MIZUHO

Channel to Discovery

FY2011, FY2012 and FY2013 Economic Outlook

February 2012

Key points of Mizuho Research Institute's (MHRI) outlook on the economy in FY2011, FY2012 and FY2013 reflecting *The First Preliminary Quarterly Estimates of GDP (1st QE)* of Japan for the Oct-Dec quarter of 2011

<The US Economy >

- **Weak growth due to fiscal tightening amid balance sheet adjustment**
  2012: +1.8% (previous forecast +1.3%)
  2013: +1.2%

<The Eurozone Economy >

- **Fiscal austerity will drag down growth. Uncertainties regarding the sovereign debt crisis will linger**
  2012: -0.4% (previous forecast +0.1%)
  2013: +0.8%

<The Asian Economy >

- **Slowdown mainly among export-driven countries. Chinese domestic demand will remain firm**
  2012: +6.8% (previous forecast +6.9%)
  2013: +6.7%

<The Japanese Economy >

- **Growth to fall into negative territory due to supply constraints following the Great East Japan Earthquake and the flooding in Thailand**
  FY2011: -0.4% (previous forecast -0.4%)
- **Full-fledged reconstruction demand will drive domestic demand-led growth**
  FY2012: +1.9% (previous forecast +1.9%)
- **Slow-down due to peak-out of reconstruction demand. Surge of demand prior to tax hike will push up growth in the second half of the fiscal year**
  FY2013: +1.1%

Mizuho Research Institute

I. The global economy

The global economy continued to stagnate in the Oct-Dec quarter of 2011

Amid lingering uncertainties in the financial and capital markets regarding the eurozone sovereign debt crisis, the Asian economies suffered supply chain disruptions due to the widespread flooding in Thailand. As in the Jul-Sep quarter of 2011, the global economy continued to stagnate in the Oct-Dec quarter of 2011.

US real GDP growth accelerated to +2.8% q-o-q p.a. in the Oct-Dec quarter of 2011 (Jul-Sep quarter: +1.8% q-o-q p.a.) (**Chart 1**). Even so, domestic final demand moderated due to factors such as the decline of government spending, resulting in the US economy driven largely by inventory investment.

Although eurozone real GDP data for the Oct-Dec quarter of 2011 are yet to be released (as of February 13, 2012), economic growth appears to have contracted in many of the eurozone countries as a result of the household and corporate sectors turning bearish due to rising concerns regarding government debt and capital shortage among financial institutions.

In Asia, economic growth either moderated or dipped into negative territory in many of the countries because of inventory adjustment in the information technology (IT) sector and the impact of the Thai floods. Economic growth in Taiwan and Singapore both contracted and the economies of South Korea and Hong Kong also remained weak. China's real GDP slowed slightly in the Oct-Dec quarter (+8.9% y-o-y) from +9.1% y-o-y in the Jul-Sep quarter. Despite the strength of consumer spending, exports and investment slowed down.

[Chart 1: Real GDP growth of major countries and areas]

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

	2010				2011			
	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec
US	3.9	3.8	2.5	2.3	0.4	1.3	1.8	2.8
Eurozone	1.5	3.6	1.7	1.1	3.1	0.6	0.5	n.a.
Japan	6.1	5.2	2.3	-0.6	-6.8	-1.5	7.0	-2.3
South Korea	8.6	5.7	2.6	2.0	5.4	3.6	3.3	1.4
Taiwan	9.0	9.7	3.7	2.3	9.0	2.8	-0.8	-1.0
Hong Kong	7.7	7.7	3.7	6.9	12.4	-2.1	0.5	1.4
Singapore	39.9	29.7	-16.7	3.9	26.6	-5.9	1.5	-4.9
Thailand	11.6	1.0	-0.5	4.3	7.5	0.2	2.1	n.a.
Philippines	17.5	6.6	1.0	1.9	8.1	1.1	3.3	3.5

(Y-o-y % change)

China	12.0	10.3	9.6	9.8	9.7	9.5	9.1	8.9
Malaysia	10.1	9.0	5.3	4.8	5.2	4.3	5.8	n.a.
Indonesia	5.9	6.3	5.8	6.8	6.4	6.5	6.5	6.5
Vietnam	5.8	6.4	7.2	7.3	5.6	5.7	6.1	6.1
India	9.4	8.8	8.4	8.3	7.8	7.7	6.9	n.a.

