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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
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(1) Current State of the Economy: Improvement Continuing,
Supported by Exports and Positive Effects of Stimulus Policies

Recent Trends

Real GDP growth for the January-to-March period was +1.2% over the previous quarter (+4.9% at an annualized rate), the fourth consecutive quarterly increase. This indicated that the movement toward improvement in the economy is continuing, as a result of the increase in exports and the positive effects of economic stimulus policies. The margin of decline in the GDP deflator (hereinafter, deflator), which shows trends in prices in the overall economy, was 3.0% below the level of the same quarter of the previous year. This margin of decline was slightly larger than in the previous quarter, despite weakening of the pace of decline in domestic prices, and reflected a movement toward increase in import prices, including those of crude oil and other materials. On the other hand, the domestic demand deflator, which excludes the effects of export and import prices, was 1.9% below the same period of the previous year, the second consecutive shrinking in its margin of decline. Corporate profitability is continuing to recover, and, as employment and income conditions have moved out of the worst phase, the rise in import prices is beginning to spread gradually to domestic prices.

By contribution of external versus domestic demand, external demand (or net exports, which equal exports minus imports) contributed +0.7 percentage point, thus posting the fourth consecutive positive figure. Domestic demand contributed +0.6 percentage point, the second consecutive positive figure. Compared with the first half of fiscal 2009, when the economy was more dependent on the external sector, it appears that during the latter half of this fiscal year the contributions of domestic and external demand were, generally, in better balance.

By component of domestic demand, in the January-to-March quarter of 2010, growth in personal consumption was +0.3% over the previous quarter, the fourth consecutive quarter-to-quarter increase. This continued rising trend reflects the positive effects of economic stimulus policies, including the payment of subsidies and the tax break for eco-friendly automobiles as well as the eco-point system. It also reflects the fact that employment and income conditions have now passed through the worst phase of the downturn. Private residential investment rose 0.3% from the previous quarter, thus marking the first increase in five quarters.

Private capital investment rose 1.0%, the second gradual quarter-to-quarter increase. Although sentiment among corporations that they have excess capacity remains strong, industrial production is increasing and corporate profitability is improving. In addition, adjustments in inventories have generally been completed, and the contribution of private inventory investment to real GDP was +0.2 percentage point for the quarter, the first positive contribution in five quarters.

In the government sector, public investment declined 1.7%, the third consecutive quarterly decrease, reflecting the diminishing effects of economic stimulus policies. On the other hand, government final consumption rose 0.5% for the quarter, and, in total, public demand rose 0.1% for the quarter.

Next, the external sector continued to make a positive contribution to GDP growth, amounting to 0.7 percentage point for the quarter. Although imports increased 2.3%, the third consecutive quarterly rise, reflecting the improvement in the domestic economy, exports climbed a high 6.9% quarter to quarter, driven principally by shipments to China and other countries in Asia.

The Economy Is Recovering

These GDP results confirm again that the economy reached bottom in spring 2009, that the real GDP is on a rising trend on a quarter-to-quarter basis, that domestic demand is increasing, and that the economy is

gathering strength. Following the previous peak in the January-to-March quarter of 2008, real GDP fell 8.6% and has only recovered to 4.7% of the previous peak level (Chart 1). However, positive growth on a quarter-to-quarter basis has now continued for one year, and it appears appropriate not to describe current conditions as “moving toward improvement,” an expression used to describe the early phases after the economy has reached bottom, but as already “recovering.”

Similarly, turning to movements in industrial production, which have preceded those of the economy as a whole, production appears to be recovering at a steady pace. Following the previous peak in February 2008, production had dropped 35.1% by February 2009 and currently has recovered to a level 13.9% below the previous peak (Chart 2). Please note that, if we make comparisons with the time just before the collapse of Lehman Brothers Holdings, production dropped 31.0% from the level in August 2008, and, as of March 2010, had recovered to a level 8.4% below the previous peak.

Chart 1: Divergence of Real GDP from the Previous Peak

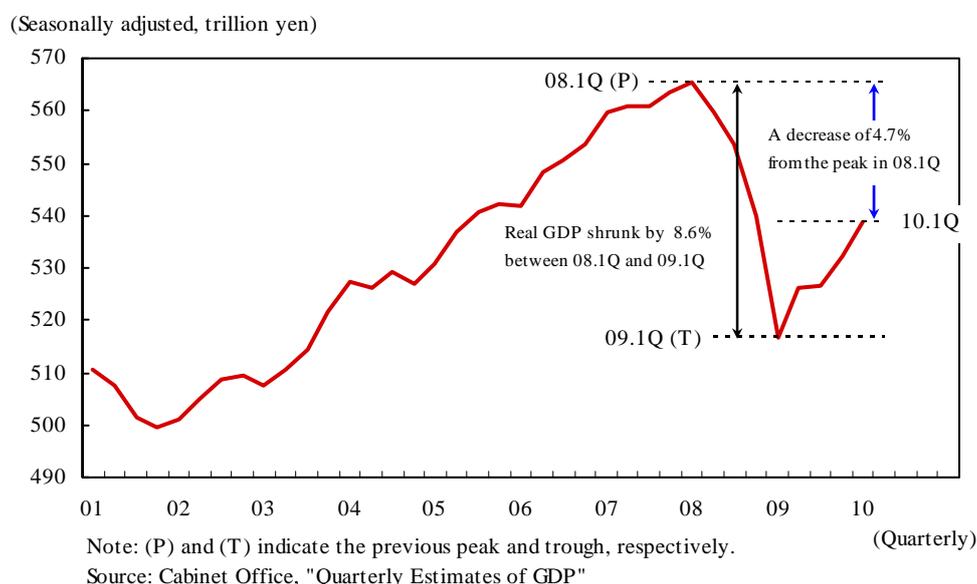
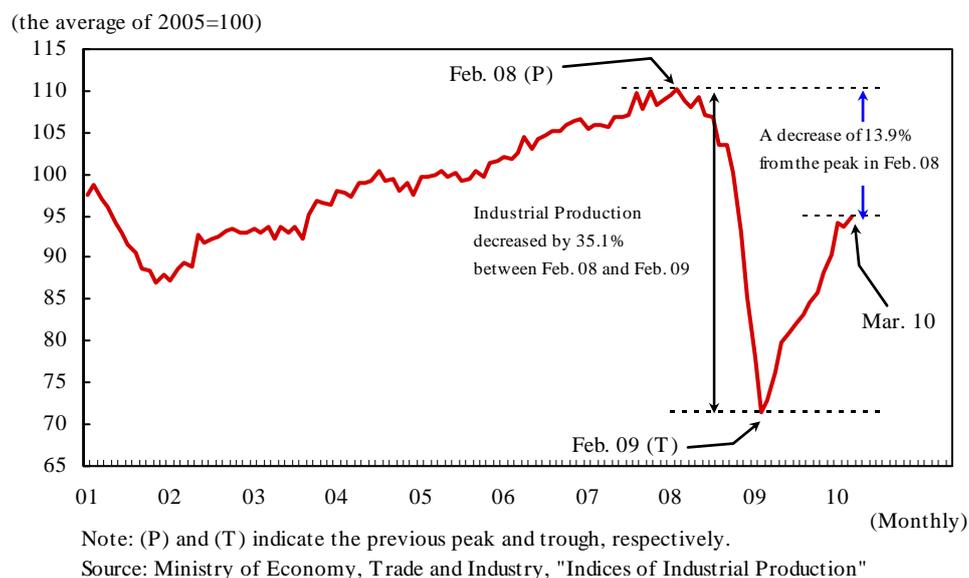


