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Forecast for the Japanese Economy in Fiscal 2010 and 2011

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

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

(1) Current State of the Economy: Recovery Momentum Weakens

(a) Recent Trends

Real GDP growth for the April-to-June period was +0.1% over the previous quarter (+0.4% at an annualized rate). Although positive growth continued for the third consecutive quarter, the rate of increase declined substantially.

Examining the contribution to real GDP of the domestic versus the external sectors, the contribution of the domestic sector was –0.2 percentage point, and it acted as a drag on growth for the first time in three quarters. External demand (net exports = exports – imports) contributed +0.3 percentage point, thus supporting growth for the fifth consecutive quarter. Therefore, the latest GDP data show firmness in external demand but relative weakness in domestic demand.

Turning first to domestic demand, personal consumption was virtually level, standing +0.0% above the previous quarter. Although the positive effects of subsidies for the purchase of new automobiles, the eco-point system, and other government policies were continuing, since the rate of growth in consumer durables has been high in comparison with the previous quarters, the rate of growth has paused, as might have been expected. In addition, although the employment and income environments have passed through the worst phase of the downturn, reflecting their lackluster pace of improvement, expenditures on services and other items are continuing to be weak. Moreover, reflecting the lack of resilience in housing starts, private residential investment began to decline again and dropped 1.3% from the previous quarter.

Although corporations still have a strong feeling of excess capacity, industrial production is on a rising trend and corporate profitability is recovering rapidly. As a result, private capital investment is showing a moderate rising trend and increased 0.5% for the April-to-June quarter, the third consecutive quarterly increase. While the movement toward inventory adjustments that had continued for a time following the collapse of Lehman Brothers Holdings has run its course, corporations are continuing to maintain a cautious stance regarding building up inventories, and the contribution of inventory investment to real GDP for the quarter was –0.2 percentage point, the first negative figure in two quarters. Overall public-sector demand declined 0.5% for the quarter, the first decrease in three quarters. Although government consumption expenditures are continuing to rise, posting a gain of 0.2% for the quarter, public investment fell 3.4% for the quarter, the fourth quarter-to-quarter decline, reflecting the diminishing positive effects of economic policies and further major cuts in budgetary allocations for the current fiscal year.

Next, the external sector is continuing to make a positive contribution to real GDP growth. Although imports are continuing to rise, posting a gain of 4.3% for the quarter, supported by improvement in the domestic economy and other factors, exports continued to support the growth rate and were up 5.9% for the quarter, mainly on the strength of increased exports to Europe and the United States, despite a slight deceleration in exports to the rest of Asia. As a result, the contribution of the external sector to real GDP was +0.3 percentage point for the quarter.

The nominal GDP declined 0.9% from the previous quarter (–3.7% at an annualized rate), thus posting the first negative figure in three quarters. In addition, the GDP deflator, which shows trends in prices in the overall economy, was 1.8% below the level of the same quarter of the previous year, which was a smaller margin of decline than in the previous quarter, reflecting a milder pace of decrease in domestic prices. However, compared with the previous quarter (on a seasonally adjusted basis), the deflator began to decline and was down 1.0%, suggesting there has been no major change in the underlying deflationary conditions.

(b) The Economy Is Recovering, But Reporting of Weak Indicators Continues.

After reaching bottom in early spring 2009, the economy has been in a recovery phase, but beginning in and following the April-to-June quarter of 2010, announcements of economic indicators suggesting a weakening in the momentum of recovery have become prominent. The GDP quick estimate (QE) data for the April-to-June quarter provide support for these indicators.

First, the industrial production index has clearly begun to lose momentum. Industrial production rose 1.5% from the previous quarter in the April-to-June period, a sharp drop from the 7.0% gain reported in the January-to-March quarter. Judging from the results of the survey of production forecasts and other information, there is a possibility that industrial production in the July-to-September period may decelerate further and stand approximately level with the previous quarter. At the same time, exports, which have been the driving force for the recovery in industrial production, are showing signs of a pause in growth. In June, real exports were 0.3% below those of the previous month, which was the first negative figure in one year and four months.

Turning to the employment situation, the unemployment rate in June was 5.3%, the fourth consecutive month-to-month deterioration. Even though employment conditions have moved out of the worst phases of the downturn, they continue to be difficult, and the rate of increase in the unemployment rate is especially high among the younger age-groups. In addition, other indicators, such as the number of housing starts and orders for machinery and equipment, remain lackluster after losing the momentum they showed after the recovery began. Moreover, although public investment has peaked out, further declines are forecast, reflecting the deep cuts in the government budget.

As a result of the effects of the sharp deterioration in economic conditions following the collapse of Lehman Brothers Holdings, there is a possibility that, on a seasonally adjusted basis, economic indicators for the

January-to-March quarter of this year may tend to be high, while those for the April-to-June quarter may be lower than would have been case otherwise. However, even taking this possible effect into account, it is clear that the momentum of the recovery is beginning to weaken, and this may bring concerns about a slowdown in the economy.

On the other hand, there are some positive signs. Wages are continuing to improve, albeit at a moderate pace. In June, total cash compensation per worker was up 1.8% compared with the previous year, the fourth consecutive monthly increase. Unscheduled compensation and special wage payments, principally summer bonuses, have begun to rise. According to the QE, real worker compensation has now increased for two consecutive quarters, rising a high 1.9% over the previous quarter in the January-to-March period, and then increasing 0.3% in the April-to-June quarter.

In addition, also according to the results of the QE, although personal consumption stood at the same level as in the previous quarter, it should come as no surprise if consumption should pause, considering the high rates of expansion thus far. From July onward, in addition to the positive effects of government policies on sales of automobiles and flat panel display (FPD) TVs, sales of other consumer durables, such as air conditioners, have continued to improve as a result of the unseasonably hot summer weather. Also, considering that a surge in demand for automobiles is forecast approaching the end of September, it is possible that consumer spending in the July-to-September quarter may begin to rise again.

With consumer spending providing support for the economy, the recovery trend is likely to continue through the first half of fiscal 2010. However, causes for concern will include the trends in the latter half of the fiscal year in view of the outlook for such developments as a reactionary decline in automobile sales, a fall in demand for consumer durables as the summer heat subsides, and the impact of the appreciation of the yen.

(2) Economic Outlook: Economy May Mark Time in the Second Half of the Fiscal Year as the Positive Impact of Policy Measures Diminishes

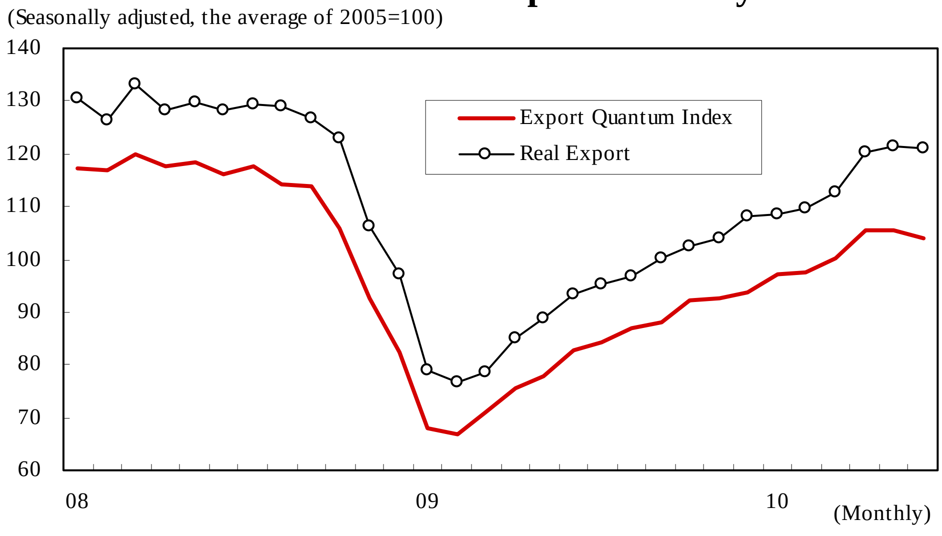
As concerns regarding future trends in the economy increase, key issues to keep in mind when considering developments going forward include: (1) What trends will emerge in Japan’s exports as uncertainties grow regarding future trends in overseas economies and if the yen appreciates further? (2) As corporate performance continues to improve, when will private capital investment recover? (3) How should we appraise the impact of the diminishing of the positive impact of government policies, which appears to be a virtual certainty? (4) Will employment and income conditions continue to improve?

In the following paragraphs, we analyze these issues.

