Economic Outlook for FY2004, FY2005 and FY2006

(Revised to reflect the Second Preliminary Quarterly Estimates of GDP for the Oct-Dec quarter of 2004)

March 2005

The Mizuho Research Institute Ltd. (MHRI) has revised its economic outlook for FY2004, FY2005 and FY2006 subsequent to the release of *The Second Preliminary Quarterly Estimates of GDP ("2nd QE")* for the Oct-Dec quarter of 2004. In comparison to MHRI's previous *Economic Outlook for FY2004, FY2005 and FY2006* released on February 18, 2005, we have revised the forecast on Japan's economic growth to reflect a major statistical change regarding Japan's gross domestic product (GDP). Nevertheless, our outlook on the fundamental direction of the economy remains unchanged.

<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: 6.2%, 2006: 6.6%)

<The Japanese Economy>

FY2004	The economy will emerge out of the doldrums and start to pick up (Real GDP growth 1.6%, nominal GDP growth 0.7%)
FY2005	A moderate recovery driven by domestic private-sector demand (Real GDP growth 1.5%, nominal GDP growth 0.9%)
FY2006	Strong domestic demand will lead to the end of deflation (Real GDP growth 1.8%, nominal GDP growth 1.5%)

Mizuho Research Institute

The Japanese Economy

○ **FY2005 Outlook:**	A moderate recovery driven by domestic private-sector demand (real GDP growth 1.5%, nominal GDP growth 0.9%)
○ **FY2006 Outlook:**	Strong domestic demand will lead to the end of deflation (real GDP growth 1.8%, nominal GDP growth 1.5%)

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

Real GDP growth in the Oct-Dec quarter of 2004 was upwardly revised

On March 14th, the Cabinet Office released the *Second Preliminary Quarterly Estimates of GDP* (*"2nd QE"*) for the Oct-Dec quarter of 2004, which revised up Japan's real GDP growth during the quarter to 0.1% q-o-q (0.5% per annum) from -0.1% q-o-q (-0.5% per annum) in the *First Preliminary Quarterly Estimates of GDP* ("*1st QE*")(**Chart 1**). Looking closer at the components of demand, (1) capital investment was downgraded from 0.7% q-o-q in the *1st QE* to 0.1% q-o-q, (2) imports were revised down from 3.1% q-o-q to 2.4% q-o-q, (3) the contribution by inventory investment was revised up from 0.0% pt q-o-q to 0.2% pt and (4) government consumption was revised up from 0.4% q-o-q to 0.8% q-o-q, thereby pushing up the rate of real GDP growth.

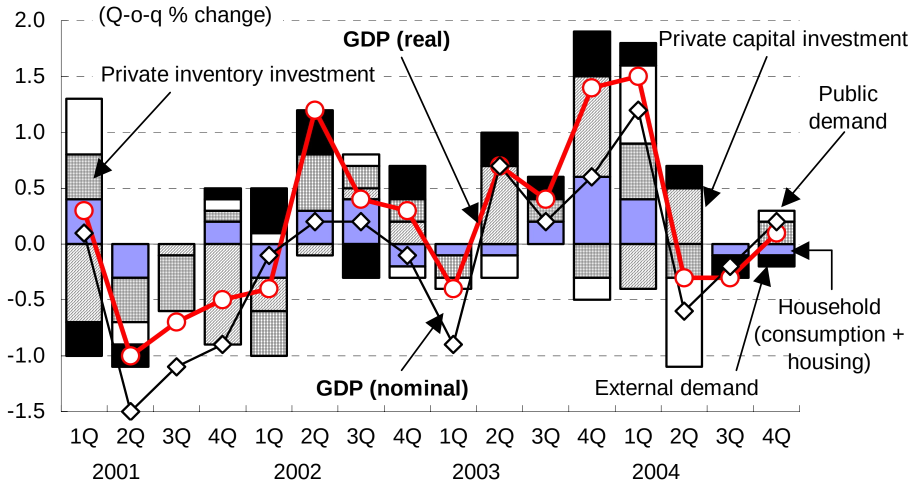
but our view on sluggish growth in the second half of 2004 remains unchanged

As a result, the time span of Japan's economic decline turned out to be shorter than initially perceived at the time of the *1st QE*, ending in only two quarters up to the Jul-Sep quarter rather than three consecutive quarters from the Apr-Jun quarter of 2004. However, even though growth in the Oct-Dec quarter turned positive, the expansion was still weak. Furthermore, note also that the upgraded components were private-sector inventory investment, government consumption and imports. Domestic private-sector demand, which comprises the core component of GDP, was subject to a slight downward revision. Thus, our judgment remains unchanged that the economy was in a soft patch in the second half of 2004.

