Economic Outlook for FY2006 and FY2007

August 2006

The Mizuho Research Institute Ltd. (MHRI) has revised its economic outlook for FY2006 and FY2007 subsequent to the release of Japan's GDP statistics for the Apr-Jun quarter of 2006. The key points of the outlook are as follows.

<The US Economy>

US economic slowdown, down mainly in the household sector, should start to pick up in the second half of 2007

2006 3.4% (previous outlook) → 3.5% (current outlook)

2007 3.0% (previous outlook) → 2.9%(current outlook)

<The Japanese Economy>

FY2006 Despite the continuation of self-sustained economic recovery, exports will slow down in the second half of the fiscal year.

Real GDP: 2.5% (previous outlook) → 2.3% (current outlook)

Nominal GDP: 2.5% (previous outlook) → 2.3% (current outlook)

FY2007 Capital investment will serve as a drag, due to slower corporate profit growth

Real GDP: 2.0% (previous outlook) → 2.3% (current outlook)

Nominal GDP: 1.5% (previous outlook) → 1.7%(current outlook)

Mizuho Research Institute

I. The current state of the US economy

The US economy slowed sharply in the Apr-Jun quarter of 2006, due mainly to slumping household demand

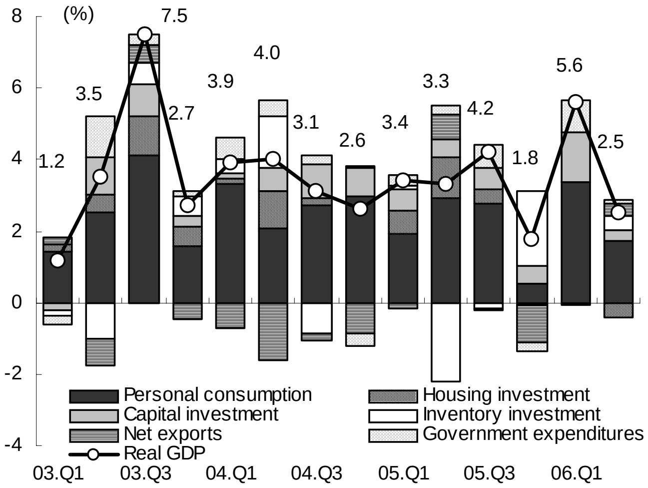
US gross domestic product (GDP) in real terms grew 2.5% q-o-q p.a. in the Apr-Jun quarter of 2006, slowing sharply from the previous quarter (5.6% q-o-q p.a.) (**Chart 1**).

The economic slowdown stems primarily from a slower pace of demand growth in the household sector due to the sharp deceleration of personal consumption (2.5% q-o-q p.a.) and the fall of housing investment (-6.3% q-o-q p.a.) for the third quarter in a row Consumption of durable consumer goods fell 0.5% q-o-q p.a., reflecting the weak sales of automobiles, while consumption of non-durable goods grew a marginal 1.7% q-o-q p.a. (5.9% q-o-q p.a. in the previous quarter). Turning to housing investment, even though collective housing (condominiums and apartments) continued to keep growing (5.6% q-o-q p.a.), sales of single-family housing dropped a sharp 13.6% q-o-q p.a.

The solid growth of business capital investment thus far also appears to have slowed sharply to 2.7% q-o-q p.a. in the Apr-Jun quarter. Even so, note that the drop of IT investment was a reaction to the surge in the previous quarter (business capital investment fell to -2.3% q-o-q p.a. in the Apr-Jun quarter from 21.8% q-o-q p.a. in the previous quarter) and that signs of change are not evident at this point in time. Although investment in transportation equipment is continuing to flatten out, construction investment and investment in industrial machinery are continuing to grow.

Averaging out the first half of 2006, the US economy grew 3.8% q-o-q p.a., more or less in step with our previous forecast (3.9% q-o-q p.a.). (That said, in view of recent data releases, the odds are high that the rate of real GDP growth in the Apr-Jun quarter will be revised upward by approximately 0.5% pt.)

[Chart 1: US real GDP growth]



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

Q-o-q % change (pa)	2006.Q2	Contribution	2006.Q1
Real GDP	+2.5	−	+5.6
Personal consumption	+2.5	+1.74	+4.8
Housing investment	-6.3	-0.40	-0.3
Capital investment	+2.7	+0.28	+13.7
Inventory investment	+52.6	+0.40	+41.2
Net exports	-627.1	+0.33	-636.6
Exports	+3.3	+0.35	+14.0
Imports	+0.2	-0.03	+9.1
Government expenditures	+0.6	+0.11	+4.9
Domestic final demand	+1.6	−	+5.4
GDP deflator	+3.3	−	+3.3

