Chapter 3 World Economic Outlook and Risks

This chapter examines 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 risk factors associated with them.

It should be noted that the outlooks presented below are subjected to require frequent revisions in line with the economic conditions.

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

Although the recession phase of the U.S. economy that had begun in December 2007 has ended in June 2009 and entered a recovery phase thereafter, demand in the household and corporate sectors is weak and the pace of the recovery is slow due to a delay in improvements in the income environment and concerns for the economy down the road. The following is an examination of the future scenario for the U.S. economy and risk factors associated with it.

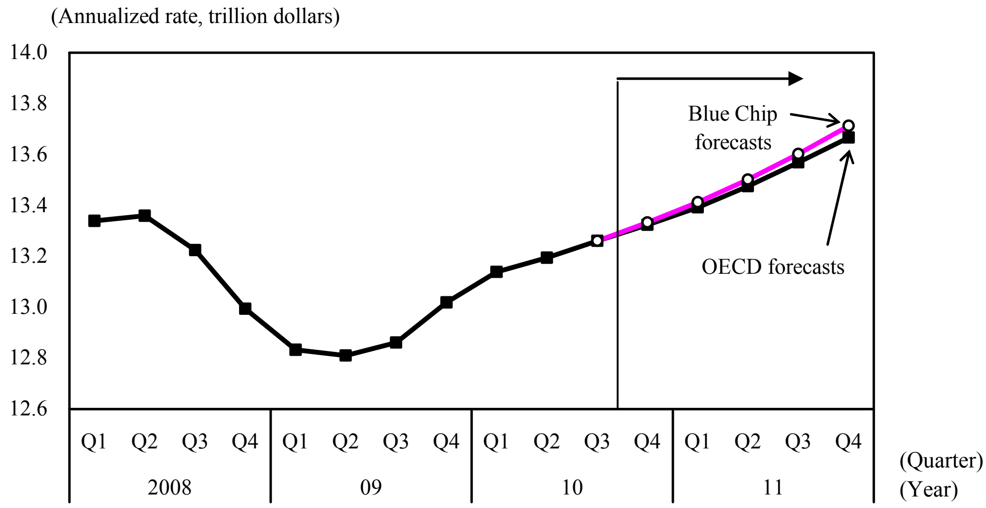
1. Economic Outlook (Main Scenario) – Moderate Recovery Expected to Continue

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 five consecutive quarters. In addition, private domestic investment has shown steady movement, having posted three consecutive quarters of growth. The economy is gradually heading for a self-sustained recovery. However, the housing market has stagnated again due to the termination of the homebuyer tax credit in April 2010 causing significant decline in residential investment.

It is forecast that the growth rate will gradually increase as the self-sustained recovery of consumption and private domestic investment gains momentum. However, mainly because the unemployment rate stays at high levels, the credit crunch continues and the effects of the stimulus packages recedes, the domestic demand will grow moderately, causing the pace of the economic recovery to be slower compared to those of the past recovery phases. Consequently, it is highly likely that the real GDP growth rate for the entire 2011 year will be between 2.0% and 2.5%. Meanwhile, although the unemployment rate is expected to be on a gradual decline from the current level, it is forecast to hover around 9% in 2011 and around 8% in 2012, which far exceeds the U.S. structural unemployment rate (5% to 6%).

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

Real GDP Level



Real GDP Growth Rate

(%)

	2010	2011			
	Q4 (October - December)	Q1 (January - March)	Q2 (April - June)	Q3 (July - September)	Q4 (October - December)
Blue Chip (average of private-sector forecasts)	2.2	2.4	2.7	3.0	3.3
OECD (November 18)	1.9	2.1	2.5	2.8	2.9

Economic Outlook by International Institutions and Others

(%)

		2010	2011
Blue Chip (average of private-sector forecasts) (November 10)	Top 10 companies	2.8	2.9
	Average	2.7	2.5
	Bottom 10 companies	2.7	1.9
OECD (November 18)		2.7	2.2
IMF (October 6)		2.6	2.3
Congressional Budget Office (CBO) (August 19)		3.0	2.1
Office of Management and Budget (OMB) (July 23)		3.2	3.6

(Note) Source: Blue Chip Economic Indicators (November 10, 2010), OECD "Economic Outlook 88" (November 18, 2010), IMF "World Economic Outlook" (October 6, 2010), U.S. Congressional Budget Office (August 19, 2010), U.S. Office of Management and Budget (July 23, 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 continue a moderate recovery since an increase in asset prices and an improvement in the employment environment are expected due to the gradual recovery of the economy; assuming that the Bush Tax Cuts scheduled to expire at the end of 2010 would continue.

