FY2014, FY2015
Economic Outlook

May 16, 2014

<The US Economy >

◆ **Private demand will hold up well due to the progress of household balance sheet adjustment. Also expect the steady expansion of employment**

2014: +2.3% (forecast in March +2.5%)
2015: +2.8% (forecast in March +2.7%)

<The Eurozone Economy >

◆ **Despite the continuation of an export and capital investment-led recovery, eurozone growth is forecast to remain at the lower half of the 1%-level, given the ongoing slump among southern European countries**

2014: +1.0% (forecast in March +1.2%)
2015: +1.3% (forecast in March +1.3%)

<The Asian Economy >

◆ **Despite forecasts of a gradual economic recovery, the rate of economic growth should continue to slow down in China due to constraints upon excessive investment**

2014: +5.9% (forecast in March +6.0%)
2015: +5.9% (forecast in March +5.9%)

<The Japanese Economy >

◆ **Despite a temporary dip due to the impact of the consumption tax hike, external demand and public demand will prop up the economy**

FY2014: +1.0% (forecast in March +0.8%)

◆ **Exports and private demand will recover.　A fall into recession will be avoided even after the consumption tax hike**

FY2015: +1.5% (forecast in March +1.6%)

I. The Chief Economist's View

The US bond and stock markets in a Goldilocks state in the first half of 2014 – Why?

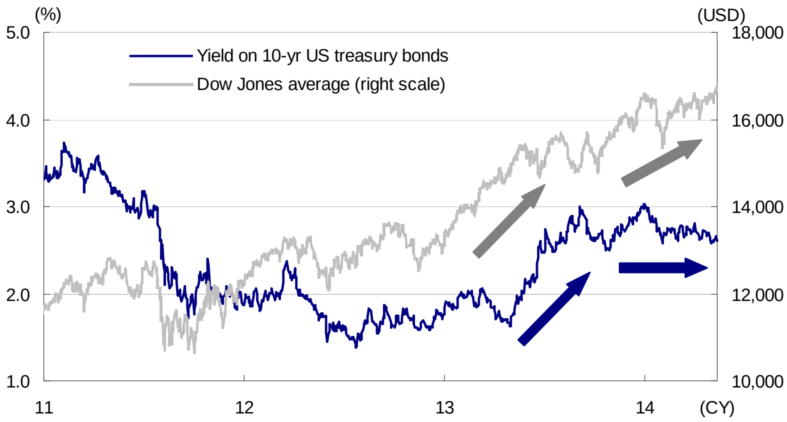
The driver of the economy lacked momentum

At the beginning of last year, Mizuho Research Institute Ltd. (MHRI) shifted its outlook on the basis of the perception that the US economy was nearing its final stage of its balance sheet adjustment process. In our previous economic outlook in February 2014, we made a further upward revision to our US economic outlook in 2014 and also forecast that the eurozone economy would recover to 1% in 2014 from an anomalous two-year consecutive period in negative territory in 2012 and 2013. Turning to Japan, we said that the Japanese economy would follow a recovery track in 2014 despite a temporary slowdown due to the consumption tax hike in April 2014. In contrast, we forecast a slowdown among the emerging countries such as the BRICs. However, despite the uncertainties regarding the emerging countries, we said that our basic scenario on the global economy in 2014 was a "neo-decoupling" in which the global economy will continue to improve driven mainly by the US and eurozone economies. Looking back at the subsequent developments, growth among Japan, the US and the eurozone was not as strong as initially expected at the beginning of the year, and the larger-than-expected concerns regarding the emerging economies served as a major factor for destabilization.

In the US, expectations toward a Great Rotation ended in a Goldilocks market

Chart 1 depicts the relationship between the Dow Jones average and the US long-term interest rate. Since 2013, there was a focus of attention upon the "Great Rotation" from bonds to stocks in the global financial markets – most notably in the US. The Down Jones average recorded historical highs since 2013 and the yield on 10-yr treasury bonds temporarily rose over 3%. As a result, the expectations toward a major shift from bonds to stocks led to discussions on the Great Rotation. However, the long-term interest rate climbed back closer to the mid 2%-level toward the middle of 2014. The current market conditions differ

Chart 1: The Dow Jones average and the yield on US 10-yr treasury bonds



Source: Bloomberg.

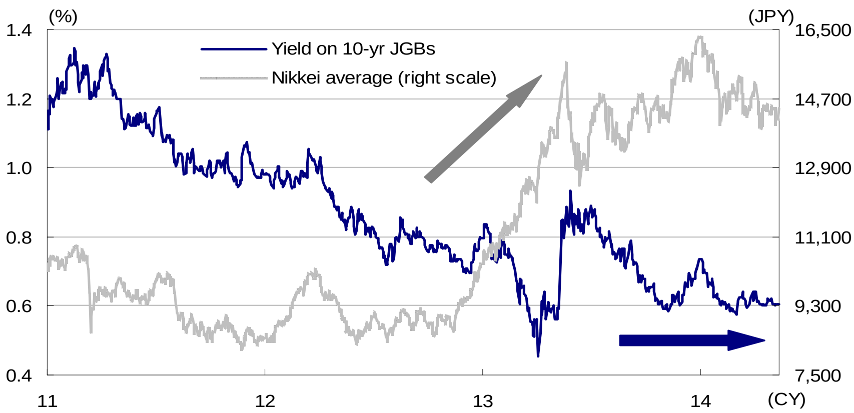
from conventional market movements in times of bullish stocks and rise of interest rates experienced by market participants in times of a market turning point. Many view the current conditions as a "Goldilocks" moment in which the stock and bond markets are neither too hot nor too cold.

The "Goldilocks" market conditions stem not only from the current developed country-led global economy but also from the perception that it would take longer than initially expected to reach the exit because of the extraordinary depth of the balance sheet adjustment since 2007. On a global scale, the developed countries of Japan, the US and the eurozone face an unprecedented output gap. As a result, even though US monetary policy has started to move toward an exit, disinflationary conditions are still lingering. In Japan, attention is gathering around the recovery from the slowdown after the consumption tax hike in April. In the emerging countries, a recovery is unlikely anytime soon since they have just entered a full-scale balance sheet adjustment process. Presumably, all these conditions combined served to create a Goldilocks moment amid the absence of a clear driver of the global economy.

Japan also stands at critical juncture in which its recovery will be tested

Chart 2 shows the relationship between the Nikkei average and the long-term interest rate. Although expectations toward "Abenomics" drove up the stock market in 2013, the stock market has been in a correction since the beginning of 2014. The yield on 10-yr JGBs has reverted to a virtually controlled market of approximately 0.6%. Japan's case is a typical "Goldilocks" condition comprised of a solid stock market and bond market which is just right. Even though Japan found its way out of its balance sheet adjustment process from 2013, this may be a reflection of the fact that the depth of balance sheet adjustment was far more serious than in the US. While the US stock market is recording a historical high, the Japanese stock market remains stagnant in 2014 amid the absence of foreign investors who had supported the rise of Japan's stock market in 2013.

