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# FY2012 and FY2013 Economic Outlook

**November 2012**

Key points of Mizuho Research Institute's (MHRI) outlook on the economy in FY2012 and FY2013 reflecting *The First Preliminary Quarterly Estimates of GDP (1st QE)* of Japan for the Jul-Sep quarter of 2012

## <The US Economy >

◆ **The "fiscal cliff" will serve as a drag upon growth.**

2012: +2.1% (previous forecast +2.0%)
2013: +1.4% (previous forecast +1.3%)

## <The Eurozone Economy >

◆ **Fiscal austerity will hamper the economic recovery. Concerns regarding the debt crisis will linger**

2012: -0.4% (previous forecast -0.4%)
2013: +0.0% (previous forecast +0.2%)

## <The Asian Economy >

◆ **Weak growth due to stagnant exports. China's recovery will also be limited**

2012: +6.1% (previous forecast +6.2%)
2013: +6.1% (previous forecast +6.1%)

## <The Japanese Economy >

◆ **Japan fell into a recession due to the slowdown of exports accompanying the deceleration of overseas economies and the negative impact stemming from the termination of the eco-car subsidies**

FY2012: +0.8% (previous forecast +1.7%)

◆ **A mild recovery in the first half driven by an upturn of exports and consumer spending. Consumption to pick up in the second half due to a last-minute rush of demand prior to the tax hike**

FY2013: +1.1% (previous forecast +1.3%)

Mizuho Research Institute

# I. The Chief Economist's View

### As the global economy continues to slow down, growth in 2013 will turn out to be weaker than 2012

**A reconfirmation of MHRI's scenario on a global slowdown**

In our previous Economic Outlook released on September 11, 2012, we made a highly unusual decision to make a drastic downward revision of our forecast in less than a month from our Economic Outlook released on August 15, 2012. While MHRI has customarily taken a more cautious stance in its outlook on global growth in comparison to the market consensus, our message from September onward has been that the global economy is subject to a far more serious downshift than our conventional storyline. While there is no material change in our latest outlook on global growth from our previous Economic Outlook in September since we already made a significant downward revision in September, we have made a sharp downward revision of our forecast on the Japanese economy in addition to a slight downward shift of our views on other areas. Although we believe that our forecast on 2012 is more or less on par with the consensus view, our view on 2013 remains below the consensus mainly with respect to the US economy, setting forth a grimmer view of the economy in 2013 than in 2012.

Turning to the Japanese economy, which was subject to a deep downward revision, our view shifted progressively for the worse from a "gradual recovery" in August, a "soft patch" in September to a "recession" in October. This has led to the downward revision of our forecast in this Economic Outlook. As a result, we have had to revise our scenario from the beginning of this year that the pace of Japan's economic growth in 2012 is the highest among Japan, the US and Europe.

Generally speaking, in times of economic stagnation, economic forecasts by research institutes are biased toward a slightly rosier outlook for the following year with hopes for better times ahead. The consensus scenario still holds that the economy will recover in 2013, based upon expectations toward policy measures such as monetary easing in Europe and the US and financial and fiscal support in China. However, given its decidedly "policy-dependent" nature, the forecast is fraught with uncertainty. On the other hand, from last year, we have consistently upheld the storyline that an improvement of the rate of economic growth in 2013 from 2012 is unlikely due to downward pressures stemming from fiscal conditions among the developed countries. While the downward pressure from fiscal conditions is referred to as the "fiscal cliff" in the US, a similar "cliff" also exists in Europe. Given these conditions, the storyline holds that the recovery of global demand will be tepid. Even though growth among emerging countries will continue to be relatively high, the level of growth will remain around the pace of growth in 2012 due to the stagnation of imports by Europe and the US and the decline of credit outstanding toward emerging countries.

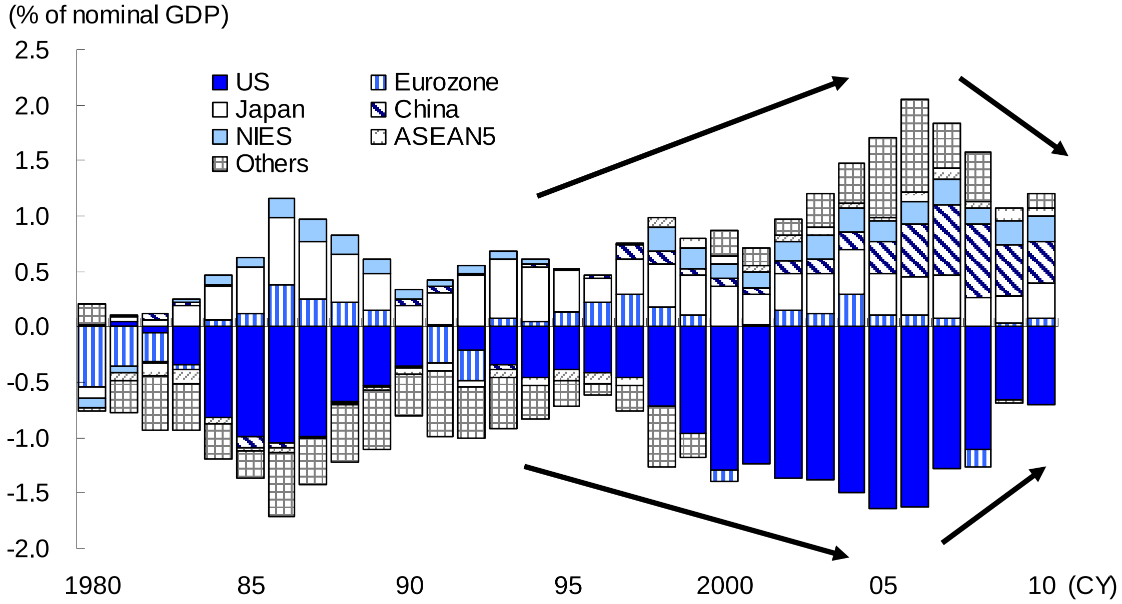
**The fiscal cliffs around the world**

To explain the fiscal tightening in the background to the fall of global demand, there is a textbook theory on the investment-savings balance (IS balance). Namely, the current account balance is represented as follows.

Current account balance = (S − I) + (tax revenue − government spending)
= private savings surplus (shortage) + fiscal surplus (deficit)

The US current account deficit stems from the shortage of savings in the private sector and the fiscal deficit. The prolonged “twin deficit” in the US enabled it to provide the world with demand over a prolonged period of time. **Chart 1** below shows the trends in the current account balances of the world since the 1980s. From a structural stand point, the US served as the engine of global growth by expanding its deficit. With the exception of 1991, the US provided the world with demand through its deficit for more than 30 years. The breadth peaked in 2005 and has continued to contract since then. The contraction of the US fiscal deficit in 2013 (the “fiscal cliff”) will lead to a further contraction of the current account deficit, and simultaneously the shortage of global demand.

