Section 2 Major countries and regions: current status and issues

2. The European economy

(1) The European economy staggering at the bottom

For European countries, owing to the close ties that had hitherto been of such mutual benefit, the financial crisis that occurred in 2008 has decelerated the growth of trade and caused a negative chain reaction in financial markets[31].

Real GDP growth in the 27 EU member countries began to deteriorate under the influence of U.S. subprime loan problem in the fall of 2007. After the Lehman shock of September 2008 both domestic and external demand collapsed, and the GDP took a sharp downturn in the first quarter of 2009 (see Figure 1-2-2-1). After the summer of 2009, the economy bottomed out and gradually started to pick up; however, the situation varies from country to country.

The large-scale economic and monetary easing measures implemented by the various governments and central banks of each European country form a background to recovery. While the economies are still showing either negative growth or moderate recovery, the impact of the termination of support programs has been substantial. Since 2001, the EU has had a policy of reducing budget deficits by 0.5% of GDP, and each country is struggling to prepare an exit strategy. The following is an overview of each country and region.

(A) The Eurozone

Eurozone real GDP growth showed a sharp drop after the third quarter of 2008, influenced by the conditions of external demand, fixed capital investment and inventory adjustment (see Figure 1-2-2-2 and Figure 1-2-2-3). This is largely due to the stalled real estate market and a decrease in exports from each country, and in particular the drastic decline in German exports which account for 30% of Eurozone GDP.

In response to the rebound of exports and the progress of inventory adjustments, real GDP growth rate started to improve in the second quarter of 2009 and registered a positive growth in the third quarter of 2009. However, the pace of recovery is still slow.

As for Eurozone member countries' exports by partner, in 2009, exports to Asia, and in particular China, improved to pre-crisis levels. Meanwhile, exports to Europe, the U.S and Japan remain stagnant with no increase (see Figure 1-2-2-4). As for imports, intra-EU imports were sluggish both before and after the crisis and imports from the U.S, Japan and other Asian countries started to deteriorate at the end of 2008 (see Figure 1-2-2-5). However, an overview of total EU imports underlines the dominant influence of China. China is the top importer and generates 18.5% of all imports, a proportion which is significantly larger than that of the second importer, the U.S, at 11.1%[32].

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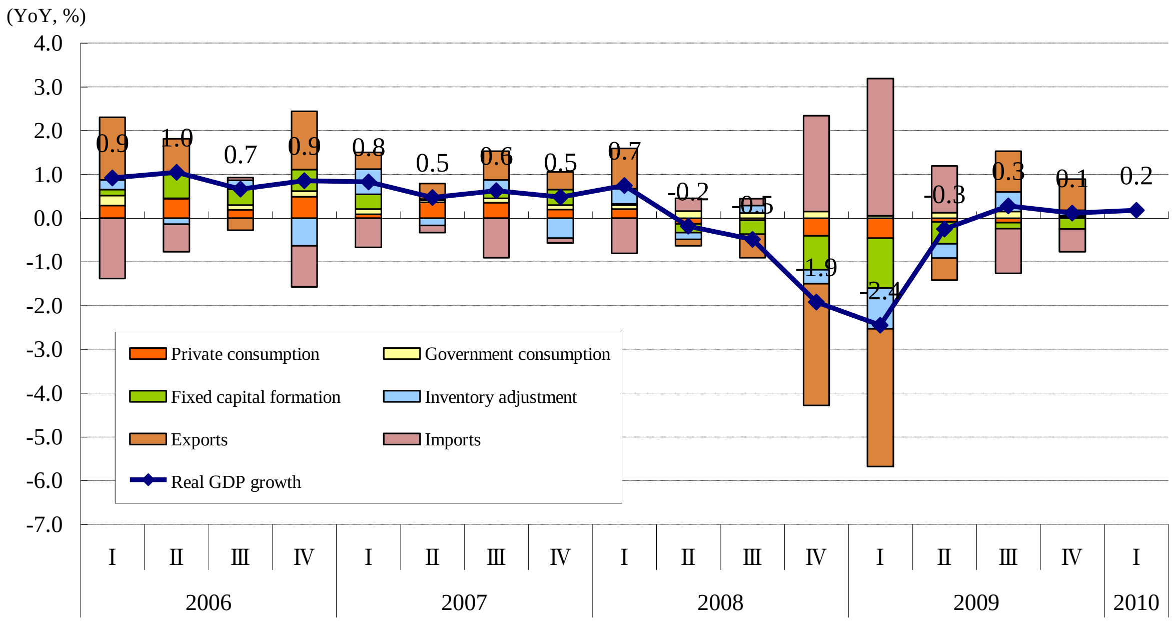
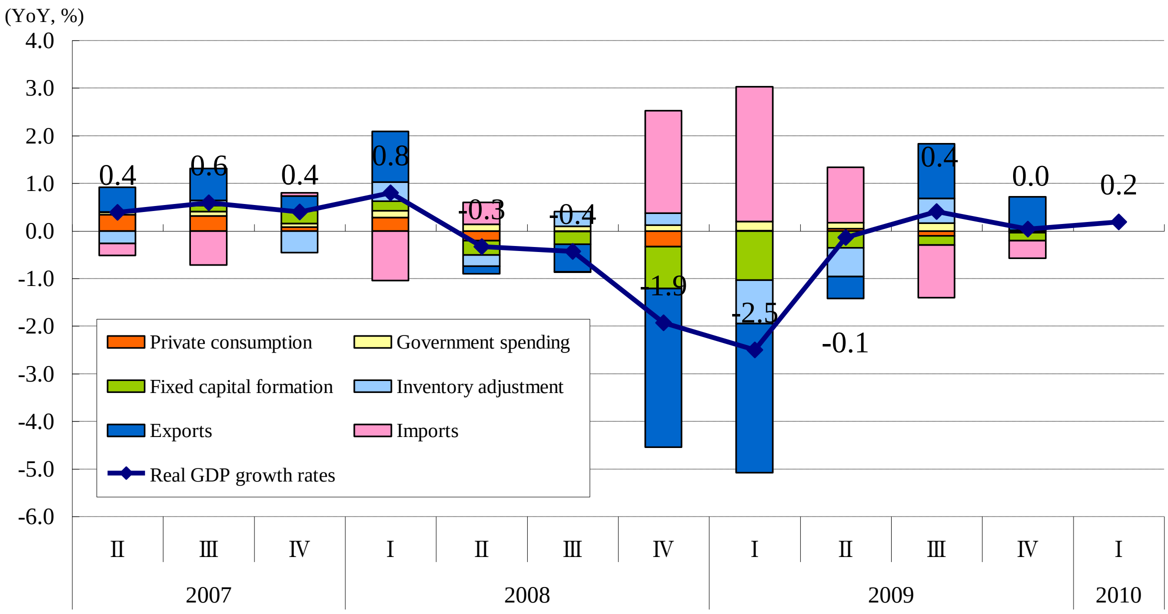
[31] Ministry of Economy, Trade and Industry (2009), "White Paper on International Economy and Trade 2009"
[32] World Trade Atlas

1-2-2-1 Trends in EU Real GDP Growth Rate



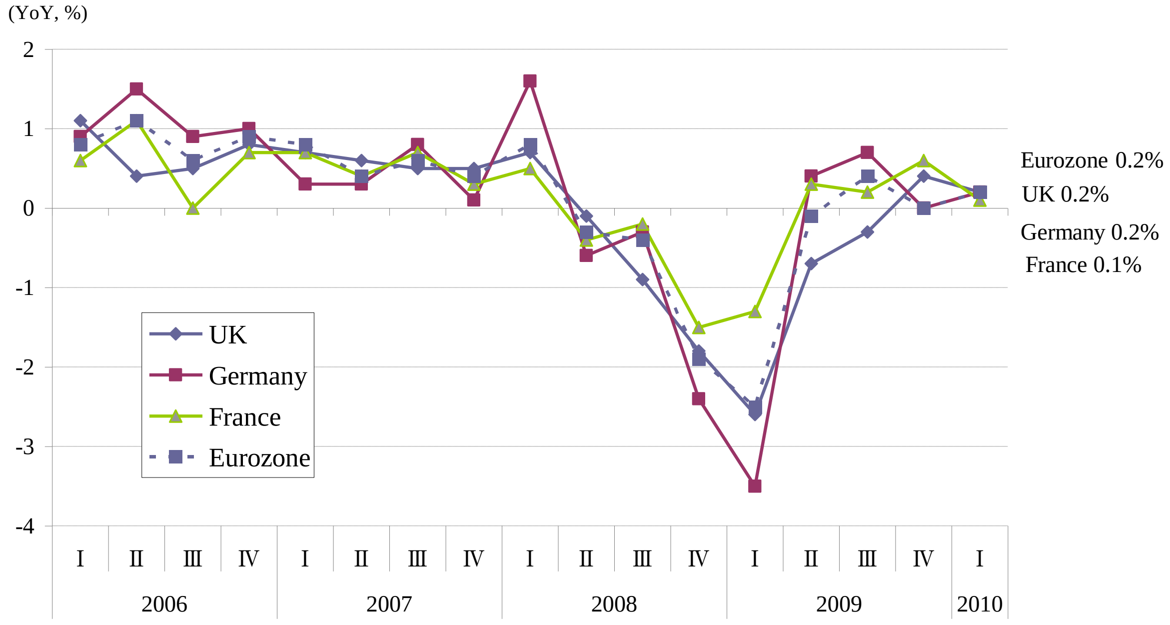
Notes: 1. Real GDP growth rate is preliminary (released on May 12, 2010).
2. All are seasonally adjusted.
Source: Eurostat

1-2-2-2 Trends in Eurozone Real GDP Growth Rates



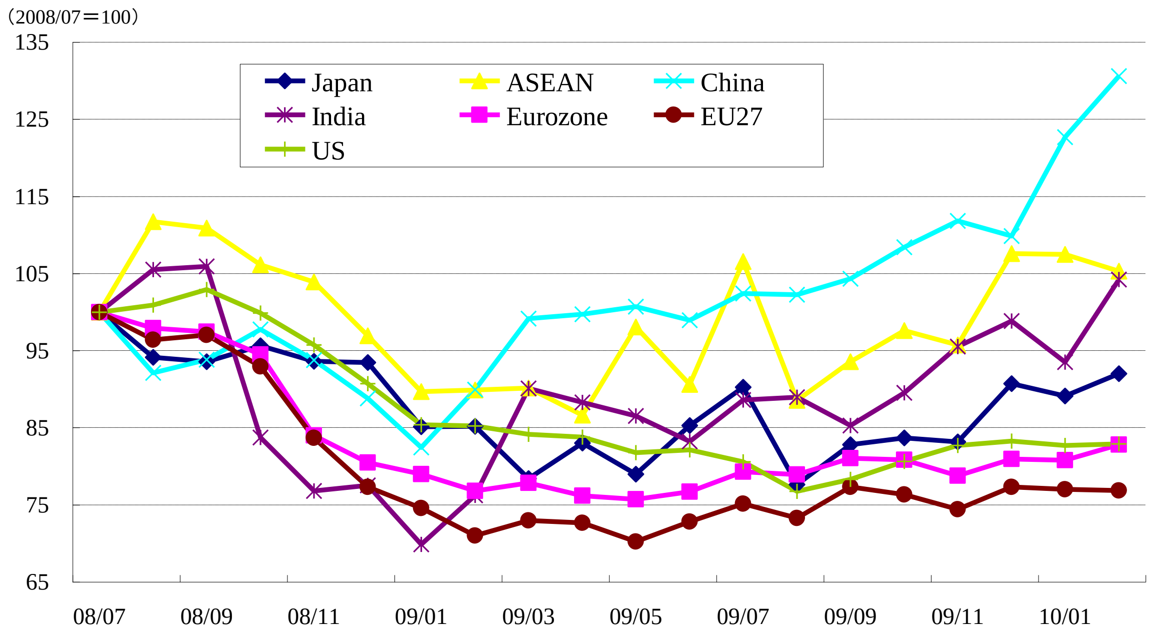
Notes: 1. Real GDP growth rates are preliminary data (released on May 12, 2010).
2. All data are seasonally adjusted.
Source: Eurostat.

1-2-2-3 Trends in UK and Major Eurozone Country Real GDP Growth Rates



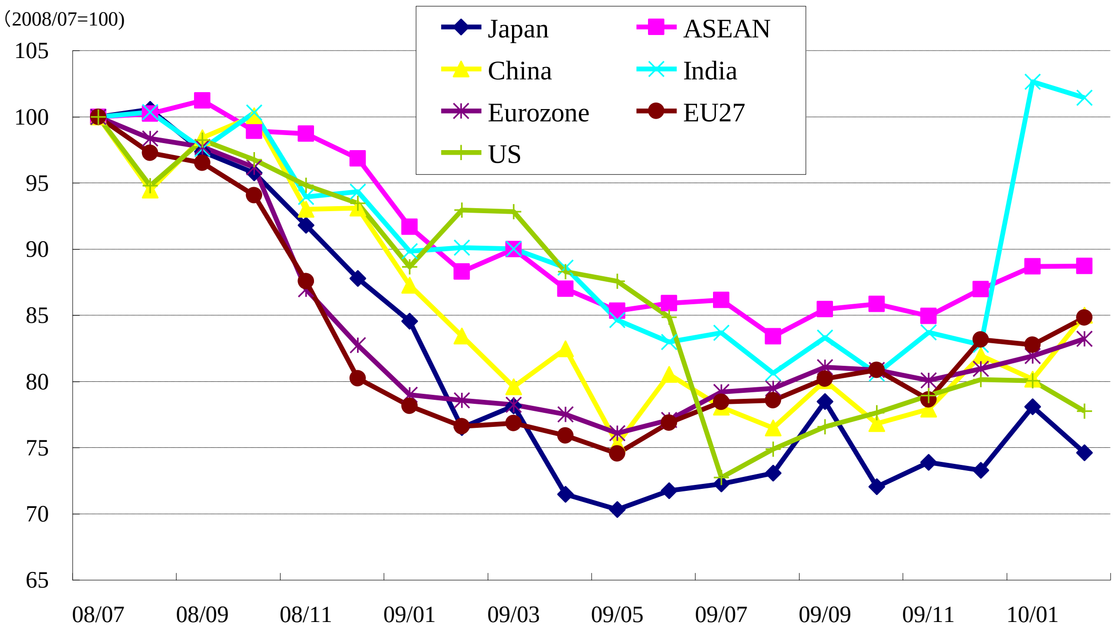
Note: Seasonally adjusted
Source: Eurostat

1-2-2-4 Trends in Eurozone Exports



Note: Seasonally adjusted export value. EU27 excludes eurozone.
Source: Eurostat

1-2-2-5 Trends in Eurozone Imports

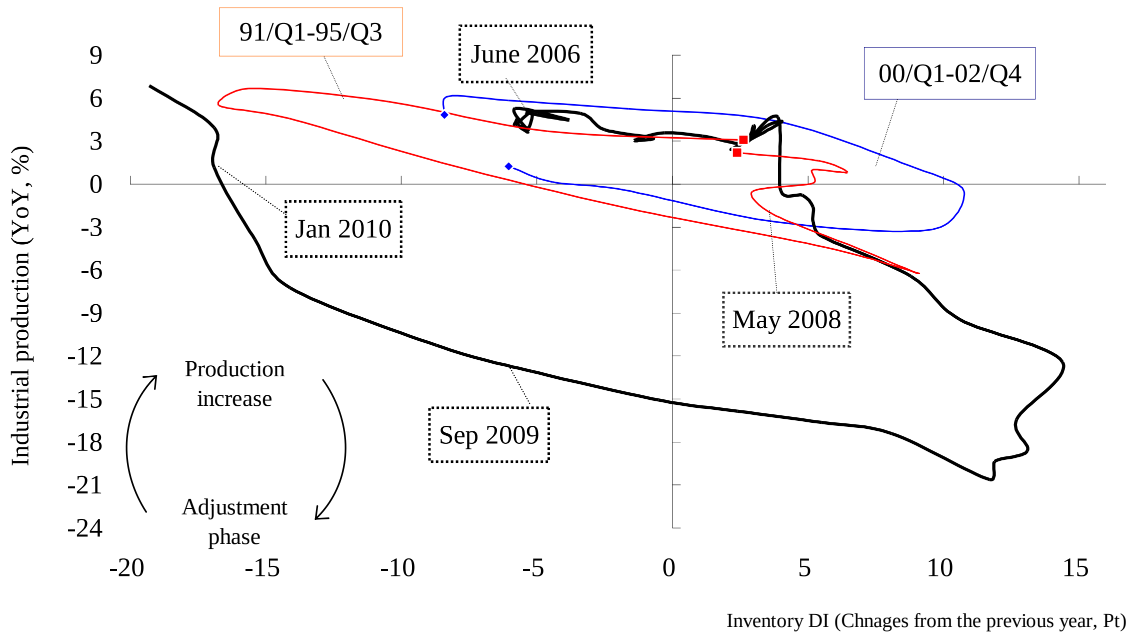


Note: Seasonally adjusted imports index. EU27 excludes eurozone.
Source: Eurostat.

Inventory adjustment, which along with shrinking demand had been one of the most compelling negative contributors, continues to progress. A graph of the inventory cycle shows that the conditions for production and inventory in the Eurozone have taken a favorable turn, shifting from an adjustment phase to a production-expansion phase (see Figure 1-2-2-6). Although production is improving partially due to the recovery of exports, operating rates are still low. Thus, it is likely to take a long time for companies' private capital investment to recover (see Figure 1-2-2-7).

