Economic Outlook for FY2005 and FY2006

May 2005

The Mizuho Research Institute Ltd. (MHRI) announces its economic outlook for FY2005 and FY2006 subsequent to the Cabinet Office's release of *The Preliminary Quarterly Estimates of GDP* for the Jan-Mar quarter of 2005. The key points of the outlook are as follows.

<The Overseas Economies>

The US Economy	Moderate expansion around its potential rate of economic growth (2005: 3.4%, 2006: 3.3%)
The Euro Zone Economy	Structural adjustment pressures will serve as a drag upon growth (2005: 1.7%, 2006: 2.0%)
The Asian Economies	A recovery from mid-2005 as the corporate sector emerges out of an inventory adjustment cycle (2005: 6.4%, 2006: 6.5%)

<The Japanese Economy>

FY2005	A moderate recovery driven by domestic private-sector demand (1.5% (real), 0.8% (nominal))
FY2006	Strong domestic demand will lead to the end of deflation (1.8% (real), 1.4% (nominal))

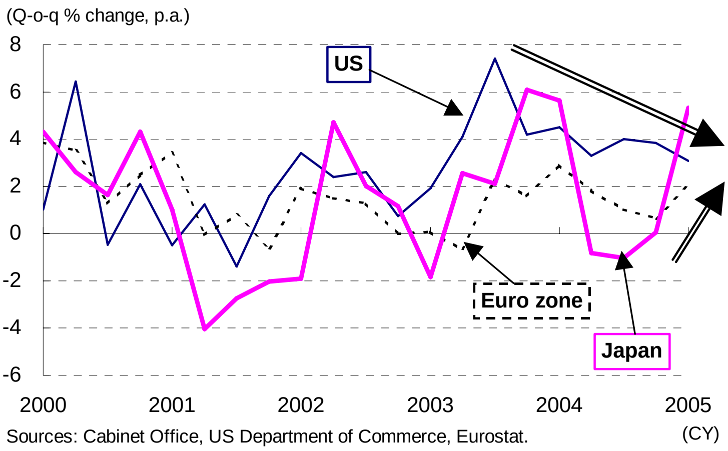
Mizuho Research Institute

I. Overview of the global economy

The surge of crude oil prices is serving as a drag upon the global economy

The global economy is slowing down since the second half of 2004 (**Chart 1**). In the US, the simultaneous slowdown of major economic indicators such as personal consumption and capital investment suggest that the economy has fallen into a soft spot in the Jan-Mar quarter of 2005 due primarily to the surge of crude oil prices. The euro zone economy is also showing signs of deceleration despite a momentary upturn of exports and stronger indicators on consumer spending with the turn of the year in 2005. Even though the Chinese economy grew a dramatic 9.5% over the same period a year ago in the Jan-Mar quarter of 2005, overall Asian economic growth is continuing to sag since the summer of 2004 due to the ebb of demand for IT and digital appliances and high crude oil prices. As exemplified by the rebound of consumer spending to levels prior to the drop in the second half of 2005, the Japanese economy recorded strong growth in the Jan-Mar quarter of 2005 driven mainly by the expansion of private-sector final demand even amid the ongoing weakness of exports. However, the sustainability of Japan's economic recovery is still unconvincing since the strong Jan-Mar quarter growth is due primarily to a reaction to the soft patch until then.

【 Chart 1: Global economic growth 】



Sources: Cabinet Office, US Department of Commerce, Eurostat.

Crude oil prices are taking a breather

Having said so, there is no need for undue pessimism. We are cautiously optimistic, due to projections that crude oil prices – one of the major causes for the global economic slowdown – will follow a gradual decline.

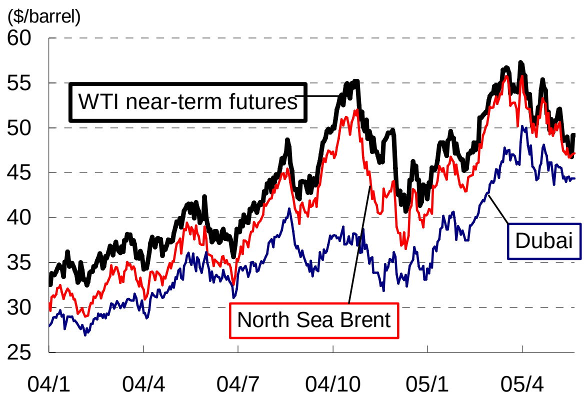
Crude oil prices (WTI near-term contracts for crude futures) have been following a virtually uninterrupted ascension since the start of 2005 (**Chart 2**). The price of crude oil per barrel, which traded around the lower half of the $40/barrel level in early January, soared once again to the $50/barrel (b) level in March. However, crude oil prices are currently stabilizing below $50/b.

The downturn of crude oil prices is attributed mainly to the buildup of private-sector crude oil stockpiles in the US and the International Energy Agency's (IEA) downgrade of its outlook on China's crude oil demand.

