Chapter 2　Exit Strategy from Emergency Economic Policies

§1. Issues of Exit Strategy

● Large-scale and unusual fiscal/monetary policies taken to deal with the world financial/economic crisis would be associated with adverse effects such as distorting the proper functions of the markets and causing an increase in long-term interest rates due to inflation or worsening fiscal balance if those policies are continued even after the crisis is over and the economy recovers. We need an "exit strategy" which lifts emergency policies and returns to normal.

● In developing an exit strategy, various issues should be carefully examined. Especially, the following points are important:

1) The timing of implementing an exit strategy needs to be carefully examined in order not to cause adverse influence on the recovering economy and financial instability again, taking into consideration the elements inherent in crisis in addition to ordinary policy management.

2) Since emergency policies often have an aspect of intervening in the market function of resource allocation, e.g., measures in which the government or the central bank takes various risks that are originally supposed to be taken in the market or measures which could incur loss and a financial burden for taxpayers, it is important to maintain and recover the market function in developing an exit strategy.

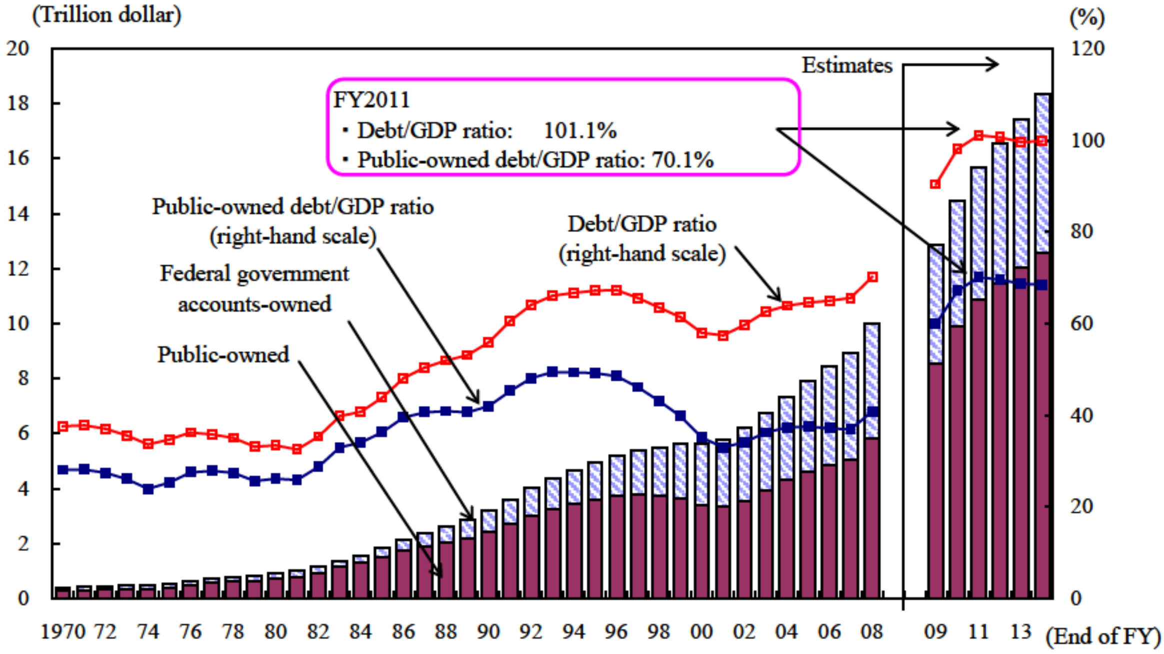
3) In the process of developing and implementing an exit strategy, it is preferable to clarify the timing and method of the implementation through communication with the market and stabilize the expectation of market players.

§2. Exit Strategy of Fiscal Policy

1. Expanding fiscal deficit and debt outstanding associated with the financial crisis response

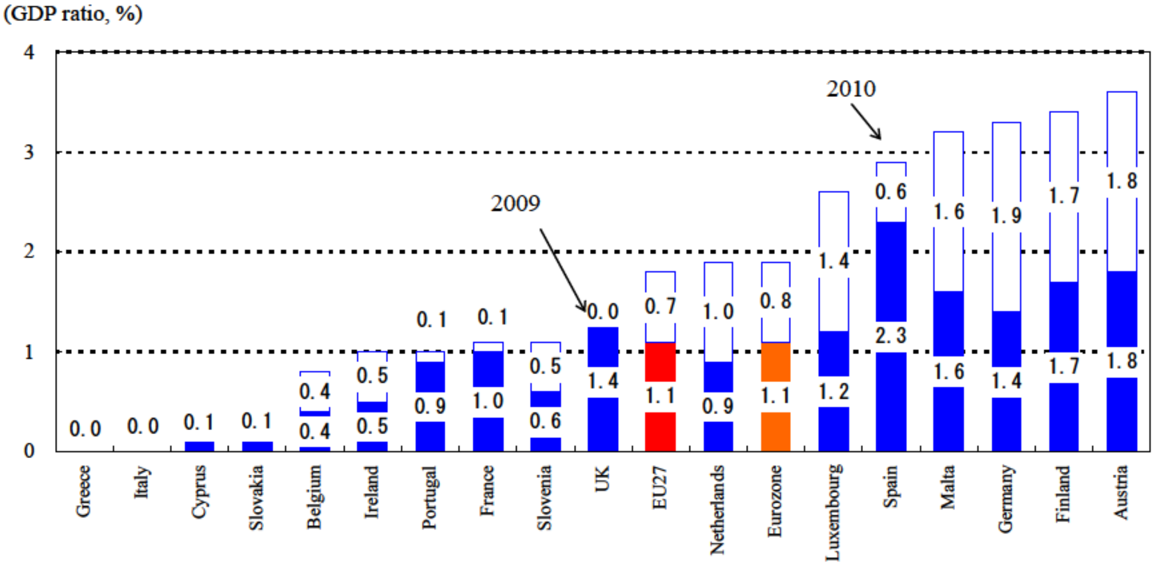
- Fiscal deficit and debt outstanding have increased associated with the financial crisis response. In the US, federal government's fiscal deficit in FY2009 is 10% of GDP and general public (privately)-owned federal government debt in FY2011 will likely exceed 70% of GDP. In Europe, many countries will likely to exceed the threshold provided in the stability and growth pact, i.e., general government fiscal deficit: 3% of GDP and general government gross debt: 60% of GDP.

Figure 2-2-5 Federal Government Debt:
Debts are expanding associated with the financial crisis response.



(Notes)1. Source: "Mid-Session Review Budget of the U.S.Government Fiscal Year 2010", Office of Management and Budget
2. Federal government accounts-owned debt is equivalent to retained amount of government bonds of social security pension trust fund.

Figure 2-2-6 Scale of Discretionary Spending in European Countries:
The scale varies depending on each country's fiscal capacity and
the degree of effects of the financial crisis.



(Note) Source: European Commission

2. Issues Concerning Exit Strategy of Financial Reconstruction

●Exit strategy of economic and fiscal policy should meet the following requirements:

(i) Timing of starting fiscal consolidation and its pace are adequate in the light of future economic outlook of recovery.

(ii) It should be a framework (fiscal consolidation target/plan and fiscal rule) with a high feasibility so that it can win the trust of the market in order to hold down long-term interest rates.

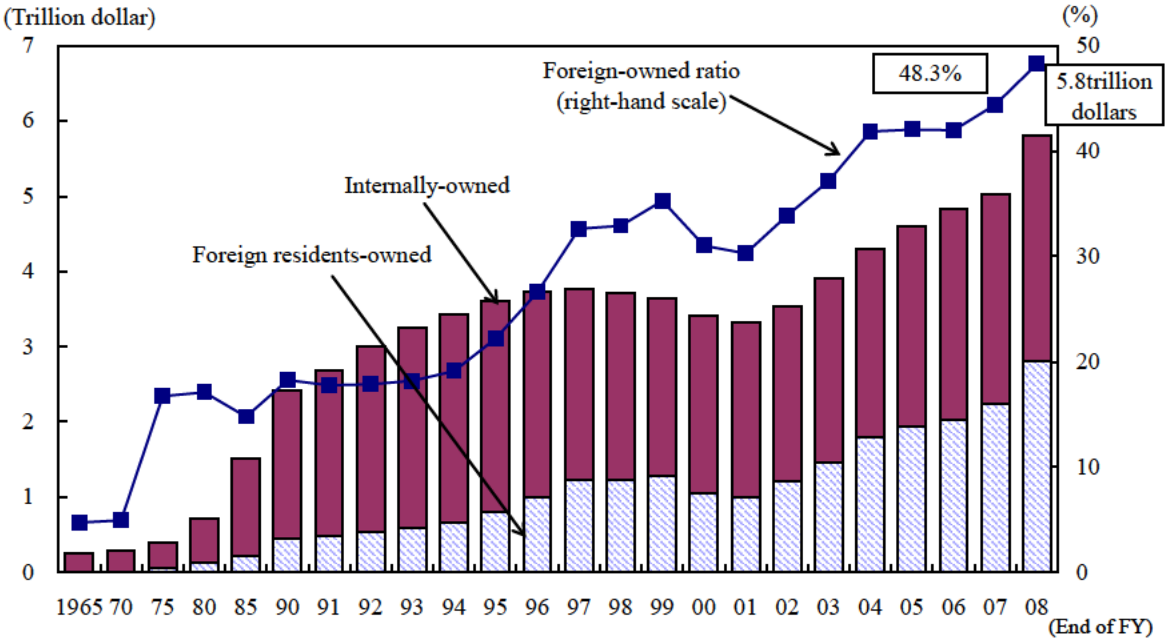
(iii) It should be a framework with some flexibility since downward risk of economic outlook is significant and uncertainty is high.

●Mistiming of fiscal consolidation due to premature reversal of policy might give damage to the momentum of self-sustained economic recovery. It is important to determine the proper timing, watching changes in GDP gap and long-term interest rates.

