

Economic Outlook for FY2009 and FY2010

August 2009

Key points of Mizuho Research Institute's (MHRI) outlook on the economy in FY2009 and FY2010
(reflecting *The First Preliminary Quarterly Estimates of GDP (1st QE)* for the Apr-Jun quarter of 2009)

<The US Economy>

Fragile recovery of final demand despite an improvement of the inventory adjustment cycle

2009 -2.7% (previous outlook -2.6%)

2010 +1.8% (previous outlook +1.2%)

<The Japanese Economy>

FY2009 -3.1% (previous outlook -3.8%)

Despite Japan's economic recovery driven by the government's economic stimulus measures, private demand will remain weak

FY2010 +0.5% (previous outlook +0.6%)

Even though the downturn of capital investment and labor will take a breather, growth will remain tepid due to a backlash to the stimulus measures

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I. The US economy

The contraction of US real GDP eased in the Apr-Jun quarter of 2009 (-1.0% q-o-q p.a.)

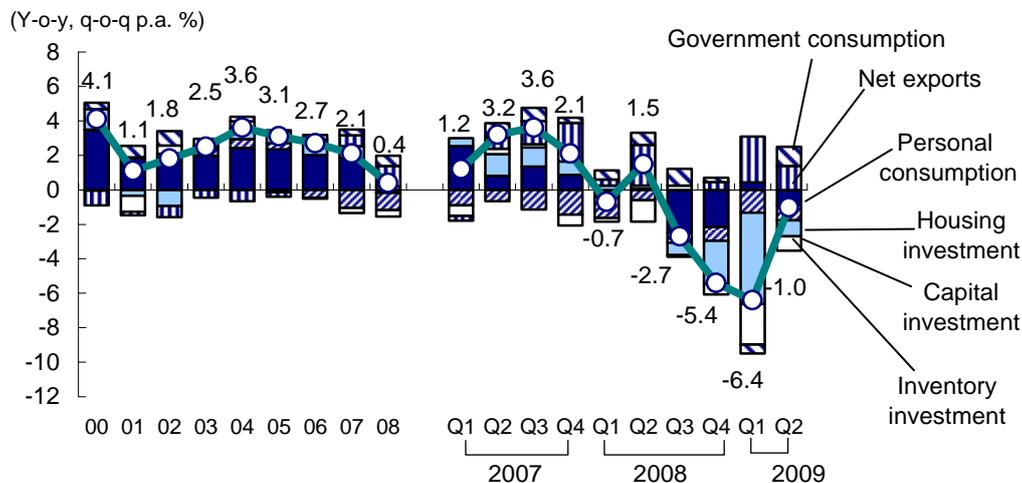
Outlook on economic growth in 2009 is revised downward to -2.7% (2009) and revised upward to +1.8% in 2010 (previous outlook in June: -2.6%, +1.2%).

According to advance estimates released by the Bureau of Economic Analysis, the contraction of US real gross domestic product (GDP) moderated substantially to -1.0% q-o-q p.a. in the Apr-Jun quarter of 2009 from -6.4% q-o-q p.a. in the previous quarter from January to March of 2009 (**Chart 1**). In addition to the improvement of capital investment which served as a major drag upon growth in the previous quarter, the negative contribution by inventory investment also shrank. The surge of government expenditures and slower pace of export fall also contributed to overall growth. On the other hand, housing investment continued to fall sharply and personal consumption contracted from the previous quarter, serving as concerns regarding the future course of the US economy.

Note that major revisions have been made to the recent US GDP data such as changes in the benchmark year. A comparison of the trends of real GDP from the Jan-Mar quarter of 2008 to the Jan-Mar quarter of 2009 prior to and after the revision revealed that growth prior to the revision was -2.5% in contrast to -3.3% after the revision, indicating that the US economic deterioration was worse than initially believed.

We have revised down our forecast on US growth in 2009 from -2.6% in our previous forecast in June to -2.7% and have revised upward our forecast on growth in 2010 from +1.2% to +1.8%. The downward revision of our forecast on growth in 2009 stems primarily from the contraction of the carry-over of growth from -1.1% to -1.3%. On the other hand, as a result of upward revisions of both inventory investment and private-sector final demand in the second half of 2009 and the first half of 2010, the rate of real GDP growth in 2010 is projected to

[Chart 1: US real GDP growth]



Note: The line represents real GDP (calendar year data on a y-o-y basis and quarterly data on a q-o-q p.a. basis). The bars represent the contribution to the line.
Source: US Department of Commerce.

be higher than previous forecasts. However, such upward revisions do not indicate a shift to an optimistic outlook. The upward revisions only reflect the fact that future uncertainties have eased somewhat and that there has been a temporary rise of demand stemming from the economic stimulus measures since our previous *Economic Outlook* in June 2009. A full-fledged recovery is unlikely any time soon since employment and balance sheet adjustments should keep consumer spending subdued. The key points of our outlook on the US economy are as follows.

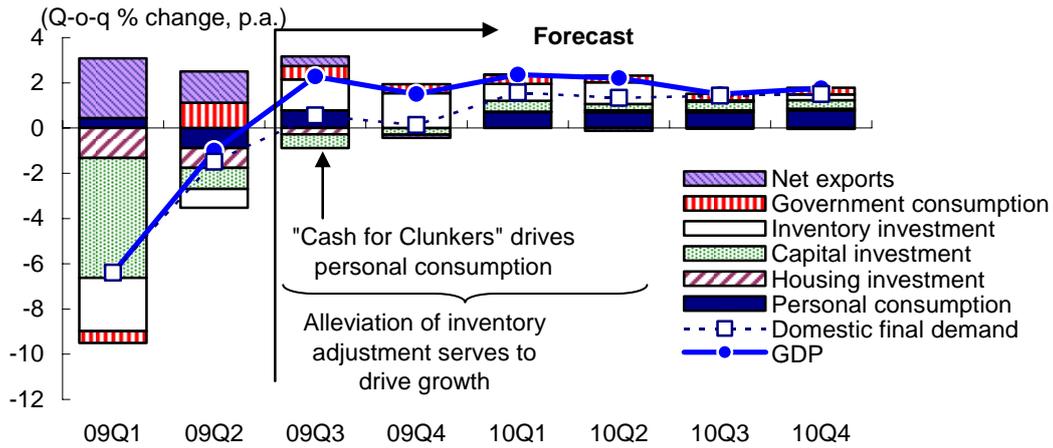
The US economy appears to have emerged out its darkest moments.