**[ Chart 1: Trends in current account deficits of the world (as a percentage of nominal GDP) ]**




Source: Made by MHRI based upon material released by the IMF.

**The fiscal cliff in Europe**

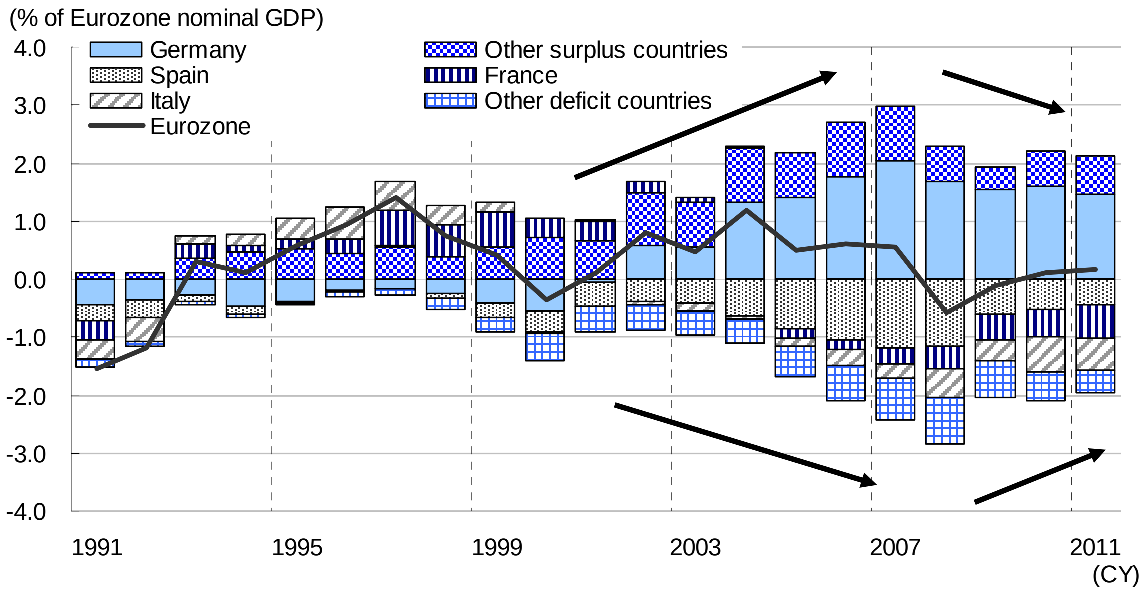
**Chart 2** shows the trends in current account balances in Europe. The gap between countries with current account deficits and those with current account surpluses started to widen – hence the expansion of imbalances –in 1999 at the time of the introduction of the euro. The structure in which the deficit countries of Europe provided not only the eurozone but also to other areas of the world with a surplus (demand) is a scaled-down version of the US deficit engine. In fact, the largest importer of Chinese exports was Europe. This implies that the world had two major engines from the 2000s onward.

However, the US-driven engine started to falter from 2007, followed by a similar loss of power of the European engine from 2009 leading to the current situation of the global economy. Europe will also be faced with the need to show a far stronger commitment toward fiscal austerity than that of the US (the European fiscal cliff) for the sake of solving its debt crisis.

**A fallacy of composition due to fiscal cliffs around the world**

**Charts 1** and **2** both depict a sharp shift from the trend up to the second half of the 2000s when the expansion of imbalances of current account balances served to stimulate the expansion of the economy. In both cases, we currently face a process of “normalization” in the contraction of imbalances. In other words, while fiscal tightening in the name of “fiscal rehabilitation” among the countries of Europe and the US is “correct”, a macroeconomic “fallacy of composition” due to the exercise of fiscal tightening around the world will lead to concerns regarding economic contraction. This is the backdrop to the economic contraction in China, Japan and other countries of Asia stemming from the fall of trade.

**[ Chart 2: Trends in current account deficits of Europe (as a percentage of nominal GDP) ]**




Note: “Other surplus countries” refer to the Netherlands, Belgium, Austria, Finland and Luxembourg.
“Other deficit countries” refer to Greece, Portugal and Ireland.
Source: Made by MHRI based upon the European Commission.

In particular, the simultaneous introversion (including their political climates) of the US and the eurozone - the largest and second largest economies of the world – has a truly significant impact. In addition, both China and Japan are focused upon their domestic political situations and are less focused on matters overseas. Since economic slowdown tends to foster socio-political destabilization, it would lead readily to the rise of further economic uncertainties. While the current situation is not a sharp deceleration recognizable by all due to an event like the collapse of Lehman Brothers in 2008, the situation is cast over ominously by a vague sense of uncertainty.

**Chance of regime change is lost due to President Obama's reelection**

I have always held the view that a major regime change, mainly with respect to fiscal conditions, accompanying the US presidential election, would provide the only chance to break out of the stagnation scenario in 2013. In other words, a worse-than-expected US economic deterioration leading to a political power shift in the US presidential election in November 2012 and thus a major regime change in economic policy would have provided the trigger. To be more specific, a drastic deterioration of the economy would lead to an election loss by the incumbent President Barack Obama and the succession by a new president who would take temporary but unprecedented economic stimulus measures even by shelving the current fiscal problem.

However, the revival of a sanguine scenario on the US economy in August onward hampered the rise of such a regime change scenario and resulted in President Obama's reelection. Since the reelection of President Obama confirmed a scenario basically maintaining continuity, our latest scenario reconfirmed the presence of a certain amount of downward pressures stemming from fiscal austerity in 2013. While the US will most likely take commensurate measures to alleviate the impact of the "fiscal cliff", even if the measures succeed in breaking down and neutralizing the "cliff", it will fall short of creating a fiscal "mountain" capable of boosting the real economy.

**Similarities with the Great Depression of the 1930s**

**Chart 3** sets forth a comparison of the conditions at the time of the Great Depression from 1929 and the current state of the economy starting from 2007 where Europe and the US remain in a serious balance sheet recession comparable to the 1930s. Note the existence of many similarities such as fiscal austerity under balance sheet adjustment pressures and the currency-weakening policies favored by each of the relevant countries.

Our latest scenario reconfirms – in consideration of the results of the US Presidential election – that the economy will continue to stagnate and that there are major uncertainties in 2013. In summary, I am inclined toward the view that the global environment will continue to exhibit (1) economic weaknesses, (2) a monetary easing race, and (3) heightened political tensions.

