Economic Outlook for FY2005 and FY2006

November 2005

The Mizuho Research Institute Ltd. (MHRI) announces its outlook on the economy for FY2005 and FY2006 subsequent to the release of *The Preliminary Quarterly Estimates of GDP ("QE")* for the Jul-Sep quarter of 2005. The key points of the outlook are as follows.

* MHRI released its previous economic outlook on September 13, 2005.

<The Overseas Economies>

The US Economy	Revised upward to reflect recent strength of demand 2005: (previous outlook) 3.5% → (current outlook) 3.6% 2006: (previous outlook) 3.3% → (current outlook) 3.4%
The Euro Zone Economy	Unchanged from previous outlook 2005: (previous outlook) 1.4% → (current outlook) 1.4% 2006: (previous outlook) 1.8% → (current outlook) 1.8%
The Asian Economies	Outlook on China revised upward, reflecting ongoing strong growth 2005: (previous outlook) 6.4% → (current outlook) 6.6% 2006: (previous outlook) 6.4% → (current outlook) 6.4%

<The Japanese Economy>

FY2005	Japan's economic growth is upwardly revised, reflecting strong consumer spending and business capital investment Real GDP: (previous outlook) 2.3% → (current outlook) 2.5% Nominal GDP: (previous outlook) 1.2%→ (current outlook) 1.4%
FY2006	Forecasts on exports and business capital investment are revised upward Real GDP: (previous outlook) 1.6%→ (current outlook) 1.8% Nominal GDP: (previous outlook) 1.3%→ (current outlook) 1.6%

Mizuho Research Institute

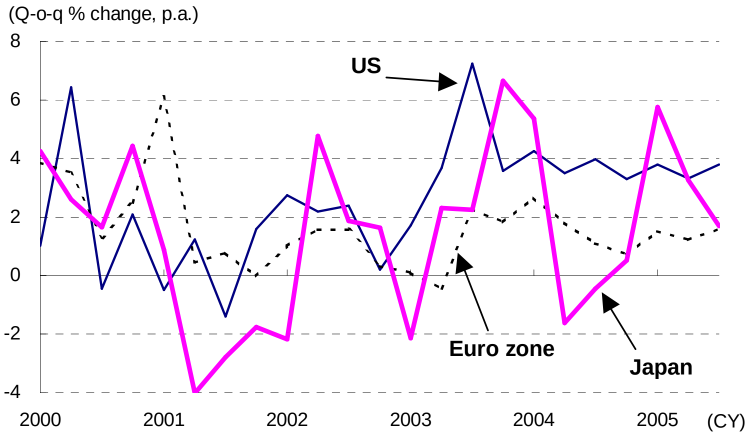
I. Overview of the global economy

The global economy remained in expansion mode in the Jul-Sep quarter of 2005

Even though the pace of Japan's economic growth slowed in the Jul-Sep quarter of 2005, the global economy remained in expansion mode, driven by the rise of economic growth above the previous quarter in Europe and the US (**Chart 1**) and the faster pace of Asia's economic growth.

Despite the negative impact stemming from the damage wreaked by the hurricanes, the US economy still grew 3.8% per annum backed by the strong growth of consumer spending. The pace of European (euro zone) economic growth also appears to have picked up slightly, given the progress of inventory adjustment stemming from the upturn of exports backed by the weak euro (to be released in the evening of November 15th Japan standard time). Turning to the Asian economies, China's real GDP grew a strong 9.4% over a year ago (o-y-a) due to the ongoing growth of investment. The newly industrialized economies (NIEs) are also growing at a faster pace with more definite signs of recovery in the IT and digital electronics sector. Even though Japan's domestic final demand slowed temporarily in a reaction to the dramatic recovery in the first half of 2005, the Japanese economy is still in expansion mode from the perspective of the entire global economy.

【 Chart 1: Global economic growth 】



Note: Jul-Sep 2005 Euro zone figures are forecasts.
Sources: Cabinet Office, US Departement of Commerce, Eurostat.

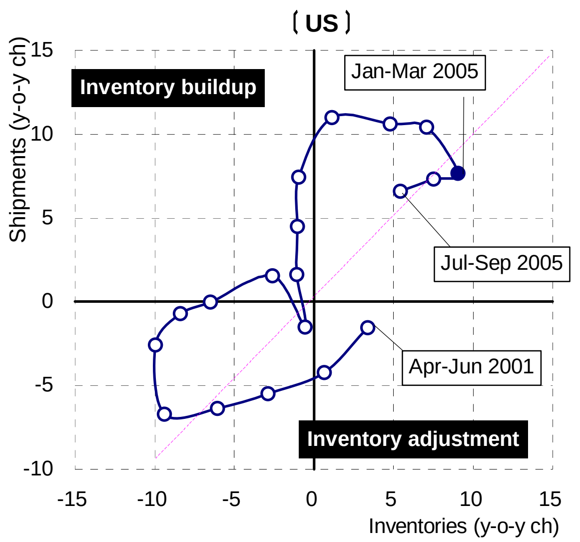
The economies around the world are emerging out of a mild inventory adjustment cycle

The ongoing growth of the global economy is due, most likely, to the fact that the economies around the world are emerging out of a mild inventory adjustment cycle in the first half of the year.

The US inventory cycle (**Chart 2**) indicates that the US economy has recovered back to the 45 degree line in the upper quadrant after falling into an inventory adjustment phase in the Jan-Mar quarter of 2005. Note that in the Jul-Sep quarter, the economy has advanced further across the 45 degree line. The euro zone inventory cycle also indicates that the economy had visited the brink of an adjustment phase in the Apr-Jun quarter of 2005. However, conditions are improving dramatically as a result of efforts to curb the rise of inventories and the increase of new orders (**Chart 3**). The Asian economies have more or less worked off their inventories of IT and digital appliances given the recovery of demand. Despite signs that inventories of certain goods were piling up in China, the inventory adjustment process is progressing due to the export drive and the strong growth of domestic demand. Even though Japan's inventory cycle indicates that Japan is still in an inventory adjustment phase, the adjustment pressures are benign (for details, refer to Section II, The Japanese Economy).

