Economic Outlook for FY2009 and FY2010

November 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 Jul-Sep quarter of 2009

<The US Economy>

	Progress of disinflationary trends amid the slow recovery of final demand
2009	-2.5% (previous outlook -2.7%)
2010	+1.9% (previous outlook +1.8%)

<The Japanese Economy>

FY2009	-2.9% (previous outlook -3.3%)
	The effect of the economic stimulus measures will gradually wear off in the second half of the fiscal year
FY2010	+0.9% (previous outlook +1.4%)
	Household income will increase due to the impact of policy initiatives
	Public investment to fall sharply

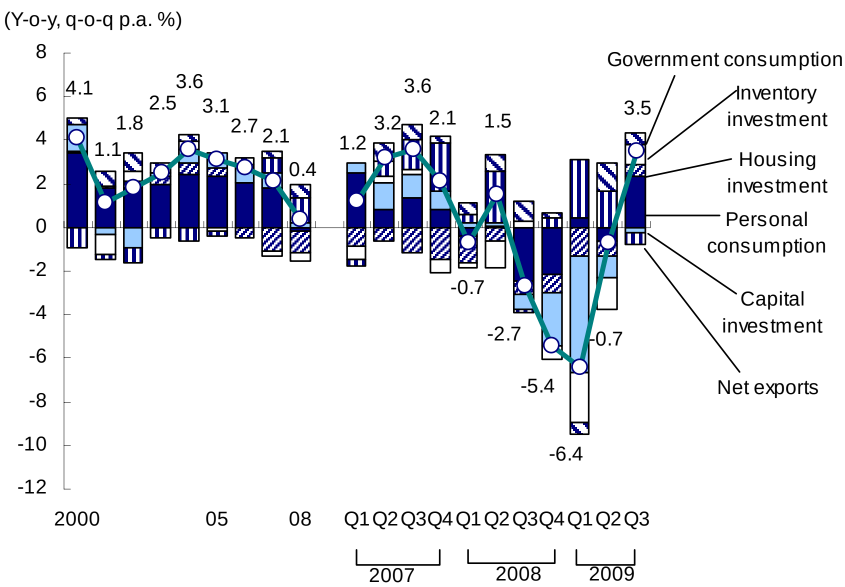
Mizuho Research Institute

I. The US economy

US real GDP grew +3.5% q-o-q p.a. in the Jul-Sep quarter of 2009, recording an expansion for the first time in five quarters

According to advance estimates released by the Bureau of Economic Analysis, US real gross domestic product (GDP) grew +3.5% q-o-q p.a. in the Jul-Sep quarter of 2009, recording an expansion for the first time in five quarters since the Apr-Jun quarter of 2008 (**Chart 1**). Looking closer at the components of demand, personal consumption grew a solid +3.4% q-o-q p.a. and housing investment picked up, recording positive growth (+23.3% q-o-q p.a.) for the first time in 15 quarters since the Oct-Dec quarter of 2005. The contraction of inventory investment also narrowed from -USD160.2 billion p.a. in the Apr-Jun quarter to –USD130.8 billion p.a. in the Jul-Sep quarter, thus contributing positively (+0.94%) to the rate of real GDP growth for the first time in the past year.

[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.

The Jul-Sep quarter was driven largely by economic stimulus measures

The strong growth in the Jul-Sep quarter stems largely from the impact of stimulus measures. Personal consumption and inventory investment picked up due to the surge of output and sales of motor vehicles as a result of the Car Allowance Rebate System (known as the "Cash for Clunkers" program). In addition to the upturn of inventory investment among car retailers, investment in inventories among other retailers and manufacturers should drive the economy going forward.

The recovery of housing investment in the Jul-Sep quarter is due to the larger-than-expected effect of the First-Time Homebuyer Tax Credit. Home prices are starting to rise, given the upturn of residential demand driven by the First-Time Homebuyer Tax Credit. In early November, new legislation was signed into law which extends the tax credit to the end of April 2010 (based upon dates of binding contracts to purchase homes) and expands the eligibility to long-time homeowners who buy a replacement principal residence. As a result of the foregoing legislation, we expect a further rise of housing investment up to the first half of FY2010.

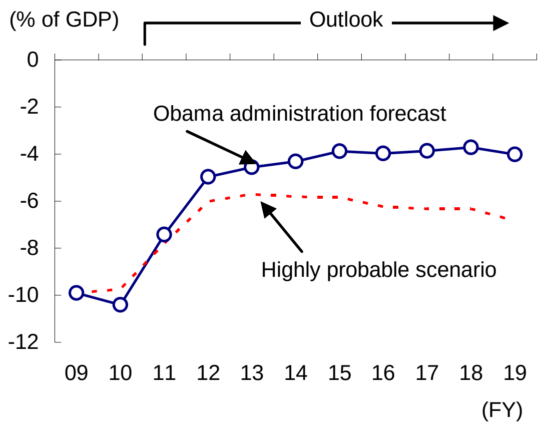
Disinflationary trends to continue, leading to rising risks of a slide into deflation

Turning to prices, note the progress of disinflationary trends. The percentage rise of the core personal consumption expenditures (PCE) deflator excluding food and energy prices stood at a low level of +1.4% q-o-q p.a. (+1.3% y-o-y) in the Jul-Sep quarter. Looking closer, durable goods prices continued to fall below the previous year while nondurable goods prices rose due to higher prices of cigarettes. In addition, the slower rise of core service prices at the moment is dragging down the core inflation rate.

