World Economic Trends
The Spring Report in 2010

-- Economic Recovery Driven by Asia and Contagion
from the Greek Fiscal Crisis --

(Summary)

May 2010

Cabinet Office
Government of Japan

<Contents>

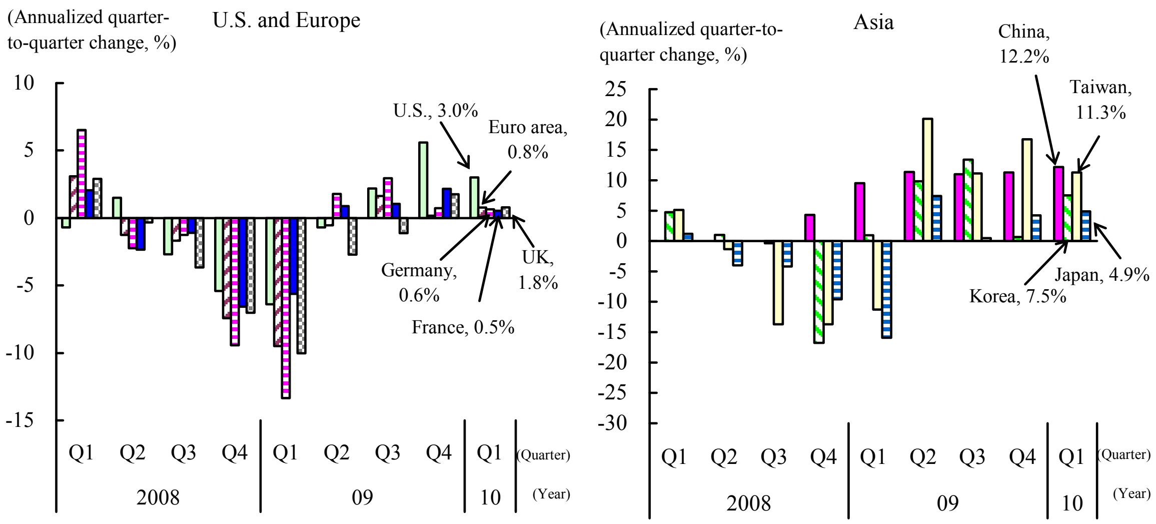
Chapter 1 Global Economic Recovery and the Greek Fiscal Crisis

Section 1 Current Global Economic Situations

Pace of Recovery Differing from Region to Region

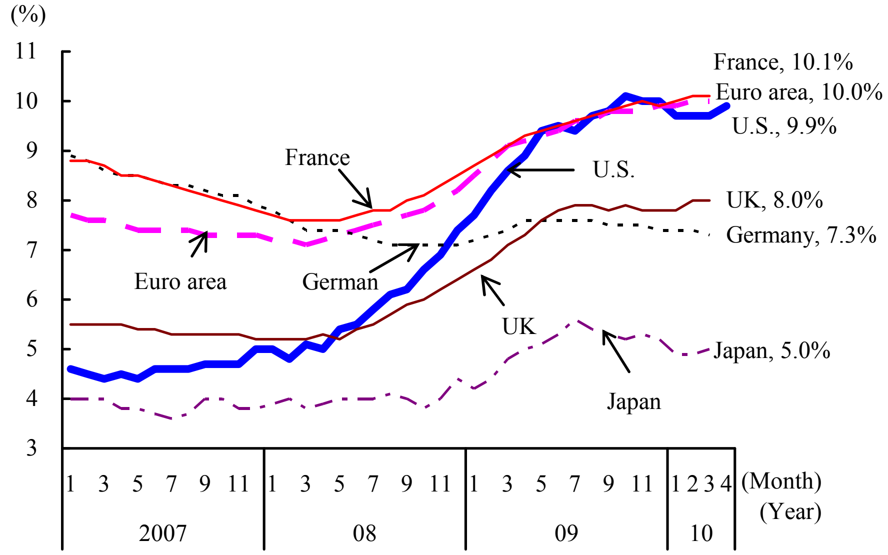
- The global economy has been recovering gradually, due partly to economic stimulus measures. However, the pace of economic recovery differs from region to region: while the Asian economy has been expanding or picking up, the pace of recovery in the U.S. has been moderate and the European economy has ceased to fall but not gained upward momentum yet.
- Meanwhile, unemployment rates have remained high in Europe and the U.S.

Figure 1-1-1 Real GDP Growth Rates of Major Countries: Turned Positive in Mid-2009



(Note) 1. Source: National and regional statistics.
2. Data for China are estimates of the People's Bank of China. Only estimates for the October-December quarter of 2008 and onward have been released.

Figure 1-1-3 Unemployment Rates of Major Countries: Remaining at a High Level

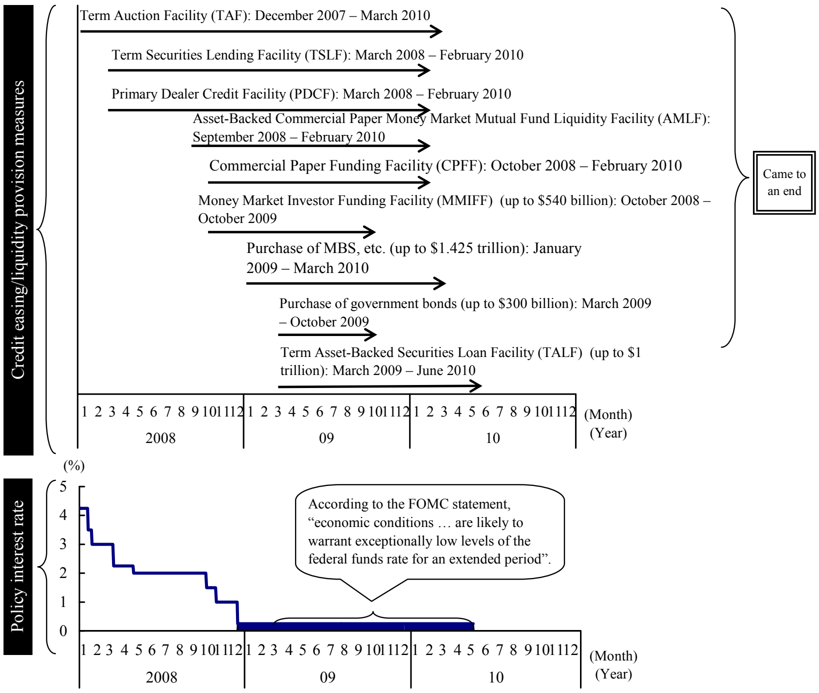


(Notes) Source: National statistics.

Emergency Policies to Stabilize Financial Systems Currently Exiting

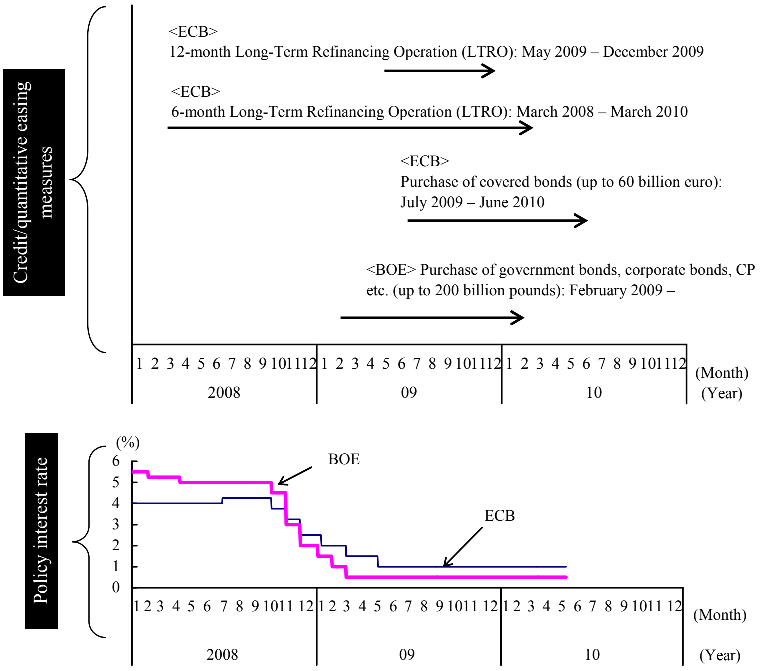
- In Europe and the U.S., after the outbreak of global financial crisis, a wide range of financial system stabilization measures have been implemented. In line with the stabilization of financial markets, these policy measures have been ceased.

Figure 1-1-4 Major Credit Easing/Liquidity Provision Measures in the U.S.



(Notes) 1. Source: Federal Reserve Board (FRB).
2. Arrows denote the periods during which the measures were carried out.

Figure 1-1-5 Credit/Quantitative Easing Measures in Europe



(Notes) 1. Source: ECB and BOE.
2. Arrows denote the periods during which the measures were carried out.
3. ECB states that the purchase of covered bonds can be referred to as "credit easing" measures, while BOE refers to the purchase of government bonds as "quantitative easing" measures.
4. In the wake of the Greek fiscal crisis, ECB decided on May 10, 2010 to conduct 6-month LTRO with limitless supply of money.

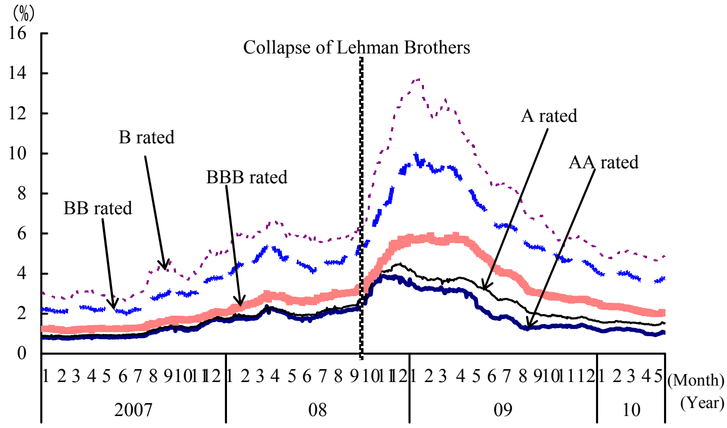
Regional Difference in the Exit from Fiscal/Monetary Policies Implemented to Stimulate the Economy

- The exit from monetary easing and fiscal stimulus measures implemented to revive the economy has already been seen in some countries in Asia, such as Australia and India.
- On the other hand, with regard to monetary policies, Europe and the U.S. have maintained their monetary easing stance with the continued record-low policy interest rates. With regard to fiscal policies, they have started deliberating on fiscal consolidation spurred by rapidly deteriorating fiscal conditions due to the outbreak of the financial crisis and the recession.

Recovery in the Financial Sector

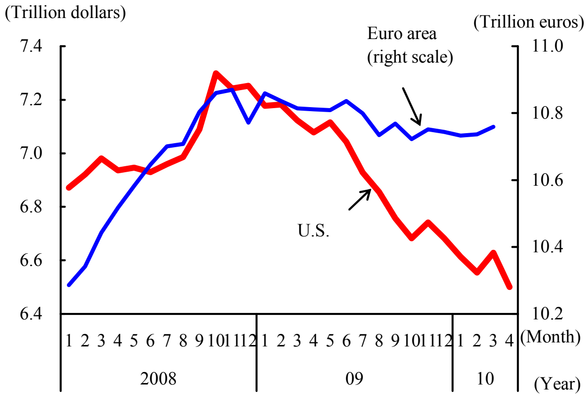
- In Europe and the U.S., direct finance has recovered to the pre-crisis level in tandem with the stabilization of financial markets. However, indirect finance through bank lending has continued to suffer from a credit crunch will decelerate the pace of economic recovery.

Figure 1-1-6 U.S. Corporate Bond Spread: Recovered to Pre-Crisis Level



(Notes) 1. Source: Bloomberg.
2. The corporate bond spread is the difference between the yield of a corporate bond (10-year) issued by a company with a credit rating and a U.S. government bond (10-year).

