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Forecast for the Japanese Economy in Fiscal 2014 and 2015

— Even if the Economy Bottoms Out, the Pace of Recovery Will Be Moderate —

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1. Outlook for the Japanese Economy in Fiscal 2014 and Fiscal 2015 —Even if the Economy Bottoms Out, the Pace of Recovery Will Be Moderate —

(1) Current State of the Economy: Two Consecutive Quarters of Negative Growth

The real GDP growth rate for the July–September quarter of 2014, which was announced on November 17, was -0.4% compared with the previous quarter (-1.6% at an annualized rate), the second consecutive quarter of negative growth. The downslide in economic indicators that followed the increase in Japan's consumption tax rate has not been stopped, and the economy remains weak.

Private consumption, following the surge in demand in the April–June quarter, showed a substantial reactionary decline of 5.0%, and then only a slight rise of 0.4% in the July–September quarter. The reactionary decline in consumption that followed the increase in the consumption tax has been prolonged, and the decrease in real incomes has reduced the purchasing power of households. There is a strong possibility that lower real incomes have weakened consumers' desire to spend. Private residential investment has also slumped, as evidenced by a sharp drop in housing starts as a result of the reactionary decrease in demand, and starts for the quarter were down 6.7% from the previous quarter, for the second consecutive quarter.

In the corporate sector, private capital investment decreased 0.2% from the previous quarter, the second quarter to quarter decline. Although corporations have substantial cash flows and the environment for fund-raising is favorable, they are adopting a cautious stance toward capital investments in view of the weakness in economic conditions. Also, the contribution of inventory investment to real GDP growth compared with the previous quarter declined sharply to -0.6 percentage point, thus pushing the overall growth rate downward. The contribution was +1.2 percentage points in the April–June quarter, but accompanying the decline in demand, unintended inventories rose and corporations moved to make inventory adjustments. It would be possible to view the progress toward adjustments in inventories as a positive development for production trends, but the rise in inventories in the previous period was substantial, and adjustments have not necessarily been completed.

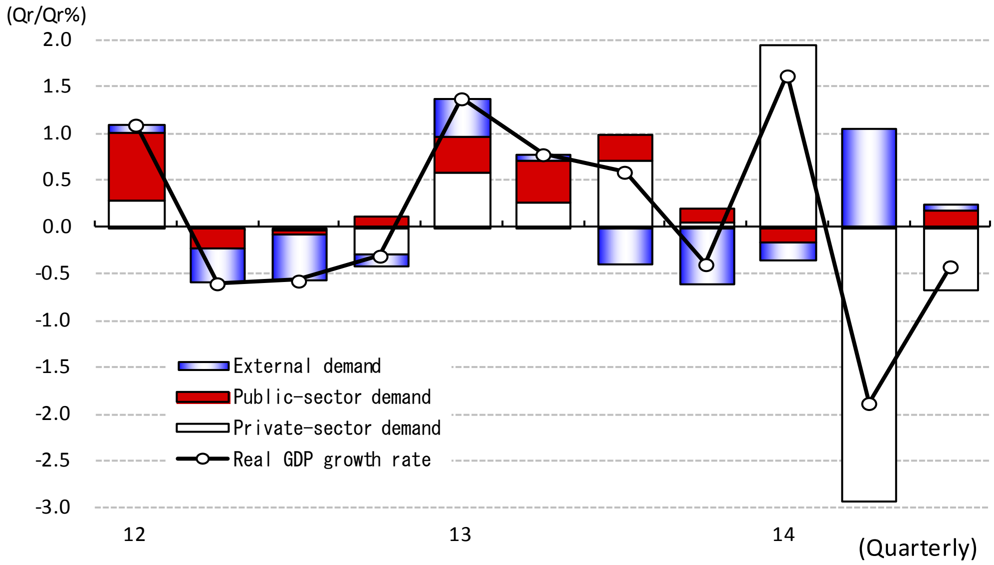
The contribution of private-sector demand to growth compared to the previous quarter was -0.7 percentage point. On the other hand, the contribution of the public sector was +0.2 percentage point, the second consecutive quarterly contribution. Because the economic policies adopted in fiscal 2013 are being fully implemented and the fiscal 2014 budget is being spent at an accelerated pace, public investment rose 2.2% over the previous quarter. However, this, combined with the fact that government consumption shifted to a rise of 0.3%, did not fully cover for the downturn in private-sector demand, and its contribution compared with the previous quarter was -0.5 percentage point.

Exports rose only 1.3% over the previous quarter even as conditions in overseas economies improved and the downward correction in the value of the yen took hold. However, reflecting the weakness of domestic demand, imports rose 0.8%, or at a slower pace than exports, resulting in a positive contribution of 0.1% in external demand to GDP growth, for the second consecutive quarter.

The GDP growth rate in nominal terms was -0.8% (-3.0% at an annualized rate, a larger margin of decline than in the April–June quarter. The GDP deflator, which reflects overall price trends in the economy, was 2.1% over the previous year. The increase in the deflator remained at this relatively high level because of the effects of the increase in the consumption tax, but was 0.3% below the level of the previous quarter, suggesting that inflationary pressures are subsiding.

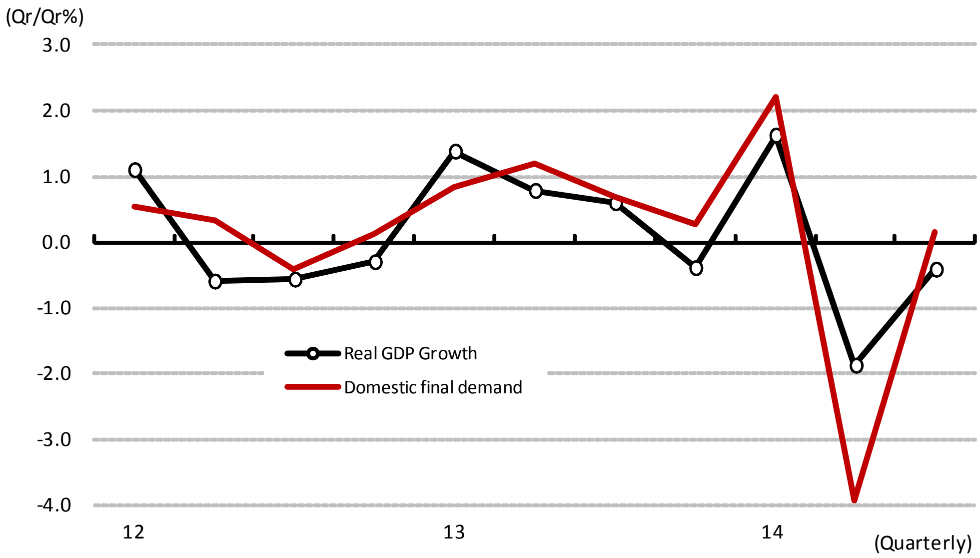
Viewing the results for the July–September quarter, although the negative contribution of inventory investment was substantial, even after excluding this factor, growth was low. These results indicate that the economy has not escaped from its weak condition. Examination of domestic final demand, which excludes inventory investment from domestic demand, shows that even though the 0.2% growth in the July–September quarter was an improvement over the -3.9% figure in the April–June quarter, demand is lacking in strength (Chart 2). Even though the employment situation improved and nominal wages, principally summer bonuses, increased, growth remained negative in real terms. Examination of trends in worker compensation shows an increase in nominal terms of 2.6% over the previous year, which was the highest figure since the April–June quarter of 1997, but, in real terms, compensation was down 0.6%, the third consecutive quarter of declines year on year. As price increases continue going forward, real incomes are forecast to remain on a decreasing trend, and there is a possibility that improvement in consumption may be delayed. Moreover, if we consider that the trend toward inventory adjustments will proceed and that inventory investments will continue to make negative contributions, this factor will restrain the real growth rate.

