

# Economic Outlook for FY2004, FY2005 and FY2006

February 2005

The Mizuho Research Institute Ltd. (MHRI) announces its economic outlook for FY2004, FY2005 and FY2006 subsequent to the release of *The Preliminary Quarterly Estimates of GDP* for the Oct-Dec quarter of 2004 by the Cabinet Office. The key points of the outlook are as follows.

## <The Overseas Economies>

<b>The US Economy</b>	Moderate expansion around its potential rate of economic growth (2005: 3.4%, 2006: 3.3%)
<b>The Euro Zone Economy</b>	Structural adjustment pressures will serve as a drag upon growth (2005: 1.7%, 2006: 2.0%)
<b>The Asian Economies</b>	A recovery from mid-2005 as the corporate sector emerges out of an inventory adjustment cycle (2005: 6.2%, 2006: 6.6%)

## <The Japanese Economy>

<b>FY2004</b>	The economy will emerge out of the doldrums and start to pick up (Real GDP growth 1.5%, nominal GDP growth 0.7%)
<b>FY2005</b>	A moderate recovery driven by domestic private-sector demand (Real GDP growth 1.5%, nominal GDP growth 0.9%)
<b>FY2006</b>	Strong domestic demand will lead to the end of deflation (Real GDP growth 1.8%, nominal GDP growth 1.5%)

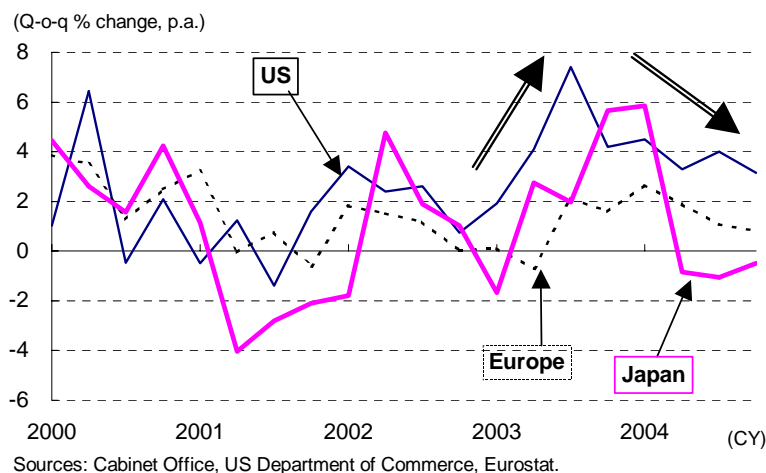
This English-language translation is based upon the outlook in Japanese released on February 18, 2005. This publication is compiled solely for the purpose of providing readers with information and is in no way meant to encourage readers to buy or sell financial instruments.

## I. Overview of the global economy

**Global growth is gradually losing momentum given the surge of crude oil prices and inventory adjustment pressures**

The global economy is losing momentum since mid-2004 despite the pickup of growth from the spring of 2003 spurred by monetary easing measures in consideration of the risks accompanying rising tensions in the Middle East (**Chart 1**). In the US, the pace of economic growth is slowing from mid-2003 given the fading impact of tax cuts, rising crude oil prices and sluggish export growth. In the euro zone, the rise of inflation and lackluster wage growth is dampening consumer spending while the slowdown of exports due to the appreciation of the euro is serving as a drag upon economic growth. The Asian economies including Japan were subject to further negative pressures as a result of efforts to adjust output due to the accumulation of unsold stocks of IT and digital-related inventories and successive natural disasters in Japan. China, however, is still enjoying strong economic growth in spite of tightening measures.

[ **Chart 1: Global economic growth** ]



**However, the downside risks of the global economy are receding**

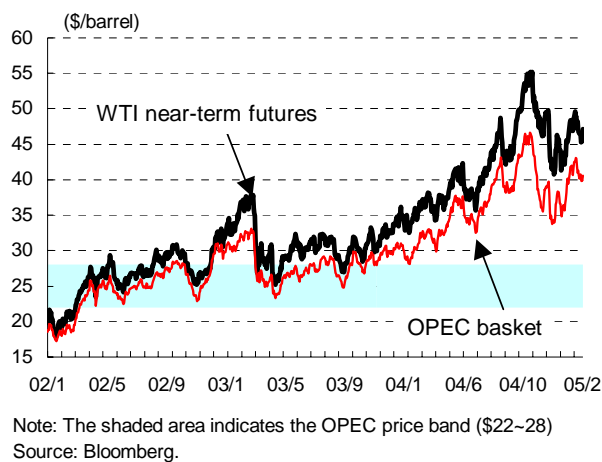
Looking forward, the global economy should avert a loss of momentum and continue to expand because of (1) the stabilization of crude oil prices and (2) the ebb of the risks of a sharp depreciation of the dollar reflecting the US “twin deficit”.

**Crude oil prices are still high albeit its stabilization**

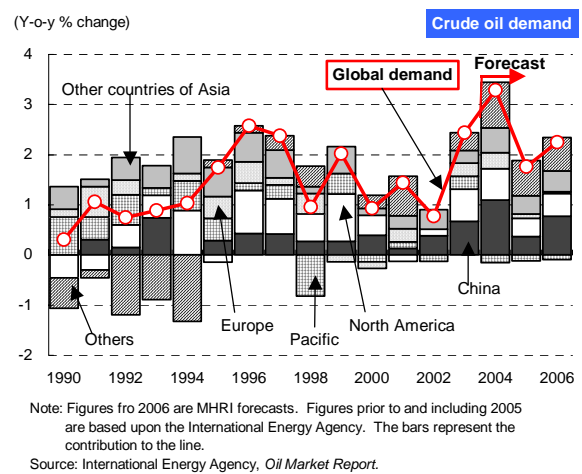
Crude oil prices (WTI near-term contracts for crude futures) are still pinned at a high level (**Chart 2**). In addition to the persistently strong demand for crude oil driven mainly by China, supply-side concerns still linger such as terrorist risks and strikes in oil-producing countries. Furthermore, another factor hampering the fall of crude oil prices is speculation that the Organization of Petroleum Exporting Countries (OPEC) will decide to reduce output at the next meeting on March 16<sup>th</sup> ahead of the seasonal drop in demand in the early spring season.