3. Goal and Efforts of Fiscal Consolidation

●In the US, the Obama administration aims to cut the fiscal deficit in half by January 2013 by tax reform, reduction of overseas contingency operations, health reform, etc., but it might be difficult to achieve depending on future economic trend. Foreign countries' high ownership ratio of US Treasury bills (48.3%) is closely related to confidence in key currency dollar and entire international financial system. Therefore, it is required to make efforts not to cause any concern in the feasibility of fiscal consolidation measures.

Figure 2-2-10 Foreign holdings ratio of (public-owned) US Treasury:
Half of US Treasury is held by foreign residents.



(Notes)1. Source: "Analytical Perspective of the FY 2010 Budget", Office of Management and Budget
2. Value in each fiscal year is as of the end of fiscal year.

- In Europe, European Commission has proposed goals and speed of each country's fiscal consolidation in November 2009. Most countries will have to initiate fiscal consolidation from 2010 (2011 at the latest). However, judging from the current economic situation and future prospects, it may be too early to start fiscal consolidation from 2010.

Table 2-2-11 Fiscal Consolidation Plans set by European Commission (Major countries): launching fiscal consolidation in 2010 may be premature

Start fiscal consolidation by 2011 at the latest.

Double line indicates the deadline of getting the excessive deficit corrected. (Budget deficit/GDP ratio: 3%)

	2009	2010	2011	2012	2013	2014
Germany			Improve structural fiscal budget by 0 5 to 0 75 point every year			
fiscal balance	-3 4	-5	-4 6	—	—	—
Structural fiscal balance	-1 9	-3 6	-3 5	—	—	—
Output gap	-2 9	-2 6	-2 2	—	—	—
France		Improve structural fiscal balance by 1 25 point every year				
fiscal balance	-8 3	-8 2	-7 7	—	—	—
Structural fiscal balance	-7	-7	-6 5	—	—	—
Output gap	-2 5	-2 5	-2 4	—	—	—
Italy		Improve structural fiscal balance by 0 5 point every year				
fiscal balance	-5 3	-5 3	-5 1	—	—	—
Structural fiscal balance	-3 5	-3 7	-3 8	—	—	—
Output gap	-3 6	-3 2	-2 5	—	—	—
Spain		Improve structural fiscal balance by 1 75 point every year				
fiscal balance	-11 2	-10 1	-9 3	—	—	—
Structural fiscal balance	-10	-8 5	-8 1	—	—	—
Output gap	-2 8	-3 6	-2 6	—	—	—
Netherlands			Improve structural fiscal balance by 0 5 to 0 75 point every year			
fiscal balance	-4 7	-6 1	-5 6	—	—	—
Structural fiscal balance	-3 2	-4 4	-4 3	—	—	—
Output gap	-2 7	-3 1	-2 4	—	—	—
Ireland		Improve structural fiscal balance by 2 points every year.				
fiscal balance	-12 5	-14 7	-14 7	—	—	—
Structural fiscal balance	-9 6	-11 5	-12 5	—	—	—
Output gap	-7 2	-7 8	-5 4	—	—	—
UK (fiscal year)		Improve structural fiscal balance by 1 75 point every year				
fiscal balance	-12 1	-12 9	-11 1	—	—	—
Structural fiscal balance	-10 5	-11 4	-9 9	—	—	—
Output gap	-3 7	-3 7	-2 9	—	—	—

(Notes) 1 Source: European Commission

2 Fiscal balance, structural fiscal balance and Output gap are based on the Economic Forecaset of European Commission (November 2009) UK's fiscal year is from March to next April Other countries' fiscal year is from January to December

3 Countries which have been recommended to correct excessive deficit should deposit 1) 0 2% of GDP and 2) 10% of deficit exceeding 3% level (total of 1) and 2) should be 0 5% of GDP at a maximum) to European Commission If the budget deficit/GDP ratio is not corrected within three years including the year when deficit exceeded 3% of GDP, the country might be subject to sanctions (confiscation of deposit)

(Reference) Fiscal Stimulus Packages of Major Foreign Countries

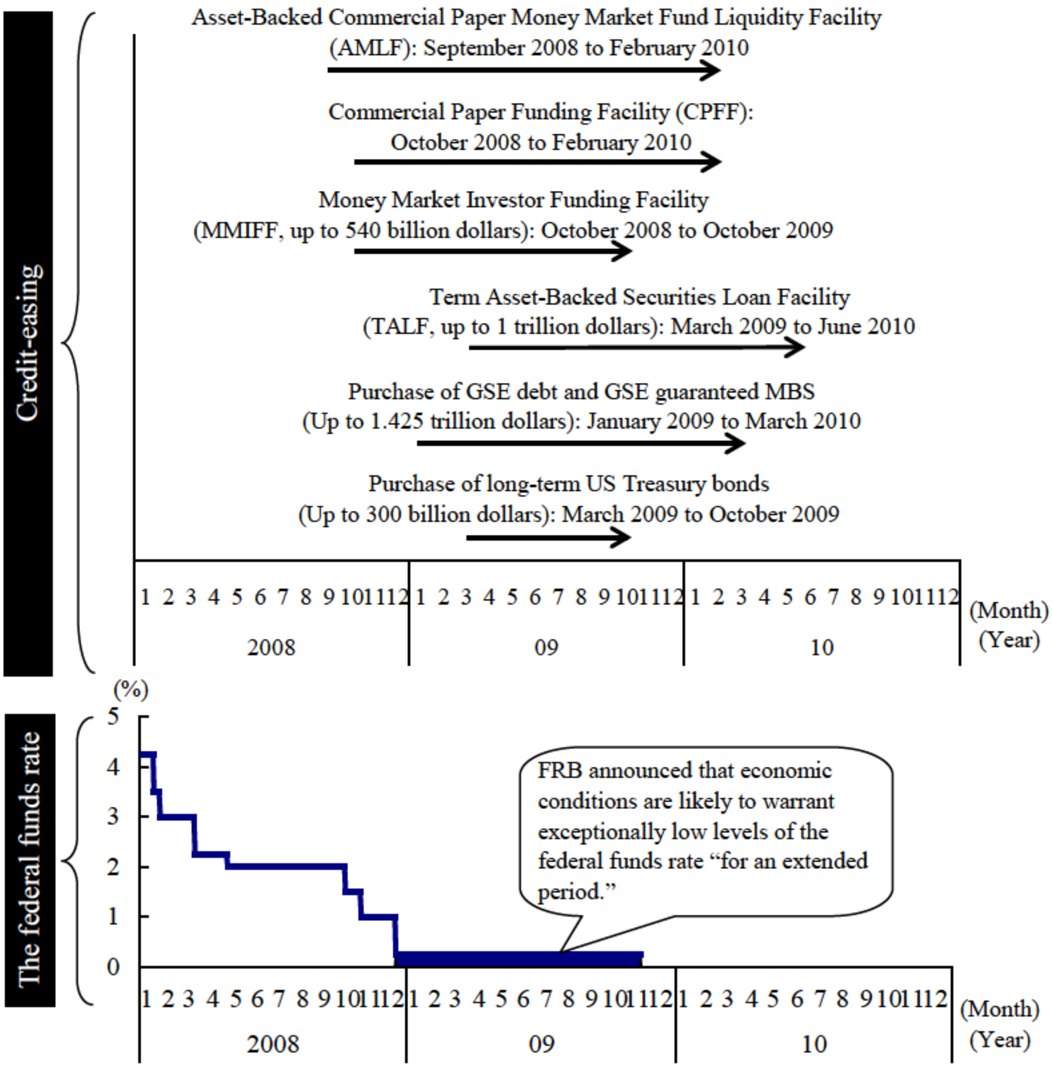
Country	Scale (GDP ratio, %) 2008	09	10	Total	Employment/Safety network	Creation of effective demand	Enhancement of growth potential
US	1.1	2.0	1.8	4.9	･Continuing to extend the period of unemployment benefits ･Increased amount of food stamp (ticket) ･Support for state governments to maintain Medicaid (medical insurance for low-income earners) ･Providing temporary benefits to pensioners ･Increase in the tax credit on expenditure on higher education ･Increase in scholarship ･Establishment of fiscal stability fund for state government to prevent layoff of teachers, etc	･Income-tax cut (up to 400 dollars per worker) ･Capital investment tax reduction (extension of special depreciation, etc.) ･Public investment (modernization of roads and bridges, investment in high-speed railway, etc) ･Support for buying fuel-efficient cars	･Environmental energy measures (modernization of power grid, etc) ･Measures for promoting science and technology ･Promotion of introducing IT to medical information
Germany	0.0	1.6	2.0	3.6	･Vocational training ･Extension of the period of subsidies for short-time work and reduction of social insurance premium burden	･Income-tax cut (reduction of minimum tax rate, etc.) ･Providing child allowance (lump-sum payment) (100 euro per capita) ･Reduction of medical insurance premium burden rate ･Capital investment tax reduction ･Support for financing of companies ･Public investment (schools, hospoitals, roads, etc.) ･Promotion of public investment by local governments ･Temporary car tax exemption for environment-friendly new cars ･Car scrapping scheme	･Support for housing renovation (energy-saving, etc)
France	0.0	0.7	0.8	1.5	･Subsidies for employment for micro enterprises ･Providing allowance to unemployed who are not covered by unemployment insurance ･construction of public housing	･Income-tax cut for middle- and low-income earners ･Support for housing acquisition (with interest subsidies) ･Support for car industry (financing to manufacturers, support for affiliate subsidiaries) ･Support for financing of companies ･Public investment (schools, roads, railways, etc.) ･Car scrapping scheme	･Support for housing renovation (energy-saving, etc.)
UK	0.2	1.4	-0.1	1.5	･Helping unemployed in search of jobs ･Vocational training	･Raising the tax allowance limit on incomes ･Temporay lowering of value-added tax (consumption tax) rate (17.5%→15%) ･Government-guaranteed loan to small businesses ･Public investment (schools, transportation, housing, etc.) ･Car scrapping scheme	･Promotion of capital investment for CO_2 reduction
China	0.4	3.2	2.7	6.3	･Housing construction for low-income earners ･Strengthening of social security (coverage, raising level, etc.)	･Public investment (railway, roads, etc.) ･Corporate value-added tax cut (expanding coverage of purchase tax deduction) ･Support for purchasing cars (reduction of car purchase tax by half, subsidies for replacing/buying cars in rural areas, subsidies for replacing cars nationwide) ･Support for purchasing home appliances (subsidies for purchasing in rural areas, subsidies for replacing in nine provinces and cities) ･Elimination of commercial banks' credit loan limit	･Industrial structure adjustment and promotion measures (industry reorganization, innovation, etc.)

