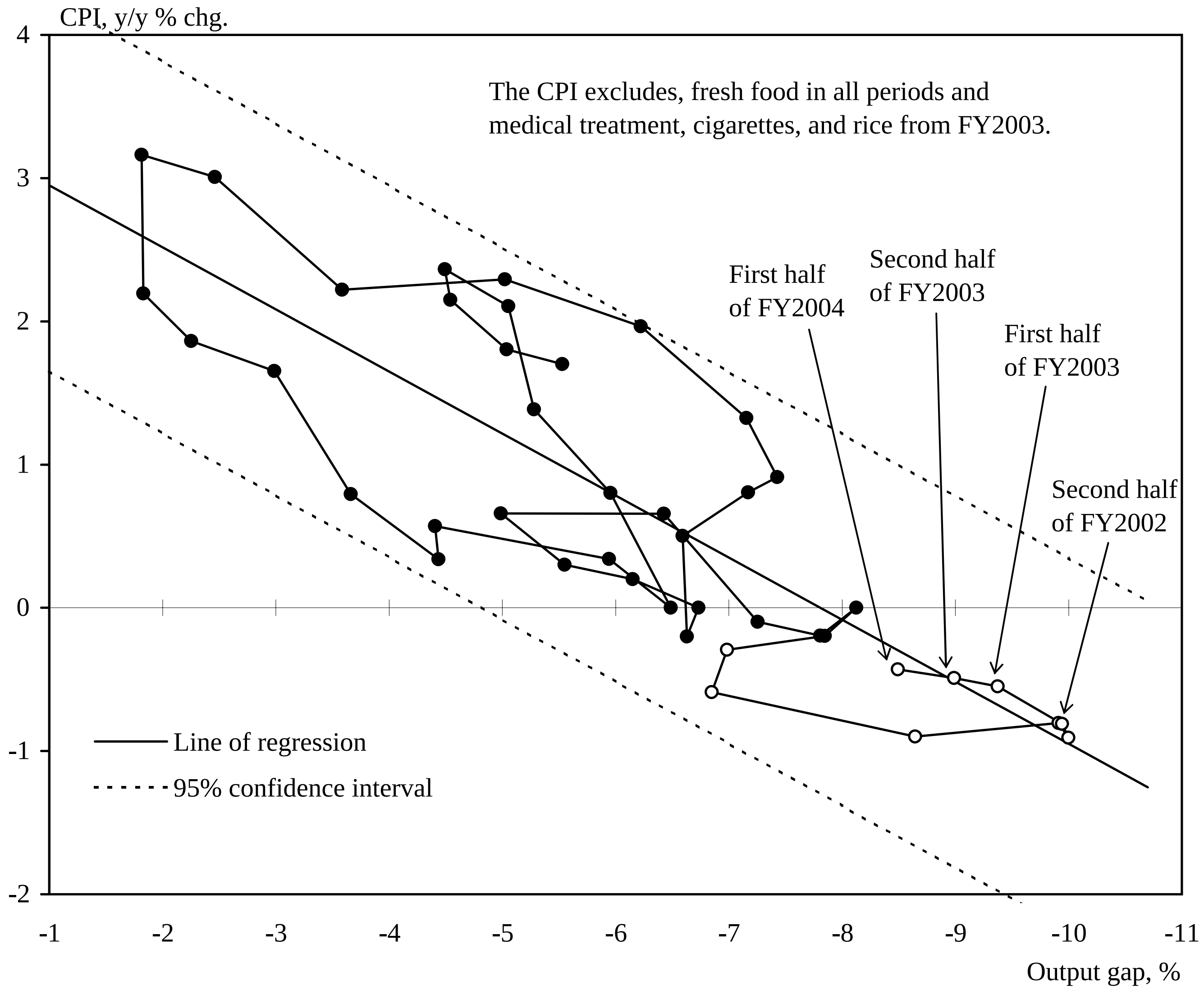


Notes: 1. Output gap is calculated as the wedge between actual and maximum outputs which are attainable by the maximum usage of capital stock and employment (estimation by the Research and Statistics Department of the Bank of Japan). These estimates always take negative values. On the other hand, international 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 first half of FY2004 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 shares in the national accounts (FY1990-FY2002 averages). 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.

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

Output Gap and Consumer Price Index



Notes: 1. For the output gap, please refer to Note 1 in Chart 12.

2. Estimation: CPI = 3.38 + 0.43 × output gap
(7.91) (8.26)

Sample 1983 to 2003 (fiscal half-years), R^2=0.68, Standard error = 0.65, *t* -values in parentheses

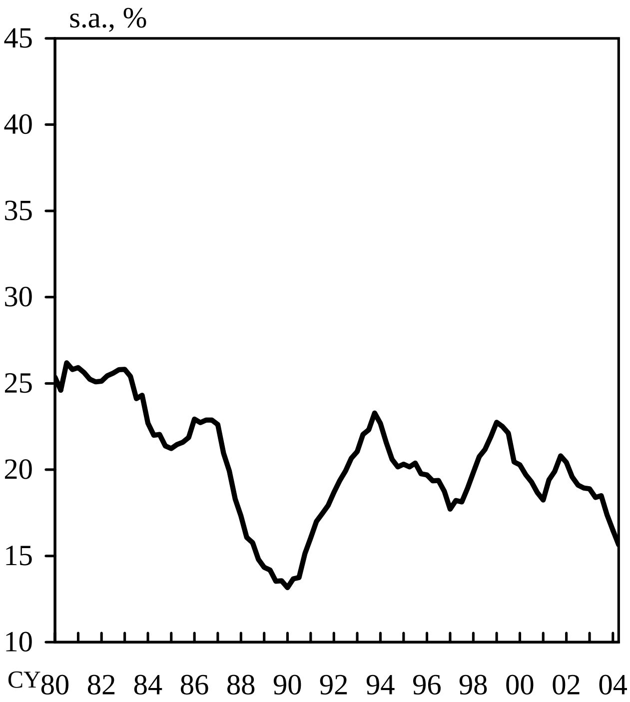
3. The CPI is consumption-tax adjusted. Figures until FY2000 are on the 1995 base. Figures for the first half of FY2004 are April-June averages.

4. Points from 2000 onward are shown by white dots.

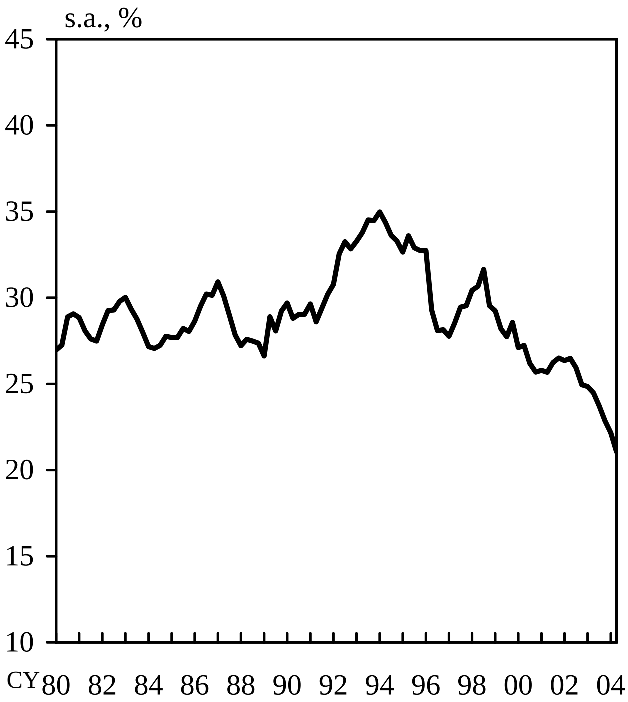
Sources: Cabinet Office, "National Accounts," "Capital Stock of Private Enterprises Statistics"; Ministry of Economy, Trade and Industry, "Indices of Industrial Production"; Ministry of Health, Labour and Welfare, "Monthly Labour Survey"; Ministry of Internal Affairs and Communications, "Consumer Price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

Pressures Arising from Firms' Excess Debt

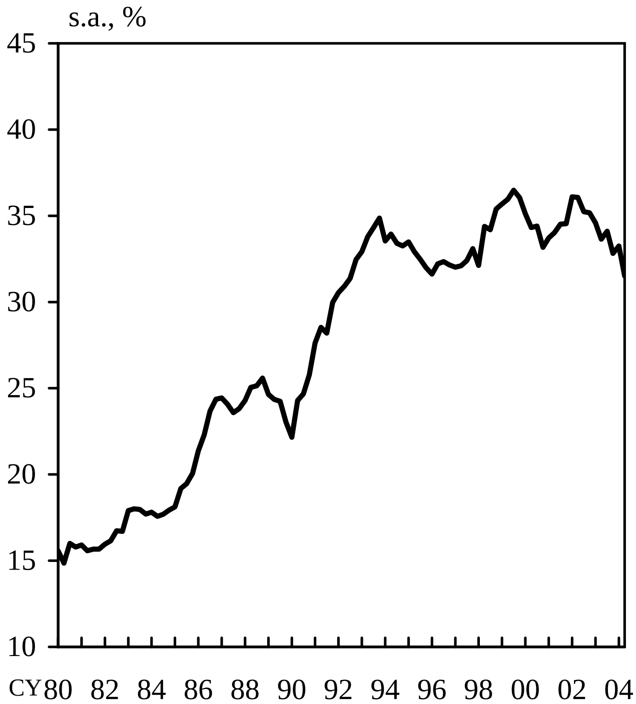
(1) Large Manufacturing Firms



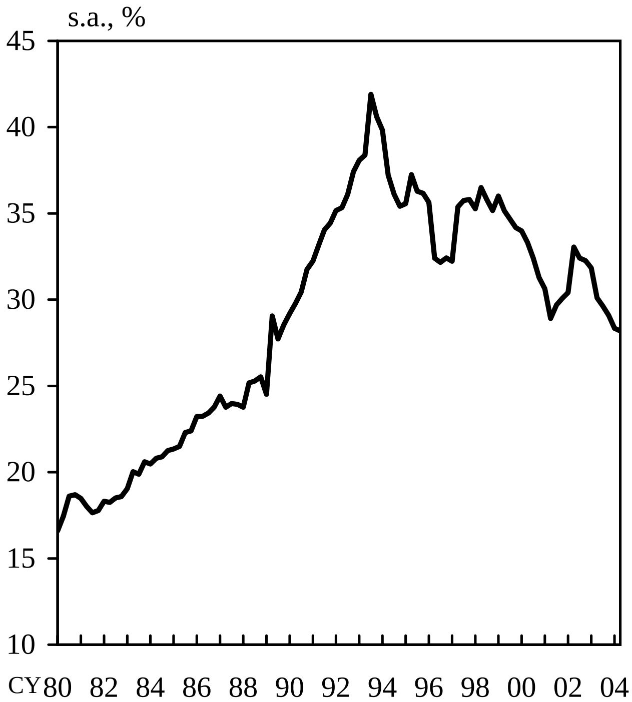
(2) Medium and Small-Sized Manufacturing Firms



(3) Large Nonmanufacturing Firms



(4) Medium and Small-Sized Nonmanufacturing Firms

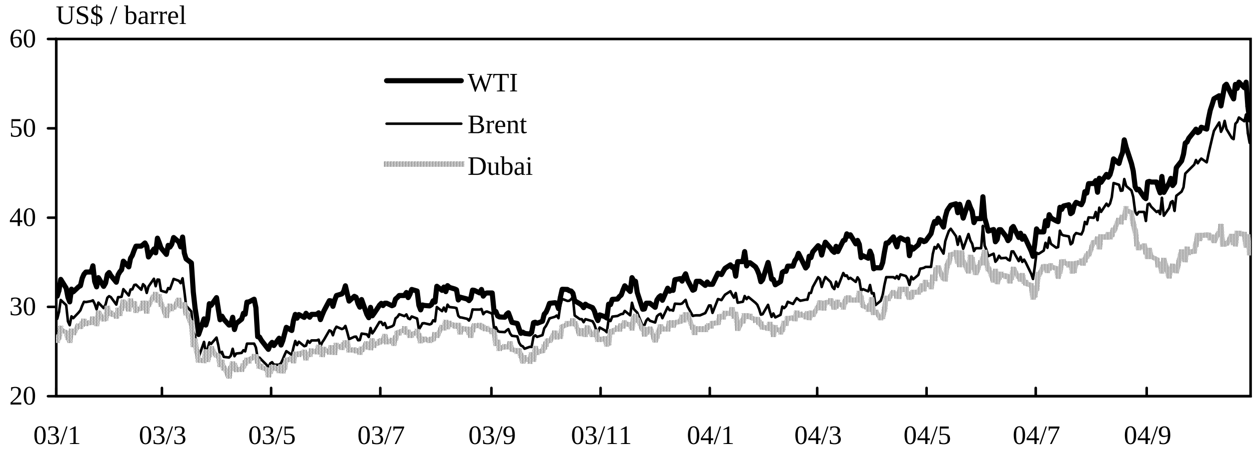


Notes: 1. Ratio of debt to sales (annualized).
2. Debts = financial debts (corporate bonds + long-term and short-term borrowings + bills discounted) - cash and deposits.
3. Electric, gas, and other services are excluded from large nonmanufacturing firms.

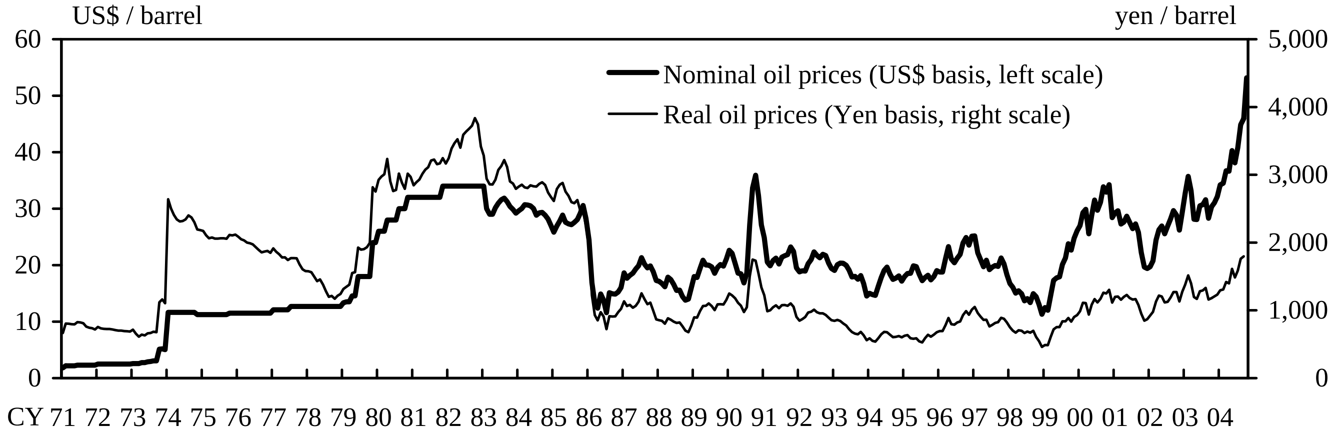
Source: Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Quarterly."