(a) Loss of Momentum in Exports and the Appreciation of the Yen

The momentum of recovery in exports is pausing. On a real GDP basis, exports rose 5.9% in the April-to-June quarter, suggesting the continuation of a steady recovery. However, on a month-by-month basis, both the indexes of export unit volumes and exports in real terms were expanding steadily through April, but in May and June, they paused at approximately the level of April (Chart 1).

Chart 1: Momentum of Export Recovery Pauses



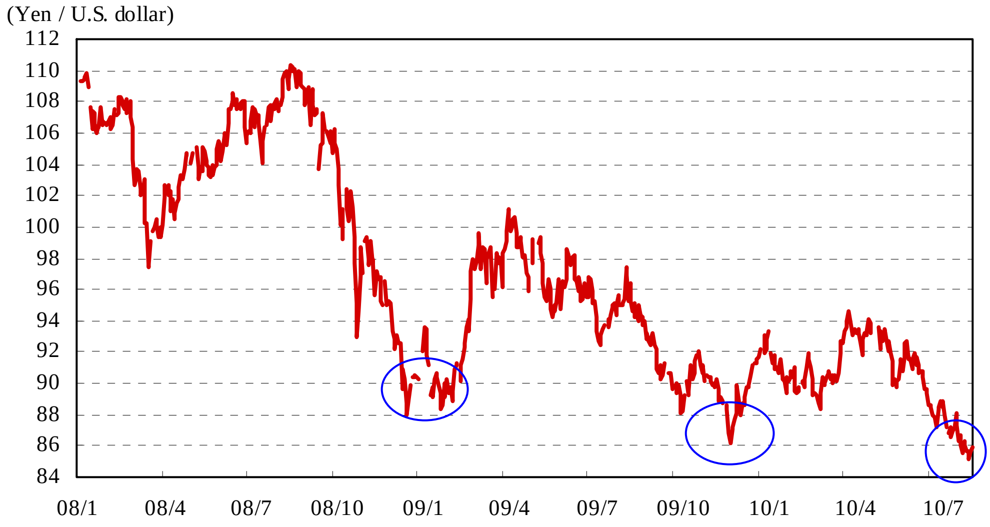
Source: Ministry of Finance, "Trade Statistics",
Bank of Japan, "Financial and Economic Statistics Monthly"

After considering such factors as the pause in the trend toward replenishing inventories in overseas markets and the fact that exports in some industries have been restrained by supply constraints, it appears that recent movements in export indicators may be due to temporary factors. Nevertheless, some reasons for concern regarding exports have emerged recently, and there are clearly justifications for being concerned about whether exports will return to their previous growth path in the July-to-September and subsequent quarters. One of these concerns is the appreciation of the yen, and another is trends in overseas economies, including those of the United States and China. These concerns have mounted since the summer of 2010, and, if these two factors are going to have an impact, it will emerge from now onward.

Turning first to yen appreciation: reflecting uncertainties regarding future trends in overseas economies and anticipated increases in interest rates, the yen appreciated temporarily to a recent high of ¥84 to US$1, the strongest it has been in approximately 15 years. Both the government and the Bank of Japan (BOJ) have successively issued statements reflecting their growing concern with the upward revaluation of the yen. A consensus is emerging that, if the yen appreciates further, they may intervene by selling yen into the market. However, the United States and the countries of Europe have accepted the depreciation of their currencies and appear to be looking toward export-led economic recoveries. Accordingly, the prevailing view now is that there will be limitations on the effectiveness of market intervention if Japan acts alone.

Currently, the yen is about ¥10 to the U.S. dollar stronger than at the beginning of the fiscal year. If the yen appreciates to the middle of the ¥80-to-¥90 range, this value will be generally close to the levels prevailing from the end of fiscal 2008 through the beginning of fiscal 2009 and in November 2009 (Chart 2). Even though this is the strongest value of the yen in 15 years, it is quite close to the level experienced twice over the past two years, and it appears that exporting companies may have developed sufficient resistance during the recent round of yen appreciation.

Chart 2: Recent Trends in the Yen/U.S. Dollar Rate



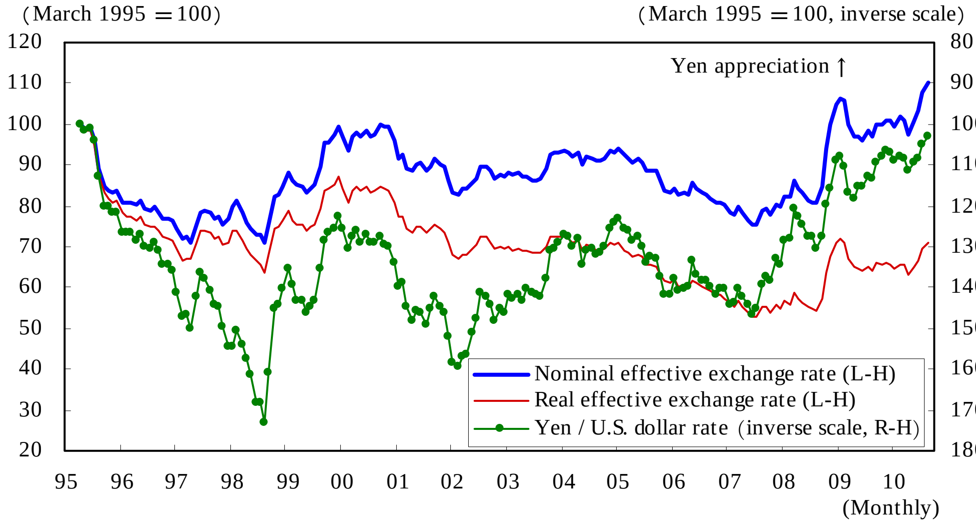
Note: Data are the closing rates of Tokyo foreign exchange market.
Source: Bank of Japan, "Financial and Economic Statistics Monthly"

Moreover, examination of movements in the nominal effective exchange rate* of the yen shows that the current level has already exceeded the level in March 1995, and that, on a trade-weighted basis, the yen has appreciated against the currencies of its main non-U.S. trading partners more than it has appreciated against the U.S. dollar (Chart 3). This reflects the fact that the yen has appreciated even more against the euro and other non-U.S. dollar currencies than it has against the U.S. dollar. However, examination of the real effective exchange rate** shows that the yen has not actually appreciated that much. The difference between these two measures of yen appreciation reflects the fact that price increases in the countries that trade with Japan have been relatively high, while the rate of price increase in Japan has been relatively low.

*The nominal effective exchange rate is calculated by computing a trade-weighted geometric average of the exchange rates between the yen and other major currencies with weights based on the percentage of trade in these currencies, and then converting the averages over time to index form. If the index rises, this implies that the yen is increasing in value vis-à-vis other currencies.

**The real effective exchange rate is computed as a trade-weighted geometric average of the exchange rates between the yen and other major currencies, but the exchange rates are adjusted for the difference between the rates of price increase in countries trading with Japan and the rate of price increase in Japan, and then the averages over time are converted to index form.

Chart 3: Level of Currency Indexes (March 1995 = 100)

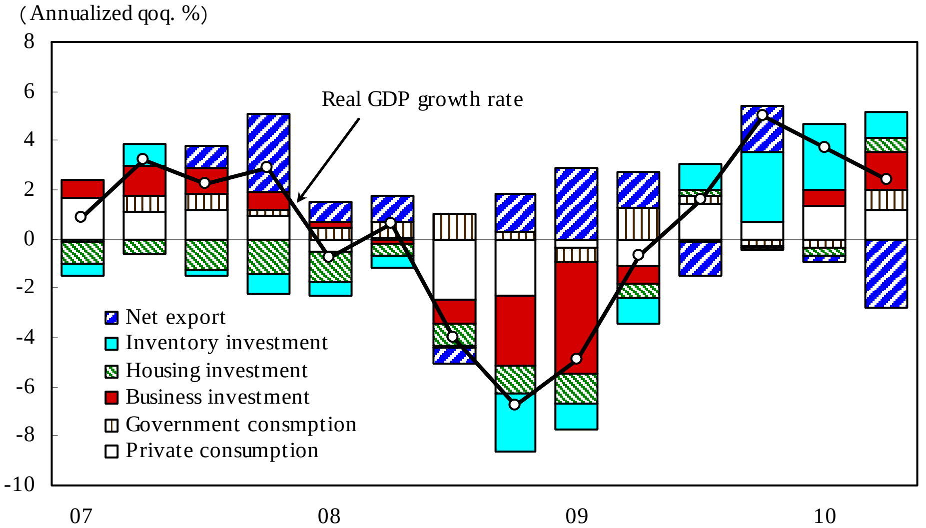


Note: Data for July and August 2010 are estimated based on the yen / U.S. dollar spot rates.
Source: Bank of Japan, "Financial and Economic Statistics Monthly"

Accordingly, even if the yen appreciates further from recent levels, provided those levels do not persist, there appears to be little reason to believe that Japan's exports will suffer severe damage. The current levels are generally within the high range for the yen, and we are forecasting that, going forward, excessively high values of the yen will gradually undergo adjustments.

