Economic Outlook for FY2005 and FY2006

(Revised to reflect the Second Preliminary Quarterly Estimates of GDP for the Jan-Mar quarter of 2005)

June 2005

The Mizuho Research Institute Ltd. (MHRI) has revised its economic outlook for FY2005 and FY2006 subsequent to the release of *The Second Preliminary Quarterly Estimates of GDP ("2nd QE")* for the Jan-Mar quarter of 2005. Although we have revised our outlook on certain components of demand from our previous *Economic Outlook for FY2005 and FY2006* released on May 20, 2005, our outlook on the fundamental direction of the economy remains unchanged.

<The Overseas Economies>

The US Economy	The economy will gather fresh momentum from mid-2005 (2005: 3.4 %→3.5%, 2006: 3.3%→3.3%)
The Euro Zone Economy	Corporate restructuring efforts will serve as a drag upon economic growth (2005: 1.7%→1.7%, 2006: 2.0%→2.0%)
The Asian Economies	A recovery from mid-2005 as the corporate sector emerges out of an inventory adjustment cycle (2005: 6.4%→6.4%, 2006: 6.5%→6.5%)

<The Japanese Economy>

FY2005	Ongoing moderate recovery driven by domestic private-sector demand (Real GDP growth 1.5%→1.5%, nominal GDP growth 0.8%→0.8%)
FY2006	Strong domestic demand and upturn of external demand will lead to the end of deflation (Real GDP growth 1.8%→1.8%, nominal GDP growth 1.4%→1.4%)

The Japanese Economy

- **FY2005 Outlook:** Ongoing moderate recovery driven by domestic private-sector demand
(real GDP growth 1.5%, nominal GDP growth 0.8%)
- **FY2006 Outlook:** Strong domestic demand and upturn of external demand will lead to the end of deflation
(real GDP growth 1.8%, nominal GDP growth 1.4%)

1. Key points and assessment of the *2nd QE*

A fractional downgrade of Jan-Mar quarter real GDP growth

In the *Second Preliminary Quarterly Estimates of GDP (“2nd QE”)* for the Jan-Mar quarter of 2005, the Cabinet Office revised downward Japan’s real GDP growth during the quarter to 1.2% q-o-q (4.9% per annum) from 1.3% q-o-q (5.3% p.a.) in the *First Preliminary Quarterly Estimates of GDP* (“*1st QE*”)(**Chart 1**). Looking closer at the components of demand, even though private capital investment was revised up from 2.0% q-o-q in the *1st QE* to 2.4% q-o-q in the *2nd QE*, personal consumption was downwardly revised from 1.2% q-o-q in the *1st QE* to 1.1% q-o-q, government consumption was revised down from 0.8% q-o-q to 0.6% q-o-q, exports were revised down from –0.2% q-o-q to –0.4% q-o-q and the contribution to real GDP by private inventory investment was revised down from 0.4% pt to 0.3% pt.

but our view on economic recovery from the turn of the year remains unchanged

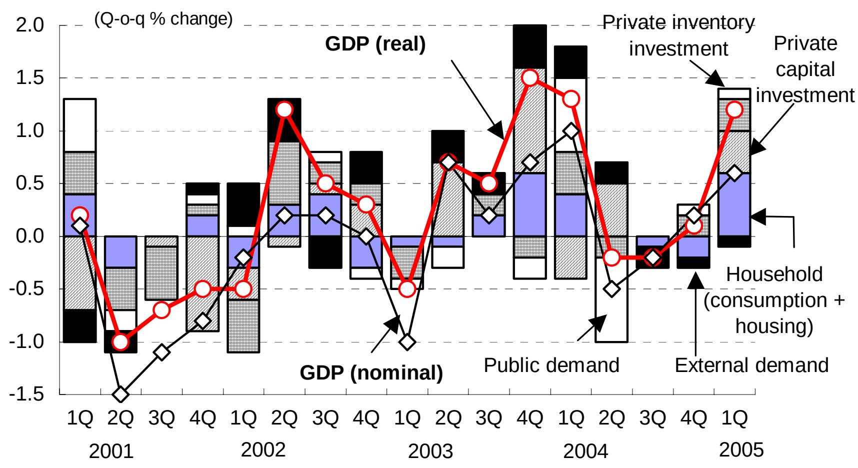
However, judging from the slim breadth of the downgrade as well as the ongoing strength of consumer spending and private corporate capital investment, we do not see the need to revise our view that the Japanese economy is picking up from the doldrums in the second half of last year, driven mainly by domestic private demand. However, the risks to the future course of the economy remain unchanged from the *1st QE* – inventory investment is rising for the second consecutive quarter and exports, which have thus far propelled the economy, are losing steam.