Subsequent to the OPEC's decision to cut over-quota output (one million b/day) at its meeting on December 10, 2004, the OPEC ministers resolved to temporarily suspend the current price band (22~28 \$/b) with a view to future price hikes at its Extraordinary Meeting on January 30, 2005. Although the output quota is currently fixed at 2.7 million b/day, it appears that output in January was held within the quota level minus the over-quota output. Judging from comments by high-ranking officials of OPEC member states, the target price band should be raised approximately \$10/b. Judging from the foregoing, the chances of a decision to cut output at the next OPEC meeting are not necessarily slim.

[ Chart 2: Crude oil price trends ]



[ Chart 3: Forecast on crude oil demand ]



**Demand for crude oil to remain strong, driven mainly by China**

**Crude oil supply by non-OPEC countries will expand**

According to projections on crude oil demand in 2005 by the International Energy Agency (IEA), crude oil demand in China will rise to 6.8 million b/d from 6.4 million b/d in the previous year, in addition to steady demand in North America, Brazil and Africa. Nevertheless, the IEA forecasts that demand for crude oil will only grow 1.8% y-o-y in 2005 (in contrast to 3.3% y-o-y in 2004) given the ebb of demand growth due to the slowdown of major economies such as Japan, the US and Europe (**Chart 3**).

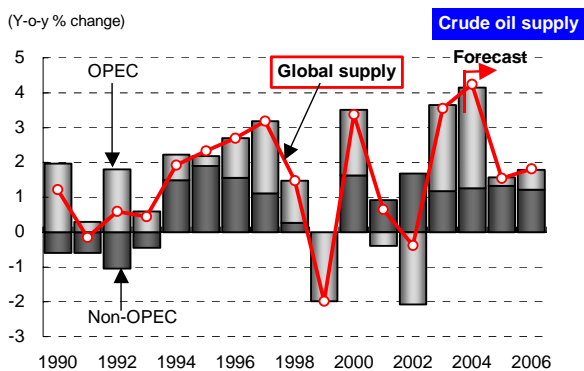
On the supply-side, the OPEC nations are still inclined to upgrade their supply capacity through the development of oil sites, as exemplified by Saudi Arabia's plan to increase output to 800 thousand b/d by 2007. Moreover, non-OPEC nations such as Russia are also boosting their supply capacity through active investment, leading to the expansion of the global capacity to supply crude oil. In view of expectations that Russia will boost its crude oil output, the OPEC nations will most likely reduce output from 2005 to 2006 in order to avoid an oversupply (**Chart 4**).

**The price of crude oil  
will gradually decline to  
\$40/b**

Judging from the foregoing supply-demand balance, the price of crude oil should gradually fall despite lingering terrorist risks and other such supply-side concerns, because of the decline of speculative transactions reflecting the ebb of expectations on extremely high crude oil prices stemming from a slower pace of demand growth. Furthermore, “black market output hikes” to supplement revenue shortfalls accompanying the fall of crude oil prices should serve as further negative pressures upon the price of crude oil.

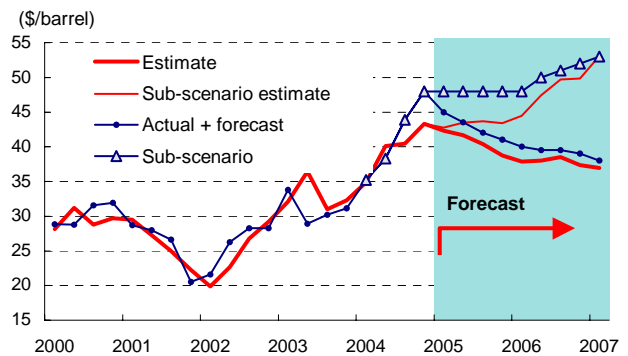
Even so, the rise of demand driven primarily by China should serve as fresh upward pressures upon the price of crude oil in 2006. Moreover, in the event crude oil prices fall closer to \$40/b, the OPEC nations may cut output in a bid to support price levels. In any event, it is unlikely that the price of crude oil will fall sharply below \$40/b.

[ Chart 4: Global petroleum supply ]



Note: Non-OPEC supply in 2005 are estimates by the International Energy Agency. OPEC supply in 2005 and 2006 are MHRI forecasts.  
Source: International Energy Agency, *Oil Market Report*.

[ Chart 5: Estimate and scenario on crude oil  
prices ]

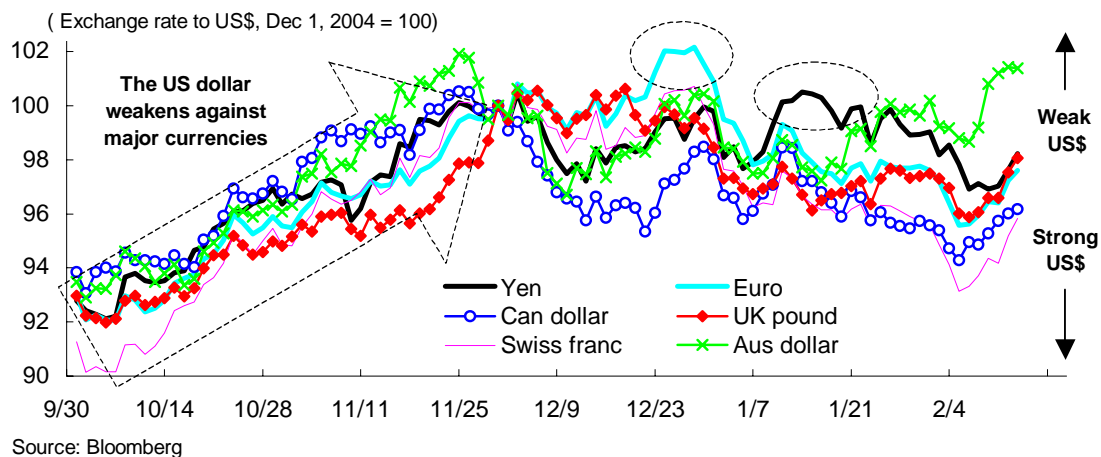


Source: MHRI estimates.