Next, let us turn to the issue of the impact of trends in overseas economies on exports from Japan. In the United States, during the April-to-June quarter, the real GDP grew, on a quarter-to-quarter basis, at an annualized rate of 2.4%, suggesting that the pace of expansion in the economy was weakening (Chart 4). The reason for the slowdown in the pace of growth was the delay in recovery of employment. However, improvement in incomes is continuing at a moderate pace, thus providing support for consumer spending, and we believe there should be little concern about a double-dip recession. Nevertheless, if financial markets experience stronger destabilizing shocks, such as a recurrence of credit market uncertainty in Europe, this may bring downward pressure on economies around the world as a result of a possible credit contraction.

Chart 4: Trends in the U.S. Real GDP Growth Rate



Source: U.S. Department of Commerce

Moreover, real GDP growth in the Chinese economy during the April-to-June quarter was 10.3%, the third consecutive double-digit increase. Along with this, domestic demand in China for infrastructure investment, consumer durables, and other goods and services remains strong, and there are clear signs of recovery in exports along with the expansion in the world economy. To respond to concerns about overheating in the economy, the Chinese government has implemented a number of policies, including increasing bank reserve deposit ratios since the beginning of the year, using administrative guidance to restrain bank lending, and enacting policies to restrain real estate speculation in April. As a result of these various measures, concerns about the emergence of an economic bubble have receded, and it appears that China will be successful in making a soft landing. Even so, the outlook is for high growth to continue, at an average pace of 9% annually.

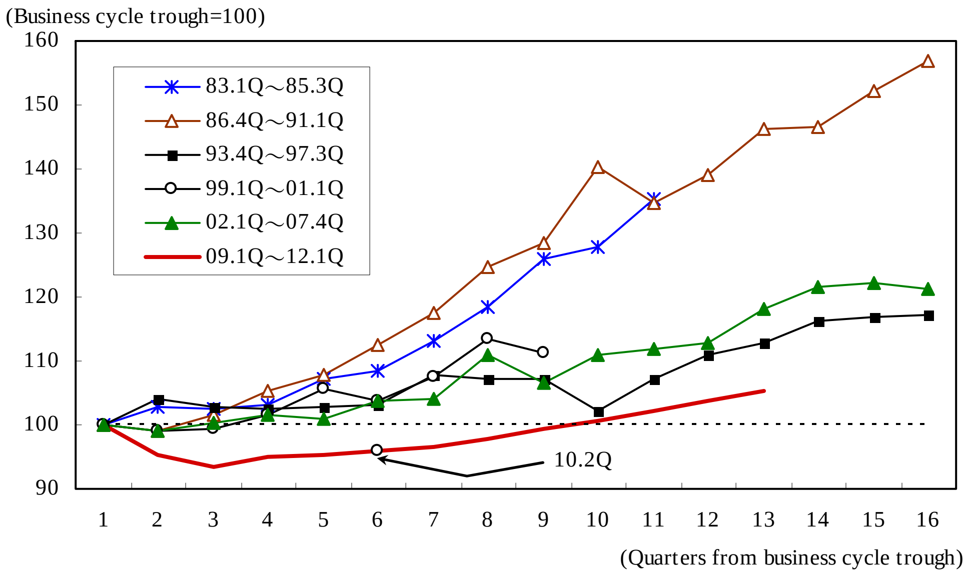
In other overseas economies, the pace of recovery may weaken somewhat in the latter half of this fiscal year; however, the risk of a loss of momentum is small, and it appears that there will be no major concerns regarding exports from Japan.

(b) Recovery in Corporate Performance and Sluggish Capital Investment: Corporations Still Adopting a Cautious Stance

Private capital investment in real terms during the April-to-June period reported its third consecutive quarter of increases, but, compared to previous recovery periods, the rate of expansion is relatively weak (Chart 5). Although improvement in corporate performance is continuing, owing to the recovery in sales and cutbacks in personnel and other fixed expenses, corporations are still restraining their capital outlays. Reasons for this are that companies are still reporting a feeling of having excess production capacity and that the appreciation of the yen is making corporations more cautious about investing in Japan.

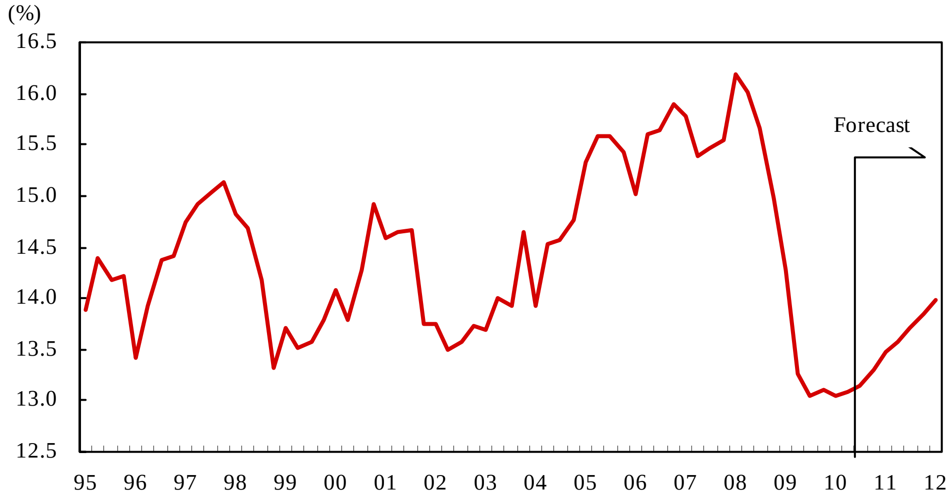
Into fiscal 2011, improvement in corporate performance is expected to continue, and the rate of capacity utilization will also rise. For these reasons, the outlook is for the upward trend in capital investment to continue. However, the rate of expansion will be moderate, and private capital investment will continue to lack the strength needed for it to drive overall economic growth. Also, an examination of trends in the capital investment ratio shows that it has now fallen to a low level, but even if it should rise, the pace of increase is still expected to be moderate (Chart 6).

Chart 5: Trends in Capital Investment during Recovery Phases



Note: Regarding the latest cycle, we assume that the trough was in the first quarter of 2009.
Figures after the third quarter of 2010 are our own forecasts.
Source: Cabinet Office, "Quarterly Estimates of GDP"

Chart 6: Capital Investment Ratio Remains at a Low Level



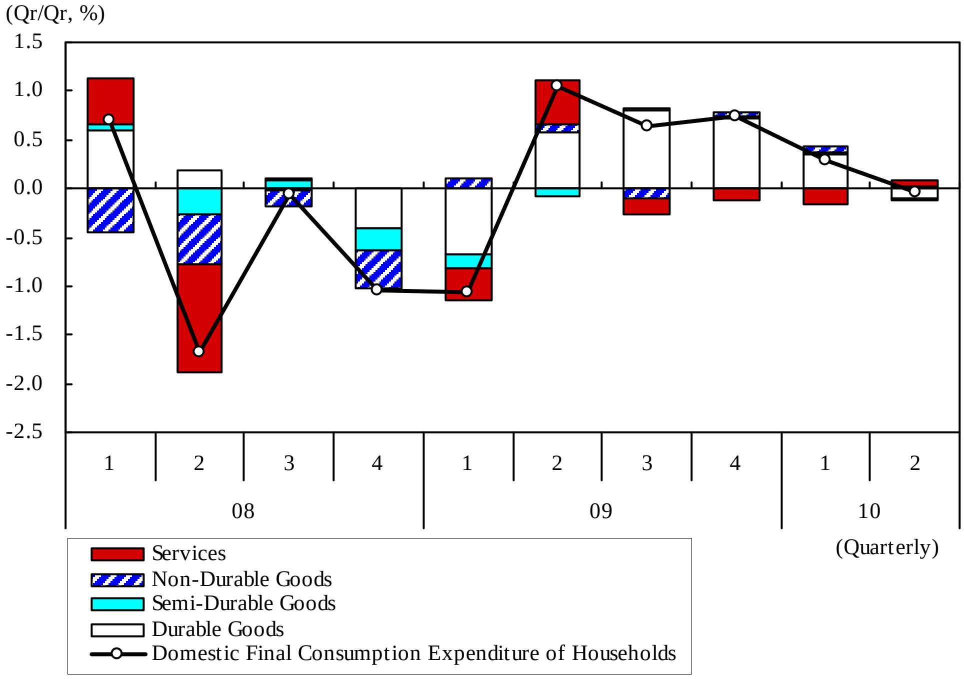
Note: Business investment ratio ＝Real business investment / Real GDP * 100

Source: Cabinet Office, "Quarterly Estimates of GDP"

(c) Expected Diminishing of the Positive Effects of Government Policies: Can the Economy Withstand the Temporary Slump?

