August 2014

Forecast for the Japanese Economy in Fiscal 2014 and 2015

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

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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: Severe Conditions following the Consumption Tax Rate Hike

Reflecting the impact of the consumption tax rate hike, the real GDP growth rate for the April–June quarter of 2014, which was announced on August 16, dropped considerably, to -1.7% compared with the previous quarter (-6.8% at an annualized rate). The margin of decrease was greater than that (-0.9% compared with the previous quarter (-3.5% at an annualized rate)) in the April–June quarter of 1997, immediately after the previous consumption tax rate hike, and this indicates that economic conditions have become still harsher following the recent consumption tax rate hike.

The impact of the consumption tax rate hike has been strongest on the household sector. Private consumption was down 5.0% from the previous quarter, a large negative rate that reflects a reaction to the +2.0% quarter-to-quarter growth in the January-March quarter, when there was a surge in demand preceding the consumption tax hike. The drop in private consumption was considerably larger than the -3.5% quarter-to-quarter growth in the April–June quarter of 1997. In addition to the portion of the drop that was a reaction to the previous surge, a decline in real income depressed households' purchasing power, and it is highly likely that this reduced consumer confidence. Similarly, housing investment dropped at the double-digit quarter-to-quarter rate of -10.3%, reflecting a sharp fall in housing starts in reaction to the previous surge.

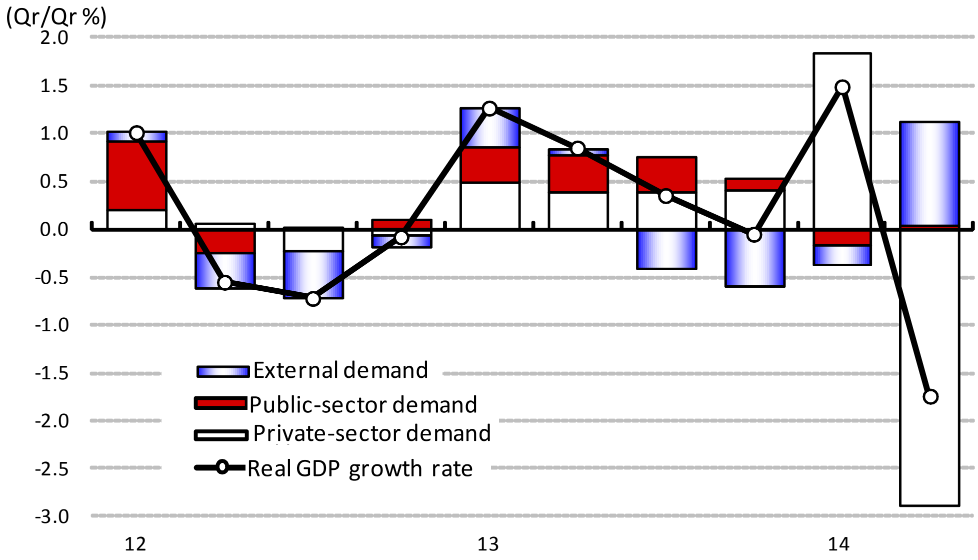
In the corporate sector, capital investment was down 2.5% from the previous quarter, the first such decrease in five quarters. As the shift to negative growth was partly the result of a reaction to the sharp positive growth in the previous quarter, the margin of decrease was restrained to a relatively small size, and companies are recording robust performances, it appears that companies have not rapidly shifted to a negative attitude regarding capital investments. On the other hand, the contribution to real GDP growth from the quarter-to-quarter change in inventory investment rose sharply, to +1.0%. The rise was partly a reaction to the drop in inventory levels associated with the demand surge in the January-March quarter, but, even when this situation is factored in, the margin of increase was large, and it appears to reflect an unintended accumulation of inventory accompanying the decrease in demand.

The contribution of these (household and corporate sector) private-sector demand components to growth in real GDP was -2.9%, a large negative figure. On the other hand, the overall contribution of the public sector was 0.0%. Public investment declined for the second consecutive quarter, edging down 0.5% from the previous quarter owing to the diminishing effects of economic stimulus measures, but this was offset by a shift to positive growth in government final consumption, which rose 0.4% from the previous quarter. As a consequence, the contribution of domestic demand to growth for the quarter dropped to -2.8%.

On the other hand, the contribution of external demand was +1.1%, the first positive figure in four quarters. Despite continued improvement in overseas economic conditions and the sustained weakness of the yen, exports remain weak, declining 0.4% from the previous quarter. However, imports dropped 5.6% from the previous quarter, the first such drop in six quarters, reflecting the sharp drop in domestic demand, and this had the effect of greatly increasing the overall contribution of external demand.

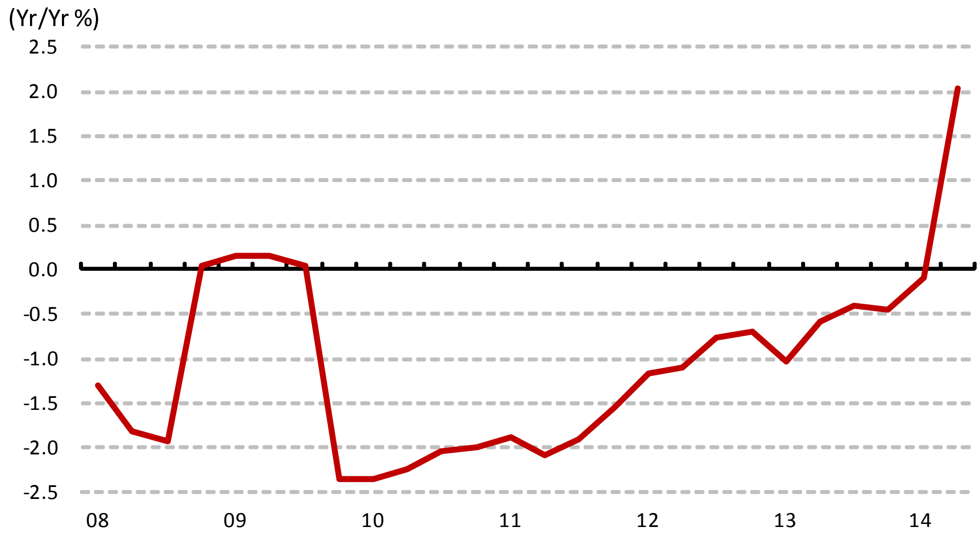
The GDP growth rate in nominal terms was -0.1% for the quarter (-0.4% at an annualized rate), and this can be considered a small margin of decrease. However, this is simply the result of the consumption tax rate hike pushing nominal figures upward, and the GDP deflator, reflecting overall price trends in the economy, was +2.0% over the previous year (+1.7% over the previous quarter), which can be considered a rapid rate of increase (Chart 2).

