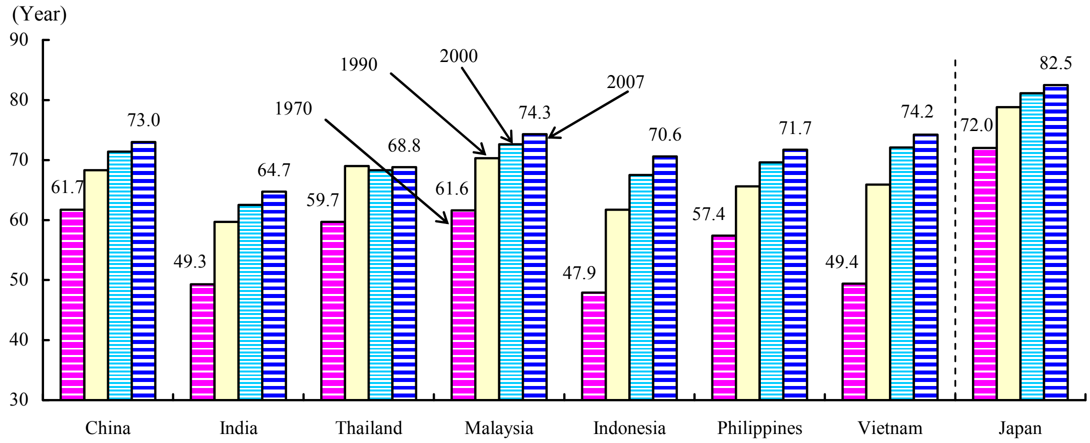
Section 4　Conditions for Asia's Long-Term Self-Sustaining Growth

1.　　Improvement of Social Security Systems

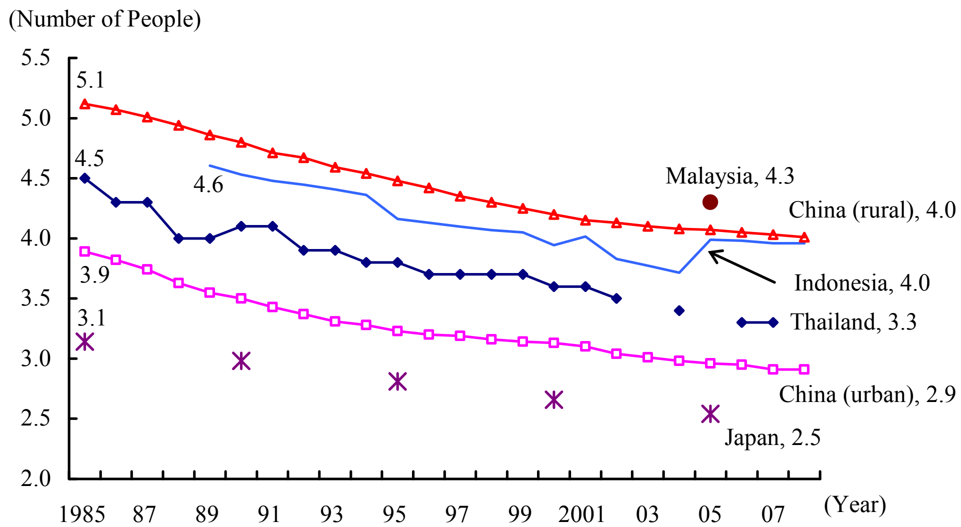
- The average life expectancy is increasing significantly and Asian countries are becoming longevity society.
- Urbanization is also advancing along with industrialization. At the same time, families are becoming more nuclear, with the average number of people per household decreasing. Under these circumstances, the function of support for the elderly, which has been carried out by families or communities seems to be deteriorating.
- It is imperative for Asian countries to improve social security systems, including pension schemes and health insurance, in order to prepare for the aged society that will come in the near future. These actions are necessary to ensure that there is a safety net and to cope with the changing social structure.

Figure 2-4-1　Life Expectancy at Birth: an Increase in Longevity



(Note) Source: World Bank "World Development Indicators 2009."

Figure 2-4-3　Average Number of People per Household: Decreasing Trend in Every Country



(Note) Source: National statistics.

(1) Overview of a pension system in Asian countries

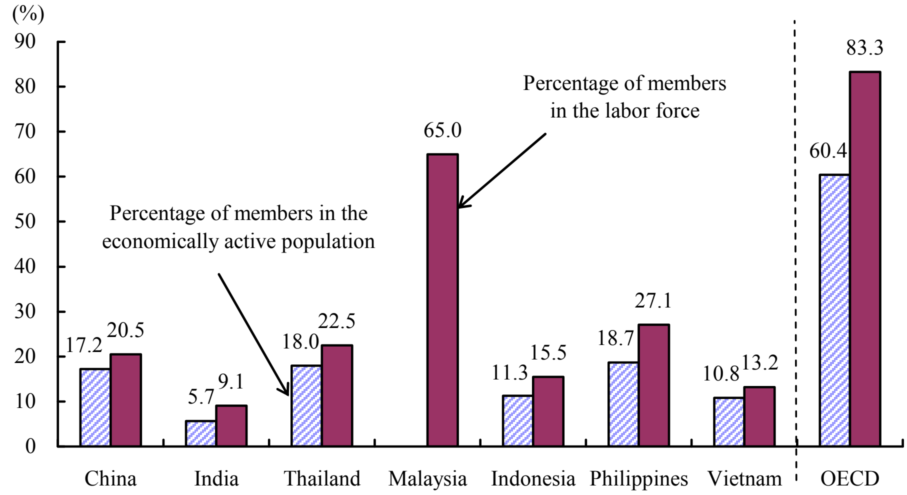
- Although Asian country has some sort of public pension system, limited coverage is a big problem for the present systems.
- Some countries have institutional problems, for example, lack of lifelong income security or automatic adjustment of the value of the pension.
- Since governments are expected to bear a heavier financial burden in the future due to an increase in the elderly population, it is necessary to review some points of the current system such as comparatively high income replacement rates and the early age to receive a pension are appropriate for the improvement of the system.

Table 2-4-4 Outline of the Pension Systems of Asian Countries

	System		Coverage	Notes
China	Urban Basic Pension Insurance	(Defined benefit (DB))	Employees of companies and self-employed workers in urban areas (compulsory)	
	Rural Basic Pension Insurance	(Defined contribution (DC))	Residents of rural areas (voluntary)	
India	○Employees' Provident Fund Scheme (EPF) ○Employees' Pension Scheme (EPS)	(DB & DC)	Employees of a company that employs 20 workers or more, and those whose monthly wage is 6,500 rupees or less (compulsory)	National pension system for the elderly (a system that provides a monthly pension for the elderly aged 65 or over who do not have a minimum regular income)
Thailand	Social Security Fund (old age benefits)	(Defined benefit (DB))	○Employees aged 15 or over and those under 60 who work for a private company ○Farmers and self-employed workers are not obliged to join it	A system that provides welfare benefits of 300 baht per month to low-income elderly people
	Government Pension fund	(DB & DC)	Civil servant	
Malaysia	Employees Provident Fund (EPF)	(Defined contribution (DC))	○Employees of a private company ○Self-employed workers are not obliged to join it	
	Civil Service Pension System	(Defined benefit (DB))	Civil servant	
Indonesia	Employees Social Security System (JAMSOSTEK)	(Defined contribution (DC))	○Establishments that employ 10 workers or more, or those that have an income of one million rupiahs or more per month ○Employers other than those above are not obliged to join it	
	Civil Service Pension System	(Defined benefit (DB))	Civil servant	
Philippines	Social Security System (SSS)	(Defined benefit (DB))	Workers in private companies up to the age of 60, self-employed workers (monthly salary is 1,000 pesos or more), etc.	
	Government Service Insurance System (GSIS)	(Defined benefit (DB))	Civil servant	
Vietnam	Social Security Benefits (old age benefits)	(Defined benefit (DB))	Civil servants, employees of private companies	

(Note) Source: OECD "Pension at a glance Asia/Pacific," the Ministry of Health, Labour and Welfare "Report on Conditions Overseas," the National Institute of Population and Social Security Research "The Review of Comparative Social Security Research No. 150," materials of JETRO, etc.

Figure 2-4-5 Coverage of the Public Pension System: Low in Many Countries



(Note) Source: OECD "Pensions at a glance Asia/Pacific," World Bank "World Development Indicators 2009.'

(2) Overview of a healthcare system in Asian countries

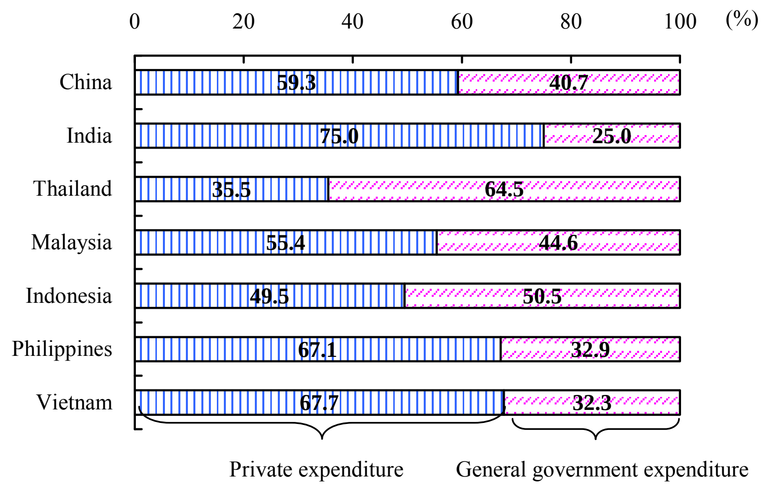
- Many Asian countries have developed a public healthcare system to some extent, except for India and other countries where such systems are hardly developed.
- However, the proportion of private expenditures in total health expenditure is high in many countries, which indicates that people pay substantial healthcare costs privately.
- It will be necessary to increase the coverage of the public healthcare system and to reduce the burden on the people, however, the burden of healthcare expenses on governments is already heavy in China and Thailand. Therefore, it is necessary to improve the current system paying attention to fiscal sustainability.