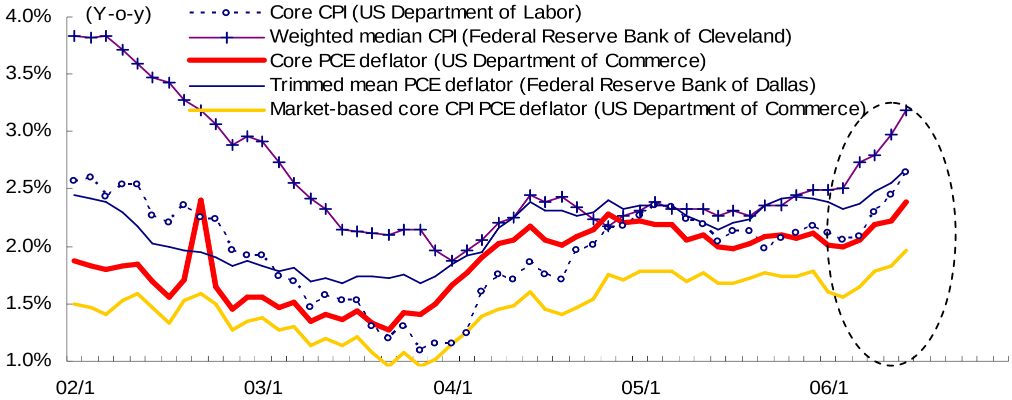
Note: Q-o-q % change (per annum) of inventory investment and net exports represent levels (unit: billion dollar).

Core inflation is starting to chart levels above the price stability zone

While US economic trends are moving in line with our expectations, price trends are an exception. The core inflation rate, which indicates the basic direction of price trends, is starting to soar above levels deemed as the price stability zone (a zone between +1% y-o-y to +2% y-o-y) (**Chart 2**).

The core personal consumption expenditure (PCE) deflator – a measure of inflation favored by the Federal Reserve Board (the Fed) – rose 2.4% y-o-y in June. Even when gauging price changes by the weight of expenditures on a CPI-basis , the rate of price changes in more than half of the goods and services have reached levels over +3% y-o-y. The rise of the core inflation rate can also be observed in other indicators, serving as a major source of concern for the Fed which is looking for the best timing to end its tightening campaign.

[Chart 2: Indicators on the core inflation rate]



Note: The trimmed mean PCE deflator is calculated on the basis of the percentage rise and w eights of the items remaining after eliminating items of spending show ing rises deemed as outliers from the price indexes of goods and services comprising the PCE every month . The w eighted median CPI refers to the percentage rise of spending items w hose cumulative values of the relative w eights are equivalent to 50% w hen listing the spending items in descending order of the percentage change. The market -based core PCE deflator incudes only goods and services w hich have market prices.

Sources: US Department of Commerce, US Department of Labor, Federal Reserve Bak of Dallas, Federal Reserve Bank of Cleveland, Federal Reserve Board.

2006 US growth forecast revised upward from 3.4% to 3.5%. Forecast on growth in 2007 revised downward from 3.0% to 2.9%. Forecasts on inflation in both 2006 and 2007 are upwardly revised.

Our forecast remains unchanged from our previous scenario that the US economy will slow down to its potential rate of growth. We have revised upward our forecast on growth in 2006 marginally from 3.4% to 3.5%. The forecast on growth in 2007 has been revised downward from 3.0% to 2.9%. Given the combined effect of energy costs serving as a damper on consumer confidence and the successive interest rate hikes resulting in a weak housing market, the US economy will likely draw closer to a "gross recession" in the second half of 2006 to the first half of 2007.

Meanwhile, we have revised upward our forecast on the core inflation rate (the rate of change of the core PCE deflator) from +2.1% to +2.3% in 2006 and from +2.1% to +2.4% in 2007 in view of the current level of inflation.

We shall look closer at the current state and future course of the US economy.

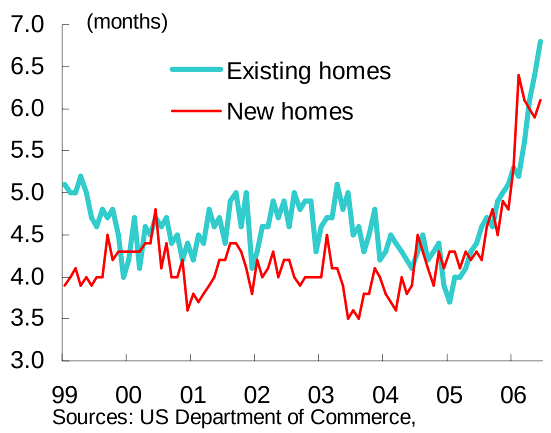
A cooling housing market

Firstly, there are more definite signs that the US housing boom is nearing its end, as we pointed out in previous forecasts. Clearly, housing investment is serving as a drag upon the economy. In the housing market, lackluster sales are leading to a sharp rise of the inventory-to-sale ratios regarding both new and existing homes (**Chart 3**). According to a major home builder, "speculative transactions in residential property are shrinking and the housing glut is the worst in the past 40 years". According to this company, contract cancellations are rising mainly in areas such as Orlando, Northern California, Palm Springs, Las Vegas and Phoenix. The sales slump appears to be affecting residential prices. On a nationwide average, the rate of price changes has slowed to 2.3% y-o-y with respect to new homes and 1.1% y-o-y with respect to existing homes (both are median values of prices for single-family homes as of June).

Reflecting the rise of the inventory-to-sale ratio, the number of housing starts is declining and the Housing Market Index, which gauges business confidence among construction companies, is falling sharply below the boom-or-bust threshold of 50. The lackluster sales and housing starts are also spreading to the labor market; payrolls related to the housing market (residential construction, residential upholstery and real estate) are declining for the third month in a row.

