

## Economic Outlook for FY2005 and FY2006

*(Revised to reflect the Second Preliminary Quarterly Estimates of GDP for the Apr-Jun quarter of 2005)*

September 2005

The Mizuho Research Institute Ltd. (MHRI) has revised its economic outlook for FY2005 and FY2006 subsequent to the release of *The Second Preliminary Quarterly Estimates of GDP ("2<sup>nd</sup> QE")* for the Apr-Jun quarter of 2005. The key points of the outlook are as follows.

### <The Overseas Economies>

<b>The US Economy</b>	Downward revision, considering the impact of Hurricane Katrina 2005: (previous outlook) 3.7% → (current outlook) 3.5% 2006: (previous outlook) 3.4% → (current outlook) 3.3%
<b>The Euro Zone Economy</b>	Unchanged from previous outlook 2005: (previous outlook) 1.4% → (current outlook) 1.4% 2006: (previous outlook) 1.8% → (current outlook) 1.8%
<b>The Asian Economies</b>	Overall growth remains unchanged despite minor revisions regarding certain countries in the region 2005: (previous outlook) 6.4% → (current outlook) 6.4% 2006: (previous outlook) 6.4% → (current outlook) 6.4%

### <The Japanese Economy>

<b>FY2005</b>	Growth is revised upward, reflecting the strength of capital investment Real GDP: (previous outlook) 1.9% → (current outlook) 2.3% Nominal GDP: (previous outlook) 0.9% → (current outlook) 1.2%
<b>FY2006</b>	Downward revision due to corporate capital investment running its course Real GDP: (previous outlook) 1.9% → (current outlook) 1.6% Nominal GDP: (previous outlook) 1.6% → (current outlook) 1.3%

This English-language translation is based upon the outlook in Japanese released on September 13, 2005. 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

## 1. The current state of the Japanese economy

We have revised upward our forecast on Japan's economic growth for FY2005 to reflect the unexpected strong growth of corporate capital investment. For FY2006, we have downgraded our forecast on the basis of projections that the growth of capital investment will slow down.

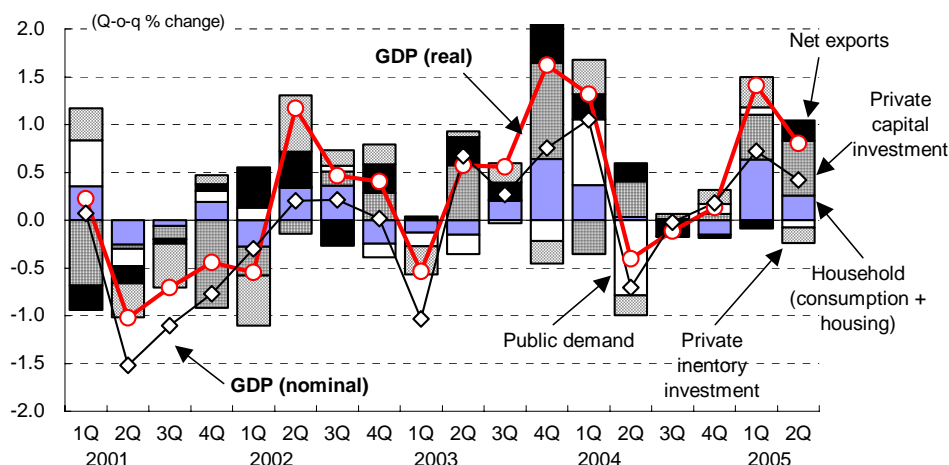
**Sharp upward revision of Apr-Jun quarter real GDP growth**

