Economic Outlook for FY2007 and FY2008

February 2007

The following is an abridged English-language translation of the economic outlook for FY2006, FY2007 and FY2008 by Mizuho Research Institute Ltd. (MHRI).

<The US Economy>

	An upturn from the second half of 2007, reflecting the housing market stabilization
2007	2.4% (previous outlook) → 2.7% (current outlook)
2008	3.0%

<The Japanese Economy>

FY2006	Growth dependent upon external demand and capital investment due to weak consumer spending
	Real GDP: 1.9% (previous outlook) → 1.9% (current outlook)
	Nominal GDP: 1.6% (previous outlook) → 1.3% (current outlook)
FY2007	Growth accelerates as the upturn gradually spreads to households
	Real GDP: 1.8% (previous outlook) → 1.9% (current outlook)
	Nominal GDP: 2.5% (previous outlook) → 2.0% (current outlook)
FY2008	The economy enters a self-sustained recovery track
	Real GDP: 2.4%
	Nominal GDP: 2.6%

Mizuho Research Institute

I. The current state of the US economy

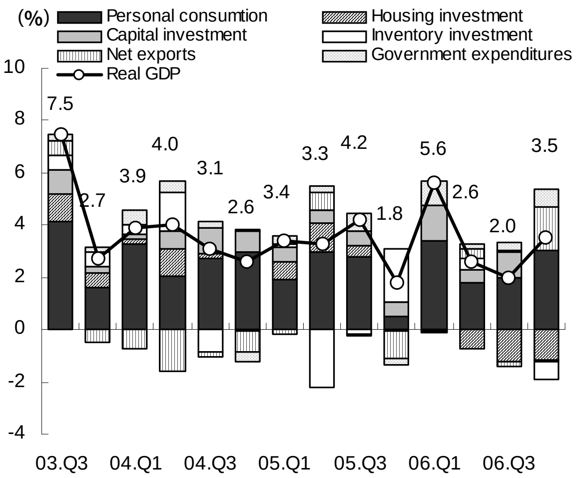
The US economy picked up in the Oct-Dec quarter of 2006, driven by consumer spending and exports

US gross domestic product (GDP) in real terms grew 3.5% q-o-q p.a. in the Oct-Dec quarter of 2006 (preliminary estimates as of January 31st), growing strongly from the previous quarter (2.0% q-o-q p.a.) (**Chart 1**). The strong above-potential growth (potential growth estimated to be around 3%) of the economy may be explained primarily by the strength of personal consumption and solid growth of exports.

The housing market continued to serve as a drag upon growth and capital investment also took a turn for the worse for the first time in 15 quarters. Housing investment fell 19.2% q-o-q p.a. (in real terms), declining at a faster pace. Capital investment also fell slightly (-0.4% q-o-q p.a.) due mainly to a softening of construction-related investment (structures and equipment). Furthermore, the contribution by inventory investment fell sharply (-0.71%), caused principally by inventory and production adjustments among motor vehicle manufacturers.

Consumer spending was stronger than expected, even amid signs of adjustment in the housing and automobile-related sectors. Consumer spending grew a strong 4.4% q-o-q p.a., supported by favorable jobs and income prospects which were driven by tailwinds provided by lower energy-related prices in comparison to the summer season and the strong stock market. Even though the outcome of the Christmas shopping season had been a source of concern, the mild winter weather – also a reason for the fall of crude oil prices – coaxed more shoppers outside, resulting in brisk sales.

[Chart 1: US real GDP growth]



Note: Q-o-q p.a.
Source: US Department of Commerce.

Q-o-q % change (p.a.)	2006.Q4	Contribution	2006.Q3
Real GDP	+3.5	−	+2.0
Personal consumption	+4.4	+3.05	+2.8
Housing investment	-19.2	-1.16	-18.7
Capital investment	-0.4	-0.05	+10.0
Inventory investment	+35.3	-0.71	+55.4
Net exports	-581.4	+1.64	-628.8
Exports	+10.0	+1.08	+6.8
Imports	-3.2	+0.56	+5.6
Government expenditures	+3.7	+0.70	+1.7
Domestic final demand	+2.4	−	+2.0
GDP deflator	+1.5	−	+1.9

Note: The q-o-q % change (p.a.) of inventory investment and net exports represent levels (unit: billion dollar).

Furthermore, given the surge of exports (10.0% q-o-q p.a.) amid the steady expansion of the overseas economies and the sharp fall of imports reflecting the decline of crude oil prices, the contribution by external demand to real GDP growth reached 1.64%, serving to offset the negative impact stemming from the housing market and automobile-related downturn.

