

# Can Japan Change? Opportunities and Challenges Ahead

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**7 Nov 2013  
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# I. Japanese Economy 1. DIR economic outlook for Japan (Sep 2013)

		2012					2013					2014				
		Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	FY 2012	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	FY 2013	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	FY 2014
Real GDP	Q/q %; annualized	-1.2	-3.5	1.1	4.1		3.8	3.2	4.2	5.4		-6.4	3.3	2.6	2.6	
	Y/y	3.8	0.3	0.4	0.3	1.2	1.2	3.0	3.8	4.0	3.0	1.5	1.5	1.1	0.5	1.2
Private spending	Q/q %; annualized	0.3	-1.5	2.0	3.4	1.6	3.0	1.2	2.2	5.9	2.4	-11.3	2.8	1.2	1.3	-0.8
Private housing investment	Q/q %; annualized	8.8	6.7	15.1	7.7	5.3	-1.0	12.6	18.3	1.6	8.1	-20.9	-5.1	6.6	4.9	-2.7
Capex	Q/q %; annualized	-2.8	-12.2	-4.8	-0.1	-1.4	5.1	5.1	7.4	8.7	2.5	0.8	7.8	7.0	7.1	5.8
Government spending	Q/q %; annualized	0.3	1.6	2.5	0.2	2.1	3.0	1.6	1.6	1.2	1.8	1.2	0.8	0.8	0.8	1.1
Public investment	Q/q %; annualized	20.8	14.4	13.5	5.8	15.0	12.7	11.9	11.3	4.7	11.0	-6.9	-7.1	-7.3	-7.6	-2.5
Exports	Q/q %; annualized	-0.7	-16.8	-10.2	16.8	-1.2	12.4	9.7	7.8	8.2	6.8	8.8	9.1	9.5	11.7	8.9
Imports	Q/q %; annualized	5.4	0.0	-7.8	4.1	3.8	6.2	4.1	5.7	8.2	3.3	3.4	3.4	3.6	6.1	4.8
Nominal GDP	Q/q %; annualized	-3.4	-3.5	0.5	2.6	0.3	3.7	2.9	4.6	6.1	2.7	-3.0	4.2	3.6	4.1	2.6
GDP deflator	Y/y	-1.0	-0.8	-0.7	-1.1	-0.9	-0.5	-0.5	-0.3	0.2	-0.3	1.1	1.3	1.5	1.7	1.4
Industrial production	Q/q	-2.1	-3.3	-1.8	0.6	-3.0	1.5	1.8	2.1	2.8	3.3	-0.6	1.8	2.0	2.5	6.1
Core CPI	Y/y	0.0	-0.2	-0.1	-0.3	-0.2	0.0	0.6	0.7	0.9	0.6	2.9	2.8	2.9	3.1	2.9
Unemployment rate	%	4.4	4.3	4.2	4.2	4.3	4.0	4.0	4.0	3.9	4.0	3.9	3.9	3.8	3.8	3.9
Trade balance (goods, services)	Y tril; annualized	-4.4	-6.6	-6.4	-10.1	-6.9	-7.0	-6.9	-7.1	-7.4	-7.1	-6.4	-5.1	-3.7	-2.2	-4.3
Current account balance	Y tril; annualized	6.1	3.9	4.3	3.1	4.4	8.5	8.6	9.2	9.5	8.9	11.1	13.1	15.3	17.7	14.3
Call rate (end-period)	%	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Major assumptions																
US real GDP	Q/q %; annualized	1.2	2.8	0.1	1.1	2.3	1.7	2.5	2.8	2.6	1.8	2.8	2.8	3.1	3.2	2.8
Crude oil price (WTI futures)	\$/bbl	93.4	92.2	88.2	94.4	92.0	94.2	100.0	100.0	100.0	98.5	100.0	100.0	100.0	100.0	100.0
Exchange rate	Yen/\$	80.1	78.6	81.2	92.3	83.1	98.8	100.0	100.0	100.0	99.7	100.0	100.0	100.0	100.0	100.0

Source: Compiled by DIR.

Note: GDP through Apr-Jun 2013 actual; thereafter DIR estimates.

## 2. IMF economic outlook for Japan

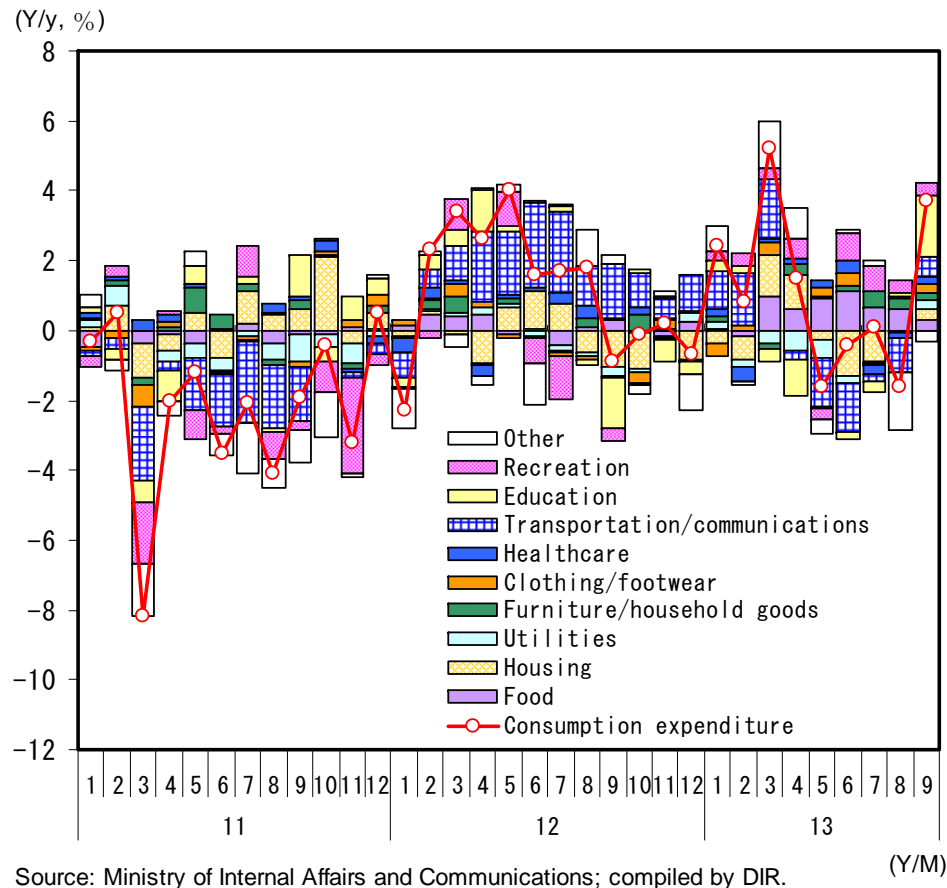
	2013CY		2014CY		2015CY		2016CY	
Forecast Timing	Apr 2013	Oct 2013	Apr 2013	Oct 2013	Apr 2013	Oct 2013	Apr 2013	Oct 2013
Real GDP (Y/y, %)	1.6	2.0	1.4	1.2	1.1	1.1	1.2	1.2
Nominal GDP (Y/y, %)	0.9	1.6	3.3	3.4	2.4	2.4	2.4	2.2
GDP deflator (%)	▲ 0.7	▲ 0.3	1.8	2.2	1.4	1.2	1.2	1.0
Exchange rate (Yen/\$)	93.3	96.5	93.8	95.6	93.7	95.2	93.6	93.7
CPI (Average, %)	0.1	0.0	3.0	2.9	2.3	1.9	2.0	1.9
CPI (End of period, %)	0.7	0.7	3.6	3.5	2.7	2.0	1.0	1.3

Source: IMF; compiled by DIR.

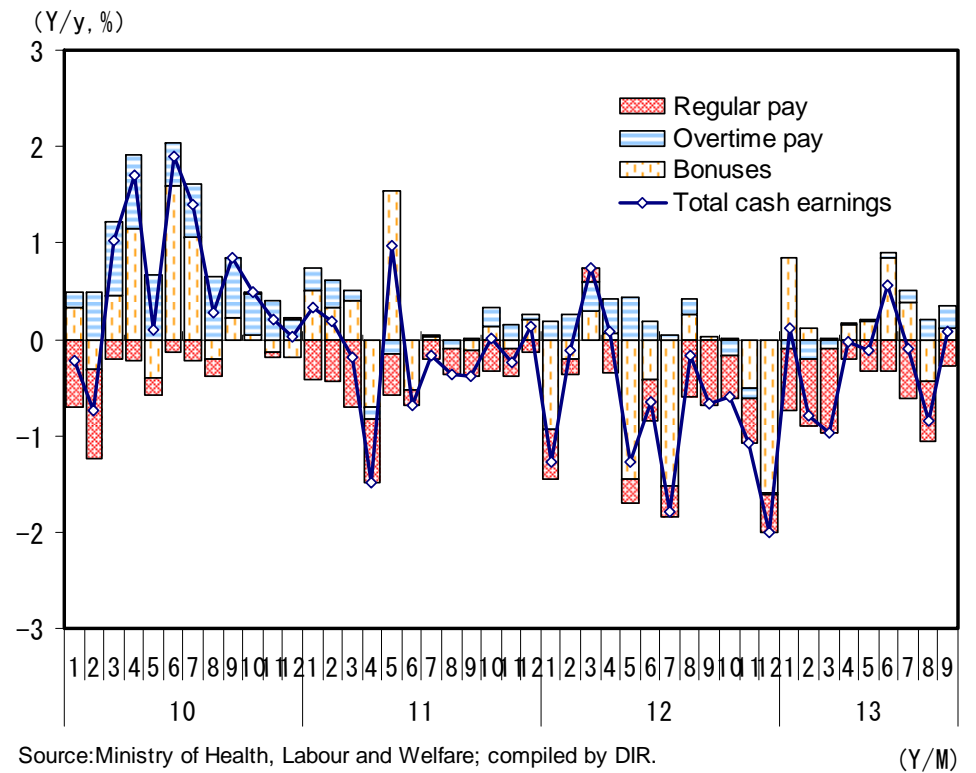
Note: Projection of Real GDP (Y/y %) was 2.0% in 2013, 1.2% in 2014 by IMF World Economic Outlook update in Jul 2013.

