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Forecast for the Japanese Economy in Fiscal 2009 and 2010

— Avoiding a Second Downturn amid Concerns about the Magnitude of a Reactionary Decline. —

Mitsubishi UFJ Research and Consulting

Economic Research Department

1. Outlook for the Japanese Economy in Fiscal 2009 and Fiscal 2010 -- Avoiding a Second Downturn amid Concerns about the Magnitude of a Reactionary Decline

(1) Current State of the Economy: Bottoming Out Continues Supported by Exports and the Positive Effects of Stimulus Policies

The real rate of GDP growth in the July-September period of 2009 was 1.2% over the previous quarter (4.8% at an annualized rate), the second consecutive quarter of positive growth. In addition, the rate of growth was higher in the July-September quarter than the 0.7% real rate of GDP growth (2.7% at an annualized rate) reported in the April-June period. These results show the economy is continuing its movement back to the path to recovery as a result of the increase in exports and the positive impact of government economic policies. On the other hand, nominal GDP declined 0.1% (minus 0.3% at an annualized rate), the sixth consecutive quarterly decline. The GDP deflator rose 0.2% over the same period of the previous year, the fourth consecutive quarter of increases, reflecting the effects of the substantial drop in crude oil prices and other import prices compared with a year earlier; however, the rate of increase diminished slightly.

An examination of the contribution of domestic and external demand to real GDP growth shows that domestic demand made a positive contribution of 0.8% in the July-September period, thus making its first positive contribution in six quarters. External demand made a positive contribution of 0.4%, for the second consecutive quarter.

By major component of demand, personal consumption increased 0.7% over the previous quarter, a high rate of expansion supported by expenditures for consumer durables, which rose because of the effects of various policy measures, including the granting of eco-points, reductions in taxes on eco-friendly automobiles, and subsidies for buying new cars. Private residential investment posted a marked decline of 7.7%, its third consecutive quarterly decline, reflecting stagnation in the number of new housing starts owing to the deterioration in the income environment for households and the expectation that housing prices may decline further going forward.

Although corporations still have a strong sense that they have excess capital equipment, production is continuing to increase, and corporate earnings appear to have moved out of the worst phases of the downturn. As a consequence, private capital investment increased a slight 1.6% from the previous quarter, the first increase in six quarters. In addition, along with the completion of inventory adjustments, the contribution of private inventory investment was a positive 0.4%, thus giving real GDP a significant boost.

Public-sector demand overall rose 0.1% for the quarter, as government final consumption expenditures showed a small rise of 0.4%, but public investment, which had increased in previous quarters because of the positive effects of economic policies that went into effect last year, began to decline and a drop of 1.2% for the quarter was reported, the first decrease in five quarters.

External demand continued to push the growth rate upward and made a 0.4% contribution to expansion in real GDP. Although imports rose 3.4%, the first rise in three quarters, against a background of the bottoming out and improvement in domestic demand, exports increased a substantial 6.4% for the quarter, reflecting progress toward inventory adjustments overseas and higher exports to the rest of Asia, as a result of the recovery of the Chinese economy and other factors.

The GDP deflator, which indicates overall prices movements in the economy as a whole, was 0.2% higher for the July-September quarter than in the same quarter of the previous year. This was the fourth consecutive increase, reflecting major declines in the prices of imports, including crude oil, compared with the previous year. On the other hand, the deflator for domestic demand, which excludes the effects of changes in the prices of exports and imports, declined 2.6%, which represented a larger decrease than in the previous quarter. This is believed likely to indicate that the effects of the decreases in import prices are beginning to influence domestic prices and the consequences of the deterioration of the income environment for households and the weakness in demand, with the exception of some consumer durables.

(2) Economic Outlook: Concerns about a Reactionary Decline and the Delay in the Permeation of the Domestic Demand Recovery

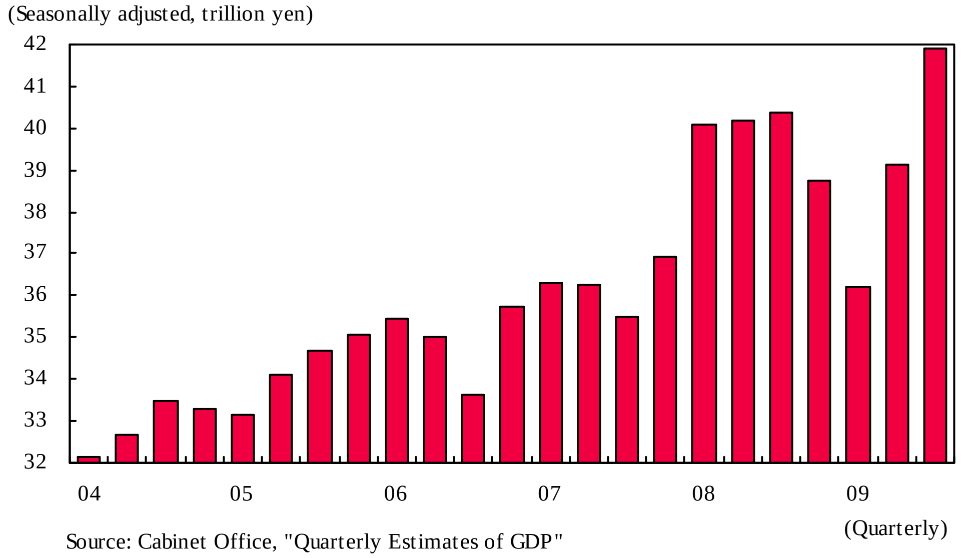
As these comments again confirm, with spring 2009 as the bottom, the movement toward bottoming out and improvement in the economy is continuing. Japan's exports and industrial production are continuing to increase as inventory adjustments in Japan and overseas have progressed and the world economy has improved, particularly in China and the other emerging economies. Also, as a result of the positive impact of the economic policies that went into effect in the previous year, demand has received a boost, mainly from personal consumption and public investment.

However, for the economy to move smoothly onto the path to recovery, a number of high hurdles must be cleared. Let us consider the important factors that we believe relate to the future directions the economy will take.

①Effects of Government Policies Are Both Positive and Negative.

The driving force for the recent bottoming out and improvement in the economy has been the boost provided to consumer spending by the positive impact of government policies. Real consumption expenditures on durable goods rose 8.1% over the previous quarter during the April-June period and 7.1% in the July-September quarter (Exhibit 1). The focus of this firm growth trend has been the positive effects of the government's eco-point system, tax reductions for environment-friendly cars, and subsidies for purchasing new automobiles. There have been periods in the past when expenditures on consumer durables have risen suddenly, but this time the amount of increase in these expenditures is setting new records, despite a harsh income environment for households. This suggests that the boost from government policies has had significant effects.

