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Forecast for the Japanese Economy in Fiscal 2009 and 2010

— The Recovery Will Be Neither “L-Shaped” Nor “V-Shaped” —



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1. Outlook for the Japanese Economy in Fiscal 2009 and Fiscal 2010

-- The Recovery Will Be Neither “L-Shaped” Nor “V-Shaped”

(1) Current State of the Economy

Real GDP growth for the January-March period on a quarter-to-quarter basis was minus 4.0% (minus 15.2% on an annualized basis), the fourth consecutive quarterly decline. The margin of decline was the largest yet recorded, exceeding the declines in the January-March period of 1974, following the first oil crisis and the October-December period of 2008. Nominal GDP in the January-March period of 2009 was 2.9% lower than for the previous quarter (an annualized rate of decline of 10.9%), also the fourth consecutive quarterly decline. Real GDP growth for fiscal 2008 as a whole, ended March 31, 2009, was minus 3.5%, the first drop in seven years, and nominal GDP growth was minus 3.7%, the first decline in six years. The percentage declines in real GDP and nominal GDP were the largest reported during the post-World War II period, thus pointing to the severity of the current economic crisis.

The percentage declines in the October-December period of 2008 and the January-March quarter of 2009 were about the same, but the underlying trends were different (Exhibit 1). First, the contribution of external demand in the October-December quarter was minus 3.2% and pushed the overall GDP growth rate down substantially; however, the contribution of external demand in the January-March quarter was minus 1.7%, indicating that although the contribution of the external sector continued to be negative, the magnitude of the impact was smaller. Although the rate of decline in exports was minus 26.0%, a significantly greater drop than in the previous quarter, imports also showed a marked decline, reflecting the decrease in domestic demand. This simultaneous drop in both exports and imports, therefore, reduced the negative contribution of the external sector to GDP growth.

Exhibit 1: Comparison of 2009:I with 2008:IV

	Qr/Qr, %	
	2009:I	2008:IV
Nominal GDP	-2.9	-1.6
Real GDP	-4.0	-3.8
Domestic demand	-2.5	-0.6
Private consumption	-1.1	-0.8
Housing investment	-5.4	5.5
Private capital investment	-10.4	-6.7
Contribution rate of inventory investment	-0.3	0.5
Government final consumption expenditure	0.3	1.6
Public investment	0.0	-0.1
Contribution rate of external demand	-1.4	-3.2
Export of goods and services	-26.0	-14.7
Import of goods and services	-15.0	3.1

Source: Cabinet Office "Quarterly Estimates of GDP"

On the other hand, the margin of decline in domestic demand during the January-March quarter increased substantially. The rates of decline in personal consumption, the main support of domestic demand, was 1.1%, and that of private capital investment was 10.4%, both representing marked decreases in those indicators. Reflecting the stagnation in the private housing market, private residential investment was down 5.4%, the first drop in three quarters. These GDP figures suggest that the effects of the decline in Japan's exports, stemming from the sharp deceleration in the world economy, have spread to the domestic economy, thus increasing the severity of the economic downturn.

The contribution of domestic inventory investment on a quarter-to-quarter basis in the January-March quarter was minus 0.3%, and this was one cause of the decline in domestic demand. Nevertheless, this development could be assessed as evidence of a trend toward a bottoming out, as a result of progress toward inventory adjustments, and it is, therefore, a positive factor pointing toward recovery in production.

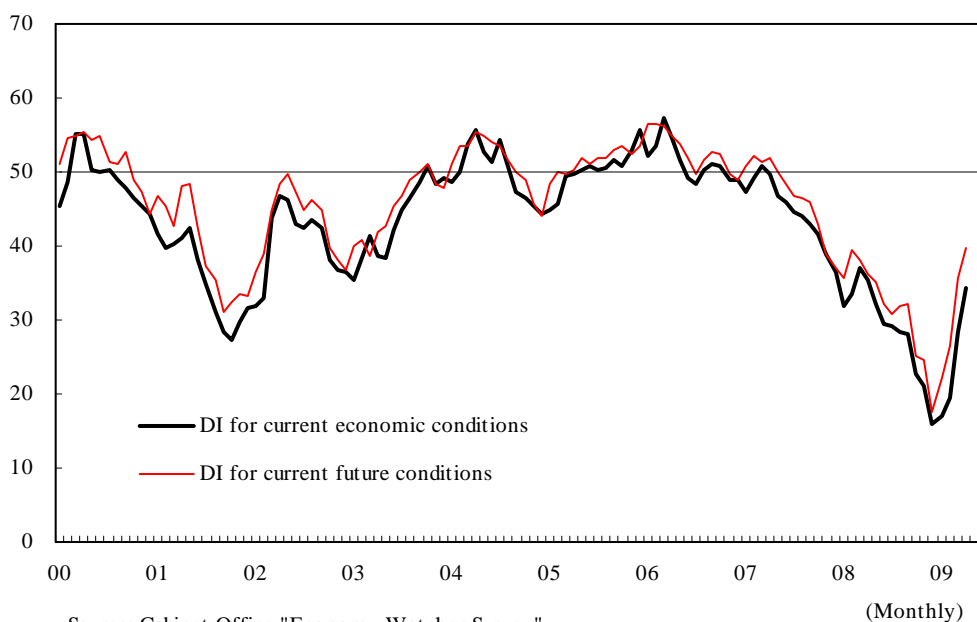
(2) Outlook for the Economy

①Economy Has Moved Out of the Worst Phase

The GDP results for the January-March quarter remind us again of the severity of the current economic downturn, but there are signs of movement toward a bottoming out. In fact, the examination of export and production data reveals that there is growing evidence to suggest that the sharp declines in these indicators have paused and stopped declining. The value of exports in March (seasonally adjusted) increased for the first time in 10 months, and industrial production in March also increased for the first time in six months. Exports and production are beginning to rise, as evidenced by the increases in the automobile and electronic parts industries, where progress has been made in adjusting domestic and overseas inventories, and the rise in the chemical industry, where demand from China is expanding.

Signs of a bottoming out are also having a positive psychological impact. In the *Economy Watcher* survey conducted by the Cabinet Office, the diffusion index (DI) for judgments regarding current economic conditions reached a low point in December 2008 and has subsequently shown improvement. In the most recent survey, for April, this indicator had risen to the same level as in the previous year, suggesting that, after the sharp deterioration in sentiment following the collapse of Lehman Brothers last September, the psychology of respondents to the survey is now improving (Exhibit 2).