Prolonged monetary easing scenario

In terms of price movements, the existence of a gaping output gap is a serious problem. As evidenced by the deterioration of the unemployment rate and the capacity utilization ratio, supply-demand conditions are easing considerably. In view of the difficulty to close the output gap, disinflationary trends may persist over a long term. In the event disinflation progresses into deflation, real debt burdens would increase, resulting in overwhelmingly adverse impacts upon the US economy. That said, amid forecasts that the US fiscal deficit (**Chart 2**) will persist over the medium-term horizon, there are high expectations (burdens) upon monetary policy as a means to prevent a fall into deflation, given the Obama administration's/Congress's apparent recognition of the limits to additional fiscal expansion.

[Chart 2: The Obama administration's fiscal deficit outlook]



Note: The "highly probable scenario" refers to the extention of the Bush-era tax cut, indexation of AMT, reduction of Iran/Afghanistan war costs, and change in discretionary spending around the nominal GDP growth rate. The impact of the healthcare reform is not considered.

Sources: Office of Management and Budget (August 25, 2009), A Committee for a Responsible Federal Budget

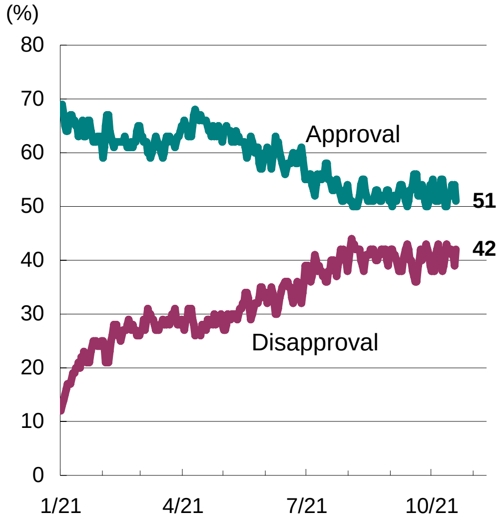
High expectations toward continuation of monetary easing in terms of the Obama administration's growth strategy and structural reforms

The continuation of monetary easing is a compelling policy option also in terms of the Obama administration's economic growth strategy and structural reforms.

The US growth strategy revealed at the G-20 Summit held in Pittsburgh (September 24^{th} and 25^{th}) and reiterated in US President Barak Obama's speech in Tokyo (November 14^{th}) presents a transition from a consumption-led to an export-led (Asia-bound exports) economy.

Admittedly, a growth strategy is not a matter belonging to the realms of monetary policy. It requires, among others, the structural transformation of the US economy (and of course, the structural transformations of China and the countries of Asia which are its trade partners). However, by continuing to ease monetary policy and keeping the dollar weak, the Obama administration would be able to trigger a path to sustainable growth, namely "job creation through the promotion of exports", which would preclude further burdens upon debt-ridden US consumers and repeating the conventional growth model which would aggravate the global imbalances. Moreover, if the Obama administration is able to sustain its economic recovery momentum and improve its employment conditions, it would be able to revive its public approval ratings which has been flagging from the stellar ratings up to inauguration (**Chart 3**) and gain the political clout necessary to tackle issues which would have an adverse impact upon the public (structural reforms) such as domestic reforms of its tax and health care systems and global issues such as energy and climate change issues and the conclusion of the Doha Development Round.

[Chart 3: The Obama administration's public approval ratings]



Note: The readings are averages during the period from the 8th to 10th of Nov 2009.
Source: Gallup Inc©

Despite positive factors such as the inventory cycle, homebuyer tax credit and continuation of monetary easing, US growth will remain weak. Forecast on 2009: -2.5%, 2010: +1.9%

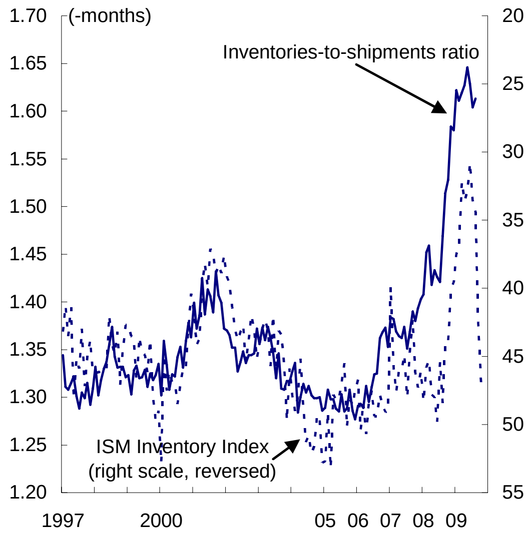
To provide a forecast on the US economy in 2010, it would be necessary to take into consideration the impacts of the inventory cycle and First-Time Homebuyer Tax Credit and the continuation of monetary easing as factors which would push up the economy. Even so, upon averaging out the impacts, we still forecast that the growth of final demand will remain weak. Despite minor upward revisions taking into account the stronger-than-expected rate of growth in the Jul-Sep quarter, we still forecast a slow growth scenario around 2%. Our outlooks on real GDP growth are -2.5% in FY2009 (previous outlook in September -2.7%) and +1.9% in FY2010 (previous outlook in September: +1.8%).

Even though the inventory cycle will continue to improve, aggressive stockpiling is unlikely

The first factor defining the short-term growth path is the improvement of the inventory cycle. A look at the movement of the ISM manufacturing index suggests that the inventory adjustment among manufacturers which had lagged the retailers may be improving rapidly at the moment (**Chart 4**). From the Oct-Dec quarter, such inventory adjustment improvement should serve as underpinnings of US economic growth.

