Economic Outlook for FY2007 and FY2008

May 2007

The Mizuho Research Institute Ltd. (MHRI) has revised its economic outlook for FY2007 and FY2008 subsequent to the release of Japan's GDP statistics 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 2.4% (previous outlook) → 2.1% (current outlook)

2008 3.0% (previous outlook) → 2.4% (current outlook)

<The Japanese Economy>

FY2007 Despite a slowdown in the first half of the fiscal year, the economy will gradually pick up in the second half of FY2007

Real GDP: 2.0% (previous outlook) → 2.1% (current outlook)

Nominal GDP: 2.0% (previous outlook) → 1.9% (current outlook)

FY2008 Continuation of a self-sustained recovery

Real GDP: 2.4% (previous outlook) → 2.1% (current outlook)

Nominal GDP: 2.6% → 2.7% (current outlook)

Mizuho Research Institute

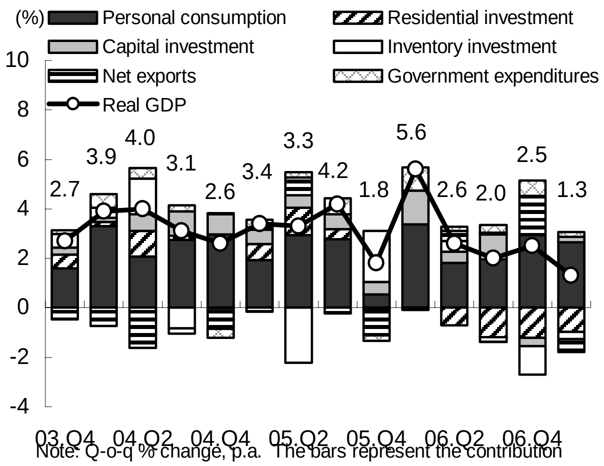
I. The current state of the US economy

US real GDP slowed to a lull in the Jan-Mar quarter of 2007

US gross domestic product (GDP) in real terms grew 1.3% q-o-q p.a. in the Jan-Mar quarter of 2007 ("advance" estimates as of April 27th), slowing sharply from the previous quarter (2.5% q-o-q p.a.) (**Chart 1**). Despite the ongoing strength of consumer spending and signs of recovery in capital investment, the continuation of the correction in residential investment and inventory adjustment, weak exports and the fall of defense spending served as a drag upon the pace of US growth.

Judging from the subsequent data releases since the advance estimates (the final March results of various indicators and revised data on January and February), the odds are high that the preliminary real GDP estimates (to be released on May 31st) will be revised downward to approximately 0.5% q-o-q p.a., dragged down mainly by downward revisions of residential investment, inventory investment and external demand. As far as the GDP statistics are concerned, the US economy slowed to a lull in the Jan-Mar quarter of 2007.

[Chart 1: US real GDP growth]



Note: Q-o-q % change, p.a. The bars represent the contribution to the line.
Source: US Department of Commerce.

Q-o-q % ch, p.a.	2007.Q1	Contribution	2006.Q4
Real GDP	+1.3	−	+2.5
Personal consumption	+3.8	+2.66	+4.2
Residential investment	-17.0	-0.97	-19.8
Capital investment	+2.0	+0.21	-3.1
Inventory investment	+14.8	-0.30	+22.4
Net exports	-597.8	-0.52	-582.6
Exports	-1.2	-0.14	+10.6
Imports	+2.3	-0.37	-2.6
Government expenditures	+0.9	+0.18	+3.4
Domestic final demand	+2.0	−	+1.9
GDP deflator	+4.0	−	+1.6

Note: The q-o-q % change (p.a.) of inventory investment and net exports are expressed as the level (unit: billion dollar).
Source: US Department of Commerce.

Sanguine signs in the corporate sector

That said, movements since April signal that the corporate sector, which has thus far shown signs of weakness, is regaining momentum. In addition to the improvement of the April ISM indexes from the month before both among manufacturers and nonmanufacturers, the May *Empire State Manufacturing Survey* (monthly survey of manufacturers conducted by the Federal Reserve Bank of New York) confirmed the improvement of business confidence. According to the survey, both the future capital expenditures index and the future technology spending index posted significant gains, serving as fresh evidence to support the recovery of capital investment indicated by the capital goods orders in March.

There are also signs of improvement in production activity. In particular, the production of automobile-related parts has recovered to levels at the end of last year, amid the progress of inventory adjustment. Furthermore, the production index in the IT sector is continuing to post solid advances.

Consumer spending is coming to a pause despite strong employment conditions

Employment conditions in the US remain firm. Even though April nonfarm payrolls increased a modest 88 thousand workers from the previous month, slowing when averaging the past three months (118 thousand workers m-o-m per month), a sharp fall of initial jobless claims in May suggest that the labor market remains tight.

Even amid these conditions, sales among retailers fell 0.2% m-o-m in April. In addition to the drop of automobile sales, core retail sales (excluding gasoline, gardening and construction materials) remained flat from the previous month. The weakness – evidenced mainly in retail sales of clothing, sporting goods and department store sales – is perceived as a backlash to the strength of consumer spending in the Jan-Mar quarter. Even so, it is necessary to keep a close eye upon the weakness in some indicators gauging consumer confidence reflecting the surge of gasoline prices and the possibility that real purchasing power may decline sharply due to inflation in the Apr-Jun quarter.

2007 growth revised down from 2.4% to 2.1%, 2008 growth revised down from 3.0% to 2.4%

Despite the emergence of brighter signs in the US economy, we have revised our scenario that the US economy will pick up from mid-2007. In our new outlook, we have made substantial downward revisions to US growth in both 2007 and 2008. While the current bullish news will lead to a recovery in the Apr-Jun quarter, they will not prove long-lasting.

[Chart 2: Outlook on the US economy]

(%)

	2006 (Actual)	2007 (Forecast)	2008 (Forecast)	2006		2007 (Forecast)		2008 (Forecast)	
				1H	2H	1H	2H	1H	2H
GDP	3.3	2.1	2.4	3.9	2.2	1.9	2.3	2.4	2.6
Personal consumption	3.2	3.2	2.5	3.2	3.1	3.5	2.7	2.5	2.3
Residential investment	-4.2	-17.5	-13.3	-3.2	-17.1	-17.3	-18.3	-14.8	-4.4
Capital investment	7.2	2.6	1.1	9.1	5.2	1.9	1.4	-0.5	4.0
Inventory investment (($100 million)	432	172	429	475	389	168	176	377	481
Government expenditures	2.1	2.1	2.8	2.4	1.9	1.9	2.5	2.9	3.0
Net exports ($100 million)	-6181	-5742	-5382	-6304	-6057	-5903	-5581	-5354	-5410
Exports	8.9	6.0	7.4	10.9	7.6	4.1	8.1	7.9	5.7
Imports	5.8	1.8	3.4	8.1	2.4	1.2	2.2	3.2	4.7
Domestic final demand	2.9	1.8	1.8	3.2	1.9	1.9	1.6	1.6	2.4
Core personal expenditures deflator <y-o-y ch>	2.2	2.2	2.1	2.1	2.3	2.2	2.2	2.2	2.0
Current account balance ($100 million)	-8,567	-7,366	-6,551	-4,315	-4,252	-3,881	-3,485	-3,276	-3,275
<as a percentage of nominal GDP>	-6.5	-5.3	-4.5	-6.6	-6.4	-5.6	-4.9	-4.5	-4.4

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.