(Notes) 1. Source Each government's data
2. Scale is based on "Update on Fiscal and Financial Sector Measures", IMF (on 26 April 2009)

§3. Exit Strategy of Monetary Policy

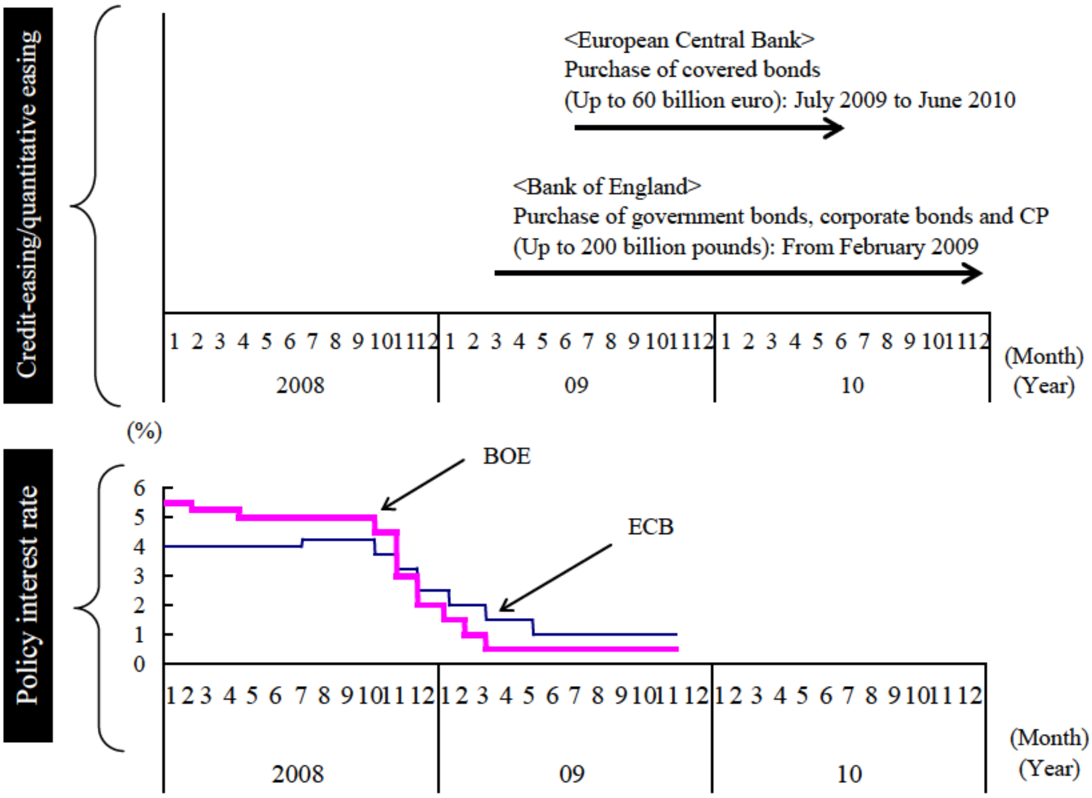
● Central banks in the US and Europe ensure market liquidity and stability of the financial system using unconventional monetary policies such as acquisition of various assets including government bonds as well as a conventional monetary policy, i.e., lowering policy interest rate.

Figure 2-3-1 The Federal Funds Rate and Major Credit-Easing Measures



(Notes)1. Source: Federal Reserve Board
2. Arrow length indicates implementation period.

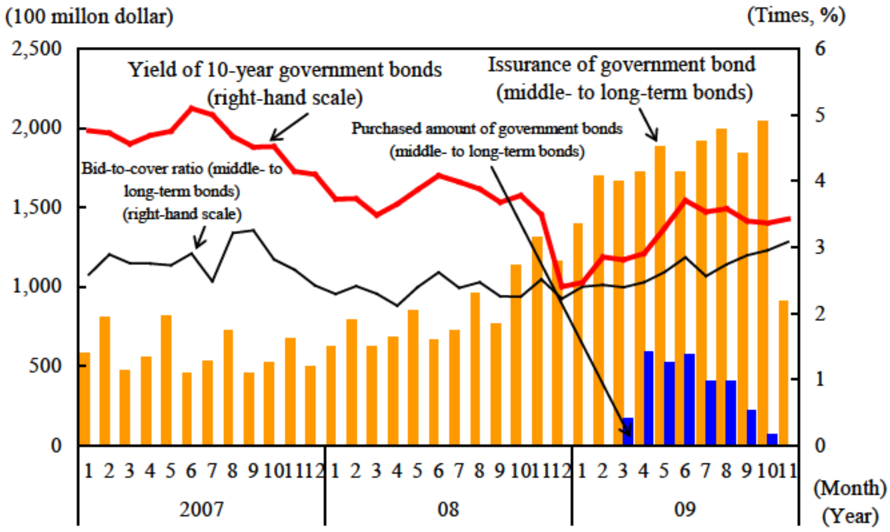
Figure 2-3-2 Policy Interest Rate and Credit-Easing/Quantitative Easing Measures



(Notes)1. Source: European Central Bank (ECB) and Bank of England (BOE)
2. Arrow line indicates implementation period.
3. ECB refers to purchase of covered bonds as "credit-easing" and BOE refers to purchase of government bonds as "quantitative easing."

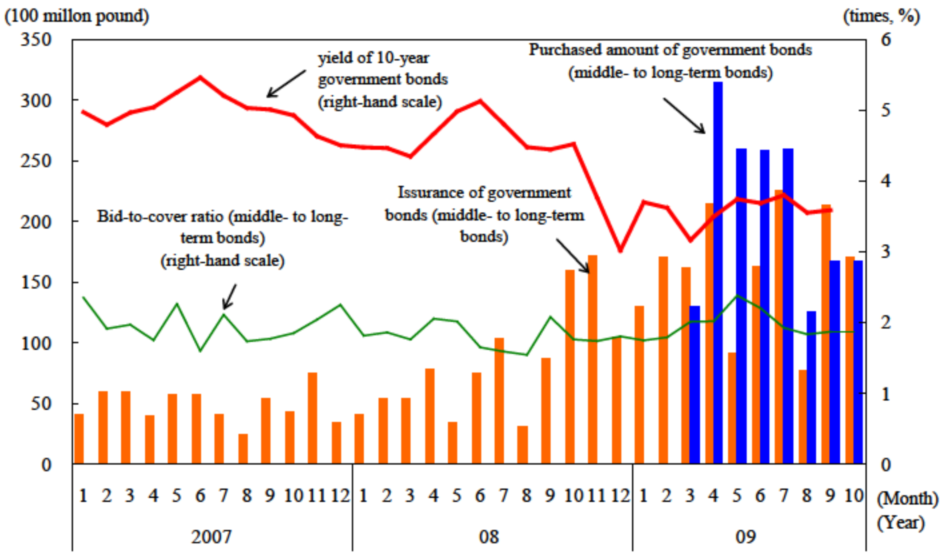
●Federal Reserve Board has purchased about half of year-to-year increase in the issuance of medium- to long-term government bonds. Bank of England has purchased medium- to long-term government bonds at a pace exceeding the issuance. European Central Bank has purchased covered bonds equivalent to 4% of total outstanding issue over the four months from July 2009. All of these measures seem to have achieved effects, e.g., long-term interest rates and bid-to-cover ratio have been stabilized so far.

Figure 2-3-5 FRB's Purchased Amount of Government Bonds and Issuance of Government Bonds: Long-term interest remains stable.



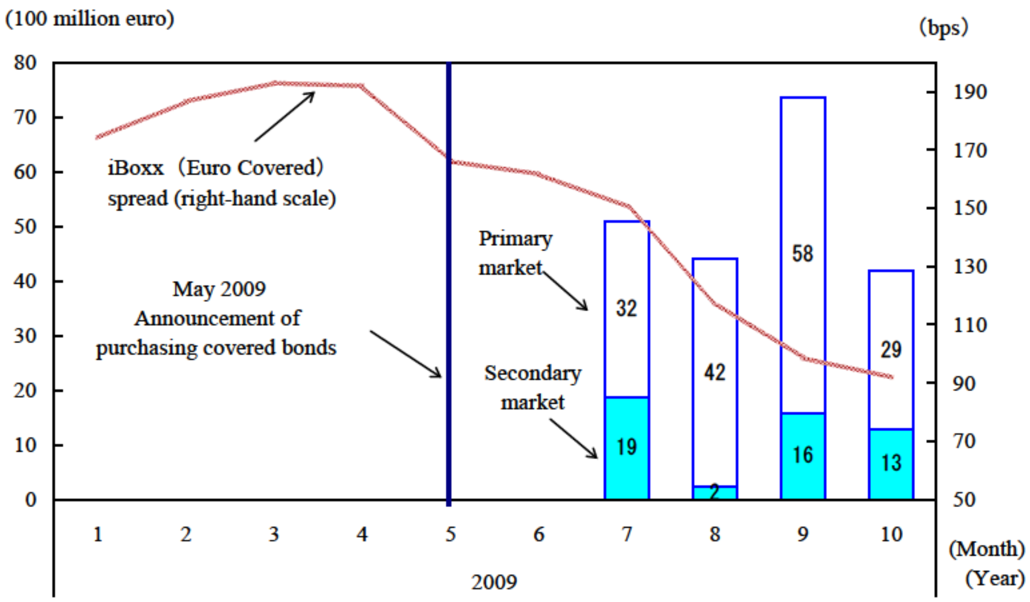
(Notes)1.Source: Federal Bank of New York, Federal Reserve Board and Datastream
2. Value in November 2009 is as of 13 November 2009.

