FY2013 and FY2014 Economic Outlook

August 14, 2013

Key points of Mizuho Research Institute's (MHRI) outlook on the economy in FY2013 and FY2014 reflecting *The First Preliminary Quarterly Estimates of GDP (1st QE)* of Japan for the Apr-Jun quarter of 2013

<The US Economy >

◆ **Even though the fall of government spending will serve as a drag, private-sector demand will hold up well due to the progress of household balance sheet adjustment. Payrolls will also grow steadily**

2013: +1.4% (forecast in June +1.6%)
2014: +2.2% (forecast in June +2.2%)

<The Eurozone Economy >

◆ **The economy will follow a gradual export-led recovery in the second half of 2013. In 2014, downward pressures from fiscal conditions should ease slightly**

2013: -0.6% (forecast in June -0.6%)
2014: +0.8% (forecast in June +0.8%)

<The Asian Economy >

◆ **Despite forecasts of a gradual export-led economic recovery, the Chinese economy will continue to slow down due to constraints upon excessive investment**

2013: +5.9% (forecast in June +6.1%)
2014: +6.0% (forecast in June +6.3%)

<The Japanese Economy >

◆ **Personal consumption and exports will serve as the engines of growth. In the second half of the fiscal year, a rush of demand prior to the consumption tax hike will accelerate the economy**

FY2013: +2.7% (forecast in June +2.7%)

◆ **Despite a temporary dip due to the impact of the consumption tax hike, the economy will avoid falling into a recession**

FY2014: +0.6% (forecast in June +0.6%)

I. The Chief Economist's View

Despite a downward revision of forecasts on emerging countries,
Japan and the US will serve as the anchors of global growth

A shift from the "era where the world may no longer depend upon the US"

In a book published by MHRI two years ago - *Nihon keizai no asu wo yomu 2012* (Forecasting the Japanese economy in 2012)[1] – the main theme was an "era where the world may no longer depend upon the US". In the background was the fact that the US had fallen into a balance sheet adjustment since 2007 following the subprime loan crisis and the so-called Lehman Shock after the collapse of Lehman Brothers. The eurozone had also slid into a balance sheet adjustment due to the eurozone debt crisis which occurred just around the same time. Japan was in a permanent state of balance sheet adjustment ever since the collapse of the bubble economy in the 1990s. In short, for the first time since WWII, the world faced a state where all the key developed economies – Japan, the US and Europe – fell into a simultaneous balance sheet adjustment from 2007 onward. During this period, it was not the foregoing developed economies of Japan, the US and Europe, but the emerging economies centering around China (referred to as the BRICs) that served as the drivers of growth. Our message two years ago - namely that "the world can no longer depend upon the US" - delivered the message that the world can no longer depend upon the developed economies such as Japan, the US and Europe (represented symbolically by the US) and implied an era in which the world depends upon China and the emerging economies.

Two years on, significant shifts in global conditions have led to an "era of dependence upon Japan and the US". At the same time, note a slowdown among China and major emerging countries even though expectations toward the emerging economies over the medium to long-term are still high. In the background is our awareness of the major progress achieved by Japan and the US in the balance sheet adjustment process and, in contrast, the fall of the emerging countries in to a balance sheet adjustment.

Top 3 Risks to global growth

Olivier Blanchard, director of research of the International Monetary Fund (IMF), listed three risks to global growth (**Chart 1**). The G20 Finance Ministers and Central Bank Governors' meeting held in Moscow, Russia on July 20, 2013 precisely addressed these risks.

Chart 1: Top Three Risks to global growth according to the IMF

1. Risks of slowdown in China and emerging economies
2. Risks stemming from the future course of Abenomics
3. Risks stemming from an exit from quantitative easing in the US

Source: MHRI.

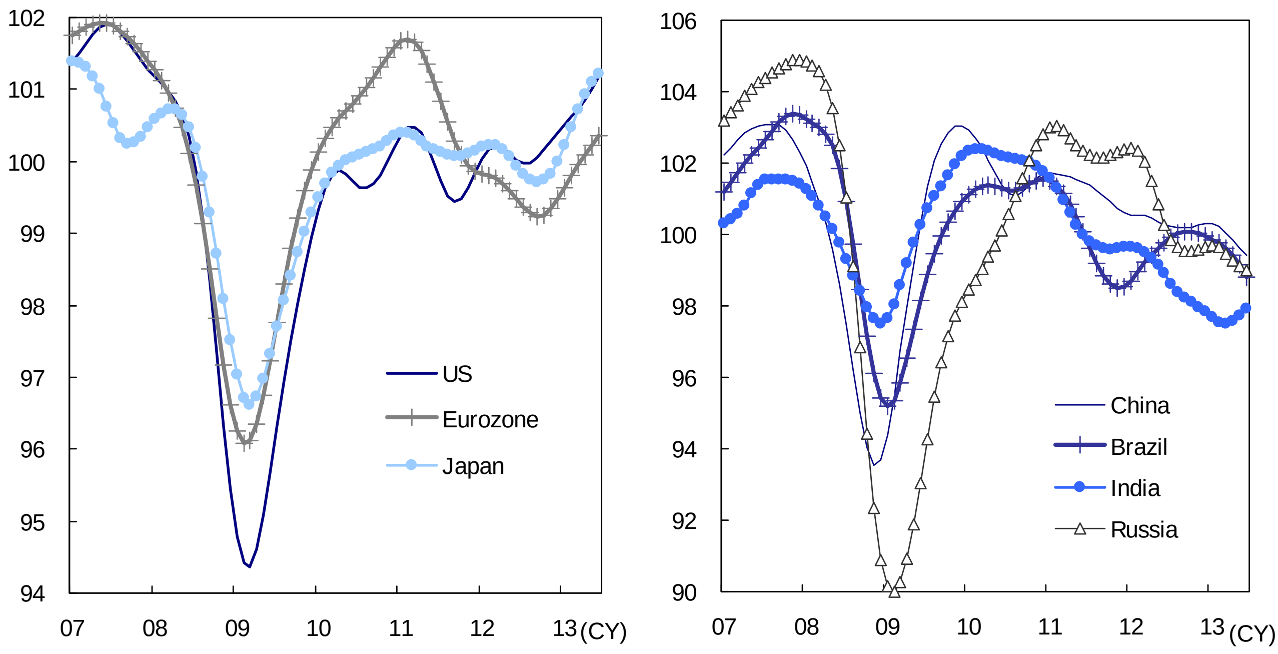
[1] *America ni tayorenai jidai 2012nen nihon keiza no asu o yomu* (MHRI, Toyo Keizai Inc., 2011)