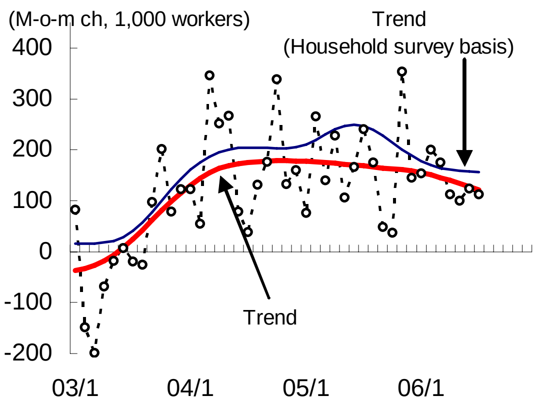
The deterioration of the housing market should continue for the time being, with a recovery expected some time around mid-2007.

[Chart 3: Residential inventory-to-sale ratios]



Sources: US Department of Commerce, Federal Real Property Association.

[Chart 4: Nonfarm payrolls]



Note: The trend is filtered using the HP filter.
Source: US Department of Commerce.

The labor market is showing signs of a mild slowdown. Consumer spending is also slowing down.

Labor market conditions are also starting to wane. The nonfarm payroll rose a modest 113 thousand m-o-m in July, revealing a mild deceleration of the pace of increase (**Chart 4**). A closer look in terms of business sectors also indicates that the rise of employment is gradually narrowing. According to the US Department of Labor, the Employment DI (= the percentage of industries in which payrolls increased from the previous month + 0.5 × the percentage of industries in which payrolls remained flat) stood at 53.2 in July. Even though the figure is above 50, which indicates the rise of employment, the decline since the beginning of the year in 2006 is starting to become more definite. The employment rate rose 0.2% pt m-o-m to 4.8%, the highest level since February, indicating that labor market conditions are easing.

Even so, wages are still rising at a high pace. On the basis of household labor compensation (wage index = hourly wages × total work hours index), wages are continuing to grow at a 5%-plus rate in comparison to the previous three-month period.

Even though high energy prices, softening employment conditions and the housing market slowdown will serve as a drag upon consumer confidence and consumer spending through the contraction and/or fading of the wealth effect, the rise of wages reflecting a relatively tight labor market should keep the pace of consumption from falling to levels leading to the risks of a recession.

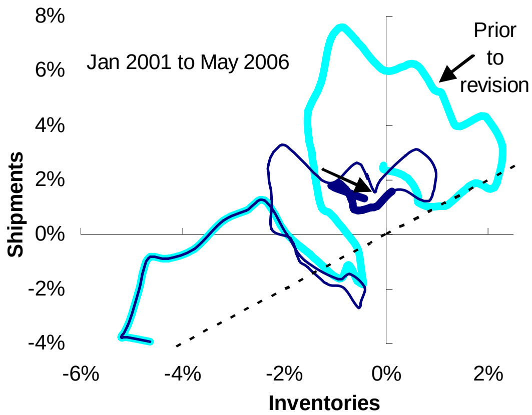
Despite the recovery of business capital investment, the slowdown of the household sector will gradually spread to investment in plant and equipment.

Although business capital investment slowed in the Apr-Jun quarter, we expect to see a recovery. Despite a significant change in shape of the manufacturing sector inventory cycle around the time the GDP statistics were updated, the chart still shows that the manufacturing sector is still in an "inventory buildup phase", thus serving as tailwinds upon manufacturing activity (**Chart 5**).

Meanwhile, the capacity utilization ratio is rising to as high as 82.4%, highlighting the strong demand for investment in plant and equipment from the perspective of production capacity. Furthermore, as indicated by the ongoing rise of new orders for IT-related investment which slowed sharply in the Apr-Jun quarter, we do not find any worrisome reasons regarding the future course of IT investment. Strong profit growth among US businesses should also serve as a driver of capital investment.

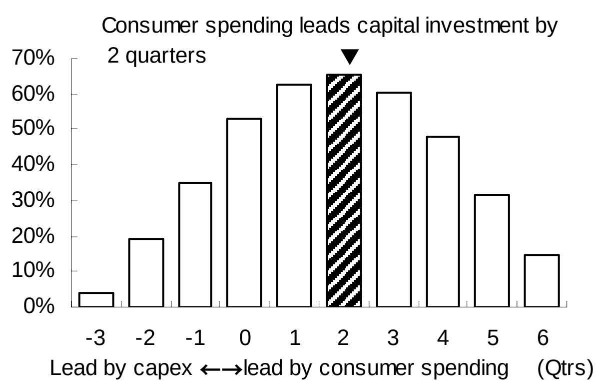
That said, consumer spending is a leading index of capital investment in the US, with a lag of approximately six months (**Chart 6**). Considering the prospects of a slowdown of household demand as mentioned above, it is difficult to perceive of the US economy being driven solely by business capital investment. Thus, the US economy will most likely start to show more signs of a slowdown toward 2007.

[Chart 5: Inventory cycle (manufacturers)]



Note: In real terms, 3MMA, y-o-y change.
Source: US Department of Commerce.

[Chart 6: Leads and lags between consumer spending and capital investment]



Note: Based upon the y-o-y % change, during the period from 1962Q1 to 2004Q4.
Source: US Department of Commerce.

Core inflation will decline in 2007. The Fed's monetary policy stance will remain difficult to read.

