

Economic Outlook for FY2007 and FY2008

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

September 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 Apr-Jun quarter of 2007. The key points of the outlook are as follows.

<The US Economy>

The housing market correction will continue to serve as a drag upon the economy

2007 1.9% (previous outlook) → 1.9% (current outlook)

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

<The Japanese Economy>

FY2007 Industrial production and consumption will pick up in the second half of FY2007

Real GDP: 2.1% (previous outlook) 1.9% (current outlook)

Nominal GDP: 2.0% (previous outlook) 1.7% (current outlook)

FY2008 Continuation of a self-sustained recovery

Reversal of nominal GDP and real GDP normalized for the first time in 11 years

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

Nominal GDP: 2.6% (previous outlook) → 2.5% (current outlook)

This English-language translation is based upon the outlook in Japanese released on September 12, 2007. This publication is compiled solely for the purpose of providing readers with information and is in no way meant to encourage readers to buy or sell financial instruments. Although this publication is compiled on the basis of sources which we believe to be reliable and correct, Mizuho Research Institute does not warrant its accuracy and certainty. Readers are requested to exercise their own judgment in the use of this publication. Please also note that the contents of this publication may be subject to change without prior notice.

I. The current state of the Japanese economy

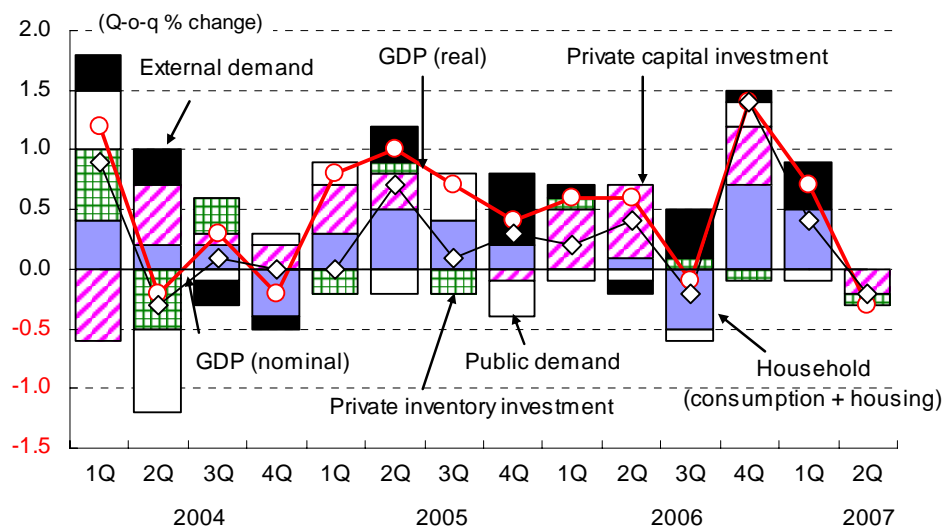
The 2nd QE for the Apr-Jun Qtr revealed that Japan's real GDP slowed sharply (-1.2% q-o-q p.a.) than previously estimated

Capital investment continued to decline for the second quarter in a row

The *Second Preliminary Quarterly Estimates of GDP* ("2nd QE") for the Apr-Jun quarter of 2007 revealed that Japan's real GDP fell (-0.3% q-o-q or -1.2% in annualized terms) in a sharp downward revision from 0.1% q-o-q (0.5% q-o-q p.a.) in the *First Preliminary Quarterly Estimates of GDP* (Chart 1). The Japanese economy recorded negative growth for the first time in three quarters, given the sharp downward revision of domestic demand, most notably capital investment.