Chart 2: Divergence of Industrial Production from the Previous Peak



(2) Economic Outlook: Pause Expected in the Latter Half of Fiscal 2010 as the Positive Impact of Policy Measures Ends

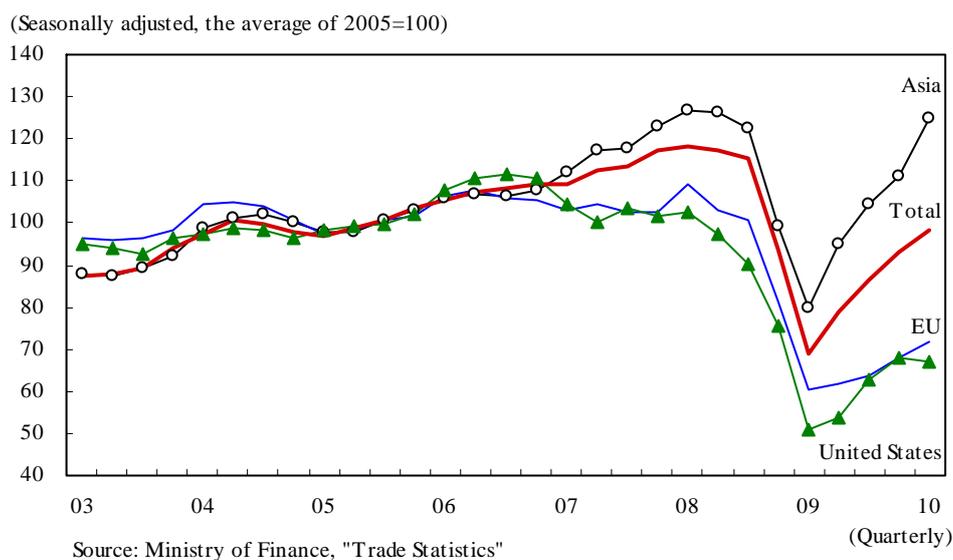
The three principal factors giving momentum to the economic recovery are (1) continuing major increases in exports as economies around the world recover, particularly the emerging nations, (2) the continuation of the positive effects on consumer spending of government stimulus policies, including the introduction of tax breaks and subsidies for eco-friendly automobiles as well as the eco-point system, and (3) the virtual completion of inventory adjustments and the movement toward restocking, which is pushing production upward. Among these, the movement toward restocking inventories appears to be the most marginal, judging from the fact that corporations have still not relaxed their cautious stance toward future developments in the economy. However, trends in the economy bear close watching because the reliance on exports and government stimulus policies carries with it the risk of a substantial weakening in economic conditions.

In the following paragraphs, we analyze the first two factors:

(a) Strong Exports and Growing Causes for Concern: Likelihood Is Small, but the Risk Could Be Substantial

The strongest driver of growth at present is the steady recovery in exports. Analysis of export volumes by geographic area shows that, even though exports to the United States and the EU have begun to rise, the tempo of increase is moderate (Chart 3). However, exports to the rest of Asia are on a firmly rising trend, and have recovered to the level of the previous peak. Growth in exports to China has been especially large, and many categories of Japan's major export products are increasing, including automobiles and automotive parts, general machinery, electric machinery, chemicals, and steel.

**Chart 3: Continuing Improvement in Exports
(Export volume index)**



Nevertheless, there one major concern regarding prospects for exports. That is the risk of economic turmoil that may occur, first of all, owing to the rising uncertainty in European credit markets.

First, the problems in European credit markets were triggered by financial problems in Greece. However, on May 9, the EU and IMF announced a major rescue plan of up to €750 billion to be used in the event that a

country adopting the euro experiences a financial crisis. As a result of this announcement, uncertainty about future developments is receding. Also, on May 10, the European Central Bank (ECB) introduced a number of major policies to eliminate market uncertainty. These included changing its previous stance and making the decision to purchase government bonds of countries adopting the euro, and, as a measure to secure liquidity in financial markets, the ECB reopened its program, which had been closed previously, to supply unlimited funds at fixed interest rates with a term of six months. In addition, to avoid turmoil in financial markets, the central banks of principal countries, including the Bank of Japan (BOJ), decided to begin to supply U.S. dollars again. As a result of these policies, the risk that credit uncertainty may spread to other European countries, including Spain and Portugal, which are also having fiscal problems, is decreasing. For these reasons, even though concerns had been rising that problems in Europe would create issues in other countries around the world, due to turmoil in financial markets and the failure of some financial institutions, it appears that the worst case scenario has been avoided. Nevertheless, conditions still need to be watched carefully for a number of reasons. These include the acceleration in the depreciation of the euro following the introduction of restrictions on short-selling German government bonds.

In such economies as those of Greece and Portugal, which are relatively small, even if cuts in government expenditures as part of fiscal the restructuring measures act to put downward pressure on these economies, the impact from the perspective of the eurozone as a whole will be marginal. (The share of the Greek economy in the GDP of all countries adopting the euro, as of 2009, was 2.6%.) For this reason, it is likely that the moderate trend toward recovery in the eurozone will continue. In particular, the decline in the value of the euro will tend to boost the current favorable trend in exports from the eurozone, and this can be expected to have a significant positive effect on economies in the region.

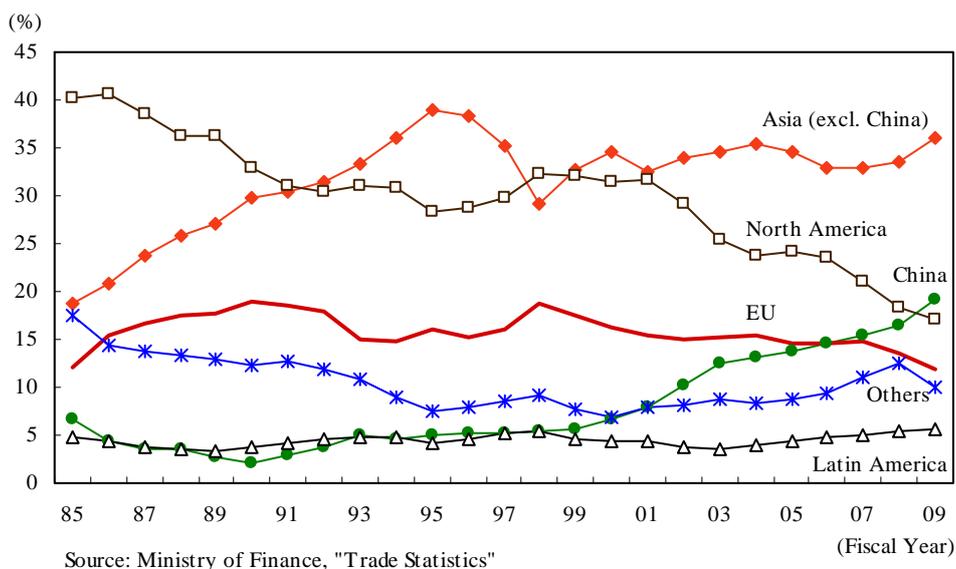
Even so, compared with other countries and regions, the momentum of recovery in Europe is weak. Also, support for the view is growing that the restructuring of countries in the region with fiscal problems will not proceed smoothly. If various countries in the eurozone fail to move together

toward solving these problems, there is concern that this may bring unsettled market conditions again. Accordingly, it will not be possible to remove this risk factor for the foreseeable future.

Regarding the impact of these conditions on the Japanese economy, Europe is not a very large purchaser of Japanese exports; accordingly, the effects will be marginal. Especially during the recovery following the collapse of Lehman Brothers, Japan's exports to the rest of Asia, including China, have rapidly increased in importance, and Europe's position as a buyer of Japanese exports has experienced a relative decline (Chart 4). The impact on Japan's exports of credit uncertainty problems in Europe is likely to be small, provided the deterioration in the world economy is not as serious as that following the collapse of Lehman Brothers.

