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Forecast for the Japanese Economy in Fiscal 2011 and 2012

**— Escaping from the Temporary Lull and
Moving Gradually toward a Stronger Recovery Trend —**



Mitsubishi UFJ Research and Consulting

Economic Research Department

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

-- Escaping from the Temporary Lull and Moving Gradually toward a Stronger Recovery Trend

(1) Current State of the Economy: Real GDP Growth Temporarily Negative

Real GDP growth for the October-to-December period was -0.3% (-1.1% at an annualized rate), the first negative figure in five quarters. Nominal GDP growth for the quarter was -0.6% (-2.5% at an annualized rate), the first negative figure in two quarters.

Examining the contribution to real GDP of the domestic and external sectors, the contribution of the domestic sector was -0.2 percentage point, while the contribution of the external sector was -0.1% percentage point. The external sector has, therefore, been a factor depressing growth for two consecutive quarters, even though it has previously been a factor driving growth, and the contribution of domestic demand was negative for the first time in five quarters.

The principal factors responsible for the decline in domestic demand included a decline of 0.7% from the previous quarter in personal consumption. Subsidies for purchases of eco-friendly cars, which had a major positive impact on sales, were terminated at the end of September, and sales of new cars during the October-to-December quarter dropped about 30% from the same period of the previous year. Another factor causing the large drop in consumption was the surge in demand for tobacco products prior to the increase in the tobacco tax in October, which was followed by a reactionary decline. Although sales of eco-friendly household appliances surged through November in advance of the scaling back of the eco-point system, this was not sufficient to offset negative factors. Consumer expenditures on services continued to be weak.

Private residential investment rose 3.0% from the previous quarter, the second consecutive quarter-to-quarter increase, reflecting the gradual improvement in housing starts, particularly condominiums.

Private capital investment was up 0.9%, for the fifth consecutive quarterly rise. Although corporations continue to be quite cautious regarding new investments, a moderate rising trend in capital investment is continuing as production levels rise and corporate profitability is staging a rapid recovery. In addition, reflecting a slight slackening in the movement toward inventory adjustments and other factors, the contribution of private inventory investment to real GDP was 0.2 percentage point, thus pushing real GDP growth upward.

Overall public-sector demand declined 0.7% from the previous quarter, the second consecutive quarterly drop. Although government consumption expenditures rose 0.2%, thus continuing a moderate upward trend, public investment decreased 5.8%, reflecting major cuts in budgetary allocations for the current fiscal year and the diminishing positive effects of the supplementary budget of the previous fiscal year.

The contribution of the external sector was -0.1 percentage point, thus tending to push real GDP growth downward for the second consecutive quarter. Imports declined a slight 0.1%, reflecting the stagnation in consumption and other components of domestic demand, the first decrease in six consecutive quarters. On the other hand, exports were down 0.7%, thus marking the first decline in seven quarters. This was due to the influence of a weakening in exports to the rest of Asia, which have been a driving force thus far, owing to a slight weakening in the momentum of expansion in the Chinese economy.

The GDP deflator, which shows trends in prices in the overall economy, was 1.6% below the level of the same quarter of the previous year. This represented a 0.5 percentage point shrinkage in the margin of decline year on year, reflecting the impact of increases in prices of fresh foods, tobacco products, and energy. However, on a seasonally adjusted basis, the GDP deflator was 0.4% below the previous quarter, indicating that deflationary conditions, against a background of excess supply, have shown no major change.

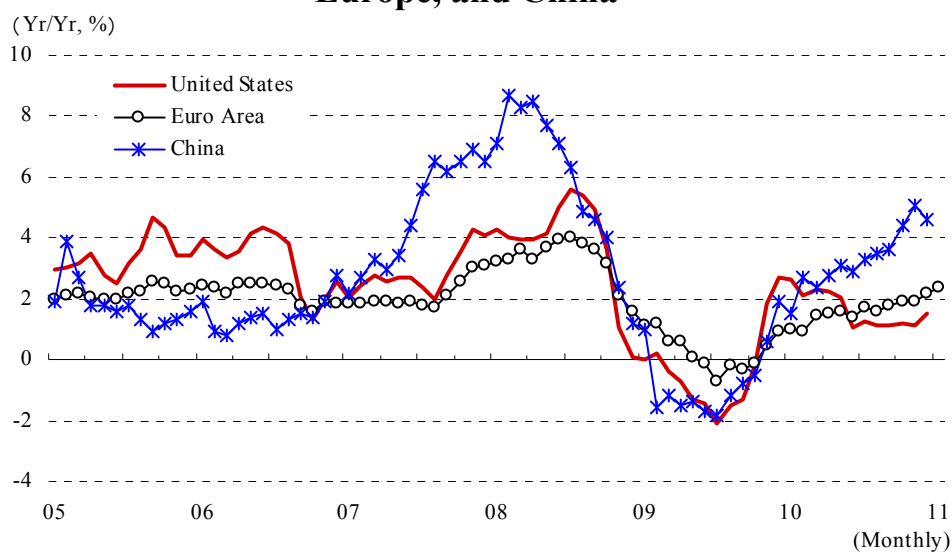
(2) Economic Outlook: How Should We Evaluate the Effects of Rising International Commodity Prices?

The Japanese economy had been on a recovery trend, after reaching bottom in March 2009, but during the October-December quarter of 2010, the real GDP posted negative growth, reminding us that recovery in the economy paused at the end of the previous year.

However, recent trends suggest that conditions are beginning to change. The global recovery trend led primarily by China and other emerging economies is continuing, and signs have appeared that Japan's exports began to rise again at the end of 2010. In addition, recent data on automobile sales indicate that, in part because of the introduction of new models, the brakes have been applied to the previous downtrend. As industrial production levels rise and corporate profitability continues to recover, private capital investment is on a rising trend, fueled mainly by replacement investment. Moreover, household incomes are increasing at a moderate pace and conditions are on a trend toward improvement. Looking ahead, it appears that the economy will escape from the current temporary pause by the middle of fiscal 2011, the year ending March 31, 2012, and expenditures by the household and corporate sectors will increase as exports rise and the pace of increase in household incomes continues. As a result, the economy will move toward a moderate recovery trend during fiscal 2011.

Nevertheless, there are still reasons for concern about the future course of the economy. These include the resumption of increases in international commodity prices, including those of crude oil, metals, and food products. Therefore, a major point seems likely to be the extent of the impact of these global price increases on domestic prices and on corporate performance. Inflationary pressures are already rising around the world (Chart 1). Some countries, including China, are implementing monetary-restraint policies, and upward pressures on interest rates are growing internationally.