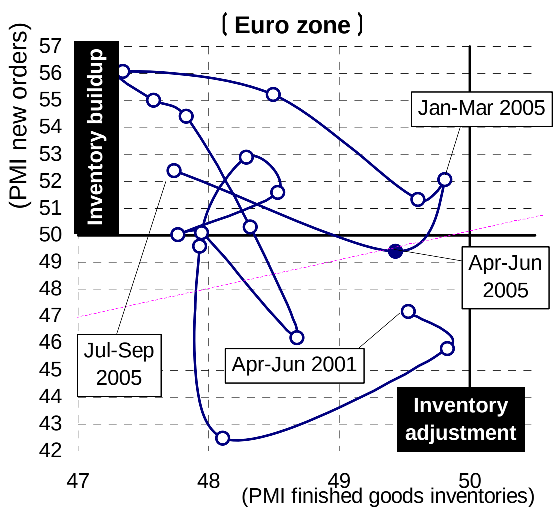
As shown above, the mild inventory adjustment pressures have more or less abated among the major economies of the world. Barring the emergence of the following risk factors, the odds are high that the global economy will continue to expand.

【 Chart 2: US inventory cycle 】



Source: US Department of Commerce.

【 Chart 3: Euro zone inventory cycle 】



Sources: Reuters, NTC Research.

The surge of crude oil prices is still the greatest risk to the global economy

The surge of crude oil prices is the greatest risk to global economic growth. The West Texas Intermediate (WTI near-term contracts) – a benchmark crude oil futures price –surged from \$35/barrel in early 2004 to a historical high of \$70/barrel at the end of August 2005, driven up by supply-side bottlenecks due to the successive hurricanes in the Gulf of Mexico where there is a concentration of US oil refineries. Even though oil prices have cooled down, reflecting the decision in the US to release its strategic petroleum reserve, prices are still hovering high around \$60/barrel.

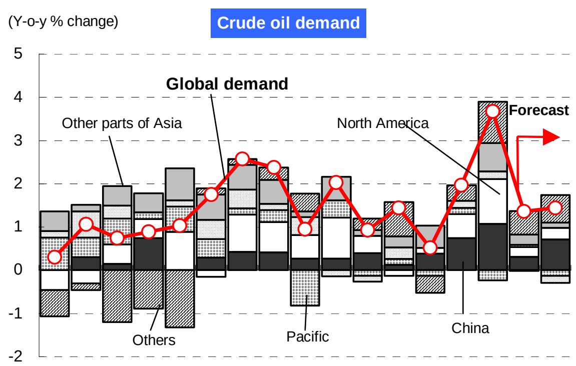
The rise of crude oil demand will likely be weaker than in 2004

Forecasting the price of crude oil on the basis of supply and demand, we are inclined to believe that crude oil demand in 2005 and 2006 will not grow as much as it did in 2004 (**Chart 4**) because of the following reasons. Firstly, the demand for crude oil will likely ebb in 2005 due in part to an economic slowdown in China and the US where there was a surge of demand in 2004. Secondly, the rise of crude oil prices will lead to restraints upon demand such as energy saving measures and shifts toward alternative energy sources.

The market will tend to focus upon limited output capacity

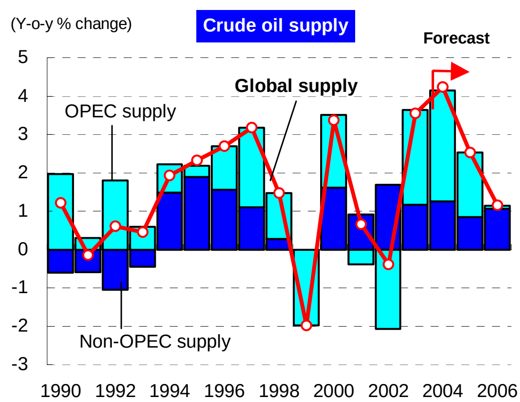
On the supply-side, the market will tend to focus upon limited output capacity despite investments to boost supply. The Organization of the Petroleum Exporting Countries (OPEC) currently has more than 100 new projects to boost output capacity and is planning to boost output to 5.5 million barrels/day by 2010. Looking beyond the OPEC, despite the ebb of output in non-OPEC countries such as Russia, output capacity is rising in Africa and Brazil as a result of capital investment and the development of new oil fields (**Chart 5**). However, judging from the fact that the OPEC's output capacity is currently down to approximately 2 million barrels/day amid lingering uncertainties regarding the development of oil facilities in Iraq, worries regarding crude oil supply will most likely continue to smoulder until the expansion of adequate supply capacity.

【 Chart 4: Global crude oil demand 】



Note: Demand up to 3Q2005 are actual results based upon the International Energy Agency (IEA). Demand from 4Q2005 are forecasts by the MHRI.
Source: International Energy Agency, *Oil Market Report.*

【 Chart 5: Global crude oil supply 】



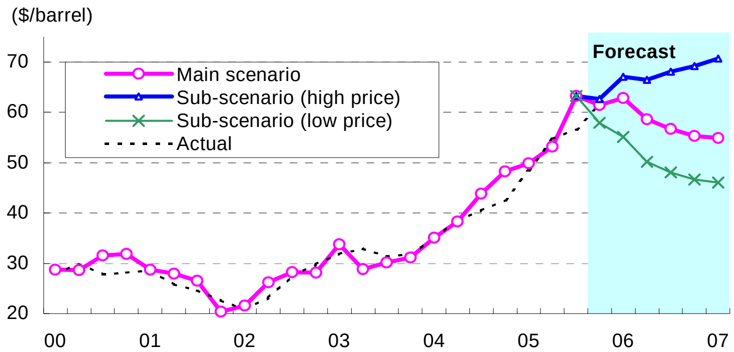
Note: Estimates by MHRI for 2005 and 2006.
Source: International Energy Agency, *Oil Market Report* .

The price of crude oil will start to decline around the turn of the year

Despite lingering supply-side concerns, the supply and demand balance of crude oil lead to our view that the price of crude oil will follow a gradual downswing reflecting the drop of demand. Furthermore, the inflow of speculative investment – heretofore accelerating the rise of crude oil prices – is coming to a pause along with the cool down of crude oil prices, providing us with reason to uphold the foregoing scenario.

However, amid persisting US refinery bottlenecks, crude oil prices will likely be locked in a narrow range at the lower end of the $60/barrel level with not much leeway to fall further during the year 2005 because of the approaching high-demand winter season. In 2006, crude oil prices will peak in the spring season when the demand for crude oil will decline and follow a more definite downhill path, reflecting the slowdown of the global economy (mainly the US) in the second half of the year. Even though the possibility of the decline of crude oil prices below $50/barrel (**Chart 6**, Sub-scenario (low price)) may not be ruled out in the event the rise of expectations on the alleviation of the supply demand balance triggers an exodus of speculative investors from the crude oil market, a drop below $50/barrel is unlikely (**Chart 6**, Main scenario) because the OPEC will be inclined to boost prices by reducing output when the price of crude oil approaches $50/barrel.

