

February 2009

Forecast for the Japanese Economy in Fiscal 2009 and 2010

— 2009: Darkness Even Following the Dawn —



Mitsubishi UFJ Research and Consulting

Economic Research Department

1. Outlook for the Japanese Economy in Fiscal 2009 and Fiscal 2010

-- 2009: Darkness Even Following the Dawn

(1) Current State of the Economy

The economy is deteriorating rapidly. During the October-December quarter of 2008, real GDP fell 3.3% from the previous quarter (–12.7% at an annualized rate), the third consecutive quarter-to-quarter decline. The margin of decline in the October-December quarter was the largest on record since the January-March quarter of 1974 when real GDP dropped 3.4% from the previous quarter, or at an annualized rate of –13.1%. However, even if the two figures are almost the same, the reasons for these two major declines are quite different from one another. In 1974, the real growth rate was reduced by increases in prices, and, while the nominal growth rate declined significantly at that time, it remained positive. In contrast, this time the nominal GDP showed a quarter-to-quarter decline of 1.7% (–6.6% at an annualized rate) (Exhibit 1).

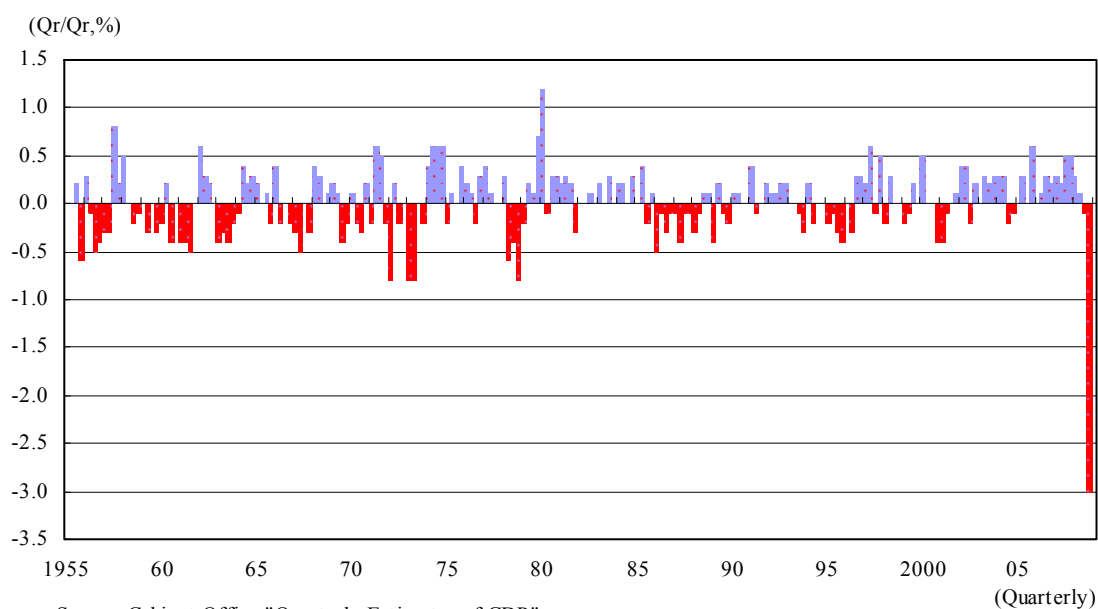
Exhibit 1: Comparison of 2008:IV with 1974:I

	Qr/Qr, %	
	2008:IV	1974:I
Nominal GDP	-1.7	1.3
Real GDP	-3.3	-3.4
Domestic demand	-0.3	-3.7
Private consumption	-0.4	-6.0
Housing investment	5.7	-7.5
Private capital investment	-5.3	-4.5
Contribution rate of inventory investment	0.4	2.9
Government final consumption expenditure	1.2	-5.2
Public investment	-0.6	-14.5
Contribution rate of external demand	-3.0	0.4
Export of goods and services	-13.9	5.7
Import of goods and services	2.9	-0.5

Source: Cabinet Office "Quarterly Estimates of GDP"

In addition, while the real growth rate, principally of domestic demand, was reduced in 1974 by the increase in prices, this time, the contribution of the external sector (exports minus imports) was an unprecedentedly large minus 3.0%, which lowered the growth rate substantially (Exhibit 2). As conditions in the world economy deteriorated swiftly, Japan's exports posted a decline of 13.9% for the October-December quarter, the largest drop every recorded. On the other hand, imports maintained a marginal increasing trend, rising 2.9% for the quarter, thus causing a large negative contribution to overall growth from the external sector.

Exhibit 2: Contribution rate of real external demand



Source: Cabinet Office "Quarterly Estimates of GDP"

However, the contribution of the domestic sector was minus 0.3%; although this was not as large as the negative contribution of the external sector, it was a factor reducing the growth rate. By component of GDP, private capital investment, which is easily influenced by declines in exports and industrial production, was adversely affected by uncertainty about future trends and the deterioration in corporate profitability. As a result, private capital investment dropped 5.3% from the previous quarter during the October-December period, the third consecutive quarterly decline and a larger margin of decline than in the two previous quarters. Private consumption declined 0.4% for the quarter, adversely impacted by the

negative effects of the sudden production adjustments among corporations on the employment and income environments.

On the other hand, private residential investment increased 5.7% in the October-December period, the second consecutive quarterly rise, owing in part to the reaction to the major decline caused previously by the implementation of revisions in Japan's building code. In addition, the contribution of private-sector inventory investments to real GDP rose to 0.4%, reflecting the accumulation of inventories. Moreover, overall public-sector demand rose 0.9%, reflecting an increase in government final consumption expenditures of 1.2%, a figure which was partially offset by a decline of 0.6% in government investment.

The GDP deflator, which shows overall price trends in the economy as a whole, moved into the positive range, rising to 0.9% over the same quarter of the previous year, reflecting the declines in the prices of crude oil and other imports. However, the upward trend in the domestic demand deflator, which excludes the effects of changes in export and import prices, decreased markedly to +0.4%. This is viewed as evidence that the declines in import prices have permeated down to domestic prices and that the sudden deterioration in domestic economic conditions is having a depressing effect on price levels.

(2) Difficult Adjustments to Continue in First Half of 2009

The shrinking in the size of economy, as evidence by the large negative growth figure, is clearly evident in exports and production activities. This is because the bursting of the bubble in the world economy has, first, had a negative impact on Japan's exports, and production activities are closely correlated with trends in exports.