Looking closer at each of the components of demand, capital investment was revised down sharply (1st QE 1.2% q-o-q → 2nd QE -1.2% q-o-q), falling for the second quarter in a row, reflecting the results of the *Financial Statements Statistics of Corporations by Industry* in the Apr-Jun quarter. Despite a slight upward revision of residential investment (1st QE -3.5% q-o-q → 2nd QE -3.4% q-o-q), both personal consumption (1st QE 0.4% q-o-q → 2nd QE 0.3% q-o-q) and public fixed capital formation (1st QE -2.1% q-o-q → 2nd QE -2.6% q-o-q) were revised downward, the contribution by domestic demand was revised down from 0.1 pt in the 1st QE to -0.3 pt. Meanwhile, the contribution to quarterly growth by private inventory investment remained unchanged from the 1st QE at -0.1 pt. Given a slight downward revision of both exports (1st QE 0.9% q-o-q → 2nd QE 0.8% q-o-q) and imports (1st QE 0.8% q-o-q → 2nd QE 0.6% q-o-q), the contribution to growth by external demand remained unchanged from the 1st QE at zero.

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



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

The GDP deflator remained unchanged from the 1st QE

Both the GDP deflator (-0.3% y-o-y) and the domestic demand deflator (-0.2% y-o-y) remained unchanged from the 1st QE. As a result, nominal GDP growth stood at -0.2% q-o-q (-0.7% q-o-q p.a.), slightly above growth in real terms.

Corporate earnings are continuing to hold up well

As far as the GDP statistics are concerned, the Japanese economy softened in the Apr-Jun quarter in terms of both domestic and external demand. However, corporate business performance continued to grow strongly during this period. Ordinary profits (based upon the *Financial Statements Statistics of Corporations by Industry*) grew a dramatic 12.0% y-o-y in the Apr-Jun quarter (Jan-Mar quarter: 7.4% y-o-y). In terms of industrial sectors, ordinary profits among manufacturers grew 17.3% (Jan-Mar quarter: 7.3% y-o-y) rebounding into double-digit growth. The strong growth stems most likely from a mark up of prices among companies mainly in the materials sector and foreign exchange rate gains primarily among processing industries due to a weaker yen during this time. Ordinary profits among nonmanufacturers also continued to grow strongly at 8.0% y-o-y (Jan-Mar quarter: 7.6% y-o-y).

Personal consumption fell into a lull during the summer months

Even though personal consumption is expected to remain stagnant in the Jul-Sep quarter, the Japanese economy should regain momentum, reaching around the potential rate of growth due to the recovery of capital investment.

In the Jul-Sep quarter, personal consumption is predicted to slow down and flatten out from the previous quarter. Amid the stagnant growth of wages, the rise of tax burdens (the local inhabitants tax) from June will serve as downward pressures upon disposable income. So far, inclement weather conditions, in addition to the tax burdens, are serving as a damper upon personal consumption.

Capital investment should pick up from the Jul-Sep quarter

In contrast, the drop of capital investment in the Apr-Jun quarter is viewed as temporary and should rebound in the Jul-Sep quarter. The Bank of Japan's *Short-term Economic Survey of Enterprises in Japan* reveals that corporate enterprises are boosting their spending outlays on a fiscal year basis. Since the downward revision of capital investment was due largely to a new sampling of the *Financial Statements Statistics of Corporations by Industry* for the Apr-Jun quarter, capital investment should pick up from the Jul-Sep quarter when the sampling effect wears off. Machinery orders (private sector orders excluding orders for ships and orders by electrical power companies), which had remained in a slump for approximately a year up to the Apr-Jun quarter, surged 17.0% m-o-m in July (June: -10.4% m-o-m), providing reasons to believe that capital investment will increase in the Jul-Sep quarter for the first time in three quarters (**Chart 2**).

