FY2012, FY2013 and FY2014 Economic Outlook

February 15, 2013

Key points of Mizuho Research Institute's (MHRI) outlook on the economy in FY2012, FY2013 and FY2014 reflecting *The First Preliminary Quarterly Estimates of GDP (1st QE)* of Japan for the Oct-Dec quarter of 2012

< The US Economy >

- **An economic slowdown in 2013 due to the fiscal crunch. A mild recovery in 2014 reflecting the progress of balance sheet adjustment**

  2013: +1.4% (forecast in December +1.4%)
  2014: +2.0%

< The Eurozone Economy >

- **Uncertainties regarding the debt crisis will linger. Fiscal austerity will serve as a drag upon growth. In 2014, downward pressures stemming from fiscal conditions will ease slightly.**

  2013: -0.3% (forecast in December +0.0%)
  2014: +0.8%

< The Asian Economy >

- **Gradual recovery amid the upturn of exports. Although the Chinese economy will recover due to the impact of the economic stimulus measures, movements to cool excessive investment are expected to intensify in the second half of 2014.**

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

< The Japanese Economy >

- **The recession stemming from the fall of exports and the expiration of the Eco-car subsidy program ended at the end of 2012.**

  FY2012: +0.8% (forecast in January +1.1%)
- **Public demand will serve as the driver of growth in the first half and a last-minute rush of demand will speed up growth in the second half**

  FY2013: +2.1% (forecast in January +2.0%)
- **Despite a temporary slump due to the consumption tax hike, the slowdown will fall short of a recession**

  FY2014: +0.4%

I. The Chief Economist's View

Will 2013 mark Japan's turnaround from its "lost two decades and lost three years"?

We have revised up our forecast on Japan, reflecting the Abe administration's policy measures

In a report titled "The Impact of the *Emergency Economic Measures* and Revision of Economic Outlook" (in Japanese) released on January 16, 2013, Mizuho Research Institute Ltd. (MHRI) has already made an upward revision of its outlook on Japan's economic growth in FY2013 to +2.0% (*Economic Outlook* in December: +1.1%). To reflect the impact of the measures (mainly the supplementary budget) of the new administration led by Prime Minister Shinzo Abe, we have raised the contribution by each of the following components as follows: public demand (+0.6% pt), external demand (+0.2% pt), private demand (+0.1% pt). Our latest *Economic Outlook* follows in the steps of the foregoing upward revisions. In contrast to our view on the Japanese economy that it has emerged out of the recession from the second half of 2012, our view on the environment overseas remains unchanged – a lower-than-consensus view on the US economy and the absence of a major change in the overall global economy in 2013 as in 2012.

On the Japanese economy which has been subject to a significant upward revision, we now forecast an upturn of the Japanese economy on the following grounds. Firstly, there are the new administration's economic measures mentioned above. At the same time, we should also add that Japan's exports are on a recovery track along with the improvement of overseas economic conditions, and accelerated further by the weakening of the yen. While it is difficult at this point in time to gauge the impact of the new administration's policy measures, our forecast on the Japanese economy may be subject to a further upward revision in the event the economic measures start to have an impact. Although the stock market is already rising to a level anticipating the measures' positive impact, we are taking a cautious stance at this point in time, leaving room for a further upward revision.

Our perception on the global economy is characterized by a prolonged economic stagnation accompanying the balance sheet adjustments in the US and European economies. Thus far, the storyline of our forecast has consistently held a lower-than-consensus view on global (mainly US) economic growth due to the fiscal crunch stemming from the "fiscal cliffs" in the US and Europe. Our latest forecast of 1.4% on US economic growth in 2013 is still lower than the market consensus which is said to be around 2%. However, with respect to 2014 onward, we forecast a rebound to the 2%-level in view of the steady progress of the balance sheet adjustment process in the US mainly in the housing sector.

We have held the view that downside pressures from fiscal conditions among the developed economies will persist in 2013 and hence that a dramatic improvement of economic growth from 2012 to 2013 would be unlikely. While the negative pressures from fiscal conditions take the form of a “fiscal cliff” in the US, similar “cliffs” also exist in Europe, leading to our view that an upturn in global demand will be sluggish. Considering that every year since 2007, expectations toward economic recovery, the upturn of interest rates and stock market and appreciation of the dollar rose in the first half of the year, similar expectations toward recovery are expected to rise in the early spring months. However, it would be necessary to keep a cautious stance toward excessive expectations due to lingering balance sheet adjustment pressures.

Balance sheet adjustment will progress steadily despite the persistence of downward pressures upon the US economy

Having said so, the downward pressures upon the US economy stemming from balance sheet adjustment should gradually ease in 2014. Thus, even in the absence of a significant improvement of global economic growth in 2013 in terms of the real economy, we have decided to place emphasis upon the possibility that there may be several significant shifts in the market due to expectations toward recovery in 2014. Furthermore, we have also revised upward our forecast on growth in Asia (including China) in 2013 and expect a rebound of the global economy over the medium term toward the mid-2010s.

The most important shift in the mid-2010s revolves around US monetary exit strategy. At this juncture, we forecast that the timing of the US interest rate hike will be sometime in or after 2017. However, given the steady progress of balance sheet adjustment in the US, market movements in anticipation of the US exit policy may occur earlier. As a result, this may also accelerate the rise of long-term interest rates.