However, the yen is appreciating sharply against the euro. This will naturally have an impact on Japan's exports to Europe. In addition, the relative weakness of the euro will increase the price competitiveness of exports from Europe in Asia and elsewhere, and there is possibility that this could cause a drop in exports from Japan.

Chart 4: Trends in Japan's Exports by Country

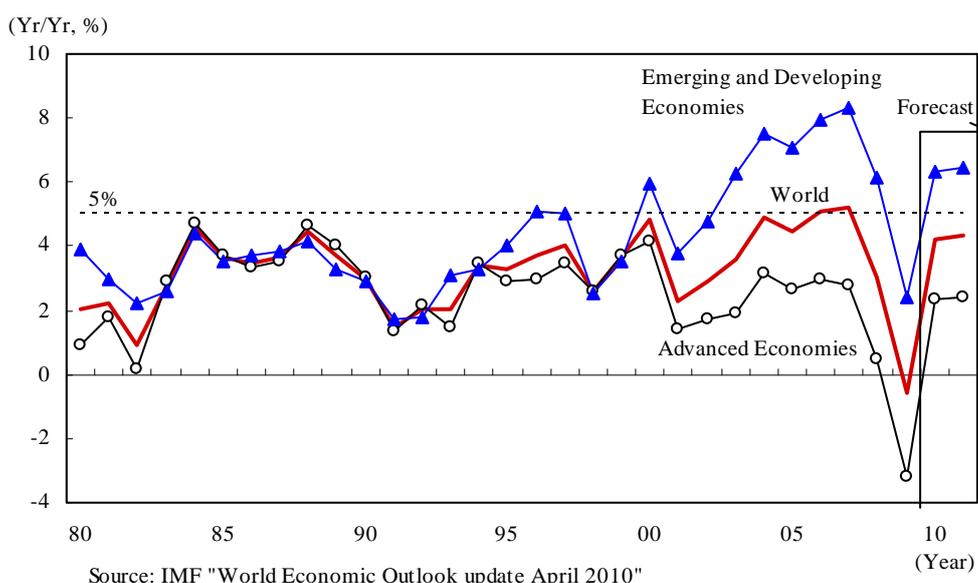


Moreover, another consideration is the unsettled political situation in Thailand. The turmoil there escalated temporarily, and there was concern about its effect on the local economy, but, at present, conditions appear to be quieting down. However, whether or not the situation will stabilize cannot be taken for granted. If unsettled conditions return, there is a possibility that this could have a negative impact on the local production of the many Japanese companies that have operations in Thailand. In the event this happens, it could bring a decline in exports of materials and parts to Thailand, and this, in turn, could have an adverse impact on the performance of the affected companies.

There is also concern that China's credit-tightening policy could cause its economy to lose momentum. In addition, growing tensions on the Korean peninsula are another risk factor.

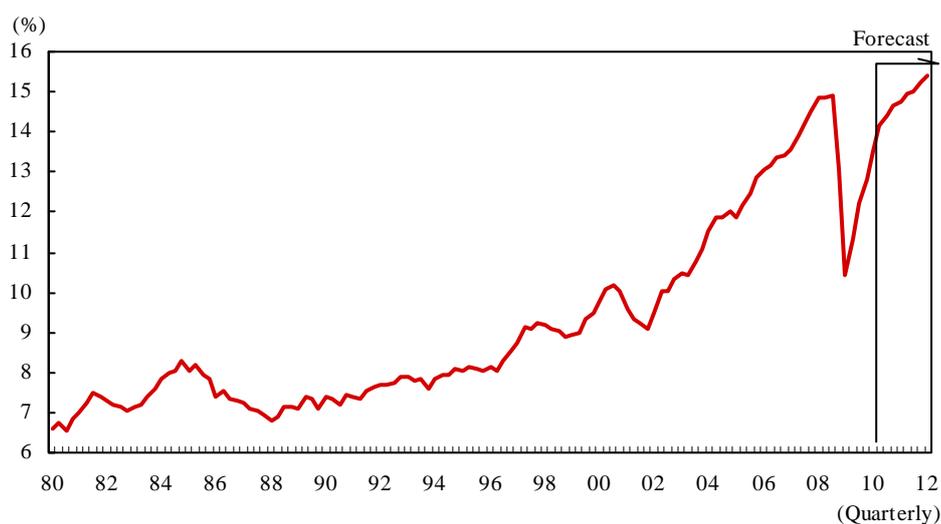
If none of the series of potential developments overseas we have just mentioned materializes, as the IMF's outlook for the world economy indicates, the emerging countries will drive growth, and the world economy is forecast to continue to recover (Chart 5). If this happens, economic growth driven by the external sector is expected to continue.

Chart 5: Outlook for the World Economy (IMF)



This kind of export-led growth has been the scenario experienced during periods of economic expansion since 2002. After declining sharply following the collapse of Lehman Brothers, dependence on the external sector has recently begun to rise again and is forecast to continue to increase going forward (Chart 6). Accordingly, in the sense that export dependence means that Japan is more susceptible to trends in the international economy, the current improvement in the economy is built on a weak foundation. Therefore, if the pace of recovery in the rest of the world weakens or economic conditions deteriorate, we will have to pay close attention to the risk of a decline in the momentum of Japan's economic recovery.

Chart 6: Continuing Increase in Dependence on External Demand



Note: Degree of Dependence on Exports = Real Export / (Real GDP + Real Import)
 Source: Cabinet Office, "Quarterly Estimates of GDP"

(b) Expected Ending of the Positive Impact of Policy Measures: Will Bring Only a Temporary Downturn

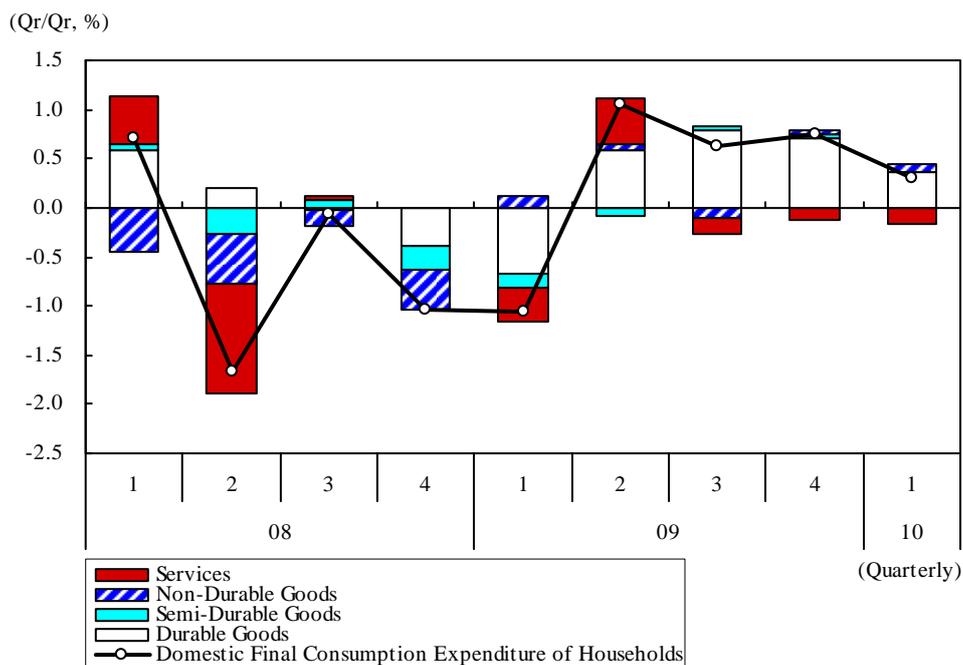
Consumer spending continues to be supported by the positive effects of economic policies. Sustained mainly by the favorable support provided by the government's tax breaks and subsidies for eco-cars as well as the introduction of the eco-point system, consumer spending on durable goods in real terms has increased for four consecutive quarters since the April-to-June quarter of 2009. This has served to boost overall consumer

spending (Chart 7). There have been periods in the past when growth in spending on consumer durables has accelerated sharply, but this time, consumption is holding firm despite harsh household income conditions. This suggests that government policies are playing a major role in supporting consumer spending.

