November 2013

Forecast for the Japanese Economy in Fiscal 2013 and 2014

— Continued Trend toward Improvement, but Temporary Slackening of Growth —

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1. Outlook for the Japanese Economy in Fiscal 2013 and Fiscal 2014
-- Improvement in the Economy Will Continue Even after the Increase in Consumption Taxes--

(1) Current State of the Economy: The Recovery Momentum Is Not as Strong as It Appears

The real GDP growth rate for the July–September quarter of 2013, which was announced on November 14, 2013, was +0.5% compared with the previous quarter (+1.9% at an annualized rate), the fourth consecutive quarter of growth. Although the rate of expansion has slackened, this latest data enables us to confirm that the economy is still showing gradual improvement. However, closer examination of the GDP data indicates that the growth rate was substantially boosted by public works and inventory investments and that the recovery momentum of the economy is not as strong as it may appear. In addition, inflationary pressures are gradually building, and the positive upward push on the real growth rate stemming from deflation is diminishing.

Private consumption, which has been a driving force for the economy thus far, rose 0.1% and remained virtually level with the previous quarter. Factors believed to account for this have been the decline in consumer confidence, a reaction to the relatively high rate of expansion in consumption until recently, and the emergence of the effects of increases in consumer prices. In nominal terms, consumption rose 0.4% over the previous quarter, thus sustaining its underlying firmness, but because the increase in the deflator was a high 0.3%, growth in consumption in real terms was restrained. In addition, although summer bonuses in 2013 were above the level of the previous year, the decline in scheduled worker compensation has continued, and real worker compensation was down 0.6% from the previous quarter. This is viewed as a negative factor for personal consumption.

Corporate capital investment increased 0.2% from the previous quarter, for the third consecutive quarterly rise, but the rate of expansion remained low. Corporate performance is improving, and business confidence is also rising, but interest in investing continues to be slow to rise.

Housing investment expanded a firm 2.7% over the previous quarter. In addition, figures for the April–June quarter were revised upward to show an increase over the previous quarter. As a result of this revision, the increase in housing investment in the July–September quarter became the fifth consecutive quarter of expansion. Recent data on the number of housing starts show increases, suggesting that expectations of higher housing loan interest rates, the surge in demand prior to the increase in the consumption tax, and other factors are pushing housing construction activities upward.

These components of private final demand, namely the total for consumption, corporate investment, and housing investment, made only a +0.2 percentage point contribution to GDP growth compared with the previous quarter. In contrast, the components of domestic final demand contributing to raising the GDP were inventory investment and public-sector demand.

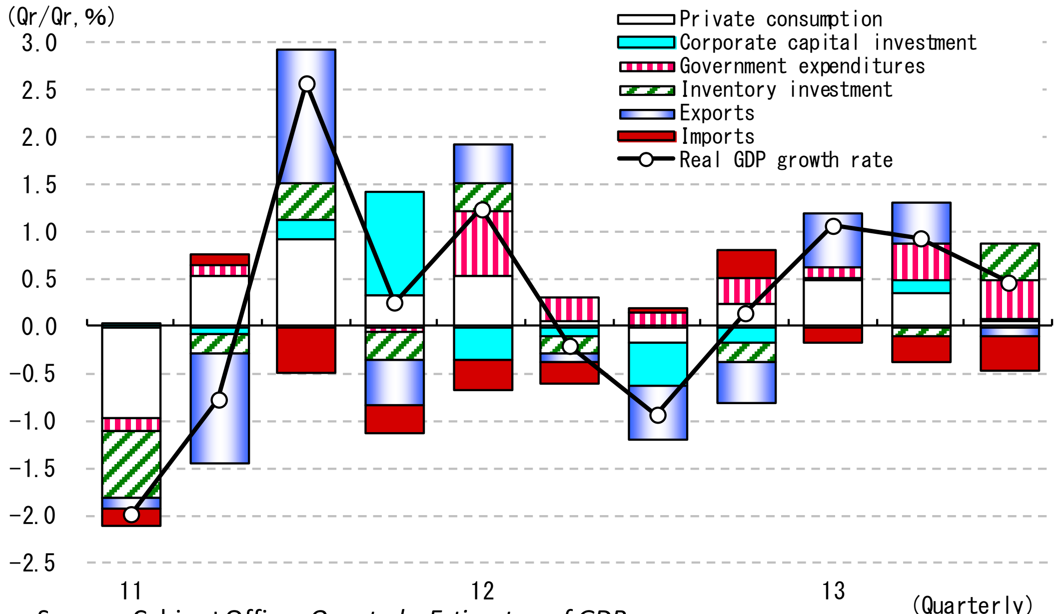
The contribution of inventory investment compared with the previous quarter was a sharply increased +0.4 percentage point. Recently, growth in industrial shipments has been weak in comparison with expansion in industrial production, and, as a result, the index of inventories has risen slightly. There is a possibility that this led to the increase in inventory investment, rather than an active building up of inventories on the part of corporations in anticipation of increases in demand. At the time of preparing the preliminary estimates, all the data had not been made available, and there is a possibility that in the second preliminary estimates the inventory data may be revised downward.

Public investment increased 6.5% over the previous quarter, the seventh consecutive quarter-to-quarter increase, and rose to the high level prevailing in the January–March quarter of 2004. This gain reflects the movement to full-scale implementation of economic policies adopted in the previous fiscal year. Government final consumption also expanded, by a steady 0.3% for the July–September quarter. Public-sector demand as a whole continued to expand at a relatively high rate and contributed 0.4 percentage point to economic growth.

Exports turned downward 0.6% for the quarter, reflecting the slowing of the recovery pace in overseas economies. On the other hand, imports of energy-related items and machinery continued to be firm, and rose 2.2% over the previous quarter. As a result, the contribution of external demand to GDP growth was minus 0.5 percentage point, the first negative figure in three quarters.

The nominal GDP growth rate for the July–September quarter was +0.4% (+1.6% at an annualized rate), the fourth consecutive quarter of positive growth. The GDP deflator, which reflects overall price trends in the economy as a whole, was 0.3% below the same quarter of the previous fiscal year, a slightly smaller margin of decline than before. However, as a result of the weakening of the yen, the import deflator rose sharply (by 14.3% over the previous quarter), and this reduced imports in real terms. In addition, the domestic deflator rose 0.4%, the first positive figure since the July–September quarter of 2008. Factors accounting for this included the fact that the deflators for the overall capital formation components of GDP, including housing investment, capital investment, and public investment rose 1.4%, a higher margin than before. Similarly, the deflator for private consumption rose 0.3%, the first positive figure since the July–September quarter of 2008. The effects of increases in prices of construction materials, rising wages in the construction sector because of labor shortages, and the impact of the rise in import prices owing to the weakening of the yen are gradually having an effect on the overall price level.

