FY2012 and FY2013 Economic Outlook

May 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 Jan-Mar quarter of 2012

<The US Economy >

- **Weak growth due to household balance sheet adjustment and fiscal tightening**
  2012: +2.0% (previous forecast +1.9%)
  2013: +1.3% (previous forecast +1.4%)

<The Eurozone Economy >

- **Fiscal austerity will serve as a drag upon growth. Lingering uncertainties regarding the sovereign debt crisis**
  2012: -0.1% (previous forecast -0.4%)
  2013: +0.7% (previous forecast +0.8%)

<The Asian Economy >

- **Slowdown mainly among export-driven countries. Chinese domestic demand will remain firm**
  2012: +6.6% (previous forecast +6.6%)
  2013: +6.5% (previous forecast +6.5%)

<The Japanese Economy >

- **Domestic demand-led recovery due to policy impacts of reconstruction-related demand and eco-car subsidies**
  FY2012: +2.0% (previous forecast +2.0%)
- **Slow-down due to peak-out of reconstruction-related demand. Surge of demand prior to tax hike will boost growth in the second half of the fiscal year**
  FY2013: +1.3% (previous forecast +1.1%)

I. The global economy

Despite a slight upturn of the global economy in the Jan-Mar quarter of 2012, soft spots linger in Europe and China

Despite a slight upturn of the global economy in the Jan-Mar quarter of 2012, soft spots linger such as eurozone growth at virtually zero and the slowdown of the Chinese economy.

US real GDP growth slowed down to +2.2% q-o-q p.a. in the Jan-Mar quarter of 2012 (Oct-Dec quarter of 2011: +3.0% q-o-q p.a.) (**Chart 1**). Despite the rise of personal consumption due in part to the warm winter weather, domestic final demand remained weak such as the fall of capital investment.

Eurozone real GDP growth turned out to be virtually zero at +0.1% q-o-q p.a. in the Jan-Mar quarter (-1.2% q-o-q p.a. in the Oct-Dec quarter). Although the German economy stood firm, Italy and Spain fell into negative growth mainly due to the impact of fiscal tightening.

In Asia, many of the economies picked up as the impact of the Thai floods receded. In addition to the higher growth of the South Korean economy from the previous quarter, both Taiwan and Singapore rose into positive territory. On the other hand, the rate of China's real GDP growth in the Jan-Mar quarter stood at +8.1% y-o-y, recording an ongoing slowdown (Oct-Dec quarter: +8.9% y-o-y). Despite a slight rise of investment in fixed assets, exports continued to slow down and personal consumption also softened.

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

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

	2010				2011				2012
	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar
US	3.9	3.8	2.5	2.3	0.4	1.3	1.8	3.0	2.2
Eurozone	1.7	3.6	1.7	1.3	2.9	0.6	0.6	-1.2	0.1
Germany	2.0	8.0	3.2	1.9	5.5	1.1	2.3	-0.7	2.1
France	1.2	2.5	1.8	1.6	3.7	-0.2	1.1	0.3	0.2
Italy	4.5	2.1	1.6	0.8	0.3	1.4	-0.8	-2.6	-3.2
Japan	5.2	5.2	2.9	-0.0	-7.9	-1.2	7.6	0.1	4.1
South Korea	9.2	5.7	2.7	2.5	5.3	3.4	3.4	1.3	3.7
Taiwan	9.0	9.7	3.7	2.3	10.0	1.0	-0.2	-0.6	1.1
Hong Kong	7.9	7.6	3.7	7.1	12.2	-1.5	0.3	1.6	1.6
Singapore	36.4	31.3	-15.9	6.9	19.7	-3.0	2.0	-2.5	10.0
Thailand	11.2	-1.1	0.1	7.2	6.1	-1.9	3.4	-36.4	—
Philippines	17.5	6.6	1.0	1.9	8.1	1.1	3.3	3.5	—
(Y-o-y % change)									
China	12.1	10.3	9.6	9.8	9.7	9.5	9.1	8.9	8.1
Malaysia	10.1	9.0	5.3	4.8	5.2	4.3	5.8	5.2	—
Indonesia	5.9	6.3	5.8	6.8	6.4	6.5	6.5	6.5	6.3
Vietnam	5.8	6.4	7.2	7.3	5.6	5.7	6.1	6.1	4.0
India	9.4	8.5	7.6	8.3	7.8	7.7	6.9	6.1	—

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

In the Jan-Mar quarter, the Japanese economy recorded strong growth of +4.1% q-o-q p.a. (Oct-Dec quarter: +0.1% q-o-q p.a.). In addition to the upturn of exports due to the fading impact of the Thai floods, the revival of the eco-car subsidies drove up the rate of personal consumption growth. Moreover, public investment also rose into positive territory along with the implementation of the budget items related to recovery after the Great East Japan Earthquake.