Chart 1: Trends in Real GDP



Source: Cabinet Office, *Quarterly Estimates of GDP*

Chart 2: Trends in Real GDP and Domestic Final Demand



Source: Cabinet Office, *Quarterly Estimates of GDP*

(2) Outlook Going Forward: Has Abenomics Been a Failure?

Prime Minister Shinzo Abe indicated that the most-important issue behind his dissolution of the Diet and calling a general election for the House of Representatives was to determine the views of the electorate regarding Abenomics. In reaction, the opposition parties, in particular, are stating that Abenomics is a failure because of the two consecutive quarters of negative real GDP growth. In reality, just how effective have economic policies been over the past two years? Also, by postponing the next increase in the consumption tax rate, can we expect stronger effects from Abenomics?

The "three arrows" of Abenomics are a bold quantitative and qualitative easing of monetary policy, a flexible public finance policy, and a growth strategy to stimulate investment in the private sector (from the original and revised versions of "Japan Revitalization Strategy"). Of these three, the most effective in stimulating the economy in the short term has been the boost provided by increases in public investment. Policies were adopted that provided for 10 trillion yen in fiscal 2012 and another 5.5 trillion yen in fiscal 2013. In addition, the government is expected to prepare a supplementary budget for this fiscal year amounting to about 3 trillion yen. The main pillars of these economic policies have been public investments. Together with activities for reconstruction and recovery following the Great East Japan Earthquake, these government policies have given a major boost to the economy (Chart 3).

Chart 3: Trends in Public Investment in Nominal Terms

Source: Cabinet Office, *Quarterly Estimates of GDP*

However, because of continuing movements toward restraining public investment as part of activities to put government finances on a sounder footing, the supply capacity of the construction industry, including equipment and labor, is shrinking. The situation has worsened to the point that construction work that has been ordered cannot proceed. These constraints on supply capacity have resulted in increases in labor costs and prices of materials. The shortage of labor in the construction industry has had an impact on the overall labor situation, and this has been one of the causes of improvement in labor conditions. In addition, capital investment in the construction industry is on a rising trend.

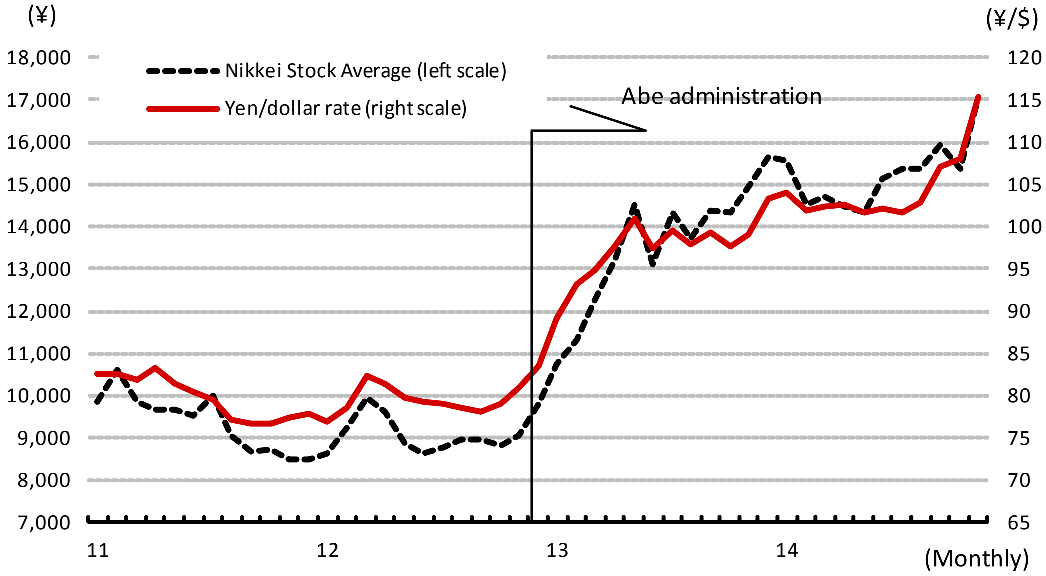
The boost to the economy of these increases in public investment is believed to have generated some results. However, stimulus to the economy coming from fiscal policy is well known to be effective if the amounts of fiscal stimulus are large. These policies have been used many times in the past, and not just by the Abe administration. They are not something that policymakers can boast about and say they were positive effects of Abenomics. If there are some aspects that are special about Abenomics, these would not be that they were policies adopted to deal with special factors, such as rapid deterioration in economic conditions in the aftermath of the Lehman Shock, the sharp appreciation of the yen, and the havoc wreaked by the Great East Japan Earthquake. What would distinguish them would be that they were formulated during a period of recovery and could not be fully implemented.

The next point is that the least effective of the three arrows has been the growth strategy. However, by its nature, the growth strategy is not intended to provide stimulus for the economy in the short term. Some of the main elements of the growth strategy are reducing the effective corporate income tax rate; relaxing restrictions on labor, agriculture, and healthcare; creating special economic zones; and implementing Trans-Pacific Partnership agreements (TPP). The government is planning to put these strategies into action, but all of them are still under consideration. The only measure that seems to have had immediate effect was the review of the asset allocation of Japan's Government Pension Investment Fund (GPIF), which pushed stock prices upward. However, many of these growth strategies have been under consideration for many years by previous administrations, including the Democratic Party of Japan (DPJ). In addition, since these measures are not such as those that would be delayed in implementation or could not be accomplished due to the prevailing economic conditions at the time, the delay in increasing the consumption tax rate this time is not likely to have a high degree of effectiveness.

