Economic Outlook for FY2009 and FY2010

May 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 Jan-Mar quarter of 2009)

<The US Economy>

A weak recovery due to strong adjustment pressures upon employment and capital investment

2009	-2.7% (previous outlook -2.5%)
2010	+1.2% (previous outlook +1.3%)

<The Japanese Economy>

FY2009	-4.2% (previous outlook -4.9%) Growth will turn positive on a fiscal 4Q/4Q-basis (the Jan-Mar quarter of 2010 over a year ago) driven by the recovery of domestic demand stemming from the economic stimulus measures
FY2010	+0.5% (previous outlook +0.9%) Deflationary risks will linger as the economic stimulus measures lose steam

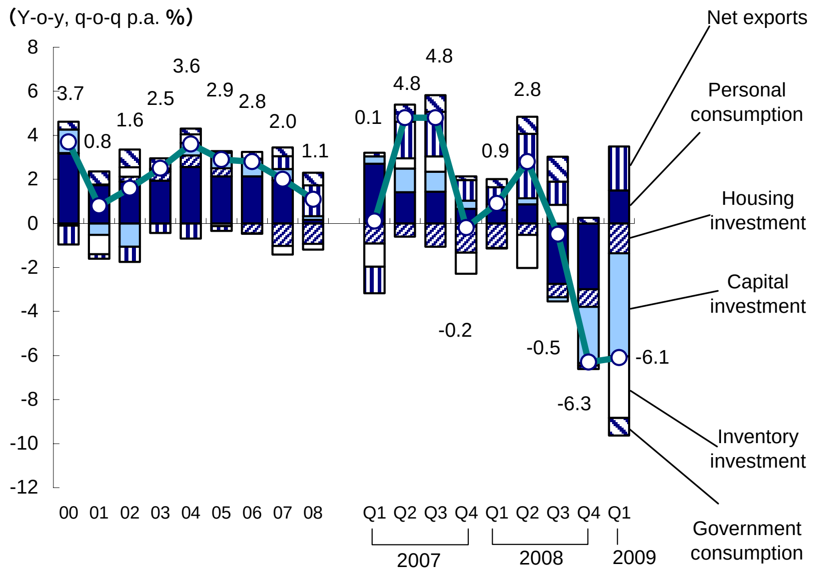
Mizuho Research Institute

I. The US economy

US real GDP continued to plummet in the Jan-Mar quarter of 2009 (-6.1% q-o-q p.a.)

According to advance estimates released by the Bureau of Economic Analysis, US real gross domestic product (GDP) continued to plummet (-6.1% q-o-q p.a.) in the Jan-Mar quarter of 2009, subsequent to the previous quarter (-6.3% q-o-q p.a.) (**Chart 1**). Despite the upturn of personal consumption (2.2% q-o-q p.a.), both housing investment and capital investment fell further and significant declines were also recorded in exports. As a result, final demand (exports + domestic demand excluding inventory investment) continued to fall sharply (-7.5% q-o-q p.a.) as in the previous quarter (-7.7% q-o-q p.a.). The second straight quarter of such a sharp decline marks the worst of its kind since the end of World War II, leading to further cutbacks on production and inventories. Inventory investment fell (- USD103.7 billion in annualized terms) and its contribution to real GDP growth reached -2.8%.

[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.

Outlook on economic growth in 2009 and 2010 are revised downward to -2.7% (2009) and +1.2% (2010) (previous outlook: -2.5%, +1.3%)

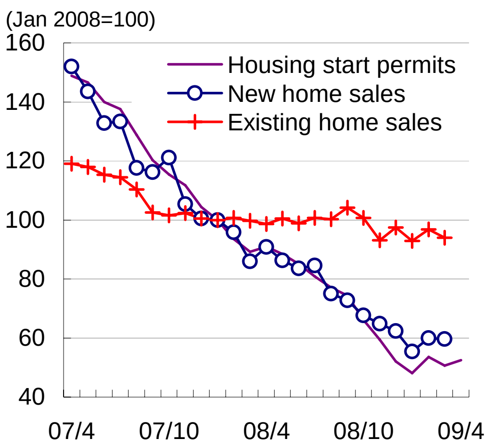
We have revised down our forecast on US growth in 2009 from -2.5% in our previous forecast in March to -2.7%. Likewise, our forecast on growth in 2010 was downwardly revised from +1.3% to +1.2%.

There are “green shoots” such as the moderation of the pace of economic deterioration hinting that economic conditions are nearing its trough, and the achievement of certain progress with respect to the financial system crisis which triggered the current economic downturn. Nevertheless, the rate of economic growth in the Jan-Mar quarter of 2009 fell sharply below our forecast in March (-4.5% q-o-q p.a.). In particular, the signs of a full-scale adjustment of corporate capital investment and the sharp deterioration of labor market conditions pushing down the level of employment far below initial forecasts lead to our view that the US economy is far weaker than we thought when we released our previous *Economic Outlook* in March.