**The dollar is regaining  
ground since the turn of  
the calendar year**

Despite the weakness of the dollar since mid-2004 reflecting the US “twin deficit” in the current account and budget balance, the decline of the dollar exchange rate is coming to a halt since the turn of the calendar year (Chart 6). Even though the dollar temporarily weakened against the yen (equivalent to the appreciation of the yen) in mid-January, the US currency has regained ground since early February.

[ Chart 6: The exchange rate of major currencies to the US dollar ]



**The recovery of confidence in the US spurs a dollar rebound**

**A temporary drop of the euro given the ebb of the risk premium of the dollar**

**Despite a temporary rebound of the dollar, yen-strengthening pressures will rise in 2006**

The dollar rebound stems primarily from the recovery of the market's confidence in the US policy stance revealed in key events and comments by high-ranking officials. For example, (1) the Iraq National Assembly election achieving a certain measure of success (January 30<sup>th</sup>) and (2) the tone-down of US President George Bush's confrontational stance in requests for "democratization" in the State of the Union address (February 2<sup>nd</sup>) served to underpin the dollar by easing geopolitical risks. Furthermore, the market's concerns regarding the US "twin deficit" receded as a result of (3) the shift of emphasis in the State of Union address toward economic policy, (4) the tone-down of Fed Chairman Alan Greenspan's caution regarding the twin-deficit, and (5) expenditure cuts in the Budget Message.

The recent strength of the euro - spurred mainly by currency market players fleeing dollar risks - is losing momentum along with the recovery of confidence in the dollar. The euro is weakening against the dollar along with the ebb of the risk premium. For the time being, we expect to see a correction of the excessive appreciation of the euro. Nevertheless, a sharp depreciation of the euro is unlikely in view of the growing importance of the euro as a junior key currency supplementing the dollar and the rising demand for the euro as an investment tool for foreign currency reserves and investment funds. On a medium-term perspective, the euro will most likely trade around 1.3 dollar to the euro.

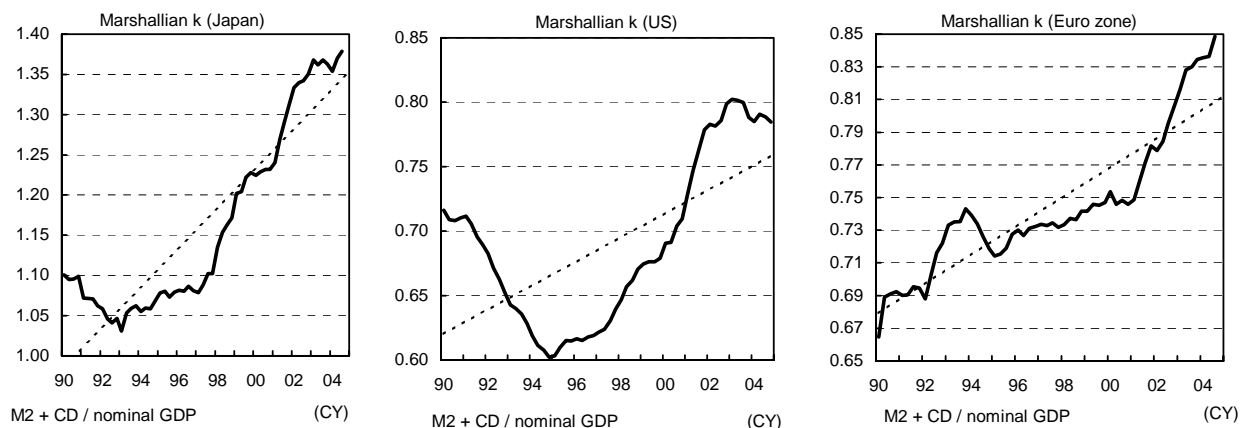
By the same token as the euro/dollar exchange rate, the dollar will test the topline amid receding speculation on a weak dollar. Despite mounting upward pressures upon Asian currencies including the yen due to forecasts of an early upward adjustment of the renminbi, the lack of progress on the reform of China's current currency system at the Group of Seven (G7) summit meeting in London (February 4~5<sup>th</sup>) should also serve to weaken the Asian currencies against the dollar. Nevertheless, there are many who point out that the current dollar-peg of China's current currency system is becoming unsustainable given its potential to create a currency oversupply because of the existence of a massive trade surplus

with the US. In view of the steps taken by the Chinese government toward currency system reform, the renminbi revaluation will most likely materialize during the forecast period up to FY2006. In view of these circumstances, it is highly unlikely that the dollar will appreciate against the Asian currencies. As for the US dollar exchange rate against the yen, yen-buying demand stemming from the massive current account surplus and the rise of investment in Japanese stocks will serve as yen-strengthening factors. We are thus inclined to believe that yen-strengthening pressures will rise after a temporary appreciation of the dollar.

**Leading industrialized countries will remain awash with excess liquidity**

In the leading industrialized countries of the world, Marshallian k, which is the ratio of M2+CDs outstanding to nominal GDP, has been significantly above trend, indicating a liquidity glut due to a prolonged period of monetary easing (**Chart 7**). If such a condition were to be left unattended under an economic recovery cycle, it would lead to the rise of asset inflation risks (an asset bubble).

**[ Chart 7: Excess liquidity in Japan, the US and the Euro zone ]**



**Major global economies sound alarms on the risks of excess liquidity**

Subsequent to the US shift of its monetary policy stance to neutral, the President of the European Central Bank (ECB) is indicating the existence of excess liquidity and the risks involved therein. While the only express indication by the Bank of Japan (BOJ) thus far is that the elimination of deflation is a precondition to the termination of the quantitative monetary easing policy due to persisting deflationary conditions, Japan and the euro zone will also be subject to pressures to shift away from their easy monetary policy stance once the pace of economic growth picks up and the demand-supply balance tightens, leading thereby to the rise of prices.