(ii) Residential investment

Since the housing affordability conditions are favorable, a recovery of residential investment is expected. However, with excessive inventory and the current unstable home prices expected to linger on for several years to come, adjustment of the housing market is highly likely to continue for a few years. Consequently, the pace of recovery of residential investment is forecast to be significantly slower than those in the past recovery phases. Residential investment accounts for 2.7% of GDP in 2009 compared to 5-7 % in the first half of the 2000s before the problem of the subprime mortgage loan emerged, and its proportional contribution to economic growth has been declining.

(iii) Private domestic investment

Production is expected to expand in an array of industries in line with a moderate recovery both in domestic and foreign demand. Accordingly, private domestic investment is likely to maintain 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 stagnant commercial real estate market.

(iv) Government spending

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. The Obama administration is considering taking additional measures mainly in infrastructure investment, since difficulty in making consensus in the Congress is expected over any measures requiring expenditure expansion, government spending is likely to remain sluggish.

(v) Net export

Both exports and imports are likely to increase and grow faster in tandem with the moderate recovery in the world and domestic economies.

2. Risk Factors Associated with the Economic Outlook

Although downside risks associated with the economic outlook have decreased from half a year ago, the risk is still skewed to the downside.

- Downside risks

(i) Unemployment rate to remain high

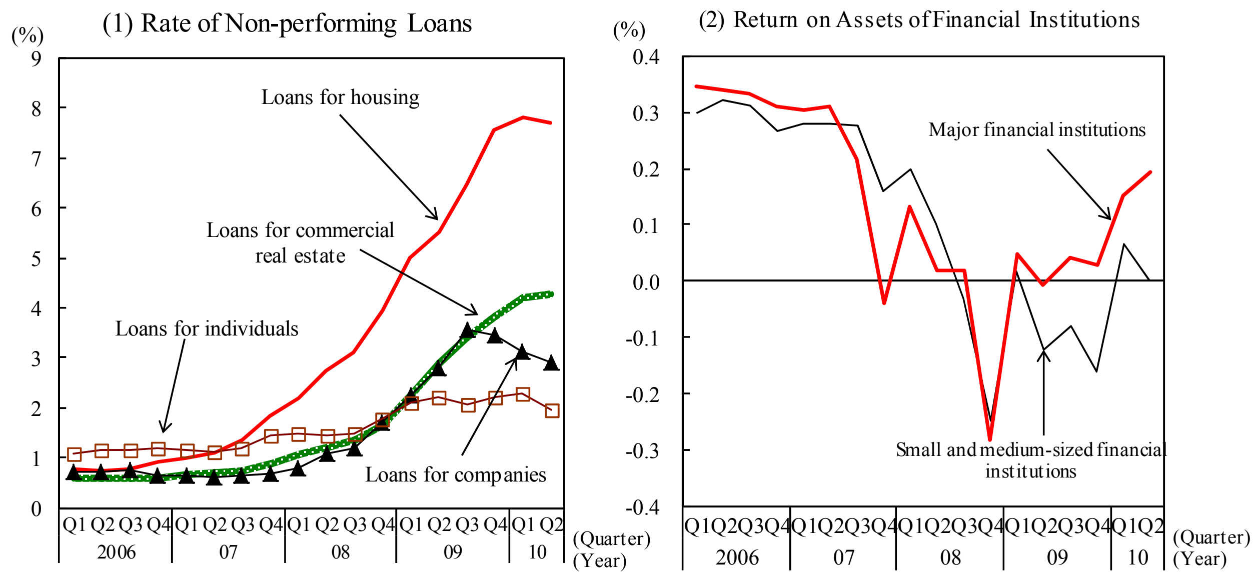
Since May 2010, the pace of the recovery in employment has moderated, with the unemployment rate remaining high, hovering at around 10%. If the mismatches in employment are not solved, it is concerned that any delay in the improvement of income environment may have negative impact on the household sector, including PCE 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, with the high levels of troubled assets in the commercial banking sector (lending sector) (Figure 3-1-2), small and medium-sized financial institutions, in particular, are struggling with severe operating conditions. If financial institutions keep lending standards tight and the credit crunch persists over the long term, it is likely that SMEs, which depend on indirect finance in raising funds, may face severe conditions and that consumption and purchase of house by households may be restrained.

Details of the financial regulations will be determined based on the Dodd-Frank Wall Street Reform and Consumer Protection Act enacted in July 2010. However, if such regulations include very strict provisions, the credit crunch may expand through deterioration in the operating conditions of financial institutions.