【 Chart 6: Estimate and scenarios on crude oil prices 】



Source: MHRI estimates

Crude oil prices may resurge if supply-side concerns rise

In the event risk factors such as those listed below lead to the rise of concerns regarding the supply of crude oil, there is a possibility that speculative investors might return to the crude oil market and drive up prices even if the risks factors do not culminate in the actual suspension of supply: (1) a further deterioration of conditions and terrorism in Iraq, (2) turmoil regarding the development of nuclear weapons by Iran (for example, a crude oil embargo), and (3) large scale strikes in Nigerian crude oil facilities. If these risks materialize, the price of crude oil would shoot above $70/barrel (**Chart 6**, Sub-scenario (high price)).

The surge of crude oil prices will serve as a drag upon economic growth via the rise of prices

In the event crude oil prices shoot up as in the Sub-scenario (high price) in **Chart 6**, the impact would drive up price levels (both corporate goods prices and consumer prices) through the rise of import prices and serve as downward pressures upon corporate earnings and profits and demand such as consumer spending and business capital investment. According to simulations based upon the Mizuho Macro-econometric Model, the rise of crude oil prices would push up the percentage change of Japan's consumer price index in FY2006 by 0.2% point, depress the rate of change of corporate earnings and profits by 0.8% point and push down the rate of real GDP growth by 0.2% point through the fall of consumer spending and capital investment (**Chart 7**).

In the US, the rise of crude oil prices would lead to a sharper rise of prices than in Japan, and thereby depress the rate of real GDP growth in 2006 by 0.4% point.

【 Chart 7: Simulation on the economic impact of the surge of crude oil prices 】

		CY2005	CY2006				CY2007	Contribution to rate of change (%pt)	
		Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	FY2005	FY2006
Crude oil price (WTI: $/barrel)	Main scenario	61.4	62.9	58.6	56.7	55.3	54.9		
	Risk scenario	62.7	67.1	66.4	68.1	69.2	70.7		
	Deviation	**1.2**	**4.2**	**7.8**	**11.4**	**13.9**	**15.9**		
Import prices (Rate of deviation: %)	**Japan**	**0.4**	**1.5**	**2.8**	**4.0**	**5.0**	**5.7**	**0.5**	**3.9**
	US	0.2	0.7	1.3	1.9	2.4	2.7	0.1	1.5
Corporate goods prices (Rate of deviation: %)	**Japan**	**0.1**	**0.2**	**0.4**	**0.6**	**0.7**	**0.9**	**0.1**	**0.6**
	US	0.1	0.3	0.7	1.1	1.5	1.8	0.0	0.9
Consumer prices (Rate of deviation: %)	**Japan**	**0.0**	**0.1**	**0.1**	**0.2**	**0.3**	**0.3**	**0.0**	**0.2**
	US	0.1	0.2	0.5	0.8	1.1	1.3	0.0	0.6
Corporate earnings (Rate of deviation:%)	**Japan**	**-0.03**	**-0.1**	**-0.3**	**-0.6**	**-1.0**	**-1.5**	**0.0**	**-0.8**
	US	-0.1	-0.5	-0.9	-1.4	-1.8	-2.1	0.0	-1.1
Real private-sector final consumption (Rate of deviation: %)	**Japan**	**-0.01**	**-0.02**	**-0.04**	**-0.06**	**-0.1**	**-0.1**	**0.0**	**-0.1**
	US	-0.1	-0.3	-0.6	-0.9	-1.1	-1.2	0.0	-0.7
Real private-sector business capital investment (Rate of deviation: %)	**Japan**	**-0.02**	**-0.1**	**-0.3**	**-0.6**	**-1.0**	**-1.5**	**0.0**	**-0.8**
	US	-0.1	-0.3	-0.6	-0.8	-1.1	-1.4	0.0	-0.7
GDP (real) (Rate of deviation: %)	**Japan**	**-0.004**	**-0.02**	**-0.1**	**-0.1**	**-0.2**	**-0.3**	**0.0**	**-0.2**
	US	-0.1	-0.2	-0.4	-0.6	-0.7	-0.8	0.0	-0.4

Note: Estimates based upon Mizuho Macro-econometric Model.

The impact upon the countries of Asia will be relatively larger

According to estimates by the Organization for Economic Co-operation and Development (OECD), a 30% rise of crude oil prices would drive up the euro zone inflation rate by 0.3% point and depress the rate of real GDP growth by 0.3% point. Judging from the gap of approximately 30% in the price of crude oil when comparing the main scenario and sub-scenario in the Jan-Mar quarter of 2007 in the aforementioned simulations regarding Japan and the US, the results are most likely derived from very similar preconditions as the OECD estimates. In other words, the impact of the rise of crude oil prices would be as follows, ranked in the order of magnitude from the lower to higher impact: (1) Japan, (2) Europe and (3) the US.

As for Asia, the Asian Development Bank (ADB) estimates that the rise of crude oil prices to $70/barrel in the Oct-Dec quarter of 2006 would depress the rate of China's real GDP growth by 1.0% point and push down the rate of real GDP growth in the ASEAN member states such as Indonesia, Malaysia, the Philippines and Thailand by approximately 1~2% point (**Chart 8**). The impact upon the newly industrialized economies (NIEs) such as Korea and Taiwan is comparatively smaller than the ASEAN countries. The foregoing leads to our view that the rise of crude oil prices would tend to have a larger impact upon the economies of Asia in comparison to Japan, the US and Europe.