The GDP deflator was revised upward and nominal GDP growth remained unchanged

The GDP deflator fell 1.0% from the same quarter over a year ago (o-y-a), less than the 1.2% o-y-a drop reported in the *1st QE*. Meanwhile, the rate of GDP growth in nominal terms stood at 0.6% q-o-q (2.2% p.a.), virtually unchanged from the *1st QE* at 0.6% q-o-q (2.3% p.a.).

The GDP deflator fell deeper into negative territory in comparison to the previous quarter from October to December of 2004 (-0.4% o-y-a) due primarily to the rise of the government consumption deflator because of a change in calculation of government worker bonus payments in the previous quarter. Thus, the drop of the GDP deflator does not indicate an acceleration of deflation. Since the GDP deflator is rising in comparison to the Jul-Sep quarter of 2004 (-1.3% o-y-a), deflationary pressures are abating as we wrote in our *Economic Outlook for FY2005 and FY2006* prior to revision.

【Chart 1: *The Second Preliminary Quarterly Estimates of GDP* for the Jan-Mar Quarter of 2005】



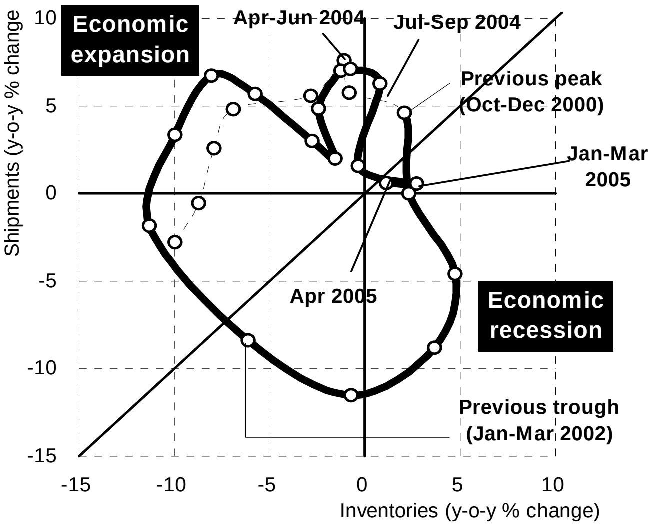
Source: Cabinet Office, *Preliminary Quarterly Estimates of GDP*.

The rise of inventory investment will serve as downward pressures upon future GDP growth

As mentioned above, the rise of private inventory investment is one of the risk factors to the future course of the economy. According to primary data such as the *Financial Statements Statistics of Corporations by Industry (Quarterly)* for the Jan-Mar quarter, even though inventories of goods-in-process are declining, raw material inventories, finished goods inventories and distributors' inventories are rising. The rise of raw material inventories is attributed to businesses' inclination to stockpile in a bid to avert the risks of rising prices. The rise of finished goods inventories is to a large extent temporary such as the intended buildup of inventories ahead of regular refurbishment of production facilities in the chemical industry and the rise of inventories of automobiles awaiting shipment overseas. Furthermore, given the possibility that the high level of inventories in the Jan-Mar quarter could be a result of excessive adjustments for seasonal factors, the rate of GDP growth may be dragged down in the Apr-Jun quarter due to technical factors as well as a run-down of inventories and a temporary reaction to the rise of inventories.