Oil Prices

(1) Oil Prices-1

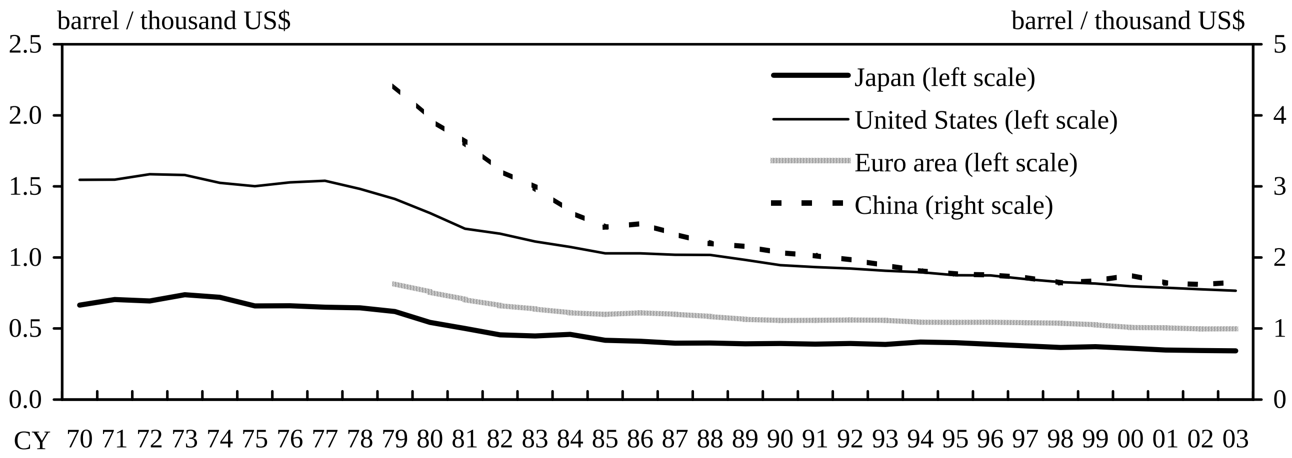


(2) Oil Prices-2



Notes: 1. Oil prices are those of Arabian Light (official price) until April 1983 and WTI thereafter.
2. Real oil prices on a yen basis are deflated by the CPI (assuming that 1971 is the base year) and converted by the exchange rate of each month.

(3) Unit Oil Consumption (Total Oil Consumption / Real GDP)



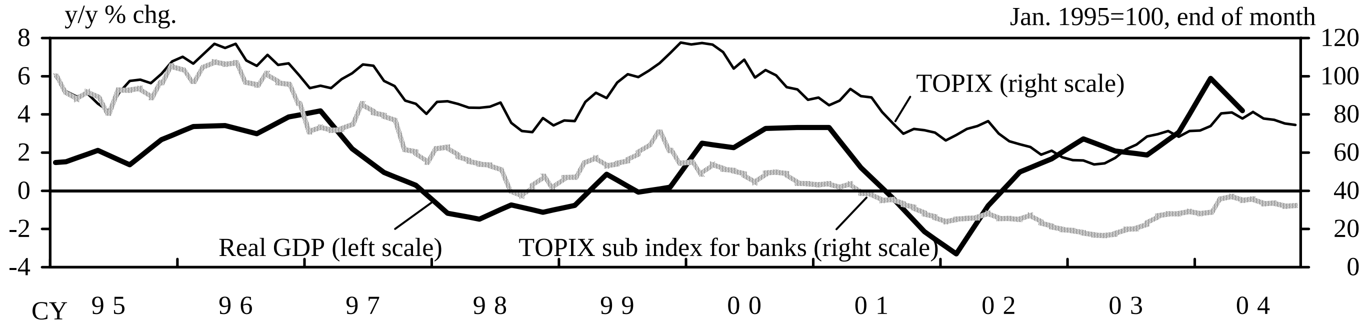
Note: Real GDP is calculated based on nominal GDP in 1995 on a U.S. dollar basis.

Sources: Ministry of Internal Affairs and Communications, "Consumer Price Index"; Bloomberg; British Petroleum; International Monetary Fund.

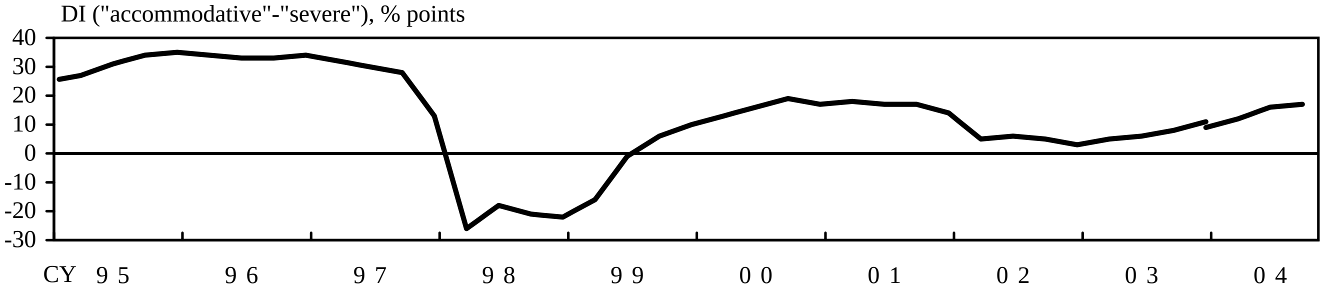
Chart 16

Financial System and Economic Activity

(1) Real GDP and Stock Prices

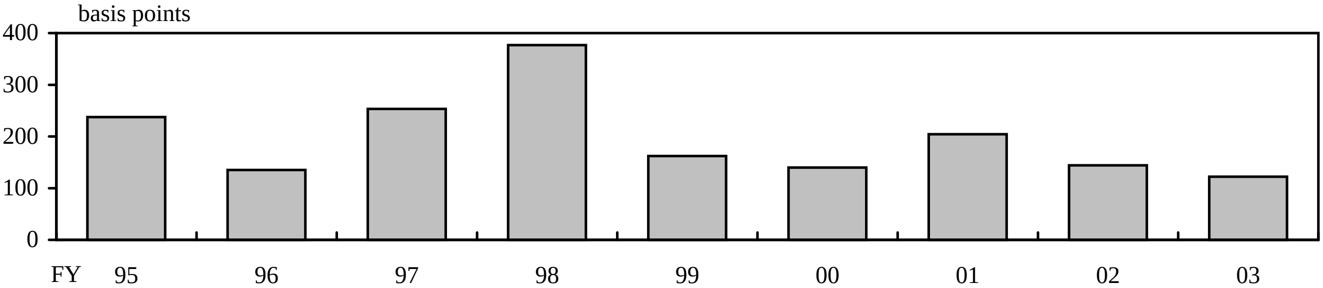


(2) Lending Attitude of Financial Institutions (Large Enterprises)



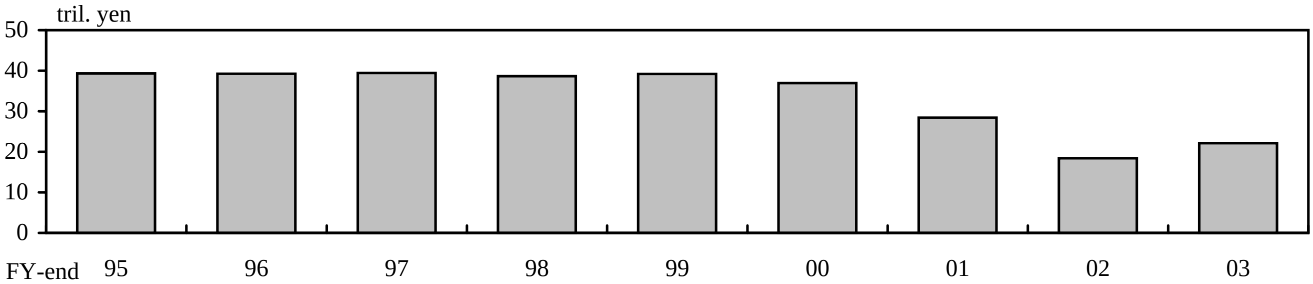
Note: The *Tankan* has been revised from the March 2004 Survey. Figures up to the December 2003 Survey are based on the previous data sets. Figures from the December 2003 Survey are on a new basis.

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



Note: 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.

(4) Stockholdings by Banks (Major Banks)



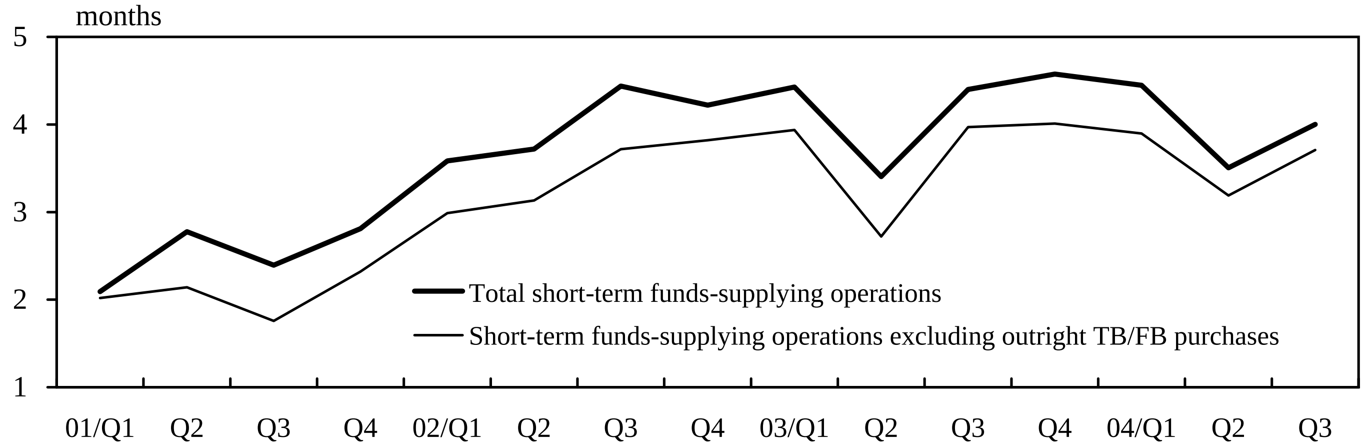
Note: Figures are from balance sheets (mark-to-market accounting has been applied since FY2001 and some banks have applied this accounting method since FY2000).

Sources: Bank of Japan, "*Tankan* - Short-term Economic Survey of Enterprises in Japan"; Cabinet Office, "National Accounts"; Japanese Bankers Association; Bloomberg.

Chart 17

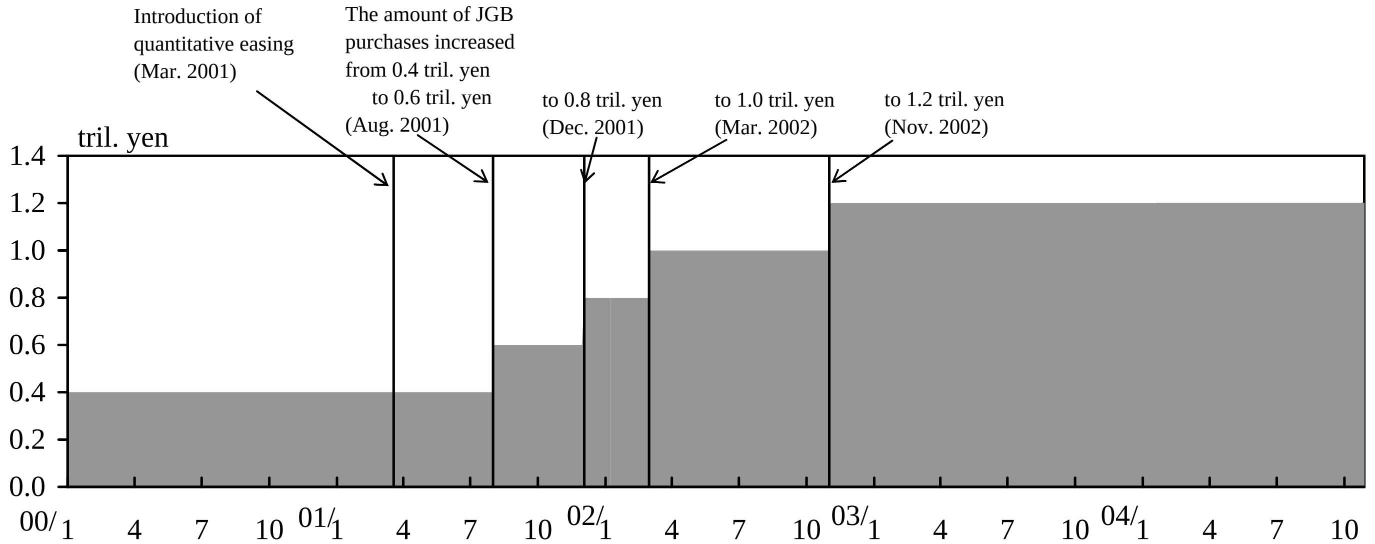
Money Market Operations

(1) Maturity of Short-Term Funds-Supplying Operations

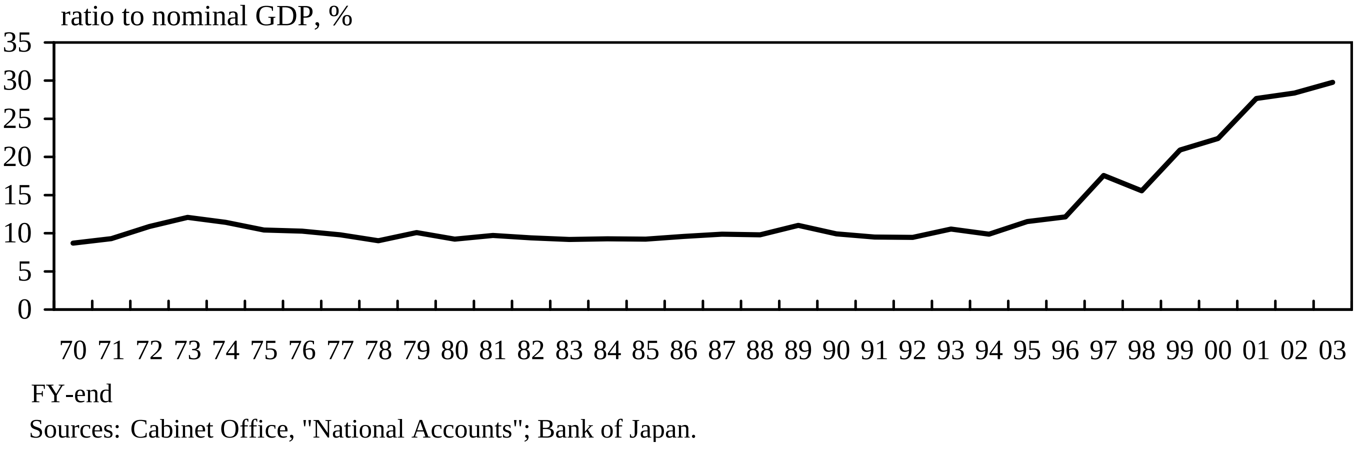


Note: Figures for "total short-term funds-supplying operations" are the amount-weighted average of the maturities of bill purchases, JGS repo transactions (JGS purchases with repurchase agreements, JGB borrowings, and TB/FB purchases with repurchase agreements) and CP purchases with repurchase agreements, and the remaining maturities of issues purchased in TB/FB purchase operations, offered during each quarter.