In the *Second Preliminary Quarterly Estimates of GDP* ("2<sup>nd</sup> QE") for the Apr-Jun quarter of 2005, the Cabinet Office revised Japan's real GDP growth during the quarter to 0.8% q-o-q (3.3% per annum) from 0.3% q-o-q (1.1% p.a.) in the *First Preliminary Quarterly Estimates of GDP* ("1<sup>st</sup> QE") (Chart 1). Looking closer at the components of demand, the main factors behind the sharp upward revision were (1) private sector corporate capital investment, revised up from 2.2% q-o-q in the 1<sup>st</sup> QE to 3.6% q-o-q, and (2) the contribution to real GDP by private sector inventory investment, revised up from -0.5% pt q-o-q to -0.2% pt q-o-q. In addition, public demand was revised up from 0.4% q-o-q to 0.3% q-o-q. Despite a downward revision of public fixed capital formation from -1.3% q-o-q to -2.6% q-o-q, government consumption was revised up from -0.2% q-o-q to 0.2% q-o-q. As for net exports, the contribution to real GDP growth remained unchanged given the minimal revisions to both exports and imports.

**Nominal GDP grew for the third quarter in a row**

Japan's GDP growth in nominal terms was also revised up from 0.0% q-o-q (0.0% p.a) in the 1<sup>st</sup> QE to 0.4% q-o-q (1.7% p.a.), marking the third consecutive quarter of growth. The GDP deflator, a measure of broad price trends, was revised downward from -0.8% o-y-a in the 1<sup>st</sup> QE to -0.9% o-y-a due to a heavier weight of private sector corporate capital investment, which has a relatively larger negative impact. However, the GDP deflator contracted in comparison to -1.0% o-y-a in the previous quarter. Taken together with the trends in nominal GDP, we believe that the Japanese economy is continuing to progress – albeit gradually - toward the end of deflation, driven mainly by domestic private sector final demand.

[ Chart 1: *The Second Preliminary Quarterly Estimates of GDP for the Apr-Jun Quarter of 2005* ]



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

**The upward revision of inventory investment may serve as a slight drag upon future economic growth**

According to explanations by the Cabinet Office, inventories of finished goods, distributor's stock and raw materials all fell from the previous quarter. However, the negative contribution to real GDP growth on a quarterly basis contracted sharply because of a dramatic rise of goods-in-process inventories. Despite the initial impression that the pace of inventory adjustment is sluggish, makers are steadily working off inventories of finished goods, as shown by the progress of inventory adjustment of IT and digital goods (IT-related producer goods) (**Chart 2**). Furthermore, there is no need for excessive alarm because goods-in-process inventories normally go hand in hand with production on orders. Looking forward, it is unlikely that inventories will derail the economy from its underlying growth path, in view of the progress of adjustment of finished goods inventories and distributor's inventories.

**Capital investment picks up in a wider range of business sectors**

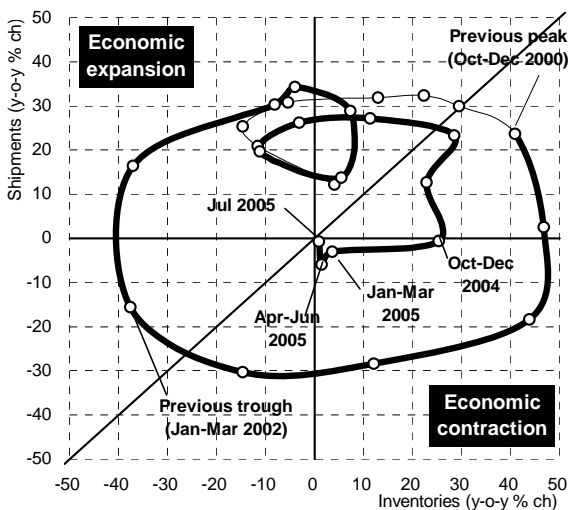
Even though various business surveys including the Bank of Japan's (BOJ) *Short-Term Economic Survey of Enterprises in Japan (Tankan)* indicated a sharp rise of capital investment in the current fiscal year, many of the related monthly indicators such as machinery orders and capital goods shipments remained sluggish. However, the *Financial Statements Statistics of Corporations by Industry (Quarterly)* for the Apr-Jun quarter revealed the steady growth of capital investment, which in turn are reflected in the recent revised GDP figures.

