May 2014

Forecast for the Japanese Economy in Fiscal 2014 and 2015

— Even if Improvement in the Economy Continues, the Pace Will Be Slow—

Mitsubishi UFJ Research and Consulting

Economic Research Department

1. Outlook for the Japanese Economy in Fiscal 2014 and Fiscal 2015 —Even if Improvement in the Economy Continues, the Pace Will Be Slow

(1) Current State of the Economy: Rapid Growth at the end of Fiscal 2013 Because of the Surge in Demand

The real GDP growth rate for the January–March quarter of 2014, which was announced on May 15, was +1.5% compared with the previous quarter (+5.9% at an annualized rate). This high rate of increase was due to the surge in demand prior to the increase in the consumption tax. The January to March period was the six consecutive quarter of growth.

Growth in total private-sector demand rose sharply to +2.3% over the previous quarter. Within this total demand figure, private consumption increased 2.1% quarter to quarter because of the effects of the surge in demand preceding the consumption tax hike. This was the highest quarter-to-quarter growth rate since the January–March quarter of 1997 following the previous increase in the consumption tax.

Housing investment rose 3.1% for the quarter, and, because of the surge in demand for housing construction prior to the consumption tax increase, total new housing starts in 2013 rose above the previous year, and the January–March period marked the eighth consecutive quarterly increase.

Corporate capital investment increased for the fourth consecutive quarter, and the rate of expansion rose to +4.9%. Along with the favorable performance of the corporate sector, management sentiment about the economy is improving and the drive to invest is reviving. Inventory investment declined (making a –0.2 percentage point contribution to growth over the previous quarter) as inventories in the distribution chain were depleted by the surge in demand.

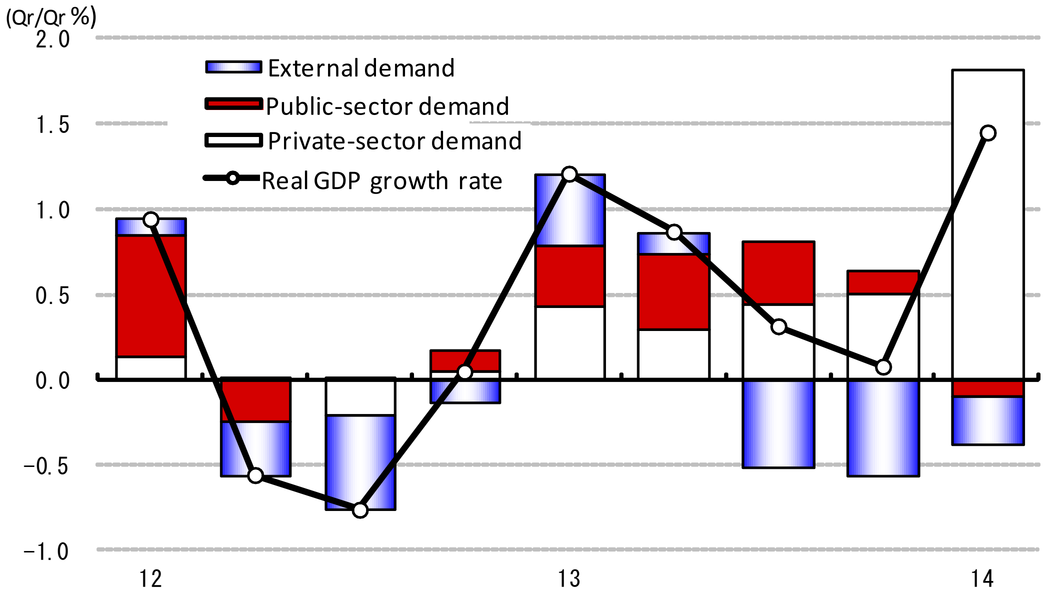
The contribution of these private-sector demand components to growth in real GDP was +1.8 percentage points, the sixth consecutive quarter of positive contributions. Moreover, the contribution in the January–March quarter was the largest for the current recovery phase. On the other hand, the overall contribution of the public-sector was –0.1 percentage point, the seventh consecutive quarter of negative contributions. Government final consumption continued to make a positive contribution, rising 0.1% over the previous quarter. However, public investment declined 2.4% from the previous quarter, the first negative figure in five quarters, reflecting the diminishing impact of economic stimulus measures. As a consequence, the contribution of domestic demand to growth for the quarter was +1.7 percentage points, thus providing an overall boost for the economy.

On the other hand, the contribution of external demand was –0.3 percentage point, the third consecutive quarterly negative figure. The pace of external trade quickened for the quarter, with exports rising 6.0% over the previous quarter and imports up 6.3%. However, there is a possibility that both the export and import figures may be overestimated because of revisions in the data used for calculation of international balance of payments statistics.

The GDP growth rate in nominal terms was +1.2% for the quarter (5.1% at an annualized rate), the six consecutive quarterly increase. In addition, the GDP deflator, which reflects overall price trends in the economy, was 0.0% over the previous year for the first time since the July–September quarter of 2009. However, as a consequence of the weakening of the yen, the import price deflator rose sharply (by 6.2% over the previous year), thus depressing imports in real terms. In addition, the domestic deflator rose 0.7%, the third consecutive positive figure. The principal reason for this was that the consumption deflator rose to +0.6% over the same period of the previous year. This suggests that trends, such as higher prices of energy, rising wages because of labor shortages, and higher import prices due to the depreciation in the value of the yen, are gradually beginning to have effects on the overall price level. However, the GDP deflator, after seasonal adjustment, was –0.2%, below the previous quarter. The domestic demand deflator was up by a smaller margin of +0.1%, and the rate of increase in domestic prices is moderating.

The growth rate of real GDP in fiscal 2013 was +2.3% over the previous year. The rate of growth on a quarter-to-quarter basis gradually declined, reflecting the weakening of the momentum in consumption and the shift toward negative contributions from external demand that began in the July-September quarter of 2013. However, since demand strengthened suddenly at the end of the fiscal year, growth for the fiscal year was +3.4%, the highest since an identical +3.4% was reported in fiscal 2010. By contribution of domestic versus external demand, the contribution of domestic demand rose to a substantial +2.8 percentage points, while the contribution of external demand was –0.5 percentage points, which was the third consecutive annual negative figure, thus indicating that economic growth was led by domestic demand. Please note that the GDP deflator for fiscal 2013 was 0.4% below the prior fiscal year, the 16th year of declines. However, this figure was smaller in absolute terms than the –0.9% decline reported in the previous fiscal year. In addition, the domestic demand deflator was up +0.3% over the prior fiscal year.

