

Monthly Report of Prospects for Japan's Economy

September 2006

Macro Economic Research Centre
Economics Department



The Japan Research Institute, Limited

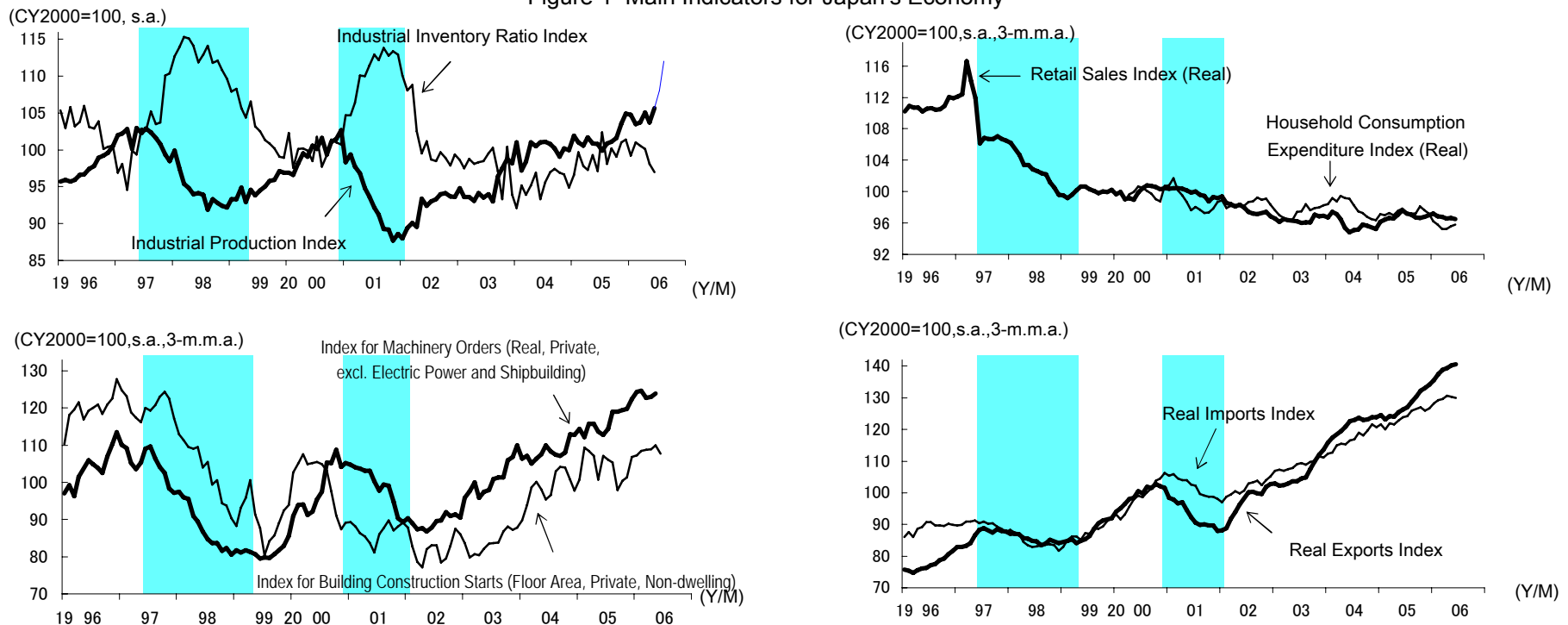
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This report is the English version of the August 2006 issue of the original Japanese version.

Current situation of Japan's economy – Continuing solid recovery

Japan's economy as a whole is continuing its solid recovery. The industrial production index, which indicates the direction and the level of economic activity, saw a 0.8 per cent rise during Q2 this year against the previous quarter, a third consecutive quarterly increase. This was mainly led by business fixed investment-related industries. Further, the index in June set a monthly record. The business conditions diffusion index (DI), showing "favourable" minus "unfavourable" in the BOJ's June Tankan Survey, also exhibited that business activity in the aggregate was expanding steadily with a wider-range of industries improving, although the DI in the material sector slightly deteriorated, principally due to the worsening terms of trade.

Figure 1 Main Indicators for Japan's Economy



Source: The Ministry of Economy, Trade and Industry, The Ministry of Internal Affairs and Communications, The Cabinet Office, The Ministry of Land, Infrastructure and Transport, The Bank of Japan

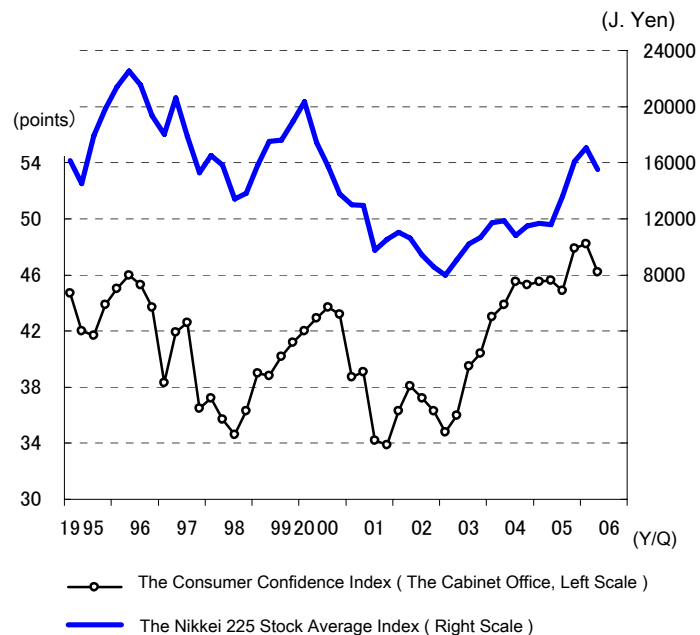
Note 1: Indices of Household Consumption Expenditure, Retail Sales, Machinery Orders, Building Construction Starts, Exports, and Imports are calculated as seasonally adjusted and 3-month moving averages.

Note 2: The Industrial Production Index in July and August 2006 is based on METI forecasts. Note 3: Shaded areas indicate periods of recession according to the Cabinet Office.

Partly softening move in demand ① – Private consumption

Japan's economy is on a firm recovery track in the aggregate. However, not all of the demand items are robust. Especially, private consumption is softening and exports are slowing. As for the household sector, private consumption has seen only a fragile move since April this year, as poor weather has curbed people from going out or has deferred their purchase of summer goods. Further, softening stock prices also have contributed to the weaker trend in private consumption through a pause in the improvement in consumer confidence. Recent newspaper reports outline that higher temperatures in the first half of July seem to have reinvigorated expenditures. However, they also say that rough weather in the last half of the month appears to have been an unfavourable factor in the recovery.

Figure 2-1 Consumer Confidence Index in the Cabinet Office Survey and Nikkei 225 Stock Average Index



Source: The Cabinet Office, The Nikkei Shimbun

Note: The figures of the Consumer Confidence Index are seasonally adjusted.

The figures of the Nikkei 225 Stock Average Index are monthly averages in March, June, September and December in each year.

Figure 2-2 Diffusion Index for Current Economic Condition by Household Activity-Related Industry < the Economy Watchers Survey by the Cabinet Office >

	Mar 05	Jun 05	Sep 05	Dec 05	Jan 06	Feb 06	Mar 06	Apr 06	May 06	Jun 06
Household activity-related	42.0	45.2	44.2	50.0	45.5	47.0	51.5	48.1	45.9	43.5
Retail	39.0	44.9	44.0	49.4	45.4	46.1	49.8	45.5	43.9	41.3
Shopping area, High street shop	37.6	38.3	39.9	43.9	40.0	39.5	46.9	42.4	41.2	40.7
Department store	37.2	55.4	48.5	64.2	56.9	58.2	60.1	50.5	47.6	40.7
Supermarket	39.3	42.3	42.7	56.3	44.6	47.2	44.7	49.8	46.5	47.5
Convenience store	43.0	46.1	45.2	40.1	38.3	40.3	41.8	39.4	37.9	42.6
Clothing shop	31.0	42.3	41.5	48.4	42.2	38.9	45.5	39.6	40.7	34.5
Electrical appliance retailer	43.8	52.4	53.5	62.5	50.0	53.0	57.1	53.0	57.1	48.8
Automobile	44.1	47.7	48.0	36.9	51.1	52.6	58.2	44.8	42.1	37.5
Others	39.2	40.7	39.4	47.2	41.3	42.3	47.1	46.6	43.3	40.2
Food and beverage	41.3	47.2	41.0	48.0	42.6	44.2	52.1	50.6	45.5	42.6
Services	49.5	46.6	45.5	53.7	47.1	49.8	55.2	52.8	50.1	48.0
Travel, transportation	48.5	45.3	44.3	55.4	46.6	47.1	55.5	54.6	49.8	47.0
Telecom company	61.9	52.0	52.2	59.9	55.3	55.6	59.7	56.5	50.4	52.9
Leisure facility operator	40.8	45.3	44.5	48.0	45.9	50.4	55.0	51.2	52.6	46.9
Other services	48.4	45.9	42.7	47.8	40.5	50.0	48.5	45.4	47.1	46.6
Housing	39.0	40.5	43.7	42.2	42.3	45.7	50.9	47.9	46.3	45.5

Source: The Cabinet Office

Note: Shaded area indicates figures above the total average in each period.