Summing up our latest economic outlook on 2013 and 2014, although we do not see a significant change from our economic outlook in 2013, except for our outlook on Japan, it would still be necessary to take a cautious view on the overseas environment. However, our outlook on 2014 is based upon the view that the balance sheet adjustment pressures over the long term in the US and Europe from 2007 onward will gradually ease. Thus, in view of the recent rise of discussions on the improvement of future expectations and the exit strategy, we have made a significant revision by steering our fundamental view to a more forward-looking position. In particular with respect to the Japanese economy, we anticipate that it has started to take a step toward out of a long tunnel. The global strength of the stock market at the moment may be a sign that it looks forward to an improvement in 2014 rather than in 2013.

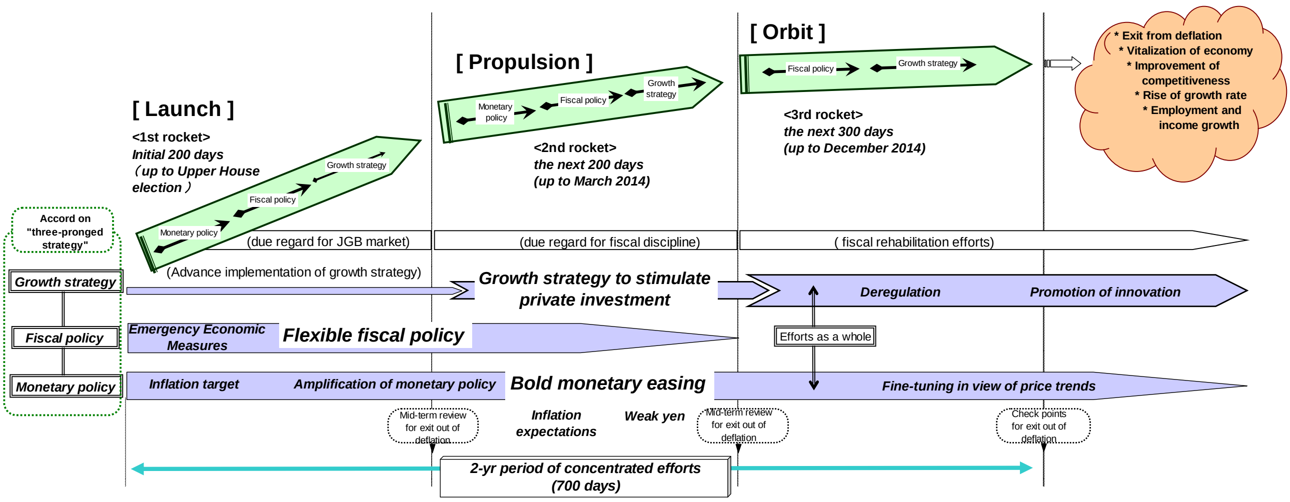
Will the Abe administration's economic measures pull Japan out of deflation?

Three months has passed already since November 14, 2012 when the date of the general election was set on December 16, 2012. Since the past three months has provided Japan with an extremely favorable environment of a weak yen and bullish stock market – a condition attributed to so-called "Abenomics" – the gist of our view is that Japan should continue to take various measures without being complacent in this favorable environment. Amid the various discussions which have started already regarding Abenomics, MHRI released an *Urgent Report* (in Japanese only) titled "What will change under the Abe administration?" on January 25th. In this report, we have set forth both MHRI's proposals in the 10 areas of the economic measures and 10 points which are necessary to turn around Japan's sentiment.

Of the 10 points necessary for a turnaround of sentiment, three are the "three prongs" needed to lift Japan's sentiment out of the "two lost decades". **Chart 1** depicts the roadmap of the "three-step rocket strategy for exit out of deflation". This sets forth the tasks to be tackled through cooperation between the government and the Bank of Japan during the two years deemed as the period of concentrated efforts for an exit out of deflation. Our fundamental perception is that even though Japan has already completed its balance sheet adjustment process and its private sector has come to possess a strong financial base, it has turned more pessimistic as a result of its transformation into a "herbivore" characterized by reduced expectations and a deleveraging and deflationary mindset.

An important point of the "three-step rocket strategy" is that the weight of the "three prongs" will gradually shift. In other words, the strategy will gradually shift into a growth strategy.

[Chart 1: The three-step rocket strategy consisting of three prongs for an exit from deflation]



Source: MHRI.

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

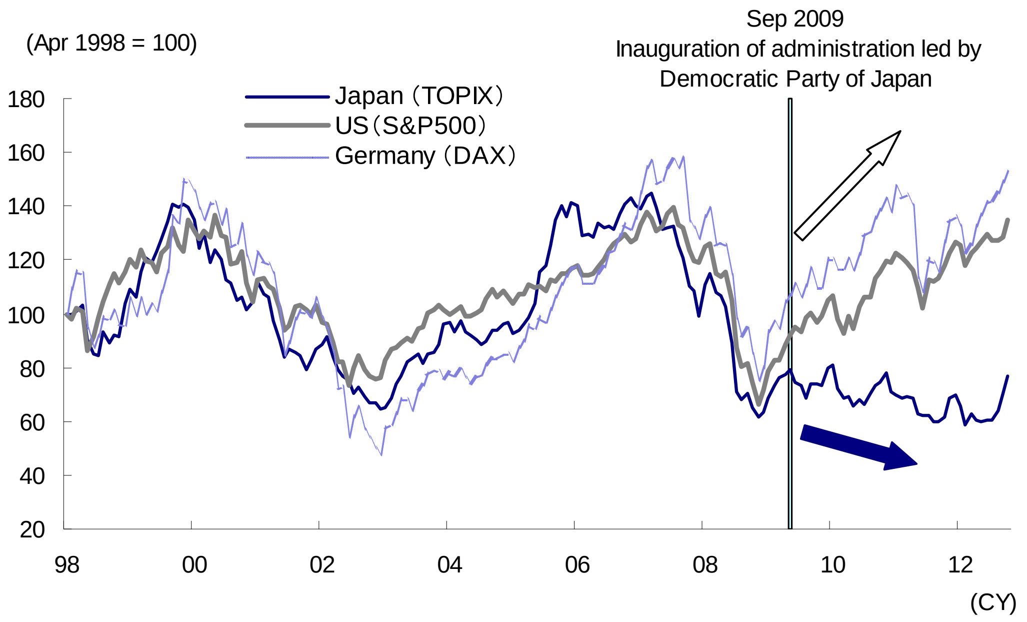
(2) The second rocket: shift to a growth strategy while continuing monetary and fiscal measures