The most significant change from our previous forecast stems from inflation trends. As mentioned before, the core inflation rate is soaring above the price stability zone, thereby drawing heightened attention along with the future course of monetary policy.

The results of simulation using a model based upon the Phillips Curve, the IS Curve and the Taylor's Rule show that the rate of US real GDP growth will trend below its potential rate of growth and that the core inflation rate will finally start to decline in 2007. Even though the current level of the federal funds rate would be deemed tight when judged by the Taylor's Rule, we are inclined toward the view that the federal funds rate will continue to rise – albeit at a slower pace – and peak at 5.50% in 2007.

Turning to actual monetary policy trends, the Federal Open Market Committee (FOMC) decided at its meeting in August to halt its interest rate hike campaign (the federal funds rate was unchanged at 5.25%) which has continued since June 2004 and took a wait-and-see stance to monitor the effect of its past interest rate hikes while expressing concerns on the risks of inflation. Although one more interest rate hike next year would be possible on the basis of the simulation above, a number of empirical studies show that the effect of monetary policy measures would peak in one to two years time. In the event the Fed decides to resume its credit tightening campaign, the timing would be brought forward.

Even so, as the US economy is expected to show more signs of slowdown from the end of 2006 to early 2007, the possibility of an interest rate cut to eliminate the risks of a recession cannot be ruled out.

[Chart 7: Outlook on the US economy]

(%)

	2005 (Actual)	2006 (Forecast)	2007 (Forecast)	2006		2007	
				1H	2H	1H	2H
GDP	3.2	3.5	2.9	3.8	2.9	2.8	2.9
Personal consumption	3.5	3.1	2.6	3.2	2.6	2.5	2.8
Housing investment	8.6	0.4	-0.8	-2.0	-1.9	-2.3	3.5
Capital investment	6.8	7.0	3.7	8.7	5.2	2.7	4.2
Inventory investment ($100 million)	197	406	347	469	343	373	322
Government expenditures	0.9	2.2	2.8	2.3	2.4	3.0	3.0
Net exports ($100 million)	-6,192	-6,205	-5,956	-6,319	-6,092	-5,907	-6,005
Exports	6.8	7.7	4.9	10.1	4.4	5.1	5.0
Imports	6.1	5.2	2.0	7.7	0.5	1.5	4.5
Domestic final demand	3.6	3.1	2.6	3.2	2.6	2.3	3.0
Core personal expenditures deflator <y-o-y ch>	2.1	2.3	2.4	2.1	2.6	2.6	2.3
Current account balance ($ 100 million)	-7,915	-8,470	-8,000	-4,240	-4,220	-3,940	-4,060
<as a percentage of nominal GDP>	-6.4	-6.4	-5.7	-6.5	-6.2	-5.7	-5.7

Notes: 1. Calendar-year figures reer to the rate of change from the previous year. Half-year term figures refer to the rate of change from the previous half-year term (annualized).
2. The shaded columns are forecasts.
3. As for the current account balance, figures for the half-year terms are adjusted for seasonal factors and the calendar-year figures are the totals. The percentages of nominal GDP are annualized.

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

II. The Japanese economy

(1) The current state of the economy

The Japanese economy slowed to 0.8% q-o-q p.a. in the Apr-Jun quarter of 2006

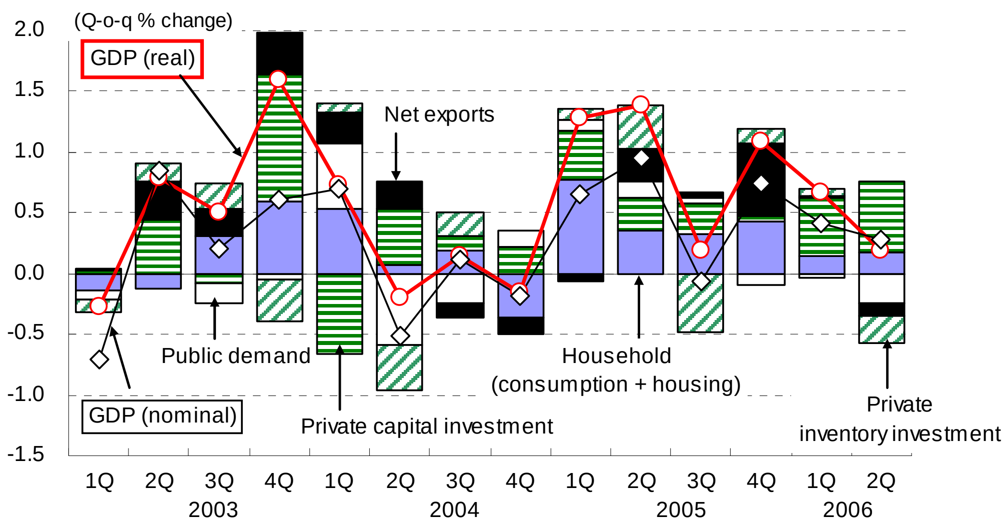
Japan's real GDP slowed sharply to 0.2% q-o-q (0.8% q-o-q per annum) in the Apr-Jun quarter of 2006 from 0.7% q-o-q (2.7% q-o-q p.a.) in the Jan-Mar quarter (**Chart 8**). Even so, note that domestic private-sector final demand continued to grow strongly, and that the primary causes of the slowdown were the decline of inventory investment, public demand and external demand. The latest readings mark the sixth consecutive quarter of growth, indicating that the Japanese economy is still in a self-sustained recovery cycle.

