FY2013 and FY2014 Economic Outlook

November 15, 2013

<The US Economy >

◆ **Even though the fall of government spending will serve as a drag, private-sector demand will hold up well due to the progress of household balance sheet adjustment. Payrolls will also grow steadily**

2013: +1.7% (forecast in September +1.5%)
2014: +2.3% (forecast in September +2.2%)

<The Eurozone Economy >

◆ **Downward pressures from fiscal conditions should ease slightly. However, eurozone growth is forecast to remain under 1% in 2014, given the ongoing slump among southern European countries**

2013: -0.4% (forecast in September -0.3%)
2014: +0.9% (forecast in September +0.8%)

<The Asian Economy >

◆ **Despite forecasts of a gradual export-led economic recovery, the rate of China's economic growth is forecast to slow down due to constraints upon excessive investment**

2013: +5.9% (forecast in September +5.8%)
2014: +5.9% (forecast in September +5.8%)

<The Japanese Economy >

◆ **In the second half of the fiscal year, a rush of demand prior to the consumption tax hike will serve as the driver of the economy**

FY2013: +2.6% (forecast in September +2.9%)

◆ **Despite a temporary dip due to the impact of the consumption tax hike, external demand will prop up the economy**

FY2014: +0.8% (forecast in September +0.7%)

I. The Chief Economist's View

Abenomics will reach a crucial stage during the next six months

Is Abenomics only about weakening the yen and lifting the stock market?

"Abenomics doesn't have any impact upon the real economy", "it's only froth whipped up by expectations toward the stock market", "it isn't spreading to outlying areas" – these are comments which I always receive on visits to various parts of Japan. Approximately a year has passed since Abenomics started to gather attention in mid-November last year. In the interim, the yen weakened by approximately 20% and the stock market surged. Given the impact of the monetary easing comprising the "first arrow", consumer confidence rose along with the rise of the stock market, and the depreciation of the yen brought about a significant improvement of corporate earnings. In addition to the expansion of consumer spending, domestic demand also rose mainly in the non-manufacturing sector driven by the expansion of public spending accompanying the "second arrow" consisting of fiscal measures. This recent pattern of economic revival is noteworthy, considering that the Japanese economy was driven by exports (external demand) in past recovery cycles.

Meanwhile, corporate enterprises have not yet staged a full-scale lift-off of wages, given the limited rise of exports despite the weakness of the yen. Demand for loans remains anemic and the recovery of capital investment is still sluggish. Comments on Abenomics that "it's just froth (expectations) driven only by the weak yen and stock market", or that "it's only a false flower bearing no real fruit" are a reflection of these conditions. Therefore, there are persistent views that Abenomics will lose steam when public demand runs out. Reflecting the weak demand for funds among corporate enterprises, lending rates have fallen to historical lows due to the supply-demand balance for funds. Given the weak demand for loans, long-term interest rates fell to the lowest level in six months in early November since financial institutions had no other option but to invest in government bonds. These conditions may continue during FY2013 (to the end of March 2014).

Corporate enterprises have evolved into "herbivores" due to the deflationary balance during the past two decades

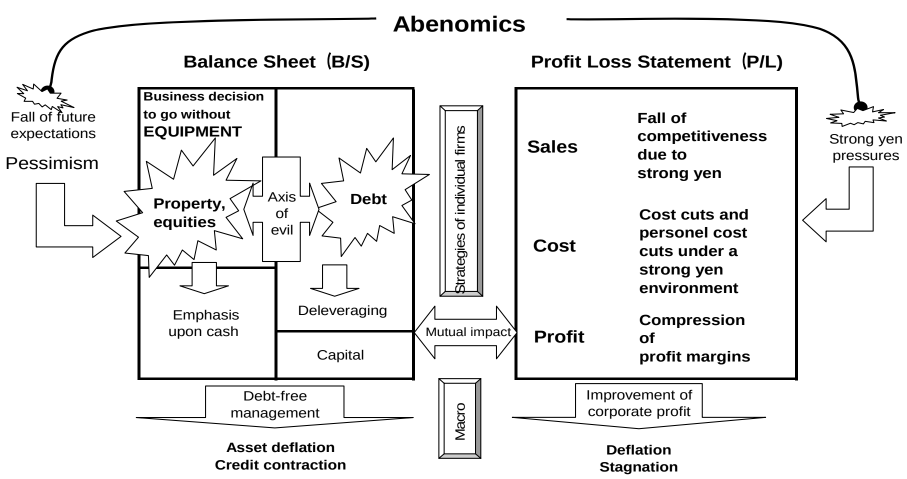
Despite the Bank of Japan's (BOJ) efforts to boost lending through "extraordinary monetary easing", and efforts among financial institutions to expand their lending, demand for loans would not be generated without action on the part of corporate enterprises. **Chart 1** is a diagrammatic representation showing how the financial strategy for survival among corporate enterprises in the aftermath of the bubble economy in the 1990s onward led to the stagnation of lending and investment, fall of wages and deflation. The foregoing process developed along with the practice (evolution) of corporate practices in their management of balance sheets (B/S) and profit-loss statements (P/L) over the years. These conditions evolved amid the downshift of future expectations in the balance sheet adjustment process from the 1990s: (1) the compression of both assets in debts in balance sheets and (2) in terms of profit-loss statements, the continuation of restructuring pressures reflecting concerns regarding the strong yen. Furthermore, these developments led to a deflationary balance among corporate enterprises during the past two decades, transforming corporate enterprises into “herbivores”.

A certain length of time (in terms of “fiscal years”) would be necessary for an evolution from an “herbivore mentality” and expansion of investment and wages

The result of the financial behavior of corporate enterprises accompanying the foregoing “herbivore evolution” is the stagnation of lending, investment and wages. However, note that this was simply rational corporate behavior as “herbivores” to lower their expectations in order to survive under an environment of asset deflation and yen appreciation during the past two decades. The difficulty to emerge out of deflation stems from the difficulty to normalize the deeply entrenched “herbivore” bias in corporate decision-making. The condition may be likened to “damp logs”. If such behavioral bias is premised upon asset deflation and the persistent strength of the yen, a shift in these premises as a result of Abenomics during the past year should lead to a slightly more positive corporate behavior.

Having said so, a certain length of time would be necessary for changes in the corporate decision-making process. As a broad rule of thumb, it would take the passage of a fiscal year to formulate and decide upon a program. Considering that Abenomics was set into motion in the second half of FY2012, there has not been enough time to set forth positive investment decisions during FY2013. Signs of positive corporate behavior would only become evident some time in FY2014 subsequent to the revision of the program for the second half of FY2013. Generally speaking, emergency actions in response to crisis situations such as restraints upon investment may be implemented immediately. In contrast, shifts

Chart 1: Diagrammatic representation of the competition of survival in the aftermath of the Bubble