Even though the housing market is stabilizing, massive stock adjustment pressures linger

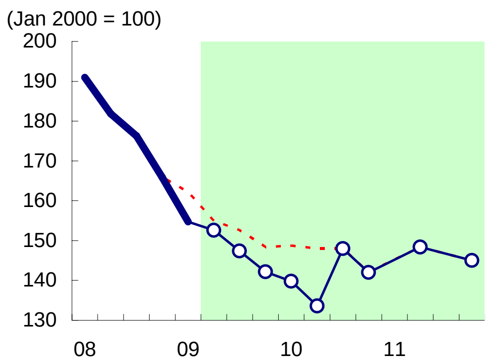
There are signs of stabilization in the housing market, in terms of both sales and housing starts of single-family homes (**Chart 2**). Ever since February, movements in both sales of newly-built single family homes and existing homes have been leveling out from their previous declines. The NAHB/Wells Fargo Housing Market Index (HMI) of the National Association of Home Builders, which gauges business confidence among home builders, stood at 16 in May (the HMI is an index derived from ratings for present single-family sales, single-family sales in the next six months and buyers traffic. On a rating scale ranging from 0 to 100, a higher rating indicates more positive responses). Even though the May rating is still quite low, note that the level has returned to levels prior to the Lehman Shock in September 2008.

[Chart 2：Housing sales and starts]



Note: Single family homes.
Sources: US Department of Commerce, National Association of Realtors.

[Chart 3: Home prices]



Note: The house price index is the average of 10 major US cities. Actual readings up to Jan-Mar Qtr of 2009. From then onward, the broken line represents futures prices as of March 13th and the O represents futures prices as of May 19th.
Sources: S&P, CME.

Having said so, there are still a considerable number of vacant homes – and hence strong adjustment pressures – in the housing market. As of the end of March 2009, the number of vacant homes for rent and for sales reached 4.155 million units and 2.114 million units respectively. In terms of household formation, which constitutes the primordial demand for housing, the number of households contracted 0.4% q-o-q during the period from the end of December 2008 to the end of March 2009, marking the sharpest fall in the past 14 years. The decrease in number of households may stem from the rise of cohabitation with relatives and acquaintances due to reasons such as foreclosures and efforts to reduce housing costs because of dire job employment conditions. Despite a modest recovery of the vacancy rate (both rental and owner-occupied homes) per household (5.6%, -0.1% pt q-o-q), the foregoing suggests that extremely strong stock adjustment pressures linger in the housing market (the vacancy rate of owner-occupied homes stood at 1.9%, -0.1% pt q-o-q).

Home prices will continue to fall and serve as a drag upon housing demand and consumer spending

As a result, home prices should continue to fall and serve as a drag upon housing demand and personal consumption. Movements of index futures in the S&P/Case-Shiller Index indicate that home prices will bottom out earlier than we had expected at the time we released our previous *Economic Outlook* in March 2009. Meanwhile, note that the depth of the "bottom" is deeper than our initial forecast (**Chart 3**). In comparison to March 2009, market forecasts regarding residential prices are turning decidedly more downbeat. Furthermore, market views factored into prices of futures are that home prices will pick up initially after bottoming out but will lack momentum and eventually flatten out. Such views appear appropriate, judging from the large stock adjustment pressures mentioned before.

Labor market conditions are worsening further. Consumer spending will remain weak even after tax cuts are implemented

Despite an extremely accommodative monetary/fiscal policy stance, the severity of labor cuts among private corporations is surpassing expectations at the time of our previous *Economic Outlook* in March. Judging from the existence of balance sheet adjustment pressures, personal consumption should remain weak.

Individual income tax cuts have started to be implemented since March. Even though the size of the tax cut is only 0.1% of disposable income as of March, the tax cuts should serve to bolster disposable income considerably from April onward. Given the progress of the spending-side of the economic stimulus measures such as public works, preliminary procedures for outlays worth USD102.9 billion have been completed by May 8th, of which USD36.8 billion have been disbursed. According to estimations by the Council of Economic Advisors (CEA), the spending-side of the economic stimulus measures possesses the potential to save or create approximately 400 thousand jobs as of early May.

However, despite the support by such policy measures, retail sales continued to slump in April (-0.4% m-o-m) subsequent to the month of March. Judging from movements of the consumer price index, real personal consumption appears to have contracted on a monthly basis in April, providing reasons to believe that spending activity is continuing to tread on fragile grounds.

The weakness of consumer spending may stem from factors such as the existence of a certain time lag until the effect of the policy measures start to emerge in the real economy as well as the extremely dire state of the job market. Nonfarm payrolls decreased by 2.66 million jobs during the period from January to April, and the unemployment rate rose to 8.9% in April. The rise of hourly wages is slowing significantly and labor compensation fell below the previous month for the fifth month in a row.

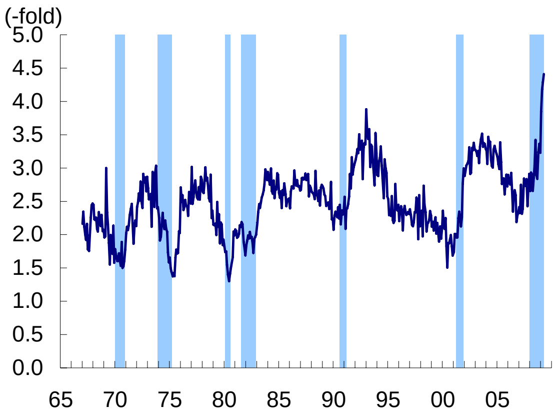
Job prospects also remain extremely downbeat. An oft-cited characteristic of US labor adjustments since the 1990s is that the ratio of "permanent dismissals" is higher than in the past. This characteristic is even more evident in the current economic downturn (**Chart 4**). Permanent dismissals pose a very different picture in comparison to temporary dismissals which stand upon the premise of reemployment when the economy recovers. The higher the ratio of permanent dismissals, the odds are higher that the timing of a labor market recovery will be delayed.

