

Economic Outlook for FY2004 and FY2005

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

December 2004

The 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* for the Jul-Sep quarter of 2004 by the Cabinet Office. In comparison to MHRI's previous *Economic Outlook for FY2004 and FY2005* released on November 17th, 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

The US economy will cruise at a pace matched with its potential rate of economic growth, driven mainly by the rise of consumer spending along with the upturn of the income environment
(4.4% in 2004, 3.5% in 2005)

The Euro Zone Economy

The weak recovery of domestic demand will serve as a drag upon sluggish economic growth in the euro zone
(1.7% in 2004, 1.7% in 2005)

The Asian Economies

Slower growth due to the ebb of demand for IT and digital-related goods
(7.3% in 2004, 6.4% in 2005)

<The Japanese Economy>

FY2004

Japan will remain on recovery track despite slower growth in the second half of the fiscal year
(real GDP growth 2.0%, nominal GDP growth 0.9%)

FY2005

Japan will draw closer to a self-sustained recovery driven by domestic private-sector demand
(real GDP growth 1.7%, nominal GDP growth 1.2%)

This English-language translation is based upon the outlook in Japanese released on December 13, 2004. This publication is compiled solely for the purpose of providing readers with information and is in no way meant to encourage readers to buy or sell financial instruments.

The Japanese Economy

FY2004 Outlook: Japan will remain on a recovery track despite slower growth in the second half of the year (real GDP growth 2.0%, nominal GDP growth 0.9%)

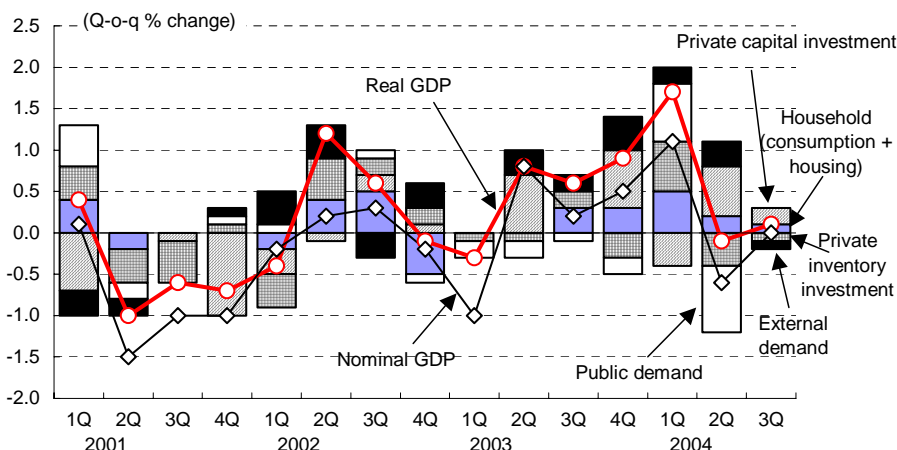
FY2005 Outlook: Japan will draw closer to a self-sustained recovery driven by domestic private-sector demand (real GDP growth 1.7%, nominal 1.2%)

1. Key points and assessment of the 2nd QE

The Cabinet Office released its *Second Preliminary Quarterly Estimates of GDP (2nd QE)* for the Jul-Sep quarter of 2004. In addition to routine revisions, the recent 2nd QE involved major changes including the annual revision of GDP for FY2003, the application of the chain-linked calculation method which improves the accuracy of the GDP deflator and changes in the method to estimate certain components of demand. Despite the sweeping changes, the resulting revision turned out to be smaller than expected. Real GDP growth in the Jul-Sep quarter was revised from 0.1% q-o-q (0.3% per annum) in the 1st QE to 0.1% q-o-q (0.2% p.a.) in the 2nd QE (Chart 1). However, real GDP growth in the Apr-Jun quarter of 2004 was subject to a major downward revision to -0.1% q-o-q from 0.3% q-o-q in the 1st QE. The near-zero percent growth for the second consecutive quarter underscored the slowdown of the Japanese economy which is feared to be at the brink of a recession.

