November 2010

Forecast for the Japanese Economy in Fiscal 2010 and 2011

— Moving toward Self-Sustaining Growth in Fiscal 2011 after Adjustments in the Second Half of Fiscal 2010 —

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1. Outlook for the Japanese Economy in Fiscal 2010 and Fiscal 2011 -- Moving toward Self-Sustaining Growth in Fiscal 2011 after Adjustments in the Second Half of Fiscal 2010

(1) Current State of the Economy: Real GDP Growth High Because of a Surge in Demand

(a) Recent Trends

Real GDP growth for the July-to-September period was +0.9% over the previous quarter (+3.9% at an annualized rate), for the fourth consecutive quarter of positive growth, and the growth momentum strengthened. Nominal GDP growth for the quarter was a high +0.7% (+2.9% at an annualized rate).

Examining the contribution to real GDP of the domestic and the external sectors, the contribution of the domestic sector was +0.9 percentage point. However, external demand (net exports = exports – imports) contributed only +0.0 percentage point, thus making virtually no contribution to growth. In contrast to external demand, which had been the driving force for the economy but has now lost momentum, domestic demand is now expanding at a high rate.

Turning first to domestic demand, the largest contribution pushing the GDP upward was the substantial growth in personal consumption of +1.1% over the previous quarter. However, the primary factors boosting consumption were temporary in nature and included the increase in the tax on tobacco products, the surge in demand for automobiles preceding the termination of subsidies for purchasing eco-friendly cars, and the strong demand for air conditioners because of the unusually hot summer weather. Private residential investment has begun to rise, increasing 1.3% for the quarter, reflecting a gradual improvement in housing starts, mainly in owner-built unit homes.

Although the cautious attitude of corporations toward new capital investment remains pronounced, the increase in production levels and the rapid recovery in corporate profits brought an increase in private capital investment of 0.8% for the quarter, the fourth consecutive quarterly rise. In addition, because of the recent rise in inventories, principally of IT-related products, the contribution of private inventory investment to real GDP was 0.1 percentage point, thus pushing GDP growth upward.

Overall public sector demand declined 0.1% for the quarter, the second small quarterly decrease. Although government consumption expenditures rose 0.1%, thus continuing a moderate increasing trend, public investment decreased 0.6%, the fifth quarter-to-quarter decline, reflecting major cuts in budgetary allocations for the current fiscal year.

The contribution of the external sector was +0.0 percentage point for the quarter, thus making virtually no contribution to growth in real GDP. Imports continued to rise, increasing 2.7% for the quarter, as a result of recovery in domestic demand and other factors. On the other hand, growth in exports, principally to the rest of Asia, slowed to +2.4% for the quarter.

The GDP deflator, which shows trends in prices in the overall economy, was 2.0% below the level of the same quarter of the previous year, which represented a slight increase in the margin of decline. This reflected a somewhat stronger declining trend in prices owing to the effects of the appreciation of the yen and other factors. On a seasonally adjusted basis, the deflator continued its decline and was down 0.2% quarter to quarter, indicating that deflationary conditions, against a background of excess supply, have shown no major change.

(b) The Economy May Have Already Begun to Pause

The Japanese economy reached bottom in March 2009 and had been in a recovery phase, but during the July-to-September quarter the trend toward recovery paused. Growth in real GDP for the quarter was a strong +0.9%, but, as mentioned previously, this was largely the result of a strong but temporary boost from personal consumption, and the contribution of consumer spending to overall growth in GDP was a substantial 0.7 percentage point.

Examination of indicators aside from consumption shows, first, that trends in industrial production are showing stronger signs of weakening. In September, industrial production declined 1.6% from the previous month, the fourth consecutive monthly decline. During the July-to-September quarter, production was down 1.8% from the prior quarter, the first decline in six quarters. The survey of production forecasts calls for a larger decline of 3.6% in October, giving a clear sign that the trends in production are weakening.

The momentum of exports is also weakening. The index for real exports in September declined a marginal 0.1%, compared with a sharp decline of 4.2% in August, but this was the second consecutive month-to-month decline. By region, exports to Asia, including China, which had been a driving force for exports, are weakening, because of the slight decline in the momentum of expansion in the Chinese economy and other factors. However, causes for this weakness included restraints on automobile exports by manufacturers, as they gave preference to domestic sales prior to the termination of subsidies to purchasers of eco-friendly cars, and the fact that production in certain industries could not keep pace with growth in overseas demand.

Among indicators of personal consumption, unit automobile sales (excluding light motor vehicles) were down 5.4% in September and then fell 28.8% year on year in October, reflecting the ending of subsidies for eco-friendly cars. In addition, expenditures on tobacco products dropped sharply in October, following an increase in prices. As these data suggest, even taking account of the strong sales of flat panel display (FPD) TVs, personal consumption during the October-to-December quarter is expected to be rather weak.

There is a strong possibility that, after entering the second half of the current fiscal year, the economy may have paused. The real GDP growth rate in the October-to-December period, which will be announced later on, is forecast to be negative temporarily year on year, and this will allow us to confirm the pause in the economic recovery since entering the second half of the fiscal year.

Nevertheless, from October onward, the economy was already forecast to mark time as the positive effects of government policies ran their course. The issue now is whether the economy will lose momentum following the current lull, thus resulting in negative real growth in GDP in the January-to-March period and subsequent quarters also in 2011.

(2) Loss of Momentum to Be Avoided

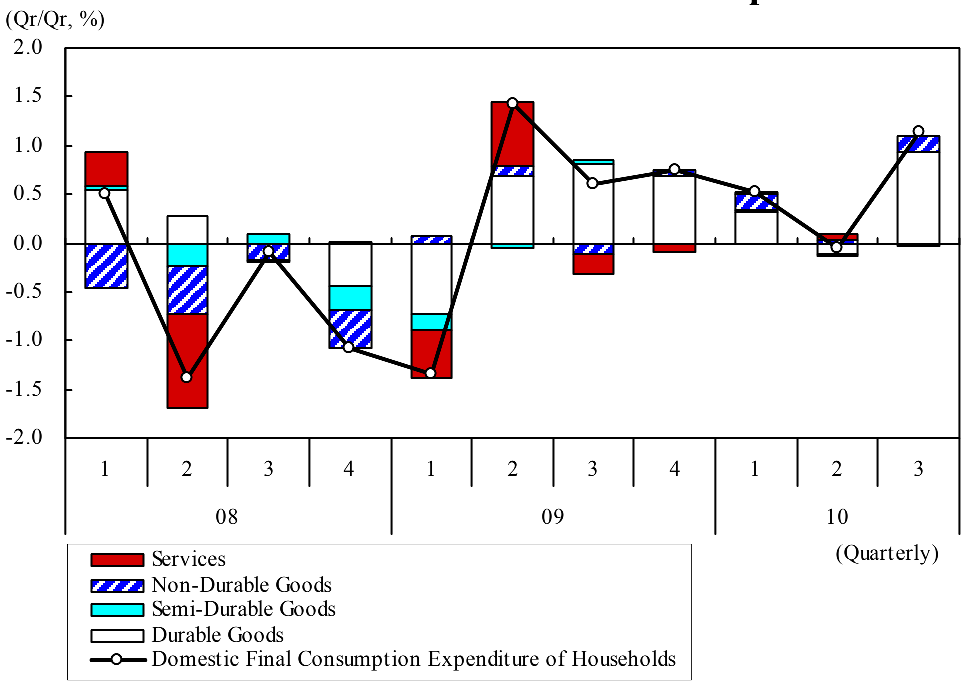
There are two principal concerns regarding the economy in the second half of the fiscal year: (a) the impact of the decline in consumption after the positive effects of government policies wear off and (b) trends in overseas economies and the impact of yen appreciation on exports and production. If it appears that consumer spending and exports weaken simultaneously, there is a strong possibility that the economy may sink into a double-dip recession.