Figure 3-1-2 Rate of Non-performing Loans and the Return on the Assets of Financial Institutions



(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.

(iii) Risk of falling into deflation

Since the beginning of 2010, the growth rate of core prices has been on the decline and has reached the lowest level during the period that the statistics is compiled. In addition, the growth rate of wages has also tended to decline since 2009. Taking into account the large size of negative GDP gap, the rate of increase in prices may decline further. If the expected inflation rate declines adoptively by a decline in the rate of increase in prices or wages, there is a risk that the growth rate of core prices might decline further and fall into deflation.

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

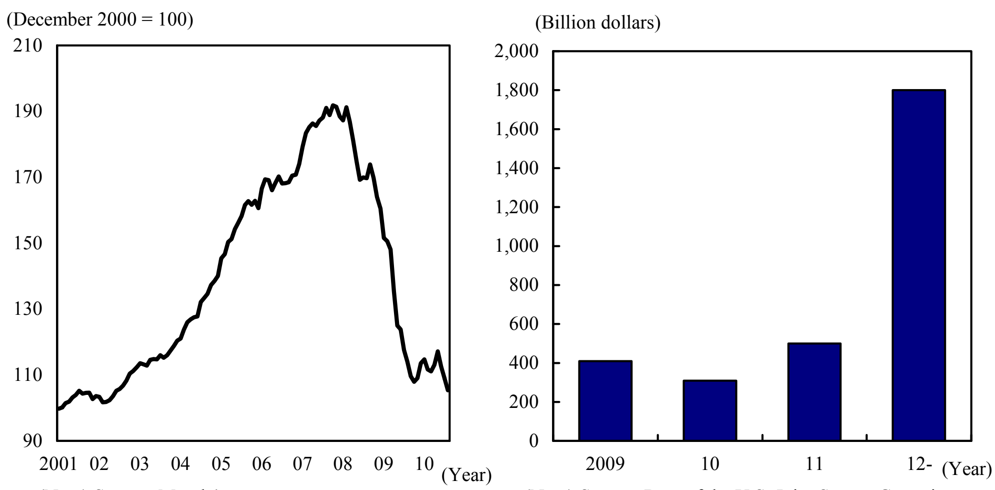
After the outbreak of the global financial and economic crisis, state budget conditions have deteriorated sharply, with the overall state budget deficits projected to continue to face a substantial revenue shortfall in 2011. In order to make up shortfalls in revenues, some states have increased taxes or decreased expenditures, raising concerns over negative impact on local economies. Since state budgets tend to lag behind the economic cycles, it is forecast to take a while before state budgets improve, implying that the stagnant situations in some local economies may be prolonged.

(v) 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 with the prices declining again (Figure 3-1-3). Commercial real estate loans have been the main source of profit in small and medium-sized financial institutions. With the ratio of non-performing loans rising, those institutions are expected to continue to be faced with severe operating conditions. Assets held by the institutions continue to deteriorate due to increasing non-performing loans. If the number of the institutions to go bankrupt increases, a recurrence of financial market turmoil might be possible (Figure 3-1-4). In addition, most of the commercial real estate loans are scheduled to expire in several years. There is concern that some failed refinancing will further worsen the market.