Figure 2-3-9 BOE's Purchased Amount of Government Bonds and Issuance of Government Bonds: Bid-to-cover ratio remains stable



(Note) Source: UK Debt Management Office and Bloomberg

Figure 2-3-8 ECB's Purchase of Covered Bonds:
Market spread has narrowed since the announcement of purchase.



(Notes)1. Source: Markit, ECB
2. iBoxx (Euro Covered) spread is the diffence between yield of euro-denominated covered bonds and yield of benchmark bonds of a similar maturity and of the most issued in the reference country

● Unconventional monetary policies have effects on direct finance such as CP while the effect on market-oriented indirect finance such as securitized paper is limited since the creditability of securitized paper has not been recovered yet.

1) The purchase of CP has effects, e.g., recovery of issuance till the end of 2008 and it supported financing of companies and financial institutions.
2) On the other hand, although the purchase of MBS has an effect of support for housing market through decline of housing loan interest rate, MBS market has not been recovered yet.
3) In addition, measures to recover ABS market liquidity including CMBS have rarely resulted in issuing of new securitized paper.

●By purchasing various assets, the balance sheet of each central bank has significantly expanded (FRB: 2 times or more, ECB: 1.5 times BOE: 3 times) and have borne the risks resulting from those assets. It is important to navigate the exit strategy, i.e., how to reduce the balance sheet, how to adjust the asset structure and how to manage the risks.

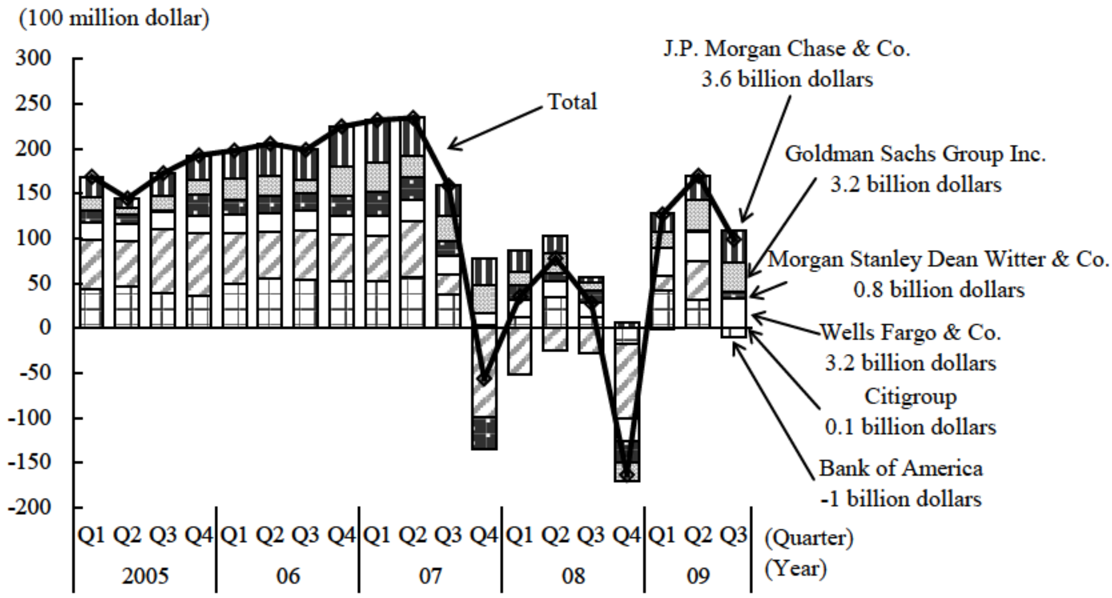
●There is a debate regarding the need of international cooperation for the timing of the exit strategy in order to prevent large-scale capital flows such as large exchange fluctuation. Meanwhile, it is also important to manage monetary policies in consideration of economic conditions such as domestic macro-economy, inflation and asset prices. It is important for future exit strategy to achieve a balance between international cooperation and domestic economic policy management.

§4. Stabilization of Financial System: Current Situation and Future

- As a result of implementing measures for the stabilization of financial system such as capital injection and debt guarantee in each country, effects are seen, e.g., increase in equity capital of financial institutions and improvement of financing environment. However, there are problems in individual institutions, and concerns such as negative effects on real economy due to delayed bad-asset disposal and credit crunch still remain.

- As for performance of financial institutions, the securities underwriting sector and proprietary trading sector reached record earnings while competitive environment was relaxed due to competitors' reorganization and bankruptcy. By contrast, in the financing sector, bad assets increased due to the effect of credit crunch and worsening real economy and the performance was worsened due to substantial amount of write-off and allowance. For this reason, the performance of major financial institutions in the US and Europe has been polarized.

Figure 2-4-3 Net Earnings and Allowance of Major Financial Institutions in the US: Increased allowance puts pressure on profit of commercial banks.



(Note) Source: Bloomberg

(Reference) Measures to Stabilize Financial Systems in Major Countries

	Support for individual financial institutions (improvement of balance sheet, etc)				Restoration of financial markets' function		Deposit protection
	Capital injection	Purchases of troubled assets	Guarantees on assets	Loans	Debt guarantee	Purchase of specified assets	
US	◆Capital injection is implemented based on "Troubled Asset Relief Program" (TARP) Injected capital: 314 5 billion dollars in total *As of 10 November 2009 ・Capital injection program: 204 7 billion dollars ・AIG: 69 8 billion dollars ・Citigroup (additional): 20 billion dollars ・Bank of America (additional): 20 billion dollars Capital repayment: 70 9 billion dollars in total *As of 10 November 2009 ◆Supervisory Capital Assessment Program was implemented on 19 largest U S bank holding companies to result in the announcement that 10 firms need additional 74 6 billion dollar capital in total	◆"Public-Private Investment Program" (PPIP) to buy troubled assets was announced Legacy Securities Investment program Scale: Up to 30 billion dollars Scale as of 5 November 2009: 16 4 billion dollars ◆FRB provides loans to LLC which buys troubled assets from AIG Loan amount: 52 5 billion dollars	◆The Government guarantees assets of Citigroup and Bank of America Guaranteed assets: 301 billion dollars ・Citigroup 301 billion dollars *Guarantee on Bank of America (118 billion dollars) was not implemented	◆FRB provided secured loans to AIG Credit line: 25 billion dollars *Reduced from initial amount 85 billion dollars	◆Federal Deposit Insurance Corporation (FDIC) guarantees debts issued newly by financial institutions Scale: 1 4 trillion dollars *It was terminated in October 2009 except in an emergency	◆Commercial Paper Funding Facility (CPFF), Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) and Money Market Investor Funding Facility (MMIFF) are created by FRB Fed's CP balance on the balance sheet: 14 3 billion dollars *As of 11 November 2009 ◆Term Asset-Backed Securities Loan Facility (TALF) in which FRB provides loan to owners of ABS, RMBS and CMBS secured by loan to consumers/SMEs is created Loan scale: Up to 1 trillion dollars ◆FRB's purchase program of GSE debt and GSE-guaranteed MBS is created Scale: Up to 1 425 trillion dollars ◆FRB announces purchase of long-term U S Treasury bond Scale: 300 billion dollars *It was terminated in October 2009	◆The deposit insurance ceiling is raised from 100 thousand dollars to 250 thousand dollars ◆Deposits in transaction accounts are fully protected ◆Insurance premium was required to be prepaid and at higher rate, due to worsening reserve rate of deposit insurance
Germany	◆80 billion-euro fund for capital injection is secured based on "Financial Market Stabilization Act" Capital injection (amount announced by the following two banks): 18 7 billion euro ・Commerzbank: 18 2 billion euro ・Aareal Bank: 500 million euro	◆A bill for creating "Bad bank" to separate bad assets from financial institutions was passed	—	◆The Government, etc provide loans to Hypo Real Estate Loan amount: 50 billion euro *It was nationalized by increasing capital with public funds in July 2009 and fully nationalized by excluding minority shareholders in October 2009	◆The Government guarantees debts of transactions between banks Scale: 400 billion euro	—	◆The deposits are now fully protected The legal ceiling of deposit insurance ceiling was 90% of deposits (up to 20 thousand euro)
France	◆40 billion-euro fund for capital injection is created Capital injection (announced): 21 5 billion euro in total ・Six major financial institutions 10 5 billion euro in total (first injection) 11 0 billion euro in total (second injection)	—	—	—	◆The Government guarantees debts of transactions between banks Scale: 320 billion euro	—	◆No change Currently 70 thousand euro
UK	◆81 2 billion-pound capital injection is announced Capital injection (announced): 50 billion pounds in total (first injection) ・RBS: 33 billion pounds ・HBOS: 11 5 billion pounds ・Lloyds: 5 5 billion pounds 31 2 billion pounds in total (second injection) ・RBS: 25 5 billion pounds ・Lloyds Banking Group: 5 7 billion pounds *HBOS was taken over by Lloyds in January 2009 and became Lloyds Banking Group	—	◆The Government guarantees financial institutions' own assets (asset-based securities, etc) based on "Asset Protection Scheme" Guaranteed assets: 282 billion pounds ・RBS: 282 billion pounds *Lloyds originally planned to participate in the APS but finally decided not to in November 2009	—	◆The Government guarantees debts issued newly by financial institutions Scale: 250 billion pounds	◆BOE announces Asset Purchase Facility (APF) including purchase of CP, corporate bonds and medium to long-term government bonds Scale: 200 billion pounds	◆The deposit insurance ceiling is raised from 35 thousand pounds to 50 thousand pounds

(Notes)1. Based on data from materials published by governments, central banks, etc.
2. In addition, ECB has purchased covered bonds (secured bonds issued by financial institutions) since July 2009 (purchase scale 60 billion euro).

§5. Framework of Monetary Policies/Measures for Stabilization of Financial System beyond the Exit

- Based on world economic crisis and a series of policy responses, there is a growing recognition that it is not enough to supervise individual financial institutions but "macro-prudence policy" which implements the policy management from the perspective of monitoring risks involved with entire financial system is needed in order to forestall financial crisis.

- In the US and Europe, efforts for securing cooperation between the central bank and the supervisory authorities and developing institutional frameworks such as setup of a new consultation body have been progressing toward the realization of macro-prudence policy.