Exhibit 2: Economy Watcher Survey

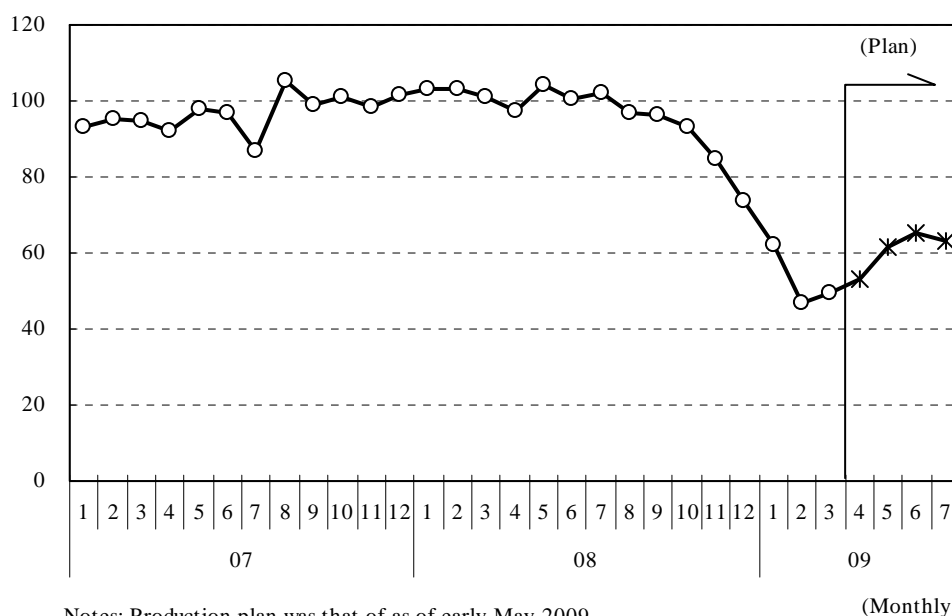


However, exports and industrial production have not returned to the levels of a year ago. Compared to the previous year, both exports and production are still 30% to 40% lower. Although the levels remain low, there has been a change in direction toward a bottoming out and a movement out of the worst phase of the downturn.

Given this change of direction, to what extent will economic activity recover? To answer this question, let us look at the principal factors that have led to the sudden drop in production in the automobile industry since last fall. Previously, when world demand for automobiles was continuing to expand, Japan's domestic automobile industry maintained a high level of production of more than about one million units per month. However, monthly production in February 2009 had fallen to below 500,000 units. In March, for the first time in eight months, production rose, and, since then, there appears to be a movement toward recovery, but production plans through July call for a level of output that will be only two-thirds of production at the previous peak (Exhibit 3).

Exhibit 3: Automobile Production: Actual and Planned

(Seasonally adjusted, ten thousands units)



Notes: Production plan was that of as of early May 2009.

Source: Japan Automobile Manufacturers Association, Inc., Jidosha Sangyo News

If the autonomous recovery in production that follows progress toward inventory adjustments is not accompanied by recovery in final demand, then this trend will not continue for long. Even if recovery in production, led the output of automobiles, continues through the first half of fiscal 2009, ending March 31, 2010, increases in production will be extremely gradual, reflecting the moderate trend toward recovery in the world economy.

② Adjusting Excesses and Other Issues Will Restrain the Recovery

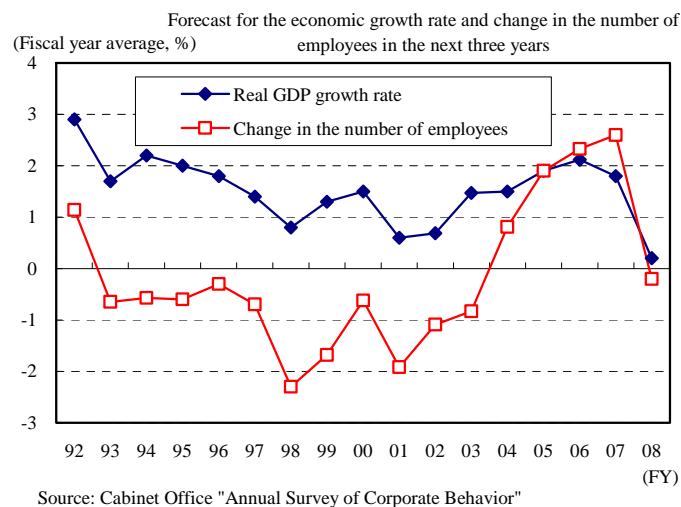
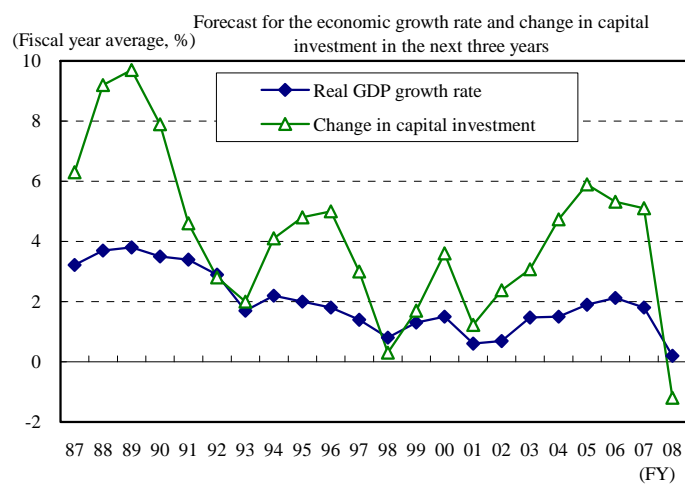
It is unclear how much industrial production, which has fallen to half its previous peak, will recover in the first half of fiscal 2009, but it will be quite difficult to recover even half of the decline that has occurred since fall 2008. At any rate, even if the process of escaping from the worst phase of the downturn continues in the first half of the current fiscal year, if we assume that, thereafter, exports and production recover only to levels that are significantly lower than they were one to two years ago, we will have to search for the appropriate levels of equipment and employment. Therefore, the next issue to be addressed will be adjustments in excess capital equipment and employment.

There are two approaches that can be taken to eliminating excess capital equipment and employment. One is to cut back excess equipment and employment, and the other is to raise the rate of utilization of equipment and labor by expanding demand. The second approach to adjustment will be the less painful of the two, but progress under this approach will depend on the economic growth rate. However, the rate of growth that corporations are expecting has declined substantially.

According to the *Survey of Corporate Behavior*, which is conducted annually by the Cabinet Office, the growth rate that corporations are anticipating over the coming three years averages 0.2% a year, the lowest level reported thus far. In addition, the expected growth rate over the coming five years is 1.0%, the same as the lowest level that has been reported thus far in this survey. The survey was conducted in February this year, and there is a possibility that this was the time when corporate psychology was at its lowest ebb. Even taking this into account, however, the growth rate corporations are expecting has declined markedly.

When the expected growth rate declines, companies must be cautious in preparing their plans for capital investment and employment. The lower the expected growth rate, the less the need for capital investment and adding to the work force to expand production. At the same time, if companies already have excess production capacity and workers, it becomes necessary to cut back on this excess capacity. The previously mentioned *Survey of Corporate Behavior* indicates that, over the coming three years, corporations, centered on manufacturing companies, have plans to reduce capital investment at an average annual rate of 1.2%, the first decline to be reported in this survey. Similarly, the outlook of corporations over the coming three years calls for reducing the number of employees at an average annual rate of 0.2% (Exhibit 4). However, the adjustments in capital equipment and employment are not about to commence again, but have already begun, following the sudden deterioration in the economy since last fall.