Chart 1: Trends in Real GDP
(on a Quarter-on-Quarter Basis)



Source: Cabinet Office, *Quarterly Estimates of GDP*

(2) The Economy Will Avert a Downturn Even after the Hike in the Consumption Tax

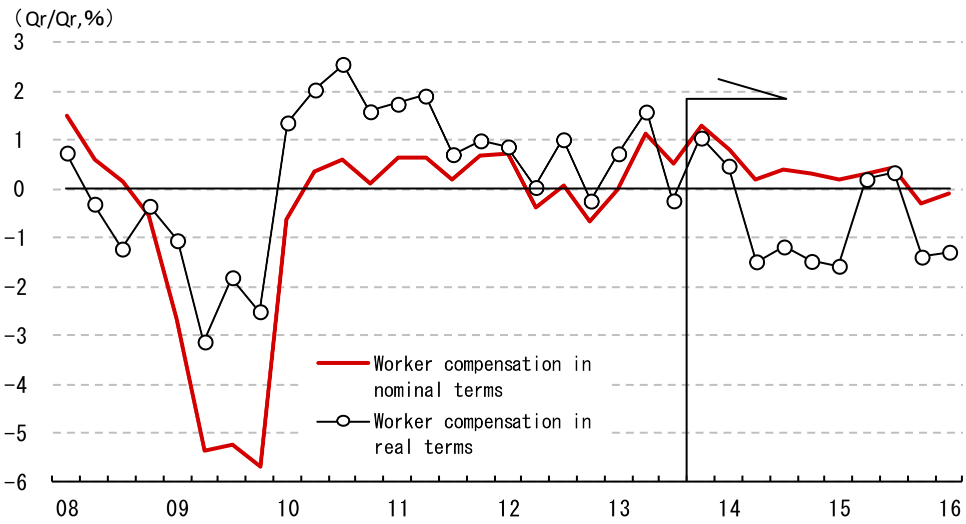
Much of the 0.9 percentage point contribution of domestic demand to GDP growth can be explained by the rise in inventory and public demand, while the contribution of the external sector was negative. This and other factors suggest that, at present, the momentum the economy has had thus far is no longer present. Since fall 2012, the economy has shown improvement mainly because of the firm growth in private consumption stemming from positive expectations about the effectiveness of Abenomics and the boosts provided by public investments due to economic policies that have incorporated flexible fiscal measures. However, stock prices, which had been increasing, are now fluctuating within a box range and consumer confidence has begun to wane. As a result, it seems that the boost given to private consumption by positive expectations was interrupted during the summer. In addition, the impact of public investment, which showed full-scale positive results during the summer of 2013, may begin to run its course because of limitations on government budget allocations and other factors.

Toward the end of the fiscal year, the outlook is for private consumption and private housing investment to show firm expansion as the surge in demand prior to the consumption tax increase becomes stronger, and the pace of improvement in the economy will quicken. However, if these temporary factors are excluded, the strength of domestic demand may weaken.

After the beginning of fiscal 2014, a temporary deterioration in the economy due to the reaction to the surge in demand cannot be avoided. The problem will be whether or not this deterioration will only be temporary and the economy can return to an improving trend in the July–September quarter of 2014.

Regarding consumption, the outlook is for weaker trends following the consumption tax increase. At present, employment conditions are improving gradually and, in some areas, signs of labor shortages are emerging. In addition, there are indications that corporations, mainly large companies, may increase wages in fiscal 2014. Also, compensation of public servants, which had been cut temporarily to provide for reconstruction expenditures, will be restored to the previous levels. As a result, workers' compensation in nominal terms is believed likely to rise gradually (Chart 2). However, the increase in wages is not expected to exceed the effects of the increase in the consumption tax. Real worker compensation has been above the previous year since 2010, but as a result of the timing of the consumption tax hike, compensation levels are expected to move below those of the previous year and, therefore, act as a factor restraining consumption.

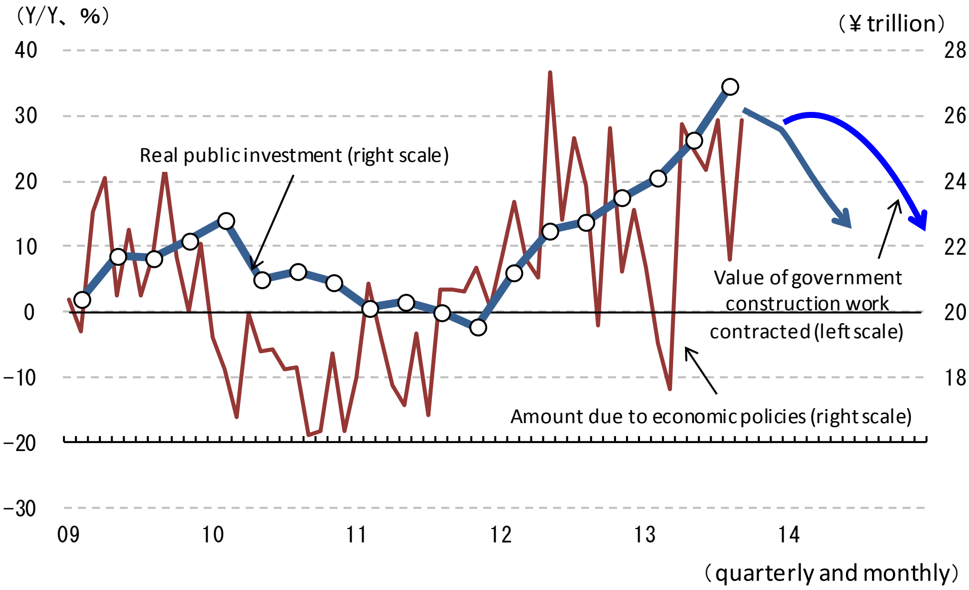
Chart 2: Forecasts for Worker Compensation



Source: Cabinet Office, *Quarterly Estimates of GDP*

Public investment, which has continued to increase to the present, as measured by the value of government construction work contracted, is continuing at a high level and this volume of work is expected to be sustained for the time being. Nevertheless, as economic policies run their course, reductions in these expenditures may be unavoidable. The government is scheduled to formulate economic policies containing allocations of about ¥5 trillion in the first part of December, but, even if these allocations are able to delay the diminishing effects of previous policy measures, it will be difficult for them to significantly lift the economy (Chart 3).

Chart 3: Trends in Public Investment in Real Terms



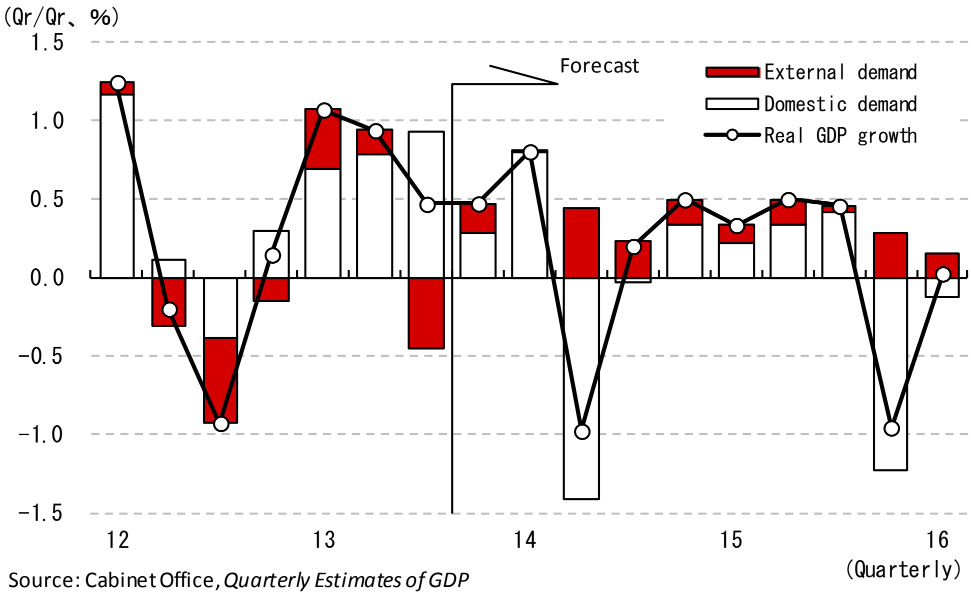
Note: National government includes public corporations and independent administrative corporations, and local governments are prefectural level governments; cities, towns and municipalities; and local public corporations.
Sources: Cabinet Office, *Quarterly Estimates of GDP*, Hokkaido Construction Industry Guarantee Associations, Eastern Japan Construction Industry Guarantee Associations, Western Japan Construction Industry Guarantee Associations: Statistics on Guarantees Provided for Construction Prepayments.