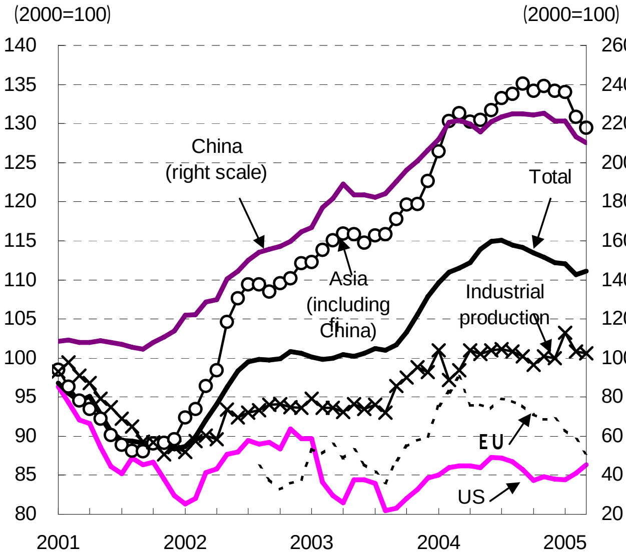
Even though the inventory cycle of the overall industrial sector indicates a slide into an inventory adjustment phase in the Jan-Mar quarter of 2005, the inventory adjustment process is nearing the 45° line in April (**Chart 2**). Considering the recent strength of demand, the odds are high that the adjustment of inventories will turn out to be short and benign as far as inventories of finished goods are concerned.

【 Chart 2: Inventory cycle of Japan's overall industrial sector 】



Source: Ministry of Economy, Trade and Industry, *Indices of Industrial Production.*

【 Chart 3: The export volume index 】



Note: Seasonally-adjusted (by X-11), 3MMA, EU 25-nation basis.
Source: Ministry of Finance, *The Summary Report on Trade of Japan.*

Exports will continue to ebb and flow

Turning to the other risk factor, exports are still following an ebb-and-flow pattern. The April export volume index fell from the previous month subsequent to a month-on-month rise in March (**Chart 3** seasonal adjustment by MHRI). Looking closer in terms of geographic destinations, US-bound exports are picking up while exports to Asia and the EU are still continuing to drop. In particular, Asia-bound exports, comprising a large percentage of total exports, are serving as downward pressures upon Japan's exports as a result of (1) inventory adjustment in the IT and digital appliance sector in Asia, and (2) the rise of materials inventories such as iron & steel and chemical products in China.

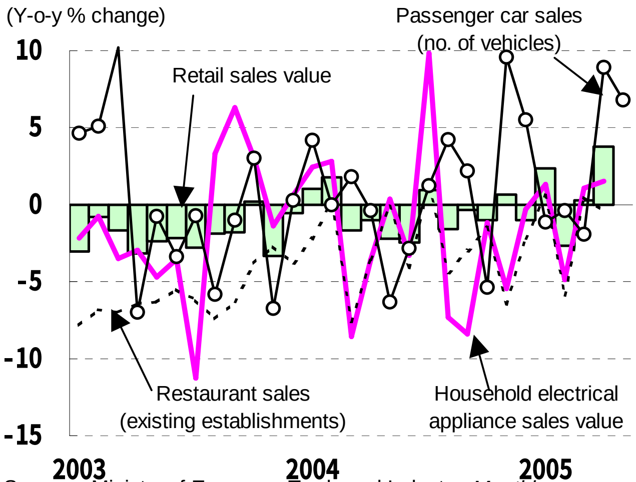
We are inclined to believe that Asia-bound exports will only start to pick up from the second half of 2005 since (1) the IT and digital appliance sector in Asia will only finish shedding their inventories in the second half of 2005, and (2) the inventory adjustment process in China will take some time due to a slower pace of China's economic growth. Looking forward, exports will most likely remain stagnant for the time being.

Consumer spending will remain strong

Meanwhile, domestic private-sector demand is continuing to chart strong growth.

