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Bank of Japan

Outlook for Economic Activity and Prices

October 2014

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

The Bank's View[1]

Summary

- From fiscal 2014 through fiscal 2016, Japan's economy is likely to continue growing at a pace above its potential as a trend, while it will be affected by the front-loaded increase and subsequent decline in demand prior to and after the consumption tax hikes.[2]

- The year-on-year rate of increase in the consumer price index (CPI, for all items less fresh food and excluding the direct effects of the consumption tax hikes) is likely to be at around the current level for the time being, and subsequently accelerate gradually and reach around 2 percent around the middle of the projection period; that is, in or around fiscal 2015. Thereafter, Japan's economy is expected to shift to a growth path that sustains such inflation in a stable manner.

- Comparing the current projections with the previous ones, the growth rate for fiscal 2014 is somewhat lower due mainly to the effects of the decline in demand following the front-loaded increase and to relatively weak exports. The projected rate of increase in prices for fiscal 2015 is somewhat lower due mainly to a decline in international commodity prices, but that for fiscal 2016 is more or less unchanged.

- In the context of the price stability target, the Bank of Japan examined the aforementioned baseline scenario (the first perspective) and upside and downside risks to the baseline scenario (the second perspective).[3] As for the conduct of monetary policy, quantitative and qualitative monetary easing (QQE) has been exerting its intended effects. The Bank will continue with the QQE, aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner. It will examine both upside and downside risks to economic activity and prices, and make adjustments as appropriate.

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[1] The text of "The Bank's View" was decided by the Policy Board at the Monetary Policy Meeting held on October 31, 2014.

[2] The October 2014 *Outlook for Economic Activity and Prices* (Outlook Report) assumes, as with the past Outlook Reports, that the consumption tax -- after having risen to 8 percent in April 2014 -- will rise to 10 percent in October 2015.

[3] As for the examination from two perspectives in the context of the price stability target, see the Bank's statement released on January 22, 2013, entitled "The 'Price Stability Target' under the Framework for the Conduct of Monetary Policy."

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

A. Outlook for Economic Activity

Japan's economy has continued to recover moderately as a trend, although some weakness, particularly on the production side, has been observed due mainly to the effects of the decline in demand following the front-loaded increase prior to the consumption tax hike. The growth rate in the April-June quarter of 2014 was substantially negative, reflecting in part the large effects of the decline in demand, mainly in durable goods such as automobiles, and somewhat weak developments in exports. In addition, the effects of irregular weather during this past summer have also exerted temporary downward pressure on private consumption. However, excluding the fluctuations in the front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike, Japan's economy has continued to grow at a pace above its potential.[4] Moreover, since the current economic recovery is led by domestic demand, which tends to have large stimulative effects on employment, an increase in employment and a tightening in labor market conditions have been developing steadily.

Looking ahead, as domestic demand is likely to maintain firmness, exports are expected to head for a moderate increase, and a virtuous cycle from income to spending is likely to be maintained in both the household and corporate sectors. Therefore, the economy is likely to continue growing at a pace above its potential as a trend, while it will be affected by a front-loaded increase and subsequent decline in demand prior to and after the consumption tax hikes.

The above projection assumes the following underlying developments.

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

First, as the Bank of Japan steadily pursues the QQE expanded on October 31, 2014,[5] financial conditions are likely to become more accommodative.[6] Namely, under the QQE, upward pressure on nominal long-term interest rates has been contained while inflation expectations have been rising on the whole, and thus real interest rates have been declining. The amount outstanding of bank lending has been increasing moderately. Stimulative effects of such accommodative financial conditions on private demand are likely to strengthen as economic activity improves.

Second, overseas economies are expected to moderately increase their growth rates as advanced economies continue to see firm recovery and its positive effects gradually spread to emerging economies. Looking at major countries and regions, the U.S. economy is expected to gradually accelerate its pace of growth supported by a virtuous cycle originating from household spending. The European economy is expected to maintain its moderate recovery, supported mainly by the resilience in private consumption and an increase in exports, although the adjustment pressure associated with the debt problem remains and a downtrend in the inflation rate has been observed. The Chinese economy is likely to continue to see generally stable growth, albeit at a slightly slower pace, as authorities carry out policy measures to support economic activity while progressing with structural reforms. Other emerging and commodity-exporting economies are expected to moderately increase their growth rates as positive effects of recovery in advanced economies spread and domestic demand picks up, reflecting accommodative financial conditions, although there are differences across countries and regions.

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[5] See the Bank's statement released on October 31, 2014, entitled "Expansion of the Quantitative and Qualitative Monetary Easing."

[6] Individual Policy Board members make their forecasts assuming the effects of past policy decisions, including the measures decided on October 31, 2014, and with reference to views incorporated in financial markets regarding future policy. Specifically, markets have factored in that short-term interest rates will continue to be effectively 0 percent throughout the projection period. While markets have been forecasting that long-term interest rates will hover at low levels throughout the projection period, this reflects market participants' forecasts for prices, which are lower than those presented in the Outlook Report. Each Policy Board member assumes the future path of long-term interest rates based on such market views, taking into account the difference in the forecasts for prices.

Third, public investment has been hovering at a high level, reflecting a boost from economic stimulus, but is expected to turn to a moderate downtrend in the second half of fiscal 2014.

Fourth, firms' and households' medium- to long-term growth expectations and potential growth rates are expected to rise moderately against the backdrop of progress in the government's growth strategy, including regulatory and institutional reforms, an increase in labor participation by women and the elderly under such strategy, and firms' initiatives toward improving productivity and their tapping of potential domestic and external demand.

Given these assumptions, to elaborate on economic activity during the projection period, <u>in the second half of fiscal 2014</u>, as for private consumption, the effects of the decline in demand following the front-loaded increase prior to the consumption tax hike are likely to remain for the time being but are expected to wane gradually, and it is expected to remain resilient with the employment and income situation continuing to improve steadily.[7] With an improvement in corporate profits and effects of monetary easing continuing to provide a boost, business fixed investment is projected to increase steadily. This increase also reflects a rise in the need for investment, such as (1) renewal investment to replace capital stock that has become outdated as a result of restrained investment for many years; (2) investment in labor-saving machinery and equipment, reflecting the tightening in labor market conditions; and (3) investment to reestablish the domestic bases of business, partly in response to developments in foreign exchange rates. Meanwhile, exports are expected to head for a moderate increase as overseas economies recover, and partly because of foreign exchange rate developments. In this situation, industrial production is expected to resume its moderate increase with the progress in inventory adjustments.

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[7] Taking into account the magnitude of the front-loaded increase in demand prior to the consumption tax hike in April 2014 and possible effects of the tax hike through a decline in real income, the effects of the two rounds of consumption tax hikes on the economic growth rate for each fiscal year are quantitatively estimated as follows: an increase of around 0.4 percentage point for fiscal 2013, a decrease of around 0.9 percentage point for fiscal 2014, an increase of around 0.2 percentage point for fiscal 2015, and about 0 percentage point for fiscal 2016. However, it should be noted that these estimates are subject to considerable uncertainty given that they depend partly on income conditions and price developments at each point in time, and therefore are subject to a considerable margin of error.

As for fiscal 2015 through fiscal 2016, a virtuous cycle of economic activity will be maintained -- supported by (1) a firm increase in domestic private demand, reflecting accommodative financial conditions and heightened growth expectations, as well as (2) an increase in exports due to growing overseas economies -- and the economy is expected to continue growing at a pace above its potential, while fluctuations in demand stemming from the scheduled second consumption tax hike are anticipated.

Comparing the current projections for growth rates up through fiscal 2016 with those in the July 2014 interim assessment, while the growth rate for fiscal 2014 is somewhat lower due mainly to the effects of the decline in demand following the front-loaded increase and relatively weak exports, those for fiscal 2015 and fiscal 2016 are more or less unchanged.

B. Outlook for Prices

The year-on-year rate of increase in the CPI (for all items less fresh food, and the same hereafter) has been around 1¼ percent recently.

Examining major factors that determine inflation rates into the future, first, the aggregate supply and demand balance (the output gap), which shows the utilization of labor and capital, has steadily continued its improving trend, mainly on the labor front, as firm domestic demand -- which tends to have large stimulative effects on employment -- has led to an increase in employment despite being affected by the front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike.[8] Specifically, the tightening trend in labor market conditions is steadily becoming more apparent, with the unemployment rate hovering around the structural unemployment rate, which is deemed to be around 3.5 percent, and the broadly-defined unemployment rates -- counting as unemployed, for example, those people who currently are not looking for work but indicate

[8] There are two approaches to estimating the output gap: (1) estimate potential GDP and then measure its difference with actual GDP; and (2) directly measure the utilization of production factors (labor and capital). As the output gap in the Outlook Report has been estimated based on the latter approach, changes in the GDP growth rate do not have a one-to-one relationship with the expansion/narrowing of the output gap. It should be noted that estimates of the output gap could differ depending on the specific methodology employed and data used, and therefore they are subject to a considerable margin of error.

their willingness to work -- continuing to be on a declining trend.[9] Firms seem to be regarding the decline in demand following the front-loaded increase as temporary, and are maintaining their positive hiring stance. In this situation, wages have continued to improve, as seen in the fact that scheduled cash earnings turned to a clear increase. Moreover, more firms have faced a capital shortage, mainly in nonmanufacturing. Therefore, a trend in which the output gap will be positive (in excess demand) is likely to take root in the second half of fiscal 2014, and thereafter the gap is expected to move further into excess demand territory. In this situation, upward pressure on wages and prices due to the tightening of supply and demand conditions is likely to steadily increase.

Second, medium- to long-term inflation expectations appear to be rising on the whole from a somewhat longer-term perspective. Such developments in inflation expectations seem to have been influencing actual wage and price settings. For example, a rise in the inflation rate, in addition to corporate performance, has been taken into account in the annual labor-management wage negotiations, and rises in base pay were revived at many firms for the first time in many years. Among firms, a shift in firms' price-setting strategy has been seen, from a low-price strategy to one of raising sales prices while increasing value added. Looking ahead, as the Bank pursues the QQE and the observed inflation rate rises, medium- to long-term inflation expectations are also likely to follow an increasing trend and gradually converge to around 2 percent -- the price stability target.

Third, as for import prices, while recent developments in foreign exchange rates will exert upward pressure on consumer prices, a decline in international commodity prices, including crude oil prices, will exert downward pressure on consumer prices for the time being.

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[9] In the labor market, there is always a mismatch to some extent between job openings and job applicants, and thus there is a certain number of unemployed even when the economy is booming. Given that there is such unemployment due to the mismatch, the unemployment rate that corresponds to a state in which excess labor force has disappeared is called the *structural unemployment rate*. However, it should be noted that the estimated structural unemployment rate tends to change over time. Moreover, the broadly-defined unemployment rates are calculated by counting as unemployed those people who are defined as being not in the labor force because they have stopped looking for work but are potentially willing to work, and those who are currently employed part time but want and are available to work longer than they do at present.

Based on the above, the outlook for the year-on-year rate of increase in the CPI (excluding the direct effects of the consumption tax hikes) is as follows.[10] It is likely to be at around the current level for the time being, and subsequently accelerate gradually and reach around 2 percent -- the price stability target -- around the middle of the projection period; that is, in or around fiscal 2015. Thereafter, the year-on-year rate of increase in the CPI is likely to edge up as medium- to long-term inflation expectations will converge to around 2 percent and the output gap is expected to continue expanding in positive territory. Comparing the current projections up through fiscal 2016 with those in the July 2014 interim assessment, the projected rate of increase in the CPI for fiscal 2015 is somewhat lower due mainly to the decline in international commodity prices, but that for fiscal 2016 is more or less unchanged.

II. Upside and Downside Risks

A. Risks to Economic Activity

The following are upside and downside risks to the Bank's aforementioned baseline scenario regarding the economy. First, there is uncertainty regarding developments in exports. The continuing lack of momentum in exports has been due to the sluggishness in overseas economies, particularly emerging economies, and to weakness in investment activity globally. In addition, exports have been affected by structural factors such as an increase in Japanese manufacturers' shifting of production sites to overseas. Risks to future developments in overseas economies include the pace of recovery in the U.S. economy and its effects on the global financial markets, the prospects regarding the debt problem and the risk of low inflation rates being protracted in Europe, the progress in structural adjustments in emerging economies, and geopolitical risks. As for Japanese firms' production share at home and abroad going forward, there is high uncertainty associated with the effects of foreign exchange rates and the pace of shifting production sites overseas. However, it should be noted that, although firms' expansion of overseas

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[10] The effects of the two rounds of consumption tax hikes on prices can be mechanically estimated by assuming that the rise in the consumption taxes will be fully passed on for all currently taxable items. On this basis, the year-on-year rate of increase in the CPI will be pushed up by 2.0 percentage points in fiscal 2014 and 1.3 percentage points in the second half of fiscal 2015 and the first half of fiscal 2016.

production could contribute to restraining exports, it could have positive effects on the economy through increasing dividends from subsidiary companies, thereby pushing up corporate profits.

The second risk is the effects of the consumption tax hikes. The effects of the decline in demand following the first round of consumption tax hikes in April 2014 and of the decline in real income remain, and they warrant continued examination. How the scheduled second round of consumption tax hikes in October 2015 will affect the economy may differ depending on consumer sentiment, the employment and income situation, and developments in prices at that time.

Third, firms' and households' medium- to long-term growth expectations may be either raised or lowered depending on future developments in regulatory and institutional reforms, innovation in the corporate sector, and the employment and income situation surrounding the household sector.

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

B. Risks to Prices

In case the aforementioned upside and downside risks to the economy materialize, it is likely that prices will also be affected to a certain degree. Other factors that could exert upside and downside risks to prices are as follows. The first concerns developments in firms' and households' medium- to long-term inflation expectations. The baseline scenario assumes that, amid a rise in observed price and wage inflation, people's inflation expectations will rise further. However, the pace at which they will rise is subject to uncertainty over developments in observed prices and to what extent they will affect inflation expectations. On this point, how developments in prices in the past fiscal year and the outlook for prices will be taken into consideration in the wage negotiations between management and labor toward the next fiscal year is of importance. Recently, somewhat weak developments in demand following the consumption tax hike and a substantial decline in crude oil prices have been exerting downward pressure on prices. If such downward pressure on prices remains, there is a risk that an improvement in inflation expectations might be delayed.

The second concerns developments in the output gap, particularly in labor market conditions. The baseline scenario assumes that, on the labor supply side, the recent increase in labor participation by the elderly and women and recent movements in firms to convert part-time employees into regular ones will continue to some extent, but uncertainty is associated with this assumption. In particular, given that the broadly-defined unemployment rates have been at low levels in addition to the standard unemployment rate, the degree of labor shortage may rise further.

The third regards the responsiveness of inflation to the output gap. Attention needs to be paid to what extent firms will raise prices and wages as the output gap tightens. On this point, there is high uncertainty as to how developments in consumption after the tax hike will affect firms' price-setting behavior.

Fourth, developments in import prices, reflecting fluctuations in international commodity prices and foreign exchange rates, as well as the extent to which such developments will spread to domestic prices, may lead prices to deviate either upward or downward from the baseline scenario.

III. Conduct of Monetary Policy

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

The first perspective concerns an examination of the baseline scenario for the outlook. Japan's economy is judged as likely to achieve around 2 percent inflation around the middle of the projection period -- that is, in or around fiscal 2015 -- and thereafter gradually shift to a growth path that sustains such inflation in a stable manner.

The second perspective involves an examination of the risks considered most relevant to the conduct of monetary policy. With regard to the baseline scenario for economic activity, upside and downside risks can be assessed as being balanced, although uncertainty remains high, including that regarding developments in exports and the effects of the consumption tax hikes. With regard to the baseline scenario for prices, there is considerable uncertainty, mainly in developments in medium- to long-term inflation expectations, and there are substantial downside risks. Examining financial imbalances from a longer-term perspective, there is no sign at this point of excessively bullish expectations in asset markets or in the activities of financial institutions.[11] Nevertheless, in a situation where the amount outstanding of government debt has shown a cumulative increase, due attention needs to be paid to the fact that financial institutions' holdings of government bonds have remained at an elevated level, although they have been on a gradual declining trend.

As for the conduct of monetary policy, the QQE has been exerting its intended effects. The Bank will continue with the QQE, aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner. It will examine both upside and downside risks to economic activity and prices, and make adjustments as appropriate.

[11] For more details, see the October 2014 issue of the Bank's *Financial System Report*.

(Appendix)

Forecasts of the Majority of Policy Board Members

y/y % chg.

	Real GDP	CPI (all items less fresh food)	Excluding the effects of the consumption tax hikes
Fiscal 2014	+0.2 to +0.7 [+0.5]	+3.1 to +3.4 [+3.2]	+1.1 to +1.4 [+1.2]
Forecasts made in July 2014	+0.6 to +1.3 [+1.0]	+3.2 to +3.5 [+3.3]	+1.2 to +1.5 [+1.3]
Fiscal 2015	+1.2 to +1.7 [+1.5]	+1.8 to +2.6 [+2.4]	+1.1 to +1.9 [+1.7]
Forecasts made in July 2014	+1.2 to +1.6 [+1.5]	+1.9 to +2.8 [+2.6]	+1.2 to +2.1 [+1.9]
Fiscal 2016	+1.0 to +1.4 [+1.2]	+1.9 to +3.0 [+2.8]	+1.2 to +2.3 [+2.1]
Forecasts made in July 2014	+1.0 to +1.5 [+1.3]	+2.0 to +3.0 [+2.8]	+1.3 to +2.3 [+2.1]

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

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

3. Individual Policy Board members make their forecasts assuming the effects of past policy decisions, including the measures decided on October 31, 2014, and with reference to views incorporated in financial markets regarding future policy.

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

5. The forecasts for the CPI that incorporate the direct effects of the consumption tax hikes are constructed as follows. First, the contribution to prices from each tax hike is mechanically computed on the assumption that the tax increase will be fully passed on for all taxable items. The CPI will be pushed up by 2.0 percentage points for fiscal 2014 and by 0.7 percentage point for fiscal 2015 and fiscal 2016, respectively. Second, these figures are added to the forecasts made by the Policy Board members.

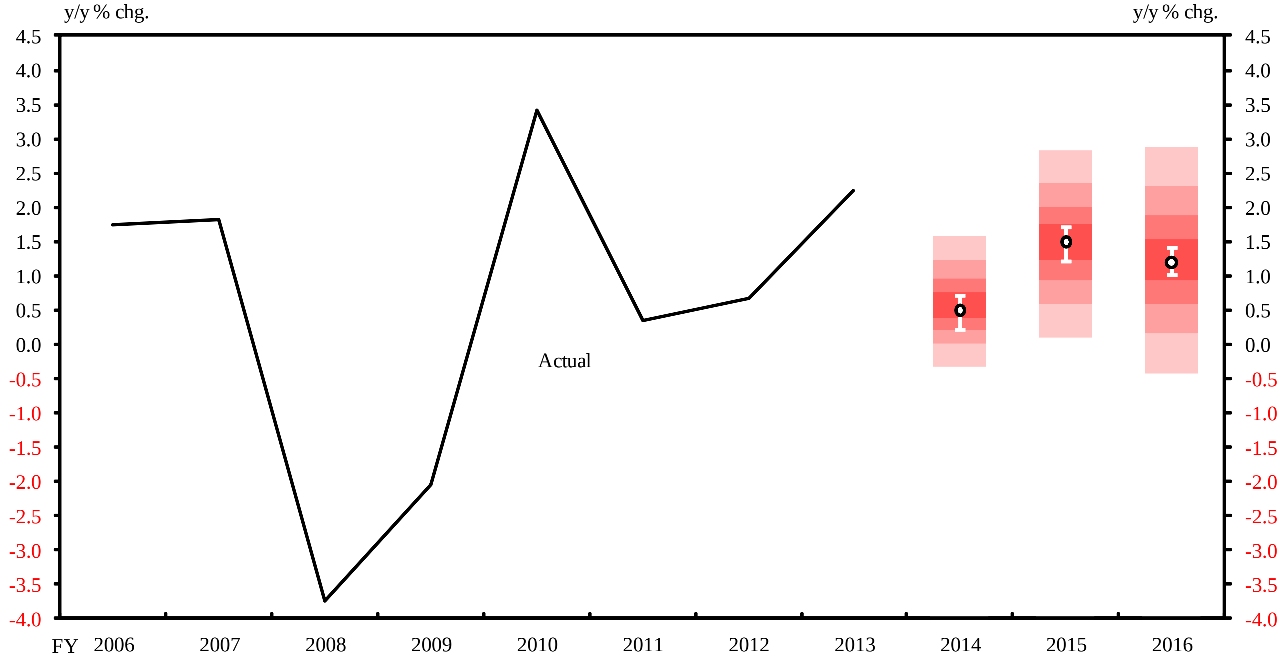
6. The ranges shown below include the forecasts of all Policy Board members.

y/y % chg.

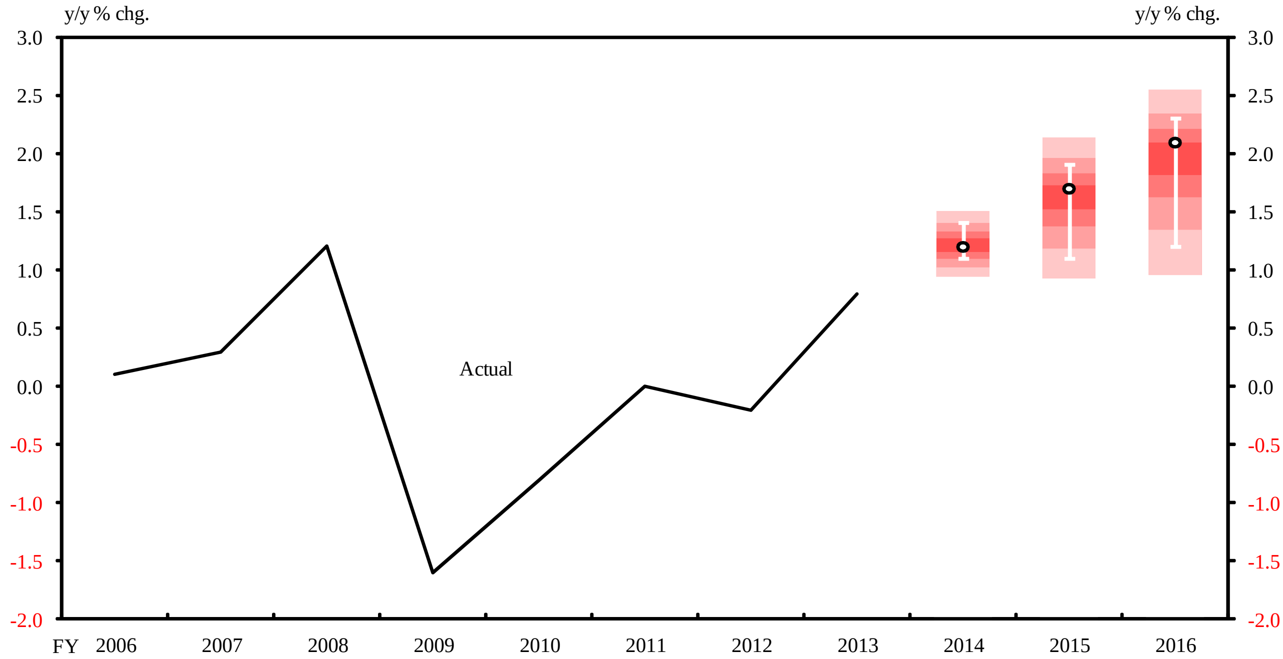
	Real GDP	CPI (all items less fresh food)	Excluding the effects of the consumption tax hikes
Fiscal 2014	+0.1 to +1.0	+3.0 to +3.4	+1.0 to +1.4
Forecasts made in July 2014	+0.5 to +1.3	+3.0 to +3.7	+1.0 to +1.7
Fiscal 2015	+0.8 to +1.8	+1.6 to +2.7	+0.9 to +2.0
Forecasts made in July 2014	+0.9 to +1.7	+1.7 to +2.8	+1.0 to +2.1
Fiscal 2016	+0.6 to +1.6	+1.6 to +3.0	+0.9 to +2.3
Forecasts made in July 2014	+0.7 to +1.6	+1.6 to +3.0	+0.9 to +2.3

Forecast Distribution Charts of Policy Board Members

(1) Real GDP



(2) CPI (All Items Less Fresh Food)



Notes: 1. The Forecast Distribution Charts are based on the aggregated probability distributions (i.e., the Risk Balance Charts) compiled from the distributions of individual policy board members, and constructed as follows. First, the upper and lower 10 percentiles of the aggregated distributions are trimmed. Second, the various percentiles of the aggregated distributions are color-coded as below.

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

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

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

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

The Background

I. Economic and Price Developments in the First Half of Fiscal 2014

Economic Activity

Looking back at Japan's economy during the first half of fiscal 2014, economic activity continued to recover moderately as a trend with a virtuous cycle from income to spending being maintained in both the household and corporate sectors, although it has been affected, mainly by the decline in demand following the front-loaded increase prior to the consumption tax hike, and some weakness on the production side has been somewhat prolonged (Chart 1 [1]).[12]

Specifically, overseas economies -- mainly advanced economies -- have been recovering, although a lackluster performance has still been partly seen (Chart 2 [1] and [2]). Looking at major countries and regions, the U.S. economy has continued to recover steadily, led mainly by private demand. The European economy has continued its moderate recovery trend, but upward momentum has been waning somewhat, particularly in manufacturers. The Chinese economy has continued to grow stably on the whole, due mainly to an improvement in external demand and the stimulus measures by the government, albeit under downward pressure associated with structural adjustment. Meanwhile, emerging economies other than China and commodity-exporting economies have been lacking momentum on the whole, although there are differences across countries and regions. Of these economies, in East Asia, which is closely tied with Japan's economy, while the NIEs have been improving somewhat due to a rise in exports to the United States, albeit with differences remaining across countries, the ASEAN economies as a whole have been lacking growth momentum despite an improvement in exports and private consumption.

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[12] Real GDP in the January-March quarter of 2014 grew significantly at a rate of 6.0 percent on an annualized quarter-on-quarter basis due to the effects of the front-loaded increase in demand prior to the consumption tax hike, followed by a substantial decline of 7.1 percent in the April-June quarter due mainly to the decline in demand. However, excluding the fluctuations in the front-loaded increase and subsequent decline in demand prior to and after the consumption tax hike, the annualized real GDP growth rate in the January-June period of 2014 over the July-December period of 2013 was 1.0 percent. Therefore, Japan's economy continued to grow at a pace above its potential, which is estimated to be around 0.5 percent or lower, although the pace was somewhat slower than that of the previous year (Chart 1 [2]).

Reflecting this situation, exports as a whole have been relatively weak due to such factors as the continued weakness in exports to the ASEAN economies, the sluggish growth in exports to China brought about by excess capacity in capital stock and adjustment in the real estate market, and the materialization of the effects of downward pressure on exports to the United States resulting from the expansion of overseas production, mainly by automakers (Chart 3). Meanwhile, public investment maintained its high level, due to the effects of the supplementary budget for fiscal 2013 and of the early implementation of the initial budget for fiscal 2014, underpinning economic activity (Chart 4 [1]).

In the household sector, with labor market conditions continuing their tightening trend, the employment and income situation has improved steadily as scheduled cash earnings have picked up, reflecting an increase in base pay, and summer bonuses have clearly increased (Charts 5 and 6). With these developments underpinning its resilient trend, private consumption has been affected mainly by the decline in demand following the front-loaded increase, and the effects, which were clearly seen in the April-June quarter, have been waning on the whole, albeit unevenly (Charts 7 and 8). In detail, sales at retail stores, which are mainly of non-durable goods and semi-durable goods, fell in April, but thereafter followed a pick-up trend despite being affected by irregular weather (Chart 8 [3] and [4]). Meanwhile, sales of durable goods such as automobiles and household electrical appliances have been affected mainly by the decline in demand following the front-loaded increase for a somewhat prolonged period, although developments toward an uptick have been observed recently (Chart 8 [1] and [2]). As for housing investment, the decline following the front-loaded increase, particularly in owner-occupied homes, has continued (Charts 4 [2] and 8 [5]). Reflecting this situation, industrial production declined substantially in the April-June quarter and has been showing some weakness thereafter due in part to inventory adjustments, mainly in durable goods and construction goods (Chart 9).

Looking at the corporate sector, profits as a whole have been on an improving trend as favorable conditions in overseas business operations offset the adverse effects of the decline in domestic demand following the front-loaded increase (Chart 10). Business sentiment has generally maintained its favorable level, although it has been affected, mainly by the consumption tax hike (Chart 11). In these circumstances, firms seem to be regarding the decline in economic activity since April 2014 as temporary, and have maintained their positive spending behavior. Business fixed investment has been on a moderate uptrend, albeit with some fluctuations (Chart 12). As for employment, with firms maintaining their positive hiring stance, the active job openings-to-applicants ratio has been on an improving trend and the unemployment rate has been at around the level of the current structural unemployment rate, which is estimated to be around 3.5 percent (Chart 5).

Reflecting these aforementioned developments in economic activity, the output gap, which captures the utilization of labor and capital, has been on an improving trend, albeit with some fluctuations due to the front-loaded increase and subsequent decline in demand, and has been hovering around 0 percent (Chart 13).

Prices

On the price front, excluding the direct effects of the consumption tax hikes, the year-on-year rate of increase in the producer price index (PPI) slowed somewhat from the pace seen some time ago, reflecting developments in international commodity prices and foreign exchange rates; however, the PPI has continued to increase moderately as past rises in import costs have continued to be passed on to product prices (Chart 14 [1]). The year-on-year rate of increase in the services producer price index (SPPI, excluding international transportation) has picked up to 0.5-1.0 percent, as firms have gradually become somewhat willing to increase business expenses on the back of continued improvement in corporate profits (Chart 14 [1]). With regard to the CPI, the overall year-on-year rate of increase has been around 1¼ percent: while the positive contribution from energy-related goods that are directly affected by international commodity prices and foreign exchange rates has diminished, price rises have continued for a broad range of items other than energy-related goods, including the effects of passing on cost increases due to past changes in foreign exchange rates, mainly on the back of an improvement in the output gap (Chart 15 [1] and [2]). Meanwhile, the year-on-year rate of increase in the CPI less food and energy has been in the range of 0.5-1.0 percent, and the rate of increase in the trimmed mean,[13] which is one of the indicators for capturing trend changes in the CPI, has tended to accelerate moderately (Chart 16 [1]). The difference between the share of items in the CPI for which prices have risen from the previous year and that for which prices have declined has continued to be on an uptrend, and the number of items for which prices have increased has been exceeding 50 percent of the total for ten consecutive months, since December 2013 (Chart 16 [2]). The GDP deflator and the domestic demand deflator have also followed moderate improving trends on the back of an improvement in the output gap (Chart 14 [2]).[14]

Meanwhile, although land prices have been declining slightly on the whole, the pace of decline has been gradually slowing. Looking at the *Land Price Survey by Prefectural Governments* for 2014 (as of July 1), in the three major metropolitan areas (Tokyo, Osaka, and Nagoya), the rate of increase in commercial land prices has accelerated on a year-on-year basis and that in residential land prices has turned positive on a year-on-year basis (Chart 17). In nonmetropolitan areas, the year-on-year rate of decline in both commercial and residential land prices has been narrowing.

II. Financial Developments

Financial Conditions

Financial conditions are accommodative.

With the Bank pursuing the QQE, the monetary base has been increasing at a high year-on-year growth rate of around 30-50 percent (Chart 18).

Firms' funding costs have been hovering at low levels. The issuance spreads for CP and corporate bonds have been low as favorable issuing conditions have continued against the backdrop of firm demand from investors (Chart 19). The average interest rates on new

[13] In order to eliminate the effects of large relative price fluctuations, the trimmed mean is obtained by mechanically excluding a certain percentage of the upper and lower tails of the price fluctuation distribution by item.

[14] Chart 14 (2) includes the effects of the consumption tax hike.

loans and discounts for both the short and long terms have been at historical low levels (Chart 20 [1]). In these circumstances, interest payments by firms have been at sufficiently low levels in relation to their profits (Chart 20 [2]).

With regard to the availability of funds for firms, financial institutions' lending attitudes -- as perceived by large as well as small firms -- have been on an improving trend (Chart 21 [1]). The levels of various diffusion indexes (DIs) clearly have been above the average for the period since 2000, and the DIs in the Short-Term Economic Survey of Enterprises in Japan (*Tankan*) have generally improved to the level of around 2006, which is the recent peak. Firms' financial positions have been favorable for both large and small firms (Chart 21 [2]). The levels of various DIs have generally improved to the recent peak seen around 2006.

Domestic demand for working capital by firms has continued to rise. There has also been an increase in demand for funds in sectors where there are prospects for high growth, such as the medical and nursing business, and for funds related to mergers and acquisitions of firms. In these circumstances, the year-on-year rate of increase in the amount outstanding of bank lending has been in the range of 2.0-3.0 percent (Chart 22 [1]). By firm size, the year-on-year rate of change in bank lending to small firms, which had long been negative, has continued to be positive, and an increase in lending has expanded to a wider range of businesses, regions, and firm sizes (Chart 22 [2]). The year-on-year rate of change in the aggregate amount outstanding of CP and corporate bonds has been negative (Chart 22 [3]). Looking at CP and corporate bonds separately, the year-on-year rate of change in the amount outstanding of CP had been negative, but has recently turned positive. On the other hand, that of corporate bonds has been negative, reflecting a high level of corporate bond redemption in the first half of fiscal 2014.

The year-on-year rate of change in the money stock (M2) has continued to see growth of around 3.0-4.0 percent, mainly reflecting the increase in bank lending (Chart 23 [1]). The ratio of money stock to nominal GDP has been on a moderate increasing trend, but the pace of the rise has recently slowed somewhat as the growth rate of nominal GDP has accelerated (Chart 23 [2]).

Developments in Financial Markets

Global financial markets remained stable on the whole, as partly evidenced by a continued downtrend in long-term interest rates and firm stock prices amid continued accommodative financial conditions. However, since the beginning of autumn 2014, the markets have been fluctuating somewhat considerably, partly because of concern over the downside risks to the global economy.

Looking at respective financial markets, stock prices were generally firm globally, with accommodative financial conditions underpinning the economy and business performance (Chart 24 [1]). However, since the beginning of autumn, stock prices had been adjusted against the background of the vigilance on high prices and of concern over the downside risks to the global economy, and then returned to an increase; thus, they have been fluctuating considerably.

Long-term interest rates in the United States and Germany have generally continued their downtrend as accommodative financial conditions have been maintained (Chart 25 [1]). Toward the beginning of autumn, long-term interest rates in the United States temporarily rose somewhat -- as did such rates in Germany -- with the ending in asset purchases and the normalization of monetary policy going forward by the Federal Reserve (Fed) having been taken into account. Since the beginning of autumn, long-term interest rates in both the United States and Germany have been declining again. Meanwhile, foreign currency funding conditions have remained stable. The LIBOR-OIS spreads in the U.S. dollar and euro have remained at historical low levels (Chart 26 [2]).

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

Long-term interest rates in Japan have been declining somewhat -- since the Bank has continued to purchase long-term government bonds and long-term interest rates in the United States and Germany have continued their downtrend -- and recently have been in the range of around 0.45-0.50 percent (Chart 25).

Stock prices continued to rise -- attributable to firm U.S. stock prices, coupled with the depreciation of the yen -- and declined rather substantially in the first half of October, reflecting the fall in stock prices globally since the start of autumn and the reversal of exchange rate developments in the yen since the beginning of October. Thereafter, stock prices have been turning to an increase again, reflecting the pick-up in foreign stock prices (Chart 24 [1]). In the Japan real estate investment trust (J-REIT) market, while active public offerings and new listings have eased supply and demand conditions, prices have followed an uptrend against the backdrop of a continued improvement in fundamentals of the real estate market, as seen in an increasing trend in the rent of office buildings, for example (Chart 24 [2]).

In foreign exchange markets, the yen had been more or less flat against the U.S. dollar through summer 2014, and thereafter it depreciated as the U.S. economy has continued to recover steadily and the ending in asset purchases and the normalization of monetary policy going forward by the Fed have been taken into account. The yen at one point reached just above 110 yen against the U.S. dollar, the level marked before the global financial crisis (Chart 27). Subsequently, there were phases in which the yen was bought back due to the strengthening in investors' risk aversion. The yen has been appreciating against the euro as the European Central Bank (ECB) introduced a series of additional monetary easing measures.

III. The Outlook for Economic Activity and Prices from the Second Half of Fiscal 2014 to Fiscal 2016

The Outlook for Economic Activity and Prices

In the outlook presented in this report, growth rates were revised downward, particularly for fiscal 2014, factoring in structural constraining factors for exports such as more expansion of overseas production than previously assumed, and taking into account the somewhat prolonged decline in household spending following the consumption tax hike given that the degree of the front-loaded increase and subsequent decline in demand seems to have been somewhat larger than previously assumed.[15] However, there is no change in the basic understanding that a virtuous cycle in the economy is likely to be maintained, with domestic private demand continuing to develop steadily, underpinned by a rise in growth expectations and effects of monetary easing, and with exports increasing, albeit moderately, on the back of a recovery in overseas economies and effects of the depreciation of the yen. Therefore, the economy is likely to continue growing at a pace above its potential as a trend, albeit with some fluctuations due to the consumption tax hikes.

As for the second half of fiscal 2014, public investment, while staying at a high level, is likely to gradually turn to a decline. As for private consumption, the effects of the decline in demand following the front-loaded increase are likely to remain for the time being but are expected to wane gradually, and it is expected to remain resilient as a trend with the employment and income situation continuing to improve steadily on the back of the tightening in labor market conditions. Business fixed investment is projected to increase steadily, supported by an improvement in corporate profits, a rise in growth expectations, and the effects of monetary easing. Exports are expected to head for an increase, mainly on the back of recovery in overseas economies led by the United States, albeit more moderately than previously assumed. In this situation, the growth rate is likely to become relatively high in the second half of fiscal 2014, and a trend in which the output gap will be positive is likely to gradually take root.

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[15] As with the past Outlook Reports, this report assumes that the consumption tax -- after having risen to 8 percent in April 2014 -- will rise to 10 percent in October 2015. The effects of the two rounds of consumption tax hikes on the economic growth rate for each fiscal year were estimated in the Outlook Report in April 2014 as follows: an increase of around 0.3 percentage point for fiscal 2013, a decrease of around 0.7 percentage point for fiscal 2014, an increase of around 0.2 percentage point for fiscal 2015, and about 0 percentage point for fiscal 2016. In this report, the percentage point increase for fiscal 2013 and decline for fiscal 2014 were provisionally estimated to be slightly larger, taking into account that the front-loaded increase and subsequent decline in demand appear to be somewhat larger than previously assumed. Specifically, the newly estimated effects are an increase of around 0.4 percentage point for fiscal 2013 and a decrease of around 0.9 percentage point for fiscal 2014. However, given that such estimates vary depending on incoming data that will be accumulated going forward, they are subject to a considerable margin of error.

In fiscal 2015, while fluctuations in demand stemming from the scheduled second round of consumption tax hikes are anticipated, the economy is expected to continue growing at a pace above its potential on average, and the output gap is likely to expand moderately within positive territory. Although public investment is projected to continue decreasing, exports are likely to increase moderately as growth in overseas economies is likely to recover to a level of around the long-term average. In addition, a rise in growth expectations and the effects of monetary easing are expected to support a self-sustained recovery in domestic private demand.

Regarding fiscal 2016, a boost to the economy brought about by the cycle of business fixed investment is likely to wane as capital stock accumulates, thereby creating downward pressure on growth. Nevertheless, as exports are expected to continue increasing moderately with overseas economies continuing to grow at around the long-term average, and as a rise in growth expectations and the effects of monetary easing are expected to continue underpinning domestic private demand, the growth rate is expected to remain somewhat above the potential.

Expressing the outlook in terms of the annual real GDP growth rate, this is projected to be around 0.5 percent for fiscal 2014, around 1.5 percent for fiscal 2015, and a little over 1 percent for fiscal 2016, and thus above the potential as a trend, albeit with some fluctuations. Comparing the current projections for growth rates with those in the July 2014 interim assessment, while the growth rate for fiscal 2014 is somewhat lower, those for fiscal 2015 and 2016 are more or less unchanged. The downward revision of the growth rates will reduce the degree of improvement in the output gap going forward; however, taking into account that the tightening trend in labor market conditions has been strengthening steadily, with firms maintaining their positive hiring stance, such reduction is likely to be only small.

The outlook for prices -- excluding the direct effects of the consumption tax hikes -- is as follows.[16] The year-on-year rate of increase in the CPI is likely to be at around the current level for the time being, and subsequently accelerate gradually and reach around 2 percent -- the price stability target -- around the middle of the projection period; that is, in or around fiscal 2015, reflecting an improving trend in the output gap and a rise in medium- to long-term inflation expectations. Thereafter, the year-on-year rate of increase in the CPI is likely to edge up as medium- to long-term inflation expectations will converge to around 2 percent and the output gap is expected to continue expanding within positive territory. Comparing the current projections with those in the July 2014 interim assessment in light of the outlook for the output gap, the projected rate of increase in the CPI for fiscal 2015 is somewhat lower due mainly to the decline in international commodity prices, but that for fiscal 2016 is more or less unchanged.

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

Government Spending

Public investment has been more or less flat at a high level due to the positive effects of the supplementary budget for fiscal 2013 and of the early implementation of the initial budget for fiscal 2014. Thereafter, in the second half of fiscal 2014, it is likely to gradually enter a declining trend as the positive effects dissipate (Charts 4 [1] and 28 [1]). Nevertheless, it is expected to remain at a relatively high level throughout the projection period against the background of increasing demand for maintenance and replacement of social infrastructure (Chart 28 [2]).

Meanwhile, the level of the amount outstanding of government liabilities as a percentage of nominal GDP has already been high. Looking ahead, even after an increase in tax revenue

[16] The effects of the two rounds of consumption tax hikes on prices can be mechanically estimated by assuming that the rises in consumption tax will be fully passed on for all currently taxable items. On this basis, the year-on-year rate of increase in the CPI will be pushed up by 2.0 percentage points in fiscal 2014 and 1.3 percentage points in the second half of fiscal 2015 and the first half of fiscal 2016.

from the consumption tax hikes and economic recovery is taken into account, the debt ratio is likely to increase further. This is mainly due to an increase in social security-related spending, reflecting the aging population (Chart 28 [3] and [4]).

Overseas Economies

Overseas economies are expected to moderately increase their growth rates as advanced economies continue to see firm recovery and its positive effects gradually spread to emerging economies. In terms of growth rates, overseas economies are expected to grow at a relatively slower pace than they did before the global financial crisis, because the after-effects of the bursting of the global credit bubble still exist. Nonetheless, the growth rate is expected to gradually return to more or less the past long-term average (Chart 29).[17]

Looking at major countries and regions, the U.S. economy is expected to gradually accelerate its pace of recovery as the firmness in the household sector spreads to the corporate sector. The European economy is expected to continue on its moderate recovery trend, supported by resilience in consumption and an increase in exports, although the adjustment pressure associated with the debt problem remains and a downtrend in the inflation rate has been observed. The Chinese economy is likely to continue to see stable growth on the whole, albeit at a somewhat slower pace, as authorities carry out policy measures to support economic activity while progressing with structural reforms. Other emerging economies and commodity-exporting economies are expected to gradually increase their growth rates, as the recovery in advanced economies spreads and as domestic demand is expected to pick up on the back of accommodative financial conditions, although there are likely to be differences across countries and regions for some time.

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[17] Looking at the weighted averages of real GDP growth rates of respective economies and regions released by the International Monetary Fund (IMF) in October 2014, by value of exports from Japan, the growth rates of overseas economies are projected to register 3.6 percent in 2014 -- that is, only about the same rate as in 2012 and 2013 -- but rise moderately to around the past long-term average, registering 4.1 percent in 2015 and 4.2 percent in 2016 (Chart 29). Nonetheless, the growth rate is likely to stay somewhat subdued even at the end of the projection period, compared with that during the period before the global financial crisis. The average growth rate for the past 34 years -- from 1980 through 2013 -- was 4.1 percent and that for the 5 years before the global financial crisis (i.e., 2003-07) was 5.3 percent.

However, the outlook for overseas economies entails the following risks. Concerning the Chinese economy, the problem of excess production capacity, mainly for materials, seems to persist and the risk that adjustment will be prolonged in the real estate market warrants attention. Other emerging economies and commodity-exporting economies might continue to lack growth momentum. With respect to the European economy, attention needs to be paid to risks that sentiment will become more cautious, partly reflecting the effects of the deceleration in the Russian economy, the consequences of the debt problem and the developments toward ensuring the soundness of the financial system, and the possibility that low inflation rates will be protracted. Meanwhile, as for the U.S. economy, the corporate sector could become more eager for spending, mainly on the back of a rise in growth expectations and accommodative financial conditions.

Exports and Imports

Assuming the aforementioned recovery in overseas economies, exports are expected to head for a moderate increase, supported by the effects of the depreciation of the yen. The timing of a pick-up has been delayed, however, and given structural restraining factors such as the expansion of overseas production by Japanese firms and sluggishness in global trade activity, exports are expected to increase at a more moderate pace through the projection period than previously assumed. In what follows, future developments in exports will be discussed from two perspectives -- (1) the volume of global trade, or exports, and (2) Japan's share in that volume -- and the basic thinking behind each perspective will be laid out by taking into account recent structural changes.

First, the volume of global trade increased at a pace above global economic growth through the mid-2000s, but clearly has been sluggish since the global financial crisis. In recent years, it has generally been increasing at almost the same pace as the global economy (Chart 30 [1]).[18] Therefore, taking into account the structural changes that have been

[18] The following, for example, has been pointed to as the background to the recent sluggishness in the volume of global trade: (1) rewinding of the so-called global value chains, mainly due to the after-effects of the global financial crisis and a rise in transportation costs accompanying an increasing trend in crude oil prices; and (2) an increase in in-house production owing to the enhancement of technology in emerging economies.

taking place since the global financial crisis, the volume of global trade is likely to increase moderately at about the same pace as global economic growth.

Next, looking at Japan's share in global exports in real terms, it has declined to around 5.0 percent since the global financial crisis, from around 6.0 percent (Chart 30 [2]). The following, for example, could be pointed to as the background to recent developments: (1) stagnant demand of capital goods in which Japan has a comparative advantage; (2) the acceleration in Japanese firms' overseas production accompanied by increases in local procurement, mainly by the automobile industry; and (3) a decline in Japan's competitiveness in exports, mainly seen in the IT-related sector, partly due to the rapid appreciation of the yen (Charts 31 [1] and 32 [1] and [2]).

Going forward, Japan's share in global exports is expected to stop declining at around the current level and thereafter pick up at a very moderate pace toward the end of the projection period. This outlook is attributable to the following factors. First, as investment activity picks up globally at a gradual pace, led mainly by advanced economies on the back of the recovery of the overseas economies as a whole, it is likely that exports such as of capital goods -- in which Japan has a comparative advantage -- will increase (Chart 31 [1]). Japan's exports of capital goods are highly likely to head toward an increase, mainly in terms of those to the United States, given that, in the United States, which is the driving force of the global economy, firmness in the household sector is now spreading to the corporate sector and the growth rate of orders for capital goods has recently been accelerating (Chart 31 [2]). Second, since the concentrated wave of the start-up of overseas production sites -- on which relocation was decided amid the phase of the appreciation of the yen after the start of the global financial crisis -- seems to have started to peak out, and on the assumption that foreign exchange rates will be at around the current level, the pace of expansion in Japanese firms' overseas production is expected to slow down to a certain extent from a somewhat longer-term perspective (Chart 31 [3]). Third, if the current level of foreign exchange rates continues, the price competitiveness of Japan's export goods could increase. For example, the global share of electronic parts and devices seems to be recovering somewhat through an expansion of sales channels for high-tech smartphones and for automobiles amid the recent depreciation of the yen (Chart 32 [2]).

This recent depreciation has substantially boosted the travel receipts that are included in exports of services in the balance of payments statistics in accordance with a substantial increase in the number of foreign visitors to Japan, and this could be regarded as an increase in the competitiveness of Japan's tourism industry.

In conclusion, exports are expected to increase moderately on the whole, reflecting a very moderate pick-up in Japan's share in exports with the volume of global trade continuing to increase at about the same rate as the global economy.

Although imports are expected to continue on a moderate increasing trend, reflecting developments in domestic demand, the pace of increase is likely to be only moderate for the time being, partly because of the recent lack of momentum in exports and the effects of the depreciation of the yen.

