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Bank of Japan

Outlook for Economic Activity and Prices

October 2009

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

The Bank's View[1]

The global economy has been gradually emerging from a grave situation of panicked contraction of economic and financial activity induced by the financial crisis that broke out in the autumn of 2008. Global financial markets have been improving, and the global economy has picked up. However, the stabilization of global financial markets and the global economy to date has largely been achieved through the effects of large-scale policy measures by public authorities around the world as well as progress in various adjustment processes in the private sector. The outlook for the global economy will hinge, among other things, on the possible consequences of balance-sheet adjustments in the United States and Europe and developments in emerging economies, which have been contributing significantly to the current recovery in the global economy. The uncertainty involved in these factors remains high, although it has decreased somewhat. Against this backdrop, in considering the outlook for economic activity and prices, the baseline scenario and various risk factors should be carefully examined.

I. Outlook for Economic Activity

In the first half of fiscal 2009, Japan's economy headed toward a pick-up following the rapid and substantial deterioration in the second half of fiscal 2008. Exports and production rose considerably against the backdrop of progress in inventory adjustments both at home and abroad as well as a recovery in overseas economies, especially emerging economies. Public investment continued to rise as the government's economic policy measures were implemented. However, business fixed investment continued to decline substantially, reflecting mainly the severe corporate profit situation and low capacity utilization. Private consumption remained generally weak amid the increasingly severe employment and income situation, although there were signs of a pick-up in durable goods consumption largely owing to the effects of various policy measures.

As with other advanced economies, the outlook for Japan's economy from the second half of fiscal 2009 through fiscal 2011 is likely to continue to hinge greatly on developments in the global economy. Japan's economy has started to pick up, and in the second half of

[1] The text of "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on October 30, 2009.

fiscal 2009 it is likely to improve gradually on the back of improvements in overseas economies as well as the effects of economic policy measures. While Japan's economy is expected to remain on a recovery trend in fiscal 2010, the pace of improvement is likely to be moderate until around the middle of fiscal 2010. This is because the pace of recovery of the global economy is likely to remain moderate and also because, in Japan, pressures to adjust employment and wages are likely to remain, while effects of demand-boosting policy measures wane. Thereafter, as balance-sheet adjustments in the United States and Europe make fair progress, improvements in the corporate sector originating from exports are likely to spill over to the household sector. Therefore, in fiscal 2011 the growth rate of Japan's economy is likely to reach a level clearly above the potential growth rate.[2]

The key features of the outlook are as follows.

Overseas Economies

It is assumed that overseas economies will recover moderately on the whole. In the second half of fiscal 2009, U.S. and European economies are expected to improve on the back of demand-boosting policy measures and progress in inventory adjustments. Emerging and commodity-exporting economies are likely to maintain high growth. Economic stimulus measures are likely to have stronger effects in these economies because balance-sheet problems in these economies are relatively minor to start with and growth is likely to be boosted by the effects of capital inflows and a recovery in exports to advanced economies. While the global economic recovery might temporarily lose momentum sometime in fiscal 2010 reflecting the waning effects of demand-boosting policy measures in each country, it is unlikely that the recovery trend of the global economy will come to a halt, for the following reasons. First, authorities in the United States and Europe are taking a stance of supporting the economic recovery through macroeconomic policies. And second, domestic demand is potentially strong in emerging economies. Therefore, the

[2] According to the latest estimate using available data, Japan's potential growth rate appears to have declined from the level previously estimated, mainly reflecting the decline in the growth of capital stock due mainly to the significant deterioration in economic conditions. The Bank of Japan estimates that the potential growth rate during the current projection period has declined to "around 0.5 percent" from the "around 1 percent" estimated in the April 2009 *Outlook for Economic Activity and Prices*. It should be noted that, when fluctuations in economic activity are large as at present, estimates of the potential growth rate should be interpreted with care.

growth rate of the global economy is expected to gradually rise through fiscal 2011. Nevertheless, it is most likely that the pace of economic recovery will remain modest on the whole as the global economy is in a recovery process while adjustments are made to various excesses that had accumulated until around the mid-2000s, and the effects of balance-sheet adjustments in the United States and Europe, in particular, are likely to persist.

The Corporate Sector

In the manufacturing sector, exports and production have been increasing because of the progress in global inventory adjustments and stronger demand induced by various policy measures. However, the level of production is still low due mainly to the earlier plunge in production. While the pace of increase in production might temporarily slow as the effects of inventory adjustments and of demand-boosting policy measures at home and abroad wane, the rising trend of production is expected to continue as long as the moderate recovery trend of the global economy continues. In the absence of a substantial decline in firms' expectations of medium- to long-term growth of global demand, business fixed investment is also expected to recover gradually with the increase in production and recovery in corporate profits. In contrast, recovery in the nonmanufacturing sector and for small firms is likely to lag behind that in the manufacturing sector, since the pursuit of cost cutbacks in the manufacturing sector will put downward pressure on demand, and the household sector will face a severe situation, as will be discussed below.

The Household Sector

Private consumption, while likely to continue to show signs of recovery with regard to consumer durable goods due to the effects of various policy measures, will probably remain generally weak amid the severe employment and income situation. Recently, against the backdrop of increased exports and production, there have been changes in some employment indicators, such as an increase in non-scheduled hours worked and a leveling out of the ratio of new job offers to applicants. However, the slack in the labor market is likely to continue for some time, and the severe situation for wages, particularly for bonus payments, will continue. Since improvements in the employment and income situation tend to lag behind any recovery in corporate profits, it is highly likely that a sustainable recovery in private consumption will be in sight in the latter half of the projection period.

Financial Environment

The financial environment has been increasingly showing signs of improvement, as indicated by the fact that issuing conditions in the CP and corporate bond markets have been improving markedly and financial institutions' lending attitudes have been becoming less severe. Looking ahead, as Japan's financial system has remained robust when compared with the situation in the United States and Europe, the conditions surrounding corporate financing, such as the lending attitudes of financial institutions, are expected to continue to improve. Meanwhile, in terms of the demand for funds, the accumulation of on-hand liquidity, which had surged from the second half of fiscal 2008, has receded and demand for funds for business fixed investment is expected to be on a declining trend. Against the backdrop of a decline in the demand for funds, it is likely that firms' financial positions will improve while the amount of fund-raising by firms both through bank loans and CP issuance declines. This is particularly the case for bank loans, the outstanding balance of which had increased markedly as bank loans became a substitute means of raising funds when the issuance of CP and corporate bonds became difficult in the second half of fiscal 2008. Therefore, as CP and corporate bond markets improve, bank lending is likely to become sluggish. Meanwhile, for some nonmanufacturing firms and small firms, the financial environment will remain severe, as improvements in their performance tend to lag those of manufacturing firms and large firms. From fiscal 2010 onward, in addition to improved funding conditions for firms, the stimulative effects of low interest rates on the back of the recovery in corporate profits will likely increase. This improvement in the financial environment as a whole is expected to support the self-sustained recovery in private demand.

II. Outlook for Prices

Given the economic outlook described above, the environment surrounding the outlook for prices can be summarized as follows. First, resource utilization of labor and production capacity, which reflects the supply and demand balance of goods and services, is projected to recover gradually as the economy improves. However, since the decline in the level of resource utilization at the beginning of fiscal 2009, which is the starting point of the projection, was extraordinarily large, the level of utilization of labor and production capacity is likely to approach gradually the historical average toward the end of the projection period. Second, unit labor costs (labor costs per unit of output) are likely to be on a downtrend as a result of efforts by firms to restrain wages. Meanwhile, judging from developments in long-term interest rates and the results of various surveys targeted at households and firms, medium- to long-term inflation expectations have been generally unchanged. In addition, while commodity prices have been on a rise from the turn of the year until recently, they are projected to remain more or less unchanged, since the pace of growth of the global economy is likely to remain modest.

As for the outlook for prices in terms of price indices, while the domestic corporate goods price index (CGPI) is expected to continue declining on a year-on-year basis in the second half of fiscal 2009 due to the deterioration in the aggregate supply and demand balance, the pace of decline will likely slow down reflecting developments in commodity prices. The rate of decline in the CGPI is likely to gradually moderate from fiscal 2010 onward as the slack in the economy dissipates.

The year-on-year rate of decline in the consumer price index (CPI) for all items excluding fresh food is expected to slow down significantly in the second half of fiscal 2009, reflecting the waning effects of the drop in the prices of petroleum products from a year before. From fiscal 2010 onward, with medium- to long-term inflation expectations likely to remain stable, the rate of decline in the CPI (excluding fresh food) is likely to continue to moderate as the aggregate supply and demand balance improves gradually. Nevertheless, the pace of decline in the CPI (excluding fresh food) is likely to slow down only modestly, given that, as described earlier, the recovery in the level of utilization of labor and production capacity is likely to be gradual and unit labor costs are likely to decline.

In an economy where prices continue to decline, whether the decline in prices will induce downward pressure on economic activity becomes a critical issue. Given that the pace of decline in prices is expected to slow down during the projection period, albeit modestly, and that the financial system and medium- to long-term inflation expectations are stable, it is unlikely that the decline in prices will induce downward pressure on economic activity.

III. Upside and Downside Risks

While the outlook described above is the scenario considered to be the most likely by the

Bank, uncertainty concerning the outlook, as mentioned previously, remains high, although such uncertainty has receded somewhat. The following upside and downside risks bear upon the outlook for economic activity.

The first risk concerns the possible consequences of balance-sheet adjustments in the United States and Europe. When debt increases substantially along with an excessive rise in asset prices, it is inevitable that during the ensuing adjustment process economic entities restrain spending in order to bring excessive debt ratios back to normal. In the past, in a number of cases including that of Japan, the scale and duration of the adjustment were greater than initially envisaged. It should be noted that the same may be the case for the balance-sheet adjustment process in the United States and Europe. In that case, it is possible that spending, especially in the household sector, might be restrained for a long period while excessive debt ratios are being corrected. The financial sector might not fulfill its credit intermediation function smoothly for a protracted period and thereby put downward pressure on economic activity for a considerable period. In addition, with the economy and the financial system still vulnerable, global financial markets and the global financial system might again become unstable if some sort of shock occurs. Should this be the case, Japan's financial markets and financial system would also be affected accordingly, leading to weaker-than-expected economic growth.

The second risk concerns developments in emerging and commodity-exporting economies. In China, the implementation of large-scale macroeconomic policies has led to high growth centered on domestic demand, and has been affecting neighboring Asian emerging economies and commodity-exporting economies. In addition, the improvement in global financial markets and large-scale monetary easing in advanced countries have increased capital inflows to emerging and commodity-exporting countries, which also seems to have been supporting economic activity in these countries. If these developments further intensify, economic developments in emerging and commodity-exporting economies could become an upside risk factor for Japan's economy. On the other hand, there is also the risk that, as a result of foreign exchange and macroeconomic policies in these countries, their economies could overheat and commodity prices could rise. Such developments might put downward pressure on domestic private demand in Japan through a worsening of the terms of trade due to high commodity prices.

The third risk concerns future developments in the various policy measures taken by countries around the globe. Since the autumn of 2008, countries around the world, including Japan, have implemented large-scale fiscal and monetary policy measures as well as policies to restore financial system stability. As a result of these measures, global financial markets have been improving and the global economy has picked up. Future developments in these policy measures will have a substantial impact on the global economy. If the effects of public demand-boosting policy measures dissipate when the private sector is still fragile, this could lead to weaker-than-expected economic growth. In this case, protectionism might spread, and this might further exert downward pressure on the global economy through a decline in trade and financial transactions. On the other hand, attention should continue to be paid to the risk that an overly prolonged accommodative financial environment together with a rise in the economic growth rate might lead to larger swings in economic activity and prices. Moreover, if the public measures are maintained for longer than necessary, the productivity of the economy as a whole might decline through the retention of resources in inefficient areas. When confidence in fiscal discipline and the conduct of monetary policy declines amid increasing public debt, this might have adverse effects on financial markets, such as substantial fluctuations in long-term interest rates.

The fourth risk concerns firms' medium- to long-term expectations of future economic growth. In this outlook, it is assumed that firms' medium- to long-term expectations for global demand will remain unchanged, and that business fixed investment will recover at a moderate pace as overseas economies recover. However, if there is a decline in Japanese firms' medium- to long-term growth expectations, triggered for example by a decline in overseas economies, it is possible that economic activity, particularly business fixed investment, will deviate downward from the projected growth path. If emerging economies are expected to maintain sustainable high growth while growth expectations for Japan fail to recover, there is also a risk that investment in and lending to emerging economies might increase but domestic investment might continue to be suppressed. In addition, a decline in firms' medium- to long-term growth expectations might lead to restrained household spending through heightened anxiety about the outlook for employment and income.

There are also considerable uncertainties regarding the outlook for inflation that could cause it to deviate either upward or downward from the projection. If any of the above-mentioned upside or downside risks affecting the level of economic activity materialize, prices may be expected to respond accordingly. There are also the following risk factors that are specific to prices. The first concerns firms' and households' medium- to long-term inflation expectations. While resource utilization of labor and production capacity is likely to improve, the pace of recovery is expected to be moderate. In these circumstances, should firms and households expect a continued decline in prices, the decline in actual prices and wages might accelerate. The second risk factor concerns the high uncertainty with respect to gauging the degree of slack in the economy or the state of utilization of labor and production capacity. When the economy is deteriorating substantially with structural changes in demand, it is possible that the supply capacity of the economy and the potential growth rate are also declining owing to obsolescence or a cutback in capital stock. In this case, if the degree of economic slack is estimated based on the output gap derived from past data, there is a risk of overestimating the downward pressure on prices. The third risk factor concerns developments in import prices. Considerable uncertainty surrounds developments in prices of primary commodities such as crude oil, leaving room for movement in either direction. On one hand, there is a risk of primary commodity prices falling as a result of a weaker-than-expected global economy. On the other hand, should the growth of emerging economies be stronger than expected or the current extremely stimulative economic measures be maintained, primary commodity prices might rise more than expected. Fluctuations in foreign exchange rates can also affect consumer prices to a certain extent, not only by influencing the swings in economic activity but also through changes in import prices.

IV. Conduct of Monetary Policy

To realize sustainable growth with price stability, the Bank assesses the economic and price situation from two perspectives and then outlines its thinking on the future conduct of monetary policy, taking into account the "understanding of medium- to long-term price stability" -- that is, the level of inflation that each member of the Policy Board understands, when conducting monetary policy, as being consistent with price stability over the medium to long term.[3]

The first perspective involves assessing the most likely outlook for economic activity and prices through fiscal 2011. As noted earlier, the economy is likely to continue improving. The rate of year-on-year decline in the CPI (excluding fresh food) is likely to moderate gradually from the second half of fiscal 2009 onward. If these developments continue, there are prospects for the economy to return to a sustainable growth path with price stability in the longer term.

The second perspective assesses the risks considered most relevant to the conduct of monetary policy, including risks that have a longer time horizon than the first perspective. In the area of economic activity, while there are some upside risks, such as economic developments in emerging and commodity-exporting economies, there are still downside risks, although somewhat diminished, with risk factors including the possible consequences of balance-sheet adjustments in the United States and Europe or potential changes in firms' medium- to long-term growth expectations. Regarding the outlook for prices, there is a possibility that inflation will rise more than expected due to a rise in commodity prices brought about by higher growth rates in emerging and commodity-exporting economies. On the other hand, there is a risk that the rate of inflation might decline due, for example, to a decline in medium- to long-term inflation expectations.

Based on the examination from the two perspectives described above, in the conduct of monetary policy the Bank will aim to maintain the extremely accommodative financial environment. The Bank will provide steady support for Japan's economy to return to a sustainable growth path with price stability.

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[3] The "understanding of medium- to long-term price stability," reviewed in April 2009, is expressed in terms of the year-on-year rate of change in the CPI and falls in the range approximately between 0 and 2 percent, with most Policy Board members' median figures at around 1 percent.

(Appendix 1)

Forecasts of the Majority of Policy Board Members

y/y % chg.

	Real GDP	Domestic CGPI	CPI (excluding fresh food)
Fiscal 2009	-3.3 to -3.2 [-3.2]	-5.3 to -5.0 [-5.2]	-1.5 to -1.5 [-1.5]
Forecasts made in July 2009	-3.7 to -3.0 [-3.4]	-6.0 to -5.8 [-5.9]	-1.5 to -1.2 [-1.3]
Fiscal 2010	+0.8 to +1.3 [+1.2]	-1.5 to -1.0 [-1.4]	-0.9 to -0.7 [-0.8]
Forecasts made in July 2009	+0.6 to +1.1 [+1.0]	-2.1 to -1.5 [-2.1]	-1.2 to -0.7 [-1.0]
Fiscal 2011	+1.6 to +2.4 [+2.1]	-1.0 to -0.3 [-0.7]	-0.7 to -0.4 [-0.4]

Notes:
1. Figures in brackets indicate forecast medians.
2. The forecasts of the majority of Policy Board members are constructed as follows: each Policy Board member's forecast takes the form of a point estimate, namely, the figure to which he or she attaches the highest probability of realization. These forecasts are then shown as a range, with the highest figure and the lowest figure excluded. It should be noted that the range does not indicate the forecast errors.
3. Individual Policy Board members make their forecasts with reference to the view of market participants regarding the future course of the policy interest rate -- a view that is incorporated in market interest rates.
4. The range shown below includes the forecasts of all Policy Board members.

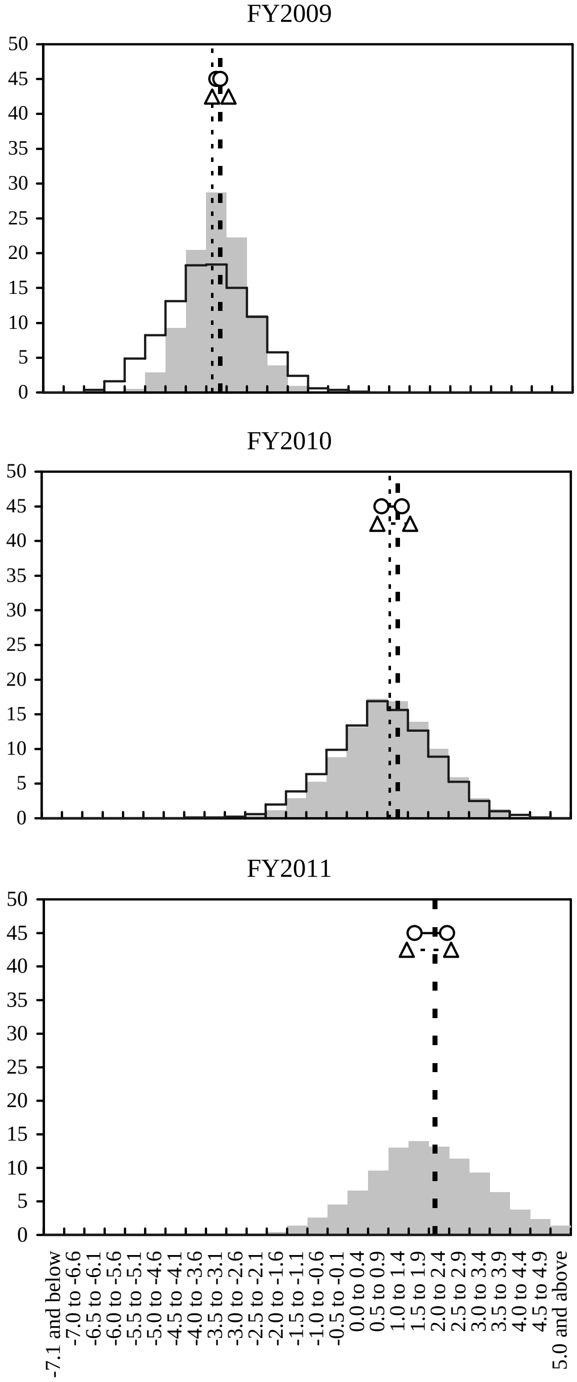
y/y % chg.

	Real GDP	Domestic CGPI	CPI (excluding fresh food)
Fiscal 2009	-3.4 to -3.0	-5.4 to -5.0	-1.6 to -1.4
Forecasts made in July 2009	-3.8 to -3.0	-6.2 to -5.7	-1.6 to -1.2
Fiscal 2010	+0.7 to +1.5	-1.5 to -0.9	-1.2 to -0.7
Forecasts made in July 2009	+0.5 to +1.5	-2.1 to -1.4	-1.2 to -0.6
Fiscal 2011	+1.4 to +2.5	-1.1 to +0.2	-1.0 to -0.3

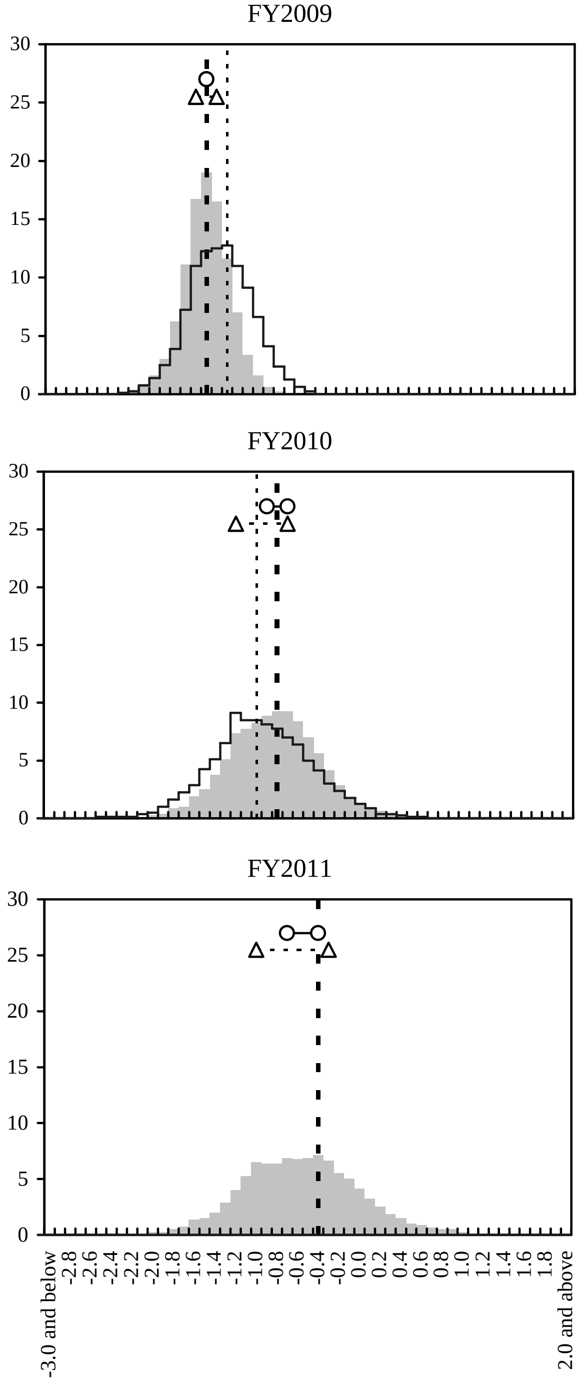
(Appendix 2)

Risk Balance Charts

(1) Real GDP



(2) CPI (Excluding Fresh Food)



Notes: 1. Vertical axes in the charts represent probability (%), while horizontal axes represent the year-on-year percentage changes in the respective indicators. Bar charts represent the probability distributions in October 2009, and solid lines represent those in July 2009.

2. Vertical dashed heavy lines indicate the median of the Policy Board members' forecasts (point estimates). O———O indicates the range of the forecasts of the majority of Policy Board members. Δ- - - -Δ indicates the range of the forecasts of all Policy Board members.

3. Vertical dashed thin lines indicate the median of the Policy Board members' forecasts (point estimates) in July 2009.

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

The Background

I. Economic and Financial Developments in the First Half of Fiscal 2009

Economic Activity

Japan's economy in the first half of fiscal 2009 headed toward a pick-up following the rapid and substantial deterioration in the second half of fiscal 2008 (Chart 1). Public investment continued to increase and exports and production also rose considerably. In contrast, business fixed investment continued to decline substantially on the back of the difficult corporate profit situation. Private consumption remained generally weak and housing investment declined as the employment and income situation became increasingly severe. These economic developments were more or less in line with the projections in the April 2009 *Outlook for Economic Activity and Prices* (Outlook Report) and in the interim assessment in July.

Specifically, public investment continued to increase owing to the implementation of the supplementary budget for fiscal 2008 and the front-loading of the fiscal 2009 budget. Exports fell significantly in the second half of fiscal 2008, but then increased in the April-June and July-September quarters of 2009 due to the effects of policy measures taken around the world and progress in adjustments of inventories overseas (Chart 2). Imports also started to increase on the back of developments in production, albeit at a moderate pace compared with that of exports. As a result, net exports, in terms of the real trade balance, reached their bottom in the January-March quarter of 2009 and increased markedly thereafter. Corporate profits fell substantially until the January-March quarter of 2009, but started to pick up, although still remaining at extremely low levels, in the April-June quarter due mainly to increased production and restrained wages (Chart 3 [1]). In these circumstances, business sentiment showed some improvement, mainly at large manufacturing firms. Against the backdrop of these developments, the decline in business fixed investment continued to moderate gradually (Chart 3 [2]). Meanwhile, although employment adjustment subsidies and other measures were implemented to support employment, the number of employees reported in the *Labour Force Survey* started to decline markedly due to the plunge in economic activity (Chart 4 [1]). As for wages, scheduled and non-scheduled cash earnings continued to mark year-on-year declines due to a reduction in working hours mainly in the manufacturing sector, while special cash earnings also declined significantly on the back of the decrease in corporate profits (Chart 4 [2]). As a result, employee income fell substantially (Chart 4 [3]). In these circumstances, private consumption remained generally weak, although durable goods consumption picked up thanks to various policy measures (Chart 5 [1]). Owing to various demand-boosting policy measures as well as the decline in retail prices, indicators of consumer sentiment improved on the whole but remained at comparatively low levels (Chart 5 [2]). The level of housing investment fell substantially because the employment and income situation became increasingly severe and the financial environment surrounding the real estate sector deteriorated.

Reflecting these developments in demand both at home and abroad, industrial production plunged in the second half of fiscal 2008, but then increased in the April-June and July-September quarters of 2009 (Chart 6 [1]). On a year-on-year basis, overall industrial production fell by more than 30 percent in the January-March quarter of 2009, but the pace of decline decelerated to about 20 percent in the July-September quarter. Looking at developments by industry, the year-on-year decline decelerated in many industries, including transport equipment and electronic parts and devices, on the back of the increase in exports and a pick-up in domestic automobile sales (Chart 6 [2]). Inventories continued to decrease owing to an increase in shipments, and the shipment-inventory balance recorded a clear improvement (Chart 6 [3]). Looking at the indices of all industrial activity,[4] the year-on-year decrease overall slowed only modestly because although the decline in the manufacturing sector decelerated, activity in the nonmanufacturing sector continued to be weak (Chart 7).

Reflecting these developments in demand and production, resource utilization of labor and production capacity remained extremely low, but improved slightly (Chart 8). A *Tankan* (Short-Term Economic Survey of Enterprises in Japan) composite indicator, a weighted average of the diffusion indices (DI) of production capacity and employment conditions where indices are weighted by capital and labor shares in the national accounts, indicated

[4] The indices of all industrial activity move generally in parallel with real GDP, although the growth rate of all industrial activity tends to be somewhat lower than that of real GDP.

that although there remained substantial economic slack, there had been some improvement. Moreover, the estimated output gap, which shows the degree of slack in the economy and was substantial in the January-March quarter of 2009, also narrowed slightly in the April-June quarter.[5]

Prices

As for prices, the effects of the drop in commodity prices, following their significant rise toward the middle of 2008, and of the economic downturn spread to both wholesale and retail prices in Japan with a slight time lag (charts 9 and 10). Compared with the projections in the interim assessment in July, the domestic corporate goods price index (CGPI) moved slightly higher than projected due mainly to a slight increase in commodity prices, while the consumer price index (CPI) moved slightly lower than projected owing to price discounts reflecting consumers' preference for inexpensive goods.

Specifically, the CGPI in August showed a year-on-year decline of 8.5 percent, marking the largest-ever decline for two months in a row since the start of the statistics in 1960, followed by a year-on-year decline of 7.9 percent in September. The CPI (excluding fresh food), after registering a decline of 2.4 percent on a year-on-year basis in August, the largest ever, showed a decrease of 2.3 percent in September. Looking at the recent trend in detail, the pace of decline in prices of goods greatly accelerated (Chart 11). Specifically, prices of petroleum products declined at a faster pace, while price changes for food products turned negative, significantly affecting overall price developments. In addition, the pace of decline in prices of durable consumer goods and other goods including daily necessities also accelerated. The year-on-year decline in prices of general services accelerated, mainly because mobile telephone charges, prices of overseas package tours, and prices of services

[5] The negative output gap seems to have narrowed slightly further in the July-September quarter. However, the output gap and the weighted average DI of the *Tankan* have recently shown a large discrepancy. The potential for calculation errors is particularly great at times when there are large fluctuations in the economy, and it is highly possible that the recent pace of decrease in the output gap may be overestimated. On the other hand, it is highly possible that the level of "excess" of the weighted average DI might be underestimated, as the DI does not reflect (1) the extent of the "excess" felt by firms, because they are only asked to indicate whether they perceive an "excess" or a "shortage;" and (2) unemployment and other factors outside the corporate sector.

related to domestic duties (housekeeping) declined at a faster pace, and the pace of increase in prices of eating out moderated. As for public utility charges, the pace of decline accelerated on a year-on-year basis, mainly due to the reduction in electricity and city gas charges.

Financial Markets

The global economy deteriorated rapidly from September 2008 onward as strains in global financial markets intensified. In order to counter the adverse feedback loop between financial and economic activity, central banks and governments around the world carried out various policy measures. As a result of these measures, the pace of deterioration in business sentiment slowed from the beginning of 2009 and strains in global financial markets gradually eased. Pressures in U.S. and European money markets declined, spreads between interbank rates and yields on government bills narrowed, and credit spreads on corporate bonds decreased (Chart 12). In addition, the financial environment in many emerging economies improved, as indicated by the appreciation of their currencies and the decline in sovereign risk premiums.

As Japan's financial markets had been adversely affected by the global financial turmoil, market functioning declined in many markets, and the economy deteriorated rapidly. Against this backdrop, the Bank reduced the policy interest rate and took various measures to ensure stability in financial markets and to facilitate corporate financing (Chart 13). The overnight call rate remained at an extremely low level following two policy interest rate reductions, and after the turn of the year interest rates on term instruments declined (Chart 14). In addition, markets expected that low short-term interest rates would prevail for some time (Chart 15).

Long-term interest rates in Japan fell until around the end of 2008, reflecting the deterioration in business sentiment, but increased thereafter as sentiment recovered, and since then have remained more or less unchanged (Chart 16). Stock prices in Japan declined sharply from the autumn of 2008 on the back of the turmoil in global financial markets and concerns over the global economic downturn, but rebounded from around the spring of 2009 along with the recovery in business sentiment (Chart 17). The yen depreciated after the turn of the year, but has appreciated since the summer (Chart 18).

The Financial Environment

The financial environment in Japan deteriorated sharply until around the end of 2008, but increasingly showed signs of improvement, particularly in the CP and corporate bond markets, from around the spring (Chart 19). The overnight call rate remained at an extremely low level following the two policy interest rate reductions, but the stimulative effects of the low interest rates were limited given the low level of economic activity and corporate profits (Chart 20).

As for the supply of funds, lending attitudes of financial institutions from the perspective of firms rapidly turned severe from the autumn of 2008 onward. Although many firms still view lending attitudes as severe, the financial situation in this regard has improved somewhat since the start of the new fiscal year in April (Chart 21 [1]). The issuing environment for CP and corporate bonds continued to improve, as indicated by the narrowing of credit spreads as well as the increase in the total value of issuance and the number of firms issuing corporate bonds, and has become favorable (Chart 22). However, issuing conditions for low-rated corporate bonds have remained severe. Concerning the demand for funds, while there was an accumulation of on-hand liquidity toward the end of the fiscal year in March 2009, this tendency has receded since the start of the new fiscal year in April and firms' funding needs for working capital and fixed investment have subsided.

In these circumstances, bank lending for corporate funding continued to record high growth toward the end of the fiscal year reflecting an increase in the demand for loans to compensate for the decline in the issuance of CP and corporate bonds as well as continued efforts to secure more on-hand liquidity (Chart 23 [2]). Thereafter, due mainly to firms' waning demand for funds, the growth rate of bank lending moderated and the issuance of CP decreased. In contrast, the issuance of corporate bonds reached a high level, reflecting the improvement in the market environment and continued efforts, especially of large firms, to lengthen the maturity of their liabilities. In these circumstances, firms' financial positions continued to improve as a whole, although many firms, particularly small ones, still considered their financial position to be weak (Chart 21 [2]). Meanwhile, the year-on-year rate of growth in the money stock (M2) increased moderately (Chart 23 [3]).

Land prices declined in metropolitan and nonmetropolitan areas. According to the *Prefectural Land Price Survey* (prices as of July 1, 2009), both commercial and residential land prices in the three major metropolitan areas (Tokyo, Osaka, and Nagoya) and in nonmetropolitan areas declined year on year (Chart 24). The fall in both commercial and residential land prices in the 23 wards of Tokyo moderated somewhat.[6]

II. The Outlook for Economic Activity and Prices: Second Half of Fiscal 2009 through Fiscal 2011

The Outlook for Economic Activity and Prices

The Bank's outlook for economic activity in Japan from the second half of fiscal 2009 through fiscal 2011 is as follows. In the second half of fiscal 2009, overseas economies are likely to continue to improve and policy effects will continue to have a favorable impact on domestic demand. In these circumstances, a further decline in medium- to long-term growth expectations can likely be avoided, business fixed investment will bottom out, and the economy will improve.[7] In fiscal 2010, the economy will continue to improve, although the pace of improvement is likely to be moderate, mainly for the following reasons: (1) public investment and durable goods consumption, both of which have contributed to pushing up the growth rate of the economy in fiscal 2009, are expected to wane; (2) the strength of the recovery in overseas economies is likely to be constrained by the adjustments of excesses that had accumulated in the past several years; and (3)

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[6] Land prices are compared for areas that are surveyed in both the *Land Price Publication* and the *Prefectural Land Price Survey*, on a semiannual basis.

[7] As for inventories, while the adjustment in automobiles and electronic parts and devices has basically been completed, the level of inventories on a macroeconomic basis remains high. This is especially the case for work-in-progress inventories and wholesale- and retail-trade inventories (Chart 25). Therefore, inventories are expected to decline throughout the projection period until fiscal 2011. However, reflecting a slowdown in the pace of decrease in inventories, the contribution of inventory investment to real GDP -- the second-order derivative of the level of inventory stock -- will be slightly above or around 0 percent from the first half of fiscal 2010 onward.

domestically, pressures to adjust employment and wages are likely to remain. In fiscal 2011, the recovery in overseas economies will become more pronounced as adjustments of excesses make further progress, and growth rates, as is often the case in phases of recovery, will likely reach levels clearly above potential growth rates. In these circumstances, the recovery in Japan's corporate sector will gradually spread to the household sector and the pace of economic recovery will accelerate.

Expressing the outlook in terms of changes in real GDP, the July-September quarter, just like the April-June quarter, is likely to show a growth rate substantially above the potential growth rate, reflecting the strong effects from the completion of inventory adjustments and from policy measures. Going forward, the pace of growth will decelerate somewhat as these effects lose steam and there might be a phase around the beginning of fiscal 2010 in which real GDP weakens temporarily, since public investment and durable goods consumption are expected to wane. However, as a trend, positive economic growth is likely to be maintained amid a continued increase in exports during fiscal 2010, and in fiscal 2011 -- when the recovery of the global economy becomes more pronounced -- the growth rate of Japan's economy is likely to clearly exceed the potential growth rate. On a fiscal-year basis, the economy is expected to shrink by 3.0-3.5 percent in fiscal 2009, but then grow again by around 1 percent in fiscal 2010 and around 2 percent in fiscal 2011.[8] Compared with the April 2009 Outlook Report and the interim assessment in July, the outlook for growth remains more or less unchanged both in fiscal 2009 and 2010.

Considering developments in the investment-saving balance, while the public-sector fiscal deficit is expected to expand substantially in fiscal 2009 due to an increase in fiscal expenditure and a decrease in tax revenue, net saving in the private sector is likely to increase, especially in the corporate sector (Chart 26). The latter is attributable to a decline in business fixed investment and inventory investment that more than offsets the

[8] It should be noted that in contrast with the annualized quarter-on-quarter growth rates during the course of fiscal 2009, the year-on-year growth rate for fiscal 2009 as a whole will be substantially negative, since fiscal 2009 started from an extremely low level of real GDP reflecting the substantial decline at the end of fiscal 2008. In terms of annualized quarter-on-quarter rates, growth will be relatively high during the course of fiscal 2009, decelerate temporarily in fiscal 2010, and start to accelerate again in fiscal 2011.

drop in corporate profits. In fiscal 2010, net saving in the private sector is expected to remain more or less unchanged, whereas the public-sector fiscal deficit is expected to decrease somewhat. Mirroring these developments, the current account surplus in fiscal 2009 is expected to remain more or less unchanged compared with fiscal 2008, and increase at a moderate pace from fiscal 2010 onward.

Regarding the environment surrounding the outlook for prices, resource utilization of labor and production capacity is projected to recover gradually as the economy improves. However, since the decline in the level of resource utilization at the beginning of fiscal 2009, which is the starting point of the projection, was extraordinarily large, the level of utilization of labor and production capacity is likely to approach gradually the historical average toward the end of the projection period. Unit labor costs (labor costs per unit of output) are likely to be on a downtrend reflecting restraints on wages (Chart 27). Meanwhile, while commodity prices are subject to uncertainties in both directions, the outlook assumes that they will remain more or less unchanged. Looking at households' inflation expectations, which are estimated based on the Bank's *Opinion Survey on the General Public's Views and Behavior*, the "expected rate of inflation over a period of one year" had risen to around 1 percent in the summer of 2008, but has recently declined to below 0 percent due to a decline or leveling off in the prices of frequently purchased items such as petroleum products and food (Chart 28). After having risen in the past, the "expected rate of inflation over the next five years" has also been declining at a moderate pace, but has remained relatively stable at a slightly positive level and changes have been small. Together with developments in indicators such as long-term interest rates, medium- to long-term inflation expectations appear to be generally stable.

Based on the above assessment, it is likely that the year-on-year rate of decline in prices, including those at the retail level, will slow down significantly in the second half of fiscal 2009, reflecting the waning effects of the drop in commodity prices following the surge in 2008. Further ahead, with medium- to long-term inflation expectations stable, the pace of decline in consumer prices is likely to continue to moderate as the economy continues to recover and the aggregate supply and demand balance gradually improves. Nevertheless, the pace of decline in consumer prices is likely to slow down only modestly, given that the recovery in the level of utilization of labor and production capacity is likely to be gradual and wages are likely to remain sluggish.

The year-on-year rate of change in the CGPI is projected to be around minus 5.0-5.5 percent for fiscal 2009, around minus 1.0-1.5 percent for fiscal 2010, and around minus 0.5-1.0 percent for fiscal 2011. The year-on-year rate of change in the CPI (excluding fresh food) for fiscal 2009, as a whole, is projected to be around minus 1.5 percent, the largest drop ever recorded on a fiscal-year basis, mainly due to fluctuations in prices of petroleum products.[9] Further ahead, the pace of decline is likely to moderate gradually to around minus 0.5-1.0 percent for fiscal 2010 and around minus 0.5 percent for fiscal 2011. Compared with the interim assessment in July, this projection of the CGPI represents a slight upward revision for both fiscal 2009 and 2010, mainly reflecting the higher than expected commodity prices, such as crude oil prices. The projection of the CPI represents a slight downward revision for fiscal 2009 reflecting current weaker-than-expected developments, while the projection for fiscal 2010 represents a slight upward revision.

The Environment Surrounding Exports and Imports

Since autumn 2008, countries around the world, including Japan, have implemented measures to restore financial system stability and aggressive monetary and fiscal policies. Thanks to the effects of these policy measures, global financial markets have started to stabilize, and the global economy has picked up after the severe downturn. Going forward, overseas economies are expected to have registered positive growth in the first half of fiscal 2009 due mainly to progress in inventory adjustments and the effects of the various policy measures, and growth rates are expected to edge up from the second half of fiscal 2009 through fiscal 2011 (Chart 29). It is assumed that the strong domestic demand in emerging economies such as China will continue. The advanced economies are also expected to remain on a moderate recovery trend underpinned by policy support from the monetary and fiscal front, although they will continue to face strong pressures from the adjustment of balance sheets, especially in the first half of the projection period. It is assumed that thereafter the recovery in the private sector will gradually gain momentum.

[9] The largest year-on-year decline recorded so far on a fiscal-year basis was minus 0.8 percent in both fiscal 2001 and 2002.

Based on these assumptions about overseas economies, Japan's exports are expected to rebound and increase sharply in fiscal 2009, especially in the first half, when the policy measures of countries around the world and progress in overseas inventories will have considerable effects.[10] From fiscal 2010 onward, as the recovery in overseas economies continues, exports are expected to continue increasing, albeit at a moderate pace when compared with the rebound phase in fiscal 2009. However, since the recovery in exports is from an extremely low level, the level of exports around the end of fiscal 2011 is unlikely to exceed the peak recorded at around the end of fiscal 2007.