However, with incomes declining, this relatively strong consumer spending may, in effect, be cutting into future demand. The strongest sales growth is being recorded for large durable goods. Once households make purchases of these types of goods, there is a possibility that they may postpone future purchases and/or replacement for some time.

The government subsidies for purchasing eco-cars will terminate at the end of September 2010, and the eco-point system is scheduled to end as of December 31 this year. The termination of these programs will likely to bring surges in demand in September and then again in December, and these will likely be followed by reactionary declines in consumer spending. A similar pattern of demand is expected in the case of cigarettes, since there will be a major increase in tobacco taxes beginning in October this year.

Chart 7: Durable Goods Purchases Boost Consumer Spending



Source: Cabinet Office, "Quarterly Estimates of GDP"

The magnitude of this reactionary decline will depend on future trends in sales and the size of the surge in demand, but, especially in the case of automobiles, which represent a major expenditure, the impact could be major. For this reason, there is a strong likelihood that consumption will drop below the level of the same period of the previous year in the October-to-December quarter of 2010, because of the decline in automobile sales, and then again in the January-to-March quarter of 2011, due to a drop in sales of eco-friendly electrical appliances. Accordingly, as a result of the weakening of consumer spending during these periods, there is a possibility that the economy may pause temporarily. However, forecasts for the latter half of fiscal 2010 call for increases in exports, capital investment, and residential investment, and, for the reasons cited next, the reactionary decline in consumer spending will be temporary. Therefore, the reactionary declines are not expected to lead to a serious loss of momentum in the economy.

First, there are signs of improvement in household incomes. The worst phase of the employment situation has ended, as evidenced by a gradual decline in the unemployment rate, and wages have generally bottomed out, as suggested by increases in the number of overtime hours worked and other indicators. Worker compensation in nominal terms, which closely reflects actual conditions in the household sector, was below the level of the same quarter of the previous year for seven consecutive quarters, through the October-to-December quarter of 2009, reflecting tougher restructuring measures in the corporate sector, but moved above the previous year in the January-to-March quarter of 2010. This suggests that the slide in this indicator has finally stopped (Chart 8). Also, worker compensation in real terms, benefiting from declining prices, has recovered the level prevailing during the April-to-June quarter of 2008, which was prior to the collapse of Lehman Brothers. Although corporations are expected to continue to adopt a tough restructuring stance for the time being, the worst phases for the employment and income situation appear to have passed. We are not envisioning sudden improvement during fiscal 2010, but gradual improvement is possible.

Next, after the eco-point system has been terminated, there is the possibility

that sales of flat-panel TVs will continue at a certain level. According to the *Consumer Confidence Survey* issued by the Cabinet Office (covering all households, including one-person households), the household ownership rate for flat-panel TVs rose from 49.7% at the end of fiscal 2008 to 63.4% at the end of fiscal 2009. Over the same period, the number of flat-panel TVs per 100 households rose from 68.2 to 94.8 (Chart 9). On the other hand, the number of TVs with picture tubes per 100 households fell from 146.2 to 120.0, but the number still exceeds the number of flat-panel TVs. Therefore, the total number of TVs with picture tubes in Japanese households, based on the figure of about 50 million households in total, is estimated to be about 62 million. Not all of these will be replaced by the time that analog broadcasting is suspended in July 2011, but this figure suggests that the potential market demand for flat-panel TVs is still quite large.

The future demand for flat-panel TVs is believed likely to be mainly for purchases of second sets by households that already own one flat-panel unit. If this demand for second, or more, sets continues to emerge, it is possible that the reactionary decline in demand, following the surge prior to the termination of the eco-point system, will be temporary.

Chart 8: Trends in Worker Compensation

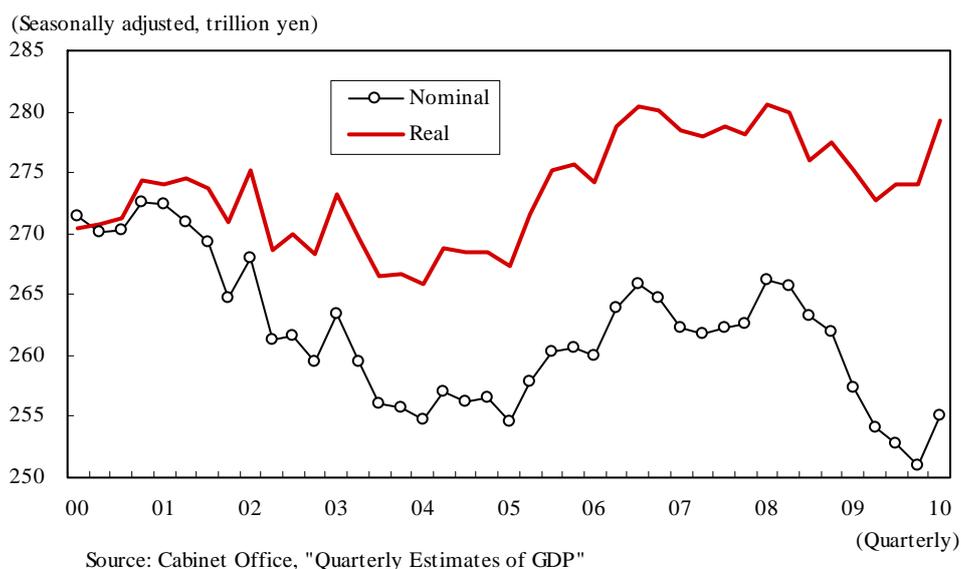
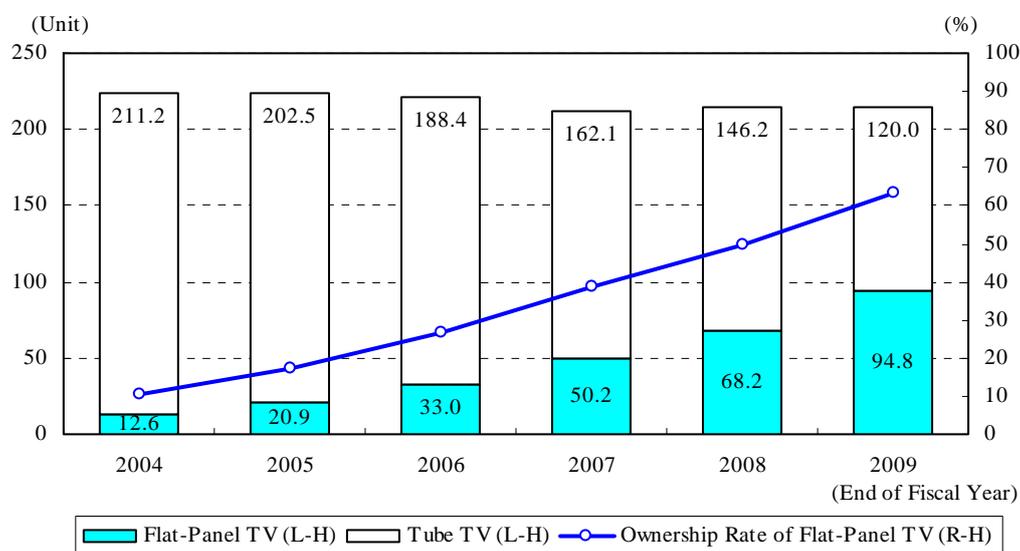


Chart 9: Ownership of TVs per 100 Households and the Ownership Rate of Flat-Panel TVs



Note: Data covers all household including single households.