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

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

However, the question is how long the first rocket will continue to accelerate. The depreciation of the yen depends largely upon expectations on economic recovery mainly with respect to the US. During the past six years, there has been a rise of optimistic views in the first half of the year, followed by a correction of the optimism in the second half of the year. Furthermore, the level of acceptance of a weak yen may be subject to subtle variations depending upon the proximity of Japan-US relations. Amid the stronger-than-expected impact of the first rocket, the next point is how it can pass the torch to the second rocket (the growth strategy). The key is the progress of trade policies including the TPP which will lead to the growth strategy. This will also be necessary to keep the first rocket accelerating even after the early spring season. Moreover, it would be necessary to start preparations from now for the growth strategy to work effectively in the second rocket.

[Chart 2: Trends in major stock market indices during the past 15 years]



Source: Bloomberg.

When will Japan emerge out of the lost two decades and the lost three years?

The Japanese economy has been mired in a prolonged stagnation referred to as the "lost two decades" since the collapse of the bubble in the 1990s. However, as shown in **Chart 2**, Japanese stocks continued to move in tandem with other major stock markets of the US and Germany for a long time after the collapse of the bubble in the 1990s. Having said so, Japanese stocks have clearly been laggards since the second half of 2009. Japan's stock markets were in a state that can be dubbed the "lost three years". Although Japanese stocks staged a sharp recovery during the past three months since November 14, 2012, conditions have not changed much in view of the past gap with US and German stock markets. In the event there should be a shift from overseas to Japanese stocks, the price of Japanese stocks could rise more than initially expected by Japanese market participants.

Even though the Abe administration has been able to achieve a certain level of success in its fiscal and monetary policy measures thus far, there are views in the market that the administration is relatively cautious toward measures such as deregulation. Currently, the question is whether the torch can be passed over to the third rocket at the current pace of market acceleration. Moreover, the sustainable recovery of the economy by the growth strategy will gain more importance as Japan moves closer to the third rocket. There is still a persistent view that the current state is still the result of a "recurrence of fire works" by temporary fiscal expansion.

Nevertheless, I would like to shed light upon the changes which have occurred in the government and private sector under the new political leadership. Japan's postwar economic growth was achieved through the joint efforts of "politics, bureaucracy and business", akin to a growth strategy by "Japan Inc." This system was once the subject to criticism, and even refuted by the Japanese themselves after the collapse of the bubble economy. However, in the world of "neo-mercantilism" in which the countries of the world compete for survival, growth strategies under a new form of cooperation among "politics, bureaucracy and business" is common among the US, Europe and the emerging economies. This is the "new normal" of statehood after the collapse of the bubble, and Japan may be following the process of its reversion to a "normal country". This may also be deemed as Japan's emergence out of deflation and, from the perspective of a reversion to normality, its "transformation from an herbivore".

The turnaround of Japan's stock market from the "lost three years" may stem from movements among overseas investors to correct their underweight positions on Japanese stocks in anticipation of Japan's reversion to a "normal country". I hold great expectations that the year 2013 will mark an important juncture in which the Japanese economy takes a step forward to an exit not only out of the "lost three years" but also the "lost two decades".

Hajime Takata, Chief Economist

II. The global economy

Signs of global economic recovery in the Oct-Dec quarter of 2012

As indicated by the upturn of growth among many of the Asian economies amid the gradual recovery of the Chinese economy, signs of recovery emerged in the Oct-Dec quarter of 2012.

Although US economic growth contracted (-0.1% q-o-q p.a.) in the Oct-Dec quarter of 2012 (Jul-Sep quarter: +3.1% q-o-q p.a.), the main cause of the contraction was the fall of government spending and slower pace of inventory investment (**Chart 3**). In contrast, private-sector final demand such as personal consumption and capital investment grew at a faster pace.

On the other hand, the eurozone remained in a recession with real GDP contracting (-2.3% q-o-q p.a.) in the Oct-Dec quarter (Jul-Sep quarter: -0.3% q-o-q p.a.).

China's real GDP grew +7.9% y-o-y in the Oct-Dec quarter (Jul-Sep quarter: +7.4% y-o-y), accelerating for the first time in eight quarters. In addition to the ongoing recovery of public investment on the back of economic stimulus measures, exports and personal consumption also grew at a faster pace.