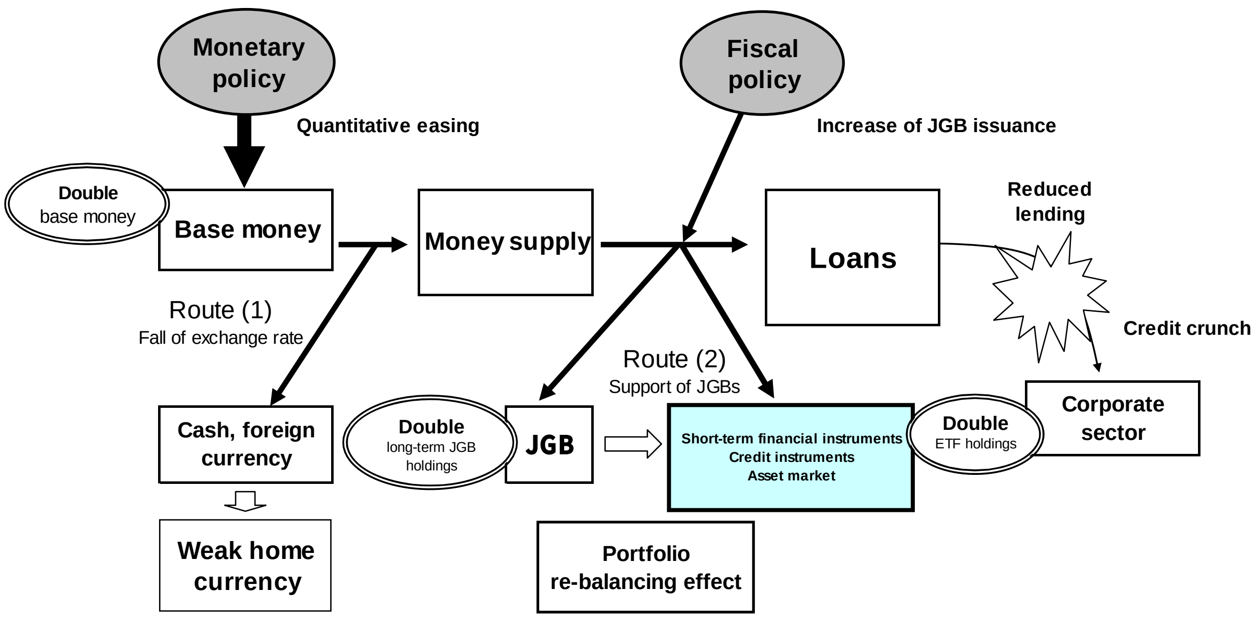


Source: Mizuho Research Institute Ltd. (MHRI) in policy stance toward positive investment and rise of wages would require time in terms of “fiscal years”. Note the existence of such “asymmetric nature” in the decision-making bias.

The impact of monetary policy: yen-weakening and portfolio re-balancing

Chart 2 sets forth a diagrammatic representation of the flow of funds under the BOJ’s current monetary policy. The “extraordinary monetary easing” in April 2013 doubles the amount of base money and expands the supply of funds under quantitative easing from the entrance of fund flows on the left-hand side of the chart. Its impact is the weakening of the yen through Route 1 and investment in government bonds through Route 2, and furthermore the rise of asset prices through the portfolio re-balancing effect. If the primary objective of monetary policy is the expansion of lending, Route 1 and Route 2 would be mere “side effects”. However, by placing stress upon the by-product - raising the temperature of the overall economy through its impact and thus laying the groundwork for the expansion of loans - such a roundabout path would lead to the rise of price levels. At the same time, the yen-weakening effect and rise of asset prices would contribute to the shift of the premises in **Chart 1**, leading to a shift of corporate behavior in their management of balance sheets and profit-loss statements. However, the process would take time in spans of “fiscal years” and would also require the rise of asset prices through an aggressive portfolio re-balancing effect. While it is true that Abenomics depends upon the stock market and real estate market, it comprises an important warm-up period to “dry the logs which have dampened in the course of the evolution into herbivores”. Thus far, the economic recovery faded prematurely before the “logs dried”, and as a result, led to a pessimistic frame of mind that “nothing would ever work”.

Chart 2: Diagrammatic representation of money flows under “extraordinary monetary easing”



Source: MHRI

Abenomics needs all its tools to dry the "damp logs" in the second half of FY2013

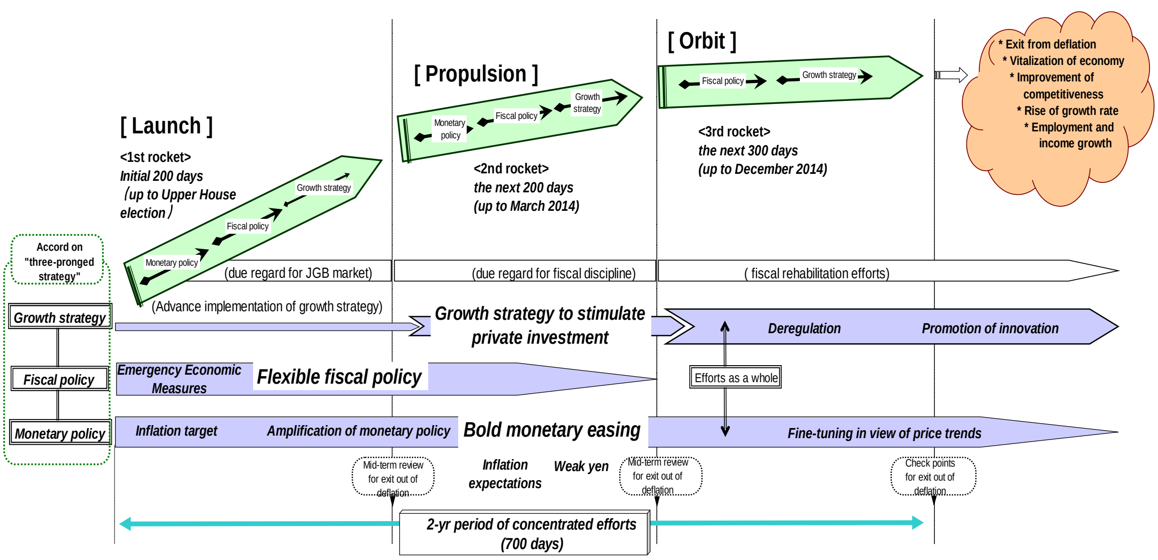
As shown in **Chart 2**, funds are not reaching corporate enterprises even with the implementation of "extraordinary monetary easing". It has only boosted the price of stocks and assets as a result of the Abenomics' by-products – namely the weak yen and portfolio re-balancing effect. While this provides reason for claims that Abenomics is "nothing but future expectations", it should be noted that the weak yen and spread of sentiment toward a better future driven by the rise of the stock market provide an essential step for corporate behavior to shift from an herbivore mentality as depicted in **Chart 1** and for funds to reach the corporate sector as shown in **Chart 2**. Therefore, Abenomics will reach a crucial stage in the second half of FY2013, namely whether it can "dry the logs" or whether the logs will stay damp and never be lighted. Given that the Japanese economy faces a major hurdle from April 2014 due to the consumption tax hike, Abenomics will need to utilize all its tools to "dry the logs" and to set it alight.

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

Chart 3 depicts the roadmap of the Abe administration's "three-step rocket strategy for an exit from deflation" using "three arrows (prongs)" in order to realize a shift of sentiment from the "lost two decades". This sets forth the tasks to be tackled through the cooperation between the government and the BOJ during the two years in 2013 and 2014 deemed as the period of concentrated efforts for an exit out of deflation.

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

Chart 3: The "three-step rocket strategy for exit from deflation" using three arrows



Source: MHRI

(1) The first rocket (Launch Phase): turnaround of sentiment through monetary & fiscal measures and currency exchange strategy, upturn of sentiment toward a lift-off

(2) The second rocket (Propulsion Phase): shift to a Growth Strategy while continuing to implement monetary and fiscal measures

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

In the second rocket, the government needs to use all of the three arrows to dry the "damp logs"

As the Japanese economy currently stands in the "Propulsion Phase" of the second rocket, it faces the task of passing the torch to the "Orbit Phase" of the third rocket. Moreover, given the consumption tax hike in April 2014, the rocket may not avoid a temporary slowdown. Thus, the second rocket will need to gather considerable momentum for the smooth passage of the torch to the third rocket. Using the foregoing metaphor, the "damp logs" will have to be thoroughly dry for a successful lighting of the third rocket.