The rate of nominal GDP growth stood at -0.0% q-o-q, resulting in only a minor deviation from GDP growth in real terms. Although the percentage change of the GDP deflator from a year ago (o-y-a) is still deep in negative territory (-1.3%), it has been upwardly revised from -2.1% at the time of the 1st QE due to the application of chain-linked computation method. The GDP deflator has also narrowed from 1.7% o-y-a in the previous quarter. The recent revision served to correct the excessive emphasis upon deflation in comparison to other price indicators and indicated that deflationary pressures are abating.

[Chart 1: The 2nd QE for the Jul-Sep Quarter of 2004]



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

Capital investment retains its momentum, reflecting the positive investment stance among companies

In terms of the components of demand, capital investment was upwardly revised (-0.2% q-o-q in real terms → 1.1%) to reflect the pick-up from 10.7% o-y-a in the Apr-Jun quarter to 14.4% o-y-a in the Jul-Sep quarter according to the *Financial Statements Statistics of Corporations by Industry* released on December 3rd. A closer look at the *Financial Statements Statistics of Corporations by Industry* reveals (1) a revival of capital investment among manufacturers after a weak patch in the previous quarter (Apr-Jun quarter 5.6% o-y-a → Jul-Sep quarter 14.8% o-y-a), and (2) the ongoing double-digit investment growth among nonmanufacturers (Apr-Jun quarter 13.0% o-y-a → Jul-Sep quarter 14.2% o-y-a), depicting a positive capital investment stance among companies spurred by strong business performance.

Along with the recent revision in the 2nd QE, GDP-based capital investment in the Jan-Mar quarter of 2004 was downgraded to a quarterly decline. According to the Cabinet Office, this reflects the sales of large fixed assets by the private sector to the government sector (negative capital investment). Excluding the impact of this factor, capital investment growth would be 1.6% q-o-q in the Jan-Mar quarter and 0.3% q-o-q in the Apr-Jun quarter, thus remaining on an upward path.

Personal consumption grew at cruise speed, reflecting the improvement of the income environment

Jul-Sep quarter personal consumption growth was downgraded on a quarter-on-quarter basis by 0.7% pt (0.9% → 0.2%) due to changes in statistics used to calculate the nominal amount (some items in the *Family Income and Expenditure Survey* are replaced with the corresponding data in the *Survey of Household Economy*) and the adoption of the chain-linked deflator. According to the Cabinet Office, the impact of the statistical change and the chain-linked deflator is approximately 0.4% pt and 0.3% pt respectively. Considering the stronger-than-expected growth of personal consumption in the 1st QE, the sharp downgrade in the revised 2nd QE figures are more consistent with other related indicators and provide a more realistic picture of the actual state of consumer spending. Subsequent to the revision, personal consumption has been growing at a pace of around 1% p.a. since the beginning of FY2004, thus slowing into cruise mode matching the upturn of income.

Inventory investment declines for second quarter in a row due to early adjustment

Turning to inventory investment, the relevant indicators suggest that companies are continuing to reduce stockpiles accumulated during the Jan-Mar quarter of 2004. The contribution by inventory investment in real terms to the quarter-on-quarter change of GDP, which stood at 0.6% pt in the Jan-Mar quarter, fell for two consecutive quarters in the Apr-Jun quarter (-0.4% pt) and the Jul-Sep quarter (-0.1% pt). From a macroeconomic perspective, the foregoing trend indicates that the inventory adjustment phase is nearing its end. As shown by the inventory-to-shipments ratio index in the *Indices of Industrial Production*, the level of inventories is relatively low, providing us with reasons to believe that inventory adjustment pressures are not so strong at the moment.