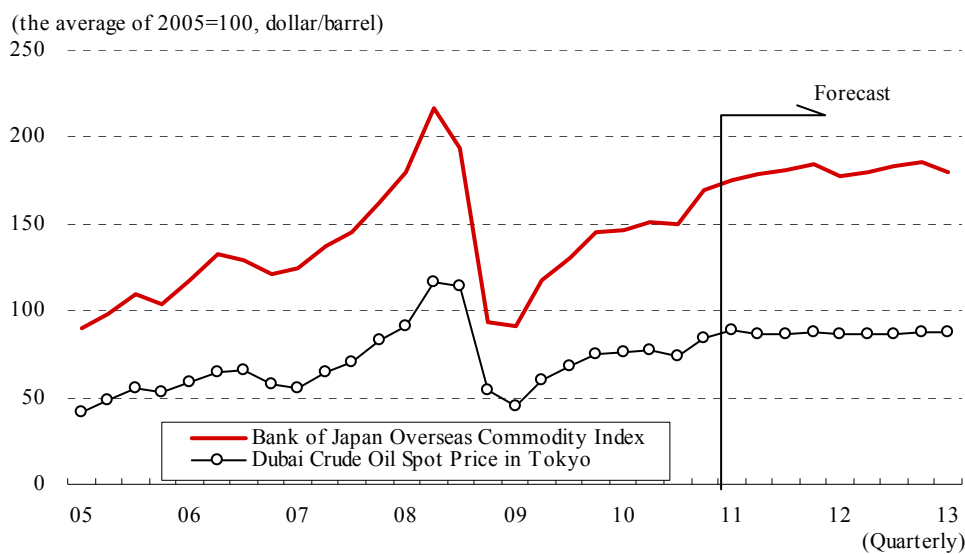
Chart 1: Rates of Consumer Price Increases in the United States, Europe, and China



Source: U.S. Bureau of Labor Statistics, European Commission, National Bureau of Statistics of China

The rise in commodity prices is believed to be the result of a combination of expansion in real demand accompanying the global economic recovery and short-term supply factors, including the entry of speculative funds in the markets and the risk of climate and geopolitical factors. Provided restrictions on speculative fund flows are tightened and weather conditions are stable, these factors are expected to subside eventually, and the leeway for further increases in prices may not be very large. If countries around the world tighten their monetary policies and this restrains price pressures coming from rising real demand and if there are no sudden disruptive factors arising, such as conflicts, violence, and unseasonable weather, it appears likely that worldwide inflationary pressures will subside. We believe that crude oil prices will remain at their current relatively high levels during the period of our forecast, but the probability of their rising to the high levels of August 2008 appears to be low (Chart 2). In addition, we are forecasting that the increases in other commodities will also gradually subside.

Chart 2: Forecasts for International Commodity Prices



Even so, as the world economy expands steadily, it is unlikely that commodity prices will drop sharply in a short period of time. There is a possibility that inflationary pressures may continue to rise globally for the time being. In that case, what will be the impact on the Japanese economy? The following factors are expected to be influenced.

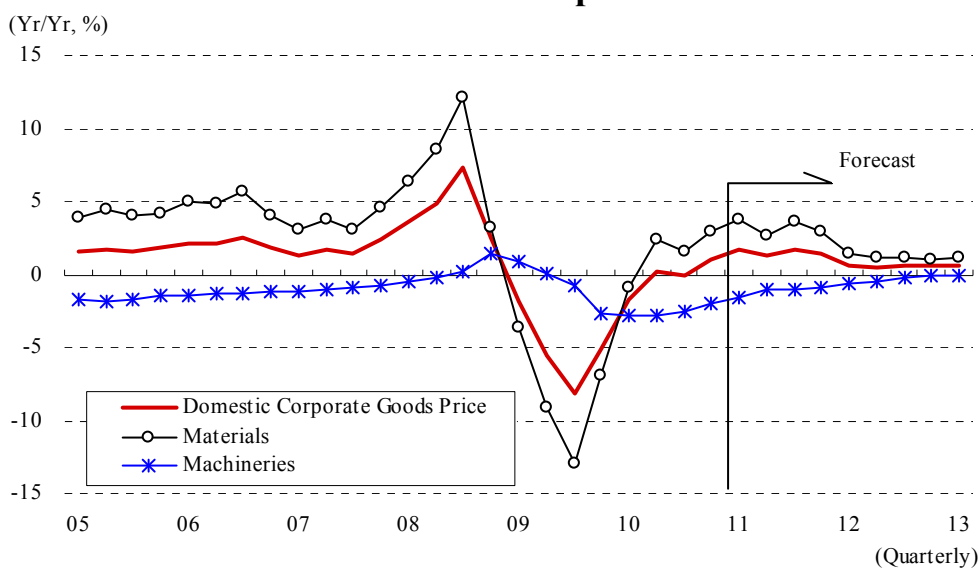
(a) Effects on Domestic Prices

First, in January 2011, the domestic corporate goods price index was already 1.6% above the level for the same period of the previous year, and the margin of increase is expanding. Among the components of the corporate goods price index, those items susceptible to the influence of commodity prices, such as crude oil and other basic materials, had already risen above their previous year levels early in the current fiscal year and their margins of increase have been expanding (Chart 3). On the other hand, prices of electric and electronic equipment and other types of machinery are currently declining, but their margin of decline is gradually shrinking.

Since the effects of the rise in commodity prices will filter through the economy, the increases in basic materials prices are expected to continue. However, since supply capacity is expected to remain in excess of demand

in the domestic economy, it will be difficult to pass the increases in the cost of materials on to final product prices, and upward pressure on prices will, therefore, probably not increase. During the period covered by our forecasts, there is a strong possibility that prices of electric and electronic equipment and other types of machinery will probably remain on a declining trend.