Our new scenario predicts "a prolonged correction of the housing market, serving as a drag upon a full-fledged recovery of the US economy". Amid the lack of a significant rise in demand for new homes, efforts to reduce inventories will persist, leading to the prolonged decline of investment activity. The commencement of restructuring efforts in the construction sector will ripple through to other sectors including personal consumption, providing us with reasons to believe that the US economy will continue to chart slow growth. We have revised down our forecast on US real GDP growth in 2007 from 2.4% to 2.1% and growth in 2008 from 3.0% to 2.4% (**Chart 2**).

The main points of our outlook are as set forth below.

The residential investment downturn will persist for a longer-than-expected period. In the backdrop is a massive glut of unsold homes

Residential investment has been falling since mid-2006. Housing starts and permits have dropped to 1423 thousand units p.a. in April, reaching such low levels for the first time since mid-1997 (**Chart 3**).

In the backdrop is a sharp rise of the inventory ratio both with respect to new and existing homes. Note that builders had 7.8 months' supply of new homes in March, indicating that home builders are subject to inventory adjustment pressures of a magnitude last experienced in the early 1990s. Despite anecdotal evidence that large-scale discounts are stimulating demand, the key point here are the trends in existing homes which compete with new homes. According to the National Association of Realtors, there were 3.75 million homes for sale as of March. The US Department of Commerce also reported that there were 2.18 million "vacant homes for sale" (including new homes) as of March. This represents the largest inventory glut since the commencement of statistics on home sales in 1955.

Moreover, the existence of a large number of relatively lower-priced existing homes will tend to serve as a drag upon demand for new homes. The slumping sales of new homes in contrast to the stable sales of existing homes serves as evidence to back our views that "despite the existence of factors supporting home purchases such as the increase in number of households and the rise of income, new homes - which are comparatively expensive - are finding it difficult to attract buyers". Although both new and existing homes will come under discounting pressures in times of a housing market downturn, such trends will fall short of eliminating the price gap between new and existing homes.

Keeping residential investment even at current levels would only serve as a major drag upon home builders' earnings, leading to our view that residential investment will continue to fall until the inventory ratio drops sharply.

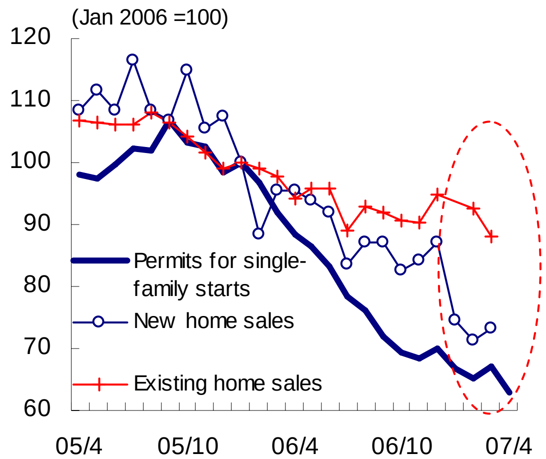
Construction-related firms will start to shed workers after the end of the housing season (the summer), subsequently spilling over to other sectors

Amid prospects that the fall of residential investment will persist, the next question is the outlook on construction-related employment and its impact.

Even though construction investment including residential investment has fallen by 6% from the peak, there have been no related layoffs thus far (**Chart 4**). However, such a situation is clearly a rare phenomenon. Assuming that residential investment will continue to decline, the fall of related employment will be inevitable. In fact, labor productivity in the construction sector has already declined to approximately -6% y-o-y. The labor hoarding in the construction sector is serving as a major drag upon corporate profits, making it difficult for companies in this sector to postpone layoffs any further. Plans to reduce workers are increasing steadily among construction companies, providing us with reason to believe that companies will start to shed excess workers this summer around the end of the peak season in the housing market.

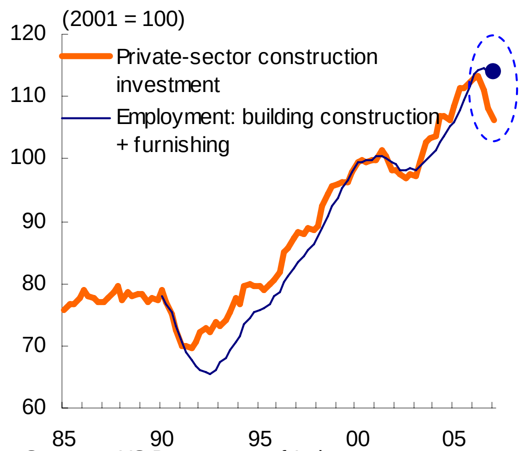
Considering the share of construction-related jobs, nonfarm payrolls should be reduced by approximately 30 thousand workers per month as a result of layoffs in the construction sector, in comparison to a case where there are no construction sector layoffs. The downturn of residential investment and related layoffs will slow down the rate of overall employment growth, leading to a gradual rise of the unemployment rate. Looking forward, prospects of strong consumer spending as experienced thus far will gradually ebb, delaying the full-fledged recovery of the US economy.

[Chart 3: US housing starts and sales]



Sources: US Department of Commerce,
National Association of Realtors.

[Chart 4: Construction spending and jobs]



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

Core inflation will remain pinned at a high level

The US economy will continue to grow at a sluggish pace, gradually leading to the decline of inflationary pressures from the perspective of the output gap. That said, core inflation will likely trend around the upper end of the price stability zone because of the high level of energy prices.

The rate of core personal consumption expenditures (PCE) deflator favored by the Federal Reserve Board as a measure of inflation fell to 2.1% y-o-y in March. Since the core CPI only rose a modest 0.2% m-o-m in April as a result of price discounts on clothing, the core PCE deflator is expected to rise 2.1% y-o-y in April.

While the core PCE deflator is nearing the range perceived as the price stability zone by the Fed (+1%~+2%), the future course of events is still uncertain. This stems from the rise of core inflation as a result of higher crude oil prices. The tightening of the supply-demand balance of crude oil products and the expansion of overseas economies such as China will likely keep oil prices pinned at a high level, thus serving as upward pressures upon the core inflation rate. Our outlook forecasts that the core inflation rate will continue to trend slightly higher than the price stability zone during 2007.