Exhibit 4: Annual Survey of Corporate Behavior



According to data released in the Bank of Japan's *Tankan* survey (*Short-Term Economic Survey of Enterprises in Japan*), the DI for business conditions that measures the difference between the number of "excess" minus "shortage" responses for capital equipment has reached its highest level since the period following the collapse of Japan's bubble economy. The reason for this has not been excessive capital investment, as during the bubble economy, but has been largely a result of the sharp decline in world demand. In part because of the improvement in corporate financial positions, more and more companies have financed their capital investment from their own funds, and it appears that the problem of excessive debt that arose following the collapse of the bubble economy is not a major issue at present. However, as slow growth continues going forward, reducing the amount of excessive equipment will take time. Therefore, a major decline in capital investment in fiscal 2009 appears to be unavoidable.

Nevertheless, the sharp downtrend in production has bottomed out, and, as production levels show a gradual recovery, the steep drop in capital investment may settle down. Orders for machinery (excluding those placed by the shipping and electric power industries), which are a leading indicator for capital investment, may be still declining during the April-June quarter, but the pace of decline is expected to become more gradual. If machinery orders begin to bottom out during the July-September

quarter, we believe private capital investment may move toward a bottoming out in the latter half of fiscal 2009.

The Bank of Japan's *Tankan* DI for business conditions that measures the difference between the number of "excess" minus "shortage" responses for the level of employment has also increased, along with the rise in DI for capital equipment. This implies that employment and income conditions will likely continue to deteriorate for the time being. As a result of government employment measures, such as the Employment Adjustment Support Fund, increases in the level of unemployment may be restrained, but, even so, the rising trend in unemployment will continue, and the unemployment rate may exceed the previous high of 5.5%.

Along with the sharp drop in production since fall 2008, employment adjustments have already begun, especially in the manufacturing sector. For this reason, if production levels begin to recover even moderately, the decline in employment in manufacturing may settle down somewhat. However, as the deterioration in conditions stemming from the drop in exports and production is spreading throughout the economy, there is concern that the employment adjustments may spread from the manufacturing to the non-manufacturing sector as well. We must resign ourselves to the fact that this, aggravated by continuing declines in wages, may lead to marked deterioration in the income environment.

On the other hand, as the expectations for a bottoming out in the economy spread, consumer psychology may improve to some degree. According to surveys of consumer behavior issued by the Cabinet Office, the index of consumer attitudes is now improving, after reaching a low point in December 2008. For this reason, compared with the steep drop in the latter half of the previous fiscal year, the outlook is for a bottoming out of personal consumption. However, if we consider the likelihood that employment and income conditions will continue to be challenging, consumer spending is likely to remain stagnant.

③Government Policies May Have a Destabilizing Effect

Even if the economy reaches bottom, recovery, thereafter, will be gradual. Since Japan has already entered a period of declining population, with trends toward fewer children per household and demographic aging, a high rate of expansion in domestic demand is unlikely. On the other hand, the world economic growth rate of around 5% that was experienced during the middle of the first decade of the 21st century is not likely to return, and the prospects for expansion in external demand similar to that experienced in recent years are limited. Even if the sudden declines in capital investment and personal consumption that were experienced in the latter half of the previous fiscal year settle down, we cannot draw a clear picture of what the shape of the recovery thereafter will be like. In response to this uncertainty, the government is adopting measures that will prevent a further downturn in the economy and increase long-term growth potential.

The government has implemented three economic policies since August 2008. The first was passed under the Fukuda cabinet and was entitled “Comprehensive Emergency Policy for Achieving Economic Security,” and the other two were implemented by the Aso cabinet and were entitled, “Livelihood Policy” and “Emergency Policy for Protecting the People’s Livelihood.” Altogether, these policies have been referred to as the “Three-Stage Rocket Economic Policies” (with total projects under these policies amounting to ¥75 trillion and fiscal expenditures totaling ¥12 trillion). In addition to these policies, the government is in the process of passing its “Economic Crisis Policy” (with total projects amounting to ¥56.8 trillion and fiscal expenditures totaling ¥15.4 trillion), which will be the largest single policy package in Japan’s history. A supplementary budget to provide the necessary financing for this program is now being considered by the Diet.

Certainly, this series of economic policies, centering around the Economic Crisis Policy, will increase the scale of the economy in fiscal 2009 and fiscal 2010. The first effect of these policies will be an expansion in public works investment. Under the Economic Crisis Policy, additional expenditures for disaster and safety measures, expenditures on facilities,

financial support to be provided to regional governments, and other items are estimated to total about ¥5 trillion. With expenditures under the regular budget for fiscal 2009 being accelerated and expenditures on public works projects under the Economic Crisis Policy beginning in the latter half of fiscal 2009, the economic growth rate will be pushed upward by expansion in public works expenditures, mainly in fiscal 2009.

In addition, these economic policies are expected to stimulate personal consumption. Under the Comprehensive Emergency Policy for Achieving Economic Security, individuals will receive fixed amounts as gifts from the government, and these are already being distributed. Also, under the Economic Crisis Policy, measures are being implemented that will encourage consumers to increase their purchases of durable goods in fiscal 2009. One of these measures aims to encourage the purchase of new hybrid and other types of eco-friendly cars. Another measure is the introduction of a point system that will give consumers credits for purchasing eco-friendly, “green” appliances, such as energy-saving air conditioners, refrigerators, and TV sets.

Moreover, under the Emergency Policy for Protecting the People’s Livelihood, tax breaks will be granted for families borrowing to purchase homes, and under the Economic Crisis Policy, the non-taxable allowance for gifts for the purchase of new homes will be expanded. These measures are expected to expand purchases of housing and increase the number of housing starts.

As these comments suggest, these various government economic measures will boost the economic growth rate, mainly in fiscal 2009. It will be difficult, however, to estimate the extent of the stimulatory impact on personal consumption and housing investment. If growth in incomes continues to be weak, even if sales of hybrid cars and green appliances increase, there is a possibility that households may cut back on other expenditures. These measures may have a temporary stimulatory effect, but the larger this effect, the larger the reactionary decline afterwards. Even if economic policies are large, they do not have the power to sustain growth in the economy; therefore, a temporary increase in demand will be

followed by a reactionary decline and may, therefore, act as a destabilizing factor.

④Scenario for Economic Growth Going Forward

The Japanese economy is showing growing signs of maturity as shrinkage in the domestic population continues. On the other hand, since the high growth in the world economy experienced thus far cannot be expected going forward, as the low rate of anticipated growth shown in the *Survey of Corporate Behavior* indicates, the growth rate of the economy in the medium term appears likely to be about 1%.