As far as the developments of economic indicators since our previous *Economic Outlook* suggest, the US economy appears to have emerged out of its darkest moments. In July, the Institute of Supply Management (ISM) business conditions index stood at 48.9 with respect to manufacturers and 46.4 for nonmanufacturers, indicating that business sentiment is continuing to improve. In particular, note that new orders index (55.3) and the production index (57.9) among manufacturers both recovered, rising above the expansion-or-contraction threshold of 50. These improvements are also prevalent in the industrial production index. In addition to a significant rise of production in the motor vehicle and parts sector in July, production among other manufacturing sectors also registered a modest increase for the first time in nine months. While the rise of production in the motor vehicle and parts sector stems most likely from the Car Allowance Rebate System (known colloquially as the “Cash for Clunkers” program), it appears that the large-scale inventory and production adjustment is about to end.

Moderation of inventory adjustment and replenishment of inventories will serve as a major driver of growth.

The moderation of inventory adjustments and replenishment of inventories will serve as major driver of growth in the near term. Even though inventory investment recorded a historical reduction of -USD141.1 billion p.a. in the Apr-Jun quarter of 2009, its negative contribution to real GDP growth in the Apr-Jun quarter contracted sharply from -2.36% in the previous quarter to -0.83% because of a slowdown in pace of inventory adjustments. The pace of inventory reduction will continue to slow down in the Jul-Sep quarter and beyond, providing reasons to believe that the contribution by inventory investment to the rate of real GDP growth will turn positive (**Chart 2**).

[Chart 2: Outlook on US real GDP growth (contribution by components of demand)]



Source: US Department of Commerce, MHRI.

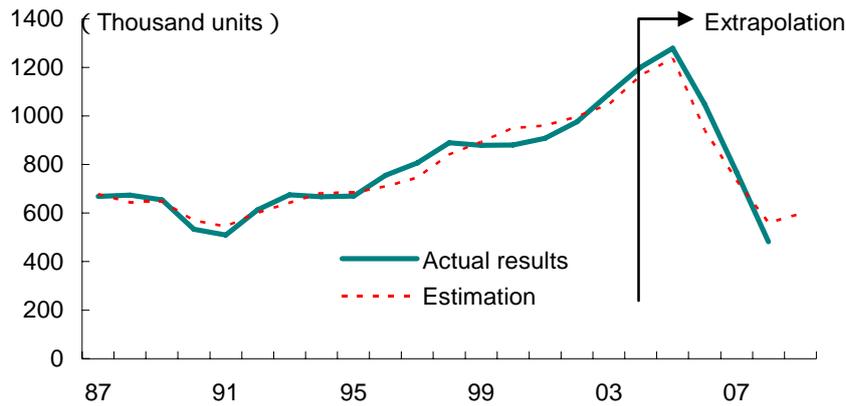
Investment costs for home purchasers will improve, leading to a recovery of housing demand. Housing investment will bottom out earlier than expected.

Turning to the developments of final demand since our previous *Economic Outlook*, the recovery of housing demand deserves a note of special mention. A mild rise of both housing sales and housing starts are observed in the housing market. In June, the number of new home sales (single-family homes) and existing home sales (single-family and multi-family homes) increased at an annualized pace of 384 thousand units and 4,890 thousand units respectively, both recording an increase for the third consecutive month. As a result, the months' supply at current sales ratio improved mainly with respect to new homes, contributing to the improvement of the sentiment on a supply glut.

Housing demand is affected largely by investment costs. Investment costs refer to mortgage interest rates, the percentage rise of home prices and the substantial costs of home ownership in consideration of tax breaks for mortgages. The fall of mortgage interest rates and the stabilization of home prices since the beginning of 2009 are serving to halt the rise of investment costs. This in turn is leading to the possibility that housing demand is starting to stabilize (**Chart 3**). The tax break on home purchase expenses (10% of home price, maximum USD8 thousand) will also serve as improvements of investment costs for first-time home buyers who are targets of the measure.

As mentioned later on, labor market conditions should remain in dire straits, keeping a full-fledged recovery of housing demand unlikely anytime soon. That said, given the gradual recovery of housing demand, housing investment should bottom out in the not-too-distant future.

[Chart 3: Estimates of housing demand in consideration of investment costs]



Notes: The explanatory variable is a constant term, investment costs, population.
 Time span of estimation from 1987 to 2003.
 Sources: US Department of Commerce, MHRI.

Exports and capital investment also show signs of improvement.

Exports and capital investment have also started to show signs of improvement. Real exports increased for two months in a row after bottoming out in April and the ISM's export orders index stood at 50.5 in July, indicating that the deterioration of exports is coming to a halt. The progress of the inventory adjustment process in IT-related goods in the NIEs of Asia and China's economic stimulus measures may be starting to have an impact. Turning to capital investment, new orders of capital goods in the private sector (ex aircraft-related), albeit low, increased for the second month in a row in June. Signs of an upturn are also prevalent with respect to capital goods shipments (ex aircraft-related), as indicated by a month-on-month increase for the first time in six months in June.