Table 2-4-11 Outline of the Public Healthcare Systems of Asian Countries

	System	Coverage	Notes
China	Urban Employees Basic Medical Care Insurance	○Employees of companies in urban areas (compulsory) ○If they are self-employed workers or employees of town and village enterprises, whether they can join the insurance system is up to the local government.	
	Urban Resident Basic Medical Care Insurance	Non-employees (dependents, etc.) in urban areas	
	New Rural Cooperative Medical System	Rural residents (voluntary)	
India	Central Government Health Scheme (CGHS)	Employees of the central government, governmental organizations, etc., and their dependents	In 2007, a scheme was started that provides health insurance services to workers below the poverty line.
	Employees' State Insurance Scheme (ESIS)	Employees and their dependents of the following: (1) non-seasonal factories using power and employing not less than 10 persons, or factories not using power and employing not less than 20 persons, (2) shops, hotels, restaurants, etc. employing 20 or more persons	
Thailand	Civil Servant Medical Benefit Scheme (CSMBS)	Civil servants	
	Social Insurance System (medical benefits)	Employees of private companies who are 15 years old or over and under 60 (benefits are provided only to the employees themselves)	
	National Health Security System: People can receive healthcare services for free in a hospital they are registered with in advance.	Self-employed workers, farmers, etc. (people not covered by the two systems above)	
Malaysia	People can receive healthcare services at a low cost in public medical institutions. Low-income earners and government employees can receive services for free.	Whole nation	
Indonesia	Health insurance for working and retired civil servants	○Civil service employees ○Employees of a company that employs 100 workers or more can join the system.	
	Employees Social Security System (JAMSOSTEK)	○The system covers establishments that employ 10 workers or more, or those that have an income of one million rupiahs or more per month (voluntary). ○Employers of establishments other than those above are not obliged to join the system.	
	Health Maintenance Security System (JPKM): Health maintenance security business provided by government-licensed bodies	Voluntary	
	Healthcare expenditure exemption system for the poor and the residents living in poverty		
Philippines	Healthcare Insurance System (Philippine Health Insurance Corporation)	The whole nation is required to join it.	Central and local governments pay insurance premiums for the poor.
Vietnam	Social Security Compensation (sickness benefits)	○Civil servants, waged workers, pensioners, the poor, etc., are obliged to join the system. ○Farmers, dependents, etc., are not obliged to.	

(Note) Source: Ministry of Health, Labour and Welfare, "Report on Conditions Overseas," National Institute of Population and Social Security Research, "The Review of Comparative Social Security Research No. 150," and materials of WHO, JETRO, etc.

Figure 2-4-12 Proportion of Public and Private Expenditures in Total Health Expenditures (2006): the Proportion of Private Expenditures is High in Many Countries

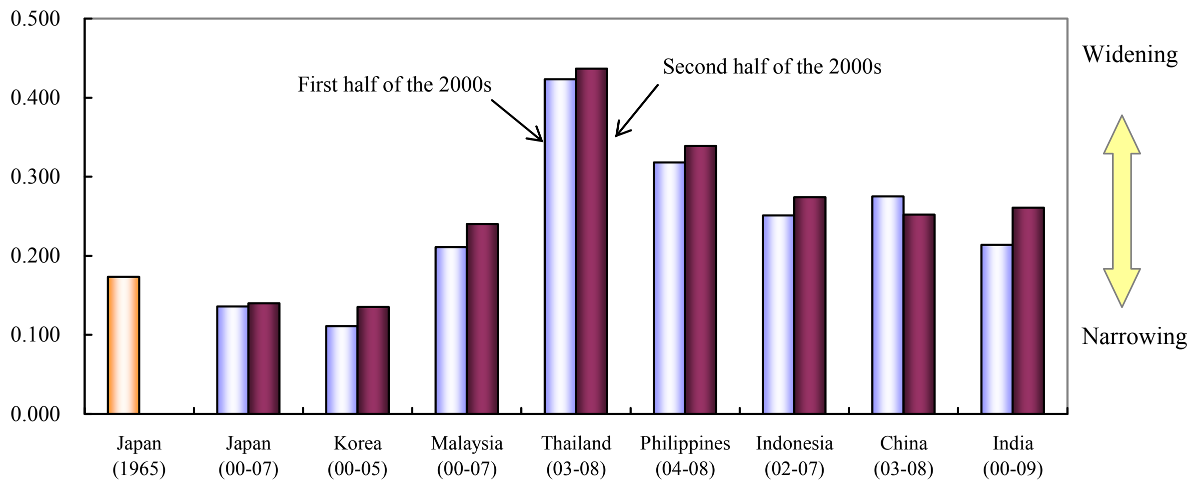


(Note) Source: WHO "World Health Statistics 2009."

2. Necessity of Reducing Income Inequality

- In recent years, Asian countries have achieved remarkable economic growth, but the growth-oriented development policies have caused some distortions, which has resulted in large income inequality. An absolute requirement for Asia's further development is the expansion of intraregional demand. It is expected that the reduction in income inequality will enhance the purchasing power of middle-income class and contribute significantly to the expansion of an Asian market.
- At present, the inequalities among regions within each country are generally expanding. Compared with Japan, Korea, etc., other countries have greater regional inequalities, which are generally greater than the inequality that Japan experienced in its period of high economic growth. In the early 2000s, China started to develop inland areas that lagged behind, which has yielded some results.
- As for incomes, the gap between the highest and lowest level is very large. In China and India, comparing the average real income growth rate per capita by income group, the average income growth rate for the high-income group is greater than that of the low-income one, which means that the income gap is widening. In Malaysia and Thailand, on the other hand, the income growth rate of the low-income group exceeds that of the high-income group, which means that income is being redistributed better. In Japan and Taiwan, which have developed further, there is no significant difference in income growth rates by the income group.

Figure 2-4-20 Regional Inequality in Asian Countries
Comparison of the Gini Coefficient for Per-Capita Gross Regional Domestic Product (GRDP)

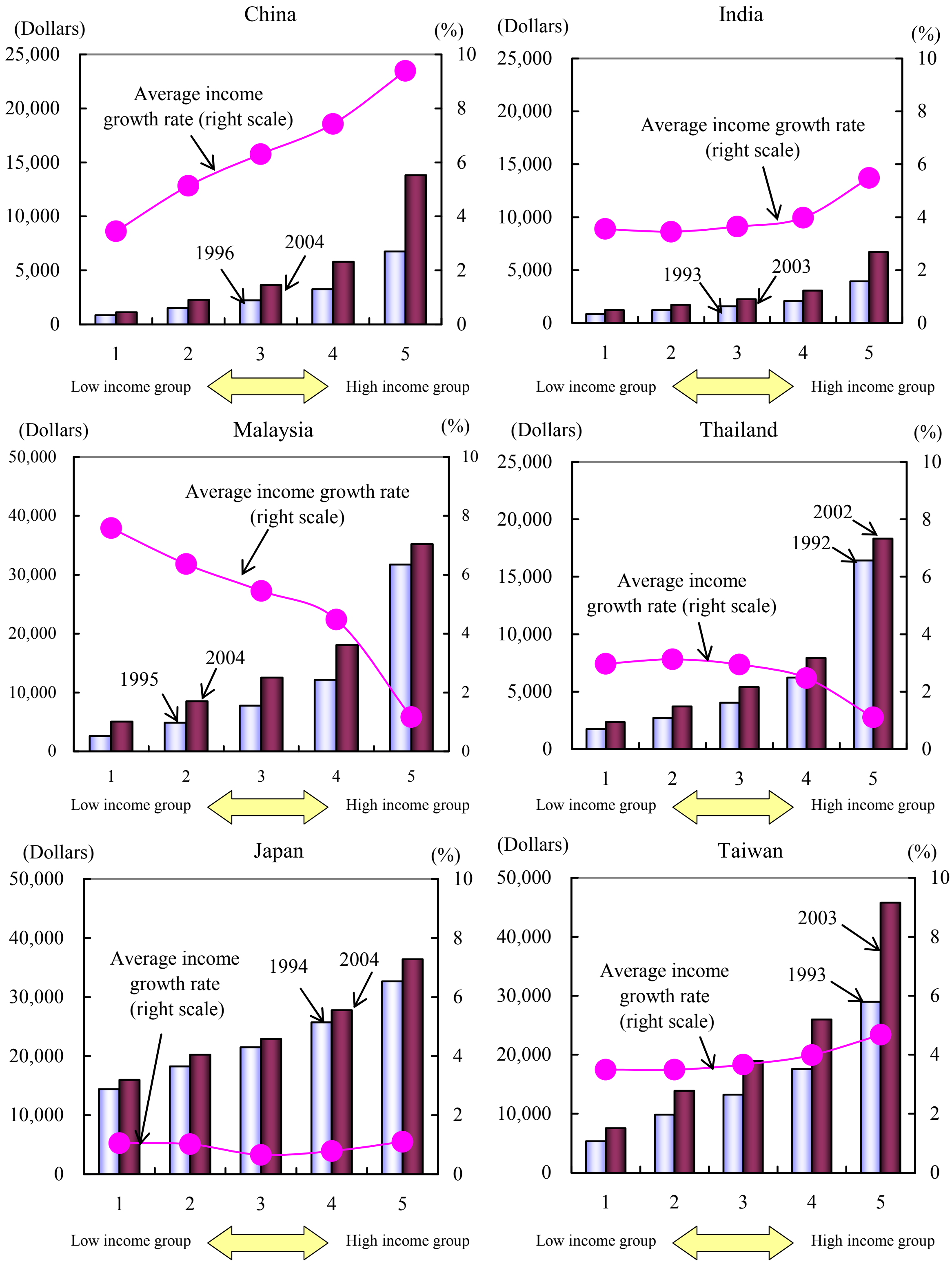


Maximum-to-minimum ratio

	Japan (00-07)	Korea (00-05)	Malaysia (00-07)	Thailand (03-08)	Philippines (04-08)	Indonesia (02-07)	China (03-08)	India (00-09)
First half of the 2000s	2.04	3.34	4.88	7.49	11.37	13.81	12.97	7.69
Second half of the 2000s	2.72	3.41	7.23	8.33	13.24	18.59	8.25	9.94

(Notes) 1. Source: Cabinet Office "Prefectural economic accounts," National statistical data.
2. The number of regions selected is the 47 prefectures for Japan, 16 provinces and cities for Korea, 14 states for Malaysia 7 regions for Thailand, 17 regions for the Philippines, 30 states for Indonesia, 31 provinces, government-ruled cities and autonomous regions for China, and 27 states for India.
3. Data of the "First half of the 2000s" and "Second half of the 2000s" refers to that for the years shown in parentheses abo
4. The Gini coefficient is calculated by weighting the population of each region.
5. The max-to-min ratio is the ratio of the per-capita GRDP of the region with the highest per-capita GRDP to the per-capi GRDP of the region with the lowest. Japan's max-to-min ratio in 1965 was 3.76.