Chart 1: Trends in Real GDP



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

Chart 2: Trends in the GDP Deflator



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

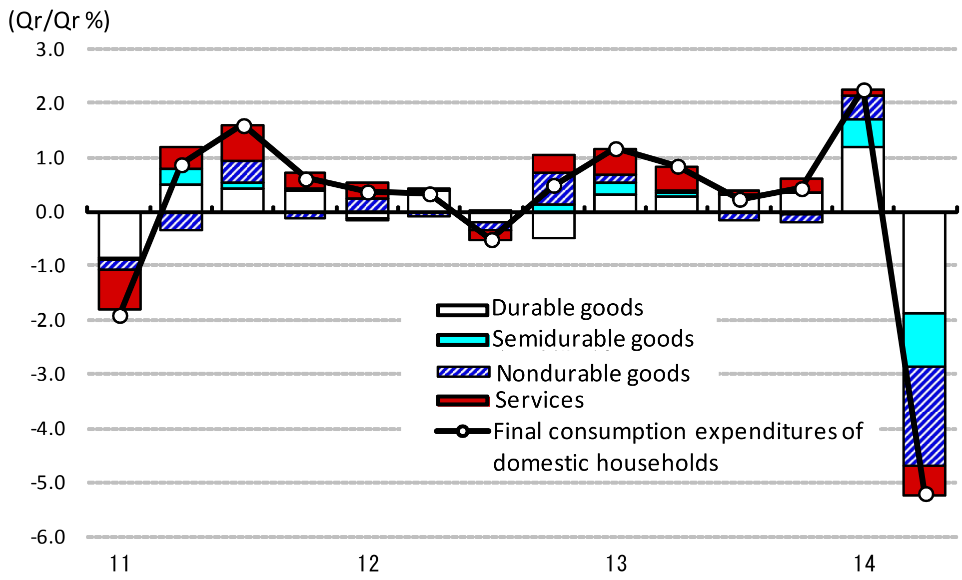
(2) A Recession Can Be Avoided, but the Risk of a Downturn Is Growing

Figures for the April-June quarter indicate that the harshness of economic conditions has increased in the wake of the consumption tax rate hike.

First, there has been a large decrease in real private consumption. Some observers are optimistic about private consumption, given that the drop in department store sales immediately after the tax hike was kept within the range anticipated by the industry, and the sales figures are truly showing underlying strength. For example, the drop in new automobile registrations (excluding light vehicles) has been restrained to a small margin–reflecting the impact of outstanding orders at the end of March on sales registered in April and subsequently, along with the effect of new model launches–and new automobile registrations began rising in July, showing 0.3% year-on-year growth. It seems that the impact of the tax increase was relatively small with respect to automobile sales. Looking at the overall private consumption picture, however, it appears that the real situation is harsher than the situation suggested by sales statistics that are primarily gathered from major retailers.

The primary reason for the private consumption slump is a large reactionary drop in durable goods sales (-18.9% from the previous quarter) that greatly exceeded growth in the January-March quarter (+13.0%) along with sharp falls in sales of semi-durable goods (-12.3%) and nondurables (-7.0%). The downtrend was seen even in services (-0.9%), which should not be showing a reactionary drop (Chart 3).

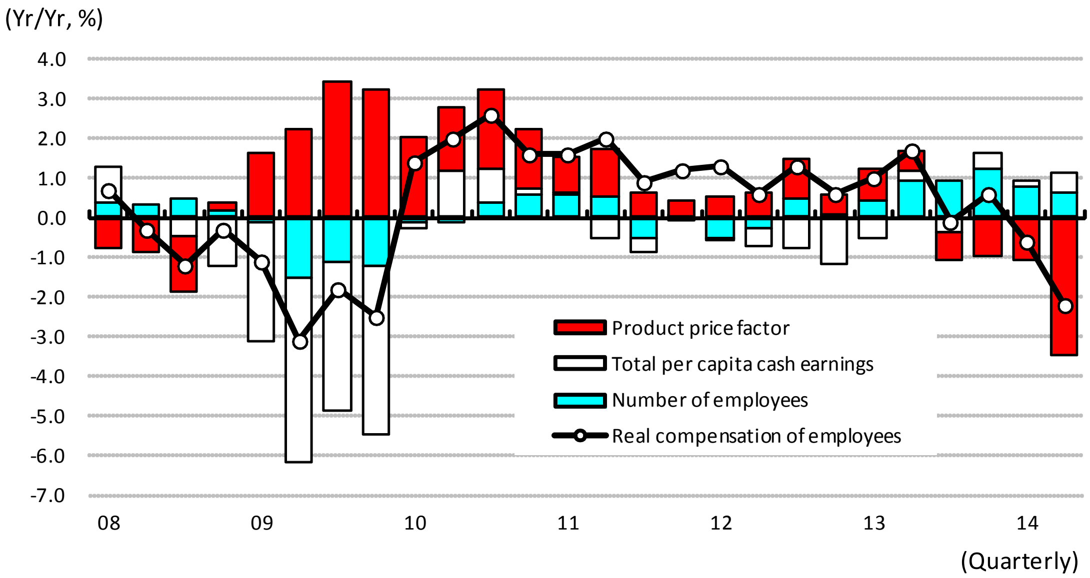
Chart 3: Breakdown of Personal Consumption in Real Terms



Source: Cabinet Office, *Quarterly Estimates of GDP*

A background factor promoting the sharp drop in private consumption is a fall in the real compensation of employees. Reflecting the spring labor offensive aimed at securing higher wages along with a rise in summer bonuses, employee compensation on a nominal basis rose smoothly–a +1.3% change from the same period of the previous year (+0.6% from the previous quarter). However, this margin of increase is not sufficient to cover the rise in product prices, so that real compensation of employees has dropped considerably (-2.2% from the previous year; -1.8% from the previous quarter; Chart 4). The private consumption deflator (excluding imputed rent) rose to +3.4% over the same period of the previous year.