【 Chart 8: The impact of higher crude oil prices upon the Asian economies 】

(%)

	Rate of GDP growth	Fiscal balance (% of GDP)
China	-1.0	-0.1
India	-1.1	-0.9
Hong Kong	-0.9	-0.1
Indonesia	-1.1	+0.2
S. Korea	-0.5	-0.9
Malaysia	-1.1	+1.0
Philippines	-1.4	-0.8
Singapore	-1.3	-0.4
Taiwan	-0.2	-1.1
Thailand	-1.8	-0.7

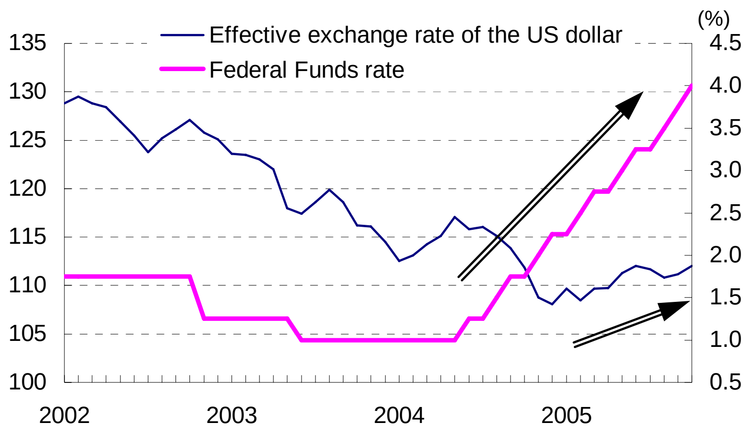
Note: The chart above sets forth the change in the event the price of crude oil rises from 53$/barrel in the Jul-Sep quarter of 2005 to 70$/barrel in the Oct-Dec quarter of 2006.
Source: Asian Development Bank, *Asian Development Outlook 2005 Update.*

The US dollar is also a risk factor for the global economy

The US dollar exchange rate is also a risk factor for the global economy. Note that the effective exchange rate of the dollar has been rising since early 2005 reflecting the successive federal funds rate hikes in the US (**Chart 9**).

Looking forward, we are inclined toward the view that the Fed will continue to raise US interest rates for the time being due to rising inflationary pressures, thereby causing the dollar to strengthen. Nevertheless, the appreciation of the dollar should come to a pause in 2006 along with the spread of a market consensus that the Fed's interest rate hikes are coming to an end. Furthermore, the US economy is predicted to slow down in the second half of the year. If this leads to market expectations on an interest rate cut and brings the economy closer to the brink of recession, the dollar would lose further ground and serve as negative pressures upon exports for export-oriented countries such as Japan with the appreciation of its own currency to the dollar.

【 Chart 9: The effective exchange rate of the dollar and the US Federal Funds rate 】



Sources: Bank of Japan, Bloomberg.

The US economy: solid growth followed by slowdown in the second half of 2006 due to successive interest rate hikes

Even if the foregoing risk factors may be averted, during the period from the second half of 2005 to the first half of 2006, the US economy will face a peak-out of the housing boom and a slower pace of consumer spending due to the rise of long-term interest rates. On the other hand, the US economy should continue to chart solid growth because the progress of inventory adjustment should lead to a rebound of inventory investment. Even so, prospects of successive interest rate hikes on the back of rising inflationary pressures provide us with reason to believe that the US economy will slip once again into an inventory adjustment cycle in the second half of 2006 and grow at a pace below the potential rate of economic growth (**Chart 10**).

The euro zone economy: sluggish domestic demand will serve as a drag upon economic recovery

The recovery of exports reflecting the weak euro and the ongoing expansion of the global economy will serve as the driver of the euro zone economy. However, since business corporations are still intent upon restructuring, business capital investment will be kept to a minimum and labor costs will remain bridled. As a result, both capital investment and consumer spending will remain sluggish, keeping the euro zone economy in a slow recovery in 2006.

The Asian economies: the recovery of demand for IT and digital appliances will keep the economy in recovery mode

The Asian economies will remain on an export-led recovery backed by the upturn of demand for semiconductors and demand in the IT and digital sector. However, the ASEAN countries will face lackluster economic growth because of higher fuel prices, which have been suppressed thus far through policy initiatives, and the sluggish growth of domestic demand due to the rise of inflationary pressures. Moreover, exports will lose momentum reflecting the US economic slowdown in the second half of 2006 and serve as a drag upon the expansion of the economy.

Turning to the Chinese economy, the environment surrounding corporate earnings and profit is deteriorating due to cost pressures stemming from the rise of crude oil prices and the fall of sales prices reflecting excessive output capacity, providing us with reasons to believe that the growth of investment will temporarily slow down. Nevertheless, given the tendency for corporate investment incentive to rise in view of the 11th Five Year Plan and the run-up to the Beijing Olympic games, corporate investment should gather fresh momentum and lead to strong economic growth in the second half of 2006 when the negative impact of weak corporate earnings and profits wears off.

Summarizing the foregoing, the NIEs and ASEAN countries will propel the recovery of the Asian economies up to mid-2006. From then onward, from the second half of 2006, the Chinese economy will regain momentum and serve as the driver, maintaining the growth of the Asian economies at the 6%-level.

The Japanese economy: self-sustained recovery toward the end of deflation

The Japanese economy will continue to follow a self-sustained recovery driven mainly by domestic private demand such as capital investment and consumer spending, reflecting the sustained improvement of corporate business performance and household income. Exports will also serve as tailwinds upon economic growth, given more definite signs of recovery of Asia-bound exports. However, toward the end of 2006, the slowdown of the US economy and the rise of household economic burdens will lead to concerns regarding the future.

【 Chart 10: Global economic forecast (calendar year basis) 】

(%)

		2004			2005			2006		
			1H	2H		1H	2H		1H	2H
US		4.2	4.1	3.6	3.6	3.6	3.6	3.4	3.6	2.8
Europe (Euro zone)		1.8	2.2	1.2	1.4	1.2	1.8	1.8	2.1	1.4
Asia		7.5			6.6			6.4		
	NIEs	5.8			4.0			4.3		
	ASEAN 4	5.9			4.9			5.0		
	China	9.5			9.4			8.6		
Japan		2.7	3.9	-0.5	2.4	4.0	1.9	1.8	1.5	2.3
		(1.9)	(0.3)	(1.6)	(2.5)	(3.6)	(1.2)	(1.8)	(2.3)	(1.3)

Note: The shaded areas are forecasts. Calendar year figures refer to the % change over the previous year and the half-year figures refer to the % change over the previous term (p.a.) Figures in parentheses regarding Japan are fiscal year data.