Figure 2-4-18　Trends in Per-Capita Real Income by Income Group



(Notes) 1. Source: IMF (2007), World Bank "World Development Indicators 2009, Penn World Table 6.3," United Nations University "World Income Inequality Database V2.0C May 2008."

2. The figures on a horizontal axis refer to the income groups (quintiles). The population is arranged in order of the value of the income and is divided into quintiles from the lowest fifth to the highest fifth. The first one is the lowest-income group and the fifth one is the highest-income group.

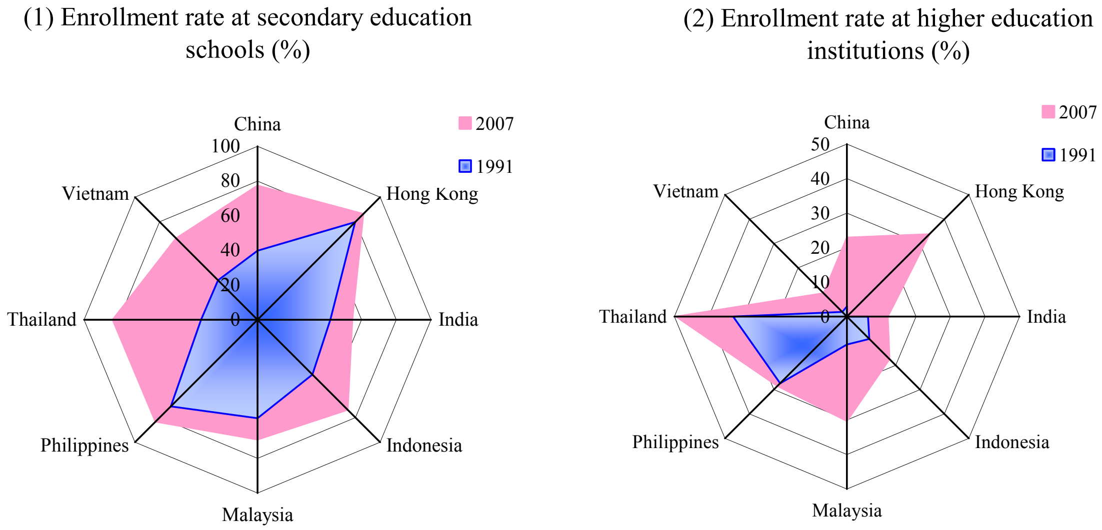
3. The bar refers to the real per-capita income of each income group, calculated by per-capita real GDP(Base year: 2005), according to IMF "World Economic Outlook 2007".

4. The average income growth rate refers to the average growth rate between the income of the 1990s and that of the 2000s in each income group.

3. Improvements in the Quality of the Labor Force

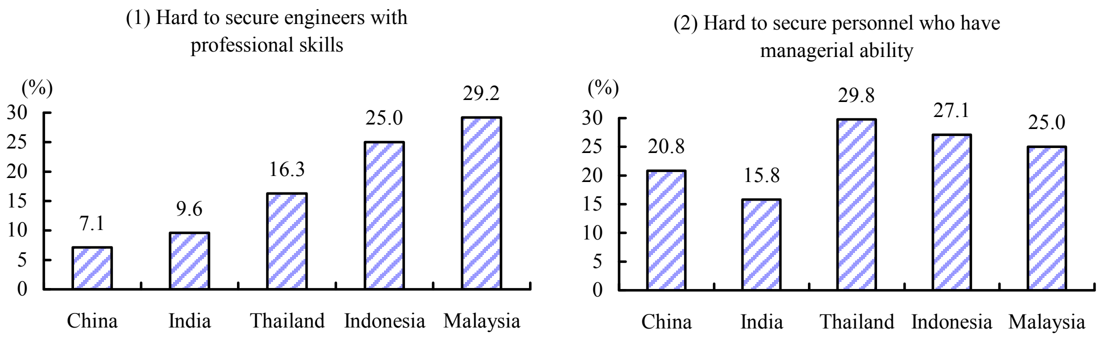
- Although the proportion of people who attend secondary education schools is increasing in Asian countries, the proportion of students who have received higher education is still low, except for Thailand. Accordingly, it is necessary to increase the proportion of the labor force that has received higher education.
- It has been pointed out that companies that advanced into Asia have difficulty in securing engineers with professional skills or personnel who have managerial ability in many countries.
- Although the quality of the labor force has recently been improving rapidly in Asian countries, development of human resources is insufficient to cope with the demands of sophisticated industries or meet the requirements of companies. For future development, it is necessary to further improve the quality of education and to develop a labor force that can satisfy the needs of more and more sophisticated industries.

Figure 2-4-23 Level of Educational Achievement: Enrollment Rate at Secondary Education Schools is Increasing



(Notes) 1. Source: World Bank.
2. The secondary education schools correspond to junior high schools and high schools in Japan. Higher education refers to education at universities, colleges, and other professional or vocational schools.
3. As for the data of 2007, India's data is that of 2006, Malaysia's that of 2005 and Vietnam's that of 2001 due to certain limitations on data collection.

Figure 2-4-25 Asia's Labor Force Demand: a Lack of Workers with Professional Skills

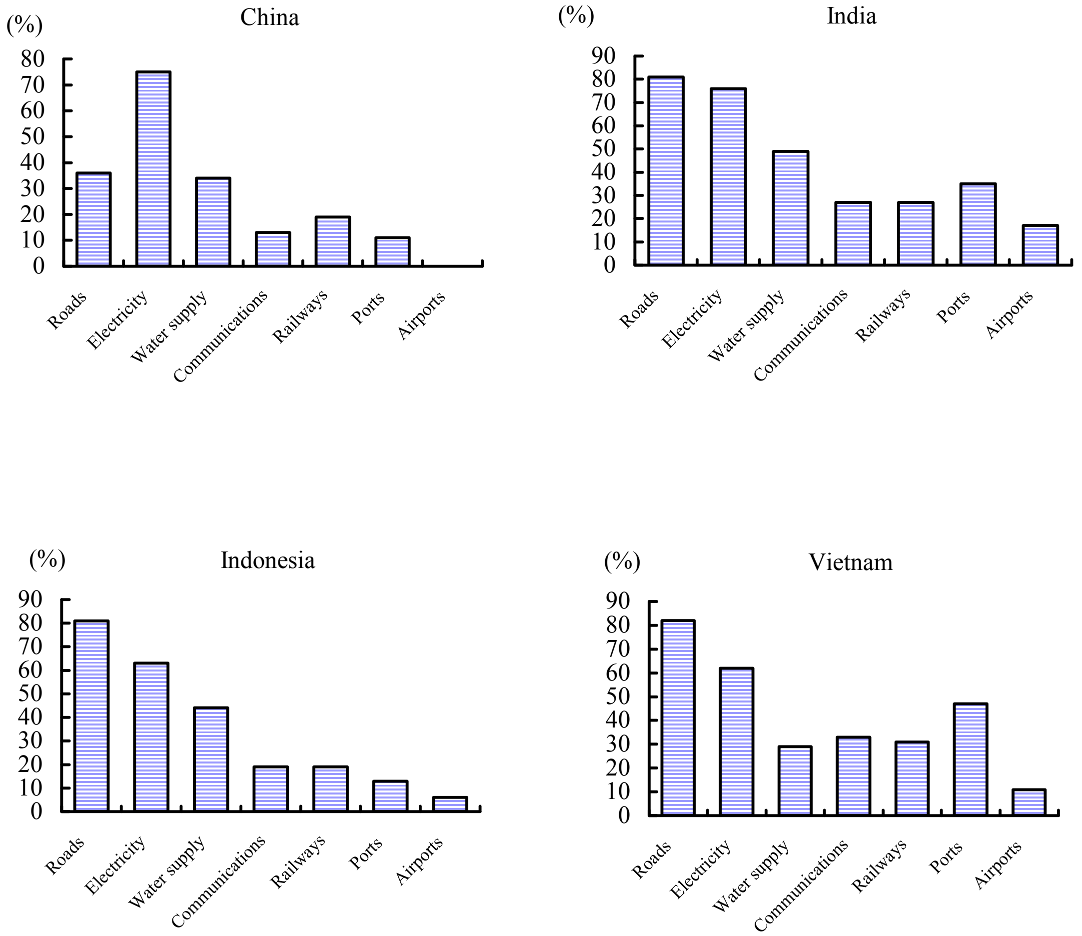


(Notes) 1. Source: Japan Bank for International Cooperation, "Survey report on overseas business operations by Japanese manufacturing companies."
2. Questionnaire to manufacturing companies that have three or more overseas affiliated firms.

