February 2008

Forecast for the Japanese Economy in Fiscal 2008 and 2009

— We Work and Work but Our Lives Do Not Seem to Get Any Easier —

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1. Outlook for the Japanese Economy in Fiscal 2008 and Fiscal 2009 -- We Work and Work but Our Lives Do Not Seem to Get Any Easier

(1) Current State of the Economy

Concern about future trends is rising, but the economy is continuing to expand at a moderate pace. According to gross domestic product (GDP) data for the October-December quarter of 2007, announced on February 14, the economy expanded 0.9% in real terms over the previous quarter (at an annualized rate of 3.7%) and 0.3% in nominal terms (an annualized rate of 1.2%, for the second consecutive quarter of positive growth. These figures represented relatively high growth, exceeding market expectations.

By domestic and external components of demand, the contribution of the external sector rose to 0.4% (figures are in real terms here and hereinafter), thus continuing to make a positive contribution to growth. Although exports to the United States, where the economy is decelerating, showed weak growth, exports to China and other emerging economies as well as to the Middle East and other resource-producing countries remained robust. As a result, exports overall expanded 2.9% over the previous quarter. In parallel with this, the contribution of the domestic economy rose to 0.5%, the first positive contribution in three quarters, resulting in a good balance between contributions from internal and external demand.

The principal driver of expansion in domestic demand was private capital investment, which increased a high 2.9% over the previous quarter. According to the Bank of Japan’s quarterly economic survey of short-term expectations of the corporate sector (Tankan) and other sources, although companies indicated that they planned to increase private capital investment in fiscal 2007, actual investment outlays slowed after the beginning of 2007. Up to the present, the sharp rise in crude oil prices has resulted in a deterioration in the profitability environment, and the implementation of revisions in the building code in Japan has slowed the pace of construction starts. Although these circumstances should have represented additional negative factors for private capital investment, in fact, capital investment now is proceeding according to plan.

Personal consumption, the largest component of GDP, remained on a rising trend, expanding 0.2% over the previous quarter, but the pace of expansion is slow because of the weakness in income growth. In addition, slight rises in prices are restraining increases in real consumption, which expanded more slowly than the 0.4% rise in consumption in nominal terms. Private residential investment fell 9.1% for the quarter, the fourth consecutive quarterly decline, reflecting the substantial drop in the number of housing starts, owing to the effects of the implementation of revisions in the building code. The margin of decline in residential investment in Japan has been larger than that in the United States, where housing construction has been adversely affected by the subprime loan issue, for two consecutive quarters.

In the government sector, public works investment continued to decline, dropping 0.7% from the previous quarter, but the margin of decline is shrinking. Also, government final consumption expenditures remained on a rising trend, increasing 0.8% from the previous quarter, thus bringing the first rise in total public-sector demand in three quarters.

The margin of decline in the GDP deflator, compared with the same quarter of the previous year, expanded to 1.3%, influenced by the increase in import prices, which are an item deducted in calculating the deflator, owing to the rise in crude oil prices. However, the domestic demand deflator, after excluding exports and import prices, was up slightly 0.1%. Although marginal, this was the first increase in five quarters, suggesting mounting pressures on domestic prices.

(2) Outlook for Fiscal 2008 and Fiscal 2009

In fiscal 2007, exports to the emerging economies as well as resource-producing nations, and certain other destinations, other than the United States, were rising. The outlook is that, when data for fiscal 2007 is released, this will have resulted in real growth of 1.6% in real terms and 0.8% in nominal terms. The external sector is expected to have contributed

1.2%, thus accounting for more than 70% of real growth in fiscal 2007. On the other hand, domestic demand was relatively weak, contributing only 0.4%. As a result, the rate of expansion in the economy will drop below the 2% growth path that had continued since fiscal 2003. The principal factor leading to weakness in domestic demand in fiscal 2007 was the sharp drop in residential investment resulting from the implementation of revisions in the building code. Private residential investment during the fiscal year fell a steep 14.3% from the previous year, thus lowering the growth rate by 0.5 percentage point. In addition, although private capital investment began to increase again in the latter half of the fiscal year, the deceleration in the first half resulted in a low 1.9% growth for the year as a whole, which represented a marked drop from 5.7% growth in fiscal 2006. Personal consumption in fiscal 2007 continued on an expansionary trend and provided underlying support for the economy, but growth for the year is expected to be 1.2%, below the 1.7% growth recorded in fiscal 2006, because of sluggish growth in incomes and the deterioration in consumer psychology stemming from concern about inflation.

In fiscal 2008 also, concern about future trends in the economy is expected to continue, influenced by the subprime loan issue, the rise in crude oil prices, and other factors. Nevertheless, a moderate expansionary trend is expected to continue. We are forecasting 1.9% growth in real terms, which will be the seventh consecutive year of positive growth. Also, in nominal terms, we expect 1.9% growth, which will mark the sixth consecutive year of positive expansion.

In the U.S. economy, which is slowing primarily because of the precipitous decline in private residential investment, we are looking for relatively low growth for the first half of 2008. However, firm trends in consumer spending and capital investment are expected to continue, thus averting a downturn in the economy. In the latter half of 2008, we are forecasting that the pace of decline in private residential investment will become more moderate and that overall economic growth will accelerate. We are looking for 1.8% real growth in 2008, a decline from the 2.2% expansion recorded in 2007. Growth in Europe and China, which was high in 2007, is expected to slow in 2008. Although the world economy is likely to move from the highest level of growth in the past 30 years to lower growth, we are looking for a continuation of an expansionary trend.

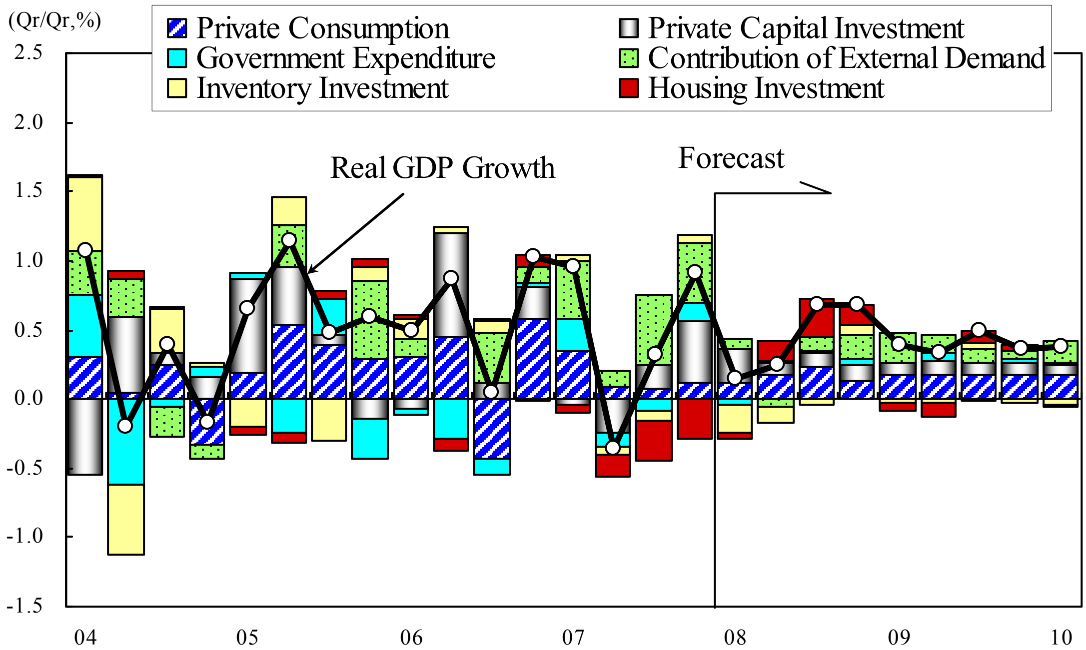
Since this will mean the continuation of conditions favoring growth in Japan's exports, we expect that the level of production will continue to rise gradually with some pauses in growth along the way. Though the profitability environment will become more challenging because of the increase in crude oil prices, we are forecasting that private capital investment will remain on an upward trend. As a result of the implementation of revisions in the building code, orders for private non-residential construction have fallen sharply, and this may temporarily restrain investment outlays related to the construction of industrial plants and commercial facilities. However, machinery orders, which are the forward indicator for machinery investment, remain firm, and thus the impact of the revisions in the building code on capital investment as a whole will be limited.