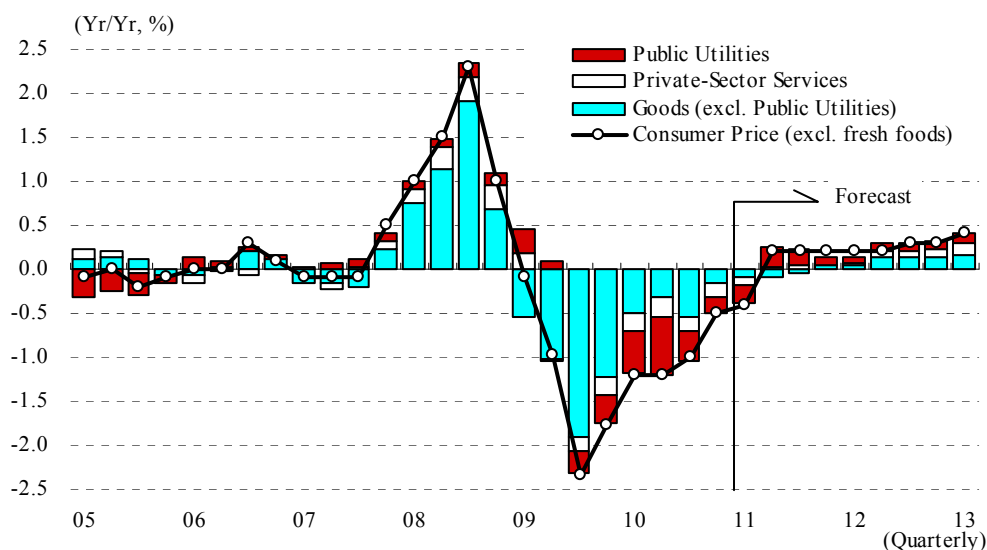
Chart 3: Forecast for Domestic Corporate Goods Price Index



Note: Materials: Petroleum & coal products, Chemicals & related products, Plastic products, Textile products, Lumber & wood products, Pulp, paper & related products, Nonferrous metals, Metal products, Iron & steel, Ceramic, stone & clay products, Agriculture, forestry & fishery products, Minerals, Scrap & waste, Electric power, gas & water, Processed foodstuffs
Machineries: Electrical machinery & equipment, Precision instruments, General machinery & equipment, Transportation equipment, Other manufacturing industry products
Source: Bank of Japan, "Corporate Goods Price Index"

As a result of the increases in prices of energy and other upstream items, the downstream consumer price index (CPI) (nationwide, comprehensive index, excluding fresh foods) is coming under pressure to rise, and the margin of decline in this index shrank to -0.4% in December. The lowering of public high school tuitions effectively to zero is viewed as likely to reduce the CPI by 0.5 percentage point. If the effect of this development is excluded, the index is already above the level of the previous year. The effect of this reduction in tuitions will run its course during fiscal 2011, and there is a strong possibility that the CPI will rise above the levels of the previous year (Chart 4).

Chart 4: Forecast for Consumer Price Index



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

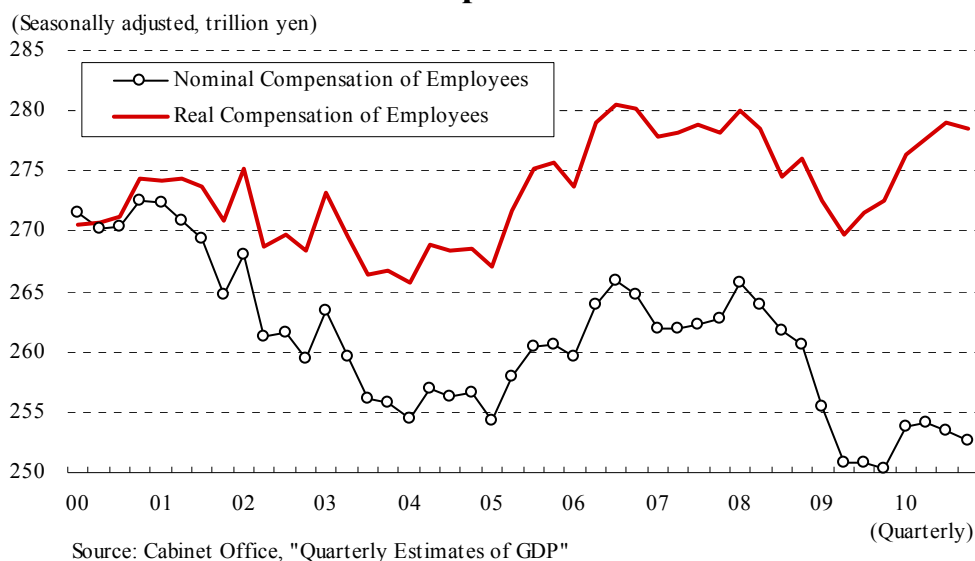
Nevertheless, even though the CPI will rise year on year, the margin of increase will remain moderate. Consumer preferences for low-priced goods is believed likely to continue going forward, and corporations will continue to find it difficult to pass increases in their costs on to the prices that consumers pay. Increases in prices of services will probably be even further delayed.

As these comments suggest, it will be difficult for upward pressures on prices caused by increases in international commodity prices to filter downstream, and there is a strong possibility that corporations will have to absorb these higher costs. However, increases in international commodity prices are believed likely not to generate inflationary pressures within Japan that will have a major effect on the economy. The reasons for this include the prognoses that the rise in international commodity prices will not climb to the levels prevailing in 2008, the value of the yen is higher than at that time, and that, unlike 2007 and 2008, there is no sense that the economy is overheating.

If inflationary pressures build within Japan, the main cause for concern will be the effects on trends in consumer spending. At present, while relatively slow growth in nominal incomes is continuing, real incomes are being

pushed upward by the decline in prices (Chart 5). If prices increase at the final demand stage, this will have a negative effect because of the erosion of real incomes. However, the pace of increase in the CPI is expected to remain moderate, and the risk of this occurring is small.

