

November 2007

**Forecast for the Japanese  
Economy in Fiscal 2007 and 2008**  
— Economy to Continue on Stable Growth Path in the Medium Term  
Unaffected by the Subprime Loan Issue —



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# **1. Forecast for the Japanese Economy in Fiscal 2007 and Fiscal 2008**

## **-- Economy to Continue on Stable Growth Path in the Medium Term**

### **Unaffected by the Subprime Loan Issue**

#### **(1) Current State of the Economy**

The Japanese economy is continuing to expand at a moderate pace. According to gross domestic product (GDP) data for the July-September quarter, announced on November 13, the economy expanded 0.6% in real terms over the previous quarter (at an annualized rate of 2.6%) and 0.3% in nominal terms (an annualized rate of 1.4%), thus returning to positive growth after negative growth in the April-June quarter. The GDP deflator continued to decline for the quarter, falling 0.3% below the same quarter of the previous year, influenced mainly by the increase in import prices, which are an item deducted in calculating the deflator. However, after excluding export and import prices, the domestic demand deflator showed a change of +0.0%, or a continued very slight increase before rounding, suggesting that deflationary pressures are in retreat.

By component of demand, private capital investment and exports, which were factors contributing to the slowdown in the economy in the April-June quarter, began to rise again. First, capital investment for the July-September quarter rose 1.7% over the April-June quarter, the first increase in three quarters. Production, which had leveled off since the beginning of this year, is beginning to rise again, and, supported by high levels of corporate profitability, private capital investment is beginning to increase again. In addition, exports to the United States, which had slowed, are not showing signs of greater strength, while exports to emerging economies, including China and resource-producing countries, remain robust. As a result, the margin of increase in exports in the July-September quarter expanded, and the contribution of the external sector rose to a relatively high +0.4%.

Personal consumption, which accounts for the majority of the GDP, rose 0.3% over the previous quarter, which was a lower rate than in the latter half of fiscal 2006. However, consumption is continuing to rise at a gradual rate appropriate to the increase in incomes. As growth in consumer

spending provides support for overall growth, private capital investment and exports, which had slowed in the previous quarter, accelerated, thus leading to relatively higher growth in the July-September quarter.

On the other hand, since the beginning of this year, private residential investment, especially the construction of one-family housing, declined 7.8% from the prior quarter, for the third consecutive quarterly decline, and the margin of decline is increasing. This was due to the influence of the sharp drop in housing starts resulting from the implementation of revisions in Japan's building code on June 20, 2007. However, this decline is due to the temporary confusion created by a slowdown in the processing of related construction permit applications as a result of the revision in the building code, and does not reflect a basic change in private residential investment.

Government final consumption expenditures remained on a rising trend and increased 0.3% over the previous quarter, but the decline in government public works investments continued (down 2.6% from the previous quarter), resulting in a slight decline in public-sector demand as a whole. Combined with private-sector demand, the contribution of domestic demand moved up to +0.2% but remained relatively small.

## **(2) Outlook for Fiscal 2007 and Fiscal 2008**

Although there are causes for concern about the future course of the economy, including the impact of the subprime loan issue, we believe the Japanese economy will continue to expand gradually. While growth in the U.S. economy will slip to about 2%, the world economy as a whole, including the newly emerging economies and resource-producing countries, will continue to show firm expansion, and the environment for Japan's exports will continue to be favorable.

Production, which has now moved out of its lull, will be supported by exports and is expected to continue to expand going forward. We are forecasting that the increase in production will be accompanied by further improvement in corporate profitability and that private capital investment will remain on an expansionary trend.

However, even though the growth mechanism will be maintained, conditions are not such that the rate of expansion will accelerate significantly in the latter half of the current fiscal year. Although conditions in the world economy are firm, growth will be maintained at about the level experienced thus far, and there is a possibility that overall growth may decline slightly, owing to deceleration in the U.S. economy and other factors. In addition, the improvement in employment in Japan has run its course, and, even though the weakness in wages may show some improvement, recovery in personal consumption will remain moderate. Moreover, as a result of the confusion in the housing market stemming from the implementation of the revised building code, the marked decline in private housing investment will tend to push growth downward.

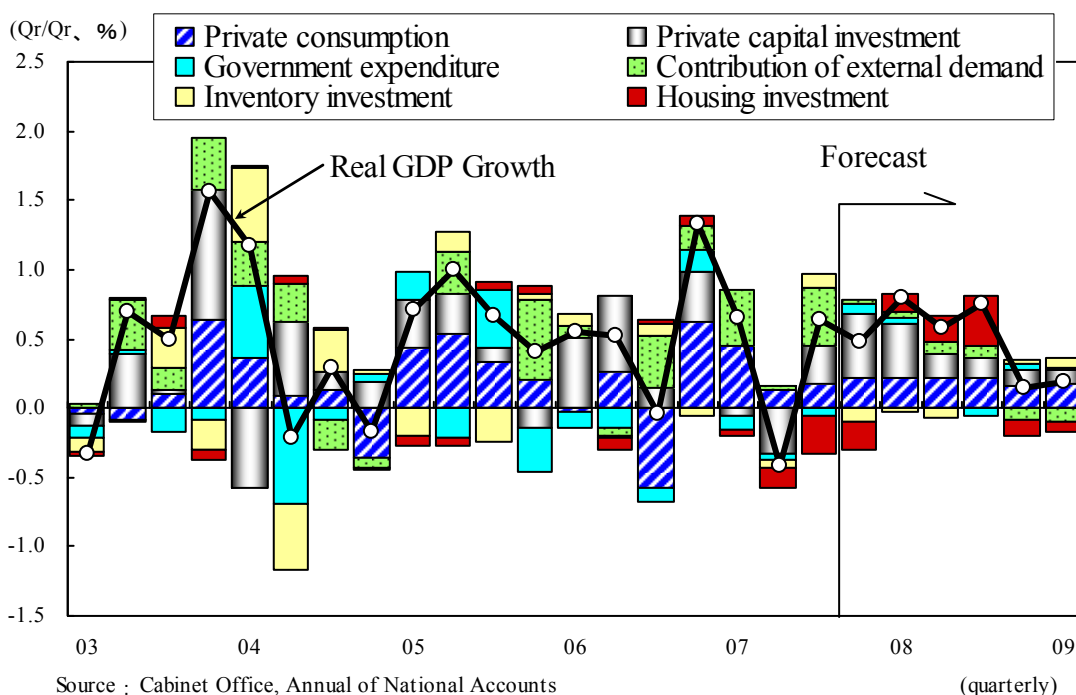
Although the forecast growth of 1.7% in real terms for fiscal 2007 will mean the attainment of positive growth for the sixth consecutive year, the rate of growth will be lower than in fiscal 2006. In addition, although the forecast growth of 1.2% in nominal terms will be the fifth consecutive year of positive growth, this will not represent much of an increase in the growth rate.