In terms of business sector, capital investment among manufacturers grew a dramatic 19.8% o-y-a (including spending on computer software). In particular, capital investment among material-related industries such as iron & steel (121.5% o-y-a) and chemicals (37.5% o-y-a) grew significantly, revealing the strong growth of capital investment across a wide industrial spectrum. The non-manufacturing sector revealed promising signs. Even though capital investment in the service sector – comprising a large section of the non-manufacturing sector – dropped 7.8% o-y-a, capital investment surged among real estate businesses (62.7% o-y-a) and wholesalers & retailers (14.1% o-y-a). Capital investment among electrical power companies also picked up (3.8%), emerging out of a sharp downswing.

**Ongoing rise of corporate business performance**

The strong growth of capital investment is sustained by the improvement of corporate business performance amid the steady growth of demand. According to the *Financial Statements Statistics of Corporations by Industry (Quarterly)*, sales among business corporations rose 3.0% o-y-a on an all-industries basis in the Apr-Jun quarter of 2005, rising for the ninth quarter in a row while current profits grew 12.9% o-y-a, rising for the 12<sup>th</sup> consecutive quarter. The double digit growth of current profits – achieved by cutting sales and general administrative expenses – even amid the rise of raw material costs such as crude oil, indicates a significant improvement of corporate profitability.

[ Chart 2: Inventory cycle of IT-related producer goods ]



Source: Ministry of Economy, Trade and Industry.

[ Chart 3: Corporate earnings forecast ]

		(Y-o-y % change)				
		FY2004	FY2005 (Forecast)		FY2006 (Forecast)	
			1H	2H		
All industries	Sales	5.6	3.0	2.8	3.3	4.0
	Current profits	24.6	7.0	8.8	5.4	8.8
Manufacturing	Sales	5.3	3.3	3.4	3.2	3.7
	Current profits	28.3	6.4	8.6	4.5	7.9
Non-manufacturing	Sales	5.7	2.9	2.5	3.1	4.2
	Current profits	22.2	7.3	9.6	5.7	9.5
Large corporations	Sales	5.8	4.4	4.7	4.0	4.9
	Current profits	24.8	7.9	10.4	5.5	9.5
Manufacturing	Sales	5.5	3.9	4.1	3.8	4.2
	Current profits	26.6	6.5	8.3	4.8	8.6
Non-manufacturing	Sales	6.0	4.7	5.2	4.3	5.3
	Current profits	22.8	9.5	12.5	6.3	10.6
Small and medium corporations	Sales	5.4	2.1	1.5	2.7	3.4
	Current profits	24.5	5.9	6.6	5.4	8.0
Manufacturing	Sales	4.9	2.4	2.4	2.5	2.9
	Current profits	32.1	6.1	9.3	3.8	6.4
Non-manufacturing	Sales	5.5	2.0	1.2	2.8	3.6
	Current profits	21.8	5.8	5.5	6.0	8.6

Note: "Large corporations" refer to corporations with capital of 1 billion yen or over, "medium corporations" refer to corporations with capital of 100 million to 1 billion yen, and "small corporations" refer to corporations with capital of 10 to 100 million yen.

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

**Capital investment will keep growing amid the rise of corporate business performance**

Judging from the above, corporate earnings will likely keep growing amid the steady growth of demand and the alleviation of deflationary pressures (**Chart 3**). However, during the current fiscal year, the rise of costs will serve as negative pressures upon the rate of profit increase, based on forecasts that the price of crude oil will remain pinned at a high level. Furthermore, since the engine of Japan's economic growth is shifting to domestic demand, corporate business performance among non-manufacturers should improve further in FY2006.

Reflecting the ongoing improvement of corporate business performance, the steady growth of capital investment should continue and spread to the non-manufacturing sector.