Weak growth of the global economy forecasted up to 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 further to +3.4% from +3.7% in 2011 (**Chart 2**). Growth in 2013 is also expected to stand around the same level as the year 2012 at +3.2%. Since the eurozone and US economies will remain on weak footing due to the impact of fiscal tightening, many of the emerging economies with a high degree of dependence upon exports to Europe and the US are also expected to slow down.

Turning to the US economy, we forecast growth of +2.0% in 2012 and a subsequent slowdown to +1.3% in 2013. Amid the limited growth of domestic private demand due to lingering balance sheet adjustment pressures in the household sector, we expect stronger downward pressures stemming from fiscal constraints in 2013.

Eurozone economic growth is forecast to fall into negative territory (-0.1%) in 2012 due to the deterioration of the South European economies. Growth in 2013 is also predicted to remain a weak +0.7%.

As for the Asian economies, an overall stagnation is expected mainly among those countries which are heavily dependent upon exports bound for the US and Europe. Real GDP growth among the export-dependent NIEs should remain weak in 2012 (+2.4%) and 2013 (+1.9%). In contrast, the ASEAN5 countries possessing solid domestic demand should enjoy relatively strong growth in 2012 (+4.7%) and 2013 (+4.5%).

The Chinese economy is forecast to follow a mild slowdown in 2012 (+8.5%) and 2013 (+8.4%). Looking forward, investment should gather momentum due to the upturn of public investment and the full-fledged start of the Twelfth Five-Year Plan. Personal consumption will likely grow steadily, driven by factors such as the rise of wages. However, China's economic growth should remain at the mid-8% level in 2013 due to the stagnation of exports bound mainly for Europe.

Even though the rate of Japan's real GDP growth - driven by post-earthquake disaster reconstruction-related demand - should rise to +2.4% in 2012 (in calendar year terms), the pace of growth is forecast to slow to +1.1% in 2013 when the demand related to reconstruction peaks out.

[Chart 2: Outlook on the global economy]

Calendar year (CY)	2010 (Actual)	2011 (Actual)	2012 (Forecast)	2013 (Forecast)	2012 (Previous: March forecast)	2013 (Previous: March forecast)
	(Y-o-y % change)				(Y-o-y % change)	
Total of forecast area	5.3	3.7	3.4	3.2	3.3	3.2
Japan, US, Eurozone	2.8	1.3	1.3	1.0	1.1	1.1
US	3.0	1.7	2.0	1.3	1.9	1.4
Eurozone	1.8	1.5	-0.1	0.7	-0.4	0.8
Japan	4.4	-0.7	2.4	1.1	2.2	0.9
Asia	9.3	7.4	6.6	6.5	6.6	6.5
NIEs	8.4	4.0	2.4	1.9	2.1	1.8
ASEAN5	7.0	4.4	4.7	4.5	4.8	4.4
China	10.4	9.2	8.5	8.4	8.6	8.4
India	8.5	7.1	6.0	5.8	6.0	5.8
Japan (FY)	3.2	-0.0	2.0	1.3	2.0	1.1
Crude oil price (WTI, USD/bbl)	80	95	97	84	97	84

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

The future course of the eurozone sovereign debt crisis is nebulous

Concerns regarding the liquidity positions of eurozone banking institutions ebbed slightly due to the ECB's introduction of the 3-yr long-term refinancing operations (LTRO) on two occasions in December 2011 and February 2012. Furthermore, despite difficulties in debt negotiations with creditor nations, the restructuring of Greek debt in March led to a temporary ebb of uncertainties in the financial markets regarding the eurozone sovereign debt crisis.

However, concerns are escalating again since April due to the poor results of the Spanish government bond auction and destabilization of political conditions. In France, François Hollande - an advocate of the renegotiation of the EU fiscal stability pact - won in the presidential election (**Chart 3**). In the Greek general election, the ruling party forming a coalition prior to the May election lost a large number of the seats in contrast to the increase of seats by the party calling for a review of fiscal austerity. As a result of a failure of the coalition negotiations to form a cabinet, a reelection will be held in June in accordance to the Greek constitution. Amid a greater possibility of a eurozone exit by Greece, capital and money market players are turning more risk averse. Future uncertainties will continue to linger, at least until the June reelection results become evident.