Figure 2-5-1 Macro-prudence Watchdog Body in Each Country/Region: New bodies are set up.

1) US

Financial Services Oversight Council

Chairman: Secretary of the Treasury

＜Duties＞

1) Advise the Congress on financial regulation and make recommendations that will enhance the orderliness and stability of financial markets
2) Monitor the financial services marketplace to identify potential threats to the stability of the United States financial system
3) Identify financial companies and financial activities that should be subject to heightened prudential standards in order to promote financial stability and mitigate systemic risks
4) Issue formal recommendations that a council member agency adopt heightened prudential firms it regulates to mitigate systemic risks
5) Facilitate information sharing and coordination among the members of the Council regarding financial services policy development, rulemakings, etc
6) Provide a forum for discussion and analysis of emerging market developments and financial regulatory issues
7) Resolve a jurisdictional dispute between that agency and another agency that is a Council member

【Voting Members】
Chairman of the Board of Governors of the Federal Reserve System
Comptroller of the Currency
(The Director of the Office of Thrift Supervision)
The Chairman of the Securities and Exchange Commission
The Chairman of the Commodity Futures Trading Commission
The Chairperson of the Federal Deposit Insurance Corporation
The Director of the Federal Housing Finance Agency
The Chairman of the National Credit Union

＋

【Non Voting Members】
State Insurance Commissioner
State Banking Supervisor

＋

【Council staff】
Permanent staff
(Detailed from U S Department of the Treasury)
Temporary staff
(Detailed from other departments/ agencies)

(Note) Source: The House Financial Services Committee

2) Eurozone

European Systemic Risk Board (ESRB)

Chairman: Selected from members of General Board

＜Duties＞

1) Macro-prudential policy for the stability of entire financial system and strengthening of soundness
2) Issue early risk warnings to supervisory authorities of EU members.
3) Weigh various evaluations on macro-economy and financial market trend and issue instructions.

【Members with voting rights (33)】
President (1) and Vice-president (1) of European Central Bank
Presidents of central banks in each country (27)
Director of European Banking Authority (1)
Director of European Insurance Authority (1)
Director of European Securities Authority (1)
Representative from European Commission (1)

＋

【Members without voting rights (28)】
Representatives of financial advisory authorities in each country (27)
Member of Economic and Fiscal Commission (European Commission) (1)

(Note) Source: European Commission. Numbers in parenthesis indicate the number of representatives

3) UK

Council for Financial Stability

Chairman: Finance Minister

＜Duties＞

1) Analyze threat to financial stability.
2) Discuss a response with institutions concerned.

Chancellor of the Exchequer ＋ Governor of BOE ＋ Chairman of Financial Services Authority

(Note) Source: HM Treasury

●In the US, efforts to rebuild a strict and comprehensive financial regulation/supervisory system which was dispersed in many institutions have progressed while issues such as strengthening of supervisory capability/methods of the authority, securing assisting personnel and ensuring the effectiveness under complicated regulatory and supervisory structures still remain.

Table 2-5-3 Financial Institution Regulatory System in the US: Complicated structure

Current system

		Federal Authorities							State authorities
		FRB	FDIC	OCC	OTS	NCUA	SEC	CFTC	
Banks	Federal -chartered banks		○	●					
	State-chartered banks	◎	○						●
			◎						●
									●
S&Ls	Federal -chartered		○		●				
	State chartered		○		◎				●
									●
Credit unions	Federal-chartered					●			
	State-chartered								●
Bank holding companies		◎							●
S&L holding companies					◎				●
Insurance companies									●
Securities companies							●		
Futures commission merchant, etc								●	

New system (bill of House Committee on Financial Services)

		Financial Services Oversight Council							CFPA
		Federal Authorities						State authorities	
		FRB	FDIC	OCC	NUCA	SEC	CFTC		
Identified financial holding companies		◎							
Banks	Federal -chartered banks		○	●					
	State-chartered banks	◎	○					●	
			◎					●	
								●	
S&Ls	State chartered		◎					●	
								●	
Credit unions	Federal-chartered				●				
	State-chartered							●	
Bank holding companies		◎						●	
Insurance companies								●	
Securities companies						●			
Investment companies (e.g., hedge fund)						●			
Futures commission merchant, etc							●		

●= License-issuing agencies (securities firm are registered) and primary supervisory authorities
◎= Primary supervisory authority
○= Inspection authority for the federal deposit/insurer

(Notes) 1 Current system: Source: Federal Reserve Bank of New York, "Outline of U S Financial System Reform Act," Hideki Nonoguchi and Yoko Takada (Monthly Research Report, Bank of Japan January 2000); etc
2 New system: Source: House Committee on Financial Services
3 OTS is integrated with OCC in the new system (Both are integrated with a new body, NBS, in the bill of U S Department of the Treasury)
4 Bank holding companies in the new system includes investment bank holding companies and nonbank financial companies
5 Identified financial holding companies are regarded as Tier1 FHC in the bill of U S Department of the Treasury

Chapter 3 World Economic Outlook and Risks

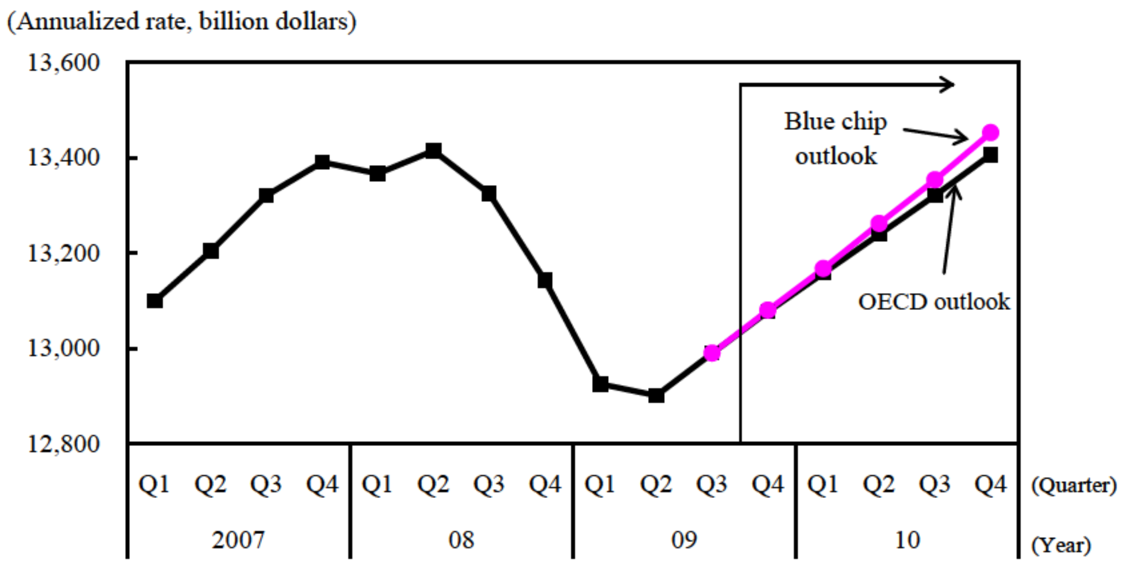
§1. US Economic Outlook and Risks

1. US Economic Outlook - Economy will be on a moderate recovery trend.

- It is expected the US economy in 2010 will be on a moderate recovery trend. With full-scale public investment since the fall of 2009 and effects of fiscal-stimulus program such as extension of preferential tax cuts for buyers of residential houses until the end of April 2010, domestic demand will be picking up and production will be widely showing movements of picking up due to advancement of inventory adjustment.
- However, the increase in private consumption which accounts for 70% of GDP will slow down due to adjustment of household balance sheets, continued credit crunch and worsening income environment accompanied with rise in unemployment. For this reason, the economic recovery pace will be still moderate even in 2010 and it is highly possible that the real economic growth rate will be at the 1% level in 2010.
- As a result, the real GDP level might not return to the level before the financial/economic crisis as of the end of 2010. On the other hand, the unemployment rate is expected to reach nearly a record postwar high level (November and December 1982: 10.8%) within 2010.

Figure 3-1-1 US Economic Outlook

Real GDP level



Real GDP growth rate

	2009	2010			
	Q4	Q1	Q2	Q3	Q4
OECD	2.7	2.5	2.5	2.5	2.6
Blue chip	2.8	2.7	2.9	2.8	3.0

International Organizations' outlook

		2009	2010
Office of Management and Budget (as of 25 Auguust)		-2.8	2.0
Congressional Budget Office (as of 25 August)		-2.5	1.7
OECD (as of 19 November)		-2.5	2.5
IMF (as of 1 October)		-2.7	1.5
Blue chip (Private forcasters) (as of 10 November)	Top 10	-2.4	3.4
	Average	-2.4	2.7
	Bottom 10	-2.5	2.0

(Note) Sources: US Department of Commerce, US Office of Management and Budget, US Congressional Budget Office, "Economic Outlook 86"(19 November 2009), OECD, "World Economic Outlook"(1 October 2009), IMF and Blue Chip Economic Indicators (10 November 2009)

2. Risk factors associated with economic outlook

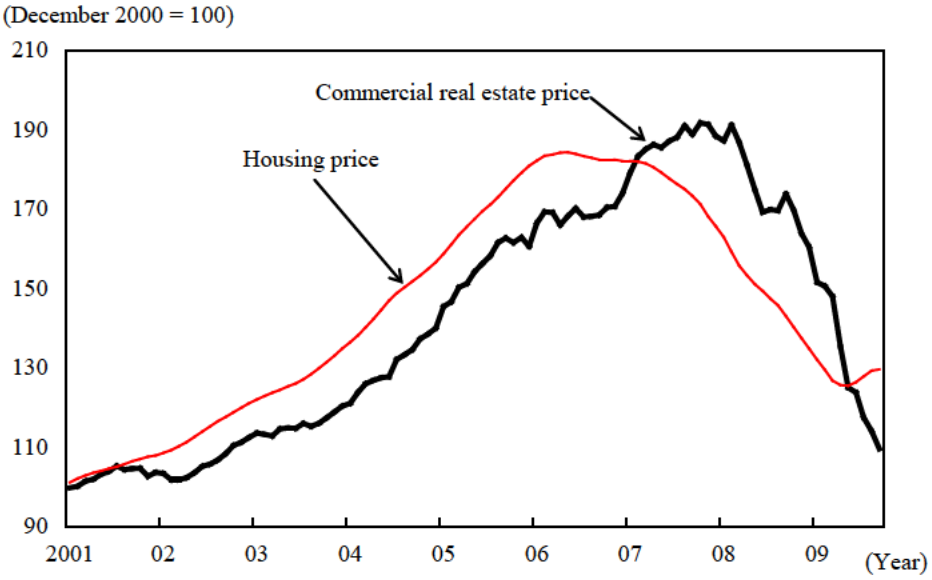
Although downside risk of outlook weakens, the risk is still skewed to the downside.