MHRI's outlook on the year 2014 is based upon an US-led recovery, with US real GDP forecast to grow 2.3% in 2014 and reach the upper half of the 2%-level in 2015. In this process, given the Federal Reserve Board's (FRB) bias toward tapering its quantitative easing measures (QE3), the gap in bias in monetary policy of Japan and the US should lead to a further weakening of the yen. Our outlook that the third rocket in **Chart 3** will shift into cruise (orbit) in FY2014 is based upon the continuation of the US-led improvement of the external environment.

The inability of the Japanese economy to emerge out of the "lost two decades" due to balance sheet adjustment since the 1990s stems from its inability to dry the "damp logs" of corporate sentiment during intermittent recovery cycles and was never able to "set light to the logs" (realize a turnaround of corporate sentiment) while the recovery lasted. Hence, we surmise, the Japanese economy fell into a spiral of further despair. In the second half of FY2013, the second rocket in **Chart 3** will need to use all its tools (policy measures) to "dry the damp logs". **Chart 4** sets forth the measures of the three arrows in the second rocket.

Chart 4: Policy responses of the "three arrows" in the second rocket (up to the end of March 2014)

	Policy measures
1st Arrow: monetary policy	Additional monetary easing measures during FY2013 (quantitative easing, expansion of ETFs and REITs)
2nd Arrow: fiscal policy	Effective implementation of the new economic stimulus package (JPY5 trillion) scheduled in December 2013
3rd Arrow: Growth Strategy (structural reforms)	Clear commitment to the reduction of corporate tax rates, expression of a symbolic stance toward Growth Strategy in addition to trade policies such as the TPP

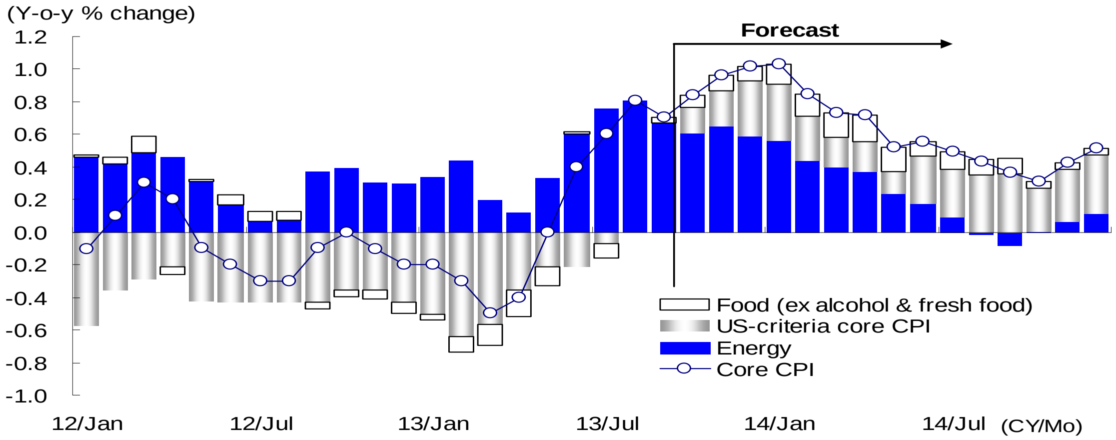
Source: MHRI

Japan, US and Europe: lift asset prices through a policy mix of fiscal tightening and monetary easing

Chart 5 sets forth Japan's consumer prices and its monthly outlook. Looking forward, the percentage rise of consumer prices are forecast to reach the 1%-level for three consecutive months from November 2013 to January 2014 and subsequently decline to the 0%-level from February 2014. Within the context of taking a comprehensive approach to shoot all three arrows in the second rocket, it would be far more effective on the part of the BOJ to implement further easing measures during FY2013 (Jan-Mar 2014) so as to provide a further nudge to prices which have risen to around 1% rather than having to ease further when prices start to fall.

On a global level, the consensus is moving back to a prolonged monetary easing scenario. The tapering of QE3 initially expected during 2013 is now expected to be postponed to sometime after March 2014 and the pace of tapering is predicted to be gradual. In Europe, the ECB took further monetary easing measures in November after the CPI fell to +0.7% in October (the so-called "CPI Shock"). The basic policy mix around the world is the continuation of monetary easing amid a bias toward fiscal tightening. Under these conditions, asset prices around the world are prone to upward pressures, most notably among the developed countries. Japan is currently in the phase of the second rocket – a critical juncture in which its economy must gather momentum and "dry the damp logs" given the rise of asset markets accompanying the global monetary easing and weakening of the yen, and to pass the torch to the third rocket. To stop now, all the efforts during the past year will go to a waste.

Chart 5: Japan's core CPI (monthly forecast, ex impact of consumption tax hike)



Sources: Ministry of Internal Affairs and Communications, MHRI

Hajime Takata, Chief Economist

II. The global economy

A tepid recovery of the global economy in the Jul-Sep quarter of 2013

In the Jul-Sep quarter of 2013, mixed results in various parts of the world combined together resulted in an overall tepid picture of the global economy.

The US economy grew at a slightly faster pace of +2.8% q-o-q p.a. in the Jul-Sep quarter (Apr-Jun quarter: +2.5% q-o-q p.a.) (**Chart 6**). However, a closer look revealed a somewhat worrying picture that growth was driven largely by inventory investment and that the pace of personal consumption and capital investment slowed down.

Even though eurozone real GDP grew +0.4% q-o-q p.a. in the Jul-Sep quarter of 2013, recording growth in positive territory for the second quarter in a row, the pace of growth slowed down from the Apr-Jun quarter (+1.1% q-o-q p.a.)

In contrast, China's real GDP grew at a faster pace of +7.8% y-o-y for the first time in three quarters in the Jul-Sep quarter (Apr-Jun quarter: +7.5% y-o-y). Even though export growth turned out to be more or less on par with the Apr-Jun quarter and that consumer spending slowed down, it appears that investment in fixed assets rose mainly in connection with infrastructure.

[Chart 6: Real GDP growth of major countries and areas]

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

	2012				2013		
	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Oct	Jan-Mar	Apr-Jun	Jul-Sep
US	3.7	1.2	2.8	0.1	1.1	2.5	2.8
Eurozone	-0.4	-1.2	-0.5	-2.0	-0.9	1.1	0.4
Japan	5.1	-0.8	-3.7	0.6	4.3	3.8	1.9
South Korea	3.3	1.2	0.2	1.1	3.4	4.5	4.3
Taiwan	5.7	-0.0	3.0	7.1	-2.5	2.3	0.4
Hong Kong	1.0	-0.4	4.3	5.7	0.9	3.2	
Singapore	7.8	0.1	-4.6	3.3	2.3	16.9	-1.0
Thailand	53.7	10.1	7.9	11.4	-6.5	-1.4	
Malaysia	7.3	5.1	4.0	9.2	-1.4	5.5	
Philippines	9.7	5.4	7.0	7.8	9.6	5.7	
Australia	5.4	1.9	3.2	2.7	2.2	2.4	
(Y-o-y % change)							
China	8.1	7.6	7.4	7.9	7.7	7.5	7.8
Indonesia	6.3	6.4	6.2	6.1	6.0	5.8	5.6
Vietnam	4.6	4.8	5.1	5.4	4.8	5.0	5.5
India	5.1	5.4	5.2	4.7	4.8	4.4	
Brazil	0.7	0.4	0.9	1.4	1.9	3.3	
Russia	4.8	4.3	3.0	2.1	1.6	1.2	1.2

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

In other parts of Asia (ex China), the South Korean economy maintained growth at the 4%-level and the growth of the Vietnamese economy picked up. On the other hand, Taiwan's economic growth stood at virtually zero and the Singapore economy fell into negative territory, resulting in mixed growth across the region.