During the April-to-June period of 2010, because of a drop in spending on durable goods of 1.3%, the first decline in five quarters, consumer spending remained at about the same level as in the previous quarter (Chart 7). Spending on consumer durables, however, remains at a high level, supported by the positive effects of government policies. Nevertheless, the outlook is for consumer spending to remain firm during the July-to-September quarter because of a surge in demand for automobiles in advance of the expiration of subsidies for the purchase of eco-friendly automobiles and the positive impact of the hot summer weather on sales of air conditioners.

Chart 7: Breakdown of Real Personal Consumption

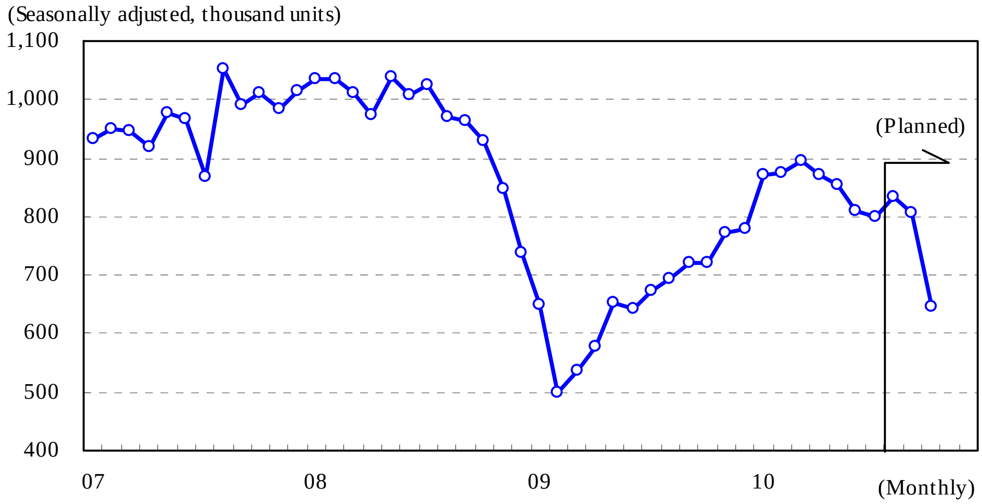


Source: Cabinet Office, "Quarterly Estimates of GDP"

However, there are strong concerns that these purchases of big-ticket durable goods may be eating into future demand. For this reason, in October and later months, the outlook is, first, for a major drop in demand for automobiles. Then, after the beginning of 2011, a reactionary decline is also forecast in FPD TVs, thus making a temporary slump in consumer spending inevitable. Examination of plans for automobile production shows that after a rise in August to cope with the expected surge in demand, production will begin to decline in September, and, in October, plans call for major cutbacks in output (Chart 8). The automobile industry has many links with other industries, and because of its effects on other sectors, there is a possibility that a temporary, major drop in production may occur beginning in the fall. In addition, after the beginning of 2011, a slump in eco-friendly household appliances, especially FPD TVs, may set in.

Issues that recently come to the fore are whether this slump in production and sales will be just temporary; whether the downturn in production may accelerate, leading to a prolonged period of adjustment; or whether the adjustment may lead to deterioration in the economy as a whole. We believe that the answers to the questions being raised will depend on the extent of progress toward improvement in the environment for consumer spending, which is discussed in the next section.

Chart 8: Production Cutbacks Planned in the Automobile Industry Beginning in the Fall



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

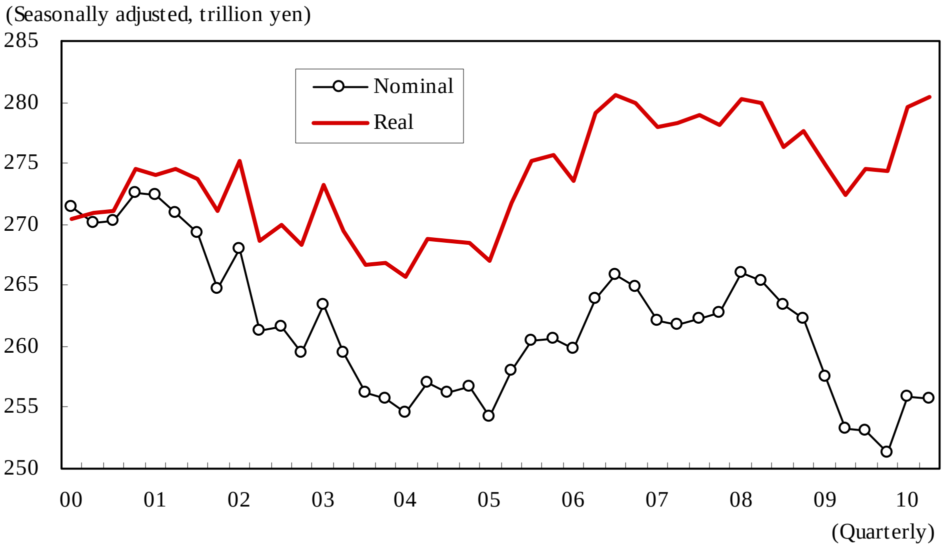
(d) Pause in Improvement in the Employment Situation: Rising Trend in Incomes to Continue

Although the employment situation has passed through the worst phases of the downturn and is on an improving upward trend, the unemployment ratio is continuing to rise, and the trend toward improvement appears to be marking time. Among various labor market segments, the situation for the younger age-groups appears is the severest. Although the ratio of new graduates finding employment rose sharply this fiscal year, the unemployment ratio among persons aged 15 to 24 stood at 11.1%, the highest level in history. However, there is some good news, such as the fact that the ratio of job offers to job seekers, while still relatively low, is continuing to rise.

On the other hand, total cash compensation per worker has risen for four consecutive months, from March through June. Other good news is that unscheduled compensation and special wage payments, principally summer bonuses, have also begun to rise. On a real basis, compensation of employed persons has already recovered to the level prevailing just prior to the collapse of Lehman Brothers Holdings, and is forecast to rise to the highest levels in history during the current fiscal year (Chart 9).

The share of labor rose temporarily in fiscal 2008 accompanying the deterioration in economic conditions, but is expected to decline going forward (Chart 10). As the feeling remains strong among corporations that their worker head counts are too high and companies continue to work to cut costs, the pace of improvement in employment and income conditions is expected to remain weak.

Chart 9: Recovery in Real Worker Compensation Continues



Source: Cabinet Office, "Quarterly Estimates of GDP"

Chart 10: Trends in the Share of Labor

Note: Labor share ＝Nominal compensation of Employees / Nominal GDP * 100

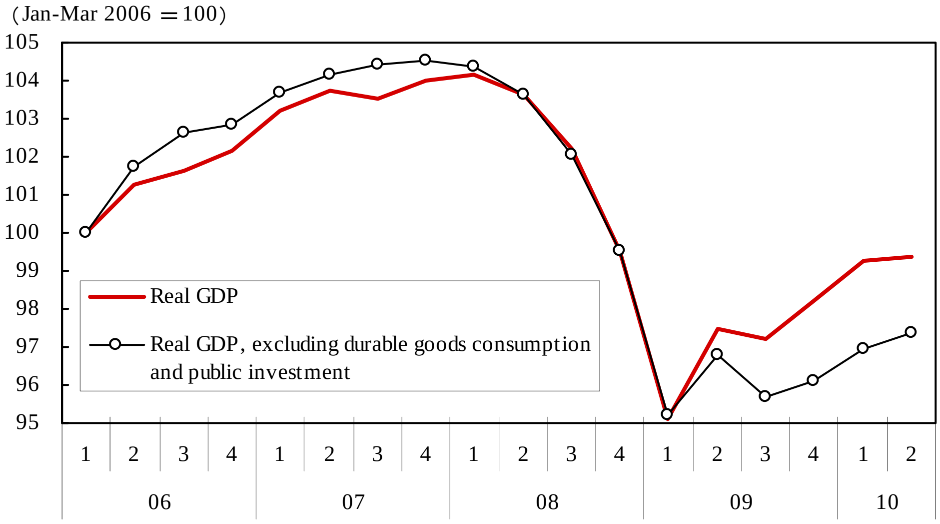
Source: Cabinet Office, "Quarterly Estimates of GDP"

However, along with the gains in corporate performance, moderate-but-steady improvement in employment and income conditions is expected to continue. For this reason, we believe that the reactionary decline in consumer spending that is forecast in the latter half of fiscal 2010, as the positive effects of government economic policies diminish, will be temporary and will not lead to an overall loss of momentum in the economy. There is a possibility that the rate of improvement in employment and income conditions will accelerate during fiscal 2011 and contribute to boosting consumer spending.

