FY2014, FY2015 Economic Outlook

August 15, 2014

<The US Economy>

◆ **A mild expansion of private demand amid the alleviation of downward pressures stemming from fiscal restraints. Expect an interest rate hike in the second half of 2015**

2014: +2.1% (forecast in June +2.2%)
2015: +2.9% (forecast in June +2.9%)

<The Eurozone Economy>

◆ **Despite the continuation of an export and capital investment-led recovery, eurozone growth is forecast to remain tepid, given lingering balance sheet adjustment pressures in many of the countries**

2014: +0.8% (forecast in June +1.0%)
2015: +1.2% (forecast in June +1.3%)

<The Asian Economy>

◆ **Look forward to a gradual expansion driven mainly by exports. While the Chinese economy is lifted temporarily by the impact of economic stimulus measures, a slowdown is expected again in 2015**

2014: +6.0% (forecast in June +5.9%)
2015: +6.0% (forecast in June +5.9%)

<The Japanese Economy>

◆ **Personal consumption and capital investment should pick up in the second half of the fiscal year**

FY2014: +0.5% (forecast in June +1.1%)

◆ **Exports and private demand will recover. A fall into recession will be avoided even after the consumption tax hike**

FY2015: +1.5% (forecast in June +1.5%)

I. The Chief Economist's View

Despite a string of disappointments in 2014, why is the world still sanguine?

The rosy scenario at the beginning of the year turned out to be a disappointment around the world. Days of endurance followed

Looking back at the developments in 2014, Mizuho Research Institute Ltd. (MHRI) revised its economic outlook in February on the basis of the perception that the US economy was nearing its final stage of its balance sheet adjustment process. At the same time, we also forecast that the eurozone economy would recover to 1% in 2014 from an anomalous two-year consecutive period in negative territory in 2012 and 2013. Turning to Japan, we said that the Japanese economy would follow a sustainable recovery track in 2014 despite a temporary slowdown due to the consumption tax hike in April 2014. Looking back at the ensuing developments, the optimistic scenario of global recovery at the beginning of this year fell short of expectations.

While we had already slashed down our outlook on the US in our previous *Economic Outlook* in May due to the impact of the cold spell early in the year, we have pushed down our outlook on the US even further. Likewise in Japan, we had forecast a slowdown in the Apr-Jun quarter due to the consumption tax hike. The unexpected sharp contraction of growth due to factors such as the heavy rain in June led to further downward pressures upon Japan's growth rate, prompting us to make a further downward revision. In the eurozone, the recovery has been weak due to the rise of deflation concerns under a process of "Japanisation". Looking back at the first half of the year, in addition to the weaker-than-expected growth among Japan, the US and the eurozone, the persistence of concerns regarding the emerging economies due in part to geopolitical concerns served as global downward pressures. Although we had predicted a state of "neo-decoupling" in which the developed countries would serve as the engine of the global economy even in the event of a lackluster recovery among the emerging economies, the first half of the year may be characterized by the absence of a notable engine in the world.

However, the current conditions are in no ways headed toward a major downturn as in the past, leading to the rise of a pessimistic outlook. Even so, as shown by persisting market views of "long-term stagnation" and that the world is still following an ebb and flow pattern since its departure from the historical global adjustment of the scale last seen since the Great Depression, there may be a greater recognition that the economy may not recover as quickly as in past cyclical recoveries. While we referred to the state of the economy as a "period of endurance" in our *Economic Outlook* as of May, it appears that this perception has grown stronger both domestically and overseas during the past three months.

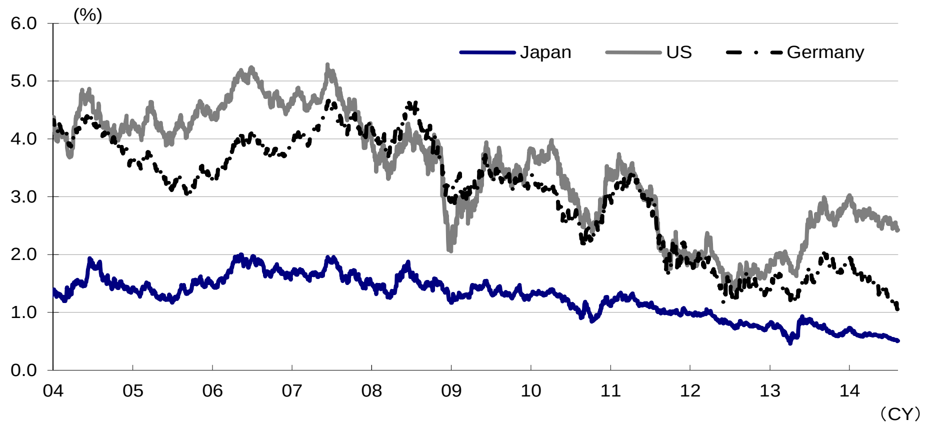
In a sharp reversal, interest rates have fallen around the world despite the "rise-of-interest rates scenario" early this year

As shown in **Chart 1**, current market conditions may be characterized by the persisting decline of long-term interest rates around the world. In the US, even though the 10-year government bond yield bottomed out in 2013, it is currently declining to nearly 2.4%. Turning to Germany, the yield on 10-yr government bonds dipped below 1%, recording a historical low. At the beginning of the year, the optimism around the world led to views of a "Great Rotation" where global financial market funds would shift from bonds to stocks and thus that interest rates would rise. However, in reality, both the stock and bond markets settled into a "Goldilocks" moment where the market is neither too hot nor too cold and views that market conditions will stay this way for some time.