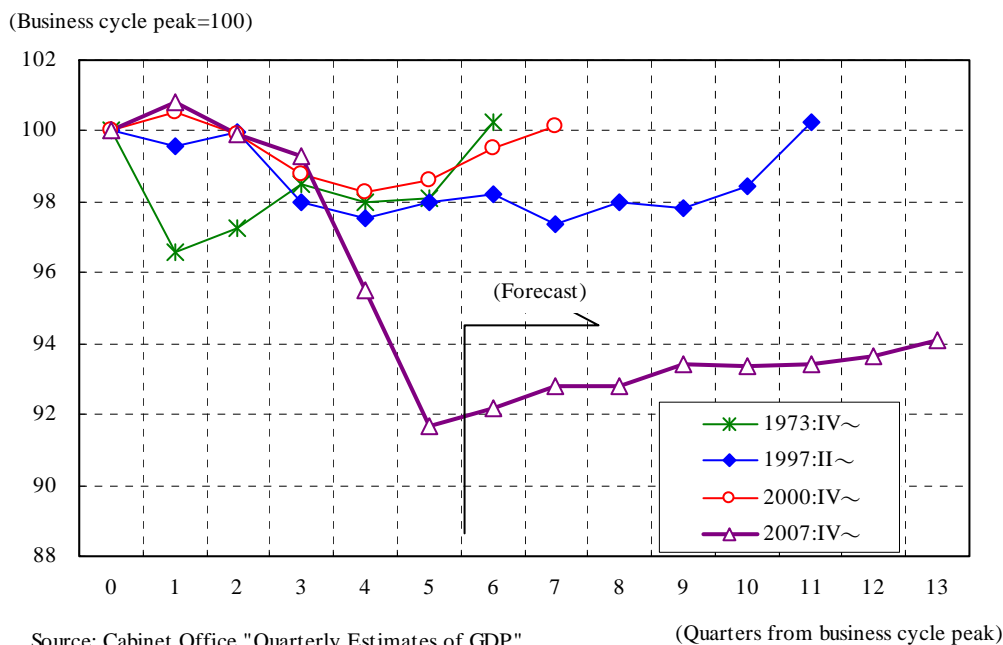
Amid these conditions, as the economy moves out of the worst phase of the downturn following its bottoming out in fiscal 2009, the pace of growth will accelerate as production increases. The effects of the government's economic policies will emerge, and there is a possibility that the growth rate in the first half of the fiscal year will be higher than expected. However, this will not reflect the underlying strength of the Japanese economy.

It is difficult to forecast when the effects of government policies will emerge and their scale, but, when the effects run their course, we must assume that there will be a reverse reaction as we move toward fiscal 2010. As a result, the pace of economic growth in fiscal 2010 may be below the basic, medium-term trend of 1%.

There is a possibility that the January-March quarter of 2009 will be the bottom of the downturn, but, compared with one year earlier, the size of the GDP will be 10% smaller. The Japanese economy experienced a shrinkage in GDP during the recession following the first oil crisis and during the downturn that began in the 1990s. However, this is the first for such a major shrinkage, and, since low growth is expected to continue, it appears unlikely that the economy will return to previous levels for the time being. If low growth continues, eliminating excess capital equipment and labor will take time. Since the issue of excessive capital and labor will remain, private capital investment and personal consumption will not expand and the growth rate will not rise. The economy will have moved out of the

worst phase of the downturn, but the growth will not increase, and a gloomy mood is likely to persist (Exhibit 5).

Exhibit 5: Real GDP after Business Cycle Peaks



The expectation that the economy will bottom out shown in the *Economy Watcher* survey is not contradictory to expectations of low growth in the medium term made clear in the *Survey of Corporate Behavior*. From a medium-term perspective, expansion in domestic demand will be difficult as the trends toward fewer children per household and demographic aging of the population continue. Also, since the bursting of the world economic bubble, expansion in external demand cannot be expected. Responding to the problems of excess capital and labor will have a restraining effect on the economy for some time, but despite this, there will be nothing strange about the emergence of periods of cyclical recovery.

Amid these circumstances, an additional factor to be considered is the impact of the largest economic stimulus policies in Japan's history, but, basically, these policies will have a destabilizing impact. The Japanese economy has not lost so much of its vitality that it will experience an L-shaped recovery, with no improvement following the downturn, and will absolutely not recover unless the largest economic packages in its history

are implemented. At the same time, however, the circumstances surrounding the Japanese economy are not conducive to the V-shaped recovery that some optimists think may occur as the implementation of major economic stimulus policies supposedly brings a sustainable rise in the growth rate.

The scenario for the economy going forward appears neither to be an L-shaped recovery, where the dawn never comes, nor a V-shaped recovery, where the dawn comes followed by a bright morning. As conditions remain dark even after the dawn, the important issue will be to sustain an upward, albeit gradual, movement in the economy.

(3) Outlook for Fiscal 2009 and Fiscal 2010

In fiscal 2009, the sharp deterioration in the economy will pause, and, especially during the first half of the fiscal year, exports and production will move out of the worst phase of the downturn and bottom out. As the positive effects of the government's economic policies also emerge, the pace of growth is expected to rise. However, even if trends toward recovery emerge, exports and production will remain extremely low compared with levels in 2007. Since adjustments in excess capital and labor will continue, private capital investment and personal consumption will be restrained, and the recovery will be gradual.

The supposition is that the turmoil in world financial markets will gradually subside approaching 2010 in part because of policy cooperation among various nations. The growth rate of the world economy in 2009 is forecast to be negative for the first time during the post-World War II era. A major decline in Japan's exports will be unavoidable, and the contribution of the external sector, as in fiscal 2008, will be a major negative figure. However, during the course of the fiscal year, exports are expected to bottom out during the first half, and then show continuing gradual recovery thereafter. Production is also forecast to decline for the second consecutive year, as exports experience a major decrease, but, as with exports, growth in production will be relatively high in the first half of the fiscal year, then

continue a gradual recovery thereafter.

Even though the economy moves toward a bottoming out, the environment for corporate profitability will be extremely tough. Recurring income is expected to decline for the third consecutive year, and, as during the previous fiscal year, the margin of decline will probably increase. In addition, the rate of equipment utilization, which has dropped to just above 40%, is expected to recover only to between 50% and 60% for the time being. Since adjustments in excess equipment will continue, private capital investment will show major declines for the second consecutive fiscal year.

The government to the people, amounting to ¥2 trillion in total, are now being disbursed, and the policies for promoting purchases of eco-friendly automobiles, including hybrid cars, as well as the eco-point system that will encourage purchases of green appliances will go into effect. In addition, the government will begin to offer the largest program of tax breaks in its history for housing loans. However, even if these policies provide support for consumer spending and private housing investment, a major positive impact is not expected. As the profit environment for corporations will remain challenging, deterioration in the employment environment is expected to continue with the margin of decline in wages and bonuses expanding. Although consumer spending will rise, principally in the first half of the fiscal year, the rate of increase compared with the previous year will remain virtually unchanged. In addition, although there are hopes for the positive effects of housing loan related tax breaks on housing investment, the desire to purchase homes may not rise, and our forecast is for a fifth consecutive year of decline in home purchases.