Industrial production is expected to be strongly influenced by the developments in exports and changes in domestic inventories. Specifically, industrial production is expected to have rebounded significantly in the April-June and July-September quarters of 2009, reflecting the effects of policy measures at home and abroad as well as progress in inventory adjustments, and the momentum of increase is likely to continue through the second half of fiscal 2009. Thereafter, while the pace of increase might temporarily slow owing mainly to fluctuations in durable goods consumption, industrial production will basically continue to increase in fiscal 2010 and 2011. Nevertheless, the level at around the end of fiscal 2011 is not likely to reach the peak level recorded at around the end of fiscal 2007.

The above-mentioned scenario for overseas economies, on which the outlook for Japan's exports and production is based, is accompanied by considerable uncertainty. Looking back on worldwide developments from around the mid-2000s, the global economy enjoyed a period of prolonged growth above rates seen in previous years due to continuing accommodative financial conditions. Since the adjustment of the excesses that had accumulated during this period may take considerable time, economic growth may be weaker than expected primarily in the U.S. and European economies, due mainly to a protracted period of vulnerability in the financial environment and a lagged recovery in employment.

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[10] Nevertheless, the year-on-year rate of change for exports in fiscal 2009 will likely be negative, since, like GDP as a whole, exports in fiscal 2009 started from an extremely low level.

On the other hand, emerging and commodity-exporting economies may grow more strongly than expected. Since many emerging economies in Asia, including China, and in Latin America face relatively little pressure for balance-sheet adjustments and have small fiscal deficits, they are considered to have a high degree of freedom in terms of macroeconomic policy and thus have an environment conducive for tapping strong potential demand. The strong domestic demand in emerging economies could be a driving force for leading the global economy to a sustainable recovery. Strong growth in emerging economies could lift growth in commodity-exporting economies through an increase in commodity prices. In addition, the recovery in global financial markets and large-scale monetary easing in advanced economies are likely to induce capital inflows to emerging and commodity-exporting economies and boost economic activity there. If these developments further intensify, economic developments in emerging and commodity-exporting economies could become an upside risk factor for Japan's economy. Meanwhile, emerging economies' foreign exchange and macroeconomic policies as well as excessive expectations and associated inflows of overseas capital might lead to an overheating of these economies and to a rise in commodity prices. Such developments might put downward pressure on domestic private demand in Japan through a worsening of the terms of trade due to high commodity prices. With regard to this, it could also be argued that since the global output gap, which can be estimated from unemployment rates and other indicators, is quite large, even if emerging economies overheat to some extent, this is not likely to result in an overheating of the global economy as a whole. However, it should be noted that there are considerable uncertainties regarding the global output gap and potential growth rate underlying this argument, particularly if availability of resources and energy is taken into account.

Moreover, the above outlook for Japan's exports is based on the assumption that the transfer of production abroad will not substantially exceed past trends (Chart 30). If the shift to overseas production accelerates, Japan's exports may grow at a sluggish pace even if there is a smooth recovery in the global economy. The issue of the location of firms' global production bases is associated with great uncertainty since many firms are still developing their strategies taking into account factors such as the shift in demand from advanced to emerging economies as well as developments in exchange rates.

Firms' Profits and Spending Behavior

Looking at aggregate income formation, while the rate of real GDP contraction reached more than 7 percent year on year in the April-June quarter of 2009, the year-on-year contraction in real gross domestic income (GDI) and real gross national income (GNI) decelerated to around 4.5 percent (Chart 31).[11] A breakdown shows that trading gains were nearly offset by the plunge in net exports and net income from the rest of the world, and the income drain from Japan that had been putting downward pressure on Japan's economy for the past year has almost come to a halt on a year-on-year basis.

Developments in the levels of the break-even point and sales in the *Financial Statements Statistics of Corporations by Industry, Quarterly* show that the break-even point for manufacturers remained high, since the plunge in sales between the autumn of 2008 and the beginning of 2009 was not offset by a cutback in fixed costs such as labor costs, and this resulted in losses, particularly for large firms in the January-March and April-June quarters of 2009 (Chart 32). Nonmanufacturing firms' sales also declined, although the degree of decline was less severe than that for manufacturers, and thus these firms needed to lower their break-even points to ensure profitability.

Looking ahead, it is highly likely that efforts by manufacturers to lower their break-even points, such as through cutbacks in labor costs and depreciation expenses, will continue for some time. In order to reduce such depreciation expenses, manufacturers are likely to promote the scrapping of existing facilities, in addition to restraining new investments.[12] Because of the reduction in fixed costs and the recovery in exports, current profits of

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[11] Real GDI = real GDP + trading gains/losses

Real GNI = real GDI + net income from the rest of the world (for example, interest income and dividend income)

Trading gains/losses = nominal net exports/weighted average of export and import deflators - real net exports

[12] After the financial crisis in 1998, firms reduced production capacity through scrapping for several years. In the current phase, firms have already started to cut back their production capacity (Chart 33 [1]). Such cutbacks in production capacity are one cause of the downward shift in the potential growth rate.

manufacturing firms are expected to record relatively clear increases in fiscal 2010. On the other hand, since the pursuit of cost cutbacks in the manufacturing sector will affect nonmanufacturing firms and it is expected that it will take time for domestic demand to recover, the profits of nonmanufacturing firms are likely to recover only moderately in fiscal 2010, even if they continue to restrain fixed costs. Therefore, a clear recovery in profits of nonmanufacturing firms is likely to be delayed until fiscal 2011.

The decline in business fixed investment, which mainly reflects weak corporate profits, has been moderating (Chart 34). Machinery investment, which has already declined to an extremely low level, is expected to pick up as capacity utilization in the manufacturing sector increases.[13] However, construction investment is likely to remain sluggish for some time, given developments in leading indicators such as construction starts (as measured in terms of floor area). Consequently, after bottoming out, business investment as a whole is likely to remain more or less unchanged at a low level or increase only slightly in the near term, and in fiscal 2010 increases will gradually become more pronounced.[14] The capital stock cycle also suggests that, as long as firms do not expect economic growth to clearly fall into negative territory, business fixed investment in fiscal 2010 will start to increase (Chart 35).[15]

Data on firms' balance sheets in the *Financial Statements Statistics of Corporations by*

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[13] Empirically, there is a high correlation between the level of machinery investment and resource utilization (Chart 33 [2]). Therefore, even if resource utilization remains at a low level, once it picks up, this will gradually pave the way for machinery investment to increase.

[14] Since business fixed investment in the April-June quarter of 2009 was at an extremely low level, even if it stops declining and remains more or less unchanged from the July-September quarter onward, the year-on-year rate of change in business fixed investment for fiscal 2009 will likely record a significant decline of about 15 percent. Business fixed investment consists of machinery investment (about 60 percent), construction investment (about 30 percent), and software investment (about 10 percent).

[15] Using a variety of assumptions, the hyperbolic curve of the capital stock cycle is estimated based on the following relationship: ratio of business fixed investment to capital stock = trend growth rate of capital coefficient + depreciation rate + expected growth rate. Since the current economic downturn is unprecedentedly deep, the estimates of the curve are subject to a certain margin of error. For example, depending on the assumptions about the trend of the capital coefficient or the depreciation rate, the year-on-year rate of change in business fixed investment in fiscal 2010 could be negative even if the expected growth rate is positive.

Industry, Quarterly show that the amount outstanding of interest-bearing debt has been on an increasing trend since hitting its most recent bottom around early 2006 (Chart 36).[16] Meanwhile, the ratio of interest-bearing debt to cash flow has recently risen substantially, mainly due to a significant drop in cash flows. The ratio of interest-bearing debt to equity has started to rise slightly, but from a long-term perspective the ratio is still at a low level, and the capital base of firms taken as a whole has remained relatively solid. Therefore, at least for large firms, it is unlikely that business fixed investment will be constrained greatly from the financial front.

Nevertheless, the outlook for business investment is also associated with great uncertainty. In particular, if downside risks stemming from overseas economies manifest themselves, firms' medium- to long-term expectations for economic growth will decline further, leading to a continued decrease in business fixed investment in fiscal 2010. Moreover, even if overseas economies continue to recover, there are downside risks, such as (1) the possibility of firms further transferring production capacity abroad to maintain competitiveness and (2) the possibility of a delay in recovery among small firms due mainly to weak private consumption and the severe financial environment. There are also upside risks, including (1) the possibility that the pace of recovery in exports will be faster than expected and (2) the possibility that firms will put greater efforts into tapping new demand, for example, in eco-related business areas.

The Employment and Income Situation and Households' Spending Behavior

The employment and income situation has been severe, with substantial slack in the labor market and a significant decrease in employee income. Given the extremely sharp economic downturn and prospects for a moderate recovery, pressures to adjust employment and wages are likely to remain for some time.

With regard to employment, the year-on-year rate of decline in labor input -- calculated as the number of employees multiplied by the number of hours worked per employee -- has

[16] The *Financial Statements Statistics of Corporations by Industry, Quarterly* only cover data of establishments located in Japan. Therefore, there may be some differences from the consolidated data of large Japanese firms that have many overseas subsidiaries and affiliates.

been smaller than that of real GDP (Chart 37 [1]). This suggests that labor productivity has temporarily declined significantly due to the rapid decline in demand and associated rapid cutbacks in production. Thus, even if demand follows a recovery trend in the future, there is much room to increase supply through a recovery in labor productivity while restraining labor input. In addition, since the decline in labor input thus far mainly reflects a decline in working hours, any increase in labor input in the first instance is likely to take the form of increases in working hours. It is thus likely to take considerable time for the number of employees to start increasing.

Meanwhile, labor productivity per employee has recently fallen substantially below the past trend (Chart 37 [2]). It is thus likely that the pressure to adjust employment will remain until the economy continues to grow and the level of labor productivity shows a relatively clear recovery.[17]

As a recovery in employment is expected to take time, the unemployment rate is likely to remain at a high level for some time. In addition, the recent increase in the unemployment rate appears to be influenced not only by the decline in the level of economic activity but also by an increase in the so-called structural unemployment rate, which stems from the mismatch between industries where labor is sought and industries where applicants seek jobs (Chart 37 [3]).[18]

Wages have been clearly declining on the back of weak corporate profits and cuts in working hours. Winter bonus payments in fiscal 2009, just like the bonus payments this summer, are expected to show an unprecedented decline. The labor share (compensation

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[17] Of course, estimates of the trend in labor productivity are subject to a certain margin of error. For example, if the strong growth trend of labor productivity in the 2000s is to be maintained by the relocation abroad of labor-intensive processes and firms' cautious attitude regarding employment, a recovery in employment will be delayed further unless real GDP growth is stronger than expected.

[18] The structural unemployment rate is estimated based on a "UV analysis," in which the mismatch between the supply of and demand for labor is estimated by comparing the unemployment (U) situation from employees' perspective and the vacancy (V) situation from firms' perspective. This method is frequently used for analyzing the labor market. For details, see "The State of the Japanese Economy: From the Perspective of Employment and Income," Research and Statistics Department, Bank of Japan, April 2005.

of employees/nominal GDP) rose to 53.7 percent in the second half of fiscal 2008, a level close to the previous peak of 54.3 percent in fiscal 2001 (Chart 38). Going forward, pressures pushing down the labor share are likely to continue[19] as firms seek to restore profitability, and thus pressures to adjust wages as well as employment are also expected to remain. Therefore, compensation of employees is expected to decline substantially in fiscal 2009 and continue to do so, albeit at a more moderate pace, in fiscal 2010. In fiscal 2011, the environment for a recovery in employee compensation is then expected to be in place.

Meanwhile, household income in real terms has not declined as much as compensation of employees in nominal terms, reflecting income transfer to households owing to various policy measures and the decline in prices (Chart 39).

Taking these factors into account, private consumption has generally been weak, while durable goods consumption has picked up due to the effects of various policy measures. Going forward, assuming that the subsidies for automobile purchases will end at the conclusion of the fiscal year in March 2010 and that sales of automobiles will consequently drop, private consumption in fiscal 2010 is likely to continue to be weak. In fiscal 2011, the recovery in private consumption is expected to gradually gain momentum as the recovery in the corporate sector spreads to the household sector.

This outlook for private consumption is subject to both upside and downside risks. Although the propensity to consume (i.e., the ratio of private consumption to disposable income) in Japan is following an upward trend due to the aging of the population (Chart 39 [2]), there is an increasing possibility that the propensity to consume could deviate downward from the long-term trend if medium- to long-term expected income (permanent income) declines amid a continuation of the severe employment and income situation. On the other hand, if firms put further efforts into tapping potential household demand or if stock prices recover due to expectations of an economic recovery, this might stimulate consumption and result in the propensity to consume to deviate upward from the long-term

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[19] The labor share in GDP declined from 54.1 percent in the January-March quarter of 2009 to 53.2 percent in the April-June quarter of 2009.

trend.[20] In addition, whether concerns over the future -- such as those associated with population aging and the low birth rate or the increase in the fiscal deficit -- further increase or instead decrease could also be a critical factor influencing the propensity to consume.

Housing investment has declined substantially since the autumn of 2008 due mainly to the worsening employment and income situation and the further deterioration in the financial environment surrounding the real estate sector. Going forward, housing investment is likely to more or less bottom out in fiscal 2009 and start to increase moderately in fiscal 2010. This is because, while housing investment was already at an extremely low level, (1) realtors' business sentiment bottomed out in the beginning of 2009 and has been improving (Chart 41 [2]), and (2) there is a growing view that it is an opportune time to purchase condominiums owing to various merits in terms of taxation, prices, and interest rates (Chart 41 [3]). Nevertheless, given that, as previously mentioned, the severe employment and income situation will likely continue, uncertainty about the timing and pace of recovery is extremely high.

The Environment Surrounding Prices

Recent developments in prices at the retail level show that the decline in input prices has been promptly reflected in sales prices as a result of severe competition amid consumers' increased preference for inexpensive goods (Chart 42). The year-on-year rate of change in the prices of goods in the CPI basket (excluding fresh food) has become negative, and the decline in the average purchase prices of these goods calculated based on the *Family Income and Expenditure Survey* has become more pronounced (Chart 43). This decline in average purchase prices appears to reflect the strengthening of consumers' preference for inexpensive goods, including a shift in purchasing to lower-priced alternative products. This change in consumer behavior will intensify competition at the retail level and lead

[20] Japanese households' financial assets have been increasing (Chart 40). In addition, as a result of population aging, about 30 percent of households no longer comprise anyone in employment. Therefore, private consumption is not determined solely by the compensation of employees, and factors such as the introduction of new products and services as well as changes in stock prices will be important.

retailers to discount prices, pushing down the price index.[21]

The year-on-year rate of decline in the CPI was 2.3 percent in the July-September quarter and is likely to clearly moderate from now on reflecting the waning effects of developments in the prices of petroleum products, which are down from their high levels of a year ago. Once these effects abate, medium- to long-term inflation expectations and developments in the aggregate supply and demand balance will be the main factors affecting consumer prices. Given the economic outlook, the aggregate supply and demand balance is expected to improve gradually amid stable medium- to long-term inflation expectations, and the pace of decline in the CPI is likely to slow modestly through the projection period.[22]

There are uncertainties associated with this outlook for prices, and developments in economic activity could cause prices to deviate either upward or downward from the projection. Specific upside or downside risks to prices include the following three factors. The first concerns uncertainty regarding firms' and households' medium- to long-term inflation expectations. In this outlook, it is assumed that medium- to long-term inflation expectations remain stable, and that there will be a tendency for the actual inflation rate to move closer to medium- to long-term inflation expectations. However, it cannot be denied that there is a risk medium- to long-term inflation expectations will shift downward if the economic slack persists for a protracted period. There is also a possibility that the tendency for the actual inflation rate to move closer to medium- to long-term inflation expectations might be stronger than expected, and that therefore the actual inflation rate

[21] Average purchase prices in the *Family Income and Expenditure Survey*, which are calculated by dividing the expenditure amount by the quantity purchased, decline as consumers purchase more lower-priced goods, such as private brand products or bargain goods. In contrast, the CPI shows the price changes of goods and services for which price surveys can be carried out continuously, and thus bargain goods are reflected only in a limited manner.

[22] Given that four years have passed since the current base year for the CPI, 2005, the negative contribution to the CPI of durable consumer goods prices, which have declined significantly in recent years, has weakened. As a result, there is an increasing tendency for the year-on-year decline in the CPI as a whole to be underestimated. This suggests that, when the base year is changed to 2010, the year-on-year rate of change in the CPI after January 2011 could be lower than projected in the current outlook. The base-year change from 2005 to 2010 is expected to take place in the summer of 2011, and the year-on-year rate of change prior to December 2010 will not be revised retroactively.

might deviate upward from the above projection, especially in the latter half of the projection period.

The second risk factor concerns the high uncertainty with respect to gauging the degree of slack in the economy or the state of utilization of labor and production capacity. When the economy is deteriorating substantially with structural changes in demand, it is possible that the supply capacity of the economy and the potential growth rate are also declining owing to obsolescence or a cutback in capital stock. In this case, if the degree of economic slack is gauged based on the output gap derived from past data, there is a risk of overestimating the downward pressure on prices.

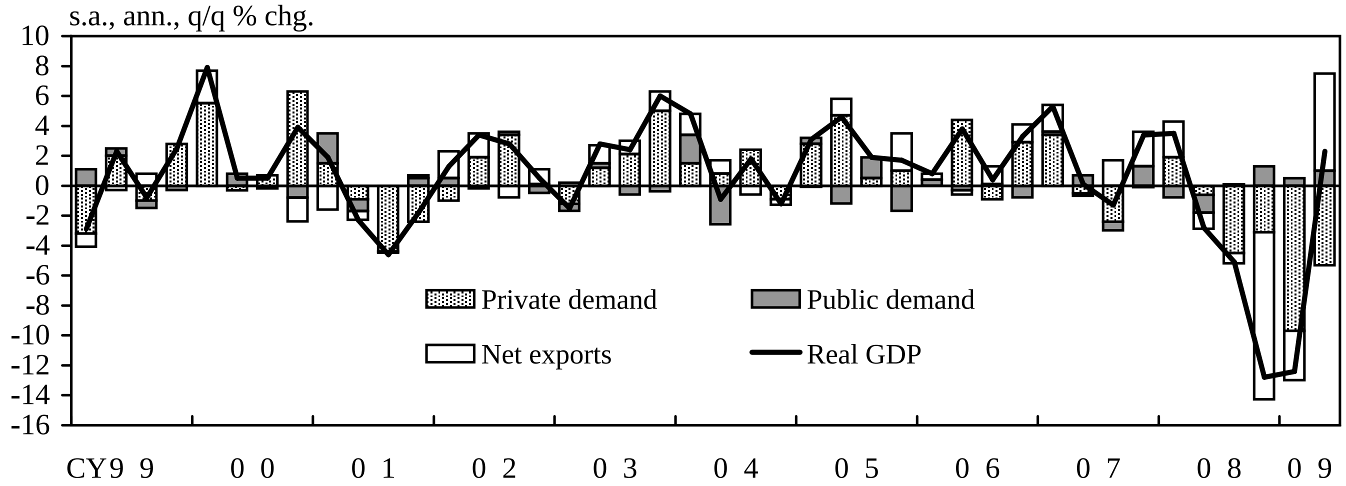
Finally, the third risk factor concerns developments in import prices. Commodity prices plunged toward the end of 2008 and rebounded toward mid-2009. As for the outlook, commodity prices are expected to generally remain at around the current level, given that the pace of global economic recovery will be moderate. However, based on recent experience, there is a possibility that commodity prices might rise or fall excessively owing to such factors as swings in the market's view concerning the outlook for the global economy. Fluctuations in foreign exchange rates can also affect consumer prices to a certain extent, not only by influencing the swings in economic activity but also through changes in import prices.[23]

[23] Other factors not mentioned here that may affect the price level include policy measures such as the abolition of provisional taxes on gasoline, the elimination of highway tolls, and free public high school tuition. If these measures are implemented, they will drive down consumer prices in fiscal 2010. However, such changes in the price level due to changes in the tax system should be interpreted as different in character from underlying price changes.

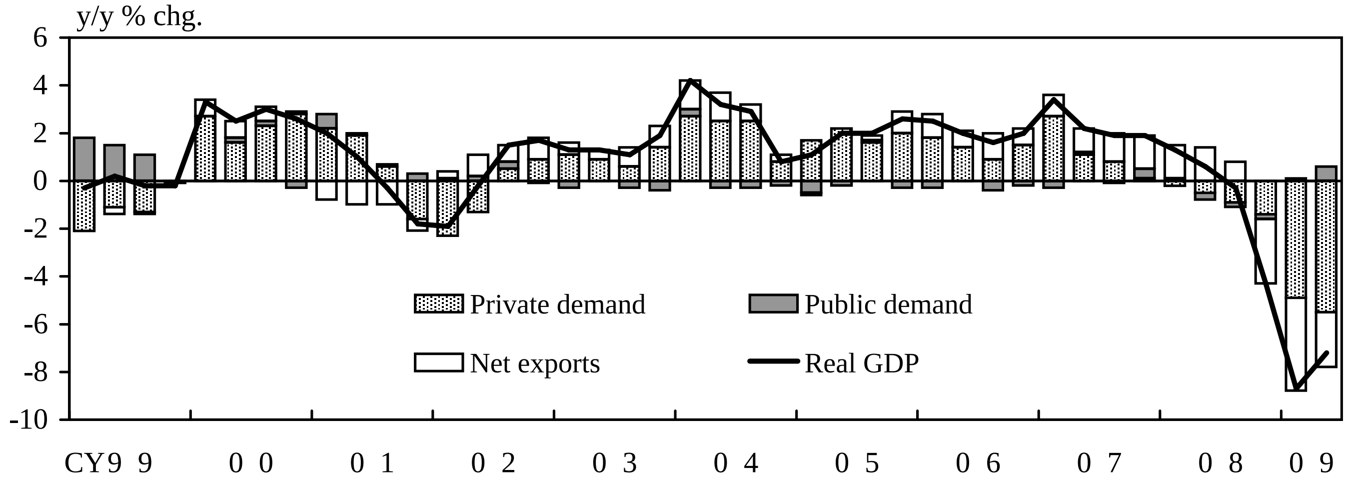
Charts

Real GDP and Indexes of Business Conditions

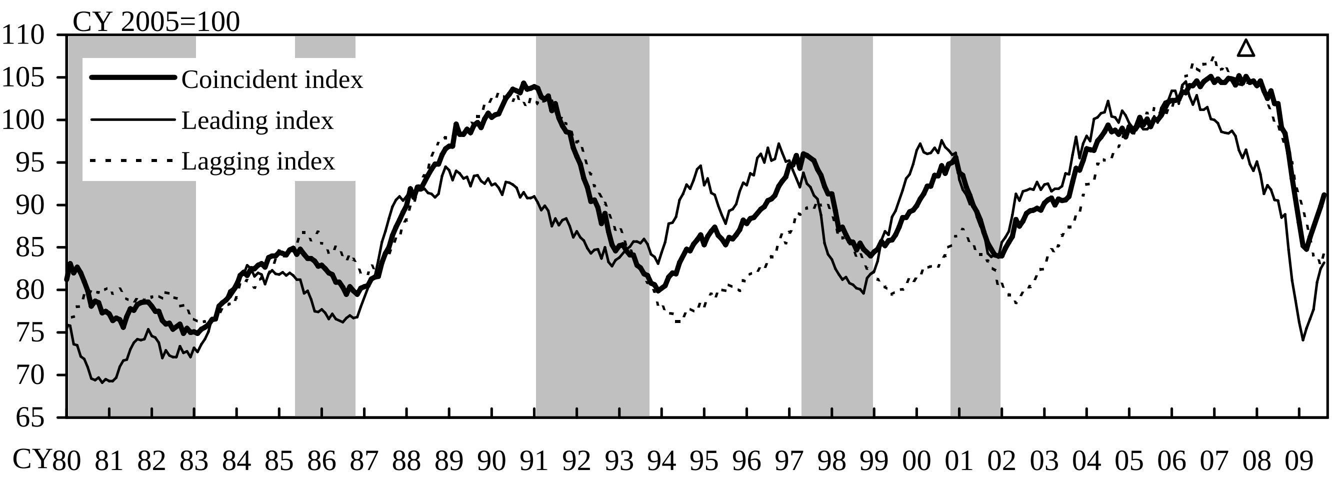
(1) Real GDP (Quarter-on-Quarter Changes)



(2) Real GDP (Year-on-Year Changes)



(3) Indexes of Business Conditions (Composite Indexes)

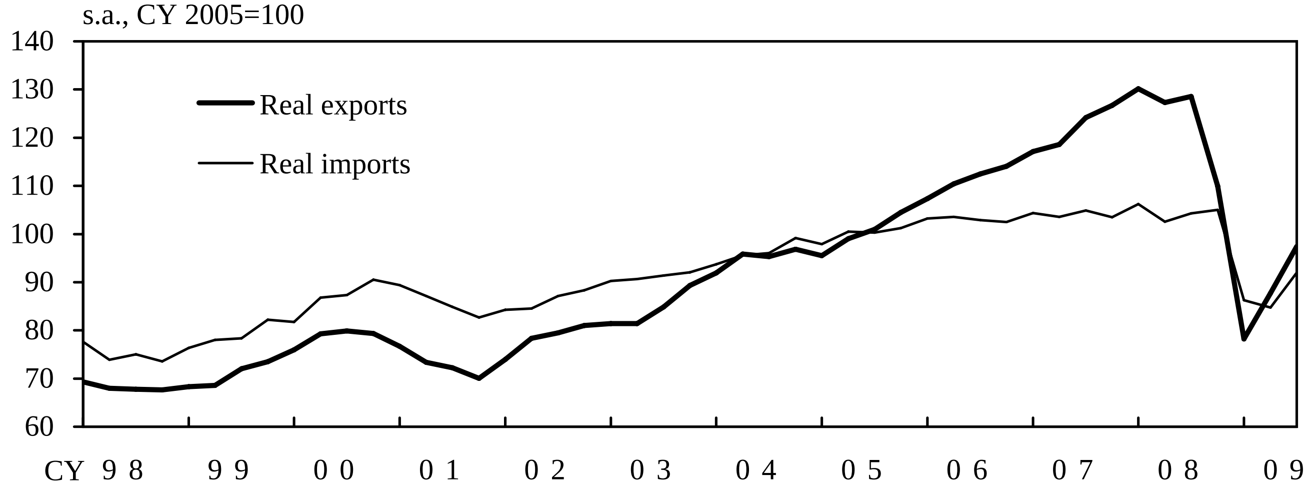


Note: Shaded areas indicate recession periods. Triangle shows the last peak.

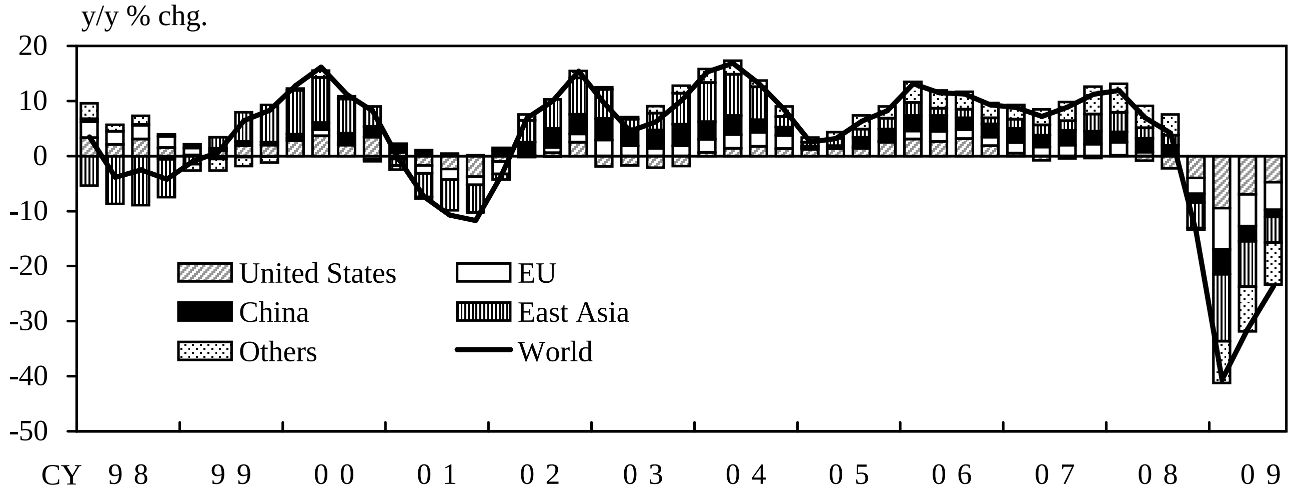
Source: Cabinet Office, "National Accounts," "Indexes of Business Conditions."

Exports and Imports

(1) Real Exports and Real Imports

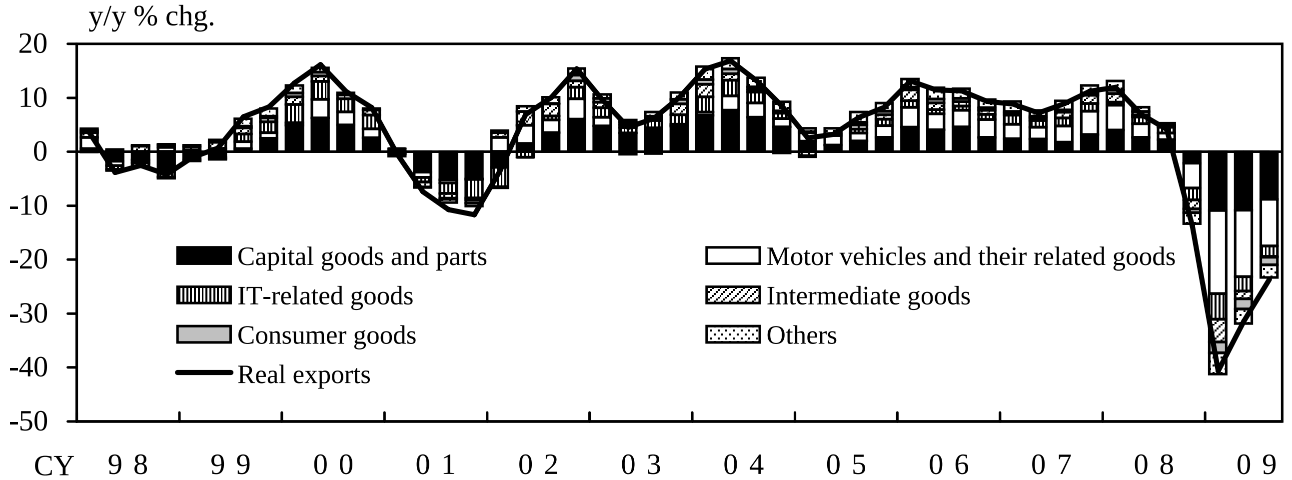


(2) Real Exports (Breakdown by Region)



Note: Data for East Asia: NIEs and ASEAN4.

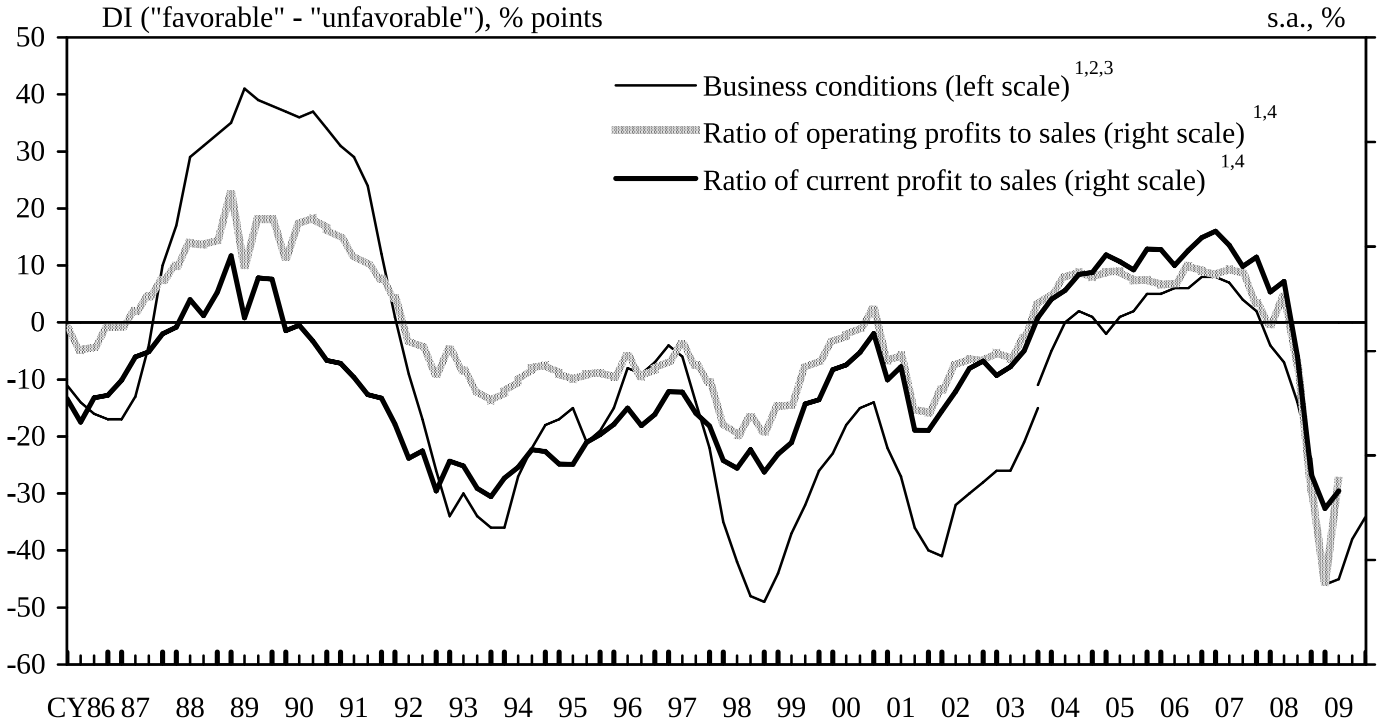
(3) Real Exports (Breakdown by Goods)



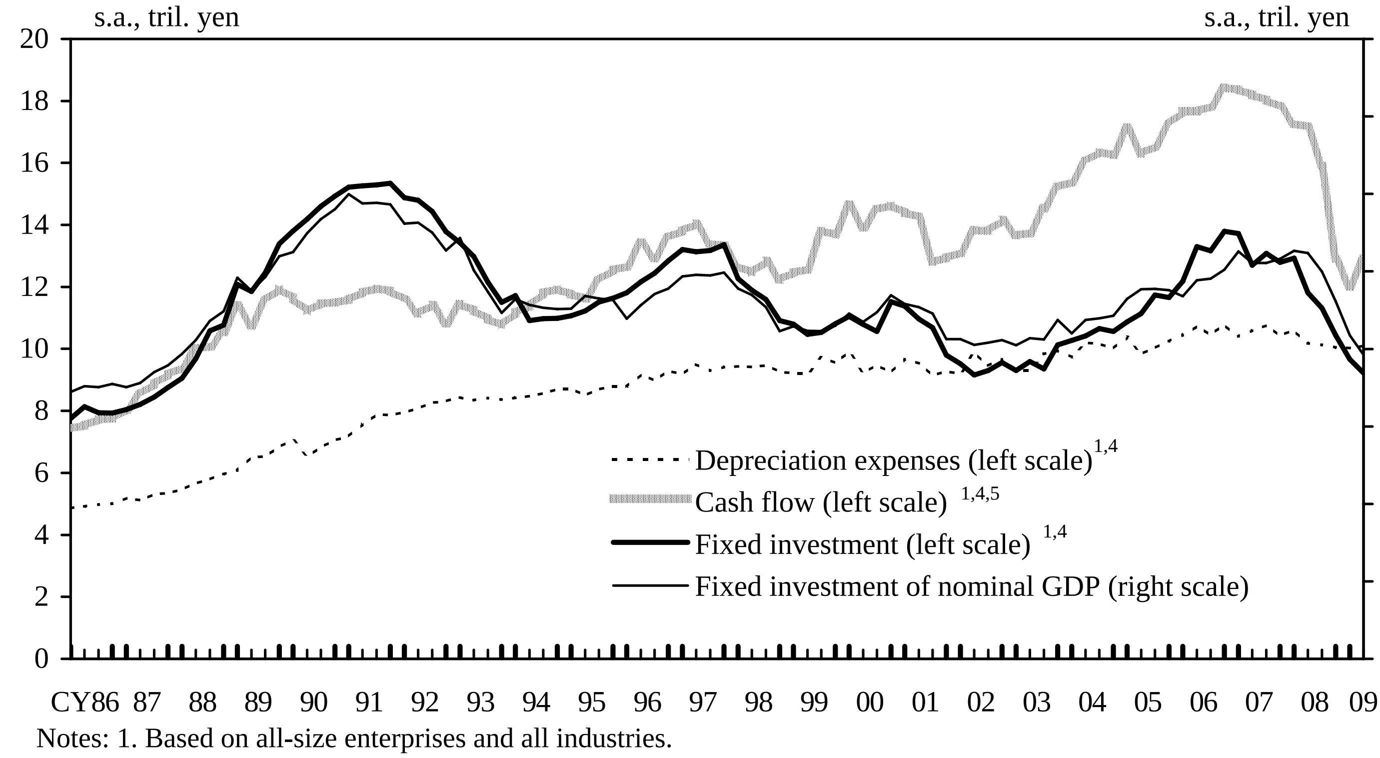
Sources: Ministry of Finance, "Trade Statistics"; Bank of Japan, "Corporate Goods Price Index."

Current Profits and Fixed Investment

(1) Current Profits



(2) Fixed Investment



Notes: 1. Based on all-size enterprises and all industries.

2. Taken from the "*Tankan*, Short-Term Economic Survey of Enterprises in Japan." The figure for 2009/Q4 is the forecast in the September 2009 survey.

3. 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.

4. Taken from the "Financial Statements Statistics of Corporations by Industry, Quarterly." Figures exclude finance and insurance.

