

## Economic Outlook for FY2006 and FY2007

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

March 2006

The Mizuho Research Institute Ltd. (MHRI) has revised its economic outlook for FY2006 and FY2007 subsequent to the release of *The Second Preliminary Quarterly Estimates of GDP* ("2<sup>nd</sup> QE") for the Oct-Dec quarter of 2005. The key points of the outlook are as follows.

### <The Overseas Economies>

<b>US</b>	Despite ongoing solid growth, the economy will slow down as the residential real estate market cools down 2006: (previous outlook) 3.2% → (current outlook) 3.2% 2007: (previous outlook) 3.0% → (current outlook) 3.0%
<b>Euro Zone</b>	Exports will serve as a drag upon economic growth 2006: (previous outlook) 1.9% → (current outlook) 1.9% 2007: (previous outlook) 1.7% → (current outlook) 1.7%
<b>Asia</b>	Ongoing strong growth, underpinned by IT demand and the rise of investment in China 2006: (previous outlook) 6.8% → (current outlook) 6.9% 2007: (previous outlook) 7.0% → (current outlook) 7.0%

### <The Japanese Economy>

<b>FY2005</b>	Full-fledged recovery of domestic private demand will serve as the driver of strong economic growth Real GDP: (previous outlook) 3.4% → (current outlook) 3.3% Nominal GDP: (previous outlook) 2.0% → (current outlook) 2.0%
<b>FY2006</b>	Continuation of self-sustained recovery will lift Japan out of deflation Real GDP: (previous outlook) 2.7% → (current outlook) 2.7% Nominal GDP: (previous outlook) 2.5% → (current outlook) 2.5%
<b>FY2007</b>	Ebb of corporate business profit growth will drag down capital investment Real GDP: (previous outlook) 1.7% → (current outlook) 1.7% Nominal GDP: (previous outlook) 1.8% → (current outlook) 1.8%

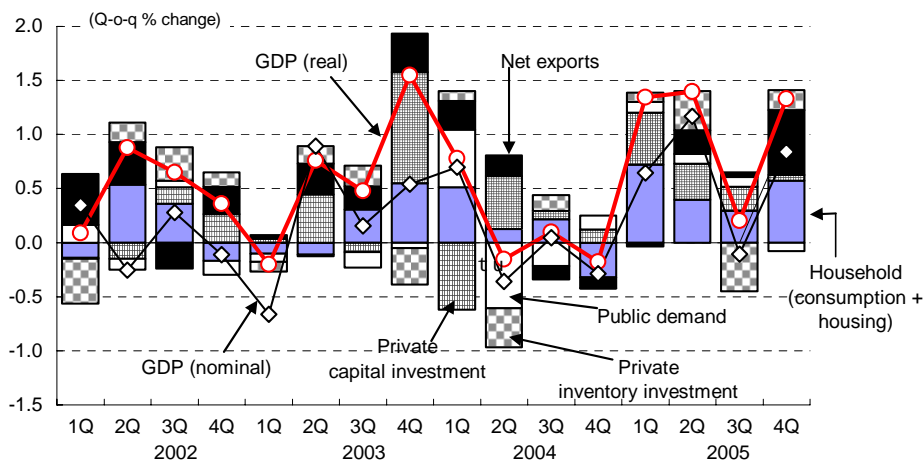
This English-language translation is based upon the outlook in Japanese released on March 14, 2006. This publication is compiled solely for the purpose of providing readers with information and is in no way meant to encourage readers to buy or sell financial instruments.

## I. The current state of the Japanese economy

**The Japanese economy grew a solid 5.4% q-o-q p.a. in the Oct-Dec quarter of 2005**

The *Second Preliminary Quarterly Estimates of GDP* (“2<sup>nd</sup> QE”) for the Oct-Dec quarter of 2005 revealed that Japan’s real GDP grew a solid 1.3 % q-o-q (5.4% per annum) (Chart 1). In addition to the ongoing growth of domestic private sector final demand (personal consumption and capital investment), the contribution by external demand also rose sharply.

[ Chart 1: Japan’s quarterly GDP growth (2<sup>nd</sup> QE results)]



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

**Private sector final demand is continuing to expand**

Looking closer at the components of demand, personal consumption grew 0.9% q-o-q (0.4% q-o-q in the previous quarter from July to September of 2005) driven by the rise in demand for warm clothing and heating due to the cold winter weather. Capital investment, while slowing to 0.4% q-o-q (1.5% q-o-q in the previous quarter), still continued to grow. Exports grew 3.5% q-o-q (3.1% in the previous quarter), recording the third straight quarter of growth at the 3%-level. Imports, on the other hand, dropped to 0.9% q-o-q (3.2% q-o-q in the previous quarter). The contribution by external demand thus rose to 0.6% pt q-o-q, pushing up the rate of economic growth. Although the contribution by private sector inventory investment rose 0.2% pt q-o-q, this is because manufacturers are not running down their inventories as much as before, and does not indicate that inventories of unsold goods are piling up.