The effects of stock price moves – Weakening stimulus to private consumption

Assuming that stock prices in the next year remain at current levels, the wealth effect of stock price moves on private consumption in FY2006 is projected to be less than in FY2005. In that case, it is also possible that the negative influence on private consumption of the scheduled increases in the financial burden on households would re-emerge. In addition, the increase in workers' total cash earnings lacks momentum. This situation is likely to continue in the next year as well, as we see the background that Japan's enterprises are becoming more cautious about raising labour's relative share, because management is very aware of the strengthening power of shareholders and the increasing necessity of competitiveness. These circumstances suggest that the growth rate of private consumption in FY2006 could be smaller than in FY2005.

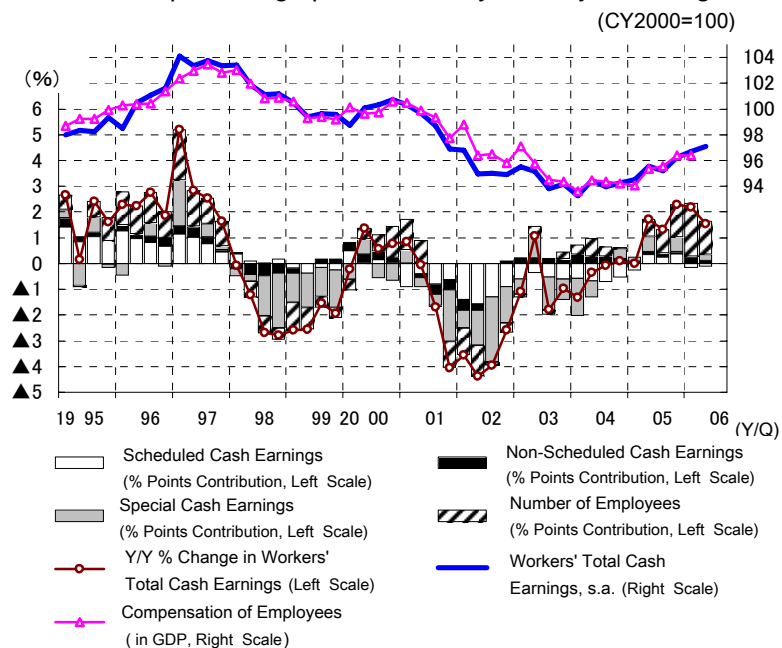
Figure 3-1 Boosting Effects of Rising Stock Prices on Private Consumption < our estimate >

	FY2005	FY2006				
		<assumed Q3/CY06 - Q1/CY07 mean Nikkei 225 Stock Average>				
		①	②	③	④	⑤
		17,000	16,000	15,000	14,000	13,000
Nikkei 225 Stock Average Index (fiscal year mean)	13,561	16,786	16,036	15,286	14,536	13,786
Rate of Increase against the Previous Fiscal Year (%)	19.8	23.8	18.2	12.7	7.2	1.7
Boosting Effect on Real Private Consumption (estimate, % points)	0.6	0.7	0.6	0.4	0.2	0.1
Negative influence on private consumption of the scheduled increases in the financial burden on households	▲0.3	▲0.6				

Source: The Japan Research Institute, Ltd. based on the data of the Cabinet Office, The Bank of Japan, and The Nikkei Shimbun

Note: This estimate is based on (i) net financial assets elasticity of real private consumption, and (ii) Nikkei 225 Stock Average elasticity of the stocks and investment funds held by households.

Figure 3-2 Contribution to Change in Workers' Total Cash Earnings < percentage points in total year-on-year change >



Source: The Ministry of Health, Labour and Welfare, The Ministry of Internal Affairs and Communications, The Cabinet Office

Note: Workers' Total Cash Earnings = Index of Total Cash Earnings × Number of Employees

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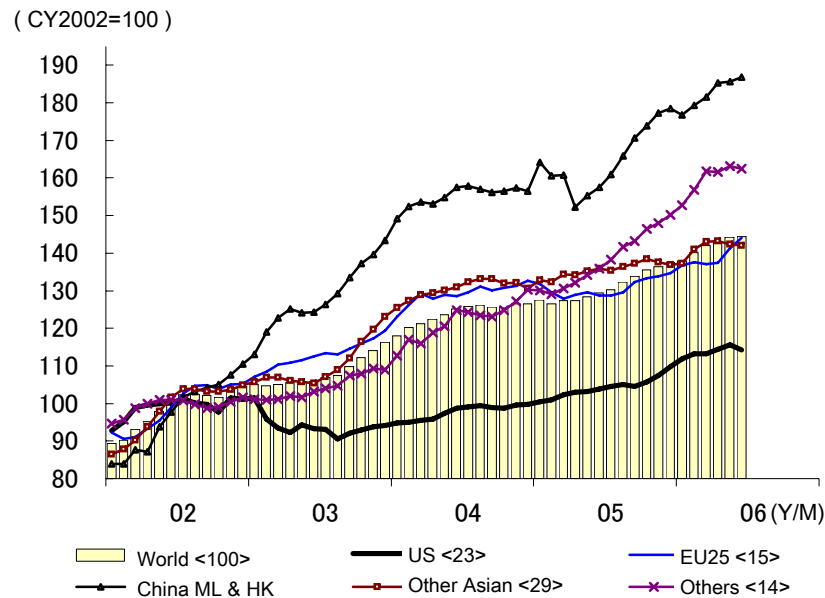
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Partly softening move in demand ② – Exports

Japan's exports saw a fifth consecutive quarterly increase in Q2 this year, shown in real terms and against the previous quarter. However, the growth of exports is decelerating, because the gradual slowing of the US economy* seems to have begun to have an adverse effect on exports of finished goods (such as motor vehicles and household electric equipment) to the US, as well as on exports of intermediate goods to the production bases of Japanese manufacturers in Asian regions.

*The US economy this year is unlikely to decelerate much in its growth rate, mainly because the expansionary trend in business fixed investment would be maintained. However, a slowdown in the housing market would begin slowing household consumption gradually, which would bring the US economy into a slightly decelerating phase

Figure 4-1 Japan's Real Exports by Region
< seasonally adjusted, 3-month moving average >

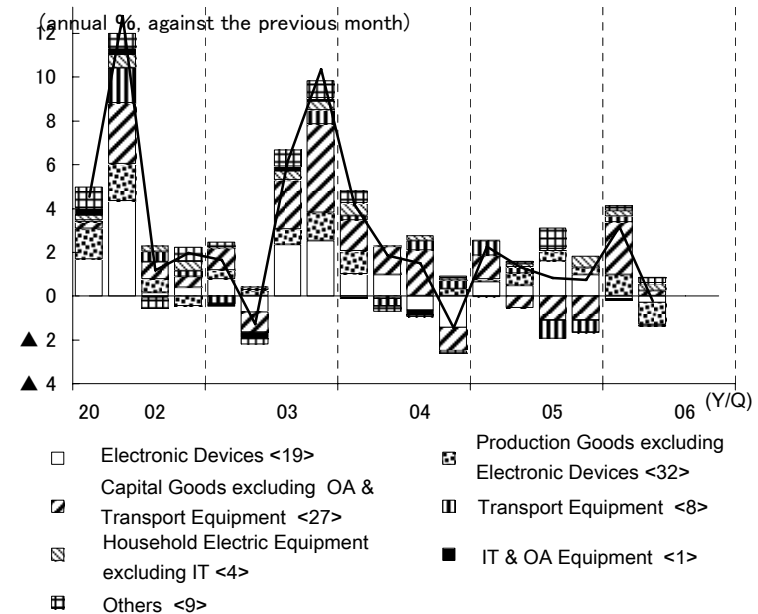


Source: The Ministry of Finance, The Bank of Japan

Note 1: The figures in angle brackets in the legend indicate the share of each region in total nominal exports of Japan (65.7 trillion JY in CY2005).