Chart 1: Trends in Real GDP



Source: Cabinet Office, *Quarterly Estimates of GDP*

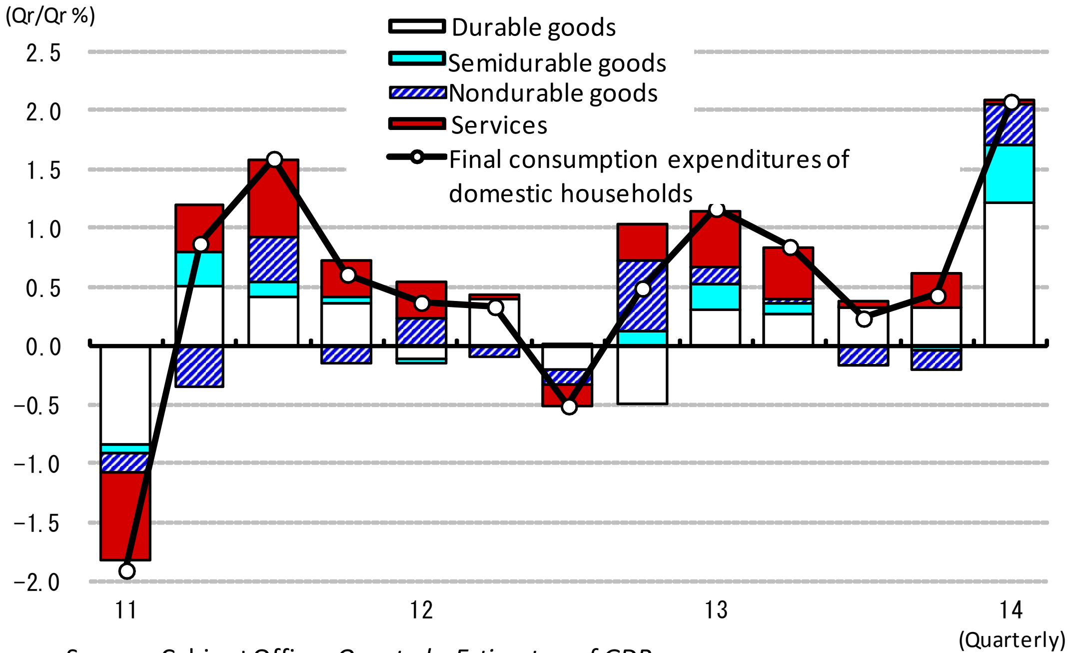
(2) A Recession Can Be Avoided, but the Risk of a Downturn Remains

During the April–June quarter of 2014, real GDP growth will unavoidably be negative temporarily because households, in particular, have already satisfied much of their latent demand and are adjusting their consumption. The point will be whether consumer spending will decline by about the same margin that it rose during the surge in demand or by a larger margin.

Examination of the breakdown of individual consumption within the GDP shows that the largest margin of increase during the January–March quarter was in purchases of consumer durables (Chart 2). This was followed by semidurable goods, such as apparel and everyday goods, and then by nondurables, such as food and daily commodities. Demand for services, which cannot be purchased in advance, showed almost no increase.

For this reason, the largest reactionary decline in demand following the increase in the consumption tax is expected to be in durable goods, where demand has been generally satisfied for the foreseeable future. It is possible, therefore, that it will take some time for the reactionary decline in demand for consumer durables to run its course. Also, slumps in demand for some semidurables and nondurable goods (such as alcoholic beverages, cigarettes, etc.) are expected, but, in part, since semidurables and nondurables include many items essential for living, the adjustment is likely to be largely completed during the April–June quarter. It is believed likely that there will be almost no reactionary decline in demand for services following the tax increase.

Chart 2: Breakdown of Personal Consumption in Real Terms



Source: Cabinet Office, *Quarterly Estimates of GDP*

Looking ahead, as data for April is released gradually, it will be possible to judge the impact of the reactionary decline in demand following the tax increase. The examination of new automobile registrations (for passenger vehicles and light vehicles) for April, which was the first related indicator to be released, shows a decline of 11.8% from the previous year, the first year-on-year decline in eight months. However, this figure is a smaller decline than the drop of 14.0% that occurred in April 1997 after the previous consumption tax hike and the decline in the first half of 2013. Moreover, registrations of light vehicles increased 5.3%, thus marking a continuous 10-month positive trend. In addition, department store sales are reportedly gradually beginning to improve following the tax increase. Also, sales of restaurants and convenience stores have been firm even after the tax rise.

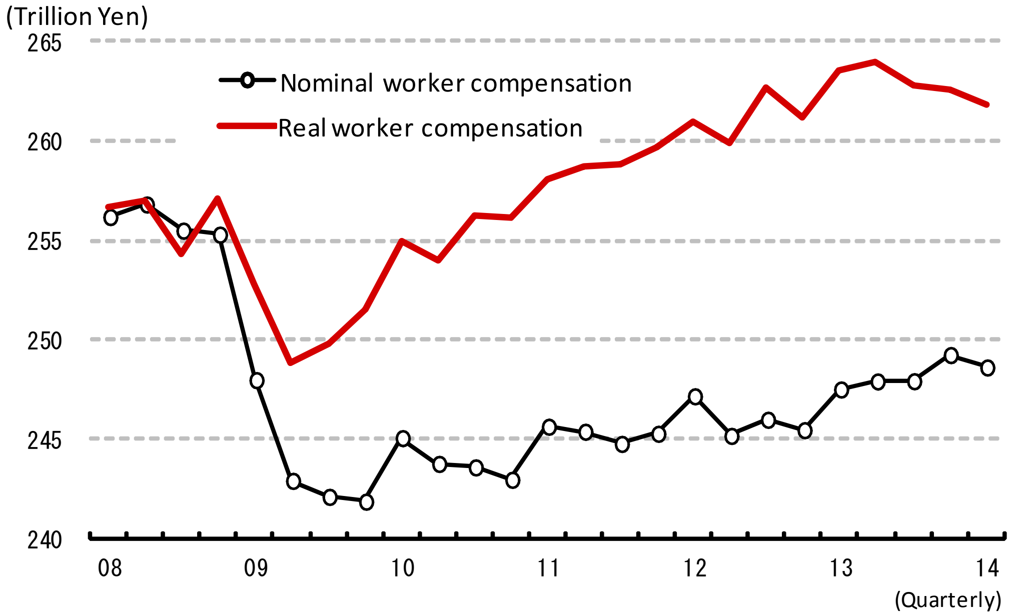
In view of these developments, it appears that the impact of the tax hike, which was a subject of concern to many, may not be as great as had been believed. Among various kinds of goods, if the reactionary decline in automobile sales, which are representative of durable goods and where the surge in demand was substantial, proves to be relatively small, there is a possibility that the underlying strength of consumer spending may steadily gain momentum. However, if car purchases prove to be lower than the surge at the end of March, there may have been instances where registrations were delayed into April. In addition, the retailing industry has implemented a range of measures to avert a sudden decline in sales following the tax increase, and these may have the effect of supporting sales. For these reasons, it will be difficult to draw conclusions too quickly about the impact of the tax increase.