Exports in December last year showed a major decline of 35.0% from the same month of the previous year, and mining and manufacturing production in the October-December quarter posted a major drop of 12.0% from the previous quarter. The loss of momentum in exports and industrial

production is a major factor leading to negative economic growth, and it appears that conditions have deteriorated even further after the beginning of 2009. In early and mid-January, exports showed a marked decline of 46.1% from the same periods of the previous year, and there is concern that, for the full month of January, exports may have dropped about 50%. In addition, the possibility has risen that production may show a decline of about 20% for the January-March quarter. It appears that economic growth for the January-March quarter may reach an even larger negative figure than in the October-December quarter.

What factors lie behind this recent adjustment, which we would have to describe as the largest and most sudden downturn ever experienced during the postwar period? The first factor is the bursting of the bubble in the world economy. As the global economy continued to expand at an annual rate of about 5% around the middle of the first decade of the 21st century, Japan's exports expanded rapidly, increasing in fiscal 2007 to 1.8 times the level in fiscal 2001. As a result, the contribution of exports to economic growth exceeded 50%. However, growth in the world economy peaked in 2007 and began to decline. Growth is now forecast to drop to zero in 2009.

However, industrial production in February, as estimated by the survey of forecasts for manufacturing production, is now expected to drop to about the level prevailing in the middle of the 1980s. This suggests that this adjustment has reached a level that cannot be best explained just by saying the worldwide economic bubble that occurred in the middle of the first decade of the 21st century has collapsed.

Background factors that can be listed as accounting for this include the rising dependence of the Japanese economy on exports, even as growth in domestic demand, especially private consumption, has continued to stagnate in recent years. In particular, sales of products, such as automobiles, for which consumers generally have to borrow funds to purchase have been adversely affected by the credit crunch and have dropped sharply throughout the world. For Japan, where the automobile and certain other industries, as well as sectors closely linked to these industries, have experienced rising dependence on exports, the adverse

impact of the bursting of the worldwide economic bubble has been extremely damaging.

Another factor has been a result of the trend among corporations toward streamlining their operations to increase productivity. As a consequence, declines in demand have an immediate effect on all kinds of economic activities, and this tends to amplify the adverse effect on economic conditions. To prevent increases in inventories, companies cut back on production, and, to reduce excess production capacity and labor, they cut capital investment and employment. More so than in the past, it is apparent that companies in a broader range of industries now find it is easier to resort to these retrenchment measures without delay.

In fiscal 2008, there were two external “shocks” that resulted in a continuation of negative growth. During the first half, there was a massive increase in the price of oil, and, in the second half, growth in the world economy decelerated. Since severe adjustments will continue during the January-March quarter of 2009, for the whole of fiscal 2008, the Japanese economy is forecast to show negative real growth of 3.2%, for the first time in seven years, and negative nominal growth of 3.2% for the first time in six years.

The rapid run-up in oil prices peaked during the summer of 2008, but subsequently prices have declined. However, economic deceleration has spread from the United States, which was the epicenter of the subprime loan issue, to Europe, which has experienced a housing bubble similar to that in the United States, and then on to China and other emerging economies. As signs of a simultaneous global economic downturn have become clearer, the major decline in Japan’s exports, mentioned previously, has been unavoidable. Also, along with the decrease in Japan’s exports, industrial production has declined rapidly. The outlook in fiscal 2008, therefore, is for a major decline in industrial output, the first drop in seven years.

For the corporate sector, the decrease in prices of oil and other resources is a positive development, but the sudden drop in sales, including exports, is

having an adverse impact, and in fiscal 2008, corporations are expected to report a second consecutive year of declining profits, with the margin of decline in fiscal 2008 larger than in the previous year. The trend toward reviewing plans for private capital investment is spreading among corporations because of the deterioration in profitability and uncertainty about future trends. As a result, a major drop in capital expenditures is likely in fiscal 2008.

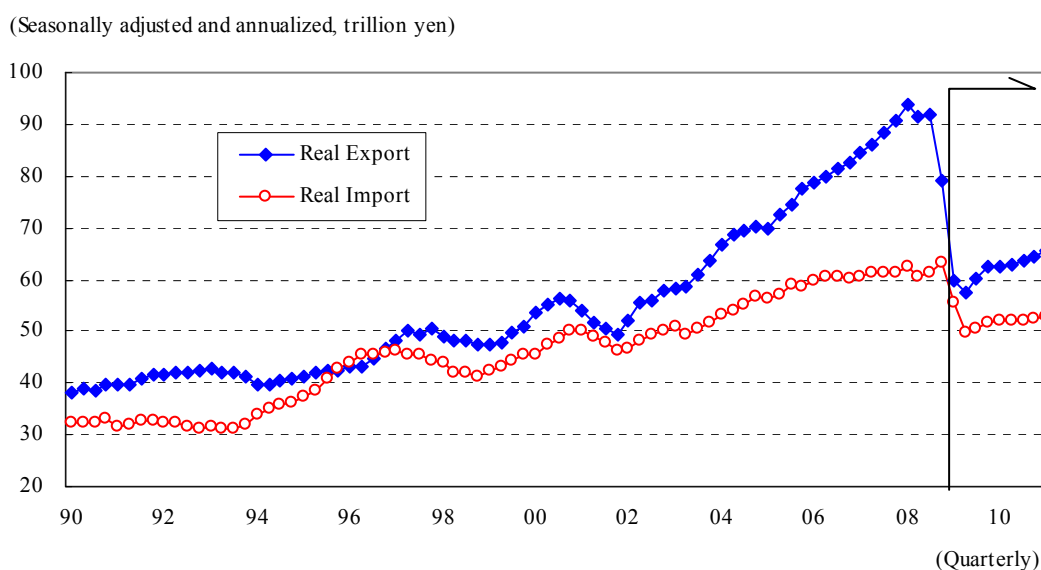
As corporate performance worsens, the number of employed persons is continuing to decrease and unemployment rates are rising. Wages, which had shown a slight rising trend, began to decline toward the end of last year, and the income environment is becoming increasingly severe. The decline in the rate of inflation in consumer prices is a positive factor for consumer spending, but growth in nominal incomes continues to be weak, and, as a consequence, consumption has begun to decrease. During fiscal 2008, consumer spending is forecast to decline for the first time in 11 years, since the time of the increase in the consumption tax rate in 1997. Private residential investment is expected to continue to decline in fiscal 2008. The negative effects of the revisions in Japan's building code have diminished, but the sudden deterioration in the domestic economy and expectations for declines in housing prices going forward are restraining housing investment. Along with the decline in the desire among households to purchase housing, condominium and other housing suppliers have adopted a cautious stance.