Japan and the US are the drivers of global growth today

Since 2007, subsequent to the simultaneous balance sheet adjustment among the developed countries, Japan and the US have made significant progress in their balance sheet adjustment processes. On the other hand, the problems faced by the global economy today stem from the fact that (1) Europe is still in the midst of balance sheet adjustment, and the countries mainly of southern Europe continue to face political instability, (2) the key emerging economies, such as China, which took expansionary measures as the anchor of global growth since 2007 are subject to negative side effects such as pressures to adjust excessive investment. Thus, since 2013, the key developed economies such as the US and Japan have started to serve as the engines of global growth upon emergence out of their balance sheet adjustment processes. In contrast, among the key emerging economies such as China which have thus far served as the drivers of global growth, adjustment pressures began to mount, dragging down their growth in comparison to the 2000s, resulting in a reversal of the bipolar structure of the global economy.

As in **Chart 2** below, the OECD's leading economic indicators portray the three-speed growth of the global economy: a recovery in Japan and the US, a slow recovery in Europe including Germany, and a slowdown in the emerging economies of China, Brazil and India. The three different speeds stem most likely from the differences in the state of progress of their balance sheet adjustment processes. Japan and the US see light at the end of their balance sheet adjustment, Europe is in the midst of the process and the key emerging economies are facing new balance sheet adjustment pressures.

Chart 2: OECD leading indicator index



Source: OECD.

Even so, the IMF's risk scenario in **Chart 1** points to risks in both Japan and the US which are the engines of growth. Firstly, the US has started to seek an exit out of quantitative easing (referred to as "QE3") since May 2013. The US has set forth that it would taper its monetary easing, and, if the US economy loses momentum as a result thereof, it would serve as a major risk to global growth. Furthermore, the US economy faces downward pressures from fiscal conditions. At the same time, the Japanese economy – the other engine of growth – is under close scrutiny regarding the sustainability (including the political circumstances) of the Abe administration's economic policies (referred to as "Abenomics") which is the very source of Japan's growth. Over the short term, the global economy is dependent upon Japan and the US, but we should note that both countries are subject to risks. Every year, outlooks on growth have been tended to falter around the middle of the year. The same may hold true this year again. At the moment, the lack of a clear direction of the market, the pause of the stock market rise and yen depreciation stem from such lingering uncertainties.

Chart 3 is the IMF's World Economic Outlook ("WEO") released on July 9, 2013. Note that the outlook on Japan's economic growth is the highest among the G7 countries, harking back to an era of "Japan as No. 1". In 2013, expectations toward Japan are the highest on a short-term perspective. Next in ranking is the US, followed by Europe which is still stagnating. While the emerging economies enjoy levels of growth which are higher than Japan, the US and Europe, it should be noted that the trend itself is continuing to slump.

Japan's "exit out of its lost two decades" due to a shift in view on US growth

While our latest economic outlook follows the steps of the upward revisions on growth mainly of the US and Japanese economies in May 2013, our global economic outlook as a whole has been subject to a downward revision. Since the

Chart 3: IMF World Economic Outlook in 2013 (G7)

	US	Canada	France	UK	Germany	Italy	Japan
GDP growth rate	1.7	1.7	-0.2	0.9	0.3	-1.8	**2.0**
Change from previous MHRI Outlook in April 2013	-0.2	0.2	-0.1	0.3	-0.3	-0.3	**0.5**

Source: Made by MHRI based upon releases by the IMF.

beginning of this year, MHRI has shifted its growth scenario, based upon our recognition that the US balance sheet adjustment would near its end. While we have revised down our outlook on US economic growth in 2013, we forecast an exit strategy from QE3 in the second half of the year due to a steady improvement of the US economy. Turning to the Japanese economy, our outlook reflects the impact of the subsequent weakening of the yen and rise of asset prices. Although we have kept our outlook on the Japanese economy in 2013 unchanged, we have revised down our outlook on the emerging economies including Asia.

Since 2007, the emerging economies served as the engines of global growth as the developed economies of Japan, the US and eurozone fell simultaneously into a balance sheet adjustment. In 2013, global growth has reversed as the Japanese and US economies started to pick up after completing their balance sheet adjustment processes. In contrast, the emerging economies, which have thus far served as the engines of growth, were faced with a new round of balance sheet adjustment pressures. As a result, overall global growth has also moderated.

Even so, note that there are more positive support factors in the current environment surrounding the Japanese economy. The revival of the US economy from an adjustment over the past six years means a reversal of the strong-yen trend, and also has the effect of raising asset prices. Abenomics rests upon these shifts. Admittedly, the Japanese economy would be subject to adverse effects, should the Chinese and emerging economies fall into an adjustment akin to a collapse of a bubble. However, considering the budding state of the Chinese economy as a market economy, a sharp contraction of the Chinese economy is unlikely. Given the shift of the “head winds” to “tail winds” upon the Japanese economy along with recovery and end of the adjustment process of the US economy, Japan must realize the expansion of its domestic demand to emerge out of the lost two decades and show its mettle as the engine of global growth.

The Japanese economy will change. But note that it will take time.

In the past economic recovery cycles in Japan, the economic recovery failed to lead to the improvement of employment and income conditions because of significant uncertainties regarding the future. Despite the rise of the stock market from the end of 2012, its sustainability is still viewed with substantial uncertainty. One of the background factors was the unease toward the continuity of Japan’s political leadership. Admittedly, Japan has had a succession of one-year premierships since 2006. Confidence in economic policies would be tenuous under such a discontinuous political leadership structure of successive changes in administration. For the past 20 years, the private sector continued to take a stance of deleveraging accompanied by balance sheet adjustment. In short, companies resorted to a management stance of balance sheet adjustment by “refraining from investment in equipment”. At the same time, amid the strong-yen environment, the corporate behavioral patterns formed during the lost two decades after the collapse of the bubble - namely attempts to survive by cutting costs and sparing profit margins –led to Japan’s “evolution into herbivores”.