Steady rise of crude oil demand will generate persistent upward pressures upon crude oil prices

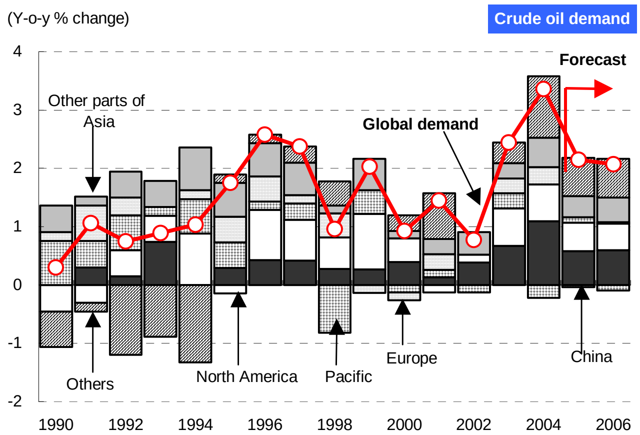
From the perspective of the demand and supply balance, even though China's demand for crude oil will most likely remain strong, the pace of demand growth should slow down due in part to a slight loss of economic growth momentum (**Chart 3**). Elsewhere, in areas such as the US and the rest of Asia, overall demand for crude oil should continue to grow steadily, leading to our view that demand-side factors will continue to serve as persistent upward pressures upon the price of crude oil.

【 **Chart 2: Crude oil price trends** 】



Source: Bloomberg.

【 **Chart 3: Forecast on global crude oil demand** 】



Note: Figures prior to and incuding 2005 are based upon the International Energy Agency (IEA). Figures on 2006 are MHRI forecasts.
Source: International Energy Agency, *Oil Market Report.*

Crude oil supply by non-OPEC countries will expand

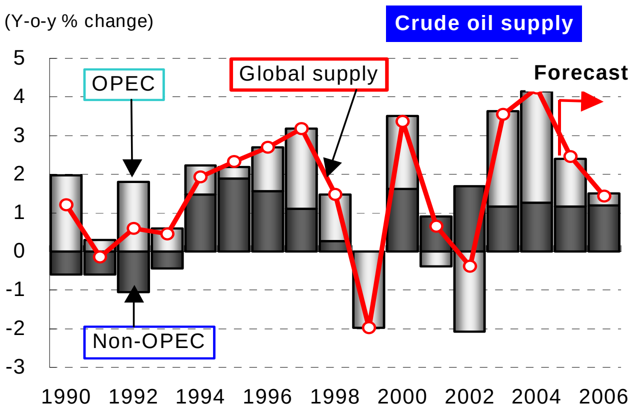
On the supply-side, the OPEC nations are showing a positive stance toward increasing their supply capacity, as shown by the OPEC's decision at its March 16th meeting to increase output by 500 thousand barrels/day (b/d). Furthermore, the OPEC nations are planning to upgrade their supply capacity to 10 million b/d by 2010. Although there is a shade of ambiguity whether all these initiatives will materialize, it appears certain that the OPEC member states are inclined toward raising their supply capacity. Moreover, non-OPEC nations such as Russia are also boosting their supply capacity through active investment in facilities and equipment, leading to the expansion of the global capacity to supply crude oil. Turning to Africa, despite projections on the rise of Libya's supply capacity, the pace of OPEC's supply growth will slow down, leaving oil producing countries with more leeway to raise output (**Chart 4**).

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

Judging from the foregoing, a further tightening of demand and supply should be averted even amid the ongoing rise of demand because of the expansion of supply capacity. Under these circumstances, we expect a gradual outflow of speculative funds from the crude oil market, thus leading to a gradual decline of crude oil prices (**Chart 5 "Main Scenario"**). The demand-supply balance of crude oil should gradually ease from mid-2006, due to forecasts that the pace of global economic growth – primarily the US – will follow a gradual decline and serve as downward pressures upon the price of crude oil. However, since the OPEC nations may cut output in a bid to support price levels in the event crude oil prices fall closer to $40/b, it is unlikely that the price of crude oil will fall sharply below $40/b.

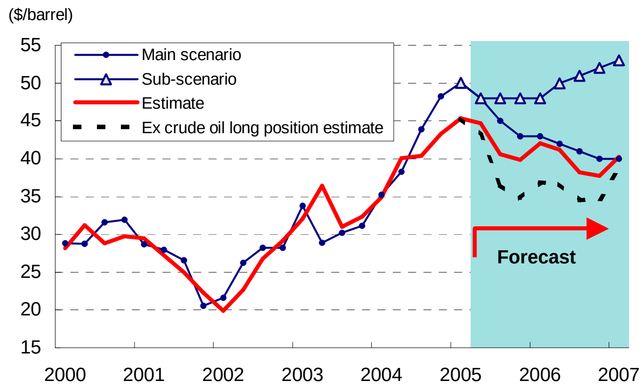
Meanwhile, in the event terrorist attacks in Iraq or strikes in Nigeria lead to the rise of supply-side concerns, it would be necessary to keep in mind that the inflow of speculative funds may drive up the price of crude oil (**Chart 5 "Sub-scenario"**)

【 Chart 4: Global crude oil supply 】



Note: Figures on 2005 and 2006 are MHRI forecasts.
Source: International Energy Agency, *Oil Market Report.*

【 Chart 5: Estimate and scenario on crude oil prices 】

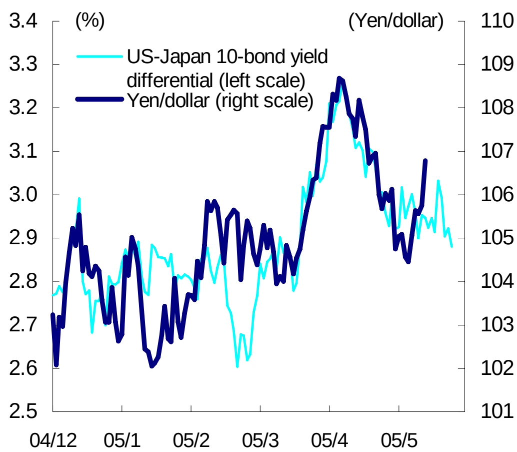


Source: MHRI estimates.

