August 2011

Forecast for the Japanese Economy in Fiscal 2011 and 2012

— Strong Recovery Momentum after the Earthquake Will Gradually Diminish —

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1. Outlook for the Japanese Economy in Fiscal 2011 and Fiscal 2012 -- Strong Recovery Momentum after the Earthquake Will Gradually Diminish

(1) Current State of the Economy: Real GDP Growth Negative for Three Consecutive Quarters

Announced on August 15, the real GDP growth rate for the April-June quarter of 2011 was –0.3% (–1.3% at an annualized rate), the third consecutive quarter of negative growth. However, since most views called for a large negative figure because of the effects of the Great East Japan Earthquake, the decline was relatively small.

Examining the contribution to real GDP of the domestic and external sector, the contribution of the domestic sector was +0.4 percentage point, while the contribution of the external sector (net exports = exports–imports) was –0.8 percentage point. The positive contribution of the domestic sector was the first in three quarters and was due to increases in public-sector demand and other factors. The large negative contribution of the external sector was the result of a major decline in exports owing to the supply constraints caused by the earthquake.

By component of domestic demand, personal consumption decreased 0.1% from the previous quarter. Although this was the third consecutive quarterly drop, the margin of decline was smaller than in the prior quarters. Automobile sales continued to be weak because of supply constraints, but sales of flat panel display (FPD) TVs held strong because of the surge in demand prior to the transition to terrestrial digital broadcasting. Sales of air conditioners and other energy-conserving appliances also held firm, and sales of durable goods boosted consumer spending overall. In general, the mood of restraint regarding consumption that followed the earthquake disaster is gradually wearing off, and consumer goods turned in an unexpectedly strong performance. Private residential investment declined 1.9%, the first decrease in four quarters, reflecting the stagnation in housing starts following the earthquake.

Private capital investment began to rise again, albeit by a small margin of +0.2% for the quarter. Although capital investment dropped temporarily just after the earthquake, due in part to supply constraints, the corporate drive to invest appears to be largely unchanged. Therefore, capital investment continues to be firm, partially due to reconstruction activities following the earthquake. The contribution of private inventory investment to real GDP was +0.3 percentage point and was a factor helping to boost the GDP growth rate.

Among public-sector demand components, government consumption expenditure continued on an increasing trend, rising 0.5% for the quarter, in part because of expenditures related to the aftermath of the earthquake. Also, owing to progress toward the construction of temporary housing in the areas stricken by the earthquake, public works investment rose 3.0% for the quarter, the first increase in six quarters. As a result, public-sector demand as a whole showed a relatively high increase of 0.9% for the quarter.

Turning next to external demand, exports posted a large decline of 4.9% because of supply constraints, but imports rose a marginal 0.1% for the quarter. As a result, the contribution of the external sector to real GDP growth was -0.8 percentage point. This was the fourth consecutive quarter that the external sector has push growth downward, and the margin of decline is expanding.

The GDP deflator, which reflects overall price trends in the economy as a whole, fell 2.2% for the quarter, a larger margin of decline than in previous quarters. After seasonal adjustment, the deflator decreased 1.1% for the quarter, a major decline. While the effects of the rise in commodity prices are gradually beginning to have an impact on domestic prices, import prices are continuing to show substantial increases, and these trends failed to put the brakes on the decline in the GDP deflator.

Although real GDP growth in the April-June quarter was negative for the third consecutive quarter, the extent of the decline is smaller than previous market expectations. Behind this is the fact that reconstruction work following the earthquake is proceeding at a faster pace than anticipated. Industrial production began to rise in April and continued to show high rates of growth in May and June. The shortages of electric power during the summer, which had been a cause for concern, have turned out not to be a major factor depressing production activities because of efforts to conserve electric power. The forecast index for manufacturing production calls for increases of around 2% over the previous month in both July and August. Also, along with the recovery in production, exports, which had dropped steeply, are now beginning to rise again. Growth in real exports moved back to the positive range in May, rising 4.5%, and then rose a substantial 8.6% in June. As constraints on the supply side are removed, demand that has been postponed will emerge, and it is likely that the domestic economy may improve at a somewhat rapid pace for the time being. Demand for reconstruction and recovery following the earthquake will also gradually emerge and provide support for the economy. The real GDP growth rate over the previous quarter is expected to return to the positive range in the July-September period, and the rate of expansion is expected to rise quickly.

(2) Three Factors Influencing the Direction of the Economy following the Earthquake: Rising Concerns about a Downturn

Accompanying the reconstruction after the earthquake, the economy is forecast to show steady expansion through the July-September quarter. As supply constraints are removed, the magnitude of demand in Japan and overseas will determine economic trends. There will be three factors for attention when considering future trends in domestic and external demand.
(a)The direction of the slowdown in domestic and overseas economic expansion,
(b) Unsettled conditions in financial markets due to deterioration in fiscal conditions in Europe and their impact on the economy, and
(c)The status of recovery in the stricken areas following the earthquake
Factors (a) and (b) may cause further appreciation of the yen, and this will have a strong adverse effect on exports from Japan. On the other hand, as regards (c), there are still many causes for concern about whether the

recovery following the Great East Japan Earthquake will proceed smoothly.

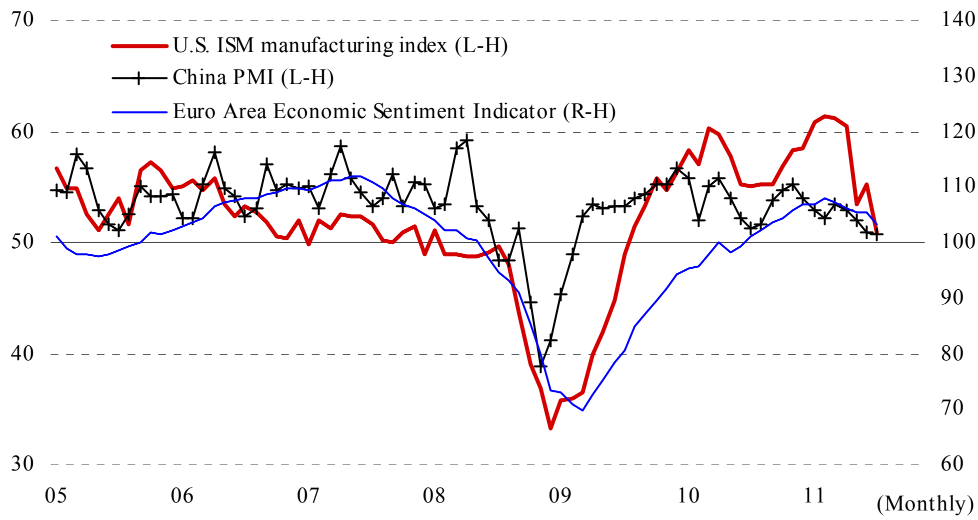
(a) The direction of the slowdown in domestic and overseas economic expansion

The rates of growth in overseas economies have clearly slowed. Examination of economic indicators of countries around the world reveals a sudden weakening (Chart 1).