External and Saving-Investment Balances

The trade deficit continued its widening trend through fiscal 2013 after recording a deficit in fiscal 2011 for the first time since fiscal 1979. Since the start of fiscal 2014, however, the trade deficit has been narrowing due to the decrease in imports following the front-loaded increase prior to the consumption tax hike (Chart 33 [1]). Reflecting these developments, the current account surplus has been widening slightly since the beginning of fiscal 2014, after following a declining trend through fiscal 2013. As for the outlook, the growth differential between Japan and the rest of the world is expected to cause a general narrowing in the trade deficit since the pace of increase in domestic demand is likely to be somewhat lower than that of last fiscal year, while the growth rates of overseas economies are expected to rise gradually. Moreover, the income balance is likely to widen its surplus as overseas assets continue to accumulate, mainly through direct investment. Reflecting such developments, the current account surplus is likely to widen, albeit moderately.[19]

[19] Considering this in terms of capital flows, which mirror developments in the current account, there is likely to be net capital outflow from Japan, as capital tends to go overseas in pursuit of higher profitability.

Looking at the domestic saving-investment balance that conceptually corresponds to the current account balance, excess saving in the private sector during the projection period will narrow at a moderate pace, while the deficit in the general government is expected to narrow at a pace somewhat exceeding the pace of the narrowing in excess saving in the private sector, partly due to an increase in tax revenue as a result of the consumption tax hikes (Chart 33 [2]). Therefore, domestic excess saving as a whole is expected to follow a moderate rising trend.

The Environment surrounding Corporate Profits and Business Fixed Investment

In the corporate sector, favorable business performance has been maintained due mainly to an increase in profits from overseas business, and firms have been raising their growth expectations moderately. On this point, regarding manufacturers, profitability on a consolidated basis has been higher than that on a non-consolidated basis, owing to the recent success in firms' overseas business, and -- coupled with the effects of the depreciation of the yen -- the receipts of dividend income and interest income, mainly from foreign subsidiaries with favorable business performance, have supported domestic profits (Chart 34 [1] and [2]). This increase in profits from overseas business is one reason that business sentiment has been maintained at a favorable level, although the economy has been affected mainly by the decline in demand following the front-loaded increase prior to the consumption tax hike (Chart 34 [3]). In such a situation, firms have strongly maintained their active hiring and investment plans.

Looking ahead, corporate profits as a whole in fiscal 2014 are expected to maintain their increasing trend, supported by the improvement in the terms of trade due to the fallback in crude oil prices and by the aforementioned increase in receipts of dividend income and interest income from firms' overseas business, although the lack of momentum in exports and the decline in demand following the front-loaded increase are likely to suppress corporate profits and the depreciation of the yen will likely exert different effects across sectors (Chart 10). Thereafter, corporate profits are expected to continue increasing. However, toward the end of the projection period, their growth rate is expected to gradually decline since the distribution of profits to households will further progress through the increase in personnel expenses at the time the economy is expected to head for a cyclical deceleration.

Business fixed investment is projected to follow a moderate uptrend, with corporate profits continuing their improving trend. Business fixed investment of nonmanufacturers is likely to remain firm amid accommodative financial conditions, and even the domestic investment of manufacturers -- which has been lagging so far -- is expected to increase steadily due partly to the developments in foreign exchange rates. Therefore, the increasing momentum of business fixed investment is expected to strengthen somewhat for the time being (Chart 35 [1]). Toward the end of the projection period, however, the pace of the cyclical increase in business fixed investment is projected to gradually slow down as capital stock accumulates.

With regard to this outlook, growth rates of business fixed investment are assessed from the viewpoint of the capital stock cycle, based on the assumption that such investment will be undertaken in order to realize the level of capital stock necessary for production activity under certain growth expectations. Since business fixed investment was suppressed to a level slightly above the depletion of capital stocks through fiscal 2013, there appears to still be ample room for business fixed investment to increase for the time being even if firms' expected growth rates remain at around 0.5 percent for some time (Chart 35 [2]). Thereafter, it is projected that business fixed investment will be supported by the continued extremely accommodative financial conditions under the QQE, both in terms of interest rates and availability of funds -- as can be seen in the decline in real interest rates and financial institutions' positive attitude toward lending -- coupled with the rise in growth expectations (Chart 36).

According to various surveys, manufacturers' business fixed investment plans for fiscal 2014 have shown a solid increase, even amid the lack of momentum in exports (Charts 35 [1] and 37 [1]). The following factors, which are mutually reinforcing, might have been at work. First, capital stock has become considerably outdated as a result of protracted investment restraints, and thus the opportunity cost of further delaying investment in the maintenance and repair of aged equipment seems to be increasing (Chart 37 [2]). Second, with firms' growth expectations rising moderately as the opportunity to earn profits globally increases, embarking on investment intended for capacity expansion in strategic areas such as development of new products has started to be seen while they reestablish their head offices in Japan as research and development sites or mother factories. Third, partly due to the appreciation trend of the yen until late 2012, a sharp acceleration toward increasing overseas investment was seen through fiscal 2013; however, some firms plan to increase their share of domestic investment for fiscal 2014, due partly to the depreciation of the yen since the end of 2012 (Chart 37 [1] and [3]).[20] Other than the aforementioned developments, given that wages have risen due to the labor shortage, while interest rates for borrowing to finance business fixed investment have been at low levels, some firms, mainly nonmanufacturers, have started to invest in labor-saving machinery and equipment instead of hiring new employees.

The Employment and Income Situation

Labor market conditions have continued to improve against the background of a continued resilient trend in domestic demand, which tends to have large simulative effects on employment. Based on the fact that a change in recent labor demand has not been seen, it is likely that firms regard the decline in domestic demand following the consumption tax hike as a temporary one (Chart 5). The pool of labor necessary for economic activity has been supplied so far by a decline in the number of unemployed and an increase in labor participation by women and the elderly, and the amount of labor input (i.e., [number of employees] times [number of hours worked]) has been rising moderately, due mainly to the increase in the number of employees (Chart 39 [3]).

On this point, assessment on the degree of the tightness of labor market conditions does not change even when, in addition to the standard unemployment rate (U3), looking at the broadly-defined unemployment rates (U4-U6) -- which count as unemployed those people who currently are not looking for work but are potentially willing to work and those people

[20] Firms are also focusing on R&D investment in Japan. The current SNA statistics in Japan do not count a large part of R&D investment as business fixed investment. However, firms' active spending in this area has a positive effect in terms of increasing employment and future global competitiveness.

who currently are employed part-time but want and are available to work longer than they do at present (Chart 38). All indicators have declined to roughly the same as bottom levels or slightly below them in the previous economic recovery phase.[21]

Against the backdrop of the tightening of labor market conditions, hourly nominal wages of employees as a whole have improved moderately, albeit with some fluctuations (Chart 39 [1]). Wages per employee have also turned to an increase because the trend of downward pressure on average wages due to an increase in the ratio of part-time workers has declined, scheduled cash earnings have improved reflecting the rise in base pay this spring, and non-scheduled cash earnings and special cash earnings (including bonuses and temporary payments) have increased (Charts 6 [1] and 39 [2]). In particular, the year-on-year rate of increase in scheduled cash earnings of regular employees has clearly accelerated recently due to the dissipation of the effects of the decline in government employees' salaries as well as the aforementioned rise in base pay (Chart 6 [2]). Reflecting these developments in the employment and income situation, the year-on-year rate of increase in employee income has been accelerating moderately (Chart 6 [3]). Meanwhile, the effects of the consumption tax hike have exerted downward pressure on the year-on-year rate of change in real employee income. However, excluding such effects, the rate of change has been on an improving trend since the beginning of this year, reflecting developments in nominal income (Chart 41 [1]).

Going forward, in a situation in which Japan's economy continues to grow at a pace above its potential as a trend, it is likely that a tightening trend in labor market conditions will strengthen and that upward pressure will be exerted clearly on wages, particularly scheduled cash earnings (Charts 6 [1] and 39 [2]). Toward the end of the projection period, the year-on-year rate of change in hourly wages is expected to accelerate, somewhat exceeding that in the CPI (excluding the direct effects of the consumption tax hikes) (Chart 47 [2]). The year-on-year rate of change in wages per employee is expected to slightly exceed that

[21] On this point, the situation in Japan is quite different from that being discussed in the United States. In the United States, it has been pointed out that broadly-defined unemployment rates have not declined by as much as the standard unemployment rate and that there are many people who are potentially willing to work and part-time workers who want and are available for additional hours of work.

in hourly wages due to the conversion of part-time employees into regular ones and an increase in the hours worked. With regard to the rise in base pay, which is an important determinant of wages from next fiscal year on, given that the year-on-year rate of increase in the CPI excluding the direct effects of the consumption tax hikes is expected to accelerate gradually, it is assumed that wage negotiations between management and labor will be based on such developments and that the annual increase in base pay will accelerate by reflecting price developments in the past fiscal year. The rise in base pay is expected not only to increase scheduled cash earnings directly, but also to lead to an increase in non-scheduled cash earnings and special cash earnings through increasing the basis that is used to calculate such earnings (Chart 6 [1]).

Under those labor market conditions and the outlook for wages, the increase in employee income is expected to accelerate moderately through the projection period (Chart 6 [3]). The labor share is expected to follow a moderate downtrend, reflecting the fact that labor productivity rises slightly ahead of real wages against the backdrop of a continued economic recovery going forward; however, it is projected to stop declining toward the latter half of the projection period at around a level somewhat higher than the average for the previous economic expansion phase of 2004-07 (Chart 39 [4]).[22]

Households' Spending Behavior

The decline in private consumption following the consumption tax hike is basically a result of the intertemporal substitution -- a decline in demand following the front-loaded increase -- although the decline in real income has also adversely affected private consumption. In addition, there could be temporary or technical factors such as irregular weather or fluctuations on the demand-side statistics. Based on these points and the favorable employment and income situation that determines the underlying trend in consumption, private consumption is expected to maintain its resilient trend.

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

Though more data accumulation would be necessary to make a comprehensive assessment of the effects of the consumption tax hike in April 2014, comparing developments in real private consumption in the GDP statistics with those at the time of the previous consumption tax hike (in April 1997), it appears that, to the extent that the front-loaded increase in demand across goods was large this time, the decline in demand was considerable (Chart 7).[23] With regard to durable goods consumption in particular, since the front-loaded increase surged compared to the underlying trend, the decline following the consumption tax hike has been substantial and prolonged.[24] Moreover, since the degree of such decline in durable goods has exceeded firms' expectations, resulting in inventory adjustments, particularly in durable goods such as automobiles and electric appliances as well as construction goods related to housing investment, they have led to some weakness in industrial production (Chart 9). While there has been some weakness in non-durable goods and semi-durable goods that cannot be explained by the decline in demand following the front-loaded increase, this is likely to have been largely due to fluctuations in demand-side statistics, such as in the *Family Income and Expenditure Survey* (Chart 40).[25]

Regarding the outlook, private consumption is expected to remain subdued for the time being, due mainly to the effects of the decline in demand following the front-loaded increase, particularly in durable goods, and irregular weather through this past summer. Nevertheless, given that these factors exert only temporary downward pressure and that the

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[23] Looking at Chart 7 (2), it would seem that the front-loaded increase in demand this time is roughly the same as that of the previous time but that the decline this time is larger than the previous one. However, the growth trend of consumption seems to have decelerated, due mainly to the declining population, and excluding such trend, both the front-loaded increase and subsequent decline this time would be somewhat larger than those of the previous time.

[24] As the background to the large front-loaded increase in demand marked this time, the following can be pointed out: (1) the consumption tax hike this time is larger; (2) receded expectations for the price decline in durable goods and the scheduled second round of consumption tax hikes next year both seem to have worked to prompt intertemporal substitution by households; (3) automobile companies have introduced new cars in a concentrated manner; and (4) the timing of the expiration of some widely used operating systems coincided with that of the consumption tax hike.

[25] Recent developments in household nominal income exhibited by the *Family Income and Expenditure Survey* have shown a substantial downward deviation from those in total cash earnings shown in the *Monthly Labour Survey*. This downward deviation of household nominal income in the *Family Income and Expenditure Survey*, which is subject to sample bias, seems to have led to weakness in estimated demand for non-durable and semi-durable goods (Chart 40 [2]).

conditions surrounding factors to determine the underlying trend in consumption have remained favorable, including an increase in employee income, firm stock prices, and a strong willingness by the elderly to spend on average, private consumption is expected to gradually show a clear pick-up and maintain its increasing trend, albeit at a very moderate pace (Chart 41 [1] and [2]).

Although the decline in real income following the consumption tax hike could have somewhat strengthened people's tendency to cut back their household spending, particularly those with low incomes and living on pensions, consumer confidence bottomed out in April and has been on an improving trend on the whole (Chart 8 [6]). As the macroeconomic background to this development, it can be pointed out that an increase in employee income reflecting the rise in base pay and the increase in summer bonuses, together with stock price increases, could have mitigated the adverse effects on real income caused by the consumption tax hike. The propensity to consume in the economy is likely to remain high, supported partly by dissaving brought about by the aging population and high consumption appetite of those within the baby-boomer generation (Chart 41 [3] and [4]).

With regard to housing investment, the decline in owner-occupied housing investment following the consumption tax hike has been prolonged, particularly in rural areas, and the adverse effects of the bottleneck on the supply side, such as the surge in construction costs, have been somewhat evident in housing for sale (Charts 4 [2] and 8 [5]). Therefore, housing investment is expected to remain somewhat weak for the time being. Thereafter, it is expected to gradually regain its resilience, assisted in part by steady improvement in the employment and income situation, housing loan rates at low levels, and anticipation of higher real estate prices.

The Environment surrounding Prices

In assessing the outlook for prices, the main factors that determine inflation rates are as follows. First, the output gap has continued its moderate improving trend due mainly to the tightening of labor market conditions, and has recently been around zero, which is the past long-term average (Chart 13 [1]). For the time being, labor market conditions are expected to improve at a modest pace since the lack of momentum in economic activity following the consumption tax hike has effects with some lag. However, as the improvement in the output gap becomes evident with the effects of the decline in demand following the consumption tax hike running their course, a trend of a positive output gap is likely to gradually take hold in the second half of fiscal 2014; thereafter, as the economy is likely to continue growing at a pace above its potential as a trend, albeit with fluctuations caused by the scheduled second round of the consumption tax hikes, the output gap is expected to move further into excess demand territory at a moderate pace. Compared with the April 2014 Outlook Report and the July 2014 interim assessment, while the downward revision of the growth rate will reduce the degree of the improvement in the output gap, this slowdown seems to have been only marginal as the tightening trend in labor market conditions is strengthening steadily amid firms' continued positive hiring stance.

Second, judging from indicators obtained from the markets and various survey results, medium- to long-term inflation expectations appear to be rising on the whole from a somewhat longer-term perspective. Economists' inflation expectations have been rising, and the results of surveys conducted of bond market participants indicate that medium- to long-term inflation expectations have been on a moderate increasing trend (Chart 42 [2] and [3]). Based on breakeven inflation rates, calculated as the yield spreads between the fixed-rate bonds and inflation-indexed bonds, market participants' inflation expectations have generally been following an uptrend while being more or less flat recently (Chart 42 [1]). In addition, according to the results of various surveys, households' inflation expectations have been rising from a somewhat longer-term perspective and firms seem to be expecting a future rise in inflation (Chart 43). Such an increase in inflation expectations seems to be bringing a change in household consumption behavior, wage negotiations between management and labor, and firms' price-setting behavior. As for the outlook, with the Bank pursuing the QQE and the observed inflation rates rising, medium- to long-term inflation expectations are likely to follow a rising trend, gradually converging to around 2 percent -- the price stability target. Meanwhile, as more begin to project that a sustainable improvement in economic activity will continue, this is also likely to lead to an increase in inflation expectations.

Third, import prices are expected to become somewhat weak, as the effects of the decline in international commodity prices of late have more than offset those of the depreciation of the yen (Chart 44 [1] and [2]). Thus, as far as energy-related items -- which require less time to pass on changes in import prices to consumer prices -- are concerned, the effects of prices of energy-related items on a year-on-year basis are likely to further decline for the time being. By contrast, for other items, as passing on changes in costs resulting from the depreciation of the yen tends to take some time, the pass-through from import prices to consumer prices is likely to continue working as a factor to push up consumer prices toward the next fiscal year, with consumption maintaining its underlying resilience (Chart 44 [3]).

Taking the above into account, as for the outlook for prices excluding the direct effects of the consumption tax hikes, the year-on-year rate of increase in the PPI is expected to generally follow a moderate uptrend, mainly due to improvements in the global economy and in the supply and demand conditions for products, albeit with some fluctuations that primarily stem from movements in international commodity prices. Partly due to the effects of the decline in international commodity prices of late, the year-on-year rate of increase in the CPI is likely to be at around the current level for the time being, and subsequently accelerate gradually and reach around 2 percent -- the price stability target -- around the middle of the projection period; that is, in or around fiscal 2015, reflecting an improving trend in the output gap and a rise in medium- to long-term inflation expectations. Toward the end of the projection period, the year-on-year rate of increase in the CPI is likely to edge up as medium- to long-term inflation expectations will converge to around 2 percent and the output gap is expected to continue expanding within positive territory. Comparing the current projections with those in the July 2014 interim assessment, the projected rate of increase in the CPI for fiscal 2015 is somewhat lower due mainly to the decline in international commodity prices, but that for fiscal 2016 is more or less unchanged.

Considering the aforementioned outlook for prices in light of its relationship with the output gap -- depicted by the so-called Phillips curve -- the year-on-year rate of increase in the CPI is assumed to respond relatively clearly to an improvement in the output gap, and the

Phillips curve is expected to gradually shift upward, reflecting a rise in medium- to long-term inflation expectations (Charts 15 [2] and 45).

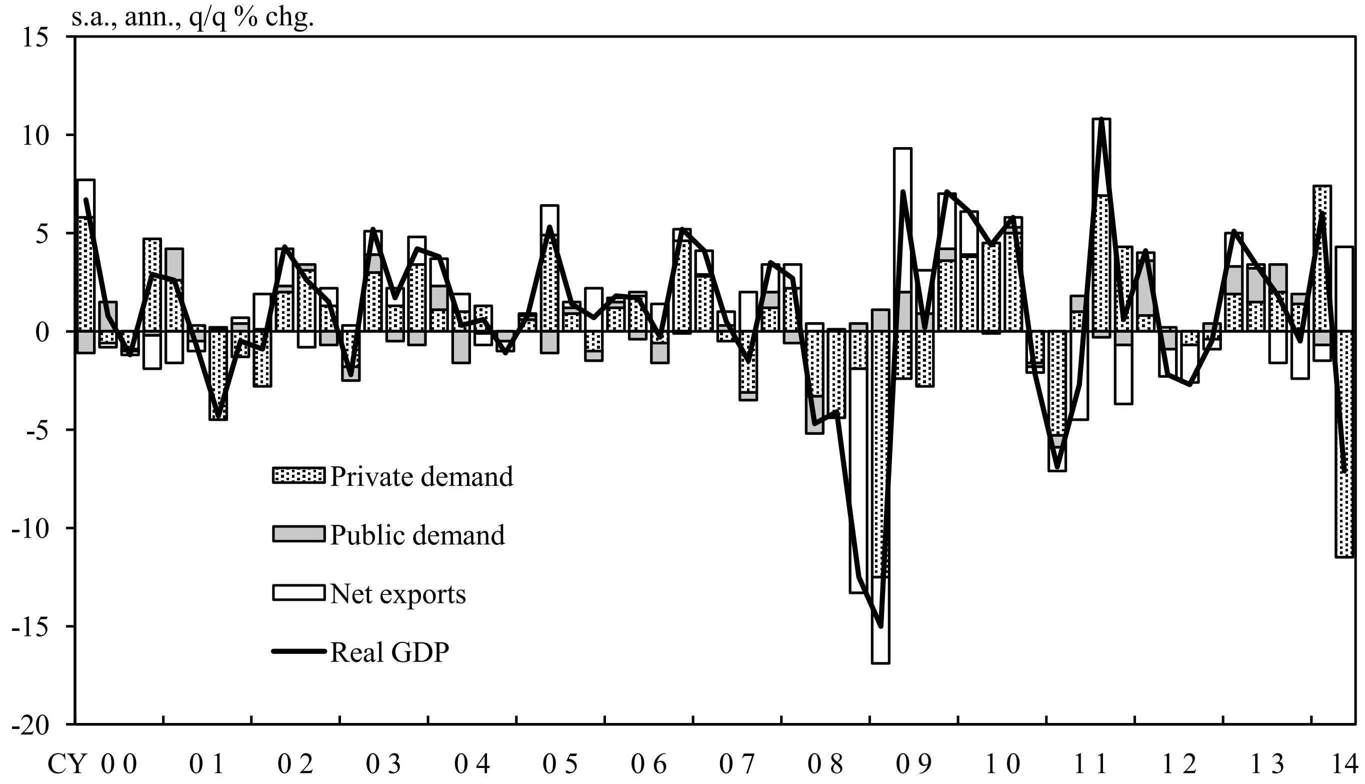
Behind such development, in addition to the Bank's strong commitment to achieving the price stability target, the changes in households' consumption and firms' price setting could operate interactively. First, looking at households, their attitude toward searching for lower prices has been less pronounced on the whole, and the tendency to select geographical convenience and high value added products seems to be more pronounced among the elderly and female workers in particular (Chart 46 [1]). Second, the power of controlling prices in the retail sector -- a mark-up rate -- might be somewhat strengthened against the background of, for example, realignment in the retail sector over the longer term (Chart 46 [2] and [3]). Third, against this background, firms' price-setting behavior in the retail and service sectors has been shifting from a low-price strategy utilizing inexpensive imported goods, as seen in the past, toward a strategy of raising sales prices while increasing value added. In relation to these points, moves among firms to pass changes in input costs -- including developments in foreign exchange rates -- on to sales prices of the final goods have become more pronounced compared with such moves in previous phases (Chart 44 [3]).

Meanwhile, in terms of the relationship between prices and nominal wages, a stable correlation between the CPI and hourly wages has been confirmed and shows that, from a long-term perspective, they simultaneously move almost in parallel (Chart 47). In the aforementioned outlook, it is assumed that a cycle between wage increases and price increases will gradually come to operate more steadily, partly because developments on the price front will be taken into account in wage negotiations. Specifically, the rate of increase in the CPI is projected to accelerate gradually as hourly wages are expected to rise moderately, reflecting the tightening of labor market conditions and the rise in people's inflation expectations.

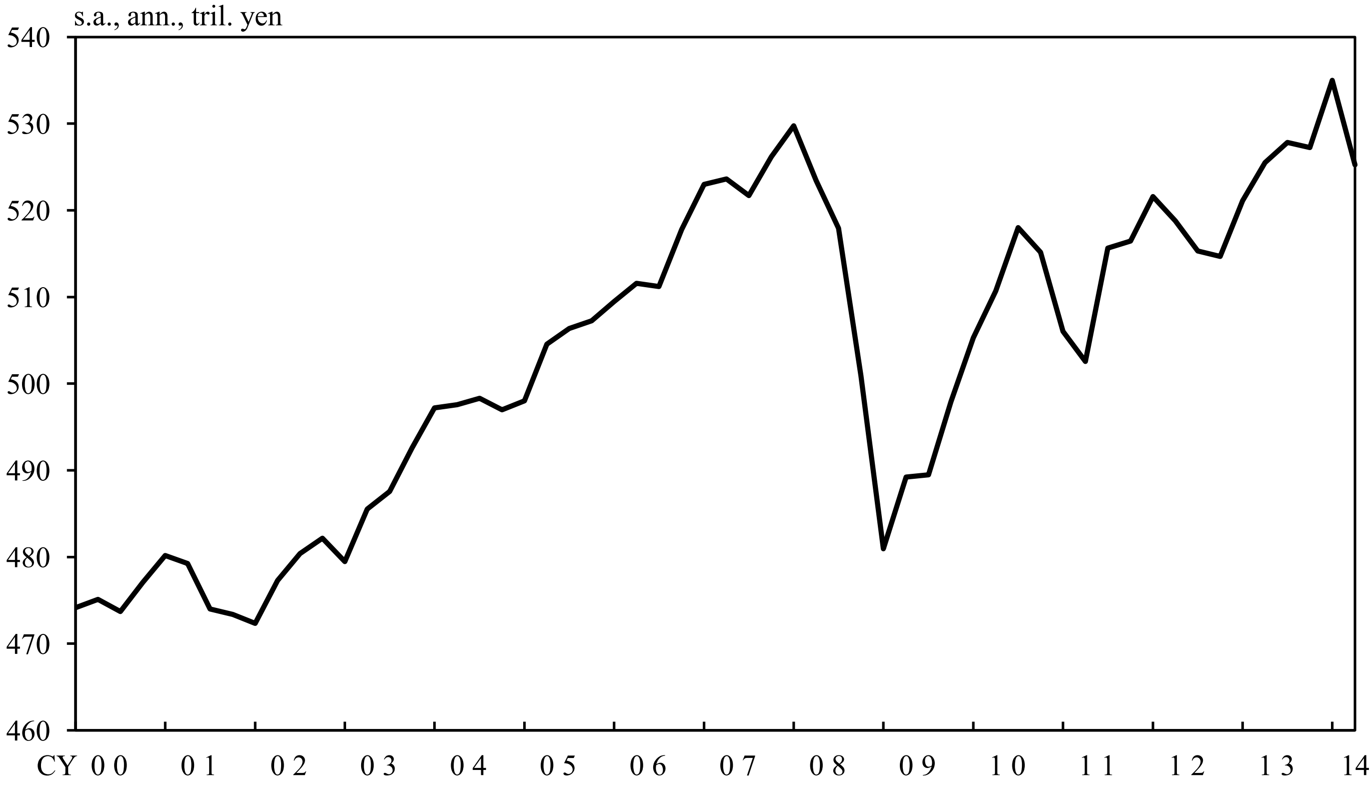
Charts

GDP

(1) Changes from the Previous Quarter



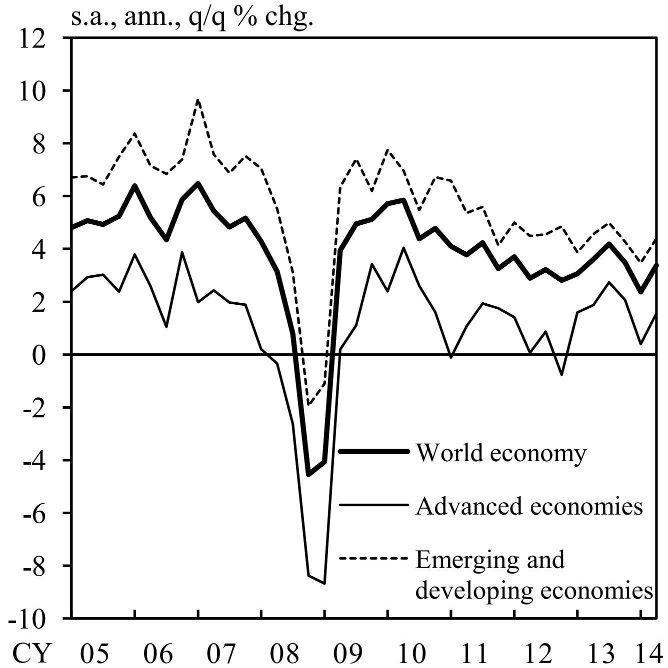
(2) Level



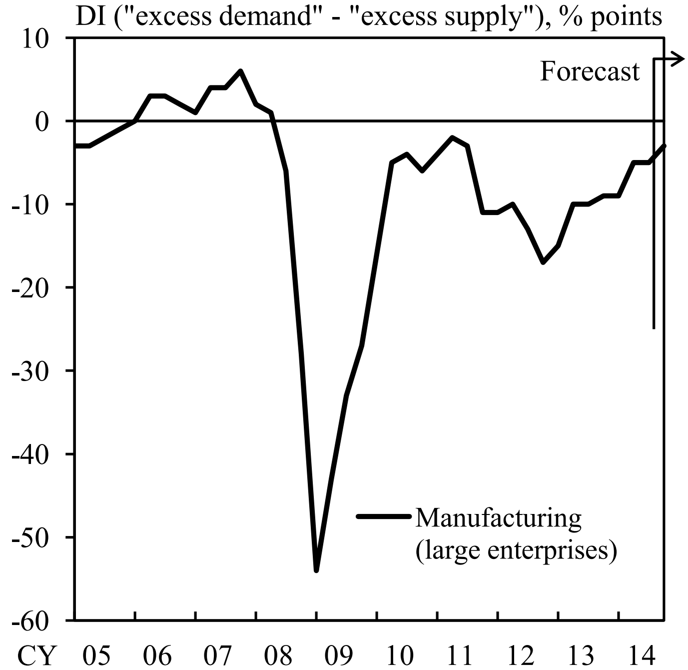
Source: Cabinet Office, "National Accounts."

World Economy and Exchange Rates

(1) Real GDP Growth Rates of the World Economy[1]



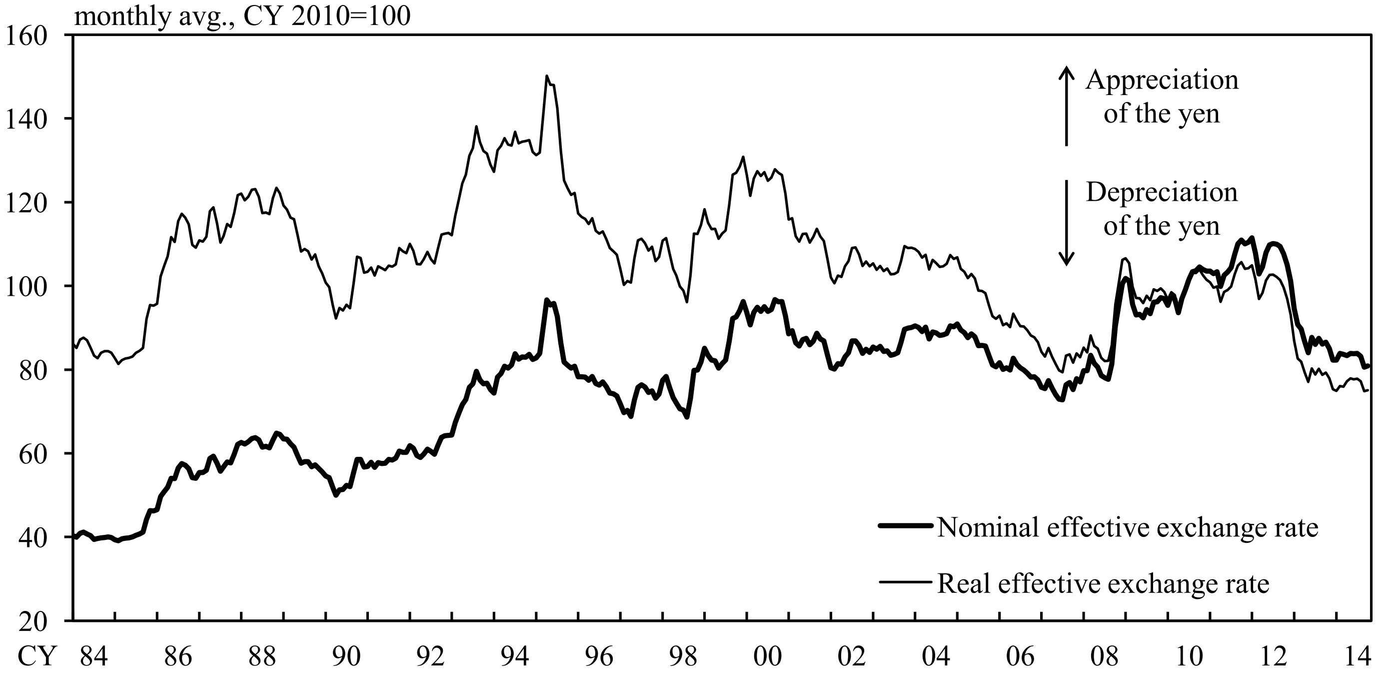
(2) Overseas Supply and Demand Conditions for Products[2]



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

2. The figure for 2014/Q4 is the forecast in the September 2014 survey.

(3) Effective Exchange Rates of the Yen

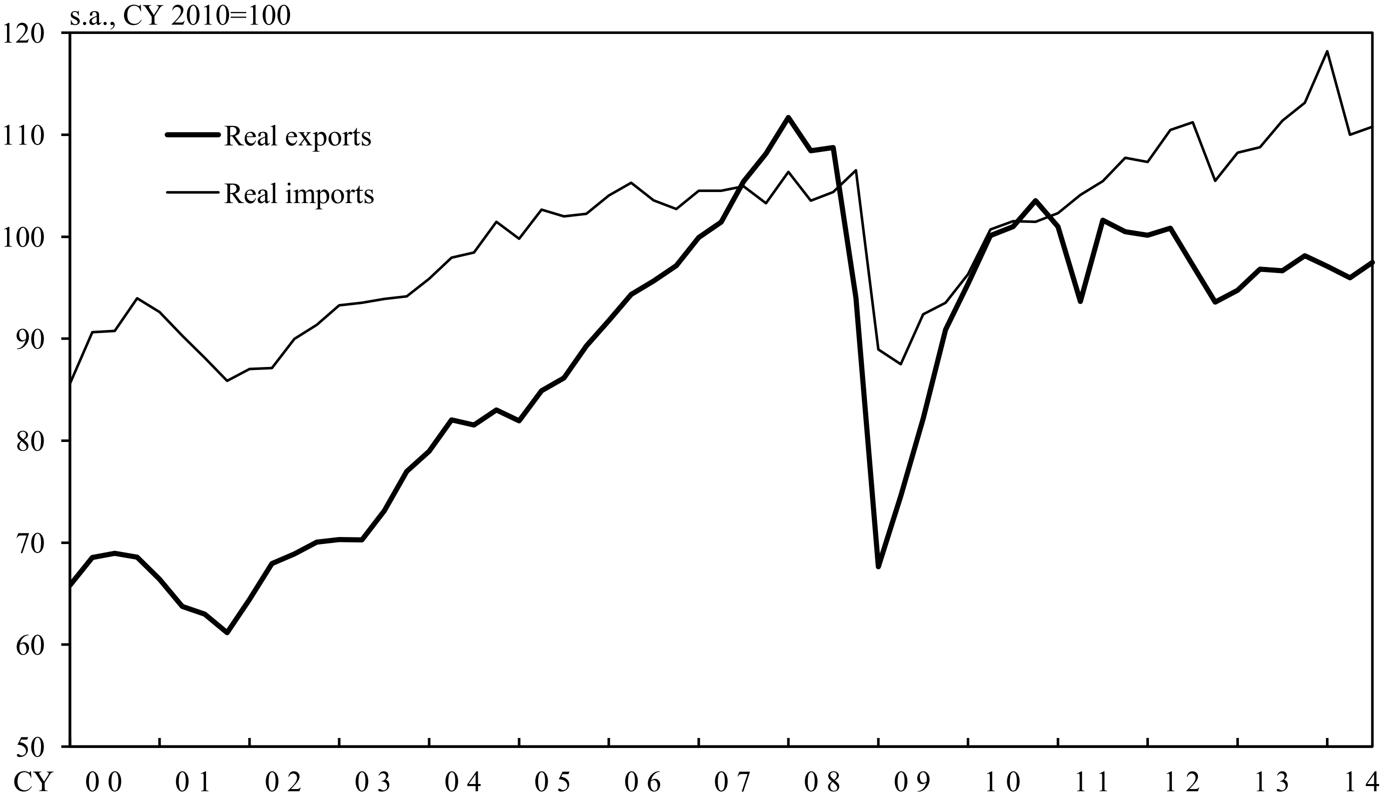


Note: Figures are based on the broad indices of the BIS effective exchange rates, and those prior to 1994 are calculated using the narrow indices. Figures for October 2014 are calculated using the Bank of Japan's nominal effective exchange rate of the yen.

Sources: IMF, "World Economic Outlook"; Bank of Japan, "*Tankan,* Short-Term Economic Survey of Enterprises in Japan"; Bank for International Settlements (BIS), etc.

Exports and Imports

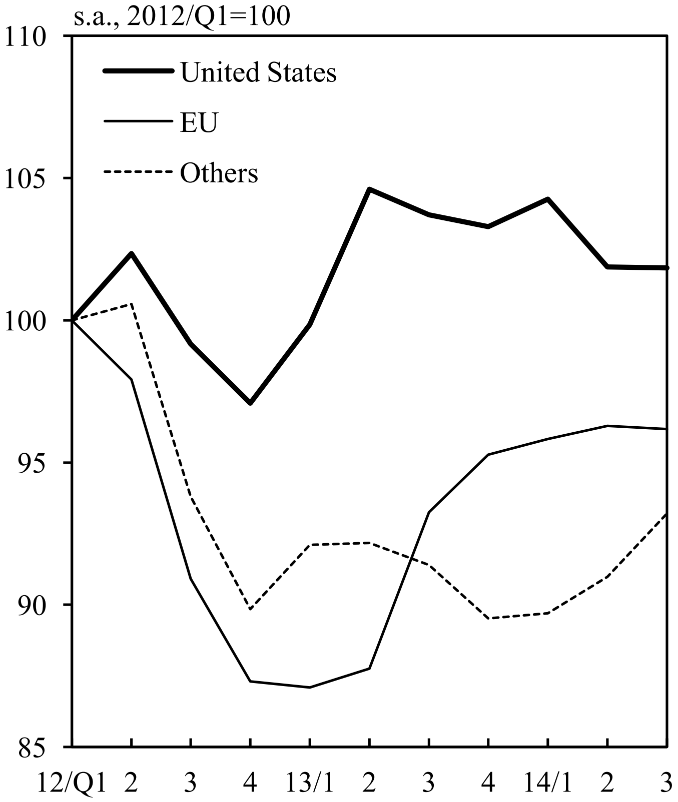
(1) Real Exports and Real Imports



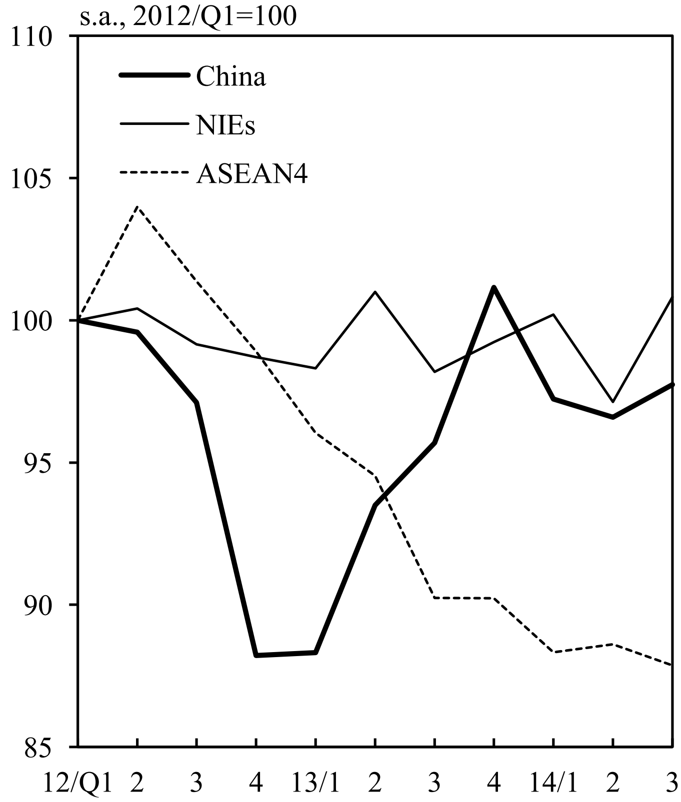
Note: Figures are seasonally adjusted by X-12-ARIMA. The same method applies to the charts below.

(2) Real Exports by Major Country and Region

(a) United States, EU, and Other Economies



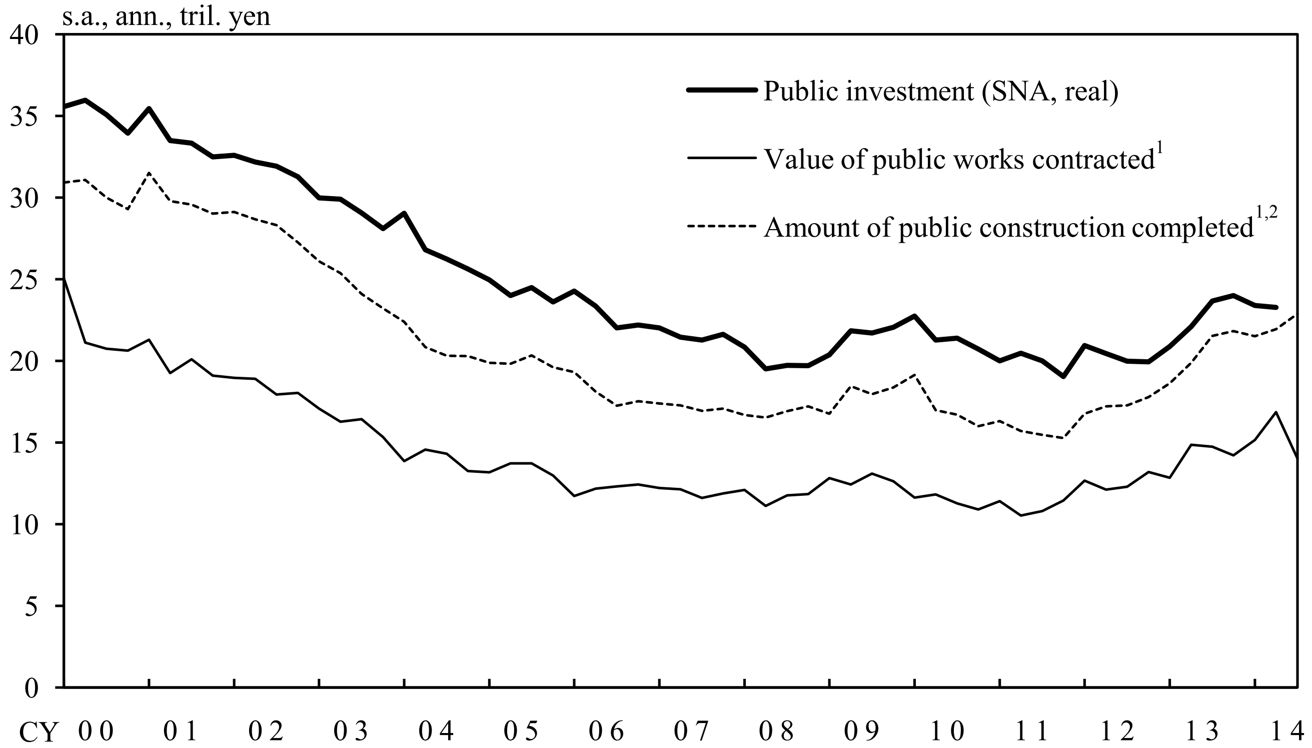
(b) China, NIEs, and ASEAN4



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

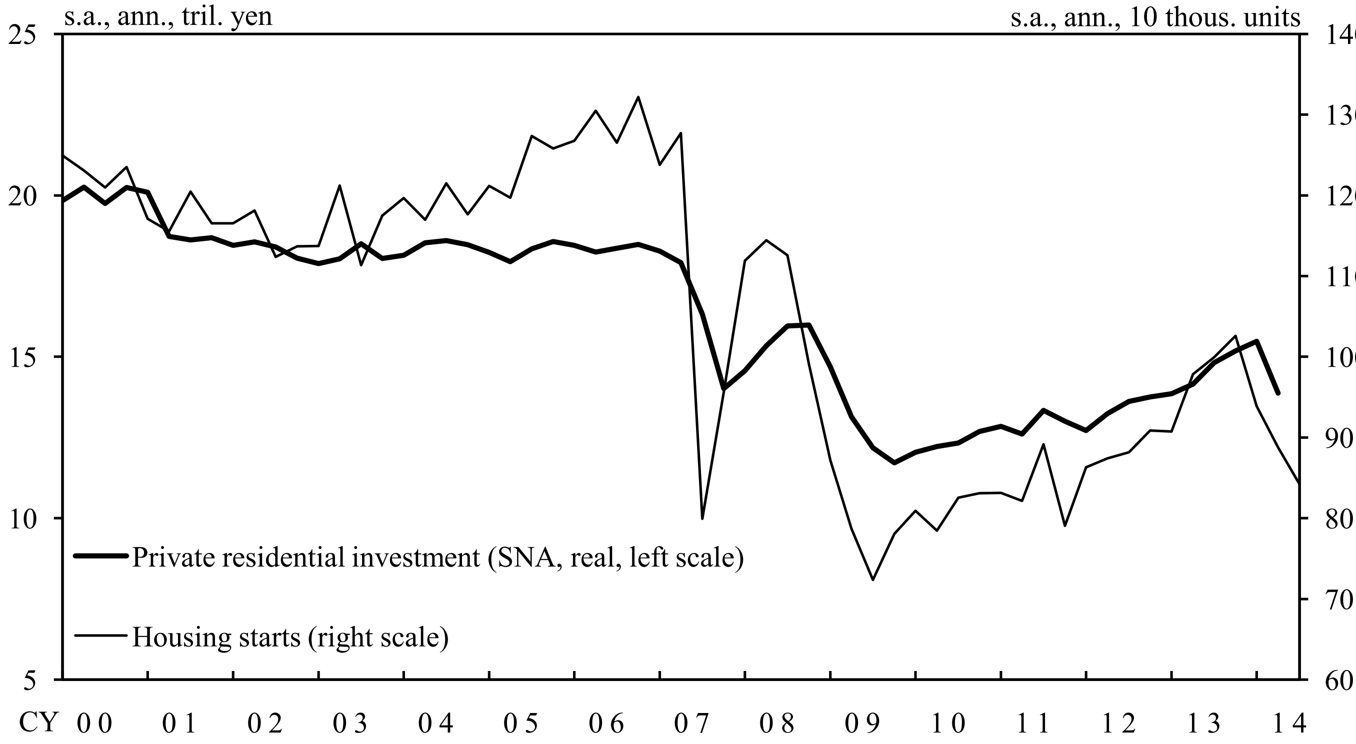
Public Investment and Housing Investment

(1) Indicators of Public Investment



Notes: 1. Figures are seasonally adjusted by X-12-ARIMA.
2. The figure for 2014/Q3 is the July-August average.

(2) Housing Starts and Private Residential Investment

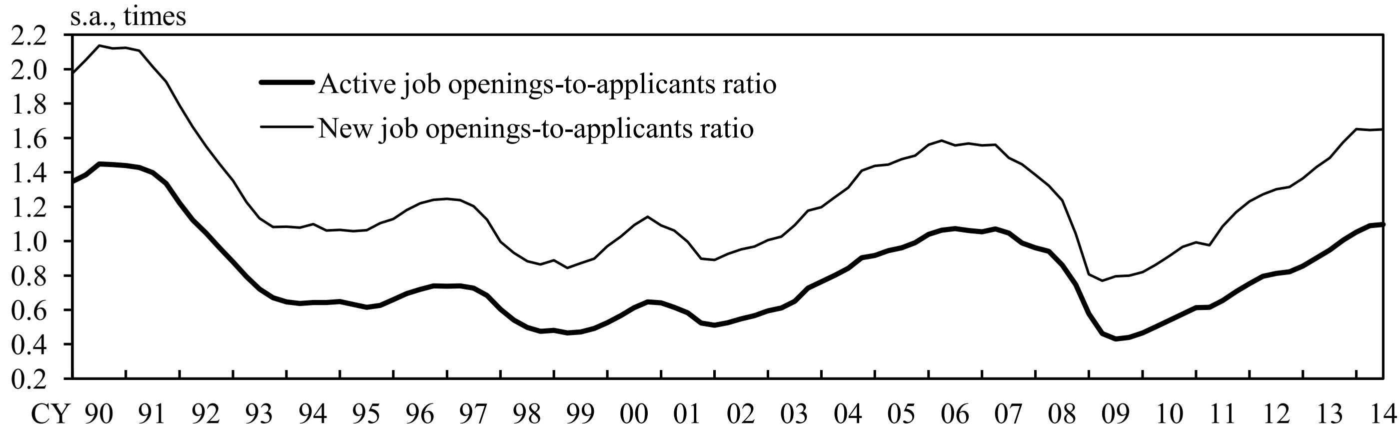


Note: The figure for housing starts for 2014/Q3 is the July-August average.