However, more difficult to evaluate are the effects of the bold quantitative and qualitative monetary easing policies and the positive expectations created by Abenomics.

The change of government and emergence of the Abe administration, the sense that the Japanese economy was facing an impasse, and other circumstances seem to have raised expectations that something positive was going to happen, and this resulted in improvement in confidence among consumers and companies. These rising expectations were further boosted by the correction in the overvaluation of the yen and by the rise in stock prices. Immediately after the announcement of the general election for the House of Representatives in November 2012, expectations regarding the bold monetary easing policy rose and the value of the yen depreciated from around 80 yen to one U.S. dollar to 102 yen in May 2013. The Nikkei Stock Average, buoyed by the expectations for the economy and the positive impact of the weaker yen, moved from just over 8,000 yen to over 15,000 yen in May 2013 (Chart 4).

Chart 4: Trends in the Yen/Dollar Rate



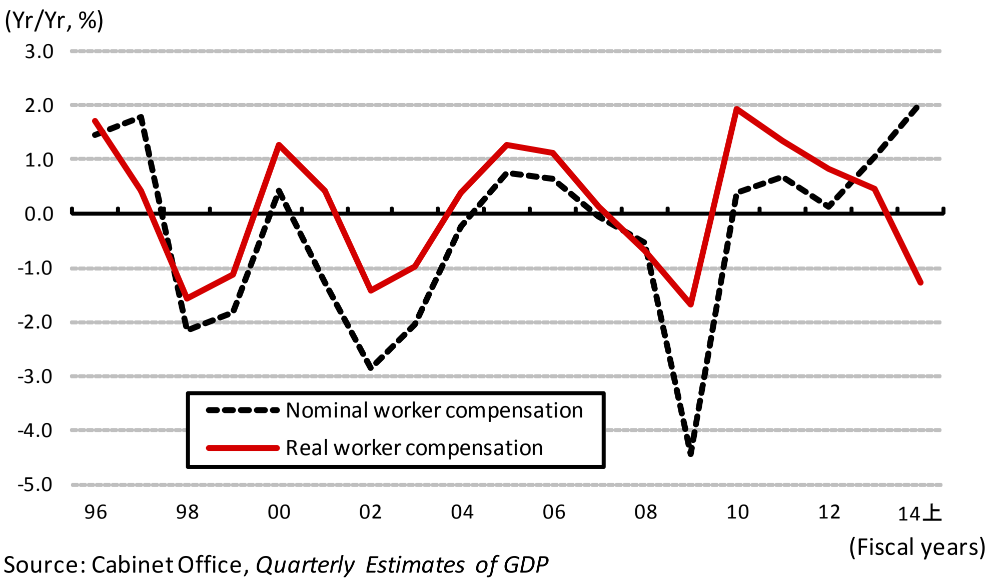
Source: Bank of Japan website, *Nihon Keizai Shimbun*

However, the bold monetary easing policy was not implemented until April of the following year, when Haruhiko Kuroda, who became governor of the Bank of Japan (BOJ) in March, put it into action. Therefore, the BOJ's new quantitative and qualitative monetary easing policies did not bring a cheaper yen and high stock prices. Instead, the expectation emerged that the yen would fall in value and stock prices would rise first, and all that happened was that financial markets responded. The evidence for this is that the level of the quantitative and qualitative easing was bolder than the market had expected. As a result, although immediately thereafter the yen weakened and stock prices rose significantly, these trends stopped in May, and, for some time after that, the yen exchange rate and stock prices leveled off and began to fluctuate in a narrow range.

Thus, although, in fact, there had been no major changes, financial markets anticipated the changes and may have been led to believe that Abenomics had already begun to function. These expectations were the highest in the household sector.

In part because of the attitude of restraint that emerged after the Great East Japan Earthquake that occurred in March 2011, personal consumption moved into a slump temporarily. However, there was a reaction thereafter, and consumption began to make a smooth recovery. Behind this development was an increase in real income (Chart 5). Examination of trends in worker compensation shows that, although income growth was weak in nominal terms, as a result of declines in prices, in real terms, the rate of growth in income was relatively high. As Chart 5 indicates, from fiscal 2010 to fiscal 2012, before the Abe administration moved into office, the rate of increase in incomes was robust. However, in fiscal 2013, as expectations about the effects of Abenomics were rising, although the rate of increase in incomes rose in nominal terms, it weakened in real terms, reflecting increases in prices. Then, in the first half of fiscal 2014, as a result of the increase in the consumption tax rate, the pace of increase in prices rose, and real incomes began to decrease. The margin of decline was comparable to the decrease in fiscal 2009 when economic conditions worldwide deteriorated because of the effects of the Lehman Stock.

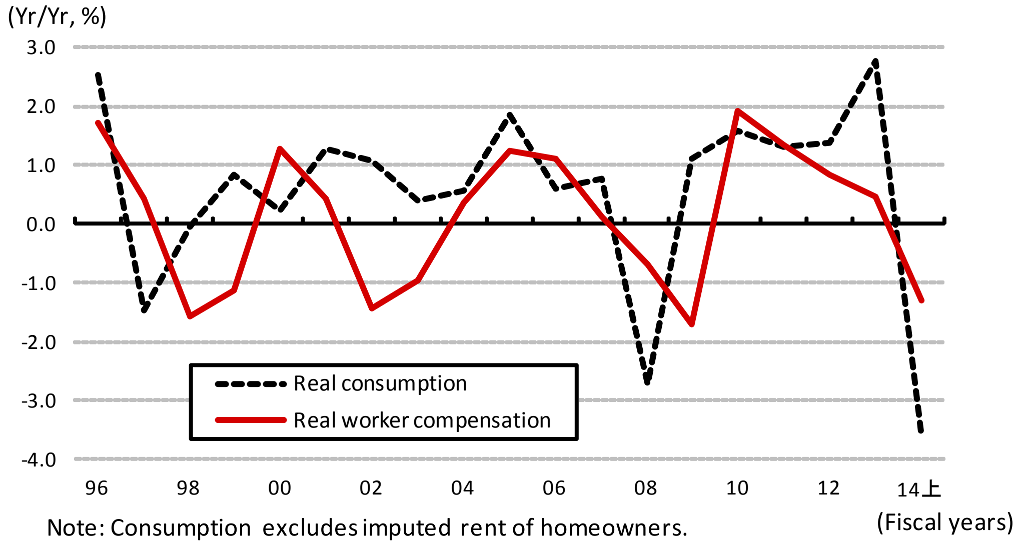
Chart 5: Trends in Worker Compensation



Source: Cabinet Office, *Quarterly Estimates of GDP*

Normally, when real incomes decline, household purchasing power decreases, and this restrains consumption. However, in fiscal 2013, consumer spending expanded steadily (Chart 6). This is believed likely to have been a result of expectations about Abenomics and the wealth effect caused by the rise in stock prices. Consumers anticipated future increases in incomes and drew down their savings or postponed further savings, and then continued to increase their spending.