(e) Even after Excluding Policy Effects, the Economy Is Recovering.

Thus far, we have commented on the four key issues to keep in mind when considering developments going forward. To conclude this section, let us look at trends in indicators after the exclusion from GDP as a whole of the effects of public investment and consumer durables consumption, which had particularly large positive effects early in the recovery. Through this analysis, we can see that since the beginning of fiscal 2009, trends in real GDP have diverged, as the positive effects of government policies had a quite strong boosting effect (Chart 11). Notwithstanding this, recovery on a real GDP basis, excluding public investment and consumer durables, has proceeded. During the latter half of the current fiscal year, real GDP overall is forecast to move into a period of stagnation as the effects of economic policies diminish. However, real GDP, excluding public investment and consumer durables consumption, is forecast to continue to recover, and this trend is expected to lead to a self-sustaining economic recovery in fiscal 2011.

Chart 11: Economic Recovery Excluding the Positive Effects of Government Policies



Source: Cabinet Office, "Quarterly Estimates of GDP"

(3) Outlook for Fiscal 2010 and Fiscal 2011: Movement toward Self-Sustaining Recovery in Fiscal 2011

In fiscal 2010, although gradual recovery will continue in the July-to-September quarter, there are concerns that the momentum of the recovery may weaken temporarily in the second half of the fiscal year because of the diminishing positive effects of government policies.

Exports will not suffer a loss of momentum, despite growing uncertainties about future trends in overseas economies, and will continue to increase gradually. Since the yen will remain within its high range, this will be a factor restraining exports, and, although growth will weaken in the latter half of the fiscal year, demand in emerging economies will remain firm. Provided the appreciation of the yen beyond ¥80 to the U.S. dollar can be avoided, exports are expected to continue on an upward trend. Imports will also remain on a rising trend as domestic demand improves, but, during the latter half of the fiscal year, import growth will slow, reflecting the weakening of domestic demand. External demand will contribute +1.2 percentage points to growth for the fiscal year, and it is expected to continue to be the driving force for the economy.

Personal consumption, although virtually level during the April-to-June quarter, will remain at a high level, particularly purchases of big-ticket consumer durables as a result of the positive impact of government policies. Consumer spending will begin to rise again in the July-to-September quarter as a result of the surge in demand for automobiles toward the end of September and increases in sales of air conditioners and refrigerators stimulated by the hot summer weather and the positive impact of the eco-point system. Nevertheless, despite tough employment and income conditions, consumer spending is holding firm, but there are concerns that this may result in lower consumption in the future. For this reason, during the second half of the fiscal year, first, a major reactionary decline in demand for automobiles is expected to set in. In addition, after the beginning of 2011, another reactionary decline in demand is expected for eco-friendly household appliances, including FPD TVs. As a result, a temporary slowdown in consumer spending will be unavoidable. This weakness in consumption is forecast to reduce the growth rate of real GDP in the second half of the fiscal year, keeping it virtually level over this period.

Industrial production will continue on an expansionary trend through the July-to-September quarter. However, as a result of the diminishing positive effects of economic policies, production cutbacks are forecast to begin in the automobile industry in October and in the eco-friendly household appliance industry, including FPD TVs, after the beginning of 2011. The upward trend in exports will continue through the latter half of the fiscal year, and is expected to support production levels, but, even so, there is a possibility that production will show some declines from the previous period in the latter half. As a consequence, corporate performance is likely to show further gains, but the pace of improvement will slow. Note that there is a possibility that the eco-point system may be extended, but, if we take into consideration the fact that the household ownership rate of FPD TVs is rising, even with an extension, sales of these TVs may gradually peak out, and lose their effectiveness as a factor boosting the economy.

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

Public works investment is expected to show further declines since major cuts were made in the fiscal 2010 budget. Government final consumption will continue to rise, but expenditures by the public sector as a whole will show further declines, and will act as a drag on the economy.

As these comments suggest, the outlook is for domestic demand to weaken significantly, especially in the latter half of the fiscal year. The contribution of domestic demand to GDP growth for the fiscal year will be +0.6 percentage point (+0.9 percentage point from the private sector and –0.3 percentage point from the public sector). However, as mentioned previously, the upward trend in exports will continue, and private-sector demand, including capital investment and residential investment, will continue to rise gradually. Even if the economy begins to mark time in the second half of the year, it should not experience a serious loss of momentum. On the contrary, although negative developments, such as the diminishing effects of economic policies and the appreciation of the yen, will tend to be the most prominent, behind the scenes, the economy is moving toward a self-sustaining recovery as corporate performance and the income environment show further improvement. For these reasons, the diminishing effects of government policies will not lead to a downward spiral of deterioration in the economy, and the economy's moving into a lull and marking time will be only a temporary phenomenon.

Our forecast is for real GDP growth of 1.7%, in fiscal 2010, the first positive growth in three years (Chart 12). Compared with fiscal 2009, the growth rate will rise sharply, but this will be due to the influence of a carryover effect of +1.3%. Calculating the growth rate during the fiscal year to take account of this carryover, real growth in fiscal 2010 will be a more-moderate +0.5% (Chart 13). Especially during the latter half of the fiscal year, the rate of growth is forecast to level off temporarily.

The nominal GDP growth rate for the fiscal year will be +0.0%, the first positive growth in three years by a thin margin, but the deflator will decline 1.7%, reflecting the continuation of deflationary pressures.

<u>In fiscal 2011</u>, the economy is forecast to move back onto a self-sustaining growth path, and deflationary pressures will subside.

Exports and private-sector demand are expected to act as driving forces for the economy in fiscal 2011. Our view is that the increase in exports will continue, as recovery proceeds in overseas economies, and the value of the yen undergoes gradual downward adjustment. Exports to the rest of Asia, particularly the emerging economies in this region, are forecast to remain especially strong. The increase in exports is expected to bring improvement in domestic demand in Japan as it brings expansion in production and gains in corporate profits. On the other hand, imports are expected to show firm expansion, reflecting the rise in domestic demand. External demand will contribute +0.5 percentage point to growth for the fiscal year, smaller than the +1.2 percentage points in the previous fiscal year.

Employment and income conditions will show a relatively weak pace of improvement, because of the strong feeling among corporations that they have excessive personnel. However, as corporations make gains in performance, the employment and income environments are expected to continue to move toward improvement. Overtime pay and bonuses as well as scheduled wage payments are expected to rise above the levels of the previous year, and the increase in incomes will bring gains in consumer spending. For this reason, consumer spending, which moved into a slump in the latter half of fiscal 2010, is expected to show gradual recovery as consumer confidence improves. Expenditures on automobiles and other major consumer durables will remain weak, but expenditures for services and other items, which had tended to be restrained previously, will begin to show improvement. Note that the outlook is for the full payment of child allowances to be postponed, and these will, therefore, not be a factor boosting consumer spending.

The rising trend in private capital investment is expected to continue, as corporate performance shows further improvement and rates of capacity utilization rise. The feeling of excess capacity among corporations will diminish, and companies will resume investments that they have been postponing. As a consequence, there is a possibility that the rate of increase in capital investment spending may rise to some extent. In addition, residential housing investment is expected to show a stronger trend toward improvement, especially in the condominium market segment, where the completion of adjustments in inventories of unsold units is in sight.

As these comments suggest, private-sector demand overall will escape from stagnation in the latter half of fiscal 2010, and there is a strong possibility that the economy will move onto a path of self-sustaining expansion in fiscal 2011. Private-sector demand is forecast to report firm growth in fiscal 2011, and it will contribute +1.4 percentage points to overall expansion.

