Economic Outlook for FY2008, FY2009 and FY2010

(revised to reflect the Second Preliminary Quarterly Estimates of GDP for the Oct-Dec quarter of 2008)

March 2009

The Mizuho Research Institute Ltd. (MHRI) has revised its economic outlook for FY2008, FY2009 and FY2010 subsequent to the release of *The Second Preliminary Quarterly Estimates of GDP ("2nd QE")* for the Oct-Dec quarter of 2008. The key points of the outlook are as follows.

<The US Economy>

Given the fall of private demand, the recovery will remain weak even after implementation of the economic stimulus measures

2009 -2.5% (previous outlook -2.4%)

2010 1.3% (previous outlook 1.3%)

<The Japanese Economy>

FY2008 -3.1% (previous outlook -2.8%)
Exports and capital investment will fall at a faster pace in the second half of the fiscal year

FY2009 -4.9% (previous outlook -4.6%)
Both domestic and external demand will slump, leading to greater risks of deflation

FY2010 0.9% (previous outlook 0.8%)
Deflation risks will linger due to a sluggish pace of recovery

Mizuho Research Institute

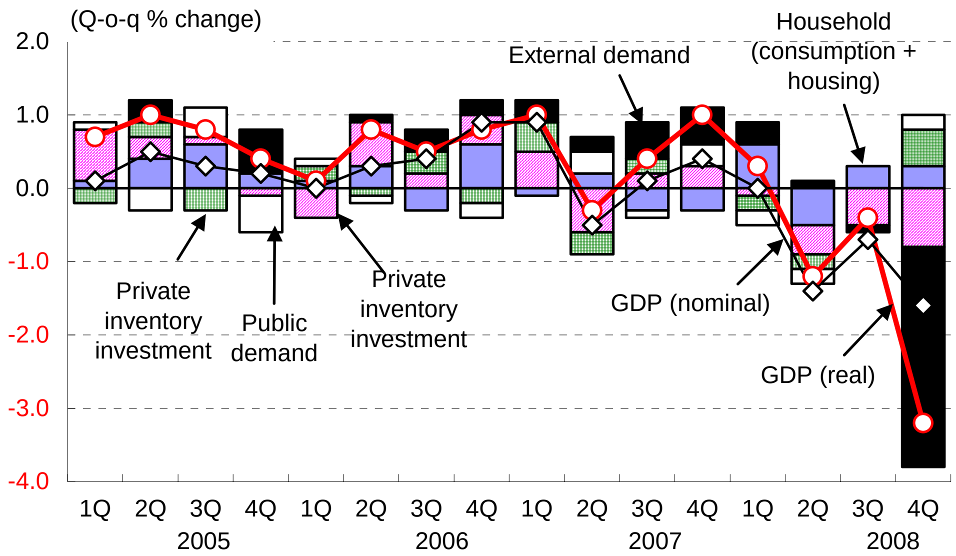
I. The current state of the Japanese economy

The 2nd *QE* for the Oct-Dec quarter of 2008 revealed a slightly higher pace of growth, mainly with respect to inventories

The *Second Preliminary Quarterly Estimates of GDP ("2nd QE")* for the Oct-Dec quarter of 2008 revealed a slight upward revision of Japan's real GDP to -3.2 % q-o-q (-12.1% p.a.) from -3.3% q-o-q (-12.7% p.a.) in the *First Preliminary Quarterly Estimates of GDP ("1st QE")* (**Chart 1**). Even though domestic demand was revised upward, this in no ways provides good news since it stems largely from an uptick of private inventory investment due to an "unintentional rise of inventories".

Looking closer at each of the components of demand, capital investment was revised down slightly from -5.3% q-o-q in the *1st QE* to -5.4% q-o-q in the *2nd QE*, to reflect the results of the *Financial Statements Statistics of Corporations by Industry*. The contribution by inventory investment to quarterly real GDP growth was revised up from +0.4% pt to +0.5% pt, due primarily to the rise of goods in process. As a result, the contribution by domestic private demand to quarterly real GDP growth was revised upward from -0.5% pt to -0.4% pt. Despite minor upward revisions of both government consumption (+1.2% q-o-q → +1.4% q-o-q) and public investment (-0.6% q-o-q → +0.1% q-o-q) the contribution by public demand remained unchanged at +0.2% pt. The contribution by domestic demand (the total of private demand and public demand) was revised upward from -0.3% pt to -0.1% pt. Since exports (-13.9% q-o-q → -13.8% q-o-q) and imports (+2.9% q-o-q → +3.0% q-o-q) were only subject to minor revisions, the contribution by external demand remained unchanged from the *1st QE* at -3.0% pt.