Reflecting the tightening of the supply and demand balance for labor, wages are expected to rise slightly, bringing a moderate rising trend in consumption. However, increases in prices will reduce real incomes, resulting in limited real growth in consumer spending in fiscal 2008 as in fiscal 2007. Private residential investment, which dropped substantially in fiscal 2007, is expected to bottom out as the confusion created by the implementation of revisions in the building code subsides. However, rising home prices are dampening the desire for purchasing housing, and it will be difficult for residential investment to return to levels prevailing in early 2007. For these reasons, although housing investment will rise, this is expected to result in a relatively small increase in comparison with the major declines experienced in the previous year.

In fiscal 2009, the factors that caused confusion previously, such as the subprime loan issue and the impact of building code revisions, as well as the reactions to these developments, are expected to subside. However, major changes in the growth potential of the Japanese economy are not expected, and we are forecasting real growth in fiscal 2009 of 1.8% and nominal growth of 1.7%. Although the world economy will experience slower growth in comparison with the period through 2007, it will continue to expand, and Japan's exports will continue to rise. The growth mechanism, which has been the driving force behind Japan's exports, will remain in place, namely: Increases in production → Improvement in corporate profitability → Expansion in capital investment.

Thus, consumer spending will rise along with growth in incomes. However, the momentum of growth will not be strong, and the rise in crude oil prices will be a factor restraining corporate profitability. Within this challenging profitability environment, the pace of growth in capital investment will become more moderate. In addition, the rate of growth in consumer spending will remain weak. It is possible that wages may rise to compensate for the increase in consumer prices, thus resulting in higher wages in nominal terms. However, raising wages in real terms will remain difficult, and, so long as consumer prices continue to increase, growth in real consumption will be marginal.

Exhibit 1: Real GDP Growth (seasonally adjusted)



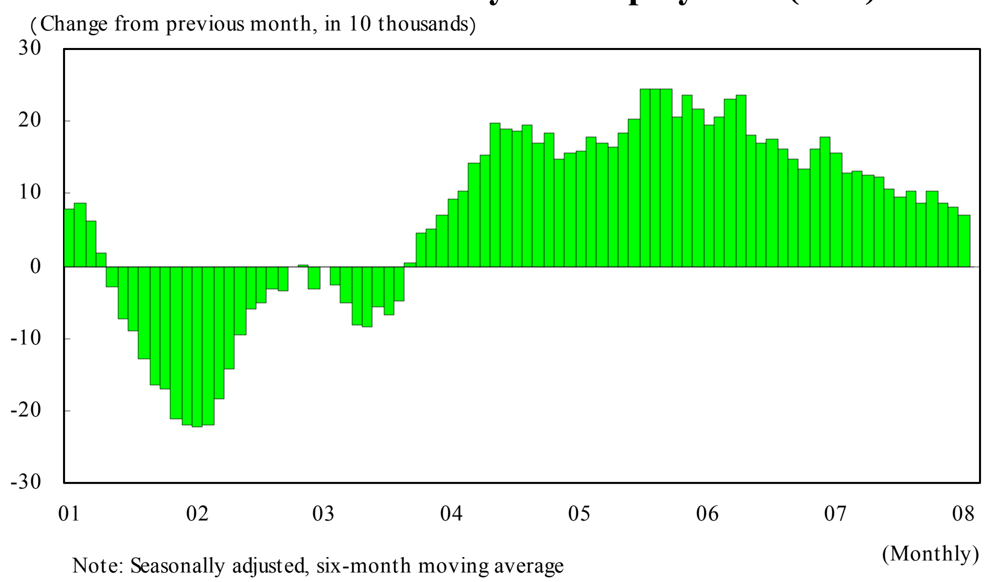
Source: Cabinet Office "Annual of National Accounts"

(3) We Work and Work but Our Lives Do Not Seem to Get Any Easier

(a) World Economy to Slow

Opinions about future economic trends are extremely gloomy. The views that the turmoil created in world financial markets by the subprime loan issue has finally spread to the real economy in the United States and that recession there is unavoidable have grown stronger. Certainly, the U.S. economy is slowing. The major decline in private residential investment that began in the April-June quarter of 2006 is continuing, and the margin of increase in non-agricultural employment, which peaked at the beginning of 2006, is shrinking (Exhibit 2). However, the important point is not just that the subprime loan issue is simply resulting in lower housing investment but that consumer spending and capital investment may decelerate because of the reverse wealth effect and credit contraction that the subprime loan issue may cause.

Exhibit 2: Nonfarm Payroll Employment (U.S.)

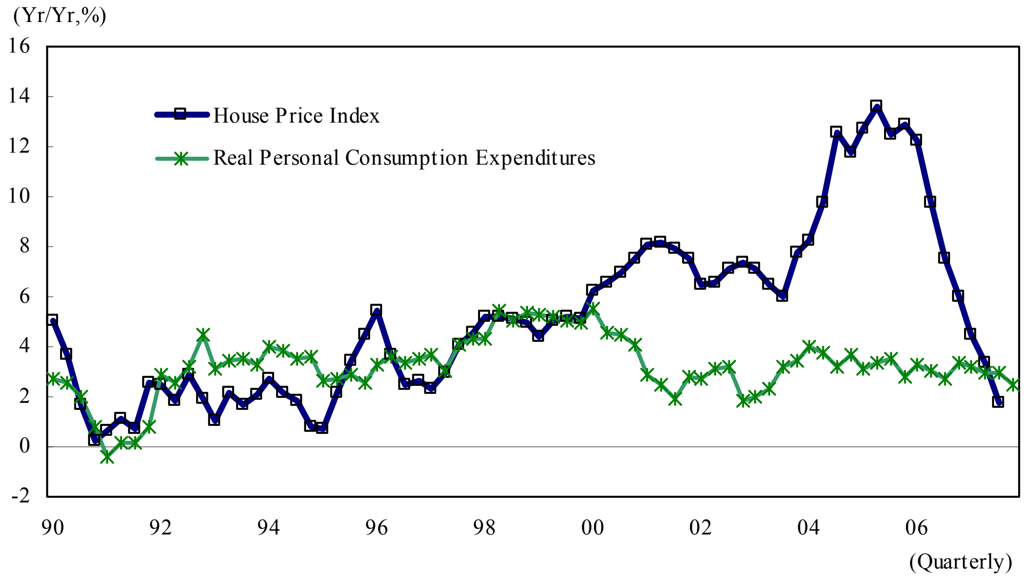


Note: Seasonally adjusted, six-month moving average
Source: U.S. Department of Labor

The losses of financial institutions in the United States are still on the rise, and their lending policies are becoming increasingly cautious. In addition, the gap between yields on corporate bonds and U.S. Treasury bonds (the credit spread) is growing larger, and it appears that fund-raising in capital markets is become more difficult. However, notwithstanding these developments, capital investment is still expanding. This means that even though obstacles to funding may be greater because of the credit contraction, companies are not being held back from making capital investments.

Although concern about consumer spending in the United States is rising because of lackluster sales during the 2007 Christmas season and other factors, in actuality, consumption is fairly stable. Exhibit 3 shows a comparison of trends in year-on-year rates of change in U.S. consumer spending and housing prices. The rate of increase in housing prices in the United States began to climb around the end of 2003, when the housing boom was still continuing, but the rate of increase dropped sharply after the boom reached a peak in 2005 and then came to an end in 2006 and thereafter. Over this period, consumer spending did not become more active along with the rise in housing prices nor did consumption stagnate when the rate of increase in housing prices began to shrink. Instead, consumer spending experienced continued stable expansion over this period.