Uncertainties regarding the European sovereign debt crisis may ebb temporarily in the event Greece accepts the fiscal tightening measures subsequent to the June reelections. However, the odds are high that a vicious cycle will ensue where stringent fiscal austerity goals will lead to economic deterioration and the failure to meet the goals will require more fiscal tightening. Thus, uncertainties regarding the European sovereign debt crisis are expected to persist over the medium to long-term horizon.

On the other hand, in the event Greece opts for a eurozone exit, a temporary state of turmoil looks inevitable. With the drachma – Greece's former currency – no longer in circulation, there is the practical problem of how to proceed with the departure from the eurozone. Furthermore, given the difficulty to gain confidence in the new currency after the transition, a sharp fall of the foreign exchange rate of the new currency is expected to trigger inflation leading to Greece's turmoil both within and outside of its country. In the process, there is the possibility of a default of all Greek government bonds and the failure of some banking institutions. The current exodus of deposits from Greek banking institutions is a reflection of concerns regarding such risks. Moreover, other members of the EU such as Germany and France may face difficult decisions. If the EU is able to take a strong position for support toward Ireland and Portugal which are already receiving financial support, and toward Spain which may require support going forward, and establish that Greece is an exceptional case, then it could succeed in forming a consensus that the European sovereign debt crisis has weathered its worst moments with Greece's exit. On the contrary, uncertainties may escalate if the financial markets continue to focus upon the "next in line after Greece".

Interbank interest rates in Europe remain stable, due in part to the maintenance of liquidity by the ECB's supply of funds. The risk of a credit crunch – for example at the time of the failure of Lehman Brothers – occurring worldwide on a concentrated and short-term basis appears to be receding. Even so, in the event a Greek exit from the eurozone materializes, it would cause a temporary stock market fall and lead to negative repercussions upon the real economy. There is no doubt that the European sovereign debt crisis remains the largest risk for the global economy.

Crude oil and the economic policy measures of the US and China are also concerns

Apart from the European sovereign debt crisis, it would also be necessary to watch the volatility of commodity prices as an ongoing risk factor. Crude oil prices are currently falling due to risk aversion in the capital and money markets. However, a resurge of crude oil prices may still occur in the event of the escalation of tensions surrounding Iran.

Note that there are also risks inherent in the US and Chinese economies. In the US, the economic policy measures after the presidential election in November 2012 require close attention. If the measures tilt toward fiscal austerity, it would serve as downside risks to economic growth in 2013. That said, in the event fiscal tightening measures are postponed, the risks of a credit downgrade may lead to financial market turmoil. Turning to the Chinese economy, we expect an investment-led recovery in the second half of 2012. However, there is also the possibility that a cautious monetary policy stance stemming from concerns regarding inflation and rise of real estate prices may keep the economy on a slowdown for a longer period of time.

In the event the reinforcement of regulatory oversight on the financial sector leads to the spread of asset compression among US and European banking institutions, it could serve as constraints upon global economic recovery of the medium to long-term. Even though attention is gathering upon the European sovereign debt crisis, it would also be necessary to keep an eye upon other risk factors

[Chart 3: Major political events]

Date	Events	Notes
2012 Mar	Russian Presidential election (4th)	Vladimir Putin reelected as President by an overwhelming victory
	Slovak Parliamentary election	Election won by pro-euro opposition party (center-left Smer-SD)
	Japan: cabinet decision on consumption tax bill	Even though deliberations commenced in May, the timing of its passage is uncertain
Apr	South Korean legislative election (11th)	Election won by ruling Saenuri party
May	French Presidential election (second round run-off on 6th)	Election won by François Hollande (Socialist Party)
	Greek legislative election (6th)	Defeat by ruling coalition. As a result of a failure to form a coalition government, a reelection scheduled in June
Jun	Greek reelection (mid-June)	Concerns regarding Greece's exit from the eurozone will escalate in the event those opposing fiscal austerity win
	G-20 Summit (Los Cabos, Mexico, 18th-19th)	
	Japan: end of ordinary Diet session (21st)	Focus of attention upon the deliberations on consumption tax bill (possible extension of Diet session)
	Strengthening of capital adequacy by European financial institutions (end of June)	Asset compression by financial institutions may serve as a drag upon real economy
Jul	Creation of European Stability Mechanism (ESM)	Congressional ratification by each of the member countries may be delayed
Sep	Japan: elections of Democratic Party of Japan (DPJ) leader, Liberal Democratic Party (LDP) leader	Risk of policy paralysis due to change of Prime Minister
Oct	18th Congress of the Communist Party of China	Rise of conservatives may lead to risks of a hardline stance toward Japan
Nov	US Presidential election (6th)	President Obama's defeat may lead to rise of uncertainties over the future. Possibility of the continuation of a divided government
Dec	South Korean Presidential election (19th)	
2013	Italy general election (spring)	
	Japan general election (end of term of House of Representatives on August 29th)	
	German general election (fall)	