4. Capital: Development of the Infrastructure

- The inadequate infrastructure is pointed out as an obstacle to investment in Asia. As for India and Indonesia, in particular, more and more companies point out the inadequacy of the infrastructure as a problem and the number of such companies has not decreased for the past decade.
- In China, the proportion of companies that point out this inadequacy as a problem has been decreasing. In Thailand, the proportion was small.
- As for India, etc., electricity supply and roads are pointed out as the type of infrastructure that requires development. Since transmission and distribution losses are around 25% in India, development of the electricity supply infrastructure is particularly urgent.

Figure 2-4-35 Infrastructure for which There is a Demand for Development (Percentage of Companies that Want the Development): the Development of Roads and the Electricity Supply Infrastructure are Necessary

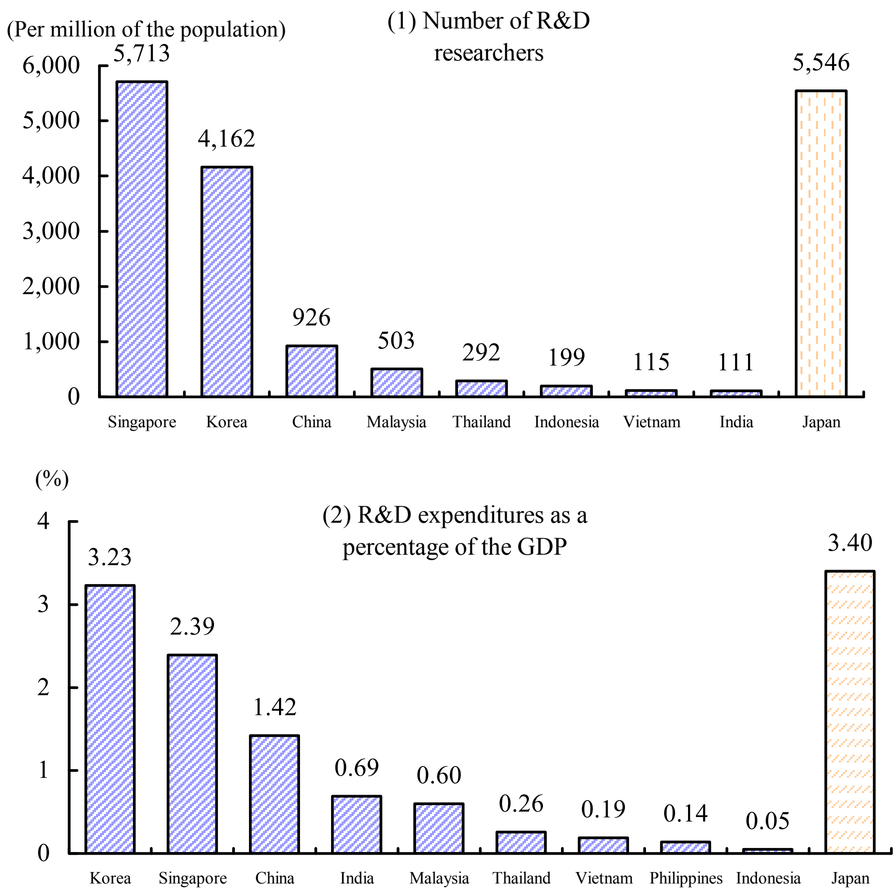


(Notes) 1. Source: Japan Bank for International Cooperation "Survey report on overseas business operations by Japanese manufacturing companies."
2. Questionnaire to manufacturing companies that have three or more overseas affiliated firms.

5. Improvement of Total Factor Productivity

- In order to increase the productivity of the whole economy, it is necessary to improve various factors that play an important role in promoting the efficiency of the whole economy through competition among companies, as well as to achieve technological progress.
- For example, it is important to conclude free trade agreements (FTAs), which promote free trade and bring about competition among companies, and to develop a business environment that helps to improve the efficiency of the whole economy.
- The number of R&D personnel and amount of R&D expenditures are still low in Asia. In the future, it is also important to make sufficient investments in R&D activities according to the stage of development.

Figure 2-4-46 R&D in Asia: Investment still at a low level

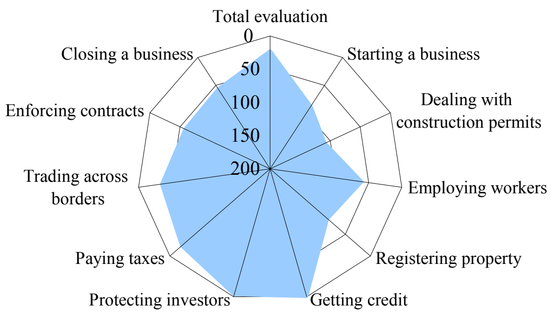


(Note) Source: World Bank "World Development Indicators."

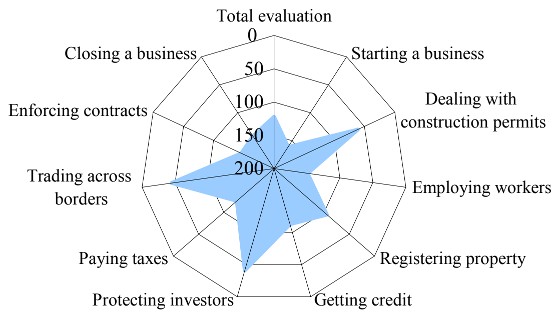
- Viewing the environment for business in Asia, Singapore, Thailand and Malaysia have succeeded in creating a relatively effective environment for business. However, the environment for business in India, Indonesia and the Philippines is not valued as much and needs improvement.

Figure 2-4-52　Business Environment in Asia

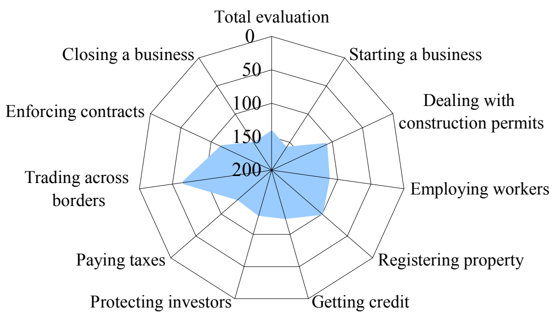
Malaysia



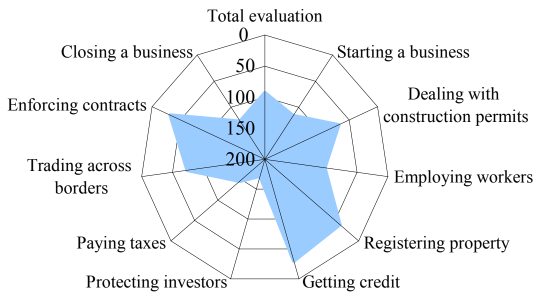
Indonesia



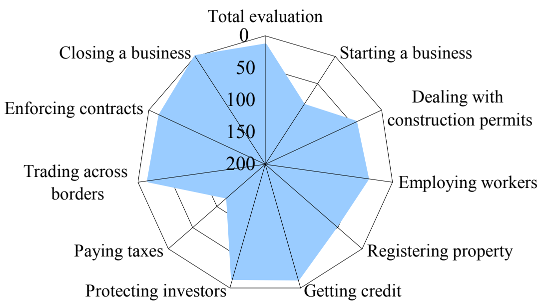
Philippines



Vietnam



Japan



(Notes) 1. Source: World Bank “Doing Business 2010.”
2. Evaluated by ranking among 183 nations.
3. “Doing Business”: Specialists prepare data as to ten items based on the laws and restrictions of each nation.
The “total evaluation” for the business environment is calculated by taking an average of the ten items below (The reference below shows the details).

(Reference) The ten items that constitute the “total evaluation” for the business environment and their sub-items in detail

1. Starting a business · · · the number of steps required for the procedures, the costs required and the number of days, etc.
2. Dealing with construction permits · · · the number of steps required for the procedures, the costs required and the number of days, etc.
3. Employing workers · · · the difficulty of hiring, the rigidity of hours, etc.
4. Registering property · · · the number of steps required for the procedures, the costs required and the number of days, etc.
5. Getting credit · · · the strength of legal rights, the depth of credit information, etc.
6. Protecting investors · · · extent of disclosure, etc.,
7. Paying taxes · · · the number of times of payment, the time required, the tax rates, etc.
8. Trading across borders · · · the number of documents related to exports and imports, the cost per container, etc.
9. Enforcing contracts · · · the number of steps required for the procedures, the number of days and costs required, etc.
10. Closing a business · · · the number of days and the costs required, etc.

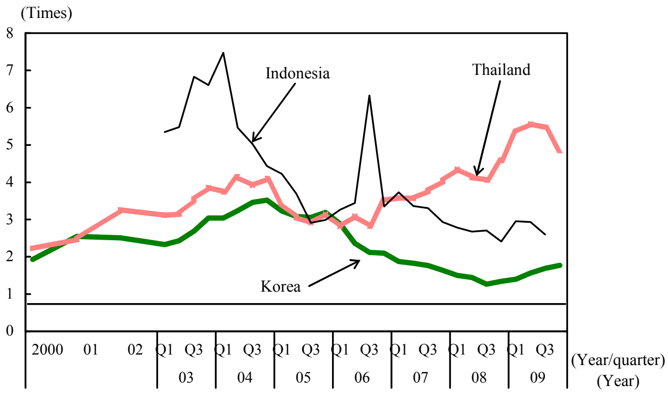
6. Maintenance of a Stable Macroeconomic Environment and Financial Environment

<u>Maintenance of a stable macroeconomic environment and financial environment</u> is an indispensable prerequisite for Asia's long-term self-sustaining growth.