The preliminary estimates will likely be revised down by 0.5% pt

Judging from the string of indicators released subsequent to the advanced estimates (data on construction expenditures, inventories and trade), the odds are high that the preliminary real GDP estimates (to be released on February 28th) will be revised downward by approximately 0.5% pt. Even so, the larger picture remains unchanged that personal consumption and exports were the main engines of growth in the last quarter.

2007: growth revised up from 2.4% to 2.7%

Our outlook on the US economy in 2007 has been revised upward from 2.4% to 2.7% (**Chart 2**). Since the revision stems mainly from the fact that the carry-over of growth from 2006 to 2007 reached 1.0% due to an uptick of real GDP growth in the Oct-Dec quarter of 2006, our view remains unchanged that growth in 2007 will slow down in comparison to 2006 (3.4%).

In the first half of 2007, growth in each of the quarters should remain weak around the mid-2% level amid the correction of the housing market and manufacturing sector. However, as mentioned later, the housing market is showing signs of stabilization, providing us with reason to believe that the downward pressures stemming from the housing market downturn will ease during the first half of 2007. The adjustment of inventories and production in the manufacturing sector will also run its course by mid-2007 and the US economy should start to pick up toward the end of 2007.

2008: the US economy will recover to 3.0%, around its potential rate of growth

The recovery momentum from the second half of 2007 should continue in 2008, driving the US economy to 3.0%, close to its potential rate of growth. Even though the baby boom generation (those born during the period from 1946 to 1964) will start to retire in 2008, it will be later than 2008 that its impact in the form of a decline of the potential growth rate will start to emerge.

[Chart 2: Outlook on the US economy]

(%)

	2006 (Actual)	2007 (Forecast)	2008 (Forecast)	2006		2007 (Forecast)	
				1H	2H	1H	2H
GDP	3.4	2.7	3.0	3.9	2.5	2.8	3.0
Personal consumption	3.2	3.1	2.8	3.2	3.2	3.3	2.7
Housing investment	-4.2	-10.7	3.8	-3.2	-16.9	-12.1	-0.5
Capital investment	7.4	4.0	4.2	9.1	5.9	2.9	4.5
Inventory investment ($100 million)	464	420	423	475	454	363	476
Government expenditures	2.1	2.3	2.4	2.4	2.0	2.6	2.2
Net exports ($100 million)	-6,178	-5,791	-5,811	-6,304	-6,051	-5,788	-5,795
Exports	8.9	7.3	6.6	10.9	7.5	7.9	6.2
Imports	5.8	3.0	4.7	8.1	2.3	2.6	4.5
Domestic final demand	3.0	2.3	2.9	3.2	2.0	2.4	2.6
Core personal expenditures deflator <y-o-y ch>	2.2	2.1	2.2	2.1	2.3	2.2	2.1
Current account balance ($100 million)	-8,522	-7,383	-7,139	-4,303	-4,218	-3,756	-3,627
<as a percentage of nominal GDP>	-6.4	-5.3	-4.9	-6.6	-6.3	-5.5	-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.

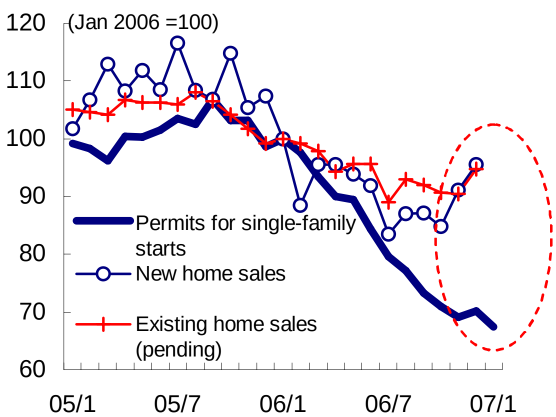
Signs of stabilization in the housing market – gradual improvement despite ongoing downturn

The housing market – thus far serving as a drag upon US economic growth – is starting to show signs of stabilization. Even though the adjustment cycle will continue for some time and downside risks will linger, the current movements ascertain the conventional view that the housing market will gradually start to improve.

Trends in residential sales provide the clearest evidence of the housing market stabilization (**Chart 3**). Sales of new homes picked up for two months in a row in November and December of 2006, recovering to the level last spring. The same trends are also evident with respect to sales of existing homes (on a contract basis). According to a home builders' survey, home sales are continuing to follow a mild recovery even after the turn of the New Year.

