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Forecast for the Japanese Economy in Fiscal 2010 and 2011

**— Risk of a Double-Dip Recession Will Be Avoided, But Concerns Remains
about the Diminishing Effects of Economic Policies —**



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1. Outlook for the Japanese Economy in Fiscal 2010 and Fiscal 2011

-- Risk of a Double-Dip Recession Will Be Avoided, But Concerns Remains about the Diminishing Effects of Economic Policies

(1) Current State of the Economy: Improvement Continuing, Supported by Exports and Positive Effects of Stimulus Policies

Real GDP growth for the October-to-December period was +1.1% over the previous quarter (+4.6% at an annualized rate), the third consecutive quarterly increase. This confirmed that the movement toward improvement in the economy is continuing even now as a consequence of growth in exports, which have been on a rising trend since the beginning of fiscal 2009, and the positive impact of economic policies. The nominal growth rate for the quarter was +0.2% (+0.9% at an annualized rate), and, thus, turned positive for the first time in seven quarters.

The margin of decline compared with the same quarter of the previous year in the GDP deflator, which shows trends in prices in the overall economy, expanded to -3.0%, influenced by the bottoming out in prices of imports, including crude oil, and a slightly stronger downward trend in domestic prices. In addition, the domestic demand deflator, which excludes the effects of export and import prices, was 2.9% below the level of the same quarter of the previous year, reflecting the continuation of a decreasing trend. Downward pressure on prices remains strong because of the growing preference among households for lower-priced goods and services owing to the stagnation in the employment and income environments.

By contribution of domestic versus external demand, domestic demand contributed +0.6 percentage point, thus posting the first positive figure in seven quarters. On the other hand, external demand contributed +0.5 percentage point, the third consecutive positive figure.

By component of domestic demand, growth in personal consumption continued at a relatively high level of +0.7% over the previous quarter, reflecting expansion in purchases of durable goods supported by the tax break on eco-friendly automobiles, the payment of subsidies for new car

purchases, and the positive impact of the eco-point system. Private residential investment decreased 3.4% from the previous quarter, the fourth consecutive quarterly decline; however, reflecting the bottoming out in the number of housing starts, the margin of decline is diminishing.

Private capital investment rose a modest 1.0% over the prior quarter, but this was the first increase in seven quarters. Although corporations are still reporting a strong feeling of excessive equipment, increases in industrial production are continuing and corporate profitability has moved out of its worst phase, suggesting that finally a movement toward improvement is under way. Also, as the movements toward inventory adjustment have run their course, the contribution of private inventory investment to real GDP was +0.1 percentage point for the October-to-December quarter, the first positive figure in four quarters.

In the government sector, public investment declined 1.6% from the previous quarter, the second quarter-to-quarter decline, reflecting the diminution of the positive effects of economic policies implemented thus far and the effects of the acceleration of budgetary allocations. On the other hand, government final consumption rose 0.8% for the quarter, thus continuing on an upward trend. In total, public demand rose 0.4% over the previous quarter.

Regarding the external sector, exports rose a strong 5.0% for the quarter, mainly because of gains in exports to the rest of Asia, accompanying recovery in the Chinese economy. On the other hand, reflecting improvement in Japan's domestic demand and other factors, imports rose 1.3% over the previous quarter, the second consecutive quarterly rise. As a consequence, the contribution of external demand to real GDP amounted to 0.5 percentage point and continued to be a driving force for growth.

(2) Economic Outlook: Although the Increase in Exports Will Continue, Many Concerns Remain

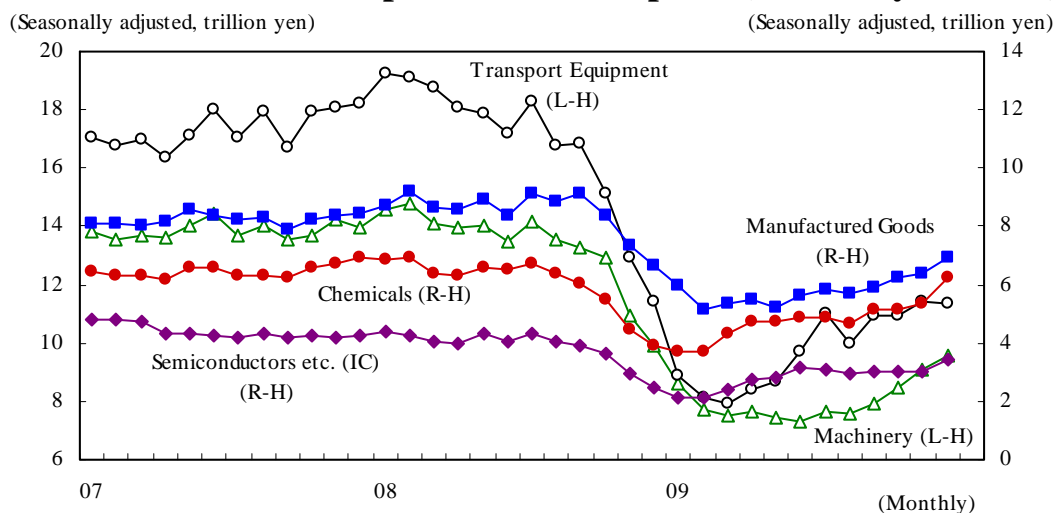
The results for real GDP for the October-to-December quarter of 2009 confirm again that the economy reached bottom in spring 2009 and has continued to improve since that time. Exports and industrial production are continuing to rise, as the adjustments in inventories in Japan and overseas have run their course, and the world economy is improving, especially in China and the other emerging economies. In addition, demand in Japan is being pushed upward, mainly by consumer spending and public investment as a result of the accumulated effects of government economic policies. Moreover, private capital investment, which had been on a deteriorating trend, is finally bottoming out and housing investment is close to bottoming out. Positive signs are appearing, as growth driven by a balance of domestic and external demand is emerging and as nominal GDP growth has begun to expand again.

However, there are a number of concerns about whether the economy will continue to show steady improvement. In the following sections, we have listed and explained our thinking regarding the issues that seem to be important in considering the future course of the economy.

(a) Unexpectedly Strong Export Growth

The main driving force for the economy at present is the steady recovery in exports. An examination of exports by product shows that, after exports in all industries plunged beginning in fall 2008, they have all continued to show improvement (Chart 1). Among various industries, the improvement in transportation machinery, centered around automobiles, has been major, while export demand for chemical products, for which demand is strong in the rest of Asia, and for steel and nonferrous metals has also been strong. Increases have also been seen in exports of electronic parts and devices and certain other products, for which worldwide demand is recovering. In addition, demand for general machinery, for which recovery has been delayed, is finally showing signs of improvement.