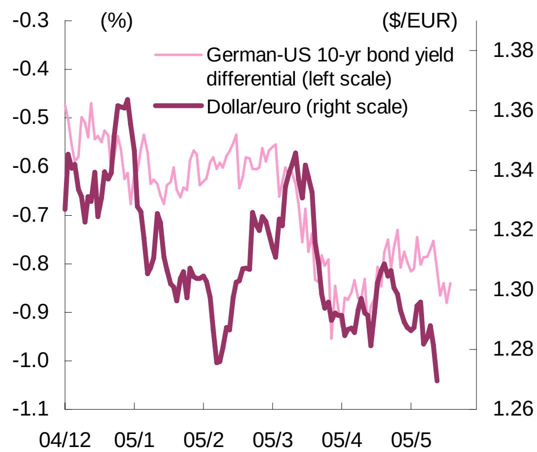
Speculation on a renminbi revaluation lead to a temporary appreciation of the yen

Meanwhile, the dollar has tended to strengthen against the yen and the euro since the beginning of the year given the rise of US interest rates reflecting the strength of the US economy (**Chart 6**). However, from April onward, US long-term interest rates have come under downward pressures along with the rise of concerns regarding the slowdown of the US economy, thus spurring a dollar sell-off. Forecasts on a revaluation (appreciation) of the renminbi intensified amid these circumstances, leading the yen to strengthen above 105 yen to the dollar.

【 Chart 6: US/Japan and German/US interest rate differential and exchange rates 】



Note: Interest rate differential = US - Japan
(8 business days forward).
Source: Bloomberg.



Note: Interest rate differential = Germany - US
(4 business days forward).

Business conditions and the renminbi hold the key

Judging from recent currency trends, economic conditions and the direction of the renbminbi will serve as key points in the forecast of exchange rates. In addition, it should be noted that the US "twin deficit" in the current account and budget balance is serving as potential dollar-weakening pressures.

Hurdles remain, requiring considerable time for a renminbi regime change

As for the revaluation of the renminbi, the predominant view has been that the Chinese government would opt to implement a gradual reform of its currency regime prior to the scheduled approval of foreign banks' renminbi-denominated operations at the end of 2006. Moreover, currency market players' expectations toward the Chinese government's political compromise on the renminbi are rising as a result of (1) increasing pressures in the US toward the *de facto* US dollar peg of the renminbi, and (2) comments by Chinese government authorities suggesting that they are easing their stance on the renminbi regime. However, since the reform of the renminbi regime and its operation is ultimately up to top-level government and party officials such as the Communist Party chairman or prime minister, we do not expect the Chinese government to ease its stance judging from comments by Prime Minister Wen Jiabao (November 28, 2004) to the effect that "nothing will be done while there is loud background noise".

Even with respect to technicalities, a shift to a Singapore-model currency basket, favored by the Chinese government over the long run, will be a time-consuming process in view of the time necessary for infrastructure preparation in China. While a gradual reform under the existing framework is also another possibility under which (1) the bandwidth of the renminbi's fluctuation (currently ±0.3% from the previous day with respect to the US dollar) would be widened, and (2) the rigid peg to the US dollar would be revised, this would be widely viewed as a result of a policy compromise, and thus be vulnerable to risks regarding the inflow of speculative funds. In any event, much of the details regarding its timing and method remain shrouded.

China will try to avoid major impact upon the economy

Despite the high probability of a renminbi regime change in 2006, the Chinese government will most likely tread cautiously and opt for a method to avoid a major disruption of the economy. Thus, even if the renminbi is revalued, the breadth and impact would be limited.

The yen will strengthen against the dollar in 2006

If the renminbi revaluation does not have a significant impact, exchange rates will most likely remain at the current level given the difficulty to make out a clear direction of the major economies of the world. However, as explained in more detail below, the relative popularity of the yen will tend to rise due to prospects that the Japanese economy will pick up in the first half of FY2006. In the second half of FY2006, the yen/dollar rate will move toward 100 yen to the dollar. Furthermore, an aversion toward dollar-denominated assets will also serve to drive the appreciation of the yen due to (1) the deceleration of the US economy in the second half of FY2006, and (2) the focus of attention on the "twin deficit" in times of US economic slowdown. The euro will also tend to gain further ground to the dollar.

【Chart 7: Global economic forecast (calendar year basis)】

(%)

		2004			2005			2006		
			1H	2H		1H	2H		1H	2H
US		4.4	4.1	3.6	3.4	3.2	3.5	3.3	3.4	2.7
Euro zone		1.8	2.3	1.1	1.7	1.6	2.3	2.0	2.2	1.2
Asia		7.5			6.4			6.5		
	NIEs	5.8			4.1			4.5		
	ASEAN4	5.9			5.2			5.4		
	China	9.5			8.8			8.5		
Japan		2.7	4.1	-0.7	1.7	2.7	1.1	1.6	1.9	2.0

Note: The shaded areas are forecasts.
Year = % change over the previous year. Half year = % change over the previous term on an annualized basis.