By country, in the United States, real GDP growth declined to 1.3% over the previous quarter in the April-June period of 2011. The most-significant factor was the leveling off of personal consumption along with the rise in gasoline prices. Even in the countries of Asia, including China, the momentum of growth is weakening, but this is believed to because of the effects of the adoption of tighter monetary policies, which are beginning to take effect. These tighter monetary policies were adopted in response to rising inflation along with the increase in food and other international commodity prices. In the eurozone, real GDP growth in the April-June period decreased to 0.7% over the previous quarter, the lowest rate of expansion in two years. The main factor accounting for this was the slowdown in exports to the United States and the countries of Asia, which had been supporting eurozone growth.

Tracing this weakening of economic growth back to its causes, it is clear that the rise in international commodity prices has been a major factor. Despite this, it appears likely that, as concerns about future directions in overseas economies have mounted, the prices of crude oil and other international commodities have peaked out, and that the negative effects of these prices will gradually wear off. Therefore, there is a possibility that overseas economies will be weak for some time, but, as international commodity market conditions stabilize, it is likely that conditions will gradually improve and momentum will not be lost.

Chart 1: Business Survey Index



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

(b) Unsettled conditions in financial markets due to deterioration in fiscal conditions in Europe and their impact on the economy

The fiscal crises in certain countries in Europe and the downgrading of the credit rating of U.S. government debt have also spurred the feeling of uncertainty regarding future economic trends.

In July, country leaders held an emergency meeting to agree on a second round of assistance for Greece to deal with that country's fiscal crisis. As a result, it appears that unsettled conditions subsided temporarily. However, because of the postponement of an increase in the European Financial Stability Fund (EFSF) and other factors, concerns mounted that the crises might spread to Italy and Spain, and there was speculation that French government debt might be downgraded. These developments will continue to require careful monitoring.

This financial turmoil may have an impact on the economy through a number of routes. First, there is concern that the tightening of fiscal discipline in Europe will put downward pressure on the economies of these countries as government-sector expenditures are reduced. Also, there is a growing belief that the decline in prices of government bonds will put pressure on the management of financial institutions holding this debt. This, in turn, may result in lower prices of financial stocks, and that may have an effect on stock markets as a whole. The decrease in stock prices may have a negative impact on the economy as asset values fall and it becomes more difficult to raise funds. Moreover, there is also concern that the deterioration in the performance of financial institutions will lead to a financial crisis. If financial markets become paralyzed as they did after the collapse of Lehman Brothers Holdings, this will present obstacles for all manner of economic activities.

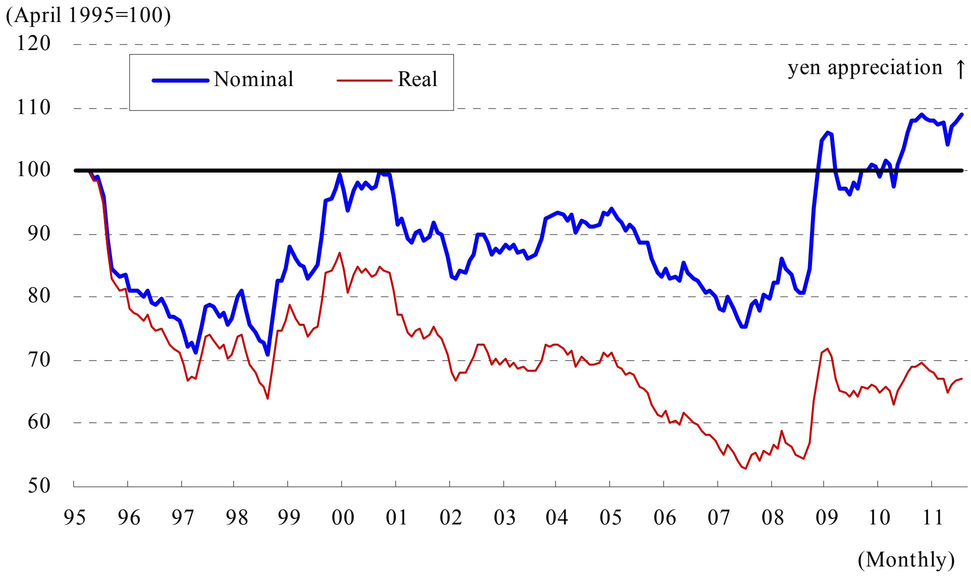
For the time being, it is hoped that Germany and France will play a central role in finding solutions to these issues, and it is possible they may calm down at least temporarily. However, the fiscal deficit problems cannot be solved overnight. Therefore, there is a risk that these problems may be rekindled at some time over the coming several years.

Risks will also remain, even regarding the fiscal issues faced by the United States. As the fact that investors are buying U.S. government bonds suggests despite the downgrade, the direct impact is minor. However, the markets are currently quite risk sensitive, and U.S. stock prices are continuing to decline, influenced by European equity prices. Although agreement was reached in the United States regarding the proposal to increase the national debt ceiling, the process of formulating measures to cut the fiscal deficit by ¥1.5 trillion this year remains, and there is a risk that this will increase the level of uncertainty about fiscal problems once again. For this reason, it appears that there will continue to be periods of unsettled movements in equity markets that have no connection with economic trends or corporate performance. As in Europe, the decline in stock prices will be a negative factor for the economy.

This uncertainty about future trends in overseas economies and unstable movements in European and U.S. financial markets is encouraging the flow of funds into yen, which is regarded to be a safe asset, and the yen has risen to a historically high range. The concern is that this may have a negative impact on exports from Japan.

Notwithstanding, a look at the effective exchange shows that, while on a nominal basis the yen rate is at a high level, on a real basis the value of the yen is not extremely high. In 1995, the exchange rate appreciated temporarily to just below ¥80 to one U.S. dollar, but using a comparison between the real effective exchange rate at that time and now, the value of the yen is currently about 30% lower in value (Chart 2).

Chart 2: Trends in the Effective Exchange Rate



Source: Bank of Japan

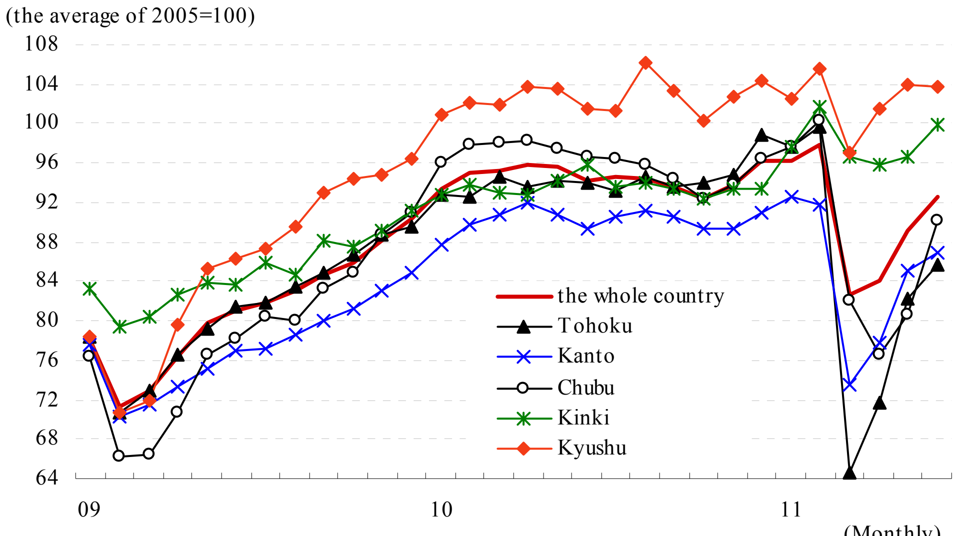
It is certain that the current yen exchange rates are bringing tough conditions to those Japanese companies that manufacture products that compete with those of such countries as Germany and South Korea, which have weaker currencies that before, and to those small and medium-sized exporting enterprises and others that have not implemented measures to cope with the appreciation of the yen. Going forward, there are concerns about declines in the unit volume of exports. However, for those products that companies continued to export even at the time of the appreciation of the yen following the collapse of Lehman Brothers Holdings, it is likely that these companies are limiting their product lineups to those items that can compete even at high values of the yen. Even if they raise export prices, this will not necessarily lead to a sudden drop in the unit volume of exports. Instead, the risk that a decline in demand because of deterioration in overseas economies will lead to a drop in unit volume seems to be higher.

