(Translation)

Economic Outlook for FY2004 and FY2005

(Revised to reflect 2nd QE for the Oct-Dec quarter of 2003)

March 2004

Mizuho Research Institute Ltd. (MHRI) has revised its economic outlook for FY2004 and FY2005 subsequent to the release of the *Second Preliminary Quarterly Estimates of GDP* (*"2nd QE"*) for the Oct-Dec quarter of 2003 by the Cabinet Office. We have revised our forecast as of February 20, 2004 on the rate of real GDP growth of the Asian economies in 2004 and the rate of Japan's GDP growth in FY2004 in both nominal and real terms. The revisions reflect the amendment of the statistics on GDP up to the Oct-Dec quarter of 2003 and in no ways represent a change in MHRI's assessment on current economic conditions and future economic outlook.

<The Overseas Economies>

The US Economy Although the economy will follow a steady recovery in 2004, growth will most likely slow in 2005 (4.4 percent in 2004, 3.3 percent in 2005).

The Euro Zone Economy The recovery of the euro zone economy will be sluggish due to the strength of the euro and structural adjustment pressures (1.6 percent in 2004, 1.6 percent in 2005).

The Asian Economies Despite the recovery of domestic demand along with the rebound of exports, a slowdown of exports will serve as a drag upon the rate of economic growth in 2005 (6.5 percent in 2004, 6.0 percent in 2005).

<The Japanese Economy>

FY2004 The Japanese economy will remain on a moderate recovery, maintaining growth at the 2 percent level (real GDP growth: 2.6 percent, nominal GDP growth: 0.7 percent).

FY2005 Although the economy will undergo a slight adjustment, it will seek the chance to return to a stable growth trajectory (real GDP growth: 1.4 percent, nominal GDP growth: 0.0 percent).

This English-language translation is based upon MHRI's outlook in Japanese released on March 12, 2004.

Mizuho Research Institute

I. The Overseas Economies

- **The US Economy** Although the economy will follow a steady recovery in 2004, growth will most likely slow in 2005 (4.4 percent in 2004, 3.3 percent in 2005).
- **The Euro Zone Economy** The recovery of the euro zone economy will be sluggish due to the strength of the euro and structural adjustment pressures (1.6 percent in 2004, 1.6 percent in 2005).
- **The Asian Economies** Despite the recovery of domestic demand along with the rebound of exports, the slowdown of exports will serve as a drag upon the rate of economic growth in 2005 (6.5 percent in 2004, 6.0 percent in 2005)

1. The US Economy

The US economy is poised for further grow in 2004, driven by a twin engine comprised of a pickup in capital investment and consumer spending on the back of improving labor market conditions. The upturn of net exports along with the global economic recovery and the weak dollar should also serve as a tailwind. MHRI forecasts that the growth of US real GDP will gather further momentum and reach 4.4 percent (our previous forecast was 4.4 percent) in 2004 and 3.1 percent in 2003. Even so, we are also inclined to believe that disinflationary pressures will linger due to an unresolved output gap. The Federal Reserve will most likely maintain an accommodative policy stance.

Looking forward, the US economy will start to lose steam in 2005. In addition to a cyclical slowdown of capital investment, consumer spending will most likely wane due to negative pressures stemming from such factors as the sluggish improvement of employment, fading effect of the tax cuts and growing household debts. Judging from the foregoing, we believe that US monetary policy will remain accommodative. Our forecast predicts that the rate of US real GDP growth will trend around 3.3 percent in 2005 (previous forecast 3.3 percent), near the potential rate of growth.

Chart 1: Forecast of the US Economy

(%)

	2003 (Actual)	2004 (Forecast)	2005 (Forecast)	2003 1st-half (Actual)	2003 2nd-half (Actual)	2004 1st-half (Forecast)	2004 2nd-half (Forecast)
GDP	3.1	4.4	3.3	2.1	5.9	4.2	3.3
Personal consumption	3.1	3.8	2.9	2.7	4.9	3.8	2.8
Housing investment	7.5	4.7	0.6	5.1	14.0	3.0	-0.8
Capital investment	2.9	8.7	9.2	1.4	10.5	7.9	9.3
Inventory investment ($100 million)	7	223	255	-15	29	160	285
Government expenditures	3.4	1.6	1.5	3.4	2.9	1.1	1.4
Net exports ($100 million)	-5,089	-5,032	-5,054	-5,080	-5,098	-5,008	-5,057
Exports	2.1	10.4	8.8	-2.2	9.7	11.3	9.9
Imports	4.0	6.8	6.6	0.7	6.6	7.3	7.4
Domestic final consumption	3.1	3.9	3.2	2.6	5.8	3.7	3.0
Consumer price index (y-o-y % ch)	2.3	1.6	1.3	2.5	2.0	1.6	1.5
Current account balance ($100 million)	-5,473	-5,391	-5,494	-2,781	-2,692	-2,681	-2,710
<as a percentage of nominal GDP>	-5.0	-4.6	-4.5	-5.2	-4.8	-4.7	-4.6