**Japan, the US and the euro zone economies tighten their budget spending**

Japan, the US and the euro zone economies are tightening their budget spending. In the US, the Budget Message's target to half the budget deficit by 2010 provides us with reason to believe that the government will suppress the level of budget spending. In the euro zone, the requirement under the Stability and Growth Pact to "keep public deficits under a 3% nominal GDP/deficit ratio in any year" will most likely be retained. Germany and France which have yet to achieve the requirement, should begin to curb their budget spending.

**Despite ongoing strong growth, the pace of US economic growth will slow down in the second half of FY2006**

**The corporate sector's efforts to upgrade financial conditions will serve as a drag upon euro zone economic growth**

**Asian economic growth will slow temporarily due to inventory adjustment in the IT/digital sector and China's tightening measures**

Japan under the Koizumi Administration is also poised to restrain the rise of budget expenditures under the policy goal to achieve a primary surplus by the early 2010s.

In view of the above-mentioned circumstances, the odds are high that both monetary and fiscal policy will serve as restraints upon economic growth.

Judging from the foregoing preconditions, the pace of US economic growth will slow slightly in the first half of 2005 due to the lingering effect of high crude oil prices and a slight rise of inventory adjustment pressures. However, in the second half of 2005, the US economy will regain momentum along with the alleviation of inventory adjustment pressures and the decline of crude oil prices. Meanwhile, in addition to successive interest rate hikes, fiscal policy will gradually serve as downward pressures upon the economy. Thus, the pace of US economic growth in the second half of 2006 will most likely fall short of its potential rate of growth (**Chart 8**).

The euro zone economy should avoid a loss of momentum given the alleviation of the negative impact of high crude oil prices and the strong euro. Nevertheless, the economic expansion will lack breadth and remain weak due to the strong inclination among companies to place priority upon the improvement of financial conditions rather than investing in plant and equipment and hiring new employees. We are thus inclined to believe that it will only be sometime after mid-2005 that the corporate sector starts to engage in forward-looking activities subsequent to the restoration of financial conditions.

The key to the Asian economy lies in the inventory adjustment cycle of the IT and digital appliance sector and the Chinese economy rather than crude oil and the foreign exchange rate. Moreover, the economies of Asia would be affected strongly by economic trends in the US, which comprises the largest market for IT and digital appliances. The IT and digital appliance sector of export-oriented industrialized economies such as South Korea and Taiwan are subject to mounting pressures to reduce unsold stocks of computers and related equipment along with the peak-out of the move to replace outdated computer models. Nevertheless, from mid-2005 to 2006, prospects of strong US economic growth provide us with reason to believe that the inventory adjustment cycle will progress and drive the Asian economies into an export-led recovery. Furthermore, active infrastructure investment among the ASEAN member states and the demand in connection with reconstruction efforts in the aftermath of the *tsunami* in the Indian Ocean should also serve to buttress the growth of the economy in the region.

China's economic growth should temporarily tone down as a result of a slower pace of growth among the leading industrialized economies and the tightening measures. Even so, the pace of China's economic growth will gather fresh momentum and enter an investment-led upturn in 2006 reflecting the strong

**The Japanese economy  
will gradually pick up  
and enter a domestic  
demand-led recovery**

investment sentiment in the corporate sector.

As the year progresses in 2005, the Japanese economy is starting to show signs that it is emerging out of a soft patch. The inventory adjustment of IT and digital appliances is progressing steadily while leading indicators on capital investment presage an ongoing expansion. The income environment in the household sector is also improving albeit at a moderate pace and the reaction to the strong demand generated by the hot summer weather and Olympic games is running its course, thus paving the way for the recovery of consumer spending. Looking forward, the economy should gradually turn more sanguine. Although exports will no longer serve as the engine of economic recovery with both the US and Chinese economies shifting to cruise mode, the Japanese economy will continue to expand toward the termination of deflation on the back of steady domestic demand.

[Chart 8: Global economic growth ]

(%)											
	2003	2004			2005			2006			
			1H	2H		1H	2H		1H	2H	
US	3.0	4.4	4.1	3.6	3.4	3.1	3.6	3.3	3.5	2.7	
Euro zone	0.5	2.0	2.2	1.3	1.7	1.6	2.2	2.0	2.2	1.4	
Asia	6.1	7.4			6.2			6.6			
	NIEs	3.0			5.7			4.0			4.4
	ASEAN4	5.3			5.9			5.1			5.2
	China	9.3			9.5			8.4			8.8
Japan	1.4	2.6	4.1	-0.9	1.0	1.3	1.8	1.9	1.9	1.9	

Notes: The shaded areas are forecasts.

CY = change over the previous year, half-year = percentage change over previous term on an annualized basis.



## II. The Japanese Economy

### 1. The current state of the Japanese economy

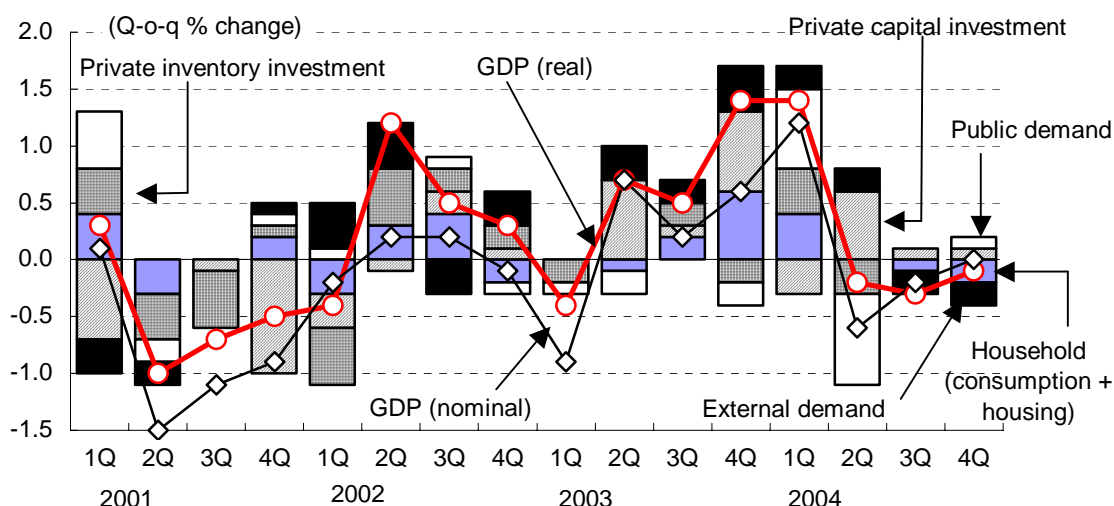
**Japan's real GDP contracted for the third consecutive quarter in the Oct-Dec quarter of 2004**

The Japanese economy remained in adjustment mode during the second half of 2004.