Despite a strong revival of economic growth, the US economy will slow down in 1H FY2006 due to interest rate hikes

Forecasting the future course of the US economy on the basis of the foregoing premises, the current accumulation of unsold stocks of inventories will serve as adjustment pressures and lead to a slower pace of growth in the first half of FY2005. Even so, the economy will avoid losing momentum since the household income environment is still in recovery mode and should start to gather pace in the second half of 2005. Given the tendency for inflationary pressures to rise amid these conditions, the Federal Reserve will continue to implement successive rate hikes, driving the federal funds rate to 4.25% by the end of 2005. By mid-2006, the effect of the successive interest rate hikes will dampen the growth of demand and lead to the rise of inventory adjustment pressures. Hence, the US economy will slow down in the second half of 2006, bringing the rate of economic growth below 3% (**Chart 7**).

The progress of corporate restructuring will serve as a drag upon euro zone economic growth

The euro zone economy is showing signs of slowdown, as shown by the deterioration of business confidence in the corporate sector. Looking forward, since the negative impact stemming from high crude oil prices and the strength of the euro should start to ease, the euro zone economy will gradually start to recover in the second half of 2005. However, the pace of recovery will most likely be sluggish since restructuring efforts in the corporate sector will serve as depressants upon consumer demand as a result of downward pressures upon household income.

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

Although Asian economic growth is currently slowing down due to the ebb of global demand for IT and digital appliances, the economic climate should improve around mid-2005 as the inventory adjustment in the IT sector comes to a pause. In China, investment in fixed assets will slow down as a result of the government's tightening measures. Even so, the Chinese economy should avoid a major loss of momentum because of strong consumer spending backed by the improvement of the income environment. The foregoing leads to our view that the rate of China's economic growth will gradually slow down.

The Japanese economy will continue to grow at a moderate pace, driven main by domestic private demand

The Japanese economy has geared into recovery mode in 2005. The inventory adjustment cycle has run its full course and the household income environment is continuing to improve albeit at a slow pace, paving the way for the recovery of personal consumption. Furthermore, the upturn of corporate investment incentive leads to prospects on the sustained growth of capital investment. Despite the sluggish growth of exports for the time being, domestic private demand such as personal consumption and capital investment should remain firm and keep the economy on a slow but steady expansion.

II. The Japanese Economy

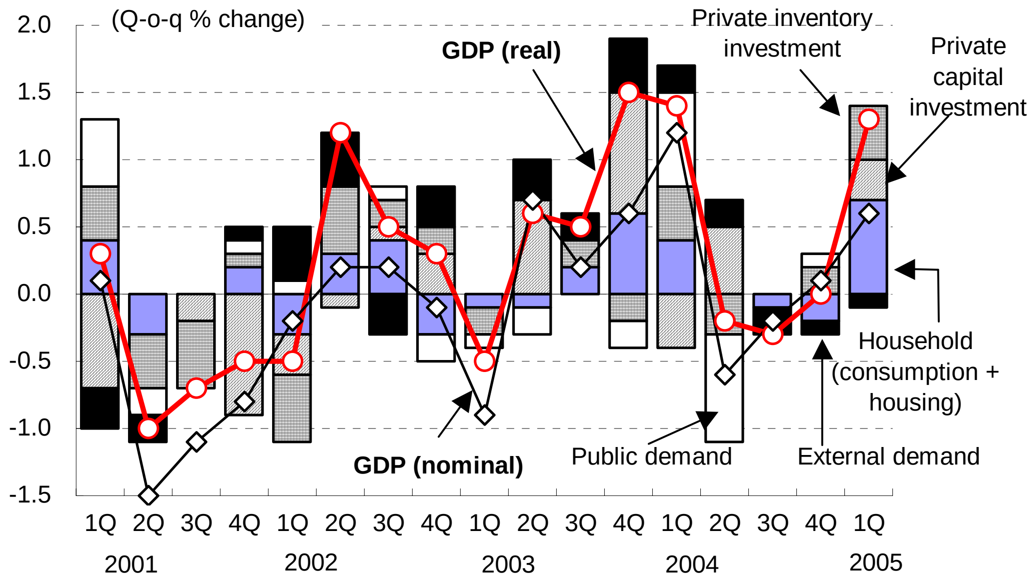
1. The current state of the Japanese economy

Japan's real GDP grew at an annualized rate of 5.3% q-o-q in the Jan-Mar quarter of 2005

Japan's real GDP grew a strong 1.3% q-o-q (5.3% per annum) in the Jan-Mar quarter of 2005 (**Chart 8**). Trends in GDP data confirm that the Japanese economy staged a rebound from the turn of the year subsequent to two consecutive quarters of contraction from the Apr-Jun quarter of 2004 and flat growth in the Oct-Dec quarter.

Looking closer at the components of demand, net exports contributed negatively for the third quarter in a row, given the downturn of exports stemming from sluggish exports to Europe and Asia amid the rise of imports. In contrast, domestic private-sector final demand served as the engine of growth as a result of (1) a dramatic 1.2% q-o-q rise of personal consumption from a slump in the second half of 2004 due to natural disasters such as typhoons and the warm winter weather, and (2) the steady rise of capital investment comprised mainly of construction investment. Private-sector inventory investment also contributed 0.4%, pushing up the rate of GDP growth. Even though public demand continued to fall despite expectations that it would bottom out, its contribution to real GDP growth turned out neutral as a result of the rise of government consumption.

【 **Chart 8: Japan's quarterly GDP growth** 】



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

Exports will remain stagnant for the time being

The three following points in the Cabinet Office's recent *1st Preliminary Quarterly Estimates of GDP ("1st QE")* are the key questions in forecasting the future course of the Japanese economy: (1) when will exports stop falling (2) how should the accumulation of inventories be interpreted, and (3) does the fall of the GDP deflator indicate an acceleration of deflation?