In fiscal 2008, we anticipate that the economy will remain on a moderate growth path. The turmoil created in financial markets by the subprime loan problem will settle down and growth in the world economy will continue. The economic mechanism under which expansion in exports leads to increases in production and further improvement in corporate profitability brings increases in private capital investment is expected to continue in fiscal 2008. There is not likely to be any change in trends toward improvement in employment and income conditions, and personal consumption will increase gradually, providing support for economic growth. The decline in government public works investment is expected to continue, but the sharp drop in private housing investment in fiscal 2007 is likely to be followed by a reactionary increase of significant proportions in fiscal 2008.

In the latter half of fiscal 2008, we are forecasting that growth in overseas

economies will slow and that expansion in demand for digital-related goods will move into a lull. As a result, the economy may slow, principally in the export sector. However, for the fiscal year as a whole, the economy is expected to show real growth of 2.2%, thus maintaining growth momentum of about 2%. In addition, the GDP deflator is forecast to rise over the previous fiscal year for the first time in 11 years, or, since 1997, when Japan's consumption tax rate was increased, and nominal growth will rise to a relatively high 2.4%.

**Exhibit 1: Real GDP Growth (seasonally adjusted)**



**(3) Four Factors Increasing Concern about the Economy**

A number of factors have been cited as causes for concern about the future course of the economy. These include the subprime loan issue, the rise in oil prices, the effects of revisions in the building code, and the lull in improvement in the employment environment. Since each of these factors may have some negative impact on the economy, the hopes for acceleration in the rate of economic expansion in the latter half of this fiscal year have begun to fade. However, we do not anticipate any change in the trend toward expansion now in progress and believe the economy will remain on

a stable growth path, expanding about 2% annually in the medium term.

### ① **The Subprime Loan Issue**

Of the various factors raising concerns about the future course of the economy, the one drawing the most attention is probably the subprime loan issue. Japan's financial institutions hold financial instruments incorporating subprime mortgages, and these institutions have reported losses on these investments. Fortunately, however, Japan's financial markets do not face the threat of become dysfunctional. The principal route by which the subprime loan issue might have an effect on the Japanese economy is if this issue results in adverse trends in the world economy, principally the United States, and this, in turn, has an impact on exports from Japan.

#### **a. Lackluster Consumption Resulting from the Reverse Wealth Effect**

There are concerns that the subprime loan issue could have an adverse impact on the United States via two routes. One would be a decline in personal consumption resulting from the reverse wealth effect created by a decline in housing prices. When housing prices are rising, individuals increase their borrowings along with the rise in the collateral value of their homes and are therefore able to increase their consumption. However, if this begins to work in the opposite direction as housing prices drop, this will have a negative impact on consumption. At present, we cannot say that there is a trend toward slower consumption because of the reverse wealth effect, but the sharp decline in private residential investment as a result of the collapse of U.S. housing boom is lasting longer than was initially expected, and concern is growing about the reverse wealth effect due to the decline in housing prices.

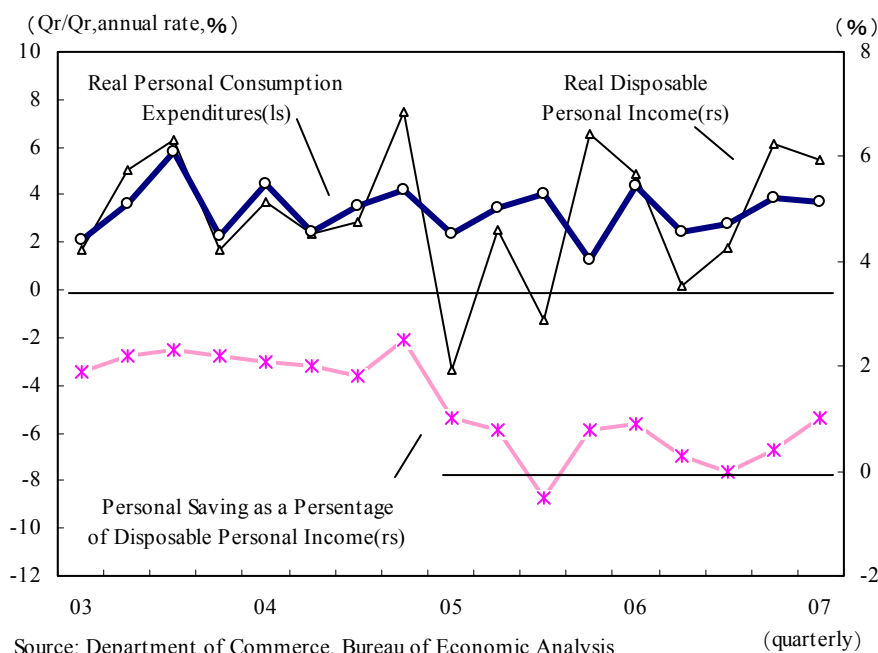
However, how much did the wealth effect actually increase consumer spending in the United States? Former Federal Reserve Board Chairman Alan Greenspan has estimated the wealth effect, and, according to his calculations, during 2004 as a whole, U.S. households were able to extract equity of about \$600 billion based on the increase in value of their homes. Nevertheless, it is uncertain whether households actually used their borrowings for consumption. Instead of using the low-cost funds they

borrowed with the equity in their homes as collateral for consumption, it would have been perfectly rational for them to use these borrowings to repay their higher-cost consumer loans.

Expanding consumption is something that households can postpone until medium-term prospects for the income environment improve and the outlook for future income becomes better. They would probably not expand their consumption just because their cash inflow improved temporarily due to increased borrowings. The important thing for increasing consumption is continuing expansion in income as a result of economic growth. Changes in the value of assets may have no direct impact on the level of consumer spending per se.

Exhibit 2 shows a comparison of trends in U.S. disposable income, personal consumption, and the savings rate. This exhibit shows that even when disposable income fluctuates, personal consumption shows relatively stable growth. Moreover, the savings rate seems to move in line with the rate of change in income. In other words, households draw down from their savings and add to their savings depending on changes in their incomes, suggesting that they are smoothing out their cash inflow, which provides the funds needed for consumption.