[Chart 1: Japan's quarterly GDP growth (2nd *QE* for the Oct-Dec quarter of 2008)]



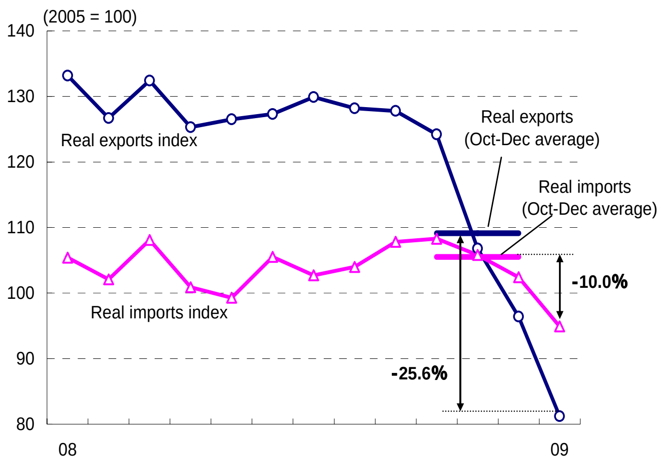
Source: Cabinet Office, *Preliminary Quarterly Estimates of GDP.*

The GDP deflator was revised downward from +0.9% y-o-y to +0.7% y-o-y. Nominal GDP growth was revised up slightly to -1.6% q-o-q (-6.4% p.a.) from -1.7% q-o-q (-6.6% p.a.) in the *1st QE*.

Jan-Mar quarter of 2009: strong possibility of another double-digit contraction in annualized terms

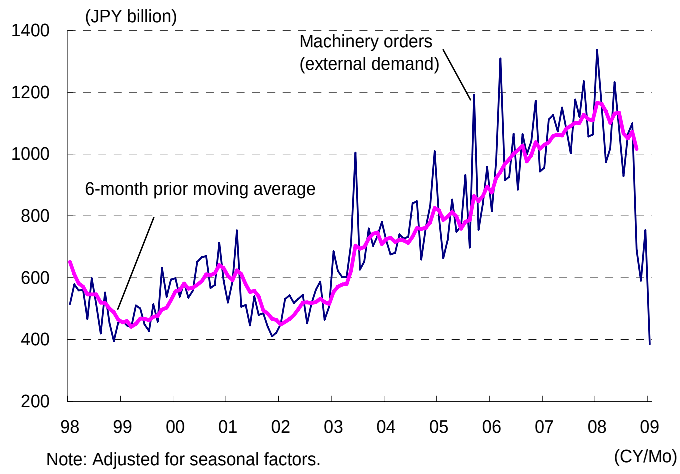
Both domestic and external demand remains in dire straits in the Jan-Mar quarter of 2009. In particular, note that the fall of exports is predicted to surpass the historical plunge in the Oct-Dec quarter of 2008. Exports in real terms (based upon releases by the Bank of Japan) as of January are 25.6% lower than the Oct-Dec quarter average, revealing a deeper drop than real imports (-10.0%) (**Chart 2**). Looking at leading indicators of exports, machinery orders (external demand) as of January do not provide signs that exports will be bottoming out (**Chart 3**). GDP-based real exports in the Jan-Mar quarter are predicted to fall by more than 20% on a quarterly basis. Even though the contribution by external demand will most likely be smaller than -3.0% pt in the Oct-Dec quarter of 2008 since imports will also take a downturn, we are inclined to believe that external demand will serve to drag down quarterly real GDP growth by approximately 2%.