Goldilocks market conditions will persist

The view of this "Goldilocks" moment stems largely from the perception that it would take longer than initially expected to reach the exit because of the extraordinary depth of the balance sheet adjustment in Japan, the US and the Eurozone since 2007. On a global scale, the developed countries of Japan, the US and the eurozone face an unprecedented output gap. As a result, even though US monetary policy has started to move toward an exit, disinflationary conditions are still lingering. The eurozone economy also faces a significant demand shortage from the perspective of the I-S balance, and as a result possesses a large current account surplus. In the emerging countries (particularly China), a rapid recovery is unlikely anytime soon since they have just entered a full-scale balance sheet adjustment process. In Japan, there are rising concerns regarding an inventory adjustment along with the rise of inventories of durable goods such as motor vehicles and a downturn of exports accompanying the slowdown of overseas economies. Admittedly, the first half of 2014 turned out to be marked with less-than-expected developments both within and outside of Japan. As a result, the first half of the year slid into a Goldilocks moment amid the absence of a clear driver of the global economy. Even though the foregoing developments were as expected in our previous *Economic Outlook*, the recovery turned out to be slower than our initial storyline.

Chart 1: The yield on 10-yr government bonds (Japan, US, Germany)



Source: Bloomberg.

A different biorhythm

The current recovery differs greatly from the biorhythms experienced by market players at times of stock market and interest rate upturns in the past. Even though the end of the balance sheet adjustment process is coming into view with respect to Japan, the US and the eurozone, the market may be coming to grips with the sheer depth and gravity of the balance sheet adjustment. Despite anticipation of an imminent exit, it seems that market players still feel that it is taking longer than expected to reach the exit. This may be deemed as a secular stagnation or simply as a “Japanisation phenomenon”.

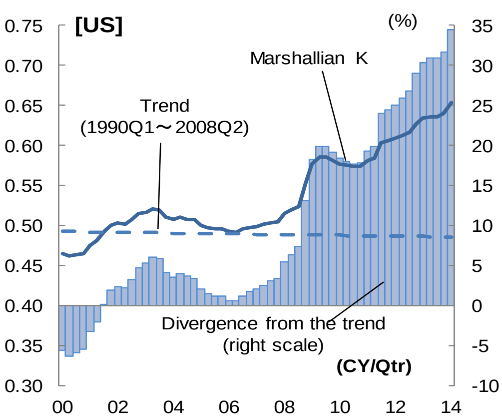
Why is the outlook devoid of gloom despite numerous concerns?

Even so, the current juncture is also characterized by the relative “lightness” of the gloom in comparison to past market downturns and that the sentiment among corporations and households is improving accordingly. In the background, this is the first time that Japan is eyeing an exit from the unprecedented adjustment since the 1990s and, likewise, that the US and eurozone economies are anticipating an exit from the serious adjustment from 2007. I note and call attention to the limited concerns in the market regarding the future and economic downturn despite the slow recovery of the global economy. The stock markets in the US and eurozone are recording historical highs and are showing signs of over-heating. Despite the relatively weak recovery, the market consensus remains unchanged that the US monetary policy will move toward an exit. In Japan, despite a slowdown due to the consumption tax hike, the outlook remains unchanged that the economy will remain on recovery track.

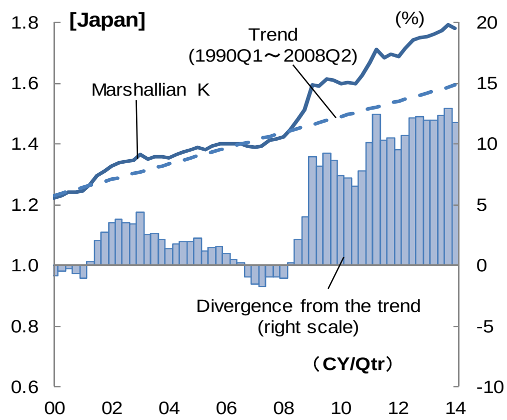
Global monetary easing and liquidity glut

The rise of asset prices stemming from the global liquidity glut is also serving as underpinnings. It appears that the abundance of money accompanying the massive monetary easing among the developed countries exists in the background of the global rise of stock and bond markets. As shown in **Chart 2**, “Marshallian K” (money supply/nominal GDP) in Japan and the US has been rising since the 2000s, and the gap between nominal GDP and money supply has been widening even further since the collapse of Lehman Brothers (the “Lehman Shock”). Presumably, the continuation of such conditions is fueling the expansion of asset market due to the global money glut.

Chart 2: “Trends in the Marshallian K” (Japan, US)



Note: Marshallian K = M2/nominal GDP.
Sources: US Department of Commerce, FRB.



Note: Marshallian K = M2/nominal GDP.
Sources: Bank of Japan, Cabinet Office.

The exit from the historical adjustment cycle since the Great Depression differs from past recovery cycles

The current juncture also possesses the characteristic of the US economy's exit from the greatest balance sheet adjustment since World War II and the Great Depression. The Federal Reserve Board (FRB), which recognizes the depth and severity of the adjustment, is conscious of the need to take a far more cautious monetary exit policy than in the past. In view of the fact that individuals and corporate businesses are still taking a cautious stance and that there is an ongoing output gap, it may become necessary to prolong the monetary easing. Hence, it should be kept in mind that the market is heading into *terra incognita*, different from anything experienced in the past. Over the long term, the continuation of monetary easing in *terra incognita* will lead to commensurate adjustment risks sometime in the future.

Even though days of endurance will persist, the exit will come into view

There is a growing awareness of that it will take time to emerge out of the balance sheet adjustment process, given numerous factors which are causing the economy to stall in the first half of 2014. In Japan, consumer and business sentiment is improving toward the future despite uncertainties due to a temporary slowdown accompanying the consumption tax hike. This may stem from an underlying perception that Japan is starting to take steps out of the collapse of the bubble economy. Looking forward, we shall be facing a period of endurance until the economy finds its way back to a steady recovery toward the second half of the year.