Under these conditions, Japan's real GDP growth slowed to +1.9% q-o-q p.a. in the Jul-Sep quarter (Apr-Jun quarter: +3.8% q-o-q p.a.) due mainly to the decline of exports.

The global economy should pick up in 2014

The global economy (the weighted average of all the countries and areas within the scope of MHRI's economic forecast) is forecast to grow around +2.9% in 2013, slowing down from +3.2% in 2012 (**Chart 7**). In addition to the US economic slowdown due to factors such as the government spending cuts, eurozone growth is also expected to remain in negative territory. Even though the emerging economies should continue to grow at a mild pace, the moderation of the economies of China, India and Russia will keep the pace of global growth subdued. Despite the ongoing moderation of the Chinese economy in 2014, growth is forecast to pick up mainly among the developed economies due to the fading impact of fiscal tightening. The global economy in 2014 should grow +3.3%, driven mainly by the upturn of growth among the US and European economies due to the progress of their balance sheet adjustment processes.

[Chart 7: MHRI outlook on the global economy]

			(Y-o-y % change)		(Y-o-y % change)	
Calendar year	2011	2012	2013	2014	2013	2014
	(Actual)	(Actual)	(Forecast)	(Forecast)	(Previous: Sep forecast)	
Total of forecast area	3.8	3.2	2.9	3.3	2.8	3.3
Japan, US, Eurozone	1.4	1.4	0.9	1.7	0.9	1.6
US	1.8	2.8	1.7	2.3	1.5	2.2
Eurozone	1.6	-0.6	-0.4	0.9	-0.3	0.8
Japan	-0.6	1.9	1.8	1.5	2.0	1.6
Asia	7.5	6.1	5.9	5.9	5.8	5.8
NIEs	4.1	1.7	2.5	3.0	2.3	3.0
ASEAN5	4.4	6.1	4.8	4.8	4.9	4.9
China	9.3	7.7	7.6	7.3	7.4	7.2
India	7.5	5.1	4.5	4.7	4.5	4.7
Australia	2.4	3.7	2.5	2.8	2.5	2.8
Brazil	2.7	0.9	2.4	2.0	2.3	2.0
Russia	4.3	3.4	1.8	3.2	2.5	3.5
Japan (FY)	0.3	1.2	2.6	0.8	2.9	0.7
Crude oil price (WTI, %/bbl)	95	94	98	96	101	96

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 stand at 1.7% in 2013. Even though the government spending cuts will serve as a drag upon growth, household balance sheet adjustment should progress, leading to the solid growth of private-sector final demand. While the government shutdown in October 2013 only has a benign impact upon the real economy, the Federal Reserve Board's (FRB) tapering of its quantitative easing measures (QE3) - amid concerns regarding fiscal conditions - may start later than initially expected and take place some time in the spring of 2014. As the impact of fiscal tightening fades in 2014, the rate of US real GDP growth should rise to +2.3%, given the ongoing solid growth of private-sector final demand.

Eurozone real GDP is forecast to contract for two years in a row in 2013 (-0.4%). Having said so, the pace of growth remained in positive territory in both the Apr-Jun and Jul-Sep quarters of 2013, indicating that the worst is over. The eurozone economy should record growth in positive territory for the first time in three years in 2014 when the impact of fiscal tightening eases. However, lingering downward pressures stemming from balance sheet adjustment in both the public and private sectors of the countries of southern Europe should keep the rate of real GDP growth below 1% at +0.9%.

In addition to the ongoing slowdown of the Chinese economy, the economies of India, Brazil and Russia are also forecast to soften

The Chinese economy is forecast to remain on a gradual downtrend in 2013 (7.6%) and 2014 (7.3%). Even though the rate of growth picked up slightly in the Jul-Sep quarter of 2013, the government is expected to keep its policy stance to wean its economy from investment. The slowdown of production accompanying the slower pace of investment should serve as a drag upon household income growth and lead to a slower pace of personal consumption growth. The pace of China's real GDP growth should gradually decline and trend around the lower half of the +7% y-o-y level in 2014.

The Indian economy will be compelled to take a fiscal austerity and monetary tightening stance in a bid to address persistent inflationary pressures stemming from the weakening of its currency from the end of May. The odds are low that the general elections scheduled in the spring of 2014 will lead to a stable government, making the progress of economic reforms unlikely. Hence, the Indian economy is forecast to keep growing around the 4%-level for two years in a row: 2013 (+4.5%), 2014 (+4.7%).

The Asian economies other than China and India should continue to follow a gradual expansion in both 2013 and 2014. The rate of growth among the NIEs (South Korea, Hong Kong, Taiwan, Singapore) should gradually pick up (+2.5% in 2013, and +3.0% in 2014) since the acceleration of growth in the US and Europe in 2014 should lead to the recovery of exports. On the other hand, the rate of real GDP of the ASEAN5 (Thailand, Malaysia, Indonesia, the Philippines, Vietnam) should keep growing around 5%: 2013 (+4.8%), and 2014 (+4.8%). However, Indonesia's growth may be dragged down by a tighter monetary policy stance in response to the rise of inflation stemming from the fall of the Indonesian Rupiah.

Turning to the Australian economy, the rate of real GDP growth is expected to remain at +2.5% in 2013 due to fiscal tightening. In 2014, growth is predicted to pick up slightly to +2.8% due to a slight mitigation of the downward pressures stemming from fiscal conditions, the impact of interest rate cuts by the Reserve Bank of Australia, and the recovery of exports

The Brazilian economy is showing signs of an upturn in its consumer spending-related indicators which deteriorated due to the anti-government demonstrations in June. However, investment is forecast to slow down due to the impact of its key interest rate hike in response to inflation concerns. The rate of Brazil's real GDP growth should reach +2.4% in 2013 and slow down to +2.0% in 2014.

The Russian economy is subject to the fall of crude oil prices and sluggish investment due to delays in projects related to natural resources and energy. The pace of real GDP growth is forecast to slow down to +1.8% in 2013. Given a high probability that the Central Bank of Russia will decide upon an interest rate cut by the end of this year, the rate of real GDP growth should rise to +3.2% in 2014 reflecting the effect of the interest rate cut and commencement of natural resource and energy-related projects.

Turning to Japan in 2013, the economy is expected to maintain growth of +1.8%, given the expansion of personal consumption reflecting the stock market recovery, upturn of exports due to the weak yen, and rise of public investment driven by the economic stimulus measures. Domestic demand such as personal consumption and housing investment may dip temporarily due to the impact of the consumption tax hike in 2014. Even so, the economy should avoid a loss of momentum, given the impact of the JPY5 trillion economic stimulus package released in October 2013, and support by external demand reflecting the weak yen and overseas economic recovery. In 2014, Japan's real GDP growth is forecast to stand at +1.5% in 2014.