The potential rate of US economic growth and the Fed's monetary policy stance

Based upon our outlook that the US economy will slow down and that core inflation will remain high, the Fed will have a more difficult time conducting monetary policy.

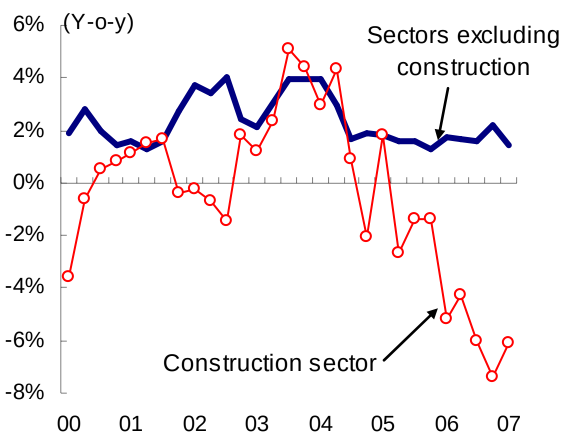
The Fed has kept its policy interest rate, the federal funds rate, unchanged since August 2006. In the statement released after its policy-setting Federal Open Market Committee (FOMC) meeting in May, the Fed continued to take a cautious stance on inflation while downgrading its assessment of the economy. Even though the words "additional firming" had already been eliminated, providing more flexibility in monetary policy, it is still premature at this juncture to say for certain that the core inflation rate will decline as expected by the Fed.

Model simulations by the Mizuho Research Institute (MHRI) revealed that monetary policy will remain unchanged for some time, but will be followed by a minor interest rate cut in the second half of 2007. Considering the slower-than-expected recovery of the US economy, the odds are high that the Fed will fine tune its monetary policy stance some time in the second half of the year. Even so, the Fed will be faced with a difficult choice since the question rests upon a matter of confidence in monetary policy – namely whether such a monetary policy decision may be implemented when the core inflation rate is pinned at a high level.

The crucial point is the possibility that "the potential rate of economic growth is declining due to structural factors" may not be eliminated. With the exception of the construction sector which is undergoing a correction, GDP-based labor productivity has not changed much since 2005 (**Chart 5**). Since demographic shifts and trends in labor participation rates do not provide evidence that the labor supply is declining (**Chart 6**), a structural decline of the potential economic growth rate is not evident as far as current conditions are concerned.

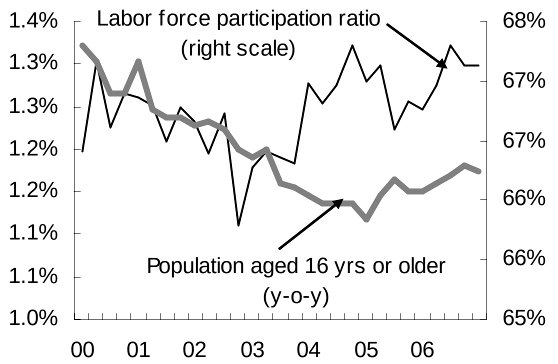
That said, if the structural decline of the potential growth rate is indeed occurring contrary to observed facts, the output gap will remain tight and inflationary pressures will persist despite the economic slowdown. Monetary easing based upon (1) an optimistic assessment that the potential rate of economic growth is higher than its original level and (2) stress upon the downside risks to the economy, would lead to the rise of inflation expectations in the future. Since such risks must be avoided at all costs, given the central bank's ultimate task to maintain price stability, all eyes will be focused upon the future course of monetary policy.

[Chart 5: Labor productivity (by sector)]



Sources: Estimates based upon US Department of Commerce and US Department of Labor.

[Chart 6: Shifts in population and labor force participation ratio]



Note: Gap accompanying population estimates revised for 16-or-older population from 1990 onward.
Sources: US Department of Labor, Haver Analytics.

II. The Japanese economy

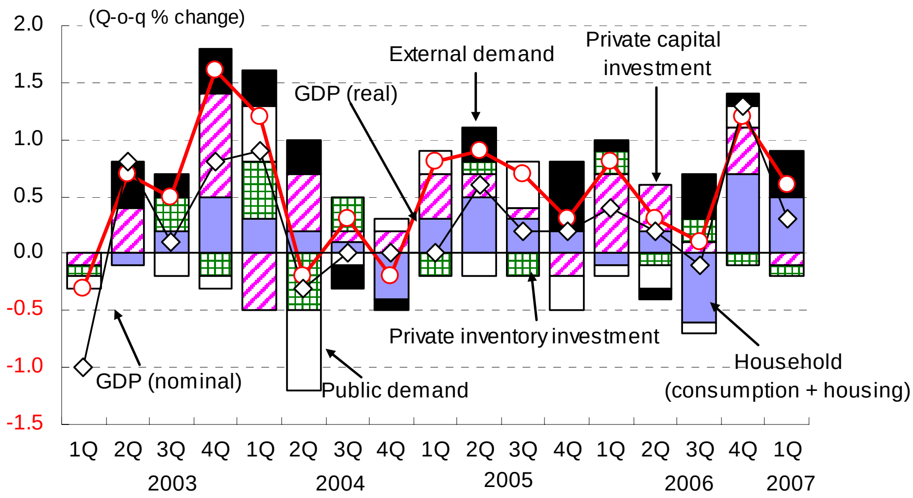
(1) The current state of the economy

The Japanese economy grew a solid 0.6% q-o-q (2.4% q-o-q p.a.) in the Jan-Mar quarter of 2007

Japan's real GDP grew 0.6% q-o-q (2.4% q-o-q p.a.) in the Jan-Mar quarter of 2007, surpassing the potential growth rate estimated to be slightly below 2% for two quarters in a row (**Chart 7**). Despite concerns regarding a backlash from the strength in the Oct-Dec quarter of 2006, growth in the Jan-Mar quarter of 2007 held up well, driven mainly by personal consumption and external demand.

Looking closer at each of the components of demand, personal consumption (0.9% q-o-q) continued to achieve solid growth subsequent to the Oct-Dec quarter of 2006 (1.1% q-o-q). Capital investment, the second pillar of domestic private demand, fell 0.9% q-o-q, dropping for the first time in five quarters. Given the strong growth of exports (3.3% q-o-q) in contrast to the sluggish rise of imports (0.9% q-o-q), external demand served as a strong driver of growth (0.4% pt). As a result of a slight ebb of both public investment and government final consumption expenditures (-0.1% q-o-q), the contribution to Japan's growth by public demand contracted (-0.0% pt). Moreover, since private inventory investment grew at a slower pace, its contribution to growth stood at -0.1% pt. Viewed overall, growth in the Jan-Mar quarter may be described primarily as external demand-driven.