In this sense, during the latter half of fiscal 2011, when overseas economies will be in a relatively weak position for a time, there is a growing possibility that growth in exports may slow.

(c)The status of recovery in the stricken areas following the earthquake

Reconstruction and repair in the aftermath of the earthquake are proceeding smoothly, and supply chains severed by the disaster have largely been restored to working order. Data on production trends by geographical area (actual data through June) indicate that all areas are recovering smoothly (Chart 3). The real GDP growth rate for the April-June period was higher than previously forecast, and the rapid recovery in production is a background factor.

Chart 3: Trends in Industrial Production Index by Area



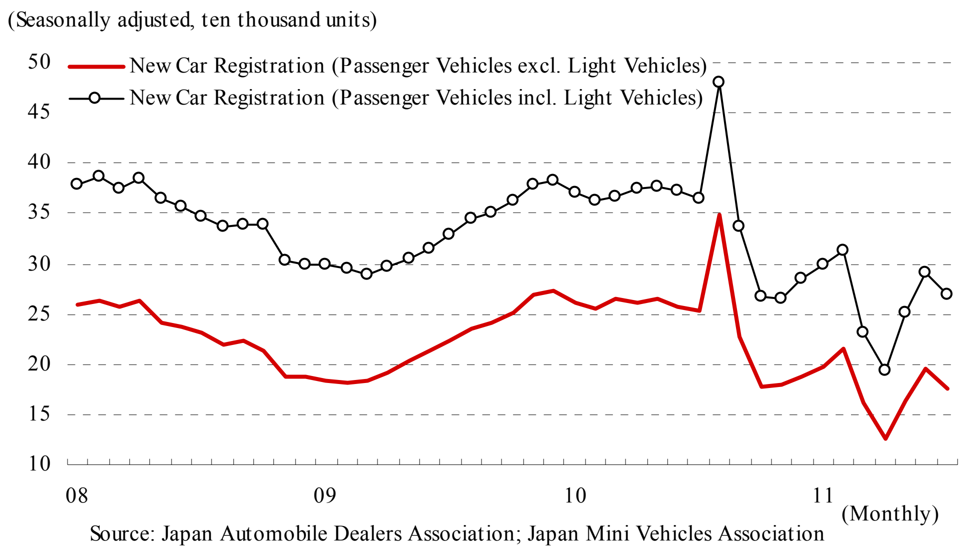
Source: Ministry of Economy, Trade and Industry

In addition to smooth progress toward reconstruction, companies will be responding to the emergence of demand that has been postponed, and the smooth recovery in domestic production is likely to continue during the July-September quarter. However, even if there is sufficient supply capacity, whether further expansion in production will be possible or not will be dependent on the size of demand.

The key point regarding demand will be the trends in consumer spending, specifically purchases of durable goods, including automobiles. Sales of automobiles moved into a slump because of supply constraints, but are now making a comeback along with the recovery in production (Chart 4). To stage a recovery from the downturn in sales in the first half of fiscal 2011, automobile manufacturers are implementing measures to increase production, and, along with this, they are expecting growth in demand. For this reason, the increase in automobile production will also contribute to giving the economy a boost during the July-September quarter. However, the positive effects of recovery in car output will gradually diminish during the October-December and subsequent quarters.

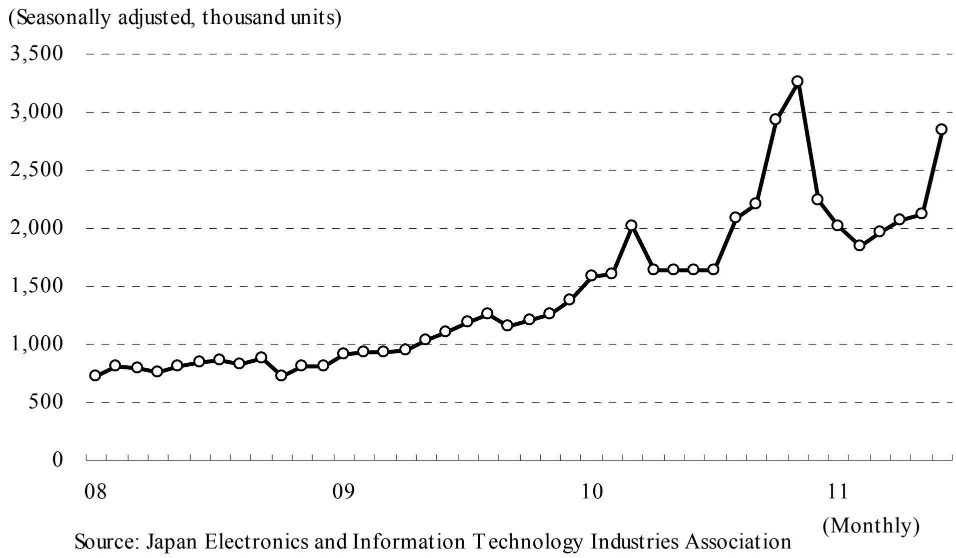
Through the July-September quarter, sales of electric power saving appliances, such as air conditioners, and consumer spending on “cool biz” goods (mainly light clothing suited to higher office temperatures) are forecast to boost consumer spending, but from the October-December period onward, the positive effects of this kind of consumption will run their course. Moreover, the sales of FPD TVs, which boosted consumer durable goods purchases during the April-June quarter, have largely been completed, and there is a strong possibility that sales of these items will level off or weaken during the July-September and subsequent quarters (Chart 5).