II. The Japanese Economy

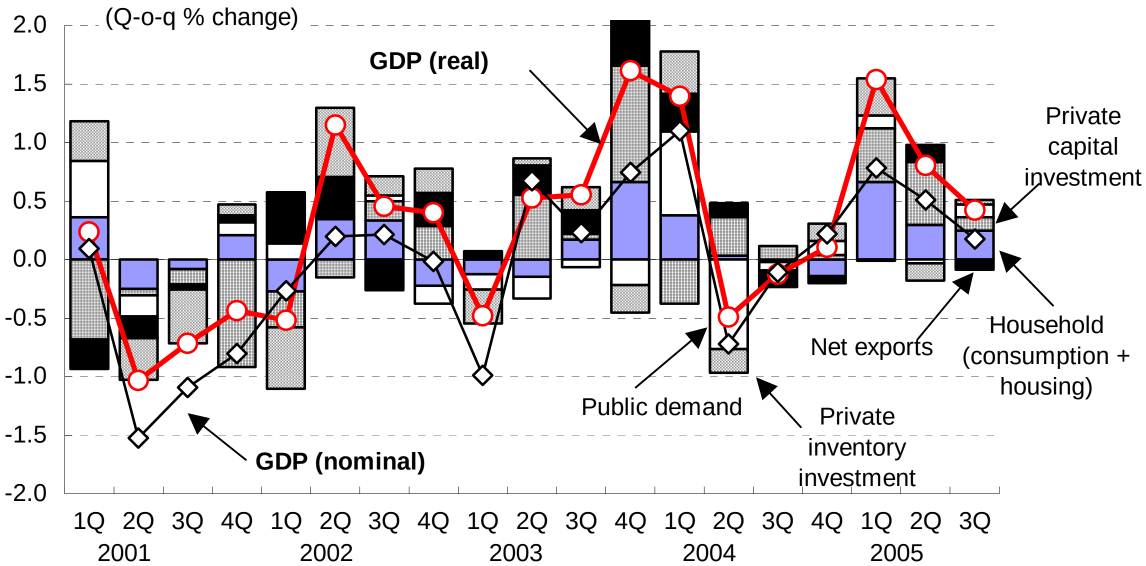
1. The current state of the Japanese economy

The Japanese economy grew for the fourth quarter in a row in Jul-Sep 2005

Japan's real GDP grew 0.4% q-o-q (translated into an annualized rate of 1.7%) in the Jul-Sep quarter of 2005. Even though the rate of economic growth slowed in comparison with the two previous quarters from January to March and April to June, the Japanese economy still grew for the fourth consecutive quarter, ascertaining its steady recovery toward the end of deflation (**Chart 11**).

Looking closer at the components of demand, personal consumption and capital investment – the two main pillars of domestic private demand – grew 0.3% q-o-q and 0.7% q-o-q respectively. Even though growth slowed from the previous quarter, both components still remained in expansion mode. Given the growth of housing investment (1.5% % q-o-q), rising for the first time in two quarters, Japan's domestic private demand continued to grow a solid 0.5% q-o-q. Public demand grew 0.5% q-o-q, picking up for the first time in two quarters, as a result of the upturn of public investment for the first time since the Jan-Mar quarter of 2002 (except for the Jan-Mar quarter of 2004 when public investment increased from the previous quarter due to statistical technicalities). As for external demand, the contribution by net exports (exports minus imports) to quarterly real GDP growth fell into negative territory (-0.1% point) despite the rise of exports (2.7% q-o-q) for the fourth consecutive quarter because of the sharp rise of imports (3.9% q-o-q) reflecting the growth of domestic demand.

【 Chart 11: Japan's quarterly GDP growth 】



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

The economy is still cruising stably despite a slower pace of growth

Even though the pace of economic growth slowed in the Jul-Sep quarter of 2005, a closer look reveals a well-balanced recovery underscored by the following factors: (1) the ongoing growth of both personal consumption and capital investment, (2) the sustained recovery of exports, and (3) the growth of the economy above its potential growth rate estimated to be around 1.5%.

The GDP deflator, a broad measure of price changes, fell 1.1% o-y-a, in falling deeper into negative territory in comparison to -0.9% o-y-a in the previous quarter. Note, however, that this is a temporary phenomenon caused by the rise of crude oil prices (domestic value-added production is pushed down since the higher price of crude oil is not shifted fully to domestic prices) and does not indicate the rise of deflationary pressures. Judging from the fact that the Japanese economy is continuing to grow above its potential rate of growth, the GDP deflator should gradually rise along with the peak-out of crude oil prices. The foregoing leads to our view that the Japanese economy is progressing steadily toward the end of deflation.

Industrial production is flattening out

Meanwhile, the industrial production index fell 0.2% q-o-q in the Jul-Sep quarter, declining for the second quarter in a row. Even though the index barely managed to rise 0.2% above the previous quarter when excluding the production of ships which is dragging down overall industrial production due to technicalities regarding the way in which statistics are compiled, the index nevertheless is unable to lift itself out of a plateau. Lingering inventory adjustment pressures in certain parts of the industrial sector are among the reasons for the sluggish rise of the inventory index.

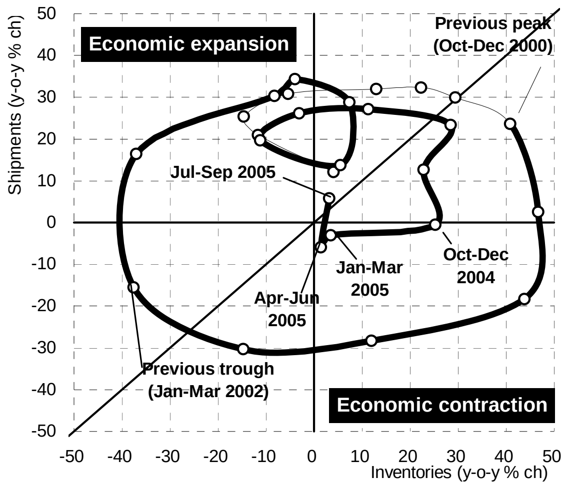
The IT and digital appliance sector has finished shedding its excess inventories

Even though the inventory adjustment process in the IT and digital appliance sector – thus far serving as a drag upon economic growth in the second half of last year – came to a slight pause in the Apr-Jun quarter, it now appears that the IT and digital appliance sector has finished shedding its excess inventories. The inventory cycle of IT-related producer goods is moving across the 45 degree line in the upper left quadrant in the Jul-Sep quarter (**Chart 12**). Production of electronic parts and devices rose a dramatic 8.5% q-o-q in the Jul-Sep quarter. Given the end of the inventory adjustment cycle, we expect production in the IT and digital appliance sector to keep recovering in the Oct-Dec quarter onward.