Chart 2: The Nikkei average and the yield on 10-yr JGBs



Source: Bloomberg.

Signs of Japanese corporate activity turning more positive

Recent media reports cite news of wage hikes such as the rise of hourly wages of temporary workers dispatched from manpower agencies and part-time employees stemming from the tightening of the labor market. There are also reports that a large-sale retailing chain will be converting the status of more than 10,000 non-regular employees into regular employee status. Such movements, meaning a shift of labor costs from variable costs to fixed costs, imply a major shift among companies from their labor retrenchment mode in the past. Thus far, the financial behavior of corporate enterprises has basically been a “lean” management stance of deleveraging comprised of slimming down assets and debts. At the same time, in order to survive in a strong-yen environment, corporate enterprises kept prices from rising and took restructuring measures in a bid to cut costs. They refrained from hiring regular employees which would serve as fixed costs and resorted instead to hiring temporary dispatch workers in order to make labor costs variable. The recent movements indicate a major change in conventional Japanese corporate financial behavior. This, in short, is a turnaround from a restructuring mode of compressing balance sheets and costs. Wage hikes amid the improvement of labor market conditions will serve to mitigate the fall of real wages accompanying the consumption tax hike. Inasmuch as the foregoing rise wages will serve to push up prices through channels such as the price of services, it would be necessary to keep a close eye upon ensuing developments.

The Japanese economy reached a crucial stage in the first half of 2014

We have thus far held the storyline that the first half of 2014 is a critical juncture in which the Japanese economy must prepare to enter the “Orbit Phase”. The timing of this juncture coincides with numerous challenges and issues such as (1) preparatory efforts to pass the torch from fiscal policy to the growth strategy, (2) measures to assuage the impact of the consumption tax hike in April, (3) an important time to nurture corporate expectations prior to their preparation of business plans for next fiscal year, and (4) the spring annual labor-management wage negotiations (“*shunto*”). As such, the future course and consequences of Abenomics will depend upon how Japan addresses these challenges.

However, note that Prime Minister Shinzo Abe’s visit to Yasukuni Shrine at the end of December 2013 is raising concerns on Japan’s right-wing shift, thereby leading to a loss of support by overseas investors. This indicates the rise of uncertainties toward Abenomics’ pro-business stance putting economic recovery first. Furthermore, even with respect to monetary policy which is the first arrow of Abenomics, speculation on further easing measures by the Bank of Japan (BOJ) are receding, leading to concerns that Japan may also be on its way to an exit by a “Japanese-version tapering”.

Even though the domestic and external environment remains “hazy” in the first half of 2014, the US stock market nevertheless is recording new highs. Despite the booming US stock market, foreign investors are continuing to side-step the

Japanese stock market in the first half of 2014. Japan will be tested for its mettle to bring back the foreign investors to the Japanese stock market by setting forth a clear scenario for its growth strategy toward the middle of the year in 2014.

On a global scale, the developed economies of Japan, the US and eurozone are continuing to recover. Despite numerous factors which are causing the economy to stall in the first half of 2014 and the rise of awareness that it will take longer than expected to emerge out of the balance sheet adjustment process, the fundamental direction of the recovery remains unchanged. Japan currently stands at a crucial juncture to overcome the temporary slowdown accompanying the consumption tax hike and to progress on to a sustainable recovery. This will be a period of endurance until the economy finds its way back to a steady recovery toward the second half of the year.

Hajime Takata, Chief Economist

II. The global economy

Global growth moderated in the Jan-Mar quarter of 2014

In the Jan-Mar quarter of 2014, the overall global economy moderated from the Oct-Dec quarter of 2013.

The US economy grew +0.1% q-o-q p.a. in the Jan-Mar quarter (Oct-Dec quarter: +2.6% q-o-q p.a.), recording growth of virtually 0% (**Chart 3**). The severe cold winter weather served to hamper corporate activity, causing a decline of housing investment, capital investment and exports. On the other hand, personal consumption held up well, due in part to the rise of demand for heating.

Eurozone real GDP grew +0.8% q-o-q p.a. in the Jan-Mar quarter of 2014 (Oct-Dec quarter: +0.9% q-o-q), recording growth in positive territory for the fourth quarter in a row. However, note that there are wide gaps among the countries of the eurozone. In contrast to the German economy's acceleration reflecting the mild winter weather and the ongoing recovery of the Spanish economy, the economies of France and Italy slumped.

China's real GDP slowed down to +7.4% y-o-y in the Jan-Mar quarter from +7.7% y-o-y in the Oct-Dec quarter. In addition to the moderation of retail sales of consumer goods and investment in fixed assets, export growth also turned out to be tepid.

[Chart 3: Real GDP growth of major countries and areas]

(Q-o-q % change, p.a.)

	2012				2013				2014
	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar
US	3.7	1.2	2.8	0.1	1.1	2.5	4.1	2.6	0.1
Eurozone	-0.3	-1.1	-0.6	-2.0	-0.8	1.3	0.6	0.9	0.8
Japan	3.8	-2.2	-3.0	0.2	4.9	3.5	1.3	0.3	5.9
South Korea	2.2	2.0	1.6	2.6	2.5	4.1	4.4	3.6	3.8
Taiwan	7.4	-0.5	4.3	5.2	-2.4	4.1	0.3	7.3	1.1
Hong Kong	0.8	1.2	3.8	4.5	2.0	2.4	2.7	4.4	
Singapore	8.6	0.0	-6.3	7.6	1.5	14.9	0.3	6.1	0.1
Thailand	50.7	12.8	6.5	12.1	-8.2	2.3	5.8	2.4	
Malaysia	7.3	5.1	4.0	9.2	-1.1	5.8	7.0	8.6	
Philippines	9.4	5.4	8.0	7.0	9.4	6.2	5.2	6.1	
Australia	4.9	2.1	2.8	1.6	2.0	3.3	2.6	3.2	
Brazil	0.6	1.0	2.2	3.6	0.0	7.5	-2.1	2.8	

(Y-o-y % change)

China	7.9	7.6	7.4	7.9	7.7	7.5	7.8	7.7	7.4
Indonesia	6.3	6.3	6.2	6.2	6.0	5.8	5.6	5.7	5.2
Vietnam	4.6	4.8	5.1	5.4	4.8	5.0	5.5	6.0	5.0
India	5.8	4.5	4.6	4.4	4.4	4.4	4.8	4.7	
Russia	4.8	4.3	3.0	2.0	0.8	1.0	1.3	2.0	

Sources: Datastream, CEIC, statistics of relevant countries and areas

Turning to the Asian economies (ex China), the region as a whole remained stagnant. Even though the South Korean economy maintained the level of growth it attained in the Oct-Dec quarter, the rate of economic growth of Taiwan, Singapore, Indonesia and Vietnam moderated from the previous quarter.

On the other hand, Japan's real GDP grew a strong +5.9% q-o-q p.a. in the Jan-Mar quarter (Oct-Dec quarter: +0.3% q-o-q p.a.) due to a last-minute rush of demand prior to the consumption tax hike.