Chart 4: Trends in Automobile Sales



Source: Japan Automobile Dealers Association; Japan Mini Vehicles Association

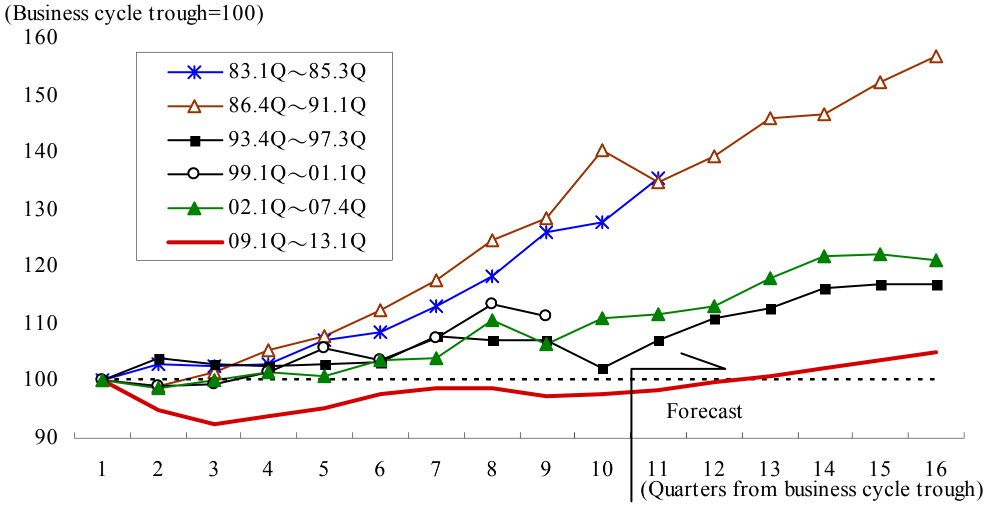
Chart 5: Trends in Sales of FPD TVs



As these comments suggest, there is a strong likelihood that, moving into the second half of this fiscal year, consumer durable purchases will weaken. In recent months, because of the lack of growth in household income and the mood of restraint among consumers, expenditures on services have shown a continued declining trend, and it is not clear whether the consumption of services will be able to make up for the decline in consumer durables purchases. Furthermore, as a result of the deterioration in corporate performance as a result of the earthquake, winter bonuses are believed likely to be below the level of the previous year. If we also take account of the possibility that taxes may be increased temporarily to finance post-earthquake recovery expenditures, the pace of consumer spending may decline going forward.

In the corporate sector, we cannot expect too much of capital investment. Looking forward, corporate performance is expected to continue to improve as reconstruction activities move ahead, and capital investment will continue on an upward trend as investments are made on reconstruction activities and measures are taken to increase electric power generation capacity. However, even if this is the case, it seems unlikely that corporations will alter their cautious stance, and, compared with recovery phases in the past, growth in capital investment is expected to be more moderate (Chart 6)

Chart 6: Trends in Capital Investment during Previous 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 2011 are our own forecasts.
Source: Cabinet Office, "Quarterly Estimates of GDP"

Given this outlook, the activities of the public sector, mainly public works investment, appear to be the only source of domestic demand that can be relied upon. The third supplementary budget, which will be prepared during the current year and will be about ¥10 trillion in size, is expected to provide support for domestic demand. However, the positive effects of these expenditures in boosting the economy on a year-on-year basis are likely to run their course during the first half of fiscal 2012.

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

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

First, we have assumed that, of the total amount of government expenditures needed for recovery from the earthquake disaster, which is estimated at ¥13 trillion, a third supplementary budget amounting to approximately ¥10 trillion will be prepared during the current year. Next year and subsequent years' budgets will contain expenditures of ¥3 trillion for this purpose. We are forecasting that ¥10 trillion of these expenditures will be funded by the issuance of recovery bonds, and another ¥3 trillion will funded by reductions in expenditures, the sale of assets, and other sources. The total issue of recovery bonds, after adding ¥2.5 trillion for the amount to be borne by the basic pension fund of the national treasury, will be ¥12.5 trillion. We believe this will be covered by increases in taxes over a five-year period, and the increase in household income and corporate income taxes will be a fixed 10%, which the government will start to impose beginning in April 2012.

Next, we have assumed that the nation will be requested to conserve electric power this winter and also again next summer but that serious shortages of electric power will be averted. While is it unrealistic to assume that power production at all nuclear power plants will be terminated, even if this should take place, corporate production activities will not be required to bear a major burden because of the construction of new thermal power plants and power-conservation efforts, such as those this summer.

Among other assumptions, the child allowance will be reduced from the latter half of fiscal 2011, and a shift will be made to an allowance for child dependents in fiscal 2012. In addition, the consumption tax will be raised twice, once in 2014 and then again in 2015, to 10%.

Fiscal 2011, Japan will aim for revitalization following the serious blows dealt by the earthquake. Work to restore the supply chains that were severed at the time of the disaster is proceeding smoothly and the response to power shortages has been flexible. On a quarter-to-quarter basis, real GDP growth has been negative for three consecutive quarters, but the ill effects of the disaster will be temporary, and there is a strong probability that the economy entered the path to recovery again with the beginning of this fiscal year.

Personal consumption is improving, as the mood of restraint that followed the earthquake has gradually subsided and the supply constraints on the production of automobiles and other products have loosened. Demand for reconstruction and recovery is rising in certain areas, including purchases of items that help conserve electric power, purchases of furniture, and payments for home repairs. Moreover, sales of FPD TVs are favorable, in part because of declines in prices of these units, and these purchases are driving consumer spending as a whole. However, in the latter half of fiscal 2011, these factors that are giving the economy a boost will run their course, and trends in consumer spending may become more sluggish because of delays in improvements in employment and income conditions, including a decline in winter bonuses.

In the corporate sector, progress is being made in returning to normal activities accompanying the completion of repairs of damaged equipment, progress in putting the distribution and other infrastructure back in order, and restoration of severed supply chains. After the earthquake, it was not possible to provide sufficient supplies of goods to meet demand from within Japan and overseas because of constraints on production, and, as a result, supply volume set limits on the size of demand. Now, however, this situation is being remedied. One of the measures for dealing with potential power shortages during the summer was to request large users of electric power to cut back on their power consumption. There is a strong possibility that effects of these cutbacks in power usage on production activities were relatively light because of increased efforts to conserve power, rotation of vacation time, conducting production operations on weekends and holidays and in the nighttime hours, and other measures. For this reason, the outlook is for a V-shaped recovery in corporate activities during the first half of the fiscal year, but, in the second half, corporate activities will be influenced by trends in demand.

On the other hand, corporate performance may suffer, with declines in sales and income, mainly because of a decline in unit volume of sales. For this reason, views of future directions in the economy may become cautious, and there is a high probability that corporations may refrain from making the major investments that would be needed for increasing production. However, as the systems for production are put in order again, we are forecasting that production activities will resume a gradual rising trend. Throughout the fiscal year, corporate investments for repairing equipment for coping with power shortages are expected to continue and will contribute to boosting capital investment.

The activities of the public sector, however, are the ones that can be relied on to give a boost to the economy. Since the beginning of the current fiscal year, government public works investment has already risen above the level of the previous fiscal year. As the expenditures in the first and second supplementary budgets are added, and along with the third supplementary budget near the end of the year, we expect that public investment will continue above the previous year's level. Also, as a result of activities to restock depleted inventories, increases in corporate inventory investment will also contribute to boosting the economy.