[Chart 3: Real GDP growth of major countries and areas]

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

	2011		2012			
	Jul-Sep	Oct-Sep	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec
US	1.3	4.1	2.0	1.3	3.1	-0.1
Eurozone	0.4	-1.4	-0.1	-0.7	-0.3	-2.3
Germany	1.5	-0.6	2.0	1.1	0.9	-2.3
France	0.8	0.3	-0.4	-0.4	0.6	-1.1
Italy	-0.5	-2.6	-3.2	-2.9	-0.8	-3.7
Japan	10.4	0.6	6.0	-1.0	-3.8	-0.4
South Korea	3.4	1.3	3.5	1.1	0.2	1.5
Taiwan	-0.5	-4.6	5.5	-0.1	3.4	6.0
Hong Kong	2.1	0.9	2.1	-0.3	2.6	
Singapore	2.0	-2.5	9.5	0.2	-6.3	1.8
Thailand	9.1	-36.8	53.3	11.7	5.0	
Philippines	2.2	7.0	11.2	4.4	5.2	7.5
Australia	4.8	2.8	5.3	2.3	1.9	

(Y-o-y % change)

China	9.2	8.9	8.1	7.6	7.4	7.9
Malaysia	5.7	5.2	5.1	5.6	5.2	
Indonesia	6.5	6.5	6.3	6.4	6.2	6.1
Vietnam	6.1	6.1	4.6	4.8	5.1	5.4
India	6.7	6.1	5.3	5.5	5.3	

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

Turning to the other Asian economies, growth among many of the countries of the region picked up, reflecting factors such as the upturn of exports. In addition to the ongoing acceleration of growth in the Philippines and Vietnam, the growth rates of South Korea, Taiwan and Singapore which have thus far been weak, have picked up.

Under this environment, the fall of Japan's economic growth eased despite the contraction of real GDP growth in the Oct-Dec quarter of 2012 (-0.4% q-o-q p.a., Jul-Sep quarter: -3.8% q-o-q p.a.).

Despite a slow pace of growth in 2013, the global economy should pick up in 2014

The rate of global economic growth (the weighted average of all the countries and areas within the scope of MHRI's economic forecast) is forecast to remain weak at +3.0% in 2013, as in 2012 (estimate: +3.1%) (**Chart 4**). In addition to the US economic slowdown due to fiscal austerity, eurozone growth is also expected to remain in negative territory. A dramatic growth among emerging economies is unlikely, considering the stagnation of exports to Europe and the US. Even so, the global economy will pick up from the second half of 2013. Global economic growth is forecast to grow +3.6% in 2014, accelerating for the first time in five years due to the upturn of the US economy amid the progress of balance sheet adjustment and the strong growth of the emerging economies.

[Chart 4: Outlook on the global economy]

（Y-o-y % change）

Calender year	2010	2011	2012	2013	2014	2012	2013
	（Actual）	（Actual）	(Forecast)	(Forecast)	(Forecast)	(Previous：Dec forecast)	
Total of forecast area	5.3	3.8	3.1	3.0	3.6	3.1	2.9
Japan , US , Eurozone	2.6	1.3	1.2	0.7	1.5	1.2	0.7
US	2.4	1.8	2.2	1.4	2.0	2.2	1.4
Eurozone	2.0	1.5	-0.5	-0.3	0.8	-0.4	0.0
Japan	4.7	-0.6	1.9	1.0	1.4	2.0	0.3
Asia	9.3	7.5	6.1	6.3	6.6	6.1	6.1
NIEs	8.4	4.0	1.6	2.1	3.5	1.6	1.7
ASEAN5	7.0	4.5	5.9	5.1	5.3	5.8	4.7
China	10.4	9.3	7.8	8.2	7.9	7.7	8.0
India	8.9	7.5	5.2	5.0	6.2	5.2	5.0
Australia	2.6	2.5	3.6	2.7	3.0	3.6	2.7
Brazil	7.5	2.7	0.9	2.9	3.5	1.0	3.1
Russia	4.3	4.3	3.4	3.0	4.0	3.3	3.2
Japan (FY)	3.4	0.3	0.8	2.1	0.4	1.0	1.1
Crude oil price (WTI , USD/bbl)	80	95	94	88	90	95	84

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

The pace of US economic growth is forecast to slow down to 1.4% in 2013. Despite the spread of a sense of reassurance stemming from the passage of a bill early this year to partially avoid the “fiscal cliff”, household spending in the first half of 2013 will likely remain subdued because of the expiration of the payroll tax cuts. As the impact of the larger burden eases from the second half of 2013 onward, the pace of economic growth should gradually pick up along with the progress of the balance sheet adjustment process due to the recovery of the housing market. In 2014, the rate of US real GDP growth should rise to +2.0%.

Eurozone real GDP is forecast to contract for two years in a row in 2013 (-0.3%). In addition to the ongoing economic slump among the countries of Southern Europe such as Italy and Spain which are subject to stringent fiscal austerity, the gap with sound economies such as Germany will widen. Even though stringent fiscal conditions will likely persist mainly among the countries of Southern Europe in 2014, its negative impact upon the economy should ease slightly and push the rate of real GDP growth into positive territory again (+0.8%).