**Exhibit 2: Income, Consumption and Saving Rate (USA)**



Based on these observations, the money that households obtain because of the wealth effect, rather than increasing their consumption, seems to be used as the funds needed to smooth out the level of their consumption. In other words, consumption does not increase or decrease along with the wealth effect or the reverse wealth effect. Instead, it seems that those consumers who have improved ability to borrow using their assets as collateral use this ability to stabilize their cash flow through borrowings and stabilize their consumption in line with their lifetime wages. Accordingly, the decline in consumption resulting from the reverse wealth effect accompanying the decline in the value of their homes may be marginal.

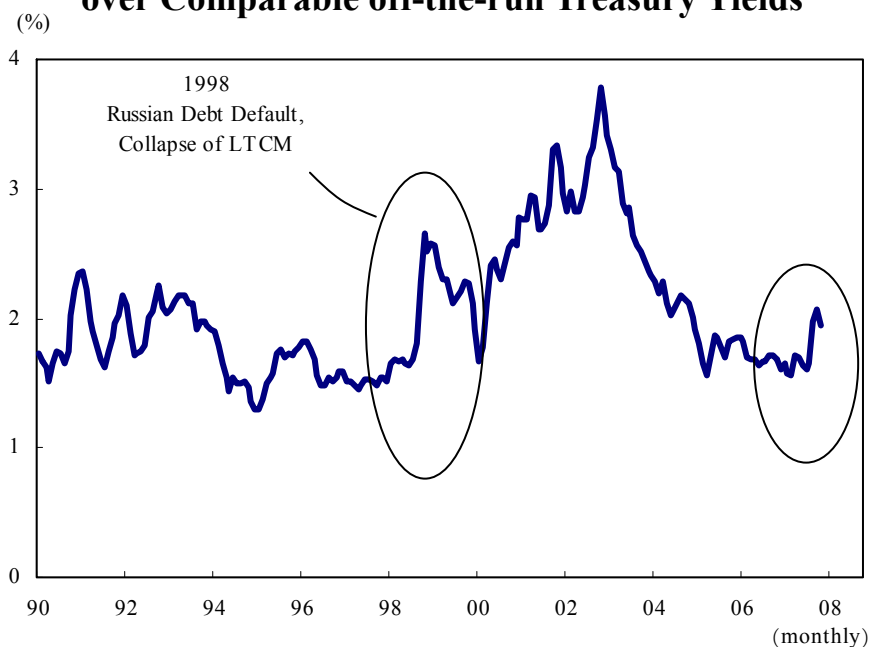
#### **b. Negative Impact of a Credit Crunch**

The other route via which the subprime loan issue might have an impact is the emergence of lackluster economic conditions overall as the subprime issue creates turmoil in financial markets that leads to a credit crunch. In fact, securitized investment products incorporating subprime loans have become extremely difficult to evaluate and their liquidity is very low. This is impairing the market mechanisms for related financial instruments and bringing a deterioration in funds flows. Some companies are experiencing difficulty in raising funds, and the financial effects of the subprime loan issue are already emerging.

The issues to consider are the extent to which financial market functions have deteriorated, how widely this has spread to financial markets as a whole, and the level of impairment of funds flows in the economy as a whole. As an indicator of trends in fund-raising, we can examine the spread between corporate bond yields (on BBB-rated bonds) and the 10-year U.S. Treasury bond yield. The emergence of the subprime loan issue has resulted in a widening of this spread, showing that corporations are finding it more difficult to raise funds (Exhibit 3). However, comparing this spread between corporate and Treasury yields in the past, the spread now is not unusually large, suggesting that corporations are not having extreme difficulties in raising funds. Thus far, a credit crunch seems to have been avoided and the subprime loan issue does not appear to have caused a shrinkage in credit that is large enough to present an obstacle to growth in

the U.S. economy.

**Exhibit 3: Spreads of Corporate Bond Yields over Comparable off-the-run Treasury Yields**



Note: The spreads shown are the yields on ten-year bonds less the ten-year Treasury yield.  
Source: FRB

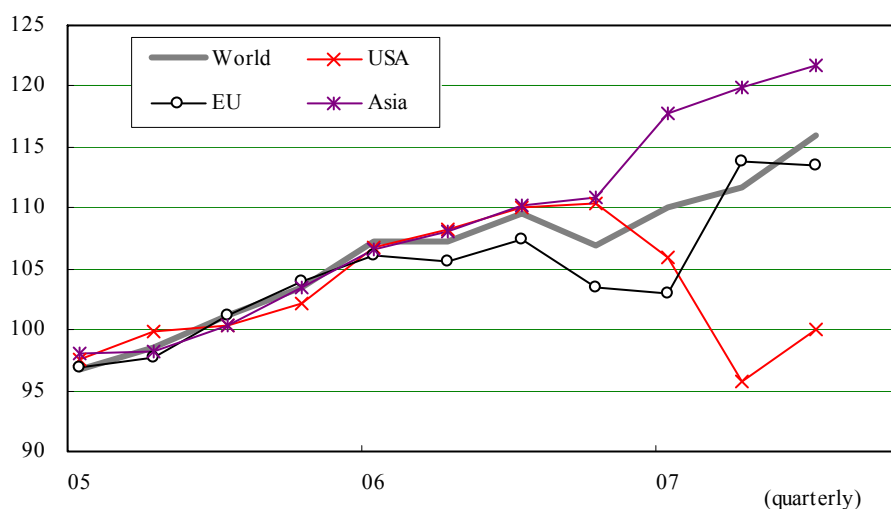
### **c. Impact of Changes in Trends in the United States on Japan's Economy**

In the event that trends in the U.S. economy are influenced via the two routes outlined previously, to what extent will this affect the Japanese economy? Compared with the past, the influence of the U.S. economy on the Japanese economy has weakened. The expansion in consumer spending in the United States is bringing expansion in exports from other countries to the United States. As a result, the U.S. economy is acting as an engine for growth in the world economy. However, as China and other emerging nations as well as resource-producing countries experience rapid economic growth themselves, they are becoming more independent from the United States as a driving force in the international economy. In addition, the shares of Japan's exports by trading partner are changing, with the share of exports to the United States declining and the shares to other Asian nations, especially China, rising.

