FY2013 and FY2014 Economic Outlook

May 17, 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 Jan-Mar 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 along with the housing market recovery**

2013: +1.6% (forecast in March +1.4%)
2014: +2.2% (forecast in March +2.0%)

<The Eurozone Economy >

◆ **Downward revision of 2013 growth forecast due to slow economic recovery. In 2014, downward pressures from fiscal conditions should ease slightly**

2013: -0.5% (forecast in March -0.3%)
2014: +0.8% (forecast in March +0.8%)

<The Asian Economy >

◆ **Despite forecasts of a gradual export-led economic recovery, forecasts on Chinese economic growth are revised down due to the impact of constraints upon housing investment and excessive investment**

2013: +6.1% (forecast in March +6.4%)
2014: +6.3% (forecast in March +6.6%)

<The Japanese Economy >

◆ **Recovery of both domestic and external demand driven by the economic stimulus measures and the weak yen. Growth to accelerate in the second half of the fiscal year due to a last-minute rush of demand**

FY2013: +2.7% (forecast in March +2.2%)

◆ **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 March +0.4%)

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I. The Chief Economist's View

Look forward to a US revival – our 2013 scenario includes an economic recovery in the US and Japan, and a slowdown among emerging economies

The US economy is continuing to pick up after the upward revision of our US outlook. A further upward revision on Japan

MHRI's latest *Economic Outlook* in May follows along the lines of the upward revisions to US and Japanese economic growth in our previous *Economic Outlook* in February 2013. Our previous outlook marked a major transition of MHRI's scenario in recent years. The key point was our recognition that the US balance sheet adjustment was nearing its end. In our latest outlook, we have made further upward revisions reflecting the subsequent improvement of the US economy and, for the first time, look forward to the exit strategy from quantitative monetary easing (QE3) in the second half of the year. With respect to the Japanese economy, we have reflected the impacts of the subsequent weakening of the yen and rise of asset prices. On the other hand, our recent outlook is characterized by the downward revisions to Asia and the emerging economies in a sharp contrast to the upward revisions to Japan and the US. As a result, we have made a slight downward revision to the overall level of global economic growth.

[Chart 1: MHRI outlook on the global economy]

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

Calendar year	2011 (Actual)	2012 (Actual)	2013 (Forecast)	2014 (Forecast)	2013 (Previous: Mar forecast)	2014 (Previous: Mar forecast)
Total of forecast area	3.8	3.1	2.9	3.6	3.0	3.6
Japan , US , Eurozone	1.3	1.2	0.9	1.6	0.7	1.5
US	1.8	2.2	1.6	2.2	1.4	2.0
Eurozone	1.5	-0.5	-0.5	0.8	-0.3	0.8
Japan	-0.6	2.0	1.8	1.6	1.1	1.4
Asia	7.5	6.1	6.1	6.3	6.4	6.6
NIEs	4.1	1.7	2.1	3.4	2.3	3.4
ASEAN5	4.5	6.1	5.4	5.1	5.5	5.3
China	9.3	7.8	7.8	7.7	8.2	7.9
India	7.5	5.0	4.7	5.3	4.8	5.9
Australia	2.4	3.6	2.6	2.9	2.7	3.0
Brazil	2.7	0.9	2.7	3.4	2.9	3.5
Russia	4.3	3.4	2.9	3.7	3.0	4.0
Japan (FY)	0.2	1.2	2.7	0.6	2.2	0.4
Crude oil price (WTI , USD/bbl)	95	94	89	90	87	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.

In our recent economic outlook, the sharp upward revision of our outlook on the Japanese economy stems largely from the depreciation of the yen. Even though we have yet to ascertain the improvement of the real economy accompanying the yen depreciation, prospects of the improvement of corporate business sentiment and the rise of consumption along with the rise of asset prices also contributed as upside factors.

We have long held the storyline based upon the protracted stagnation of the economy accompanying the balance sheet adjustment process in the US and Europe. However, since our previous outlook, we have focused upon the significant improvement of the US housing sector, leading to a major shift of our outlook that the downward pressures stemming from the US balance sheet adjustment will ease toward 2014. Our latest outlook takes the foregoing view of the US economic recovery a step further. Based upon the recognition that the balance sheet adjustment process in the US is nearly completed, we look toward an exit strategy from QE3 in the second half of 2013. Despite downward pressures from fiscal constraints this year, the US economy is forecast to return to cruise mode (around the upper end of the 2%-level) from the second half of the 2010s onward. This would mean a dissolution of Japan's concerns regarding the strong yen and a large step out of its "lost two decades".

In contrast, the eurozone economy is continuing to stagnate, resulting in yet another downward revision of our outlook on growth. In addition to the slow balance sheet adjustment process, the eurozone is also subject to negative pressures from fiscal constraints. The US and eurozone economies are not yet entirely free from the jinx of annually recurring "springtime swoons" since 2007. However, balance sheet adjustment pressures are easing in the US and conditions are unlikely to reach a crisis situation in the eurozone this year. All the more, there is the possibility that this would contribute to the annual rise of expectations toward recovery in the second half of the year, and lead further to a recovery trend spanning from 2014 to the second half of the 2010s. In the eurozone, it is necessary to take note that there is a bias toward easing the fiscal tightening due to popular opposition, and that there are rising pressures not only from within the eurozone but also from the US toward Germany to expand its domestic demand due to its current account surplus. Despite the uncertainties faced by the leading industrialized countries of Japan, the US and the eurozone, we take note of the fact that monetary and fiscal support measures have been taken for the recovery of economic conditions and rise of asset prices.

The Abe administration's three-step rocket strategy for an exit from deflation

Chart 2 depicts the roadmap of the Abe administration's "three-step rocket strategy for exit out of deflation" comprised of "three prongs (or arrows)" in order to realize a shift in sentiment from the "two lost decades". This sets forth the tasks to be tackled through cooperation between the government and the Bank of Japan during the two years in 2013 and 2014 deemed as the period of concentrated efforts for an exit out of deflation.

