

November 2011

Forecast for the Japanese Economy in Fiscal 2011 and 2012

**— Strong Recovery Momentum after the Earthquake
Will Gradually Diminish —**



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1. Outlook for the Japanese Economy in Fiscal 2011 and Fiscal 2012

-- Strong Recovery Momentum after the Earthquake

Will Gradually Diminish

(1) Current State of the Economy: Real GDP Growth Takes a Major Turn Upward

Announced on November 14, the real GDP growth rate for the July-September period of 2011 was a robust +1.5% over the previous quarter (+6.0% at an annualized rate), the first positive growth in four quarters. Industrial production, which temporarily dropped sharply because of the effects of the Great East Japan Earthquake, recovered dramatically because of the restoration of supply chains. Contrary to concerns, electric power shortages during the summer did not act as a major drag on production because of the energy-saving activities of corporations.

Examining the contribution to real GDP of domestic and external demand, the contribution of domestic demand was +1.0 percentage point, while the contribution of external demand (net exports = exports – imports) was +0.4 percentage point. This was the second consecutive quarter for domestic demand to make a positive contribution to growth, and it was due to the solid increase in personal consumption and other factors. External demand made its first positive contribution in five quarters as a result of a large increase in exports accompanying the removal of supply side constraints.

By component of domestic demand, consumption increased 1.0% over the previous quarter for the second consecutive quarterly rise, and the margin of growth increased. Sales of automobiles improved rapidly, as a result of recovery in supply capacity, and there were signs of improvement in travel expenditures and the consumption of other services, reflecting the wearing off of the mood of restraint that followed the earthquake. Private residential investment ended its declining trend and rose 5.0% over the previous quarter, reflecting the bottoming out in the number of new housing starts that had been postponed following the earthquake.

Private capital investment rose by a relatively small margin of 1.1% over

the previous quarter, but the gain for the July-September period was the first increase in five quarters. This increase reflected the restarting of investing activities that had been postponed following the earthquake, the emergence of investments for reconstruction in the wake of the disaster, and other factors. Private inventory investment made a positive contribution of 0.2 percentage point to real GDP growth as companies moved to build up inventories of products that had been seriously depleted as a result of the effects of the disaster and certain other products, including semiconductors. This was the second consecutive quarter for inventory investment to make a positive contribution to real GDP growth.

Among public-sector demand components, government consumption expenditure continued on an increasing trend, rising 0.4% for the quarter, in part because of expenditures related to the aftermath of the earthquake. On the other hand, public works investment ended its rising trend and declined 2.8% from the previous quarter as the positive effects of construction of temporary housing in the areas stricken by the earthquake began to diminish. As a result, public-sector demand as a whole showed a small decrease of 0.1% from the previous quarter.

Turning next to external demand, imports rose 3.4% for the quarter, reflecting the expansion in demand for energy fuels for power generation, the recovery of domestic production, and other factors. Meanwhile, exports rose a substantial 6.2% over the previous quarter because of the restoration of supply systems and the movement among corporations to replenish their overseas inventories. As a result, the contribution of external demand to real GDP growth was +0.4 percentage point, the first time in five quarters for the external sector to give a boost to growth.

The GDP deflator, which reflects overall price trends in the economy as a whole, was 1.9% below the level of the same quarter of the previous fiscal year. Although this margin of decline was smaller than in the previous quarter, significant declines year on year in this indicator are continuing. The pace of decline in domestic prices is slowing, but the leveling off of import prices at a high level continues to be a factor that is depressing the GDP deflator.

(2) Growing Concerns about a Downturn in the Economy: External Demand Holds the Key

The trend toward rapid improvement in the economy that has continued following the Great East Japan Earthquake appears to be running its course. Even so, demand related to recovery, principally for public works, is expected, and recovery in the world economy is forecast to continue at a moderate pace. Therefore, the outlook is for the improving trend in the economy to continue. Demand for automobiles, which has been postponed by supply shortages, is expected to boost production and consumption going forward. However, recently, uncertainty regarding future trends in the economy has increased substantially.

There appear to be three factors at present that may add to the risk of an economic downturn.

(a) The risk of the slowdown in overseas economies, and, in particular, the impact of the financial crises in Europe,

(b) The effects of inventory adjustments and other factors on industrial production, and

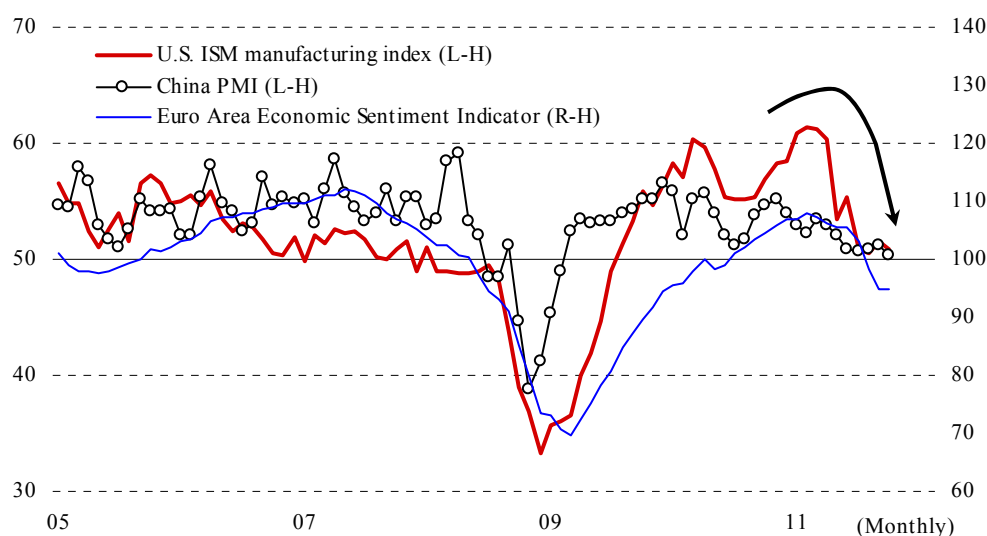
(c) The sustainability of the recovery in domestic demand, including consumption and private capital investment.

The following sections of this report present our views regarding these risk factors.

(a) Increasing Risk of a Slowdown in Overseas Economies

Recovery trends in overseas economies have weakened. Indicators from countries around the world showed a sudden tendency to soften through the summer, and Europe is one of the areas where this has been most pronounced (Chart 1).