The timing and pace of QE3 tapering and its impact upon the financial markets and global economy pose risks

The greatest risk to the global economy in 2014 is the timing of commencement and pace of tapering of QE3 in the US. From May onward, the rise of speculation that the FRB was nearing a decision to taper QE3 led to the rise of US long-term interest rates and outflow of funds from the emerging countries. Many of the emerging countries faced a "triple sell-off" of stocks, currency and bonds, prompting some countries to respond by raising interest rates.

Despite the escalation of views that the tapering of QE3 would start in September, the speculation temporarily ebbed due to the turmoil in the US Congress over the FY2014 budget and debt ceiling. At the moment, the emerging markets have regained stability along with the ebb of speculation on the tapering of QE3.

The US government shutdown in October only appears to have had a benign impact upon the real economy. Corporate business conditions and employment-related indicators are trending on firm grounds. Even though the outbreak of partisan clashes regarding the budget and government debt ceiling are unavoidable over the year-end, we are inclined toward the view that discussions on the fiscal crunch will be put off until the end of the midterm election (November 2014) and that the tapering of QE3 will start around the spring of 2014. In view of the developments in the first half of 2013, the FRB will likely taper its asset purchases at an extremely cautious pace. Furthermore, since the financial markets also appear to have factored in the tapering of QE3 in the near future, it is unlikely that the financial, capital and foreign exchange markets will be as volatile as in the first half of 2013.

Even so, we cannot rule out altogether the risk of a sharp rise of long-term interest rates or capital outflow from the emerging countries at some time in the course of the FRB's tapering of QE3. In comparison to conditions at the time of the Latin American Debt Crisis in the 1980s and Asian Currency Crisis in the 1990s, the emerging economies possess more foreign currency reserves than in the past, making them more resilient to currency crises. Thus, while the chances are slim that a significant capital exodus would occur and trigger a widespread currency/financial crisis, note that such risks may rise in certain countries facing large current account deficits and inflationary pressures.

A sharp downturn of the Chinese economy remains a concern

Even though the Chinese economy picked up slightly in the Jul-Sep quarter, China still possesses problems in its financial system, which is the reverse side of the coin of its structural dependence upon excessive investment. In the event credit risks materialize among sectors which have continued to invest heavily by funding from the so-called "shadow banks", the financial sector may fall into turmoil in the form of losses on high-yield financial instruments and rise of nonperforming loans. Moreover, this may have a negative effect upon capital investment and personal consumption, leading to the risk of a sharp slowdown of the Chinese economy. Note that a global stock market fall may ensue since the slowdown of the Chinese economy would have a negative impact upon the business results of global companies. Furthermore, it may also serve as a negative effect upon the real economy – primarily of the Asian countries possessing close trade relations with China.

In 2014, it would be necessary to keep a close eye upon how developments in the US and China - the two largest economies of the world – affect the global economy in terms of both the real economy and financial markets.

[Chart 8: Key political and economic events]

2013 Nov	Europe	ECB Governing Council meeting (7th) (0.25% rate cut)
	Japan	BOJ Monetary Policy Meeting (20th, 21st)
Dec	Europe	ECB Governing Council meeting (5th)
	Japan, ASEAN Summit meeting (Tokyo, 13th to 15th)	
	US	FOMC (17th, 18th)
	Japan	BOJ Monetary Policy Meeting (19th, 20th)
	Europe	EU summit meeting (19th, 20th)
2014 Jan	Europe	Latvia's adoption of the euro (1st)
	Europe	ECB Governing Council meeting (9th)
	US	Deadline of stop-gap budget (15th)
	Japan	BOJ Monetary Policy Meeting (21st, 22nd)
	US	FOMC (28th, 29th)
	US	End of term of office of FRB Chairman Ben S. Bernanke (31st)
Feb	US	Assumption of office of FRB Chairman Janet S. Yellen (1st)
	Europe	ECB Governing Council meeting (6th)
	US	End of debt ceiling exemption (7th)
	Sochi Winter Olympics (Russia, 7th to 23rd)	
	Japan	BOJ Monetary Policy Meeting (17th, 18th)
Mar	Europe	ECB Governing Council meeting (6th)
	Japan	BOJ Monetary Policy Meeting (10th, 11th)
	US	FOMC (18th, 19th)
	China	National People's Congress
2014 Apr-Dec	Japan	Consumption tax hike (5% → 8%, April 1st)
	Europe	ECB Governing Council meeting (April 3rd)
	Japan	BOJ Monetary Policy Meeting (April 7th, 8th)
	Indonesia general elections (April 9th)	
	US	FOMC (April 29th, 30th)
	Japan	BOJ Monetary Policy Meeting (April 30th)
	India	India general elections (around April)
	Europe	ECB Governing Council meeting (May 8th)
	Japan	BOJ Monetary Policy Meeting (May 20th, 21st)
	Europe	European parliament election (May 22nd to 25th)
	Europe	ECB Governing Council meeting (June 5th)
	Japan	BOJ Monetary Policy Meeting (June 12th, 13th)
	Brazil	FIFA World Cup Soccer, Brazil (June 12th to July 13th)
	US	FOMC (June 17th, 18th)
	Europe	ECB Governing Council meeting (July 3rd)
	US	FOMC (July 29th, 30th)
	Europe	ECB Governing Council meeting (August 7th)
	Europe	ECB Governing Council meeting (September 4th)
	US	FOMC (September 16th, 17th)
	Europe	Scottish independence referendum (September 18th)
	Europe	ECB Governing Council meeting (October 2nd)
	US	FOMC (October 28th, 29th)
	Brazil	Brazil presidential election (October)
	US	US midterm elections (November 4th)
	Europe	ECB Governing Council meeting (November 6th)
	G-20 Summit (Australia, November 15th, 16th)	
	APEC Summit (China, November)	
	Europe	ECB Governing Council meeting (December 4th)
	US	FOMC (December 16th, 17th)

Source: MHRI

III. The Japanese economy

(1) Jul-Sep quarter 2013 *1st QE*

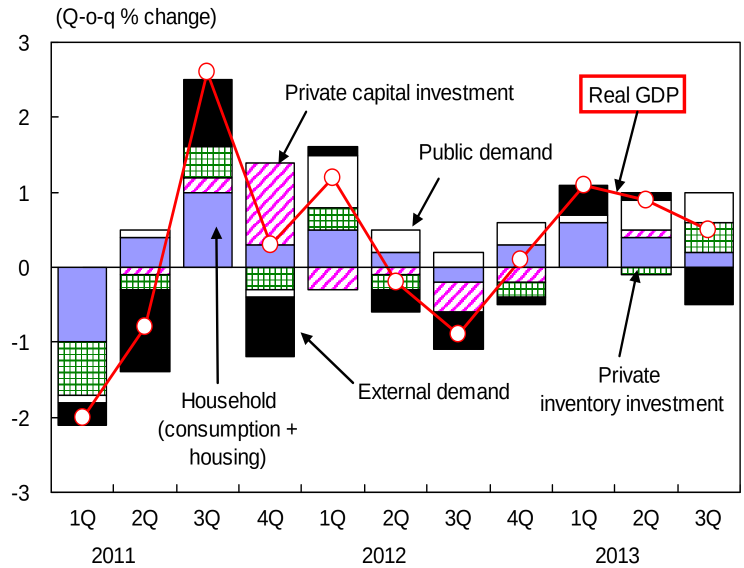
The Japanese economy slowed down to +1.9% q-o-q p.a. in the Jul-Sep quarter

According to the *First Preliminary Quarterly Estimates of GDP (1st QE)* for the Jul-Sep quarter of 2013, Japan's real GDP grew +0.5% q-o-q (or +1.9% in annualized terms). Even though the economy continued to grow for four consecutive quarters, the pace of growth moderated from the strong growth in the two previous quarters (**Chart 9**). The slowdown stemmed primarily from the fall of exports for the first time in three quarters and the slower pace of personal consumption growth. On the other hand, public demand continued to grow strongly, providing support to the overall economy.