Exhibit 3: Housing Prices and Personal Consumption Expenditures



Source: Office of Federal Housing Enterprise Oversight(OFHEO), U.S. Department of Commerce

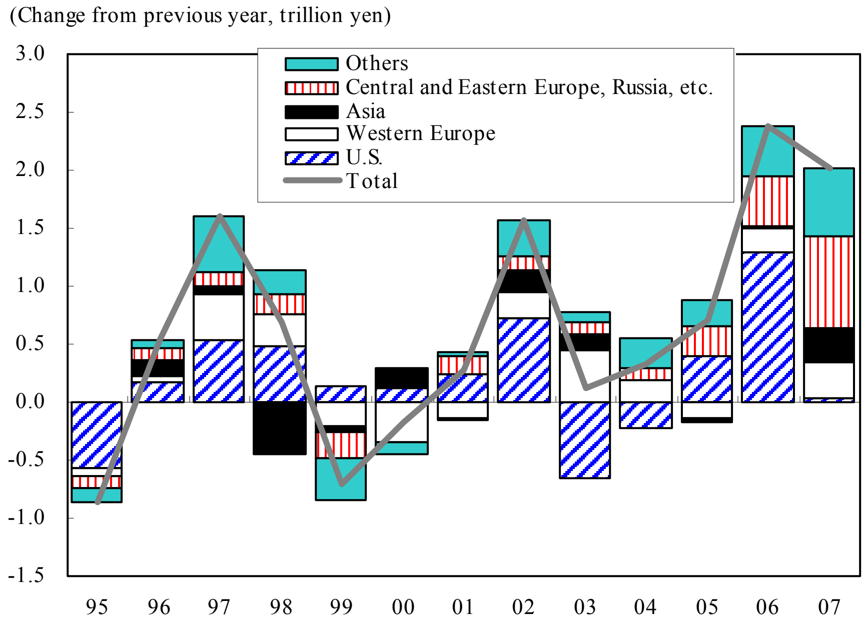
Instead of the asset effect stemming from the rising value of housing and stocks held by individuals acting to expand consumption, consumers expanded their sources of borrowings, and this seems likely to have supported stable expansion in their spending. Since stagnation in the housing market is likely to continue for some time, housing prices may drop going forward. In that case, obtaining loans based on asset collateral will become more difficult, and this may have a negative impact on consumption. However, even then, we believe it is reasonable to question whether the negative wealth effect resulting from declines in asset prices will necessarily bring a major decline in consumer spending.

If consumer spending and capital investment remain firm, it is likely that the U.S. economy will avoid the risk of a downturn. However, as the trends in employment shown in Exhibit 2 suggest, the deceleration in the U.S. economy is continuing, thus giving rise to the possibility that the growth mechanism in the world economy that has prevailed for about 10 years may be changing. This mechanism is based on expansion in consumption in the U.S. economy and expansion in the U.S. current account trade deficit, combined with growth in exports from other countries. If this happens, the deceleration in the U.S. economy will become a factor acting to slow growth in the world economy, and it will be important to be aware of the risks this may create.

Will the impact on the Japanese economy increase as growth in the world economy drops substantially along with the deceleration in the U.S. economy? Recently, assessments of “decoupling”—the idea which holds that even if the U.S. economy decelerates, growth in the emerging economies and resource-producing countries will continue and expansion in the world economy will also continue—have not been very favorable. Of course, as the mutual dependency of countries around the world has grown as a result of trade and capital transactions, the economies of the United States and other countries have not been completely independent from one another. However, this does not mean that the world economy must be 100% linked to the deceleration of the U.S. economy.

Even if Japan’s exports to the United States are stagnant on the one hand, exports to China and other emerging economies, Russia, and resource-producing countries in the Middle East and elsewhere may experience major expansion. Exhibit 4 provides a glimpse of automobile exports from Japan and the breakdown of export destinations by country and region. Previously, in many cases, expansion in automobile exports from Japan was supported by exports to the U.S. market. In 2006, for example, more than 50% of the growth in Japan's automobile exports was accounted for by expansion in exports to the United States. However, in 2007, when the overall amount of export growth was similar to growth in 2006, exports to the U.S. market were level, while growth in exports to the Middle East and Russia accounted for more than one-third of the rise in Japan's automobile exports. In addition to this, exports to Asia, Latin America, Australia, and other markets contributed to the expansion in Japan's overall automobile exports. At present at least, it is clear that the so-called decoupling phenomenon is contributing to the growth in the Japanese economy. It would overly optimistic to assume that this will continue indefinitely, but would it not also be overly pessimistic to think that these trade flows will cease abruptly in 2008?

Exhibit 4: Japan's Export of Motor Vehicles by Area (Country)

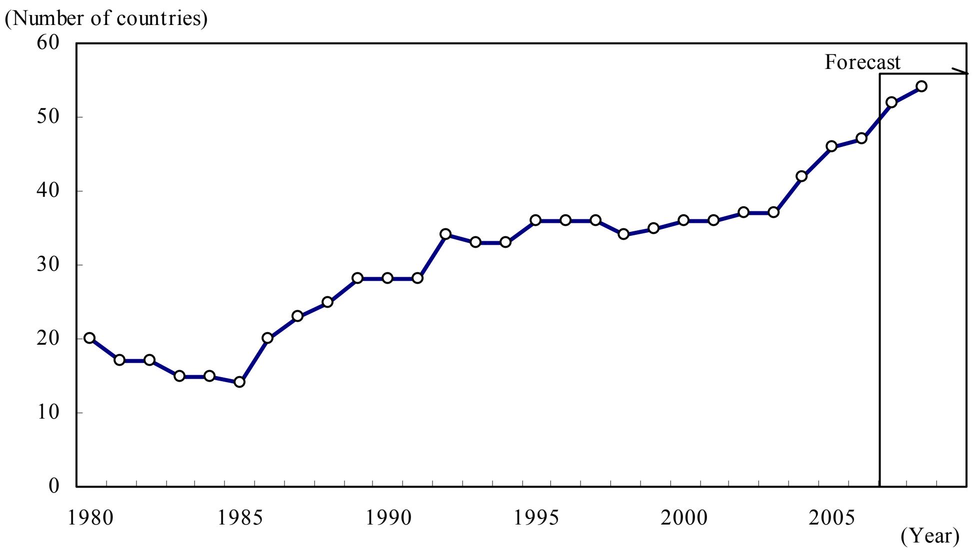


Note: Asia comprises of China and NIEs, ASEAN

Source: Ministry of Finance "Trade Statistics of Japan"

The background for decoupling includes the slowdown in the U.S. economy, and, at the same time, growth in other countries. The rapid growth in world demand for automobiles is a result of the fact that the peoples of many countries can now afford to purchase automobiles, whereas, in the past it was difficult for any but the people of advanced countries to buy vehicles. A rough guide for the level of nominal GDP per capita that countries must have to be classified as "developed" is US$10,000. In 1985, there were 14 countries that could be classified as developed, but in 2006, the number had increased to 47. There is a possibility that in 2007 more than 50 countries, or about 30% of the world's 180 countries and regions, may have passed over the qualifying line for membership in the "US$10,000 club" (Exhibit 5). Although it may be difficult to make such simple comparisons, since price levels have changed over the past 20 years, if one of the factors behind decoupling is the structural shift in the world economy represented by the movement of more and more people into the middle classes, it is reasonable to believe that the impact of the deceleration in the U.S. economy on the world economy as a whole may be more moderate than in the past.