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

In a sharp downturn from its strong growth in the previous quarter from July to September (+7.0% q-o-q p.a.), the Japanese economy shrank in the Oct-Dec quarter of 2011 (-2.3% q-o-q p.a.). The sharp drop of automobile and electrical appliance exports stemming from the shortage of parts due to the Thai floods served as a significant drag upon growth.

Another year of slow growth for the global economy in 2013

In 2012, the rate of global economic growth (the weighted average of all the countries and areas within the scope of MHRI's economic forecast) is predicted to slow down to the lower half of the 3%-level from forecasted growth of +3.7% in 2011 (**Chart 2**). Growth in 2013 is also expected to remain soft as in the year 2012. The eurozone and US economies will remain on weak footing due to the impact of fiscal tightening. Many of the emerging countries are also expected to slowdown due to the stagnation of exports to Europe and the US.

Turning to the US economy, we forecast growth of +1.8% in 2012 and a subsequent slowdown to +1.2% in 2013. A full-fledged recovery of private demand is unlikely due to lingering balance sheet adjustment pressures in the household sector. Given the commencement of budget cuts based upon the Budget Control Act of 2011, we expect stronger downward pressures stemming from fiscal constraints in 2013.

The eurozone economy is expected to fall into a recession from the end of 2011 to 2012. Subsequent to a contraction of real GDP growth in 2012 (-0.4%), the pace of growth will likely remain a slow +0.8% in 2013 amid persistent downward pressures stemming from fiscal tightening.

As for the Asian economies, an overall stagnation is expected due primarily to sluggish exports stemming from the European and US economic slump. Real GDP growth among the export-dependent NIEs should remain weak in 2012 (+2.1%) and 2013 (+1.8%). In contrast, the ASEAN5 countries possessing robust domestic demand should enjoy relatively strong growth in 2012 (+4.5%) and 2013

[Chart 2: Outlook on the global economy]

(Y-o-y % change)

Calendar year (CY)	2009 (Actual)	2010 (Actual)	2011 (Forecast)	2012 (Forecast)	2013 (Forecast)
Total of forecast area	-0.1	5.3	3.7	3.3	3.3
Japan, US, Eurozone	-4.1	2.8	1.3	1.0	1.0
US	-3.5	3.0	1.7	1.8	1.2
Eurozone	-4.3	1.8	1.5	-0.4	0.8
Japan	-5.5	4.4	-0.9	2.0	1.0
Asia	6.1	9.3	7.5	6.8	6.7
NIEs	-0.7	8.3	4.0	2.1	1.8
ASEAN5	1.6	7.0	4.7	4.5	4.4
China	9.2	10.4	9.2	8.6	8.4
India	7.0	8.7	7.4	6.9	6.9
Japan (FY)	-2.1	3.1	-0.4	1.9	1.1
Crude oil price (WTI, USD/bbl)	62	80	95	94	84

Note: The total of the forecast area is calculated upon the 2010 GDP share (PPP) by the IMF.
Sources: IMF, MHRI.

(+4.4%).

The Chinese economy is forecast to follow a mild slowdown in 2012 (+8.6%) and 2013 (+8.4%). Looking forward, monetary policy should turn slightly accommodative reflecting the peak-out of inflation, leading to the steady growth of investment. Personal consumption will likely grow steadily, driven by factors such as the rise of wages. However, the rate of economic growth should slow down slightly due to the stagnant growth of exports bound mainly for Europe.

Even though the rate of Japan's real GDP growth - driven by reconstruction demand - should rise to +2.0% in 2012 (in calendar year terms), the pace of growth is forecast to slow sharply to +1.0% in 2013 when the demand related to reconstruction peaks out.