Even though domestic private demand grew for the fourth quarter in a row, note that it was driven largely by private inventory investment and public demand. Personal consumption remained virtually flat (+0.1% q-o-q) due to a pause in improvement of consumer confidence reflecting the stock market adjustment in addition to bad weather conditions. Given the nascent signs of a rush of demand prior to the consumption tax hike, housing investment grew +2.7% q-o-q, increasing for the sixth quarter in a row. Even though capital investment rose +0.2% q-o-q, marking an increase for the third consecutive quarter, the growth was extremely weak. Meanwhile, the movement among companies to run down their inventories subsided, leading to a significant positive contribution by private-sector inventory investment (+0.4% pt).

Public demand continued to grow strongly, increasing +1.6% q-o-q. Given the progress of projects related to the emergency economic stimulus measures, public investment rose to +6.5% q-o-q. Government consumption also grew +0.3% q-o-q reflecting factors such as the rise of social security-related

[Chart 9: Japan's quarterly real GDP growth]



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

Exports fell for the first time in three quarters (-0.6% q-o-q). In addition to the decline of exports to Asia where some of the economies are slowing down, it appears that exports bound for the US also turned stagnant. In contrast, given the rise of imports (+2.2% q-o-q), the contribution by external demand fell deep into negative territory (-0.5% pt).

The domestic demand deflator rose for the first time since the Jul-Sep quarter of 2008

The domestic demand deflator rose into positive territory (+0.5% y-o-y) for the first time since the Jul-Sep quarter of 2008, reflecting the rise of energy prices and rise in cost of construction materials and labor costs in the construction sector. However, since the breadth of the rise of the import deflator (+14.2% y-o-y) was larger than the export deflator (+11.0% y-o-y) (a deterioration of the terms of trade), the GDP deflator remained in negative territory (-0.3% y-o-y).

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

Growth in FY2013 2H will accelerate due to a last-minute rush of demand. FY2013 real GDP growth: +2.6%

Even though the Japanese economy slowed down in the Jul-Sep quarter due to weak exports, the pace of economic growth should pick up again from the Oct-Dec quarter. This is due primarily to the fact that the last-minute rush of demand prior to the consumption tax hike will push up Japan’s domestic demand. According to estimates by MHRI, the last-minute rush of demand in FY2013 (personal consumption and housing investment combined) is slightly less than JPY3 trillion (approximately 0.6% of GDP). While the housing investment over the summer months appears to have included, to a certain extent, the accelerated demand prior to the consumption tax hike, the last-minute demand in personal consumption should start to materialize in the form of durable goods purchases from now on.

Furthermore, the weakness of the yen thus far should start to serve as a driver of exports (in terms of quantity), and exports should gradually gather momentum in the second half of the fiscal year reflecting the mild recovery of the overseas economies. Machinery orders (external demand), a leading indicator, grew a strong +10.9% in the Jul-Sep quarter, and exports of machinery should grow at a faster pace from the Oct-Dec quarter. In addition, capital investment should maintain its momentum in the second half of the fiscal year amid the growth of sales accompanying the recovery of demand and the rise of profitability of exports due to the weak yen.

Turning to public investment, the implementation of the public works projects related to the emergency economic stimulus measures in January 2013 are about to run its course. “The value of public works contracted”, a leading indicator of public works, has already peaked out, providing reasons to believe that public investment will take a downturn in the second half of the fiscal year. Even though government consumption will continue to grow due mainly to the rise of social security payments along with the ageing of the population, the strength of public demand as a driver of real GDP growth is expected to fade in the second half of FY2013.

Despite a slower pace of growth of public demand in the second half of FY2013, the pace of economic growth is forecast to rise to the +3% p.a. to +4% p.a.-level in annualized terms, driven by private-sector demand pushed up by the last-minute rush of demand prior to the consumption tax hike. This leads to our forecast that the pace of real GDP growth in FY2013 will grow +2.6% (forecast in September: +2.9%) (**Chart 10**).

[Chart 10: Outlook on the Japanese economy]

		2011	2012	2013	2014	2012	2013				2014				2015
		FY				Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar
GDP (real)	Q-o-q % ch	0.3	1.2	2.6	0.8	0.1	1.1	0.9	0.5	0.8	1.0	-1.3	0.7	0.4	0.4
	Q-o-q % ch p.a.	--	--	--	--	0.6	4.3	3.8	1.9	3.3	4.1	-5.2	2.9	1.7	1.7
Domestic demand	Q-o-q % ch	1.3	2.0	2.6	0.1	0.3	0.7	0.8	0.9	0.7	1.0	-1.7	0.4	0.2	0.2
Private sector demand	Q-o-q % ch	1.4	1.2	2.2	-0.2	0.0	0.7	0.5	0.7	0.9	1.4	-2.4	0.4	0.4	0.4
Personal consumption	Q-o-q % ch	1.6	1.6	2.3	-1.3	0.4	0.8	0.6	0.1	0.8	1.8	-3.6	0.5	0.2	0.2
Housing investment	Q-o-q % ch	3.7	5.3	7.3	-6.6	3.2	2.3	0.4	2.7	3.5	-2.5	-9.0	1.0	1.7	2.5
Capital investment	Q-o-q % ch	4.1	-1.3	1.2	3.7	-1.2	0.1	1.1	0.2	1.8	1.5	1.0	0.3	0.6	0.7
Inventory investment	Q-o-q contribution, % pt	-0.5	-0.1	-0.1	0.3	-0.2	-0.0	-0.1	0.4	-0.2	-0.1	0.5	-0.1	0.0	0.0
Public sector demand	Q-o-q % ch	0.9	4.3	3.8	1.0	1.1	0.5	1.6	1.6	0.1	-0.3	0.7	0.4	-0.2	-0.3
Government consumption	Q-o-q % ch	1.4	2.1	1.7	1.7	0.6	0.0	0.8	0.3	0.4	0.5	0.4	0.4	0.4	0.4
Public investment	Q-o-q % ch	-2.2	14.9	12.6	-2.0	3.3	2.5	4.8	6.5	-1.1	-3.0	2.0	0.1	-2.8	-3.4
External demand	Q-o-q contribution, % pt	-1.0	-0.8	-0.1	0.6	-0.1	0.4	0.1	-0.5	0.1	-0.1	0.3	0.3	0.2	0.1
Exports	Q-o-q % ch	-1.6	-1.2	3.9	5.7	-3.0	3.9	2.9	-0.6	1.3	1.2	1.5	1.7	1.8	1.9
Imports	Q-o-q % ch	5.3	3.9	3.9	1.8	-1.7	1.0	1.7	2.2	0.7	1.3	-0.5	-0.2	0.7	1.0
GDP (nominal)	Q-o-q % ch	-1.4	0.3	2.3	1.8	0.2	0.7	1.1	0.4	0.5	1.2	-0.2	0.6	0.4	0.3
GDP deflator	Y-o-y % ch	-1.7	-0.9	-0.3	1.0	-0.7	-1.1	-0.5	-0.3	-0.6	0.1	0.9	1.1	1.2	1.0
Domestic demand deflator	Y-o-y % ch	-0.5	-0.8	0.1	1.0	-0.8	-0.8	-0.3	0.5	0.3	0.0	1.1	1.0	1.0	1.1