Chart 1: Continued Improvement in Exports (Trends by Product)

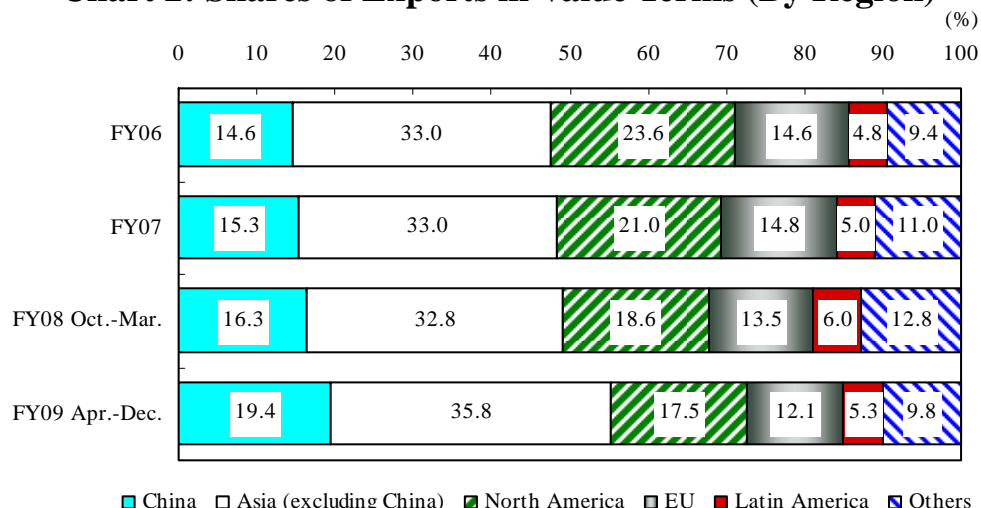


Notes: "Manufactured Goods" category includes iron and steel product, nonferrous metals, manufactures of metals, textile yarn and fabrics, and rubber manufactured, etc.

Source: Ministry of Finance, "Trade Statistics"

By region, recovery has been particularly strong in exports to the rest of Asia. Although there has been some improvement in exports to North America and the EU, the momentum is not very strong. If we compare the shares of exports to various regions after April 2009, when exports began to increase again, and shares before that, the shares of exports to China and the rest of Asia have increased, while the shares of exports to Europe and the Americas have continued to decline (Chart 2). If we consider the fact that the pace of recovery in Asia has been faster than that in Europe and the Americas, this trend toward a higher share of exports to Asia seems likely to become even more pronounced.

Chart 2: Shares of Exports in Value Terms (By Region)

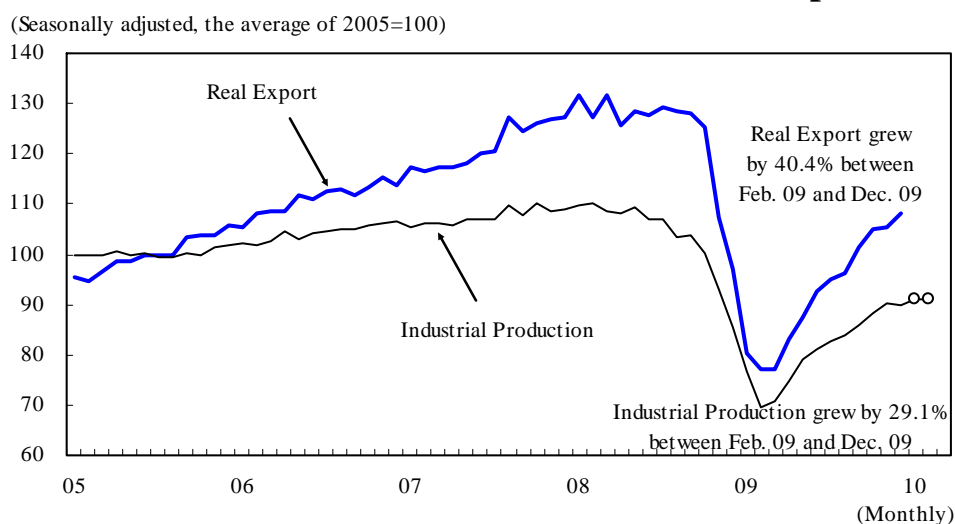


Legend: China (Cyan), Asia (excluding China) (White), North America (Green), EU (Grey), Latin America (Red), Others (Blue)

Source: Ministry of Finance, "Trade Statistics"

Along with the rise in exports, industrial production in Japan is increasing. The index of mining and industrial production reached bottom in February 2009, and, through December 2009, it had risen for 10 consecutive months. The margin of increase over this period has been about 30%. On the other hand, over the same period, the index of real exports (data issued by the Bank of Japan) has risen about 40%, substantially higher than the increase in the value of exports (Chart 3). The sharp decline in exports since fall 2008 was the principal cause of the steep drop in industrial production, and, in part because of the subsequent reactionary rise, production is recovering driven by external demand.

Chart 3: Industrial Production and Real Export



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

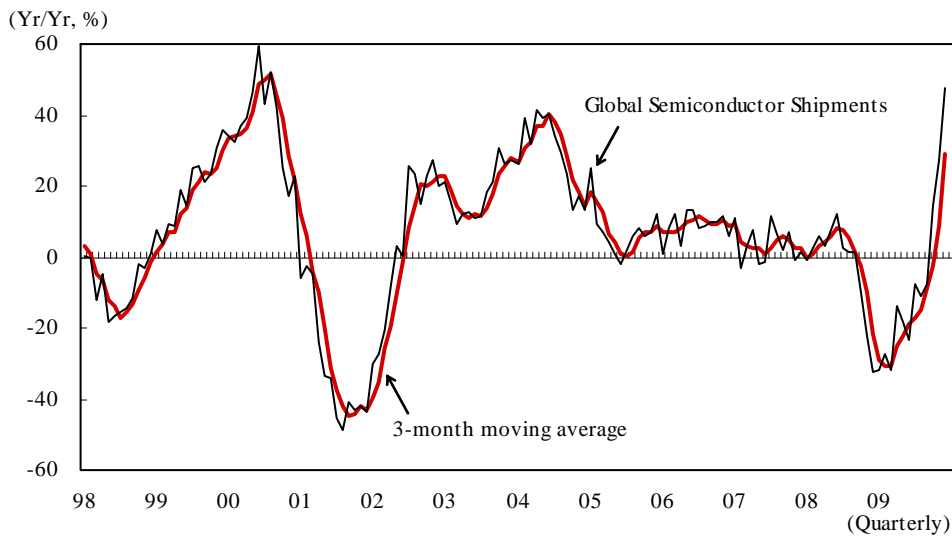
Source: Ministry of Economy, Trade and Industry, "Indices of Industrial Production", Bank of Japan, "Financial and Economic Statistics Monthly"

Major factors influencing the timing of the bottoming out of Japan's exports in 2009 were not only the recovery of demand in overseas economies but also the restocking of inventories in foreign markets that had been adjusted downward. However, the restocking of inventories is believed likely to have run its course. Going forward, the momentum of exports is expected to grow weaker as the rate of expansion in exports adjusts to the rate of increase in demand in overseas markets. Even so, however, the rate of increase in exports is likely to be relatively higher than the growth of domestic demand. Therefore, the dependence of real GDP on

exports will continue to rise.

Among export items, the demand for electronic components, including semiconductors, is rising worldwide, and this is expected to provide impetus for Japan's exports. Beginning in fall 2008, semiconductor shipments around the world drop sharply, but recently have begun to rise rapidly, suggesting strongly that the silicon cycle has moved into an upswing phase (Chart 4).

