

(Translation)

# **Economic Outlook for FY2004 and FY2005**

## **(Revised to reflect the *Second Preliminary Quarterly Estimates of GDP for the Jan-Mar quarter of 2004*)**

June 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* (“2<sup>nd</sup> QE”) for the Jan-Mar quarter of 2004 by the Cabinet Office. In comparison to MHRI’s previous *Economic Outlook for FY2004 and FY2005* released on May 21, 2004, we have revised the rate of growth with respect to several components of demand of the Japanese economy for FY2004. We have also revised the rate of real GDP growth of several Asian economies. Nevertheless, our assessment on the current status and outlook of the economy remains unchanged. Our overall forecast on the rate of real GDP growth for Japan and Asia remains unchanged from our previous outlook released in May 21<sup>st</sup>.

### **<The Overseas Economies>**

<b>The US Economy</b>	The US economy will look for stable growth toward 2005 (4.4% in 2004, 3.6% in 2005).
<b>The Euro Zone Economy</b>	Economic recovery in the euro zone will lag other areas due to structural adjustment pressures (1.7% in 2004, 1.8% in 2005).
<b>The Asian Economies</b>	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>**

<b>FY2004</b>	Although Japan will remain on recovery track, its growth momentum will gradually wane (real GDP growth: 3.4%, nominal GDP growth: 1.7%).
<b>FY2005</b>	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 revised outlook in Japanese released on June 9, 2004.

## 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 upon 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 3.6%), near the potential rate of growth.

**Chart 1: Forecast of the US Economy**

	2003 (Actual)	2004 (Forecast)	2005 (Forecast)	2004		2005	
				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 up to the beginning of 2004 will remain a drag upon exports, 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 1.7%) in 2004 and 1.8% (our previous forecast was 1.8%) in 2005. Consumer prices should rise at a rate around 2% given the sluggish recovery of the economy. However, we have revised our forecast on the rate of change of Euro zone consumer prices in 2004 (1.9% → 2.0%) reflecting the rise of consumer prices to 2.5% o-y-a in May due to the surge of crude oil prices.

Furthermore, Euro zone real GDP growth in 2003 has been upwardly revised (0.4% → 0.5%), given the upgrade of real GDP growth in France.

**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	0.5	1.7	1.8	1.0	0.9	0.9	0.8
	Germany	-0.1	1.4	1.4	0.8	0.8	0.7	0.6
	France	0.5	2.2	2.3	1.3	0.9	1.3	1.1
	Italy	0.4	1.6	1.7	0.8	1.2	0.8	0.6
	UK	2.2	2.9	2.5	1.4	1.3	1.3	1.3
Euro zone consumer prices		2.1	2.0	1.7	2.0	2.1	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. The shaded columns are forecasts.

Sources: Eurostat, ECB, ONS.

### 3. The Asian Economies

To reflect the recent updates on real GDP growth in ASEAN4 released since our previous forecast (May 21<sup>st</sup>), we have revised downward our forecast on real GDP growth in Thailand in 2004 and 2005. By the same token, we have upwardly revised our forecasts on growth in Malaysia, Indonesia and the Philippines, thus lifting slightly our growth forecast regarding ASEAN4. However, our overall forecast for the Asian economies remains unchanged from our previous forecast.

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 rise of global demand for information technology (IT)-related appliances, 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 7.1%). In China, where there have been 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 the 8% level (y-o-y) in the second half of the year.

In 2005, we expect China's economic growth to slow to 7.9% 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 6.2%) in 2005.

**Chart 3: Forecast of the Asian Economies**

	2002 (Actual)	2003 (Actual)	2004 (Forecast)	2005 (Forecast)
Asia (average)	6.1	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	1.9	3.2	5.7	4.3
Singapore	2.2	1.1	6.3	4.3
ASEAN4 (average)	4.6	5.3	5.5	5.0
Thailand	5.4	6.8	6.8	5.8
Malaysia	4.1	5.3	6.1	4.8
Indonesia	4.3	4.5	4.7	4.6
Philippines	4.3	4.7	4.5	4.5
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%).

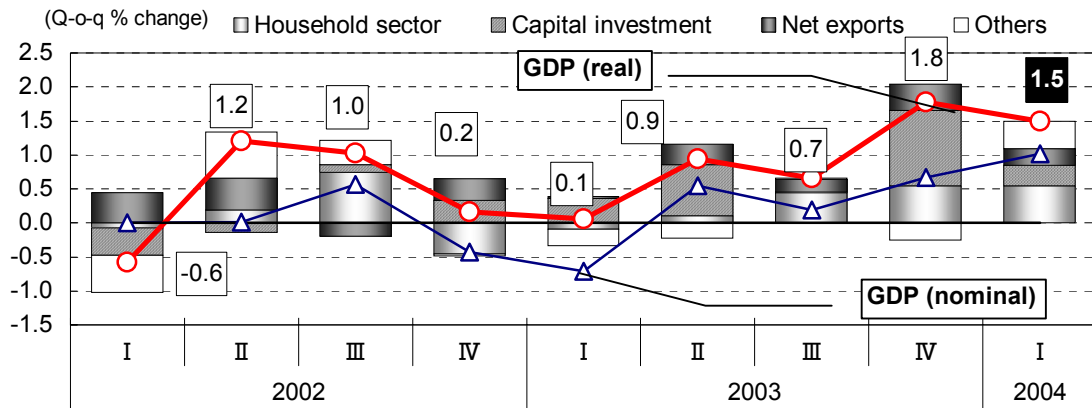
### 1. Key points and assessment of the 2<sup>nd</sup> QE

The Cabinet Office released its *Second Quarterly Estimates of GDP (2<sup>nd</sup> QE)* for the Jan-Mar quarter of 2004, raising its estimate for real GDP growth by 0.1% pt (0.5% pt on an annualized basis) to 1.5% q-o-q (6.1% p.a.) from 1.4% q-o-q (5.6% p.a.) in the *First Preliminary Quarterly Estimates of GDP (1<sup>st</sup> QE)*. The Cabinet Office also revised upward Japan's nominal GDP for the same quarter to 1.0% q-o-q (4.1% p.a.) from 0.8% q-o-q (3.2% p.a. in the *1<sup>st</sup> QE*). However, there were no revisions regarding Japan's economic growth in FY2003 both in real terms (3.2% y-o-y) and nominal terms (0.7% y-o-y).

