Economic Outlook for FY2007 and FY2008

(revised to reflect the Second Preliminary Quarterly Estimates of GDP for the Oct-Dec quarter of 2006)

March 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 Oct-Dec quarter of 2006. The key points of the outlook are as follows.

<The US Economy>

	The US economy will start to pick up from the second half of 2007 along with the stabilization of the housing market
2007	2.7% (previous outlook) → 2.4% (current outlook)
2008	3.0% (previous outlook) → 3.0%(current outlook)

<The Japanese Economy>

FY2006	Growth dependent upon external demand and capital investment due to weak consumer spending
	Real GDP: 1.9% (previous outlook) → 2.0% (current outlook)
	Nominal GDP: 1.3% (previous outlook) → 1.3% (current outlook)
FY2007	Japan's economy will accelerate as the upturn gradually spreads to households
	Real GDP: 1.9% (previous outlook) → 2.0% (current outlook)
	Nominal GDP: 2.0% (previous outlook) → 2.0% (current outlook)
FY2008	The economy will enter a self-sustained recovery track
	Real GDP: 2.4% (previous outlook) → 2.4% (current outlook)
	Nominal GDP: 2.6% → 2.6% (current outlook)

Mizuho Research Institute

I. The US economy

Global financial market turmoil, due partially to a correction of "excessive optimism" regarding the US economy

The global financial markets were rocked in turmoil from late February to early March. While the stock market fall in China (February 27th) acted as the direct trigger, its global spread was caused by a correction of the "excessive optimism" on the US economy amid a string of weaker-than-expected indicators and an unwinding of yen-carry trades (and speculation thereof)

In the US, real gross domestic product (GDP) in the Oct-Dec quarter of 2006 was revised down sharply from 3.5% q-o-q p.a. (advance estimates) to 2.2% q-o-q p.a. (preliminary estimates, released February 28th). This stems largely from the fact that the breadth of inventory investment growth turned out to be half the advance estimates and capital investment growth was revised downward from -0.4% q-o-q p.a. to -2.4% q-o-q p.a..

Despite predominant concerns regarding the downside risks of the US economy due to the correction of the housing market and manufacturing sector, the focus of attention had been shifting to the upside risks in view of the solid labor market conditions and the strength of consumer spending even after the year-end shopping season as evident in the Federal Open Market Committee statement in January and Federal Reserve Board Chairman Ben Bernanke's Congressional testimony (February 14th and 15th). However, media reports on former Fed Chairman Alan Greenspan's comments regarding a recession and a string of weak data such as durable goods orders, GDP and residential sales drove market participants to make a 180-degree revision of their excessively optimistic views on the future course of the US economy, in turn leading to a global stock market correction.

The possibility of a soft landing of the US economy is still high

As far as the data releases in March are concerned, the chances are still quite high that the US economy will follow a soft landing scenario as expected. The February manufacturing ISM index improved above the expansion-or-contraction threshold of 50, indicating the steady improvement of inventory adjustment. Even though the widely-watched nonfarm payroll growth (February) slowed to roughly 97,000 workers from the previous month, nonfarm payrolls are still growing at a rate of approximately 160,000 workers per month when averaging the past three-month period, indicating that labor market conditions are still firm.

Although financial markets have calmed down, downside risks of the US economy still linger

The unwinding of yen carry trades also appears to be coming to a pause. The large interest rate gap between Japan and other countries may be serving as scant incentive for investors to unwind their yen carry transactions. The global financial markets are regaining stability given the reconfirmation of the soft-landing scenario of the US economy and the position adjustment regarding yen carry trades. Judging from the relatively narrow breadth of the correction and the stabilization in a short period of time, the odds are low that the recent correction will have a negative impact upon the global economy.

Even so, as the recent experience shows, the rise of concerns regarding the loss of momentum of the US economy may still lead to events such as (i) a stock market correction due to a downward revision of prospect returns or (ii) the unwinding of yen carry transactions due to expectations on a sharp interest rate cut by the Fed. The recent rise of delinquency rates associated with the problems in the subprime mortgage market - forcing major banks to set aside massive loan-loss provisions - are a source of concern. Even though the chances are slim that the subprime mortgage problems will serve as the Achilles heel of the US economy unless job prospects continue to worsen, the situation requires close attention given the persistence of negative indicators such as the rise of nonperforming loans.