Chart 4: The Silicon Cycle Has Entered into an Upward Swing



Source: Semiconductor Industry Association, "Global Billings Report"

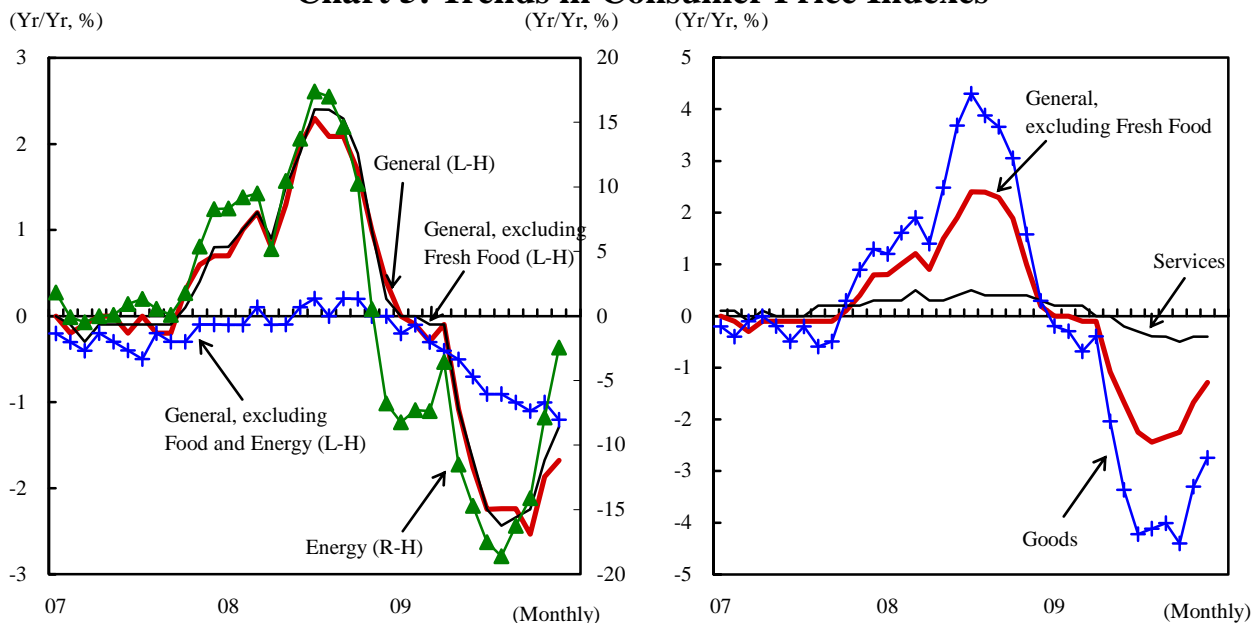
However, the current export-led growth scenario was also played out in 2002 and thereafter. Since this scenario means that Japan is dependent on trends in overseas economies, the recent improvement in economic conditions can be said to be resting on a weak foundation. For this reason, inasmuch as the recovery in European economies may be delayed because of fiscal problems and the pace of recovery in the world economy may weaken as countries around the world adopt exit strategies, it will probably be necessary to take account of the risk that the momentum of improvement even in Japan may slacken.

(b) Delay in Dealing with Deflation

As prices continue to decline, deflationary conditions are persisting. The overall consumer price index (CPI) (excluding fresh food products) dropped below the level of the previous year in March 2009 and, through December, remained lower than the same period of the prior year for 10 consecutive months (Chart 5). Nevertheless, after dropping to 2.4% below the previous year in August, which was the largest monthly margin of decline since these data have been prepared, the overall decline has diminished as the margin of decline in energy prices, including gasoline and electricity, has decreased. Judging from the increases in prices of crude oil and other items, the price of energy is expected to rise above the levels of the same period of the previous year shortly. Therefore, the margin of decline in the CPI (excluding fresh food products) is expected to diminish.

However, in December 2009, the overall CPI after the exclusion of both food items (with the exception of alcoholic beverages) and energy, stood at 1.2% below the same month of the previous year. This was the largest such decline for this index in history, and this decline indicates that deflation is not subsiding even after the exclusion of energy prices. Instead, consumer prices are being subjected to downward pressure as consumers become increasingly frugal in their spending behavior. In addition to the declines in prices of goods, including especially consumer durable goods, such as electric appliances, more recently, prices of services have also dropped below the previous year's levels (Chart 5).

Chart 5: Trends in Consumer Price Indexes



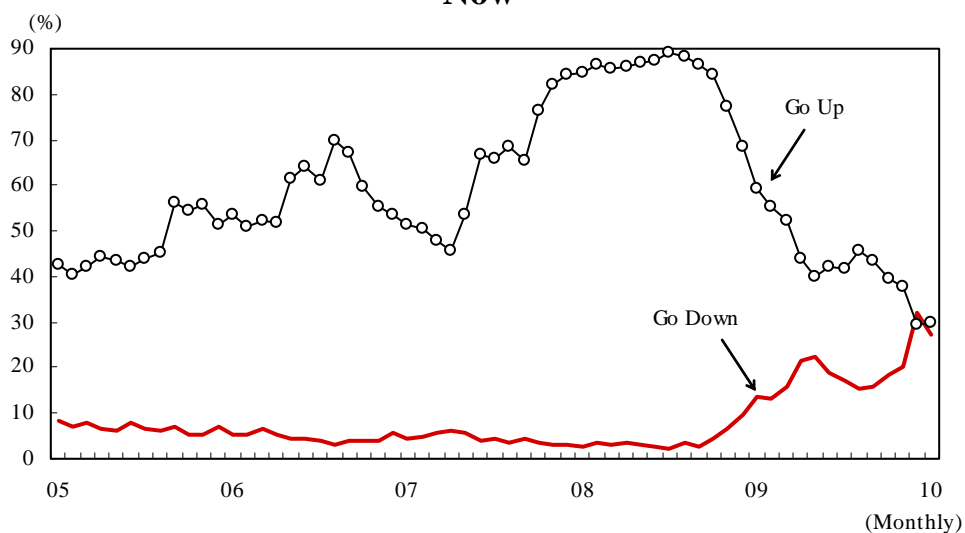
Source: Ministry of Internal Affairs and Communications, "Consumer Price Index"

Consumer prices will be influenced by changes in government policies. On the one hand, the elimination of tuition fees at public high schools, the payment of subsidies for attending private high schools, and the elimination of some expressway tolls from fiscal 2010 will contribute to lowering consumer prices. On the other hand, however, upcoming increases in the tax on cigarettes from October 2010 will have the opposite effect. Even eliminating the effects of policy changes, deflation is likely to continue through fiscal 2010. An upward trend in consumer prices, compared with the same levels of the previous year, is expected to be delayed until fiscal 2011, when the increase in energy prices is expected to have filtered through the economy and service prices stop declining as wages bottom out.

Awareness of the deflationary state of the economy is spreading among consumers. Surveys of consumer expectations of prices one year from now yield results showing that the number of people responding "prices will decline" is virtually balanced against those responding "prices will rise." This suggests that consumers are anticipating that the rate of inflation will decline (Chart 6).

Under deflationary conditions, if expectations rise that prices are going to decline further, consumers may tend to postpone purchases even more so than before. There is a possibility that this will lead to a further weakening of demand that may increase deflationary pressures.