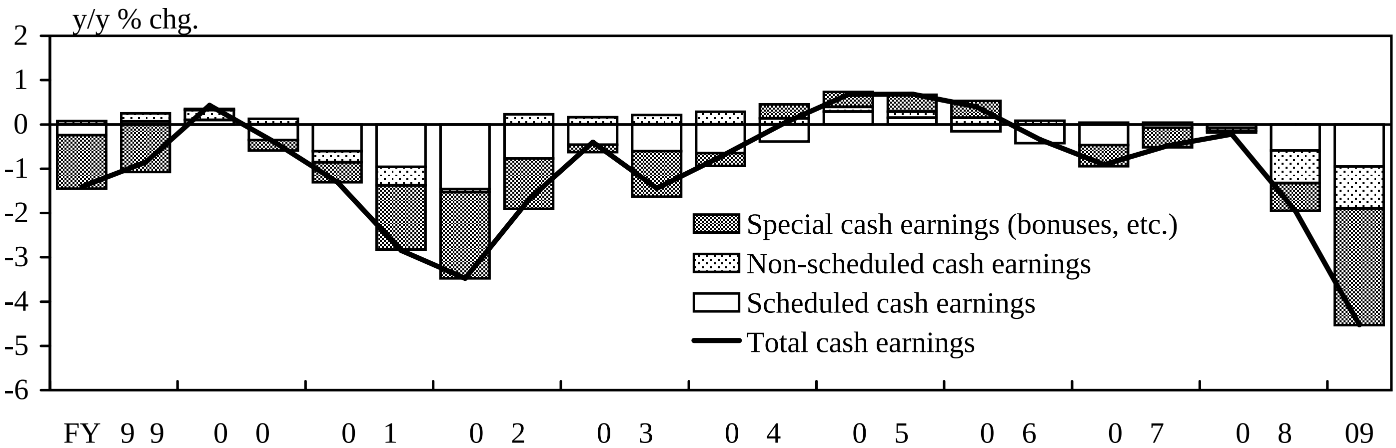
5. Cash flow = depreciation expenses + current profits/2

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

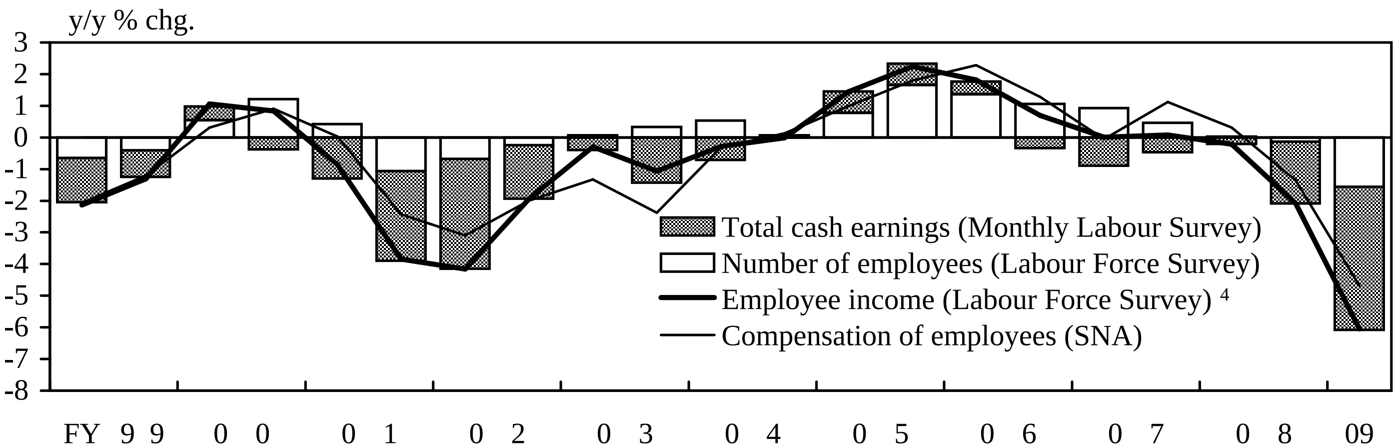
Employee Income

(1) Number of Employees[1,2]

(2) Total Cash Earnings (Monthly Labour Survey)[1,3]



(3) Employee Income[1,3]

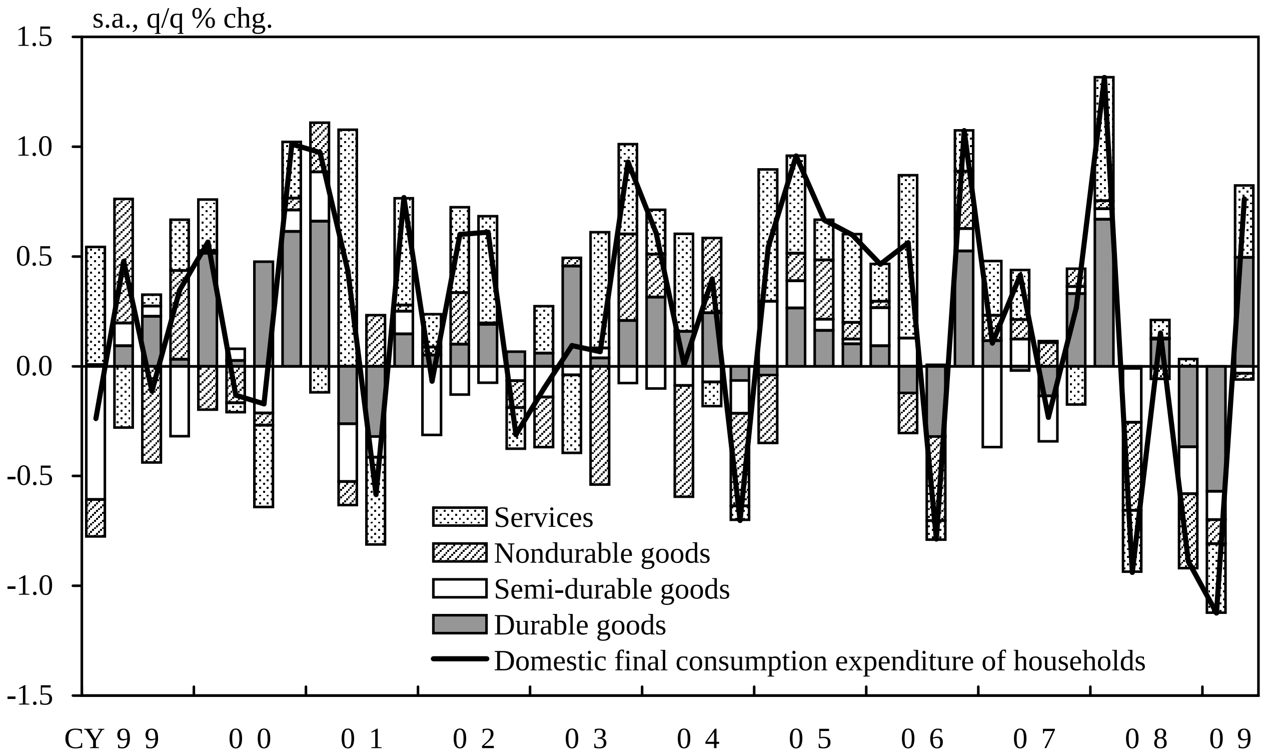


Notes: 1. Data from "Monthly Labour Survey" are for establishments with at least five employees.
2. Figures for 2009/Q3 are the July-August averages.
3. Figures for the first half of fiscal 2009 are the April-August averages, except for the figure for compensation of employees, which is the annualized value of 2009/Q2.
4. Calculated as the number of employees (Labour Force Survey) multiplied by total cash earnings (Monthly Labour Survey).

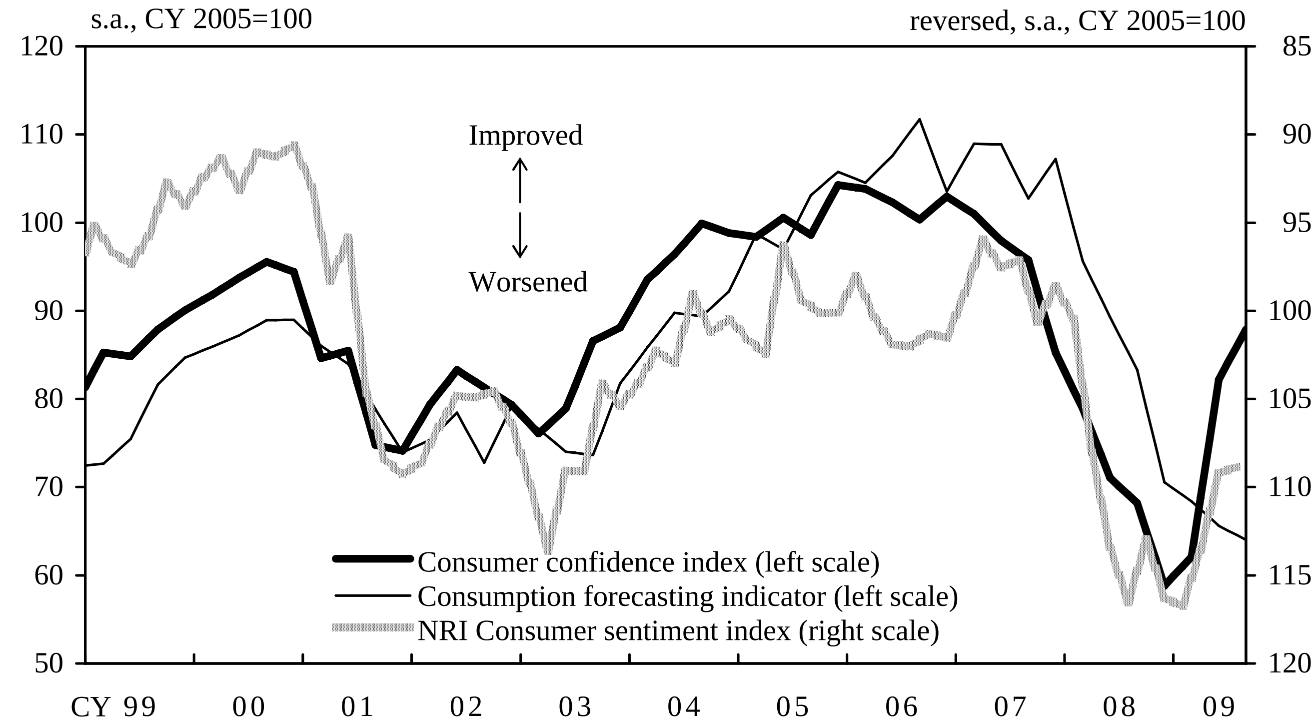
Sources: Ministry of Health, Labour and Welfare, "Monthly Labour Survey"; Cabinet Office, "National Accounts"; Ministry of Internal Affairs and Communications, "Labour Force Survey."

Private Consumption

(1) Breakdown of Real Domestic Final Consumption Expenditure of Households



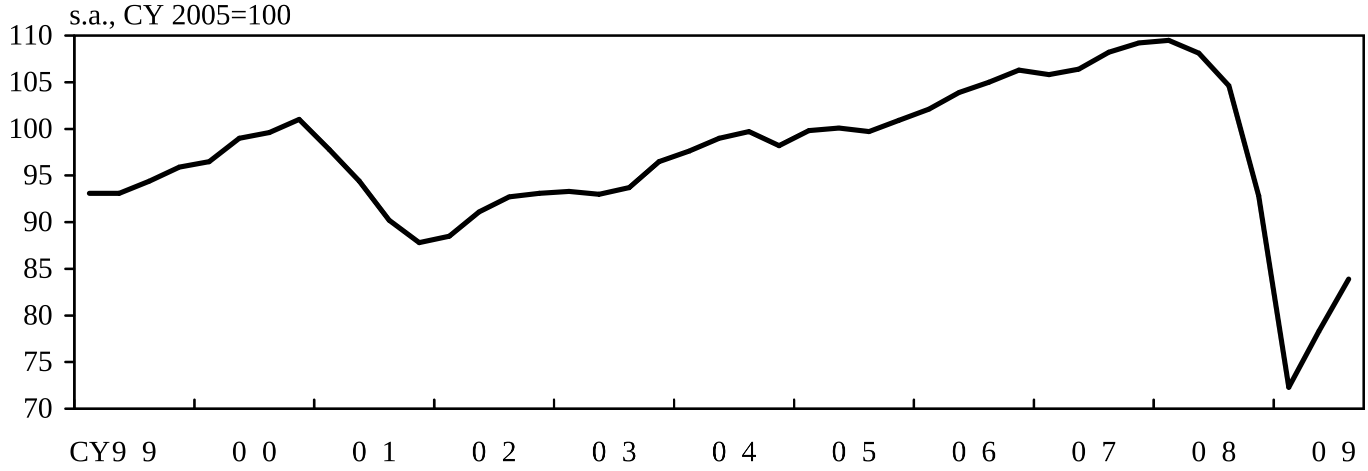
(2) Consumer Confidence



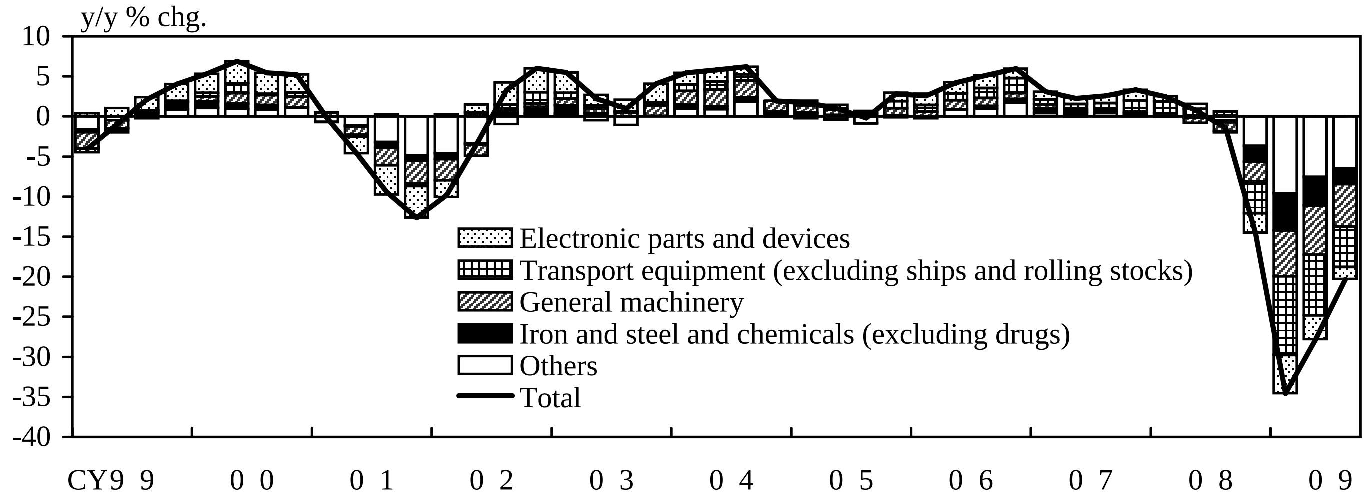
Sources: Cabinet Office, "National Accounts," "Consumer Confidence Survey";
Nikkei Inc., "Consumption Forecasting Indicator";
Nippon Research Institute (NRI), "Consumer Sentiment Survey."

Production

(1) Industrial Production

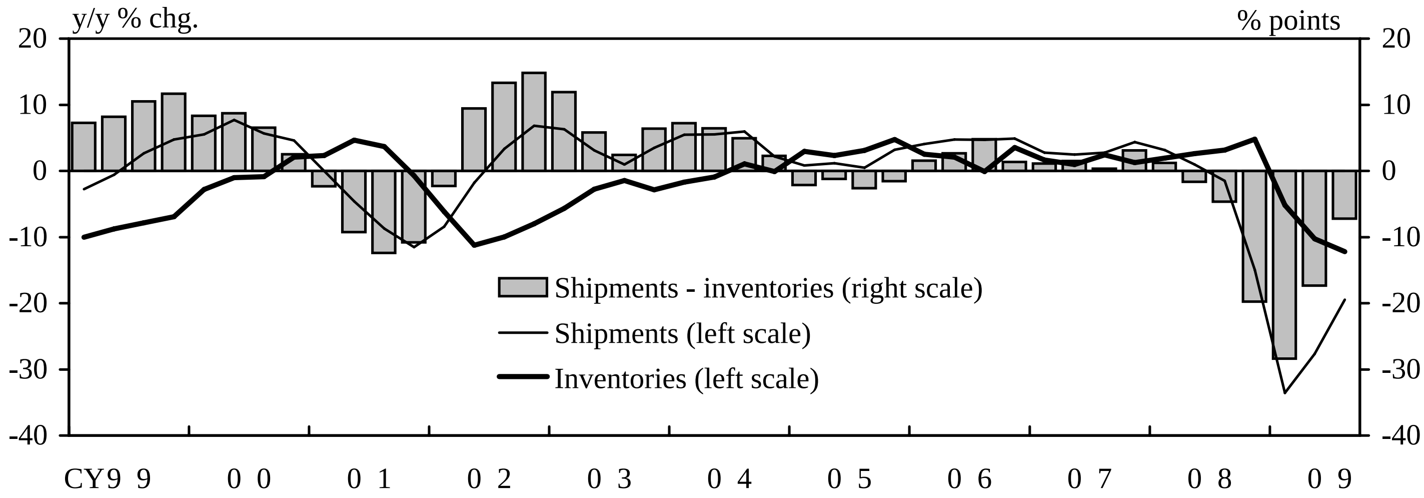


(2) Production (Breakdown by Industry)



Note: Figures up to CY 2003 are on the 2000 base.

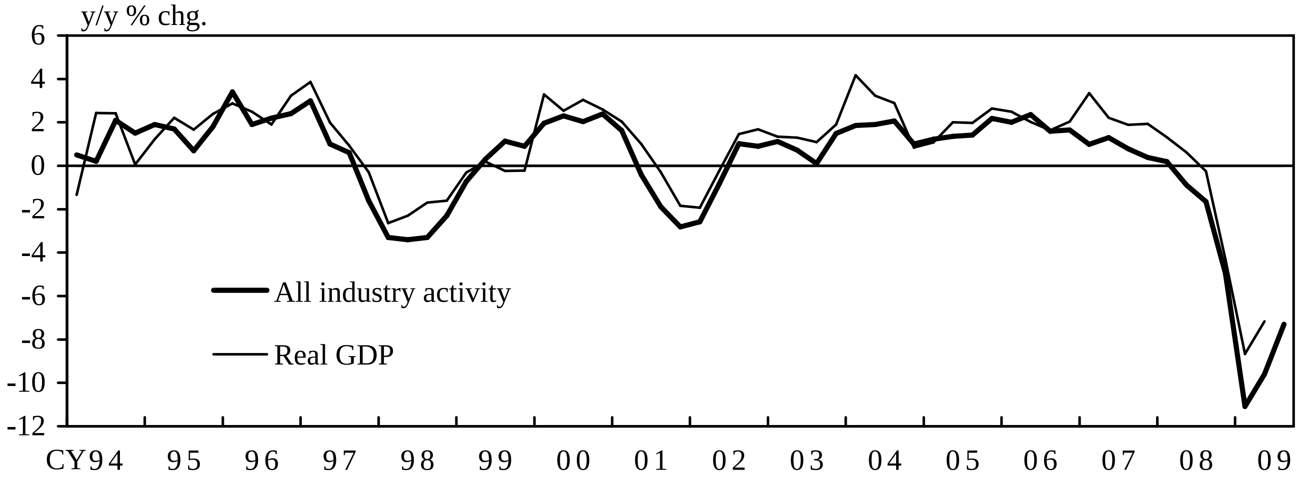
(3) Shipment-Inventory Balance (Mining and Manufacturing)



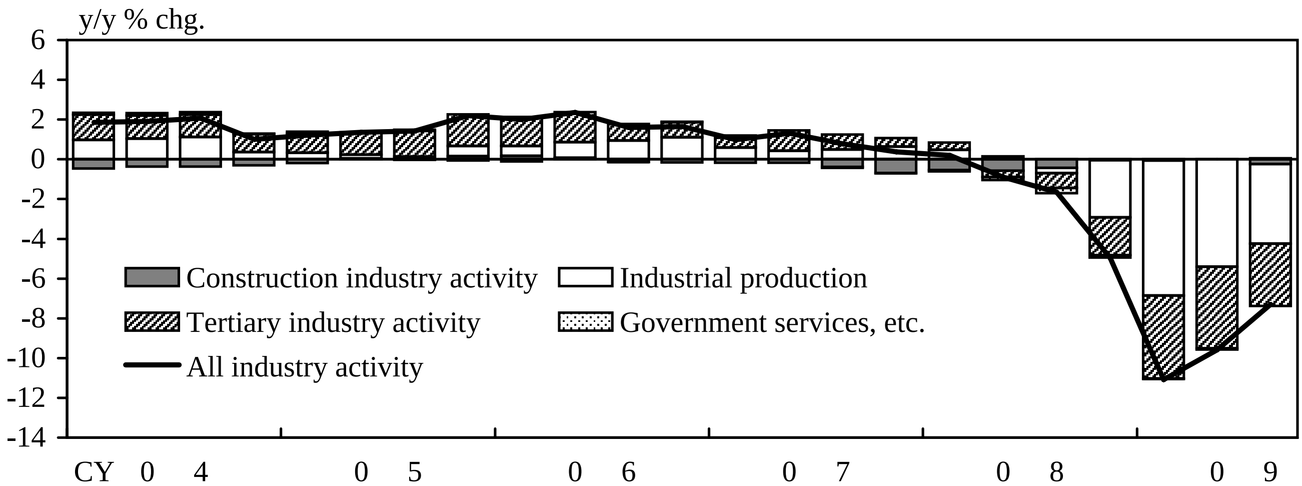
Source: Ministry of Economy, Trade and Industry, "Indices of Industrial Production."

All Industry Activity

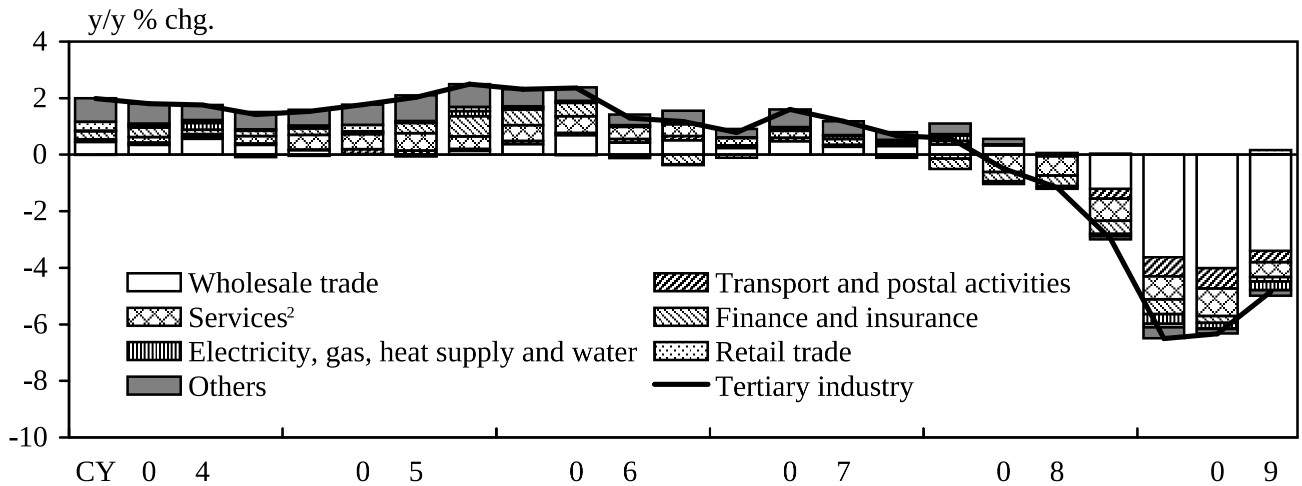
(1) All Industry Activity and Real GDP[1]



(2) All Industry Activity[1]



(3) Tertiary Industry Activity[1]

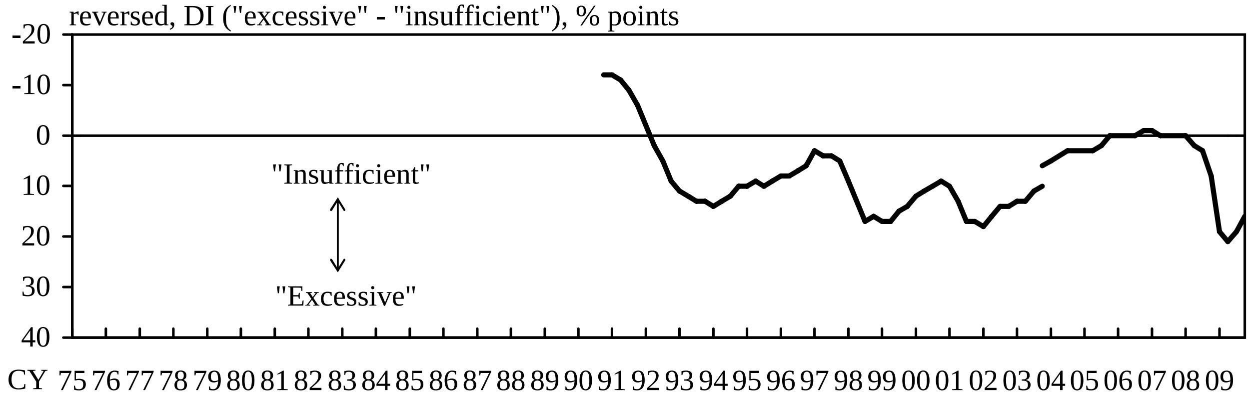


Notes: 1. Figures for 2009/Q3 are the July-August averages.
2. Consisting of scientific research, professional and technical services; living-related and personal services and amusement services; and miscellaneous services (except government services, etc.).

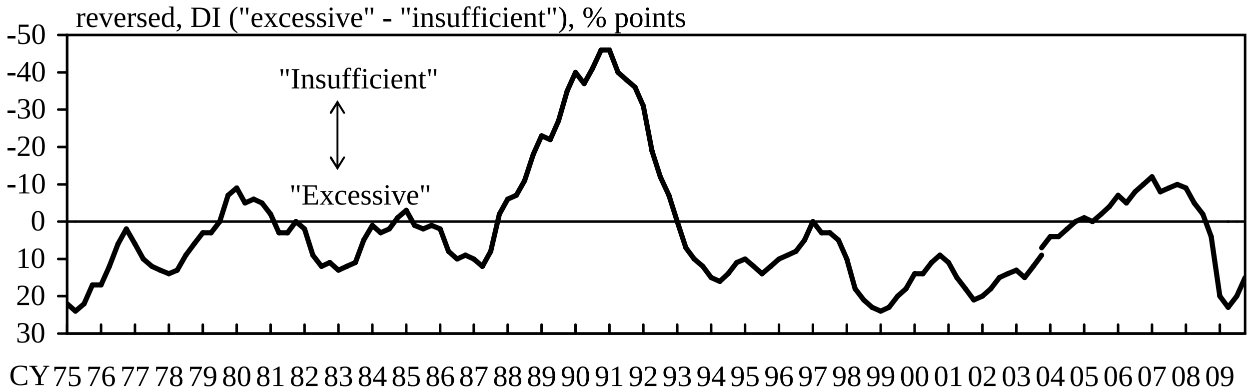
Sources: Ministry of Economy, Trade and Industry, "Indices of All Industry Activity," "Indices of Tertiary Industry Activity"; Cabinet Office, "National Accounts."

Resource Utilization

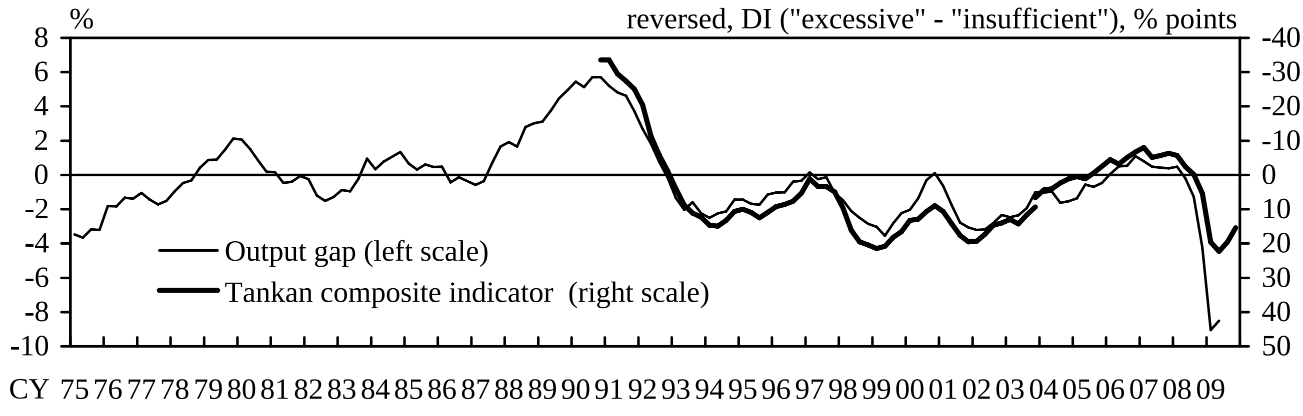
(1) Production Capacity DI



(2) Employment Conditions DI



(3) Tankan Composite Indicator and Output Gap



Notes: 1. Figures of the DI are based on all-size enterprises and all industries. Figures of the DI for 2009/Q4 are the forecasts in the September 2009 survey.

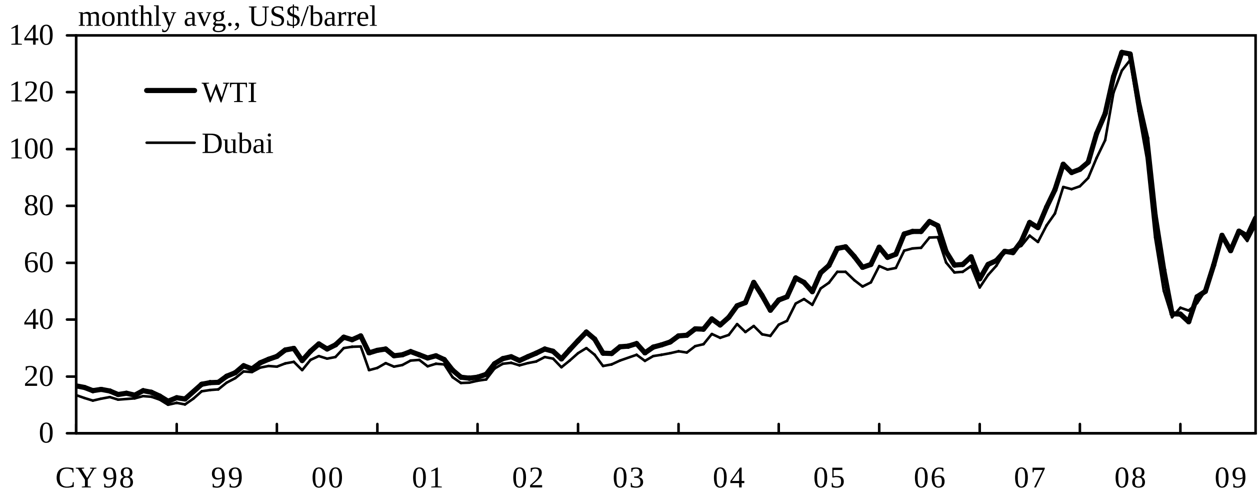
2. By use of the *Tankan* , the Tankan composite indicator is calculated as the average of the DI of production capacity and employment conditions, weighted by capital and labor shares in the national accounts (fiscal 1990-2007 average). The output gap is estimated by the Research and Statistics Department, Bank of Japan. For the estimation procedures, see "The New Estimates of Output Gap and Potential Growth Rate" (Bank of Japan Review Series, May 2006).

3. 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.

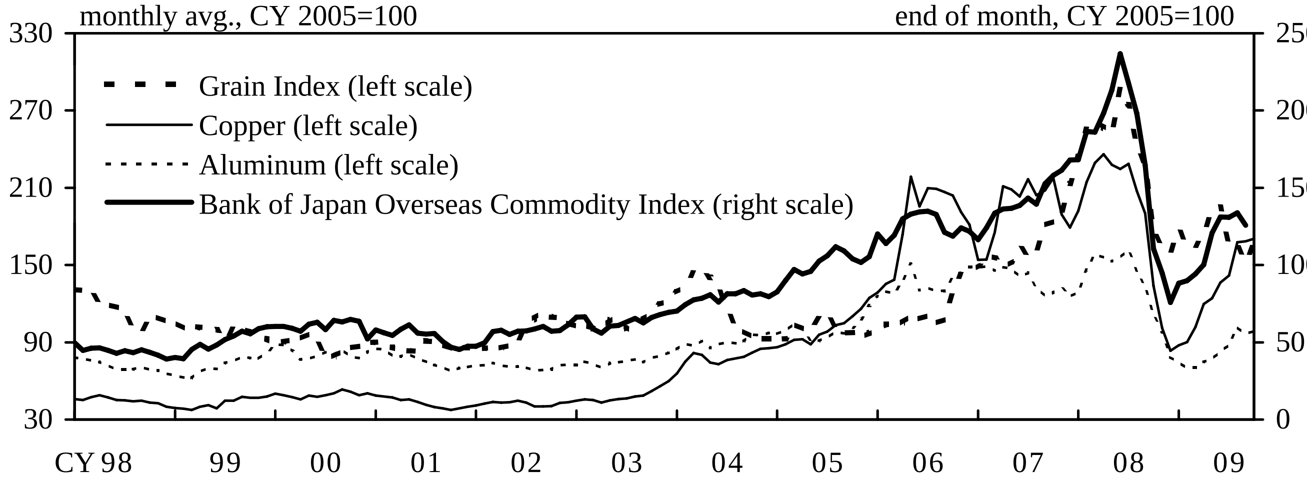
Sources: Cabinet Office, "National Accounts"; Cabinet Office and Ministry of Finance, "Business Outlook Survey"; Ministry of Internal Affairs and Communications, "Labour Force Survey"; Ministry of Health, Labour and Welfare, "Monthly Labour Survey," "Report on Employment Service"; Ministry of Economy,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

Commodity Prices

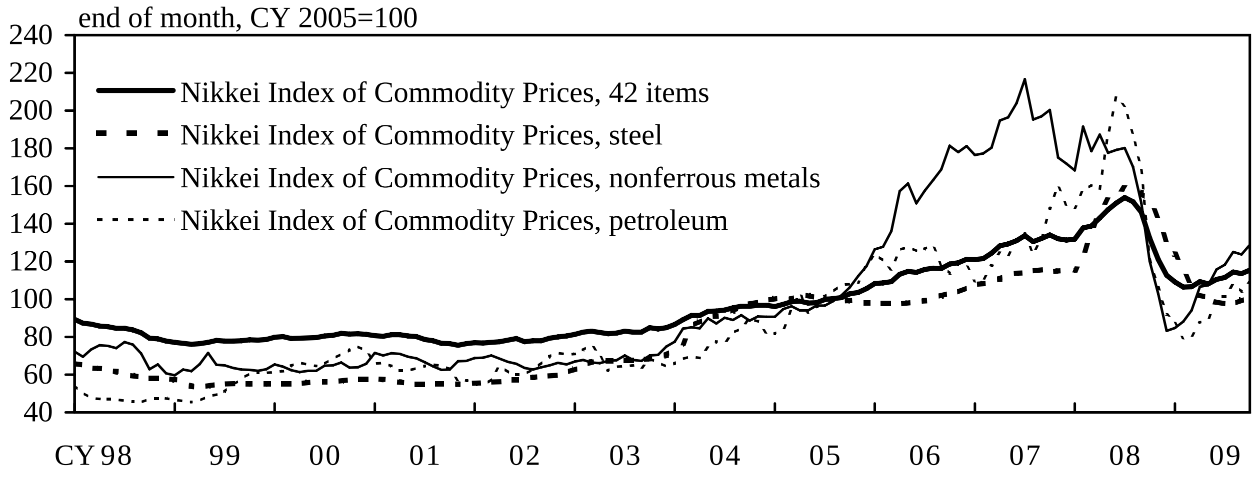
(1) Oil Prices



(2) International Commodity Prices[1]



(3) Domestic Commodity Prices[2]



Notes: 1. The Grain Index is the weighted average of prices of three selected items (wheat, soybeans, and corn) in overseas commodity markets. The weights are based on the value of imports in the Trade Statistics of Japan.

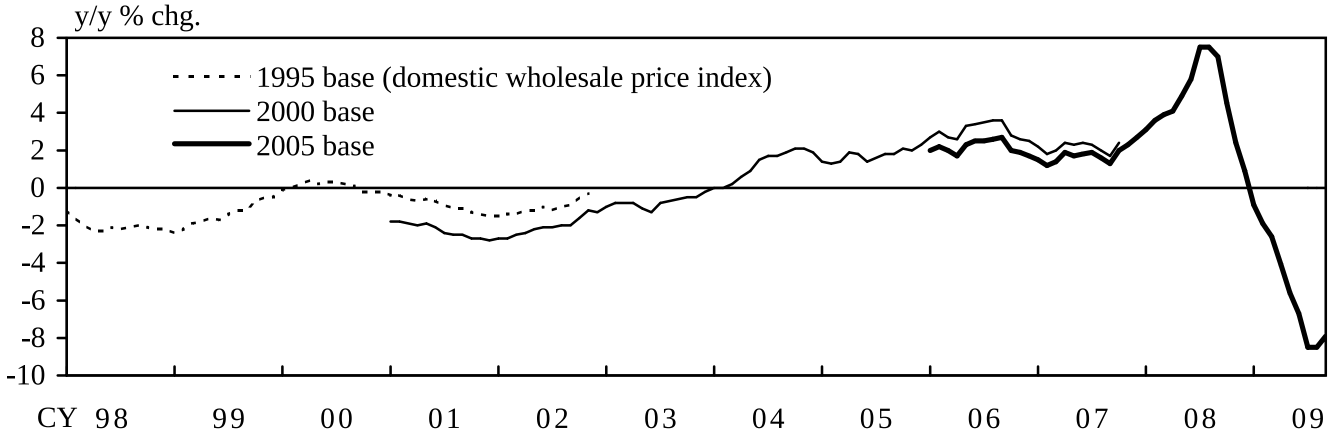
2. Steel: steel bars, H sections, steel plates, etc. Nonferrous metals: unwrought copper, unwrought aluminum, etc. Petroleum: gasoline, kerosene, gas oil, fuel oil C.

Sources: Bank of Japan, "Bank of Japan Overseas Commodity Index"; Nikkei Inc., etc.

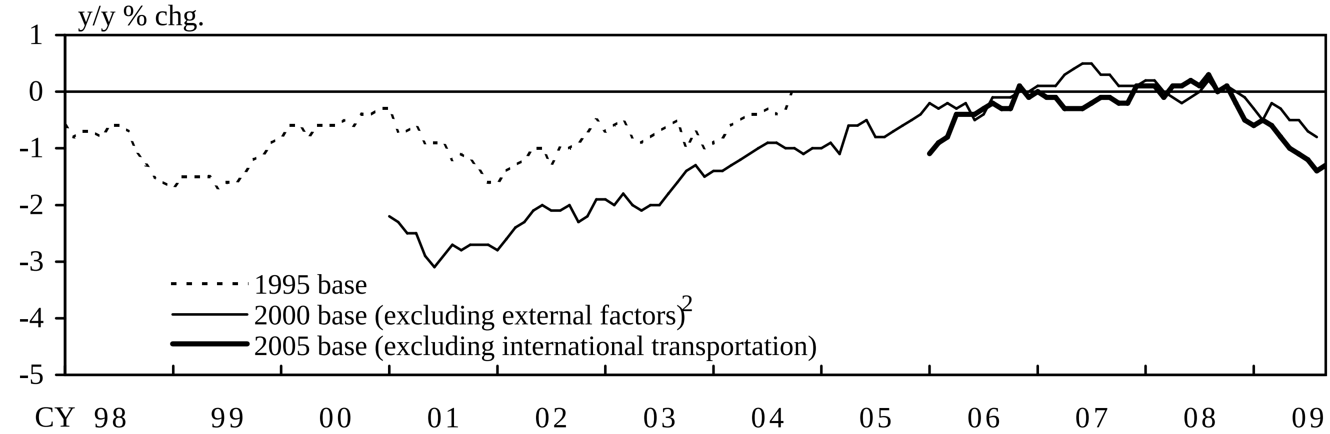
Chart 10

Prices

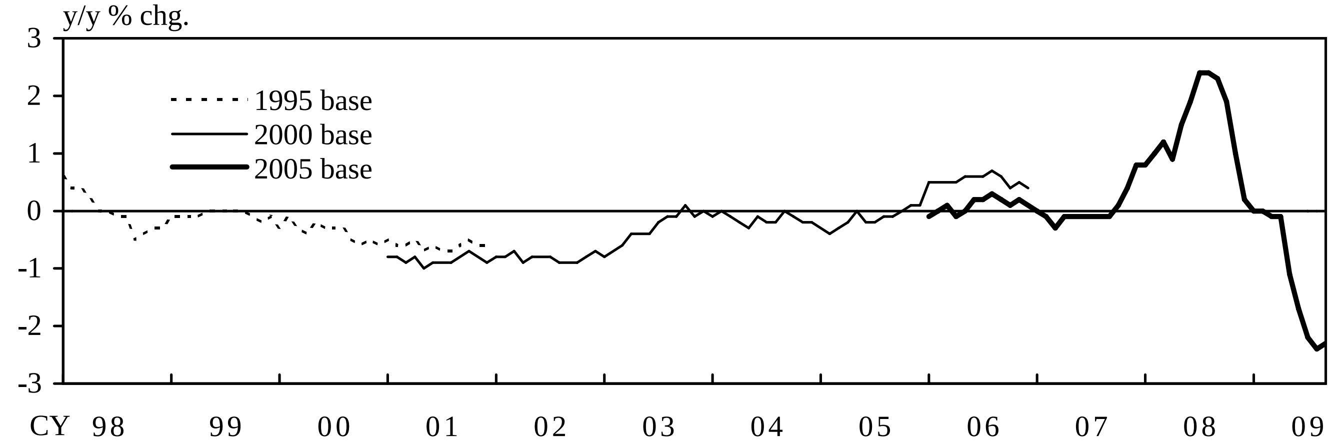
(1) Domestic Corporate Goods Price Index[1]



(2) Corporate Services Price Index[1]



(3) Consumer Price Index[1] (excluding fresh food)

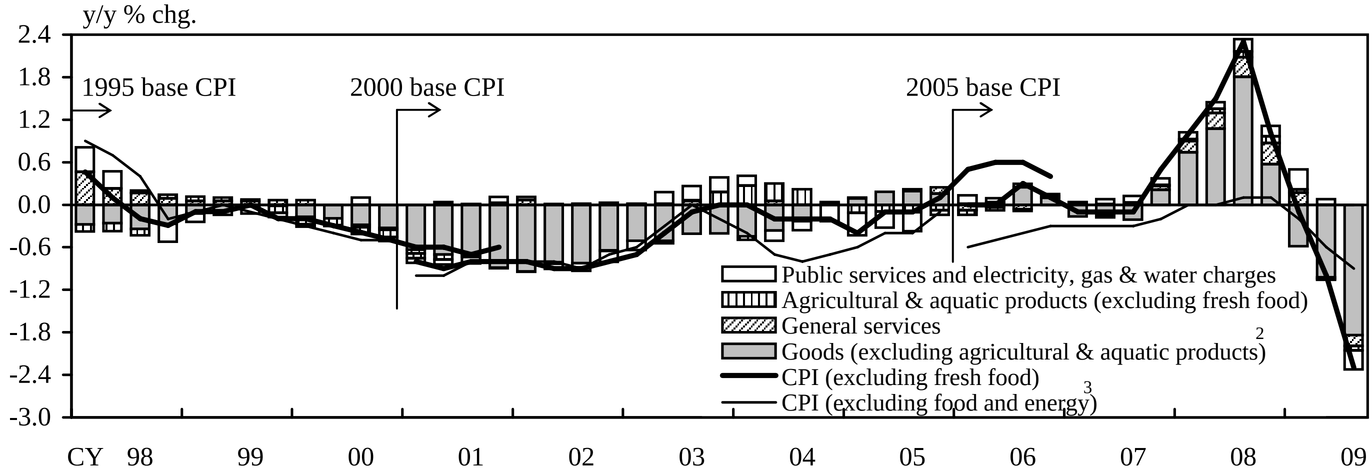


Notes: 1. Adjusted to exclude the effect of a change in the consumption tax rate.
2. External factors consist of international air passenger transportation; ocean liner; ocean tramper; ocean tanker; oceangoing ship chartering services; and international air freight.