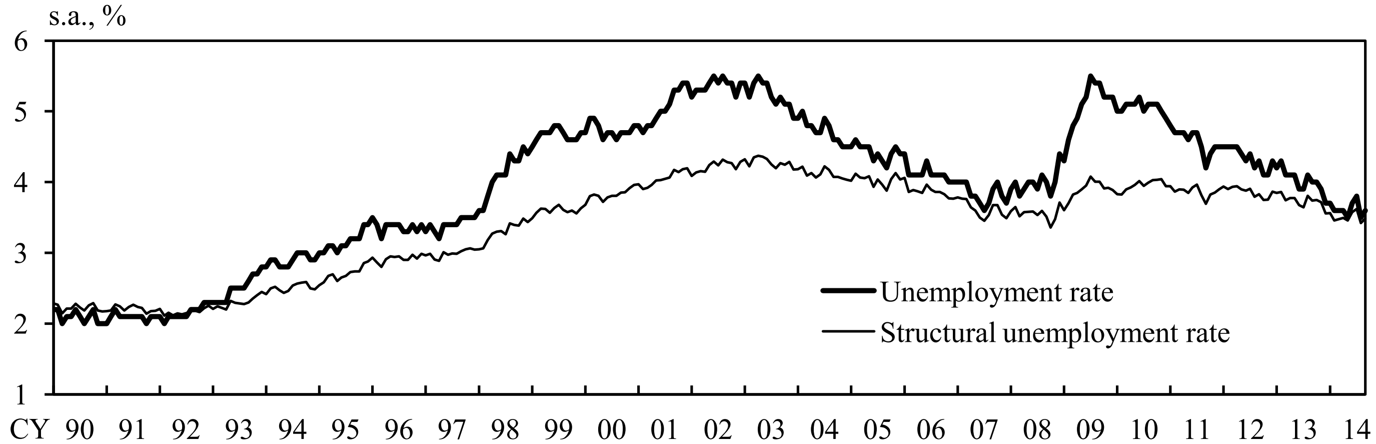
Sources: Cabinet Office, "National Accounts"; East Japan Construction Surety, etc., "Public Works Prepayment Surety Statistics"; Ministry of Land, Infrastructure, Transport and Tourism, "Integrated Statistics on Construction Works," "Statistics on Building Construction Starts."

Labor Supply and Demand

(1) Job Openings-to-Applicants Ratio

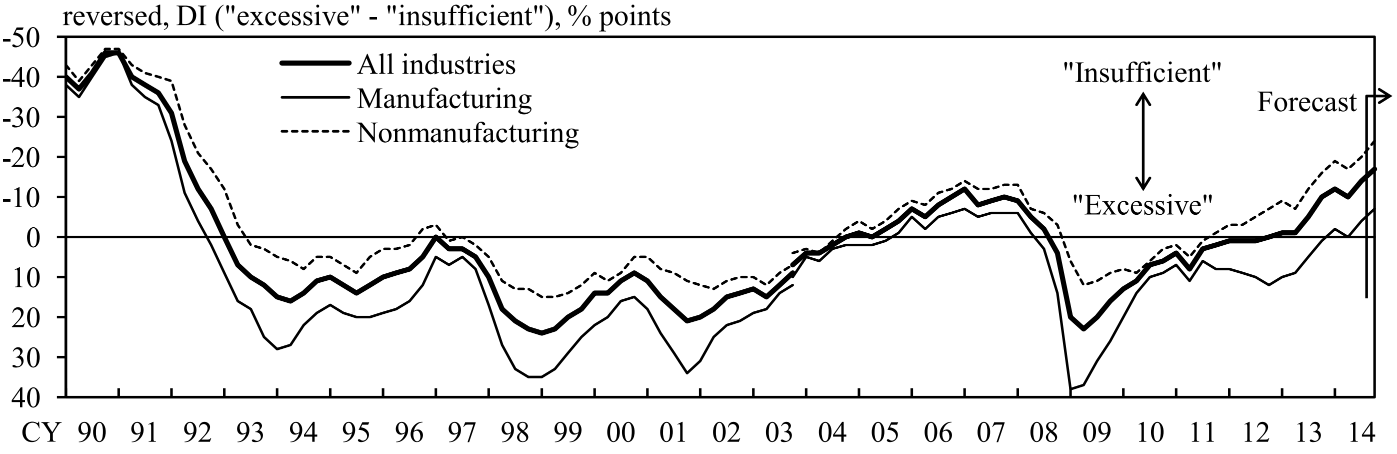


(2) Unemployment Rate



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

(3) Employment Conditions DI

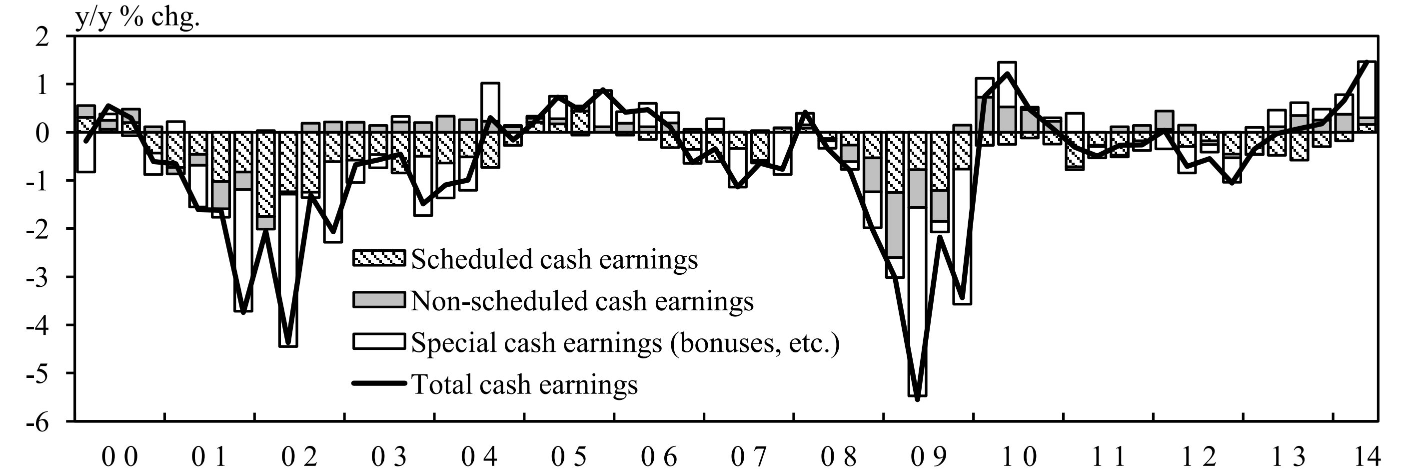


Note: Data from the "Tankan" are based on enterprises of all sizes. The "Tankan" was revised from the March 2004 survey. Figures up to the December 2003 survey are based on the previous data sets. Figures from the December 2003 survey are on the new basis. Figures for 2014/Q4 are the forecasts in the September 2014 survey.

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

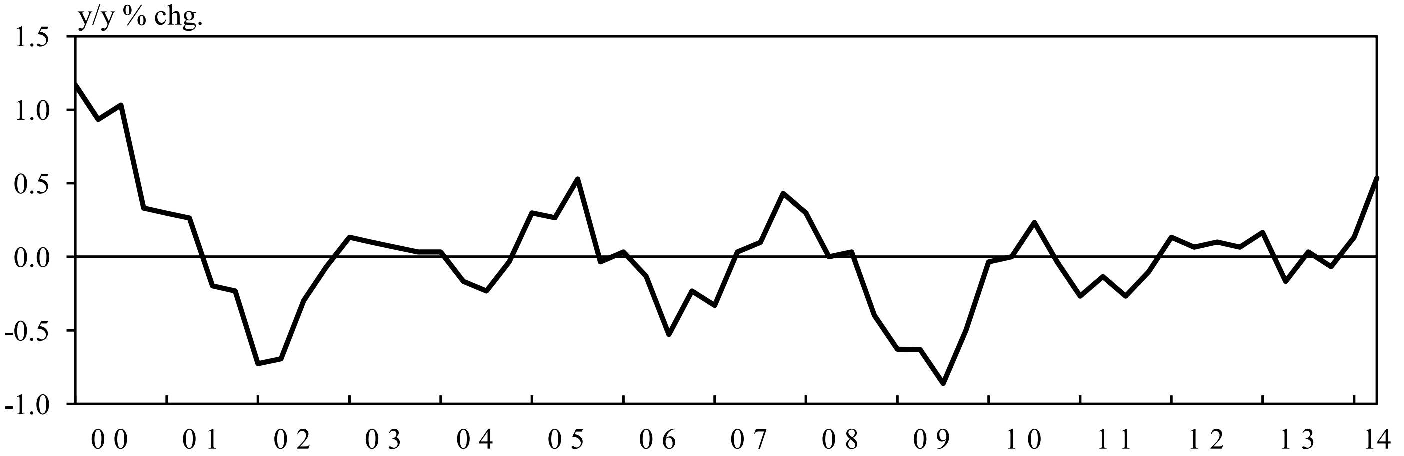
Employee Income

(1) Breakdown of Total Cash Earnings

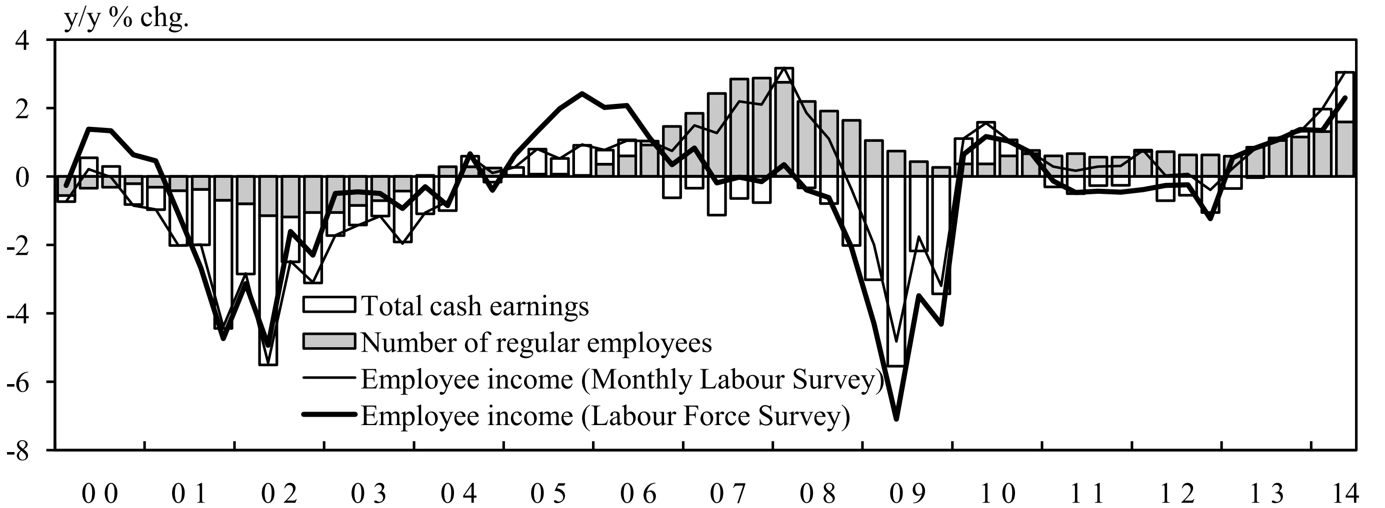


Note: Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February.
The same definition applies to the charts below.

(2) Scheduled Cash Earnings of Full-Time Employees



(3) Breakdown of Employee Income

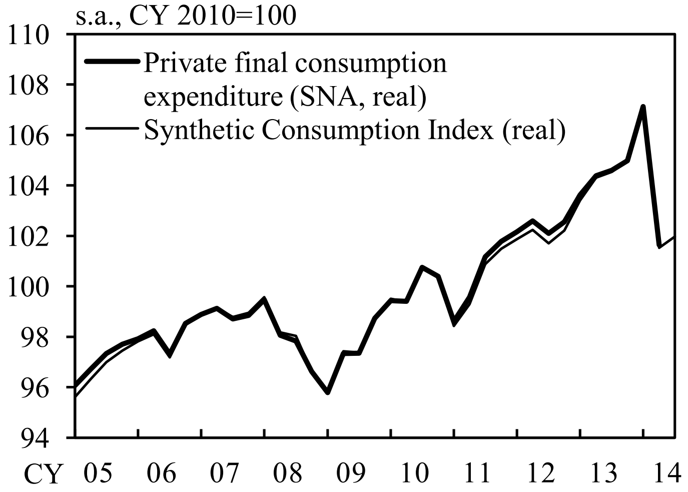


Note: Employee income (Monthly Labour Survey) = number of regular employees (Monthly Labour Survey) × total cash earnings
Employee income (Labour Force Survey) = number of employees (Labour Force Survey) × total cash earnings

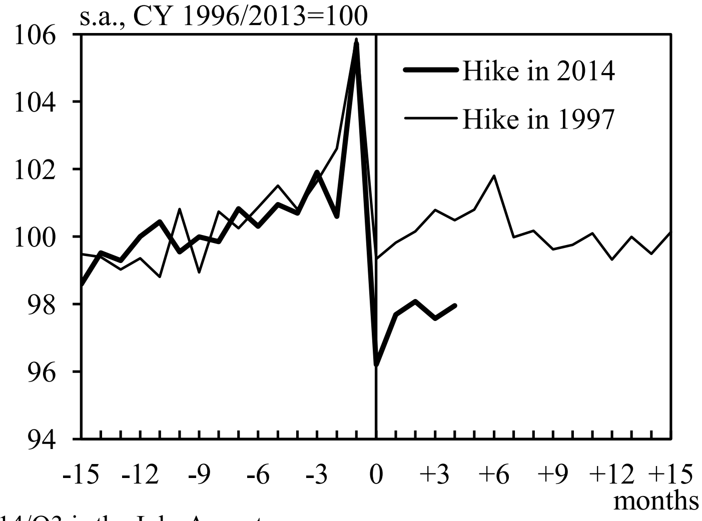
Sources: Ministry of Health, Labour and Welfare, "Monthly Labour Survey"; Ministry of Internal Affairs and Communications, "Labour Force Survey."

Private Consumption

(1) Private Final Consumption Expenditure and Synthetic Consumption Index



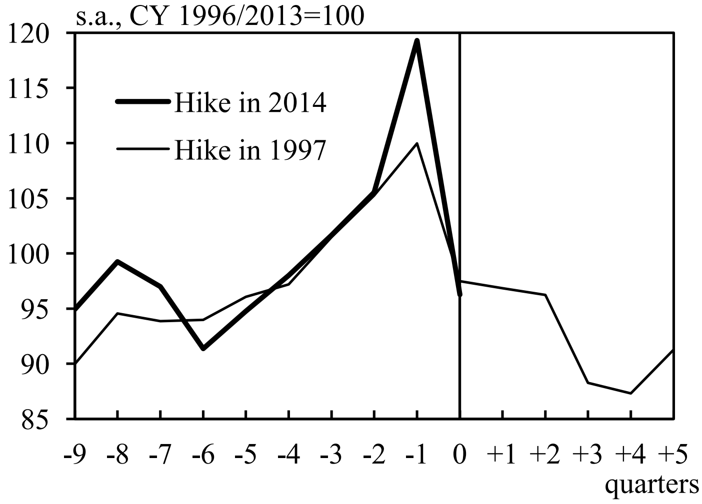
(2) Synthetic Consumption Index prior to and after the Consumption Tax Hikes



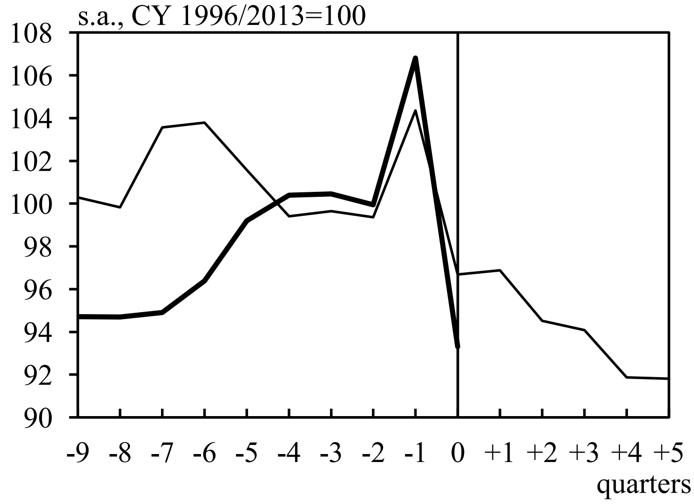
Notes: 1. The figure for the "Synthetic Consumption Index" for 2014/Q3 is the July-August average.
2. In Chart (2), month 0 represents April 1997/2014, concurrent with the rise in the consumption tax rate.

(3) Consumption Expenditure by Type (SNA)

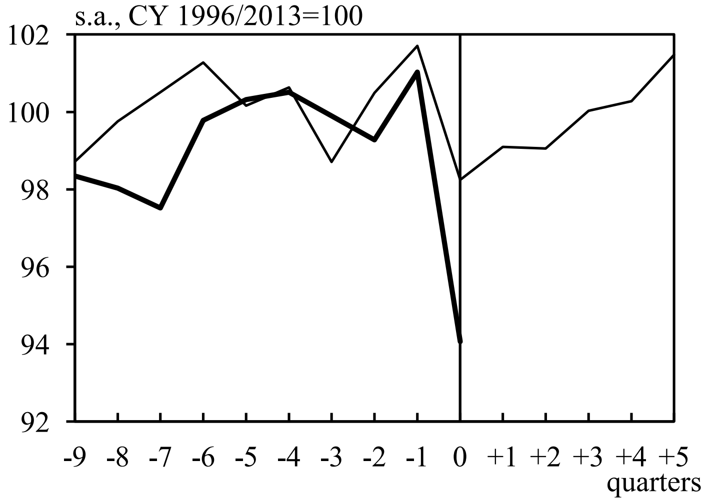
(a) Durable Goods



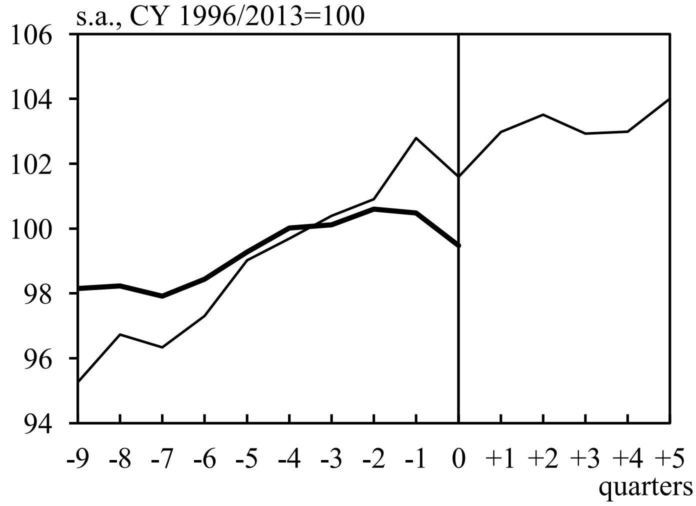
(b) Semi-Durable Goods



(c) Non-Durable Goods



(d) Services

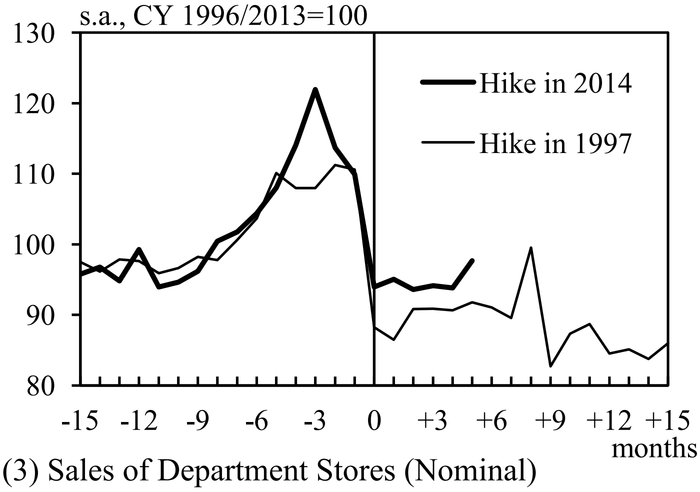


Note: Quarter 0 represents the quarters that include April 1997/2014, concurrent with the rise in the consumption tax rate.

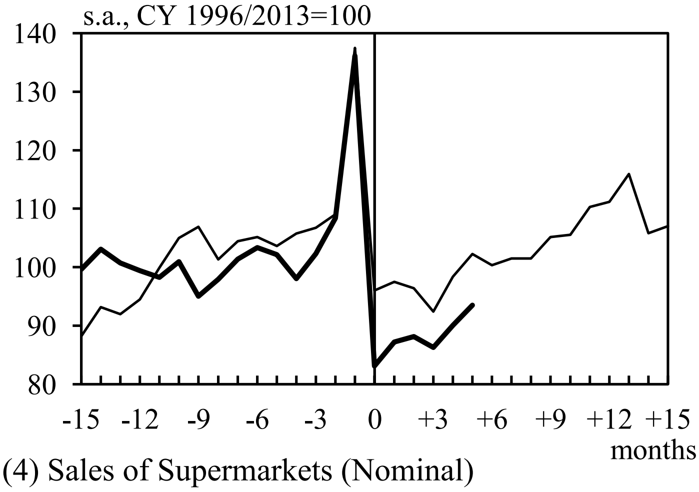
Source: Cabinet Office, "National Accounts," "Synthetic Consumption Index."

Household Expenditure prior to and after the Consumption Tax Hikes

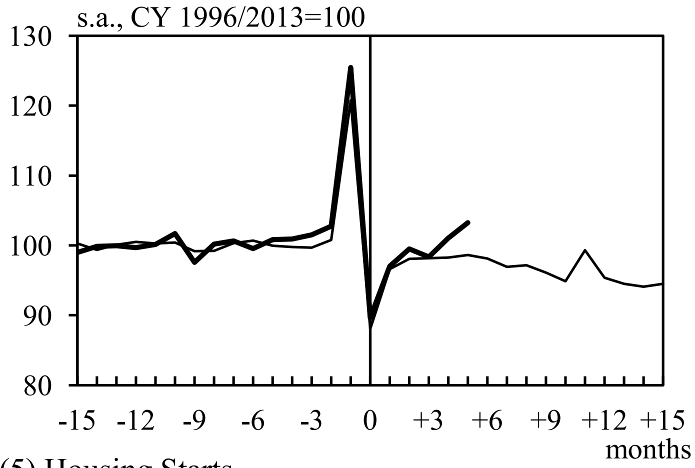
(1) New Passenger-Car Registrations



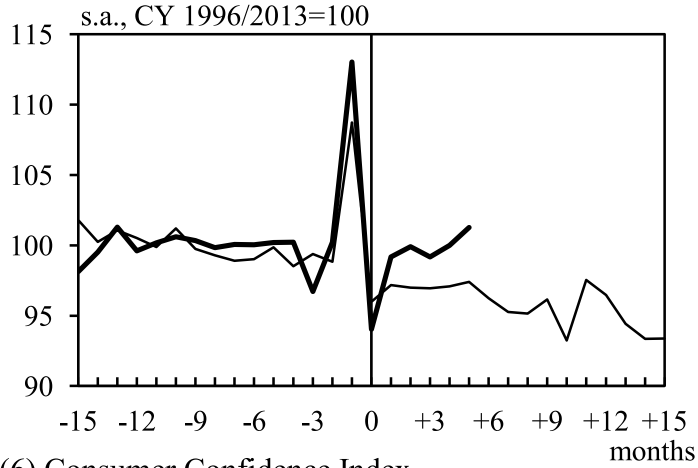
(2) Sales of Household Electrical Appliances (Real)



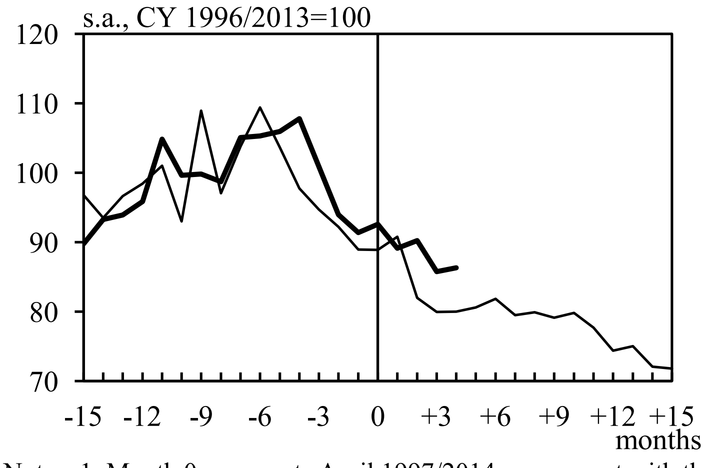
(3) Sales of Department Stores (Nominal)



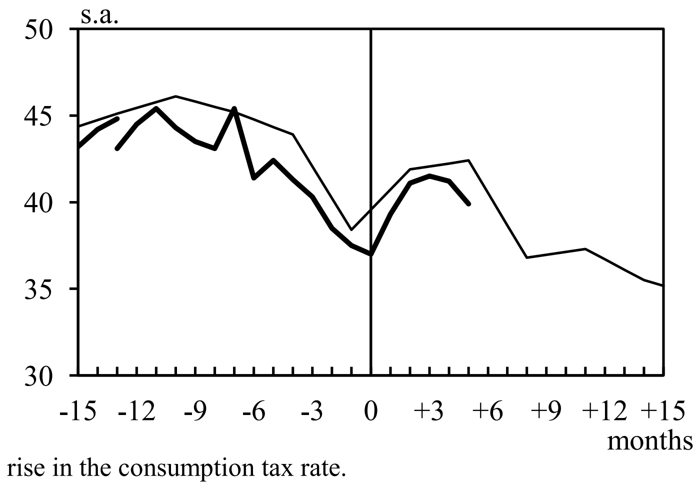
(4) Sales of Supermarkets (Nominal)



(5) Housing Starts



(6) Consumer Confidence Index



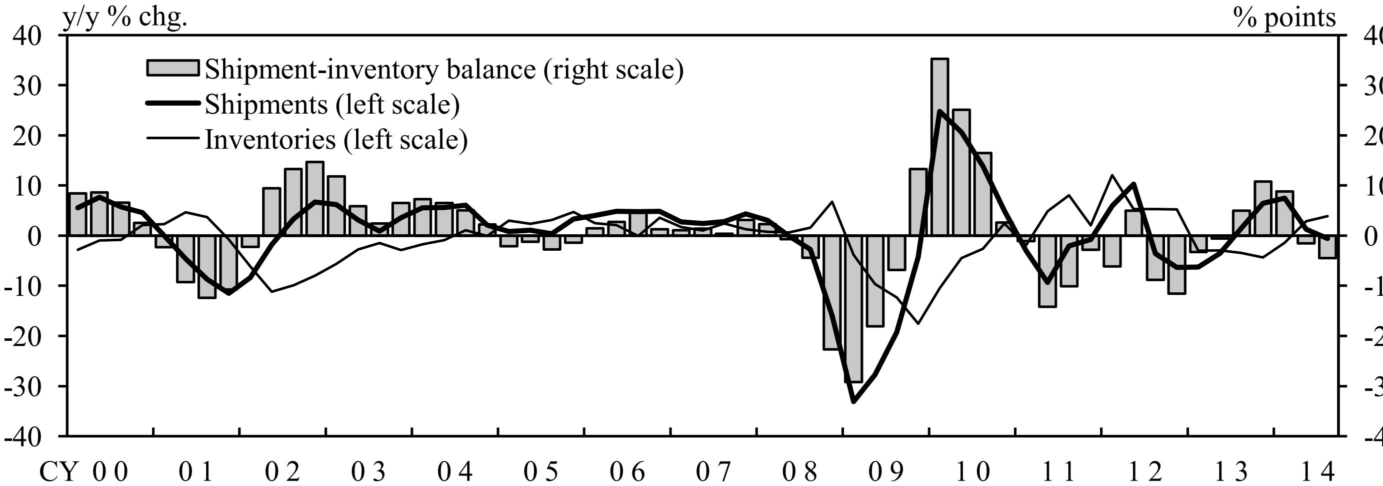
Notes: 1. Month 0 represents April 1997/2014, concurrent with the rise in the consumption tax rate.
2. Figures for Charts (1) through (4) are seasonally adjusted by X-12-ARIMA.
3. Figures for Chart (1) include small cars with engine sizes of 660 cc or less.
4. Figures for Charts (3) and (4) are adjusted to exclude the effects of the increase in the number of stores.
5. For the figures for the hike in 1997 in Chart (6), data are linearly interpolated since the "Consumer Confidence Survey" was conducted quarterly at that time. In the -12 months for the hike in 2014, the Cabinet Office changed the method for conducting the survey to a postal method, along with some other changes. For this reason, there is a discontinuity between data up to the -13 months for the hike in 2014, which were obtained from the survey on the visit-and-leave method, and those thereafter. The figure for the -13 months for the hike in 2014 on the postal-method basis is obtained from an examination survey.

Sources: Cabinet Office, "Consumer Confidence Survey"; Ministry of Economy, Trade and Industry, "Current Survey of Commerce," etc.

Industrial Production

(1) Industrial Production

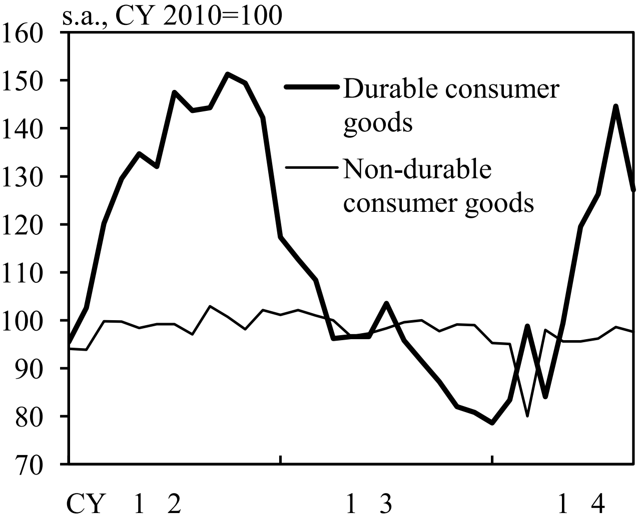
(2) Shipment-Inventory Balance (Mining and Manufacturing)



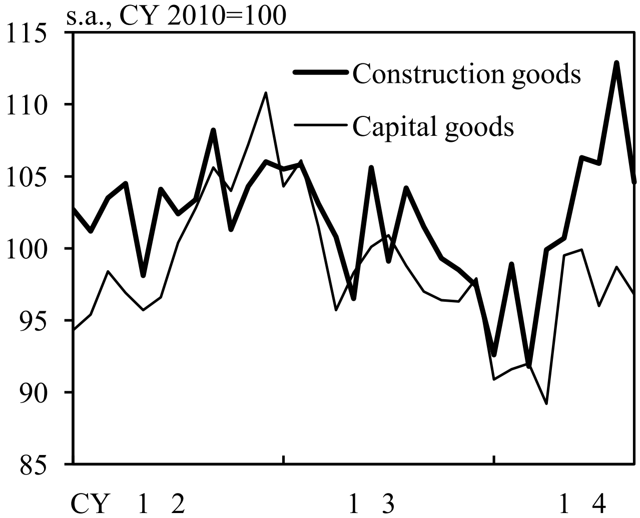
Note: Shipment-inventory balance = shipments (y/y % change) - inventories (y/y % change)

(3) Inventory Ratio

(a) Consumer Goods



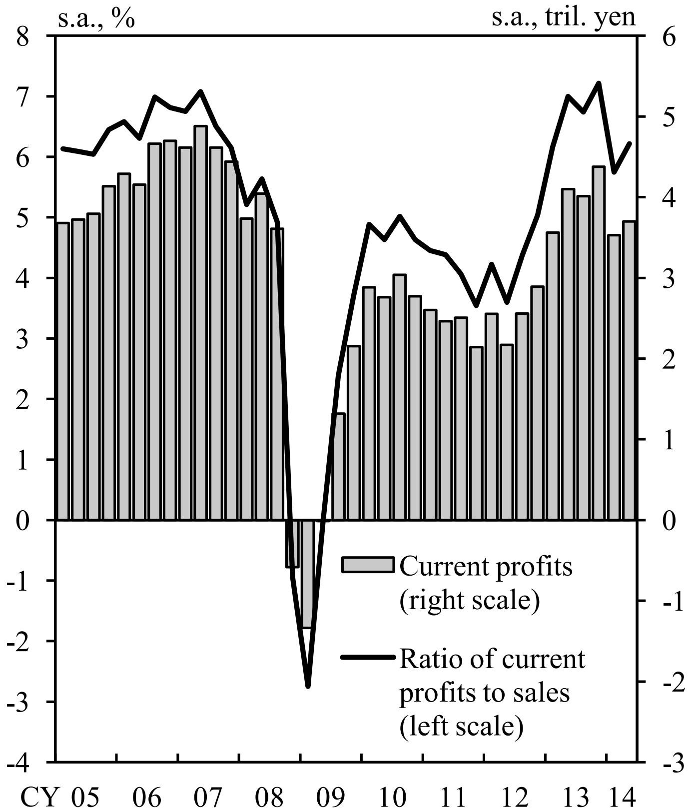
(b) Capital Goods and Construction Goods



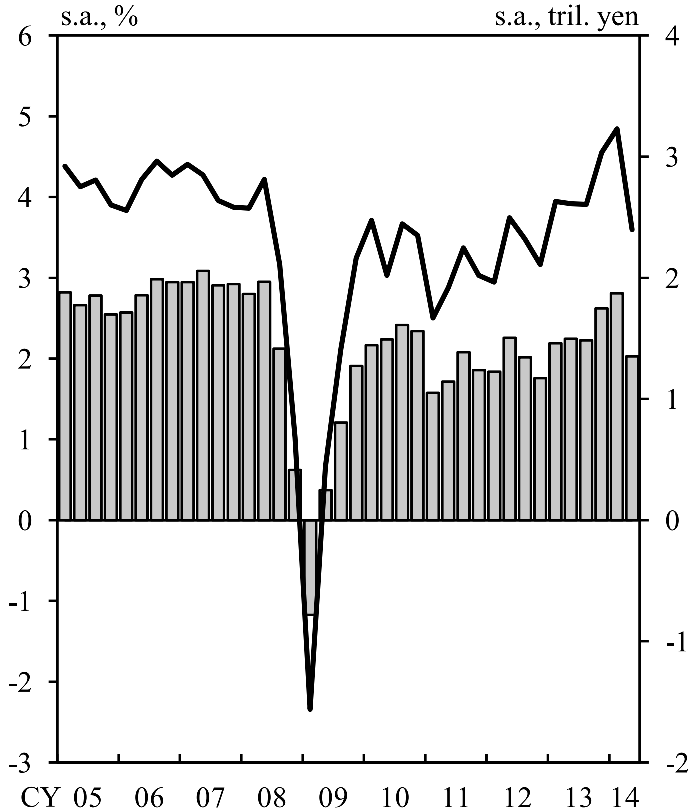
Source: Ministry of Economy, Trade and Industry (METI), "Indices of Industrial Production."

Corporate Profits

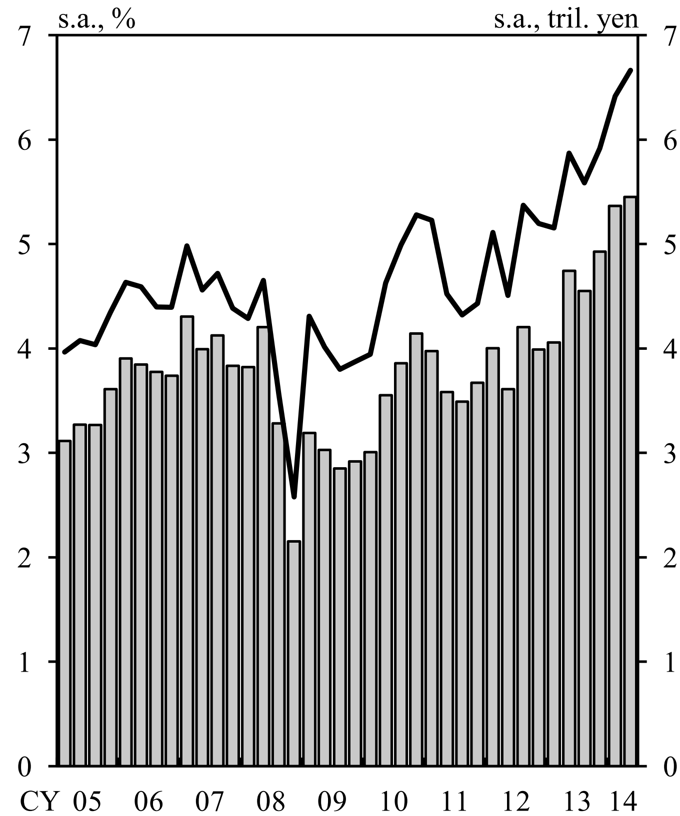
(1) Large Manufacturing Firms



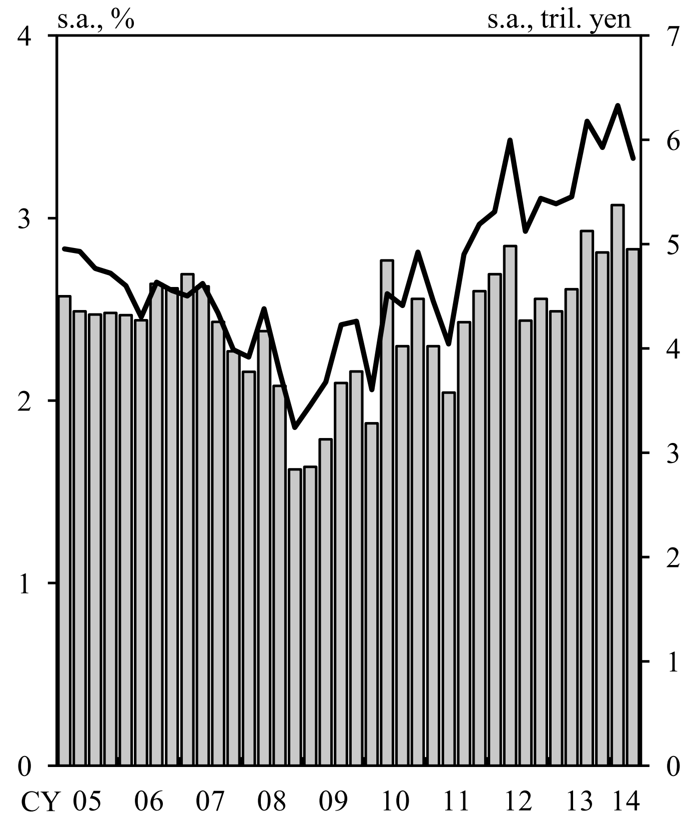
(2) Medium-Sized and Small Manufacturing Firms



(3) Large Nonmanufacturing Firms



(4) Medium-Sized and Small Nonmanufacturing Firms

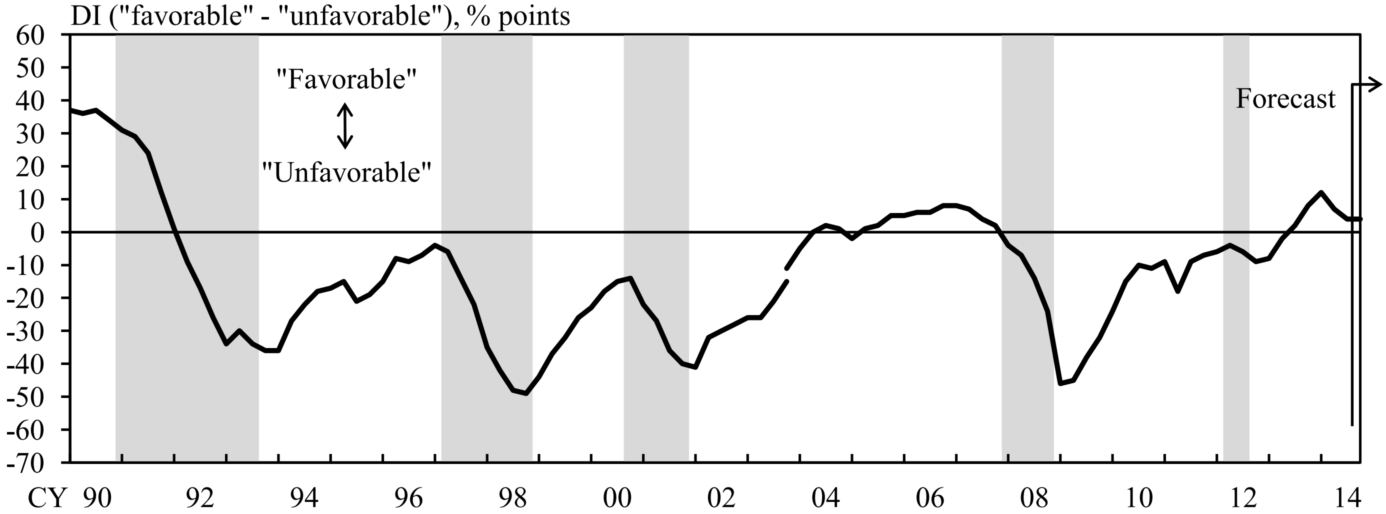


Notes: 1. Excluding "Finance and Insurance."
2. Seasonally adjusted by X-12-ARIMA.

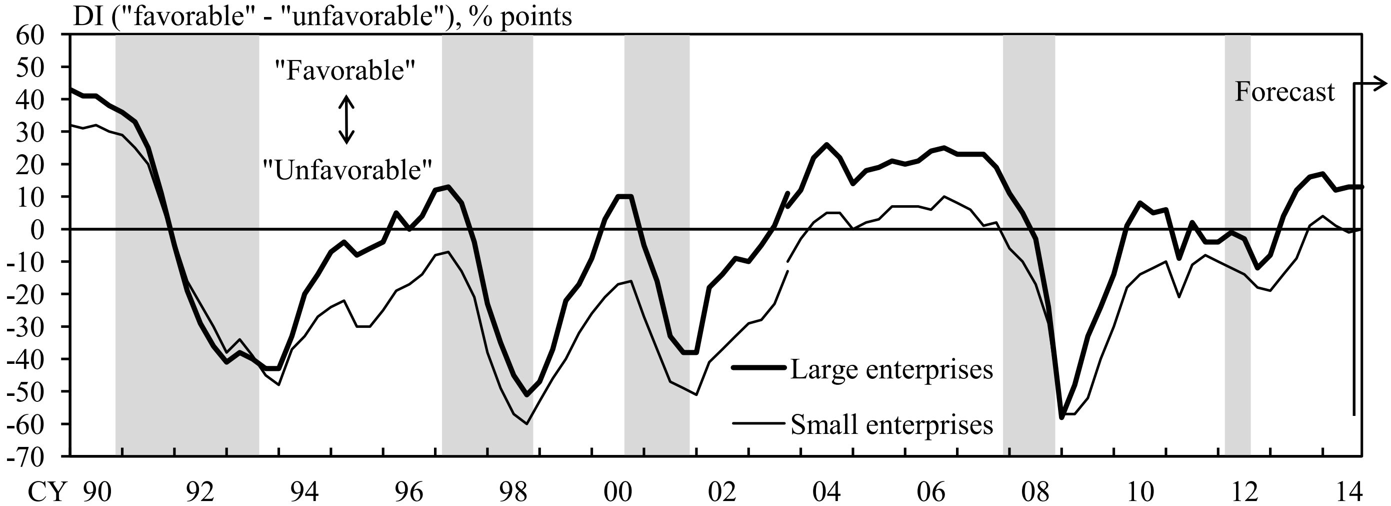
Source: Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Quarterly."

Business Conditions

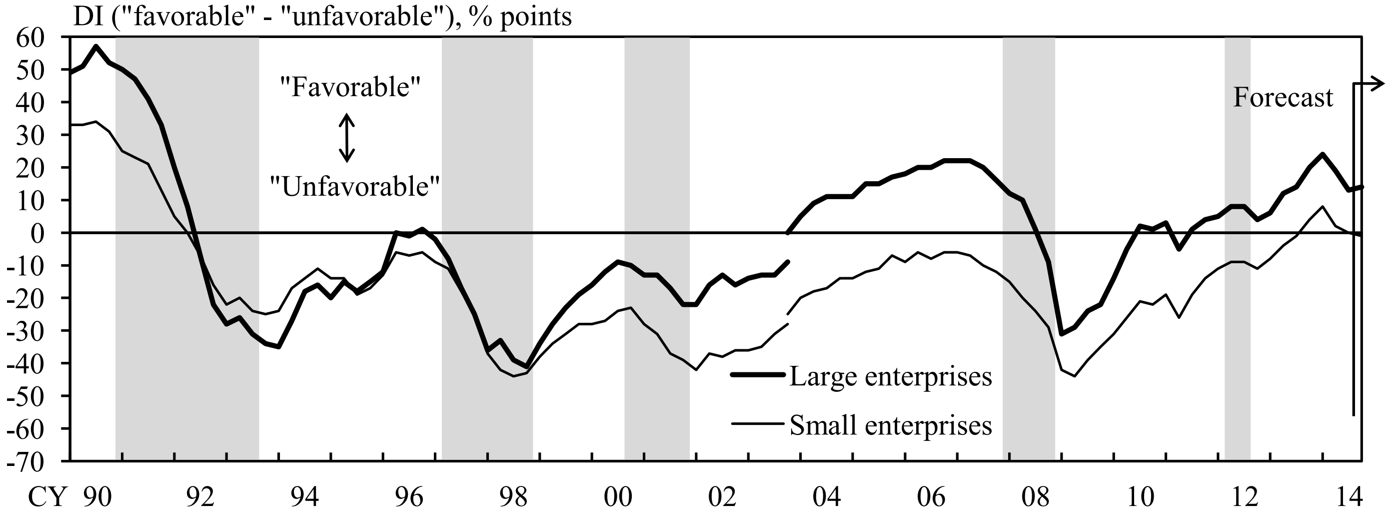
(1) All Industries and Enterprises



(2) Manufacturing



(3) Nonmanufacturing

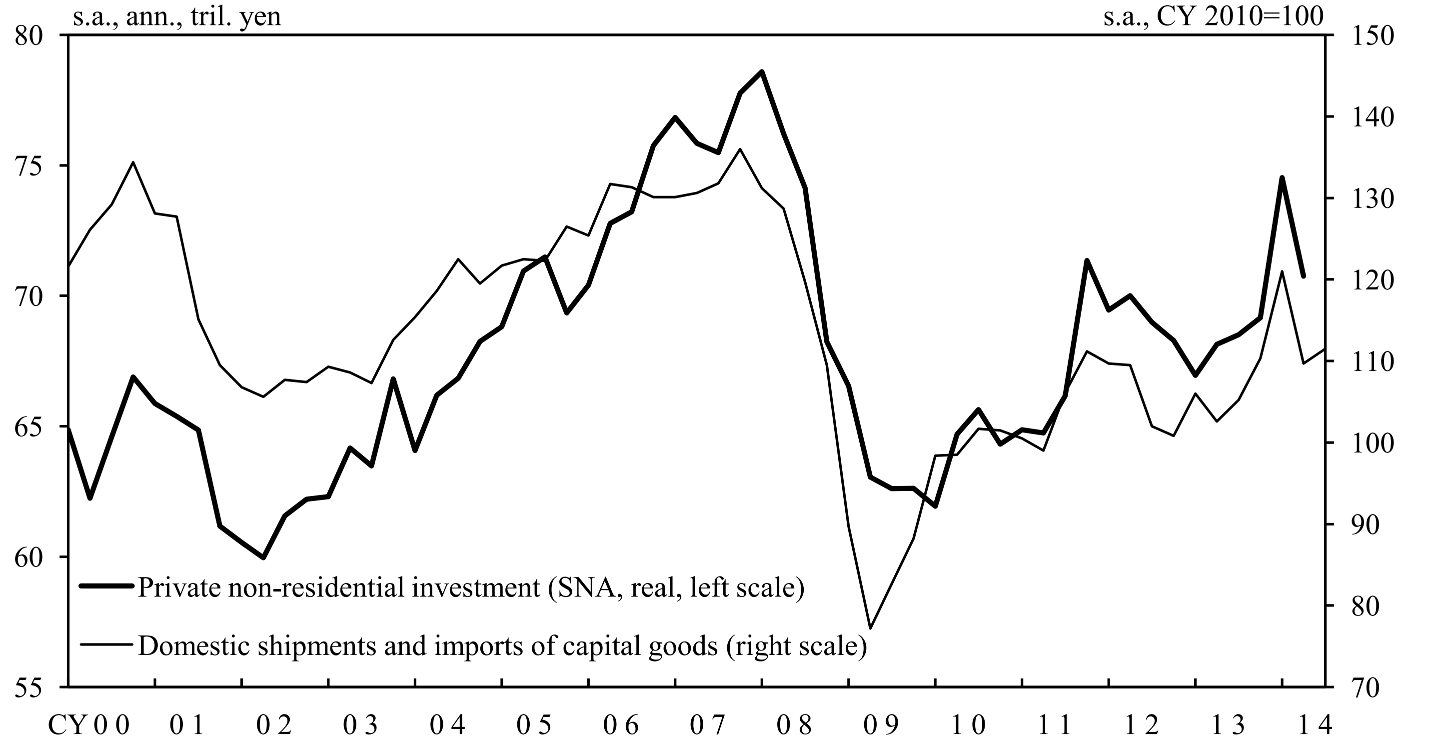


Notes: 1. The "Tankan" was revised from the March 2004 survey. Figures up to the December 2003 survey are based on the previous data sets. Figures from the December 2003 survey are on the new basis. Figures for 2014/Q4 are the forecasts in the September 2014 survey.
2. Shaded areas indicate recession periods.