Chart 6: Consumer Expectations Regarding Prices One Year from Now

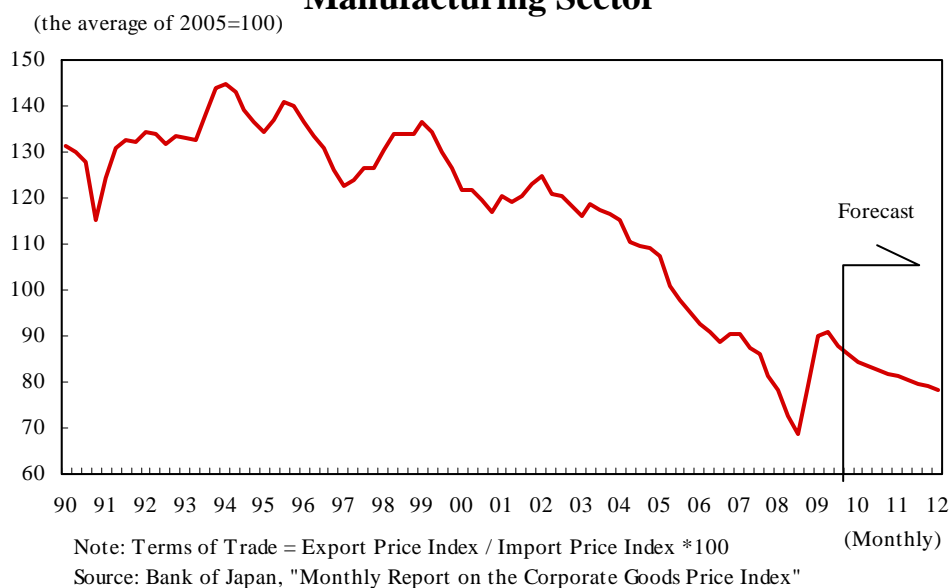


Note: The figures are the percentage of the households, which expect price to go up or to go down a year ahead. (excluding one-person households, original series)

Source: Cabinet office, "Monthly Consumer Confidence Survey"

On the other hand, as the world economy recovers, prices in international commodity markets, including the market for crude oil, are expected to rise. If corporations can pass the prices of these raw materials fully onto their sales prices, the impact will be neutral. However, if they cannot pass their high material costs on to their customers, then profitability will come under pressure. Under deflationary conditions, it is not easy to increase sales prices; therefore, the terms of trade, which had shown improvement, are expected to start to deteriorate again. As marginal profit ratios decline, this will tend to lower corporate profitability (Chart 7).

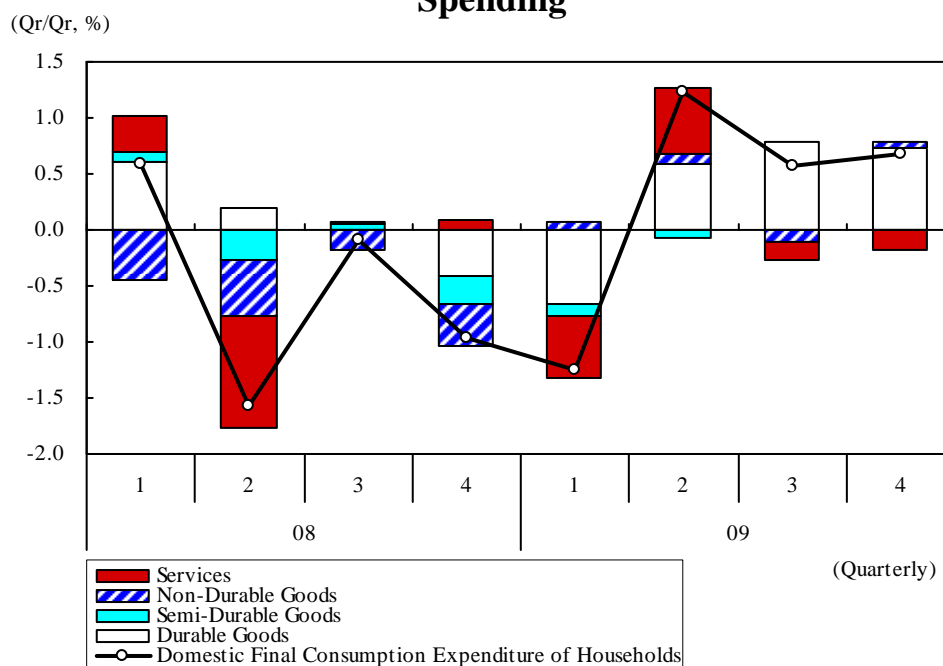
Chart 7: Anticipated Deterioration in the Terms of Trade in the Manufacturing Sector



(c)The Unavoidable Reactionary Decline in Consumer Spending

At present, consumer spending is still being boosted by the positive impact of economic policies. As a result mainly of the positive effect of the eco-point system as well as tax breaks and subsidies for purchasing eco-friendly cars, growth in spending on consumer durables in real terms since the April-to-June quarter has shown high and sustained momentum, rising 8.0% from the previous quarter in the April-to-June quarter, and then increasing 10.2% and 8.9% in the next two quarters (Chart 8). There have been periods in the past when purchases of durable goods accelerated suddenly, but, this time, these strong growth rates are being sustained in the midst of a difficult income environment for households, suggesting that consumer spending on durables is receiving a significant boost from policy measures.

Chart 8: Consumer Durable Purchases Are Driving Consumer Spending



Source: Cabinet Office, "Quarterly Estimates of GDP"

However, with incomes declining, there is a strong possibility that, in effect, current consumption is likely to erode future consumption levels. Especially in view of the fact that the items showing growth in sales are big-ticket consumer durables, consumers are expected to refrain from making new purchases for some time after buying them. According to recent data, worker compensation (in nominal terms) has declined for seven consecutive quarters through the October-to-December period of 2009, and, as corporations restructure, weakness in worker compensation is forecast to continue (Chart 9). For these reasons, if the positive effects of government policies run their course, it will be difficult to avoid a large drop in the sale of these consumer goods.

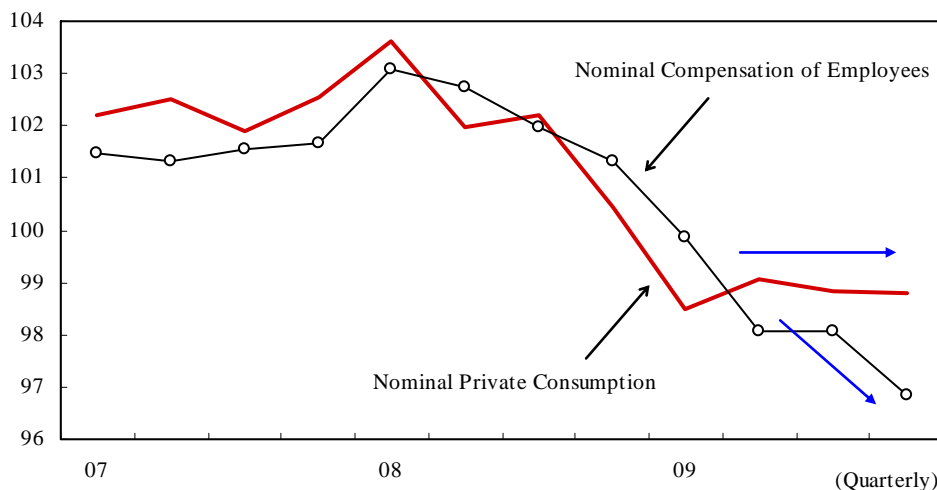
Subsidies for purchasing eco-friendly cars are scheduled to terminate at the end of September 2010, and the eco-point system is set to end at the end of December 2010. For this reason, there may be a surge in demand for the relevant items before the cutoff dates in September and December, but the surges are likely to be followed by reactionary declines. A similar pattern of surge followed by a decline is expected for sales of cigarettes because a

major increase in the tobacco tax is scheduled for October 2010.