Looking forward, the eradication of uncertainties under a strong-yen environment and political stabilization will be indispensable for economic recovery. The resolution of the “twisted Diet” by the Upper House election on July 21, 2013 may lead to expectations toward political stability over the next three years. At the same time, approximately six months has passed since the yen started to weaken, and the steady improvement of the US economy has led to the ebb of concerns regarding the strong yen. However, for the improvement of sentiment, the establishment of confidence with the passage of “time” would be indispensable. Since decisions in human society are formed through a certain decision-making process, changes would only make their way to the far ends of the employment and income environment through the process of amendments to plans for the second half of FY2013 and FY2014. In other words, there would be little time, and thus, little effect until then.

The roadmap of the “three-step rocket strategy for an exit from deflation” using “three arrows (prongs)”

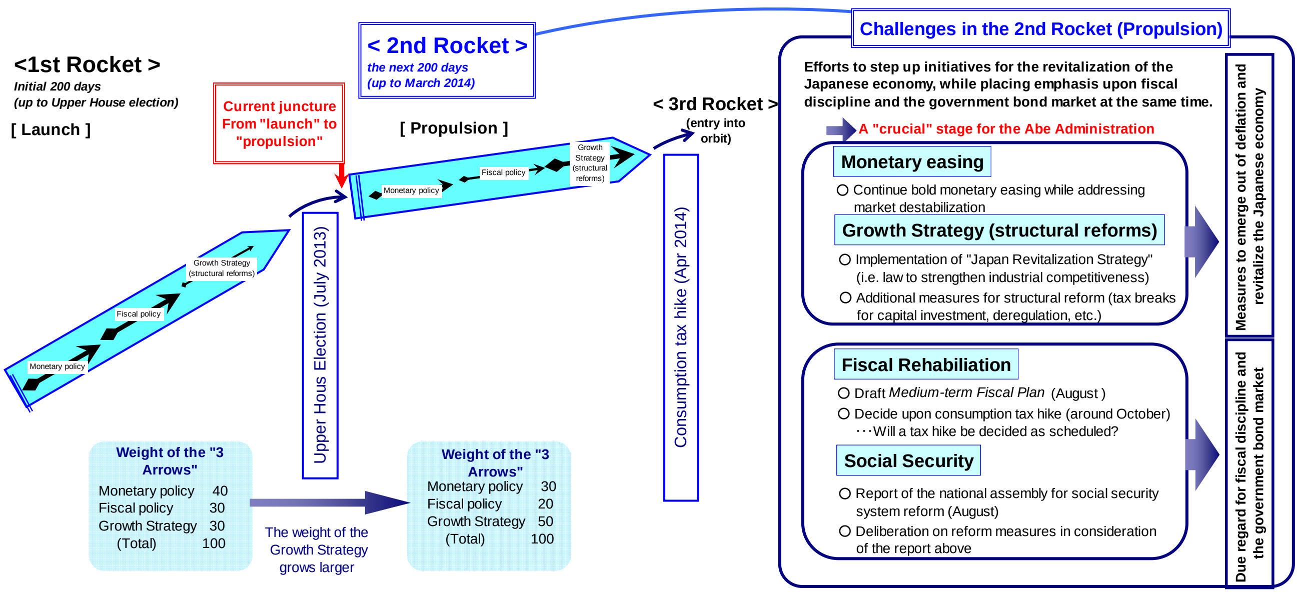
On July 26th, MHRI released an “emergency report” titled “What has changed with Abenomics? - a mid-year evaluation and of the Abe administration and future outlook” (in Japanese only). This is a follow-up of our report titled “What will change under the Abe administration?” (in Japanese only) released six months before on January 25, 2013. Ever since this report in January, we have portrayed a roadmap of the “three-step rocket strategy for an exit from deflation” using “three arrows (prongs)”. The first rocket is the state of “regime change” which requires a lift-off by a large propelling force defying gravity by using all three arrows - namely monetary, fiscal and growth (structural reform) strategies. From the perspective of this objective, the first rocket has achieved commensurate results. In contrast, the second rocket involves a crucial stage in which the task is to utilize structural reform strategies and the private sector for a self-sustained recovery. Furthermore, this is also a stage in which emphasis will be placed upon fiscal discipline in order to secure the stability of the government bond market in view of the exit (**Chart 4**)

The tasks of the second-stage rocket: self-sustained economic growth and fiscal discipline

An important point of the “three-step rocket strategy” is that the weight of the “three arrows” will gradually shift. In other words, the focus of the strategy will gradually shift to the stimulation of economic growth through structural reforms (referred to as the “Growth Strategy”). In the first rocket, the key was to weaken the yen by monetary policy measures and boost sentiment by fiscal spending. The mission was to bide time until the shift of focus to the second rocket – namely the promotion of structural reforms. During this time, the behavior of corporate enterprises would be transformed through an improvement of sentiment by weakening the yen and raising asset (equities and property) prices in order to increase domestic demand. While the first rocket had no other alternative but to depend upon the impact of monetary and fiscal policy measures and the wealth effect of higher asset prices driven by expectations, the sustainability of the impact was conditional upon the establishment of confidence toward the future course of structural reforms accompanied by political stability. Overseas expectations toward Japan's political stability after the Upper House election on July 21st are much higher than perceived in Japan. If the resolution of the "twisted Diet" leads to political stability up to 2016, Japan would become the most politically stable country among the G7.

The first rocket delivered a strong message that a shift of sentiment is necessary through the concerted effort of the government. In the background was the awareness that a state of deflation such as Japan's was never experienced among the developed countries since the end of World War II and that a shift of sentiment would be necessary since an exit from deflation is "asymmetrical" with responses toward inflation. While I described the state of Japan's sentiment as "herbivores" as a result of its past balance sheet adjustment process which lasted for more than 20 years, the first rocket marks a juncture in Japan's transformation. Having achieved a certain degree of success in shifting sentiment in Japan, the next stage depends upon whether Japan can achieve a shift in household and corporate sector behavior. In short, the focus of attention will turn to the strength of the private sector.