On the other hand, exports, which have begun to show a declining trend, are expected to begin to rise again accompanying the improvement in overseas economies. In the United States, as a result of the deterioration in confidence along with the difficulties in reaching agreement in discussions of fiscal issues, the momentum of economic recovery, especially in the private demand sector, has weakened temporarily. However, when a path to moderate fiscal restructuring is found, it is viewed as likely that recovery momentum will emerge again in 2014. Also, in China and other Asian countries, where the pace of recovery is only moderate at present, are expected to sustain firmness in economic trends going forward. In addition, as the yen settles down around ¥100 to one U.S. dollar, Japan’s export competitiveness will gradually recover, and the benefits of the cheaper yen will permeate the economy. As these comments suggest, the environment for exports will gradually improve, and the growth in unit volume of exports, which has been only moderate thus far, is expected to accelerate in fiscal 2014.

Since this will bring an increase in the contribution of the external sector to the economy, negative growth in real GDP will be experienced only in the

April–June quarter of 2014, and the economy will return to positive growth from the July–September quarter onward (Chart 4). Please note that domestic demand is expected to show negative growth for two quarters following the increase in the consumption tax. Thereafter, private consumption will gradually bottom out, and corporate capital investment will continue to rise. Since the deterioration will only be temporary, a downturn in the economy should be averted.

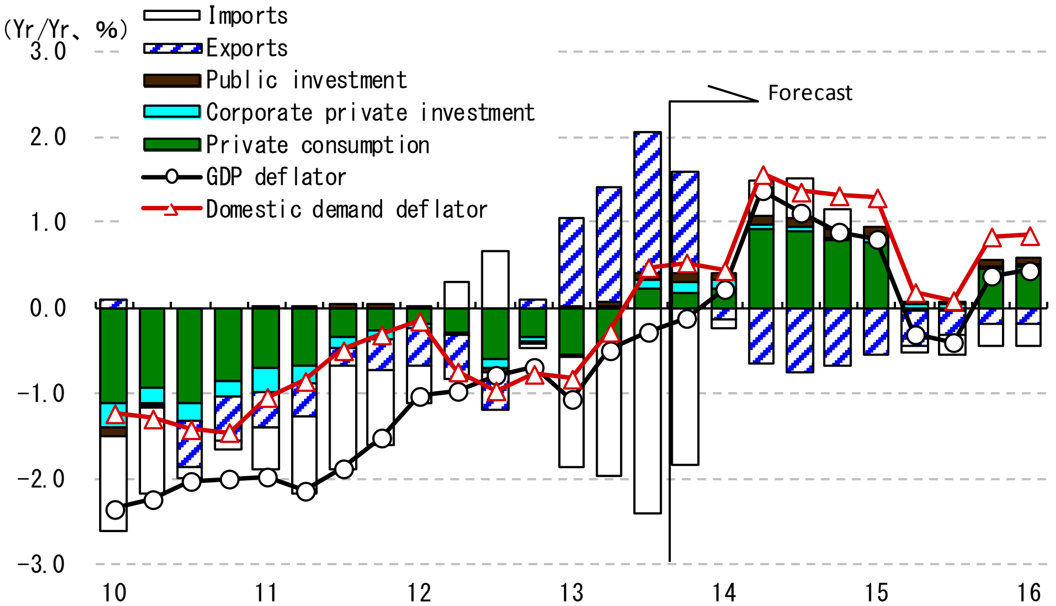
Chart 4: Breakdown of Domestic and External Demand



Source: Cabinet Office, *Quarterly Estimates of GDP*

However, it is necessary to note that at present inflationary pressures are rising. The margins of decline from the previous year in various deflators are diminishing, and the deflator for domestic demand is now above the previous year for the first time since the July–September quarter of 2008 (Chart 5). If it appears that the rate of increase in the deflators accelerates, this will be a factor restraining real GDP growth.

Chart 5: Contribution of Deflators (Year on Year)



Source: Cabinet Office, *Quarterly Estimates of GDP*

(Quarterly)

Note that we have assumed that the consumption tax will be increased to 10%, as scheduled, in October 2015, but there is a possibility that the actual timing of the increase may be postponed. Minister of Finance, Taro Aso expressed the view that, from the perspective of the budget formulation process, the date of the tax increase should be December 2014, but the GDP statistics available at that time will only be those through the July–September quarter of 2014. Although the forecast is for the GDP to be expanding over the previous quarter by that time, compared to the rate of growth used for deciding on the increase in the tax to 8% (actual growth in the April–June quarter of 2013), there is a strong possibility that growth in the quarter used as a reference may be considerably lower.

(3) Outlook for Fiscal 2013 and Fiscal 2014: Averting a Downturn as Exports Provide Support for the Economy

We have prepared this outlook based on the assumption that the consumption tax rate will be increased, as scheduled, to 10% in October 2015. In addition, we have assumed that, as the consumption tax rate increases, the government will implement economic measures amounting to about ¥5 trillion centered around public investment and that this will be a factor supporting the economy in fiscal 2014.

Please note that, although agreements under the Trans-Pacific Partnership (TPP) negotiations may be reached in the near future, we think that these will have only a slight effect on the economy during the forecast period and that serious electric power shortages will continue to be averted going forward. Also, regarding the 2020 Tokyo Olympics, we believe that the effects will be limited to pushing stock prices upward in the short term and improving consumer confidence. The effects on the economy during the forecast period will be marginal.

In the latter half of fiscal 2013, the real GDP growth rate is expected to show rising margins of increase toward the end of the fiscal year. Adverse factors for the economy seem likely to include the diminishing effects of public investments under economic stimulus policies, which have boosted the economy thus far, and a shift to negative contributions to growth from inventory investments. However, exports will begin to rise as a result of improvement in overseas economies and domestic demand will regain firmness.

Among components of final demand, the growth rate of private consumption will rise as we approach the end of the fiscal year, and consumption is expected to be a driving force for the economy. However, much of this improvement will be due to the surge in demand prior to the consumption tax increase. The improvement will not result from future expectations that might boost consumption nor will it be a reflection of delayed increases in wages. In particular, for major durable goods purchases, there will be a positive impact from new additions to the housing stock, and sales are expected to become active toward the end of the fiscal year, although this will have the effect of eroding future demand.

In the area of private housing investment, the number of new housing starts will peak out, but a large backlog of orders for housing has piled up prior to the increase in the consumption tax, and the rising trend will continue through the remainder of the fiscal year.