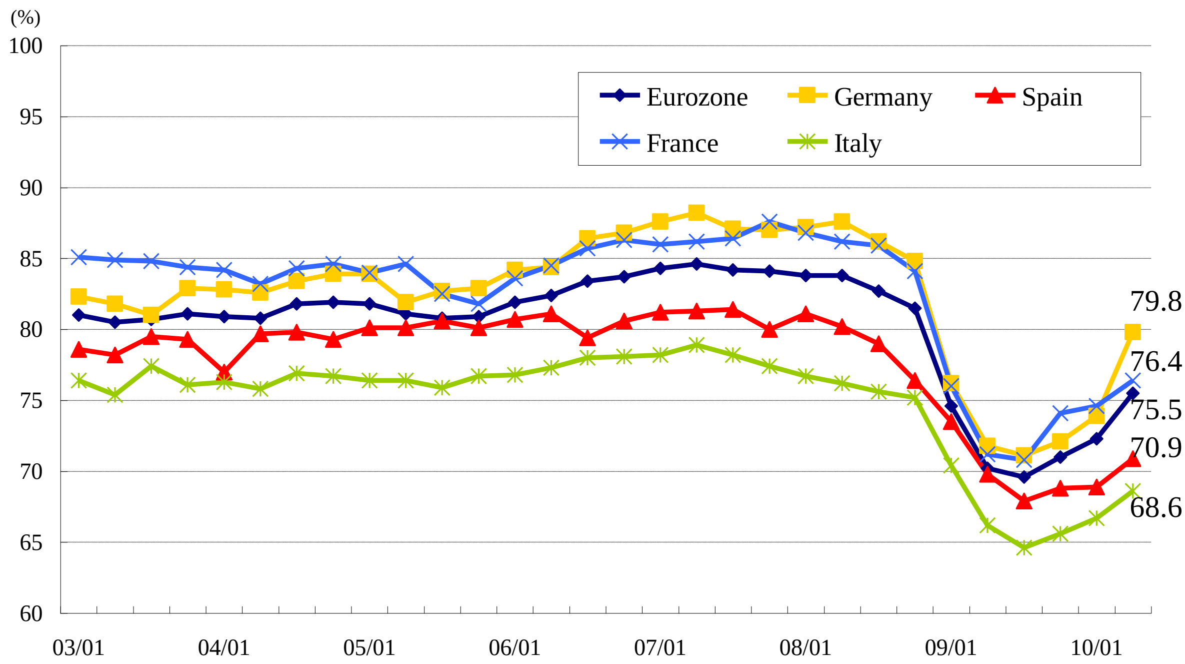
The extent of damage to the employment markets after the financial crisis largely widely by country. In particular, the trend in the unemployment rate of Spain contrasts with that of Germany. In Spain, the unemployment rate rose sharply after the Lehman shock of September 2008, and remains high, reaching more than 18% in 2010. By contrast, the unemployment rate in Germany has remained level at 7% even in the aftermath of the financial crisis (see Figure 1-2-2-8). This will be discussed greater detail later.

1-2-2-6 Inventory Circulation in Eurozone



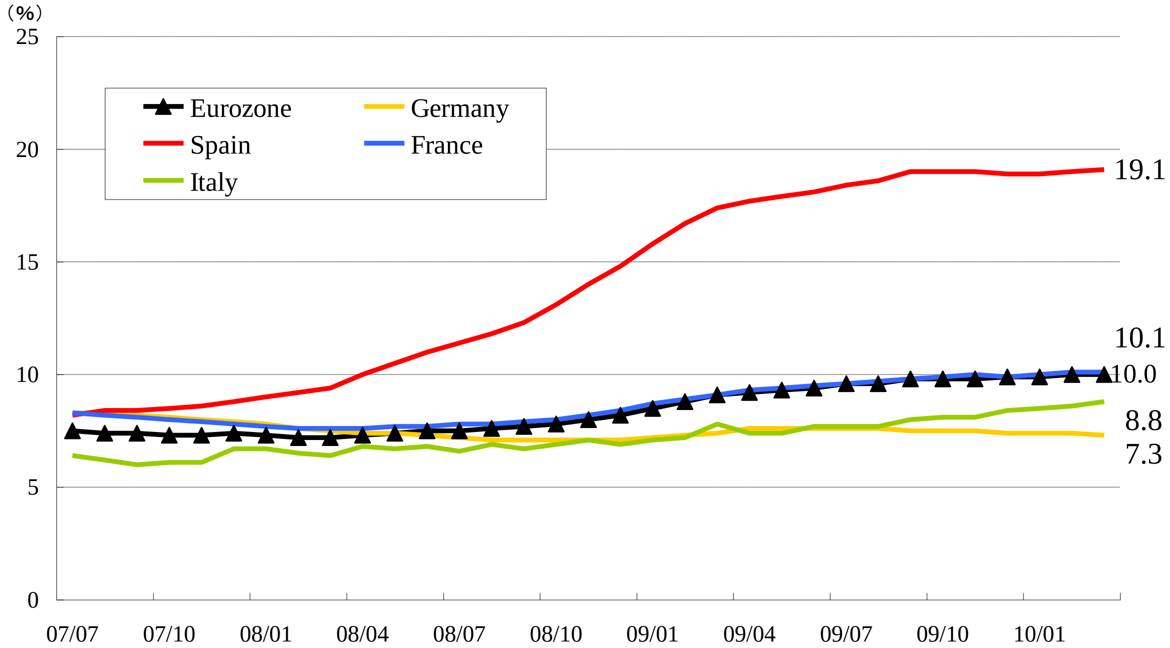
Note: The first quarter of 1991 to the third quarter of 1995 was affected by European currency crisis, [European Exchange Rate Mechanism (ERM) crisis].
The first quarter of 2000 to the fourth quarter of 2002 is the recession period due to the economic slow-down in the U.S.
Source: European Commission Survey, Eurostat

1-2-2-7 Eurozone Operating Ratio



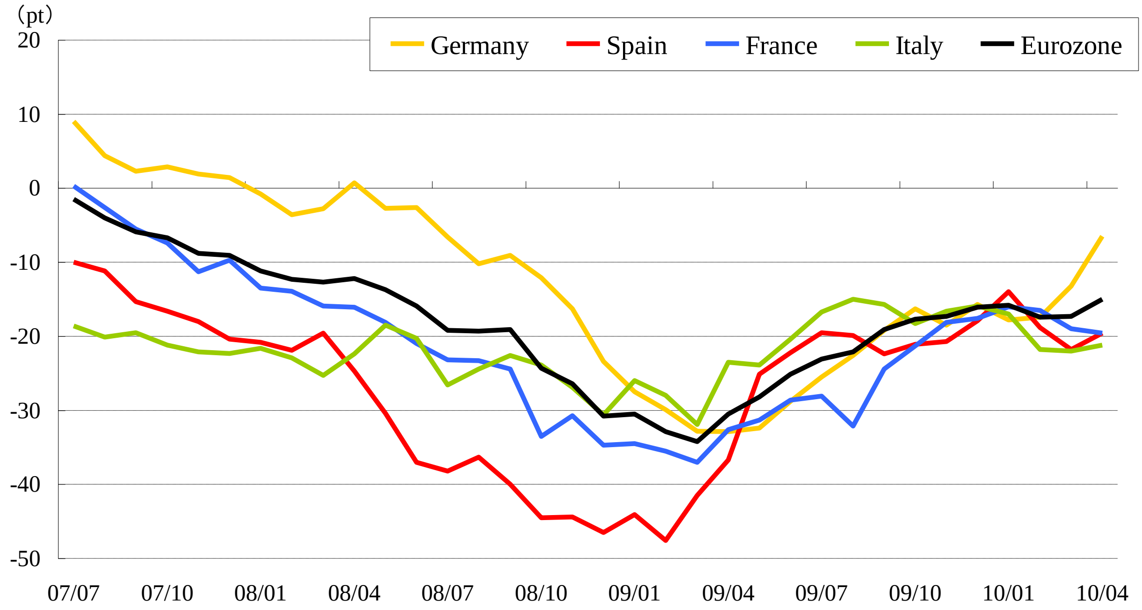
Source: European Commission Survey

1-2-2-8 Trends in Unemployment Rates for Major Eurozone Countries



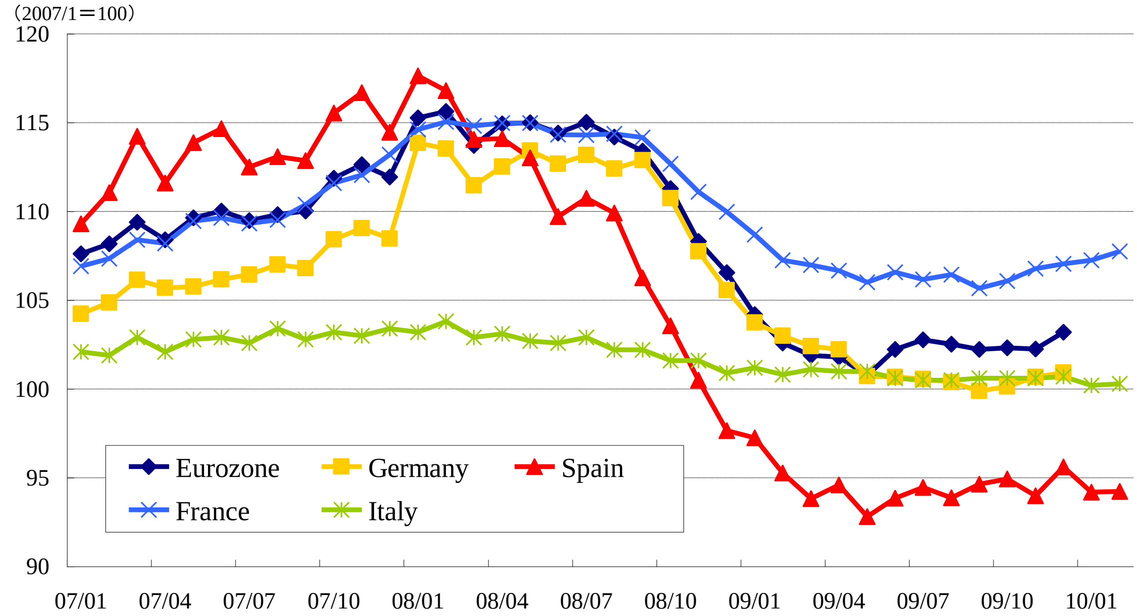
Note: Seasonally adjusted
Source: Eurostat

1-2-2-9 Trends in Eurozone Consumer Confidence Index



Notes: Consumer Confidence Index is calculated based on each DI of the following year of (a) financial market prospect, (b) economic forecast, (c) unemployment forecast and (c) saving estimate.
Source: European Commission Survey

1-2-2-10 Trends in Eurozone Retail Sales Index

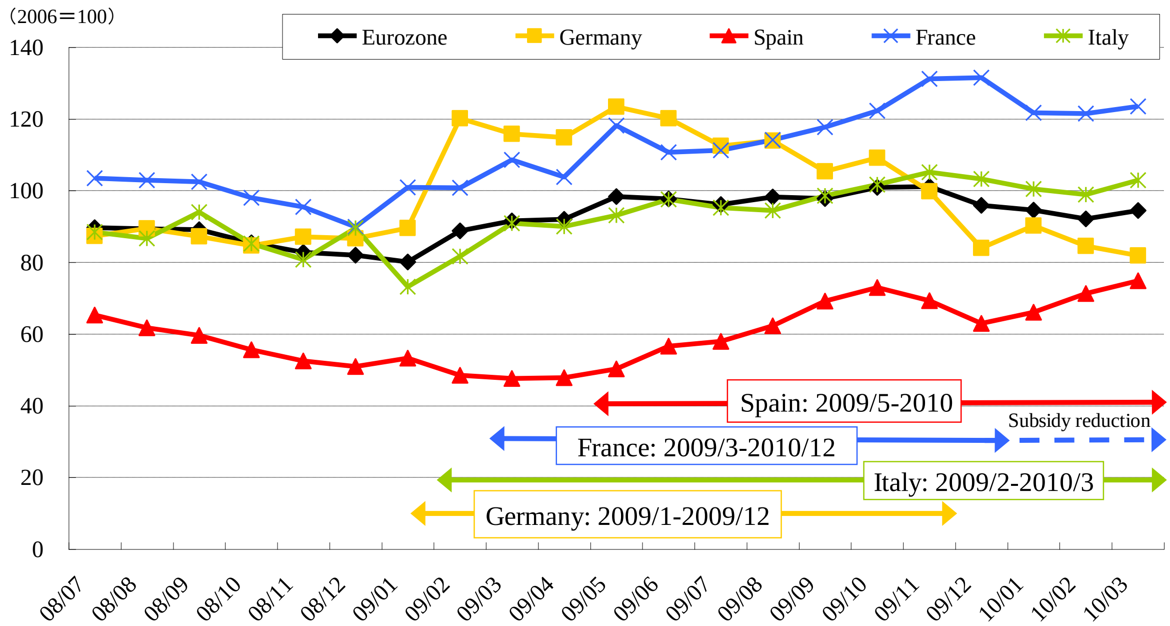


Note: Seasonally adjusted.

Source: Eurostat, National Institute of Statistics of Italy

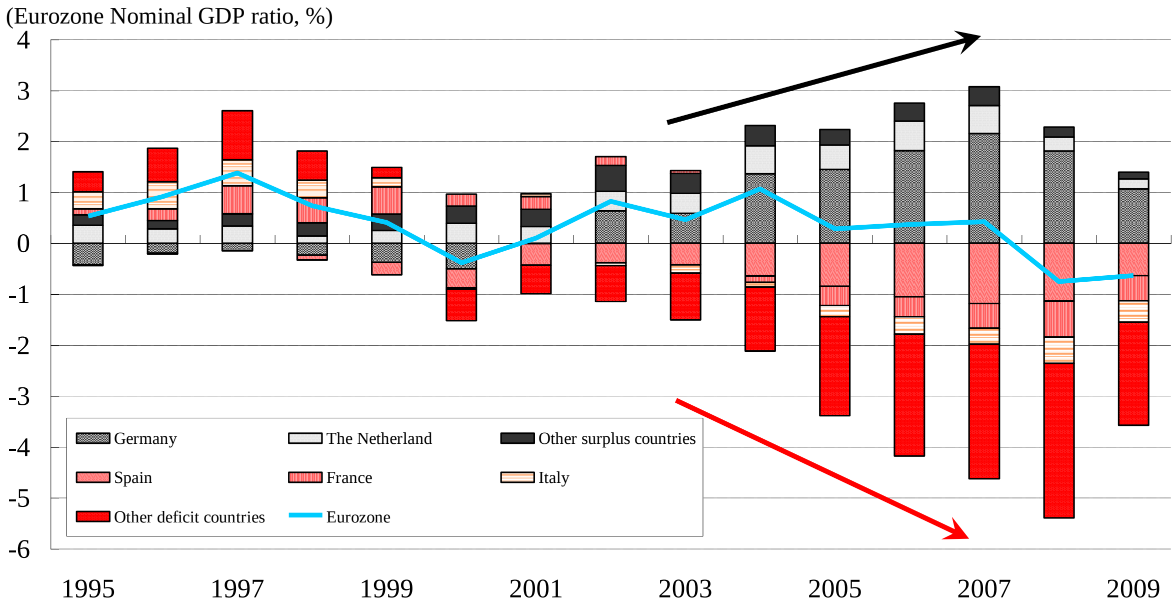
While the course the economy will take is unclear, no country has seen sizable improvement in consumer sentiment and the trend in personal consumption for all countries remains stagnant (see Figure 1-2-2-9). After the Lehman shock the retail sales index (which excludes automobile sales) of each country started to fall. Spain in particular experienced a rapid deterioration of her employment market and saw a steep drop in the index (see Figure 1-2-2-10). As for automobile sales, each country demonstrated a favorable trend owing to a series of automobile purchase support programs introduced in the first half of 2009. However, the termination of programs and the scaling down of support caused a last-minute surge in demand and its reverse effect, a drop in sales, and it would be difficult to describe the recovery as sound (see Figure 1-2-2-11). As long as economic reexpansion is moderate, it is likely to take a long time for employment, income and consumption to recover.

1-2-2-11 Trends in New Vehicle Registrations in Eurozone



Notes: 1. Seasonally adjusted.
2. The time period indicated in the graph is the period of new car purchase support measure implemented period.
Source: Eurostat

1-2-2-12 Trends in Current Account Balances Between Eurozone Countries

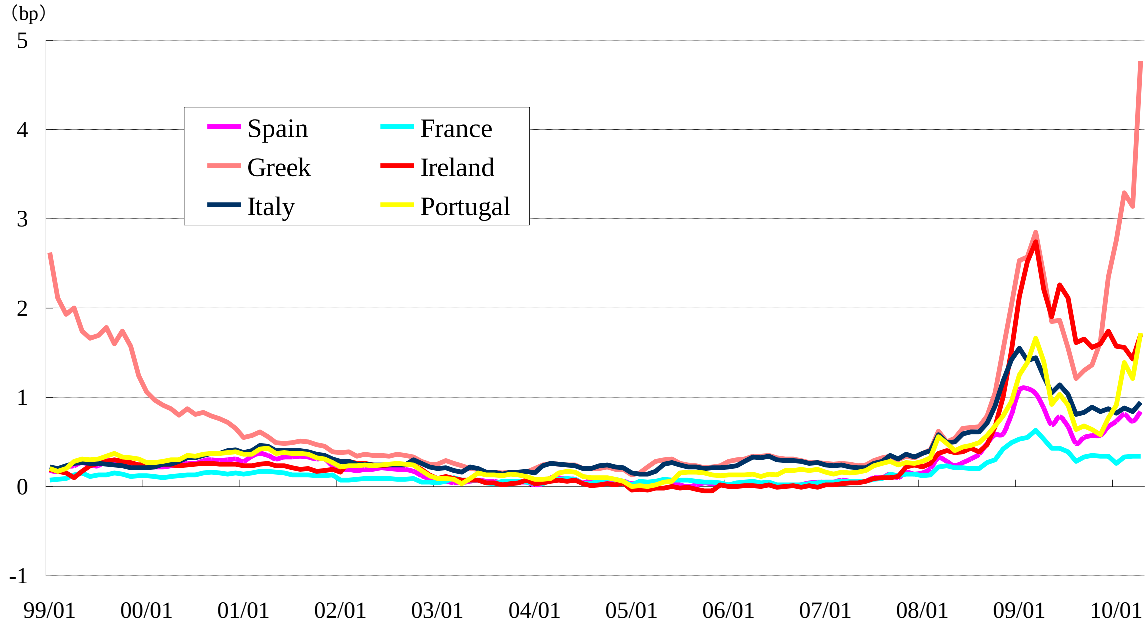


Notes: "Other surplus countries" are Belgium, Luxemburg, Austria and Finland. "Other deficit countries" includes Ireland, Greek and Portugal. Eurozone represents 12 countries excluding Cyprus, Malta, Slovenia and Slovakia.
Source: AMECO

With regard to currency unification in Europe, which introduced a unified currency, the euro, the centralization of authority over fiscal and exchange policy in the ECB has been pointed out as a problem because it does not allow interest rate adjustments that meet the requirements of each country. In addition, the exchange rate can be no longer be used to control current accounts. Thus, the imbalance of current accounts in the region remains uncorrected and has indeed expanded since the introduction of the euro (see Figure 1-2-2-12). In addition, when Eurozone member countries faced excess debt and their default risk rose, neither the EU nor the ECB had any policies to cope with the situation.