### 3. Current Economic Situation ①

Breakdown of Real Household Consumption Expenditure

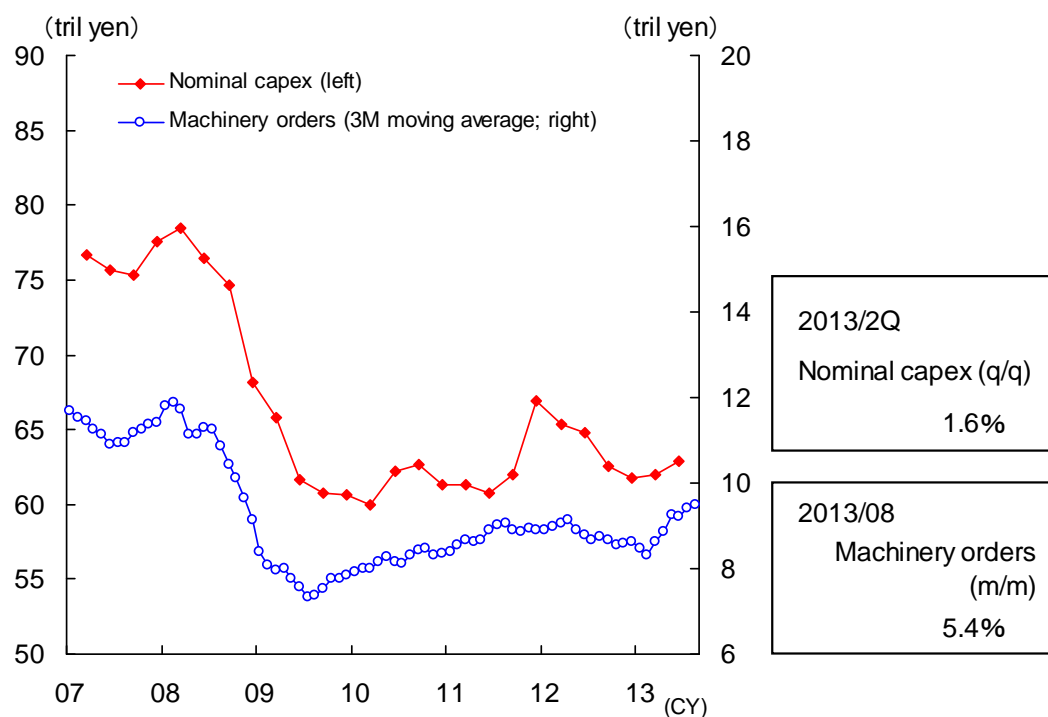


Breakdown of Employee Compensation



### 3. Current Economic Situation ②

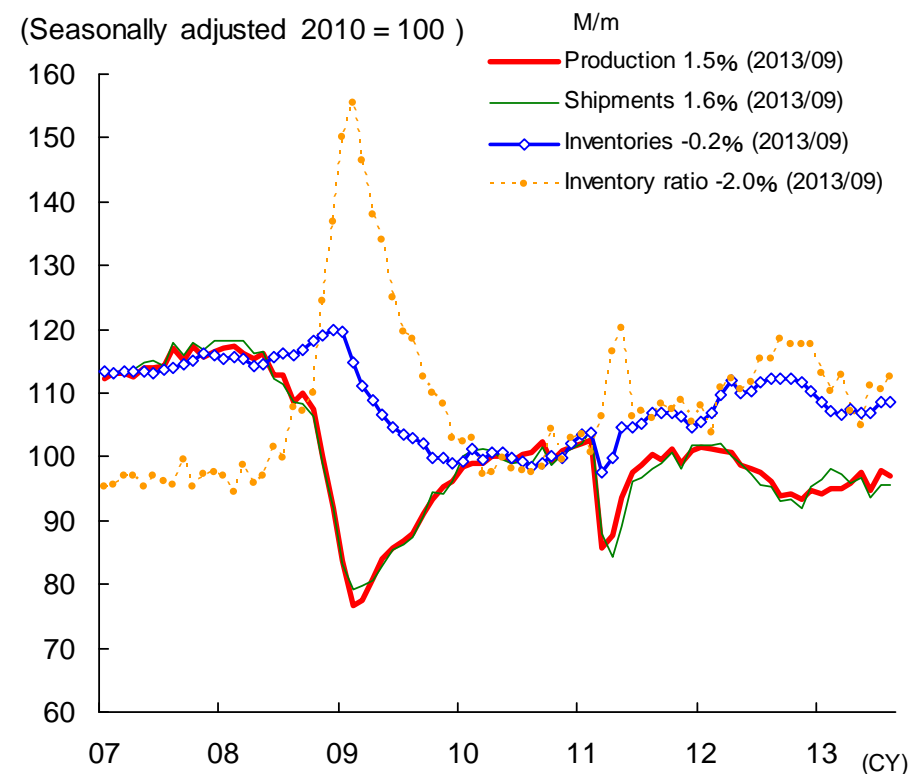
#### Machinery Orders and Nominal Capex



Source: Cabinet Office; compiled by DIR.

Note: Machinery orders seasonally adjusted, annualized. Private-sector orders excl. those for shipbuilding and from electric power companies.

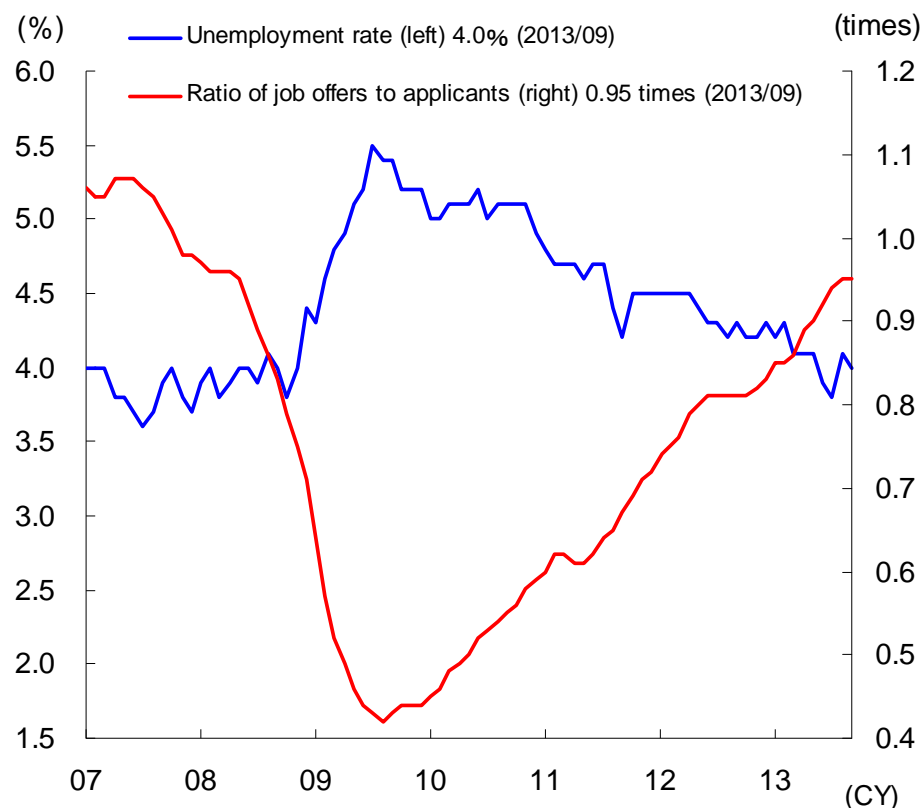
#### Industrial Production



Source: Ministry of Economy, Trade and Industry; compiled by DIR.