The global economy should pick up, driven mainly by the developed countries

The global economy (the weighted average of all the countries and areas within the scope of MHRI's economic forecast) is forecast to grow around +3.2% in 2014, accelerating from +3.0% in 2013 (**Chart 4**). The pace of US economic growth is forecast to rise to the 2%-level, considering the ebb of downward pressures from fiscal constraints and the expansion of private demand. Likewise, eurozone economic growth should also rise into positive territory for the first time in three years as the negative impact of fiscal constraints starts to fade. On the other hand, the overall pace of Asia's economic growth should remain around the same level as 2013 due to a gradual slowdown of the Chinese economy. The emerging economies should remain stagnant, given the slowdown of the Brazilian and Russian economies. In 2015, the global economy should continue to be driven by the developed economies in contrast to the stagnation of the emerging countries. The rate of global economic growth should rise to 3.5% in 2015, driven by the developed economies such as the US and eurozone economies.

[Chart 4: MHRI outlook on the global economy]

(Y-o-y % change) (Y-o-y % change)

Calendar year	2011 (Actual)	2012 (Actual)	2013 (Actual)	2014 (Forecast)	2015 (Forecast)	2014 (March forecast)	2015 (March forecast)
Total of forecast area	3.9	3.2	3.0	3.2	3.5	3.4	3.5
Japan, US, Eurozone	1.4	1.4	1.0	1.7	2.1	1.9	2.1
US	1.8	2.8	1.9	2.3	2.8	2.5	2.7
Eurozone	1.6	-0.6	-0.4	1.0	1.3	1.2	1.3
Japan	-0.5	1.4	1.6	1.7	1.3	1.3	1.4
Asia	7.6	6.0	6.0	5.9	5.9	6.0	5.9
NIEs	4.2	1.8	2.7	3.4	3.4	3.3	3.3
ASEAN5	4.5	6.2	5.1	4.9	4.9	5.1	5.0
China	9.3	7.7	7.7	7.4	7.2	7.5	7.3
India	7.7	4.8	4.6	4.5	4.5	4.5	4.5
Australia	2.6	3.6	2.4	2.7	2.6	2.8	2.7
Brazil	2.7	1.0	2.3	1.6	1.8	1.6	1.8
Russia	4.3	3.4	1.3	0.2	2.0	2.2	2.8
Japan (FY)	0.3	0.7	2.3	1.0	1.5	0.8	1.6
Crude oil price (WTI, %/bbl)	95	94	98	99	95	96	93

Note: The total of the forecast area is calculated upon the 2012 GDP share (PPP) by the IMF.
Sources: International Monetary Fund (IMF), MHRI.

The pace of US economic growth is forecast to stand at +2.3% in 2014. Even though growth in the Jan-Mar quarter turned out weak due to the severely cold winter weather, the recent spate of economic data is picking up. From the Apr-Jun quarter onward, the US economy should revive to a recovery track of around +2% to +3% p.a. given the ongoing solid growth of private-sector final demand. The strong growth of private-sector final demand should continue in 2015, raising the pace of economic growth to +2.8%.

Eurozone real GDP is forecast to grow +1.0% in 2014, recording growth in positive territory for the first time in three years. In addition to the solid growth of the German economy, economic growth is picking up also among the countries of southern Europe. However, the recovery will likely be tepid and the upturn of domestic demand is expected to be weak among countries subject to downward pressures stemming from balance sheet adjustment in both the public and private sectors. Even though exports will pick up in 2015, being supported by the weak euro, domestic demand will fall short of a full-fledged recovery. The rate of real GDP growth in 2015 should remain at the lower half of the 1%-level, (forecast: 1.3%).

Stagnant growth expected among the emerging countries

The Chinese economy is forecast to remain on a downtrend in 2014 (7.4%) and 2015 (7.2%). China’s real estate market has been softening, given the Chinese government’s policy stance to wean its economy from investment. The odds are high that a sharp fall of economic activity may be avoided because the government is currently implementing small-scale economic stimulus measures. However, since the weakening of the real estate market will serve as a factor to drag down personal consumption, the pace of domestic demand growth will gradually slow down together with the deceleration of investment.

Turning to the Indian economy, domestic demand remains tepid due to the government’s fiscal austerity and monetary tightening. Although concerns regarding a current account deficit and inflation have slightly abated, it is still too early to ease its tightening stance. The pace of India’s economic growth is forecast to remain around the 4%-level for four years in a row since 2012: +4.5% in 2014, +4.5% in 2015.

The Asian economies other than China and India should continue to follow a gradual expansion in both 2014 and 2015. The NIEs (South Korea, Hong Kong, Taiwan, Singapore) should keep growing at the 3%-level (+3.4% in 2014, and +3.4% in 2015) since the economic recovery of the US and Europe should serve as tailwinds for exports. The rate of real GDP of the ASEAN5 (Thailand, Malaysia, Indonesia, the Philippines, Vietnam) should keep growing around 5% (+4.9% in 2014, and +4.9% in 2015). However, Indonesia’s growth may be dragged down by a tighter monetary policy stance and the ongoing political turmoil in Thailand will keep its economic growth subdued. Meanwhile, economic growth of the Philippines is following firm footing. In all of these countries, the recovery of exports should prop up the economy.

Turning to the Australian economy, personal consumption has been treading on firm grounds, reflecting the rise of asset prices due to an accommodative monetary policy stance. In view of forecasts of the recovery of exports and capital investment, the rate of real GDP growth should rise to +2.7% in 2014 from +2.4% in 2013 (estimate by MHRI). In 2015, the Australian economy should moderate slightly to +2.6%, since the slowdown of the Chinese economy should lead to the stagnation of natural resource exports.

The Brazilian economy is still weak, due in part to the impact of the interest rate hikes thus far. Since inflation concerns have not been dispelled completely, the economy is in no state to allow the implementation of large scale economic stimulus measures. The stagnation of demand in China and Argentina which are major destinations for Brazil's exports are also serving as a drag upon the recovery of exports and production. Given the need for fiscal austerity and monetary tightening in order to quell inflation concerns and to avoid a credit rating downgrade, the rate of Brazil's real GDP growth should remain a feeble +1.6% in 2014 and +1.8% in 2015.

Turning to the Russian economy, the economic sanctions by the countries of the west due to Russia's response to the Ukraine (Crimea) is leading to the outflow of capital and fall of investment. The rise of inflation accompanying the weakening of the ruble is eroding real income, leading to a high possibility of a slowdown of personal consumption going forward. In 2014, the pace of real GDP growth is forecast to slow down to a near-zero level of +0.2%. Even though a slight recovery is expected in 2015, the odds are high that uncertainties will linger due to the protraction of the Ukraine crisis. Russia's economic growth is expected to remain at +2.0% in 2015.

The Japanese economy is forecast to keep expanding at a mild pace, growing +1.7% (on a calendar year basis) in 2014 and +1.3% in 2015 despite the drag upon personal consumption and housing investment due to the two consumption tax hikes scheduled, because of Japan's export growth reflecting the weak yen and recovery of the overseas economies, and the ongoing recovery of capital investment.