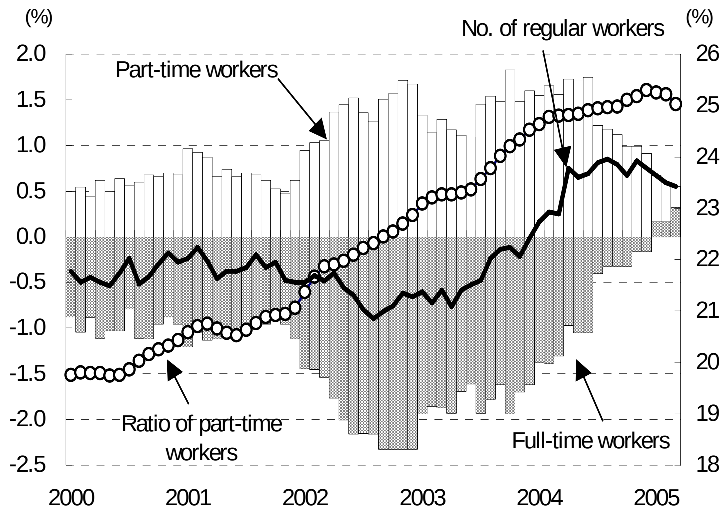
Personal consumption is continuing to grow strongly subsequent to a sharp pick-up in the Jan-Mar quarter. According to the *Family Income and Expenditure Survey*, real consumption expenditures (on an all-households basis) in April surpassed the Jan-Mar average by approximately 0.4%. Sales-side statistics also indicate strong consumer spending. Despite the impact of higher gasoline prices, retail sales grew a dramatic 3.8% o-y-a in April given the brisk sales of passenger cars and household electrical appliances. Outlays for travel grew above the previous year for the fourth consecutive month since the turn of the year and restaurants (existing establishments) are maintaining sales equivalent to previous-year levels while services are also growing steadily (**Chart 4**).

【 Chart 4: Sales Statistics 】



Sources: Ministry of Economy, Trade and Industry, *Monthly Statistics of the Current Survey of Commerce*,
Japan Automobile Manufacturers Association, Inc.,
Nippon Electric Big-Stores Association.

【 Chart 5: Ratio of part-time workers】



Note: The "ratio of part-time workers" is based upon MHRI calculations and are 3-qtr moving averages.
Source: Ministry of Health, Labor and Welfare, *Monthly Labor Survey.*

The improvement of the income environment is serving as a driver of personal consumption

The steady improvement of household income may be cited as the primary factor in the background to the strength of personal consumption. According to the *Monthly Labor Survey*, the number of regular workers has been rising gradually since the beginning of 2004. From early 2005, the number of full-time workers has also started to increase (**Chart 5**). Furthermore in April, the number of part-time workers dropped from the previous year in contrast to the rise of full-time workers, revealing a qualitative improvement of the labor market in the form of a sharp decline of the ratio of part-time workers.

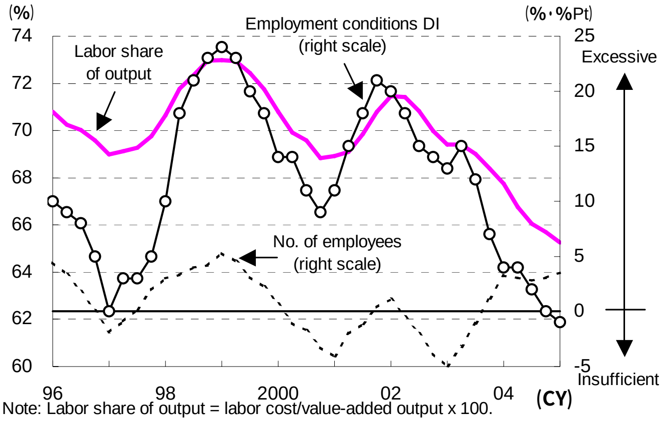
Given the pause in the shift toward part-time workers which has thus far served pushed down wages per worker, there are signs that wages are also improving as shown by the rise of base wages in April, marking an upturn for the first time in 4.5 years. According to the Nippon Keidanren, this year's *shunto* (spring wage negotiation) wage hike rate rose slightly above the previous year. Furthermore, on the basis of currently available data, summer bonus payments should rise above the previous year.