Source: Made by MHRI

II. The Japanese economy

(1) The current state of the economy

Strong domestic demand-led growth in the Jan-Mar quarter

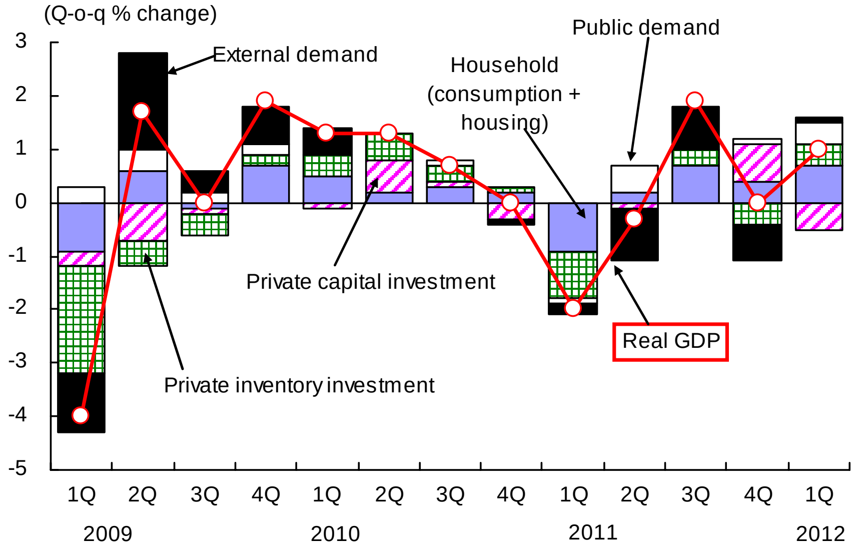
Japan's real GDP grew a strong +1.0% q-o-q (+4.1% in annualized terms) in the Jan-Mar quarter of 2012 (**Chart 4**).

Domestic private demand continued to grow at a mild pace (+0.6% q-o-q, contribution: +0.5% pt). Personal consumption grew a strong +1.1% q-o-q due to factors such as the surge of automobile purchases driven by the government subsidies for purchases of fuel-efficient cars (the "eco-car subsidies"). In contrast, housing investment (-1.6% q-o-q) and capital investment (-3.9% q-o-q) both declined. The decline of private inventory investment moderated along with the recovery of production, thus serving to push up the rate of growth (contribution: +0.4% pt).

Public demand grew +1.5% q-o-q (contribution: +0.4% pt) from the Oct-Dec quarter of 2011 (+0.2% q-o-q). Given the successive implementation of the budget items related to reconstruction after the earthquake disaster in the FY2011 third supplementary budget, public investment grew a strong +5.4% q-o-q, recording an increase for the first time in three quarters. In addition to the ongoing rise of social security benefits, the spending earmarked for rubble disposal in the disaster-afflicted areas led to a faster pace of growth in government consumption (+0.7% q-o-q) from the Oct-Dec quarter of 2011 (+0.4% q-o-q).

Domestic demand – combining both private and public demand – grew +0.9% q-o-q (contribution: +0.9% pt) leading to the view that growth in the Jan-Mar quarter was driven mainly by domestic demand. Considering that personal consumption was boosted by the eco-car subsidies, the expansion of domestic demand in the Jan-Mar quarter was due largely to the impact of policy measures.