(1) Changes in monetary policies after the Asian currency crisis and a review of the financial system

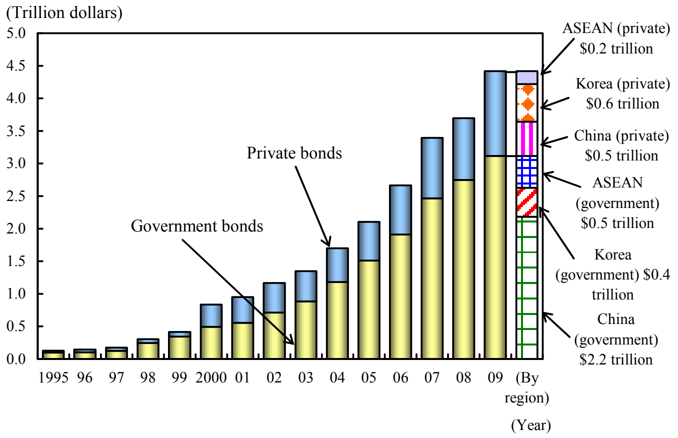
- Before the Asian currency crisis, the East Asian countries adopted the *de facto* dollar peg system with free capital mobility basically secured, and exchange rates became an anchor for monetary policies (a target used as a guideline in monetary policies). The *de facto* dollar peg system caused excessive capital inflows, which became one of the major causes of the currency crisis. Based on the lessons from this crisis, the exchange rate system was changed to a floating rate one and an inflation target was introduced as a monetary policy measure. These measures aim at ensuring the transparency of monetary policies and stabilizing expectations in the market.
- Before the Asian currency crisis, the East Asian countries had current account deficits at almost any time while there was an insufficient accumulation of foreign currency to cover short-term foreign debt. Therefore, rapid capital outflows make it difficult to maintain stable exchange markets, which can cause a currency crisis. In order to cope with such a critical situation, the East Asian countries started to reduce foreign short-term debt and accumulate foreign currency.

Figure 2-4-61 Changes in Foreign Currency Reserves/Foreign Short-Term Debt: Significant Recovery toward 2004



(Note) Source: Central banks.

Figure 2-4-66 Scale of the Asian-Currency Bond Market: an Increase in the Amount of the Issuance of Mainly Government Bonds



(Notes) 1. Source: Asian Development Bank.
2. Hong Kong is included in China. ASEAN means the total value of the debt issued by Indonesia, Malaysia, Thailand, the Philippines, Singapore and Vietnam.

- The Chiang Mai Initiative (CMI) was established to accommodate foreign currency within the Asian region in an emergency. In order to enable cooperation to be swifter and smoother, the ASEAN +3 (Japan, China and Korea) countries agreed to unify a network of bilateral currency swap agreements (multilateralization).
- In order to strengthen the financial system, the supervisory system was centralized by newly establishing a financial supervisory institution or the supervisory function of the central banks was strengthened. Soundness regulations have been strengthened through the partial application of Basel II, and a deposit insurance system was introduced.

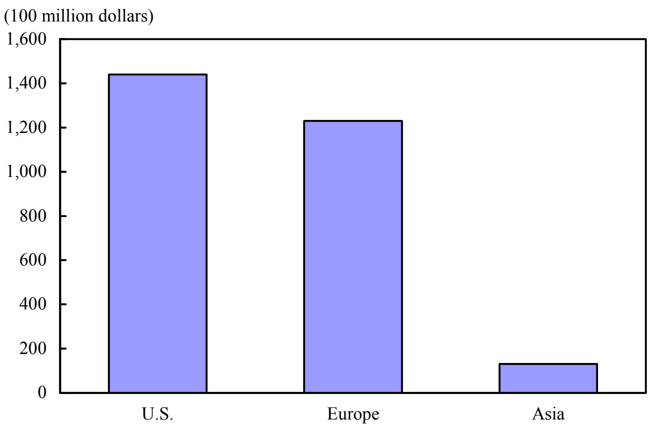
- Before the Asian currency crisis, East Asian countries had a maturity/currency mismatch whereby short-term borrowing in terms of dollars, etc., was used for long-term financing for investment and real property in terms of domestic currency. This mismatch made the currency crisis more serious. In order to resolve the mismatch and to use Asian savings directly for intraregional investment, the issuance of Asian-currency bonds was promoted and the measures shown below were taken.

(i) the Asian Bond Markets Initiative (ABMI)
(ii) the Asia Bond Fund (ABF)
(iii) the Association of Credit Rating Agencies in Asia (ACRAA)

(2) Influence of the global financial crisis

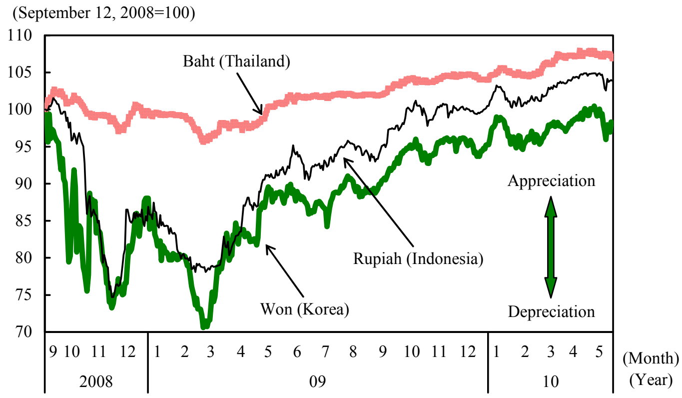
- Asia held a small amount of the securitized products that triggered the global financial crisis, and thus its losses were less (13 billion dollars) than those of the U.S. and Europe. The influence of the global financial crisis on Asia was limited in terms of finance.
- In Korea, concern arose that foreign currency could not be sufficiently secured for the stabilization of the exchange rate while short-term funds were flowing out. Temporarily, the value of the won dropped substantially against the dollar. As for Asia as a whole, however, there was no major confusion such as that in the previous Asian currency crisis thanks to the experience of the previous crisis and the measures taken after the crisis.

Figure 2-4-67 Estimated Losses related to Securitized Products: Small Losses in Asia



(Note) Source: IMF "Global Financial Stability Report, April 2008."

Figure 2-4-69 Nominal Exchange Rate to the Dollar after the Collapse of Lehman Brothers: Sharp Depreciation of the Won



(Note) Source: Bloomberg.

(3) Challenges for the future

- It is likely that the carry trade will be activated further, in which financing is raised in dollars, yen, euro and other low-interest rate currencies and then investment is made in Asian countries. In order to cope with the inflow of short-term funds, first of all, it is necessary to (i) take appropriate measures to restrict any sharp increase in asset prices caused by fund inflows and (ii) adjust exchange rates flexibly. If short-term funds still inflow despite these measures, the introduction of temporary capital controls should be examined for the maintenance of a stable macroeconomic environment.
- Capital transactions have been liberalized and exports as a proportion of the nominal GDP are high in many Asian countries, which are thus vulnerable to external shocks. When a global crisis occurs with deterioration in the fiscal conditions, there is a risk that the recession will become worse and speculation tends to be stimulated due to limited room for public spending. Accordingly, it is desirable to maintain fiscal soundness in normal times.
- In order to recognize the symptoms of the crisis and enhance crisis awareness on the government, it is effective to introduce an early-warning system.
- Under the CMI, the currency authorities of the ASEAN +3 (Japan, China and Korea) countries conduct mutual surveillance of macroeconomic conditions and economic policies. The strengthening of surveillance is important for the purpose of preventing economic confusion such as in the Asian currency crisis. At the same time, this strengthening is important as a prerequisite for raising the upper limit of independent operations apart from the IMF operations (IMF-delinking).
- As for currency unification, its merits and demerits should be carefully examined. While currency unification has the advantage of reducing costs of exchange rate fluctuations, the unification region should be an optimum currency area since the countries joining it have to abandon their own monetary policies. When the Asian region is examined from this viewpoint, it cannot be concluded that the conditions for an optimum currency area are fulfilled for the whole of Asia. Furthermore, currency unification requires that growth rates of economies within the region should converge. It should be noted that the Asian countries are now at various stages of economic growth.

Chapter 3 World Economic Outlook and Risks

This chapter predicts the future of the U.S., European and Asian economies as well as the world economy as a whole by presenting some possible scenarios and examines risk factors associated with these scenarios.

It has to be borne in mind that the outlooks provided in here are subjected to require frequent revisions in line with the ever-changing economic conditions.

Section 1 Outlook and Risks for the U.S. Economy

Although the U.S. economy entered a recessionary phase in December 2007, it ceased to fall in mid-2009 thanks to economic stimulus measures and relevant monetary policies implemented by the government and the FRB and has been on a moderate recovery path since then. The following is an examination of the future scenario for the U.S. economy and risk factors associated with it.