2: Others: Middle Eastern countries, South American countries, Russia and so on.

Figure 4-2 Contribution by Commodity to Real Exports to Asian Countries excluding China (Mainland and HK)



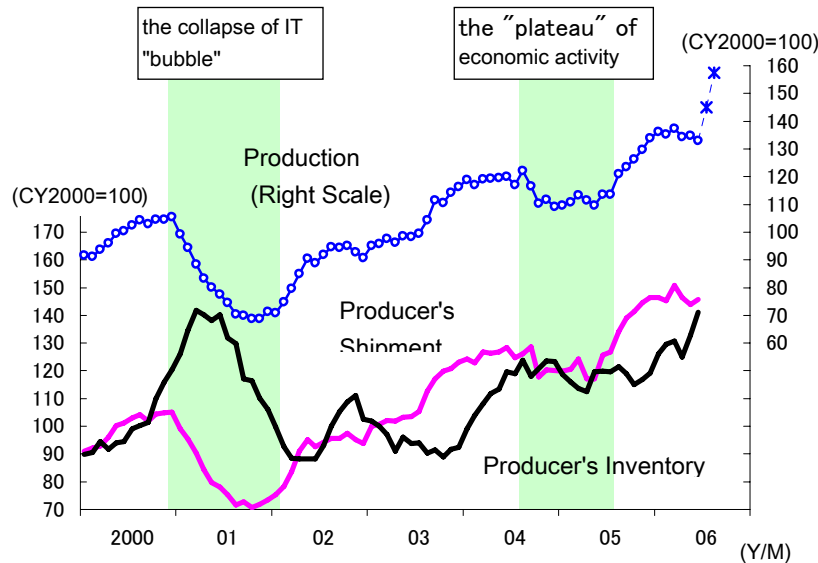
Source: The Ministry of Finance, The Bank of Japan

Note: The figures in angle brackets in the legend indicate the share of each commodity in total nominal exports to Asian countries excluding China (Mainland and Hong Kong) [JY 19.0 trillion in CY2005].

Another downside risk to watch – Adjustment in the IT sector

An adjustment in the IT sector could be one of the downside risks needing a closer watch. The domestic IT sector, especially the electronic parts and devices sector, has seen a very rapid expansion since the last half of CY2005. Accordingly, a slowing in a part of domestic and/or overseas demand could trigger a production adjustment in that double-digit expansion sector. It is true that the recent fast growth in the inventory of electronic parts and devices would be a "positive increase" in inventory, which is attributable to surging demand for liquid crystal display (LCD) TVs and plasma display panel (PDP) TVs in Japan, the US and European countries, as well as to swelling demand for mobile phones worldwide. However, the level of the industrial production index in the sector, which is currently at the same level as in the peak of the "IT bubble" period, suggests that the pressure for inventory adjustment could be strengthened as demand for goods slows.

Figure 5-1 Indices of Industrial Production, Shipments and Inventories in the Electronic Parts and Devices Sector



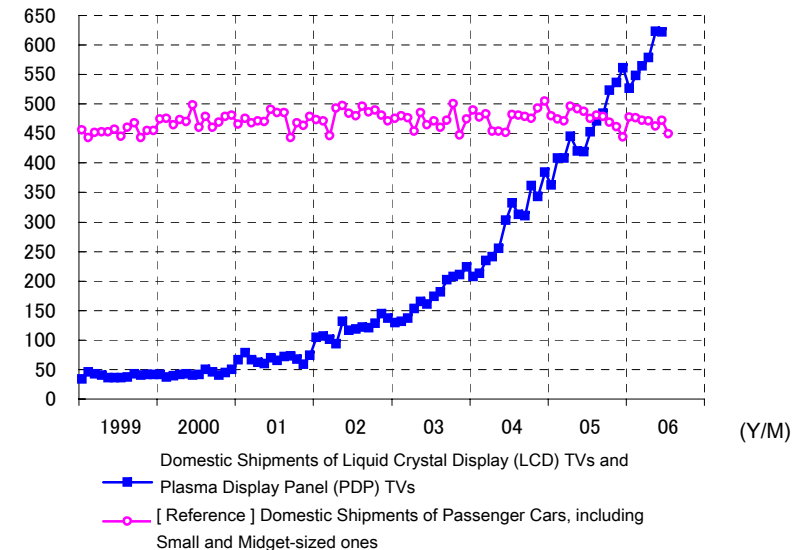
Source: The Ministry of Economy, Trade and Industry

Note 1: The Industrial Production Index in July and August 2006 is based on METI forecasts.

Note 2: The recent "plateau" of economic activity is indicated as the shaded area during August 2004 and July 2005.

Figure 5-2 Domestic Shipments of Liquid Crystal Display (LCD) TVs and Plasma Display Panel (PDP) TVs

(Seasonally Adjusted, Annual Base, 10,000 Units)

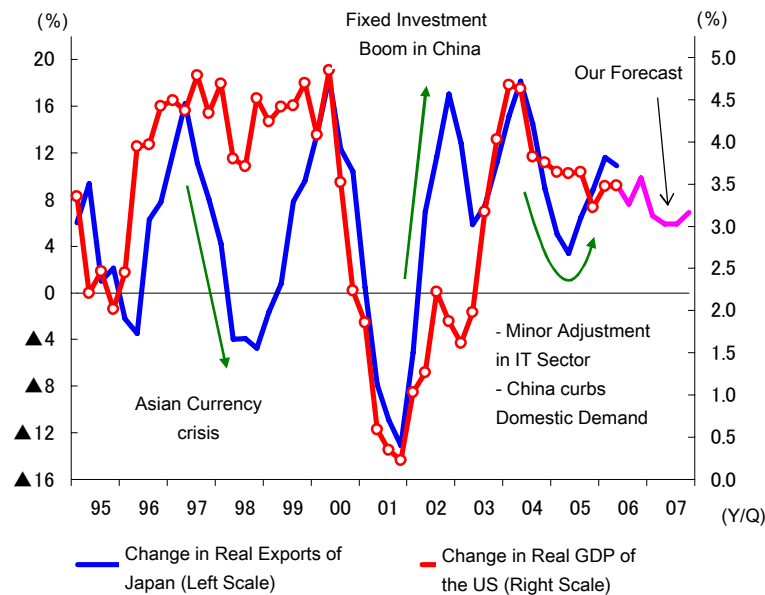


Source: The Japan Research Institute, Ltd. based on the data of Japan Electronics and Information Technology Industries Association (JEITA) and Japan Automobile Dealers Association (JADA)

Economic phase for the present – Mild slowdown in pace of expansion

Japan's economy should continue to recover. However, looking at the economic phase for the present, the pace of the economic recovery would see a mild slowdown due to certain curbing factors. These are: (i) The pace of the increase in exports would be gradually slowing down as the US economy is projected to move into a slightly decelerating phase. (ii) Higher prices of resources such as crude oil, as well as the current level of or an uptrend of interest rates, could continue to erode corporate profits. (iii) Under the circumstances where a high-paced recovery in stock prices is virtually unlikely, the boosting effect on private consumption is expected to be weakening to some extent, mainly in the last half of FY2006.

Figure 6-1 Change in Real GDP of the US and Real Exports of Japan



Source: The US Department of Commerce, The Bank of Japan, The Ministry of Finance
The Japan Research Institute, Ltd.