2007 US real GDP revised downward

Given the recent revision of data, MHRI has revised down its forecast on the rate of US economic growth in 2007 to 2.4% (previous forecast: 2.7%). While the downgrade is largely a reflection of the downward revision of growth in the Oct-Dec quarter of 2006, growth in the first half of 2007 has been revised down mainly with respect to capital investment in view of the current weakness of durable goods orders.

Even so, judging from the strong intent among companies to spend on plant and equipment, the weakness of capital investment since the second half of 2006 is most likely a temporary lull. Capital investment is predicted to regain momentum from the Apr-Jun quarter of 2007. Since our forecast remains unchanged that the US economy will start to pick up from the second half of 2007 when the housing market and manufacturing sector correction runs its course, our forecast on growth in 2008 remains unchanged at 3.0%.

[Chart 1: Outlook on the US economy]

(%)

	2006 (Actual)	2007 (Forecast)	2008 (Forecast)	2006		2007 (Forecast)	
				1H	2H	1H	2H
GDP	3.3	2.4	3.0	3.9	2.2	2.3	3.0
Personal consumption	3.2	3.1	2.8	3.2	3.1	3.3	2.7
Housing investment	-4.2	-11.2	3.8	-3.2	-16.9	-13.1	-0.5
Capital investment	7.3	3.3	4.3	9.1	5.4	1.3	5.2
Inventory investment ($100 million)	419	86	92	475	364	25	147
Government expenditures	2.1	2.2	2.4	2.4	1.8	2.5	2.2
Net exports ($100 million)	-6,187	-5,708	-5,755	-6,304	-6,070	-5,676	-5,739
Exports	8.9	6.7	6.4	10.9	7.6	6.8	5.6
Imports	5.8	2.1	4.8	8.1	2.5	0.6	4.6
Domestic final demand	2.9	2.2	2.9	3.2	1.9	2.1	2.7
Core personal expenditures deflator <y-o-y ch>	2.2	2.1	2.2	2.1	2.3	2.1	2.1
Current account balance ($100 million)	-8,539	-7,293	-7,089	-4,303	-4,235	-3,692	-3,601
<as a percentage of nominal GDP>	-6.4	-5.3	-4.8	-6.6	-6.3	-5.4	-5.1

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. 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.

II. The Japanese economy

(1) The current state of the economy

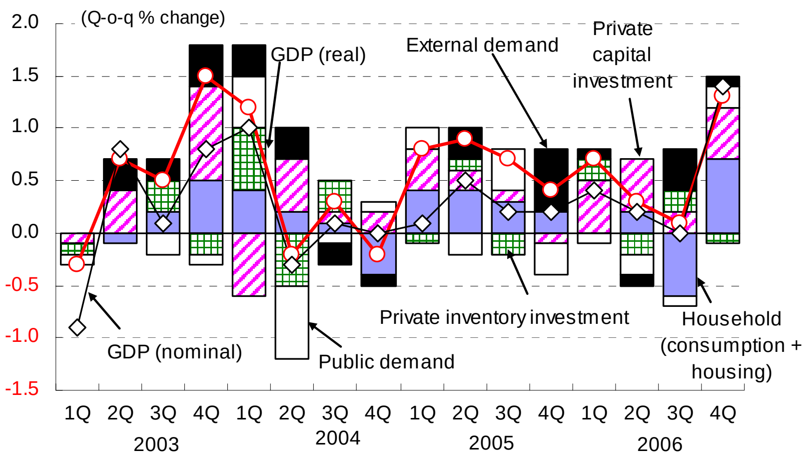
The 2nd QE revealed that Japan's economy grew faster than previously estimated (5.5% q-o-q p.a.) in the Oct-Dec quarter of 2006

The *Second Preliminary Quarterly Estimates of GDP ("2nd QE")* for the Oct-Dec quarter of 2006 revealed that Japan's real GDP grew 1.3% q-o-q (5.5% q-o-q p.a.) in an upward revision from 1.2% q-o-q (4.8% q-o-q p.a.) in the *First Preliminary Quarterly Estimates of GDP* (**Chart 2**). As a result of the downward revision of external demand and the upward revision of domestic demand (mainly capital investment), Japan's economy grew strongly, turning out to be more domestic demand-driven than in the *First Preliminary Quarterly Estimates of GDP ("1st QE").*