(a) Views of Consumption after Positive Effects of Policy Measures Wear Off

First, let us consider trends in consumption in the coming months. Looking first at real personal consumption in the GDP statistics, during the July-to-September period, consumer durables showed a sharp increase of 11.1% over the previous quarter, and non-durable goods, including tobacco products, also rose a favorable 0.6%, thus giving a major boost to consumer spending as a whole (Chart 1). However, spending on services, which account for the largest share of consumption (about 55% on a real basis), has remained lackluster and has made almost no contribution to boosting consumer spending.

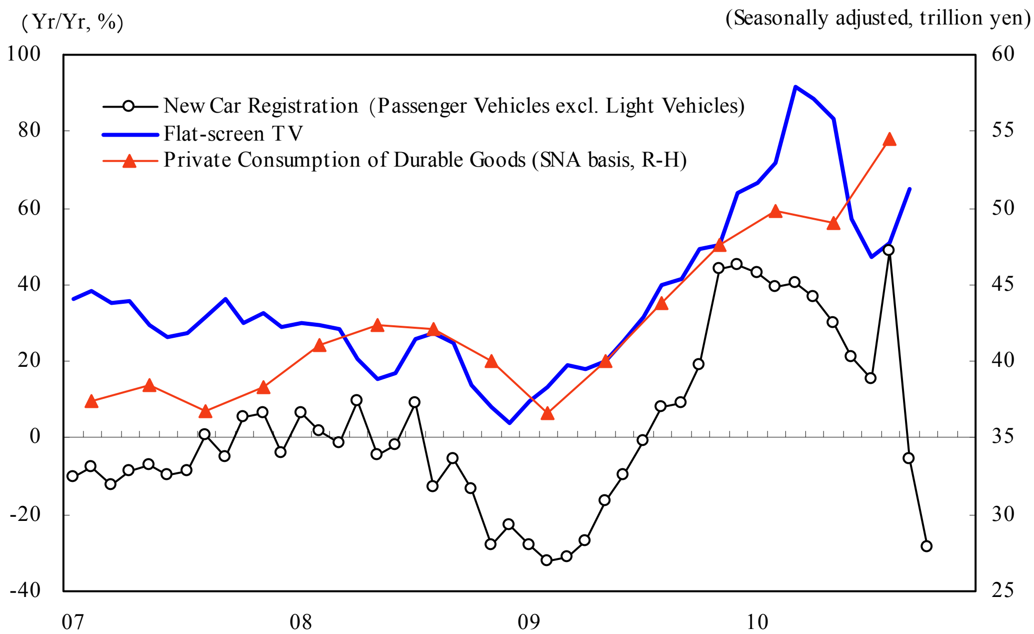
More recently, since September, sales of automobiles have dropped significantly but sales of appliances that are eligible for eco-points, such as FPD TVs and air conditioners, have been strong as consumers keep in mind the schedule for scaling back and ending the eco-point system (Chart 2). Moreover, sales of such goods as PCs, smart phones, and other IT-related items as well as sales of “white goods,” such as washing machines and microwave ovens that are not eligible for eco-points, have been strong,

Chart 1: Breakdown of Real Consumption



Source: Cabinet Office, "Quarterly Estimates of GDP"

Chart 2: Durable Goods Consumption



Note: Figures for flat-screen TV are the sum of over 10-inch liquid crystal and plasma display panel television; three-month moving average.

Source: Japan Automobile Dealers Association;
Japan Electronics and Information Technology Industries Association, "Domestic Shipments of Major Consumer Electronic Equipment";
Cabinet Office, "Quarterly Estimates of GDP"

perhaps because consumers have had more occasion to visit appliance stores. For this reason, sales of these durable goods in the October-to-December quarter seem likely to provide support for consumer spending. However, the impact of appliances is small in comparison with automobiles, and, given the decline in tobacco products in October and subsequent months, it appears unlikely that they will make up for the decline in expenditures on other items.

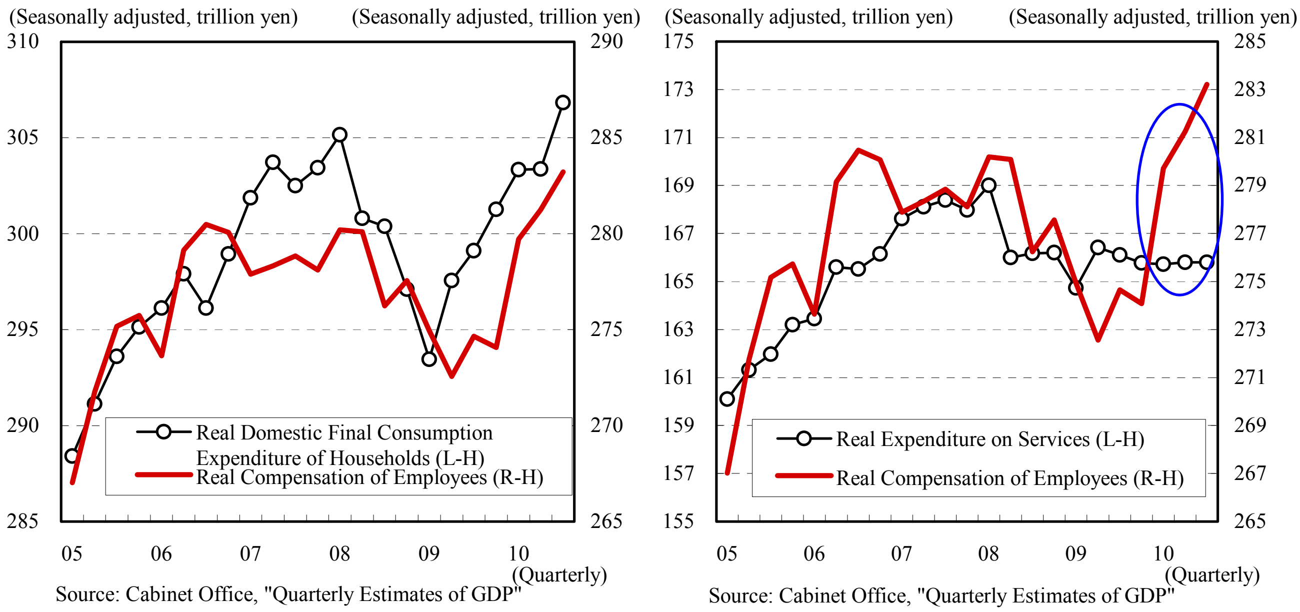
There is a possibility that the slump in automobile sales will end because of the launching of new models near the end of calendar 2010. Also, there is a strong likelihood that there will be a final surge in demand for FPD TVs prior to the termination of the eco-point system at the end of March 2011. As a result, there is a possibility consumer spending may recover.

Nevertheless, in April and later months, accompanying the termination of the eco-point system, sales of eco-friendly appliances are forecast to drop sharply. There are strong concerns that accelerated spending in previous months may have eaten into a substantial amount of future demand for automobiles, FPD TVs, and other durables, which are items that consumers do not replace frequently. Therefore, demand for these good is forecast to remain stagnant for the foreseeable future.

