

Economic Outlook for FY2007 and FY2008

(revised to reflect the Second Preliminary Quarterly Estimates of GDP for the Jan-Mar quarter of 2007)

June 2007

The Mizuho Research Institute Ltd. (MHRI) has revised its economic outlook for FY2007 and FY2008 subsequent to the release of *The Second Preliminary Quarterly Estimates of GDP* ("2nd QE") for the Jan-Mar quarter of 2007. The key points of the outlook are as follows.

<The US Economy>

A full-fledged recovery will be delayed due to spillovers from the housing market correction

2007 2.1% (previous outlook) → 2.0% (current outlook)

2008 2.4% (previous outlook) → 2.4% (current outlook)

<The Japanese Economy>

FY2007 Despite a lull in the first half of the fiscal year, industrial production and consumption will gradually pick up in the second half of FY2007

Real GDP: 2.1% (previous outlook) → 2.1% (current outlook)

Nominal GDP: 1.9% (previous outlook) → 1.9% (current outlook)

FY2008 More signs of a self-sustained recovery

Real GDP: 2.1% (previous outlook) → 2.1% (current outlook)

Nominal GDP: 2.7% → 2.7% (current outlook)

This English-language translation is based upon the outlook in Japanese released on June 13, 2007. This publication is compiled solely for the purpose of providing readers with information and is in no way meant to encourage readers to buy or sell financial instruments. Although this publication is compiled on the basis of sources which we believe to be reliable and correct, Mizuho Research Institute does not warrant its accuracy and certainty. Readers are requested to exercise their own judgment in the use of this publication. Please also note that the contents of this publication may be subject to change without prior notice.

I. The current state of the Japanese economy

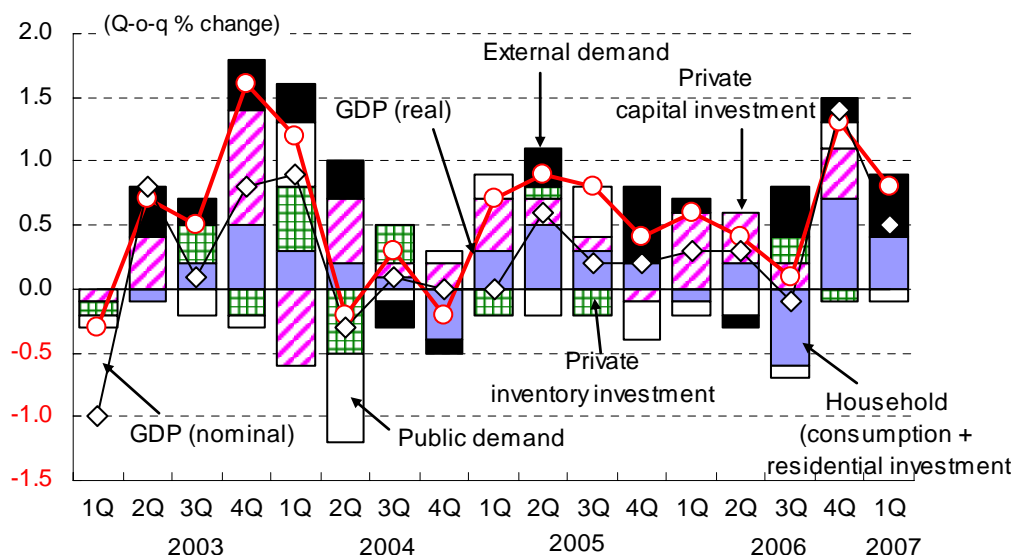
The 2nd QE revealed that Japan's economy grew faster than previously estimated (3.3% q-o-q p.a.) in the Jan-Mar quarter of 2007

Capital investment grew far above expectations

The *Second Preliminary Quarterly Estimates of GDP* ("2nd QE") for the Jan-Mar quarter of 2007 revealed that Japan's real GDP grew 0.8% q-o-q (3.3% q-o-q p.a.) in an upward revision from 0.6% q-o-q (2.4% q-o-q p.a.) in the *First Preliminary Quarterly Estimates of GDP* (Chart 1). Given the upward revisions of both domestic and external demand, Japan's economy surpassed its potential rate of growth (estimated to be approximately 2%) for the second quarter in a row.