Capital investment grew far above expectations

With the exception of a slight downward revision of personal consumption (*1st QE* 1.1% q-o-q→ *2nd QE* 1.0% q-o-q), both housing investment (*1st QE* 2.0% q-o-q → *2nd QE* 2.2% q-o-q) and capital investment (*1st QE* 2.2% q-o-q → *2nd QE* 3.1% q-o-q) were revised upward. Private-sector inventory investment remained unchanged from the *1st QE* (contribution to growth -0.1% pt q-o-q). As a result, the contribution by domestic private sector demand to quarterly real GDP growth was revised up from 1.2% pt in the *1st QE* to 1.4% pt. Furthermore, public investment (*1st QE* 2.7% q-o-q → *2nd QE* 3.7% q-o-q) and government expenditures (*1st QE* % 0.0%q-o-q → *2nd QE* 0.1% q-o-q) were revised upward, resulting in an upward revision of the contribution by public demand from 0.1% pt to 0.2% pt. In contrast, the contribution to growth by external demand was revised downward from the *1st QE* (*1st QE* % 0.2% pt q-o-q → *2nd QE* 0.1% pt q-o-q) as a result of a slight downward revision of both exports (*1st QE* 1.1% q-o-q → *2nd QE* 0.6% q-o-q) and imports (*1st QE* -0.0% q-o-q → *2nd QE* -0.2% q-o-q).

[Chart 2: Japan's quarterly GDP growth]



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

The GDP deflator remains unchanged

Both the GDP deflator (-0.5% y-o-y) and the domestic demand deflator (-0.1% y-o-y) remained unchanged from the *1st QE*. Nominal GDP was revised up from 1.2% q-o-q (5.0% q-o-q p.a.) in the *1st QE* to 1.4% q-o-q (5.6% q-o-q p.a.), rising slightly above the rate of real GDP growth.

Strong corporate performance – except for businesses which were adversely affected by the warm winter weather

Even though Japan's economy grew strongly in the Oct-Dec quarter of 2006, driven mainly by domestic demand, corporate earnings growth slowed slightly during this time period. The pace of ordinary profit growth (based upon the *Financial Statements Statistics of Corporations by Industry*) in the Oct-Dec quarter slowed down to 8.3% y-o-y from the previous quarter (15.5% y-o-y), revealing a decline of the rate of profit growth. A decomposition of the factors in **Chart 3** shows that the rising burden of fixed costs such as labor costs amid the slowdown of sales is pushing down corporate earnings. While the chart reveals that the burden of fixed costs – mainly labor costs – is rising, the profit slowdown in the Oct-Dec quarter stems primarily from a slower rate of growth on the revenue side. This stems from weak sales in certain sectors which were affected negatively by the warm winter weather. As a result of the past winter's unseasonably warm weather, sales among retailers suffering declines in sales of items such as winter clothing and foodstuffs fell 4.3% y-o-y (previous quarter: -1.5% y-o-y) and sales among electrical power companies slowed to 2.2% y-o-y (previous quarter: 2.7% y-o-y) due to the drop in demand for heating. In these sectors, ordinary profits fell as follows: (1) retailers -5.7% y-o-y (previous quarter: 42.7% y-o-y), (2) electrical power companies -17.1% (previous quarter: 23.7%). Judging from the more or less solid performance among other sectors, the slowdown of corporate earnings in the Oct-Dec quarter is most likely due to the warm winter weather which is a transient factor.

Capital investment is still holding up well

Machinery orders (private demand excluding orders for ships and orders by electrical power companies) – a leading indicator of capital investment – are continuing to grow strongly. Given the 3.9% m-o-m rise (previous month: -0.7% m-o-m) in January, the odds are high that the growth of machinery orders in the Jan-Mar quarter will surpass the level in the Oct-Dec quarter of 2006 (2.0% q-o-q). In the Bank of Japan's (BOJ) *Short-Term Economic Survey of Enterprises in Japan (*the *Tankan)* in December 2006, the diffusion index (DI) on production capacity (all-enterprises and all-industries basis) revealed that enterprises feel a shortage of capacity for the first time in approximately 15 years since 1992. Given the ongoing favorable environment surrounding capital investment, there are no signs that the solid growth of capital investment will lose momentum.