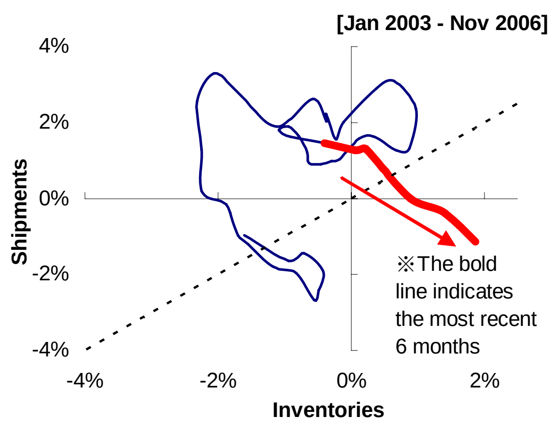
Viewed overall, residential demand appears to be stimulated by the combined effect of the following factors: (1) the maintenance of favorable employment prospects, (2) the rise in perception that homes are now under-valued due to the fall of residential home prices in some areas and sales promotion by residential property sellers, and (3) the fall of mortgage rates after peaking in mid-2006. Even though it would be necessary to wait until the home-buying season in early spring in order to verify the recovery of demand, as indicated in FED Chairman Ben S. Bernanke's semiannual testimony to Congress (February 14, 2007), the clouds hanging over the housing market appear to be lifting.

[Chart 3: US housing starts and sales]



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

[Chart 4: Inventory cycle (manufacturing)]



Note: Real terms, y-o-y % ch of 3MMA.
Source: US Department of Commerce.

On the other hand, the fall of housing starts is expected to continue for some time. From a macroeconomic perspective, the percentage of housing investment (to nominal GDP) has fallen approximately 1% pt from the peak of 6.3% (2005). The excessively high pace of investment is abating and the inventory ratio is showing signs of peaking out. That said, note that both the level of investment and inventories are still high in comparison to past averages, suggesting that the correction will continue for a while.

The manufacturing sector will remain in a lull

The manufacturing sector - mainly housing-related manufacturers and automobile makers – remain in a lull. The manufacturing sector appears to have slipped into an inventory and production adjustment phase since the second half of 2006. In the absence of signs of a lift-off, barring the IT sector which is continuing to expand strongly, the softness should prevail for the time being.

Inventory and production adjustment pressures are rising among manufacturers, as shown by the fact that inventory investment dragged down real GDP growth by approximately 0.7% pt in the Oct-Dec quarter of 2006. The inventory cycle of the manufacturing sector has progressed rapidly from an "inventory buildup" phase to an "inventory adjustment" phase during the past six months (**Chart 4**). The ISM manufacturing index fell below the boom-or-bust threshold of 50 in January. The drop was due to a sharp decline of the inventory index (January 39.9, down 8.6 pt from the previous month), indicating the continuation of inventory adjustment even after the turn of the New Year.

However, note that the progress in inventory adjustment is a positive factor for future production activity. Even though the spread of inventory adjustment should lead to the slowdown of employment, conditions should pick up in the second half of the year.

Jobs and income prospects have held up well. A mild slowdown of jobs and income growth will likely lead to a slower pace of consumer spending

Jobs and income prospects have been stronger than anticipated, underpinning consumer spending growth even amid the housing market correction. However, considering that employment moves more or less in step with or slightly lags overall economic conditions, jobs should start to gradually slow down. The improvement of real purchasing power stemming from the fall of crude oil prices will fade, leading to a mild slowdown of consumer spending growth.

The nonfarm payroll has been growing strongly at a pace of 170 thousand workers per month (3-month average of the period from November to January). Given the ongoing high growth of hourly wages, the wage index (hourly wages multiplied by the total work hours index, a proxy variable of labor compensation) stood at a high level of 5.2% p.a. compared to three months ago (**Chart 5**). A juxtaposition of the wage index to core retail sales provides evidence that the strong growth of labor compensation is underpinning consumer spending.

Despite the slight tightening of current labor market conditions, there are signs that the labor market is easing in certain areas such as the gradual rise of applications for new jobless claims and the gradual rise in number of insured jobless. Given the US economy falling below its potential rate of growth, the pace of jobs growth should gradually slow down. Consumer spending should also slow down slightly along with these changes in labor market conditions.

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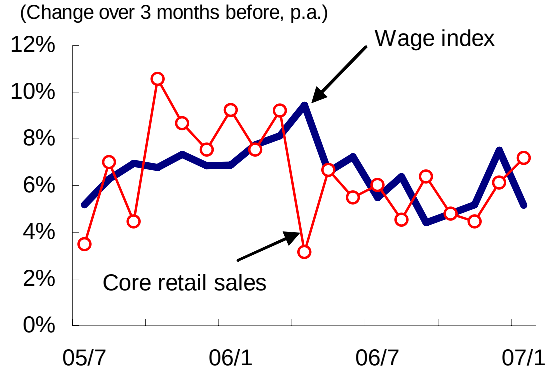
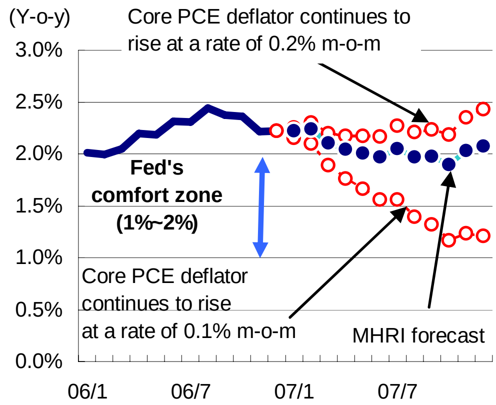
[Chart 5: Employment & income and consumer spending]