Exhibit 5: The Number of Countries Whose per Capita GDP Are over 10 Thousand Dollars



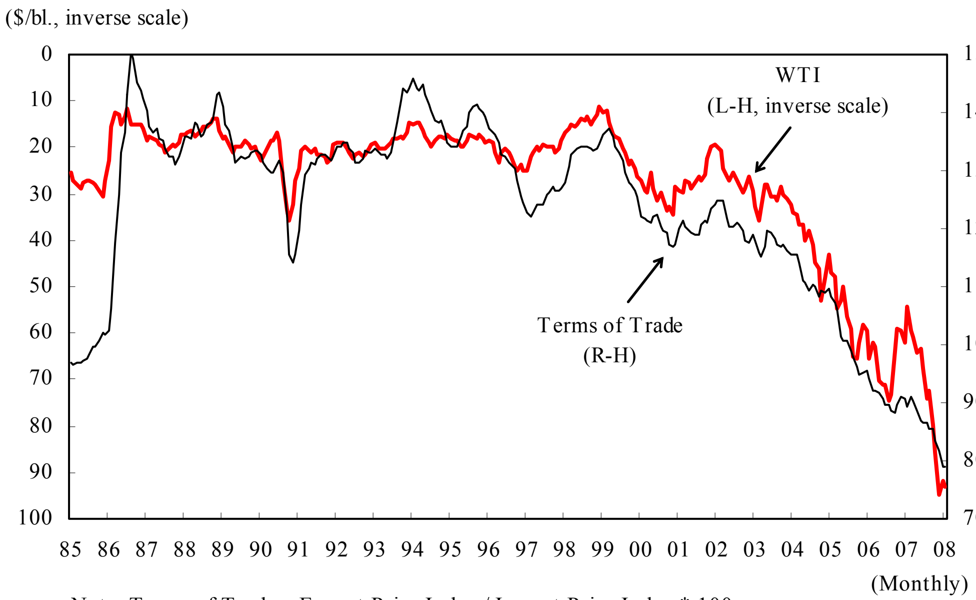
Note: Based on current prices. Forecast for 2007 and 2008 are derived from IMF.
Source: IMF

(b) Terms of Trade Continue to Deteriorate

If the subprime loan issue does not bring a downturn in the U.S. economy and the slowdown in the world economy is not severe, the growth mechanism of the Japanese economy that is driven by exports is likely to be sustainable. Our forecast this time calls for a continuation of real growth of slightly less than 2% in fiscal 2008 and fiscal 2009. However, even if the Japanese economy expands at a rate comparable to its latent growth potential, it will be more difficult for companies to generate profits.

For the Japanese economy, which is dependent on imports of raw materials, the increase in crude oil and other raw material prices implies a shift of income from Japan to overseas economies. Even if crude oil and other raw material prices increase, it is difficult for Japan to use these materials as inputs and then raise the export prices of the goods it produces, and, as a result, the terms of trade (measured by the export price index divided by the import price index) deteriorate. Since 1999, when crude oil prices began to rise again, Japan's terms of trade have continued to deteriorate, and have now fallen to lower levels than at any time previously (Exhibit 6). When the terms of trade deteriorate, Japanese goods can be purchased more cheaply by overseas buyers, and Japanese companies are obliged to buy imports at a high price. If we work out the implications for the flow of

Exhibit 6: WTI and Japan's Terms of Trade

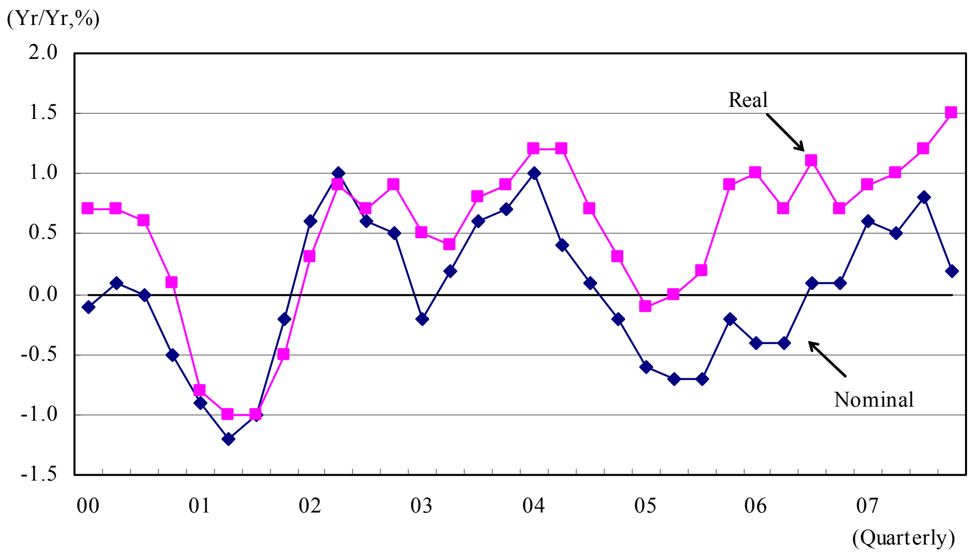


Note: Terms of Trade = Export Price Index / Import Price Index * 100
Source: Bank of Japan "Price Indexes Monthly"

goods, in order for Japan to import the same volume of goods, it must export a higher volume of goods.

The growth of the Japanese economy has been described as export-led. In fact, in real terms, external demand accounts for a significant portion of economic growth. However, beginning about 2003, when the deterioration in Japan's terms of trade began to accelerate, contribution of the external sector in nominal terms fell substantially below the contribution in real terms. Then, beginning around 2004, if we average the nominal contribution of external demand, it is virtually zero. In other words, the nominal surplus is not growing (Exhibit 7). When the nominal surplus is not growing, this means that even if exports increase, this is offset by increases in imports, and we cannot make money from exporting.

Exhibit 7: Net Export's Contribution to GDP Growth

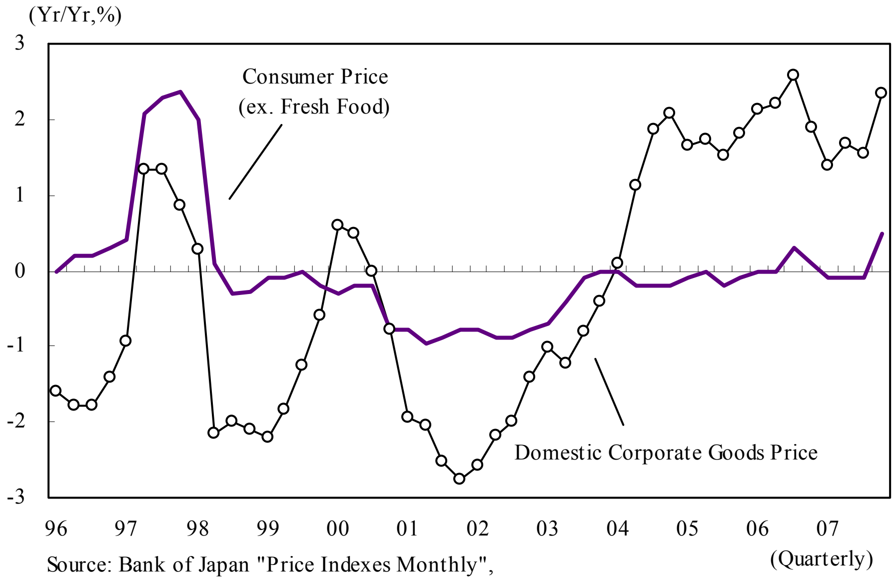


Source: Cabinet Office "Quarterly Estimates of GDP"

For corporations, the deterioration in the terms of trade means that generating profits is difficult because the increase in raw material prices brings higher variable costs, thereby lowering the rate of marginal profit ((sales - variable costs)/sales). Even if the rate of marginal profit declines, provided sales expand, it is possible to increase profits, but if the world economy slows, generating profits through increases in sales will become more difficult.

In the domestic market also, companies have been confronting conditions that make it difficult to generate profits. As a result of increases in raw material prices, domestic corporate goods prices that are located upstream in the production chain have continued to rise along with increases in raw material prices. On the other hand, downstream prices to consumers have continued to fall by small margins (Exhibit 8). In other words, this inflation upstream and deflation downstream have made it difficult for companies to sustain their margins, and continuing to generate profits has become difficult.