**[ Chart 3: A comparison of the Great Depression and the current state of the global economy ]**

| | **Great Depression (1929 onward)** | **Current downturn (2007 onward)** |
|---|---|---|
| Starting point | October 24, 1929 (Black Thursday) | 2007 (summer): Subprime Loan Crisis |
| Background | Credit expansion and investment boom in the 1920s | US subprime loan boom and euro bubble in Europe in the 2000s |
| Financial crisis | 1931: bankruptcy of Credit-Anstalt | 2008: collapse of Lehman Brothers |
| Fiscal tightening | Fiscal tightening accompanying the shift to the gold standard | Budget austerity due to eurozone sovereign debt crisis<br>Fiscal tightening stemming from US debt ceiling |
| Currency policy | Currency weakening race | The monetary easing in the US and Europe is essentially weakening their currencies |
| Protectionism | Rise of protectionism | Signs of protectionism among some emerging countries |

Source: MHRI.

Hajime Takata, Chief Economist

## II. The global economy

**A worldwide economic stagnation in the Jul-Sep quarter of 2012**

The Jul-Sep quarter of 2012 saw a broad stagnation of the global economy such as the weakness of the Asian economies amid the slowdown of the Chinese economy.

US economic growth improved slightly, growing +2.0% q-o-q p.a. in the Jul-Sep quarter (Apr-Jun quarter: +1.3% q-o-q p.a.) (**Chart 4**). Despite the decline of exports and capital investment, personal consumption and housing investment grew at a faster pace. Note also that defense spending surged.

Eurozone real GDP (to be released on November 15, 2012) most likely continued to contract in the Jul-Sep quarter, judging from the spate of recent data releases.

China's real GDP grew +7.4% q-o-q p.a. in the Jul-Sep quarter, (Apr-Jun quarter: +7.6% q-o-q p.a.) slowing down for the seventh quarter in a row. Despite the recovery of capital investment reflecting the impact of the economic stimulus measures, exports remained in the doldrums.

Turning to the Asian economies, many of the countries of the region slowed down due to stagnant exports. The pace of economic growth in South Korea and Indonesia moderated and Singapore fell into negative territory. Although economic growth in both Taiwan and Vietnam picked up slightly, they still lack strength.

Amid these conditions, the pace of Japan's real GDP growth fell sharply to -3.5% q-o-q p.a. (Apr-Jun quarter: +0.3% q-o-q p.a.).

**[ Chart 4: Real GDP growth of major countries and areas ]**

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

| | 2011 | | | | 2012 | | |
|---|---|---|---|---|---|---|---|
| | Jan-Mar | Apr-Jun | Jul-Sep | Oct-Dec | Jan-Mar | Apr-Jun | Jul-Sep |
| US | 0.1 | 2.5 | 1.3 | 4.1 | 2.0 | 1.3 | 2.0 |
| Eurozone | 2.6 | 0.9 | 0.3 | -1.3 | -0.0 | -0.7 | |
| Germany | 5.0 | 1.8 | 1.5 | -0.6 | 2.0 | 1.1 | |
| France | 3.5 | 0.3 | 1.0 | 0.1 | 0.1 | -0.1 | |
| Italy | 0.4 | 1.2 | -0.9 | -2.7 | -3.2 | -3.3 | |
| Japan | -8.0 | -2.1 | 9.5 | -1.2 | 5.2 | 0.3 | -3.5 |
| South Korea | 5.3 | 3.4 | 3.4 | 1.3 | 3.5 | 1.1 | 0.6 |
| Taiwan | 10.4 | 2.1 | -1.9 | -2.1 | 1.6 | 2.2 | 3.5 |
| Hong Kong | 11.9 | -2.3 | 2.1 | 0.9 | 2.1 | -0.2 | |
| Singapore | 19.7 | -3.0 | 2.0 | -2.5 | 9.8 | 0.2 | -1.5 |
| Thailand | 3.4 | -2.8 | 6.7 | -35.7 | 50.8 | 13.9 | |
| Philippines | 6.2 | 1.9 | 2.5 | 7.3 | 12.6 | 0.9 | |
| Australia | -1.7 | 5.6 | 4.6 | 2.0 | 5.6 | 2.6 | |

(Y-o-y % change)

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| China | 9.8 | 9.5 | 9.1 | 8.9 | 8.1 | 7.6 | 7.4 |
| Malaysia | 5.1 | 4.3 | 5.7 | 5.2 | 4.9 | 5.4 | |
| Indonesia | 6.4 | 6.5 | 6.5 | 6.5 | 6.3 | 6.4 | 6.2 |
| Vietnam | 5.6 | 5.7 | 6.1 | 6.1 | 4.0 | 4.7 | 5.4 |
| India | 9.2 | 8.0 | 6.7 | 6.1 | 5.3 | 5.5 | |
| Brazil | 4.2 | 3.3 | 2.1 | 1.4 | 0.8 | 0.5 | |
| Russia | 4.0 | 3.4 | 5.0 | 4.8 | 4.9 | 4.0 | |

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

**The global economy to remain in the doldrums in 2013**

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 +3.1% in 2012 from +3.8% in 2011 (**Chart 5**). Growth in 2013 is also expected to moderate further to +2.9%. The chances are slim that the US and eurozone economies will be able to emerge out of the doldrums due to downward pressures stemming from tight fiscal conditions. Growth among many of the emerging economies is also expected to remain sluggish – in particular those which are prone to the impact of the export slump to developed countries and fund inflows from Europe and the US.

Turning to the US economy, we forecast growth of +2.1% in 2012 and slow down to +1.4% in 2013. As for the "fiscal cliff", some of the spending cuts and tax hikes (in the form of the termination of tax cuts) should be postponed in a bid to alleviate the cliff's impact upon the economy. However, since it will not be possible to eliminate the fiscal cliff entirely, it will continue to remain a drag upon growth in 2013.

Eurozone economic growth is forecast to remain in negative territory (-0.4%) in 2012 and stand at +0.0% in 2013. Fiscal austerity will serve as a drag upon economic recovery in the countries of the region. In particular, the economies of southern Europe such as Greece and Spain, which are faced with drastic fiscal austerity measures, will continue to stagnate and lead to a further widening of the gap with fiscally sound countries such as Germany.