However, a bullish scenario of aggressive stockpiling by companies is unlikely. This is due to forecasts of a backlash to the economic stimulus measures (the second factor determining the short-term growth path) and the weak recovery of private demand (the third factor determining the short-term growth path).

[Chart 4: The inventory ratio and ISM index (manufacturing)]



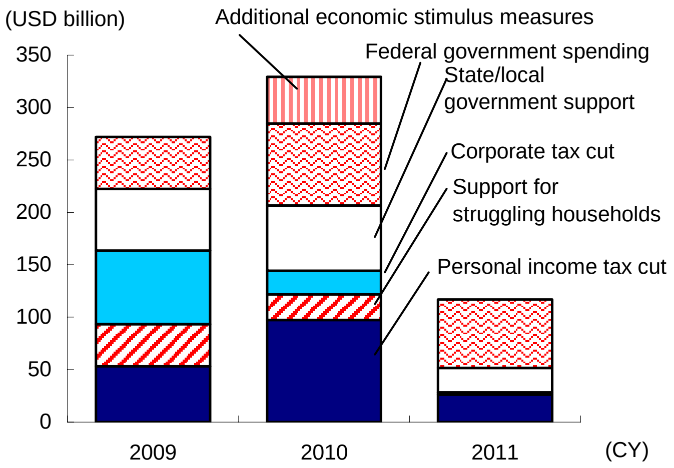
Note: "Inventories-to-shipments ratio" = inventories in real terms ÷shipments in real terms.
Source: MHRI.

The impact of the economic stimulus measures will fade. Look out for a backlash in 2010.

Turning to the economic stimulus measures, the extension and expansion of the First-Time Homebuyer Tax Credit is predicted to spur a strong rise of existing home sales in the first half of 2010. As a result of the tax credit, existing home sales should rise approximately 5.9 million units p.a. in the Jan-Mar quarter of 2010 and serve to push up housing investment in the form of real estate agents' commission fees. Housing starts should also rise in tandem.

However, a backlash is expected from the Apr-Jun quarter of 2010 along with the termination of the tax credit. Thus, we expect only a modest rise of housing investment, when averaging out the year 2010.

[Chart 5: The fiscal size of the economic stimulus measures]



Note: The AMT-related income tax cut continued from the Bush administration are not included in the personal income tax cut.
Sources: Congressional Budget Office, MHRI.

Moreover, even though the fiscal size of the entire economic stimulus package including the additional measures such as the tax credit extension in 2010 will grow from 2009, the breadth of the marginal increase will contract sharply, and thus will not have as much of a positive impact upon the economy as in 2009 (**Chart 5**). Note that a large part of the additional measures is constituted of the expansion of entities eligible (by the abolition of the total earnings criteria) for the extension of term of loss carrybacks (extended to five years from what is normally two years). Such indirect support measures are unlikely to possess much effect in generating demand.

High rate of unemployment to persist.

A self-sustained rise of private demand is unlikely for the time being. This stems from forecasts of a "jobless recovery" and a persistently high rate of unemployment. Even though we do not expect downward pressures due to further reverse wealth effects as a result of the recovery of stock prices and stabilization of home prices, personal consumption should remain under downward pressures due to dire labor market conditions and tight financial conditions.

Given the strong growth of real GDP in the Jul-Sep quarter, the optimum level of labor input (measured by labor hours) in terms of maximizing corporate earnings has improved, more or less closing the gap with actual labor input (measured by labor hours). However, even if the economy keeps growing at a fast pace around 3% p.a., the quantity of labor input would only start to follow a clear upward curve from the Apr-Jun quarter of 2010, and the timing of a job recovery would be much later. Going forward, even if business conditions improve, it would not provide much hope for the employment of new workers since the odds are high that companies would cope with the situation by increasing

Disinflationary trends will continue, given the massive output gap. The risks of deflation will rise over the second half of 2010.

the work hours of existing workers through, for example, the increase of overtime and the conversion of part-time workers into full-time workers.

Amid forecasts of the persistence of a massive output gap symbolized by the high unemployment rate, prices will continue to follow disinflationary trends.

Even though the percentage change of the core PCE deflator has already fallen to +1.3% y-o-y in the Jul-Sep quarter of 2009, a further decline to +0.8% y-o-y is predicted in the Oct-Dec quarter of 2010 (**Chart 6**). By then, the specter of deflation which haunted the US economy in the first half of the 2000s should be felt strongly once again.

The Federal Open Market Committee (FOMC) said in its statement at its meeting in November that it would keep the federal funds rate at 0 to 1/4 percent due to "low rates of resource utilization, subdued inflation trends and stable inflation expectations". Since a major change from the "low rates of resource utilization, subdued inflation trends and stable inflation expectations" is unlikely, the chances are slim that the exceptionally low interest rates will be subject to change.

[Chart 6: Outlook on the US economy]

(%)