We are forecasting real GDP growth of minus 3.8% in fiscal 2009, the second consecutive year of major declines. However, this forecast is influenced by the substantial negative growth in the latter half of fiscal 2008, which pushed the starting point in fiscal 2009 to a lower level than it would have been otherwise. After excluding this factor, the growth rate during the year as a whole was plus 1.1%, a significant recovery from the previous fiscal year (Exhibit 6).

In fiscal 2010, world financial markets will settle down, and the margin of decline in U.S. housing prices will diminish and move toward bottoming out. The growth rate of the world economy will most likely become positive again, led by China and other emerging economies. Although we are not assuming that the growth rate of the world economy will return to the 5% level experienced in the first decade of the 21st century, the environment for Japan's exports will remain challenging, but since moderate increases in exports will continue, we are forecasting that the Japanese economy will be able to avoid another severe downturn.

However, since the problems of excess capital equipment and labor will persist, recovery in consumer spending and private capital investment will be gradual. Consumer spending will continue to show little or no growth because of such negative factors as the difficult conditions in the income environment and the diminishing impact of the government's economic stimulation policies. After two successive years of major declines, private capital investment, as might be expected, is forecast to recover, but because of the low expectations for future growth among corporations and the lingering excess of capital equipment, the rate of increase will be moderate.

Real growth in fiscal 2010 is forecast to be a positive 0.9%, and growth in nominal terms will be plus 0.1%. Thus growth rates will appear to be higher than in fiscal 2009, but this forecast is influenced by the growth that is forecast in fiscal 2009, which will push the starting point in fiscal 2010 to a higher level than it would have been otherwise. After excluding this factor, the real expansion rate for the year as a whole will be only plus 0.1%, or virtually zero growth.

Exhibit 6: Carry-over from Previous Year and Growth Rate during the Year

	Carry-over from the previous year (A)	Growth rate during the year (B)	Real GDP growth rate (A)+(B)
FY2007 (actual)	1.6	0.2	1.8
FY2008 (actual)	1.0	-4.5	-3.5
FY2009 (forecast)	-4.9	1.1	-3.8
FY2010 (forecast)	0.8	0.1	0.9

Source: Cabinet Office "Quarterly Estimates of GDP"

1. In general, when an economic growth rate for a certain year is cited, the figure is a rate of change over the course of the year, or, in other words, it shows the rate of change between the total size of the GDP in the previous year and total size of the GDP in the year in question.
2. As a result, in the event that the rate of growth on a quarterly basis in the GDP rises (or falls) toward the end of the fiscal year, even if the growth rate for the next year on quarter-to-quarter basis is zero, the growth rate on a full year comparison basis may be positive (or negative). The height of this "launching pad" when the annual rate of growth is calculated represents a kind of carry-over.
3. In fiscal 2008, although the growth rate during the year as a whole was a substantial minus 4.5%, the carry-over from the previous fiscal year was plus 1.0%, and, after adjusting for this effect, the negative growth was minus 3.5%. Conversely, in fiscal 2009, the growth rate during the year is forecast to be 1.1%, but because of the substantial negative carry-over of minus 4.9%, the growth rate measured over the course of the year will be minus 3.8%, or, as a result, a similar margin of decline as the minus 3.5% in fiscal 2008.
4. Thus, the rate of growth measured during the course of the year is closer to the actual feeling of conditions than comparisons between full years.

Image of the Carry-over from the Previous Year

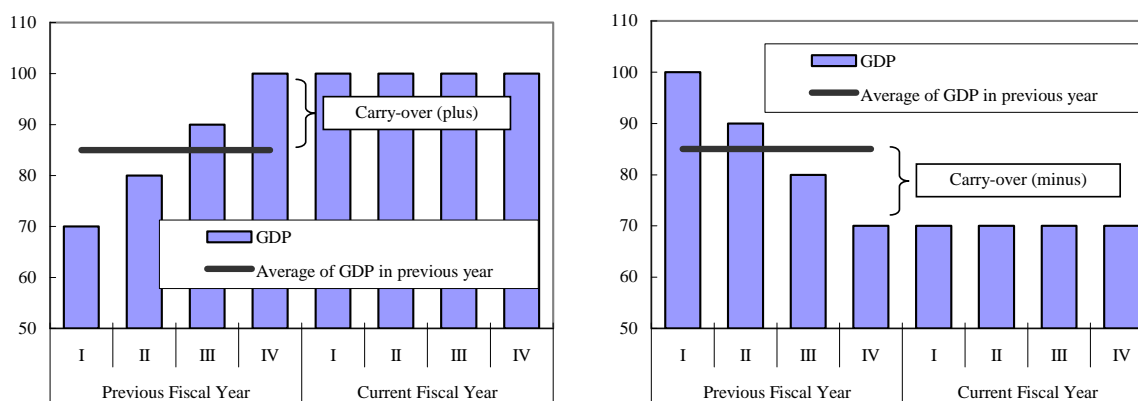
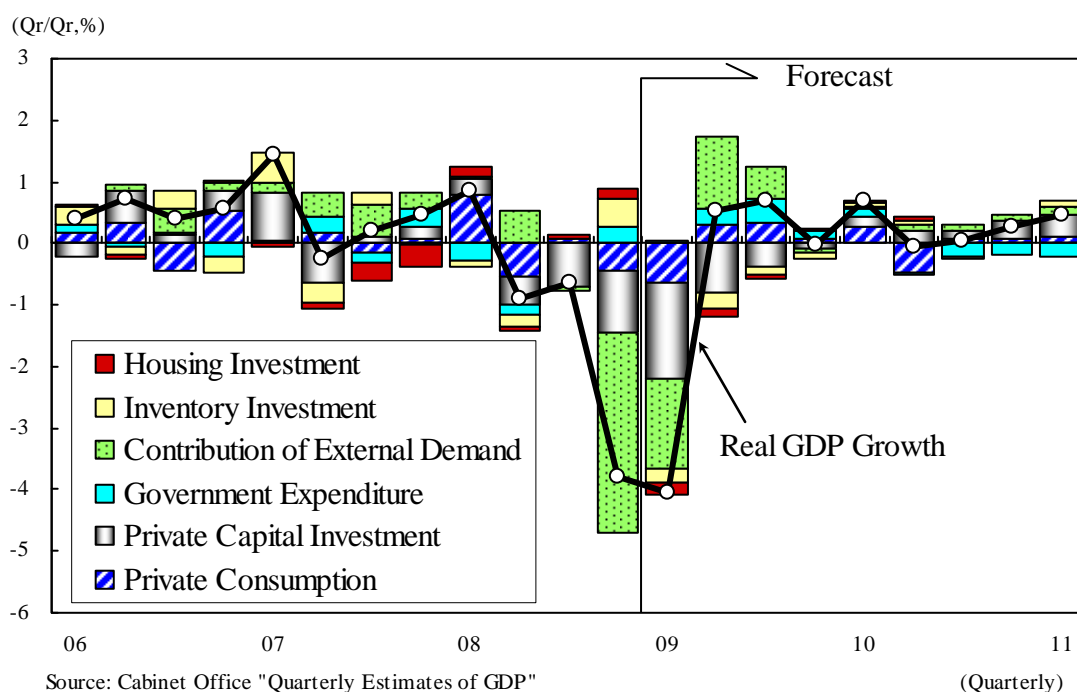