Exhibit 8: Domestic Corporate Goods Price and Consumer Price

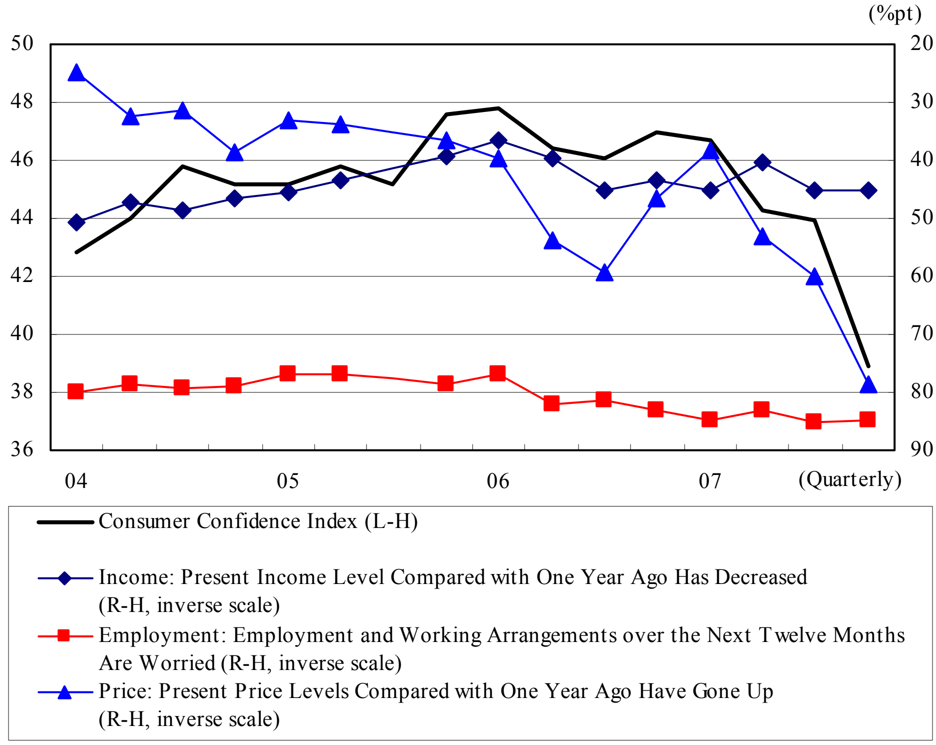


Source: Bank of Japan "Price Indexes Monthly",
Statistics Bureau "Monthly Report on the Consumer Price Index"

(c) Environment for Households to Deteriorate Significantly

As the environment for generating profits has become more difficult for corporations, companies have finally been obliged to reflect their higher costs in their sales prices, resulting in higher consumer prices. If consumer prices rise when incomes are not rising, it is not surprising that consumers tend to lose the drive to consume. Certainly, consumer psychology has taken a turn for the worse. The survey of consumer attitudes issued by Japan's Cabinet Office shows a rapid deterioration in 2007. Using the surveys of consumer awareness issued by the Bank of Japan, we made a comparison (Exhibit 9) of the percentage of persons responding "my income is lower than it was a year ago," the percentage of persons responding "I am significantly concerned/somewhat concerned about being employed one year from now," and the percentage of persons responding "I believe prices have risen significantly/somewhat compared with a year ago." According to the results of this comparison, although consumer psychology had been improving in previous years because of the bottoming out of conditions in the income environment and the subsiding of anxieties about employment security, in 2007, consumer psychology took a turn for the worse along with rising concern about inflation.

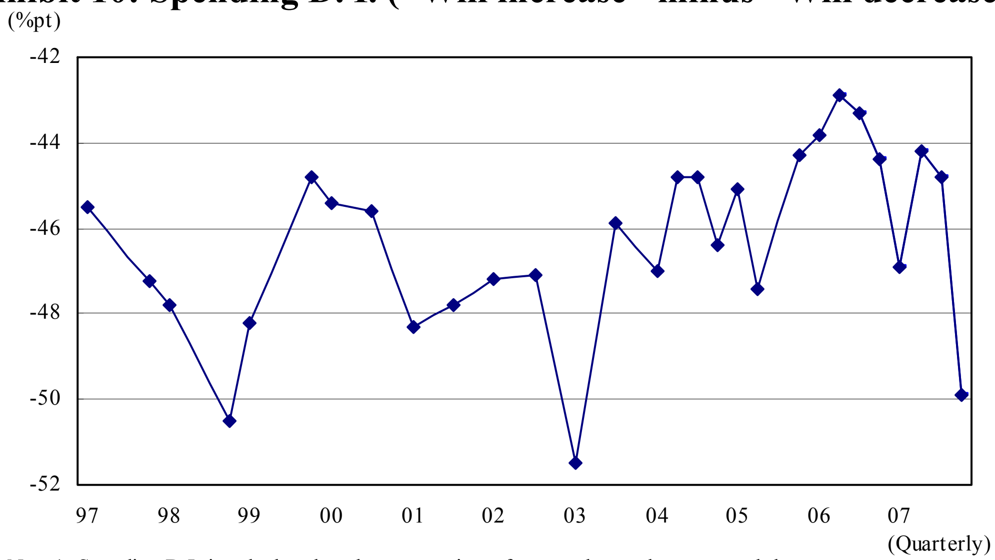
Exhibit 9: Fear of Inflation Depressed Consumer Confidence



Note: Due to change in survey methods, there are statistical gaps before and after the June 2006 survey, but those gaps are adjusted on the graph above.
Source: Bank of Japan "Opinion Survey on the General Public's Views and Behavior", Cabinet Office "Consumer Confidence Survey"

Since increases in prices will cut into real incomes, this may lead consumers to become more cautious about spending. We also used the Bank of Japan's surveys of consumer awareness to compare the percentage of persons who responded "will increase" versus those replying "will decrease" to questions regarding their current spending and spending one year into the future. We subtracted the number of "decrease" responses from the number of “increase” responses to calculate a diffusion index (DI). We found that the percentage of “decrease” responses was expanding and that consumers are becoming more cautious about spending (Exhibit 10).

Exhibit 10: Spending D. I. ("Will increase" minus "Will decrease")



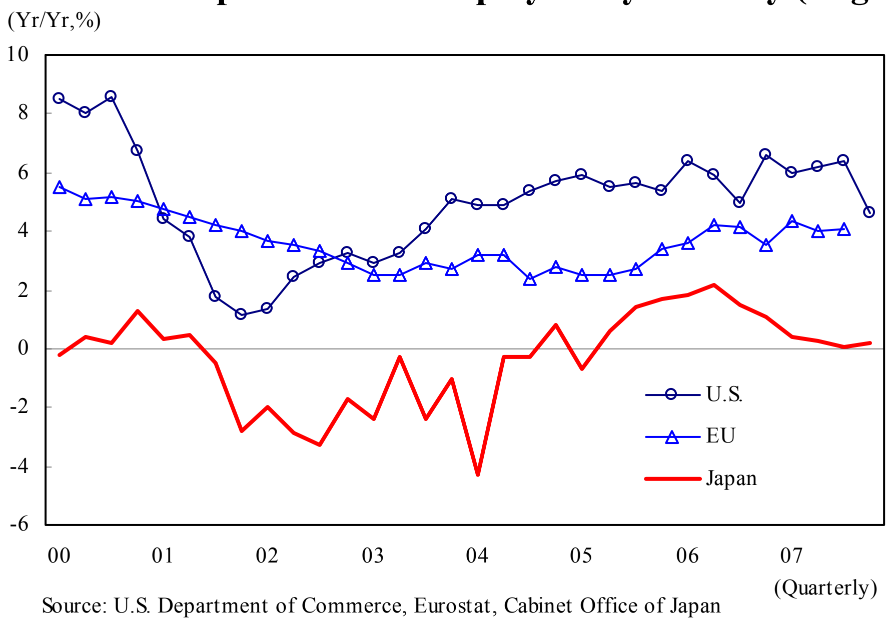
Note1: Spending D.I. is calculated as the proportion of respondents who answered that their spending level one year from now compared with the present "will increase" minus the propotion of those who answered that they "will decrease".

Note2: Due to change in survey methods, there are statistical gaps before and after the June 2006 survey, but those gaps are adjusted on the graph above.

