Economic Outlook for FY2003 and FY2004

(Revised to reflect 2nd QE)

December 2003

Summary

The Mizuho Research Institute (MHRI) has revised its economic outlook for FY2003 and FY2004 subsequent to the release of the *Second Preliminary Quarterly Estimates of GDP* ("*2nd QE*") for the Jul-Sep quarter of 2003 by the Cabinet Office. The key points of the outlook are as follows.

The revised growth rates are as follows

- Real GDP growth: FY2003 +2.2% (MHRI's forecast in November was +2.7%)
  FY2004 +2.3% (MHRI's November Forecast was +2.3%)
- Nominal GDP growth: FY2003 –0.2% (MHRI's November Forecast was –0.1%)
  FY2004 +0.2% (MHRI's November Forecast was +0.3%)

The revision of our forecast is due to the revision of the statistics on gross domestic product (GDP) and in no ways represents a change in MHRI's assessment on current economic conditions and future economic outlook. MHRI predicts that the Japanese economy will remain on a recovery track driven by exports and capital investment from the second half of FY2003 to FY2004. Although structural problems and lingering deflationary pressures will hamper a full-blown recovery, the Japanese economy may emerge out of a prolonged period of stagnation if efforts at reform in the private sector and appropriate policy management by the government succeed in setting forth sanguine prospects toward future growth.

Mizuho Research Institute

1. Revision of Japan's GDP statistics

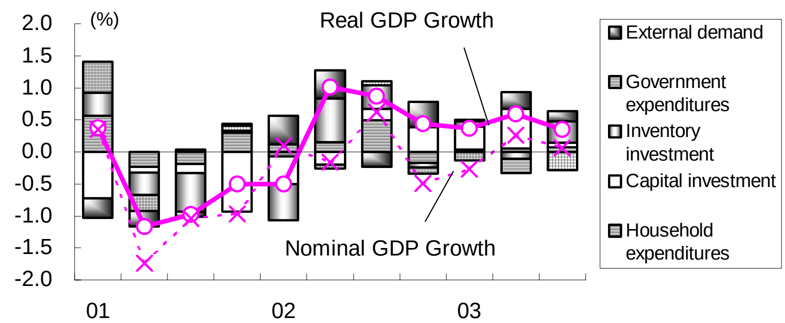
Japan's real GDP growth in 2003 was subject to a sharp downward revision. As of the Jul-Sep quarter, the carry-over of GDP growth from FY2002 to FY2003 has contracted from 2.4 % pt to 1.7 % pt.

On December 9, 2003, the Cabinet Office released its *Second Preliminary Quarterly Estimates of GDP* ("*2nd QE*") for the Jul-Sep quarter. As a result thereof, Japan's GDP statistics were subject to a major revision since the process involved (1) the revision of the original series (released on December 4th) accompanying (i) the revision of the "revised estimation" of GDP in FY2001 to "final estimation" and (ii) the revision of the preliminary quarterly estimation of GDP in FY2002 to revised estimation and (2) the change in the seasonal adjustment model along with (i) and (ii) above in addition to the routine operation of revising the *1st QE* to the *2nd QE*[1].

The rate of real GDP growth in 2003 was downwardly revised as follows, thus subduing the stronger-than-real impression of the GDP figures: Jan-Mar quarter of 2003 (+0.5% → 0.4%), Apr-Jun quarter of 2003 (+0.9% → +0.6%), Jul-Sep quarter of 2003 (+0.6% → +0.3%) (Chart 1). As a result, the "carry-over" of real GDP growth from FY2002 to FY2003 as of the Jul-Sep quarter of 2003 contracted sharply from +2.4% at the time of the *1st QE* to +1.7%[2].