The improvement of corporate business performance is spreading to household income and capital investment

Meanwhile, according to the recently released *Financial Statements Statistics of Corporations by Industry (Quarterly)* for the Jan-Mar quarter, the labor share of output is continue to decline, indicating that companies are still inclined to reduce labor costs (**Chart 6**). However, the employment conditions DI of the Bank of Japan's (BOJ) *Short-Term Economic Survey of Enterprises in Japan (Tankan)* shows that corporate enterprises no longer feel the burden of excessive labor on a macroeconomic perspective. If past experience is of any guide to future events, we should gradually see a shift in stance among corporations from the reduction of labor costs to efforts to secure labor. The impending retirement of the baby-boom generation should serve as a driver of this trend. Looking forward, we expect an ongoing improvement of the household income environment through the rise of employment and wages.

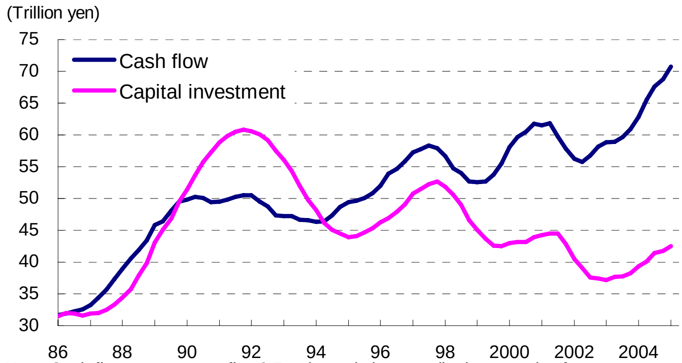
Note also that corporate cash flows are continuing to increase against a backdrop of improving business performance, surpassing levels during the so-called "Bubble Period" of the booming 1990s (**Chart 7**). Although corporate enterprises were inclined to channel their cash flow to debt repayment during the period from the late 1990s to the mid-2000s, corporations are no longer burdened by excess debts and thus are in a position enabling them to use their cash flow for forward-looking investments. Once the economy shifts gear from the current doldrums and starts to take on a more sanguine hue, we should see a full-fledged channel of cash flow to capital investment.

【Chart 6: The labor share of output and the employment conditions DI】



Note: Labor share of output = labor cost/value-added output x 100.
No. of employees = % ch o-y-a. Both the labor share of output and the no. of employees are 4-qtr moving averages on an all-industries, all-sizes basis.
Sources: Ministry of Finance, *Financial Statements Statistics of Corporations by Industry*, Bank of Japan, *Short-Term Economic Survey of Enterprises in Japan (Tankan).*

【Chart 7: Cash flow and capital investment】



Note: Cash flow = current profit x 0.5 + depreciation cost (both are totals of most recent four quarters)
Source: Ministry of Finance, *Financial Statements Statistics of Corporations by Industry (Quarterly).*

2. FY2005 Outlook

Look forward to moderate economic expansion in FY2005

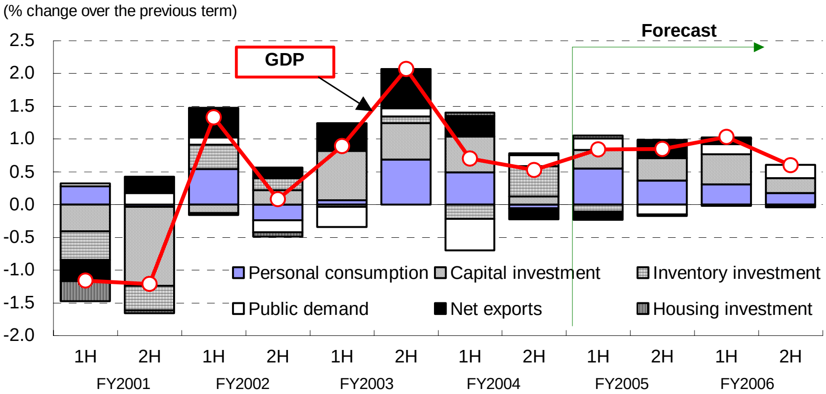
The foregoing leads to our view that the overall Japanese economy will grow steadily in the first half of FY2005, given the continuation of a virtuous cycle starting with the improvement of corporate business performance. Personal consumption will rise steadily against a backdrop of a sustained improvement of the income environment. Capital investment will also remain on an upward trajectory. Public demand is also expected to contribute to GDP growth given a halt to the fall of public investment due to the progress of post-disaster reconstruction works. However, since exports will remain weak and certain sectors of the domestic economy may be compelled to adjust inventories, GDP growth will most likely be subdued.