Inventory adjustment pressures are also benign in non-IT sectors

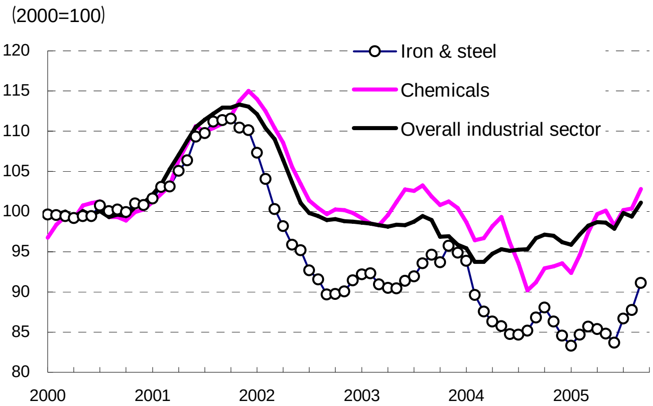
On the other hand, inventories are rising in sectors other than those related to information technology. Industrial sector inventories mainly in basic materials such as iron & steel and chemicals rose 3.3% y-o-y as of the end of September, surpassing the rise of shipments in the Jul-Sep quarter (0.6% y-o-y), indicating that the inventory adjustment cycle is continuing. However, the movement of the inventory ratio index (by industrial sector) reveals that inventories in the chemicals sector is still standing at average levels since 2000 and that inventory levels in the iron & steel sector remain low (**Chart 13**). The sharp rise of inventories on a year-on-year basis is due mainly to a backlash to the tight supply of basic materials driven up by Chinese demand last year. Thus, we still consider that the level of inventories falls within an appropriate range. Despite the curtailment of production with respect to certain items such as general-purpose steel products, adjustment pressures in non-IT sectors are benign.

【 Chart 12: Inventory cycle of IT-related producer goods 】



Source: Ministry of Economy, Trade and Industry.

【 Chart 13: The inventory ratio index 】



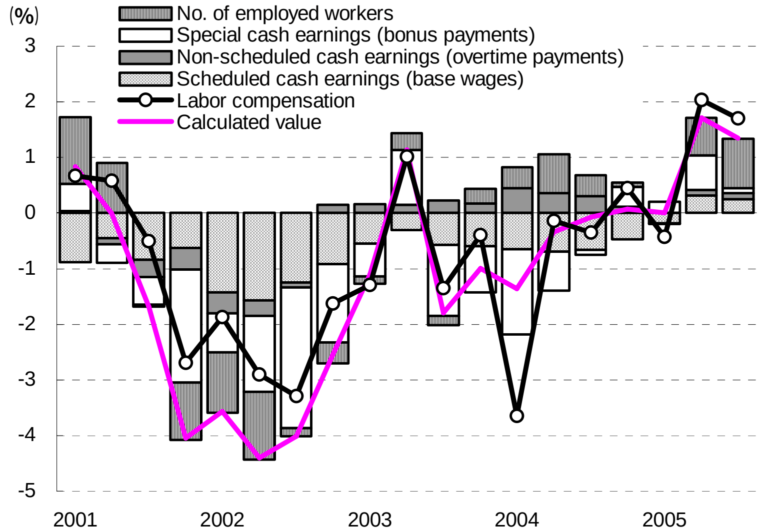
Note: Seasonally-adjusted, 3MMA.
Source: Ministry of Economy, Trade and Industry, *Indices of Industrial Production, Producer's Shipments, Producer's Inventory of Finished Goods and Producer's Inventory Ratio of Finished Goods (Index)*.

The sustainability of domestic private demand is the key

Judging from the end of the inventory adjustment cycle in the IT and digital appliance sector and the benign inventory adjustment pressures in non-IT sectors, against a backdrop of a gradual pick-up of external demand, the key in forecasting the future course of the economy is the sustainability of domestic private-sector final demand.

The trends in household income is extremely important in providing an outlook on the future course of personal consumption, one of the main pillars of domestic private-sector final demand. Labor compensation grew 1.7% o-y-a in the Jul-Sep quarter, recording ongoing strong growth subsequent to the Apr-Jun quarter. Compared with the previous quarter, the contribution to growth by special cash earnings (bonus payments) fell while the contribution by the increase of employed workers rose due to the improvement of labor market conditions (**Chart 14**). As shown by MHRI's forecast that average winter bonus payments paid by private-sector business corporations will rise 3.5% o-y-a, the environment surrounding household income should continue to improve. Consumer spending should continue to grow, reflecting the improvement of employment and income.

【 Chart 14: Labor compensation 】

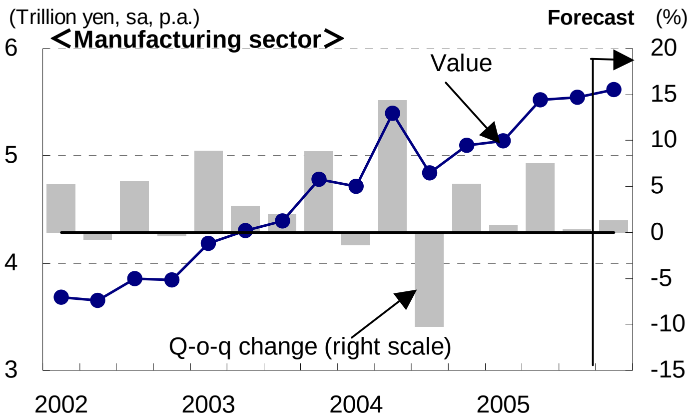


Note: "Calculated value" = nominal wages x number of employed workers.
The bars represent the contribution to the calculated value.
Sources: Ministry of Health, Labour and Welfare, *Monthly Labour Survey,*
Ministry of Internal Affairs and Communications, *Labour Force Survey,*
Cabinet Office, *Annual Report on National Accounts* .