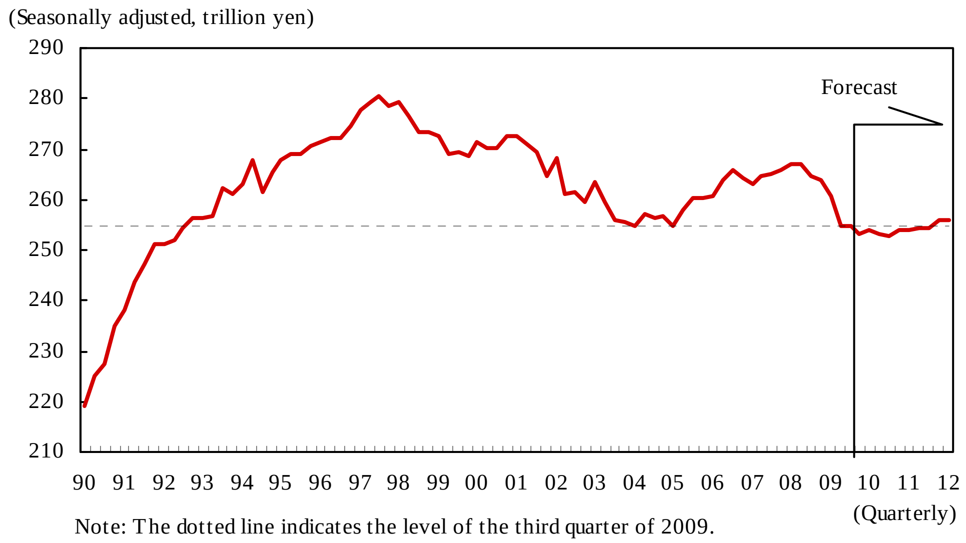
Exhibit 1: Real Consumption Expenditures on Durable Goods



Source: Cabinet Office, "Quarterly Estimates of GDP"

However, as incomes are in the midst of a decline, there is a strong possibility that the net effect of these policies may be to move consumer spending forward. The strongest growth has been reported for big-ticket consumer durables, which consumers tend to buy but then postpone future purchases of the same items for some time. Recent data show that employee compensation (in nominal terms) has now fallen to the levels prevailing in 1992 and from 2004 to 2005. In view of movements among corporations to restructure their operations, the forecast is for further declines in income going forward (Exhibit 2).

Exhibit 2: Employee Compensation



Note: The dotted line indicates the level of the third quarter of 2009.
Source: Cabinet Office, "Quarterly Estimates of GDP"

Turning to government subsidies for purchasing new, eco-friendly cars, the schedule calls for ending this subsidy program at the end of fiscal 2009 (March 31, 2010). There is a strong possibility of a surge in demand as the end of fiscal 2009 approaches followed by a reactionary decline in demand in early fiscal 2010. On the other hand, in the case of the government's eco-point system, flat-screen TV sets, which are eligible for these points, will receive a boost from the scheduled switch-over to terrestrial digital broadcasting beginning in July 2011. Therefore, the impact of the reactionary decline when the eco-point program is terminated will probably not be as large as in the case of the eco-car subsidies. Similarly, sales of air conditioners, which are also eligible for eco-points, are influenced by unseasonable weather conditions and other factors and, at the present time, do not seem to be benefiting from the eco-point program. Therefore, there may be no reactionary decline in demand for these products.

Please note that in our forecast we have assumed that the eco-point program and the subsidies for buying new eco-friendly cars will both be terminated at the end of March 2010, although there have been recent signs that these programs may be extended. If so, the anticipated surge in demand and the reactionary decline will be evened out. Moreover, if the programs are extended, they will encourage consumers to make purchases of the related products, but we believe this will increase the amount of consumer spending that will be brought forward.

In any case, if household incomes do not show a full-scale recovery, increases and decreases in consumer spending will continue to be sensitive to government policies, and, when policies are terminated, the effect of having brought consumption forward will contribute to a major reactionary decline in spending.

The policies that are expected to have a direct effect on household incomes include the payment of allowances for children and the effective elimination of tuition fees for national high schools, both of which will have a direct positive effect on disposable incomes. Although the exact timing of these measures has not been specified, provided they are put into effect and payments begin not long after the beginning of fiscal 2010, they will provide support for personal consumption from the beginning of the fiscal year. In addition, other measures, such as the elimination of the temporary road tax, will probably have a positive effect on consumer spending by increasing consumer purchasing power. However, it is not clear at present what percentage of this increase in purchasing power will actually be used for consumption.

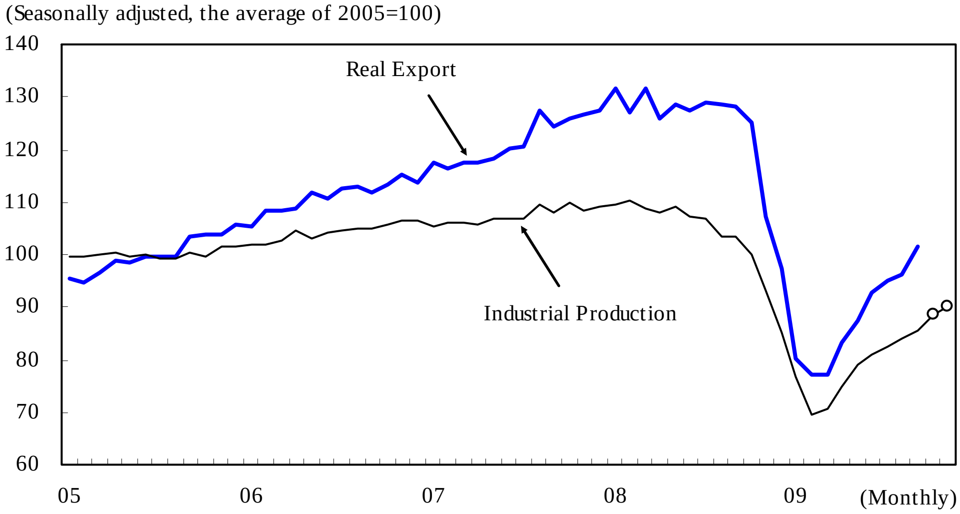
On the other hand, the suspension of a portion of public investment and cutbacks in government expenditures under the new administration will have a negative impact on the economy. Real public investment began to decline from the previous quarter during the July-September period, but the additional allocations for public investment that were approved at the time of the passage of the government's supplementary budget in May are expected to come on stream in the latter half of fiscal 2009. Even if certain public works projects are suspended, there seems to be little reason for concern that a sharp decline in public investment will be a factor reducing the economic growth rate. Instead, following the beginning of fiscal 2010, the positive effects of the previously mentioned supplementary budget will end, and, as we are assuming that the cutbacks in public investment will be expanded in the fiscal 2010 budget, there is concern that the margin of decline in public investment will increase.