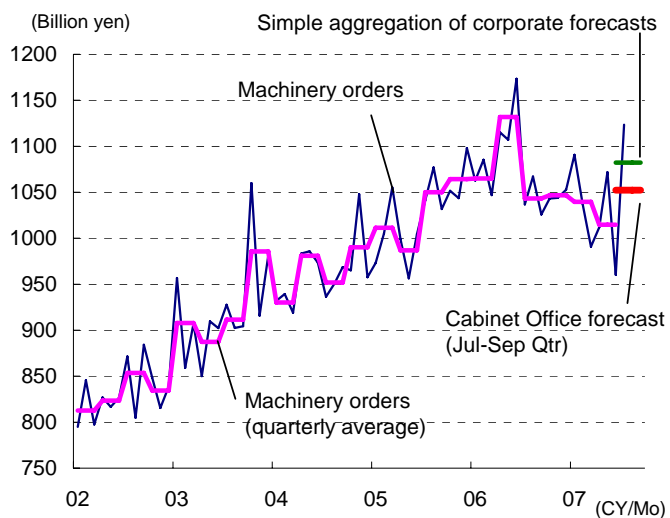
Exports should continue to follow a gradual uptrend

Exports should continue to follow a gradual uptrend as exports to Asia should continue to cover the slump of US-bound exports. Since imports are also expected to grow at a moderate pace, the contribution by external demand to economic growth should stand near zero for the second quarter in a row subsequent to the Apr-Jun quarter. Judging from these trends in demand, real GDP growth in the Jul-Sep quarter should recover to around 2% per annum, driven primarily to the rebound of capital investment

**Industrial production
will pick up as the
IT-sector emerges out
of an inventory
adjustment phase**

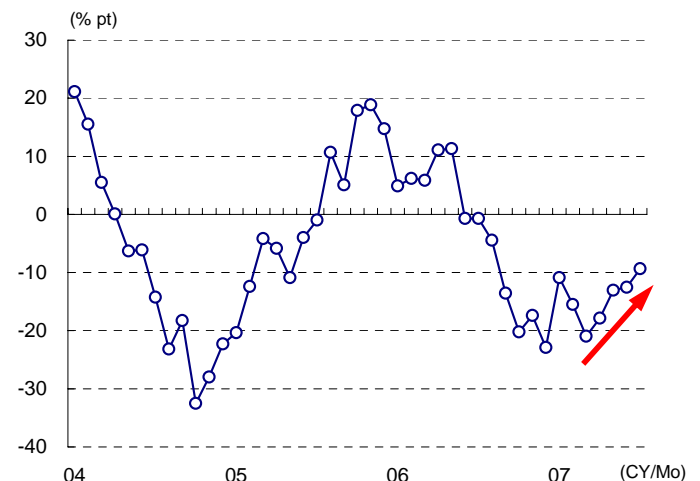
Turning to the supply side, industrial production is estimated to rise approximately 1~2% q-o-q in the Jul-Sep quarter. Even though industrial production dipped slightly in July (July: -0.4% m-o-m, June: 1.3% m-o-m), dragged down by factors such as the suspension of car production due to the Niigataken Chuetsu-oki Earthquake, the forecast indexes are rather bullish (August: 6.8% m-o-m, September: -2.5% m-o-m). Although car makers were compelled to reduce output by approximately 100 thousand units in July, car output is gradually catching up in August. The IT sector as a whole is emerging out of an inventory adjustment cycle (**Chart 3**) since inventories are falling in downstream sectors such as the information & telecommunication machinery industry despite the high level of inventory growth in upstream industries such as the electronic parts & devices industry. From August onward, production activity should gradually pick up, driven mainly by the automobile and IT sectors.

[Chart 2: Machinery orders]



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

[Chart 3: Shipments-inventories balance in IT-related sectors]



Note: Shipments-inventories balance = shipments (y-o-y ch) minus inventories (y-o-y ch)
IT sector = information & telecommunication machinery + electronic parts & devices.
Source: Ministry of Economy, Trade and Industry, *Indices of Industrial Production*.