Chart 5: Deflation Is Pushing Real Compensation of Employees Upward

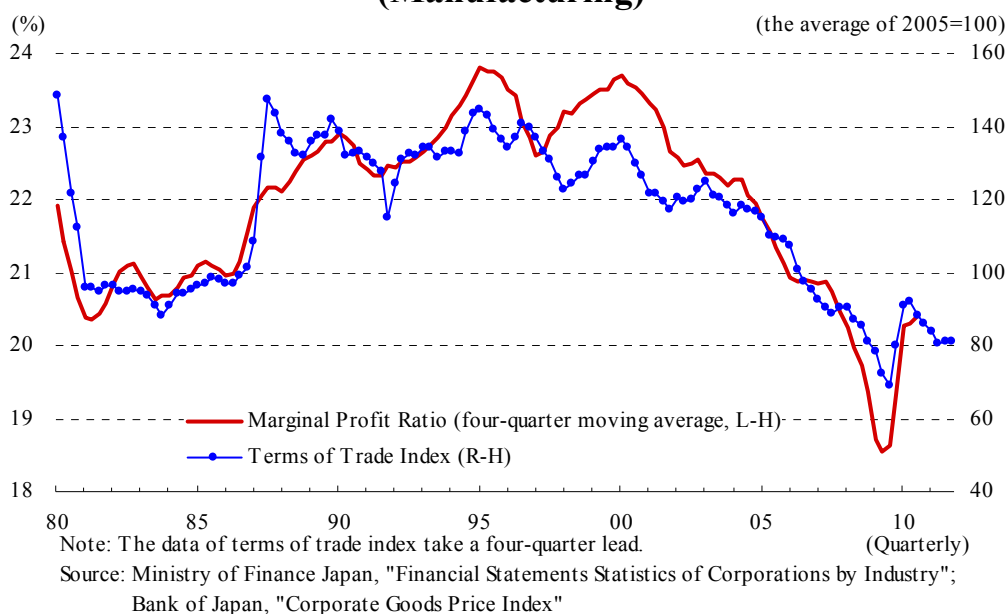


(b) Effects on Corporate Performance

As previously mentioned, it will be difficult for corporations to sufficiently pass on increases in their costs to the prices of their products. This deterioration in their terms of trade will be a factor reducing corporate profits by lowering their marginal profit ratio (gross profit margin ratio). Deterioration in the terms of trade (export prices divided by import prices) was forced on companies around the fall of 2008, but, thereafter, the terms of trade improved as international commodity prices dropped sharply, and this was a factor accounting for improvement in corporate profits (Chart 6). However, at present, the terms of trade are deteriorating again as international commodity prices are on the rise once more. In general, marginal profit ratios of corporations respond to changes in the terms of trade after a lag; therefore, there is a possibility that, going forward, marginal profit ratios will decline and have a negative impact on

profitability. However, marginal profit ratios are not the only factors that determine corporate profits. Sales are expected to continue to rise owing to increases in exports and other factors, and although the rate of growth is believed likely to weaken, corporations are viewed as likely to sustain the increase in profits.

**Chart 6: Terms of Trade Index and Marginal Profit Ratio
(Manufacturing)**



(c) Effects on Incomes of the Deterioration in the Terms of Trade

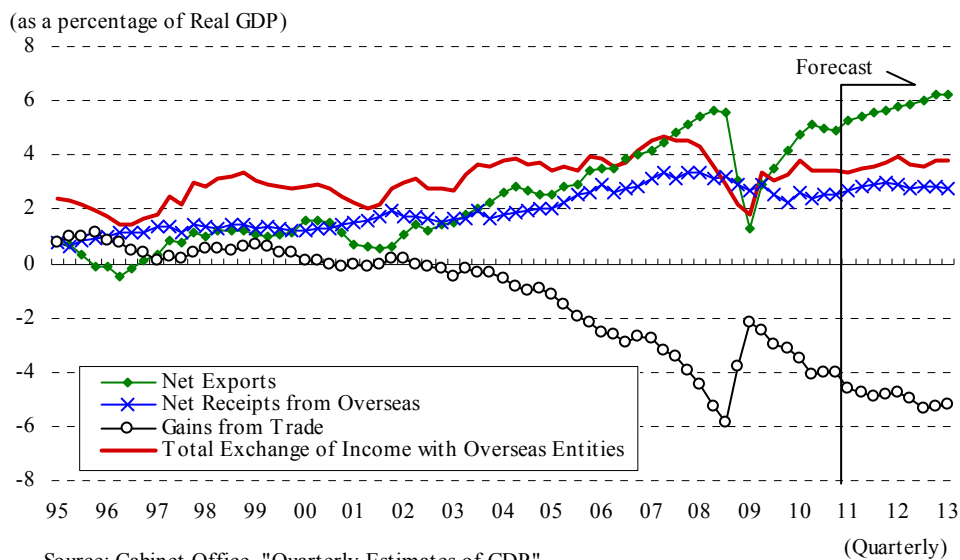
Import prices (prices of inputs) are rising as a result of the increase in international commodity prices. On the other hand, if these increases cannot be passed on sufficiently to prices of exports (prices of outputs), a country's terms of trade will deteriorate. This means that gains from trade are diminished.

Gains from trade arise from transactions with overseas entities and imply a transfer of income arising from differences between export and import prices. In transactions with overseas entities, if import prices rise, payments to overseas entities will rise, and the outflow of income overseas will increase. Conversely, if export prices increase, payments from overseas

entities will increase, and the inflow of income into the domestic economy will rise. In other words, the gains from trade vary with changes in the terms of trade. However, since real gross domestic income (GDI) equals the real gross domestic product (GDP) plus the gains from trade, if gains from trade decline (because of a deterioration in the terms of trade), real GDP declines.

When international commodity prices begin to increase, since it may be difficult to raise prices of final demand goods, etc., that have been produced for export by Japanese companies, corporate terms of trade will deteriorate. In fact, at the time of the increase in international commodity prices in 2008, the gains from trade were negative (the flow of income overseas expanded). At present, the negative gains from trade are expanding once again, and this is expected to continue during the period covered by our forecast (Chart 7).

Chart 7: Trends in Income Exchange with Overseas Entities



However, if we look at movements of income to and from overseas from a comprehensive perspective, we can see that the deterioration in gains from trade is not necessarily one-sided. First, real net exports, which represent the balance of trade in quantitative volume terms, are expanding, and they

are offsetting the decline in gains from trade. Moreover, net receipts of interest and dividends from overseas (after netting out payments and receipts), which reflect the effects of expansion in net external assets, are maintaining a large and continuing surplus. If we examine the results of the total exchange of income with overseas entities, we find that this reached bottom early in 2009 and is now on a rising trend. Looking ahead, even if gains from trade deteriorate, the outlook is for the total exchange of income with overseas entities to remain at a high level.

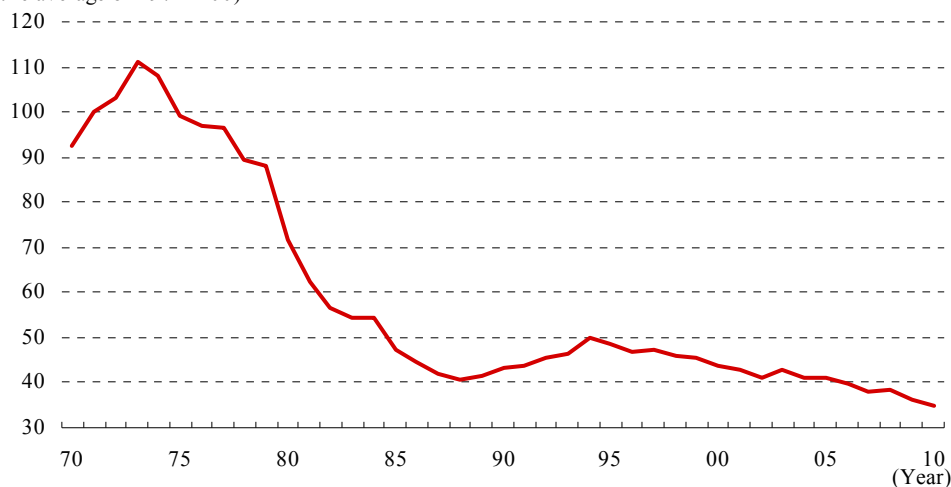
(d) Effects on the Macroeconomy

As a result of energy conservation and the shift toward services in the industrial structure, the dependence of the Japanese economy on crude oil and other sources of energy is gradually decreasing and its ability to withstand increases in international commodity prices is rising. If we examine the amount of crude oil input necessary for generating real GDP, by comparing the basic crude oil unit and GDP, we find that, in 2010, this energy requirement was at the lowest level in history. This implies that the economy's capacity for withstanding price increases has significantly strengthened (Chart 8).