Hajime Takata, Chief Economist

II. The global economy

Global growth picked up in the Apr-Jun quarter of 2014

In the Apr-Jun quarter of 2014, it appears that the global economy – mainly the US and Chinese economies – picked up from the sluggishness in the Jan-Mar quarter.

The US economy grew +4.0% q-o-q p.a. in the Apr-Jun quarter (Jan-Mar quarter: -2.1% q-o-q p.a.), recording an expansion for the first time in two quarters (**Chart 3**). Even though growth dipped into negative territory in the Jan-Mar quarter because of the severely cold winter weather, personal consumption and capital investment grew in addition to the upturn of housing investment in the Apr-Jun quarter.

Eurozone real GDP slowed to +0.2% q-o-q p.a. in the Apr-Jun quarter of 2014 (Jan-Mar quarter: +0.8% q-o-q p.a.). Even though German economic growth dipped into negative territory, this is most likely temporary due to calendar factors. Looking at the eurozone as a whole, the economy is continuing to follow a gradual economic recovery.

China's real GDP grew +7.5% y-o-y in the Apr-Jan quarter, accelerating slightly from +7.4% y-o-y in the Jan-Mar quarter. In addition to a slight rise of investment in fixed assets, export growth also picked up.

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

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

	2013				2014	
	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun
US	2.7	1.8	4.5	3.5	-2.1	4.0
Eurozone	-0.8	1.3	0.4	1.2	0.8	0.2
Japan	5.2	3.4	1.4	-0.2	6.1	-6.8
South Korea	2.5	4.1	4.4	3.6	3.8	2.4
Taiwan	-2.2	3.8	0.1	7.6	1.9	5.9
Hong Kong	2.1	2.1	3.1	3.7	1.0	
Singapore	1.9	10.2	0.7	6.9	1.8	0.1
Thailand	-5.4	0.7	6.1	0.5	-8.2	
Malaysia	-1.2	6.8	7.1	7.6	3.3	
Philippines	8.7	6.7	4.1	6.9	4.7	
Australia	1.1	3.7	2.8	3.2	4.5	
Brazil	1.5	6.6	-1.2	1.8	0.7	

(Y-o-y % change)

China	7.7	7.5	7.8	7.7	7.4	7.5
Indonesia	6.0	5.8	5.6	5.7	5.2	5.1
Vietnam	4.8	5.0	5.5	6.0	5.1	5.3
India	4.4	4.7	5.2	4.6	4.6	
Russia	0.8	1.0	1.3	2.0	0.9	0.8

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

Turning to the Asian economies (ex China), the sense of recovery is turning stronger due to the upturn of exports to the US and Europe. In addition to a higher rate of growth in Taiwan and Vietnam, statistical releases suggest the acceleration of growth in India, Malaysia and Thailand. However, the rate of economic growth slowed down in South Korea and Indonesia due to the stagnant rise of domestic demand.

On the other hand, Japan’s real GDP growth in the Apr-Jun quarter fell sharply (-6.8% q-o-q p.a.) from the Jan-Mar quarter (+6.1% q-o-q p.a.) due to the consumption tax hike.

The global economy should pick up, driven mainly by the developed countries

In 2014, while the global economy (the weighted average of all the countries and areas within the scope of MHRI’s economic forecast) is forecast to grow +3.1% remaining around the level in 2013, the recovery should gather pace in the second half of the year, driven mainly by the developed countries (**Chart 4**). In addition to forecasts that the US economy will continue to grow at the 3%-level on an annualized basis, the eurozone economy should also follow a gradual recovery path. On the other hand, the overall pace of Asia’s economic growth should remain around the same level as 2013 due to a gradual slowdown of the Chinese economy. The emerging economies should remain stagnant, given the slowdown of the Brazilian and Russian economies. In 2015, the global economy should continue to be driven by the developed economies in contrast to the stagnation of the emerging countries. The rate of global economic growth should rise to 3.5% in 2015, driven by the developed economies such as the US.

[Chart 4: MHRI outlook on the global economy]

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

Calendar year	2011 (Actual)	2012 (Actual)	2013 (Actual)	2014 (Forecast)	2015 (Forecast)	2014 (June forecast)	2015 (June forecast)
Total of forecast area	3.8	3.1	3.1	3.1	3.5	3.2	3.5
Japan, US, Eurozone	1.3	1.2	1.2	1.5	2.1	1.7	2.1
US	1.6	2.3	2.2	2.1	2.9	2.2	2.9
Eurozone	1.6	-0.6	-0.4	0.8	1.2	1.0	1.3
Japan	-0.5	1.5	1.5	1.2	1.3	1.7	1.3
Asia	7.6	6.1	6.1	6.0	6.0	5.9	5.9
NIEs	4.2	2.0	2.8	3.5	3.5	3.5	3.4
ASEAN5	4.5	6.2	5.2	4.4	5.0	4.4	5.1
China	9.3	7.7	7.7	7.5	7.3	7.4	7.2
India	7.7	4.8	4.7	4.7	4.8	4.7	4.8
Australia	2.6	3.7	2.4	3.0	2.6	3.0	2.6
Brazil	2.7	1.0	2.5	0.8	1.2	1.2	1.6
Russia	4.3	3.4	1.3	0.1	1.0	0.2	2.0
Japan (FY)	0.3	0.7	2.3	0.5	1.5	1.1	1.5
Crude oil price (WTI, %/bbl)	95	94	98	100	97	99	95

Note: The total of the forecast area is calculated upon the 2012 GDP share (PPP) by the IMF.
Sources: International Monetary Fund (IMF), MHRI.