### 3. Current Economic Situation ③

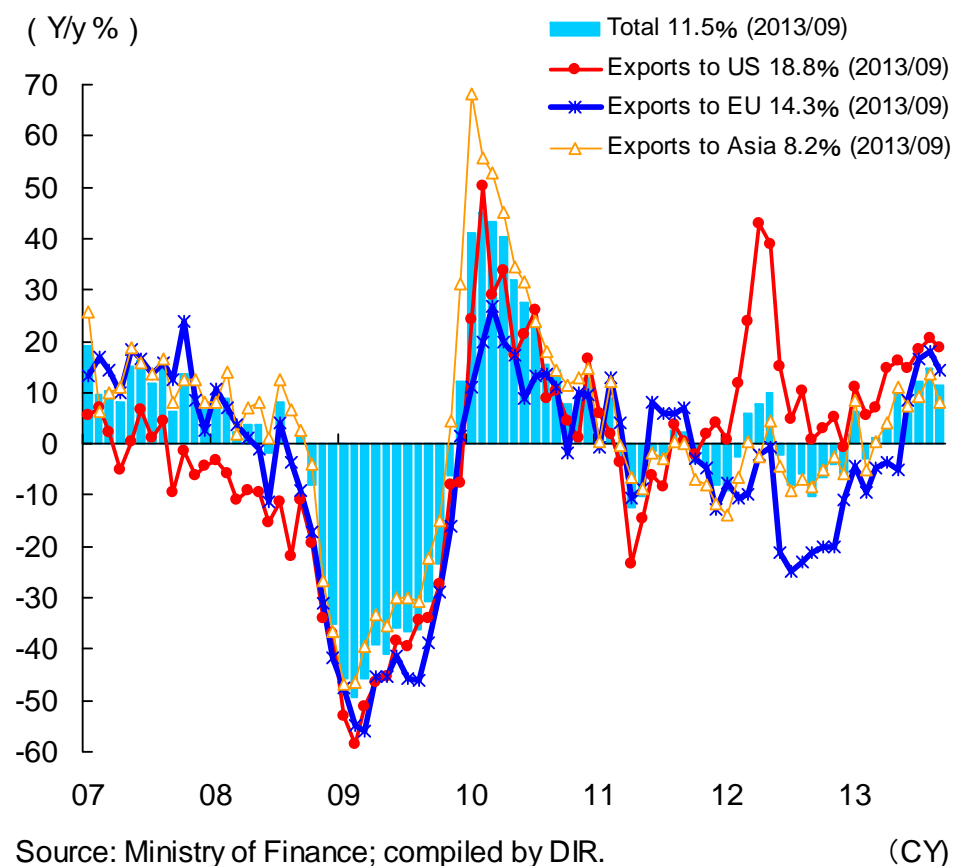
#### Unemployment, Ratio of Job Offers to Applicants



Source: Ministry of Internal Affairs and Communications, Ministry of Health, Labour and Welfare; compiled by DIR.

Note: Unemployment rate during Mar-Aug 2011 does not cover three devastated quake-hit prefectures.

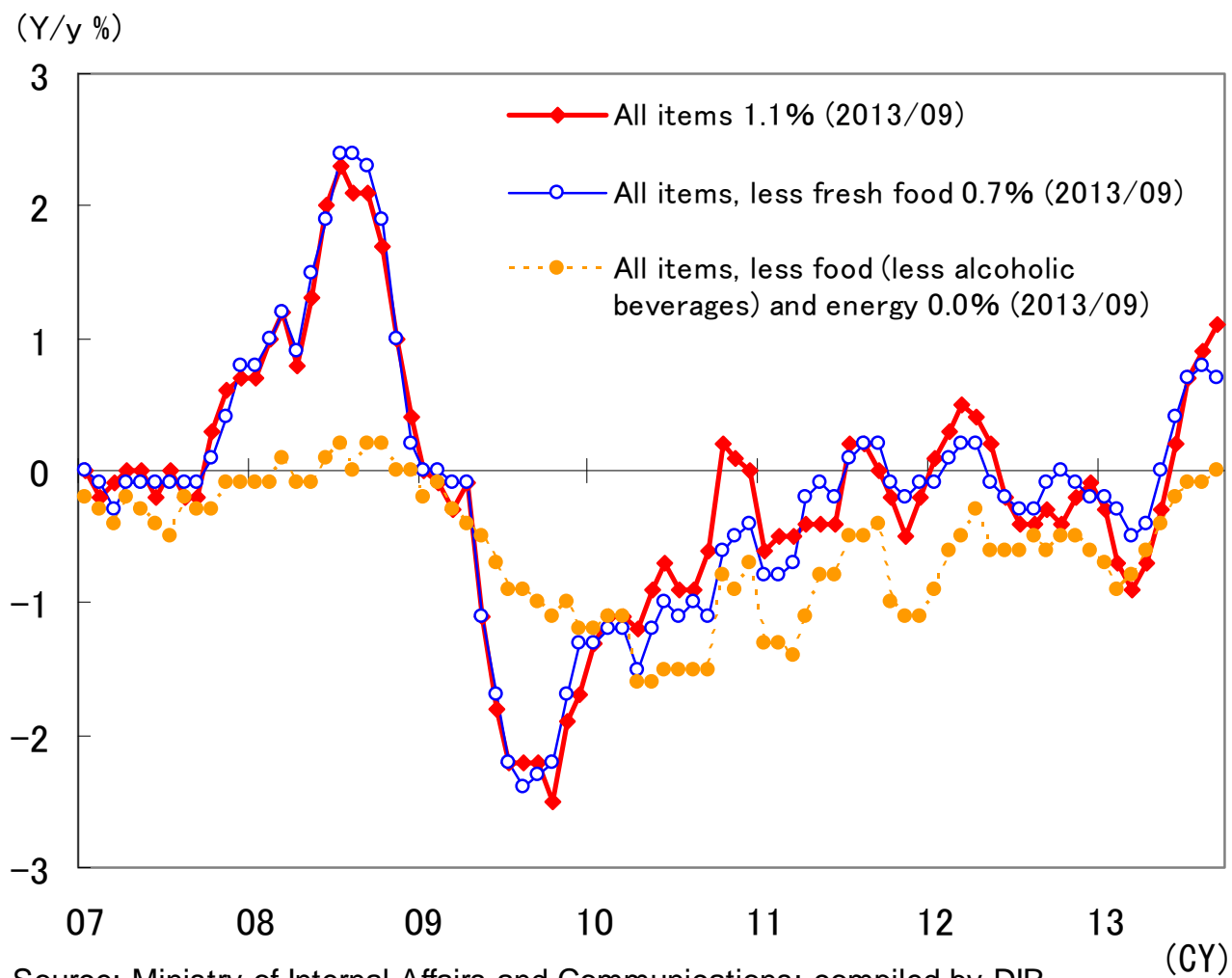
#### Exports by Trading Partner (value)



Source: Ministry of Finance; compiled by DIR.