An important point of the "three-step rocket strategy" is that the weight of the "three arrows" will gradually shift. In other words, the strategy will gradually pass the torch to a strategy to boost economic growth mainly through structural reforms ("growth strategy").

(1) The first rocket: turnaround of sentiment through monetary and fiscal measures, turnaround of sentiment toward a lift-off

(2) The second rocket: shift to a growth strategy while continuing monetary and fiscal measures

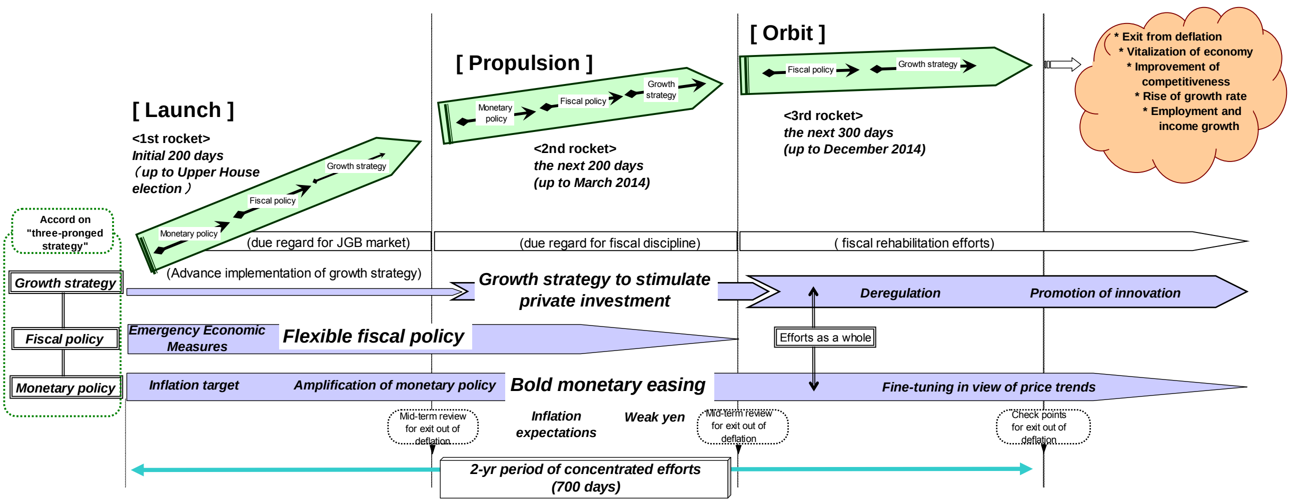
(3) The third rocket: shift into cruise (orbit) mode through sustained growth

The first rocket is being launched at the current stage. The weight upon the weakening of the yen through monetary policy and the improvement of sentiment through fiscal spending is leading to the rise of the stock market. In particular, note that the Japanese yen is weakening not only against the US dollar but also against other currencies.

Watch for the resumption of the "Springtime Monetary Easing Olympics"

The Abe administration has taken a "three-pronged" approach based upon the "three arrows" of monetary easing, flexible fiscal policy and growth strategy. Considering the difficulty for a growth strategy to have immediate effect, a major growth strategy of the Abe administration is its trade policy to seek overseas markets and the correction of the strong yen. In particular, the correction of the strong yen is a large pillar. If we stand upon the assumption that the US possesses the initiative in setting foreign exchange rate trends, it was extremely important (to the extent that it could even be deemed as the "fourth arrow") for the Abe administration to win the tacit acceptance of a weak yen through the adoption of a more cooperative stance with the US. Furthermore, the administration's

[Chart 2: The three-step rocket strategy consisting of three arrows for an exit from deflation]



Source: MHRI.

competence in diplomacy and negotiation are extremely important to win the global acceptance of Japan's efforts to emerge out of deflation through the maintenance of cooperative relations with other countries including the emerging economies. As such, the response toward Japan at the Group of Seven (G7) summit held in the UK in May 2013 may be deemed as a success of Japan's foregoing stance.

The new fiscal year starting in April 2013 has ushered in a new "Springtime Monetary Easing Olympics". Even though the countries of the world are still subject to the negative side effects of balance sheet adjustment and fiscal constraints, they are engaged not only in a race to exert their influence upon the foreign exchange market but in a race to lift asset prices through the stimulation of domestic demand. In other words, as the US balance sheet adjustment process nears its end, the Olympic games of monetary easing are moving into another stage – namely from a currency-weakening race to a race to boost asset prices.

Chart 3: Dates and matters decided at the monetary policy meetings of Japan, the US and Europe since April 2013 (the "Springtime Monetary Easing Olympics")

Date	Central bank	Matters decided
April 3rd, 4th	Bank of Japan (BOJ)	"will enter a new phase of monetary easing"
April 30th, May 1st	Federal Reserve Board (FRB)	continuation of the current accommodative stance, with a close eye upon the removal of the policy accommodation in view of the improvement of economic conditions
May 2nd	European Central Bank (ECB)	A further monetary accommodation by cutting the key policy rate from 0.75% to 0.5%

Source: MHRI.

At the same time, the "Springtime Monetary Easing Olympics" is characterized by the participation in the monetary easing race by many emerging countries. This indicates that the emerging countries have entered currency-weakening race amid the slowdown of their economies.