Looking closer at each of the components of demand, personal consumption (*1st QE* 0.9% q-o-q → *2nd QE* 0.8% q-o-q), housing investment (*1st QE* -0.3% q-o-q → *2nd QE* -0.5% q-o-q) and public fixed capital formation (*1st QE* -0.1% q-o-q → *2nd QE* -1.2% q-o-q) were all revised downward from the *1st QE*. Even so, as a result of the upward revisions of capital investment (*1st QE* -0.9% q-o-q → *2nd QE* -0.3% q-o-q) and private-sector inventory investment (*1st QE* contribution to growth -0.1% pt → *2nd QE* -0.0% pt) reflecting the results of the *Financial Statements Statistics of Corporations by Industry*, the contribution to growth by private demand was revised upward from 0.2% pt to 0.3% pt. Furthermore, since export growth remained unchanged from the *1st QE* at 3.3% q-o-q while imports were revised downward (*1st QE* 0.9% q-o-q → *2nd QE* 0.4% q-o-q), the contribution to growth by external demand was revised up to 0.5% pt from 0.4% pt in the *1st QE*.

[Chart 1: Japan's quarterly GDP growth (2nd QE for the Jan-Mar quarter of 2007)]



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

The GDP deflator was subject to a slight downward revision

The GDP deflator was revised down slightly to -0.3% y-o-y (*1st QE* -0.2% y-o-y) as a result of a downward revision of the capital investment deflator (*1st QE* 0.8% y-o-y → *2nd QE* 0.6% y-o-y). Even though nominal GDP was revised up from 0.3% q-o-q (1.2% q-o-q p.a.) in the *1st QE* to 0.5% q-o-q (2.1% q-o-q p.a.), growth in nominal terms still fell short of real GDP growth as in the *1st QE*.

Corporate earnings are slowing down

As summarized above, the Japanese economy continued to grow strongly in the Jan-Mar quarter of 2007. Even though growth was primarily export-driven, domestic demand also grew above the previous quarter. In contrast, corporate performance slowed slightly during the period. The pace of ordinary profit growth (based upon the *Financial Statements Statistics of Corporations by Industry*) in the Jan-Mar quarter slowed down to 7.4% y-o-y from 8.3% y-o-y in the previous quarter from October to December of 2006, revealing a decline of the rate of profit growth. Looking closer, in terms of industrial sector, ordinary profits among manufacturers slowed sharply to 7.2% y-o-y (Oct-Dec quarter 14.8% y-o-y). The slowdown most likely stems from production cutbacks among car manufacturers and IT-related companies in the Jan-Mar quarter. In contrast, profits among nonmanufacturers picked up, growing 7.6% y-o-y (Oct-Dec quarter 2.9% y-o-y). The upturn of profits among retailers, which had sagged at the end of last year due to the unseasonable warm winter weather, contributed to the rise of profits among nonmanufacturers. Viewed overall, even though corporate profits are rising, the pace of recovery is slowing down due to the rise of costs such as raw materials and labor.

Capital investment is still holding up well

Progressing further into the Apr-Jun quarter, the Japanese economy appears to be moving more or less in line with our *Economic Outlook for FY2007 and FY2008* released in May 2007. There have been concerns that capital investment would fall, given the negative growth of quarterly capital investment in the 1st QE for the Jan-Mar quarter and the sharp fall of machinery order forecasts in the Apr-Jun quarter (-11.8% q-o-q). However, it now appears certain that capital investment will surpass the Apr-Jun forecast, since capital investment in the 2nd QE grew slightly above the previous quarter and machinery orders (private demand excluding orders for ships and orders by electrical power companies) in April also rose 2.2% m-o-m (March -4.5% m-o-m) for the first time in three months (**Chart 2**). Given the strong incentive to spend on plant and equipment among corporations, machinery orders will likely rise above the previous quarter in the Apr-Jun quarter. Capital investment is still holding up well even though we may not expect the high rate of investment growth witnessed in 2006.