	2008	2009 (Forecast)	2010 (Forecast)	2008		2009 (Forecast)		2010 (Forecast)	
				1H	2H	1H	2H	1H	2H
GDP	0.4	-2.5	1.9	0.5	-2.3	-4.8	2.0	2.1	1.4
Personal consumption	-0.2	-0.7	1.1	0.0	-2.5	-0.7	1.3	0.8	1.5
Housing investment	-22.9	-19.0	1.7	-25.7	-17.7	-31.1	10.8	7.7	-17.2
Capital investment	1.6	-17.8	1.0	2.9	-7.8	-28.0	-4.5	2.4	3.8
Inventory investment (USD100 million)	-259	-1,222	-415	-183	-336	-1,371	-1,074	-527	-303
Government consumption	3.1	2.0	2.1	2.6	3.6	0.6	3.3	1.9	1.5
Net exports (USD 100 million)	-4,943	-3,559	-3,657	-5,135	-4,751	-3,585	-3,533	-3,606	-3,707
Exports	5.4	-10.5	6.3	6.4	-4.2	-21.6	9.1	6.2	3.8
Imports	-3.2	-14.6	5.6	-3.4	-6.7	-26.8	6.6	5.8	4.1
Domestic final demand	-0.4	-2.6	1.3	-0.3	-2.5	-4.7	1.4	1.4	1.3
Unemployment rate	5.8	9.2	10.0	5.2	6.5	8.7	9.8	10.0	10.0
Nonfarm payrolls (per month, 1,000 persons)	-189	-423	-20	-82	-297	-600	-246	-55	15
PCE deflator <y-o-y change>	3.3	0.2	1.4	3.7	3.0	0.1	0.2	1.7	1.1
Core PCE deflator <y-o-y change>	2.4	1.5	1.0	2.5	2.3	1.7	1.4	1.2	0.8
Current account balance (USD 100 million)	-7,061	-4,102	-4,358	-3,670	-3,391	-2,032	-2,070	-2,122	-2,236
<as a percentage of nominal GDP>	-4.9	-2.9	-3.0	-5.1	-4.7	-2.9	-2.9	-2.9	-3.0

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.

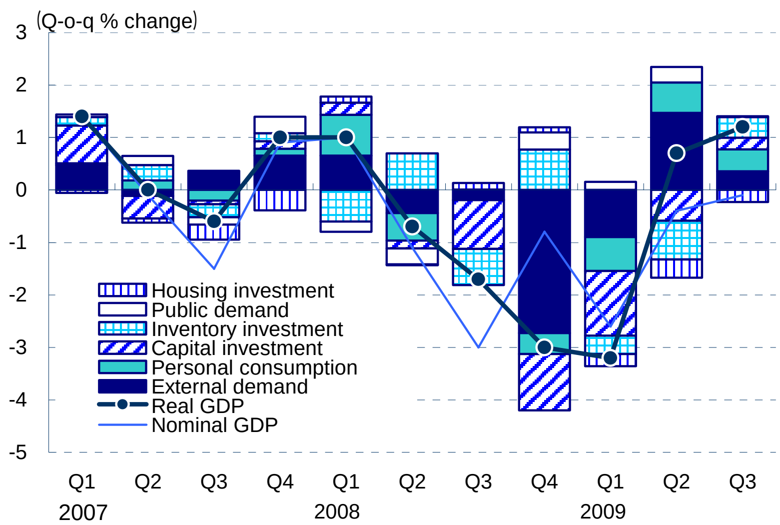
II. The Japanese economy

(1) The current state of the economy

Japan's economy expanded for the second quarter in a row

Japan's real GDP grew at a rate of +1.2% q-o-q (+4.8% in annualized terms) in the Jul-Sep quarter of 2009, expanding for the second quarter in a row subsequent to the Apr-Jun quarter (+0.7% q-o-q) (**Chart 7**). Looking closer at each of the components of demand, personal consumption continued to grow a strong +0.7% q-o-q. Even though consumption of semi-durable goods (-0.7% q-o-q) and non-durable goods (-0.0% q-o-q) continued to fall due to the downturn of labor market conditions, consumption of durable consumer goods (+7.1% q-o-q) such as motor vehicles and flat-panel TVs surged as a result of stimulus measures such as the tax cuts on environment-friendly vehicles and the Eco-Point Program promoting purchases of energy-saving appliances. Housing investment fell sharply (-7.7% q-o-q), declining for the third quarter in a row, amid an unhampered fall of construction starts stemming from factors such as the sluggish sales of condominiums. Capital investment increased (+1.6% q-o-q) for the first time in six quarters. Despite the ongoing contraction of investment activity, the decline is taking a breather mainly with respect to capital goods investment. Furthermore, the contribution by inventory investment to GDP growth rose to +0.4% pt. As a result of the foregoing factors, the contribution by domestic private demand rose to +0.8% pt, serving to push up the rate of Japan's GDP growth. The contribution by public demand stood at +0.0% pt. Even though government consumption increased 0.4% q-o-q, public investment decreased (-1.2% q-o-q). Exports grew strongly (+6.4% q-o-q), recording solid growth for the second straight quarter, helped mainly by exports of goods benefiting from the economic stimulus measures taken around the world. However, the contribution

[Chart 7：Japan's quarterly GDP growth]



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

by external demand shrank from +1.5% pt in the Apr-Jun quarter to +0.4% pt in the Jul-Sep quarter of 2009 because imports also picked up (+3.4% q-o-q) amid the recovery of domestic production.

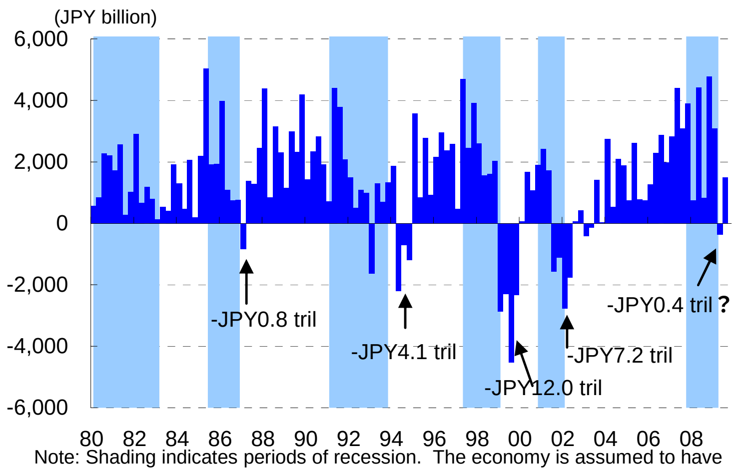
Deflationary pressures are intensifying.