As these comments suggest, it is likely that domestic demand will remain weak for the time being. As a consequence, the direction of the economy appears likely to change, depending on the impact of the policies adopted by the government. Especially, following the beginning of fiscal 2010, there will be combination of positive and negative factors at work. If the effects of the payment of allowances for children and other measures are minimal, concerns about a second downturn in the economy will spread.

②Reliance on External Demand for the Bottoming Out and Continued Improvement

The strongest driver of the economy at present is external demand. After reaching bottom in February 2009, the mining and manufacturing production index had risen to 23.3% year on year in September. However, at the same time, the index of exports in real terms (the portion released by the Bank of Japan) had climbed to 31.2%, substantially higher than the rise in industrial production (Exhibit 3). The steep decline in exports that began in fall 2008 was the main cause of the corresponding drop in production, but, in part because of a reactionary rise, the recent recovery in production is being driven mainly by external demand.

Exhibit 3: Industrial Production and Real Export



Note: Round marks indicate forecast figures based on the Survey of Production Forecast in Manufacturing.

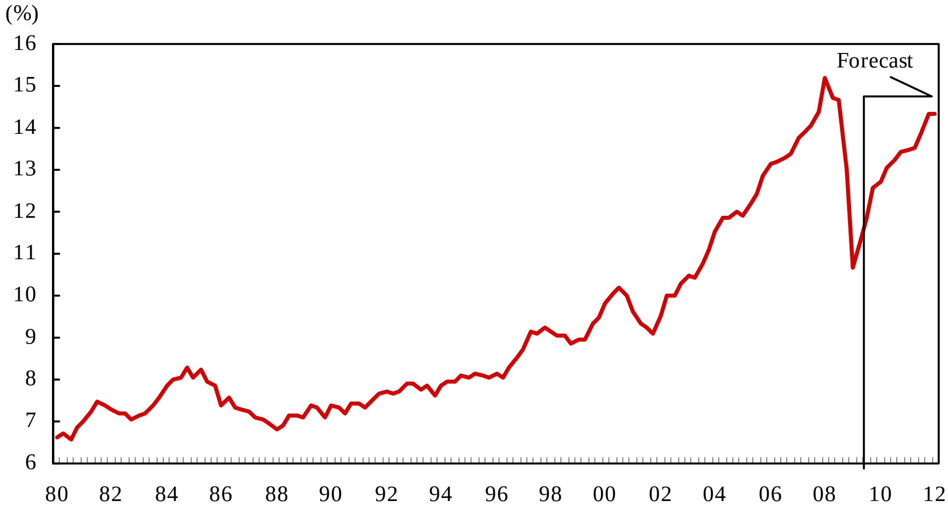
Source: Ministry of Economy, Trade and Industry, "Indices of Industrial Production", Bank of Japan, "Financial and Economic Statistics Monthly"

By region, exports to Asia, especially China, and, by product, exports of auto-related products, electronic components and devices, and IT-related products are robust. However, the increase thus far has been due not only to the recovery in demand overseas but is also a result of the contribution of exports for the replenishment of inventories overseas that had been cut back. When the replenishment of inventories is completed, we, therefore, anticipate that the momentum of exports will slow to match the deceleration in the pace of expansion in demand.

In addition, even though overseas economies are bottoming out and improving, it appears to be unlikely that the high rates of growth that prevailed from 2004 to 2007 will return in a short period of time. If external demand does not rise as assumed, there is a possibility that exports may be constrained by another adjustment in inventories in overseas markets.

Even so, we expect that the dependence on exports in real GDP will continue to rise (Exhibit 4). The reason is that, after the economy has bottomed out, driven by exports, this momentum seems quite unlikely to be transferred to domestic demand. This scenario of growth highly dependent on external demand was also played out in 2002 and subsequent years. We think this means that the economy will continue to be susceptible to trends in overseas economies and that the recent bottoming out and improvement in the economy is standing on a weak foundation.

Exhibit 4: Degree of Dependence on Exports



Note: Degree of Dependence on Exports = Real Export / (Real GDP + Real Import)
Source: Cabinet Office, "Quarterly Estimates of GDP"

③Delayed Transference of the Impact of the Bottoming Out and Improvement from the Corporate to the Household Sector

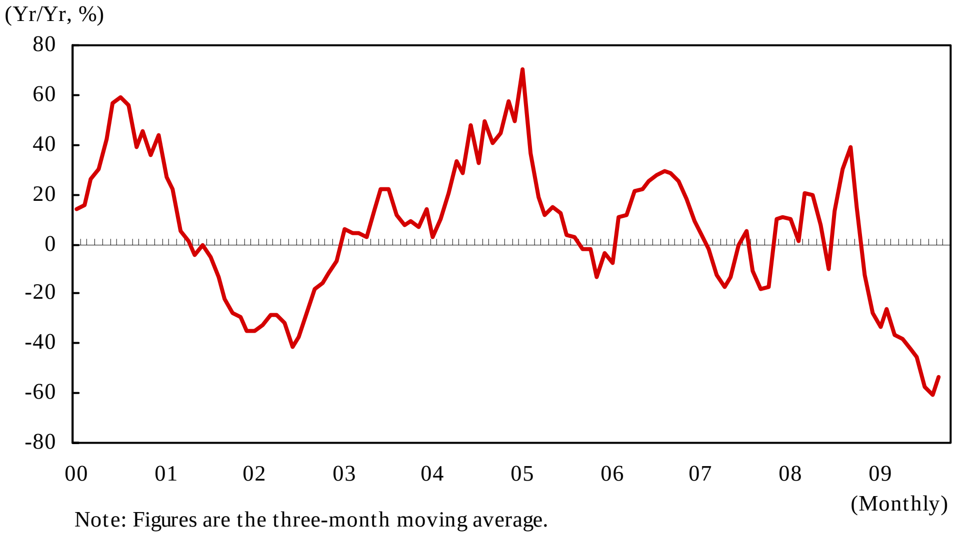
The corporate sector has escaped from the worst phases of the downturn, and, while the level of activities remains relatively low, the trend toward improvement is continuing. Among various sectors, conditions in the manufacturing industries are clearly favorable. Inventory adjustments have run their course, and the level of inventories is low compared with the value of shipments.