Figure 6-1 Impact of Increase in Oil Prices on Corporate Current Profits < Our Estimate >

(Trillion JY)

Import Price of Crude Oil (CIF)	assumed average price during FY2006			
	(1) \$65/bl.	(2) \$70/bl.	(3) \$75/bl.	(4) \$80/bl.
(A) The increase in costs caused by higher oil prices	▲ 2.1	▲ 3.1	▲ 4.2	▲ 5.2
(B) The amount of the costs which enterprises would have passed through to the household sector	0.3	0.4	0.5	0.6
(A)+(B) The net amount of the impact of higher oil prices on corporate profits	▲ 1.8 (▲ 3.4%)	▲ 2.8 (▲ 5.1%)	▲ 3.7 (▲ 6.8%)	▲ 4.6 (▲ 8.5%)

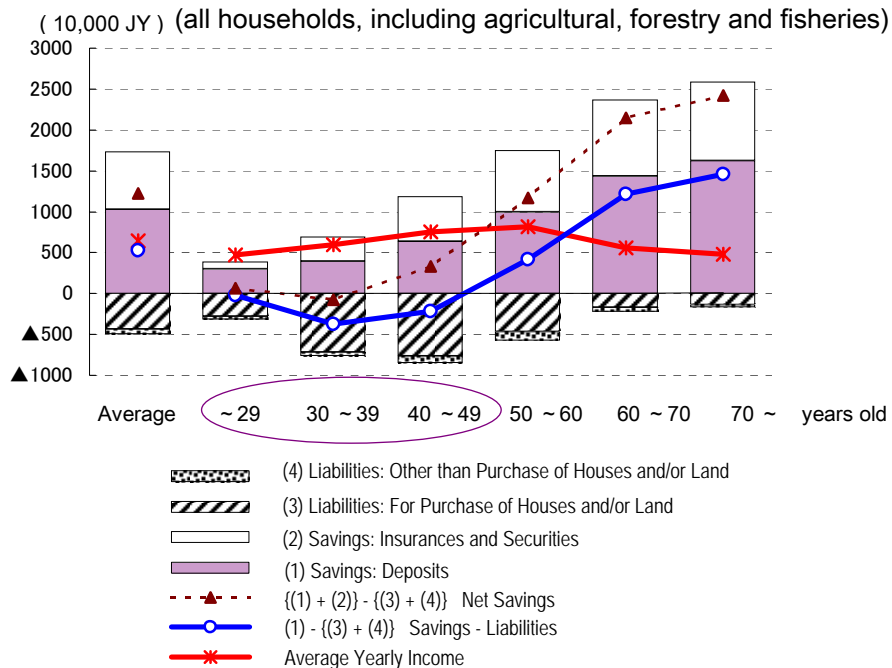
- Note 1: The figures in parentheses indicate the share of the total amount of current profits in FY2005 (estimated 47.5 trillion JY).
 2: The average in FY2005 of the import price of crude oil was \$55.50/barrel.
 3: The average JY/\$ exchange rate in FY 2006 is assumed to be 114.50JY/\$.
 4: The impact of the change in oil prices is calculated as the total amount of (i) an increase in costs caused by higher oil price and (ii) the amount of the costs which enterprises would have passed through to the household sector.

Source: The Japan Research Institute, Ltd. based on the data of the Ministry of Finance, the Cabinet Office, and The Ministry of Internal Affairs and Communications

Impact of higher interest rates – Limited for the present

The impact of the end of "zero interest rate policy" and subsequent higher interest rates on household income as well as corporate profits is expected to be limited for the present. The household sector would feel a positive influence as a whole, that is, higher interest rates would increase household income, albeit some diversification between each bracket of households would be seen due to the differences in liabilities. With a mild slowdown of economic activity expected, it is likely that the pace of a rise in interest rates would be moderate, which is projected to make the degree of the impact somewhat limited. On the other hand, the corporate sector is expected to see an adverse influence on their current profits, mainly because higher interest rates would increase interest payments. However, enterprises' continuous efforts to cut interest bearing liabilities thus far seem to contribute to minimising the negative impact, at least in the short run. Our estimate shows that an assumed 2.2 trillion JY of negative impact on current profits, which would be caused by a 1 percentage point hike in interest rates on average during FY2006, would be able to be absorbed into an assumed 2.8 trillion JY of positive influence produced by an estimated 1 per cent rise in sales.

Figure 7-1 Amounts of Savings and Liabilities Held per Household by Age Group of Household Head



Source: The Ministry of Internal Affairs and Communications

Figure 7-2 Impact of Rise in Interest Rates on Households and Nonfinancial Corporations < our estimate >

Changes in Interest Rates		0.250	0.375	0.500	1.000
(the average on FY2005 → the average on FY2006)		percentage points	percentage points	percentage points	percentage points
Households	Increase in interest receipts (1) (trillion JY)	1.8	2.7	3.7	7.3
	Increase in interest payments (2) (trillion JY)	0.8	1.2	1.6	3.3
	Impact on net interest income (1) - (2) (trillion JY)	1.0	1.5	2.0	4.1
	[Boosting] Effect on private consumption (percentage points contribution)	0.1% pts	0.1% pts	0.2% pts	0.3% pts
Nonfinancial Corporations	Increase in interest receipts (1) (trillion JY)	0.5	0.7	1.0	2.0
	Increase in interest payments (2) (trillion JY)	1.0	1.6	2.1	4.2
	Impact on net interest income (1) - (2) (trillion JY)	▲ 0.6	▲ 0.8	▲ 1.1	▲ 2.2
	[Adverse] Effect on current profits (percentage points contribution)	▲ 1.1% pts	▲ 1.6% pts	▲ 2.2% pts	▲ 4.4% pts

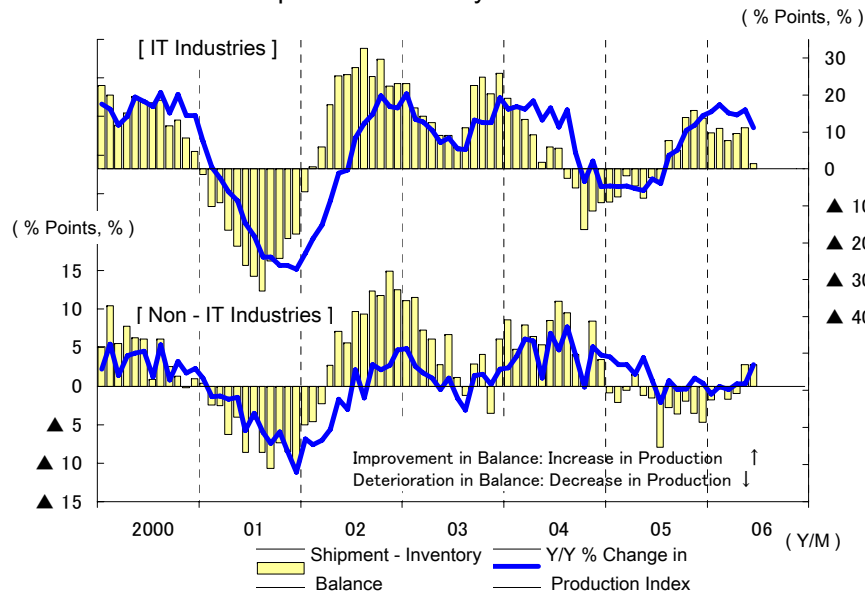
Source: The Japan Research Institute, Ltd. based on the data of The Cabinet Office, the Bank of Japan, and The Ministry of Finance

Note: The marginal propensity to consume on net interest income in households is assumed to be 0.25, based on assets income elasticity of private consumption expenditure.

Appreciable ability to absorb shocks – Backdrop of continuous recovery

It is also widely recognised that Japan's economy would retain appreciable abilities to absorb shocks, which differs from those observed during the time of the collapse of the "IT bubble" or during the temporary slack period in 2004. The main abilities seen are as follows: (i) The improvement in shipment-inventory balance in non-IT sectors, for a short-term factor. Even if pressure for adjustments arises in the IT sector, the non-IT sectors would bolster demand and a major production adjustment across all sectors of industry could be avoided. (ii) The dissipation of structural adjustment pressures in the corporate sector as well as abundant liquidity as its financial strength, for a medium-to-long-term factor. With the management focus shifting from the "adjustment of excessive labour, capital equipment and debt" to "active business expansion aiming at survival against fierce global competition" as well as "securing human resources with developed abilities", with a view to the retirement of the baby-boomer generation and a full-scale decrease in population, there is little risk that the upward trend of business fixed investment and employment could falter in the short run.