Chart 4: Dates and matters decided at monetary policy meetings since April 2013 (the "Springtime Monetary Easing Olympics")

Date	Country	Matters decided
April 16th	Turkey	Rate cut from 5.5% → 5%
April 23rd	Hungary	Rate cut from 5% → 4.75%
May 3rd	India	Rate cut from 7.50% → 7.25%
May 7th	Australia	Rate cut from 3% → 2.75%
May 8th	Poland	Rate cut from 3.25% → 3%
May 9th	South Korea	Rate cut from 2.75% → 2.5%
May 10th	Vietnam	Rate cut from 8% → 7%

Source: MHRI

Considering that the current Springtime Monetary Easing Olympics is prone to reignite a "currency war" encompassing not only the industrialized countries but also the emerging economies as well, the key is to avoid conflicts and adopt a cooperative stance in the global political and diplomatic environment. As I said before, the avoidance of a strong yen through the development of cooperative relations – mainly between Japan and the US – possesses crucial importance as the "fourth arrow". Japan's cooperative stance with the US since the end of last year led to a significant shift in the foreign exchange market, which I often liken to a child's game of "Red Light Green Light". [The US plays the role of the stop light, hence possessing the initiative to let exchange rates move in a certain direction (under a green light) until it halts the appreciation or depreciation of a certain currency (under a red light).] As the Monetary Easing Olympics moves into a new stage with the participation of emerging countries, Japan will need to take a new cooperative approach.

Since the turn of the new fiscal year, Japan's summit-level diplomacy involved Prime Minister Shinzo Abe's visit to Russia, the Middle East and Turkey during the Golden Week holidays in May. Given Russia's position as the host country of the Group of 20 (G20) summit meeting this year, it would be important to build cooperative relations with the host country which assumes a key diplomatic role. Turkey is among the countries joining the Monetary Easing Olympics. It is very important that the current administration is resorting to diplomatic efforts to gain acceptance of Japan's current situation in the global arena. The "fourth arrow", which is in effect a currency rate and diplomatic strategy including due consideration toward emerging economies, possesses significant impact.

The growth strategy holds the key to sustainable growth

Thus far, the Abe administration's fiscal and monetary policy measures have achieved a certain level of success. However, there are views in the market that the administration is relatively cautious toward structural reforms. Currently, the question is whether the torch can be passed over to the third rocket at the current pace of market acceleration. Moreover, the sustainable recovery of the economy by structural reforms under the growth strategy will gain more importance as Japan moves closer to the third rocket.

The market is watching closely whether the Abe administration will be able to maintain its focus upon the economy. While the "fourth arrow" mentioned above refers to external relations, and centers mainly upon relations with the US, it goes without mention that relations with the neighboring countries of Asia are just as important. In fact, the fourth arrow is accomplishing great success as a substitute of the growth strategy which is the third arrow. The remaining task of the fourth arrow is relations with China and South Korea. The normalization of relations with neighboring countries will grow more tenous if the Abe administration shifts away from its priority upon the economy and places excessive emphasis upon political matters such as the constitution. No doubt, the people of Japan look toward the Abe administration to maintain its focus upon the economy.

The overseas risk factors in 2013 are the downward pressures stemming from US fiscal conditions, the persisting adjustment pressures in the eurozone, and the slowdown of the Chinese economy. In Japan, the risk is the possibility of political destabilization. Thus, the delicate task of economic policy management will become increasingly important even after the House of Councilors election in July 2013.

We view the year 2013 as a year of Japan's stock market normalization and a step forward out of not only the "Lost Three Years" for the Japanese stock market but also the "Lost Two Decades" for the Japanese economy. Despite a slightly more cautious view with respect to some parts of the global economy, we look forward to a further global recovery in 2014 in our latest economic outlook.

Hajime Takata, Chief Economist

II. The global economy

The global economy was patchy in the Jan-Mar quarter of 2013

Even though the global economy is heading for a gradual recovery from its stagnation in mid-2012, there were signs of patchiness in the Jan-Mar quarter of 2013.

The US economy grew +2.5% q-o-q p.a. in the Jan-Mar quarter of 2013 (Oct-Dec quarter: +0.4% q-o-q p.a.) (**Chart 5**). Despite the ongoing fall of government spending, private-sector final demand such as personal consumption and capital investment grew strongly.

In contrast, the eurozone remained in a recession with real GDP contracting (-0.9% q-o-q p.a.) in the Jan-Mar quarter (Oct-Dec quarter: -2.3% q-o-q p.a.).

China's real GDP slowed down again, registering +7.7% y-o-y in the Jan-Mar quarter (Oct-Dec quarter: +7.9% y-o-y). Even though investment in fixed assets continued to grow strongly, it appears that the contribution to growth by capital formation fell due to the reduction of inventory.

Growth among many of the Asian economies other than China have either moderated or receded. In contrast to the rise of growth in South Korea, economic growth of Taiwan and Singapore fell into negative territory. The rate of economic growth also fell in Indonesia and Vietnam.

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

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

	2011	2012				2013
	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar
US	4.1	2.0	1.3	3.1	0.4	2.5
Eurozone	-1.3	-0.3	-0.6	-0.3	-2.3	-0.9
Japan	0.8	5.3	-0.9	-3.5	1.0	3.5
South Korea	1.5	3.3	1.2	0.2	1.1	3.5
Taiwan	-4.6	5.0	-0.1	3.9	7.3	-3.2
Hong Kong	2.1	1.0	-0.4	4.3	5.7	0.9
Singapore	-2.3	7.8	0.1	-4.6	3.3	-1.4
Thailand	-35.9	48.0	13.0	6.1	15.0	
Philippines	7.0	11.2	4.4	5.2	7.5	
Australia	2.4	5.0	2.6	2.6	2.4	

(Y-o-y % change)

China	8.9	8.1	7.6	7.4	7.9	7.7
Malaysia	5.3	5.1	5.6	5.3	6.5	4.1
Indonesia	6.5	6.3	6.4	6.2	6.1	6.0
Vietnam	6.1	4.6	4.8	5.1	5.4	4.9
India	6.0	5.1	5.5	5.3	4.5	
Brazil	1.4	0.8	0.5	0.9	1.4	
Russia	5.1	4.8	4.3	3.0	2.1	

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

Under this environment, Japan's real GDP growth accelerated to +3.5% q-o-q p.a. in the Jan-Mar quarter of 2013 (Oct-Dec quarter: +1.0% q-o-q p.a.).