**[ Chart 5: Outlook on the global economy ]**

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

| Calender year | 2010 | 2011 | 2012 | 2013 | 2012 | 2013 |
|---|---|---|---|---|---|---|
| | (Actual) | (Actual) | (Forecast) | (Forecast) | (Previous：Sep forecast) | |
| Tolal of forecast area | 5.3 | 3.8 | 3.1 | 2.9 | 3.2 | 3.0 |
| Japan , US , Eurozone | 2.6 | 1.3 | 1.1 | 0.7 | 1.2 | 0.8 |
| US | 2.4 | 1.8 | 2.1 | 1.4 | 2.0 | 1.3 |
| Eurozone | 2.0 | 1.5 | -0.4 | 0.0 | -0.4 | 0.2 |
| Japan | 4.5 | -0.7 | 1.6 | 0.4 | 2.2 | 0.9 |
| Asia | 9.3 | 7.5 | 6.1 | 6.1 | 6.2 | 6.1 |
| NIEs | 8.4 | 4.0 | 1.7 | 1.7 | 1.9 | 1.8 |
| ASEAN5 | 7.0 | 4.4 | 5.6 | 4.3 | 5.7 | 4.2 |
| China | 10.4 | 9.3 | 7.7 | 8.0 | 7.8 | 8.1 |
| India | 8.9 | 7.5 | 5.4 | 5.2 | 5.4 | 5.2 |
| Australia | 2.4 | 2.3 | 3.4 | 2.5 | － | － |
| Brazil | 7.5 | 2.7 | 1.3 | 3.3 | 1.2 | 3.2 |
| Rusia | 4.3 | 4.3 | 3.3 | 3.2 | 3.2 | 3.2 |
| Japan (FY) | 3.3 | -0.0 | 0.8 | 1.1 | 1.7 | 1.3 |
| Crude oil price (WTI , USD/bbl) | 80 | 95 | 95 | 84 | 96 | 86 |

Note: The total of the forecast area is calculated upon the 2011 GDP share(PPP) by the IMF

Sources: International Monetary Fund (IMF), MHRI.

China’s real GDP growth is forecast to moderate to +7.7% in 2012 and subsequently pick up to +8.0% in 2013. Given the recent measures for monetary easing and front-loading of infrastructure investment, growth is expected to gather momentum from around the end of 2012 to the first half of 2013. Having said so, a dramatic acceleration of the growth rate is unlikely considering careful policy maneuvering due to concerns regarding inflation caused by a heating of the economy and a resurge of real estate prices stemming from excessive investment.

Turning to Asia, economic growth will most likely remain stagnant among countries which are highly dependent upon Europe, US and China for their exports. Real GDP growth among the NIEs (South Korea, Hong Kong, Taiwan, Singapore) should remain weak at +1.7% in both 2012 and 2013. In contrast, the ASEAN5 countries (Thailand, Malaysia, Indonesia, the Philippines, Vietnam) possessing solid domestic demand should enjoy relatively strong growth. However, the pace of real GDP growth will likely slow down in 2013 as follows: 2012 (+5.6%) → 2013 (+4.3%).

In India, persistent inflationary pressures will hamper the recovery of domestic demand, leading to our forecast that real GDP growth will continue to slow down to +5.4% in 2012 and +5.2% in 2013.

The Australian economy is forecast to slow down from the second half of 2012 to 2013 as a result of fiscal tightening. The rate of real GDP growth should stand at +3.4% in 2012 and slow down to +2.5% in 2013.

Turning to the Brazilian economy, the lingering effect of the fiscal and monetary tightening last year should keep the pace of real GDP growth subdued at +1.3%. Having said so, current economic conditions appear to be picking up given the impact of the monetary easing and economic stimulus measures, leading to our view that the Brazilian economy will rise to +3.3% in 2013.

The pace of Russia’s real GDP growth should stand around the 3%-level in 2012 (+3.3%) and 2013 (+3.2%), due to forecasts of a moderate decline in price of crude oil.

Turning to Japan, the pace of real GDP growth is forecast to grow +1.6% in 2012 (on a calendar year basis), on the back of reconstruction-related demand. However, given Japan’s slip into recession in the second half of 2012 and the slow pace of recovery in 2013, the pace of real GDP growth should slow sharply to +0.4% in 2013.

**Focus of attention upon US efforts to alleviate the fiscal cliff**

At the moment, all eyes are focused upon responses to the US “fiscal cliff” which is capable of affecting the course of the global economy. As mentioned before, MHRI believes that downward pressures upon the economy may not be avoided despite the postponement of some of the fiscal tightening measures. Despite the reelection of President Barack Obama in the presidential election in November, Congress will remain “twisted” with a Democratic Party majority in

The Senate and a Republican Party majority in the House of Representatives (**Chart 6**). While Congress should look for ways to avoid the fiscal cliff, bipartisan cooperation will most likely face a rocky road. In the event discussions turn out to be protracted, there are risks that the rise of uncertainties regarding the future will lead to a more cautious spending behavior among households and businesses, resulting in a downturn of the economy. There is also room for change in the economic growth scenario from the New Year onward depending upon how deep the cliff turns out.

**[ Chart 6: Major political events ]**

| | | |
|---|---|---|
| 2012 Sep | Europe | ECB Governing Council meeting (6th) |
| | | Announcement of details of government bond purchasing program |
| | Japan | Closing of ordinary Diet session (8th) |
| | | Failure to pass bill on issuance of deficit-covering bonds |
| | APEC summit meeting (Vladivostok, 9th) | |
| | Europe | Federal Constitutional Court of Germany decided upon the constitutionality of the European Stability Mechanism (ESM) (12th) |
| | Europe | Netherlands general election (12th) |
| | | The ruling People's Party for Freedom and Democracy (pro-fiscal tightening) won the election |
| | US | FOMC (12th, 13th) |
| | | Decision to implement QE3 - including additional purchases of mortgage-backed securities (MBS)(USD40 billion/month) |
| | Japan | Bank of Japan (BOJ) Monetary Policy Meeting (18th, 19th) |
| | | Expand the size of the Asset Purchase Program by JPY10 trillion |
| | Japan | Re-election of Yoshihiko Noda as leader of the Democratic Party of Japan (DPJ) (21st) |
| | Japan | Re-election of Shinzo Abe as leader of the Liberal Democratic Party (26th) |
| Oct | Europe | ECB Governing Council meeting (4th) |
| | Japan | Bank of Japan (BOJ) Monetary Policy Meeting (4th, 5th) |
| | Europe | Inaugural meeting of the ESM (8th) |
| | IMF/World Bank Annual Meeting (Tokyo, 12th - 14th) | |
| | Europe | EU summit meeting (18th, 19th) |
| | Japan | Bank of Japan (BOJ) Monetary Policy Meeting (30th) Decision to increase th total size of the Asset Purchase Program by JPY11 trillion |
| Nov | G20 Meeting of Finance Ministers and Central Bank Governors (4th, 5th) | |
| | US | Presidential election, federal congressional election (6th). Re-election of President Barack Obama. Congress remains twisted with a Democratic party majority in the Senate and a Republican Party majority in the House of Representatives) |
| | Europe | Greek parliament passes draft budget iwith austerity measures (12th) |
| | China | 18th National Congress of the Communist Party of China (8th - 14th) |
| | Europe | ECB Governing Council meeting (8th) |
| | ASEAN summit meeting (18th - 20th) | |
| | Japan | Bank of Japan (BOJ) Monetary Policy Meeting (19th, 20th) |
| | Europe | EU summit meeting (22nd, 23rd) |
| Dec | Europe | ECB Governing Council meeting (6th) |
| | US | FOMC (11th, 12th) |
| | Europe | EU summit meeting (13th, 14th) |
| | S. Korea | Presidential election (19th) |
| | Japan | Bank of Japan (BOJ) Monetary Policy Meeting (19th, 20th) |
| 2013 Jan | Europe | ECB Governing Council meeting (10th) |
| | Japan | Bank of Japan (BOJ) Monetary Policy Meeting (21st, 22nd) |
| | US | FOMC (29th, 30th) |
| Feb | Europe | ECB Governing Council meeting (7th) |
| | Japan | Bank of Japan (BOJ) Monetary Policy Meeting (13th, 14th) |
| Mar | Japan | Bank of Japan (BOJ) Monetary Policy Meeting (6th, 7th) |
| | Europe | ECB Governing Council meeting (7th) |
| | US | FOMC (19th, 20th) |

Source: MHRI.