**The labor share of output will bottom out reflecting the ebb of sentiment on excess labor**

In addition to capital investment, another key point in the outlook on Japan's economy is whether the improvement of corporate business performance will lead more readily to the increase of labor costs. The *Financial Statements Statistics of Corporations by Industry (Quarterly)* for the Apr-Jun quarter indicated that the labor share of output is bottoming out amid the reduction of excess labor (**Chart 4**). Going forward, businesses will most likely refrain from excessive restraints upon labor costs and accept the rise of labor costs as long as they correspond to the rise of earnings.

**Household income environment will continue to improve**

These shifts are also verified by employment and income statistics. The number of employed workers is continuing to rise in 2005 along with the increase of full-time workers (permanent employees). The labor market is improving not only quantitatively but also in qualitative terms. The rise of part-time employment – thus far serving as a drag upon average wages – is coming to a pause, causing scheduled cash earnings (base wages) per employee to increase above the previous year since April. Furthermore, summer bonus payments grew above the previous year in a wide range of business sectors, reflecting the improvement of corporate business performance, leading to a sharp rise of labor compensation (payrolls) (**Chart 5**).

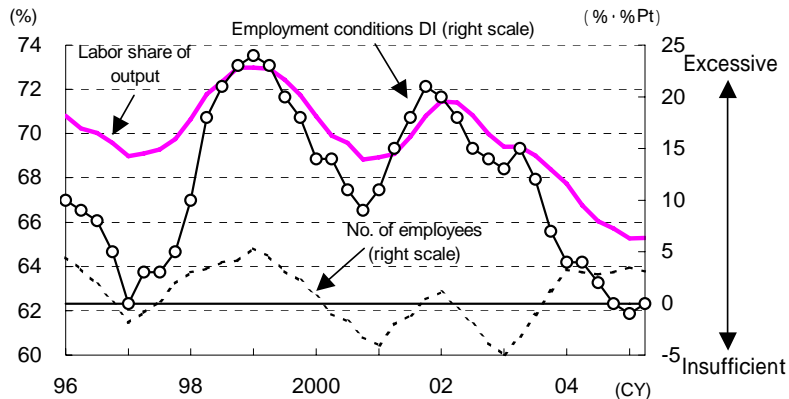
**Consumer spending should remain strong**

Given the ongoing improvement of household income conditions, consumer spending continued to grow steadily along with the upturn of consumer confidence in the Apr-Jun quarter. Despite the sluggish pace of personal consumption at the moment, as shown by real consumption expenditures in July (*Family Income and Expenditure Survey*) falling a sharp 4.7% in comparison to the Apr-June average, we are inclined to toward the view that consumer spending will continue to grow steadily on the tailwinds of the improvement of household income conditions along with the rise of corporate business performance.

**The upturn of exports will also underpin the economy**

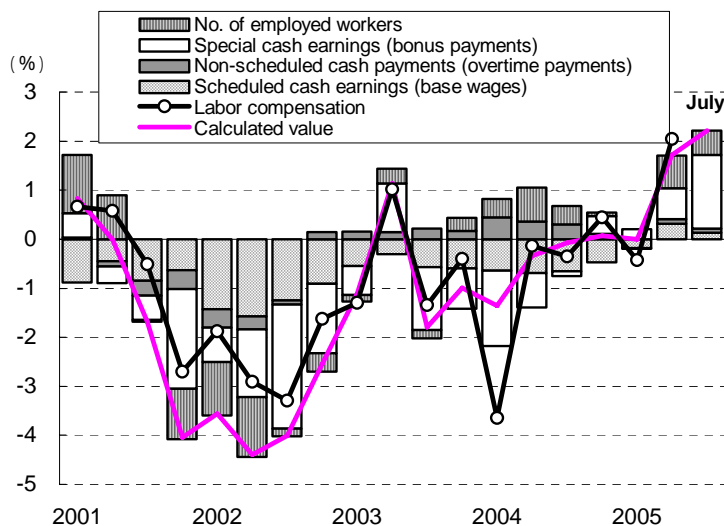
Exports – in particular with respect to Asia-bound exports – are also showing signs of recovery from the doldrums since the turn of the year. Looking forward, even though the fall of inventory investment may serve as a drag, the Japanese economy should continue to expand, driven by the growth of domestic private-sector demand and the recovery of exports.