Activities in the manufacturing sector have increased on a month-to-month basis for seven consecutive months since March this year, because of the improvement in exports and increases in sales of consumer durables resulting from the positive effects of government policies. However, the index of mining and manufacturing production, according to the confirmed figures for September, stood at 85.7 (2005=100). This figure was close to the lowest point in the previous business cycle, which stood at 87.0 as of November 2001. Therefore, industrial production has only just finally reached a point close to the low point in the previous downturn. Accordingly, corporations do not sense that conditions have bottomed out because their output is still at the level prevailing at the trough of the previous recession.

Judging from the forecast index for industrial production, firm increases in output should continue at least for the rest of the calendar year, but this upward trend will be dependent on external demand and the positive impact of government measures. The movement to restock inventories in Japan and overseas has run its course and growth in exports is slowing. Therefore, from the beginning of 2010, the rate of increase in industrial production is forecast to weaken gradually. Also, after the beginning of 2010, the margin of decline in public investment is expected to widen, and, together with the reactionary decline that is expected if the eco-point program and eco-car subsidies are terminated, it is conceivable that industrial production might plateau during the first half of fiscal 2010.

Private capital investment, which had been on a declining trend, increased over the previous quarter during the July-September period, according to the statistics for real GDP, and there is a possibility that it has reached the bottom for this downturn. This increase in capital investment is judged to be a result of the increase in production and the improvement in corporate performance, but another factor is probably that corporations made selective investments in new equipment that they could no longer postpone. When corporations make relatively large investments, these are accompanied by investments in construction work, but data indicate that orders for construction, including manufacturing plants, have fallen substantially and remain at a low level (Exhibit 5). For this reason, the recent increase in capital investment leads us to think that corporations are making a bare minimum of small-scale investments that are essential, including replacement of certain equipment. The utilization rate of capital equipment remains low, and corporations are still reporting that they have excess equipment. Therefore, even if private capital investment has reached bottom, increases in investment going forward are likely to be gradual.

Exhibit 5: Construction Orders of Factories, Warehouse and Power Plants Received from Manufacturing Industry

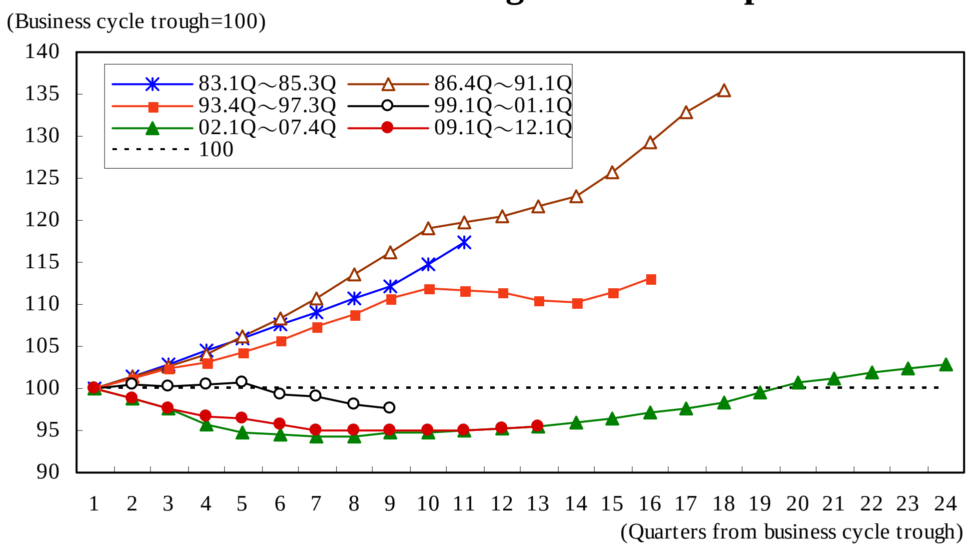


Note: Figures are the three-month moving average.
Source: Ministry of Land, Infrastructure, Transport and Tourism, "Current Survey of Orders Received for Construction [Large 50 Constructors]"

As these comments suggest, even if the momentum in the corporate sector is weakening, the trend toward improvement is expected to continue. What is important when considering the future direction of the economy is the issue of when and to what extent this improvement in the corporate sector will begin to influence the household sector. If the bottoming out and improvement at the corporate level does not bring increases in wages and other income items, we cannot expect full-scale recovery in domestic demand.

Exhibit 6 sets the timing of the commencement of previous expansionary phases at 100 and shows the corresponding level of personnel costs (based on Corporate Statistics). Until the early 1990s, when the economy reached the bottom of the cycle and began to recover, personnel costs also rose in tandem with the recovery. However, after the mid-1990s, even after the economy began to expand, corporations moved ahead, instead, with cuts in personnel costs. This was because corporations had strengthened their stance of cutting fixed costs until they could secure a sufficient level of profitability when the economy had recovered. This has made it more difficult for the benefits of economy recovery to be passed on to households. Looking ahead also, corporations still have a strong sense that they have excess personnel. Therefore, we believe it will take time before the benefits of the improvements in the corporate sector will be passed on to the household sector.

Exhibit 6: Personnel Costs during Economic Expansion Periods



Note: Figures are the four-quarter moving average.
Regarding the latest period, we assume that the trough was in the first quarter of 2009.
Figures after the third quarter of 2009 are our own forecasts.
Source: Ministry of Finance Japan, "Financial Statements Statistics of Corporations by Industry"

MURC is forecasting that the upturn in employee compensation on a fiscal year basis will start with fiscal 2011, but the margin of increase will be minimal.

As the foregoing analysis suggests, the economy is continuing to bottom out and improve at the present time, but this is because of robust external demand and the positive effects of government policies. Concerns are spreading that the effects of these policies may end temporarily at the beginning of fiscal 2010, and the economy may experience a second downturn. In fact, since improvement in external demand and the improvement in the corporate sector will continue, a second downturn will probably be averted. However, it is entirely conceivable that the pace of improvement may slow temporarily and the economy may reach a plateau.