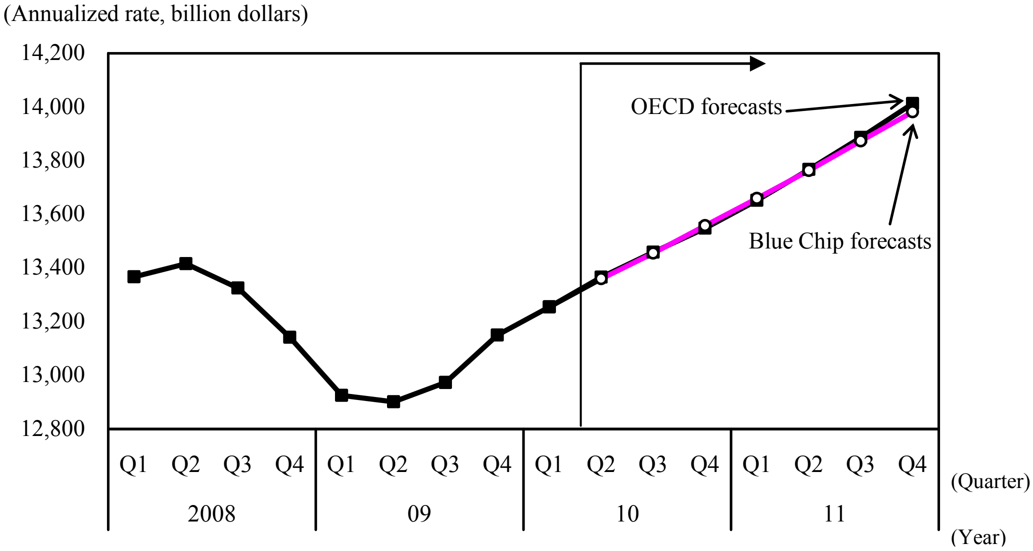
1. Economic Outlook (Main Scenario) ― Moderate Recovery Expected to Continue

Still under downward pressure such as the unemployment rate remaining high, the economy has been on a moderate recovery trend, supported by policy measures. In particular, personal consumption expenditure (PCE), which accounts for approximately 70% of GDP, has continued to grow for the three consecutive quarters starting from the third quarter of 2009, with the growth tempo accelerating in the first quarter of 2010 supported by increasing employment and reduced savings rates. Furthermore, private domestic investment, whose recovery has lagged, has also been on an upward trend helped by production expansion due to inventory adjustments having run their course and both domestic and overseas demand picking up moderately. As seen in these developments, the overall economy is gradually heading for a self-sustained recovery.

It is predicted that positive economic growth will be maintained, aided by domestic and overseas demand recovering in tandem with the global economic recovery as well as support from policy measures which is likely to continue within 2010. However, a delay in the improvement of the household income environment attributable to the unemployment rate staying at high levels and the continued credit crunch is forecast to prevent PCE and housing investment from increasing strongly, and thus the economic recovery tempo is expected to be moderate. Consequently, it is highly likely that the overall real GDP growth rate in 2010 will be anywhere between 2.5% and 3.0%. Meanwhile, although the unemployment rate is expected to be on a gradual decline from the current level, it is forecast to hover in the range of between 9.5% and around 10% in 2010, and roughly between 8.5% and 9.5% in 2011.

Figure 3-1-1 Outlook for the U.S. Economy

Real GDP Level



Real GDP Growth Rate

(%)

	2010			2011			
	Q2 (April-June)	Q3 (July-September)	Q4 (October-December)	Q1 (January-March)	Q2 (April-June)	Q3 (July-September)	Q4 (October-December)
OECD (May 26, 2010)	3.4	2.8	2.7	3.1	3.4	3.5	3.7
Blue Chip (average of private-sector forecasts)	3.2	2.9	3.1	3.0	3.1	3.2	3.2

Economic Outlook by International Institutions and Others

(%)

		2010	2011
Office of Management and Budget (OMB) (February 1)		2.7	3.8
Congressional Budget Office (CBO) (January 26)		2.2	1.9
IMF (April 21)		3.1	2.6
OECD (May 26)		3.2	3.2
Blue Chip (average of private-sector forecasts) (May 10)	Top 10 companies	3.6	4.0
	Average	3.2	3.1
	Bottom 10 companies	3.0	2.1

(Note) Source: U.S. Department of Commerce, Office of Management and Budget (February 1, 2010), Congressional Budget Office (January 26, 2010), "World Economic Outlook", IMF (April 21, 2010), "Economic Outlook 87", OECD (May 26, 2010), and Blue Chip Economic Indicators (May 10, 2010).

The following is an overview of individual demand items.

(i) Personal consumption expenditure (PCE)

Although the unemployment rate is expected to remain high and the credit crunch and adjustment of the household balance sheet are likely to continue, PCE is forecast to get on a track to a moderate recovery within 2010 since the extended implementation of some policy measures such as income tax cuts and unemployment benefits is expected to make a certain contribution to support PCE. In 2011 and onward, despite the ongoing improvement in the employment environment, the pace of the recovery of PCE is likely to remain moderate with the supporting effects of policy measures diminishing.

(ii) Residential investment

Thanks to the extension of the home buyer tax credit, housing starts picked up in the first quarter of 2010. However, the completion of the tax credit measures at the end of April is forecast to significantly moderate housing demand through mid-2010 in response to the previously brisk demand created under the measures. Meanwhile, taking it into consideration that the house sales continue to occur under a favorable environment and the income environment has also been improving gradually, residential investment is expected to bounce back from the second half of 2010 onward. Nevertheless, with the number of foreclosed houses increasing and flowing on successively into the used house market, the pace of recovery of residential investment is forecast to be slower than in the past.

(iii) Private domestic investment

Due to the inventory adjustment by corporations almost running its course and a gradual recovery in both domestic and overseas demand, production is expected to expand in an array of industries. Accordingly, capital investment is likely to continue maintaining positive growth. However, the pace of growth of overall investment is forecast to remain slow due to the continuing credit crunch, witnessed particularly in the difficulties in SMEs financing stemming from the worsening financial position of small and medium-sized financial institutions, together with an expected delay in the recovery of structure investment hit by the sluggish commercial real estate market.

(iv) Government spending

Economic stimulus packages are expected to decrease significantly in and after the fourth quarter of 2010. In addition, rapidly growing state and local budget deficits have caused annual expenditures to be slashed in a wide range of areas. Although the government is considering taking additional measures, they are likely to be smaller in scale than those introduced in February 2009. Thus, government spending is forecast to remain sluggish.

(v) Net export

Both exports and imports are likely to increase in tandem with a gradual recovery in the world and domestic economies. As the U.S. economic recovery accelerates, imports are expected to grow faster than exports, increasingly having a negative contribution to GDP growth. Nevertheless, once concrete measures are formulated under the National Export Initiative and the government starts giving its full support, exports may expand, thus the trade deficit narrows.

2. Risk Factors Associated with the Economic Outlook

Although downside risks associated with the economic outlook have decreased, the risk is still skewed to the downside.

- **Downside risks**

(i) Unemployment rate to remain high

While the employment environment has picked up mainly in the private sector since 2010, increasingly heading for a self-sustained recovery, the unemployment rate has remained high, hovering at around 10%. If it continues, there is concern that any delay in the improvement of the income environment will adversely affect the household sector, including consumption and housing.

(ii) Continuing credit crunch

Owing partly to financial system stabilization measures implemented by the government and the FRB, the financial market has shown signs of improvement. However, the commercial banking sector (lending sector) is struggling with severe operating conditions with the rate of troubled assets continuing to rise. If financial institutions keep lending standards tight under these circumstances and thus the credit crunch persists over the long term, it is likely that SMEs which depend on indirect finance in raising funds will be devastated and that consumption and house acquisitions by households will be restrained.

(iii) Dampened local economies due to growing state fiscal deficits

After the outbreak of the global financial and economic crisis, state budget conditions have deteriorated sharply, with the overall state budget deficit projected to hit a record high in fiscal 2010. In order to cover shortfalls in revenues, an increasing number of states have raised taxes and slashed expenditures. If these measures continue to be employed, this is likely to hit local economies. Furthermore, since state budgets tend to move in line with the economy while lagging slightly behind it, it is forecast to take a while before state budgets recover. In this case, the downturn in local economies may be prolonged.

(iv) Stagnant commercial real estate market and the worsening operating conditions of small and medium-sized financial institutions

The commercial real estate market has remained unstable, although commercial real estate prices have shown signs of ceasing to fall. Commercial real estate loans have been provided chiefly by small and medium-sized financial institutions. With the ratio of delinquency and nonperforming loans rising, they are expected to continue to be faced with severe operating conditions. If assets held by small and medium-sized financial institutions further deteriorate due to increasing nonperforming loans to cause a number of such institutions to go bankrupt, a recurrence of financial market turmoil is possible. In addition, current commercial real estate loans are scheduled to expire in and after 2010, in line with which loan refinancing is expected to be carried out in full swing. There is concern that some failed refinancing will further weaken the market.

(v) Economic slowdown due to the diminishing effects of the stimulus packages

A considerable downsizing of economic stimulus measures from the fourth quarter of 2010 and onward could have a negative impact on the economy with the effects of such measures likely to diminish. Despite the possible extension of some programs such as income tax cuts and unemployment benefits, the economic recovery may stall unless private demand gets onto a self-sustained recovery path prior to the expiration of such measures.

(vi) Export decline caused by the weakening European economy

In the event that the problems triggered by the Greek fiscal crisis have a contagion effect on other south European countries faced with troubled economic and fiscal conditions, causing a rapid depreciation of the euro and deterioration of the real economy in Europe, this may reduce U.S. exports and expand the trade deficit of the US.

(vii) Rise in long-term interest rates

There is concern that if long-term interest rates increase due to heightening worries concerning the sustainability of the public finance, a rise in domestic interest rates may depress consumer spending and investment. Moreover, if the increasing interest payment burden deepens the fiscal difficulty, this could prevent the government from implementing flexible fiscal management that could be revised in line with future economic trends.

- **Upside risks**

Factors that may help the economy to recover faster than predicted in the main scenario are considered to be as follows:

(i) Improved employment situation
If the recovery in the world and US economies boosts demand more than expected, the employment situation may considerably improve, benefiting from the expansion of production. If this occurs, the ensuing improvement of the income environment could increase consumption, thus accelerating economic growth.

(ii) Easing the credit crunch

If the balance sheet of financial institutions improve and credit risks for households and enterprises reduce in line with the economic recovery, financial institutions may ease lending standards, which is likely in turn to facilitate consumption as well as investment.

(iii) Rise in asset prices

If the accelerated stabilization of financial systems and economic recovery boost stock and housing prices, the balance sheet adjustment burden on households and financial institutions may be alleviated. Accordingly, credit flows to households may recover, helping consumer spending to expand through the wealth effect.