The pace of US economic growth is forecast to stand at +2.1% in 2014. Even though growth in the Jan-Mar quarter turned out to fall into negative territory due to the severely cold winter weather, the recent spate of economic data is picking up. From the Apr-Jun quarter onward, the US economy should revive to a recovery track of around +3% to +4% p.a. given the ongoing solid growth of private-sector final demand. The strong growth of private-sector final demand should continue in 2015, raising the pace of economic growth to +2.9%.

Eurozone real GDP is forecast to grow +0.8% in 2014, recording growth in positive territory for the first time in three years. Even though growth in the Apr-Jun quarter was close to zero, the German economy is treading on solid grounds. Despite the continuation of a tepid recovery among the countries of southern Europe which are subject to downward pressures stemming from balance sheet adjustment in both the public and private sectors, the eurozone economy as a whole should continue to follow a mild recovery from the Jul-Sep quarter onward. Even though exports will pick up in 2015, being supported by the weak euro, domestic demand will fall short of a full-fledged recovery. The rate of real GDP growth in 2015 should remain at the lower half of the 1%-level, (forecast: 1.2%).

Stagnant growth expected among the emerging countries

The Chinese economy is forecast to remain on a downtrend in 2014 (7.5%) and 2015 (7.3%). That said, recent economic indicators are improving slightly due to the impact of economic stimulus measures. However, since the government will continue to steer its policy to wean the economy from its dependence upon investment, the Chinese economy should lapse into a gradual slowdown again from the end of 2014.

Turning to the Indian economy, domestic demand is continuing to follow weak footing due to the government’s fiscal austerity and monetary tightening. Despite the upturn of some economic indicators in the Apr-Jun quarter, it appears that this was due to the impact of temporary factors such as changes in the tax system. Given the continuation of a tightening stance amid lingering concerns regarding the current account deficit and inflation, a dramatic acceleration of growth is unlikely. The pace of India’s economic growth is forecast to remain around the 4%-level for four years in a row since 2012: +4.7% in 2014, +4.8% in 2015.

The Asian economies other than China and India should continue to follow a gradual expansion in both 2014 and 2015. The NIEs (South Korea, Hong Kong, Taiwan, Singapore) should grow at a faster pace than the 2%-level growth in 2013, reaching +3.5% in 2014 and +3.5% in 2015 since the economic recovery of the US and Europe should serve as tailwinds for exports. The rate of real GDP of the ASEAN5 (Thailand, Malaysia, Indonesia, the Philippines, Vietnam) is forecast to slow down to +4.4%. The pace of economic growth is forecast to slow down in Thailand given its ongoing political turmoil, and in Indonesia due to a tight monetary policy stance. Even though the pace of growth should rise to +5.0% due mainly to the expansion of trade, domestic demand is expected to stagnate in many of the countries.

Turning to Australia, the rate of real GDP growth should rise to +3.0% in 2014 (2013: +2.4%). However, the pace of growth is forecast to slow down in the second half of the year dragged down mainly by exports and capital investment. Even though the Australian economy should moderate slightly to +2.6% in 2015 due to the slowdown in the second half of 2014, the economy is forecast to pick up on the back of the expansion of investment in infrastructure.

The Brazilian economy is still weak, due in part to the impact of the interest rate hikes thus far. In addition, the stagnation of demand in China and Argentina which are major destinations for Brazil's exports are also serving as a drag upon the recovery of exports and production. Looking forward, given the limited leeway for fiscal and monetary policy options amid inflation concerns and the risks of a credit downgrade, the rate of Brazil's real GDP growth should remain a feeble +0.8% in 2014 and +1.2% in 2015.

Turning to the Russian economy, the economic sanctions by the countries of the west due to Russia's response to the Ukraine (Crimea) is leading to the outflow of capital and hence the fall of the growth rate. There are concerns that the economic sanctions stepped up toward the end of July will push down investment and consumption even further. In 2014, the pace of real GDP growth is forecast to slow down to a near-zero level of +0.1%. Even though a slight recovery is expected in 2015, the odds are high that uncertainties will linger due to the protraction of sour relations with the West. Russia's economic growth is expected to remain at +1.0% in 2015.

The Japanese economy will be propped up by the rise of public investment and expansion of capital investment due to economic stimulus measures despite the drag upon personal consumption and housing investment due to the two consumption tax hikes. Exports – which are currently weak – should pick up in 2015 against a backdrop of the weak yen and overseas economic recovery mainly in the countries of the West. The pace of growth (on a calendar year basis) is forecast to keep growing at a mild pace of +1.2% in 2014 and+1.3% in 2015.

Keep a close eye upon the risks of financial market volatility accompanying the shift of US monetary policy, geopolitical risks, and the risks of China's economic slowdown

Given the slight upturn of the overall global economy such as the current improvement of economic indicators in the US and China, the global financial and capital markets are generally stable. However, the global economic recovery is still fragile and vulnerable to risks.

One of the risk factors in 2015 is the impact of the US monetary policy shift upon global money flows. Judging from the FRB's steady steps toward the tapering of its third round of quantitative easing (QE3), the odds are high that QE3 will be ended in October this year. While the focus of attention is shifting to the exit policy, the FRB is expected to keep a cautious policy stance and refrain from lifting interest rates at once and continue to reinvest in Treasury bonds for some time. Although the first rate hike is expected to occur in the second half of 2015, the rise of speculation on the rate hike entails the risks of financial market turmoil. Considering the association that a US monetary policy tightening will lead to a decline of capital flows into emerging countries, the risk of an outflow of funds from the emerging countries such as the capital flight experienced last spring cannot be ruled out altogether. Emerging countries possessing current account deficits and concerns regarding inflation (such as Brazil and India) will have to take extra care.