Chart 1: Business Survey Index



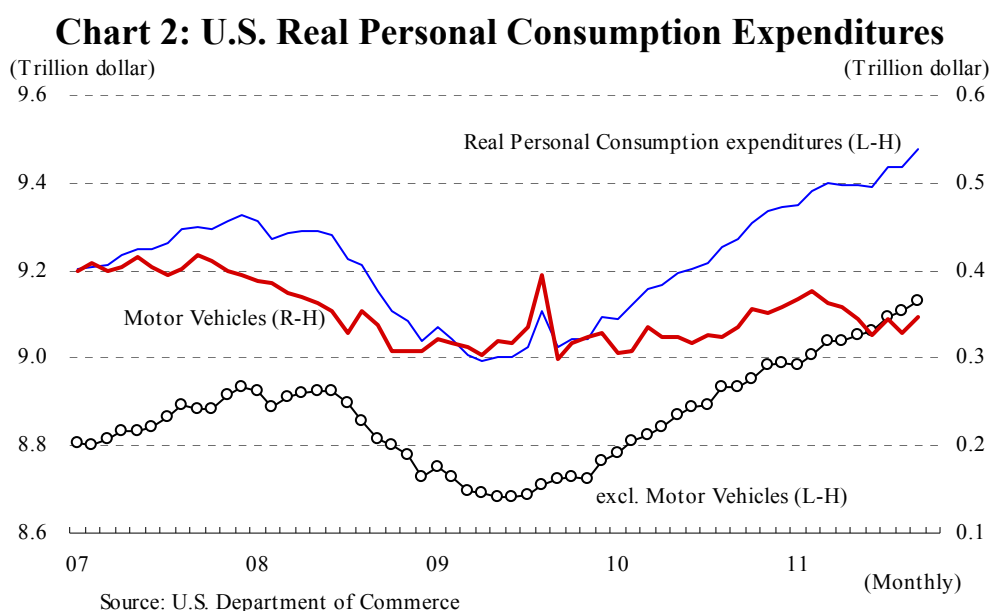
Source: Institute for Supply Management; China Federation of Logistics & Purchasing; Eurostat

In Europe, as a result of the financial crisis, confidence among corporations and individuals has waned, and this trend has surfaced in the real economy as well. The real GDP growth rate in the eurozone has been virtually flat, rising +0.7% in the April-June quarter at an annualized rate, followed by a gain of +0.6% in the July-September quarter. Despite the weakening of the euro, exports to the region's principal markets of the Americans and Asia are stagnant, while growth in domestic demand in the eurozone is weak.

Even after a comprehensive strategy for the fiscal crises has been agreed upon, uncertainties remain about whether it can be implemented, and the turmoil in financial markets has not died down. Although no one appears to be expecting that the financial crises will plunge world financial markets into severe turmoil, these fiscal issues cannot be solved overnight. For the time being, it is thought that the risk of these issues being rekindled will remain, and there is concern that this will act as a drag on the recovery of the economies of Europe. The economy of Germany, the core country of the eurozone, is still holding firm, and, if the turmoil in financial markets quiets down, we can expect moderate economic recovery. On the other hand, cutting fiscal spending will be a negative factor for the countries of the region, and optimism about the future is not warranted.

In China and the rest of Asia, the feeling of a slowdown, due to the effects of the tightening of monetary policy, is growing. Real GDP growth in the July-September quarter of 2011 in China was 9.1% and was, therefore, still at a high level; however, the rate of growth is gradually declining because of the monetary tightening. Nevertheless, inflationary pressures are weakening bit by bit, and the way is being cleared for a change in monetary policy. It is hoped that the movement toward improvement will strengthen gradually, without major adjustments.

On the other hand, in the United States, the GDP growth rate in the July-September quarter recovered to 2.5% at an annualized rate, and the trend toward improvement in the economy has strengthened. In the first half of 2011, consumer spending weakened because of the increase in gasoline prices and shortage of supply in the automobile market, and a feeling of stagnation spread. However, consumption is now on a recovery trend, in part because gasoline prices have started to decline (Chart 2). Sales of automobiles in October recovered to an annual rate of 13 million cars, and there is a possibility that this figure may increase going forward. There is also a view that is gaining currency that conditions during the Christmas season will not be so difficult, and, looking forward, the possibility is increasing that growth in consumer spending will hold firm. In addition, corporate performance also remains favorable, and capital investment is expanding steadily.



Nevertheless, the clashes between political parties in the United States regarding restoring soundness to government finances may lead to a cut off during the current year of the temporary social welfare tax reductions and the extension of unemployment insurance benefits, thus giving rise to the risk of serious repercussions for consumer spending. However, if the recovery continues to proceed smoothly, this will, without doubt, be a major positive development for the economies of Asia and Europe.

As the foregoing comments suggest, although the risk of a downturn in the world economy may persist during fiscal 2011, since the economies of emerging countries and the United States are expected to remain generally firm, a loss of momentum is likely to be avoided.

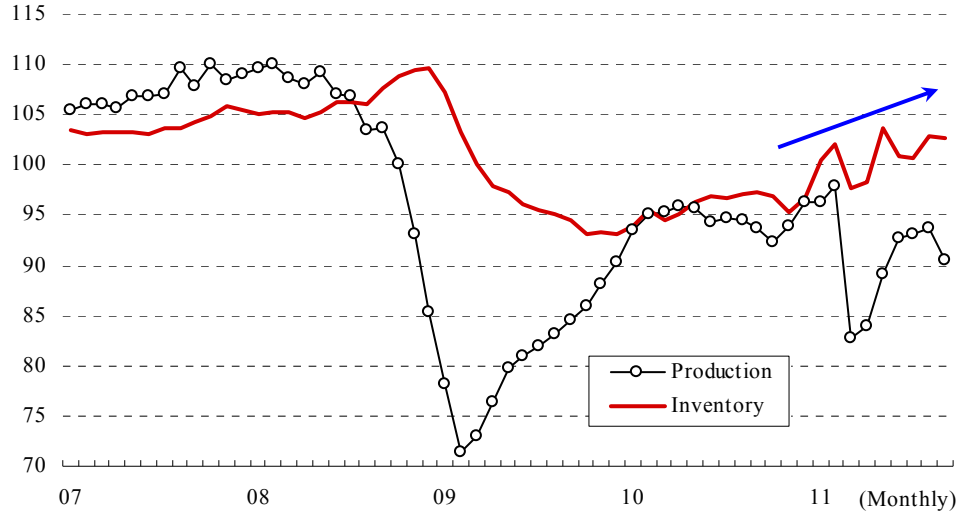
(b) Risk that Inventory Adjustments May Restrain Production

The slowdown in growth of economies overseas will have an impact on domestic production because of the effect on Japan's exports. The index of industrial production, which has recovered smoothly during the period of reconstruction following the Great East Japan Earthquake, declined 3.3% from the previous month in September, the first decrease since the earthquake. The forecast index for industrial production in both October and November calls for increases in output over the previous month, but the risk of a downturn exists because production in the automobile and certain other industries may have to be curtailed because of the effects of the floods in Thailand.