An examination of trends in exports from Japan by region shows that, since the beginning of this year, exports to the United States are slowing, reflecting the deceleration of the U.S. economy. On the other hand, exports to other Asian countries and to other resource-producing nations are continuing to rise, acting as the driving force for continued overall expansion in Japan's exports (Exhibit 4). As these trends suggest, the linkages between trends in the U.S. economy and the economies of Japan and other countries have become weaker than in the past. Although it may be unrealistic to think that this decoupling of the U.S. and other economies will continue forever, provided the recent slowdown in the U.S. economy is temporary and provided the economy begins to accelerate again at some point, the effect on the Japanese economy is expected to be marginal.

**Exhibit 4: Quantum Index of Export by Region**

(CY2000=100)



Note: Seasonally adjusted

Source: Ministry of Finance, Trade Statistics of Japan

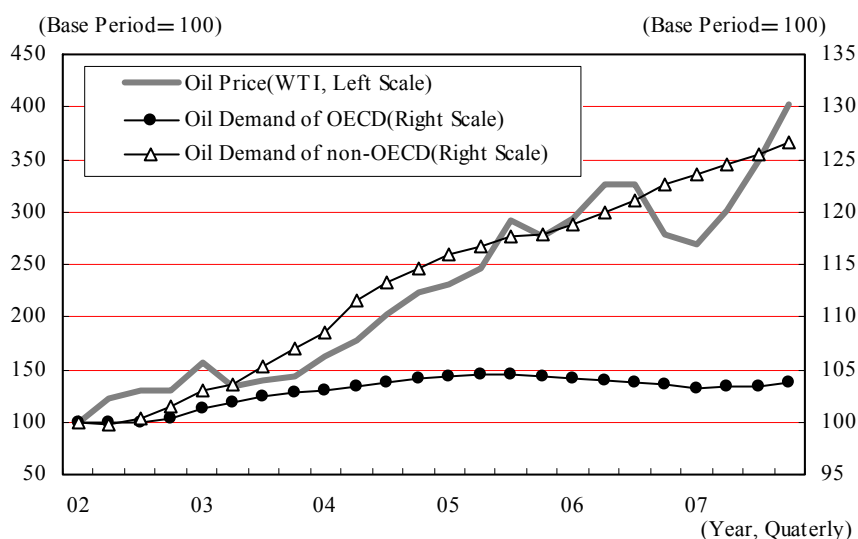
## ② The Rise in Oil Prices

Oil prices, which had peaked and settled down in summer 2006, began to rise again thereafter, and the WTI price rose close to \$100 a barrel. Thus far, the world economy is continuing to experience firm expansion, despite the rise in oil prices, without rapid inflation in the prices of downstream final goods. Factors accounting for this stability in prices include the fact that compared to the time of the first and second oil shocks, the volume of oil

needed for economic growth has diminished, thus giving the international economy more immunity to the adverse effects of oil price increases. In addition, the expansion in industrial production capacity has brought greater stability to prices of final goods. This change in the economic picture since then has not been altered, but there is rising concern that, if oil prices continue to rise as they have recently, at some point they will become an obstacle to growth in the world economy.

As concerns about a slowdown in the global economy have grown and the increase in crude oil prices has continued, observers have pointed out that developments are being influenced by speculative flows of funds against a background of rising geopolitical risk and turmoil in international financial markets. However, the influence of the factors creating turmoil is likely to be temporary, and oil prices should eventually come to be determined to reflect supply and demand conditions. One of the key factors behind the rising trend in oil prices in recent years has been expansion in demand from emerging countries, especially China (Exhibit 5). If price levels that do not reflect supply and demand continue for a prolonged period, the detrimental effect on the world economy will spread, but, if the international economy does begin to slow, oil prices will settle down to levels appropriate to supply and demand conditions. Provided the geopolitical risk of developments that would lead to a prolonged decline in supply capacity

**Exhibit 5: Oil Price and Oil Demand**



(Notes) 2002Q1 = 100. 4 quarters moving averages are used for Oil Demand Data. Data for 2007Q4 are projections.

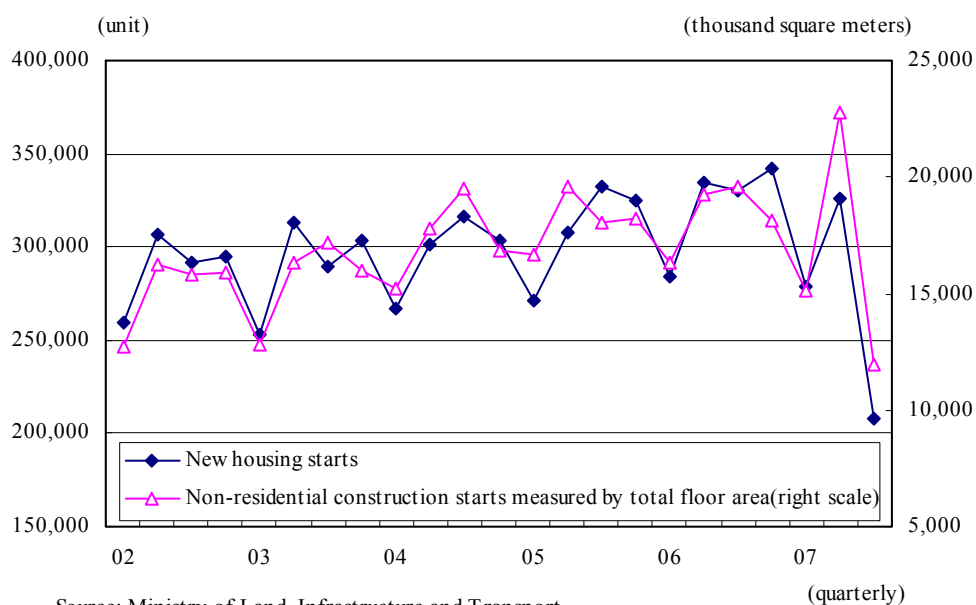
(Source) IEA

among oil-producing countries does not emerge, we believe the probability that the rise in oil prices will bring a downturn in the world economy is small.