Japan's real GDP in the Oct-Dec quarter of 2004 shrank 0.1% quarter-on-quarter (q-o-q), which is translated into an annualized contraction of 0.5% (**Chart 9**). Looking closer at each of the components of demand, the weak growth of exports was more than offset by the rise of imports, leading to a negative contribution by external demand (-0.2% pt). The contribution by domestic private demand turned out to be more or less flat (-0.0% pt) despite the strength of capital investment and housing investment because personal consumption was dragged down by the unseasonable warm winter weather. Public demand served as a positive contribution to real GDP growth (+0.1% pt) given the contraction of the drop of public fixed capital formation and the ongoing rise of government expenditures.

Furthermore, the retroactive revision of GDP figures revealed that the economy shrank in the Jul-Sep quarter of 2004, meaning that Japan's economic growth receded for three quarters in a row. Although these figures provide fodder for views that the Japanese economy has already slipped into a recession, it is too early at this point in time to arrive at such a judgment with any certainty because the breadth of the contraction is extremely small in all of the three quarters and the figures may still be upwardly revised in the final estimation (and/or along with seasonal adjustments every quarter).

[ Chart 9: Japan's quarterly GDP growth ]



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

**Industrial production is expected to rise for the first time in three quarters in the Jan-Mar quarter of 2005**

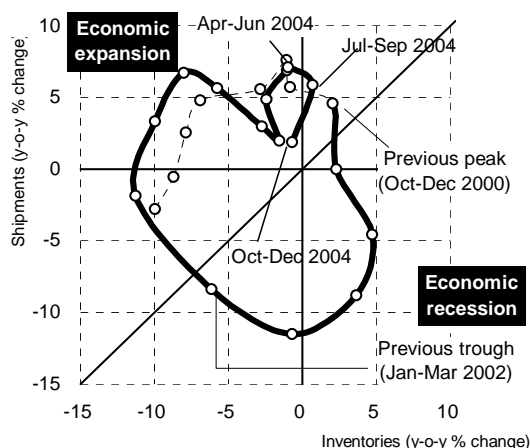
**Recent data reveal an upturn of domestic private demand since the turn of the year**

Since the beginning of the year 2005, the Japanese economy has been showing signs that it is gradually bottoming out.

The indices of industrial production (IP) fell for the second month in a row in the Oct-Dec quarter of 2004 (-0.6% q-o-q), revealing that the economy has fallen into the doldrums as indicated by the rate of real GDP growth. Note, however, that the projected rate of IP growth in the Jan-Mar quarter based upon the forecast index is more than 1% higher than the Oct-Dec quarter of 2004. As the inventory cycle (**Chart 10**) shows, this is due to the steady progress of inventory adjustment as a result of efforts among companies to cut output during the second half of 2004. In addition to the characteristic that the recent rise of inventory adjustment pressures was limited only to the IT and digital appliances and automobile-related sectors, the auto-related sector has already finished reducing their inventory overhang. Both the inventory rate and inventory index in the transportation equipment industry has fallen by more than 20% month-on-month (m-o-m) in December. Final product demand for IT and digital appliances such as liquid crystal TVs is growing steadily due in part to lower prices, leading to a high probability that the inventory adjustment cycle will run its course by the end of the current fiscal year (March 31, 2005).

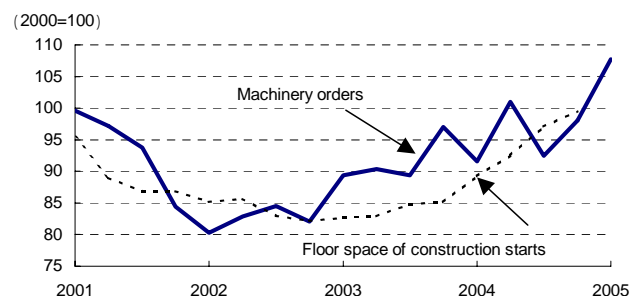
On the demand-side, the year-on-year increase of sales at department stores over the New Year's shopping season and the brisk sales of winter clothing along with the drop of the temperature signal an upturn of consumer spending. Data on labor compensation in the Oct-Dec quarter of 2004, released concurrently with the GDP figures, also rose 0.4% over a year ago (o-y-a), recording an increase for the first time in six quarters. The improvement of the income environment provides us with expectations on the upturn of personal consumption. Turning to capital investment, which comprises the second pillar of domestic private demand, leading indicators such as machinery orders and construction orders are rising steadily, indicating that the current uptrend will continue (**Chart 11**).

[ Chart 10: The Inventory cycle ]



Source: Ministry of Economy, Trade and Industry.