Even so, a strong recovery of capital investment is unlikely. The capacity utilization rate is still mired at an extremely low level and is unlikely to reach levels requiring capital investment to raise production anytime soon. Indeed, capital investment projections among manufacturers also remain at a level indicating only a mild increase. Recent movements of construction investment (ex residential investment) are a source of concern. The fall of commercial real estate prices (-18% in the period from January to May of 2009) and the rise of the office vacancy rate indicate the rise of adjustment pressures upon construction investment, providing concerns regarding the future course of events.

On the other hand, the environment surrounding personal consumption is still severe. Despite the rise of motor vehicle sale due to policy measures, a backlash is likely in the Oct-Dec quarter.

In contrast to signs of an upturn of production activity and investment activity, personal consumption – making up 70% of nominal GDP – remains fragile. Despite a strong rise of domestic motor vehicle sales (11.22 thousand units p.a., +16.0% m-o-m according to the US Department of Commerce) due to the Cash for Clunkers program, retail sales fell in July (-0.1% m-o-m). Core retail sales (ex auto, building supplies & gasoline stations) fell for the fifth month in a row. Since the overall pattern should remain unchanged throughout the Jul-Sep quarter, sales of motor vehicles will continue to be pushed up by the Cash for Clunkers program but consumption of all other items is forecast to remain subdued. Since

the Cash for Clunkers program only prompts consumers to purchase cars they had intended to buy (assuming that the entire budget for the program will be depleted in the Jul-Sep quarter of 2009 even though the program runs until the September 30, 2010), a backlash is expected in the Oct-Sep quarter. In the background are problems stemming from dismal labor market conditions and balance sheet adjustment pressures, which provide reasons to believe that personal consumption will remain weak throughout the forecast horizon.

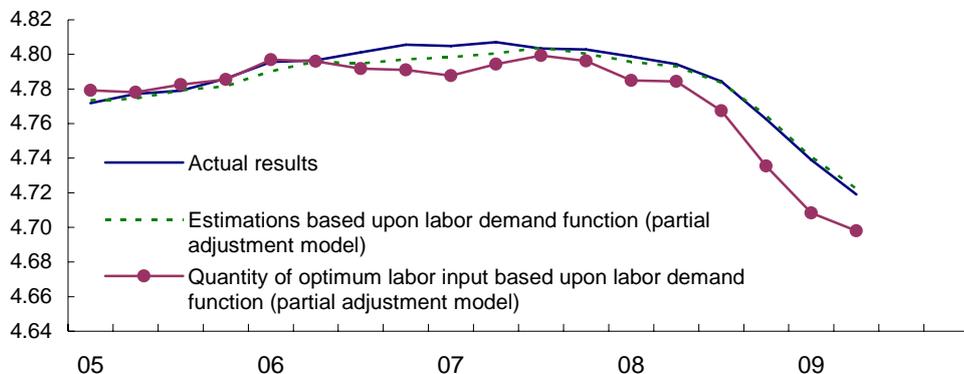
There are predictions of a reaction to the labor market adjustments thus far.

In July, US employment data revealed a significant moderation of the month-on-month deterioration of nonfarm payroll employment, suggesting that labor market conditions are improving. Amid these developments, there are views that “jobs may increase at a faster-than-expected pace along with the economic recovery in a reaction to the sharp deterioration of employment thus far”. The reasoning goes that there will be a severe shortage of labor in the service sector along with the recovery of demand, because the service sector has been subject to larger job cuts than in past economic downturns and labor productivity in the service sector is lower than in the manufacturing sector and thus, this will contribute to the upturn of employment.

In fact, the labor adjustments thus far are still inadequate. A recovery is unlikely anytime soon.

However, estimates of labor demand actually indicate that the labor adjustments thus far are inadequate in comparison to the optimum level. Estimates of the labor demand function during the period from 1995 to 2004 indicates that while the upturn of production served to push up labor demand, the rise of real wages and the cyclical and structural rise of productivity served as restraints upon labor demand. Furthermore, estimates of the labor demand function for the period from 2005 onward more or less coincides with actual labor demand, underscoring the continuation of the mechanism where real wages and productivity are restraining labor demand (**Chart 4**). Moreover, optimum labor input for the maximization of corporate profit falls far below labor demand, suggesting that labor adjustment among US companies are still inadequate.

[Chart 4: Labor demand and optimum labor input]



Notes: Non-farm private sector. Total labor input expressed as a logarithm (1992 average = 100). The time span of estimations of labor demand function (partial adjustment model) is from 1995Q1 to 2004Q4.

Sources: US Department of Labor, MHRI.

The reverse asset effect will persist and serve to restrain consumer spending. Given a large output gap, the odds are high that price levels will remain low.

It will also take a long time to resolve the various problems stemming from balance sheet adjustments. The impact of the stock market plunge and fall of residential prices should raise the saving rate during the forecast horizon. The rising saving rate and the foregoing labor market problems should serve as restraints upon consumer spending.

In summary, the US economy has emerged out of its worst moments and the rate of economic growth should pick up along with the improvement of the inventory cycle. However, personal consumption – a key component of final demand – will remain stagnant because of the deterioration of labor market conditions and the problems stemming from balance sheet adjustments, leading to our view that the US economic recovery will continue to lack momentum (**Chart 5**). Given these underlying conditions, a huge output gap will continue to linger and keep inflation low.