(3) Will Imports Decline?

The double-digit negative growth figure for the October-December quarter of 2008 was a consequence of the substantial negative contribution to growth of the external sector. The principal reason for this was the sudden decline in exports, but the continuing rise in imports also had an influence on the major increase in the negative contribution of the external sector. During the January-March quarter of 2009, exports are expected to show a further decline, and the trends in imports for the quarter will have a significant effect on economic growth.

Imports can be divided into two types. One type is linked to and moves together with exports. To manufacture export goods, companies must import raw materials from overseas. In this case, if exports decline, imports will decline in parallel with exports. Examination of the fluctuations in exports and imports in the past shows that the two generally move in the same direction (Exhibit 3).

Exhibit 3: Real Export and Import



In contrast, goods that are imported to satisfy domestic demand for consumer spending, housing investment, and other economic activities are not directly influenced by trends in exports. These are the second type of imports. There is a continuing, medium-term shift toward purchasing low-cost imported products, and, in the short-term, appreciation of the yen is a factor supporting growth in imports.

Last year, during the October-December quarter, exports dropped markedly, but why did imports increase? If the reason is that imports of the second type, which are not correlated with exports, rose, then, during the January-March and subsequent quarters, imports may not show a sharp decline similar to the drop in exports. In that case, we should not be surprised if the growth rate of real GDP in the January-March quarter of 2009 is minus 20% or more.

On the other hand, if the first type of imports is the main type, and we take the stance that basically imports will move in tandem with exports, the increase in imports in the October-December quarter could have been explained by pointing out that imports had probably not yet caught up with the decline in exports. In that case, we would forecast a major drop in imports in the January-March and subsequent quarters. However, in that case also, the GDP growth rate would be a large negative figure, but compared with the case where imports do not decline, the absolute size of the negative growth figure would be smaller.

In our forecast, the decline in imports for the January-March quarter is not as large as the decline in exports, but we are assuming a decrease of more than 10% from the previous quarter. As a consequence, our forecast for real GDP growth in the January-March quarter is -3.6% (-13.6% at an annualized rate).

(4) Dawn Will Always Come

Following the sudden deterioration in economic conditions, certain set phrases have come into general use to describe the downturn, such as “once in a 100 years” and “unprecedented.” A general mood of despair that “dawn” will never come has spread widely. Certainly, various negative factors have all come together at once, and we are experiencing shrinkages in exports and production that we have never seen before. Following this all-too-drastic change, the bottom to the downturn seems to have disappeared, but there is no night without a dawn.

The rapid deterioration in the economy, as evidenced by the sharp drop in production, can also be interpreted as a swift adjustment along the way to recovery. Even though we cannot see a bottom to the downturn, if an adjustment involving cutbacks of 30% to 40% from peak levels proceeds, production will approach a bottoming-out level. It is difficult to imagine a scenario where the economy continues to deteriorate at the current rate indefinitely.

In the export sector, such industries as automobiles and electronic components, where inventories have accumulated in Japan and overseas owing to the sudden drop in demand, are currently working to adjust their inventories to the proper levels in the January-March quarter of 2009. We cannot rule out the possibility that this adjustment might be delayed into the April-June quarter, but we believe that production adjustments aimed adjusting inventories will pause by the middle of the current year.

In addition, the economic policies being put into place in countries around the world, including the United States, China, European nations, and Japan, are expected to have a positive effect on economic growth. China's four trillion yuan economic policy package also includes some previously existing measures that are already being implemented. Moreover, the effects of the economic policies now going into the implementation phases in the United States and Japan will emerge in the latter half of this year. The economic deceleration has been sudden in all countries, and we believe it would be overly optimistic to think that the effects of these policies will result in major increases in economic growth, but they will be one factor that is expected to bring a bottoming out in the latter half of this year.

We should also note that the decline in prices of oil and other raw materials is improving Japan's terms of trade. The decline in sales is having a devastating impact on corporate profitability, but the increase in marginal profitability due to the decline in variable costs is a positive factor that has not come to the surface. However, as the downturn proceeds, demand will slacken, and prices of inputs, including raw materials, will decline relative to output prices, thus leading to an improvement in the terms of trade. This is a common pattern that occurs when economies move toward recovery. The improvement in the terms of trade will lead to improvement in the profit conditions for Japanese companies and will be one factor that will move the economy toward recovery.

In fiscal 2009, severe adjustments in capital investment and employment will continue, and movements toward economic recovery will not spread. We are forecasting real economic growth of minus 4.3% and nominal growth of minus 4.6%, both of which figures will represent the second

consecutive year of significant negative growth.

Although the turmoil in world financial markets will subside gradually as we move toward 2010, in part because of the cooperative policies adopted by countries around the world, world economic growth is expected to drop to zero. A marked decline in Japan's exports will be unavoidable. Imports are also forecast to decline, but the contribution of the external sector will be a substantial negative figure as during fiscal 2008.

Along with the major decrease in exports, production is forecast to show a substantial decline for the second consecutive year. Conditions for corporate profitability will be extremely challenging, and recurring profit is expected to decline for the third consecutive year. Since the downward trend in production will continue and conditions for corporate profitability will remain challenging, a second consecutive year of decline in private capital investment will probably be unavoidable.

While the government will distribute lump-sum grants totaling ¥2 trillion to consumers and the largest tax breaks on housing loans ever offered in Japan are expected to go into effect, these measures are expected to have only a marginal positive impact on consumer spending and private residential investment. As the conditions for corporate profitability will remain challenging, the deterioration in the employment environment will continue and the size of cuts in wages in bonuses will increase. The income environment will also become substantially more difficult, and consumer spending will decline. In addition, since the desire among consumers to purchase housing will remain weak and suppliers of homes will continue to exercise caution, we are forecasting a third consecutive year of decline in private residential investment.