What will determine consumption going forward will be trends in employment, wages, and incomes. The employment situation is improving, which is a favorable trend for the economy in the post-tax hike period. The unemployment ratio in March was a low 3.6%, the same as in the previous month, and the ratio of job openings to job applications in March was above 1.0 for the fourth consecutive month. During the spring labor offensive aimed at securing higher wages this year, large corporations, in particular, made increases in base wages and raised temporary compensation payments. This trend is spreading, and there are anticipations that conditions in the income environment will also take a turn for the better in tandem with improvements in the labor environment.

Nevertheless, corporations are still adopting a cautious stance toward increases in employment costs, and there is a possibility that improvement in wage conditions of companies as a whole, including small and medium-sized enterprises, may be delayed. For this reason, it will be difficult to judge the extent of improvement in incomes until after we have seen trends in wages in April and subsequent months and summer bonuses.

In addition, even if wages rise, it is virtually certain that such increases will be insufficient to compensate for the rise in prices, inclusive of the consumption tax. Therefore, real wages will decline. Since the beginning of 2013, nominal worker compensation has shown a gradual rising trend, mainly because of the increase in the number of workers, but from mid-2013 onward, prices have begun to rise, and, as a result, worker compensation in real terms has already entered a downward trend (Chart 3). From April onward, the consumer price index (CPI) is expected to rise about 2% over the previous year because of the impact of the higher consumption tax rate. Accordingly, it is certain that declines in real worker compensation will spread.

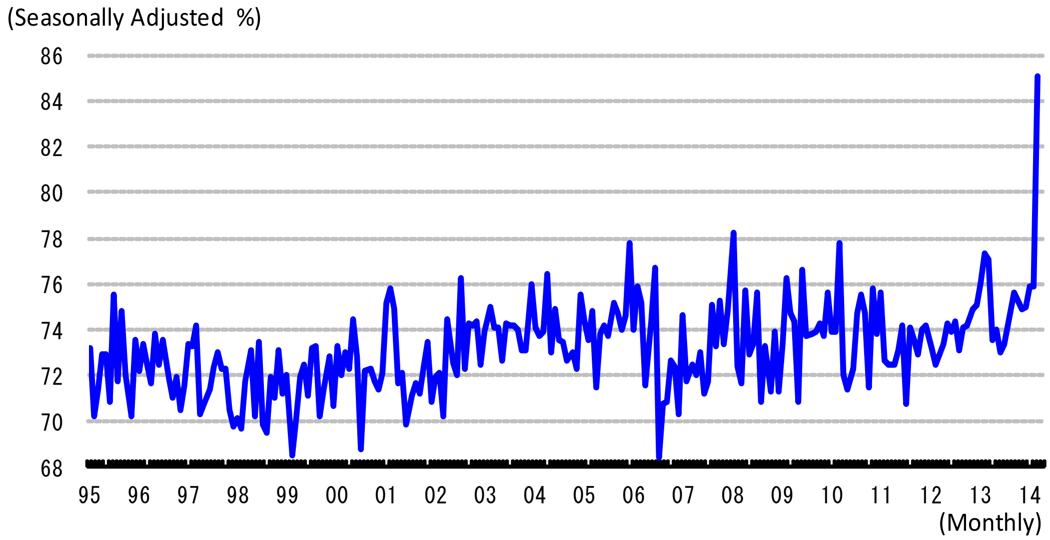
Chart 3: Nominal and Real Worker Compensation



Source: Cabinet Office, *Quarterly Estimates of GDP*

In addition, along with the surge in demand, the propensity to consume (consumption expenditure divided by disposable income) rose sharply in March. This suggests that consumers were not bound by income constraints at that time, and actively spent their available funds (Chart 4). Even if we take into account some degree of increase in the propensity to consume (seasonally adjusted) in March due to demographic aging of the population, compared with the time of the previous increase in the consumption tax rate in 1997, the increase in March 2014 was conspicuously high. Consumers may have actively stepped up their spending because they were taking into account increases in wages and bonuses after April 2014. In such cases, they expect consumption to settle down at a level appropriate for their incomes. If incomes do not rise by this amount, consumers may discover that their savings have decreased, and there is a possibility that they will begin to restrain their consumption.

Chart 4: Average Propensity to Consume



Note: From 2000 onward, data covers all worker households (including farming, forestry, and fishery households). In 1999 and prior years, farming, forestry, and fishery households were excluded.

Source: Ministry of Internal Affairs and Communications, *Family Income and Expenditure Survey*

Another reason why consumption expanded significantly more than incomes may be that households have become more sensitive to price increases and, therefore, have a strong drive to purchase goods as cheaply as possible. If this is the case, there is a possibility that consumer behavior may become considerably more cautious following the consumption tax rate increase.

If we take this into consideration, it will be necessary to make judgments regarding trends in consumption following the tax hike carefully based on data released in May and subsequent months. At present, it is too early to draw the conclusion that the impact of the consumption tax hike will be minimal.

Another cause for concern, in addition to consumption trends, following the tax increase will be trends in exports. Judging from movements in the index of exports in volume terms at present, exports are relatively stagnant. Even if domestic demand remains firm, if exports are weak, the economic recovery might be delayed. As a result of the movement of production facilities of Japanese companies offshore and delays among exporting companies in lowering their prices, the decline in the value of the yen has still not resulted in an increase in export volumes. However, since it has been over a year since the yen began to weaken, the cheaper yen is expected to begin to have a positive effect, and, if conditions in overseas economies improve, exports are forecast to pick up.