Moreover, our trial calculations to compute an index measuring the real burden of crude oil prices, taking account of changes in the relative unit price of crude oil and fluctuations in exchange rates, show that, in 2010, the actual real burden increased compared with 2009, but still remains below the level at the time of the two previous oil crises and below the level in 2008, when crude oil prices reached an all-time high. For this reason, if prices of crude oil and other commodities remain at the level shown in Chart 2, then the damage that international commodity price increases will do to the macroeconomy is not as great as may be feared.

Chart 8: Declining Unit Input of Crude Oil

(the average of 1971=100)

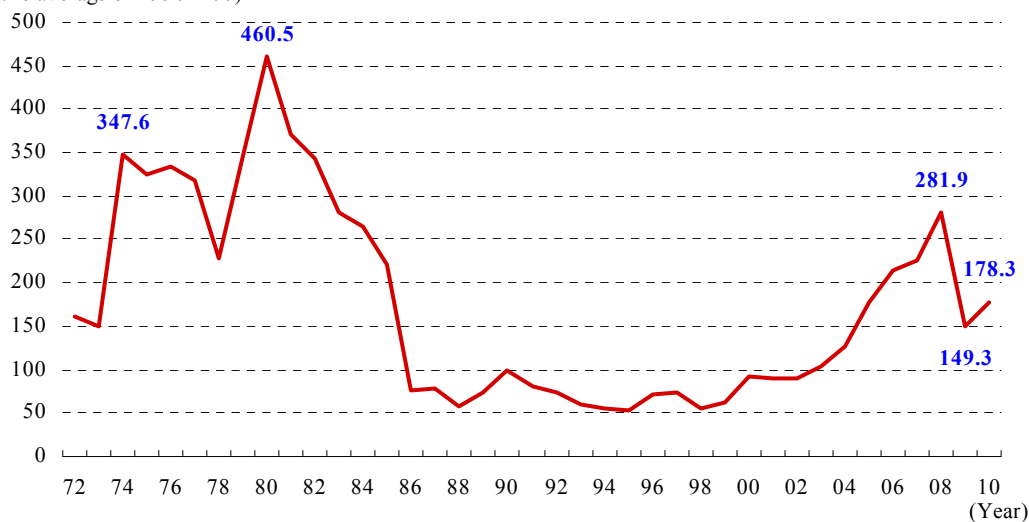


Note: Unit Input of Crude Oil = Import Volume of Crude Oil and Raw Oil / Real GDP

Source: Cabinet Office, "Quarterly Estimates of GDP"; Ministry of Finance Japan, "Trade Statistics"

Chart 9: Trends in the Index of the Real Burden of Crude Oil Prices

(the average of 1990=100)



Note: Index of Real Burden of Crude Oil Prices

= Yen-denominated Relative Price of Crude Oil × Unit Input of Crude Oil

The Price of Crude Oil is relative to GDP deflator.

Unit Input of Crude Oil = Import Volume of Crude Oil and Raw Oil / Real GDP

Source: Cabinet Office, Ministry of Finance Japan, Bank of Japan, NYMEX

As these comments suggest, the increases in international commodity prices have given rise to concerns about the spread of inflation worldwide, but it appears likely that the room for further increases going forward is limited. Moreover, the detrimental impact on the Japanese economy is

expected to be relatively minor and unlikely to be a direct causal factor leading to a loss of momentum in the economy. However, if overseas economies deteriorate as a result of increases in international commodity prices or the pace of expansion in overseas economies slows because of the tightening of monetary policies, this may have a detrimental impact if Japan's exports decline as a result. For these reasons, these price increases will continue to give rise to concern about the future course of the economy.

(3) Outlook for Fiscal 2010 and Fiscal 2011: After Escaping from the Temporary Lull, Stronger Recovery Trend in Fiscal 2011

The following paragraphs outline our forecasts by year. Please note that, because of related uncertainties, these forecasts do not include any assumptions regarding the issues currently being considered by the government regarding simultaneous reforms in taxation and social security or the course of discussions related to Trans Pacific Partnership (TPP) agreements.

In fiscal 2010, the economy is forecast to begin to show positive growth again in real GDP in the January-to-March quarter, and the economy will escape from its temporary lull. Exports will be favorable as recovery continues in overseas economies, and industrial production, which had dropped below the level of the previous year for two consecutive quarters, is expected to return to a rising trend year on year. In addition, regarding personal consumption, although a reactionary decline is expected in sales of flat panel display (FPD) TVs, the effects of the reactionary decline in car and tobacco product sales are expected to run their course. Along with improvement in employment and income conditions, consumption is expected to rise above the previous quarter. Private residential investment and private capital investment are expected to remain on a gradual rising trend.

As a result, our forecast is for real GDP growth of +3.0%, 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 1.9% owing to growth in fiscal 2009 (Chart 11). Calculating the growth rate during the fiscal year to take account of this carryover, as a result of the economy moving into a lull, real growth in fiscal 2010 will remain at 1.1%. The nominal GDP growth rate for the fiscal year will be 1.1%, the first positive growth in three years. The GDP deflator will decline 1.8%, reflecting the continuation of deflationary pressures.

In fiscal 2011, the movement toward recovery will continue. Exports will continue to be the driving force. The firm recovery trend will continue, as the world recovery, centered in the emerging countries, and the gradual correction of the excessive appreciation of the yen progress. The increase in exports is expected to lead to improvement in domestic demand via expansion in industrial production and gains in corporate profitability. On the other hand, imports will also show steady increases, reflecting the rise in domestic demand. The contribution of the external sector will remain about +0.4 percentage point, but will be smaller than the +1.1 percentage point contribution in the previous fiscal year.