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

		2011	2012	2013	2014	2012	2013				2014				2015
		FY				Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar
Industrial production	Q-o-q % ch	-0.7	-2.9	3.4	2.5	-1.9	0.6	1.5	1.7	2.5	2.5	-1.3	-0.3	0.7	1.1
Ordinary profits	Y-o-y % ch	-2.0	8.1	14.3	1.9	5.9	5.6	21.5	19.7	13.2	5.2	-3.2	1.5	6.6	2.8
Nominal labor compensation	Y-o-y % ch	0.6	-0.3	0.9	0.9	-0.7	-0.0	1.1	0.5	1.3	0.7	1.0	1.0	0.7	0.8
Unemployment rate	%	4.5	4.3	3.9	3.8	4.2	4.2	4.0	4.0	3.9	3.9	3.8	3.9	3.8	3.7
New housing starts	P.a., 10,000 units	84.1	89.3	97.6	89.0	91.8	90.4	98.1	99.4	100.1	91.9	87.0	88.2	89.5	92.1
Current account balance	P.a., JPY tril	7.6	4.4	4.8	8.8	4.3	3.1	8.9	2.2	4.2	4.7	9.2	6.8	10.7	9.9
Domestic corporate goods prices	Y-o-y % ch	1.4	-1.1	1.8	3.4	-0.9	-0.3	0.7	2.2	2.4	1.9	3.2	3.3	3.5	3.7
Consumer prices	Y-o-y % ch	0.0	-0.2	0.6	2.7	-0.1	-0.3	0.0	0.7	0.9	0.8	2.8	2.6	2.6	2.7
Consumer prices (ex consumption tax)	Y-o-y % ch	0.0	-0.2	0.6	0.5	-0.1	-0.3	0.0	0.7	0.9	0.8	0.6	0.4	0.4	0.6
Uncollateralized overnight call rate	%	0.08	0.06	0～0.10	0～0.10	0.08	0.06	0.07	0.06	0～0.10	0～0.10	0～0.10	0～0.10	0～0.10	0～0.10
Yield on newly-issued 10-yr JGBs	%	1.05	0.78	0.75	0.86	0.75	0.70	0.73	0.77	0.69	0.80	0.75	0.80	0.90	1.00
Nikkei average	JPY	9,181	9,650	14,500	15,500	9,234	11,444	13,621	14,139	14,700	15,400	14,800	15,300	15,800	16,100
Exchange rate	JPY/USD	79.0	83.0	99.0	103.0	81.0	92.0	99.0	99.0	98.0	100.0	101.0	102.0	103.0	104.0
Crude oil price (WTI nearest term contract)	USD/bbl	97.0	92.0	98.0	96.0	88.0	94.0	94.0	106.0	97.0	96.0	96.0	96.0	96.0	96.0

Notes: 1. Figures in the shaded areas are forecasts.The readings above may differ from public releases because the rates of change are calculated based upon actual results.
2. Ordinary profits are based upon the *Financial Statements Statistics of Corporations by Industry* (all industries) (ex finance & insurance, and production, transmission and distribution of electricity services).
3. Consumer prices exclude fresh food (2010 base).
4. Quarterly data on the unemployment rate, new housing starts and current account balance are seasonally-adjusted.
5. Of the finance-related indices, the uncollateralized overnight call rate refers to the rate at the end of term, the yield on newly-issued 10-yr JGBs refers to the average of the end-of-month rates during the relevant 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

FY2014 real GDP growth will slow down to +0.8%

In October 2013, Prime Minister Shinzo Abe publicly announced his final decision to raise the consumption tax to 8% from April 2014 and to implement a package of economic stimulus measures worth JPY5 trillion. The odds are high that further details of the package will be decided in December and that a supplementary budget will be passed upon the turn of the New Year. While the economic stimulus measures include items such as cash benefits (simple benefits) for low income earners (JPY0.3 trillion), and cash benefits for home purchasers (housing benefits) (JPY0.3 trillion), the use of the remaining JPY3.5 trillion is yet to be determined. Based upon the assumption that JPY2.5 trillion of the remaining JPY3.5 trillion would be earmarked for public works, MHRI estimates that the economic stimulus measures would push up the rate of real GDP growth by approximately 0.5% pt.

The implementation of the public works projects in the economic stimulus measures from around early spring should temporarily lift public investment. Even so, a sharp fall of real GDP growth looks inevitable immediately after the consumption tax hike in the Apr-Jun quarter of 2014 (forecast: -5.2% q-o-q p.a.), due to a backlash to the last-minute demand and erosion of household real income.

From the Jul-Sep quarter of 2014, the Japanese economy should return to a gradual recovery track, driven by the growth of exports reflecting the weakness of the yen and recovery of the overseas economies, and the ongoing upturn of capital investment supported by the improvement of corporate earnings. Personal consumption (real) will likely fall below previous-year levels throughout the year because of the erosion of real income due to the consumption tax hike. However, on a quarterly basis, personal consumption should gradually pick up from the level in the Apr-Jun quarter which slumped due to the backlash to the last-minute rush of demand. The pace of real GDP growth in FY2014 is forecast to grow +0.8% (forecast in September: +0.7%).

Y-o-y change of FY2014 core CPI (ex impact of consumption tax hike) should remain around the same level as FY2013. Inflation will gradually rise from FY2015

As of the Jul-Sep quarter of 2013, 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 approximately JPY8.5 trillion) (**Chart 11**). In the second half of FY2013, the Japanese economy is forecast to grow strongly and temporarily close the negative output gap in the Jan-Mar quarter of 2014. However, the output gap will remain in negative territory during FY2014 after the negative output gap widens again in the Apr-Jun quarter of 2014.

The core CPI (general, excluding fresh food) rose to +0.7% y-o-y as of September 2013. However, this stems largely from the rise of energy prices such as the upturn of gasoline prices and electrical power charges reflecting the weak yen and rise of crude oil prices. As the negative output gap closes amid the strong growth of the economy, the year-on-year change of the US-criteria core CPI (the general CPI excluding food and energy) should inch up into positive territory from the end of 2013 to early 2014. During this time, the core CPI should rise to around +1% y-o-y. During the full-year FY2013, the year-on-year change of the core CPI is expected to reach +0.6% y-o-y, rising for the first time since FY2008.