Nominal GDP growth surpasses growth in real terms given the alleviation of deflationary pressures

Nominal GDP growth grew 0.2% q-o-q (1.0% p.a.), surpassing the rate of real GDP growth due to the contraction of the GDP deflator to –0.4% over a year ago (o-y-a). Although a large part of the contraction of the deflator was due to one-off factors such as the rise of fresh food prices and the increase of government worker wages (accompanying the change in number of months in calculating bonus payments), deflationary pressures are gradually subsiding as indicated by the contraction of the gross fixed capital formation deflator (Jul-Sep quarter –0.5% o-y-a → Oct-Dec quarter –0.1% o-y-a).

【Chart 1: ***The Second Preliminary Quarterly Estimates of GDP*** **for the Oct-Dec Quarter**】

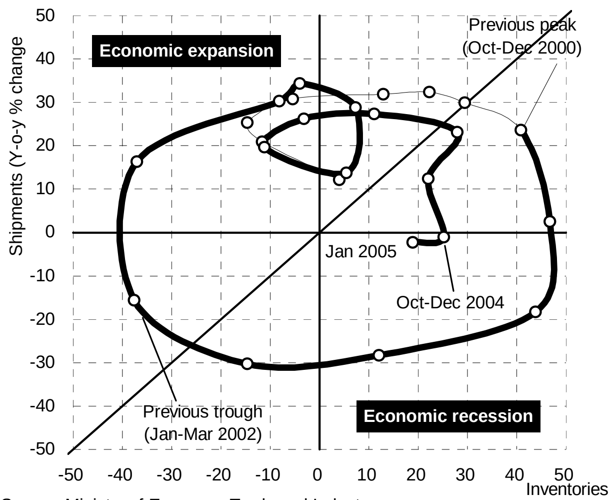


Source: Cabinet Office, *Preliminary Quarterly Estimates of GDP.*

The inventory buildup is most likely temporary

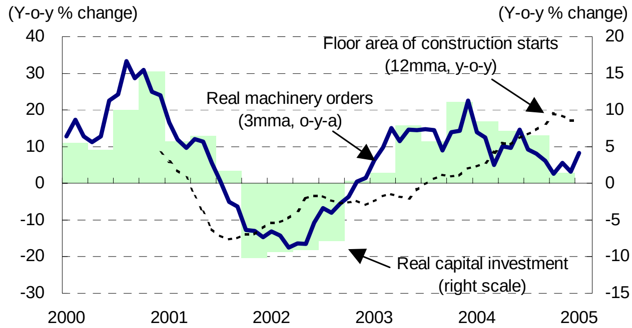
Particularly noteworthy in the recent GDP revision is the upgrade of private inventory investment. However, as far as the *Financial Statements Statistics of Corporations by Industry (Quarterly)* of the Oct-Dec quarter indicate, the increase of inventory investment is due largely to the rise of products in progress. According to the Cabinet Office, the increase was most prominent among industrial machinery. In most cases, industrial machinery is manufactured on an order basis rather than a speculative basis. Thus, although products in process are temporarily recorded as inventory investment, the majority is scheduled for delivery and will be ultimately accounted for as capital investment. While raw material inventories mainly in the IT and digital appliance sector also appear to be edging higher, the *Indices of Industrial Production* reveal that manufacturers are steadily shedding inventories (**Chart 2**). Moreover, there are no signs of an overhang with respect to distributor's inventory and finished goods inventory. The foregoing leads to our judgment that the rise of inventory investment in the Oct-Dec quarter is due largely to temporary factors and that cyclical inventory adjustment pressures are not rising.

【 Chart 2: Inventory Cycle of IT-Related Producer Goods 】



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

【 Chart 3: Leading Indicators on Capital Investment 】



Notes: 1. "Real machinery orders" refer to private-sector orders excluding orders for ships and orders by electric power companies. The deflator = corporate goods price index (capital goods).
2. "Floor space of construction starts" refer to private-sector non-residential construction starts.