Chart 4: Key policy challenges in the second rocket (propulsion) of the "three-step rocket strategy for exit from deflation")



Source: MHRI

Japan's success in adjusting its debt in its balance sheet over the past 20 years and achieving top-level balance sheets of its private corporate enterprises and banks stems from the stability of its government bond market. If this stability is impaired, there is the risk that the balance sheet adjustment process will revert back to point zero. The government's need to emphasize fiscal discipline in the second rocket "even at the expense of certain pains" stems from the need to maintain the stability of the government bond market. The entry of the economy into a self-autonomous orbit mode would entail the rise of upward pressures upon interest rates. In order to keep interest rates from rising under such an environment, it is indispensable for the government to show its resolve to purchase government bonds and, at the same time, to maintain its fiscal discipline. From the foregoing perspective, the steady implementation of the consumption tax hike would serve as the minimum proof of the government's fiscal discipline. The task of the second rocket is to achieve a self-autonomous recovery on the basis of confidence in the government bond market.

Hajime Takata, Chief Economist

II. The global economy

The global economy picked up in the Apr-Jun quarter of 2013, driven mainly by developed economies

In the Apr-Jun quarter of 2013, the global economy showed signs of recovery driven mainly by the developed economies. In contrast, the pace of economic growth slowed among some emerging economies, as evidenced by the slowdown of the Chinese economy.

The US economy grew at a slightly faster pace of +1.7% q-o-q p.a. in the Apr-Jun quarter (Jan-Mar quarter: +1.1% q-o-q p.a.). In addition to the improvement of public demand - the negative breadth of government spending narrowed – private-sector final demand also stood firm, as evidenced by the pick up of personal consumption and upturn of capital investment.

Even though eurozone real GDP data for the Apr-Jun quarter is yet to be released (scheduled to be released late in August 14, 2013 JST), latest economic data releases suggest positive growth for the first time in seven quarters.

On the other hand, China's real GDP slowed down for the second quarter in a row, registering +7.5% y-o-y in the Apr-Jun quarter (Jan-Mar quarter: +7.7% y-o-y). The slowdown of fixed asset investment and the weakness of exports served to drag down growth.

The growth of Asian economies other than China was mixed. The economies of South Korea and Singapore accelerated and Taiwan's economic growth picked

[Chart 5: Real GDP growth of major countries and areas]

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

	2012				2013	
	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Sep	Jan-Mar	Apr-Jun
US	3.7	1.2	2.8	0.1	1.1	1.7
Eurozone	-0.2	-0.8	-0.5	-2.3	-0.8	
Japan	4.8	-0.9	-3.6	1.0	3.8	2.6
South Korea	3.3	1.2	0.2	1.1	3.4	4.4
Taiwan	5.7	-0.0	3.0	7.1	-2.7	2.4
Hong Kong	1.0	-0.4	4.3	5.7	0.9	
Singapore	7.8	0.1	-4.6	3.3	1.7	15.5
Thailand	51.0	12.6	7.1	11.7	-8.4	
Philippines	9.1	6.0	6.9	8.0	8.9	
Australia	5.1	2.2	3.1	2.3	2.2	

(Y-o-y % change)

China	8.1	7.6	7.4	7.9	7.7	7.5
Malaysia	5.1	5.6	5.3	6.5	4.1	
Indonesia	6.3	6.4	6.2	6.1	6.0	5.8
Vietnam	4.6	4.8	5.1	5.4	4.8	5.0
India	5.1	5.4	5.2	4.7	4.8	
Brazil	0.8	0.5	0.9	1.4	1.9	
Russia	4.8	4.3	3.0	2.1	1.6	

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

up, rising into positive territory. In contrast, the rate of Indonesia's economic growth slowed down.

Under these conditions, Japan's real GDP growth grew +2.6% q-o-q p.a. in the Apr-Jun quarter (Jan-Mar quarter: +3.8% q-o-q p.a.) remaining in positive territory.

The global economy should pick up in 2014

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 +2.8% in 2013, slowing down from the +3.2% in 2012 (**Chart 6**). In addition to the US economic slowdown from the previous year, eurozone growth is also expected to remain in negative territory. Even though the emerging economies should continue to grow, China's economic slowdown will keep the pace of global growth subdued. Despite the slowdown of the Chinese economy, growth is forecast to pick up mainly among the developed economies due to the fading impact of fiscal tightening in 2014. The global economy in 2014 should grow +3.3%, accelerating for the first time in four years, driven mainly by the upturn of growth among the US and European economies due to the progress of their balance sheet adjustment processes.

[Chart 6: MHRI outlook on the global economy]

Calendar year	2011 (Actual)	2012 (Actual)	2013 (Forecast)	2014 (Forecast)	2013 (Previous: June forecast)	2014 (Previous: June forecast)
				(Y-o-y % change)		(Y-o-y % change)
Total of forecast area	3.8	3.2	2.8	3.3	2.9	3.5
Japan, US, Eurozone	1.4	1.4	0.7	1.6	0.8	1.6
US	1.8	2.8	1.4	2.2	1.6	2.2
Eurozone	1.5	-0.5	-0.6	0.8	-0.6	0.8
Japan	-0.6	2.0	1.9	1.6	1.9	1.6
Asia	7.5	6.1	5.9	6.0	6.1	6.3
NIEs	4.1	1.7	2.3	3.0	2.1	3.4
ASEAN5	4.4	6.1	4.9	5.0	5.1	5.1
China	9.3	7.8	7.4	7.2	7.8	7.7
India	7.5	5.1	5.0	5.3	5.0	5.3
Australia	2.4	3.6	2.5	2.8	2.6	3.0
Brazil	2.7	0.9	2.1	2.3	2.5	3.3
Russia	4.3	3.4	2.5	3.5	2.9	3.7
Japan (FY)	0.3	1.2	2.7	0.6	2.7	0.6
Crude oil price (WTI,$/bbl)	95	94	97	96	89	90

Note: The total of the forecast area is calculated upon the 2011 GDP share (PPP) by the IMF.
Sources: International Monetary Fund (IMF), MHRI.

The pace of US economic growth is forecast to stand at +1.4% in 2013. Even though the government spending cuts will serve as a drag upon growth, household balance sheet adjustment should progress, leading to the solid growth of private-sector final demand. Amid the ongoing rise of employment, the Federal Reserve Board (FRB) is predicted to taper its quantitative easing measures (QE3) from the second half of 2013. As the decline of government spending moderates in 2014, the rate of US real GDP growth should rise to +2.2%, given the ongoing solid growth of private-sector final demand.