Meanwhile, in October 2009 Greece modified its current account deficit to GDP ratio from 3.7% to 12.7%, explaining that the former administration had underestimated the figure[33]. As a result, in December 2009 major rating agencies lowered the Greek Government Bond rating, and their value took a dive. Concern spread to other Eurozone member countries with straitened state finances, such as Italy, Spain, Portugal and Ireland, and this in turn has revealed many issues relating to the handling of sovereign risk within the euro area (see Figure 1-2-2-13, Figure 1-2-2-14 and Figure 1-2-2-15)

1-2-2-13 Yield Spread Against German Govt Bonds

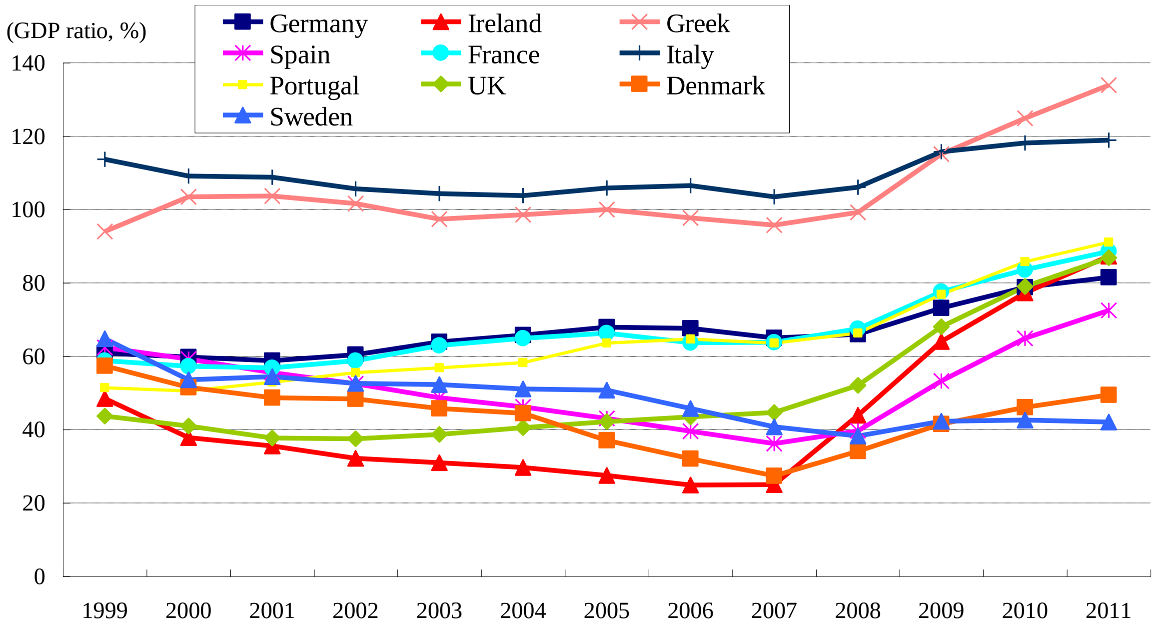


Notes: Difference between the yield of German 10-year maturity government bond (monthly) and the yild of 10-year maturity bond issued by other governments.

Source: ECB

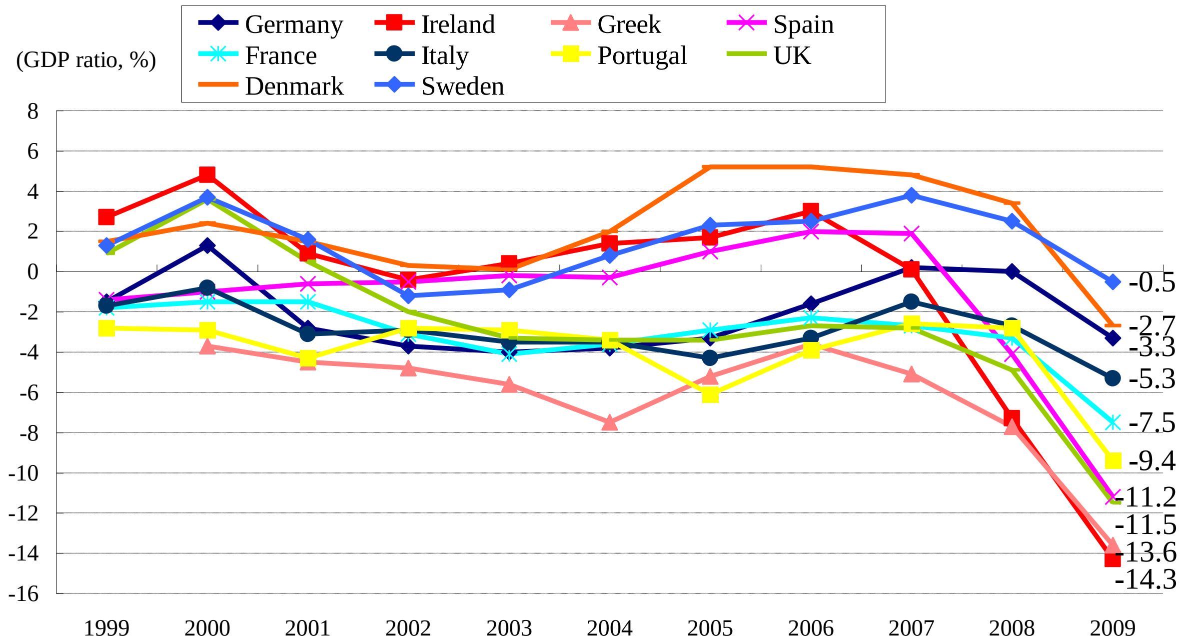
33 EUROSTAT revised Greek's budget deficit ratio to GDP upward from 12.7% to 13.6% as of April 22, 2010. In response to this revision, major rating agencies announced their policies to degrade Greek's national bonds one rank further and the prices of the bonds plunged in the market.

1-2-2-14 Govt Debt (General) for European Countries as Proportion of GDP



Note: Data for 2010 and onwards are estimate.
Source: AMECO

1-2-2-15 Fiscal Balance as Proportion of GDP for European Countries



Source: Eurostat

As a temporary remedy for the Greek problem[34], Eurozone member states, in alliance with the IMF,

[34] Paul De Grauwe (2010) "Crisis in the eurozone and how to deal with it" CEPS Policy Briefs, 2010.2 analyses that the reasons why the Greek Crisis became the crisis for all Eurozone are due to (i) the Greek government, (ii) the financial markets and (iii) authorities in the Eurozone. He raises points such as; (i) had the issue of falsification of records. (ii) is related to the issue that private rating agencies give rating to national bonds. As for (iii), each country in the Eurozone didn't immediately declare its position to support for Greek and ECB made the collateral eligibility requirements ambiguous. Furthermore, he proposes short-term measures such as (i) each EU member countries to swiftly act on the remedy, and (ii) Regarding the evaluation of collateral eligibility for repurchase agreements, ECB itself shall give rating for national bonds. In addition, as one of the medium-to-long term issues, he pointed out the enlarging disparity of the competitiveness within the zone and proposed to solve the issue by deepening the integration through EU version of IMF, EMF, and the establishment of common Euro bond market.

decided to accept Greece's request for assistance and offer financial support. To prepare for the future credit crisis, the Centre for European Policy Studies (CEPS), for example, has proposed the establishment a European Monetary Fund (EMF), an EU version of the IMF[35]. As a mid- to long-term solution, besides of course requiring that each country strengthen its fiscal management, it may be necessary to consider establishing this type of complementary institution[36].

(a) Germany

Real GDP growth in Germany, which accounts for 30% of Eurozone GDP, rebounded in the second quarter in 2009, supported by large-scale economic stimulus measures and a recovery in overseas demand. However, as adjustments in corporate employment and capital investment drag on, a downward trend is again emerging, in particular in personal consumption and fixed capital investment, and this is slowing the pace of recovery (see Figure 1-2-2-16).

The breakdown by destination of exports that contributed to the improvement of GDP growth confirms that the contribution of intra-EU exports is substantial. Despite their small scale[37], exports to Asia, primarily China, and non-Eurozone European countries have been relatively robust since the first half of 2009 (see Figure 1-2-2-17). Since the recovery of Europe as a whole is expected to be weak, one of the important challenges for German companies will be to expand export and develop sales routes out of Europe.

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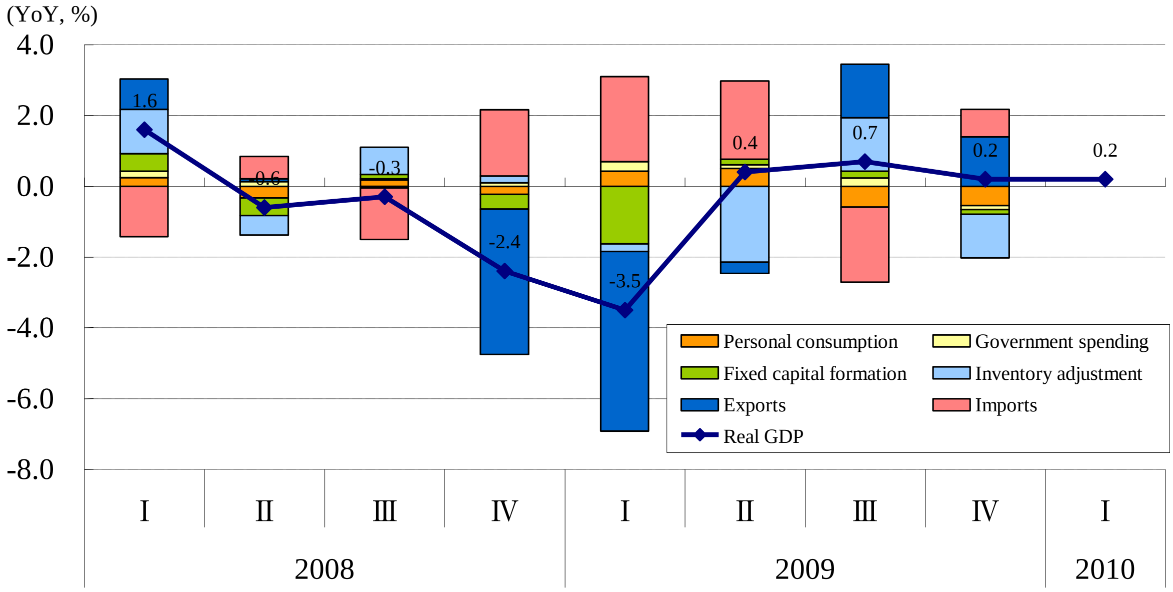
35 Daniel Gros and Thomas Mayer (2010), "How to deal with sovereign default in Europe: Towards a Euro(pean) Monetary Fund", CEPS Policy Briefs, 2010.2 proposes EMF as a structure which would be capable of organizing "an orderly default" at the outbreak of default nation problem. With this plan, a country that breached the public finance control criteria makes contributions and in principle, each country can take out funds within the limit of the contributions. For the withdrawal of funds that exceed the limitation, strict conditions and supervision will be mandatorily imposed. When the conditions cannot be satisfied, penalties will be assigned. Defaulting national bonds, after being set a certain haircut which is the assessment rate of collateral, should be exchanged with EMF bonds. (To be specific, for example, when a system is designed to evaluate national bonds of up to an amount equal to 60% of the GDP of the defaulting country, for a case that a debt-to-GDP ratio of 120% which is default, 60/120 (50%) of the national bonds will be exchanged with EMF bonds.) Under the system, countries that refuse to cooperate will be also assigned penalties.

36 Besides, while the integration of currency policies and fiscal policies progresses, there is an issue for the increasing disparity of the competitiveness of each economy within the region. European Commission (2010), "Quarterly Report on the Euro Area - Volume 9 No 1" analyzes the imbalance of current account balance and the enhancement of competitiveness disparity in the Eurozone. The report pointed out the possibility that the imbalance of current account balance reduced by the global financial crisis may rebound as well as the fact that the correction of the competitiveness disparity observed after the economic crisis was very limited. It also stresses that the Euro countries need to implement structural reforms to prevent further enhancement of disparity and deepen the economic cooperation.

37 The ratio of Germany's Asia-bound exports to its total exports stayed at 14% while its intra-EU exports marked 63% in 2009.

1-2-2-16 Trends in German Real GDP Growth Rate



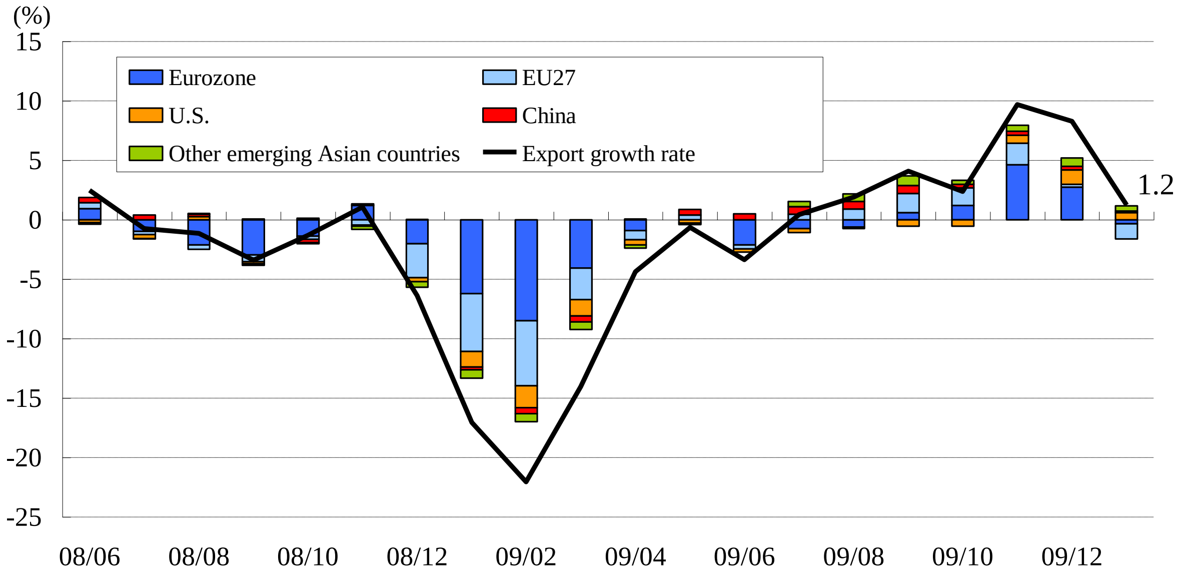
Notes: 1. Real GDP growth is preliminary (released on May 12, 2010)
2. All are seasonally adjusted.
Source: Eurostat

The Ifo Business Climate Index, which measures both the current situation and future expectations, shows firstly that the expectation index started improving sometime between November 2008 and January 2009, when economic stimulus plans were announced. Then all indexes were on an upward trend by the second quarter of 2009 (see Figure 1-2-2-18). Despite slow economic recovery, business confidence is improving.

From the outbreak of the financial crisis to the first half of 2009, the German government implemented two sets of large-scale economic stimulus packages worth, according to official announcements at the time, €50 billion each[38]. In addition, the (revised) Act to Accelerate Economic Growth was passed in the fall of 2009 and enacted in January 2010, offering measures including child allowance increases and inheritance tax reductions, in order to relieve €8.5 billion of the populace's financial burden.

[38] According to the information released by European Commission, from 2009 to 2010, Germany implemented an economic stimulus measures equivalent to some €90 billion of which actual fiscal spending is 3.6% of GDP.
Urgent economic measures established in December 21, 2008 include KfW Bankengruppe's expansion of loans for small-to-medium sized businesses, temporary revival of declining balance depreciation method, the increase in investment for "CO2 building rehabilitation programme", earlier implementation of transportation investment including noise measures and road development, the increase in the fiscal budget for Federal Ministry for Economy and Technology for "Regional Economic Development" which is a joint project of Federal government and State governments, the raise of limit to receive tax deduction for the maintenance and modification of housing by handicraftsman, exemption of automobile tax which can be applied up to 2 years for the purchase of automobile that satisfies certain environment criteria and enhancement of WeGebAU, a special program for older workers and people with low qualifications. In addition, "Pact for employment and stability" which is the second urgent economic measures formed in February 20, 2009 contains income tax reduction, lowering insurance fee for public health insurance system, the provision of Children bonus which is a temporary subsidy of €100 per children and the increase in child benefit for people unemployed for a long time, the enhancement of working hour reduction system, the investment for school, nursery home, hospital and road development, the support of research and development by small-to-medium sized businesses for climate conservation and energy-efficiency improvement and a new automobile purchase support program.