The trend toward improvement in employment and income conditions will continue as the feeling among companies that they have excess workers diminishes gradually and corporate performance improves. The forecast is for overtime pay, bonuses, and scheduled wages to continue above the previous year's levels and for the increases in income to lead to higher levels of consumption. At the beginning of fiscal 2011, there will be a reactionary decline to the positive effects of government policies that pushed demand upward temporarily, and there is a possibility the rate of expansion in consumer spending will weaken. Nevertheless, consumption is likely to remain firm, supported by the improvement in incomes. Expenditures for big-ticket consumer durables, such as automobiles and FPD TVs, will remain weak, but expenditures on services and other items, which have been restrained, are expected to make a comeback.

Although the rate of increase in corporate profits will slow significantly, the trend toward improvement will be sustained. The effects of reduction in personnel expenses and other fixed costs will run their course, and the deterioration in the marginal profit ratio owing to the rise in basic material prices will be a negative factor for profitability. However, increases in sales will give a boost to profits and most likely offset these negative factors. As corporate performance improves and the rates of capacity utilization rise, the increasing 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 the number of housing starts bottoms out and begins to recover.

As these comments suggest, private-sector demand overall will escape from its temporary lull, and there is a strong possibility that the recovery trend will gradually gather strength.

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. As a result of the positive effects of economic policies passed in October 2010, there may be some periods when public investment increases, but this is likely to be temporary. For the fiscal year as a whole, this will remain a negative factor for the economy. While government final consumption expenditures, principally social security costs, will continue to expand, there is a strong likelihood that expenditures of the public sector as a whole will show further shrinkage.

We are forecasting real growth of 1.9% in fiscal 2011. The carryover effect will be small (+0.6%), and the growth rate, calculated during the fiscal year, will be 1.3%, virtually the same as in fiscal 2010.

In addition, the outlook is for deflationary pressures to gradually subside along with economic recovery and the rise in international commodity prices. The outlook is for the nominal GDP to rise 1.1% over the previous

year and for the decline in the GDP deflator to shrink to -0.7% . 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.

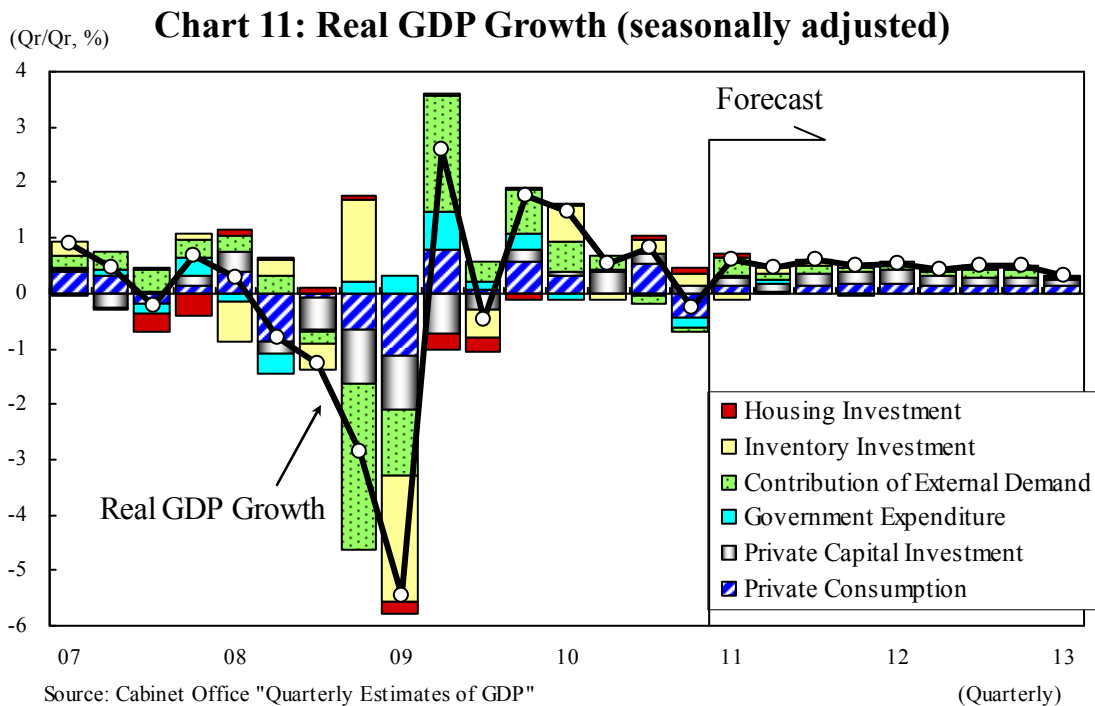
In fiscal 2012, the outlook is for the movement toward recovery to continue. Since economic conditions overseas will continue to be firm, Japan's exports are expected to show a relatively high rate of growth. Although imports will also rise, the contribution of external demand will remain at about $+0.4$ percentage point and will provide a boost to economic growth comparable to that in fiscal 2011. The contribution of domestic demand will rise to $+1.6$ 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 sustain a rising trend.

Real growth in fiscal 2012 is forecast to be $+2.0\%$, higher than in the previous fiscal year. Nominal GDP will rise 2.0% and the GDP deflator is forecast to move to $+0.1\%$ above the previous fiscal year, thus largely attaining the goal of eliminating deflationary pressures for the first time in 15 years, or since 1997.

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)	0.6 %	-4.6 %	-4.1 %
FY2009 (actual)	-5.7 %	3.3 %	-2.4 %
FY2010 (forecast)	1.9 %	1.1 %	3.0 %
FY2011 (forecast)	0.6 %	1.3 %	1.9 %
FY2012 (forecast)	0.9 %	1.1 %	2.0 %

Source: Cabinet Office "Quarterly Estimates of GDP"



2. Forecasts of Economic Activity by Sector

(1) Corporations

- As they entered the 21st century, domestic 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 is showing rapid improvement. Looking ahead, this upward trend in profits is expected to continue, accompanying the recovery in production.
- 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. Accordingly, as corporate profitability and the rate of capacity utilization have increased, private capital investment has recently begun to recover. However, full-scale recovery in capital investment aimed at increasing production capacity will be difficult in view of low growth due to corporations entering overseas markets and in the domestic market.

(2) Households

- Employment conditions are continuing to show gradual improvement. The number of persons in the workforce and the number of employed persons are both continuing to rise year on year. Going forward, the unemployment rate is expected to remain on a gradual declining trend. Income conditions in the household sector, where improvement has been slow, are showing growing signs of moving toward improvement, including continued improvement year on year not only in

non-scheduled compensation but also in 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 weaken temporarily during the first half of 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 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 the nominal income growth rate 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 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 expenditures within the annual general account, 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. Under this policy, since social security related expenditures, including medical expenses and nursing care for seniors, are expected to continue to rise in tandem with the demographic aging of the population and this will bring increases in government final consumption expenditures, the rate of growth in such expenditures will most likely be restrained. In addition, the outlook is for continued reductions in the level of public investments.