Looking closer at each of the components of demand, domestic private-sector final demand served as the driver of growth, given the ongoing rise of domestic private sector demand (0.5%q-o-q) and the dramatic increase of business capital investment (3.8% q-o-q). Net exports pushed down real GDP by 0.1% pt because of a sharp slowdown of exports amid the ongoing gradual rise of imports. Private sector inventory investment pushed down the rate of growth by 0.2% pt as manufacturers worked off their dealer stock. Meanwhile, public investment dragged down growth by 0.2% pt due to the ongoing decline of public investment and the downturn of government consumption into negative territory.

The risks of a backslide into deflation are receding

The GDP deflator, a broad measure of price changes, narrowed to -0.8% y-o-y, compared with -1.2% y-o-y in the previous quarter. Although the GDP deflator is still in negative territory due to the rise of the import deflator reflecting the high price of crude oil, the domestic demand deflator rose to 0.1% y-o-y. Judging from the fact that the output gap (calculated by MHRI) is already charting positive territory, we believe that the Japanese economy has already emerged out of deflation. The movements of the GDP deflator and recent price trends indicate that the risks of a backslide into deflation are gradually receding.

[Chart 8: Japan's quarterly GDP growth]



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

The current expansion has surpassed the *Heisei* Boom

The economic expansion starting in January 2002 reached its 53rd month in June and has outlasted the *Heisei* Boom which lasted for 51 months. If the economy continues to expand, the length of the current expansion cycle would catch up with the *Izanagi* Boom (57 months) in October. Even though domestic demand is gaining strength, leading to our view that the current economic expansion will surpass the *Izanagi* Boom, there are risk factors such as the US economic slowdown and the negative impact upon corporate business sentiment due to rising costs stemming from the rise of crude oil prices.

(2) Forecast of the Japanese economy in FY2006 and FY2007

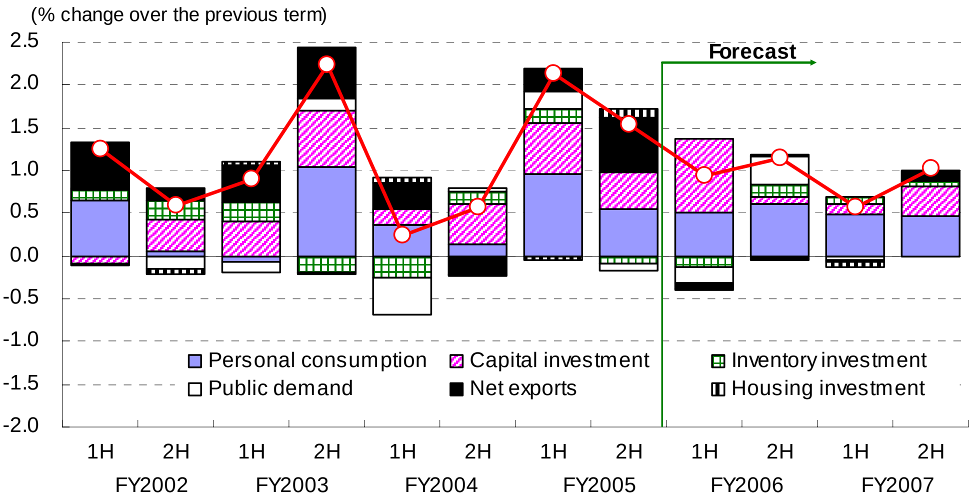
1H FY2006: Japan will continue to follow a self-sustained recovery driven mainly by private demand

Japan's rate of real GDP growth should pick up, driven mainly by personal consumption and business capital investment, and reach an annual rate of 2~3% in the Jul-Sep quarter of 2006. This should bring the rate of real GDP in the first half of 2006 to 0.9% over the previous term (an annualized rate of 1.9% over the previous term), on par with Japan's potential growth rate.

2H FY2006: external demand and capital investment will drag down growth

In the second half of FY2006, export growth is predicted to slow along with the deceleration of the US economy. The stagnation of production and corporate earnings reflecting the slowdown of external demand should lead to a slower pace of capital investment growth, causing the economy to pause on the landing as in the second half of FY2004. In contrast, personal consumption should remain strong, reflecting the ongoing improvement of the income environment. Moreover, inventory investment and public demand, which had served as a drag upon growth in the first half of the year, will pick up and push up the rate of real GDP growth. Thus, even though the economy will show signs of stagnation in the second half of 2006 due mainly to the slowdown of exports, the pace of growth itself will remain high at 1.1% over the previous term (an annualized rate of 2.3% over the previous term) (**Chart 9**).

[Chart 9: Forecast on Japan's real GDP growth]



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

FY2006: the Japanese economy will continue to grow a solid 2.3%

Judging from the foregoing, we expect full-year GDP growth in FY2006 to reach 2.3% in real terms (previous forecast: 2.5%) and 2.3% in nominal terms (previous forecast: 2.5%), growing strongly above 2% for the second year in a row subsequent to FY2005. The GDP deflator should climb to 0.1% y-o-y, rising into positive territory for the first time since FY1997 when the consumption tax was raised.