Chart 6: Trends in Real Worker Compensation and Real Consumption

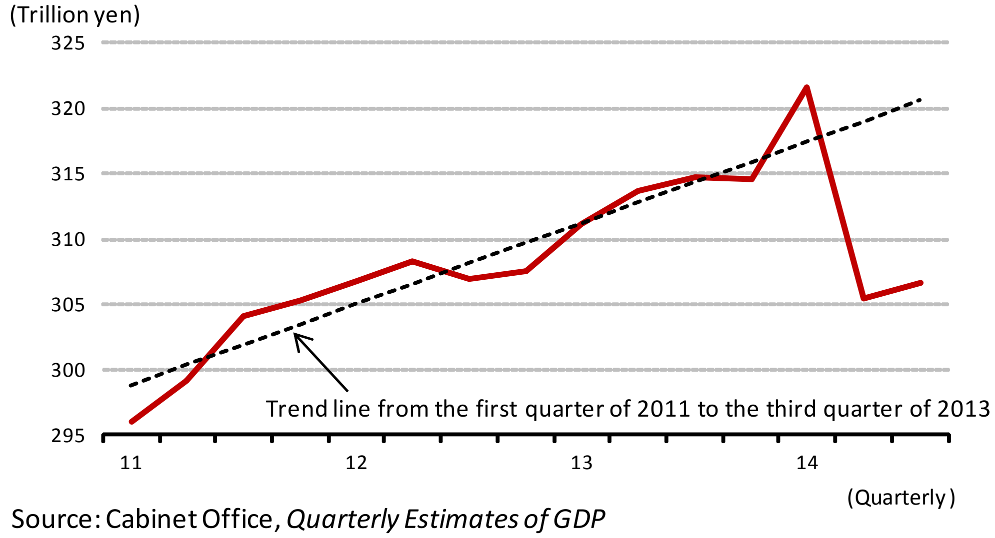


Note: Consumption excludes imputed rent of homeowners.
Source: Cabinet Office, *Quarterly Estimates of GDP*

Notwithstanding this, it appears that not all households placed full faith in Abenomics. For example, the improvement in consumer confidence levelled off beginning in summer 2013, and real consumer spending began to decline from the previous quarter in the October–December period of 2013. (The figure this time was revised downward from +0.4% to -0.0%.) We can also point out that the annualized rate of growth in GDP in real terms for the October–December quarter of 2013 was revised downward to –1.6%, suggesting the possibility that the economy had already begun to weaken. However, the development that erased these weak trends was the surge in demand that preceded the increase in the consumption tax rate. Among consumption categories, the increase in expenditures on consumer durables was especially rapid, thus giving a strong boost to the economy.

Recent data on real consumption show that the slump in the April–June quarter of 2014 was larger than the surge in the preceding January–March quarter (Chart 7). The reactionary decline should have been about the same amount as the surge in demand, suggesting that since the reactionary decline was larger, other factors may have been the cause of the sharp drop in consumer spending. If one of these factors was a reaction to the sense of anticipation that Abenomics created through the end of fiscal 2013, then this means that when the reaction to the surge in demand runs its course, consumption will not necessarily return to its previous pace of increase.

Chart 7: Trends in Real Personal Consumption



Source: Cabinet Office, *Quarterly Estimates of GDP*

As this analysis suggests, after the Abe administration took office, it was clear that the economy was on a recovery trend. It seems likely that, before the positive effects of Abenomics emerged, a major factor was the upwelling of anticipation about its positive effects, mainly in the household sector. To begin with, before we make judgments about the pros and cons of Abenomics, it appears we can say that the truth is that no implementable policies have been put forward.

(3) Outlook for Fiscal 2014 and Fiscal 2015: Recovery Will Only Be Gradual after the Economy Bottoms Out

We have prepared this outlook based on the assumption that the next consumption tax rate hike will be postponed 18 months from the originally scheduled date, until April 2017. In addition, we have assumed that a supplementary budget for fiscal 2014, with stimulatory measures of about 3 trillion yen, will be formulated and passed.

In fiscal 2014, although growth will become positive again during the latter half, because of the magnitude of the slump in the first half, real GDP growth for the full fiscal year will be -0.9%, the first full year of negative growth in five years, since 2009. In addition, private capital investment and exports will give a boost to the economy, but because of weak recovery power of the household sector, the pace of growth in the latter half will only be gradual. After the exclusion of a carryover effect of +1.1%, the rate of growth in fiscal 2013 is forecast to be a substantial decline of 2.0%.

Growth in private consumption will become positive again from the October–December quarter onward as the reactionary decline following the increase in the consumption tax rate runs its course and the impact of weather-related factors diminishes. Various factors will support recovery in consumption, including the outlook for increases in the winter bonuses, especially among large corporations. However, there is a strong possibility that the pace of improvement in the October–December quarter and onward will be gradual. Even though wages and bonuses will begin to increase again, this will be true mainly for large companies and not spread through the economy. For these reasons, the increase in incomes will not be sufficient to offset the negative effect of the increase in the consumption tax burden because real disposable income will decline substantially and have a negative effect on household spending behavior. The surge in demand for large household appliances, including flat-panel TVs, air conditioners, and refrigerators as well as automobiles, was quite large, thus satisfying a considerable portion of future demand for these items. The impact of this reactionary decline in demand is likely to be prolonged. As a result, through fiscal 2013, real consumption rose, thereby leading to a rise in the propensity to consume, but, in fiscal 2014, growth in real consumption is forecast to be -2.8%, the first negative growth in six years, since fiscal 2008.

Growth in real worker compensation in the first half slumped to -1.3% compared with the previous year because of the impact of the increase in the consumption tax rate. During the latter half of the fiscal year, despite an expected rise in employed workers and a slight weakening of the pace of price increases, negative growth is forecast to continue. For the full year, real worker compensation will be down 0.9% year on year, the first decline in five years, since 2009. (For the latter half, growth is forecast to be -0.6%.) Also, reflecting the increase in the number of workers and the rise in per capita wages, growth in nominal terms over the previous year is expected to be +1.2%, the fifth consecutive year of increases, but the rate of increase in prices will exceed this rate of growth.