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

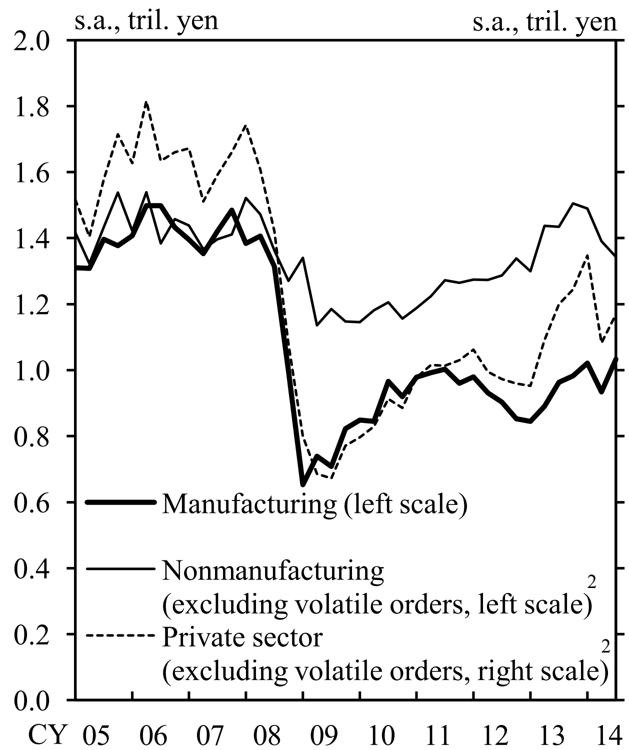
Fixed Investment

(1) Private Non-Residential Investment, and Domestic Shipments and Imports of Capital Goods

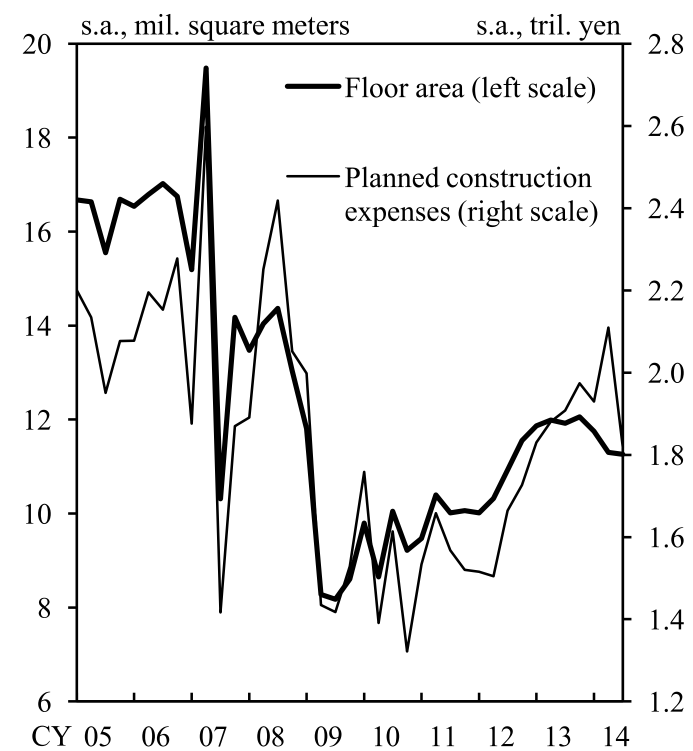


Note: The figure for 2014/Q3 is the July-August average.

(2) Machinery Orders[1]



(3) Construction Starts (Private, Nondwelling Use)[1,3]

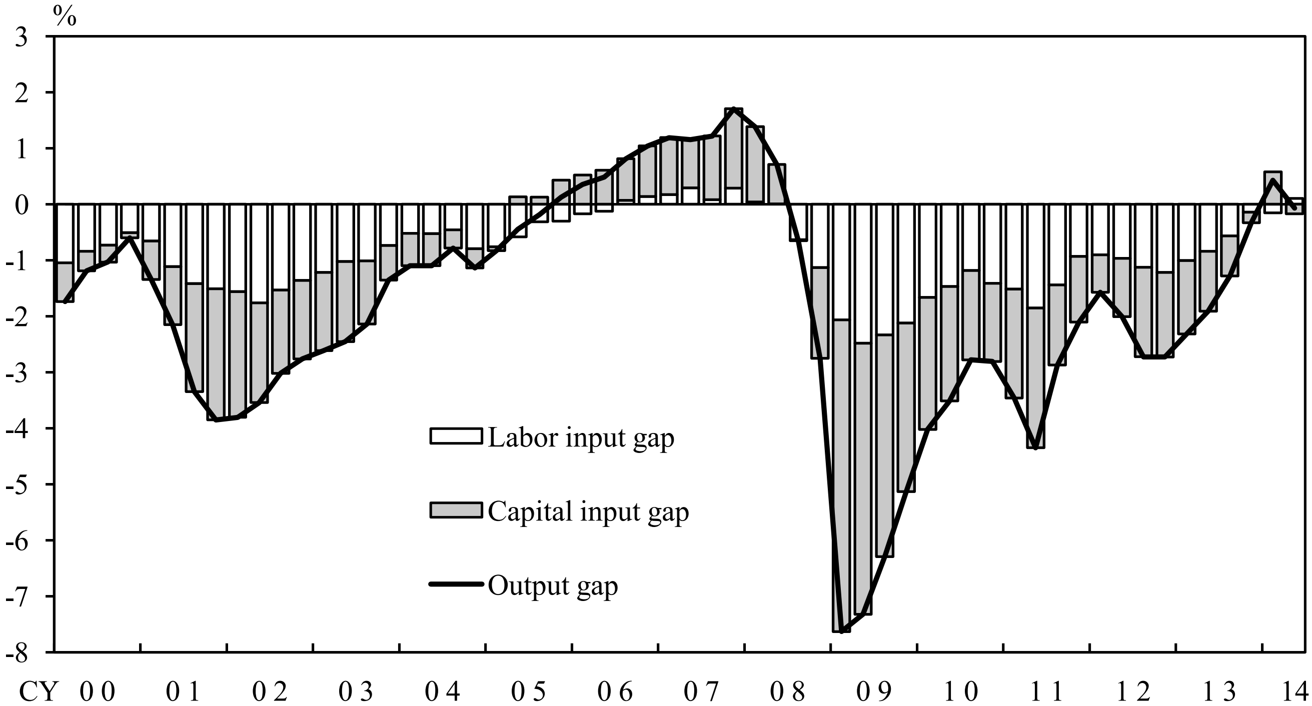


Notes: 1. Figures for 2014/Q3 are July-August averages in the quarterly amount.
2. Volatile orders: orders for ships and those from electric power companies.
3. Figures are seasonally adjusted by X-12-ARIMA.

Sources: Cabinet Office, "National Accounts," "Orders Received for Machinery";
Ministry of Economy, Trade and Industry, "Indices of Industrial Domestic Shipments and Imports";
Ministry of Land, Infrastructure, Transport and Tourism, "Statistics on Building Construction Starts."

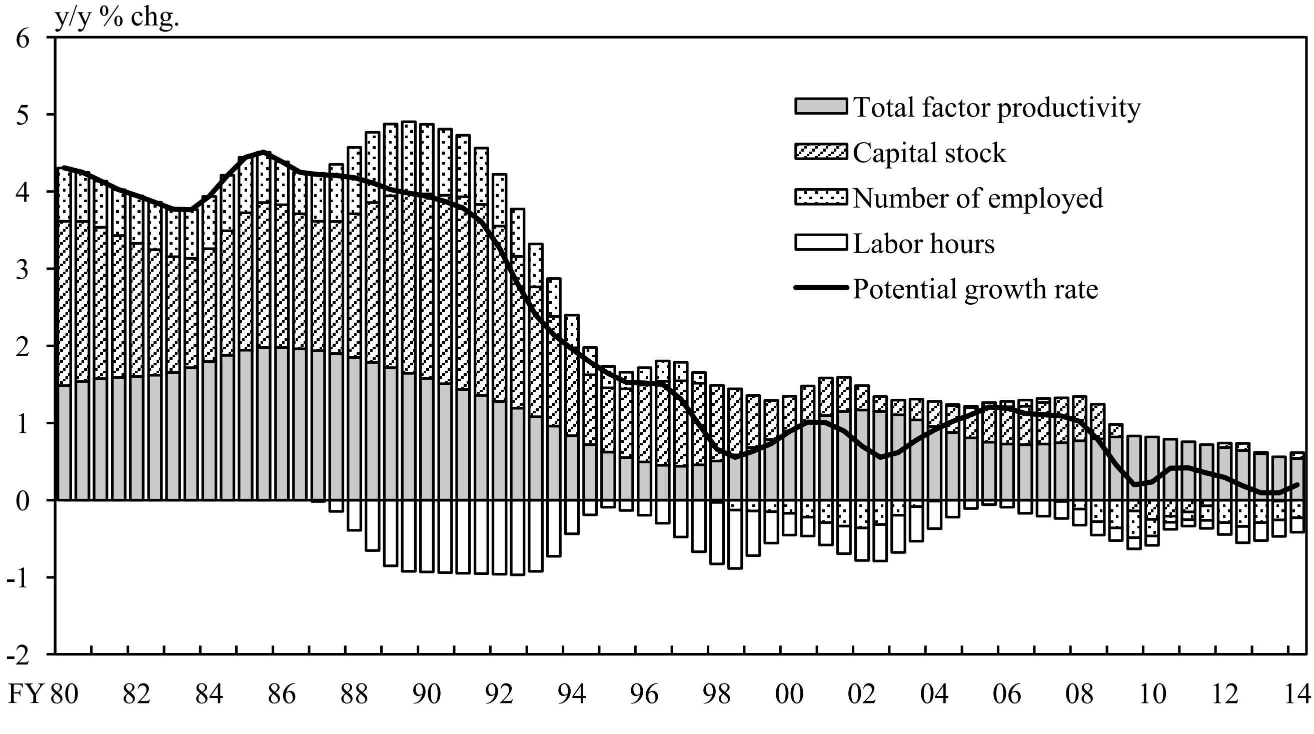
Output Gap and Potential Growth Rate

(1) Output Gap



Note: The output gap and the potential growth rate are estimated by the Research and Statistics Department, Bank of Japan. For the estimation procedures, see "The New Estimates of Output Gap and Potential Growth Rate," Bank of Japan Review Series, 2006-E-3. The same definition applies to the chart below.

(2) Potential Growth Rate

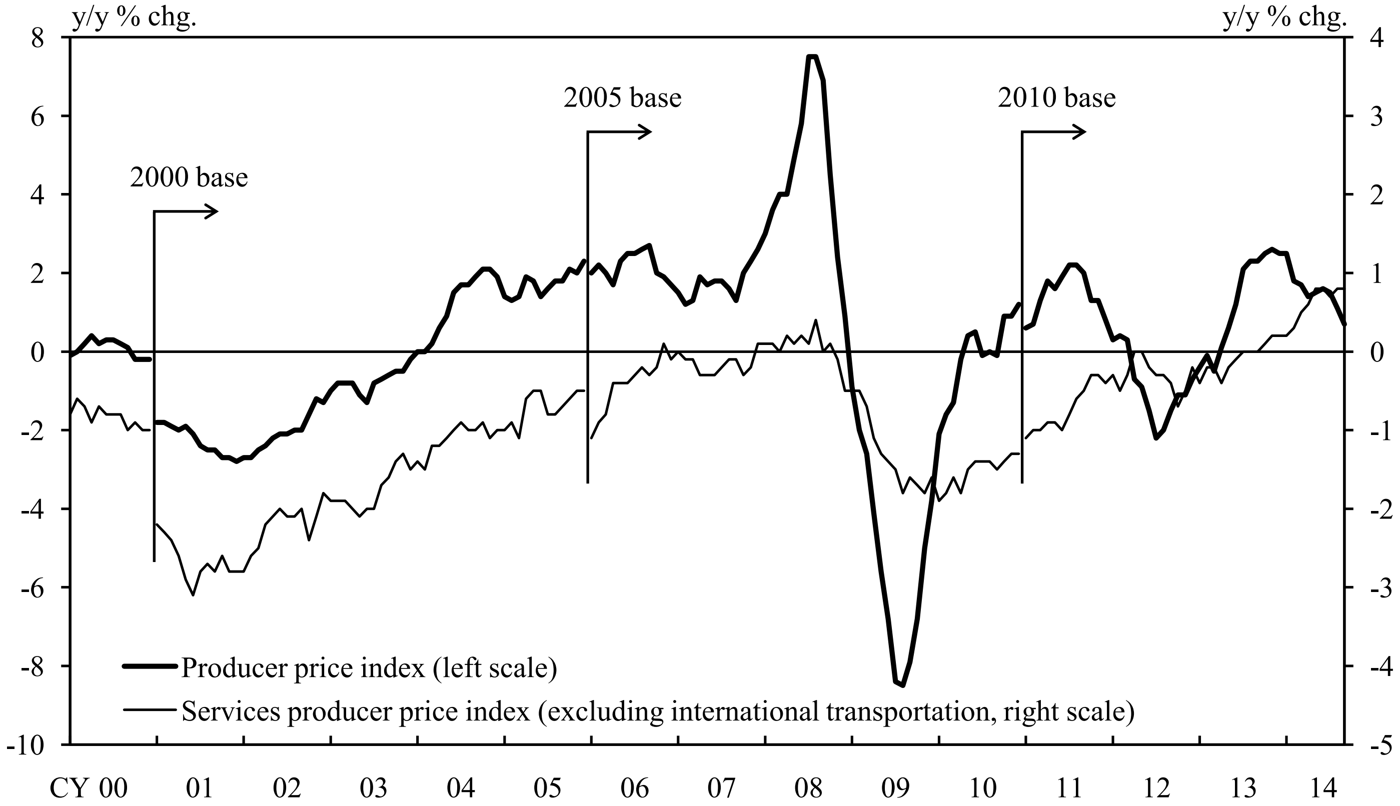


Note: Figures for the first half of fiscal 2014 are those of 2014/Q2.

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

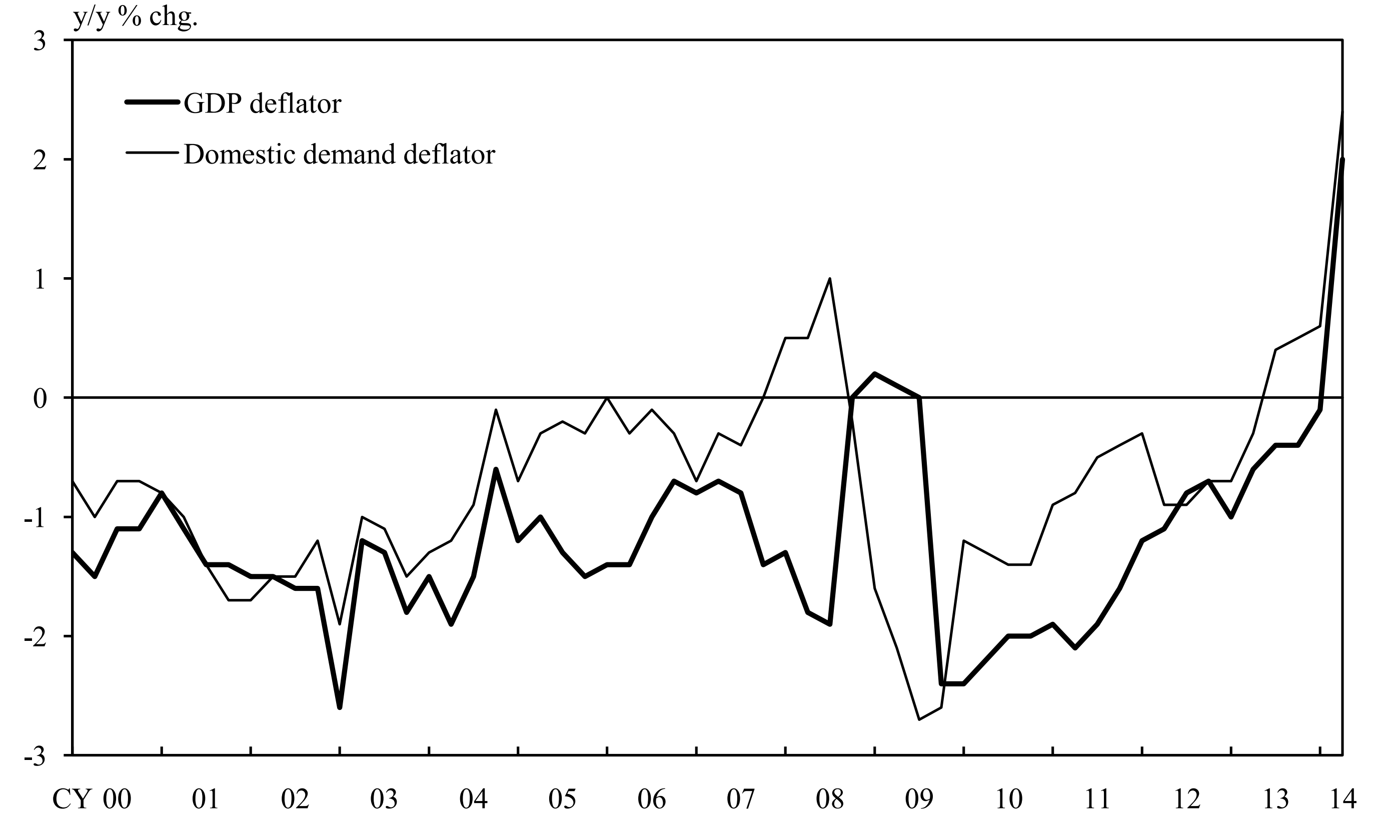
Prices

(1) Producer Price Index and Services Producer Price Index



Note: Figures from April 2014 onward are adjusted to exclude the direct effects of the consumption tax hike, using indices excluding the consumption tax.

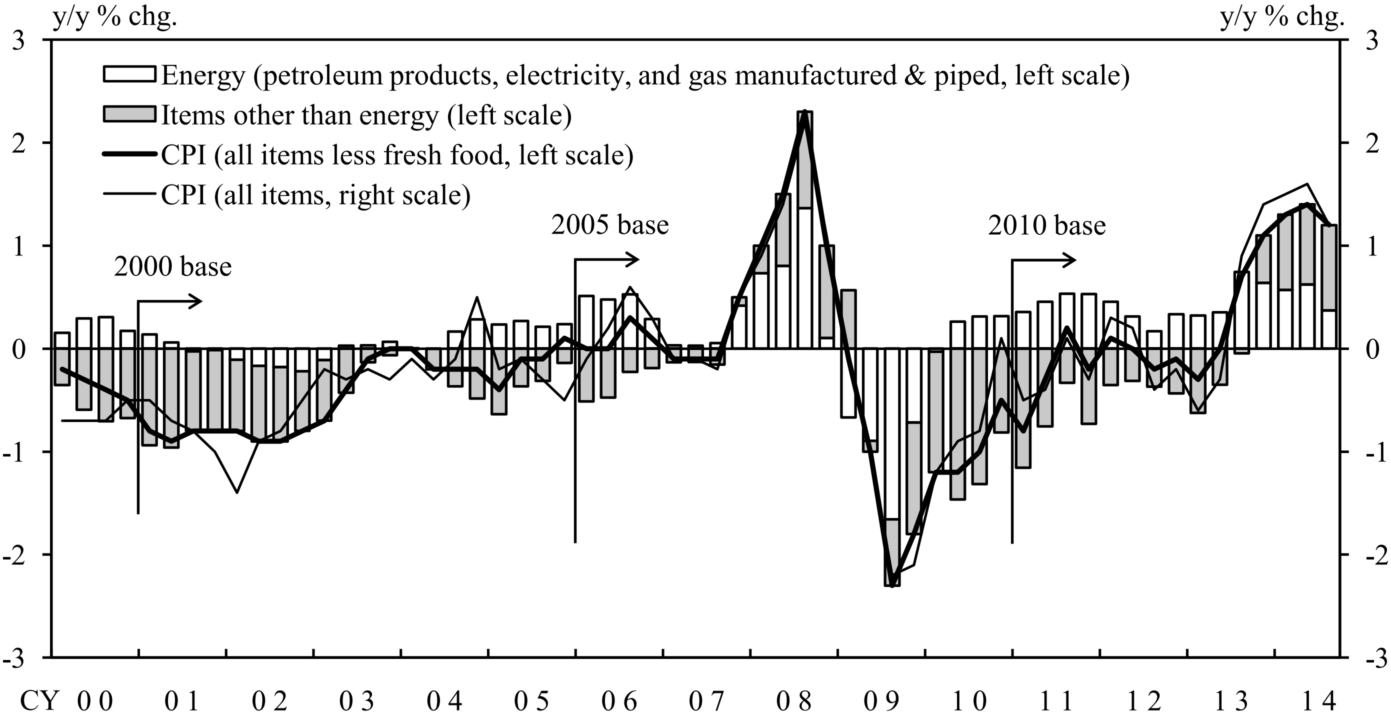
(2) GDP Deflator



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

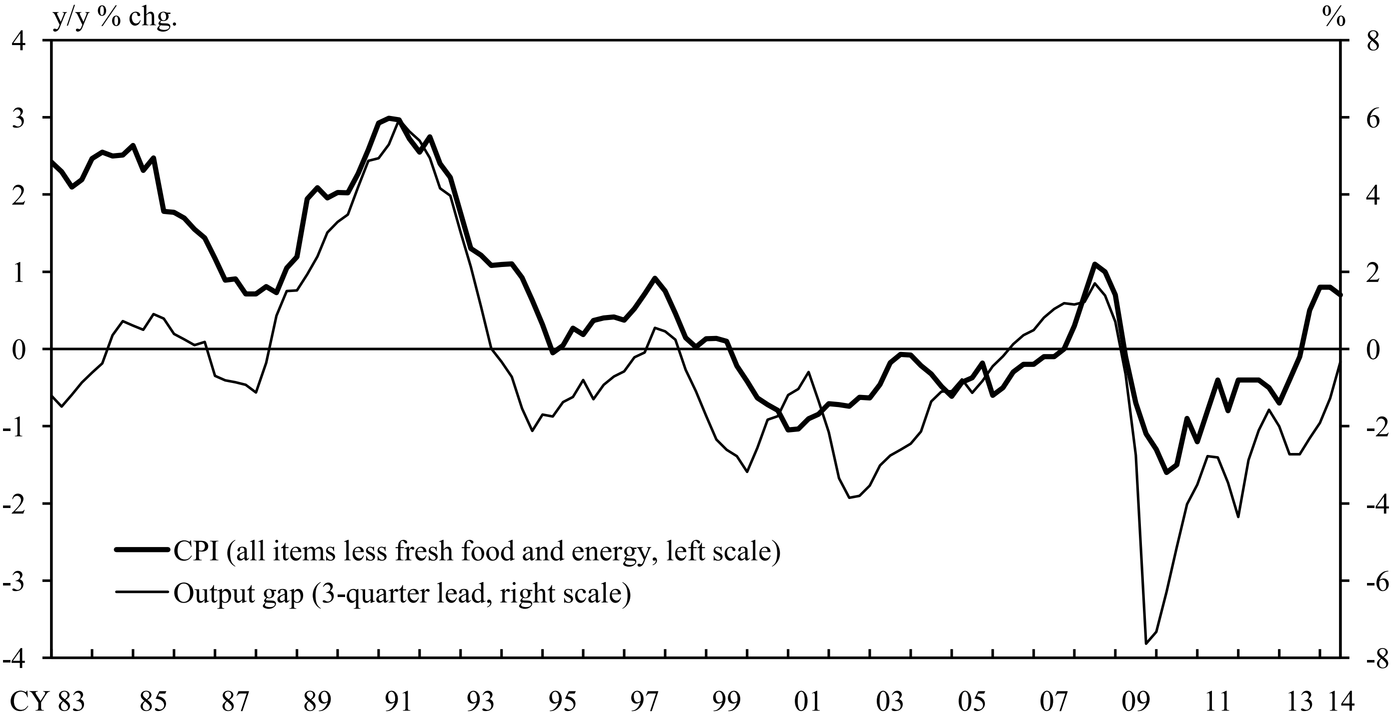
Consumer Price Index (1)

(1) Consumer Price Index



Notes: 1. Figures for energy (petroleum products, electricity, and gas manufactured & piped) and the items other than energy are calculated using published indices. Figures up to 2005/Q4 are calculated by weighting year-on-year rates of price changes. The same method applies to the CPI (all items less fresh food and energy) in Chart (2).
2. Figures from 2014/Q2 onward are estimated to adjust the direct effects of the consumption tax hike.

(2) Consumer Price Index and Output Gap

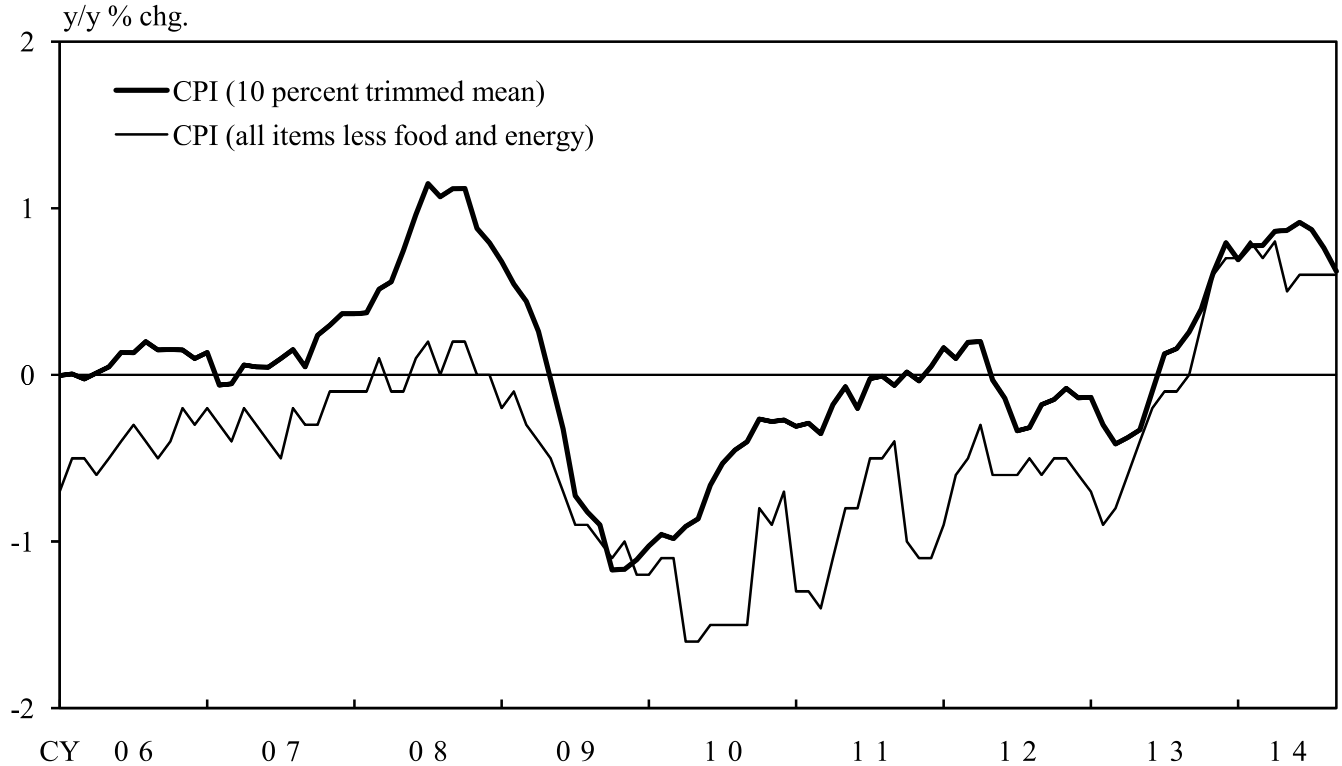


Notes: 1. Figures for the CPI are adjusted to exclude the estimated effect of changes in the consumption tax rate.
2. The output gap is estimated by the Research and Statistics Department, Bank of Japan. For the estimation procedures, see "The New Estimates of Output Gap and Potential Growth Rate," Bank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

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

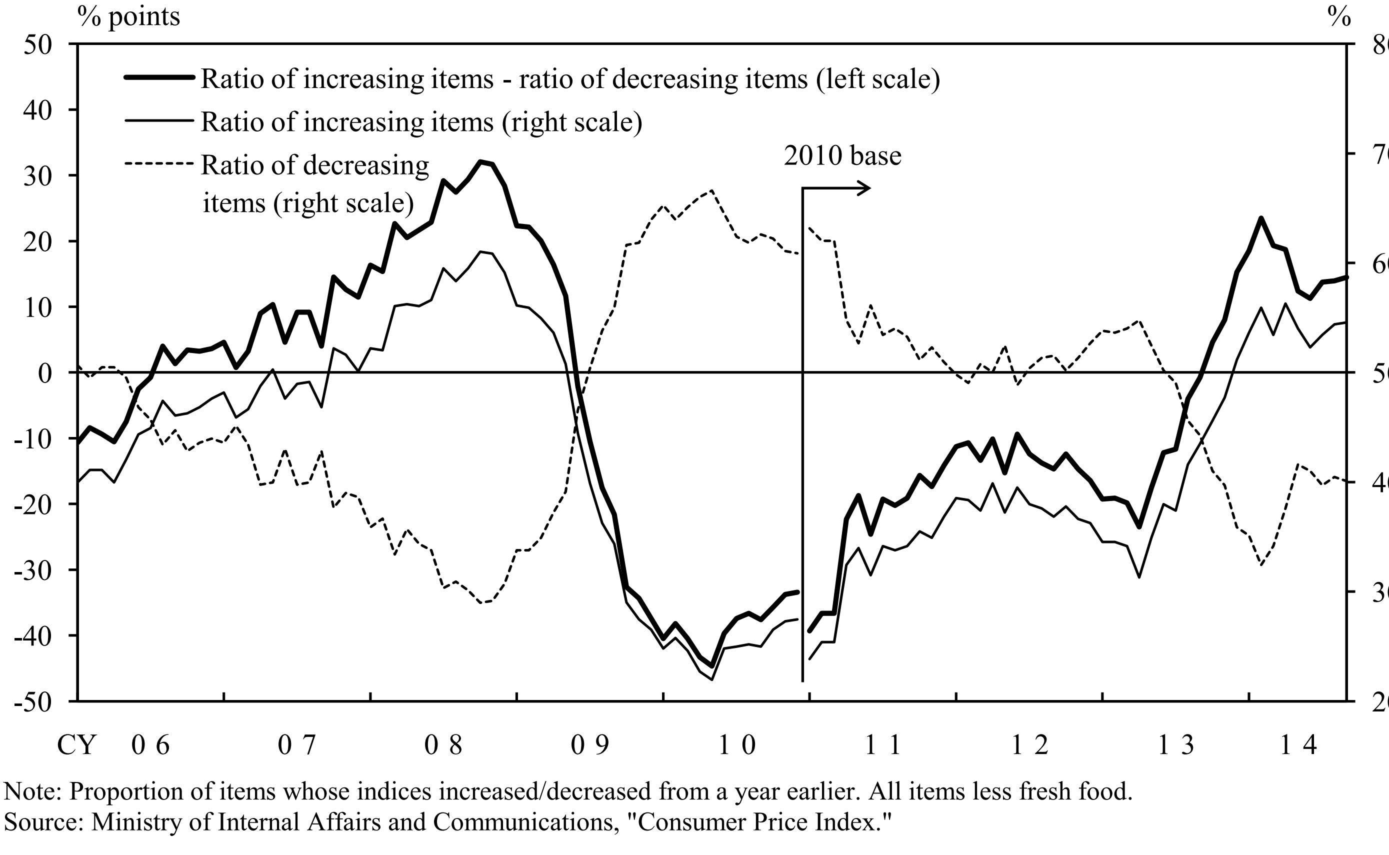
Consumer Price Index (2)

(1) Trend Changes in Consumer Prices



Notes: 1. Figures for the 10 percent trimmed mean are weighted averages of items; these items are obtained by rearranging year-on-year rates of price changes in ascending order and then excluding items in both the upper and lower 10 percent tails by weight.
2. Figures from April 2014 onward are estimated to adjust the direct effects of the consumption tax hike. The same rule applies to the chart below.

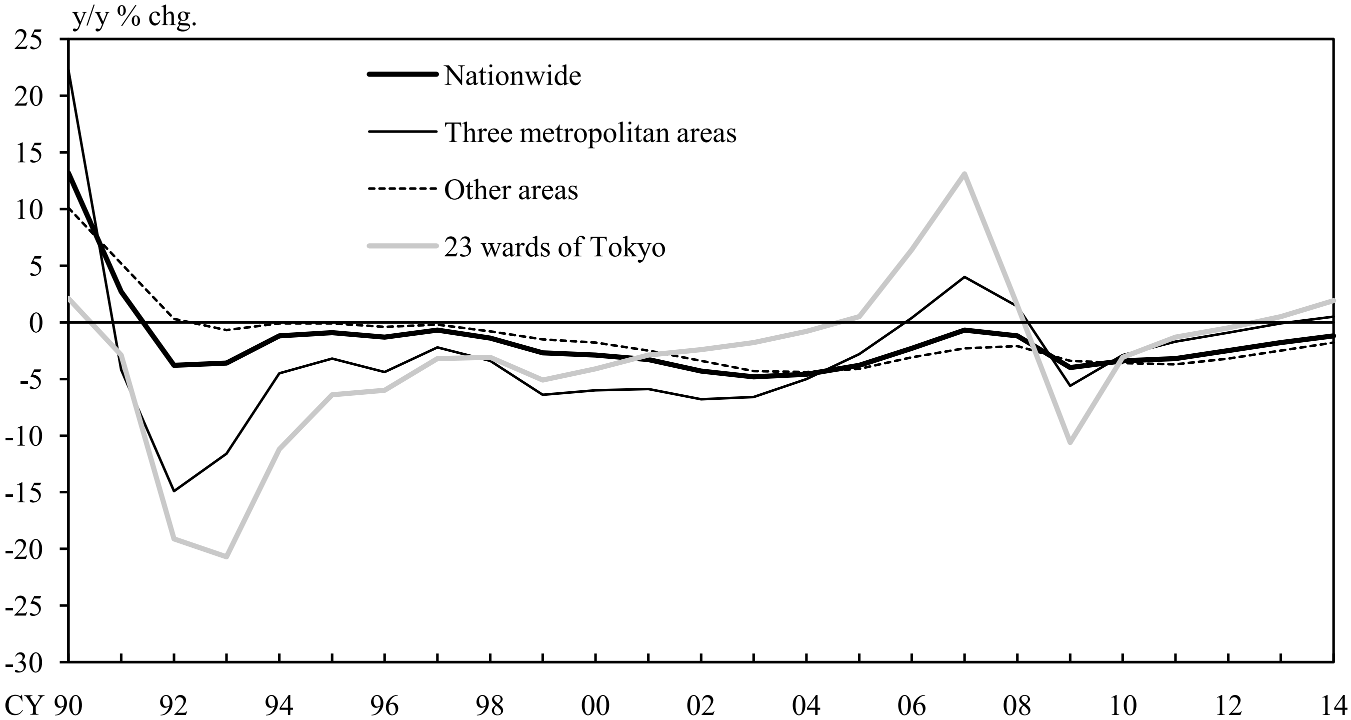
(2) Ratio of Increasing and Decreasing Items



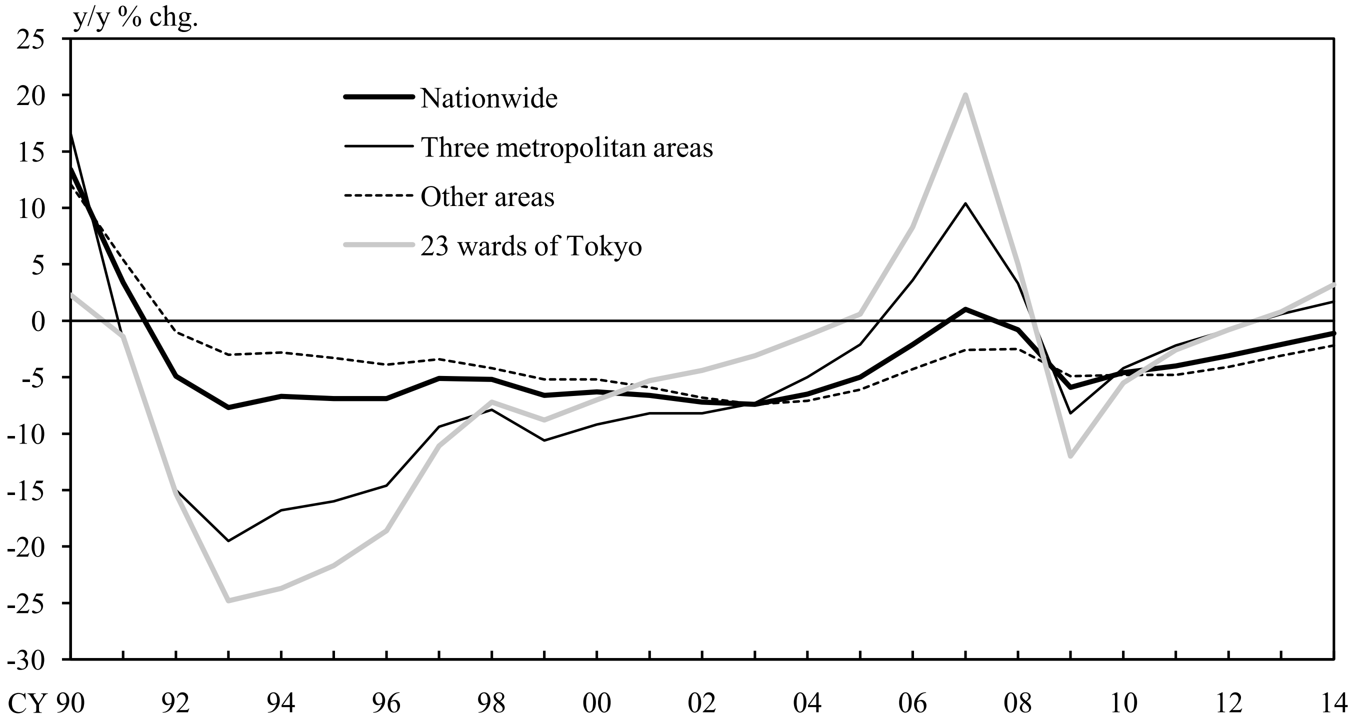
Note: Proportion of items whose indices increased/decreased from a year earlier. All items less fresh food.
Source: Ministry of Internal Affairs and Communications, "Consumer Price Index."

Land Prices

(1) Residential Land



(2) Commercial Land

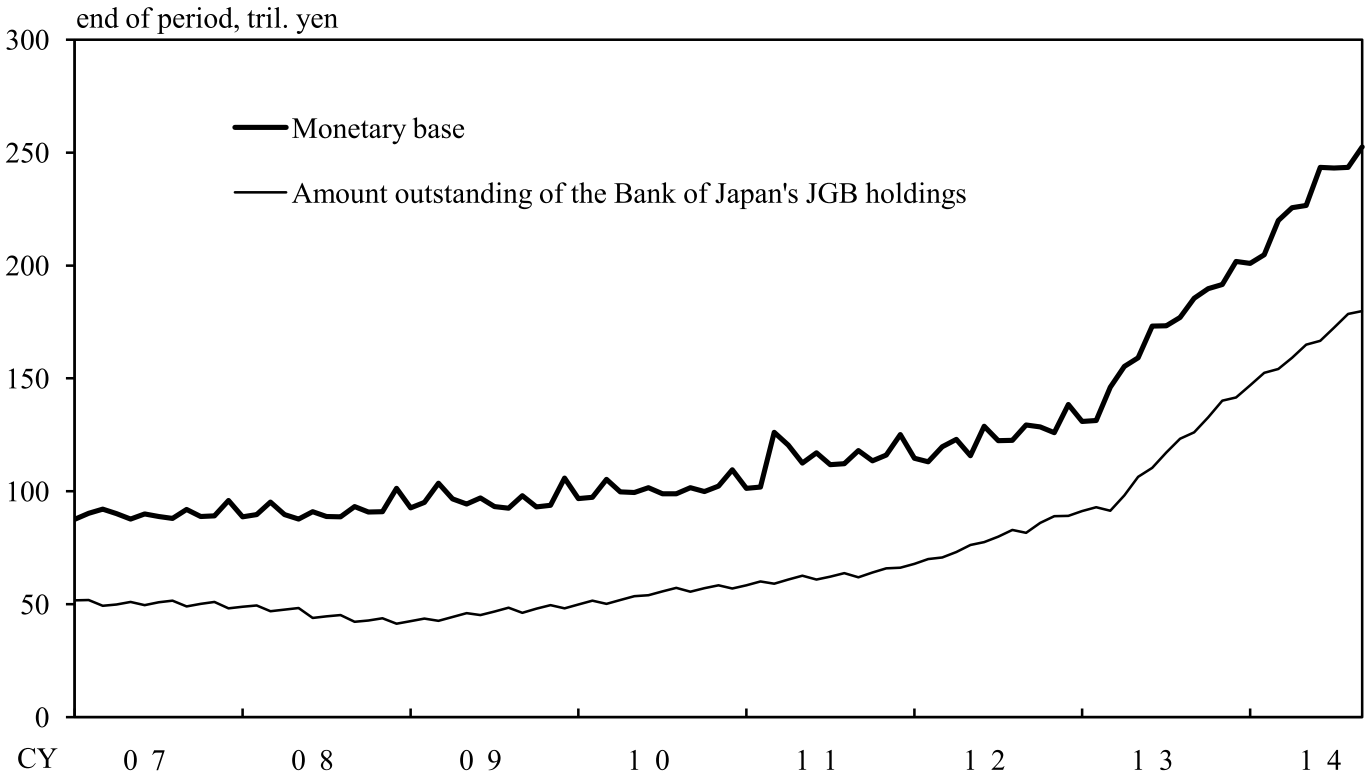


Notes: 1. Figures are as of July 1.
2. Three metropolitan areas: the Tokyo area (Tokyo, Kanagawa, Saitama, Chiba, and Ibaraki prefectures), the Osaka area (Osaka, Hyogo, Kyoto, and Nara prefectures), and the Nagoya area (Aichi and Mie prefectures). Other areas: other than the three metropolitan areas.

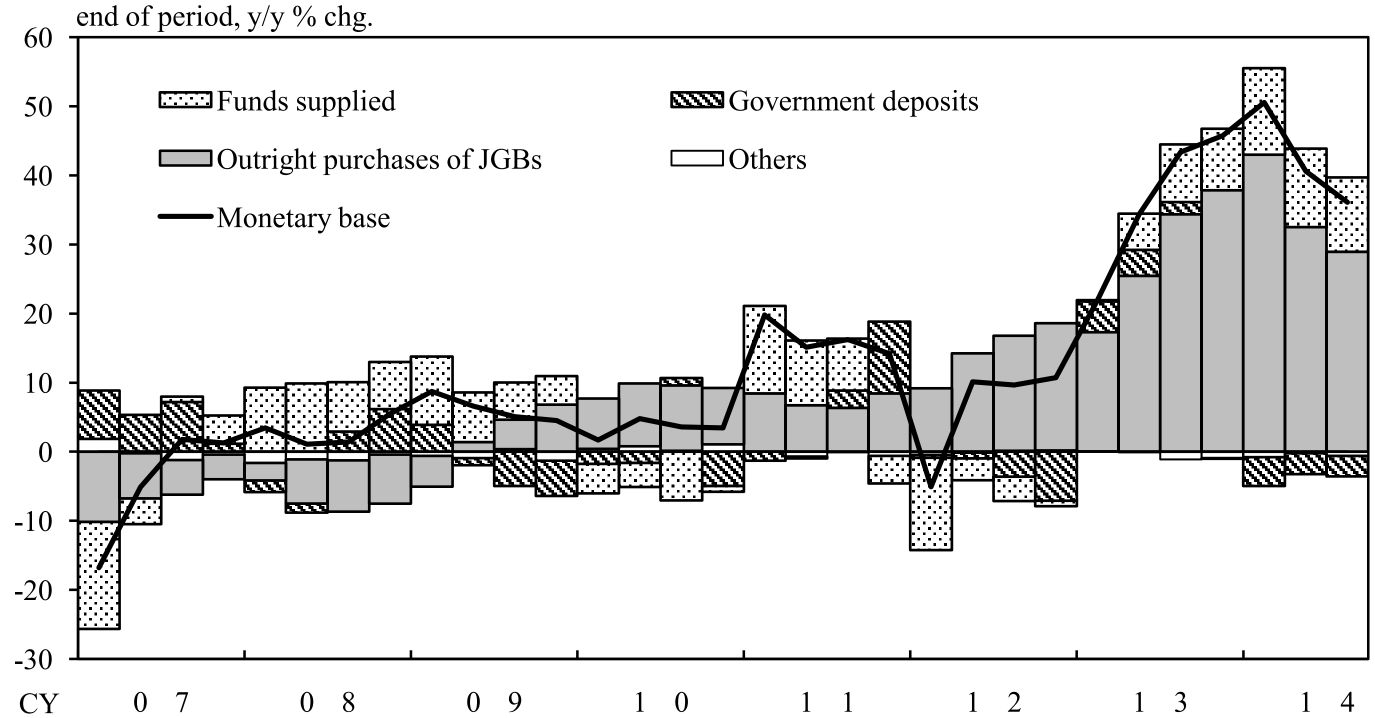
Source: Ministry of Land, Infrastructure, Transport and Tourism, "Land Price Survey by Prefectural Governments."

Monetary Base and JGB Purchases

(1) Expansion in the Monetary Base and JGB Holdings



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



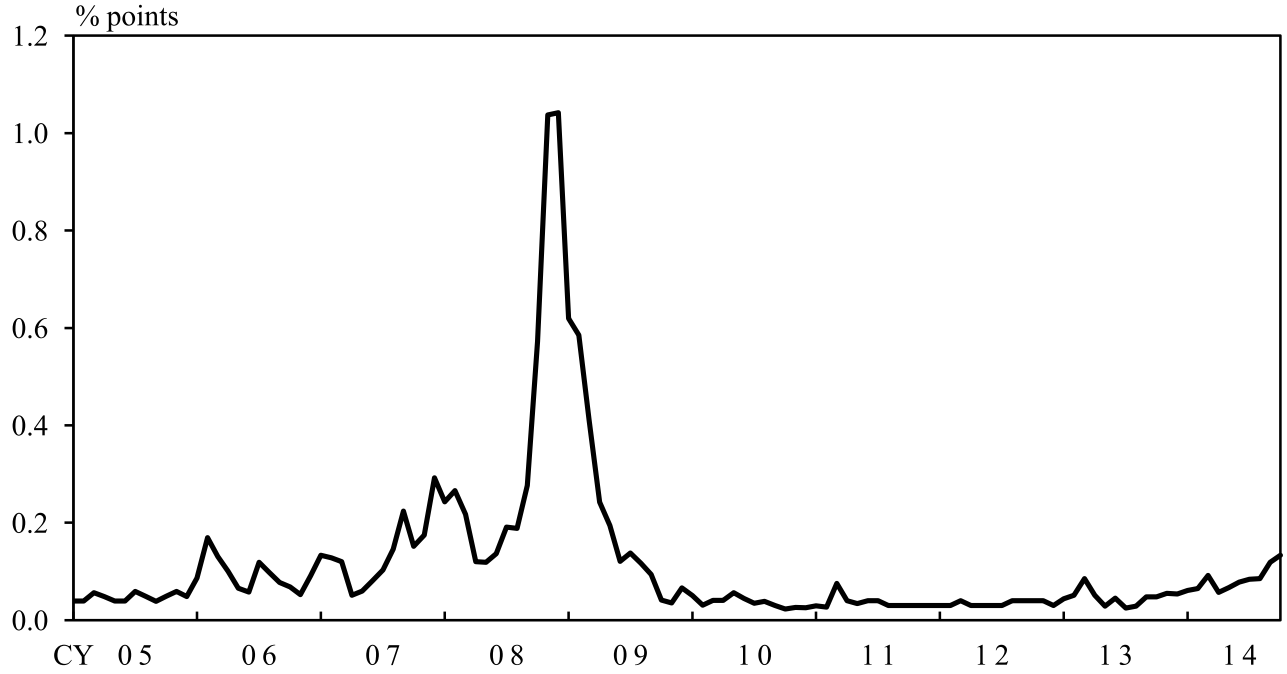
Notes: 1. Funds supplied are calculated by adding the amounts outstanding of (1) assets purchased through market operations (excluding outright purchases of JGBs), (2) funds-supplying operations against pooled collateral, and (3) the Loan Support Program, etc.