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 +2.9% in 2013, remaining around the same level as in 2012 (+3.1%) (**Chart 6**). In addition to the US economic slowdown due to fiscal austerity, eurozone growth is also expected to remain in negative territory. A dramatic rise of growth among emerging economies is unlikely, considering the stagnation of exports to Europe and the US. Even so, note that the weakness of growth in 2013 stems largely from the stagnation of growth in 2012 (a low "carry-over of growth). The global economy should gather momentum in the second half of 2013 and grow +3.6% in 2014, accelerating for the first time in four years due to the upturn of the US and eurozone economies and the solid growth of the emerging economies.

[Chart 6: MHRI outlook on the global economy (re-posted)]

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

Calendar year	2011	2012	2013	2014	2013	2014
	(Actual)	(Actual)	(Forecast)	(Forecast)	(Previous: Mar forecast)	
Total of forecast area	3.8	3.1	2.9	3.6	3.0	3.6
Japan , US , Eurozone	1.3	1.2	0.9	1.6	0.7	1.5
US	1.8	2.2	1.6	2.2	1.4	2.0
Eurozone	1.5	-0.5	-0.5	0.8	-0.3	0.8
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Asia	7.5	6.1	6.1	6.3	6.4	6.6
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ASEAN5	4.5	6.1	5.4	5.1	5.5	5.3
China	9.3	7.8	7.8	7.7	8.2	7.9
India	7.5	5.0	4.7	5.3	4.8	5.9
Australia	2.4	3.6	2.6	2.9	2.7	3.0
Brazil	2.7	0.9	2.7	3.4	2.9	3.5
Russia	4.3	3.4	2.9	3.7	3.0	4.0
Japan (FY)	0.2	1.2	2.7	0.6	2.2	0.4
Crude oil price (WTI , USD/bbl)	95	94	89	90	87	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 slow down to +1.6% in 2013. Even though the government spending cuts will serve as a drag upon growth, household balance sheet adjustment should progress along with the recovery of the housing market, leading to the solid growth of private-sector final demand. Amid the ongoing rise of employment, the Federal Reserve Board (FRB) is predicted to reduce the scope of its quantitative easing measures by the end of 2013. 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 (-0.5%). Recent data releases indicate the slow recovery of the overall eurozone economy, providing reasons to believe that eurozone growth will remain in negative territory during the first half of 2013. Even so, the eurozone economy should climb back to positive territory from the second half of 2013 amid the stabilization of the financial environment due to a lower possibility of extreme scenarios such as the collapse of the euro. Even though the eurozone economy should gradually recover in 2014, lingering downward pressures stemming from fiscal austerity mainly among the countries of Southern Europe should keep the rate of real GDP growth below 1% at +0.8%.

The Chinese economy is forecast to remain on a gradual downtrend in 2013 (+7.8%) and 2014 (+7.7%). While investment for the promotion of urbanization and construction of small and medium-sized housing will serve to propel growth from the second half of 2013 to the first half of 2014, measures to cool housing investment will also be taken at the same time. All in all, a sharp rise of investment is unlikely. In the second half of 2014, the drive to correct excessive investment is expected to intensify, leading to a slight slowdown of the economy.

India will be obliged to tighten its reigns upon monetary policy in order to address the deterioration of its current account balance. Hence, the Indian economy is forecast to keep growing around 5%: +4.7% in 2013, and +5.3% in 2014.

The Asian economies other than China and India should continue to follow a gradual export-led recovery in both 2013 and 2014. Among the NIEs (South Korea, Hong Kong, Taiwan, Singapore), real GDP growth should gradually rise (+2.1% in 2013, and +3.4% in 2014) due to the rise of exports along with the acceleration of growth in the US and Europe in 2014. The ASEAN5 (Thailand, Malaysia, Indonesia, the Philippines, Vietnam) should also be able to maintain its solid pace of growth (+5.4% in 2013, and +5.1% in 2014).

As for the Australian economy, the rate of real GDP growth is expected to stand at +2.6% in 2013 due to the impact of fiscal austerity. In 2014, growth is predicted to pick up slightly to +2.9% on the back of the recovery of exports and investment amid a slight mitigation of the downward pressures stemming from fiscal conditions.

Turning to Brazil, despite the upturn of the economy, the pace of recovery is slow reflecting factors such as the sluggish rise of exports. Furthermore, the shift of monetary policy to a tightening stance due to the rise of inflation concerns may serve as a drag upon private-sector demand. Even though the government's economic measures should lead to a gradual economic recovery, the rate of real GDP growth is forecast to remain a moderate +2.7% in 2013 and +3.4% in 2014.

Even though the pace of Russia's real GDP growth is forecast to stand at +2.9% in 2013 due to the decline in price of crude oil and other factors, the pace of growth should rise to +3.7% in 2014 due to factors such as the recovery of investment.

Turning to Japan in 2013, the economy is expected to maintain growth of +1.8% due to the upturn of exports, production and capital investment on the back of the weak yen in addition to the impact of the 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.

US fiscal conditions and downturn of Chinese demand pose risks

Expectations toward economic recovery are rising in the financial and capital markets, as shown by the rise of the stock markets around the world. However, it should be noted that current economic data releases are not necessarily all strong and that the stock market rise is driven largely by expectations.

It would be necessary to keep in mind the possibility that the impact of fiscal austerity in the US and Europe and the downturn of Chinese demand may serve as an impediment to global economic recovery.