Figure 8-1 Inventory Adjustment shown as change in Shipment - Inventory Balance and Production

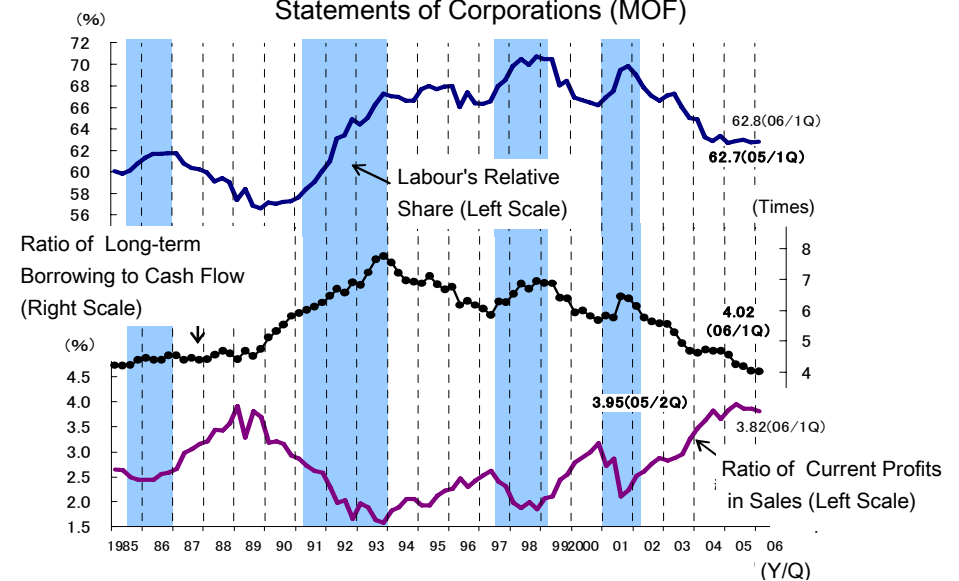


Source: The Ministry of Economy, Trade and Industry

Note 1: Shipment - Inventory Balance = Y/Y Change in Shipments - Y/Y Change in Inventory

Note 2: IT Industries: Electrical machinery, Information and communication electronics equipment, Electronic parts and devices, Precision instruments

Figure 8-2 Main Indicators based on Financial Statements of Corporations (MOF)



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

Note: Labour's relative share = Personnel expenses / (Personnel expenses + Depreciation expenses + Interest expenses + Current profits)

Ratio of Long-term borrowing to Cash flow = (Bonds + Long-term borrowing) / (Current profits x 0.5 + Depreciation expenses)

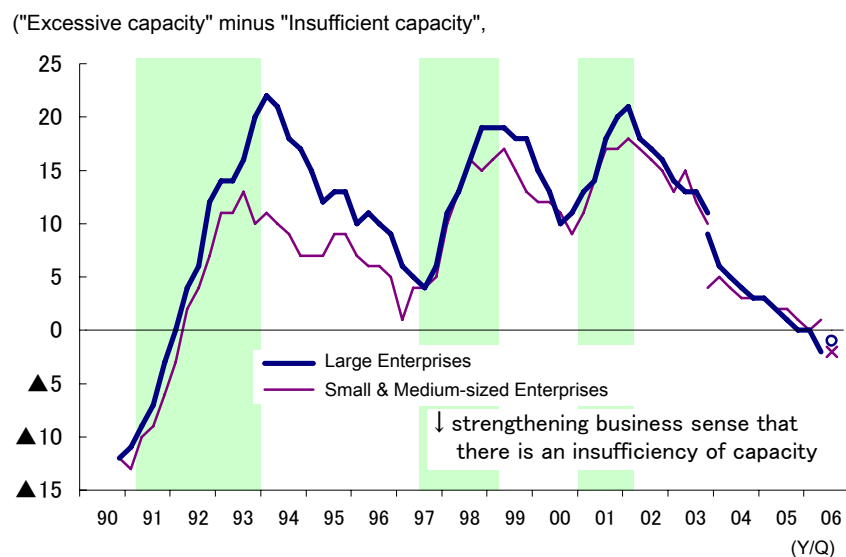
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Business fixed investment ① - Continuing solid expansionary trend

According to the annual projections in the BOJ's June Tankan Survey, business fixed investment in all industries is expected to see as solid an expansion in FY2006 as in FY2005. This outlook is possible in both of the following two statistical ways: (i) the projection including land purchase expenses and excluding software investment, which is available on a longer-term statistical basis, and (ii) the projection including software investment and excluding land purchase expenses, which is similar in content to the GDP- based figures. Business fixed investment is projected to grow at 6.2% in (i) and 7.6% in (ii) during FY2006, exhibiting an almost equivalent growth rate to the figure in FY2005, 5.4% in (i) and 8.8% in (ii). Especially, based on the first basis, the tempo of the projected 6.2% expansion in FY2006 would outpace the average expansion rate of 4.7% during the 1988-91 "bubble economy" period. Judging from the Tankan Survey, it is highly unlikely that business fixed investment would decelerate noticeably in the projection period.

Figure 9-1 Production Capacity < Diffusion Index
in BOJ's Tankan Survey, all industries >



Source: The Bank of Japan, "Tankan", The Cabinet Office

Note 1: The marks below each line, ○ or ×, indicate the forecast DIs which had been made three months before.

2: Shaded areas indicate periods of recession according to the Cabinet Office.

Figure 9-2 Annual Projections of Business Fixed Investment
The BOJ's Tankan March 2006 Survey

(% change, on a year-on-year basis)

	Weight (FY2005)	FY2004 (actual)	FY2005 (actual)	FY2006 (forecast)	FY2005 (forecast, as of June 05)
【Large Enterprises】 All Industries	66.9	3.5	6.8	12.2	10.9
Manufacturing	23.9	15.1	13.3	16.7	17.1
Nonmanufacturing	43.0	▲1.6	3.5	9.8	7.8
Basic Materials	7.2	9.0	16.5	25.2	17.9
Chemicals	2.9	7.5	13.5	13.0	14.8
Iron & Steel	1.5	▲3.3	35.5	41.2	36.6
Processing	16.7	17.8	12.0	12.9	16.8
Electrical Machinery	6.3	20.5	0.0	16.7	7.2
Motor Vehicles	5.2	19.9	30.1	4.1	28.6
Leasing	15.7	2.6	0.8	1.4	2.3
Non-manufacturing	9.0	▲5.4	16.6	6.1	13.0
Information & Communications	5.1	5.2	▲0.2	27.6	9.6
Electric & Gas Utilities	4.4	▲15.9	3.9	14.7	16.7
Retailing	2.9	10.0	5.3	13.1	9.8
Construction & Real Estate	2.2	▲9.3	▲7.8	20.1	2.3
【Small & Medium-sized Enterprises】 All Industries	16.2	12.7	12.8	▲7.1	▲0.2
Manufacturing	4.3	29.9	5.0	3.9	▲7.6
Non-manufacturing	11.9	7.0	16.0	▲11.1	2.8
【All Enterprises】 All Industries	100.0	5.1	8.8	7.6	8.8
Manufacturing	33.2	16.4	12.4	13.3	12.8
Non-manufacturing	66.8	0.5	7.1	4.8	6.8

Source: The Bank of Japan, "Tankan"

Note: The figures include Software Investment and exclude Land Purchase Expenses.