Source: Cabinet Office, "Consumer Confidence Survey covering all of Japan"

Please note that there are many uncertainties surrounding trends in sales of automobiles following the termination of the subsidies for purchasing new cars. However, the tax break for eco-cars will be continued, and the launching of new models as well as other factors are expected to boost automobile sales. Therefore, the sudden decline in unit sales in the latter half of fiscal 2010 will not continue, and there is a possibility that, going forward, sales will be maintained at a certain level.

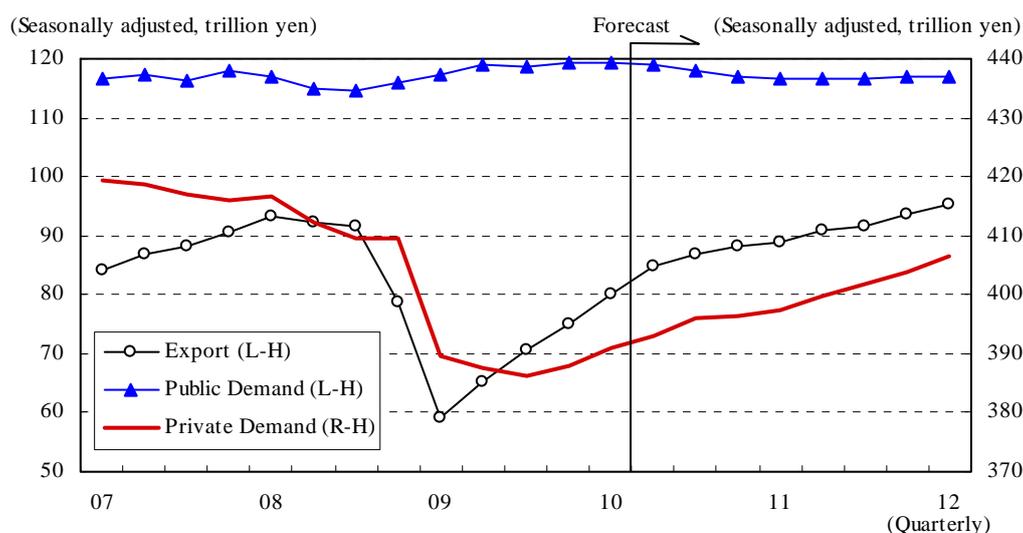
(c) Looking to Self-Sustaining Recovery: Subsiding of Deflationary Pressures

With the ending of the positive benefits of government stimulus policies, even though consumer spending is expected to decline in the latter half of fiscal 2010, this reactionary decline is believed likely to be temporary. The economy will not likely experience a serious loss of momentum as a result. Consequently, in part because the benefits of the improvement in corporate profitability as a result of strong exports will start to filter through into private-sector demand, the growth momentum of the economy will begin to rise again in fiscal 2011. As might be expected, the sentiment among corporations that they have too many employees and too much production

capacity will fade, thus leading to some increase in the pace of improvement in the employment and income situations. It is, therefore, likely that along with the rise in rates of equipment utilization and improvement in corporate profitability, the rising trend in capital investment will continue.

Turning to the trends in the components of real GDP going forward, although public demand will stagnate, reflecting the cutbacks in public investment, the increase in exports is forecast to continue (Chart 10). Also, private-sector demand, after a temporary slowdown in the pace of recovery in the latter half of fiscal 2010, will pick up speed again in fiscal 2011. As the economy enters fiscal 2011, the economy is expected to finally move back to a self-sustaining growth path.

Chart 10: Growth in Private-Sector Demand Expected to Continue

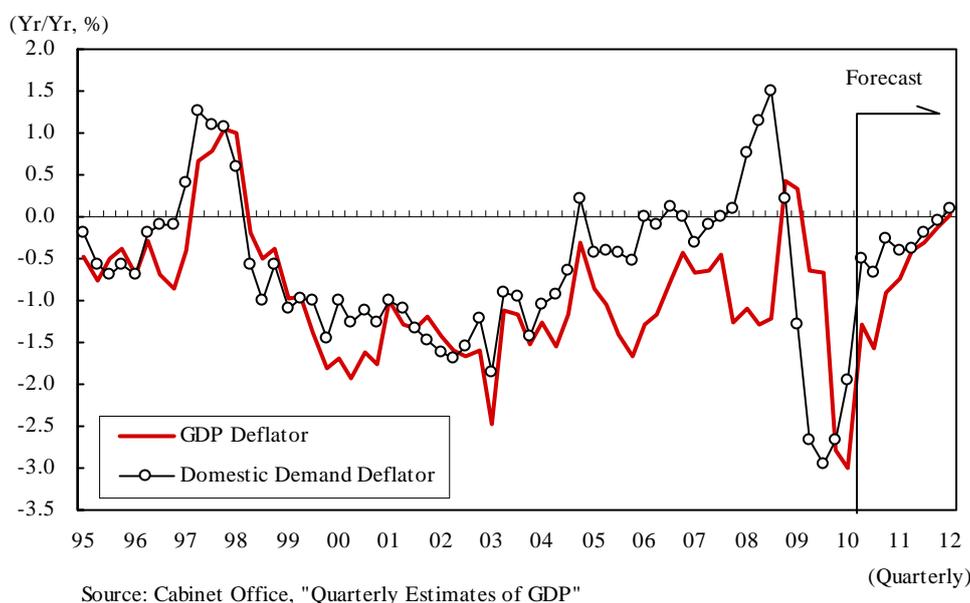


Note: Private Demand is the total of Private Consumption, Private Residential Investment, Private Non-Residential Investment and Private Inventory.
 Source: Cabinet Office, "Quarterly Estimates of GDP"

Along with the recovery in demand, deflationary pressures are likely to gradually subside in fiscal 2011. Not only will the rise in energy prices continue, prices of other goods and services will start to bottom out, and the consumer price index (general, excluding fresh foods) will rise above the levels of the same period of the previous year. Movements in the deflator will slightly lag other price indicators, but, toward the end of fiscal 2011, it

may also rise over the previous year's level.

Chart 11: Diminishing Margin of Decline in the GDP Deflator



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

In fiscal 2010, during the first half, the Japanese economy will gradually lose some momentum as the government makes further cuts in public investment and the rate of increase in exports pauses temporarily. However, consumer spending will remain firm, supported by the positive effects of stimulus policies, and both private capital and private residential investment will bottom out. As a result, the recovery trend will continue. Nevertheless, during the latter half of the fiscal year, the positive effects of government stimulus policies will end, thus bringing concerns about a temporary weakening of the trend toward recovery.

Despite certain risk factors, exports are forecast to remain strong because of continuing recovery in overseas economies. Since the pace of recovery overseas will settle down as time passes, the rate of expansion will moderate toward the end of the fiscal year, but the upward trend will be

maintained. As a result of the improvement in the domestic economy, growth in imports will remain firm, but, even so, the external sector will contribute 0.9 percentage point and is expected to continue to be a driving force for the economy.