### 3. Current Economic Situation ④

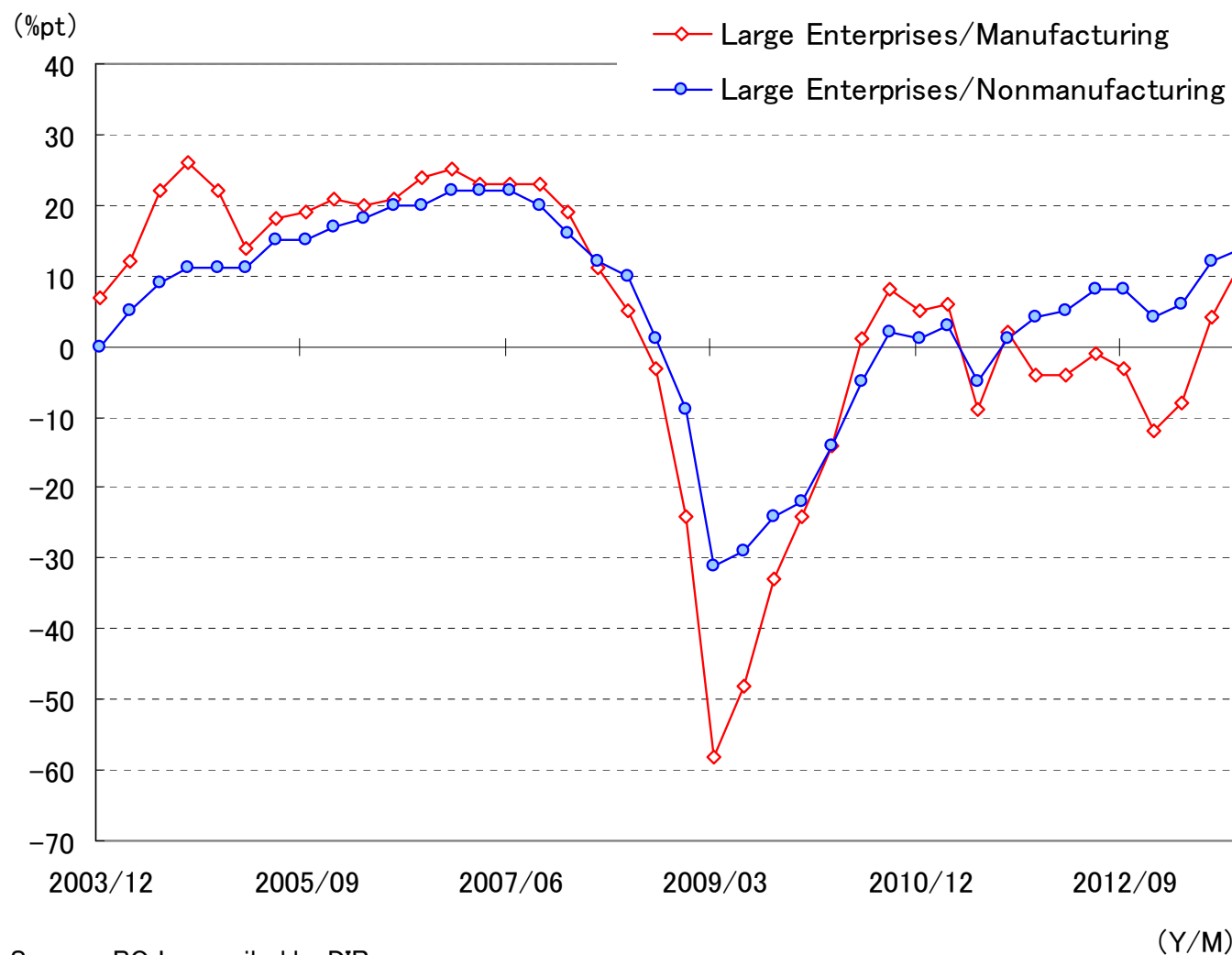
#### Consumer Price Index





### 3. Current Economic Situation ⑤

#### BOJ TANKAN Business Conditions: DI

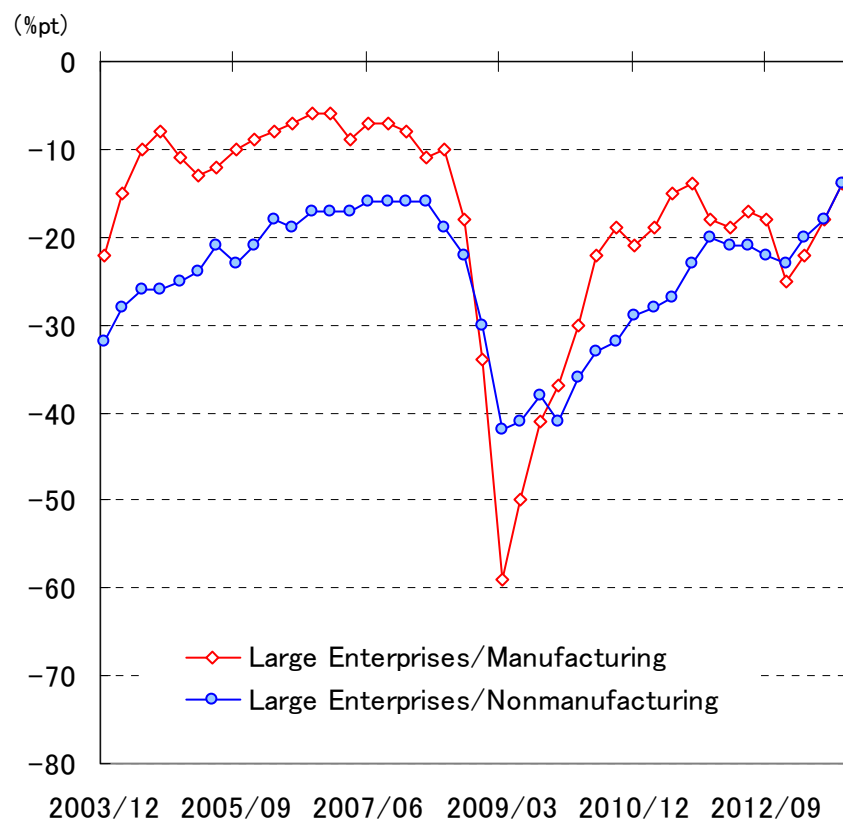


Source: BOJ; compiled by DIR.

Note: Diffusion index of "Favorable" minus "Unfavorable".

### 3. Current Economic Situation ⑥

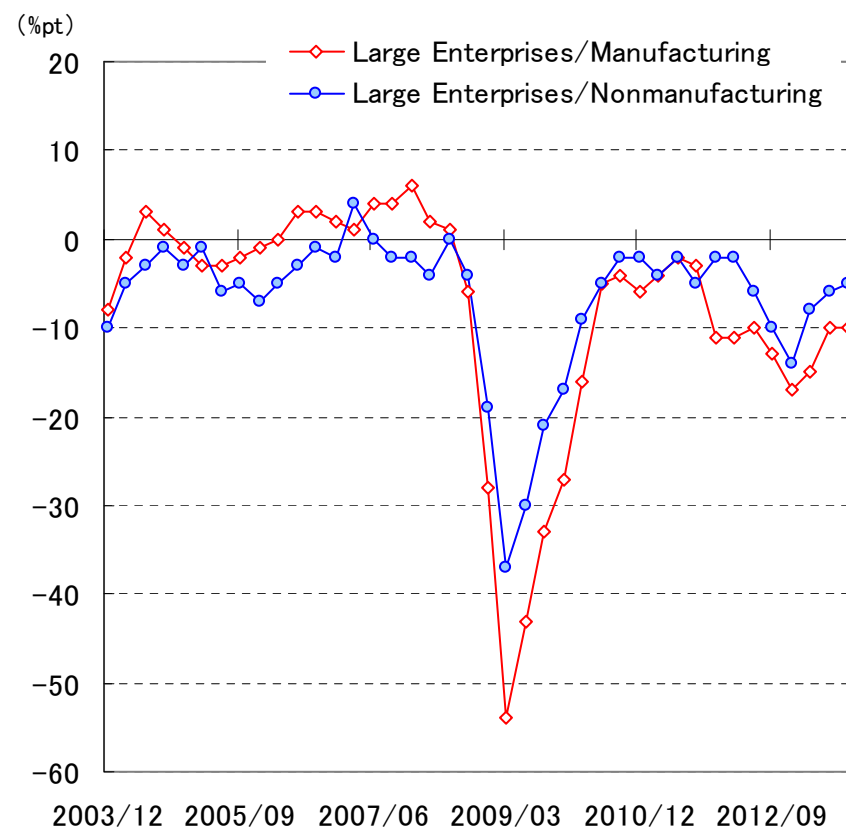
#### Domestic Supply & Demand Conditions for Products and Services: DI



Source:BOJ; compiled by DIR.

Note: Diffusion index of "Excess demand" minus "Excess supply".

#### Overseas Supply & Demand Conditions for Products: DI

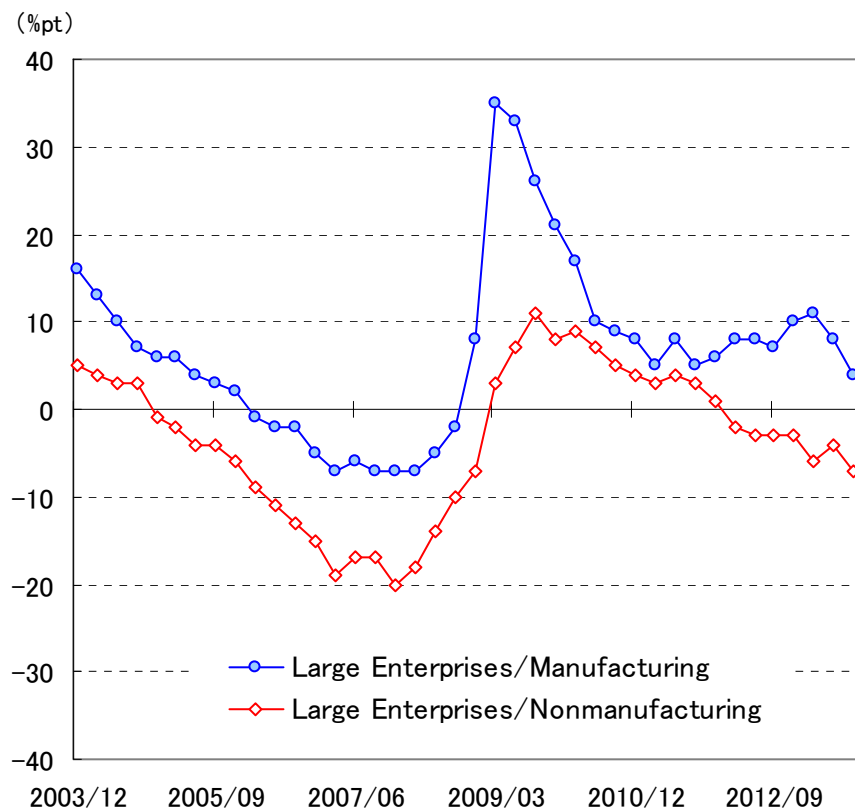


Source:BOJ; compiled by DIR.

Note: Diffusion index of "Excess demand" minus "Excess supply".