Note: YR = rate of change from the previous year. Half-year term = rate of change per annum from the previous term. 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 given the appreciation of the euro and adjustment pressures stemming from structural problems. Although the global economic upturn will serve as a tailwind for exports, the pace of export growth will gradually start to falter due to the appreciation of the euro. Moreover, the recovery of capital investment and personal consumption will also lack momentum given the slow improvement of the debt overhang and excess labor in the euro area. 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 1.6 percent in 2004 (previous forecast 1.6 percent) and 1.6 percent (previous forecast 1.6%) in 2005.

Chart 2: Forecast of the Euro Zone Economy

(%)

		2003	2004	2005	2003		2004	
		(Actual)	(Forecast)	(Forecast)	1st-half (Actual)	2nd-half (Actual)	1st-half (Forecast)	2nd-half (Forecast)
Real GDP	Euro zone	0.4	1.6	1.6	-0.1	0.5	0.9	0.9
	Private consumption	1.0	1.3	1.5	0.6	0.2	0.8	0.8
	Government consumption	1.9	1.5	1.4	0.8	1.2	0.6	0.5
	Investment	-1.2	0.8	1.5	-1.0	0.0	0.5	0.7
	External demand (1 billion euro)	158.3	171.8	167.4	76.4	82.0	83.7	88.1
	Exports	0.0	2.8	1.6	-2.2	2.0	1.2	1.1
	Imports	1.5	2.4	2.0	-0.7	1.6	1.2	0.8
	Inventories (1 billion euro)	11.6	23.7	34.8	6.6	5.0	11.7	12.0
	Germany	-0.1	1.4	1.2	-0.3	0.2	0.9	0.8
	France	0.2	1.6	1.5	-0.3	0.5	1.0	0.8
	Italy	0.4	1.6	1.5	-0.1	0.4	0.9	0.9
	UK	2.3	2.9	2.5	0.9	1.6	1.5	1.2
Euro zone consumer prices		2.1	1.8	1.7	2.1	2.0	1.8	1.7

Notes: Rate of real GDP growth. The shaded columns are forecasts.
Sources: Eurostat, ECB, ONS.

3. The Asian Economies

The Asian economies should enjoy a moderate growth of consumer spending and private demand in 2004 along with the rise of exports. Due partially to a rebound from the SARS-induced lull in the previous year, we expect real GDP growth to grow slightly above 2003 and reach 6.5 percent (previous forecast 6.4 percent) in 2004. In South Korea, the growth of exports and a policy mix of fiscal and monetary measures should succeed in lifting the economy out of the doldrums into a cyclical recovery. Meanwhile in China – showing signs of an overheating economy – we predict (1) a slowdown of fixed asset investment stemming from measures to tighten monetary policy and restrain investments, (2) a lower tax refund rate, and (3) a deceleration of exports reflecting the fact that the shift of production sites overseas has run its course. Judging from the foregoing, we expect the rate of China's real GDP growth to slow to 8.4 percent in 2004.

In 2005, we expect the export momentum to wane reflecting the slowdown of the US and Chinese economies, thus dragging down the overall growth rate of the Asian economies. Even so, the odds are high that the countries of the region will take economic stimulus measures such as cutting taxes and expanding public investment to address the deceleration of exports. We expect real GDP growth in the Asian economies to reach 6.0 percent in 2005 (previous forecast 6.0%).