Furthermore, the rise of geopolitical risks in Ukraine, Iraq and Palestine is a source of concern. In the event of a further escalation of conditions, there is the risk that it will have a negative impact upon the global economy through market volatility of the crude oil, financial and capital markets.

Turning to China where the problems of excessive investment and shadow banking surfaced, even though the economy is starting to improve due to the effect of economic stimulus measures, the risk of a sharp and major adjustment cycle cannot be ruled out altogether. Given China’s role as the world’s growth center since the 2000s, its slowdown would have a major impact upon the real economy and the financial and capital markets of the Asian countries including Japan. No doubt, the Chinese economy is a major risk factor for the world economy during the forecast horizon.

[Chart 5: Key political and economic events in 2014]

2014 Sep	Japan	Cabinet shuffle (3rd)
	Japan	BOJ Monetary Policy Meeting (3rd, 4th)
	Europe	ECB Governing Council Meeting (4th)
	NATO Summit Meeting (4th, 5th) (UK)	
	Europe	Swedish General Elections (14th)
	UN General Assembly (16th to Oct 1st) (New York, US)	
	US	FOMC (16th, 17th)
	Europe	Scottish independence referendum (18th)
	G20 Meeting of Finance and Central Bank Governors (20th, 21st) (Cairns, Australia)	
Oct	Europe	ECB Governing Council Meeting (2nd)
	Brazil	Presidential Election (5th)
	Japan	BOJ Monetary Policy Meeting (6th, 7th)
	G20 Meeting of Finance and Central Bank Governors (9th, 10th) (Washington DC, US)	
	Annual Meeting of the IMF and the World Bank Group (10th)	
	US	FOMC (28th, 29th)
	Japan	BOJ Monetary Policy Meeting (Outlook Report) (31st)
	ASEAN Summit Meeting (October) (Nay Pyi Taw, Myanmar)	
	China	Fourth Plenary Session of the 18th Communist Party of China, Central Committee (October)
Nov	US	US midterm elections (4th)
	Europe	ECB unification of banking supervision (4th)
	Europe	ECB Governing Council Meeting (6th)
	G20 Summit Meeting (Brisbane, Australia) (15th, 16th)	
	Japan	BOJ Monetary Policy Meeting (18th, 19th)
	APEC Economic Leaders' Meeting (Beijing, China) (November)	
Dec	COP20 (Lima, Peru) (1st - 12th)	
	Europe	ECB Governing Council Meeting (4th)
	US	FOMC (16th, 17th)
	Japan	BOJ Monetary Policy Meeting (18th, 19th)
	Japan	Decision on consumption tax hike in October 2015 (December)
	China	Central Economic Work Conference (December)

Source: Made by MHRI.

III. The Japanese economy

(1) Overview of the Apr-Jun quarter 2014 1st *QE*

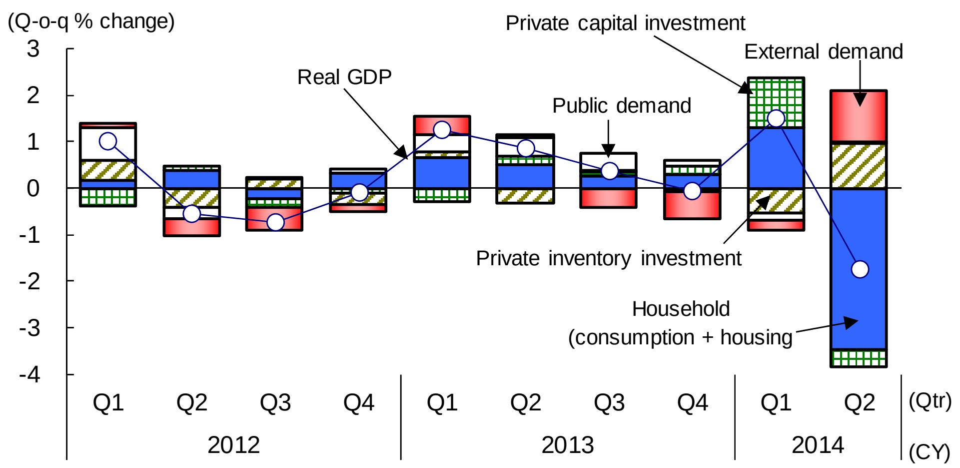
The Japanese economy fell sharply (-6.8% q-o-q p.a.) in the Apr-Jun quarter of 2014 due to a backlash to the last-minute rush of demand prior to the consumption tax hike

According to the *First Preliminary Quarterly Estimates of GDP (1st QE)* for the Apr-Jun quarter of 2014, Japan's real GDP fell a sharp -1.7% q-o-q (or -6.8% in annualized terms) (**Chart 6**).

Domestic private demand fell a sharp -3.7% q-o-q (contribution to real GDP -2.9% pt), serving as a drag upon Japan's growth rate. In addition to a backlash to the last-minute rush of demand prior to the consumption tax hike, downward pressures stemming from unseasonable weather conditions resulted in a sharp fall of personal consumption (-5.0% q-o-q). It appears that the backlash to durable goods (-18.9% q-o-q) and semi-durable goods (-12.3% q-o-q) turned out strongly due to the large size of the last-minute rush of demand in the Jan-Mar quarter. The fall of non-durable goods (-7.0% q-o-q) and services (-0.9% q-o-q) in the Apr-Jun quarter turned out to be large relative to the magnitude of demand in the Jan-Mar quarter, suggesting that the ebb of real income due to the consumption tax hike and the impact of the bad weather contributed to the downward pressure.