As the trend toward recovery from the steep drop in domestic economic activity following the earthquake gradually gains momentum, movements in exports will be a major factor determining trends in the economy as a whole from the latter half of the fiscal year onward. During the April-June quarter, since exports were also restrained because of constraints on supply, corporations were unable to respond fully to strong overseas demand, and exports moved temporarily into a slump. However, during the July-September quarter, exports are forecast to begin to rise again along with the recovery in supply capacity. Inventories in overseas markets for many products were depleted after supplies from Japan stopped, and, since the restocking of inventory levels will be another factor increasing exports, exports are believed likely to increase by a larger margin than the rise in overseas demand.

However, if the rise in exports to restock depleted inventories overseas runs its course after the beginning of the second half of the current fiscal year and growth in overseas economies weakens, there is a strong possibility that growth in exports will become sluggish. On the other hand, imports will most likely continue to be firm. Reasons for this include rising imports of energy fuels, such as LNG, accompanying the increase in thermal power generation to replace a portion of nuclear power generation. Another factor will be the continuing trend among corporations to shift a portion of domestic production to overseas plants. For this reason, the outlook is for the contribution of the external sector to run at approximately zero.

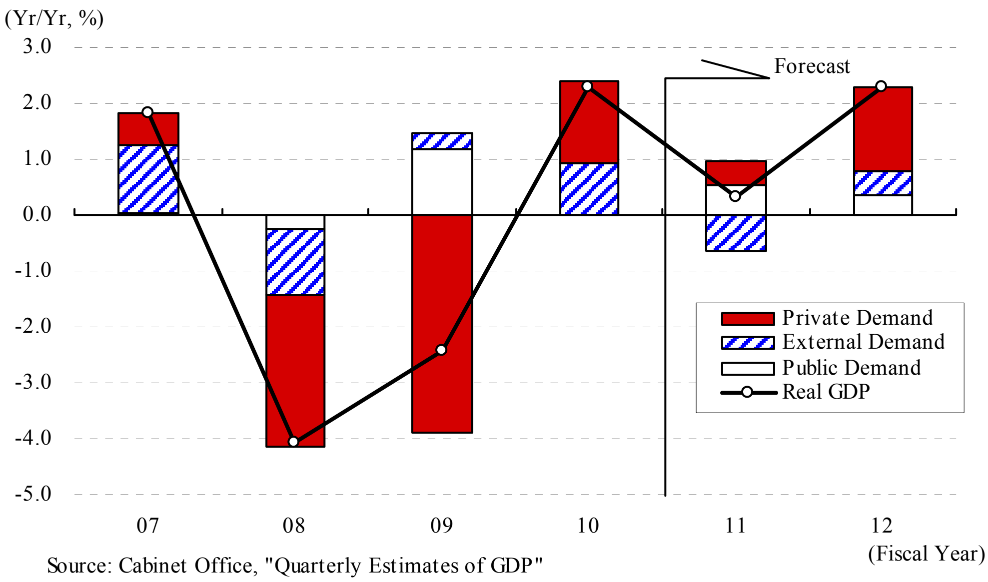
Looking at these trends on a quarterly basis, during the July-September quarter, domestic and overseas demand will both show firm increases, and, as a result, the real GDP growth rate will return to the positive range. Public-sector demand, comprising public works investment and government consumption, will continue to give a boost to the economy as demand related to recovery in the areas stricken by the earthquake moves into full swing. Also, since exports will begin to rise again, there is a possibility that the rate of GDP growth in the July-September quarter will rise suddenly.

In the latter half of fiscal 2011, however, the pace of recovery appears likely to slacken. The principal reason will be the slowdown in export growth. Among domestic demand components, expansion in public works investment will continue and private capital investment will remain on an increasing trend, but growth in personal consumption will weaken.

Real GDP growth in fiscal 2011 is forecast to be +0.3%. This will imply a sharp slowing in the rate of expansion in comparison with the +2.3% reported in fiscal 2010, but the fiscal 2011 growth figure includes a negative carryover effect (of –0.6%). If the carryover effect is eliminated and growth is calculated during the fiscal year, the rate of expansion will be +0.9%, a significant recovery from fiscal 2010 when the real GDP growth rate was –0.1%.

Examining the contribution of domestic demand versus external demand, the contribution of external demand is forecast to be a substantial –0.6%, but domestic demand will contribute +1.0%, thus acting as the driving force for the economy (Chart 7). Among components of domestic demand, private-sector demand will contribute +0.4 percentage point and public-sector demand will contribute +0.6 percentage point. These figures indicate that growth will be supported by demand for recovery from the disaster, particularly by public works investment. In addition, among the components of private-sector demand, the contribution of inventory investment will be +0.3 percentage point, implying that much of the improvement can be explained by the restocking of inventories.

Chart 7: Breakdown of Contribution Rates to Real GDP Growth by Demand



Please note that, as a result of the recovery in the economy and the rise in international commodity prices, deflationary pressures will gradually diminish, but the year-on-year change in the GDP deflator is expected to be –1.1%. The rate of growth in the nominal GDP in fiscal 2011 will be –0.7%, the first negative figure in two years. On a quarter-to-quarter basis, the margin of decline year on year in the deflator will shrink and converge to approximately zero by the end of fiscal 2011.

In fiscal 2012, the increased demand related to recovery from the earthquake, coming mainly from the public sector, will be joined by robust increases in private-sector demand and external demand, resulting in a continuation of the recovery trend in the economy.

Through the first half of fiscal 2012, demand for public works investment and other expenditures related to recovery from the disaster will continue to boost the economy, but in the latter half of fiscal 2012, the positive effects of these expenditures are expected to gradually run their course. On the one hand, consumer spending as well as employment and income conditions will improve, but, with the introduction of an earthquake recovery tax, there is a possibility that the momentum may weaken beginning early in fiscal 2012.

However, as a result of improvement in overseas economies, exports will continue to be firm, and the contribution of the external sector will move into the positive range. Also, since improvement in corporate profitability will continue, capital investment is expected to remain on an upward trend. As a result, private-sector demand is forecast to be firm.

Real growth in fiscal 2012 is forecast to be +2.3%, a sharp rise over growth in the previous fiscal year. However, this figure will be pushed upward by a substantial carryover effect of +1.2%. After the elimination of this effect, the growth rate, calculated during the fiscal year, will be +1.1%, implying that the outlook during fiscal 2012 is for continued recovery at about the same pace as in fiscal 2011. The nominal GDP is forecast to rise 2.7% over the previous fiscal year, and the outlook is for the GDP deflator to rise 0.4% year on year. Although this rise will be small, the change in the deflator will move into the positive range, thus possibly signaling the end of deflation for the first time in 15 years, since 1997. However, much of this rise will be due to a sharp decline in the import deflator, meaning that there may be little feeling that deflationary pressures have been eliminated.