<Downside risks>

(i) Rekindled fears about management of financial institutions

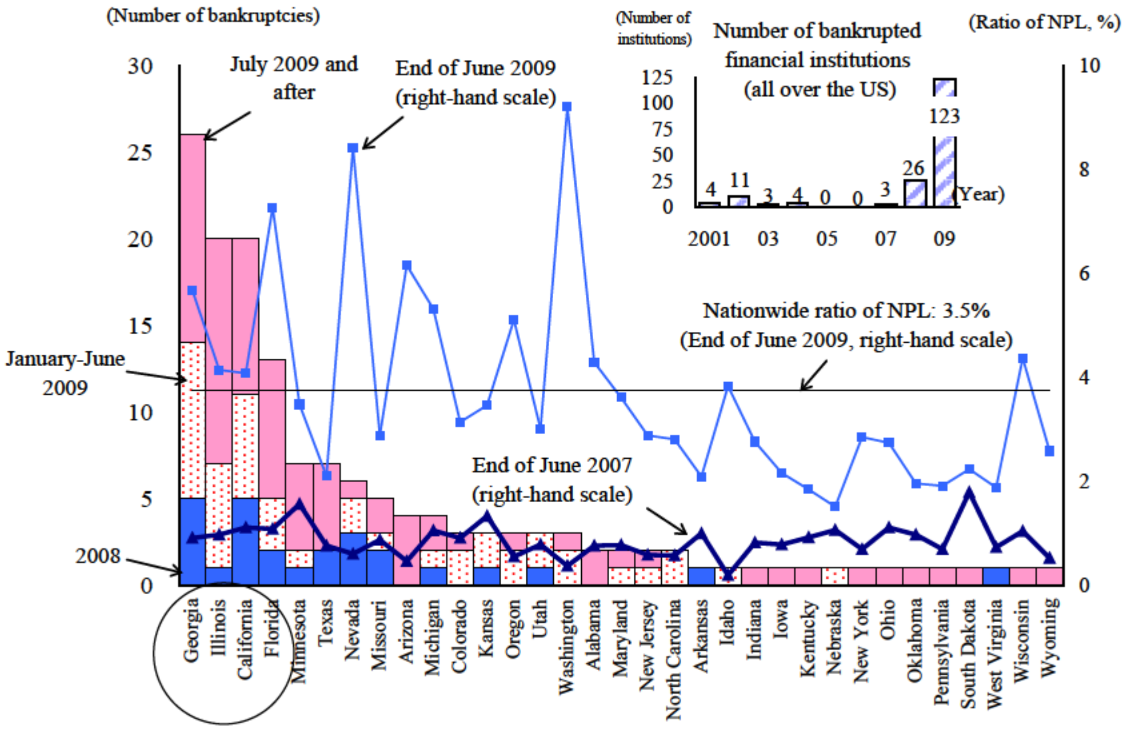
Financial institution-owned lending outstanding for commercial real estate has exceeded subprime loans. The delinquency rate has increased and bad assets have increased as a result of decreased earning rate of commercial real estate by the recession and there is fear of new financial uncertainty. Especially in medium/small-sized financial institutions, the percentage of loans to commercial real estate in total assets is higher and many of those conduct community-based businesses. Therefore, if the earning rate of commercial real estate decreases due to the stagnation of local economy, bankruptcies might increase due to deteriorated assets.

Box 1-5 Figure 2 Commercial Real Estate Price Trends:
Substantial drop continues.



(Notes) 1. Sources: Standard & Poor's and Moody's
2. S&P/Case-Shiller Home Price Indiex (20 cities) is used for housing price and Moody's/REAL Commercial Property Index is used for commercial real estate price.

Box 1-4 Figure 6 Number of Bankrupted Financial Institutions and
Ratio of Nonperforming Loans to Total Loans by State:
The number of bankruptcies has rapidly increased since the beginning of 2009.
The ratio of nonperforming loans is also on an upward trend.



(Notes)1. Source: FDIC (as of 13 November 2009)
2. States with one or more bankrupted financial institutions since 2008 are shown in the chart.

(ii) Further worsening credit crunch due to a vicious cycle between financial crisis and worsening real economy

The ratio of nonperforming loans in financial institution-owned assets has continued to rise and the credit standards of financial institutions are still strict. If the economy continues to be stagnant and corporate profits and employment are worsened due to protracted credit crunch, there would be a risk to fall into the vicious cycle that bad assets further increase due to corporate bankruptcies and increase in past due loans to households and that causes further credit crunch.

(iii) Worse-than-expected employment situation

The employment situation continues to worsen. If the unemployment rate further increases exceeding 10.8%, a record postwar high level (November and December 1982 during the recession after the second oil crisis), that might further place downward pressure on private consumption.

(iv) Increase in long-term interest rates

If long-term interest rates increase as a result of growing distrust in fiscal stability, that might curb private consumption and investment. If the fiscal rigidity further progresses as the interest payment burden increases, that might prevent future flexible fiscal management based on economic situation.

<Upside risks>

(i) Increase in asset price

If the stability of financial system and the economic recovery are accelerated and stock prices and housing prices increase, it is possible to reduce the burden in the balance sheet adjustment of households and financial institutions and to restore the credit flow to households as well as expanding private consumptions through asset effects.

(ii) Expansion of exports accompanied with better-than-expected world economic recovery

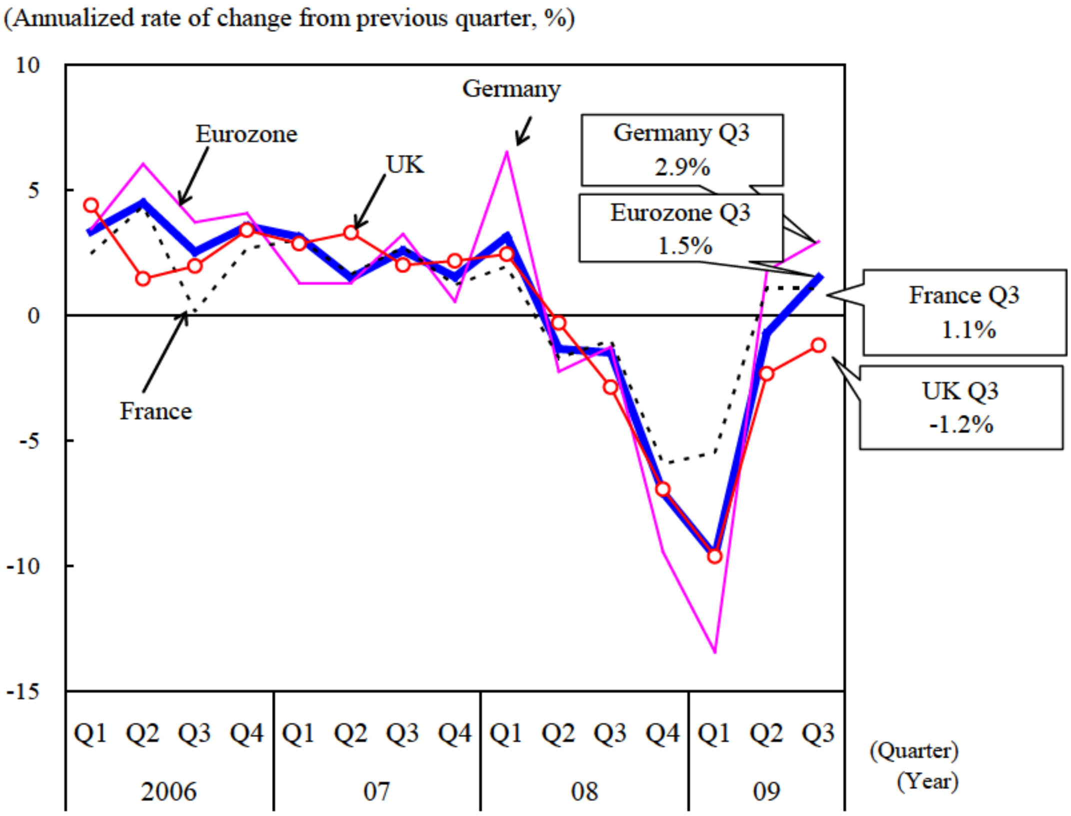
If worldwide demand increases more than expected accompanied with world economic recovery, the economic recovery pace might accelerate through expansion of exports.

§2. European Economic Outlook and Risks

1. European economic outlook – Economy will be picking up only slowly.

- It is expected that European economy will gradually pick up in 2010, but its pace seems to be very slow due to reduced or termination of policy support measures such as car scrap incentive, ongoing credit crunch and worsening employment.
- As for domestic demand, downward pressure on consumptions is strong due to worsening employment conditions. As for foreign demand, it would take a fair amount of time to the full recovery of export to major trading partners i.e., the US, Russia and Central/Eastern Europe. Given these circumstances, the real economic growth rate in 2010 is expected to be less than 1%.