Downside risks regarding personal consumption due to sluggish wage growth and weak consumer confidence

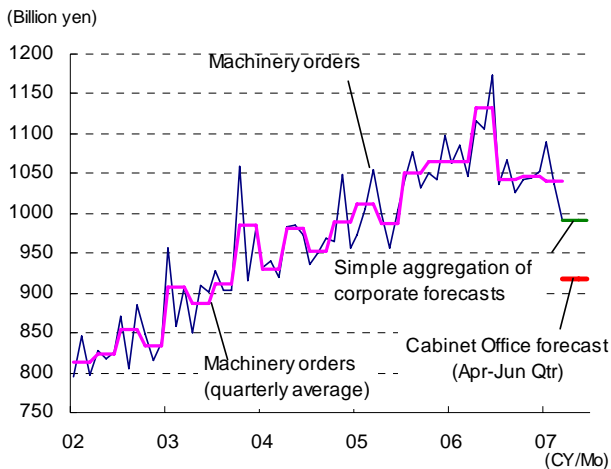
The strong growth of personal consumption, which continued for two quarters in a row up to the Jan-Mar quarter, is predicted to lose steam in the Apr-Jun quarter, reflecting the sluggish rise of wages and weak consumer confidence. Even though personal consumption appears to have grown strongly in April, as shown by real consumption expenditures (based upon the *Family Income and Expenditure Survey*) growing a solid 1.1% y-o-y (March 0.1% y-o-y), clouds are spreading over the environment surrounding consumer spending. For example, (1) nominal wages fell at a faster pace in April (-0.7% y-o-y, compared to -0.1% y-o-y in March) (**Chart 3**) and (2) the household activity-related DI in the *Economy Watchers Survey (May)* worsened. The temporary alleviation of tax burdens

accompanying the transfer of tax revenue sources from the central to local governments most likely contributed to the rise of personal consumption in the Jan-Mar quarter. Since these factors boosting income would fade away on a quarterly basis, personal consumption is predicted to slow down in the Apr-Jun quarter. There are downside risks to personal consumption in the Jul-Sep quarter, due in part to the rise of the local inhabitant tax serving as negative pressures upon income from June onward.

Production will pick up in the Apr-Jun quarter

On the supply-side, industrial production is expected to turn upward for the first time in two quarters in the Apr-Jun quarter. Even though industrial production dipped slightly in April (-0.1% m-o-m, compared to -0.3% m-o-m in March), production is set to rise 1.7% q-o-q in the Apr-Jun quarter according to estimations based upon forecast indexes. While IT-related production will most likely flatten out due to high inventory levels, production in non-IT sectors should gradually pick up given the absence of excessive inventories. The production cutbacks in the Jan-Mar quarter appears to have been a temporary phenomenon in a backlash to the surge of car output stemming from factors such as the release of new models toward the end of the year.

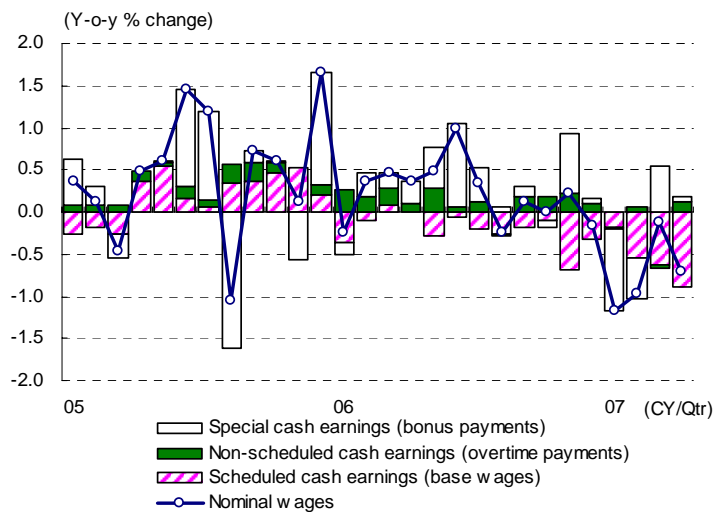
[Chart 2: Machinery orders]



Note: Machinery orders = private-sector orders excluding orders for ships and orders by electrical power companies.