Exhibit 7: Real GDP Growth (seasonally adjusted)



2. Forecasts of Economic Activity by Sector

(1) Corporations

- Corporations completed their disposal of negative assets left over from Japan's bubble economy, and their financial positions and profitability recovered substantially after 2000, supported by strong exports. Accordingly, the risks of a major downturn in production, capital investment, or other aspects of corporate activities had receded for a prolonged period.
- However, since fall 2008, domestic and overseas demand has dropped sharply, and companies are making major adjustments in production to reduce their inventories. As a result, production has dropped rapidly, mainly in such industries as automobiles, digital-related products (semiconductors and LCDs), general machinery, and other items. Since the beginning of 2009, there have been signs of a bottoming out of production, but because of the continuation of weakness in domestic and overseas demand for the foreseeable future, the underlying pace of

recovery is gradual and industrial activity is likely to continue at a low level.

- As a result of the deterioration in the domestic and overseas economies, corporate profitability is falling sharply and private capital investment is decreasing. Investments for the renewal of equipment and for increasing value-added to remain competitive are necessary, but because of the rapid emergence of a feeling of excess capital equipment capacity following the drop in demand, there is a possibility that adjustments in private capital investments will be prolonged.
- The level of recurring profits had exceeded the peak levels attained previously during Japan's bubble era and the time of the IT boom and were continuing at record levels, but profitability has now begun to decline. This is due to higher costs, including increases in raw material prices, personnel costs, and depreciation charges, combined with the effects of deceleration in the world economy, including sharp declines in domestic and international sales, including exports. The more recent declines in raw material prices and the improvement in Japan's terms of trade will both be beneficial for corporate profitability; however, until the world economy begins to recover, a robust upward trend in profitability will be unlikely.

(2) Households

- The stagnation in corporate activities is adversely affecting the household sector through declines in incomes, and consumer spending is declining.
- Since autumn 2008, faced with major declines in demand, companies have reduced personnel, principally by cutting back the number of non-regular employees, whose numbers increased during the last recovery phase. This has resulted in a marked deterioration in conditions in the employment environment. Although it is thought that the increase in the number of unemployed persons will be restrained by expansion in the Employment Adjustment Support Fund, because a full-scale recovery in demand is not occurring, employment adjustments are continuing, and the unemployment rate is expected to continue to rise.

- Policies incorporated in economic policies, including measures to promote the purchase of eco-friendly products, are believed likely to bring an increase in consumer spending in the short term. However, there is a strong possibility of a major decline in wages, principally because of reductions in bonuses accompanying the deterioration in corporate performance, and, as a consequence, the household income environment is becoming increasingly severe. Consumer spending, in general, is expected to remain at about current levels.
- In the area of residential investment, although the sons and daughters of the baby-boom generation had been purchasing their first homes, the market has unavoidably stagnated since the revision in Japan's building code in June 2007. Even after the effects of the building code revision have run their course, housing sales have remained lackluster because of expectations that home prices may decline further and uncertainty regarding future trends. In addition, the slower growth in the number of households in the medium term will have a restraining effect on residential investment.

(3) Government

- Following the collapse of Japan's bubble economy, the structure of government finances deteriorated rapidly. Along with the decline in nominal income growth rates in the 1990s and major tax cuts, government tax revenues have declined. Moreover, on the expenditure side, social welfare costs have continued to rise as the population has aged demographically, and expenditures for public works increased as a result of the implementation of major government spending programs to stimulate the economy.
- After the year 2000, to implement structural reforms, the government suspended major spending programs aimed at stimulating the economy, and spending on public works projects was reduced substantially. Moreover, local governments are experiencing fiscal difficulties and have continued to reduce their spending on public works. Along with the economic recovery, tax revenues began to expand again, but the government has basically maintained its policy of making structural reforms in its finances.

- To reduce its fiscal deficit, the government is working to restrain its expenditures through systemic reforms to control government final consumption expenditures, including social welfare expenses. However, under the government's Basic Policies for Economic and Fiscal Reform 2009 (referred to more informally as the "Sturdy Bones Policy 2009") the policy of restraining social welfare expenses is expected to undergo scrutiny, and government final consumption expenditures, principally social welfare payments, will continue to expand.
- Government public works investment is continuing on a decreasing trend, reflecting the weakness in financial positions of both the national and regional governments. However, as a result of the large-scale economic policies that have been introduced as the economic downturn has become increasingly serious, prospects are that there will be major increases in public works investment. The financial position of the government has become increasingly severe, and it will be difficult to sustain expansion in public works investment; however, the previously mentioned development will bring an end to declining trends in public works investment.

(4) Trends in Overseas Economies

- The world economy has slipped into a simultaneous global downturn. During the January-March quarter, the United States and European countries reported substantial negative growth figures, and the slowdown in the growth rates of China and other newly emerging countries has become clear.
- In the world economy in 2009, the positive effects of the economic policies adopted by countries around the world are expected to have a gradual braking effect on the deterioration in economic conditions. However, the capacity for recovery in consumer spending in the United States, which was the driving force for the world economy, is weak because of the adjustment in household liabilities and deterioration in employment conditions. For this reason, approaching 2010, the pace of the recovery in the world economy is expected to be gradual and the outlook is for continued slow growth.
- As the effects of the worldwide recession have spread, Japan's exports

are posting the largest declines in their history. Since exports had become the driving force for growth in Japan, supported by high growth in the world economy, the repercussions of the sudden slowdown in exports are extremely large. For the time being, there are no prospects for a return to the rapid growth experienced previously in the world economy, and considerable time will likely be necessary before exports return to their previous levels.

- Since the level of exports has declined substantially, the trade balance is generally expected to remain around equilibrium, and it will be difficult for Japanese companies to generate earnings from trade. Although the income account is expected to continue to be firm, supported by income from Japan's net overseas assets, the current account surplus is expected to remain at about half the surplus reported in fiscal 2007.