On the other hand, public investment is expected to continue to be restrained because of the weakness in the financial positions of the national and local governments. Although the pace of decline in public investment may diminish, as one would expect, it will remain a negative factor for the economy. Government final consumption expenditures, principally social security costs, will continue to expand, but expenditures of the public sector as a whole are expected to shrink. The contribution of the public sector to overall growth will remain stagnant at –0.2 percentage point.

We are forecasting real growth of +1.7% in fiscal 2011, the same as in the previous fiscal year. However, this growth rate reflects a carryover effect of +0.3, smaller than in the previous year. Calculating the growth rate during the fiscal year to take account of this carryover, real growth in fiscal 2011 will be +1.4%, which will be substantially higher than the growth rate in fiscal 2010 after adjustment for the carryover in that year. As mentioned previously, the contribution of external demand will be +0.5 percentage point and that of the public sector will be –0.2 percentage point. In contrast, the contribution of private-sector demand is expected to rise to +1.4 percentage points, implying the economy will take major steps toward a self-sustaining recovery led by the private sector.

In addition, the outlook is for deflationary pressures to gradually subside along with recovery. Growth in nominal GDP will rise to +1.5%, and the margin of the decline in the deflator will shrink to –0.2%. Viewing trends on a quarter-to-quarter basis, the margin of the decline in the deflator on a year-on-year basis will shrink to zero by the last quarter of the fiscal year.

In fiscal 2012, a self-sustaining recovery is expected to continue. The contribution of external demand will rise by a small margin of +0.3 percentage point, but the contribution of domestic demand will increase to +1.6 percentage points (with +1.5 percentage points from private-sector demand and +0.1 percentage point from the public sector). Improvement in employment and income conditions will continue, and consumer spending will remain firm. Since corporations will report further improvement in performance, the rising trend in capital investment will continue.

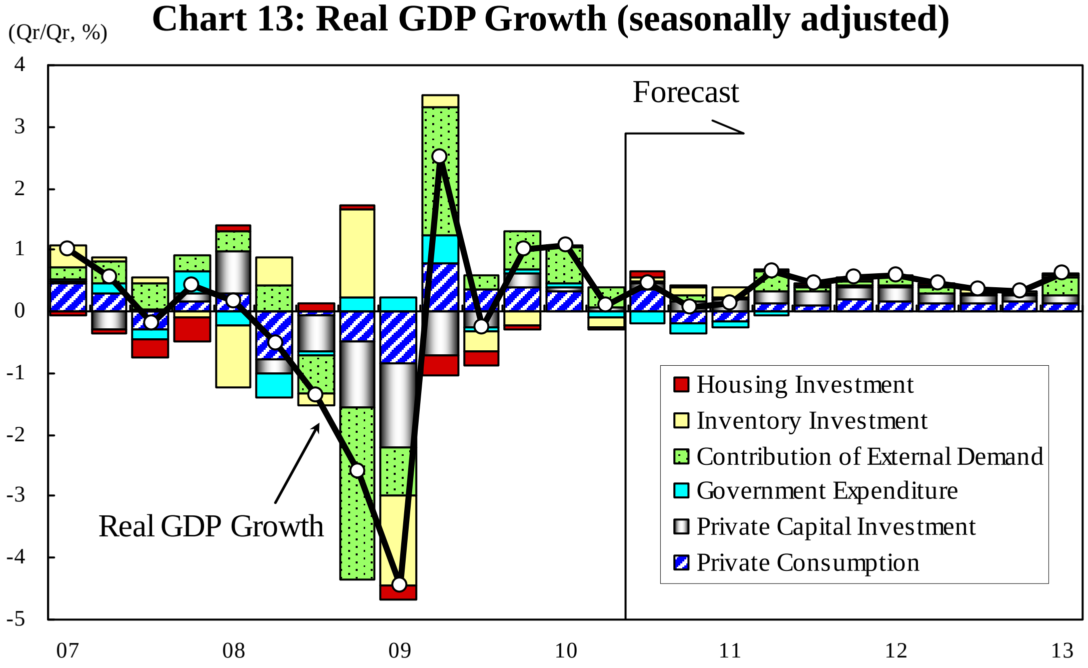
We are forecasting real growth of +1.9% in fiscal 2012, which is expected to be slightly higher than in the previous fiscal year. The outlook is for the rate of growth in nominal GDP to rise to +1.9%. In addition, the margin of decline in the deflator will diminish to –0.0%, implying that we should be in sight of purging deflationary pressures from the economy.

Chart 12: Real GDP Growth (Fiscal Year)

	Carry-over from the previous year (A)	Growth rate during the year (B)	Real GDP growth rate (A)+(B)
FY2008 (actual)	0.3 %	-4.0 %	-3.7 %
FY2009 (actual)	-4.8 %	2.9 %	-1.9 %
FY2010 (forecast)	1.3 %	0.5 %	1.7 %
FY2011 (forecast)	0.3 %	1.4 %	1.7 %
FY2012 (forecast)	0.8 %	1.1 %	1.9 %

Source: Cabinet Office "Quarterly Estimates of GDP"

Chart 13: Real GDP Growth (seasonally adjusted)



Source: Cabinet Office "Quarterly Estimates of GDP"

2. Forecasts of Economic Activity by Sector

(1) Corporations

- As they entered the 21st century, corporations had completed their disposal of negative assets left over from Japan's bubble economy, and their financial positions and profitability recovered substantially, supported by strong exports. Accordingly, the risks of a major downturn in production, capital investment, or other aspects of corporate activities had receded for the time being.
- However, following the collapse of Lehman Brothers Holdings in autumn 2008, domestic and overseas aggregate demand dropped sharply, and companies made major adjustments in production to reduce their inventories. As a result, production dropped rapidly, mainly in automobiles, general machinery, and certain other industries. Since the beginning of 2009, however, production has begun to improve, and, despite the fact that the pace of recovery has slowed because of the diminishing of the effects of government policies, the outlook is for production to remain on a rising trend going forward, supported by growth in exports, which will be sustained by recovery in the world economy.
- Recurring profits, prior to the downturn, had exceeded the peak levels attained previously during Japan's bubble era and the time of the IT boom, and they were continuing at record levels. However, because of rapid deterioration in the world economy, recurring profits dropped sharply along with the decline in sales in Japan and overseas. However, as a result of recovery in production and the positive effects of reductions in expenses, including personnel costs, corporate profitability has shown rapid improvement.
- As a result of the deterioration in the domestic and overseas economies during the downturn, corporate profitability fell sharply and private capital investment went into a steep decline. Nevertheless, there is a need to maintain a certain level of capital investment to replace equipment and raise product value added to increase competitiveness. As corporate profitability and rates of capacity utilization have recovered, private capital investment has begun to show improvement,

even though it remains at a relatively low level. However, since it will take more time for the strong feeling of excess capital equipment capacity in the corporate sector to subside, an aggressive trend toward investment to expand capacity is not likely for the time being.

(2) Households

- Employment conditions began to improve in the first half of 2009, along with recovery in the economy, but the pace of improvement has stalled and unemployment rates are rising again. Although the employment situation remains especially tough for the younger age-groups, looking ahead, the number of employed persons is expected to begin to rise above the level of the previous year, and a moderate trend toward improvement is forecast to continue.
- As a result of economic policies to promote the purchases of eco-friendly products, consumer spending, principally for durable goods, began to rise, but the positive effects of these policies are beginning to diminish. Although a decline in consumer spending is expected in the latter half of fiscal 2010 as a temporary reaction to the scheduled termination of these policies, consumer spending is forecast to show a rising trend along with improvement in the income environment in fiscal 2011.
- Housing starts, which dropped and reached bottom in fall 2009, are now viewed as being on an improving trend, but the level of activities remains low. Going forward, for the time being, housing starts are likely to remain on a rising trend with some fluctuations; however, because of the extremely large decline experienced during the downturn and the structural restraining factor of continued slowing in the rate of growth in the number of households, the rate of increase in the number of housing starts will remain moderate.