Balance sheet adjustment pressures are also high. Tax cuts will be channeled to savings

Household balance sheet pressures will also continue to affect personal consumption. In 2008, the household sector saw their asset-holdings erode by approximately USD11 trillion (**Chart 5**). The erosion surpasses annual disposable income. Furthermore, forecasts by MHRI predict that the erosion of household assets will continue in 2009 (shrinking by more than USD2 trillion). Even though assets will pick up in 2010, the upturn will only be strong enough to offset the erosion in 2009. In short, households will find it difficult to claw back their nest egg. Accordingly, households will be inclined to save for the future and raise the ratio of savings to income (the saving rate) and to cut back upon consumption.

The debt overhang in the household sector will also serve to curb consumption. Even though the Federal government's mortgage relief plan is expected to alleviate the mortgage repayment burdens among households, as long as the ratio of outstanding debt to disposable income (household leverage ratio) remains high, new car loans and credit car loans will be restrained and thus keep consumer spending subdued from the perspective of credit. Amid these circumstances, the chances are high that the aforementioned tax cut will be channeled to savings (or debt repayment).

[Chart 4：The ratio of permanent dismissals to temporary dismissals]



Note: Up to 1993, terminations of temporary employment contracts are included in permanent dismissals. The shaded areas indicate periods of recession.
Source: US Department of Labor.

[Chart 5: Forecast on household assets]

	End of 2008	End of 2009	End of 2010
Home equity	USD18.3 tril	USD16.9 tril	USD16.9 tril
Financial assets	USD40.8 tril	USD39.8 tril	USD42.3 tril
Y-o-y change	USD-11.1 tril	USD-2.4 tril	USD2.5 tril

Wealth effect (3.75 cent change in consumer spending per USD1 change in asset value)
↓

Impact upon consumer spending	USD-416.0 bil	USD-91.6 bil	USD93.2 bil

Note: Home equity and financial assets as of the end of 2009 and 2010 are estimates based upon the Case-Shiller futures index and the Dow Jones Industrial Average (forecasts by MHRI).
Sources: US Federal Reserve Board, MHRI.

Despite the current improvement of business confidence, loan demand is contracting sharply. Full-fledged capital investment adjustment along with the downturn of expectations on economic growth

Turning to the corporate sector, business confidence is improving both among manufacturers and nonmanufacturers. In April, the ISM manufacturing and nonmanufacturing indexes improved to 40.1 (+3.8pt m-o-m) and 43.7 (+2.9pt m-o-m) respectively. In view of the fact that the indexes on new orders (manufacturing: 47.2 or +6.0pt m-o-m, nonmanufacturing: 47.0 or +8.2pt m-o-m) are improving close to 50, the odds are high that the business conditions index will surpass 50 in mid-2009.

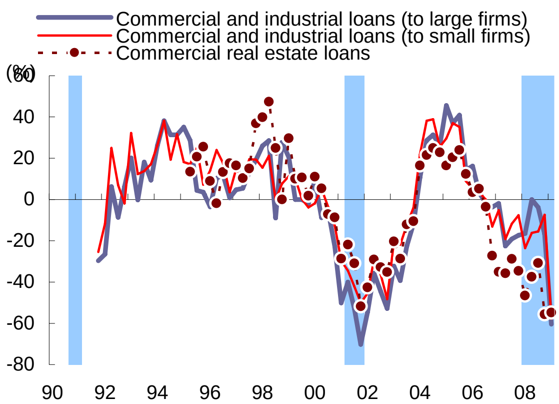
Meanwhile, a survey by the US Federal Reserve Board indicates a sharp fall of demand for loans among businesses (**Chart 6**). The ongoing price declines of office and commercial facilities in the commercial real estate market suggest the rise of sentiment among businesses that they are burdened by overcapacity. The capacity utilization ratio in the industrial sector fell to 69.1% in April, the lowest since 1967 when such data may be traced back, indicating that the incentive among companies to invest in new capacity is at a nadir. Furthermore, note that there are growing problems in the corporate sector in terms of profitability and soundness, as implied by the successive downgrading of corporate bonds.

We are thus inclined to believe that capital investment activity in the corporate sector has entered an adjustment phase along with a sharp downturn of growth expectations (**Chart 7**). The current adjustment most likely surpasses the curtailment of investment following the collapse of the IT Bubble.

Even though the risks of deflation are receding for now, there are few reasons to be optimistic

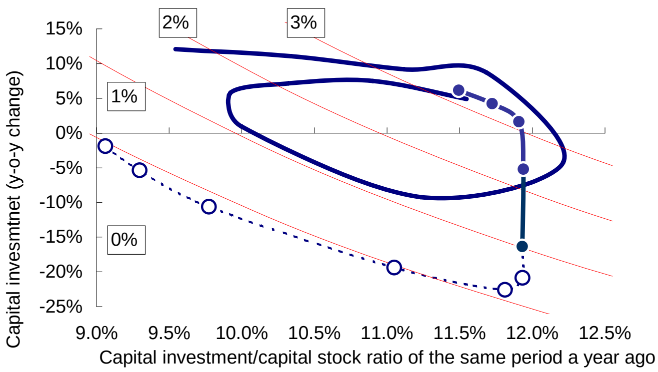
We have revised upward our outlook on inflation, based upon the current alleviation of disinflation trends (**Chart 8**). However, our overall outlook remains unchanged that growth will remain weak and that a large output gap will continue to exist. The upside risks to disinflation stemming from the downturn of inflation expectations should not be underestimated.