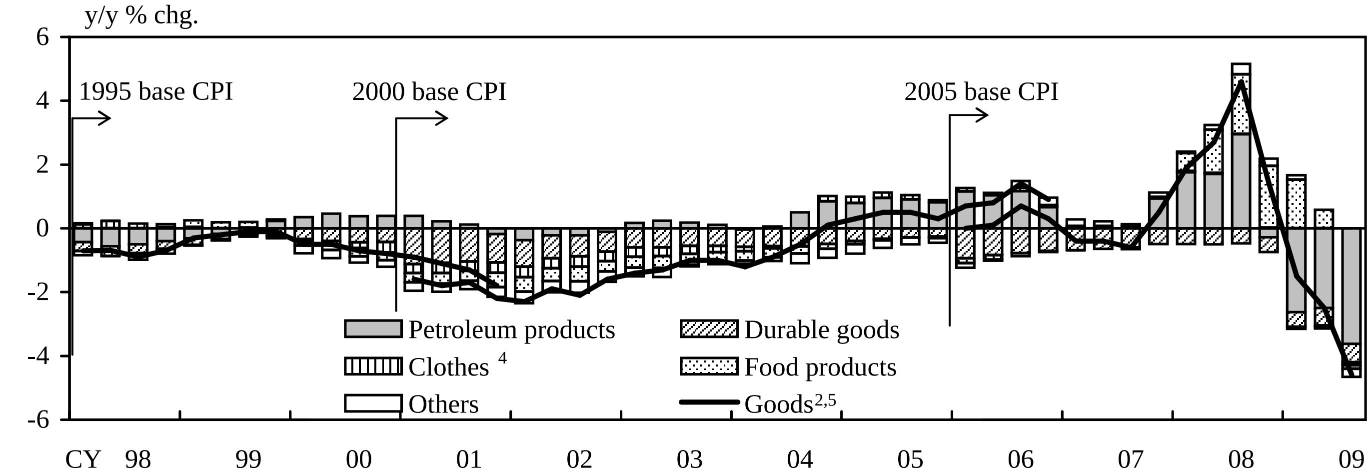
Sources: Ministry of Internal Affairs and Communications, "Consumer Price Index"; Bank of Japan, "Corporate Goods Price Index," "Wholesale Price Index," "Corporate Services Price Index."

Consumer Price Index

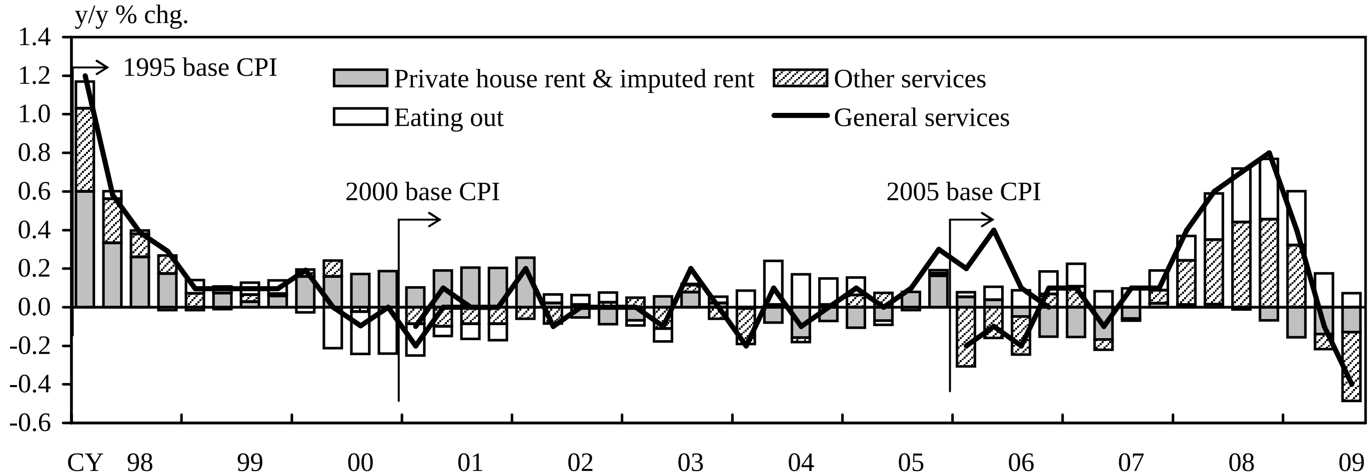
(1) Consumer Price Index (Excluding Fresh Food)



(2) Goods (Excluding Agricultural & Aquatic Products)[2]



(3) General Services

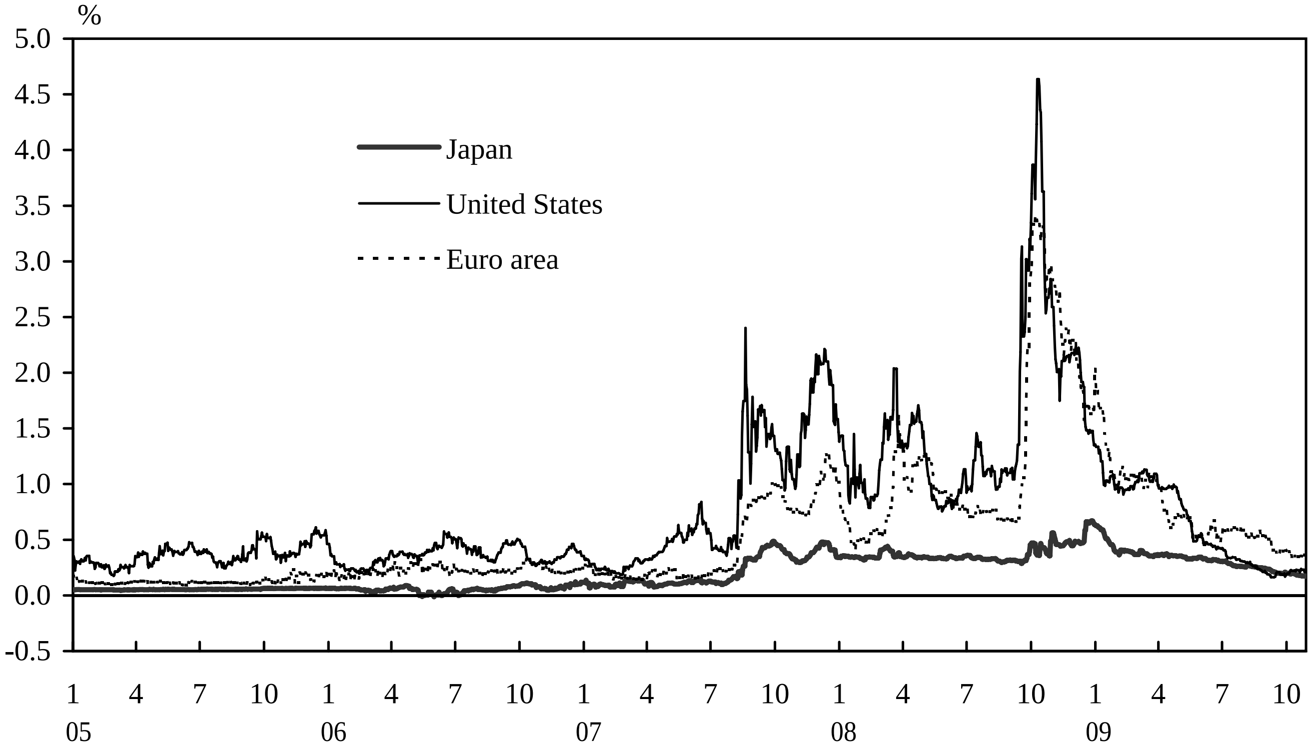


Notes: 1. Figures are adjusted to exclude the effect of a change in the consumption tax rate.
2. The items are basically the same as the definition published by the Ministry of Internal Affairs and Communications. However, electricity, gas & water charges are excluded from goods.
3. Alcoholic beverages are excluded from food.
4. Including shirts, sweaters & underwear.
5. Excluding agricultural & aquatic products.

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

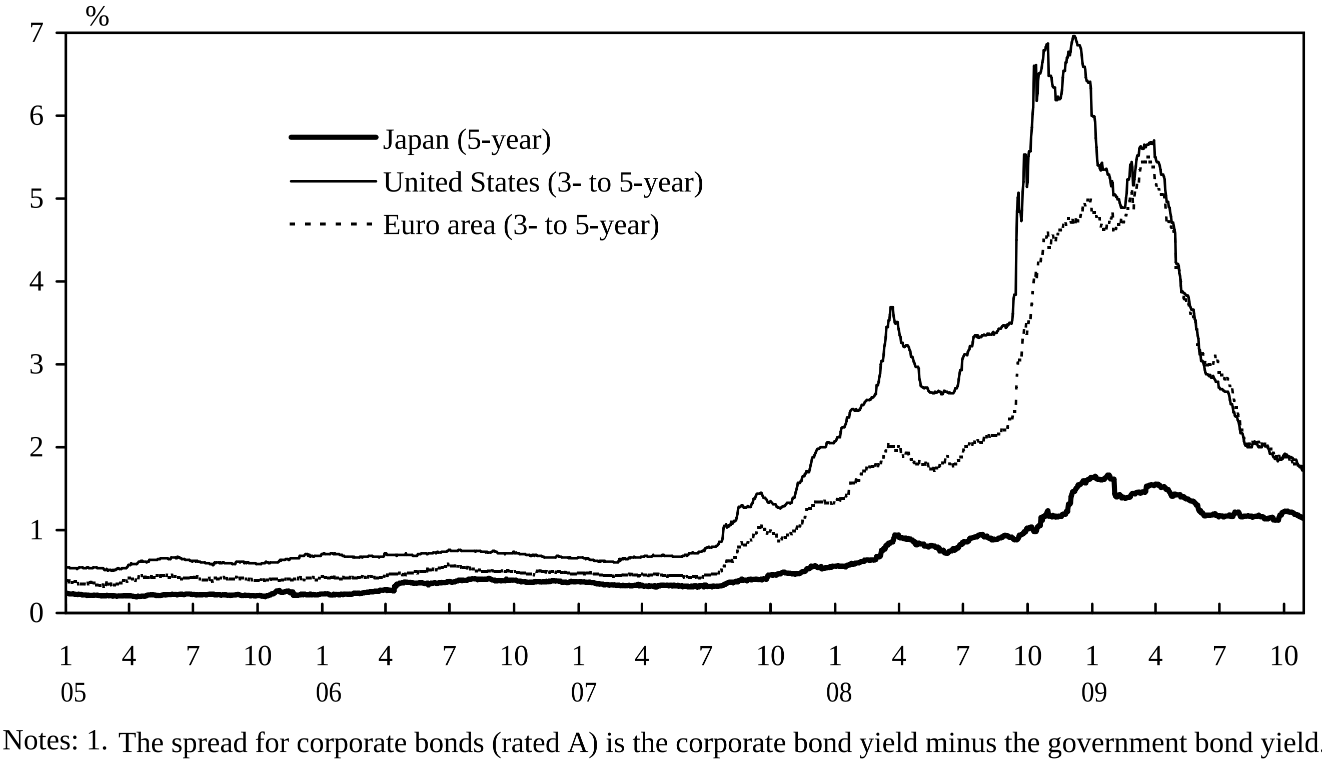
Credit Spread in Major Economies

(1) Spread for Term Instruments in Major Economies



Notes: 1. The spread for term instruments is Libor (3-month) minus the short-term government security (3-month) yield.
2. The German short-term government security yield is used for the euro area.

(2) Spread for Corporate Bonds in Major Economies



Notes: 1. The spread for corporate bonds (rated A) is the corporate bond yield minus the government bond yield.
2. The indicated rating of corporate bonds in Japan is of R&I and those in the United States and the euro area are of Moody's, S&P, and Fitch.

Sources: Japan Securities Dealers Association; Merrill Lynch; Bloomberg.

The Bank of Japan's Measures since Autumn 2008

Monetary Policy Measures

1. Reductions in the Policy Interest Rate

- 0.5 percent → 0.3 percent (Oct. 2008) → 0.1 percent (Dec. 2008)

2. Measures to Ensure Stability in Financial Markets

- Provision of abundant funds through money market operations
- U.S. dollar funds-supplying operations (1.5 billion U.S. dollars [peak: 127.6 billion U.S. dollars as of December 2008])
- Acceptance of cross-border bonds (i.e., bonds issued by the governments of the United States, the United Kingdom, Germany, and France) as eligible collateral
- Increase in outright purchases of JGBs (14.4 trillion yen per year → 21.6 trillion yen per year [March 2009])

3. Steps to Facilitate Corporate Financing

- Special funds-supplying operations to facilitate corporate financing (6.9 trillion yen)
- Outright purchases of CP and ABCP (0.1 trillion yen [peak: 1.6 trillion yen as of Mar. 2009])
- Outright purchases of corporate bonds (0.3 trillion yen)
- Expansion in the range of corporate debt eligible as collateral (A-rated or higher → BBB-rated or higher)

  (The total amount of eligible collateral for special funds-supplying operations to facilitate corporate financing: 3.9 trillion yen as of the end of November 2008 → 10.6 trillion yen)

Measures to Secure the Stability of the Financial System

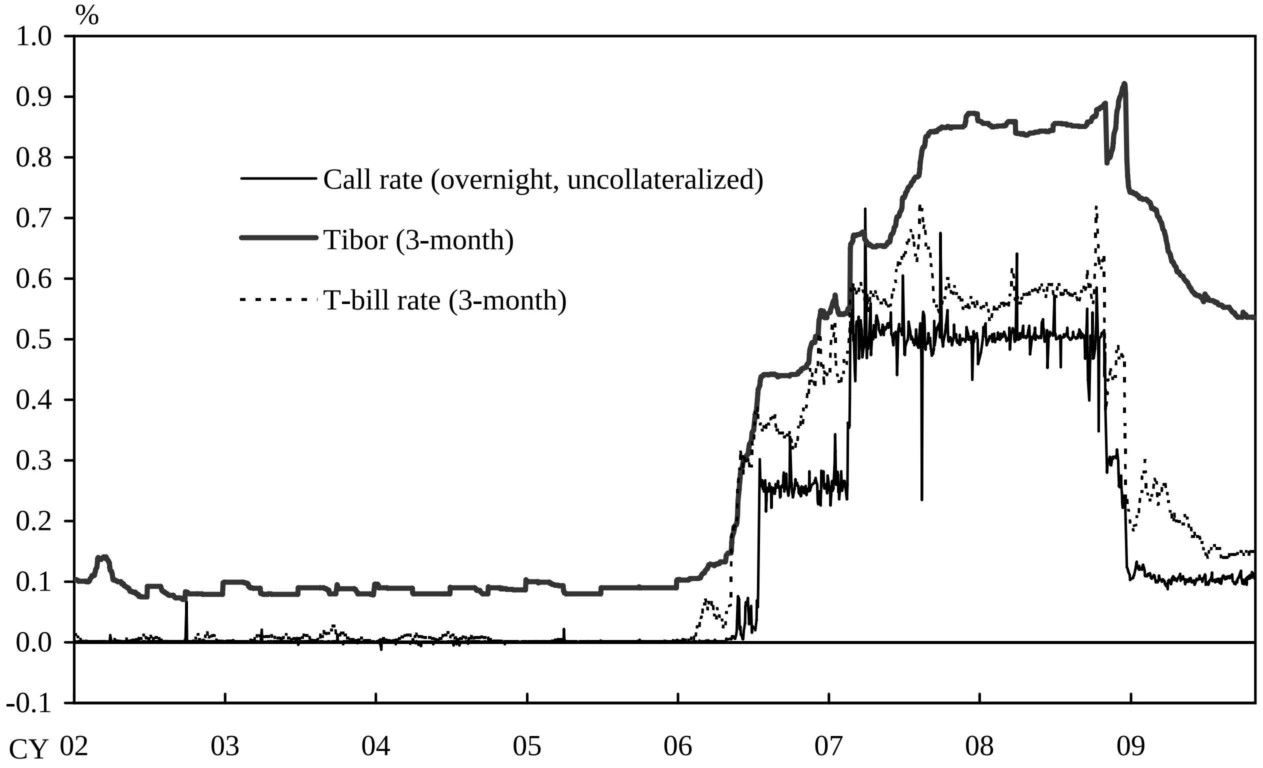
- Purchases of stocks held by banks (upper limit of the amount to be purchased: 1 trillion yen)
- Provision of subordinated loans to banks (upper limit of the amount of loans to be provided: 1 trillion yen)

Note: Amounts outstanding are as of end-September 2009.

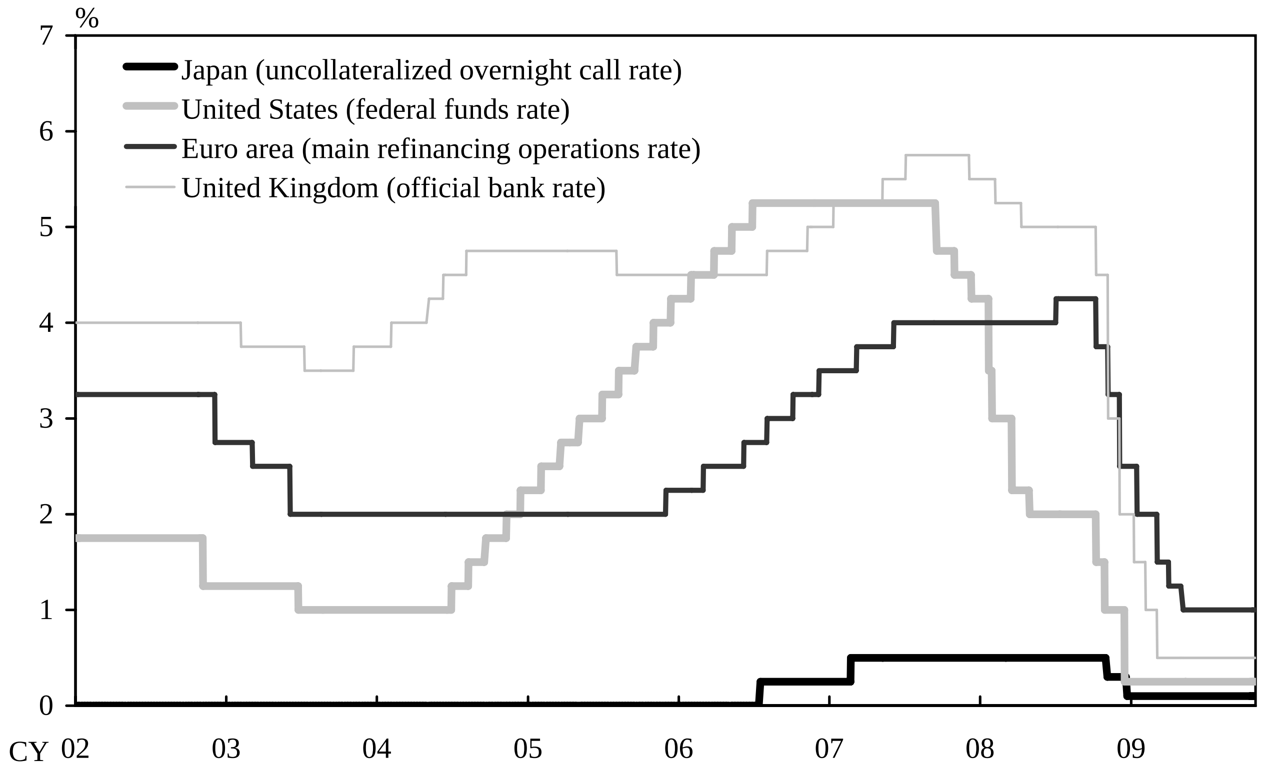
Chart 14

Short-Term Interest Rates

(1) Short-Term Interest Rates



(2) Policy Interest Rates in Major Economies

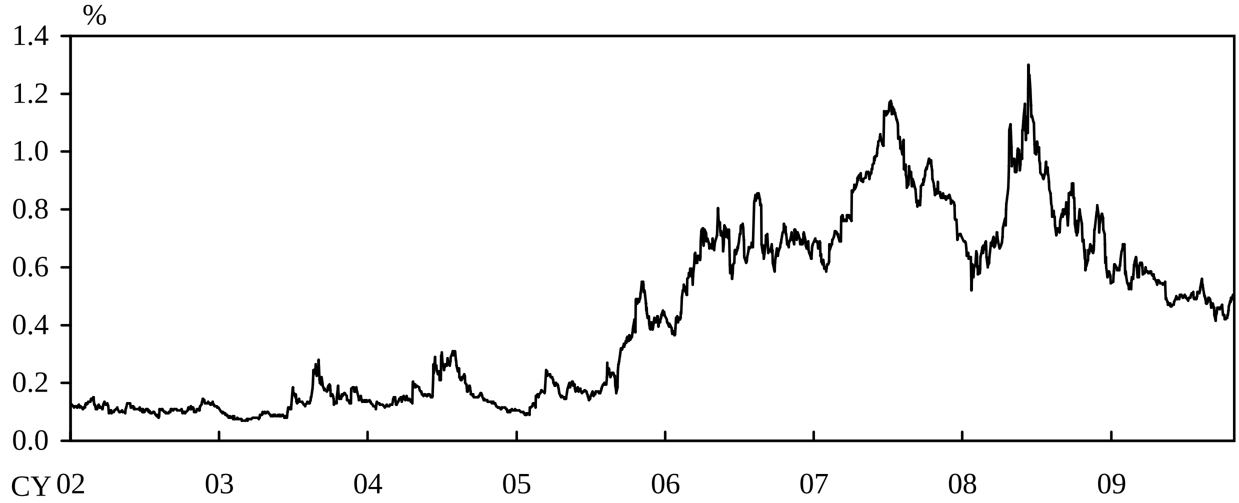


Note: The policy interest rate of Japan is considered 0 percent during the period when the operating target of money market operations was the outstanding balance of current accounts at the Bank of Japan.

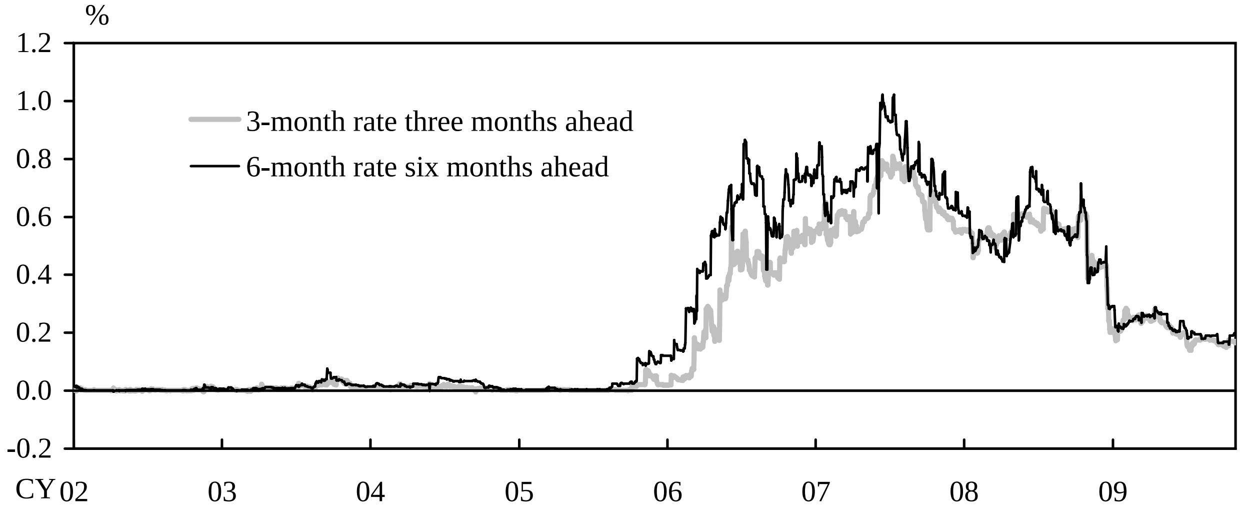
Sources: Bank of Japan; other central banks; Bloomberg.

Market Participants' Expectations on Interest Rates in the Future

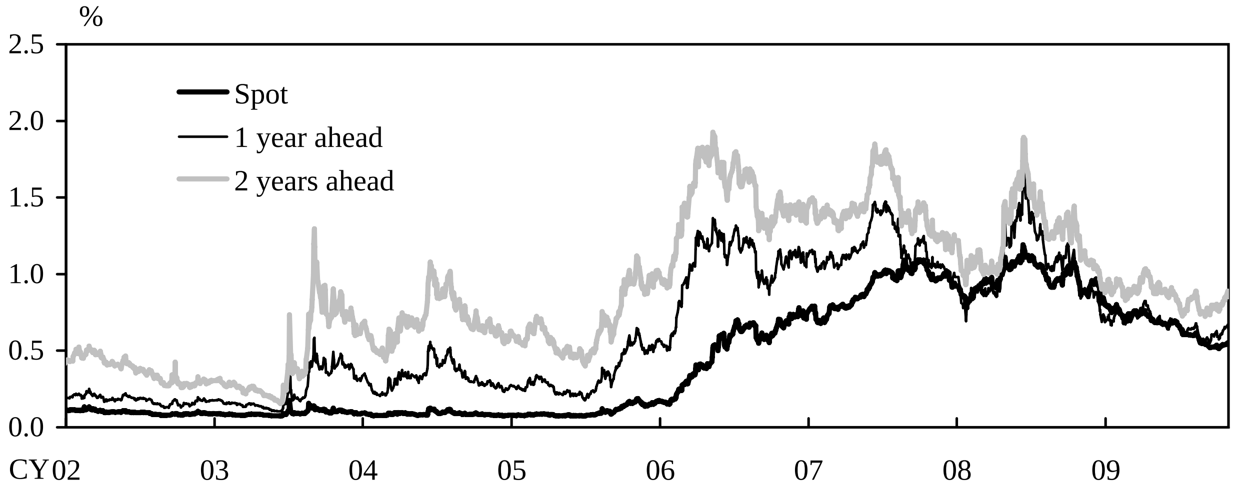
(1) Euroyen Interest Rate Futures (3-Month, Leading Contract Months)



(2) Implied Forward Rates (3-Month, 6-Month)



(3) Implied Forward Rates (1-Year)

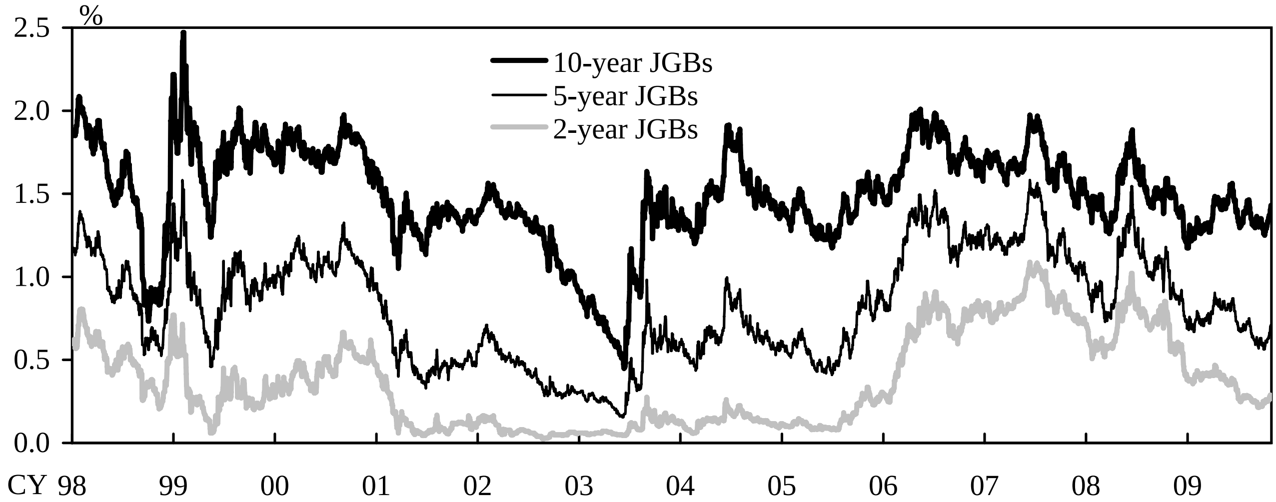


Note: Calculated from yen-yen swap rates.

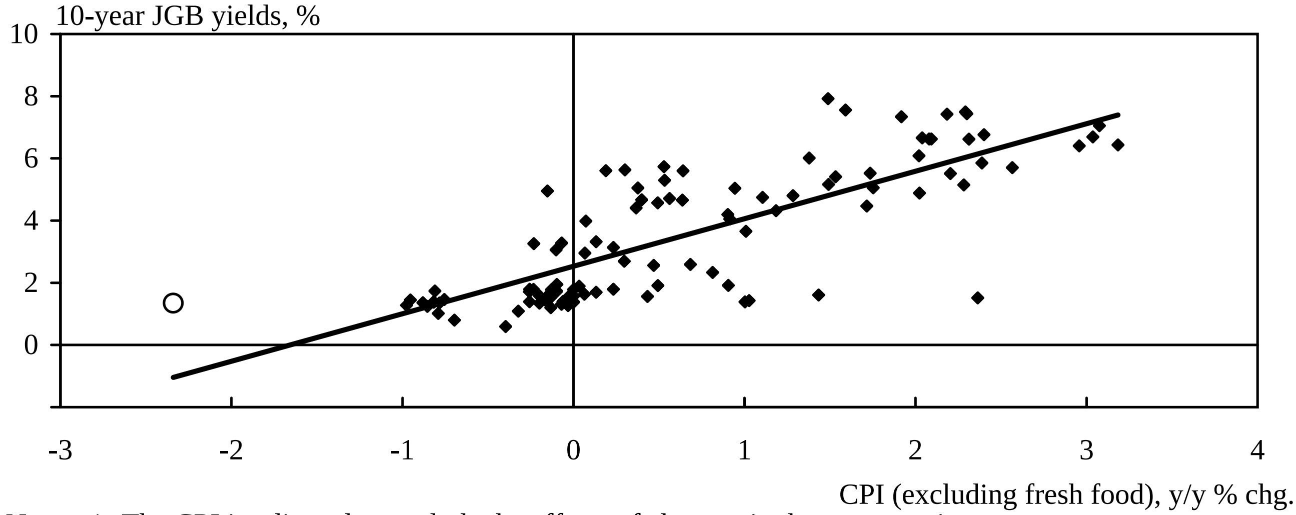
Sources: Tokyo Financial Exchange; Bloomberg.

Long-Term Interest Rates

(1) Government Bond Yields

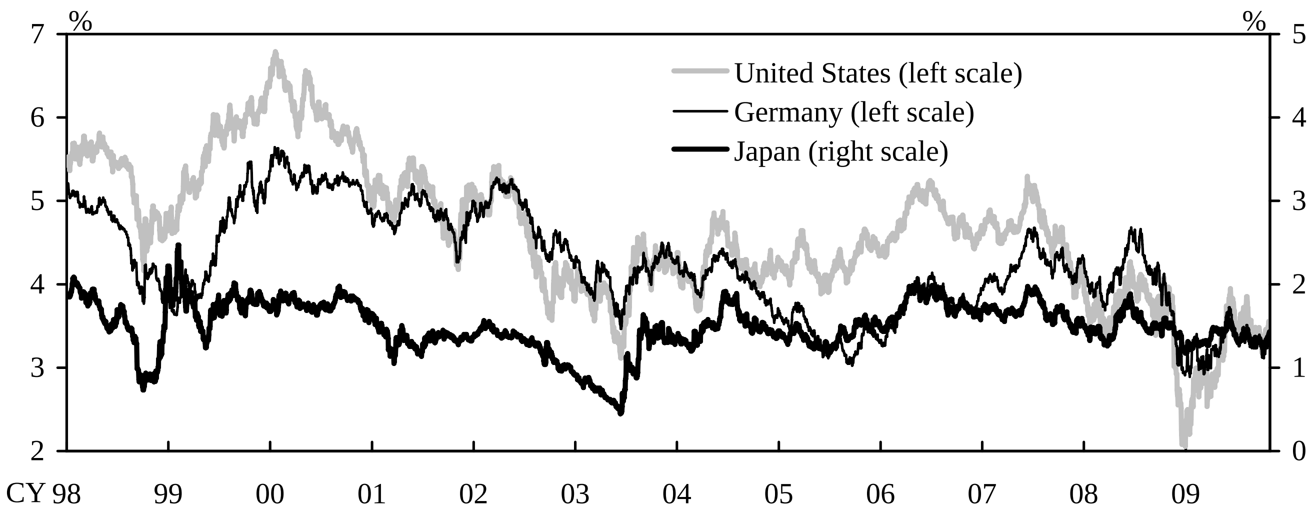


(2) Long-Term Interest Rates and Change in the Consumer Price Index



Notes: 1. The CPI is adjusted to exclude the effects of changes in the consumption tax rate.
2. The sample period is 1983/Q3-2009/Q3. The white circle indicates the latest data.

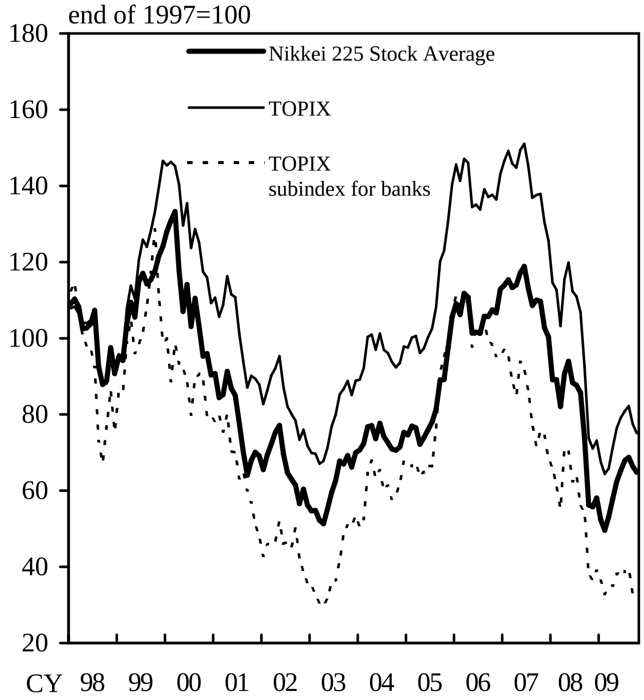
(3) Long-Term Interest Rates in Major Countries (10-Year Government Bond Yields)



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

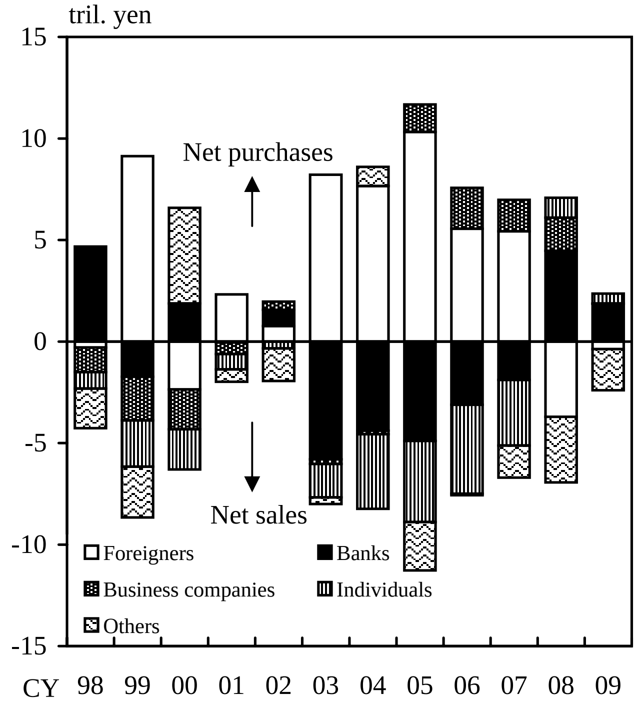
Stock Prices

(1) Stock Prices



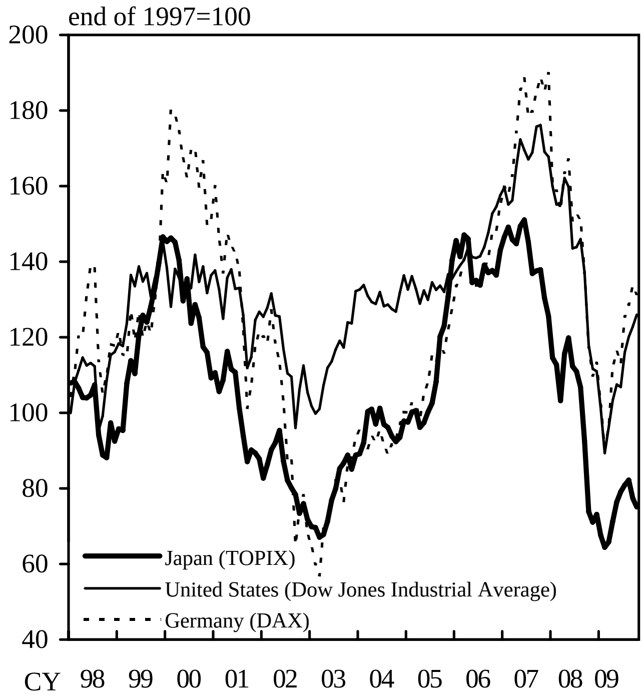
Note: Data are at end of month.

(2) Trading Volume by Investor Type



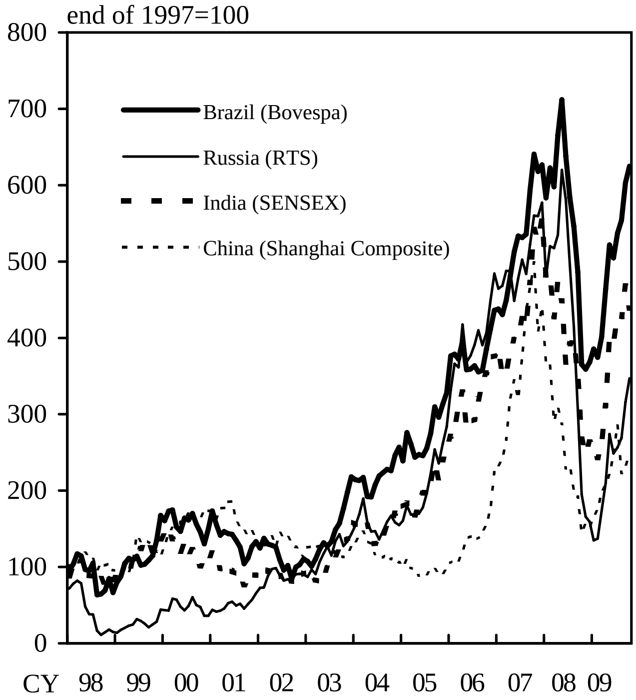
Notes: 1. Figures are the sum of the first and second sections of the Tokyo, Osaka, and Nagoya stock exchanges.
2. Figures for 2009 are those of January-September in terms of annual amount.

(3) Stock Prices in Major Countries



Note: Data are at end of month.

(4) Stock Prices in the BRIC Economies

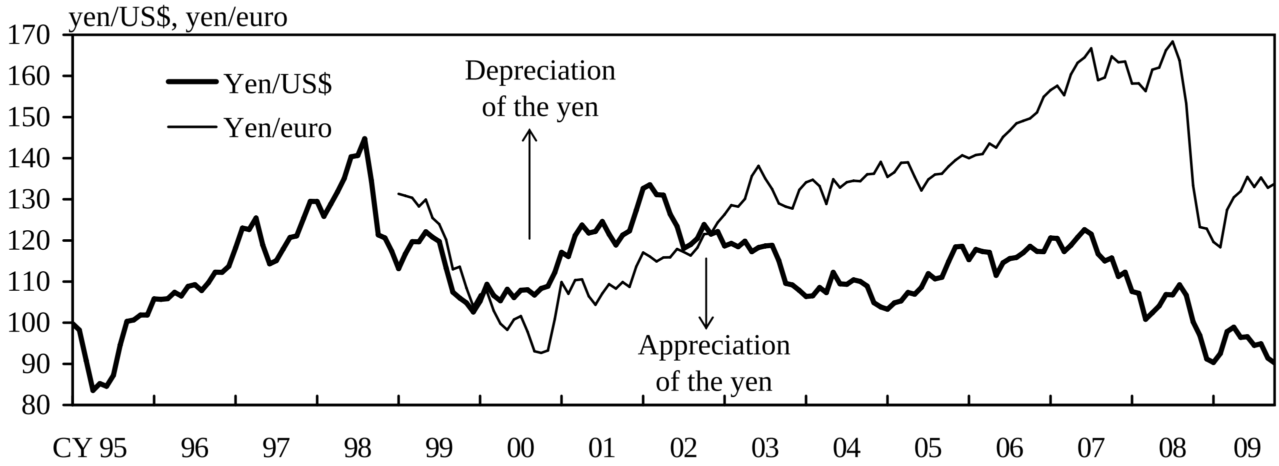


Note: Data are at end of month.