Figure 1-1-7 Outstanding Bank Loans in the U.S. and Europe: Remaining on a Downward Trend



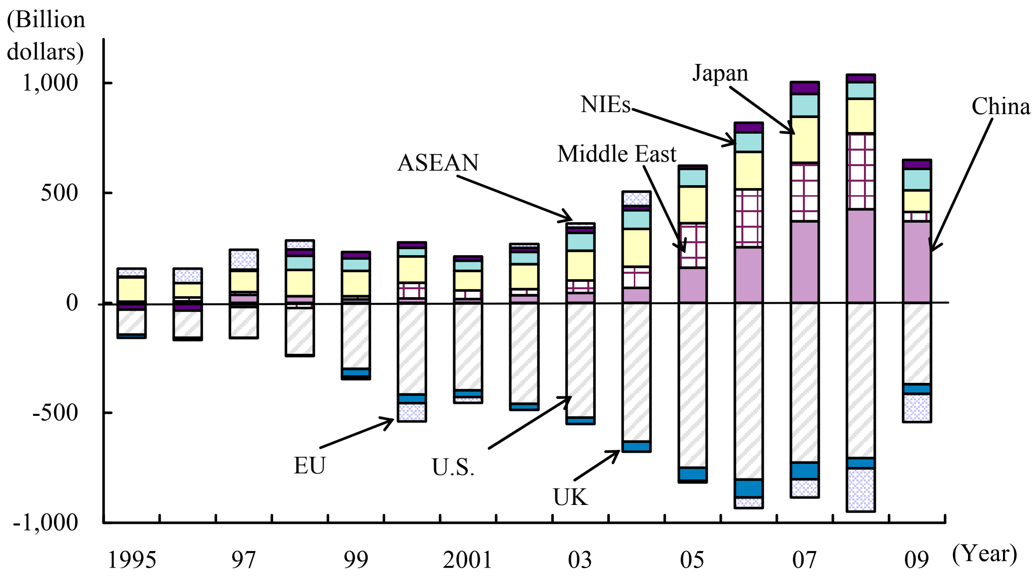
(Notes) 1. Source: ECB and FRB.
2. In the U.S., certain assets and liabilities that were previously off-balance sheet have started to be recorded on the balance sheet from April 2010. The U.S. data for April 2010 are thus estimates discounting the impact of this change.

Risk Factors Accumulating

- Although the global economy is forecast to follow a moderate recovery path, it is likely to be put under downward pressure, such as from unfavorable employment conditions with unemployment rates remaining at high levels and the continued credit crunch. In addition, there are many other risk factors that may have an adverse impact on the global economic recovery, including:
  - Sovereign risk and its contagion
  - Deflationary pressures deriving from the extremely wide GDP gap
  - The economic recovery stalling as a result of a rushed policy exit without sufficient caution
  - Excess liquidity worldwide due to the carry trades using low interest-rate currencies
  - An intensifying credit crunch due to financial regulations tightened with more haste than caution
  - Political and social turmoil as well as a rising tide of protectionism against the backdrop of a worsening employment

- Triggered by the recent global financial crisis, the world economy has greatly changed involving the expanding presence of Asian countries and a shakeup of global economic systems due to the implementation of financial regulatory reforms.
- The global imbalance, which had swollen rapidly in and after 2003 and became one of the reasons behind the crisis, narrowed significantly in 2009.
- However, since mid-2009, the amount of the U.S. trade deficit has increased again. Furthermore, there are signs that the flow of international funds has restarted, centering on the U.S. Thus, it is necessary to keep a close watch on whether the global rebalancing will continue to maintain its momentum.

Figure 1-1-10 Current Account Trends by Country and Region: Current Account Imbalance Narrowed in 2009



(Notes) 1. Source: "World Economic Outlook Database", IMF.
2. Figures for 2009 are IMF estimates.
3. Singapore is included in both NIEs and ASEAN.

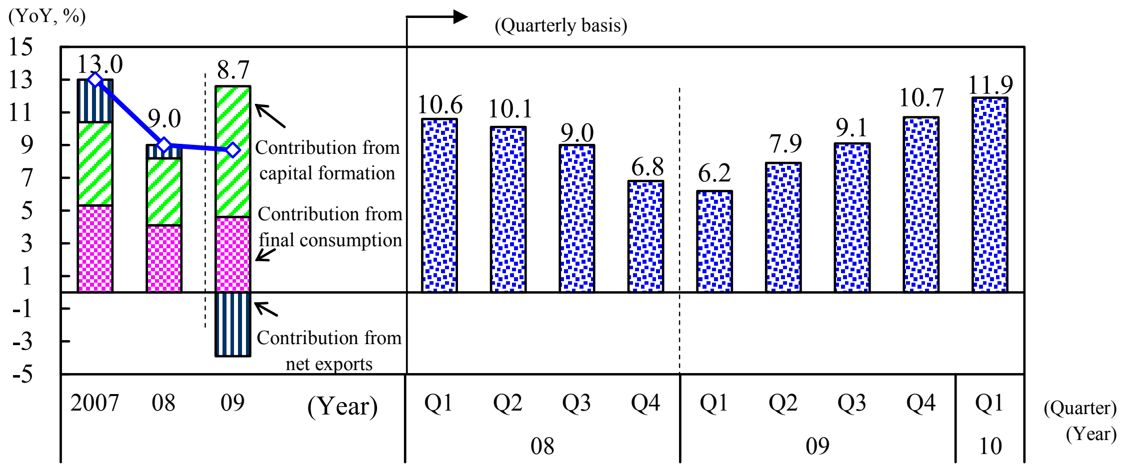
Section 2 Asian Economy

1. Economic Trends in China

(1) Current economic situation

- The Chinese economy has been expanding mainly in domestic demand, thanks partly to the effect of policy stimulus, which have been implemented since November 2008. In 2009, despite the negative contribution from external demand, economic growth was achieved due primarily to strong domestic demand driven by investment and consumption.

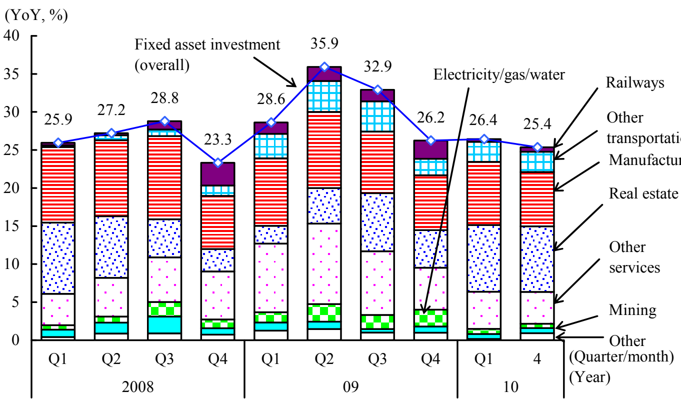
Figure 1-2-1 Real GDP Growth Rate: Economy Expanding Led by Domestic Demand



(Notes) 1. Source: National Bureau of Statistics of China.
2. Due to a revision of statistics, there exists a discontinuity between figures prior to 2009 and those for 2009 onwards in the chart above. Revised real GDP growth rates are 14.2% for 2007 and 9.6% for 2008, of which details have not been released.

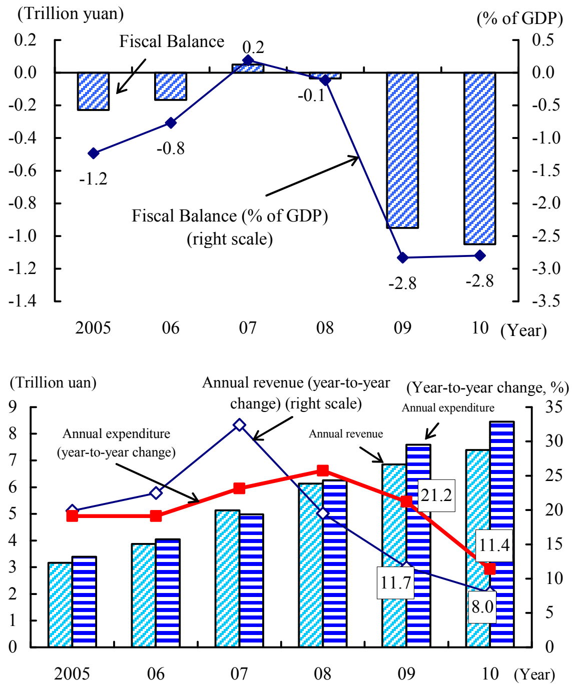
- Although the growth rate of fixed asset investments has slowed since 2009, the high growth level has been maintained. Meanwhile, despite the expansionary fiscal policies continuing into 2010, the public investment budget is projected to increase by only about 9% in 2010 from the previous year, a significant slowdown compared with the more than 70% year-on-year increase posted in 2009. Accordingly, the contribution to economic growth of public investment is likely to reduce in 2010. On the other hand, real estate development investment that plunged tentatively has regained its growth momentum.

Figure 1-2-2 Fixed Asset Investment in Urban Areas: Despite the Growth Pace Slowing, High Growth Levels have been Maintained



(Notes) 1. Source: "Fixed Asset Investment in Urban Areas", National Bureau of Statistics of China.
2. Investment projects carried out by government organizations at the county level or above, corporations, etc., accounted for 86% of total fixed asset investment in China in 2009.
3. With regard to real estate development investment, statistics on land purchasing costs were revised in November 2009.

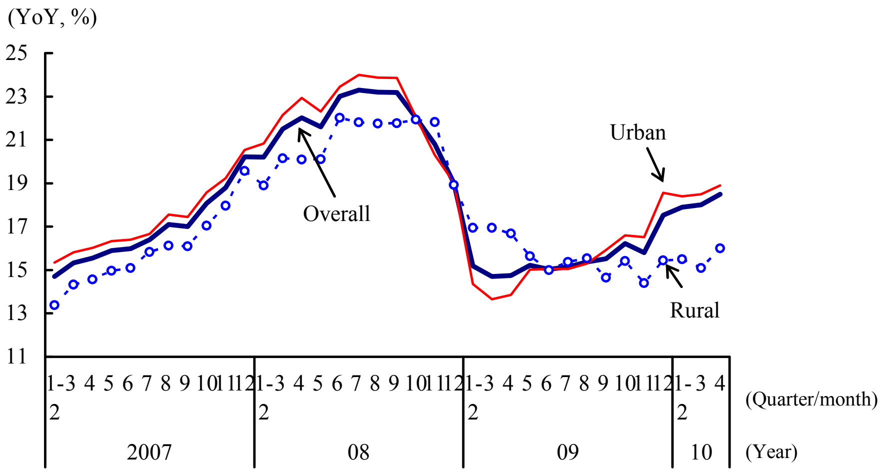
Figure 1-2-3 Fiscal Conditions: Increase in Annual Expenditure Likely to Slow in 2010



(Notes) 1. Source: National Bureau of Statistics of China and "Report on the Implementation of the Central and Local Budgets for 2009 and on the draft central and local Budget for 2010", Ministry of Finance, People's Republic of China.
2. Data for 2010 are on a budget basis.

- The growth of consumption has been accelerating in line with the surge in spending in urban areas. In addition to the continued consumption promotion measures, the improving income situation and consumer sentiment are likely to shore up the solid growth in consumption for a while.

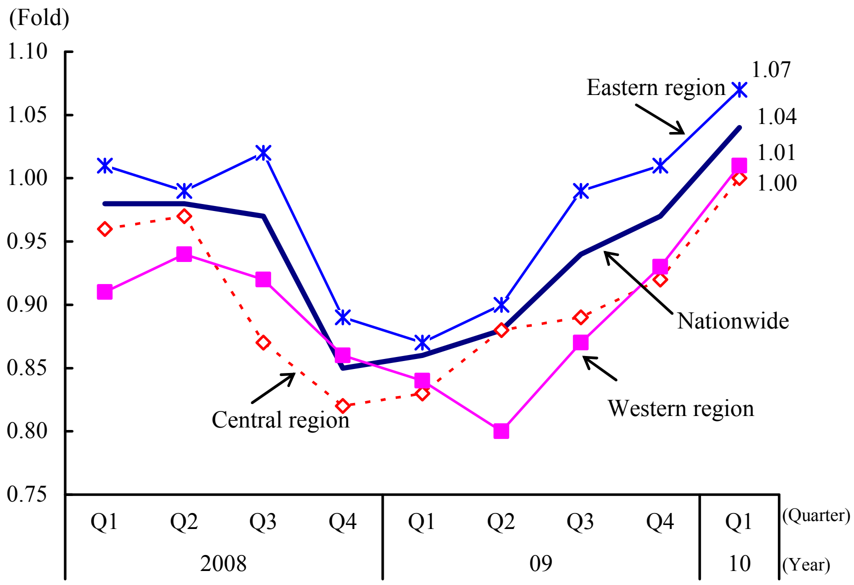
Figure 1-2-4 Total Retail Sales of Consumer Goods: Consumption Growing Steadily



(Notes) 1. Source: National Bureau of Statistics of China.
2. In order to exclude the influence of the Chinese New Year, accumulated figures for January and February are compared.
3. Consumption in urban areas accounted for 68% of the total in 2009, with the remaining 32% accounted for by that in rural areas.