Signs that public investment is bottoming out

Public demand as a whole was upgraded. This stems from an upward revision of public fixed capital formation (public investment) (-4.2% q-o-q → -2.2% q-o-q) to reflect the statistics on public works completed in September despite the downward revision of government consumption (0.6% q-o-q → 0.4% q-o-q) due to reasons such as the revision of the deflator. Public investment surged in the Jan-Mar quarter from the previous quarter, reflecting the large amount of fixed assets sold by the private sector to the government sector mentioned above. The sharp fall in the Apr-Jun quarter is a backlash to the Jan-Mar surge. However, estimations by the Cabinet Office excluding the impact of this factor show an ongoing decline: Jan-Mar quarter (-3.4%), Apr-Jun quarter (-6.4%). The breadth of the fall contracted in the Jul-Sep quarter, indicating that public investment is bottoming out.

External demand served as a drag upon growth due to sluggish exports

External demand turned out to be a negative contribution to GDP growth as a result of the slowdown of exports. However, it should be noted that the adoption of the chain-linked deflator affected imports in a strong way, resulting in a downward revision of imports in the Jul-Sep quarter (2.7% q-o-q → 1.8% q-o-q). Meanwhile, since exports were only subject to a minor revision (0.4% q-o-q → 0.6% q-o-q), the contribution by external demand has been upwardly revised.

The Japanese economy is still in recovery mode driven by domestic private-sector demand

Although Japan's real GDP growth stood at zero for two quarters in a row, this is due largely to a temporary inventory adjustment and the sluggish growth of exports. Judging from the fact that the main driver of the economy – domestic private-sector final demand such as capital investment and personal consumption – is still growing, we believe that the Japanese economy is still in recovery mode.

2. Forecast of the Japanese economy in FY2004

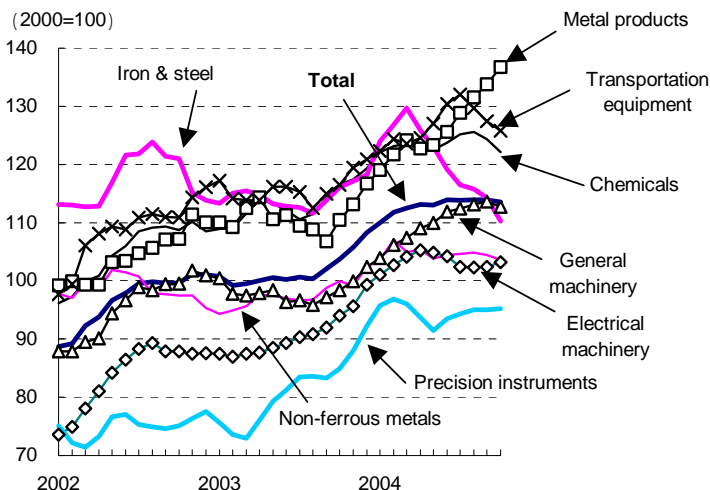
Export trends and inventory adjustment in the IT and digital consumer electronics sector are the key points in the future outlook

In addition to the recent GDP updates, recent economic indicators such as the lower-than-expected industrial production and machinery orders in October signal the slowdown of the economy, triggering concerns in some quarters regarding a slide into recession. The following section discusses the possibility of a recession and provides an outlook on the future course of the economy.

Summarizing the background to Japan's recent economic slowdown, the loss of momentum stems from (1) the ebb of the temporary rise of production in anticipation of demand related to the Olympic Games, (2) restraints upon personal consumption and production activity due to natural disasters such as the successive typhoons, (3) the sluggish growth of exports reflecting the slowdown of overseas economies such as the US, (4) inventory adjustment in the IT and digital consumer electronics sector, (5) concerns regarding the negative effect of the surge of crude oil prices, and (6) the drop of public investment. As for capital investment, regarded thus far as one of the causes of the recent slowdown, the 2nd QE served to confirm its ongoing rise.