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Business fixed investment ② - Focusing on higher value added products

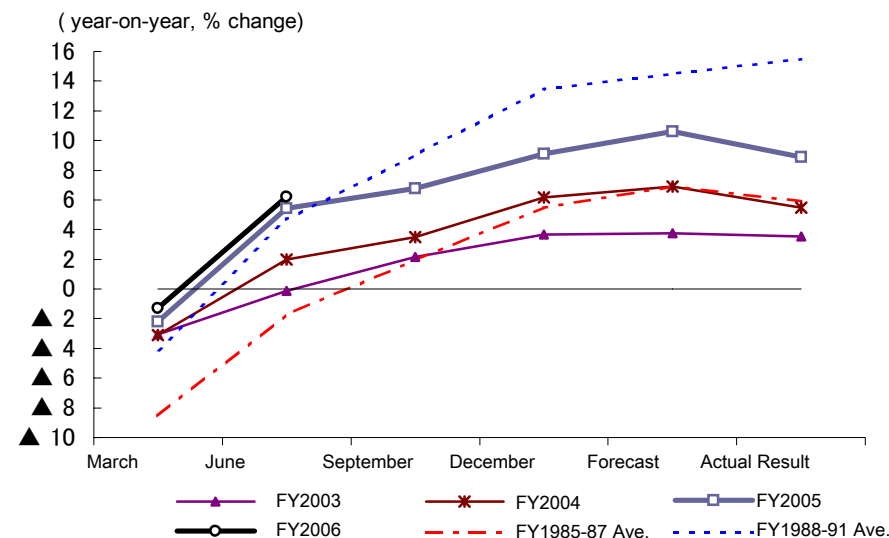
Looking by investment area, based on the Cabinet Office survey in January this year, more weight is expected to be put on "expansion to new business areas", "improvement in quality of products and/or services", and "research and development (R&D)" in the coming three years, compared with the past three years. On the other hand, the relative weight of "replacement, maintenance and repair" and "rationalisation and labour saving" would decrease. Further, the in-depth observation on business fixed investment of thirty large enterprises, which are planning a high level of or a rapid growth of investment, suggests that they are placing more importance on "making their products and/or services higher value added", and "expanding to and cultivating new business areas". It also indicates that they are regarding the tendencies such as "selection and focusing" and "returning to domestic sites" as their "key concepts" in planning, showing a conformity with the Cabinet Office survey results. In this context, the strengthening in the production capacity of liquid crystal display (LCD)-related products is one of the visible moves among manufacturing industries.

Figure 10-1 Capital Investment by Investment Area
<Cabinet Office survey results, multiple answers>

	Over the past 3 years (1)	For the next 3 years (2)	(2) - (1)
Production and/or Sales Capacity increase	56.0	54.8	▲ 1.2
Replacement, maintenance and repair	51.0	44.1	▲ 6.9
Improvement in quality of products and/or services	28.0	32.6	▲ 4.6
Rationalisation and labour saving	40.8	36.0	▲ 4.8
Utilisation of information technology	29.5	27.6	▲ 1.9
Research and development	20.4	24.2	▲ 3.8
Expansion to new business areas	11.1	17.1	▲ 6.0
Overseas direct investment	10.7	12.0	▲ 1.3
Environmental measures	8.1	11.1	▲ 3.0
Miscellaneous	4.1	3.6	▲ 0.5
No planning	1.7	1.6	▲ 0.1

Source: The Japan Research Institute, Ltd. based on the results of "Annual Survey of Corporate Behaviour FY2005" conducted by the Cabinet Office

Figure 10-2 Annual Projection Development of Business Fixed Investment
<The BOJ's Tankan March 2006 Survey, all industries >



Source: The Bank of Japan, "Tankan"

Note 1: The figures include Land Purchase Expenses and exclude Software Investment

2: This graph indicates the revision pattern of business fixed investment. The horizontal axis represents the point of time when the survey is conducted for each fiscal year. Namely, the first survey for each year (March survey) is at the far left, and the last survey (June survey of the following year; actual result) is at the far right.

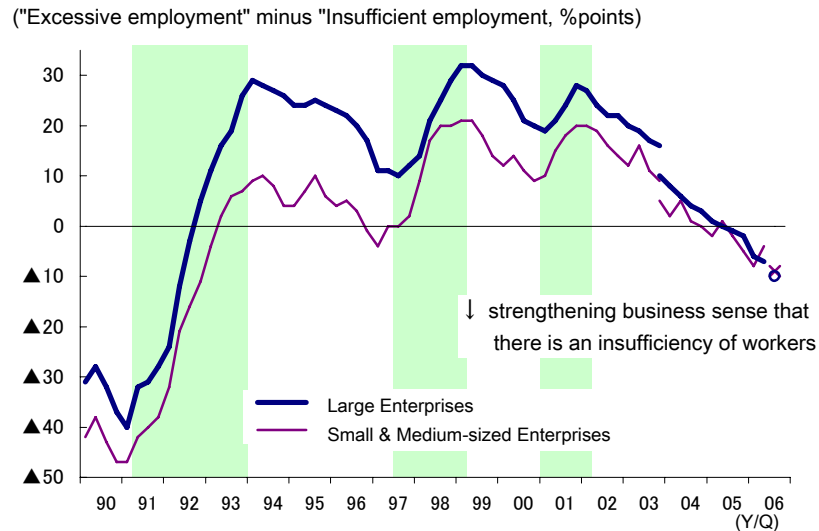
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Employment situation - Continuing improvement in labour demand

The employment situation in Japan continues to be improving in a steady manner. This trend is against the backdrop of a solid expansion of business activities, as well as the increasing necessity of enterprises to make sure of and to nurture enough talented employees, in anticipation of the mass retirement of the baby-boomer generation. According to the June 2006 Tankan Survey, the Diffusion Index (DI) on employment conditions saw a firm improvement among large enterprises. Albeit a pause in improvement on an all-sized industries basis was seen, it was caused by a decrease in insufficiency among small and medium-sized enterprises, possibly due to a seasonal factor. Actually, the survey shows a good advance in the forecast three months hence on an all-sized industries basis, a negative 10% point outlook, which exhibits the tightest employment situation since CY1992. Under these circumstances, the total number of corporate jobs offered to college graduates (who will graduate in spring next year) is expected to reach the highest since the "bubble era" in CY1991, according to the survey conducted by Works Institute, Recruit Co.,Ltd.

Figure 11-1 Employment Condition < Diffusion Index
in BOJ's Tankan Survey, all industries >

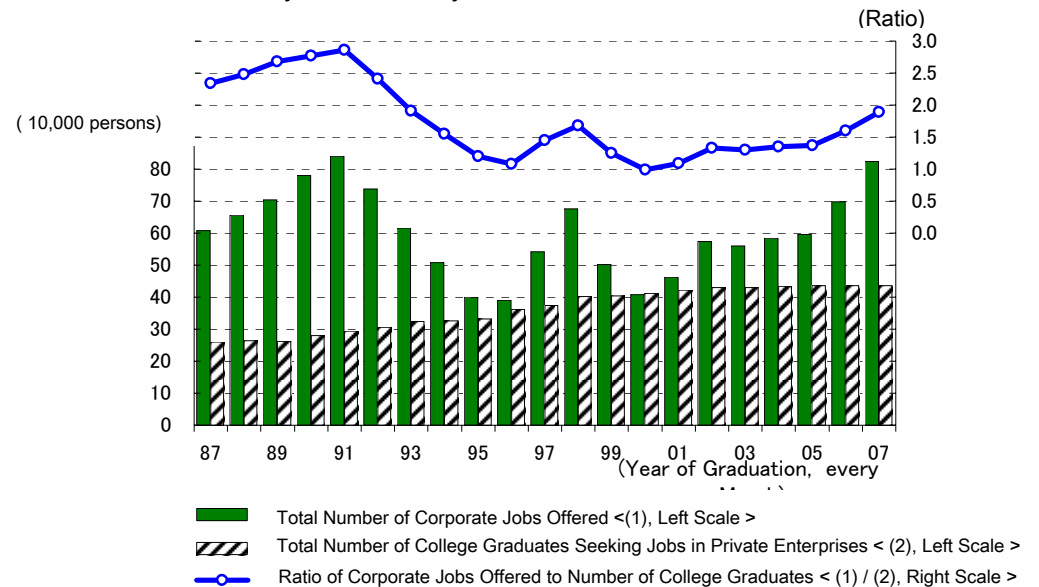


Source: The Bank of Japan, "Tankan", The Cabinet Office

Note 1: The marks below each line, ○ or ×, indicate the forecast DI's which had been made three months before.

2: Shaded areas indicate periods of recession according to the Cabinet Office.