The outlook is for corporate capital investment to remain on a moderate rising trend. Although companies will refrain from making aggressive investments to raise capacity, reflecting the improvement in corporate performance, companies will make investments to maintain competitiveness and investments to replace older production capacity. This will be a factor supporting the economy. Since the expansion in domestic demand and the rise in the value of exports owing to the cheaper yen will bring an increase in sales, corporate performance is expected to show steady improvement, with steady increases in current income. The margin of expansion in income is expected to be especially large in the manufacturing sector. On the other hand, since the cost burden of corporations will rise because of the weakening of the yen, the improvement in profit ratios will gradually reach a ceiling.

In the area of public investment, maintaining the current high levels will be difficult because of budgetary constraints and shortages of personnel in the construction industry. This may lead to declines in public investment in comparison with the previous quarters.

Although exports moved temporarily below the levels of the previous year during the July–September quarter, they are expected to begin to rise again as overseas economies experience gradual recovery. However, the shift of production facilities outside Japan will continue, and the ratio of overseas production of Japanese companies will remain on an upward trend. Given this trend, there is likely to be a limit on how much the cheaper yen can boost the unit volume of exports. The rates of growth in exports may therefore remain at moderate levels.

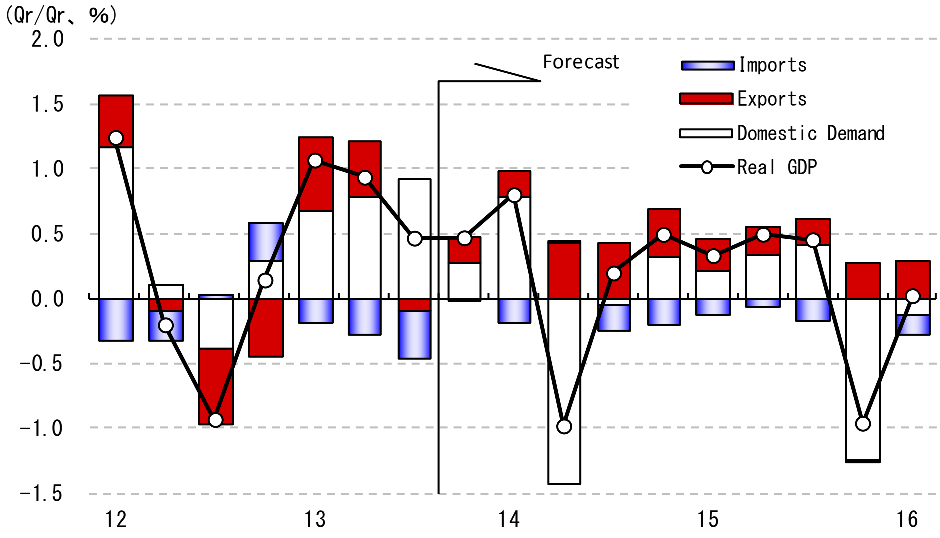
In view of these trends in the economy, although the industrial production index will continue to rise, the pace of increase is forecast to continue to be moderate. Compared with the decline of 3.0% in fiscal 2012, the increase in industrial production may be limited to +2.5%. While gradual improvement in employment conditions will continue, companies will continue to restrain personnel expenses, and increases in wages will be relatively small.

Regarding prices, the effects of high import prices due to the depreciation of the yen are gradually moving downstream, and the outlook is for inflationary pressures to rise going forward. The index of domestic corporate prices declined 1.1% in fiscal 2012 but is forecast to reverse this trend and rise 1.6% in fiscal 2013. In the midst of a market where domestic households prefer lower-priced goods and services, it will be difficult for corporations to pass on increases in their costs sufficiently to retail prices. Therefore, the outlook is for the consumer price index (less fresh food), which declined 0.2% in fiscal 2012, to rise 0.6% in fiscal 2013. As real wages continue to be stagnant, it will be difficult to imagine that the anticipated rate of inflation will start to rise first, thus suggesting that this will be a difficult environment for the Bank of Japan to reach its monetary policy target of 2.0% inflation in consumer prices.

We are forecasting that real growth in fiscal 2013 will be +2.4%. The economy will continue to improve, and, nearing the end of the fiscal year, there will be surge in demand, mainly private consumption, prior to the increase in the consumption tax. As a consequence, growth is likely to be relatively firm in the latter half of the fiscal year. The contribution of the external sector will remain at about +0.0%, as growth in exports will be only slightly higher than growth in imports. After exclusion of a carryover effect of +0.6%, the outlook for the rate of real growth calculated during the fiscal year will be +1.8%, which will be a higher pace of expansion than in fiscal 2011, when growth was boosted sharply by reconstruction and recovery expenditures in the aftermath of the Great East Japan Earthquake.

The rate of GDP growth in nominal terms in fiscal 2013 is forecast to rise to +2.2%. Although the GDP deflator will remain at levels below the previous year and decline 0.2% for the fiscal year as whole, the domestic demand deflator, which excludes the effects of external demand, will rise to 0.3% over the previous year, thus bringing a weakening of deflationary pressures.

Chart 6: Forecast of Contribution Rates to Real GDP Growth by Demand (on a Quarter-on-Quarter Basis)



Source: Cabinet Office, *Quarterly Estimates of GDP*

In fiscal 2014, as a result of the effects following the rise in the consumption tax, the outlook is for growth in real GDP to remain at a marginal +0.4% over the previous fiscal year. In addition, the positive impact of public investment, which boosted the economy during fiscal 2013, will run its course, and, even after taking account of the positive effects of economic policies, public investments will decline in comparison with the previous fiscal year, and this will be a factor lowering the growth rate. Although the trend toward improvement in the corporate sector will continue, the positive impact of the cheaper yen on corporate profitability will run its course. Also, since the cost burden on corporations will rise, corporate performance will lack robustness. After exclusion of a carryover effect of +0.9%, the rate of real growth in fiscal 2014, calculated during the fiscal year, will be –0.4%.

On the other hand, as overseas economies show improvement, Japan's exports will expand, and thus provide support for the economy. In manufacturing, exports will make up for the slack caused by lackluster domestic demand, and there is a possibility that by lowering export prices, manufacturing companies will increase their competitiveness and make stronger efforts to increase the unit volume of their exports. Examination of the contributions of the domestic and external sectors separately shows that domestic demand will decline 0.3% from the previous fiscal year for the first drop in five years (since 2009), while external demand will rise to 0.7%. Thus, external demand will make up for the weakness in domestic demand resulting from the slump in the household sector owing to the rise in the consumption tax and the resulting stagnation in the domestic corporate sector.

To overcome the slump in the economy following the increase in the consumption tax, we assume that economic policies will be implemented involving ¥5 trillion in expenditures, centering around public investments (which we assume will amount to ¥3 trillion). Nevertheless, it will be difficult for the government to maintain the high levels of expenditures of the previous year, and the outlook is for public investment to decline below prior year levels for the first time in three years.

As a result of the support for the economy from external demand, the April–June period of 2014 is expected to be the only quarter of negative real GDP growth in fiscal 2014, and the outlook is for the economy to avert a downturn following the hike in the consumption tax. However, compared with fiscal 2013, it will be difficult to avoid a major slowdown in the pace of recovery, and, if the weakness in private consumption is prolonged, there is a risk that the economy may experience a downturn.