**The decline of the GDP deflator is due mainly to the rise of the import deflator**

The GDP deflator, a broad measure of price changes, stood at -1.6% over a year ago (o-y-a), falling deeper into negative territory in comparison to -1.4% o-y-a in the previous year. Since this is due to a sharp rise of the import deflator (13.3% y-o-y) along with the surge of crude oil prices, it does not represent the rise of deflationary pressures.

Overall, the 2<sup>nd</sup> QE results portray that the self-sustained recovery of the economy is continuing, driven mainly by domestic private sector final demand.

**The BOJ ends  
quantitative monetary  
easing policy**

The Bank of Japan (BOJ) decided to end its quantitative monetary easing policy at its Monetary Policy Meeting held on March 8<sup>th</sup> and 9<sup>th</sup>, as the consumer price index (general “CPI” excluding fresh foods) rose year on year in January, marking the third consecutive month of gain. Given the rise of economic growth above the potential growth rate, the output gap (the gap between demand and supply) calculated by MHRI rose into positive territory in the Oct-Dec quarter of 2005. The BOJ’s decision at this point in time is appropriate in the light of the current conditions.

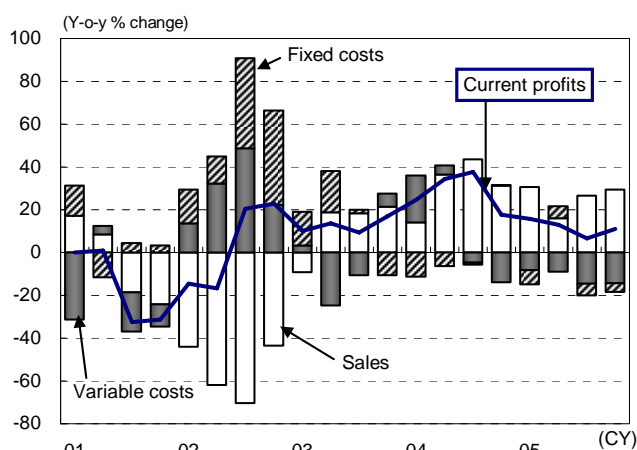
Taken together, we find no reasons for a major revision of our *Economic Outlook for FY2006* released on February 21, 2006.

## II. Forecast of the Japanese economy in FY2006

**Corporate profit growth recovered to double-digit levels in the Oct-Dec quarter of 2005**

Current profits (based upon the *Financial Statements Statistics of Corporations by Industry*) grew 11.1% y-o-y (6.6% in the previous quarter) in the Oct-Dec quarter of 2005, recovering to double-digit profit growth (**Chart 2**). Even though the rise of raw material and fuel costs along with the surge of crude oil prices continued to serve as negative pressures upon corporate profits, the rate of profit growth picked up for the first time in five quarters as a result of the shift of costs to prices and the recovery of sales.

[ Chart 2: Current profits ]



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

**The strong corporate performance is continuing in FY2006**

Looking forward, corporate profits should grow around 10% y-o-y in the first half of 2006 along with Japan's autonomous economic recovery driven by domestic private sector demand. Despite forecasts that the pace of profit growth will slow down in the second half of FY2006 due to the ebb of external demand along with the deceleration of the overseas economies (mainly the US), corporate profit should grow around 7% y-o-y on a full-year basis in FY2006, marking the fifth consecutive year of profit growth (**Chart 3**).

[ Chart 3: Corporate earnings forecast ]

		(Y-o-y % change)			
		FY2004	FY2005	FY2006	FY2007
			(Forecast)	(Forecast)	(Forecast)
All industries	Sales	5.6	4.6	4.1	3.0
	Current profits	24.6	10.3	7.3	3.2
Manufacturing	Sales	5.3	6.0	3.9	1.7
	Current profits	28.3	14.4	7.1	3.0
Non-manufacturing	Sales	5.7	4.0	4.1	3.6
	Current profits	22.2	7.4	7.4	3.4
Large corporations	Sales	5.8	6.3	4.7	2.9
	Current profits	24.8	12.6	8.2	3.6
Manufacturing	Sales	5.5	6.9	4.3	1.8
	Current profits	26.6	15.6	7.6	3.3
Non-manufacturing	Sales	6.0	5.8	5.0	3.8
	Current profits	22.8	9.2	8.9	4.1
Small and medium corporations	Sales	5.4	3.4	3.6	3.1
	Current profits	24.5	7.7	6.2	2.7

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

**FY2007: profit growth will slow sharply**

**Our forecast on FY2006 and FY2007 growth remains unchanged**

In FY2007, the rise of fixed costs such as labor costs will weigh heavily upon current profit growth. As a result, the pace of corporate profit growth will slow down in FY2007, dragging down capital investment in the corporate sector.

We have revised our economic outlook as set forth in **Chart 4**, to reflect the 2<sup>nd</sup> *QE* for the Oct-Dec quarter of 2005 and the *Financial Statements Statistics of Corporations by Industry*. The rate of real GDP growth in FY2005 was revised down from the previous forecast of 3.4% y-o-y as of February 21, 2006 to 3.3% y-o-y, due to a slight downward revision of growth in the Oct-Dec quarter of 2005. Our forecast on real GDP growth in FY2006 and FY2007 remains unchanged at 2.7% y-o-y and 1.7% y-o-y respectively.