[ Chart 11: Leading indicators of capital investment ]



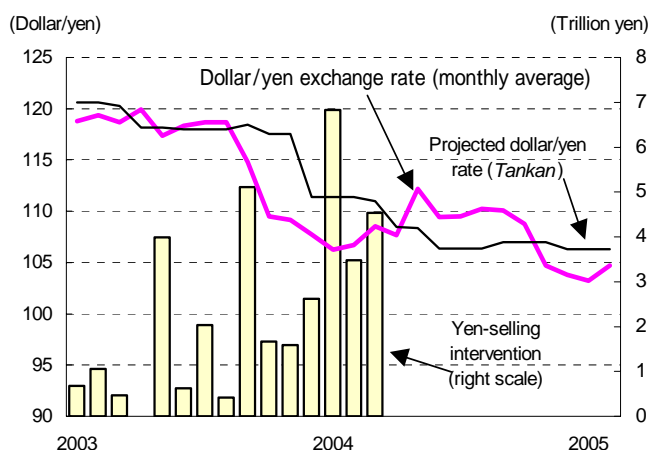
Notes: 1. Machinery orders = private sector orders for ships and orders by electrical power companies (seasonally adjusted).  
2. Floor space of construction starts = private sector non-residential orders (4-qtr moving average).  
Sources: Cabinet Office, *Orders Received for Machinery*, Ministry of Land, Infrastructure and Transport, *Building Construction Started*.

**The greatest risk factor – the appreciation of the yen – is coming to a halt**

The appreciation of the yen – thus far the greatest risk factor to the Japanese economy – is coming to a halt, raising the probability of economic recovery.

The yen gained more ground to the dollar since the turn of the New Year, temporarily reaching the 102-yen level. According to profit projections in the Bank of Japan's (BOJ) *Short-term Economic Survey of Enterprises in Japan* (the *Tankan* survey) in December 2004, companies project an exchange rate of 106.3 yen/dollar in the second half of FY2004 (**Chart 12**). An appreciation of the yen above this level would raise the risks of a loss of momentum as a result of a downward revision of profit projections among export-oriented companies. However, given the rise of market confidence in the US government's fiscal policy stance, the dollar has been strengthening against the yen since February. The risks of a downgrade of corporate profit projections are receding on the basis of forecasts that the dollar will remain relatively strong for some time as mentioned earlier on.

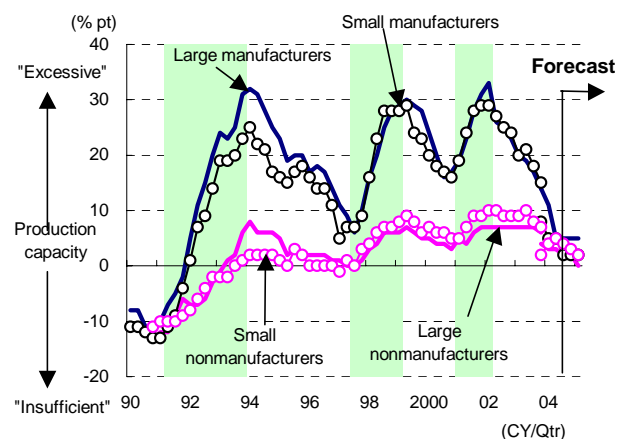
**[Chart 12: The actual and projected dollar/yen rate]**



Note: The dollar/yen rate in February 2005 is the average during the period from February 1st~15th.

Sources: Ministry of Finance, Bank of Japan.

**[ Chart 13: The Production Capacity DI ]**



Note: Both the old and new data series are set forth for 4Q2003.

Source: Bank of Japan, *Short-term Economic Survey of Enterprises in Japan*.

**The elimination of the “three overhangs” will reinforce the virtuous cycle toward economic recovery**

As far as output and demand trends suggest, the Japanese economy has emerged out of an adjustment and henceforth moving forward on a fresh recovery path. The largest risk factor – the strength of the yen – is receding at least for the time being. As explained more fully below, the Japanese economy is achieving the conditions for an autonomous recovery. Looking forward, Japan should move forward on a stable path toward the elimination of deflation.

A virtuous cycle is indispensable for a self-autonomous economic recovery. Namely, the growth of corporate profit must spread to household income and corporate capital investment, thus generating further demand. Ever since the collapse of the bubble economy in the 1990s, the Japanese economy has been unable to achieve such a virtuous cycle due to the massive overhangs in capacity, labor and debt (the so-called “three overhangs”) which led to the inclination among companies to place priority upon debt repayment over wages and cash flow. As we write this report, Japan is finally drawing closer to the elimination of

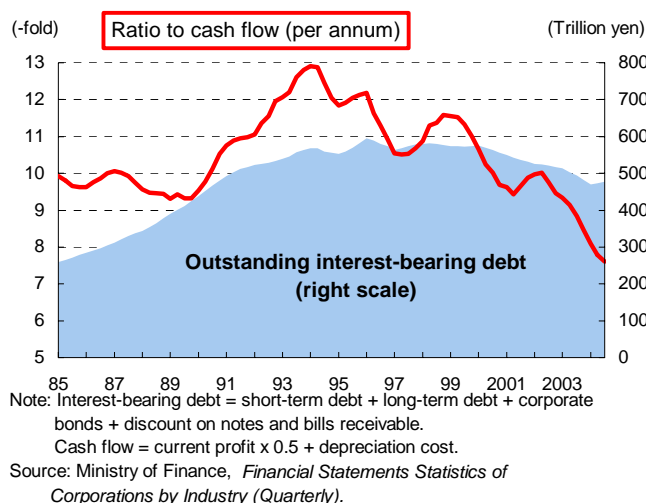
**The abundant cash flow in the corporate sector is serving as the engine of economic recovery**

the “three overhangs”. In the December *Tankan* survey, the production capacity index among large manufacturers fell to the lowest level since 1992. Likewise, the production capacity index among large nonmanufacturers is also projected to reach zero in the March survey, indicating that the labor overhang has more or less disappeared on a macroeconomic basis (**Chart 13**).