(4) Trends in Overseas Economies

- The world economy is continuing to recover. In the United States and Germany, the recovery in personal consumption is quite clear, and these two countries have entered a phase of self-sustaining recovery. Also, strong economic growth is continuing in the emerging countries, but some of these are experiencing overheating, and rising prices of food products and energy are giving rise to stronger concerns about inflation.
- The outlook is for recovery in the world economy to continue. Self-sustaining expansion is expected to continue in the United States and Europe as the income environment shows further improvement. Although the financial crises in Europe are serious, these are not likely

to derail recovery in the global economy. Although the emerging countries, including China, will continue to increase interest rates owing to concerns about inflation, the impact on their economies will be marginal, and they are expected to continue to grow propelled by a balance of domestic and external demand.

- As the world economy recovers, Japan's exports are increasing. By region, thus far, Japan's exports to the United States and the EU have risen gradually, but exports to the rest of Asia have been expanding at a brisk pace. Since the summer of 2010, the rates of growth in Japan's exports to Asia have slowed temporarily, but the outlook is for these exports to begin to rise again, reflecting the expansion in the economies of the region.
- The surplus generated in the industrial 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 moderate recovery in the trade surplus continues, 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 gradually giving rise to increases in 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 goods 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 certain other basic materials are continuing 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 likely to continue to exceed demand. In

addition, since yen appreciation will be a factor pushing prices downward, the pace of increase in domestic corporate goods 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, declines 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 risk of economic downturns, 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 overseas economies and the deterioration in the government fiscal position around the world may place upward pressure on long-term interest rates. In foreign exchange markets, participants have become more risk adverse, 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 a 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	1.0	-4.6	-3.7	1.1	1.1	2.0	
Real GDP	1.8	-4.1	-2.4	3.0	1.9	2.0	
Contribution of domestic demand	0.6	-3.0	-2.7	2.0	1.4	1.6	
Private consumption	1.4	-2.2	0.0	1.2	0.4	1.0	
Housing investment	-13.5	-3.6	-18.2	0.3	5.2	2.3	
Private capital investment	0.8	-6.9	-13.6	5.6	5.4	5.0	
Contribution of inventory investment	0.1	-0.3	-1.1	0.5	0.3	0.1	
Government expenditure	0.1	-1.1	5.2	0.0	-0.2	0.1	
Public investment	-6.4	-6.8	14.2	-8.7	-4.7	-2.8	
Government final consumption expenditure	1.5	0.2	3.4	1.9	0.7	0.6	
Contribution of external demand	1.2	-1.2	0.3	1.1	0.4	0.4	
Export of goods and services	9.3	-10.4	-9.6	18.0	6.9	6.7	
Import of goods and services	1.9	-4.2	-11.0	10.9	4.3	4.5	
GDP deflator	-0.9	-0.5	-1.3	-1.8	-0.7	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	16.6	17.8	18.8	
balance on goods (trillion yen)	11.7	1.2	6.6	7.3	6.7	7.5	
balance on service (trillion yen)	-2.6	-2.0	-1.8	-1.5	-1.5	-1.4	
balance on income (trillion yen)	16.8	14.6	12.1	11.8	13.7	13.6	
Industrial production	2.7	-12.7	-8.9	9.7	3.7	3.8	
Unemployment rate(%)	3.8	4.1	5.2	5.1	4.8	4.6	
New housing starts(annualized, ten thousand units)	103.6	103.9	77.5	82.2	86.4	88.1	
Domestic corporate goods prices	2.3	3.1	-5.2	0.7	1.3	0.6	
Consumer prices	0.2	1.2	-1.7	-0.4	0.0	0.3	
excluding freshfood	0.3	1.2	-1.6	-0.8	0.2	0.3	
Yen/U.S.Dollar	114.2	100.5	92.8	85.6	81.5	83.9	
Uncollateralized call rates (O/N) (%)*	0.505	0.363	0.102	0.091	0.090	0.145	
Newly issued government bond yields (10years) (%)	1.60	1.46	1.36	1.15	1.28	1.38	
WTI future price (near month contract, US dollar/barrel)	82.2	85.9	70.7	82.0	88.3	89.8	
Dubai crude oil prices (US dollar/barrel)	77.3	82.1	69.7	80.5	85.6	86.8	

* actual=average, forecast=end of period

Chart 13: Outlook for Calendar 2010-2012

	CY2008 (actual)	CY2009 (actual)	CY2010 (forecast)	Forecast	
				CY2011 (forecast)	CY2012 (forecast)
	Yr/Yr, %				
Nominal GDP	-2.2	-6.6	1.8	0.6	2.1
Real GDP	-1.2	-6.3	3.9	1.8	2.1
Contribution of domestic demand	-1.4	-4.8	2.1	1.3	1.6
Private consumption	-0.7	-1.9	1.9	0.3	1.0
Housing investment	-8.0	-14.0	-6.2	6.4	2.2
Private capital investment	-1.4	-16.7	2.2	5.5	5.6
Contribution of inventory investment	-0.2	-1.1	0.6	0.4	0.6
Government expenditure	-1.1	4.1	1.2	-0.4	0.0
Public investment	-8.6	10.4	-3.3	-6.7	-3.3
Government final consumption expenditure	0.5	3.0	2.2	0.9	0.6
Contribution of external demand	0.2	-1.5	1.8	0.4	0.4
Export of goods and services	1.6	-23.9	24.0	7.6	6.9
Import of goods and services	0.4	-15.3	9.8	5.3	4.5
GDP deflator	-1.0	-0.4	-2.1	-1.1	0.0

	CY2008 (actual)	CY2009 (actual)	CY2010 (forecast)	Forecast	
				CY2011 (forecast)	CY2012 (forecast)
	Yr/Yr, %				
Current account balance (trillion yen)	16.4	13.3	17.1	17.0	18.6
balance on goods (trillion yen)	4.0	4.0	8.0	6.3	7.5
balance on service (trillion yen)	-2.1	-1.9	-1.5	-1.5	-1.4
balance on income (trillion yen)	15.8	12.3	11.6	13.3	13.6
Industrial production	-3.4	-21.9	15.9	3.1	3.9
Unemployment rate (%)	4.0	5.1	5.1	4.8	4.6
New housing starts(annualized, ten thousand units)	109.3	78.8	81.3	86.0	87.8
Domestic corporate goods prices	4.6	-5.2	-0.2	1.6	0.6
Consumer prices	1.4	-1.4	-0.7	0.0	0.2
excluding freshfood	1.5	-1.3	-1.0	0.0	0.3
Yen/U.S.Dollar	103.4	93.5	87.8	81.3	83.5
Uncollateralized call rates (O/N) (%)*	0.462	0.105	0.093	0.090	0.105
Newly issued government bond yields (10years) (%)	1.48	1.34	1.17	1.27	1.34
WTI future price (near month contract, US dollar/barrel)	99.6	61.8	79.5	88.1	89.4
Dubai crude oil prices (US dollar/barrel)	93.8	61.8	78.0	85.6	86.4

