(Summary Translation)

Economic Outlook for FY2004 and FY2005

May 2004

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

<The Overseas Economies>

The US Economy — The US economy will look for stable growth toward 2005 (4.4% in 2004, 3.6% in 2005).

The Euro Zone Economy — Economic recovery in the euro zone will lag other areas due to structural adjustment pressures (1.7% in 2004, 1.8% in 2005).

The Asian Economies — Asian economic growth will gradually slow down in 2005 given the ebb of export growth (7.1% in 2004, 6.2% in 2005).

<The Japanese Economy>

FY2004 — Although Japan will remain on recovery track, its growth momentum will gradually wane (real GDP growth: 3.4%, nominal GDP growth: 1.7%).

FY2005 — Japan will search for the chance to enter a stable growth trajectory after emerging from a cyclical slowdown (real GDP growth: 1.7%, nominal GDP growth: 0.6%).

This English-language translation is based upon MHRI's outlook in Japanese released on May 21, 2004.

Mizuho Research Institute

I. The Overseas Economies

○ **The US Economy** The US economy will look for stable growth toward 2005 (4.4 % in 2004, 3.6% in 2005).

○ **The Euro Zone Economy** Economic recovery in the euro zone will lag other areas due to structural adjustment pressures (1.7% in 2004, 1.8% in 2005).

○ **The Asian Economies** Asian economic growth will gradually slow down in 2005 given the ebb of export growth (7.1% in 2004, 6.2% in 2005).

1. The US Economy

The US economy will continue to post strong growth in 2004, driven by a twin engine comprised of a cyclical recovery of capital investment and solid consumer spending on the back of improving labor market conditions. Our forecast looks for US real GDP to grow 4.4% in 2004 (our previous forecast was 4.4%). Given the end of disinflation, we are also inclined to believe that the Fed will tighten, in a policy shift from an extremely accommodative stance as an emergency step to address deflation. Even so, we expect the interest rate hike to be implemented in small steps given the moderate rise of the inflation rate.

In 2005, the US economy should follow a self-sustained growth track albeit at a slower pace. In contrast to an ongoing virtuous cycle where the rise of labor productivity will lead to the improvement of household income, thus sustaining the rise of consumer spending, the fading impact of tax cuts and the rise of household debts will serve as restraints to growth. Furthermore, capital investment will start to peak out, serving to dampen growth. Inflation will likely remain subdued with the annual percentage rise of the consumer price index at 1.4%. Our forecast predicts that the rate of US real GDP growth will trend around 3.6% (our previous forecast was 3.3%), near the potential rate of growth.

Chart 1: Forecast of the US Economy

(%)

	2003	2004	2005	2004		2005	
	(Actual)	(Forecast)	(Forecast)	1st-half (Forecast)	2nd-half (Forecast)	1st-half (Forecast)	2nd-half (Forecast)
GDP (real)	3.1	4.4	3.6	4.1	3.5	3.6	3.6
Personal consumption	3.1	3.9	3.3	3.7	3.3	3.3	3.3
Housing investment	7.5	4.0	0.6	1.9	-0.8	1.1	0.9
Capital investment	3.0	9.1	9.1	8.3	9.2	9.7	7.9
Inventory investment ($100 million)	-8	208	300	177	240	260	340
Government expenditures	3.3	1.7	1.5	1.3	1.4	1.4	1.8
Net exports ($100 million)	-5,091	-5,166	-5,249	-5,139	-5,193	-5,231	-5,268
Exports	2.0	9.7	8.8	9.6	9.9	8.6	8.4
Imports	4.0	7.0	6.6	6.9	7.4	6.4	6.2
Domestic final consumption	3.4	4.0	3.4	3.6	3.4	3.5	3.4
Consumer price index (y-o-y % ch)	2.3	1.9	1.4	2.3	1.2	1.5	1.4
Current account balance ($100 million)	-5,519	-5,590	-5,642	-2,810	-2,780	-2,810	-2,832
<as a percentage of nominal GDP>	-5.0	-4.8	-4.6	-4.9	-4.7	-4.7	-4.6

Notes: 1. CY= rate of change from the previous year. Half-year term = rate of change per annum from the previous term.
2. The shaded columns are forecasts.

Sources: US Department of Commerce, US Department of Labor.