Figure 3-1-3 Commercial Real Estate Prices and the Scale of Refinancing

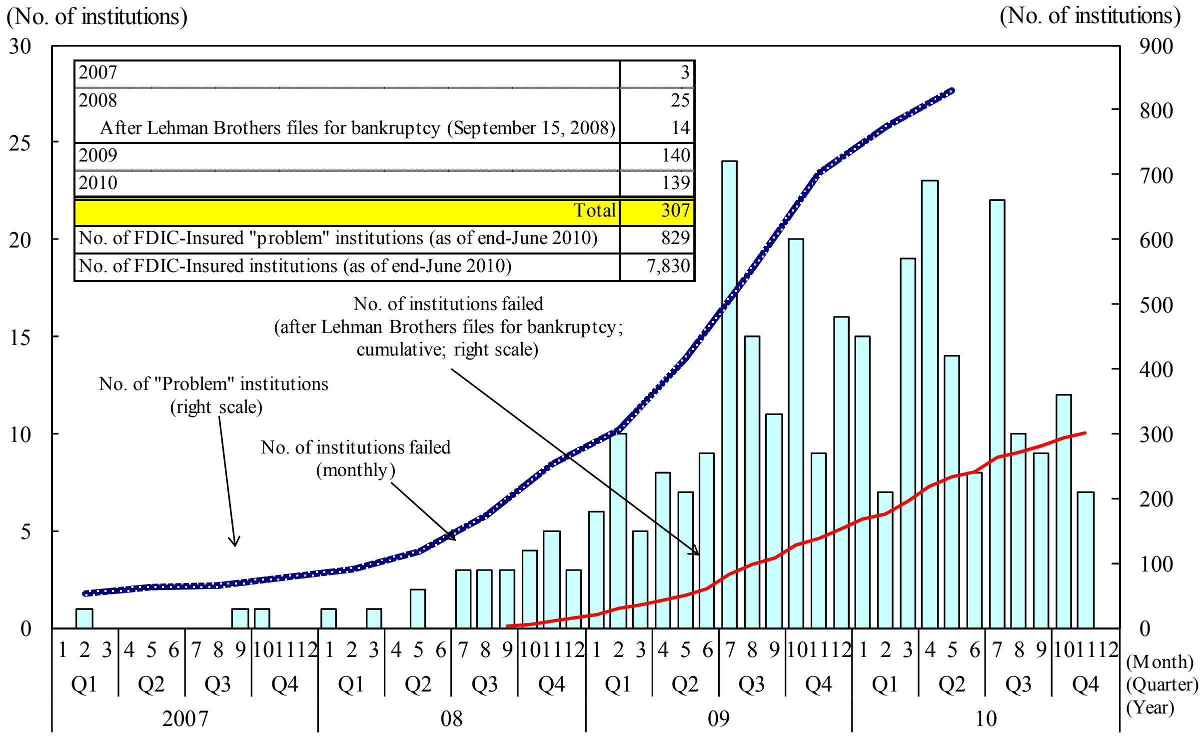
(1) Commercial real estate prices (2) Scale of refinancing of commercial real estate



(Note) Source: Moody's

(Note) Source: Data of the U.S. Joint Survey Committee

Figure 3-1-4 Number of Bank Failures: Failures among Small and Medium-sized Financial Institutions to Continue



(Notes) 1. Source: Federal Deposit Insurance Corporation (FDIC).
2. The number of institutions failed is as of November 12, 2010. The number of "Problem" institutions is as of June 2010.
3. Finantial institutions subject to the survey are depositary financial institutions (Commercial banks and savings institutions).

(vi) Risk regarding the continuity of policies

Since the size of the stimulus packages will be significantly reduced in and after the fourth quarter of 2010, there is concern that the impact of such measures likely to recede. Extension of some part of the measures such as the Making Work Pay tax credit and unemployment insurance payments is being discussed. However, if debate in the Congress is stuck in coordinating the passage of the bills and such measures are curtailed to a large extent or shelved, the economic recovery may stall. If uncertainty in relation to the continuity of policies elevates and uneasiness over the prospects for the economy heightens, it may depress the sentiment of households or corporations, which will restrain demand. Furthermore, if the Bush Tax Cuts were not extended, it would have the effect similar to the tax increase, which might cause economic downturn.

- Upside risks

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

(i) Easing credit crunch

If the balance sheet of financial institutions improves or credit risks for households and enterprises are significantly reduced or loans increase due to the creation of credit by financial institutions as a result of additional monetary easing in line with the economic recovery, consumption and investment may expand.

(ii) Rise in asset prices

If the effect of the additional monetary easing realizes more than expected, boosting stocks and house prices, and the burden of balance sheet adjustment for households and financial institutions may be alleviated so that credit flows to households may recover, helping PCE to expand through the wealth effect.

(iii) Rise in expected inflation rate

If the effect of the additional monetary easing realizes more than expected or an increase in import prices due to the more depreciation of the dollar significantly raises the expected inflation rate, the growth rates in consumption and investment may increase.

(iv) Expansion of PCE due to a decline in the households saving rate

If households do not proceed with balance sheet adjustment and the savings rate declines more than expected, PCE may expand temporarily. However, in the medium-to-long term a balance sheet adjustment may again cause a slump in consumption.

(v) Expansion of export bolstered by a faster-than-expected recovery of the world economy

If foreign countries see their domestic demand grow more rapidly than expected in tandem with a recovery in the world economy, the pace of economic recovery in the U.S. may accelerate, spurred by expanding exports. If the dollar depreciates further, or if support from the National Export Initiative proves effective, exports may expand further.

Section 2 Outlook and Risks for the European Economy

Although unemployment rates as a whole remain at high levels in Europe, the economies have been picking up in general. 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) – Moderate Pickup

The European economy has generally picked up. However, the real economic growth rate for the third quarter of 2010 has slowed its pace of recovery compared to that for the first half of 2010.