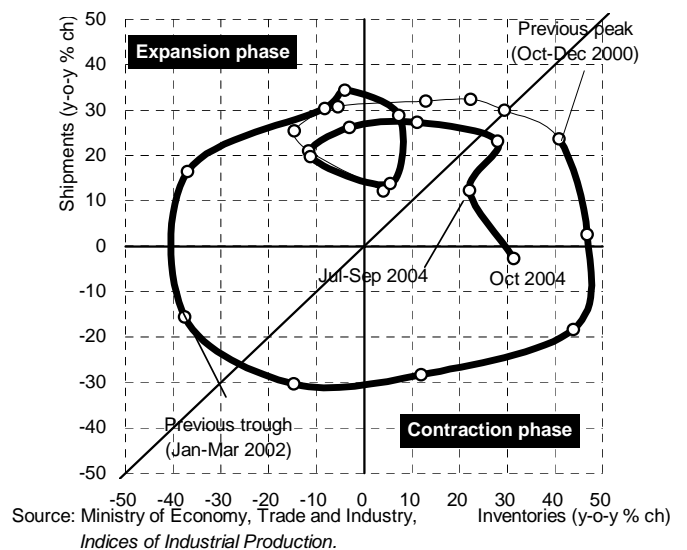
Of the foregoing factors which are dragging down the pace of economic growth, factors (1) and (2) are unmistakably short-term in nature. Furthermore, in view of the recent stabilization of crude oil prices and forecasts based upon leading indicators that public investment will bottom out, the impact of (5) and (6) will also be mild. Thus, the key points in the future course of the economy are the sluggish growth of exports and inventory adjustment in the IT and digital consumer electronics sector.

[Chart 2: Volume of Exports]



Note: Seasonally adjusted (by X-11), 3MMA.
Source: Ministry of Finance, *The Summary Report on Trade of Japan*.

[Chart 3: Inventory Adjustment of IT-Related Producer Goods]



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

Exports will pick up, driven by the sustained expansion of the US and Chinese economies

The recent slowdown of export growth stems mainly from (1) dwindling export capacity in the materials industries due to strong domestic demand for materials such as iron and steel, (2) the fall of electrical machinery exports reflecting the ebb of global demand for IT and digital appliances, and (3) the pause of automobile exports to the US and China (Chart 2). Although the cautious stance toward investment in plant and equipment among materials manufacturers makes it unlikely that the materials industry's export capacity will recover anytime soon, the ongoing expansion of the US and Chinese economies leads to our view that exports will gradually start to pick up once the global inventory adjustment of IT and digital appliances and the adjustment of automobile inventories in the US and China run their course.

The future course of inventory adjustment in the IT-related industries depends upon the year-end shopping season

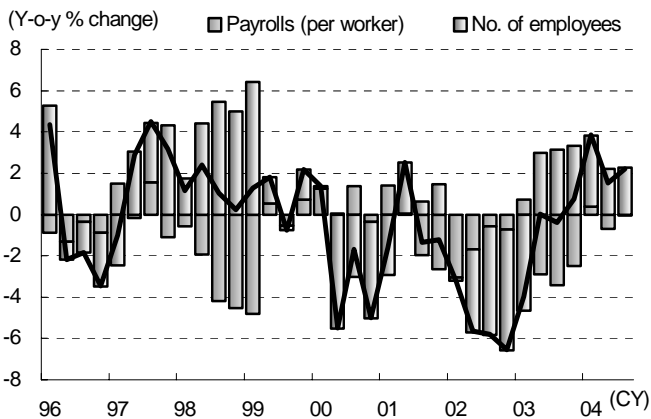
Although the domestic inventory adjustment of information-related producer goods progressed rapidly in the Jul-Sep quarter of 2004, inventories are piling up again in October (Chart 3). Even so, inventory levels are lower in comparison to the period after the collapse of the IT bubble because of proactive steps to reduce output by manufacturers. Furthermore, the rise of inventory levels stems probably from an intentional accumulation of inventories in the run-up to the year-end shopping season. In view of the brisk sales of digital consumer electronic appliances even after the Olympic Games, there is no need for undue pessimism at the current juncture. The outcome of the year-end shopping season holds the key to the future course of inventory adjustment.