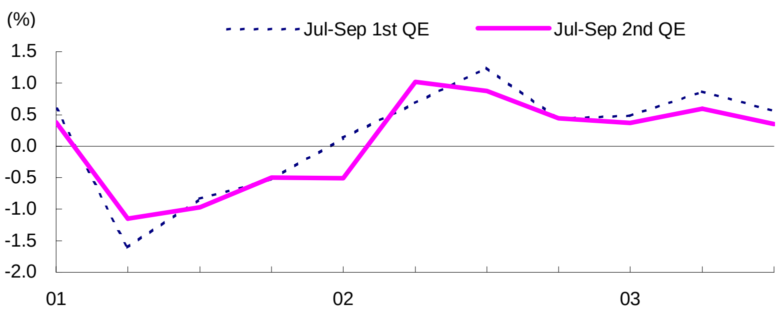
Chart 1: Real GDP Growth (Quarterly Change)

(1) Real GDP Growth and Degree of Contribution by Major Demand Components



Note: The bars represent the degree of contribution by each of the components to the rate of real GDP gowth.
Source: Cabinet Office, *Second Preliminary Quarterly Estimates of GDP* .

(2) Revision of Real GDP Growth



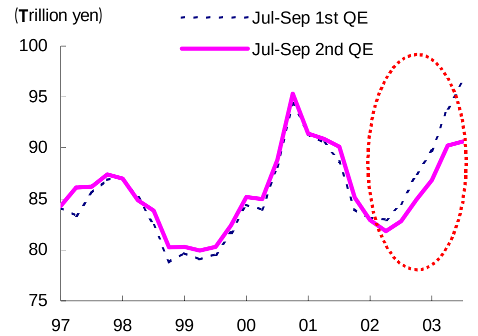
Source: Cabinet Office, *Second Preliminary Quarterly Estimates of GDP.*

A major upward revision of the capital investment deflator resulted in a steep downward revision of capital investment in real terms

The capital investment deflator was upwardly revised along with the release of the revised estimation, thereby resulting in a steep downward revision of real capital investment in particular with respect to the period since 2002 (Chart 2). In the FY2002 revised estimation of GDP, nominal capital investment was revised downward by a mere 1.3% (from –4.5% y-o-y to –5.8%) in contrast to a sharp downward revision by 3.2% (from –0.1% to –3.3%) in real terms. According to the Cabinet Office, the upward revision of the capital investment deflator stems from a more precise classification of commodities. Certain equipment categorized under "electronic calculation devices and their parts" – formerly classified under capital investment in the preliminary estimate – are now classified as intermediate input, thus lowering the ratio of these items in capital investment. This in turn lowered the proportion of these commodities – of which significant prices falls are observed – in the deflator, according to the Cabinet Office's explanation.

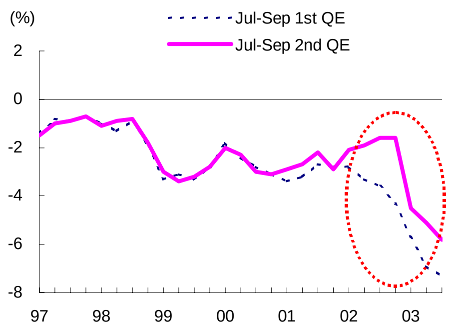
Chart 2: A Major Revision Regarding Capital Investment

(1) Revision of real capital investment



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

(2) Revision of capital investment deflator



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

2. Forecast of the Japanese economy in FY2003 and FY2004 (revised)

MHRI has downwardly revised its forecast on FY2003 real GDP growth to +2.2%. The forecast on FY2004 is unchanged at +2.3%.

MHRI has revised its forecast on Japan's economic growth in FY2003 and FY2004 to reflect a major revision of the GDP statistics by the Cabinet Office (Chart 3). Our forecast on real GDP growth in FY2003 has been downwardly revised to +2.2% from +2.7% - MHRI's forecast immediately after the 1^{st} *QE* in November. The forecast on FY2004 is unchanged from the previous forecast at +2.3%. Despite the weaknesses explained in more detail below, the Japanese economy will most likely remain on a recovery path driven by exports and capital investment from the second half of FY2003 to FY2004. MHRI's forecast on nominal GDP growth now stands at –0.2% in FY2003 (MHRI's forecast in November was –0.1%) and +0.2% in FY2004 (November forecast was +0.3%).