Figure 3-2-1 Real GDP Growth Rate of Major European Countries



(Note) Source: Statistical Office of the European Commission (EUROSTAT), Federal Statistical Office of Germany, Institut national de la statistique et des etudes economiques (INSEE) and Bureau of Statistics, UK

Table 3-2-2 Forecast by Major International Institutions

		2009	2010
Office of Management and Budget (as of 25 Auguust)		-2.8	2.0
Congressional Budget Office (as of 25 August)		-2.5	1.7
OECD (as of 19 November)		-2.5	2.5
IMF (as of 1 October)		-2.7	1.5
Blue chip (Private forcasters) (as of 10 November)	Top 10	-2.4	3.4
	Average	-2.4	2.7
	Bottom 10	-2.5	2.0

(Note) Source: US Department of Commerce, US Office of Management and Budget, US Congressional Budget Office, "Economic Outlook 86"(19 November 2009), OECD, "World Economic Outlook"(1 October 2009), IMF and Blue Chip Economic Indicators (10 November 2009)

2. Risk factors associated with outlook

Although European economy has leveled off, it is highly dependent on policy support and lacks the source of self-sustained recovery. It is also highly uncertain since the vicious cycle between financial crisis and worsening real economy continues. The risk surrounding the outlook is skewed to the downside.

<Downside risk>

(i) Protracted vicious cycle between financial market and real economy due to delay in taking measures for nonperforming loans

In Europe, about 60% of potential loss (Eurozone: about 800 billion dollars and UK: about 600 billion dollars) have not been dealt with (neither written-off nor made allowance). The lending standards of financial institutions in Eurozone are still strict. The credit crunch continues.

(ii) Negative effect on financial/real economy due to protracted economic stagnation in Central/Eastern Europe

In Central/Eastern European countries, the economic stagnation has continued since the end of 2008 as a result of the financial crisis and they (Hungary, Latvia, Rumania, Poland, etc.) have received financial support from IMF and EU. Financial institutions in Austria and Sweden which have large exposure to Central/Eastern Europe are facing worsening business conditions due to increased non-performing loans, leading to the destabilization of financial systems in Europe as a whole.

(iii) Worse-than-expected employment situation

The worsening unemployment rate beyond expectation might place downward pressure on private consumptions through worsening income environment.

(iv) Increase in long-term interest rates associated with increase in fiscal deficit

The interest spreads between the yield of German government bond and that of Irish, Greek and Italian government bonds have expanded due to concerns over fiscal sustainability, etc. Although the spreads have narrowed from their peaks in February 2009, if they expand again, consumption and investment would be depressed and that might be drag on economic recovery.

(v) Negative influences on the economy due to a premature reversal in emergency fiscal/monetary policy

European Commission clarified the targets and pace of fiscal consolidation for 13 countries in November 2009. Each country will start the fiscal consolidation by 2011 at the latest and improve annual structural fiscal balance by 0.5 to 2 points (see §2 of Chapter 2). However, since output gap is expected to expand even in 2010 in many countries, the timing of fiscal consolidation might be too early compared to the current situation and outlook of the economy.

<Upside risks>

Expansion of exports accompanied with better-than-expected world economic recovery

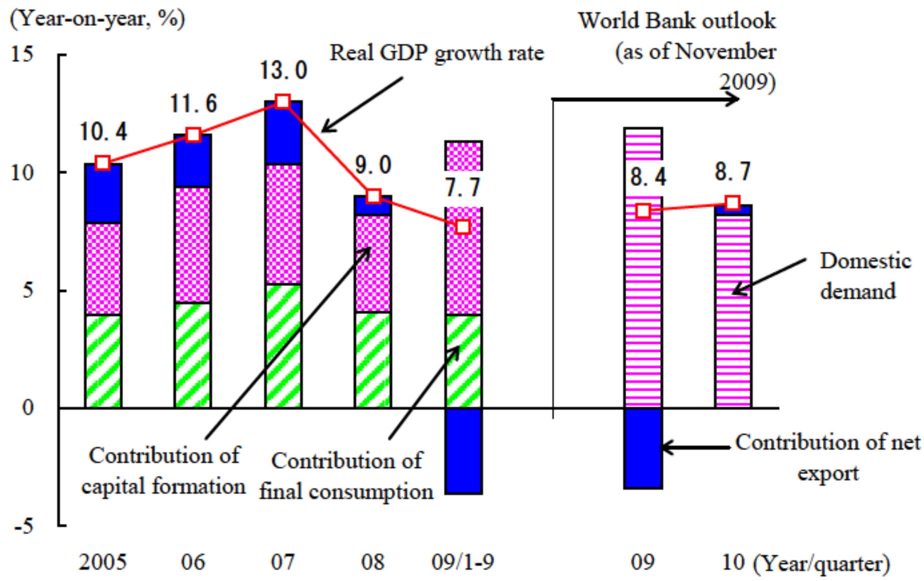
Exports to outside Eurozone have increased due mainly to the demand in China and other Asian countries. If the economies of the US and Central/Eastern European countries, i.e., major export markets, pick up more than expected in the future due to effects of economic-stimulus packages, progress in inventory adjustment, etc., Overtime, the benefits would spread from exports to production, employment and consumption resulting in a faster-than-expected recovery.

§3. Asian Economic Outlook and Risks

1. Asian Economic Outlook – Recovery trend continues.

- Chinese economy will continue to show a recovery trend in 2010 since domestic demand is expected to remain strong while exports, mainly to the US and Europe, are still weak. The growth rate is expected to further increase with full-scale recovery of the US and European economy in the future.
- Korea, Taiwan and ASEAN are expected to be on a recovery trend since exports to China will remain strong. However, the full-scale recovery would keep in line with the US and European economic recovery.
- In India, the decrease in agricultural production due to a serious shortage of rain in monsoon season in 2009 will have a negative impact on individual income and the recovery speed seems to be slower compared to the past economic expansion phase.

Figure 3-3-1 Chinese Real GDP Growth Rate and Contribution of Domestic Demand and Net Export



(Note) Source: National Bureau of Statistics of China and World Bank

Table 3-3-2 Outlook of Asian Countries' Real GDP Growth Rate

(Year-on-year, %)

	IMF (as of October 2009)		ADB (as of September 2009)		OECD (as of November 2009)	
	2009	2010	2009	2010	2009	2010
China	8.5	9.0	8.2	8.9	8.3	10.2
Korea	-1.0	3.6	-2.0	4.0	0.1	4.4
Taiwan	-4.1	3.7	-4.9	2.4	—	—
Singapore	-3.3	4.1	-5.0	3.5	—	—
Thailand	-3.5	3.7	-3.2	3.0	—	—
Malaysia	-3.6	2.5	-3.1	4.2	—	—
Indonesia	4.0	4.8	4.3	5.4	4.5	5.3
India	5.4	6.4	6.0	7.0	6.1	7.3

(Notes) 1. Source: "World Economic Outlook", (as of 1 October 2009) IMF,
"Asian Development Outlook 2009 Update", (as of 22 September 2009) ADB and
"Economic Outlook 86", (as of 19 November 2009) OECD
2. ADB and OECD outlooks of India are fiscal year (from April to next March) outlooks.

2. Risk factors associated with economic outlook

As for short-term prospect of Asian economy, the following both downside and upside risks are expected. Overall, upside and downside risks are balanced.

<Downside risks>

(i) Sluggishness of exports accompanied with the protracted recession of developed countries

In the US and Europe, there is a risk of continuing economic downturn due to continued credit crunch and worsening employment situation. If so, the full-scale economic recovery might be delayed in Korea, Taiwan, Singapore and other countries with a small domestic market and even Chinese growth rate might decrease.

(ii) Asset bubbles in China widening (gap between asset price increase and fundamentals)

Real estate prices have significantly increased in parts of China. If there is an excessive gap between such increase and fundamentals, <u>it is possible to adopt tight monetary policy. If that policy effect is stronger than expected, domestic demand would become weaker and might cause downturn in economy</u>. In addition, due to downturn in Chinese economy, the economy in Korea, Taiwan, etc. in which increased exports to China is one of factors to pick up economy might also be slowing.

(iii) Excessive appreciation of currency exchange rate in some countries/regions

In some Asian countries such as Korea and Taiwan, rapid appreciation of currency exchange rate has been seen. Particularly in Korea, sharp depreciation of the won immediately after the world financial crisis may be one of factors to pick up exports. However, if the appreciation of currency exchange rate continues, it would have an effect on price competitiveness and the recovery of exports might be pausing.

<Upside risks>

(i) Expansion of exports accompanied with better-than-expected world economic recovery

If worldwide demand increases more than expected accompanied with world economic recovery, the recovery of exports would become faster and the economic recovery pace might accelerate.

(ii) Better-than-expected increase in Chinese household consumption

If Chinese household consumption increases more than expected due to additional consumption-stimulus policies and asset effects of rise in stocks etc., the economic recovery pace might be faster in not only China but also Korea, Taiwan and other countries through further increase in exports to China.

§4. World Economic Outlook and Risks

1. World Economic Outlook - moderate recovery

- In Asia, since positive trend toward economic recovery will expand mainly in China and the economy of developed countries will be gradually picking up, it is expected that the pace of recovery of world economy will be moderate and growth rates will gradually increase in 2010.
- However, since it is expected that the recovery pace of the US economy which accounts for one-quarter of the world GDP will be slow, the world economic recovery pace will be slow and the growth rate would remain at the 2% level in 2010.

2. Risk factors associated with economic outlook

There are both upside and downside risks associated with economic outlook, but the risk is skewed to downside.

<Downside risks>

(i) Vicious cycle between credit crunch and worsening real economy in the US and Europe

In the US and Europe, financial institutions' write-offs of nonperforming loans have been delayed and their lending standards are still strict. If the economy is stagnant and corporate profits and employment are worsened due to protracted credit crunch, there would be a risk to fall into the vicious cycle that bad assets further increase due to corporate bankruptcies and increase in past due loans to households and that causes further credit crunch. If so, the US and European economic recovery would be significantly delayed and the world economic recovery pace would be very slow.

(ii) Worse-than-expected employment situation

In the US and Europe, the employment situations continue to worsen and the unemployment rates will continue to increase. If worse-than-expected employment situation is seen, that might place downward pressure on private consumption through worsening income environment.