Chart 3: Forecast of the Asian Economies

(%)

	2002	2003 (Estimate)	2004 (Forecast)	2005 (Forecast)
Asia (average)	6.0	6.0	6.5	6.0
NIES (average)	4.5	2.9	4.7	4.3
S. Korea	6.3	2.9	4.8	5.0
Taiwan	3.6	3.2	4.5	3.9
Hongkong	2.3	3.3	4.9	3.4
Singapore	2.2	1.1	4.6	3.6
ASEAN4 (average)	4.4	5.1	5.3	5.0
Thailand	5.4	6.7	7.0	6.1
Malaysia	4.1	5.2	5.4	5.1
Indonesia	3.7	4.1	4.3	4.2
Philippines	4.4	4.5	4.3	4.4
China	8.0	9.1	8.4	7.7

Notes: 1. Real GDP growth (change over the previous year).
2. Weighted average on the basis of each country's nominal GDP in 2000.
Sources: Government data provided by each of the relevant countries.

II. The Japanese Economy

○ **FY2004** The Japanese economy will remain on a moderate recovery, maintaining growth at the 2 percent level (<u>real GDP growth: 2.6 percent, nominal GDP growth: 0.7 percent</u>)

○ **FY2005** Although the economy will undergo a slight adjustment, it will seek the chance to return to a stable growth trajectory (real GDP growth: 1.4 percent, nominal GDP growth: 0.0 percent).

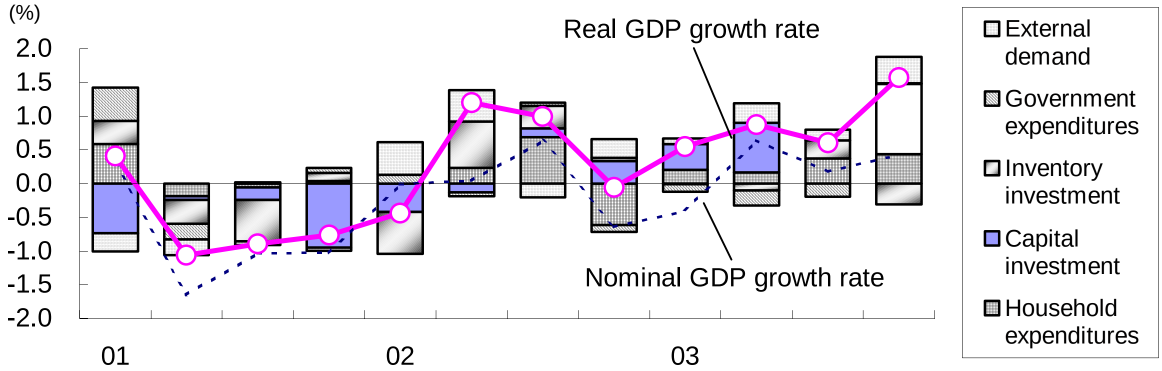
1. Key points and assessment of the *2nd QE*

The Cabinet Office released its *Second Preliminary Quarterly Estimates of GDP ("2nd QE")* for the Oct-Dec quarter of 2003, revising downward Japan's rate of real GDP growth during the quarter by 0.1 percent (-0.6 percent on an annualized basis) to 1.6 percent q-o-q (6.4 percent p.a.) from 1.7 percent q-o-q (7.0 percent p.a.) in the *First Preliminary Quarterly Estimates of GDP ("1st QE").* By the same token, nominal GDP growth for the same quarter was also revised downward to 0.4 percent q-o-q (1.7 percent p.a.) from 0.7 percent q-o-q (2.6 percent p.a.) in the *1st QE*.

A closer look at the components of demand reveals an upward revision of capital investment to 6.3 percent q-o-q (*1st QE* 5.1 percent), reflecting the release of upbeat statistics such as the *Financial Statements Statistics of Corporations by Industry.* While exports were also revised upward to 4.6 percent q-o-q (*1st QE* 4.2%), pushing up the rate of real GDP growth, inventory investment turned out sharply lower at –137.0 billion yen (*1st QE* 1.989 trillion yen), serving to depress Japan's real GDP growth. Public investment was also revised to –0.7 percent q-o-q from 0.2 percent q-o-q in the *1st QE*.