● A look at the employment situation finds that the unemployment rate has decreased in tandem with the economic recovery. The supply and demand balance in the labor market is also tending to tighten, mainly in the coastal regions. Minimum wages that were left unchanged in 2009 have begun rising in various regions in 2010.

Figure 1-2-12 Ratio of Job Offers to Job Seekers (By Region): Supply and Demand Balance in Labor Market is tightening



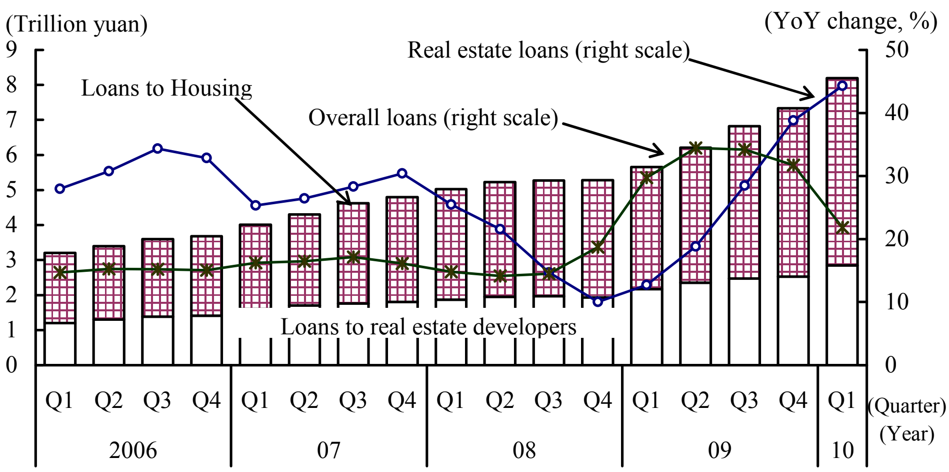
(Notes) 1. Source: Ministry of Human Resources and Social Security of the People's Republic of China.
2. The eastern region includes cities located in coastal areas such as the Pearl River Delta, Yangtze River Delta, and the Bohai Rim. The central region comprises Henan, Hubei and others, while the western region consists of Chongqing, Sichuan and others.

(2) Three risks

(i) Risk of overheating in the real estate market

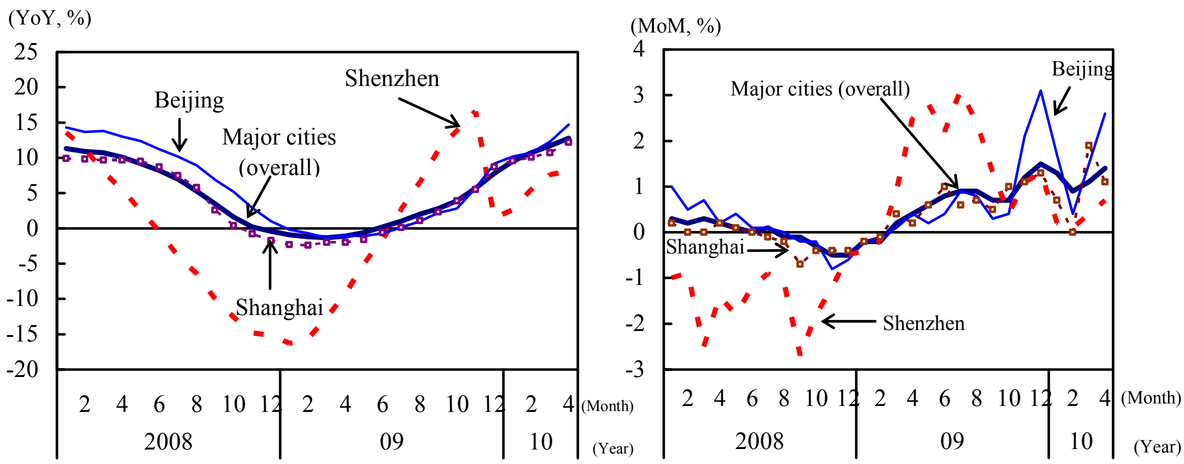
- Bank lending has been on the rise supported by easing monetary policies. Out of overall new bank lending in 2009, approximately 20% (about 2 trillion yuan) went into the real estate market. Real estate-related outstanding loans have increased more rapidly than overall outstanding loans since the end of 2009.
- The rates of increasing in building sale prices in major cities have risen up to the 10% level since February 2010, almost as high as the level seen in 2003-2004 period and 2007, when the fear of a real estate bubble loomed large. Moreover, according to surveys conducted by the People's Bank of China and the Chinese Academy of Social Sciences, the acquisition of real estate for investment and speculation purposes was considerable. This exposes the risk of the real estate market heating up.
- In an effort to cope with these circumstances, the Chinese government has further stepped up financial supervision since the beginning of 2010. The real estate market has continued to be put under strict controls in the issuance of a new regulation in April 2010 that stipulates a adjourn loans for the purchase of third homes or more in some cities.

Figure 1-2-16 Real Estate Loans: Growing More Rapidly than Overall Loans Since End-2009



(Note) Source: People's Bank of China.

Figure 1-2-17 Building Sale Prices in Major Cities: 10% Year-to-Year Growth Level Maintained since February 2010

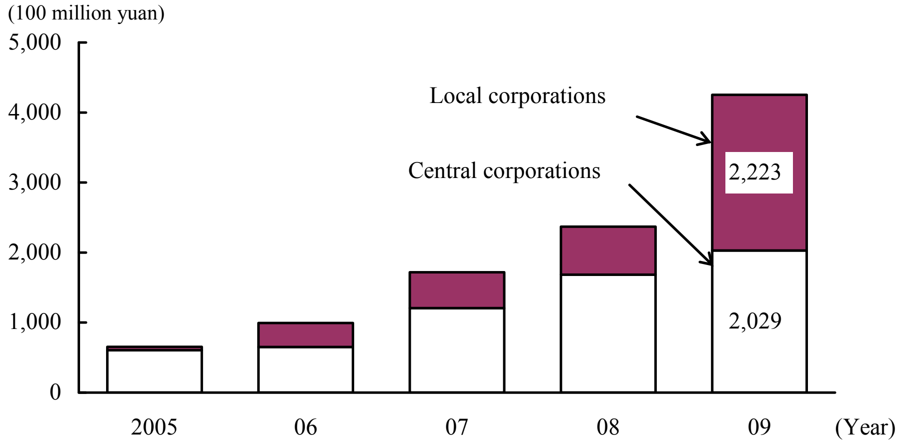


(Note) Source: National Bureau of Statistics of China.

(ii) Risk of the fund raising platform of local governments generating nonperforming loans

- In order to cover fund shortages, local governments have established government-invested urban infrastructure development corporations (the fund raising platform of local governments), through which they raise money for the construction of infrastructure and the development of real estate. The total value of the bonds issued by local corporations, including the fund raising platform of local governments, surged in 2009 to more than treble the previous year's figure. Meanwhile, total debts are estimated to be around 5 trillion yuan as of May 2009. Given that all of the debts were bank borrowings, this means they accounted for about 12% of total bank loans outstanding.
- If the fund raising platform of local governments fail in business, the fiscal position of local governments will deteriorate since they are liable to pay for the debt as guarantee providers. If there is no explicit debt guarantee, this could cause banks to suffer from nonperforming loans. If this occurs on a large scale, it may cause financial system instability or bring downward pressure on the economy.

Figure 1-2-23 Value of Bonds Issued by Local Corporations: More Than Trebled from the Previous Year in 2009

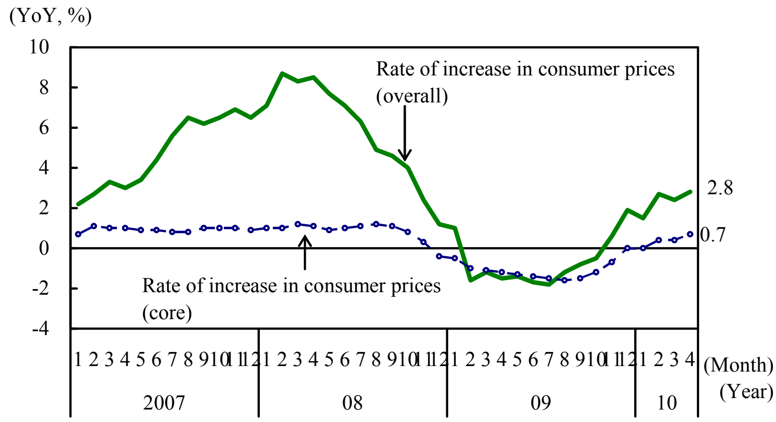


(Note) Source: China Government Securities Depositary Trust and Clearing Co., Ltd.

(iii) Risk of inflation

- The rate of increase in consumer prices has accelerated. However, with the rate of increase in core consumer prices(excluding food and energy prices) remaining low, this increase does not signal the trend of inflation, but is rather the result of a rise in food prices due partly to irregular weather.
- Nevertheless, there is a risk of inflation since the economy may overheat in line with large amount of bank lending and expanding public finance and the labor market may tighten. On the other hand, deflationary pressures may be created due to excess supply in some industries.

Figure 1-2-24 Rate of Increase in Consumer Prices: Remaining Positive since November 2009

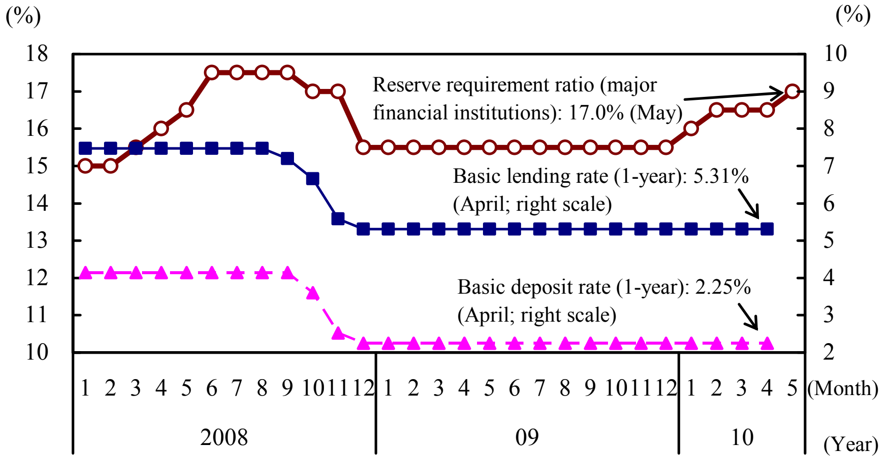


(Notes) 1. Source: National Bureau of Statistics of China.
2. Core consumer prices exclude food and energy prices.

(3) Monetary policy adjustment

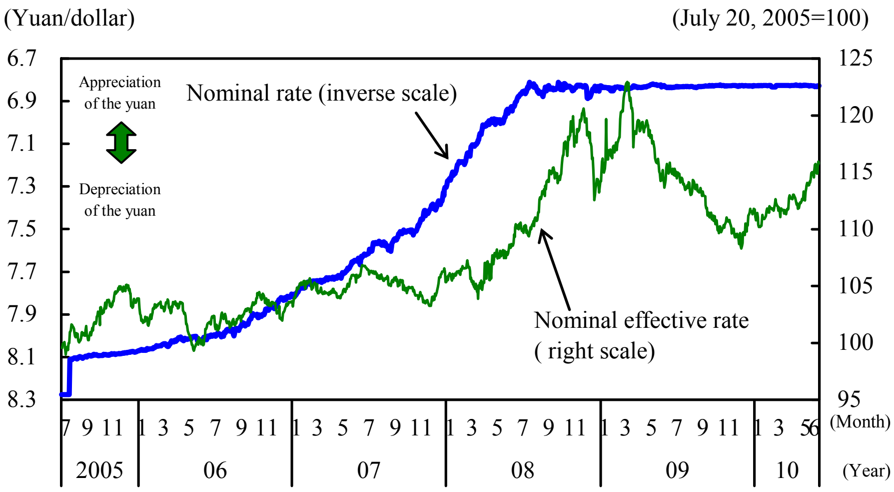
- In comparison with the past, the policy interest rate has remained low. The reserve requirement ratio was raised by 50 basis points in each of January, February, and May 2010 to absorb liquidity. The central bank has accelerated its efforts to absorb liquidity from the market since the second half of 2009 through the issuance of central bank bills. The yuan/dollar rate has leveled off since July 2008. Revaluation of the yuan will reduce import prices and thus help curb upward pressure on prices.