**[ Chart 4: The labor share of output and the employment conditions DI ]**



Note: "Labor share of output" = labor cost/value-added output x 100.  
 "No. of employees" = % ch o-y-a. Both the labor share of output and the no. of employees are 4-qtr moving averages on an all-industries, all-sizes basis.  
 Sources: Ministry of Finance, *Financial Statements Statistics of Corporations by Industry*, Bank of Japan, *Short-Term Economic Survey of Enterprises in Japan (Tankan)*.

**[ Chart 5: Trends in labor compensation (payrolls) ]**



Note: "Calculated value" = nominal wages x number of employed workers.  
 The bars represent the contribution to the line (calculated value).  
 Sources: Ministry of Health, Labor and Welfare, *Monthly Labor Survey*, Ministry of Internal Affairs and Communications, *Labor Force Survey*, Cabinet Office, *Annual Report on National Accounts*.

## 2. Forecast of the Japanese economy in FY2005 and FY2006

**FY2005 growth will surpass previous year: 2.3% (real GDP), 1.2% (nominal GDP)**

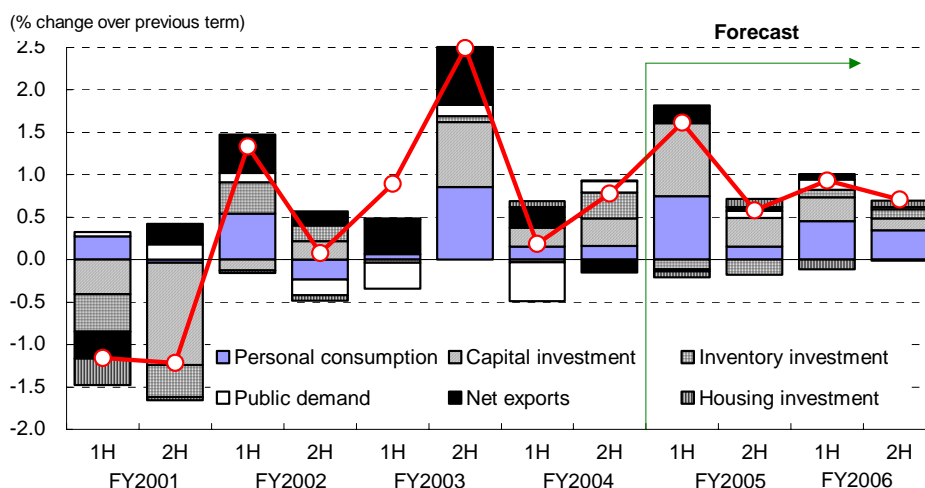
**Deflationary pressures will subside, stemming from ongoing above-potential growth**

**1H FY2005** Judging from the foregoing, the Japanese economy will show a steady expansion of private-sector final demand amid: (1) the upturn of personal consumption reflecting the improvement of the income environment, (2) the acceleration of corporate capital investment along with its spread to the non-manufacturing sector, and (3) the recovery of exports reflecting the progress of the inventory adjustment process overseas. Given these developments, stocks of unsold inventories in the private sector will be eliminated and the Japanese economy will show more definite signs of stronger growth.

**2H FY2005** Japan's economic growth will slow slightly due to a reaction to the strong growth in the first half of the fiscal year (**Chart 6**). By this time, the improvement of corporate business performance will lead to the steady growth of personal consumption through the rise of capital investment and increase of household income. The growth of final demand will lead to a further improvement of corporate business performance, setting in motion a virtuous cycle where the Japanese economy is able to feed its own recovery.