As for the first question, exports fell 0.2% q-o-q in the Jan-Mar quarter of 2005, dropping for the first time since the Oct-Dec quarter of 2001. Exports will most likely remain sluggish until around mid-2005 due to the slowdown of the US economy and inventory adjustment of IT and digital appliances in Asia.

The possibility of a reactionary drop of inventory investment in the Apr-Jun quarter

Turning to the second question regarding inventories, the sum of inventories of finished goods and distributors' inventory covered by the *1st QE* only amount to approximately two-thirds of total inventory stock (**Chart 9**). Furthermore, judging from fundamental data such as the industrial production index and statistics on commercial sales, it is unlikely that the contribution to real GDP by inventory investment will rise as high as +0.4% pt. If the high contribution stems from technical factors such as adjustments for seasonal factors, the odds are high that inventory investment will fall as a payback to the Apr-Jun quarter.

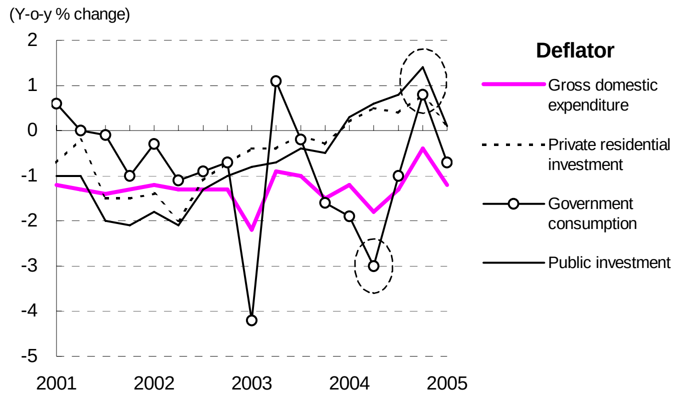
【 **Chart 9: Private sector inventory stock** 】

	Inventory stock (real terms) (Trillion yen)	Composition ratio (%)
Finished goods inventory	18.0	17.5
Goods-in-process inventory	20.2	19.7
Distributors' inventory	50.0	48.6
Raw material inventory	14.7	14.3
Total	103.0	100.0

Note: Total inventory investment in real terms with the *Financial Statements Statistics of Corporations by Industry (Quarterly)* at the end of 1993 as the benchmark.

Sources: Cabinet Office, *Annual Report on National Accounts*, Ministry of Finance, *Financial Statements Statistics of Corporations by Industry (Quarterly)*.

【 **Chart 10: GDP deflator**】



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

Fall of GDP deflator is a reaction to special factors

Thirdly, the fall of the GDP deflator is due primarily to a reaction to the previous quarter and does not indicate an acceleration of deflation. In the previous quarter from October to December of 2004, the GDP deflator temporarily rose as a result of (1) the rise of the government consumption deflator due to the increase of government workers' bonus payments, and (2) the rise of the construction-related deflator due to higher prices of building materials (**Chart 10**). On the contrary, deflationary pressures are abating judging from the fact that the breadth of the fall of the GDP deflator is narrowing in comparison to the Jul-Sep quarter of 2004.

Apr-Jun quarter growth will most likely slow to zero percent

Taking into consideration the foregoing key points, the rate of Apr-Jun quarter real GDP growth will most likely stand near zero percent because of (1) the high probability that consumer spending will slow sharply in a reaction to the Jan-Mar quarter, and (2) prospects of a reactionary drop of inventory investment. However, given the underlying strength of domestic private demand, the slowdown should only be perceived as a temporary lull in Japan's moderate expansion.

Most of the negative factors dragging down economic growth no longer exist

Looking backward in time, note that Japan fell into a soft patch in the second half of 2004 as a result of factors such as the reaction to the strong demand spurred by the hot summer weather and the Olympic Games, the inventory adjustment in the IT and digital appliance sector, concerns regarding the surge of crude oil prices, the slowdown of exports, the fall of public investment and a pause in capital investment among manufacturers. Apart from the slowdown of exports, most of these factors no longer exist, leading to a significant alleviation of downward pressures upon the economy (**Chart 11**).

[Chart 11: Negative factors upon economic growth in the second half of 2004]

	Factors dragging down growth in the second half of 2004	Status as of March	Current status (Apr-Jun quarter)	Outlook from Jul-Sep onward
①	Reaction to strong demand for consumer electronic appliances spurred by the Olympic games	Subsided	–	–
②	Impact of natural disasters such as the successive typhoons and the Chuetsu earthquake	Subsided	–	–
③	Inventory adjustment in IT and digital appliance sector	Adjustment in progress	Subsided	Rise of output
④	Concerns regarding negative impact due to surge of crude oil prices	Prices of related products are rising	Surge of gasoline prices	Pause in rise of prices
⑤	Slower export growth due to overseas economic slowdown	Real exports drop into negative territory	Hitting bottom	Recovery
⑥	Fall of pubic investment	The gradual decline continues	Ceasing to fall	Another downturn in FY2H
⑦	Pause in capital investment among manufacturers	Slight increase	Ongoing expansion	Ongoing expansion

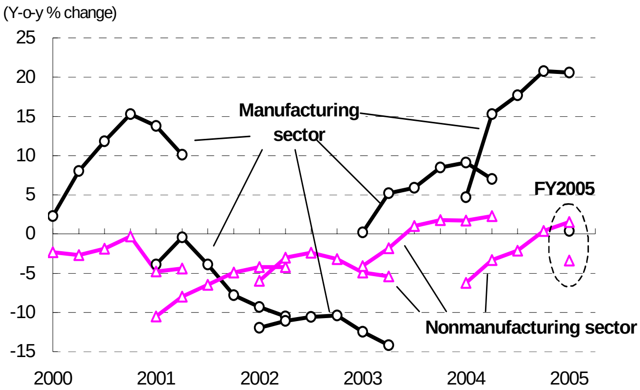
Note: The shaded areas indicate that the negative impact will linger.