[Chart 7: Major political and economic events]

2013 May	US	FOMC (Apr 30th, May 1st)
	Europe	ECB Governing Council meeting (2nd)
		interest rate cut decision (0.25%)
	G7 Meeting of Finance Ministers and Central Bank Governors (UK, 10th, 11th)	
	Japan	BOJ Monetary Policy Meeting (21st, 22nd)
	Europe	EU summit meeting (22nd)
Jun	Europe	ECB Governing Council meeting (6th)
	Japan	BOJ Monetary Policy Meeting (10th, 11th)
	Iran	Presidential election (14th)
	G8 summit meeting (UK, 17th, 18th)	
	US	FOMC (18th, 19th)
	Japan	Election for the Tokyo Metropolitan Assembly (23rd)
	Europe	EU summit meeting (27th, 28th)
Jul	Europe	Accession of Croatia to the EU
	Europe	ECB Governing Council meeting (4th)
	Japan	BOJ Monetary Policy Meeting (10th, 11th)
	G20 Meeting of Finance Ministers and Central Bank Governors (Moscow, 19th, 20th)	
	US	FOMC (30th, 31st)
	Japan	House of Councilors election
Aug	Europe	ECB Governing Council meeting (1st)
	Japan	BOJ Monetary Policy Meeting (7th, 8th)
Sep	Europe	ECB Governing Council meeting (5th)
	Japan	BOJ Monetary Policy Meeting (4th, 5th)
	G20 summit meeting (St. Petersburg, Russia, 5th, 6th)	
	IOC to decide upon the venue of the 2020 Olympic games (7th)	
	US	FOMC (17th, 18th)
	Europe	German federal election (22nd)
Oct	Europe	ECB Governing Council meeting (2nd)
	Japan	BOJ Monetary Policy Meeting (3rd, 4th)
	APEC	Economic Leaders' Meeting (Bali, Indonesia, 7th, 8th)
		CEO Summit (Bali, Indonesia, 5th to 7th)
	G20 Meeting of Finance Ministers and Central Bank Governors (Washington DC, 10th, 11th)	
	Europe	EU summit meeting (24th, 25th)
	US	FOMC (29th, 30th)
	Japan	BOJ Monetary Policy Meeting (31st)
Nov	Australia	Federal election (1st)
	Europe	ECB Governing Council meeting (7th)
	Japan	BOJ Monetary Policy Meeting (20th, 21th)
Dec	Europe	ECB Governing Council meeting (5th)
	US	FOMC (17th, 18th)
	Japan	BOJ Monetary Policy Meeting (19th, 20th)
	Europe	EU summit meeting (19th, 20th)
	Japan, ASEAN summit meeting (Japan)	

Source: MHRI.

III. The Japanese economy

(1) The current state of the economy

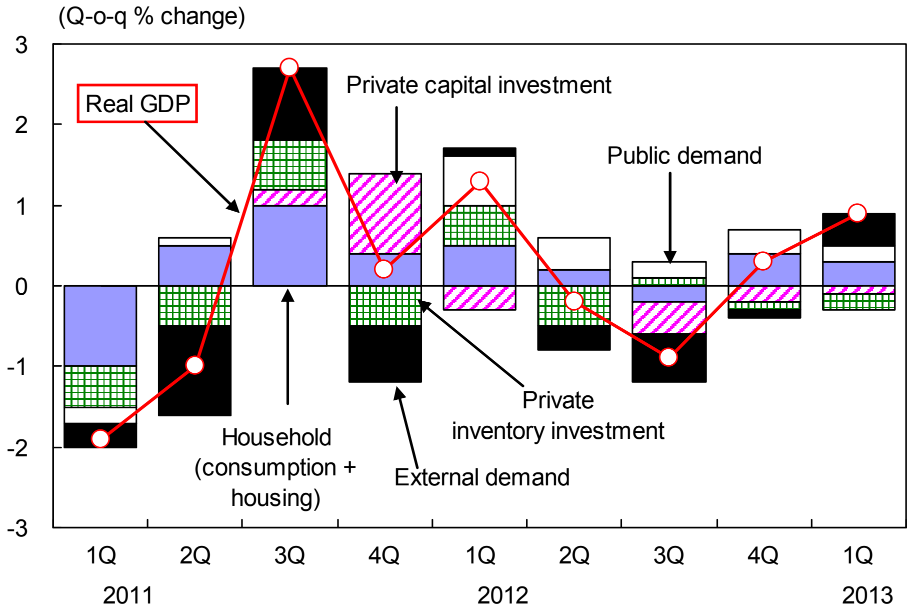
The Japanese economy grew a strong +3.5% q-o-q p.a. in the Jan-Mar quarter of 2013, due mainly to the rise of personal consumption and exports

According to the *First Preliminary Quarterly Estimates of GDP (1st QE)* for the Jan-Mar quarter of 2013, Japan's real GDP recorded strong growth of +0.9% q-o-q (or +3.5% in annualized terms) (**Chart 8**).

Domestic private demand grew +0.5% q-o-q (contribution to quarterly real GDP growth: +0.3% pt), expanding for the second quarter in a row. The pace of personal consumption growth picked up, reaching +0.9% q-o-q (Oct-Dec quarter: +0.4%), driven by factors such as the improvement of sentiment reflecting the rise of stock prices. In contrast, capital investment fell (-0.7% q-o-q) (Oct-Dec quarter: -1.5% q-o-q), declining for the fifth quarter in a row as manufactures continued to take a cautious stance. Private inventory investment also contributed negatively (-0.2% pt) because of ongoing moves to reduce inventory.

Public demand grew +0.6% q-o-q (contribution: +0.2% pt), continuing to expand for the fifth quarter in a row. Even though public investment continued to rise, growing +0.8% q-o-q (Oct-Dec quarter: +2.8% q-o-q), the pace of growth slowed down. On the other hand, government consumption, which rose a solid +0.6% q-o-q (Oct-Dec quarter: +0.7% q-o-q), is continuing to grow on the back of the rise of social security-related expenditures accompanying the ageing of the population.

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



Source: Cabinet Office, *Preliminary Quarterly Estimates of GDP.*

Exports picked up for the fist time in four quarters, growing a dramatic +3.8% q-o-q (Oct-Dec quarter: -2.9% q-o-q). It appears that US-bound motor vehicle exports served as the driver. Even though imports also took an upturn, rising +1.0% q-o-q (Oct-Dec quarter: -2.2% q-o-q), the growth of imports still fell far below that of exports. Thus, external demand worked as a significant positive contribution to growth (+0.4% pt). Growth in the Jan-Mar quarter may be viewed as well-balanced between domestic and external demand.