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

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

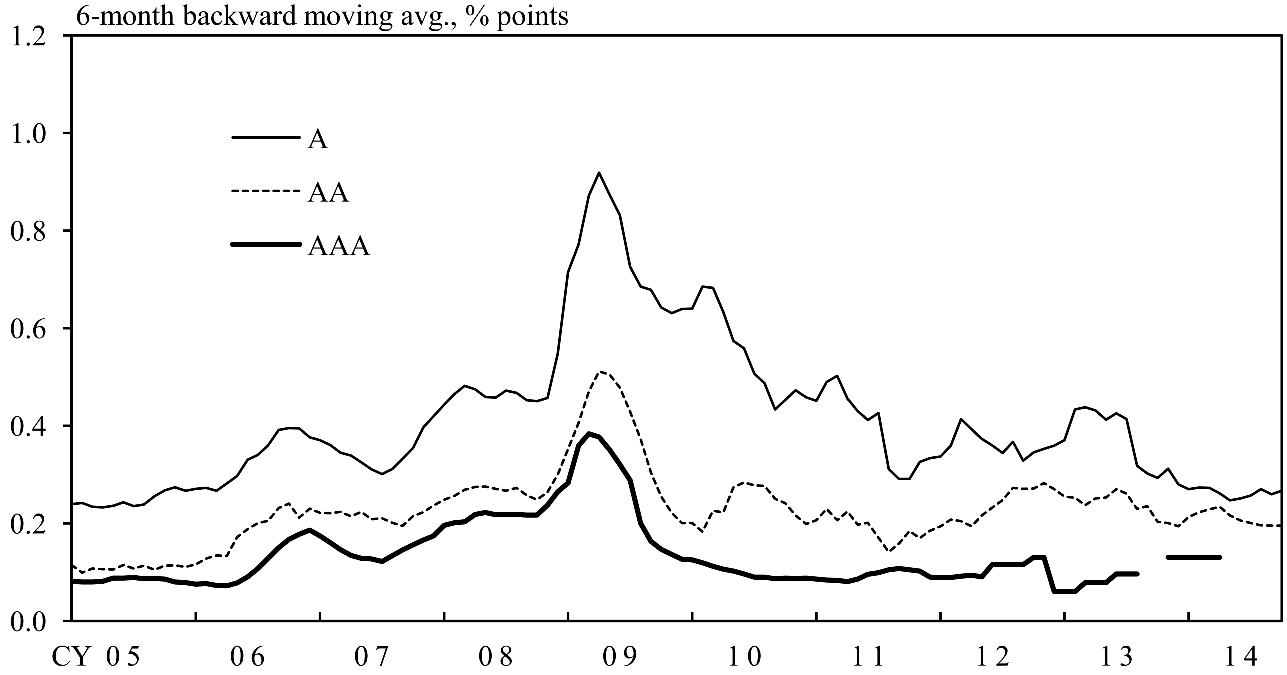
Spreads for CP and Corporate Bonds

(1) Issuance Spreads for CP



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

(2) Issuance Spreads for Corporate Bonds by Securities Rating

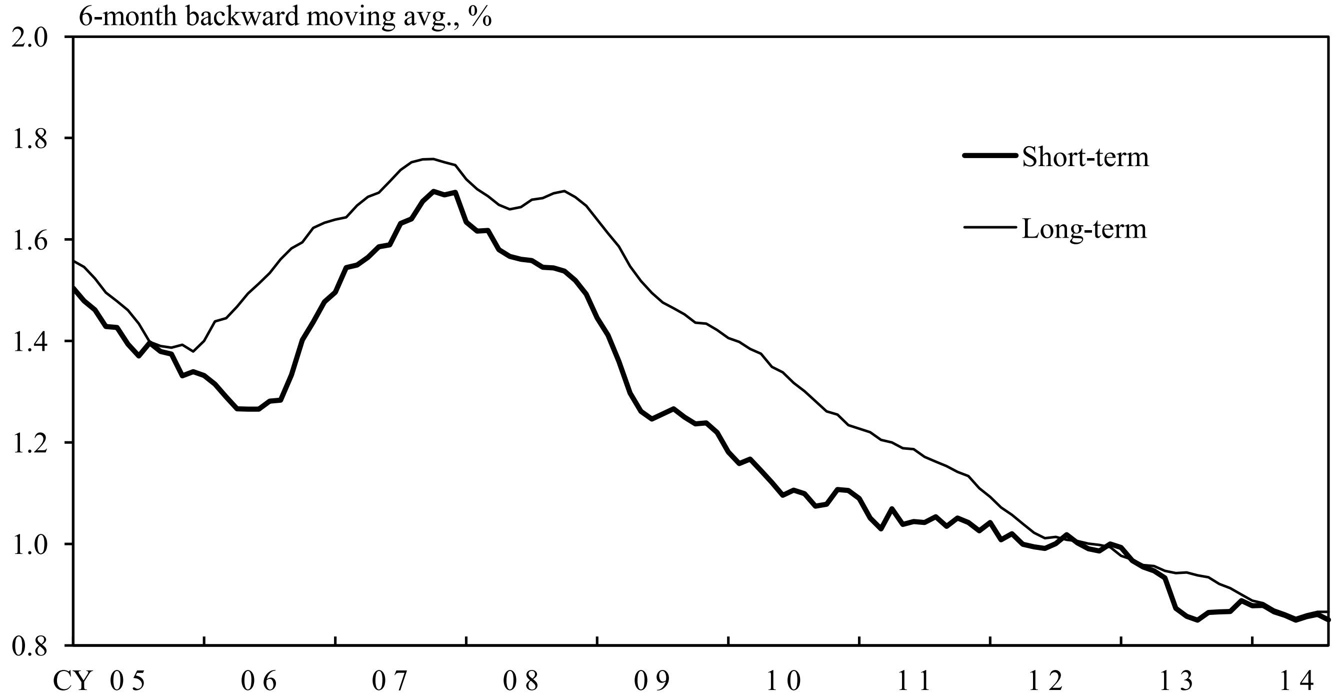


Notes: 1. The issuance spreads for corporate bonds are the issuance rate of these bonds minus the government bond yield.
2. Figures are the average of all maturities issued in domestic markets, based on the launch date.
3. Bonds issued by banks and securities companies, etc., are excluded.
4. Bonds are classified by the highest ratings among Moody's, S&P, R&I, and JCR.
5. Breaks in line indicate the periods when bonds were not issued for six or more months.

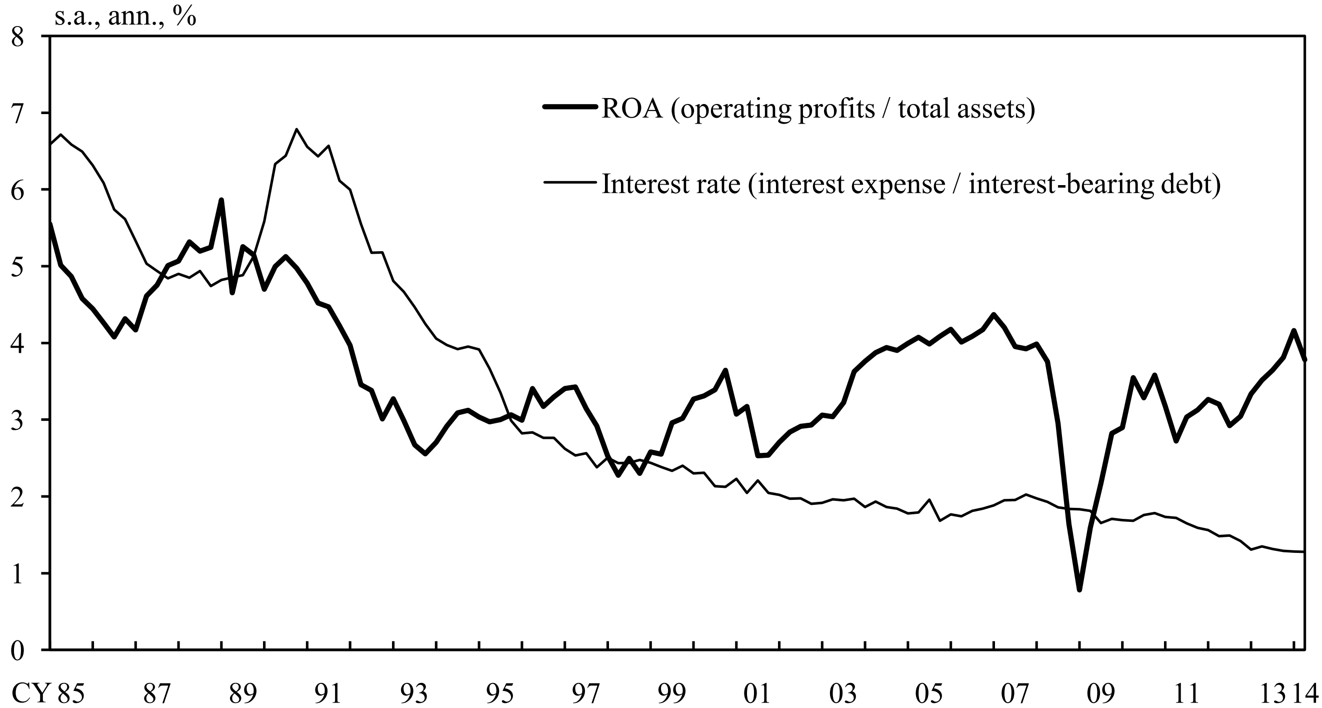
Sources: Bank of Japan, "Average Yields on Newly Issued Domestic Commercial Paper"; Japan Securities Depository Center; Capital Eye, Ltd.; I-N Information Systems; Bloomberg.

Bank Lending Rates

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



(2) ROA and Interest Rate



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

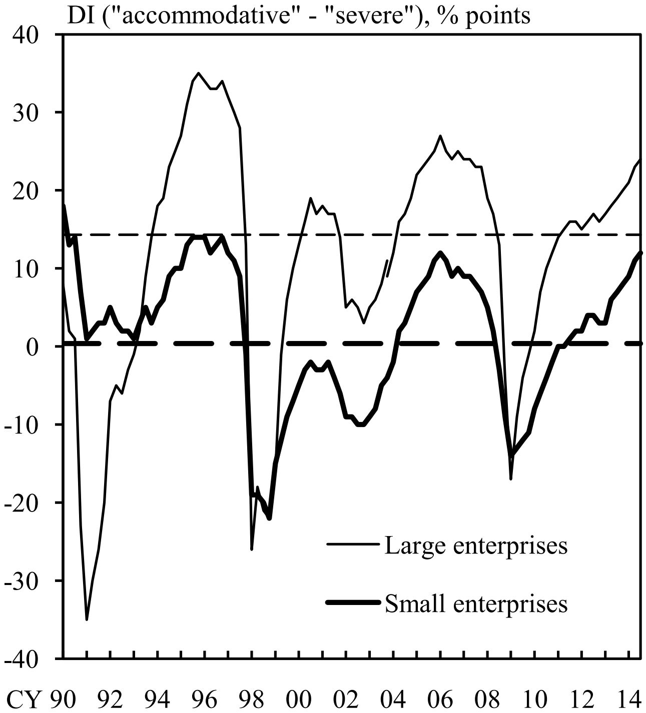
2. The interest-bearing debt is the sum of long- and short-term borrowings, corporate bonds, and bills receivable discounted outstanding.

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

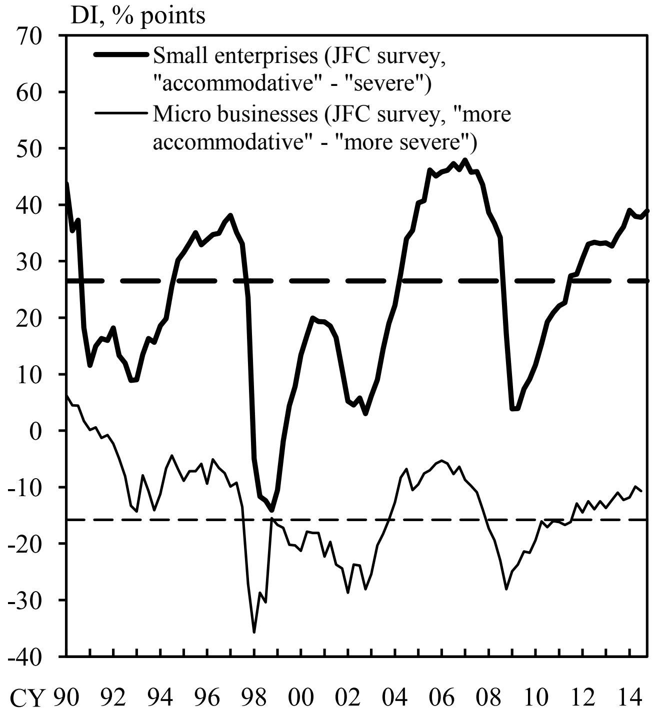
Corporate Finance-Related Indicators

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

(a) *Tankan*

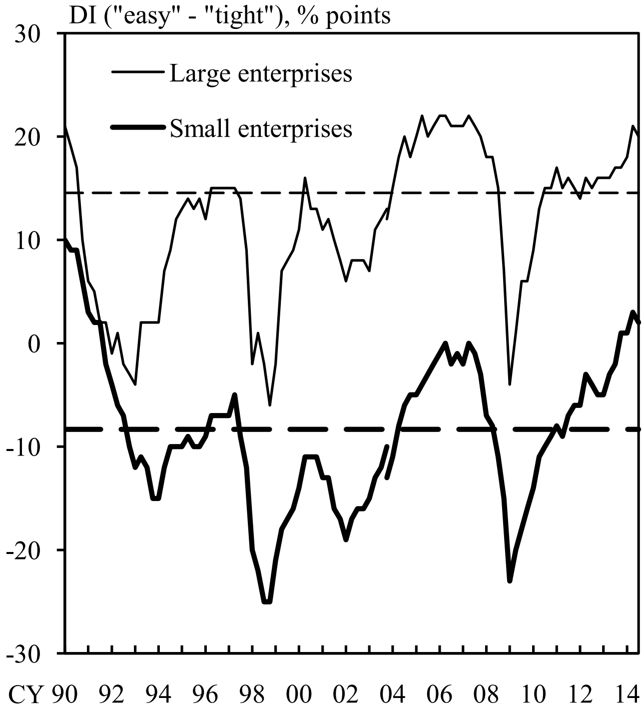


(b) Other Surveys

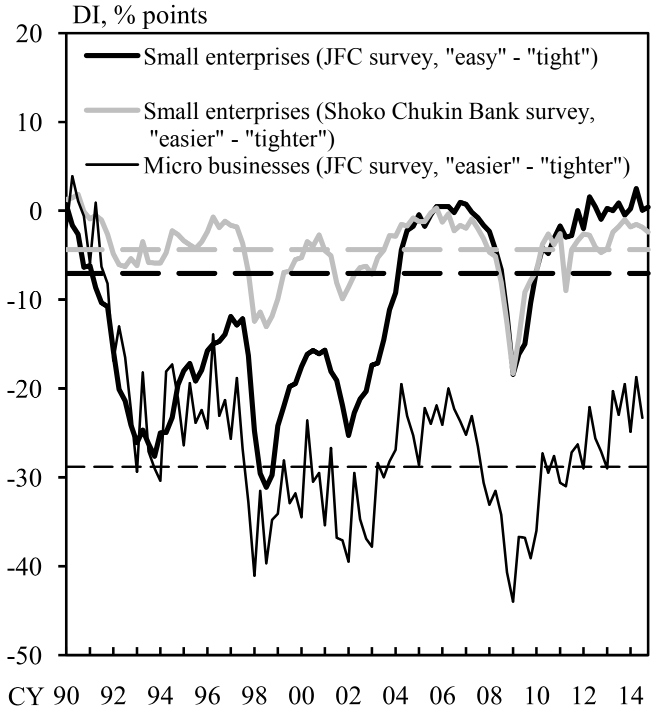


(2) Financial Position

(a) *Tankan*



(b) Other Surveys

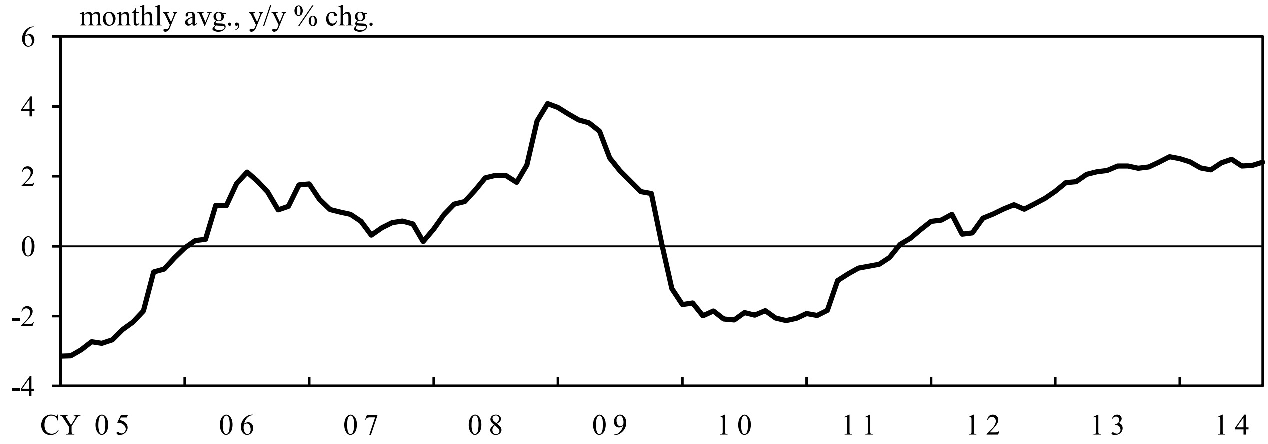


Notes: 1. Data from the "Tankan" are based on all industries. The "Tankan" was revised from the March 2004 survey. Figures up to the December 2003 survey are based on the previous data sets. Figures from the December 2003 survey are on the new basis. Broken lines are the averages since 2000.
2. Figures for 2014/Q4 are those of October.

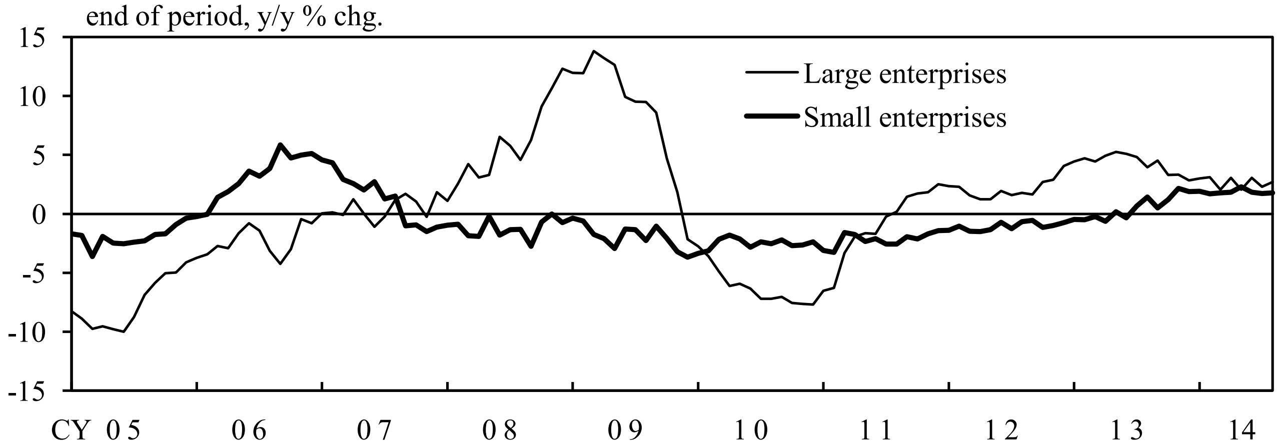
Sources: Bank of Japan, "*Tankan,* Short-Term Economic Survey of Enterprises in Japan";
Shoko Chukin Bank, Ltd., "Business Survey Index for Small and Medium-Sized Businesses";
Japan Finance Corporation (JFC), "Monthly Survey of Small Businesses in Japan," "Quarterly Survey of Small Businesses in Japan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

Amount Outstanding of Bank Lending, CP, and Corporate Bonds

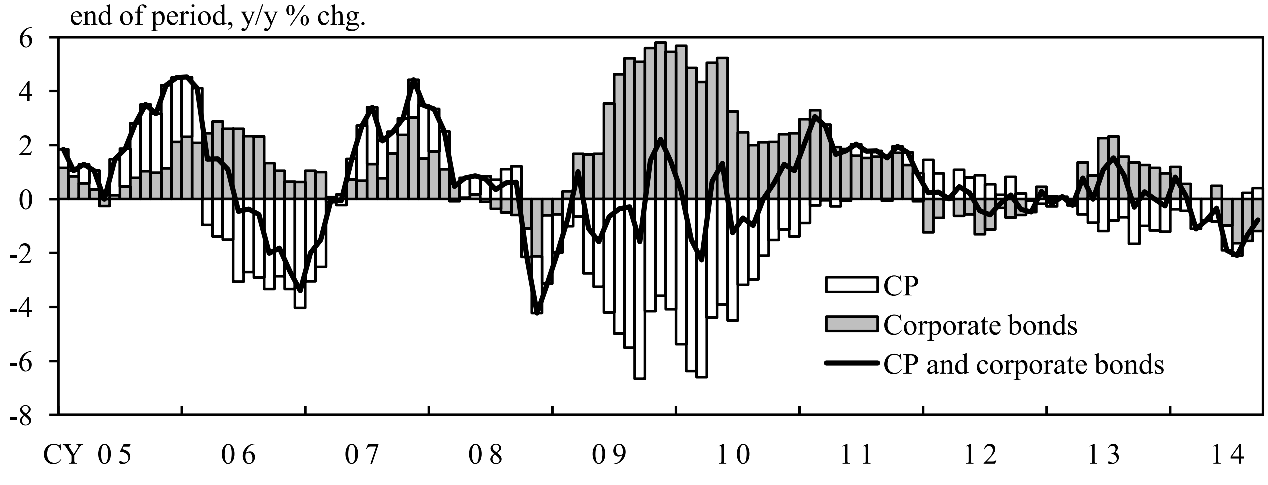
(1) Lending by Domestic Commercial Banks (Total of Major and Regional Banks)



(2) Lending by Domestically Licensed Banks (by Firm Size)



(3) Amount Outstanding of CP and Corporate Bonds



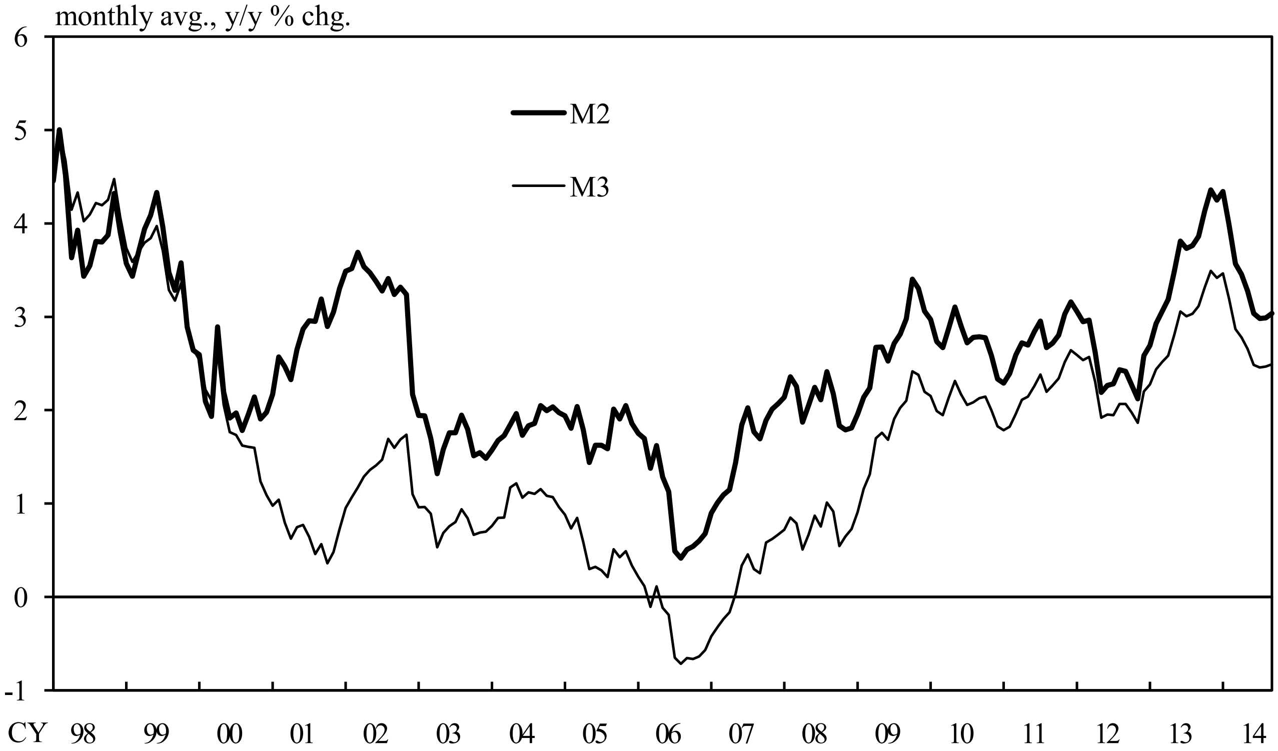
Notes: 1. Figures for CP are those of short-term corporate bonds registered under the book-entry transfer system. Those issued by banks, securities companies, and others such as foreign corporations are excluded; ABCP is included. Figures up to March 2008 are those compiled by the Bank of Japan.

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

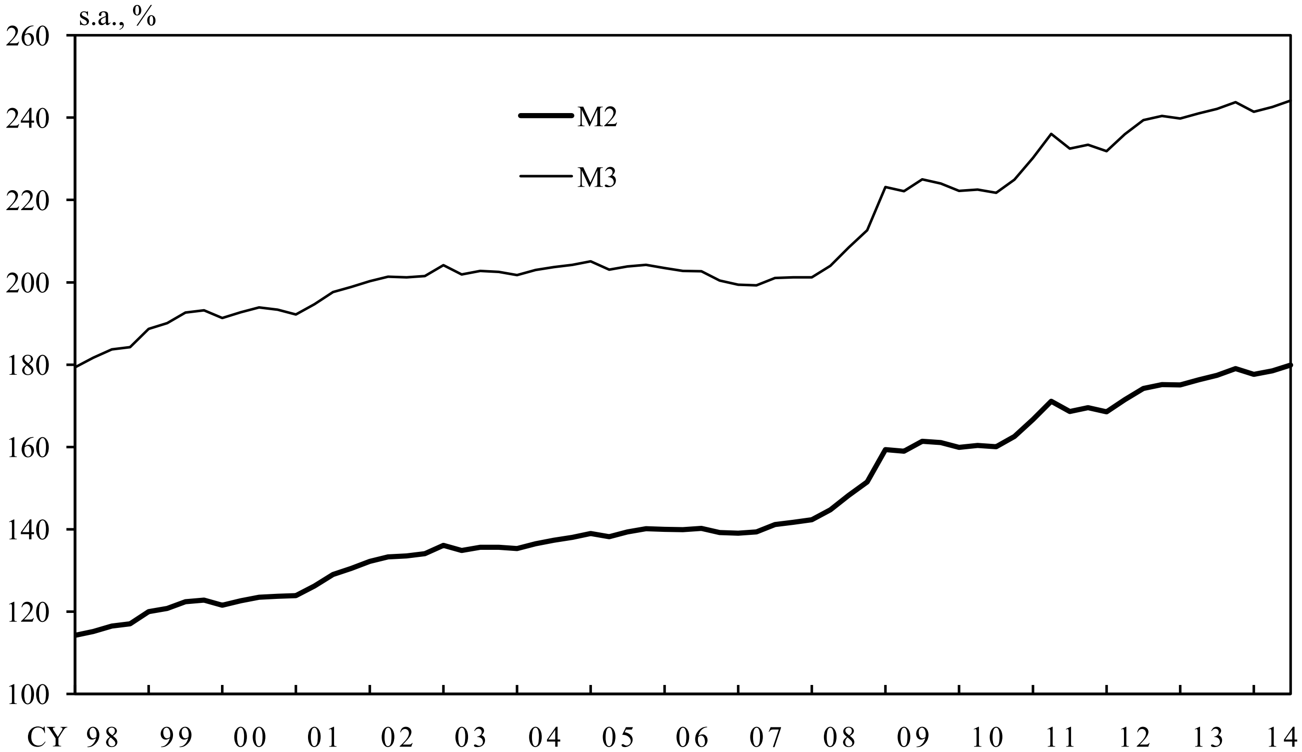
Sources: Bank of Japan, "Principal Figures of Financial Institutions," "Deposits, Vault Cash, and Loans and Bills Discounted"; Japan Securities Depository Center; Japan Securities Dealers Association; I-N Information Systems.

Money Stock

(1) Changes from a Year Earlier



(2) Ratio of Money Stock to Nominal GDP



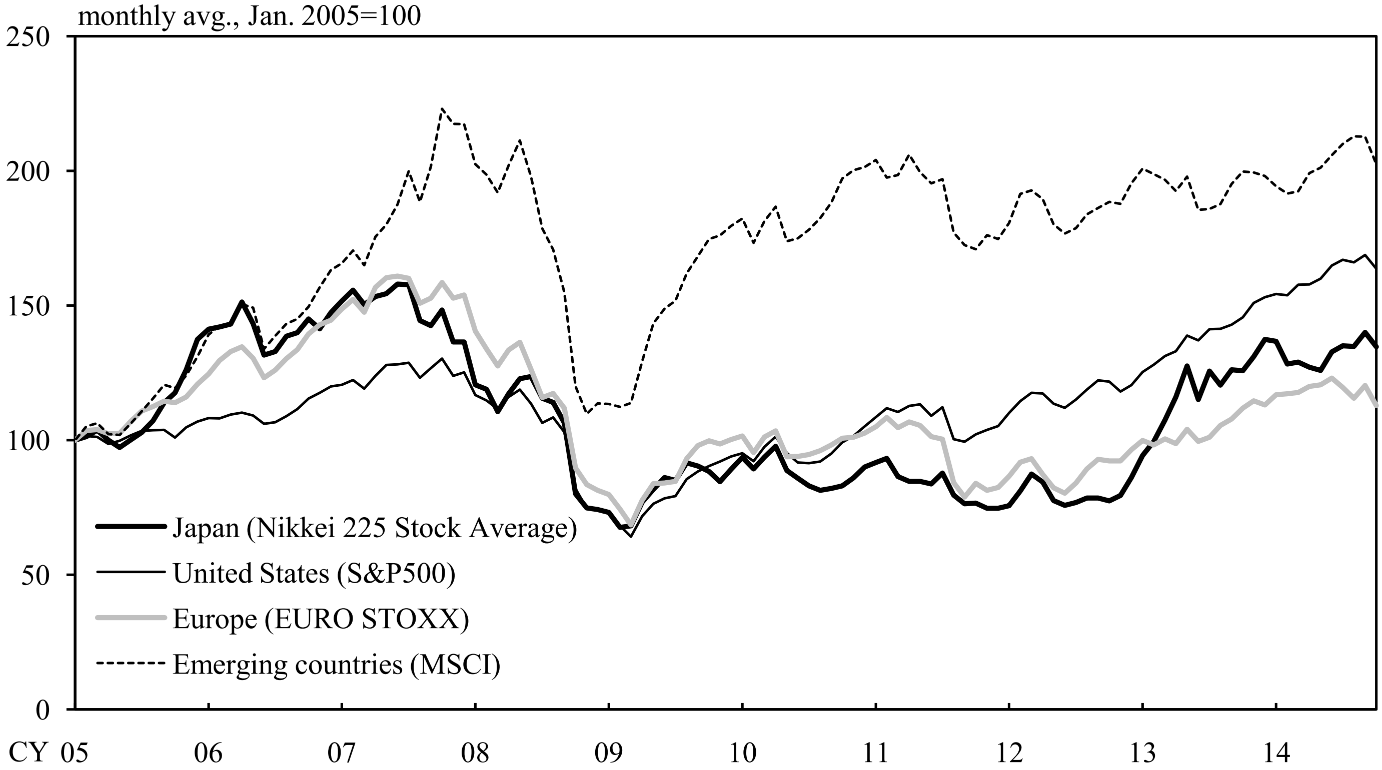
Notes: 1. Figures for M2 up to March 2003 are the former series of the figures for M2+CDs.
2. Figures for M3 up to March 2003 are the former series of the figures for M3+CDs minus the figures for pecuniary trusts.
3. The figure for nominal GDP in 2014/Q3 is assumed to be unchanged from the previous quarter.

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

Chart 24

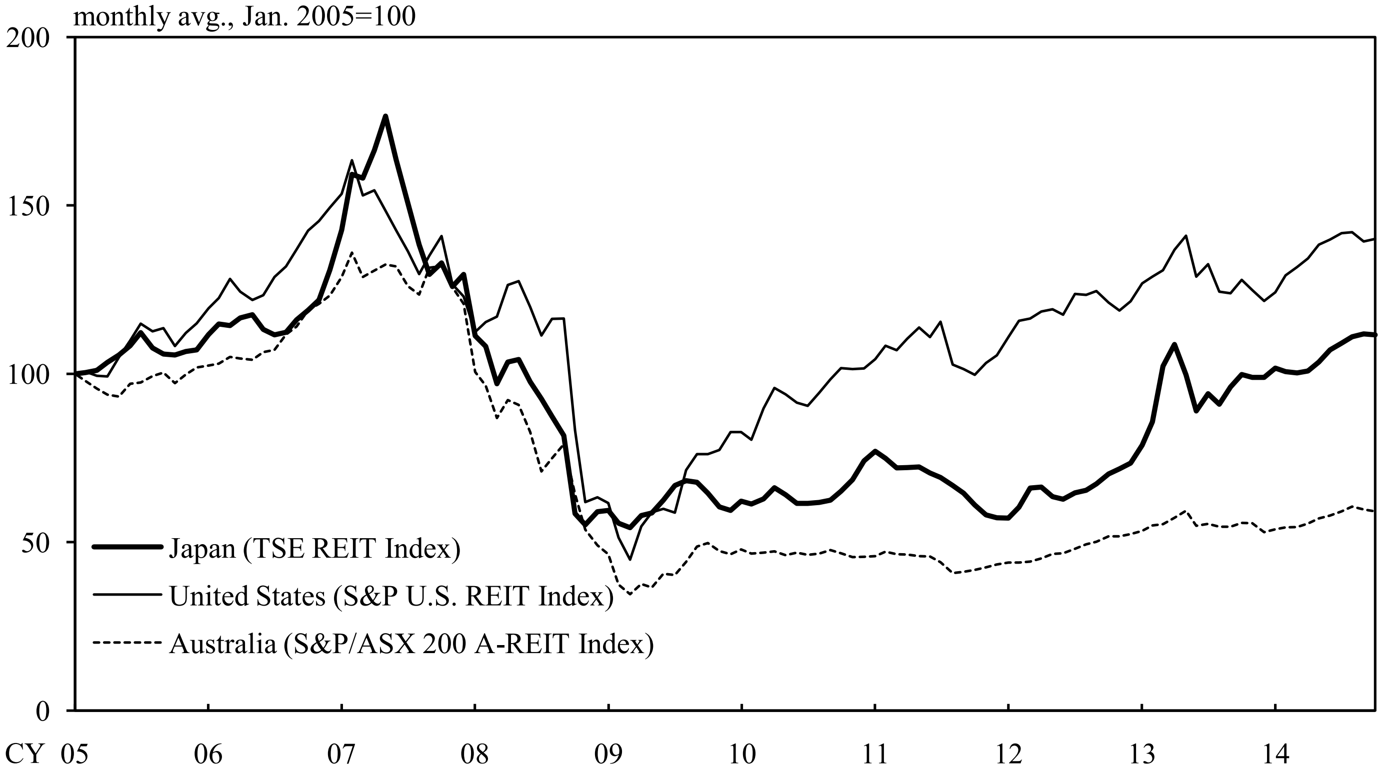
Stock Prices and REIT Prices

(1) Selected Stock Prices



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

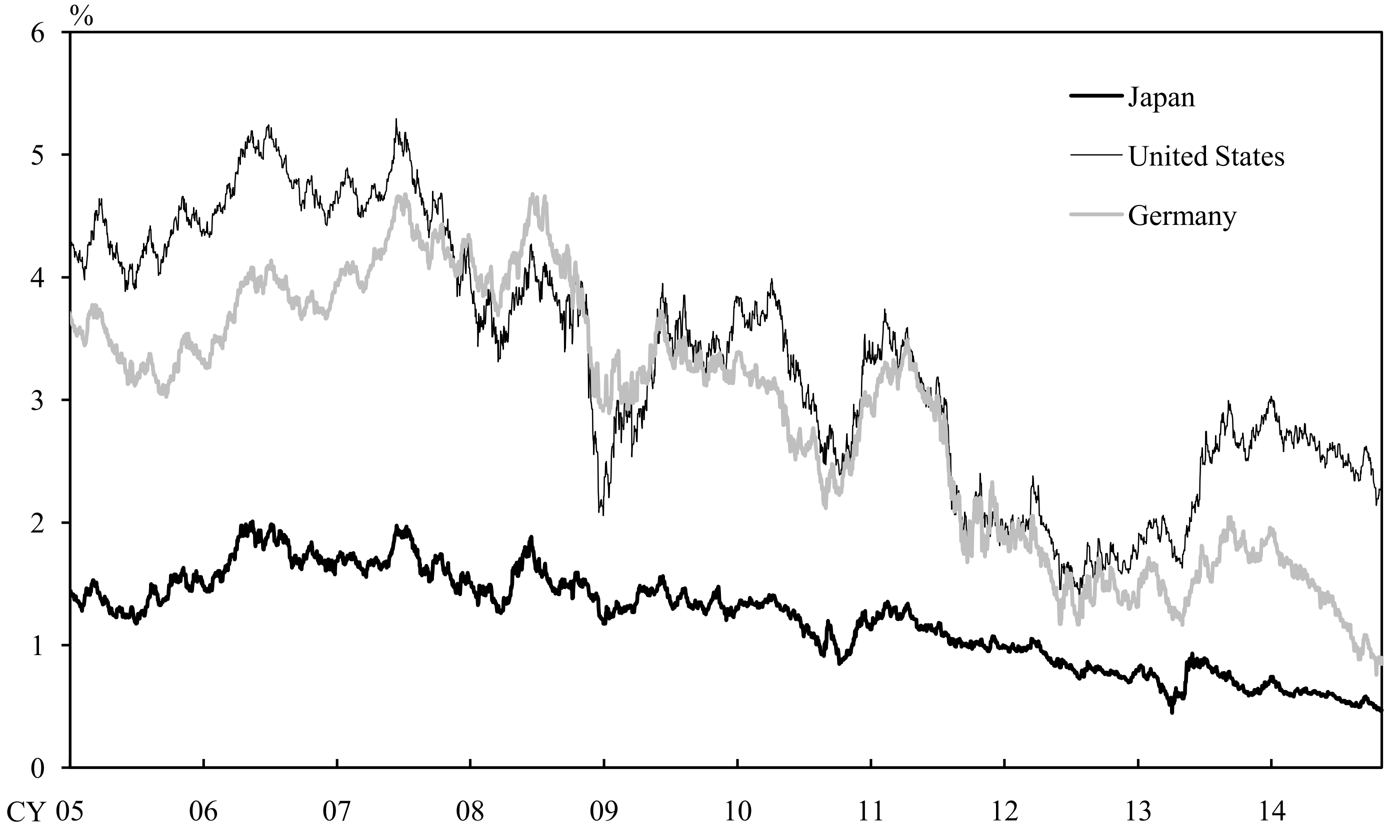
(2) Selected REIT Indexes



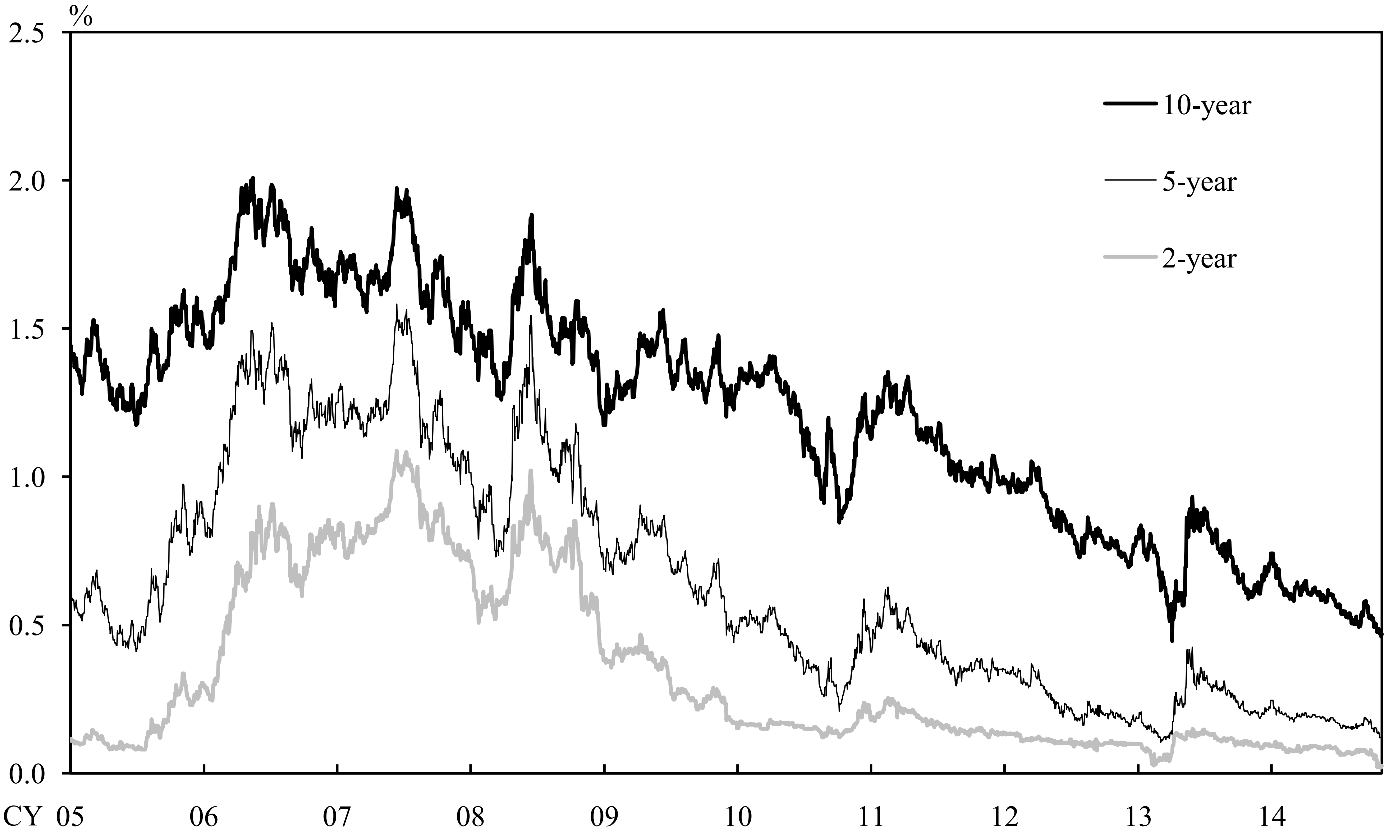
Source: Bloomberg.

Nominal Benchmark Yields

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



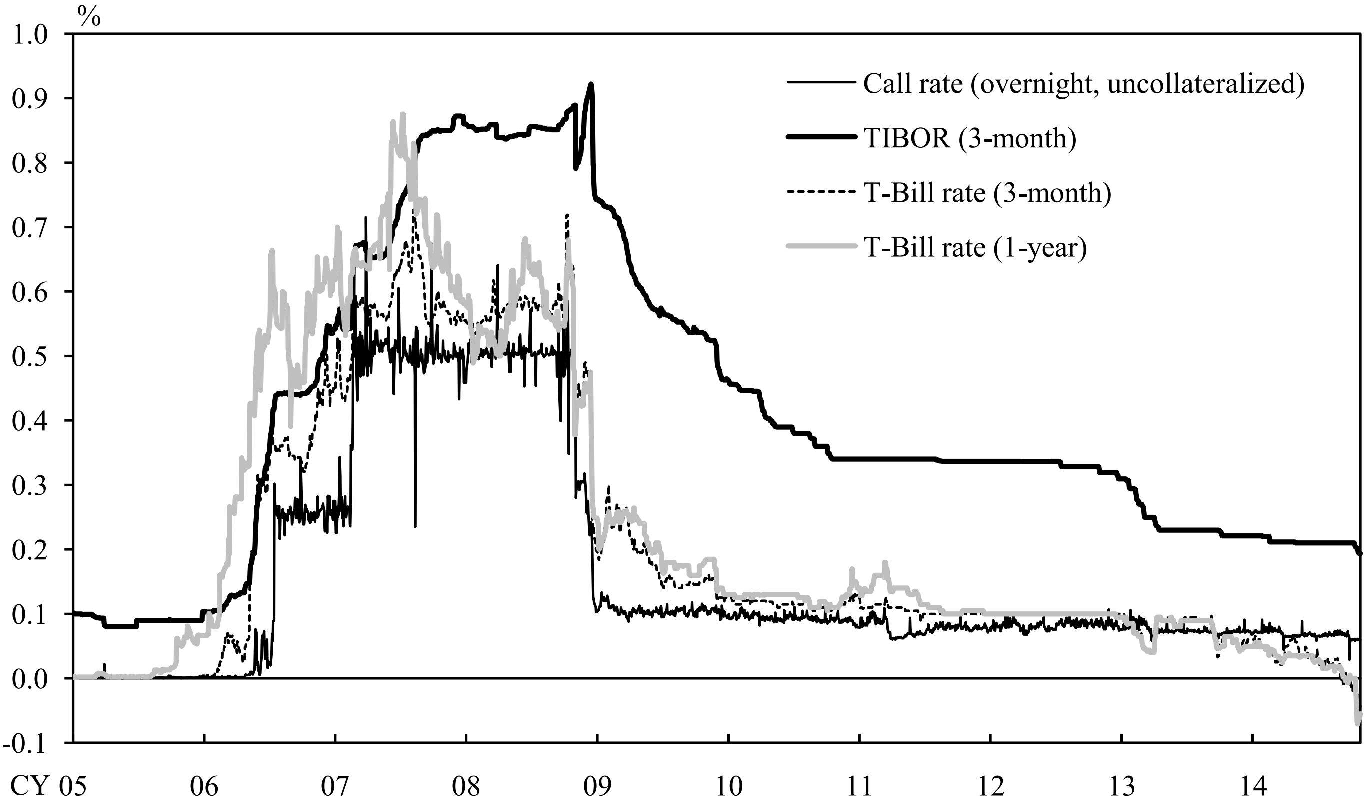
(2) JGB Yields



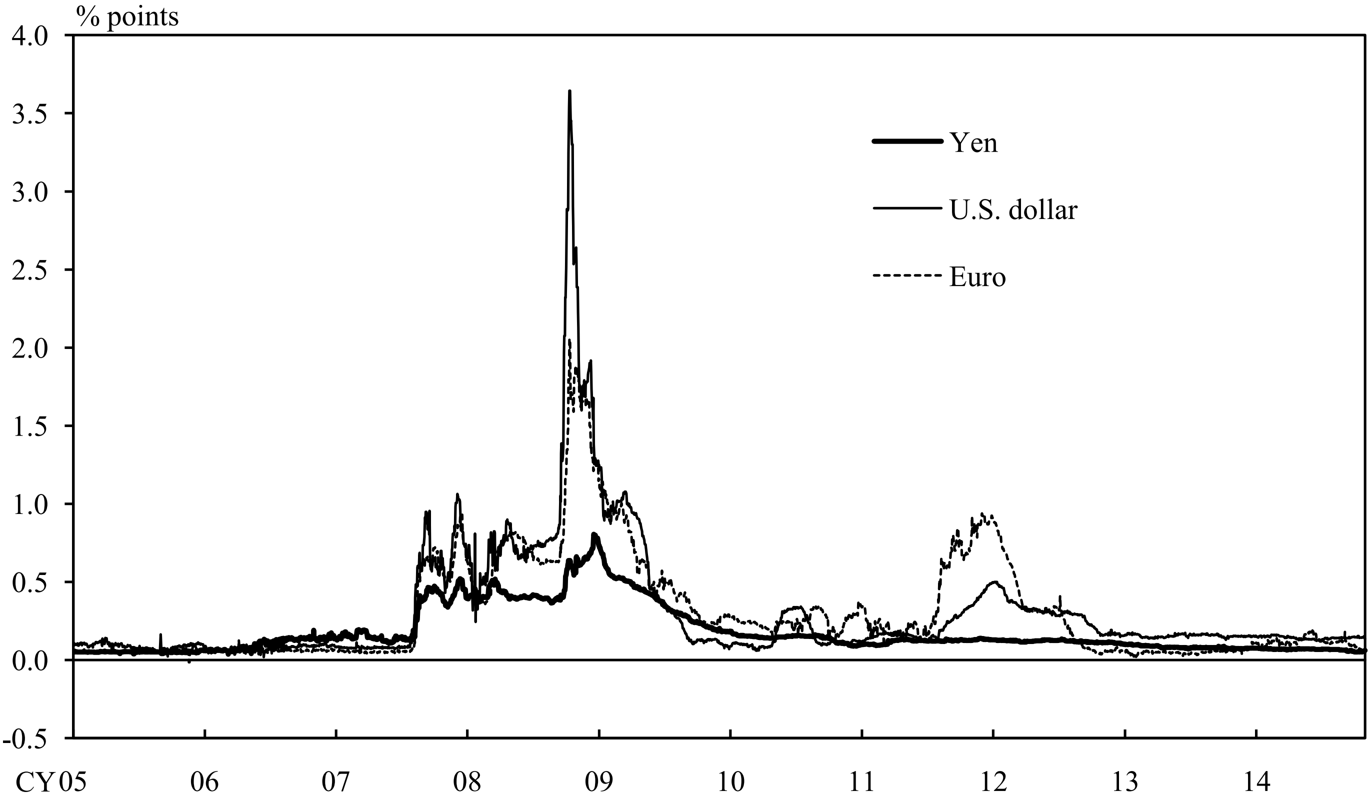
Source: Bloomberg.