### ③ Effects of Revisions in the Building Code

Following the implementation of the revised building code in Japan on June 20, the processing of building permit applications has been thrown into turmoil, resulting in significant declines in housing and office building starts (Exhibit 6). Private-sector housing investment at the GDP level has already shown a major decline in the July-September quarter and is expected to remain at a low level during the latter half of the current fiscal year. The drop in housing investment is having an impact on related demand, including construction materials, furniture, and electric appliances as well as acting as a factor depressing the growth rate. However, this turmoil is a temporary phenomenon accompanying the revision of the building code, and conditions are expected to return to normal levels in fiscal 2008. In this forecast, we are looking for a marked decline year on year in housing investment of 11.5% in fiscal 2007, but for a rebound to 9.9% expansion in fiscal 2008.

**Exhibit 6: New Housing Starts and Non-residential Construction Starts Measured by Total Floor Area**



Source: Ministry of Land, Infrastructure and Transport, Monthly of construction Statistics

However, before the recent turmoil occurred, housing investment was beginning to move into a period of adjustment reflecting the rises in land prices and construction costs. The sharp drop in the July-September quarter was not due just to the revision in the building code, but also seems in part to have been the result of ongoing adjustments in the housing market. When the temporary turmoil we are experiencing now subsides, housing starts will return to normal, but it may be difficult for them to return to levels prevailing previously.

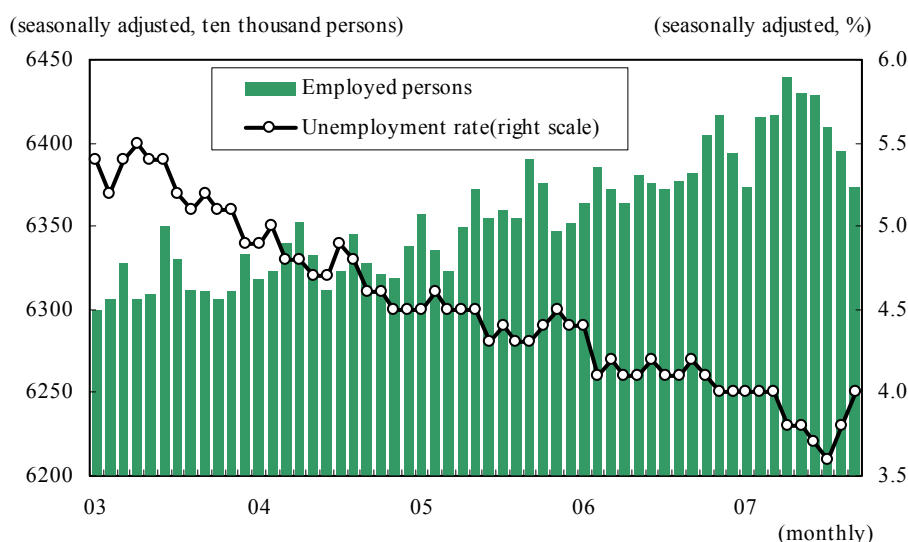
Declines in construction starts have also emerged in the markets for non-residential construction, including industrial plants, office buildings, and retail stores. The decline in construction investment translates directly into a decline in private capital investment and will have an impact on investment in equipment to be installed in industrial plants. Nevertheless, the impact of delays in construction starts on private capital investment will be less direct than the impact on housing investment.

In the July-September quarter, non-residential construction starts measured by total floor area fell 39.4% year on year. However, there was a surge in demand preceding the implementation of the revised building code, and construction begun prior to implementation is continuing, implying that the degree of turmoil, as evidenced by the sharp drop in construction starts since July, is not as great as it might seem. In addition, the portion accounted for by investments in the construction of industrial plants and certain other non-residential buildings is only a portion of capital investment. Even including the capital equipment that will be installed in industrial plants that have been completed, the impact of the stagnation in construction starts on capital investment is expected to be marginal. The outlook for capital investment will be determined by the production activities of corporations, trends in profitability, and the necessity for investments to increase competitiveness in the medium term. As moderate growth in the economy continues, we are forecasting that private capital investment will remain on a relatively stable upward trend.

#### **④ Lull in Improvement in the Employment Environment**

Growth in per capita wages is weak, but, as a result of the improvement in the employment environment, employee compensation, from the point of view of the economy as a whole, is expanding moderately and providing support for consumer spending. However, the number of persons in the workforce has now declined for five months running and stands 660,000 persons lower than the previous peak reached in April this year (Exhibit 7). After excluding self-employed persons and certain other groups, the number of employed persons has not declined substantially, but weakness in this indicator has been clear over the last several months. The unemployment rate, which had been in decline, has recently shown a slight rise. These and other indicators suggest changes in the trend toward improvement in the employment environment and are causes for concern about the outlook for consumption.

### Exhibit 7: Employed Persons and Unemployment Rate



Source: Ministry of Internal Affairs and Communications, Labor Force Survey

At the same time that members of Japan's baby boom generation are entering their 60s, the size of the younger population is declining. Under these demographic conditions, it will be difficult for the number of persons in the workforce and the number of employed persons to continue to increase indefinitely. As a result, there is a possibility that per capita wages may increase somewhat. Although the rate of unemployment has risen recently, it remains at a relatively low level and the labor market continues

to be tight. Over the past year, as the baby boom generation has retired and then been reemployed at lower wages, the number of new graduates entering the workforce has increased, and the number of part-time workers has risen, the net effect has been to push per capita wages downward, but we anticipate that these developments will run their course and that wages may soon begin to rise as the labor market tightens.

Although the number of persons in the workforce has not shown much increase, wages, which previously were weak, are now showing some improvement. As a result, we are forecasting that, as in the past, consumer spending will continue to increase moderately as employee compensation rises.

## **2. Forecasts of Economic Activity by Sector**

### **(1) Corporations**

- Corporations have completed their disposal of negative assets left over from Japan's bubble economy, and their financial positions and profitability have recovered. The risks of a possible downturn in production, capital investment, or other aspects of corporate activities have receded, and companies are moving ahead with the further development of their activities, including the expansion of production capacity.
- Production is expanding, supported by growth in exports of automobiles, digital-related products (including semiconductors and LCDs), and other items as well as expansion in domestic demand. Along with expansion in shipments, inventory levels are also rising, but companies are adopting a cautious stance toward increasing inventories and the rate of increase in inventories is moderate.
- As a result of the improvement in corporate profitability and recovery in the economy, recurring profit among corporations has already exceeded the previous peaks reached during the bubble economy and the IT boom and now stands at its highest level in history. Although certain factors are causing a deterioration in the corporate profit environment, including the run-up in raw material prices, increases in

personnel costs and depreciation charges, and higher interest payment accompanying higher overall interest rates, companies are still able to report increases in profits because of gains in sales in Japan and overseas, including rising exports.