The Asian economies should gradually pick up from 2013 to 2014. In China, the pace of real GDP is forecast to rise to +8.2% in 2013 and slow somewhat to 7.9% in 2014. The pace of economic growth should gradually accelerate toward the first half of 2014 reflecting the rise of fixed asset investment and recovery of exports due to the economic stimulus measures. In the second half of 2014, the Chinese economy is forecast to slow down slightly due to the intensification of moves to rein in excessive investment. Even though the NIEs (South Korea, Hong Kong, Taiwan, Singapore) may not be expected to grow strongly amid the stagnation of demand among developed countries, a mild recovery of exports should gradually lift the rate of real GDP growth to +2.1% in 2013, and +3.5% in 2014. The countries of the ASEAN5 (Thailand, Malaysia, Indonesia, the Philippines, Vietnam) should be able to maintain its pace of growth at the 5%-level (+5.1% in 2013, and +5.3% in 2014) on the back of solid domestic demand.

In India, despite the slowdown of economic growth to +5.0% in 2013 due to the lingering effect of monetary tightening, growth in 2014 should rise to +6.2% driven by an expected recovery of domestic demand.

As for the Australian economy, the rate of real GDP growth should stand at +2.7% in 2013 due to fiscal austerity. In 2014, growth is predicted to rise slightly to +3.0% on the back of the recovery of exports and investment.

The Brazilian economy is currently showing signs of stagnation due to the weakness of investment. Given the impact of the government’s economic stimulus measures, the rate of real GDP growth should gradually pick up, reaching +2.9% in 2013 and +3.5% in 2014.

Even though the pace of Russia’s real GDP growth is forecast to stand at +3.0% in 2013 due to the decline in price of crude oil and other factors, the pace of growth should rise to +4.0% in 2014 due to factors such as the recovery of investment.

Turning to Japan, the economy is expected to climb out of recession and maintain growth of +1.0% in 2013, due in part to the Abe administration's *Emergency Economic Measures for the Revitalization of the Japanese Economy*. Even though domestic demand may dip temporarily due to the impact of the consumption tax hike in 2014, the economy should avoid a loss of momentum, given its support by external demand reflecting the depreciation of the yen and overseas economic recovery. Real GDP growth is forecast to rise to +1.4% in 2014.

Uncertainties will linger in connection with US fiscal conditions, the eurozone debt crisis, and the sustainability of the Chinese economy

For the time being, a sharp fiscal tightening in the US has been avoided and the risk of materialization of a drastic event such as the collapse of the euro has receded due to an agreement for additional support toward Greece in November 2012 among other factors. The recovery of the Chinese economy is serving to push up exports and production of peripheral Asia countries, leading to the spread of confidence regarding the future course of the global economy.

Even so, there is still the possibility of a US government bond downgrade and financial market turmoil due to an imbroglio surrounding the issue of raising the US government debt ceiling. Furthermore, the general election in Italy at the end of February and the political uncertainties in Spain stemming from allegations of illicit contributions to the ruling party may serve to intensify the concerns regarding the eurozone debt crisis. Moreover, note that there are uncertainties regarding the pace and sustainability of China's economic recovery in view of its need to adjust its excessive investments over the medium-term horizon. Despite the spread of sanguine views in the financial and capital markets over the world, it will be necessary to keep a close eye on these risk factors.

III. The Japanese economy

(1) The current state of the economy

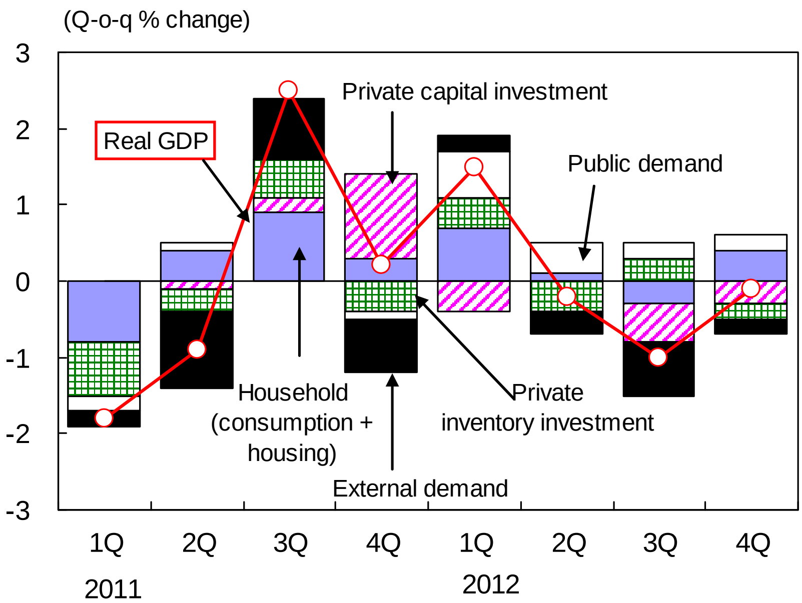
The Japanese economy contracted for the third consecutive quarter in the Oct-Dec quarter of 2012 as exports continued to fall sharply

According to the *First Preliminary Quarterly Estimates of GDP (1st QE)* for the Oct-Dec quarter of 2012, Japan's real GDP contracted for the third quarter in a row (-0.1% q-o-q, or -0.4% in annualized terms) (**Chart 5**).

The contraction stems primarily from the sharp fall of exports (-3.7% q-o-q) in the Oct-Dec quarter of 2012 as in the previous quarter from July to September. Despite signs of an upturn of the overseas economies, it did not lead to an upturn of exports from Japan as of the Oct-Dec quarter of 2012. On the other hand, as a result of the fall of imports (-2.3% q-o-q) along with domestic output cuts within Japan, the breadth of the negative contribution by external demand to quarterly real GDP growth turned out to contract from -0.7% pt in the Jul-Sep quarter to -0.2% pt.