(3) Government

- With the collapse of Japan's bubble economy early in the 1990s as a turning point, the structure of government finances deteriorated rapidly. Along with the decline in nominal income growth rates in the 1990s and major tax cuts, government tax revenues have declined. Moreover, on the expenditure side, social welfare costs have continued to rise as the population has aged demographically, and expenditures for public works increased because of the implementation of major government spending programs to stimulate the economy.
- After the year 2000, to implement structural reforms, the government stopped major spending programs aimed at stimulating the economy, and spending on public works projects was reduced substantially. Moreover, local governments are experiencing fiscal difficulties and have continued to reduce their spending on public works. Along with the improvement in the economy, tax revenues began to expand again, but the government has basically maintained its policy of making structural reforms in its finances.
- However, from autumn 2008, as the economic downturn became increasingly serious, a number of economic policies and other measures were enacted, resulting in a rise in government expenditures. In the first half of fiscal 2009, government public investment increased substantially. On the other hand, since the increase in expenditures accompanying the implementation of these policies was funded through the issuance of government bonds and because tax revenues fell sharply along with the deterioration in the economy, the government's fiscal position has deteriorated.
- Given this deterioration in public finances, the government adopted its "Fiscal Management Strategy" and is working to formulate its budgets within a medium-term time frame extending from fiscal 2011 to fiscal 2013. According to this strategy, the policy of the government will be to restrain to its annual general account expenditures, after the exclusion of the issuance of government bonds and certain other items, to about ¥71 trillion, which was the level in the fiscal 2010 budget. Since social security related expenditures, including medical expenses and nursing care for seniors, are expected to rise going forward in tandem with the

demographic aging of the population, the government's final consumption expenditures will continue to rise. However, because of major reductions in the level of public investments, on a GDP basis, total real government expenditures are expected to continue to decline.

(4) Trends in Overseas Economies

- Growth in the world economy, which continued at high rates from the latter half of 2009 through the beginning of 2010, is showing signs of a pause, but the trend toward recovery is generally continuing. In the United States and Europe, the pace of recovery is slow because of delays in improvement in employment conditions. In addition, growth in China has declined slightly, because of the effects of monetary tightening.
- In the United States, increases in incomes are providing support for consumer spending, and it is expected that a double-dip recession will be avoided. Although growth in China will decline from double-digit levels, there is a strong likelihood that it will remain relatively high, averaging about 9% annually.
- As the world economy recovers, Japan's exports are increasing. By region, although Japan's exports to the United States and Europe are rising gradually, exports to countries in Asia have been expanding at a relatively brisk pace. Even though the rates of growth in Japan's exports to Asia at present are beginning to slow, the outlook is for exports to remain on an increasing trend.
- The surplus generated in the international income account by Japan's net overseas assets will be influenced to some extent by world economic conditions but is expected to remain steady. As the recovery in the trade surplus continues to be moderate, the surplus in the income account is likely to continue to account for a large share of the current account surplus.

3. Forecasts for Prices and Financial Markets

- The prices of raw materials, especially crude oil and metals, have moved above the levels of the previous year, thus boosting some prices. In the medium term, considerations of supply capacity and expansion in demand in China and other newly emerging economies suggest that inflationary pressures upstream and deflationary pressures on industrial and other products downstream will persist.
- Among domestic corporate prices, the prices of petroleum products and nonferrous metals, which are influenced by international commodity market prices, as well as prices of steel, chemicals, and other basic materials have begun to rise. Although the trends toward firming and increases in basic material prices are expected to continue going forward, the pace of increase is expected to be moderate because supply capacity in Japan is expected to continue to exceed demand. The outlook is for the decline in consumer prices to bottom out after the beginning of fiscal 2011, but, in the interim, it may continue because of the strong downward pressure on sales prices to final consumers.
- Regarding monetary policy, the lifting of quantitative easing in March 2006 set in motion the process of normalizing monetary policy to raise interest rates in Japan from their excessively low levels. However, as a result of the turbulence in financial markets triggered by the subprime loan crisis and the recognition of the risk of a downturn in the domestic and overseas economies, in fall 2008 and onward, measures were implemented to ease monetary policy. In October 2009, although some temporary measures to ease monetary policy were retracted, in view of continuing deflation, strong policies were adopted to ease monetary policy again in December 2009, based on the stance of not tolerating negative figures for changes in consumer prices. For the time being, the Bank of Japan is expected to continue its stance of easing monetary policy.
- As the recovery in the economy continues, with deflation continuing and short-term interest rates remaining stable, long-term interest rates are also expected to remain low. Looking ahead, there is a possibility that a sustained recovery in various countries and the deterioration in government fiscal positions around the world may place upward

pressure on long-term interest rates. In foreign exchange markets, participants have become more risk averse, and, during the latter half of fiscal 2008, the U.S. dollar and the yen strengthened. However, since spring 2009, a trend emerged to buy back European currencies and the currencies of resource-producing countries. In 2010, however, instability in foreign exchange markets has continued as the euro weakened because of concerns about government fiscal problems in some EU countries, and the U.S. dollar also declined in value because of prospects for the further relaxation of monetary policy. Country-specific factors, in addition to economic trends, that are receiving attention as currencies are bought and sold in foreign currency markets include monetary policy and government financial positions.

Chart 14: Outlook for Fiscal 2010-2012

Forecast

Yr/Yr、%

	FY2008 (actual)	FY2009 (actual)	FY2010 (forecast)	FY2011 (forecast)	FY2012 (forecast)
Nominal GDP	-4.2	-3.6	0.0	1.5	1.9
Real GDP	-3.7	-1.9	1.7	1.7	1.9
Contribution of domestic demand	-2.6	-2.3	0.6	1.2	1.6
Private consumption	-1.8	0.7	1.1	0.4	1.0
Housing investment	-3.7	-18.5	0.1	4.9	3.0
Private capital investment	-6.8	-15.3	3.0	5.8	4.8
Contribution of inventory investment	-0.1	-0.5	-0.2	0.3	0.1
Government expenditure	-1.3	3.0	-1.2	-0.9	0.2
Public investment	-6.6	9.3	-12.2	-7.8	-1.5
Government final consumption expenditure	-0.1	1.7	1.1	0.5	0.5
Contribution of external demand	-1.2	0.4	1.2	0.5	0.3
Export of goods and services	-10.4	-9.5	19.2	5.8	5.7
Import of goods and services	-4.0	-11.8	11.3	2.8	4.2
GDP deflator	-0.4	-1.7	-1.7	-0.2	0.0

Forecast

Yr/Yr、%

	FY2008 (actual)	FY2009 (actual)	FY2010 (forecast)	FY2011 (forecast)	FY2012 (forecast)
Current account balance (trillion yen)	12.3	15.8	17.2	19.0	19.1
balance on goods (trillion yen)	1.2	6.6	8.0	9.6	9.8
balance on service (trillion yen)	-2.0	-1.8	-1.8	-1.8	-1.8
balance on income (trillion yen)	14.6	12.1	12.2	12.5	12.8
Industrial production	-12.7	-8.9	11.5	2.6	3.7
Unemployment rate(%)	4.1	5.2	5.1	4.9	4.6
New housing starts(annualized, ten thousand units)	103.9	77.5	80.5	86.3	88.2
Domestic corporate goods prices	3.1	-5.3	0.5	0.4	0.6
Consumer prices	1.2	-1.7	-0.7	0.0	0.3
excluding freshfood	1.2	-1.6	-0.9	0.1	0.3
Yen/U.S.Dollar	100.5	92.8	87.8	87.9	89.9
Uncollateralized call rates (O/N) (%)*	0.363	0.102	0.100	0.100	0.250
Newly issued government bond yields (10years) (%)	1.46	1.36	1.16	1.26	1.37
WTI future price (near month contract, US dollar/barrel)	85.9	70.7	79.6	83.3	85.3
Dubai crude oil prices (US dollar/barrel)	82.1	69.7	77.6	80.6	82.3

* actual=average, forecast=end of period

Chart 15: Outlook for Calendar 2010-2012

Forecast

Yr/Yr、%

	CY2008 (actual)	CY2009 (actual)	CY2010 (forecast)	CY2011 (forecast)	CY2012 (forecast)
Nominal GDP	-2.0	-6.1	0.7	0.6	2.1
Real GDP	-1.2	-5.2	2.7	1.3	2.0
Contribution of domestic demand	-1.3	-3.9	0.8	0.8	1.7
Private consumption	-0.7	-1.0	1.9	0.1	1.1
Housing investment	-8.1	-14.2	-6.2	5.4	3.5
Private capital investment	0.1	-19.2	0.4	5.2	5.5
Contribution of inventory investment	-0.4	-0.3	-3.5	0.3	0.6
Government expenditure	-1.2	2.4	0.0	-1.5	0.2
Public investment	-8.5	7.4	-6.8	-11.2	-2.1
Government final consumption expenditure	0.3	1.5	1.4	0.4	0.6
Contribution of external demand	0.1	-1.3	1.8	0.5	0.3
Export of goods and services	1.6	-23.9	25.4	6.4	6.1
Import of goods and services	1.0	-16.7	10.9	3.6	4.4
GDP deflator	-0.8	-0.9	-2.0	-0.6	0.1