A strong year-end shopping season reflecting the improvement of the income environment

The environment surrounding personal consumption is improving steadily. According to the *Financial Statements Statistics of Corporations by Industry*, current profits of corporate enterprises grew 37.9% o-y-a in the Jul-Sep quarter of 2004 and total employee wages are also rising above the previous-year levels (Chart 4). Furthermore, employee payrolls (per worker) are bottoming out, indicating that the household income environment is improving. Personal consumption is following a steady course reflecting the improvement of the income environment. In the first half of 2004, personal consumption was driven largely by consumer confidence (consumption propensity). Since the early autumn months, the rise of income is serving to complement the backlash to the sentiment-led consumer spending in the first half of the year, thus keeping the level of personal consumption above the previous year (Chart 5).

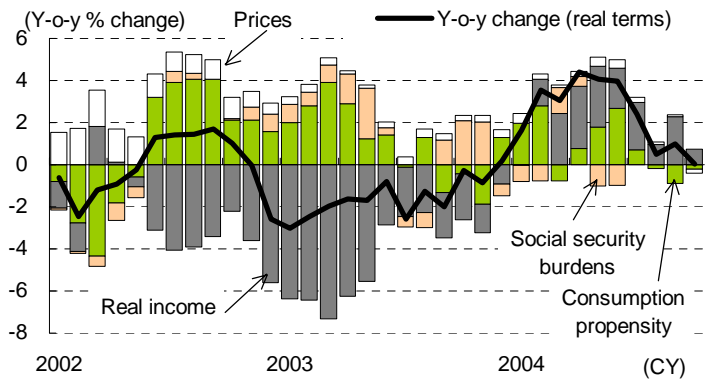
In the countdown to the end of the calendar year, the income environment is continuing to improve as indicated by factors such as the rise of winter bonus payments above the previous year reflecting the dramatic improvement of corporate business performance. A strong year-end shopping season should serve to reduce the inventories of IT and digital consumer electronic appliances.

[Chart 4: Employee Payrolls]



Source: Ministry of Finance, *Financial Statements Statistics of Corporations by Industry (Quarterly)*.

[Chart 5: Real Consumption Expenditures]



Note: 3MMA.

Source: Ministry of Public Management, Home Affairs, Posts and Telecommunications, *Report on the Family Income and Expenditure Survey*.

Capital investment should also continue to grow

A moderate pace of economic growth in the second half of FY2004

A significant rise of capital investment growth is unlikely for the time being, judging from the sharp fall (-8.4% q-o-q) of private-sector machinery orders (excluding volatile ones for ships and those from electric power companies, an advance indicator of capital investment) in the Jul-Sep quarter followed by an unexpected drop in October (-3.1% m-o-m). However, the rise of capital construction investments on a construction starts basis and prospects of a reaction to delays during the summer months owing to bad weather conditions provide us with reasons to believe that construction investment will serve to buttress capital investment. In addition, the strength of personal consumption will lead to the upturn of business performance among nonmanufacturers and push up the level of capital investment. Given the foregoing, capital investment should remain on an upward trend from the Oct-Dec quarter.