[Chart 5: Outlook on the US economy]

	2008	2009 (Forecast)	2010 (Forecast)	2008		2009 (Forecast)		2010 (Forecast)	
				1H	2H	1H	2H	1H	2H
GDP	0.4	-2.7	1.8	0.5	-2.3	-4.8	1.3	2.1	1.7
Personal consumption	-0.2	-1.0	0.7	0.0	-2.5	-0.8	0.2	0.7	1.0
Housing investment	-22.9	-24.5	-2.2	-25.7	-17.7	-32.5	-13.2	1.2	3.0
Capital investment	1.6	-18.1	0.6	2.9	-7.8	-27.9	-6.0	2.4	3.8
Inventory investment (USD100 million)	-259	-998	43	-183	-336	-1,275	-720	-68	153
Government consumption	3.1	1.9	2.2	2.6	3.6	0.3	3.4	1.9	1.5
Net exports (USD100 million)	-4,943	-3,452	-3,333	-5,135	-4,751	-3,629	-3,276	-3,316	-3,349
Exports	5.4	-12.7	3.4	6.4	-4.2	-22.2	0.2	3.7	6.0
Imports	-3.2	-16.8	2.1	-3.4	-6.7	-26.9	-3.8	3.5	5.3
Domestic final demand	-0.4	-3.1	0.9	-0.3	-2.5	-4.8	-0.1	1.1	1.4
Unemployment rate	5.8	9.4	10.9	5.2	6.5	8.7	10.1	10.8	10.9
Nonfarm payrolls (per month, 1,000 persons)	-189	-383	-16	-82	-297	-603	-210	-48	15
PCE deflator <y-o-y change>	3.3	0.0	1.8	3.7	3.0	0.1	-0.0	1.8	1.8
Core PCE deflator <y-o-y change>	2.4	1.5	1.6	2.5	2.3	1.7	1.4	1.6	1.6
Current account balance (USD 100 million)	-7,061	-3,792	-3,898	-3,670	-3,391	-1,953	-1,839	-1,914	-1,984
<as a percentage of nominal GDP>	-4.9	-2.7	-2.6	-5.1	-4.7	-2.8	-2.6	-2.6	-2.7

Notes: 1. Calendar-year figures refer to the rate of change from the previous year. Half-year term figures refer to the rate of change from the previous half-year term (annualized).

2. The shaded columns are forecasts.

3. Regarding the current account balance, figures for the half-year terms are adjusted for seasonal factors and the calendar-year figures are the totals. The percentages of nominal GDP are annualized.

Sources: US Department of Commerce, US Department of Labor, MHLI.

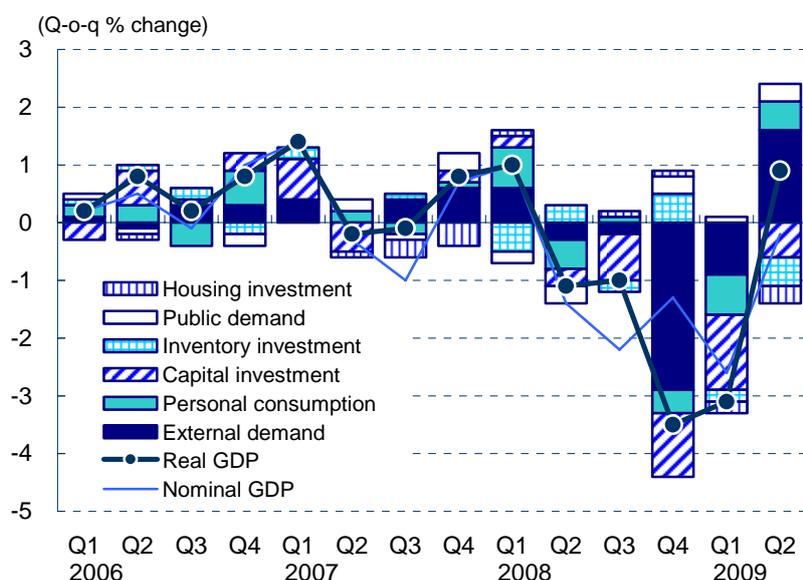
II. The Japanese economy

(1) The current state of the economy

Japan's economy expanded for the first time in five quarters.

Japan's real GDP expanded at a rate of +0.9% q-o-q (+3.7% in annualized terms) in the Apr-Jun quarter of 2009, finally emerging out of its worst economic downturn in post-WWII history which had continued from the Apr-Jun quarter of 2008, by recording positive economic growth for the first time in five quarters (**Chart 6**). Looking closer at each of the components of demand, personal consumption grew a relatively strong +0.8% q-o-q. Even though consumption of semi-durable goods (-0.2% q-o-q) and non-durable goods (-0.2% q-o-q) continued to fall as a result of a downturn of labor market conditions as indicated by the fall of real labor compensation (-1.7% q-o-q) from -0.5% q-o-q in the Jan-Mar quarter, consumption of durable consumer goods such as motor vehicles and flat-panel TVs surged (+6.6% q-o-q) as a result of stimulus measures such as the tax cuts on environment-friendly vehicles and the eco-point program promoting energy-saving appliances. Housing investment fell sharply (-9.5% q-o-q), declining for the second quarter in a row, amid a further fall of construction starts stemming from factors such as the sluggish sales of condominiums. Capital investment declined for the fifth consecutive quarter (-4.3% q-o-q). Even though industrial production and corporate earnings have bottomed out, the capacity utilization ratio is still mired at historical lows. Given the lack of confidence on the recovery of demand, companies remain extremely cautious regarding capital investment. Private inventory investment served as a drag upon GDP growth (contribution: -0.5% pt) amid the progress of the inventory adjustment process. As a result of these factors, domestic private-sector demand was a significant drag upon the rate of Japan's GDP growth (contribution: -1.0% pt). In contrast, the contribution by

[Chart 6: Japan's quarterly GDP growth]



Source: Made by MHRI, based upon Cabinet Office, *Preliminary Quarterly Estimates of GDP*.

public demand served to push up growth (contribution: +0.3% pt). Even though the contribution by government consumption was slightly negative (-0.3% q-o-q), the successive economic stimulus measures since last fiscal year led to a sharp increase of public investment (+8.1% q-o-q). Given the rebound of exports (+6.3% q-o-q) for the first time in five quarters and the ongoing decline of imports (-5.1% q-o-q) due to output cuts and sluggish domestic demand, the contribution by external demand rose to a historical high of +1.6% pt and served as a significant driver of growth.