[Chart 6： Demand for loans by businesses]



Note: "Percentage of banking institutions which reported a strengthening of demand for loans over the previous three months" minus "percentage of banking institutions which reported a weakening of demand over the previous three months". Shading indicates periods of recession.
Source: US Federal Reserve Board.

[Chart 7: The capital investment cycle]



Note: The equilibrium lines toward expected growth rates (the values in the graph above) are based upon the premise that the rate of depreciation is 9.6% and that the rate of change of the capital coefficient is -0.6%. Actual readings for the years from 1997 to 2007, the quarterly results in 2008 and 2009 (●), and forecasts (○).
Sources: US Department of Commerce, MHRI.

[Chart 8: Outlook on the US economy]

(%)

	2008	2009 (Forecast)	2010 (Forecast)	2008 1H	2008 2H	2009 (Forecast) 1H	2009 (Forecast) 2H	2010 (Forecast) 1H	2010 (Forecast) 2H
GDP	1.1	-2.7	1.2	1.1	-1.2	-4.9	0.4	1.4	1.7
Personal consumption	0.2	-1.0	0.4	1.0	-2.7	-0.5	-0.4	0.6	0.9
Housing investment	-20.8	-24.2	-10.9	-22.9	-17.1	-30.2	-18.3	-12.0	0.0
Capital investment	1.6	-19.8	-1.2	2.7	-6.1	-29.5	-11.6	1.6	4.5
Inventory investment (USD100 million)	-291	-437	-16	-304	-277	-811	-63	58	-90
Government consumption	2.9	2.0	5.9	2.1	4.2	-0.8	5.5	6.1	5.9
Net exports (USD100 million)	-3,902	-3,092	-3,316	-4,217	-3,588	-3,070	-3,113	-3,247	-3,386
Exports	6.2	-13.3	1.6	6.7	-2.2	-23.6	-0.6	2.0	3.0
Imports	-3.5	-14.8	2.7	-2.8	-8.1	-24.2	0.0	3.3	4.1
Domestic final demand	-0.0	-3.1	1.2	0.4	-2.3	-4.7	-0.6	1.6	2.3
Unemployment rate	5.8	9.2	9.6	5.2	6.5	8.7	9.8	9.6	9.5
Nonfarm payrolls (per month, 1,000 persons)	-189	-301	-13	-82	-297	-492	-110	-38	13
PCE deflator <y-o-y change>	3.3	-0.6	1.4	3.6	3.1	0.0	-1.2	0.9	1.9
Core PCE deflator <y-o-y change>	2.2	1.8	1.8	2.2	2.1	1.8	1.8	1.9	1.7
Current account balance (USD 100 million)	-6,733	-3,194	-3,772	-3,591	-3,141	-1,619	-1,575	-1,762	-2,010
<as a percentage of nominal GDP>	-4.7	-2.3	-2.6	-5.1	-4.4	-2.3	-2.2	-2.5	-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, MHRI.

II. The Japanese economy

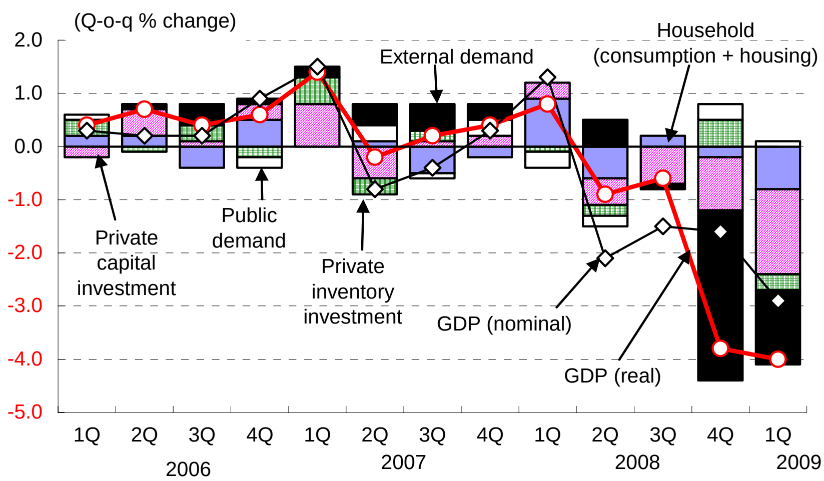
(1) The current state of the economy

Japan's economy shrank at the fastest pace in post-WWII history in the Jan-Mar quarter due to a sharp fall of domestic private-sector demand

Japan's real GDP shrank in the Jan-Mar quarter of 2009(-4.0% q-o-q, or -15.2% in annualized terms), marking the sharpest fall since the end of World War II (**Chart 9**).