II. Forecast of the Japanese economy in FY2007 and FY2008

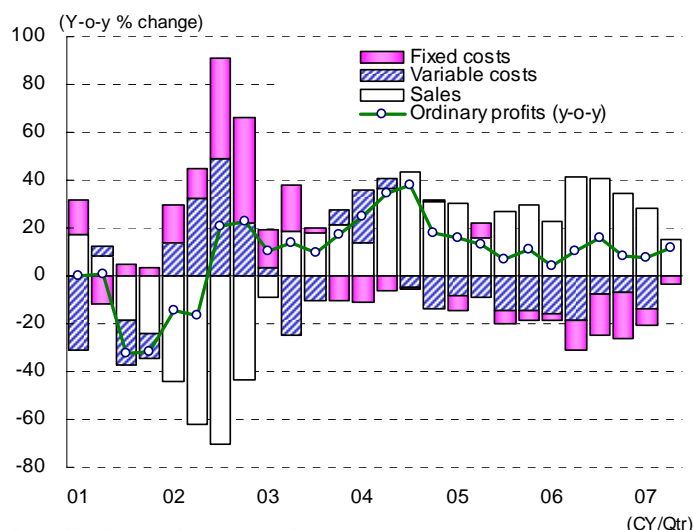
The economy will gradually pick up in the 2HFY2007

In the second half of FY2007, industrial production growth is predicted to accelerate, driven mainly by the IT sector which has finished shedding excessive inventories. The rise of production should serve to push up wages such as overtime payments (non-scheduled cash earnings) and lead to a gradual rise of personal consumption which had slumped due to the rise of burdens over the summer months. In addition to the steady growth of capital investment, exports should grow steadily, as exports to destinations other than the US will offset the weakness of US-bound exports. The rate of economic growth in the second half of FY2007 should reach 2.6% p.a., surpassing growth in the first half of the fiscal year (0.7%, MHRI estimates).

Corporate earnings will continue to grow

A closer look at the ordinary profits of corporations (**Chart 4**) reveals that the rise of variable costs up to the Jan-Mar quarter served as a drag upon earnings. However, the variable ratio (variable costs/sales) in the Apr-Jun quarter remained unchanged from the same period a year ago, more or less neutral to ordinary profits. Japanese companies have been helped by (1) foreign exchange gains due to the depreciation of the yen during this time, and (2) the fall of crude oil prices from the previous year. Given the appreciation of the yen and the rise of crude oil prices in the Jul-Sep quarter, the rise of variable costs should serve as a drag upon corporate earnings again. Fixed costs (mainly labor costs) are also predicted to edge up, leading to a gradual slowdown of earnings growth in FY2008. Even so, ordinary profits (based upon the *Financial Statements Statistics of Corporations by Industry*) are forecast to grow for the sixth year in a row, given the rise of earnings in both FY2007 and FY2008 (**Chart 5**).

[Chart 4: Ordinary profits]



[Chart 5: Corporate earnings forecast]

		(Y-o-y % change)			
		FY2005	FY2006	FY2007 (Forecast)	FY2008 (Forecast)
Total	Sales	4.6	7.3	3.6	3.8
	Ordinary profits	8.4	10.0	7.8	5.0
Manufacturing	Sales	6.1	4.8	4.3	3.2
	Ordinary profits	12.4	12.7	9.1	5.9
Nonmanufacturing	Sales	3.9	8.4	3.3	4.0
	Ordinary profits	5.7	8.1	6.8	4.3
Large corporations	Sales	6.5	5.0	4.1	3.8
	Ordinary profits	13.9	12.8	8.5	6.2
Manufacturing	Sales	7.1	6.5	4.0	3.5
	Ordinary profits	14.7	13.7	10.0	6.7
Nonmanufacturing	Sales	6.0	3.8	4.2	4.0
	Ordinary profits	13.0	11.7	6.7	5.7
Small and medium corporations	Sales	3.2	8.9	3.2	3.7
	Ordinary profits	2.4	6.7	6.8	3.3

Note: "Large corporations" = corporations with capital of 1 billion yen or over

"Medium corporations" = corporations with capital of 100 million to 1 billion yen,

"Small corporations" = corporations with capital of 10 to 100 million yen,

Source: Ministry of Finance, *Financial Statements Statistics of Corporations by Industry, Quarterly*.