The concern at present is the sudden rise in inventories (Chart 3). As a result of the weakening of demand overseas and the reaction to the rapid return to production in the midst of supply shortages following the earthquake, the level of inventories is rising in the basic materials industries, such as steel and chemicals, and other industries, including electronic parts and devices and electric machinery. Movements to restrain production to make adjustments in inventories are already under way, and output levels are already below the levels of March 2011, the month when the earthquake occurred (Chart 4). Also, in the information and

Chart 3: Industrial Production and Inventory

(the average of 2005=100)

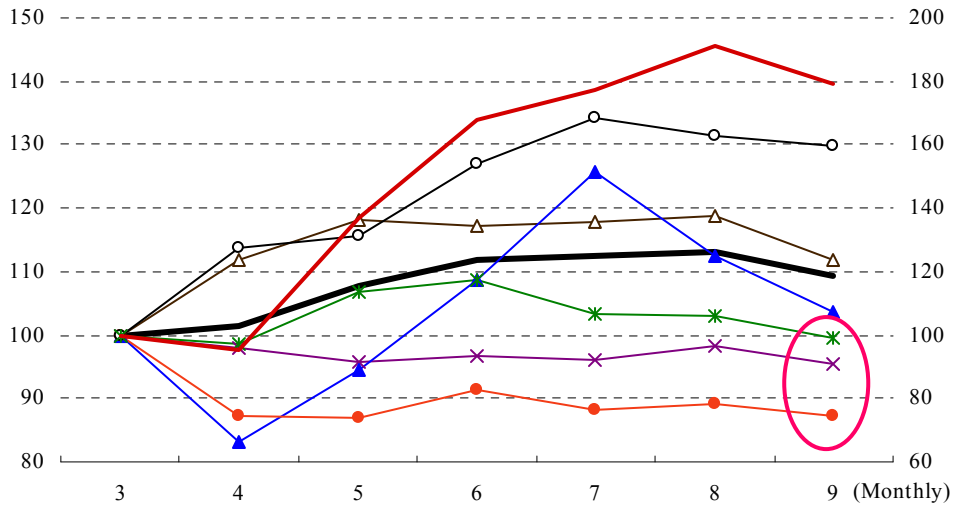


Source: Ministry of Economy, Trade and Industry, "Indices of Industrial Production"

Chart 4: Industrial Production Index by Industry

(March 2011=100)

(March 2011=100)



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

- Mining and manufacturing
- × Iron and steel
- △ General machinery
- ▲ Information and communications electronics equipment
- Electronic parts and devices
- Precision instruments
- * Chemicals (excl. Drugs)
- Transport equipment (Motor vehicles, R-H)

telecommunications equipment industries, sales of flat panel display (FPD) TVs have dropped markedly, and the outlook is for substantial cutbacks in domestic production as further significant declines are forecast. On the other hand, conditions are strong in the automobile, precision machinery, and general machinery industries. Production of automobiles in particular, which accounts for a high share of domestic production, is making up for the declines in production in other industries and raising the overall level of output.

An examination of a range of industries shows that production activities are not as favorable across the board as might be thought and that some industries are hiding in the shadow of the automobile sector, which has recovered rapidly along with the restoration of supply chains.

Trends in domestic and overseas demand will have an impact on production trends looking forward. As previously mentioned, although the risk of a downturn in Europe, which could have an effect on external demand, is growing, it is believed that the risk of a major downturn in the United States and Asia is low, and exports are expected to increase moderately. The trend toward replenishing automobile inventories in overseas markets is likely to continue for the time being, and automobile exports will remain firm.

On the other hand, although there is a possibility that the weak trends in domestic demand, which we will discuss next, will persist, the economy will be supported by demand related to recovery following the earthquake and by automobile sales. A major downturn is likely to be avoided.

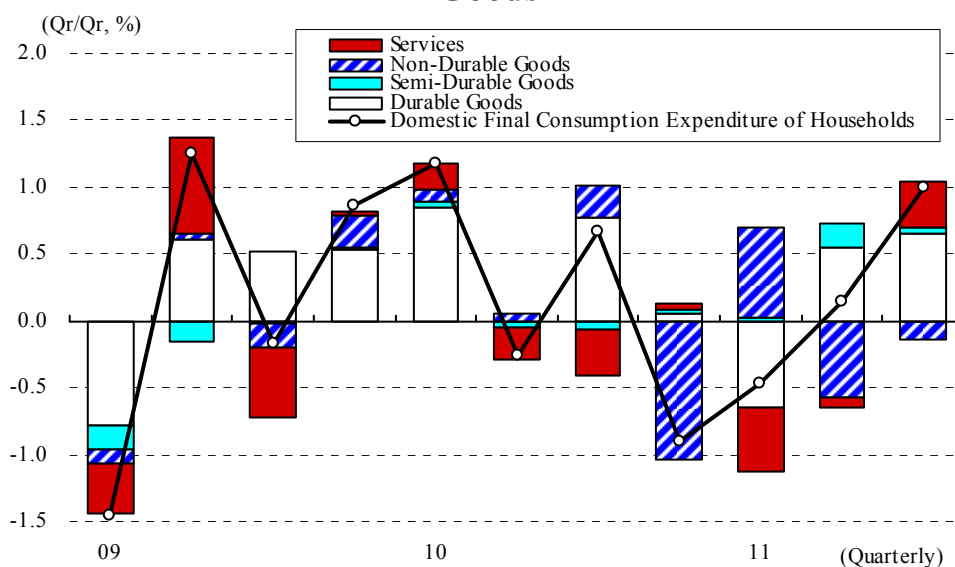
Notwithstanding this, the pace of recovery in domestic and external demand will remain moderate, and it is likely to take some time to reduce the inventories, which have accumulated recently, to a proper level. For this reason, with the exception of the automobile industry, there is a strong possibility that production in the latter half of fiscal 2011 will stagnate. Therefore, production levels in Japan will continue to be supported by the automobile industry for some time.

(c) Weakness in Private-Sector Demand for the Time Being

Personal consumption showed a firm increase in the real GDP statistics for the July-September quarter. Within overall consumption, growth was led by automobiles and other consumer durables (Chart 5).

Automobile sales, which had slumped because of supply constraints, are now continuing to improve along with the recovery in output. To make a comeback from the slump in the first half of fiscal 2011, automobile companies have adopted a policy of increasing production, and they are expecting an increase in demand in tandem with their rising output. Because of the continuation of high gasoline prices and the growing awareness of energy conservation, demand for eco-friendly cars and small vehicles is strong, and sales of automobiles are give a boost to overall consumption. However, from the October-December quarter onward, the outlook is for the boost to consumption coming from automobile sales to gradually diminish. In addition, there are major uncertainties, and there is a possibility that the floods in Thailand may have an impact on production in some industries in Japan.