### 3. Current Economic Situation ⑦

#### Employment Conditions: DI

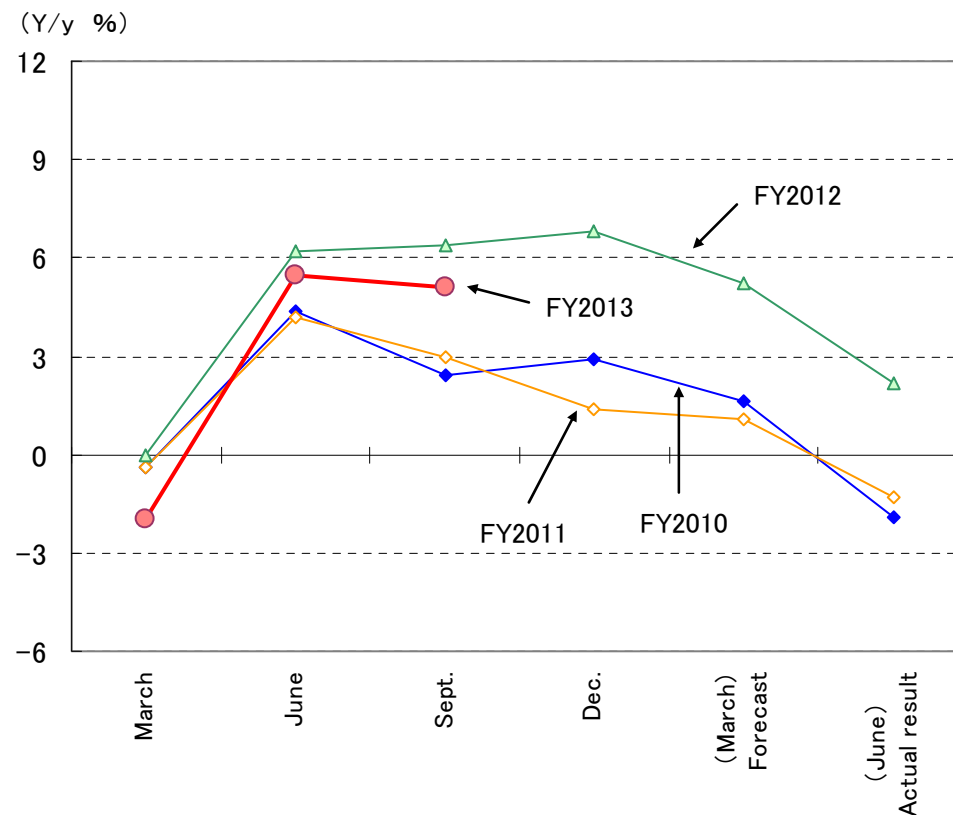


Source:BOJ; compiled by DIR.

Note: Diffusion index of "Excessive employment" minus "Insufficient employment".

(Y/M)

#### Fixed Investment Including Land Purchases

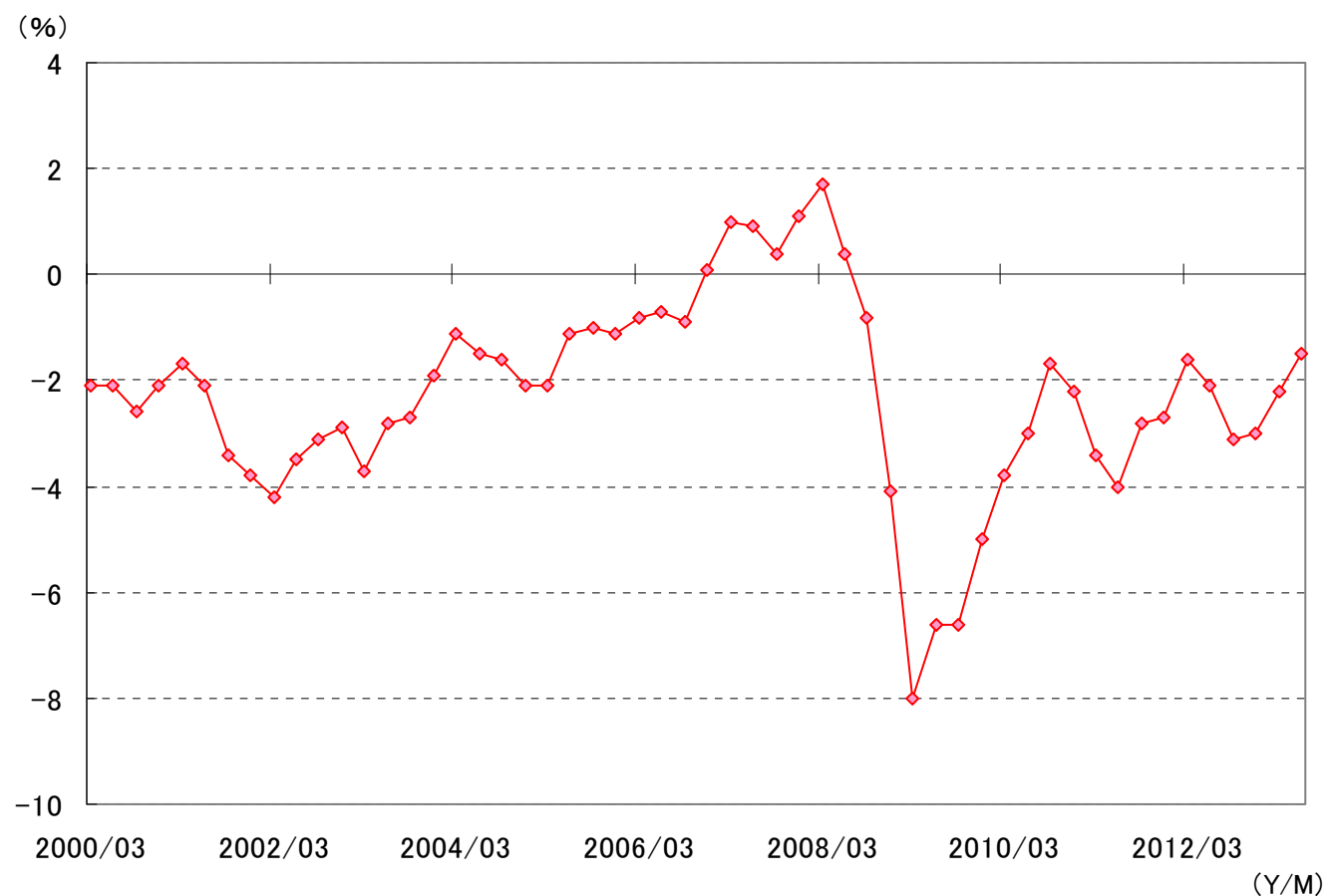


Note: The graphs indicate the revision pattern of fixed investment. The horizontal axis represents the point of time when the survey is conducted for each fiscal year. Namely, the first survey for each year (March survey) is on the left, and the last survey (June survey of the following year; actual result) is on the right. The vertical axis represents the year-to-year percent change. Excludes software investment.

Source:BOJ; compiled by DIR.

### 3. Current Economic Situation ⑧

#### GDP Gap



Source: Cabinet Office; compiled by DIR.

Note: GDP gap = (Actual GDP - Potential GDP) / Potential GDP.

## II. Monetary Policy 1. Quantitative and Qualitative Monetary Easing ①

### ○Quantitative and Qualitative Monetary Easing (4 Apr 2013 Monetary Policy Meeting)

BOJ to achieve price stability target of 2% in terms of y/y change in CPI as early as possible (roughly two-year time horizon) by doubling monetary base and exposure to JGBs, ETFs in two years, and more than doubling average remaining maturity periods for JGB purchases.

#### 1. Adoption of monetary base controls

- Main target for money market ops changed from uncollateralized overnight call rate to monetary base
- BOJ to conduct money market ops so that monetary base will increase at annual rate of about Y60-70 tril

#### 2. Increased purchases of long-term JGBs, maturity extension

- BOJ to buy long-term JGBs so that central bank's exposure will increase at annual rate of about Y50 tril
- JGBs with all maturities eligible for purchases, and average remaining maturity of BOJ's JGB exposure to be extended from nearly three years at present to about seven years

#### 3. Increased ETF/J-REIT purchases

- BOJ to buy ETFs, J-REITs so that its exposure will increase at an annual rate of Y1 tril, Y30 bil respectively

#### 4. Continuation of quantitative/qualitative monetary easing

- BOJ to stay with quantitative/qualitative monetary easing, aiming to achieve price stability target of 2%, as long as necessary to maintain that level of inflation.

Source: Bank of Japan; compiled by DIR.