Forecast

Yr/Yr、%

	CY2008 (actual)	CY2009 (actual)	CY2010 (forecast)	CY2011 (forecast)	CY2012 (forecast)
Current account balance (trillion yen)	16.4	13.3	17.2	18.5	18.8
balance on goods (trillion yen)	4.0	4.0	8.3	9.2	9.7
balance on service (trillion yen)	-2.1	-1.9	-1.8	-1.8	-1.8
balance on income (trillion yen)	15.8	12.3	11.8	12.4	12.7
Industrial production	-3.4	-21.9	17.8	2.0	3.9
Unemployment rate (%)	4.0	5.1	5.1	4.9	4.7
New housing starts(annualized, ten thousand units)	109.3	78.8	80.1	85.5	87.8
Domestic corporate goods prices	4.6	-5.2	-0.2	0.5	0.5
Consumer prices	1.4	-1.4	-0.8	-0.2	0.2
excluding freshfood	1.5	-1.3	-1.0	-0.2	0.3
Yen/U.S.Dollar	103.4	93.5	88.9	87.3	89.6
Uncollateralized call rates (O/N) (%)*	0.462	0.105	0.100	0.100	0.250
Newly issued government bond yields (10years) (%)	1.48	1.34	1.20	1.22	1.35
WTI future price (near month contract, US dollar/barrel)	99.6	61.8	78.9	82.6	84.8
Dubai crude oil prices (US dollar/barrel)	93.8	61.8	76.9	80.1	81.8

* actual=average, forecast=end of period

Chart 16: Outlook for 2010-2011 (Quarterly)

Forecast

Qr/Qr、%
Yr/Yr、%

	FY2009				FY2010				FY2011			
	4-6	7-9	10-12	1-3	4-6	7-9	10-12	1-3	4-6	7-9	10-12	1-3
Nominal GDP	0.6	-0.6	0.4	1.4	-0.9	-0.1	-0.3	0.5	0.8	-0.2	0.6	1.1
	-6.3	-5.8	-3.8	1.8	0.2	0.8	0.0	-0.8	1.0	0.8	1.6	2.5
Real GDP	2.5	-0.3	1.0	1.1	0.1	0.4	0.1	0.1	0.7	0.4	0.6	0.6
	-5.7	-5.2	-1.0	4.7	2.0	2.7	1.6	0.7	1.4	1.4	1.7	2.4
Contribution of domestic demand (Qr/Qr,%)	0.4	-0.5	0.4	0.5	-0.2	0.4	0.0	0.1	0.3	0.4	0.5	0.5
Private consumption	1.3	0.6	0.7	0.5	0.0	0.6	-0.3	-0.3	0.2	0.2	0.3	0.3
	-1.1	-0.4	1.2	3.3	1.8	1.9	0.9	0.0	0.2	-0.2	0.5	1.0
Housing investment	-9.6	-7.2	-2.9	0.3	-1.3	4.3	2.2	0.6	0.6	0.7	2.1	0.5
	-9.9	-20.3	-24.5	-18.1	-10.5	0.1	5.5	6.0	8.0	4.0	4.0	4.0
Private capital investment	-4.8	-1.8	1.5	0.6	0.5	0.8	1.3	1.4	1.4	1.5	1.5	1.6
	-22.1	-20.9	-13.5	-4.6	0.8	3.3	3.3	4.1	5.1	5.7	6.0	6.1
Contribution of inventory investment (Qr/Qr,%)	0.2	-0.3	-0.2	0.0	-0.2	0.0	0.1	0.1	0.0	0.0	0.0	0.0
Government expenditure	1.8	-0.3	0.3	0.3	-0.5	-0.9	-0.7	-0.4	-0.2	0.0	0.1	0.1
	3.2	3.4	3.2	2.3	0.5	-0.6	-2.1	-2.6	-1.7	-1.2	-0.6	0.0
Public investment	9.5	-1.8	-1.3	-1.2	-3.4	-5.4	-4.4	-3.3	-1.5	-0.9	-0.5	-0.4
	13.9	11.6	9.2	4.6	-7.2	-10.8	-13.7	-15.5	-13.8	-9.8	-6.0	-3.2
Government final consumption expenditure	0.2	0.1	0.7	0.6	0.2	0.1	0.0	0.1	0.1	0.2	0.2	0.1
	1.7	2.0	1.7	1.5	1.5	1.5	0.9	0.4	0.2	0.3	0.6	0.6
Contribution of external demand (Qr/Qr,%)	2.1	0.2	0.6	0.6	0.3	0.0	0.1	0.1	0.3	0.1	0.0	0.1
Export of goods and services	10.4	8.5	5.7	7.0	5.9	2.5	0.6	0.4	2.1	1.7	1.5	1.3
	-29.3	-22.7	-4.7	34.6	30.0	22.8	16.9	9.7	5.7	4.8	5.8	6.7
Import of goods and services	-5.0	6.3	1.5	3.0	4.3	2.6	0.1	0.1	0.1	1.4	1.4	0.7
	-18.3	-16.0	-15.4	5.5	16.0	11.9	10.4	7.2	2.9	1.7	3.0	3.6
GDP deflator (Yr/Yr,%)	-0.6	-0.7	-2.8	-2.8	-1.8	-1.8	-1.6	-1.5	-0.4	-0.5	-0.2	0.1

Forecast

Yr/Yr、%

	FY2009				FY2010				FY2011			
	4-6	7-9	10-12	1-3	4-6	7-9	10-12	1-3	4-6	7-9	10-12	1-3
Current account balance (trillion yen)*	3.5	3.6	4.0	4.7	3.6	4.4	4.7	4.5	4.2	4.7	5.3	5.0
balance on goods (trillion yen)*	1.0	1.4	1.9	2.4	1.8	2.0	2.0	2.1	2.3	2.3	2.4	2.5
balance on service (trillion yen)*	-0.5	-0.4	-0.4	-0.5	-0.4	-0.4	-0.5	-0.5	-0.5	-0.5	-0.5	-0.4
balance on income (trillion yen)*	3.3	2.9	2.7	3.0	2.6	3.1	3.5	3.3	2.7	3.2	3.8	3.3
Industrial production (Qr/Qr、%)	6.5	5.3	5.9	7.0	1.5	0.7	-0.6	-0.1	1.0	1.1	1.2	1.0
(Yr/Yr、%)	-27.4	-19.4	-4.3	27.5	21.0	16.5	9.1	1.6	0.9	1.7	3.4	4.4
Unemployment rate (%)*	5.1	5.4	5.2	4.9	5.2	5.2	5.1	5.0	5.0	4.9	4.8	4.8
New housing starts(annualized, ten thousand units)	76.9	71.3	79.1	83.7	76.0	78.4	82.8	85.3	84.4	84.4	87.8	88.7
Domestic corporate goods prices (Yr/Yr,%)	-5.5	-8.3	-5.2	-1.7	0.2	0.2	0.8	0.6	0.1	0.5	0.6	0.6
Consumer prices (Yr/Yr,%)	-1.0	-2.2	-2.1	-1.2	-0.9	-0.9	-0.4	-0.6	-0.3	0.0	0.1	0.1
excluding freshfood (Yr/Yr,%)	-1.0	-2.3	-1.8	-1.2	-1.2	-0.9	-0.6	-0.6	-0.1	0.0	0.1	0.1
Yen/U.S.Dollar	97.3	93.6	89.7	90.7	92.0	86.7	86.0	86.4	87.0	87.6	88.2	88.8
Uncollateralized call rates (O/N) (%)**	0.103	0.103	0.104	0.098	0.093	0.100	0.100	0.100	0.100	0.100	0.100	0.100
Newly issued government bond yields (10years) (%)	1.45	1.34	1.31	1.33	1.27	1.07	1.13	1.16	1.20	1.24	1.28	1.31
WTI future price (near month contract, US dollar/barrel)	59.6	68.3	76.2	78.7	78.0	78.0	81.0	81.5	82.5	83.0	83.5	84.0
Dubai crude oil prices (US dollar/barrel)	59.2	68.1	75.4	75.9	77.6	75.4	78.5	79.0	80.0	80.5	81.0	81.0

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