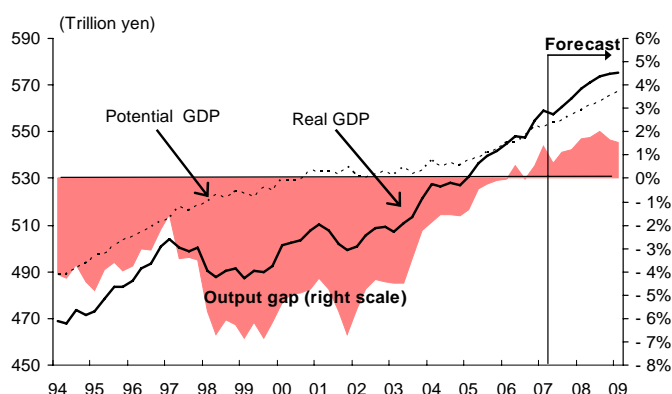
Forecast on growth revised downward for both FY2007 (1.9%) and FY2008 (2.0%)

We have revised down our forecast on Japan's growth for both FY2007 (2.1% → 1.9%) and FY2008 (2.1% → 2.0%) from our previous forecast (August 15th). That said, our views on the Japanese economy remains fundamentally unchanged from our previous forecast that the Japanese economy will start to show more definite signs of a self-sustained recovery from the second half of FY2007 to the first half of FY2008. As for growth in FY2007, we have revised down our forecast on capital investment reflecting the lower-than-expected data regarding the Apr-Jun quarter, and lowered our forecast on personal consumption by 0.2% pt because of a higher possibility that consumer spending over the summer months will turn out to be weaker than expected. As regards FY2008, we revised down our forecast on personal consumption in consideration of the slow recovery of wages.

The output gap will widen in the first half of FY2008

The output gap (the gap between demand and supply) estimated by MHRI stood at 0.6% as of the Apr-Jun quarter of 2007 (**Chart 6**). In the first half of FY2008, the breadth of the output gap in positive territory should gradually widen to approximately 2%, leading to the gradual ebb of price fall risks. The GDP deflator should turn positive, reaching 0.5% y-o-y in FY2008, normalizing the reversal of nominal and real GDP growth for the first time in 11 years since 1997.

[Chart 6: The output gap]



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

Uncertain impact of the subprime loan crisis upon the real economy

Tremors from the financial market turmoil stemming from the US subprime loan crisis are still reverberating. According to MHRI's forecast, the prolonged correction of the US housing market will continue to serve as a drag, keeping US economic growth at the 2%-level in 2008 (**Chart 9**). As far as the slowdown of the US economy does not worsen any further, the Japanese economy would be able to keep growing at around 2%.

Having said so, given the difficulty to forecast the impact of the financial market turmoil upon the real economy, the risks of a further escalation of the negative impact may not be ruled out. We envisage four main channels through which the Japanese economy may be affected by the US subprime loan crisis

- (1) Japanese financial institutions suffer losses from investment in

asset-backed securities (ABS) and collateralized debt obligations (CDO).

- (2) The appreciation of the yen along with the unwinding of yen-carry trades will push down corporate earnings
- (3) The fall of US domestic demand (personal consumption and capital investment) stemming from the deterioration of corporate/consumer confidence and the credit squeeze will serve as a further drag upon Japan's exports to the US
- (4) The fall of emerging country stocks, currencies and commodity markets amid global risk aversion tendencies serves as a drag upon growth in regions other than the US, leading to the fall of Japan's exports