(5) But Adjustments Will Continue Even after Dawn Has Come

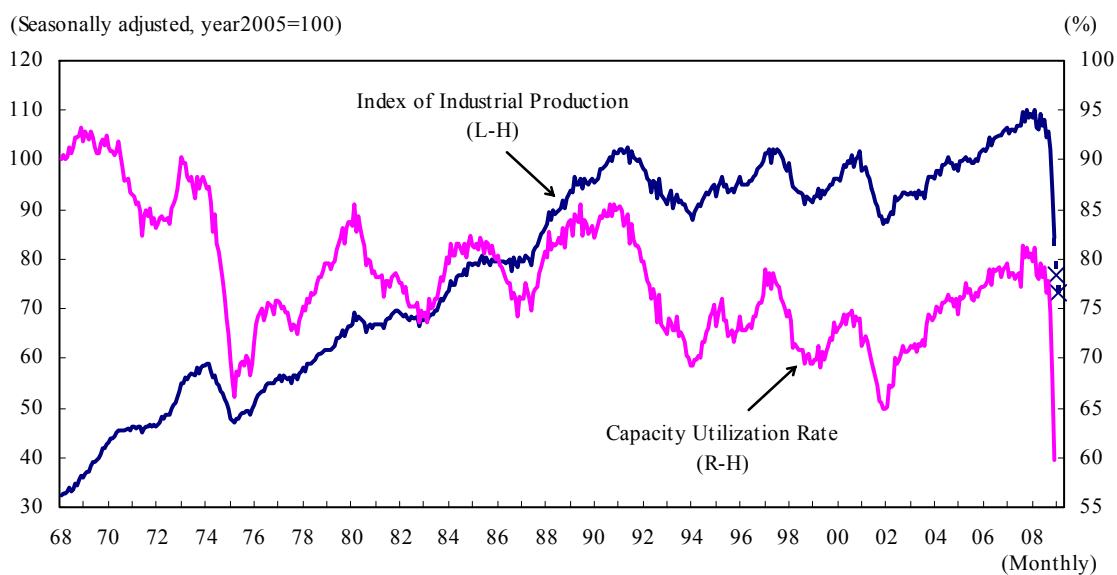
In the latter half of this year, even if the trend toward rapid deterioration in the economy pauses and signs of bottoming out emerge, it will probably still be too soon to expect full-scale recovery. There is no need to become

overly pessimistic and think that dawn will never come, but it would be overly optimistic to think that when the day does dawn that the recovery will proceed smoothly. Growth in the world economy is expected to bottom out in 2010 and subsequently, but growth will not return to the 5% level prevailing in the middle of the first decade of the 21st century. Instead, the pace of growth is likely to range between 2.5% and 3.0%. Even if the sharp decline in exports comes to an end, this will not mean that exports will move to a robust expansionary trend.

While we should not expect that economic growth will be significantly boosted by expansion in exports as it was previously, on the one hand, it is also not realistic to think that economic growth in Japan's now mature economy will be led by expansion in domestic demand. It has become difficult for the Japanese economy to sustain a stable economic growth rate around 2%. Even if the rapid adjustment in production now taking place pauses, the pace of recovery in production thereafter is likely to be gradual.

According to the survey of forecasts for manufacturing production, the level of industrial production in February this year will be 34% below the level of February 2008, or at about the same level as in the mid-1980s. In other words, the expansion in production, built up over the past quarter century, has essentially been wiped out in a period of one year, and the impact of this setback is enormous. Moreover, as a result of the expansion in production capacity over this period and other factors, data on the utilization of capacity show that, as of December 2008, slightly less than 60% of available capacity was in use and that the current level of utilization is the lowest since 1968, when preparation of these data began. If we consider that further significant declines in production are expected in January and later months, the rate of capacity utilization will decline even further (Exhibit 4).

Exhibit 4: Industrial Production and Capacity Utilization Rate



Note: Data of Jan. and Feb. 2009 are forecast figures based on the Survey of Production Forecast in Manufacturing.

Figures are seasonally adjusted.

Source: Ministry of Economy, Trade and Industry

Even if some degree of bottoming out occurs following the pause in the sharp downward trend in production, output is likely to continue at quite a low level compared with the previous peak. In that case, it will be necessary to adjust the level of equipment and employment to a point that is appropriate for the new production level. It is possible that Japanese corporations, which learned many lessons following the bursting of Japan's bubble economy at the beginning of the 1990s, will work faster than at any time in the past to reduce capital equipment and adjust employment to avoid having excessive facilities and employment.

While dawn will not be delayed indefinitely and appears likely to come in the middle of this year, it is possible that adjustments that assume the darkness of the pre-dawn hours will be a heavy burden on the economy thereafter. Thus far, the Japanese economy has been driven by expansion in exports and accompanying increases in output. If, along with the decline in exports, the Japanese economy settles down with production levels that imply only 60% capacity utilization, another major decline in capital investment in 2009, following the drop in fiscal 2008, will be unavoidable.

In addition, the adjustment in employment, which has already begun, will become even more severe as the economy moves into fiscal 2009. During fiscal 2009, the outlook is for a decline of 1.57 million in the number of employed persons, and the unemployment rate may rise to over 6%. Per capita wages are likely to show significant declines, principally in the compensation categories of overtime and bonuses, and, as a whole, employee compensation may show a marked decline of 4.6%. Although the decline in prices will push real incomes upward, consumer spending in fiscal 2009 is forecast to show its second consecutive year of decline, as consumers face a rapid deterioration in the employment and income environments. The scenario in which consumer spending remains firm and provides support for the economy, even as the economy moves into recession, is becoming more difficult to assume.

In fiscal 2010, the beneficial effects of the economic policies adopted by countries around the world will begin to emerge to some extent, and the rate of growth in the world economy, which had slowed, will begin to recover. As a result of increases in exports, signs of bottoming out will emerge in the Japanese economy also, and consumer spending as well as private capital investment will begin to expand gradually. However, the growth rate in the world economy will be at a relatively low level compared with the 5% growth that prevailed around the middle of the first decade of the 21st century. The Japanese economy will have difficulty in returning to a 2% annual growth path, and we are forecasting positive real growth of 1.1% in fiscal 2010 and a nominal growth rate of 0.4%.