[Chart 2:Exports and imports (real)]



Source: Bank of Japan, *Real Exports and Real Imports*

[Chart 3: Machinery orders (external demand)]

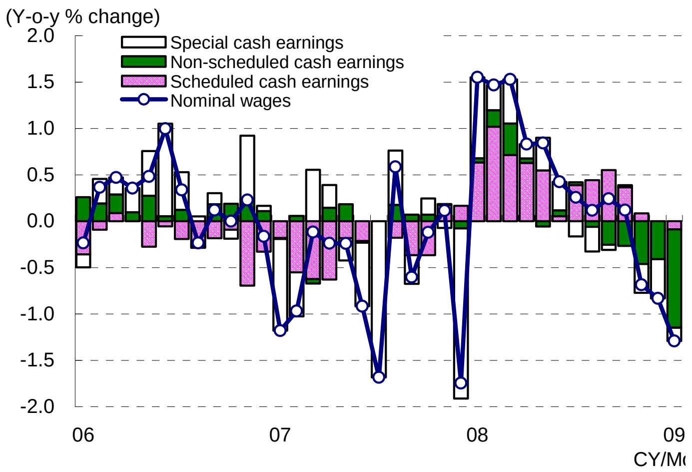


Note: Adjusted for seasonal factors.
Source: Cabinet Office, *Orders Received for Machinery.*

Domestic demand is predicted to contract at a faster pace than in the Oct-Dec quarter of 2008. Given the deterioration of the income environment, consumers are refraining from purchasing items such as cars and clothing items. Nominal wages are falling at a faster pace, due mainly to the decline of overtime payments accompanying massive production cuts (**Chart 4**). As exemplified by the widening breadth of the year-on-year fall of department store sales and automobile sales (**Chart 5**), personal consumption is poised for a quarterly drop again in the Jan-Mar quarter. As for the flat-sum cash payments, they will not have much of an impact upon growth in the Jan-Mar quarter due to the small number of local government which will be distributing the payments during the month of March. Furthermore, leading indicators such as machinery orders provide us with reason to believe that capital investment will fall at a faster pace. The contribution by inventory investment will fall into negative territory due to large-scale production cuts and serve as drag upon growth.

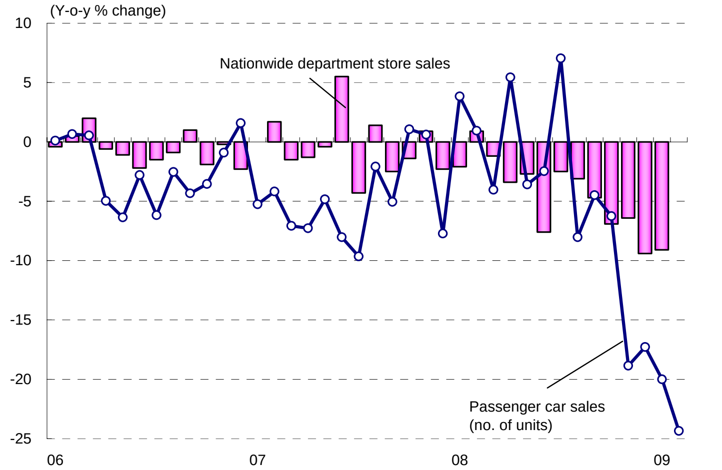
Thus, given a deeper fall of domestic demand along with a significant drag upon growth stemming from external demand, the odds are high that Japan's real GDP will record a double-digit contraction in annualized terms for the second quarter in a row in the Jan-Mar quarter. As a result, FY2008 real GDP growth is predicted to fall to -3.1% (previous outlook: -2.8%).

[Chart 4: Nominal wages]



Source: Ministry of Health, Labor and Welfare, *Monthly Labor Survey*

[Chart 5: Passenger car sales and department store sales]



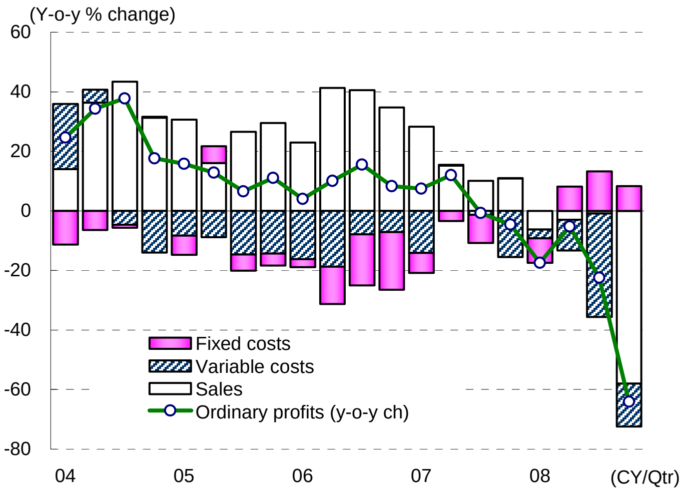
Sources: Japan Automobile Dealers Association,
Japan Department Stores Association.