Chart 4: Breakdown of Factors Affecting Real Compensation of Employees



Note: Total per capita cash earnings figures are for enterprises with five or more employees, and compensation of employees is calculated on a nominal GDP basis.

Sources: Ministry of Health, Labour and Welfare, *Monthly Labour Statistics*
Ministry of Internal Affairs and Communications, *Labour Force Survey*
Cabinet Office, *Quarterly Estimates of GDP (Preliminary)*

Besides this drop in households' real purchasing power, there is a strong likelihood that the consumption tax hike has impacted consumer psychology and thereby intensified proclivities to restrain household spending. In other words, the background factors contributing to the large drop in private consumption are believed to encompass–in addition to the reactionary decrease–signs that households have begun tightening their belts.

Moreover, it should be noted that much of the rise in nominal compensation of employees is attributable to an increase in the number of employees and that per capita earnings for the April–June quarter rose only 0.5% from the same period of the previous year. This degree of increase cannot be described as a scenario of smooth growth in earnings, and it should also be pointed out that it may be only a portion of companies that are actually boosting base wages and bonuses.

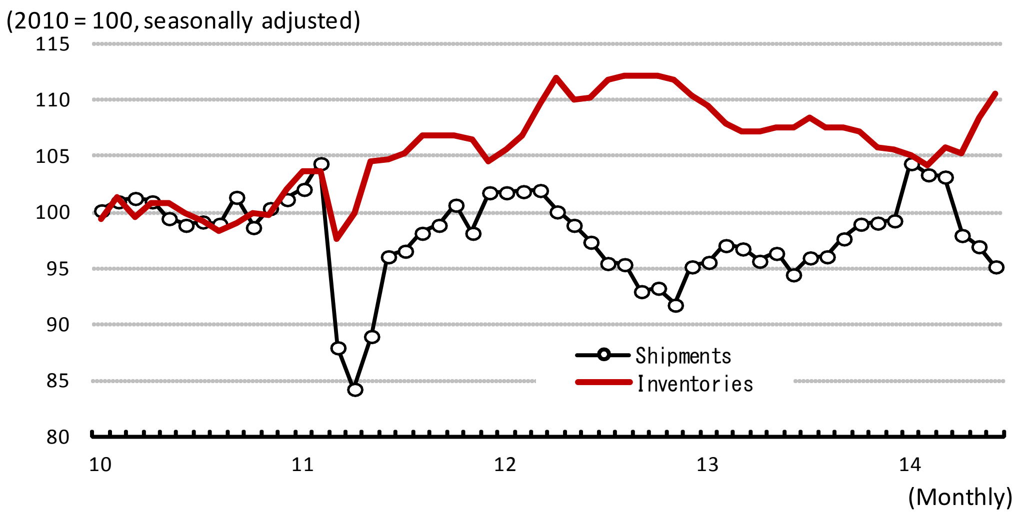
One positive factor is the continued improvement seen in the employment situation. However, the unemployment rate rose to 3.7% in June, so that, on average, the unemployment rate is currently remaining flat, and there is currently a hiatus in the overall employment situation improvement trend. An increase in the number of labor market entrants is leading to a rise in the number of unemployed people and, given that the number of employed people is at a high level, it cannot be said that the employment situation is deteriorating, but the post-tax-hike drop in demand has been accompanied by the possibility that the perception of tightness in the supply-demand relationship for labor is fading.

It is believed that the reason the improving employment situation is not leading to wage hikes is that companies are continuing to maintain a cautious stance regarding increases in employment costs. While progressive improvement in employment and wage situations is anticipated, it appears that the pace of such improvement will be kept slow. If this is true, then there is a high likelihood that progress will be similarly slow with respect to the projected trend of gradual fading of the reactionary dip in private consumption followed by gradual strengthening.

Second, the fact that inventory levels are rapidly rising is cause for concern. The rise in inventory levels is reflected in the inventories index, and the most-recently released figures confirm that inventory levels are rising in a wide range of industry sectors and stages. Although there is a possibility that the figures may be significantly revised at the second preliminary reporting stage, the size of inventories' current contribution to GDP on a quarter-to-quarter basis is the largest seen since the +1.4% contribution in the October-December 2008 quarter immediately following the Lehman Shock, and it is greater than the +0.8% contribution in the April-June 1997 quarter. Just as in the cases of those two previous inventory accumulation episodes, there is a high likelihood that the inventory accumulation will be immediately followed by efforts to rapidly reduce inventory levels that have the side effect of restraining production activities.

The index of industrial production peaked this January before the demand surge became full in scale and has subsequently trended downward, but the manufacturing production index forecast surveys released in July and August suggest that it will increase (by +2.5% and +1.1%, respectively). This appears to show that expectations of severe conditions going forward are not so widespread. However, companies are intensifying their efforts to quickly shrink the inventories they have accumulated, and there is concern that there may consequently be a large dip in production.

Chart 5: Trends in Indices of Shipments and Inventories

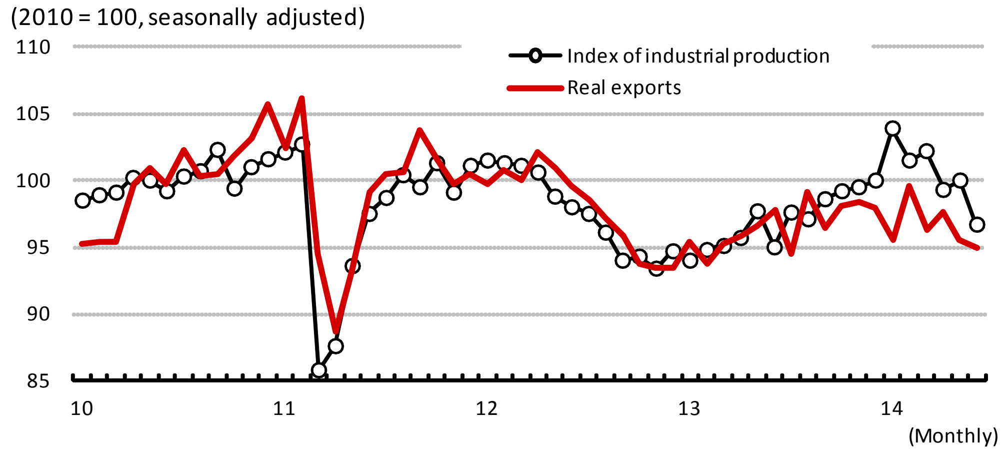


Source: Ministry of Economy, Trade and Industry, *Indices of Industrial Production*

Third, the fact that exports are not growing is cause for concern. Through the end of March, a portion of exports was restrained with the goal of giving priority to responding to the demand surge in Japan, and there were expectations that a reaction to this export restraint would emerge from April. Based on trends in currently available export volume indicators and other statistics, however, it appears that export trends remain sluggish. Real exports in the April-June quarter were down 0.4% from the previous quarter, the first such decline in three quarters. Because trends in exports and production generally move in parallel, continued slackness in exports can be expected to have an increasingly widespread impact on domestic production.