The escalation of the eurozone sovereign debt crisis is the largest risk factor

Uncertainties in the financial and capital markets are receding slightly in comparison with the end of last year, reflecting (1) the abatement of concerns regarding the liquidity positions of eurozone banks due to the ECB's introduction of the 3-yr long-term refinancing operations (LTRO) in December 2011, and (2) expectations toward the progress of Greek debt reduction negotiations.

However, there is still the risk of a "disorderly default" in the absence of sufficient private investor participation. Even if the impending crisis is averted by a Greek bailout in March 2012, subsequent deadlines follow such as (1) the recapitalization of major European banking institutions at the end of June, (2) the establishment of the European Stability Mechanism (ESM) and, (3) the massive redemptions of Italian and Spanish government bonds in July. At each such juncture, attention will gather upon the eurozone sovereign debt crisis. Also, the French presidential election scheduled in April and May this year may lead to the rise of concerns in the financial market due to political destabilization. The eurozone sovereign debt crisis remains the largest risk to the global economy, given the lingering possibility that it might escalate into a global financial crisis at some time.

Another risk: the surge of crude oil prices due to tensions regarding Iran

The rise of tensions surrounding Iran is another source of concern. The countries of the West have implemented sanctions including the embargo of Iranian crude oil in response to Iran's suspected nuclear development program. This is leading to rising tensions such as warnings by Iran on a possible blockade of the Straits of Hormuz.

Even though the uncertainties regarding Iran may keep the price of crude oil at a high level, we believe that the chances are remote that a full-scale armed conflict will lead to a further surge of crude oil prices. MHRI's forecasts that the price of crude oil (WTI) will remain high from 2011 (USD95/bbl) to 2012 (USD94/bbl) and subsequently decline in 2013 (USD84/bbl) reflecting the stagnation of demand.

However, there is a risk of a further rise of crude oil prices in the event of the escalation of uncertainties regarding the supply of crude oil via the Persian Gulf if dispute erupts between Iran and the countries of the west (or Israel). The rising tensions surrounding Iran require close attention as a risk factor ranking second to the eurozone sovereign debt crisis.

II. The Japanese economy

(1) The current state of the economy

The Japanese economy contracted in the Oct-Dec quarter of 2011 due to supply constraints stemming from the Thai floods

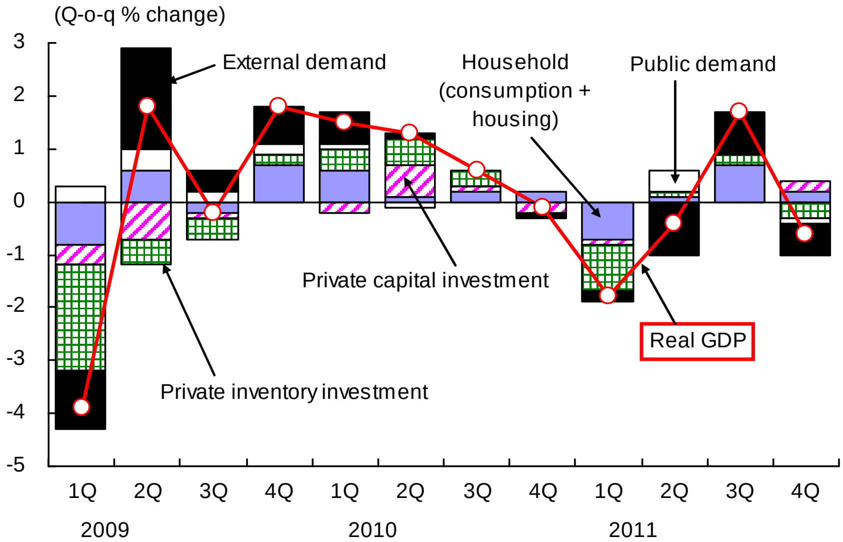
The rate of Japan's real GDP growth turned out to be -0.6% q-o-q (-2.3% in annualized terms), contracting for the first time in two quarters in the Oct-Dec quarter of 2011, (**Chart 3**).