[Chart 4: Japan's quarterly real GDP growth]



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

Exports grew +2.9% q-o-q in the Jan-Mar quarter. The results appear somewhat soft, considering the sharp fall of exports in the Oct-Dec quarter of 2011 (-3.7% q-o-q) due to the impact of the Thai floods. Even though US-bound auto exports picked up, exports to Europe and China weakened. Meanwhile, imports continued to rise in the Jan-Mar quarter (+1.9% q-o-q) (Oct-Dec quarter: +0.9% q-o-q) due to factors such as the increase of fuel demand along with the reinforcement of thermal electrical power generation. As a result, the contribution by external demand stood at a moderate +0.1% pt.

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

Reconstruction-related demand will keep the economy on recovery track. FY2012 growth: +2.0%

In FY2012, the Japanese economy should remain in recovery mode, propped up by the twin pillars of reconstruction-related demand and the eco-car subsidies. That said, in view of the lingering impact of the strong yen thus far and the weak recovery among the overseas economies, the odds are high that exports will slump and that external demand may not be expected to serve as the engine of growth.

Given the subsequent implementation of the reconstruction-related spending in the third supplementary budget passed in November 2011, public investment should continue to grow throughout FY2012. Mizuho Research Institute (MHRI) has held the view that public investment in connection with reconstruction and recovery from the Great East Japan Earthquake will peak sometime in mid-FY2012 (the Jul-Sep quarter) on the basis of the pace of reconstruction after the Great Hanshin-Awaji Earthquake. However, we are now inclined to believe that the peak will take place later-than-expected, judging from (1) the delay in disposal of rubble, (2) the time-consuming nature of negotiations for adjustment of property rights for the transfer of settlements to higher grounds, and (3) the difficulties in construction bidding stemming from the shortage of construction-related workers. Reconstruction-related public investment is forecast to peak in the Jan-Mar quarter of 2013, approximately six months later than previously expected.

In the first half of FY2012, personal consumption should remain on firm footing given the impact of the revival of the eco-car subsidies amid the gradual recovery of labor market conditions. Domestic private demand should remain on solid grounds during this period, as exemplified by the gradual expansion of capital investment reflecting the improvement of corporate earnings.

However, there is a growing possibility that the eco-car subsidies will reach the earmarked spending level and be terminated in the Jul-Sep quarter. A fall of personal consumption will be inevitable in the Oct-Dec quarter due to a backlash to automotive sales in reaction to the boost from the eco-car subsidies. Furthermore, in FY2013, the slowdown of the US economy stemming from fiscal tightening may have a negative impact upon Japan’s exports and industrial production. Although it is unlikely that Japan will slide into recession, considering its support by reconstruction-related demand, we expect the Japanese economy to fall into a “soft patch” toward the end of FY2012.

As set forth above, the economy may slow down in the second half of FY2012. However, on a fiscal year basis, we forecast real GDP to grow +2.0% in FY2012 (MHRI’s previous forecast in March 2012: +2.0%), driven by the increase of public demand accompanying the reconstruction from the earthquake and the gradual expansion of domestic private demand.

Reconstruction-related demand will peak out.
FY2013 growth: +1.3%

In the first half of FY2013, public investment is expected to start falling due to the peak-out of reconstruction-related demand. Given also the stagnation of exports due to the overseas economic slump, the Japanese economy is forecast to stagnate as it loses its engine of growth in the first half of FY2013. 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* - on which Diet deliberations have started - 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, last-minute demand mainly in 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 a backlash to the surge of 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 GDP growth is forecast to slow down from FY2012 to +1.3% (March forecast: +1.1%). The upward revision from our previous forecast in March stems mainly from the following factors: (1) firstly, the fall of public investment in FY2013 was estimated to be smaller than previously expected (March forecast: -4.1% y-o-y → -1.3% y-o-y) due to reconstruction-related demand peaking later than initially expected, and (2) secondly, the contribution by external demand was revised upward (March forecast: -0.1% pt → +0.1% pt) along with a revision of the assumed JPY/USD exchange rate slightly toward a weak yen (March forecast: FY2012 JPY78/USD, FY2013 JPY78/USD → latest forecast: FY2012 JPY80/USD, FY2013 JPY81/USD).