Personal consumption is forecast to remain firm in the first half of fiscal 2010, supported principally by purchases of large consumer durables owing to the positive effects of government stimulus policies. Since a surge in demand for automobiles is expected toward the end of September, this is likely to give a major boost to consumer spending. However, since this spending is occurring at a time when the employment and income situations are harsh, there are concerns that it may result in lower consumption in the future. For this reason, in the latter half of the fiscal year, a substantial reactionary decline is forecast for automobile sales, and, after the beginning of 2011, another reactionary decline is expected in flat-panel TVs and other eco-friendly household appliances, thus making a temporary drop in consumer spending unavoidable. As a result of these trends in consumption, the rate of growth in real GDP in the second half of the fiscal year is forecast to level off.

However, as mentioned previously, the increase in exports will continue, and, during the fiscal year, components of private-sector demand—namely, private capital investment and residential investment—will continue to rise gradually. As a consequence, even though the economy pauses, it will not experience a serious loss of momentum.

In the corporate sector, improvement will continue, centering on the manufacturing sector. The rate of increase in industrial production will settle down, but is expected to remain on the rising trend. In addition, corporate profits will continue to show improvement along with growth in sales and the positive impact of reductions in personnel and other costs. However, raising sales prices will continue to be difficult, thus restraining profitability at a relatively low level. For this reason, although recovery in private capital investment will continue, corporations will not make aggressive investments for increasing capacity, and private capital investment will fall short of being a driving force in the economy.

Our forecast for fiscal 2010 calls for growth of +2.0%, the first positive growth figure in three years (Chart 12). Compared with fiscal 2009, the rate of expansion will rise sharply, but this is because of a carryover effect of +1.5% due to relatively lower growth in fiscal 2009. 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, rates of GDP growth compared with the previous period may be negative temporarily.

The nominal GDP growth rate for the fiscal year will be +0.9%, which, like the figure for real growth, will be the first positive figure in three years; however, the deflator will decline 1.1%, reflecting the continuation of deflationary pressures.

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

As a result of the continuation of economic recovery overseas, Japan's exports are forecast to continue to rise, and industrial production will remain on an upward trend. Moreover, along with improvement in employment and income conditions, consumer spending, which will have decreased in the latter half of fiscal 2010, will begin to show improvement. Although there will be some uncertainties, provided various government policies are implemented, including the payment of the full amount of child allowances from beginning in 2011, these will be effective in raising consumption. In addition, improvement in corporate profitability and the increase in capacity utilization rates will result in a continuation of the upward trend in private capital investment.

The level of real GDP and industrial production will remain below the previous peak in fiscal 2007, and the trend toward improvement in corporate profitability should lead to a gradual subsiding of the feeling of excessive capacity and employment levels among corporations.

We are forecasting real growth of +1.4% in fiscal 2011, and it will appear

that growth over the previous fiscal year is declining; however, this will be due to a carryover effect of +0.2%. Calculating the growth rate during the fiscal year to take account of this carryover, real growth in fiscal 2011 will be +1.2%, which will be substantially higher than the rate of growth in fiscal 2010 after adjustment for the carryover. Also, since imports will increase along with growth in exports, the contribution of the external sector will decline to only +0.1 percentage point. In contrast, the contribution of domestic demand is forecast to rise to 1.3 percentage points, as the trend toward self-sustaining growth gathers strength.

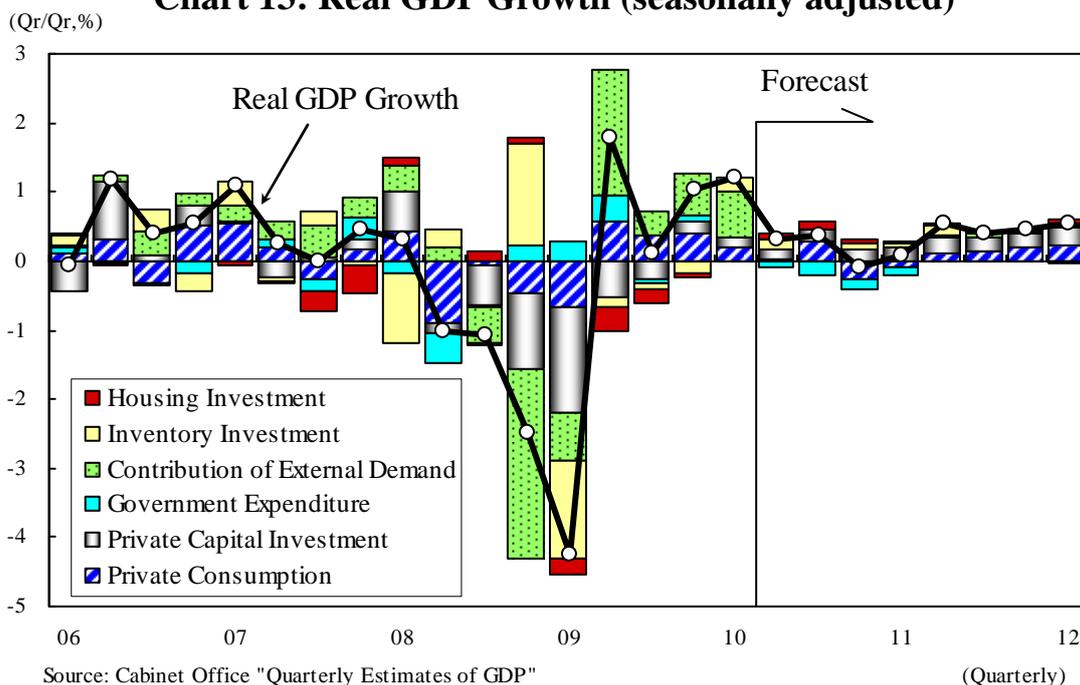
Moreover, as the economic recovery proceeds, deflationary pressures are forecast to diminish. The rate of GDP growth in nominal terms will rise to 1.1%, and the margin of decline in the deflator will shrink to -0.2%. On a quarter-to-quarter basis, the margin of decline in the deflator, on a year-on-year basis, is forecast to shrink to zero.

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)
FY2007 (actual)	1.3 %	0.5 %	1.8 %
FY2008 (actual)	0.5 %	-4.3 %	-3.7 %
FY2009 (actual)	-4.5 %	2.6 %	-1.9 %
FY2010 (forecast)	1.5 %	0.5 %	2.0 %
FY2011 (forecast)	0.2 %	1.2 %	1.4 %

Source: Cabinet Office "Quarterly Estimates of GDP"

Chart 13: Real GDP Growth (seasonally adjusted)



2. Forecasts of Economic Activity by Sector

(1) Corporations

- As they entered the 21st century, corporations had completed their disposal of negative assets left over from Japan's bubble economy, and their financial positions and profitability recovered substantially, supported by strong exports. Accordingly, the risks of a major downturn in production, capital investment, or other aspects of corporate activities had receded for the time being.
- However, starting in autumn 2008, domestic and overseas demand began to drop sharply, and companies made major adjustments in production to reduce their inventories. As a result, production dropped rapidly, mainly in such industries as automobiles, digital-related products (including semiconductors and LCDs), general machinery, and other items. Since the beginning of 2009, production has bottomed out and shown improvement, but, after the reaction following inventory adjustments and the ending of the positive effects of government

policies, the pace of recovery in production has become moderate. However, industrial activity is likely to continue at a low level for the time being.

- As a result of the deterioration in the domestic and overseas economies, corporate profitability has fallen sharply and private capital investment has plunged substantially. Nevertheless, there is a need to make a certain level of capital investment to replace equipment and raise product value added to increase competitiveness. In addition, as rates of capacity utilization have risen, along with the increase in industrial production, 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.
- Prior to the downturn, recurring profits 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, accompanying the recent improvement in the world economy and the positive effects of cost reductions, including personnel expenses, corporate profitability is showing improvement. Nevertheless, it is expected to take some time for recurring profits, which have decreased markedly, to recover to the previous levels.