FY2007: slower growth due mainly to weak capital investment

In the first half of FY2007, the pace of economic growth will likely remain sluggish due to the lingering effect of the overseas economic slowdown from the second half of FY2006. Even though crude oil prices should peak out in the summer of 2006, providing a pause in the rise of raw material and fuel costs, the increase of fixed costs such as labor costs and financial costs will start to weigh down upon corporate earnings and lead to a sharp slowdown of profit growth. Even though personal consumption should continue to grow amid the ongoing rise of income, the ebb of corporate earnings growth should lead to a sharp drop of capital investment.

Although the pace of economic growth will pick up slightly in the second half of FY2007 reflecting the upturn of the overseas economies, we expect full-year GDP growth in FY2007 to stand at 1.7% in real terms (previous forecast: 1.5%) and 2.3% in nominal terms (previous forecast: 2.0%) (**Chart 10**).

【 Chart 10: Outlook on the Japanese economy 】

(%)

	FY2005	FY2006	FY2007	FY2006		FY2007		FY2006	FY2007
				1H	2H	1H	2H	(Contribution)	(Contribution)
	(Actual)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)
GDP (real)	3.2	2.3	1.7	0.9	1.1	0.6	1.0	-	-
Domestic demand	2.8	2.1	1.7	1.0	1.2	0.6	0.9	2.1	1.7
Private sector demand	3.3	2.8	2.0	1.6	1.1	0.8	1.2	2.2	1.5
Personal consumption	2.3	2.0	1.8	0.9	1.1	0.9	0.8	1.1	1.0
Housing investment	-0.2	1.1	-1.5	-0.7	0.7	-2.0	0.3	0.0	-0.1
Capital investment	7.5	7.4	2.3	5.7	0.5	0.8	2.3	1.1	0.4
Public sector demand	0.8	-0.3	0.5	-0.9	1.5	-0.2	-0.0	-0.1	0.1
Government consumption	1.5	1.0	1.3	0.1	1.5	0.3	0.5	0.2	0.2
Public investment	-1.4	-5.1	-2.4	-4.5	1.1	-1.5	-2.3	-0.2	-0.1
Net exports (contribution)	0.5	0.2	-0.0	-0.1	-0.0	-0.0	0.1	0.2	-0.0
Exports	9.1	6.6	3.0	2.7	1.1	1.0	2.7	1.0	0.5
Imports	6.5	5.9	3.4	3.8	1.8	1.4	2.3	-0.8	-0.5
GDP (nominal)	1.8	2.3	2.3	1.2	1.3	1.2	0.8		
GDP deflator	-1.4	0.1	0.7	-0.3	0.4	0.8	0.5		
Industrial production	1.6	3.4	2.1	1.7	0.7	0.7	2.2		
Unemployment rate	4.4	4.0	3.7	4.1	4.0	3.7	3.7		
Current account balance (trillion yen)	19.1	18.9	20.5	18.8	19.2	20.2	20.8		
as a percentage of nominal GDP	3.8	3.7	3.9	3.7	3.7	3.8	3.9		
Corporate goods prices	2.1	2.5	-0.0	3.1	1.9	0.2	-0.2		
Consumer prices	0.1	0.6	0.5	0.6	0.6	0.5	0.6		
Long-term interest rate (%)	1.42	2.00	2.25	1.90	2.10	2.20	2.30		
Nikkei stock average (yen)	13,549	16,200	17,300	15,800	16,600	17,100	17,500		
Exchange rate (yen/dollar)	113.2	111	107	114	109	106	108		
Crude oil price (WTI $/barrel)	60.0	73.0	67.4	72.8	73.2	70.1	64.7		

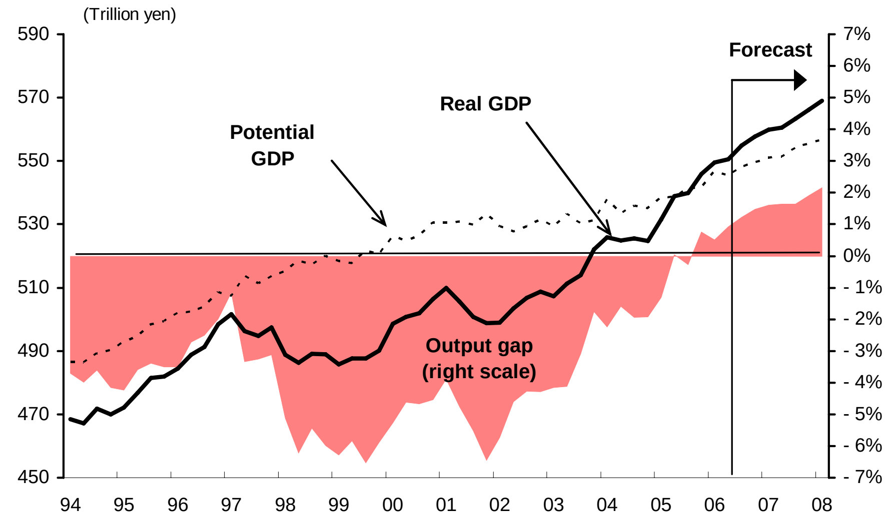
Notes: 1. FY = rate of change from the previous year. Half-year = rate of change from the previous term (excluding the unemployment rate, current account balance and prices).
2. Half-year corporate goods prices and half-year consumer prices = rate of change over a year ago. Consumer prices = nationwide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

The output gap (the gap between demand and supply) calculated by MHRI has been charting positive territory since the Oct-Dec quarter of 2005 as Japan's economic growth continues to outpace its potential rate of growth (**Chart 11**). On the basis of MHRI's forecast, the positive output gap (indicating an excess of demand) should continue to expand at a moderate pace despite an economic slowdown during the second half of FY2006 to the first half of FY2007, because the economy will keep growing at its potential rate of growth. While the Bank of Japan (BOJ) will most likely keep monetary policy unchanged during the calendar year 2006 in order to assess the impact of the termination of the zero interest rate policy in July, we expect the central bank to gradually raise the target interest rate from then onward at a pace of approximately once in every 6-month period.