The GDP deflator, a broad measure of price changes, shrank from +0.5% y-o-y in the Apr-Jun quarter to +0.2% y-o-y in the Jul-Sep quarter. Even though the GDP deflator still remains in positive territory due primarily to the ongoing steep fall of the import deflator (-28.9% y-o-y), the domestic demand deflator fell dramatically (-2.6% y-o-y) from -1.8% y-o-y in the previous quarter, registering the sharpest fall in history under the new data series. Even in terms of the old data series, the GDP deflator recorded the sharpest fall since the Jul-Sep quarter of 1958 (-3.9% y-o-y). Deflationary trends are intensifying within Japan.

Inventory investment may actually be weaker

While inventories grew JPY1.5 trillion (s.a.), resulting in Japan's stronger-than-expected real GDP growth (the consensus forecast was +0.7% q-o-q), the SNA-based inventory investment released by the Cabinet Office may not necessarily reflect actual conditions. Looking back at the past three "troughs" of the economic cycle, inventory investment fell on a net basis for three to four quarters in a row, and registered considerable falls on a cumulative basis (-JPY4.1 trillion to -JPY12.0 trillion, s.a.). In contrast, inventory investment declined by only 0.4% trillion in the Apr-Jun quarter (**Chart 8**). Considering the extreme severity of the recent economic downturn, it seems improbable that the inventory adjustment process progressed without the reduction of domestic inventories. Moreover, as of September 2009, the inventory index in the *Indices of Industrial Production* has fallen by 13.7% from the recent peak (December 2008), revealing inconsistencies between the movement of SNA-based inventory investment with other statistics. Thus, there may be a dramatic revision of the readings on inventory investment in forthcoming data revisions including *The Second Preliminary Quarterly Estimates of GDP.*

[Chart 8: Economic cycles and inventory investment (seasonally adjusted)]



Note: Shading indicates periods of recession. The economy is assumed to have entered an expansion cycle after bottoming in the Jan-Mar quarter of 2009.
Source: Made by MHRI, based upon Cabinet Office, *Preliminary Quarterly Estimates of GDP.*

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

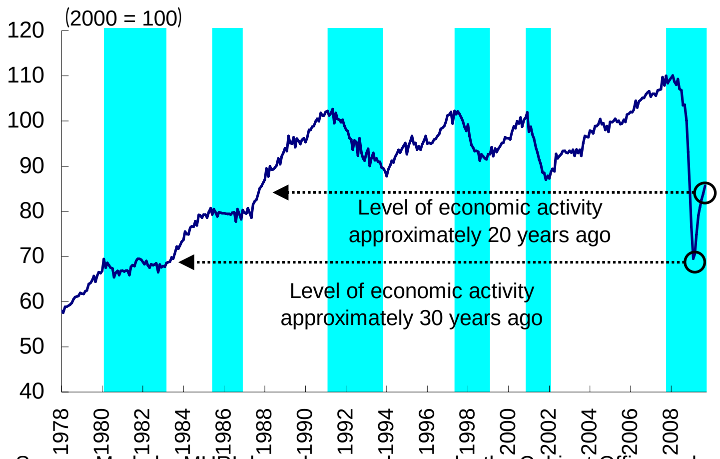
Corporate investment activity will remain conservative for some time

Turning to the future course of the economy, domestic private demand should continue to tread on fragile grounds. The corporate sector's profitability is gradually recovering due to the rise of production and reduction of fixed costs. That said, the level of production activity remains unchanged from nearly 20 years ago and is 22.2% lower than the recent peak (**Chart 9**). Current profits of listed corporations for the year ending March 2010 are forecast to reach only one-third the level of the peak in the year ending March 2008 (based upon releases by NIKKEI225 companies excluding financial corporations, aggregated by MHRI). Under the current situation, companies continue to have neither the needs nor means to engage in nonessential investments. Furthermore, given the higher target regarding the reduction of greenhouse gas emissions subsequent to the formation of the Hatoyama Cabinet, in addition to uncertainties surrounding the actual steps required to achieve the target, it is difficult for companies to make major domestic investment decisions over the medium to long term. Since companies will continue to take a conservative investment stance going forward, capital investment should remain weak, with the bulk comprised of investments to maintain and renew existing equipment.

The recovery of fundamentals surrounding personal consumption is also unlikely

In the household sector, employment and income conditions are also predicted to remain in dire straits for some time. Even though marginal employment reduction pressures are easing along with the recovery of production, note that developments in production and employment after the Lehman Shock reveal that the breadth of labor reduction was far less than the breadth of production cuts. Thus, even when production picks up, the odds are high that companies will place priority on the improvement of their reduced labor productivity and that it would take time for the recovery of output to feed through to the rise of employment. Turning to wages, winter bonus payments and wage hike negotiations next spring should turn out to be extremely stringent for employees amid slumping corporate profits and persistent pressures upon employers to reduce labor costs. An

[Chart 9: Industrial production index (long-term)]



Source: Made by MHRI, based upon releases by the Cabinet Office and The Ministry of Economy, Trade and Industry.

autonomous recovery of personal consumption is unlikely.