However, after declining sharply as the surge in demand runs its course, we cannot anticipate any increase over the previous period for the time being in the value of sales, but more serious declines will not take place. For this reason, in April 2011 and later, trends in consumption will depend to a significant extent on consumption of services and semi-durable goods, which have been stagnant thus far.

It appears that the sudden increase in consumer spending along with the surge in demand was not necessarily paid for by withdrawal of savings or borrowings, and our judgment is that this consumer behavior was backed by increases in income. The graph on the left in Chart 3 compares real domestic final consumption expenditures with real worker compensation. Both of these indicators reached their highest levels in history during the July-to-September quarter, and, as the graph suggests, the two are correlated. (On a seasonally adjusted basis, over the past one-year period, worker income has increased ¥8.6 trillion, while consumer expenditures have risen ¥7.7 billion.) Similarly, the graph on the right in Chart 3 shows movements in real expenditures on services and real worker compensation, but, in recent quarters, the movements of these two indicators have diverged. In other words, there is a possibility that consumers have given priority to spending the increase in their incomes on durable goods and restrained spending on services. For this reason, provided the rise in worker compensation continues, even if consumption of durable goods does not increase, there is a possibility that consumers will shift to purchasing services and semi-durable goods that they have been restraining in previous quarters.

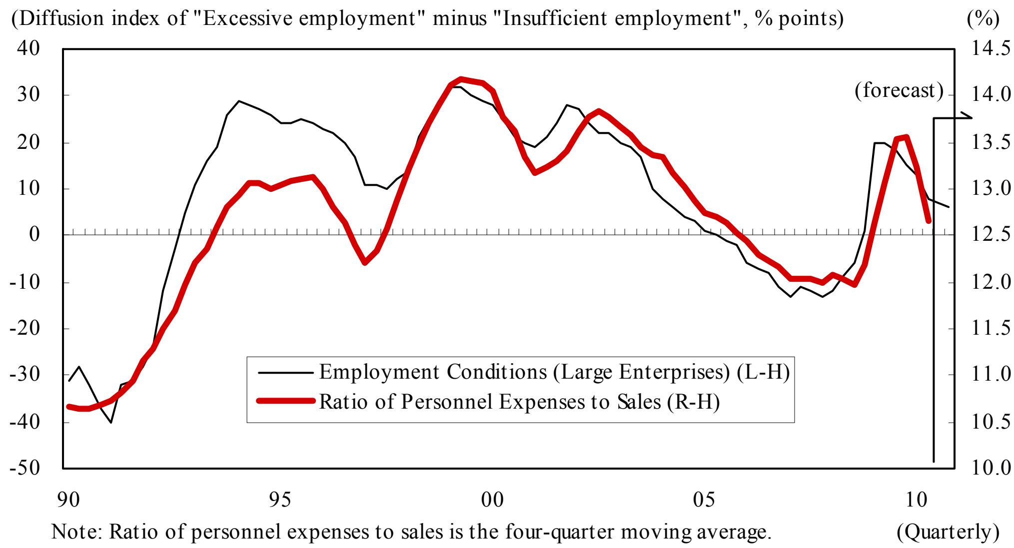
Chart 3: Trends in Real Worker Compensation and Consumption



Reflecting the improvement in corporate performance, wages are continuing on an improving trend. Total cash earnings per worker in September were up 0.9% compared with the same month of the previous year, for the seventh year-on-year increase. Recent months have seen increases not only in non-scheduled compensation and special salary payments but also increases year on year in scheduled wages, and the trend toward improvement in wages is spreading. In addition, the average per worker summer bonus for 2010 was 1.1% above the previous year, the first increase in four years. The outlook is for increases in winter bonuses on a per worker basis and for an expansion in the ratio of workers receiving bonus payments in comparison with summer bonuses.

Turning next to the employment situation, the unemployment rate in September was 5.0%, the third consecutive month-to-month decline, and the ratio of job offers to job seekers improved. The feeling among corporations that they have excess workers is diminishing gradually, and the improvement in performance may be more readily reflected in improvement in employment and income conditions (Chart 4). While it is clear that the employment and income situations remain tough, provided that the recent improvement continues, this will provide support for personal consumption.

Chart 4: Trends in Employment Conditions D.I. (Large Enterprises) and the Ratio of Personnel Expenses to Sales

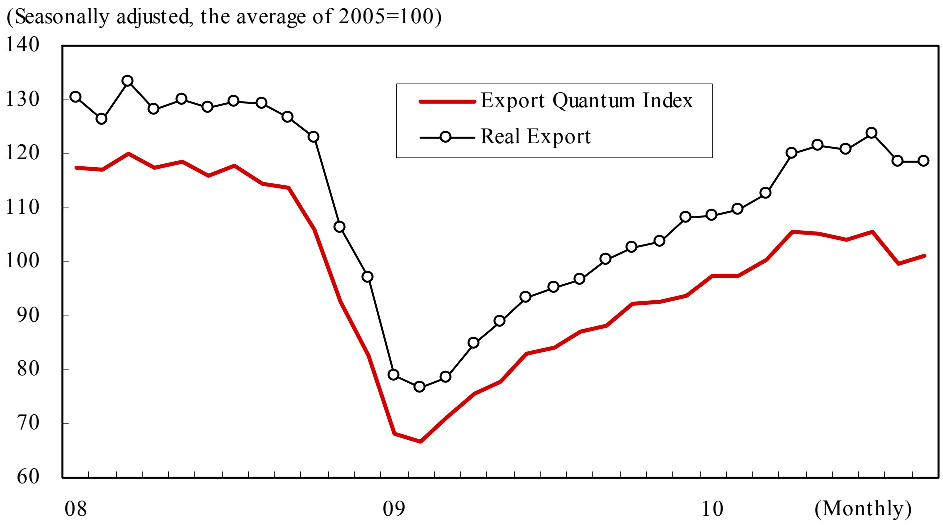


Note: Ratio of personnel expenses to sales is the four-quarter moving average.
Source: Ministry of Finance, "Financial Statements Statistics of Corporations by Industry"; Bank of Japan, "The Tankan Survey"

(b) Impact of Yen Appreciation and Trends in Overseas Economies

The momentum of recovery in exports has paused, and concerns about future trends are increasing. On a real GDP basis, exports rose 2.4% over the previous quarter during the July-to-September period, indicating a continuing upward trend. However, on a month-to-month basis, the levels of both the export quantum index and real exports have shown a slight declining trend (Chart 5).

Chart 5: Export Quantum Index and Real Export

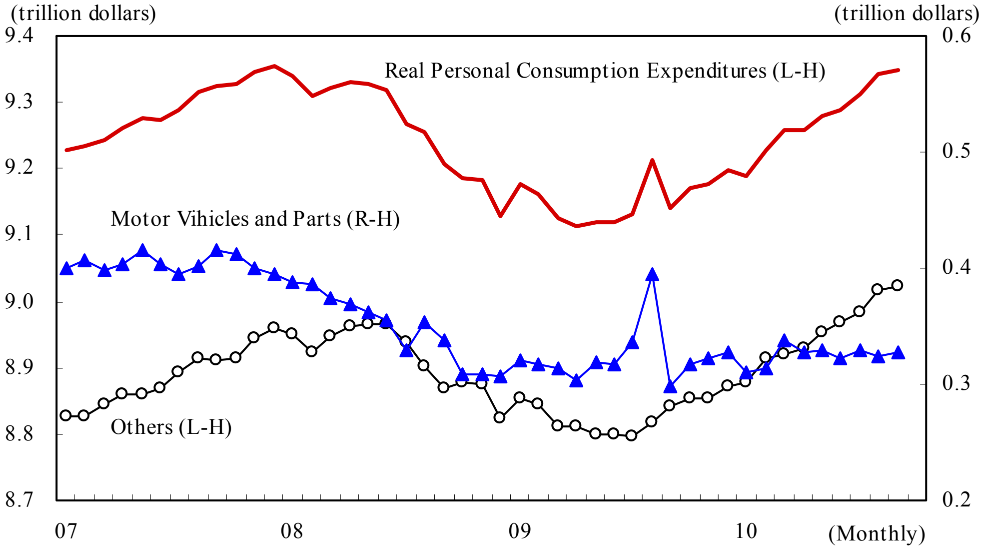


Source: Ministry of Finance, "Trade Statistics";
Bank of Japan, "Financial and Economic Statistics Monthly"

Concerns regarding exports include, first, the impact of yen appreciation, followed by trends in overseas economies, including the United States and China.