[Chart 11: The output gap]

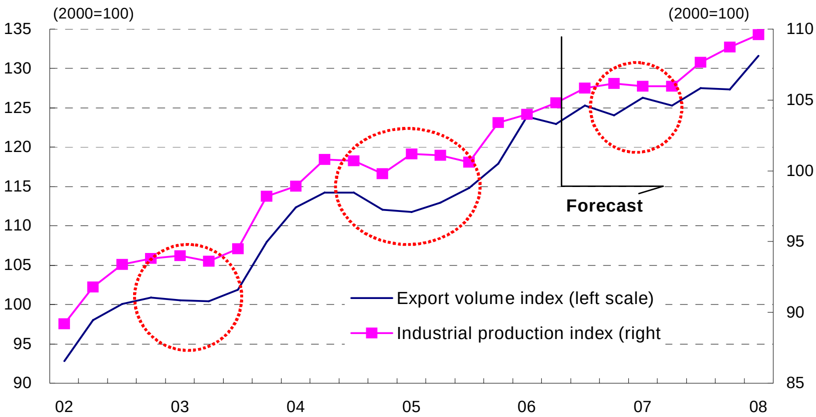


Note: Estimates by MHRI.
Sources: Cabinet Office, Ministry of Economy, Trade and Industry, Ministry of Internal Affairs and Communications, and others.

The Japanese economy will slow down to the third "landing" in the second half of FY006 to early FY2007

Sluggish exports reflecting the slowdown of the US economy and a minor adjustment in the IT-related sector will flatten out production activity in the second half of FY2006, slowing down Japan's current economic recovery to the third "landing" or pause in economic growth (**Chart 12**). The Chinese regulatory authority's contemplation of tightening measures to cool down overheated domestic investment is also reminiscent of the second half of FY2004. That said, the odds are high that domestic investment in China will not slow down as much as in the second half of FY2004 given the scheduled Olympic Games in Beijing. Furthermore, although market conditions for liquid crystal panels are softening along with the rise of inventories of flat-panel television sets in the European market, inventory adjustment pressures are localized in certain items, as shown by solid DRAM market conditions. The slowdown of China-bound exports and the adjustment in IT-related sectors will most likely turn out to be benign in comparison with the previous "landing". Note also that in the second half of FY2004, the non-manufacturing sector offset the shortfalls in the manufacturing sector to prevent a major economic slump. At the current juncture, the Tertiary Industry Activity Index is continuing to rise, providing us with reasons to believe that the non-manufacturing sector will underpin the economy again. The pause in the second half of FY2006 to early FY2007 will not develop into a recession and the Japanese economy will continue to expand, outlasting the *Izanagi* Boom (lasting 57 months) in November.

[Chart 12: Trends in the export volume index and the industrial production index]



Note: Adjusted for seasonal factors. Seasonal adjustments for the export volume are by MHRI.
Sources: Ministry of Finance, *The Summary Report on Trade of Japan,* Ministry of Economy, Trade and Industry, *Indices of Industrial Production.*

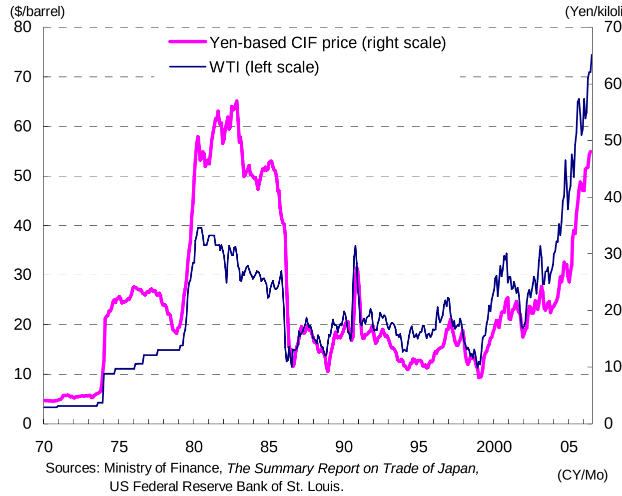
High crude oil and commodity prices will gradually push down corporate profits

Soaring crude oil and nonferrous metal prices are serving as a greater drag upon corporate profits. The benchmark price of crude oil (WTI) is currently trending around the mid-$70/barrel level. While the price of rude oil surged temporarily to the $70/barrel level when a series of major hurricanes hit the US last summer, petroleum prices are starting to be fixed at the $70/barrel level on the back of mounding geopolitical risks. Compared with last year when the rise was perceived as a temporary uptick stemming from a transient factor (the hurricanes), the surge this year has a more serious psychological impact upon businesses. On the basis of the yen-based CIF price of crude oil to Japan, the price of crude oil is edging closer to the level during the Second Oil Shock (**Chart 13**). Furthermore, prices of nonferrous metals such as copper and aluminum are rising more sharply than during the Second Oil Shock. While the corporate activity-related DI of the *Economy Watchers Survey* has been declining since the peak in early 2006, comments reveal mounting concerns regarding the rise of raw material and fuel costs (**Chart 14**).