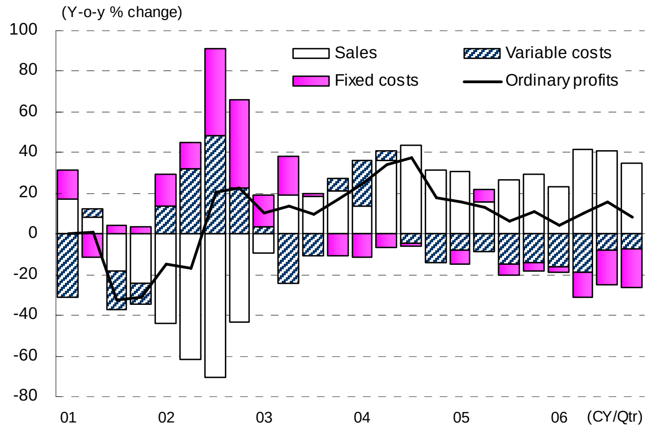
Personal consumption is picking up, due to the fading impact of the warm winter weather

Even though personal consumption grew 1.0% q-o-q in the Oct-Dec quarter, the level itself was not so high, as it only made up for the drop in the Jul-Sept quarter (-1.1% q-o-q). That said, personal consumption is starting to pick up, with the negative impact of the unseasonably warm winter weather starting to fade from the turn of the year. The *Economy Watchers Survey* in February indicates that the DI for both current and future household activity is improving due to the brisk sales of spring clothing (**Chart 4**).

Production fell among manufacturers (mainly automobile makers) in the Jan-Mar quarter

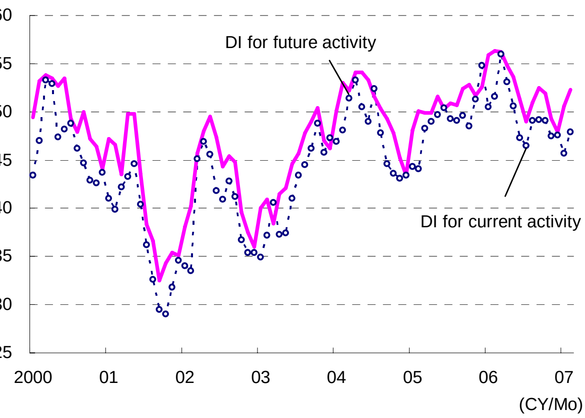
On the supply-side, the odds are high that industrial production will decline for the first time in six quarters in the Jan-Mar quarter. Industrial production fell 1.5% m-o-m in January (previous month: 0.9% m-o-m), declining for the first time in four months. According to estimations on the basis of forecast indexes, production in the Jan-Mar quarter is set to fall 1.0% q-o-q in the Jan-Mar quarter, dropping for the first time in six quarters. The background factors for the production downshift may be traced to: (1) the fact that the transportation equipment industry is subject to a backlash to the year-end increase of production along with the introduction of new car models, and (2) movements suggesting that companies in the electronic parts & devices industry are reducing output in a bid to run down accumulated inventories.

[Chart 3: Ordinary profits]



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

[Chart 4: Household activity-related DI]



Source: Cabinet Office, *Economy Watchers Survey.*

(2) Forecast of the Japanese economy in FY2007 and FY2008

The risks of financial market turmoil are still lingering

Japanese stock prices fell simultaneously with the appreciation of the yen from late February to early March when the global financial markets were rocked in turmoil. The Nikkei stock average fell from the 18,000-yen level to the mid-16,000-yen level at one point and the yen/dollar exchange rate progressed to the 115 yen/dollar level from around the 120 yen/dollar level. Japan's stock market suffered a greater impact in comparison to other parts of the world since the appreciation of the yen accompanying the unwinding of yen carry transactions led to concerns regarding the fall of profits of export-oriented firms. The persistence of sluggish stock prices and the strength of the yen would lead to concerns that the deterioration of corporate earnings and consumer sentiment will dampen domestic demand. The stock market subsequently regained ground to the 17,000-yen level, serving to halt the appreciation of the yen. Since the recent financial market turmoil turned out to be temporary, its impact upon the real economy should be limited. However, there are lingering risks that the financial market turmoil overseas will trigger another bout of yen strengthening and stock market slide through the unwinding of yen carry trades.

Forecast on growth in FY2006 and FY2007 are revised upward

Given the recent revision, we have upgraded our forecast on Japan's economic growth in FY2006 to 2.0% (previous forecast: 1.9%) and 2.0% in FY2007 (previous forecast: 1.9%). The upgrade with respect to FY2006 reflects the current strength of capital investment. Moreover, as mentioned before, companies enjoyed strong business performance with the exception of sectors subject to the adverse effect of the warm winter weather. Turning to FY2007, corporate profits should continue to increase at a pace around 5% y-o-y (**Chart 5**) despite the moderation of profit growth due to the stagnation of exports and rise of labor costs in the first half of the fiscal year. We have thus revised upward our view on capital investment in FY2007 considering the strength of corporate business performance.