(2) Households

- Since autumn 2008, faced with major declines in demand, companies reduced the number of personnel, and this resulted in a marked deterioration in conditions in the employment environment. However, from the first half of calendar 2009, the economy has begun to show improvement, and, even though employment conditions remain harsh, there have been signs of improvement. Looking ahead, the number of employed persons is expected to begin to rise above the level of the previous year, and the unemployment rate, although still high, is expected to show a gradual decline.

- As a result of economic policies to promote the purchases of eco-friendly products, consumer spending, principally for durable goods, is continuing to increase. Although consumer spending may decline temporarily in the latter half of fiscal 2010, as the effects of economic policies run their course, consumption is expected to strengthen in fiscal 2011 because of an increase in the pace of improvement in the income environment, the payment of the full amount of child allowances by the government, and other factors.
- Housing starts, which dropped sharply from fall 2008, reached bottom in fall 2009, and are now showing improvement. However, the level remains low compared with past levels. For the time being, housing starts are likely to remain on a rising trend because of the extremely large decline they showed previously. Nevertheless, since the slower growth in the number of households will be a structural factor restraining residential investment, expansion in housing starts is expected to 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 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.
- The government has adopted a policy of shifting the allocation of its expenditures from “concrete (public investment) to people” and has adopted a policy of focusing on providing support for households. The budget drafted for fiscal 2010 contains such measures, including the payment of child allowances and the effective elimination of tuition fees for attending public high schools. On the other hand, under the initial fiscal 2010 budget, public investment in the general account budget is to be reduced by a substantial 18.3% in comparison with the initial budget of the previous fiscal year. As a result, public investment is likely to decline for the foreseeable future. Regarding government final consumption, along with the demographic aging of the population, social welfare payments, including health- and nursing-care costs, are expected to continue to rise, but growth in these expenditures is likely to be restrained, as measures are taken to restrain and slash expenditures in other areas.

(4) Trends in Overseas Economies

- The world economy is continuing to show signs of improvement. In the January-to-March quarter of 2010, the United States and the countries of Europe continued to report positive growth (compared with the previous quarter), and growth in China was at double-digit levels, as in the previous quarter.
- The outlook is for recovery in the world economy to continue in 2010. Consumer spending in the United States is showing clear improvement, and, in China, even though there is concern about the tightening of monetary policy, there is a strong possibility that high growth rates will

continue. However, as a result of the confusion created by fiscal problems in Greece, conditions in international financial markets have become decidedly more unsettled, and there is concern that this may have a depressing effect on the world economy.

- 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 are expanding at a brisk pace. These exports to the rest of Asia are expected to be a driving force for the Japanese economy, and the outlook is for exports to continue on a rising trend going forward.
- 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 come to occupy a larger share of the current account surplus.

3. Forecasts for Prices and Financial Markets

- The sharp declines experienced previously in the prices of raw materials, especially crude oil and metals, have ended, and prices of these commodities are rising again, thus boosting some prices. However, in the medium term, considerations of supply capacity and expansion in demand in China and other newly emerging economies suggest that inflationary pressures upstream and deflationary pressures on industrial and other 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 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.
- Regarding the recovery in the economy, deflation is continuing, short-term interest rates are remaining stable at low levels, and long-term interest rates are also expected to remain low. However, there is a possibility that sustained recovery in various countries and the deterioration in government fiscal positions around the world may place upward pressure on 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 calendar 2010, owing to concerns about fiscal problems in Europe, market participants began to buy U.S. dollars and yen once again. The directions taken by countries around the world as regards their current easy monetary policies and expansionary fiscal policies have become factors to be taken into account when considering foreign currency rates.

Chart 14: Outlook for Fiscal 2010-2011

	FY2007 (actual)	FY2008 (actual)	FY2009 (actual)	Forecast ↘	
				FY2010 (forecast)	FY2011 (forecast)
	Yr/Yr, %				
Nominal GDP	0.9	-4.2	-3.7	0.9	1.1
Real GDP	1.8	-3.7	-1.9	2.0	1.4
Contribution of domestic demand	0.5	-2.6	-2.4	1.1	1.3
Private consumption	1.4	-1.8	0.6	0.9	0.4
Housing investment	-13.5	-3.7	-18.5	5.3	5.2
Private capital investment	1.3	-6.8	-15.1	4.1	6.0
Contribution of inventory investment	0.0	-0.1	-0.5	0.2	0.2
Government expenditure	0.1	-1.3	2.9	-1.4	-0.6
Public investment	-6.4	-6.6	8.7	-12.1	-7.0
Government final consumption expenditure	1.5	-0.1	1.8	1.0	0.6
Contribution of external demand	1.2	-1.2	0.4	0.9	0.1
Export of goods and services	9.3	-10.4	-9.6	19.9	6.4
Import of goods and services	1.8	-4.0	-11.8	14.5	6.4
GDP deflator	-0.9	-0.4	-1.8	-1.1	-0.2

	FY2007 (actual)	FY2008 (actual)	FY2009 (actual)	Forecast ↘	
				FY2010 (forecast)	FY2011 (forecast)
	Yr/Yr, %				
Current account balance (trillion yen)	24.5	12.3	15.7	17.5	18.3
balance on goods (trillion yen)	11.7	1.2	6.6	7.9	8.0
balance on service (trillion yen)	-2.6	-2.0	-1.8	-2.0	-2.1
balance on income (trillion yen)	16.8	14.6	12.0	12.9	13.7
Industrial production	2.7	-12.7	-8.9	12.7	3.0
Unemployment rate(%)	3.8	4.1	5.2	4.8	4.6
New housing starts(annualized, ten thousand units)	103.6	103.9	77.5	85.6	90.3
Domestic corporate goods prices	2.3	3.1	-5.2	1.1	1.0
Consumer prices	0.2	1.2	-1.7	-0.7	0.1
excluding freshfood	0.3	1.2	-1.6	-0.8	0.1
Yen/U.S.Dollar	114.2	100.5	92.8	93.3	95.8
Uncollateralized call rates (O/N) (%)*	0.505	0.363	0.098	0.100	0.250
Newly issued government bond yields (10years) (%)	1.60	1.46	1.36	1.35	1.51
WTI future price (near month contract, US dollar/barrel)	82.2	85.9	70.6	79.6	83.3
Dubai crude oil prices (US dollar/barrel)	77.3	82.1	69.7	78.1	80.6

* actual=average, forecast=end of period

Chart 15: Outlook for Calendar 2010-2011

	CY2007 (actual)	CY2008 (actual)	CY2009 (actual)	Forecast		Yr/Yr, %
				CY2010 (forecast)	CY2011 (forecast)	
Nominal GDP	1.6	-2.0	-6.1	1.2	0.6	
Real GDP	2.4	-1.2	-5.2	3.0	1.0	
Contribution of domestic demand	1.2	-1.3	-4.0	1.2	1.0	
Private consumption	1.6	-0.7	-1.0	1.6	0.1	
Housing investment	-9.6	-8.1	-14.2	-2.7	7.2	
Private capital investment	2.6	0.1	-19.3	1.5	5.6	
Contribution of inventory investment	0.3	-0.4	-0.3	1.8	0.2	
Government expenditure	-0.2	-1.2	2.5	-0.3	-1.3	
Public investment	-7.4	-8.5	7.4	-7.4	-11.1	
Government final consumption expenditure	1.5	0.3	1.5	1.3	0.6	
Contribution of external demand	1.1	0.1	-1.3	1.6	0.0	
Export of goods and services	8.4	1.6	-23.9	25.6	7.4	
Import of goods and services	1.6	1.0	-16.8	12.8	7.8	
GDP deflator	-0.7	-0.8	-0.9	-1.7	-0.4	