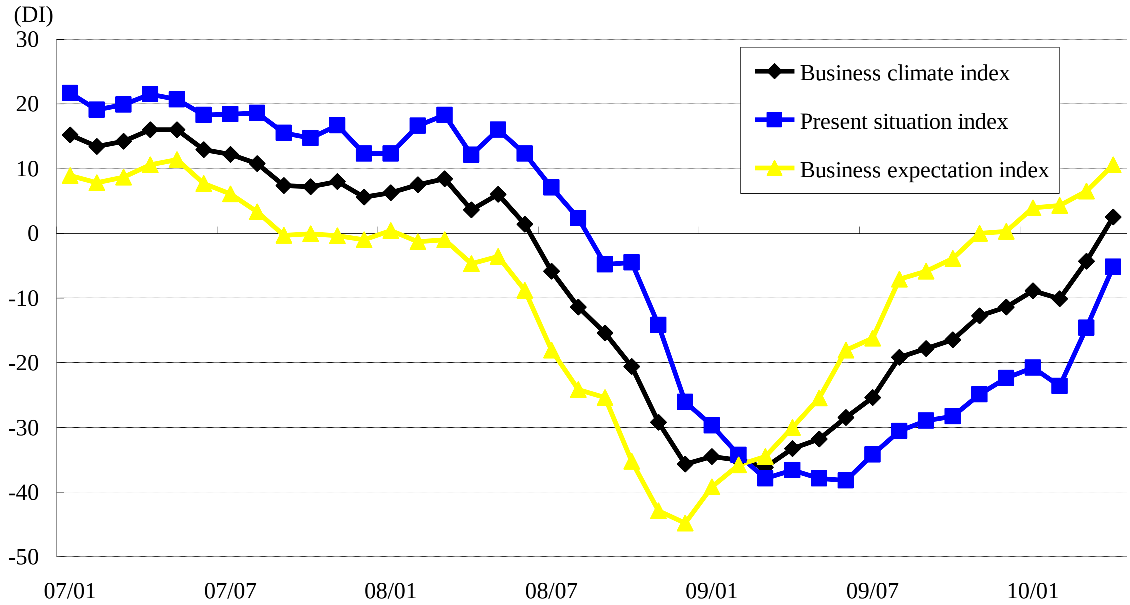
1-2-2-17 German Exports and Contributions of Each Export Destination



Notes: 1. Backward-looking three-month moving average, the comparison of the data with three-month prior one.
2. EU27 excludes eurozone. Other emerging Asian countries includes ASEAN, India, Korea, Hong Kong and Taiwan.

Source: World Trade Atlas

1-2-2-18 IFO Business Climate Index Trends



Note: Seasonally adjusted

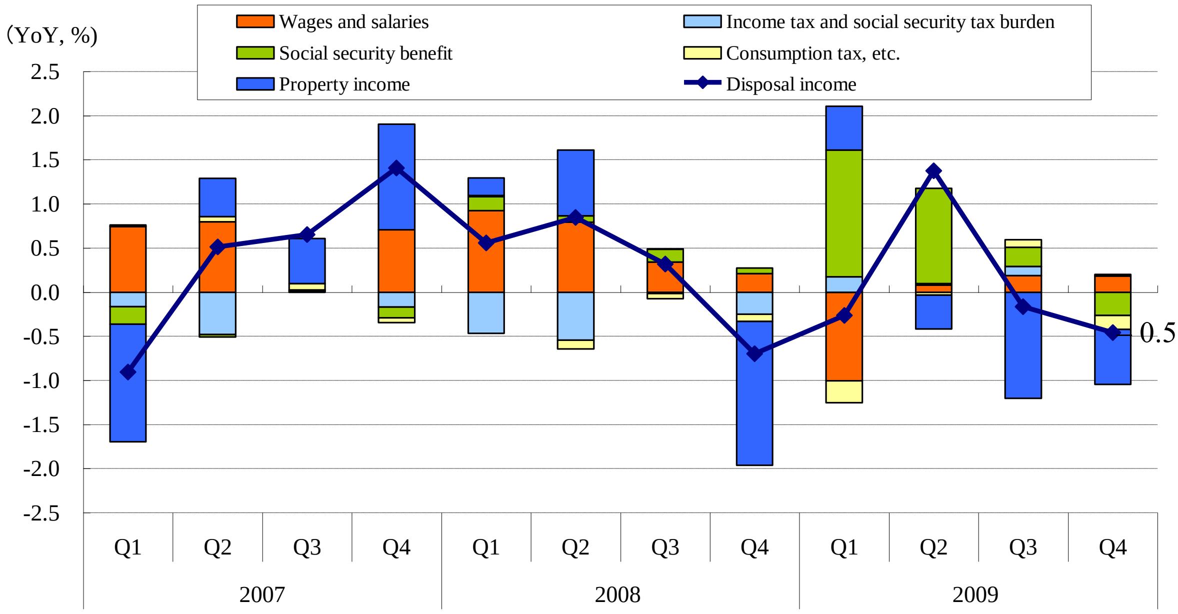
Source: IFO Institute

Among the programs, as mentioned earlier the enhancement of the wage compensation policy for employees with reduced working hours successfully contained the increase in unemployment, and the unemployment rate in Germany has been level since the summer of 2009. (See previous figure: The trend in the unemployment rate in the major Eurozone countries) Moreover, a new car-buyer support program[39], one of the direct consumption stimulus plans, had a considerable impact

[39] Subsidy of €2,500 is granted for the replacement of an automobile which is over 9 years with a new car which satisfies a certain environment criteria (including a second-hand model which was registered within a year). It was implemented from January 2009 to September 2009. Initial budget was €1.5 billion to cover 0.6 million cars, however, due to overwhelming response, the amount was increased to €5.0 billion for 2 million cars.

temporarily; however, negative growth followed the termination of the program as a result of its reverse effect. (See previous figure: The trend in new-car registration in the Eurozone.)

1-2-2-19 Trends in German Disposable Income and Contributions of Items of Expenditure



Note: "Consumption tax, etc" includes the tax on social security benefit.
Source: Federal Statistical Office

The trend in household income shows a significant decline in property income immediately after the financial crisis and disposable income registered minus 0.7% year-on-year growth. Later, wages and salaries drastically deteriorated as well, but started to improve with the support of social welfare payments. Tax cuts also served as a contributing factor; however, from the second half of 2009, disposable income took a negative turn due to a further drop in property income and reduced social welfare payments (see Figure 1-2-2-19). Under these conditions, consumer confidence remains low and it is likely to take some time for personal consumption to recover (Figure 1-2-2-9).

(b) France

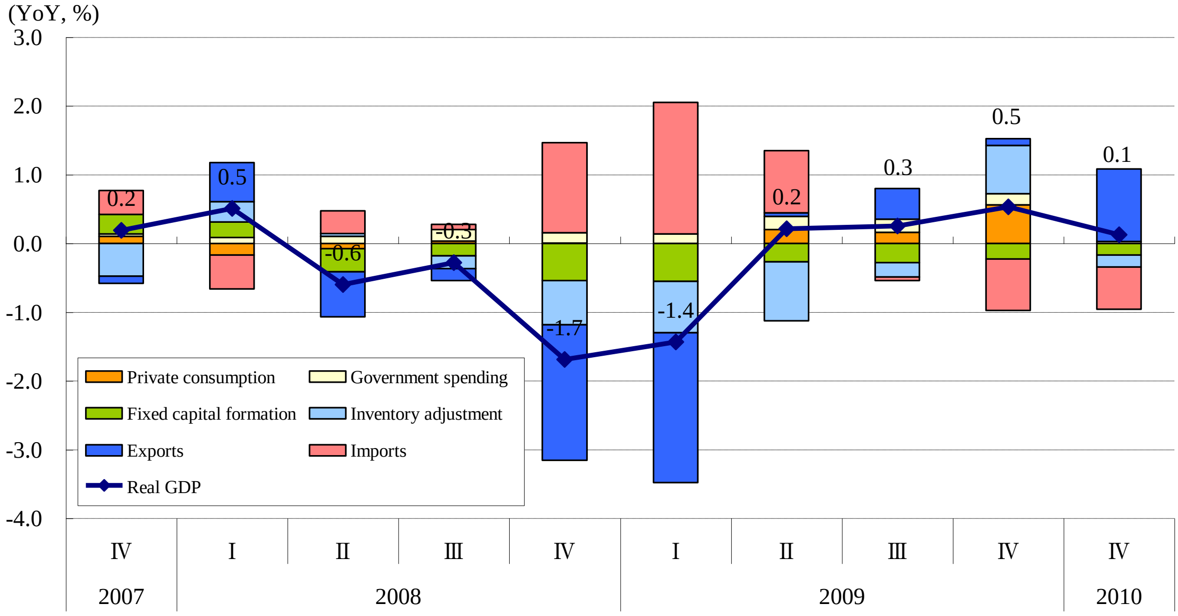
In France, the impact of the collapse of the housing bubble and the effect of the financial crisis on its microeconomy was contained at a relatively low level compared to other developed countries. From the second quarter of 2008, economic growth gradually lost pace, primarily on account of the formation of fixed capital, with growth in the fourth quarter of 2008, after the outbreak of the Lehman shock, down 1.7% from the previous term. However, the real GDP growth rate revived in the second quarter of 2009, primarily due to the recovery of transport machinery exports, and has maintained moderate growth (see Figure 1-2-2-20).

The French government brought into effect economic measures with the support of companies and industries at their core. In October 2008, immediately after the outbreak of the financial crisis, the government announced an economic stimulus plan[40] that included exemption from professional tax for new investments, the establishment of Sovereign Wealth Funds aimed at rescuing companies, and the creation of an ombudsman to oversee banks' corporate lending. Following this, in December

[40] It was reported that €175.0 billion would be spent in 3 years. The announcement was made in October 23, 2009.

2008, the government announced a further economic activation plan[41] as part of a comprehensive economic stimulus package, implementing the measures in 2009. The actual fiscal spending associated with the measures in 2009 was equivalent to 1.0% of GDP, or approximately €19.5 billion.

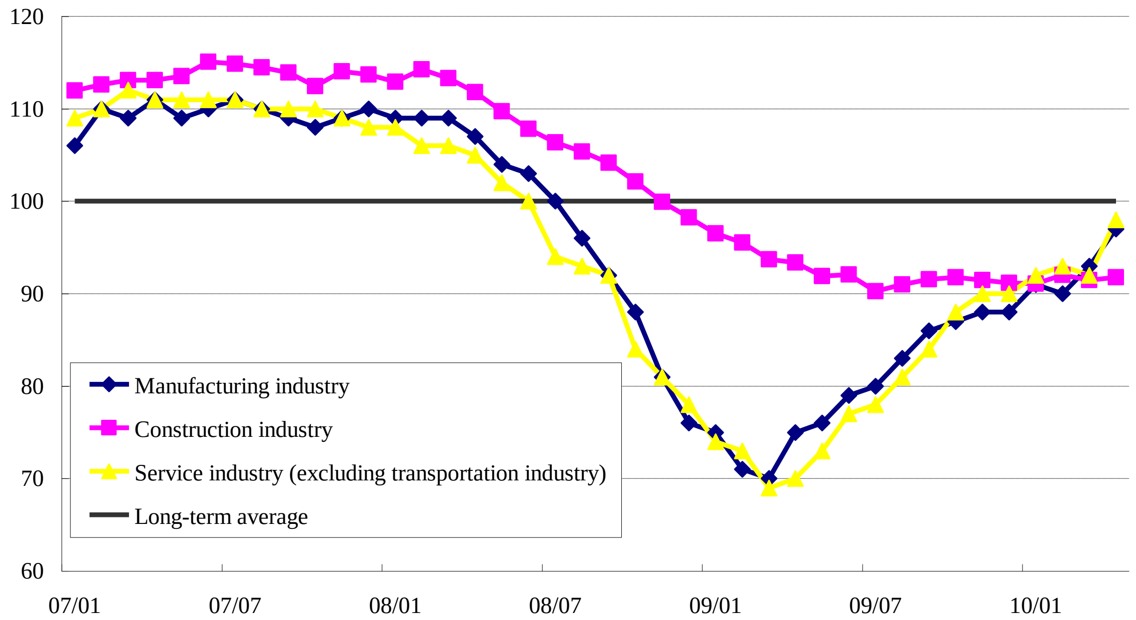
1-2-2-20 Trends in French Real GDP Growth Rate



Notes: All data are preliminary data (released on May 12, 2010). Seasonally adjusted
Source: National Institute for Statistics and Economic Studies (INSEE)

1-2-2-21 Trends in Business Climates for French Manufacturing, Construction and Service Industries

[41] Major items include the followings: (i) Front-loaded reimbursement of research and development tax and value-added tax for companies, (ii) Infrastructure investment by national companies, (iii) Support for automobile industry and construction industry (including the provision of subsidy of €1,000 for the replacement of vehicle over 10 years with that with higher energy efficiency), (iv) Assistance for small-to-medium sized businesses (including the provision of €25.00 million to small businesses),
(v)Housing support (including newly development of 100,000 of public housing and the enhancement of the application of interest-free loans for first time home-buyers), (vi) Support for low-income families (the provision of special subsidy of €200 per household), and (vii) Employment measures (Reduction of social insurance fee that employers have to pay for companies with 10 employees or less which newly hired a staff by the end of 2009.)

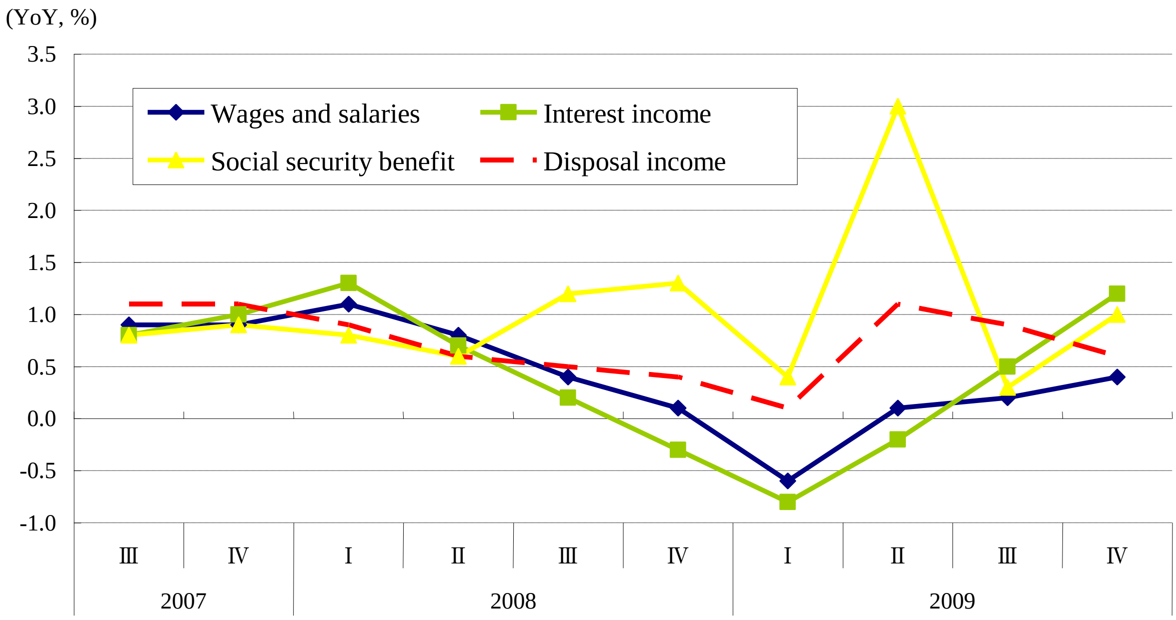


Source: National Institute for Statistics and Economic Studies (INSEE)

Partially due to the support from these programs, according to the business confidence by industry index, the manufacturing and service industries started recovering in the middle of 2009 and have remained at the same level since October 2009. In addition, while the real estate market started to stabilize, having sunk significantly after the second quarter of 2008, business confidence in the construction industry stopped deteriorating and started leveling out in the middle of 2009. (See Figure 1-2-2-21.)

One of the characteristic economic trends in France is expanding personal consumption before and after the financial crisis. This is mainly due to service consumption, which continued to increase. The retail sales index also shows a robust trend compared to other Eurozone member states (Figure 1-2-2-11). The number of newly-registered cars showed strong growth in the fourth quarter of 2009, but lost momentum going into 2010. Analysis suggests that the reduction of new-car purchase incentives in January 2010 had a negative impact on sales (1-2-2-11).

1-2-2-22 Trends in French Disposable Income and Household Income



Note: Seasonally adjusted
Source: National Institute for Statistics and Economic Studies (INSEE)

The unemployment rate in France exceeds 10% (Figure 1-2-2-8). On the other hand, compared with the fall in wages, the drop in growth rate for income has seen a slowdown, owing to the support of social welfare benefits. This has in turn supported robust personal consumption (1-2-2-22).

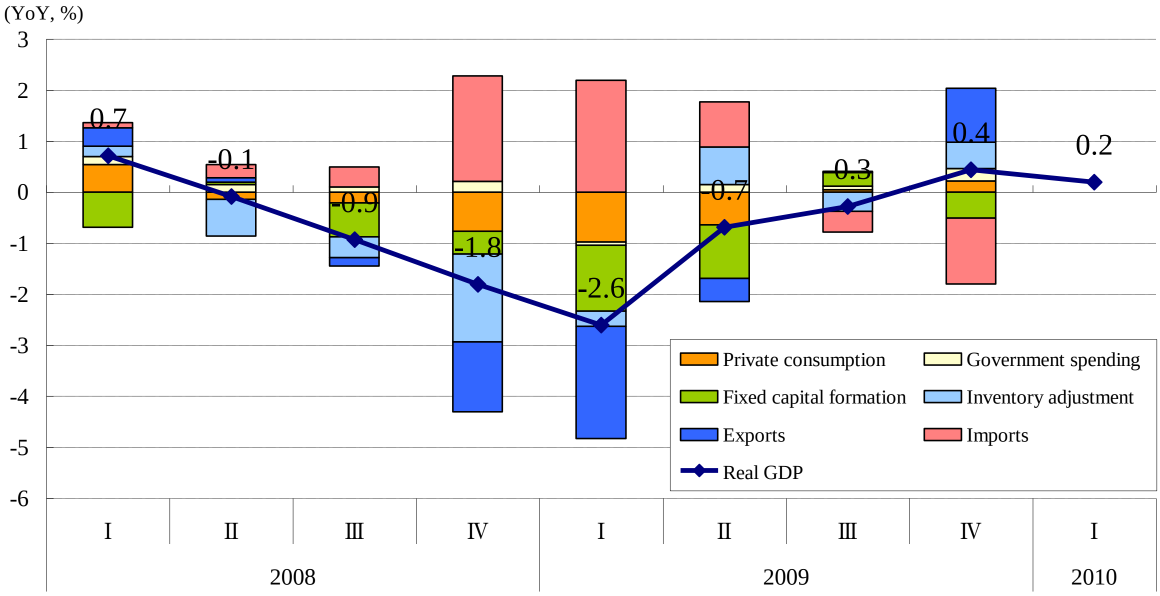
(B) The United Kingdom

In the United Kingdom, households have been pressured to adjust their balance sheets by the credit crunch which followed the financial crisis and the collapse of the housing bubble, and this move has given rise to sluggish personal consumption and housing investment, which have made a major negative contribution to economic growth.