[Chart 7: Japan's quarterly GDP growth]



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

The negative GDP deflator contracted

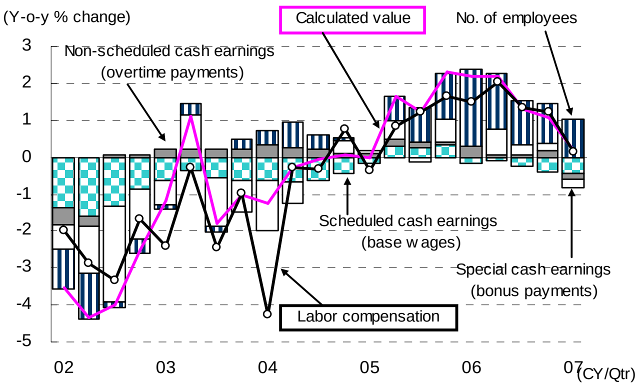
The GDP deflator, a broad measure of price changes, rose to -0.2% y-o-y from -0.5% y-o-y in the previous quarter. Even though the personal consumption deflator fell -0.7% y-o-y, falling further into negative territory (-0.3% y-o-y in the Oct-Dec quarter of 2006), the capital investment deflator (0.3% y-o-y → 0.7% y-o-y), the residential investment deflator (2.2% y-o-y → 2.3% y-o-y) and the public investment deflator (0.9% y-o-y → 1.1% y-o-y) all rose higher, reflecting the higher price of materials. The rate of nominal GDP growth stood at 0.3%

q-o-q (1.2% q-o-q p.a.), falling below the rate of growth in real terms.

Labor compensation slowed sharply

According to data on labor compensation in the Jan-Mar quarter released simultaneously with the GDP statistics, labor compensation rose 0.2% y-o-y (1.2% y-o-y in the Oct-Dec quarter), slowing down to the level in the previous year (**Chart 8**). Even though the number of employees is continuing to increase at a rate of approximately 1% y-o-y, nominal wages were pushed further into negative territory from around the turn of the New Year. Despite the recovery of personal consumption for two consecutive quarters, doubts remain regarding the sustainability of personal consumption from the Apr-Jun quarter onward.

[Chart 8: Labor compensation]

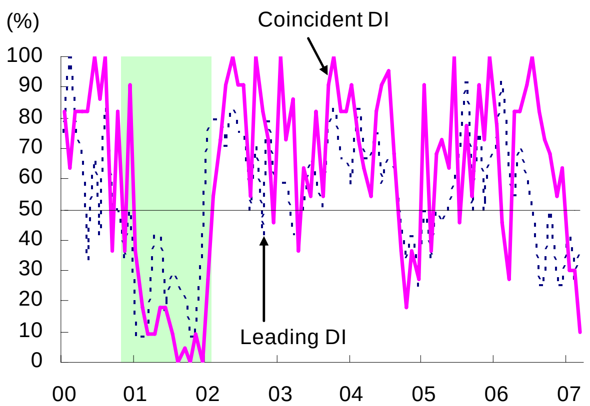


Note: Calculated value = nominal w ages x no. of employees. The bars represent the contribution to the line.
Sources: Ministry of Health, Labor and Welfare, *Monthly Labor Survey*,
Ministry of Internal Affairs and Communications, *Labor Force Survey*,
Cabinet Office, *Annual Report on National Accounts*.

The *Indexes of Business Conditions* tell a different story

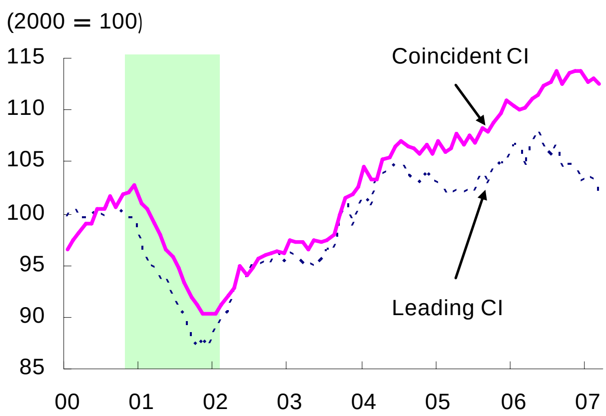
While Japan's GDP statistics reveal that the economy continued to grow steadily in the Jan-Mar quarter, the *Indexes of Business Conditions* indicate that the economy is slowing down. The diffusion index (DI) of coincident indicators fell below the boom-or-bust threshold of 50% for three months in a row up to March and the DI of leading indicators also fell short of 50% for nine consecutive months since July (**Chart 9**). The composite index (CI) of coincident indicators – gauging the level of the economy – is also following a downward path since

[Chart 9: Diffusion Index of business indicators]



Source: Cabinet Office, *Indexes of Business Conditions.*

[Chart 10: Composite Index of business indicators]



Source: Cabinet Office, *Indexes of Business Conditions.*

peaking in December 2006 (**Chart 10**). As far as the *Indexes of Business Conditions* are concerned, the Japanese economy slowed down in the Jan-Mar quarter.

The contradiction can be explained by the higher value-added of IT-related products

Why do the GDP statistics and the *Indexes of Business Conditions* tell a contradicting story of the Japanese economy? One of the plausible reasons is that there is a gap between growth in terms of quantity and growth on a value-added basis. As we mentioned above, growth was driven by personal consumption and exports in the Jan-Mar quarter. Looking closer at personal consumption, durable goods consumption grew a strong 3.4% q-o-q, serving as a driver of overall consumer spending. The strong growth of durable goods consumption and exports on a real value-added basis stems largely from the higher value-added of IT-related products. In the event of technological advance – such as flat-panel TV screens growing larger and personal computers being equipped with more advanced features – the real value-added calculated of IT-related products turns out to be slightly higher due to the fall of the price index even in the absence of a change in the actual unit purchase price or export price. Our presumption is that the higher value-added of IT-related products served to push up Japan's real GDP. That said, considering that the actual volume of exports was virtually flat and that the volume of durable goods consumption in the household sector did not seem to rise as much in terms of a value-added basis, we are inclined to believe that corporate business sentiment was not as sanguine as the GDP statistics suggest, as shown by the deterioration of the business conditions DI among manufacturers in the Bank of Japan's (BOJ) *Short-Term Economic Survey of Enterprises in Japan (TANKAN)* in March.