Figure 1-2-28 Reserve Requirement Ratio and Basic Interest Rate: Reserve Deposit Ratio Raised in January, February and May



(Notes) 1. Source: People's Bank of China.
2. Since reserve deposit ratios at major financial institutions prior to August 2008 hav not been released, overall data for the institutions is used instead.

Figure 1-2-31 Nominal Yuan/Dollar Rate: Remains flat since July 2008

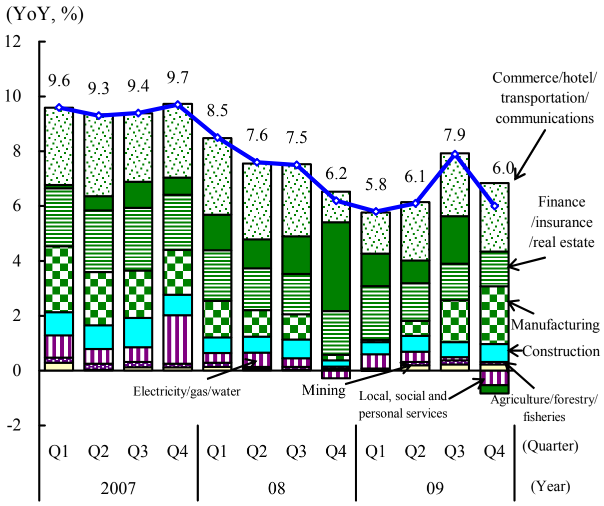


(Note) Source: Bloomberg.

2. Economic Trends in India

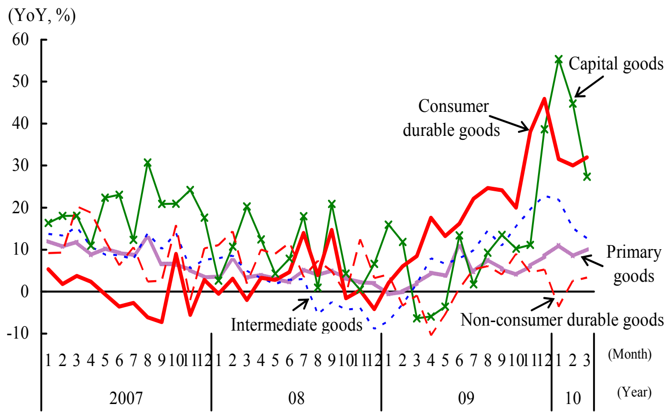
- The Indian economy has been <u>on a recovery path mainly led by domestic demand</u> due partly to the three economic stimulus programs announced in and after December 2008.
- Production, chiefly that of consumer durable goods, has been growing, aided by increasing automobile sales. As the production of capital goods has also been on the rise since the end of 2009, demand for capital investment seems to be picking up.

Figure 1-2-33 Real Economic Growth Rate: Economy Stays on a Recovery Trend



(Notes) 1. Source: Central Statistical Organization, India.
2. Based on factor prices.

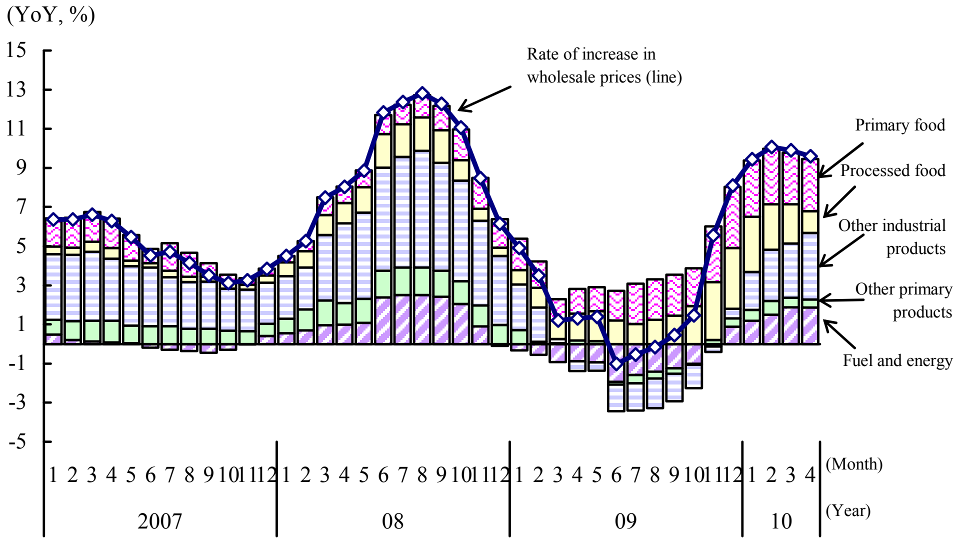
Figure 1-2-35 Industrial Production (by Goods): Increasing Centering on Consumer Durable Goods



(Notes) 1. Source: Ministry of Statistics and Programme Implementation and Ministry of Commerce and Industry, Government of India.
2. Industrial production weights by industry or use are as follows (base 1993=100):
(1) By industry: manufacturing, 79.4; mining, 10.5; and electricity, 10.2.
(2) By use: primary goods, 35.6; consumer goods, 28.7(of which durable goods, 5.4; and non-durable goods, 23.3); intermediate goods, 26.5; and capital goods, 9.3.

- On the other hand, upward pressure on prices has been spreading from food, which is chiefly exposed to such pressure due to reduced agricultural production, to a number of other items, <u>heightening concerns about imminent inflation</u>.

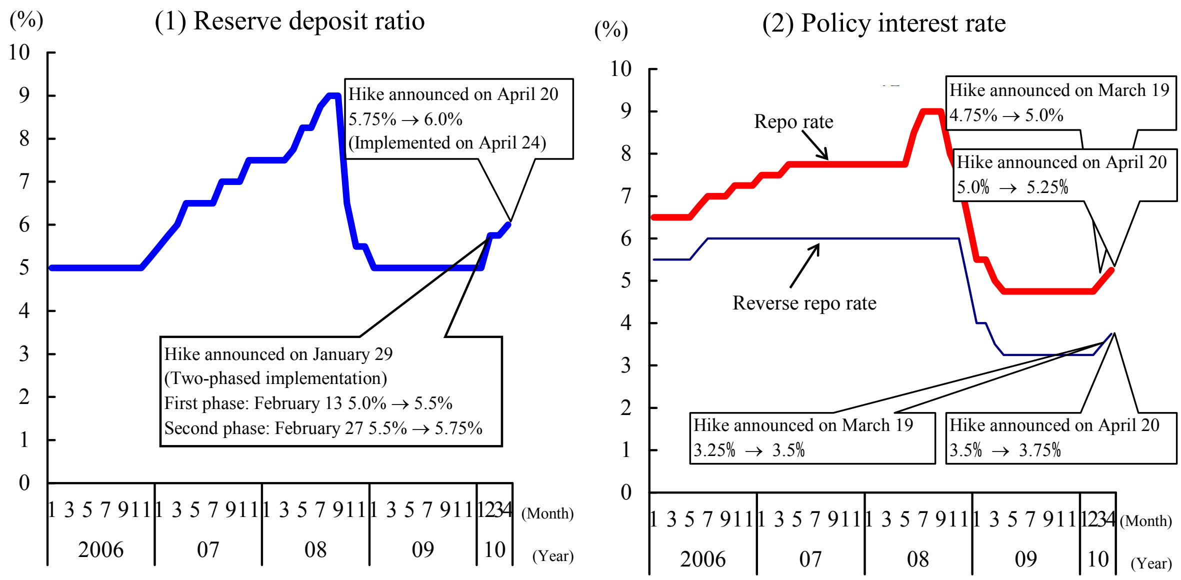
Figure 1-2-36 Rate of Increase in Wholesale Prices (Contribution Ratio by Item): Rising since September 2009



(Notes) 1. Source: Ministry of Commerce and Industry, Government of India.
2. The rate of increase in wholesale prices is the price index that is most closely watched by the Indian government and financial authorities.

- The economic recovery and an increase in prices have prompted the Indian government to shift from an eased monetary policy to a normal one; it has raised each of the policy interest rates and the reserve deposit ratio twice so far in 2010.

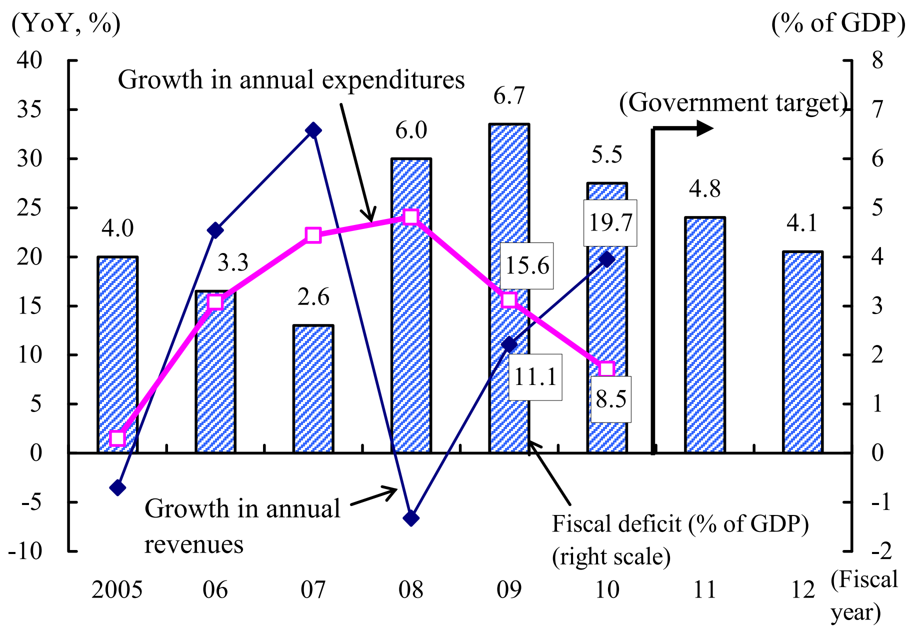
Figure 1-2-41 Reserve Deposit Ratio and Policy Interest Rate: Raised in 2010



(Note) Source: Reserve Bank of India.

- The government has also changed its fiscal policy with the aim of fiscal consolidation; it has proposed a target of fiscal deficit reduction in the budget plan for fiscal 2010 (April 2010 through March 2011).

Figure 1-2-43 Fiscal Deficit (Central Government Basis): Shift to Normal Fiscal Policy



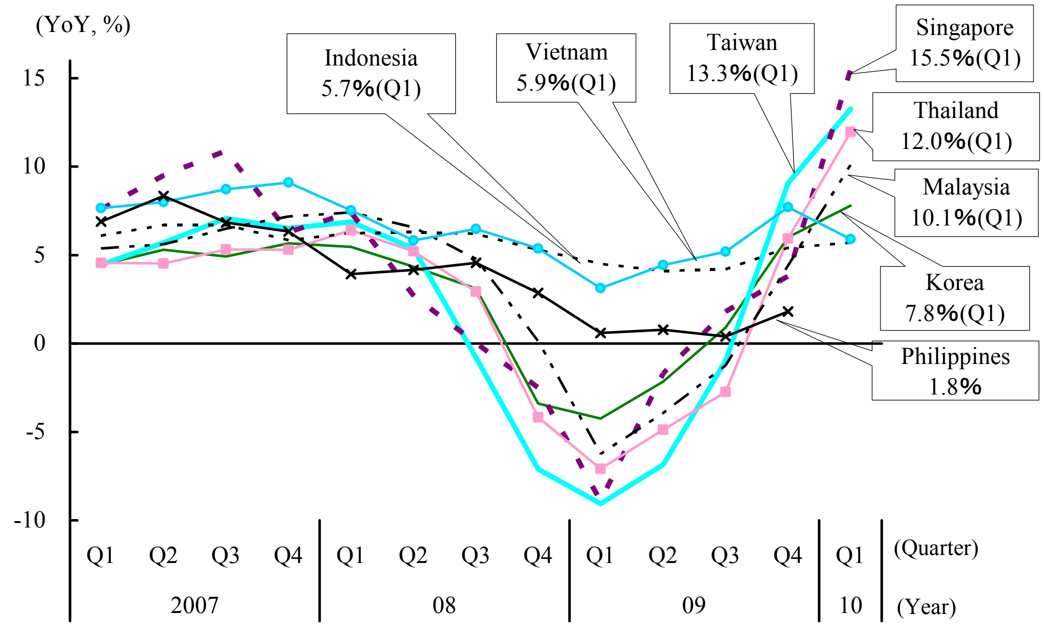
(Notes) 1. Source: Ministry of Finance, Government of India.
2. Fiscal year in India is from April through March of the following year.
3. Figures for fiscal 2009 are estimated results, while those for fiscal 2010 are based on the budget plan.