Money Market Rates

(1) Short-Term Interest Rates



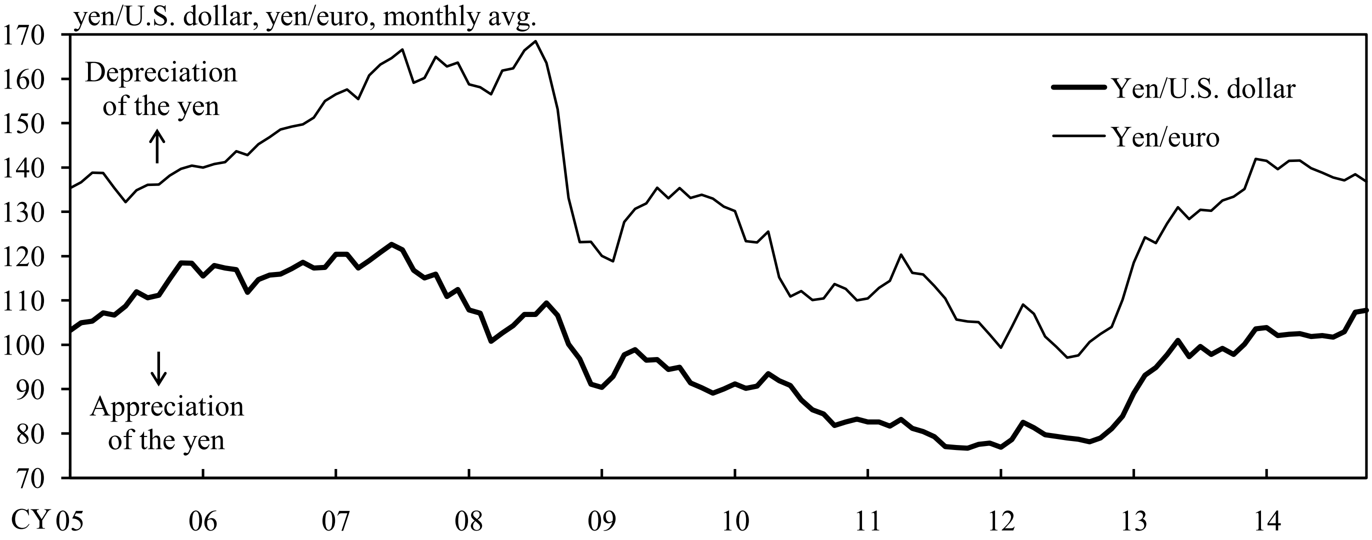
(2) Credit Spreads for Yen-, Dollar-, and Euro-Denominated Term Instruments



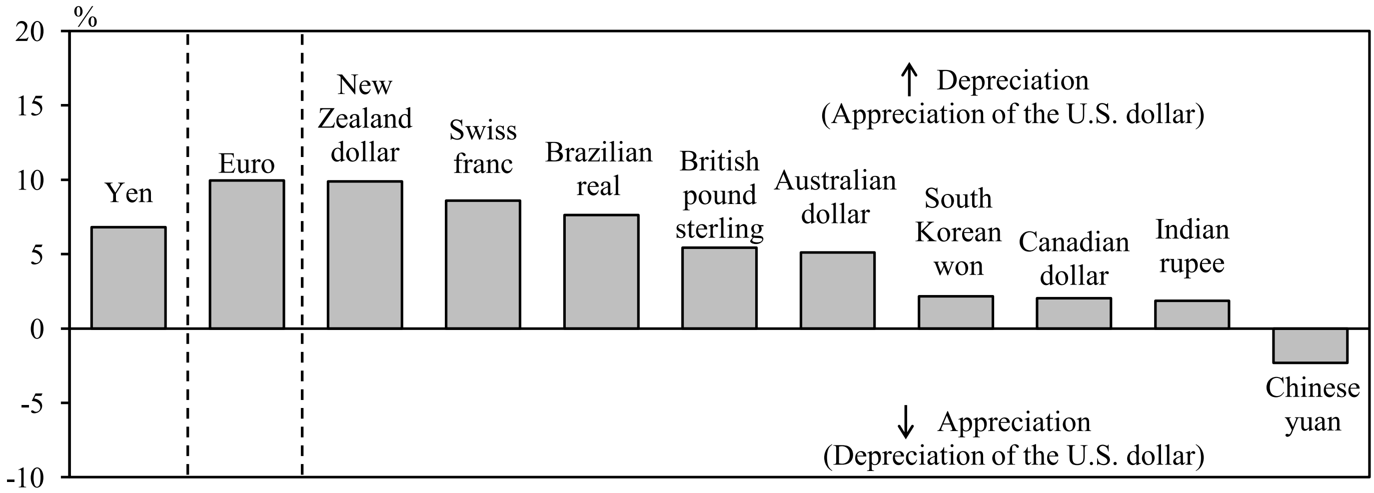
Note: The credit spreads for term instruments are LIBOR (3-month) minus yields on overnight index swaps (3-month).
Sources: Bank of Japan; Bloomberg.

Exchange Rates

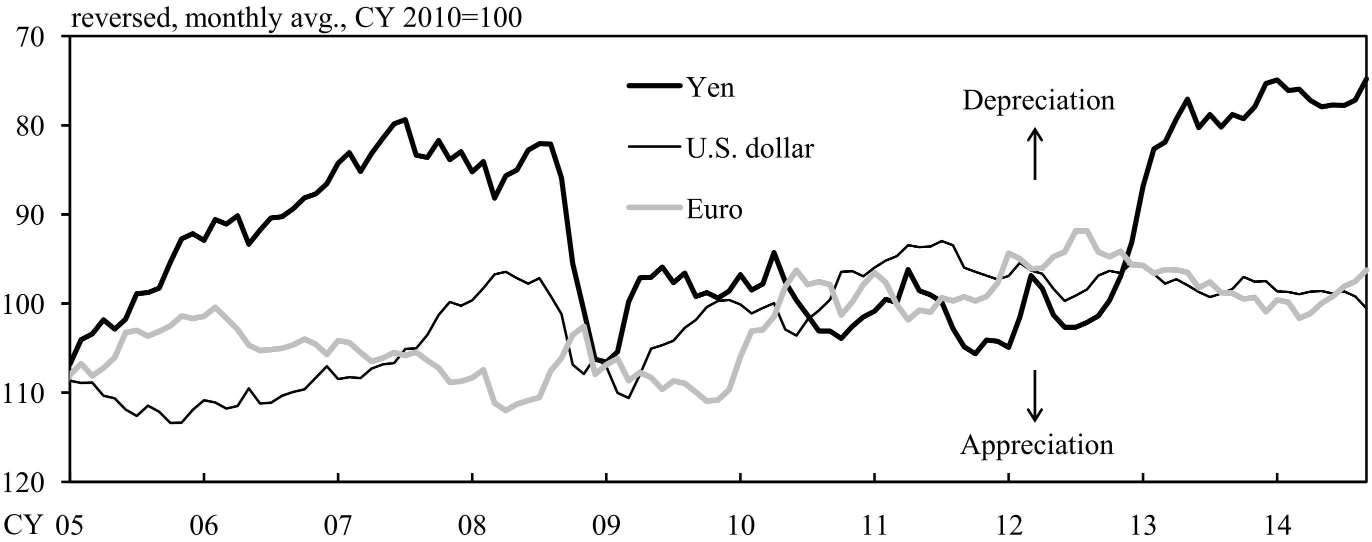
(1) Yen/U.S. Dollar and Yen/Euro



(2) Rates of Change in Selected Currencies against the U.S. Dollar (Since the End of April 2014)



(3) Real Effective Exchange Rates



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

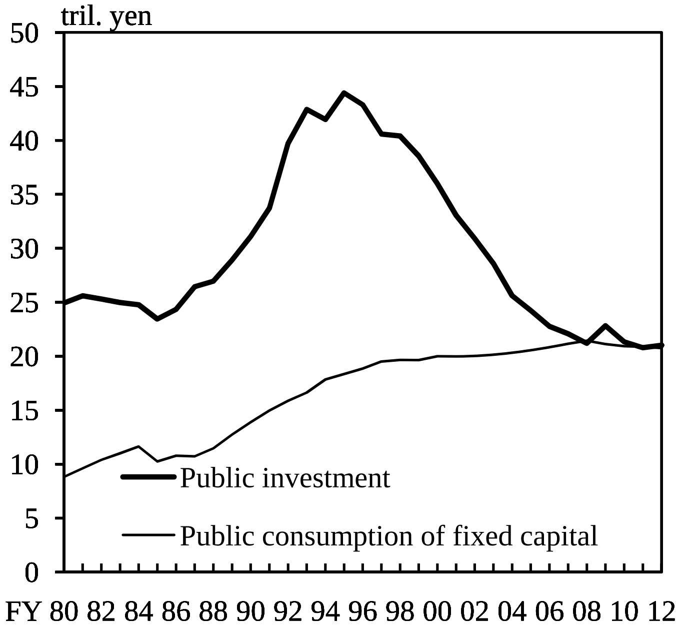
Government Spending

(1) Front-Loading Investment of the General Government

		Contract ratio[1] End-June	Contract ratio[1] End-Sept.	Budget amount
Supplementary budget for FY2013	T[2]	Around 70%	Around 90%	1.7 tril. yen
	A	68%	-	
Budget for FY2014	T[2]	40% or more	60% or more	9.2 tril. yen
	A	44%	-	

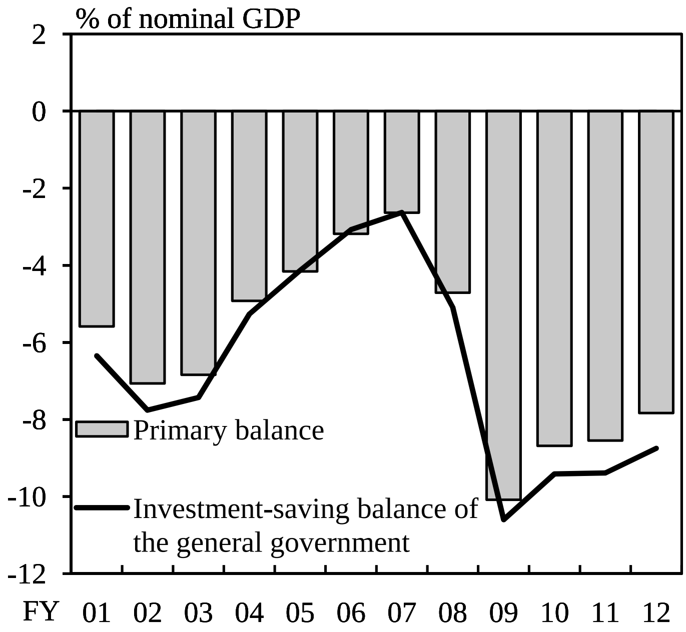
T=target, A=actual

(2) Maintenance and Replacement of Social Capital[3]

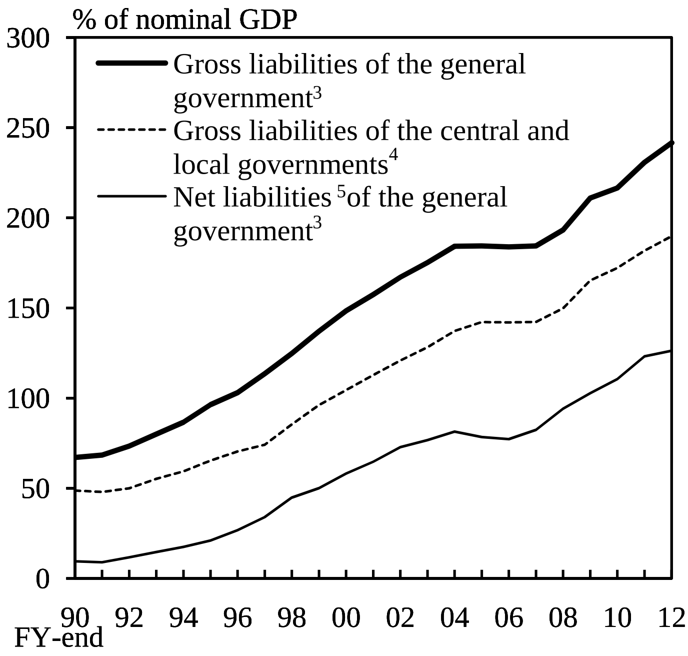


Notes: 1. The contract ratio is defined as the contract amount over the budget.
2. The target contract ratio includes the budget for public investment and other miscellaneous expenses.
3. Figures up through fiscal 1993 are calculated using the year-on-year rate of change in the figures on the 2000 base.

(3) Fiscal Balance[1]



(4) Government Liabilities[2]

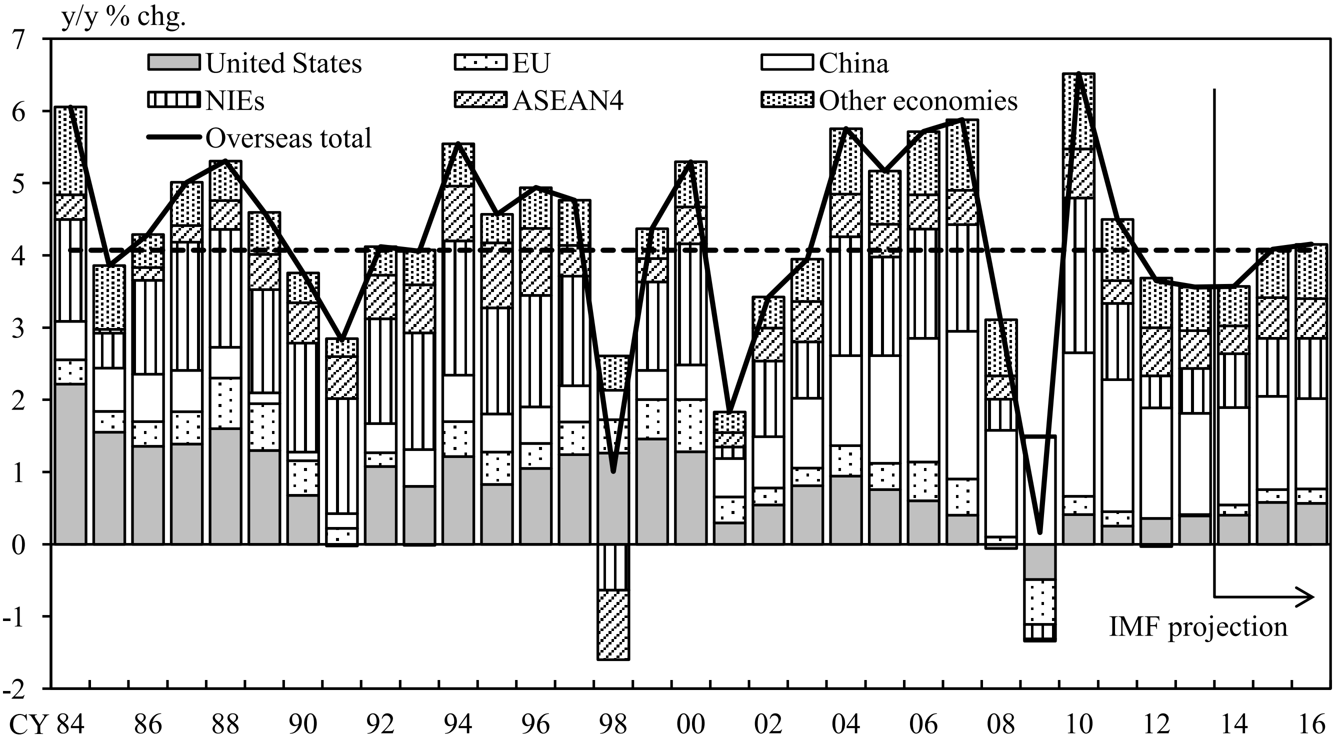


Notes: 1. Factors such as transfer of reserves in a special account to the general account are excluded from the investment-saving balance of the general government.
2. Figures up through fiscal 1993 are on the 2000 base. From fiscal 1994, they are on the 2005 base.
3. The general government consists of the central government, local governments, and social security funds.
4. Outstanding debt reported in "Economic and Fiscal Projections for Medium to Long Term Analysis (July 2014)."
5. Gross liabilities minus financial assets.

Source: Cabinet Office, "National Accounts," "Economic and Fiscal Projections for Medium to Long Term Analysis," etc.

Overseas Economies

(1) Real GDP Growth Rates of Overseas Economies



Notes: 1. Figures for the overseas total are the weighted averages of real GDP growth rates, from "World Economic Outlook," by value of exports from Japan to each economy. The same method applies to the chart below.
2. The broken line indicates the average of 1980-2013 (4.1 percent).

(2) Forecast of Real GDP Growth Rates by Major Country and Region

y/y % chg.

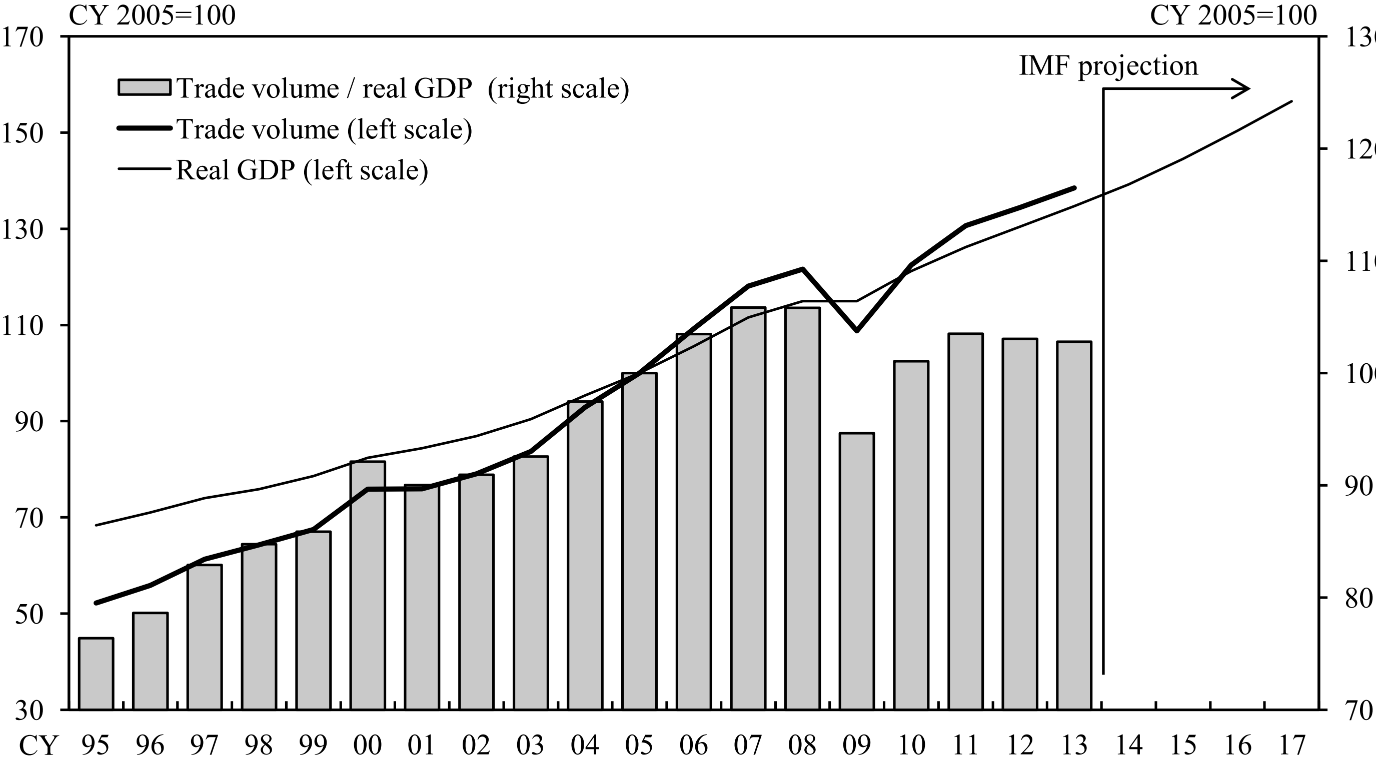
	Actual			IMF projection		
	CY 2011	2012	2013	2014	2015	2016
Overseas total	***4.5***	***3.7***	***3.6***	***3.6*** (3.7)	***4.1*** (4.1)	***4.2***
United States <18.5>	***1.6***	***2.3***	***2.2***	***2.2*** (1.7)	***3.1*** (3.0)	***3.0***
EU <10.0>	***1.8***	***-0.3***	***0.2***	***1.4*** (1.6)	***1.8*** (1.9)	***2.0***
East Asia <50.9>	***5.9***	***4.9***	***4.9***	***4.8*** (5.0)	***5.2*** (5.2)	***5.1***
China <18.1>	***9.3***	***7.7***	***7.7***	***7.4*** (7.4)	***7.1*** (7.1)	***6.8***
NIEs <21.9>	***4.4***	***1.9***	***2.8***	***3.4*** (3.6)	***3.6*** (3.8)	***3.8***
ASEAN4 <10.9>	***3.0***	***6.3***	***4.4***	***3.5*** (4.1)	***5.1*** (4.8)	***5.0***
Other economies <20.6>	***4.5***	***3.6***	***3.0***	***2.7*** (3.0)	***3.4*** (3.6)	***3.8***

Notes: 1. Shares of each country and region in the total amount of exports in 2013 are shown in angular brackets.
2. Figures in parentheses are projections in July 2014. Figures for some countries and regions, not available in July, are calculated using those in April. Figures for the EU are calculated using October projections and those differences from July.

Sources: IMF, "World Economic Outlook"; Ministry of Finance, "Trade Statistics."

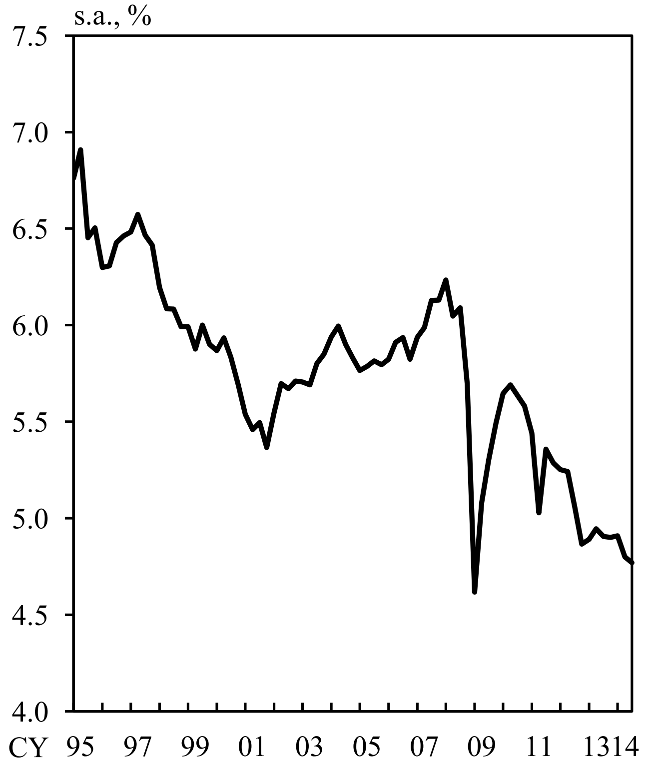
World Trade Volume and Shares by Country

(1) Real GDP and Trade Volume of the World Economy

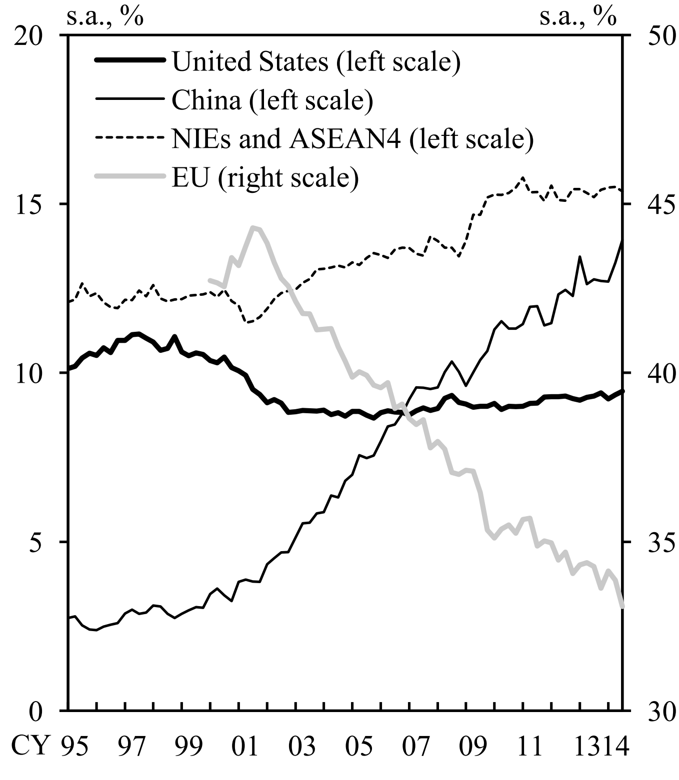


(2) Shares in World Real Exports by Country and Region

(a) Japan



(b) Overseas Economies

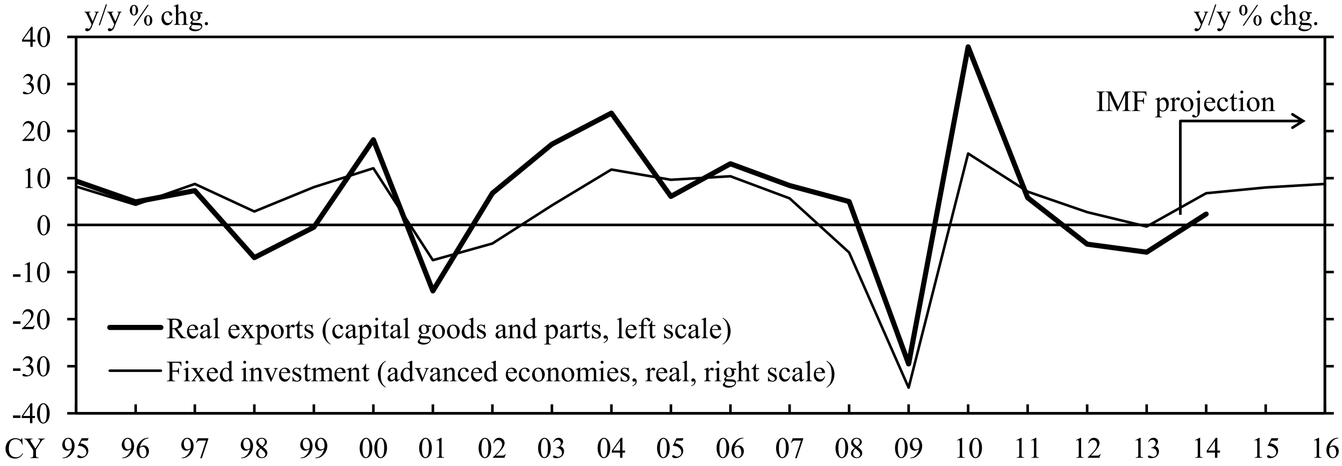


Note: Figures for 2014/Q3 are July-August averages.

Sources: CEIC; Datastream; Eurostat; IMF, "World Economic Outlook"; CPB Netherlands Bureau for Economic Policy Analysis; World Bank.

Exports of Capital Goods and Domestic/Overseas Fixed Investment

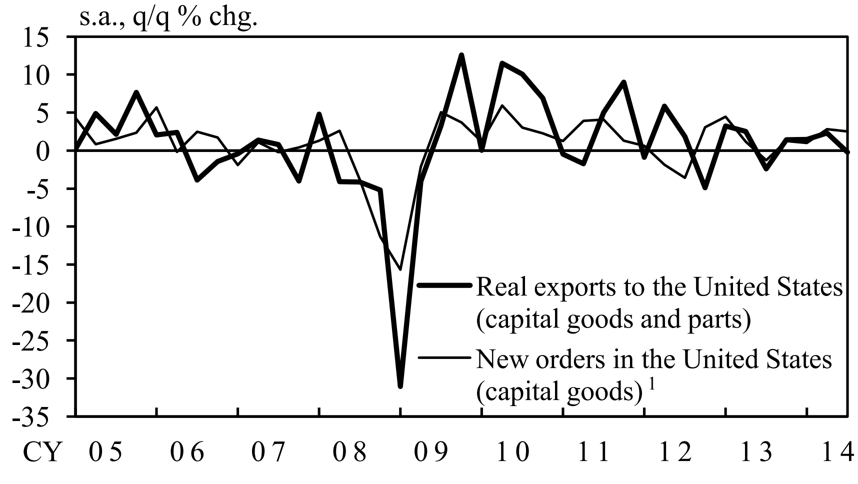
(1) Exports of Capital Goods and Parts, and Fixed Investment of Overseas Economies



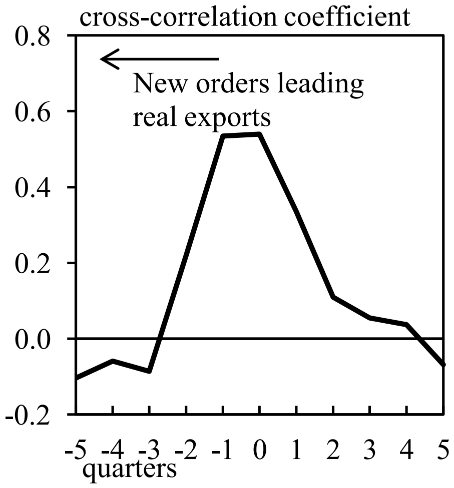
Notes: 1. Figures for fixed investment of advanced economies are calculated using their GDP growth rate and the ratio of investment to their GDP from "World Economic Outlook."
2. The figure for real exports for 2014 is the January-September average.

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

(a) Growth Rate

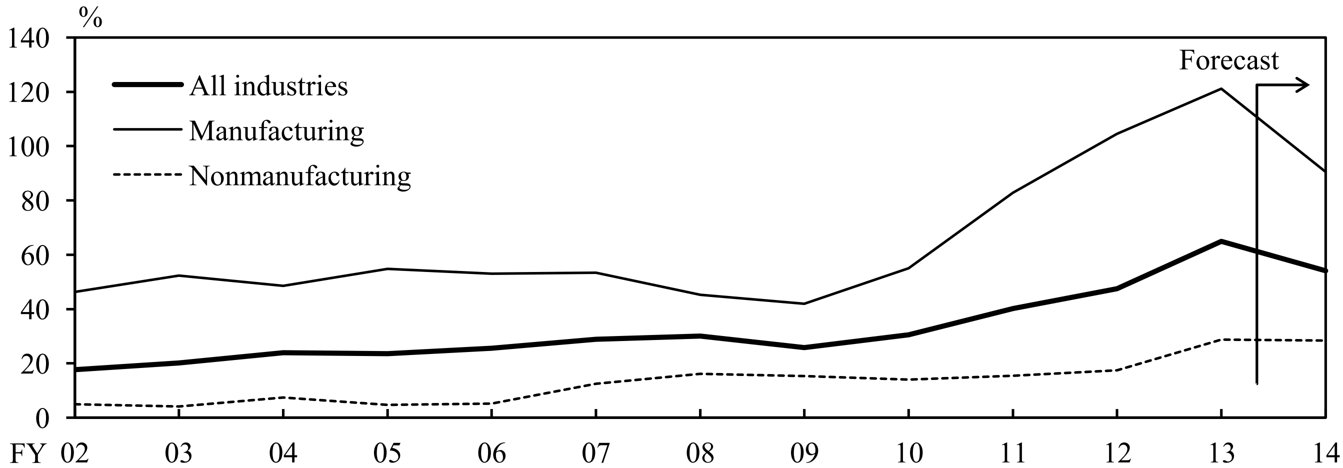


(b) Cross-Correlation[2]



Notes: 1. Nondefense capital goods excluding aircrafts.
2. The sample period is 1992/Q2-2014/Q3.

(3) Overseas/Domestic Ratio of Business Fixed Investment

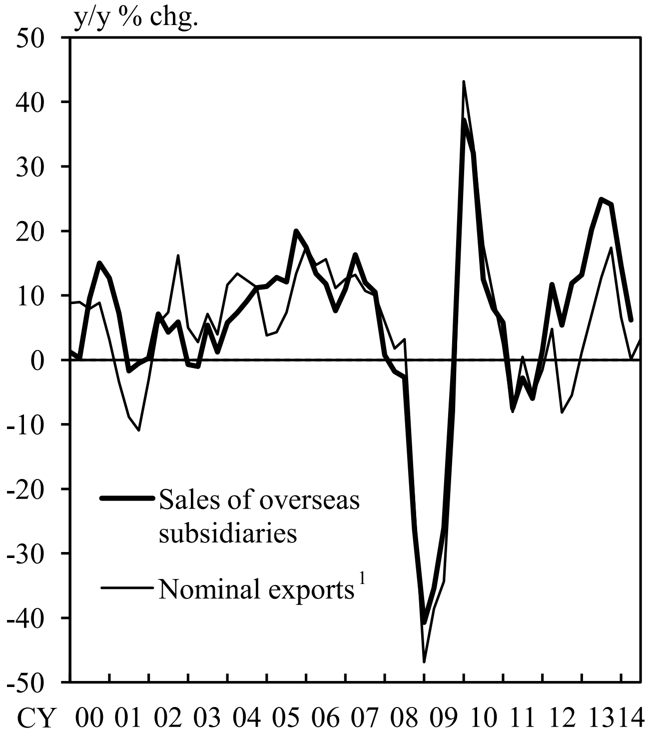


Sources: CEIC; IMF, "World Economic Outlook"; Ministry of Finance, "Trade Statistics"; Bank of Japan, "Corporate Goods Price Index"; Development Bank of Japan, "Survey on Planned Capital Spending."

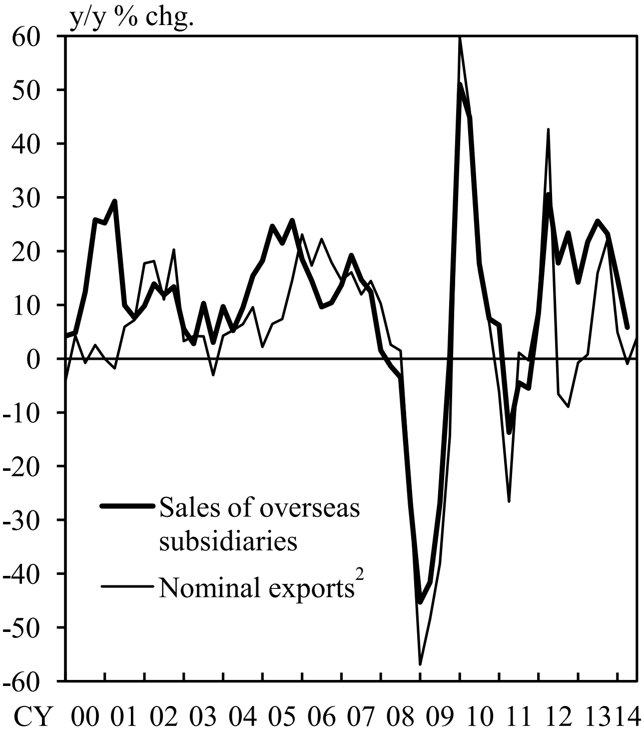
Effect of Overseas Shift in Production and Competitiveness

(1) Overseas Shift in Production

(a) Manufacturing



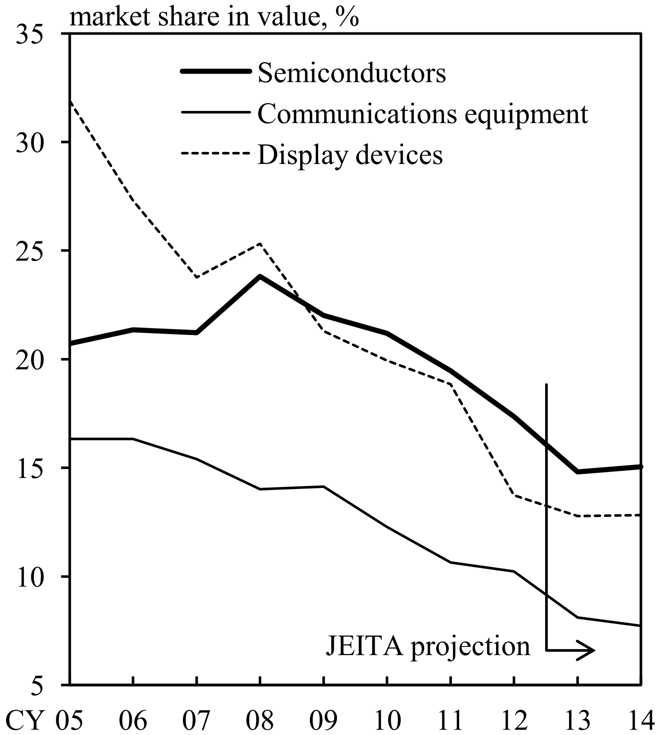
(b) Transport Equipment



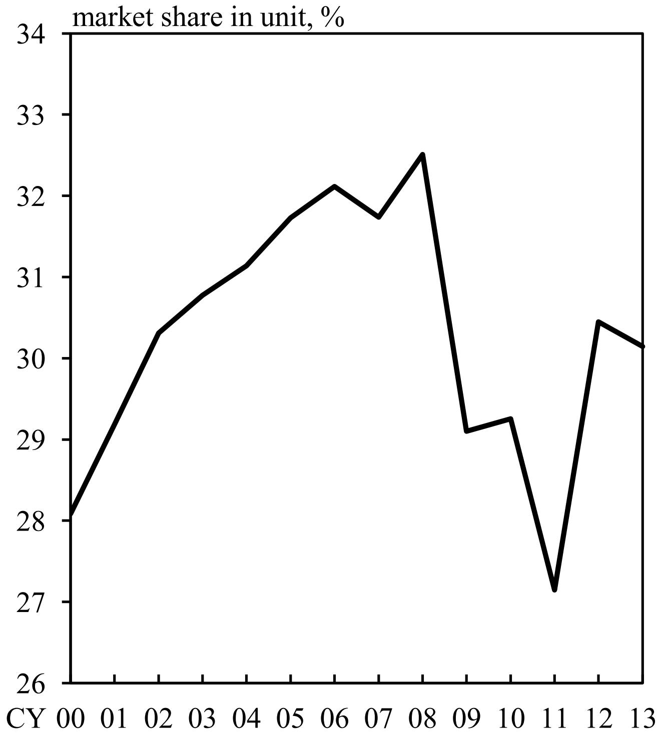
Notes: 1. Figures are the total value of exports.
2. Figures are those of transport equipment.

(2) Worldwide Market Share by Product

(a) IT-Related Products



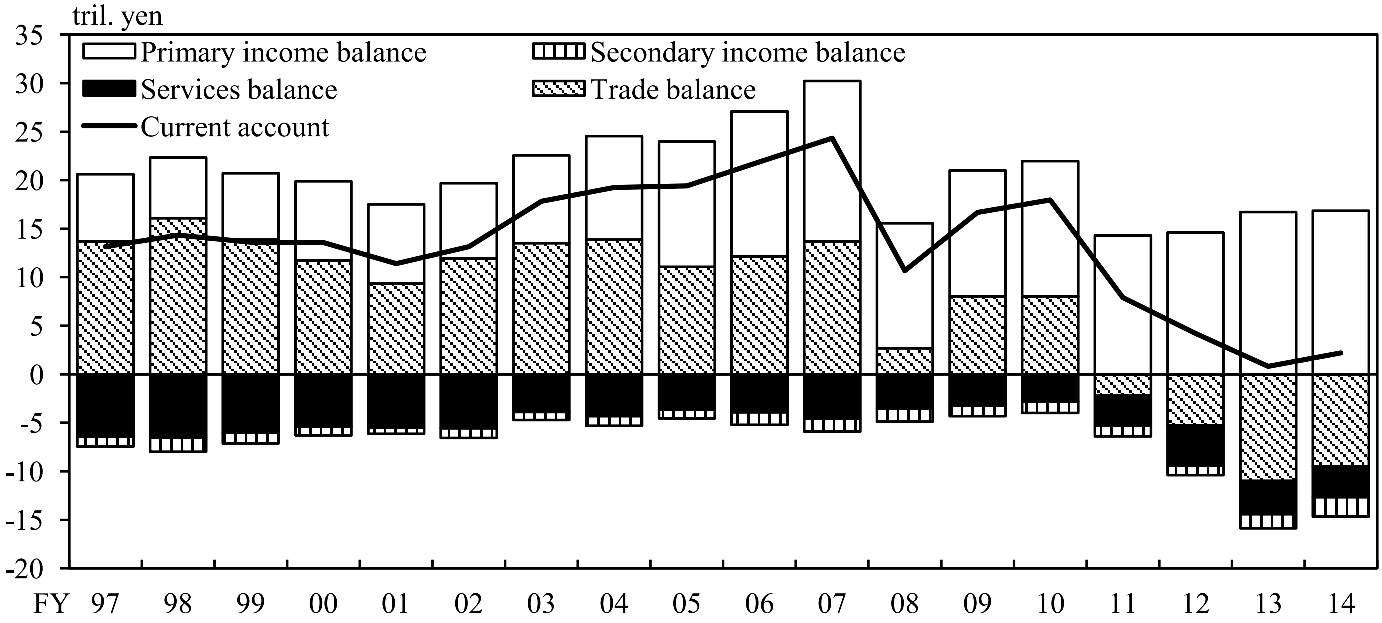
(b) Motor Vehicles



Sources: Ministry of Economy, Trade and Industry, "Quarterly Survey of Overseas Subsidiaries";
Ministry of Finance, "Trade Statistics";
JEITA, "Production Forecasts for the Global Electronics and Information Technology Industries";
OICA; publication of each automobile company.

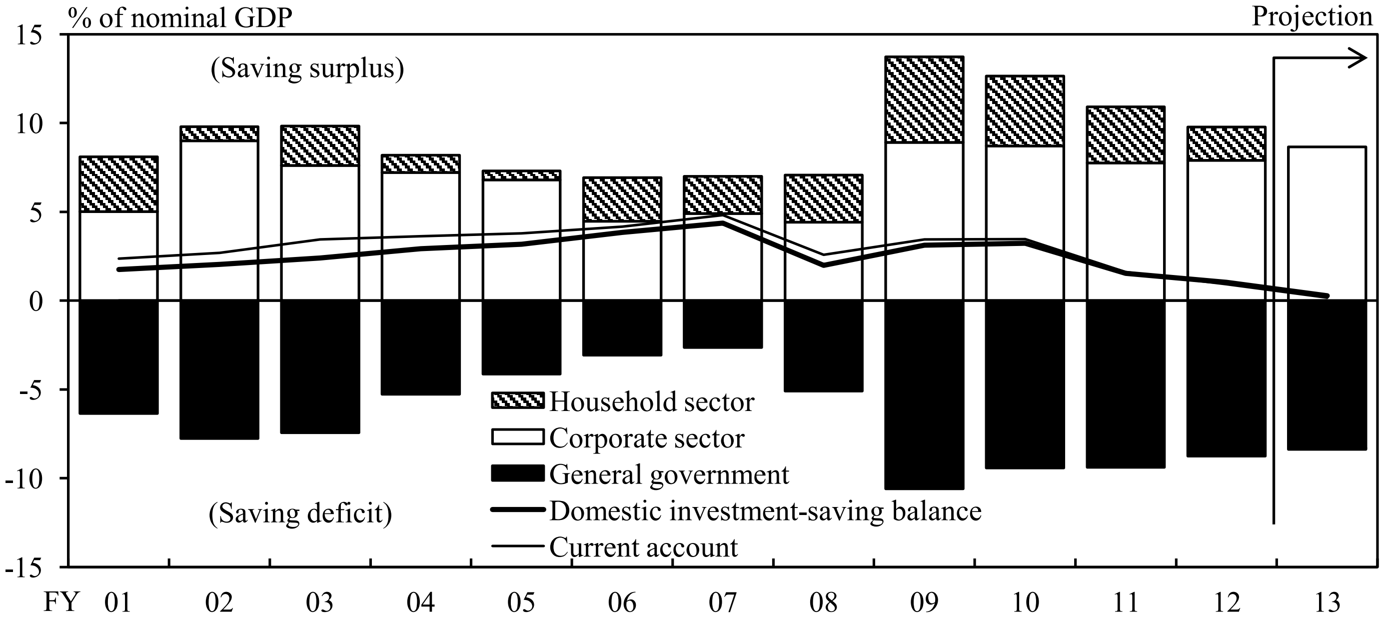
Current Account and Investment-Saving Balance

(1) Current Account



Note: Figures for fiscal 2014 are April-August averages in terms of the annual amount.

(2) Investment-Saving Balance



Notes: 1. The factors described in the note to Chart 28 (3) are excluded.

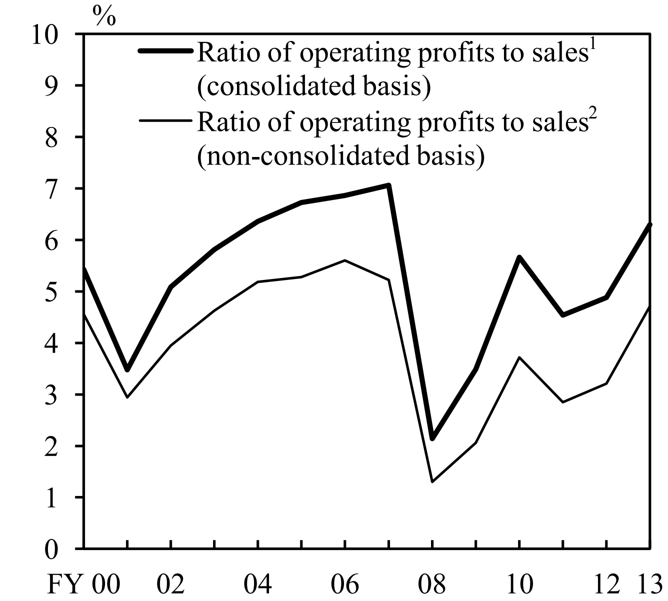
2. The figure for the investment-saving balance of the general government for fiscal 2013 is based on the "Economic and Fiscal Projections for Medium to Long Term Analysis (July 2014)." The figure for the balance of the household sector is estimated by subtracting private consumption expenditure and private residential investment from personal disposable income, which is calculated using the estimated nominal disposable income in Chart 41 (3). The figure for the balance of the corporate sector is the residue.

3. The domestic investment-saving balance for fiscal 2013 is estimated by adding 0.1 percentage point (the difference between the domestic investment-saving balance and the current account in fiscal 2012) from the current account.