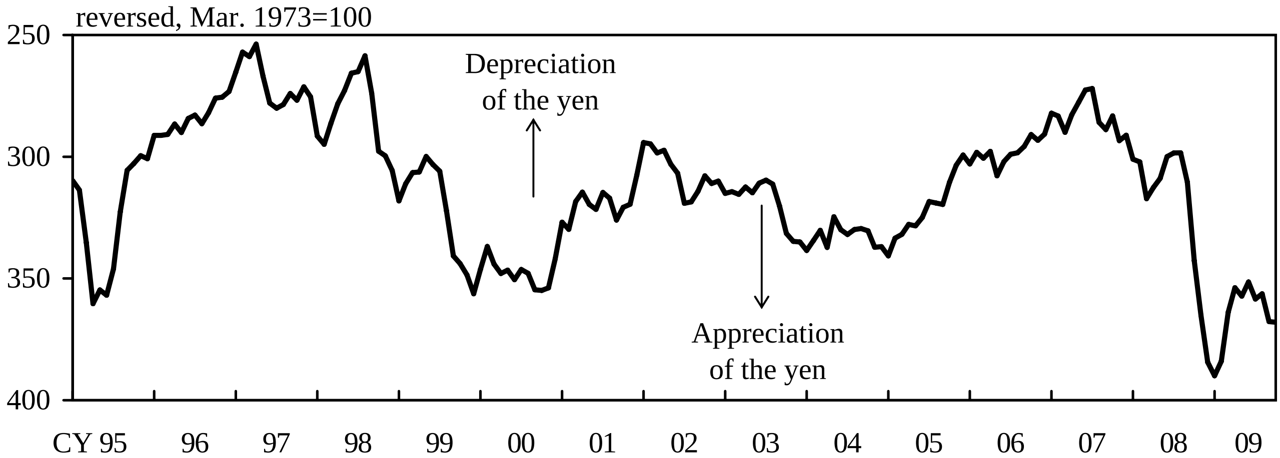
Sources: Nikkei Inc.; Tokyo Stock Exchange; Bloomberg.

Exchange Rates

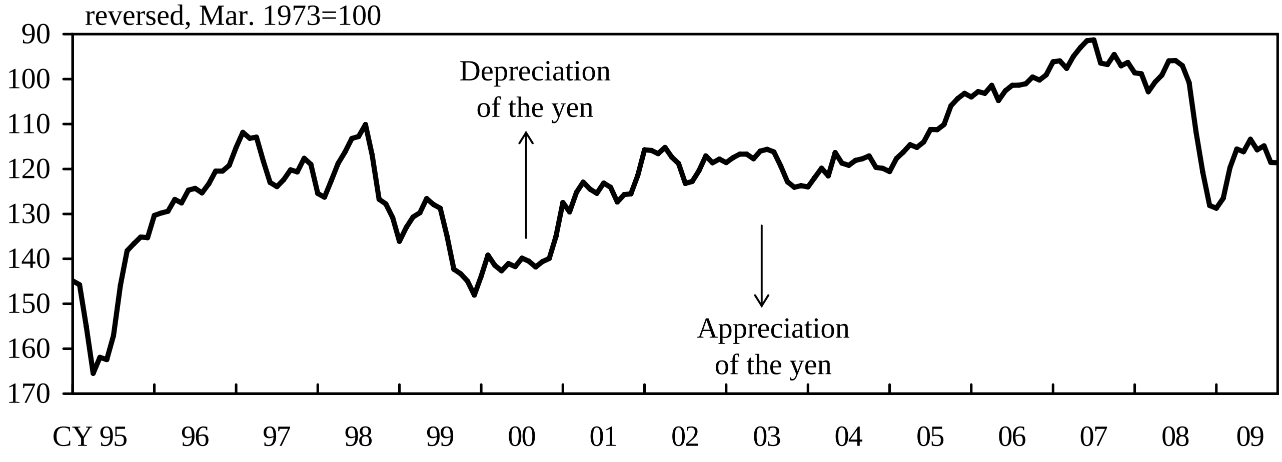
(1) Yen/US$ and Yen/Euro



(2) Nominal Effective Exchange Rate[1]



(3) Real Effective Exchange Rate[2]



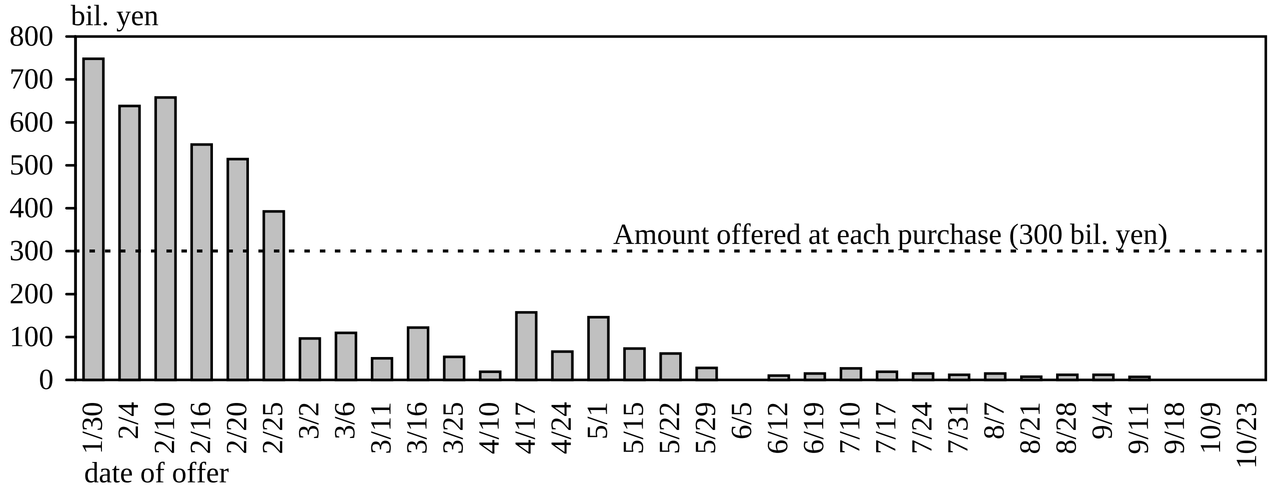
Notes: 1. The nominal effective exchange rate is a weighted average of the yen's exchange rates against 15 currencies that have a large share among Japanese total exports.

2. The real effective exchange rate is a weighted average of the yen's real exchange rates against 15 currencies that have a large share among Japanese total exports. The yen's real exchange rates are calculated from the nominal exchange rates and price indexes of the relevant countries.

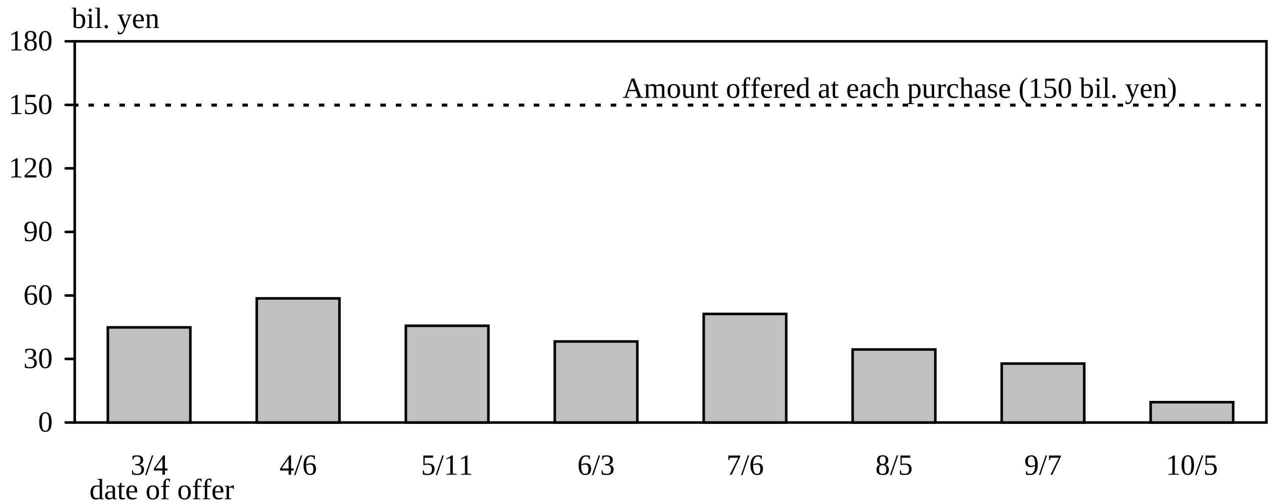
Source: Bank of Japan.

Outright Purchases of CP and Corporate Bonds

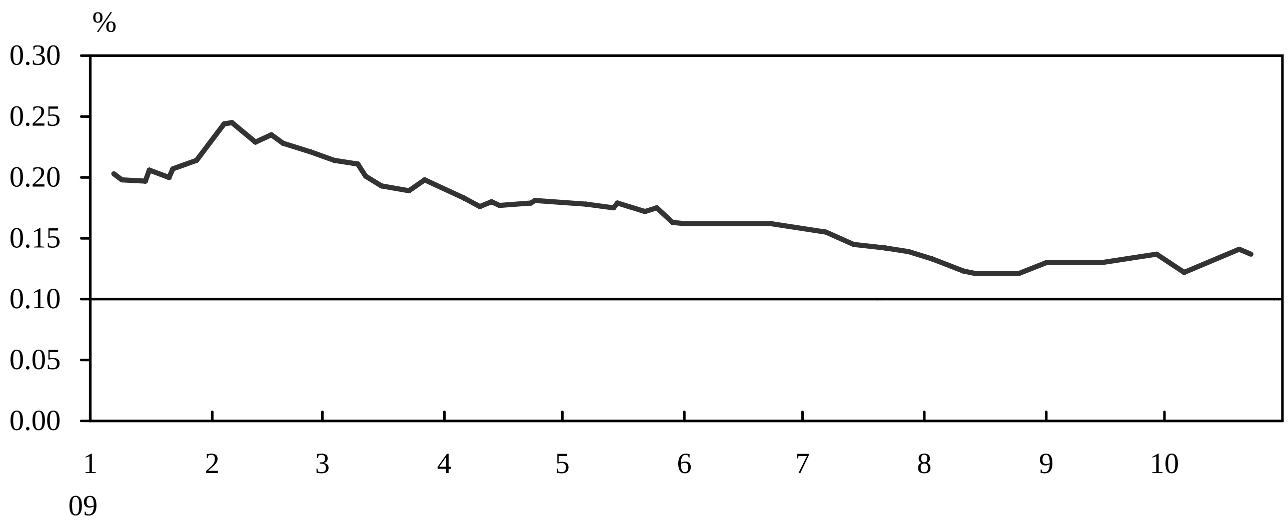
(1) Amounts of Competitive Bid for CP Purchases



(2) Amounts of Competitive Bid for Corporate Bonds Purchases



(3) Average Successful Bid Rate for Funds-Supplying Operations against Pooled Collateral (3-Month)

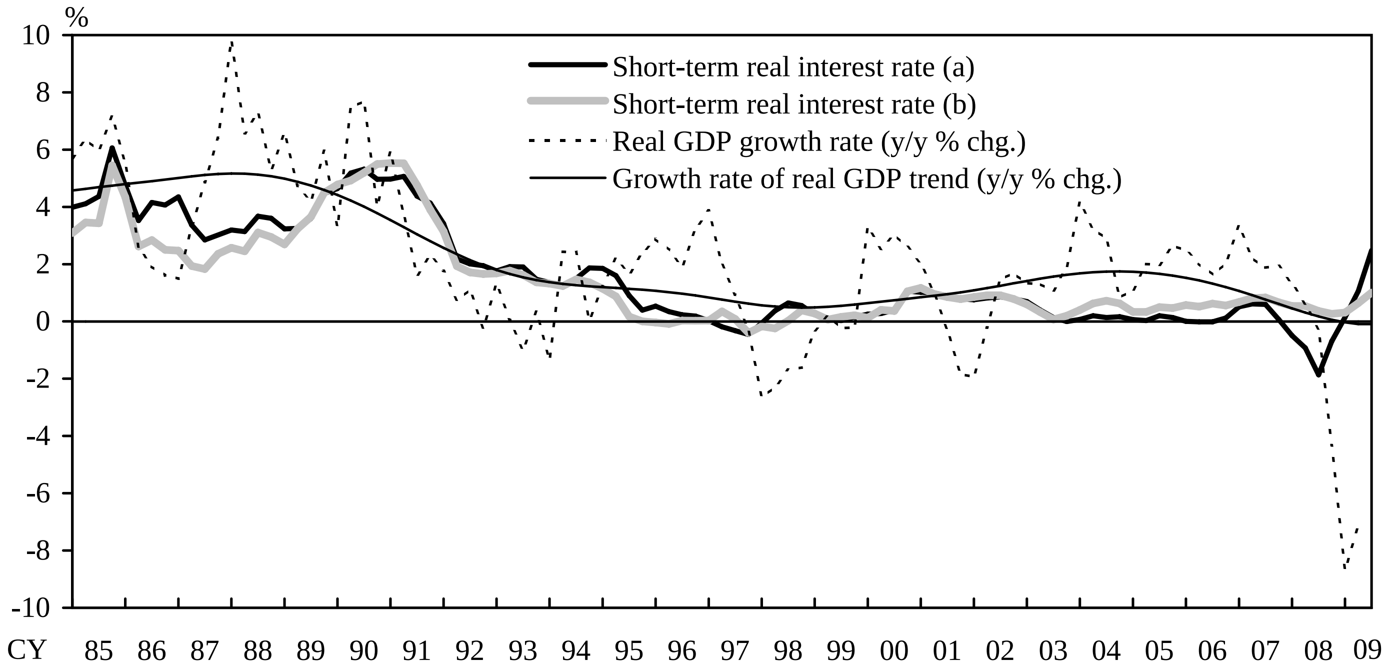


Notes: 1. Maturity of over 75 days and up to 104 days.
2. Interest rates on loans provided by the special funds-supplying operations to facilitate corporate financing are 0.1 percent.

Source: Bank of Japan.

Interest Rates and Economic Activity

(1) Short-Term Real Interest Rate and Real GDP Growth Rate



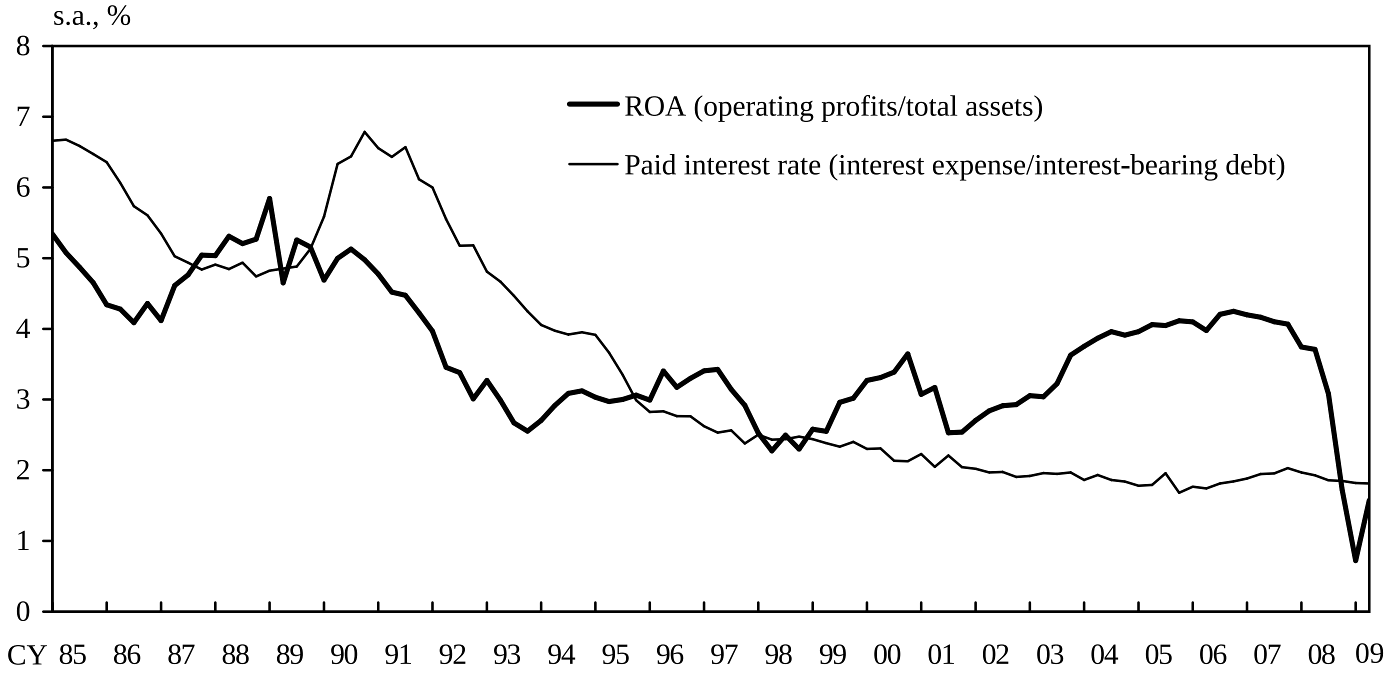
Notes: 1. Short-term real interest rate (a) = call rate (overnight, uncollateralized) - y/y % chg. in the consumer price index (excluding fresh food)

2. Short-term real interest rate (b) = call rate (overnight, uncollateralized) - y/y % chg. in the consumer price index (excluding food [alcoholic beverages are excluded from food] and energy)

3. Figures for the consumer price index are adjusted to exclude the effect of changes in the consumption tax rate.

4. Real GDP trend is calculated by applying the HP filter.

(2) ROA and Paid Interest Rate
("Financial Statements Statistics of Corporations by Industry, Quarterly," All Enterprises)



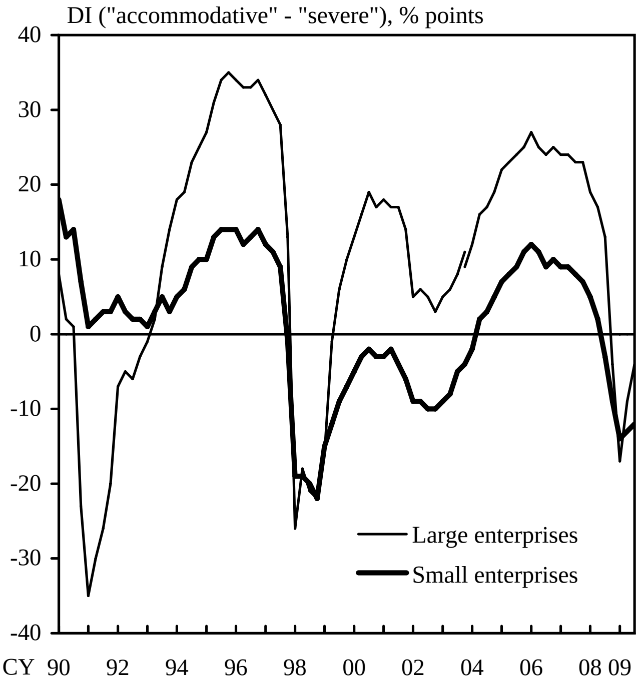
Note: Interest-bearing debt = long- and short-term borrowings + corporate bonds + bills receivable discounted outstanding

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

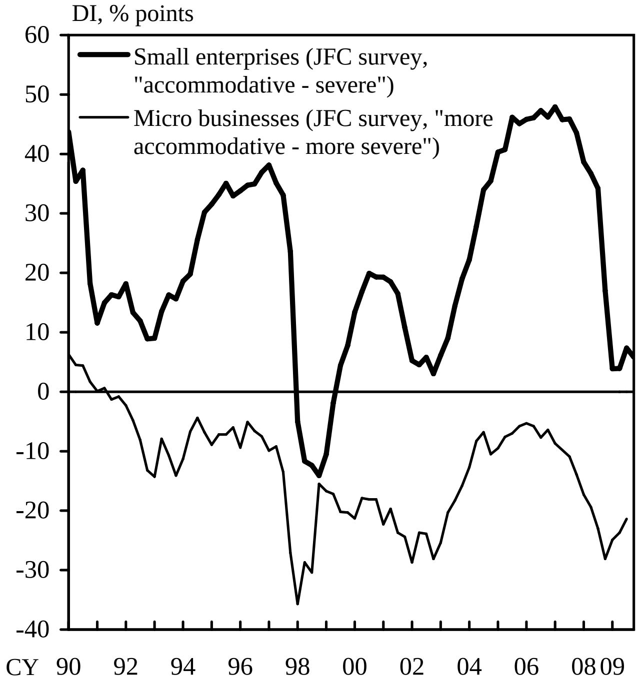
Corporate Finance-Related Indicators

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

(a) *Tankan*

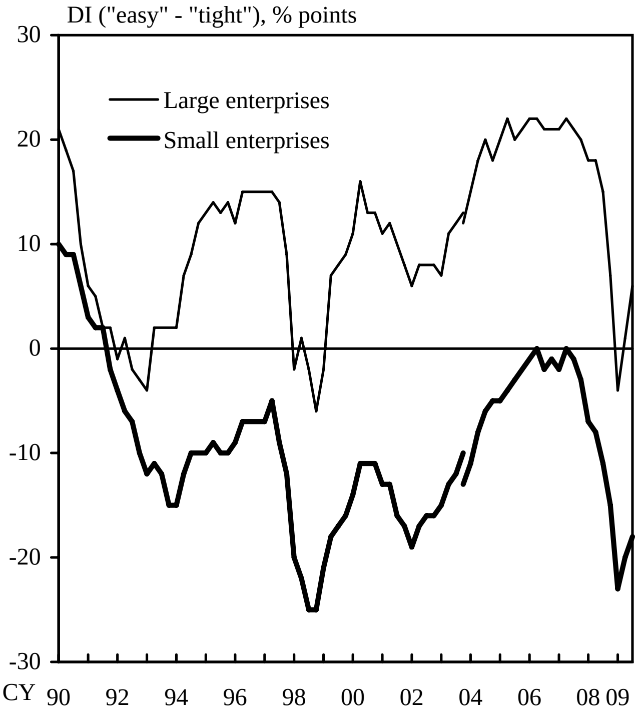


(b) Other Surveys

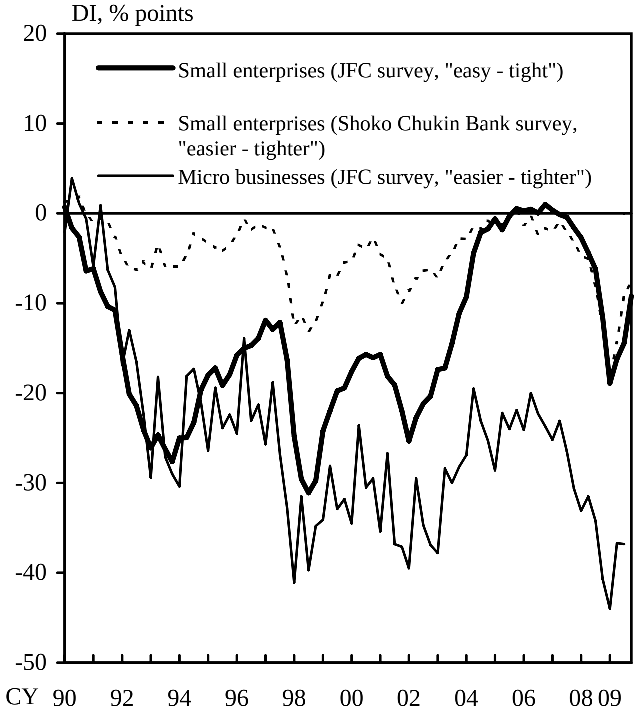


(2) Financial Position

(a) *Tankan*



(b) Other Surveys

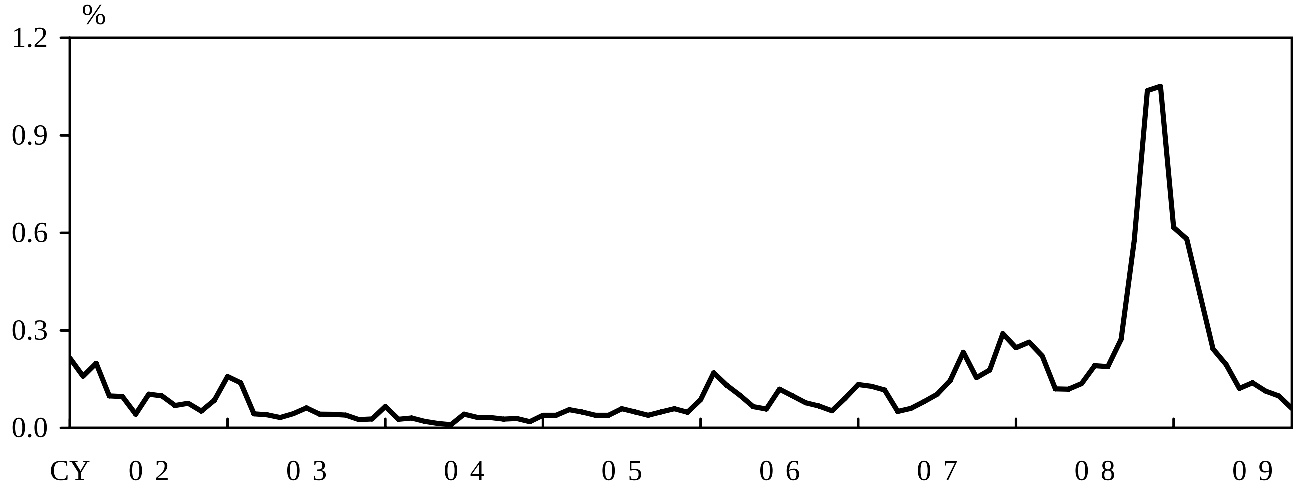


Note: Data of the *Tankan* are based on all industries. The *Tankan* has been revised from the March 2004 survey. Figures up to the December 2003 survey are based on the previous data sets. Figures from the December 2003 survey are on a new basis.

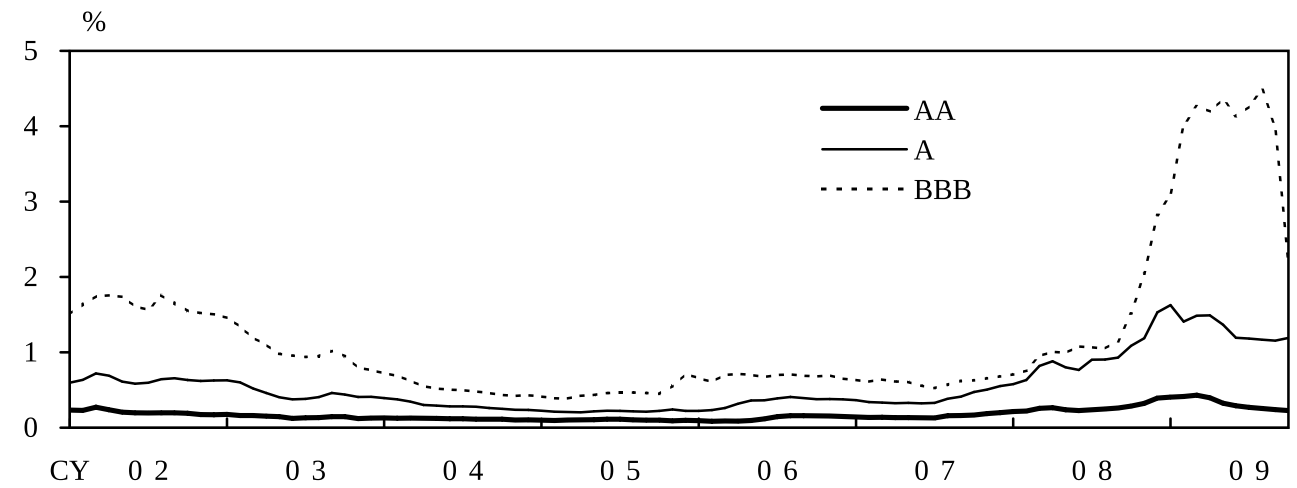
Sources: Bank of Japan, "*Tankan,* Short-Term Economic Survey of Enterprises in Japan"; Shoko Chukin Bank, Ltd., "Business Survey Index for Small and Medium-Sized Businesses"; Japan Finance Corporation (JFC), "Monthly Survey of Small Businesses in Japan," "Quarterly Survey of Small Businesses in Japan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

Commercial Paper and Corporate Bonds Markets

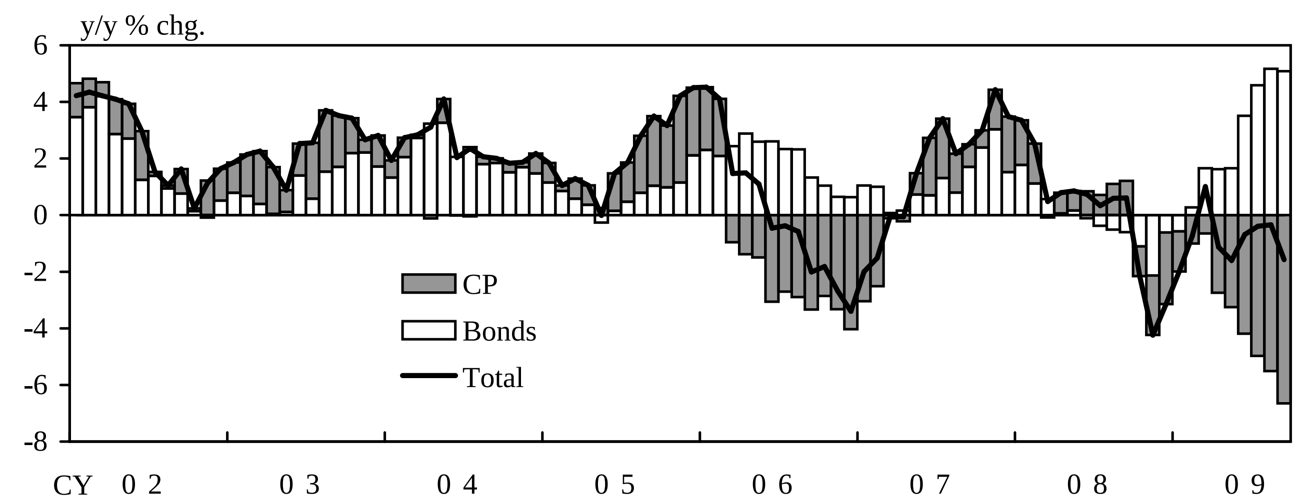
(1) Spread for CP (3-Month)[1]



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



(3) Amount Outstanding of CP and Corporate Bonds

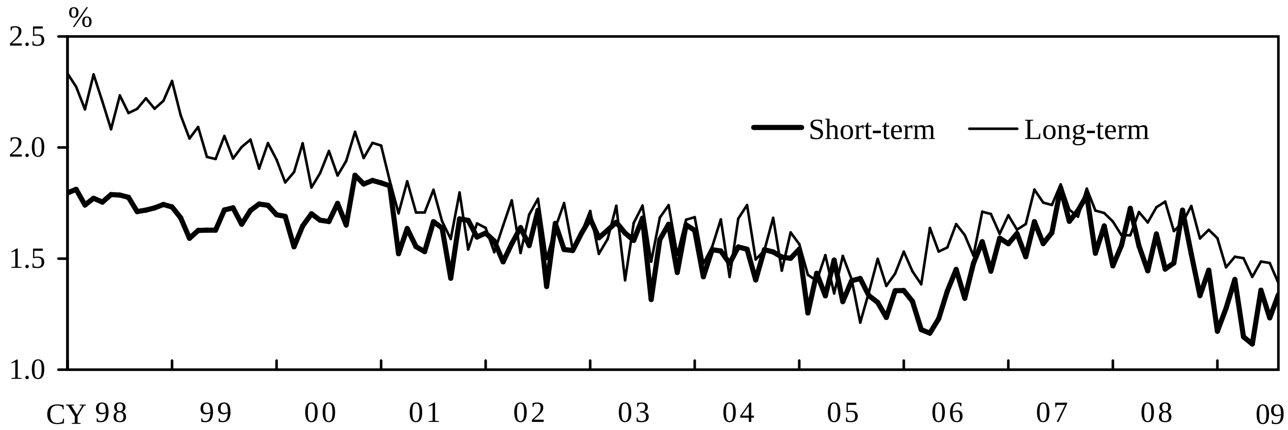


Notes: 1. The spread for CP is the average issuance rate of CP (rated a-1 or higher) minus the short-term government security yield.
2. The spread for corporate bonds is the corporate bond yield minus the government bond yield.
3. The indicated ratings of corporate bonds are of R&I.

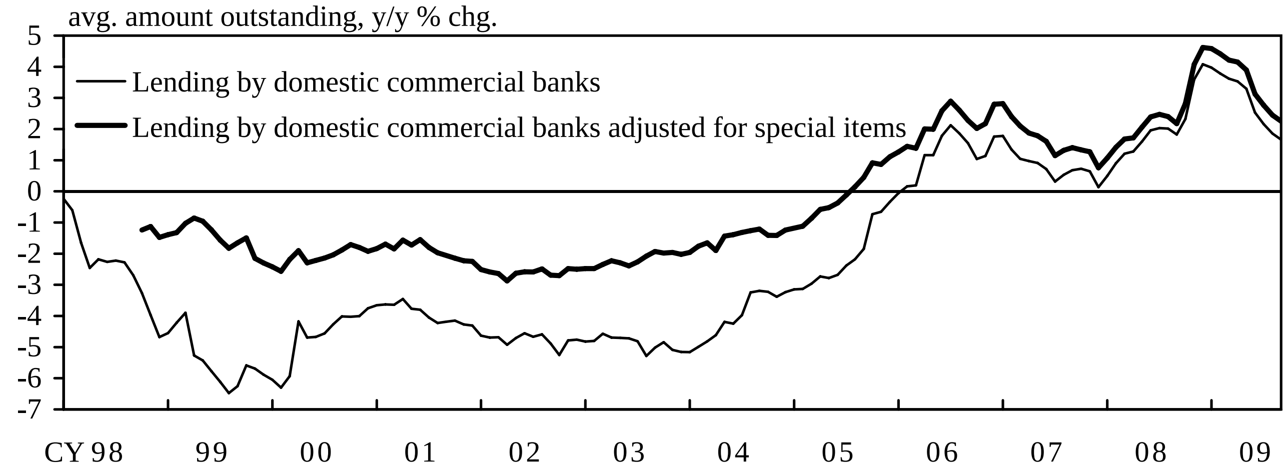
Sources: Bank of Japan; Japan Securities Depository Center; Japan Securities Dealers Association; I-N Information Systems; Bloomberg.

Bank Lending and Money Stock

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

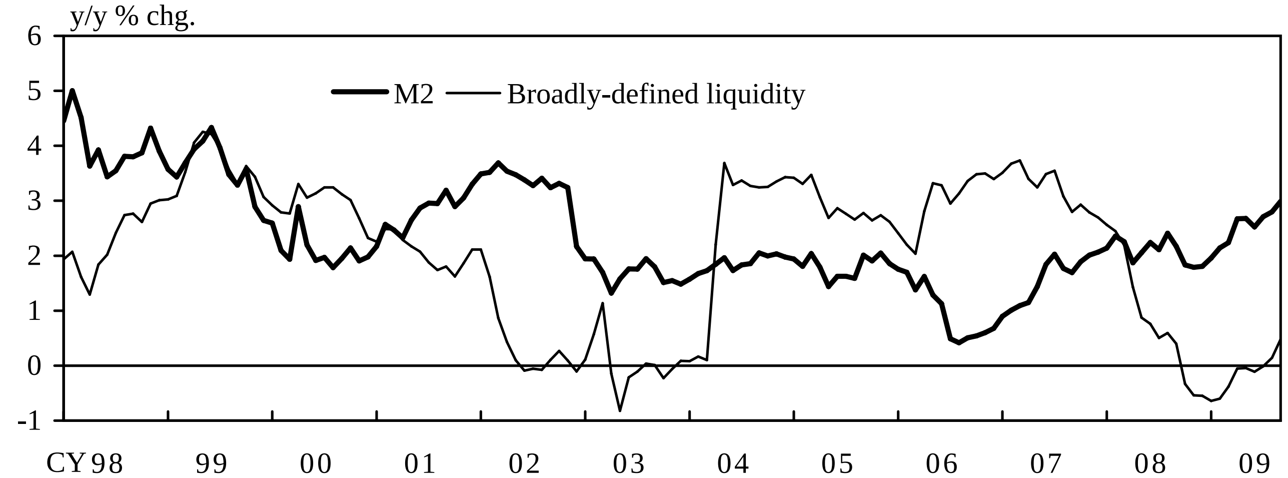


(2) Lending by Domestic Commercial Banks



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

(3) Money Stock



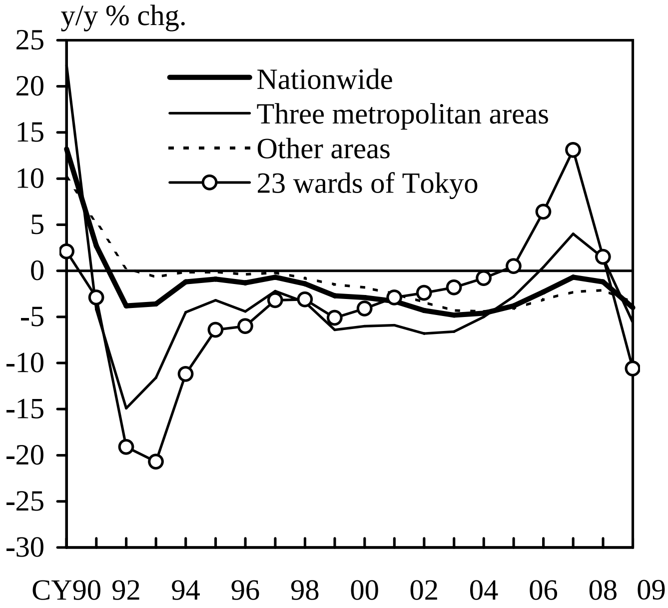
Notes: 1. Figures for M2 up to March 2004 are the former series of the figures for M2+CDs.
2. Figures for broadly-defined liquidity up to March 2004 are the former series of the figures for broadly-defined liquidity, subtracting the figures for repurchase agreements and those for securities lending with cash collateral transactions.

Sources: Bank of Japan, "Principal Figures of Financial Institutions," "Money Stock," "Average Contracted Interest Rates on Loans and Discounts."