3. Forecasts for Prices and Financial Markets

- Prices of raw materials, especially oil and metals, posted major declines in the latter half of 2008, but have subsequently ceased to decline, but upstream inflationary pressures have eased. However, in the medium term, considerations of supply capacity and expansion in demand in China and other newly emerging economies suggest that inflationary pressures upstream and deflationary pressures on industrial and other final products downstream will persist.
- The effects of the decline in raw material prices are reaching the domestic price level in Japan. Although declines in prices of petroleum, nonferrous metals, and other products—which are sensitive to and tend to be correlated with trends in international commodity markets—have paused, prices of other basic materials and machinery are on a declining trend, and the margins of decline in domestic corporate goods prices compared with the same period of the previous year have increased. Rates of change in consumer prices have also become negative as a result of the drop in corporate goods prices and deterioration in the domestic economy.
- Regarding monetary policy, the lifting of quantitative easing in March 2006 set in motion the process of normalizing monetary policy to raise

interest rates in Japan from their excessively low levels. However, as a result of the turbulence in financial markets triggered by the subprime loan crisis and the recognition of the risk of a downturn in the domestic and overseas economies, in October 2008, interest rates were lowered as part of Japan's stance of reinforcing and cooperating with the monetary policies of the United States and the countries of Europe. Also in line with this stance, a further reduction was implemented in December 2008. The Bank of Japan is expected to continue its policy of monetary easing until the turbulence in financial markets settles down and the uncertainty regarding the domestic and overseas economies subsides.

- Since the capacity of the economy for recovery is weak, and short-term interest rates are remaining stable at low levels, long-term interest rates are also expected to remain low. However, there is a possibility that deterioration in government fiscal positions around the world, as a result of the adoption of major economic stimulus measures, may place upward pressure on interest rates. In foreign exchange markets, as the turmoil in international financial markets continues in the latter half of 2008, the U.S. dollar and the yen strengthened, while the value of currencies of European and resource-producing countries declined. Recently, however, a reverse reaction has emerged. Amid this environment, differences in interest rates and current account imbalances among countries are diminishing. Policies adopted by various countries and their medium- to long-term economic prospects will likely rise in importance as determinants of directions in foreign currency market rates.

Exhibit 8: Outlook for Fiscal 2009-2010

	FY2006 (actual)	FY2007 (actual)	FY2008 (actual)	Forecast	
				FY2009 (forecast)	FY2010 (forecast)
	Yr/Yr, %				
Nominal GDP	1.5	1.0	-3.7	-4.5	0.1
Real GDP	2.3	1.8	-3.5	-3.8	0.9
Contribution of domestic demand	1.4	0.6	-2.2	-2.6	0.5
Private consumption	1.1	0.9	-0.5	-0.1	-0.1
Housing investment	-0.2	-13.5	-3.0	-6.2	3.1
Private capital investment	5.5	2.1	-10.3	-18.7	4.4
Contribution of inventory investment	0.2	0.1	-0.1	-0.3	0.0
Government expenditure	-0.9	0.5	-0.5	3.6	-0.6
Public investment	-8.8	-6.3	-4.5	10.7	-8.7
Government final consumption expenditure	1.1	2.1	0.4	2.1	1.3
Contribution of external demand	0.8	1.3	-1.3	-1.3	0.4
Export of goods and services	8.3	9.3	-10.2	-18.9	5.3
Import of goods and services	3.1	1.7	-3.5	-10.7	2.3
GDP deflator	-0.7	-0.9	-0.3	-0.7	-0.8

	FY2006 (actual)	FY2007 (actual)	FY2008 (actual)	Forecast	
				FY2009 (forecast)	FY2010 (forecast)
	Yr/Yr, %				
Current account balance (trillion yen)	21.2	24.5	12.2	9.0	11.4
balance on goods (trillion yen)	10.5	11.7	1.2	1.2	1.2
balance on service (trillion yen)	-2.3	-2.6	-2.2	-2.6	-2.2
balance on income (trillion yen)	14.2	16.8	14.6	11.9	13.8
Industrial production	4.6	2.7	-12.7	-14.9	2.9
Unemployment rate(%)	4.1	3.8	4.1	5.4	5.8
New housing starts(annualized, ten thousand units)	128.5	103.6	103.9	95.5	102.1
Domestic corporate goods prices	1.9	2.3	3.2	-5.5	0.9
Consumer prices	0.3	0.2	1.2	-1.5	-0.6
excluding freshfood	0.1	0.3	1.2	-1.6	-0.6
Yen/U.S.Dollar	116.9	114.2	100.5	94.6	96.8
Uncollateralized call rates (O/N) (%)*	0.209	0.505	0.363	0.100	0.100
Newly issued government bond yields (10years) (%)	1.77	1.60	1.46	1.45	1.53
WTI future price (near month contract, US dollar/barrel)	64.9	82.2	85.9	57.8	64.8
Dubai crude oil prices (US dollar/barrel)	60.9	77.3	82.1	56.7	62.1

* actual=average, forecast=end of period

Exhibit 9: Outlook for Calendar 2009-2010

	CY2006 (actual)	CY2007 (actual)	CY2008 (actual)	Forecast	
				CY2009 (forecast)	CY2010 (forecast)
	Yr/Yr, %				
Nominal GDP	1.1	1.7	-1.6	-6.4	-0.2
Real GDP	2.0	2.3	-0.7	-6.6	1.1
Contribution of domestic demand	1.2	1.2	-0.9	-4.0	0.5
Private consumption	1.5	0.7	0.6	-1.2	0.4
Housing investment	0.5	-9.7	-7.6	-4.9	1.1
Private capital investment	2.3	5.7	-4.0	-22.3	-0.2
Contribution of inventory investment	0.2	0.3	-0.2	-0.2	-0.1
Government expenditure	-0.9	0.1	-0.6	2.8	1.3
Public investment	-5.7	-7.3	-6.9	6.9	0.0
Government final consumption expenditure	0.4	1.9	0.8	1.9	1.6
Contribution of external demand	0.8	1.1	0.2	-2.6	0.6
Export of goods and services	9.7	8.4	1.8	-28.8	7.1
Import of goods and services	4.2	1.5	0.9	-14.1	1.7
GDP deflator	-0.9	-0.7	-0.9	0.2	-1.3

	CY2006 (actual)	CY2007 (actual)	CY2008 (actual)	Forecast	
				CY2009 (forecast)	CY2010 (forecast)
	Yr/Yr, %				
Current account balance (trillion yen)	19.8	24.8	16.4	8.4	10.4
balance on goods (trillion yen)	9.5	12.3	4.0	0.7	0.7
balance on service (trillion yen)	-2.1	-2.5	-2.1	-2.8	-2.3
balance on income (trillion yen)	13.7	16.3	15.8	11.8	13.5
Industrial production	4.5	2.8	-3.4	-24.8	5.2
Unemployment rate (%)	4.1	3.9	4.0	5.1	5.8
New housing starts(annualized, ten thousand units)	129.0	106.1	109.3	93.5	100.5
Domestic corporate goods prices	2.2	1.8	4.6	-5.4	-0.2
Consumer prices	0.3	0.0	1.4	-1.2	-0.8
excluding freshfood	0.1	0.0	1.5	-1.3	-0.8
Yen/U.S.Dollar	116.3	117.8	103.4	94.5	95.7
Uncollateralized call rates (O/N) (%)*	0.113	0.474	0.462	0.100	0.100
Newly issued government bond yields (10years) (%)	1.74	1.68	1.48	1.39	1.51
WTI future price (near month contract, US dollar/barrel)	66.2	72.3	99.6	53.3	63.3
Dubai crude oil prices (US dollar/barrel)	61.6	68.4	93.8	52.9	61.0