FY2012 real GDP growth: +1.2%

The rate of real GDP growth in FY2012 turned out to be +1.2%. While external demand served as a significant drag (-0.8% pt) upon growth, the contribution by public demand reached +1.2% pt. FY2012 may be deemed as a year driven by demand for reconstruction from the Great East Japan Earthquake. Meanwhile, domestic private-sector demand grew, spurred main by personal consumption (+1.6% q-o-q). Its contribution to growth reached +0.8% pt.

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

Public demand will serve as the engine of growth in FY2013 1H

In the first half of FY2013 (the Apr-Jun and Jul-Sep quarters), the Japanese economy should continue to grow at a level around +2% p.a. to +3% p.a. Over the summer months, 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* and push up the rate of economic growth.

Domestic private-sector demand will likely follow a gradual expansion. Personal consumption should continue to follow a gradual upward trend, given the improvement of the income environment indicated by the year-on-year rise of summer bonus payments for the first time in three years, in addition to the improvement of consumer confidence backed by the rise of the stock market. Over the summer months, the last-minute rush of demand prior to the consumption tax hike from FY2014 should emerge in the form of housing investment. Investment among manufacturers, which have thus far taken a cautious stance, should gradually rise again, leading to a modest upturn of capital investment.

The quantitative impact of the weak yen should gradually emerge amid the mild recovery of overseas economies, leading to the rise of exports over the summer. External demand should also serve as a factor pushing up the rate of growth.

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 addition of personal consumption to housing investment in the last-minute rush of demand 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. On the other hand, public investment (albeit still high) should level off around the end of the fiscal year, given the fading impact of the economic stimulus measures.

As a result, the pace of real GDP growth in FY2013 is forecast to rise to +2.7% (forecast in March: +2.2%) (**Chart 9**). We have made revisions to exports and capital investment in view of the impact of the weakening yen and have revised upward our outlook on personal consumption reflecting the improvement of consumer confidence due to the rise of stock prices.

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

In the Apr-Jun quarter of 2014, Japan may not avoid a sharp contraction of growth into negative territory (forecast to be -6.5% q-o-q p.a.) due to a fall of personal consumption and housing investment 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.

On the other hand, in view of concerns regarding the rise of government bond yields in the event Japan's fiscal rehabilitation goal over the medium to long-term turns tenuous, it would be difficult for Japan to increase its public works expenditures from FY2014 onward, and hence lead to a gradual decline of public investment. 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 March: +0.4%). The main reason for the recent upgrade from our previous forecast is the upward revision of our forecasts on exports and capital investment reflecting the impact of the yen depreciation.

The risks: US economic downturn and reversal of exchange rate trends (yen strengthening)

As explained above, our main scenario in this economic outlook is the rise of Japan's economic growth in FY2013 and the maintenance of the economic expansion in FY2014 even after the consumption tax hike. However, this scenario is subject to several risks. Looking overseas, there is the risk of a yen appreciation in the event of an unexpected slowdown of the US economy due to factors such as the reduction of government spending. In the event of a US economic downturn, market speculation on a receding US monetary policy exit (such as the reduction of quantitative easing) may trigger a reversal of the forex rate trend to a strong yen.

[Chart 9: Outlook on the Japanese economy]

		2011	2012	2013	2014	2012	2013				2014				2015
		FY				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	0.2	1.2	2.7	0.6	0.3	0.9	0.7	0.9	1.0	1.2	-1.7	0.5	0.5	0.4
	Q-o-q % ch p.a.	--	--	--	--	1.0	3.5	2.7	3.7	3.9	4.9	-6.5	1.9	1.9	1.7
Domestic demand	Q-o-q % ch	1.3	2.0	2.3	-0.2	0.3	0.5	0.6	0.8	0.8	1.1	-1.9	0.3	0.3	0.2
Private sector demand	Q-o-q % ch	1.4	1.1	2.0	-0.5	0.1	0.5	0.5	0.7	0.9	1.3	-2.6	0.4	0.4	0.4
Personal consumption	Q-o-q % ch	1.5	1.6	2.2	-1.2	0.4	0.9	0.3	0.3	0.7	1.9	-3.6	0.5	0.2	0.2
Housing investment	Q-o-q % ch	3.7	5.3	7.6	-8.4	3.5	1.9	1.0	4.3	2.0	-5.5	-8.1	1.5	1.0	1.5
Capital investment	Q-o-q % ch	4.1	-1.5	1.5	3.2	-1.5	-0.7	0.9	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	-0.2	0.2	-0.1	-0.2	0.0	0.0	-0.1	-0.2	0.4	-0.1	0.1	0.0
Public sector demand	Q-o-q % ch	0.9	4.8	3.1	0.8	1.1	0.6	0.8	1.0	0.6	0.3	0.2	0.0	-0.1	-0.3
Government consumption	Q-o-q % ch	1.4	2.6	1.6	1.9	0.7	0.6	0.3	0.3	0.3	0.3	0.7	0.5	0.5	0.5
Public investment	Q-o-q % ch	-2.2	15.2	9.8	-4.5	2.8	0.8	2.6	3.9	2.0	0.4	-1.9	-2.1	-2.9	-3.9
External demand	Q-o-q contribution, % pt	-1.0	-0.8	0.4	0.9	-0.1	0.4	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.2
Exports	Q-o-q % ch	-1.6	-1.3	3.7	5.4	-2.9	3.8	1.0	1.5	1.8	1.8	0.9	1.0	1.3	1.4
Imports	Q-o-q % ch	5.3	3.8	0.9	0.6	-2.2	1.0	0.3	0.5	0.8	0.9	-0.5	-0.3	0.2	0.3
GDP (nominal)	Q-o-q % ch	-1.4	0.3	2.0	1.5	0.1	0.4	0.8	0.2	1.2	1.4	0.2	-0.5	0.1	0.0
GDP deflator	Y-o-y % ch	-1.7	-0.9	-0.7	0.9	-0.7	-1.2	-0.7	-1.3	-0.9	0.0	1.5	1.3	0.7	0.1
Domestic demand deflator	Y-o-y % ch	-0.5	-0.8	-0.5	1.1	-0.8	-0.9	-0.4	-0.5	-0.5	-0.5	0.8	1.1	1.3	1.3