Up to now, owing to the impact of exporters' shift of manufacturing bases to overseas sites and postponement of export price reductions, yen depreciation has not readily generated the effect of increasing export volume. Given that over 1.5 years have already passed since the shift to a yen depreciation trend, however, it can be expected that the effects of the weak yen will gradually emerge going forward. In view of this, it is projected that export activities will become more active in step with the progress of economic recovery overseas. Because supply capability limitations will keep the rise in export dynamism gradual, however, it is difficult to anticipate that exports will be a principal locomotive propelling economic recovery.

Chart 6: Trends in Index of Industrial Production and Real Exports



Sources: Ministry of Economy, Trade and Industry, *Indices of Industrial Production*
Bank of Japan, *Real Exports and Real Imports*

In light of several factors–including the likelihood of a reaction to the large economic slump in the April-June quarter, expectations of a rise in public investment based on the fiscal 2013 supplemental budget and full-scale implementation of the fiscal 2014 budget, and expectations of a rise in exports in response to recovery trends in overseas economies–the economy is thought likely to return to a positive growth path in the July–September quarter of 2014. It appears that the economy will be able to avoid entering a recession.

However, based on consideration of other factors–including that fact that a rise in private consumption is not likely to be strong amid the continued weakness of real earnings and the fact that progressive inventory adjustments will cause the contribution of inventory investments to GDP growth to become negative–it is difficult to anticipate a smooth economic recovery process. Regarding the sluggishness of real earnings, there is concern that the restraint of private consumption will continue going forward, and if an additional rise in product prices were to occur, the negative effect of private consumption restraint would be further magnified. In addition, if the slackness of exports persists going forward, economic recovery momentum will be further diminished.

(3) Outlook for Fiscal 2014 and Fiscal 2015: Recovery to Be Restrained to a Moderate Pace

We have prepared this outlook based on the assumption that the next consumption tax rate hike will be implemented, as scheduled, 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 the 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; however, we think the impact of a decision to restart or not restart the operation of nuclear power plants will have only a slight effect on the economy during the forecast period. 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, because of the large impact of the drop in the April-June quarter, the outlook for growth in fiscal 2014 as a whole is for real GDP to remain at a marginal +0.2% over the previous fiscal year. Although a recession will be avoided due to the support from capital investment and external demand, because of weak growth in domestic demand, after the exclusion of a carryover effect of +1.1%, the rate of growth in fiscal 2014 is forecast to be –0.9%.

Regarding private consumption, there is likely to be a shift to growth during the July-September quarter as a reaction to the sharp drop in the April-June quarter. Such factors as an increase in summer bonuses centered on large corporations will promote growth in private consumption. However, there is a high likelihood that the pace of recovery in the October-December quarter and subsequently will be kept moderate. Regular wages and bonuses have begun to rise, but this trend is mainly confined to large corporations and is not spreading to companies in general. Consequently, the increase in incomes will not fully cover the increased burden due to the higher consumption tax, so real disposable incomes will decline considerably, and this will have a negative impact on household consumption. Regarding sales of such large electric appliances as flat-panel TVs, air conditioners, and refrigerators, the previous demand surge was large in magnitude and is expected to considerably undermine future demand. The reactionary impact to that demand surge is expected to persist over the long term.

Worker compensation in real terms is expected to decline 1.4% 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. The outlook is for worker compensation to rise 0.9% over the previous year in nominal terms, the fifth consecutive annual increase, reflecting increases in the number of workers and in compensation per worker, but real compensation will decline because the percentage increase in prices will exceed the percentage rise in nominal wages. As a result, even though consumers' rising propensity to consume supported a steady rise in real consumption through fiscal 2013, consumption is expected to decline 1.4% in fiscal 2014, the first decrease in six years, since fiscal 2008.

Corporate capital investment is forecast to continue on a moderate rising trend as corporate performance improves. The trend in real capital investment shifted to negative quarter-on-quarter growth in the April-June quarter, and machinery orders during that quarter were down by a large margin from the previous quarter, but this is thought to be a temporary dip. 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, corporate performance in fiscal 2014 is expected to be impacted by 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. Moreover, 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 reach a ceiling, and a small decrease in corporate profitability is anticipated.

Public investment during the first half of fiscal 2014 is forecast to remain firm because of the positive effect of the 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 1.0% from the previous fiscal year.

On the other hand, against the backdrop of recovering economic conditions overseas, a recovery, albeit modest, in the pace of export growth is likely to be a factor supporting the economy. Reflecting the increasing diffusion of benefits from yen depreciation, it is expected that exports of general machinery and electronic components and devices, which have been slow to recover so far, may pick up. For imports, on the other hand, the rate of increase is expected to remain moderate, even after a temporary decline stemming from 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 is likely to 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 -0.2%, significantly lower than the +2.7% contribution in fiscal 2013. This is expected to be the first time domestic demand has made a negative contribution to growth since fiscal 2009. On the other hand, the contribution of external demand is expected to rise from –0.5% in fiscal 2013 to +0.4% in fiscal 2014, the first positive figure since fiscal 2010. However, this increase is not strong enough to fully offset the drop in household sector demand owing to the consumption tax increase.

Examining growth rates by quarter in fiscal 2014, real GDP is expected to return to positive quarter-to-quarter growth, of 0.9%, 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. In addition to a return to growth in private consumption as a reaction to the previous sharp slump, it is expected that the economy will be supported by public investment, an increase in private capital investment, and improvement in exports. Although imports will show only weak growth in the July–September quarter, reflecting the stagnation in domestic demand, the rate of import growth is expected to surpass the rate of export growth, causing the contribution of the external sector to become negative. 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. Given the large impact of reactive increases, however, there appears to be increasing support for prudently waiting to see October-December quarter results before making judgments about the strength of economic recovery.