Source: Bank of Japan "Opinion Survey on the General Public's Views and Behavior"

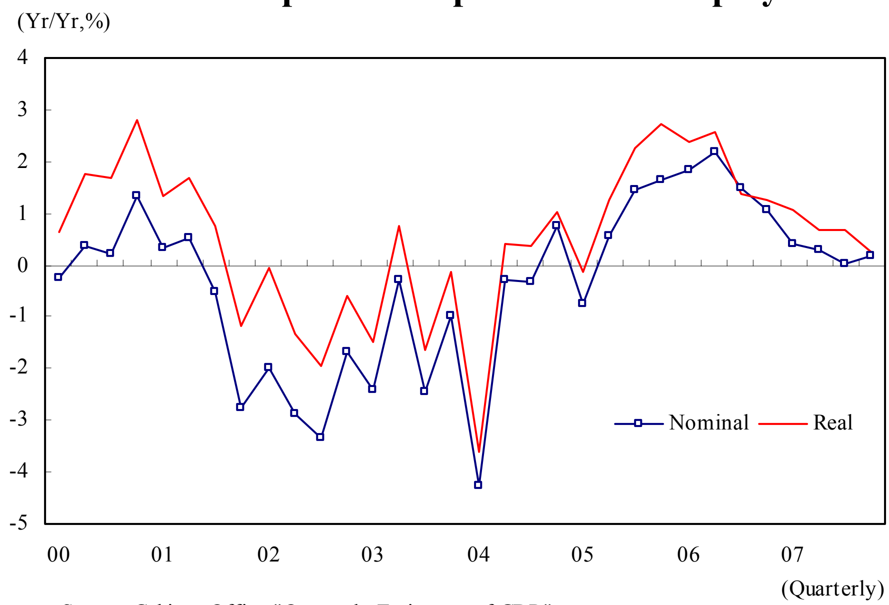
Caution about consumption because of rising prices is likely to be exacerbated in an environment where incomes are not increasing. On the one hand, growth in the number of employed persons is only moderate and, on the other, the per capita wage is continuing to decline. Together, these two trends are resulting in overall employment income that is virtually unchanged from the previous year. The lack of growth in employment incomes is quite pronounced in comparison with the United States and Europe (Exhibit 11). Previously, Japan was experiencing deflation and this reduced the difference, compared with the United States and Europe, in real terms of employment income, but the weak growth in Japan’s employment income still remains pronounced. Also, since Japan’s previous deflationary trends have become inflationary, price trends will no longer push Japan’s employment income upward in real terms (Exhibit 12). Consumers seem to have sensed these trends, and this has resulted in a sudden deterioration in consumer confidence.

Exhibit 11: Compensation of Employees by Country (Region)



Source: U.S. Department of Commerce, Eurostat, Cabinet Office of Japan

Exhibit 12: Japan's Compensation of Employees



Source: Cabinet Office "Quarterly Estimates of GDP"

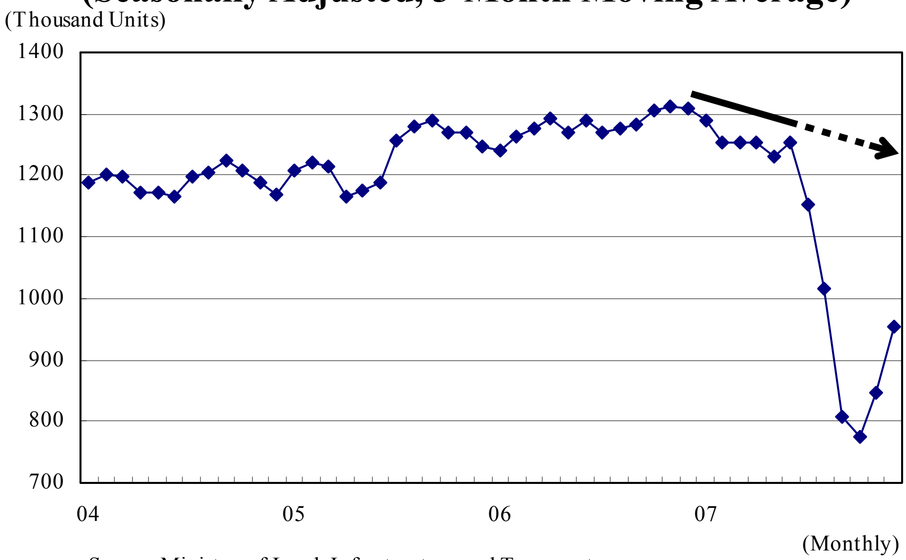
(d) Housing Market Activity Gradually Returns to More Normal Levels

As a result of the revision in the building code in June 2007, there was a sharp drop in housing starts in the July-September quarter, but since October, unit housing starts, including owner-built homes, have returned to prior levels and total housing starts also are gradually bottoming out. In 2008, the restraining effect of the housing code revision is expected to subside, as processing of confirmation documents for condominium apartments and large-scale construction developments returns to normal, implying that the effect of building code changes on housing construction will have been temporary.

Nevertheless, the pace of housing starts was slowing even prior to the implementation of revisions in the housing code. As a result of higher land prices and rising costs of construction, prices of housing were on the increase, and the drive to purchase homes was diminishing. In addition, the feeling that housing prices and interest rates might rise going forward had also diminished, compared with the past, and the mood that formerly encouraged people to purchase housing as quickly as possible had also subsided. Moreover, the movement among the children of the baby-boom generation to purchase their first homes had run its course.

In other words, the substantial drop in housing starts after July 2007 was without doubt due largely to the confusion created by housing code revisions, but, at the same time, another contributing factor was the decline in the actual level of underlying demand in the housing market (Exhibit 13). The effects of building code revisions are subsiding, but starts in the October-December quarter of 2007 were still below those of the previous

Exhibit 13: New Housing Starts
(Seasonally Adjusted, 3-Month Moving Average)



Source: Ministry of Land, Infrastructure and Transport year. Taking account of the adjustments now ongoing in the market for condominium sales, it may be rather difficult for housing starts to return to the levels prevailing in early 2007, but, in fiscal 2008 and beyond, housing starts are forecast to return to about 1.1 million units on an annual basis.

(e) We Work and Work but Our Lives Do Not Seem to Get Any Easier

The problem drawing the most attention at present in forecasting the economy is the subprime loan issue. This issue has spread risks and created turbulence in the world's financial markets that no one has experienced previously and is clouding the outlook for future economic trends. Certainly, we cannot take our eyes off the repercussions of the subprime loan problem, but this is only one of the risks that may have an influence on the Japanese economy going forward. Therefore, we cannot focus just on the subprime loan issue.

We believe that other than the subprime loan issue, there may be spreading risks related to future trends in the Japanese economy. The run-up in crude oil costs and other raw material prices is leading to deterioration in Japan's terms of trade and an outflow of income from Japan to countries overseas. We have been confronting the problem of who is going to bear this burden for some time. As the world economy has experienced the highest growth in the past 30 years, Japan may have been able to recover some of this income that has been transferred overseas through expansion in its exports, but, along with the slowdown in the world economy, the issue of how to deal with the burden resulting from the deterioration in Japan's terms of trade has come to the fore.

First, companies will face growing difficulty in remaining profitable as their marginal profit ratios decline. Even if they transfer their burden to consumers in desperation through increases in prices, this will only increase the burden on consumers. The decline in real incomes resulting from rising consumer prices will cast a dark shadow on future trends in consumer spending. This change is already becoming apparent in residential investment, and the desire among households for purchasing homes is receding.

A deterioration in a country's terms of trade means that its purchasing power is lowered. Companies will find it more difficult to generate profits, and real income of consumers will not increase. Increasingly, the feeling that "we work and work but our lives do not seem to get any easier" will gradually spread. The question in our minds is whether this feeling represents a major risk for the future of the Japanese economy. The pessimistic mood stemming from the subprime loan issue is becoming stronger, and, even after we overcome the challenges that fiscal 2008 will bring, we believe the Japanese economy will still face tough going.

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, especially private capital investment. Along with expansion in shipments, inventory levels are also rising, but companies are adopting a cautious stance toward increasing inventories, and the pace of expansion in inventories is moderate.
- 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 uptrend 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 uptrend.