Eurozone real GDP is forecast to contract for two years in a row in 2013 (-0.6%). Having said so, many of the recent economic data releases of the eurozone countries indicate a recovery, leading to our forecast that growth will edge up and remain in positive territory in the second half of 2013. The eurozone economy should record growth in positive territory for the first time in three years in 2014, due to a mild economic recovery driven by exports. However, lingering downward pressures stemming from fiscal austerity among the countries of southern Europe should keep the rate of real GDP growth below 1% at +0.8%.

The Chinese economy will continue to slow down

The Chinese economy is forecast to remain on a gradual downtrend in 2013 (+7.4%) and 2014 (+7.2%). The government is taking a clearer stance to wean its economic growth from investment. Given the absence of large-scale economic stimulus measures and monetary easing, China's economic growth should gradually decline, dragged down mainly by fixed asset investment.

The Indian economy will be compelled to take a fiscal austerity and monetary tightening stance in a bid to address its current account deficit and persistent inflationary pressures. Hence, the Indian economy is forecast to keep growing around 5%: +5.0% in 2013, and +5.3% in 2014.

The Asian economies other than China and India should continue to follow a gradual expansion in both 2013 and 2014. Even though the NIEs (South Korea, Hong Kong, Taiwan, Singapore) are vulnerable to China's economic slowdown, the rate of growth should gradually pick up (+2.3% in 2013, and +3.0% in 2014) due to the rise of exports along with the acceleration of growth in the US and Europe in 2014. On the other hand, the rate of real GDP of the ASEAN5 (Thailand, Malaysia, Indonesia, the Philippines, Vietnam) should keep growing around 5%: +4.9% in 2013, and +5.0% in 2014.

Turning to the Australian economy, the rate of real GDP growth is expected to remain at +2.5% in 2013 due to sluggish exports related to natural resources bound primarily to China. In 2014, growth is predicted to pick up slightly to +2.8% on the back of the recovery of exports toward developed countries and investment amid a slight mitigation of the downward pressures stemming from fiscal conditions.

Turning to Brazil, the economy is headed for a recovery despite a very sluggish pace of recovery. The outbreak of anti-government demonstrations in June also served to worsen business and consumer confidence. Furthermore, the ongoing monetary tightening stance due to the rise of inflation concerns is also serving as a drag upon private-sector demand. The rate of real GDP growth is forecast to remain a tepid +2.1% in 2013 and +2.3% in 2014.

Given Russia's economic downturn due to the fall of crude oil prices and delays in projects related to natural resources and energy, the pace of growth should stand at +2.5% in 2013. In 2014, the rate of real GDP growth should rise to +3.5% reflecting the effect of the interest rate cut and commencement of natural resource and energy-related projects.

Turning to Japan in 2013, the economy is expected to maintain growth of +1.9%, given the strength of personal consumption reflecting the stock market recovery, upturn of exports due to the weak yen, and the impact of economic stimulus measures. Even though domestic demand may dip temporarily due to the impact of the consumption tax hike in 2014, the economy should avoid a loss of momentum, given its support by external demand reflecting the depreciation of the yen and overseas economic recovery. Real GDP growth is forecast to rise to +1.6% in 2014.

Do not overlook the risk of a sharp economic downturn in China

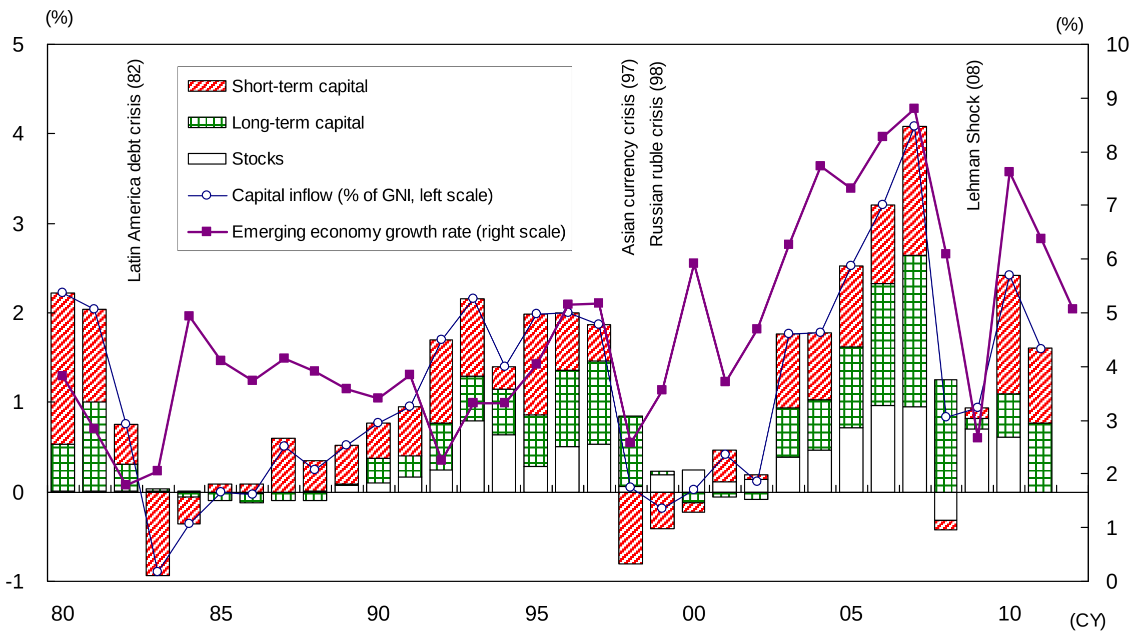
In the foregoing outlook, MHRI forecasts a gradual slowdown of the Chinese economy. However, there is the risk of a sharp deceleration of the Chinese economy should concerns regarding the country's so-called "shadow banking" system rise and the turmoil in the financial sector serves as a negative impact upon the real economy. In such case, not only investment but also consumer spending would fall sharply, and may have a negative impact upon the business results of foreign corporate enterprises (including Japanese companies) doing business in China. A domino effect of successive bank failures as experienced after the collapse of Lehman Brothers is unlikely, given the tenuous link between the financial market of China and overseas markets. Even so, note that a global stock market fall may ensue since the slowdown of the Chinese economy would have a negative impact upon the business results of global companies. Furthermore, it may also serve as a negative effect upon the real economy – primarily of the Asian countries possessing close trade relations with China.