Growth in corporate capital investment in real terms during the first half of the fiscal year was -1.4%, but a rising trend is expected in the latter half based on the improvement in orders for machinery and equipment and the ample supply of cash that corporations have on hand. Although companies will continue to refrain from making investments for the expansion of capacity in the latter half, they will make capital outlays to maintain competitiveness as well as investments in the maintenance and renewal of facilities and the enhancement of their IT systems. These investments are expected to provide underlying support for the economy. The outlook is for growth in real capital investment of 2.3% in the latter half of the fiscal year and growth of 1.8% for the full fiscal year compared with the previous year. Corporate performance in fiscal 2014 will be adversely affected by the temporary slump in sales following the increase in the consumption tax rate and increases in costs, including higher personnel costs. On the other hand, marginal profits will be boosted by the rise in export prices accompanying the depreciation of the yen and lower prices of crude oil and other raw materials. As a consequence, a marginal decrease in corporate profitability is forecast.

Public investment during the first half of fiscal 2014 rose 0.4% owing to the positive impact of the accelerated use of budgetary allocations as well as economic measures amounting to about 5.5 trillion yen in the supplementary budget for fiscal 2013. In the latter half of fiscal 2014, since these positive factors will run their course for the time being, there is a possibility that public investment may decline. Nevertheless, since there is a possibility that the implementation of budgetary allocations has not yet boosted public investment due to delays in construction and other factors, there is a possibility that the pace of decline will be moderate. Accordingly, public investment may begin to decline, and, for the fiscal year as a whole, the outlook is for a small decrease of 1.0%. Note that the government is considering an increase of about 2 trillion yen in its supplementary budget for fiscal 2014, but the effects of this will emerge in fiscal 2015.

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, electronic components and devices, and certain other products, which have been slow to recover, are now increasing gradually. Imports, after declining temporarily because of the slump in domestic demand that followed the hike in the consumption tax rate, are expected to continue to increase gradually. This will be because the increase in demand for LNG and other energy sources, which has boosted imports, will run its course, and the pace of growth 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 over the full fiscal year, the contribution of domestic demand is expected to be -1.3 percentage points, a sharp reversal from +2.7 percentage points in fiscal 2013 and the first negative contribution since fiscal 2009. In contrast, the contribution of external demand is expected to rise to +0.5 percentage point compared with -0.5 percentage point in fiscal 2013 and the first positive contribution since fiscal 2010. However, this increase will not be strong enough to fully offset the drop in household sector demand owing to the consumption tax increase.

Note that the growth rate of nominal GDP is expected to be +1.4%. However, this figure is inflated due to the hike in the consumption tax rate, and the GDP deflator will rise to +2.3%.

Taking account of these movements in the economy, although the index of industrial production will begin to rise again in the October–December quarter, since the level of inventories remains high, the pace of recovery is forecast to be gradual. In contrast to fiscal 2013, when industrial production rose 3.2%, in fiscal 2014, a decline of 1.4% is forecast, which will be the first negative figure since fiscal 2009. In addition, the employment situation will continue to improve, and some industries will experience a significant shortage of workers, but companies will maintain their basic stance of exercising caution in increasing personnel expenses. In part because the pace of improvement in corporate performance will slow, it is unlikely the rate of increase in wages will rise. Therefore, the outlook is for real wages to continue substantially below the previous year.

In fiscal 2014, the forecast is for the consumer price index (CPI) (excluding fresh food) to increase 3.0% over the previous fiscal year, but, after the exclusion of the effects of the consumption tax hike, the increase will be only 1.0%. Although the yen has recently depreciated further, the increase in import prices is expected to be offset by declines in the price of crude oil and international commodities, and the upstream pressure on prices is forecast to weaken by the end of fiscal 2014. Although the target date for reaching the BOJ’s inflation target will be approaching at that time, upward pressures on prices are expected to remain mild, and, in the latter half of the fiscal year, the inflation rate is likely to be below +1.0% over the previous year after excluding the effects of the consumption tax hike.

In fiscal 2015, the postponement of the increase in the consumption tax rate to 10% would be a reason for revising forecasts upward, but the surge in demand and reactionary decline during the fiscal year are expected to offset each other. Therefore, we have made only slight revisions in our forecasts.

Personal consumption will continue to rise but only at a moderate pace. The upward pressure on prices coming from the hike in the consumption tax rate will run its course and the trend toward improvement in wages will continue along with marginal increases in base wages during the 2015 spring wage offensive. Therefore, real worker compensation in fiscal 2015 is forecast to show a steady increase, rising to 1.2% year on year. However, the movement to make adjustments in consumption under low wage growth conditions is believed likely to persist throughout the fiscal year, and real consumption will most likely not rise by the same margin as the increase in incomes.

Corporate performance is forecast to begin to improve again. Along with recovery in domestic and overseas demand, the cheaper yen will increase the sales of exporting companies. At the same time, since international commodity prices are expected to remain stable, this will offset the disadvantages of yen depreciation, and improvement in Japan's terms of trade will continue. For this reason, corporate profit ratios will likely move toward improvement. As a result of these developments, further increases in corporate capital investment are forecast. Although new investments may be restrained to the lowest levels possible, along with the improvement in corporate performance, the scope of industries undertaking investments will broaden.