While Germany posted a high growth rate that for Greece was negative for eight quarters consecutively and the growth rates of France and Italy also remained modest. A substantial disparity exists between Germany, whose economy is driven by increases in exports and production, and Southern European countries, which are not only disadvantaged in terms of their export competitiveness, but also have to cope with massive fiscal consolidation.

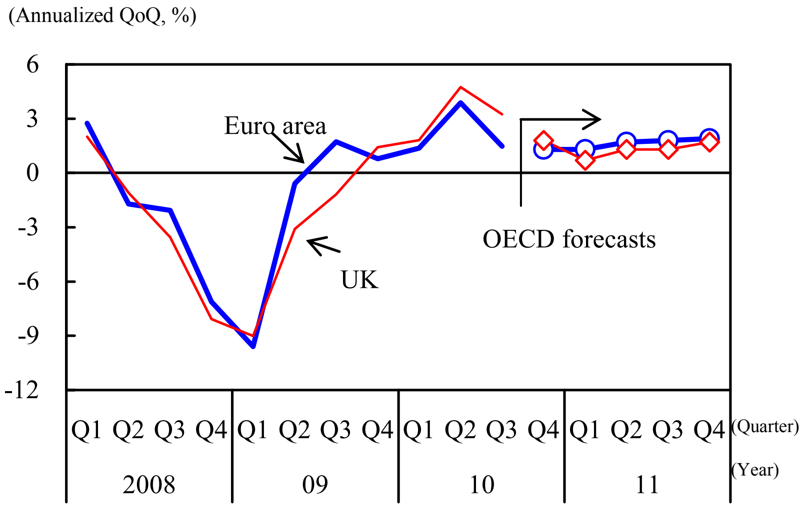
Although the pace of exports and production in Germany, which has been the main driver of the European economy, has slowed, it is forecast that the trend for the European economy as a whole will be to moderately pick up. However, it should be noted that fiscal contraction by European countries may have negative impact on the economy. Consequently, the real economic growth rate of the euro area for the entire 2011 is forecast at around the level between 1.0% and 2.0%.

Concerning foreign demand, an increase in exports is expected to continue to drive the economy of the European region. However, since the pace of overseas orders for manufacturers has slowed recently, there remains concern about the continuity of the economic recovery that has so far been led by exports.

With regard to domestic demand, increases in production and exports in Germany have already diffused to private consumption through improvement in the income environment, making its economic recovery more self-sustaining. Accordingly, the economy is expected to continue to pick up. However, in Europe as a whole, the recovery of the economy is less self-sustaining, with unemployment rates remaining at high levels. Except for some countries such as Germany, the severe employment condition is expected to continue and the unemployment rate is expected to remain at high levels, hovering at around 10%.

The forecast for real economic growth rates by international organizations, etc. indicate that the forecast for Germany is higher than that for France or the UK, and Germany is expected to continue to lead the economic recovery of Europe (Figure 3-2-1, Table 3-2-2).

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



(Note) Source: Eurostat and OECD

Table 3-2-2 Outlook for the Real GDP Growth Rates by International Institutions and Others

(YoY, %)

		2010	2011	2012
OECD (November 18)	Euro area	1.7	1.7	2.0
	Germany	3.5	2.5	2.2
	France	1.6	1.6	2.0
	UK	1.8	1.7	2.0
IMF (October 6)	Euro area	1.7	1.5	—
	Germany	3.3	2.0	—
	France	1.6	1.6	—
	UK	1.7	2.0	—
European Commission (September 13)	Euro area	1.7	—	—
	Germany	3.4	—	—
	France	1.6	—	—
	UK	1.7	—	—
ECB (September 2)	Euro area	1.4-1.8 (Median 1.6)	0.5-2.3 (Median 1.4)	—

(Note) Source: OECD "Economic Outlook 88" (November 18, 2010), IMF "World Economic Outlook" (October 6, 2010), European Commission"Interim forecast September 2010" (September 13, 2010), ECB "Staff Macroeconomic Projections for the Euro Area" (September 2, 2010).

Meanwhile, according to the outlook by the OECD, Greece and Portugal are forecast to post negative real economic growth rates for 2011, in contrast to Germany. Further expansion of the disparities among countries may cause concern for the stable growth of the European economy.

2. Risk Factors Associated with the Economic Outlook

Concerning the future of the European economy, both upside and downside risks are considered. But the risk balance is still skewed to the downside.