Notes: Wage index = hourly wages x total work hours index. Nonfarm private sector.
Core retail sales = retail sales (including services) excluding automobiles, building materials & landscaping and gasoline.
Sources: US Department of Labor, US Department of Commerce.

[Chart 6: The core PCE deflator]



Source: US Department of Commerce.

The US economy will pick up from around mid-2007 to 2008

Personal consumption, the mainstay of US economic growth, has been maintaining momentum along with strength of employment. Even though these trends indicate a higher chance of the economy picking up, we have decided to keep our view unchanged that the US economy will slow down in the first half of 2007. After the housing and manufacturing sector adjustment runs its course by mid-year, the US economy should regain momentum around its potential rate of growth.

Despite a decline of the core inflation rate, it will stay high throughout 2007. Monetary policy will remain unchanged for some time.

As the economy continues to fall short of its potential rate of growth, the decline of the core inflation rate should remain mild and remain around the upper end of the price stability zone. While the Fed had held monetary policy unchanged since August 2006, it now appears that the monetary authorities will keep this stance for a prolonged period.

The core personal consumption expenditures (PCE) deflator has been following a mild decline since the peak in the summer of 2006 (**Chart 6**). That said, the core PCE deflator still rose 2.2% y-o-y in December 2006, surpassing the Fed's comfort zone (the price stability zone = +1%~+2%).

Under the current state of the US economy, there seems to be a minor inflation gap, measured either in terms of the output gap or a comparison of NAIRU (Non-Accelerated Inflation Rate of Unemployment) and the unemployment rate. Given prospects that such conditions will persist, the decline of the core inflation remain should remain benign and stay around the upper end of the price stability zone. In particular, from the second half of 2007, the core inflation should start to rise along with the recovery of the US economy.

Fed Chairman Ben Bernanke's continued to take a cautious view in his testimony to Congress (February 14th and 15th) that while "there are some indications that inflation pressures are beginning to diminish", "it will consequently be some time before we can be confident that underlying inflation is moderating as anticipated." Eight months has lapsed already since the Fed decided to keep the federal funds rate unchanged. As in the second half of the 1990s, the odds are high that the Fed will keep the federal funds rate unchanged for a longer-than-expected period.

II. The Japanese economy

(1) The current state of the economy

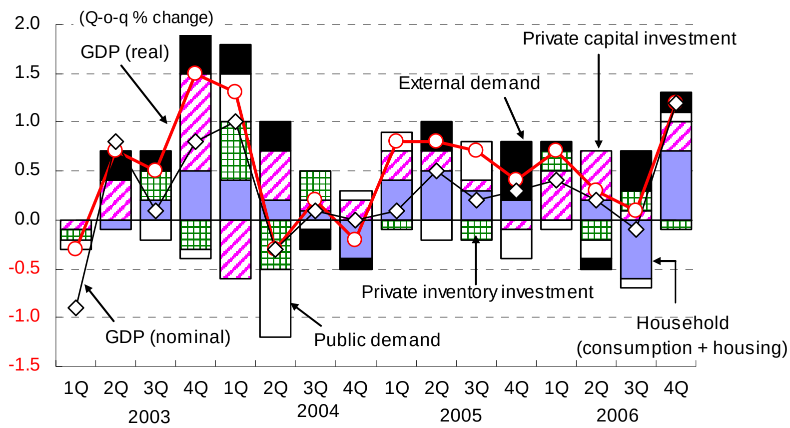
The Japanese economy grew a strong 4.8% q-o-q p.a. in the Oct-Dec quarter of 2006

Japan's real GDP grew a strong 1.2% q-o-q (4.8% q-o-q per annum) in the Oct-Dec quarter of 2006 (**Chart 7**). Given the recovery of domestic demand which had sagged in the Jul-Sep quarter due mainly to weak personal consumption, the recent readings reveal the well-balanced growth of both domestic and external demand.