Sources: Cabinet Office, *Orders Received for Machinery, Annual Report on National Accounts,* Ministry of Land, Infrastructure and Transport, *Annual Report on Contruction Starts.*

Smaller-than-expected downward revision of capital investment

The downward revision of capital investment was within expectations in view of the sharp slowdown from 13.9% o-y-a in the Jul-Sep quarter of 2004 (excluding investment in software) to 3.0% o-y-a in the Oct-Dec quarter of 2004 in the *Financial Statements Statistics of Corporations by Industry*. The revision was smaller than expected mainly because of a recalculation of seasonal adjustments, as shown by the downward revision of quarterly data for the Jul-Sep quarter of 2004 from 0.4% in the 1st QE to –0.1%. Even so, capital investment turned out more or less flat in the second half of 2004 due to the downgrade, underscoring a loss of momentum.

Looking forward, the ongoing sharp rise of construction starts (floor area) and rudimentary signs of an upturn of machinery orders (**Chart 3**) point to the steady rise of leading indicators. Capital investment will start to gather fresh momentum from the Jan-Mar quarter of 2005.

Consumer spending fell due to weather factors and the surge of food prices

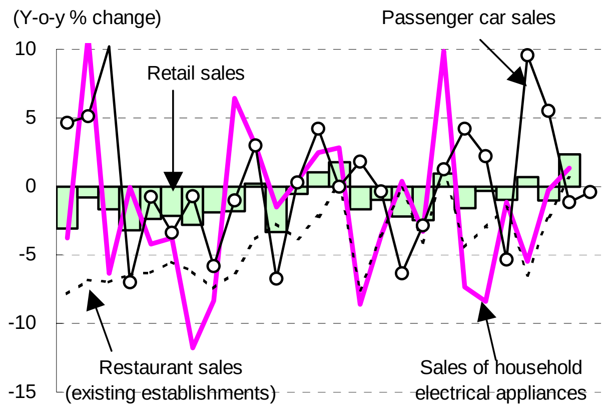
Personal consumption was revised up slightly from the *1st QE* reflecting data such as *the Survey of Household Economy* (December). However, personal consumption remained unchanged at –0.3% on a quarter-on-quarter basis.

The drop of consumer spending in the Oct-Dec quarter stems mainly from weather factors of a temporary nature as follows: (1) subdued spending on leisure and recreational activities due to the typhoons in October, (2) sluggish sales of winter clothing due to the unseasonable warm winter weather, and (3) the decline of real purchasing power due to the surge of fresh food prices.

Nevertheless, winter clothing has been selling briskly since the turn of the year along with the declining temperature, leading to the ebb of these downside factors (**Chart 4**). Despite certain soft spots such as the sharp drop of Tokyo department store sales in February, consumer spending as a whole is picking up.

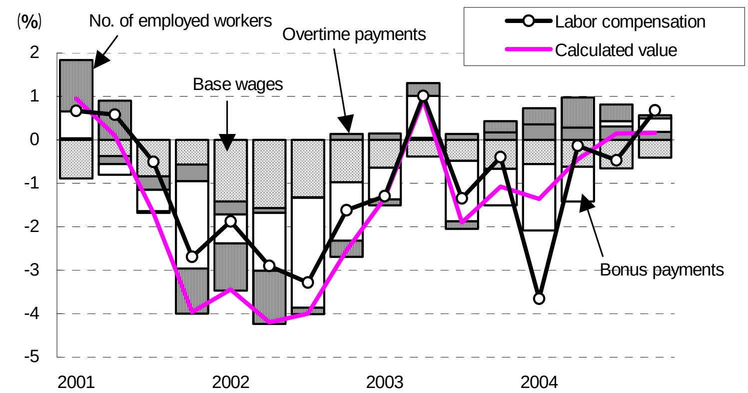
In addition, data on labor compensation in the Oct-Dec quarter of 2004 simultaneously revised with the *2nd QE*, grew on a nominal basis from 0.4% o-y-a in the *1st QE* to 0.7% o-y-a, reflecting the upward revision of bonus payments (special cash earnings) in the *Final Report of Monthly Labor Survey* in December (**Chart 5**). Furthermore, nominal wages rose 0.4% o-y-a in January given the increase of bonus payments (special cash earnings) and a smaller decline of base wages (scheduled cash earnings). The confirmation of a slight improvement of consumer confidence in the *Consumer Confidence Survey* leads to our view that consumer spending will rise steadily along with the improvement of the income environment.