The positive growth in nominal GDP will continue, and the rate of expansion will rise to +1.5%. Nevertheless, this will reflect the effects of the rise in the consumption tax rate, and the deflator is expected to rise 1.0% over the previous fiscal year.

As a result of the series of economic measures adopted following the collapse of Lehman Brothers, demand for automobiles and household appliances, such as flat panel TVs, air conditioners, and refrigerators, has already been satisfied. In addition, during the hot summer of 2013, sales of air conditioners and other consumer durables were brisk. For these reasons, there is a possibility that the surge in demand followed by a reactionary decline may be less pronounced than at the time of the last increase in consumption taxes in 1997. However, it will probably be difficult to avert negative effects on household consumer behavior because wages are not increasing and prices are rising, thus depressing disposable incomes. Worker compensation in real terms is forecast to decline 1.4% in fiscal

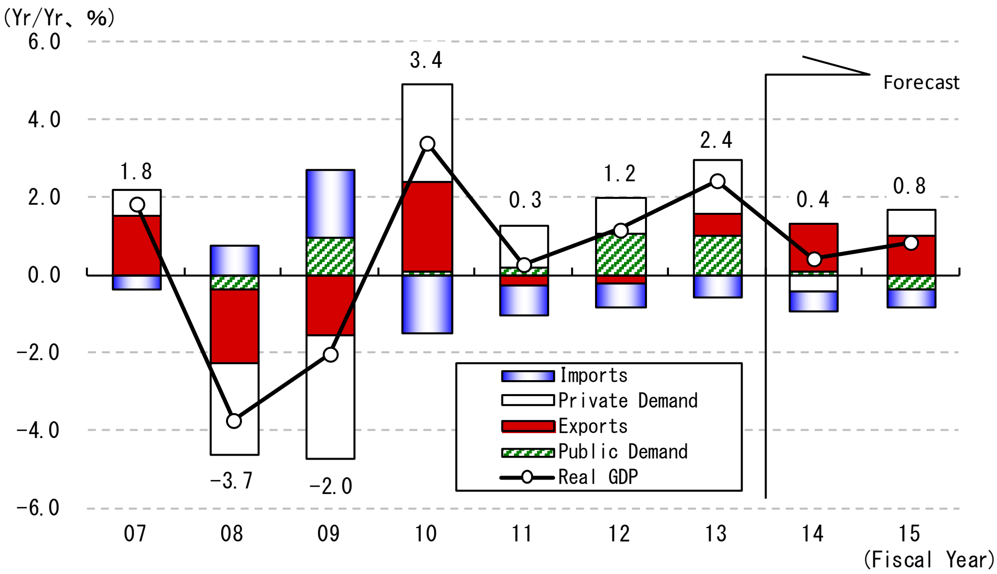
2014, the first year-on-year downturn in five years (since 2009). Through fiscal 2013, households are forecast to increase their propensities to consume and continue to spend, but in fiscal 2014 the outlook is for consumption to decline 0.9%, the first decrease in six years (since 2008).
These conditions will make it difficult for inflationary pressures to push prices upward. The outlook is for the consumer price index (less fresh food) to rise 2.4%, but, after excluding the impact of the increase in the consumption tax, the increase will be only 0.4%. Inflationary pressures from upstream in the value chain are expected to weaken because of the shift to a declining trend in the prices of crude oil and other international commodities and the weakening of upward pressure as the effects of the depreciation of the yen run their course. Even though the date for reaching the inflation target rate set by the Bank of Japan will be approaching in fiscal 2014, inflationary pressures are likely to remain moderate.

In fiscal 2015, we assume that the consumption tax will be raise to 10%. For this reason, there will be a surge in demand prior to the tax hike, followed by a reactionary decline; however, since the hike will take place during the fiscal year, the negative effect on average will be smaller than that following the tax increase in fiscal 2014. Although private consumption may decline, it will maintain an increase of 0.4% for the year as a whole because of increases in the first half of the fiscal year. Notwithstanding, after exclusion of a carryover effect of +0.3% in private consumption, it will rise by a small margin of 0.2%. The outlook is for weak trends in consumer spending because of continuing declines in real wages.
Exports are expected to provide support for the economy in fiscal 2015. We think that the recovery trends in overseas economies will continue, and Japanese companies will be able to gradually strengthen their export competitiveness as the yen settles down fully at lower levels. On the other hand, reflecting the weakness in domestic demand, the growth in imports will become more moderate, and the contribution of external demand will rise to +0.5%, a level similar to that of the previous fiscal year.
Regarding public investment, the effectiveness of government measures will have run its course, and the outlook is for public investment to drop substantially below the levels of the previous year. However, although not

definite as of this time, there is a possibility that further economic measures may be adopted along with the increase in the consumption tax rate and that these will reduce the margin of decline.

We are forecasting real GDP growth of 0.8% in fiscal 2015. During the first half of the fiscal year, the economy will show improvement along with the surge in demand, but, in the second half, the outlook is for a reactionary decline. The economy will be supported by external demand, but, if the growth in exports is weak, concerns about a possible downturn in the economy may emerge. After exclusion of a carryover effect of +0.5%, the rate of real growth calculated during the fiscal year will slow to +0.4%. However, considering the likely condition of the economy around December 2014, when the decision on the consumption tax hike will be made, we cannot rule out the possibility that the tax increase may be delayed.

Chart 7: Forecast of Real GDP Growth Rates (on a Year-on-Year Basis)



Source: Cabinet Office, *Quarterly Estimates of GDP*

These conditions will make it difficult for inflationary pressures to push prices upward. The outlook is for the consumer price index (less fresh food) to rise 2.2%, but, after excluding the impact of the increase in the consumption tax, the increase will be only 0.2%. Even though the date for reaching the inflation target rate set by the Bank of Japan will be approaching, inflationary pressures are likely to remain moderate.

Chart 8: Real GDP Growth① (Fiscal Year)

Forecast

		FY 2012				FY 2013				FY 2014				FY 2012	FY 2013	FY 2014	FY 2015
		4-6	7-9	10-12	1-3	4-6	7-9	10-12	1-3	4-6	7-9	10-12	1-3	(Actual)	(Forecast)	(Forecast)	(Forecast)
Nominal GDP	Qr/Qr	-0.7	-1.2	0.2	0.7	1.1	0.4	0.7	0.9	-0.0	0.1	0.4	0.5				
	annualized Qr/Qr	-2.6	-4.6	0.7	2.8	4.3	1.6	2.7	3.5	-0.1	0.5	1.8	2.2	0.3	2.2	1.5	0.9
	Yr/Yr	2.8	-0.5	-0.4	-0.8	0.6	2.4	2.8	3.2	1.9	1.7	1.3	0.9				
Real GDP	Qr/Qr	-0.2	-0.9	0.1	1.1	0.9	0.5	0.5	0.8	-1.0	0.2	0.5	0.3				
	annualized Qr/Qr	-0.8	-3.7	0.6	4.3	3.8	1.9	1.9	3.2	-3.9	0.8	2.0	1.3	1.2	2.4	0.4	0.8
	Yr/Yr	3.8	0.3	0.3	0.3	1.1	2.7	2.9	3.0	0.6	0.6	0.4	0.1				
GDP deflator	Yr/Yr	-1.0	-0.8	-0.7	-1.1	-0.5	-0.3	-0.1	0.2	1.4	1.1	0.9	0.8	-0.9	-0.2	1.0	0.0