● Downside risks

(i) Concern over fiscal sustainability and the recurrence of financial system uneasiness

With concern about fiscal sustainability still heightened after the Greek financial crisis, there has been a rise in the yields of government bonds and sovereign CDS issued by Central and Eastern European and Southern European countries such as Portugal and Ireland whose fiscal conditions have deteriorated as much as in Greece. Spain is suffering from a worsening employment situation with more than 20% unemployment rate owing to the recession after the collapse of the housing bubble. Besides, it is feared that a vicious circle has arisen between the financial system problem and recession, and the fiscal condition of the country may grow into a more serious problem. Accordingly, a plunge in government bonds prices (yields on them rise) and a surge in sovereign CDS raise the risk of causing more serious turmoil in the financial markets resulting in a slowdown of the economic recovery.

Out of concern for fiscal sustainability, there is a contagion risk of concern for the soundness and management of financial institutions holding the government bonds of fiscally troubled countries or with a massive outstanding balance of foreign credit to these countries.

(ii) Decrease in export due to the slowing U.S. and Asian economies

During the recovery phase at this time, the share exports to China is small, accounting for 6.5% (in 2009) of exports to regions outside the Euro area. But its rate of growth is high, and its contribution to the growth of exports as a whole is also considerable.

If the U.S. economy, which accounted for 11.9% (in 2009) of exports for regions outside the Euro area, and the Chinese economy, with a higher growth rate in spite of its small share of exports to regions outside the Euro area, slow down further, exports that are playing the role of a driver for the European economy will decline. In addition, it is considered that this may have negative impact on production and private consumption, which have been recovering supported by increasing exports, with a downside risk to the economy as a whole.

(iii) Employment to worsen than expected

The unemployment rate of Europe as a whole has remained at high levels, hovering at around 10%. If the economy fails to get on track to a self-sustained recovery and the unemployment rate increases, there is a downside risk to private consumption through deterioration in the income environment and consumer sentiment.

- Upside risks

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

Expansion of export bolstered by a faster-than-expected recovery of the world economy

If the economies of the U.S. and China, the main destinations for European exports, recover strongly, exports will consequently boost production, employment and consumption, and the pace of the economic recovery may be relatively fast. Major European countries such as Germany have deepened their relationships with the Central and Eastern European economies through trade, investment and so on. Since the economies of the Central and Eastern European countries have been ceasing to deteriorate, exports to such countries may grow.

Section 3 Outlook and Risks for the Asian Economy

In the Asian economies, India still sees its economy expanding, while the pace of economic expansion in China is slowing down slightly, with Korea, Taiwan the ASEAN region in general also seeing a slightly slowing recovery. 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 mainly in domestic demand. However, mainly due to a lull in the growth in domestic demand and changes in the policy stance of the government, pace of expansion has slowed a little from around the middle of 2010. Concerning the future prospects, it is expected that while exports are unlikely to gain a strong growth momentum due to the moderate recovery in the U.S. and European economies, domestic demand remain favorable despite the termination of the four trillion yuan package and part of the consumption stimulus measures in and after 2011. Thus, the economy is expected to continue to expand although its pace will become slower.

In India, the economy has been expanding mainly in domestic demand. It is expected that the expansionary trend will be maintained, supported by steady domestic demand.

In Korea, Taiwan and ASEAN, the economies have been on the recovery path in general, but the pace of this recovery has been rather moderate mainly due to slowing exports, primarily to China, and inventory adjustments mainly on IT products. Those economies, with the ratio of exports to GDP generally being high, are liable to be effected by the movement of the world economy, particularly the Chinese economy. It is expected that the underlying trends in the world economy will continue to grow moderately and the Chinese economy will continue to expand although its pace will become slower, accordingly, those economies will also continue to recover despite at the slower pace.

According to outlooks by international institutions, while the Chinese economy is forecast to grow at about 8% to 9% in 2011, the economies of Korea, Taiwan and ASEAN excluding Indonesia will generally post growth rates of 4% to 5% in that year, slow down from 2010. Indonesia is likely to see an increase at a rate similar to that in 2010, helped by a strong expansion of domestic demand. A growth rate of between 8% and 9% is forecast in India. Those views are mostly appropriate.

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

(YoY, %)

	2009 actual results	IMF (October 2010)		ADB (September 2010)		OECD (November 2010)		World Bank (October 2010)	
		2010	2011	2010	2011	2010	2011	2010	2011
China	9.1	10.5	9.6	9.6	9.1	10.5	9.7	10.0	8.7
India	7.4	9.7	8.4	8.5	8.7	9.1	8.2	–	–
Korea	0.2	6.1	4.5	6.0	4.6	6.2	4.3	–	–
Taiwan	-1.9	9.3	4.4	7.7	4.0	–	–	–	–
Singapore	-1.3	15.0	4.5	14.0	5.0	–	–	–	–
Thailand	-2.2	7.5	4.0	7.0	4.5	–	–	7.5	3.2
Malaysia	-1.7	6.7	5.3	6.8	5.0	–	–	7.4	4.8
Indonesia	4.5	6.0	6.2	6.1	6.3	6.1	6.3	6.0	6.2