Capital outflows from emerging economies also pose concerns

The expansion of capital outflows from the emerging countries pose another significant risk upon the global economy. In the first half of 2013, many of the emerging countries were faced with a "triple sell-off" of stocks, currencies and bonds amid the rise of speculation that the US would taper its monetary easing ("QE3").

A look back into the past tells us that a major capital exodus from emerging countries leads to a sharp fall of economic growth among those countries, as shown by the Latin America Crisis in the 1980s and the Asian Currency Crisis in the 1990s (**Chart 7**). Given such past lessons, the countries of Latin America and Asia possess more foreign currency reserves than in the past, making them more resilient to currency crises. Moreover, the recent stabilization of the financial and capital markets provide reasons to believe that the markets have more or less factored in the tapering of QE3. In such context, the chances are slim that a significant capital exodus would occur and trigger a widespread currency/financial crisis. Having said so, note that such risks may rise in certain countries facing large current account deficits and inflationary pressures.

[Chart 7: Growth rates and capital inflows of emerging countries]



Note: Capital inflows exclude direct investment and loans by public institutions.
The bars represent the breakdown of the capital inflows.
Sources: World Bank, *Global Development Finance.*

III. The Japanese economy

(1) 2013 Apr-Jun quarter *1st QE*

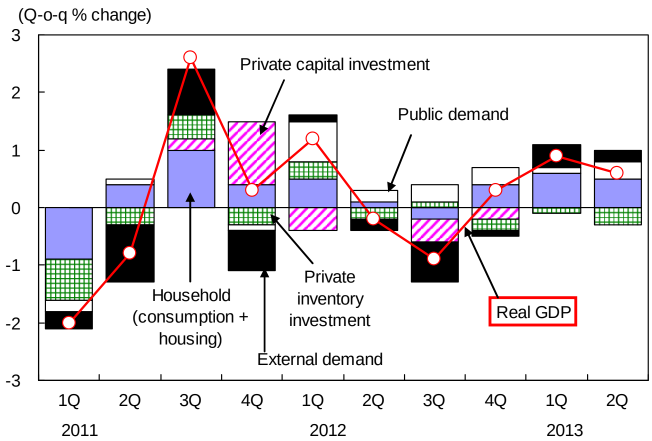
The Japanese economy grew for the third consecutive quarter, driven by personal consumption and exports

According to the *First Preliminary Quarterly Estimates of GDP (1st QE)* for the Apr-Jun quarter of 2013, Japan's real GDP grew +0.6% q-o-q (or +2.6% in annualized terms), continuing to expand for the third consecutive quarter (**Chart 8**).

Even though domestic private demand grew +0.2% q-o-q (contribution to quarterly real GDP growth: +0.2% pt), expanding for the third quarter in a row, the pace of growth moderated from the Jan-Mar quarter (+0.6% q-o-q). Personal consumption continued to grow strongly (+0.8% q-o-q) (Jan-Mar quarter: +0.8% q-o-q), backed by the improvement of consumer confidence. Although housing investment dipped slightly (-0.2% q-o-q) (Jan-Mar quarter: 1.9% q-o-q), the latest readings may be viewed as the sustainment of strong growth, considering that it comes after a continuous rise for four consecutive quarters. On the other hand, capital investment fell (-0.1% q-o-q) (Jan-Mar quarter: -0.2% q-o-q) recording a contraction for the sixth quarter in a row. Even though capital investment has been more or less flat, showing signs of bottoming out during the past two quarters, corporate enterprises remain cautious regarding domestic investment, resulting in the sluggish recovery of capital investment. As companies continued to slash inventories, domestic inventory investment served as a significant drag upon growth (-0.3% pt).

Public demand grew +1.0% q-o-q (contribution: +0.3% pt), marking an expansion for the sixth quarter in a row. The pace of public investment growth gathered momentum, rising +1.8% q-o-q (Jan-Mar quarter: +1.1% q-o-q) along with the implementation of projects related to the *Emergency Economic Measures for The Revitalization of the Japanese Economy*. Government consumption also grew +0.8%

[Chart 8: Japan's quarterly real GDP growth]



Source: Cabinet Office, *Preliminary Quarterly Estimates of GDP,* q-o-q (Jan-Mar quarter: +0.1% q-o-q), is continuing to expand reflecting factors such as the rise of social security-related expenditures.

Exports grew a strong +3.0% q-o-q (Jan-Mar quarter: +4.0% q-o-q). It appears that the weakness of the yen is gradually having a positive impact upon export volumes, leading to the recovery of exports of items such as transport equipment and general machinery. Even though imports also grew, expanding +1.5% q-o-q (Jan-Mar quarter: +1.0% q-o-q) along with the recovery of domestic production, the contribution by external demand stood at +0.2% pt since the growth of imports fell below that of exports. Growth in the Apr-Jun quarter may be judged as well-balanced between domestic and external demand

(2) Outlook on the Japanese economy in FY2013 and FY2014

Growth will accelerate in the Jul-Sep quarter

The Japanese economy should continue to grow in the Jul-Sep quarter. Public investment is forecast to pick up along with the full-fledged implementation of the additional public works projects in the *Emergency Economic Measures for the Revitalization of the Japanese Economy*. In addition to the ongoing expansion of exports amid the weakness of the yen, capital investment is also expected to take an upturn reflecting the improvement of corporate business results. Since summer bonus payments among private-sector companies appear to have increased on a year-on-year basis, personal consumption is also expected to remain on solid footing. Given the maintenance of a virtuous cycle in which private, public and external demand all grow, Jul-Sep quarter real GDP (forecast: +4.1% p.a.) is forecast to accelerate from the Apr-Jun quarter.