Looking closer at each of the components of demand, the breadth of the fall of personal consumption widened from -0.8% q-o-q in the Oct-Dec quarter of 2008 to -1.1% q-o-q in the Jan-Mar quarter of 2009. Given a rising trend among consumers to cut back upon purchases of cars and clothing items amid the deterioration of labor market conditions, sales weakened with respect to both durable goods (-7.4% q-o-q) and semi-durable goods (-2.3% q-o-q). Services also softened (-0.5% q-o-q) due to an inclination to dine out less often than before. Housing investment (-5.4% q-o-q) fell for the first time in three quarters, following a decline of housing starts from last summer stemming from slumping condominium sales. Capital investment fell at a faster pace (-10.4% q-o-q), against a backdrop of the deterioration of corporate earnings and the fall of capacity utilization. Given the progress of inventory adjustment, the contribution by private-sector inventory investment to economic growth fell to -0.3% pt. The contribution by domestic private-sector demand stood at -2.7% pt, serving as a major drag upon growth. Even though public investment fell slightly (-0.0% q-o-q), the contribution to growth by public demand rose 0.1% pt due to the increase of government consumption (+0.3% q-o-q), thereby serving to alleviate the fall of the growth rate. As a result, domestic demand served as a major drag upon growth (-2.6% pt). Despite a further fall of exports (-26.0% q-o-q), the contribution by external demand stood at -1.4% pt in the Jan-Mar quarter, in comparison to -3.2% pt in the previous quarter, due to a double-digit decline of imports (-15.0% q-o-q) stemming from the decrease in output and the weakness of domestic demand.

[Chart 9：Japan's quarterly GDP growth]



Source: Cabinet Office, *Preliminary Quarterly Estimates of GDP.*

The domestic demand deflator fell into negative territory

The GDP deflator, a broad measure of price changes, rose to 1.1% y-o-y from 0.7% y-o-y in the previous quarter. As a result, the breadth of the fall of nominal GDP growth turned out to be smaller (-2.9% q-o-q, or -10.9% p.a.) than the fall of real GDP growth. This stems from the sharp decline of the import deflator (-23.2% y-o-y). As indicated by the downturn of the domestic demand deflator to -0.9% y-o-y from +0.3% y-o-y in the previous quarter, deflationary trends are in fact intensifying.

The carry-over of growth in FY2009 fell sharply to -4.9%

The rate of real GDP in FY2008 stood at -3.5%, recording a historical low even on a fiscal year basis. Given a double-digit contraction of real GDP for the second quarter in a row in the second half of FY2008, FY2009 will start out with an unprecedented negative carry-over of -4.9%.

Exports and production are bottoming out due to the progress of the inventory adjustment process

While the Japanese economy has suffered sharp declines due to the global financial crisis, the latest economic indicators suggest that the economy is emerging out of its worst moments. Although the quantity of exports plunged in March (-41.1% y-o-y), the breadth of the fall has in fact narrowed since February (-45.4% y-o-y). Even though industrial production fell by more than 30% in a mere half-year period since the outbreak of the financial crisis, industrial production rose for the first time in six months in March (+1.6% m-o-m). Furthermore, industrial production is projected to grow in both April (+4.3% m-o-m) and May (+6.1% m-o-m). In addition to the progress of the inventory adjustment process due to the massive output cuts thus far, China's economic stimulus measures appear to be leading to the recovery in demand for materials and electronic parts.

More time necessary for a recovery of capital investment

However, note that the capacity utilization rate is mired at a historical low due to the sharp curtailment of production during the second half of FY2008 (**Chart 10**). Even though industrial production is bottoming out, the level of production in the Apr-Jun quarter is approximately 30% lower in comparison to the same period a year ago, and therefore stands far from eliminating the excessive production capacity. More time will be necessary for businesses to start raising their capital investment activity.

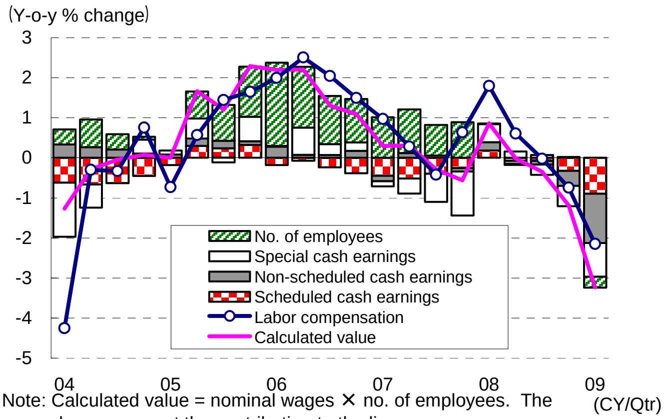
Labor market conditions are worsening at a faster pace

Conditions surrounding personal consumption are also severe. In March, the unemployment rate rose to 4.8% and nominal wages fell sharply (-3.9% y-o-y). Labor compensation on a nominal basis fell in the Jan-Mar quarter (-2.2% y-o-y), recording the sharpest fall in five years since the Jan-Mar quarter of 2004 (**Chart 11**). Looking forward, we expect production activity to gradually pick up and the breadth of the fall of non-scheduled cash earnings (overtime payments) to narrow. Even so, the odds are high that summer bonus payments this year will fall at a double-digit pace and that labor adjustment pressures will linger. All in all, severe income conditions will likely persist for some time.

[Chart 10： The capacity utilization rate]

Source: Ministry of Economy, Trade and Industry, *Indices of Industrial Production.*

[Chart 11: Labor compensation]



Note: Calculated value = nominal wages × no. of employees. The bars represent the contribution to the line.

Sources: Ministry of Health, Labor and Welfare, *Monthly Labor Survey,* Ministry of Internal Affairs and Communications, *Labor Force Survey,* Cabinet Office, *National Accounts.* .