Looking closer at each of the components of demand, personal consumption (1.1% q-o-q) and capital investment (2.2% q-o-q) – the twin pillars of domestic private-sector demand – both grew strongly. Furthermore, since imports remained more or less flat while exports (1.1% q-o-q) continued to grow, external demand pushed up Japan's growth by 0.2% pt, continuing to serve as a positive contribution as in the previous quarter. Public demand also pushed up real GDP growth by 0.1% pt as a result of the upturn of public investment (2.7% q-o-q). Meanwhile, given the contraction of private-sector inventory investment, its contribution to growth fell 0.1% pt.

Even though growth in the Oct-Dec quarter looks quite good when viewing the quarter alone, the strong results are due largely to a reaction to the subdued growth in the Jul-Sep quarter. Considering that Jul-Sep quarter personal consumption was revised down to -1.1% q-o-q, consumer spending in the Oct-Dec quarter has merely recovered to the level in the Apr-Jun quarter of 2006. Likewise, the rise of public investment for the first time in five quarter is only a temporary phenomenon due to a reaction to the extremely slow progress of public works to the public works budget up to the Jul-Sept quarter.

[Chart 7: Japan's quarterly GDP growth]



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

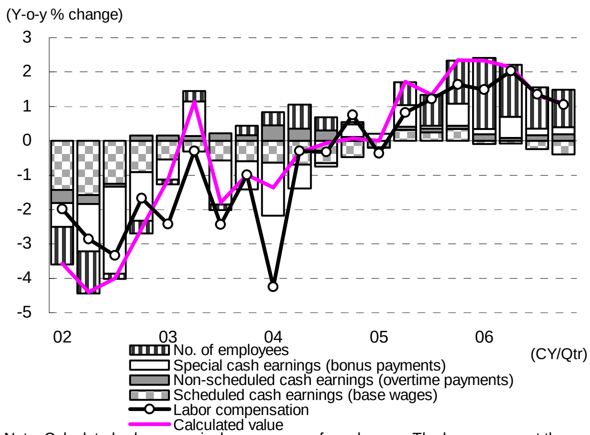
The domestic demand deflator revisits negative territory

The GDP deflator, a broad measure of price changes, narrowed to -0.5% y-o-y from -0.7% y-o-y in the previous quarter, due mainly to a sharp slowdown of the import deflator to 6.3% y-o-y in comparison to 11.8% y-o-y in the previous quarter. However, given the downturn of the personal consumption deflator to -0.3% y-o-y, the domestic demand deflator fell into negative territory again (-0.1% y-o-y). Prices will be subject to downward pressures for the time being, as crude oil prices remain below year-ago levels.

Labor compensation is slowing down

Labor compensation rose 1.1% y-o-y in the Oct-Dec quarter, slowing down from the previous quarter (1.4% y-o-y) for the second quarter in a row, despite the payment of year-end bonus payments around this time of the year (**Chart 8**). Even though labor market conditions are tightening, the fact that the rise of employment is comprised mainly of non-regular workers is serving as restraints upon overall wages. The increase of permanent income accompanying the rise of wages would be necessary for a sustainable rise of consumer spending. In such context, attention is gathering around the future course of wages and income.

[Chart 8: Labor compensation]



Note: Calculated value = nominal wages 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.*

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

The Japanese economy will slow down in the first half of FY2007

The Japanese economy is predicted to slow down in the first half of FY2007. The view stems from forecasts that exports will fall into a lull due to the slowdown of overseas economies and inventory adjustment in IT-related sectors and lead to the decline of production activity. The rate of corporate profit growth will decline given the slower pace of revenue growth accompanying the slowdown of exports and the rise of labor costs and serve as a damper upon capital investment growth. Moreover, as part of the transfer of tax resources from the central to local governments, the amount of residential taxes will increase in June and lead inevitably to a temporary slowdown of disposable income growth. As a result, personal consumption is expected to weaken in the Jul-Sep quarter.

External demand-led recovery in the second half of FY2007

Even so, the chances are slim that Japan’s economic slowdown in the first half of FY2007 will develop in to a recession. The probability of a soft landing of the US economy is increasing and the Chinese economy is continuing to achieve strong growth. Judging from the ongoing weakness of the yen, a sharp fall of exports is unlikely. As for the adjustment of inventories in the IT-related sector, the breadth of adjustment should remain narrow amid the ongoing growth of demand for household electronic appliances. Wages should gradually rise and underpin personal consumption from around April when most firms in Japan revise wages.

In the second half of FY2007, exports will regain momentum reflecting the recovery of overseas economies – mainly the US. Furthermore, the current depreciation of the yen should support the recovery of exports. The pace of corporate profit growth should rise due to the recovery of exports, leading thereby to the rise of capital investment (**Chart 9**).