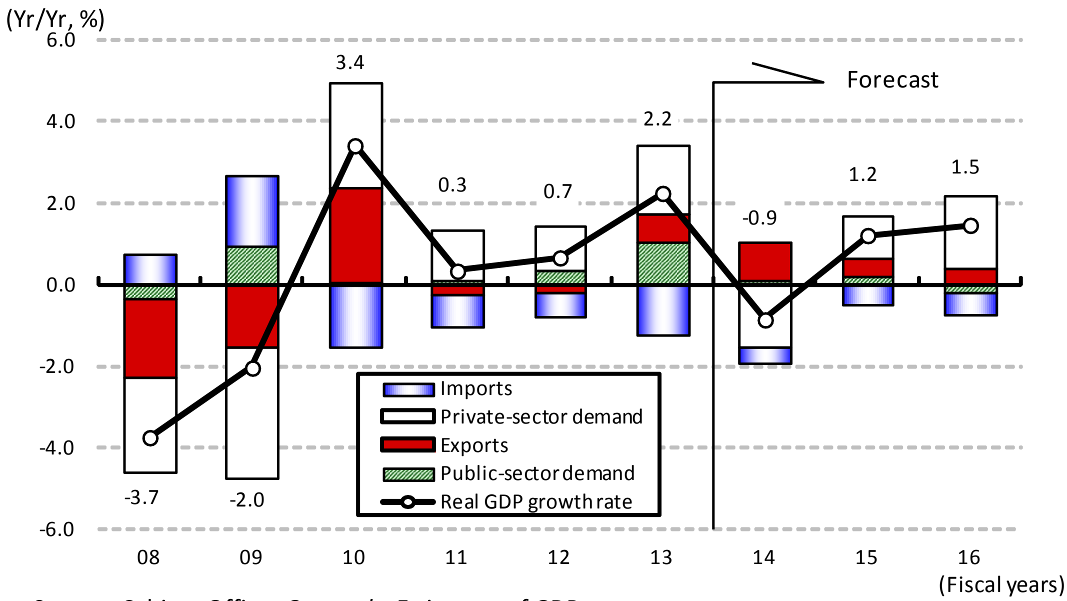
Exports will likely remain on an upward trend during fiscal 2015. Overseas economies will continue on a recovery trend, and the settling down of the yen at lower levels is expected to increase the competitiveness of Japanese companies. However, since it will be difficult to correct structural changes—such as the movement of Japanese factories to overseas locations—in a short period of time, the pace of increase in exports will be moderate. For this reason, even though growth in imports remains low, reflecting the gradual pace of improvement in the domestic economy, the contribution of the external sector will be virtually unchanged.

Public investment is expected to remain firm in the first half of fiscal 2015, because of the positive impact of economic policies adopted in fiscal 2014, but then fall below the previous year's levels for the full fiscal year as the positive effects of these policies run their course.

We are forecasting real GDP growth of +1.2% year on year in fiscal 2015. The economy is expected to remain on a moderate recovery path throughout the fiscal year. Although the economy will lack strength because of the absence of growth drivers, the effects of the consumption tax hike will run their course, and, after the exclusion of a carryover effect of +0.3%, the outlook is for real GDP growth to rise to +0.9%. Note that, while nominal GDP will continue at a relatively high rate of +1.8%, the rate of change in the deflator will drop to +0.6%.

We are forecasting that movements to increase the consumption tax rate in April 2017 will begin to emerge in the latter half of fiscal 2016. During the first half of fiscal 2017, moderate improvement in the economy will continue, but the outlook is for a more-robust recovery in the latter half.

Chart 8: Contributions to the GDP Growth Rate by Demand Component (Fiscal years)



Source: Cabinet Office, *Quarterly Estimates of GDP*

Chart 9: 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 %	1.5 %	2.2 %
FY2014 (forecast)	1.1 %	-2.0 %	-0.9 %
FY2015 (forecast)	0.3 %	0.9 %	1.2 %
FY2016 (forecast)	0.5 %	1.0 %	1.5 %

Source: Cabinet Office, "Quarterly Estimates of GDP"

2. Forecasts of Economic Activity by Sector

(1) Corporations

- Industrial production sustained an increasing trend 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 reactionary decrease in the wake of the consumption tax rate increase. The decline continued in the July–September quarter. As a result of the slump in demand, inventories have risen, and this will be a factor leading companies to restrain production. Against this backdrop, exports are increasing moderately, and domestic demand is gradually improving. The outlook is for a continuing upward trend in industrial production. 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 in fiscal 2013 improved substantially, especially in the manufacturing sector, owing to the depreciation of the yen and other factors, with corporate profitability rising by a large margin, as the surge in demand prior to the consumption tax rate hike joined with other positive factors. In fiscal 2014, profit margins are deteriorating because of slow growth in sales following the consumption tax rate increase and rising costs, and corporate income is forecast to decline marginally. From fiscal 2015 onward, the outlook is for a continuation of an upward trend in profit, mainly in manufacturing industries, as Japan’s terms of trade improve along with the decrease in the value of the yen and declines in crude oil prices.
- Going forward, as the full-scale trend toward 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. This trend will likely continue, even with progressive yen depreciation. Against a

background of improvement in corporate performance, there is a strong possibility that the increasing trend in capital investment centered on facility replacement investment will continue for the time being.

(2) Households

- Employment and wage conditions are continuing to improve even after the consumption tax rate increase. Regarding per capital earnings, the declining trend in scheduled contractual earnings has 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, although companies are quite concerned about rising fixed costs, and there is a possibility that they may not raise wages sufficiently, real incomes are expected to show gradual improvement as the rate of increase in prices remains moderate.
- Private consumption, which dropped substantially in the April–June 2014 quarter because of a reaction to the surge in demand prior to the consumption tax rate hike, showed improvement in the July–September quarter, but the margin of increase was small due to unseasonable weather conditions. Since real incomes have decreased significantly, the pace of improvement during fiscal 2014 will be moderate. In fiscal 2015 also, although real incomes are expected to begin to rise again, a sudden acceleration in the pace of improvement is not expected because it will take time for the increases in consumption to rise to the level of improvement in incomes.
- In fiscal 2014, new housing starts have trended downward owing to a reaction to the previous surge, but the outlook is for gradual improvement. For the time being, increases will be only moderate, with some weak movements, mainly in the markets for owner-built and rental housing. However, from fiscal 2015 onward, as the effects of weakness in the economy diminish and awareness rises of the next consumption tax rate hike, which is now likely to come

in April 2017, the level of housing starts is expected to rise gradually.

(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. As a result of the postponement of the increase in the consumption tax rate to 10%, which was scheduled for October 2015, there is a possibility that it will be difficult to attain the objective of putting government finances on a sounder footing (with a goal of restraining the primary fiscal balance for national and local government to within 3.3% of GDP).
- 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 yen, with objectives that included preventing and minimizing the effects of disasters, and increased expenditures

related to public works investment substantially. As a result of the implementation of measures in the supplementary budget, public investment in fiscal 2013 showed a marked rise. Moreover, the government has begun the full-scale implementation of economic measures amounting to about 5.5 trillion yen under a supplementary budget for fiscal 2013 with the objective of dealing with the risks of a downturn and other contingencies that may accompany the increase in the consumption tax rate. The outlook is for the implementation of economic policies through a supplementary budget in fiscal 2014, and the positive effects will emerge in fiscal 2015.

- As these comments suggest, the outlook is for the implementation of government economic measures for the third consecutive year, and government expenditure (on a GDP basis) is likely to continue rising as the economy moves into fiscal 2015. In fiscal 2016, government expenditures will shift to a decreasing trend, as the boosting effect of economic countermeasures progressively diminishes and causes a large drop in public works investment.