(2) Outright Purchases of Long-Term JGBs



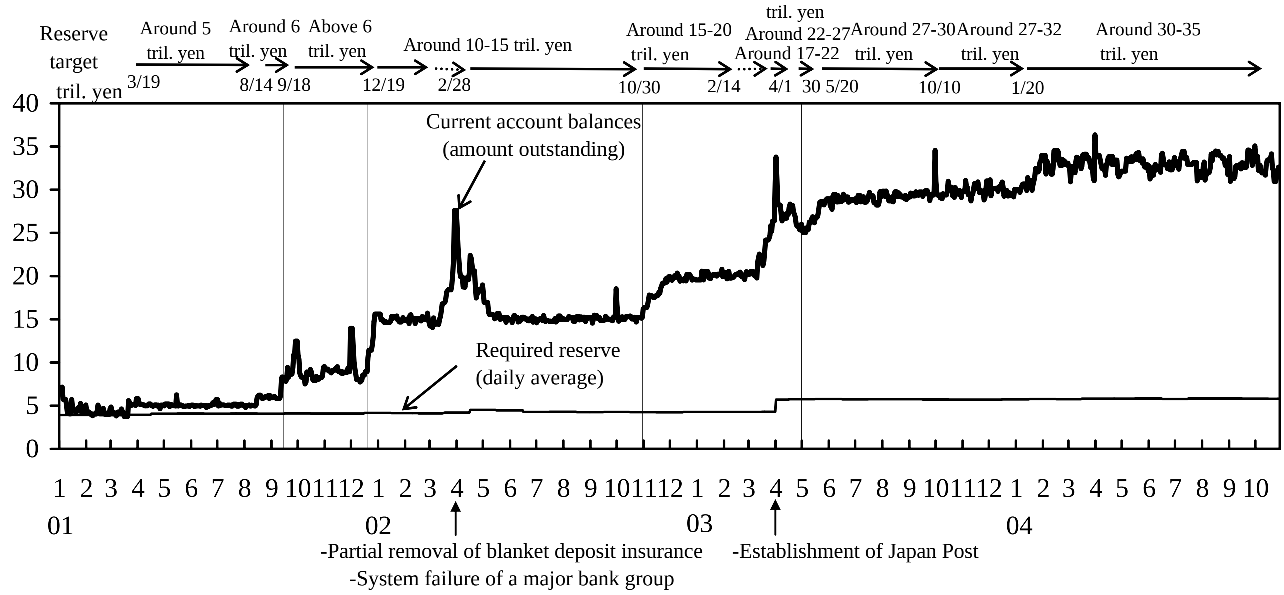
(3) Size of the Balance Sheet of the Bank of Japan



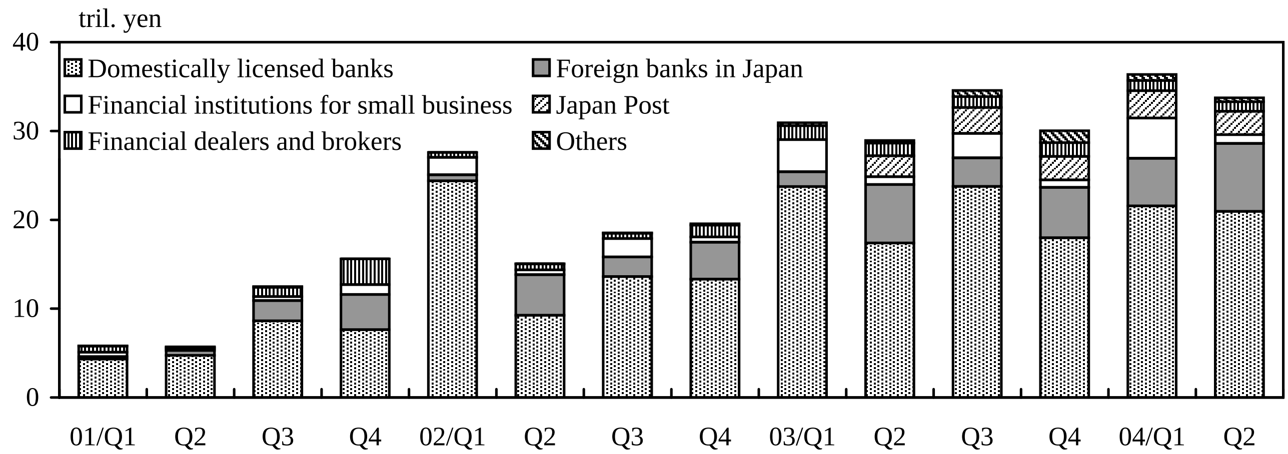
Sources: Cabinet Office, "National Accounts"; Bank of Japan.

BOJ Current Account Balances and Money Market Rates

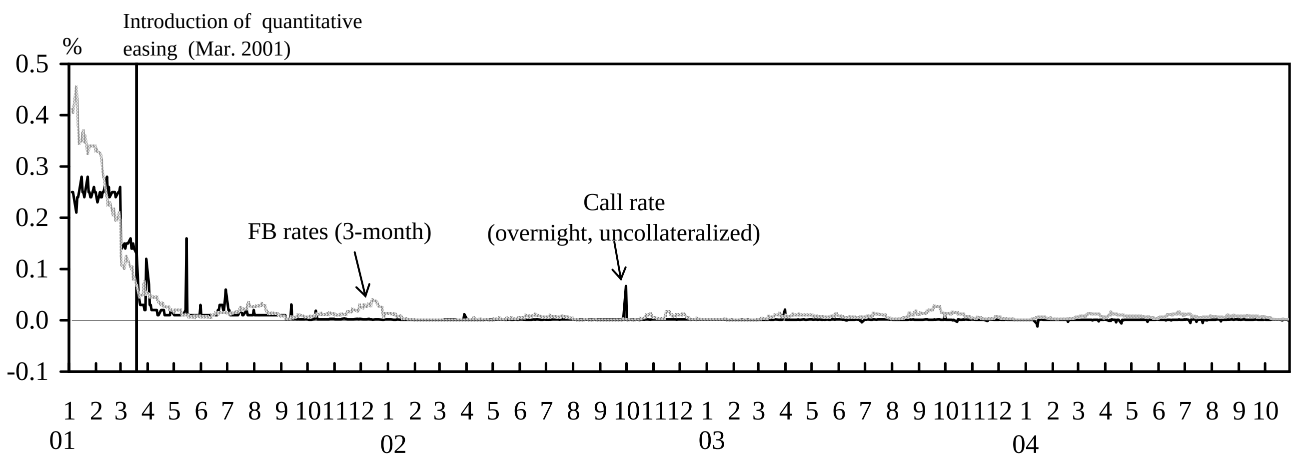
(1) BOJ Current Account Balances



(2) Breakdown of BOJ Current Account Balances into Sectors



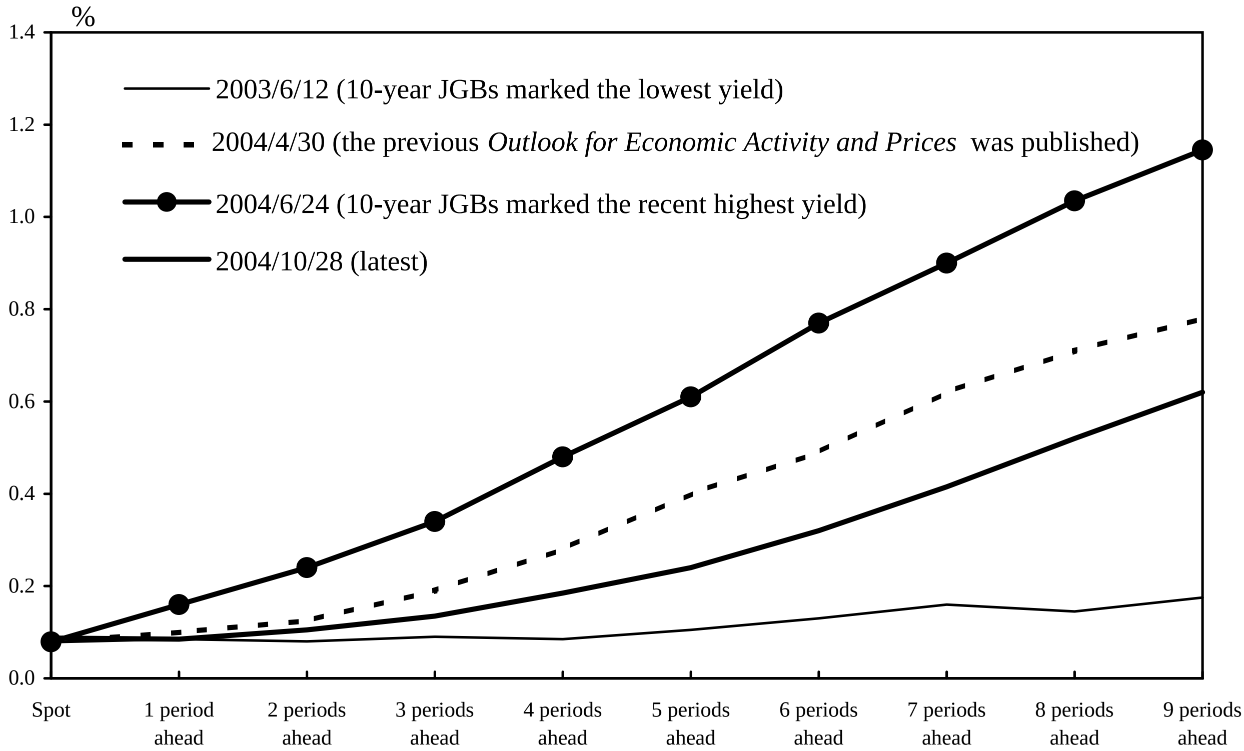
(3) Money Market Rates



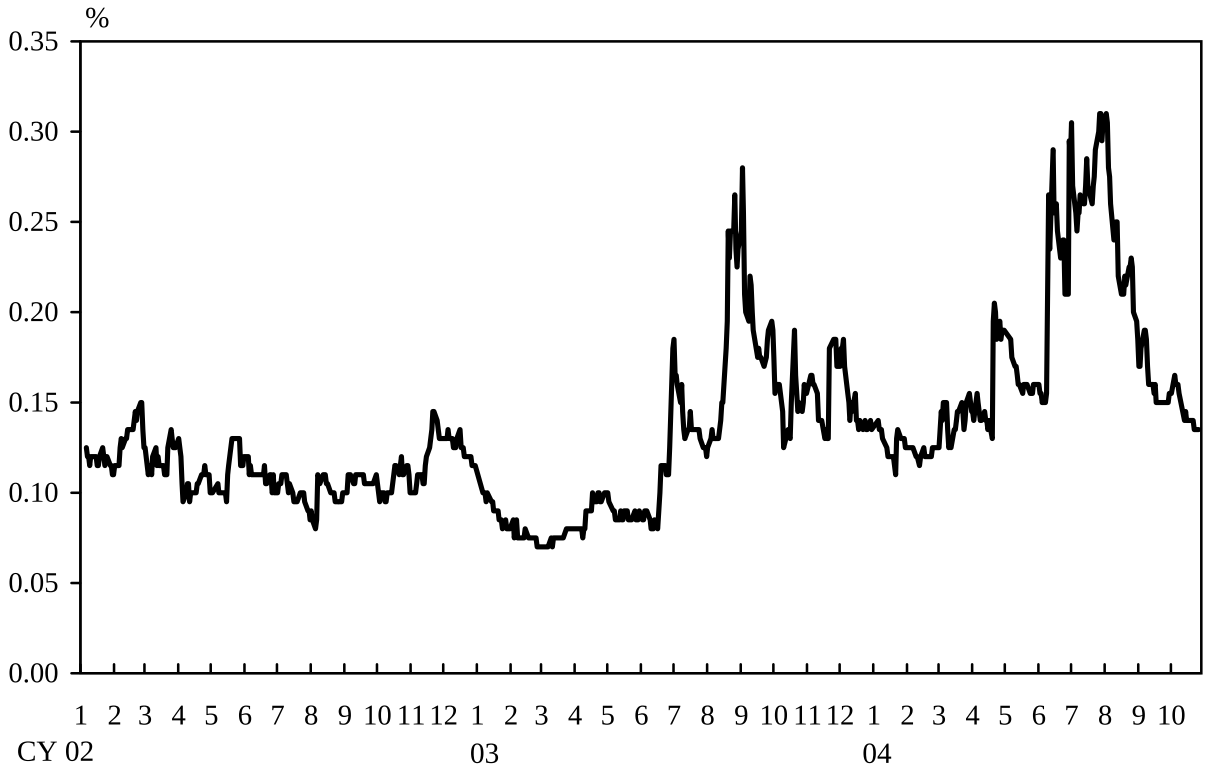
Sources: Bank of Japan; Japan Bond Trading Co., Ltd.