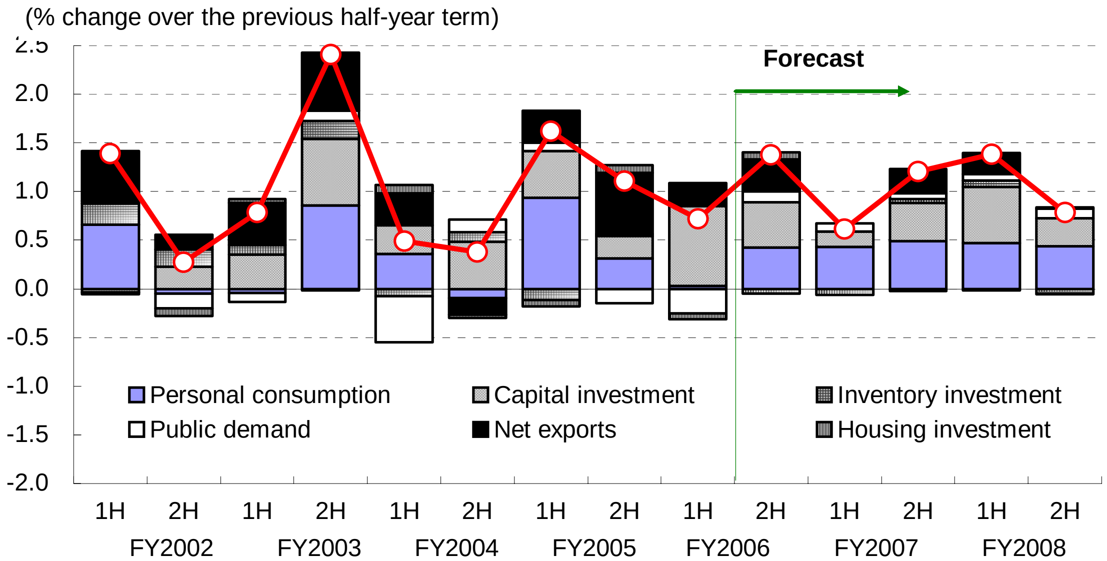
FY2007 real GDP growth: 1.9%

Judging from the foregoing, we expect full-year GDP growth in FY2007 to reach 1.9% in real terms (previous forecast: 1.8%), achieving growth comparable to FY2006 (1.9%, MHRI estimates). Even though domestic prices will remain under downward pressures given the decline of energy prices, the FY2007 GDP deflator is only expected to rise 0.1% y-o-y due in part to the decline of the import deflator accompanying the fall of crude oil prices. As a result, growth in nominal terms will reach 2.0% (previous forecast: 2.5%). For the first time in a decade since 1997 when the consumption tax was raised, Japan's growth in nominal terms should surpass its growth in real terms (**Charts 10, 11**).

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. As in FY2005, the pattern of growth will be well-balanced among personal consumption, capital investment and external demand, thus driving the pace of growth in FY2008 to 2.4% in real terms and 2.6% in nominal terms.

[Chart 9: Forecast on Japan's real GDP growth (half-year basis)]



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

【 Chart 10: Outlook on the Japanese economy (fiscal year basis) 】

(%)

	FY2005 (Actual)	FY2006 (Forecast)	FY2007 (Forecast)	FY2008 (Forecast)	FY2005 (Contribution) (Actual)	FY2006 (Contribution) (Forecast)	FY2007 (Contribution) (Forecast)	FY2008 (Contribution) (Forecast)
GDP (real)	2.4	1.9	1.9	2.4	-	-	-	-
Domestic demand	1.9	1.3	1.7	2.1	1.9	1.3	1.6	2.0
Private sector demand	2.4	2.1	1.9	2.5	1.8	1.5	1.5	1.9
Personal consumption	1.9	0.7	1.6	1.7	1.1	0.4	0.9	0.9
Housing investment	-1.0	0.5	0.8	-0.9	-0.0	0.0	0.0	-0.0
Capital investment	5.7	7.7	3.7	5.6	0.8	1.2	0.6	0.9
Public sector demand	0.4	-1.3	0.8	0.7	0.1	-0.3	0.2	0.1
Government consumption	0.9	1.0	1.7	1.9	0.2	0.2	0.3	0.3
Public investment	-1.4	-10.0	-3.2	-4.6	-0.1	-0.4	-0.1	-0.2
Net exports (contribution)	0.6	0.7	0.3	0.4	0.6	0.7	0.3	0.4
Exports	9.0	7.6	4.1	6.2	1.2	1.1	0.6	0.9
Imports	6.0	3.4	3.0	5.3	-0.6	-0.4	-0.3	-0.6
GDP (nominal)	1.0	1.3	2.0	2.6				
GDP deflator	-1.4	-0.6	0.1	0.2				
Industrial production	1.6	4.6	2.2	2.8				
Unemployment rate	4.4	4.1	3.7	3.5				
Current account balance (trillion yen)	19.1	20.8	23.7	24.8				
as a percentage of nominal GDP	3.8	4.1	4.6	4.7				
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	2.25				
Nikkei stock average (yen)	13,549	16,500	18,200	18,800				
Exchange rate (yen/dollar)	113.2	117	119	116				
Crude oil price (WTI $/dollar)	60.0	64.4	54.7	57.8				