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

		2011	2012	2013	2014	2012	2013				2014				2015
		FY				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	-1.0	-3.4	3.8	1.2	-1.9	2.2	1.3	1.7	1.9	2.0	-1.8	-0.5	0.7	1.1
Ordinary profits	Y-o-y % ch	-2.0	8.8	10.6	2.7	5.9	7.9	12.8	15.5	12.8	3.5	-3.3	0.7	9.0	4.0
Nominal labor compensation	Y-o-y % ch	0.6	-0.3	0.3	0.7	-0.7	-0.1	0.3	0.0	0.4	0.3	0.7	0.7	0.7	0.8
Unemployment rate	%	4.5	4.3	3.8	3.6	4.2	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	94.3	85.9	91.8	90.4	92.1	96.4	97.5	90.6	84.3	84.7	86.1	89.1
Current account balance	P.a., JPY tril	7.6	4.3	5.9	9.8	4.3	2.9	4.4	4.1	7.4	8.3	12.8	9.9	9.7	7.7
Domestic corporate goods prices	Y-o-y % ch	1.4	-1.1	1.3	3.6	-0.9	-0.3	0.7	1.6	1.8	1.0	2.8	3.3	3.9	4.4
Consumer prices	Y-o-y % ch	0.0	-0.2	0.1	2.3	-0.1	-0.3	-0.2	0.1	0.2	0.1	2.0	2.1	2.4	2.5
Uncollateralized overnight call rate	%	0.08	0.06	0～0.10	0～0.10	0.08	0.06	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	%	1.05	0.78	0.90	1.03	0.75	0.70	0.74	0.90	0.95	1.00	0.95	1.00	1.05	1.10
Nikkei average	JPY	9,181	9,650	15,200	16,000	9,234	11,444	14,200	15,200	15,500	15,800	15,400	15,800	16,200	16,500
Exchange rate	JPY/USD	79.0	83.0	102.0	107.0	81.0	92.0	100.0	102.0	103.0	104.0	105.0	106.0	107.0	108.0
Crude oil price (WTI nearest term contract)	USD/bbl	97.0	92.0	86.0	93.0	88.0	94.0	92.0	87.0	81.0	83.0	87.0	92.0	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, the yield on newly-adjusted 10-yr JGBs refers to the averages of the end-of-month rates, 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.

Risks in the domestic economy: uncertainties surrounding the consumption tax hike

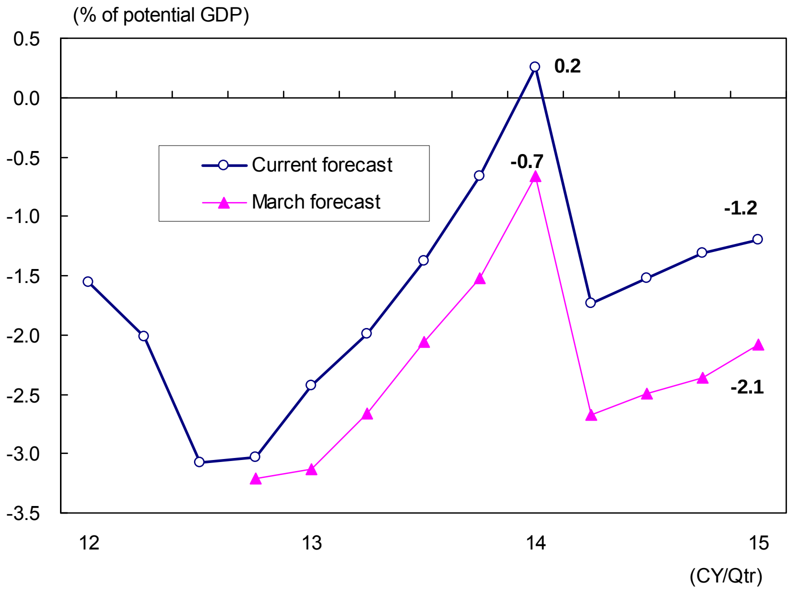
Turning to domestic factors, there are significant uncertainties surrounding the consumption tax hike. Assuming that the consumption tax hike is postponed from FY2014 on the basis of the judgment to avoid an economic downturn over the summer months and to emerge out of deflation, there are the risks of the rise of long-term interest rates and an extreme weakening of the yen due to a "Japan sell-off". In particular, the risks of the rise of long-term interest rates would intensify if the consumption tax hike is put off without setting the timing of the next hike.

Furthermore, even if the consumption tax is raised as scheduled, it would be difficult to accurately forecast the size of the last-minute rush of demand, its backlash, and the impact upon personal consumption due to the fall of real income. Amid the sensitivity of consumers toward the rise of prices under a deflationary environment, a shopping spree ahead of the second consumption tax hike in October 2015 would serve to increase the size of the last-minute demand, and thereby lead to a larger backlash thereafter. On the other hand, if we assume that demand has been depleted to a certain extent already due to the Eco-Car tax cuts and subsidies to promote purchases of fuel-efficient cars and Eco-Point Program to stimulate purchases of energy-conserving household appliances, the last-minute demand would turn out to be smaller.