[ Chart 4: Outlook on the Japanese economy ]

(%)

	FY2004	FY2005	FY2006	FY2007	FY2004	FY2005	FY2006	FY2007
	(Actual)	(Forecast)	(Forecast)	(Forecast)	(Contribution)	(Contribution)	(Contribution)	(Contribution)
	(Actual)	(Forecast)	(Forecast)	(Forecast)	(Actual)	(Forecast)	(Forecast)	(Forecast)
GDP (real)	1.7	3.3	2.7	1.7	-	-	-	-
Domestic demand	1.3	3.0	2.4	1.4	1.2	2.9	2.3	1.4
Private sector demand	2.1	3.6	2.9	1.7	1.6	2.7	2.2	1.3
Personal consumption	1.7	2.4	1.8	1.9	1.0	1.4	1.0	1.1
Housing investment	1.7	0.7	1.3	-0.3	0.1	0.0	0.0	-0.0
Capital investment	5.4	7.5	6.6	2.0	0.7	1.1	1.0	0.3
Public sector debt	-1.4	1.0	0.4	0.6	-0.3	0.2	0.1	0.1
Government consumption	1.8	1.7	2.2	2.1	0.3	0.3	0.4	0.4
Public investment	-12.4	-1.8	-7.0	-5.1	-0.7	-0.1	-0.3	-0.2
Net exports (contribution)	0.5	0.5	0.3	0.2	0.5	0.5	0.3	0.2
Exports	11.4	9.0	7.7	4.8	1.4	1.2	1.1	0.7
Imports	8.7	6.5	6.4	3.9	-0.9	-0.8	-0.9	-0.5
GDP (nominal)	0.5	2.0	2.5	1.8				
GDP deflator	-1.2	-1.3	-0.2	0.1				
Industrial production	4.1	1.7	3.8	2.4				
Unemployment rate	4.6	4.4	4.0	3.7				
Current account balance (trillion yen)	18.3	18.0	20.1	22.2				
as a percentage of nominal GDP	3.7	3.6	3.9	4.2				
Corporate goods prices	1.5	2.0	1.2	-0.3				
Consumer prices	-0.3	0.0	0.2	0.4				
Long-term interest rate (%)	1.52	1.41	1.90	2.15				
Nikkei stock average (yen)	11,321	13,547	17,300	18,100				
Exchange rate (yen/dollar)	107.5	113	110	107				
Crude oil price (WTI \$/barrel)	45.1	59.4	59.5	51.8				

(%)

	FY2004		FY2005		FY2006	
	1H	2H	1H	2H	1H	2H
	(Actual)	(Actual)	(Actual)	(Forecast)	(Forecast)	(Forecast)
GDP (real)	0.3	0.5	2.2	1.8	1.3	0.9
Domestic demand	0.0	0.7	2.0	1.2	1.3	1.0
Private sector demand	0.6	0.9	2.4	1.6	1.6	1.1
Personal consumption	0.7	0.3	1.7	1.2	0.8	0.9
Housing investment	1.8	-0.2	-1.7	5.4	-1.3	-0.1
Capital investment	1.6	2.8	4.8	2.5	4.5	1.8
Public sector debt	-1.9	0.3	0.8	-0.0	0.1	0.6
Government consumption	0.8	0.9	0.9	0.8	1.2	1.3
Public investment	-11.6	-2.1	0.9	-3.2	-4.4	-2.2
Net exports (contribution)	0.3	-0.2	0.2	0.6	0.0	-0.0
Exports	6.0	1.3	4.9	6.3	3.7	1.5
Imports	4.6	3.1	3.8	2.0	4.2	2.1
GDP (nominal)	0.0	0.1	1.4	1.1	1.8	0.1
GDP deflator	-1.5	-0.8	-1.2	-1.3	-0.2	-0.3
Industrial production	2.2	-0.1	0.3	2.8	2.0	1.0
Unemployment rate	4.7	4.6	4.3	4.4	4.1	4.0
Current account balance (trillion yen)	18.7	18.3	17.2	18.8	18.3	21.8
as a percentage of nominal GDP	3.8	3.7	3.4	3.7	3.5	4.2
Corporate goods prices	1.4	1.7	1.6	2.4	1.9	0.5
Consumer prices	-0.2	0.2	-0.1	0.2	0.2	0.2
Long-term interest rate (%)	1.62	1.42	1.29	1.53	1.80	2.00
Nikkei stock average (yen)	11,339	11,303	11,794	15,300	17,100	17,500
Exchange rate (yen/dollar)	109.8	105.2	109.4	117	112	107
Crude oil price (WTI \$/barrel)	41.1	49.2	58.2	60.6	61.4	57.5

- 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.  
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, Indices of Industrial Production, Producer's Inventory of Finished Goods, Producer's Inventory Ratio of Finished Goods (Index), 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.

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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', goes up to touch the 'U', and then curves down to end under the 'O'.