(6) Growing Consensus Favoring a Major Policy Response

The rapid deterioration in the economy since fall last year has been influenced the bursting of the global economic bubble, but, at the same time, some developments have posed questions as regards whether the mode of economic expansion Japan has followed in the postwar period can be continued in its present form. It is now certain that fiscal 2008 will be the year of the largest negative growth figure for Japan in the postwar era, and there is a possibility that the economy may show an even larger

negative growth figure is fiscal 2009. Based on our forecasts, Japan's GDP will shrink by close to 10% over this two-year period. It is only to be expected that expectations are rising for the adoption of a major economic policy package that will help to compensate for the resulting decline in demand, which is estimated at about ¥40 trillion.

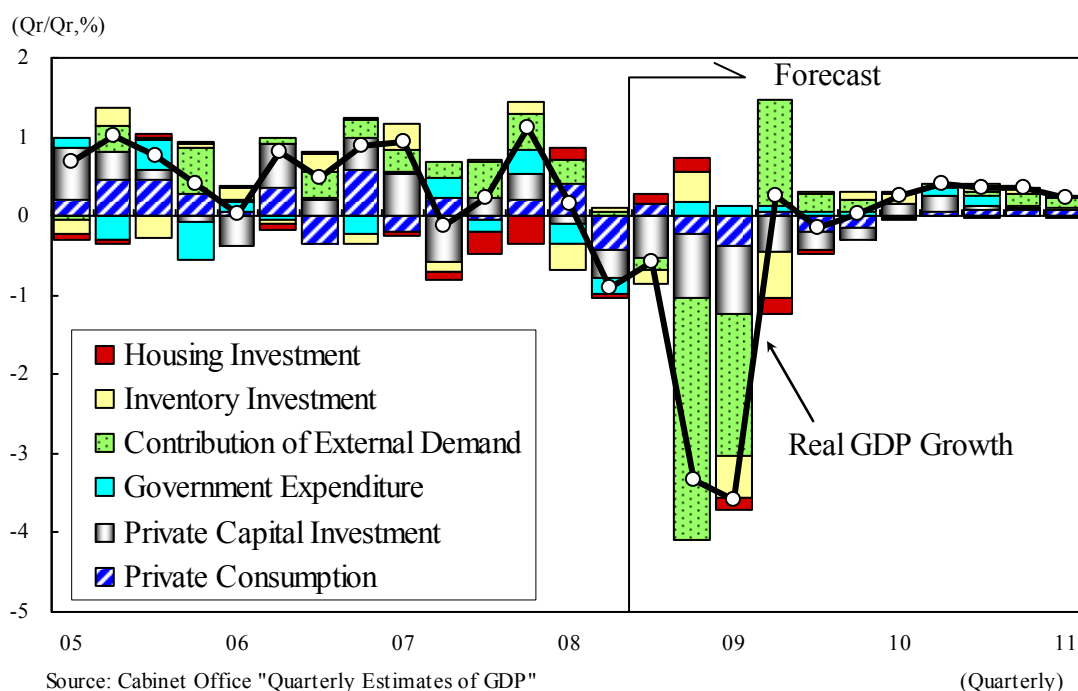
Without doubt, the sudden deterioration in the employment environment will be accompanied by social unrest, and it will be necessary for the government to adopt emergency policies. However, even if the shortfall in demand is compensated for one year, we have to be aware that this problem will persist into the following year. Japan's era of rapid growth ended with the first oil crisis, and the Japanese economy reached a major turning point. This was because Japan made the transition from being an economy with expanding demand and a shortage of supply to an economy where there was an excess of supply and insufficient demand. When the Japanese economy was supply-constrained, expansion in capital investment brought forth additional capital investment, and expansion in incomes led to increased demand for consumer goods and services, thus leading to further economic growth. But in the latter, demand-constrained Japanese economy following the first oil crisis, capital investment resulted in excess capacity.

Policies for augmenting the shortage of demand included expansion in fiscal spending and low interest rates, but the most-effective measure was probably expanding exports to meet overseas demand that was supported by growth in the world economy. Japan's longest period of economic recovery in the postwar period, which began in early 2002, was strongly supported by expansion in exports, and it perhaps should have been labeled the "global bubble period of expansion." However, even if the sharp deceleration in the world economy that is taking place now settles down, but then Japan finds that it cannot expect a return to the high growth that prevailed in the middle of the first decade of the 21st century, Japan must make major modifications in its growth strategy.

Recently, the phrases "once in a 100 years" and "unprecedented" are used frequently to describe today's economic conditions, but it appears to be quite difficult to formulate a new, long-term growth strategy for Japan.

However, without doubt, debate regarding the necessary economic policies within the government and the private sector in Japan will become quite active going forward. We must not expect that long-term strategies will have the effect of raising growth in the near term. The criterion for making judgments about policies is frequently the effectiveness of measures to raise economic growth rates through the multiplier effect of government expenditure policies. However, rather than policies that create demand in the short term, we should give attention to those measures that will build Japan's social infrastructure and provide for long-term economic growth and improvement in living standards.

Exhibit 5: Real GDP Growth (seasonally adjusted)



2. Forecasts of Economic Activity by Sector

(1) Corporations

- Corporations completed their disposal of negative assets left over from Japan's bubble economy, and their financial positions and profitability recovered substantially after 2000, supported by strong exports. Accordingly, the risks of a major downturn in production, capital investment, or other aspects of corporate activities receded.
- At present, however, production is declining rapidly because of sudden decreases in exports of automobiles, digital-related products (semiconductors and LCDs), general machinery, and other items as well as a slowdown in private capital investment. Along with the decline in demand in Japan and overseas, shipments are dropping, and inventories are rising rapidly in a wide range of industries. As a result, companies are implementing major adjustments in production, and this is spurring further production declines.
- As a result of the deterioration in the domestic and overseas economies, corporate profitability is falling sharply and private capital investment is decreasing. Investments for the renewal of equipment and for increasing value-added to remain competitive are necessary, but because of the rapid emergence of a feeling of excess capital equipment capacity following the drop in demand, there is a possibility that adjustments in private capital investments will be prolonged.
- The level of recurring profits had exceeded the peak levels attained previously during Japan's bubble era and the time of the IT boom and were continuing to rise to record levels, but profitability has now begun to decline. This is due to higher costs, including increases in raw material prices, personnel costs, and depreciation charges, combined with the effects of deceleration in the world economy, including weakness in domestic and international sales, including exports. The more recent declines in raw material prices and the improvement in Japan's terms of trade will both be beneficial for corporate profitability; however, until the world economy begins to recover, a robust upward trend in profitability will be unlikely.