(3) Outlook for Fiscal 2009 and Fiscal 2010: Plateauing of the Economy Will Also Avert a Second Downturn

In fiscal 2009, the trend toward improvement in the economy is forecast to continue. However, the principal causes of this will be the recovery in exports, accompanying the improvement in overseas economics, and the positive effects of government economic policies. Domestic demand in the private sector will continue to be weak. When the pace of increase in exports pauses and the effects of economic policies run their course, there is a strong possibility that the pace of improvement in the economy may gradually weaken.

Exports will continue on an upward trend supported by improvement in overseas economies and movements to replenish inventories accompanying the completion of inventory adjustments in overseas markets. This will act as a driver boosting industrial production. However, since we cannot expect overseas economies to return to the previous rapid growth path in a short period, when the replenishment of inventories runs its course, the rate of increase in exports is expected to diminish gradually.

The economic policies enacted in fiscal 2008 and fiscal 2009 are expected to make a major contribution to boosting the rate of growth in fiscal 2009. As a result of the effects of these economic policies, consumer spending is expected to continue to be firm, supported principally by purchases of big-ticket consumer durables. Toward the end of the current fiscal year, as the deadlines for receiving eco-points and the payment of subsidies for purchasing eco-cars approach, a surge in demand is anticipated. However, this will occur against a background of harsh employment and income environments, and there is concern that this surge may, to some extent, eat into household resources for future consumer spending. Government public works spending has begun to decline, compared with the previous quarter, according to recent data, but is expected to remain at a relatively high level for the remainder of the current fiscal year.

Production will continue to increase as exports rise, inventory adjustments end, and the positive effects of economic policies emerge. There is a possibility that capital investment has finally reached bottom, but its recovery momentum will be weak going forward. Also, since growth in exports will slow, the pace of improvement in the economy may slow in the latter half of fiscal 2009.

Corporate profitability is moving out of the worst phase as sales recover and the effects of reductions in fixed costs, including reductions in personnel expenses, take effect. Although corporate profitability will begin to rise over the levels of the previous year toward the end of the current fiscal year, the level will remain relatively low, and, for the fiscal year as a whole, profits will show double-digit declines compared with the previous fiscal year. Capital investment is believed likely to finally bottom out, as corporate performance improves and companies focus their investments on purchases of capital equipment that can no longer be postponed. However, since companies will still perceive capacity levels as being excessive, trends in investment will remain sluggish. In addition, as might be expected, private housing investment will begin to show improvement in the latter half of the fiscal year, as the inventory of unsold condominiums gradually declines, but the level of new housing starts will remain extremely low.

Our forecast for real GDP in fiscal 2009 calls for a decline of 2.5% year on year, a somewhat smaller decrease than the 3.2% drop in fiscal 2008. However, as a result of a sharp decline in growth in the latter half of fiscal 2008, the carryover into fiscal 2009 will be a substantial minus 4.2%, and, after adjusting for this effect, the growth rate will be plus 1.7%, a major recovery compared with the previous fiscal year (Exhibit 7).

<u>In fiscal 2010</u>, the economic recovery will continue, but the eco-point program and the subsidies for eco-cars will be terminated, and public investment will decrease. Moreover, as a result of stagnation in consumer

spending because of the delay in improvement in the income and employment environments, the momentum of improvement will weaken. However, because of the continuing upward trend in exports and the positive effects of government policies, such as the commencement of payments allowances for children, the economy is expected to avoid the crisis of slipping into a second downturn, but there are concerns that the economy may plateau in the first half of the fiscal year.

In the corporate sector, gradual movements toward improvement will likely continue. Industrial production will continue on an upward trend, even though the pace of increase will diminish. Also, corporate profitability will increase, owing to the rise in sales and the effects of cost reductions, but will remain at a relatively low level because of weakness in sales prices and other factors. Therefore, although the recovery in capital investment will continue, since corporations will restrain capital outlays to a bare minimum, the increase will be modest and will not be strong enough to drive the economy upward.

Among other considerations, further gradual improvement is expected in the employment and income environments, where improvement has been delayed, and in private housing investment, but trends in both will remain weak.

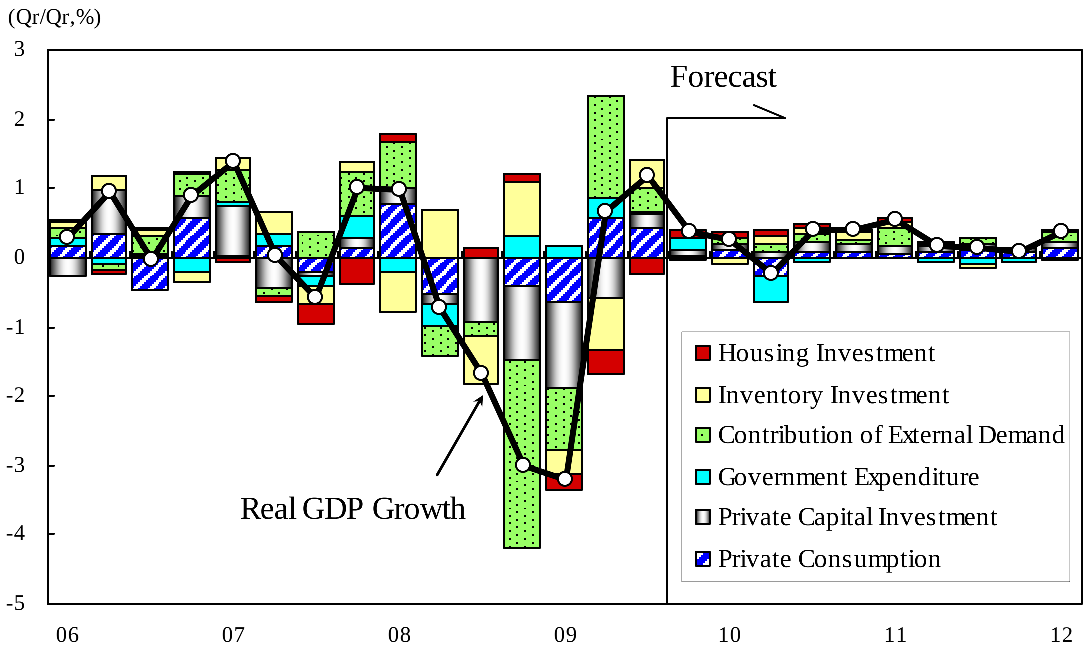
Our forecast for real GDP in fiscal 2010 is for growth of 1.0%. Compared with fiscal 2009, the growth rate will appear to increase markedly in comparison with fiscal 2009, but there will be a carryover effect of +0.7%. Therefore growth in fiscal 2010 measured during year (and thereby adjusting for this effect) will be a relatively weak plus 0.3%.