3. Economic Trends in Other Asian Regions

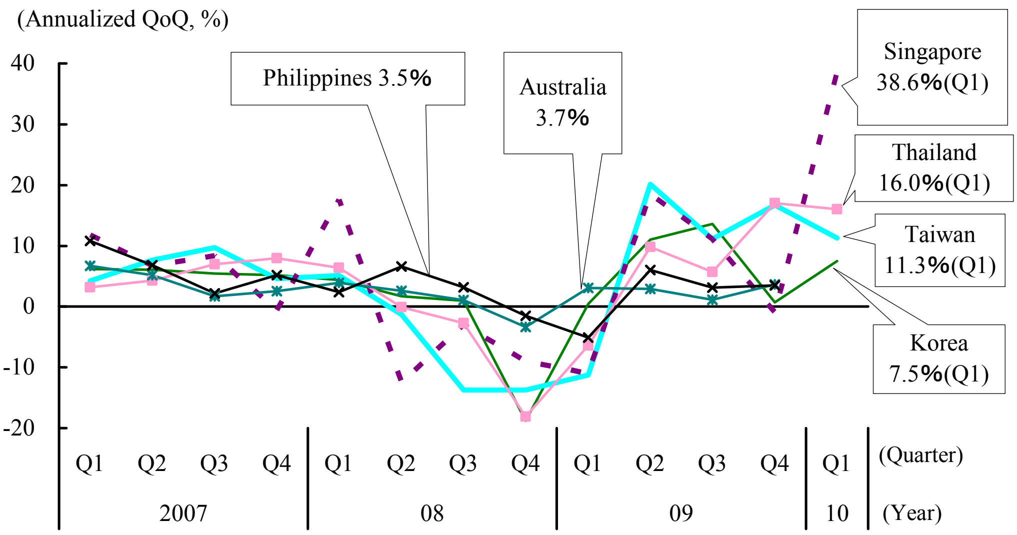
- Other Asian economies, which slowed in the latter half of 2008 dented by the outbreak of the global financial crisis, bottomed out during the first quarter of 2009. Real GDP growth rates for Korea, Taiwan, Thailand and Singapore turned positive, year on year, in the second quarter of 2009. Since then, the economies of these regions have been on a trend towards steady recovery. In general, these Asian economies had started to recover by around the first quarter of 2010.

Figure 1-2-44 Real GDP Growth Rates in Asian Regions: Recovered in General

(1) Year-to-year changes



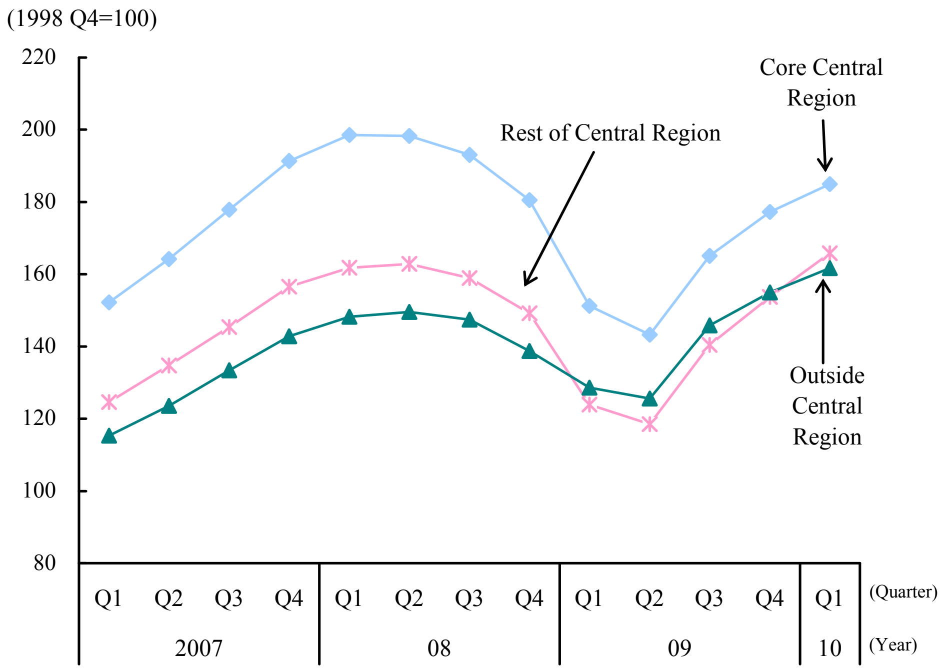
(2) Annualized quarter-to-quarter change



(Notes) 1. Source: National and regional statistics.
2. Figures for the first quarter of 2010 are not available for the Philippines and Australia.

- Due to monetary easing maintained during 2009, the pickup of the Asian economy, and low interest rates in Europe and the U.S., capital has flowed back into the Asian region. As a consequence, asset prices have been on the rise in some countries and regions such as Singapore. The prices of private houses in Singapore, for example, have bottomed out and have continued to increase since the July-September quarter of 2009.
- Some countries in Asia have shifted to monetary tightening due to the increase in asset prices. For instance, Australia raised the policy interest rate in October 2009, then other five rate hikes have been implemented. Other countries such as India and Malaysia have also increased their policy interest rates, whereas China raised the reserve deposit ratio. As evidenced by these moves, Asian regions have gradually shifted to monetary tightening.

Figure 1-2-55 Private Housing Price Index in Singapore: Increasing since the third quarter of 2009



(Note) Source: Urban Redevelopment Authority, Singapore.

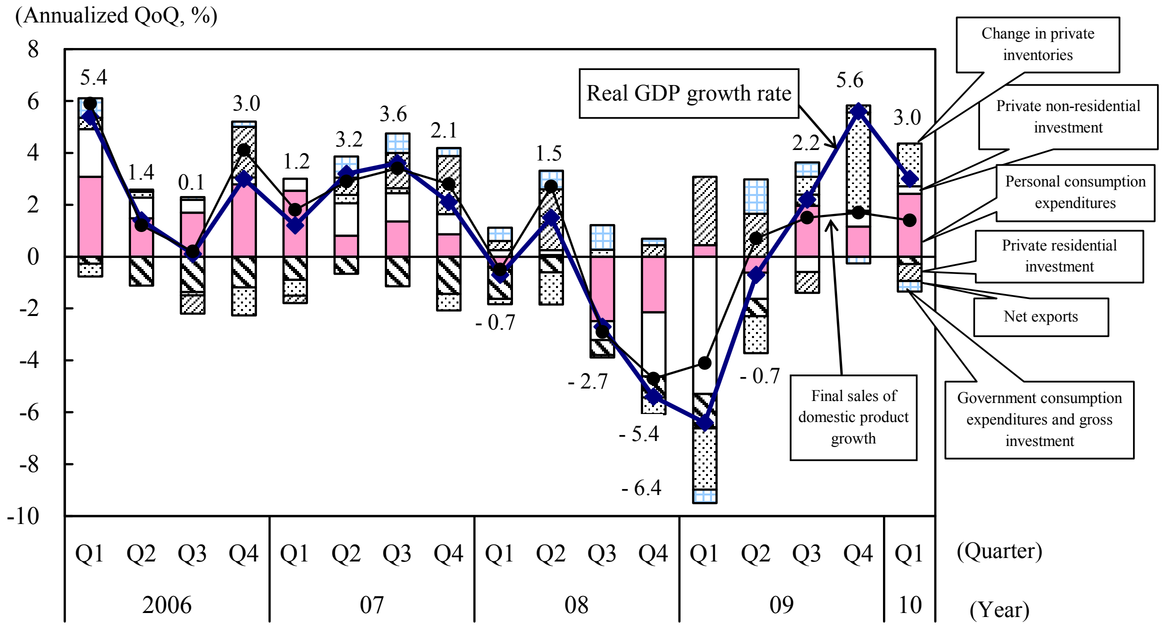
Section 3 U.S. Economy

1. U.S. Economy Starting to Recover

(1) Overview of the U.S. economy

- Still under downward pressure such as from the unemployment rate remaining high, the economy has been on a moderate recovery trend supported by policy measures. However, with considerable amount of positive contribution of private inventory, final demand has not gained a strong growth momentum. Under these circumstances, the effects of fiscal stimulus measures are expected to diminish in the fall of 2010 and onward.

Figure 1-3-1 Real GDP Growth Rate: Economy Recovering Moderately

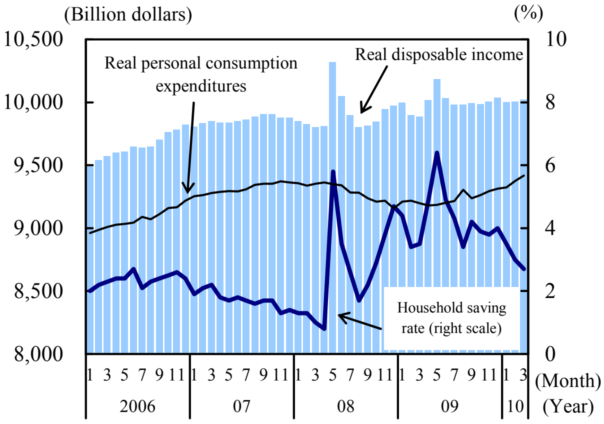


(Note) Source: U.S. Department of Commerce.

(2) Personal Consumption Expenditures

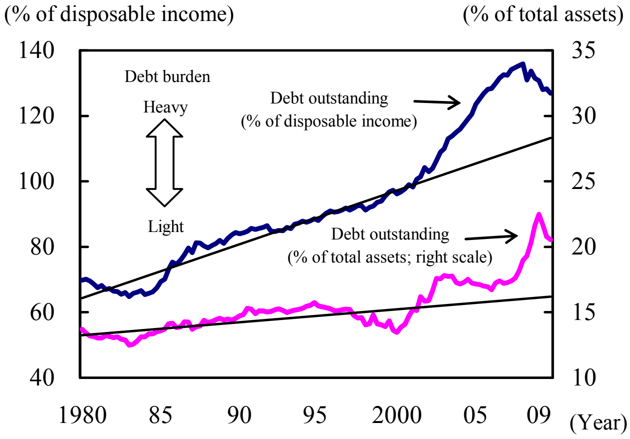
- Personal Consumption Expenditures or PCE have been picking up thanks to the income improvement and recovering consumer sentiment buoyed by the improved employment situation. Accelerating PCE from the beginning of 2010 indicates that it appears to be moving toward autonomous recovery. However, it has to be borne in mind that these moves have been propped up by policy measures and the reduced saving rate.
- Amid the continuing adjustment of household balance sheets, credit crunch, and the unemployment rate staying at high levels, the situation surrounding PCE is likely to remain weak. It is still uncertain whether PCE will smoothly get on the track of autonomous recovery.

Figure 1-3-3 Personal Consumption Expenditures
Despite a recovery, the saving rate is declining



(Note) Source: U.S. Department of Commerce.