2. The Euro Zone Economy

Lagging in economic recovery in comparison to Japan and the US, the euro zone economy will likely remain tepid in 2004 because of structural adjustment pressures such as its labor overhang. Although the strength of the euro will remain a drag upon exports up to the beginning of 2004, we still expect a moderate rise of exports reflecting the global economic expansion. Nevertheless, export growth should gradually lose momentum due to a slower pace of US and Asian economic growth in 2005. Furthermore, the recovery of both capital investment and personal spending will be weak, given the delay in adjusting the debt and labor overhang. Countries with fiscal deficits such as Germany and France will also be bound by the Stability and Growth Pact to curb the rise of government expenditures. Our forecast on the rate of real GDP growth in the euro zone is 1.7% (our previous forecast was 1.6%) in 2004 and 1.8% (our previous forecast was 1.6%) in 2005.

Chart 2: Forecast of the Euro Zone Economy

(%)

		2003 (Actual)	2004 (Forecast)	2005 (Forecast)	2004		2005	
					1st-half (Forecast)	2nd-half (Forecast)	1st-half (Forecast)	2nd-half (Forecast)
Real GDP	Euro zone	0.4	1.7	1.8	1.0	1.0	0.9	0.8
	Germany	-0.1	1.4	1.4	0.8	0.9	0.7	0.5
	France	0.2	1.9	2.0	1.2	1.0	1.0	1.0
	Italy	0.4	1.6	1.7	0.8	1.2	0.8	0.5
	UK	2.2	2.9	2.5	1.4	1.3	1.3	1.3
Euro zone consumer prices		2.1	1.9	1.7	1.9	1.8	1.7	1.7

Notes: 1. Rate of GDP growth. CY= rate of change over the previous year. Half-year term = rate of change over the previous term.
2. Consumer prices = rate of change over the previous year.
3. The shaded columns are forecasts.

Sources: Eurostat, ECB, ONS.

3. The Asian Economies

In 2004, we expect the Asian economies to pick up with the main engine gradually shifting to domestic demand. In addition to the steady growth of exports and capital investment due to the global rise of information technology (IT)-related demand, we look forward to a rebound of consumer spending from the SARS-induced lull in the previous year. However, the growth of exports should gradually level out on the basis of predictions that the rise of IT-related demand will run its course by the end of 2004. We expect real GDP growth in the Asian economies to reach 7.1% (our previous forecast was 6.5%). In China, exhibiting signs of overheating in certain sectors, monetary tightening measures such as the step-by-step hike of the deposit reserve requirement ratio since the second half of 2003 and measures to restrain investment will gradually start to have effect. While the rate of economic growth will surpass 9% y-o-y in the first half of the year, growth will likely fall to 8% y-o-y in the second half of the year.

We expect China's economic growth to slow to 7.9% in 2005 given the impact of the policy measures to quell investment. In addition to the deceleration of the Chinese economy, the decline of US economic growth should lead to a slower pace of NIEs and Asean exports. Since capital investment will also lose momentum along with the slowdown of exports, we expect real GDP growth in the Asian economies to fall to 6.2% (our previous forecast was 6.0%) in 2005.

Chart 3: Forecast of the Asian Economies

(%)

	2002 (Actual)	2003 (Actual)	2004 (Forecast)	2005 (Forecast)
Asia (average)	6.2	6.0	7.1	6.2
NIEs (average)	4.9	3.0	5.5	4.8
S.Korea	7.0	3.1	5.4	5.3
Taiwan	3.6	3.2	5.4	4.3
Hongkong	2.3	3.3	5.7	4.3
Singapore	2.2	1.1	6.3	4.3
ASEAN4 (average)	4.4	5.1	5.4	4.9
Thailand	5.4	6.7	7.0	6.1
Malaysia	4.1	5.2	5.8	4.8
Indonesia	3.7	4.1	4.3	4.2
Philippines	4.4	4.5	4.3	4.4
China	8.0	9.1	9.0	7.9

Notes: 1. Real GDP growth (rate of change over the previous year).
2. The shaded columns are forecasts.
3. Weighted average on the basis of each country's nominal GDP in 2000.

Source: Government data disclosed by each of the relevant countries.

II. The Japanese Economy

○ **FY2004** Although Japan will remain on recovery track, its growth momentum will gradually wane (real GDP growth: 3.4%, nominal GDP growth: 1.7%).

○ **FY2005** Japan will search for a chance to enter a stable growth trajectory after emerging out of a cyclical slowdown (real GDP growth: 1.7%, nominal GDP growth: 0.6%).