Growth in FY2013 2H will accelerate due to a last-minute rush of demand. FY2013 real GDP growth: +2.7%

In the second half of 2013 (the Oct-Dec quarter of 2013 and the Jan-Mar quarter of 2014), the last-minute rush of demand in personal consumption should lead to the acceleration of growth. According to estimates by MHRI, the last-minute rush of demand in FY2013 is slightly less than JPY3 trillion (approximately 0.6% of GDP).

The growth of exports should also gain momentum amid a slight pickup of growth of the US and eurozone economies and full-fledged quantitative impact of the weak yen in the second half of FY2013. Capital investment is also expected to pick up in the second half of the fiscal year along with the increase of exports, production and corporate earnings.

As a result, the pace of real GDP growth in FY2013 is forecast to grow +2.7% (forecast in June: +2.7%) (**Chart 9**).

Even though FY2014 real GDP growth will fall to +0.6%, a recession is unlikely

We shall be forming our final view on the schedule and breadth of the consumption tax hike on the basis of a questionnaire survey of experts conducted in late August and the *Second Preliminary Quarterly Estimates of GDP* (“*2nd QE*”) regarding the Apr-Jun quarter of 2013 (scheduled to be released on September 9, 2013). Our outlook is based upon the premise that the consumption tax will be raised from 5% to 8% in April 2014. Furthermore, in order to mitigate the drop of economic activity accompanying the consumption tax hike, a FY2013 supplementary budget of approximately JPY1.9 trillion (national expenditure basis) should be compiled around the turn of the New Year. Looking at its breakdown, the supplementary budget will likely include cash payments toward home buyers (JPY0.3 trillion), cash payments toward low-income earners to ease the burden of the consumption tax hike (JPY0.3 trillion), and additional public works expenditures (JPY1.3 trillion). Since the budget surplus from the previous year will be used to fund the supplementary budget, there are no plans to issue more government bonds.

The supplementary budget is deemed to have some effect in mitigating the fall of real GDP particularly in view of the implementation of public works at the beginning of FY2014. Even so, Japan may not avoid a sharp contraction of growth into negative territory (forecast to be -6.0% q-o-q p.a.) due to a fall of personal consumption and housing investment in the Apr-Jun quarter of 2014 in a backlash to the last-minute rush of demand. Even so, a fall into recession is unlikely, given the rise of exports reflecting the weak yen and overseas economic recovery and the ongoing recovery of capital investment held up by the improvement of corporate earnings. The Japanese economy should return to a mild recovery track from the Jul-Sep quarter as personal consumption and housing investment pick up gradually from the downturn stemming from the backlash to the last-minute rush of demand before the consumption tax hike.

In view of the difficulty to keep FY2014 public works expenditures at a level during the period from FY2012 to FY2013 in consideration of fiscal conditions, public investment will likely fall in the second half of FY2014. Even though government consumption will continue to increase reflecting the expansion of social security expenditures accompanying the ageing of the population, the growth of overall public demand (combining both public investment and government consumption) is expected to slow sharply. As a result, the rate of FY2014 real GDP growth is forecast to fall to +0.6% (forecast in June: +0.6%).

[Chart 9: Outlook on the Japanese economy]

		2011 FY	2012	2013	2014	2013 Jan-Mar	2013 Apr-Jun	2013 Jul-Sep	2013 Oct-Dec	2014 Jan-Mar	2014 Apr-Jun	2014 Jul-Sep	2014 Oct-Dec	2015 Jan-Mar
GDP (real)	Q-o-q % ch	0.3	1.2	2.7	0.6	0.9	0.6	1.0	0.8	1.1	-1.5	0.6	0.3	0.3
	Q-o-q % ch p.a.	--	--	--	--	3.8	2.6	4.2	3.3	4.7	-6.0	2.5	1.3	1.1
Domestic demand	Q-o-q % ch	1.3	2.0	2.4	-0.1	0.5	0.4	1.0	0.8	1.1	-1.9	0.3	0.1	0.1
Private sector demand	Q-o-q % ch	1.4	1.2	2.1	-0.4	0.6	0.2	0.9	0.9	1.3	-2.6	0.4	0.4	0.4
Personal consumption	Q-o-q % ch	1.6	1.6	2.7	-1.3	0.8	0.8	0.3	0.7	1.8	-3.6	0.5	0.2	0.2
Housing investment	Q-o-q % ch	3.7	5.3	7.9	-6.1	1.9	-0.2	4.5	3.7	-3.7	-8.2	1.1	2.0	1.9
Capital investment	Q-o-q % ch	4.1	-1.4	0.9	3.2	-0.2	-0.1	1.7	1.8	1.2	0.3	0.4	0.6	0.8
Inventory investment	Q-o-q contribution, % pt	-0.5	-0.1	-0.3	0.3	-0.1	-0.3	0.2	-0.1	-0.1	0.4	-0.1	0.0	0.0
Public sector demand	Q-o-q % ch	0.9	4.3	3.3	0.7	0.3	1.0	1.2	0.6	0.4	0.4	0.0	-0.8	-0.8
Government consumption	Q-o-q % ch	1.4	2.1	1.8	1.7	0.1	0.8	0.3	0.4	0.3	0.5	0.5	0.5	0.5
Public investment	Q-o-q % ch	-2.2	15.0	10.1	-3.9	1.1	1.8	4.8	1.6	1.1	0.4	-1.7	-6.0	-6.5
External demand	Q-o-q contribution, % pt	-1.0	-0.8	0.3	0.7	0.4	0.2	0.0	-0.1	0.0	0.3	0.3	0.2	0.1
Exports	Q-o-q % ch	-1.6	-1.2	4.8	5.8	4.0	3.0	0.8	1.0	1.0	1.5	1.7	1.9	1.9
Imports	Q-o-q % ch	5.3	3.8	2.6	1.5	1.0	1.5	0.5	1.3	0.8	-0.4	-0.2	0.8	1.0
GDP (nominal)	Q-o-q % ch	-1.4	0.3	2.3	1.7	0.6	0.7	0.8	0.5	1.6	-0.1	0.3	-0.1	0.1
GDP deflator	Y-o-y % ch	-1.7	-0.9	-0.3	1.0	-1.1	-0.3	-0.6	-0.7	0.2	1.3	1.3	1.1	0.4
Domestic demand deflator	Y-o-y % ch	-0.5	-0.8	-0.2	1.0	-0.8	-0.1	-0.1	-0.3	-0.2	0.6	1.2	1.3	1.2