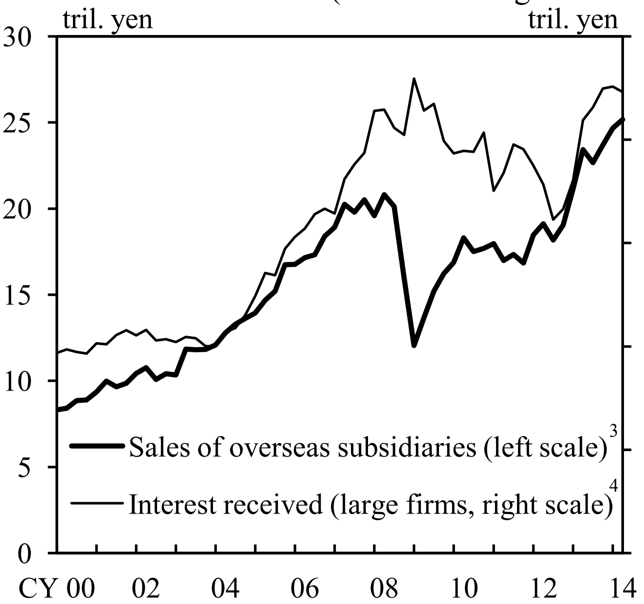
Sources: Cabinet Office, "National Accounts," "Economic and Fiscal Projections for Medium to Long Term Analysis"; Ministry of Finance and Bank of Japan, "Balance of Payments."

Corporate Profits and Confidence

(1) Corporate Profits of Manufacturing Industries

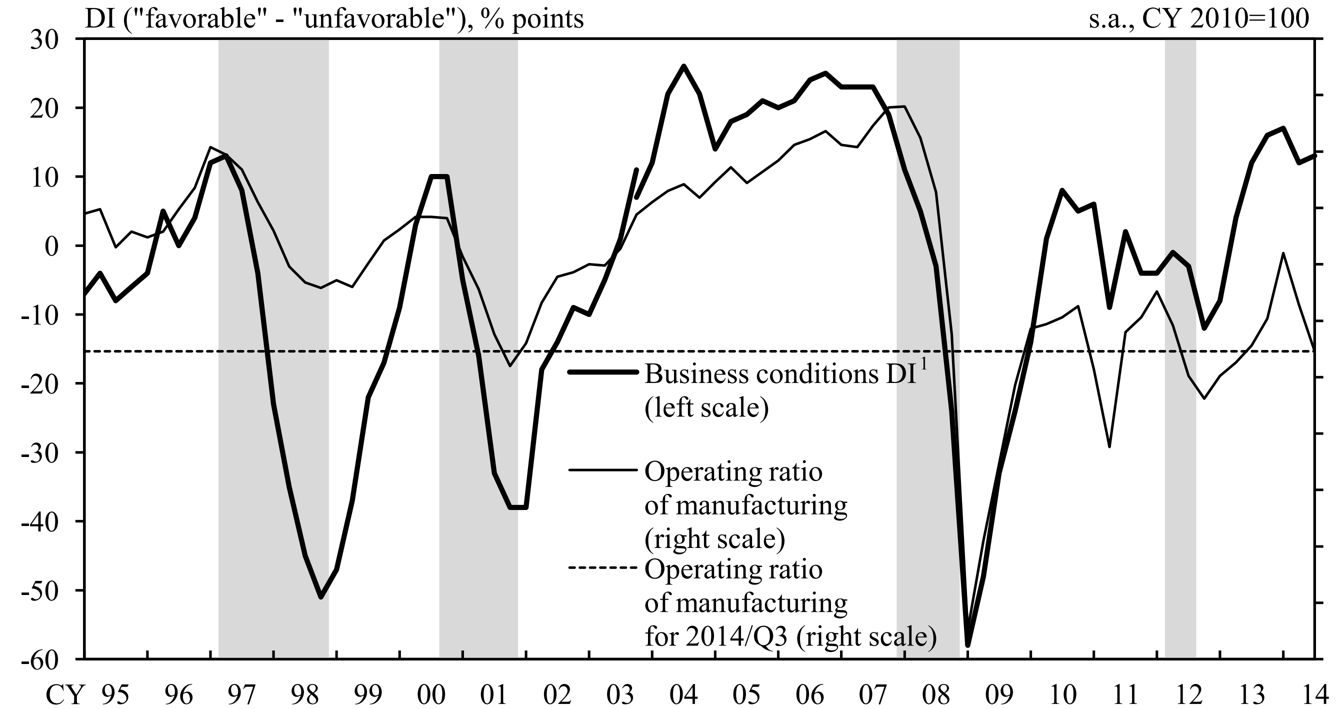


(2) Sales of Overseas Subsidiaries, and Interest and Dividends Received (Manufacturing Industries)



Notes: 1. The ratio of operating profits to sales (consolidated basis) is based on listed companies.
2. The ratio of operating profits to sales (non-consolidated basis) is based on listed and non-listed companies with capital of 100 million yen or more.
3. Figures for sales of overseas subsidiaries exclude sales to Japan.
4. Figures for interest received are 4-quarter backward moving averages and include dividends income.

(3) Business Conditions and Operating Ratio

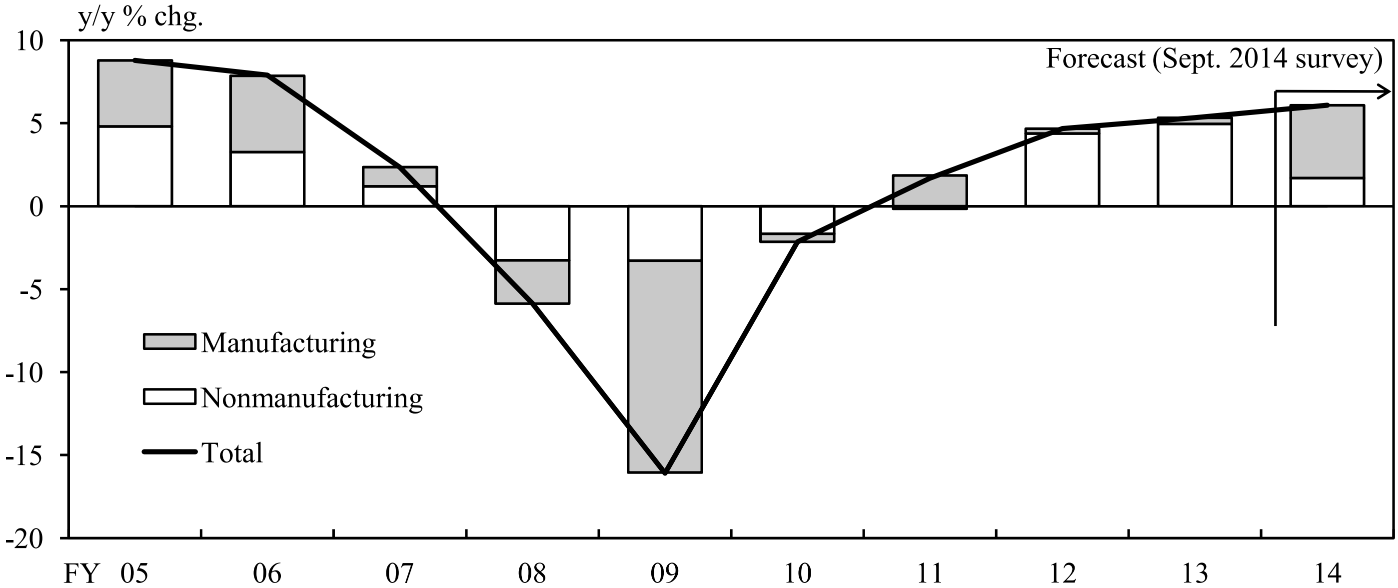


Notes: 1. Data from the "Tankan" are based on large manufacturing enterprises. The "Tankan" was revised from the March 2004 survey. Figures up to the December 2003 survey are based on the previous data sets. Figures from the December 2003 survey are on the new basis.
2. The figure of operating ratio of manufacturing for 2014/Q3 is the July-August average.
3. Shaded areas indicate recession periods.

Sources: Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Quarterly"; Ministry of Economy, Trade and Industry, "Indices of Industrial Production," "Quarterly Survey of Overseas Subsidiaries"; Bank of Japan, "*Tankan,* Short-Term Economic Survey of Enterprises in Japan," etc.

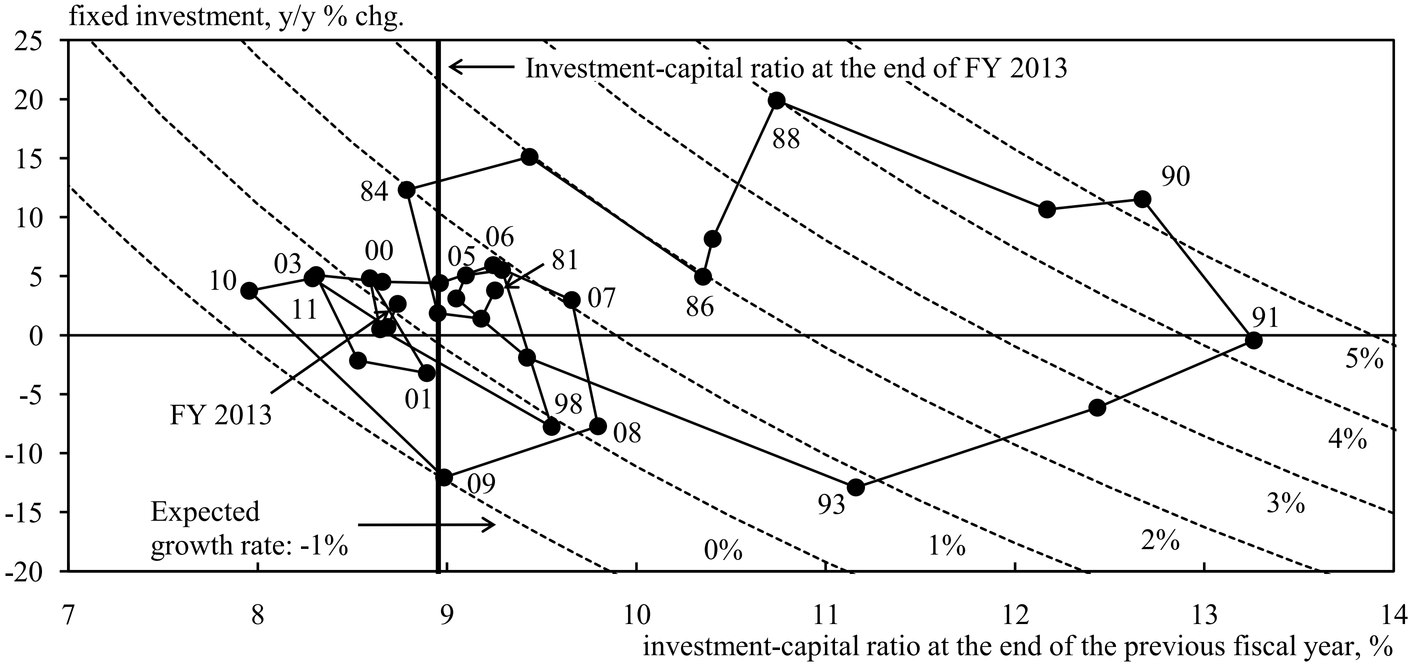
Business Fixed Investment Plans and Capital Stock Cycles

(1) Business Fixed Investments (*Tankan,* All Enterprises)



Notes: 1. Includes software investment and excludes land purchasing expenses.
2. Figures up to fiscal 2008 are based on the previous accounting standard for lease transactions, and figures from fiscal 2009 onward are based on the new standard.

(2) Capital Stock Cycles

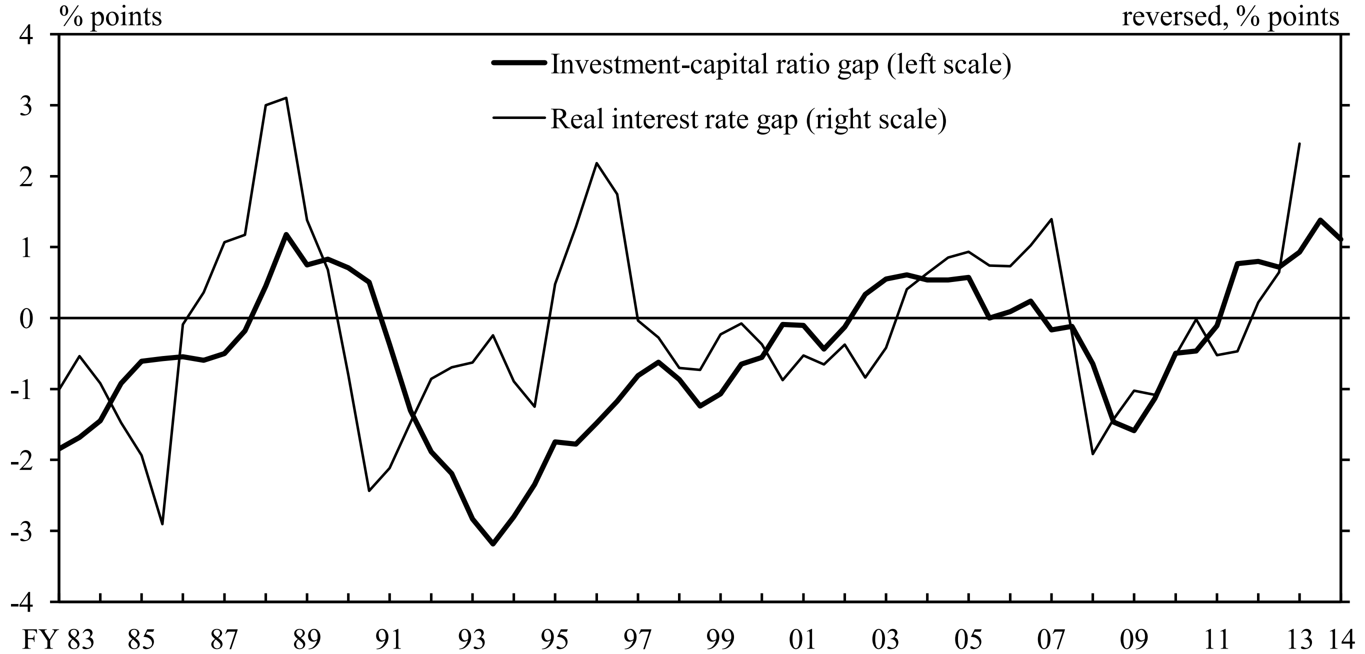


1. Capital stock cycles in the chart show the relationship between the investment-capital ratio and the year-on-year rate of change in fixed investment.
2. As these variables have the following relation, a hyperbolic curve can be drawn for a given expected growth rate.
Year-on-year rate of change in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

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

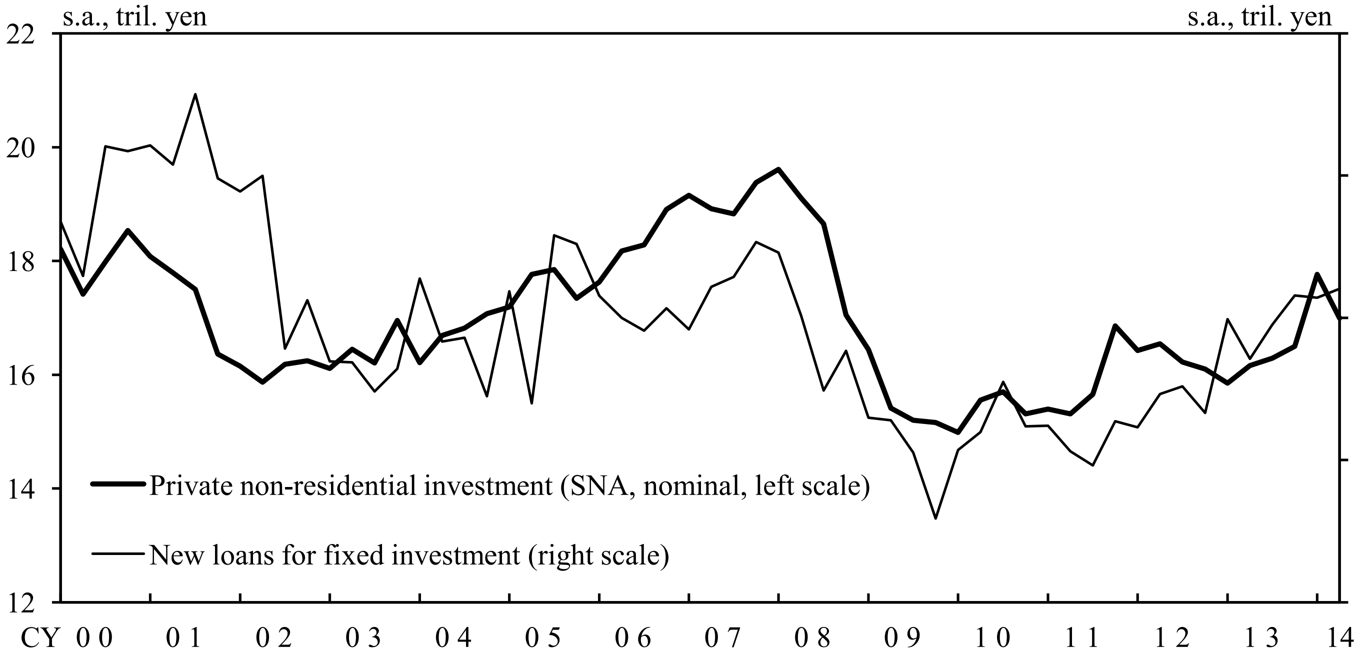
Monetary Easing and Business Fixed Investment

(1) Real Interest Rate Gap and Business Fixed Investment



Notes: 1. The figure for the first half of fiscal 2014 is that of 2014/Q2.
2. The investment-capital ratio gap is calculated by subtracting the long-run equilibrium ratio, estimated from the potential GDP growth rate and other factors, from the actual ratio.
3. Real interest rate gap = call rate - domestic demand deflator (y/y % change, 1 year ahead) - potential growth rate (y/y % change)
In calculating the real interest rate gap for the first half of fiscal 2013, the 1-year-ahead domestic demand deflator is that of 2014/Q2.

(2) Bank Loans and Business Fixed Investment

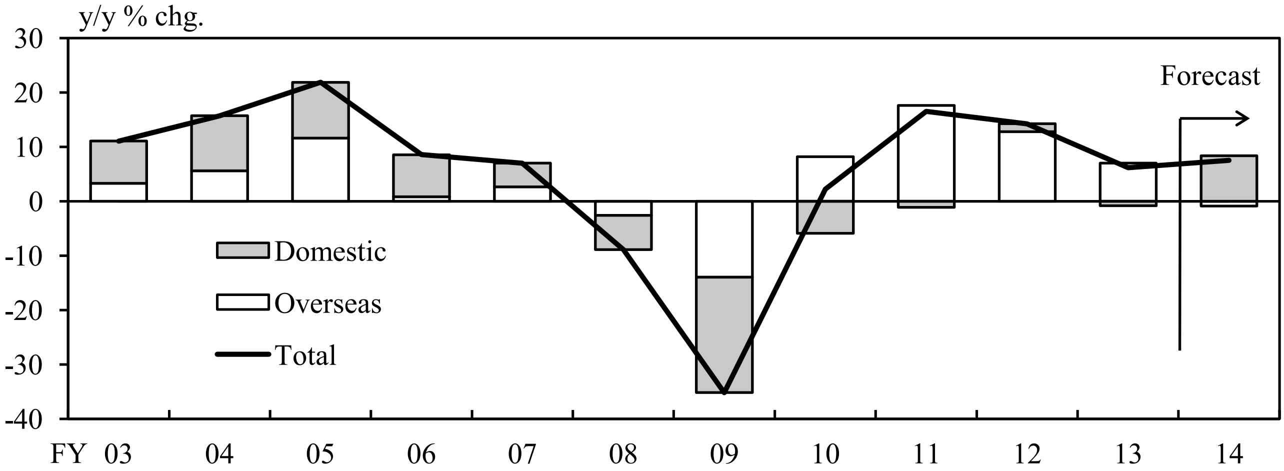


Note: Figures for new loans for fixed investment exclude those of loans for households, local governments, etc. Seasonally adjusted by X-12-ARIMA.

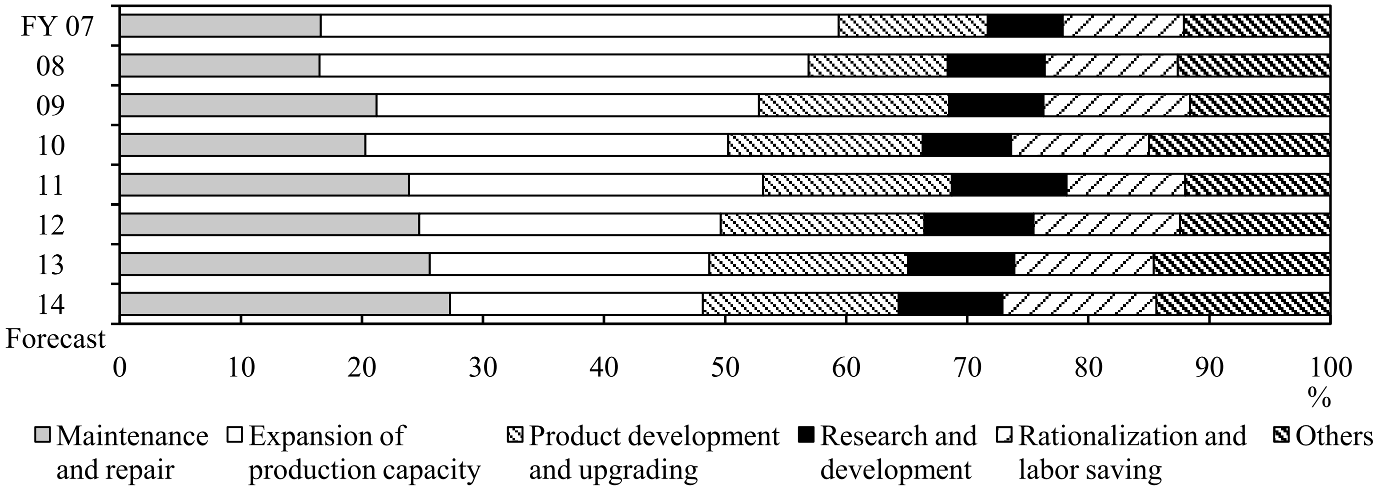
Sources: Cabinet Office, "National Accounts";
Research Institute of Economy, Trade and Industry, "Japan Industrial Productivity Database";
Bank of Japan, "Loans and Bills Discounted by Sector," etc.

Business Fixed Investment in Manufacturing Sector

(1) Domestic and Overseas Fixed Investment Plans

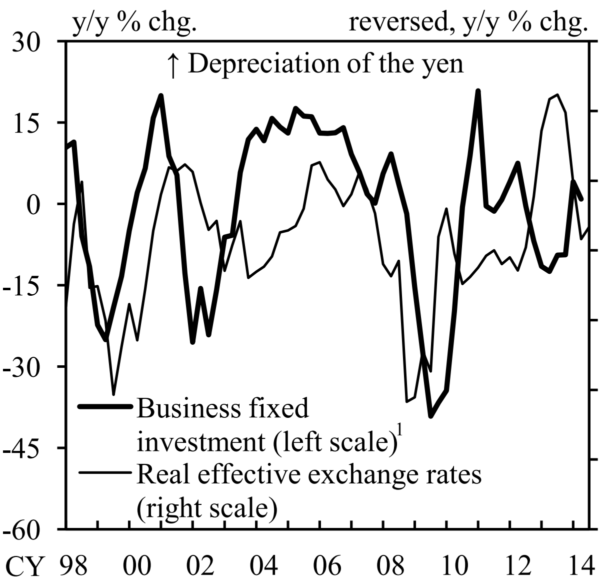


(2) Investment Motives

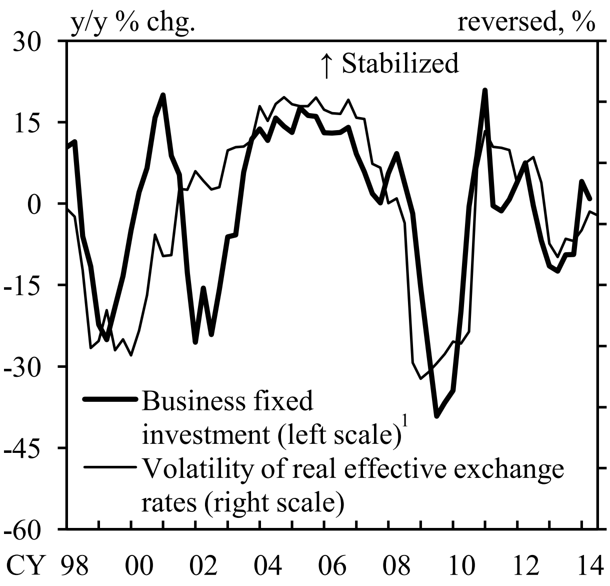


(3) Exchange Rates and Business Fixed Investment

(a) Exchange Rate Levels



(b) Exchange Rate Volatilities



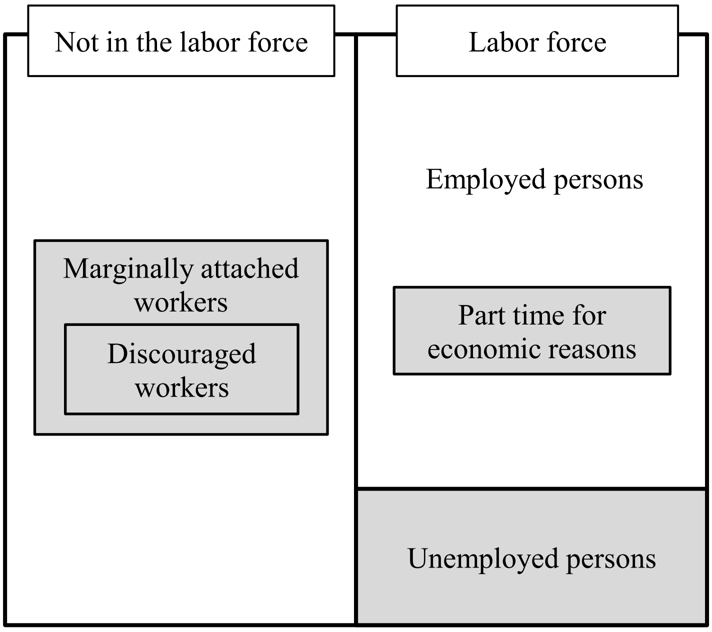
Notes: 1. Figures are based on large manufacturing firms and exclude software investment.
2. Volatilities in Chart (b) are standard deviations of month-on-month rates of change in exchange rates for past 2 years.

Sources: Development Bank of Japan, "Survey on Planned Capital Spending";
Ministry of Finance, "Financial Statements Statistics of Corporations by Industry, Quarterly," etc.

Unemployment Rates

(1) Definitions

<Alternative Measures of Unemployed Persons>



<Alternative Measures of the Unemployment Rate>

U-3 (Unemployment rate)

$$\frac{\text{Unemployed persons}}{\text{Labor force}}$$

U-4

$$\frac{\text{Unemployed persons + Discouraged workers}}{\text{Labor force + Discouraged workers}}$$

U-5

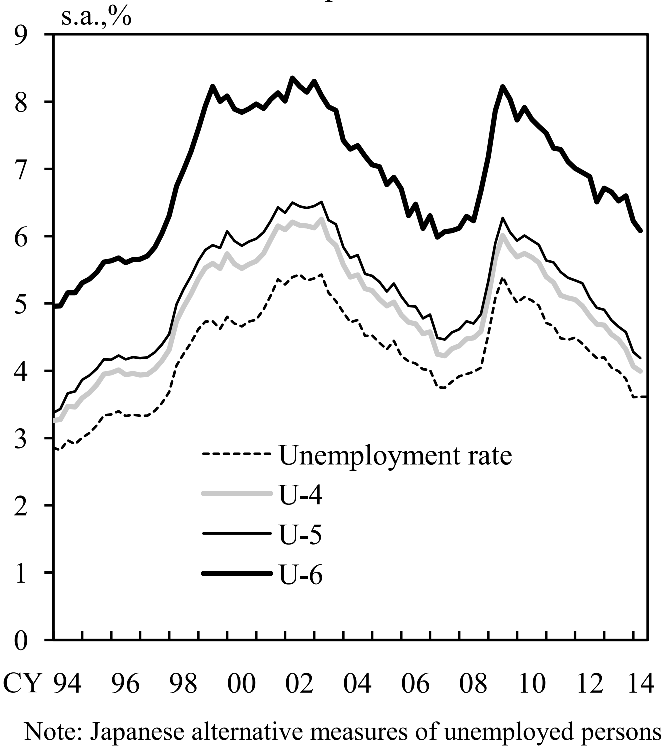
$$\frac{\text{Unemployed persons + Marginally attached workers}}{\text{Labor force + Marginally attached workers}}$$

U-6

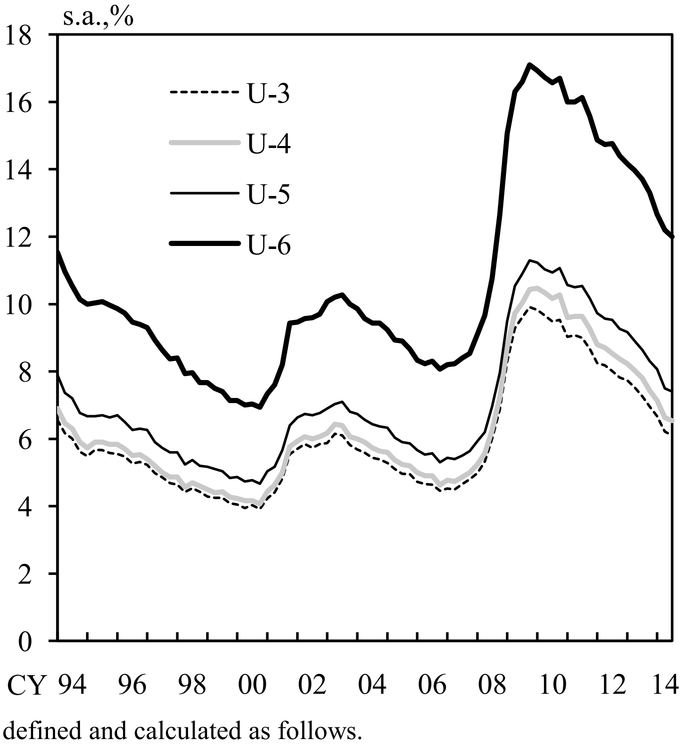
$$\frac{\text{Unemployed persons + Marginally attached workers + Part time for economic reasons}}{\text{Labor force + Marginally attached workers}}$$

(2) Alternative Measures of the Unemployment Rate

<Japan>



<United States>

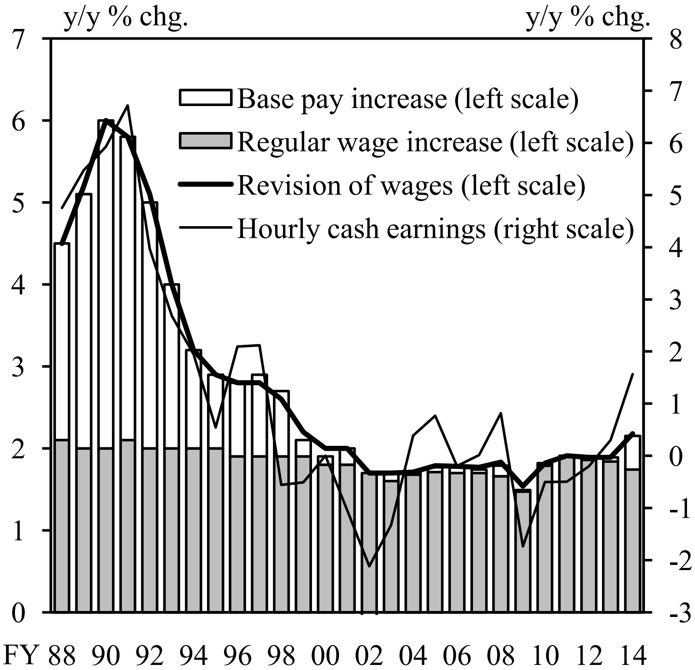


Note: Japanese alternative measures of unemployed persons are defined and calculated as follows.
Marginally attached workers are persons not in the labor force who want to work and had sought a job in the past year (in the past half year only for CY 1994), and are able to take a job immediately. Discouraged workers, a subset of marginally attached workers, are not seeking a job due to lack of an appropriate one. Part-time workers for economic reasons are those who work fewer than 35 hours per week and seek additional work.
Figures are seasonally adjusted by X-12-ARIMA.
Figures for CY 1994-2001 are linearly interpolated, since figures for CY 1994-98 are annual data and figures for CY 1999-2001 are semiannual data. Figures for 2011/Q1-Q3 are estimated values. Figures for workers employed part-time for economic reasons for 2013/Q1-2014/Q2 are estimated values.

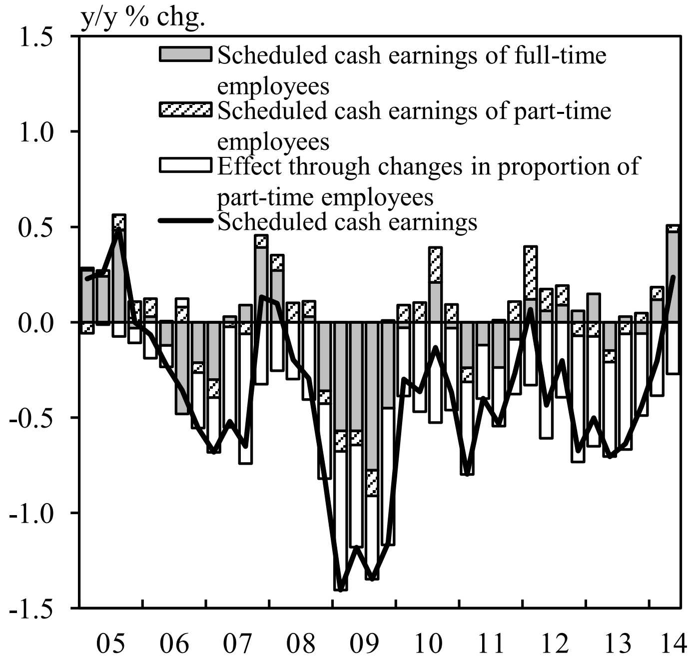
Sources: Ministry of Internal Affairs and Communications, "Labour Force Survey"; U.S. Bureau of Labor Statistics (BLS).

Wages and Employee Income

(1) Hourly Cash Earnings and Revision of Wages[1]

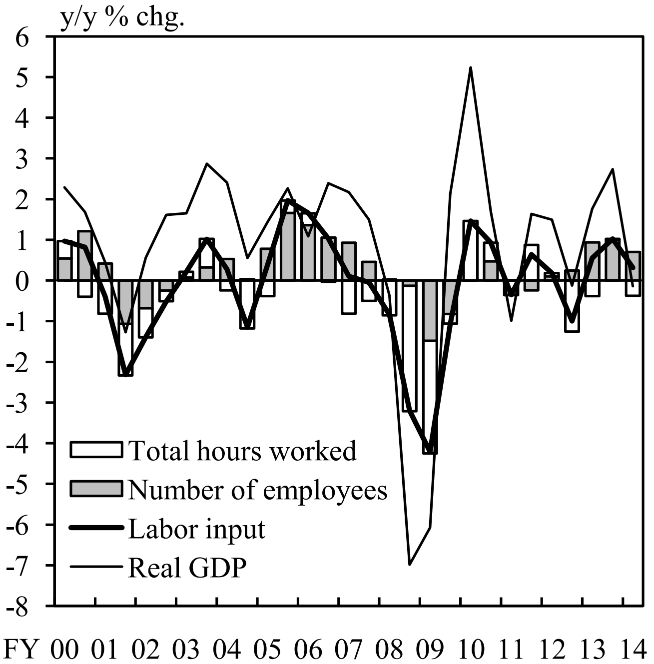


(2) Breakdown of Scheduled Cash Earnings[2]

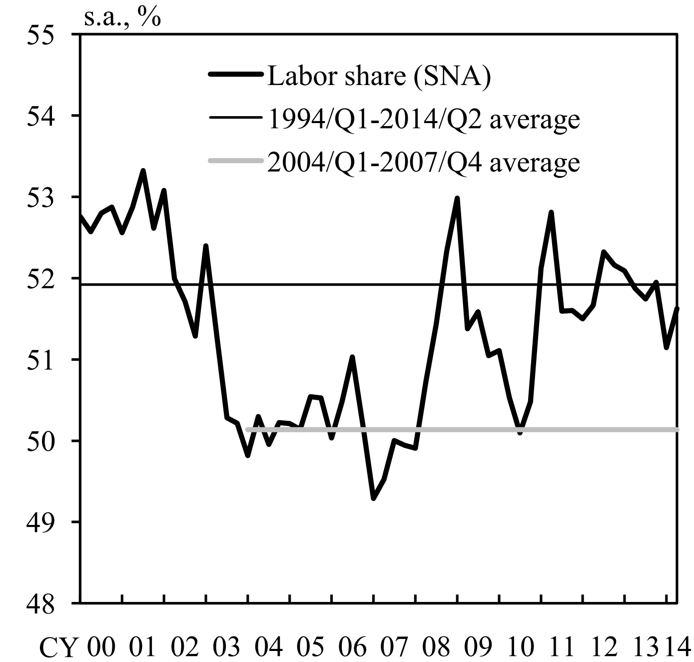


Notes: 1. Figures for revision of wages up through fiscal 2013 are based on Central Labour Relations Commission, and the figure for fiscal 2014 is based on Japanese Trade Union Confederation.
Figures for hourly cash earnings up through fiscal 1990 are those for establishments with 30 or more employees, and the figure for fiscal 2014 is the April-August average.
2. Q1 = March-May, Q2 = June-August, Q3 = September-November, Q4 = December-February.

(3) Labor Input[1]



(4) Labor Share[2]



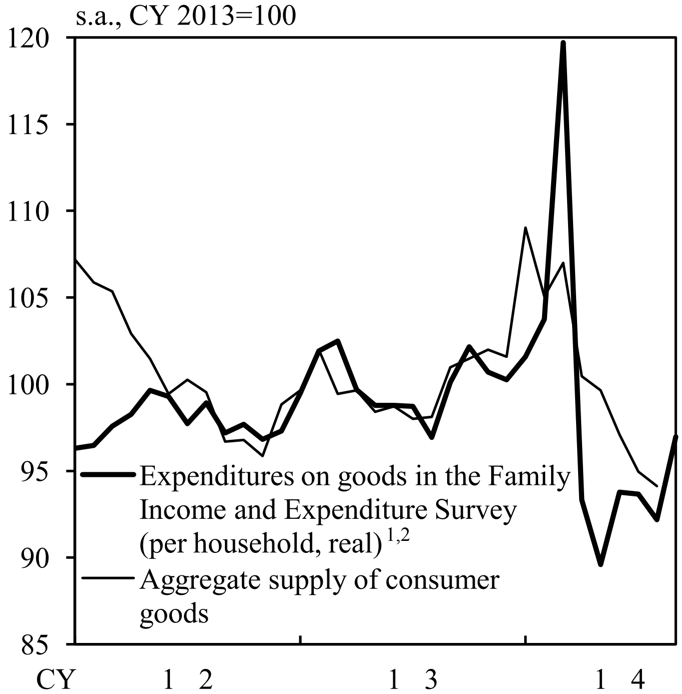
Notes: 1. Figures for the first half of fiscal 2014 are April-August averages (except real GDP). The figure for real GDP for the first half of fiscal 2014 is the year-on-year rate of change in 2014/Q2.
Labor input = number of employees (Labour Force Survey) × total hours worked
2. Labor share = compensation of employees / nominal GDP × 100

Sources: Ministry of Health, Labour and Welfare, "Monthly Labour Survey"; Ministry of Internal Affairs and Communications, "Labour Force Survey"; Cabinet Office, "National Accounts"; Central Labour Relations Commission, "Comprehensive Survey on Wage Conditions"; Japanese Trade Union Confederation.

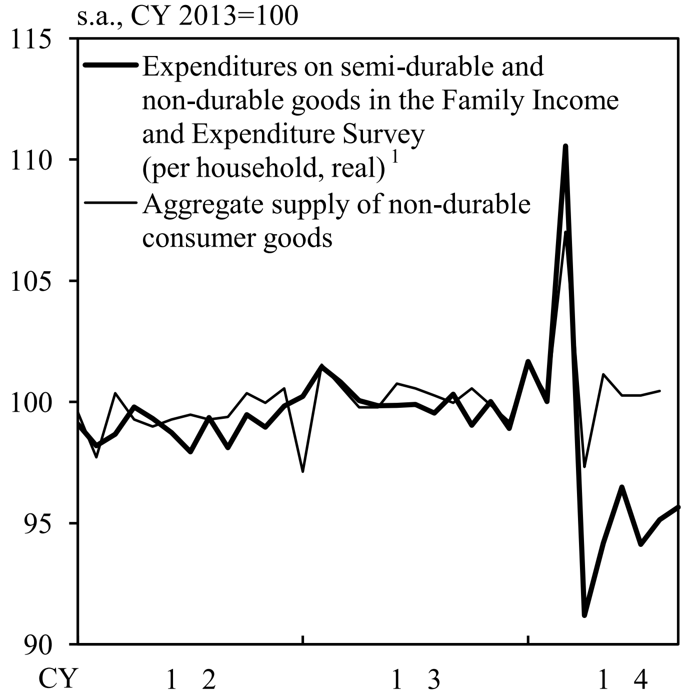
Private Consumption on the Supply and Demand Sides

(1) Supply-Side and Demand-Side Statistics

(a) Aggregate Supply of Consumer Goods and Consumption Expenditures



(b) Of Which: Non-Durable and Semi-Durable Goods

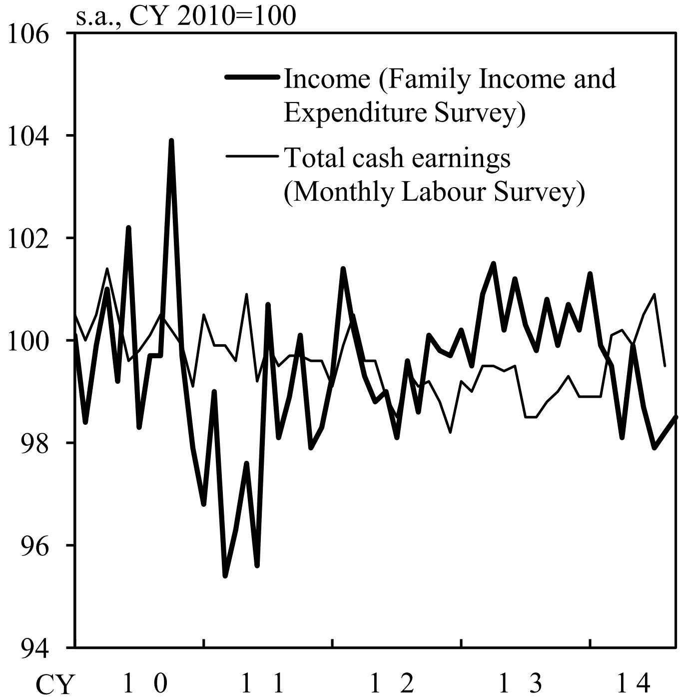


Notes: 1. Figures are of two-or-more-person households. They are deflated by the CPI corresponding to each type of goods, and seasonally adjusted by X-12-ARIMA.

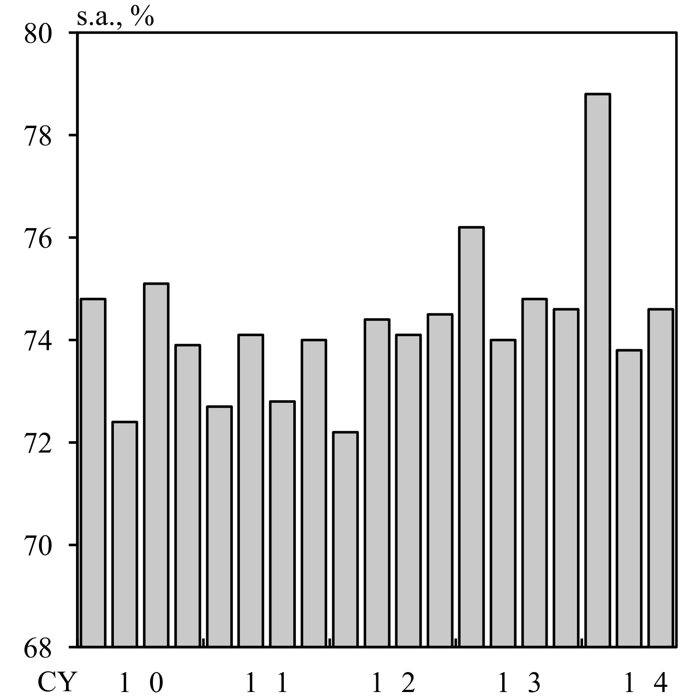
2. Figures are the sum of durable, semi-durable, and non-durable goods.

(2) Family Income and Expenditure Survey

(a) Income (Nominal)



(b) Average Propensity to Consume

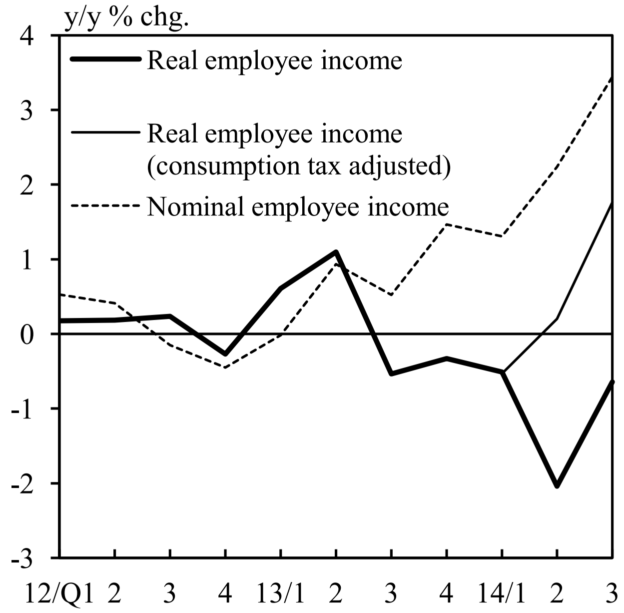


Note: Figures for income and average propensity to consume are of two-or-more-person workers' households.

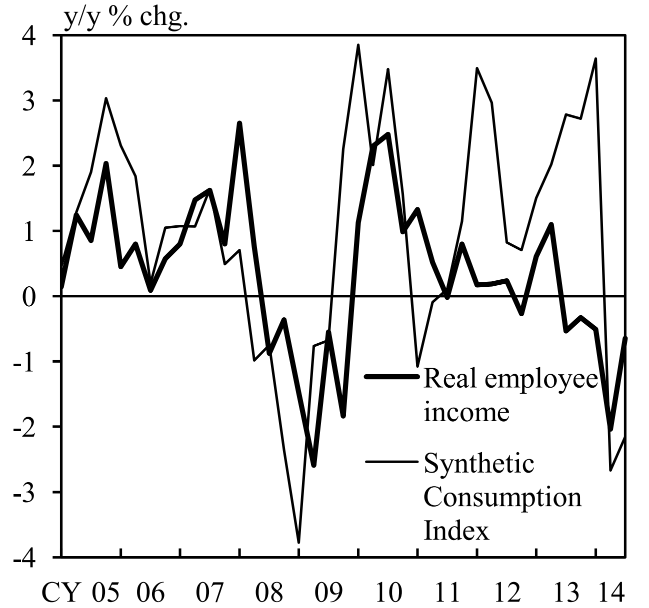
Sources: Ministry of Economy, Trade and Industry, "Indices of Industrial Domestic Shipments and Imports"; Ministry of Internal Affairs and Communications, "Family Income and Expenditure Survey"; Ministry of Health, Labour and Welfare, "Monthly Labour Survey," etc.