The main factor behind the contraction was the fall of exports due to disruptions to production of cars and IT (information technology) appliances stemming from the shortage of parts caused by the flooding in Thailand. Exports fell sharply (-3.1% q-o-q) in the Oct-Dec quarter. Due in part to the ongoing rise of imports (+1.0% q-o-q), the contribution by external demand contracted (-0.6% pt), serving as a significant drag upon the rate of GDP growth.

Meanwhile, domestic private demand continued to grow at a mild pace (+0.2% q-o-q, contribution: +0.1% pt). Despite the fall of housing investment (-0.8% q-o-q) and private inventory investment (contribution: -0.3% pt), both personal consumption (+0.3% q-o-q) and capital investment (+1.9% q-o-q) grew during this period.

Public demand fell for the second quarter in a row (-0.2% q-o-q, contribution: -0.1% pt), indicating that reconstruction demand is not yet in full swing. Despite the expansion of government consumption (+0.3% q-o-q), public investment (-2.5% q-o-q) fell for the second consecutive quarter. Domestic demand –

[Chart 3: Japan's quarterly real GDP growth]



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

combining both private and public demand – inched up into positive territory (+0.1% q-o-q, contribution: +0.1% pt).

Monthly data indicate a recovery

Even so, monthly economic indicators indicate a recovery of the Japanese economy amid the abatement of the impact of the Thai floods. The export quantity (adjusted for seasonal factors by MHRI) in December 2011 increased (+1.8% m-o-m) for the first time in three months and the industrial production index also staged a dramatic rebound (+3.8% m-o-m). Note also that domestic new car sales also rose sharply in January, reflecting the revival of the eco-car subsidies.

(2) Outlook on the Japanese economy in FY2011, FY2012 and FY2013

A return to positive growth in the Jan-Mar Qtr 2012. FY2011 growth: -0.4%

The Japanese economy is forecast to grow at a fast pace in the Jan-Mar quarter of 2012 (forecast +3.8% q-o-q p.a.) as a result of (1) the rebound of exports along with the alleviation of supply constraints due to the Thai floods, (2) the rise of public investment stemming from reconstruction demand and (3) the increase of automotive sales prompted by the revival of the eco-car subsidies. Accordingly, Japan's economic growth is forecast to stand at -0.4% in FY2011 (MHRI's previous forecast in December 2011: -0.4%) (**Chart 4**).

Reconstruction demand will keep the economy on recovery track. FY2012 growth : +1.9%

Even though Japan's exports are predicted to stall in the first half of FY2012 because of the weak growth of the overseas economies and the impact of the strong yen, the Japanese economy should remain on a recovery track, driven mainly by domestic demand stemming from the emergence of demand related to reconstruction after the earthquake.

The three supplementary budgets in FY2011 and the *Expenses related to the Great East Japan Earthquake* earmarked in the *Special Account for Reconstruction from the Great East Japan Earthquake* in the FY2012 initial budget (draft) totals approximately JPY18 trillion. Even when subtracting the spending necessary for purchase of land and financial assistance, which will not have a direct impact upon GDP growth, approximately JPY12 trillion will serve as a factor to boost growth. Considering that approximately JPY3 trillion of the 1st and 2nd supplementary budgets have already been disbursed, the remaining JPY9 trillion should be invested from 2012 onward. In particular, we expect public investment to grow at a fast pace and serve as the driver of Japan's economic recovery in the first half of FY2012.

Furthermore, we expect personal consumption to grow steadily on the back of the gradual improvement of labor market conditions. The revival of the eco-car subsidies should also be counted as an additional upside factor. In addition to the strength of consumer spending, the gradual rise of capital investment reflecting the improvement of corporate earnings and profits should keep domestic private demand should on firm footing during this period.