Deflationary pressures are intensifying.

The GDP deflator, a broad measure of price changes, stood at +0.5% y-o-y, shrinking from +0.9% y-o-y in the previous quarter. Even though the GDP deflator is still in positive territory due primarily to the ongoing steep fall of the import deflator (-25.2% y-o-y), the domestic demand deflator fell at a faster pace (-1.7% y-o-y) in comparison to -1.0% y-o-y in the previous quarter, indicating the intensification of deflationary pressures amid the slumping economy.

The negative carry-over of growth shrank due to inclusion of retroactive estimations of SNA data series.

The Cabinet Office has released retroactive estimations of SNA data series from 1980 under the current standards and the results have been reflected in estimations up to the *1st QE* of the Apr-Jun quarter of 2009. Given a slight alleviation of the fall of real GDP growth in the second half of FY2008, the carry-over of growth to FY2009 (the rate of growth assuming that 4Q/4Q growth is zero) improved from -4.6% to -4.2%.

(2) Outlook on the Japanese economy in FY2009 and FY2010

Subsequent to Japan's economic recovery, the loss of steam of external demand is a source of concern.

Even though external demand was a main driver of the economic recovery in the Apr-Jun quarter, it is uncertain if it will continue to achieve a sustained recovery and serve as a strong engine of Japan's economic growth. The goods driving exports at the moment are chemical products, materials such as non-ferrous metals and electrical machinery (mainly IT-related parts and materials) (**Chart 7**). Looking first at exports of materials, the current boom is a very much a "temporary boom" driven largely by the Chinese government's 4 trillion yuan economic stimulus package. However, considering that the Chinese economy is nearing the government target of 8% growth as a result of aggressive fiscal spending, the odds are high that public investment in China will gradually decline and that the "temporary boom" will start to fade. Furthermore, note that in the materials sector, there are (1) materials which are piling up in Chinese local inventories, and (2) goods produced by Japanese manufacturers which may lose export competitiveness along with the global rise of production capacity expected ahead. Thus, there is a strong likelihood that exports of materials will lose momentum toward the year-end. Turning to IT-related parts and materials, market conditions are improving along with the global progress of inventory adjustment. The odds are high that exports will continue to grow for the time being, driven mainly by exports to South Korea and Taiwan. However, the crucially-important recovery of final demand for Japan's exports is unlikely anytime soon because of projections that consumer spending and capital investment will remain sluggish in the US which generates the largest demand for Japan's exports. Therefore, there is the possibility that exports of IT-related parts and materials will lose steam once the rise of output among companies for the replenishment of inventories runs its

[Chart 7: Trends of the export quantity index]

(Q-o-q % change)		Quarterly data			
		2008/Sep	2008/Dec	2009/Mar	2009/Jun
Exports (by goods)	General	-1.1	-17.0	-26.3	10.0
	Chemicals	-2.4	-20.8	-4.0	19.9
	Iron & steel products	5.9	-13.8	-23.9	-6.3
	Nonferrous metals	0.4	-13.1	-10.7	24.4
	Machinery	-0.7	-13.6	-26.7	-9.9
	Electrical machinery	-4.1	-18.1	-31.2	26.9
	Transport equipment	-2.9	-17.8	-38.9	9.3
Exports (by geographic destinations)	World	-1.1	-17.0	-26.3	10.0
	Asia	-0.5	-17.3	-20.8	14.3
	China	-3.0	-16.8	-17.0	13.6
	ASEAN	2.6	-14.2	-31.5	10.0
	NIEs	0.5	-19.3	-19.7	16.9
	US	-7.5	-15.4	-33.4	6.0
	EU	-0.2	-17.6	-28.1	1.6

Note: Seasonal adjustments by MHRl.

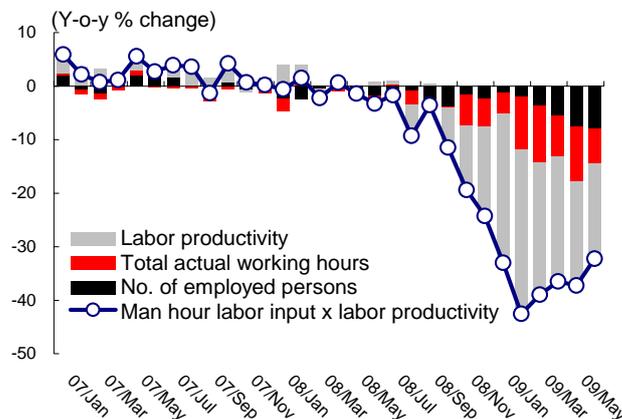
Source: Made by MHRl, based upon Ministry of Finance, *Trade Statistics of Japan*.

Adjustment pressures upon capital investment and employment will push down domestic demand.

course. Despite ad hoc movements such as the temporary rise of US-bound automotive exports in the Jul-Sep quarter due to the Cash for Clunkers program in the US, exports overall will lack momentum for some time due to predictions that the recovery of final demand will remain weak throughout the world.