Figure 1-3-9 Ratio of Household Debt Outstanding
Dropping, but still hovering far above the trend

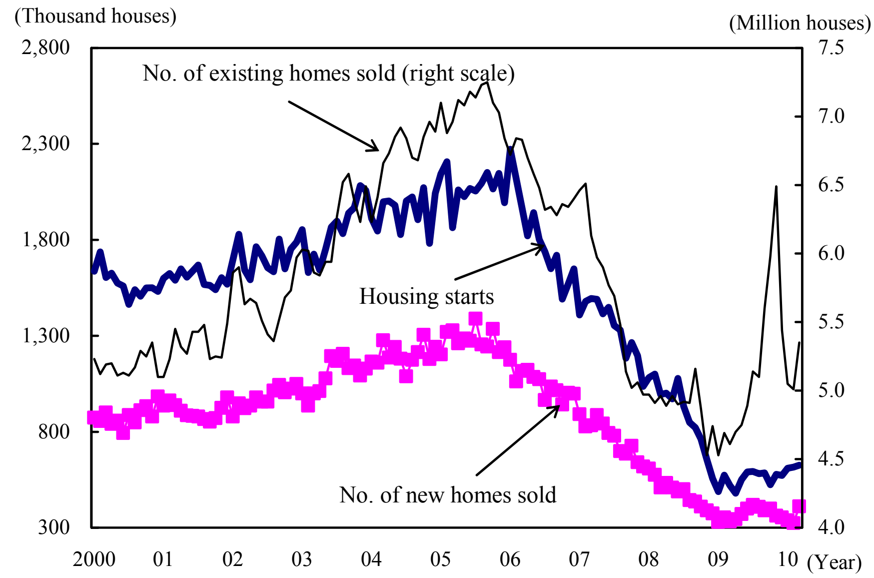


(Note) Source: Federal Reserve Board (FRB) and the U.S. Department of Commerce.

(3) Housing

- Although the housing market appears to have started to recover in the first half of 2009, it remained in the doldrums from the end of 2009 through the beginning of 2010. There is a concern that major packages, implemented to support housing market by the government and FRB, have come to an end by April 2010, and will likely have a negative impact on the housing market down the road.
- Although there is a favorable environment for the purchase of houses due to cuts in interest rates on mortgage loans and the drop in house prices, the recovery of the housing market has delayed. Behind this are the lack of improvement in employment situation and worries over the economy, which have dissuaded consumers from buying houses. On the other hand, on the supply side, the fact that the number of foreclosed houses has remained high and such houses have entered the existing home market may have put general downward pressure on house prices.

Figure 1-3-18 Housing Market Trends (Construction and Sales Trends): Although having appeared to begin to recover in 2009, the market has slowed since the end of 2009.

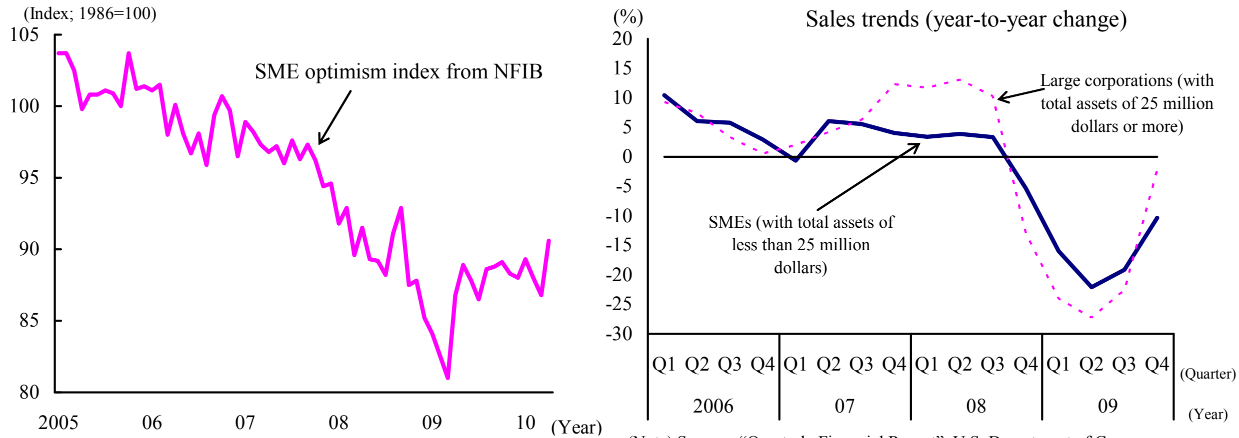


(Note) Source: U.S. Department of Commerce and National Association of Realtors (NAR).

(4) Corporate activities

- Although production and capacity utilization plunged in and after the second half of 2008, they have followed a recovery path since mid-2009 due to a gradual recovery in domestic demand supported by the government's economic stimulus measures.
- Private-sector capital investment tumbled in and after mid-2008. However, after bottoming out in the fourth quarter of 2009, it has increased moderately. While IT investment has been robust to a significant extent, investment in structures has continued to decline.
- Corporations have endeavored to slash their inventories, which piled up considerably due to decline in demand hit by the outbreak of the global financial and economic crisis. Consequently, inventory investment began to increase in the first quarter of 2010. From this point onward, an increasing number of corporations are likely to shift their stance from reducing inventory to boosting it.
- Since small and medium-sized enterprises (SMEs) account for 50% of private-sector employment, moves of the SMEs have a significant impact on the overall economy. While most SMEs depend largely on borrowings from small and medium-sized financial institutions, the latter are currently in a difficult financial position, making it difficult for SMEs to raise operating funds. The slow recovery of SMEs has prompted the Obama administration to support them.

Figure 1-3-27 SMEs Business Sentiment and Sales Trends: SMEs have been slow to recover



(Note) Source: National Federation of Independent Business (NFIB).

(Note) Source: "Quarterly Financial Report", U.S. Department of Commerce.

(5) Trade

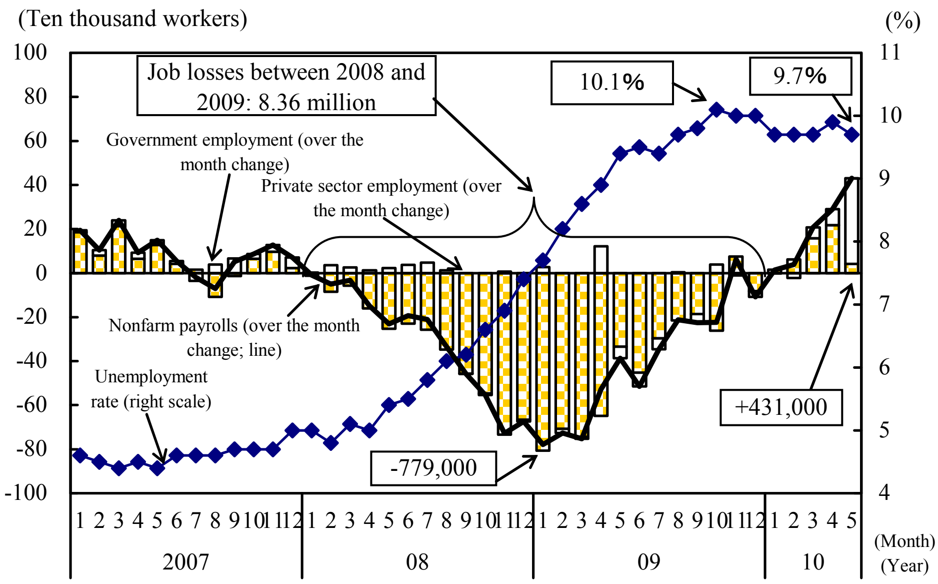
- The trade in goods and services declined in terms of both exports and imports in and after the second half of 2008 amidst lackluster domestic and overseas demand. However, both exports and imports have picked up since mid-2009, making the trade deficit resume expanding.
- In March 2010, President Obama announced the outline of the "National Export Initiative", setting a goal of "doubling U.S. exports over the next five years". With the government planning to formulate a relevant comprehensive policy by the end of June 2010, the development of U.S. exports needs to be closely watched.

2. Downward Pressure on and Future Risks for the U.S. Economy

(1) Employment

- The unemployment rate remains as high as around the 10% level. While cumulative job losses for the two years of 2008 and 2009 amounted to 8.36 million, the number of long-term unemployment continues to increase. On the other hand, nonfarm payrolls, which had continued to decrease, rose by 290,000 in April 2010 from the previous month. Although the employment environment remains harsh, the sharp deterioration in the overall employment picture appears to be easing.
- The trends in employment by industry in and after mid-2009 show that the number of employees in the construction industry has been on a declining trend. There are regional differences in terms of the degree of decline, with a significant drop seen chiefly in the West Coast, South and the Great Lakes Regions.
- Federal government employment has soared since March 2010 reflecting the hiring of temporary workers on Census 2010. However, while suffering from difficult financial conditions on account of plummeting tax revenues, state and local governments have dismissed some employees or refrained from new recruitment, resulting in a continued decline in their employment record.
- The employment program under fiscal stimulus packages enacted in February 2009 has created 2.378 million jobs.
- The government and private research institutions have provided the following outlook: whereas employment is expected to increase gradually, the unemployment rate is likely to be slow to improve and will remain at high levels for a while since some workers who left the labor market due to the worsening employment environment are now reentering it.

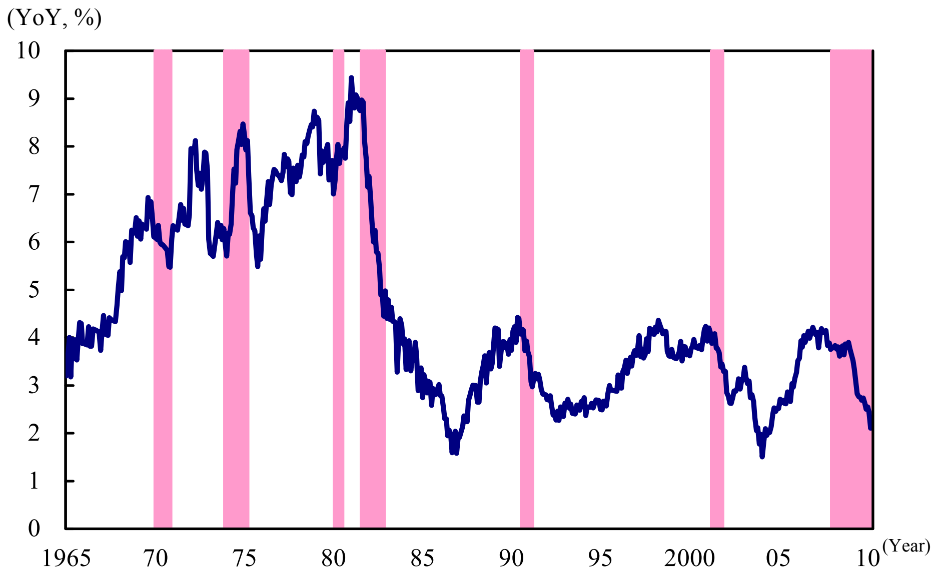
Figure 1-3-34 Nonfarm Payrolls over the Month Change and the Unemployment Rate: While employment is increasing, the unemployment rate remains high at nearly the 10% level



(Note) Source: U.S. Department of Labor.

- A look at the trend in wages finds that the rate of increase in the hourly earnings of non-supervisory employees (private nonfarm sector; year-to-year changes) has been on the decline since December 2007 when the U.S. economy entered a recession phase. Due to the falling trade union membership ratio, downward wage rigidity is likely to have weakened. In addition, changes in wage system may further decelerate the rate of increase in wages.

Figure 1-3-45 Average Hourly Earnings of Nonfarm Private-Sector Production and Non-Supervisory Employees: Rate of Increase in Earnings is Falling

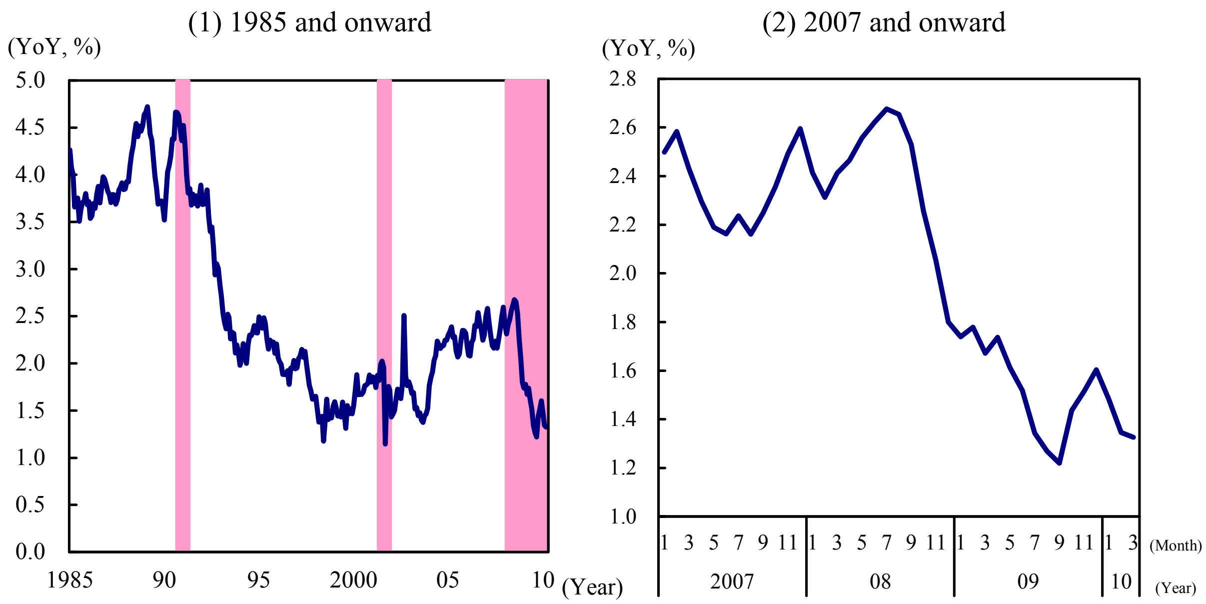


(Notes) 1. Source: U.S. Department of Labor.
2. Shaded areas are periods between peaks and troughs of economic cycles.