1. Forecast of the Japanese Economy in FY2004

The Japanese economy is continuing exhibit strong growth, fueled by the upturn of consumer spending amid the rise of exports and capital investment. Japan's rate of real GDP growth reached 1.4% q-o-q (an annualized rate of 5.6%) in the Jan-Mar quarter of 2004, remaining on a solid growth trajectory from the Oct-Dec quarter of 2003 (1.7% q-o-q). This brings Japan's growth in FY2003 to a strong 3.2%, lifting nominal growth into positive territory (0.7%) for the first time in three years. Furthermore, given the spurt in the second half of FY2003, Japan now has a "carry-over" equivalent to 2.0% to the following fiscal year starting in April 2004.

In FY2004, exports should continue to rise amid the ongoing growth of the global economies and capital investment is also expected to increase reflecting the expansion of demand. Moreover, we also expect the strong growth of consumer spending amid the rise in consumption of durable consumer goods ahead of the Olympic games in Athens. This reflects the rise of household income such as higher bonus payments due to the improvement of corporate earnings and the increase of retirement income as the baby-boomer generation reaches retirement age.

However, judging from forecasts that US and Chinese economic growth will wane in the second half of the year, a slower pace of export growth which has thus far served as the driver of economic growth is inevitable. Furthermore, given the limited improvement of labor compensation – the source of consumer spending – the growth of personal consumption will slow in the second half of the fiscal year, leading to a peak-out of the growth momentum. Due in part to a large carry-over from FY2003, we forecast that Japan's GDP in FY2004 will reach 3.4% in real terms (our previous forecast was 2.6%) and 1.7% in nominal terms (previous forecast 0.7%), surpassing growth in the previous fiscal year.

2. Forecast of the Japanese Economy in FY2005

A slower rate of GDP growth looks inevitable in FY2005 because of the slowdown of export growth reflecting the global economic deceleration and the ebb of corporate capital investment to upgrade capacity among IT and digital electronic appliance makers. The short-term recovery cycle starting in early 2002 will run its course. Furthermore, negative pressures upon the household sector such as higher social security burdens will serve as restraints upon Japan's growth. However, labor market conditions will gradually strengthen amid the improvement of corporate earnings, leading to a greater degree of stability in consumer spending. Thus, we are inclined to believe that Japan will be able to maintain economic growth around its potential rate of growth. We forecast Japan' GDP to expand 1.7% in real terms (our previous forecast was 1.4%) and 0.6% in nominal terms (previous forecast 0.0%) in FY2005.

Looking forward to FY2006, we expect capital investment to regain momentum, judging from the mild improvement of corporate expectations on economic growth amid Japan's recovery and a greater likelihood that non-manufacturers, which have lagged so far, will gradually feel more inclined to invest in fixed assets along with the sustained recovery of consumer spending. Barring major external shocks such as (1) a graver-than-expected slowdown of the overseas economies, (2) a surge of crude oil prices reflecting geopolitical risks and (3) financial market turmoil such as the sharp rise of long-term interest rates and stock market plunge, the steady recovery of consumer spending should lead to the expansion of capital investment among non-manufacturers, thus paving the way for a stable self-sustained growth path toward the end of deflation.

3. Highlights

As mentioned in the foregoing sections, the Japanese economy has finally reached a stage where the end of deflation is perceivable. The current focus of attention is not "how likely" but rather "when" Japan will emerge out of deflation. The Japanese bond market assumes that deflationary conditions will end and that the BOJ will dismantle its quantitative easing policy during FY2005. However, the proverbial "last mile" may be longer than expected.

The direction of price trends depends fundamentally upon the size of the output gap. Despite our estimate that the output gap has shrunk to less than –2% of GDP, the contraction will most likely come to a pause since Japan's recovery cycle will run its course sometime during or after the second half of FY2004. Furthermore, despite oft-voiced concerns regarding the surge in price of commodities such as crude oil, the rise of prices is contained in limited upstream sectors such as raw materials. Price rises are more subdued in downstream sectors closer to consumers and subject to fiercer competition. Prices of services – comprising more than 50% of the consumer price index (CPI) – move in lock step with the unit labor cost (ULC). Judging from the fall of the ULC accompanying corporate efforts to cut labor costs and the rise of labor productivity, prices of services will not rise so easily. The year-on-year percentage rise of the CPI will turn positive only around the end of 2005 at the earliest (MHRI forecasts that the year-on-year rise of the CPI will stand at –0.1% in FY2005).