Emerging market risks require close attention – in particular China's economic slowdown and the escalation of the Ukraine crisis

Ever since last year, the intermittent rise of concerns regarding the emerging economies have caused the fall of stock prices and foreign exchange rates of emerging market currencies. Even though the markets are regaining stability at the moment, concerns regarding the emerging economies are expected to linger.

Considering the Federal Reserve Board's (the Fed) steady steps toward the tapering of its third round of quantitative easing (QE3), the odds are high that QE3 will be ended by the end of 2014. The US shift from a tapering of QE3 to a tightening stance will tend to create the impression that capital flows to the emerging countries will decline, meaning that the risks of market destabilization will persist due to speculation on the timing of the interest rate hike in the US.

Since the emerging countries such as Brazil and India possessing current account deficits and concerns regarding inflation will be compelled to take a relatively tighter fiscal and monetary policy stance in order to reduce the potential risks of a capital exodus, a full-fledged recovery is unlikely anytime soon.

Turning to China where the problems of excessive investment and shadow banking are starting to surface, there is a high possibility that the economy will continue to slow down. Moreover, the risk of a fall into a sharp and major adjustment cycle cannot be ruled out altogether. Despite regional disparities, current signs that the real estate market is starting to soften must be watched closely. Given China's role as the world's growth center in the 2000s, its slowdown would have a major impact upon the real economy and the financial and capital markets of the world – centering upon the countries of Asia including Japan. No doubt, the Chinese economy is the greatest risk factor for the world economy during the forecast horizon.

Geopolitical risks also require ongoing attention. Dangerous and unpredictable conditions have been continuing since early spring due to the rise of tensions between Russia and the Ukraine over Crimea, leading to economic sanctions by the countries of the west upon Russia. Even though it is unlikely that either Russia or the countries of the west will resort to drastic steps, if the west steps up its economic sanctions and Russia responds by suspending the supply of energy, this may serve as a considerable blow upon the global economy (mainly Europe).

Over territorial issues, tensions are rising between China and Vietnam and the Philippines. For some time, it will be necessary to keep a close eye upon the risks of a slowdown/adjustment of the emerging economies and the rise of geopolitical risks.

[Chart 5:　Key political and economic events in 2014]

2014 May	India	General elections (vote 12th, opening of ballots 16th)
	Japan	BOJ Monetary Policy Meeting (20th, 21st)
	Europe	European parliament election (22nd - 25th)
	Europe	Belgian general elections (25th)
	Ukraine	Presidential election (25th)
Jun	G7 summit meeting (Brussels, Belgium) (4th, 5th)	
	Europe	ECB Governing Council Meeting (5th)
	Japan	BOJ Monetary Policy Meeting (12th, 13th)
	FIFA World Cup Soccer, Brazil (June 12th - July 13th)	
	US	FOMC (17th, 18th)
	Europe	EU summit meeting (26th, 27th)
	Japan	New growth strategy (in June)
	Egypt	Presidential election (26th - 28th)
Jul	Europe	ECB Governing Council Meeting (3rd)
	Indonesia	Presidential election (9th)
	Japan	BOJ Monetary Policy Meeting (Interim assessment of Outlook Report)(14th, 15th)
	US	FOMC (29th, 30th)
	US	FRB Chairman Semiannual Monetary Policy Report to Congress (July)
Aug	Europe	ECB Governing Council Meeting (7th)
	Japan	BOJ Monetary Policy Meeting (7th, 8th)
Sep	Japan	BOJ Monetary Policy Meeting (3rd, 4th)
	Europe	ECB Governing Council Meeting (4th)
	Nato Summit Meeting (4th, 5th) (UK)	
	Europe	Swedish General Elections (14th)
	US	FOMC (16th, 17th)
	Europe	Scottish independence referendum (18th)
	G20 Meeting of Finance Ministers and Central Bank Governors (20th, 21st) (Cairns, Australia)	
	Europe	French Senate elections (September)
	UN General Assembly (September)	
Oct	Europe	ECB Governing Council Meeting (2nd)
	Japan	BOJ Monetary Policy Meeting (6th, 7th)
	Annual Meeting of the IMF and World Bank Group (Washington DC, US) (10th)	
	G20 Meeting of Finance Ministers and Central Bank Governors (Washington DC, US) (10th)	
	US	FOMC (28th, 29th)
	Japan	BOJ Monetary Policy Meeting (Outlook Report) (31st)
	APEC Economic Leaders' Meeting (Beijing, China) (mid-October)	
	ASEAN Summit (Nay Pyi Taw, Myanmar) (October)	
	Brazil	Presidential Election (October)
Nov	US	US midterm elections (4th)
	Europe	ECB unification of banking supervision (4th)
	Europe	ECB Governing Council Meeting (6th)
	G20 Summit Meeting (Brisbane, Australia) (15th, 16th)	
	Japan	BOJ Monetary Policy Meeting (18th, 19th)
Dec	COP20 (Lima, Peru) (1st - 12th)	
	Europe	ECB Monetary Policy Meeting (4th)
	US	FOMC (16th, 17th)
	Japan	BOJ Monetary Policy Meeting (18th, 19th)
	Japan	Decision on consumption tax hike in October 2015 (December)
	China	Central Economic Work Conference (December)

Source: Made by MHRI.

III. The Japanese economy

(1) Overview of the Jan-Mar quarter 2014 *1st QE*

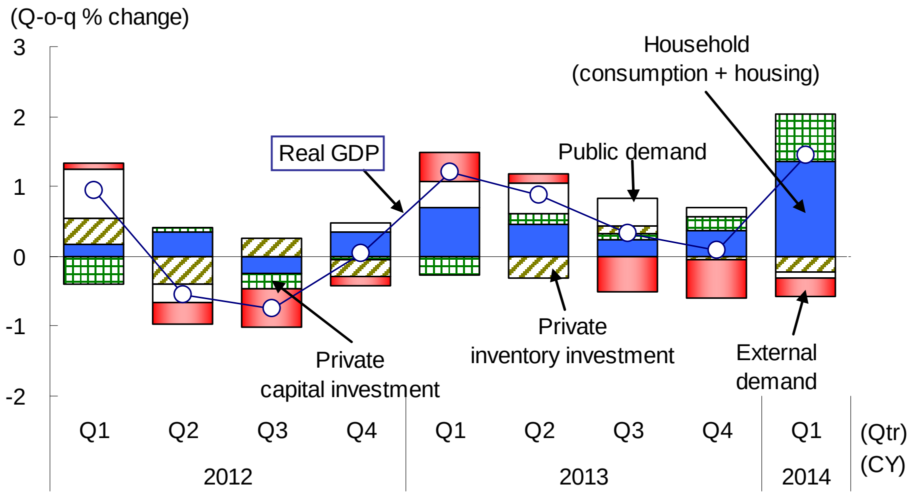
The Japanese economy grew a strong +5.9% q-o-q p.a. in the Jan-Mar quarter of 2014 the last-minute rush of demand prior to the consumption tax hike

According to the *First Preliminary Quarterly Estimates of GDP (1st QE)* for the Jan-Mar quarter of 2014, Japan's real GDP grew a strong +1.5% q-o-q (or +5.9% in annualized terms) (**Chart 6**).