Environment Surrounding Private Consumption

(1) Real Employee Income

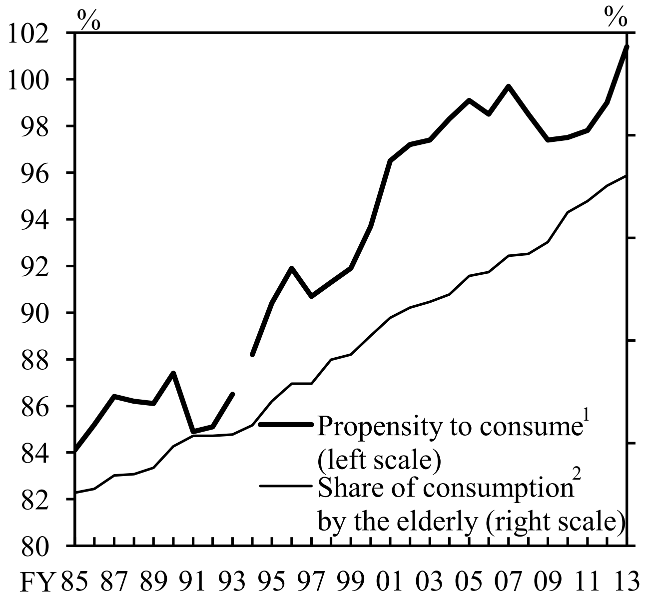


(2) Real Employee Income and Private Consumption

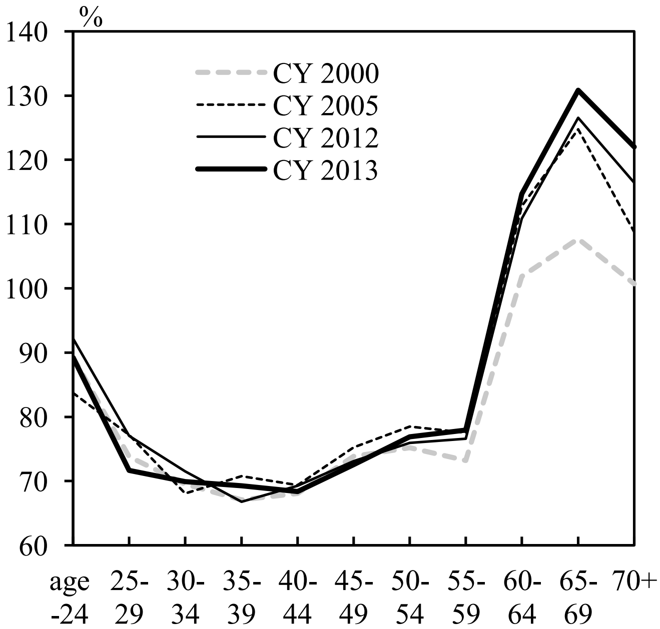


Notes: 1. Nominal (real) employee income = number of regular employees × nominal (real) cash earnings
Figures for 2014/Q3 are July-August averages.
2. For computing the figures for real employee income (consumption tax adjusted), figures of nominal cash earnings are deflated by the CPI (all items less imputed rent) that is estimated to adjust the direct effects of the consumption tax hike.
3. Figures for the "Synthetic Consumption Index" are year-on-year rates of change in the seasonally adjusted series.

(3) Propensity to Consume



(4) Propensity to Consume by Age[3]

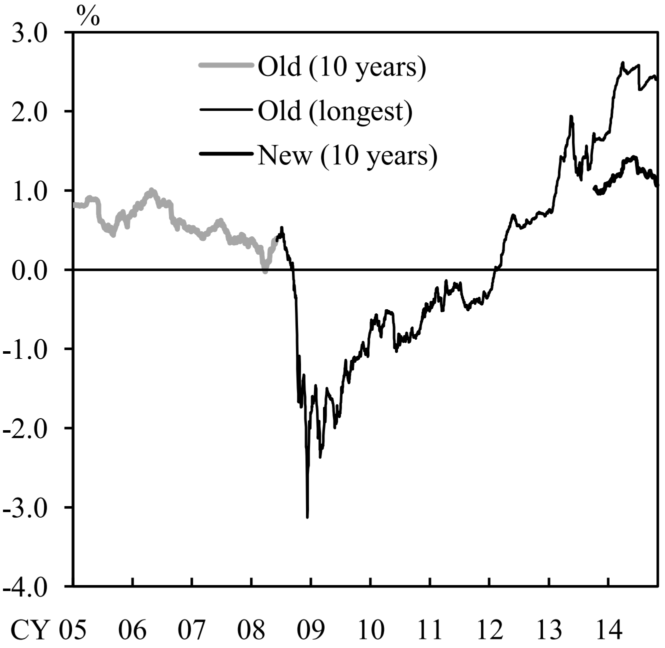


Notes: 1. Figures are on a "National Accounts" basis. They are on the 2000 base up through fiscal 1993 and on the 2005 base from fiscal 1994 onward. Figures for fiscal 2013 are estimated by the Research and Statistics Department, Bank of Japan. They include estimated transfers of income from the government to households through the economic policy packages.
2. Based on the "Family Income and Expenditure Survey" (two-or-more-person households). Figures up to fiscal 1999 exclude agricultural, forestry, and fisheries households. Figures are for age 60 and over.
3. Figures are on a "Family Income and Expenditure Survey" basis. Calculated by using consumption expenditure and disposable income that are the weighted averages of workers' households and no-occupation households.

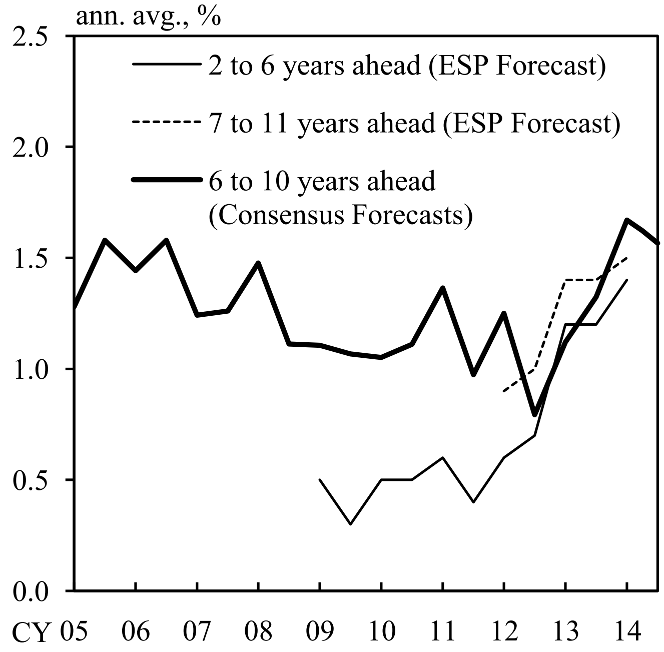
Sources: Ministry of Health, Labour and Welfare, "Monthly Labour Survey"; Cabinet Office, "National Accounts," "Synthetic Consumption Index"; Ministry of Internal Affairs and Communications, "Family Income and Expenditure Survey," "Consumer Price Index," etc.

Inflation Expectations (1)

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



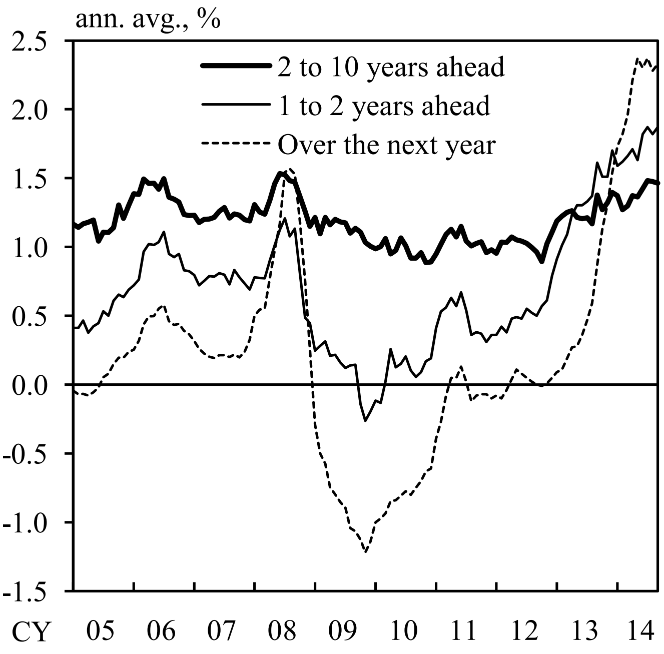
(2) Economists[2]



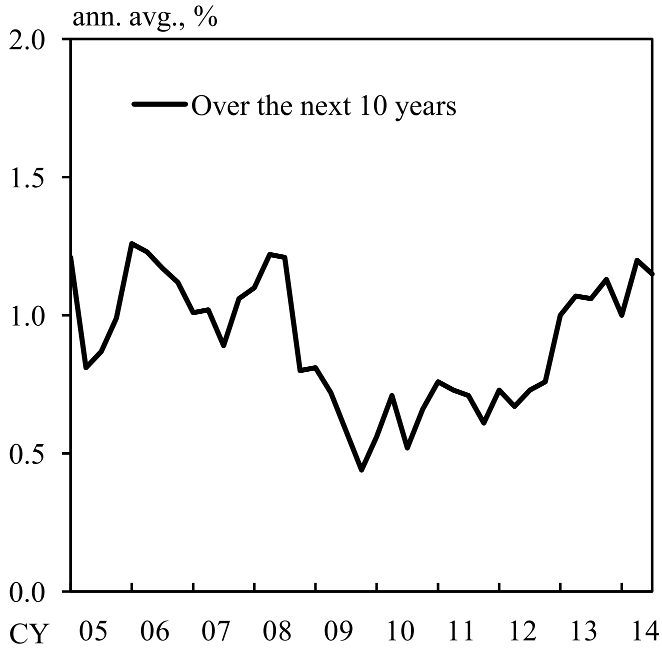
Notes: 1. BEI (break-even inflation) rates are yield spreads between fixed-rate coupon-bearing JGBs and inflation-indexed JGBs. Inflation-indexed JGBs issued since October 2013 are designated as "new," while the rest are designated as "old." Figures for "old (longest)" are calculated using yield data for issue No. 16 of the inflation-indexed JGBs, which matures in June 2018.
2. Figures for the Consensus Forecasts are compiled every January, April, July, and October. Those up through April 2014 are compiled every April and October. Figures for the ESP Forecast are compiled every June and December, and exclude the effects of the consumption tax hikes.

(3) Market Participants

(a) QUICK Survey



(b) Survey by Mizuho Securities



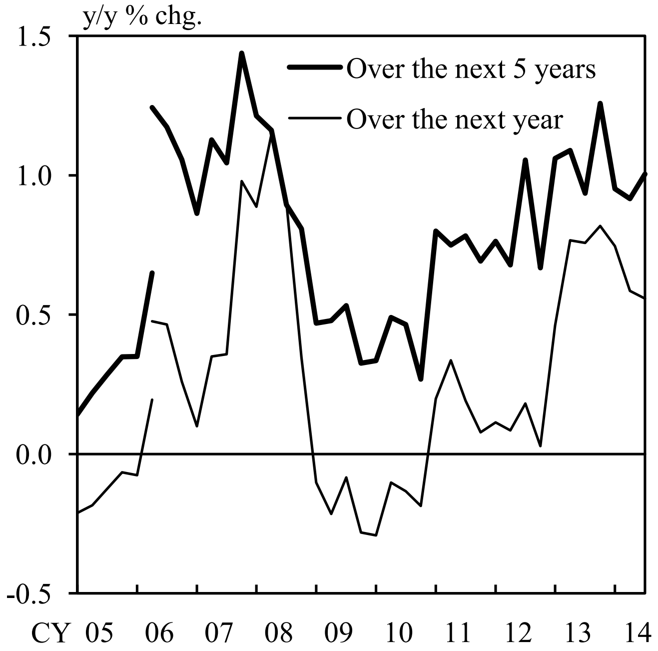
Note: From the September 2013 survey, the QUICK Monthly Market Survey (Bonds) has asked respondents to include the effects of the consumption tax hikes. Figures for the survey by Mizuho Securities exclude the effects of the consumption tax hikes.

Sources: Consensus Economics Inc., "Consensus Forecasts"; JCER, "ESP Forecast"; QUICK, "QUICK Monthly Market Survey (Bonds)"; Mizuho Securities, "Investor Survey"; Bloomberg.

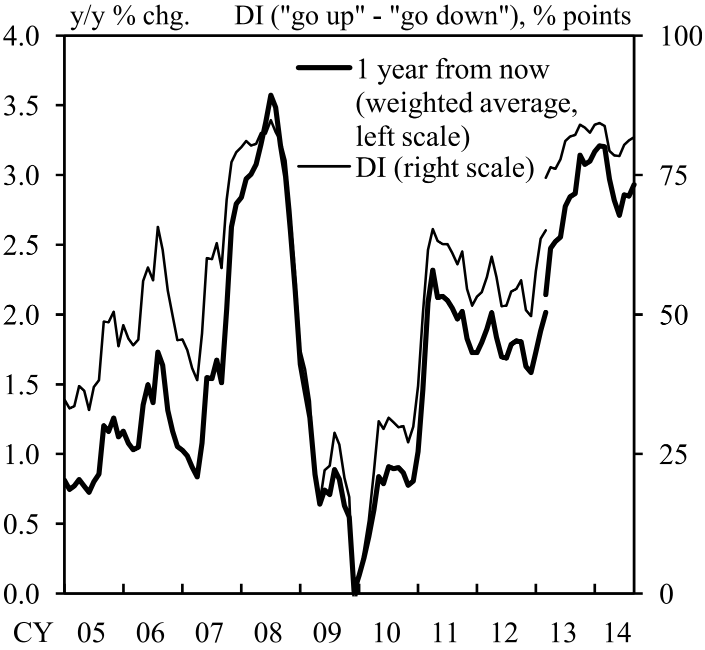
Inflation Expectations (2)

(1) Households

(a) Opinion Survey on the General Public's Views and Behavior[1, 2]



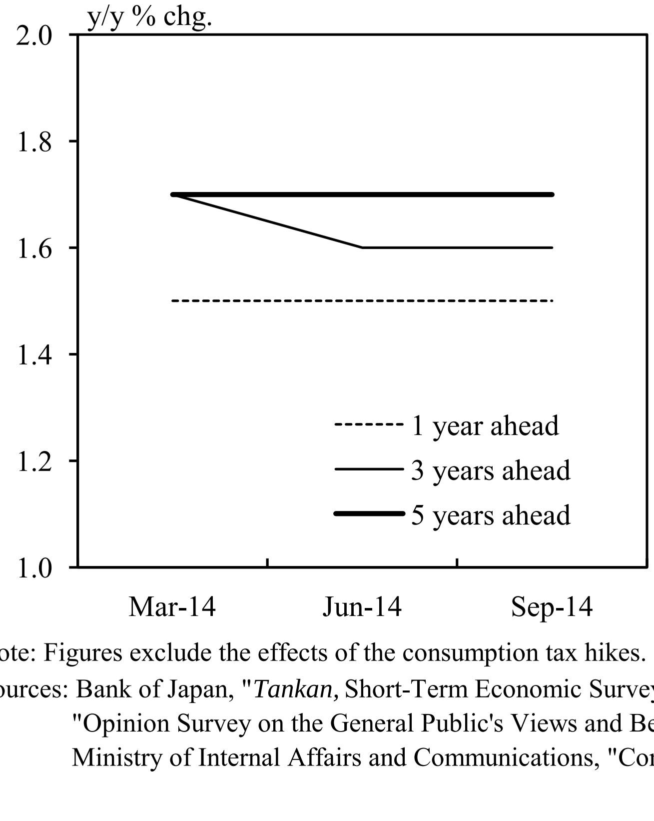
(b) Consumer Confidence Survey[3, 4]



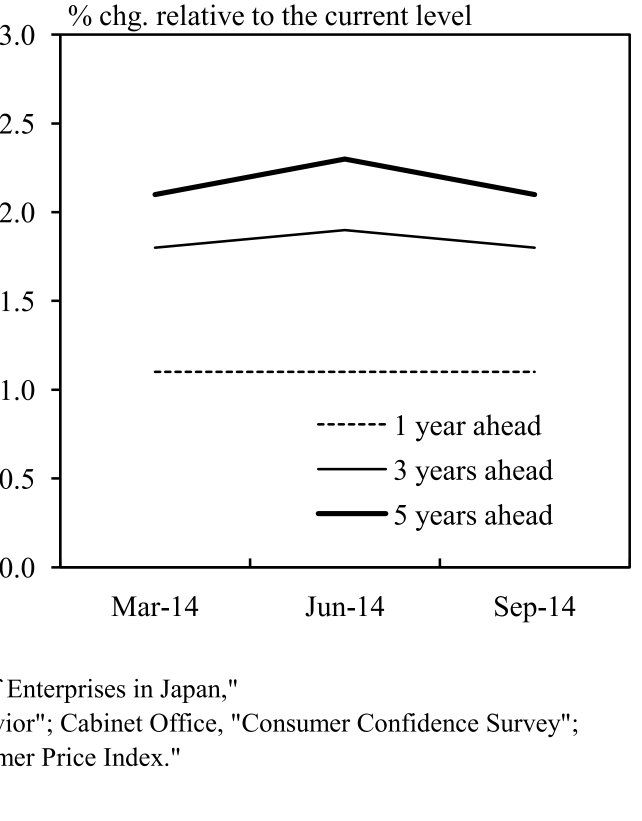
Notes: 1. Figures are estimated using the modified Carlson-Parkin method. For details, see "On Inflation Expectations," Bank of Japan Review Series, 2008-J-15 (available in Japanese only).
2. From the June 2013 survey, the Opinion Survey has asked respondents to exclude the effects of the consumption tax hikes.
3. Figures are for all households.
4. The weighted average is calculated based on the following assumption: survey responses chosen by households as their expected inflation rates -- "-5% or below," "from -5% to -2%," "from -2% to 0%," "from 0% to +2%," "from +2% to +5%," and "+5% or above" -- indicate inflation rates of -5%, -3.5%, -1%, +1%, +3.5%, and +5%, respectively.

(2) Enterprises (*Tankan,* All Industries and Enterprises, Average)

(a) Outlook of General Prices



(b) Outlook of Output Prices

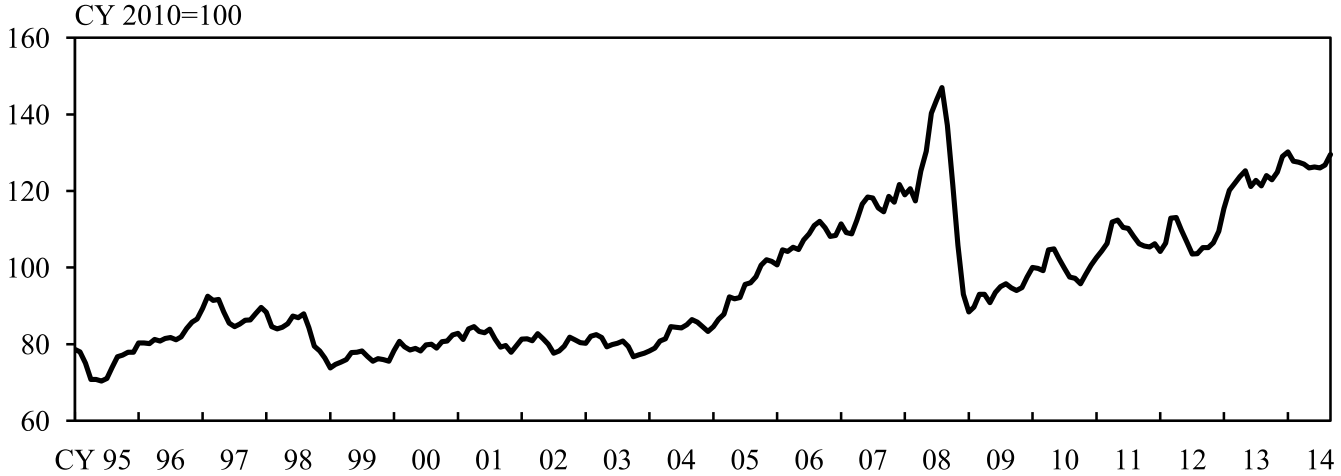


Note: Figures exclude the effects of the consumption tax hikes.

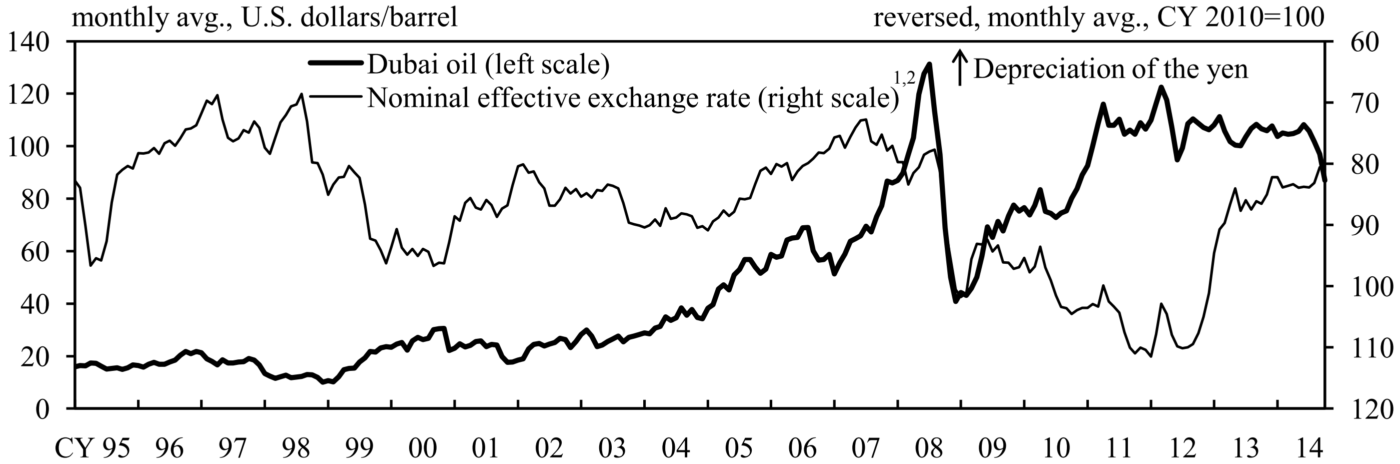
Sources: Bank of Japan, "*Tankan,* Short-Term Economic Survey of Enterprises in Japan," "Opinion Survey on the General Public's Views and Behavior"; Cabinet Office, "Consumer Confidence Survey"; Ministry of Internal Affairs and Communications, "Consumer Price Index."

Exchange Rates and Import Prices

(1) Import Price Index (Yen Basis)

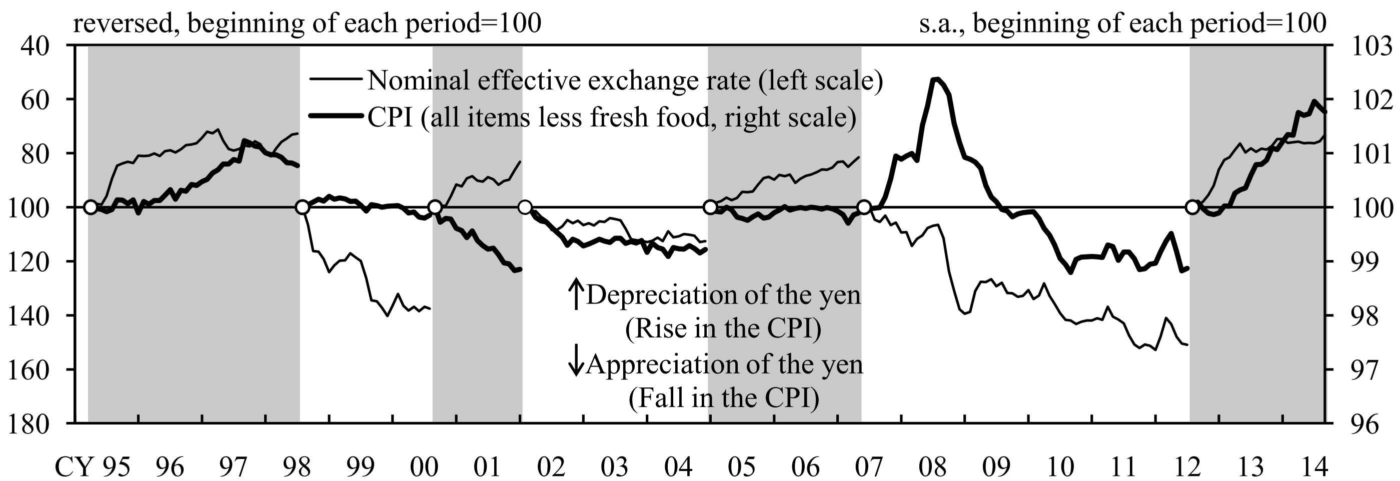


(2) Oil Price and Exchange Rate



Notes: 1. Figures for the nominal effective exchange rate are based on the broad index of the BIS effective exchange rate. The same definition applies to the chart below.
2. The figure for October 2014 is calculated using the Bank of Japan's nominal effective exchange rate of the yen.

(3) Exchange Rate and Consumer Price Index

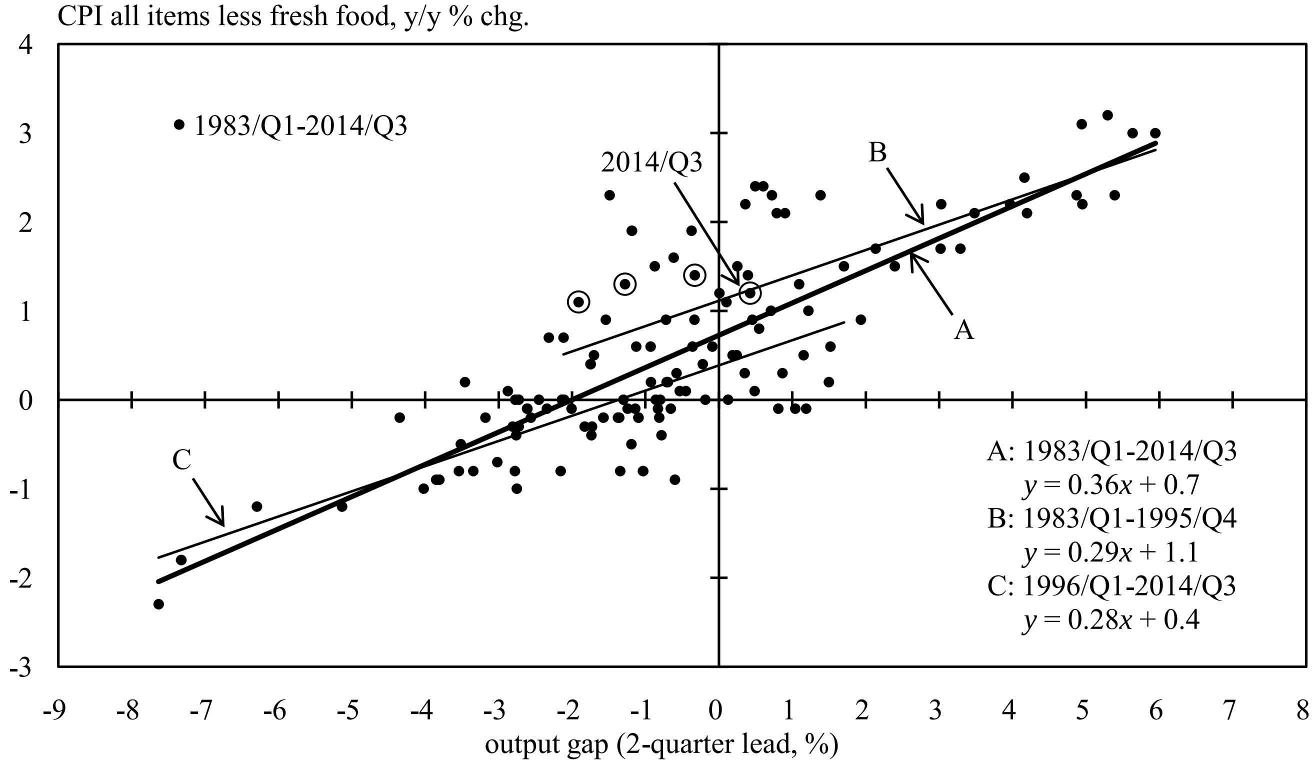


Notes: 1. Shaded areas indicate periods where the yen is on a depreciating trend. Duration of each period is chosen based on the nominal effective exchange rate and the yen/U.S. dollar rate.
2. Figures for the CPI are adjusted to exclude the estimated effect of changes in the consumption tax rate.

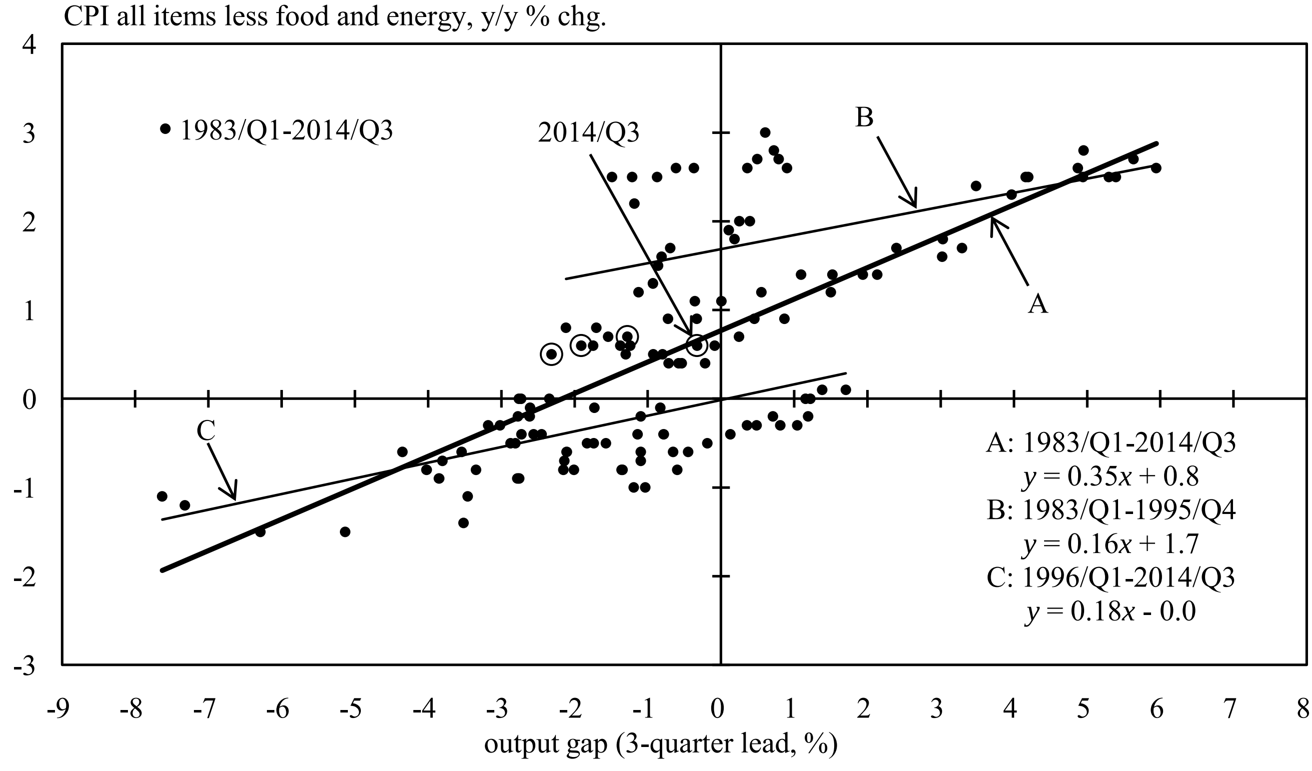
Sources: Bank of Japan, "Corporate Goods Price Index"; Ministry of Internal Affairs and Communications, "Consumer Price Index"; Nikkei Inc.; Bank for International Settlements (BIS), etc.

Output Gap and Inflation Rate

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



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

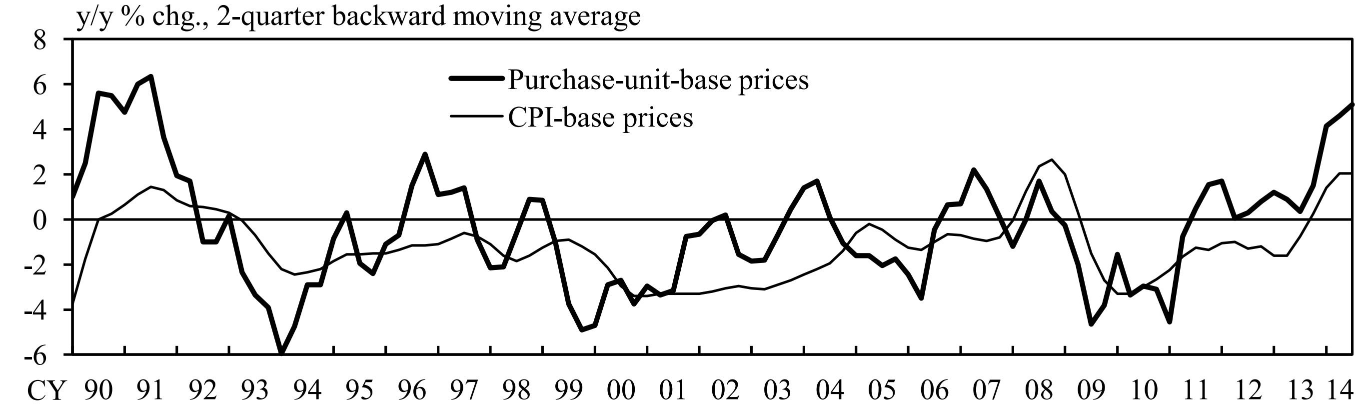


Notes: 1. The circled marks are the latest four positions.
2. Figures for the CPI are adjusted to exclude the estimated effect of changes in the consumption tax rate.
3. The output gap is estimated by the Research and Statistics Department, Bank of Japan. For the estimation procedures, see "The New Estimates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

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

Household Consumption and Firms' Price-Setting Behavior

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

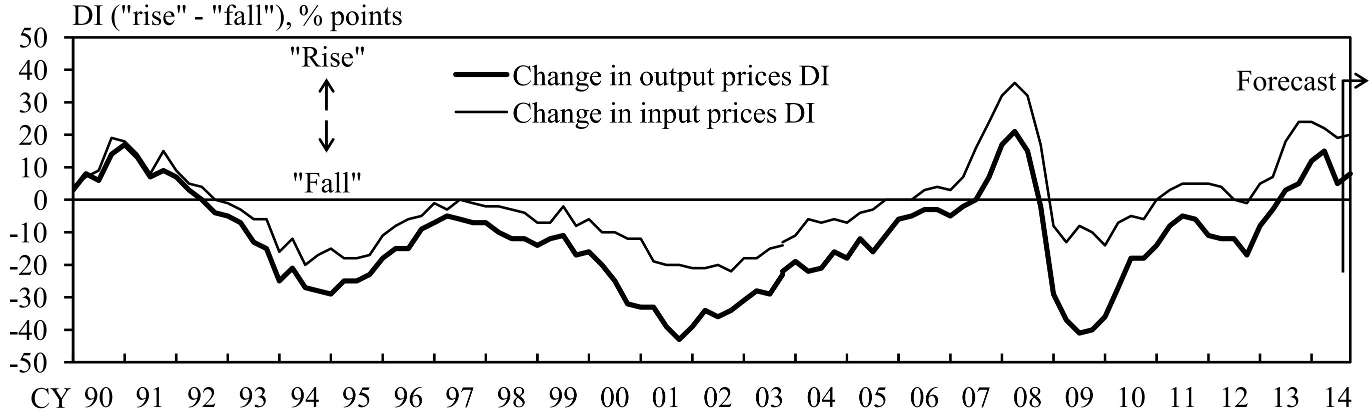


Notes: 1. Items continuously available in both the CPI and the "Family Income and Expenditure Survey" are selected. The selected items are goods excluding fresh food, petroleum products, and electricity, manufactured & piped gas & water charges. Hence they mainly consist of food products, agricultural, aquatic & livestock products (less fresh food), clothes, and durable goods.

2. Figures for the purchase-unit-base prices and CPI-base prices are adjusted to exclude the estimated effect of changes in the consumption tax rate.

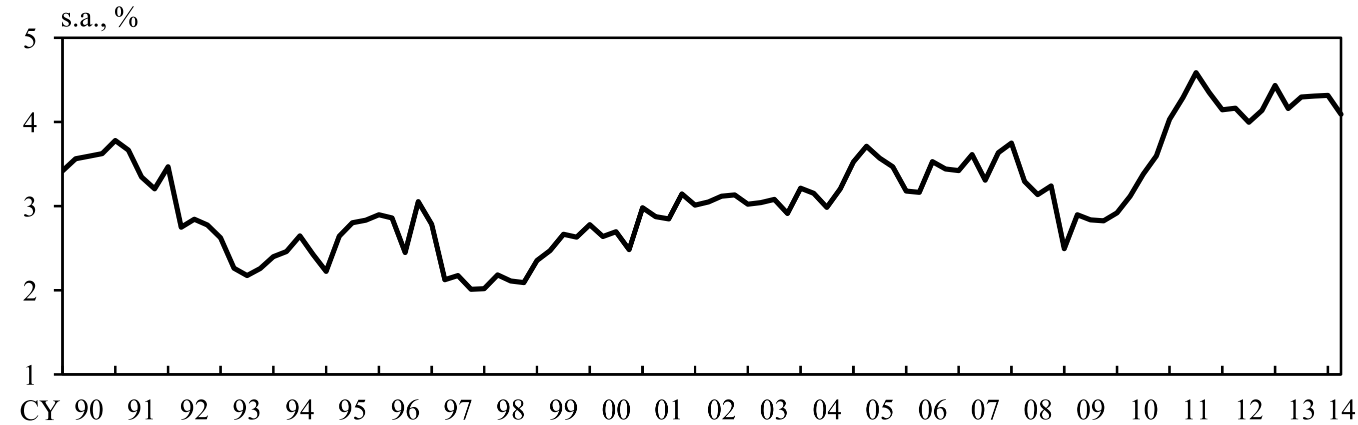
3. Figures for 2014/Q3 are July-August averages.

(2) Change in Output and Input Prices DI in the Retail Sector (*Tankan,* Large Enterprises)



Note: The "Tankan" was revised from the March 2004 survey. Figures up to the December 2003 survey are based on the previous data sets. Figures from the December 2003 survey are on the new basis. Figures for 2014/Q4 are the forecasts in the September 2014 survey.

(3) Retail Sector's Ratio of Operating Profits to Sales (Large Firms)

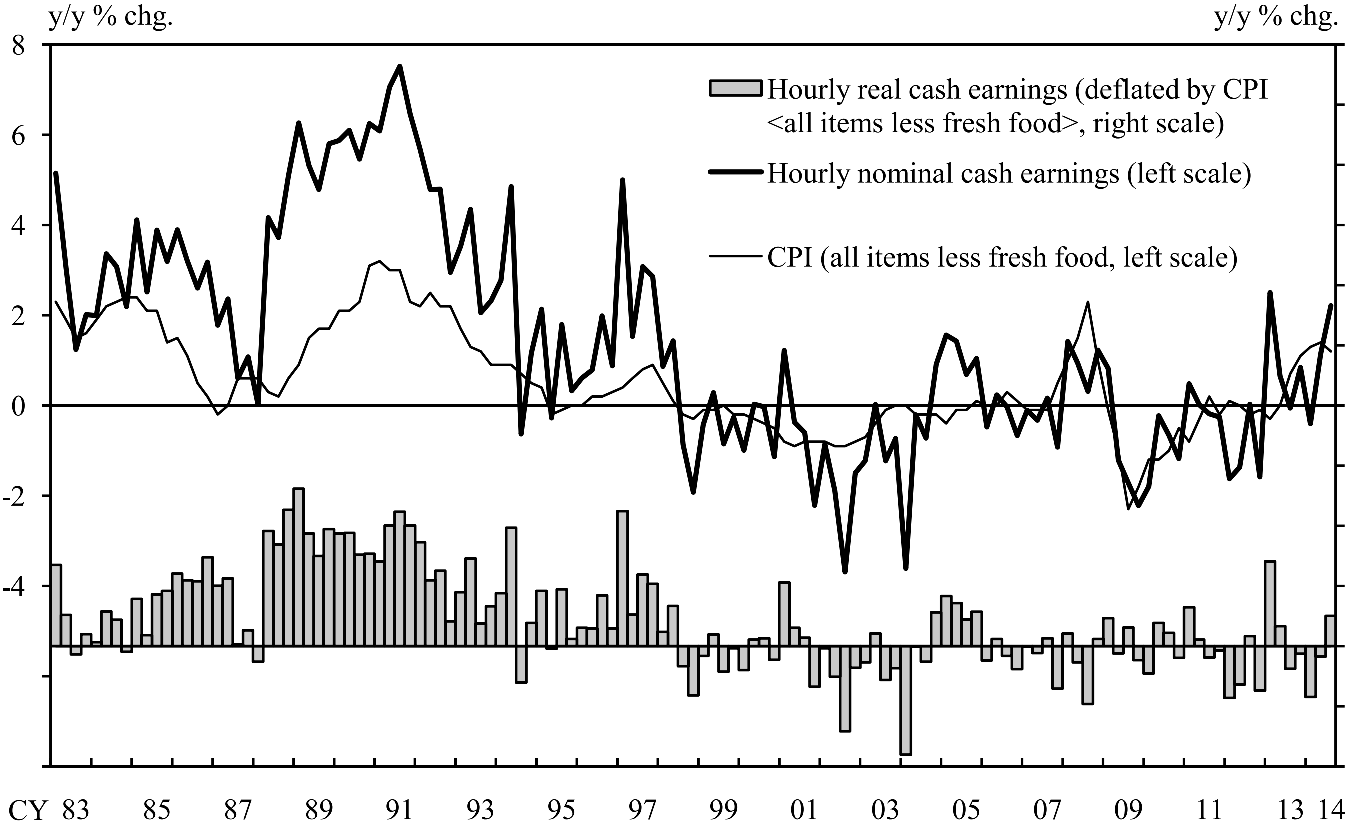


Note: The retail sector includes the eating and drinking services sector. Figures are seasonally adjusted by X-12-ARIMA.

Sources: Ministry of Internal Affairs and Communications, "Family Income and Expenditure Survey," "Consumer Price Index"; Bank of Japan, "*Tankan,* Short-Term Economic Survey of Enterprises in Japan"; Ministry of Finance, "Financial Statements Statistics of Corporation by Industry, Quarterly."

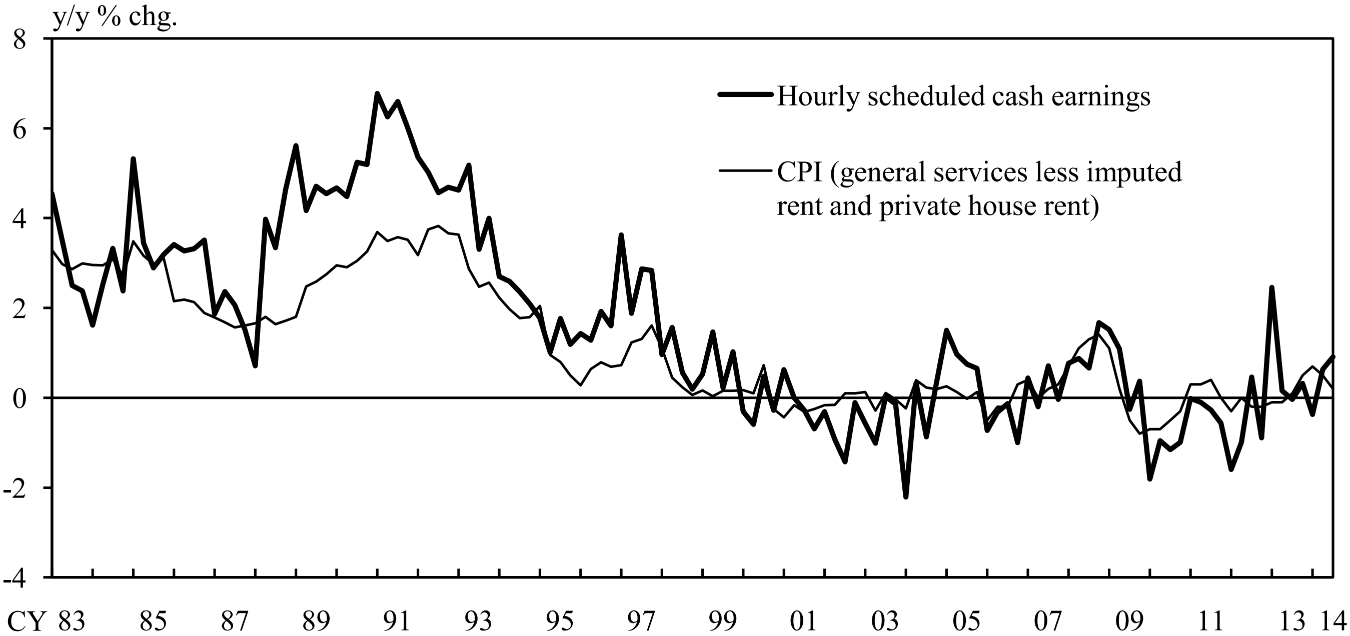
Prices and Wages

(1) CPI (All Items Less Fresh Food) and Hourly Cash Earnings



Notes: 1. Figures for 2014/Q3 are July-August averages. The same definition applies to the chart below.
2. Figures for the CPI are adjusted to exclude the estimated effect of changes in the consumption tax rate. The same rule applies to the chart below.
3. Figures for hourly cash earnings up through 1990/Q4 are those for establishments with 30 or more employees. The same definition applies to the chart below.

(2) CPI (General Services) and Scheduled Cash Earnings



Note: Figures for the CPI (general services less imputed rent and private house rent) are calculated using published indices. Figures up to 2005/Q4 are calculated by weighting year-on-year rates of price change.
Sources: Ministry of Internal Affairs and Communications, "Consumer Price Index"; Ministry of Health, Labour and Welfare, "Monthly Labour Survey."

Reference

Economic Assessment by Region (Regional Economic Report)

Region	Assessment in July 2014	Changes from the previous assessment	Assessment in October 2014
Hokkaido	The economy has been recovering moderately as a trend, while the subsequent decline in demand following the front-loaded increase prior to the consumption tax hike has been observed in some aspects.	⇨	The economy has been recovering moderately as a trend. Meanwhile, the subsequent decline in demand following the front-loaded increase prior to the consumption tax hike has been easing.
Tohoku	The economy has continued to recover as a trend, while the subsequent decline in demand following the front-loaded increase prior to the consumption tax hike has been observed.	⇘	The economy has been recovering moderately as a trend, while the subsequent decline in demand following the front-loaded increase prior to the consumption tax hike has been observed.
Hokuriku	The economy has been recovering moderately as a trend, while it has been affected by the subsequent decline in demand following the front-loaded increase prior to the consumption tax hike.	⇨	The economy has been recovering moderately as a trend, while it has been affected by the subsequent decline in demand following the front-loaded increase prior to the consumption tax hike.
Kanto-Koshinetsu	The economy has continued to recover moderately as a trend, while the subsequent decline in demand following the front-loaded increase prior to the consumption tax hike has been observed.	⇨	The economy has continued to recover moderately as a trend, although some weakness particularly on the production side has been observed due mainly to the effects of the subsequent decline in demand following the front-loaded increase prior to the consumption tax hike.
Tokai	The economy has continued to recover as a trend, while the subsequent decline in demand following the front-loaded increase prior to the consumption tax hike has recently been observed.	⇨	The economy has continued to recover as a trend, and the effects of the subsequent decline in demand following the front-loaded increase prior to the consumption tax hike have been waning on the whole, albeit somewhat unevenly.
Kinki	The economy has been recovering moderately as a trend, while the subsequent decline in demand following the front-loaded increase prior to the consumption tax hike has been observed.	⇨	The economy has been recovering moderately as a trend, while the subsequent decline in demand following the front-loaded increase prior to the consumption tax hike has been observed.
Chugoku	The economy has been recovering moderately as a trend, while the subsequent decline in demand following the front-loaded increase prior to the consumption tax hike has been observed.	⇨	The economy has been recovering moderately as a trend, although somewhat subdued growth has been observed on the production side. Meanwhile, the effects of the subsequent decline in demand following the front-loaded increase prior to the consumption tax hike have begun to wane on the whole.
Shikoku	The economy has continued to recover moderately as a trend, while the subsequent decline in demand following the front-loaded increase prior to the consumption tax hike has been observed.	⇨	The economy has continued to recover moderately as a trend, while the subsequent decline in demand following the front-loaded increase prior to the consumption tax hike and other movements have been observed.
Kyushu-Okinawa	The economy has been recovering moderately as a trend, while the subsequent decline in demand following the front-loaded increase prior to the consumption tax hike has been observed.	⇨	The economy has been recovering moderately as a trend. Meanwhile, the subsequent decline in demand following the front-loaded increase prior to the consumption tax hike has been easing gradually.

Note: The Regional Economic Report (summary) is available on the Bank of Japan's web site (http://www.boj.or.jp/en/research/brp/rer/rer141020.htm/).

Source: Bank of Japan, "Regional Economic Report (Summary) October 2014."