The impact of the economic stimulus measures will push up the rate of growth in FY2009

While exports and industrial production are bottoming out, overall conditions surrounding domestic demand remain severe. That said, the effect of the government's economic stimulus measures should gradually emerge from the Apr-Jun quarter. The government of Japan has provided a total of four economic stimulus packages since August 2008. In particular, the size of the stimulus package announced on April 10, 2009 (the *"Policy Package to Address Economic Crisis"*) is extremely large, totaling JPY56.8 trillion yen (of which JPY15.4 trillion are national government expenditures). The rate of economic growth in FY2009 will be pushed up as the successive economic stimulus packages start to emerge – mainly in personal consumption and public investment. The rate of real GDP growth is predicted to bottom out – achieving zero percent growth – in the Apr-Jun quarter and subsequently show a definite upturn into positive territory in the Jul-Sep quarter.

Turning to personal consumption, fixed-sum cash benefits totaling JPY2 trillion are being distributed during the period from March to June. In addition to subsidies for the purchase of environment-friendly vehicles from April, the government has also started to provide subsidies for purchasers replacing cars that are at least 13 years old with new ones (the so-called "scrap bonus"). Furthermore, the "eco-point" scheme toward purchases of energy-efficient household electrical appliances has started from mid-May. The impact of these measures should drive the recovery of durable goods consumption toward the end of FY2009.

Public investment is poised for a dramatic upturn from the Apr-Jun quarter along with the implementation of the public works projects in the FY2008 supplementary budget and the acceleration of the FY2009 initial budget (the government target is an implementation rate of 80% in the first half of the fiscal year). Furthermore, additional public works projects are earmarked in the FY2009 supplementary budget, serving as a driver of public investment from the second half of FY2009 to the first half of FY2010.

The stimulus will lose steam in FY2010

However, there are concerns that the economic stimulus measures will lose steam in FY2010. Even though the subsidies for environment-friendly cars will continue through FY2011, the rest of the measures will only last until the end of FY2009. Therefore, the odds are high that demand will decline in FY2010 in a backlash to the last-minute rush to take advantage of the measures toward the end of FY2009.

Assuming that the public works budget in FY2010 will return to the level in FY2008 when there were no economic stimulus measures, public investment would fall sharply from the level subsequent to the FY2009 supplementary budget. In such event, public investment may start to decline from mid-FY2010 and serve as a drag upon the rate of economic growth.

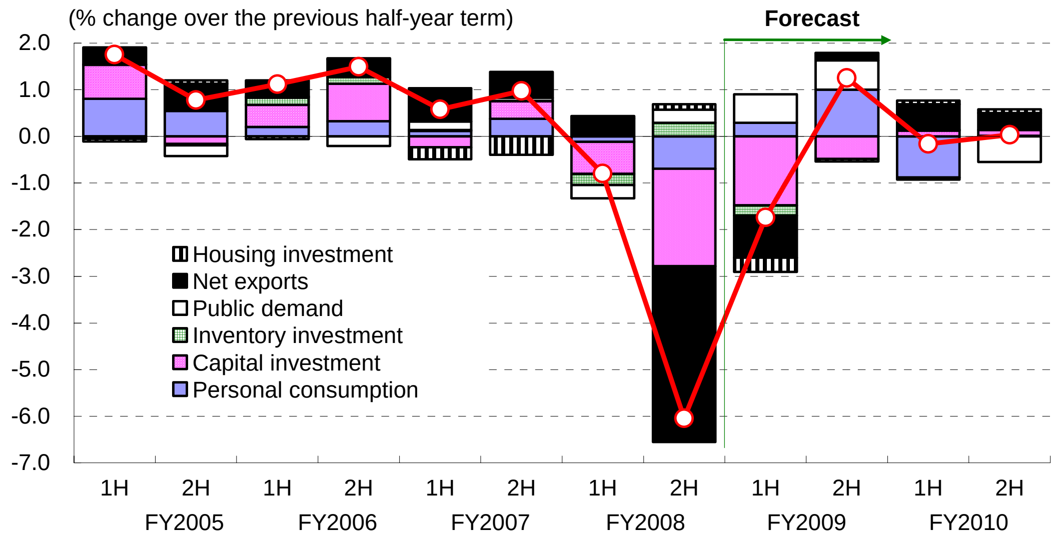
If the recovery of exports gains momentum by that time, it would be able to offset to some extent, the stagnation of domestic demand stemming from the fading impact of the stimulus measures. However, it is unlikely that the US and European economies will able to stage a strong recovery in a short period of time, considering the problem of nonperforming loans and adjustment pressures upon the housing market. Moreover, given the concentration of economic stimulus measures in 2009 in many countries including the emerging economies, some of these countries may also be subject to backlashes in 2010 as in the case of Japan. Insofar as a rapid export recovery is unlikely, the Japanese economy will slide back into a slump again in FY2010.

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

Real GDP growth in FY2009: -4.2 (previous outlook -4.9%)

The impact of the economic stimulus measures will gradually start to surface – mainly in personal consumption and public investment – from the Apr-Jun quarter of 2009. The overseas economies should also emerge out its worst moments, leading to prospects of a mild upturn of exports. Even though housing investment and capital investment are predicted to remain in a downturn, the rate of real GDP growth should level out in the Apr-Jun quarter and show a definite upturn into positive territory from the Jul-Sep quarter. While growth in the first half of FY2009 is forecast to remain in negative territory (-1.7% from the previous term) due to the negative carry-over, the rate of growth in the second half of FY2009 is predicted to rise into positive territory (1.3% from the previous term) for the first time since the second half of FY2007 (**Chart 12**).