【 Chart 11: Outlook on the Japanese economy (half-year basis)】

(%)

	FY2005		FY2006		FY2007	
	1H (Actual)	2H (Actual)	1H (Actual)	2H (Forecast)	1H (Forecast)	2H (Forecast)
GDP (real)	1.6	1.1	0.7	1.4	0.6	1.2
Domestic demand	1.3	0.5	0.5	1.1	0.6	1.0
Private sector demand	1.6	0.9	1.1	1.2	0.7	1.2
Personal consumption	1.7	0.6	0.1	0.8	0.8	0.9
Housing investment	-1.7	2.4	-1.7	2.2	-0.0	-0.7
Capital investment	3.2	1.5	5.4	2.9	1.0	2.4
Public sector demand	0.4	-0.7	-1.2	0.5	0.4	0.3
Government consumption	0.5	-0.6	1.0	0.7	0.9	0.9
Public investment	0.4	-0.9	-9.4	-0.0	-1.9	-2.4
Net exports (contribution)	0.3	0.6	0.2	0.3	-0.0	0.2
Exports	4.8	6.5	3.1	2.3	1.3	3.4
Imports	2.9	2.4	2.2	0.1	1.7	2.3
GDP (nominal)	0.7	0.6	0.3	1.4	0.5	1.6
GDP deflator	-1.2	-1.5	-0.9	-0.3	-0.1	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	3.8	3.8
Current account balance (trillion yen)	17.5	20.9	18.0	23.4	21.3	25.8
as a percentage of nominal GDP	3.5	4.1	3.6	4.6	4.1	4.9
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	17,100	18,000	18,400
Exchange rate (yen/dollar)	109.4	117.1	115.4	119	120	118
Crude oil price (WTI $/barrel)	58.2	61.8	70.6	58.2	54.6	54.8

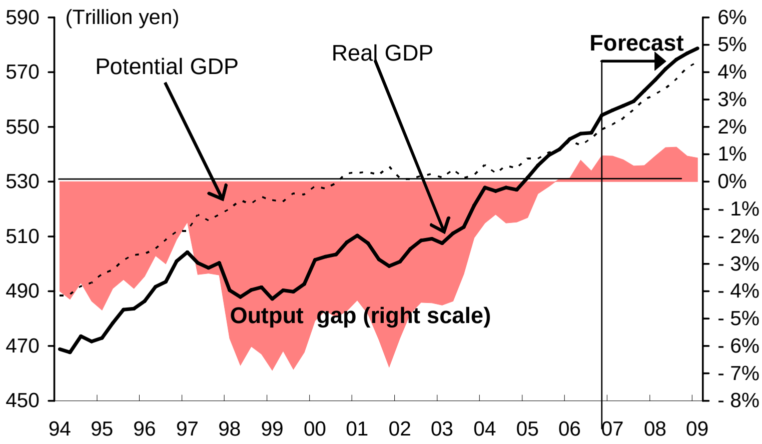
Notes: 1. FY = rate of change from the previous year. Half-year = rate of change from the previous term (excluding the unemployment rate, current account balance and prices).
2. Half-year corporate goods prices and half-year consumer prices = rate of change over a year ago. Consumer prices = nationwide (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*.

The output gap is moving in positive territory

The output gap (the gap between demand and supply) estimated by MHRI rose approximately 1%, charting positive territory, as of the Oct-Dec quarter of 2006 (**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 in FY2008. When the positive output gap narrows in the first half of FY2007, price fall risks will intensify due in part to forecasts that crude oil prices will fall below year-ago levels. In terms of monetary policy, the odds are high that it will become difficult to raise interest rates. However, price fall risks should abate as the positive output gap widens from the second half of FY2007.

[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.