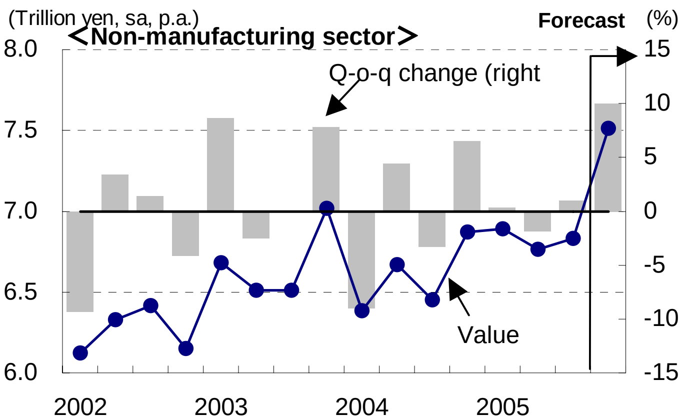
Leading indicator suggests an acceleration of capital investment growth

Even though business capital investment – the second pillar of domestic private-sector demand – fell 0.7% q-o-q in the Jul-Sep quarter, this component should regain momentum from the Oct-Dec quarter onward. Machinery orders (private-sector demand excluding shipbuilding orders and orders by electric power companies), which is a leading indicator of capital investment trends, rose 2.1% q-o-q in the Jul-Sep quarter and is estimated to gather further momentum and grow 6.2% q-o-q in the Oct-Dec quarter. Note that the substantial increase of capital investment plans during the current fiscal year revealed by various surveys such as the Bank of Japan's (BOJ) *Short-Term Economic Survey of Enterprises in Japan (the "Tankan")* is now materializing. A closer look at machinery orders indicates a pause in the growth of business fixed investment among manufacturers in contrast to an estimated 10.0% q-o-q rise among non-manufacturers in the Oct-Dec quarter (**Chart 15**). Capital investment is growing sharply among non-manufacturers as we write this report, indicating that the rise of capital investment is spreading across the industrial spectrum. Since businesses have shed their excess capacity and debt and are flush with capital flow, they are taking a more forward-looking and positive stance toward business fixed investment. Looking forward, capital investment should keep growing with the main engine shifting to non-manufacturers.

【 Chart 15: Machinery orders 】



Note: The latest figures are forecasts by the Cabinet Office.
Source: Cabinet Office, *Orders Received for Machinery.*



Note: The latest figures are forecasts by the Cabinet Office.
Source: Cabinet Office, *Orders Received for Machinery*.

2. Forecast of the Japanese economy in FY2005 and FY2006

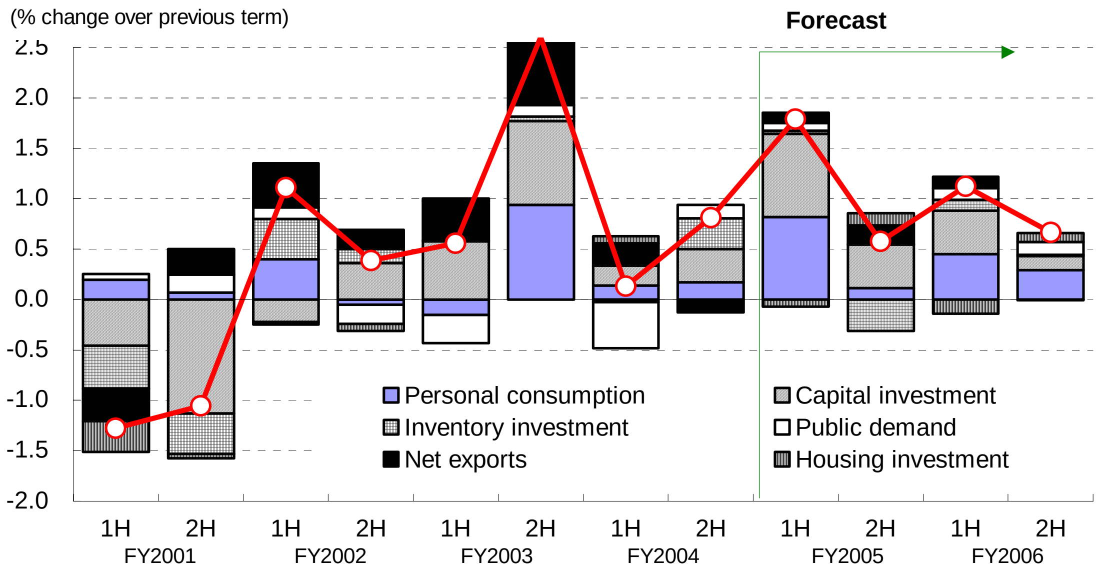
FY2005: 2.5% real GDP growth, 1.4% nominal GDP growth

1H FY2005 The economy grew a strong 1.8% from the previous term (3.6% in annualized terms), driven mainly by personal consumption and capital investment (**Chart 16**).

2H FY2006 The economy will continue to grow strongly, given the ongoing expansion of personal consumption, capital investment and exports. However, the growth of personal consumption and capital investment may slow down in a reaction to the strong rise in the first half of the fiscal year and the high level of inventory investment thus far may come under negative pressure and serve as drag upon GDP growth. On the other hand, housing investment will rise into positive territory and the contribution by net exports will grow, thus keeping the rate of economic growth at the 1% level in annualized terms. The improvement of corporate business performance will lead to the steady rise of personal consumption through the growth of capital investment and increase of household income. The Japanese economy will roll into a virtuous cycle in which the rise of final demand will lead to a further improvement of corporate business performance, leading to more definite signs of autonomous economic recovery. In the second half of FY2005, Japan's real GDP will keep growing around its potential rate of growth, moving closer to the end of deflation.

Thus, even though the rate of economic growth will slow to 0.6% (1.2% p.a.) in the second half of FY2006 due to a reaction to the first half of the fiscal year, we expect full-year real GDP growth in FY2005 to surpass the previous year and reach 2.5% (previous forecast: 2.3%) in real terms and 1.4% (previous forecast: 1.2%) in nominal terms.

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



Note: MHRI forecasts from 1H FY2005 onward.
Sources: Cabinet Office, *Preliminary Quarterly Estimates of GDP.*

1H FY2006: growth will accelerate, reaching around 2% per annum

1H FY2006 We predict the Japanese economy to rise above 2% p.a. reflecting the rebound of personal consumption amid the ongoing improvement of household income conditions and the ongoing growth of capital investment backed by the expansion of exports and consumer spending.

2H FY2006: the appreciation of the yen will serve as a drag upon growth

2H FY2006 In addition to a slower pace of personal consumption growth stemming from the abolition of across-the-board tax credits and full-fledged discussions regarding the consumption tax hike, the contribution by net exports will fall into negative territory due to the fall of exports along with the US economic slowdown and appreciation of the yen. Reflecting these circumstances, businesses will start to take a wait-and-see stance regarding capital investment, dragging down the rate of economic growth to around 1.5%.

Judging from the foregoing, MHRI forecasts that Japan's real GDP in FY2006 will slow from 1.1% over the previous term (2.3% p.a.) in the first half of FY2006 to 0.7% over the previous term (1.3% p.a.) in the second half. This brings full-year GDP growth in FY2006 to 1.8% in real terms and 1.6% in nominal terms (**Chart 17**).