As for (1), there are no reports as yet that Japanese financial institutions are suffering massive losses stemming from ABS and CDO including US subprime loans in their original assets. Regarding (2), even though the appreciation of the yen over the summer months will serve as an unmistakable drag upon earnings among export-oriented firms, the impact will not derail Japan's economic recovery as far as the yen/dollar exchange rate remains around the 110 yen/dollar-level. However, in the event yen strengthens sharply against the dollar (below 110 yen/dollar), the deterioration of corporate business performance would dampen capital investment and lead to concerns regarding a fall into recession. Turning to (3), market concerns are rising regarding a further decline of the US growth rate due to the US nonfarm payroll declining in August for the first time in approximately four years. If the rest of the world falls into conditions described under (4), the Japanese economy may not avoid a slide into recession. Future developments will be closely monitored, since it is uncertain at this point in time how and to what extent the subprime loan problem will affect the real economy.

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

(%)

	FY2005	FY2006	FY2007	FY2008	FY2005	FY2006	FY2007	FY2008
	(Actual)	(Actual)	(Forecast)	(Forecast)	(Contribution)	(Contribution)	(Contribution)	(Contribution)
	(Actual)	(Actual)	(Forecast)	(Forecast)	(Actual)	(Actual)	(Forecast)	(Forecast)
GDP (real)	2.4	2.1	1.9	2.0	-	-	-	-
Domestic demand	1.9	1.3	1.4	1.7	1.9	1.3	1.3	1.7
Private sector demand	2.4	2.2	1.7	2.1	1.8	1.6	1.2	1.6
Personal consumption	1.9	0.7	1.4	1.5	1.1	0.4	0.8	0.9
Residential investment	-1.0	0.4	0.1	-0.8	-0.0	0.0	0.0	-0.0
Capital investment	5.7	8.0	3.3	4.4	0.8	1.2	0.5	0.7
Public sector demand	0.4	-1.4	0.3	0.4	0.1	-0.3	0.1	0.1
Government consumption	0.9	0.9	0.9	0.8	0.2	0.2	0.2	0.1
Public investment	-1.4	-9.6	-2.4	-1.4	-0.1	-0.4	-0.1	-0.1
Net exports (contribution)	0.6	0.8	0.6	0.3	0.6	0.8	0.6	0.3
Exports	9.0	8.2	6.1	5.6	1.2	1.2	0.9	0.9
Imports	6.0	3.3	3.1	5.3	-0.6	-0.4	-0.3	-0.6
GDP (nominal)	1.0	1.4	1.7	2.5				
GDP deflator	-1.4	-0.6	-0.1	0.5				
Industrial production	1.6	4.8	2.4	3.6				
Unemployment rate	4.4	4.1	3.7	3.6				
Current account balance (trillion yen)	19.1	21.2	23.5	25.6				
as a percentage of nominal GDP	3.8	4.1	4.5	4.8				
Domestic corporate goods prices	2.1	2.8	2.0	1.8				
Consumer prices	-0.1	0.1	-0.0	0.2				
Long term interest rate (%)	1.42	1.75	1.78	2.14				
Nikkei stock average (yen)	13,549	16,450	17,200	18,200				
Exchange rate (yen/dollar)	113.2	117.0	115	114				
Crude oil price (WTI/barrel)	60.0	64.9	66.0	63.1				

[Chart 8: Outlook on the Japanese economy (half-year)]

(%)