Interest Rate Futures

(1) Euroyen Interest Rate Futures (3-Month)



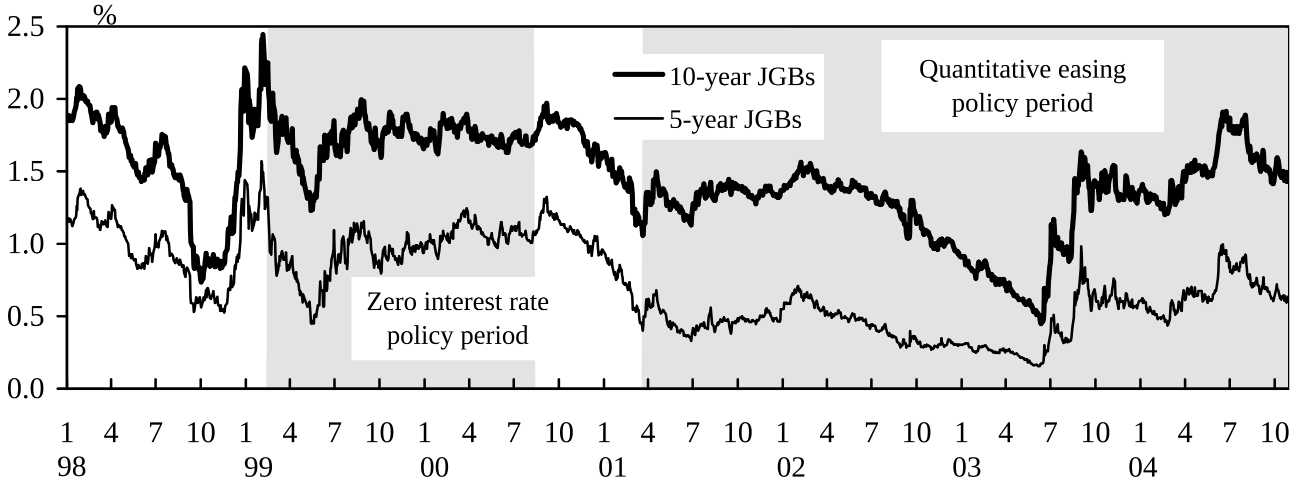
(2) Euroyen Interest Rate Futures (3-Month) Leading Contract Months



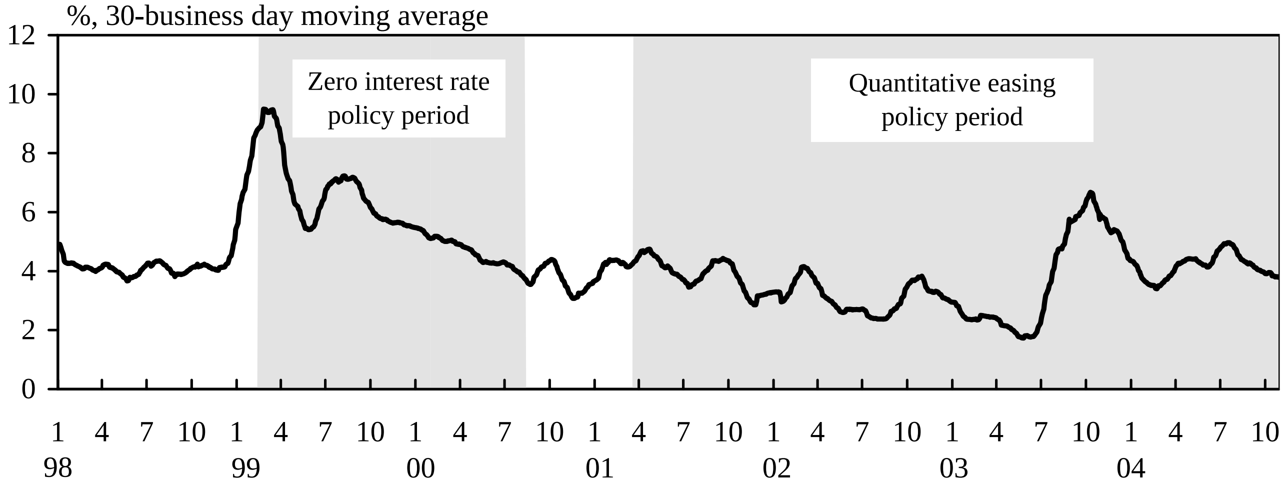
Source: Tokyo International Financial Futures Exchange.

Long-Term Interest Rates

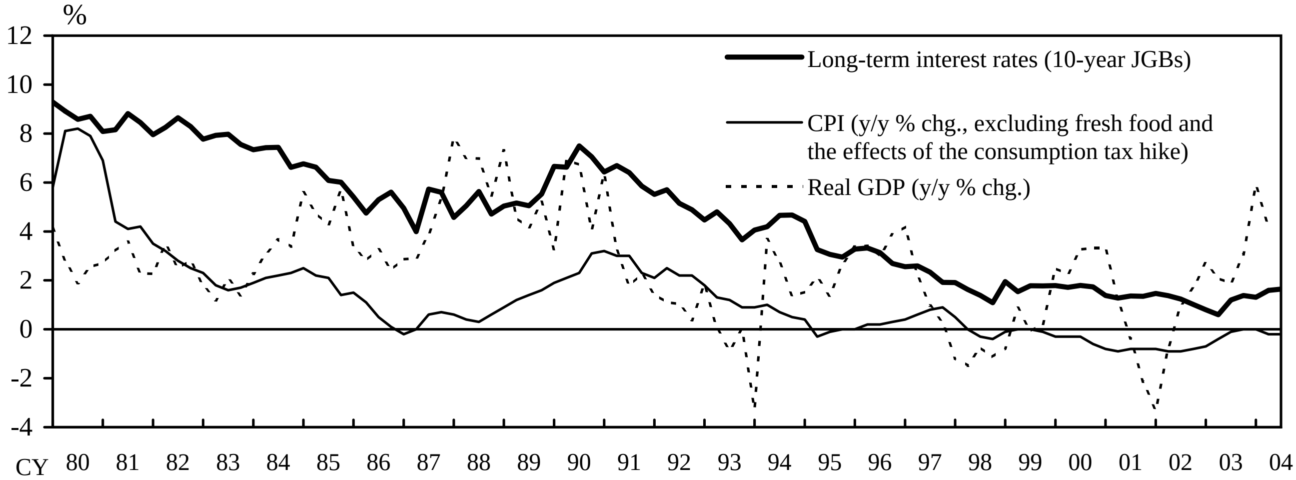
(1) Interest Rates



(2) Implied Volatility



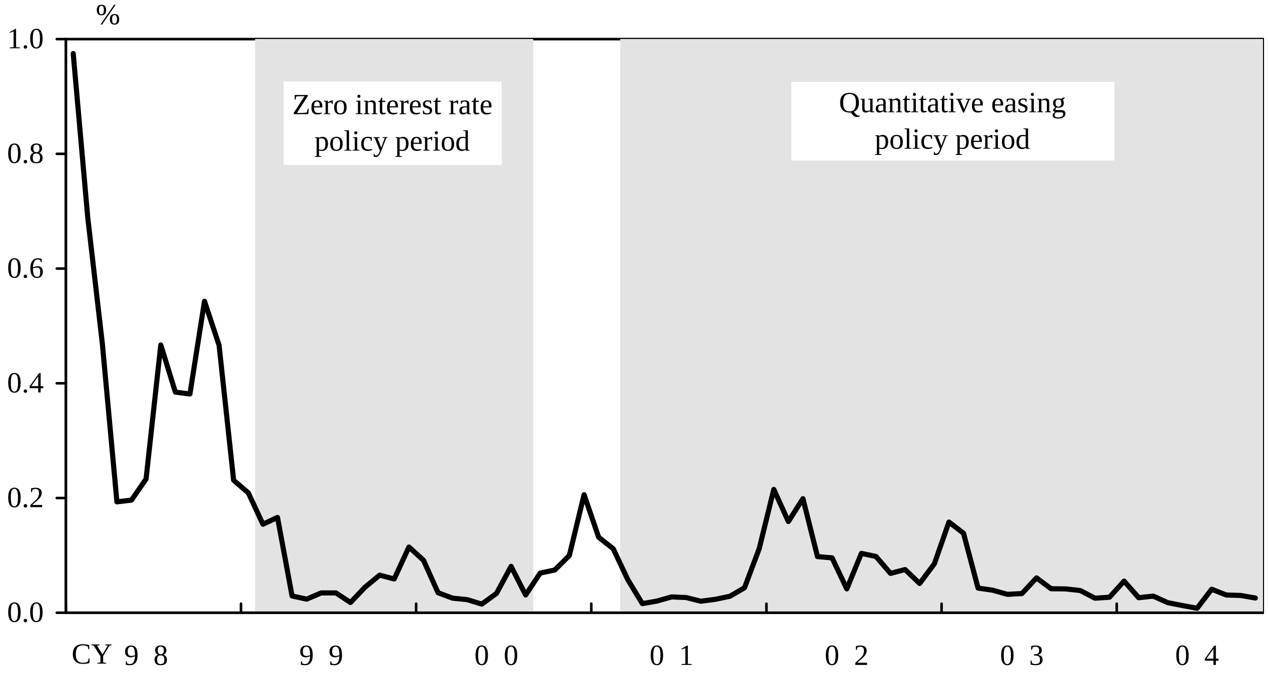
(3) Long-Term Interest Rates, CPI and Real GDP



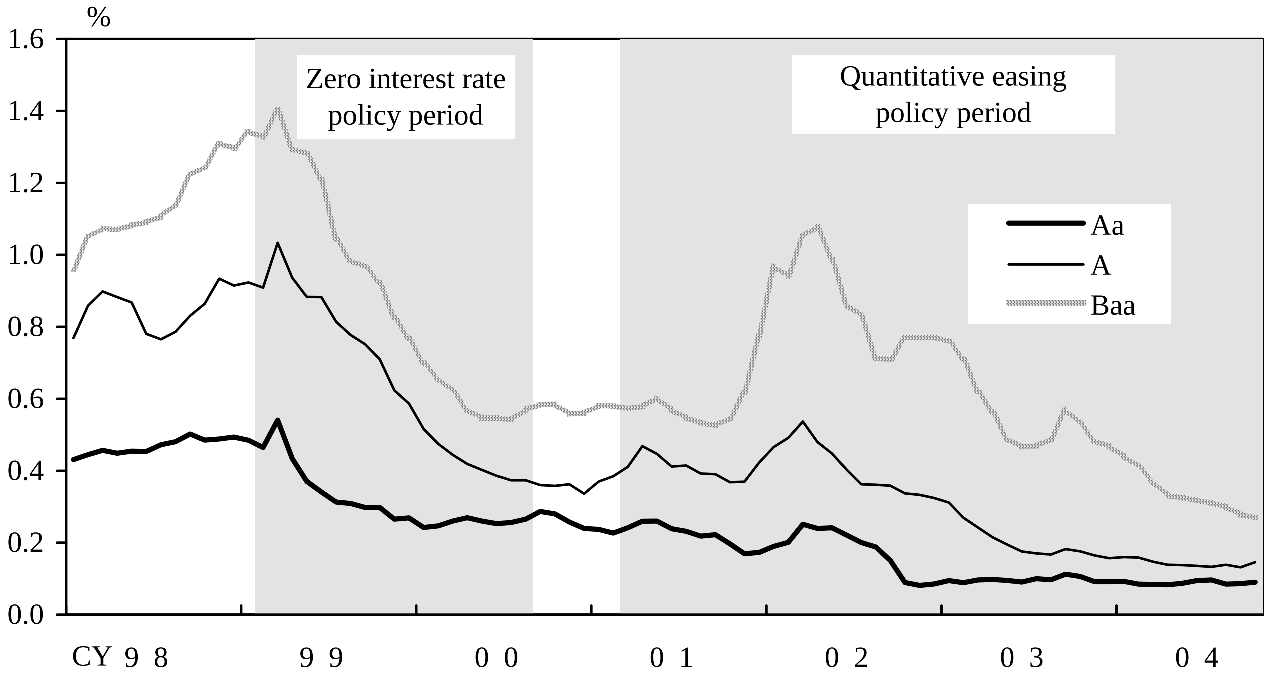
Sources: Cabinet Office, "National Accounts"; Ministry of Internal Affairs and Communications, "Consumer Price Index"; Japan Securities Dealers Association; Tokyo Stock Exchange; Bloomberg.

Credit Spreads

(1) Commercial Paper (3-Month) [1, 2, 3, 4]



(2) Corporate Bonds (5-Year) [4, 5, 6]

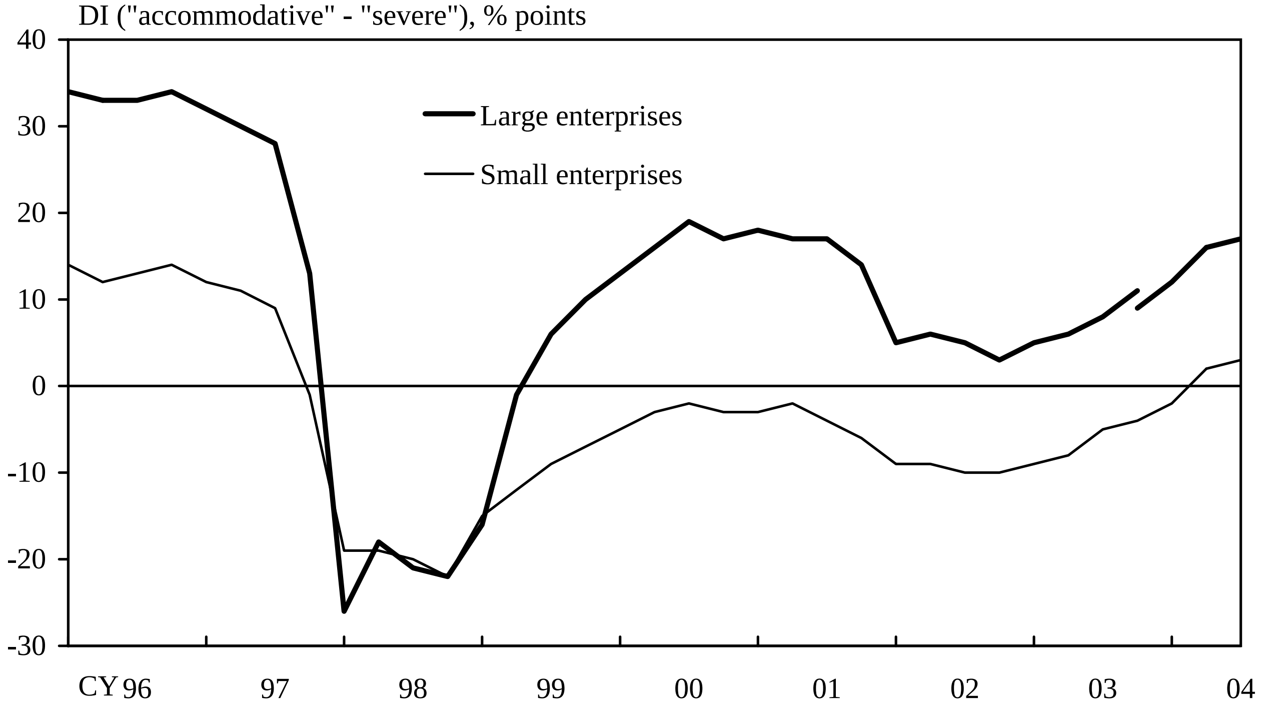


Notes: 1. The spread for CP is the average issuance rate of CP minus the FB/TB yield.
2. CP ratings are A-1 or above.
3. FB/TB yields before May 1999 are on bills with a 6-month maturity.
4. The spreads for both CP and corporate bonds in October 2004 is the average of data from October 1 to 27.
5. The spread for corporate bonds is the corporate bond yield minus the government bond yield.
6. The indicated ratings of corporate bonds are of Moody's.