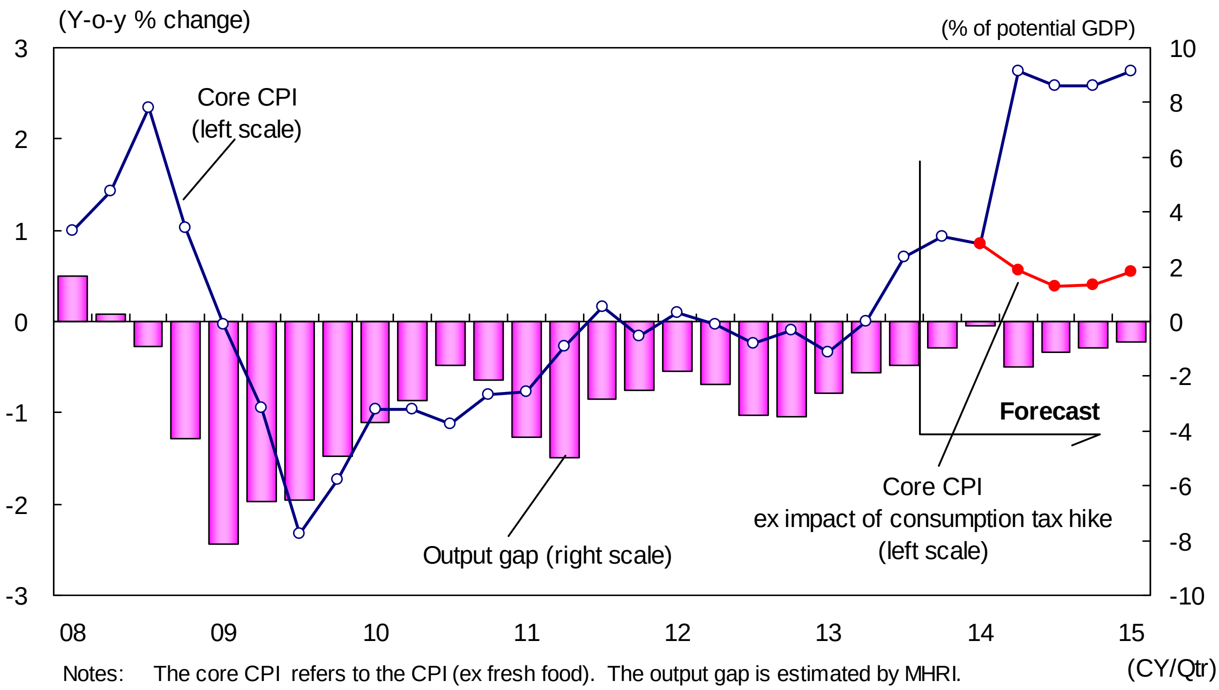
However, when the negative output gap widens in FY2014 as domestic demand falls due to the impact of the consumption tax hike, companies will tend to cut prices in order to maintain their market shares, hence serving as a drag upon the rise of prices. The year-on-year change of the core CPI should stand at +0.5% in FY2014 (+2.7% when including the impact of the consumption tax hike) standing around the same level as FY2013 due to: (1) the fall of the contribution of energy prices reflecting the gradual stabilization of crude oil prices which have thus far climbed higher because of rising tensions in Egypt and Syria, and (2) the fading impact of the higher electrical utility fees. The BOJ will likely decide to extend its quantitative and qualitative monetary easing measures when it becomes evident that it is difficult to achieve the inflation target of "2% in two years".

Focus of attention upon wage trends

A key focus of attention in FY2014 is the trends in wages. The Abe administration is calling for wage hikes on various occasions such as the forum for discussion on wage increases among labor and management representatives and politicians. There have been some positive comments on wage hikes from among management representatives.

A look at the past trends in wage hikes in the *shunto* annual spring labor-management wage negotiations (according to the Ministry of Health, Labor and Welfare, based upon major corporate enterprises) show that the wage hike rate has continued to hover around the 1%-level after falling below 2% in FY2002

[Chart 11: The output gap and the core CPI]



Notes: The core CPI refers to the CPI (ex fresh food). 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

under deflation (**Chart 12**). Considering that annual wage hikes are said to be approximately 1.6~1.8%, the increase in base wages would be more or less zero. Furthermore, since the rise in weight of non-regular workers had served as a continuous drag upon average wages, MHRI forecasts that the annual spring wage hike rate will rise from 1.80% in FY2013 to 1.92% in FY2014 and that scheduled cash earnings would rise a modest +0.2% y-o-y. However, in view of past trends (FY1992 - FY2012), the rate of growth of scheduled cash earnings would not reach 1% unless the annual spring wage hike rate rises to around 3% (**Chart 13**). Although the annual spring wage hike rate may turn out to be slightly higher than MHRI's forecast due to the government's request, it would still be difficult to rise above 2%. Even though the wage hike rate rose to 1.99% in FY2008 at the end of the longest economic expansion cycle prior before the so-called Lehman Shock, it should be noted that this wage hike only occurred after five years of corporate earnings expansion. First and foremost, the continuation of economic growth and improvement of corporate earnings over the medium to long term would be necessary for a full-fledged rise of wages.

[Chart 12: *Shunto* annual spring wage hike rate]

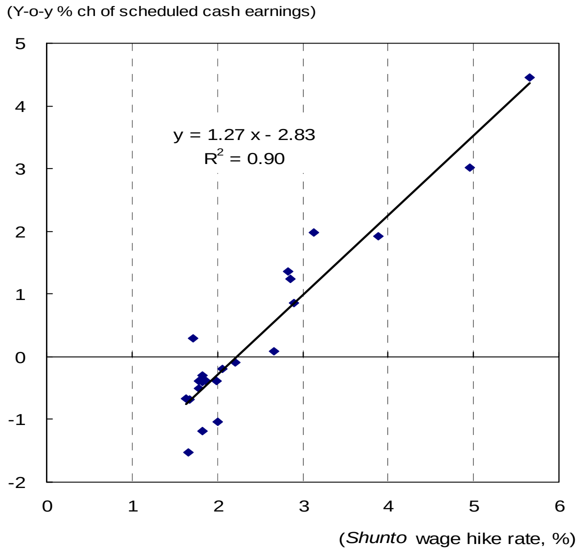
(%)

FY	*Shunto* annual spring wage hike rate	Scheduled cash earnings	Previous FY: Ordinary profits (Y-o-y % ch)	Previous FY: Core CPI (Y-o-y % ch)
2000	2.06	-0.2	28.7	-0.1
01	2.01	-1.0	21.6	-0.4
02	1.66	-1.5	-20.0	-0.8
03	1.63	-0.7	7.6	-0.8
04	1.67	-0.7	17.2	-0.2
05	1.71	0.3	24.5	-0.2
06	1.79	-0.4	8.9	0.1
07	1.87	-0.4	10.5	0.1
08	1.99	-0.4	-2.1	0.3
09	1.83	-1.2	-38.5	1.2
10	1.82	-0.3	-0.0	-1.6
11	1.83	-0.4	39.0	-0.8
12	1.78	-0.4	-2.0	0.0
13	1.80	-0.3	8.1	-0.2
14	1.92	0.2	14.3	0.6

Notes: 1. The *Shunto* wage hike rate is based upon major corporate enterprises (Ministry of Health, Labor and Welfare)
2. "Scheduled cash earnings" pertain to enterprises with 5 or more employees
3. "Ordinary profits" based upon Ministry of Finance, *Financial Statements Statistics of Corporations by Industry*
4. "Core CPI" refers to "general CPI (ex fresh food)"
5. The figures framed within the bold line are forecasts by MHRI

Sources: Made by MHRI based upon Ministry of Health, Labor and Welfare, *Minkan shuyo-kigyo shunki chin-age yokyu daketsu jokyo* (Spring wage negotiations among major private enterprises), *Monthly Labor Survey*, Ministry of Finance, *Financial Statements Statistics of Corporations by Industry*, Ministry of Internal Affairs and Communications, *Consumer Price Index*

[Chart 13: The *shunto* annual spring wage hike rate and scheduled cash earnings]



Note: The graph above pertains to the period from FY1991 to FY2012. "Scheduled cash earnings" pertain to enterprises with 5 or more employees.

Sources: Made by MHRI based upon Ministry of Health, Labor and Welfare, *Minkan shuyo-kigyo shunki chin-age yokyu daketsu jokyo* (Spring wage negotiations among major private enterprises), *Monthly Labor Survey*.

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