Chart 5: Household Domestic Final Consumption Expenditure by Goods

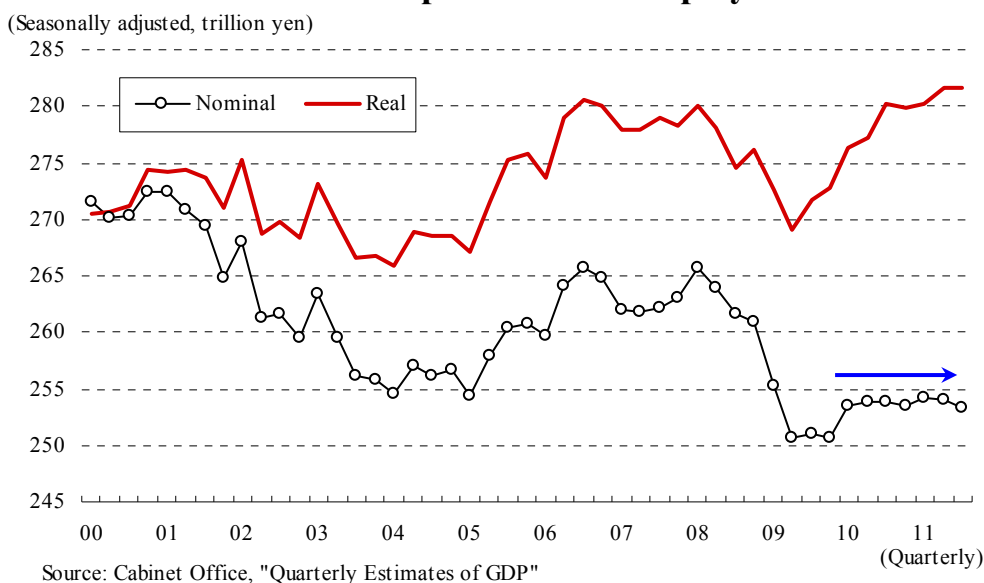


Source: Cabinet Office, "Quarterly Estimates of GDP"

As a result of the full-scale transition to terrestrial digital broadcasting in Japan, sales of FPD TVs were strong through July 2011, but from August, sales of these units have fallen precipitously, and they are not expected give a boost to consumption going forward. Also, sales of air conditioners and other energy-saving appliances were favorable during the July-September quarter, but their effectiveness in boosting consumption is expected to wear off in subsequent quarters.

As these points suggest, going into the second half of fiscal 2011, it is quite likely that growth in durable goods consumption will weaken. One positive trend is that, along with the waning of the mood of restraint that followed the earthquake, expenditures on services are improving. Nevertheless, in view of the weak growth in household incomes and the deterioration in corporate performance following the earthquake, there is a strong possibility that winter bonuses in 2011, like the summer bonuses, will fall below the level of the same period of the previous year. It will therefore be difficult for them to cover for the stagnation in consumer durable sales. Examination of worker compensation shows that, while employee remuneration in real terms is at the highest level in history because of price deflation, in nominal terms it is in the process of recovery but has not shown much improvement since the deterioration in economic conditions following the collapse of Lehman Brothers Holdings. Recent data show it to be virtually level (Chart 6). Even though the real purchasing power of

Chart 6: Compensation of Employees



households has risen, if income in nominal terms does not increase, it seems unlikely that consumer confidence will make a significant comeback.

Turning to the corporate sector, a major improvement in capital investment seems unlikely. Looking ahead, corporate performance will continue to recover along with reconstruction activities in the aftermath of the earthquake. It also seems likely that investment for reconstruction will be joined by investments for expanding electric power generating capacity and that the increasing trend in capital investment will continue. However, even if this is the case, we believe that corporations will not alter their cautious stance, and, even in comparison with previous recovery periods, growth in capital investment will be moderate. Particularly in view of the recent appreciation of the yen to new highs, corporations seem likely to postpone those investments they do not view as being necessary or urgent.

The economy is believed likely to continue to show improvement going forward since demand for recovery-related investments, mainly public works spending, is expected along with the continued firmness in production and sales of automobiles. However, as the previous comments suggest, some temporary weakening of both domestic and external demand seems to be unavoidable in the second half of fiscal 2011. Thereafter, whether the recovery trend gathers momentum again will depend largely on trends in demand overseas.

(3) Outlook for Fiscal 2011 and Fiscal 2012: Pace of Recovery Trend Will Slow in the Latter Half of Fiscal 2011

In preparing the forecasts outlined in the following paragraphs, the following assumptions have been made.

First, we have assumed that the content of the third supplementary budget, including recovery funding and other items will be approved in the form currently under discussion in the Diet.

Next, we have assumed that, while requests have been made for electric power conservation this winter and next summer, serious shortages of power will not occur. We believe that the idea of suspending the operation of all nuclear generating plants is unrealistic, but even if this should happen, the installation of new thermal power plants and power conservation efforts, such as those made during the summer of 2011, will probably not place an undue burden on corporation production activities.

Among other assumptions, changes will be made in the child allowance system, including a reduction in the amount of allowances from the latter half of fiscal 2011 and an introduction of income limits beginning in fiscal 2012. In addition, we have assumed that the consumption tax will be increased on two occasions, once in fiscal 2014 and then again in fiscal 2015, to 10%.

Regarding the Trans Pacific Partnership (TPP) agreement, at this stage Japan has agreed to begin discussions with related countries with an eye to participating in negotiations. We have not taken the effects of TPP into account in these forecasts.

In the latter half of fiscal 2011, the pace of expansion in the economy will weaken. Restoration of supply chains severed by the earthquake will be almost fully completed, preparations will be made for dealing with the issue of power shortages, and constraints on the supply side will generally be eliminated. Nevertheless, since domestic and external demand will lack strength, the high rate of real GDP growth experienced in the

July-September quarter of 2011 cannot be sustained.

Personal consumption will continue to be firm as the mood of restraint that followed the earthquake wanes, the supply constraints on automobile production are eliminated, and the demand for responding to electric power conservation requirements increases. However, in the latter half of the fiscal year, factors that have boosted the economy up to that point will run their course, and trends in consumption are forecast to weaken significantly, in part because improvement in incomes will be delayed due to the decline in winter bonuses. Growth in automobile sales, which are forecast to remain strong, will also weaken on a quarter-to-quarter basis.

In the corporate sector, production activities will return almost to normal as companies come within sight of fully repairing damaged plants and equipment, progress is made in putting the distribution and other infrastructure back in order, and supply chains are restored. Also, during the summer, the adverse effects of steps taken to deal with expected power shortages were minor. For these reasons, during the first half of fiscal 2011, corporate activities showed a V-shaped recovery pattern, but, in the latter half, there is a possibility that these activities may experience a temporary lull. Inventories in some industries are increasing rapidly, and there is a strong possibility that production adjustments may be made in the second half. Moreover, since the utilization rate of plants and equipment will not rise and the yen is at historically high levels, corporations are expected to refrain from making major investments to increase capacity. Investments for repairing equipment and for dealing with electric power shortages will continue, but their positive impact is expected to be marginal.

The activities of the public sector, however, are the ones that can be relied on to give a boost to the economy. Public works investment in the July-September quarter was below the level of the same period of the previous year, but this was because of the postponement of some demand, and these investments are expected to have a positive impact when they are implemented in the second half. Especially after the beginning of next year, the full positive effects of the third supplementary budget are expected to emerge.