A closer look at Japan's real GDP growth in terms of the major components of demand reveals that the degree of contribution by external demand was revised downward by 0.1% pt as a result of an upward revision of imports to 2.8% q-o-q (*1<sup>st</sup> QE* 1.9%) reflecting the Balance of Payments statistics and the GDP deflator. The degree of contribution by domestic private demand to real GDP growth was revised upward (by slightly more than 0.1% pt) as a result of (1) a downward revision of capital investment to 1.7% q-o-q (*1<sup>st</sup> QE* 2.4%), and (2) an upward revision of the degree of contribution by private inventory investment to 0.5% from 0.2%. The downward revision of capital investment is due most likely to the carry-over of deliveries of machinery and equipment ordered in the Jan-Mar quarter. We are inclined to believe that the deferment of deliveries led to the rise of supply-side inventories, thus resulting in an upward revision of inventory investment. Meanwhile, there was only a modest revision of public demand in terms of both government consumption and public fixed capital formation.

The recent revision of GDP estimates is well within our forecast range. Even the stronger-than-expected growth of inventory investment is only a temporary jump in figures. Since the rise of inventory investment will be transferred to capital investment in the Apr-Jun quarter, we see no need to revise our forecast on the overall economy.

**Chart 4: The Second Preliminary Quarterly Estimates of GDP (2<sup>nd</sup> QE)**



Note: The bars represent the degree of contribution by each of the components of demand to real GDP. (Yr/Qtr)  
 Source: Cabinet Office, *Preliminary Quarterly Estimates of GDP*.

**2. Forecast of the Japanese Economy in FY2004**

The Japanese economy will be driven in FY2004 by a sustained rise of exports reflecting the ongoing global economic expansion and growth of capital investment backed by rising demand. We also look forward to solid consumer spending amid the growth of demand for durable consumer goods ahead of the Olympic games in Athens. However, judging from forecasts that US and Chinese economic growth will wane in the second half of the year, export growth - thus far the driver of economic growth - will inevitably slow down. Furthermore, given the limited rise of labor compensation (which is the source of consumer spending) stemming from a reluctance among companies to raise wages, 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 3.4%) and 1.7% in nominal terms (previous forecast 1.7%), surpassing growth in the previous fiscal year.

**3. 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 largely driven thus far by rosy expectations

toward the future. Judging from the foregoing, we are inclined to believe that Japan will be able to maintain economic growth around its potential rate of growth. We forecast Japan's GDP to expand 1.7% in real terms (our previous forecast was 1.7%) and 0.6% in nominal terms (previous forecast 0.6%) 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 above, 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 current consensus among Japanese bond market players is 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. Although we estimate that the output gap has shrunk to less than -2% of GDP as a result of the growth of demand, the contraction will come to a pause since Japan's recovery cycle should 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 5: Forecast of the Japanese Economy**

(%)

	FY2003	FY2004	FY2005	FY2004		FY2005		FY2004	FY2005
	(Actual)	(Forecast)	(Forecast)	1st-half	2nd-half	1st-half	2nd-half	(Contribution)	(Contribution)
				(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)
GDP (real)	3.2	3.4	1.7	1.5	0.9	0.8	0.8	–	–
Domestic demand	2.4	2.8	1.4	1.2	0.8	0.6	0.7	2.7	1.3
Private sector demand	3.9	3.8	1.5	1.7	1.0	0.7	0.7	2.9	1.2
Personal consumption	1.4	2.1	1.1	0.9	0.6	0.5	0.5	1.2	0.6
Housing investment	0.3	1.7	-0.3	1.2	0.0	-0.6	0.6	0.1	-0.0
Capital investment	12.0	9.4	3.5	4.4	2.3	1.6	1.5	1.6	0.6
Public sector demand	-2.5	-0.7	0.7	-0.4	0.0	0.3	0.6	-0.1	0.1
Government consumption	0.9	1.6	2.1	0.7	0.8	1.1	1.2	0.3	0.3
Public investment	-12.1	-7.7	-4.5	-4.0	-2.7	-2.4	-1.7	-0.4	-0.2
Net exports (contribution)	0.8	0.7	0.4	0.3	0.2	0.2	0.2	0.7	0.4
Exports	10.9	11.8	6.4	5.4	3.4	3.1	3.1	1.5	0.9
Imports	4.8	8.4	5.4	4.2	2.9	2.6	2.6	-0.8	-0.5
GDP (nominal)	0.7	1.7	0.6	0.9	0.3	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	21.1	23.0		
as a percentage of nominal GDP	3.4	3.9	4.2	3.8	4.1	4.1	4.5		
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	1.70	1.85	1.60	1.80	1.80	1.90		
Nikkei stock average (yen)	9,929	11,800	12,250	11,700	11,900	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*.

**MIZUHO**

The logo for Mizuho, featuring the word "MIZUHO" in a bold, dark blue, sans-serif font. Below the text is a red, curved underline that starts under the 'M' and ends under the 'O', arching slightly upwards in the middle.