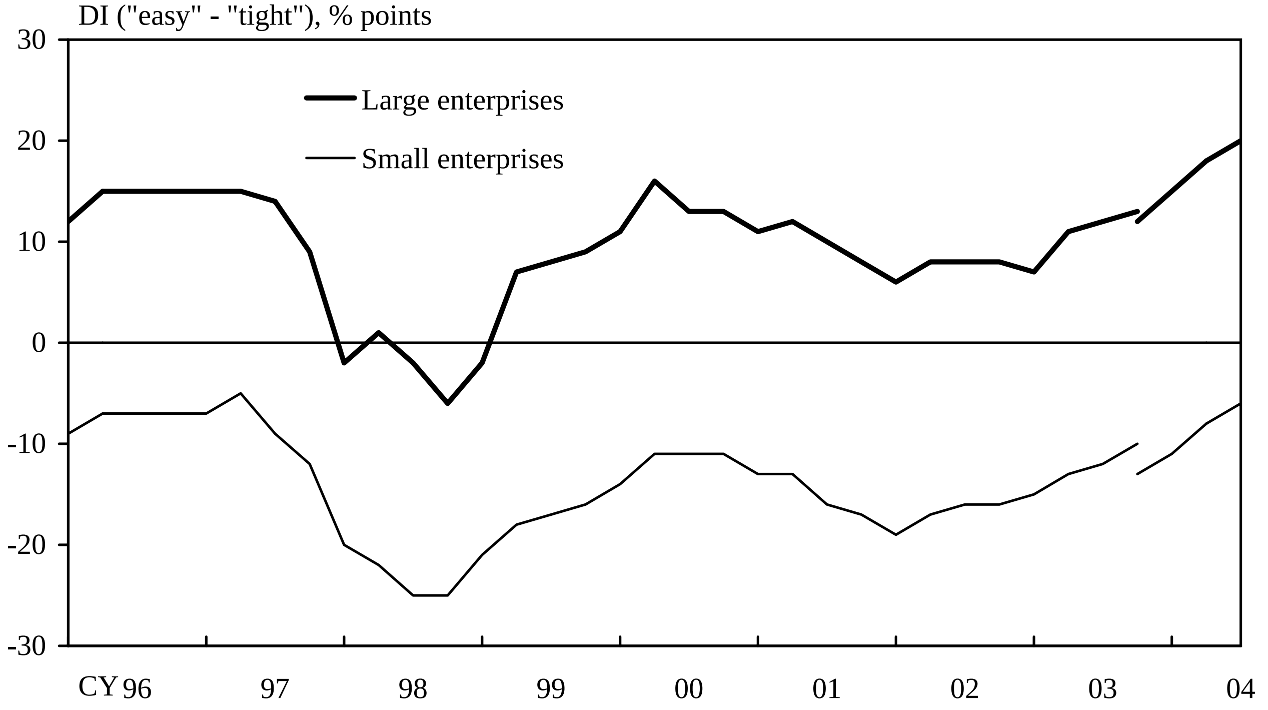
Sources: Bank of Japan; Japan Bond Trading Co., Ltd.; Japan Securities Dealers Association.

Lending Attitude of Financial Institutions and Financial Positions of Firms

(1) Lending Attitude of Financial Institutions



(2) Financial Position

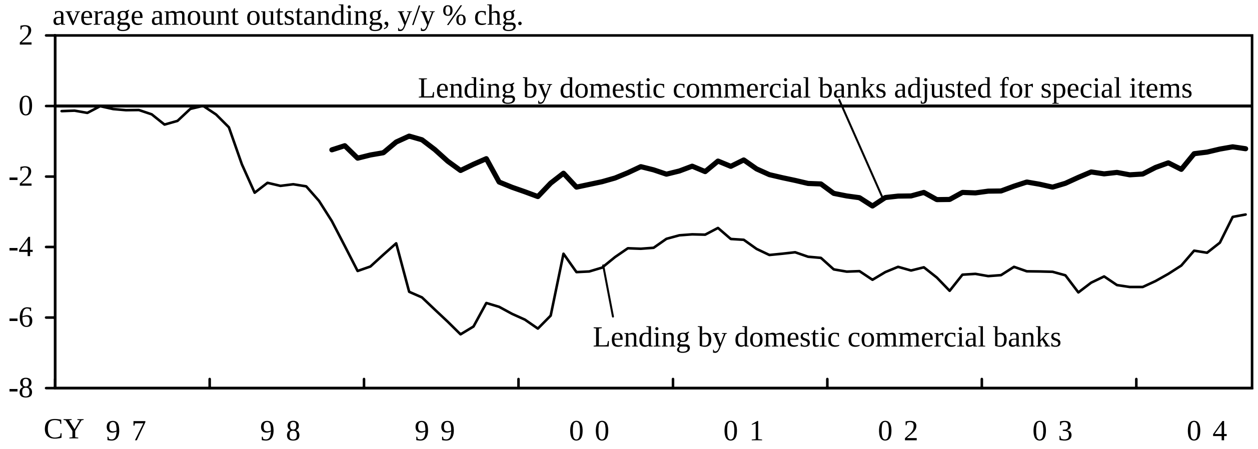


Note: The *Tankan* has been revised from the March 2004 survey. Figures up to the December 2003 survey are based on the previous data sets. Figures from the December 2003 survey are on a new basis.

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

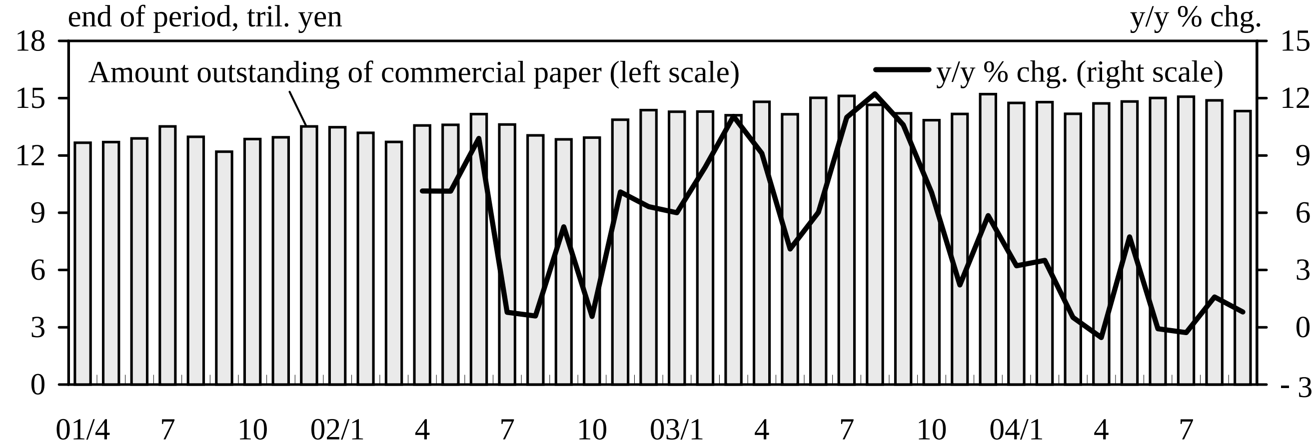
Fund-Raising by Firms

(1) Lending by Domestic Commercial Banks



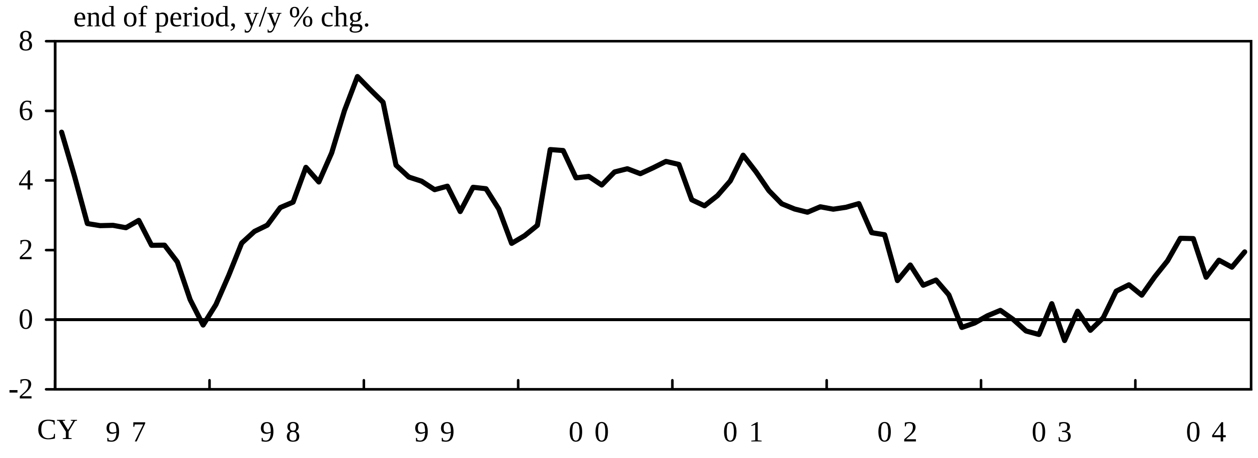
Note: Adjusted figures exclude fluctuations from liquidations of loans, loan write-offs, etc.

(2) Amount Outstanding of Commercial Paper



Notes: 1. Figures are those of financial institutions that hold current amounts with the Bank of Japan.
2. Excludes those issued by banks.

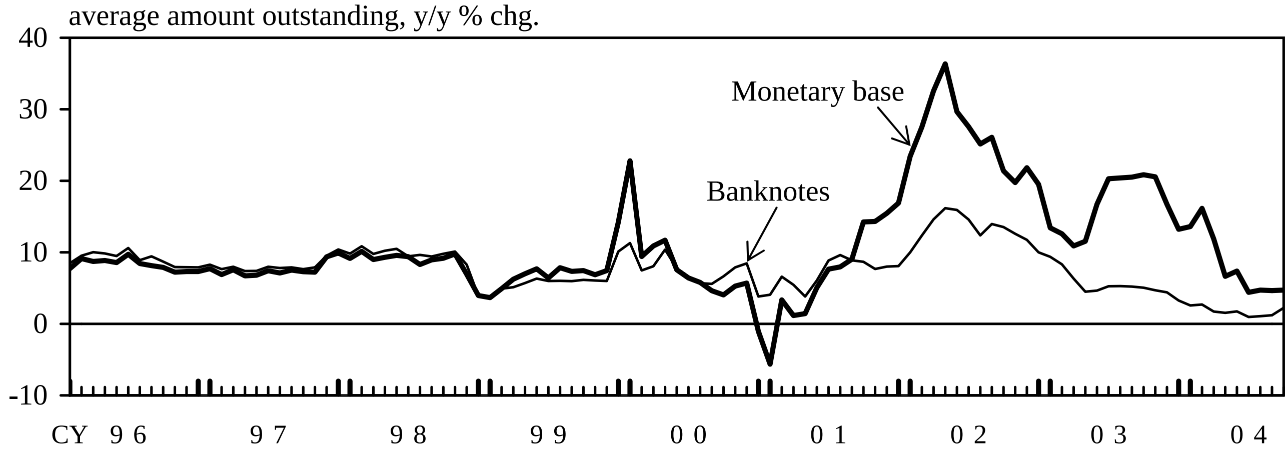
(3) Amount Outstanding of Corporate Bonds (Changes from a Year Earlier)



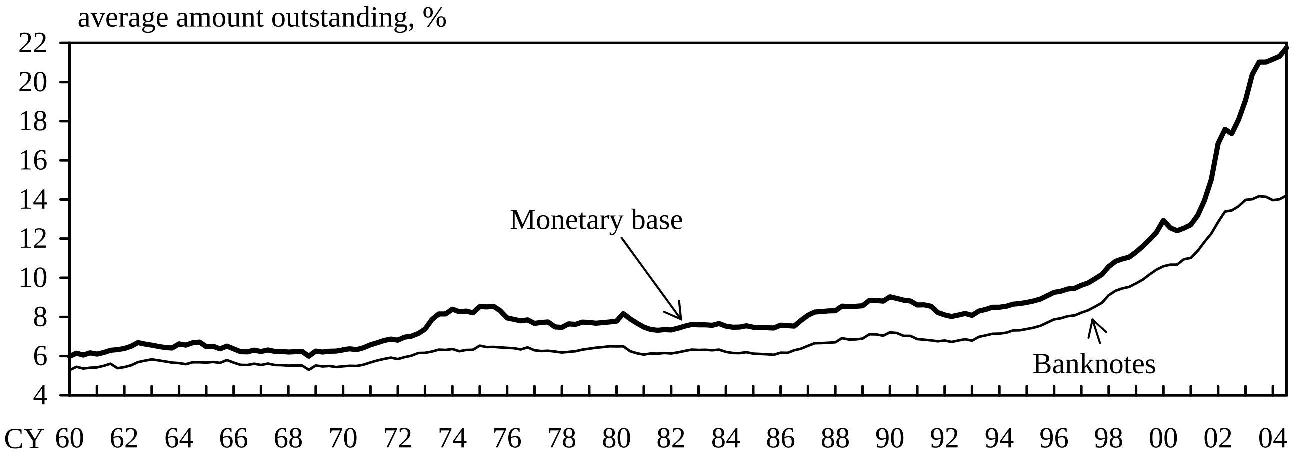
Sources: Bank of Japan; Japan Securities Dealers Association; IN Information Center.