Looking closer at domestic conditions, it appears certain that the adjustment pressures upon capital investment and employment will drag down domestic private demand. According to estimations by the MHRI, the level of plant and equipment held by companies is approximately 9% over the appropriate level. This is clearly excessive even in comparison to the levels after the collapse of Japan's asset bubble in the early 1990s (approximately 5%) and after the collapse of the IT-bubble in the early 2000s (approximately 8%). Under such circumstances, companies will be compelled to take a restrictive stance toward capital investment, providing reasons to believe that investment in plant and equipment will continue to decline for some time. Moreover, there are strong adjustment pressures upon employment as well. A look at the change in production activity during the sharp production downturn since the second half of last year in terms of labor productivity, total actual working hours and number of employed persons reveals the following pattern. At the outset, labor productivity fell, followed by the reduction of working hours since last fall, leading to the decline in number of employed persons from early spring this year (**Chart 8**). Therefore, the future course of corporate behavior would progress in the following way. Firstly, during a recovery of production activity, companies would place top priority upon labor productivity and subsequently lengthen working hours for the efficient utilization of existing workers. A full-fledged rise in number of employed persons is unlikely to occur until productivity and working hours recover to a certain level. According to MHRI's projections, the adjustment of labor would bottom out around mid-2010. Until then, labor adjustments – combined with the fall of wages – will send downward pressures upon labor

[Chart 8: Factor decomposition of industrial production]



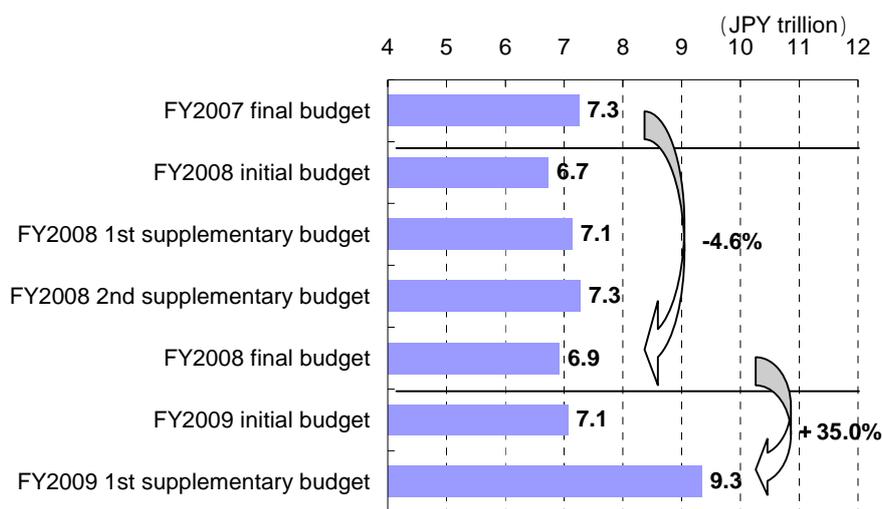
Sources: Made by MHRI, based upon data releases by the Ministry of Internal Affairs and Communications, Ministry of Health, Labor and Welfare, Japan Productivity Center.

The effect of policy measures should wear off.

compensation and continue to linger as a negative effect upon consumer spending.

Amid the absence of sanguine signs in the fundamentals of domestic private-sector demand, the prospective driver of domestic demand is public demand which surged in the Apr-Jun quarter. Public works-related expenditures (based upon the general account budget) after the first budget supplement for FY2009 are set to increase by 35.0% from the previous fiscal year (**Chart 9**). Considering the government’s haste to implement the budget, the odds are high that it will prop up the economy until the year-end in terms of both measures recognized as government consumption and measures contributing to personal consumption. However, this year’s massive fiscal spending will inevitably lose steam or result in a backlash without an augmentation or extension of its time span. Note that there is a strong possibility toward FY2010 that the impact of the fiscal spending measures will fade and that the resulting backlash will serve as a drag upon the economy.

[Chart 9: Public works-related expenditures in the general account budget]



Source: Made by MHRI based upon data releases by the Ministry of Finance.

MHRI’s latest *Economic Outlook* is based upon the premise that fiscal policy will remain unchanged.

Admittedly, the government’s basic fiscal policy stance may shift dramatically depending upon the results of the general election of the House of Representatives. However, in the latest revision of MHRI’s *Economic Outlook*, we have only taken into account measures which are officially approved to date without a premature forecast of the results. Therefore, the matters set forth in the policy declarations (the Manifestos) of both the Liberal Democratic Party (LDP) and Democratic Party of Japan (DPJ) are not taken into consideration. Furthermore, MHRI’s *Economic Outlook* is based upon the premise that the tax cuts on environment-friendly cars and the Eco-point program will end as of the currently-determined termination dates without prejudging the possibility of their extensions.

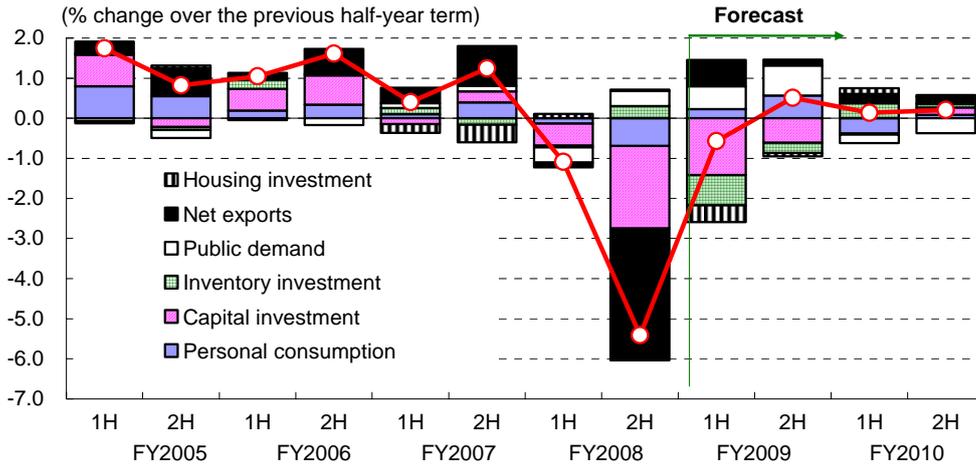
FY2009 real GDP growth:
-3.1% (previous outlook
-3.8%)