Domestic private demand stood at -0.2% q-o-q (contribution: -0.1% pt). Personal consumption took an upturn, rising +0.4% q-o-q, given the gradual recovery of automobile purchases from the downturn following the termination of the government subsidies for purchases of fuel-efficient cars (the "Eco-car subsidies") and the increase in purchases of winter clothing items due to the exceptionally cold winter weather. Housing investment also continued to grow strongly (+3.5% q-o-q) due in part to a last-minute rush of housing starts prior to the deadline for construction starts of housing under the Eco-point program for housing (October 2012). On the other hand, capital investment fell sharply (-2.6% q-o-q) and the contribution by private inventory investment also turned negative (-0.2% pt) due to the more cautious corporate behavior mainly among

[Chart 5: Japan's quarterly real GDP growth]



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

manufacturers.

Meanwhile, public demand grew +0.7% q-o-q (contribution: +0.2% pt), continuing to expand for the fourth quarter in a row. Given the progress of public works related to post-earthquake reconstruction, public investment continued to rise, growing +1.5% q-o-q. Government consumption also continued to grow at a gradual pace (+0.6% q-o-q). Domestic demand – combining both private and public demand – grew +0.1% q-o-q (contribution: +0.1% pt), marking a slight upturn for the first time in two quarters.

(2) Outlook on the Japanese economy in FY2012, FY2013 and FY2014

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

Although the Japanese economy continued to contract for three quarters in a row up to the Oct-Dec quarter of 2012, it appears that Japan has already emerged out of recession. Judging from the rise of industrial production in December 2012 (+2.5% m-o-m) and plans to increase output in both January and February of 2013, the odds are high that the latest recession presumed to have started in March 2012 has ended in November 2012 (the recession and the timing of the peaks and troughs of the business cycle may change going forward due to changes in seasonal adjustments and annual revisions of statistical data).

In the Jan-Mar quarter of 2013, exports are forecast to take an upturn, reflecting the recovery of overseas economies such as China. In addition to the ongoing rise of public investment reflecting the implementation of reconstruction works, personal consumption should continue to expand amid the upturn of car sales on a quarterly basis due to a gradual rise of sales from the slump after expiration of the Eco-car subsidies. The pace of growth should rise into positive territory for the first time in a year in the Jan-Mar quarter of 2013.

Having said so, the slump up to the Oct-Dec quarter of 2012 will serve as a drag, keeping the rate of FY2012 real GDP growth at +0.8%.

FY2013 real GDP growth: +2.1%. Public demand will drive growth in the first half of the fiscal year and a last-minute rush of demand will serve as the driver in the second half

In the first half of FY2013 (the Apr-Jun and Jul-Sep quarters), the full-fledged implementation of the additional public works projects in the *Emergency Economic Measures for The Revitalization of the Japanese Economy* (Cabinet Decision on January 11, 2013) should lead to a further rise of public investment. Given the additional public works worth more than JPY5 trillion in the *Emergency Economic Measures*, simulations by MHRI estimate that it would push up real GDP by a total of +1.1% pt. However, given the expected larger-than-usual carry-over of the public works earmarked in the FY2013 initial budget to FY2014, the net increase of public investment in FY2013 would be around JPY3 trillion (0.6% of GDP). Although we expect private domestic demand to follow a recovery path from the Jan-Mar quarter, the growth of personal consumption should turn out to be mild since an increase of summer bonus payments is unlikely due to the weak corporate earnings in FY2012. On the other hand, manufacturers which have taken a cautious stance toward investment thus far are expected to gradually resume investment, leading to an upturn of capital investment. Moreover, the sustained recovery of overseas economies such as China and the depreciation of the yen should gradually lead to the rise in volume of exports over the summer months.

In the second half of FY2013 (the Oct-Dec quarter of 2013 and the Jan-Mar quarter of 2014), the last-minute rush of demand prior to the consumption tax hike should serve to push up domestic demand. In the run-up to the consumption tax hike (5% → 8%) in April 2014, the generation of a last-minute rush of demand mainly with respect to personal consumption and housing investment should serve as the driver of growth in the second half of FY2013. MHRI estimates that the last-minute demand generated would be a little less than JPY3 trillion (0.6% of GDP). Furthermore, the faster pace of export growth stemming from a slight acceleration of the economic recovery among the eurozone and US economies in the second half of FY2013 should also serve as an upside factor for Japan's economic growth. Capital investment is also predicted to grow at a faster pace in the second half of the fiscal year due to the recovery of corporate business earnings. In contrast, even though public investment will remain at a high level, the pace of increase should level out in the second half of the fiscal year.

As a result, the rate of real GDP growth in FY2013 is forecast to accelerate to +2.1% (January forecast: +2.0%).

FY2014 real GDP growth will fall to +0.4% but avoid slipping into recession

In the Apr-Jun quarter of 2014, a sharp contraction of growth into negative territory may not be avoided due to a backlash to the last-minute rush of demand. Even so, the Japanese economy is forecast to return to a gradual recovery path from the Jul-Sep quarter and avoid a slide into recession. The rise of exports reflecting the rise of overseas economic growth and the weak yen will serve to prop up the economy. On the other hand, if Japan attempts to achieve its fiscal rehabilitation goal (halve the FY2015 primary balance deficit from FY2010), it would be difficult to increase its public works expenditures from FY2014 onward, and hence lead to a gradual decline of public investment throughout the year. As a result, the rate of FY2014 real GDP growth is forecast to fall sharply to +0.4%.