In the first quarter of 2009, the real GDP growth rate dropped 2.6% compared to the previous month. However, due to the support of government stimulus programs, GDP rebounded in the fourth quarter of 2009 after its 7th consecutive quarterly drop (see Figure 1-2-2-23). Meanwhile, the amount of outstanding general government deficits swelled to close to 70% of GDP, and the U.K. government announced a policy to improve the fiscal balance in its 2009 Pre-Budget Report (fiscal year 2010 budget compilation policy).

Business confidence DI by industry in the U.K. shows all industries bottomed out in the first half of 2009 and started showing overall improvement in the second half of the same year. However, business confidence in the construction industry has remained low and recovery in the real estate market, primarily commercial real estate, has been delayed (see Figure 1-2-2-24). Exports and production, which saw a steep decline after the outbreak of the financial crisis, started to recover in the fall of 2009. Exports registered a year-on-year basis growth at the end of 2009 and have continued to expand, while production is still struggling (see Figure 1-2-2-25).

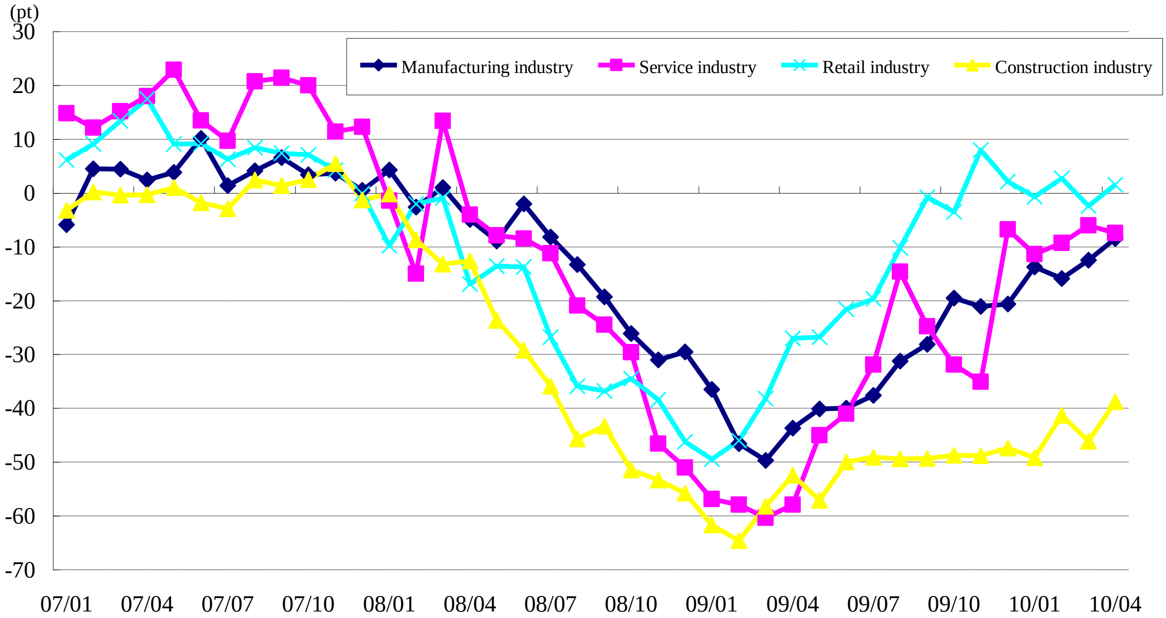
1-2-2-23 Trends in UK Real GDP Growth Rate



Notes: 1. Real GPD growth rates are preliminary data (released on May 12, 2010)
2. All data are seasonally adjusted.

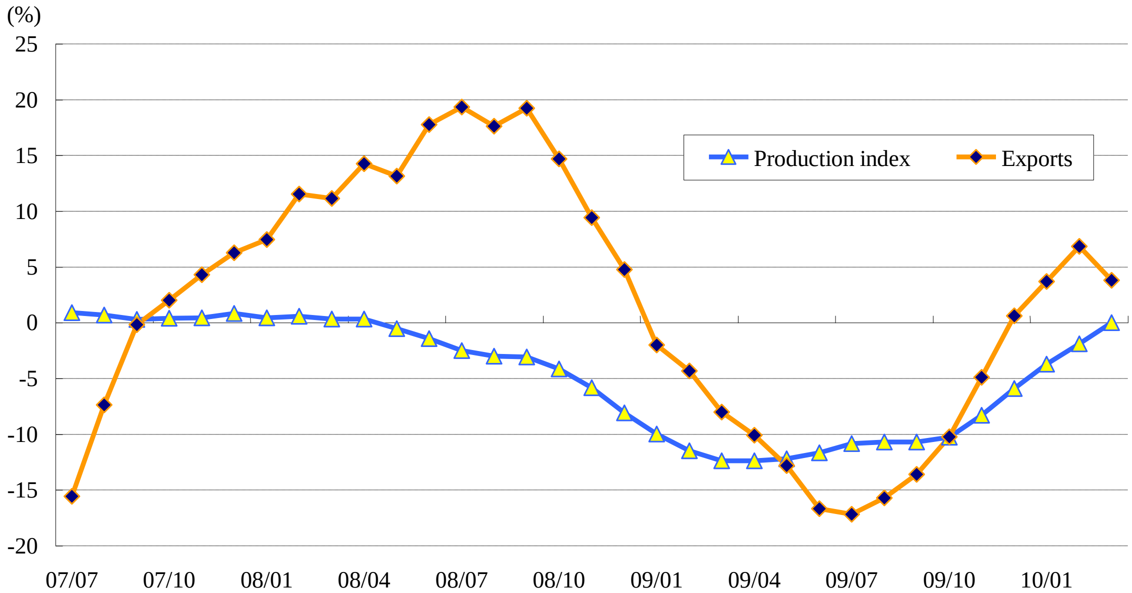
Source: Eurostat

1-2-2-24 Trends in UK Confidence Index by Industry



Source: European Comission

1-2-2-25 Trends in UK Exports and Production



Note: The comparison of the same month of the previous year of three-month moving average
Source: Office for National Statistics, the UK (ONS), UK TradeInfo

Since the fall of 2008, the housing market has been on the road to recovery, helped by a series of government support programs[42] including a raising of the upper limit for Stamp Duty Land Tax (SDLT) exemptions[43] and support for housing loan repayments. Amid concern that the effectiveness

[42] In England, real estate property buyers are the subject of "Stamp Duty Land Tax". Tax rates vary depending on a purchase price, however, the tax is exempted for the transactions with prices of 125,000 pound or less. This upper limit for the exemption was increased to 175,000 pound from September 3, 2008 to December 31, 2009.

[43] Post-financial crisis government supports announced in the Pre-Budget report of November 24, 2008 (fiscal year 2009 budget compilation policy) include the followings: (i) VAT reduction, (ii) Front-loaded public investment in housing, education, transportation and other construction area, (iii) Investment for the energy-efficiency improvement measures and railroads for the expansion of low-carbon related business and the generation of employment in the area, (iv) Income tax cuts, (v) Front-loaded provision of children benefit (vi) Provision of one-off payment for pensioners, (vii) Housing loan payment assistance (Three month extension for the seizure

of such policies would be lost after the termination of these programs, the U.K. government nonetheless announced the end of the SDLT exemption support program at the end of 2009 as planned[44]. Consequently, real estate trade surged with last-minute demand. The figure dropped again owing to the reverse effect in 2010 (see Figure 1-2-2-26), and the government temporarily introduced preferential treatment for first-time buyers[45].

A scheme to promote the purchase of new cars[46] was introduced in the U.K. as well, and this supported automobile sales. Moreover, value-added tax (VAT) was reduced from 17.5% to 15% to stimulate consumption; however, this program ended at the end of December 2009. U.K. retail sales amount and volume indexes do not indicate any downward trend around the time of the financial crisis. This is because these indexes do not include service consumption, which was severely affected by the crisis (see Figure 1-2-2-27). GDP statistics confirm that personal consumption, mainly service consumption, dramatically decreased after the crisis and started a gradual recovery in the second half of 2009. However, growth is still weak (see Figure 1-2-2-28).

1-2-2-26 UK Housing Price Index and Number of Real Estate Transactions

Note: Seasonally adjusted data
Source: Nationwide, HM Revenue & Customs

of house due to the delinquency of housing loan. However, the extension of loan payment term has to bear government guarantee as a precondition.), (viii) Job placement support for unemployed people, and (ix) Financing support for small-to-medium sized businesses. Besides in December 2008, an additional economic stimulus plan was announced including Banking Bill (to provide financing support to banks of which management is in trouble and to collect information from the bank and share with the financial authority), Saving Gateway Accounts Bill (to encourage the low-income segment to save by supplying 50 pence for every 1 pound of saving funded by the government) and Homeowner Mortgage Support Scheme (to extend the payment of loan interest up to 2 years for the households whose house would likely be seized after the job-cut or wage reduction.)
In addition, in January 2009, there was an announcement on measures to encourage the low-carbon promotion in the automobile industry. Furthermore, the budget bill for fiscal year 2009 “Building Britain’s Future” announced in April 2009 included a new car purchase promotion plan (mentioned later), additional support for housing market and the support plan for companies mainly low-carbon related businesses.

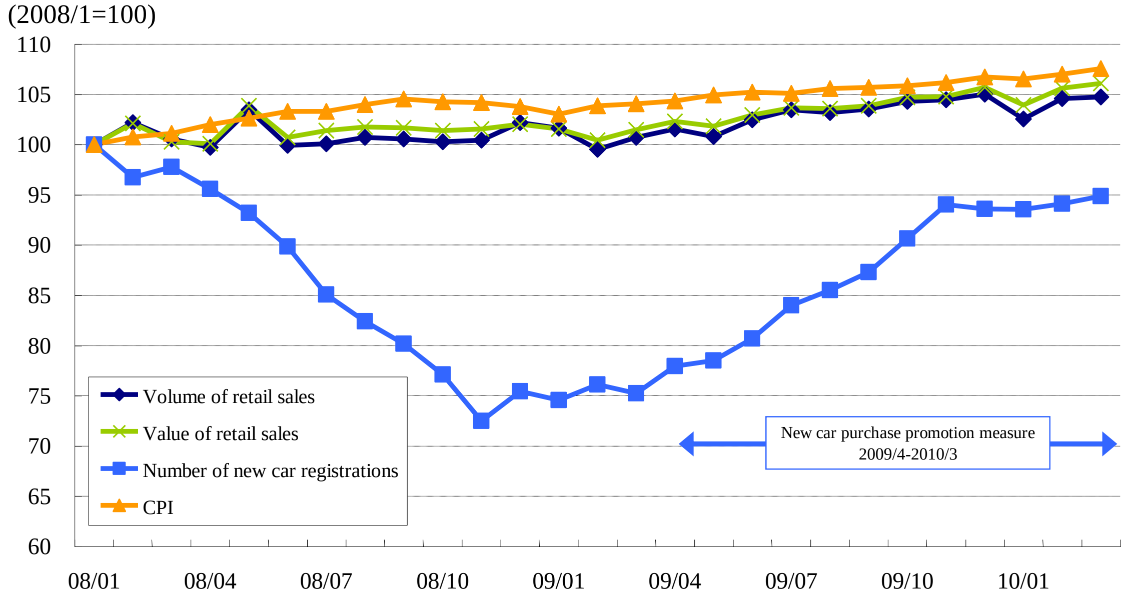
44 HM Treasury (2009), Pre-Budget Report 2009

45 HM Treasury (2010), Budget 2010

46 The scheme is to encourage the replacement of home-use car which was registered over 10 years ago. The budget was 0.3 billion pound and the subsidy of 2,000 pound was provided per person. It is a joint-initiative with the automobile industry that also shared 0.3 billion pound of the budget providing a half of subsidy (1,000 pound) per person. It was schedule to end in February 28, 2010 or at the time that the budget runs out.

As for the income situation in the U.K, the growth rate of the average wage significantly dropped; however, real disposable income showed relatively stable growth even after the crisis (see Figure 1-2-2-29). Reasons for this include increase in social welfare payments and income tax cuts (see Figure 1-2-2-30). However, as mentioned earlier, in the midst of deteriorating public finances, the end of crisis support programs is also approaching. In addition, although the unemployment rate is becoming more stable, fear of unemployment is suppressing consumer sentiment. Thus, personal consumption is anticipated to remain stagnant (see Figure 1-2-2-31).

1-2-2-27 Trends in UK Retail Sales and Prices

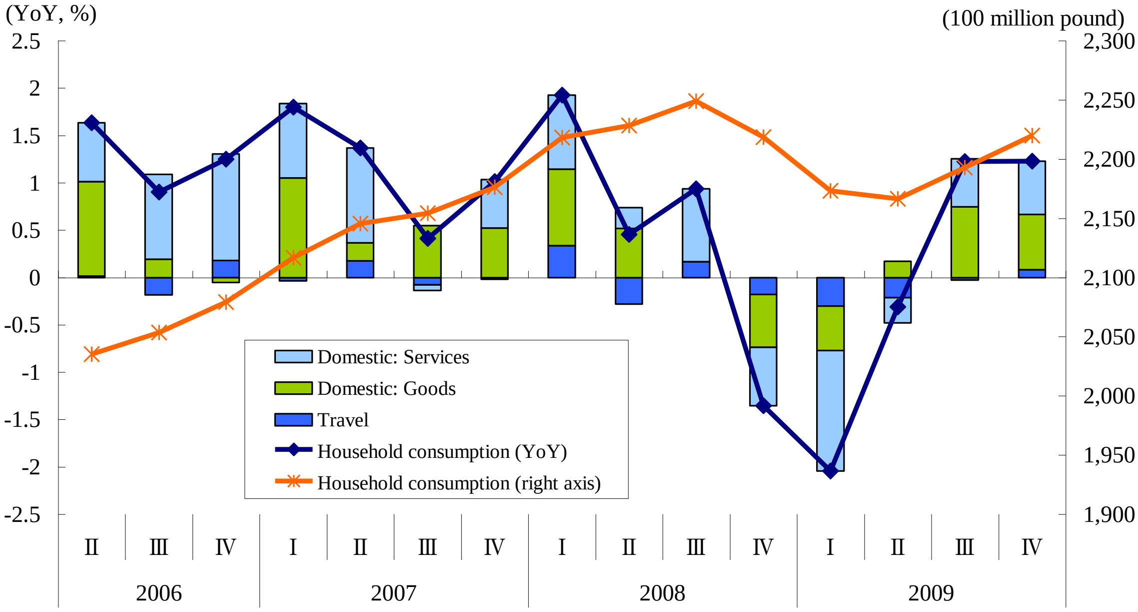


Notes: 1. All data are seasonally adjusted.

2. Retail volume index and retail sales amount index exclude fuel.

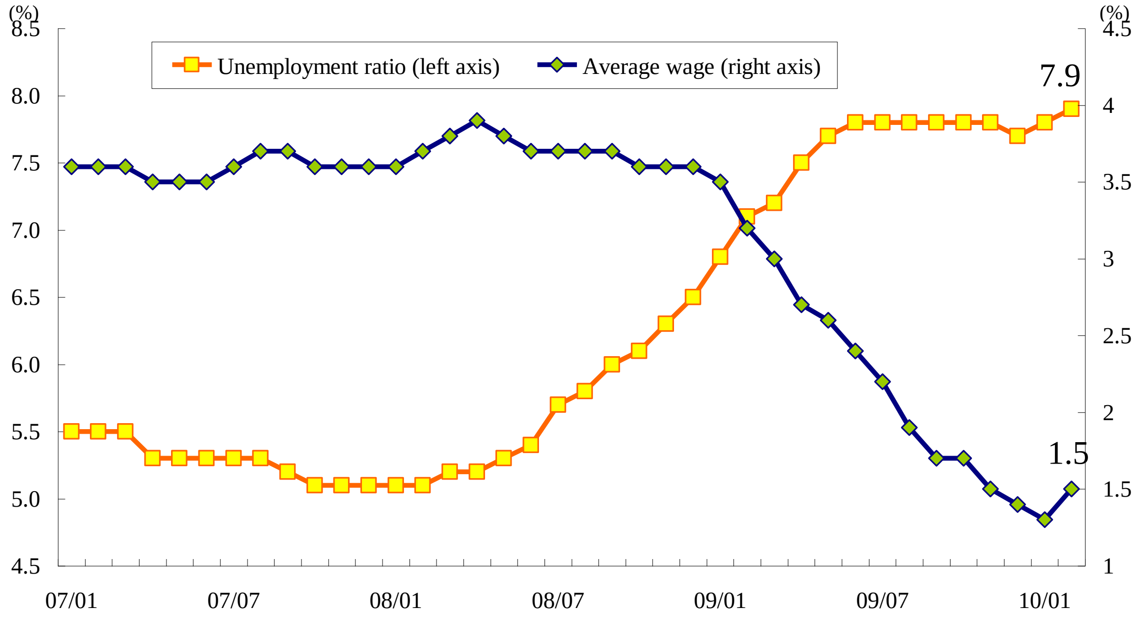
Source: Eurostat, Office for National Statistics, the UK (ONS)