Even as the yen-dollar exchange rate approaches its historical high, thus far it has not set a new record and has continued to fluctuate in the range between ¥80 and ¥85 to one U.S. dollar. Factors behind the sudden pause in yen appreciation have included pessimistic views regarding conditions in economies overseas, especially the United States, and diminishing prospects for further monetary easing. Although improvement in employment and housing starts in the United States is lagging, the economy is continuing to recover. Among various indicators, personal consumption is improving steadily, and expenditures on automobiles remain level, but other expenditure indicators are favorable and have recovered their peak levels before the financial crisis (Chart 6). In addition, corporations in both the manufacturing and non-manufacturing sectors are reporting brisk activity (Chart 7). Eventually, the pace of improvement in employment conditions is expected to rise. Amid these conditions, there is a possibility that prospects for further monetary easing in the United States will gradually diminish.

Chart 6: U.S. Personal Consumption

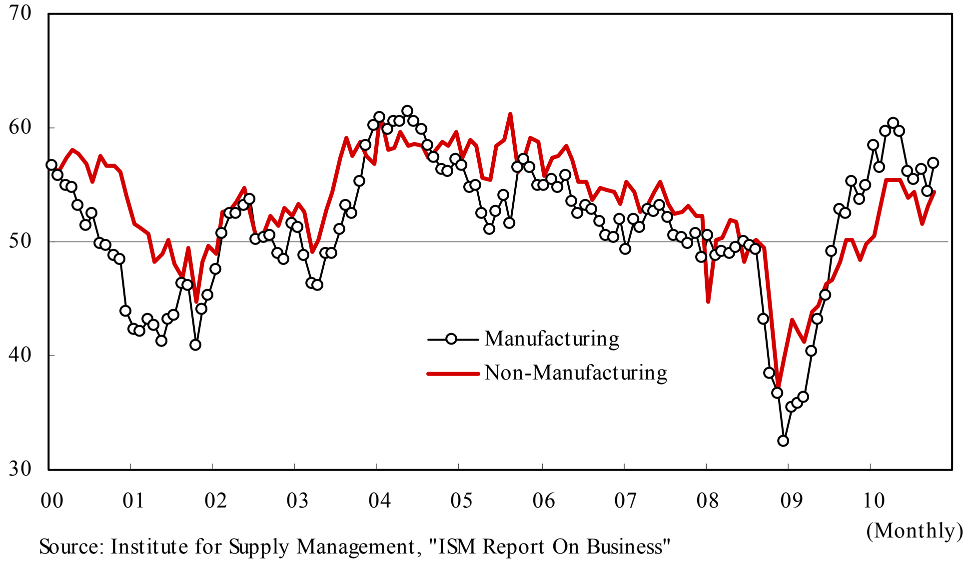


Source: U.S. Department of Commerce, "Personal Income and Outlays"

The recovery trend in the world economy, centering around the emerging economies, is viewed as likely to continue going forward, and Japan's exports are again expected to show an increasing trend. Recently, fiscal problems in some European countries have been emerging, including those of Ireland and Portugal, but these issues are not believed likely to have a major effect on the world economy.

If the recovery in the world economy proceeds smoothly, the value of the yen, which investors have purchased because of the lack of alternative currencies, may begin to adjust. The current value of the yen is generally believed to be at the top end of possible valuations, and the current high level may adjust downward. Provided the yen undergoes no further appreciation to reach a record high and the current levels do not become established, we believe there are no major reasons for concern that Japan's exports will be seriously damaged.

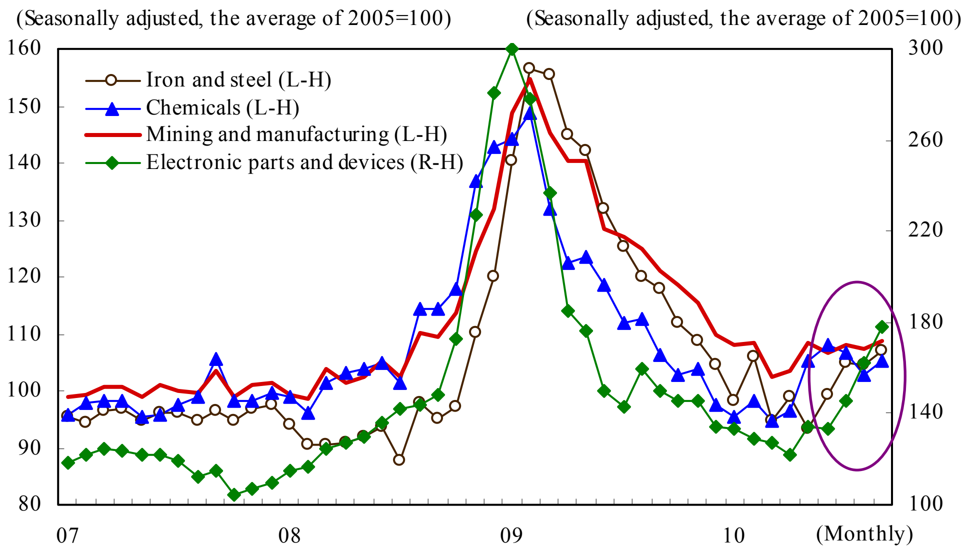
Chart 7: Trends in the ISM Index



Source: Institute for Supply Management, "ISM Report On Business"

Note that, as a result of the recent weakness in exports, inventories in some industries, including electronic components and devices as well as steel, are rising (Chart 8).The decline in overseas demand is believed likely to be due to temporary factors, including inventory adjustments in China, and the trend toward production adjustments may be completed in a relatively short period. For this reason, even though there is a possibility that these adjustments may restrain production in the latter half of fiscal 2010, this will probably not bring a loss of momentum in the economy.