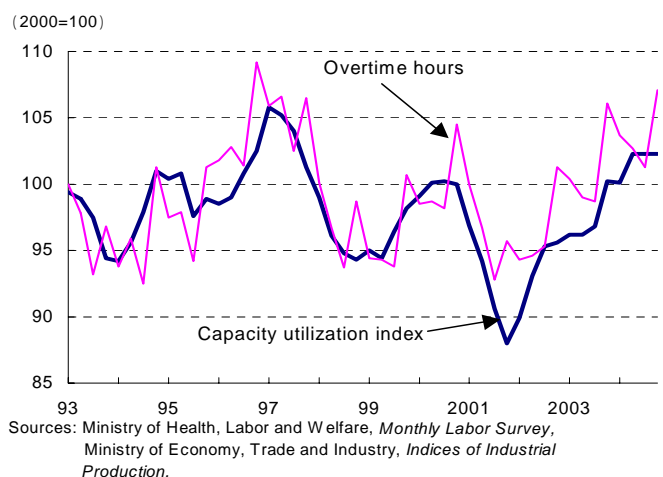
In addition to the reduction of labor costs, companies have been inclined to keep capital investment within the limits of cash flow and to direct the surplus funds to debt repayment. As a result, interest-bearing debt in the corporate sector started to fall after peaking around 1998. Therefore, coupled with the increase of cash flow, debt burdens in the corporate sector have fallen far below the level at the time of the bubble economy (**Chart 14**). On a macroeconomic basis, the debt overhang has also been eliminated.

Given the elimination of the “three overhangs”, companies should start to use more of their cash flow to invest in plant and equipment and hire more workers. Under the current situation where the capacity utilization rate and overtime hours are close to the highest level since the collapse of the bubble economy, the absence of the excess capacity and labor will enable a smoother transfer mechanism for the upgrade of production capacity to lead more directly to the expansion of capital investment and employment. The Japanese economy is now poised to enter a virtuous cycle toward autonomous recovery driven by the abundant cash flow in the corporate sector.

[ Chart 14: Outstanding interest-bearing debt ]



[ Chart 15: The capacity utilization rate and overtime hours ]



## 2. Forecast of the Japanese economy in FY2004, FY2005 and FY2006

**FY2004: Japan's GDP growth will slow to 1.5% in real terms and 0.7% in nominal terms**

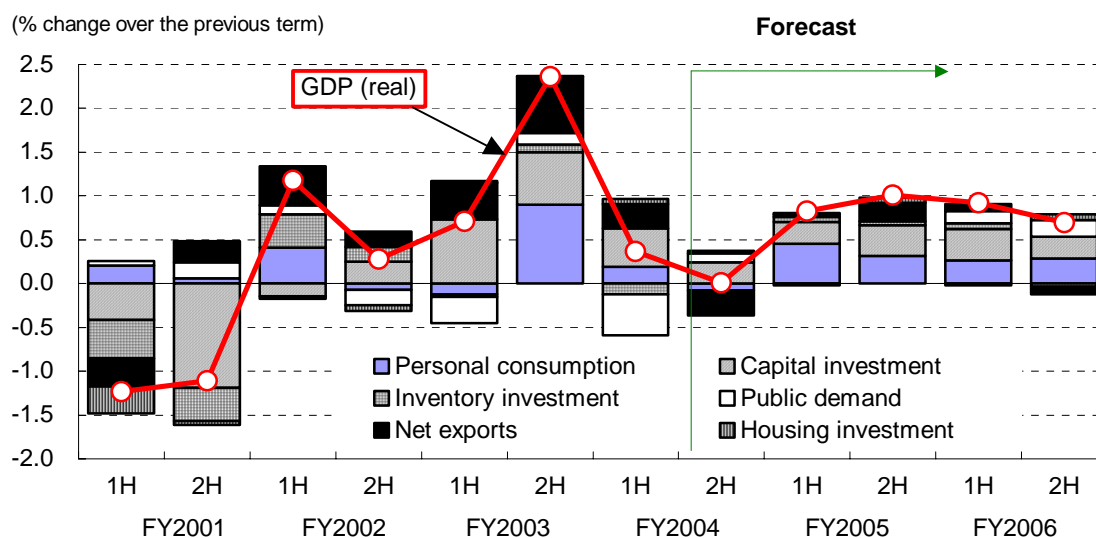
**FY2005: GDP growth will gradually gather momentum, driven mainly by domestic private demand**

In the second half of FY2004, the Japanese economy should gradually emerge out of a soft patch, along with the recovery of personal consumption and the ongoing expansion of capital investment on the back of an improving income environment amid the gradual ebb of inventory adjustment pressures around the end of the fiscal year. However, the pace of real GDP growth in the second half of FY2004 will most likely remain virtually flat at 0.0% y-o-y (0.0% in annualized terms) given the contraction of the economy for three consecutive quarters up to the end of last year (**Chart 16**). Thus, the pace of Japan's GDP growth in FY2004 will slow to 1.5% in real terms (our previous forecast was 2.0%) and 0.7% in nominal terms (previous forecast: 0.9%).

In FY2005, consumer spending will gradually recover to a level more consistent with income growth given the sustained improvement of the income environment stemming from the ongoing rise of corporate performance. Helped by the growth of consumer spending, capital investment will also continue to expand, with the main driver shifting from the manufacturing to the nonmanufacturing sector. Although exports will lack the spectacular momentum to serve as the main driver of the economy, net exports will nevertheless keep growing and buttress the pace of economic growth.

Our forecast on the rate of Japan's real GDP growth is 0.8% over the previous term (1.7% p.a.) in the first half of FY2005 and 1.0% over the previous term (2.0 % p.a.) in the second half FY2005. This brings full-year GDP growth in FY2005 to 1.5% (previous forecast: 1.7%) in real terms and 0.9% (previous forecast: 1.2%) in nominal terms.

[ **Chart 16: Forecast on Japan's real GDP growth** ]



Note: Figures for the second half of FY2004 are MHRI forecasts.  
Source: Cabinet Office, *The Preliminary Estimates of GDP*.

**FY2006: steady  
expansion followed by  
a slight slowdown in  
the second half**

In the first half of FY2006, the Japanese economy will continue to enjoy the steady growth of domestic private demand generated by the continuation of a virtuous cycle; namely the expansion of the economy leading to the growth of corporate earnings, thereby contributing to the rise of consumer spending through the rise of capital investment and household income. Meanwhile in the second half of FY2006, the growth of exports will start to wane because of a slower pace of US economic growth coupled with the advance of the yen to the dollar reflecting the gap in economic growth between Japan and the US. Furthermore, as exemplified by the debate on the consumption tax hike subsequent to the abolishment of the fixed-rate tax cuts, concerns regarding the future rise of household burdens on the back of the ballooning fiscal deficit will serve as a damper upon personal consumption. The Japanese economy will gradually slow down in the second half of FY2006.