The economy is slowing to a lull

It is difficult to say which is a better measure of the actual state of the economy; growth in terms of quantity or growth in terms of value-added. However, as far as the reference dates of business cycles are concerned, peaks and troughs are determined on the basis of the *Indexes of Business Conditions.* Thus, it would be appropriate to say that the economy slowed down in the Jan-Mar quarter on the basis of the *Indexes of Business Conditions*. According to the Cabinet Office, "a lull (*odoriba*)" is defined as a "period of stagnation without expansion for several months during an ongoing expansion cycle". Furthermore, the Cabinet Office also says that "the DI readings may fall below 50% for several months even when each of the individual economic indicators are more or less flat". This definition provides us with reason to believe that the Japanese economy eased into a "lull" in the Jan-Mar quarter of 2007.

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

Stagnation expected in the first half of FY2007

The Japanese economy is predicted to stay in a lull (slow down) in the first half of FY2007. In addition to forecasts that exports will slow down due to a larger impact from the US economic slowdown, production activity is poised to flatten out, as the IT sector continues to adjust its inventory level.

Although there are rising concerns regarding a slowdown of capital investment due to a sharply lower outlook on machinery orders in the Apr-Jun quarter, the downside risks regarding personal consumption are larger. According to the FY2007 capital investment plans in the March *TANKAN* survey, both manufacturers and nonmanufacturers are planning to increase spending in the first half of the fiscal year. Moreover, even though capital investment fell in the Jan-Mar quarter, this was due partially to orders in FY2006 being postponed to FY2007 because land and machinery could not be procured in time, meaning that capital investment may rise further in the first half of FY2007. Since the sharp fall of machinery order forecasts stems from cautious estimations by machinery manufacturers at the beginning of the fiscal year and does not present a fundamental shift, capital investment should return to an upward trajectory from the Apr-Jun quarter onward.

Downward risks to personal consumption in the first half of FY2007

It now appears difficult for personal consumption to keep its recovery momentum after two consecutive quarters of strong growth. Since the strength of consumer spending in the Oct-Dec quarter was due to a rebound from the slumping summer months and that consumer spending in the Jan-Mar quarter owes its strength to a temporary fall of income tax burdens accompanying the transfer of tax revenues from the central to local governments. Looking beyond the Apr-Jun quarter, in addition to the lackluster rise of wages which serves as the basis for consumer spending, the rise of the local inhabitant tax from June will serve as downward pressures upon disposable income. Our forecast predicts that personal consumption will stagnate in the first half of FY2007 (**Chart 11**).

The economy will start to pick up in the second half of FY2007

That said, it is unlikely that the economic slowdown in the first half of FY2007 will be as serious as a recession. Despite the continuation of US economic growth around the 2% level, Japan’s exports will not suffer serious shortfalls since exports to rapidly growing economies such as China will cover the softness of US-bound exports. As for the IT sector inventory adjustment, the breadth of the adjustment will turn out to be benign amid the growing demand mainly for consumer electronic appliances.

In the second half of FY2007, production activity will start to pick up as the inventory adjustment in the IT sector will run its course. Personal consumption should also emerge out of the doldrums stemming from the rise of household burdens in the summer months and start to grow at a faster pace. However, the rise of personal consumption will be limited due to the slow recovery of wages, as explained in more detail later. We expect the Japanese economy to recover gradually after picking up from the lull up to the first half of FY2007, and grow 2.2% p.a. in the second half of FY2007.

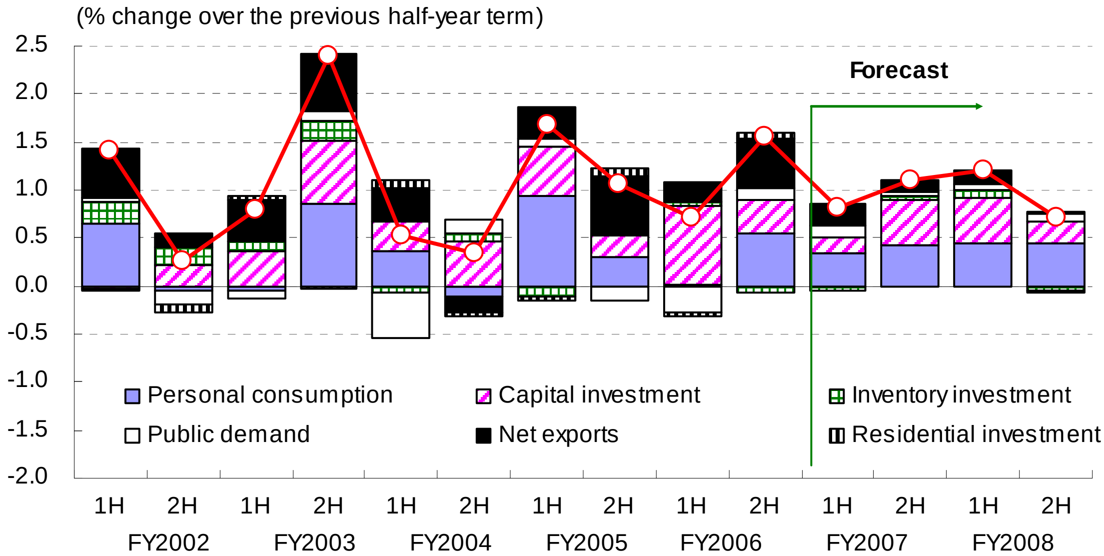
FY2007 real GDP growth: 2.1%

Judging from the foregoing, we expect full-year GDP growth in FY2007 to reach 2.1% in real terms (previous forecast: 2.0%), achieving growth comparable to FY2006. In FY2007, the GDP deflator is predicted to remain in negative territory (-0.2% y-o-y), for the tenth year in a row. As a result, growth in nominal terms is only expected to reach 1.9% (previous forecast: 2.0%), falling below the rate of real economic growth.

FY2008: more definite signs of self-sustained recovery

In FY2008, the Japanese economy is predicted to show more signs of self-sustained recovery, given the rise of personal consumption and capital investment amid the recovery of exports and production activity continuing from the second half of FY2007. The corporate activity expansion should trickle down to the household sector albeit at a slow speed, leading to the rise of personal consumption reflecting the recovery of wages and income. Furthermore, corporate capital investment should also continue backed by the corporate sector's strong performance. Given the well-balanced contribution by personal consumption, capital investment and external demand, the economy should continue to grow at the 2% level in FY2008, reaching 2.1% in real terms (previous forecast: 2.4%) and 2.7% in nominal terms (previous forecast: 2.6%).