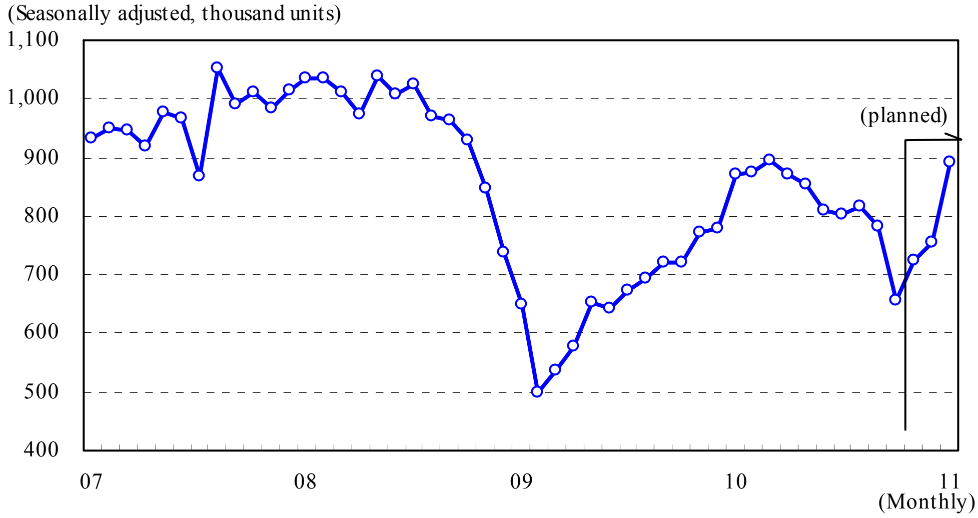
Chart 8: Trends in the Inventory Ratio Index



Source: Ministry of Economy, Trade and Industry, "Indices of Industrial Production"

Also, while automobile sales are forecast to drop sharply in the October-to-December quarter, production plans call for recovery, mainly for exports (Chart 9). There, however, are only plans, and, while there is a possibility that they may be revised, it is clear the decline experienced into October will not be any deeper.

Chart 9: Planned Automobile Production Levels



Notes: Figure for October is estimated number. Production plan is that of as of early November 2010.
Source: Japan Automobile Manufacturers Association, Inc., Jidosha Sangyo News

As these comments suggest, although it will not be possible to avoid the pause in the economy in the latter half of fiscal 2010, even as the positive effects of government policies run their course, the forecast is that a double-dip recession will be avoided. The increasing trends in private capital investment and housing are moderate, but they are expected to continue, and, since corporate performance will remain on an upward trend, the outlook is for household incomes to improve gradually. The recovery trends in the domestic economy are not believed likely to end abruptly, and, moving into fiscal 2011, the momentum of economic recovery will improve.

(3) Outlook for Fiscal 2010 and Fiscal 2011: Following Adjustments in the Latter Half of Fiscal 2010, the Economy Will Move toward Self-Sustaining Recovery in Fiscal 2011

In fiscal 2010, as the positive effects of government policies diminish, the real GDP in the October-to-December period will decline from the previous quarter, and there is a possibility that the economy will experience a pause.

Exports will not lose momentum, even though uncertainty regarding future trends in overseas economies is increasing, and are forecast to rise gradually. Since the yen will remain at the top end of possible valuations, this will be a factor restraining exports. However, even though growth rates of exports will slow, demand from emerging countries is firm, and, provided the yen does not settle down at values stronger than ¥80 to the U.S. dollar, the rising trend in exports will be maintained. Imports will continue to rise along with the recovery in domestic demand, but import growth may slow in the latter half of the fiscal year, reflecting the weakness in domestic demand. External demand will contribute 1.1 percentage points to growth for the fiscal year, and it is expected to continue to be a driving force for the economy.

Personal consumption is forecast to decline from the previous quarter during the October-to-December period. As a result of the scaling down and exclusion of some items from the eco-point system, there will be a surge in demand for FPD TVs and certain other products, but this will not be sufficient to make up for the drop in automobile and tobacco product consumption. After the beginning of calendar 2011, the approach of the cutoff date for the eco-point system at the end of March will be accompanied by a surge in demand, and the downtrend in automobile sales in comparison with the previous month is expected to have run its course by then. Therefore, the decline in personal consumption will pause.

Industrial production in the October-to-December quarter is forecast to continue the decline posted in the July-to-September period as the positive effects of government policies run their course. The upward trend in exports is expected to continue and provide support for production, but, in some industries, there are movements in progress to adjust inventories, and there is a possibility that production may stagnate. For this reason, even though the improving trend in corporate performance will continue, the pace of improvement may slow.

Despite the improvement in corporate performance, companies still have the feeling that they have an excess of capital equipment, and the appreciation of the yen is making them more careful. Under these conditions, companies in the manufacturing sector have inevitably become more cautious; accordingly, the outlook is for only moderate increases in capital investment, and it will lack the strength necessary to drive growth in the economy as a whole. Even though private residential investment has reached bottom, a full-scale recovery will require additional time.

Public works investment is expected to show further declines since major cuts were made in the fiscal 2010 budget. Although the passage of a supplementary budget, as a further economic policy, is anticipated, the amount of the increase in public works investment will be small, and it is believed the real impact will not be felt until fiscal 2011. Government final consumption will continue to rise, centering around social welfare expenditures, but spending by the public sector as a whole will show further declines and will act as a drag on the economy.

However, as mentioned previously, the increase in exports will continue, and there will be an uptrend trend, albeit moderate, throughout the fiscal year in private capital investment and private housing investment. Therefore, even as the economy pauses in the latter half of fiscal 2010, it will not experience a serious loss of momentum.

To the contrary, although negative factors, such as the diminishing effects of government economic policies and the appreciation of the yen draw the most attention, behind these negative factors, the outlook is for corporate performance and the income environment to continue to improve and for progress to be made in other areas in preparation for self-sustaining recovery. For this reason, the wearing off of the positive effects of government policies will not lead to a spiraling deterioration in the economy, and stagnation will be temporary.

Our forecast is for real GDP growth of 2.6% in fiscal 2010, the first positive growth in three years (Chart 10). Compared with fiscal 2009, the rate of growth will rise rapidly, but this will be due to the influence of a carryover effect of 1.6% owing 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 a more-moderate 1.0% (Chart 11).

The nominal GDP growth rate for the fiscal year will be 1.0%, the first positive growth in three years. The GDP deflator will decline 1.5%, reflecting the continuation of deflationary pressures.

In fiscal 2011, the economy is forecast to move back onto a self-sustaining growth path beginning in the summer, and deflationary pressures will subside.

Exports and private-sector demand are expected to act as driving forces for the economy in fiscal 2011. Exports are likely to sustain an upward trend supported by continued recovery in overseas economies and the gradual correction of the upward value of the yen. In particular, exports to emerging countries, particularly in Asia, are expected to sustain favorable expansion. The increase in exports is expected to contribute to recovery in domestic demand through expansion in industrial production and improvement in corporate profitability. On the other hand, imports are likely to show firm growth, reflecting the increase in domestic demand. External demand will contribute 0.4 percentage point to growth for the fiscal year, smaller than the 1.1 percentage points in the previous fiscal year.

Employment and income conditions will continue to improve along with the gains in corporate performance, as the feeling among companies that they have excess workers diminishes gradually. The forecast is for overtime pay, bonuses, and scheduled wages to continue previous-year levels and for the increases in income to lead to higher levels of consumption. For this reason, consumer spending, which decreased in the latter half of fiscal 2010, is expected to gradually rise along with improvement in consumer confidence. Expenditures for big-ticket consumer durables, such as automobiles, will remain weak, but expenditures on services and other items, which have been restrained, are expected to make a comeback.

Moreover, as corporate performance improves and rates of capacity utilization rise, the rising trend in private capital investment is expected to continue. Since the feeling among corporations that they have an excess of capital equipment is diminishing, there is a possibility that they may restart investments that have been postponed, and the pace of increase in capital investment will rise slightly. In addition, the gradual uptrend in private housing investment is also likely to continue.

As these comments suggest, private-sector demand overall will escape from stagnation in the latter half of fiscal 2010, and there is a strong possibility that the economy will move onto a path of self-sustaining expansion in fiscal 2011.

On the other hand, public investment is expected to continue to be restrained because of the weakness in the financial positions of the national and local governments. Although the pace of decline in public investment may slow, as one would expect, it will remain a negative factor for the economy. While government final consumption expenditures, principally social security costs, will continue to expand, expenditures of the public sector as a whole are expected to shrink.