Capital investment plans and the construction investment cycle indicate a sustained expansion of capital investment

Meanwhile, the upturn of corporate business performance is spreading to capital investment and household income, forming a virtuous cycle indispensable for an autonomous recovery of the economy.

Considering the time of the year, the Bank of Japan's (BOJ) *Short-Term Economic Survey of Enterprises in Japan* (*"Tankan"*) in March revealed a relatively high level of planned capital investment for FY2005 and underscored the strong incentive to invest in plant and equipment in the corporate sector (**Chart 12**). Moreover, the construction investment cycle is showing signs of bottoming out, presaging that capital investment is about to enter a medium-term expansion cycle (**Chart 13**). These factors, together with the abundant cash flow in the corporate sector stemming from the upturn of business performance, provide us with reasons to believe that capital investment will continue to follow an upward curve.

【Chart 12: BOJ *Tankan* capital investment plan】



Note: The graph above is based upon capital investmet plans for every fiscal year, plotted at the time of each survey.
Source: Bank of Japan, *Tankan*.

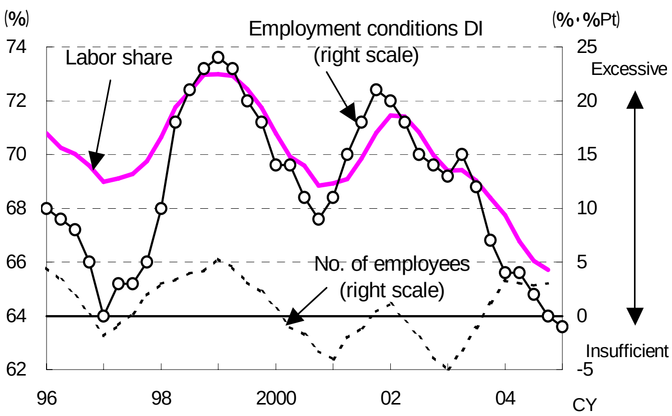
【Chart 13: The construction cycle】

Sources: Ministry of Land, Infrastructure and Transport, Cabinet Office.

Upturn of corporate performance is pushing up household income via the rise of employment and dividends

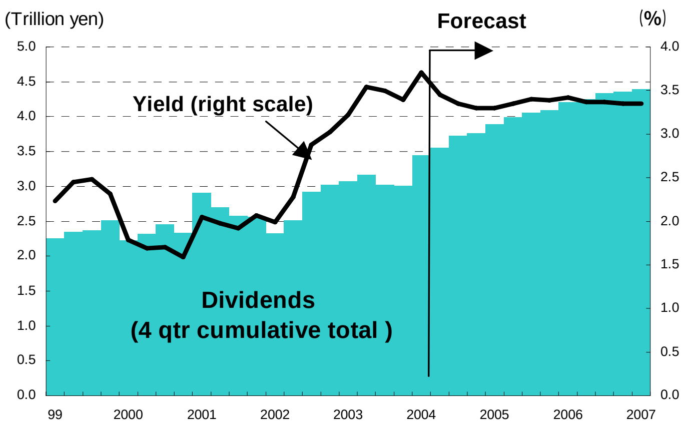
The March *Tankan* survey also revealed that the employment conditions DI (all industrial sectors and all sizes) fell to –1, indicating a shortage of labor on a macroeconomic perspective (**Chart 14**). Looking forward, the improvement of corporate business performance should push up household income through the rise of employment. Moreover, according to latest available data, dividends received in the household sector increased 37% o-y-a (approximately 430 billion yen) in the Jan-Mar quarter of 2004 (**Chart 15**). This is equivalent to approximately 0.2% of total labor compensation. Under the current circumstances where labor compensation is falling, or at best increasing at a very slow pace, the rise of dividends is contributing to the rise of income. Household dividend income is still rising given the continuation of strong corporate business performance and the shift in attitude toward dividends. The foregoing leads to our view that the improvement of corporate business performance is gradually leading to the rise of household income.

【Chart 14: Employment conditions DI and labor compensation】



Note: Labor share = labore cost/value-added output x 100. Both labor share and no. of employees = y-o-y % ch (4qma) on an all-industry, all-size basis.
Sources: Ministry of Finance, *Financial Statements Statistics of Corporations by Industry*, Bank of Japan, *Tankan*.