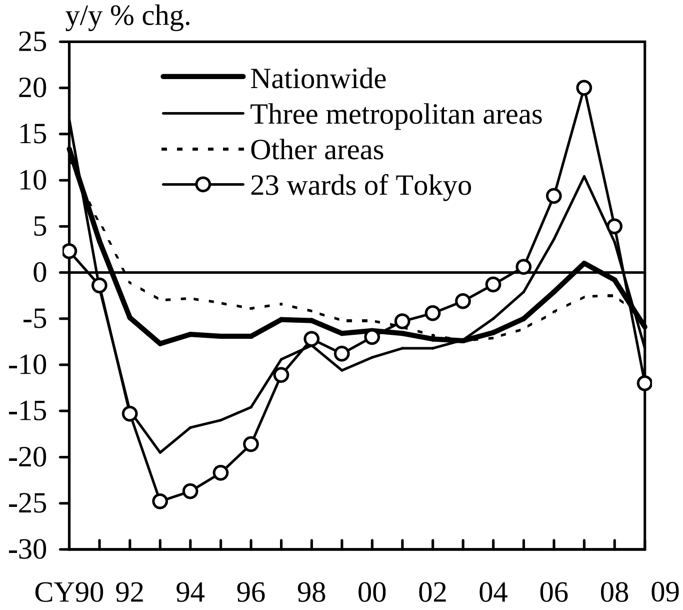
Land Prices

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

(a) Residential Land

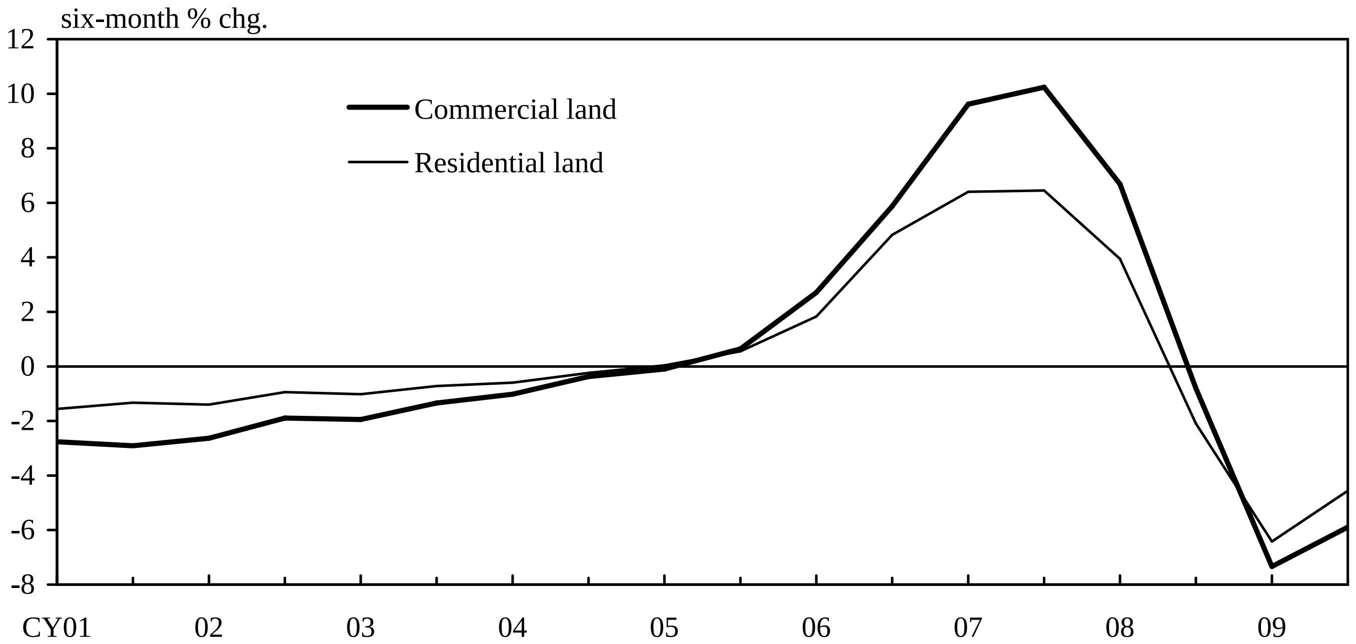


(b) Commercial Land



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

(2) Land Prices in 23 Wards of Tokyo

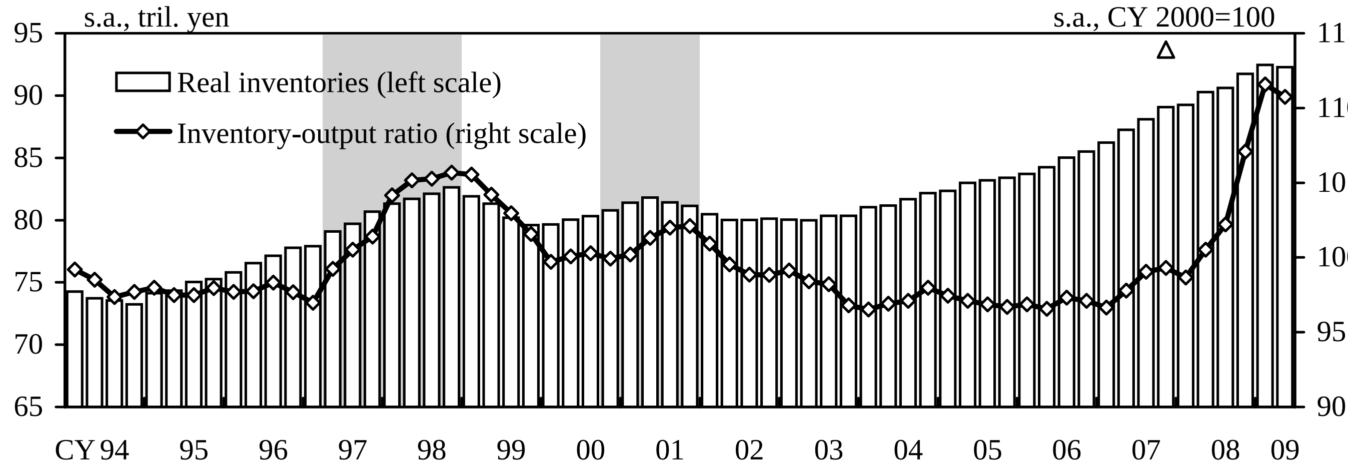


Note: Figures in the chart are six-month percentage change in land prices available in both "Land Price Publication" and "Prefectural Land Price Survey" (residential: 58 points, commercial: 44 points).

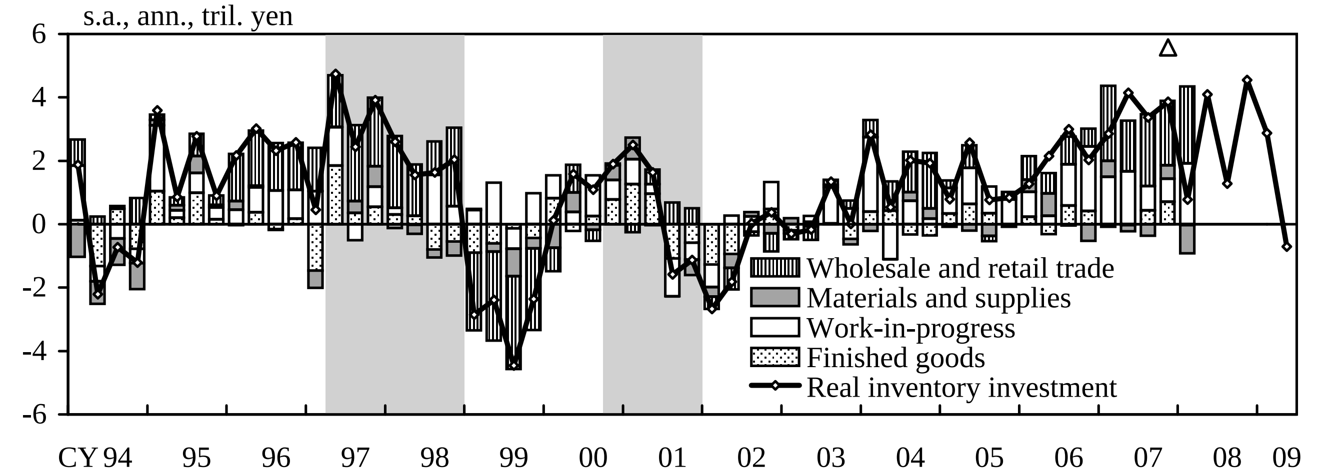
Source: Ministry of Land, Infrastructure and Transport, "Land Price Publication," "Prefectural Land Price Survey."

Inventory Investment

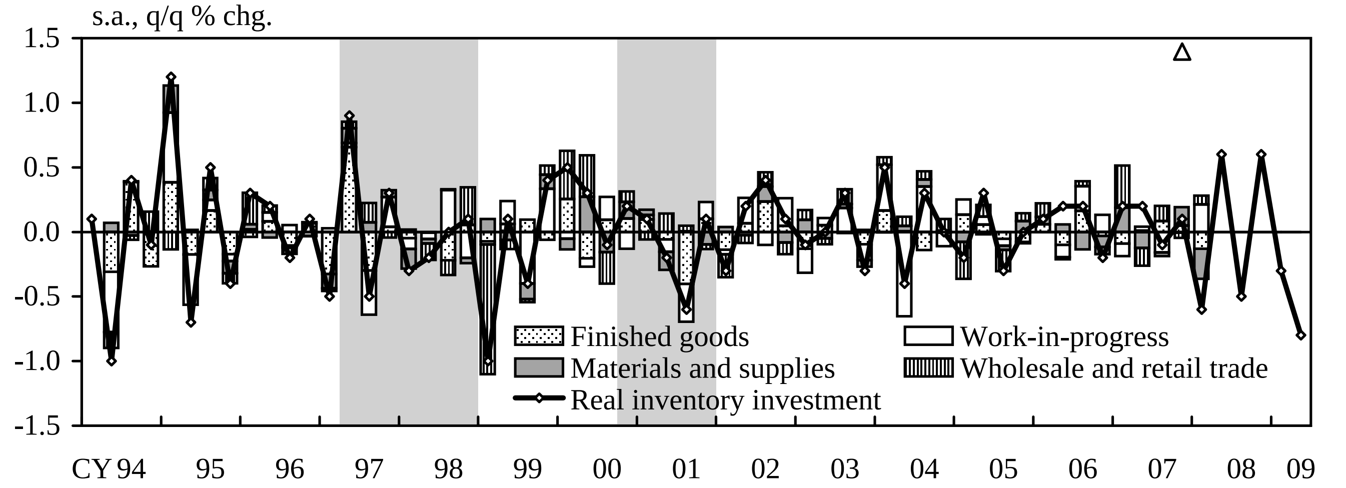
(1) Real Inventories and Inventory-Output Ratio[1,2,3]



(2) Real Inventory Investment (Changes in Real Inventories)[2,3]



(3) Contributions of Real Inventory Investment to Real GDP Growth Rate[3]

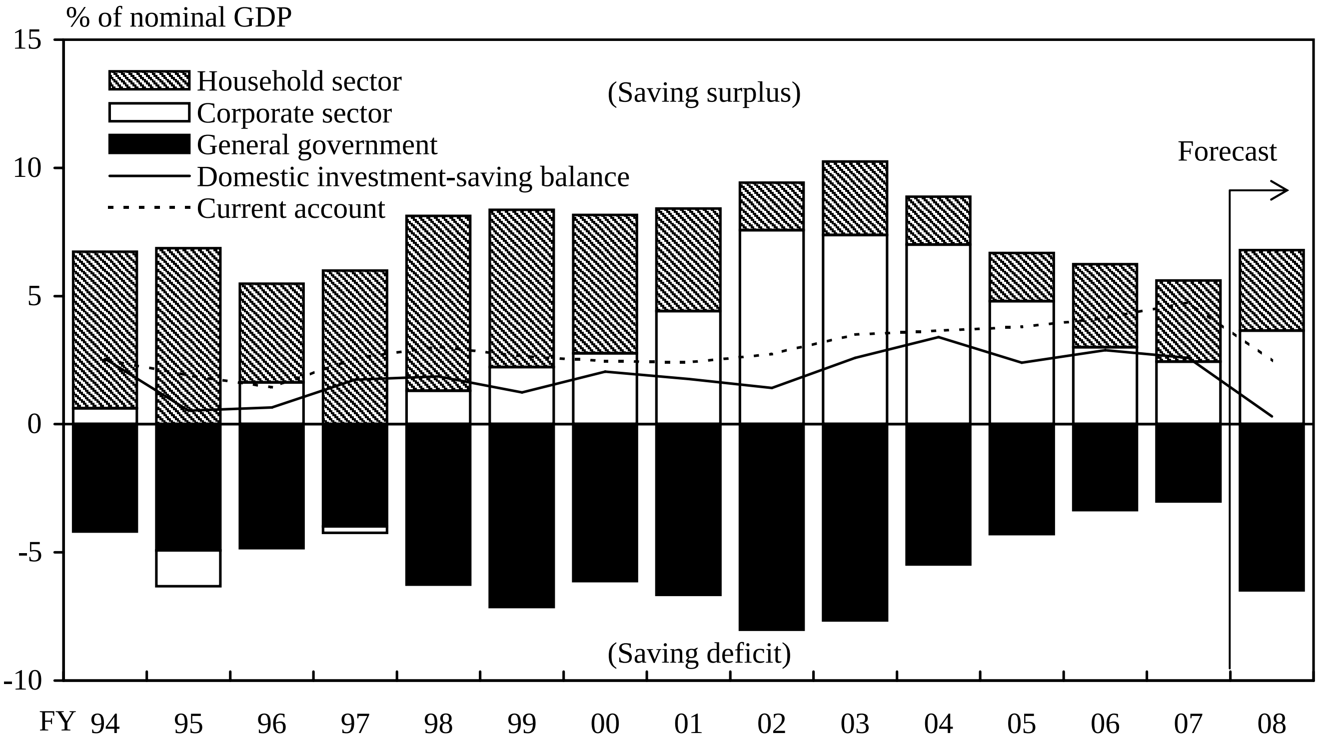


Notes: 1. Inventory-output ratio = real inventories/real GDP
2. Real inventories are calculated by use of the quarterly basis time-series data of real inventory investment, with reference to the nominal inventories at the end of 2000.
3. Shaded areas indicate recession periods. Triangle shows the last peak.

Source: Cabinet Office, "National Accounts."

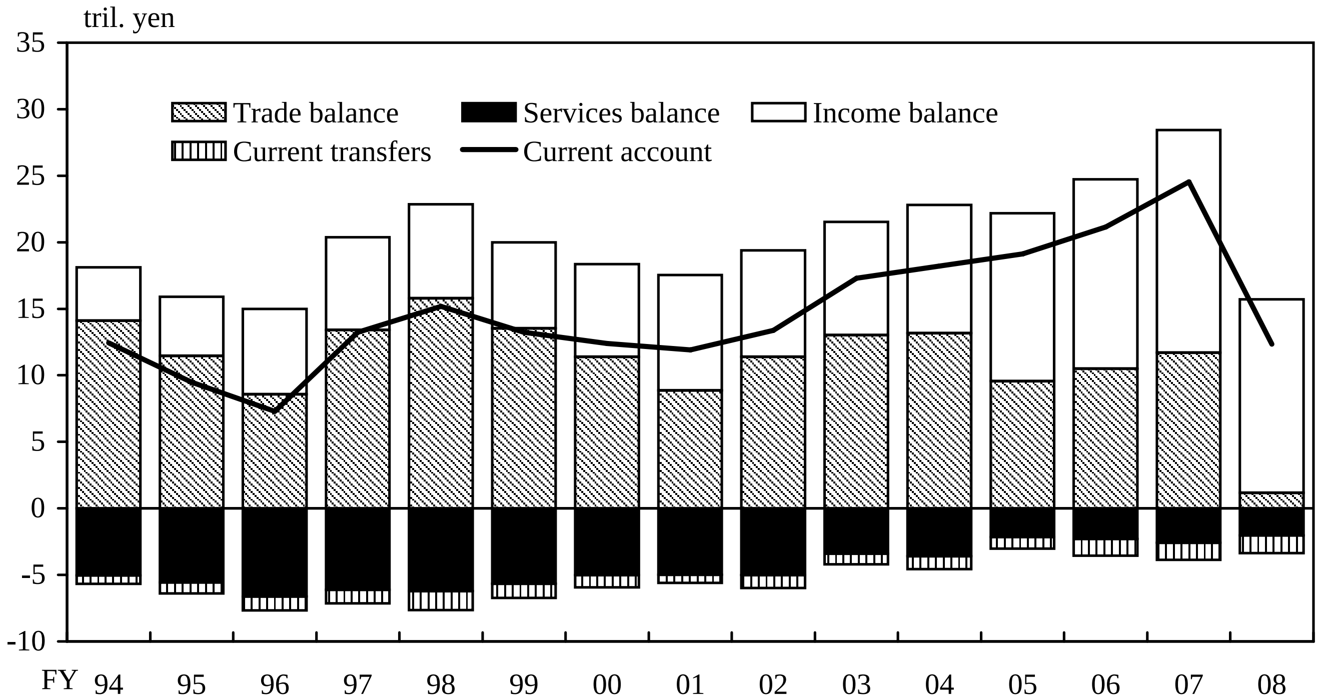
Investment-Saving Balance

(1) Investment-Saving Balance



Note: The forecast is made by the Research and Statistics Department, Bank of Japan.
For the forecasting procedure, see chart 25 in "Outlook for Economic Activity and Prices" (April 2009).

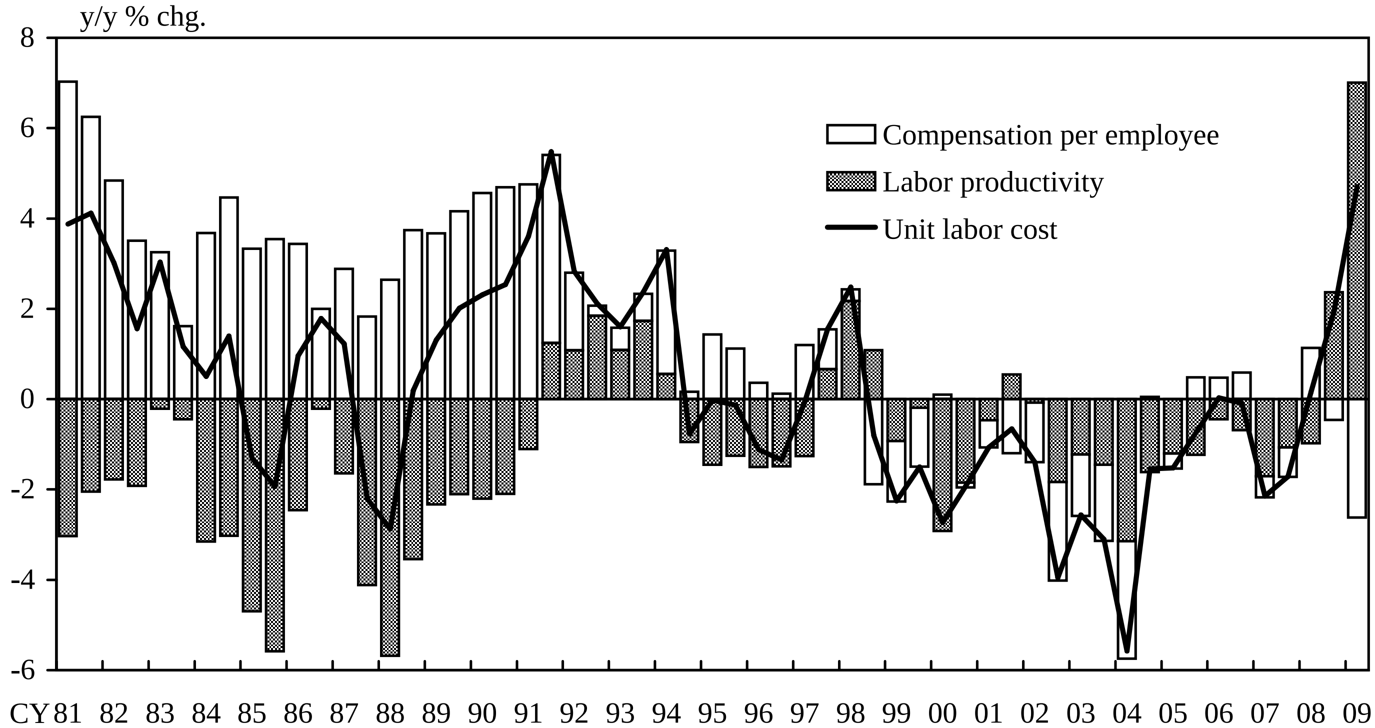
(2) Current Account



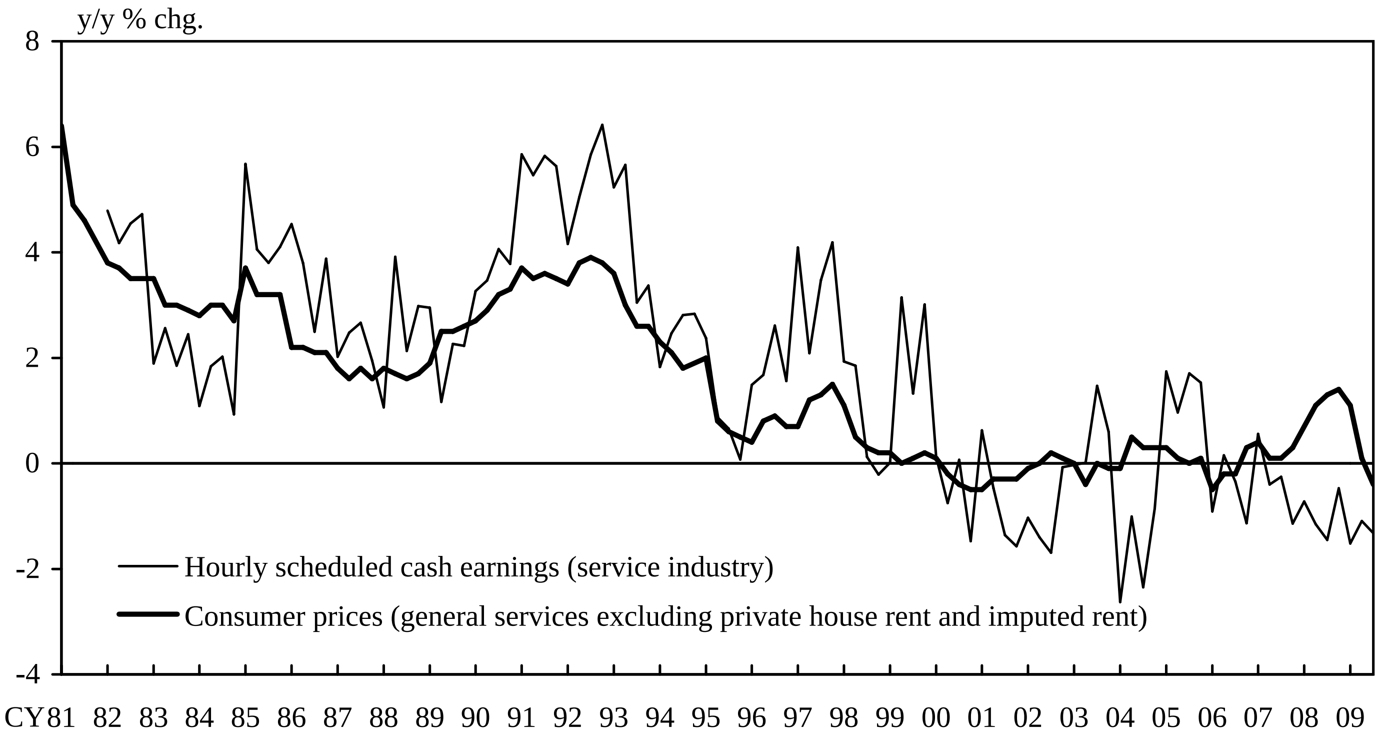
Sources: Cabinet Office, "National Accounts," "The Medium- to Long-term Projections for Comparative Analysis of Alternative Economic Scenarios and Fiscal Assumptions"; Ministry of Finance and Bank of Japan, "Balance of Payments."

Wages and Prices

(1) Unit Labor Cost



(2) Service Prices and Wages[1,2]

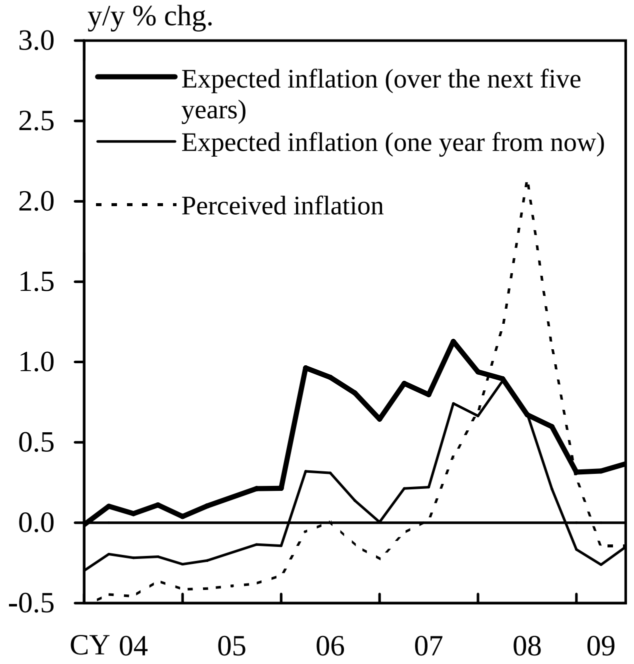


Notes: 1. For the particular definitions of figures, see Chart 26 in "Outlook for Economic Activity and Prices" (April 2009).
2. Figures for 2009/Q3 are the July-August averages.

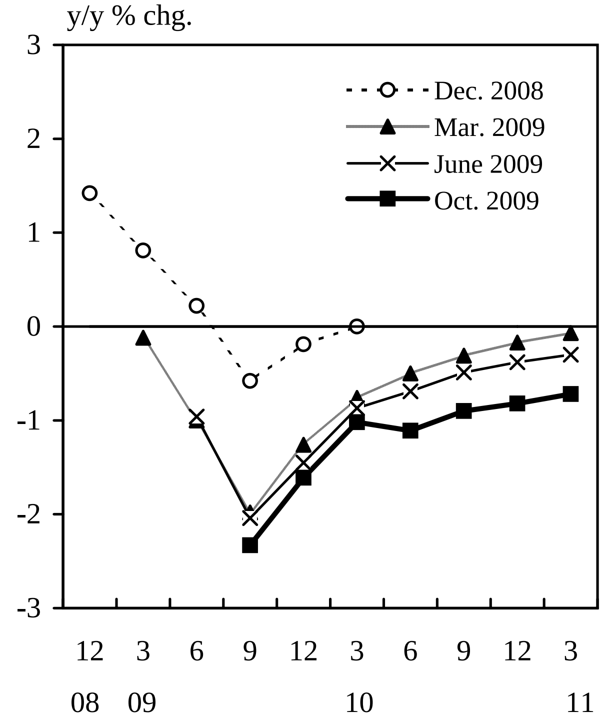
Sources: Ministry of Health, Labour and Welfare, "Monthly Labour Survey"; Cabinet Office, "National Accounts"; Ministry of Internal Affairs and Communications, "Labour Force Survey," "Consumer Price Index."

Inflation Expectations

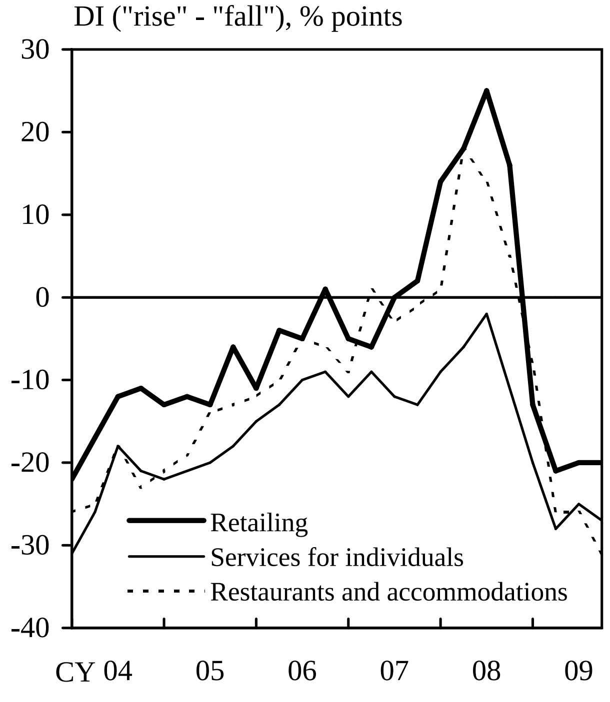
(1) Households[1]



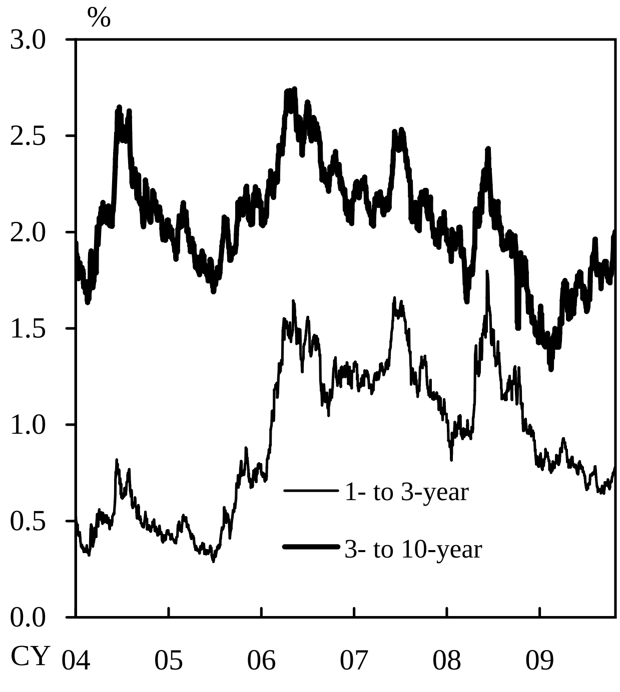
(2) Economists (ESP Forecast)[2]



(3) Firms (*Tankan*)[3]



(4) Implied Forward Rates[4]

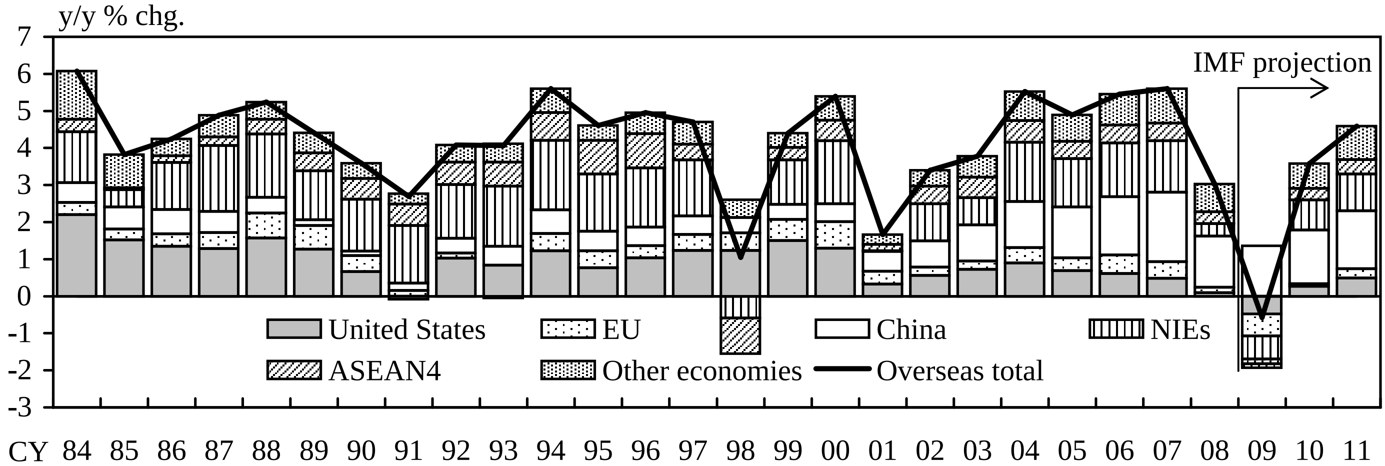


Notes: 1. Figures are estimated based on the results of "Opinion Survey on the General Public's Views and Behavior," using a modified Carlson-Parkin method. For details, see Sekine, Yoshimura, and Wada (2008), "On Inflation Expectations," Bank of Japan Review Series, 2008-J-15 (available in Japanese only).
2. Figures are the average of economists' projections in the ESP Forecast for year on year CPI inflation rate.
3. Change in output prices of all-size enterprises (forecasts of one quarter ahead) in the *Tankan.*
4. Figures are calculated from yen-yen swap rates.

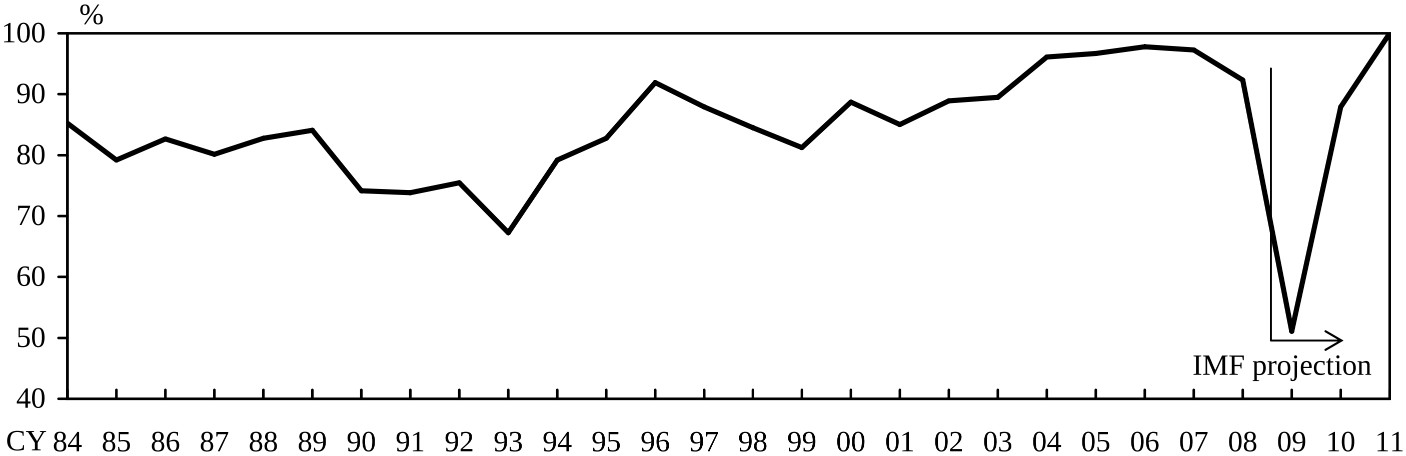
Sources: Bank of Japan, "Opinion Survey on the General Public's Views and Behavior," "*Tankan*, Short-Term Economic Survey of Enterprises in Japan"; Economic Planning Association, "ESP Forecast"; Bloomberg.

Overseas Economies

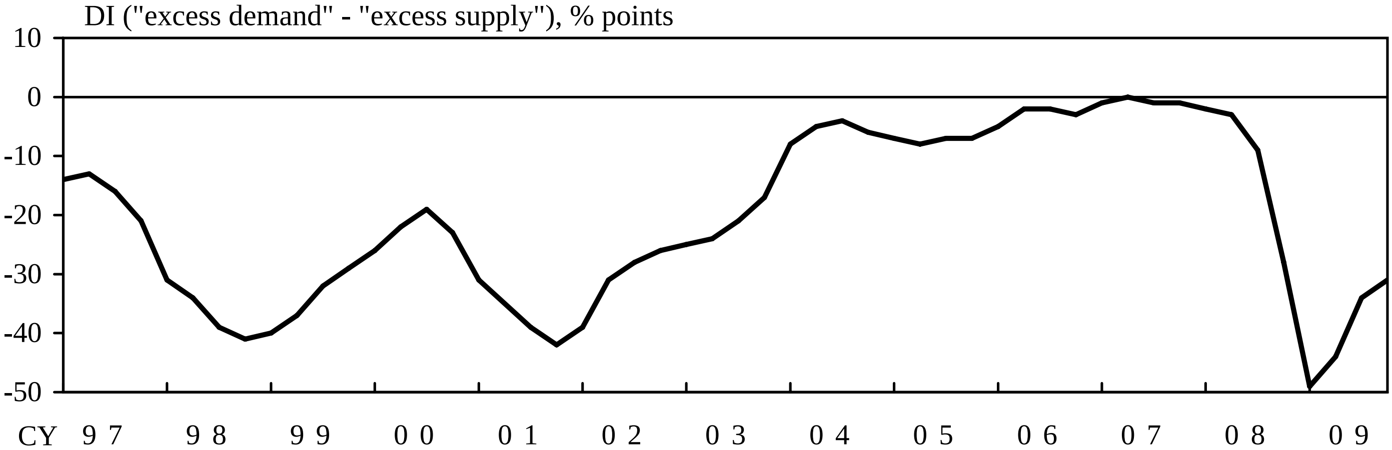
(1) Real GDP Growth Rates of Overseas Economies[1]



(2) Percentage Share of the Number of Economies Recording Positive Real GDP Growth



(3) Overseas Supply and Demand Conditions for Products DI[2,3]

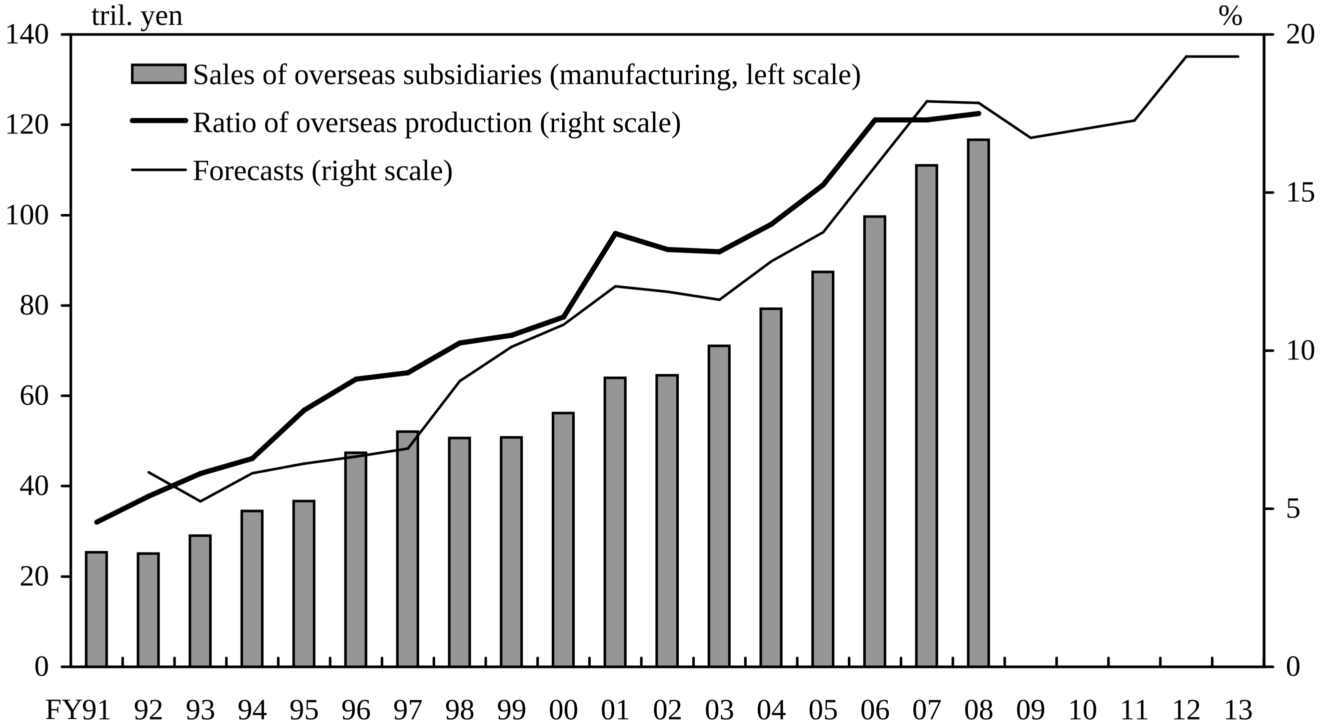


Notes: 1. Real GDP growth rate of the overseas total is the weighted average of real GDP growth rates by value of exports from Japan to each economy.
2. Figures of the DI are based on all-size enterprises and all industries.
3. Figures of the DI for 2009/Q4 are the forecasts in the September 2009 survey.

Sources: IMF, "World Economic Outlook"; Ministry of Finance, "Trade Statistics"; Bank of Japan, "*Tankan,* Short-Term Economic Survey of Enterprises in Japan."

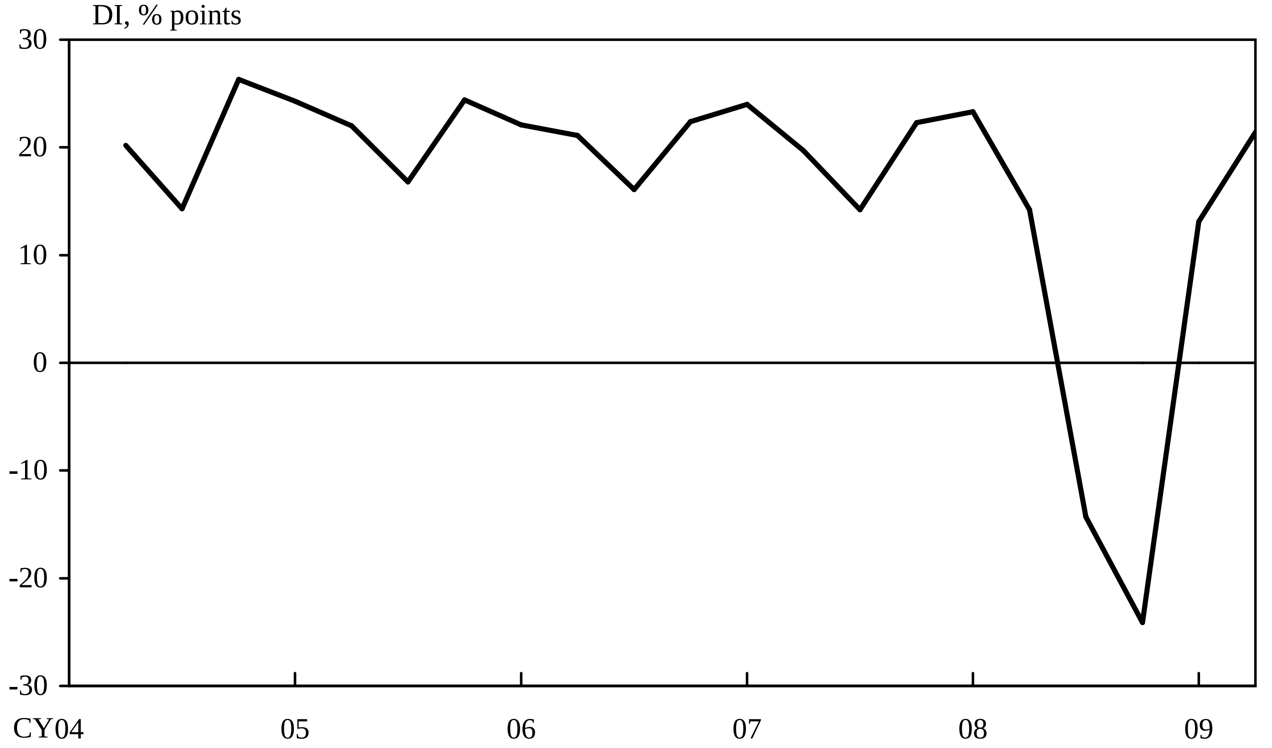
Overseas Subsidiaries

(1) Sales of Overseas Subsidiaries (Manufacturing) and Ratio of Overseas Production



Notes: 1. Sales of overseas subsidiaries and ratio of overseas production for fiscal 2008 are estimates by responding companies.
2. For each year in the x-axis, the forecast is made five years earlier.