While public investment should still trend high in the second half of FY2012, a downturn is expected. Amid the ongoing stagnation of exports, the Japanese economy will lose its engine of growth, leading to a slowdown toward the end of the fiscal year.

On a fiscal year basis, we forecast real GDP to grow +1.9% in FY2012 (MHRI's previous forecast in December 2011: +1.9%), driven by the gradual expansion of domestic private demand and the increase of public demand accompanying the reconstruction from the earthquake.

Peak-out of reconstruction demand. FY2013 growth will slow down to +1.1%

The Japanese economy will enter a "soft patch" in the first half of FY2013 due to a double punch of the peak-out of reconstruction demand and export stagnation accompanying the overseas economic slump. A look at reconstruction demand on a fiscal year basis indicates the likelihood that it will reach a peak sometime in FY2012 and that public investment will continue to decline throughout FY2013. Furthermore, given the fading impact of the eco-car subsidies which are currently scheduled to be terminated at the end of January 2013, personal consumption growth is also expected to slow down. Note that the Japanese economy risks falling into a recession during this period, depending upon overseas economic trends.

In the second half of FY2013, the last-minute rush of demand prior to the consumption tax hike should serve to push up domestic demand. The *Comprehensive Reform of Social Security and Tax* sets forth a roadmap to raise the consumption tax to 8% in April 2014 and to 10% in October 2015. In the run-up to the tax hike, the last-minute demand in forms such as personal consumption and housing investment should push up the rate of economic growth in the second half of FY2013. As a matter of course, a decline of purchasing power due to the tax hike and backlash to the last-minute demand is expected in FY2014.

Thus, even though the economy will slide into a soft patch in the first half of FY2013, a last-minute rush of demand is forecast to push up the rate of growth in the second half of the fiscal year. On a fiscal year basis, the pace of real DP growth is forecast to slow down from FY2012 to +1.1%.

[Chart 4: Outlook on the Japanese economy]

		FY2010	FY2011	FY2012	FY2013	2011				2012				2013				2014
						Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
GDP (real)	Q-o-q % ch	3.1	-0.4	1.9	1.1	-1.8	-0.4	1.7	-0.6	0.9	0.6	0.4	0.2	0.1	0.0	0.3	0.7	0.8
	Q-o-q % ch p.a.	--	--	--	--	-6.8	-1.5	7.0	-2.3	3.8	2.6	1.6	1.0	0.2	0.1	1.3	2.8	3.4
Domestic demand	Q-o-q % ch	2.4	0.5	1.8	1.2	-1.6	0.7	0.9	0.1	0.6	0.6	0.4	0.2	0.1	0.1	0.3	0.7	0.9
Private sector demand	Q-o-q % ch	3.0	0.0	1.9	1.5	-2.1	0.3	1.3	0.2	0.4	0.6	0.5	0.3	0.2	0.1	0.3	0.8	1.1
Personal consumption	Q-o-q % ch	1.5	0.7	1.2	1.2	-1.1	0.3	1.0	0.3	0.4	0.2	0.2	0.1	0.0	0.1	0.2	0.7	1.4
Housing investment	Q-o-q % ch	2.3	2.5	0.1	6.8	1.6	-2.5	4.5	-0.8	-4.7	1.4	0.5	1.9	1.9	0.5	3.0	3.8	-2.3
Capital investment	Q-o-q % ch	3.5	0.0	3.8	1.9	-0.5	-0.2	-0.0	1.9	0.5	1.1	1.2	0.7	0.4	0.3	0.4	0.4	0.5
Inventory investment	Q-o-q contribution, % pt	0.8	-0.4	0.2	-0.0	-0.9	0.1	0.2	-0.3	0.1	0.1	0.1	0.0	0.1	-0.1	-0.0	0.0	0.0
Public sector demand	Q-o-q % ch	0.5	1.9	1.6	0.2	-0.1	1.8	-0.0	-0.2	1.1	0.8	0.1	-0.1	-0.2	0.0	0.2	0.3	0.4
Government consumption	Q-o-q % ch	2.3	1.9	0.8	1.1	0.4	0.7	0.3	0.3	0.5	0.0	0.1	0.2	0.1	0.3	0.4	0.4	0.6
Public investment	Q-o-q % ch	-6.8	2.0	5.1	-4.1	-2.5	6.6	-1.6	-2.5	4.2	4.5	0.4	-1.1	-1.8	-1.5	-0.9	-0.4	-0.2
External demand	Q-o-q contribution, % pt	0.8	-0.9	0.1	-0.1	-0.2	-1.0	0.8	-0.6	0.4	-0.0	-0.0	0.0	-0.1	-0.1	0.0	-0.0	-0.1
Exports	Q-o-q % ch	17.2	-1.3	3.3	1.4	-0.3	-6.2	8.6	-3.1	2.0	0.6	0.6	0.7	-0.2	-0.1	0.7	0.8	0.8
Imports	Q-o-q % ch	12.0	4.7	2.6	2.1	1.0	0.3	3.4	1.0	-0.4	0.7	0.7	0.6	0.2	0.3	0.4	0.9	1.5
GDP (nominal)	Q-o-q % ch	1.1	-2.3	1.7	1.2	-1.9	-1.5	1.5	-0.8	0.9	0.5	0.6	0.1	0.3	-0.3	0.7	0.6	1.0
GDP deflator	Y-o-y % ch	-1.9	-1.9	-0.2	0.1	-1.9	-2.3	-2.1	-1.6	-1.4	-0.7	-0.1	-0.2	0.3	0.0	0.2	0.1	0.1
Domestic demand deflator	Y-o-y % ch	-1.2	-0.6	-0.3	-0.4	-1.0	-1.0	-0.7	-0.3	-0.5	-0.3	-0.4	-0.3	-0.2	-0.4	-0.5	-0.4	-0.4