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, reflecting the weak tempo of recovery in private consumption, the pace of economic recovery will unavoidably weaken substantially compared with fiscal 2013. If deterioration in overseas economies causes a slump in exports and private consumption decreases, 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 +2.1%.

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 very moderate, and there is a possibility that rising inventory adjustment pressure will lead to negative quarter-on-quarter GDP growth in the July-September quarter. The outlook is for a slight increase of 0.2% in fiscal 2014, compared with an increase of 3.2% in fiscal 2013. Moreover, although the improvement trend in the employment situation will continue, some industries will still experience severe labor shortages, and companies, in general, are likely to continue to maintain a fundamental stance of working to restrain personnel costs. In fiscal 2014, the corporate profitability trend will shift from improvement to weakening, and it is hard to imagine an additional acceleration of growth in wages. The trend of considerable declines in real wages is expected to continue.

Under these circumstances, upward pressures on prices are unlikely to gain momentum. The CPI (excluding fresh food) is forecast to rise 3.0% over the previous fiscal year, but when the effects of the consumption tax hike are excluded, the CPI will rise only 1.0%. Upstream inflationary pressures are expected to weaken as international commodity prices, including the price of crude oil, continue stable 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.

<u>In fiscal 2015</u>, 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 midway through the fiscal year, on average, the negative impact will be small in comparison with fiscal 2014. Personal consumption will continue to rise, by +1.5% 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 will remain below the previous year's levels, consumer spending is forecast to continue to be weak.

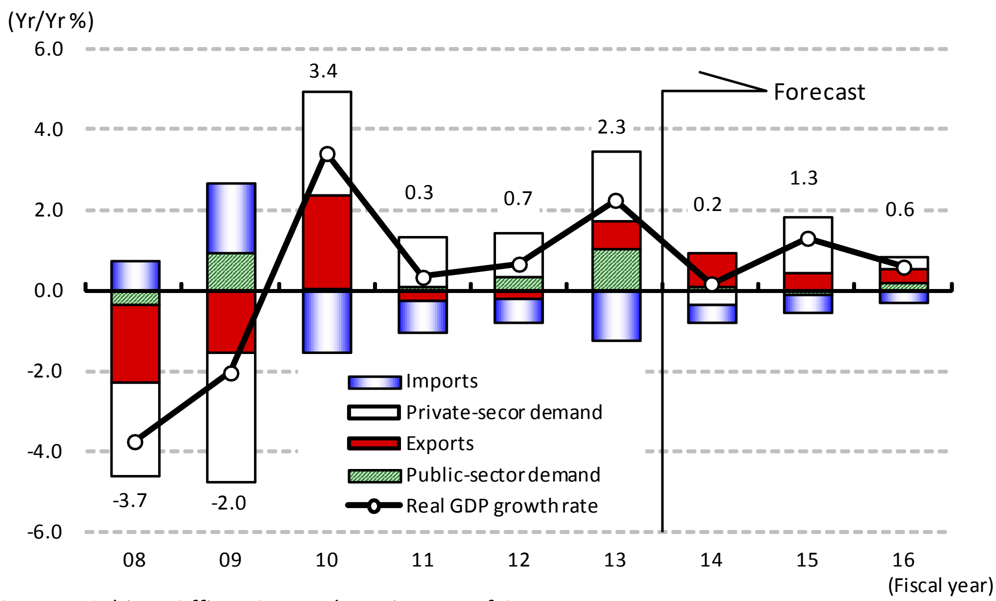
Although the improving trend in corporate performance will continue, in the midst of a further increase in the consumption tax, it will lack robustness. For this reason, the drive among corporations to make capital investments will not rise, and there is a high likelihood that companies will continue 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 the competitiveness of Japan's exports will gradually recover as the weaker yen takes hold. However, because of the difficulty of correcting such structural changes as shifts of manufacturing bases to overseas sites within a short period of time, the pace of increase is expected to be moderate. On the other hand, since growth in imports will be moderate, reflecting the weakness of domestic demand, the contribution of overseas demand is expected to be unchanged.

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 additional economic policies along with the October 2015 increase in the consumption tax and that these will reduce the margin of decline in public investment.

We are forecasting real GDP growth of +1.3% 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, and this is expected to elevate the growth rate for the fiscal year, but, in the second half, the outlook is for a reactionary decline that causes economic conditions to deteriorate. The economy will be supported in the latter half of fiscal 2015 by external demand, but strong growth in exports cannot be expected and, amid a further worsening of households' financial situations owing to the impact of the consumption tax rate hike, concerns about the possibility of a recession may emerge. After the exclusion of a carryover effect of +0.7%, the rate of growth calculated for the fiscal year will slow to +0.6%. Note that the nominal GDP growth rate will remain at a relatively high +1.6% because of effects of the increase in the consumption tax rate. The GDP deflator will remain positive at +0.3% year on year.

Chart 7: Contributions to Growth in GDP by Demand Component (Fiscal Year)



Source: Cabinet Office, *Quarterly Estimates of GDP*

Chart 8: Real GDP Growth (Fiscal Year)

	Carry-over from the previous year (A)	Growth rate during the year (B)	Real GDP growth rate (A)+(B)
FY2013 (actual)	0.7 %	1.6 %	2.3 %
FY2014 (forecast)	1.1 %	-0.9 %	0.2 %
FY2015 (forecast)	0.7 %	0.6 %	1.3 %
FY2016 (forecast)	-0.1 %	0.7 %	0.6 %

Source: Cabinet Office, "Quarterly Estimates of GDP"

2. Forecasts of Economic Activity by Sector

(1) Corporations

- Production sustained a trend of increase after bottoming out in autumn 2012 but declined in the April-June 2014 quarter for the first time in six quarters owing to the impact of such factors as a reactive decrease in the wake of the consumption tax rate increase. On the other hand, inventory levels are rising along with inventory adjustment pressure. Against this backdrop, companies are tending to restrain production volume for the time being, although the outlook is to a shift to recovering production levels beginning sometime this autumn, and, with the exception of the period immediately after the consumption tax rate hike in 2015, the fundamental trend of increase in production is expected to be sustained. 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, corporate profitability rose by a large margin, as the surge in demand prior to the consumption tax rate increase joined with other positive factors. The margin of increase in profit is forecast to be small in fiscal 2014, reflecting a sales decline following the consumption tax rate hike along with and profit deterioration because of higher costs, but a sustained trend of moderate growth in profitability is forecast for fiscal 2015 and subsequently.
- Going forward, as the full-scale trend of population shrinkage makes it difficult to expect growth in domestic demand, corporations are maintaining a cautious stance toward making new capital investments in Japan and are shifting toward investing in overseas production facilities in emerging countries and other countries where demand is expected to increase. For this reason, even with progressive yen depreciation, a recovery of capital

investment in Japan is not projected. Against a background of improvement in corporate performance, there is a strong possibility that the trend of increase in capital investment centered on facility replacement investment will continue for the time being.