In fiscal 2011, the recovery trend will continue. As overseas economies begin to experience full-scale recovery, growth in Japan’s exports and increases in production are forecast to continue. In addition, the employment and income environments will begin to improve, and consumer spending will rise. We believe capital investment will rise as corporate profitability increases. However, the pace of expansion in consumption and investment will be only marginal, and there will be little feeling of recovery.

The level of real GDP and the mining and manufacturing production index will remain low in comparison with the peak in fiscal 2007. Under these conditions, there is a possibility that corporations will not fully revise their views that their production capacity and personnel levels are excessive.

We are forecasting real growth of 1.1% in fiscal 2011. As in fiscal 2010, there will be a carryover effect of plus 0.8%, and, therefore, growth in fiscal 2011 measured during the year (and thereby adjusting for this effect) will be plus 0.3%, about the same pace of increase as in fiscal 2010.

Exhibit 7: Real GDP Growth (seasonally adjusted)



Source: Cabinet Office "Quarterly Estimates of GDP"

2. Forecasts of Economic Activity by Sector

(1) Corporations

- As they entered the 21st century, corporations had completed their disposal of negative assets left over from Japan's bubble economy, and their financial positions and profitability recovered substantially, supported by strong exports. Accordingly, the risks of a major downturn in production, capital investment, or other aspects of corporate activities had receded for the time being.
- However, starting in autumn 2008, domestic and overseas demand began to drop sharply, and companies made major adjustments in production to reduce their inventories. As a result, production dropped rapidly, mainly in such industries as automobiles, digital-related products (including semiconductors and LCDs), general machinery, and other items. Since the beginning of 2009, production has bottomed out and shown improvement, but due to the reaction following inventory adjustments and because the positive effects of government policies have run their course, the pace of recovery in production has been only moderate, and industrial activity is likely to continue at a low level for the time being.
- As a result of the deterioration in the domestic and overseas economies, corporate profitability has fallen sharply and private capital investment has declined. Although there are signs of a bottoming out of capital investment along with the increase in production, and there is a necessity for making investments to replace equipment and raise product value added to increase competitiveness, a strong feeling of excess capital equipment capacity is persisting as a consequence of the sharp drop in demand. Accordingly, there is a strong possibility that private capital investment will remain at a low level.
- Recurring profits had exceeded the peak levels attained previously during Japan's bubble era and the time of the IT boom, and they were continuing at record levels. However, because of rapid deterioration in the world economy, recurring profits dropped sharply along with the decline in sales in Japan and overseas. As a result of the recent improvement in the world economy and progress among corporations

in reducing fixed costs, including personnel expenses, corporations have moved out of the worst phases of the downturn. Nevertheless, it is expected to take some time for profitability, which has decreased markedly, to recover to the previous levels.

(2) Households

- The stagnation in corporate activities is adversely affecting the household sector through declines in incomes.
- Since autumn 2008, faced with major declines in demand, companies have reduced the number of personnel, and this has resulted in a marked deterioration in conditions in the employment environment. Although the feeling among corporations that they have an excess of personnel is being relieved by progress toward employment adjustments, it is still strong. As a result, corporations are maintaining a cautious stance toward hiring new personnel. For this reason, the unemployment rate is believed likely to remain at a high level.
- As a result of measures that were incorporated into economic crisis policies to promote the purchases of eco-friendly products, consumer spending, principally for durable goods, is increasing at present. As the household income environment continues to be severe, although payment of government allowances for households with children will provide support for household incomes, other factors, such as a reactionary decline in the demand for consumer durables that escalated substantially in fiscal 2009, will bring lackluster trends in individual consumption in fiscal 2010.
- In the area of residential investment, although the sons and daughters of the baby-boom generation have 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 ran their course, housing sales have remained lackluster because of expectations that home prices may decline further and the severity of the employment environment. In addition, the slower growth in the number of households in the medium term will have a restraining effect on residential investment.

(3) Government

- With the collapse of Japan's bubble economy early in the 1990s as a turning point, 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 improvement in the economy, tax revenues began to expand again, but the government has basically maintained its policy of making structural reforms in its finances.
- However, from autumn 2008, as the economic downturn became increasingly serious, a number of economic policies and other measures were enacted, resulting in a rise in government expenditures. In the first half of fiscal 2009, government public investment increased substantially. On the other hand, since the increase in expenditures was funded through the issuance of government bonds, the government's fiscal position has deteriorated.
- The new administration, led by the Democratic Party of Japan (DPJ), which was elected in September, has positioned policies to support households, such as the payment of allowances to households with children, as the centerpiece of its policies. Amid the current harsh fiscal conditions, the new administration has adopted a policy of reviewing the structure of government expenditures with the objective of squeezing out the resources needed for paying the allowances to households with children and other programs it plans to begin in fiscal 2010. Under this policy, the government is expected to continue to cut public investments. Regarding government final consumption, along with the demographic aging of the population, social welfare payments,

including health-care costs, are expected to continue to rise, but growth in these expenditures is likely to be restrained in fiscal 2010 and subsequent years, as measures are taken to reduce and increase the efficiency of usage of funds in other areas.

(4) Trends in Overseas Economies

- The world economy is showing signs of improvement. In the July-September quarter, the United States and the countries of Europe reported positive growth (compared to the previous quarter), and growth in China accelerated.
- Moving into 2010, the effects of economic policies and the movements toward replenishing inventories in the world economy are expected to give a boost to growth. However, the capacity for recovery in consumer spending in the United States is weak, and there appears to be a strong possibility that improvement in employment globally will be delayed. For this reason, the tempo of recovery in the world economy will be gradual, and the outlook is for low growth at rates below potential levels.
- As the world economy bottoms out and conditions improve, Japan’s exports are also showing improvement. This upward trend is expected to continue, but, since the tempo of recovery in the world economy is moderate, the pace of increase is likely to be moderate. As the recovery of consumer spending in the U.S. economy continues to be weak, exports of transportation equipment and consumer goods to the United States cannot be expected to recover their previous levels. The ratio of Japan’s exports to Asia and countries in other regions will increase, but the unit volume of exports overall will remain relatively low in comparison with previous levels.
- Income from Japan’s net overseas assets will be influenced to some extent by world economic conditions but is expected to remain steady. As the recovery in the trade surplus continues to be moderate, the surplus in the income account is likely to come to account for a larger share of the current account surplus.