In view of the foregoing factors, Japan's real GDP is forecast to contract 3.1% y-o-y in FY2009 (ending March 2010). In addition to the ongoing growth of exports due to demand propped up by the economic stimulus measures around the world and the moves to replenish inventories, domestic public demand should also support the economy toward the end of the calendar year in December 2009. In contrast, the odds are high that domestic private demand will remain lackluster with capital investment, housing investment and inventory investment all continuing to decline. From around the turn of the New Year, the fall of capital investment and housing investment should gradually ease while global economic stimulus measures lose effect. During this period, personal consumption should remain in positive territory owing to the effect of policy measures despite negative pressures stemming from the deterioration of labor market conditions. In particular, a last-minute rush of demand to take advantage of the various consumption stimulus measures before their expiration is expected in the Jan-Mar quarter of 2010. The upward revision of growth from the previous MHRI *Economic Outlook* reflects the contraction of the negative carry-over of growth mentioned before and the larger-than-expected manifestation of the impact of global economic stimulus measures. We have not necessarily shifted our outlook on private sector demand to a more optimistic view and recognize the need to be cautious on the future course of Japan's economy.

FY2010: real GDP growth:
+0.5% (previous outlook
+0.6%)

Japan's real GDP in FY2010 is projected to grow +0.5% y-o-y. Exports should continue to grow at a gradual pace, in step with the recovery of the global economy. Even though capital investment and housing investment are expected to stop declining and start to pick up, the recovery will lack momentum. Personal consumption is forecast to ebb and flow amid lackluster labor market conditions after a sharp downturn due to a backlash to the last-minute consumer spending rush in the Apr-Jun quarter. Public demand will most likely serve as a drag upon the economy next fiscal year due to a backlash to the massive economic stimulus measures in FY2009.

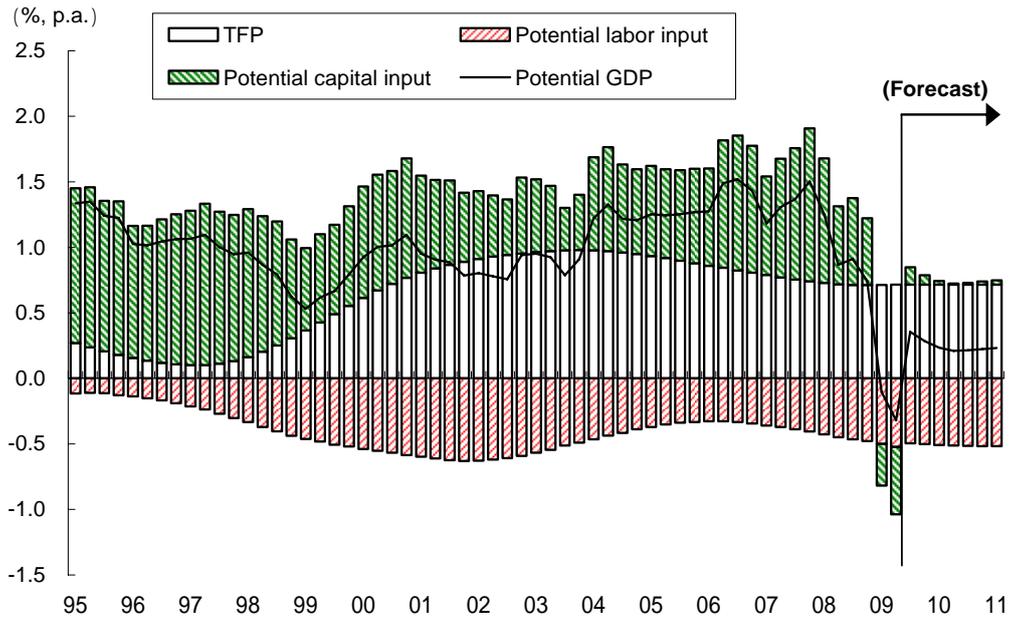
[Chart 10: Outlook on Japan's real GDP growth]



Price levels will continue to fall, given Japan's persistent recessionary gap.

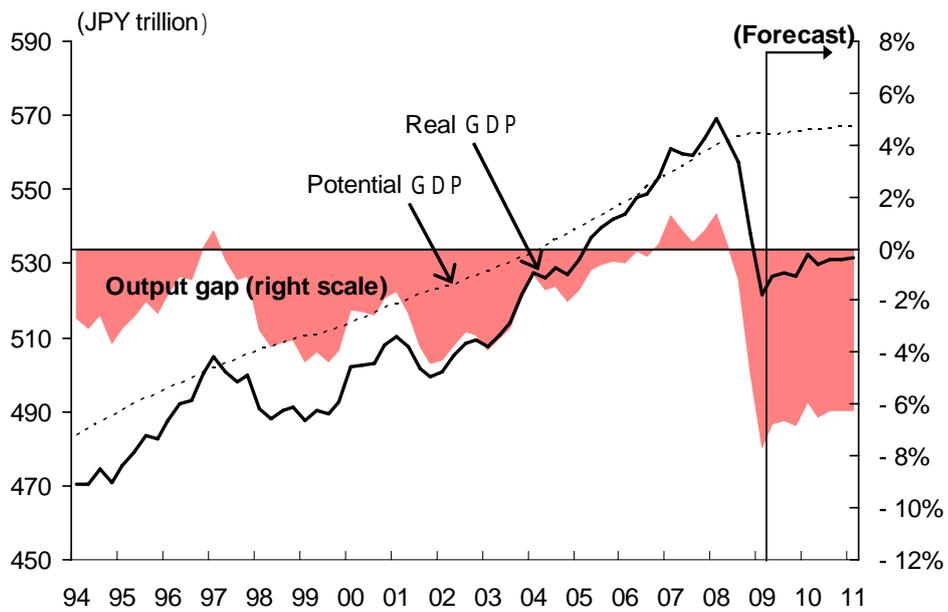
Japan's potential rate of GDP growth should move around the lower half of the +0%-level for some time (**Chart 11**). Assuming that the economy will only grow around +0.5% in FY2010, we do not expect the recessionary gap (the output gap in negative territory) to contract much (**Chart 12**). Accordingly, the odds are high that the fundamentals will continue to send downward pressures upon prices. Both the GDP deflator (FY2009: -0.2%; FY2010: -1.0%) and core CPI excluding fresh foods (FY2009: -1.3%; FY2010: -0.5%) are predicted to follow a downswing and that deflationary pressures will persist.