Domestic private demand accelerated to +2.3% q-o-q (contribution to real GDP +1.8% pt), serving as the engine of Japan's growth. The last-minute rush of demand prior to the consumption tax hike in April became evident in a wide range of items, resulting in a strong +2.1% q-o-q rise of personal consumption (Oct-Dec quarter +0.4% q-o-q). Capital investment also rose to +4.9% q-o-q (Oct-Dec quarter +1.4% q-o-q) driven by large-scale projects related to power plants and the shortage of capacity among nonmanufacturers. Housing investment grew +3.1 q-o-q, rising for eight quarters in a row, driven by the progress of housing starts which were front-loaded in a rush before the consumption tax hike. On the other hand, private-sector inventory investment turned out to be a negative contribution to growth (-0.2% pt) due to a run-down of stocks in a bid to meet the last-minute demand.

Public demand fell (0.4% q-o-q, contribution -0.1% pt), declining for the first time in seven quarters. Despite the ongoing growth of government consumption (+0.1% q-o-q) reflecting factors such as the rise of social security-related expenditures, public investment slowed sharply (-2.4% q-o-q) as post-disaster reconstruction-related demand peaked out and the projects related to the emergency economic stimulus measures (in the FY2012 supplementary budget passed in February 2013) ran their course.

[Chart 6: Japan's quarterly real GDP growth]



Source: Cabinet Office, *National Accounts.*

Exports grew +6.0% q-o-q, recording a rise for two quarters in a row (note however, that the estimation of exports may have turned out to be larger than what they are due to the impact of the renewal of the *Balance of Payments Statistics* used in the estimation). Even though exports to the emerging countries of Asia slumped, exports to the US continued to pick up. On the other hand, the last-minute rush of demand for durable consumer goods and mineral fuel ahead of the consumption tax hike and environment tax hike led to a further acceleration of imports (+6.3% q-o-q), keeping the contribution by external demand in negative territory (-0.3% pt) for the third quarter in a row (Oct-Dec quarter -0.6% pt).

FY2013 growth: +2.3%

FY2013 real GDP grew +2.3%. Personal consumption turned out to grow a slightly higher +2.5% y-o-y due to the improvement of consumer sentiment along with the rise of the stock market in the first half of the fiscal year and the gradual materialization of the last-minute rush of demand prior to the consumption tax hike in the second half of the fiscal year. Public investment also rose sharply (+15.3% y-o-y), given the large-scale fiscal stimulus. The year may be summed up as a year of growth driven by the policy effect of "Abenomics" which led to the expansion of domestic demand. On the other hand, the contribution by external demand remained negative (-0.5% pt) due to the rise of imports of fuel and durable consumer goods.

(2) Outlook on the Japanese economy in FY2014 and FY2015

Even though growth in FY2014 will decline to +1.0%, a recession will be avoided

In FY2014, the pace of Japan's economic growth will fall deep into negative territory in the Apr-Jun quarter immediately after the consumption tax hike. However, the economy should return to a recovery track from the Jul-Sep quarter on the back of the recovery of external demand and the implementation of additional public works projects in the economic stimulus package.

In the Apr-Jun quarter, public investment should serve to underpin growth due to the implementation of the projects in the economic stimulus package (the "Economic Measures for Realization of Positive Cycles") compiled by the FY2013 supplementary budget. Of the economic stimulus measures worth JPY5.5 trillion, we expect that approximately JPY2 trillion will be earmarked for public works possessing immediate stimulus upon the economy. Furthermore, given the fall of imports along with the fall of domestic demand after the consumption tax hike and efforts to strengthen exports in items such as cars, external demand should serve as a significant positive contribution to growth. Even so, the Apr-Jun quarter may not avoid a sharp plunge of growth into negative territory (forecast: -4.0% q-o-q p.a.) due to the fall of personal consumption and housing investment because of the backlash to the last-minute rush of demand prior to the consumption tax hike and erosion of household real income.

From the Jul-Sep quarter, the Japanese economy should return to a gradual recovery track, driven by the growth of exports reflecting the weakness of the yen and recovery of the overseas economies. Personal consumption (in real terms) will likely fall below previous-year levels throughout the year because of the erosion of real income due to the consumption tax hike. However, personal consumption should gradually pick up from the level in the Apr-Jun quarter which slumped due to the backlash to the last-minute rush of demand.

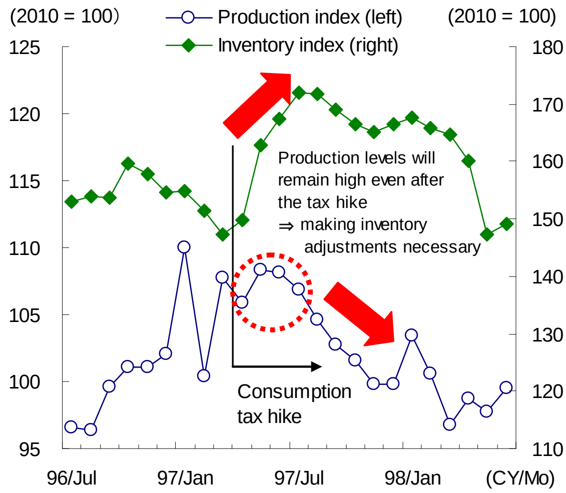
As such, the pace of real GDP growth in FY2014 is forecast to slow down to +1.0% (forecast in March: +0.8%) (**Chart 11**).

The risks of inventory adjustment are not as large as in 1997 following the previous consumption tax hike

At the time of the previous consumption tax hike (1997), durable goods makers retained their aggressive production plans, leading to the build-up of inventories over the summer months and making an inventory adjustment inevitable (**Chart 7**; since then, the slowdown of exports accompanying the Asian Financial Crisis and fall of domestic demand due to Japan's domestic financial crisis led to the prolongation of the inventory adjustment until the end of 1998).

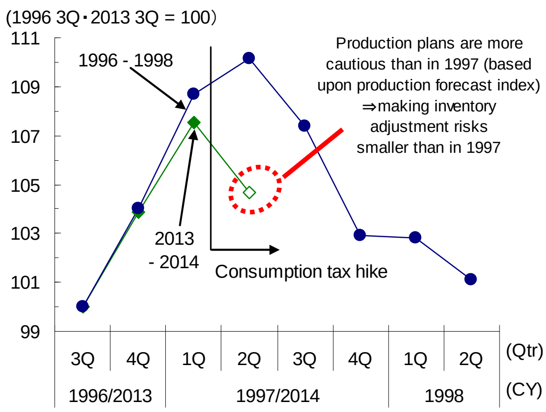
In comparison, the production plans with respect to durable consumer goods this time are considerably more cautious than in 1997. According to estimations of the level of production based upon the production forecast index, the level of production in the Apr-Jun quarter of 2014 would fall sharply below the Jan-Mar quarter and would only be around the level in the Oct-Dec quarter of 2013 (**Chart 8**; refer to the notes to chart for the estimation method). Judging from various media reports that the breadth of the fall of personal consumption in April was more or less comparable to the time of the previous consumption tax hike, amid the adoption of production plans which are more cautious than in 1997, the inventory adjustment risks over the summer months would not be so large.