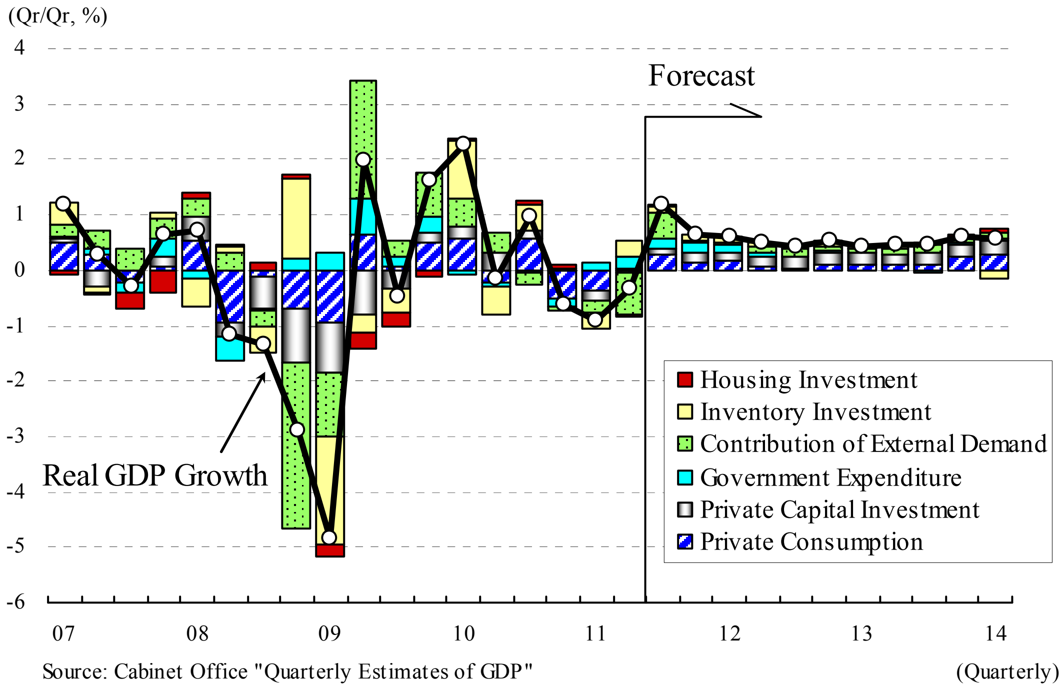
Although imports will rise, along with the recovery in the economy, the rate of growth in exports will be large, and the contribution of the external sector will move into the positive range, rising to +0.4 percentage point. On the other hand, the contribution of domestic demand will increase to +1.9 percentage points, and most of this will be accounted for by a contribution of +1.5 percentage points from private-sector demand. The contribution of the public sector will be only +0.4 percentage point.

Chart 8: Real GDP Growth (Fiscal Year)

	Carry-over from the previous year (A)	Growth rate during the year (B)	Real GDP growth rate (A)+(B)
FY2010 (actual)	2.4 %	-0.1 %	2.3 %
FY2011 (forecast)	-0.6 %	0.9 %	0.3 %
FY2012 (forecast)	1.2 %	1.1 %	2.3 %
FY2013 (forecast)	0.9 %	1.1 %	2.0 %

Source: Cabinet Office "Quarterly Estimates of GDP"

Chart 9: Real GDP Growth (seasonally adjusted)



Source: Cabinet Office "Quarterly Estimates of GDP"

2. Forecasts of Economic Activity by Sector

(1) Corporations

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

necessary condition will be stability in the world economy.

(2) Households

- Even though the effects of the earthquake on the unemployment ratio have not emerged, employment conditions are severe, as evidenced by the decline in the number of employed workers and other indicators. Moreover, the income environment continues to be stagnant. Although the employment environment is expected to show gradual improvement along with recovery in the domestic economy, the decline in corporate profits as a result of the earthquake is steep, and it will take time until wages begin to improve.

- The constraints on production and the mood of restraint among consumers following in the wake of the earthquake are gradually diminishing, and consumer spending is generally improving as such factors as strong sales of energy-saving appliances and FPD TVs continue to be strong. However, as these factors boosting consumer durable purchases run their course, if temporary taxes are imposed to repay recovery bonds, growth in consumer spending may become more moderate.
- Housing starts, which reached bottom in autumn 2009, are now viewed as being on an improving trend, but the level of activity remains low. Since a certain level of demand for housing is expected to continue, and housing investment will most likely continue to improve, but the rate of increase in the number of housing starts will remain moderate because the slowing in the rate of growth in the number of households will act as a restraining factor.

(3) Government

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

- However, from autumn 2008, as the economic downturn became increasingly serious, a number of economic policies and other measures were enacted, resulting in a rise in government expenditures. In fiscal 2009, government public investment increased substantially. Since the increase in expenditures accompanying the implementation of these policies was funded through the issuance of government bonds and because tax revenues fell sharply along with the deterioration in the economy, the government's fiscal position has deteriorated rapidly.
- In the midst of this deterioration in public finances, the government adopted its "Fiscal Management Strategy" in June 2010 and strengthened its initiatives to restore soundness to government finances. Based on this strategy, the medium-term fiscal framework was revised in August 2011, and the government has announced a policy of restraining fiscal outlays—excluding government bond expenses and certain other items in the general account budget (as well as the expenditures mentioned below related to the earthquake)—to ¥71 trillion, which was the level in the initial fiscal 2011 budget.
- On the other hand, expenditures for reconstruction and recovery following the Great East Japan Earthquake, which occurred in March 2011, during the five-year period through 2015 are expected to be about ¥19 trillion. If the ¥6 trillion included in the first and second supplementary budgets are excluded from this total, then the expenditures will come to ¥13 trillion. To fund these expenditures minus any reductions in outlays, proceeds from the sales of national assets, or other factors, the government is intending to impose certain tax measures with a limited term of effectiveness. In the draft bill prepared in June for simultaneous reform in social security and taxation, the proposal is to increase the consumption tax to 10% by 2015 to provide funding for social security. If this is taken into consideration, it is expected that the funding for recovery following the earthquake will be covered by increases in individual and corporate income taxes.
- Based on these considerations, the outlook is for expenditures to

increase, principally those for recovery following the earthquake, and for the increase to be mainly expenditures on public works investment in the stricken areas.

(4) Trends in Overseas Economies

- The pace of recovery in the world economy is slowing. In the United States, personal consumption has weakened as a result of the rise in gasoline prices. Sentiment about economic conditions among corporations in Europe is biding time. In Asia, although growth in China and certain other countries is continuing, there is evidence of a broadening trend in certain areas toward a slowdown because of the effects of monetary tightening measures.
- Although the recovery trend in the world is expected to continue, the risk of a downturn is rising because of the substantial increase in the seriousness of debt problems in Europe. In the United States, the rise in gasoline prices will pause, and consumption will continue its moderate rise. Although the impact of measures to tighten monetary conditions will linger in China and other countries in Asia, the impact on the economies of the region will be light, and balanced growth in domestic and external demand is expected to continue.
- Japan's exports, after decreasing substantially because of the supply constraints caused by the earthquake, are now improving rapidly. However, in the latter half of fiscal 2011, as a result of the slowing of overseas economies, the rate of increase in exports is expected to become more moderate. Japan's imports are also expected to rise, mainly because of the increase in requirements for natural gas and other mineral fuels following the shutdown of some of the country's nuclear power plants.
- Japan's trade surplus is expected to show a sharp decrease because of the stagnation in exports and the rise in imports in fiscal 2011. However, the surplus generated in the income account by Japan's net overseas assets is expected to hold steady. For this reason, the current account surplus will dip temporarily in fiscal 2011, but continue at a high level thereafter.