(2) Households

- The income environment is becoming more severe as employee compensation, which had been increasing, albeit at a declining pace, has now declined below the level of the same period of the previous year, and consumer spending has weakened.
- Since autumn 2008, faced with major declines in demand, companies have reduced personnel, principally by cutting back the number of non-regular employees, whose numbers increased during the last recovery phase. This has resulted in a marked deterioration in conditions in the employment environment. The employment adjustments are expected to be rapid and large in scale, and substantial increases in unemployment rates are forecast.
- There is a strong possibility that wages, which had shown continuing weak growth, may decline significantly as a result of decreases in bonuses accompanying the deterioration of corporate performance. Even though price levels may decline going forward, the income environment is likely to become increasingly severe along with movements toward adjustments in employment, and as a consequence personal consumption may trend downward.
- In the area of residential investment, although the sons and daughters of the baby-boom generation had been purchasing their first homes, the market has unavoidably stagnated since the revision in Japan's building code in June 2007. Even after the effects of the building code revision have run their course, housing sales have remained lackluster because of expectations that home prices may decline further and uncertainty regarding future trends. In addition, the slower growth in the number of households in the medium term will have a restraining effect on residential investment.

(3) Government

- Following the collapse of Japan's bubble economy, the structure of government finances deteriorated rapidly. Along with the decline in nominal income growth rates in the 1990s and major tax cuts, government tax revenues have declined. Moreover, on the expenditure side, social welfare costs have continued to rise as the population has aged demographically, and expenditures for public works increased as a result of the implementation of major government spending programs to stimulate the economy.
- After the year 2000, to implement structural reforms, the government suspended major spending programs aimed at stimulating the economy and spending on public works projects was reduced substantially. Moreover, local governments are experiencing fiscal difficulties and have continued to reduce their spending on public works. Along with the economic recovery, tax revenues began to expand again, but the government has basically maintained its policy of making structural reforms in its finances.
- To reduce its fiscal deficit, the government is working to restrain its expenditures through systemic reforms to control government final consumption expenditures, including social welfare expenses. Nevertheless, even if these reforms are implemented, they will probably only succeed in lowering the pace of expansion in these expenditures, and government final consumption expenditures, principally social welfare payments, will continue to expand.
- The financial positions of both national and local governments continue to be weak, and the decline in public-sector investment spending is expected to continue, although there is a possibility that the pace of decline may be more moderate going forward. As reductions in national and local government public investments have continued, the ratios of these investments to GDP have declined substantially. For this reason, concern is mounting that Japan may not be able to sustain necessary social capital if cuts continue. In addition, as the global recession has become more serious, movements toward expanding fiscal spending, including major economic policy packages and other measures, are growing stronger.

(4) Trends in Overseas Economies

- The world economy is showing increasingly clear signs of a simultaneous global recession. During the October-December quarter, the United States and European countries reported substantial negative growth figures, and the growth rates of China and other newly emerging countries are clearly slowing.
- Substantial further deterioration is expected in the world economy in 2009. Consumer spending in the United States, which had been a driving force for the world economy, will likely continue to show negative growth as the household sector makes adjustments in its debt levels. Uncertainty in the financial system is expected to continue, as European and U.S. financial institutions are lagging behind in dealing with their non-performing loans, and movements toward adjustment of employment levels are accelerating around the world. Moving into 2010, although the deterioration in economic conditions is expected to come under control gradually, the outlook is for a moderate pace of recovery and low growth.
- As the effects of the worldwide recession have spread, Japan's exports are posting the largest declines in history. Since exports had become the driving force for growth in Japan, supported by high growth in the world economy, the repercussions of the sudden slowdown in exports are extremely large. For the time being, there are no prospects for a return to the rapid growth experienced previously in the world economy, and considerable time will likely be necessary before exports return to their previous levels.
- Since the level of exports has declined substantially, the trade balance is generally expected to remain around equilibrium, and it will be difficult for Japanese companies to generate earnings from trade. Although the income account is expected to continue to be firm, supported by income from Japan's net overseas assets, the current account surplus is expected to remain at about half the surplus reported in fiscal 2007.

3. Forecasts for Prices and Financial Markets

- Since the latter half of 2008, prices of raw materials, especially oil and metals, have shown major declines, and upstream inflationary pressures have diminished for the time being. However, in the medium term, considerations of supply capacity and expansion in demand in China and other newly emerging economies suggest that inflationary pressures upstream and deflationary pressures on industrial and other final products downstream will persist.
- The effects of the decline in raw material prices are reaching the domestic price level in Japan. Prices of petroleum, nonferrous metal, and other products—which are sensitive to and tend to be correlated with trends in international commodity markets—as well as ferrous and chemical products are on a declining trend. Recent data indicate that corporate goods prices have fallen below the levels of the previous year for the first time in five years. The rates of change in consumer prices are expected to become negative going forward as a result of declines in energy prices and the deterioration in the domestic economy.
- Regarding monetary policy, the lifting of quantitative easing in March 2006 set in motion the process of normalizing monetary policy to raise interest rates in Japan from their excessively low levels. However, as a result of the turbulence in financial markets triggered by the subprime loan crisis and the recognition of the risk of a downturn in the domestic and overseas economies, in October 2008, interest rates were lowered as part of Japan's stance of reinforcing and cooperating with the monetary policies of the United States and the countries of Europe. Also in line with this stance, a further reduction was implemented in December 2008. The Bank of Japan is expected to continue its policy of monetary easing until the turbulence in financial markets settles down and the uncertainty regarding the domestic and overseas economies subsides.
- Since the economic downturn is expected to continue and the rate of increase in prices to decline, long-term interest rates are expected to remain at low levels. However, there is a possibility that deterioration in government fiscal positions around the world, as a result of the adoption of major economic stimulus measures, may place upward

pressure on interest rates. In foreign exchange markets, the volume of capital transactions shrank rapidly in the latter half of fiscal 2008 owing to the turmoil in international financial markets, and pressures for appreciation of the U.S. dollar, principally against the euro, increased. In addition, the currencies of resource-producing economies depreciated along with the decline in raw material prices. The yen had been subject to negative purchasing activity, but at present appreciation of the yen is being held in check by the deterioration of economic conditions in Japan due to the decline in exports. Amid this environment, differences in interest rates and current account imbalances among countries are diminishing. Policies adopted by various countries and their medium-to-long-term economic prospects will likely rise in importance as determinants of directions in foreign currency market rates.