(Notes) 1. Source: "World Economic Outlook" (October 6, 2010), IMF; "Asian Development Outlook 2010 Update" (September 28, 2010), ADB; "Economic Outlook 88" (November 18, 2010), OECD; "East Asia and Pacific Economic Update 2010, Volume 2" (October 19, 2010), World Bank;"China Quarterly Update, November 2010" (November 3, 2010), World Bank.
2. 2009 actual results for India and forecasts by ADB and OECD are on a fiscal year (April through March of the following year) basis. Actual results for 2009 and forcast by ADB are on a factor cost basis. Forecasts by IMF and OECD are on a market price basis.

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. The outlook for China is largely dependent on the direction of policies such as monetary policies or consumption stimulus measures, with the possibility of both upside and downside risks subject to the policies. The trends in China may affect the outlook for Korea, Taiwan and ASEAN region as well.

● Downside risks

(i) Higher real estate prices in China and the effect on domestic demand of monetary tightening to cope with them

In China, reflecting the monetary easing after the occurrence of the global financial crisis, with loans for real estate surging, there has been concern that the real estate market is overheated as real estate prices began to increase from the middle of 2009. In 2010, although measures to restrict real estate prices were taken twice, in April and September, real estate prices are still on the increase. In future, if the rise in real estate prices accelerates and restrictive measures are taken further, and their impacts realize more than expected, then asset prices and domestic demand may plunge, likely resulting in an economic slowdown. Furthermore, it is feared that a slowdown in China may slow down the economies of Korea, Taiwan and others whose current economic recovery is attributed partly to increase in exports to China.

(ii) Accelerating inflation in China and India and its resulting negative impact on consumption

In China, the rate of increase in the consumer price has been rising, posting 4.4% in October 2010. Although the current increase in prices is mainly attributable to an increase in food prices mostly due to weather factors, the rate of increase in the core CPI is also gradually increasing, albeit at a low level, which should be carefully watched. In India as well, rising food prices and the expansion of domestic demand are exerting pressure to raise prices. In 2010, policy interest rate has been raised six times to contain inflation, but the rate of increase in wholesale prices is still at high levels. It is feared that a continuation of price hikes in both China and India may act as downward pressure on consumption.

(iii) Excess capital inflows

The monetary easing policies implemented in developed countries, in concert with a more favorable economic outlook for emerging countries, including Asia, than for developed countries, have facilitated capital flows into Asia, sharply boosting asset prices and facilitating the appreciation of currencies in some countries. Although various measures, including ones for regulating capital inflows or restricting real estate prices, have been taken from around the middle of 2010 to deal with the situation, capital inflows are highly likely to continue. It may have negative impact on the economy through the effect on export competitiveness if a significant appreciation of their currencies continues.

A further increase in asset prices is considered to bring about the effect of raising growth rates through the wealth effect in the short term. However, if a change in the flow of the international financial capital market is triggered by some factor that rapidly drives off funds from emerging countries including Asia, it might be possible that the stability of the financial system would be threatened in future.

(iv) Exports to be dampened by a slow recovery in the economies of the developed countries

Although the U.S. and European economies have been recovering, the pace of recovery has been moderate. Moreover, there are still quite a few downside risks on the economies, including unemployment rates at high levels and the continuing credit crunch. The pace of economic recovery could slow down in countries and regions whose domestic markets are small, such as Korea, Taiwan and Singapore through the negative impact on their exports if the U.S. and European economies stagnated. There is concern that the pace of economic expansion in China could also slow down. In addition, Korea and Taiwan might experience a longer inventory adjustment phase mainly in IT products, their main industry.

● Short-term upside risks

The following is considered to be a short-term upward factor for the economy.

Rise in asset prices bolstered by capital inflows

As described above, the monetary easing policies in developed countries have been facilitating capital inflows into Asian countries, causing a substantial rise in asset prices in certain countries. If asset prices continue to rise, this may become a factor that elevates the growth rate in the short term through the wealth effect.

Section 4 World Economic Outlook and Risks

Taking into consideration the outlooks and risks of the U.S., European and Asian economies examined above, this section explores the world economic outlook and the risk factors associated with it.