We are forecasting real growth of 1.3% in fiscal 2011. The carryover effect will be small (+0.1%) and the growth rate, calculated during the fiscal year, will be 1.2%, virtually the same as in fiscal 2010.

In addition, the outlook is for deflationary pressures to gradually subside along with economic recovery. The outlook is for the nominal GDP to rise 0.9% over the previous year and for the decline in the GDP deflator to shrink to –0.4%. On a quarter-by-quarter basis, the rate of change year on year in the deflator will show improvement and will converge to approximately zero by the end of fiscal 2011.

In fiscal 2012, the outlook is for the continuation of self-sustaining recovery. The contribution of external demand will remain at about +0.4 percentage point, but the contribution of domestic demand will rise to +1.4 percentage points. Improvement in the employment and income conditions will continue, and personal consumption will continue to be firm. Since corporate performance will also remain on an upward trend, private capital investment is expected to maintain a rising trend.

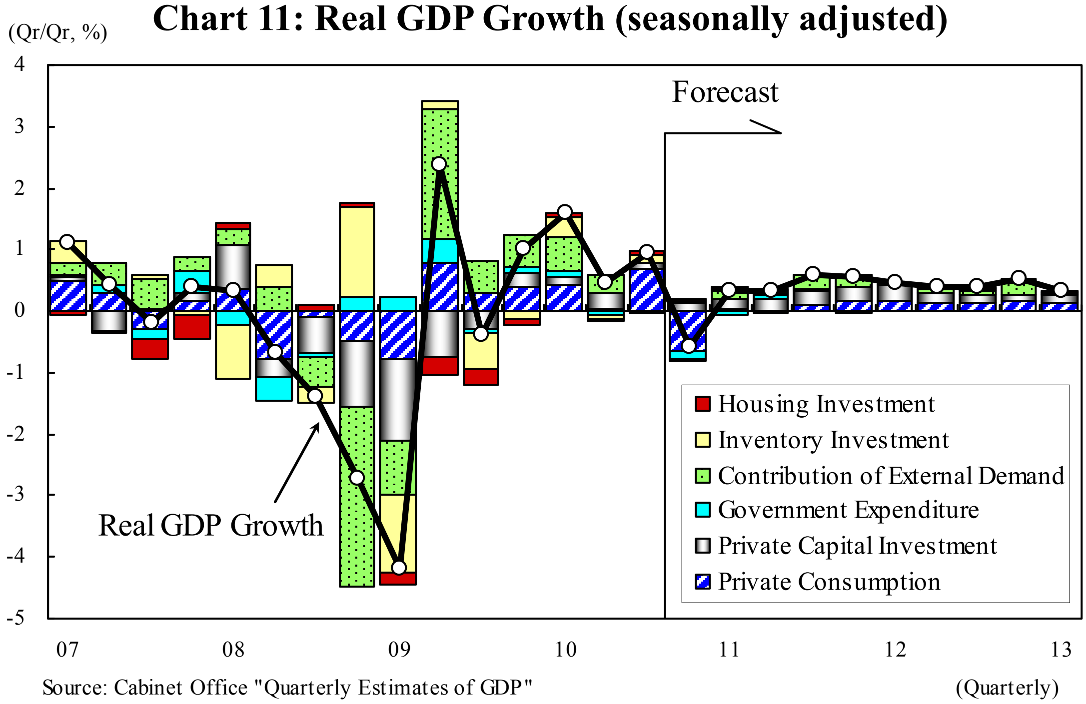
Real growth in fiscal 2012 is forecast to be +1.8%, higher than in the previous fiscal year. Nominal GDP will rise 1.7% and the GDP deflator will be 0.1% below the previous fiscal year, thus largely attaining the goal of eliminating deflationary pressures.

Chart 10: Real GDP Growth (Fiscal Year)

	Carry-over from the previous year (A)	Growth rate during the year (B)	Real GDP growth rate (A)+(B)
FY2008 (actual)	0.4 %	-4.2 %	-3.8 %
FY2009 (actual)	-4.7 %	2.9 %	-1.8 %
FY2010 (forecast)	1.6 %	1.0 %	2.6 %
FY2011 (forecast)	0.1 %	1.2 %	1.3 %
FY2012 (forecast)	0.7 %	1.1 %	1.8 %

Source: Cabinet Office "Quarterly Estimates of GDP"

Chart 11: 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 risk of a major downturn in production, capital investment, or other aspects of corporate activities had receded for the time being.
- However, following the collapse of Lehman Brothers Holdings in autumn 2008, domestic and overseas aggregate demand dropped sharply, and companies made major adjustments in production to reduce their inventories. As a result, production dropped rapidly, mainly in automobiles, general machinery, and certain other industries. Nevertheless, since the beginning of fiscal 2009, production has been recovering, and, even if the positive effects of government economic measures diminish and the economy pauses, the outlook is for

production to remain on a rising trend going forward, supported by growth in exports, which will be sustained by recovery in the world economy.

- Recurring profits, prior to the downturn, 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. Thereafter, owing to recovery in production activities and the positive effect of reductions in personnel and other costs, corporate profitability has shown rapid improvement.
- As a result of the deterioration in the domestic and overseas economies during the downturn, corporate profitability fell sharply and private capital investment went into a steep decline. Nevertheless, there is a need to maintain a certain level of capital investment to replace equipment and raise product value added to increase competitiveness. As corporate profitability and rates of capacity utilization have increased, private capital investment has begun to recover. However, full-scale capital investment aimed at increasing production capacity will be difficult in view of low growth in entry into overseas markets and in the domestic market.

(2) Households

- Although employment conditions are tough, recently, there have been signs of improvement. Looking ahead also, the the number of employed persons is continuing to rise year on year and the unemployment is on a gradual declining trend. In the household income environment, trends toward improvement are spreading, including, finally, the beginning of increases in non-scheduled compensation, special salary payments, and scheduled wages.
- The government's programs to encourage purchases of eco-friendly goods, which contributed to boosting consumer spending, are being scaled back, and this is bringing surges in demand prior to the ending of various programs, but reactionary declines following these programs are appearing. As a result of the ending of these programs, consumption

is expected to stagnate temporarily during the first half of fiscal 2011, but, as a result of the improvement in the income environment, consumption is expected to resume a rising trend in the latter half of fiscal 2011.

- Housing starts, which dropped and reached bottom in autumn 2009, are now viewed as being on an improving trend, but the level of activities remains low. Going forward, for the time being, housing starts are likely to remain on a rising trend with some fluctuations; however, because of the extremely large decline experienced during the downturn and the structural restraining factor of continued slowing in the rate of growth in the number of households, the rate of increase in the number of housing starts will remain moderate.

(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 have increased because 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. 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.

- Given this deterioration in public finances, the government adopted its "Fiscal Management Strategy" in June 2010, which is intended to restore fiscal soundness, and is working to formulate its budgets within a medium-term time frame, extending from fiscal 2011 to fiscal 2013. According to this strategy, the policy of the government will be to restrain its annual general account expenditures, after the exclusion of the issuance of government bonds and certain other items, to ¥71 trillion, which was the level in the fiscal 2010 budget. Since social security related expenditures, including medical expenses and nursing care for seniors, are expected to rise in tandem with the demographic aging of the population, the government's final consumption expenditures will continue to rise. However, because of major reductions in the level of public investments, on a GDP basis, total real government expenditures are expected to continue to decline.