[Chart 7: The indices on production and inventories (durable consumer goods) before and after the consumption tax hike in 1997]



Source: Ministry of Economy, Trade and Industry, *Indices of Industrial Production.*

[Chart 8: The production index (durable consumer goods) before and after the consumption tax hike (1997, 2014)]



Note: The Apr-Jun qtr of 2014 is estimated on the assumption that production in April and May will be according to the production forecast index (durable consumer goods) and that June will be flat.
Source: Ministry of Economy, Trade and Industry, *Indices of Industrial Production.*

Our latest *Economic Outlook* is based upon the assumption (as of May 16th) that several of the 17 nuclear power reactors currently applying for screening under the new safety standards would be restarted (**Chart 9**). The restart of the nuclear power reactors should serve to push up the rate of real GDP growth by curbing imports.

FY2015 real GDP growth will rise to +1.5%. While growth in 1H will be pushed up by the last-minute rush of demand, a backlash will ensue in 2H

In FY2015, we assume that the consumption tax rate will be raised as scheduled to 10% in October (**Chart 10**). Therefore, the last-minute rush of demand and its backlash accompanying the consumption tax hike will serve as a volatile factor upon growth in FY2015. According to a trial calculation based upon movements at the time of the tax hike in FY1997 as well as recent trends, the rate of real GDP growth (on a q-o-q basis) would be pushed up by approximately 0.5% pt in the first half of FY2015 and be dragged down by approximately 1.5% pt in the second half of FY2015.

Again in FY2015, we also expect the compilation of an economic stimulus package totaling approximately JPY2 trillion (of which approximately JPY1.5 trillion will be earmarked for public works) to prevent the economy from falling into a recession after the consumption tax hike. We expect the additional public works projects to be implemented in the second half of the fiscal year and push up the rate of real GDP in FY2015 by approximately 0.3% pt. Furthermore, we also assume that a reduced tax rate will be applied for food (excluding alcoholic beverages and restaurant meals) at the time of the consumption tax hike in FY2015.

As shown above, we expect growth in FY2015 to be pushed up by a last-minute rush of demand in the first half of the fiscal year, followed by a sharp fall into negative territory again in the Oct-Dec quarter immediately after the consumption tax hike. Even so, the Japanese economy should pick up toward the end of the fiscal year (end of March 2016) due to the rise of exports reflecting the overseas economic recovery and the upturn of capital investment. Hence, we

[Chart 9: Assumptions regarding the restart of nuclear power reactors]

		Electric power company	Name of nuclear power reactor	Rated output (10,000 kW)
2014	3Q	Kyushu Electric Power Co., Inc.	Kawauchi (Reactors No. 1,2)	89.0×2
2015	3Q		Genkai (Reactors No. 3,4)	118.0×2
		Shikoku Electric Power Co. Inc.	Ikata (Reactor No. 3)	89.0
	4Q	Kansai Electric Power Co., Inc	Ooi (Reactors No. 3,4)	118.0×2
			Takahama (Reactors No. 3,4)	87.0×2
		Hokkaido Electric Power Co., Inc.	Tomari (Reactor No. 3)	91.2
			Tomari (Reactors No. 1,2)	57.9×2
			Total	1120

Note: Assumption in MHRI's latest *Economic Outlook*
Sources: Made by MHRI based upon various media reports.

[Chart 10: Assumptions regarding the consumption tax hike]

	Details
Consumption tax rate	・Raised to 8% in Apr 2014 ・Raised to 10% in Oct 2015
Reduced tax rate	・Introduced in Oct 2015 ・Applied to food (ex alcoholic beverages and restaurant meals)
Economic stimulus measures (for consumption tax hike)	・JPY5.5 tril economic stimulus package at the time of the FY2014 tax hike (approximately JPY2 tril for public works) ・JPY2 tril economic stimulus package at the time of the FY2015 tax hike (approximately JPY1.5 tril for public works)

Note: Assumption in MHRI's latest *Economic Outlook*
Sources: Made by MHRI based upon various media reports.

forecast that the Japanese economy will grow +1.5% in FY2015 (forecast in March: +1.6%).

[Chart 11: Outlook on the Japanese economy]

		2012	2013	2014	2015	2013		2014				2015				2016
		FY				Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar
GDP (real)	Q-o-q % ch	0.7	2.3	1.0	1.5	0.3	0.1	1.5	-1.0	0.8	0.3	0.3	0.6	0.8	-0.9	0.8
	Q-o-q % ch p.a.	--	--	--	--	1.3	0.3	5.9	-4.0	3.2	1.4	1.3	2.3	3.2	-3.6	3.4
Domestic demand	Q-o-q % ch	1.4	2.7	0.6	1.1	0.8	0.6	1.7	-1.7	0.4	0.4	0.3	0.6	0.9	-1.6	0.6
Private sector demand	Q-o-q % ch	1.4	2.2	0.4	1.3	0.6	0.7	2.3	-2.4	0.3	0.6	0.5	0.8	1.2	-2.3	0.6
Personal consumption	Q-o-q % ch	1.5	2.5	-0.7	1.3	0.2	0.4	2.1	-3.1	0.6	0.4	0.3	0.9	1.6	-2.9	0.7
Housing investment	Q-o-q % ch	5.3	9.5	-5.8	-1.1	3.3	4.3	3.1	-7.4	-4.3	-1.1	2.2	1.7	0.2	-4.8	-2.4
Capital investment	Q-o-q % ch	0.8	1.7	4.6	2.5	0.7	1.4	4.9	0.3	-0.5	0.4	0.6	0.8	1.0	0.3	0.7
Inventory investment	Q-o-q contribution, % pt	-0.1	-0.3	0.2	-0.1	0.1	0.0	-0.2	0.2	0.1	0.2	0.0	-0.1	-0.2	0.1	0.0
Public sector demand	Q-o-q % ch	1.4	4.5	1.3	0.6	1.5	0.5	-0.4	0.8	0.6	-0.3	-0.3	0.2	0.1	0.8	0.5
Government consumption	Q-o-q % ch	1.5	2.1	1.6	1.5	0.2	0.3	0.1	0.5	0.5	0.5	0.5	0.3	0.3	0.3	0.3
Public investment	Q-o-q % ch	1.3	15.3	-1.0	-3.2	6.9	1.2	-2.4	1.8	1.0	-4.0	-4.2	-0.5	-0.9	3.4	1.7
External demand	Q-o-q contribution, % pt	-0.8	-0.5	0.5	0.4	-0.5	-0.6	-0.3	0.8	0.5	-0.1	0.0	-0.1	-0.2	0.8	0.3
Exports	Q-o-q % ch	-1.2	4.7	7.8	4.8	-0.7	0.5	6.0	1.5	1.0	1.2	1.2	1.0	1.0	1.9	1.1
Imports	Q-o-q % ch	3.7	7.1	4.1	2.8	2.4	3.7	6.3	-2.5	-1.6	1.4	1.0	1.5	1.9	-2.0	-0.5
GDP (nominal)	Q-o-q % ch	-0.2	1.9	2.7	2.2	0.2	0.2	1.2	0.8	0.8	0.5	0.1	1.0	0.6	0.0	0.8
GDP deflator	Y-o-y % ch	-0.9	-0.3	1.6	0.7	-0.4	-0.4	0.0	1.4	1.8	1.6	1.8	0.5	0.3	0.9	1.2
Domestic demand deflator	Y-o-y % ch	-0.8	0.3	1.6	0.8	0.3	0.5	0.7	1.7	1.8	1.4	1.4	0.4	0.4	1.0	1.3

