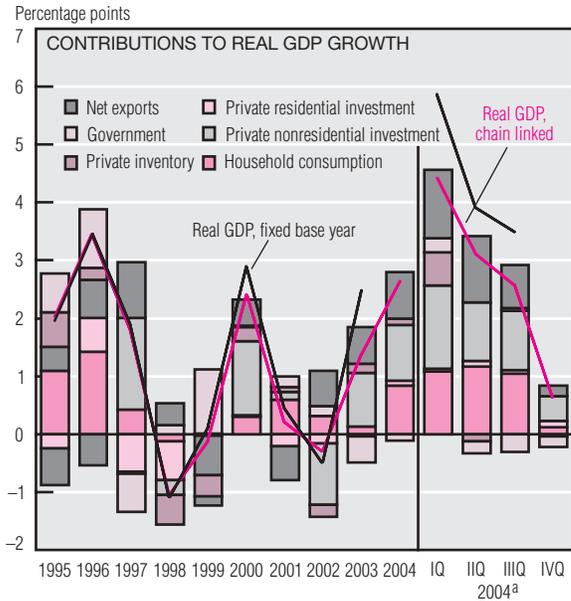


Japan's Economy

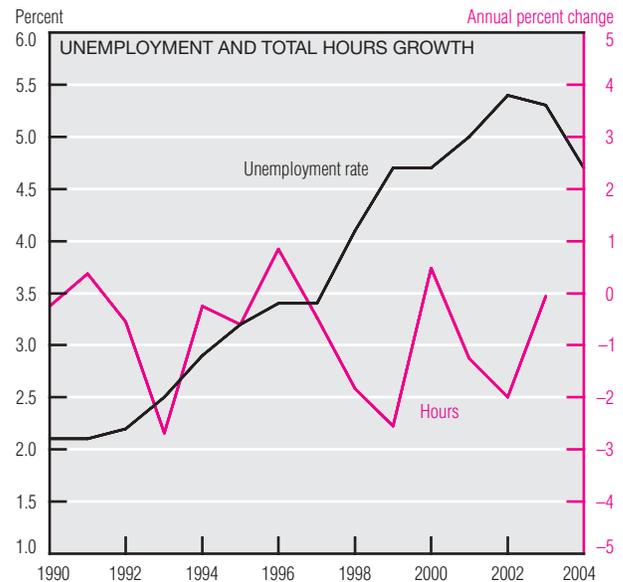
Japan's Real GDP Growth and Selected Components

	Annualized quarterly percent change					
	2003		2004			
	IIIQ	IVQ	IQ	IIQ	IIIQ	IVQ
GDP	2.0	5.7	5.8	-0.8	-1.1	-0.5
Consumption	0.5	4.7	3.1	0.3	-0.8	-1.3
Residential investment	9.2	-4.1	1.6	4.6	3.3	3.5
Nonresidential investment	1.7	21.1	-8.4	16.1	1.7	2.8
Government consumption and investment	-0.4	-2.6	11.9	-13.3	-0.6	1.1
Exports	14.4	22.6	20.2	14.8	2.6	5.1
Imports	9.6	8.1	14.3	8.1	10.1	13.0



Japanese Trade

	1999	2000	2001	2002	2003	2004
Share of Japanese exports (percent)^b						
U.S.	31.0	30.0	30.4	28.8	24.9	22.7
China	5.6	6.3	7.7	9.6	12.2	13.0
Association of Southeast Asian Nations plus newly industrialized Asian countries						
European Union (15 countries)	30.7	33.9	31.5	32.4	33.3	34.1
Other	17.8	16.4	16.0	14.7	15.3	15.0
Other	15.2	17.1	14.9	13.4	14.4	14.4
Share of Japanese imports (percent)^b						
U.S.	21.7	19.1	18.3	17.4	15.6	14.3
China	13.8	14.5	16.6	18.3	19.7	20.4
Association of Southeast Asian Nations plus newly industrialized Asian countries						
European Union (15 countries)	13.8	12.3	12.8	13.0	12.8	12.6
Other	9.9	13.0	12.7	21.1	13.4	13.4
Other	25.9	28.0	27.7	27.4	28.2	29.6
Growth rate						
Exports	-7.1	8.0	-4.9	6.2	5.5	12.5
Imports	-5.2	10.8	3.0	0.0	3.0	11.5



a. Four-quarter percent change.

b. 2004 data through the first three quarters.

SOURCES: International Monetary Fund, *Direction of Trade Statistics Yearbook*, 2004; Organisation for Economic Co-operation and Development, *Monthly Statistics of International Trade*, January 2005, and *Productivity Database*; and Government of Japan's Economic and Social Research Institute, Cabinet Office, Statistics Bureau, and Ministry of Internal Affairs and Communication.

In the fourth quarter of 2004, Japan's real GDP fell at an annualized rate of 0.5%. Following the downward revisions to second- and third-quarter growth rates, 2004:IVQ was the third straight quarter in which real GDP contracted. Nevertheless, the real GDP growth rate of 2.6% for 2004 was the highest since 1996, mainly because of large quarterly growth rates in 2003:IVQ and 2004:IQ.

Net exports have been among the major contributors to Japan's real growth in recent years, and the overall trade increase has contributed to the

economy's expansion. China's share of Japan's total trade is now nearly equal to that of the U.S. In recent years, the former has been growing and the latter shrinking. Japan's increased exposure to China has made some analysts fear that a slowdown in China's growth could adversely affect Japan's economy.