The size of these reactionary declines will depend on the environment for sales going forward and the size of the surge in demand. However, especially in the case of high-cost items, such as automobiles, the impact is expected to be substantial. For this reason, there is a strong possibility that consumption may decline following the decrease in automobile sales in the October-to-December quarter of 2010 and then decline again in the January-to-March period of 2011 because of the drop in reaction to the surge in purchases of eco-friendly household appliances. A rise in concerns about a possible loss of momentum toward the end of 2010 is likely. However, since exports are continuing to rise and because of other factors, such as the beginning of upward trends in capital investment and residential investments, even with this timing in the weakening in consumption, the outlook is that a loss of momentum can be avoided. However, there is a possibility that the economy may pause temporarily.

Chart 9: Consumption Continues Firm Even with Incomes Declining

(Seasonally adjusted, the average of 2005=100)



Source: Cabinet Office, "Quarterly Estimates of GDP"

On the other hand, the policy measures that can be relied on to boost consumption are those that add directly to household disposable incomes. These include the payment of child allowances, the effective elimination of tuition fees at public high schools, and income compensation for individual farm households.

However, the effects of these policies in boosting disposable incomes are not expected to be very large in fiscal 2010. Along with the commencement of payments of child allowances, the allowance for child dependents will be terminated, and the payment of fixed stipends that began in fiscal 2009 will end. For these reasons, the actual boost compared with the previous year will actually not be substantial.

Also, the income compensation for farm households in fiscal 2010 will be marginal. Therefore, we probably should not be overly optimistic about the positive effects of policies on consumer spending. The effects will become larger beginning in fiscal 2011, when the full amounts of child allowances are paid and when the scope of income compensation for farm households is expanded. When the likely reactionary decline in consumption occurs in the latter half of fiscal 2010, these policy measures will be too weak to play a supporting role for consumption.

(d) How Big Will the Impact of the Exhaustion of Public investment Allocations Be?

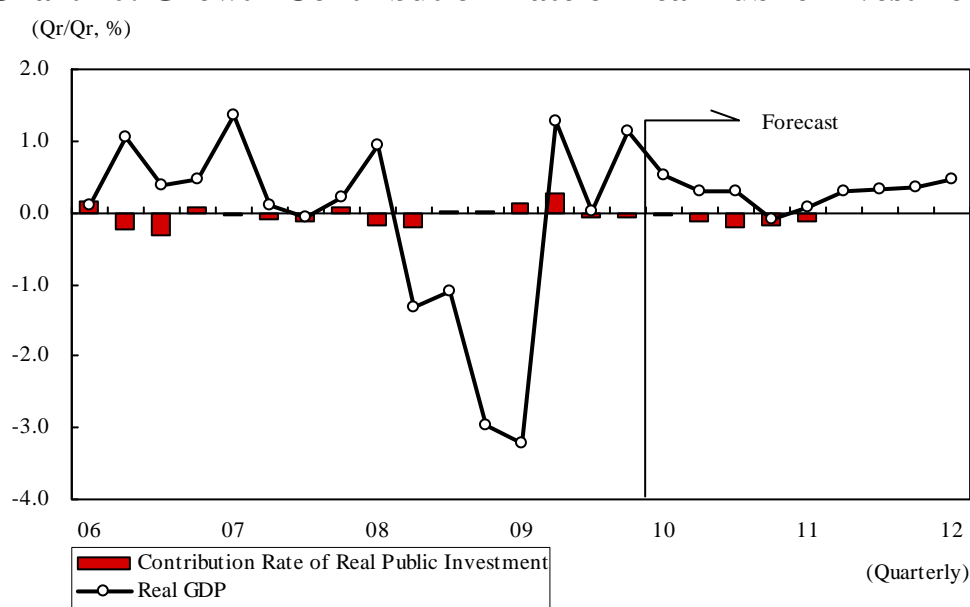
After the beginning of fiscal 2010, the positive effects of policy measures will have run their course, and public investment will decrease. There has been concern for some time that the risk of a double-dip recession would increase. Factors behind this concern have been the effects of the suspension by the current administration of some public works expenditures that were added to the first supplementary budget for fiscal 2009. Another factor causing concern is that, in the national general account budget for fiscal 2010, expenditures related to public investment have been cut by a substantial 18.3% (or about ¥1.3 trillion). However it appears that the impact of the plunge in public investment may not actually be very large.

Examining movement in public investment more closely, as a result of the passage of two supplementary budgets in fiscal 2008, which added to public investment allocations, the effect of an accelerated execution of the budget for fiscal 2009, and other factors, public investments rose firmly in the January-to-March and April-to-June quarters of 2009. However, the

contribution of these expenditures to the real GDP growth rate was marginal (Chart 10). This was because the absolute amount of these expenditures has shrunk (The share of public investment in real GDP in fiscal 2008 was only 3.4%, and the share of such investment in nominal GDP was only 4.0%.) and because the impact on the economy as a whole will be small, unless the increase or decrease in public investment is substantial.

What is more, public investment in real terms has declined from the previous quarter for two consecutive periods—July-to-September and October-to-December—and, even if it drops further after the beginning of fiscal 2010, it will not act as a drag on the economy. The effect of the first supplementary budget for fiscal 2009, even taking account of the suspension by the current administration of some expenditures allocated in that budget, will not give the originally anticipated boost to the economy. The fall off in public investment that has been expected after the beginning of fiscal 2010 is already taking place.

Chart 10: Growth Contribution Rate of Real Public Investment



It is not likely that the effects of the first supplementary budget for fiscal 2009 will emerge with a delay at a later date, but the positive impact of the

transfer of funds (approximately ¥500 billion) to local governments for supporting infrastructure improvements, which was contained in the second supplementary budget for fiscal 2009, is expected to emerge in the first half of fiscal 2010. For this reason, it is not likely that the economy will experience a double-dip recession in the first half of fiscal 2010 because of a decline in public investment.

(3) Outlook for Fiscal 2010 and Fiscal 2011: Cause for Concern in the Second Half of Fiscal 2010 when the Positive Impact of Policy Measures Ends

In fiscal 2009, real GDP growth is expected to be positive in the January-to-March quarter. Industrial production is forecast to expand compared with the prior quarter and the robust sales of automobiles and flat panel display (FPD) TVs will continue even after the beginning of the year. For the fiscal year as a whole, industrial production will be 2.2% below the previous fiscal year, but the margin of decline is forecast to be less than the 3.7% drop reported in fiscal 2008 (Chart 11). However, as a result of the sharp drop in production in the latter half of fiscal 2008, production levels have a large carryover effect of -4.0%. After excluding this effect, growth in industrial production is forecast to show substantial recovery and rise 1.7% (Chart 11).

In fiscal 2010, the growth momentum of the economy may slacken gradually in the first half of fiscal 2010, owing to an expansion in the margin of decline in public investment and a pause in the pace of growth in exports. However, the trend toward improvement in the economy will continue, as consumer spending remains firm, and private capital investment as well as housing investment begin to bottom out. Nevertheless, as a result of the ending of the positive impact of policy measures, there are concerns that the economy may pause temporarily in the latter half of fiscal 2010.