Exhibit 6: Outlook for Fiscal 2008-2010

	FY2006 (actual)	FY2007 (actual)	Forecast ↘			Yr/Yr, %
			FY2008 (forecast)	FY2009 (forecast)	FY2010 (forecast)	
Nominal GDP	1.5	1.0	-3.2	-4.6	0.4	
Real GDP	2.3	1.9	-3.2	-4.3	1.1	
Contribution of domestic demand	1.4	0.7	-1.8	-2.9	0.8	
Private consumption	1.1	0.8	-0.2	-0.9	0.0	
Housing investment	-0.2	-13.0	-1.9	-5.6	0.2	
Private capital investment	5.6	2.3	-8.1	-11.6	1.8	
Contribution of inventory investment	0.2	0.1	-0.2	-0.7	0.2	
Government expenditure	-0.9	0.7	-0.5	1.3	1.0	
Public investment	-8.8	-5.8	-4.2	0.6	-1.6	
Government final consumption expenditure	1.1	2.2	0.3	1.5	1.5	
Contribution of external demand	0.8	1.3	-1.5	-1.4	0.4	
Export of goods and services	8.3	9.3	-10.3	-24.7	5.8	
Import of goods and services	3.1	1.8	-2.3	-15.2	2.6	
GDP deflator	-0.7	-0.9	0.0	-0.3	-0.8	

	FY2006 (actual)	FY2007 (actual)	Forecast ↘			Yr/Yr, %
			FY2008 (forecast)	FY2009 (forecast)	FY2010 (forecast)	
Current account balance (trillion yen)	21.2	24.5	12.4	10.6	11.2	
balance on goods (trillion yen)	10.5	11.7	1.1	0.5	-0.2	
balance on service (trillion yen)	-2.3	-2.6	-2.2	-2.2	-1.9	
balance on income (trillion yen)	14.2	16.8	14.9	13.8	14.7	
Industrial production	4.6	2.6	-12.0	-22.9	1.6	
Unemployment rate(%)	4.1	3.8	4.2	5.8	6.1	
New housing starts(annualized, ten thousand units)	128.5	103.6	106.7	101.8	102.1	
Domestic corporate goods prices	2.0	2.2	3.2	-6.1	0.9	
Consumer prices	0.3	0.2	1.2	-1.2	-0.1	
excluding freshfood	0.1	0.3	1.2	-1.3	-0.1	
Yen/U.S.Dollar	116.9	114.2	99.7	87.9	89.9	
Uncollateralized call rates (O/N) (%)*	0.209	0.505	0.100	0.100	0.100	
Newly issued government bond yields (10years) (%)	1.77	1.60	1.45	1.34	1.43	
WTI future price (near month contract, US dollar/barrel)	64.9	82.2	85.7	53.3	63.0	
Dubai crude oil prices (US dollar/barrel)	60.9	77.3	82.1	50.3	59.5	

* actual=average, forecast=end of period

Exhibit 7: Outlook for Calendar 2009-2010

	CY2006 (actual)	CY2007 (actual)	CY2008 (actual)	Forecast	
				CY2009 (forecast)	CY2010 (forecast)
	Yr/Yr, %				
Nominal GDP	1.1	1.7	-1.6	-5.7	-0.4
Real GDP	2.0	2.4	-0.7	-6.4	0.8
Contribution of domestic demand	1.2	1.3	-0.9	-3.5	0.1
Private consumption	1.5	0.7	0.5	-1.1	-0.2
Housing investment	0.5	-9.3	-6.9	-3.5	-1.2
Private capital investment	2.3	5.8	-3.7	-14.5	-0.2
Contribution of inventory investment	0.2	0.3	-0.2	-0.6	0.2
Government expenditure	-0.9	0.2	-0.5	1.3	0.9
Public investment	-5.7	-7.0	-6.5	1.1	-1.7
Government final consumption expenditure	0.4	2.0	0.8	1.4	1.4
Contribution of external demand	0.8	1.1	0.1	-2.9	0.6
Export of goods and services	9.7	8.4	1.7	-32.7	5.9
Import of goods and services	4.2	1.5	1.1	-16.0	0.4
GDP deflator	-0.9	-0.7	-0.9	0.8	-1.2

	CY2006 (actual)	CY2007 (actual)	CY2008 (actual)	Forecast	
				CY2009 (forecast)	CY2010 (forecast)
	Yr/Yr, %				
Current account balance (trillion yen)	19.8	24.8	16.3	9.8	10.9
balance on goods (trillion yen)	9.5	12.3	4.0	-0.1	0.0
balance on service (trillion yen)	-2.1	-2.5	-2.2	-2.3	-1.9
balance on income (trillion yen)	13.7	16.3	15.8	13.7	14.3
Industrial production	4.5	2.8	-3.4	-29.6	1.6
Unemployment rate (%)	4.1	3.9	4.0	5.5	6.1
New housing starts(annualized, ten thousand units)	129.0	106.1	109.3	101.9	101.9
Domestic corporate goods prices	2.2	1.8	4.6	-5.9	-0.3
Consumer prices	0.3	0.0	1.4	-1.0	-0.3
excluding freshfood	0.1	0.0	1.5	-1.1	-0.3
Yen/U.S.Dollar	116.3	117.8	103.4	88.6	89.1
Uncollateralized call rates (O/N) (%)*	0.113	0.474	0.333	0.100	0.100
Newly issued government bond yields (10years) (%)	1.74	1.68	1.48	1.30	1.41
WTI future price (near month contract, US dollar/barrel)	66.2	72.3	99.6	49.2	61.0
Dubai crude oil prices (US dollar/barrel)	61.6	68.4	93.8	47.8	57.5

* actual=average, forecast=end of period

Exhibit 8: Outlook for 2008-2010 (Quarterly)