(iii) Negative influences on the economy due to a premature reversal in emergency fiscal and monetary policy

After the world financial and economic crisis, each government and central bank conducted first-ever large-scale fiscal and monetary expansion policies to support each country's economy. In the process of changing these policies, however, <u>if the timing of starting fiscal consolidation or monetary tightening is too early or the pace of the change is too fast, that might interfere with economic recovery</u> (see Chapter 2).

(iv) International financial market disruption caused by the sharp depreciation of the dollar and the plunge in the price of US government bonds

If the market had concerned about fiscal sustainability of the US and the credibility of the dollar had been lost, it would be possible to occur the plunge in the price of US government bonds which are issued in large numbers and the sharp depreciation of the dollar. Since the U.S. dollar is a key currency, it might lead to the situation that many trades and capital transactions are disrupted, values of government- or financial institution-owned dollar-denominated assets fall sharply and international financial market falls into turmoil, having significant impact on the real economy.

(v) Increase in the price of crude oil

As for the price of crude oil, after significantly decreasing from 145 dollars in July 2008 to 34 dollars in December 2008, it has risen to around 80 dollars since October 2009 (as of November 2009). If the price of crude oil continues to rise, that might place downward pressure on consumptions of crude oil-importing countries (especially the US) through worsening terms of trade.

(vi) Spread of Influenza A (H1N1)

If the number of infected people rapidly increases or the case-fatality rate increases due to mutation in the virus, business activities, e.g., production activities and tourism industry, would be seriously affected.

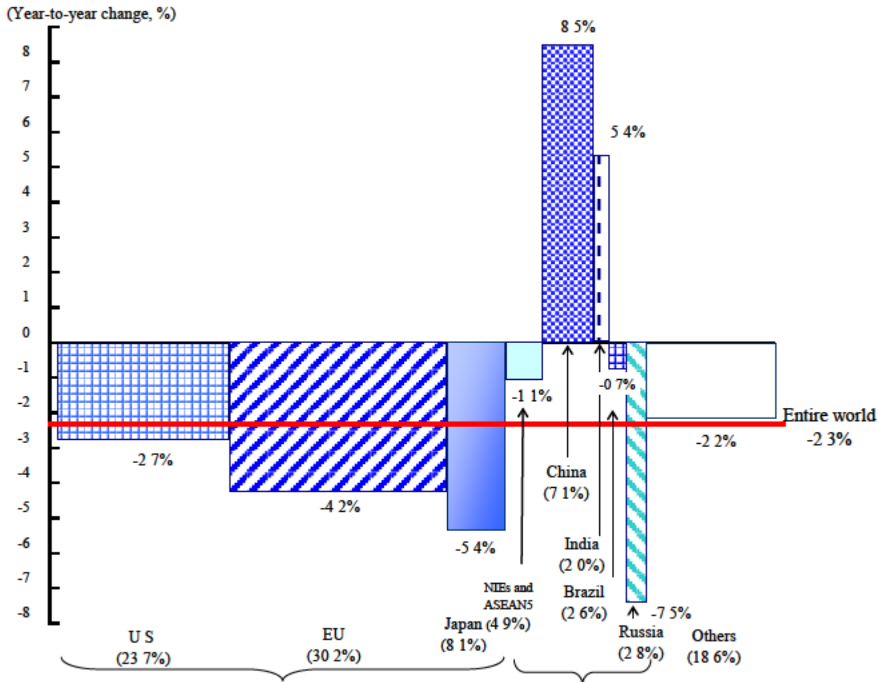
<Upside risks>

Expansion of exports accompanied with better-than-expected world economic recovery

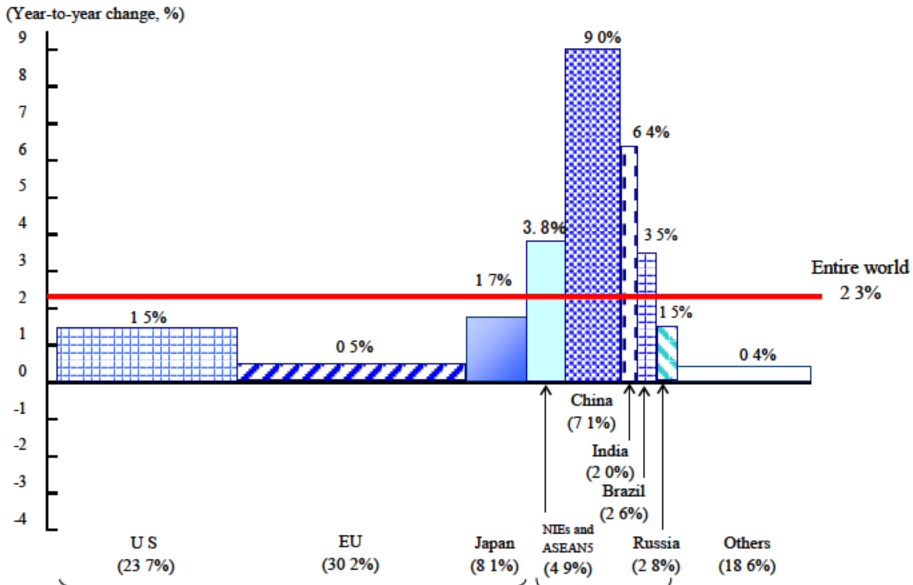
If worldwide demand increases more than expected accompanied with world economic recovery, the recovery of exports would become faster and the economic recovery might be accelerated.

Figure 3-4-1 IMF's Economic Growth Outlook and Impact on World Economy

（1）Real GDP Growth Estimates for 2009



（2）Real GDP Growth Estimates for 2010



(Notes) 1 Source: "World Economic Outlook Database, October 2009", IMF
2 The horizontal axis indicates countries' and country groups' shares of nominal world GDP(percentage shares in parentheses) Areas for countries and country groups can be interpreted as representing their impacts on the world economy
3 "Others" include about 140 countries such as Middle Eastern, African,South American and CIS countries(not including Russia)
4 Above figures are based on market exchange rates

Table 3-4-2 International institutions' Economic Outlook for Major Countries and Regions

Real economic growth

<World economy> (Year-to-year change, %)

International institution	2007	2008	2009	Outlook for 2010	
	(Actual)	(Actual)	(Estimates)	June 2009	November 2009
IMF (based on market exchange rate)	3.8	1.8	-2.3	1.0	2.3
IMF (based on purchasing power parity)	5.2	3.0	-1.1	1.9	3.1
European Commission	5.1	3.1	-1.2	1.9	3.1

<Country-by-Country Growth (average forecast of 3 institutions)> (Year-to-year change, %)

Country/Region		2007	2008	2009	Outlook for 2010	
		(Actual)	(Actual)	(Estimates)	June 2009	November 2009
U.S.		2.1	0.4	-2.5	0.0	2.1
Asia	Korea	5.1	2.3	-0.7	1.7	3.4
	China	13.0	9.2	8.5	7.9	9.6
	ASEAN 5(note2,3)	6.3	4.8	0.7	2.3	4.0
Europe	Europe 4(note2,3)	2.3	0.4	-4.2	-0.1	1.0
	Euro area	2.7	0.6	-4.0	-0.3	0.6

(Notes) 1. International institutions are IMF (as of 1 October 2009), OECD (as of 19 November 2009) and European Commission (as of 3 November 2009).

2. ASEAN 5:Indonesia, Malaysia, Philippines, Thailand and Vietnam.
Europe 4:Germany, France, Italy and the UK.

3. Actual figures and estimates for each country are simple average of data from the three international institutions. However,data for ASEAN 5 from the IMF. Europe 4 data are the four countries' data weighted by nominal GDP in 2008(simple averages of respective data from these institutions)

Table 3-4-3 Private Institutions' Economic Outlook for Major Countries and Regions

Real economic growth

(Year-to-year change, %)

	Country/Region	1999-2008 (Average for past 10 years)	2007 (Acutual)	2008 (Acutual)	2009 (Estimates)	Outlook for 2010 (June 2009)	Outlook for 2010 (November 2009)
World economy (33 countries/regions)		3.6	4.2	2.0	-1.8	2.2	3.0
Americas	U.S.	2.6	2.1	0.4	-2.4	1.8	2.7
Americas	Canada	2.9	2.5	0.4	-2.4	1.9	2.3
Americas	Mexico	2.9	3.3	1.3	-6.9	2.1	3.2
Americas	Brazil	3.3	5.7	5.1	0.1	3.1	4.3
Asia,Oceania	Northeast Asia	8.5	11.0	7.1	5.4	6.6	7.7
Asia,Oceania	China	9.8	13.0	9.0	8.2	8.1	9.1
Asia,Oceania	ASEAN	5.0	6.3	4.2	-0.0	3.2	4.4
Asia,Oceania	India	7.1	9.3	7.5	6.0	6.7	7.0
Asia,Oceania	Australia	3.3	4.2	2.3	0.6	1.6	2.2
Europe	Europe 4	1.8	2.3	0.4	-4.2	0.4	1.3
Europe	Euro area	2.1	2.7	0.6	-3.9	0.5	1.3
Europe	Russia	6.9	8.1	5.6	-7.2	1.2	3.0

(Notes) 1. Actual figures for countries are based on their respective statistics.
The outlook indicates average of the preivate institutions' forecast (published in August to November 2009).
Private institutions: Blue Chip (2009 and 2010, 52 companies), CREDIT SUISSE、 Economist Intelligence Unit, JP Morgan, Bank of Tokyo-Mitsubishi UFJ, Nomura Securities, Mitsubishi Research Institute, and Mizuho Research Institute.

2. The World economy (33 countries/regions) covers North and Latin America (4 countries), Asia and Oceania (10 countries and Taiwan) and Europe(18 countries).Northeast Asia covers China, Korea, Taiwan and Hong Kong.
ASEAN covers Singapore, Indonesia, Thailand, Malaysia and Philippines.
Europe 4 covers Germany, France, Italy and UK. The euro area covers 16 member countries (as of 1January 2009).

3. World economy figure is a total of the 33 economies' real economic growth rates weighted by nominal GDP (in 2008).
Figures for Northeast Asia, ASEAN and Europe 4 are calculated in the same way. Nominal GDP weights are the 33 economies' shares of their total nominal GDP.

4. Above values are based on market exchange rates.