The pace of growth in exports may slow gradually toward the end of the fiscal year as the movement to restock inventories in overseas markets runs

its course and overseas economies experience difficulties in returning to their previous high-growth paths in a short period of time. However, exports will continue to expand, and, even though imports grow as a result of the improvement in domestic demand, the contribution of the external sector is forecast to be 0.5 percentage point, and it will continue to be the growth driver for the economy.

Consumer spending will remain firm, supported mainly by purchases of big-ticket consumer durables as a result of the positive effects of policy measures. Especially around the end of September, consumer spending will receive a major boost from the surge in demand for automobiles. However, this spending will be occurring in harsh employment and income environments, and there is strong concern that this will erode future consumption. For this reason, in the latter half of the fiscal year, a reactionary decline is forecast, first in automobile sales, followed by a slump in sales of FPD TVs and other eco-friendly household appliances. These reactionary declines are forecast to bring an unavoidable temporary decline in consumption. As a result, concerns about a loss of momentum in the economy are forecast to mount toward the end of the fiscal year.

However, as mentioned previously, the increase in exports will continue and, during the fiscal year, capital investment and housing investment will begin to rise, thus in actuality averting the loss of momentum. Nevertheless, there is a possibility that the economy may experience a temporary pause.

In the corporate sector, the gradual trend toward improvement will continue. The pace of gains in industrial production may diminish, but the outlook is for the continuation of a rising trend. In addition, corporate profits and sales will expand, and improvements in performance will continue as companies benefit from the positive effects of cuts in staff compensation and other costs; however, as a result of stagnation in sales prices and other factors, the level of profits will likely remain relatively low. For this reason, although the recovery in capital investment will continue, investments will be limited only to those that are necessary. Therefore, the rise in capital spending will be marginal, and investment will lack the strength to be a driving force in the economy.

Among other indicators, gradual improvement is expected in the employment and income environments and in housing investment, but the pace of improvement will be weak.

Our forecast for real growth in fiscal 2010 calls for an increase of 1.4%. It appears that the growth rate will be higher than in fiscal 2009, but this is because of a carryover effect of +1.1% due to growth in fiscal 2009. Calculating the growth rate during the fiscal year to take account of this carryover, real growth in fiscal 2010 will be only a weak +0.3%. Especially during the latter half of the fiscal year, the growth rates for some periods compared with the previous period are likely to be negative.

In fiscal 2011, the pace of improvement in the economy will be somewhat higher than in the previous fiscal year, but it will still be moderate.

Industrial production is forecast to increase as growth in exports continues along with the full-scale recovery in overseas economies. In addition, the employment and income environments will move toward gradual improvement, and consumption, which is forecast to have fallen in the latter half of the previous fiscal year, will show improvement. Also, in fiscal 2011, various policies, such as the payment of child allowances for the full fiscal year for the first time, will have a positive effect on consumption. Moreover, private capital is expected to continue to rise along with the improvement in corporate profits.

However, the pace of expansion in these indicators will be small, and the feeling of little real economic recovery will persist. The levels of GDP and the industrial production index will be low in comparison with the previous peak in fiscal 2007. Under these conditions, there is a possibility that the sense among corporations of excessive equipment and staff will not be sufficiently alleviated. Although the outlook is for deflationary pressures to ease gradually, corporations will not be in a position to raise prices aggressively.

We are forecasting real growth of +1.0% over the previous fiscal year in fiscal 2011. The impact of the carryover effect will be a small +0.3%, and

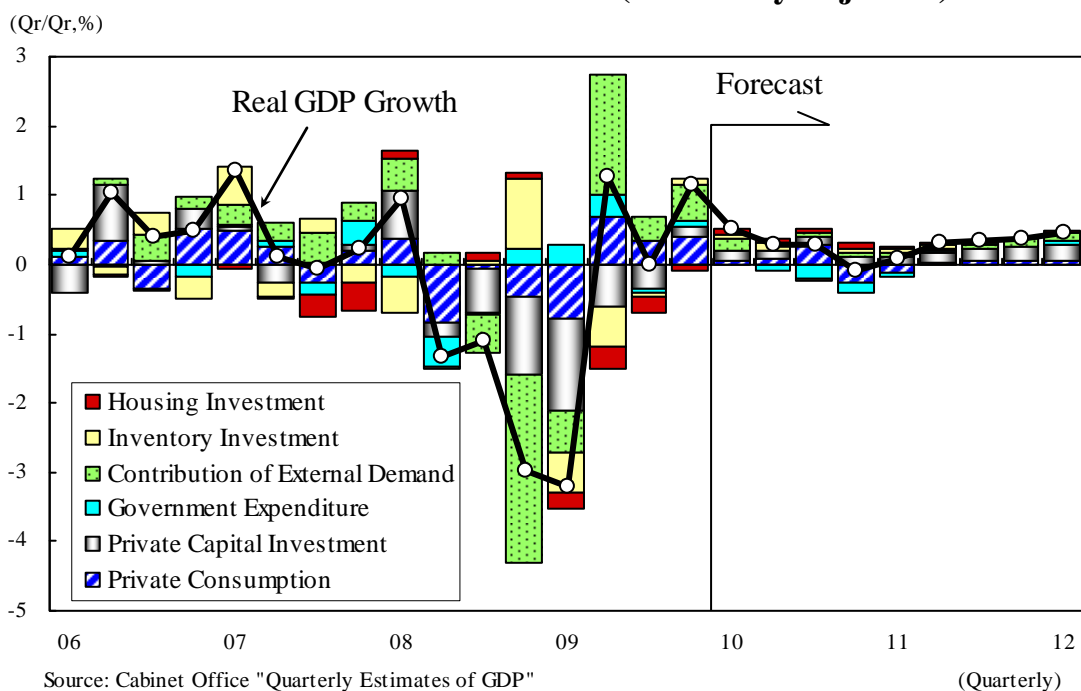
growth in fiscal 2011 measured during the year (and thereby adjusted for this effect) will be +0.7%, or somewhat higher than in fiscal 2010.

Chart 11: Real GDP Growth (Fiscal Year)

	Carry-over from the previous year (A)	Growth rate during the year (B)	Real GDP growth rate (A)+(B)
FY2007 (actual)	1.5 %	0.3 %	1.8 %
FY2008 (actual)	0.9 %	-4.6 %	-3.7 %
FY2009 (forecast)	-4.0 %	1.8 %	-2.2 %
FY2010 (forecast)	1.1 %	0.3 %	1.4 %
FY2011 (forecast)	0.3 %	0.7 %	1.0 %

Source: Cabinet Office "Quarterly Estimates of GDP"

Chart 12: Real GDP Growth (seasonally adjusted)



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 plunged substantially. However, at present, private capital investment is believed to have bottomed out because there is a necessity for making investments to replace equipment and raise product value added to increase competitiveness; however capital investment motivated by the improvement in production levels is still at a low level. However, since profit levels remain low compared with the past and a strong feeling of excess capital equipment capacity persists, an aggressive trend toward investment to expand capacity is not likely for the time being.
- 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. However, it is expected to take some time for recurring profit, which has decreased markedly, to recover to the previous levels.