【Chart 15: Dividends received in the household sector】



Note: Yield = dividend ÷ investment, shareholdings outstanding (market value).
Sources: Cabinet Office, *Annual Report on National Accounts*, Bank of Japan, *Flow of Funds Accounts in Japan.*

2. Forecast of the Japanese economy in FY2005 and FY2006

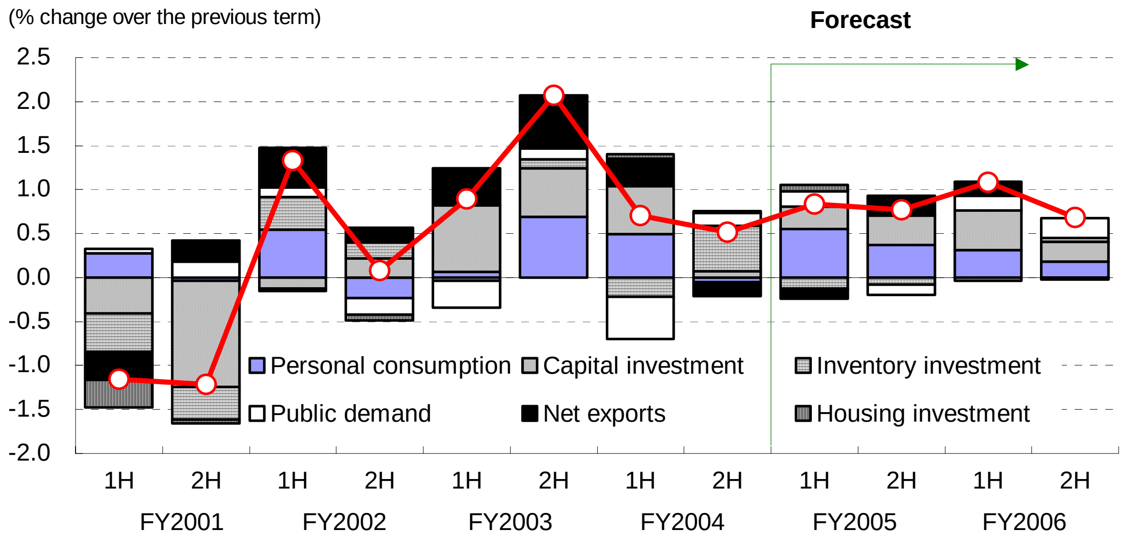
In FY2005, the economy will continue to grow around 1.5%, driven mainly by domestic private demand

1H FY2005: In addition to the ongoing rise of capital investment amid the recovery of personal consumption reflecting the improvement of the income environment, the rise of public demand along with the bottoming of public investment will contribute to GDP growth (**Chart 16**). In contrast, external demand will remain a drag upon growth given sluggish export growth.

2H FY2005: Despite the rise of personal consumption and capital investment and the positive contribution from external demand due to the upturn of exports, the pace of GDP growth will fail to gather momentum due to the fall of public investment because of the fading impact of post-disaster reconstruction works. The rate of real GDP growth will stand around 1.5%, slightly above the potential rate of growth.

As a result, we expect Japan's real GDP to grow around 0.8% over the previous term (1.7% p.a.) in the first half of FY2005 and 0.8% over the previous term (1.5 % p.a.) in the second half FY2005. This brings full-year GDP growth in FY2005 to 1.5% (previous forecast: 1.5%) in real terms and 0.8% (previous forecast: 0.9%) in nominal terms.

【 Chart 16: Forecast on Japan's real GDP growth 】



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

1H FY2006: stronger upward pressures upon wages reflecting faster economic growth

1H FY2006: The Japanese economy will gather momentum as a result of (1) a further rise of capital investment reflecting the upturn of exports and the steady expansion of domestic demand, and (2) the contribution by public demand due to the bottoming of public investment. Also around this time, the rapid improvement of labor market conditions will lead to upward pressures upon wages.

2H FY2006: slower economic growth due to a stronger yen

2H FY2006: Japan's economic growth will slow down due factors such as (1) the fall 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 fixed-rate tax cut. MHRI estimates that a 10-yen appreciation of the yen to the dollar would push down the rate of real GDP growth by 0.25% pt in the first year as a result of the drop of domestic demand (mainly capital investment) reflecting the decline of exports (**Chart 17**). Even though the growth of exports will slow further in the second year, the breadth of the fall of real GDP growth will remain around 0.25% pt because the drop of demand will serve as a depressant upon imports. Furthermore, given prospects that the consumer price index (CPI) will only rise marginally above the previous year, the timing of Japan's exit out of deflation will be postponed if there is an earlier-than-expected surge of the yen.

Abolition of fixed-rate tax cut will depress personal consumption from FY2006 onward

The abolition of the fixed-rate tax cut will most likely start to have an undeniable impact in FY2007. In the event the 3.3 trillion yen fixed-rate tax cut is phased out during 2006~2007 as planned by the government, it would drag down the growth of nominal disposable income in FY2006 by 0.61% pt. By the same token, personal consumption in real terms and real GDP would also drop 0.17% pt and 0.10% pt respectively (**Chart 18**). Furthermore, since the fixed-rate tax cut would also have a similar effect when phased out sometime after January 2007, it would have a similarly negative impact upon personal consumption and real GDP growth in FY2007. Assuming that the consumption tax rate is raised from the current 5% to 7% in FY2007 amid these circumstances, its impact alone would drag down the pace of real GDP growth by around 0.4% pt. The combined impact together with the fixed-rate tax cut abolishment would push down the rate of GDP growth in FY2007 by as much as 0.5% pt. Depending upon the state of the economy, the risks of a loss of momentum would increase.

Although FY2006 GDP growth will rise to 1.8%, growth will slow in the second half of the fiscal year

MHRI's forecast looks for FY2006 real GDP growth to slow from 1.1% over the previous term (2.2% p.a.) in the first half to 0.7% over the previous term (1.4% p.a.) in the second half. This brings full-year GDP growth in FY2006 to 1.8% in real terms and 1.5% in nominal terms.