[Chart 11: Forecast on Japan's real GDP growth (half-year basis)]

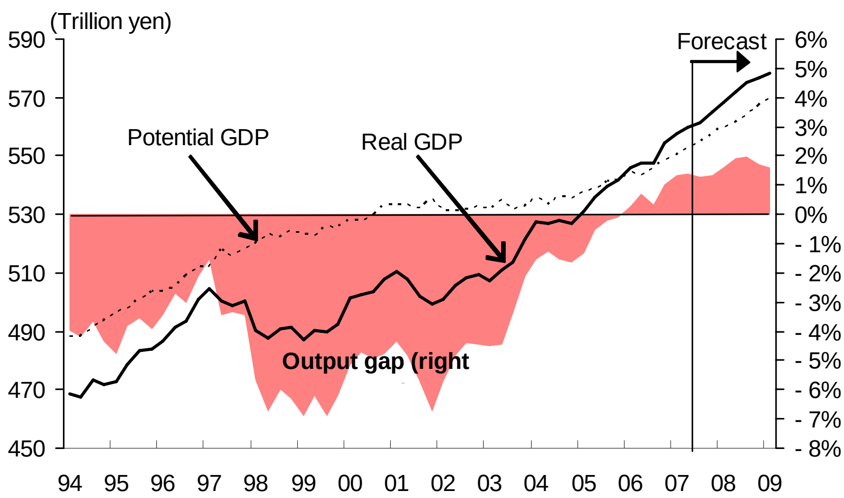


Source: Cabinet Office, *Preliminary Quarterly Estimates of GDP.*

The output gap will widen from the second half of FY2007

The output gap (the gap between demand and supply) estimated by MHRI stood at 1.3% as of the Jan-Mar quarter of 2007 (**Chart 12**). Although the output gap will temporarily contract due to the economic slowdown in the first half of FY2007, the output gap is expected to widen again toward FY2008. When the positive output gap narrows in the first half of FY2007, the risks of a price fall will intensify due in part to forecasts that crude oil prices will fall below year-ago levels. In terms of monetary policy, the situation will make it more difficult for the central bank to step forward with an interest rate hike. However, price fall risks should abate as the positive output gap widens from the second half of FY2007. The GDP deflator should turn positive, reaching 0.6% y-o-y in FY2008, resulting in the reversal of the nominal and real rates of economic growth for the first time in 11 years since FY1997 when the consumption tax was raised.

[Chart 12: The output gap]



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

【Chart 13: Outlook on the Japanese economy (fiscal year basis)】

(%)

	FY2005 (Actual)	FY2006 (Actual)	FY2007 (Forecast)	FY2008 (Forecast)	FY2005 (Contribution) (Actual)	FY2006 (Contribution) (Actual)	FY2007 (Contribution) (Forecast)	FY2008 (Contribution) (Forecast)
GDP (real)	2.4	1.9	2.1	2.1	-	-	-	-
Domestic demand	1.9	1.2	1.7	2.0	1.9	1.1	1.6	1.9
Private sector demand	2.4	1.9	1.9	2.3	1.8	1.4	1.4	1.7
Personal consumption	1.9	0.8	1.5	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	7.2	3.8	5.1	0.8	1.1	0.6	0.8
Public sector demand	0.4	-1.3	0.9	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	-9.2	-2.5	-4.7	-0.1	-0.4	-0.1	-0.2
Net exports (contribution)	0.6	0.8	0.5	0.2	0.6	0.8	0.5	0.2
Exports	9.0	8.3	5.9	5.2	1.2	1.2	0.9	0.8
Imports	6.0	3.4	3.0	5.3	-0.6	-0.4	-0.3	-0.6
GDP (nominal)	1.0	1.3	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	23.0	25.5				
as a percentage of nominal GDP	3.8	4.2	4.4	4.8				
Domestic corporate goods prices	2.1	2.8	0.9	1.3				
Consumer prices	-0.1	0.1	0.1	0.5				
Long-term interest rate (%)	1.42	1.75	1.73	1.86				
Nikkei stock average (yen)	13,549	16,450	18,100	18,600				
Exchange rate (yen/dollar)	113.2	117.0	117	113				
Crude oil price (WTI/barrel)	60.0	64.9	64.0	59.8				

【Chart 14: Outlook on the Japanese economy (half-year basis)】

(%)

	FY2006		FY2007		FY2008	
	1H (Actual)	2H (Actual)	1H (Forecast)	2H (Forecast)	1H (Forecast)	2H (Forecast)
GDP (real)	0.7	1.6	0.8	1.1	1.2	0.7
Domestic demand	0.5	1.0	0.6	1.0	1.1	0.7
Private sector demand	1.1	1.2	0.6	1.2	1.3	0.8
Personal consumption	0.0	1.0	0.6	0.8	0.8	0.8
Residential investment	-1.6	1.9	-0.1	-0.3	-0.5	-0.4
Capital investment	5.4	2.3	1.0	3.0	2.9	1.5
Public sector demand	-1.2	0.5	0.6	0.2	0.4	0.4
Government consumption	1.0	0.4	1.1	0.8	1.0	1.0
Public investment	-9.4	1.4	-1.8	-2.3	-2.4	-2.4
Net exports (contribution)	0.2	0.5	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	1.8	2.3	2.9	2.4
GDP (nominal)	0.3	1.4	0.6	1.3	1.6	0.9
GDP deflator	-1.0	-0.4	-0.4	0.0	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	21.7	23.4	24.7	25.4
as a percentage of nominal GDP	3.7	4.5	4.2	4.5	4.7	4.7
Domestic corporate goods prices	3.3	2.3	0.9	0.8	1.3	1.3
Consumer prices	0.1	-0.0	-0.0	0.2	0.4	0.5
Long-term interest rate (%)	1.80	1.70	1.70	1.75	1.80	1.93
Nikkei stock average (yen)	15,900	17,000	17,900	18,300	18,500	18,700
Exchange rate (yen/dollar)	115.4	118.6	119	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* .

Outlooks on wages and personal consumption are revised downward

The most significant change in view set forth in our latest *Economic Outlook* is that we have revised downward our views on wages and personal consumption in FY2007 and FY2008. Along with the downgrade of our outlook on wages, we have revised downward our forecast on personal consumption growth to 1.5% y-o-y in FY2007 (previous forecast: 1.6% y-o-y) and 1.6% y-o-y in FY2008 (previous forecast: 1.7% y-o-y). Our reasons for the downgrade are as follows.

Wages growth will remain sluggish

Even though nominal wages grew 0.7% y-o-y in FY2005, rising for the first time in five years, the pace of growth slowed to 0.1% y-o-y in FY2006. In particular, scheduled cash earnings (base wages), constituting the major part of wages, fell from 0.3% y-o-y in FY2005 to -0.4% in FY2006, serving as a large impact upon nominal wage growth. Why are wages slumping despite the improvement of corporate business performance and the tightening labor market? The following factors are cited as the plausible causes of the sluggish growth of wages: (1) companies continuing to avoid the rise of labor costs in view of global competitiveness, (2) the retirement of the relatively well-paid baby boom generation of workers, (3) the increase of non-regular workers such as part-time and temporary workers, and (4) the impact of salary cuts among local government workers accompanying the tightening of local government finances.