Notes: Figures in the shaded areas are forecasts.
Source: Made by MHRI based upon Cabinet Office, *Preliminary Quarterly Estimates of GDP*

		2012	2013	2014	2015	2013		2014				2015				2016
		FY				Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar
Industrial production	Q-o-q % ch	-2.9	3.2	2.5	2.6	1.8	1.8	2.9	-1.4	-0.4	0.7	1.0	0.9	1.4	-0.7	-0.3
Ordinary profits	Y-o-y % ch	8.1	20.4	1.7	3.7	20.1	25.1	15.5	-0.5	4.3	0.5	2.8	6.9	3.4	3.5	1.1
Nominal compensation of employees	Y-o-y % ch	0.1	1.0	1.5	1.6	0.6	1.6	0.4	1.5	1.3	1.8	1.2	1.6	1.7	1.9	1.2
Unemployment rate	%	4.3	3.9	3.6	3.5	4.0	3.9	3.6	3.6	3.6	3.6	3.6	3.5	3.5	3.5	3.5
New housing starts	P.a., 10,000 units	89.3	98.7	91.1	88.6	99.0	104.1	93.4	89.1	89.9	91.2	94.8	94.6	88.4	85.3	86.5
Current account balance	P.a., JPY tril	4.2	0.8	3.9	5.8	2.3	0.0	-5.6	3.6	4.3	5.4	1.3	5.4	3.7	8.4	5.7
Domestic corporate goods prices	Y-o-y % ch	-1.1	1.9	3.9	2.4	2.2	2.5	1.9	4.1	4.0	3.8	3.8	1.2	1.4	3.3	3.6
Consumer prices	Y-o-y % ch	-0.2	0.8	3.1	1.6	0.7	1.1	1.3	3.2	3.1	3.0	3.0	1.0	1.1	2.1	2.2
Consumer prices (ex consumption tax)	Y-o-y % ch	-0.2	0.8	1.1	1.1	0.7	1.1	1.3	1.3	1.1	1.0	1.0	1.0	1.1	1.0	1.1
Uncollateralized overnight call rate	%	0.06	0.04	0～0.10	0～0.10	0.06	0.07	0.04	0～0.10	0～0.10	0～0.10	0～0.10	0～0.10	0～0.10	0～0.10	0～0.10
Yield on newly-issued 10-yr JGBs	%	0.78	0.69	0.79	1.05	0.77	0.64	0.63	0.64	0.78	0.85	0.90	0.95	1.00	1.10	1.15
Nikkei average	JPY	9,650	14,424	15,600	17,400	14,139	14,972	14,964	14,800	15,600	15,900	16,200	16,700	17,200	17,500	18,000
Exchange rate	JPY/USD	83.0	100.0	105.0	112.0	99.0	101.0	103.0	103.0	105.0	106.0	107.0	109.0	111.0	113.0	114.0
Crude oil price (WTI nearest term contract)	USD/bbl	92.0	99.0	98.0	94.0	106.0	98.0	99.0	100.0	99.0	98.0	96.0	95.0	95.0	94.0	94.0

Notes: 1. Figures in the shaded areas are forecasts.The readings above may differ from public releases because the rates of change are calculated based upon actual results.
2. Ordinary profits are based upon the *Financial Statements Statistics of Corporations by Industry* (all industries) (ex finance & insurance, and production, transmission and distribution of electricity services).
3. Consumer prices exclude fresh food (2010 base). Based upon the assumption that the consumption tax will be raised to 8% in Apr 2014 and 10% in Oct 2015 (with a reduced tax rate to be applied to food (ex alcoholic beverages and restaurant meals) in Oct 2015.
4. Quarterly data on the unemployment rate, new housing starts and current account balance are seasonally-adjusted.
5. Of the finance-related indices, the uncollateralized overnight call rate refers to the rate at the end of term, the yield on newly-issued 10-yr JGBs refers to the average of the end-of-month rates during the relevant term, and all others are averages during the relevant terms.

Sources: Made by MHRI based upon Cabinet Office, *Preliminary Quarterly Estimates of GDP*, Ministry of Economy, Trade and Industry, *Indices of Industrial Production*, Ministry of Finance, *Financial Statements Statistics of Corporations by Industry, Quarterly*, Ministry of Internal Affairs and Communications, *Labor Force Survey, Consumer Price Index*, Ministry of Land, Infrastructure, Transport and Tourism, *Current Survey on Construction Statistics*, Bank of Japan, *Balance of Payments*, *Corporate Goods Price Index*, *Financial and Economic Statistics Monthly, Foreign Exchange Rates*, Japan Bond Trading Co., Ltd., *Latest Daily JGB Rates*, Nikkei Inc. and Bloomberg