Chart 9: Real GDP Growth② (Fiscal Year)

	Carry-over from the previous year (A)	Growth rate during the year (B)	Real GDP growth rate (A)+(B)
FY2012 (actual)	1.7 %	-0.5 %	1.2 %
FY2013 (forecast)	0.6 %	1.8 %	2.4 %
FY2014 (forecast)	0.9 %	-0.4 %	0.4 %
FY2015 (forecast)	0.5 %	0.4 %	0.8 %

Source: Cabinet Office, "Quarterly Estimates of GDP"

2. Forecasts of Economic Activity by Sector

(1) Corporations

- Production bottomed out in autumn 2012 and began recovering against the backdrop of improvement in domestic and overseas demand. Because of the strengthening of exports along with gradual recovery in overseas economies, a rise in demand for construction materials owing to the government's economic countermeasures, and other factors, production is forecast to continue to increase going forward. In the latter half of fiscal 2013, it is projected that the upward rise in production will be supplemented by a demand surge prior to the raising of the consumption tax rate. Although it is expected that the demand surge will be followed by a reactionary demand slump, it is forecast that the continued robustness of exports will prevent a sharp drop in production.
- Corporate performance, principally in the manufacturing sector, is continuing to post gains as a result of the improvement in economic conditions and the increase in sales owing to the depreciation of the yen. In fiscal 2013, the outlook is for the margins of increase in corporate profitability to rise, as the surge in demand prior to the consumption tax rate increase joins with other positive factors. However, in fiscal 2014 and fiscal 2015, the margins of increase in profits are forecast to shrink, as sales decline following the consumption tax hike, and higher costs will bring a deterioration in profitability.
- Since a certain minimum level of capital investment is required to maintain and replace the existing capital stock as well as to increase efficiency, this will provide support for private capital investment. However, as the trends toward the demographic aging of the population and the decline in the birthrate remain unchanged, corporations are adopting a cautious stance toward making capital investments in Japan. This has brought a shift in corporate investment behavior toward investing in overseas production locations in the emerging and other countries, where demand is expected to increase. For this reason, although the yen has depreciated from previous high levels, a recovery of capital investment in Japan is not projected. Although corporate

performance is recovering steadily, this is not bringing a rise in the drive to invest among corporations, and the margin of increase in corporate capital investments is expected to be relatively small.

(2) Households

- Labor conditions are continuing to show gradual improvement, and this is viewed as likely to continue going forward as the economy improves. On the other hand, because of structural and other factors, scheduled worker compensation continues to stagnate, and the income environment remains challenging. In addition, after the consumption tax rate is raised, companies are not expected to raise wages to compensate for the higher taxes; therefore, real wages are forecast to show a significant decline.
- As the improvement in consumer confidence seems to have reached a peak, private consumption, which had been on a rising trend, has paused. Although the outlook is for the momentum in consumer spending to return, as the end of the fiscal year approaches, and a surge in demand emerges prior to the consumption tax increase, consumption is expected to weaken temporarily again due to a reactionary slump following the surge in demand. Subsequently, amid a projected decline in real income, growth in consumption is likely to be restrained to a gradual pace.
- Housing construction starts are continuing at a high level, supported by low housing loan interest rates, expectations of increases in mortgage rates, and the additional push provided by the surge in demand prior to the consumption tax hike. At present, there is a backlog of orders, mainly for owner-built housing, and it appears to be unlikely that there will be a sharp drop off in new starts for the time being. In addition, although it will be impossible to avoid the effects of the reactionary decline in demand following the increase in consumption taxes, a major downturn should be averted through the expansion of tax breaks on housing loans and other measures to lighten the burden of housing construction costs.

(3) Government

- Since the collapse of Lehman Brothers Holdings, the implementation of a series of economic measures designed to deal with the economic downturn, combined with a major drop in tax revenues amid the deterioration of economic conditions, has led to a substantial expansion of the government's fiscal deficit as well as a marked rise in the balance of government debt outstanding. Moreover, social welfare expenditures have continued to rise against the backdrop of demographic aging, but the government has been unable to secure stable funding for those welfare costs. The dual objectives of realizing fiscal soundness and making the social welfare system stable have become major concerns for the Japanese economy.
- To address these issues, Prime Minister Shinzo Abe made the decision to increase the consumption tax rate to 8% in April 2014, based on a reform law that was passed in August 2012 to deal with both social welfare and taxation policies comprehensively. The increase in revenues from this source is to be used to fund social security. Going forward, after due examination of the state of the economy in the spring of 2015, consideration will be given to whether or not to make a further increase in the consumption tax to 10%, as scheduled, in October 2015.
- To provide for reconstruction and recovery in the aftermath of the March 2011 earthquake, the government has passed and implemented supplementary budgets for disaster recovery, and these are bringing continued increases in public investment, especially in the areas directly impacted by the earthquake. On the other hand, the administration of Prime Minister Shinzo Abe has announced that one of its principal policy objectives is to eliminate deflation and revive the economy, and that one of his three main policies to accomplish this will be to pursue "a flexible public finance policy." Under the supplementary budget for fiscal 2012, the government is implementing economic measures amounting to more than ¥10 trillion and has increased expenditures related to public investment substantially. The results of these measures are emerging in fiscal 2013, and public investment has been boosted significantly. Moreover, the government is scheduled to implement economic measures amounting to about ¥5

trillion under a supplementary budget for fiscal 2013 with the objective of dealing with the risks of a downturn and other contingencies that may accompany the increase in the consumption tax rate.

- The positive effects of the public investments included in the supplementary budget for fiscal 2012 are expected to run their course by mid-fiscal 2013, and it will be impossible to make up for the resulting decline in such investments within the supplementary budget for fiscal 2013. For this reason, public investments will decrease in fiscal 2014.

(4) Trends in Overseas Economies

- The world economy is experiencing moderate growth. The U.S. economy is continuing to expand, driven by private consumption. The European economies are showing gradual improvement as the debt issues have settled down. In China, the economy is cruising steadily forward, despite pressures for structural adjustments, and is expanding just above 7% at an annual rate.
- Going forward, the outlook is for moderate growth in the world economy. The U.S. economy is expected to continue a moderate recovery, driven mainly by the private sector, while still experiencing uncertainties related to fiscal and monetary policies. In Europe, as domestic demand remains relatively weak, improvements will be limited to gradual recovery led by exports. In China, although dealing with excessive production capacity will continue to be a bottleneck, the economy is expected to sustain firm economic growth in the upper half of the 7% to 8% range.
- Japan’s exports (on a customs-clearance, volume basis) are forecast to maintain a trend of increase going forward as the world economy shows moderate expansion. Japan’s imports (on a customs-clearance, volume basis) are expected to trend upward along with the recovery in the domestic economy, despite the possibility of a temporary downturn accompanying the increase of the consumption tax rate.
- Japan’s trade balance (on an international balance of payments basis) moved to a deficit position in fiscal 2011, but, because of the increase in the surplus in the income account, the current account has remained

in surplus. During our forecast period, although the value of exports will rise, the deficit in the trade balance will continue, but the surplus in the income account will keep the current account balance in surplus.