Of the foregoing factors, corporate awareness of global competitiveness is taking the form of restraints upon wages despite the strength of business performance. Even so, this only serves as an explanation of the slow pace of wage hikes and is not a factor behind the actual fall of scheduled cash earnings in FY2006. As for the rise of the employment ratio of non-regular workers, there is no doubt that it served as a drag upon wages throughout the current economic expansion. Note however that the employment ratio of non-regular workers has been slowing down since the start of FY2006 and that its negative impact upon the overall wage growth is abating. Turning to the baby boom generation of workers, even though these workers have been retiring in droves since the second half of FY2006, its impact upon overall wages is not so large in terms of their weight. The three factors above may not be deemed as the major cause of the fall of scheduled cash earnings in FY2006. On the other hand, the tightening of local government finances appears to have had a certain impact upon the fall of wages.

Weak consumer spending in the summer months last year is the major cause of the current stagnation of wages

Then, what is the major cause of the fall of wages? We scrutinized the *Monthly Labor Survey* to examine which sectors are experiencing the fall of wages. According to the results, the odds are high that the major cause of the current stagnation of wages is the deterioration of business performance among consumer spending-related businesses accompanying the slump of consumer spending last summer.

Chart 15 sets forth the percentage change of scheduled cash earnings (the bulk of nominal wages) according to business establishments classified by their size (in terms of the number of employees). The chart reveals that wages of small establishments (5~29 employees) served as a significant drag (-0.65% pt) upon overall wages in 2006. Furthermore, **Chart 16** sets forth the percentage change of scheduled cash earnings and their contribution to overall wage growth classified by industrial sector. The negative contribution by the four sectors including (1) wholesale and retail trade, (2) eating & drinking places, accommodations, (3) education, learning support, and (4) services not elsewhere classified amounts to -0.64% pt, providing an explanation for the fall of scheduled cash earnings in establishments with 5~29 employees. With respect to establishments engaged in education & learning support services, there is a high possibility that the decline stems from the salary cuts among public school workers accompanying the tightening of local government finances.

[Chart 15: Scheduled cash earnings (y-o-y ch) – contribution by size of business establishments]

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

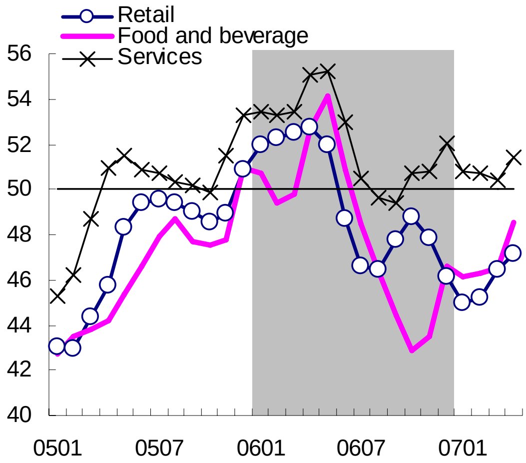
[Chart 16: Scheduled cash earnings of business establishments with 5~29 employees – contribution by industrial sectors]

	Scheduled cash earnings (y-o-y	Ratio in total workers	Contribution to total
All industries	-1.3%	42.0%	-0.68%
Mining	-6.9%	0.1%	-0.00%
Construction	-0.5%	4.5%	-0.02%
Manufacturing	-0.4%	5.3%	-0.02%
Electricity, gas, heat supply and water	-6.8%	0.1%	-0.01%
Information and communications	2.4%	0.8%	0.02%
Transport	0.6%	1.7%	0.01%
Wholesale and retail trade	-1.8%	11.5%	-0.21%
Finance and insurance	-1.3%	1.3%	-0.02%
Real estate	8.5%	0.5%	0.04%
Eating and drinking places, accommodations	-4.6%	4.4%	-0.20%
Medical, health care and welfare	-0.9%	3.5%	-0.03%
Education, learning support	-4.8%	2.5%	-0.12%
Compound services	0.4%	0.6%	0.00%
Services, not elsewhere classified	-2.4%	5.0%	-0.12%
Contribution by the shaded sectors			-0.65%

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

The common characteristic of the remaining three sectors is that they are all related to personal consumption. The wage falls in these sectors stem most likely from the deterioration of business performance due to the stagnation of personal consumption last summer. In these consumer spending-related sectors, we are inclined toward the view that the deterioration of the business environment for small and medium-sized firms also served to aggravate the fall of business performance among establishments with 5~29 employees. In fact, the household activity-related DI (retail, food & beverages and services) in the *Economy Watchers Survey* (a survey of respondents comprised mainly of small and medium-sized business owners) all fell sharply in the summer of 2006 (**Chart 17**).

[Chart 17: Household activity-related DI on current conditions]



Note: 3MMA.

Source: Cabinet Office, *Economy Watchers Survey.*

The ripple effect of the recovery from the corporate to the household sector will be slow

To provide a perspective view on future wage developments, the recovery of personal consumption from the year-end should lead to a gradual abatement of the wage falls in sectors related to consumer spending. Even so, the remaining two factors will still persist. Awareness of global competitiveness in the corporate sector will keep wage growth limited among private enterprises and local government workers' salaries will continue to be slashed. Although the wage hikes resulting from the *shunto* (labor-management wage talks in the spring) in FY2007 should improve from the previous year, the breadth of the improvement is expected to be narrow. Furthermore, the supply-demand balance of full-time workers is not tightening as much as part-time or temporary workers. In view of these underlying factors, the ripple effect of the economic recovery from the corporate sector to the household sector will continue to be extremely slow.

(3) Financial markets

Even though the BOJ's stance on interest rate hike will remain unchanged, stagnant price movements and the US economic slowdown will serve as shackles

The BOJ raised its policy interest rate for the first time in seven months, bringing the target for the uncollateralized overnight call rate to 0.5%, at its Monetary Policy Meeting (MPM) on February 21, 2007. Since the January MPM decided to leave the policy interest rate unchanged by a six-to-three vote among the board members, there were some who expected a policy reversal by a hairbreadth margin. However, Deputy Governor Kazumasa Iwata turned out to be only board member opposed to a rate hike at the February MPM. While the BOJ placed emphasis upon current economic indicators when it decided to forgo an interest rate hike in December 2006 and January 2007, the comments of the MPM members indicate the BOJ's strong desire to normalize interest rates in its decision to raise the policy interest rate in February.