Slow improvement of the output gap

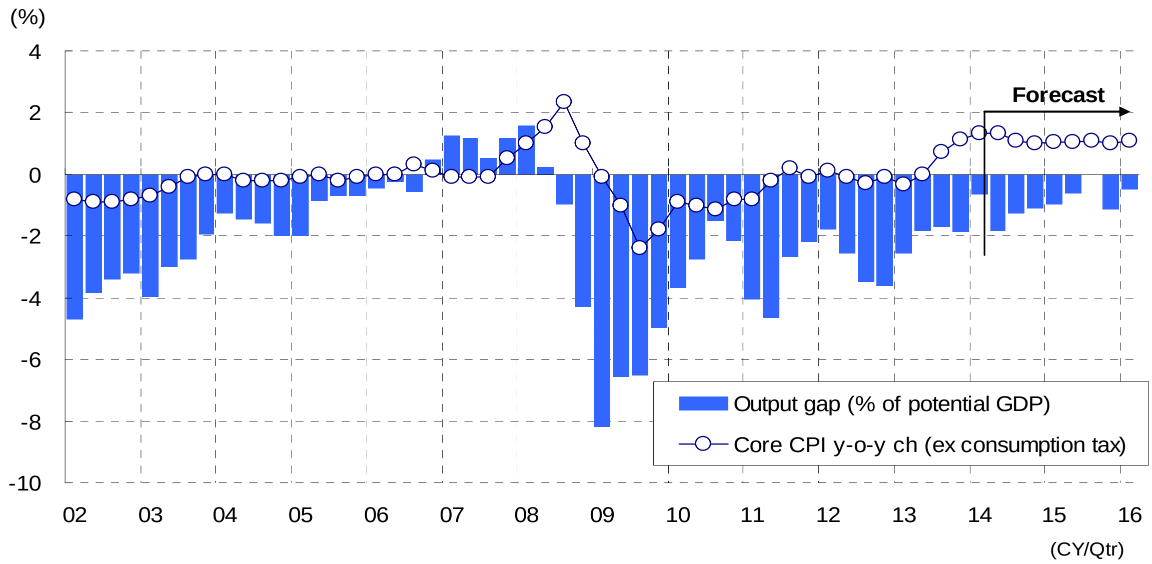
As of the Jan-Mar quarter of 2014, the output gap (the gap between actual GDP and potential GDP) estimated by MHRI stood at -0.6% of potential GDP (meaning an excess of supply of approximately JPY3 trillion) (**Chart 12**). That said, the breadth of the negative output gap should widen again in the Apr-Jun quarter of 2014 due to the fading impact of the last-minute rush of demand and remain in negative territory during FY2014. In FY2015, even though demand and supply should balance at one point in time during the Jul-Sep quarter prior to the consumption tax hike, the output gap should fall into negative territory after the tax hike. Due in part to the impact of the two consumption tax hikes, the output gap is only expected to improve at a slow pace.

The odds are high that the y-o-y change of the core CPI (ex impact of consumption tax hike) will fail to reach 2% in FY2015

The core CPI (general, excluding fresh food) rose to +1.3% y-o-y as of March 2014. However, this stems largely from the rise of energy prices such as the upturn of gasoline prices and electrical power charges reflecting the weak yen and rise of crude oil prices. The upward pressures stemming from these factors upon the percentage change of the CPI should gradually fade. Furthermore, the expansion of the negative output gap due to the temporary fall of domestic demand stemming from the consumption tax hike should serve to curb the rise of inflation for the time being. Despite movements to raise prices to cover both the rise of costs up until then and the rise of the consumption tax at the time of the tax hike in April, the rise of the core CPI should moderate from May onward.

Even so, in the second half of FY2014, we expect to see moves to pass on the recovery of wages to prices along with the gradual recovery of domestic demand. The year-on-year change of the core CPI (excluding the impact of the consumption tax hike) for the full year in FY2014 should stand at +1.1% (+3.1% when including the impact of the consumption tax hike), surpassing the rise in FY2013.

[Chart 12: The output gap and the core CPI]



Notes: The core CPI refers to the CPI (ex fresh food). The output gap is estimated by MHRI.
Sources: Made by MHRI based upon Cabinet Office, *National Accounts,* Ministry of Internal Affairs and Communications, *Consumer Price Index* , and others.

Again in FY2015, the fall of demand after the consumption tax hike should keep the rise of the inflation rate subdued. During the full year FY2015, the year-on-year change of the core CPI (excluding the impact of the consumption tax hike) is expected to reach +1.1% (+1.6% when including the impact of the consumption tax hike), rising at a pace on par with FY2014.

As shown above, despite a gradual rise of the inflation rate, the rise will still fall short of the Bank of Japan's (BOJ) inflation target of "2% in two years". The BOJ will likely decide to extend its quantitative and qualitative monetary easing measures when it becomes evident that it is difficult to achieve its target.

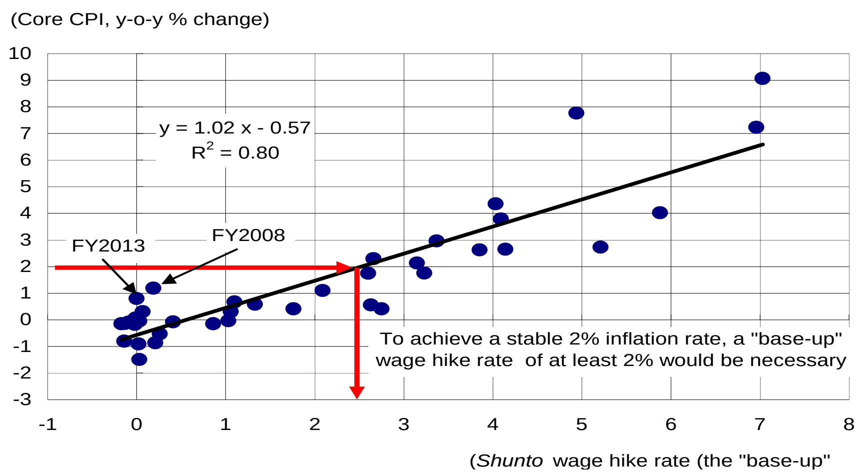
The 2014 *shunto* wage negotiations appear to have achieved "base-up" of around 0.4%

Turning to the spring labor-management wage negotiations ("*shunto*") in 2014 which gathered attention to forecast the future course of the economy and prices, the results of surveys by the Japanese Trade Union Confederation (RENGO) reveal that the negotiations are about to reach agreement on a "base-up" (an increase of the overall level of wages) of slightly over 2%. Excluding the regular wage hike among large companies (which is said to be around 1.6% to 1.8%), on average it appears that a base-up wage hike of approximately 0.4% has been achieved.

The base-up wage hike of 0.4% or so, which the 2014 *shunto* appears to have achieved, is not necessarily sufficient in view of the 2% inflation target. In order to keep the inflation rate stably at 2% , a base-up of at least 2% would be necessary (**Chart 13**). Even if the inflation rate reaches 2%, in the event the "base-up" rate falls below 2%, it would lead to the erosion of household real purchasing power and send downward pressures upon prices through the decline of consumption. To reach the 2% inflation target, it would be necessary to achieve progressively larger wage hikes in the *shunto* negotiations from 2015 onward.

However, in view of the fact that base-up rates have hovered at more or less zero for more than 10 years, the rise of the base-up rate in the 2014 *shunto* – however modest it may be – may be deemed as an important step toward achieve-

[Chart 13: The *shunto* wage hike rate (the base-up portion) and inflation rate (FY1976 – FY2013)]



Notes: 1. The y-o-y change of the core CPI in FY1997 excludes the impact of the consumption tax hike.
2. The shunto wage hike rate (the "base-up" portion) is subtracting the regular wage hike (assumed to be 1.8%) from the overall wage hike rate.

Sources: Made by MHRI based upon releases by the Ministry of Health, Labor and Welfare and the Ministry of Internal Affairs and Communications.

ment of the 2% inflation target. From around mid-FY2014 when the economy returns to a recovery track, we expect a movement to pass on the rise of costs stemming from the wage hike to prices of products and services, If this movement takes root, this would gradually lower the hurdles for corporate enterprises to raise wages and lead to a further spread of “base-up” hikes in the *shunto* negotiations in 2015. MHRI forecasts that the wage increase rate would gradually rise from 2016 onward if the economic expansion continues over the medium- to long-term.

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