[Chart 6: Outlook on the Japanese economy]

		2011	2012	2013	2014	2012		2013				2014				2015
		FY				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	0.3	0.8	2.1	0.4	-1.0	-0.1	0.4	0.7	0.9	0.9	1.1	-1.8	0.5	0.4	0.6
	Q-o-q % ch p.a.	--	--	--	--	-3.8	-0.4	1.4	3.0	3.7	3.5	4.7	-6.9	1.9	1.8	2.3
Domestic demand	Q-o-q % ch	1.3	1.7	1.9	-0.3	-0.3	0.1	0.2	0.6	0.7	0.7	1.0	-2.0	0.3	0.3	0.4
Private sector demand	Q-o-q % ch	1.4	0.9	1.4	-0.6	-0.6	-0.2	0.1	0.4	0.5	0.9	1.3	-2.7	0.4	0.4	0.5
Personal consumption	Q-o-q % ch	1.5	1.4	1.4	-1.3	-0.5	0.4	0.1	0.2	0.2	0.7	1.9	-3.6	0.5	0.2	0.2
Housing investment	Q-o-q % ch	3.7	4.2	6.4	-7.9	1.6	3.5	-1.9	1.6	5.3	1.9	-3.7	-9.5	0.7	1.6	4.8
Capital investment	Q-o-q % ch	4.1	-1.9	1.8	2.6	-3.6	-2.6	0.4	1.2	1.7	1.7	1.0	0.1	0.3	0.4	0.6
Inventory investment	Q-o-q contribution, % pt	-0.5	-0.1	-0.1	0.2	0.3	-0.2	0.1	-0.0	-0.1	-0.1	-0.2	0.4	-0.1	0.1	0.0
Public sector demand	Q-o-q % ch	0.9	4.5	3.5	0.8	0.8	0.7	0.6	1.2	1.4	0.2	0.1	0.1	0.1	0.0	0.2
Government consumption	Q-o-q % ch	1.5	2.5	1.6	1.9	0.4	0.6	0.5	0.3	0.3	0.4	0.3	0.5	0.5	0.5	0.6
Public investment	Q-o-q % ch	-2.3	14.2	11.8	-4.1	2.5	1.5	1.1	5.1	6.1	-0.4	-0.8	-1.5	-1.8	-2.2	-1.4
External demand	Q-o-q contribution, % pt	-1.0	-0.9	0.1	0.7	-0.7	-0.2	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.2
Exports	Q-o-q % ch	-1.6	-2.5	1.6	5.4	-5.1	-3.7	1.0	1.3	1.8	2.0	2.0	0.8	0.9	1.1	1.2
Imports	Q-o-q % ch	5.3	3.4	0.7	0.9	-0.5	-2.3	0.2	0.5	0.7	1.0	1.1	-0.5	-0.3	0.1	0.2
GDP (nominal)	Q-o-q % ch	-1.4	0.2	1.7	0.8	-1.1	-0.4	0.6	0.7	0.5	0.4	1.7	-0.3	-0.6	-0.5	1.0
GDP deflator	Y-o-y % ch	-1.7	-0.6	-0.4	0.3	-0.8	-0.6	-0.5	-0.3	-0.6	-0.7	-0.2	1.1	0.5	0.0	-0.2
Domestic demand deflator	Y-o-y % ch	-0.5	-0.7	-0.6	0.6	-0.9	-0.7	-0.4	-0.1	-0.3	-0.9	-0.9	-0.1	0.4	0.9	1.1

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

		2011	2012	2013	2014	2012		2013				2014				2015
		FY				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	-1.0	-2.7	4.4	-0.4	-4.2	-1.9	3.2	1.6	1.8	1.9	1.0	-2.2	-1.0	0.5	0.9
Ordinary profits	Y-o-y % ch	-2.0	6.2	9.3	0.6	6.4	-2.5	6.5	10.5	11.4	9.4	6.7	-6.5	1.7	6.0	1.8
Nominal labor compensation	Y-o-y % ch	0.6	-0.2	0.2	0.7	0.1	-0.6	0.0	0.0	0.2	0.3	0.1	0.7	0.6	0.6	0.6
Unemployment rate	%	4.5	4.2	3.9	3.8	4.2	4.2	4.1	4.0	3.9	3.8	3.7	3.8	3.8	3.7	3.7
New housing starts	P.a., 10,000 units	84.1	88.9	94.1	86.0	87.6	91.8	88.3	90.8	96.4	97.8	90.7	84.4	84.9	86.2	88.8
Current account balance	P.a., JPY tril	7.6	4.1	6.3	8.7	3.8	3.0	3.9	3.2	4.3	7.8	10.5	11.9	8.2	6.9	8.7
Domestic corporate goods prices	Y-o-y % ch	1.4	-0.9	0.6	3.4	-1.9	-0.8	0.0	1.1	0.9	0.7	-0.2	2.2	3.3	3.8	4.3
Consumer prices	Y-o-y % ch	0.0	-0.1	-0.1	1.9	-0.2	-0.1	-0.2	-0.0	0.0	-0.0	-0.3	1.5	1.8	2.1	2.3
Uncollateralized overnight call rate	%	0.08	0～0.10	0～0.10	0～0.10	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	%	1.05	0.81	0.90	1.05	0.78	0.76	0.81	0.90	0.85	0.85	0.90	0.90	0.95	1.10	1.15
Nikkei average	JPY	9,181	9,600	11,600	12,000	8,886	9,234	11,200	11,700	11,500	11,500	11,800	11,600	11,900	12,100	12,300
Exchange rate	JPY/USD	79.0	83.0	93.0	94.0	79.0	81.0	92.0	94.0	92.0	92.0	93.0	93.0	94.0	94.0	95.0
Crude oil price (WTI nearest term contract)	USD/bbl	97.0	92.0	85.0	93.0	92.0	88.0	95.0	92.0	85.0	80.0	83.0	87.0	93.0	96.0	95.0