Chart 3: Forecast of the Japanese Economy

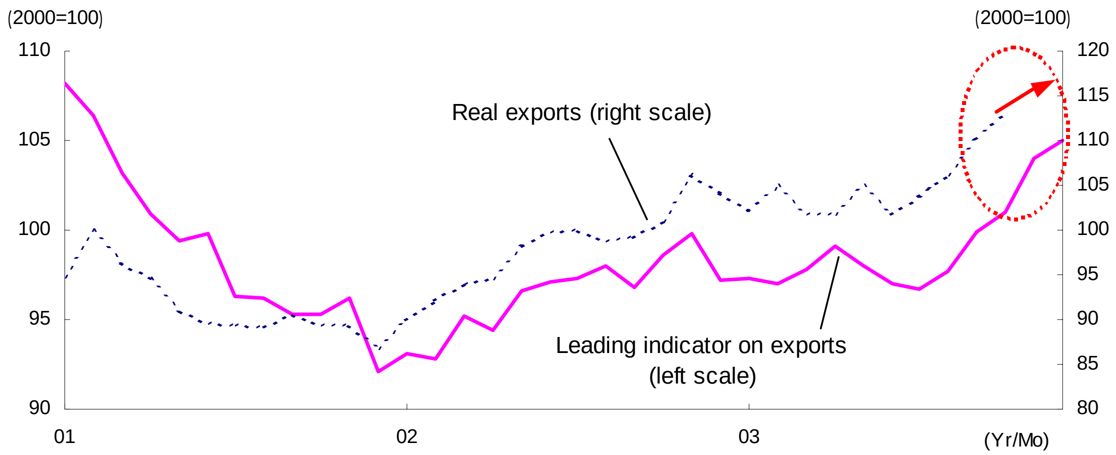
(%)

	FY2002	FY2003	FY2004	FY2003		FY2004		FY2003	FY2004
				1st-half	2nd-half	1st-half	2nd-half	(Contribution)	(Contribution)
	(Actual)	(Forecast)	(Forecast)	(Actual)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)
GDP (real)	1.2	2.2	2.3	1.0	1.4	1.0	1.2	-	-
Domestic demand	0.4	1.6	1.8	0.6	1.2	0.7	1.0	1.6	1.7
Private sector demand	0.5	2.6	2.5	1.4	1.1	1.2	1.5	1.9	1.9
Personal consumption	1.0	0.6	1.2	0.1	0.6	0.6	0.6	0.3	0.6
Housing investment	-2.1	0.5	-1.0	1.1	0.8	-2.0	1.5	0.0	-0.0
Capital investment	-3.3	9.3	7.4	5.3	3.3	3.5	4.0	1.5	1.2
Public sector demand	0.1	-1.4	-0.8	-2.0	1.5	-1.0	-0.9	-0.3	-0.2
Government consumption	2.1	0.9	1.3	0.2	1.0	0.6	0.5	0.1	0.2
Public investment	-5.0	-8.0	-7.3	-8.1	3.2	-5.8	-5.2	-0.5	-0.4
Net exports (contribution)	0.8	0.6	0.6	0.4	0.2	0.3	0.2	0.6	0.6
Exports	12.0	8.0	8.8	3.3	4.3	4.8	3.3	0.9	1.1
Imports	5.5	3.6	5.8	0.3	3.4	3.1	1.9	-0.3	-0.5
GDP (nominal)	-0.7	-0.2	0.2	0.2	-0.6	0.7	-0.4		
Industrial production	2.8	3.8	5.1	0.1	5.9	1.4	1.3		
Unemployment rate	5.4	5.3	5.0	5.3	5.3	5.2	4.9		
Current account balance (trillion yen)	13.4	15.8	18.0	8.4	7.4	9.2	8.8		
as a percentage of nominal GDP	2.7	3.2	3.6	3.4	3.0	3.7	3.5		
Corporate goods prices	-1.6	-0.8	-0.7	-0.9	-0.6	-0.6	-0.8		
Consumer prices	-0.8	-0.2	-0.3	-0.3	0.0	-0.4	-0.3		
Long-term interest rate (%)	1.11	1.17	1.70	0.90	1.45	1.60	1.80		
Nikkei stock average (yen)	9,582	10,000	11,500	9,178	10,800	11,500	11,500		
Exchange rate (yen/dollar)	121.9	113.5	107.0	118.0	109.1	107.0	107.0		
Crude oil price (dollar/barrel)	29.1	29.5	28.5	29.6	29.5	29.0	28.0		