(2) Households

- The employment and wages situations are continuing to improve even after the consumption tax rate increase. Regarding per capital earnings, the trend of decline in scheduled contractual earnings is being halted, and per capital earnings are trending upward owing to support from growth in non-scheduled cash earnings (overtime pay) and special earnings (bonuses). Nevertheless, companies are not expected to raise nominal wages in line with the increase in consumer prices, including the increase attributable to the consumption tax rate hike, so it is inevitably likely that real wages will be forced downward going forward.
- Private consumption dropped greatly in the April-June 2014 quarter because of a reaction to the surge in demand prior to the consumption tax rate hike. Although a shift to increasing consumption is projected during the July-September quarter as a reaction to the previous sharp downturn, the subsequent recovery in consumption is seen as likely to be restrained to a gradual pace amid large drops in real earnings. A surge in demand will occur prior to the October 2015 consumption tax hike and a reactionary decline in demand will occur thereafter, but because the margin of that hike is smaller than the April 2014 hike, the magnitudes of the surge and reactionary decline are expected to be relatively small.
- In fiscal 2014 and subsequently, new housing starts are expected to trend downward owing to a reaction to the previous surge.

  Although starts are continuing to be weak at this point, given the upcoming increase of the consumption tax rate to 10%, it is expected that there will be another surge of demand prior to March 31, 2015, which is the deadline for signing contracts eligible for tax benefits. After that, the outlook is for sluggish starts, reflecting a reaction to the previous surge along with other factors.

(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.
- 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 increased expenditures related to public works investment substantially. The results of these measures emerged in fiscal 2013, and public investment has been boosted significantly. Moreover, the government is beginning the full-scale implementation of 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 expenditure (on a GDP basis) is likely to continue rising as the economy moves into fiscal 2014. Although government expenditure will shift to a trend of decrease in fiscal 2015, as the up-push effect from economic countermeasures progressively diminishes and causes a large drop in public works investment, the outlook is for a renewed rise in government expenditure in fiscal 2016 owing to an increase in government final consumption.

(4) Trends in Overseas Economies

- The world economy is sustaining moderate growth. In the United States, moderate economic expansion is continuing, and the Federal Reserve Board (FRB) is expected to end its quantitative monetary easing policy (QE3). In Europe, there has been a hiatus in the trend of economic recovery, and there are concerns regarding the intensification of the situation in the Ukraine. The emerging countries are moderately accelerating their economic growth, benefitting from the effects of China's economic countermeasures. Improvement in Thailand's public security situation is enabling that country to show signs of economic recovery, while the impact of a ferry-sinking incident is promoting economic deceleration in South Korea.
- 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 an economic growth rate in the mid-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, although the pace of the increase is likely to be moderate. Japan’s imports (on a customs-clearance, volume basis) are expected to trend upward along with the continuing recovery in the domestic economy.
- Japan’s trade balance (on an international balance of payments basis) moved to a deficit position in fiscal 2011, and the size of the deficit reached a record high level in fiscal 2013 owing to a large increase in imports. The size of the trade deficit decreased in fiscal 2014, reflecting the restrained growth of imports, but the outlook is for continued large deficits going forward. Owing to Japan’s primary income surplus, the country is sustaining its current account surplus, but the level of that surplus is likely to be low.

3. Forecasts for Prices and Financial Markets

- Despite temporary rises in crude oil prices owing to rising geopolitical risks, the fact that crude oil supply and demand are roughly in balance is promoting a general trend of stability in crude oil prices. While demand mainly in emerging economies is increasing gradually, growth in shale oil production and other developments are expected to increase crude oil supplies. As this is expected to continue keeping crude oil supply and demand balanced, crude oil prices are likely to remain stable barring rises in geopolitical risks.
- The rate of increase in prices has risen sharply because of the consumption tax rate hike. Since international commodity prices are stable and the effects of yen depreciation are progressively running their course, however, the upward pressure on domestic prices is weakening. Consequently, the year-on-year rates of growth in domestic corporate goods and consumer goods are both close to zero. Against the backdrop of consumers' deeply rooted preference for low-priced bargains along with the consumption drop attributable to the consumption tax rate hike, it will continue to be difficult for companies to raise prices easily, so the rate of price increases is expected to decrease going forward.
- Since 2008, Japan has moved ahead with measures to ease monetary policy. After implementing a comprehensive policy for monetary easing in October 2010, the BOJ adopted a "2% inflation target" in January 2013 and made the decision to implement a policy of "quantitative and qualitative monetary easing" in April 2013. The BOJ is expected to continue its stance of maintaining an easy monetary policy for the time being, and there is a possibility that it may implement additional easing measures in the case that it becomes difficult to attain its inflation rate target.
- Long-term interest rates are expected to remain at low levels against a background of low and 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 an increasingly strong downward correction in the value of the yen. Going forward, the yen is likely to continue to be easily susceptible to progressive depreciation based on foreign exchange markets' consideration of the Japan-U.S. interest rate gap.