II. Forecast of the Japanese economy in FY2009 and FY2010

Corporate earnings will continue to fall sharply mainly among manufacturers in FY2009

The *Financial Statements Statistics of Corporations by Industry* for the Oct-Dec quarter revealed the plunge of both sales (-11.6% y-o-y) and ordinary profits (-64.1% y-o-y). A factor decomposition of ordinary profits among manufacturers reveals that the sharp fall of sales is offsetting the reduction of fixed costs, leading to the sharp fall of profits (**Chart 6**). In particular, note that ordinary profits among manufacturers have dropped as much as 94.3% y-o-y due to the fall of demand and the appreciation of the yen, meaning that their profits have been virtually wiped out. Export-dependent sectors such as transportation equipment and electrical machinery have already fallen into a state of negative earnings. Despite prospects that the fall of energy prices will lead to an improvement of Japan's terms of trade to a certain extent in FY2009, the corporate sector – mainly manufacturers – will continue to suffer major profit falls because of a large impact of the earnings decline due to the drop of demand (**Chart 7**). Even though profits will take an upturn due to the bottoming of demand in FY2010, profit levels nevertheless should remain low.

[Chart 6: Ordinary profits (manufacturers)]



Note: Fixed costs = labor costs + depreciation costs + non-operating expenses.
Source: Ministry of Finance, *Financial Statements Statistics of Corporations by Industry.*

[Chart 7: Corporate earnings forecast]

(Y-o-y % change)			FY2007	FY2008 (Forecast)	FY2009 (Forecast)	FY2010 (Forecast)
Total		Sales	1.5	-6.4	-8.4	0.2
		Ordinary profits	-3.3	-37.7	-43.6	15.7
	Manufacturing	Sales	6.7	-10.9	-20.0	3.4
		Ordinary profits	-1.4	-58.4	-86.1	201.3
	Nonmanufacturing	Sales	-0.8	-4.3	-3.5	-0.9
		Ordinary profits	-4.7	-21.3	-25.7	1.1
Large corporations		Sales	4.0	-4.2	-13.6	0.6
		Ordinary profits	-0.7	-40.9	-47.2	23.0
	Manufacturing	Sales	5.1	-9.2	-24.1	4.3
		Ordinary profits	-2.2	-60.7	-83.0	184.5
	Nonmanufacturing	Sales	3.1	-0.2	-5.9	-1.6
		Ordinary profits	1.0	-18.7	-27.9	2.3
Small and medium corporations		Sales	-0.3	-8.0	-4.5	-0.1
		Ordinary profits	-6.6	-33.3	-39.1	8.0

Note: From FY2008, large nonmanufacturing corporaitons include financial holding companies.
Source: Made by MHRI, based upon the *Financial Statements Statistics of Corporations by Industry, Quarterly* of the Ministry of Finance.

Forecast on growth in FY2009 revised down to -4.9%

Given the sharp fall of real GDP growth in the second half of FY2008, FY2009 will start out with a large negative carry-over (estimated to be -4.4%). In the current revision, we have revised down the rate of Japan's real GDP growth in FY2009 to -4.9% (previous outlook: -4.6%) (**Chart 8**). Our view remains unchanged from our previous *Economic Outlook* that the Japanese economy will stop falling along with the bottoming of the overseas economies in the second half of 2009 and start to pick up on a fragile recovery in 2010. Our forecast on real GDP growth in FY2010 has been revised to +0.9% (previous outlook: +0.8%).

The output gap will fall deeper into negative territory to around the -8%-level

The output gap (the gap between actual GDP and potential GDP) estimated by MHRI stood at -4.0% as of the Oct-Dec quarter of 2008 (**Chart 9**). If the Japanese economy proceeds as set forth in our outlook, the output gap should fall deeper into negative territory, reaching the -8%-level in FY2009. Since the breadth of the negative output gap will not contract much in FY2010, a deflationary gap surpassing -6% will linger at the end of FY2010. The fall of consumer prices excluding food and energy prices (core core CPI) should intensify throughout FY2010.