- If slowdowns in overseas economies and inventory adjustments in the digital-related goods industries bring a temporary leveling off of industrial production, the resulting sluggish growth in corporate profitability may restrain expansion in capital investment. However, the upward trend in production is expected to continue in the medium term, and investments for the replacement of older equipment and for increasing the value added of products to improve competitiveness will be necessary. For these reasons, the deceleration in capital investment is expected to be marginal, and capital outlays are likely to continue on an upward trend.

## **(2) Households**

- Household incomes are continuing to recover, but the pace of improvement is gradual, and the positive benefits of economic expansion are hardly spreading fully from the corporate sector to the household sector. Personal consumption is still on a rising trend and is providing support for the economy but is not strong enough to be a driving force in the economy.
- The drastic restructurings that companies undertook to reduce excess employment have been completed for the time being. As the economic recovery continues and the baby-boom generation of workers begins to retire in 2007, companies are showing growing interest in expanding their workforces. The employment and income environments are expected to continue their moderate trend toward improvement.
- However, corporations are continuing to exercise restraint regarding increases in wages. In addition, the ending of tax cuts and the increase in the welfare burden will be factors putting downward pressure on disposable incomes, principally those of members of the current workforce. Increases in consumer spending will continue to be moderate as incomes show only gradual expansion.
- Private housing investment will receive a positive impetus as the sons

and daughters of the baby-boom generation purchase their first homes, but, in the medium term, growth in the number of households will slow. In addition, other factors restraining housing investment are revisions in the building code, which went into effect in June, which delaying housing starts, and rising prices of real estate in urban areas.

### **(3) Government**

- Following the bursting of Japan's economic bubble, government finances deteriorated rapidly, and the public sector has continued to issue large volumes of government bonds. Along with the decline in nominal economic growth rates, the government made major reductions in taxes that resulted in a drop in tax revenues. Moreover, on the expenditure side, as the population has aged demographically, social welfare costs have risen, and, as a result of the implementation of major government spending programs to stimulate the domestic economy in the 1990s, expenditures for public works increased.
- The administration of former Prime Minister Junichiro Koizumi did not undertake any major spending programs to stimulate the economy because his goal was to make structural reforms in government finances and reduce spending on public works. Moreover, local governments have experienced deterioration in their financial position and have cut their public works spending. Along with the ongoing economic recovery, tax revenues are expanding, but the subsequent administrations have also maintained a policy of making structural reforms in government finances. Accordingly, on an annual basis, further cuts in public works spending are expected at the national and local levels.
- The basic policy of the Japanese government is also to reduce its deficits by restraining government final consumption expenditure. To this end, the government is endeavoring to restrain the increase in social welfare expenditures through systemic reforms. However, even if these reforms are implemented, they will probably only succeed in lowering the pace of expansion in these expenditures. We anticipate that government final consumption expenditures, principally social welfare payments, will continue to increase.

- Reductions in public-sector capital formation, at both the national and local levels, are continuing, and the ratio of these public investments to GDP has declined substantially. For this reason, concern is growing that Japan may not be able to sustain necessary social capital. The financial positions of national and local governments remain weak, and the decline in public-sector investment spending is expected to continue, but there is a possibility that the pace of decline may be more moderate going forward.

#### **(4) Trends in Overseas Economies**

- The world economy is continuing on an expansionary trend. A number of factors, however, may bring a temporary slowdown. These include the impact of the subprime loan issue in the United States on both the U.S. economy and world financial markets, overheating in the Chinese economy, and rising oil prices. However, at present, we believe that the risk of a hard landing as a result of a sharp drop in the value of the U.S. dollar that might lead to a downturn in the world economy as a whole is minimal.
- Although there is a possibility that Japan's exports might experience a temporary adjustment because of a deceleration in the world economy, we believe the rising trend in Japan's exports will continue. The expansion in the overseas production of Japanese companies will be one factor restraining exports. However, we are forecasting that exports from Japan will continue to rise because worldwide demand for automobiles is expanding rapidly, high rates of growth will continue in the emerging economies and resource-producing nations, and demand for electronic parts, principally in the rest of Asia, is growing.
- Turning to imports, as China and other emerging industrializing countries rapidly expand their production capacity and Japanese companies continue to locate portions of their production capacity overseas to achieve the optimal division of production, Japan's imports of products and parts, principally from the rest of Asia, will continue to increase. In addition, as a result of continuing high primary product prices, imports of raw materials in value terms are expected to remain at a high level.

- We are looking for continued growth in both exports and imports, as the trade dependence of the Japanese economy continues to increase. Net exports will continue to make a positive contribution to Japan's economic growth. Moreover, reflecting the overseas expansion of Japanese companies, dividends and other income from their overseas subsidiaries will expand, and income from monetary assets held in foreign currencies will also increase. As a result, Japan's surplus in the income accounts of its balance of payments is on track to rise to, and then exceed, the levels of the country's trade surplus.

### **3. Forecasts for Prices and Financial Markets**

- Prices of raw materials, including crude oil, remain at relatively high levels by standards of past years. On the other hand, the supply capacity of China and other emerging industrializing countries is expanding, and, because of this and other factors, prices of industrial products are stable. As a consequence, the world's price structure is undergoing major changes, owing to inflationary pressures upstream and deflationary pressures downstream.
- These developments are having an impact on Japan's domestic prices. While domestic corporate prices are increasing on the one hand, consumer prices—while bottoming out—have yet to show a broadly based upward trend.
- Regarding monetary policy, following the lifting of the quantitative policy of monetary easing in March 2006 and the ending of the zero interest rate policy in July, a further increase in interest rates was implemented in February 2007. The process of normalizing monetary policy to raise interest rates from their excessively low levels and permit the interest rate mechanism to operate properly has begun. Looking ahead, we believe there will be a series of further slight increases at an unhurried pace, as the monetary authorities confirm the continuation of the economic recovery and the stability of prices.
- A gradual upward trend in long-term interest rates is expected to continue as the economic recovery proceeds and the monetary policy interest rate is increased. Stock prices are expected to continue to rise, reflecting the improvement in profitability of Japanese companies not

only in Japan but also in overseas markets. In foreign exchange markets, despite the expansion in Japan's trade surplus, the yen has not appreciated significantly. Confidence in the euro and the currencies of the resource-producing countries is gradually increasing, and they are appreciating gradually against the U.S. dollar and the yen. Funds tend to flow into the currencies of countries viewed as stronger, based on such factors as differences in perceptions of the state of their underlying economies, interest rate differentials, and trends in monetary policy. At present, however, there are not major differences among economic trends in Japan, the United States, and Europe, and we are forecasting that the yen will remain relatively stable.