Notes: 1. Figures in the shaded areas are forecasts.The readings above may differ from public releases because the rates of change are calculated based upon actual results.
2. Ordinary profits are based upon the *Financial Statements Statistics of Corporations by Industry* (all industries) (ex finance & insurance, and production, transmission and distribution of electricity services).
3. Consumer prices exclude fresh food (2010 base).
4. Quarterly data on the unemployment rate, new housing starts and current account balance are seasonally-adjusted.
5. Of the finance-related indices, the uncollateralized overnight call rate refers to the rate at the end of term and all others are averages during the relevant terms.

Sources: Made by MHRI based upon Cabinet Office, Preliminary Quarterly Estimates of GDP, Ministry of Economy, Trade and Industry, *Indices of Industrial Production*, Ministry of Finance, *Financial Statements, Statistics of Corporations by Industry, Quarterly*, Ministry of Internal Affairs and Communications, *Labor Force Survey, Consumer Price Index*, Ministry of Land, Infrastructure, Transport and Tourism, *Current Survey on Construction Statistics*, Bank of Japan, *Balance of Payments*, *Corporate Goods Price Index*, *Financial and Economic Statistics Monthly, Foreign Exchange Rates*, Japan Bond Trading Co., Ltd., *Latest Daily JGB Rates*, Nikkei Inc. and Bloomberg.

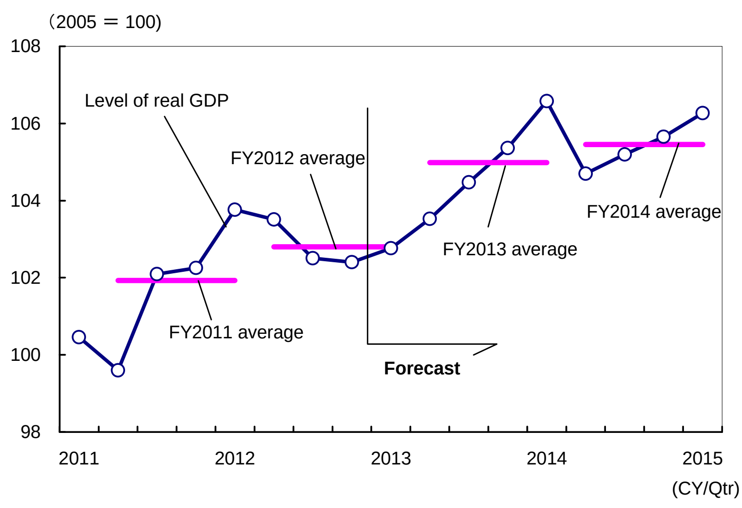
An exit out of deflation is unlikely during FY2014

While the foregoing is our main scenario of our latest outlook, **Chart 7** sets forth the level of real GDP on the basis of this scenario. Even though the excess of supply in Japan's output gap (the gap between actual GDP and potential GDP) exceeding 2% in FY2013, is set to contract, the gap is predicted to widen again because of a sharp decline of economic activity in the Apr-Jun quarter of 2014 due to a backlash to the last-minute rush of demand. The core CPI excluding the impact of the consumption tax hike (the general consumer price index excluding fresh food) should remain around zero up to FY2014 and an exit out of deflation is unlikely during FY2014. Our forecasts on the year-on-year change of the core CPI are -0.1% in FY2012, -0.1% in FY2013, and +1.9% in FY2014 (-0.2% when eliminating the impact of the consumption tax hike).

An exit out of deflation will be sometime after FY2016

The Abe administration's three-pronged economic policy measures comprised of bold monetary easing, flexible fiscal spending and growth strategy stimulating private investment (dubbed "Abenomics") is the cause of the recent depreciation of the yen and rise of the stock market. Of the three prongs, Abenomics has started moving in the form of requests for an inflation target toward the Bank of Japan in terms of monetary policy, and the *Emergency Economic Measures* in terms of fiscal spending. Thus far, Abenomics has been well-received by the market. However, it would be difficult for fiscal spending to keep driving demand from FY2014 and beyond. The success or failure of Abenomics would depend on whether the third prong – namely growth strategy – will be able to generate expectations toward the sustained growth of demand and improvement of the output gap and lift the expected rate of inflation through a synergetic effect with monetary policy. While an exit out of deflation will come into view if Abenomics can jump-start such a virtuous cycle, this would be a process taking years to be achieved. In particular, the growth strategy may face difficulties to be effective during FY2014 and FY2015 when demand will be restrained by the consumption

[Chart 7: Trends in real GDP]



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

tax hike. Even if the growth strategy is successful, an exit out of deflation will only come into view from FY2016 onward. Considering the persistence of deflation since the second half of the 1990s, it is no easy task to put an end to deflation in a matter of one or two years. The government and the Bank of Japan will need to engage in the formulation and implementation of a growth strategy and take steps for monetary easing over the medium to long-term.

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