External demand will continue to follow an uptrend

On the other hand, the odds are high that external demand will continue to follow an upward trend. Exports are continuing to pick up, benefiting from economic stimulus measures such as the initiatives to boost motor vehicle purchases in the US and Europe and public infrastructure investment in China. Even though the pace of export growth may moderate because demand for some goods may start to lose steam along with the termination of the stimulus measures, exports are still expected to grow, driven mainly by exports to newly emerging countries of Asia given their quick recovery of demand after the financial crisis. In contrast, the recovery of exports should remain mild toward the US and Europe where stock adjustment pressures linger in the household and financial sectors.

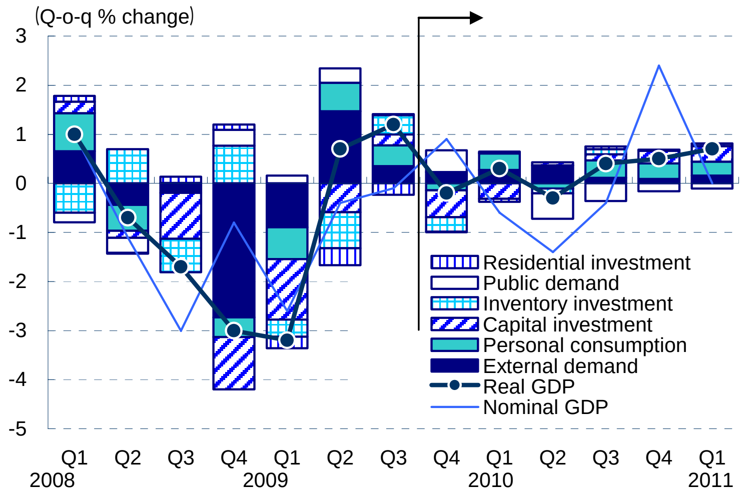
The future course of the economy will depend upon public policy measures.

Considering that private demand will follow an ebb-and-flow pattern and external demand will continue to grow, the greatest factor serving as a risk upon the economy during the coming year is the Hatoyama administration's fiscal policy. Japan's GDP growth rate may be subject to large swings depending upon government policy. The key points include questions such as the following. (1) Firstly, how will the budget suspended (JPY2.9 trillion) in the first supplementary budget be used in the second supplementary budget? (2) Secondly, will the subsidies for purchases of environment-friendly cars and the Eco-Point Program (to stimulate purchases of energy-saving electrical appliances) be terminated next March? (3) Thirdly, will the provisional tax rates be abolished next April? As for the first question, the suspension of public investment etc. earmarked under the first supplementary budget will drag down GDP by approximately 0.2% pt over the turn of the New Year. If the effect is concentrated in the Jan-Mar quarter of 2010, it would push down GDP growth by as much as 0.8% pt. Despite current discussions on another economic stimulus package (under the keyword "3K" which stands for "Koyo, Keizai, and Kankyo", the Japanese for "employment, the economy and the environment") by a second supplementary budget to offset the negative impact, the details are not yet apparent. Even though budget requests are not yet submitted with respect to the second question, it appears that discussions are progressing in the direction of continuing at least the Eco-Point Program. Assuming that the program is terminated at the end of the fiscal year (end of March 2010), a last-minute spending spree would push up sales of flat-panel TVs and cars in the Jan-Mar quarter of 2010, followed by a sharp fall due to a backlash from the following quarter from April to June. If the program is continued, such impacts would not materialize. Turning to the third question, the abolition of the provision tax rates would have a considerable impact upon private demand in FY2010 since the fiscal deficit due to the abolition would have to be financed by government bonds. On the other hand, such impact would not occur if they are replaced by environment-related taxes. The impact of the additional economic stimulus package to be financed by the second supplementary budget is not factored in the revision of the latest MHRI *Economic Outlook* since its contents and size are yet uncertain. Furthermore, on the basis of developments to date, we assume that the subsidies for purchases of environment-friendly cars will be abolished, the Eco-Point Program to stimulate purchases of energy-saving electrical appliances will be continued, and that the provisional tax rates will be abolished (these assumptions are unchanged from the previous MHRI *Economic Outlook*). Therefore, note that there is a high possibility that our outlook on the economy may change in the event the foregoing premises are altered as a result of political decisions.

FY2009 real GDP growth: -2.9% (previous outlook -3.3%)

In view of the foregoing factors, Japan's real GDP is forecast to contract 2.9% y-o-y in FY2009 and FY2010 (ending March 2010). Despite forecasts that personal consumption will slump for some time due to the fading impact of stimulus measures such as the Eco-Point Program, a rebound is expected in the Jan-Mar quarter due to a last-minute rush of demand to take advantage of the subsidies for purchases of environment-friendly cars before its termination. Housing investment should continue to follow a downhill path. Capital investment is also predicted to remain on a downtrend mainly in terms of investment in construction material. Public investment will gradually serve as a drag upon growth, in view of forecasts that the impact of the suspension of the first supplementary budget will intensify from around the year-end. External demand should continue to rise.

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



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

FY2010: real GDP growth: +0.9% (previous outlook +1.4%)

Japan's real GDP in FY2010 is projected to grow +0.9% y-o-y. Even though the rate of personal consumption growth may dip into negative territory in the Apr-Jun quarter due to a backlash to the last-minute surge of demand, measures such as the child allowance and the abolition of provisional tax rates should underpin purchasing power from then onward, and keep consumer spending on an uptrend. While capital investment and housing investment should bottom out and start to pick up, the rebound will most likely be tepid. Public demand is forecast to serve as a drag upon growth because of a possible slash of public works-related expenditures in the general account budget (initial budget) from the FY2009 supplementary budget. Exports – albeit a slight slowdown – should follow an uptrend along with the global economic recovery driven mainly by emerging economies.