[Chart 5: Outlook on the Japanese economy]

		FY2010	FY2011	FY2012	FY2013	2011				2012				2013				2014
						Jan–Mar	Apr–Jun	Jul–Sep	Oct–Dec	Jan–Mar	Apr–Jun	Jul–Sep	Oct–Dec	Jan–Mar	Apr–Jun	Jul–Sep	Oct–Dec	Jan–Mar
GDP (real)	Q-o-q % ch	3.2	−0.0	2.0	1.3	−2.0	−0.3	1.9	0.0	1.0	0.4	0.4	0.1	0.1	0.3	0.4	0.5	0.8
	Q-o-q % ch p.a.	−−	−−	−−	−−	−7.9	−1.2	7.6	0.1	4.1	1.6	1.7	0.6	0.4	1.1	1.6	2.2	3.0
Domestic demand	Q-o-q % ch	2.4	1.0	2.0	1.1	−1.8	0.7	1.1	0.8	0.9	0.4	0.4	−0.1	0.2	0.2	0.3	0.5	0.8
Private sector demand	Q-o-q % ch	3.0	0.5	2.0	1.2	−2.2	0.3	1.4	0.9	0.6	0.5	0.4	−0.2	0.2	0.2	0.4	0.6	1.0
Personal consumption	Q-o-q % ch	1.5	1.1	1.4	1.1	−1.5	0.6	1.1	0.7	1.1	0.1	0.2	−0.5	0.1	0.1	0.2	0.9	2.0
Housing investment	Q-o-q % ch	2.4	3.6	1.2	7.5	1.6	−3.1	4.8	0.1	−1.6	0.1	0.8	1.7	−0.9	2.3	4.7	6.1	−8.1
Capital investment	Q-o-q % ch	3.5	0.2	2.6	2.0	0.2	−0.4	−0.2	5.2	−3.9	2.0	0.8	0.8	0.4	0.4	0.5	0.4	0.5
Inventory investment	Q-o-q contribution, % pt	0.9	−0.4	0.3	−0.2	−0.9	0.0	0.3	−0.4	0.4	0.0	0.0	0.0	0.1	−0.0	−0.0	−0.3	−0.3
Public sector demand	Q-o-q % ch	0.5	2.4	2.1	0.8	−0.6	2.0	0.1	0.2	1.5	0.2	0.5	0.4	0.1	0.2	0.2	0.2	0.0
Government consumption	Q-o-q % ch	2.3	1.9	1.3	1.2	0.4	0.7	0.3	0.4	0.7	0.2	0.3	0.3	0.1	0.3	0.5	0.5	0.2
Public investment	Q-o-q % ch	−6.7	3.9	5.9	−1.3	−4.6	7.3	−0.6	−0.5	5.4	0.4	1.8	1.0	0.1	−0.2	−1.1	−1.2	−1.2
External demand	Q-o-q contribution, % pt	0.8	−1.0	−0.1	0.1	−0.2	−1.0	0.8	−0.7	0.1	−0.0	−0.0	0.2	−0.0	0.0	0.0	−0.0	−0.0
Exports	Q-o-q % ch	17.2	−1.4	3.8	2.4	−0.4	−6.3	8.7	−3.7	2.9	0.5	0.7	0.9	−0.1	0.6	0.8	0.9	0.9
Imports	Q-o-q % ch	12.0	5.3	3.8	1.6	1.2	0.2	3.5	0.9	1.9	0.6	0.7	−0.3	0.2	0.3	0.5	0.9	1.0
GDP (nominal)	Q-o-q % ch	1.1	−1.9	1.7	1.3	−2.6	−1.0	1.5	−0.3	1.0	0.1	0.7	−0.1	0.4	0.0	0.8	0.3	0.9
GDP deflator	Y-o-y % ch	−1.9	−1.9	−0.4	0.0	−1.9	−2.4	−2.2	−1.9	−1.2	−1.0	−0.4	−0.2	0.1	0.0	0.1	0.1	−0.1
Domestic demand deflator	Y-o-y % ch	−1.2	−0.7	−0.4	−0.5	−1.0	−1.1	−0.7	−0.6	−0.3	−0.6	−0.5	−0.4	−0.3	−0.6	−0.6	−0.5	−0.5