Judging from the foregoing, the odds are high that the conditions for termination of the BOJ's quantitative easing policy – namely that "the CPI registers stably a 0% or an increase year on year" – will not be fulfilled during FY2005. In addition, there will be a number of major financial system reforms in FY2005 such as the abolition of the insurance coverage of bank deposits and the mandatory application of impairment accounting as Japan's cyclical recovery winds down. Nevertheless, since Japan's financial system is substantially stronger and real estate prices are showing signs of bottoming out, a major disruption should be averted. Even so, we are inclined toward the view that the BOJ will refrain from changing its monetary policy stance during FY2005, taking heed of the premature termination of the zero interest rate policy in 2000 and also as a means to discern the impact of the financial system reforms.

In FY2006, we expect the CPI to grow stably above 0% and pave the way to an end of general deflation. Land prices will also start to rise, albeit limited to urban areas, and lead to prospects of an end to asset deflation. Thus, in addition to the termination of both general and asset deflation, Japan's economy will most likely return to a stable self-sustained growth trajectory, providing us with reasons to believe that monetary policy will be phased back to normal mode.

Chart 4: Forecast of the Japanese Economy

(%)

	FY2003	FY2004	FY2005	FY2004		FY2005		FY2004	FY2005
				1st-half	2nd-half	1st-half	2nd-half	(Contribution)	(Contribution)
	(Actual)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)
GDP (real)	3.2	3.4	1.7	1.5	1.0	0.8	0.8	-	-
Domestic demand	2.4	2.8	1.4	1.3	0.9	0.6	0.7	2.7	1.3
Private sector demand	3.9	3.7	1.6	1.7	1.0	0.7	0.7	2.8	1.2
Personal consumption	1.6	2.1	1.1	0.8	0.6	0.5	0.5	1.1	0.6
Housing investment	0.3	1.7	-0.3	1.2	0.0	-0.6	0.6	0.1	-0.0
Capital investment	12.4	9.4	3.5	4.2	2.3	1.6	1.5	1.6	0.6
Public sector demand	-2.7	-0.6	0.7	-0.3	0.2	0.3	0.5	-0.1	0.1
Government consumption	0.8	1.6	2.1	0.8	1.0	1.0	1.2	0.3	0.3
Public investment	-12.3	-7.7	-4.5	-4.0	-2.4	-2.4	-1.9	-0.4	-0.2
Net exports (contribution)	0.9	0.8	0.4	0.3	0.2	0.2	0.2	0.8	0.4
Exports	10.9	11.8	6.4	5.4	3.4	3.1	3.1	1.5	0.9
Imports	4.5	7.8	5.4	3.9	2.9	2.6	2.6	-0.7	-0.5
GDP (nominal)	0.7	1.7	0.6	1.0	0.4	0.2	0.5		
Industrial production	3.5	7.4	3.3	9.1	5.8	3.2	3.4		
Unemployment rate	5.4	4.7	4.1	4.7	4.6	4.2	4.1		
Current account balance (trillion yen)	17.3	20.0	21.8	19.2	21.2	21.0	23.1		
as a percentage of nominal GDP	3.4	3.9	4.3	3.8	4.1	4.1	4.4		
Corporate goods prices	-0.5	0.2	-0.4	0.5	0.0	-0.3	-0.4		
Consumer prices	-0.2	-0.2	-0.1	-0.2	-0.3	-0.3	0.0		
Long-term interest rate (%)	1.12	1.60	1.80	1.55	1.65	1.70	1.90		
Nikkei stock average (yen)	9,929	11,650	12,250	11,800	11,500	12,000	12,500		
Exchange rate (yen/dollar)	113.0	110	114	109	111	113	115		
Crude oil price (WTI)	31.4	34.8	30.8	35.5	34.0	31.0	30.5		

Notes: 1. FY= rate of change from the previous year. Half-year term = rate of change from the previous term (excluding the unemployment rate, current account balance and prices).
2. Half-year corporate goods prices and half-year consumer prices = rate of change over the same period a year ago. Consumer prices = nationwide (excluding perishable food).
3. Half-year unemployment rate and half-year current account balance are adjusted for seasonal factors.
4. Crude oil prices = nearest term contract for WTI 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 Public Management, Home Affairs, Posts and Telecommunications, *Labor Force Survey, Consumer Price Index,*
Ministry of Finance, *Balance of Payments* ,
Bank of Japan, *Corporate Goods Price Index.*