Chart 9: Outlook for Fiscal 2014-2016

Forecast → Yr/Yr、%

	FY2010 (actual)	FY2011 (actual)	FY2012 (actual)	FY2013 (actual)	FY2014 (forecast)	FY2015 (forecast)	FY2016 (forecast)
Nominal GDP	1.3	-1.4	-0.2	1.9	2.3	1.6	0.8
Real GDP	3.4	0.3	0.7	2.3	0.2	1.3	0.6
Contribution of domestic demand	2.6	1.4	1.4	2.7	-0.2	1.3	1.3
Private consumption	1.6	1.4	1.5	2.5	-1.4	1.5	0.1
Housing investment	2.2	3.2	5.4	9.5	-10.3	-0.9	-5.5
Private capital investment	3.8	4.8	0.7	2.7	5.0	4.4	2.1
Contribution of inventory investment	1.0	-0.3	-0.1	-0.4	0.2	-0.1	0.1
Government expenditure	0.3	0.5	1.4	4.2	0.4	-0.4	0.8
Public investment	-6.4	-3.2	1.3	15.1	-1.0	-7.3	-0.7
Government final consumption expenditure	2.0	1.2	1.5	1.8	0.9	1.3	1.1
Contribution of external demand	0.8	-1.0	-0.8	-0.5	0.4	0.0	0.0
Export of goods and services	17.2	-1.6	-1.3	4.8	5.1	2.6	2.1
Import of goods and services	12.0	5.3	3.6	7.0	2.5	2.2	1.3
GDP deflator	-2.0	-1.7	-0.9	-0.4	2.1	0.3	0.3

Forecast → Yr/Yr、%

	FY2010 (actual)	FY2011 (actual)	FY2012 (actual)	FY2013 (actual)	FY2014 (forecast)	FY2015 (forecast)	FY2016 (forecast)
Current account balance (trillion yen)	18.0	7.9	4.2	0.8	2.7	2.9	3.0
balance on goods (trillion yen)	8.0	-2.2	-5.2	-11.0	-9.3	-9.7	-9.8
balance on service (trillion yen)	-2.8	-3.1	-4.2	-3.5	-3.2	-3.1	-3.0
balance on income (trillion yen)	13.9	14.3	14.6	16.7	16.7	17.0	17.1
Industrial production	15.4	-0.6	-3.0	3.2	0.2	2.5	1.5
Unemployment rate(%)	5.0	4.5	4.3	3.9	3.6	3.5	3.4
New housing starts(annualized, ten thousand units)	77.5	81.9	89.3	98.7	89.7	88.7	85.6
Domestic corporate goods prices	0.4	1.4	-1.1	1.9	3.8	0.8	0.8
Consumer prices	-0.4	-0.1	-0.3	0.9	3.0	0.7	0.5
excluding freshfood	-0.8	0.0	-0.2	0.8	3.0	0.6	0.5
Yen/U.S.Dollar	85.7	79.1	83.1	100.2	102.5	104.3	105.7
Uncollateralized call rates (O/N) (%)*	0.091	0.077	0.082	0.073	0.064	0.055	0.050
Newly issued government bond yields (10years) (%)	1.15	1.05	0.78	0.69	0.57	0.59	0.68
WTI future price (near month contract, US dollar/barrel)	83.4	97.3	92.1	99.0	98.8	95.5	94.3
Dubai crude oil prices (US dollar/barrel)	84.2	110.1	107.1	104.5	103.4	100.6	99.4

* actual=average, forecast=end of period

Chart 10: Outlook for Calendar 2014-2016

Forecast

Yr/Yr、%

	CY2010 (actual)	CY2011 (actual)	CY2012 (actual)	CY2013 (actual)	CY2014 (forecast)	CY2015 (forecast)	CY2016 (forecast)
Nominal GDP	2.4	-2.3	0.5	0.9	2.5	1.8	0.7
Real GDP	4.7	-0.5	1.5	1.5	1.0	1.1	0.4
Contribution of domestic demand	2.9	0.4	2.3	1.8	1.1	0.9	0.9
Private consumption	2.8	0.3	2.0	2.0	0.0	0.8	0.0
Housing investment	-4.5	5.1	2.9	8.8	-4.4	-2.5	-7.3
Private capital investment	0.3	4.1	3.7	-1.5	8.3	3.5	2.4
Contribution of inventory investment	1.0	-0.4	0.1	-0.3	-0.2	0.1	0.0
Government expenditure	1.6	-0.5	1.9	3.6	1.2	-0.4	0.5
Public investment	0.7	-8.2	2.9	11.3	3.3	-6.7	-2.5
Government final consumption expenditure	1.9	1.2	1.7	2.0	0.7	1.3	1.2
Contribution of external demand	1.7	-0.9	-0.9	-0.3	-0.2	0.2	0.1
Export of goods and services	24.4	-0.4	-0.2	1.6	7.2	2.1	2.3
Import of goods and services	11.1	5.9	5.3	3.4	7.1	1.0	1.2
GDP deflator	-2.2	-1.9	-0.9	-0.6	1.5	0.7	0.3

Forecast

Yr/Yr、%

	CY2010 (actual)	CY2011 (actual)	CY2012 (actual)	CY2013 (actual)	CY2014 (forecast)	CY2015 (forecast)	CY2016 (forecast)
Current account balance (trillion yen)	19.1	10.1	4.7	3.2	0.7	2.9	3.1
balance on goods (trillion yen)	9.5	-0.3	-4.3	-8.8	-10.7	-9.6	-9.7
balance on service (trillion yen)	-3.0	-3.0	-4.0	-3.5	-3.4	-3.1	-3.0
balance on income (trillion yen)	13.6	14.6	14.1	16.5	16.5	17.0	17.1
Industrial production	15.6	-2.8	0.6	-0.8	2.8	1.6	1.2
Unemployment rate (%)	5.1	4.6	4.3	4.0	3.6	3.5	3.5
New housing starts(annualized, ten thousand units)	81.3	83.4	88.2	97.8	90.1	90.5	85.4
Domestic corporate goods prices	-0.1	1.5	-0.9	1.3	3.5	1.0	1.4
Consumer prices	-0.7	-0.3	0.0	0.4	2.7	1.1	0.8
excluding freshfood	-1.0	-0.2	-0.1	0.4	2.6	1.0	0.9
Yen/U.S.Dollar	87.8	79.8	79.8	97.6	102.4	103.9	105.4
Uncollateralized call rates (O/N) (%)*	0.093	0.078	0.083	0.075	0.067	0.058	0.050
Newly issued government bond yields (10years) (%)	1.17	1.12	0.85	0.71	0.57	0.60	0.63
WTI future price (near month contract, US dollar/barrel)	79.5	95.1	94.2	98.0	99.3	95.8	94.6
Dubai crude oil prices (US dollar/barrel)	78.0	106.2	109.1	105.5	104.1	101.0	99.7