## Exhibit 8: Outlook for fiscal 2007-2008

	Forecast ↘ Yr/Yr, %				
	FY2004 (actual)	FY2005 (actual)	FY2006 (actual)	FY2007 (forecast)	FY2008 (forecast)
Nominal GDP	0.9	1.0	1.3	1.2	2.4
Real GDP	2.0	2.4	2.0	1.7	2.2
Contribution of domestic demand	1.4	1.9	1.3	0.8	2.1
Private consumption	1.3	1.9	0.7	1.7	1.5
Housing investment	1.7	-1.0	0.4	-11.5	9.9
Private capital investment	6.3	5.7	7.7	2.5	5.9
Contribution of inventory investment	0.1	-0.1	0.0	-0.1	-0.1
Government expenditure	-1.5	0.4	-1.4	-0.2	0.2
Public investment	-12.7	-1.4	-9.6	-5.6	-4.2
Government final consumption expenditure	1.7	0.9	0.9	1.0	1.2
Contribution of external demand	0.5	0.5	0.8	0.9	0.2
Export of goods and services	11.4	9.0	8.2	7.7	7.3
Import of goods and services	8.4	6.0	3.4	2.6	6.9
GDP deflator	-1.0	-1.3	-0.7	-0.4	0.2

	Forecast ↘ Yr/Yr, %				
	FY2004 (actual)	FY2005 (actual)	FY2006 (actual)	FY2007 (forecast)	FY2008 (forecast)
Current account balance (trillion yen)	18.2	19.1	21.2	25.5	27.1
balance on goods (trillion yen)	13.2	9.6	10.5	12.5	12.5
balance on service (trillion yen)	-3.6	-2.2	-2.3	-3.3	-4.3
balance on income (trillion yen)	9.6	12.6	14.2	17.4	20.1
Industrial production	4.0	1.6	4.8	3.0	2.5
Unemployment rate(%)	4.6	4.4	4.1	3.8	3.8
New housing starts(annualized, ten thousand units)	119.3	124.9	128.5	106.1	120.9
Corporate goods prices	1.8	4.1	4.4	3.7	2.3
Domestic corporate goods prices	1.5	2.1	2.8	2.5	1.3
Consumer prices	0.0	-0.3	0.3	0.1	0.5
excluding freshfood	-0.1	-0.1	0.1	0.1	0.5
Yen/U.S.Dollar	107.5	113.3	116.9	116.8	118.5
Uncollateralized call rates (O/N) (%)*	0.001	0.001	0.220	0.750	1.250
Newly issued government bond yields (10years) (%)	1.52	1.43	1.77	1.67	1.80
WTI future price (near month contract, US dollar/barrel)	45.1	60.0	64.9	78.1	83.5
Dubai crude oil prices (US dollar/barrel)	36.6	53.7	60.9	74.1	79.1

\* actual=average, forecast=end of period

## Exhibit 9: Outlook for calendar 2007-2008

	CY2004 (actual)	CY2005 (actual)	CY2006 (actual)	Forecast	
				CY2007 (forecast)	CY2008 (forecast)
	Yr/Yr, %				
Nominal GDP	1.6	0.6	1.2	1.5	2.0
Real GDP	2.7	1.9	2.2	1.8	2.2
Contribution of domestic demand	1.9	1.7	1.4	0.9	1.9
Private consumption	1.6	1.6	0.9	1.7	1.4
Housing investment	1.9	-1.3	1.0	-8.3	3.4
Private capital investment	5.6	6.6	7.4	2.9	6.4
Contribution of inventory investment	0.3	-0.1	0.1	0.0	-0.1
Government expenditure	-0.6	0.0	-1.3	-0.5	0.3
Public investment	-9.0	-6.2	-7.4	-6.2	-4.8
Government final consumption expenditure	1.9	1.7	0.4	0.9	1.4
Contribution of external demand	0.8	0.3	0.8	1.0	0.3
Export of goods and services	13.9	7.0	9.6	8.0	7.3
Import of goods and services	8.1	5.8	4.5	2.2	5.9
GDP deflator	-1.1	-1.3	-0.9	-0.3	-0.2

	CY2004 (actual)	CY2005 (actual)	CY2006 (actual)	Forecast	
				CY2007 (forecast)	CY2008 (forecast)
	Yr/Yr, %				
Current account balance (trillion yen)	18.6	18.3	19.8	25.5	26.1
balance on goods (trillion yen)	13.9	10.3	9.5	12.9	12.2
balance on service (trillion yen)	-3.7	-2.6	-2.1	-2.7	-4.2
balance on income (trillion yen)	9.3	11.4	13.7	16.7	19.4
Industrial production	5.5	1.1	4.8	2.7	3.2
Unemployment rate (%)	4.7	4.4	4.1	3.8	3.8
New housing starts(annualized, ten thousand units)	118.9	123.6	129.0	107.8	120.0
Corporate goods prices	1.2	3.1	5.0	3.4	2.9
Domestic corporate goods prices	1.2	1.7	3.0	2.3	1.7
Consumer prices	0.0	-0.3	0.2	0.0	0.5
excluding freshfood	-0.1	-0.1	0.1	0.0	0.5
Yen/U.S.Dollar	108.2	110.2	116.3	117.9	117.3
Uncollateralized call rates (O/N) (%)*	0.001	0.001	0.125	0.500	1.000
Newly issued government bond yields (10years) (%)	1.50	1.38	1.74	1.69	1.75
WTI future price (near month contract, US dollar/barrel)	41.4	56.6	66.2	71.4	83.8
Dubai crude oil prices (US dollar/barrel)	33.6	49.5	61.6	67.9	79.1