(2) Sales Prospects DI of Overseas Subsidiaries (Manufacturing)

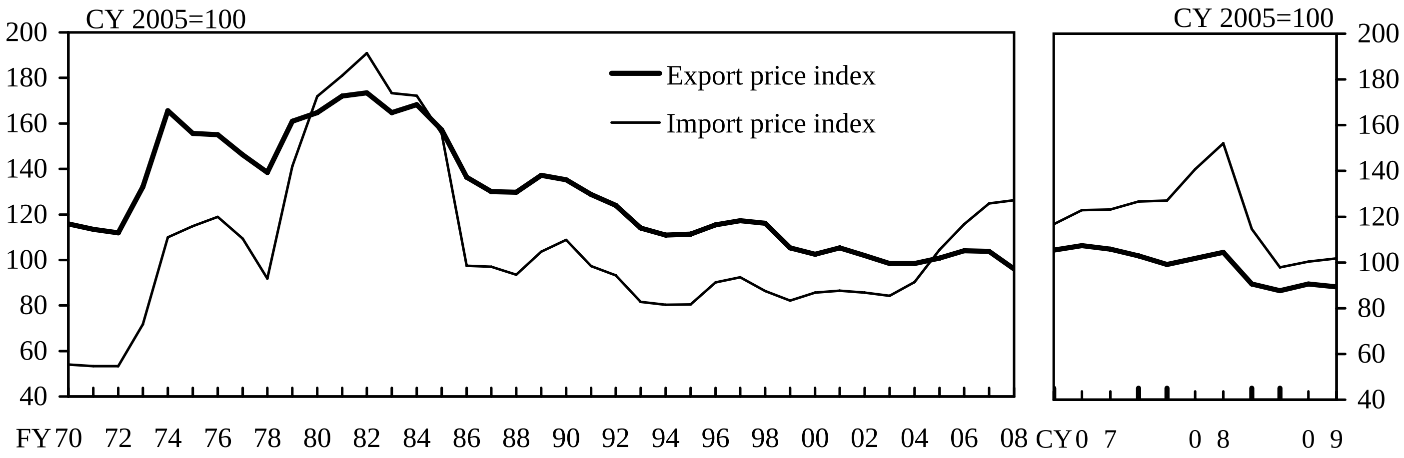


Note: DI = "Proportion of companies that responded that they would expect an increase" - "Proportion of companies that responded that they would expect a decrease."

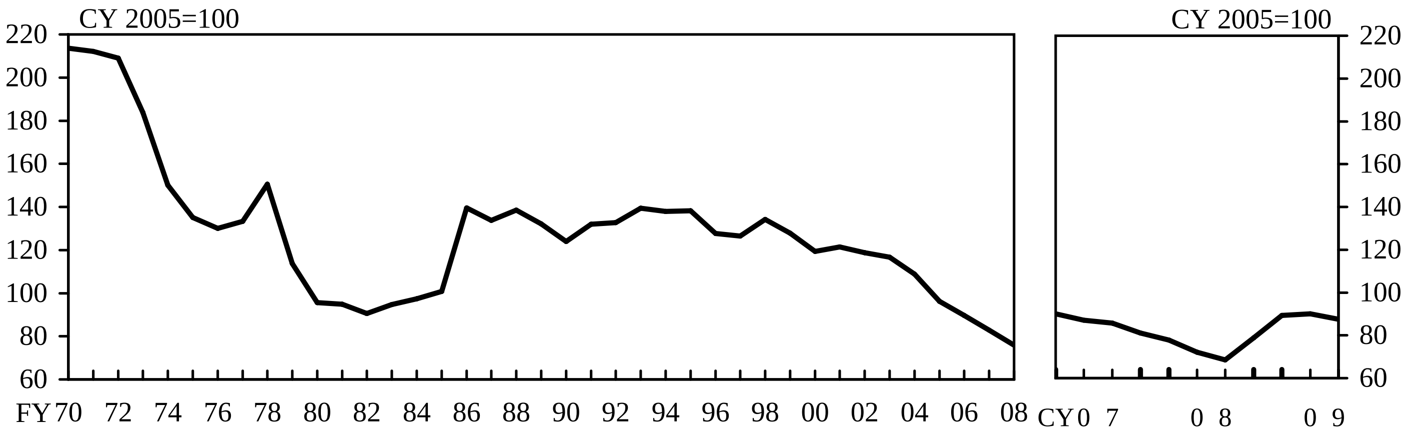
Sources: Ministry of Economy, Trade and Industry, "Survey of Overseas Business Activities," "Quarterly Survey of Overseas Subsidiaries"; Cabinet Office, "Annual Survey of Corporate Behavior."

Aggregate Income Formation

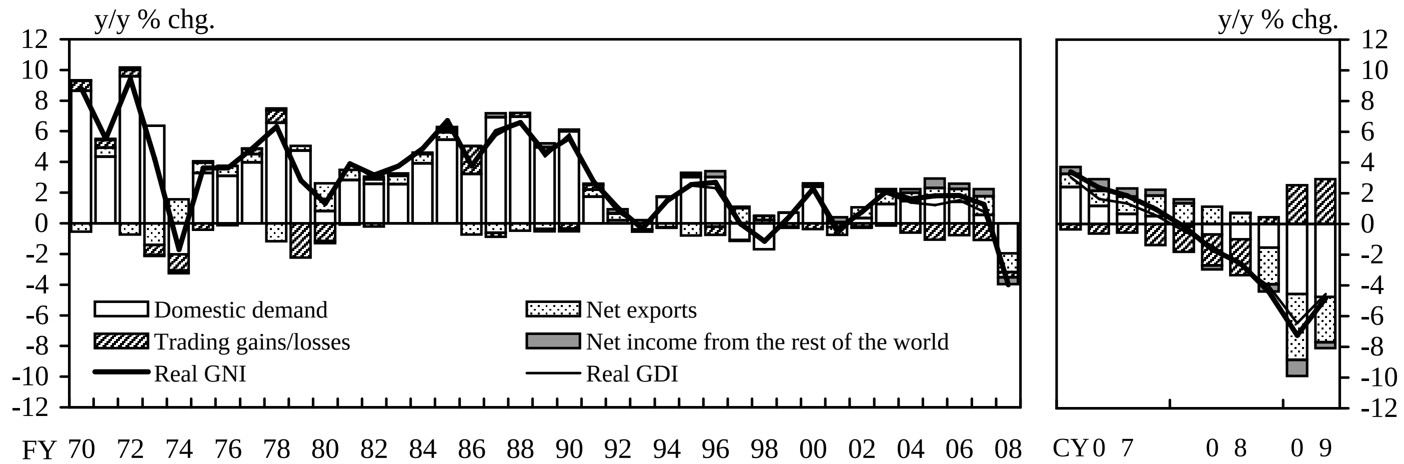
(1) Export and Import Price Indexes[1]



(2) Terms of Trade Index (Export Price Index/Import Price Index)[1]



(3) Real GDI and Real GNI[2,3]



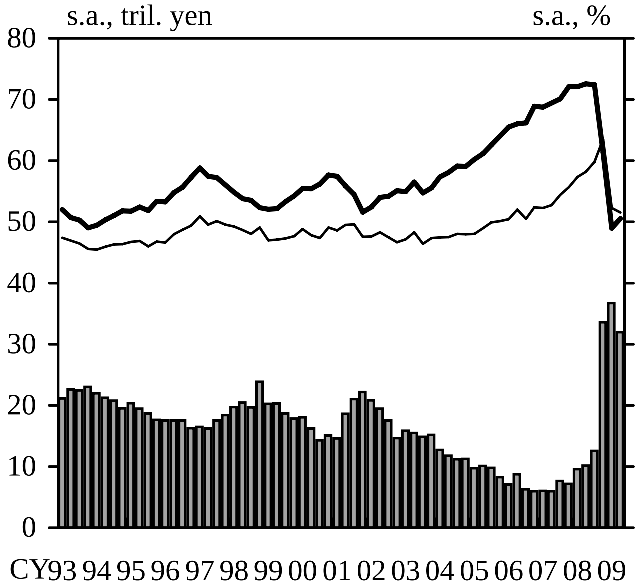
Notes: 1. The price indexes are on a yen basis.
2. Figures of components indicate their contributions to changes in real GNI.
3. Real GDP = domestic demand + net exports
Real GDI = real GDP + trading gains/losses
Real GNI = real GDI + net income from the rest of the world
= real GDP + trading gains/losses + net income from the rest of the world

Sources: Cabinet Office, "National Accounts"; Bank of Japan, "Corporate Goods Price Index."

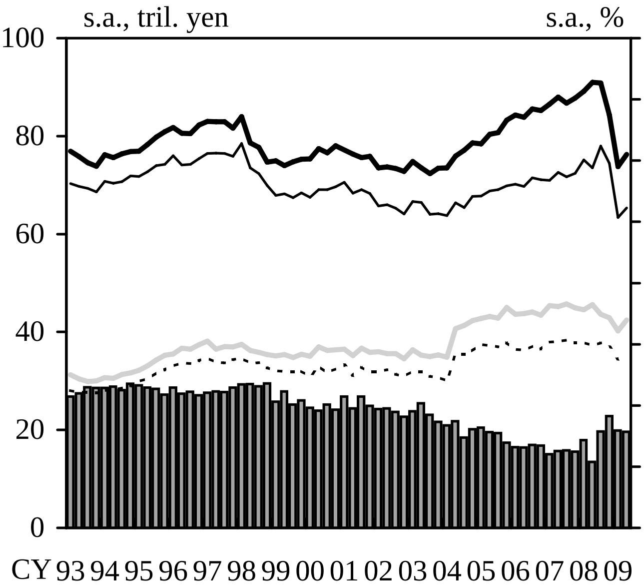
Ratio of Break-Even Point to Sales

(1) Large Enterprises

(a) Manufacturing

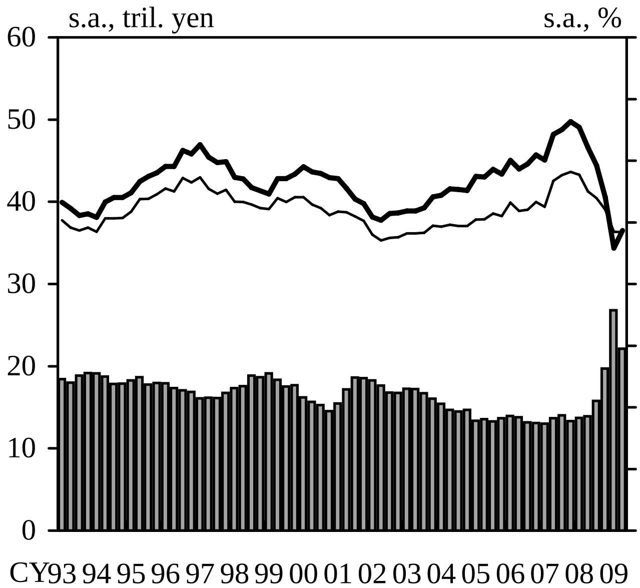


(b) Nonmanufacturing

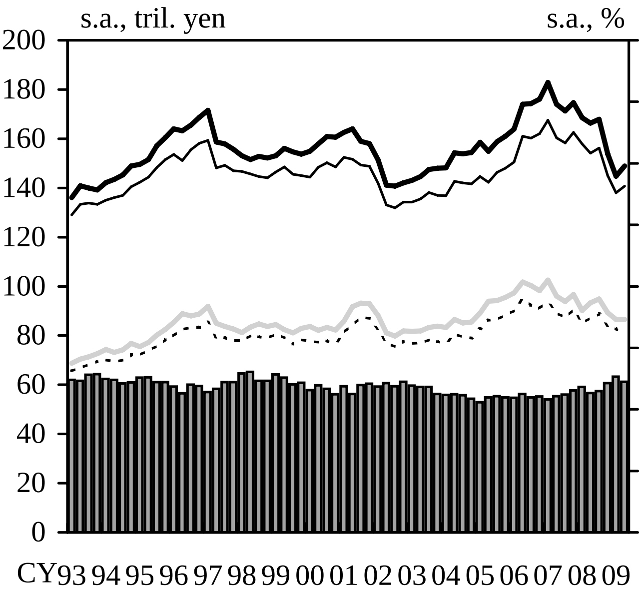


(2) Medium-Sized and Small Enterprises

(a) Manufacturing



(b) Nonmanufacturing



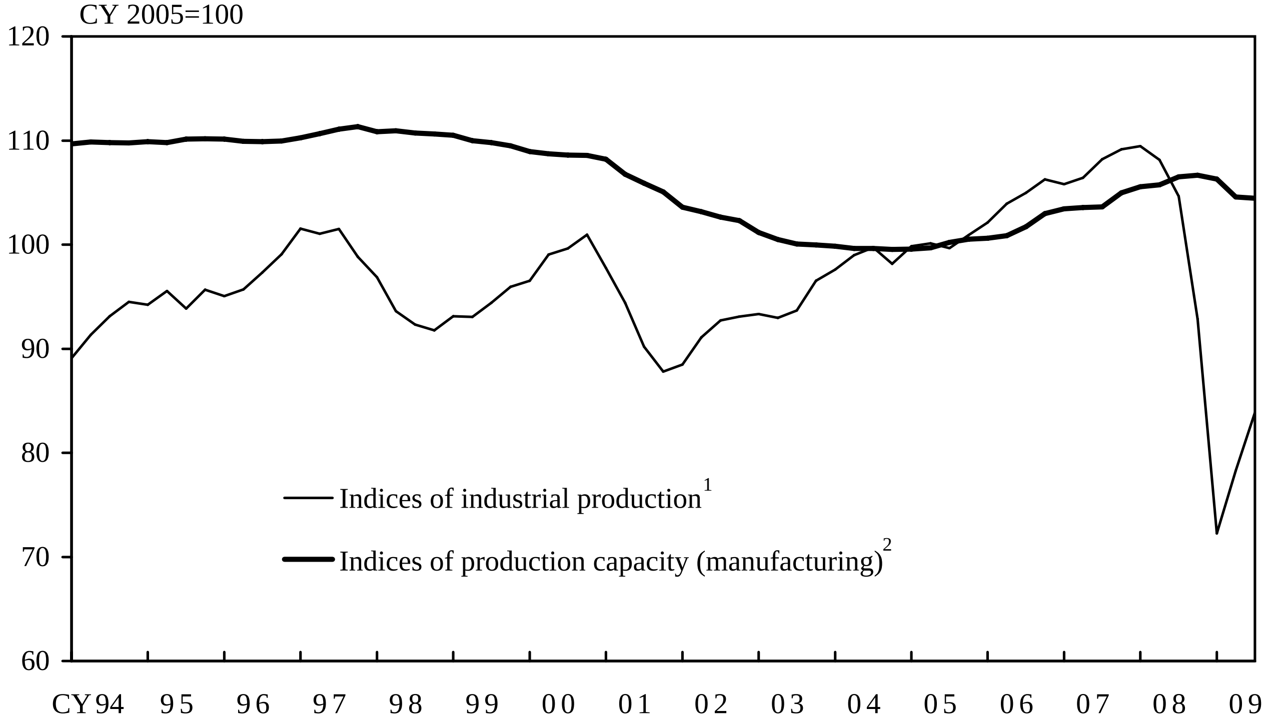
Ratio of break-even point to sales (right scale)
Sales (left scale)
Break-even point (left scale)
Sales of nonmanufacturing excluding wholesaling and transportation (left scale)
Break-even point of nonmanufacturing excluding wholesaling and transportation (left scale)

Notes: 1. For the particular definitions of figures, see Chart 32 in "Outlook for Economic Activity and Prices" (April 2009).
2. "Large enterprises" refers to enterprises with capital stock of 1 billion yen or more, and "medium-sized and small enterprises" refers to enterprises with capital stock of 10 million yen or more but less than 1 billion yen.

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

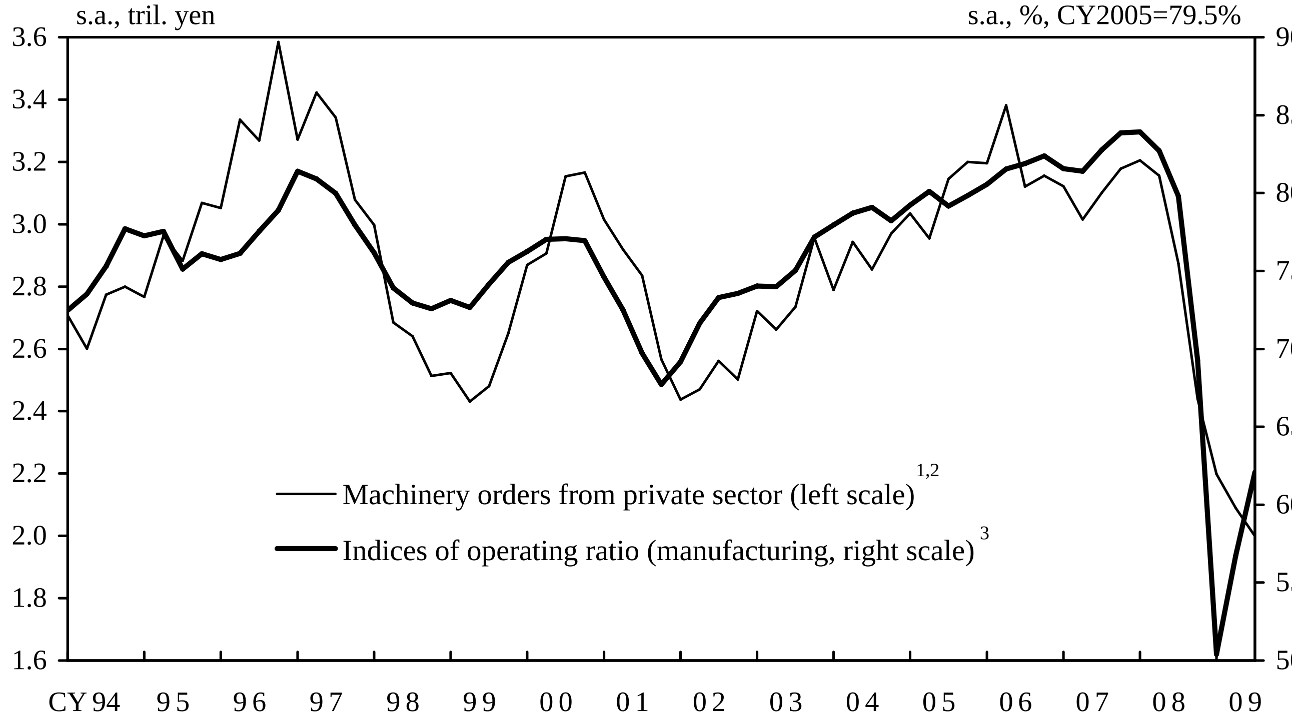
Production Capacity and Capacity Utilization

(1) Industrial Production and Production Capacity



Notes: 1. Seasonally adjusted.
2. The figure for 2009/Q3 is the July-August average.

(2) Capacity Utilization and Machinery Investment

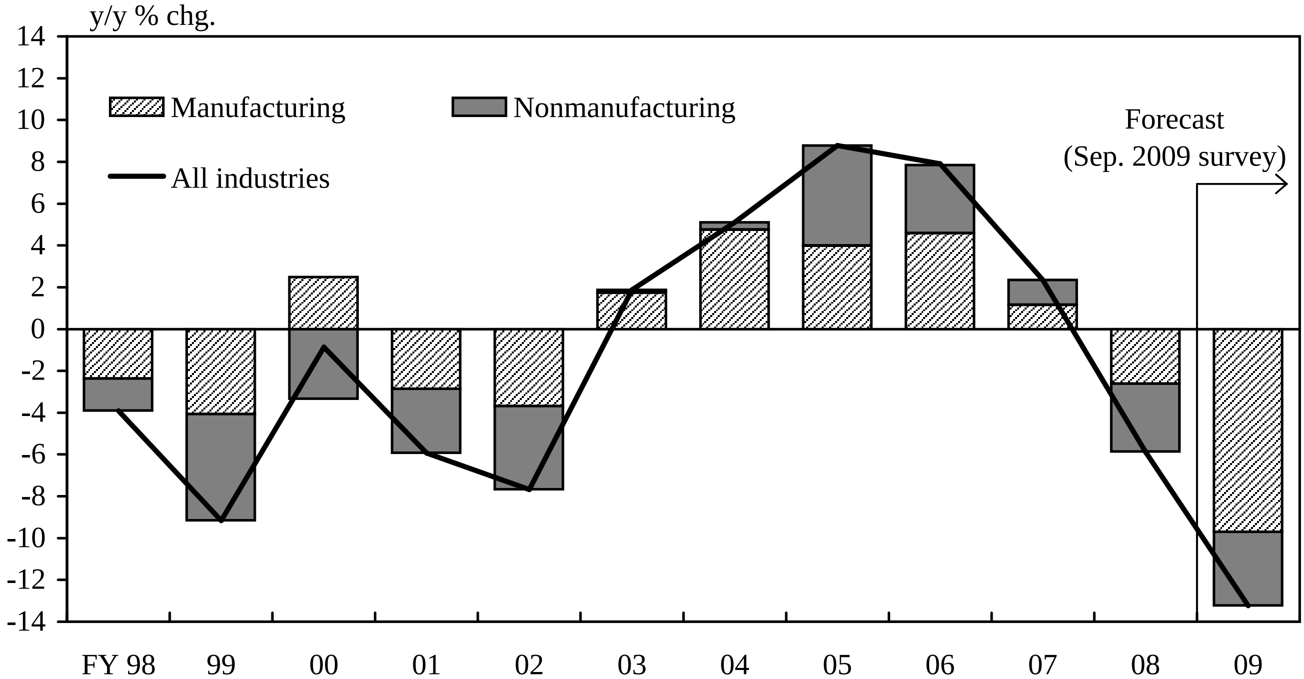


Notes: 1. Excluding orders related to ships and those made by electric power companies.
2. The figure for 2009/Q3 is the average of July-August in terms of quarterly amount.
3. The figure for 2009/Q3 is the July-August average.

Sources: Ministry of Economy, Trade and Industry, "Indices of Industrial Production"; Cabinet Office, "Orders Received for Machinery."

Fixed Investment Plans

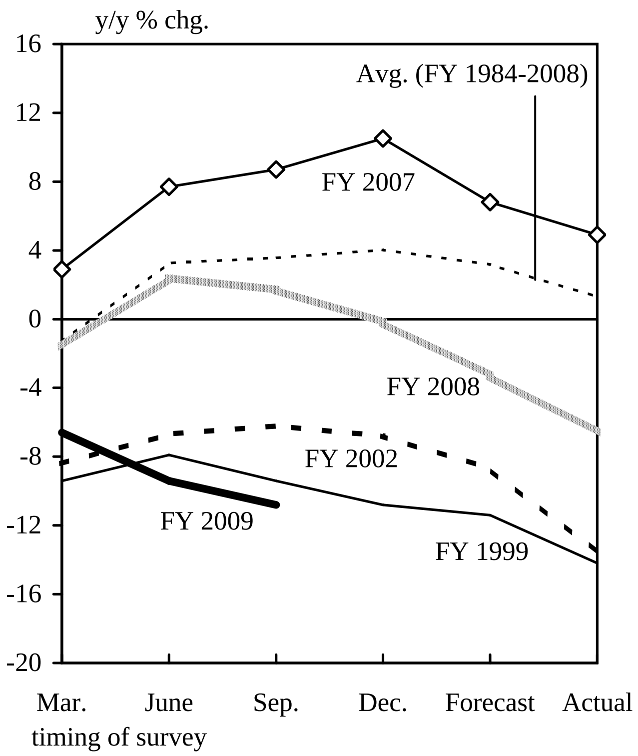
(1) Fixed Investment Plans as Surveyed (*Tankan,* All-Size Enterprises)



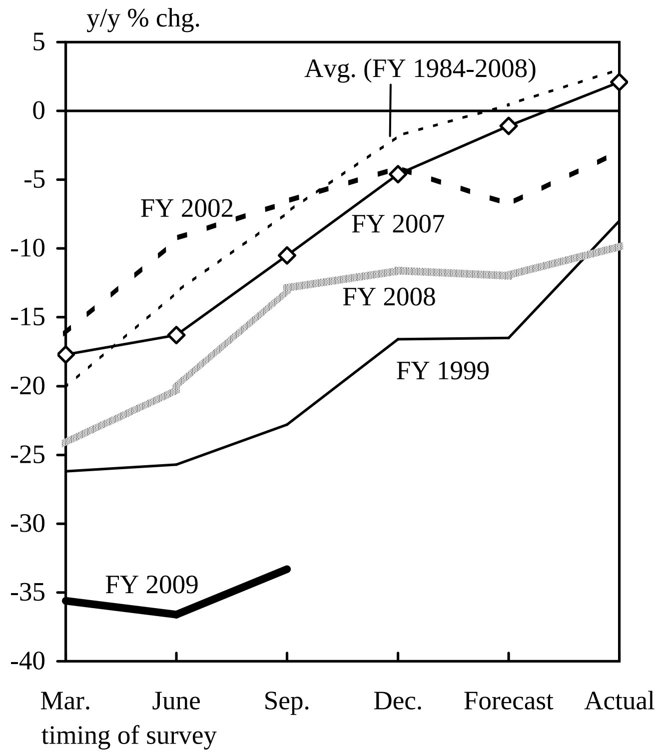
Note: Figures up to fiscal 2002 include land purchasing expenses and exclude software investment.
Figures from fiscal 2003 exclude land purchasing expenses and include software investment.

(2) Developments of Fixed Investment Plans (*Tankan,* All Industries)

(a) Large Enterprises



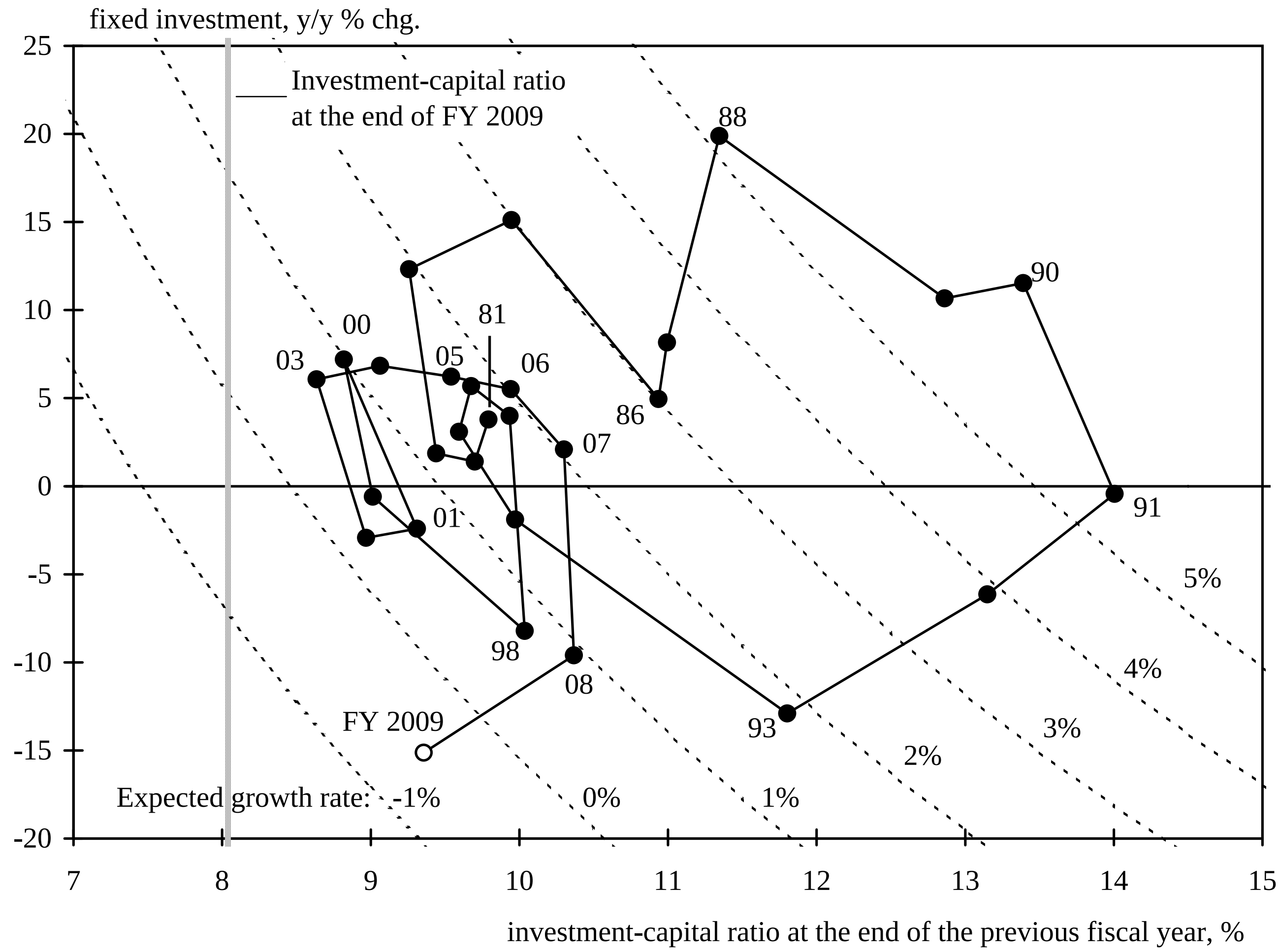
(b) Small Enterprises



Note: Figures include land purchasing expenses and exclude software investment.

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

Capital Stock Cycle



1. Capital stock cycle in the chart shows the relationship between the investment-capital ratio and the year-on-year rate of change in fixed investment.

2. As these variables have the following relation, a hyperbolic curve can be drawn for a given expected growth rate.

   Year-on-year rate of change in fixed investment (y-axis) × investment-capital ratio at the end of the previous fiscal year (x-axis) = expected growth rate + trend growth rate of capital coefficient + depreciation rate

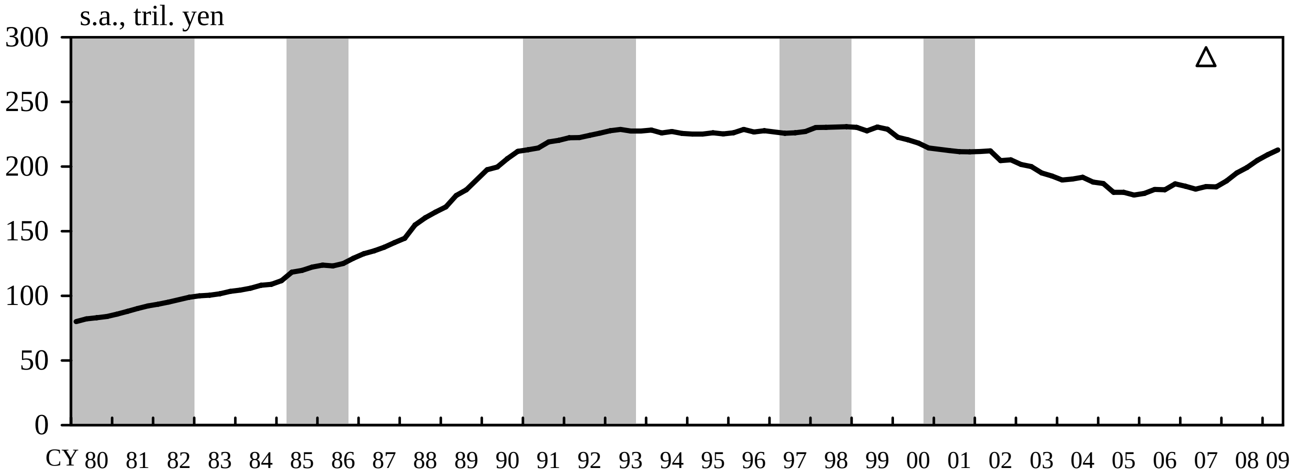
3. The phase of fixed investment at a certain time can be evaluated in relation to the hyperbolic curve corresponding to the expected growth rate at that time.

Note: Figures for fiscal 2009 are calculated based on the annualized value of fixed investment in 2009/Q2.

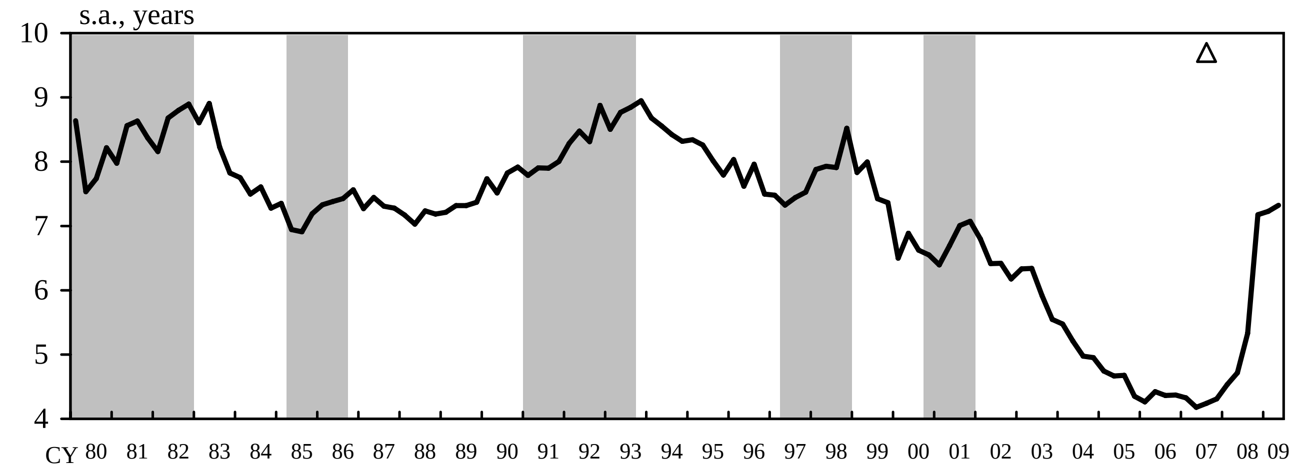
Sources: Cabinet Office, "National Accounts," "Annual Report on Gross Capital Stock of Private Enterprises," "Preliminary Quarterly Estimates of Gross Capital Stock of Private Enterprises"; Ministry of Economy, Trade and Industry, "Census of Manufactures"; Research Institute of Economy, Trade and Industry, "Japan Industrial Productivity Database 2009."

Corporate Financial Position

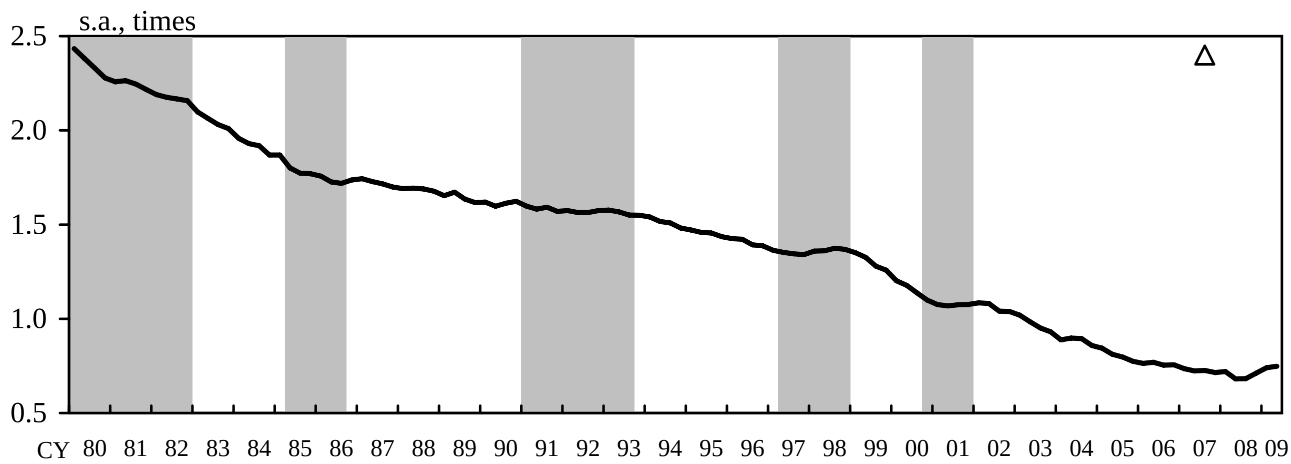
(1) Interest-Bearing Debt



(2) Interest-Bearing Debt/Cash Flow



(3) Interest-Bearing Debt/Equity Capital

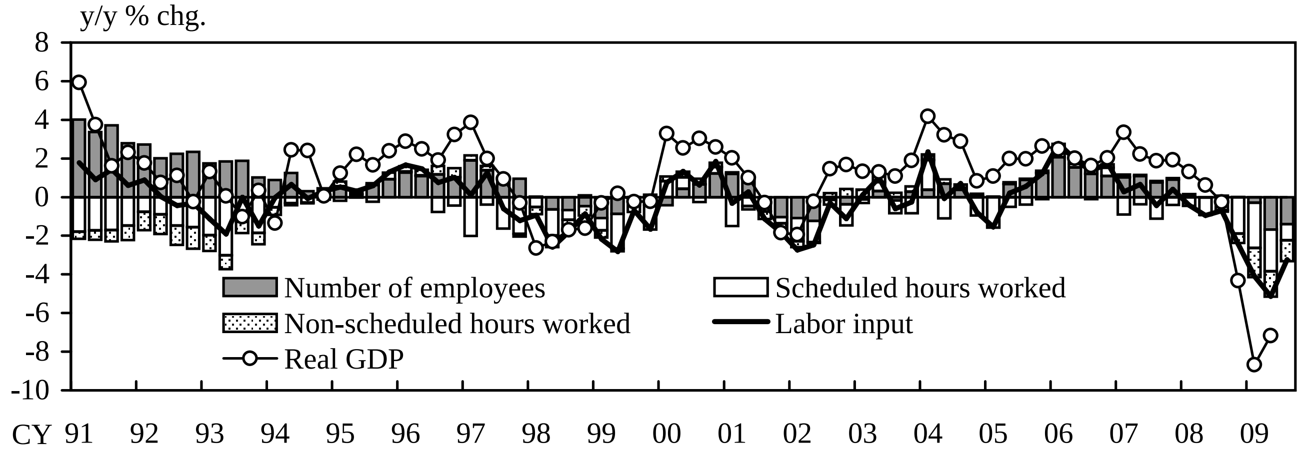


Notes: 1. Figures refer to enterprises with capital stock of 1 billion yen or more.
2. Interest-bearing debt = long-and short-term borrowings + bonds
3. Cash flow = annualized depreciation expenses + annualized ordinary profits/2
4. Equity capital = earned surplus + capital surplus + capital stock
5. Shaded areas indicate recession periods. Triangle shows the last peak.

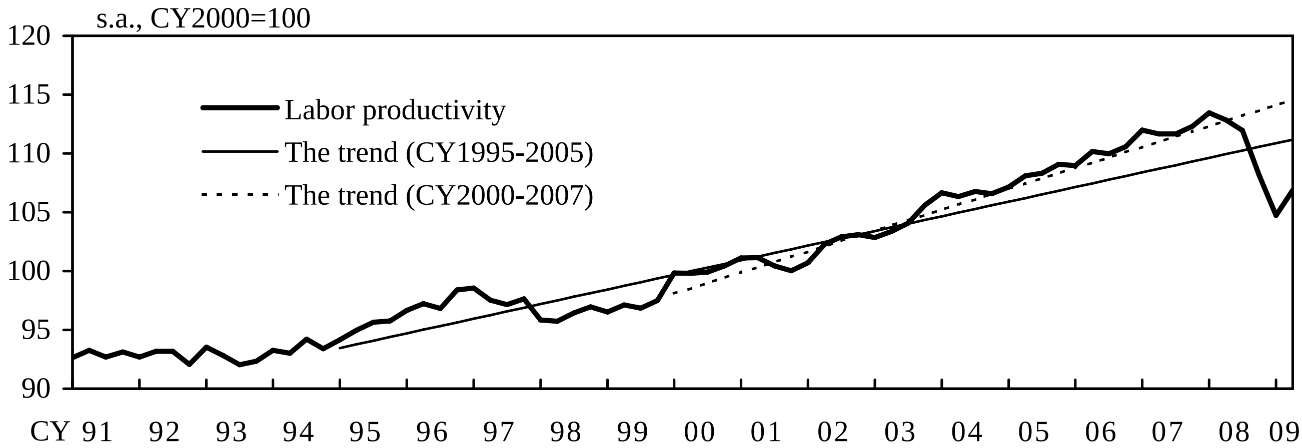
Source: Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Quarterly."