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 perishables).
3. Half-year unemployment rate and half-year current account balance are adjusted for seasonal factors.
4. Crude oil price = nearest 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 Public Management, Home Affairs, Posts and Telecommunications, *Labor Force Survey, Consumer Price Index,*
Bank of Japan, *Balance of Payments Statistics, Corporate Goods Price Index.*

Chart 4: Leading Indicator on Exports and Real Exports



Note: The leading indicator on exports = composite index composed of the following indicators (base year 2000): OECD composite leading indicator (six-month rate of change), Nikkei global commodity market (three-month rate of change), global semiconductor sales ("), US ISM manufacturing index ("), US manufacturing sector inventories ("), US new orders for transportation equipment (") , US new orders for computers and electrical appliances ("), US automotive inventories of Japanese automakers - inverse number ("), effective exchange rate - inverse number (12-month rate of change).
Sources: Bank of Japan, OECD, US Department of Commerce, World Semiconductor Trade Statistics, Automotive News.

Japan will remain on a gradual recovery driven by exports and capital investment

The downward revision with respect to FY2003 reflects the revision of GDP statistics up to the first half of FY2003 and does not represent a change in MHRI's assessment on current economic conditions and future economic outlook. Leading indicators on exports provide us with reasons to believe that exports will remain on an uptrend (Chart 4). Turning to capital investment, leading indicators such as machine tool orders (domestic demand) and machinery orders presage the strong growth of capital investment in the second half of FY2003. We are inclined to believe that the economy will continue to recover, powered by exports and capital investment.

FY2004 will serve as a decisive test on whether the current upturn of the economy will develop into a full-blown economic recovery

The current recovery of the Japanese economy is subject to various weaknesses. First of all, the current recovery is still dependent on external demand. Therefore, there is a potential risk that a loss of momentum of the overseas economies or a sharp appreciation of the yen would trigger a slowdown of exports and lead directly to the deceleration of the entire Japanese economy. The second risk factor is that the current recovery of the Japanese economy is limited to large manufacturers and that the waves of demand have not yet rippled through to non-manufacturers and small and medium enterprises. Thirdly, the deflation of asset prices (a plunge in land and stock prices) and the deflation of general prices (a fall in product prices) are still negatively affecting the Japanese economy. Finally, Japan's declining birthrate and aging population may be a drag upon the recovery of demand in the household sector. Depending upon the course of debate on pension and tax system reform, there is a risk that the rise of concerns regarding the future will dampen household spending incentives. In the light of these downside risks, it is difficult to conclude that the current upturn of the economy will lead directly to a full-blown recovery.

Even so, it is also true that the maintenance of the current upturn will alleviate the negative pressures stemming from these structural problems and provide economic entities with more confidence toward future growth expectations. Although there is no room for unabashed optimism, the current upturn may lead Japan out of its prolonged slump if efforts at reform in the private sector and appropriate policy management (including a vision on the future) by the government succeed in setting forth sanguine prospects toward future growth. FY2004 will serve as a decisive test on the medium-term recovery of the Japanese economy.

[1] The national accounts published in December each year includes data from the previous (calendar and fiscal) year as "revised estimation", and data from the year before that (calendar and fiscal) as "final estimation".

[2] The "carry-over" refers to the rate of growth which would be attained in FY2003 if GDP shows zero growth in the following two quarters in the Oct-Dec quarter of 2003 and the Jan-Mar quarter of 2004.