(2) Households

- Since autumn 2008, faced with major declines in demand, companies have reduced the number of their 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, and 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 the implementation of economic policies that incorporate measures to promote the purchases of eco-friendly products, consumer spending, principally for durable goods, is continuing to increase. Although consumer spending may decline temporarily in the latter half of fiscal 2010, as the effects of economic policies run their course, consumption is expected to improve in fiscal 2011 as the income environment improves, influenced by the payment of the full amount of government child allowances and other factors.
- 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 diminished, 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 stopped 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 accompanying the implementation of these policies was funded through the issuance of government bonds and because tax revenues fell sharply along with the deterioration in the economy, the government's fiscal position has deteriorated.
- In September 2009, a new administration was elected, centered around the Democratic Party of Japan (DPJ). This administration has adopted a policy of providing support for households by shifting the allocation of government funds from "concrete (public investment) to people." The budget drafted for fiscal 2010 contains such measures, including the payment of child allowances and the effective elimination of tuition fees for attending public high schools. On the other hand, under the draft fiscal 2010 budget, public investment in the general account budget are to be reduced by a substantial 18.3% in comparison with the

initial budget of the previous fiscal year. As a result, public investment is likely to decline for the foreseeable future. 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 expenditures and increase the efficiency of the use of funds in other areas.

(4) Trends in Overseas Economies

- The world economy is continuing to show signs of improvement. In the October-to-December quarter of 2009, the United States and the countries of Europe continued to report positive growth (compared with the previous quarter), and growth in China accelerated to double-digit levels for the first time in 18 months.
- The outlook is for recovery in the world economy to continue in 2010. Consumer spending in the United States is showing clear improvement, and, in China, even though there is concern about a tightening of monetary policy, there is a strong possibility that high growth rates will continue. However, improvement in employment conditions in Europe may be delayed, and the outlook is for a slow pace of recovery because of the deterioration in the financial positions of certain countries.
- As the world economy recovers, Japan's exports are increasing. By region, although Japan's exports to the United States and Europe are rising gradually, exports to countries in Asia are expanding at a brisk pace. These exports to the rest of Asia are expected to be a driving force, and the outlook is for exports to continue on a rising trend going forward.
- The surplus generated in the international income account by 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 occupy 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, thus boosting some prices. 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. The outlook is for the decline in consumer prices to bottom out after the beginning of fiscal 2011, but in the interim it may continue 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 fall 2008 and onward, measures were implemented to ease monetary policy. In October 2009, temporary measures to ease monetary policy were retracted, while in December 2009, strong policies were adopted to ease monetary policy again based on the stance of not tolerating declines in consumer prices. For the time being, the Bank of Japan is expected to continue its stance of easing monetary policy.
- 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.

Chart 13: Outlook for Fiscal 2010-2011

	FY2007 (actual)	FY2008 (actual)	Forecast ↘			Yr/Yr, %
			FY2009 (forecast)	FY2010 (forecast)	FY2011 (forecast)	
Nominal GDP	0.9	-4.2	-3.9	0.2	0.7	
Real GDP	1.8	-3.7	-2.2	1.4	1.0	
Contribution of domestic demand	0.5	-2.6	-2.5	0.9	0.7	
Private consumption	1.4	-1.8	0.5	0.8	-0.1	
Housing investment	-13.5	-3.7	-18.2	5.1	4.3	
Private capital investment	1.3	-6.8	-15.4	3.0	4.4	
Contribution of inventory investment	0.0	-0.1	-0.4	0.2	0.1	
Government expenditure	0.1	-1.3	2.7	-1.3	-0.3	
Public investment	-6.4	-6.6	6.8	-11.7	-5.6	
Government final consumption expenditure	1.5	-0.1	1.9	0.9	0.7	
Contribution of external demand	1.2	-1.2	0.3	0.5	0.2	
Export of goods and services	9.3	-10.4	-10.4	15.1	6.4	
Import of goods and services	1.8	-4.2	-11.8	11.7	5.1	
GDP deflator	-0.8	-0.5	-1.7	-1.2	-0.2	

	FY2007 (actual)	FY2008 (actual)	Forecast ↘			Yr/Yr, %
			FY2009 (forecast)	FY2010 (forecast)	FY2011 (forecast)	
Current account balance (trillion yen)	24.5	12.3	15.4	16.5	17.6	
balance on goods (trillion yen)	11.7	1.2	6.3	6.5	6.8	
balance on service (trillion yen)	-2.6	-2.0	-2.1	-2.0	-2.0	
balance on income (trillion yen)	16.8	14.6	12.3	13.3	14.1	
Industrial production	2.7	-12.7	-10.1	7.7	2.3	
Unemployment rate(%)	3.8	4.1	5.3	5.1	4.9	
New housing starts(annualized, ten thousand units)	103.6	103.9	77.3	84.7	88.7	
Domestic corporate goods prices	2.3	3.2	-5.3	0.3	0.8	
Consumer prices	0.2	1.2	-1.7	-0.9	0.2	
excluding freshfood	0.3	1.2	-1.6	-1.0	0.2	
Yen/U.S.Dollar	114.2	100.5	92.6	92.2	95.7	
Uncollateralized call rates (O/N) (%)*	0.505	0.363	0.100	0.100	0.250	
Newly issued government bond yields (10years) (%)	1.60	1.46	1.36	1.41	1.51	
WTI future price (near month contract, US dollar/barrel)	82.2	85.9	69.6	78.5	82.8	
Dubai crude oil prices (US dollar/barrel)	77.3	82.1	68.9	76.3	80.1	

* actual=average, forecast=end of period

Chart 14: Outlook for Calendar 2010-2011

	CY2007 (actual)	CY2008 (actual)	CY2009 (actual)	Forecast	
				CY2010 (forecast)	CY2011 (forecast)
	Yr/Yr, %				
Nominal GDP	1.6	-2.0	-6.0	0.3	0.3
Real GDP	2.4	-1.2	-5.0	1.9	0.7
Contribution of domestic demand	1.2	-1.3	-3.8	0.8	0.5
Private consumption	1.6	-0.7	-1.0	1.4	-0.2
Housing investment	-9.6	-8.1	-14.2	-2.1	6.2
Private capital investment	2.6	0.1	-19.3	0.5	3.9
Contribution of inventory investment	0.3	-0.4	-0.1	0.0	0.0
Government expenditure	-0.2	-1.3	2.3	-0.4	-1.1
Public investment	-7.4	-8.5	5.8	-7.1	-10.1
Government final consumption expenditure	1.5	0.3	1.7	1.1	0.7
Contribution of external demand	1.1	0.1	-1.2	1.2	0.2
Export of goods and services	8.4	1.6	-24.0	20.5	6.8
Import of goods and services	1.6	0.9	-17.0	11.5	5.9
GDP deflator	-0.7	-0.8	-1.0	-1.6	-0.4