Source: Made by MHRI based upon Cabinet Office, *Preliminary Quarterly Estimates of GDP* .

		FY2010	FY2011	FY2012	FY2013	2011				2012				2013				2014
						Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Industrial production	Q-o-q % ch	8.9	-2.5	4.2	1.6	-2.0	-4.0	4.3	-0.4	2.0	0.7	1.0	0.9	-0.2	0.0	0.7	0.7	0.7
Ordinary profits	Y-o-y % ch	39.0	-4.3	10.0	6.3	11.0	-13.2	-3.1	-5.5	5.1	18.5	10.8	7.6	4.4	4.5	5.7	6.9	8.0
Nominal labor compensation	Y-o-y % ch	0.5	0.2	0.5	0.5	0.6	0.3	-0.2	0.2	0.3	0.6	0.5	0.5	0.2	0.2	0.7	0.6	0.5
Unemployment rate	%	5.0	4.5	4.3	4.1	4.7	4.6	4.4	4.5	4.4	4.3	4.3	4.2	4.2	4.2	4.1	4.0	4.0
New housing starts	P.a., 10,000 units	81.9	83.2	84.2	90.6	83.2	82.4	88.3	79.6	82.1	82.1	82.8	85.8	86.1	87.6	91.1	94.1	88.8
Current account balance	P.a., JPY tril	16.1	8.3	10.9	13.6	13.0	7.6	10.8	7.0	7.9	9.5	11.6	11.5	11.7	11.3	14.7	14.6	14.5
Domestic corporate goods prices	Y-o-y % ch	0.7	1.7	-0.6	-0.5	1.8	2.5	2.6	1.5	0.3	-1.1	-0.8	-0.2	-0.3	-0.4	-0.5	-0.7	-0.5
Consumer prices	Y-o-y % ch	-0.8	-0.1	-0.4	-0.4	-0.8	-0.2	0.2	-0.2	-0.3	-0.4	-0.4	-0.3	-0.3	-0.4	-0.4	-0.4	-0.4
Uncollateralized overnight call rate	%	0.06	0～0.10	0～0.10	0～0.10	0.06	0.07	0.08	0.08	0～0.10	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	%	1.13	1.06	1.06	1.00	1.24	1.16	1.04	1.03	0.99	1.00	1.05	1.10	1.10	1.00	1.00	1.00	1.00
Nikkei average	JPY	9,961	9,150	9,200	9,050	10,308	9,612	9,255	8,582	8,900	8,700	9,200	9,500	9,200	8,900	8,900	9,100	9,200
Exchange rate	JPY/USD	86.0	78.0	76.0	76.0	82.3	81.7	77.8	77.4	77.0	75.0	77.0	78.0	75.0	75.0	75.0	76.0	77.0
Crude oil price (WTI nearest term contract)	USD/bbl	84.0	96.0	91.0	82.0	94.6	102.3	89.5	94.1	100.0	91.0	93.0	92.0	88.0	85.0	81.0	81.0	82.0