1-2-2-28 Trends in UK Personal Consumption



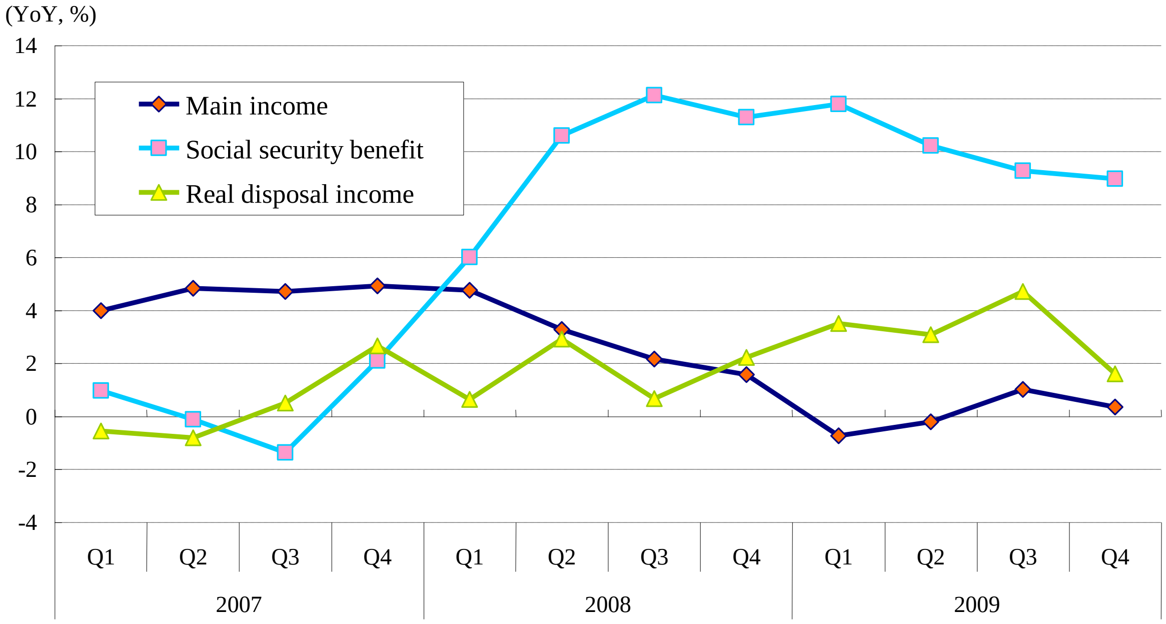
Note: Seasonally adjusted
Source: Eurostat,Office for National Statistics, the UK (ONS)

1-2-2-29 Trends in UK Unemployment Rate and Average Wages



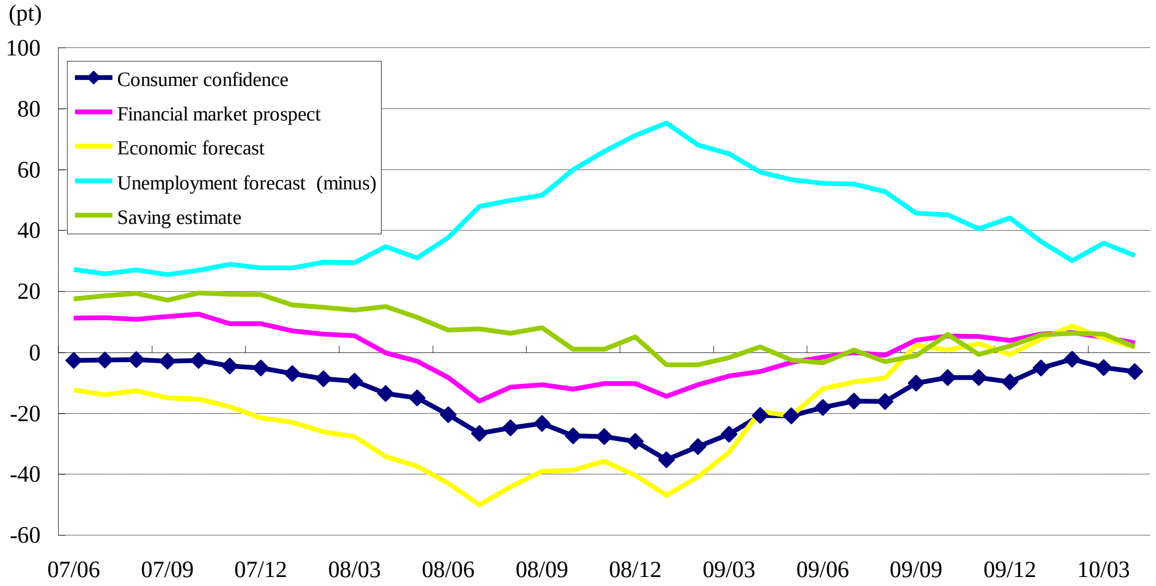
Notes: Average wages exclude bonuses and a three-month average moving. Seasonally adjusted.
Source: Eurostat, Office for National Statistics, the UK (ONS)

1-2-2-30 Trends in UK Household Income



Source: Office for National Statistics, the UK (ONS)

1-2-2-31 UK Consumer Confidence Index



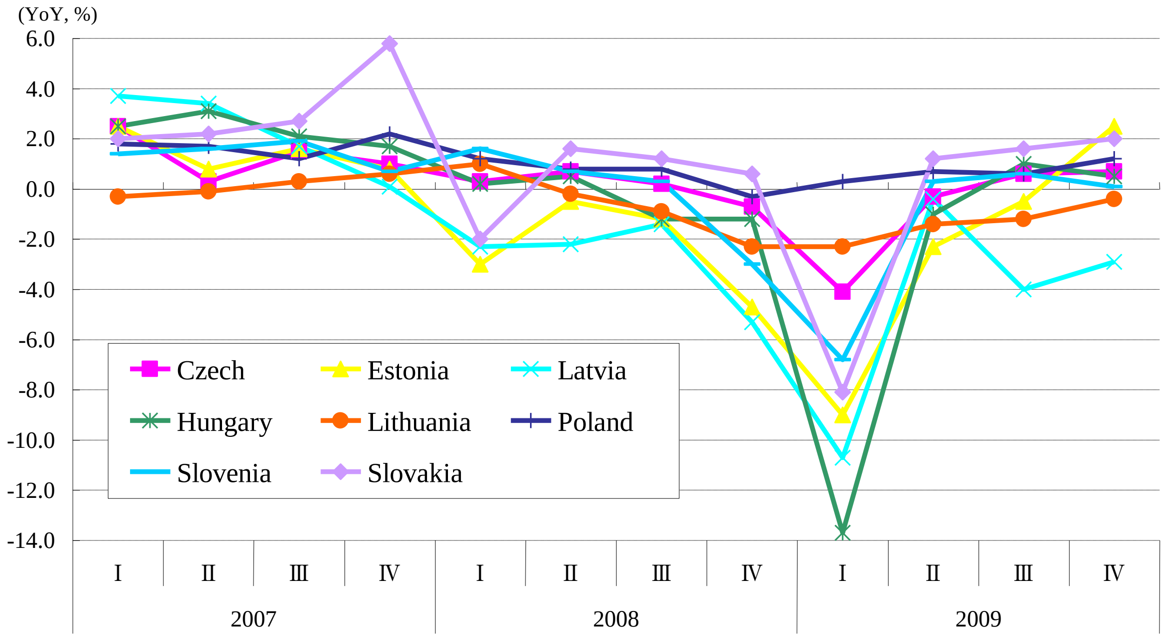
Notes: Consumer confidence index is calculated based on the DI of the following year of (a) financial market prospect, (b) economic forecast, (c) unemployment forecast and (d) saving estimate.

Source: European Commission Survey

(C) Central and East European countries

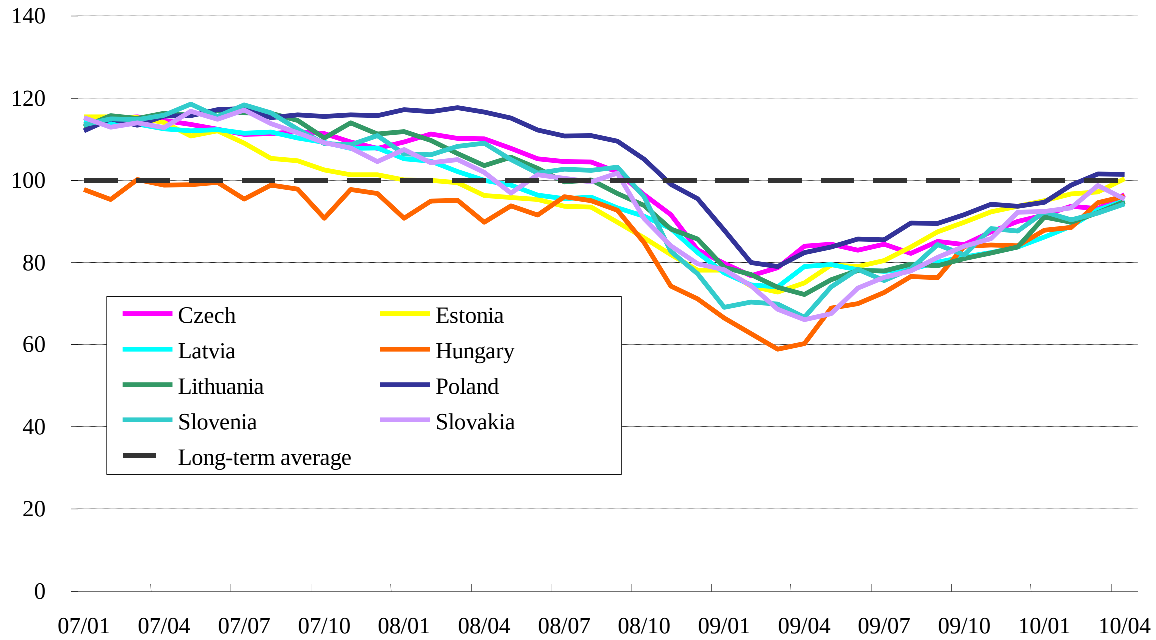
With the U.S. and West European countries beginning to show signs of recovery, Central and East European countries, whose economies had been expanding based on the infusion of capital from abroad, and in particular from West European countries, also started to revive from the second half of 2009, albeit weakly (see Figure 1-2-2-32). Business climate indexes are improving in each country and the recovery of external demand is likely to contribute to further growth (see Figure 1-2-2-33). On the other hand, it has been forecast that consumption will remain stagnant against a background of persistently high unemployment, and investment is also likely to have a tough time picking up.

1-2-2-32 Trends in Real GDP Growth Rates for Central and East European Countries



Note: Seasonally adjusted
Source: Eurostat

1-2-2-33 Trends in Business Climate Confidence for Central and East European Countries



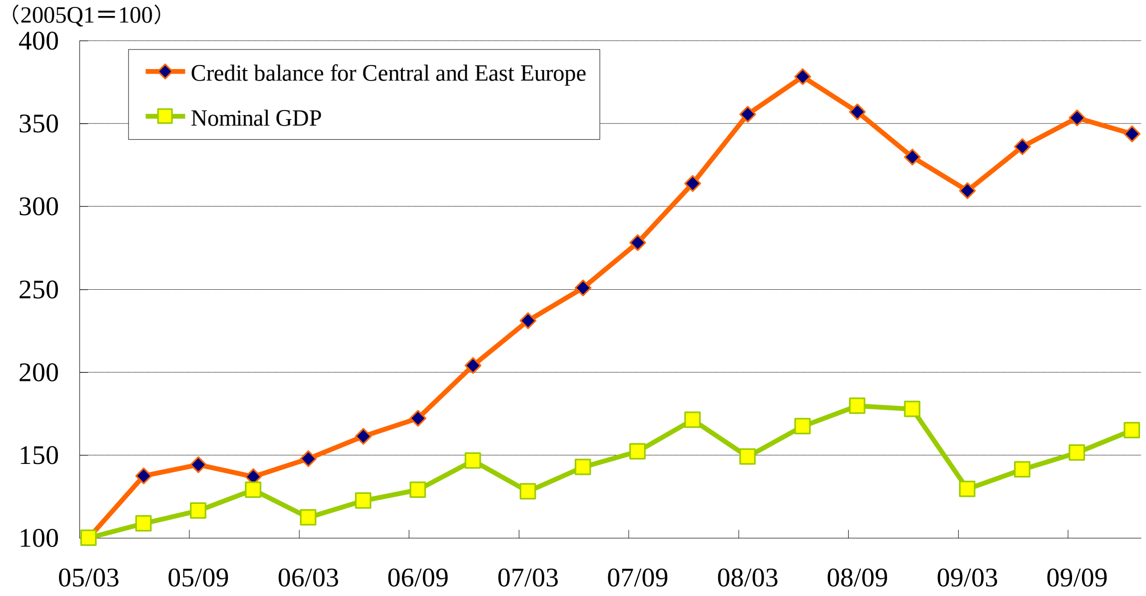
Source: European Commission

There is no sign of any credit or financial crisis in Central and East European countries as a whole, and the region is enjoying relatively stable conditions. The following vulnerabilities should however be noted.

First, they are heavily dependent on major EU countries for exports. After the financial crisis, the total export of Central and East European countries dropped sharply; however, automobile exports saw a leap in the second half of 2009, supported primarily by policies to promote the purchase of new automobiles in Germany and France. There are concerns that the business recovery may stall half-way owing to the termination of support programs in the major countries.

Second, Central and East European countries have an enormous amount of debt. Nearly 90% of lenders are financial institutions in Europe, with institutions in Austria holding the largest share[47]. Greece (whose financial institutions have been shaken with public finance issues of their own) and Sweden are also seen as major lenders to some Central and East European countries[48]. Loans from financial institutions in Western Europe to Central and Eastern Europe temporarily dropped after the outbreak of the financial crisis; however, the situation has been on track for recovery since the second quarter of 2009. It is assumed that there will be no major changes in capital flow, considering the profitability of trade with Central and East European countries[49]. Since a large portion of the credit that Central and East European countries hold is in foreign currency, there is still concern about the swelling of debts which will occur when their currencies once again depreciate against the euro (see Figure 1-2-2-34 and Figure 1-2-2-35).

1-2-2-34 Trends in Credit Balances for Central and East European Countries



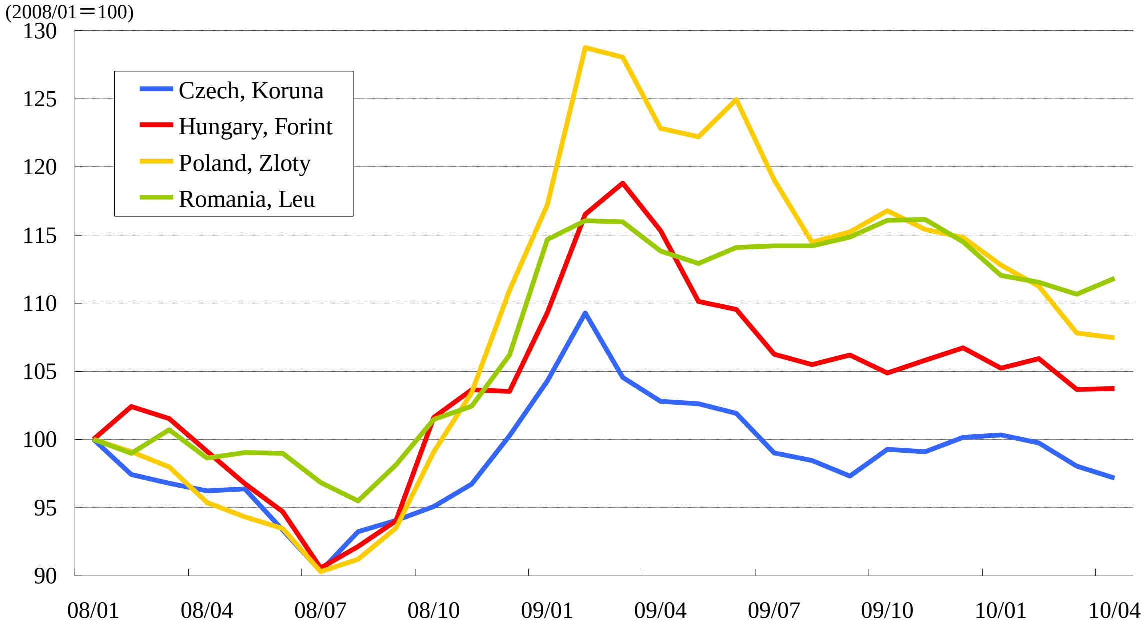
Notes: The data is the sum of data for 8 EU member countries that have not adopted Euro. The data of credit balance is the sum of those for all Bank of International Settlements (BIS) member countries and at a final risk base.
Source: BIS, Eurostat

47 Mizuho Research Institute Ltd. (2009) "CHUUTOUOU KIKIWA OUSHUUO OSOUNOKA? CHUUTOUOUTO OUSHUUSHUYOUKOKUKANNO KEIZAI/KINYUURENKANSEINO KOUSATSU" (MIZUHO OUSHUU INSAITO June 9, 2009)

48 Swedish financial institutions have an outstanding share in the credit extended for Baltic countries including Estonia, Latvia and Lithuania and Greek financial institutions have a dominant share in the credit extended for Bulgaria. (MIZUHO OUSHUU INSAITO "CHUUTOUOU KIKIWA OUSHUUO OSOUNOKA? CHUUTOUOUTO OUSHUUSHUYOUKOKUKANNO KEIZAI/KINYUURENKANSEINO KOUSATSU" June 9, 2009)

49 Deutsche Bank Research (2009)," Credit Monitor Eastern Europe – 2010: Deleveraging is the name of the game", December 17, 2009

1-2-2-35 Trends in Euro Exchange Rates against the Currencies of Central and East European Countries



Notes: 1. Trend of the exchange rates against Euro. The index used January 2008 as its base, 100.
2. The data includes Central and East European countries that joined in 2004 or later, have not adopted Euro and take a floating exchange rate system.
Source: European Central Bank (ECB)

(B) The road to stabilization for Europe's financial markets

After the financial crisis, governments and central banks in each European country implemented large-scale measures to support their financial markets. Each government immediately provided measures to protect credit by announcing programs such as protection of deposits and government debt guarantees. In Eurozone and the United Kingdom, the European Central Bank (ECB) and the Bank of England (BOE) drastically lowered policy interest rates, easing monetary policy (see Figure 1-2-2-36).

In the Eurozone, in May 2009 the ECB announced the enhancement of unorthodox measures such as the operation of unlimited fund provision, which it had been promoting since the fall of 2008. In addition to the purchase of about €60 billion of covered bonds[50], the ECB implemented liquidity emergency measures[51] by introducing the provision of liquidity for the total amount equivalent to the collateral presented at regular bidding, and a relaxation of eligible collateral qualifications.