(4) Trends in Overseas Economies

- The world economy is continuing to recover. Although the pace of recovery in the industrialized countries is relatively moderate because of delayed improvement in employment and concerns about fiscal crises, the emerging countries are recovering at a steady rate and some of these are experiencing overheating.
- The recovery in the world economy is forecast to continue. In Europe and North America, the outlook is for moderate recovery to continue, and these regions seem to have distanced themselves from the possibility of sinking into a double-dip recession. The movements toward fiscal restructuring are not of a magnitude likely to have a detrimental effect on these economies. China has raised interest rates along with rising inflation, but high economic growth is expected to continue in that country.
- 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 have been expanding at a relatively brisk pace. Even though the rates of growth in Japan's exports to Asia have slowed temporarily, the outlook is for these exports to remain on an increasing trend, reflecting the expansion in the economies of the region.

- 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 continue to account for a large share of the current account surplus.

3. Forecasts for Prices and Financial Markets

- The prices of raw materials, especially crude oil and metals, have moved above the levels of the previous year, thus boosting some prices. 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 products downstream will persist.
- Among domestic corporate prices, the prices of petroleum products and nonferrous metals, which are influenced by international commodity market prices, as well as the prices of steel and other basic materials have begun to rise. Although the trends toward firming and increases in basic material prices are expected to continue going forward, the pace of increase is expected to be moderate because supply capacity in Japan is expected to continue to exceed demand. In addition, since yen appreciation will be a factor pushing prices downward, the pace of increase in domestic corporate prices will remain moderate. 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 excessively easy monetary conditions. However, as a result of turbulence in financial

markets and the risks of economic downturn, mainly in the United States and Europe, in autumn 2008 and onward, measures were implemented to ease monetary policy. Thereafter, along with the return of stability to financial markets, although a portion of quantitative easing policies were lifted with set time limits, in view of continuing deflation, stronger policies were adopted to ease monetary policy again in December 2009. In addition, to cope with the increasing risk of economic downturns in Japan and overseas, in October 2010, a comprehensive policy for monetary easing was prepared. For the time being, the Bank of Japan is expected to continue its stance of easing monetary policy.

- As the recovery in the economy continues, with deflation continuing and short-term interest rates remaining stable, long-term interest rates are also expected to remain low. However, there is a possibility that a sustained recovery in various countries and the deterioration in government fiscal positions around the world may place upward pressure on long-term interest rates. In foreign exchange markets, participants have become more risk averse, and, during the latter half of fiscal 2008, the U.S. dollar and the yen strengthened. However, since spring 2009, a trend emerged to buy back European currencies and the currencies of resource-producing countries. In 2010, however, the euro weakened because of concerns about government fiscal problems in some EU countries, the U.S. dollar also declined in value because of prospects for the further relaxation of monetary policy, and the yen has appreciated.

Chart 12: Outlook for Fiscal 2010-2012

Forecast

Yr/Yr、%

	FY2007 (actual)	FY2008 (actual)	FY2009 (actual)	FY2010 (forecast)	FY2011 (forecast)	FY2012 (forecast)
Nominal GDP	0.9	-4.2	-3.6	1.0	0.9	1.7
Real GDP	1.8	-3.8	-1.8	2.6	1.3	1.8
Contribution of domestic demand	0.5	-2.6	-2.3	1.4	1.0	1.4
Private consumption	1.4	-1.8	0.8	1.4	0.1	1.0
Housing investment	-13.5	-3.7	-18.4	-0.9	4.7	2.2
Private capital investment	1.3	-6.8	-15.3	4.5	5.6	4.9
Contribution of inventory investment	0.0	-0.1	-0.5	0.0	0.1	0.1
Government expenditure	0.1	-1.3	3.0	-0.2	-0.2	0.0
Public investment	-6.4	-6.6	9.3	-6.6	-3.3	-2.7
Government final consumption expenditure	1.5	-0.1	1.7	1.1	0.5	0.5
Contribution of external demand	1.2	-1.3	0.5	1.1	0.4	0.4
Export of goods and services	9.3	-10.4	-9.5	19.3	5.9	6.0
Import of goods and services	1.9	-3.7	-12.2	11.4	3.9	4.2
GDP deflator	-0.8	-0.4	-1.8	-1.5	-0.4	-0.1

Forecast

Yr/Yr、%

	FY2007 (actual)	FY2008 (actual)	FY2009 (actual)	FY2010 (forecast)	FY2011 (forecast)	FY2012 (forecast)
Current account balance (trillion yen)	24.5	12.3	15.8	17.6	18.3	17.9
balance on goods (trillion yen)	11.7	1.2	6.6	8.7	9.2	8.7
balance on service (trillion yen)	-2.6	-2.0	-1.8	-1.8	-1.7	-1.7
balance on income (trillion yen)	16.8	14.6	12.1	11.8	12.0	11.9
Industrial production	2.7	-12.7	-8.9	8.3	1.5	3.6
Unemployment rate(%)	3.8	4.1	5.2	5.0	4.8	4.5
New housing starts(annualized, ten thousand units)	103.6	103.9	77.5	81.5	84.6	85.6
Domestic corporate goods prices	2.3	3.1	-5.2	0.4	0.6	0.7
Consumer prices	0.2	1.2	-1.7	-0.4	-0.1	0.3
excluding freshfood	0.3	1.2	-1.6	-0.8	0.1	0.3
Yen/U.S.Dollar	114.2	100.5	92.8	84.7	81.3	83.8
Uncollateralized call rates (O/N) (%)	0.505	0.363	0.102	0.090	0.090	0.250
Newly issued government bond yields (10years) (%)	1.60	1.46	1.36	1.10	1.19	1.33
WTI future price (near month contract, US dollar/barrel)	82.2	85.9	70.7	80.8	86.8	87.8
Dubai crude oil prices (US dollar/barrel)	77.3	82.1	69.7	79.0	84.1	84.8

Chart 13: Outlook for Calendar 2010-2012

Forecast

Yr/Yr、%

	CY2007 (actual)	CY2008 (actual)	CY2009 (actual)	CY2010 (forecast)	CY2011 (forecast)	CY2012 (forecast)
Nominal GDP	1.6	-2.0	-6.1	1.5	0.5	1.7
Real GDP	2.4	-1.2	-5.2	3.6	1.1	1.9
Contribution of domestic demand	1.2	-1.3	-3.9	1.6	0.7	1.5
Private consumption	1.6	-0.7	-1.0	2.1	-0.1	0.9
Housing investment	-9.6	-8.1	-14.2	-6.7	5.1	2.1
Private capital investment	2.6	0.1	-19.2	1.6	5.2	5.6
Contribution of inventory investment	0.3	-0.4	-0.3	-0.1	0.0	-0.1
Government expenditure	-0.2	-1.2	2.4	0.7	-0.5	0.1
Public investment	-7.4	-8.5	7.4	-3.1	-5.6	-2.2
Government final consumption expenditure	1.5	0.3	1.5	1.4	0.5	0.5
Contribution of external demand	1.1	0.1	-1.3	1.9	0.4	0.4
Export of goods and services	8.4	1.6	-23.9	25.1	6.7	6.7
Import of goods and services	1.6	1.2	-16.7	10.4	4.7	4.8
GDP deflator	-0.7	-0.8	-0.9	-2.0	-0.6	-0.1