[Chart 12: Outlook on Japan's real GDP growth (half-year basis)]



Source: Cabinet Office, *Preliminary Quarterly Estimates of GDP.*

Accordingly, the rate of real GDP growth in FY2009 (-4.2%) will take a deeper plunge than in FY2008. This is due to the fact that the carry-over of growth from FY2008 to FY2009 has dropped sharply (-4.9%) because of the precipitous fall in the second half of FY2008 (-6.0% from the previous term). The rate of growth in the Jan-Mar quarter of 2010 over a year ago is expected to reach 1.8%. The rate of nominal GDP growth (-3.2%) is predicted to surpass the rate of real GDP growth. This stems from the upturn of the GDP deflator (+1.0% y-o-y) for the first time since FY1997, due primarily to the fall of the import deflator along with the fall of prices of commodities such as crude oil.

FY2010 real GDP growth: +0.5% (previous outlook +0.9%)

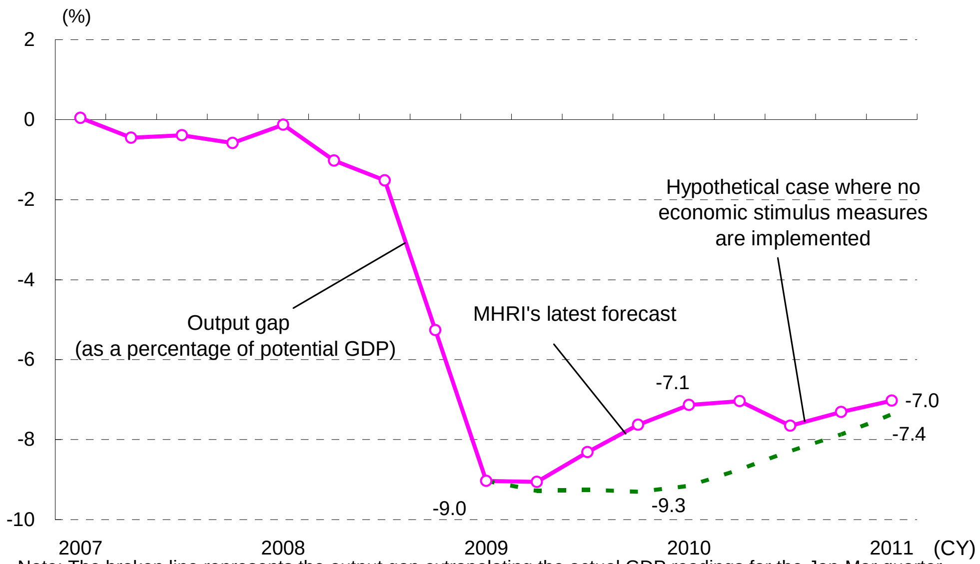
As mentioned before, the impact of the economic stimulus measures will start to wear off in FY2010. Meanwhile, the pace of export recovery will moderate and capital investment will only bottom out at best, providing little hope of pushing up the rate of economic growth. The rate of real GDP growth in the first half of FY2010 should remain slightly in negative territory (-0.2% over the previous term), due primarily to the fall of personal consumption in a backlash to the acceleration of demand. In the second half of FY2010, public investment will start to follow a more definite downturn. Even though the reactionary fall of personal consumption will ease, the rate of real GDP growth in the second half of FY2010 should remain more or less flat at +0.0% over the previous term.

FY2010 real GDP is forecast to rise into positive territory (+0.5%) for the first time in three years. However, this is due to a positive carry-over of growth (predicted to reach +1.0%), in a reverse situation to FY2009. The rate of growth in the Jan-Mar quarter of 2011 over a year ago should fall (-0.2%), exhibiting more signs of stagnation. Moreover, the rate of GDP growth in nominal terms (-0.5%) should fall below growth in real terms again.

Lingering deflationary risks

The output gap (the gap between real GDP and potential GDP) estimated by MHRI stood at -9.0% as of the Jan-Mar quarter of 2009 (**Chart 13**). If the Japanese economy follows the path described in our outlook, the breadth of the output gap in negative territory should contract to around -7% at the end of FY2009 and flatten out from then onward. In comparison with a hypothetical case where no stimulus measures are taken, the negative output gap would shrink by approximately 2% as of the end of FY2009. Prime Minister Taro Aso had set forth a target to achieve the fastest economic recovery among the major economies of the world. Judging from various economic indicators, the Japanese economy most likely reached its trough around March 2009, leading to a high probability that Japan has bottomed out ahead of the major economies of the US and Europe. This stems from the progress of inventory adjustment through massive output cuts by Japanese companies in comparison to their overseas counterparts and the government's vigorous fiscal spending. The recent spate of economic stimulus measures is commendable for halting a further expansion of the output gap.

[Chart 13: The output gap]



Note: The broken line represents the output gap extrapolating the actual GDP readings for the Jan-Mar quarter of 2009 on a quarter-on-quarter basis.

Sources: Estimates by MHRI based upon Cabinet Office, *National Accounts* and *Gross Capital Stock of Private Enterprises.*

Even so, the risks of deflation should continue to smolder due to a lingering output gap of approximately -7% as of the end of FY2010. Despite the difficulty to foretell the future course of economic policy following the general election of the House of Representatives, it will be necessary to devise ways to minimize the backlash after the economic stimulus measures. For example, it would be necessary to discuss (1) the extension of the eco-point system to promote the purchase of environment-friendly household electrical appliances with respect to certain items such as digital terrestrial television sets in FY2010, and (2) the mitigation of the reduction of public works expenditures in the initial budget so as to avoid a sharp fall of public investment.