Despite widespread expectations that Japan's GDP figures would be upwardly revised, the outcome was a downward revision. Nevertheless the results are not inconsistent with our views given the relatively small breadth of the amendments and the fact that the revisions of each of the demand components are roughly in line with forecasts. Furthermore, keeping in mind that both capital investment and exports – the main drivers of the economy – were both revised upwards and that the sharp decline of inventory investment at this juncture does not represent a reduction of inventories in the negative sense that companies are reducing output, the recent downward revision of GDP statistics should not necessarily be interpreted as negative signs of the economy. Taking account of these statistical revisions, our forecast on Japan's real GDP growth for FY2003 now stands at 2.9 percent (0.3 percent in nominal terms).

Chart 4: Oct-Dec Quarter 2003 2nd *QE*



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

2. Forecast of the Japanese Economy in FY2004

We do not expect the economy to slow down in FY2004 given the unlikely prospects of an escalation of negative pressures stemming from structural problems such as the debt overhang and excess capital stock. Exogenous factors also provide reasons to be upbeat. Despite negative factors upon economic recovery such as the appreciation of the yen, tax hikes and larger social security burdens upon households, there are positive factors that would spur demand such as the US-driven global economic expansion and the ongoing boom in information technology (IT)-related products and digital consumer appliances. In view of the foregoing, the economy will most likely remain on a moderate recovery and avoid peaking out during FY2004. We forecast that Japan's GDP in FY2004 will reach 2.6 percent in real terms (revised from our previous forecast of 2.5 percent) and 0.7 percent in nominal terms (previous forecast 0.6%).

A closer look at the components of GDP reveals that the recovery of Japan's economy is still driven by exports (9.1 percent y-o-y) and capital investment (8.0 percent y-o-y). Although a sharp rise of consumer spending is unlikely given the weak recovery of labor market conditions and constraints such as greater tax and social security burdens upon households, the silver lining in the cloud is the incentive to renew durable consumer goods in the household sector amid the digital consumer electronics boom. This should keep personal consumption growth fairly strong at 1.7 percent y-o-y.

3. Forecast of the Japanese Economy in FY2005

We are inclined toward the view that Japan's economic growth will lose momentum in FY2005, based upon prospects that the current IT-digital consumer electronics boom will come to a pause. The growth of capital investment comprised mainly of the replacement of old equipment will likely lose momentum and the reaction to the purchase of durable goods during the previous year will also dampen the growth of personal consumption. Thus the current economic recovery starting in January 2002 may slide into an adjustment phase without the chance to shift into a full-fledged recovery strong enough to provide prospects of an emergence out of deflation.

However, even in the foregoing scenario, we do not expect cyclical adjustment pressures such as the debt overhang and excess capital stock to build up in FY2005 given the corporate sector's cautious stance regarding inventory control and capital investment. Furthermore, as mentioned in more detail below, we should note a substantial progress in the mitigation of structural adjustment pressures and the improvement of the expected rate of growth. Thus, even if the Japanese economy peaks out, the government and the BOJ would still be able to lift the economy out of a relatively benign adjustment by taking appropriate measures to stabilize the economy. If the decline in growth rate turns out to be mild, the Japanese economy would be better positioned to achieve stable growth and emerge out of deflation in the ensuing recovery cycle.

4. The Current Recovery

Japan's current economic recovery starting in January 2002 is proving more resilient than initially expected. Although the output gap (potential GDP minus actual GDP) causing deflation is still unresolved, it is shrinking as a result of Japan's economic growth during the past two years. Corporate and household concerns regarding deflation are also abating given the economic recovery and the contraction of the output gap. Moreover, the negative pressures stemming from structural problems of Japan's economy such as the debt overhang and excess labor, which are a drag upon growth, are easing. As for the fall of growth expectations that has hampered forward-looking investment activity by corporations, it should be noted that the extreme decline is coming to a halt. The restraints stemming from these negative factors should be alleviated as long as the economy continues to recover during FY2004. The events thus far are worthy of commendation for setting the backdrop for the Japanese economy's return to a sustainable growth trajectory.

However, note also that the current economic recovery is limited due to several factors. First of all, the divergence along the corporate spectrum in terms of size and sector has widened to an unprecedented level. The recovery to date has been uneven with the positive impact of export growth benefiting mostly large manufacturers and having limited effect upon small and medium businesses and non-manufacturers. The disparity is also having an adverse influence upon the progress in adjustment of excess labor and debt overhang. It is leading to a delay in improvement among small and medium companies and non-manufacturers (in particular construction companies, real estate firms and retailers) and a yawning economic gap among geographic regions stemming from the performance of local industries.