Turning to other components of private demand, capital investment fell -2.5% % q-o-q and recorded a downturn for the first time in five quarters, due to a backlash to the concentration of large-scale projects related to power plants and investment in semiconductor manufacturing equipment in the Jan-Mar quarter. A backlash to the rush before the consumption tax hike became evident in owner-occupied houses, leading to a downturn of housing investment (-10.3% q-o-q) for the first time in nine quarters. In contrast, private-sector inventory investment turned out to be a large positive contribution to growth (+1.0% pt). In addition to the replenishment of inventories which declined due to the last-minute demand, it seems that there was an "unintended rise of inventories" along with the weaker-than-expected growth of final demand.

[Chart 6: Japan's quarterly real GDP growth]



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

Public demand grew +0.2% q-o-q (contribution +0.0% pt), rising for the first time in two quarters. Government consumption grew (+0.4% q-o-q) for the first time in two quarters due to factors such as the rise of social security-related expenditures. Although public investment fell (-0.5% q-o-q) for the second quarter in a row due to factors such as the peak-out of demand related to post-disaster reconstruction, the early implementation of public works in the FY2013 supplementary budget and FY2014 budget served as underlying support and narrowing the breadth of contraction in comparison with the previous quarter.

The contribution by external demand rose into positive territory (+1.1% pt) for the first time in four quarters and served to support the growth rate. Imports took a sharp downturn (-5.6% q-o-q)(Jan-Mar quarter: +6.4% q-o-q) and pushed up the contribution by external demand. In contrast, exports declined (-0.4% q-o-q), given the stagnation of exports bound for the US reflecting the expansion of overseas production bases amid the ongoing slump of exports bound for Asian countries.

(2) Outlook on the Japanese economy in FY2014 and FY2015

Growth should pick up in the Jul-Sep quarter due to the fading backlash to the last-minute rush of demand

Japan's economic growth is expected to return to positive territory in the Jul-Sep quarter. The growth of capital investment should remain subdued because of concerns regarding a lingering backlash to the concentration of investment in the Jan-Mar quarter and economic conditions after the tax hike. Since the fall of imports stemming from a backlash to the last-minute rush of demand should generally dissipate amid the tepid recovery of exports, the contribution by external demand is forecast to contract sharply from the Apr-Jun quarter. Meanwhile, amid the fading impact of the backlash to the last-minute rush of demand and the bad weather, the increase of summer bonus payments will serve as underpinnings and lead to the upturn of personal consumption. Public demand is also forecast to keep rising given the progress of public works projects earmarked in the FY2013 supplementary budget and the FY2014 budget. In the Jul-Sep quarter, the pace of Japan's growth should accelerate (forecast: +4.4% q-o-q p.a.) as personal consumption picks up from the fall after the consumption tax hike, and the rise of public demand contributes to push up the rate of growth.

FY2014 growth rate will decline to +0.5%

In the second half of FY2014 (Oct-Dec quarter of 2014, Jan-Mar quarter of 2015) the impact of the early implementation of public works projects should come to a halt, leading to a gradual decline of public investment. On the other hand, amid the ongoing recovery of personal consumption, capital investment is forecast to return to an upward trend, keeping domestic demand on a recovery. Exports are also expected to grow albeit at a mild pace, reflecting the weak yen and overseas economic recovery.

Even so, in terms of the full year FY2014, the decline of personal consumption reflecting the erosion of real income due to the consumption tax hike should serve as a significant drag upon growth. We forecast that the Japanese economy will grow +0.5% in FY2014 (forecast in June: +1.1%) (**Chart 9**).

Our latest *Economic Outlook* is based upon the assumption that several of the 19 nuclear power reactors currently applying for screening under the new safety standards as of August 15th would be restarted (**Chart 7**). The restart of the nuclear power reactors should serve to push up the rate of real GDP growth slightly by curbing imports.

FY2015 real GDP growth rate will rise to +1.5%. While growth in 1H will be pushed up by the last-minute rush of demand, a backlash will ensue in 2H

In FY2015, we assume that the consumption tax rate will be raised as scheduled to 10% in October (**Chart 8**). Therefore, the last-minute rush of demand and its backlash accompanying the consumption tax hike will serve as a volatile factor upon growth in FY2015. According to a trial calculation based upon movements at the time of the tax hike in FY1997 as well as recent trends, the rate of real GDP growth (on a q-o-q basis) would be pushed up by approximately 0.5% pt in the first half of FY2015 and be dragged down by approximately 1.5% pt in the second half of FY2015.

Again in FY2015, we also expect the compilation of an economic stimulus package totaling approximately JPY2 trillion (of which approximately JPY1.5 trillion will be earmarked for public works) to prevent the economy from falling into a recession after the consumption tax hike. We expect the additional public works projects to be implemented in the second half of the fiscal year and push up the rate of real GDP in FY2015 by approximately 0.3% pt. Furthermore, we also assume that a reduced tax rate will be applied for food (excluding alcoholic beverages and restaurant meals) at the time of the consumption tax hike in FY2015.

[Chart 7: Assumptions regarding the restart of nuclear power reactors]

		Electric power company	Name of nuclear power reactor	Rated output (10,000 kW)
2014	4Q	Kyushu Electric Power Co., Inc.	Sendai (Reactors No. 1,2)	89.0×2
2015	3Q		Genkai (Reactors No. 3,4)	118.0×2
		Shikoku Electric Power Co. Inc.	Ikata (Reactor No. 3)	89.0
	4Q	Kansai Electric Power Co., Inc	Ohi (Reactors No. 3,4)	118.0×2
			Takahama (Reactors No. 3,4)	87.0×2
		Hokkaido Electric Power Co., Inc.	Tomari (Reactor No. 3)	91.2
			Tomari (Reactors No. 1,2)	57.9×2
			Total	1120

Note: Assumption in MHRI's latest *Economic Outlook*
Sources: Made by MHRI based upon various media reports.