【 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: Labor Compensation 】



Note: "Calculated value" = nominal wages x number of employed workers. The bars represent the contribution to the line (calculated value).

Sources: Ministry of Health, Labor and Welfare, *Monthly Labor Survey,*
Ministry of Internal Affairs and Communications, *Labor Force Survey,*
Cabinet Office, *Annual Report on National Accounts.*

Although a positive contribution by external demand is unlikely, the negative contribution by public demand has been eliminated

The negative contribution to GDP by external demand shrank (-0.2% pt → -0.1% pt) as a result of a downward revision of imports in the *2nd QE* amid the sluggish growth of exports. However, exports will only start to gather momentum from around the second half of the year due to (1) the ongoing ebb of global demand for IT and digital appliances continuing up to the middle of 2005 and (2) the entry of the US economy into a slight inventory adjustment phase. We do not expect exports to bolster the economy any time soon.

On the other hand, public investment, which has served so far as a major drag upon the economy, stood at –0.4% q-o-q in the Oct-Dec quarter of 2004 due in part to the progress of post-disaster reconstruction works. Furthermore, given the ongoing rise of government consumption reflecting the increase of medical costs along with the aging population, public demand in the Oct-Dec quarter turned out to be a positive contribution to economic growth.

Economic conditions are picking up, driven mainly by domestic private demand

As explained above, the recent *2nd QE* only reconfirmed the stagnation of the Japanese economy in the second half of 2004. However, as shown by the upward revision of labor compensation, it provides us with sufficient reason for us to maintain our view that the economy is continuing to follow a domestic demand-led recovery since the turn of the year.

2. FY2004 Outlook

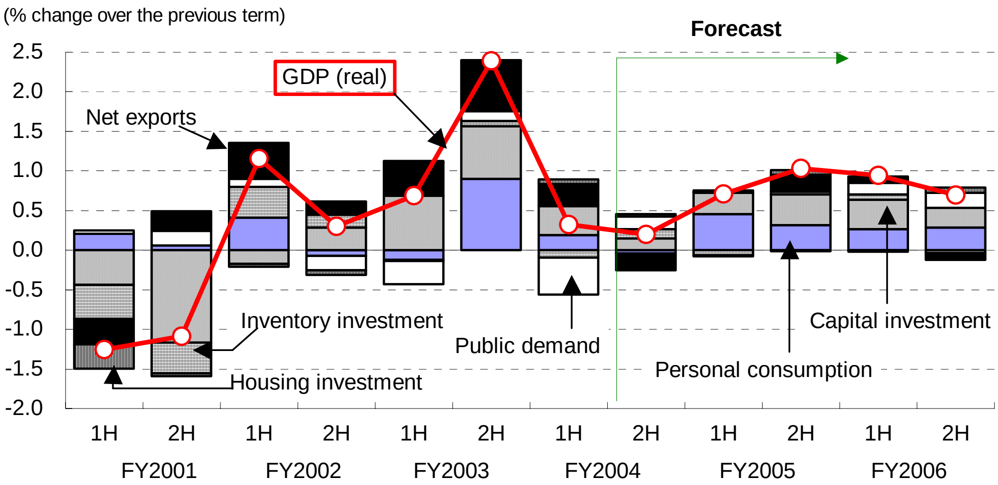
The economy will gather momentum in the Jan-Mar quarter

We may not expect external demand to push up the rate of real GDP growth in the Jan-Mar quarter of 2005 because of the ongoing sluggish growth of exports. However, since public investment is bottoming out due to the implementation of post-disaster reconstruction works and the contribution by domestic private-sector demand is rising, driven mainly of capital investment and consumer spending, we are inclined toward the view that the pace of real GDP growth will pick up in the Jan-Mar quarter.