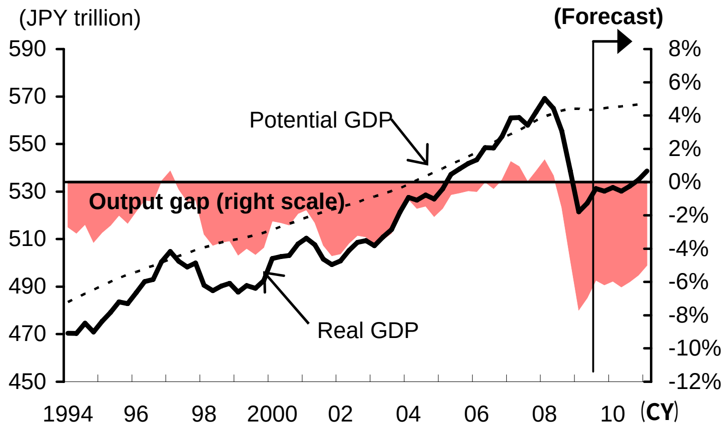
Despite risks of a lull, a "double-dip" should be avoided

Let us turn to the current spread of concerns regarding a "double dip". As far as the currently-debated "double dip" refers to a sharp contraction of demand and production similar to the contraction experienced since the autumn season of 2008 or a fall into a recession from the current expansion (believed to have started from the Jan-Mar quarter of 2009), MHRI believes that the risks of such a "double dip" are remote. As mentioned before, extremely severe conditions following an ebb-and-flow pattern will continue if we limit our analysis to domestic private demand alone. However, since growth will be underpinned by external demand, a persistent contraction of production activity is unlikely. That said, there is still the possibility that production activity will temporarily stall and the economy will fall into a condition which may be described as a "lull" next spring when the impact of the backlash to the surge of demand to take advantage of the subsidies for purchases of environment-friendly cars and the sharp fall of public investment will intensify.

Deflation will linger

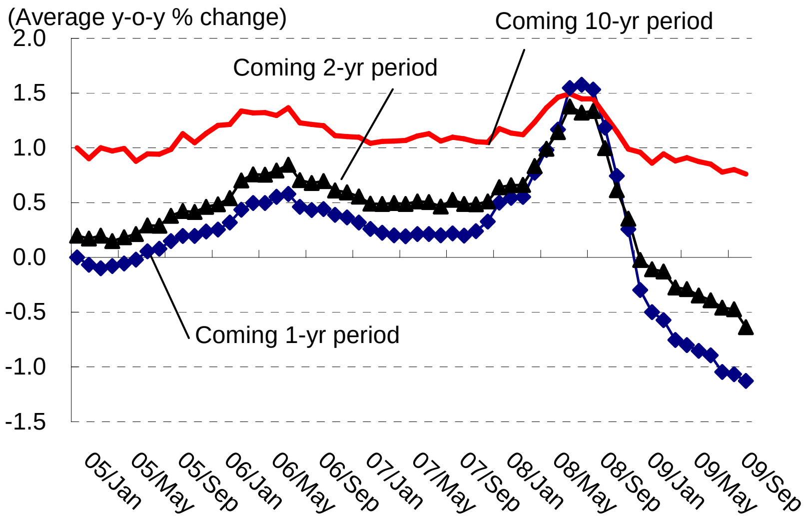
Japan's potential rate of GDP growth should move around the lower half of the +0%-level for some time. Since real GDP is expected to grow only around +0.9% in FY2010, the currently widening recessionary gap (the output gap in negative territory) will not contract much (**Chart 11**). Furthermore, expectations on deflation over the short term and expectations on disinflation over the medium to long term are intensifying (**Chart 12**). Accordingly, the odds are high that price levels will remain under strong downward pressures. Based upon forecasts that the GDP deflator (FY2009: -0.5%; FY2010: -1.4%) and core CPI excluding fresh foods (FY2009: -1.3%: FY2010: -1.1%) will continue to follow a downswing, the odds are high that deflationary pressures will persist over a prolonged period.

[Chart 11: Japan's output gap]



Note: Estimates by MHRI.
Sources: Cabinet Office, Ministry of Economy, Trade and Industry, Ministry of Internal Affairs and Communications.

[Chart 12: Inflation expectations among bond market investors]



Source: Made by MHRI, based upon survey by QUICK Survey System.

[Chart 13: Outlook on the Japanese economy]