* actual=average, forecast=end of period

Chart 11: 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	4-7	7-10	10-13	1-4
Nominal GDP	0.3	0.3	0.3	1.6	-0.1	0.9	0.5	0.5	0.4	0.3	0.1	0.2
	0.7	1.9	2.0	2.9	1.9	2.7	2.7	1.8	2.3	1.9	1.2	1.1
Real GDP	0.9	0.4	0.0	1.5	-1.7	0.9	0.1	0.5	0.5	0.7	-1.0	0.3
	1.2	2.3	2.5	3.0	-0.1	0.5	0.6	-0.3	2.2	1.9	0.7	0.6
Contribution of domestic demand (Qr/Qr,%)	0.8	0.8	0.5	1.7	-2.8	1.0	0.2	0.5	-2.8	1.0	0.2	0.5
Private consumption	0.7	0.2	0.4	2.0	-5.0	2.5	0.1	0.3	0.4	1.2	-1.8	0.4
	1.8	2.4	2.3	3.5	-2.5	-0.3	-0.6	-2.3	3.4	2.1	0.2	0.3
Housing investment	2.1	4.7	2.4	2.0	-10.3	-4.7	-2.0	4.2	7.1	-5.4	-8.4	-0.4
	6.8	8.5	10.4	12.1	-1.9	-10.9	-14.6	-12.6	4.2	3.3	-3.3	-7.5
Private capital investment	1.4	0.6	1.4	7.7	-2.5	0.7	1.0	1.4	0.6	3.0	-0.8	0.6
	-2.7	-0.9	1.2	11.6	7.1	7.1	6.7	0.6	3.7	6.0	4.2	3.5
Contribution of inventory investment (Qr/Qr,%)	-0.3	0.0	-0.1	-0.5	1.0	-0.5	0.0	0.1	0.1	-0.2	0.1	-0.1
Government expenditure	1.6	1.5	0.5	-0.6	0.2	0.4	0.2	-0.5	-0.4	0.1	0.1	0.1
	3.3	4.9	5.5	3.1	1.2	0.5	0.1	0.0	0.0	-0.5	-0.9	-0.3
Public investment	5.8	7.1	1.4	-2.5	-0.5	1.1	-0.8	-3.5	-3.2	-1.3	-0.8	-0.4
	8.1	18.9	20.8	11.6	5.2	-0.4	-2.5	-3.9	-6.4	-8.4	-8.5	-5.7
Government final consumption expenditure	0.4	0.2	0.2	-0.1	0.4	0.3	0.4	0.3	0.2	0.4	0.3	0.3
	2.5	2.2	1.8	0.7	0.6	0.7	0.9	1.3	1.2	1.4	1.3	1.2
Contribution of external demand (Qr/Qr,%)	0.1	-0.4	-0.6	-0.2	1.1	-0.1	-0.1	0.0	1.1	-0.1	-0.1	0.0
Export of goods and services	3.0	-0.7	0.3	6.5	-0.4	0.5	0.6	0.4	0.8	0.5	0.8	0.6
	-0.1	3.2	6.9	9.4	5.5	6.9	6.9	1.2	2.5	2.0	2.7	3.1
Import of goods and services	2.3	1.8	3.7	6.4	-5.6	1.2	0.9	0.3	0.7	1.2	-1.0	0.5
	0.8	3.2	9.2	15.0	6.0	5.4	2.5	-3.3	3.0	3.1	1.2	1.4
GDP deflator (Yr/Yr,%)	-0.6	-0.4	-0.4	-0.1	2.0	2.1	2.1	2.1	2.0	2.1	2.1	2.1

Forecast

Yr/Yr、%

	FY2013				FY2014				FY2015			
	4-6	7-9	10-12	1-3	4-6	7-9	10-12	1-3	4-7	7-10	10-13	1-4
Current account balance (trillion yen)*	1.8	0.6	0.0	-1.4	0.6	0.6	0.9	0.8	0.9	0.5	1.0	0.7
balance on goods (trillion yen)*	-1.7	-2.3	-2.8	-3.9	-2.2	-2.4	-2.1	-2.4	-2.3	-2.7	-2.2	-2.5
balance on service (trillion yen)*	-0.7	-0.9	-1.0	-1.0	-0.8	-0.8	-0.8	-0.8	-0.7	-0.8	-0.8	-0.8
balance on income (trillion yen)*	4.5	4.0	4.1	4.0	4.1	4.2	4.3	4.3	4.3	4.3	4.3	4.3
Industrial production (Qr/Qr、%)	1.6	1.8	1.8	2.9	-3.8	-0.2	1.0	0.7	0.9	1.8	-1.6	0.3
(Yr/Yr、%)	-3.0	2.3	5.8	8.2	2.7	0.7	-0.2	-2.4	2.5	4.6	1.8	1.3
Unemployment rate (%)*	4.0	4.0	3.9	3.6	3.6	3.6	3.6	3.5	3.5	3.4	3.5	3.6
New housing starts(annualized, ten thousand units)	98.0	99.0	104.1	93.4	88.7	88.3	89.9	92.4	93.9	89.2	86.7	85.2
Domestic corporate goods prices (Yr/Yr,%)	0.7	2.2	2.5	1.9	4.4	4.2	3.7	3.0	-0.3	-0.2	1.8	2.0
Consumer prices (Yr/Yr,%)	-0.2	0.9	1.4	1.5	3.5	3.3	2.8	2.6	0.3	0.2	1.1	1.1
excluding freshfood (Yr/Yr,%)	0.0	0.7	1.1	1.3	3.4	3.2	2.8	2.5	0.2	0.2	1.1	1.1
Yen/U.S.Dollar	98.7	98.9	100.4	102.8	102.1	102.1	102.7	103.1	103.6	104.2	104.6	104.9
Uncollateralized call rates (O/N) (%)**	0.073	0.073	0.072	0.074	0.067	0.069	0.060	0.060	0.060	0.060	0.050	0.050
Newly issued government bond yields (10years) (%)	0.73	0.77	0.64	0.63	0.60	0.52	0.55	0.60	0.65	0.60	0.55	0.55
WTI future price (near month contract, US dollar/barrel)	94.2	105.8	97.5	98.7	103.0	98.8	96.9	96.4	96.0	95.6	95.3	95.0
Dubai crude oil prices (US dollar/barrel)	100.8	106.2	106.8	104.4	106.2	103.5	102.2	101.6	101.1	100.8	100.5	100.2

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