[Chart 11: Japan's potential GDP]



Source: Made by MHRI based upon various sources.

[Chart 12: Japan's output gap]



Note: Estimates by MHRI.

Sources: Cabinet Office, Ministry of Economy, Trade and Industry, Ministry of Internal Affairs and Communications, and others.

[Chart 13: Outlook on the Japanese economy (FY basis)]

(%)	FY2008	FY2009	FY2010	FY2008		FY2009		FY2010		FY2008	FY2009	FY2010
	(Actual)	(Forecast)	(Forecast)	1H (Actual)	2H (Actual)	1H (Forecast)	2H (Forecast)	1H (Forecast)	2H (Forecast)	(Contribution) (Actual)	(Contribution) (Forecast)	(Contribution) (Forecast)
GDP (real)	-3.2	-3.1	0.5	-2.2	-10.5	-1.1	1.0	0.3	0.4	-	-	-
Domestic demand	-2.1	-2.7	0.1	-2.1	-4.1	-3.7	0.7	-0.2	0.1	-2.0	-2.6	0.1
Private sector demand	-2.5	-5.0	0.2	-1.6	-6.2	-6.3	-1.1	0.3	1.1	-1.9	-3.7	0.2
Personal consumption	-0.5	0.3	-0.1	-0.5	-2.5	0.8	2.0	-1.3	0.3	-0.3	0.1	-0.1
Housing investment	-3.1	-15.6	4.9	8.3	2.8	-26.7	-7.1	12.3	3.0	-0.1	-0.4	0.1
Capital investment	-9.6	-18.0	-1.7	-6.8	-24.7	-18.8	-9.2	-0.5	3.0	-1.5	-2.7	-0.2
Public sector demand	-0.5	5.1	-0.2	-3.6	3.7	5.2	6.6	-1.7	-3.2	-0.1	1.1	-0.0
Government consumption	0.3	2.8	1.2	-1.9	2.6	1.1	6.6	0.7	-2.8	0.1	0.5	0.2
Public investment	-4.4	16.7	-6.6	-11.6	9.1	25.8	6.7	-12.4	-5.2	-0.2	0.6	-0.3
Net exports (contribution)	-1.2	-0.4	0.4	-0.2	-6.6	1.3	0.3	0.5	0.4	-1.2	-0.4	0.4
Exports	-10.2	-16.9	6.1	-3.4	-41.6	-10.9	7.2	5.9	5.4	-1.6	-2.5	0.8
Imports	-3.7	-13.9	3.9	-3.0	-9.9	-23.9	6.1	3.0	3.5	0.4	1.5	-0.4
GDP (nominal)	-3.5	-3.3	-0.5	-4.0	-7.2	-3.0	0.2	-1.5	0.9			
GDP deflator	-0.3	-0.2	-1.0	-1.4	0.9	0.7	-1.2	-1.2	-0.7			
Industrial production	-12.7	-12.7	2.4	-2.7	-22.4	-2.2	4.2	-0.5	1.7			
Unemployment rate	4.1	5.5	5.5	4.0	4.2	5.3	5.7	5.7	5.3			
Current account balance (JPY trillion)	12.2	18.4	21.3	18.2	7.6	18.6	17.5	19.9	21.2			
as a percentage of nominal GDP	2.5	3.8	4.4	3.6	1.6	3.9	3.6	4.2	4.4			
Domestic corporate goods prices	3.2	-5.8	-1.8	6.1	0.4	-7.2	-4.3	-1.9	-1.7			
Consumer prices	1.2	-1.3	-0.5	1.9	0.5	-1.6	-0.9	-0.4	-0.5			
Long-term interest rate (%)	1.48	1.38	1.43	1.60	1.35	1.40	1.35	1.40	1.45			
Nikkei stock average (JPY)	10,850	9,750	10,700	13,300	8,400	9,600	9,900	10,500	10,900			
Exchange rate (JPY/USD)	100.5	96	100	106.1	94.8	96	97	99	102			
Crude oil price (WTI)	85.9	68	78	121.0	50.9	64	72	79	78			

Notes: 1. FY = rate of change from the previous year. Half-year GDP = rate of change from the previous term p.a. (the GDP deflator = rate of change from the previous year).
2. Half-year industrial production = rate of change from the previous term. The half-year unemployment rate and half-year current account balance are adjusted for seasonal factors and the figures on current account balance are converted into annualized rates.
3. Half-year corporate goods prices and half-year consumer prices = rate of change over a year ago. Consumer prices = nationwide (excluding fresh foods).
Sources: Cabinet Office, *National Accounts*, Ministry of Economy, Trade and Industry, *Indices of Industrial Production*, Ministry of Internal Affairs and Communications, *Labor Force Survey*, *Consumer Price Index*, Bank of Japan, *Balance of Payments*, *Corporate Goods Price Index*.

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