Notes: 1. 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-relate 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.

Excess supply will linger even at the end of FY2013

The output gap (the gap between actual GDP and potential GDP) estimated by MHRI stood at -3.2% of potential GDP (meaning an excess of supply of JPY16.8 trillion) as of the Oct-Dec quarter of 2011. In the event the Japanese economy grows according to our latest *Economic Outlook*, the output gap should reach -1.0% (an excess of supply of JPY5.3 trillion) as of the end of FY2013 (**Chart 5**). However, note that it is necessary to take into consideration that the level of economic activity in the Jan-Mar quarter of 2014 – which is the final quarter of the forecast period – is boosted by last-minute demand prior to the consumption tax hike. In the absence of the impact of the last-minute demand, the output gap would be approximately -2% as of the end of FY2013.

An exit from deflation is not yet visible

The consumer price index excluding fresh food ("core CPI") and the consumer price index excluding food (ex alcoholic beverages) and energy (the "US-criteria core CPI") stood at -0.1% y-o-y and -1.1% y-o-y respectively as of December 2011. In contrast to the ongoing decline of the US-criteria CPI due to price falls of durable goods, the breadth of the fall of the core CPI has turned out to be narrower as a result of the year-on-year rise of energy prices.

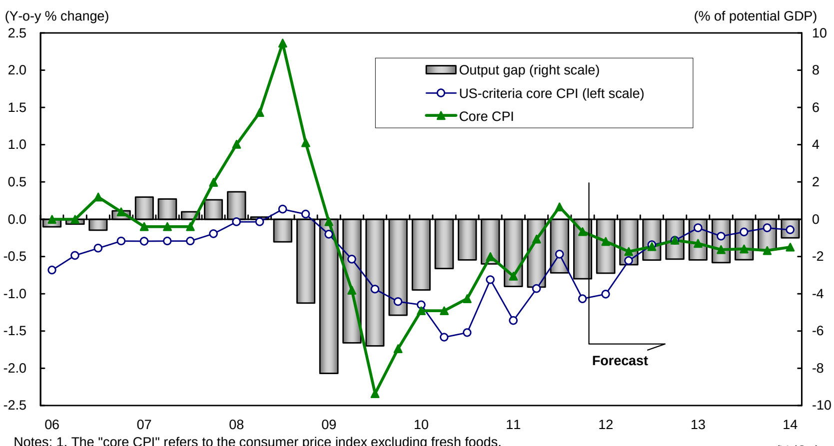
During the forecast horizon, we expect that the output gap in negative territory (the deflationary gap) will gradually contract and that the US-criteria core CPI will decline at a slower pace. In contrast, since energy prices – thus far serving to push up the core CPI – are expected to gradually decline going forward, the breadth of the fall of the core CPI is forecast to widen slightly from FY2012. We expect the core CPI to follow a gradual decline in FY2011 (-0.1% y-o-y), FY2012 (-0.4% y-o-y) and FY2013 (-0.4% y-o-y). Thus, an exit out of deflation is unlikely during the forecast horizon.