Notwithstanding this, turmoil in financial markets and the negative impact on emerging countries because of the tapering of the monetary easing policy in the United States may continue to be an unsettling factor. At this time, financial markets are beginning to settle down temporarily, and the possibility that uncertainty in emerging markets may lead to a decline in exports is small. However, if the currencies of emerging countries decline in value and this, in turn, creates turmoil in world financial markets, concerns will remain regarding deterioration in economic conditions overseas and a possible slump in exports that might be caused by the appreciation of the yen.

In the corporate sector, performance, especially of large enterprises, is improving steadily, and ordinary income for fiscal 2013 is believed likely to set a new record. Improvement in performance of companies in the manufacturing sector is mainly due to the downward correction in the value of the yen, which has raised export prices when translated to yen. In the non-manufacturing sector, the main factor is the expansion in domestic demand, mainly due to increased activity in manufacturing and private consumption. In fiscal 2014 and subsequently, the pace of improvement in performance will weaken due to the effects of the consumption tax hike and increases in costs because of the weaker yen and other factors, but the upward trend in profits will continue.

Capital investment is likely to continue to rise, along with the improvement in corporate performance. Orders for machinery and equipment (private-sector orders, excluding shipping and electric power), which are a leading indicator for capital investment, are continuing on an upward trend and may be a factor moderating the slump in the economy immediately following the increase in the consumption tax.

As these comments suggest, since corporate performance is expected to continue to improve and exports to increase as overseas economies bottom out, concerns about the economy slipping into a recession after the consumption tax increase are relatively limited. Instead, the economy is thought likely to return to a positive growth path in the July–September quarter of 2014. However, if recovery in consumer spending is delayed and exports stagnate because of deterioration in overseas economies, the risk will increase that improvement in the economy after the consumption tax hike will be delayed.

Please note that the rate of real GDP growth in the July–September quarter will receive attention when the judgment is made regarding whether to make a further increase in the consumption tax, to 10%. This next increase is scheduled for October 2015, but if tax measures are enacted, accompanying the tax increase, that would lighten the burden of the consumption tax rise, it will be necessary to decide on the content of the changes in the tax system in December this year. The figure that will be available at that time for reference will be the GDP figure for the July–September quarter. If negative growth continues during the July–September period, the possibility of pushing the timing of the tax rise into the future cannot be ruled out.

(3) Outlook for Fiscal 2014 and Fiscal 2015: Contribution of External Demand Will Be Marginal, and the Overall Pace of Recovery Will Continue to Be Moderate

We have prepared this outlook based on the assumption that the consumption tax rate will be increased, as scheduled, to 10% in October 2015. At present, however, we have not made any assumptions that economic measures will be implemented because of the timing of the increase. We have also assumed that the effects of any agreements under the Trans-Pacific Partnership (TPP) negotiations and a second round of economic growth strategies of the Abe administration will have only a slight effect on the economy during the forecast period. We also think that serious electric power shortages will continue to be averted going forward. Regarding the economic impact of the 2020 Tokyo Summer Olympics, although preparations for the Olympics may increase demand for construction, we believe that the effects in any single fiscal year will be moderate.

In fiscal 2014, the effects of the rise in the consumption tax at the beginning of the fiscal year will be apparent mainly in the household sector. The outlook for growth in fiscal 2014 is for real GDP to remain at a marginal +0.6% over the previous fiscal year. Although a recession will be avoided due to the support provided by external demand, because of weak growth in domestic demand, after the exclusion of a carryover effect of +1.2%, the rate of real growth in fiscal 2014, calculated during the fiscal year, is forecast to be –0.5%.

Regarding consumption, a sudden decline in personal consumption from the previous quarter during the April–June period, in reaction to the surge in demand, will be unavoidable. Sales of large electric appliances, such as flat-panel TVs, air conditioners, and refrigerators, as well as automobiles had already increased temporarily due to the series of economic measures taken after the collapse of Lehman Brothers. Also, sales of air conditioners and certain other items have been rising steadily because of the effects of the unseasonably hot weather during the summer of 2013. This series of developments was joined by the surge in demand before the rise in the consumption tax, and, in the case of durable goods, there is a possibility that future demand has been satisfied for the time being. On the other hand, since there are limitations on how much demand for services and non-durable goods can be brought forward, it appears that increases over the previous quarter will begin again during the July–September period, but, thereafter, the pace of the rise in sales is expected to be more moderate. Although regular wages and bonuses have begun to rise, but because this trend is mainly confined to large corporations and is not spreading to companies in general, the increase in incomes will not fully cover the increased burden due to the higher consumption tax. As a result, real disposable incomes will decline, and this will have a negative impact on household consumption.

Worker compensation in real terms is expected to decline 1.2% from the previous fiscal year due to the rise in the consumption tax, and this will be the first time in five years, since 2009, for this indicator to decline. Although the outlook is for worker compensation to rise 0.5% over the previous year in nominal terms, reflecting the increase in the number of workers and compensation per worker, the fifth consecutive annual increase, the percentage increase in prices will exceed the percentage rise in nominal wages. As a result, even though real consumption rose through fiscal 2013, as consumers increased their propensity to consume, in fiscal 2014, consumption will decline 0.4%, the first decrease in six years, since 2008.

Corporate capital investment is forecast to continue on a moderate rising trend as corporate performance improves. Companies will continue to restrain aggressive investments in the expansion of capacity but will make such capital outlays to maintain their competitiveness as well as investments in the maintenance and renewal of facilities and enhancement of their IT systems. These investments are expected to provide underlying support for the economy. However, the pace of improvement in corporate performance in fiscal 2014 is expected to weaken because companies will likely experience a temporary slump in sales after the increase in the consumption tax, and the boost to exports coming from the weaker yen is expected to run its course. On the other hand, the cost burden on companies will rise because of the increase in labor costs and the effects of the cheaper yen on the prices of other inputs. As a consequence, the improvement in profit margins will gradually approach a ceiling.

Public investment during the first half of fiscal 2014 is forecast to remain firm because of accelerated use of budgetary allocations and total economic measures amounting to about ¥5.5 trillion in the supplementary budget for fiscal 2013. However, in the latter half of fiscal 2014, public investment is expected to begin to decline. Nevertheless, there is a possibility that the implementation of budgetary allocations has not yet boosted public investment due to the delay in construction and other factors. Accordingly, the pace of decline may be moderate. For the fiscal year as a whole, public investment is forecast to show a decline of 0.4% from the previous fiscal year.