[Chart 8: Assumptions regarding the consumption tax hike]

	Details
Consumption tax rate	・Raised to 8% in Apr 2014 ・Raised to 10% in Oct 2015
Reduced tax rate	・Introduced in Oct 2015 ・Applied to food (ex alcoholic beverages and restaurant meals)
Economic stimulus measures (for consumption tax hike)	・JPY5.5 tril economic stimulus package at the time of the FY2014 tax hike (approximately JPY2 tril for public works) ・JPY2 tril economic stimulus package at the time of the FY2015 tax hike (approximately JPY1.5 tril for public works)

Note: Assumption in MHRI's latest *Economic Outlook*
Sources: Made by MHRI based upon various media reports.

[Chart 9: Outlook on the Japanese economy]

		2012	2013	2014	2015	2013	2014				2015				2016
		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	0.7	2.3	0.5	1.5	-0.0	1.5	-1.7	1.1	0.5	0.4	0.6	0.6	-0.9	0.8
	Q-o-q % ch p.a.	--	--	--	--	-0.2	6.1	-6.8	4.4	1.9	1.4	2.3	2.4	-3.7	3.1
Domestic demand	Q-o-q % ch	1.4	2.7	-0.1	1.4	0.5	1.6	-2.7	0.9	0.5	0.4	0.6	0.8	-1.4	0.5
Private sector demand	Q-o-q % ch	1.4	2.2	-0.3	1.5	0.5	2.4	-3.7	1.0	0.8	0.6	0.7	1.0	-2.1	0.4
Personal consumption	Q-o-q % ch	1.5	2.5	-1.8	1.7	0.4	2.0	-5.0	1.5	0.8	0.5	0.7	1.6	-3.0	0.7
Housing investment	Q-o-q % ch	5.4	9.5	-8.1	-0.2	2.4	2.0	-10.3	-3.4	1.9	1.8	3.1	-0.7	-6.2	-3.8
Capital investment	Q-o-q % ch	0.7	2.7	4.5	3.0	1.4	7.7	-2.5	0.4	0.7	0.8	0.8	1.0	0.3	0.7
Inventory investment	Q-o-q contribution, % pt	-0.1	-0.5	0.5	-0.2	-0.1	-0.5	1.0	-0.1	-0.0	-0.0	-0.1	-0.3	0.3	-0.1
Public sector demand	Q-o-q % ch	1.4	4.2	0.5	0.9	0.5	-0.6	0.2	0.7	-0.3	-0.3	0.3	0.2	0.8	0.7
Government consumption	Q-o-q % ch	1.5	1.8	1.0	1.7	0.2	-0.1	0.4	0.4	0.4	0.4	0.5	0.5	0.5	0.5
Public investment	Q-o-q % ch	1.3	15.1	-1.3	-2.6	1.4	-2.5	-0.5	2.3	-3.0	-3.1	-0.5	-0.9	2.2	1.5
External demand	Q-o-q contribution, % pt	-0.8	-0.5	0.6	0.1	-0.6	-0.2	1.1	0.1	-0.0	-0.0	-0.0	-0.2	0.5	0.3
Exports	Q-o-q % ch	-1.3	4.8	5.5	4.3	0.3	6.5	-0.4	0.7	0.7	1.2	1.1	1.1	1.2	1.0
Imports	Q-o-q % ch	3.6	7.0	1.6	3.0	3.7	6.4	-5.6	-0.0	0.8	1.1	1.2	2.0	-1.6	-0.3
GDP (nominal)	Q-o-q % ch	-0.2	1.9	2.3	2.3	0.3	1.6	-0.1	0.8	0.8	0.4	1.0	0.2	-0.1	0.9
GDP deflator	Y-o-y % ch	-0.9	-0.4	1.8	0.7	-0.4	-0.1	2.0	1.8	1.7	1.7	0.5	0.4	1.0	1.0
Domestic demand deflator	Y-o-y % ch	-0.8	0.3	1.9	0.8	0.5	0.6	2.4	1.9	1.6	1.5	0.4	0.5	1.1	1.2

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

		2012	2013	2014	2015		2014				2015				2016
		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	-2.9	3.2	0.2	2.2	1.8	2.9	-3.8	-0.3	0.7	1.0	0.9	1.4	-1.3	-0.6
Ordinary profits	Y-o-y % ch	8.1	20.9	-0.1	3.2	25.1	17.2	-2.0	2.6	0.2	-0.6	5.1	3.0	3.3	1.5
Nominal compensation of employees	Y-o-y % ch	0.1	1.0	1.6	1.6	1.6	0.5	1.3	1.6	2.0	1.6	1.7	1.7	1.9	0.8
Unemployment rate	%	4.3	3.9	3.6	3.5	3.9	3.6	3.6	3.6	3.6	3.6	3.5	3.5	3.5	3.5
New housing starts	P.a., 10,000 units	89.3	98.7	91.2	88.4	104.1	93.4	88.7	89.9	91.7	94.9	95.3	88.3	84.7	85.8
Current account balance	P.a., JPY tril	4.2	0.8	2.8	3.6	0.0	-5.5	2.6	3.6	5.8	1.2	3.2	2.2	7.3	3.5
Domestic corporate goods prices	Y-o-y % ch	-1.1	1.9	4.0	2.4	2.5	1.9	4.4	4.1	3.8	3.8	1.2	1.4	3.3	3.6
Consumer prices	Y-o-y % ch	-0.2	0.8	3.1	1.7	1.1	1.3	3.3	3.1	3.0	3.0	1.0	1.1	2.2	2.3
Consumer prices (ex consumption tax)	Y-o-y % ch	-0.2	0.8	1.1	1.1	1.1	1.3	1.4	1.1	1.0	1.0	1.0	1.1	1.1	1.2
Uncollateralized overnight call rate	%	0.06	0.04	0～0.10	0～0.10	0.07	0.04	0.06	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	%	0.78	0.69	0.65	1.04	0.64	0.63	0.60	0.56	0.65	0.80	0.90	1.00	1.10	1.15
Nikkei average	JPY	9,650	14,424	15,700	17,500	14,972	14,964	14,650	15,600	16,100	16,400	16,900	17,400	17,600	18,100
Exchange rate	JPY/USD	83.0	100.0	103.0	110.0	101.0	103.0	102.0	102.0	104.0	105.0	107.0	109.0	111.0	112.0
Crude oil price (WTI nearest term contract)	USD/bbl	92.0	99.0	100.0	96.0	98.0	99.0	103.0	99.0	98.0	98.0	97.0	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). Based upon the assumption that the consumption tax will be raised to 8% in Apr 2014 and 10% in Oct 2015 (with a reduced tax rate to be applied to food (ex alcoholic beverages and restaurant meals) in Oct 2015.
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.