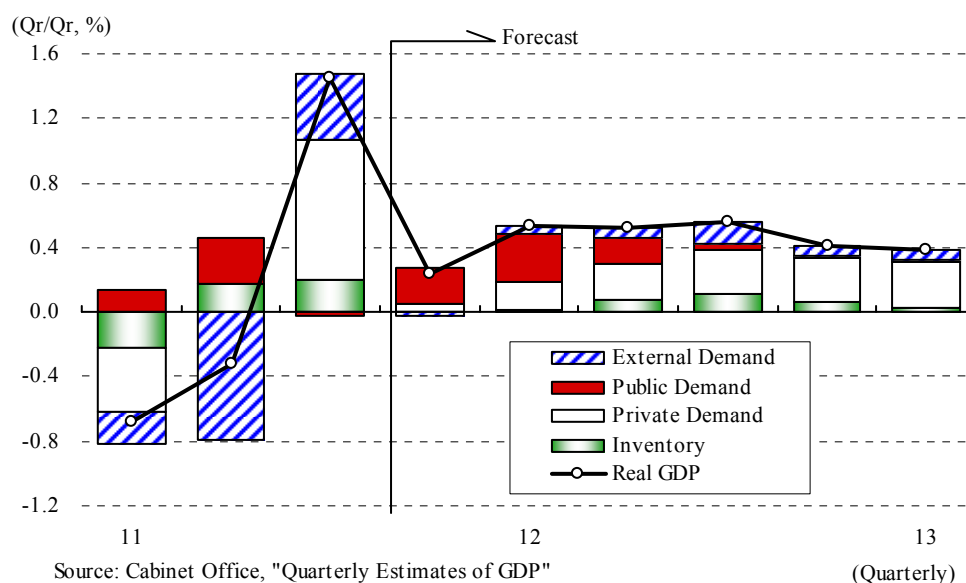
Growth in exports is likely to weaken suddenly. During the July-September quarter, exports expanded smoothly because of recovery in supply capacity, but, in the second half, they are believed likely to show only slight expansion. The movement to replenish overseas inventories, principally in the automobile industry, will provide support for exports overall, but the slower growth in overseas economies and appreciation of the yen will restrain exports. On the other hand, since thermal power generation will expand as an alternative to nuclear power, imports of LNG and other energy fuels will show strong expansion. Also, since the trend toward replacing portions of domestic production with overseas output will continue, imports are expected to continue to be firm. For this reason, the contribution of external demand to growth will fluctuate around zero.

Real GDP growth in fiscal 2011 is forecast to be +0.4%. This will imply a sharp slowing in the rate of expansion in comparison with the +2.4% reported in fiscal 2010, but the fiscal 2011 growth figure includes a negative carryover effect (of -0.5%). If the carryover effect is eliminated and growth is calculated during the fiscal year, the rate of expansion will be +0.9%, a significant recovery from fiscal 2010 when the real GDP growth rate was -0.1%.

Examining the contribution of domestic demand versus external demand, the contribution of external demand is forecast to be a substantial -0.7%, but domestic demand will contribute +1.1%, thus acting as the driving force for the economy (Chart 7). Among components of domestic demand, private sector demand will contribute +0.6 percentage point and public sector demand will contribute +0.5 percentage point. These figures indicate that growth will be supported by demand for recovery from the disaster, particularly by public works investment. In addition, among the components of private-sector demand, the contribution of inventory investment will be +0.2 percentage point.

During the second half of the fiscal year, little contribution can be expected from the external demand and, at the same time, growth in private-sector demand will be reliant on public-sector demand.

Chart 7: Contribution Rates to Real GDP Growth by Demand



Note that, as a result of the recovery in the economy and the rise in international commodity prices, deflationary pressures will gradually diminish, but the year-on-year change in the GDP deflator is expected to be a substantial -1.8% . The rate of growth in the nominal GDP in fiscal 2011 will be -1.3% , the first minus figure in two years.

In fiscal 2012, the increased demand related to recovery from the earthquake, coming mainly from the public sector, will be joined by steady increases in private sector demand and external demand, resulting in a strengthening again in the recovery momentum.

In the first half of fiscal 2012, following the passage of the third supplementary budget, full-scale demand related to the recovery will emerge, including continued increases in public works investment and other developments, and this will give a strong boost to the economy. However, these positive effects are forecast to run their course in the second half of the fiscal year. On the other hand, along with the improvement in employment and income conditions, consumer spending is expected to move onto a gradual upward trend. In addition, since corporate performance will continue to improve, capital investment will also increase,

and private-sector demand is forecast to remain firm.

As a result of improvement in overseas economies, a firm trend is forecast for exports, and the contribution of external demand will become positive. The firmness in the U.S. economy is likely to spread to the economies of Asia and Europe, and the outlook is for improvement in the export environment. Moreover, if the uncertainties regarding future trends in overseas economies recede, the upward pressure on the yen is expected to weaken.

Real growth in fiscal 2012 is forecast to be +2.1%, a sharp rise over growth in the previous fiscal year. However, this figure will be pushed upward by a substantial carryover effect (of +1.0%). After the elimination of this effect, the growth rate, calculated during the fiscal year, will be +1.1%, implying that the outlook during fiscal 2012 is for continued recovery at a somewhat faster pace than in fiscal 2011.

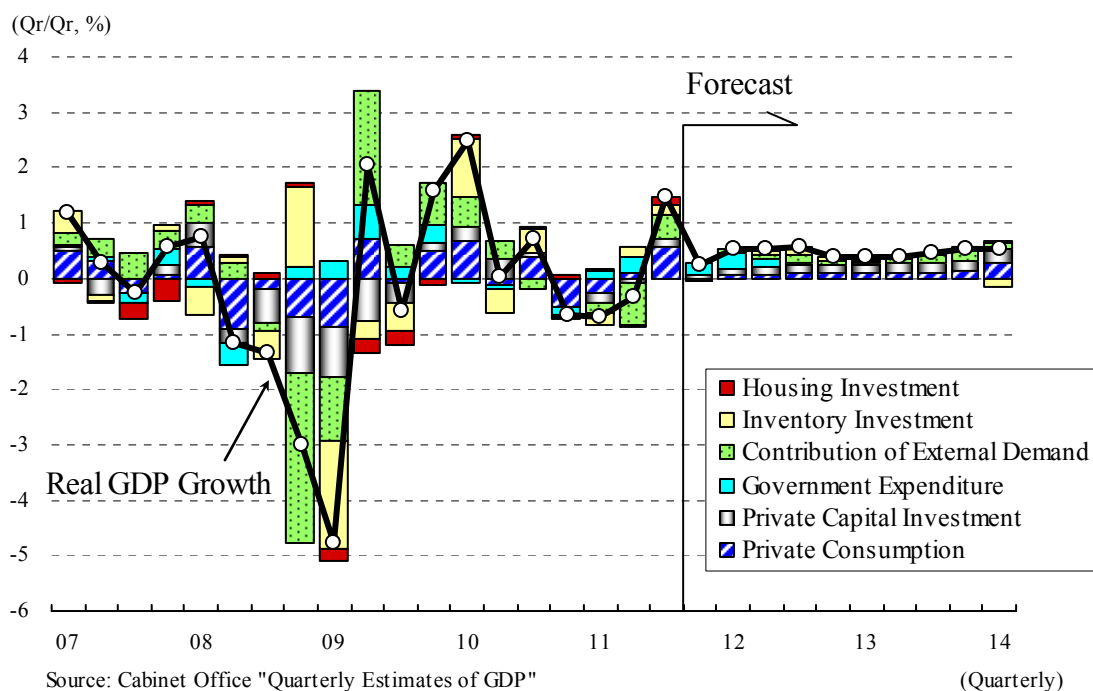
The nominal GDP is forecast to rise +1.8% over the previous fiscal year, and the outlook is for the deflator to show a small decline of -0.2% year on year. Although the margin of decline will shrink substantially compared with the drop in the previous year, this will not eliminate deflation.