In the second half of FY2005, the stirrings of autonomous economic recovery will spread further, sustaining the expansion of personal consumption and capital investment. Furthermore, exports should pick up and the contribution by net external demand should turn positive as the US economy gathers fresh momentum and the economies of Asia emerge out of an inventory adjustment phase. However, the pace of GDP growth will remain sluggish given the likelihood of a sharp fall of public investment due to the fading impact of post-disaster reconstruction works.

Rate of economic growth will be slightly above potential growth in FY2005

As a result, we expect Japan's real GDP to keep growing at a pace slightly above the potential rate of economic growth around the lower half of the 1% level during FY2005. Although full-year FY2005 GDP growth in real terms will slow down from the previous year to 1.5% y-o-y (previous forecast: 1.5% y-o-y), the rate of nominal GDP growth will rise slightly from the previous year to 0.8% y-o-y (previous forecast: 0.8% y-o-y), indicating the alleviation of deflationary pressures.

【 **Chart 8: Trends in Real GDP Growth (Half Year)** 】



Note: Figures for 1H FY2005 onward are MHRI forecasts.
Source: Cabinet Office, *Preliminary Quarterly Estimates of GDP*.

3. FY2006 Outlook

The economy will gather further momentum in the first half of FY2006

In the first half of FY2006, a further rise of capital investment reflecting the recovery of exports and the strength of domestic demand should provide more definite signs of economic recovery. Public investment will most likely stop declining in view of the fact that they have already dwindled to pre-Bubble levels. The economy should gather momentum as a result of the sustained expansion of private sector demand and the bottoming out of public investment.

Full year FY2006 real GDP will reach 1.8%

However, the odds are high that the economy will slow down again in the second half of FY2006 due to (1) the drop of exports along with the ebb of US economic growth and the appreciation of the yen, and (2) a slower pace of personal consumption growth stemming from the abolition of the across-the-board tax credit. Furthermore, the appreciation of the yen will lead to (1) the expansion of the output gap as a result of weaker demand and (2) the decline of prices through the fall of import prices. Thus, it is necessary to take heed of the possibility that an earlier-than-expected surge of the yen may lead to a postponement of Japan's exit out of deflation.

Turning to the 3.3 trillion yen across-the-board tax credit, it has been decided that the tax cut will be halved by January 2006. Its complete abolishment by January 2007 is currently under debate. If events unfold as scheduled, it would push down the rate of growth of disposable income in FY2006 and serve as a drag upon personal consumption and real GDP growth. Since it would have a similar impact in 2007, if the Japanese economy slows down in the second half of FY2006, the abolishment of the across-the-board tax credit would have an undeniable impact upon the Japanese economy in 2007. Given the possibility of a consumption tax hike in FY2007, the household sector would be vulnerable to the rise of concerns regarding increasing burdens.

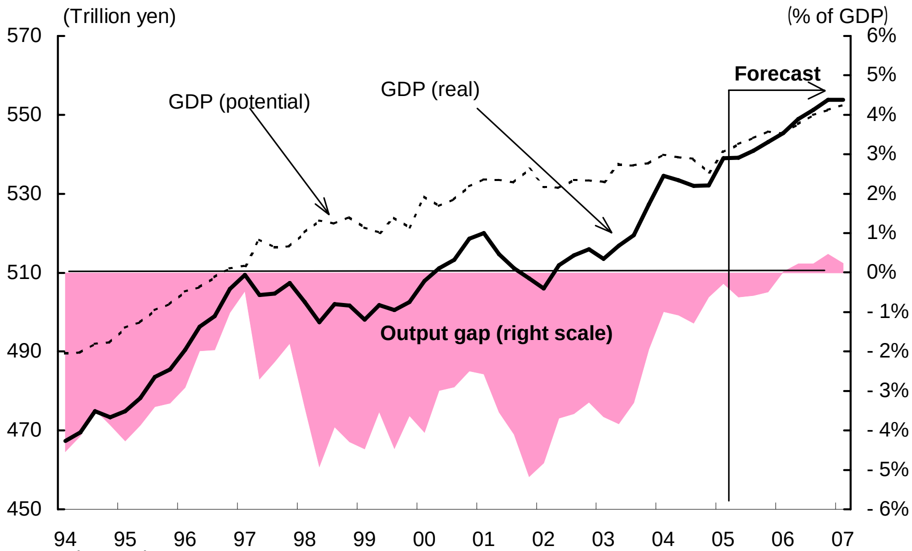
As a result of the foregoing, MHRI's forecast on the rate of real GDP growth in FY2006 is 1.8% y-o-y in real terms (previous forecast: 1.8% y-o-y) and 1.4% y-o-y in nominal terms (previous forecast: 1.4% y-o-y).