# 1. Quantitative and Qualitative Monetary Easing ②

## Monetary Base Target, BOJ's Balance Sheet

(tril yen)

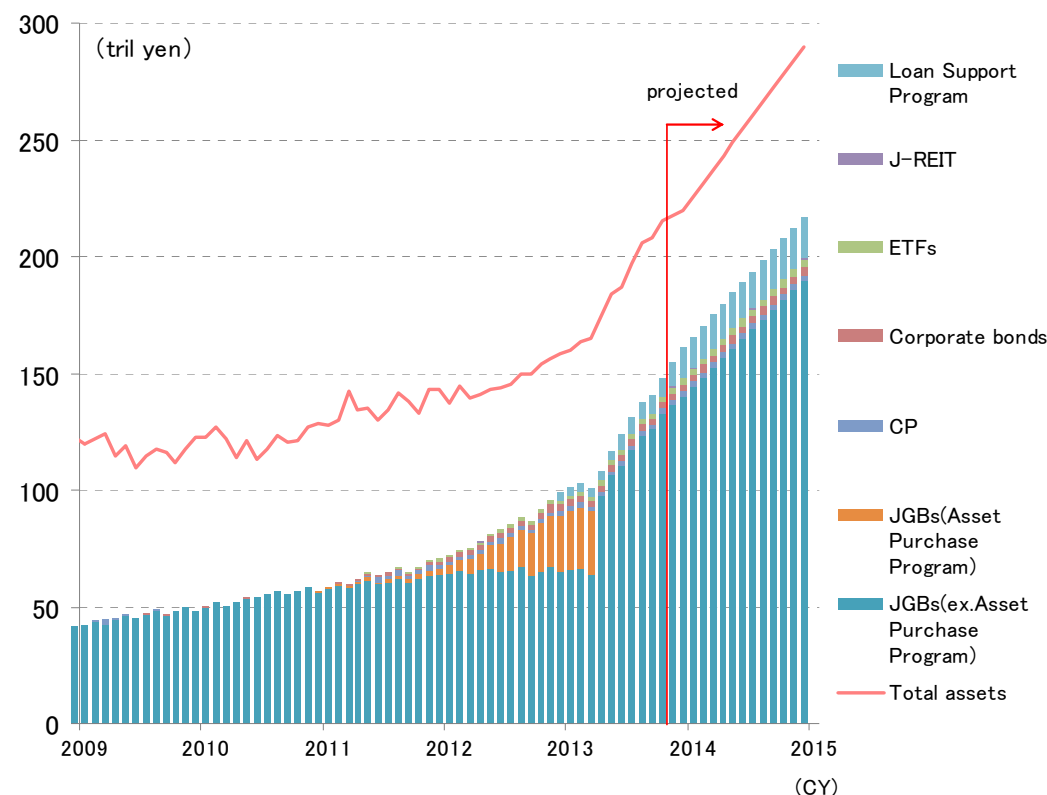
	End-2012 (actual)	End-2013 (projected)	End-2014 (projected)
Monetary base	138	200	270

### Breakdown of the bank's balance sheet

JGBs	89	140	190
CP	2.1	2.2	2.2
Corporate bonds	2.9	3.2	3.2
ETFs	1.5	2.5	3.5
J-REITs	0.11	0.14	0.17
Loan Support Program	3.3	13	18
<b>Total assets (including others)</b>	<b>158</b>	<b>220</b>	<b>290</b>
Banknotes	87	88	90
Current deposits	47	107	175
<b>Total liabilities and net assets (including others)</b>	<b>158</b>	<b>220</b>	<b>290</b>

Source: Bank of Japan; compiled by DIR.

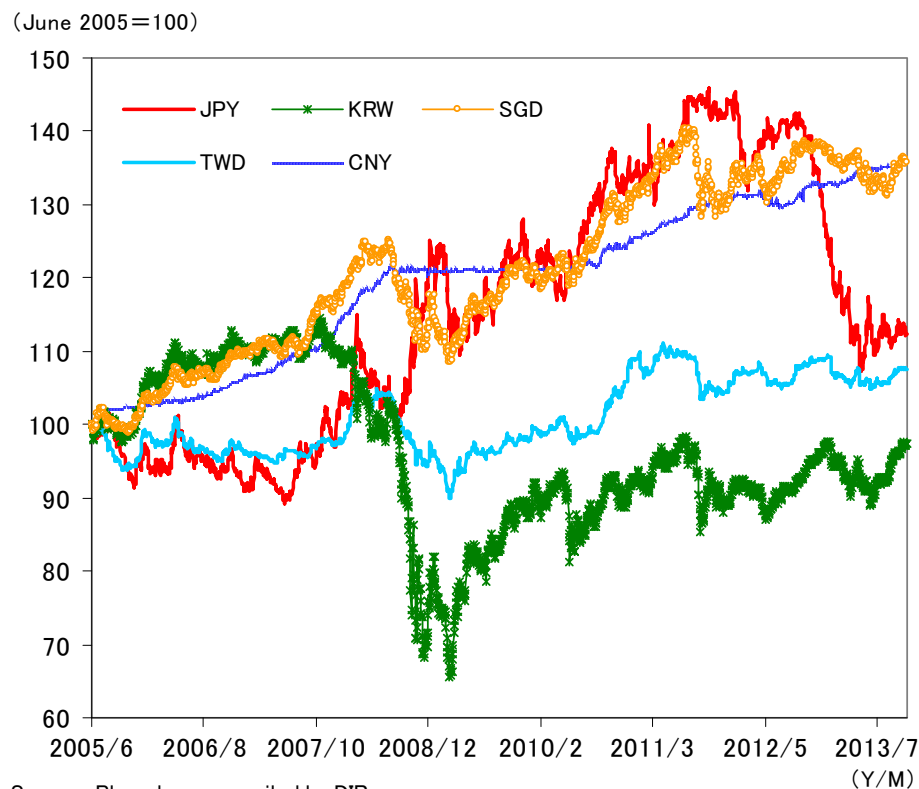
## Breakdown of BOJ Assets



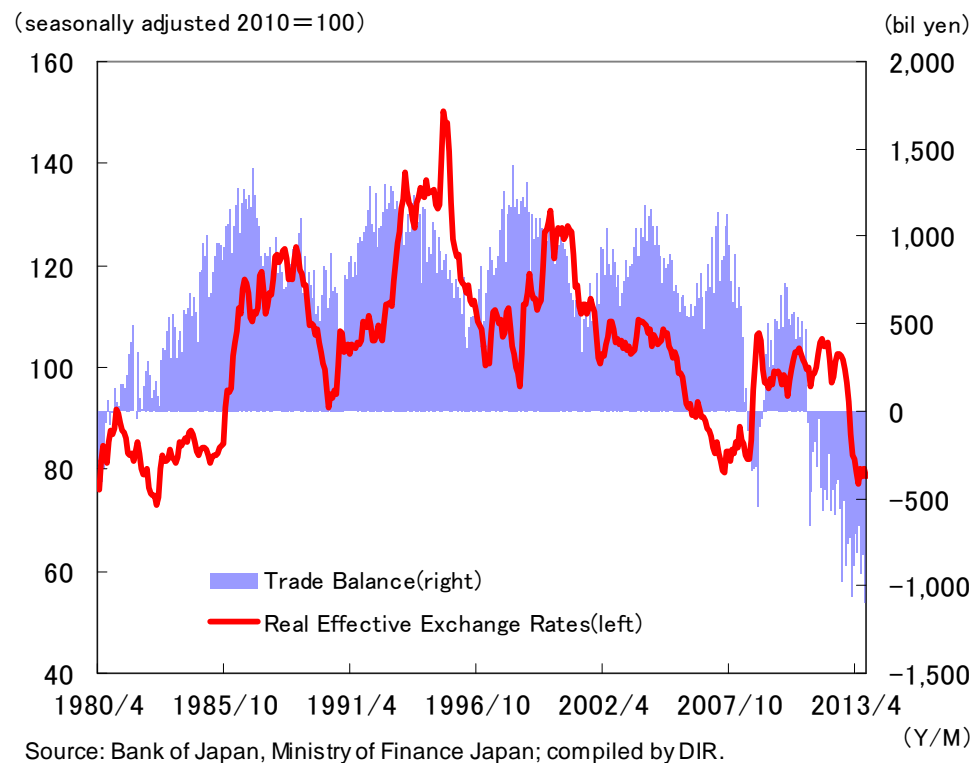
Note: Actual figures until Oct 2013. Estimates thereafter assume that BOJ will increase exposure by same amount every month to achieve targets.