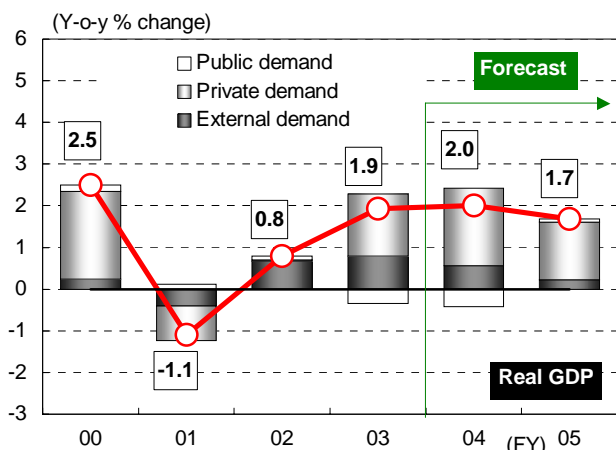
Judging from the foregoing, (1) corporate profits will continue to rise amid the gradual upturn of exports reflecting the ongoing expansion of the overseas economies and (2) personal consumption will follow a steady course backed by the improvement of the income environment. Although capital investment may fall into a temporary lull along with a pause in the manufacturing sector until the pickup of capital spending among nonmanufacturers, public investment will bottom out because of full-fledged post-disaster reconstruction works and keep the economy from falling into a deep abyss.

The foregoing provides us with reasons to believe that the IT and digital electronics sector will near the end of an inventory adjustment phase by the end of fiscal year in March 2005. Albeit on a short-term, the economy may technically fall into a recession as a result of restraints upon industrial production amid lingering pressures to shed excess stocks of unsold goods.

**FY2004 real GDP
forecast: 2.0%**

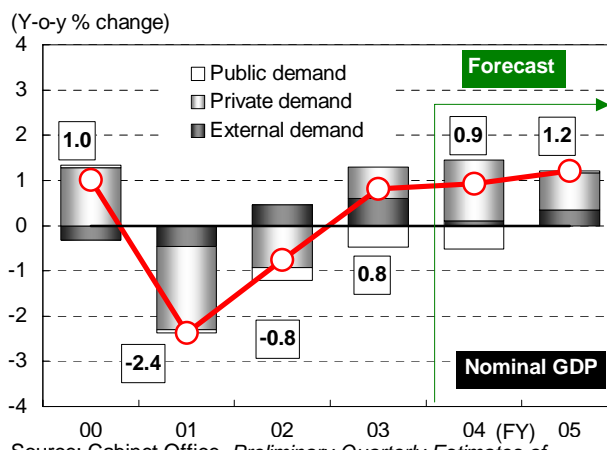
Our forecast of Japan's real GDP growth in FY2004 on a half-year basis projects a slowdown from 0.7% over the previous term (1.1% prior to revision) in the first half to 0.4% (0.8% prior to revision) in the second half of the fiscal year. However, full-year GDP growth should reach 2.0% (2.9% prior to revision) in real terms and 0.9% (1.0% prior to revision) in nominal terms and turn out slightly higher than the previous fiscal year because of a large 2.0% carry-over from the previous fiscal year.

[Chart 6: Real GDP Growth]



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

[Chart 7: Nominal GDP Growth]



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

3. Forecast of the Japanese economy in FY2005

In FY2005, exports should continue to grow reflecting the ongoing expansion of the overseas economies and serve to underpin the Japanese economy. Since the income environment should also continue to improve reflecting the rise of corporate profits, personal consumption will most likely grow at a pace matching the rise of income. The sustained growth of personal consumption will also serve as tailwinds for capital investment. A major slowdown of capital investment should be avoided with the driver of investment shifting from the manufacturing to the nonmanufacturing sector.

The rate of GDP growth should gather further momentum in the second half of FY2005 along with (1) positive pressures upon business performance and capital investment among nonmanufacturers spurred by the ongoing growth of personal consumption and (2) the emergence of the corporate sector out of an adjustment cycle as indicated by the ebb of the overly restrictive stance regarding inventories in the corporate sector reflecting the rise of expectations toward the elimination of deflationary pressures. Given a virtuous cycle where the upturn of corporate business performance feeds through to the recovery of household income, which in turn serves as a further driver of corporate performance, the Japanese economy will edge closer to an autonomous recovery driven by domestic private demand. As a result, the rate of real GDP growth should accelerate further from the first half to the second half of the fiscal year.