Figure 11-2 College Graduate Recruitment Situation <private enterprise basis>
< Survey conducted by Works Institute, Recruit Co.,Ltd >

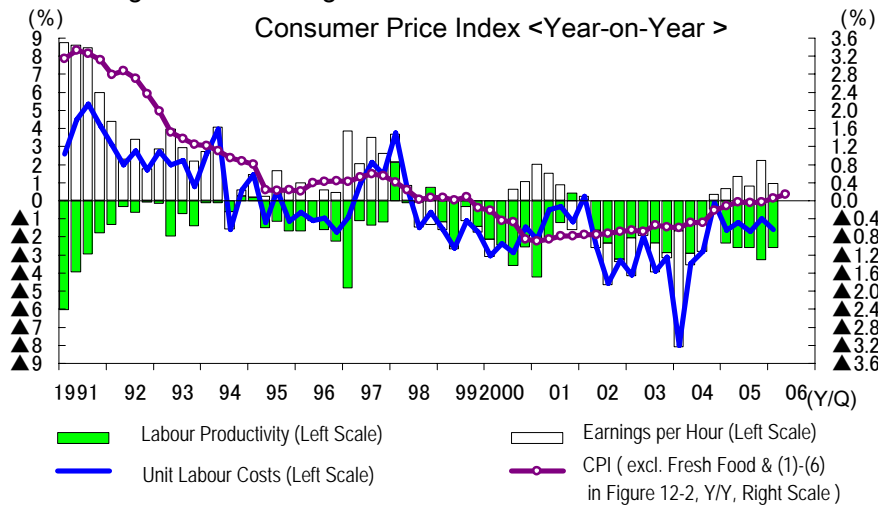


Source: Works Institute, Recruit Co.,Ltd, "College Graduate Recruitment Survey"

CPI growth rate – To settle into positive trend, yet no noticeable acceleration

The Consumer Price Index (CPI, excluding fresh food) rose 0.6 per cent on a year-on-year basis in June, the same annual growth rate as in the previous month. As for the prospects, the growth of the index is likely to settle more firmly into positive territory, especially if we see the index on a "core-core" basis, which excludes not only fresh food but also the special items that are shown as (1)-(6) in the legend in Figure 12-2 below, as the economy would continue to grow at a pace slightly above the potential GDP growth rate. However, it is unlikely that the pace of the increase in the index would accelerate noticeably. This is partly because, with a year-on-year slowdown in the growth of oil prices, there is little likelihood of an acceleration of the rate of increase in final petroleum product prices. In addition, the unit labour costs, which have a great influence on the "core-core" index, would likely follow a downward trend for the present, due to the following factors: (i) a moderate pace of recovery in wages, reflecting the corporate behaviour that more importance should be placed on curbing personnel expenses rather than on passing the costs through to consumers, (ii) a continuous improvement of labour productivity, as a favourable effect of the development of IT as well as the internationalised division of labour, and (iii) highly price selective consumers, affected by curbed wage growth, which would also influence (i).

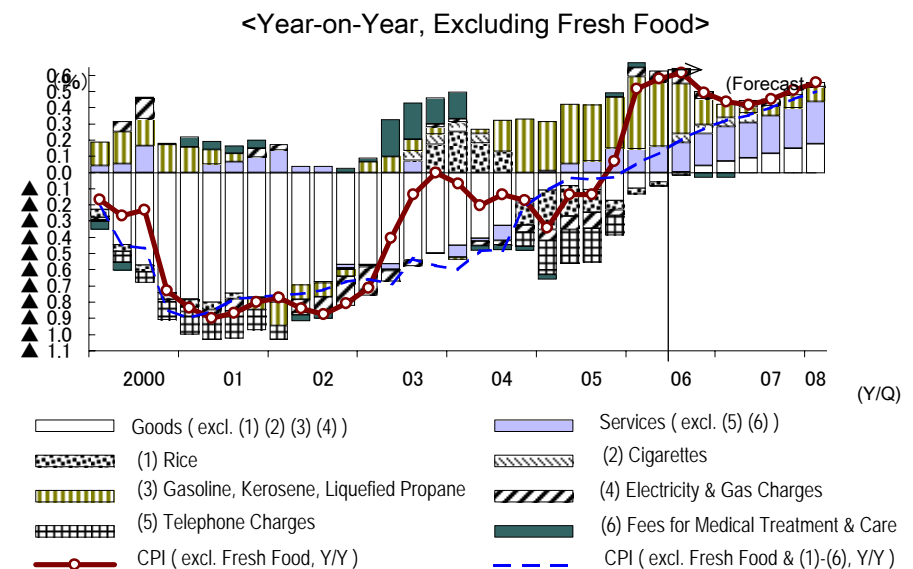
Figure 12-1 Change in Unit Labour Costs and



Source: The Cabinet Office, The Ministry of Health, Labour and Welfare, The Ministry of Internal Affairs and Communications.

Note: Unit Labour Costs = Nominal Compensation of Employees / Real GDP
 Labour Productivity = Real GDP / (Index of Regular Employment × Index of Total Hours Worked)
 Earnings per Hour = Nominal Compensation of Employees / (Index of Regular Employees × Index of Total Hours Worked)

Figure 12-2 Change in Consumer Price Index

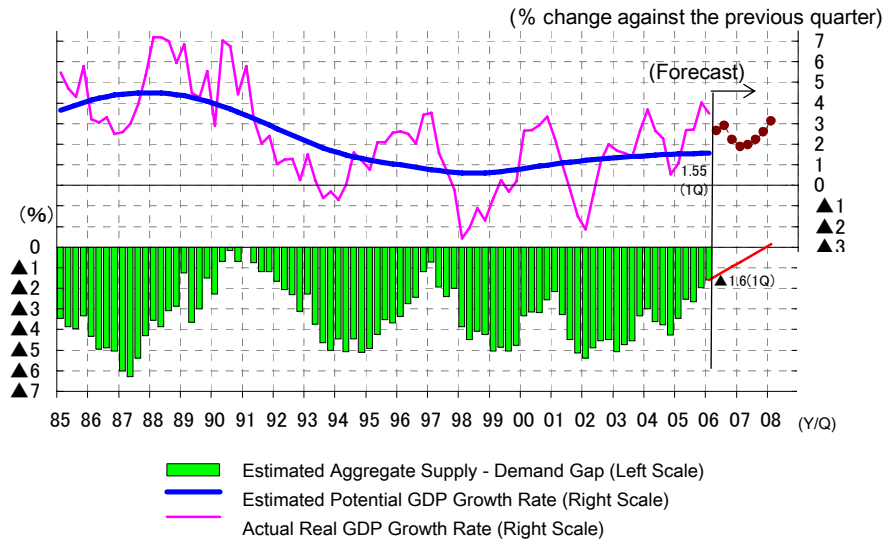


Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Internal Affairs and Communications.
 Note: The assumed average price of imported crude oil (on a CIF base) is \$67/barrel in FY2006, \$71/barrel in FY2007 (the actual result in FY2005 was \$55/barrel)

The GDP growth rate – A more sustainable recovery trajectory

Taken all in all, Japan's economy should continue to recover, adjusting its pace of recovery to a more sustainable growth trajectory, with a view to the recovery period outlasting the "Izanagi boom" (the longest in the past) into a record 58th consecutive recovery month in November this year. According to our projection, the GDP during FY2006 is expected to grow at 2.2 per cent in real terms into the spring of 2007, at a pace slightly above the potential GDP growth rate. Further, it is projected that the real GDP growth rate in FY2007 would accelerate to around 2.5 per cent, with the pace over the last half of the fiscal year accelerating further. This would be due to the favourable influence of the re-acceleration in the US economy, as well as the emerging positive impact of the mass retirement of the baby-boomer generation. As for the latter, it is expected to have a gradual impact on the economy mainly through the following two channels: (i) the boosting effect of the increase in the total amount of lump-sum retirement allowances on private consumption, and (ii) the enhancing influence of the decrease in personnel expenses on corporate profits.