Manufacturers are shifting more of their costs to prices

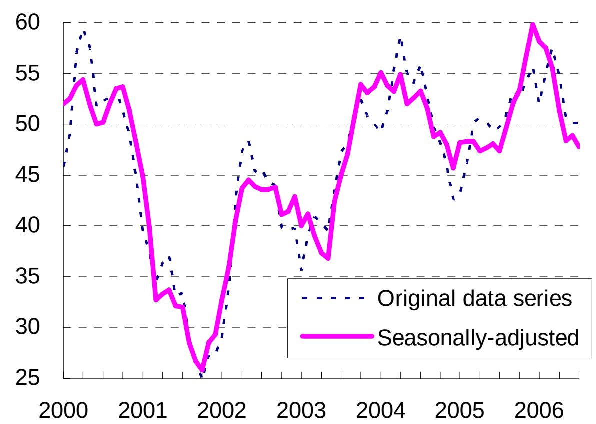
Chart 15 depicts the changes in adjusted terms of trade (terms of trade adjusted for input ratios) from FY2003 to FY2005. Of the raw materials industries, the adjusted terms of trade are dipping into negative territory in industrial sectors such as textile products, pulp & paper, chemical products, ceramics, stone & clay and nonferrous metals. Going forward, we expect a gradual shift of costs to prices in these sectors. This should lead to a certain degree of improvement in profitability in the manufacturing and raw material sectors. In contrast, the terms of trade are negative among processing sectors. In particular, given the difficulty to shift costs to prices in industrial sectors such as electrical machinery because of fierce competition, companies are continuing to absorb the burden through the increase of sales volumes and cost-cuts. Looking forward, the difficulties in passing on costs to prices should persist among companies in the processing industries and serve as downward pressures upon profits.

[Chart 13: Crude oil prices (WTI and CIF price)]



Sources: Ministry of Finance, *The Summary Report on Trade of Japan*, US Federal Reserve Bank of St. Louis.

[Chart 14: Corporate activity-related DI (Economy Watchers Survey]



Note: Seasonal adjustments by MHRI (X-11).
Source: Cabinet Office, *Economy Watchers Survey.*

However, the high price of crude oil will only have a limited impact upon the overall Japanese economy. According to trial calculations using the Mizuho Macroeconometric Model (MMM), even if the price of crude oil rises from $60/barrel (the actual level in FY2005) to $75/barrel, it would only raise consumer prices by 0.3% and push down the rate of GDP growth by 0.2% (**Chart 16**). While high crude oil prices will serve as an undeniable drag upon corporate profits, the high price of petroleum alone will not derail the recovery of the Japanese economy.

[Chart 15: Adjusted terms of trade]

(%)

	Input price (Rate of rise)	Output price (Rate of rise)	Trade terms (Breadth of change)	Adjusted trade terms (Breadth of change)
Manufacturing industry	12.7	5.1	-6.7	-3.6
Foods	0.4	0.8	0.4	1.3
Textile products	3.2	0.4	-2.7	-1.9
Pulp, paper and w ooden products	4.8	0.3	-4.3	-4.5
Chemical products	24.1	11.8	-9.9	-1.2
Petroleum and coal products	79.8	42.4	-20.8	3.7
Ceramic, stone and clay products	9.7	2.5	-6.6	-2.1
Iron and steel	41.3	30.8	-7.4	21.7
Non-ferrous metals	51.7	27.3	-16.1	-6.7
Metal products	18.1	4.6	-11.5	-9.3
General machinery	5.1	0.5	-4.4	-4.9
Electrical machinery	0.1	-7.2	-7.3	-15.9
Transportation equipment	1.8	-1.0	-2.8	-7.6
Precision instruments	0.9	-1.7	-2.6	-3.5
Miscellaneous manufacturing products	9.1	2.7	-5.9	-3.0

Note: Rate of change from FY2003 to FY2005. The adjusted trade terms are the terms of trade after adjustments for input ratios.
Source: Bank of Japan, *Input-Output Price Index of the Manufacturing Industry by Sector.*

[Chart 16: The impact of the rise of crude oil prices]

(%)

	Price of crude oil (WTI, $ barrel)			
	65	70	75	80
Current profits	-0.4	-0.9	-1.3	-1.7
Real GDP	-0.1	-0.1	-0.2	-0.3
Personal consumption	-0.0	-0.0	-0.1	-0.1
Capital investment	-0.4	-0.8	-1.2	-1.6
Consumer prices	0.1	0.2	0.3	0.4
Corporate goods prices	0.3	0.5	0.8	1.0

Notes: 1. Estimates using the MMM (comparison w ith a case w here the price of crude oil is $60/barrel).
2. Current profits are based upon the *Financial Statements Statistics of Corporations by Industry (Quarterly).*

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