Although imports will rise along with the recovery in the economy, the rate of increase in exports will exceed this, and external demand will make a contribution to growth of +0.3 percentage point. On the other hand, the contribution of domestic demand will increase to +1.8 percentage points, with private-sector contributing +1.3 percentage points and the public sector contributing +0.5 percentage point.

Chart 8: Real GDP Growth (Fiscal Year)

	Carry-over from the previous year (A)	Growth rate during the year (B)	Real GDP growth rate (A)+(B)
FY2010 (actual)	2.5 %	-0.1 %	2.4 %
FY2011 (forecast)	-0.5 %	0.9 %	0.4 %
FY2012 (forecast)	1.0 %	1.1 %	2.1 %
FY2013 (forecast)	0.8 %	1.0 %	1.8 %

Chart 9: Real GDP Growth (seasonally adjusted)



2. Forecasts of Economic Activity by Sector

(1) Corporations

- As they entered the 21st century, corporations had completed their disposal of negative assets left over from Japan's bubble economy, and their financial positions and profitability recovered substantially, supported by strong exports. Accordingly, the risk of a major downturn in production, capital investment, or other aspects of corporate activities had receded for the time being.
- However, as a result of the collapse of Lehman Brothers Holdings in autumn 2008, economic conditions changed markedly, domestic and overseas aggregate demand dropped sharply, and companies made adjustments in production to reduce their inventories. As a result, corporate profitability dropped substantially, mainly in the automobile and other manufacturing industries. Corporations were confronted with deterioration in their cash flow and rates of capacity utilization, and they adopted a stronger posture of refraining from capital investment.
- After the beginning of fiscal 2009, industrial production began to bottom out, as a result of the recovery in the world economy and the positive effects of government policy measures. Owing to recovery in production activities and the positive effect of reductions in personnel and other costs, corporate profitability began to show rapid improvement. Although the economy moved into a temporary lull, as a result of the slowdown in exports and other factors, production in the corporate sector remained generally on a rising trend. During this period, the recovery in private capital investment was moderate as companies moved into overseas markets and growth in the domestic market was weak.
- The Great East Japan Earthquake dealt a serious blow to corporate activities. The aftereffects of the earthquake constrained production over a wide range of industries as the production facilities in the affected region were seriously damaged, supply chains were disrupted, and electric power service was interrupted. However, following the temporary confusion immediately after the earthquake, corporate activities are currently showing rapid improvement, but, to maintain the

recovery trend going forward, a necessary condition will be stability in the world economy.

(2) Households

- At present, although the nationwide unemployment rate has shown major improvement, companies are still adopting a cautious stance toward hiring. Going forward, only moderate improvement in the pace of improvement is expected. On the other hand, the household income environment continues to be stagnant. Improvement in wages is expected to take time, in part because of the steep decline in corporation earnings as a result of the earthquake.
- The mood of restraint among consumers and constraints on production that followed in the wake of the earthquake have almost disappeared, and consumer spending is improving along with recovery in automobile sales combined with the special demand for FPD TVs stimulated by purchases of energy-saving appliances and the transition to terrestrial digital TV broadcasting. However, after these factors boosting consumer durable purchases run their course, the outlook is for growth in consumer spending to become more moderate.
- Housing starts, which reached bottom in autumn 2009, are now viewed as being on an improving trend, but the level of activity remains low. A certain level of demand for housing is expected to continue, and housing investment will most likely continue to improve, but the rate of increase in the number of housing starts will remain moderate because the slowing in the rate of growth in the number of households will act as a restraining factor.

(3) Government

- As a result of the collapse of Japan's bubble economy early in the 1990s, the economy has stagnated. Also, because of the implementation of economic measures for public works investment and large tax reductions as well as the rise in social welfare costs accompanying the aging of the population, the structure of government finances deteriorated rapidly. After the year 2000, to implement structural

reforms, the government continued to reduce public works spending, and, along with the improvement in the economy, tax revenues expanded and fiscal deficits were on the decline.

- 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 rapidly.
- In the midst of this deterioration in public finances, the government adopted its "Fiscal Management Strategy" in June 2010 and strengthened its initiatives to restore soundness to government finances. Based on this strategy, the medium-term fiscal framework was revised in August 2011, and the government has announced a policy of restraining fiscal outlays—excluding government bond expenses and certain other items in the general account budget (and with the exception of expenditures related to the earthquake)—to ¥71 trillion, which was the level in the initial fiscal 2011 budget.
- On the other hand, expenditures for reconstruction and recovery following the Great East Japan Earthquake, which occurred in March 2011, during the five-year period through 2015 are expected to be about ¥19 trillion. If the ¥6 trillion included in the first and second supplementary budgets are excluded from this total, then the necessary expenditures over the coming five-year period are expected to total about ¥13 trillion. The third supplementary budget proposal, which will aim for full-scale recovery, includes an earthquake recovery budget of about ¥9.2 trillion (excluding the portion borrowed temporarily from the national pension fund that must be returned). The outlook is for government expenditures to continue to increase going forward, mainly due to expenses related to recovery projects, and there will most likely be a major increase in public works investment in fiscal 2012.
- To fund these expenditures, it is expected that, for the time being, the government will issue ¥11,550 billion in recovery bonds. To amortize these bonds in fiscal 2012 and later years, the government will reduce

its other expenditures and make use of non-tax revenues, while also raising corporate and individual income taxes as well as individual inhabitants' taxes for a specified period. However, since the size of the increase in taxes on an annual basis will not be so large, the impact on the economy is expected to be small.

(4) Trends in Overseas Economies

- The pace of recovery in the world economy is slowing. In the United States, the rise in the price of gasoline has paused and personal consumption is showing improvement. Stagnation is spreading among European economies because of the government fiscal crises, and, even in China, where high economic growth is continuing, there are clear signs of a trend toward deceleration as a result of tighter monetary policy.
- Although the recovery trend in the world is expected to continue, the risk of a downturn is rising because of the substantial increase in the seriousness of fiscal crises in Europe. In the United States, consumption is expected to increase along with the recovery in incomes. In China and the rest of Asia also, the prospects are for changes in the current tighter monetary policies and a transition to a period of balanced growth in domestic and external demand.
- Japan's exports (on a volume basis) are now improving rapidly, following the restoration of supply chains that were cut off by the earthquake. However, in the latter half of fiscal 2011, as a result of the slowing of overseas economies, the rate of increase in exports is expected to become more moderate. Japan's imports (on a volume basis) are also expected to rise, mainly because of the increase in requirements for natural gas and other mineral fuels following the shutdown of a number of the country's nuclear power plants.
- Japan's trade balance in fiscal 2011 is expected to move to a deficit position because of the stagnation in exports and the rise in imports. On the other hand, the surplus generated in the income account by Japan's net overseas assets is expected to hold steady. For this reason, the current account surplus will dip temporarily in fiscal 2011, but continue to expand thereafter.