Monetary Base

(1) Changes from a Year Earlier [1]

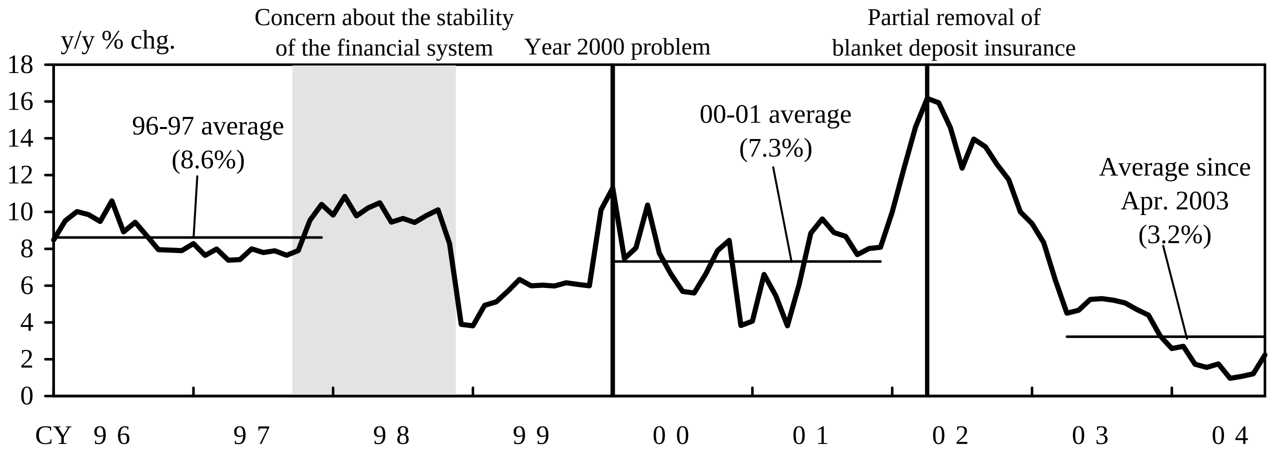


(2) Ratio of Monetary Base to Nominal GDP [1, 2, 3]



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. For figures up to March 1981, reserve balances are used in place of current deposits. For figures up to 1969, amount outstanding of coins in circulation are those at the end of the month.
3. Figure for nominal GDP in 2004/Q3 is assumed to be unchanged from the previous quarter.

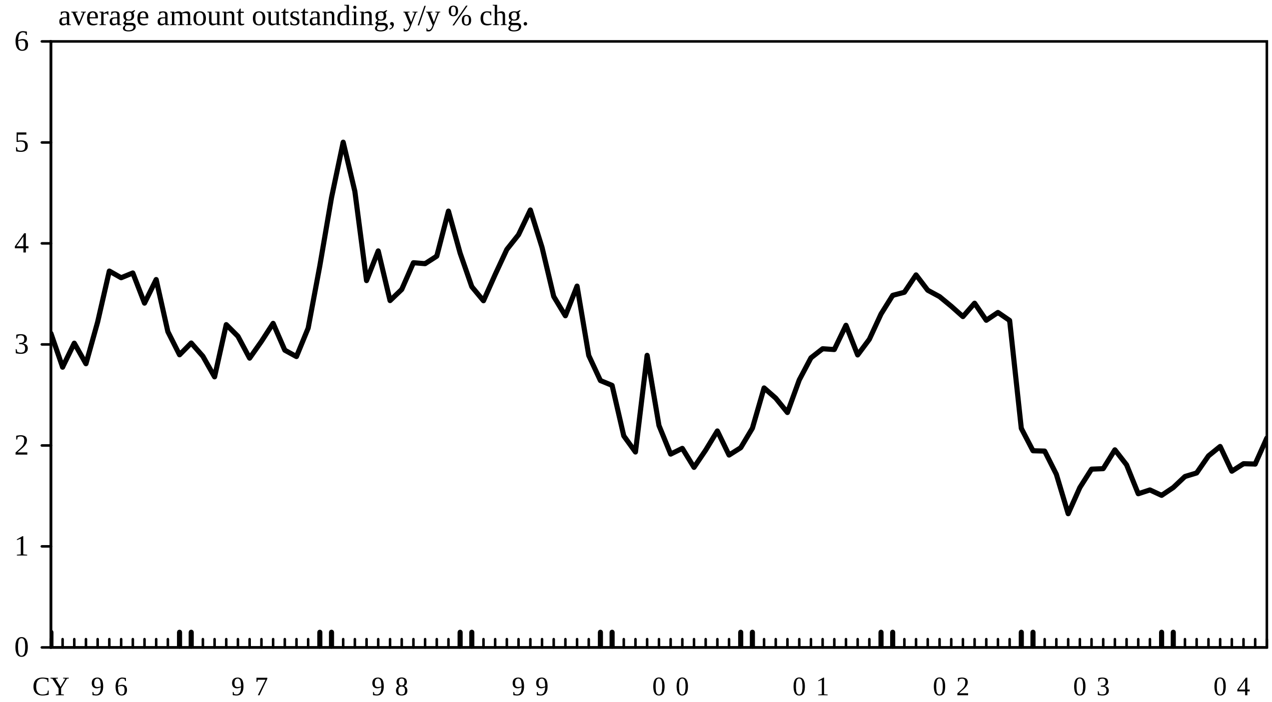
(3) Amount Outstanding of Banknotes in Circulation



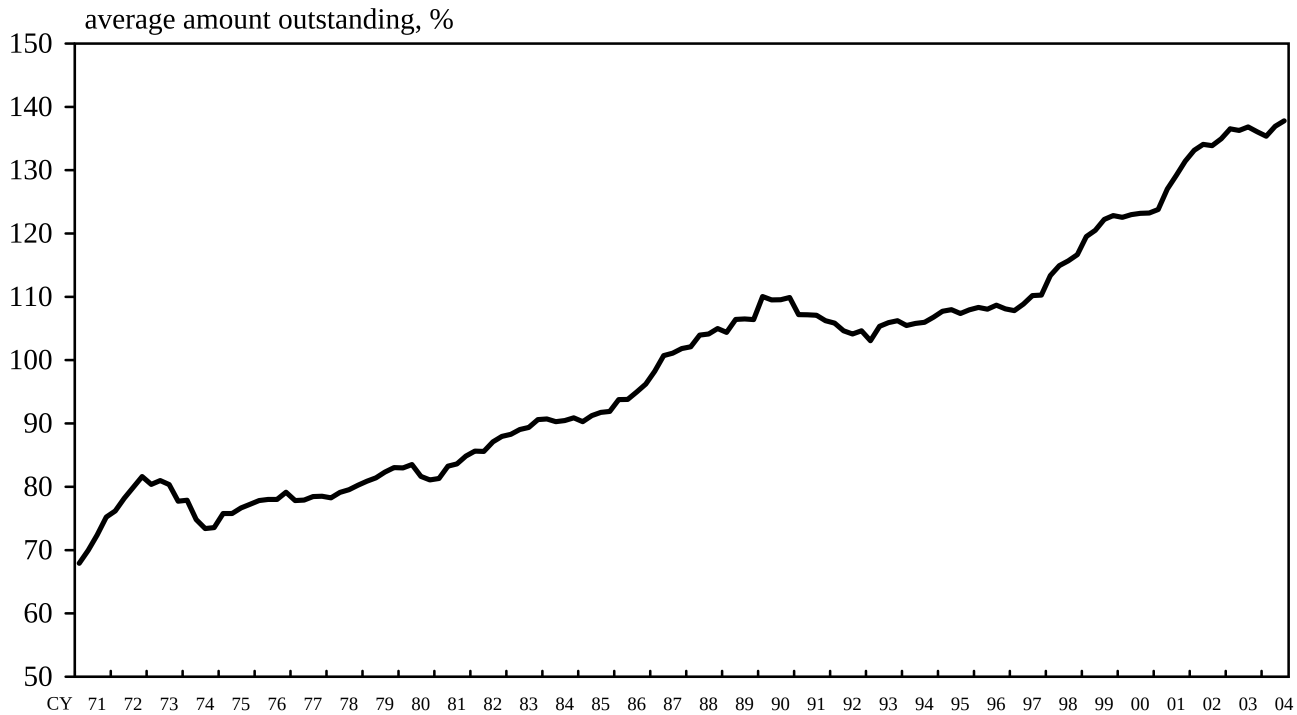
Sources: Cabinet Office, "National Accounts"; Bank of Japan.

Money Stock (M_2+CDs)

(1) Changes from a Year Earlier



(2) Ratio of Money Stock to Nominal GDP



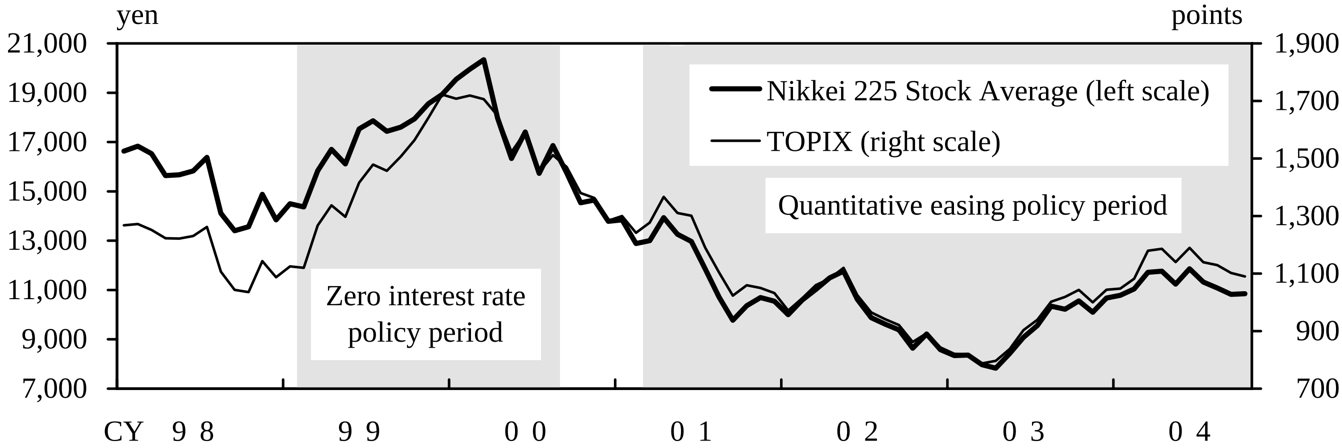
Note: Nominal GDP in 2004/Q3 is assumed to be unchanged from the previous quarter.

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

Chart 26

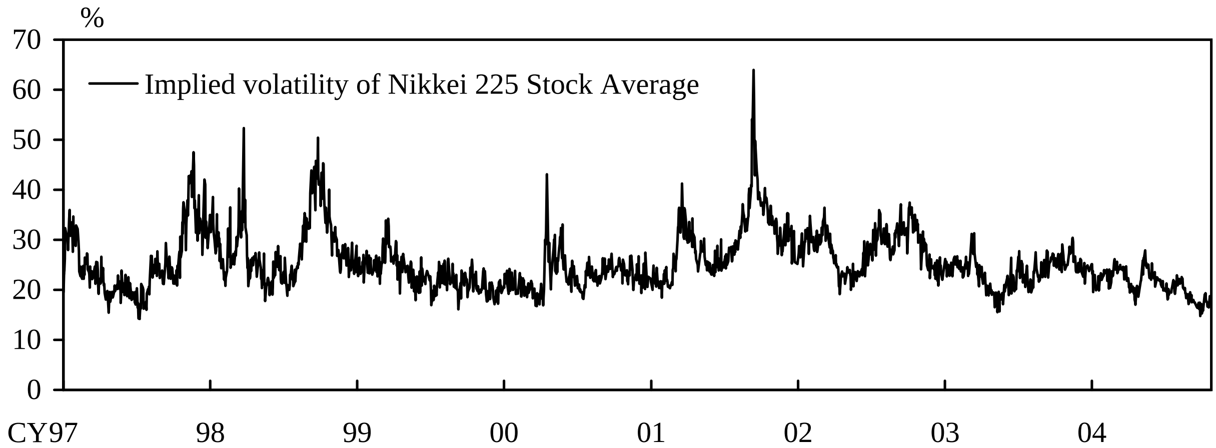
Stock Prices

(1) Japan

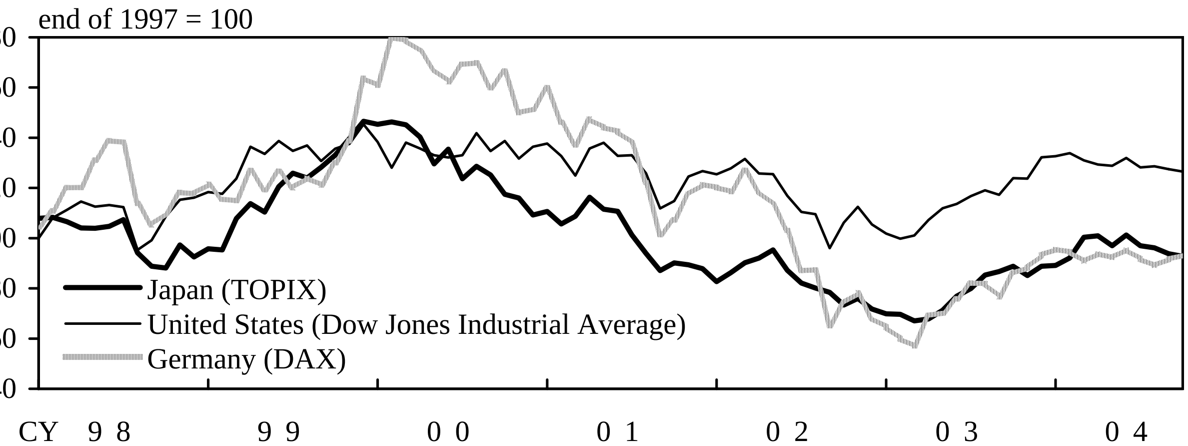


Note: Data are at end of month. Figures for October 2004 are those of October 28.