As a result, we expect Japan's real GDP to grow a strong 1.6% q-o-q (3.3% p.a.), surpassing potential economic growth in the first half of FY2005. In the second half of FY2005, the economy will keep growing at around 0.6% (1.2% p.a.) (**Chart 7**). This brings full-year GDP growth in FY2005 to 2.3% y-o-y (previous forecast: 1.9% y-o-y) in real terms and 1.2% y-o-y (previous forecast 0.9% y-o-y) in nominal terms.

[ **Chart 6: Forecast on Japan's real GDP growth** ]



Note: Figures from 1H FY2005 are MHR1 forecasts.  
Source: Cabinet Office, *Preliminary Quarterly Estimates of GDP*.

**1H FY2006: the economy will keep growing around 2% per annum**

**2H FY2006: growth will slow down due to the appreciation of the yen**

**1H FY2006** The economy will continue to follow an autonomous recovery track given the steady growth of domestic and external demand. Even though the contribution by net exports will fall due to sluggish exports and rise of imports reflecting the growth of domestic demand and the appreciation of the yen, the Japanese economy will continue to grow around 2% in annualized terms given the strong growth of private-sector final demand.

**2H FY2006:** Exports will fall along with the US economic slowdown and the appreciation of the yen, tipping the contribution by net exports into negative territory. Turning to domestic demand, (1) consumer spending is also predicted to slow down due to the abolition of across-the-board tax credits, while (2) concerns regarding future demand stemming from the strong yen and sluggish consumer spending will dampen the growth of capital investment.

Judging from the foregoing, MHRI forecasts that Japan's real GDP in FY2006 will slow from 0.9% over the previous term (1.9% p.a.) in the first half of FY2006 to 0.7% over the previous term (1.4% p.a.) in the second half. This brings full-year GDP growth in FY2006 to 1.6% y-o-y in real terms and 1.3% y-o-y in nominal terms.

[ Chart 10: Outlook on the Japanese Economy]

	FY2004 (Actual)	FY2005 (Forecast)	FY2006 (Forecast)	FY2005		FY2006		FY2005	FY2006
				1H	2H	1H	2H	(Contribution)	(Contribution)
				(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)
GDP (real)	1.9	2.3	1.6	1.6	0.6	0.9	0.7	-	-
Domestic demand	1.5	2.2	1.5	1.4	0.5	0.9	0.7	2.1	1.5
Private sector demand	2.3	2.7	1.7	1.9	0.6	1.0	0.9	2.1	1.3
Personal consumption	1.2	1.6	1.3	1.3	0.3	0.8	0.6	0.9	0.7
Housing investment	2.1	-0.6	-0.8	-2.0	2.7	-3.1	2.3	-0.0	-0.0
Capital investment	5.2	7.8	3.2	5.5	2.1	1.7	0.9	1.2	0.5
Public sector demand	-1.4	0.3	0.9	-0.1	0.4	0.6	0.1	0.1	0.2
Government consumption	2.7	2.3	2.4	1.0	1.5	1.2	0.7	0.4	0.4
Public investment	-15.1	-7.4	-5.6	-4.1	-4.4	-2.3	-2.7	-0.3	-0.2
Net exports (contribution)	0.5	0.1	0.0	0.2	0.1	0.1	-0.0	0.1	0.0
Exports	11.9	6.7	6.4	3.7	4.0	3.2	2.2	0.9	0.9
Imports	9.3	6.5	6.7	2.4	4.2	3.2	2.7	-0.7	-0.9
GDP (nominal)	0.8	1.2	1.3	0.9	0.2	0.9	0.4		
Industrial production	4.1	1.7	3.9	0.8	2.1	2.5	0.8		
Unemployment	4.6	4.2	3.7	4.4	4.0	3.8	3.6		
Current account balance	18.3	17.1	18.3	16.5	17.6	19.4	17.3		
as a percentage of nominal GDP	3.6	3.3	3.5	3.2	3.4	3.7	3.3		
Corporate goods prices	1.5	1.2	-0.6	1.5	0.8	-0.1	-1.1		
Consumer prices	-0.3	-0.0	0.2	-0.1	0.1	0.1	0.2		
Long-term interest rate (%)	1.52	1.43	1.85	1.30	1.55	1.75	1.95		
Nikkei stock average (yen)	11,321	12,350	13,400	11,700	13,000	13,400	13,400		
Exchange rate (yen/dollar)	107.5	109	102	109	108	103	101		
Crude oil price (WTI \$/barrel)	45.1	59.0	54.6	57.2	60.9	56.7	52.5		

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 a year ago.