Source: Cabinet Office, *Orders Received for Machinery*.

[Chart 3: Nominal wages]



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

II. Forecast of the Japanese economy in FY2007 and FY2008

The economy will slow down in the 1HFY2007 due to weak personal consumption and a smaller contribution by external demand

In the first half of FY2007, Japan's economic growth rate is forecast to slow down below its potential rate of growth. Given the fall of exports to the US, exports will slow down and the contribution to growth by external demand will contract. Furthermore, we expect personal consumption to stagnate given the sluggish rise of wages and the rise of tax burdens this summer. On the supply-side, industrial production growth will turn out to be meager, as the IT-related sectors remain in an inventory adjustment phase.

A recovery from 2HFY2007, given the end of inventory adjustment in IT-related sectors and the upturn of consumer spending

Production activity should pick up as the year progresses into the second half of FY2007, as the inventory adjustment cycle in the IT sector runs its course. The rise of production will lead to the recovery of wages such as overtime payments and feed through to a gradual rise of consumer spending. Even though a slower pace of capital investment growth will be inevitable from FY2006 due to a pause in investment among IT sectors, capital investment should continue to follow an upward trajectory backed by solid corporate earnings growth.

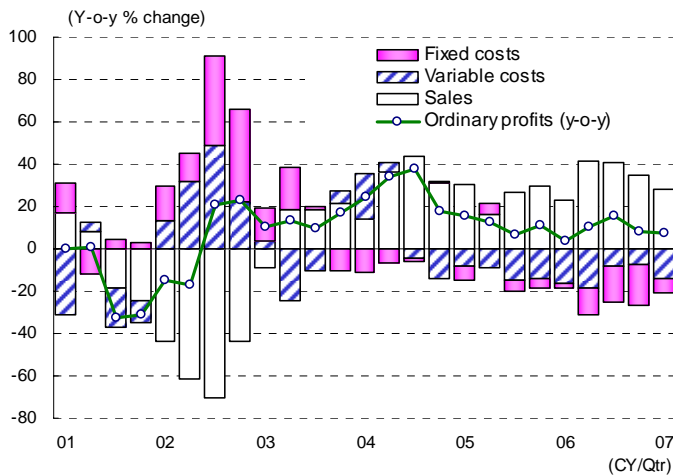
Corporate earnings will continue to grow

A closer look at the ordinary profits of corporations (**Chart 4**) reveals that the rise of both variable and fixed costs are starting to serve as downward pressures upon earnings. Among the background factors behind the rise of variable costs are the higher raw material and fuel costs stemming from the surge of the crude oil and metal markets. Turning to fixed costs, note a significant rise of depreciation costs and labor costs due to the increase of personnel. Undeniably, corporations are facing higher hurdles to maintain the rise of profits under growing cost burdens. That said, corporate business performance should still continue to improve as a result of ongoing earnings growth in FY2007 and FY2008. Even though the pace will slow down from the double-digit rise in FY2006, ordinary profits (based upon the *Family Income and Expenditure Survey*) should continue to grow for the sixth year in a row (**Chart 5**).

Forecast on growth in FY2007 and FY2008 remains unchanged from our previous outlook

We have kept our forecast on Japan's growth in FY2007 and FY2008 unchanged from our previous forecast (May 21st) at 2.1% for both years. Our fundamental scenario remains unchanged from our previous forecast. Despite stagnant growth in the first half of FY2007, the economy will pick up from the second half of FY2007 and start to show more definite signs of a self-sustained recovery in FY2008.