【 Chart 17: Outlook on the Japanese economy 】

(%)

	FY2004	FY2005	FY2006	FY2005		FY2006		FY2005	FY2006
				1H	2H	1H	2H	(Contribution)	(Contribution)
	(Actual)	(Forecast)	(Forecast)	(Actual)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)
GDP (real)	1.9	2.5	1.8	1.8	0.6	1.1	0.7	-	-
Domestic demand	1.4	2.4	1.6	1.7	0.4	1.0	0.7	2.3	1.6
Private sector demand	2.3	2.9	1.7	2.1	0.5	1.1	0.7	2.2	1.3
Personal consumption	1.2	1.7	1.2	1.5	0.2	0.8	0.5	1.0	0.7
Housing investment	2.1	-0.2	-0.9	-1.9	3.5	-3.9	2.7	-0.0	-0.0
Capital investment	5.1	7.9	4.3	5.3	2.7	2.6	0.9	1.2	0.7
Public sector demand	-1.4	0.5	1.0	0.3	0.0	0.5	0.6	0.1	0.2
Government consumption	2.7	2.2	2.3	0.8	1.6	1.1	0.8	0.4	0.4
Public investment	-15.1	-5.9	-5.0	-1.6	-6.1	-2.3	-0.1	-0.3	-0.2
Net exports (contribution)	0.5	0.1	0.1	0.1	0.2	0.1	-0.0	0.1	0.1
Exports	11.9	8.0	7.2	4.5	4.7	3.8	1.8	1.1	1.0
Imports	9.4	8.1	6.7	4.3	3.9	3.6	2.2	-0.9	-0.9
GDP (nominal)	0.8	1.4	1.6	1.0	0.2	1.4	0.2		
Industrial production	4.1	1.3	3.6	0.3	2.1	2.2	0.8		
Unemployment rate	4.6	4.2	3.9	4.3	4.1	4.0	3.9		
Current account balance (trillion yen)	18.3	17.1	17.8	17.1	17.1	18.2	17.5		
as a percentage of nominal GDP	3.6	3.3	3.4	3.3	3.3	3.5	3.4		
Corporate goods prices	1.5	1.8	-0.5	1.6	1.9	0.5	-1.5		
Consumer prices	-0.3	0.0	0.2	-0.1	0.2	0.3	0.2		
Long-term interest rate (%)	1.52	1.49	1.91	1.30	1.68	1.83	2.00		
Nikkei stock average (yen)	11,321	12,997	14,550	11,794	14,200	14,600	14,500		
Exchange rate (yen/dollar)	107.5	112	108	109.4	116	110	105		
Crude oil price (WTI $/barrel)	45.1	60.2	56.3	58.2	62.2	57.6	55.1		

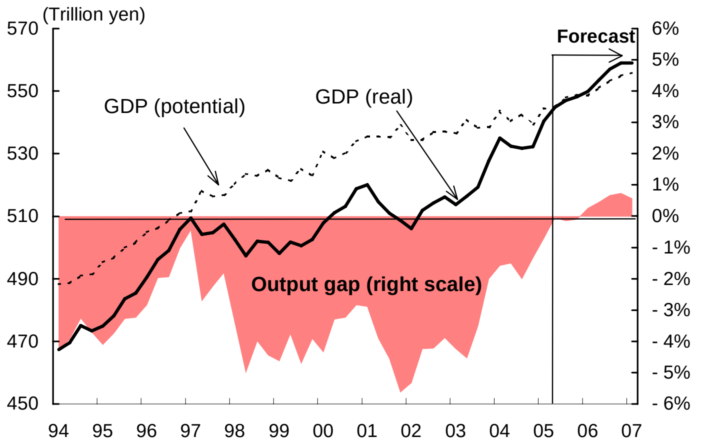
Notes: 1. FY = rate of change from the previous year. Half-year = rate of change from the previous term (excluding the unemployment rate, current account balance and prices).
2. Half-year corporate goods prices and half-year consumer prices = rate of change over a year ago.
Consumer prices = nationwide (excluding fresh foods).
3. Half-year unemployment rate and half-year current account balance are adjusted for seasonal factors.
Figures on current account balance are converted into annualized rates.
4. Crude oil price = near-term contract for WTI crude futures.
The long-term interest rate = newly-issued 10-yr government bonds.

Sources: Cabinet Office, *Annual Report on National Accounts*,
Ministry of Economy, Trade and Industry, *Indices of Industrial Production, Producer's Inventory of Finished Goods and Producer's Inventory Ratio of Finished Goods (Index),*
Ministry of Internal Affairs and Communications, *Labor Force Survey, Consumer Price Index*,
Ministry of Finance, *Balance of Payments,*

The percentage rise of the CPI will turn positive in mid-2005

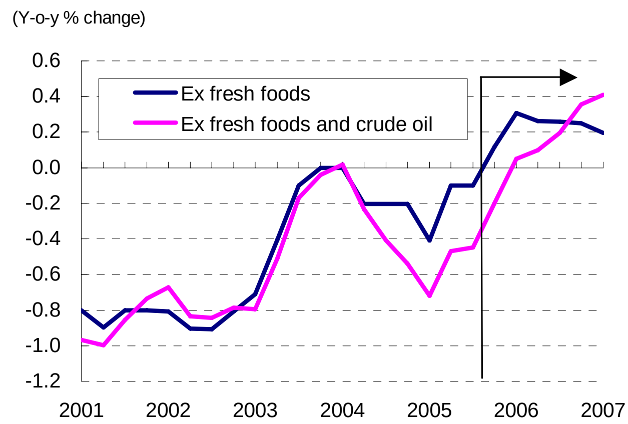
Looking forward on future price trends on the basis of MHRI's forecast on the economy, the output gap (the gap between demand and supply) which has narrowed considerably should rise into positive territory in early 2006 if the Japanese economy continues to move forward on a domestic demand-led recovery as set forth in MHRI's economic forecast (**Chart 18**). The percentage rise of the consumer price index (CPI) will likely turn positive around mid-2005, one step ahead of the output gap, due in part to the rise of prices of crude oil-related products (**Chart 19**). The precondition 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 the Apr-Jun quarter of 2006 when the economic indicators on the Jan-Mar quarter of 2006 are confirmed.

【 Chart 18: 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 19: The CPI 】



Note: "Ex fresh foods and crude oil" = "Ex fresh foods" minus gasoline and heating oil.
Source: Ministry of Internal Affairs and Communications, *Consumer Price Index.*

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