On the other hand, as economic conditions in countries overseas bottom out and improve, the recovery in the pace of growth in exports will be a factor supporting the economy. In manufacturing, there is a possibility that a movement among companies to lower export prices may emerge to increase the unit volume of exports to make up for the weakness of domestic demand. There are also hopes that demand for exports of general machinery and electronic components and devices, which has been slow to recover, may pick up. For imports, on the other hand, the rate of increase is expected to remain moderate, even after a temporary decline, because of the slump in domestic demand following the increase in the consumption tax. Since the growth in demand for LNG and other energy sources, which has boosted imports thus far, will run its course, the pace of increase in import volumes going forward will be in line with the rate of increase in domestic demand for electric power.

Turning next to the contributions of domestic and overseas demand to growth, the contribution of domestic demand is expected to be 0.4

percentage point, significantly lower than the 2.8 percentage points in fiscal 2013. On the other hand, the contribution of external demand will rise from –0.5 percentage point in fiscal 2013 to +0.2 percentage point in fiscal 2014, the first positive figure in four years.

Examining growth rates by quarter in fiscal 2014, real GDP is expected to decline 1.1% in the April–June quarter, because of the slump in consumer spending. However, positive quarter-to-quarter growth, of 0.5%, is expected to return in the July–September quarter, and the outlook is for averting a slip into recession as a result of the increase in the consumption tax rate. As the slump in consumption runs its course, consumer spending is expected to begin to increase but continue to be relatively weak. In addition, the economy will be supported by public investment, increases in private capital investment, and improvement in exports. Moreover, imports will fall sharply in the April–June quarter, reflecting the stagnation in domestic demand following the consumption tax increase, and then show only weak growth in the July–September quarter. As a result, the contribution of the external sector will continue to be positive and act to boost economic growth. If real GDP expands as forecast in the July–September quarter, this should remove obstacles to another increase in the consumption tax rate in October 2015.

In the latter half of fiscal 2014, the emergence of a declining trend in public investment will tend to reduce the economic growth rate, but since the upward trends in private capital investment and exports are expected to continue, the outlook is for the economy to remain on course toward recovery. However, compared with fiscal 2013, the pace of recovery will unavoidably weaken substantially. If the stagnation in consumer spending is prolonged and deterioration in overseas economies causes a slump in exports, the risk of recession may emerge.

Note, however, that the nominal GDP growth rate will continue to be positive and rise to +2.3% for the fiscal year. However, this will be an inflated figure resulting from the effects of the increase in the consumption tax rate, and the GDP deflator will rise to +1.7%.

Taking account of these movements in the economy, although the index of industrial production will continue to recover, the pace of improvement is expected to remain moderate. The outlook is for an increase of 2.2% in fiscal 2014, compared with an increase of 3.2% in fiscal 2013. Moreover, although the moderate improvement in the employment situation will continue, some industries will still experience labor shortages, and companies, in general, are likely to continue to restrain personnel costs. In fiscal 2014, the pace of improvement in corporate performance will weaken, and growth in wages is expected to become more moderate. This will lead to declines in real wages.

Under these circumstances, upward pressures on prices are unlikely to gain momentum. The CPI (excluding fresh food) is forecast to rise 2.9% over the previous fiscal year, but when the effects of the consumption tax hike are excluded, the CPI will rise only 0.9%. Upstream inflationary pressures are expected to weaken as international commodity prices, including the price of crude oil, begin to decline and the effects of the weakening of the yen run their course. From the summer onward, increases in prices will weaken. The timing for this will be as we approach the deadline for reaching the Bank of Japan’s inflation target, but it seems likely that upward pressures on prices will continue to be moderate. For this reason, there is a possibility that additional monetary easing measures will be implemented.

In fiscal 2015, it is assumed that the consumption tax will be increased to 10% in October 2015. A surge in demand will occur prior to the increase and a reactionary decline in demand thereafter, but because this will occur during the fiscal year, on average, the negative impact will be small in comparison with fiscal 2014. Personal consumption will continue to rise, by +0.7% for the fiscal year as a whole, because of increases in the first half of the fiscal year, but there is a possibility of a substantial slump in the second half of the fiscal year. As real wages remain below the previous year's levels, consumer spending is forecast to continue to be weak.

Although the improving trend in corporate performance will continue, in the midst of a further increase in the consumption tax, it will lack robustness. For this reason, the drive among corporations to make capital investments will not rise, and there is a possibility that companies will continue to restrain new investments to the minimum level deemed necessary.

The highest expectations for providing support for the economy during fiscal 2015 will be placed on exports. It is believed likely that the recovery trend in overseas economies will continue and that competitiveness of Japan's exports will gradually strengthen as the weaker yen takes hold. On the other hand, since growth in imports will be moderate, reflecting the weakness of domestic demand, the contribution of overseas demand will continue to be positive, standing at 0.3 percentage point.

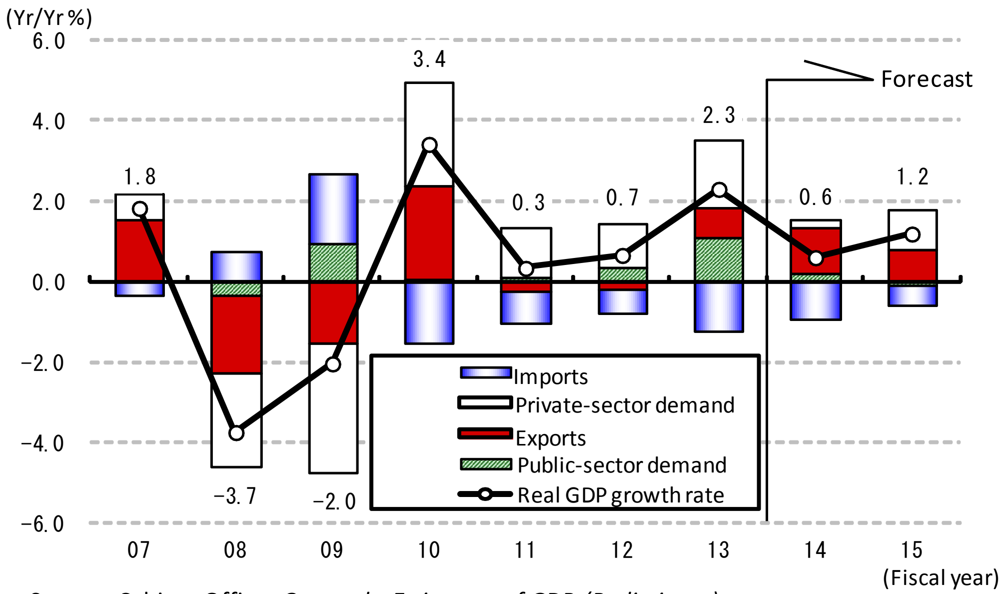
Public investment is expected to fall below the previous year's levels by a significant margin as the effectiveness of government economic policies diminishes. However, although not expected at present, there is a possibility that the government will implement further economic policies along with the October 2015 increase in the consumption tax, and these will reduce the margin of decline in public investment.