	CY2007 (actual)	CY2008 (actual)	CY2009 (actual)	Forecast		Yr/Yr, %
				CY2010 (forecast)	CY2011 (forecast)	
Current account balance (trillion yen)	24.8	16.4	13.3	17.6	18.0	
balance on goods (trillion yen)	12.3	4.0	4.0	8.3	7.9	
balance on service (trillion yen)	-2.5	-2.1	-1.9	-2.0	-2.1	
balance on income (trillion yen)	16.3	15.8	12.3	12.6	13.5	
Industrial production	2.8	-3.4	-21.9	18.6	2.5	
Unemployment rate (%)	3.9	4.0	5.1	4.9	4.7	
New housing starts(annualized, ten thousand units)	106.1	109.3	78.8	84.4	89.4	
Domestic corporate goods prices	1.7	4.6	-5.2	0.3	1.1	
Consumer prices	0.0	1.4	-1.4	-0.9	-0.1	
excluding freshfood	0.0	1.5	-1.3	-1.0	-0.1	
Yen/U.S.Dollar	117.8	103.4	93.5	92.4	95.3	
Uncollateralized call rates (O/N) (%)*	0.474	0.462	0.104	0.100	0.100	
Newly issued government bond yields (10years) (%)	1.68	1.48	1.34	1.34	1.47	
WTI future price (near month contract, US dollar/barrel)	72.3	99.6	61.8	78.8	82.6	
Dubai crude oil prices (US dollar/barrel)	68.4	93.8	61.8	77.3	80.1	

* actual=average, forecast=end of period

Chart 16: Outlook for 2010-2011 (Quarterly)

	Forecast											
	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	0.2	-0.3	0.3	1.2	0.2	-0.3	-0.2	0.2	0.8	-0.2	0.6	0.7
	-6.2	-5.8	-3.8	1.4	1.4	1.4	0.7	-0.1	0.4	0.7	1.3	2.2
Real GDP	1.8	0.1	1.0	1.2	0.3	0.4	-0.1	0.1	0.5	0.4	0.5	0.5
	-5.7	-5.2	-1.1	4.6	2.7	3.0	1.6	0.7	0.9	1.0	1.4	2.2
Contribution of domestic demand (Qr/Qr,%)	-0.1	-0.2	0.4	0.6	0.3	0.4	-0.1	0.1	0.5	0.4	0.4	0.5
Private consumption	1.0	0.6	0.7	0.3	0.1	0.5	-0.4	-0.2	0.2	0.2	0.3	0.4
Housing investment	-1.1	-0.4	1.2	2.7	1.7	1.6	0.5	0.0	0.1	-0.1	0.6	1.2
Private capital investment	-9.8	-7.3	-2.7	0.3	3.9	3.7	2.7	1.0	1.2	0.5	0.4	1.3
Contribution of inventory investment (Qr/Qr,%)	-9.9	-20.3	-24.5	-18.2	-6.0	5.0	11.0	12.0	9.0	5.5	3.2	3.5
Government expenditure	-3.7	-2.0	1.3	1.0	1.1	1.3	1.3	1.4	1.5	1.5	1.4	1.8
Public investment	-22.2	-21.1	-13.9	-3.2	1.2	4.6	4.8	5.3	5.6	5.7	6.0	6.4
Government final consumption expenditure	-0.1	-0.1	-0.2	0.2	0.1	0.0	0.1	0.1	0.1	0.0	0.0	0.0
Government expenditure	1.5	-0.1	0.4	0.1	-0.4	-0.9	-0.6	-0.5	0.1	0.1	0.0	0.1
Government final consumption expenditure	3.3	3.5	3.3	1.8	0.2	-0.7	-2.3	-2.5	-1.6	-0.9	-0.3	0.5
Public investment	7.3	-1.0	-1.2	-1.7	-2.9	-5.3	-4.6	-4.1	-0.2	-0.4	-0.7	-0.2
Government final consumption expenditure	13.9	11.6	9.3	2.4	-6.5	-10.7	-14.1	-15.1	-15.2	-9.6	-4.9	-0.4
Government final consumption expenditure	0.2	0.1	0.7	0.5	0.1	0.0	0.1	0.2	0.2	0.2	0.1	0.1
Government final consumption expenditure	1.8	2.1	1.8	1.5	1.4	1.3	0.8	0.4	0.5	0.6	0.7	0.7
Contribution of external demand (Qr/Qr,%)	1.8	0.4	0.6	0.7	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.0
Export of goods and services	10.1	8.6	5.8	6.9	5.9	2.5	1.8	0.7	2.2	0.8	2.0	1.8
Import of goods and services	-29.3	-22.7	-4.7	34.3	30.0	22.7	18.0	11.2	7.4	5.6	5.8	7.1
Import of goods and services	-3.7	5.6	1.5	2.3	6.7	2.8	2.0	0.7	2.3	0.5	2.0	1.7
Import of goods and services	-18.5	-16.2	-15.3	5.7	17.0	14.0	14.5	12.6	8.0	5.6	5.6	6.6
GDP deflator (Yr/Yr,%)	-0.6	-0.7	-2.7	-3.0	-1.3	-1.5	-0.9	-0.7	-0.4	-0.3	-0.1	0.0

	Forecast											
	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	4.5	4.5	4.2	4.7	4.3	4.5	4.4	5.1	4.5
balance on goods (trillion yen)*	1.0	1.4	1.9	2.4	2.1	1.8	2.0	2.0	2.1	1.8	2.0	2.1
balance on service (trillion yen)*	-0.5	-0.4	-0.4	-0.5	-0.6	-0.4	-0.5	-0.5	-0.7	-0.5	-0.5	-0.5
balance on income (trillion yen)*	3.3	2.9	2.7	2.9	3.3	3.1	3.5	3.1	3.5	3.3	3.9	3.3
Industrial production (Qr/Qr, %)	6.5	5.3	5.9	7.0	2.3	0.7	-0.2	0.0	1.0	1.1	1.3	1.5
Industrial production (Yr/Yr, %)	-27.4	-19.4	-4.3	27.5	21.7	17.5	10.5	3.0	1.3	2.2	3.6	4.9
Unemployment rate (%)*	5.1	5.4	5.2	4.9	4.9	4.9	4.8	4.7	4.7	4.7	4.6	4.6
New housing starts(annualized, ten thousand units)	76.9	71.3	79.1	83.7	83.5	83.0	87.3	89.0	88.6	88.0	91.9	92.9
Domestic corporate goods prices (Yr/Yr,%)	-5.5	-8.2	-5.2	-1.7	0.4	0.8	1.7	1.6	1.0	0.9	1.0	1.2
Consumer prices (Yr/Yr,%)	-1.0	-2.2	-2.1	-1.2	-1.1	-0.8	-0.5	-0.6	-0.1	0.0	0.3	0.2
excluding freshfood (Yr/Yr,%)	-1.0	-2.3	-1.8	-1.2	-1.2	-0.8	-0.6	-0.6	0.0	0.0	0.2	0.2
Yen/U.S.Dollar	97.3	93.6	89.7	90.7	92.5	92.8	93.5	94.5	95.0	95.5	96.0	96.5
Uncollateralized call rates (O/N) (%)**	0.103	0.103	0.104	0.098	0.100	0.100	0.100	0.100	0.100	0.100	0.100	0.250
Newly issued government bond yields (10years) (%)	1.45	1.34	1.31	1.35	1.29	1.33	1.38	1.41	1.45	1.49	1.53	1.56
WTI future price (near month contract, US dollar/barrel)	59.6	68.3	76.2	78.3	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	78.8	76.0	78.5	79.0	80.0	80.5	81.0	81.0

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

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