[Chart 4: Ordinary profits]



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

[Chart 5: Corporate earnings forecast]

		(Y-o-y % change)			
		FY2005	FY2006	FY2007 (Forecast)	FY2008 (Forecast)
Total	Sales	4.6	7.3	3.5	5.6
	Ordinary profits	8.4	10.0	3.9	5.1
Manufacturing	Sales	6.1	4.8	3.2	6.0
	Ordinary profits	12.4	12.7	4.3	5.6
Nonmanufacturing	Sales	3.9	8.4	3.6	5.4
	Ordinary profits	5.7	8.1	3.6	4.7
Large corporations	Sales	6.5	5.0	3.8	6.1
	Ordinary profits	13.9	12.8	4.2	5.6
Manufacturing	Sales	7.1	6.5	3.6	6.5
	Ordinary profits	14.7	13.7	4.5	6.1
Nonmanufacturing	Sales	6.0	3.8	4.0	5.9
	Ordinary profits	13.0	11.7	3.8	5.0
Small and medium corporations	Sales	3.2	8.9	3.3	5.2
	Ordinary profits	2.4	6.7	3.5	4.5

Note: Large corporations = corporations with capital of 1 billion yen or over
Medium corporations = corporations with capital of 100 million to 1 billion yen
Small corporations = corporations with capital of 10 to 100 million yen
Source: Compiled by MHRI on the basis of Ministry of Finance, *Financial Statements Statistics of Corporations by Industry, Quarterly*.

[Chart 6: Outlook on the Japanese economy (FY)]

	FY2005	FY2006	FY2007	FY2008	FY2005 FY2006 FY2007 FY2008 (%)			
					(Contribution)	(Contribution)	(Contribution)	(Contribution)
	(Actual)	(Actual)	(Forecast)	(Forecast)	(Actual)	(Actual)	(Forecast)	(Forecast)
GDP (real)	2.4	2.1	2.1	2.1	-	-	-	-
Domestic demand	1.9	1.3	1.6	2.0	1.9	1.3	1.5	1.9
Private sector demand	2.4	2.1	1.8	2.3	1.8	1.6	1.4	1.8
Personal consumption	1.9	0.7	1.4	1.6	1.1	0.4	0.8	0.9
Residential investment	-1.0	0.4	0.7	-0.9	-0.0	0.0	0.0	-0.0
Capital investment	5.8	7.9	4.0	5.2	0.8	1.2	0.6	0.8
Public sector demand	0.4	-1.3	0.8	0.7	0.1	-0.3	0.2	0.1
Government consumption	0.9	0.9	1.7	1.9	0.2	0.2	0.3	0.3
Public investment	-1.4	-9.6	-3.1	-4.8	-0.1	-0.4	-0.1	-0.2
Net exports (contribution)	0.6	0.8	0.6	0.2	0.6	0.8	0.6	0.2
Exports	9.0	8.3	5.8	5.2	1.2	1.2	0.9	0.8
Imports	6.0	3.2	2.8	5.4	-0.6	-0.4	-0.3	-0.6
GDP (nominal)	1.0	1.4	1.9	2.7				
GDP deflator	-1.4	-0.6	-0.2	0.6				
Industrial production	1.6	4.7	2.6	3.4				
Unemployment rate	4.4	4.1	3.8	3.6				
Current account balance (trillion yen)	19.1	21.3	23.1	25.6				
as a percentage of nominal GDP	3.8	4.2	4.4	4.8				
Domestic corporate goods prices	2.1	2.8	1.3	1.3				
Consumer prices	-0.1	0.1	0.1	0.5				
Long-term interest rate (%)	1.42	1.75	1.83	1.94				
Nikkei stock average (yen)	13,549	16,450	18,100	18,600				
Exchange rate (yen/dollar)	113.2	117.0	118	113				
Crude oil price (WTI/barrel)	60.0	64.9	64.0	59.8				

[Chart 7: Outlook on the Japanese economy (half-year)]

(%)