3. Forecasts for Prices and Financial Markets

- The increases in prices of raw materials, especially crude oil and metals, are pushing some prices upward. In the medium term, considerations of supply capacity and expansion in demand in China and other newly emerging economies suggest that inflationary pressures upstream and deflationary pressures on industrial and other products downstream will persist.
- Although adjustments are forecast to continue for the time being, international commodity market prices are expected to remain on an upward trend in the medium-to-long term, and, along with this, domestic corporate prices are expected to continue to rise. However, the pace of increase is expected to be moderate because supply capacity in Japan is likely to continue to exceed demand and since yen appreciation will be a factor pushing prices downward. The outlook for consumer prices is for continued small decreases because of the strong downward pressure on sales prices to final consumers.
- Regarding monetary policy, following the collapse of Lehman Brothers Holdings in fall 2008, measures were implemented to ease monetary policy. Thereafter, along with the return of stability to financial markets, although a portion of quantitative easing policies were lifted with set time limits, in view of continuing deflation, stronger policies were adopted to ease monetary policy again in December 2009. In addition, to cope with the increasing risk of economic downturns in Japan and overseas, in October 2010, a comprehensive policy for monetary easing was prepared. Then in March 2011, following the earthquake, and then again in August 2011, additional monetary easing policies were implemented because of growing concerns again regarding the direction of economic trends in Japan and overseas. For the time being, the Bank of Japan is expected to continue its stance of easing monetary policy.
- Although the economy is expected to recover following its steep drop in the wake of the earthquake, long-term interest rates are expected to remain low against a background of stable short-term rates. However, there is a possibility that the sustained recovery in overseas economies and the deterioration in government fiscal positions around the world

may place upward pressure on long-term interest rates. In foreign exchange markets, during 2010, the yen appreciated because of the weakness of the euro due to government fiscal problems in some EU countries and due to a decline in the value of the U.S. dollar related to that country's policy of quantitative easing. In 2011, there have been concerns not only about fiscal issues in Europe but also in the United States, and the trend toward yen appreciation has continued.

Chart 10: Outlook for Fiscal 2011-2012

Forecast

Yr/Yr、%

	FY2009 (actual)	FY2010 (actual)	FY2011 (forecast)	FY2012 (forecast)	FY2013 (forecast)
Nominal GDP	-3.7	0.4	-0.7	2.7	1.8
Real GDP	-2.4	2.3	0.3	2.3	2.0
Contribution of domestic demand	-2.7	1.5	1.0	1.9	1.6
Private consumption	0.0	0.8	-0.2	0.7	0.8
Housing investment	-18.2	-0.3	1.9	3.6	3.3
Private capital investment	-13.6	4.2	1.2	5.3	6.0
Contribution of inventory investment	-1.1	0.5	0.3	0.2	0.1
Government expenditure	5.2	0.0	2.3	1.4	0.2
Public investment	14.2	-10.0	3.6	5.5	-2.0
Government final consumption expenditure	3.5	2.2	2.0	0.6	0.6
Contribution of external demand	0.3	0.9	-0.6	0.4	0.4
Export of goods and services	-9.6	17.0	-0.6	7.4	7.1
Import of goods and services	-11.0	11.0	3.8	4.5	4.5
GDP deflator	-1.3	-1.9	-1.1	0.4	-0.2

Forecast

Yr/Yr、%

	FY2009 (actual)	FY2010 (actual)	FY2011 (forecast)	FY2012 (forecast)	FY2013 (forecast)
Current account balance (trillion yen)	15.8	16.1	10.1	14.3	15.4
balance on goods (trillion yen)	6.6	6.5	0.8	4.6	4.8
balance on service (trillion yen)	-1.8	-1.3	-1.6	-1.5	-1.4
balance on income (trillion yen)	12.1	12.1	12.0	12.4	13.1
Industrial production	-8.8	8.9	-1.2	4.0	3.6
Unemployment rate(%)	5.2	5.0	4.7	4.6	4.5
New housing starts(annualized, ten thousand units)	77.5	81.9	84.2	87.6	88.6
Domestic corporate goods prices	-5.2	0.7	1.3	-0.1	0.5
Consumer prices	-1.7	-0.4	-0.5	-0.3	0.2
excluding freshfood	-1.6	-0.8	-0.3	-0.2	0.2
Yen/U.S.Dollar	92.8	85.7	78.2	78.5	81.4
Uncollateralized call rates (O/N) (%)*	0.102	0.091	0.069	0.070	0.070
Newly issued government bond yields (10years) (%)	1.37	1.16	1.07	1.19	1.37
WTI future price (near month contract, US dollar/barrel)	70.7	83.4	87.3	82.1	86.5
Dubai crude oil prices (US dollar/barrel)	69.7	84.2	96.3	86.0	88.3

* actual=average, forecast=end of period

Chart 5: Outlook for Calendar 2011-2012

Forecast

Yr/Yr、%

	CY2009 (actual)	CY2010 (actual)	CY2011 (forecast)	CY2012 (forecast)	CY2013 (forecast)
Nominal GDP	-6.6	1.7	-2.0	2.8	1.8
Real GDP	-6.3	4.0	-0.5	2.4	1.9
Contribution of domestic demand	-4.8	2.1	0.2	2.1	1.5
Private consumption	-1.9	1.8	-0.7	0.8	0.7
Housing investment	-14.0	-6.3	2.8	3.1	3.4
Private capital investment	-16.7	2.1	0.8	4.6	5.9
Contribution of inventory investment	-1.1	0.7	0.1	0.4	0.2
Government expenditure	4.1	1.2	1.2	2.1	0.3
Public investment	10.4	-3.4	-3.7	8.2	-0.6
Government final consumption expenditure	3.0	2.2	2.3	0.9	0.5
Contribution of external demand	-1.5	1.8	-0.6	0.3	0.4
Export of goods and services	-23.9	23.9	0.2	6.3	6.9
Import of goods and services	-15.3	9.8	4.7	4.5	4.4
GDP deflator	-0.4	-2.1	-1.5	0.5	-0.1

Forecast

Yr/Yr、%

	CY2009 (actual)	CY2010 (actual)	CY2011 (forecast)	CY2012 (forecast)	CY2013 (forecast)
Current account balance (trillion yen)	13.3	17.2	10.4	13.8	15.0
balance on goods (trillion yen)	4.0	8.0	0.5	4.4	4.8
balance on service (trillion yen)	-1.9	-1.4	-1.5	-1.5	-1.5
balance on income (trillion yen)	12.3	11.7	12.6	12.0	12.9
Industrial production	-21.9	16.4	-2.3	4.0	3.2
Unemployment rate (%)	5.0	5.1	4.7	4.6	4.5
New housing starts(annualized, ten thousand units)	78.8	81.3	83.3	87.2	88.4
Domestic corporate goods prices	-5.2	-0.2	1.8	-0.4	0.6
Consumer prices	-1.4	-0.7	-0.5	-0.3	0.1
excluding freshfood	-1.3	-1.0	-0.4	-0.2	0.1
Yen/U.S.Dollar	93.5	87.8	79.6	77.9	80.3
Uncollateralized call rates (O/N) (%)*	0.105	0.093	0.074	0.070	0.070
Newly issued government bond yields (10years) (%)	1.35	1.18	1.12	1.13	1.34
WTI future price (near month contract, US dollar/barrel)	61.8	79.5	90.8	81.1	85.5
Dubai crude oil prices (US dollar/barrel)	61.8	78.0	99.6	86.0	87.8