* actual=average, forecast=end of period

Exhibit 10: Outlook for 2009-2010 (Quarterly)

	Forecast											
	FY2008				FY2009				FY2010			
	4-6	7-9	10-12	1-3	4-6	7-9	10-12	1-3	4-6	7-9	10-12	1-3
Nominal GDP	-2.1	-1.5	-1.6	-2.9	-0.9	-0.4	-1.0	1.8	-1.0	-0.1	-0.1	1.9
	-0.9	-1.8	-3.6	-8.6	-6.3	-6.1	-4.7	-0.7	-0.6	-0.2	0.5	0.7
Real GDP	-0.9	-0.6	-3.8	-4.0	0.5	0.7	0.0	0.7	-0.1	0.1	0.3	0.5
	0.6	-0.3	-4.3	-9.7	-7.5	-6.7	-2.5	1.7	1.2	0.7	0.8	0.8
Contribution of domestic demand (Qr/Qr,%)	-1.4	-0.6	-0.6	-2.6	-0.6	0.2	0.1	0.7	-0.2	0.0	0.2	0.4
Private consumption	-1.0	0.1	-0.8	-1.1	0.5	0.5	0.1	0.4	-0.8	0.1	0.1	0.2
	0.3	0.7	-0.3	-2.8	-1.2	-0.8	0.1	1.6	0.3	-0.1	-0.1	-0.3
Housing investment	-2.0	3.1	5.5	-5.4	-4.5	-2.0	0.8	1.0	2.0	0.2	0.3	0.7
	-16.5	-5.5	11.7	0.8	-1.8	-6.6	-10.8	-4.7	1.7	4.0	3.5	3.2
Private capital investment	-2.9	-4.4	-6.7	-10.4	-5.7	-2.8	-0.7	1.2	1.7	1.0	2.1	2.7
	0.4	-4.2	-11.8	-22.6	-24.7	-23.2	-18.4	-8.0	-0.6	3.4	6.3	7.7
Contribution of inventory investment (Qr/Qr,%)	-0.2	0.0	0.4	-0.2	-0.2	-0.1	-0.1	0.1	0.1	0.0	0.0	0.1
Government expenditure	-0.7	0.0	1.3	0.2	1.0	1.6	0.6	0.6	-0.1	-0.9	-0.8	-0.9
	-1.2	-0.8	-0.8	0.8	2.4	4.0	3.9	4.1	2.5	0.3	-1.6	-3.1
Public investment	-0.8	1.0	-0.1	0.0	4.0	5.4	2.9	0.7	-2.8	-4.8	-5.5	-5.6
	-8.3	-6.6	-4.6	0.2	4.7	9.2	12.9	13.4	6.1	-4.2	-11.8	-17.4
Government final consumption expenditure	-0.8	-0.2	1.6	0.3	0.3	0.8	0.1	0.6	0.4	0.0	0.3	0.1
	0.1	0.4	0.2	0.9	2.0	3.0	1.6	1.9	2.0	1.2	1.3	0.8
Contribution of external demand (Qr/Qr,%)	0.5	-0.1	-3.3	-1.4	1.2	0.5	-0.1	0.0	0.1	0.1	0.1	0.1
Export of goods and services	-0.8	1.0	-14.7	-26.0	7.0	5.1	0.3	0.6	1.1	1.4	1.5	1.6
	5.9	4.4	-12.6	-36.5	-31.9	-29.1	-16.6	13.5	7.3	3.5	4.7	5.7
Import of goods and services	-4.2	1.5	3.1	-15.0	-2.0	0.9	0.7	0.4	0.4	0.6	0.7	0.7
	-2.0	0.0	2.9	-14.9	-12.7	-13.3	-15.3	0.0	2.4	2.1	2.2	2.4
GDP deflator (Yr/Yr,%)	-1.5	-1.5	0.7	1.1	1.3	0.6	-2.2	-2.4	-1.8	-0.9	-0.3	-0.1

	Forecast											
	FY2008				FY2009				FY2010			
	4-6	7-9	10-12	1-3	4-6	7-9	10-12	1-3	4-6	7-9	10-12	1-3
Current account balance (trillion yen)*	5.0	4.0	2.1	1.7	2.4	2.5	2.1	2.3	2.7	2.9	2.9	3.2
balance on goods (trillion yen)*	1.8	0.8	-0.7	-0.5	0.8	0.5	-0.1	-0.1	0.2	0.4	0.2	0.5
balance on service (trillion yen)*	-0.5	-0.4	-0.5	-0.8	-0.7	-0.6	-0.6	-0.6	-0.6	-0.6	-0.5	-0.5
balance on income (trillion yen)*	4.0	4.0	3.6	3.2	2.7	2.9	3.1	3.3	3.4	3.5	3.5	3.6
Industrial production (Qr/Qr, %)	-1.3	-3.2	-11.3	-22.1	6.2	5.6	0.2	0.3	0.4	0.4	0.6	0.7
(Yr/Yr, %)	0.8	-1.4	-14.5	-34.6	-29.2	-21.7	-12.1	12.3	6.3	1.8	1.8	1.8
Unemployment rate (%)*	4.0	4.0	4.0	4.4	5.0	5.3	5.6	5.8	5.8	5.8	5.8	5.7
New housing starts(annualized, ten thousand units)	112.0	110.2	101.0	90.4	92.9	93.0	97.4	99.3	99.4	99.6	103.6	106.6
Domestic corporate goods prices (Yr/Yr,%)	4.9	7.3	2.6	-1.8	-5.1	-8.7	-5.8	-2.1	-0.7	0.4	1.7	2.0
Consumer prices (Yr/Yr,%)	1.4	2.2	1.1	-0.1	-1.2	-2.0	-1.5	-1.2	-0.7	-0.6	-0.5	-0.4
excluding freshfood (Yr/Yr,%)	1.5	2.3	1.0	-0.1	-1.3	-2.1	-1.5	-1.3	-0.7	-0.6	-0.5	-0.4
Yen/U.S.Dollar	104.5	107.6	96.1	93.6	97.0	94.5	93.0	94.0	95.3	96.3	97.3	98.3
Uncollateralized call rates (O/N) (%)**	0.507	0.501	0.333	0.110	0.100	0.100	0.100	0.100	0.100	0.100	0.100	0.100
Newly issued government bond yields (10years) (%)	1.61	1.51	1.43	1.28	1.41	1.43	1.45	1.50	1.50	1.50	1.55	1.55
WTI future price (near month contract, US dollar/barrel)	124.0	118.0	58.7	43.1	54.0	57.0	59.0	61.0	63.0	64.0	65.0	67.0
Dubai crude oil prices (US dollar/barrel)	116.9	113.8	53.3	44.4	53.4	56.0	58.0	59.5	61.0	61.5	62.0	64.0

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