FY2004 real GDP growth will reach 1.6%

As a result of the foregoing, FY2004 real GDP growth should remain flat throughout the year with growth in the first half standing at 0.3% q-o-q (0.4% q-o-q prior to revision) and second half growth reaching 0.2% q-o-q (0.0% q-o-q prior to revision). Nevertheless, on a full-year basis, GDP growth should turn out to be relatively strong, reaching 1.6% (1.5% prior to revision) in real terms and 0.7% (0.7% prior to revision) in nominal terms, due to a large 2.0% carry-over from the previous fiscal year.

【 Chart 6: Trends in Real GDP Growth (Half Year) 】



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

3. FY2005 Outlook

The pace of economic growth will gradually speed up, driven by domestic private demand

In FY2005, consumer spending will gradually recover to a level more consistent with income growth given the sustained improvement of the income environment stemming from the ongoing rise of corporate performance. Helped by the growth of consumer spending, capital investment will also continue to grow, with the main driver shifting from the manufacturing to the nonmanufacturing sector. Although exports will lack the spectacular momentum to serve as the main driver of the economy, net exports will nevertheless keep growing and buttress the pace of economic growth given the ongoing growth of the US economy and the recovery of global demand for IT and digital appliances in the second half of the fiscal year.

FY2005 real GDP will reach 1.5%

Our forecast on real GDP growth in FY2005 is 0.7% over the previous term (1.4% p.a.) in the first half and 1.0% over the previous term (2.1% p.a.) in the second half. This brings full-year GDP growth in FY2005 to 1.5% (previous forecast: 1.5%) in real terms and 0.9% (previous forecast: 0.9%) in nominal terms.

Although a cursory glance gives the impression that the pace of growth will slow down from the previous year, it should be noted that the carry-over of growth from FY2004 to FY2005 is a mere 0.4%. Thus, the rate of GDP growth in FY2005 actually surpasses the negative rate of growth in FY2004.

4. FY2006 Outlook

The ongoing strength of domestic demand will lead to the elimination of deflationary pressures

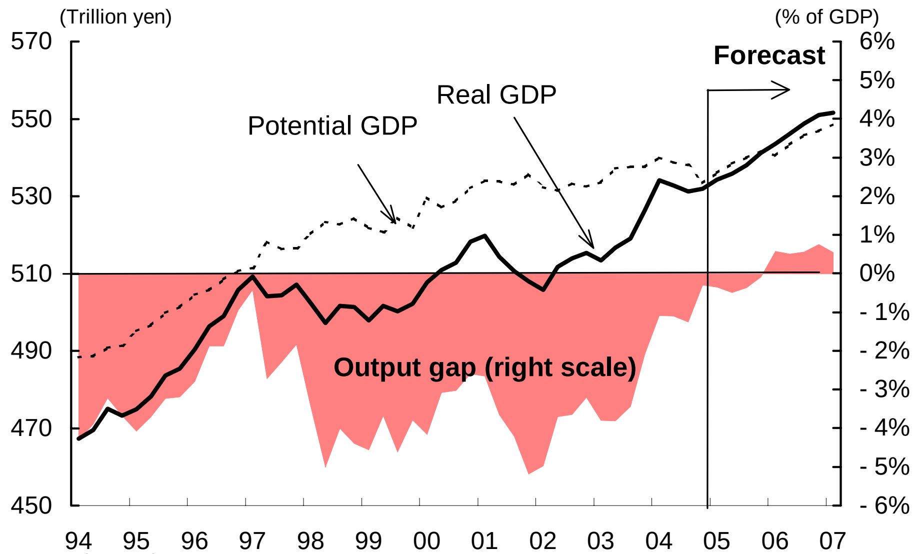
A virtuous cycle will continue in the first half of FY2006, where the expansion of the economy will lead to the growth of corporate earnings and fuel the rise of consumer spending via the increase of capital investment and household income. The continuation of the virtuous cycle will in turn generate the strong growth of domestic private-sector demand. Since the efforts to reduce public investment to restore fiscal conditions should reach the reduction target by then, the breadth of the fall of public investment should be minimal. However, given forecasts that the US economy will start to show signs of an adjustment in the second half of FY2006, the yen will tend to strengthen against the dollar reflecting the gap in economic fundamentals between Japan and the US. Thus, both overseas demand and the exchange rate will serve as a drag upon Japan’s export growth. Furthermore, as exemplified by the debate on the consumption tax hike subsequent to the abolition of the fixed-rate tax cut, concerns regarding the future rise of household burdens against a backdrop of the ballooning fiscal deficit will serve as restraints upon consumer spending.