We are forecasting real GDP growth of +1.2% year on year in fiscal 2015. During the first half of the fiscal year, the economy will show improvement in part because of the surge in demand, but, in the second half, the outlook is for a reactionary decline. The economy will be supported in the latter half of fiscal 2015 by external demand, but, if the growth in exports is weak, concerns about a possible recession may emerge. After the exclusion of a carryover effect of +0.6%, the rate of real growth calculated during the fiscal year will slow to +0.6%.

Note that the nominal GDP growth rate will remain at a relatively high

+1.7% because of effects of the increase in the consumption tax rate. The GDP deflator will remain positive at +0.5% year on year.

Chart 5: Contributions to Growth in GDP by Demand Component (Fiscal Year)



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

Chart 6: Real GDP Growth (Fiscal Year)

	Carry-over from the previous year (A)	Growth rate during the year (B)	Real GDP growth rate (A)+(B)
FY2012 (actual)	1.4 %	-0.8 %	0.7 %
FY2013 (actual)	0.7 %	1.6 %	2.3 %
FY2014 (forecast)	1.2 %	-0.5 %	0.6 %
FY2015 (forecast)	0.6 %	0.6 %	1.2 %

2. Forecasts of Economic Activity by Sector

(1) Corporations

- Production bottomed out in autumn 2012 and has been rising for five consecutive quarters. Growth in export shipments is weak, but shipments to the domestic market are holding strong because of the increase in production to meet the surge in domestic demand in advance of the hike in Japan's consumption tax rate and other factors, and are acting as a driving force for the economy. A temporary decline in demand is forecast following the increase in the consumption tax rate, but in part because of improvement in exports, a further sharp drop in production will be averted. However, since manufacturing corporations are expected to continue to move their production facilities overseas, the pace of improvement in production is likely to continue to be moderate.
- 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 rate hike, and profit deteriorates because of higher costs.
- 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

facilities 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. There is a strong possibility that the rising trend in capital investment will continue for the time being, against a background of improvement in corporate performance, but the outlook is for the pace of increase to continue to be moderate as a strong drive among companies to invest is not likely to emerge.

(2) Households

- In fiscal 2013, the employment situation continued to improve. On the one hand, recovery in the income environment, principally scheduled worker compensation, was delayed. However, during the spring labor offensive, some brighter trends toward wage increases emerged, and, going forward, conditions are seen as improving gradually. Nevertheless, companies are not expected to raise nominal wages to compensate for the higher taxes; therefore, real wages are forecast to show a significant decline.
- As a result of the surge in demand prior to the increase in the consumption tax rate, consumer spending, especially on durable goods, increased substantially during the January–March quarter of 2014. A temporary, reactionary slump during the April–June quarter will be unavoidable, but, because of the bottoming out in nominal wages, consumer spending is seen as likely to show gradual improvement. However, amid a projected decline in real income, the pace of improvement in consumption is likely to be restrained to a gradual pace.
- In fiscal 2013, the number of new housing starts rose a major 10.6% over the previous fiscal year, but, currently, starts are declining as the reactionary decline in demand sets in following the surge caused by the consumption tax rate increase. Also, because the tight supply and demand balance for workers and materials is

causing a rise in wages and construction materials, construction costs are rising and housing completions are being delayed. Although the expansion of tax breaks on housing loans and other measures to lighten the burden of housing construction costs are in effect, orders for new housing have not shown improvement, and the number of new housing starts is expected to remain stagnant for the time being.

(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, and the fact that the government has been unable to secure stable funding for those welfare costs is one factor behind the rising fiscal deficits. 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, the consumption tax rate was increased to 8% in April 2014, based on a reform law that was passed previously to deal with both social welfare and taxation policies comprehensively. Whether the consumption tax will be raised on schedule to 10% in October 2015 is expected to be decided after the government gives due consideration to economic trends before the end of the year.
- 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. In addition, 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 is to pursue “a flexible public finance policy.” Under the supplementary budget for fiscal 2012, the government implemented economic measures amounting to more than ¥10 trillion, with objectives that included preventing and minimizing the effects of disasters, and has increased expenditures related to public investment substantially. The results of these measures emerged in fiscal 2013, and public investment has been boosted significantly. Moreover, the government is scheduled to implement economic measures amounting to about ¥5.5 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.

- As a consequence of the implementation of government economic measures for two consecutive years, government expenditures (on a GDP basis) will likely rise as the economy moves into fiscal 2014. Although government final consumption will continue to rise in fiscal 2015, since public investment will turn downward, the outlook is for total government expenditures to begin to decline.

(4) Trends in Overseas Economies

- The world economy, especially the industrialized countries, is experiencing moderate growth. In the United States, economic expansion is continuing, despite the effects of the severe winter weather, and the Federal Reserve Board (FRB) is continuing the step-by-step phasing down of its quantitative monetary easing policy (QE3). The European economies are showing gradual improvement, as government debt issues settle down. In the emerging countries, while the Chinese economy is continuing to show a moderate decline in growth, Thailand, South Korea, and certain other countries are experiencing rising political uncertainty. In addition, the turmoil in the Ukraine is putting adjustment pressures on markets.

- 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. In Europe, even as domestic demand remains relatively weak, economies in that region are seen as likely to show moderate improvement 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-7.9% range.
- Japan's exports (on a customs-clearance, volume basis) are forecast to maintain an increasing trend 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 continuing 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 and has remained in the red. During the January-to-March period of 2014, a deficit was also reported in the current account balance (seasonally adjusted). Recently, one of the main reasons for this deficit has been the sharp expansion in imports due to the surge in demand prior to the rise in the consumption tax rate. However, the current account balance is expected to move back into the black during 2014.