## 2. Developments in Financial Market ① Foreign Exchange

### US Dollar Exchange Rates vs. Asian Currencies

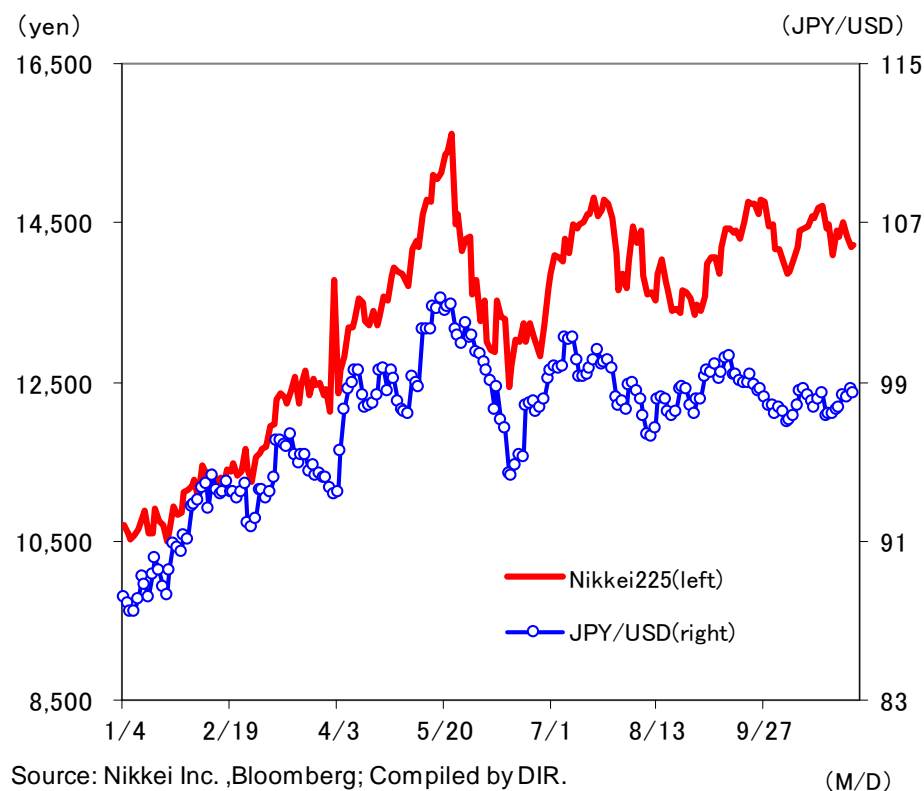


### Real Effective Exchange Rate, Trade Balance

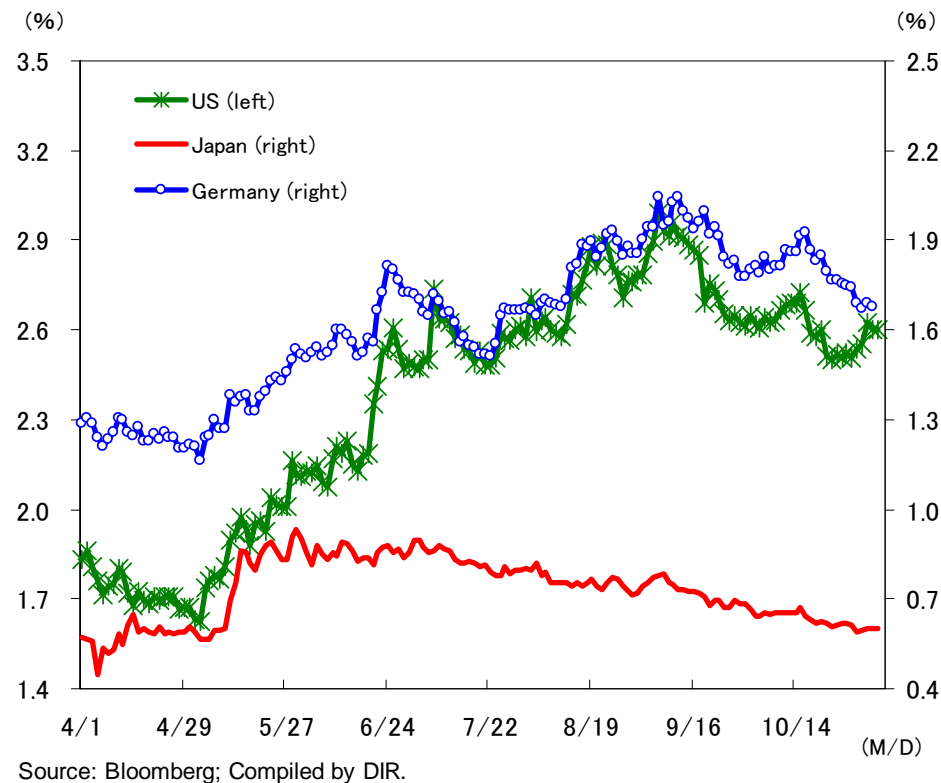


## 2. Developments in Financial Market ② Equities and Bonds

### Nikkei 225, JPY/USD



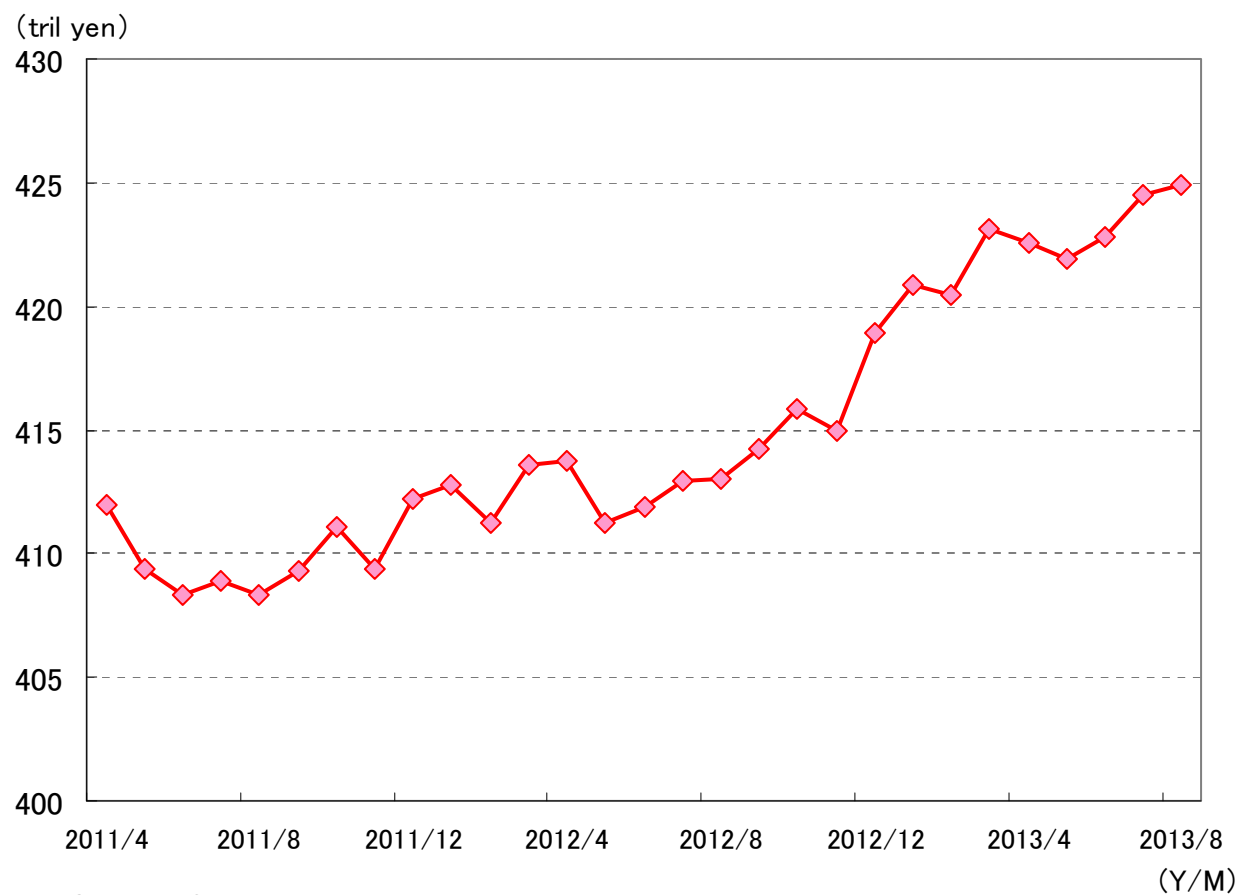
### Yields on 10-year Government Bonds





## 2. Developments in Financial Market ③ Bank Loans

### Bank Loans Outstanding



Source: BOJ; compiled by DIR

Note: Average loans at domestically licensed banks (ordinary ops, trust banking ops, foreign ops).

### III. Japan Revitalization Strategy -Japan is BACK- (Jun 2013)

Revitalization of Japanese Industry	<ul style="list-style-type: none"><li>•Accelerate structural reform</li><li>•Reform job market, strengthen human resources</li><li>•Promote innovation</li><li>•Build world's most advanced IT infrastructure</li><li>•Strengthen Japan's competitiveness as international business hub</li><li>•Foster innovation at SMEs</li></ul>
Strategic Market Creation	<ul style="list-style-type: none"><li>•Extend nation's healthy life expectancy</li><li>•Realize clean and economical energy demand and supply</li><li>•Develop safe, efficient, economical next-generation infrastructure</li><li>•Build regional communities whose unique resources attract global demand</li></ul>
Increase Foreign Trade	<ul style="list-style-type: none"><li>•Establish strategic trade relations and promote economic partnerships</li><li>•Implement strategies to capture large shares of global markets</li><li>•Lay groundwork for provision of financing, human resources to support Japan's growth</li></ul>

Source: Cabinet Secretariat; compiled by DIR.