- 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 Japan's bubble economy and the IT boom and is continuing to set new records. 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 rising depreciation charges, companies have still been able to report increases in profits because of gains in sales in Japan and overseas, including expanding exports. However, as costs continue to rise, the inability of companies to pass these higher costs on to the prices of goods is placing pressure on corporate profitability and leading to shrinkage in incremental profits.

(2) Households

- Household incomes are continuing to recover, but the pace of improvement is gradual, and the positive benefits of economic expansion are still not 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.
- Along with the continuation of the economic recovery plus the retirement of a substantial number of the members of the baby-boom generation and the decline in the number of younger workers, the employment environment has improved. Going forward, the population of labor force age individuals and the number of persons employed will reach a ceiling, and improvement in employment conditions is expected to continue at a moderate pace.
- Corporations are continuing to exercise restraint in raising employee compensation, but wages, which have shown little increase for some time, are expected to begin to rise marginally, reflecting the increasingly tighter supply conditions in labor markets and the rising margin of increases in consumer prices. As incomes expand moderately, consumer spending is also expected to show moderate increases.

- Regarding residential investment, although the sons and daughters of the baby-boom generation are now purchasing their first homes, a number of factors are expected to restrain growth in housing investment in the years ahead. These include the continued slowing of growth in the number of households in the medium term, the delays in the number of housing starts caused by the implementation of revisions in Japan's building code in June 2007, and higher prices of homes because of increasing land prices in urban areas.

(3) Government

- Following the bursting of Japan's economic bubble, the public sector has continued to issue a large volume of government bonds. Along with the decline in nominal economic growth rates, the government made major reductions in taxes that results 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 economy in the 1990s, expenditures for public works increased.
- After 2000, because of the government's goal of making structural reforms in its finances, spending on public works was reduced and no major spending programs to stimulate the economy were implemented. Moreover, local governments have also continued to reduce their spending on public works because of their own financial difficulties. Along with the economic recovery, tax revenues have expanded, but the government has basically continued policies for making structural reforms in government finances. Accordingly, on an annual basis, further cuts in public-works spending are expected to continue 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. In addition, the administration of Prime Minister Yasuo Fukuda appears to be moving

backward on some reforms. We anticipate that the government's 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 mounting that Japan may not be able to sustain necessary social capital, if cuts in public-works investments continue. 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. However, uncertainty about future trends is growing because of the expanding scope of problems related to the U.S. subprime loan issue, and the world economy may experience a temporary slowdown. In addition, other causes for concern include the overheating of 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.
- Even if a temporary slowdown occurs, the world economy is expected to continue to expand, and the rising trend in Japan's exports will continue. The expansion in the overseas production of Japanese companies will be one factor restraining exports, but we are forecasting that demand for Japan's exports will expand because of growth in worldwide demand for automobiles, high rates of growth in the emerging economies and resource-producing nations, and expanding demand for electronic parts, principally in the rest of Asia.
- Japan's imports of products and parts, mainly from the rest of Asia, will continue to increase. Although growth in Japan's domestic demand will be moderate, production capacity in China and other emerging economies will expand rapidly, and Japanese companies will proceed with their strategies of the international division of production. In

addition, plateauing of the prices of primary products at high levels will push the value of imports upward.

- We are looking for continued growth in both Japan's 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 overseas 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 goods prices are increasing on the one hand, consumer prices, while now beginning to rise, are only slightly above the levels of the previous year.
- 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. However, as a result of the turbulence in financial markets created by the subprime loan issue, policy interest rates have been left unchanged. When the current turbulence subsides, we believe further slight increases in interest rates will resume.
- When the problems in financial markets arising from the subprime loan

issue quiet down, long-term interest rates are expected to rise moderately along with the economic recovery and the resumption of increases in policy interest rates. Stock prices appear to be relatively undervalued, but when financial markets regain stability, we expect they will rise. In foreign exchange markets, the yen has not appreciated significantly, despite the expansion in Japan's trade surplus. 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. As a result of the recent substantial reductions in U.S. interest rates and market instability, foreign exchange markets have temporarily experienced major fluctuations; however, there are no major differences among economic trends in Japan, the United States, and Europe, and we believe relative stability will continue.

Exhibit 14: Outlook for Fiscal 2007-2009

Forecast

Yr/Yr、%

	FY2005 (actual)	FY2006 (actual)	FY2007 (forecast)	FY2008 (forecast)	FY2009 (forecast)
Nominal GDP	1.1	1.6	0.8	1.9	1.7
Real GDP	2.4	2.4	1.6	1.9	1.8
Contribution of domestic demand	1.9	1.6	0.4	1.3	1.3
Private consumption	2.0	1.7	1.2	1.1	1.3
Housing investment	-1.2	0.2	-14.3	5.4	2.5
Private capital investment	6.7	5.7	1.9	4.3	2.2
Contribution of inventory investment	0.0	0.2	-0.1	-0.3	0.0
Government expenditure	-0.6	-1.8	0.2	0.3	0.4
Public investment	-5.6	-9.1	-3.2	-3.0	-2.8
Government final consumption expenditure	0.8	0.1	1.0	1.0	1.1
Contribution of external demand	0.5	0.8	1.2	0.6	0.6
Export of goods and services	9.0	8.4	8.7	5.6	6.5
Import of goods and services	5.9	3.1	1.3	2.7	3.9
GDP deflator	-1.3	-0.8	-0.8	0.0	-0.1

Forecast

Yr/Yr、%

	FY2005 (actual)	FY2006 (actual)	FY2007 (forecast)	FY2008 (forecast)	FY2009 (forecast)
Current account balance (trillion yen)	19.1	21.2	25.7	28.2	28.5
balance on goods (trillion yen)	9.6	10.5	12.3	12.8	11.4
balance on service (trillion yen)	-2.2	-2.3	-2.3	-1.8	-1.6
balance on income (trillion yen)	12.6	14.2	16.8	18.4	19.9
Industrial production	1.6	4.8	2.5	1.5	2.4
Unemployment rate(%)	4.4	4.1	3.8	3.8	3.8
New housing starts(annualized, ten thousand units)	124.9	128.5	101.9	112.4	115.3
Corporate goods prices	3.4	3.2	2.6	0.9	2.4
Domestic corporate goods prices	1.8	2.0	2.1	1.4	1.4
Consumer prices	-0.3	0.3	0.2	0.7	0.7
excluding freshfood	-0.1	0.1	0.2	0.7	0.7
Yen/U.S.Dollar	113.3	116.9	114.7	106.9	111.3
Uncollateralized call rates (O/N) (%)*	0.001	0.220	0.500	0.750	1.000
Newly issued government bond yields (10years) (%)	1.43	1.77	1.62	1.60	1.80
WTI future price (near month contract, US dollar/barrel)	60.0	64.9	79.5	89.0	97.0
Dubai crude oil prices (US dollar/barrel)	53.7	60.9	75.0	84.3	92.9

* actual=average, forecast=end of period

Exhibit 15: Outlook for Calendar 2008-2009

Forecast

Yr/Yr、%

	CY2005 (actual)	CY2006 (actual)	CY2007 (actual)	CY2008 (forecast)	CY2009 (forecast)
Nominal GDP	0.7	1.4	1.3	1.4	1.9
Real GDP	1.9	2.4	2.1	1.6	1.9
Contribution of domestic demand	1.7	1.6	1.0	0.9	1.4
Private consumption	1.3	2.0	1.4	1.0	1.3
Housing investment	-1.5	0.9	-9.5	-4.2	6.4
Private capital investment	9.2	4.3	2.7	4.8	2.4
Contribution of inventory investment	-0.1	0.2	0.0	-0.3	0.0
Government expenditure	-0.9	-2.0	0.2	0.1	0.4
Public investment	-10.1	-8.1	-2.3	-4.7	-2.5
Government final consumption expenditure	1.6	-0.4	0.8	1.2	1.0
Contribution of external demand	0.3	0.8	1.2	0.7	0.5
Export of goods and services	7.0	9.7	8.8	5.9	6.4
Import of goods and services	5.8	4.2	1.7	1.8	3.9
GDP deflator	-1.2	-1.0	-0.7	-0.3	0.0