[Chart 14: Outlook on the Japanese economy (FY basis)]

(%)

	FY2007 (Actual)	FY2008 (Actual)	FY2009 (Forecast)	FY2010 (Forecast)	FY2007 (Contribution) (Actual)	FY2008 (Contribution) (Actual)	FY2009 (Contribution) (Forecast)	FY2010 (Contribution) (Forecast)
GDP (real)	1.8	-3.5	-4.2	0.5	-	-	-	-
Domestic demand	0.6	-2.3	-1.6	-0.4	0.6	-2.2	-1.6	-0.4
Private sector demand	0.6	-2.8	-3.5	-0.5	0.4	-2.1	-2.6	-0.4
Personal consumption	0.9	-0.5	0.7	-0.6	0.5	-0.3	0.4	-0.4
Housing investment	-13.5	-3.0	-9.4	3.4	-0.4	-0.1	-0.3	0.1
Capital investment	2.1	-10.3	-18.1	-0.3	0.3	-1.6	-2.7	-0.0
Public sector demand	0.5	-0.5	5.0	-0.1	0.1	-0.1	1.1	-0.0
Government consumption	2.1	0.4	3.1	0.7	0.4	0.1	0.6	0.1
Public investment	-6.3	-4.5	14.8	-4.3	-0.2	-0.2	0.5	-0.2
Net exports (contribution)	1.2	-1.3	-2.7	0.8	1.2	-1.3	-2.7	0.8
Exports	9.3	-10.2	-22.9	8.1	1.4	-1.6	-3.4	1.0
Imports	1.7	-3.5	-6.2	1.4	-0.2	0.4	0.7	-0.2
GDP (nominal)	1.0	-3.7	-3.2	-0.5				
GDP deflator	-0.9	-0.2	1.0	-0.9				
Industrial production	2.7	-12.7	-15.1	3.1				
Unemployment rate	3.8	4.1	5.3	5.5				
Current account balance (JPY trillion)	24.5	12.2	13.6	19.5				
as a percentage of nominal GDP	4.7	2.5	2.8	4.1				
Domestic corporate goods prices	2.3	3.2	-7.0	-2.3				
Consumer prices	0.3	1.2	-1.7	-0.3				
Long-term interest rate (%)	1.59	1.48	1.38	1.43				
Nikkei stock average (JPY)	16,000	10,850	9,000	10,000				
Exchange rate (JPY/USD)	114.2	100.5	99	103				
Crude oil price (WTI)	82.2	85.9	51	60				

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*, Ministry of Finance, *Balance of Payments*, Bank of Japan, *Corporate Goods Price Index*.

[Chart 15: Outlook on the Japanese economy (half-year basis)]

(%)

	FY2008		FY2009		FY2010	
	1H (Actual)	2H (Actual)	1H (Forecast)	2H (Forecast)	1H (Forecast)	2H (Forecast)
GDP (real)	-1.6	-11.7	-3.4	2.5	-0.3	0.1
Domestic demand	-2.7	-4.2	-2.2	2.2	-1.4	-0.7
Private sector demand	-2.7	-6.2	-4.5	1.2	-1.9	0.6
Personal consumption	-0.4	-2.5	1.0	3.4	-2.9	0.1
Housing investment	3.9	8.5	-19.5	-3.7	5.9	5.7
Capital investment	-8.4	-25.2	-19.7	-7.3	2.0	2.0
Public sector demand	-2.7	2.8	5.5	5.5	0.2	-4.6
Government consumption	-2.1	3.3	3.2	2.7	0.2	-0.1
Public investment	-5.7	0.8	17.8	19.5	0.1	-23.5
Net exports (contribution)	0.8	-7.5	-1.8	0.3	1.1	0.7
Exports	1.7	-44.4	-22.1	8.8	8.2	7.2
Imports	-4.5	-7.6	-11.2	6.7	-1.1	1.5
GDP (nominal)	-4.4	-7.4	-2.8	0.2	-0.4	-0.9
GDP deflator	-1.4	1.0	2.7	-0.7	-1.2	-0.6
Industrial production	-2.7	-22.4	-4.9	4.2	-0.2	2.5
Unemployment rate	4.0	4.2	5.1	5.5	5.6	5.3
Current account balance (JPY trillion)	18.2	7.6	12.8	13.0	19.4	18.0
as a percentage of nominal GDP	3.6	1.6	2.7	2.7	4.0	3.8
Domestic corporate goods prices	6.1	0.4	-8.3	-5.8	-2.6	-1.9
Consumer prices	1.9	0.5	-1.7	-1.6	-0.6	0.0
Long-term interest rate (%)	1.60	1.35	1.40	1.35	1.40	1.45
Nikkei stock average (JPY)	13,300	8,400	8,900	9,100	9,700	10,300
Exchange rate (JPY/USD)	106.1	94.8	98	100	102	104
Crude oil price (WTI)	121.0	50.9	51	52	58	63

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* , Ministry of Finance, *Balance of Payments* , Bank of Japan, *Corporate Goods Price Index* .

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Mizuho Research Institute Ltd., Kazuhiko Yano, Senior Economist kazuhiko.yano@mizuho-ri.co.jp

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