## IV. Comprehensive Reform of Social Security and Tax

Children & Child-rearing	<ul style="list-style-type: none"><li>○ Increased child-rearing support<ul style="list-style-type: none"><li>• Efforts to resolve nursery waiting-list problem</li></ul></li></ul>
Medical/long-term Care	<ul style="list-style-type: none"><li>○ Reform of systems to provide medical/long-term care services<ul style="list-style-type: none"><li>• More specialization, closer cooperation between hospitals; promotion of home health care, etc.</li><li>• Establishment of integrated community care system</li></ul></li><li>○ Establishment of equitable, sustainable institutions for children with serious/chronic diseases</li><li>○ Reform of medical/long-term care insurance system<ul style="list-style-type: none"><li>• Stabilization of finances of medical insurance system</li><li>• Achieving fairness in sharing tax burden</li><li>• Optimization of medical treatment areas eligible for health insurance benefits</li><li>• Improvement in prioritization, efficiency in long-term care insurance benefits</li><li>• More reductions in long-term care insurance contribution by low-income earners</li></ul></li></ul>
Pensions	<ul style="list-style-type: none"><li>○ Improvement of pension system<ul style="list-style-type: none"><li>• Additional pension benefits to the low-income elderly, physically handicapped, shorter pension eligibility, etc.</li></ul></li></ul>

Source: Cabinet Secretariat's Office for Social Security Reform; compiled by DIR.

## V. Raising Consumption Tax with Economic Stimulus Package

### 1. Cabinet decision (Oct 2013)

- ✓ Consumption tax rate to be hiked from 5% to 8% in Apr 2014 as scheduled
- ✓ Economic stimulus package to be hammered out in early Dec with emphasis on end to deflation, economic revival
- ✓ Fiscal consolidation targets to be pursued according to mid-term fiscal plan
- ✓ Bill for social security reforms to be submitted at next regular Diet session based on stipulations of Article 4 of Act to Promote Social Security Reform (Aug 2013)

Source: Cabinet Secretariat; compiled by DIR.

## 2. Outline of Stimulus Package ① Growth strategy implementation policy

### ✓ Measures to boost growth

- Expedite implementation of growth strategies according to “Policy regarding the implementation of the growth strategy” (Headquarters for Japan’s Economic Revitalization Decision, Oct 2013)
- Investment tax credit, etc. (refer to next page)

#### Key points of “Policy regarding the implementation of the growth strategy”

- Lay groundwork for regulatory, institutional reforms
  - Structural reforms to be expedited in strategic regions among corporations nationwide
- Stimulate capex, shift Japan’s resources to growth industries
  - Support to be provided for betterment of operating environment, tax code to be made more investment-friendly so as to stimulate forward-looking investment
  - ○ Reform employment system and strengthen workforce skills
  - Early attempts to reform employment system and strengthen workforce skills, promotion of university reform (e.g. human resources, wage system)
- Creation of strategic markets through structural reforms
  - Create new markets, which could serve as main engines for economic growth, through regulatory, institutional reforms, outsourcing public services
- Pursuit of growth strategies separately designed for each region, support for innovation in SMEs
  - Central/local governments’ joint support for innovation in SMEs

Source: Cabinet Secretariat; compiled by DIR.

V. Raising Consumption Tax with Economic Stimulus Package

## 2. Outline of Stimulus Package ② Others

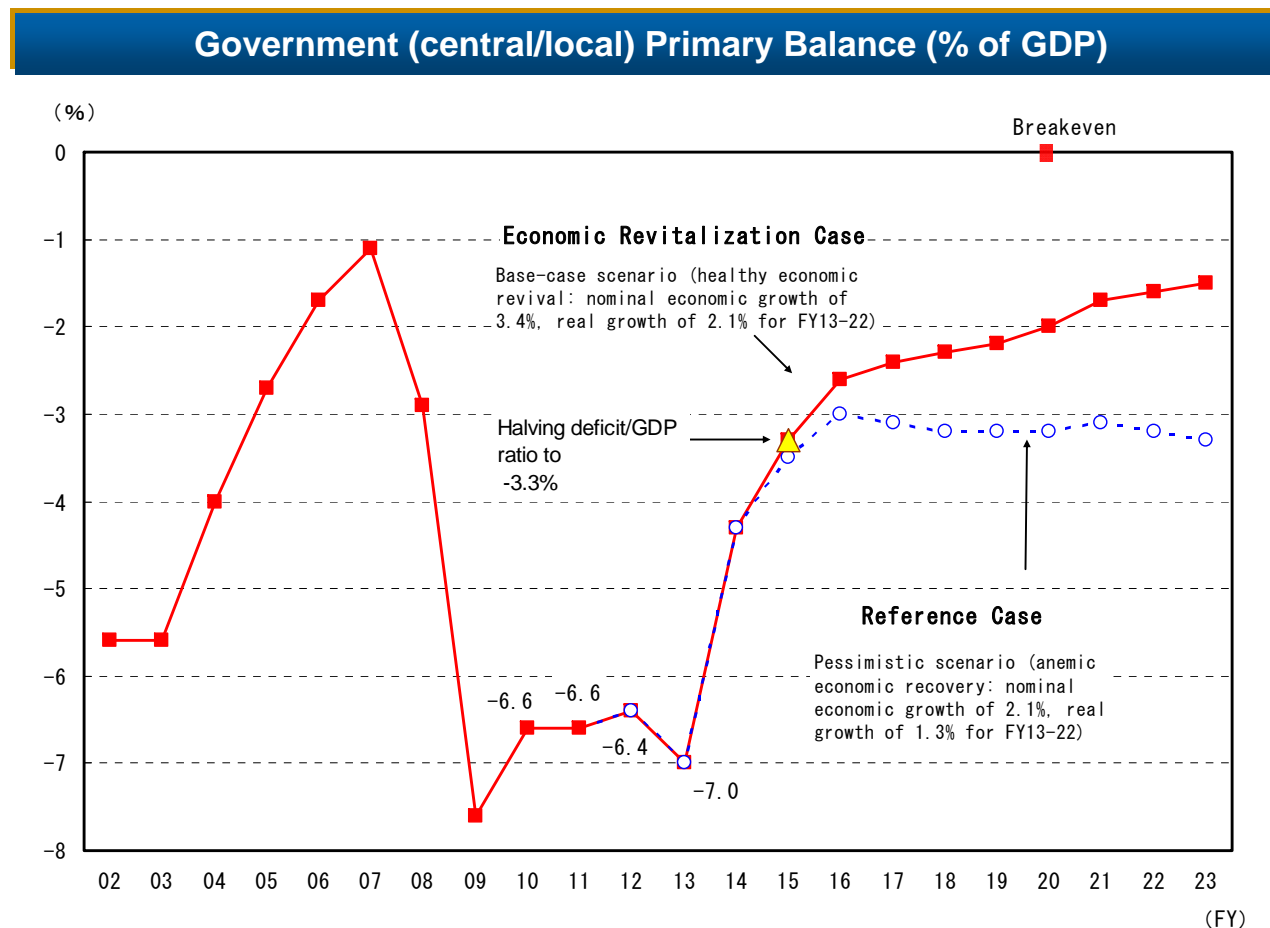
- ✓ Create virtuous economic circle through cooperation between government, labor and management
    - Consider expansion of tax incentives promoting wage hikes (※), year-early abolition of special corporate tax for disaster reconstruction (※)
  - ✓ New economic stimulus measures worth Y5 tril
    - New stimulus measures to be hammered out in early December to ease fallout of pullback from last-minute purchases leading up to consumption tax hike
  - ✓ Benefits for low-income households (some Y300 bil)
    - Providing ¥10,000 to ¥15,000 per person in low-income households now exempt from residential tax
  - ✓ Benefits for home-buyers (some Y310 bil), review of motor vehicle taxation
  - ✓ Measures to ensure consumption tax hike being smoothly passed on to consumers
  - ✓ Efforts to ensure smooth infrastructure rebuild, revival in areas devastated by Great East Japan Earthquake
- ※ Estimated tax revenue declines from tax system reform in economic stimulus; ① Y730 bil from investment tax credit, ② Y160 bil from expansion of incentives for wage hikes, ③ Y110 bil from home loan tax credit assuming tax reform carried out. Special corporate tax for disaster reconstruction estimated at Y914.5 bil in initial FY2013 budget.

Source: Cabinet Secretariat; compiled by DIR.

V. Raising Consumption Tax with Economic Stimulus Package

## VI. Framework for Medium-term Fiscal Consolidation (approved by Cabinet 8 Aug)

Government (central/local) aims to halve primary deficit as % of GDP ratio from FY2010 level to 3.3% by FY2015 and achieve a primary surplus by FY2020. Thereafter, government will seek to steadily reduce public debt as % of GDP.



Source: Cabinet Office; compiled by DIR.

Note: Government (central/local) primary deficit stood at 6.6% of GDP in FY10. Thus, 50%-reduction target set at 3.3%. Expenditures and revenues for disaster reconstruction excluded from underlying data.

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- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

\*The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.

Financial instruments firm: chief of Kanto Local Finance Bureau(Kin-sho)No.108

Memberships: Japan Securities Dealers Association

The Financial Futures Association of Japan

Japan Investment Advisers Association

Type II Financial Instruments Firms Association