Forecast on growth in FY2008 remains unchanged from our previous outlook (2.4%)

Our forecast on the first half of FY2007 remains unchanged that growth will shift down due to the stagnation of exports and inventory adjustment in the IT sector. The trends in export volume provide evidence that exports are slowing down, with the exception of the sharp rise of China-bound exports because of the timing of the Chinese New Year (**Chart 6**). Even so, corporate capital investment will continue to grow, reflecting the strength of corporate business performance. Furthermore, the currently stagnant nominal wages should pick up from April along with the *shunto* (spring labor negotiation) wage hikes and serve as a driver to the recovery of consumer spending. The Japanese economy should start to show more definite signs of an autonomous recovery from the second half of FY2007 when exports regain momentum along with the recovery of the overseas economies. Our forecast remains unchanged that growth in FY2008 will reach 2.4% (previous forecast: 2.4%) given the well-balanced contribution by personal consumption, capital investment and external demand.

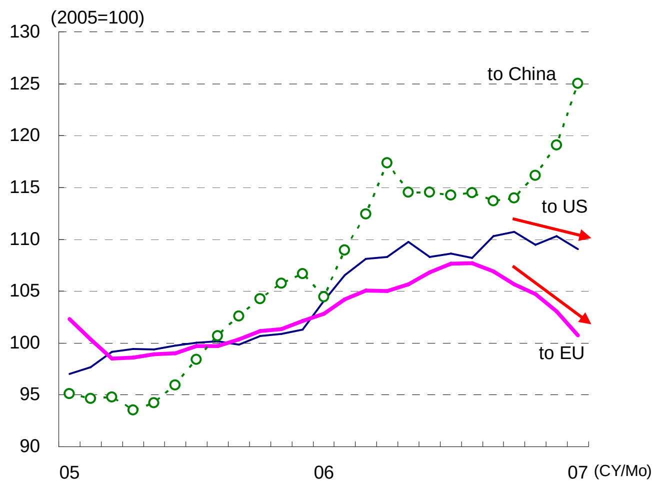
[Chart 5: Corporate profits (forecast)]

(Y-o-y % change)

			FY2005	FY2006 (Forecast)	FY2007 (Forecast)	FY2008 (Forecast)
Total		Sales	4.6	6.7	3.7	6.9
		Ordinary profits	8.4	9.2	4.9	6.3
	Manufacturing	Sales	6.1	5.2	3.4	7.5
		Ordinary profits	12.4	12.1	4.9	7.1
	Non-manufacturing	Sales	3.9	7.4	3.8	6.6
		Ordinary profits	5.7	7.1	4.8	5.8
Large corporations		Sales	6.5	5.5	4.1	7.4
		Ordinary profits	13.9	12.2	5.2	7.0
	Manufacturing	Sales	7.1	6.6	3.8	8.0
		Ordinary profits	14.7	13.9	5.1	7.2
	Non-manufacturing	Sales	6.0	4.6	4.4	7.0
		Ordinary profits	13.0	10.4	5.3	6.7
Small and medium-sized corporations		Sales	3.2	7.6	3.4	6.4
		Ordinary profits	2.4	5.5	4.4	5.6

Note: "Large corporations" refer to corporations with capital of 1 billion or over, "medium-sized corporations" refer to corporations with capital of 100 million to 1 billion yen, "small corporations" refer to corporations with capital of 10 to 100 million yen.
Source: Ministry of Finance, *Financial Statement Statistics of Corporations,Quarterly.*

[Chart 6: Trends in export volume]



Note: Seasonally adjusted, 3mma. Seasonal adjustments by MHRI (X-12).
Source: Ministry of Finance, *Summary Report on Trade of Japan.*

【 Chart 9: Outlook on the Japanese economy (FY) 】

(%)