Our forecast on the rate of Japan's real GDP growth is 0.9% over the previous term (1.9% p.a.) in the first half of FY2006 and 0.7% over the previous term (1.4 % p.a.) in the second half FY2006. This brings full-year GDP growth in FY2006 to 1.8% in real terms and 1.5% in nominal terms.

[ Chart 17: Outlook on the Japanese economy (FY) ]

(%)

	FY2003	FY2004	FY2005	FY2006	FY2004 (Contribution)	FY2005 (Contribution)	FY2006 (Contribution)
	(Actual)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)
GDP (real)	2.0	1.5	1.5	1.8	-	-	-
Domestic demand	1.2	1.1	1.3	1.7	1.1	1.3	1.6
Private sector demand	2.0	1.9	1.7	1.8	1.5	1.3	1.4
Personal consumption	0.5	1.1	1.0	1.0	0.6	0.6	0.6
Housing investment	-0.3	2.3	0.7	1.1	0.1	0.0	0.0
Capital investment	8.2	5.7	3.5	4.1	0.9	0.6	0.7
Public sector demand	-1.4	-1.6	0.3	1.2	-0.4	0.1	0.3
Government consumption	1.2	2.4	2.1	2.3	0.4	0.4	0.4
Public investment	-9.0	-14.9	-6.5	-3.5	-0.8	-0.3	-0.1
Net exports (contribution)	0.8	0.4	-0.0	0.2	0.4	-0.0	0.2
Exports	10.0	12.2	6.5	5.8	1.5	0.9	0.8
Imports	3.1	10.2	7.8	5.5	-1.0	-0.9	-0.7
GDP (nominal)	0.8	0.7	0.9	1.5			
Industrial production	3.5	4.7	1.9	2.8			
Unemployment rate	5.1	4.7	4.2	3.6			
Current account balance (trillion yen)	17.3	18.8	20.2	21.1			
as a percentage of nominal GDP	3.5	3.7	4.0	4.1			
Corporate goods prices	-0.5	1.6	0.7	-0.6			
Consumer prices	-0.2	0.1	-0.3	0.2			
Long-term interest rate (%)	1.12	1.51	1.75	2.10			
Nikkei stock average (yen)	9,938	11,300	12,200	13,000			
Exchange rate (yen/dollar)	113.0	107	107	101			
Crude oil price (WTI \$/barrel)	31.4	43.8	41.6	39.0			

[ Chart 18: Outlook on the Japanese economy (half-year) ]

(%)

	FY2004		FY2005		FY2006	
	1H (Actual)	2H (Forecast)	1H (Forecast)	2H (Forecast)	1H (Forecast)	2H (Forecast)
GDP (real)	0.4	0.0	0.8	1.0	0.9	0.7
Domestic demand	0.1	0.3	0.8	0.8	0.8	0.8
Private sector demand	0.8	0.3	1.0	1.0	0.9	0.7
Personal consumption	0.3	-0.1	0.8	0.6	0.5	0.5
Housing investment	1.8	0.8	-0.5	1.6	-0.6	1.8
Capital investment	2.9	1.6	1.6	2.2	2.3	1.5
Public sector demand	-2.0	0.5	0.1	0.0	0.6	0.9
Government consumption	1.5	0.7	1.0	1.4	1.0	1.1
Public investment	-14.3	-0.5	-3.2	-5.6	-1.0	-0.1
Net exports (contribution)	0.3	-0.3	0.0	0.2	0.1	-0.1
Exports	6.2	2.1	3.5	3.7	2.9	2.0
Imports	4.9	5.3	3.8	2.5	2.7	3.0
GDP (nominal)	-0.1	0.3	0.3	0.9	0.6	0.9

- 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 the same period 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, *Production, Shipment and Inventory Indexes*,  
 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*.

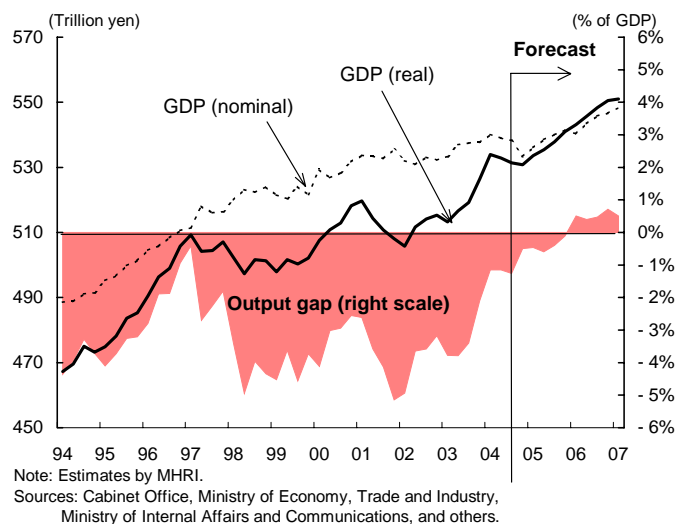
**The percentage rise of the CPI will turn positive in the first half of FY2006**

**The GDP deflator will also contract**

Looking forward on price trends on the basis of MHRI's economic forecast set forth herein, the output gap (the gap between demand and supply capacity) has narrowed considerably as a result of Japan's three-year consecutive economic expansion beginning with the trough in January 2002 (**Chart 19**). Therefore, if the Japanese economy shifts into a domestic demand-led recovery as predicted in MHRI's forecast, the output gap will contract further and turn positive in early 2006. As a result, the percentage rise of consumer prices will most likely turn positive in the first half of FY2006. One of the preconditions set forth by the BOJ for the termination of the quantitative easing policy, namely that "the consumer price index registers stably a zero percent or an increase year on year" should be fulfilled around mid-2006.

Given the ebb of deflationary pressures, the GDP deflator will shrink from -0.8% y-o-y in FY2004 to -0.6% in FY2005 and -0.3% in FY2006.

**[ Chart 19: The output gap ]**



- End -