(iv) Export expansion bolstered by a faster-than-expected recovery of the world economy

If countries see their domestic demand grow more rapidly than expected in tandem with a recovery in the world economy, the pace of the U.S. economic recovery may accelerate spurred by expanding exports. If concrete measures are formulated in accordance with the National Export Initiative and full government support starts to be given, exports may expand significantly to drive economic growth.

Section 2 Outlook and Risks for the European Economy

Although the European region continues to be facing serious conditions such as unemployment rates remaining at high levels, the economy has ceased to fall. The following is an examination of the main future scenarios of the European economy and the risk factors associated with it.

1. Economic Outlook (Main Scenario) — Considerably Slow Pace of Pickup

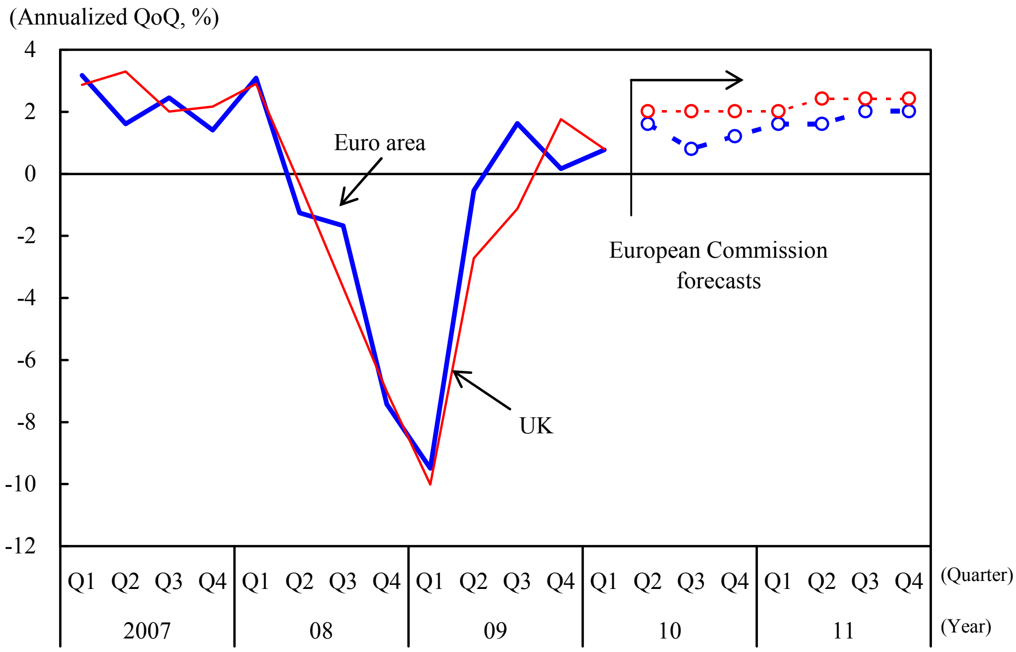
While continuing to struggle under severe circumstances, including unemployment rates that remain at high levels, the European economy has ceased to fall. However, although many countries and regions such as the euro area, Germany, and France have secured positive growth in the first quarter of 2010, the growth rates were mostly as low as below 1% on an annualized quarter-to-quarter basis, indicating that the pace of the growth has been slower than that in either the U.S. or Japan.

It is predicted that the economy will pursue a moderate recovery trend, with the real economic growth rate of the euro area for the full 2010 projected at around 1%. However, it should be noted that the Greek fiscal crisis might heighten concerns over the fiscal conditions of other European countries and the European financial system, which could make the volatile financial and capital market more unstable. Moreover, there exist some downside risks including credit crunch stemming from credit loss due to the loans to emerging countries, weakening demand for automobiles in reaction to previously strong sales under the automobile scrapping schemes, and the worsening employment picture. These risks are likely to force the economy to remain in the doldrums, giving downward pressure on the growth rate.

With regard to domestic demand, the recovery of consumption is expected to be weak due to automobile demand slackening as a result of the completion of the automobile scrapping schemes that had thus far boosted automobile sales, and with unemployment rates remaining at high levels.

With regard to overseas demand, on the other hand, it is expected to take a while before exports to Russia and Central and Eastern Europe, which were the driver behind the past economic recovery and whose shares in the exports from Europe have been on the rise since 2000, enter a full-fledged recovery stage, whereas exports to Asia and the U.S. are forecast to pick up. In addition, the recent depreciation of the euro against major currencies is likely to boost exports (Figure 3-2-1 and Table 3-2-2).

Figure 3-2-1 Real Economic Growth Rates of the European Region



(Note) Source: Eurostat and the European Commission.

Table 3-2-2 Economic Outlook by International Institutions and Others

(YoY, %)

		2010	2011
OECD (May 26, 2010)	Euro area	1.2	1.8
	Germany	1.9	2.1
	France	1.7	2.1
	UK	1.3	2.5
European Commission (May 2, 2010)	Euro area	0.9	1.5
	Germany	1.2	1.6
	France	1.3	1.5
	UK	1.2	2.1
IMF (April 21, 2010)	Euro area	1.0	1.5
	Germany	1.2	1.7
	France	1.5	1.0
	UK	1.3	2.5
ECB (March 4, 2010)	Euro area	0.4-1.2 (Medium 0.8)	0.5-2.5 (Medium 1.5)

(Note) Source: OECD “Economic Outlook 87,” European Commission “European Economic Forecast Spring 2010,” IMF “World Economic Outlook,” and ECB “Staff Macroeconomic Projections for the Euro Area”.

2. Risk Factors Associated with the Economic Outlook

The European economy, which ceased to fall in around the fall of 2009, has far been supported chiefly by policy measures and, accordingly, has not gained self-sustained recovery momentum yet. Moreover, with the high risk of a vicious circle of financial market turmoil such as the Greek fiscal crisis and real economy deterioration, the risk of the future economy is still skewed to the downside.

- Downside risks

If the following occurs, contrary to the above-presented main scenario, the economy is likely to remain sluggish.

(i) Contagion of the Greek fiscal crisis to other countries

The yields on Greek government bonds have increased and the yield spread between Greek and German government bonds has widened due to worries about the sustainability of public finances. Consequently, heightening concerns about the sustainability of the Greek public finance with the redemption of a huge amount of government bonds scheduled for the near future have thrown the already struggling market into further turmoil. If the Greek fiscal crisis causes "contagion", raising concerns about the fiscal sustainability of public finances in other European countries such as Portugal, Ireland, Spain and Italy, which are also burdened with heavy fiscal deficits, and the prices of government bonds issued by such countries plunge (yields on them rise), the ever-volatile financial markets may become even more volatile, hampering economic recovery.

(ii) Financial systems to become unstable due to the Greek fiscal crisis

If contagion from the Greek fiscal crisis spreads to other countries, the ever-volatile financial markets may become even more volatile due to heightening worries about the financial system as a whole in line with rising concerns over expanding losses of financial institutions holding government bonds issued by such countries (see Chapter 1, Section 4). In addition, Europe has lagged behind the U.S. in nonperforming loan write-offs[1]. Financial institutions in the euro area have maintained their tightened lending standard. Amid decreasing loans, it is feared that credit crunch may worsen further.

(iii) Adverse impact of the completion of automobile scrapping schemes to spread

In the European region, the effects of some policy measures including the automobile scrapping schemes contributed to shoring up the overall European economy. However, expected weak demand over the next few years in reaction to the brisk demand created under such support measures may depress consumer spending and cause automobile-related industries to slump for a while (see Chapter 1, Section 4).

(iv) Employment to become worse-than-expected

If unemployment rates that have hovered at high levels rise even higher, this may put downward pressure on consumer spending through deterioration in the income environment and dampened consumer sentiment.

- Upside risks

If the following occur, contrary to the above-presented main scenario, the economy may pick up at a faster pace than expected.

[1] According to the IMF (2010a), aggregate losses of European banks from 2007 through 2010 are estimated at about $665 billion in the euro area and about $455 billion in the UK, accounting for 48.8% of overall estimated losses worldwide.

Export expansion bolstered by a faster-than-expected recovery of the world economy

Exports to outside the euro area, mainly those to Asia including China, have currently been growing. Meanwhile, the depreciation of the euro has been ongoing in foreign exchange markets. If economies in the U.S. and Central and Eastern Europe, the main destinations of European exports, recover strongly, this is likely to boost exports and then trigger a wave of positive knock-on effects on output, employment and consumption. Consequently, the pace of recovery of the economy could be relatively faster than predicted.

Section 3 Outlook and Risks for the Asian Economy

As has already been seen in Chapter 1, Section 2, China sees its economy expanding and the economies of other Asian countries in general have also been on a recovery trend. The following is an examination of the main scenario for the Asian economy in the future and the risk factors associated with it.

1. Economic Outlook (Main Scenario) — Remaining on an Expansion or Recovery Trend

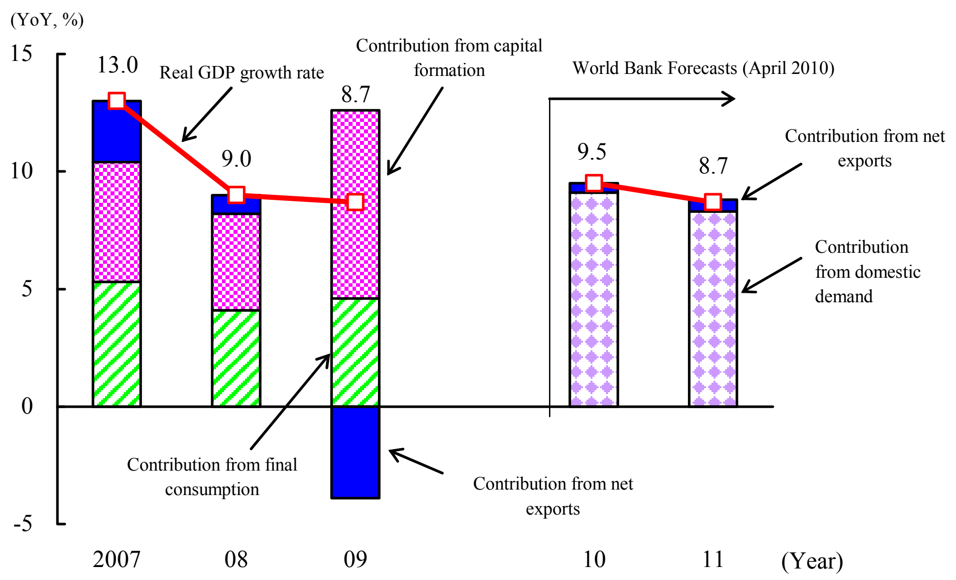
In China, the economy has been expanding chiefly in domestic demand, buoyed partly by a 4 trillion yuan package to mainly boost investment in infrastructure projects unveiled in November 2008 along with programs to encourage consumer spending of automobiles and home appliances. It is predicted that the economy will continue expanding, supported by domestic demand that is forecast to remain favorable, despite the fact that exports are unlikely to gain strong growth momentum due to the slow recovery in the U.S. and European economies. (Figure 3-3-1).