As shown above, we expect growth in FY2015 to be pushed up by a last-minute rush of demand in the first half of the fiscal year, followed by a sharp fall into negative territory again in the Oct-Dec quarter immediately after the consumption tax hike. Even so, the Japanese economy should pick up toward the end of the fiscal year (end of March 2016) due to the upturn of capital investment and implementation of public works projects. Hence, we forecast that the Japanese economy will grow +1.5% in FY2015 (forecast in June: +1.5%).

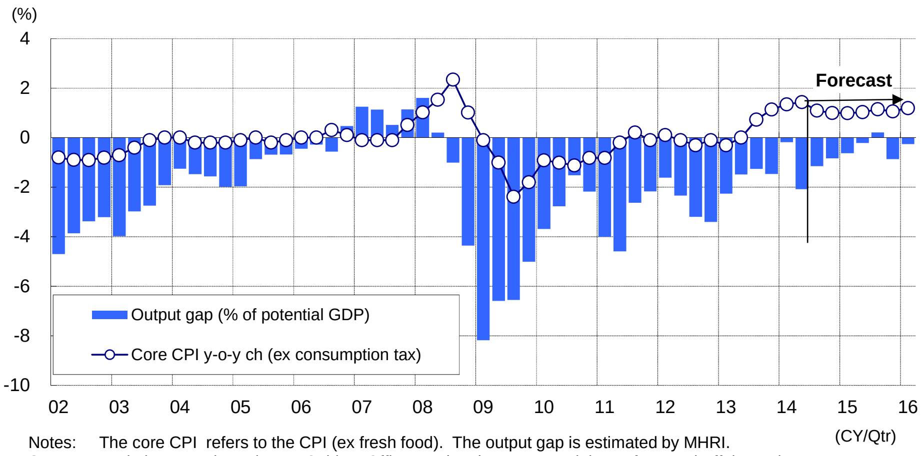
Slow improvement of the output gap

As of the Apr-Jun quarter of 2014, the output gap (the gap between actual GDP and potential GDP) in negative territory estimated by MHRI widened to -2.1% of potential GDP (meaning an excess of supply of approximately JPY11 trillion) (**Chart 10**). While the breadth of the negative output gap should narrow again in the Jul-Sep quarter of 2014, the output gap should fall into negative territory after the tax hike. In FY2015, while the excess supply should be resolved temporarily in the Jul-Sep quarter in the run-up to the next consumption tax hike, the output gap should fall into negative territory once again after the tax hike. Due in part to the impact of the two consumption tax hikes, the output gap is only expected to improve at a slow pace.

The odds are high that the y-o-y change of the core CPI (ex impact of consumption tax hike) will fail to reach 2% in FY2015

The core CPI (general, excluding fresh food) – excluding the impact of the consumption tax hike – has been shrinking since peaking in April 2014 (+1.5% y-o-y), declining to +1.3% y-o-y as of June 2014. It appears that the upward pressure upon the percentage change of the CPI stemming from the weak yen is starting to fade. Looking forward, the rise of energy prices stemming from the weak yen and higher crude oil prices and the movements to cover the rise of import costs should gradually continue to fade from the Jul-Sep quarter. Furthermore, the expansion of the negative output gap due to the consumption tax hike should serve to curb the rise of inflation for the time being. The rise of the core CPI should continue to moderate until fall.

[Chart 10: 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 Cabinet Office, *National Accounts,* Ministry of Internal Affairs and Communications, *Consumer Price Index*, and others.

Even so, in the second half of FY2014, we expect to see moves to pass on the recovery of wages to prices along with the gradual recovery of domestic demand. The year-on-year change of the core CPI (excluding the impact of the consumption tax hike) for the full year in FY2014 should stand at +1.1% (+3.1% when including the impact of the consumption tax hike), surpassing the rise in FY2013.

Again in FY2015, the fall of demand after the consumption tax hike should keep the rise of the inflation rate subdued. During the full year FY2015, the year-on-year change of the core CPI (excluding the impact of the consumption tax hike) is expected to reach +1.1% (+1.7% when including the impact of the consumption tax hike), rising at a pace on par with FY2014.

As shown above, despite a gradual rise of the inflation rate, the rise will still fall short of the Bank of Japan's (BOJ) inflation target of "2% in two years". The BOJ will likely decide to extend its quantitative and qualitative monetary easing measures when it becomes evident that it is difficult to achieve its target.

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