(4) Trends in Overseas Economies

- The world economy is sustaining moderate growth. In the United States, gradual economic expansion is continuing, and the Federal Reserve Board (FRB) finally finished its quantitative monetary easing policy (QE3). In Europe, the economies are marking time, and there are concerns about possible deflationary risk. The European Central Bank (ECB) has stepped up its monetary easing policy. Among the emerging countries, China again is showing moderate economic deceleration, but, in some countries, including India, there are signs of improvement.
- Going forward, the outlook is for moderate growth in the world economy. The U.S. economy is expected to continue a moderate expansion, driven mainly by the private sector demand. In Europe, conditions going forward are forecast to show improvement, albeit at a slow pace. 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 7%.

- 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, although the pace of the increase is likely to be gradual. 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) has moved into a deficit position, because of a marked rise in imports, and the size of the deficit reached a record high level in fiscal 2013. Looking forward, the trade deficit is expected to show a decreasing trend near fiscal 2015, along with the cheaper yen and declines in oil prices. The surplus in the primary income balance will continue to rise, and, for this reason, the surplus in the current account balance will rise near fiscal 2015.

3. Forecasts for Prices and Financial Markets

- The price of crude oil may experience increases along with rising geopolitical risks and concern about a slowing in the world economy. However, crude oil supply and demand are almost in balance, and prices are basically stable. Despite this, the likelihood of slight decreases in oil prices has risen because of such factors as the growing awareness that oil-producing countries are competing with one another as the supply of shale oil from the United States rises.
- The rate of increase in the domestic price level in fiscal 2014 has risen sharply because of the consumption tax rate hike. However, international commodity prices have fallen and the depreciation of the yen has run its course, thus bringing slower price increases in recent months. The depreciation of the yen may continue, but the impact of the decline in international commodity prices is expected to have a larger effect. As a result, the rates of increase in prices may diminish going forward. The impact of the consumption tax rate hike will diminish in fiscal 2015 and thereafter, and, since the domestic economy is not overheating and with stability in energy prices, the rates of increase in prices are expected to be moderate.
- 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. Moreover, in October 2014, further monetary easing measures were implemented. In the event that it becomes difficult to attain the BOJ’s inflation target, there is a possibility that the BOJ may implement further monetary easing policies; however, it may be obliged at some point by pushing the timing for reaching the inflation target further into the future.
- 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 because of negative factors, including 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 10: 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	1.4	1.8	1.8
Real GDP	3.4	0.3	0.7	2.2	-0.9	1.2	1.5
Contribution of domestic demand	2.6	1.4	1.4	2.7	-1.4	1.3	1.3
Private consumption	1.6	1.4	1.5	2.5	-2.8	1.1	1.8
Housing investment	2.2	3.2	5.4	9.5	-11.7	1.1	9.2
Private capital investment	3.8	4.8	0.7	2.6	1.8	3.6	2.9
Contribution of inventory investment	1.0	-0.3	-0.1	-0.4	0.3	-0.2	0.0
Government expenditure	0.3	0.5	1.4	4.2	0.5	0.8	-0.7
Public investment	-6.4	-3.2	1.3	15.0	1.4	-0.6	-7.9
Government final consumption expenditure	2.0	1.2	1.5	1.8	0.4	1.2	1.1
Contribution of external demand	0.8	-1.0	-0.8	-0.5	0.5	0.0	0.0
Export of goods and services	17.2	-1.6	-1.3	4.8	5.5	2.4	2.3
Import of goods and services	12.0	5.3	3.6	7.0	2.2	2.3	2.6
GDP deflator	-2.0	-1.7	-0.9	-0.4	2.3	0.6	0.6

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	3.6	5.8	5.6
balance on goods (trillion yen)	8.0	-2.2	-5.2	-11.0	-8.8	-7.4	-7.7
balance on service (trillion yen)	-2.8	-3.1	-4.2	-3.5	-3.3	-3.2	-3.1
balance on income (trillion yen)	13.9	14.3	14.6	16.7	17.7	18.3	18.4
Industrial production	15.4	-0.6	-3.0	3.2	-1.3	1.8	2.8
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	86.5	87.1	94.0
Domestic corporate goods prices	0.4	1.4	-1.1	1.9	3.3	-0.8	0.1
Consumer prices	-0.4	-0.1	-0.3	0.9	3.1	0.4	0.5
excluding freshfood	-0.8	0.0	-0.2	0.8	3.0	0.4	0.5
Yen/U.S.Dollar	85.7	79.1	83.1	100.2	108.1	115.9	117.0
Uncollateralized call rates (O/N) (%)*	0.091	0.077	0.082	0.073	0.063	0.055	0.050
Newly issued government bond yields (10years) (%)	1.15	1.05	0.78	0.69	0.54	0.59	0.68
WTI future price (near month contract, US dollar/barrel)	83.4	97.3	92.1	99.0	89.5	76.7	75.5
Dubai crude oil prices (US dollar/barrel)	84.2	110.1	107.1	104.5	92.8	79.7	78.5

* actual=average, forecast=end of period

Chart 11: 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	1.9	1.7	1.7
Real GDP	4.7	-0.5	1.5	1.5	0.3	0.4	1.4
Contribution of domestic demand	2.9	0.4	2.3	1.8	0.3	0.2	0.2
Private consumption	2.8	0.3	2.0	2.0	-0.9	-0.1	1.4
Housing investment	-4.5	5.1	2.9	8.8	-5.2	-3.9	7.7
Private capital investment	0.3	4.1	3.7	-1.5	5.7	2.1	2.7
Contribution of inventory investment	1.0	-0.4	0.1	-0.3	0.0	0.0	0.0
Government expenditure	1.6	-0.5	1.9	3.6	1.2	0.6	-0.2
Public investment	0.7	-8.2	2.9	11.3	4.8	-1.0	-5.4
Government final consumption expenditure	1.9	1.2	1.7	2.0	0.3	1.1	1.1
Contribution of external demand	1.7	-0.9	-0.9	-0.3	-0.1	0.2	0.0
Export of goods and services	24.4	-0.4	-0.2	1.6	7.4	2.2	2.3
Import of goods and services	11.1	5.9	5.3	3.4	6.8	0.9	2.2
GDP deflator	-2.2	-1.9	-0.9	-0.6	1.6	1.3	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	1.1	5.7	5.8
balance on goods (trillion yen)	9.5	-0.3	-4.3	-8.8	-10.7	-7.3	-7.5
balance on service (trillion yen)	-3.0	-3.0	-4.0	-3.5	-3.4	-3.3	-3.1
balance on income (trillion yen)	13.6	14.6	14.1	16.5	17.2	18.2	18.3
Industrial production	15.6	-2.8	0.6	-0.8	1.8	0.2	2.3
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	88.4	86.5	93.6
Domestic corporate goods prices	-0.1	1.5	-0.9	1.3	3.2	-0.1	0.0
Consumer prices	-0.7	-0.3	0.0	0.4	2.8	1.0	0.5
excluding freshfood	-1.0	-0.2	-0.1	0.4	2.6	0.9	0.5
Yen/U.S.Dollar	87.8	79.8	79.8	97.6	105.2	115.3	116.9
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	0.56	0.58	0.65
WTI future price (near month contract, US dollar/barrel)	79.5	95.1	94.2	98.0	94.7	77.0	75.8
Dubai crude oil prices (US dollar/barrel)	78.0	106.2	109.1	105.5	98.8	80.0	78.8