		2011 FY	2012	2013	2014	2013 Jan-Mar	2013 Apr-Jun	2013 Jul-Sep	2013 Oct-Dec	2014 Jan-Mar	2014 Apr-Jun	2014 Jul-Sep	2014 Oct-Dec	2015 Jan-Mar
Industrial production	Q-o-q % ch	-0.7	-2.9	3.1	1.5	0.6	1.5	2.2	1.8	1.6	-1.5	-0.4	0.8	1.2
Ordinary profits	Y-o-y % ch	-2.0	8.1	11.2	1.7	5.6	10.3	15.2	14.0	6.9	-5.0	0.7	7.0	3.5
Nominal labor compensation	Y-o-y % ch	0.6	-0.3	0.6	0.7	-0.0	1.0	0.2	0.7	0.6	0.8	0.7	0.7	0.6
Unemployment rate	%	4.5	4.3	3.9	3.7	4.2	4.0	3.9	3.8	3.7	3.7	3.8	3.7	3.6
New housing starts	P.a., 10,000 units	84.1	89.3	97.8	90.2	90.4	98.1	100.1	99.8	92.5	88.2	89.4	90.7	93.3
Current account balance	P.a., JPY tril	7.6	4.4	6.1	11.0	3.1	8.5	4.8	6.1	6.1	15.4	9.7	11.0	9.3
Domestic corporate goods prices	Y-o-y % ch	1.4	-1.1	1.5	3.7	-0.3	0.6	1.9	2.0	1.6	3.0	3.6	4.1	4.2
Consumer prices	Y-o-y % ch	0.0	-0.2	0.3	2.5	-0.3	0.0	0.4	0.4	0.4	2.3	2.4	2.6	2.7
Uncollateralized overnight call rate	%	0.08	0.06	0～0.10	0～0.10	0.06	0.07	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	%	1.05	0.78	0.88	1.06	0.70	0.73	0.84	0.95	1.00	0.95	1.00	1.10	1.20
Nikkei average	JPY	9,181	9,650	14,600	15,500	11,444	13,621	14,300	15,000	15,500	14,800	15,300	15,800	16,100
Exchange rate	JPY/USD	79.0	83.0	101.0	105.0	92.0	99.0	99.0	102.0	103.0	104.0	105.0	105.0	106.0
Crude oil price (WTI nearest term contract)	USD/bbl	97.0	92.0	97.0	96.0	94.0	94.0	104.0	95.0	96.0	96.0	96.0	97.0	96.0

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).

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 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.

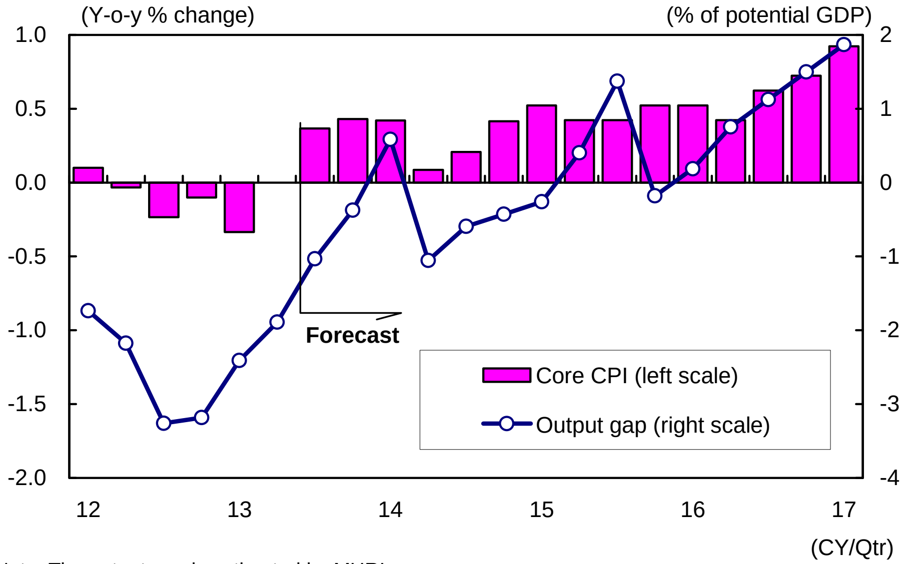
Y-o-y change of FY2014 core CPI (ex impact of consumption tax hike) should remain around the same level as FY2013. Inflation will gradually rise from FY2015

The core CPI (general, excluding fresh food) is forecast to stand at +0.3% y-o-y in FY2013, and +2.5% y-o-y (+0.3% y-o-y when excluding the impact of the consumption tax hike) in FY2014, falling far below the inflation target of "2% in two years".

In the background is our forecast that the output gap (the gap between actual GDP and potential GDP) will temporarily sink deep into negative territory in the beginning of FY2014 due to the fall of domestic demand accompanying the consumption tax hike. As of the Apr-Jun quarter of 2013, the output gap estimated by MHRI stood at -1.9% of potential GDP (meaning an excess of supply of approximately JPY10.1 trillion) (**Chart 10**). Even though the Japanese economy is forecast to grow strongly in FY2013 and temporarily close the negative output gap in the Jan-Mar quarter of 2014, the output gap will turn negative again in the Apr-Jun quarter of 2014 and stay in negative territory during FY2014. It will be difficult for prices to rise during this time period, considering that companies will tend to cut prices in order to maintain their market shares.

That said, even if the target of "2% in two years" cannot be achieved, the current monetary easing policy should not be viewed immediately as a failure. MHRI forecasts that the Japanese economy will continue to expand from FY2015 onward, leading to the gradual rise of inflation over the medium term. In order to ensure such a trend, it will be important to maintain an accommodative monetary policy stance, and at the same time, promote investment activity and innovation

[Chart 10: Medium-term outlook on the output gap and core CPI]



Note: The output gap is estimated by MHRI.
The core CPI (y-o-y % ch) excludes the impact of the consumption tax hike.
Sources: Made by MHRI based upon Ministry of Internal Affairs and Communications, *Consumer Price Index*, Cabinet Office, *National Accounts*, and others.

through the implementation and upgrade of structural reform measures so as to form an environment under which the improvement of corporate profitability leads to the rise of wages.

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