Although the rate of real GDP growth in the first half of FY2005 is forecast to grow only 0.8% on a half-year basis (1.6% p.a.), the pace of growth should rise to 1.1% (2.3% p.a.) in the second half of the fiscal year. Our forecast looks for full year GDP growth to reach 1.7% (2.1% prior to revision) in real terms and 1.2% (1.4% prior to revision) in nominal terms.

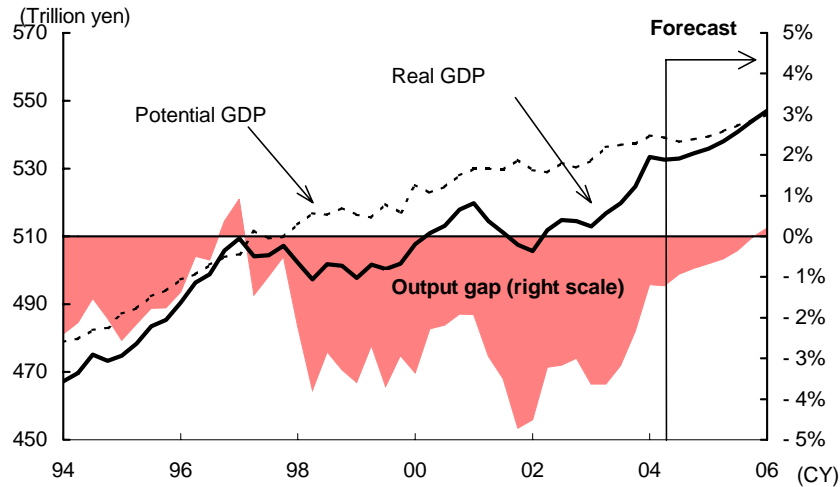
4. **Japan's**
emergence
out of deflation in
FY2006

Note that there still is the possibility that exogenous shocks may increase the risks of Japan's slide into recession.

As noted in our previous *Economic Outlook on FY2004 and FY2005*, the price of crude oil and the foreign exchange rate are the greatest risk factors in the future course of the economy. Since the West Texas Intermediate (WTI) futures contract (the crude oil benchmark) is currently stable in the mid-\$40s per barrel, concerns regarding the adverse impact of high crude oil prices are receding at the moment. As for the foreign exchange rate, the appreciation of the yen appears to be taking a breather. Having lost its earlier gains to the dollar, the yen is currently trading around 105 yen after strengthening at point to the 101-yen level to the dollar. Nevertheless, given the unresolved uncertainties regarding crude oil supply such as the turmoil in Iraq, there still are the risks of a rebound of crude oil prices. Furthermore, the underlying cause of the appreciation of the yen is the weakness of the dollar stemming from the "twin deficit" of the US current account and budget. This, too, is still unresolved. Thus, it is necessary to keep a close eye upon crude oil prices and the foreign exchange rate.

Note also that the deflationary pressures stemming from fiscal policy measures is an emerging risk factor. In view of the fact that the Japanese economy will continue to depend largely upon personal consumption growth, the government faces a delicate task of implementing fiscal policy measures without dampening consumer confidence due to concerns regarding the rise of burdens upon households.

[Chart 8: The Output Gap]



Note: Estimates by MHRI. Since the estimates are based upon data since 1994 due to statistical limitations, the potential rate of GDP growth is extremely low in comparison to GDP statistics prior to revision (currently around the lower end of the 1% level).
Sources: Cabinet Office, Ministry of Economy, Trade and Industry, Ministry of Public Management, Home Affairs, Posts and Telecommunications.

If Japan can avoid these risks, the economy will draw nearer to the end of deflation as the economy gathers momentum in the second half of FY2005. The output gap has already narrowed considerably given the rapid economic recovery since the end of 2003 (Chart 8). For the time being, the contraction of the output gap will be an extremely slow process because the economy will only grow at a pace around its potential rate of growth. However, once the economic recovery picks up in the second half of FY2005, the output gap should diminish by the end of FY2005 and the year-on-year change of the consumer price index should turn positive.