Forecast

Yr/Yr、%

	CY2007 (actual)	CY2008 (actual)	CY2009 (actual)	CY2010 (forecast)	CY2011 (forecast)	CY2012 (forecast)
Current account balance (trillion yen)	24.8	16.4	13.3	17.4	18.3	17.8
balance on goods (trillion yen)	12.3	4.0	4.0	8.6	9.3	8.8
balance on service (trillion yen)	-2.5	-2.1	-1.9	-1.7	-1.8	-1.7
balance on income (trillion yen)	16.3	15.8	12.3	11.6	11.9	11.9
Industrial production	2.8	-3.4	-21.9	15.4	-0.1	4.0
Unemployment rate (%)	3.9	4.0	5.1	5.0	4.8	4.6
New housing starts(annualized, ten thousand units)	106.1	109.3	78.8	81.2	84.5	85.6
Domestic corporate goods prices	1.7	4.6	-5.2	-0.2	0.7	0.6
Consumer prices	0.0	1.4	-1.4	-0.7	-0.1	0.2
excluding freshfood	0.0	1.5	-1.3	-1.0	0.0	0.2
Yen/U.S.Dollar	117.8	103.4	93.5	87.3	80.7	83.4
Uncollateralized call rates (O/N) (%)	0.474	0.462	0.105	0.090	0.090	0.100
Newly issued government bond yields (10years) (%)	1.68	1.48	1.34	1.16	1.15	1.30
WTI future price (near month contract, US dollar/barrel)	72.3	99.6	61.8	79.2	86.3	87.4
Dubai crude oil prices (US dollar/barrel)	68.4	93.8	61.8	77.4	83.8	84.4

Chart 14: 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	0.3	-0.6	0.4	1.7	-0.7	0.7	-0.8	0.5	0.0	0.3	0.7	0.8
	-6.3	-5.8	-3.8	1.8	0.8	2.3	1.0	0.1	0.4	-0.1	1.3	1.9
Real GDP	2.4	-0.4	1.0	1.6	0.4	0.9	-0.6	0.3	0.3	0.6	0.5	0.5
	-5.8	-5.1	-0.9	5.0	2.7	4.4	2.3	1.2	0.9	0.6	1.7	2.0
Contribution of domestic demand (Qr/Qr,%)	0.3	-0.9	0.5	1.0	0.1	0.9	-0.6	0.2	0.3	0.4	0.4	0.4
Private consumption	1.3	0.5	0.7	0.7	0.1	1.1	-1.1	0.1	-0.1	0.2	0.3	0.3
	-1.1	-0.4	1.2	3.3	1.9	2.6	0.8	0.2	0.0	-0.9	0.5	0.7
Housing investment	-9.2	-8.3	-3.5	2.0	-0.8	1.3	1.8	1.7	1.4	0.7	0.3	0.2
	-9.9	-20.3	-24.5	-18.0	-10.5	-1.0	4.5	4.1	6.3	5.7	4.2	2.6
Private capital investment	-5.0	-2.1	1.7	1.0	1.8	0.8	0.9	1.3	1.4	1.5	1.5	1.6
	-22.1	-20.9	-13.5	-4.5	2.5	5.5	4.7	4.9	4.6	5.3	5.9	6.2
Contribution of inventory investment (Qr/Qr,%)	0.1	-0.6	-0.1	0.3	-0.1	0.1	0.0	0.0	0.1	0.0	0.0	0.0
Government expenditure	1.7	-0.2	0.3	0.4	-0.3	-0.1	-0.6	-0.3	0.3	0.2	-0.2	0.0
	3.2	3.4	3.2	2.3	0.7	0.6	-0.8	-1.0	-0.6	-0.6	0.1	0.4
Public investment	9.1	-2.1	-1.0	-0.7	-2.3	-0.6	-4.0	-3.4	1.9	1.0	-1.5	-1.3
	13.9	11.6	9.2	4.6	-5.6	-4.1	-7.6	-8.2	-7.5	-5.9	-1.6	0.0
Government final consumption expenditure	0.1	0.2	0.6	0.6	0.2	0.1	0.1	0.2	0.1	0.1	0.1	0.2
	1.7	2.0	1.7	1.5	1.6	1.4	1.0	0.6	0.5	0.5	0.5	0.4
Contribution of external demand (Qr/Qr,%)	2.1	0.5	0.5	0.6	0.3	0.0	0.0	0.1	0.0	0.2	0.2	0.0
Export of goods and services	10.1	9.3	5.1	7.0	5.6	2.4	0.9	1.5	0.3	2.0	2.6	2.2
	-29.3	-22.7	-4.7	34.5	30.3	21.5	16.9	10.8	5.2	4.7	6.5	7.3
Import of goods and services	-5.4	5.2	1.4	3.2	4.0	2.7	0.8	0.8	0.2	0.7	1.9	2.3
	-17.8	-16.3	-16.0	4.0	14.6	11.9	11.1	8.5	4.5	2.5	3.6	5.2
GDP deflator (Yr/Yr,%)	-0.5	-0.7	-2.9	-3.0	-1.8	-2.0	-1.3	-1.0	-0.5	-0.7	-0.4	-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)*	3.5	3.6	4.0	4.7	3.8	4.3	4.8	4.8	3.9	4.5	5.2	4.8
balance on goods (trillion yen)*	1.0	1.4	1.9	2.4	1.8	2.1	2.3	2.5	1.9	2.3	2.6	2.5
balance on service (trillion yen)*	-0.5	-0.4	-0.4	-0.5	-0.4	-0.3	-0.5	-0.6	-0.4	-0.3	-0.6	-0.5
balance on income (trillion yen)*	3.3	2.9	2.7	3.0	2.6	2.8	3.4	3.1	2.7	2.8	3.5	3.2
Industrial production (Qr/Qr、%)	6.5	5.3	5.9	7.0	1.5	-1.8	-3.5	1.5	0.8	1.1	1.2	1.0
Industrial production (Yr/Yr、%)	-27.4	-19.4	-4.3	27.5	21.0	13.5	3.4	-2.2	-3.1	0.1	4.9	4.2
Unemployment rate (%)*	5.1	5.4	5.2	4.9	5.2	5.1	4.9	4.9	4.8	4.8	4.8	4.7
New housing starts(annualized, ten thousand units)	76.9	71.3	79.1	83.7	76.0	81.2	84.4	85.1	84.2	83.4	85.4	85.3
Domestic corporate goods prices (Yr/Yr,%)	-5.5	-8.2	-5.2	-1.7	0.2	-0.1	1.0	0.8	0.3	0.9	0.6	0.6
Consumer prices (Yr/Yr,%)	-1.0	-2.2	-2.1	-1.2	-0.9	-0.8	0.1	-0.1	0.0	-0.1	-0.2	-0.1
excluding freshfood (Yr/Yr,%)	-1.0	-2.3	-1.8	-1.2	-1.2	-1.0	-0.5	-0.4	0.1	0.1	0.1	0.1
Yen/U.S.Dollar	97.3	93.6	89.7	90.7	92.0	85.9	80.8	80.0	80.0	80.8	81.8	82.5
Uncollateralized call rates (O/N) (%)	0.103	0.103	0.104	0.098	0.093	0.094	0.090	0.090	0.090	0.090	0.090	0.090
Newly issued government bond yields (10years) (%)	1.45	1.34	1.31	1.33	1.27	1.05	0.99	1.09	1.13	1.17	1.21	1.24
WTI future price (near month contract, US dollar/barrel)	59.6	68.3	76.2	78.7	78.0	76.2	84.0	85.0	86.0	87.0	87.0	87.0
Dubai crude oil prices (US dollar/barrel)	59.2	68.1	75.4	75.9	77.6	74.2	81.7	82.5	83.5	84.5	84.5	84.0

*seasonally adjusted