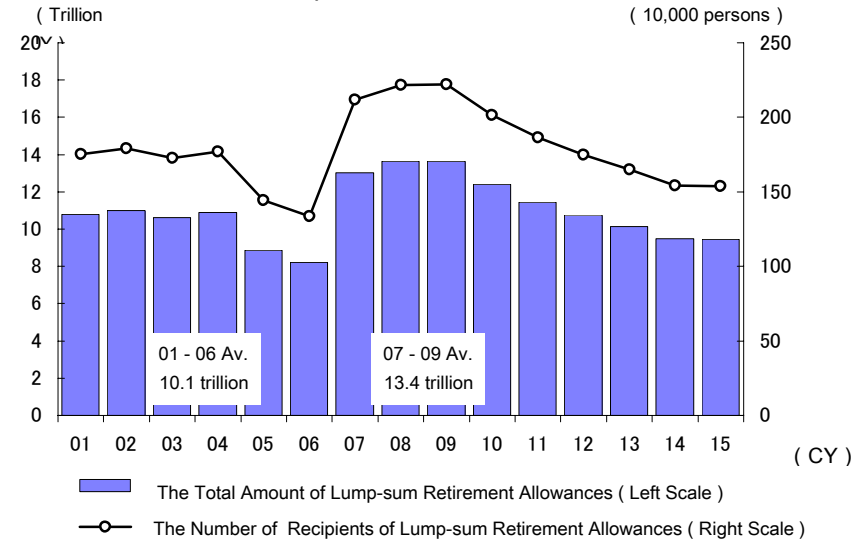
Figure 13-1 Estimate of Potential GDP Growth Rate of Japan and Aggregate Supply - Demand Gap



Source: The Japan Research Institute, Ltd. based on the data of The Cabinet Office, The Ministry of Internal Affairs and Communications, The Ministry of Economy, Trade and Industry

Note 1: Estimated Aggregate Supply - Demand Gap = (Actual Real GDP Growth Rate - Estimated Potential GDP Growth Rate) / Estimated Potential GDP Growth Rate [our estimate]

Figure 13-2 Estimate and Projection of Total Amount of Lump-sum Retirement Allowances



Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Health, Labour and Welfare, National Institute of Population and Social Security Research, The Ministry of Internal Affairs and Communications.

Note: Estimate till CY2004, and projection from CY2005 onwards.

2: The figures from Q2 CY2006 to Q1 CY2008 are based on our real GDP growth rate projections, with estimated potential GDP growth rate fixed at the level of 1.55%

Prospects for Japan's economy - Re-acceleration into FY2007

(1) Projection for economic growth

Japan's economy should continue to recover, adjusting its pace of recovery to a more sustainable growth trajectory, with a view to the recovery period outlasting the "Izanagi boom".

(i) According to our projection, the GDP during FY2006 is expected to grow at 2.2 per cent in real terms, at a pace slightly above the potential GDP growth rate. However, looking at the economic phase for the present, the pace of the economic recovery would see a mild slowdown due to these curbing factors: (i) a mild slowdown of the US economy, (ii) higher natural resource prices, (iii) a moderate pace of recovery in wages, and (iv) a weakening wealth effect of stock prices on private consumption.

(ii) Looking further, the real GDP growth rate would accelerate to around 2.5 per cent in FY2007, with the pace over the last half accelerating further. This would be due to the favourable influence of the re-acceleration in the US economy, and the emerging positive and gradual impact of the mass retirement of the baby-boomer generation.

(iii) As for prices, the CPI (excluding fresh foods) growth rate would stay positive, and remain very modest, reflecting a mild narrowing of the aggregate supply-demand gap. The following trend factors are expected to make a move in CPI more moderate and stable: (a) intense market competition, (b) a moderate pace of recovery in wages, and (c) a more moderate tempo of increase in natural resource prices than in the previous year albeit maintaining its uptrend.

(2) Factors which would make the recovery period longer

It is also widely recognised that Japan's economy would retain appreciable abilities to absorb shocks, which differs from those observed during the time of the collapse of the "IT bubble" or during the temporary slack period in 2004. The main abilities seen are as follows:

(i) The improvement in shipment-inventory balance in non-IT sectors, for a short-term factor. Even if pressure for adjustments arises in the IT sector, the non-IT sectors would bolster demand and a major production adjustment across all sectors of industry could be avoided.

(ii) The dissipation of structural adjustment pressures in the corporate sector as well as abundant liquidity as its financial strength, for a medium-to-long-term factor. With the management focus shifting from the "adjustment of excessive labour, capital equipment and debt" to "active business expansion aiming at survival against fierce global competition" as well as "securing human resources with developed abilities", with a view to the retirement of the baby-boomer generation and a full-scale decrease in population, there is little risk that the upward trend of business fixed investment and employment could falter in the short run.

(3) Uncertainties expected in the recovery

The downside risk to the central projection would be that, reflecting an assumed rapid deceleration in the US economy, the pace of production in the IT sector could lose its momentum sharply, and Japan's stock prices could turn sluggish.

Figure 14 Projections for GDP Growth and Main Indicators of Japan

(seasonally adjusted, annual % changes from the previous quarter)

	CY2005		CY2006				CY2007		FY2004	FY2005	FY2006	FY2007
	7~9	10~12	1~3	4~6	7~9	10~12	1~3	4~6				
	(Actual)		(Projection)									
Real GDP	0.8	4.4	2.7	0.8	2.6	2.4	1.8	2.4	1.7	3.2	2.2	2.5
Private Consumption Expenditure	1.8	2.6	0.8	1.9	1.8	2.3	2.0	2.1	1.6	2.3	1.8	2.3
Housing Investment	7.7	7.3	2.8	▲ 10.3	6.8	5.7	3.5	2.8	1.7	▲ 0.2	1.3	3.7
Business Fixed Investment	7.3	1.1	13.9	16.2	5.3	4.0	4.2	4.5	5.6	7.5	8.8	5.2
Private Inventories (percentage points contribution)	(▲ 1.9)	(0.5)	(0.2)	(▲ 0.9)	(0.4)	(0.3)	(▲ 0.2)	(0.0)	(▲ 0.3)	(0.2)	(▲ 0.2)	0.1
Government Consumption Expenditure	0.7	0.7	0.2	▲ 0.8	2.0	1.7	1.5	1.2	1.8	1.5	0.7	1.3
Public Investment	1.3	▲ 10.4	▲ 2.3	▲ 17.1	▲ 1.4	▲ 2.7	▲ 3.9	▲ 7.0	▲ 12.4	▲ 1.4	▲ 6.9	▲ 5.5
Net Exports (percentage points contribution)	(0.3)	(2.4)	(0.2)	(▲ 0.3)	(▲ 0.3)	(▲ 0.2)	(0.0)	(0.4)	(0.5)	(0.5)	(0.2)	0.2
Exports of Goods and Services	13.1	15.9	9.2	3.5	2.4	3.0	4.8	8.4	11.4	9.1	6.3	7.0
Imports of Goods and Services	14.0	▲ 2.4	10.5	7.3	5.6	5.2	6.0	6.8	8.7	6.5	6.4	6.8

(% changes from the same quarter of the previous year)

Real GDP	2.8	3.7	3.6	2.0	2.7	1.8	2.1	2.3	1.7	3.2	2.2	2.5
Nominal GDP	1.4	2.1	2.4	1.2	2.3	1.8	2.3	2.5	0.5	1.8	1.9	2.9
Consumer Price Index (excl. fresh food)	▲ 0.1	0.1	0.5	0.6	0.6	0.5	0.4	0.4	▲ 0.2	0.1	0.5	0.5
Industrial Production Index	▲ 0.2	3.0	3.2	4.1	4.9	2.6	2.4	2.6	4.1	1.6	3.5	2.8
Unemployment Rate (%)	4.3	4.5	4.2	4.1	4.0	3.9	3.8	3.7	4.6	4.4	3.9	3.6
Current Account Balances (trillion JY)	4.75	4.75	5.52	4.43	5.06	3.74	6.41	4.08	18.21	19.12	19.64	19.85
Share of Nominal GDP (%)	3.5	4.2	4.0	3.7	3.6	3.6	3.5	3.4	3.7	3.8	3.8	3.7
Exchange Rates (JY/US\$)	111.2	117.3	116.9	114.4	114.0	110.0	110.0	112.0	107.5	113.3	112.1	109.0

Source: The Cabinet Office, The Ministry of Internal Affairs and Communications, The Ministry of Economy, Trade and Industry, The Ministry of Finance.

The projection figures are based on those of The Japan Research Institute, Ltd.

Note: The projections are made based on the following assumptions;

- (1) The US economy is expected to move into a slightly decelerating phase over spring 2007 (the projected real GDP growth rate is 3.4% in CY2006 and 3.0% in CY2007).
- (2) The assumed average price of imported crude oil is \$67/barrel in FY2006 and \$71/barrel in FY2007 (the actual result in FY2005 was \$55/barrel).
- (3) It is assumed that the BOJ will continue to raise the rate by 0.25% every half a year from the last half of this fiscal year onwards.
- (4) The tax credit in income tax and in local inhabitants tax would be discontinued in January 2007.