A VAT hike would generate last-minute demand in FY2008

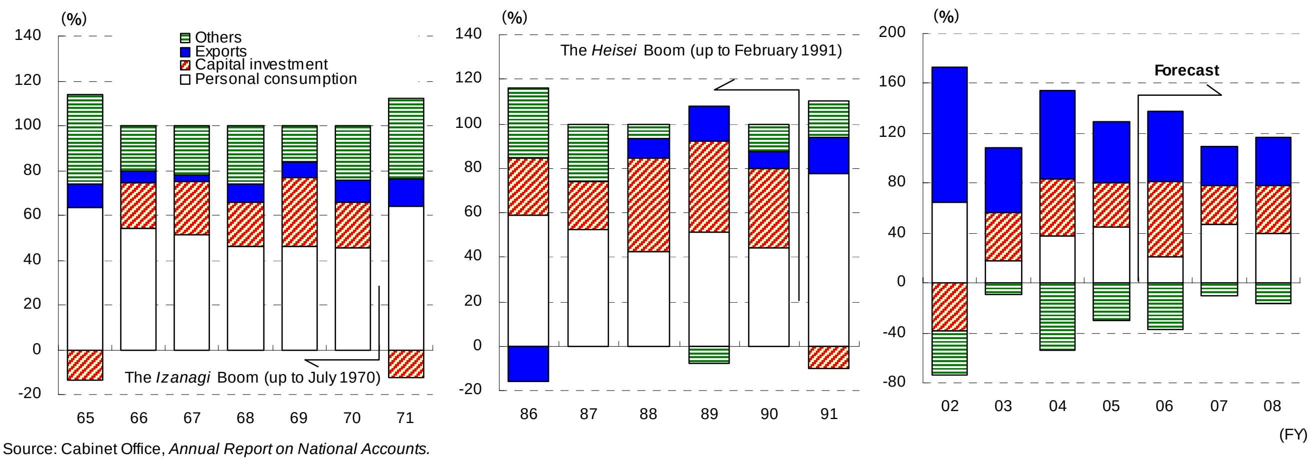
Our latest *Economic Outlook* is based upon the assumption that the consumption tax (VAT) will not be raised until FY2009. Given discussions within the Tax Research Commission and the Diet at the end of 2007, a VAT hike may be implemented from FY2009 at the earliest. However, considering the current improvement of the fiscal balance due to the sharp rise of tax revenues, the odds are high that the VAT hike will be postponed. Assuming that the VAT is raised in FY2009, it would generate a spending rush among consumers in FY2008. According to estimates by MHRI on the basis of the impact of the introduction of the VAT and subsequent rate hikes in the past, a VAT hike in FY2009 would generate a last-minute rush of demand equivalent to approximately 2.5 trillion yen (personal consumption: 1.5 trillion yen, housing investment: 1.0 trillion yen) in FY2008. As a result, growth in FY2008 would be pushed up by approximately 0.5%.

Although we expect the pace of wage growth to gradually rise and lead to a recovery of personal consumption in FY2007, the possibility may not be ruled out that personal consumption will continue to decline due to the sluggish rise of wages and income. In this case, the benefits of economic expansion would be confined within the corporate sector and fail to spread to the household sector. In such event, there is the possibility that growth in FY2008 will drop sharply.

Signs of "economic maturation" missing in past booms

In **Chart 13**, we have forth a comparison of the contribution by each of the demand components in the *Izanagi* Boom, the *Heisei* Boom and current economic recovery. Note the decline of the contribution by personal consumption toward the latter half of both the *Izanagi* and *Heisei* booms. In other words, the "maturation of the economy" - meaning a shift of the backbone of growth to personal consumption (the household sector) – was not the common pattern in the past. In contrast, the current recovery is driven largely by exports, indicating its high dependence upon external demand. External demand is fueling capital investment, leading to the current growth of the economy. However, growth dependent upon external demand and capital investment may hardly be called sustainable because capital investment will eventually peak out along with the accumulation of capital stock. In fact, the drop of capital investment served as the main cause of the ensuing recession after the *Izanagi* and *Heisei* booms. Of the estimated growth in FY2006 (1.9%), the contribution by the components of demand are as follows: personal consumption (0.4% pt), capital investment (1.2% pt), and external demand (0.7% pt). In the event personal consumption continues to stagnate and the pattern of growth in FY2006 remains unchanged, the pace of growth would drop to around 1% if capital investment stops growing. Even though a sharp slowdown of capital investment is unlikely in FY2007, judging from the sizable demand to renew equipment which have become obsolete after Japan's economic bubble, these risks could emerge from around FY2008 if consumer spending remains weak. Since the recovery of household income and consumption is indispensable for the sustainable growth of the economy at the current 2%-level, a careful stance should be taken for policy measures leading to additional household burdens while the ripple effect of the economic recovery to the household sector is uncertain.

[Chart 13: The contribution by the components of demand in the *Izanagi* Boom, the *Heisei* Boom and the current recovery]



Source: Cabinet Office, *Annual Report on National Accounts.*

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