Meanwhile, in January 2009 the U.K government announced there would be i) protection of assets owned by financial institutions; (ii) government guarantees for asset-backed securities (ABS) and (iii) an Asset Purchase Facility to purchase up to ₤50 billion of assets. Under scheme (iii), the BOE will

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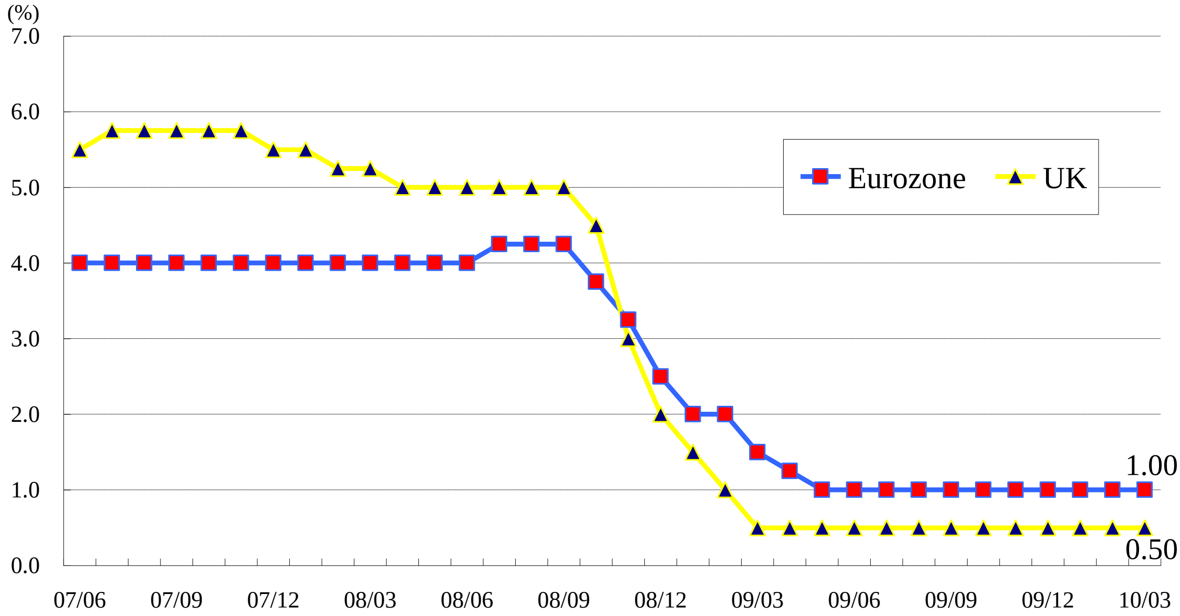
50 "Covered bond" is the bonds that financial institutions issue providing loans that they own as collateral. For the collateral, high-grad loans such as mortgage and the loans for local government are selected. Majority is issued by European financial institutions.

51 The background for the enhancement of "untraditional measures" includes (i) decline in commodity prices, (ii) outlook for contained inflation influenced by the deteriorated economy in the Eurozone and the world. (iii) stabilized expectation for inflation for the medium-to-long term, and (iv) slowdown in the money supply increase and the further decline in the bank's loans for private sectors. As for the purchase of cover bonds, the president of the European Central Bank, Jean-Claude Trichet, commented that it is not "quantitative easing" but "credit support" and its purpose is; to promote the lower interest rates for term-fixed products; to encourage the bank loans to be maintained and expanded; to improve the liquidity in private bond markets and; to relax the financing environment for banks and companies.

purchase highly-rated assets from financial institutions[52]. With its deposit reserve, the BOE will acquire a large amount of UK government bonds as a quantitative easing tool.

1-2-2-36 Major Policy Interest Rate Trends for Eurozone and UK

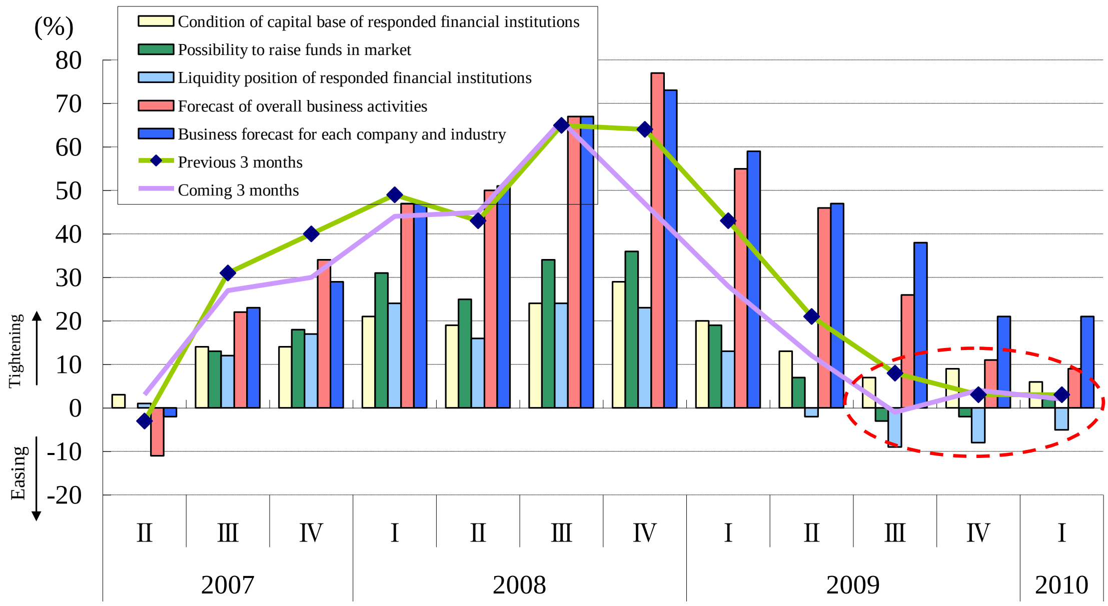


Note: Data are month-end data.
Source: European Central Bank (ECB), Bank of England (BOE)

Under these conditions, in 2009 financial institutions in the Eurozone started showing considerable improvement in their stance on both corporate and individual lending. The background to this relaxation in attitude towards lending includes the improved liquidity position and a better economic outlook (see Figure 1-2-2-37 and Figure 1-2-2-38). U.K. financial institutions have also been improving their stance on lending since 2009. The DI for corporate loans and loans for individual customers with collateral have taken a favorable turn, and loans for individual customers without collateral are likely to rebound (see Figure 1-2-2-39).

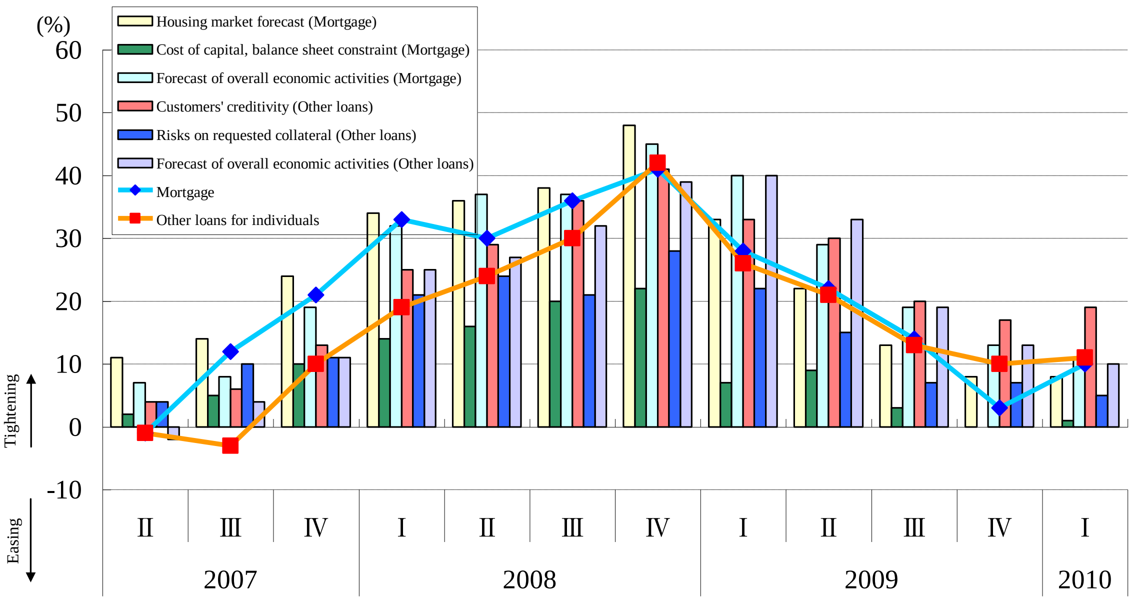
52 Its original purpose was to directly influence over the financing of companies and improve the business credit availability through the purchase of highly ranked CPs, corporate bonds, syndicate loans, and ABS with some restrictions using the funds acquired with the short-term national bonds issued by HM Treasury. In March 2009, the authority of BOE in this scheme was enhanced and it became possible to use this scheme as a tool for quantitative easing.

1-2-2-37 Reasons for Corporate Lending and Tightening Attitudes in Eurozone Financial Institutions



Notes: The line graph shows the ratio of financial institutions that have contributed for the tightening of loan attitudes to the total number of respondents. (actual data for the previous 3 months and forecast for the coming 3 months) The bar graph represents the trend of contribution factors for the tightened loan attitudes in the previous 3 months.
Source: European Central Bank (ECB).

1-2-2-38 Reasons for Individual Lending and Tightening Attitudes in Eurozone Financial Institutions



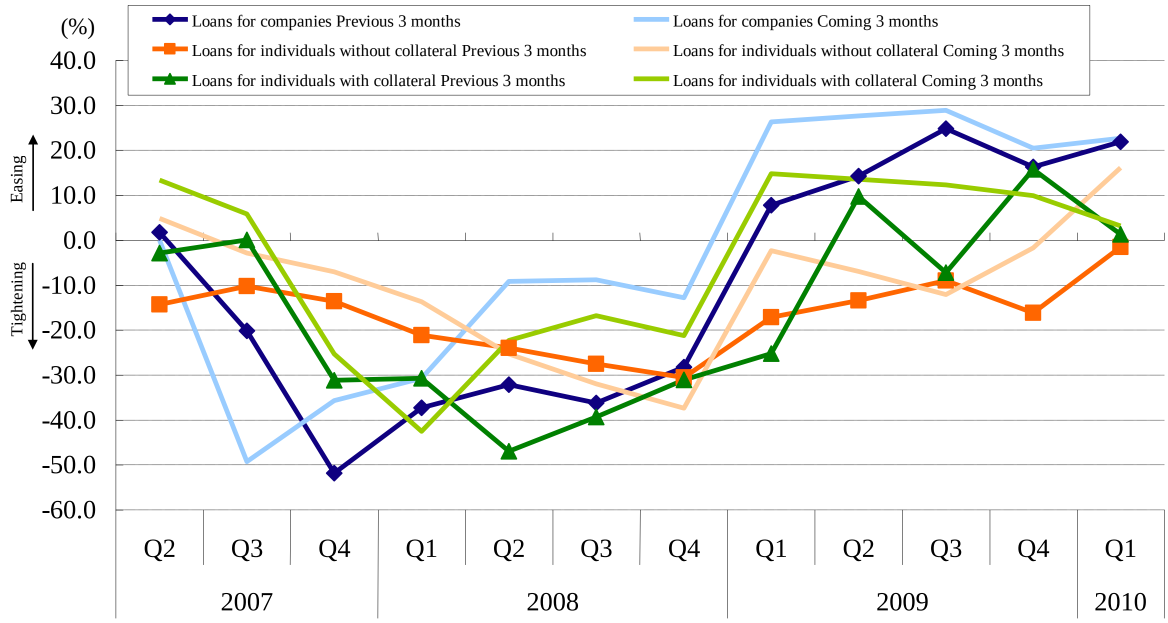
Notes: The line graph shows the ratio of financial institutions that have contributed for the tightening of loan attitudes to the total number of respondents. (mortgages and other loans for individuals) The bar graph represents the trend of contribution factors for the tightened mortgage and loan attitudes in the previous 3 months.
Source: European Central Bank (ECB).

The urgent measures issued after the crisis between the end of 2009 and 2010 are gradually coming to an end. While maintaining low interest rates, the ECM began terminating the unorthodox monetary easing measures one by one from the end of 2009. Meanwhile, the BOE announced the suspension of the asset purchase program in February 2010.

The soundness of European financial institutions was confirmed by stress tests carried out by the Committee of European Banking Supervisors (CEBS) on 22 major banks, using both a baseline scenario and an adverse scenario. The assumption of the adverse scenario was that the Eurozone real GDP growth rate would be minus 5.2% in 2009 and minus 2.7% in 2010, and subsequent trading losses would be about €400 billion. Under this scenario, it was estimated that the banks would still maintain a sufficient capital adequacy ratio. (The proportion of Tier 1 capital in all surveyed banks exceeded 9%.) It is important to note that the 22 banks surveyed held only 60% of all assets of financial institutions in the region. However, since the assumed adverse scenario used data stricter than IMF forecasts, according to some analyses the actual loss would be lower than that of the adverse scenario mentioned above[53].

Meanwhile, according to the IMF's estimate[54] released in April 2010, the accumulated loss of European financial institutions for the period from September 2007 to the end of 2010 would be about $455 billion in the U.K, about $665billion in the Eurozone, about $156 billion other areas in Europe[55] and about $1,276 billion, in Europe as a whole[56]. Attention must also be given to the proportion of bad loans that had not been processed by December 2009: 22% in the U.K, 37% in the Eurozone and 47%, other areas in Europe (see Figure 1-2-2-40).

1-2-2-39 UK Financial Institution Lending Attitudes by Type of Borrower



Notes: The ratios were calculated based on DI for lending attitude of the previous 3 months and coming three months matching the market share of each responded financial institution.
Source: Bank of England (BOE)

In the Eurozone, as a result of companies' efforts to improve business by reducing their employment costs, the increase in allowance for bad debts peaked in 2009, and the pace of growth is expected to slacken in 2010. In the U.K, losses from bad housing loans were kept lower than the forecast issued in the fall of 2009, and the outlook for total losses is improving. However, the economic recovery in Europe is generally slow and largely supported by measures implemented by governments. If the

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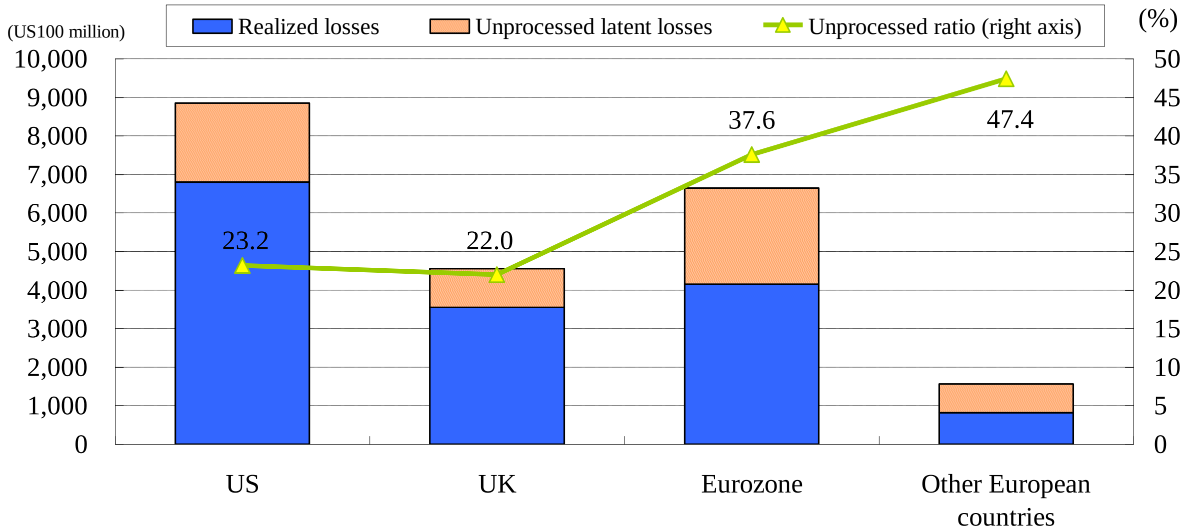
53 Mizuho Research Institute Ltd. (2009) "OUBEISHUYOUGINKOUNO FURYOUSAIKENMONDAINO MITOUSHI.-FURYOUSAIKENWA TOUGEO KOETAKA" (December 24, 2009)
54 IMF (2010), Global Financial Stability Report, April 2010
55 Denmark, Norway, Iceland, Sweden and Switzerland
56 The amounts substantially improved from the estimate of October 2009. The concerned IMF report warns the uncertainty of this estimate due to the constrain of data.

economy loses pace again, bad debts may swell. Continued caution is therefore required.

1-2-2-40 Value of Potential Losses for US and European Financial Institutions



Notes: 1. Realized losses are the value from the second quarter of 2007 to the fourth quarter of 2009. Unprocessed latent losses are estimated fro the first quarter of 2010 to the fourth quarter of 20110.

2. "Other European countries" include Denmark, Norway, Iceland, Sweden and Switzerland.

Source: IMF Estimates

The IMF's crisis ripple-effect simulation[57] has been useful for understanding the financial risk of Central and East European countries. This simulation assumes that if a full-scale cross-border credit default issue should arise, simultaneous credit and liquidity crises will follow and spread to other countries.

According to estimates, financial institutions in Italy and Germany will be greatly affected if Austrian financial institutions, which are the largest lenders to Central and East European countries, experience credit default issues (see "1" in Table 1-2-2-41). The results also indicate that a credit default of Italian financial institutions will affect French financial institutions (see "2" in Table 1-2-2-41), and a credit default of French financial institutions will have an impact on German financial institutions (see "3" in Table 1-2-2-41). Unless major European countries such as the U.K, Germany and France have default issues, the influence over Europe as a whole in terms of loss of capital would be limited[58]. As mentioned earlier, local currencies have stopped depreciating against the euro (see previously listed Figure 1-2-2-35), and this will help stabilize the financial systems in Central and Eastern Europe for the time being.

(C) Employment measures and social security during the crisis

As mentioned earlier, the response of labor markets in the major European countries to the crisis has varied by country. A comparison of unemployment rates shows that the rates are currently slowly improving. However, immediately after the financial crisis, the rates had been high in every country. In particular, in Spain the unemployment rate quickly approached 20%, due to large-scale job cuts in the manufacturing, service and construction industries (see Figure 1-2-2-42).