\* actual=average, forecast=end of period

## Exhibit 10: Outlook for 2007-2008 (Quarterly)

	Forecast											
	FY2006				FY2007				FY2008			
	4-6	7-9	10-12	1-3	4-6	7-9	10-12	1-3	4-6	7-9	10-12	1-3
Nominal GDP	0.3	-0.2	1.4	0.3	-0.3	0.3	0.7	0.1	0.7	1.1	0.7	-0.1
	0.9	0.7	1.6	2.1	1.2	1.8	0.9	1.0	1.8	2.8	2.5	2.5
Real GDP	0.5	-0.0	1.3	0.7	-0.4	0.6	0.5	0.8	0.6	0.8	0.2	0.2
	2.0	1.5	2.2	2.4	1.5	2.1	1.3	1.7	2.5	2.7	2.1	1.7
Contribution of domestic demand (Qr/Qr,%)	0.6	-0.4	1.2	0.2	-0.4	0.2	0.4	0.8	0.5	0.7	0.2	0.3
Private consumption	0.5	-1.0	1.1	0.8	0.2	0.3	0.4	0.4	0.4	0.4	0.3	0.3
	1.4	-0.4	0.5	1.4	1.2	2.4	1.8	1.3	1.5	1.5	1.5	1.4
Housing investment	-2.1	0.8	2.2	-1.4	-4.1	-7.8	-6.3	4.4	5.9	11.0	-3.0	-2.0
	1.2	-0.1	0.9	-0.4	-2.4	-11.1	-18.4	-13.4	-4.5	14.8	18.8	11.7
Private capital investment	3.7	0.9	2.3	-0.3	-2.1	1.7	2.9	2.4	1.1	0.9	0.7	0.6
	6.8	6.9	10.6	6.9	0.5	1.5	2.2	5.1	8.3	7.4	5.1	3.3
Contribution of inventory investment (Qr/Qr,%)	-0.0	0.1	-0.1	-0.0	-0.1	0.1	-0.1	0.0	-0.1	0.0	0.0	0.1
Government expenditure	-0.6	-0.5	0.7	-0.4	-0.2	-0.3	0.4	0.2	0.0	-0.3	0.2	0.1
	-0.6	-2.7	-1.1	-1.0	-0.2	-0.1	-0.6	0.2	0.5	0.4	0.0	0.0
Public investment	-6.0	-4.9	3.7	-1.1	-2.7	-2.6	-0.7	-0.3	-1.1	-2.1	-0.6	-0.3
	-6.5	-14.8	-8.9	-8.0	-5.6	-3.2	-6.8	-6.0	-4.8	-4.3	-4.0	-4.0
Government final consumption expenditure	0.8	0.6	0.1	-0.2	0.4	0.3	0.5	0.4	0.2	0.2	0.3	0.3
	0.6	0.4	1.3	1.2	0.8	0.7	1.0	1.6	1.4	1.4	1.1	1.0
Contribution of external demand (Qr/Qr,%)	-0.1	0.4	0.2	0.4	0.0	0.4	0.0	0.0	0.1	0.1	-0.1	-0.1
Export of goods and services	0.6	2.3	1.0	3.4	0.9	2.9	1.2	1.0	2.8	2.4	0.6	0.5
	10.1	9.3	6.5	7.3	7.6	8.4	8.6	6.2	8.2	7.7	7.0	6.5
Import of goods and services	1.2	-0.2	-0.2	0.9	0.8	0.5	1.2	1.0	2.6	2.2	1.2	1.2
	6.6	2.5	2.6	1.8	1.3	2.0	3.4	3.4	5.3	7.1	7.5	7.4
GDP deflator (Yr/Yr,%)	-1.1	-0.7	-0.5	-0.3	-0.3	-0.3	-0.4	-0.7	-0.7	0.1	0.4	0.8

	Forecast											
	FY2006				FY2007				FY2008			
	4-6	7-9	10-12	1-3	4-6	7-9	10-12	1-3	4-6	7-9	10-12	1-3
Current account balance (trillion yen)*	4.6	4.8	5.7	5.6	6.5	6.2	6.9	6.0	6.3	6.5	7.3	6.9
balance on goods (trillion yen)*	2.1	2.1	2.9	3.0	3.0	3.4	3.0	3.4	2.7	3.0	3.1	3.1
balance on service (trillion yen)*	-0.7	-0.7	-0.3	-0.6	-0.7	-0.7	-0.8	-1.1	-1.2	-1.0	-0.9	-1.1
balance on income (trillion yen)*	3.4	3.5	3.6	3.6	4.5	3.8	4.4	4.6	5.4	5.3	4.9	5.3
Industrial production (Qr/Qr, %)	1.3	1.3	2.2	-1.3	0.2	2.2	1.4	0.6	0.5	0.4	0.1	0.1
(Yr/Yr, %)	4.7	5.6	6.0	3.1	2.4	2.7	2.8	4.2	4.7	2.5	1.7	0.9
Unemployment rate (%)*	4.1	4.1	4.0	4.0	3.8	3.8	3.9	3.8	3.8	3.8	3.8	3.7
New housing starts(annualized, ten thousand units)	130.2	127.0	131.3	125.2	126.7	79.9	102.1	117.5	122.1	121.1	119.0	121.2
Corporate goods prices (Yr/Yr,%)	5.0	5.7	3.7	3.3	4.2	2.4	3.6	4.4	3.0	2.5	1.9	1.6
Domestic corporate goods prices (Yr/Yr,%)	3.1	3.6	2.6	2.0	2.4	2.0	2.7	2.9	1.8	1.4	0.9	1.0
Consumer prices (Yr/Yr,%)	0.2	0.6	0.3	-0.1	-0.1	-0.2	0.3	0.4	0.5	0.6	0.5	0.5
excluding freshfood (Yr/Yr,%)	0.0	0.3	0.1	-0.1	-0.1	-0.1	0.3	0.4	0.5	0.5	0.5	0.5
Yen/U.S.Dollar	114.4	116.2	117.8	119.4	120.7	117.8	113.6	115.0	117.0	118.0	119.0	120.0
Uncollateralized call rates (O/N) (%)**	0.020	0.223	0.255	0.382	0.514	0.500	0.500	0.750	0.750	1.000	1.000	1.250
Newly issued government bond yields (10years) (%)	1.89	1.79	1.69	1.71	1.74	1.72	1.58	1.65	1.73	1.78	1.83	1.83
WTI future price (near month contract, US dollar/barrel)	70.7	70.5	60.2	58.2	65.0	75.4	87.0	85.0	82.0	84.0	84.0	84.0
Dubai crude oil prices (US dollar/barrel)	64.8	66.0	57.4	55.3	64.8	70.0	81.5	80.0	77.5	79.5	79.5	80.0

\*seasonally adjusted \*\* actual=average, forecast=end of period