* actual=average, forecast=end of period

Chart 12: 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	0.4	0.1	1.5	-0.1	-0.8	1.5	0.4	0.6	-0.2	1.1	0.1
	0.6	1.9	2.0	2.9	1.9	0.8	2.1	1.0	1.6	2.4	1.8	1.6
Real GDP	0.8	0.6	-0.4	1.6	-1.9	-0.4	0.4	0.3	0.4	0.4	0.2	0.4
	1.2	2.3	2.5	2.9	-0.2	-1.2	-0.3	-1.7	0.5	1.5	1.4	1.4
Contribution of domestic demand (Qr/Qr,%)	0.7	1.0	0.2	1.8	-2.9	-0.5	0.5	0.3	-2.9	-0.5	0.5	0.3
Private consumption	0.8	0.3	0.0	2.2	-5.0	0.4	0.6	0.2	0.2	0.2	0.3	0.3
	1.8	2.4	2.4	3.5	-2.6	-2.7	-2.0	-3.9	1.4	1.3	0.9	1.0
Housing investment	2.4	4.3	2.2	2.3	-10.0	-6.7	-2.3	3.2	3.6	-3.0	-1.1	3.6
	6.8	8.5	10.4	12.0	-2.0	-12.3	-15.9	-15.2	-2.6	1.2	2.6	3.0
Private capital investment	1.8	0.7	0.8	7.5	-4.8	-0.2	1.8	1.2	0.8	0.7	0.6	0.7
	-2.7	-0.9	1.1	11.4	3.8	2.8	3.9	-2.0	3.6	4.5	3.4	3.0
Contribution of inventory investment (Qr/Qr,%)	-0.5	0.3	-0.1	-0.5	1.2	-0.6	-0.1	0.0	0.0	0.1	0.0	-0.1
Government expenditure	1.8	1.1	0.5	-0.6	0.1	0.7	0.0	-0.3	0.2	0.6	0.2	0.0
	3.3	4.9	5.5	3.0	0.6	0.8	0.2	0.3	0.8	0.6	0.7	1.0
Public investment	6.1	5.7	1.7	-2.0	0.3	2.2	-0.6	-2.5	-0.1	1.9	-0.1	-1.3
	8.1	18.8	20.7	11.3	5.2	2.9	0.1	-1.0	-1.3	-1.0	-0.7	0.3
Government final consumption expenditure	0.6	0.1	0.2	-0.2	0.0	0.3	0.2	0.3	0.3	0.3	0.2	0.3
	2.5	2.2	1.8	0.7	0.0	0.3	0.3	0.9	1.2	1.2	1.2	1.1
Contribution of external demand (Qr/Qr,%)	0.1	-0.4	-0.6	-0.2	1.0	0.1	-0.1	-0.1	1.0	0.1	-0.1	-0.1
Export of goods and services	3.1	-0.6	0.2	6.4	-0.5	1.3	0.3	0.4	0.5	0.8	0.7	0.6
	-0.1	3.2	6.9	9.4	5.4	7.4	7.6	1.6	2.6	2.0	2.5	2.6
Import of goods and services	2.4	1.8	3.7	6.2	-5.4	0.8	0.5	0.7	0.6	0.5	0.5	0.4
	0.8	3.2	9.2	14.9	6.0	5.0	1.9	-3.4	3.4	2.1	1.8	2.1
GDP deflator (Yr/Yr,%)	-0.6	-0.4	-0.4	-0.1	2.0	2.1	2.4	2.7	2.0	2.1	2.4	2.7

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	0.7	0.6	1.2	1.2	1.4	1.5	1.7	1.7
balance on goods (trillion yen)*	-1.7	-2.3	-2.8	-3.9	-2.2	-2.5	-2.0	-2.0	-1.9	-1.9	-1.7	-1.7
balance on service (trillion yen)*	-0.7	-0.9	-1.0	-1.0	-0.7	-0.9	-0.9	-0.8	-0.8	-0.8	-0.8	-0.8
balance on income (trillion yen)*	4.5	4.0	4.1	4.0	4.1	4.6	4.4	4.5	4.6	4.6	4.6	4.6
Industrial production (Qr/Qr、%)	1.6	1.8	1.8	2.9	-3.8	-1.9	0.6	0.6	0.6	0.7	0.6	0.5
(Yr/Yr、%)	-3.0	2.3	5.8	8.2	2.7	-1.0	-2.4	-4.5	-0.1	2.6	2.6	2.4
Unemployment rate (%)*	4.0	4.0	3.9	3.6	3.6	3.6	3.5	3.5	3.5	3.5	3.5	3.5
New housing starts(annualized, ten thousand units)	98.0	99.0	104.1	93.4	88.7	85.5	85.9	86.0	86.0	86.6	87.5	88.6
Domestic corporate goods prices (Yr/Yr,%)	0.7	2.2	2.5	2.0	4.3	4.0	2.7	2.1	-1.1	-1.0	-0.5	-0.3
Consumer prices (Yr/Yr,%)	-0.2	0.9	1.4	1.5	3.5	3.3	3.0	2.7	0.5	0.4	0.4	0.4
excluding freshfood (Yr/Yr,%)	0.0	0.7	1.1	1.3	3.4	3.2	2.8	2.6	0.4	0.3	0.4	0.4
Yen/U.S.Dollar	98.7	98.9	100.4	102.8	102.1	103.9	112.0	114.4	115.0	115.6	116.2	116.6
Uncollateralized call rates (O/N) (%)**	0.073	0.073	0.072	0.074	0.067	0.067	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	0.53	0.50	0.55	0.55	0.60	0.60	0.60
WTI future price (near month contract, US dollar/barrel)	94.2	105.8	97.5	98.7	103.0	97.2	80.1	77.6	77.1	76.8	76.5	76.2
Dubai crude oil prices (US dollar/barrel)	100.8	106.2	106.8	104.4	106.2	101.5	83.0	80.6	80.1	79.8	79.5	79.2

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