Labor Input and Labor Productivity

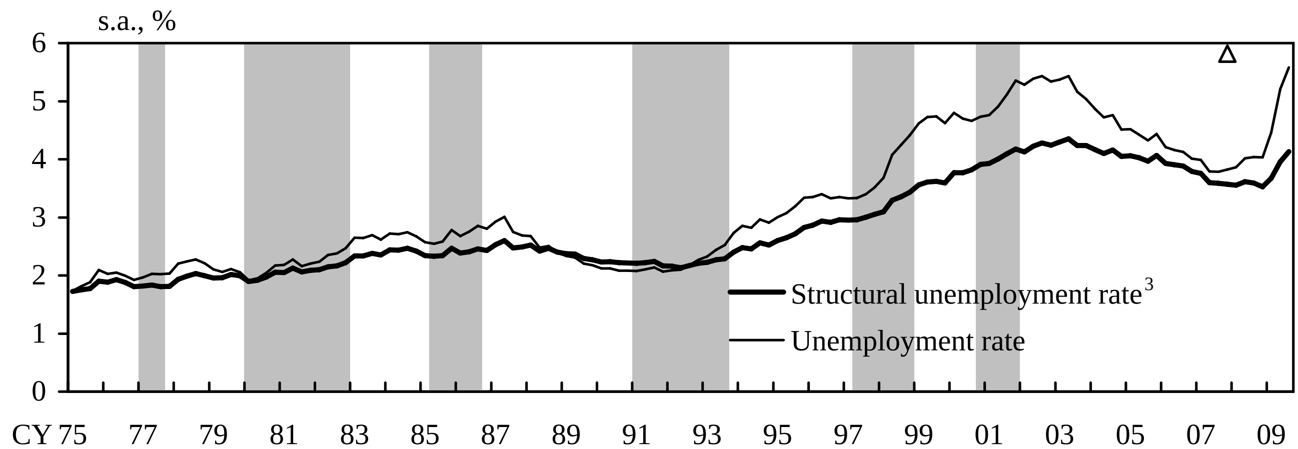
(1) Real GDP and Labor Input[1]



(2) Labor Productivity and the Trend



(3) Unemployment Rate and Structural Unemployment Rate[1,2]

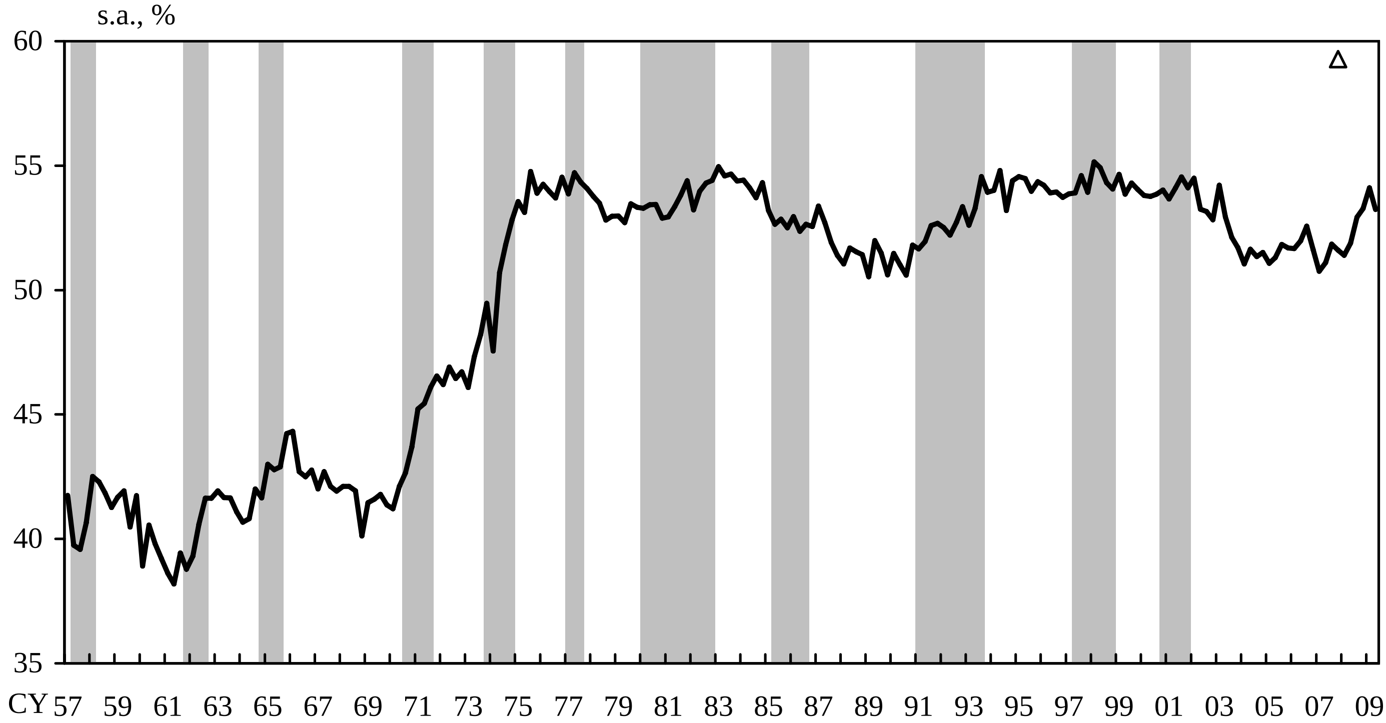


Notes: 1. Figures for 2009/Q3 are the July-August averages.
2. Shaded areas indicate recession periods. Triangle shows the last peak.
3. Figures are estimated by the Research and Statistics Department, Bank of Japan.

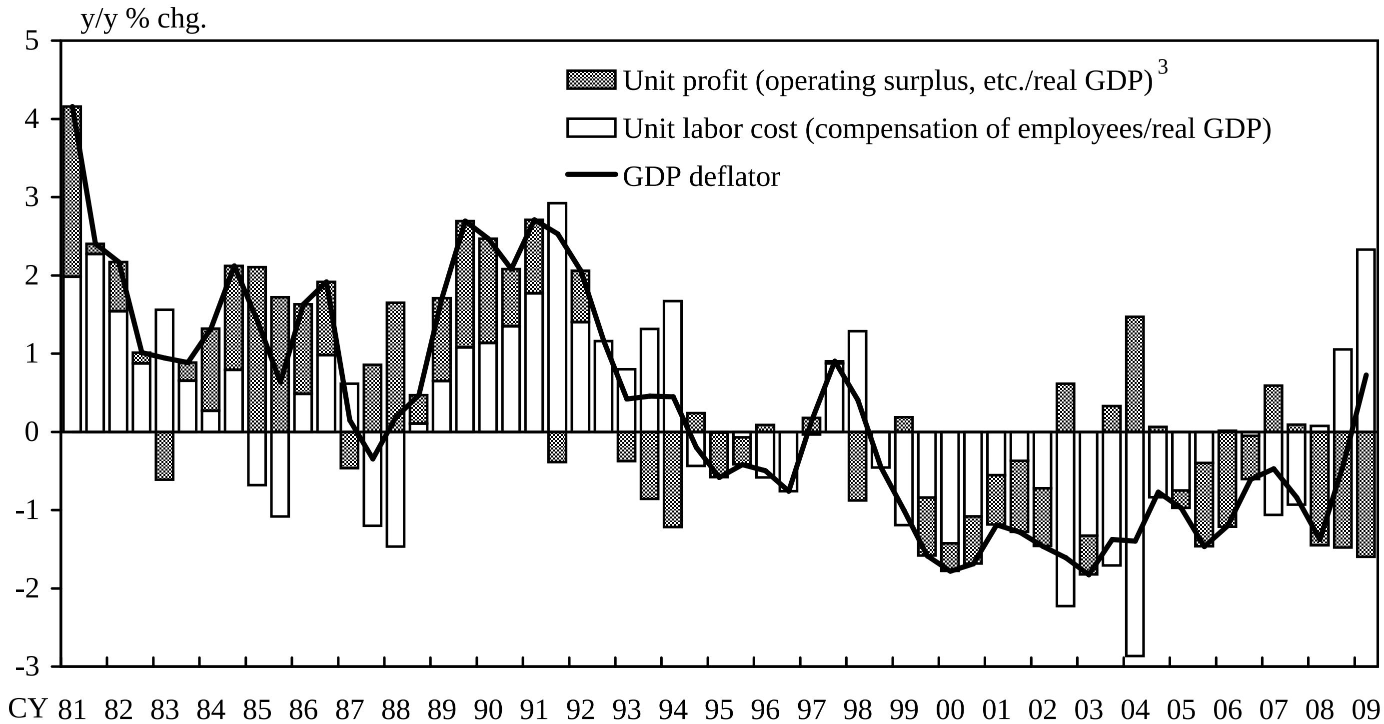
Sources: Ministry of Internal Affairs and Communications, "Labour Force Survey"; Ministry of Health, Labour and Welfare, "Monthly Labour Survey," "Report on Employment Service"; Cabinet Office, "National Accounts."

Labor Share

(1) Labor Share[1,2]



(2) Decomposition of GDP Deflator in Terms of Distribution

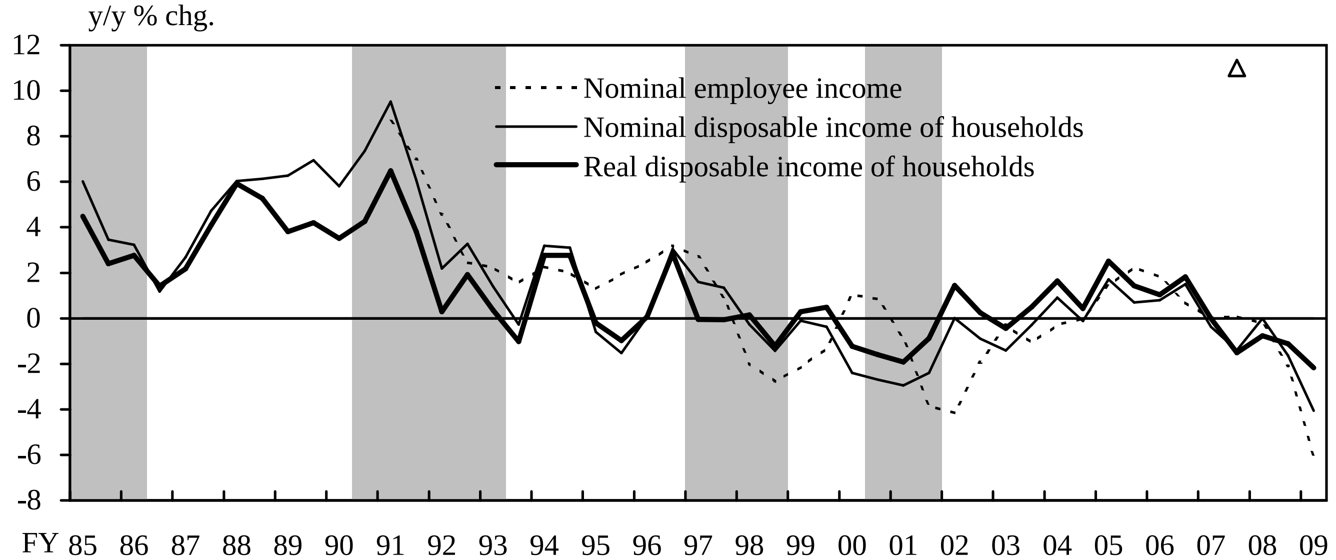


Notes: 1. Labor share = compensation of employees / nominal GDP. Figures prior to 1979/Q4 are based on 68SNA.
2. Shaded areas indicate recession periods. Triangle shows the last peak.
3. Operating surplus, etc. includes: operating surplus and mixed income; consumption of fixed capital; taxes on production and imports; subsidies; and statistical discrepancy.

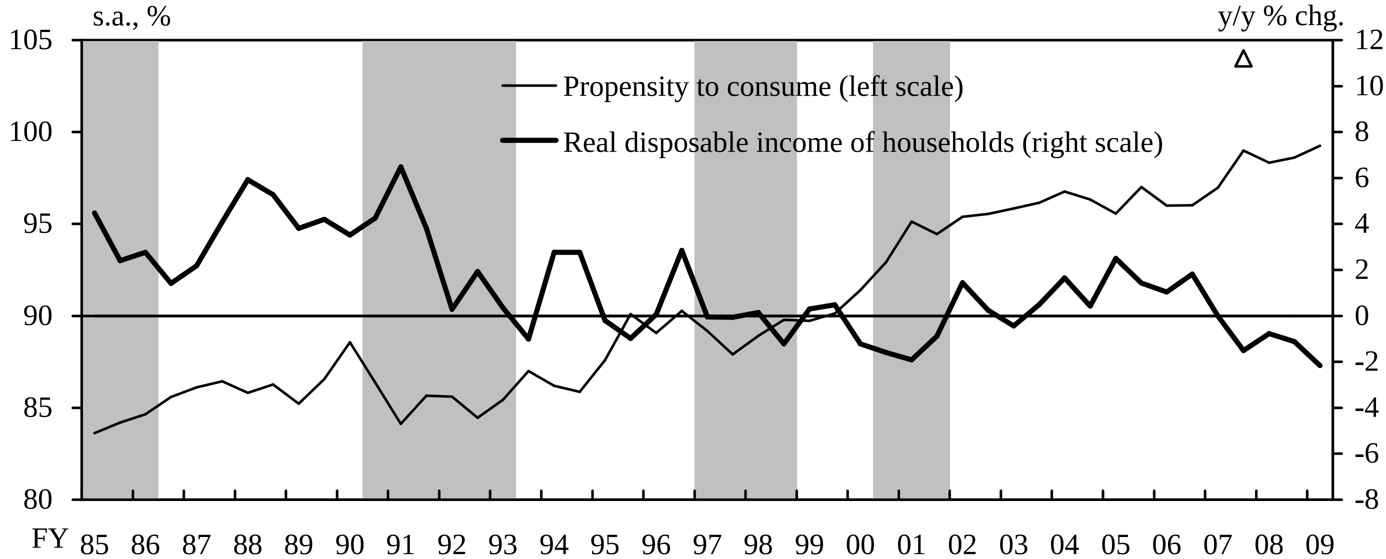
Source: Cabinet Office, "National Accounts."

Disposable Income of Households and Propensity to Consume

(1) Employee Income and Disposable Income of Households



(2) Real Disposable Income of Households and Propensity to Consume

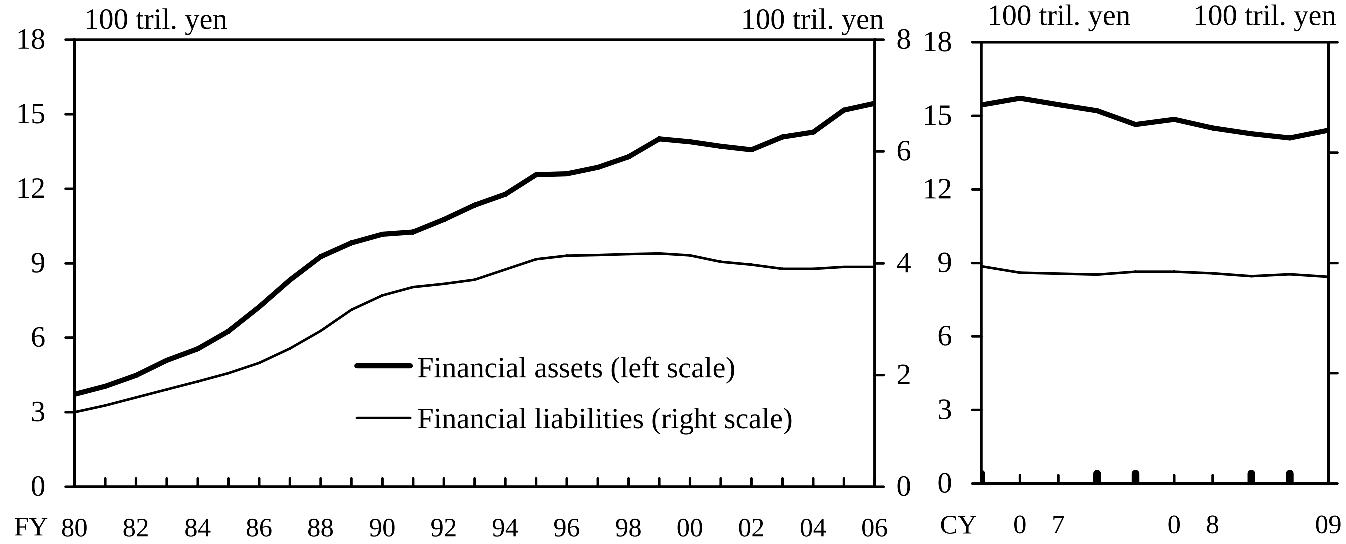


Notes: 1. Shaded areas indicate recession periods. Triangle shows the last peak.
2. Nominal employee income is calculated as the number of employees (Labour Force Survey) multiplied by total cash earnings for establishments with at least five employees (Monthly Labour Survey). The figure for the first half of fiscal 2009 is the April-August average.
3. Figures for nominal disposable income of households and real disposable income of households for fiscal 2008 and 2009 are estimated by the Research and Statistics Department, Bank of Japan. Nominal disposable income of households for the first half of fiscal 2009 includes estimated transfers of income from the government to households through the recent economic policy packages consisting of the fixed-sum benefit; the tax reduction and subsidies for eco-friendly cars; and the eco-point system for household electrical appliances.
4. Figures for propensity to consume for fiscal 2008 and 2009 are estimated by the Research and Statistics Department, Bank of Japan. Propensity to consume is calculated as consumption of households divided by disposable income.

Sources: Cabinet Office, "National Accounts," "Economic Policy Package: Measures to Support People's Daily Lives," "Policy Package to Address Economic Crisis";
Ministry of Internal Affairs and Communications, "Labour Force Survey," "Estimates of Local Tax Revenue";
Ministry of Health, Labour and Welfare, "Monthly Labour Survey";
Ministry of Finance, "Survey of the Amount Settled of Tax and Stamp Revenues," "Financial Statements Statistics of Corporations by Industry, Annually."

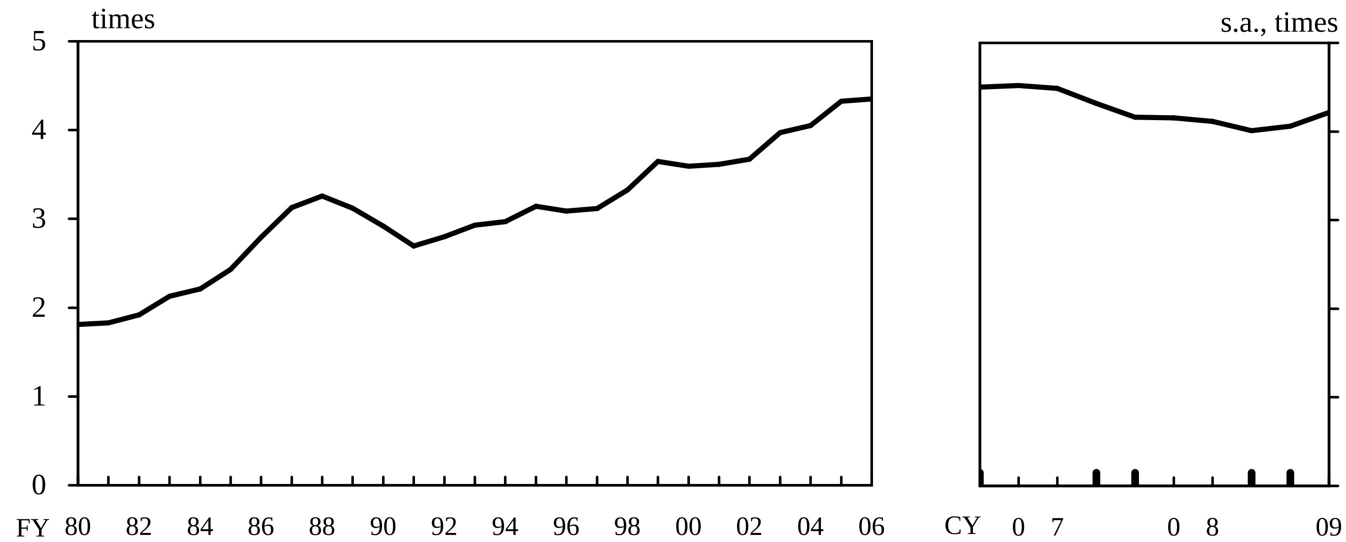
Household Financial Position

(1) Financial Assets and Liabilities



(2) Net Financial Assets

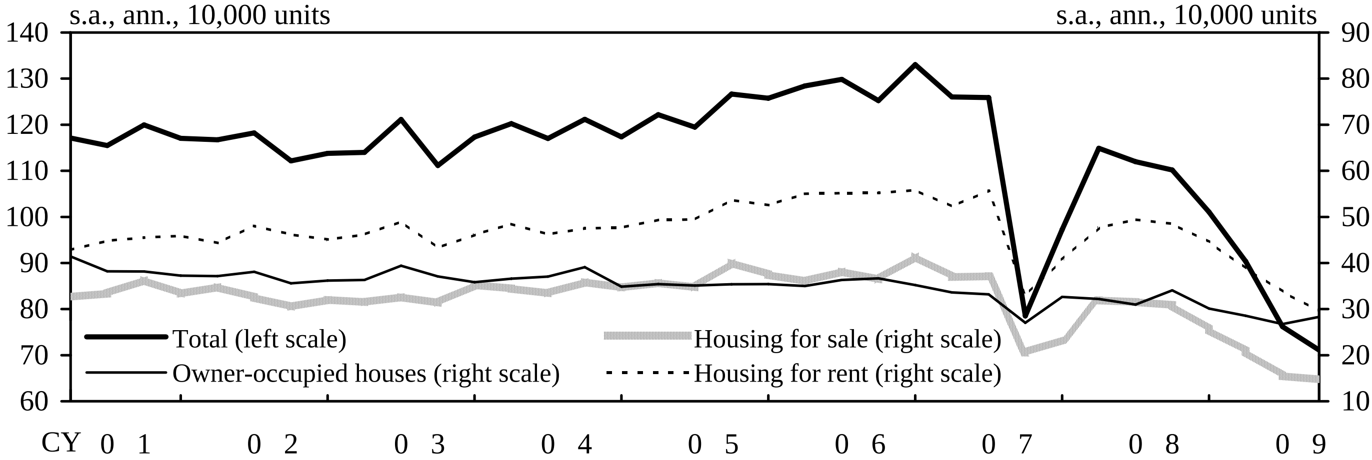
(3) Net Financial Assets/Compensation of Employees



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

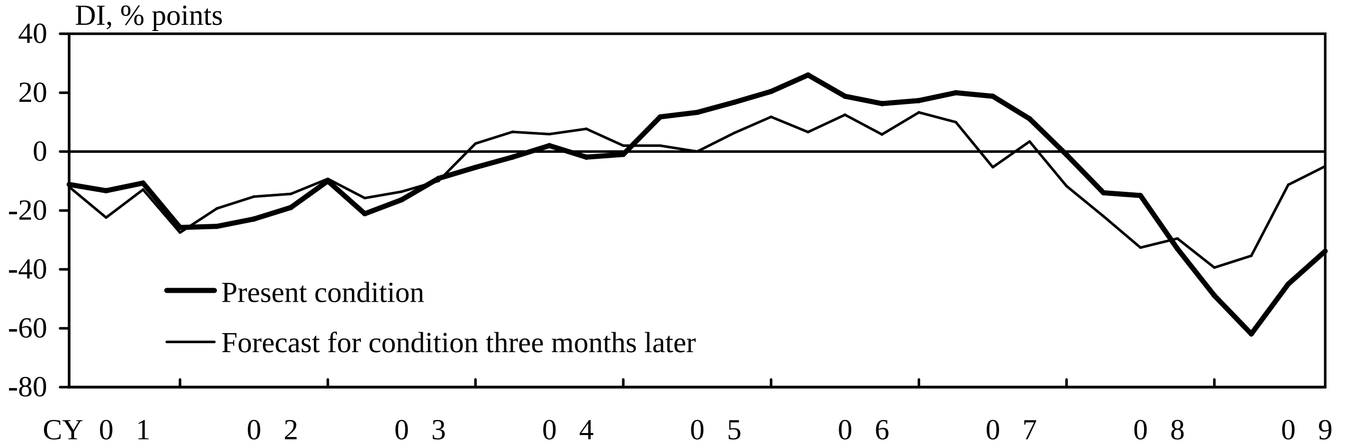
Housing Investment

(1) Housing Starts



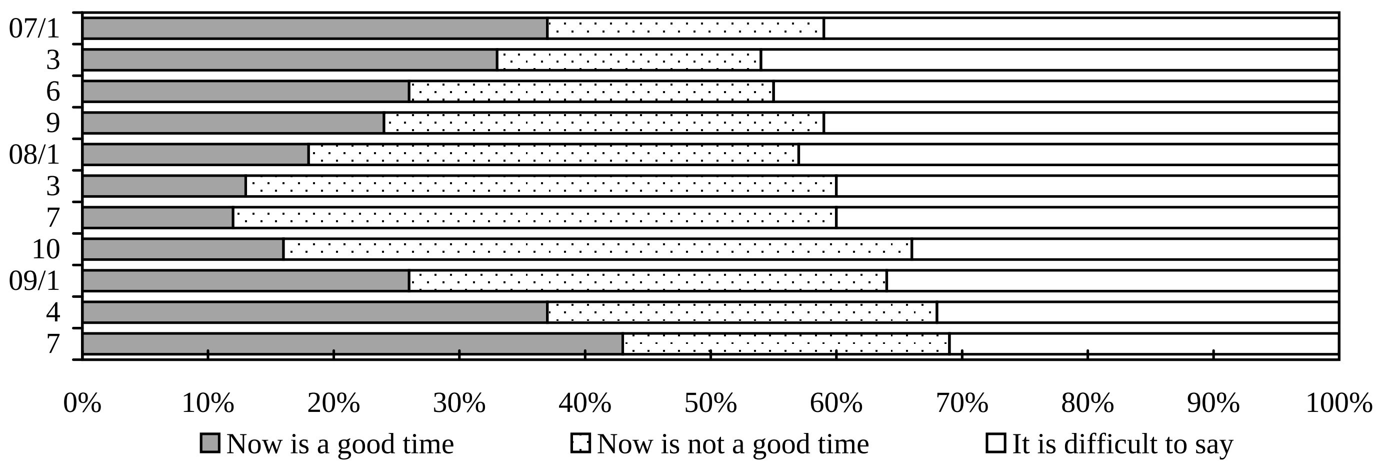
Note: Figures for 2009/Q3 are the July-August averages.

(2) Real Estate Industry Diffusion Index



Notes: 1. DI = {("good" + "slightly good" × 0.5) - ("slightly bad" × 0.5 + "bad")} ÷ total × 100
2. Figures for 2009/Q3 are as of July 1.

(3) Questionnaire Survey on Consumers' Perception of Apartment Purchase

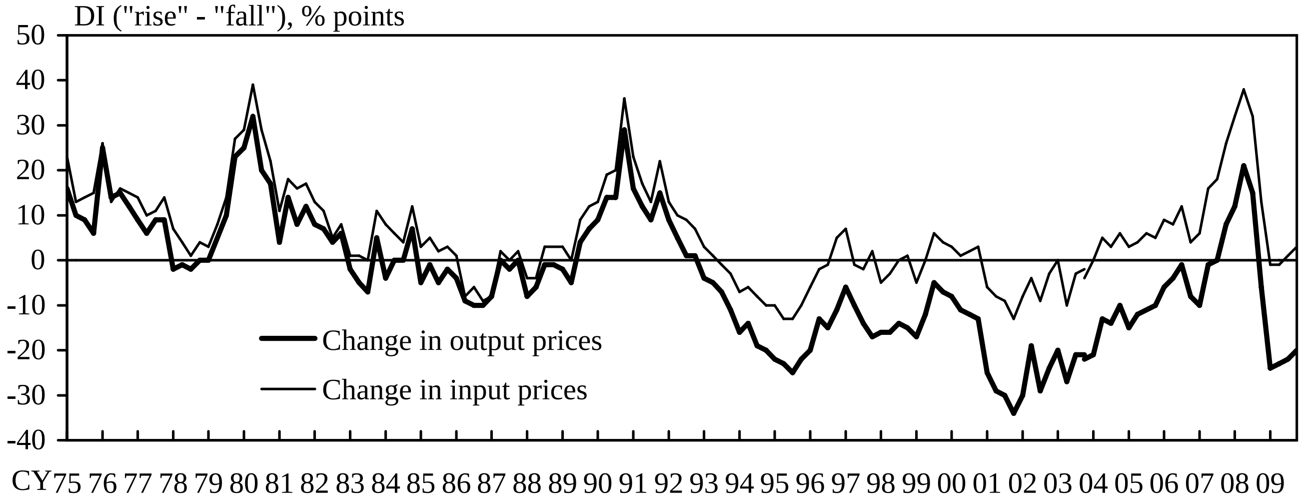


Note: Those surveyed by HASEKO URBEST Inc. were visitors to model apartments in the Tokyo metropolitan area.

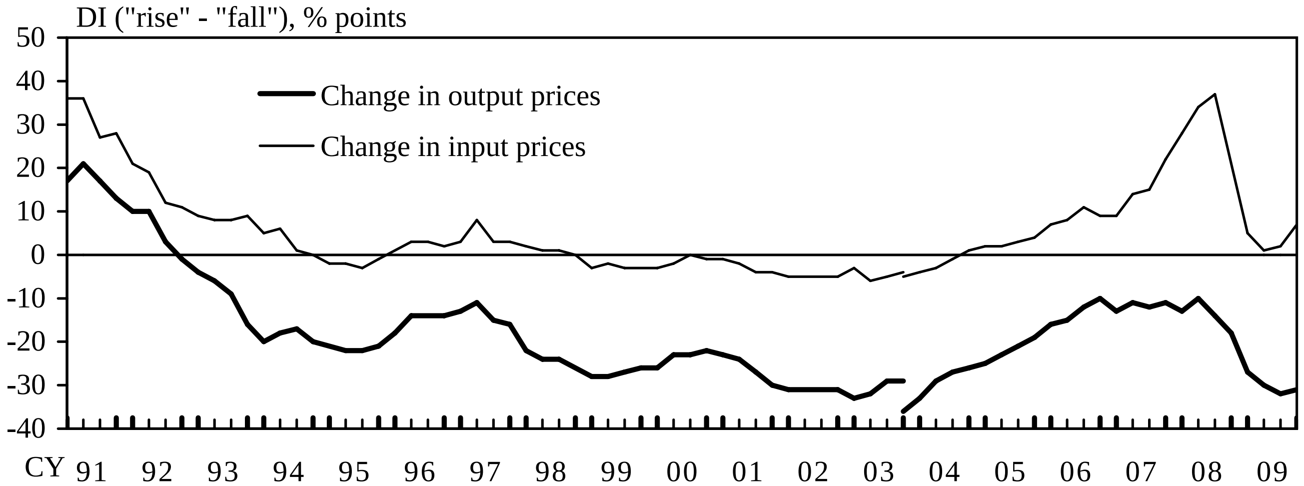
Sources: Ministry of Land, Infrastructure, Transport and Tourism, "Statistics on Building Construction Starts"; The Land Institute of Japan, "Real Estate Industry Diffusion Index"; HASEKO URBEST Inc.

Changes in Output and Input Prices

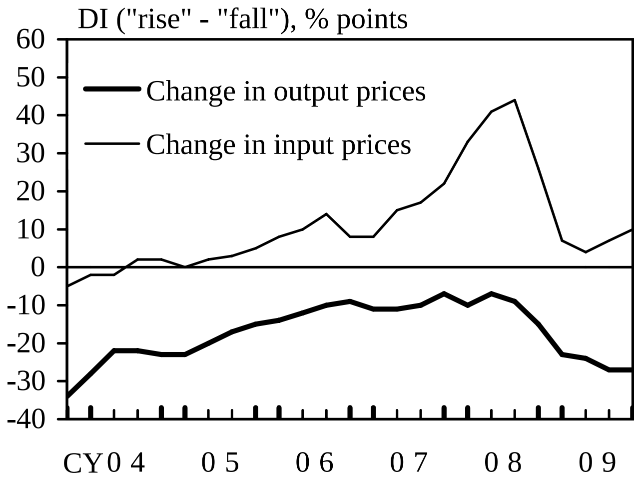
(1) Retailing



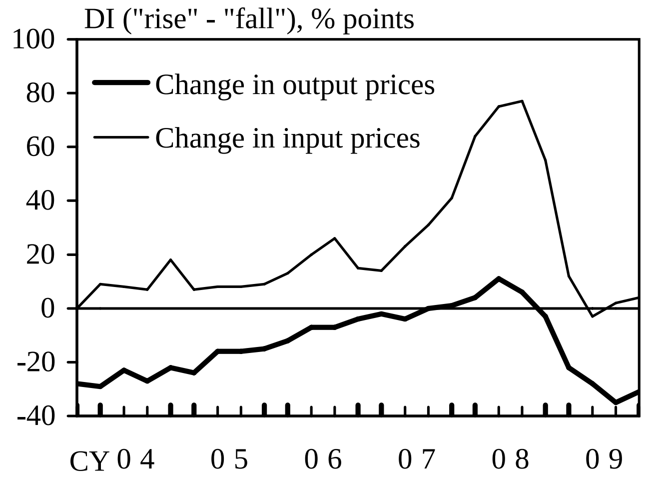
(2) Services



(3) Services for Individuals



(4) Restaurants and Accommodations



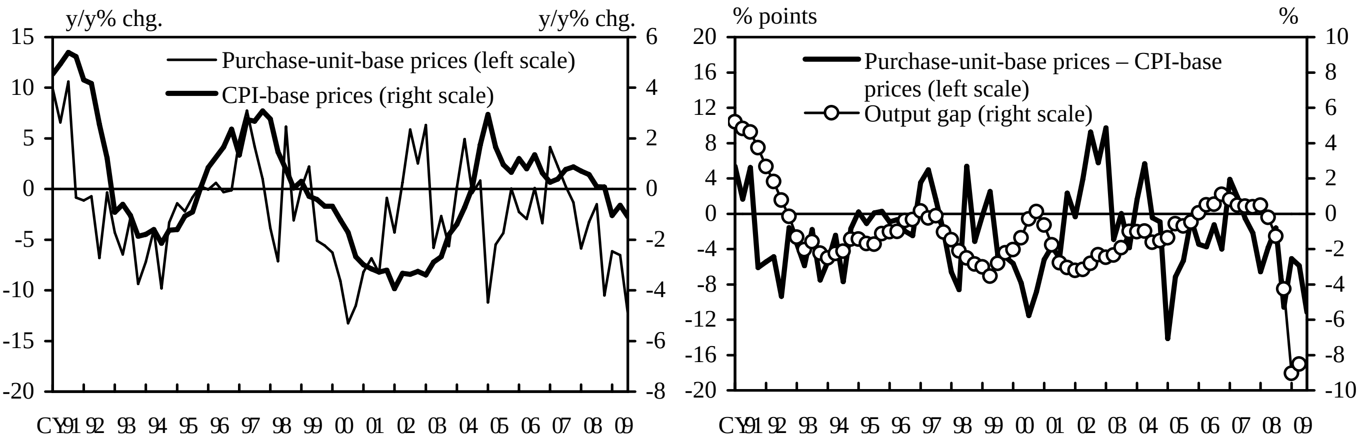
Notes: 1. Figures are based on all-size enterprises. Figures for 2009/Q4 are the forecasts in the September 2009 survey.

2. 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.

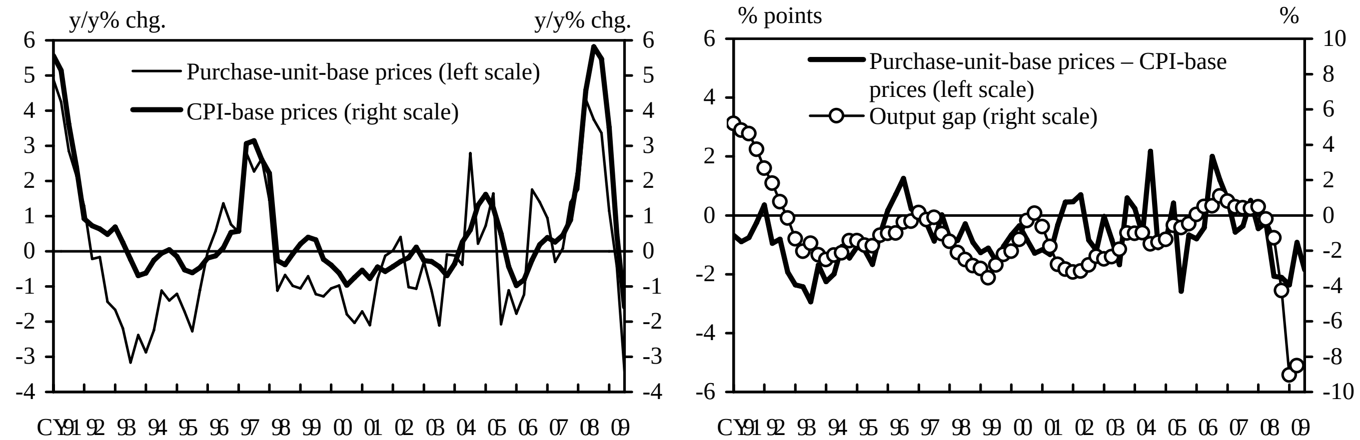
Source: Bank of Japan, "*Tankan*, Short-Term Economic Survey of Enterprises in Japan."

Goods Prices Facing Consumers

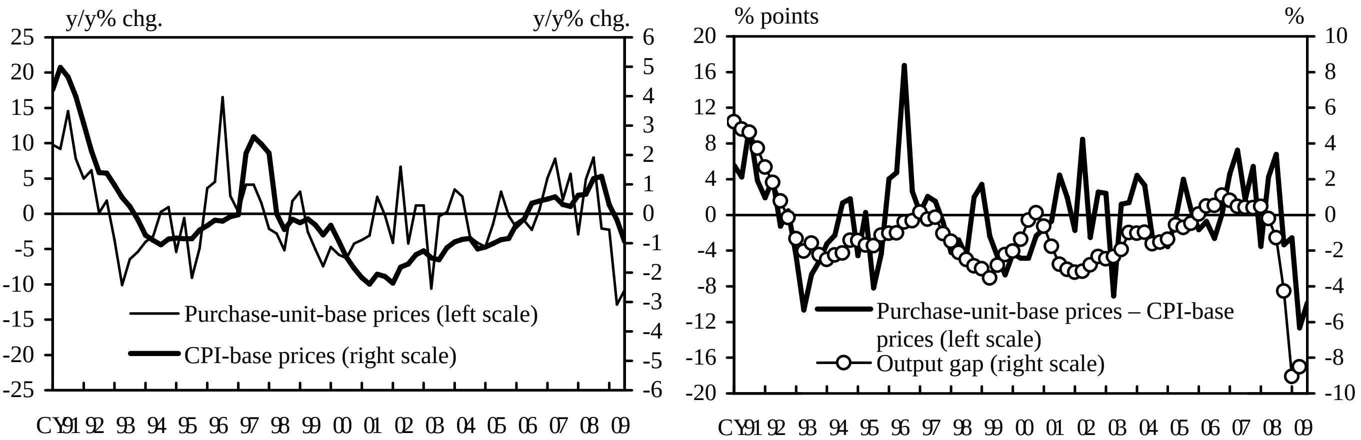
(1) Clothes



(2) Food Products, Agricultural & Aquatic Products (Excluding Fresh Foods)



(3) Other Goods



Notes: 1. Items continuously available in both of the Ministry of Internal Affairs and Communication's two kinds of statistics are selected for each group.
2. Definitions of the items are basically the same as those published by the Ministry of Internal Affairs and Communications.
3. Other goods exclude clothes (including shirts, sweaters & underwear); food products; agricultural & aquatic products; durable goods; petroleum products; and electricity, gas & water charges.
4. The output gap is estimated by the Research and Statistics Department, Bank of Japan. For the estimation procedures, see "The New Estimates of Output Gap and Potential Growth Rate" (Bank of Japan Review Series, May 2006).
5. Figures for 2009/Q3 are the July-August averages.

Sources: Ministry of Internal Affairs and Communications, "Consumer Price Index," "Monthly Report on the Family Income and Expenditure Survey"; Cabinet Office, "National Accounts," etc.

Economic Assessment by Region (Regional Economic Report)

Region	Assessment in July 2009	Difference between assessments	Assessment in October 2009
Hokkaido	The economy is stagnant.	⇗	The economy has shown signs of picking up, although it remains stagnant.
Tohoku	Economic conditions have begun to stop worsening, although they are still severe.	⇗	The economy, especially the manufacturing industry, has shown signs of picking up, although economic conditions as a whole remain severe.
Hokuriku	There are signs that economic conditions have begun to stop worsening, although they are still severe.	⇗	The economy has shown some signs of picking up, although economic conditions as a whole remain severe.
Kanto-Koshinetsu	Economic conditions, after deteriorating significantly, have begun to stop worsening.	⇗	The economy is bottoming out and turning upward.
Tokai	Economic conditions have begun to stop worsening, mainly because exports and production have picked up.	⇗	The economy has started to pick up.
Kinki	Economic conditions have begun to stop worsening, although they are still severe.	⇗	The economy, with some lingering severity in employment, has shown signs of picking up.
Chugoku	Economic conditions have begun to stop worsening.	⇗	The economy, having leveled out, has shown some signs of picking up.
Shikoku	There are signs that economic activity has begun to stop worsening, although economic conditions as a whole have continued to deteriorate.	⇗	Economic conditions have stopped worsening as a whole, although they remain severe.
Kyushu-Okinawa	Economic conditions, after deteriorating significantly, have begun to stop worsening.	⇗	The economy has leveled out with some signs of picking up.

Note: The Regional Economic Report (summary) is available on the Bank of Japan's web site (http://www.boj.or.jp/en/type/ronbun/chiiki_rep/chiiki0910.htm).

Source: Bank of Japan, "Regional Economic Report (Summary) October 2009."