The output gap will remain negative (an excess of supply) even at the end of FY2014

The output gap (the gap between actual GDP and potential GDP) estimated by MHRI stood at -2.4% of potential GDP (meaning an excess of supply of approximately JPY13.0 trillion) (**Chart 10**). Since the rate of growth rose in the Jan-Mar quarter, the breadth of the gap in negative territory contracted in comparison to -3.0% of potential GDP as of the Oct-Dec quarter of 2012. During FY2013, the Japanese economy is forecast to grow at a pace above its potential rate of growth (estimated by MHRI to be around +1.0% p.a. at the moment),

[Chart 10: Outlook on the output gap]



Sources: Made by MHRI based upon Cabinet Office, *National Accounts* .

leading to the contraction of the negative output gap (excessive supply) toward the end of FY2013. The output gap is forecast to reach +0.2%, thus temporarily resolving the excess supply, in the Jan-Mar quarter of 2014 when the last-minute rush of demand will push up the level of economic activity. However, the breadth of the negative output gap is predicted to widen sharply again in the Apr-Jun quarter of 2014 due to a backlash to the last-minute rush of demand. Even though the breadth of the negative output gap should gradually contract from then onward, the excess of supply will likely persist, leaving the output gap at -1.2% even at the end of FY2014. Since MHRI's economic outlook as of March 2013 forecast that the output gap would stand at -2.1% at the end of FY2014, the breadth of the negative output gap would contract by 0.9 pt as a result of the upward revision of our latest economic outlook.

The odds are low that Japan will emerge out of deflation during FY2014

Despite our upward revision of growth, our view that the excess of supply would persist even at the end of FY2014 remains unchanged from our previous economic outlook, making an exit out of deflation unlikely in the foreseeable future. The core CPI excluding the impact of the consumption tax hike will likely trend around zero until FY2014. The core CPI (general, excluding fresh food) is forecast to stand at +0.1% y-o-y in FY2013, and +2.3% y-o-y (+0.2% y-o-y when excluding the impact of the consumption tax hike) in FY2014.

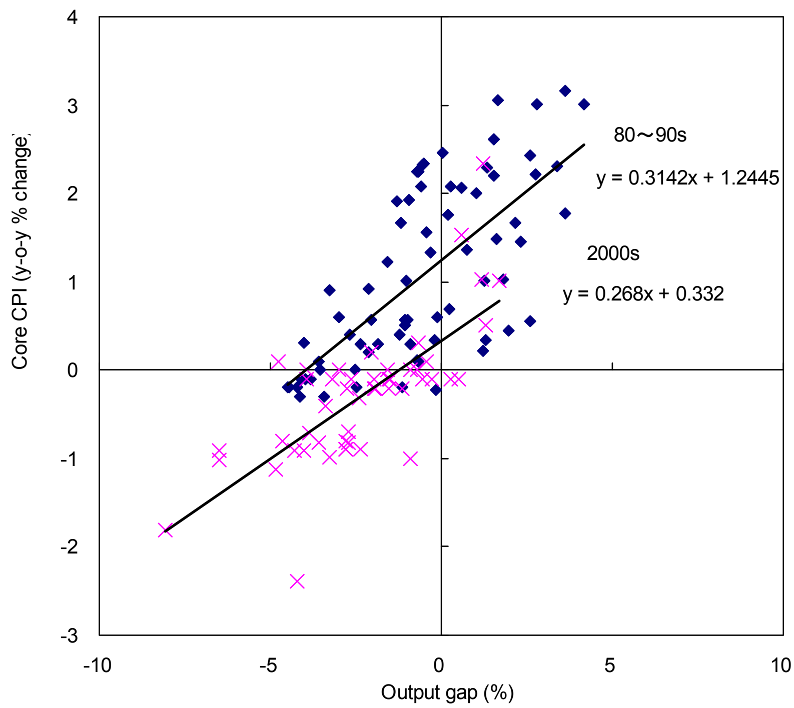
It would take several years for the Phillips curve to shift upward

At the Monetary Policy Meeting on April 3rd and 4th, the Bank of Japan (BOJ) decided to step up its monetary easing (a "new phase of monetary policy in terms of quantity and quality") to realize an inflation rate of 2% with a time horizon of two years. However, judging from the difficulty to resolve the negative output gap during FY2014, it would be difficult to achieve this target in two years.

In addition to closing the negative output gap by the expansion of the economy over the medium to long term, it would be necessary for the Phillips curve (the curve representing the relationship between the rate of inflation and the output gap) to shift upward. A look at the relationship between the output gap estimated by MHRI and the year-on-year change of the core CPI shows a significant downward shift of the line representing the relationship between the two in the 2000s in comparison to the period from 1980 to the 1990s (**Chart 11**). Based upon the Phillips curve in the 2000s, the core CPI would still be +0.3% y-o-y even in the event the output gap is zero. A straightforward calculation would result in an unrealistic output gap of +6.2% necessary to achieve an inflation rate of 2%. Even though an upward shift of the Phillips curve is necessary in order to emerge out of deflation, it would require not only monetary policy but also the growth strategy (the third arrow of Abenomics) to generate expectations toward the continuous growth of demand and the improvement of the output gap. However, we should keep in mind that it would take several years to achieve this goal. In particular, corporate behavior will tend to remain cautious during FY2014 and FY2015 when the impact of the consumption tax hike will keep demand subdued. During this period, a full-fledged rise of capital investment for the reinforcement of production capacity and rise of workers' base wages is unlikely, considering that such moves occur in times of the rise of growth expectations. Therefore, even if the monetary easing policy and growth strategy are successful, it will only be some time from FY2016 onward that Japan can look forward to an exit out of deflation.

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. In the event the formulation of a growth strategy and implementation of monetary easing over the medium to long term leads to the perception that the economy is progressing steadily toward closing the output gap and emerging out of deflation, there should be a gradual shift in corporate and household behavior. The success of the Kuroda-led BOJ's monetary easing and the Abe administration's economic policies ("Abenomics") which includes the foregoing should be evaluated not in terms of a two year time span but over a longer period of time.

[Chart 11: The relationship between the core CPI and the output gap (the Phillips curve)]



Notes: 1. The core CPI = general CPI excluding fresh food
2. The output gap is 3-quarter lag
3. 1980s - 1990s: 1983/1Q - 2000/3Q, 2000s: 2000/4Q onward

Sources: Made by MHRI based upon Cabinet Office, *National Accounts*, Ministry of Internal Affairs and Communications, *Consumer Price Index*, etc.

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