3. Forecasts for Prices and Financial Markets

- The sharp declines experienced previously in the prices of raw materials, especially crude oil and metals, have ended, and prices of these commodities are rising again, but upstream inflationary pressures are weak. 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.
- Among domestic corporate prices, the prices of petroleum products and other items that are influenced by international commodity market prices have begun to rise, but prices of other materials are continuing to show weakness, and prices of machinery are declining. Although the trends toward firming and increases in these prices may continue going forward, the pace of increase is expected to be moderate because of the weak recovery momentum in the domestic economy and other factors. Consumer prices are expected to continue on a declining trend during the forecast period because of the strong downward pressure on sales prices to final consumers.
- 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 a strong momentum in the economy is lacking, and short-term interest rates are remaining stable at low levels, long-term interest rates are also expected to remain low. However, there is a possibility that sustained recovery in various countries and the deterioration in

government fiscal positions around the world may place upward pressure on interest rates. In foreign exchange markets, as the turmoil in international financial markets continued in the latter half of 2008, the U.S. dollar and the yen strengthened, but, along with the improvement in the economies of countries around the world, since spring 2009, a trend has emerged to buy back European currencies and the currencies of resource-producing countries. Going forward, the directions taken by countries as regards their current easy monetary policies and expansionary fiscal policies are becoming factors to be taken into account when considering foreign currency rates.

Exhibit 8: Outlook for Fiscal 2009-2010

Forecast → Yr/Yr、%

	FY2007 (actual)	FY2008 (actual)	FY2009 (forecast)	FY2010 (forecast)	FY2011 (forecast)
Nominal GDP	1.0	-3.5	-3.1	0.0	0.7
Real GDP	1.8	-3.2	-2.5	1.0	1.1
Contribution of domestic demand	0.6	-2.0	-2.1	0.7	0.8
Private consumption	0.9	-0.5	0.4	0.2	0.6
Housing investment	-13.5	-3.0	-15.9	6.4	2.5
Private capital investment	2.1	-9.6	-13.0	3.2	2.8
Contribution of inventory investment	0.1	0.0	-0.5	0.3	0.1
Government expenditure	0.5	-0.5	2.8	-1.5	-0.8
Public investment	-6.3	-4.4	11.3	-12.2	-8.5
Government final consumption expenditure	2.1	0.3	1.1	1.0	0.7
Contribution of external demand	1.3	-1.2	-0.4	0.4	0.4
Export of goods and services	9.3	-10.2	-11.5	10.9	6.8
Import of goods and services	1.7	-3.6	-9.0	8.4	4.6
GDP deflator	-0.9	-0.3	-0.6	-1.1	-0.4

Forecast → Yr/Yr、%

	FY2007 (actual)	FY2008 (actual)	FY2009 (forecast)	FY2010 (forecast)	FY2011 (forecast)
Current account balance (trillion yen)	24.5	12.3	15.8	17.3	17.7
balance on goods (trillion yen)	11.7	1.2	5.6	5.7	5.7
balance on service (trillion yen)	-2.6	-2.0	-2.0	-1.8	-1.6
balance on income (trillion yen)	16.8	14.6	13.4	14.4	15.1
Industrial production	2.7	-12.7	-10.3	5.4	3.2
Unemployment rate(%)	3.8	4.1	5.4	5.4	5.1
New housing starts(annualized, ten thousand units)	103.6	103.9	76.9	85.9	88.3
Domestic corporate goods prices	2.3	3.2	-5.3	0.0	0.7
Consumer prices	0.2	1.2	-1.5	-0.8	0.0
excluding freshfood	0.3	1.2	-1.6	-0.8	0.0
Yen/U.S.Dollar	114.2	100.5	93.0	95.3	100.8
Uncollateralized call rates (O/N) (%)*	0.505	0.363	0.100	0.100	0.500
Newly issued government bond yields (10years) (%)	1.60	1.46	1.37	1.43	1.58
WTI future price (near month contract, US dollar/barrel)	82.2	85.9	70.6	80.5	83.3
Dubai crude oil prices (US dollar/barrel)	77.3	82.1	69.4	78.0	80.3

* actual=average, forecast=end of period

Exhibit 9: Outlook for Calendar 2009-2010

Forecast

Yr/Yr、%

	CY2007 (actual)	CY2008 (actual)	CY2009 (forecast)	CY2010 (forecast)	CY2011 (forecast)
Nominal GDP	1.7	-1.6	-5.2	0.1	0.7
Real GDP	2.3	-0.7	-5.2	1.4	1.2
Contribution of domestic demand	1.2	-0.9	-3.4	0.6	0.8
Private consumption	0.7	0.6	-0.8	0.6	0.4
Housing investment	-9.7	-7.6	-12.9	1.2	3.9
Private capital investment	5.7	-3.9	-17.9	1.7	3.1
Contribution of inventory investment	0.3	-0.2	-0.2	0.1	0.2
Government expenditure	0.1	-0.6	2.4	-0.4	-1.0
Public investment	-7.3	-6.9	9.4	-7.0	-9.5
Government final consumption expenditure	1.9	0.8	1.0	1.1	0.7
Contribution of external demand	1.1	0.2	-1.8	0.8	0.4
Export of goods and services	8.4	1.8	-24.0	14.9	6.9
Import of goods and services	1.5	0.9	-13.9	9.0	4.1
GDP deflator	-0.7	-0.9	0.0	-1.3	-0.5

Forecast

Yr/Yr、%

	CY2007 (actual)	CY2008 (actual)	CY2009 (forecast)	CY2010 (forecast)	CY2011 (forecast)
Current account balance (trillion yen)	24.8	16.4	13.7	16.4	17.5
balance on goods (trillion yen)	12.3	4.0	3.8	5.4	5.5
balance on service (trillion yen)	-2.5	-2.1	-2.0	-1.9	-1.6
balance on income (trillion yen)	16.3	15.8	13.2	14.0	14.9
Industrial production	2.8	-3.4	-22.4	10.4	2.6
Unemployment rate (%)	3.9	4.0	5.2	5.4	5.2
New housing starts(annualized, ten thousand units)	106.1	109.3	78.3	85.2	88.0
Domestic corporate goods prices	1.8	4.6	-5.2	-0.5	0.5
Consumer prices	0.0	1.4	-1.3	-0.9	-0.1
excluding freshfood	0.0	1.5	-1.3	-0.9	-0.2
Yen/U.S.Dollar	117.8	103.4	93.7	93.4	99.9
Uncollateralized call rates (O/N) (%)*	0.474	0.462	0.100	0.100	0.250
Newly issued government bond yields (10years) (%)	1.68	1.48	1.35	1.40	1.54
WTI future price (near month contract, US dollar/barrel)	72.3	99.6	62.0	79.4	82.8
Dubai crude oil prices (US dollar/barrel)	68.4	93.8	61.7	77.1	79.8