Forecast

Yr/Yr、%

	CY2005 (actual)	CY2006 (actual)	CY2007 (actual)	CY2008 (forecast)	CY2009 (forecast)
Current account balance (trillion yen)	18.3	19.8	25.0	27.6	28.3
balance on goods (trillion yen)	10.3	9.5	12.4	12.7	11.7
balance on service (trillion yen)	-2.6	-2.1	-2.3	-1.9	-1.7
balance on income (trillion yen)	11.4	13.7	16.3	17.9	19.4
Industrial production	1.1	4.8	2.7	1.6	2.3
Unemployment rate (%)	4.4	4.1	3.9	3.8	3.8
New housing starts(annualized, ten thousand units)	123.6	129.0	106.1	110.6	112.4
Corporate goods prices	2.9	3.6	2.5	1.2	2.2
Domestic corporate goods prices	1.7	2.2	1.7	2.0	1.3
Consumer prices	-0.3	0.2	0.0	0.7	0.7
excluding freshfood	-0.1	0.1	0.0	0.7	0.7
Yen/U.S.Dollar	110.2	116.3	117.8	106.4	110.5
Uncollateralized call rates (O/N) (%)*	0.001	0.125	0.493	0.750	1.000
Newly issued government bond yields (10years) (%)	1.38	1.74	1.68	1.54	1.78
WTI future price (near month contract, US dollar/barrel)	56.6	66.2	72.3	87.7	95.0
Dubai crude oil prices (US dollar/barrel)	49.5	61.6	68.4	82.9	90.8

* actual=average, forecast=end of period

Exhibit 16: Outlook for 2007-2009 (Quarterly)

Forecast (from FY2007 1-3)

Qr/Qr、%
Yr/Yr、%

	FY2007				FY2008				FY2009			
	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	-0.5	0.1	0.3	0.4	0.5	0.8	0.5	0.6	0.2	0.4	0.3	0.7
	1.2	1.1	0.7	0.3	1.2	1.9	2.1	2.4	2.0	1.7	1.5	1.7
Real GDP	-0.4	0.3	0.9	0.2	0.2	0.7	0.7	0.4	0.3	0.5	0.4	0.4
	1.7	1.7	2.0	1.2	1.6	2.0	1.7	2.0	2.1	1.9	1.6	1.6
Contribution of domestic demand (Qr/Qr,%)	-0.5	-0.2	0.5	0.1	0.3	0.6	0.5	0.2	0.2	0.4	0.3	0.2
Private consumption	0.2	0.1	0.2	0.2	0.3	0.4	0.2	0.3	0.3	0.3	0.3	0.3
	1.1	1.7	1.3	0.7	0.9	1.1	1.2	1.3	1.3	1.2	1.3	1.3
Housing investment	-4.4	-8.3	-9.1	-1.3	5.1	9.3	4.3	-1.6	-3.0	2.5	1.6	-0.5
	-2.8	-11.5	-21.5	-21.3	-13.4	3.1	18.2	18.0	8.9	2.1	-0.6	0.5
Private capital investment	-1.5	1.1	2.9	1.5	0.5	0.7	0.7	0.5	0.6	0.5	0.5	0.4
	0.3	0.5	2.4	4.1	6.1	5.6	3.6	2.5	2.5	2.3	2.2	2.0
Contribution of inventory investment (Qr/Qr,%)	-0.1	-0.1	0.1	-0.2	-0.1	0.0	0.1	0.0	0.0	0.1	0.0	0.0
Government expenditure	-0.4	-0.4	0.6	-0.2	0.1	0.0	0.2	0.0	0.2	0.0	0.1	0.1
	0.1	0.2	0.8	-0.2	0.3	0.6	0.0	0.3	0.6	0.5	0.2	0.4
Public investment	-4.2	-1.9	-0.7	-1.6	-0.4	-0.3	-0.5	-0.8	-0.7	-0.8	-0.9	-0.6
	-2.3	0.0	-1.7	-7.4	-4.8	-3.5	-2.8	-1.6	-2.4	-3.0	-3.1	-2.7
Government final consumption expenditure	0.3	0.1	0.8	0.2	0.1	0.2	0.2	0.3	0.3	0.3	0.2	0.3
	0.5	0.4	1.4	1.5	1.2	1.4	0.8	0.8	1.1	1.1	1.1	1.2
Contribution of external demand (Qr/Qr,%)	0.1	0.5	0.4	0.1	-0.1	0.1	0.2	0.2	0.1	0.1	0.1	0.2
Export of goods and services	1.1	2.9	2.9	0.1	0.7	1.6	1.7	1.8	1.5	1.5	1.5	1.7
	7.8	8.6	10.9	7.2	6.8	5.5	4.2	5.9	6.7	6.6	6.4	6.3
Import of goods and services	0.5	-0.1	0.5	-0.3	1.2	1.2	0.9	0.7	0.8	1.1	1.3	1.0
	1.5	1.5	1.8	0.6	1.2	2.6	3.0	4.1	3.8	3.6	4.0	4.3
GDP deflator (Yr/Yr,%)	-0.5	-0.6	-1.3	-0.9	-0.4	-0.1	0.3	0.3	-0.1	-0.2	0.0	0.1

Forecast (from FY2007 1-3)

Yr/Yr、%

	FY2007				FY2008				FY2009			
	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)*	6.5	6.2	6.6	6.6	7.2	6.8	7.2	7.2	7.4	6.8	7.1	7.4
balance on goods (trillion yen)*	3.0	3.3	3.2	3.7	3.1	3.2	2.7	4.0	3.7	2.6	2.1	3.0
balance on service (trillion yen)*	-0.7	-0.6	-0.4	-0.5	-0.5	-0.5	-0.3	-0.5	-0.5	-0.4	-0.3	-0.5
balance on income (trillion yen)*	4.5	3.8	4.0	4.5	5.1	4.9	4.4	4.9	5.6	5.3	4.7	5.3
Industrial production (Qr/Qr、%)	0.2	2.2	1.3	-1.2	0.1	0.9	0.5	0.7	0.5	0.6	0.6	0.6
(Yr/Yr、%)	2.4	2.7	2.8	2.3	2.5	0.8	0.6	2.2	2.7	2.3	2.6	2.3
Unemployment rate (%)*	3.8	3.8	3.9	3.9	3.9	3.8	3.8	3.8	3.8	3.8	3.7	3.7
New housing starts(annualized, ten thousand units)	125.4	80.9	95.5	106.5	110.9	112.3	112.2	114.6	114.5	115.1	114.7	117.5
Corporate goods prices (Yr/Yr,%)	3.2	2.0	2.6	2.7	1.0	0.7	0.6	1.4	2.4	2.7	2.6	2.2
Domestic corporate goods prices (Yr/Yr,%)	1.7	1.6	2.3	3.0	2.2	1.7	1.0	0.9	1.4	1.5	1.4	1.2
Consumer prices (Yr/Yr,%)	-0.1	-0.2	0.5	0.7	0.8	0.7	0.7	0.6	0.7	0.7	0.7	0.7
excluding freshfood (Yr/Yr,%)	-0.1	-0.1	0.5	0.8	0.8	0.6	0.6	0.6	0.7	0.7	0.7	0.7
Yen/U.S.Dollar	120.7	117.8	113.1	107.0	105.0	106.0	107.5	109.0	110.0	111.0	112.0	112.0
Uncollateralized call rates (O/N) (%)**	0.514	0.497	0.493	0.500	0.500	0.500	0.750	0.750	0.750	1.000	1.000	1.000
Newly issued government bond yields (10years) (%)	1.74	1.72	1.56	1.46	1.50	1.55	1.65	1.70	1.75	1.82	1.83	1.80
WTI future price (near month contract, US dollar/barrel)	65.0	75.4	90.7	87.0	86.0	88.0	90.0	92.0	94.0	96.0	98.0	100.0
Dubai crude oil prices (US dollar/barrel)	64.8	70.0	83.3	82.0	81.5	83.0	85.0	87.5	89.5	92.0	94.0	96.0

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