1. Economic Outlook (Main Scenario) –Moderate Recovery Continues

Despite remaining under severe circumstances, such as the high rates of unemployment, the world economy has been recovering moderately. It is forecast that the underlying trend in the U.S. economy will continue in the direction of moderate recovery, the Asian economies will stay on an expansion or recovery trend with the pace slowing, and meanwhile the European economy will tend to moderately pick up. Consequently, the world economy as a whole is forecast to continue its moderate recovery, resulting in real economic growth rates in the lower half of the 3% range at market exchange rate basis for the entire 2011 year. Meanwhile, both international and private institutions estimate that the world economy will grow at a rate approximately in the lower half of the 3% range in real terms in the entire 2011 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) Recurrence of the financial system problem based on concern about the fiscal situation in Europe

The turmoil in the financial market triggered by the Greek financial crisis and the spread of concern over the fiscal condition and the financial system of European countries have calmed down, following the determination in May 2010 of measures to support Greece by the IMF, EU and others, the agreement to establish the European Financial Stabilization Mechanism (fund of 750 billion euros) and the release of the stress test results in July by the Committee of European Banking Supervisors. However, the public finances of some European countries are still in a serious situation. In November 2010, Ireland decided to receive support based on the European Financial Stabilization Mechanism, etc., with the issue starting to rekindle from the fall of 2010.

The spread of those concerns to the entire international financial market may not only restrain the growth of private consumption in countries around the world through the wealth effect, such as a fall in stock prices, but also reduce the exports from the U.S., China and other countries that would be affected by any deterioration in the European economy; it is feared that the world economy may slump again with Europe as its epicenter.

(ii) Excessive capital inflows to emerging countries

With the easing monetary policies being continuously employed in developed countries, funds are flowing into the emerging countries, including Asia, mainly due to the favorable growth estimates for those countries compared to the developed countries.

Massive inflows of such funds have caused a rapid increase in asset prices in emerging countries, such as those in Asia, and concern for asset bubbles is mounting in some areas. Some countries/regions of the emerging countries such as those in Asia have tightened monetary policies, such as raising policy interest rates. If the tightening effects were realized more than anticipated, a faltering of domestic demand might be brought about through a decline in asset prices. Meanwhile, if the flows of the international financial market shifted in some way and capital rapidly flew out of the emerging countries, including Asia, the stability of the financial systems of these emerging countries and the stability of the entire macroeconomy might be threatened. Since the outbreak of the global financial crisis, the Asian region has become an engine of world economic growth. Consequently, if the Asian economy slows down significantly, it is feared that the economic recovery for the entire world may be blocked.

(iii) Delay in the economic recovery due to simultaneous and excessive fiscal contraction by countries

The recovery of the world economy after the global financial crisis is still moderate. However, the fiscal conditions of developed countries such as the U.S. and Europe have been deteriorating due to the unprecedented level of fiscal expansion that was hammered out after the global financial crisis in 2008 and the drop in tax revenues attributable to the slowing down of the economy.

Advanced countries, excluding Japan, agreed to at least halve their respective fiscal deficits by 2013 at the G20 Toronto Summit in June 2010. During the process in which countries fulfill the commitment, if fiscal consolidations are simultaneously accelerated in an excessively contractionary manner, it is feared that this will hamper economic recovery.

(iv) Contraction of world trade due to a rise in protectionism

In the U.S. and European countries that were at the center of the global financial crisis, the recovery of domestic demand has been moderate due to the high unemployment rates, a credit crunch and balance sheet adjustments by households, relying on exports more than ever. For example, the U.S. is implementing the National Export Initiative with the target of doubling exports in five years. Competition among countries involving their governments is intensifying over the export of infrastructure to emerging countries including Asia and the development of new markets. At the G20 Seoul Summit in November 2010, countries agreed to correct any new protective measures. However, in spite of the agreement, if any country puts a higher priority on its national interests by taking protective measures, it is feared that global trade may contract and the recovery of the economy will be disrupted as a result.

(v) Rise in international commodity prices

We are in a situation where excessive liquidity are being left unused on a global scale because advanced countries are continuing their monetary easing policies. If the capital flow into international commodity markets for the investment in oil, metals (copper, etc.), grains, etc., and international commodity prices go up, it may have negative impact on the real economy.

● Short-term upside risks

The following is considered to be a short-term upward factor for the economy.

Rise in asset prices, etc.
As already mentioned, the excessive liquidity, piling up in the global financial market, flow into emerging countries to be invested there, causing a rise in asset prices in some places. If the rise in asset prices continues in spite of regulations on capital inflows and measures to restrain real estate prices, which have been adopted in some countries/regions, the economic growth rates may be elevated through the wealth effect in the short term. However, if the rise in asset prices continues and the economy overheats, the authorities will have to implement significant monetary tightening. In this case, asset prices may plunge, negatively affecting the real economy as a result.