	FY2005 (Actual)	FY2006 (Forecast)	FY2007 (Forecast)	FY2008 (Forecast)	FY2005 (Contribution) (Actual)	FY2006 (Contribution) (Forecast)	FY2007 (Contribution) (Forecast)	FY2008 (Contribution) (Forecast)
GDP (real)	2.4	2.0	2.0	2.4	-	-	-	-
Domestic demand	1.9	1.4	1.8	2.1	1.9	1.4	1.7	2.0
Private sector demand	2.4	2.2	2.1	2.5	1.8	1.6	1.6	1.9
Personal consumption	1.9	0.7	1.6	1.7	1.1	0.4	0.9	0.9
Housing investment	-1.0	0.6	0.7	-0.9	-0.0	0.0	0.0	-0.0
Capital investment	5.7	8.4	4.5	5.6	0.8	1.3	0.7	0.9
Public sector demand	0.4	-1.2	0.6	0.7	0.1	-0.3	0.1	0.1
Government consumption	0.9	1.0	1.5	1.9	0.2	0.2	0.3	0.3
Public investment	-1.4	-9.7	-3.3	-4.7	-0.1	-0.4	-0.1	-0.2
Net exports (contribution)	0.6	0.7	0.3	0.3	0.6	0.7	0.3	0.3
Exports	9.0	7.3	4.1	6.2	1.2	1.0	0.6	0.9
Imports	6.0	3.2	2.8	5.3	-0.6	-0.4	-0.3	-0.6
GDP (nominal)	1.0	1.3	2.0	2.6				
GDP deflator	-1.4	-0.7	-0.0	0.2				
Industrial production	1.6	4.4	2.6	3.4				
Unemployment rate	4.4	4.1	3.7	3.5				
Current account balance (trillion yen)	19.1	20.4	22.8	23.5				
as a percentage of nominal GDP)	3.8	4.0	4.4	4.4				
Domestic corporate goods prices	2.1	2.9	0.8	1.3				
Consumer prices	-0.1	0.1	0.2	0.5				
Long-term interest rate (%)	1.42	1.75	1.88	2.16				
Nikkei stock average (yen)	13,549	16,400	17,900	18,600				
Exchange rate (yen/dollar)	113.2	117	118	116				
Crude oil price (WTI $/barrel)	60.0	64.9	54.7	57.8				

Notes: 1. FY = rate of change from the previous year.
2. Consumer prices = nationwide (excluding fresh foods).
3. 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 10: Outlook on the Japanese economy (half-year)** 】

(%)

	FY2005		FY2006		FY2007	
	1H (Actual)	2H (Actual)	1H (Actual)	2H (Forecast)	1H (Forecast)	2H (Forecast)
GDP (real)	1.6	1.1	0.7	1.6	0.6	1.2
Domestic demand	1.4	0.5	0.6	1.3	0.7	1.0
Private sector demand	1.7	0.8	1.1	1.4	0.8	1.2
Personal consumption	1.7	0.6	0.0	0.7	0.8	0.9
Housing investment	-1.7	2.4	-1.7	2.3	-0.1	-0.7
Capital investment	3.4	1.3	5.6	4.1	1.4	2.2
Public sector demand	0.4	-0.7	-1.2	0.7	0.2	0.2
Government consumption	0.5	-0.6	1.0	0.7	0.8	0.8
Public investment	0.5	-1.0	-9.3	0.6	-2.2	-2.3
Net exports (contribution)	0.3	0.6	0.2	0.3	0.0	0.2
Exports	4.7	6.6	3.0	2.0	1.4	3.4
Imports	2.8	2.4	2.1	-0.1	1.7	2.3
GDP (nominal)	0.7	0.5	0.4	1.3	0.6	1.5
GDP deflator	-1.2	-1.5	-0.9	-0.6	-0.3	0.3
Industrial production	0.3	2.8	1.6	2.4	0.3	2.6
Unemployment rate	4.4	4.3	4.1	4.0	4.0	3.5
Current account balance (trillion yen)	17.9	20.2	18.7	22.2	21.0	24.6
as a percentage of nominal GDP	3.6	4.0	3.7	4.3	4.1	4.7
Domestic corporate goods prices	1.7	2.5	3.3	2.6	0.8	0.7
Consumer prices	-0.1	-0.1	0.1	0.1	0.1	0.2
Long-term interest rate (%)	1.29	1.54	1.80	1.70	1.80	1.95
Nikkei stock average (yen)	11,797	15,300	15,900	16,900	17,500	18,300
Exchange rate (yen/dollar)	109.4	117.1	115.4	119	118	118
Crude oil price (WTI $/barrel)	58.2	61.8	70.6	59.2	54.6	54.8

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.*

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Mizuho Research Institute Ltd. Makoto Ono, Senior Economist makoto.ono@mizuho-ri.co.jp

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