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

		FY2010	FY2011	FY2012	FY2013	2011				2012				2013				2014
						Jan–Mar	Apr–Jun	Jul–Sep	Oct–Dec	Jan–Mar	Apr–Jun	Jul–Sep	Oct–Dec	Jan–Mar	Apr–Jun	Jul–Sep	Oct–Dec	Jan–Mar
Industrial production	Q-o-q % ch	9.3	−1.0	3.8	1.6	−1.5	−4.2	5.4	0.4	1.3	0.4	0.9	0.5	−0.1	0.0	0.8	0.8	0.7
Ordinary profits	Y-o-y % ch	39.0	−4.4	9.2	6.3	11.0	−13.2	−3.1	−5.4	4.9	17.7	10.8	6.6	3.1	3.7	5.9	7.3	8.4
Nominal labor compensation	Y-o-y % ch	0.5	0.1	0.4	0.6	0.6	0.2	−0.3	0.3	0.1	0.2	0.4	0.6	0.4	0.6	0.6	0.6	0.6
Unemployment rate	%	5.0	4.5	4.4	4.2	4.8	4.7	4.4	4.5	4.5	4.5	4.4	4.3	4.3	4.3	4.2	4.1	4.1
New housing starts	P.a., 10,000 units	81.9	84.1	87.2	94.4	83.2	82.4	88.3	79.6	86.2	86.0	86.9	89.1	86.4	90.6	95.9	99.2	90.8
Current account balance	P.a., JPY tril	16.7	7.9	9.8	13.7	13.9	7.5	10.2	6.7	7.1	7.4	9.5	10.7	11.0	11.3	14.2	14.5	14.8
Domestic corporate goods prices	Y-o-y % ch	0.7	1.7	−1.0	−0.6	1.8	2.5	2.6	1.5	0.5	−0.6	−1.0	−1.0	−1.2	−1.2	−0.7	−0.3	−0.0
Consumer prices	Y-o-y % ch	−0.8	0.0	−0.2	−0.2	−0.8	−0.2	0.2	−0.2	0.1	−0.2	−0.3	−0.2	−0.2	−0.3	−0.2	−0.1	−0.0
Uncollateralized overnight call rate	%	0.06	0.08	0〜0.10	0〜0.10	0.06	0.07	0.08	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
Yield on newly-issued 10-yr JGBs	%	1.13	1.05	0.95	0.99	1.24	1.16	1.04	1.03	0.97	0.92	0.95	1.00	0.95	0.95	0.95	1.00	1.05
Nikkei average	JPY	9,961	9,181	9,600	9,600	10,308	9,612	9,255	8,582	9,274	9,200	9,500	9,800	9,500	9,300	9,400	9,700	9,900
Exchange rate	JPY/USD	86.0	79.0	80.0	81.0	82.3	81.7	77.8	77.4	79.3	80.0	78.0	80.0	79.0	79.0	79.0	81.0	82.0
Crude oil price (WTI nearest term contract)	USD/bbl	84.0	97.0	93.0	82.0	94.6	102.3	89.5	94.1	103.0	98.0	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 when excluding the impact of the last-minute rush of demand

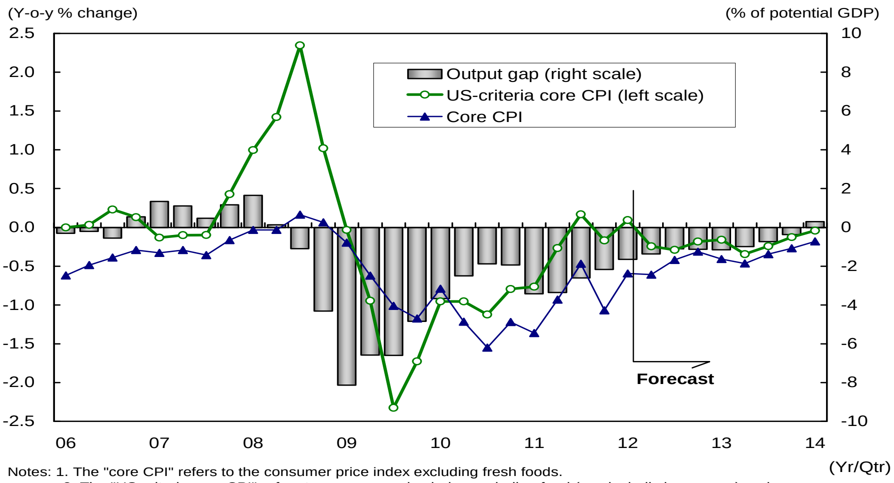
The output gap (the gap between actual GDP and potential GDP) estimated by MHRI stood at -1.6% of potential GDP (meaning an excess of supply of JPY8.7 trillion) as of the Jan-Mar quarter of 2012 (**Chart 6**). In the event the Japanese economy grows according to our latest *Economic Outlook*, the output gap should reach +0.3% (an excess of demand of JPY1.6 trillion) as of the end of FY2013, resulting in a closure of the deflationary gap. However, note 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 a last-minute rush of demand prior to the consumption tax hike. In the absence of the impact of the such surge of demand, the output gap would be approximately -1% 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 +0.2% y-o-y and -0.5% y-o-y respectively as of March 2012. In contrast to the ongoing y-o-y decline of the US-criteria CPI due to price falls of durable goods, there has been a slight upturn of the core CPI. However, note that a technical factor - the revision of television items surveyed - is serving to push up the index by approximately 0.3%.