In FY2006, the Japanese economy will gradually slow down from 0.9% over the previous term (1.9% p.a.) in the first half to 0.7% over the previous term (1.4% p.a.) in the second half. However, given the 0.7% carry-over from the previous fiscal year, full-year growth will most likely be higher than the previous year and reach 1.8%.

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

Looking forward on price trends on the basis the foregoing economic outlook, the output gap (demand – production capacity), which has already contracted considerably, should turn positive in early 2006 (**Chart 7**). As a result, the percentage rise of consumer prices will most likely turn positive in the first half of FY2006. 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 mid-2006.

【 Chart 7: 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 8: Outlook on the Japanese Economy】

(%)

	FY2003 (Actual)	FY2004 (Forecast)	FY2005 (Forecast)	FY2006 (Forecast)	FY2004 (Contribution) (Forecast)	FY2005 (Contribution) (Forecast)	FY2006 (Contribution) (Forecast)
GDP (real)	2.0	1.6	1.5	1.8	-	-	-
Domestic demand	1.2	1.1	1.3	1.7	1.1	1.3	1.6
Private sector demand	2.0	1.9	1.6	1.8	1.5	1.2	1.4
Personal consumption	0.5	1.1	1.0	1.0	0.6	0.6	0.6
Housing investment	-0.3	2.3	0.7	1.1	0.1	0.0	0.0
Capital investment	8.2	5.1	3.5	4.4	0.8	0.5	0.7
Public sector demand	-1.4	-1.4	0.3	1.2	-0.3	0.1	0.3
Government consumption	1.2	2.6	2.1	2.3	0.5	0.4	0.4
Public investment	-9.0	-14.9	-6.5	-3.4	-0.8	-0.3	-0.1
Net exports (contribution)	0.8	0.5	0.0	0.2	0.5	0.0	0.2
Exports	10.0	12.2	6.5	5.8	1.5	0.9	0.8
Imports	3.1	9.8	7.4	5.5	-1.0	-0.9	-0.7
GDP (nominal)	0.8	0.7	0.9	1.5			
Industrial production	3.5	4.7	1.9	2.8			
Unemployment rate	5.1	4.7	4.2	3.6			
Current account balance	17.3	18.8	20.2	21.1			
as a percentage of nominal GDP	3.5	3.7	4.0	4.1			
Corporate goods prices	-0.5	1.6	0.7	-0.6			
Consumer prices	-0.1	-0.2	-0.2	0.2			
Long-term interest rate (%)	1.12	1.52	1.75	2.10			
Nikkei stock average (yen)	9,938	11,313	12,400	13,000			
Exchange rate (yen/dollar)	113.0	107	107	101			
Crude oil price (WTI$/barrel)	31.4	45.0	41.6	39.4			

(%)

	FY2004		FY2005		FY2006	
	1H (Actual)	2H (Forecast)	1H (Forecast)	2H (Forecast)	1H (Forecast)	2H (Forecast)
GDP (real)	0.3	0.2	0.7	1.0	0.9	0.7
Domestic demand	0.1	0.4	0.7	0.8	0.9	0.8
Private sector demand	0.7	0.3	0.9	1.1	0.9	0.7
Personal consumption	0.3	-0.1	0.8	0.6	0.5	0.5
Housing investment	1.8	0.8	-0.5	1.6	-0.6	1.8
Capital investment	2.4	1.0	1.8	2.5	2.4	1.5
Public sector demand	-2.0	0.7	0.0	-0.0	0.7	0.9
Government consumption	1.6	1.0	0.9	1.3	1.1	1.1
Public investment	-14.3	-0.4	-3.3	-5.5	-1.1	-0.1
Net exports (contribution)	0.3	-0.2	0.0	0.2	0.1	-0.1
Exports	6.2	2.1	3.5	3.7	2.9	2.0
Imports	4.8	4.5	3.8	2.5	2.7	3.0
GDP (nominal)	-0.1	0.4	0.2	1.0	0.6	0.6

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. Consumer prices = nationwide (excluding fresh foods).
3. 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*,
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*.

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