	FY2006		FY2007		FY2008	
	1H	2H	1H	2H	1H	2H
	(Actual)	(Actual)	(Forecast)	(Forecast)	(Forecast)	(Forecast)
GDP (real)	1.7	3.4	0.7	2.6	2.2	0.9
Domestic demand	1.3	2.3	0.3	2.5	1.8	0.9
Private sector demand	2.4	2.8	0.4	2.9	2.3	1.2
Personal consumption	-0.1	2.0	1.2	1.0	1.8	1.7
Residential investment	-2.4	2.7	-4.7	7.5	-2.5	-5.3
Capital investment	12.2	5.8	-0.2	7.7	4.6	1.3
Public sector demand	-2.2	0.5	-0.3	1.2	0.2	-0.1
Government consumption	2.1	0.5	0.9	1.3	0.7	0.3
Public investment	-17.6	0.9	-5.6	0.9	-2.1	-1.7
Net exports (contribution)	0.4	1.0	0.5	0.2	0.4	0.1
Exports	6.2	7.5	6.0	5.2	6.7	3.7
Imports	4.1	0.3	3.3	5.2	5.6	4.8
GDP (nominal)	0.9	3.0	0.5	2.9	2.9	1.2
GDP deflator	-1.0	-0.4	-0.3	-0.0	0.5	0.5
Industrial production	2.2	2.2	0.2	2.4	1.9	1.0
Unemployment rate	4.1	4.0	3.7	3.6	3.6	3.6
Current account balance (trillion yen)	18.6	22.7	23.4	23.0	25.8	25.0
as a percentage of nominal GDP	3.7	4.4	4.5	4.4	4.9	4.7
Domestic corporate goods prices	3.3	2.3	2.2	1.7	1.8	1.8
Consumer prices	0.1	-0.0	-0.1	0.1	0.2	0.2
Long term interest rate (%)	1.80	1.70	1.70	1.85	2.10	2.18
Nikkei stock average (yen)	15,900	17,000	17,300	17,100	17,900	18,500
Exchange rate (yen/dollar)	115.4	118.6	119	112	113	115
Crude oil price (WTI/barrel)	70.6	59.2	69.1	62.9	65.1	61.0

Notes: 1. FY = rate of change from the previous year. Half-year GDP = rate of change from the previous term p.a.

(the GDP deflator = rate of change from the previous year).

2. Half-year corporate goods prices and half-year consumer prices = rate of change over a year ago.

Consumer prices = nationwide (excluding fresh foods).

3. Half-year industrial production = rate of change from the previous term. The half-year unemployment rate and half-year current account balance are adjusted for seasonal factors and the figures on current account balance are converted into annualized rates.

4. Crude oil price = near-term contract for WTI crude futures. The long-term interest rate = newly-issued 10-yr government bonds.

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

[Chart 9: Outlook on the US economy]

(%)

	2006	2007	2008	2007 (Forecast)		2008 (Forecast)	
	(Actual)	(Forecast)	(Forecast)	1H	2H	1H	2H
GDP	2.9	1.9	2.4	1.7	2.4	2.4	2.6
Personal consumption	3.1	2.7	2.2	3.1	1.4	2.5	2.3
Residential investment	-4.6	-16.3	-12.9	-14.9	-16.9	-14.8	-4.4
Capital investment	6.6	3.7	3.5	2.7	4.7	2.7	4.0
Inventory investment (\$100 million)	403	51	41	19	75	-12	93
Government expenditures	1.8	1.9	2.9	1.7	2.9	2.9	3.0
Net exports (\$100 million)	-6,245	-5,607	-4,989	-5,950	-5,299	-4,966	-5,012
Exports	8.4	6.7	7.2	5.6	7.3	7.9	5.7
Imports	5.9	1.2	2.0	1.6	-1.3	2.2	4.7
Domestic final demand	2.7	1.6	1.8	1.8	1.2	1.9	2.4
Core personal consumption expenditures deflator <y-o-y ch>	2.2	2.0	1.9	2.2	1.9	1.8	1.9
Current account balance (\$100 million)	-8,115	-7,221	-6,325	-3,804	-3,418	-3,164	-3,162
<as a percentage of nominal GDP>	-6.2	-5.2	-4.3	-5.6	-4.9	-4.4	-4.3

Notes: 1. Calendar-year figures refer to the rate of change from the previous year. Half-year term figures refer to the rate of change from the previous half-year term (annualized).

2. The shaded columns are forecasts.

3. As for the current account balance, figures for the half-year terms are adjusted for seasonal factors and the calendar-year figures are the totals. The percentages of nominal GDP are annualized.

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

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