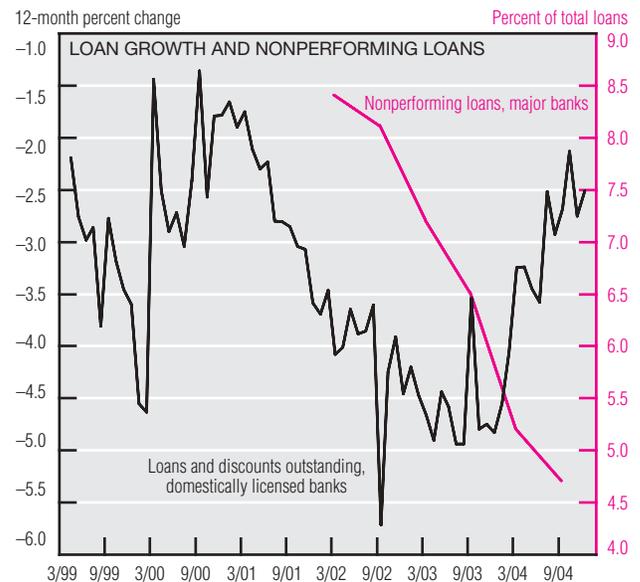
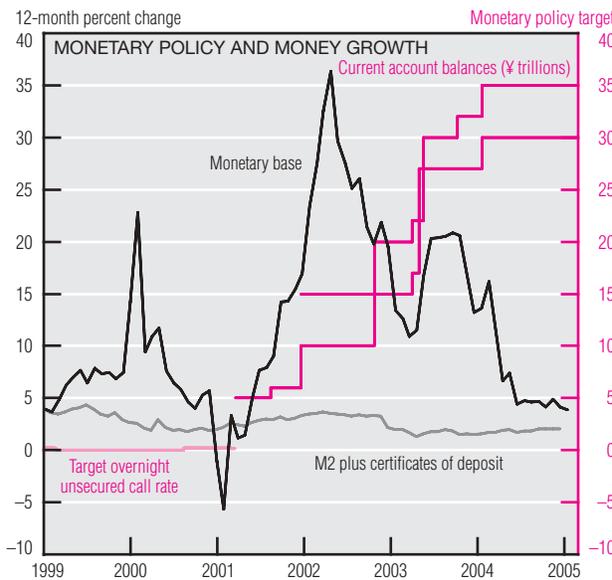
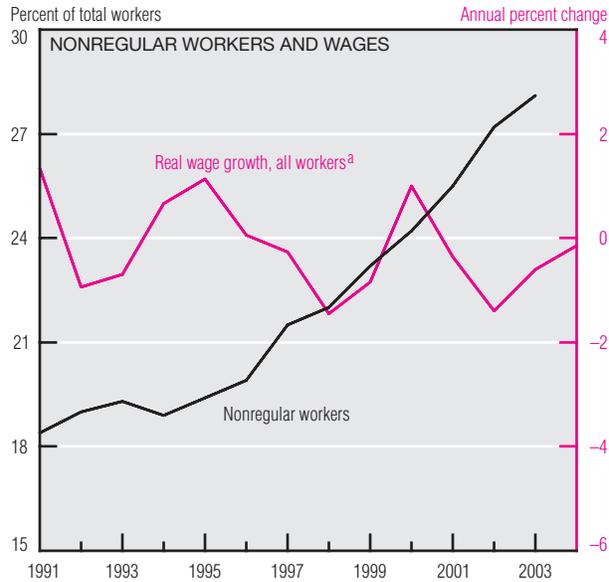
Unlike the U.S., Japan's consumer spending has not been a key source of economic growth in the past decade, mainly because real compensation per worker has been decreasing. That is, nominal compensation has been

falling faster than prices. Employers have been able to reduce their real labor costs by shifting from regular to nonregular workers (part-time employees, workers on short-term contracts, and workers employed by temp agencies). Although the total number of workers has not changed much since 1997, total hours worked have been trending downward.

Japan has experienced persistent deflation over the past decade. As a countermeasure, the Bank of Japan switched in March 2001 from targeting

(continued on next page)

Japan's Economy (cont.)



a. Growth in compensation per employee in the business sector minus annual percent change in consumer prices. Data for 2004 are from an OECD forecast.
SOURCES: Organisation for Economic Co-operation and Development, *OECD Economic Outlook* no. 76, annex tables and *OECD Economic Surveys—Japan*, January 2005; Bank of Japan, *Results of the Opinion Survey on the General Public's Mindset and Behavior*; Japan's Financial Services Agency; and Bloomberg Financial Information Services.

an overnight unsecured call rate to a program of “quantitative easing,” in which current account balances held at the central bank are targeted. The Bank of Japan supplies these balances, currently targeted at 30¥–35¥ trillion, primarily by purchasing government bonds. In 2003, the Bank announced that it would continue its program of quantitative easing at least until core inflation (measured by the 12-month change in consumer prices excluding fresh food) rises to 0% or higher and its Policy Board forecasts a positive

inflation rate for the year ahead. The rate of price inflation has now reached nearly 0%, and survey measures of consumer inflation expectations have been increasing as well.

The monetary base grew significantly as the Bank ratcheted up current account balances. However, no similar increase occurred in one of the major monetary aggregates (M2 plus certificates of deposit). Moreover, loan growth has remained negative since the program's inception, although it recently has been moving

closer to 0%. The problems within Japan's banking sector have been well documented. A positive development for banking is that the goal of halving the nonperforming loan ratio at major banks from 8.4% in March 2002 to 4.2% in March 2005 seems achievable. Japan hopes to improve the efficiency of its economy further by a phased-in privatization (2007–17) of Japanese Post, the largest financial institution in the world with assets totaling 80% of Japan's GDP.