3. Forecasts for Prices and Financial Markets

- The slowing of the Chinese economy has put the brakes on the one-way increase in raw materials prices, but 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.
- Since the rise in energy prices owing to the decline in the value of the yen and other factors is running its course, upward pressures on domestic prices are weakening, and the rising trend in domestic corporate prices is expected to peak out and have a braking effect on the rise in consumer prices. During fiscal 2014, although the margins of increase in prices are expected to expand temporarily because of the increase in the consumption tax rate, after the 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 the increases in wages will also be marginal, their capability to boost prices will be limited.
- 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 with the title, “Joint Statement of the Government and Bank of Japan on Overcoming Deflation and Achieving Sustainable Economic Growth.” 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 7: Outlook for Fiscal 2014-2015

Forecast

Yr/Yr、%

	FY2010 (actual)	FY2011 (actual)	FY2012 (actual)	FY2013 (actual)	FY2014 (forecast)	FY2015 (forecast)
Nominal GDP	1.3	-1.4	-0.2	1.9	2.3	1.7
Real GDP	3.4	0.3	0.7	2.3	0.6	1.2
Contribution of domestic demand	2.6	1.4	1.4	2.8	0.4	0.9
Private consumption	1.6	1.4	1.5	2.5	-0.4	0.7
Housing investment	2.2	3.2	5.3	9.5	-7.5	-0.9
Private capital investment	3.8	4.8	0.8	1.7	4.5	3.8
Contribution of inventory investment	1.0	-0.3	-0.1	-0.3	0.1	0.0
Government expenditure	0.3	0.5	1.4	4.5	0.9	-0.3
Public investment	-6.4	-3.2	1.3	15.3	-0.4	-7.2
Government final consumption expenditure	2.0	1.2	1.5	2.1	1.3	1.4
Contribution of external demand	0.8	-1.0	-0.8	-0.5	0.2	0.3
Export of goods and services	17.2	-1.6	-1.2	4.7	6.7	4.6
Import of goods and services	12.0	5.3	3.7	7.1	4.7	2.5
GDP deflator	-2.0	-1.7	-0.9	-0.4	1.7	0.5

Forecast

Yr/Yr、%

	FY2010 (actual)	FY2011 (actual)	FY2012 (actual)	FY2013 (actual)	FY2014 (forecast)	FY2015 (forecast)
Current account balance (trillion yen)	18.0	7.9	4.2	0.8	2.5	5.2
balance on goods (trillion yen)	8.0	-2.2	-5.2	-10.9	-9.5	-7.1
balance on service (trillion yen)	-2.8	-3.1	-4.2	-3.6	-3.6	-3.5
balance on income (trillion yen)	13.9	14.3	14.6	16.7	16.9	17.2
Industrial production	15.4	-0.6	-3.0	3.2	2.2	3.0
Unemployment rate(%)	5.0	4.5	4.3	3.9	3.7	3.6
New housing starts(annualized, ten thousand units)	77.5	81.9	89.3	98.7	88.1	87.7
Domestic corporate goods prices	0.4	1.4	-1.1	1.9	3.3	0.8
Consumer prices	-0.4	-0.1	-0.3	0.9	2.9	1.0
excluding freshfood	-0.8	0.0	-0.2	0.8	2.9	1.0
Yen/U.S.Dollar	85.7	79.1	83.1	100.2	102.2	103.9
Uncollateralized call rates (O/N) (%)*	0.091	0.077	0.082	0.073	0.070	0.070
Newly issued government bond yields (10years) (%)	1.15	1.05	0.78	0.69	0.71	0.89
WTI future price (near month contract, US dollar/barrel)	83.4	97.3	92.1	99.0	99.5	96.6
Dubai crude oil prices (US dollar/barrel)	84.2	110.1	107.1	104.5	102.6	98.7

* actual=average, forecast=end of period

Chart 8: Outlook for Calendar 2014-2015

Forecast

Yr/Yr、%

	CY2010 (actual)	CY2011 (actual)	CY2012 (actual)	CY2013 (actual)	CY2014 (forecast)	CY2015 (forecast)
Nominal GDP	2.4	-2.3	0.5	0.9	2.6	1.9
Real GDP	4.7	-0.5	1.4	1.6	1.3	1.1
Contribution of domestic demand	2.9	0.4	2.3	1.9	1.7	0.7
Private consumption	2.8	0.3	2.0	2.0	0.9	0.4
Housing investment	-4.5	5.1	2.9	8.9	-1.6	-3.2
Private capital investment	0.3	4.1	3.7	-1.5	6.5	3.1
Contribution of inventory investment	1.0	-0.4	0.1	-0.3	-0.1	0.1
Government expenditure	1.6	-0.5	1.9	3.8	1.7	-0.1
Public investment	0.7	-8.2	2.8	11.4	3.7	-6.1
Government final consumption expenditure	1.9	1.2	1.7	2.2	1.2	1.5
Contribution of external demand	1.7	-0.9	-0.9	-0.3	-0.4	0.4
Export of goods and services	24.4	-0.4	-0.1	1.7	8.0	4.3
Import of goods and services	11.1	5.9	5.3	3.4	8.9	1.6
GDP deflator	-2.2	-1.9	-0.9	-0.6	1.2	0.8

Forecast

Yr/Yr、%

	CY2010 (actual)	CY2011 (actual)	CY2012 (actual)	CY2013 (actual)	CY2014 (forecast)	CY2015 (forecast)
Current account balance (trillion yen)	19.1	10.1	4.7	3.2	0.3	4.6
balance on goods (trillion yen)	9.5	-0.3	-4.3	-8.8	-11.1	-7.7
balance on service (trillion yen)	-3.0	-3.0	-4.0	-3.5	-3.8	-3.5
balance on income (trillion yen)	13.6	14.6	14.1	16.5	16.7	17.1
Industrial production	15.6	-2.8	0.6	-0.8	4.3	2.4
Unemployment rate (%)	5.1	4.6	4.3	4.0	3.7	3.6
New housing starts(annualized, ten thousand units)	81.3	83.4	88.3	97.8	89.4	88.7
Domestic corporate goods prices	-0.1	1.5	-0.9	1.3	3.1	1.0
Consumer prices	-0.7	-0.3	0.0	0.4	2.6	1.3
excluding freshfood	-1.0	-0.2	-0.1	0.4	2.5	1.2
Yen/U.S.Dollar	87.8	79.8	79.8	97.6	102.2	103.5
Uncollateralized call rates (O/N) (%)*	0.093	0.078	0.083	0.075	0.071	0.070
Newly issued government bond yields (10years) (%)	1.17	1.12	0.85	0.71	0.66	0.86
WTI future price (near month contract, US dollar/barrel)	79.5	95.1	94.2	98.0	99.6	97.1
Dubai crude oil prices (US dollar/barrel)	78.0	106.2	109.1	105.5	103.4	99.5