【Chart 17: Impact of the appreciation of the yen】

(% pt)

	1st year	2nd year
GDP (real)	-0.25	-0.25
Domestic demand	-0.13	-0.08
Exports	-0.40	-1.15
Imports	0.71	0.05
CPI	-0.26	-0.22

Note: MHRI's simulation on the impact of a 10-yen appreciation of the yen to the dollar. The figures represent the percentage change over the previous year.
Sources: Cabinet Office, *Annual Report on National*

【Chart 18: Impact of the abolition of the fixed-rate tax cut】

	Negative impact of tax cut abolition (% pt)		
	FY2005	FY2006	FY2007
Disposable income (nominal)	-0.11	-0.61	-0.59
Personal consumption (real)	-0.03	-0.17	-0.20
GDP (real)	-0.01	-0.10	-0.12

Notes: 1. Simulation by MHRI.
2. The fixed-rate tax cut will be halved from 2006 and abolished by the end of 2006.

【Chart 19: Outlook on the Japanese economy】

(%)

	FY2004	FY2005	FY2006	FY2005		FY2006		FY2005	FY2006
				1H	2H	1H	2H	(Contribution)	(Contribution)
	(Actual)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)
GDP (real)	1.9	1.5	1.8	0.8	0.8	1.1	0.7	-	-
Domestic demand	1.4	1.5	1.6	1.0	0.5	0.9	0.7	1.5	1.5
Private sector demand	2.3	1.8	1.7	1.0	0.8	1.0	0.6	1.3	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	2.2	0.2	2.1	-0.1	0.3	-0.1	0.1	0.0
Capital investment	5.1	3.2	4.7	1.6	2.2	2.9	1.4	0.5	0.7
Public sector demand	-1.5	0.6	1.1	0.8	-0.5	0.7	1.0	0.1	0.2
Government consumption	2.7	2.3	2.4	1.2	1.1	1.2	1.3	0.4	0.4
Public investment	-15.5	-5.7	-4.5	-0.3	-6.9	-1.4	-0.2	-0.3	-0.2
Net exports (contribution)	0.5	-0.1	0.2	-0.1	0.2	0.1	-0.0	-0.1	0.2
Exports	11.9	4.6	6.5	1.8	4.1	3.2	2.3	0.6	0.9
Imports	9.3	6.3	5.3	3.0	2.8	2.4	2.8	-0.7	-0.7
GDP (nominal)	0.7	0.8	1.4	0.5	0.5	0.8	0.6		
Industrial production	4.1	2.1	3.2	1.3	1.7	2.2	0.6		
Unemployment rate	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	1.55	1.90	1.40	1.70	1.85	1.95		
Nikkei stock average (yen)	11,321	11,800	12,500	11,500	12,100	12,500	12,500		
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.*

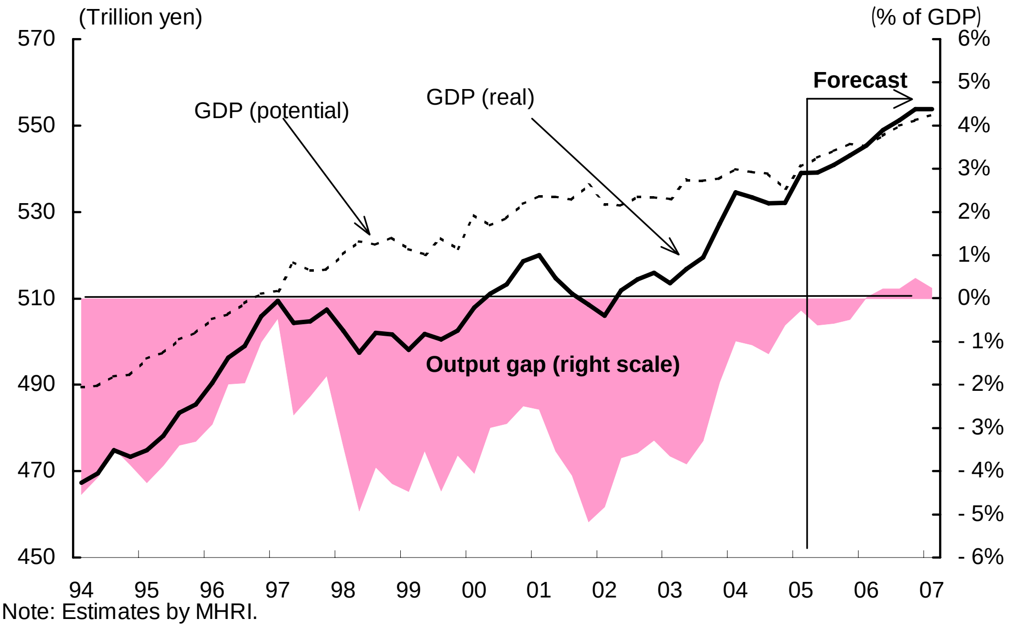
The percentage rise of the CPI will turn positive in the first half of FY2006

Looking forward on price trends on the basis of MHRI's economic forecast, 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 20**). 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. The shift will gradually emerge in the form of the rise of upward pressures upon wages, leading to the rise of the percentage rise of the consumer price index (CPI) into positive territory in the first half of FY2006.

The GDP deflator will also rise

Given the ebb of deflationary pressures, the percentage change of the GDP deflator will gradually rise from -1.2% y-o-y in FY2004 to -0.7% y-o-y in FY2005 and -0.4% y-o-y in FY2006.

【 Chart 20: The output gap 】



Note: Estimates by MHRI.

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