(2) Prices

- The price index for personal consumption expenditure excluding food and energy (Core PCE inflation), has continued decreasing year on year.

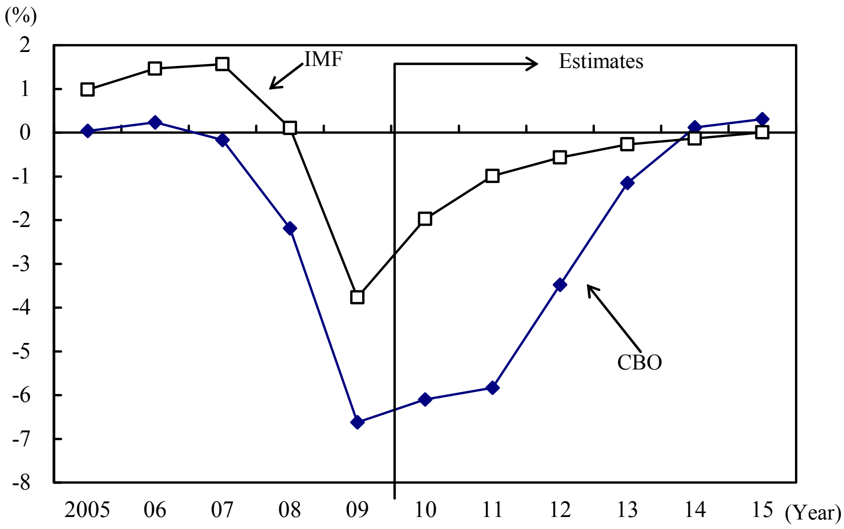
Figure 1-3-49 Core PCE inflation: Inflation rate has been falling since mid-2008



(Notes) 1. Source: U.S. Department of Commerce.
2. Shaded areas are periods between peaks and troughs of economic cycles.

● A large GDP gap still exists in 2010. In addition, with the drop in the expected inflation backed by reduced import prices due to the appreciation of the dollar and the declining rate of increase in wages, some argue the possibility of deflation.

Figure 1-3-51 GDP Gap: Large GDP Gap Still Exists in 2010

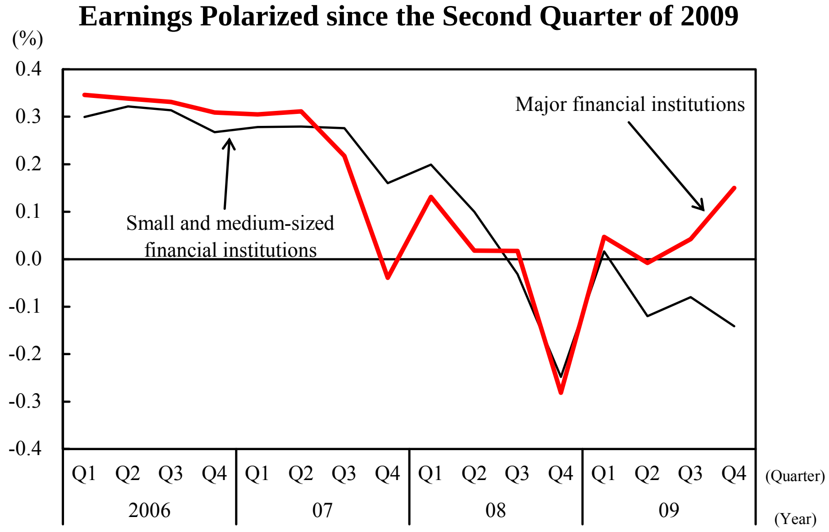


(Notes) 1. Source: Congressional Budget Office (CBO) and IMF.
2. Data for 2010 and onward are estimates.

(3) Financial system

● Owing partly to financial system stabilization measures implemented by the government and FRB, the financial market has shown signs of improvement. However, when examining the operating conditions of individual financial institutions, two types of polarization have been ongoing: (i) whereas investment banks and underwriting sectors are managing well, the commercial banking sector continues to be badly off; and (ii) whereas the earnings of major financial institutions have picked up, small and medium-sized financial institutions continue to suffer from a severe earnings environment.

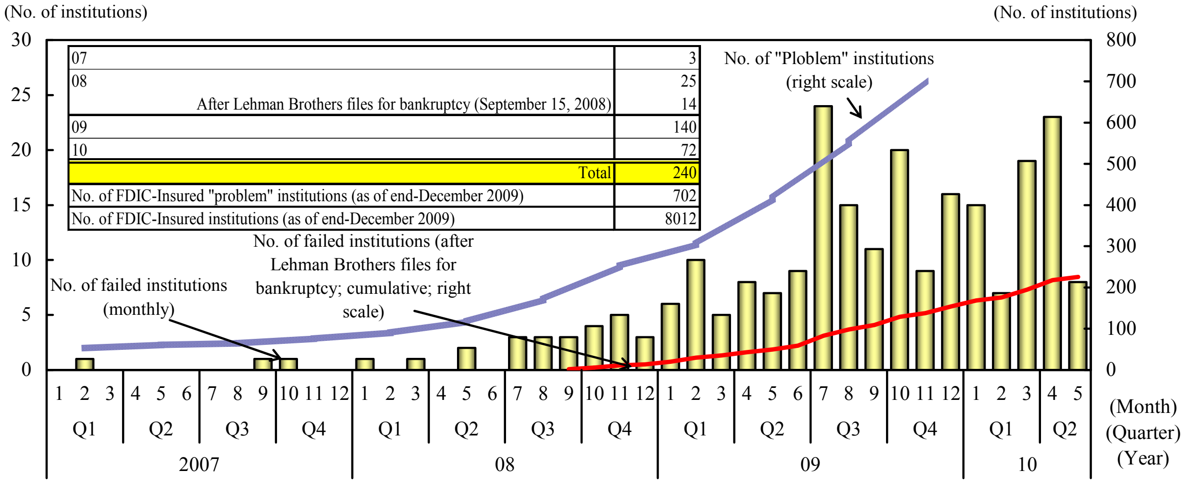
Figure 1-3-57 Return on the Assets of Financial Institutions: Earnings Polarized since the Second Quarter of 2009



(Notes) 1. Source: Federal Deposit Insurance Corporation (FDIC).
2. Return on assets = quarterly net income/average total assets.
3. Small and medium-sized financial institutions refer to commercial banks with total assets of less than 10 billion dollars and savings institutions with total assets of less than 5 billion dollars.

- It can be pointed out that the financial sector is exposed to the following risks: <u>commercial real estate lending continuing to turn into troubled assets</u> mainly at small and medium-sized financial institutions; and <u>a recurrence of financial market turmoil expected to be triggered</u> by realized sovereign risks <u>that would cause many countries to sustain government bond-related losses.</u>

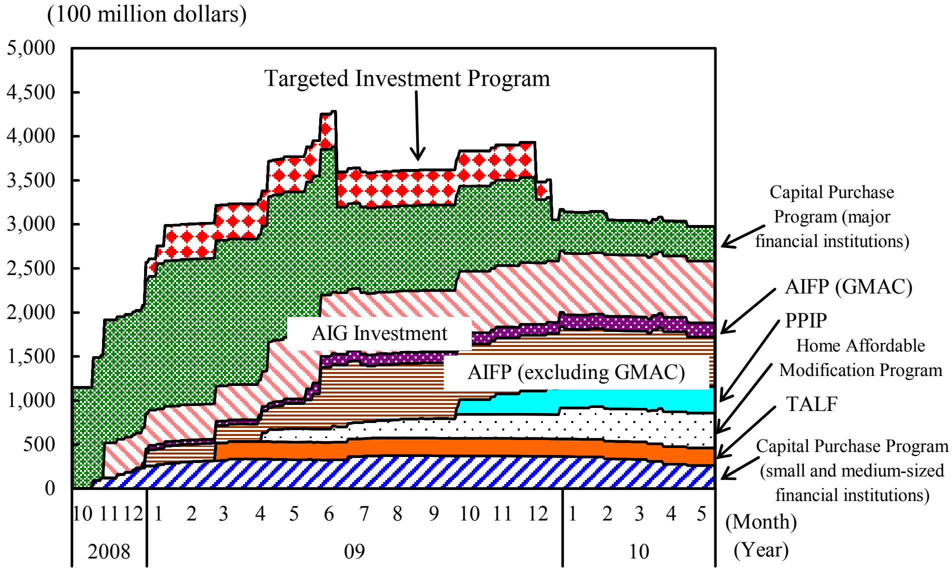
Figure 1-3-58 Number of Cases of Financial Institution Collapse and Troubled Financial Institutions: Number of Cases of Collapse is Increasing



(Notes) 1. Source: Federal Deposit Insurance Corporation (FDIC).
2. The number of failed institutions is as of May 14, 2010. The number of "Ploblem" institutions is as of December 2009.
3. Financial institutions subject to the survey are depositary financial institutions (Commercial banks and savings institutions).

- Partly due to the polarization between large financial institutions and small and medium-sized ones in terms of operating conditions, while the former have made progress in paying back capital injections (outstanding value) carried out in accordance with Troubled Asset Relief Program (TARP), <u>the latter has lagged behind in doing so.</u>

Figure 1-3-59 Use of TARP funds: Changing Gradually



(Notes) 1. Source: U.S. Department of the Treasury.
2. Major financial institutions = Financial institutions subject to stress testing.
3. PRIP = Public-Private Investment Program
4. TALF = Term Asset-Backed Securities Loan Facility
5. On top of these, 100 million dollars have been spent for Small Business Community Lending Initiative (as of May 14, 2010).

3. Exit from Crisis Response

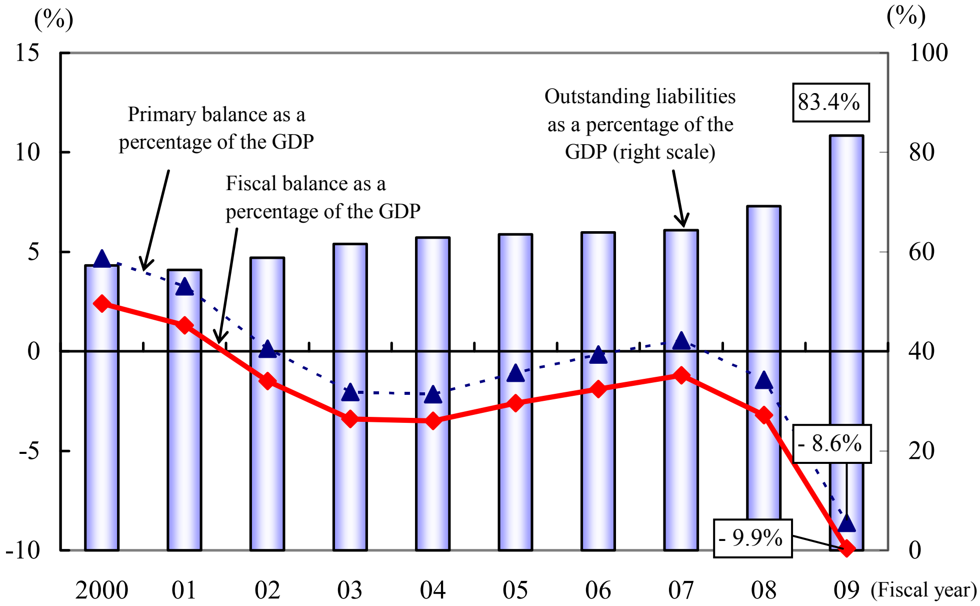
As the economic recovery appears to be gradually taking hold, the U.S. government has become increasingly active in shifting away from its crisis response policy. When examining what fiscal and monetary policies are ideal for the future, it is important to study lessons from past economic recessions that were triggered by a financial crisis and a credit crunch (the Great Depression, the S&L Crisis, etc.), as is the case with the recent economic slump.