* actual=average, forecast=end of period

Chart 9: Outlook for 2014-2015 (Quarterly)

Forecast

Qr/Qr、%
Yr/Yr、%

	FY2013				FY2014				FY2015			
	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	0.9	0.2	0.2	1.2	0.6	0.4	0.6	0.4	0.6	0.5	0.0	0.1
	0.7	1.9	2.1	3.0	2.1	2.5	2.7	1.9	2.0	2.1	1.4	1.3
Real GDP	0.9	0.3	0.1	1.5	-1.1	0.5	0.3	0.4	0.5	0.8	-0.9	0.1
	1.3	2.4	2.5	3.0	0.5	0.9	1.0	0.0	1.7	2.0	0.6	0.4
Contribution of domestic demand (Qr/Qr,%)	0.7	0.8	0.6	1.7	-1.8	0.4	0.2	0.3	-1.8	0.4	0.2	0.3
Private consumption	0.7	0.2	0.4	2.1	-2.7	0.6	0.2	0.3	0.6	1.1	-2.1	-0.2
	1.8	2.4	2.3	3.5	-0.1	0.2	0.0	-1.7	1.6	2.1	-0.2	-0.7
Housing investment	0.8	3.3	4.3	3.1	-8.9	-4.6	-0.5	1.2	1.7	0.8	-3.8	-3.0
	6.9	8.6	10.5	11.9	1.2	-6.5	-10.9	-12.5	-2.3	3.2	-0.2	-4.3
Private capital investment	1.0	0.7	1.4	4.9	-0.6	0.3	0.5	1.1	1.3	1.9	-0.7	1.3
	-2.8	-0.8	1.1	8.4	6.6	6.0	5.0	1.3	3.2	4.7	3.5	3.8
Contribution of inventory investment (Qr/Qr,%)	-0.3	0.1	0.0	-0.2	0.2	0.0	0.0	0.0	0.0	-0.1	0.1	-0.1
Government expenditure	1.8	1.5	0.5	-0.4	0.4	0.4	0.1	-0.3	-0.3	0.0	0.1	0.2
	3.5	5.1	5.7	3.5	1.8	0.9	0.5	0.5	0.2	-0.4	-0.7	-0.3
Public investment	6.4	6.9	1.2	-2.4	1.0	0.0	-1.2	-2.5	-3.1	-1.5	-1.1	-1.0
	8.2	19.0	20.8	11.9	6.5	-0.1	-2.4	-2.8	-6.6	-7.9	-7.8	-6.6
Government final consumption expenditure	0.7	0.2	0.3	0.1	0.3	0.4	0.4	0.3	0.3	0.3	0.3	0.4
	2.8	2.5	2.0	1.2	1.0	1.2	1.3	1.6	1.6	1.4	1.3	1.4
Contribution of external demand (Qr/Qr,%)	0.1	-0.5	-0.6	-0.3	0.7	0.1	0.1	0.1	0.7	0.1	0.1	0.1
Export of goods and services	2.9	-0.7	0.5	6.0	0.5	1.1	1.0	1.1	1.1	1.2	1.5	1.2
	0.0	3.2	7.0	8.9	6.1	8.3	8.7	3.7	3.9	4.4	5.0	5.0
Import of goods and services	1.8	2.4	3.7	6.3	-2.8	0.4	0.4	0.6	1.0	1.4	-0.7	0.5
	0.8	3.2	9.2	15.0	9.8	7.4	4.0	-1.5	2.3	3.4	2.3	2.2
GDP deflator (Yr/Yr,%)	-0.6	-0.4	-0.4	0.0	1.6	1.6	1.6	1.9	1.6	1.6	1.6	1.9

Forecast

Yr/Yr、%

	FY2013				FY2014				FY2015			
	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)*	1.8	0.6	0.0	-1.4	0.6	0.3	0.8	1.0	1.3	1.1	1.4	1.6
balance on goods (trillion yen)*	-1.7	-2.3	-2.8	-3.8	-2.3	-2.6	-2.3	-2.0	-1.8	-2.0	-1.7	-1.4
balance on service (trillion yen)*	-0.7	-0.9	-1.0	-1.1	-1.0	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9
balance on income (trillion yen)*	4.5	4.0	4.1	4.0	4.2	4.2	4.3	4.3	4.3	4.3	4.4	4.3
Industrial production (Qr/Qr、%)	1.6	1.8	1.8	2.9	-2.3	0.8	0.4	1.0	1.0	1.8	-1.5	0.8
(Yr/Yr、%)	-3.0	2.3	5.8	8.2	4.1	3.3	1.7	-0.3	3.3	4.3	2.2	2.1
Unemployment rate (%)*	4.0	4.0	3.9	3.6	3.7	3.7	3.6	3.6	3.6	3.5	3.6	3.7
New housing starts(annualized, ten thousand units)	98.0	99.0	104.1	93.4	89.1	87.3	87.7	88.6	91.0	88.6	86.5	84.7
Domestic corporate goods prices (Yr/Yr,%)	0.7	2.2	2.5	1.9	4.0	3.7	3.0	2.7	-0.3	-0.3	1.8	1.8
Consumer prices (Yr/Yr,%)	-0.2	0.9	1.4	1.5	3.3	3.0	2.8	2.6	0.3	0.3	1.7	1.7
excluding freshfood (Yr/Yr,%)	0.0	0.7	1.1	1.3	3.1	3.0	2.8	2.5	0.3	0.3	1.7	1.7
Yen/U.S.Dollar	98.7	98.9	100.4	102.8	102.0	101.8	102.3	102.7	103.2	103.8	104.2	104.5
Uncollateralized call rates (O/N) (%)**	0.073	0.073	0.072	0.074	0.070	0.070	0.070	0.070	0.070	0.070	0.070	0.070
Newly issued government bond yields (10years) (%)	0.73	0.77	0.64	0.63	0.62	0.67	0.74	0.80	0.84	0.88	0.92	0.95
WTI future price (near month contract, US dollar/barrel)	94.2	105.8	97.5	98.7	100.9	99.8	99.0	98.3	97.5	96.8	96.0	96.0
Dubai crude oil prices (US dollar/barrel)	100.8	106.2	106.8	104.4	104.3	103.0	102.0	101.1	100.0	99.0	98.0	98.0

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