		FY2008	FY2009	FY2010	2009				2010				2011
					Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
GDP (real)	Q-o-q % ch	-3.2	-2.9	0.9	-3.2	0.7	1.2	-0.2	0.3	-0.3	0.4	0.5	0.7
	Q-o-q % ch p.a.	--	--	--	-12.2	2.7	4.8	-0.9	1.2	-1.0	1.6	2.2	2.9
Domestic demand	Q-o-q % ch	-2.0	-2.7	-0.1	-2.3	-0.8	0.8	-0.5	0.0	-0.6	0.3	0.5	0.6
Private sector demand	Q-o-q % ch p.a.	-2.5	-4.4	0.7	-3.1	-1.4	1.0	-1.3	0.0	-0.2	0.8	0.8	0.9
Personal consumption	Q-o-q % ch	-0.5	0.3	1.1	-1.1	1.0	0.7	-0.2	0.6	-0.2	0.6	0.5	0.5
Housing investment	Q-o-q % ch	-3.0	-18.4	-1.9	-6.6	-10.2	-7.7	-0.4	-2.3	0.1	2.2	0.6	0.2
Capital investment	Q-o-q % ch	-9.6	-15.8	-0.4	-8.2	-4.2	1.6	-4.0	-2.5	0.5	1.0	2.0	2.5
Inventory investment	Q-o-q contribution, % pt	0.1	-0.6	0.0	-0.4	-0.7	0.4	-0.3	0.0	-0.1	0.1	0.0	0.0
Public sector demand	Q-o-q % ch	-0.5	3.3	-2.8	0.7	1.2	0.1	1.9	0.1	-2.1	-1.5	-0.7	-0.5
Government consumption	Q-o-q % ch	0.3	2.0	2.0	0.1	-0.2	0.4	1.5	1.8	-0.2	-0.2	0.3	0.1
Public investment	Q-o-q % ch	-4.4	10.5	-26.2	3.1	7.7	-1.2	3.7	-7.7	-12.2	-9.0	-7.0	-4.1
External demand	Q-o-q contribution, % pt	-1.2	-0.3	1.0	-0.9	1.5	0.4	0.2	0.3	0.4	0.1	0.1	0.2
Exports	Q-o-q % ch	-10.2	-12.8	10.1	-21.6	6.4	6.4	4.0	3.0	1.8	1.5	1.5	1.5
Imports	Q-o-q % ch	-3.6	-10.9	2.9	-14.0	-4.2	3.4	2.2	1.0	-1.0	0.8	1.0	0.5
GDP (nominal)	Q-o-q % ch	-3.5	-3.4	-0.5	-2.6	-0.4	-0.1	0.9	-0.6	-1.4	-0.4	2.4	0.0
GDP deflator	Y-o-y % ch	-0.3	-0.5	-1.4	0.9	0.4	0.2	-0.2	-2.5	-1.8	-1.6	-1.3	-0.9
Domestic demand deflator	Y-o-y % ch	0.4	-1.9	-1.4	-1.1	-1.7	-2.6	-1.6	-1.4	-1.1	-1.6	-1.6	-1.3

Note: The readings above may differ from public releases because the rates of change are calculated based upon actual results.
Source: Made by MHRI based upon Cabinet Office, *Preliminary Quarterly Estimates of GDP.*

		FY2008	FY2009	FY2010	2009				2010				2011
					Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Industrial production	q-o-q % ch	-12.6	-9.8	6.2	-22.2	8.3	7.4	5.4	1.7	-0.5	0.6	0.7	1.0
Ordinary profits	y-o-y % ch	-39.0	-36.0	36.3	-69.0	-53.0	-48.6	-48.9	71.0	48.7	45.4	48.8	12.9
Nominal labor compensation	y-o-y ch	-0.5	-4.1	-1.0	-2.2	-4.7	-3.7	-5.2	-2.4	-1.4	-1.0	-1.2	-0.2
Unemployment rate	%	4.1	5.5	5.4	4.4	5.2	5.5	5.7	5.7	5.6	5.5	5.4	5.2
New housing starts (no. of units)	p.a., 10,000 units	103.9	74.3	78.3	90.4	76.2	70.7	73.5	75.6	78.3	78.7	80.5	82.8
Current account balance	p.a., JPY tril	12.3	15.3	20.1	7.2	15.8	14.9	19.1	10.4	14.8	19.0	26.2	16.7
Domestic corporate goods prices	y-o-y % ch	3.2	-5.0	-2.0	-1.8	-5.5	-8.3	-4.7	-1.1	-1.4	-1.8	-2.2	-2.8
Consumer prices	y-o-y % ch	1.2	-1.3	-1.1	0.0	-1.0	-2.3	-1.2	-0.6	-1.0	-1.1	-1.2	-1.2
Uncollateralized overnight call rate	%	0.09	0.10	0.10	0.09	0.11	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Yield on newly-issued 10-yr JGBs	%	1.44	1.41	1.43	1.29	1.42	1.34	1.42	1.40	1.40	1.40	1.40	1.50
Nikkei average	JPY	10,802	9,850	10,700	7,930	9,294	10,141	9,900	10,000	10,300	10,600	10,800	11,000
Exchange rate	JPY/USD	100.5	92.0	92.0	93.6	97.3	93.6	90.0	89.0	90.0	91.0	93.0	95.0
Crude oil price (WTI nearest term contract)	USD/bbl	85.9	73.3	74.1	43.0	59.6	68.1	80.7	84.7	77.2	73.6	72.5	73.0

Notes: 1. The readings above may differ from public releases because the rates of change are calculated based upon actual results.
2. Ordinary profits are based upon the *Financial Statements Statistics of Corporations by Industry (all industries).*
3. Consumer prices exclude fresh food.
4. Quarterly data on the unemployment rate, new housing starts and current account balance are seasonally-adjusted.
5. Of the finance-relate indices, the uncollateralized overnight call rate refers to the rate at the end of term and all others are averages during the relevant terms.

Sources: Made by MHRI based upon Cabinet Office, *Preliminary Quarterly Estimates of GDP,* Ministry of Economy, Trade and Industry, *Indices of Industrial Production,* Ministry of Finance, *Financial Statements Statistics of Corporations by Industry, Quarterly,* Ministry of Internal Affairs and Communications, *Labor Force Survey, Consumer Price Index,* Ministry of Land, Infrastructure, Transport and Tourism, *Current Survey on Construction Statistics,* Bank of Japan, *Balance of Payments, Corporate Goods Price Index, Financial and Economic Statistics Monthly, Foreign Exchange Rates,* Japan Bond Trading Co., Ltd., *Latest Daily JGB Rates,* Nikkei Inc. and Bloomberg.

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

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