	CY2007 (actual)	CY2008 (actual)	CY2009 (actual)	Forecast	
				CY2010 (forecast)	CY2011 (forecast)
	Yr/Yr, %				
Current account balance (trillion yen)	24.8	16.4	13.3	16.4	17.2
balance on goods (trillion yen)	12.3	4.0	4.1	6.8	6.7
balance on service (trillion yen)	-2.5	-2.1	-1.9	-2.0	-2.0
balance on income (trillion yen)	16.3	15.8	12.3	12.9	13.8
Industrial production	2.8	-3.4	-22.4	13.2	1.6
Unemployment rate (%)	3.9	4.0	5.1	5.1	5.0
New housing starts(annualized, ten thousand units)	106.1	109.3	78.8	84.0	87.8
Domestic corporate goods prices	1.8	4.6	-5.2	-0.4	0.8
Consumer prices	0.0	1.4	-1.4	-1.1	0.0
excluding freshfood	0.0	1.5	-1.3	-1.1	-0.1
Yen/U.S.Dollar	117.8	103.4	93.5	91.3	94.9
Uncollateralized call rates (O/N) (%)*	0.474	0.462	0.104	0.100	0.100
Newly issued government bond yields (10years) (%)	1.68	1.48	1.34	1.39	1.47
WTI future price (near month contract, US dollar/barrel)	72.3	99.6	61.8	76.9	82.1
Dubai crude oil prices (US dollar/barrel)	68.4	93.8	61.8	74.9	79.6

* actual=average, forecast=end of period

Chart 15: Outlook for 2010-2011 (Quarterly)

	Forecast								Qr/Qr, % Yr/Yr, %			
	FY2009				FY2010				FY2011			
	4-6	7-9	10-12	1-3	4-6	7-9	10-12	1-3	4-6	7-9	10-12	1-3
Nominal GDP	-0.1	-0.5	0.2	0.5	-0.2	0.2	-0.3	0.1	0.2	0.4	0.3	0.4
	-6.2	-5.8	-3.3	0.0	0.1	0.8	0.1	-0.2	0.1	0.4	0.9	1.5
Real GDP	1.3	0.0	1.1	0.5	0.3	0.3	-0.1	0.1	0.3	0.3	0.4	0.5
	-5.7	-5.2	-0.4	2.6	2.0	2.3	0.9	0.5	0.6	0.6	1.0	1.6
Contribution of domestic demand (Qr/Qr,%)	-0.5	-0.3	0.6	0.3	0.3	0.3	-0.1	0.0	0.3	0.3	0.3	0.4
Private consumption	1.1	0.6	0.7	0.1	0.1	0.5	-0.4	-0.2	0.0	0.1	0.1	0.1
Housing investment	-1.1	-0.4	1.1	2.6	1.5	1.4	0.3	-0.1	-0.1	-0.5	0.0	0.4
Private capital investment	-9.4	-7.8	-3.4	2.7	2.8	3.1	2.8	0.9	0.9	0.4	0.3	0.8
Contribution of inventory investment (Qr/Qr,%)	-9.9	-20.3	-24.5	-17.0	-6.0	5.0	12.0	10.1	7.9	0.2	2.5	2.4
Government expenditure	-4.2	-2.5	1.0	1.0	0.9	1.0	0.9	0.9	1.0	1.1	1.3	1.6
Public investment	-22.2	-21.1	-13.6	-4.7	0.2	3.8	3.9	3.6	3.7	3.9	4.5	5.2
Government final consumption expenditure	-0.6	-0.1	0.1	0.1	0.1	0.0	0.1	0.1	0.0	0.0	0.0	0.0
Government expenditure	1.4	-0.2	0.4	0.0	-0.4	-0.8	-0.6	-0.2	0.1	0.1	0.1	0.2
Public investment	3.3	3.3	2.9	1.4	0.0	-0.7	-2.1	-2.2	-1.3	-0.7	0.0	0.7
Government final consumption expenditure	6.4	-1.6	-1.6	-1.0	-2.7	-5.2	-4.8	-3.2	0.1	-0.1	-0.2	-0.1
Contribution of inventory investment (Qr/Qr,%)	12.6	9.4	6.3	1.7	-6.7	-10.2	-13.1	-15.1	-14.3	-8.6	-3.0	1.0
Contribution of external demand (Qr/Qr,%)	0.3	0.1	0.8	0.1	0.1	0.1	0.2	0.2	0.1	0.1	0.1	0.2
Export of goods and services	2.0	2.2	2.1	1.4	1.2	1.1	0.6	0.7	0.7	0.7	0.7	0.6
Import of goods and services	1.7	0.3	0.5	0.2	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1
Export of goods and services	9.2	8.4	5.0	5.0	4.2	2.2	0.6	0.9	2.3	2.4	0.7	0.9
Import of goods and services	-29.4	-22.7	-5.0	30.4	24.4	17.4	12.5	8.1	6.2	6.4	6.4	6.4
GDP deflator (Yr/Yr,%)	-3.9	5.4	1.3	3.9	4.5	2.2	0.3	0.6	2.2	2.1	0.0	0.2
	-18.8	-16.5	-15.3	6.6	15.9	12.4	11.3	7.8	5.4	5.3	5.0	4.6
	-0.6	-0.6	-3.0	-2.5	-1.8	-1.4	-0.8	-0.8	-0.4	-0.3	-0.1	-0.1

	Forecast								Yr/Yr, %			
	FY2009				FY2010				FY2011			
	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)*	4.0	3.8	3.8	4.0	4.3	4.2	4.2	4.1	4.3	4.6	4.7	4.5
balance on goods (trillion yen)*	1.4	1.5	1.7	1.9	1.8	1.7	1.6	1.5	1.6	1.8	1.8	1.7
balance on service (trillion yen)*	-0.5	-0.3	-0.4	-0.8	-0.5	-0.3	-0.4	-0.7	-0.5	-0.3	-0.4	-0.7
balance on income (trillion yen)*	3.4	2.9	2.8	3.2	3.4	3.1	3.3	3.5	3.6	3.3	3.7	3.7
Industrial production (Qr/Qr, %)	8.3	7.4	4.5	3.2	0.8	0.6	0.3	-0.3	0.7	1.0	1.1	1.2
(Yr/Yr, %)	-27.8	-20.1	-5.4	24.9	16.6	9.0	4.9	1.2	1.2	1.5	2.5	4.0
Unemployment rate (%)*	5.2	5.5	5.1	5.1	5.2	5.1	5.1	5.1	5.0	5.0	4.9	4.8
New housing starts(annualized, ten thousand units)	76.9	71.3	79.1	82.7	83.8	84.3	85.1	86.0	87.3	88.6	89.3	89.9
Domestic corporate goods prices (Yr/Yr,%)	-5.4	-8.3	-5.3	-1.8	-0.3	-0.1	0.9	0.9	0.8	0.8	0.8	0.7
Consumer prices (Yr/Yr,%)	-1.0	-2.2	-2.1	-1.3	-1.5	-1.0	-0.6	-0.5	0.1	0.1	0.2	0.2
excluding freshfood (Yr/Yr,%)	-1.0	-2.3	-1.8	-1.2	-1.5	-1.0	-0.7	-0.6	0.1	0.1	0.2	0.2
Yen/U.S.Dollar	97.3	93.6	89.7	90.0	90.5	91.8	92.8	93.8	94.5	95.3	96.0	97.0
Uncollateralized call rates (O/N) (**)	0.103	0.103	0.104	0.100	0.100	0.100	0.100	0.100	0.100	0.100	0.100	0.250
Newly issued government bond yields (10years) (%)	1.45	1.34	1.31	1.35	1.38	1.41	1.43	1.43	1.45	1.49	1.53	1.56
WTI future price (near month contract, US dollar/barrel)	59.6	68.3	76.2	74.5	75.0	78.0	80.0	81.0	82.0	82.5	83.0	83.5
Dubai crude oil prices (US dollar/barrel)	59.2	68.1	75.4	73.0	73.2	76.0	77.5	78.5	79.5	80.0	80.5	80.5

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

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