Secondly, the autonomous recovery mechanism inherent in the economy is not functioning properly in Japan. Even though excessive concerns in the corporate sector regarding deflation and the expected rate of growth have abated considerably, corporate business sentiment has not yet improved to levels generating forward-looking investments to boost capacity and employ more workers. Even among large manufacturers who are enjoying comparatively favorable performance, the pickup in capital investment to upgrade capacity is only witnessed among IT-goods and digital equipment makers. From a macroeconomic perspective, the pace of capital investment growth is not yet strong enough to spur further industrial production. Furthermore, the recovery of consumer spending is still limited given the tepid recovery of labor market conditions and lingering concerns toward future tax hikes and pension system. Japan’s economic recovery is still dependent upon external demand and remains vulnerable to exogenous shocks because of the inadequate recovery of domestic demand. The possibility of Japan losing steam again may not be overlooked depending upon risks such as a sharp appreciation of the yen, a slowdown of the overseas economies and a premature tightening of macroeconomic policy by the government. Moreover, there are numerous unresolved issues such as the management of the fiscal deficit, a sustainable social security system and a socio-economic system capable of coping with an aging and declining population.

In short, we find scant reasons to be optimistic regarding the future course of Japan’s economy. While it goes without mention that the private sector must continue its best efforts to reform, the government must provide appropriate policy steps and set forth a clear future vision in order to lift the Japanese economy out of deflation into a full-fledged recovery.

Chart 5: Forecast of the Japanese Economy

(%)

	FY2003	FY2004	FY2005	FY2003		FY2004		FY2004	FY2005
				1st-half	2nd-half	1st-half	2nd-half	(Contribution)	(Contribution)
	(Estimate)	(Forecast)	(Forecast)	(Actual)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)
GDP (real)	2.9	2.6	1.4	1.5	2.1	1.1	1.0	-	-
Domestic demand	2.2	2.2	1.3	1.1	1.7	0.9	0.8	2.1	1.2
Private sector demand	3.4	3.0	1.4	1.9	2.1	1.3	1.2	2.2	1.1
Personal consumption	1.3	1.7	1.1	0.8	1.2	0.8	0.6	0.9	0.6
Housing investment	-0.0	-1.2	-0.0	0.9	-0.1	-1.4	0.6	-0.0	-0.0
Capital investment	11.5	8.0	3.4	5.8	6.6	2.6	3.9	1.4	0.6
Public sector demand	-2.0	-0.7	0.8	-1.7	0.1	-0.6	-0.4	-0.1	0.2
Government consumption	1.1	1.5	2.3	0.4	1.0	0.6	0.8	0.2	0.4
Public investment	-10.4	-7.6	-4.3	-7.7	-2.0	-4.6	-4.3	-0.4	-0.2
Net exports (contribution)	0.8	0.5	0.2	0.4	0.4	0.3	0.1	0.5	0.2
Exports	9.5	9.1	5.4	4.0	6.4	4.3	3.1	1.1	0.7
Imports	3.9	6.5	5.1	0.6	3.7	2.9	3.3	-0.6	-0.5
GDP (nominal)	0.3	0.7	0.0	0.5	0.1	0.8	0.1		
Industrial production	3.0	4.8	2.0	0.1	4.7	1.9	1.2		
Unemployment rate	5.2	4.9	4.4	5.3	5.1	5.1	4.7		
Current account balance (trillion yen)	16.4	18.7	21.7	16.7	16.5	18.4	19.4		
as a percentage of nominal GDP	3.3	3.7	4.3	3.3	3.3	3.7	3.9		
Corporate goods prices	-0.6	-0.4	-0.8	-0.9	-0.3	-0.3	-0.6		
Consumer prices	-0.2	-0.2	-0.3	-0.3	0.0	-0.2	-0.3		
Long-term interest rate (%)	1.12	1.30	1.30	0.90	1.34	1.40	1.20		
Nikkei stock average (yen)	9,939	11,250	11,300	9,178	10,700	11,500	11,000		
Exchange rate (yen/dollar)	113.0	107.0	109.0	118	108	107	107		
Crude oil price (dollar/barrel)	30.8	29.1	26.4	29.6	32.1	29.5	28.8		

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 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,*
Bank of Japan, *Balance of Payments Statistics, Corporate Goods Price Index.*

- End -

MIZUHO