3. Forecasts for Prices and Financial Markets

- The slowing of the Chinese economy has put the brakes on the one-way increase in raw material prices, and these prices, especially crude oil, have topped out at high levels. While demand in emerging economies is increasing gradually, the shale gas revolution and other developments are expected to increase resource supplies, and resource prices are expected to remain in a generally stable range.
- The margins of increase in domestic corporate prices, as well as consumer prices, are expanding because of the influence of increases in energy prices caused by the decline in the value of the yen. However, there has been a hiatus in the trend toward increase in international commodity market prices, and, since the decline in the value of the yen has also stopped, upward pressures on prices are weakening. Although the margins of increase in prices are expect to expand temporarily because of the increase in the consumption tax rate, after exclusion of this factor, the rates of increase in prices are expected to be small. Consumers are continuing to search for low-priced bargains, and conditions will continue that will make it difficult for companies to raise prices easily.
- Since 2008, Japan has moved ahead with measures to ease monetary policy. In October 2010, a comprehensive policy for monetary easing was implemented, and subsequently, additional measures were implemented to ease monetary policy. Then, in January 2013, a “2% inflation target” was adopted, and the Abe administration and the BOJ issued a joint communique. In April, the BOJ made the decision to implement a policy of “quantitative and qualitative monetary easing.” For the foreseeable future, the BOJ is expected to continue its stance of maintaining an easy monetary policy.
- Long-term interest rates are expected to remain at low levels against a background of low, stable short-term rates. However, there is a possibility that the recovery in overseas economies and deterioration in

government fiscal structures around the world may place upward pressure on long-term interest rates. In foreign exchange markets, beginning in 2010, the yen appreciated substantially against a background of financial crises in Europe and additional monetary easing in the United States. Thereafter, following the advent of the administration of Prime Minister Abe, dramatic measures to ease monetary conditions have been adopted, and there has been a downward correction in the value of the yen.

Chart 10: Outlook for Fiscal 2013-2014

Forecast ↘ Yr/Yr、%

	FY2010 (actual)	FY2011 (actual)	FY2012 (actual)	FY2013 (forecast)	FY2014 (forecast)	FY2015 (forecast)
Nominal GDP	1.3	-1.4	0.3	2.2	1.5	0.9
Real GDP	3.4	0.3	1.2	2.4	0.4	0.8
Contribution of domestic demand	2.6	1.3	2.0	2.4	-0.3	0.3
Private consumption	1.7	1.6	1.6	1.8	-0.9	0.4
Housing investment	2.2	3.7	5.3	7.5	-3.3	1.1
Private capital investment	3.6	4.1	-1.3	1.5	1.3	2.9
Contribution of inventory investment	0.9	-0.4	-0.1	-0.1	0.1	-0.1
Government expenditure	0.4	0.9	4.3	3.9	0.4	-1.3
Public investment	-6.4	-2.2	14.9	13.0	-4.3	-12.4
Government final consumption expenditure	2.0	1.4	2.1	1.7	1.7	1.6
Contribution of external demand	0.8	-1.0	-0.8	0.0	0.7	0.5
Export of goods and services	17.2	-1.6	-1.2	3.8	7.7	6.3
Import of goods and services	12.0	5.3	3.9	3.3	2.7	2.6
GDP deflator	-2.0	-1.7	-0.9	-0.2	1.0	0.0

Forecast ↘ Yr/Yr、%

	FY2010 (actual)	FY2011 (actual)	FY2012 (actual)	FY2013 (forecast)	FY2014 (forecast)	FY2015 (forecast)
Current account balance (trillion yen)	16.7	7.6	4.4	4.9	7.0	7.9
balance on goods (trillion yen)	6.5	-3.5	-6.9	-9.7	-7.9	-7.7
balance on service (trillion yen)	-1.3	-1.8	-2.5	-1.4	-1.5	-1.4
balance on income (trillion yen)	12.6	14.0	14.7	17.3	17.7	18.3
Industrial production	15.4	-0.6	-3.1	2.6	1.6	3.0
Unemployment rate(%)	5.0	4.5	4.3	3.9	3.9	3.8
New housing starts(annualized, ten thousand units)	77.5	81.9	89.3	98.3	89.9	87.9
Domestic corporate goods prices	0.4	1.4	-1.1	1.6	3.1	1.3
Consumer prices	-0.4	-0.1	-0.3	0.6	2.4	0.9
excluding freshfood	-0.8	0.0	-0.2	0.5	2.4	0.8
Yen/U.S.Dollar	85.7	79.1	83.1	98.7	101.0	103.9
Uncollateralized call rates (O/N) (%)*	0.091	0.077	0.082	0.072	0.070	0.070
Newly issued government bond yields (10years) (%)	1.15	1.05	0.78	0.68	0.77	0.95
WTI future price (near month contract, US dollar/barrel)	83.4	97.3	92.1	97.6	93.0	93.0
Dubai crude oil prices (US dollar/barrel)	84.2	110.1	107.1	102.5	96.4	95.5

* actual=average, forecast=end of period

Chart 11: Outlook for Calendar 2013-2014

Forecast

Yr/Yr、%

	CY2010 (actual)	CY2011 (actual)	CY2012 (actual)	CY2013 (forecast)	CY2014 (forecast)	CY2015 (forecast)
Nominal GDP	2.4	-2.5	1.1	1.3	2.0	1.0
Real GDP	4.7	-0.6	1.9	1.7	1.1	0.9
Contribution of domestic demand	2.9	0.3	2.8	1.9	0.7	0.2
Private consumption	2.8	0.4	2.3	1.6	-0.1	0.2
Housing investment	-4.5	5.5	3.0	8.3	-0.4	-0.1
Private capital investment	0.3	3.3	2.0	-1.4	2.8	2.7
Contribution of inventory investment	1.0	-0.7	0.0	-0.1	0.0	0.0
Government expenditure	1.6	-0.2	4.2	4.0	1.4	-0.9
Public investment	0.7	-7.5	12.5	14.6	-0.2	-10.2
Government final consumption expenditure	1.9	1.4	2.4	1.5	1.8	1.6
Contribution of external demand	1.7	-0.9	-0.9	-0.1	0.5	0.7
Export of goods and services	24.4	-0.4	-0.1	1.7	6.7	7.1
Import of goods and services	11.1	5.9	5.5	2.4	3.3	2.7
GDP deflator	-2.2	-1.9	-0.9	-0.5	0.9	0.1

Forecast

Yr/Yr、%

	CY2010 (actual)	CY2011 (actual)	CY2012 (actual)	CY2013 (forecast)	CY2014 (forecast)	CY2015 (forecast)
Current account balance (trillion yen)	17.9	9.6	4.8	4.7	6.3	7.6
balance on goods (trillion yen)	8.0	-1.6	-5.8	-9.6	-8.5	-7.7
balance on service (trillion yen)	-1.4	-1.8	-2.5	-1.5	-1.5	-1.4
balance on income (trillion yen)	12.4	14.0	14.3	16.8	17.6	18.1
Industrial production	15.6	-2.8	0.6	-0.9	2.9	2.7
Unemployment rate (%)	5.1	4.6	4.4	4.0	3.9	3.8
New housing starts(annualized, ten thousand units)	81.3	83.4	88.3	96.9	91.5	89.4
Domestic corporate goods prices	-0.1	1.5	-0.9	1.2	2.8	1.4
Consumer prices	-0.7	-0.3	0.0	0.2	2.0	1.1
excluding freshfood	-1.0	-0.2	-0.1	0.3	1.9	1.1
Yen/U.S.Dollar	87.8	79.8	79.8	97.2	100.1	103.3
Uncollateralized call rates (O/N) (%)*	0.093	0.078	0.083	0.075	0.070	0.070
Newly issued government bond yields (10years) (%)	1.17	1.12	0.85	0.70	0.71	0.92
WTI future price (near month contract, US dollar/barrel)	79.5	95.1	94.2	97.7	93.2	93.0
Dubai crude oil prices (US dollar/barrel)	78.0	106.2	109.1	104.6	97.4	95.5