* actual=average, forecast=end of period

Exhibit 10: Outlook for 2009-2010 (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	-1.1	-3.0	-0.8	-2.6	-0.4	-0.1	0.5	1.2	-1.6	-0.7	1.0	1.9
	-0.8	-1.8	-3.6	-7.8	-6.5	-4.4	-2.3	1.1	0.1	-0.5	-0.3	0.5
Real GDP	-0.7	-1.7	-3.0	-3.2	0.7	1.2	0.4	0.3	-0.2	0.4	0.4	0.6
	0.6	-0.3	-4.3	-8.6	-7.0	-4.5	-0.8	2.7	1.5	0.7	0.8	1.2
Contribution of domestic demand (Qr/Qr,%)	-0.3	-1.5	-0.3	-2.3	-0.8	0.8	0.4	0.2	-0.3	0.3	0.4	0.3
Private consumption	-0.9	0.0	-0.7	-1.1	1.0	0.7	0.1	0.2	-0.4	0.2	0.2	0.1
	0.3	0.7	-0.3	-2.8	-0.8	-0.1	0.6	2.0	0.6	0.0	0.1	0.0
Housing investment	-0.4	4.3	3.3	-6.6	-10.2	-7.7	3.3	2.7	2.8	1.1	1.2	1.7
	-16.5	-5.4	11.8	0.6	-10.0	-20.4	-20.0	-12.0	0.4	10.0	8.0	7.0
Private capital investment	-0.9	-5.8	-7.0	-8.2	-4.2	1.6	0.5	0.5	0.7	1.0	0.9	0.9
	0.4	-4.1	-11.7	-20.5	-23.5	-16.6	-10.0	-1.6	3.1	2.9	3.2	3.5
Contribution of inventory investment (Qr/Qr,%)	0.7	-0.7	0.8	-0.4	-0.7	0.4	0.0	-0.1	0.1	0.1	0.1	0.1
Government expenditure	-1.4	0.0	1.5	0.7	1.2	0.1	0.7	0.1	-1.6	-0.3	0.0	0.0
	-1.2	-0.8	-0.8	0.6	2.9	3.2	3.0	2.2	-0.6	-1.1	-2.2	-1.9
Public investment	-4.8	0.7	2.5	3.1	7.7	-1.2	1.5	-0.8	-9.0	-2.7	-1.0	-1.2
	-8.2	-6.6	-4.6	0.4	15.9	13.1	11.3	7.1	-11.0	-11.6	-13.1	-12.4
Government final consumption expenditure	-0.8	-0.1	1.3	0.1	-0.2	0.4	0.5	0.3	0.1	0.2	0.2	0.2
	0.1	0.4	0.2	0.6	1.1	1.5	0.9	1.0	1.3	1.1	0.9	0.7
Contribution of external demand (Qr/Qr,%)	-0.4	-0.2	-2.7	-0.9	1.5	0.4	0.0	0.1	0.1	0.1	0.1	0.2
Export of goods and services	-3.9	-1.9	-13.5	-21.6	6.4	6.4	6.6	1.6	2.5	2.1	2.0	0.9
	5.9	4.4	-12.5	-36.3	-29.3	-23.0	-5.4	25.2	20.2	10.7	6.8	7.7
Import of goods and services	-1.9	-1.0	1.5	-14.0	-4.2	3.4	6.3	1.0	1.9	1.4	1.7	-0.8
	-2.0	0.0	3.0	-15.5	-17.6	-13.4	-9.5	6.4	16.5	10.2	4.0	4.3
GDP deflator (Yr/Yr,%)	-1.5	-1.6	0.7	0.9	0.5	0.2	-1.5	-1.5	-1.5	-1.2	-1.0	-0.6

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)*	5.0	4.0	2.1	1.8	4.0	3.7	4.4	3.6	4.2	3.9	4.8	4.4
balance on goods (trillion yen)*	1.8	0.8	-0.7	-0.5	1.4	1.5	1.2	1.0	1.5	1.3	1.1	1.4
balance on service (trillion yen)*	-0.5	-0.4	-0.5	-0.6	-0.5	-0.4	-0.5	-0.6	-0.5	-0.3	-0.5	-0.5
balance on income (trillion yen)*	4.0	4.0	3.6	3.2	3.4	2.9	4.0	3.4	3.5	3.1	4.4	3.8
Industrial production (Qr/Qr、%)	-1.3	-3.2	-11.3	-22.1	8.3	7.4	4.6	1.3	-0.1	0.4	0.5	0.6
(Yr/Yr、%)	0.8	-1.4	-14.5	-34.6	-27.8	-20.1	-4.9	22.8	13.5	6.0	2.3	1.2
Unemployment rate (%)*	4.0	4.0	4.0	4.4	5.2	5.5	5.5	5.5	5.5	5.4	5.4	5.3
New housing starts(annualized, ten thousand units)	112.0	110.2	101.0	90.4	76.2	70.7	77.6	84.2	84.2	85.7	86.2	87.6
Domestic corporate goods prices (Yr/Yr,%)	4.9	7.3	2.6	-1.8	-5.4	-8.3	-5.2	-1.8	-0.4	-0.2	0.4	0.3
Consumer prices (Yr/Yr,%)	1.4	2.2	1.1	-0.1	-1.0	-2.2	-1.8	-1.0	-1.1	-0.8	-0.6	-0.5
excluding freshfood (Yr/Yr,%)	1.5	2.3	1.0	-0.1	-1.0	-2.3	-1.7	-1.0	-1.2	-0.8	-0.7	-0.6
Yen/U.S.Dollar	104.5	107.6	96.1	93.6	97.3	93.6	90.3	91.0	92.3	94.3	96.3	98.3
Uncollateralized call rates (O/N) (%)**	0.507	0.501	0.333	0.110	0.110	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	1.28	1.45	1.34	1.35	1.35	1.38	1.41	1.45	1.49
WTI future price (near month contract, US dollar/barrel)	124.0	118.0	58.7	43.1	59.6	68.3	77.0	77.5	79.0	80.0	81.0	82.0
Dubai crude oil prices (US dollar/barrel)	116.9	113.8	53.3	44.4	59.2	68.1	75.0	75.5	77.0	77.5	78.5	79.0

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