* actual=average, forecast=end of period

Chart 6: Outlook for 2011-2012 (Quarterly)

Forecast (from FY2011 4-6)

Qr/Qr、%
Yr/Yr、%

	FY2010				FY2011				FY2012			
	4-6	7-9	10-12	1-3	4-6	7-9	10-12	1-3	4-6	7-9	10-12	1-3
Nominal GDP	-0.9	0.6	-1.0	-1.5	-1.4	1.7	1.2	0.7	0.3	0.9	0.5	0.2
	1.1	2.8	0.5	-2.9	-3.2	-2.2	0.0	2.4	3.8	3.0	2.2	2.1
Real GDP	-0.1	1.0	-0.6	-0.9	-0.3	1.2	0.7	0.6	0.5	0.4	0.5	0.4
	3.1	5.0	2.1	-1.0	-1.0	-0.7	0.7	2.3	2.9	2.2	2.1	2.0
Contribution of domestic demand (Qr/Qr,%)	-0.5	1.2	-0.6	-0.7	0.4	0.7	0.6	0.6	0.4	0.3	0.4	0.4
Private consumption	-0.4	0.9	-0.9	-0.6	-0.1	0.5	0.2	0.3	0.1	0.1	0.2	0.2
	1.3	2.5	0.6	-1.0	-0.6	-1.1	0.0	0.9	1.1	0.7	0.6	0.5
Housing investment	-0.1	2.1	2.8	0.2	-1.9	1.4	1.1	0.7	0.4	1.3	1.2	0.9
	-10.5	-1.3	6.2	5.2	3.2	2.3	0.9	1.4	3.7	3.4	3.7	3.8
Private capital investment	2.4	1.1	0.1	-1.4	0.2	0.9	1.2	1.1	1.4	1.4	1.4	1.5
	3.2	6.7	5.5	2.0	0.1	-0.2	1.0	3.4	4.7	5.2	5.4	5.8
Contribution of inventory investment (Qr/Qr,%)	-0.5	0.5	0.0	-0.3	0.3	0.1	0.1	0.1	0.1	0.0	0.1	0.0
Government expenditure	-0.2	-0.1	-0.6	0.6	0.9	0.7	0.8	0.6	0.3	0.0	0.2	0.0
	1.9	0.8	-1.8	-0.8	1.1	1.6	3.1	3.2	2.2	1.7	1.3	0.6
Public investment	-5.3	-2.2	-5.8	-1.0	3.0	2.4	2.6	2.8	1.5	0.4	0.0	-0.2
	-4.4	-4.9	-13.5	-14.3	-5.4	-1.8	7.2	11.4	9.7	7.6	4.9	1.7
Government final consumption expenditure	0.9	0.5	0.4	0.9	0.5	0.5	0.3	0.2	0.0	0.1	0.1	0.1
	2.8	2.0	1.5	2.6	2.2	2.2	2.2	1.4	1.0	0.6	0.4	0.3
Contribution of external demand (Qr/Qr,%)	0.4	-0.2	-0.1	-0.2	-0.8	0.5	0.0	0.0	0.1	0.1	0.1	0.1
Export of goods and services	6.7	0.7	-1.0	0.0	-4.9	4.8	1.7	1.4	1.6	1.8	1.7	1.6
	30.2	21.2	13.2	6.5	-5.3	-1.3	1.3	2.7	9.7	6.6	6.6	6.8
Import of goods and services	4.9	2.6	-0.6	1.5	0.1	1.4	1.6	1.1	0.9	0.9	1.2	1.2
	14.4	11.5	9.7	8.5	3.7	2.4	4.7	4.2	5.1	4.5	4.1	4.2
GDP deflator (Yr/Yr,%)	-2.0	-2.1	-1.6	-1.9	-2.2	-1.5	-0.6	0.2	0.9	0.7	0.1	0.0

Forecast (from FY2011 4-6)

Yr/Yr、%

	FY2010				FY2011				FY2012			
	4-6	7-9	10-12	1-3	4-6	7-9	10-12	1-3	4-6	7-9	10-12	1-3
Current account balance (trillion yen)*	3.9	4.4	4.3	3.3	1.9	2.3	2.6	3.0	3.4	3.6	3.4	3.4
balance on goods (trillion yen)*	1.8	2.0	1.8	0.9	-1.3	0.1	0.8	1.1	1.1	1.1	1.0	1.3
balance on service (trillion yen)*	-0.3	-0.3	-0.4	-0.3	-0.4	-0.4	-0.5	-0.4	-0.4	-0.3	-0.4	-0.4
balance on income (trillion yen)*	2.7	3.0	3.2	3.1	3.8	2.9	2.6	2.6	3.0	3.2	3.1	2.9
Industrial production (Qr/Qr、%)	0.7	-1.0	-0.1	-2.0	-4.0	5.9	0.6	0.8	0.5	0.8	0.8	0.8
Industrial production (Yr/Yr、%)	21.3	14.0	5.9	-2.5	-6.8	-0.2	-0.3	3.0	8.0	2.8	2.7	2.9
Unemployment rate (%)*	5.1	5.0	5.0	4.7	4.6	4.8	4.8	4.7	4.7	4.6	4.6	4.6
New housing starts(annualized, ten thousand units)	77.6	81.5	84.3	84.2	81.0	82.6	85.5	88.2	87.2	86.0	87.5	90.0
Domestic corporate goods prices (Yr/Yr,%)	0.2	-0.2	1.0	1.7	2.4	2.2	1.1	-0.4	-1.2	-0.3	0.4	0.8
Consumer prices (Yr/Yr,%)	-0.9	-0.8	0.1	-0.5	-0.4	-0.2	-0.7	-0.5	-0.3	-0.4	-0.2	-0.1
excluding freshfood (Yr/Yr,%)	-1.2	-1.1	-0.5	-0.8	-0.3	-0.1	-0.4	-0.4	-0.4	-0.2	-0.1	0.0
Yen/U.S.Dollar	92.0	85.9	82.6	82.3	81.7	77.8	76.5	77.0	77.6	78.2	78.8	79.4
Uncollateralized call rates (O/N) (%)**	0.093	0.094	0.089	0.088	0.067	0.070	0.070	0.070	0.070	0.070	0.070	0.070
Newly issued government bond yields (10years) (%)	1.28	1.05	1.05	1.25	1.19	1.04	1.02	1.06	1.09	1.16	1.23	1.28
WTI future price (near month contract, US dollar/barrel)	78.0	76.2	85.2	94.1	102.6	86.4	80.0	80.0	80.0	81.5	83.0	84.0
Dubai crude oil prices (US dollar/barrel)	77.6	74.2	84.3	100.5	110.6	98.4	89.0	87.0	85.0	85.5	86.5	87.0

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