4. Price Outlook

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

The output gap (the gap between demand and supply capacity) has narrowed considerably as a result of Japan's three-year consecutive economic expansion starting with the trough in January 2002 (**Chart 9**). Following our scenario, the output gap should contract further and turn positive in early 2006. The shift will gradually emerge in the form of the rise of upward pressures upon wages and the percentage change of the consumer price index (CPI) will turn positive from a year earlier 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.

【 **Chart 9: The Output Gap** 】



Note: Estimates by MHRI.

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

【Chart 10: Outlook on the Japanese Economy】

(%)

	FY2004 (Actual)	FY2005 (Forecast)	FY2006 (Forecast)	FY2005 1H (Forecast)	FY2005 2H (Forecast)	FY2006 1H (Forecast)	FY2006 2H (Forecast)	FY2005 (Contribution) (Forecast)	FY2006 (Contribution) (Forecast)
GDP (real)	1.9	1.5	1.8	0.8	0.8	1.0	0.6	-	-
Domestic demand	1.5	1.6	1.6	1.0	0.6	0.9	0.6	1.6	1.5
Private sector demand	2.3	1.9	1.7	1.0	0.9	1.0	0.5	1.4	1.3
Personal consumption	1.2	1.4	1.0	1.0	0.7	0.6	0.3	0.8	0.6
Housing investment	2.1	1.1	-0.4	1.2	-0.5	0.2	-0.7	0.0	-0.0
Capital investment	5.3	3.5	4.7	1.8	2.2	2.9	1.4	0.5	0.7
Public sector demand	-1.4	0.6	0.9	0.8	-0.7	0.7	0.9	0.1	0.2
Government consumption	2.7	2.3	2.3	1.1	1.2	1.1	1.2	0.4	0.4
Public investment	-15.1	-5.3	-4.9	0.0	-8.1	-1.3	-0.2	-0.2	-0.2
Net exports (contribution)	0.5	-0.1	0.2	-0.1	0.3	0.1	-0.0	-0.1	0.2
Exports	11.9	4.6	6.4	1.8	4.1	3.1	2.3	0.6	0.9
Imports	9.3	6.2	5.5	3.2	2.3	2.8	2.8	-0.7	-0.7
GDP (nominal)	0.8	0.8	1.4	0.4	0.6	0.8	0.4		
Industrial production	4.1	1.9	3.5	1.0	1.9	2.4	0.5		
Unemployment	4.6	4.3	3.6	4.5	4.0	3.7	3.5		
Current account balance (trillion yen)	18.3	18.0	18.9	16.6	19.9	17.9	20.3		
as a percentage of nominal GDP	3.6	3.5	3.7	3.3	3.9	3.5	3.9		
Corporate goods prices	1.5	0.6	-0.6	1.0	0.2	-0.3	-1.0		
Consumer prices	-0.3	-0.0	0.2	-0.1	0.0	0.2	0.2		
Long-term interest rate (%)	1.52	1.45	1.93	1.30	1.60	1.85	2.00		
Nikkei stock average (yen)	11,321	11,600	12,600	11,300	11,900	12,500	12,700		
Exchange rate (yen/dollar)	107.5	106	102	107	106	103	101		
Crude oil price (WTI $/barrel)	45.1	44.8	40.8	46.5	43.0	41.5	40.0		

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, *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* .

＊＊＊＊＊＊＊＊＊

Mizuho Research Institute Ltd.
Atsushi Takeda, Senior Economist atsushi.takeda@mizuho-ri.co.jp

MIZUHO