**The future course of the Chinese economy is also turning cloudy**

Another point in our outlook on the global economy in 2013 is the pace of recovery of the Chinese economy. Currently, signs of recovery are evident in monthly data such as the manufacturing PMI and fixed asset investment due to the impact of monetary easing and economic stimulus measures. On the other hand, exports – mainly toward emerging countries – are continuing to slow down and inventory adjustment pressures still linger due to excessive supply capacity. Despite our forecast that China's economic growth will pick up as a result of the economic stimulus measures, there are risks that economic activity will remain stagnant due to a prolongation of the inventory adjustment accompanying the export slowdown and a full-fledged adjustment of the excessive fixed asset investment thus far. China is aspiring to realize a shift from its export and investment-driven growth pattern. The question of whether or not China will be able to achieve a soft landing should be watched closely as a decisive factor for the medium to long-term course of the global economy.

**Uncertainties regarding the eurozone sovereign debt crisis are still persisting**

Turning to the eurozone sovereign debt crisis, it should be noted that uncertainties are currently abating in the financial markets given the establishment of the European Stability Mechanism (ESM) and Outright Monetary Transactions (OMT) by the European Central Bank (ECB). Market attention is currently gathering around the course of developments regarding Spain's request for financial support and discussions on review of Greece's bailout program. Given the Greek parliament's passage of a draft budget for 2013 which includes austerity measures, the odds are high that a decision on further funding is forthcoming.

Even so, when we extend our forecast horizon to next year and beyond, we cannot rule out the possibility of a resurgence of financial market uncertainties. The countries providing support will continue to request countries being bailed out to take drastic fiscal austerity measures. Moreover, the termination of support and speculation on Greece's exit from the eurozone is still a risk. The weak growth of the eurozone economy due to fiscal tightening will remain a drag upon global economic recovery and lingering uncertainties regarding the eurozone sovereign debt crisis will continue to serve as a risk leading to a global economic downturn via the financial markets.

# III. The Japanese economy

## (1) The current state of the economy

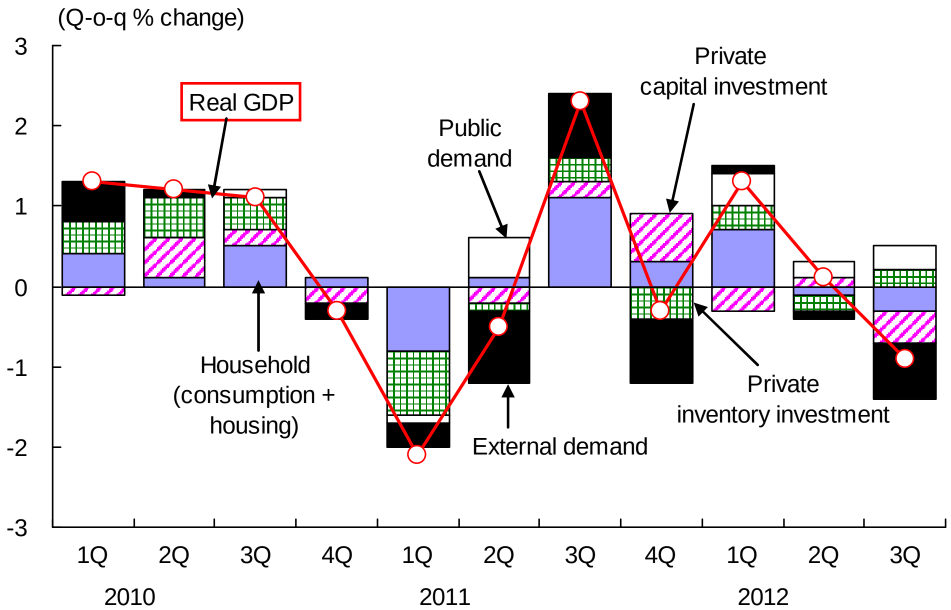
**Japan's economy contracted in the Jul-Sep quarter due to the fall of exports and domestic private demand**

Japan's real GDP contracted 0.9% q-o-q (-3.5% in annualized terms) in the Jul-Sep quarter of 2012, falling into negative territory for the first time in three quarters (**Chart 7**). The latest results confirmed that the Japanese economy slipped into recession after peaking in March 2012.

The main factor of Japan's contraction was the sharp fall of exports (-5.0% q-o-q). While Japan's exports bound for all countries and areas suffered declines, reflecting the global economic slowdown, the fall was particularly sharp with respect to exports to Europe and China. Even though imports also fell slightly (-0.3% q-o-q), the sharp drop of exports led to a major drag upon quarterly real GDP growth by external demand (-0.7% pt).

Domestic private demand fell 0.6% q-o-q (contribution to q-o-q real GDP growth: -0.4% pt) in the Jul-Sep quarter of 2012. Personal consumption (-0.5% q-o-q) declined as durable goods consumption fell (-2.1% q-o-q) along with the termination of the government subsidies for purchases of fuel-efficient cars (the "eco-car subsidies") and spending on nondurable goods (-1.0% q-o-q) and services (-0.1% q-o-q) also weakened. Furthermore, capital investment also fell sharply (-3.2% q-o-q), reflecting a more cautious behavior among businesses (particularly manufacturers). Even though housing investment remained solid (+0.9% q-o-q) on the back of the low level of interest rates and inventory investment contributed positively to growth, it was not enough to offset the drop of personal consumption and capital investment.

**[ Chart 7: Japan's quarterly real GDP growth ]**




Source: Cabinet Office, *Preliminary Quarterly Estimates*.

Meanwhile, public demand grew +1.1% q-o-q (contribution: +0.3% pt) due to factors such as the progress of reconstruction works, recording a rise for the fourth quarter in a row. Domestic demand – combining both private and public demand – turned out to fall (-0.2% q-o-q, contribution: -0.2% pt). It was the first time since the Jan-Mar quarter of 2011 (-1.8% q-o-q, contribution: -1.8% pt) in the aftermath of the Great East Japan Earthquake that a fall of domestic demand was recorded.