* actual=average, forecast=end of period

Chart 12: Outlook for 2013-2014 (Quarterly)

Forecast (from FY2013 10-12) — Qr/Qr、% / Yr/Yr、%

	FY2012				FY2013				FY2014			
	4-6	7-9	10-12	1-3	4-6	7-9	10-12	1-3	4-6	7-9	10-12	1-3
Nominal GDP	-0.7	-1.2	0.2	0.7	1.1	0.4	0.7	0.9	0.0	0.1	0.4	0.5
	2.8	-0.5	-0.4	-0.8	0.6	2.4	2.8	3.2	1.9	1.7	1.3	0.9
Real GDP	-0.2	-0.9	0.1	1.1	0.9	0.5	0.5	0.8	-1.0	0.2	0.5	0.3
	3.8	0.3	0.3	0.3	1.1	2.7	2.9	3.0	0.6	0.6	0.4	0.1
Contribution of domestic demand (Qr/Qr,%)	0.1	-0.4	0.3	0.7	0.8	0.9	0.3	0.8	-1.4	0.0	0.3	0.2
Private consumption	0.1	-0.3	0.4	0.8	0.6	0.1	0.2	1.0	-2.2	0.4	0.2	0.2
	3.1	1.3	1.0	1.1	1.6	1.9	1.7	1.9	-1.0	-0.6	-0.6	-1.4
Housing investment	2.7	1.1	3.2	2.3	0.4	2.7	2.1	1.0	-4.1	-1.9	-0.7	1.1
	4.7	1.5	5.8	9.4	7.1	8.9	7.7	6.2	1.6	-2.9	-5.6	-5.6
Private capital investment	-0.6	-3.3	-1.2	0.1	1.1	0.2	1.8	2.1	-1.6	-0.6	1.2	1.1
	7.0	1.5	-7.2	-5.0	-3.2	0.0	3.2	5.3	2.7	1.7	1.1	0.0
Contribution of inventory investment (Qr/Qr,%)	-0.2	0.0	-0.2	0.0	-0.1	0.4	-0.2	-0.1	0.2	-0.2	0.1	0.0
Government expenditure	1.1	0.6	1.1	0.5	1.6	1.6	0.3	-0.3	0.2	0.1	-0.2	-0.3
	3.5	4.4	5.9	3.5	3.5	4.8	4.1	3.3	1.9	0.6	-0.3	-0.4
Public investment	6.0	1.2	3.3	2.5	4.8	6.5	-0.4	-2.6	-0.5	-1.4	-2.0	-2.8
	11.2	15.0	19.6	13.1	12.7	19.3	13.7	8.0	2.9	-4.4	-6.5	-6.7
Government final consumption expenditure	0.1	0.4	0.6	0.0	0.8	0.3	0.4	0.4	0.4	0.5	0.3	0.4
	2.2	2.3	2.7	1.1	1.8	1.7	1.5	1.9	1.6	1.9	1.7	1.6
Contribution of external demand (Qr/Qr,%)	-0.3	-0.5	-0.1	0.4	0.1	-0.5	0.2	0.0	0.4	0.2	0.2	0.1
Export of goods and services	-0.5	-3.8	-3.0	3.9	2.9	-0.6	1.3	1.2	2.7	2.6	2.1	1.5
	9.2	-4.8	-5.0	-3.3	0.0	3.0	7.3	5.0	4.4	8.6	8.6	9.1
Import of goods and services	1.4	-0.3	-1.7	1.0	1.7	2.2	0.1	1.0	-0.1	1.0	1.0	0.7
	9.1	5.2	1.2	0.5	0.9	3.1	5.0	4.2	3.7	2.2	2.9	1.8
GDP deflator (Yr/Yr,%)	-1.0	-0.8	-0.7	-1.1	-0.5	-0.3	-0.1	0.2	1.4	1.1	0.9	0.8

Forecast (from FY2013 10-12) — Yr/Yr、%

	FY2012				FY2013				FY2014			
	4-6	7-9	10-12	1-3	4-6	7-9	10-12	1-3	4-6	7-9	10-12	1-3
Current account balance (trillion yen)*	1.5	1.0	1.1	0.8	2.2	0.6	1.2	1.0	1.7	1.6	1.9	1.7
balance on goods (trillion yen)*	-1.1	-1.7	-1.6	-2.5	-1.9	-2.8	-2.3	-2.6	-2.0	-2.1	-1.8	-2.1
balance on service (trillion yen)*	-0.7	-0.8	-0.6	-0.5	-0.2	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4
balance on income (trillion yen)*	3.6	3.7	3.6	3.9	4.6	4.1	4.2	4.3	4.4	4.4	4.5	4.5
Industrial production (Qr/Qr、%)	-2.2	-3.2	-1.9	0.6	1.5	1.7	1.3	1.8	-1.5	0.5	0.8	1.0
Industrial production (Yr/Yr、%)	6.8	-3.9	-5.9	-7.9	-3.1	2.3	5.4	5.6	3.2	1.4	1.7	0.4
Unemployment rate (%)*	4.4	4.3	4.2	4.2	4.0	4.0	3.9	3.9	4.0	4.0	3.9	3.9
New housing starts(annualized, ten thousand units)	87.6	87.6	91.8	90.4	98.1	99.4	99.7	96.0	91.5	89.2	89.4	89.8
Domestic corporate goods prices (Yr/Yr,%)	-1.1	-1.9	-0.9	-0.3	0.7	2.2	2.2	1.2	3.7	3.0	2.8	2.9
Consumer prices (Yr/Yr,%)	0.2	-0.4	-0.2	-0.6	-0.2	0.9	0.8	0.8	2.6	2.4	2.3	2.3
excluding freshfood (Yr/Yr,%)	-0.1	-0.3	-0.1	-0.3	0.0	0.7	0.7	0.6	2.6	2.4	2.3	2.3
Yen/U.S.Dollar	80.2	78.6	81.2	92.4	98.7	98.9	98.6	98.6	99.5	100.6	101.5	102.3
Uncollateralized call rates (O/N) (%)**	0.078	0.085	0.084	0.082	0.073	0.073	0.070	0.070	0.070	0.070	0.070	0.070
Newly issued government bond yields (10years) (%)	0.88	0.79	0.75	0.70	0.73	0.77	0.61	0.61	0.68	0.75	0.81	0.85
WTI future price (near month contract, US dollar/barrel)	93.5	92.2	88.2	94.4	94.2	105.8	96.4	93.8	93.1	93.0	93.0	93.0
Dubai crude oil prices (US dollar/barrel)	106.5	106.1	107.4	108.3	100.8	106.2	103.3	99.8	98.0	96.5	95.5	95.5

*seasonally adjusted　　** actual=average, forecast=end of period