Nevertheless, it will still take some more time until “the consumer price index registers stably a zero percent or an increase year-on-year”, one of the conditions for the BOJ to end its quantitative easing stance regarding monetary policy. This is because a sharp contraction of the output gap cannot be expected due to the rise of supply capacity as a result of the ongoing growth of capital investment and rise of employment amid the slow growth of demand. Looking forward, it will only be sometime in FY2006 that the Japanese economy emerges out of deflation in the genuine sense that it will be freed from a negative spiral where the fall of prices leads to the contraction of economic activity and thereby satisfy the requisite conditions for the normalization of monetary policy.

[Chart 9: Forecast of the Japanese Economy]

(%)

	FY2003	FY2004	FY2005	FY2004		FY2005		FY2004	FY2005
	(Actual)	(Forecast)	(Forecast)	1H	2H	1H	2H	(Contribution)	(Contribution)
				(Actual)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)
GDP (real)	1.9	2.0	1.7	0.7	0.4	0.8	1.1	-	-
Domestic demand	1.2	1.4	1.4	0.4	0.5	0.7	1.0	1.4	1.5
Private sector demand	2.0	2.4	1.7	1.2	0.6	0.7	1.3	1.9	1.4
Personal consumption	0.5	1.6	1.0	0.9	0.3	0.5	0.8	0.9	0.6
Housing investment	-0.5	3.1	-0.8	1.5	2.8	-2.3	0.2	0.1	-0.0
Capital investment	8.2	6.1	3.2	3.6	1.3	1.4	2.1	0.9	0.5
Public sector demand	-1.5	-1.8	0.4	-2.1	0.2	0.4	-0.2	-0.4	0.1
Government consumption	1.1	2.3	2.3	1.5	0.5	1.2	1.6	0.4	0.4
Public investment	-9.2	-15.2	-7.1	-14.3	-0.8	-2.6	-7.4	-0.8	-0.3
Net exports (contribution)	0.8	0.6	0.2	0.3	-0.0	0.1	0.1	0.6	0.2
Exports	9.9	12.2	6.4	6.1	2.5	3.1	3.9	1.5	0.8
Imports	3.4	8.9	5.5	4.3	3.5	2.2	2.9	-0.9	-0.6
GDP (nominal)	0.8	0.9	1.2	-0.0	0.7	0.3	1.1		
Industrial production	3.5	4.4	2.2	6.9	2.1	1.0	3.3		
Unemployment rate	5.1	4.5	4.1	4.7	4.4	4.2	3.9		
Current account balance (trillion yen)	17.3	18.3	19.6	18.7	18.0	19.1	20.1		
as a percentage of nominal GDP	3.5	3.6	3.8	3.7	3.5	3.8	3.9		
Corporate goods prices	-0.5	1.6	0.2	1.4	1.8	0.4	0.0		
Consumer prices	-0.2	-0.2	-0.1	-0.2	-0.3	-0.1	0.0		
Long-term interest rate (%)	1.12	1.55	1.85	1.60	1.50	1.70	2.00		
Nikkei stock average (yen)	9,938	11,263	12,200	11,326	11,200	11,900	12,500		
Exchange rate (yen/dollar)	113.0	105.9	106	109.7	102	104	108		
Crude oil price (WTI \$/barrel)	31.4	43.8	42.5	41.1	46.5	43.5	41.5		

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. Half-year corporate goods prices and half-year consumer prices = rate of change over the same period a year ago.

3. Half-year unemployment rate and half-year current account balance are adjusted for seasonal factors.

4. 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, *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, Corporate Goods Price Index*.

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MIZUHO

The logo consists of the word "MIZUHO" in a bold, dark blue, sans-serif font. Below the text is a red, curved line that starts under the 'M', dips down, and then rises to end under the 'O'.