Consumer prices = nationwide (excluding fresh foods).

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

Figures on current account balance are converted into annualized rates.

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 Internal Affairs and Communications, *Labor Force Survey, Consumer Price Index*,

Ministry of Finance, *Balance of Payments*,

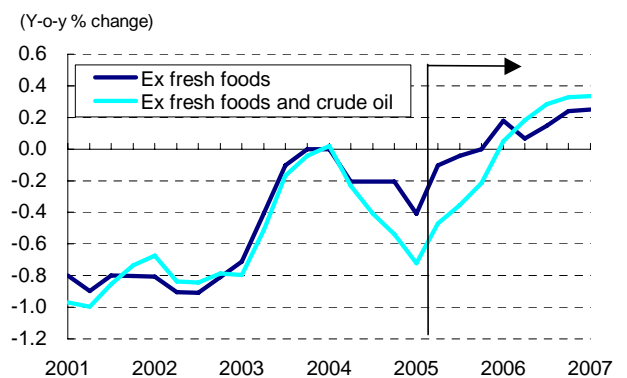
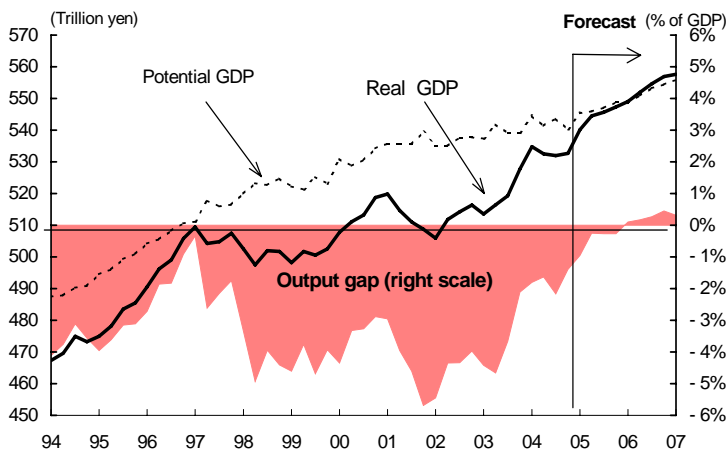
Bank of Japan, *Corporate Goods Price Index*.

**The percentage rise of the CPI will turn positive in early 2006**

The output gap (the gap between demand and supply) will narrow and disappear early in 2006 as a result of Japan's ongoing economic growth (**Chart 8**) and gradually lead to the rise of prices in various ways such as the rise of upward pressures upon wages. In addition, the surge of crude oil prices will serve as upward pressures upon prices through the price of gasoline and push the percentage rise of the consumer price index into positive territory in the Jan-Mar quarter of 2006 (**Chart 9**). One of the preconditions set forth by the BOJ for the termination of the quantitative easing policy, namely that "the consumer price index registers stably a zero percent or an increase year on year" should be fulfilled around mid-2006.

[ Chart 8: The output gap ]

[ Chart 9: The consumer price index (CPI) ]



Note: Estimates by MHRI. Contribution by total factor productivity is not included in potential GDP.  
Sources: Cabinet Office, Ministry of Economy, Trade and Industry, Ministry of Internal Affairs and Communications and others.

Note: "Ex fresh foods and crude oil" = "Ex fresh foods" minus gasoline and heating oil.  
Source: Ministry of Internal Affairs and Communications, *Consumer Price Index*.

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**MIZUHO**

The logo features 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', with a slight upward curve in the middle.