(2) Implied Volatility



(3) Major Countries

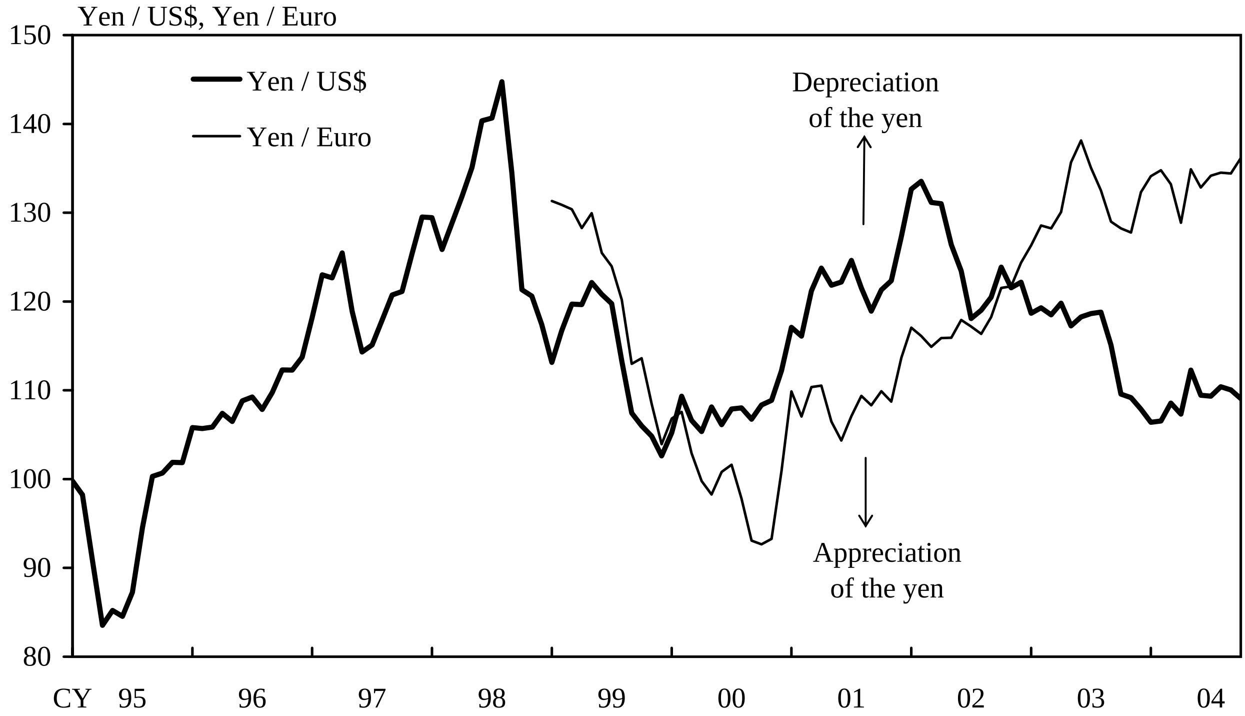


Note: Data are at end of month. Figures for October 2004 are those of October 28.

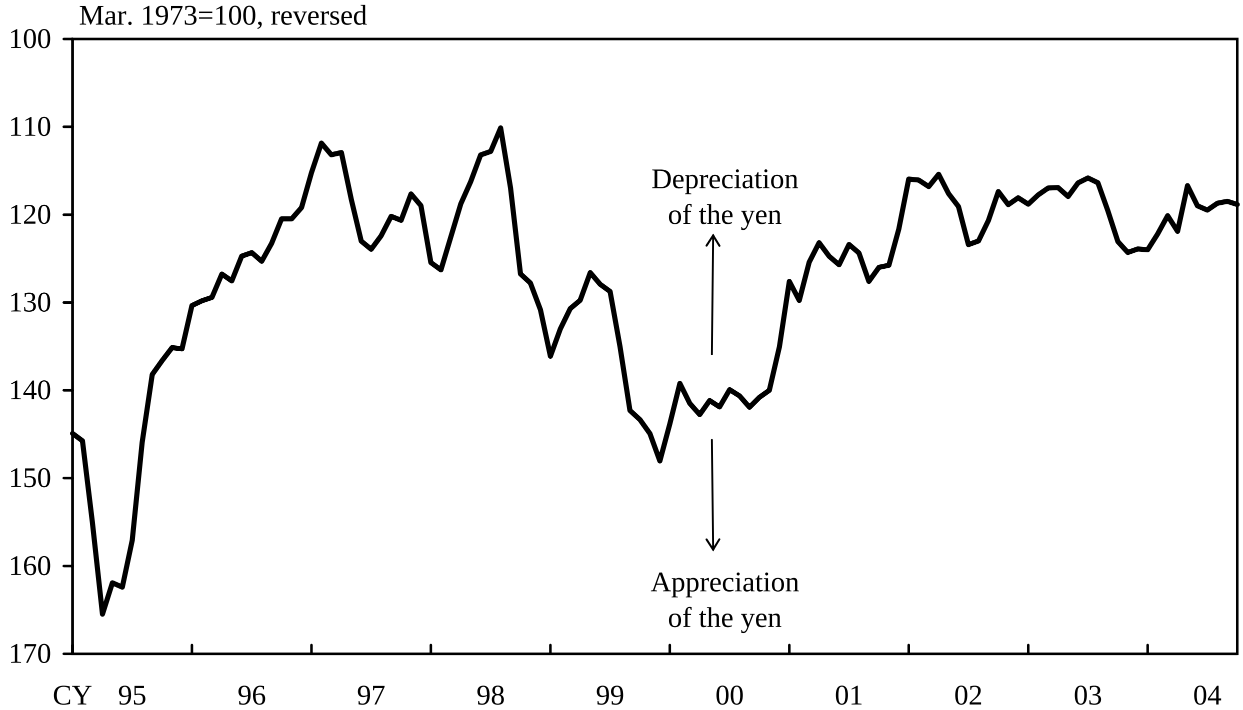
Sources: *Nihon Keizai Shimbun* ; Tokyo Stock Exchange; Bloomberg.

Exchange Rates

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



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

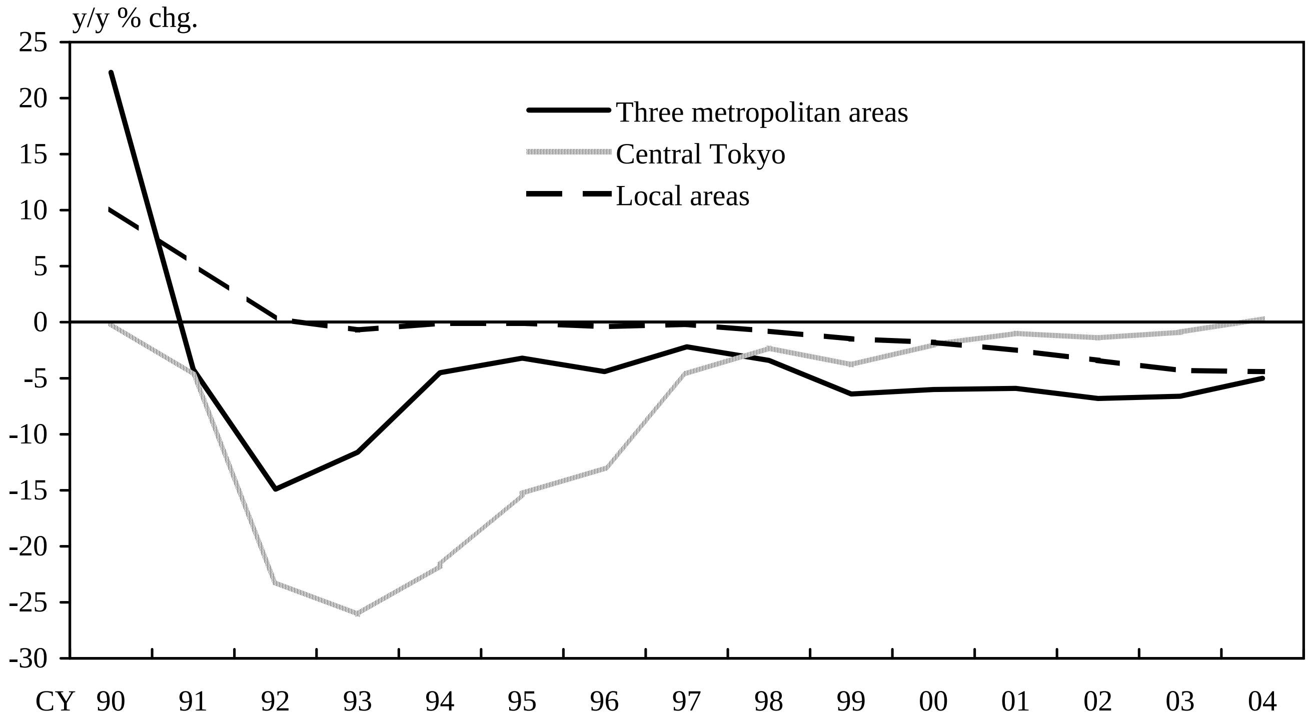


Notes: 1. Monthly average. Figures for October 2004 are averages up to the latest available data.
2. The real effective exchange rate is set against 15 currencies that have a large share among Japanese total exports. Producer price indices (PPI) or wholesale price indices (WPI) are used to deflate the nominal effective exchange rates.

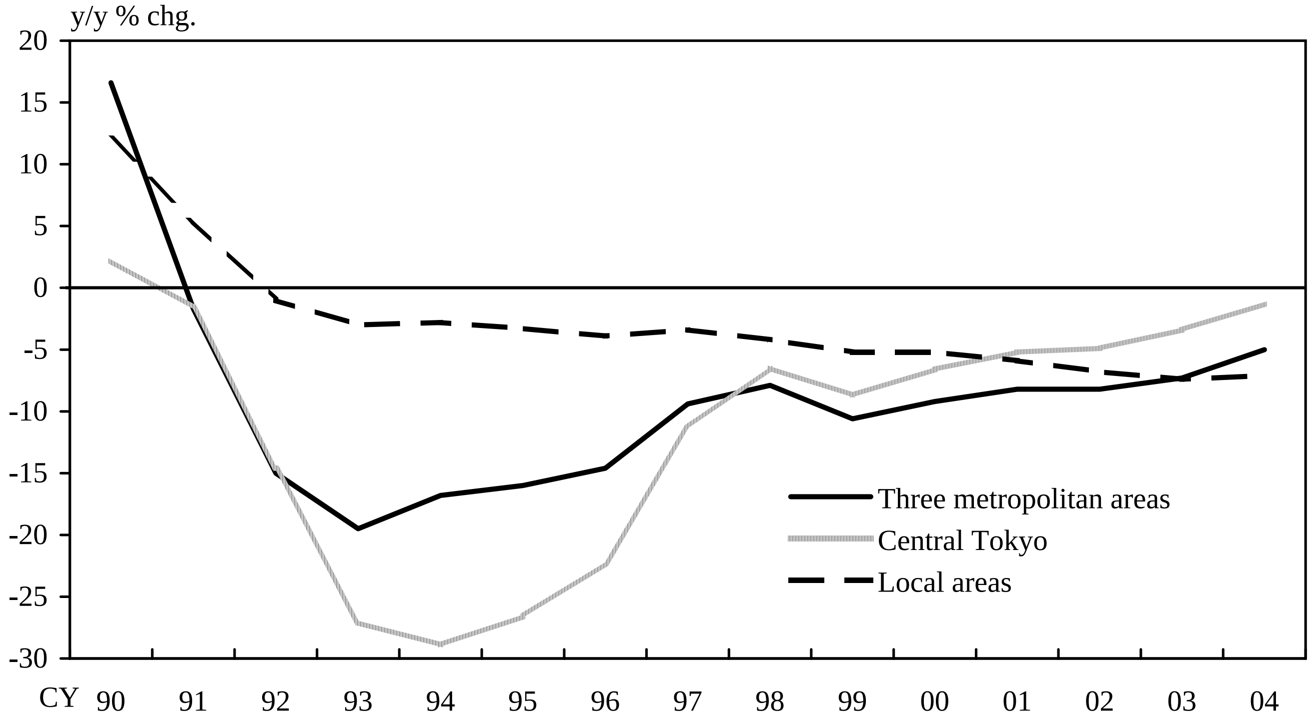
Source: Bank of Japan.

Land Prices

(1) Residential Land



(2) Commercial Land

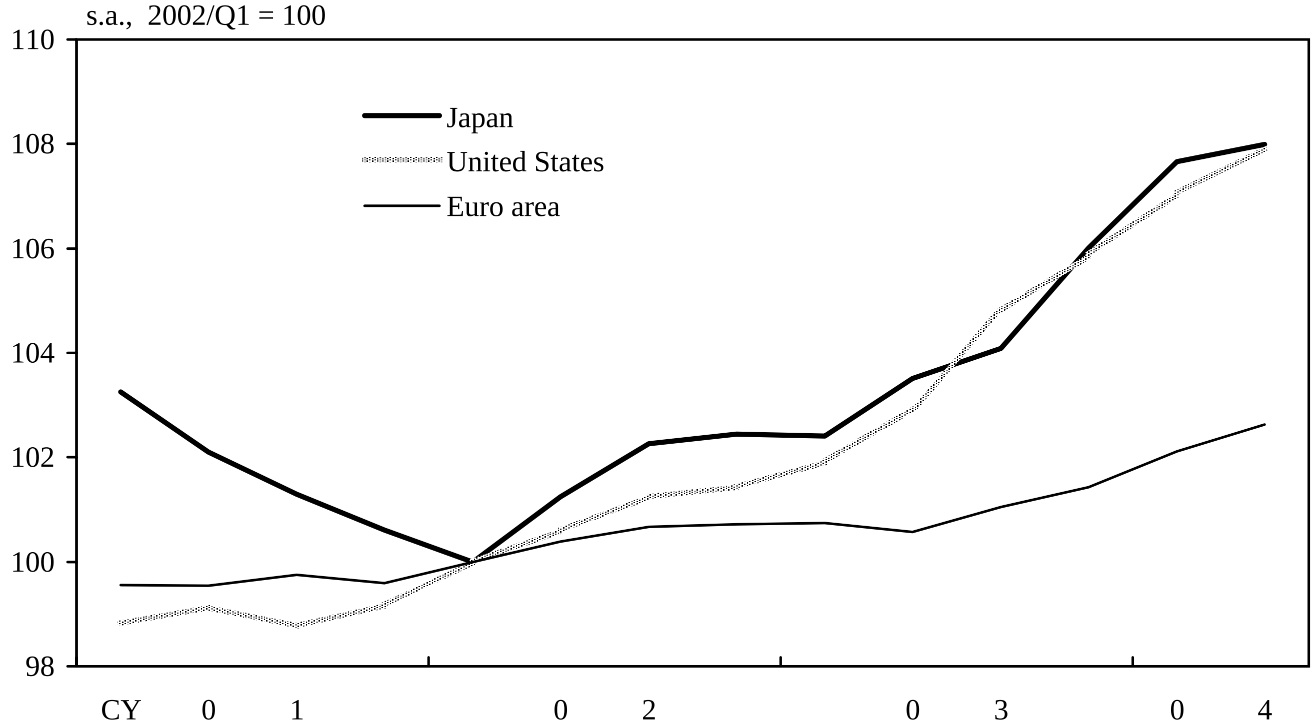


Note: Central Tokyo: average of eight wards in central Tokyo, such as Chiyoda Ward, Chuo Ward, and Minato Ward.