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. Meanwhile, energy prices – thus far serving to push up the core CPI – are expected to gradually decline going forward. As a result, the core CPI which stood at 0.0% y-o-y in FY2011 is expected to follow a gradual decline in FY2012 (-0.2% y-o-y) and FY2013 (-0.2% y-o-y). The Bank of Japan’s (BOJ) *Outlook for Economic Activity and Prices* (April 2012) forecasts the core CPI to rise +0.3% in FY2012 and +0.7% in FY2013 (the median of the BOJ Policy Board members’ forecasts). Although the future outlook depends upon

[Chart 6: 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.

trends in commodity prices, it is unlikely that consumer prices will continue to follow a sustained uptrend given the output gap lingering in negative territory. 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, there are significant uncertainties going forward.

The greatest risk is an overseas economic downturn and a further strengthening of the yen. In the event of an escalation of the eurozone sovereign debt crisis, a temporary global stock market fall and yen appreciation may not be avoided, serving as a negative impact to some extent even upon the Japanese economy.

If all nuclear power reactors remain suspended, the rise of fuel imports will drag down the rate of Japan's GDP 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. All nuclear power plants within Japan were suspended in early May. The shortage of electrical power this summer is a concern, given the opacity of discussions regarding the restart of operations of the nuclear power plants. According to the committee on power supply and demand of the National Policy Unit, in the event none of the nuclear power plants are restarted, the Kansai Electric Power Co. (KEPCO) will face around a 15% shortage of power supply at peak demand. The supply reserve rates will fall below 3% in Hokkaido, Tohoku, Shikoku and Kyushu.

The government of Japan appears to be considering a request for electrical power conservation of approximately 15% toward the areas served by KEPCO and approximately 5% - 10% in other areas. Although areas other than those served by KEPCO should be able to meet the conservation levels without much problem just by reducing the use of air conditioners and lighting, there are concerns that production activity might be hindered by complying with the conservation request in areas served by KEPCO. Having said so, since it is possible to make up for the production shortfall in the summer by increasing production from the autumn onward and to ease the negative impact by substituting the shortfall by areas with relative leeway in electrical power supply, the impact upon production stemming from the quantitative shortage of electrical power on an all-nation fiscal-year basis should be benign.

However, the rise of costs due to the reinforcement of thermal electrical power plants may not be avoided. According to estimates by MHRI, in the event all of Japan's nuclear power plants remain shut down, fuel costs for thermal power generation will rise to approximately JPY7.3 trillion in FY2012 (fuel costs totaled approximately JPY3.7 trillion in FY2010 when the nuclear power plants were operating normally, with the exception with the period after the earthquake disaster) (**Chart 7**). Since most of the fuel will be imported, the rise of overseas payment will serve as a drag upon Japan's GDP. The impact of the rise of fuel imports upon FY2012 real GDP is estimated to be -0.4% pt in comparison with FY2010 and -0.2% pt in comparison with FY2011. Should the suspension of the nuclear power plants persist over a prolonged period, the odds are high that the decision to raise electric power charges currently discussed by Tokyo Electric Power Company (TEPCO) will spread to other electrical power companies as well. In such event, the negative impact upon personal consumption and capital investment should gradually intensify.

[Chart 7: Fuel costs in the event nuclear power plants remain shut down and its impact upon GDP (estimates)]

			FY2010	FY2011	FY2012
Thermal electrical power generation costs		(JPY tril)	3.7	6.1	7.3
Impact upon GDP (change from 2010)	Nominal	(% pt)	—	-0.5	-0.8
	Real	(% pt)	—	-0.2	-0.4
Impact upon GDP (Y-o-y change)	Nominal	(% pt)	—	-0.5	-0.3
	Real	(% pt)	—	-0.2	-0.2

Note: Estimates based upon MHRI's forecast on crude oil price and others
Sources: Made by MHRI based upon releases by The Federation of Electric Power Companies of Japan and others

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