Measures to stimulate domestic demand are needed quickly to avoid deflation

As explained above, the Japanese economy will face serious risks of deflation once again as it registers the second consecutive year of negative growth. Given the substantial downside risks to the view that the overseas economies will bottom out in 2009, there is no guarantee that the fall of exports will come to a halt in 2009. To stem its large negative output gap on its own, Japan must implement additional economic measures to stimulate domestic demand as soon as possible.

[Chart 8: Outlook on the Japanese economy]

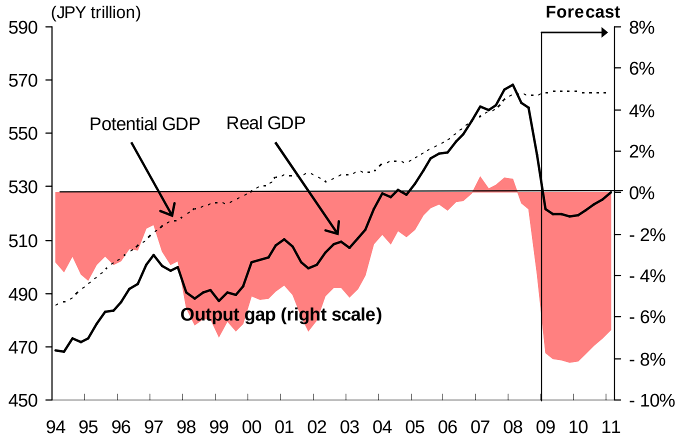
(%)

	FY2007	FY2008	FY2009	FY2010	FY2008		FY2009		FY2007	FY2008	FY2009	FY2010
					1H	2H	1H	2H	(Contribution)	(Contribution)	(Contribution)	(Contribution)
	(Actual)	(Forecast)	(Forecast)	(Forecast)	(Actual)	(Forecast)	(Forecast)	(Forecast)	(Actual)	(Forecast)	(Forecast)	(Forecast)
GDP (real)	1.9	-3.1	-4.9	0.9	-2.3	-10.1	-4.4	-0.3	-	-	-	-
Domestic demand	0.7	-1.8	-2.7	0.4	-2.7	-2.4	-3.5	-1.1	0.6	-1.7	-2.6	0.4
Private sector demand	0.6	-2.2	-4.2	0.3	-2.6	-4.0	-5.6	-1.6	0.5	-1.7	-3.1	0.2
Personal consumption	0.8	-0.2	-0.5	0.3	-0.5	-1.0	-0.5	-0.3	0.5	-0.1	-0.3	0.2
Housing investment	-13.0	-2.2	-3.1	1.2	4.6	9.7	-9.5	-1.6	-0.4	-0.1	-0.1	0.0
Capital investment	2.3	-8.7	-16.5	-0.8	-8.3	-20.3	-19.2	-7.3	0.4	-1.4	-2.5	-0.1
Public sector demand	0.7	-0.3	2.6	0.8	-2.7	3.2	3.5	0.4	0.1	-0.1	0.6	0.2
Government consumption	2.2	0.5	2.6	1.6	-2.2	3.5	2.8	1.4	0.4	0.1	0.5	0.3
Public investment	-5.8	-3.8	2.5	-3.2	-5.2	1.8	7.0	-4.3	-0.2	-0.1	0.1	-0.1
Net exports (contribution)	1.2	-1.3	-2.1	0.5	0.1	-7.1	-0.9	0.8	1.2	-1.3	-2.1	0.5
Exports	9.3	-9.8	-23.6	7.1	-1.1	-41.5	-24.7	6.1	1.4	-1.6	-3.5	0.8
Imports	1.8	-2.5	-13.2	3.2	-3.0	-5.8	-21.8	-1.3	-0.2	0.3	1.5	-0.3
GDP (nominal)	1.0	-3.3	-3.9	-0.0	-3.4	-6.7	-3.6	-1.9				
GDP deflator	-0.9	-0.3	1.0	-0.9	-1.5	1.1	2.3	-0.4				
Industrial production	2.6	-12.2	-23.9	3.6	-1.8	-22.3	-13.8	1.7				
Unemployment rate	3.8	4.1	5.3	5.5	4.0	4.2	5.0	5.5				
Current account balance (JPY trillion)	24.5	12.3	14.8	18.0	17.5	8.8	13.4	15.9				
as a percentage of nominal GDP)	4.7	2.5	3.1	3.8	3.4	1.8	2.8	3.3				
Domestic corporate goods prices	2.3	3.7	-5.7	0.8	6.0	1.3	-6.8	-4.5				
Consumer prices	0.3	1.3	-1.4	-0.1	1.9	0.7	-1.5	-1.3				
Long-term interest rate (%)	1.59	1.47	1.19	1.38	1.60	1.33	1.20	1.18				
Nikkei stock average (JPY)	16,000	10,800	7,800	9,000	13,300	8,300	7,500	8,100				
Exchange rate (JPY/USD)	114.2	100	98	102	106	95	97	99				
Crude oil price (WTI)	82.2	86	45	61	121.0	51	42	49				