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

**The pace of growth is forecast to register a modest +0.8% in FY2012**

The odds are high that the Japanese economy will continue to contract in the Oct-Dec quarter of 2012. Despite signs that China's domestic demand is currently picking up mainly in terms of investment, a full-fledged recovery of Japan's exports is unlikely without progress in China's inventory adjustment process. Japan's domestic demand will continue to be propped up by the expansion of public investment accompanying the implementation of reconstruction works. However, given the termination of the eco-car subsidies in late September, the level of automotive sales is expected to take a further dip and personal consumption should continue to decline in the Oct-Dec quarter. As for capital investment, a rapid recovery from the sharp fall in the Jul-Sep quarter is unlikely amid persistent concerns regarding the future course of the economy.

Even so, we believe that the prospects of a protraction of the current recession extending over the year-end are slim at the moment. The first factor behind our view is that automotive sales and production – which had slumped in a reaction to the eco-car subsidies – are expected to bottom out by the end of the year. Looking back at the termination of the previous eco-car subsidy program (September 7, 2010), the number of cars sold bottomed out in the following month of October. Car production also picked up in November. Likewise, after the termination of the latest program on September 21, 2012, automotive sales should bottom out and production should pick up by the end of the year.

The second factor is that exports are expected to recover (mainly exports to China) from the New Year. As the Chinese economy gradually gathers momentum in the first half of 2013 due to the impact of the economic stimulus measures, exports by Japan should take an upturn from the New Year along with the progress of China's inventory adjustment process. However, the pace of recovery will most likely be tepid due to the slowdown of the US economy as a result of the impact of the fiscal cliff.

Although it may take some time for capital investment to recover, judging from the increasingly cautious behavior among corporations, the increase of public demand accompanying reconstruction from the earthquake disaster will continue to prop up the economy. In 2013, the Japanese economy should emerge out of a recession as personal consumption and exports bottom out amid the ongoing expansion of public demand. The Japanese economy is expected to register a mild expansion of +0.3% q-o-q (+1.1% p.a.) in the Jan-Mar quarter of 2013.

Since the Japanese economy will contract in both the Jul-Sep and Oct-Dec quarters of 2012, the rate of real GDP growth in FY2012 is predicted to stand at +0.8% (September forecast: +1.7%). The major reason for the downward revision of our forecast from September is the downturn of exports due to the overseas economic slowdown and accompanying postponement of capital investment stemming from a more cautious corporate behavior primarily among manufacturers.

**FY2013 real GDP growth: +1.1%. Growth in the second half of the year will accelerate due to a last-minute rush of demand**

In the first half of FY2013 (the Apr-Jun and Jul-Sep quarters), we expect a gradual recovery of personal consumption from the backlash due to the termination of the eco-car subsidy program and a mild recovery of capital investment along with the bottoming out of production. On the other hand, the odds are high that reconstruction-related demand propping up the economic recovery in FY2012 will peak out by the end of FY2012. Since most of the public works to restore infrastructure are scheduled to be completed in FY2012, public investment is predicted to take a downturn in FY2013. Even so, since public works such as those for relocations of communities to higher grounds should shift into high gear in FY2013, the pace of decline of public investment is expected to be moderate. Furthermore, in view of forecasts that the pace of export recovery will continue to be mild, the pace of growth in FY2013 is expected to remain at the +1%-level p.a.

In the second half of FY2013 (the Oct-Dec quarter of 2013 and Jan-Mar quarter of 2014), the last-minute rush of demand prior to the consumption tax hike is forecast to push up domestic demand. The generation of last-minute demand mainly with respect to personal consumption and housing investment by the consumption tax hike (5% → 8%) in April 2014 is expected to push up the rate of growth in the second half of FY2013.

As a result, the rate of real GDP growth in FY2013 is forecast to accelerate slightly from FY2012, reaching +1.1% (September forecast: +1.3%).

## [ Chart 8: Outlook on the Japanese economy ]

| | | FY 2010 | FY 2011 | FY 2012 | FY 2013 | 2012 Jan-Mar | 2012 Apr-Jun | 2012 Jul-Sep | 2012 Oct-Dec | 2013 Jan-Mar | 2013 Apr-Jun | 2013 Jul-Sep | 2013 Oct-Dec | 2014 Jan-Mar |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| GDP (real) | Q-o-q % ch | 3.3 | -0.0 | 0.8 | 1.1 | 1.3 | 0.1 | -0.9 | -0.1 | 0.3 | 0.3 | 0.4 | 0.5 | 0.9 |
| | Q-o-q % ch p.a. | -- | -- | -- | -- | 5.2 | 0.3 | -3.5 | -0.3 | 1.1 | 1.3 | 1.7 | 2.2 | 3.7 |
| Domestic demand | Q-o-q % ch | 2.6 | 1.0 | 1.6 | 1.1 | 1.1 | 0.2 | -0.2 | 0.0 | 0.2 | 0.3 | 0.3 | 0.5 | 0.9 |
| Private sector demand | Q-o-q % ch | 3.2 | 0.6 | 1.0 | 1.1 | 1.0 | -0.1 | -0.6 | -0.1 | 0.2 | 0.3 | 0.4 | 0.6 | 1.1 |
| Personal consumption | Q-o-q % ch | 1.6 | 1.2 | 1.0 | 1.2 | 1.2 | -0.1 | -0.5 | -0.2 | 0.1 | 0.2 | 0.3 | 0.8 | 2.0 |
| Housing investment | Q-o-q % ch | 2.6 | 3.8 | 2.5 | 6.6 | -1.1 | 1.5 | 0.9 | -0.4 | 1.3 | 3.2 | 3.0 | 2.3 | -5.0 |
| Capital investment | Q-o-q % ch | 3.9 | 1.1 | -0.4 | 1.3 | -1.9 | 0.9 | -3.2 | -0.3 | 0.3 | 0.8 | 0.9 | 0.7 | 0.5 |
| Inventory investment | Q-o-q contribution, % pt | 0.8 | -0.5 | 0.1 | -0.2 | 0.3 | -0.2 | 0.2 | 0.1 | 0.0 | -0.1 | -0.1 | -0.3 | -0.3 |
| Public sector demand | Q-o-q % ch | 0.8 | 2.2 | 3.2 | 1.1 | 1.6 | 0.9 | 1.1 | 0.2 | 0.3 | 0.2 | 0.2 | 0.2 | 0.2 |
| Government consumption | Q-o-q % ch | 2.5 | 1.9 | 2.0 | 1.6 | 1.1 | 0.5 | 0.3 | 0.3 | 0.3 | 0.3 | 0.5 | 0.5 | 0.6 |
| Public investment | Q-o-q % ch | -6.0 | 2.9 | 8.7 | -1.5 | 4.2 | 2.6 | 4.0 | 0.2 | 0.4 | -0.6 | -0.8 | -1.3 | -1.8 |
| External demand | Q-o-q contribution, % pt | 0.8 | -1.0 | -0.8 | -0.0 | 0.1 | -0.1 | -0.7 | 0.0 | 0.0 | 0.0 | 0.1 | 0.0 | 0.0 |
| Exports | Q-o-q % ch | 17.4 | -1.4 | -0.4 | 1.1 | 3.3 | 1.3 | -5.0 | -0.5 | 0.5 | 0.7 | 1.0 | 1.1 | 1.0 |
| Imports | Q-o-q % ch | 12.3 | 5.6 | 4.4 | 1.2 | 2.2 | 1.8 | -0.3 | -0.4 | 0.2 | 0.4 | 0.5 | 0.7 | 0.8 |
| GDP (nominal) | Q-o-q % ch | 1.2 | -2.0 | 0.2 | 0.8 | 1.4 | -0.3 | -0.9 | -0.2 | 0.5 | 0.2 | 0.2 | 0.4 | 0.9 |
| GDP deflator | Y-o-y % ch | -2.1 | -1.9 | -0.6 | -0.3 | -1.3 | -0.9 | -0.7 | -0.3 | -0.3 | 0.0 | -0.4 | -0.4 | -0.6 |
| Domestic demand deflator | Y-o-y % ch | -1.4 | -0.7 | -0.7 | -0.5 | -0.4 | -0.6 | -0.8 | -0.6 | -0.7 | -0.7 | -0.5 | -0.5 | -0.5 |