<Fiscal policy>

(1) Current fiscal conditions

- In fiscal 2009, the fiscal balance recorded a record-high deficit of 1,415.7 billion dollars (9.9% of GDP), dented by reduced tax revenues due to the economic downturn and increased outlays stemming from expansive fiscal spending along with tax cuts. The deficit is expected to surpass 1 trillion dollars in both fiscal 2010 and 2011 as well.
- In line with the gradual strengthening of prospects for an economic recovery, moves toward fiscal consolidation have begun in full swing. Setting the medium-term fiscal goal of "bringing the federal budget into primary balance by 2015", the government has organized a bipartisan commission to discuss specific measures.

Figure 1-3-63 Fiscal Conditions of Federal Government: Deteriorating Sharply



(Note) Source: Office of Management and Budget (OMB).

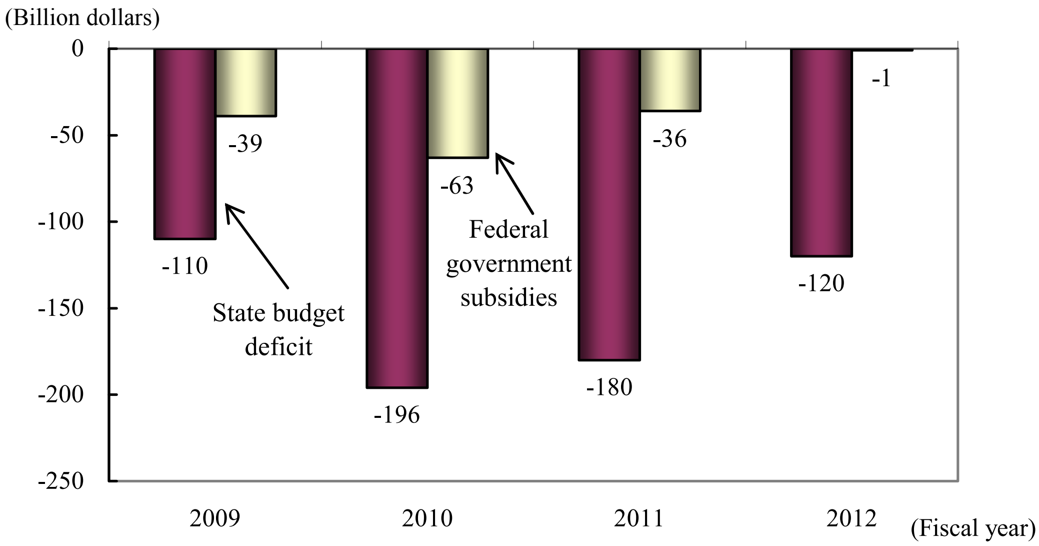
(2) Cases in the Past

- Historically, "lessons from 1937", the year when rapid and significant fiscal tightening caused an economic slowdown, as well as initiatives implemented by the Clinton administration in the 1990s, should be referred.
- The latter is of particular note. The Clinton administration enforced fiscal discipline and implemented measures to cut outlays and boost receipts. The administration's commitment to fiscal consolidation was highly rated by the market and won its trust in the realization of the consolidation, a major factor contributing to the budget turning into the black and the subsequent economic recovery.

(3) Should-be Fiscal Policy

- What we have learned from past case of fiscal consolidation is that “to prevent premature fiscal consolidation” and “government commitment to fiscal consolidation” are of paramount importance. Taking these into consideration, the Obama administration has proposed “expansionary fiscal contractions” as a principle for fiscal consolidation.
- The idea of “expansionary fiscal contractions” is to reduce expected future fiscal deficits by addressing the problems that lie behind the long-term fiscal deficit. Based on this, various steps have been taken with the consideration of past lessons, such as passing related bills for the reform of the health insurance system and the enforcement of fiscal discipline.
- Furthermore, the sustainability of fiscal consolidation depends largely on the development of crucial policy issues (such as the health insurance system reform), state budget conditions, and the moves of government sponsored enterprises (GSEs).
- In particular, state budgets are forecast to remain deep in the red in both fiscal 2011 and 2012. In order to cover shortfalls in receipts, many states have raised taxes and slashed outlays through such measures as education and welfare-related expenditure cuts and the dismissal of state government employees. There is a concern that these moves may adversely affect local economies. If weakened local economies force the states to remain in a difficult budget position over the long term, it is likely that further fiscal burden will be shouldered by the Federal government.

Figure 1-3-62 Outlook for State Budgets: To Remain Deep in the Red



(Notes) 1. Source: Center on Budget and Policy Priorities (CBPP).
2. Federal government subsidies are provided in accordance with the American Recovery and Reinvestment Act enacted in February 2009.
3. Budget deficits in and after fiscal 2010 are estimates.

<Monetary policy>

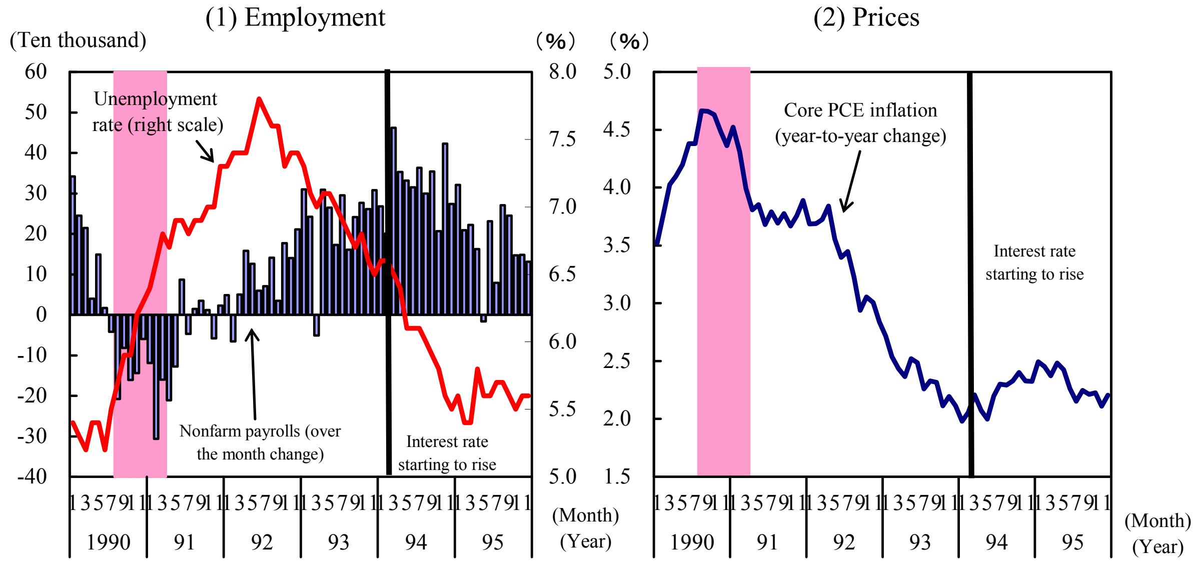
(1) Current financial conditions

- The stabilization of the financial market brought major financial system stabilization programs and measures to provide liquidity, which were formulated in response to the market turmoil, to an end by March 2010. Moreover, purchases of various types of assets introduced as credit easing measures have almost run their course.
- While nontraditional monetary policies are exiting, <u>the focus of attention will shift to when the unexceptionally low levels of Federal Funds rate (FF rate) will be raised</u> in future. <u>The timing of this raise is particularly crucial not to bring downward pressure on the economy, which has recently picked out.</u>

(2) Cases in the Past

- When examining trends in employment and prices, the objectives of U.S. monetary policy, in the early 1990s, employment remaining on a moderate recovery after the economy hit the bottom in March 1991. The unemployment rate entered a full-fledged recovery after peaking out (7.8%) in June 1992.
- Meanwhile, a look at price trends shows that the Phillips curve shifted downward compared to that prior to 1990 accompanied by a fall in NAIRU, indicating disinflation tendency. The Core PCE inflation dropped to as low as around 2%, year on year, at the beginning of 1994.
- <u>FRB did not raise the target for the federal funds rate for about two years even after the economy entered the recovery phase and unemployment started to decline. It was when the inflation rate surpassed 2% in February 1994 and then began following an upward path that the interest rate was raised.</u>

Figure 1-3-72 Employment and Price Conditions in the 1990s: Labor market takes a significant time to recover and Core PCE inflation decreased, even after the economy began picking up



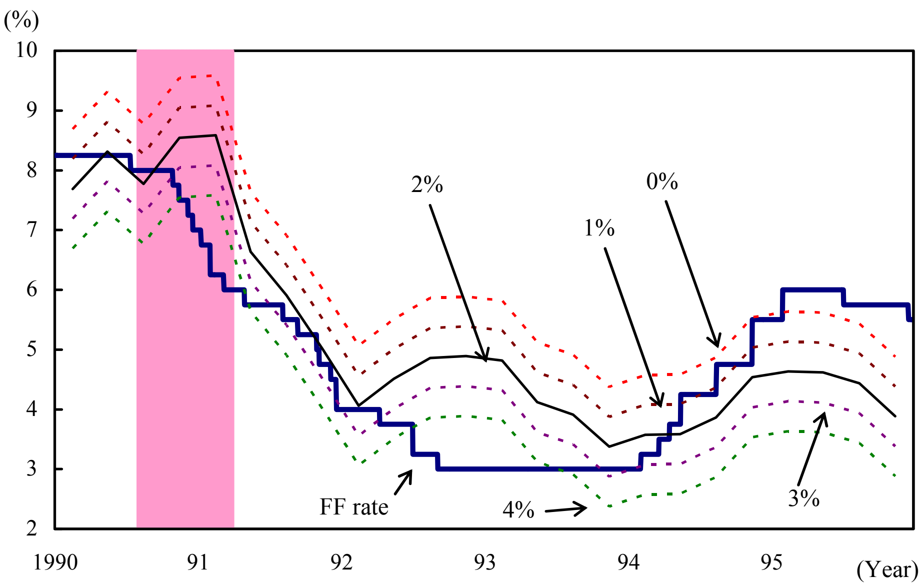
(Notes) 1. Source: U.S. Department of Labor.
2. Shaded areas are periods between peaks and troughs of economic cycles.

(Notes) 1. Source: U.S. Department of Commerce.
2. Shaded areas are periods between peaks and troughs of economic cycles.

(3) Should-be Monetary Policy

- It is desirable for the monetary policy in normal time to adopt a forward-looking stance (management based on future prospects). However, in an economic recovery phase after a financial crisis in which the credit creation remains weak, early monetary tightening is likely to dampen the upward momentum of the real economy. Therefore, a strong recovery of the economy follows after a cautious stance under which monetary tightening measures should be implemented, confirmed by the recovery of the real economy.
- A comparison of the target for FF rate levels in the early 1990s with the theoretical levels based on Taylor rule indicates that its target remained at low level even in 1992-1993, when the economy started to recover. After shifting to a tightening policy, on the other hand, the FF rate was raised rapidly to cope with rising asset prices and concern about inflation derived from the expansive monetary policy.
- Although international capital flows such as those into emerging countries through dollar carry trades and primary commodity markets are an essential factor in determining the timing of any shift to a tightening monetary policy from this point onward, it is highly likely that the shift to such a policy within 2010 will be too early. It is now vital to prop up the economic recovery by maintaining easing monetary policies for a while.

Figure 1-3-74 FF Rate in the 1990s based on Taylor Rule (Theoretical FF rate): The target for the federal funds rate remained at low level up to the first half of 1994 even after the economy started to recover



(Notes) 1. Source: U.S. Department of Commerce and Federal Reserve Bank of St. Louis.
2. Shaded areas are periods between peaks and troughs of economic cycles.
3. A theoretical FF rate is calculated as follows:

FF rate = equilibrium real interest rate + inflation rate
+ α x (inflation rate – inflation rate target)
+ β x GDP gap.

With regard to α and β,α=β= 0.5, which Taylor argues the rule provides a good discription of U.S. monetary policy since 1985, is used.

4. The equilibrium real interest rate is 2.5%, while the inflation rate is the overall PCE. Five cases with a target inflation rate of 0%, 1%, 2%, 3% and 4% each are presented.