3. Forecasts for Prices and Financial Markets

- The increases in the prices of raw materials, especially crude oil and metals, are pushing some prices upward. 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.
- Although adjustments are forecast to continue for the time being, international commodity market prices are expected to remain on an upward trend in the medium-to-long term, and, along with this, domestic corporate prices are expected to continue to rise. However, the pace of increase is expected to be moderate because supply capacity in Japan is likely to continue to exceed demand and since yen appreciation will be a factor pushing prices downward. The outlook for consumer prices is for continued small decreases because of the strong downward pressure on sales prices to final consumers.
- Following the collapse of Lehman Brothers Holdings in fall 2008, 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 the risks of a downturn and 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. Then, through 2011, in March, August, and October, additional “monetary easing policies” were implemented. For the time being, the Bank of Japan is expected to continue its stance of easing monetary policy.
- Long-term interest rates are expected to remain low against a background of stable short-term rates. However, there is a possibility that the sustained recovery in overseas economies and the deterioration in government fiscal positions around the world may place upward pressure on long-term interest rates. In foreign exchange markets, during 2010, the yen appreciated because of the weakness of the euro due to government fiscal crises in some EU countries and due to a

decline in the value of the U.S. dollar related to that country's policy of quantitative easing. In 2011 also, as there have been concerns regarding financial conditions in Europe and the United States as well as about economic slowdowns in those areas, the trend toward yen appreciation has continued.

Chart 10: Outlook for Fiscal 2011-2012

	FY2009 (actual)	FY2010 (actual)	Forecast ↘			Yr/Yr, %
			FY2011 (forecast)	FY2012 (forecast)	FY2013 (forecast)	
Nominal GDP	-3.7	0.4	-1.3	1.8	1.4	
Real GDP	-2.4	2.4	0.4	2.1	1.8	
Contribution of domestic demand	-2.7	1.5	1.1	1.8	1.4	
Private consumption	0.0	1.0	0.4	0.6	0.8	
Housing investment	-18.2	-0.2	5.3	3.6	3.0	
Private capital investment	-13.6	4.2	0.1	3.8	5.0	
Contribution of inventory investment	-1.1	0.5	0.2	0.2	0.1	
Government expenditure	5.2	0.1	2.2	2.1	0.0	
Public investment	14.3	-9.8	1.5	8.4	-2.9	
Government final consumption expenditure	3.5	2.3	2.3	0.8	0.6	
Contribution of external demand	0.3	0.9	-0.7	0.3	0.4	
Export of goods and services	-9.6	17.1	-0.2	5.9	6.8	
Import of goods and services	-11.0	10.9	4.5	4.0	4.3	
GDP deflator	-1.3	-2.0	-1.8	-0.2	-0.4	

	FY2009 (actual)	FY2010 (actual)	Forecast ↘			Yr/Yr, %
			FY2011 (forecast)	FY2012 (forecast)	FY2013 (forecast)	
Current account balance (trillion yen)	15.8	16.1	9.5	12.8	13.6	
balance on goods (trillion yen)	6.6	6.5	-1.2	1.9	1.8	
balance on service (trillion yen)	-1.8	-1.3	-1.9	-1.7	-1.7	
balance on income (trillion yen)	12.1	12.1	13.6	13.8	14.6	
Industrial production	-8.8	8.9	-2.6	3.0	3.2	
Unemployment rate(%)	5.2	5.0	4.4	4.2	4.1	
New housing starts(annualized, ten thousand units)	77.5	81.9	85.2	87.0	88.5	
Domestic corporate goods prices	-5.2	0.7	1.5	-0.8	0.8	
Consumer prices	-1.7	-0.4	-0.3	-0.3	0.3	
excluding freshfood	-1.6	-0.8	-0.1	-0.4	0.3	
Yen/U.S.Dollar	92.8	85.7	78.8	78.8	81.0	
Uncollateralized call rates (O/N) (%)*	0.102	0.091	0.074	0.079	0.080	
Newly issued government bond yields (10years) (%)	1.37	1.14	1.06	1.11	1.32	
WTI future price (near month contract, US dollar/barrel)	70.7	83.4	94.0	89.5	93.5	
Dubai crude oil prices (US dollar/barrel)	69.7	84.2	107.0	94.1	94.8	

* actual=average, forecast=end of period

Chart 5: Outlook for Calendar 2011-2012

	CY2009 (actual)	CY2010 (actual)	Forecast			Yr/Yr, %
			CY2011 (forecast)	CY2012 (forecast)	CY2013 (forecast)	
Nominal GDP	-6.6	1.8	-2.3	1.6	1.4	
Real GDP	-6.3	4.1	-0.3	2.1	1.8	
Contribution of domestic demand	-4.8	2.2	0.3	2.0	1.4	
Private consumption	-1.9	2.0	-0.2	0.8	0.7	
Housing investment	-14.0	-6.2	5.5	3.9	2.8	
Private capital investment	-16.7	2.1	0.1	3.1	4.6	
Contribution of inventory investment	-1.1	0.7	0.1	0.3	0.4	
Government expenditure	4.1	1.3	1.1	2.7	0.3	
Public investment	10.5	-3.3	-5.4	10.4	-0.9	
Government final consumption expenditure	3.0	2.3	2.5	1.2	0.5	
Contribution of external demand	-1.5	1.8	-0.7	0.1	0.3	
Export of goods and services	-23.9	24.1	0.8	4.8	6.8	
Import of goods and services	-15.3	9.8	5.5	3.9	4.5	
GDP deflator	-0.4	-2.2	-1.9	-0.4	-0.4	

	CY2009 (actual)	CY2010 (actual)	Forecast			Yr/Yr, %
			CY2011 (forecast)	CY2012 (forecast)	CY2013 (forecast)	
Current account balance (trillion yen)	13.3	17.2	10.1	12.1	13.4	
balance on goods (trillion yen)	4.0	8.0	-0.7	1.7	1.8	
balance on service (trillion yen)	-1.9	-1.4	-1.7	-1.8	-1.7	
balance on income (trillion yen)	12.3	11.7	13.6	13.3	14.4	
Industrial production	-21.9	16.4	-3.3	2.6	2.8	
Unemployment rate (%)	5.0	5.1	4.5	4.2	4.1	
New housing starts(annualized, ten thousand units)	78.8	81.3	84.7	86.7	88.3	
Domestic corporate goods prices	-5.2	-0.1	2.0	-1.0	0.6	
Consumer prices	-1.4	-0.7	-0.3	-0.5	0.2	
excluding freshfood	-1.3	-1.0	-0.2	-0.5	0.2	
Yen/U.S.Dollar	93.5	87.8	79.9	78.4	80.5	
Uncollateralized call rates (O/N) (%)*	0.105	0.094	0.077	0.078	0.080	
Newly issued government bond yields (10years) (%)	1.35	1.16	1.12	1.07	1.26	
WTI future price (near month contract, US dollar/barrel)	61.8	79.5	94.6	89.8	92.5	
Dubai crude oil prices (US dollar/barrel)	61.8	78.0	106.3	96.5	94.3	