Notes: 1. FY = rate of change from the previous year. Half-year GDP = rate of change from the previous term p.a. (the GDP deflator = rate of change from the previous year).
2. Half-year corporate goods prices and half-year consumer prices = rate of change over a year ago. Consumer prices = nationwide (excluding fresh foods).
3. Half-year industrial production = rate of change from the previous term. The half-year unemployment rate and half-year current account balance are adjusted for seasonal factors and the figures on current account balance are converted into annualized rates.
4. Crude oil price = near-term contract for WTI crude futures. The long-term interest rate = yield on newly-issued 10-yr government bonds.

Sources: Cabinet Office, *National Accounts*, Ministry of Economy,Trade and Industry, *Indices of Industrial Production*, Ministry of Internal Affairs and Communications, *Labor Force Survey*, *Consumer Price Index*, Ministry of Finance, *Balance of Payments*, Bank of Japan, *Corporate Goods Price Index*.

[Chart 9: The output gap]



Note: Estimates by MHRI.
Sources: Cabinet Office, Ministry of Economy, Trade and Industry,
Ministry of Interal Affairs and Communications, and others.

[Chart 10: Outlook on the US economy]

(%)

	2008	2009 (Forecast)	2010 (Forecast)	2008		2009 (Forecast)		2010 (Forecast)	
				1H	2H	1H	2H	1H	2H
GDP	1.1	-2.5	1.3	1.1	-1.2	-4.3	-0.0	1.6	1.9
Personal consumption	0.2	-2.3	0.4	1.0	-2.7	-2.8	-1.0	0.7	1.0
Housing investment	-20.7	-23.4	-12.0	-22.9	-16.9	-26.9	-22.7	-11.5	0.0
Capital investment	1.7	-12.2	1.6	2.7	-5.9	-17.9	-6.1	4.2	4.5
Inventory investment (USD100 million)	-276	-153	-158	-304	-248	-335	30	-80	-235
Government expenditures	2.9	4.0	5.9	2.1	4.3	3.1	5.6	6.1	5.9
Net exports (USD100 million)	-3,923	-3,793	-3,980	-4,217	-3,630	-3,786	-3,799	-3,903	-4,058
Exports	6.2	-10.5	1.6	6.7	-2.2	-17.8	-2.8	3.2	3.0
Imports	-3.4	-9.0	2.4	-2.8	-7.7	-12.9	-2.1	3.7	4.1
Domestic final demand	-0.0	-2.6	1.4	0.4	-2.2	-3.8	-0.6	2.0	2.4
Unemployment rate	5.8	9.4	9.1	5.2	6.5	8.9	9.8	9.2	9.0
Nonfarm payrolls (per month, 1,000 persons)	-187	-238	-13	-82	-291	-380	-95	-38	13
PCE deflator <y-o-y ch>	3.3	0.7	1.5	3.6	3.1	0.9	0.5	1.4	1.5
Core PCE deflator<y-o-y ch>	2.2	0.7	0.8	2.2	2.1	1.1	0.4	0.6	1.1
Current account balance (USD100 million)	-6,761	-4,335	-4,612	-3,566	-3,195	-2,247	-2,088	-2,281	-2,331
<as a percentage of nominal GDP>	-4.7	-3.0	-3.1	-5.0	-4.5	-3.2	-2.9	-3.1	-3.1

Notes: 1. Calendar-year figures refer to the rate of change from the previous year. Half-year term figures refer to the rate of change from the previous half-year term (annualized).
2. The shaded columns are forecasts.
3. Regarding the current account balance, figures for the half-year terms are adjusted for seasonal factors and the calendar-year figures are the totals. The percentages of nominal GDP are annualized.

Sources: US Department of Commerce, US Department of Labor, MHRI.

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