In India, the economy has been recovering chiefly in domestic demand. It is predicted that the recovery trend will be maintained helped by domestic demand, which is forecast to remain favorable.

A look at Korea, Taiwan and ASEAN shows that the economies in these regions have generally been on a recovery path, thanks partly to the effects of economic stimulus measures and an increase in exports to China. It is predicted that these economies will continue to recover aided by exports to China, which are forecast to grow steadily. However, depending considerably on the recovery of exports to Europe and the U.S., with domestic markets small in scale and exports accounting for a large proportion of the nominal GDP in these countries, their economies are unlikely to enter a full-fledged recovery phase before the economies of Europe and the U.S. enter a recovery phase.

Meanwhile, according to forecasts by international institutions, the Chinese and Indian economies are projected to grow about 9-11% and about 8%, respectively, in 2010, a growth that is faster than in 2009. Indonesia is likely to see its economy increase about 5-6%, a higher rate of increase than in 2009. Other countries and regions are forecast to record about 4-8% year-to-year growth each, a sharp recovery from the negative or almost zero growth posted in 2009 (Table 3-3-2). The Asian economy in general is expected to expand at accelerated rates of increase.

Figure 3-3-1 China: Real GDP Growth Rate and the Contribution by Demand



(Notes) 1. Source: National Bureau of Statistics of China and World Bank.
2. In line with the statistics standard revision, revised figures for the actual results of real economic growth rates up to 2008 have been released. However, because those of the contribution by demand item have not been revealed, the data prior to the revision is used.

Table 3-3-2 Forecasts for Real GDP Growth Rates of Asian Countries and Regions

(YoY, %)

	2009 actual results	IMF (April 2010)		ADB (April 2010)		World Bank (April 2010)		OECD (May 2010)	
		2010	2011	2010	2011	2010	2011	2010	2011
China	8.7	10.0	9.9	9.6	9.1	9.5	8.7	11.1	9.7
India	7.2	8.8	8.4	8.2	8.7	—	—	8.3	8.5
Korea	0.2	4.5	5.0	5.2	4.6	—	—	5.8	4.7
Taiwan	-1.9	6.5	4.8	4.9	4.0	—	—	—	—
Singapore	-1.3	8.9	6.8	6.3	5.0	—	—	—	—
Thailand	-2.3	5.5	5.5	4.0	4.5	6.2	4.0	—	—
Malaysia	-1.7	4.7	5.0	5.3	5.0	5.7	5.3	—	—
Indonesia	4.5	6.0	6.2	5.5	6.0	5.6	6.2	6.0	6.2

(Notes) 1. Source: "Regional Economic Outlook" (April 29, 2010), IMF; "Asian Development Outlook 2010" (April 13, 2010), ADB; "East Asia and Pacific Economic Update 2010, Volume I" (April 7, 2010), World Bank; and "Economic Outlook 87" (May 26, 2010), OECD.
2. Forecasts for India by OECD and ADB are on a fiscal year (April through March of the following year) basis. The 2009 figures for India are the advance estimate.

2. Risk Factors Associated with the Economic Outlook

There are both upside and downside risks for the future of the Asian economy as described below, with a balance maintained between them.

- **Downside risks**

(i) Exports to be depressed by a slow recovery in the economies of the developed countries

Although the European and U.S. economies have been recovering or picking up, the pace of growth has been slow. Moreover, on top of the downward pressure such as the harsh employment situation, there are still quite a few downside risks in these economies, including sovereign risks. Adversely affected by the slow recovery in the European and U.S. economies, a full-scale economic recovery could be delayed in countries and regions whose domestic market is small, such as Korea, Taiwan, and Singapore. There is concern that China's growth rate could also be reduced.

(ii) A sharp drop in asset prices and a rapid decrease in domestic demand due to accelerated monetary tightening in China

The money supply has been growing significantly in China under its easing monetary policy. Under these circumstances, rising inflation worries and property prices mainly in certain areas have prompted the authorities to move towards monetary tightening, including the lifting of the reserve requirement ratio and the introduction of stricter financial regulations mainly on real estate loans. If the inflation realizes, or the rise of property prices accelerates, the authorities will likely shift to a more decisive monetary tightening. If the policy turns out to be far more effective than expected in terms of monetary tightening, it could trigger a sharp drop in asset prices and a rapid decrease in domestic demand accompanied by a possible slowdown in the economy. In such a case, countries and regions whose current economic recovery is attributed partly to robust exports to China, such as Korea and Taiwan, may see their economies also slow down.

(iii) Accelerating inflation in India and intensifying monetary tightening to cope with it are to have a negative impact on domestic demand

With the increasing upward pressure on prices backed by a strong recovery in domestic demand and a rise in international commodity prices, it is feared in India that increases in a wide range of general prices, i.e. inflation, could be imminent. In line with the accelerating inflation from this point onward, monetary tightening is likely to intensify. If this turns out to be far more effective than expected, it could have an adverse impact on domestic demand.

(iv) Excess capital inflows

The easing monetary policies implemented in developed countries, in concert with a more favorable economic outlook for emerging countries including Asia than that for developed countries, have facilitated capital flows into Asia. Such large-scale capital inflows could bring about inflation or sharply boost asset prices in these countries, threatening the stability of the financial system.

- Upside risks

The factor likely to boost the pace of economic recovery faster than predicted in the main scenario is as follows:

Export expansion bolstered by the faster-than-expected recovery of the world economy

If the U.S. and European countries see their demand grow more briskly than expected in tandem with a recovery of the global economy, the pace of the Asian economic recovery may accelerate thanks to brisk exports.

Section 4 World Economic Outlook and Risks

We have seen the outlooks and risks for each of the U.S., European and Asian economies in the above sections. Taking them into consideration, this section explores the global economic outlook and the pertaining risks.

1. Economic Outlook (Main Scenario) — To Follow a Moderate Recovery Path

Despite remaining under severe circumstances such as high unemployment rates, the global economy has been recovering moderately owing partly to the effects of stimulus packages. It is predicted that while the U.S. and Asian economies will stay on a recovery trend, the European economy will tend to gradually start to pick up. The global economy as a whole is forecast to continue a slow recovery to result in a real economic growth rate of about 3% in the full 2010 year.

Meanwhile, both international and private institutions estimate that the global economy will grow about 3% in real terms in the full 2010 year.

2. Risk Factors Associated with the Economic Outlook

There are both upside and downside risks associated with the outlook as described below, and the risk is skewed to the downside.

- Downside risks

(i) Contagion from the Greek fiscal crisis

The financial market turmoil triggered by the Greek fiscal crisis may heighten concerns over the fiscal conditions of other European countries and the financial systems in Europe, making the ever-volatile financial capital markets more unstable. If stock prices plunge further, this may hold consumer spending growth in check across the world through the wealth effect and dampen household and business sentiment, which have just started to improve. Furthermore, the weakening euro may decrease U.S. and Chinese exports, of which exports to the EU account for approximately 20%. All of these indicate that the fragile conditions in Europe could cause the global economy to fall into a slump again.

(ii) Economic recovery to stall as a result of a rushed shift from emergency fiscal and monetary policies without due caution

The unprecedented fiscal expansion and monetary easing implemented by the governments and central banks of many countries since the outbreak of the global financial and economic crisis have propped up economies in these countries. During the process of shifting from such policies, if they embark on fiscal consolidation or monetary tightening too early, or carry them out at too rapid a pace, this could hamper the economic recovery.

(iii) Rise in crude oil prices

Crude oil prices have risen gradually since the beginning of 2010; they surpassed $85 in April and then hovered at around $70 in mid-May. If crude oil prices continue rising in line with the economic recovery, this is likely to reduce consumption in the crude oil importing countries (particularly the U.S.) due to worsening terms of trade.

- Short-term upside risks

(i) Sharp increase in U.S. consumption

In the U.S., the saving rate has been on the decline since the beginning of 2010 and consumption has been increasing without household balance sheet adjustment proceeding significantly. If these circumstances continue, the global economy may recover faster over the short term, thanks to expanding demand from the

U.S.

However, over the medium term, this could create new risks due to the worsening global imbalance problems as a result of a resumption of U.S. current account deficit expansion.

(ii) Rise in asset prices, etc., in emerging countries, mainly China and India

In China, the continued easing monetary policy together with capital inflows from overseas has been boosting asset prices. India has also seen prices rising backed by demand recovery. As witnessed in these cases, prices of assets or goods and services have been on the rise primarily in Asian emerging countries. If asset prices are on an upward trend, this may increase the growth rate over the short term through the wealth effect.

However, if left undealt with over the medium term, the rising asset prices and ongoing inflation will later force the authorities to implement significant monetary tightening. This could cause asset prices to plunge and have a negative impact on the real economy.