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

| | | FY 2010 | FY 2011 | FY 2012 | FY 2013 | 2012 Jan-Mar | 2012 Apr-Jun | 2012 Jul-Sep | 2012 Oct-Dec | 2013 Jan-Mar | 2013 Apr-Jun | 2013 Jul-Sep | 2013 Oct-Dec | 2014 Jan-Mar |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Industrial production | Q-o-q % ch | 9.3 | -1.0 | -4.1 | 1.4 | 1.3 | -2.0 | -4.2 | -3.7 | 2.0 | 1.0 | 1.3 | 1.3 | 1.1 |
| Ordinary profits | Y-o-y % ch | 39.0 | -2.0 | 0.6 | 5.6 | 14.1 | 15.1 | -4.7 | -1.6 | -5.2 | 4.8 | 4.6 | 8.3 | 4.7 |
| Nominal labor compensation | Y-o-y % ch | 0.5 | 0.1 | -0.2 | 0.4 | 0.0 | -0.4 | 0.1 | -0.4 | 0.1 | 0.3 | 0.4 | 0.5 | 0.4 |
| Unemployment rate | % | 5.0 | 4.5 | 4.3 | 4.2 | 4.5 | 4.4 | 4.2 | 4.2 | 4.3 | 4.3 | 4.2 | 4.1 | 4.1 |
| New housing starts | P.a., 10,000 units | 81.9 | 84.1 | 87.3 | 93.0 | 86.2 | 87.8 | 87.4 | 86.0 | 87.4 | 90.2 | 95.1 | 96.5 | 89.8 |
| Current account balance | P.a., JPY tril | 16.7 | 7.6 | 5.3 | 6.6 | 5.9 | 6.1 | 3.7 | 5.5 | 5.8 | 6.0 | 6.2 | 7.8 | 7.5 |
| Domestic corporate goods prices | Y-o-y % ch | 0.4 | 1.3 | -1.4 | -0.7 | 0.3 | -0.9 | -1.8 | -1.1 | -1.5 | -1.4 | -0.9 | -0.5 | -0.1 |
| Consumer prices | Y-o-y % ch | -0.8 | 0.0 | -0.2 | -0.3 | 0.1 | 0.0 | -0.2 | -0.2 | -0.4 | -0.4 | -0.4 | -0.3 | -0.2 |
| Uncollateralized overnight call rate | % | 0.06 | 0.08 | 0〜0.10 | 0〜0.10 | 0.08 | 0.08 | 0.08 | 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 | 1.05 | 0.79 | 0.79 | 0.97 | 0.85 | 0.78 | 0.76 | 0.75 | 0.75 | 0.75 | 0.80 | 0.85 |
| Nikkei average | JPY | 9,961 | 9,181 | 8,900 | 9,200 | 9,274 | 9,036 | 8,886 | 8,700 | 8,700 | 8,800 | 9,000 | 9,300 | 9,500 |
| Exchange rate | JPY/USD | 86.0 | 79.0 | 79.0 | 81.0 | 79.3 | 80.2 | 79.0 | 78.0 | 79.0 | 80.0 | 80.0 | 81.0 | 82.0 |
| Crude oil price (WTI nearest term contract) | USD/bbl | 84.0 | 97.0 | 91.0 | 82.0 | 103.0 | 93.0 | 92.0 | 90.0 | 88.0 | 85.0 | 83.0 | 81.0 | 80.0 |

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-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.

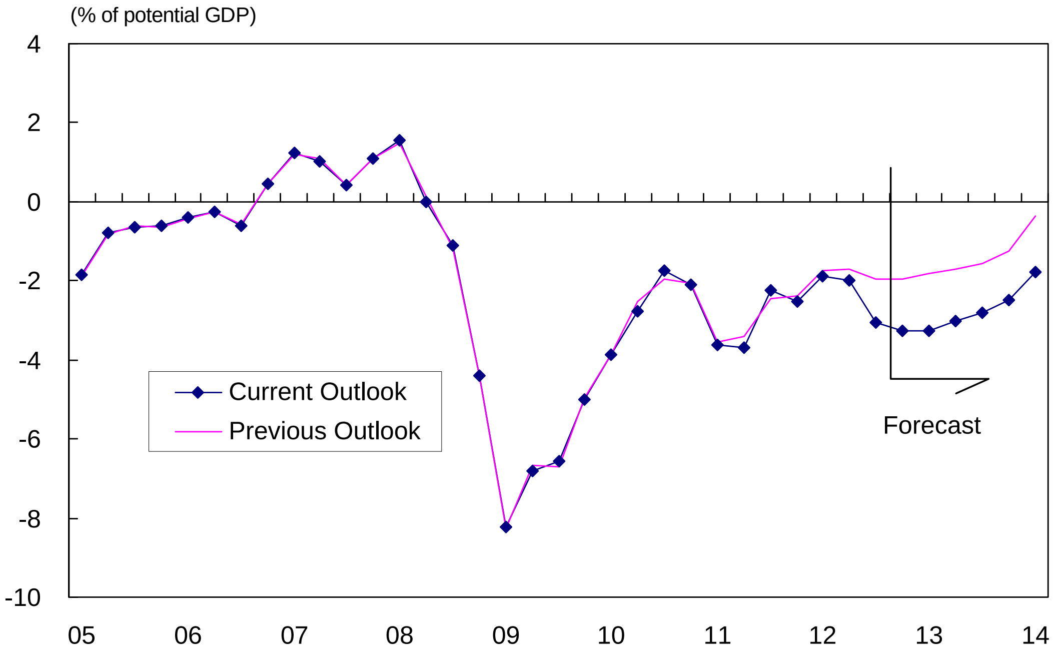
**The negative output gap has widened again**