The largest risk is an overseas economic downturn and appreciation of the yen

Notwithstanding our main scenario outlook above, significant uncertainties continue to linger going forward.

The greatest risk is an overseas economic downturn and a further strengthening of the yen. In the event the eurozone sovereign debt crisis triggers a global financial crisis and credit crunch, the odds are high that Japan's economic

[Chart 5: The output gap and the core CPI and US-criteria core CPI]



Notes: 1. The "core CPI" refers to the consumer price index excluding fresh foods.
2. The "US-criteria core CPI" refers to consumer price index excluding food (ex alcoholic beverages) and energy.
3. The "output gap" is estimated by MHRI.
Sources: Made by MHRI based upon Ministry of Internal Affairs and Communications, *Consumer Price Index,* Cabinet Office, *National Accounts* and others.

growth would fall into negative territory in FY2012 just as it did after the Lehman Shock and that the yen would come under further strengthening pressures.

Trade deficit will persist in the event crude oil prices remain high

Japan's trade balance (customs clearance, calendar-year basis) in 2011 fell into a deficit (-JPY2.5 trillion) for the first time in 31 years since 1980. The greatest factor behind the fall into a trade deficit is the rise of import prices such as crude oil (**Chart 6**). MHRI's outlook forecasts a trade deficit for two years in a row in FY2011 (-JPY3.8 trillion) and FY2012 (-JPY2.2 trillion) and a slight surplus in FY2013 (+JPY0.4 trillion) (**Chart 7**). However, the trade deficit is estimated to persist if the price of crude oil continue to trend at a high level of JPY96/bbl (the estimated price of the WTI crude oil during FY2011) in both FY2012 and FY2013. The trade deficit would expand further in the event the price of crude oil surges due to the rise of tensions surrounding Iran.

If all nuclear power reactors remain suspended, the rise of LNG imports will drag down Japan's rate of economic growth

The electrical power shortage and rise of fossil fuel imports accompanying the suspension of nuclear power plants will also serve to drag down Japan's rate of economic growth. Only three nuclear power plants remain operating as of February 14, 2012 and are scheduled to undergo regular inspections by May. In the event all of the nuclear power plants are suspended, the shortage of electrical power may serve as constraints upon economic activity in the summer. Despite the government's efforts to mitigate the negative effect upon economic activity in ways such as electrical power-saving efforts, its success is unpredictable. Moreover, even if Japan is able to avoid the negative impact of the quantitative constraints upon electrical power, the increase of fossil fuel imports is inevitable. It will be necessary to keep a close eye upon such domestic risks as well as the risks in the overseas economies.

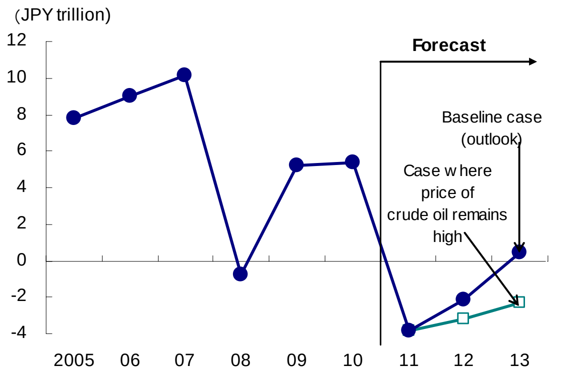
Chart 6: 2011 trade deficit (y-o-y change)

(JPY trillion)

	Amount	Quantity factor	Price factor
Exports	-1.8	-2.1	0.2
Imports	-7.3	-1.9	-5.3
Trade balance	-9.1	-4.0	-5.1

Note: The increase of the amount of imports is expressed by a negative value (—).
Source: Made by MHRI based upon Ministry of Finance, *Trade Statistics.*

Chart 7: Japan's trade balance (forecast)



Note: "Case where price of crude oil remains high" is estimated upon the assumption that the price of crude oil from 2012 remains at the estimated price in FY2011.
Source: Ministry of Finance, *Trade Statistics,* MHRI.

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