[57] IMF (2010), Global Financial Stability Report, April 2009

[58] Mizuho Research Institute Ltd. (2009) "CHUUTOUOU KIKIWA OUSHUUO OSOUNOKA? CHUUTOUOUTO OUSHUUSHUYOUKOKUKANNO KEIZAI/KINYUURENKANSEINO KOUSATSU" (MIZUHO OUSHUU INSAITO June 9, 2009)

The background to the rapid deterioration of the employment market in Spain includes continued use of an inflexible wage system and a relaxing of regulations on irregular employment, the latter beginning in mid-1990. In Spain, wages are decided only after considerable negotiation, and the process of reaching a consensus involves not just the industries but also the wider communities concerned. Therefore, it is inevitable that wages will respond slowly to changes in the economy. In order to reduce labor costs swiftly, it is necessary to reduce employment; however, a significant burden in compensation is incurred in dismissing fully-protected, regular employees. Consequently, following deregulation the proportion of irregular employees in the labor force reached 40%, and, since their dismissal costs would be relatively low, many younger laborers were dismissed, causing the unemployment rate hike[59].

1-2-2-41 Capital Losses in the Event of Crisis

	Austria	**Belgium**	**France**	**Germany**	**Ireland**	**Italy**	**Netherlands**	**Portugal**	**Spain**	**Sweden**	**UK**
Trigger country											
(1) Austria		-7.1	-3.6	-13.1	-5.2	-14.3	-5.5	-1.6	-0.8	-3.4	-1.2
Belgium	-4.2		-16.2	-8.2	-23.2	-3.6	-75	-3.9	-3.5	-7.5	-5.9
(3) France	-37.4	-303.4		-72.2	-75.1	-41.4	-162	-30.2	-31	-60	-47.4
Germany	-54.9	-69.6	-36.2		-62.9	-52.2	-87.7	-20.4	-18	-121.8	-22.9
Ireland	-6.3	-68.3	-9.7	-21.9		-5.2	-17	-5.2	-3.8	-9.7	-15.5
(2) Italy	-36.8	-33.9	-50.2	-36.9	-29.6		-51.1	-6.5	-5.9	-5.1	-6
Netherland	-15.5	-183.3	-36.2	-30.6	-39.8	-12.7		-12.3	-14.8	-26.9	-17
Portugal	-1.6	-5.7	-3.3	-4.7	-3	-1	-5.4		-9.9	-1.1	-1.2
Spain	-5	-30.5	-21.4	-29.6	-20.2	-4.8	-45.5	-48.7		-13.2	-11.8
Sweden	-1.1	-3	-2.3	-6.3	-3.7	-0.4	-5.5	-0.5	-0.6		-2
UK	-178.8	-780.1	-337	-366.4	-454.1	-142.4	-708.4	-137.6	-126.8	-382.9	

Notes: The degrees of losses were estimated on the assumption that all of cross-boarder credits of a trigger country resulted in losses, 65% was refinanced and estimated sales prices were 50% of book value.
Source: IMF Estimates

In contrast to the situation in Spain on the other hand, the unemployment rate in Germany became stable at a relatively early stage after a slow increase. This is considered to be the result of a government enhancement program for compensation for reductions in working-hours[60]. Working-hour reduction compensation has existed for some time, so is therefore not a new policy. Since this system provides a subsidy to offset reduced wages, it makes it easier for companies to cut wages and reduce working hours in a severe business environment. Therefore, companies can avoid the cost of arranging new employment after business recovers and maintain long-term competitiveness by retaining skilled laborers, while employees can enjoy job security and maintain at least a certain level of income[61].

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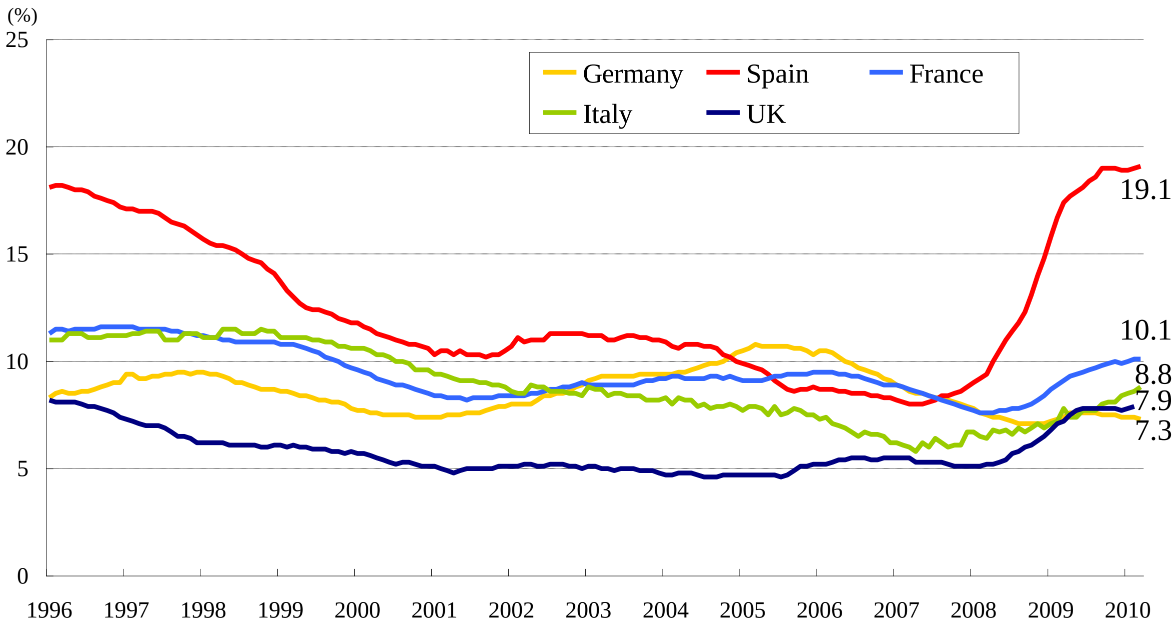
59 The Economist, " So hard to bend: Rigidities in the labour market make recovery even harder", February 2010

60 Under the working-hour reduction compensation system of Germany, when a wage is cut due to the reduction of working hours at an business establishment, if the company is compensating the loss of wage of the worker and at least one thirds of workers at the same business establishment are having over 10% of wage cut, 60% of the difference between the original wage and the wage reduced due to the decreased working hours (if there is a child, 67%) is subsidized. The payment term is decided considering factors such as maintained employment. (The Japan Institute for Labour Policy and Training 2007 "DOITSU/FURANSUNO ROUDOU/KOYOUSEISAKUTO SHAKAIHOSHO")

61 For your information, working-hour reduction compensation system is not unique to Germany and exists in other European countries including Spain. However, it is said that the system is not working in Spain because the agreement between employer and employees is mandatory, but the negotiation does not settle peacefully due to the strong unions. (Mizuho Research Institute Ltd. 2009 "OUSHUUNO KAKAERU KOYOUCHOUSETSUATSURYOKU – OUSHUUNO KOYOUCHOUSEIWA HONKAKUKASURUNOKA" (MIZUHO OUSHUU INSAITO October 19, 2009)

1-2-2-42 Long Term Trends in Unemployment Rates of Major European Countries



Note: Seasonally adjusted monthly data
Source: Eurostat

As part of a second set of urgent economic measures announced in January 2009, the federal government in Germany extended the system's payment period to 18 months for applications made between January and December 2009. The payment period had already been extended to 12 months in July 2007. The period was extended again in May 2005 to 24 months, and in January 2009 it was announced that its scope would be further enlarged by relaxing application requirements. The size of the budget was about €5 billion for 2009, and over €3 billion for 2010. The number of applications leaped after the financial crisis and drastically increased again n January 2009 following the announcement (see Figure 1-2-2-43).

In the light of the above, the policy of enhancing the working-hour reduction compensation system is often considered to be a successful case of employment measures. However, from the mid- and long-term points of view, there is concern that it may harm the efficiency of resource allocation, hindering the potential growth rate and increasing structural unemployment. One report by the European Commission[62] evaluating the economic measures of each European country comments that, for the short term, countries should give priority to maintaining employment and supporting the poor, but that this support should be provided only to targeted groups and for a limited time, and should not interfere with efforts to realize the long-term goal of renovating the labor market. The report also states that the working-hour reduction compensation system may conflict with the principle that competition in the region should be fair, and that coordination at the EU-level is necessary. Furthermore, some analyses[63] suggest that when economic recovery is slow, the effect of this type of employment measure will be to prolong employment adjustments, since there will be strong

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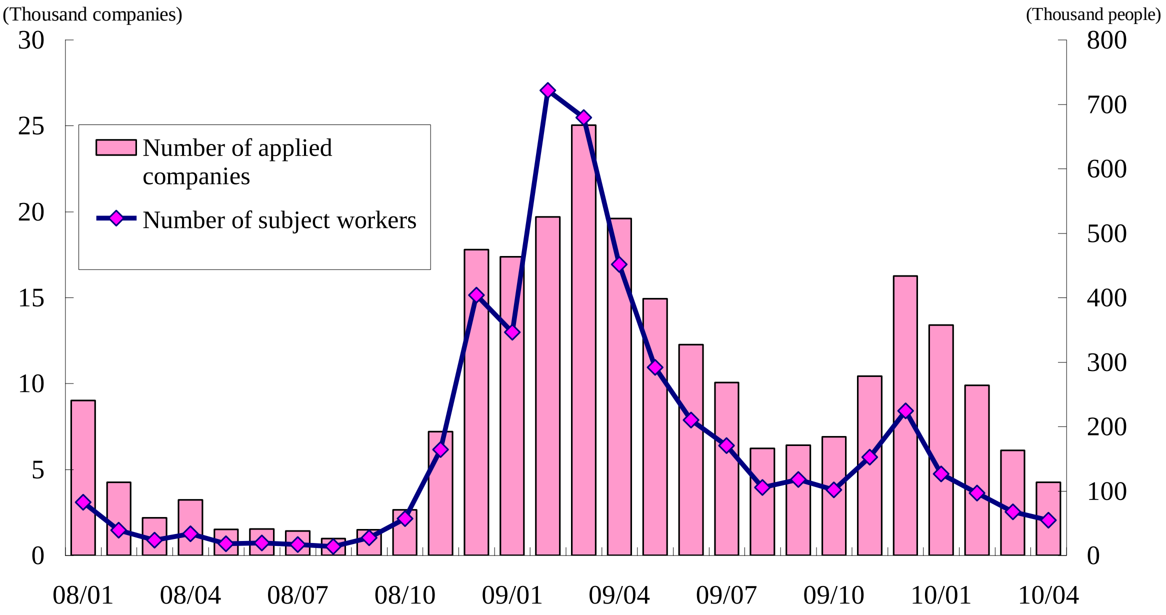
[62] European Commission (2009), "The EU's response to support the real economy during the economic crisis: an overview of Member States' recovery measures" European Economy, Occasional Paper 51, 2009.

[63] Mizuho Research Institute Ltd. 2009 "OUSHUUNO KAKAERU KOYOUCHOUSETSUATSURYOKU – OUSHUUNO KOYOUCHOUSEIWA HONKAKUKASURUNOKA" (MIZUHO OUSHUU INSAITO October 19, 2009

adjustment pressure to fill the gap between actual labor input and ideal labor input based on production and wage conditions. Even in Germany then, risks in the employment market remain.

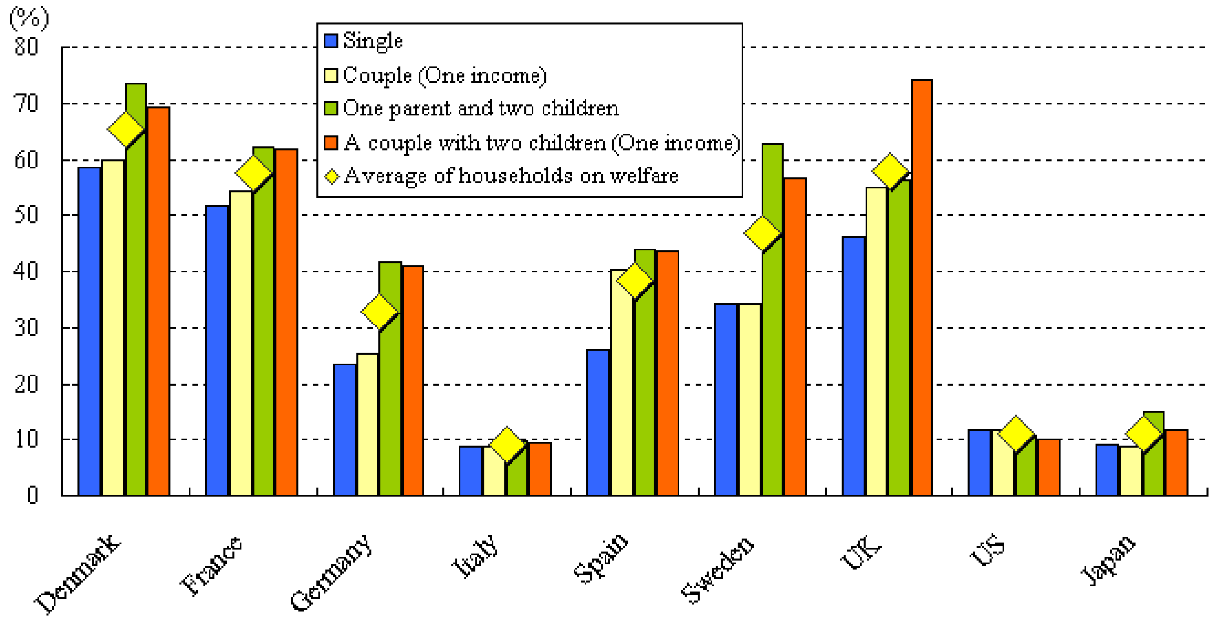
1-2-2-43 Trends in Number of Applications for German Reduced Operation System



Note: The number of subject workers is an application base.
Source: Federal Ministry of Labour and Asocial Affairs, Germany

As for the rate of unemployment benefits provided in place of income in case of 5 years' unemployment, with the exception of Italy, Denmark and Sweden, the major European countries show a higher rate of benefits compared to Japan and the U.S (see Figure 1-2-2-44). There is no direct relationship between unemployment benefits and personal consumption; however, this type of social safety net is considered as important infrastructure to support households in times of crisis.

1-2-2-44 Comparison of Unemployment Benefit Replacement Rate for Each Country



Notes: The ratio of unemployed benefit received during 5 years (60 months) of unemployment period to substitute incomes. Data of 2008. Assumed incomes used for the calculation are 67% and 100% of average wage. The assumed group is households that are not on welfare.

Column 10 Flexicurity in Northern Europe

"Flexicurity" is a portmanteau of "flexibility" and "security", and denotes a policy designed to realize both a relaxed and flexible labor market and a compassionate social security system. Such policies have been in place since the 1990s, mainly in Northern European countries and the Netherlands. Recently, this word has been attracting popular attention because these countries have relatively low and stable unemployment rates and rank high in studies into the overall happiness of nations.

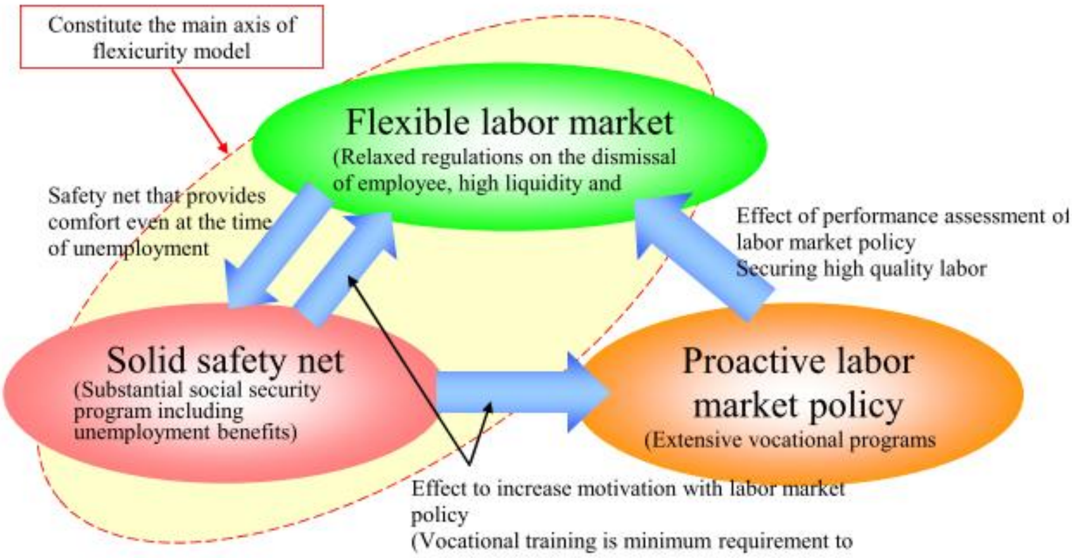
The most successful case is Denmark, which has created a "Golden Triangle"[64] connecting the following: (i) a flexible labor market with relaxed regulations regarding dismissal; (ii) a compassionate social security safety net for the unemployed; and (iii) extensive positive employment measures such as vocational training programs. This system ensures easy industry structure adjustment, stimulates economic growth and creates a favourable cycle for the whole society. Flexicurity was adopted by the EU as an employment strategy in 2005, and also has been adopted into the Lisbon strategy-based approaches to employment strategy in all relevant countries. "Europe 2020", announced by the European Commission in March 2010, clearly states the promotion of the Flexicurity principle.

Flexicurity has been viable in Northern European countries because of their small populations, high standards of education, homogeneous labor populations and very high rates of labor union participation by industry, where the latter in particular serves as infrastructure to protect workers. Therefore, this is not a model that can be easily applied in many countries. Moreover, Denmark also

[64] Bredgaard, T., Larsen, F. and Madsen P.K.(2005)," The Flexible Danish Labour Market- a Review", CARMA Research Paper01:2005. Aalborg University, CARMA, had introduced as "golden triangle" and it was again introduced at European Commission (2006), "Employment in Europe 2006".

experienced problems as a result of the financial crisis. Its unemployment rate, which up to that time had been kept low, started to increase following the crisis, and there is concern over the growing burden on public finances. Nonetheless, as a positive labor policy, Flexicurity can teach us a great deal.

Colum figure 10-1: "Golden Triangle" of Denmark



Source: European Commission