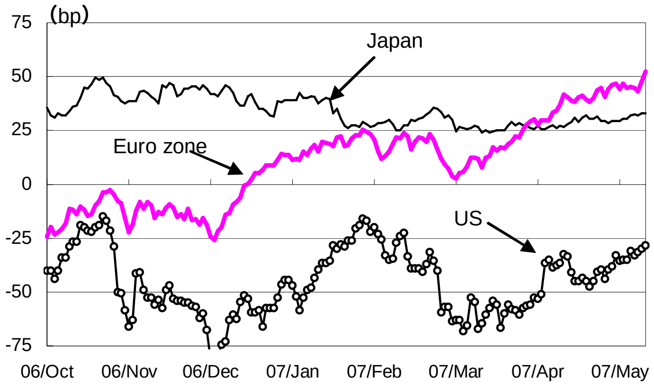
Even though the BOJ's *Outlook for Economic Activity and Prices (April 2007)* raised its concerns regarding the downside risks of the US economy and an inventory adjustment of IT-related goods, the central bank maintained its scenario that the Japanese economy will continue to grow at a pace slightly above its potential. While the BOJ was compelled to revise downward its price forecast due to the current stagnation of prices, it maintained its underlying scenario of a gradual acceleration of prices (**Chart 18**). Despite the absence of major surprises in the recent *Outlook*, the BOJ's adherence to its existing scenario even amid the economic lull and price falls appears to signal its eagerness to normalize interest rates. Given BOJ Governor Toshihiko Fukui's comments that an interest rate hike is possible even when prices are falling, it goes beyond doubt that the BOJ will continue to tighten.

[Chart 18: Forecast medians of BOJ Policy Board Members]

		Oct-06	Apr-07	Change
Real GDP	FY2007	2.1%	2.1%	±0.0%
	FY2008		2.1%	
Domestic CGPI	FY2007	1.2%	0.7%	-0.5%
	FY2008		1.0%	
CPI (excluding fresh food)	FY2007	0.5%	0.1%	-0.4%
	FY2008		0.5%	

Note: Y-o-y change.
Source: Compiled by MHRI on the basis of BOJ, *Outlook for Economic Activity Prices.*

[Chart 19: Change of policy interest rates factored in by short-term money markets]



Note: Breadth between policy interest rates now and at the end of 2007 factored in by interest rate futures market participants.
Source: Bloomberg.

Market attention is gathering around the timing of the next interest rate hike. The short-term money market has more or less factored in an interest rate hike by the end of the year. According to questionnaire surveys, the current consensus is sometime around August to September after the Upper House elections in July (**Chart 19**). However, since the central bank will be compelled to take a cautious stance regarding a rate hike with the fall of prices and the slowdown of both the Japanese and US economies, there is a high possibility that the timing of the rate hike will be later than the consensus. From then onward, we expect an interest rate hike at a pace of once every six months amid the recovery of the economic and rise of prices.

Long-term interest rates will be range-bound and the pace of rise will be extremely low even after a rate hike

The 10-year JGB yield – an indicator of long-term interest rates – is moving in a narrow range around 1.6~1.8%. Despite a temporary drop to the 1.5%-level reflecting the fall of US interest rates subsequent to the global stock market fall, the yield on 10-yr JGBs climbed back to its former range in lockstep with US interest rates as the stock market regained its earlier losses. Market volatility is declining sharply amid (1) the slim prospects that the economy and prices will rise anytime soon, and (2) views that a further interest rate hike is unlikely in the absence of a monetary policy shift.

The long-term interest rate should remain range-bound for the time being as Japan's economic slowdown and price falls are perceived as factors pushing down interest rates while the BOJ's bias toward raising interest rates will serve to curb the fall of interest rates. Although we expect another interest rate hike by the BOJ during the second half of the fiscal year, the rise of long-term interest rates accompanying the interest rate hike should turn out to be limited. Given the prospects of an interest rate cut in the US reflecting the slowing economy, the fall of US long-term interest rates will most likely serve as restraints upon the rise of Japanese interest rates. Looking forward, we expect nominal interest rates to gradually rise along with the rise of both real interest rates and inflation, reflecting the economic recovery and the upturn of prices.

Stock markets will rise, albeit slowly

Even though Japanese stocks are picking up after dropping at the time of the global stock market fall in February, they have not yet recovered to the level prior to the fall. Despite growing perception of Japanese stocks as laggards in comparison to overseas stocks which are recording new highs, it should be noted that the weakness stems in part from cautious outlooks on corporate performance. While the current corporate outlooks on business performance should be revised as the year progresses since the current outlooks are rather conservative due to factors such as presumptions on forex rates, it is also true that investors remain unconvinced of an upward revision amid forecasts of a slowdown of both the Japanese and US economies.

Looking forward, while the topside of the stock market should remain heavy amid prospects of economic slowdown, we expect the stock market to turn upward along with the rise of speculation on the upgrade of corporate performance outlooks. That said, we expect that the pace of the stock market recovery will be sluggish in view of (1) a slower rate of profit growth because of the overseas economic slowdown, and (2) the lack of perception that Japanese stocks are significantly undervalued.

A gradual appreciation of the yen in FY2008

The yen strengthened against the dollar, advancing at one point to 115 yen/dollar, due to the fall of US interest rates stemming from a flight to quality accompanying the global stock market fall and speculation that investors will start to unwind their yen carry-trades. However, the yen subsequently weakened to the current 120 yen/dollar-level reflecting the rise of US interest rates. Furthermore, yen carry-trades appear to be rising in popularity again, given the acceleration of the yen's appreciation against high-yielding currencies such as the Australian dollar, New Zealand dollar and the euro backed by a strong economy and speculation on an interest rate hike.

Although yen-weakening pressures should linger for a while, we expect the yen to strengthen gradually in FY2008. Our view stems from forecasts on an interest rate cut in the US and the end of euro zone interest rate hikes on one hand and the BOJ's gradual interest rate hikes and the contraction of the interest rate differential on the other. Nevertheless, we do not expect the strength of the yen to accelerate since the low interest rate level of the yen remains unchanged and that yen carry-trades will persist given the existence of an absolute interest rate differential.

[Chart 20: Market outlook]

	2007/ Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	2008/ Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	2009/ Jan-Mar
Uncollateralized call (overnight, %)	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.25
Euroyen TIBOR (3-month, %)	0.598	0.665	0.73	0.93	0.98	1.18	1.23	1.43	1.48
Interest rate swap (5-year, %)	1.345	1.445	1.56	1.56	1.61	1.66	1.71	1.86	1.96
Newly-issued JGBs (10-year, %)	1.671	1.673	1.75	1.75	1.75	1.80	1.80	1.90	1.95
Nikkei average (Yen)	17,400	17,700	18,000	18,200	18,300	18,400	18,500	18,600	18,800
Exchange rate (Yen/dollar)	119	120	118	117	115	114	113	112	112

Note: The shaded column refers to actual results. The uncollateralized call rate refers to the end-of-term rates and the rest are averages during the term.

* * * * * * * * *

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

MIZUHO