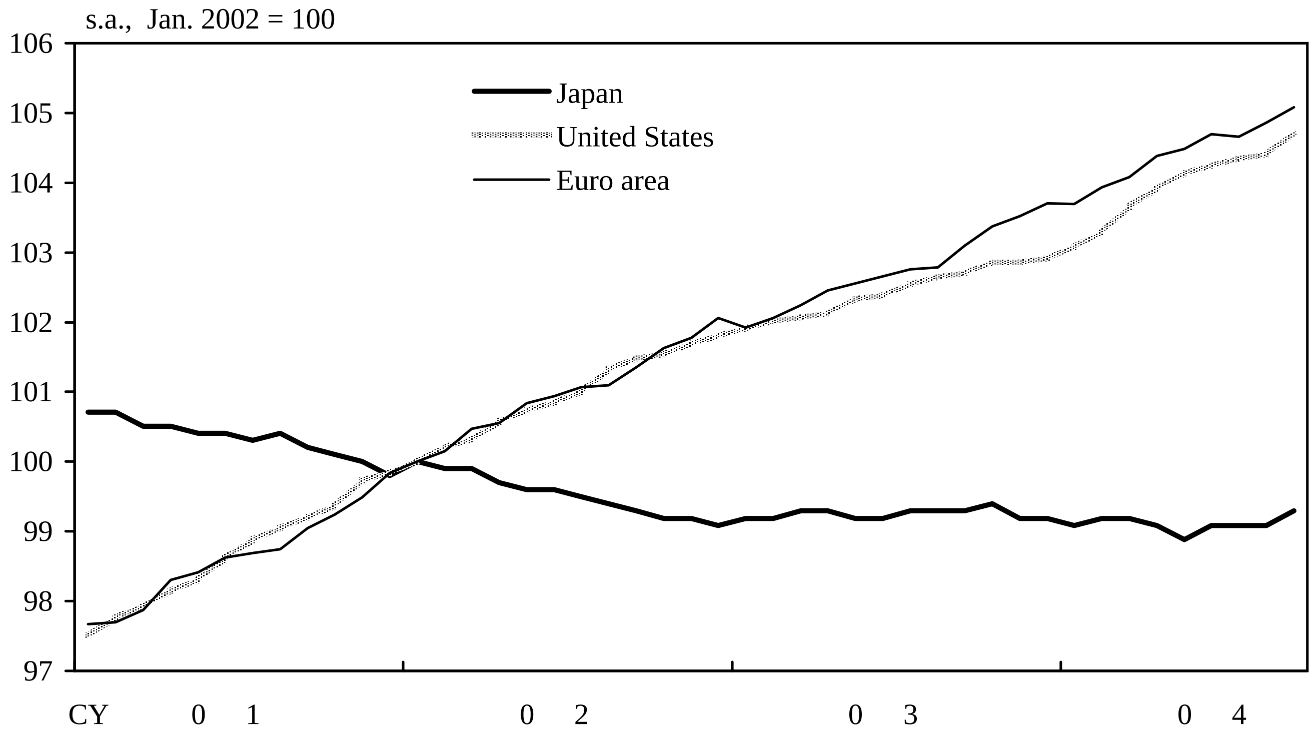
Source: Ministry of Land, Infrastructure and Transport, "Prefectural Land Price Survey."

Real GDP and Consumer Prices (1)

(1) Real GDP



(2) Consumer Prices

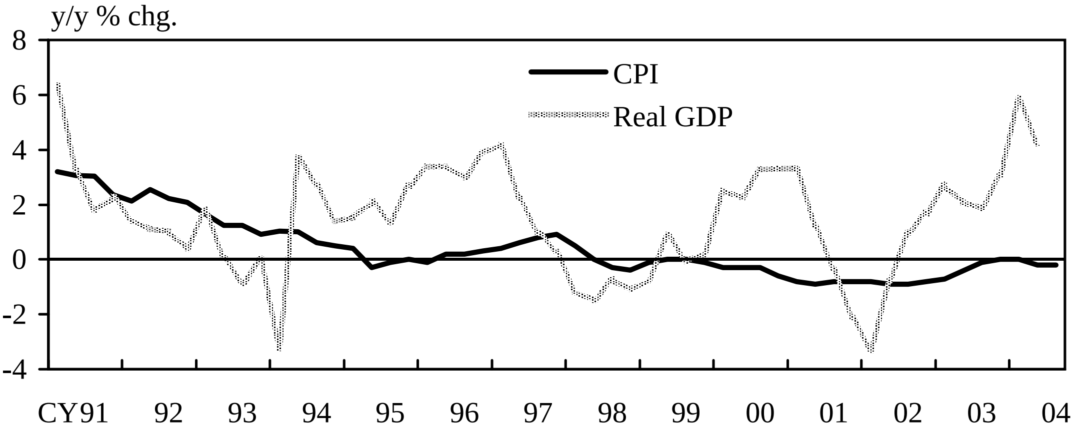


Note: Japan: CPI (general, excluding fresh food). United States: CPI (all items less food and energy). Euro area: HICP (all items excluding energy, food, alcohol, and tobacco).

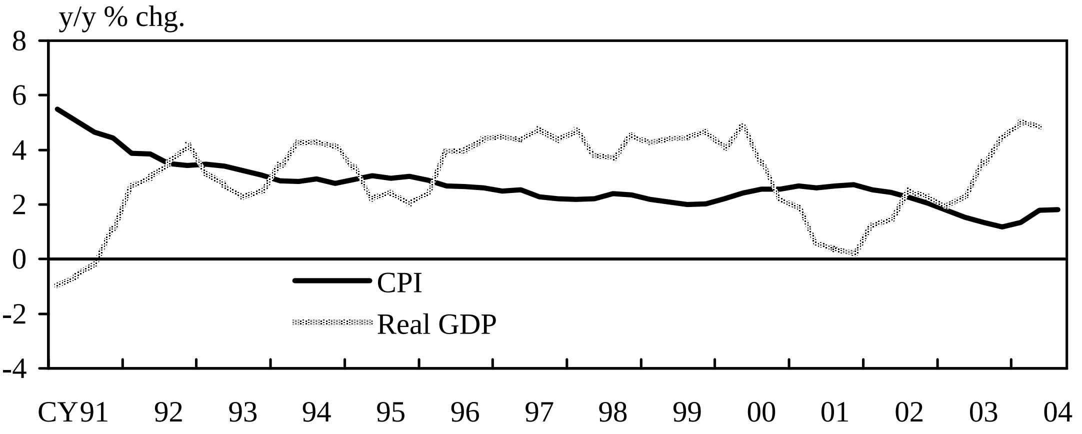
Sources: National and regional statistics bureaus.

Real GDP and Consumer Prices (2)

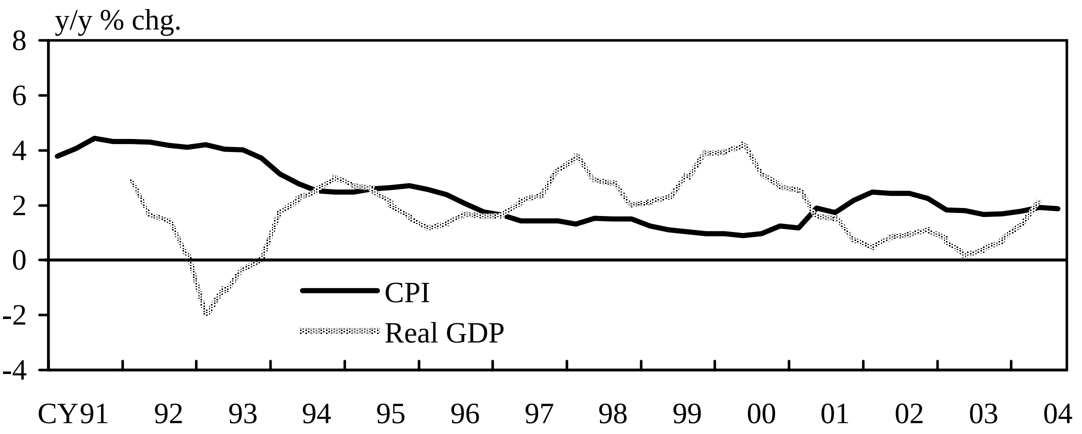
(1) Japan



(2) United States



(3) Euro area

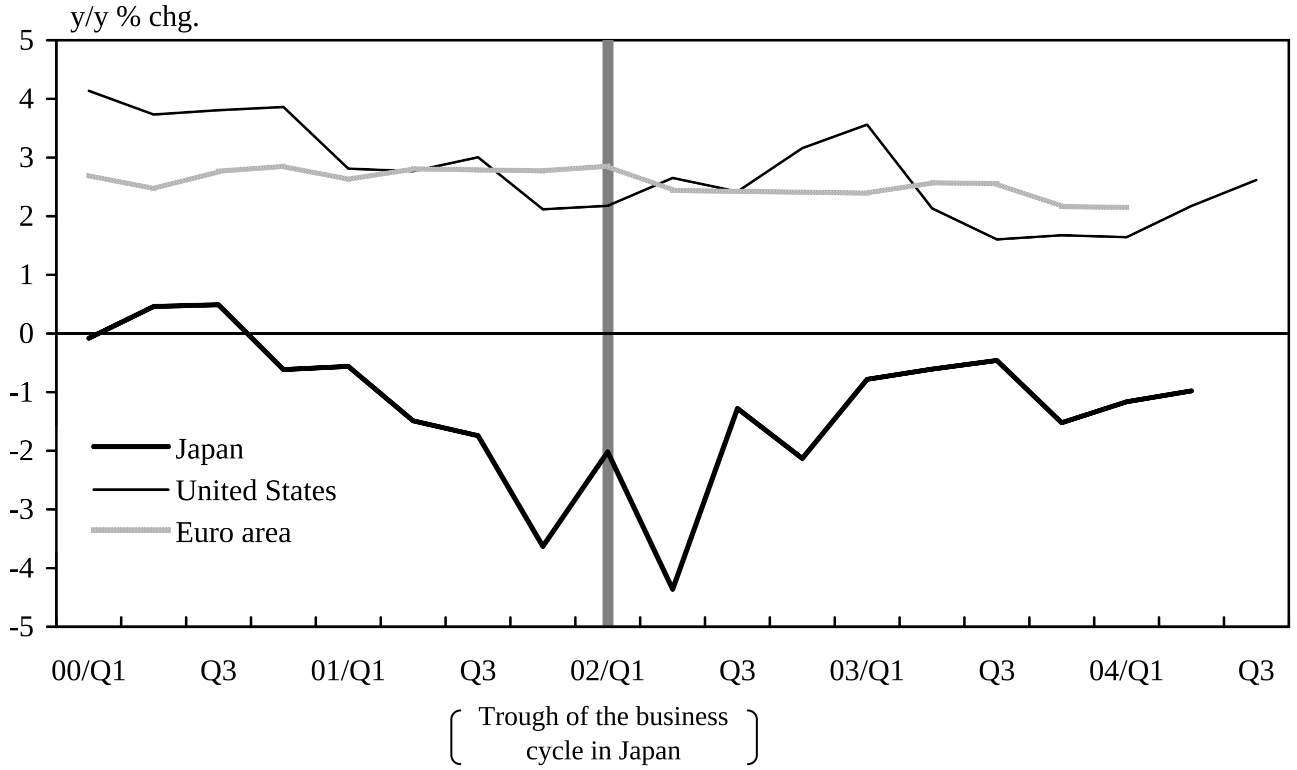


Note: Japan: CPI (general, excluding fresh food). United States: CPI (all items less food and energy). Euro area: HICP (all items excluding energy, food, alcohol, and tobacco).

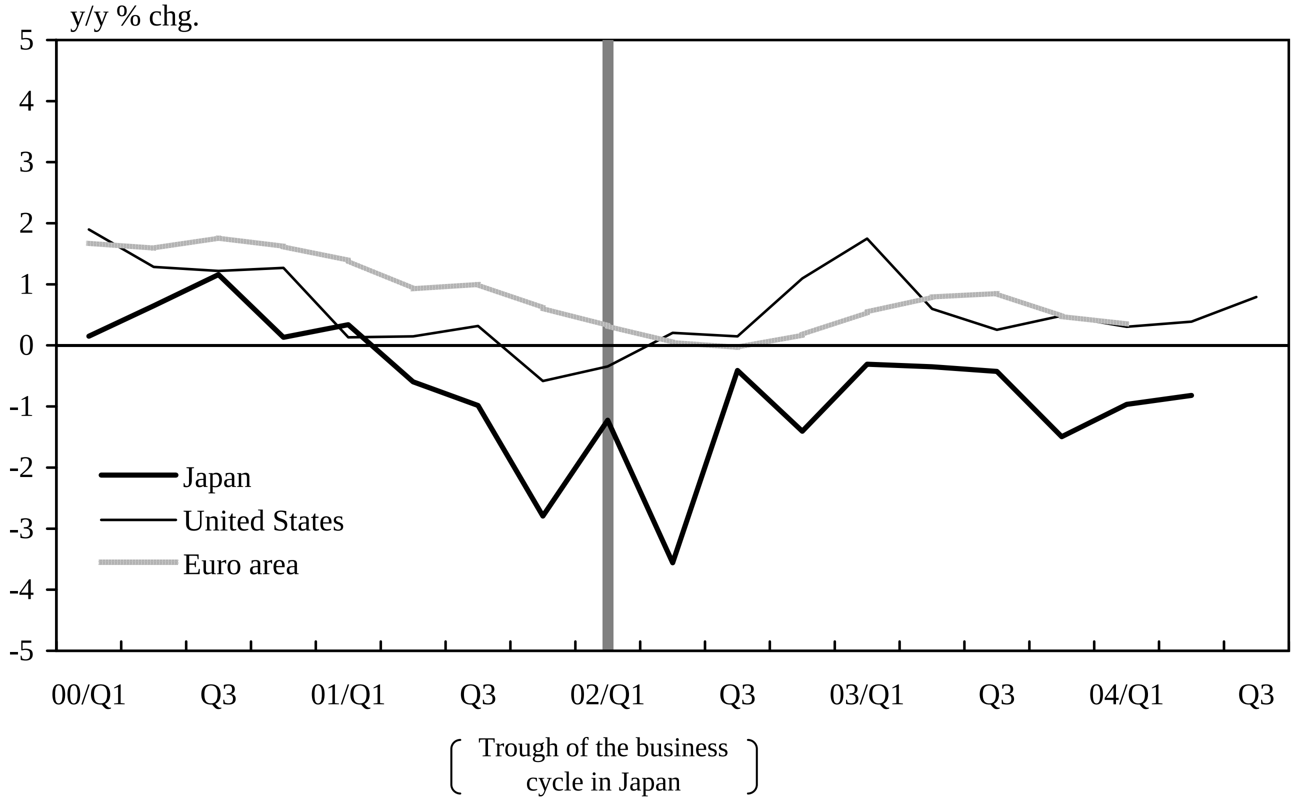
Sources: National and regional statistics bureaus.

Nominal Wages and Real Wages

(1) Nominal Wages



(2) Real Wages



Note: As for wages in Japan, Q1=Mar.-May, Q2=Jun.-Aug., Q3=Sep.-Nov., Q4=Dec.-Feb.

Sources: Ministry of Health, Labour and Welfare, "Monthly Labour Survey"; Ministry of Internal Affairs and Communications, "Consumer Price Index"; National governments; central banks; European Commission.