* actual=average, forecast=end of period

Chart 6: Outlook for 2011-2012 (Quarterly)

	Forecast											
	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	-0.9	0.1	-0.9	-1.1	-1.5	1.4	0.1	0.7	0.1	0.7	0.4	0.3
	1.1	2.8	0.5	-2.9	-3.2	-1.9	-1.0	0.9	2.3	1.5	1.8	1.6
Real GDP	0.0	0.7	-0.7	-0.7	-0.3	1.5	0.2	0.5	0.5	0.6	0.4	0.4
	3.2	5.2	2.3	-1.0	-1.1	0.0	0.7	2.1	2.5	1.7	2.1	2.0
Contribution of domestic demand (Qr/Qr,%)	-0.2	0.9	-0.6	-0.5	0.5	1.0	0.3	0.5	0.5	0.4	0.3	0.3
Private consumption	-0.2	0.7	-0.9	-0.5	0.2	1.0	0.0	0.1	0.1	0.2	0.2	0.2
	1.4	2.6	0.8	-0.9	-0.5	0.1	0.6	1.2	1.2	0.3	0.5	0.6
Housing investment	0.6	1.1	2.1	1.4	-1.1	5.0	0.2	0.2	0.9	0.8	0.9	0.6
	-10.4	-1.2	6.2	5.2	3.1	7.5	5.9	4.3	6.3	2.2	3.0	3.2
Private capital investment	2.8	0.6	-0.1	-1.1	-0.5	1.1	0.5	0.7	1.1	1.1	1.0	1.1
	3.1	6.7	5.5	1.8	-1.3	-0.4	0.0	1.6	3.3	3.5	4.0	4.3
Contribution of inventory investment (Qr/Qr,%)	-0.4	0.4	0.0	-0.2	0.2	0.2	0.0	0.0	0.1	0.1	0.1	0.0
Government expenditure	-0.2	0.0	-0.6	0.6	1.2	-0.1	0.9	1.2	0.6	0.2	0.0	0.1
	2.0	0.9	-1.7	-0.7	1.5	1.2	2.6	3.3	2.4	2.8	2.3	0.9
Public investment	-5.9	-1.2	-5.9	-1.1	3.7	-2.8	3.8	5.4	2.6	0.7	0.2	-0.2
	-4.2	-4.7	-13.3	-14.1	-3.9	-6.1	3.5	10.3	9.1	13.1	9.2	3.4
Government final consumption expenditure	1.0	0.4	0.4	0.9	0.7	0.4	0.4	0.3	0.2	0.0	0.1	0.1
	2.9	2.1	1.6	2.7	2.4	2.4	2.4	1.8	1.4	1.0	0.6	0.4
Contribution of external demand (Qr/Qr,%)	0.3	-0.2	0.0	-0.2	-0.8	0.4	0.0	0.0	0.1	0.1	0.1	0.1
Export of goods and services	6.6	0.1	-0.5	0.2	-5.0	6.2	0.2	0.6	1.2	1.6	1.7	1.8
	30.3	21.3	13.3	6.4	-5.3	1.1	1.1	2.1	8.4	3.7	5.3	6.5
Import of goods and services	5.3	1.5	-0.2	1.7	0.1	3.4	0.4	0.3	0.8	0.8	1.3	1.4
	14.4	11.4	9.7	8.3	3.2	5.1	5.5	4.0	5.8	3.1	3.0	4.3
GDP deflator (Yr/Yr,%)	-2.0	-2.3	-1.7	-1.9	-2.2	-1.9	-1.7	-1.1	-0.2	-0.2	-0.2	-0.3

	Forecast											
	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)*	3.9	4.4	4.3	3.3	1.9	2.6	2.2	2.6	3.1	3.1	3.1	3.1
balance on goods (trillion yen)*	1.8	2.0	1.8	0.9	-1.2	-0.1	-0.2	0.3	0.5	0.4	0.4	0.5
balance on service (trillion yen)*	-0.3	-0.3	-0.4	-0.3	-0.3	-0.6	-0.5	-0.4	-0.4	-0.5	-0.4	-0.4
balance on income (trillion yen)*	2.7	3.0	3.2	3.1	3.8	3.6	3.1	3.0	3.4	3.5	3.4	3.4
Industrial production (Qr/Qr, %)	0.7	-1.0	-0.1	-2.0	-4.0	4.3	0.3	0.7	0.3	0.6	0.7	0.7
(Yr/Yr, %)	21.3	14.0	5.9	-2.5	-6.8	-2.1	-2.1	1.1	5.8	2.0	2.1	2.3
Unemployment rate (%)*	5.1	5.0	5.0	4.7	4.6	4.4	4.3	4.3	4.2	4.2	4.2	4.2
New housing starts(annualized, ten thousand units)	77.6	81.5	84.3	84.2	81.0	87.8	85.5	86.5	86.6	86.7	87.0	87.7
Domestic corporate goods prices (Yr/Yr,%)	0.2	-0.1	1.0	1.8	2.5	2.6	1.3	-0.5	-1.7	-1.2	-0.5	0.1
Consumer prices (Yr/Yr,%)	-0.9	-0.8	0.1	-0.5	-0.5	0.1	-0.2	-0.6	-0.6	-0.6	-0.2	0.1
excluding fresh food (Yr/Yr,%)	-1.2	-1.1	-0.5	-0.8	-0.2	0.2	-0.1	-0.4	-0.7	-0.6	-0.2	0.1
Yen/U.S.Dollar	92.0	85.9	82.6	82.3	81.7	77.8	77.6	78.0	78.0	78.4	79.0	79.6
Uncollateralized call rates (O/N) (**)	0.093	0.093	0.090	0.088	0.067	0.078	0.075	0.076	0.077	0.078	0.079	0.080
Newly issued government bond yields (10years) (%)	1.22	1.00	1.09	1.25	1.17	1.05	1.01	1.02	1.05	1.09	1.13	1.18
WTI future price (near month contract, US dollar/barrel)	78.0	76.2	85.2	94.1	102.6	89.8	91.8	92.0	89.0	88.0	90.0	91.0
Dubai crude oil prices (US dollar/barrel)	77.6	74.2	84.3	100.5	110.6	107.0	107.2	103.0	97.0	93.0	93.0	93.5

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

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