The output gap (the gap between actual GDP and potential GDP) estimated by MHRI stood at -3.1% of potential GDP (meaning an excess of supply of JPY16.2 trillion) as of the Jul-Sep quarter of 2012 (**Chart 9**). Given the economic contraction in the Jul-Sep quarter, the breadth of the negative output gap widened significantly from -2.0% of potential GDP as of the Apr-Jun quarter. Based upon our current outlook, the negative output gap should widen to -3.3% of potential GDP in the Oct-Dec quarter of 2012. Even though the negative output gap should gradually narrow from then onward, Japan's excess supply will not be resolved even at the end of FY2013 with a negative output gap of -1.8% of potential GDP (an excess of supply of JPY9.6 trillion). The odds are high that the impact of the consumption tax hike will push down the level of real GDP growth and lead to a further widening of the negative output gap . Although we said in our *Economic Outlook* as of September 2012 that the negative output gap will be more or less be closed at the end of FY2013, the current recession has made Japan's emergence out of deflation unlikely anytime soon.

**The core CPI is continuing to fall**

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 -0.6% y-o-y respectively as of September 2012. Even though the breadth of the US-criteria core CPI in negative territory should gradually narrow during the forecast horizon, we do not expect it to bottom out due to the lingering negative output gap. Due in part to forecasts of a decline of energy prices due to the fall of crude oil prices, the core CPI should continue to decline in FY2012 (-0.2%) and FY2013 (-0.3%). Thus, an exit out of deflation is unlikely during the forecast horizon.

**[ Chart 9: The output gap ]**




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

**Exports and overseas economic trends hold the key to Japan's recovery after the turn of the New Year**

The foregoing is our main forecast scenario. However, note that the scenario of Japan's economic recovery from the New Year is not so certain at the current juncture and that there are strong concerns toward the future. There is no doubt that overseas economic developments of countries such as the US and China – and the future course of Japan's exports reflecting such developments – will hold the key to whether the economic recovery will be achieved as predicted in our main forecast scenario. Nevertheless, the US economy is subject to uncertainties regarding responses toward the fiscal cliff while the Chinese economy is also subject to the risks that the prolongation of the inventory adjustment process will hamper its recovery.

**The deterioration of relations between Japan and China pose concerns**

Furthermore, it is difficult to provide a forecast on the impact of the deterioration of Sino-Japan relations triggered by the Senkaku Islands issue. Even though the anti-Japan protests in China which flared up in mid-September have calmed down in a relatively short time span, the impact of Chinese consumers' boycott of Japanese goods and decline of human exchange between Japan and China continues to persist. The most salient is the decline of Japanese car sales and number of visitors to Japan from China.

Sales of Japanese cars in China decreased by approximately 30% to 60%, and several Japanese car makers have suspended production of cars for exports to China. Most Japanese car makers manufacture their cars for the Chinese market in China, and exports are limited to expensive models. A look at automotive sales in 2011 reveals that Japan's exports of finished cars to China totaled only 225 thousand units (**Chart 10**). This sets off a sharp contrast with 30%~40% of automotive sales to US and Europe being exported. Thus, the suspension of finished car exports to China will only have a limited impact upon overall exports and domestic production. However, the decline of local production and sales in China will serve as negative pressures upon profits on a consolidated basis for car manufacturers. There is no doubt that a loss of market share in the competitive Chinese market will be a blow.

The number of visitors from China totaled approximately 1.41 million in 2010 and approximately 1.04 million in 2011 when the number fell due to the Great East Japan Earthquake (**Chart 11**). Given that the amount of consumption per visitor was approximately JPY140 thousand to JPY160 thousand per person, the total amount of consumption by multiplying this by the number of visitors would be approximately JPY200 billion in 2010 and approximately JPY170 billion in 2011. This is included in the balance of payments statistics and classified as goods and services acquired by travelers under "Travel" under the category of "Services". While the number of visitors to Japan had almost doubled from the year before in the period from April to August of 2012, the pace of increase slowed down to +9.8% y-o-y in September due to the impact of the anti-Japan demonstrations. Assuming that the number of Chinese visitors to Japan would have been approximately two million (doubling from 2011) in absence of the deterioration of Sino-Japanese relations, the fall of consumption by Chinese tourists would be approximately JPY150 billion (on the basis of calculations that the amount of spending per person is JPY150 thousand) if the number decreases to one million persons. Since this is only 0.03% of GDP, it will only have a limited impact upon the rate of economic growth, despite the significant impact upon certain sectors such as those related to travel.

As shown above, the impact of the deterioration of Sino-Japanese relations such as the suspension of car exports to China and the decline of Chinese tourists will not have such a significant impact upon growth over the short-term. However, the fall of earnings among Chinese subsidiaries of Japanese corporations may have a considerable impact upon the consolidated earnings of the parent company. Furthermore, in the event of a resurgence of Sino-Japanese tensions, there is the risk that the boycott of Japanese products could escalate and have a negative impact upon exports. Moreover, it could also have various impacts over the medium to long-term such as the acceleration of the exodus of Japanese production sites in China to other areas.

**Chart 10: Automobile production (local production and exports, 2011)**

(10,000 units, %)

| | | Total | Local production | | Exports | |
|---|---|---|---|---|---|---|
| | | | | Weight | | Weight |
| World (total) | | 1832.4 | 1386.0 | 75.6 | 446.4 | 24.4 |
| | US | 381.1 | 238.4 | 62.6 | 142.7 | 37.4 |
| | Europe | 249.4 | 149.9 | 60.1 | 99.5 | 39.9 |
| | China | 329.3 | 306.8 | 93.2 | 22.5 | 6.8 |

Note: The weight refers to the ratio of local production and exports to the total.
Sources: FOURIN, Japan Automobile Manufacturers Association, Inc.

**Chart 11: Chinese travelers to Japan and amount of spending**

| | | |
|---|---|---|
| Chinese visitors to Japan (10,000 persons) | 2010 | 141.3 |
| | 2011 | 104.4 |
| Spending per person (JPY10,000) | 2010 | 14.5 |
| | 2011 | 16.4 |
| Total spending (JPY100 million) | 2010 | 2055.7 |
| | 2011 | 1715.1 |

Note: "Spending per person" in 2010 is the average from April to December
Sources: Japan National Tourism Organization, Japan Tourism Agency.

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