Forecast
↘

Qr/Qr, %
Yr/Yr, %

	FY2008				FY2009				FY2010			
	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	-1.4	-0.7	-1.7	-2.4	-1.3	-0.6	-0.7	0.5	0.1	0.4	-0.2	0.7
	-0.9	-1.8	-3.8	-6.4	-5.6	-6.0	-4.6	-2.2	-0.6	0.3	0.7	1.1
Real GDP	-0.9	-0.6	-3.3	-3.6	0.3	-0.2	0.0	0.3	0.4	0.4	0.4	0.2
	0.7	-0.2	-4.6	-8.5	-6.9	-6.8	-3.3	0.0	0.6	1.1	1.3	1.5
Contribution of domestic demand (Qr/Qr,%)	-1.0	-0.4	-0.3	-1.8	-1.1	-0.4	-0.1	0.2	0.4	0.3	0.2	0.1
Private consumption	-0.7	0.3	-0.4	-0.6	0.1	-0.3	-0.2	-0.1	0.1	0.1	0.1	0.1
Housing investment	0.3	0.6	-0.3	-1.5	-0.6	-1.3	-1.0	-0.5	-0.5	-0.1	0.3	0.5
Private capital investment	-1.9	4.0	5.7	-4.1	-5.3	-1.5	0.4	1.0	0.2	-0.9	-0.1	0.9
Contribution of inventory investment (Qr/Qr,%)	-15.9	-4.7	12.6	3.4	-0.2	-5.6	-10.3	-5.5	0.1	0.6	0.1	0.1
Government expenditure	-2.3	-3.4	-5.3	-5.7	-3.0	-1.5	-1.0	1.0	1.5	0.5	0.3	0.1
Public investment	0.7	-4.0	-11.6	-15.6	-16.3	-14.6	-11.1	-4.5	-0.1	1.9	3.1	2.3
Government final consumption expenditure	0.1	-0.2	0.4	-0.5	-0.6	0.0	0.1	0.1	0.0	0.1	0.1	0.0
Government expenditure	-0.9	0.0	0.9	0.5	0.3	0.2	0.2	-0.1	0.4	0.5	0.1	0.1
Public investment	-1.0	-0.6	-1.1	0.5	1.7	1.9	1.3	0.6	0.9	1.1	0.9	1.1
Government final consumption expenditure	-0.8	1.0	-0.6	0.9	1.0	0.2	-1.1	-1.4	0.3	0.2	-0.4	-0.8
Government final consumption expenditure	-7.6	-6.0	-5.0	0.4	2.1	1.2	1.1	-1.5	-2.2	-2.3	-1.4	-0.8
Government final consumption expenditure	-0.9	-0.2	1.2	0.4	0.1	0.3	0.5	0.2	0.4	0.6	0.2	0.2
Government final consumption expenditure	0.2	0.5	0.0	0.5	1.6	2.0	1.4	1.1	1.4	1.7	1.4	1.5
Contribution of external demand (Qr/Qr,%)	0.1	-0.1	-3.0	-1.8	1.3	0.2	0.1	0.0	0.0	0.1	0.1	0.1
Export of goods and services	-2.3	0.6	-13.9	-24.8	-3.4	4.3	3.9	0.5	0.6	0.8	1.5	1.6
Import of goods and services	5.9	4.4	-12.9	-36.3	-37.1	-34.8	-21.3	5.1	9.5	5.9	3.4	4.6
Import of goods and services	-3.1	1.7	2.9	-12.0	-10.7	2.0	2.3	0.3	0.2	0.3	0.4	0.6
Import of goods and services	-1.7	0.3	3.0	-10.8	-17.8	-17.5	-18.0	-6.6	4.9	3.1	1.2	1.5
GDP deflator (Yr/Yr,%)	-1.5	-1.6	0.9	2.2	1.4	0.9	-1.4	-2.1	-1.2	-0.8	-0.6	-0.3

Forecast
↘

Yr/Yr, %

	FY2008				FY2009				FY2010			
	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)*	4.8	3.6	2.3	1.9	2.6	2.7	2.7	2.7	2.8	2.8	2.8	2.9
balance on goods (trillion yen)*	1.6	0.3	-0.4	-0.6	0.2	0.1	0.1	0.0	0.1	-0.1	-0.2	-0.2
balance on service (trillion yen)*	-0.5	-0.4	-0.6	-0.6	-0.6	-0.5	-0.6	-0.5	-0.5	-0.5	-0.5	-0.4
balance on income (trillion yen)*	4.0	4.1	3.6	3.5	3.4	3.5	3.5	3.5	3.5	3.7	3.8	3.8
Industrial production (Qr/Qr, %)	-0.8	-1.3	-12.0	-21.1	-3.7	3.0	2.0	-0.4	-0.1	0.2	0.3	0.2
Industrial production (Yr/Yr, %)	1.0	-1.4	-14.8	-32.1	-34.0	-30.9	-20.3	0.7	4.4	1.8	-0.1	0.6
Unemployment rate (%)*	4.0	4.1	4.0	4.8	5.4	5.8	6.0	6.2	6.1	6.2	6.1	6.1
New housing starts(annualized, ten thousand units)	112.0	110.2	101.0	103.2	102.1	101.1	101.2	102.9	101.8	100.9	102.2	103.6
Domestic corporate goods prices (Yr/Yr,%)	4.9	7.1	2.9	-1.8	-5.8	-9.3	-6.5	-2.9	-0.8	0.7	1.7	2.3
Consumer prices (Yr/Yr,%)	1.4	2.2	1.1	-0.1	-0.7	-1.9	-1.4	-0.7	-0.4	-0.2	0.0	0.3
excluding freshfood (Yr/Yr,%)	1.5	2.3	1.0	-0.1	-0.8	-2.0	-1.4	-0.8	-0.4	-0.2	0.0	0.3
Yen/U.S.Dollar	104.5	107.6	96.1	90.5	89.5	88.0	86.5	87.5	88.8	89.8	90.5	90.5
Uncollateralized call rates (O/N) (**)	0.507	0.501	0.333	0.100	0.100	0.100	0.100	0.100	0.100	0.100	0.100	0.100
Newly issued government bond yields (10years) (%)	1.61	1.51	1.43	1.25	1.30	1.30	1.35	1.40	1.40	1.40	1.45	1.45
WTI future price (near month contract, US dollar/barrel)	124.0	118.0	58.7	42.0	48.0	52.0	55.0	58.0	60.0	62.0	64.0	66.0
Dubai crude oil prices (US dollar/barrel)	116.9	113.8	53.3	44.5	47.0	48.5	51.0	54.5	56.5	58.5	60.5	62.5

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