	FY2006		FY2007		FY2008	
	1H (Actual)	2H (Actual)	1H (Forecast)	2H (Forecast)	1H (Forecast)	2H (Forecast)
GDP (real)	0.8	1.8	0.7	1.0	1.2	0.8
Domestic demand	0.6	1.2	0.5	0.9	1.1	0.8
Private sector demand	1.1	1.4	0.5	1.1	1.4	0.8
Personal consumption	0.0	0.9	0.6	0.8	0.8	0.8
Residential investment	-1.6	1.8	-0.1	-0.3	-0.5	-0.5
Capital investment	5.4	3.4	1.0	2.5	3.1	1.6
Public sector demand	-1.2	0.4	0.5	0.3	0.2	0.7
Government consumption	1.0	0.3	1.1	0.9	0.8	1.1
Public investment	-9.4	0.6	-2.0	-2.3	-2.9	-1.6
Net exports (contribution)	0.2	0.6	0.2	0.1	0.1	0.0
Exports	3.1	3.7	2.7	2.5	3.0	1.8
Imports	2.1	-0.2	1.7	2.5	2.9	2.4
GDP (nominal)	0.4	1.6	0.5	1.2	1.7	0.9
GDP deflator	-1.0	-0.4	-0.4	-0.1	0.6	0.6
Industrial production	2.2	2.1	0.4	2.6	1.7	0.8
Unemployment rate	4.1	4.0	3.9	3.7	3.6	3.5
Current account balance (trillion yen)	18.6	22.9	22.0	23.4	24.9	25.4
as a percentage of nominal GDP	3.7	4.5	4.3	4.5	4.7	4.7
Domestic corporate goods prices	3.3	2.3	1.4	1.3	1.3	1.2
Consumer prices	0.1	-0.0	-0.0	0.2	0.4	0.5
Long-term interest rate (%)	1.80	1.70	1.80	1.85	1.90	1.98
Nikkei stock average (yen)	15,900	17,000	17,900	18,300	18,500	18,700
Exchange rate (yen/dollar)	115.4	118.6	120	116	114	112
Crude oil price (WTI/barrel)	70.6	59.2	66.7	61.3	61.1	58.5

Notes: 1. FY = rate of change from the previous year. Half-year = rate of change from the previous term (excluding the unemployment rate, current account balance and prices).

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 unemployment rate and half-year current account balance are adjusted for seasonal factors. 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 = newly-issued 10-yr government bonds.

Sources: Cabinet Office, *Annual Report on 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 8: Outlook on the US economy]

(%)

	2006	2007	2008	2006		2007 (Forecast)		2008 (Forecast)	
	(Actual)	(Forecast)	(Forecast)	1H	2H	1H	2H	1H	2H
GDP	3.3	2.0	2.4	3.9	2.2	1.7	2.4	2.4	2.6
Personal consumption	3.2	3.4	2.5	3.2	3.1	3.8	2.7	2.5	2.3
Residential investment	-4.2	-17.2	-13.4	-3.2	-17.1	-16.6	-18.4	-14.8	-4.4
Capital investment	7.2	2.8	1.1	9.1	5.2	2.4	1.4	-0.5	4.0
Inventory investment (\$100 million)	432	36	314	475	389	13	60	261	366
Government expenditures	2.1	2.1	2.8	2.4	1.9	2.0	2.5	2.9	3.0
Net exports (\$100 million)	-6,181	-5,884	-5,528	-6,304	-6,057	-6,044	-5,724	-5,498	-5,557
Exports	8.9	6.2	7.4	10.9	7.6	4.5	8.1	7.9	5.7
Imports	5.8	2.6	3.4	8.1	2.4	2.9	2.2	3.2	4.7
Domestic final demand	2.9	2.0	1.8	3.2	1.9	2.2	1.6	1.6	2.4
Core personal consumption expenditures deflator <y-o-y ch>	2.2	2.1	2.1	2.1	2.3	2.1	2.1	2.2	2.0
Current account balance (\$100 million)	-8,567	-7,535	-6,725	-4,315	-4,252	-3,966	-3,569	-3,362	-3,363
<as a percentage of nominal GDP>	-6.5	-5.4	-4.6	-6.6	-6.4	-5.8	-5.1	-4.7	-4.5

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. As for 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.

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