* actual=average, forecast=end of period

Chart 14: Outlook for 2010-2012 (Quarterly)

Forecast

Qr/Qr, %
Yr/Yr, %

	FY2010				FY2011				FY2012			
	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	-0.6	0.6	-0.6	0.6	0.2	0.2	0.6	0.9	0.4	0.2	0.5	0.6
	1.1	2.7	0.6	0.2	0.7	0.3	1.3	2.2	2.1	2.1	1.9	1.9
Real GDP	0.5	0.8	-0.3	0.6	0.5	0.6	0.5	0.6	0.4	0.5	0.5	0.3
	3.1	4.9	2.2	1.9	1.6	1.4	2.2	2.2	2.1	2.0	1.9	1.8
Contribution of domestic demand (Qr/Qr,%)	0.3	1.0	-0.2	0.3	0.3	0.4	0.5	0.4	0.4	0.4	0.3	0.3
Private consumption	0.0	0.9	-0.7	0.2	0.0	0.2	0.3	0.3	0.2	0.2	0.3	0.2
	1.4	2.5	0.6	0.4	0.4	-0.3	0.8	0.9	1.1	1.1	1.0	0.9
Housing investment	-0.3	1.8	3.0	2.3	0.3	1.3	0.5	0.1	0.7	0.9	0.5	0.3
	-10.6	-1.3	6.5	7.1	7.5	6.9	4.5	2.2	2.5	2.0	2.2	2.4
Private capital investment	2.9	1.5	0.9	1.1	1.3	1.5	1.6	1.6	1.2	1.0	0.8	0.8
	3.0	6.6	6.1	6.5	4.9	4.9	5.6	6.1	6.1	5.5	4.7	3.9
Contribution of inventory investment (Qr/Qr,%)	-0.1	0.3	0.2	-0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Government expenditure	0.1	-0.2	-0.7	0.1	0.2	0.0	-0.1	-0.1	0.1	0.1	0.1	0.1
	1.8	0.8	-1.9	-0.6	-0.6	-0.7	0.4	-0.1	0.0	0.0	0.1	0.3
Public investment	-4.1	-2.1	-5.8	-0.4	0.8	-0.5	-1.8	-1.7	-0.4	-0.2	-0.2	-0.4
	-4.3	-4.6	-13.3	-10.1	-8.6	-8.2	-0.6	-3.1	-4.3	-3.9	-2.4	-1.1
Government final consumption expenditure	1.1	0.3	0.2	0.2	0.1	0.2	0.1	0.2	0.2	0.2	0.1	0.1
	2.8	2.0	1.3	1.7	0.8	0.7	0.6	0.6	0.6	0.7	0.7	0.6
Contribution of external demand (Qr/Qr,%)	0.3	-0.1	-0.1	0.3	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.0
Export of goods and services	5.3	1.5	-0.7	3.4	1.7	1.6	1.7	1.7	1.6	1.8	1.9	0.7
	30.4	21.3	13.3	9.8	6.1	6.1	8.7	6.8	6.7	7.0	7.1	6.1
Import of goods and services	4.0	2.9	-0.1	1.3	1.1	0.7	1.5	0.8	1.3	1.1	1.2	0.6
	14.3	11.5	9.9	8.2	5.3	3.0	4.7	4.2	4.4	4.9	4.5	4.3
GDP deflator (Yr/Yr,%)	-1.9	-2.1	-1.6	-1.6	-0.9	-1.0	-0.9	0.0	0.0	0.1	0.1	0.1

Forecast

Yr/Yr, %

	FY2010				FY2011				FY2012			
	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)*	3.8	4.4	4.2	4.1	3.8	4.5	4.5	4.8	4.1	4.7	4.7	5.0
balance on goods (trillion yen)*	1.8	2.0	1.7	1.7	1.3	1.6	1.6	2.2	1.6	1.8	1.9	2.2
balance on service (trillion yen)*	-0.4	-0.2	-0.4	-0.5	-0.4	-0.2	-0.4	-0.5	-0.3	-0.2	-0.4	-0.4
balance on income (trillion yen)*	2.6	2.9	3.1	3.1	3.2	3.3	3.6	3.4	3.1	3.3	3.5	3.4
Industrial production (Qr/Qr, %)	1.5	-1.8	-1.6	3.5	0.6	1.1	1.2	1.0	0.9	0.8	0.7	0.7
(Yr/Yr, %)	21.0	13.5	4.9	1.7	0.6	3.8	6.4	3.9	4.2	4.1	3.5	3.2
Unemployment rate (%)*	5.2	5.1	5.0	4.9	4.8	4.8	4.7	4.7	4.7	4.6	4.6	4.6
New housing starts(annualized, ten thousand units)	77.6	81.5	84.3	85.3	85.7	86.3	86.5	86.8	87.6	88.0	88.2	88.3
Domestic corporate goods prices (Yr/Yr,%)	0.2	-0.1	1.0	1.7	1.3	1.8	1.5	0.6	0.5	0.6	0.6	0.7
Consumer prices (Yr/Yr,%)	-0.9	-0.8	0.1	-0.2	0.0	0.0	-0.1	0.1	0.2	0.3	0.3	0.4
excluding freshfood (Yr/Yr,%)	-1.2	-1.0	-0.5	-0.4	0.2	0.2	0.2	0.2	0.2	0.3	0.3	0.4
Yen/U.S.Dollar	92.0	85.9	82.6	81.9	80.5	80.9	81.9	82.6	83.2	83.8	84.2	84.2
Uncollateralized call rates (O/N) (%)**	0.093	0.094	0.089	0.090	0.090	0.090	0.090	0.090	0.090	0.090	0.150	0.250
Newly issued government bond yields (10years) (%)	1.27	1.05	1.04	1.25	1.27	1.27	1.28	1.29	1.33	1.36	1.40	1.44
WTI future price (near month contract, US dollar/barrel)	78.0	76.2	85.2	88.5	87.0	88.0	89.0	89.0	89.0	89.5	90.0	90.5
Dubai crude oil prices (US dollar/barrel)	77.6	74.2	84.3	86.0	84.5	85.5	86.5	86.0	86.0	86.5	87.0	87.5

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

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