

Economic Outlook for FY2006 and FY2007

November 2006

The Mizuho Research Institute Ltd. (MHRI) has revised its economic outlook for FY2006 and FY2007 subsequent to the release of Japan's GDP statistics for the Jul-Sep quarter of 2006. The key points of the outlook are as follows.

<The US Economy>

A slowdown mainly in the household sector, with an upturn in the second half of 2007

2006 3.5% (previous outlook) → 3.3% (current outlook)

2007 2.8% (previous outlook) → 2.4% (current outlook)

<The Japanese Economy>

FY2006 Despite an ongoing autonomous recovery, exports will slow down in the second half of the fiscal year

Real GDP: 2.3% (previous outlook) → 2.3% (current outlook)

Nominal GDP: 2.1% (previous outlook) → 1.8% (current outlook)

FY2007 Capital investment will serve as a drag, due to slower corporate profit growth

Real GDP: 1.6% (previous outlook) → 1.7% (current outlook)

Nominal GDP: 2.2% (previous outlook) → 2.6% (current outlook)

This English-language translation is based upon the outlook in Japanese released on November 16, 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 US economy

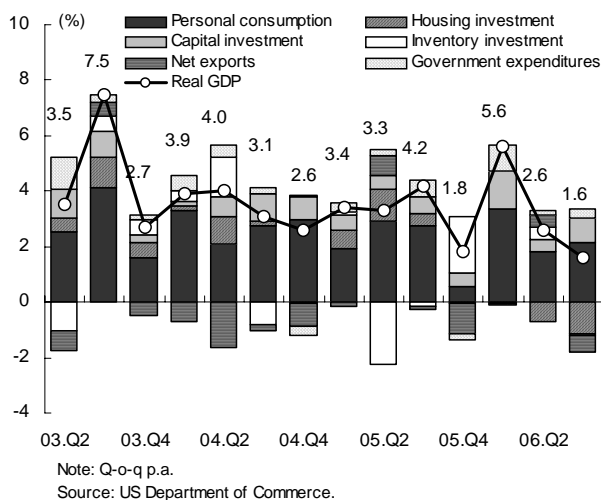
A further slowdown of the US economy in the Jul-Sep quarter of 2006, due mainly to the downturn of housing investment

US gross domestic product (GDP) in real terms grew an anemic 1.6% q-o-q p.a. in the Jul-Sep quarter of 2006 (preliminary estimates as of October 27th), slowing sharply from the previous quarter (2.6% q-o-q p.a.) (**Chart 1**). The primary cause was the worse-than-expected fall of housing investment. Housing investment dropped at a faster pace (-17.4% q-o-q p.a.) than the previous quarter (-11.1% q-o-q p.a.), contributing negatively to real GDP growth (-1.1%).

Despite the sharper-than-expected fall of housing investment, its impact is not yet spreading to other components of demand. Personal consumption rose 3.1% q-o-q p.a., growing stronger than the previous quarter and business capital investment also staged a dramatic recovery (8.6% q-o-q p.a.). The both combined result in a strong 3.9% q-o-q p.a. rise of demand. Furthermore, imports accelerated to 7.8% q-o-q p.a. (1.4% q-o-q p.a. in the previous quarter), reflecting the strength of consumer spending and capital investment. Thus, despite the solid growth of exports (6.5% q-o-q p.a.), driven on the tailwinds of steady overseas economic expansion, net exports turned out to drag down (-0.6%) the rate of US growth.

Even though the odds are high that the rate of real GDP growth in the Jul-Sep quarter will be upwardly revised, judging from the string of data releases (construction expenditures, inventories and trade) since the preliminary estimates of real GDP growth, the revision will likely be small (+0.1% pt to +0.2% pt).

[Chart 1: US real GDP growth]



Q-o-q % change (p.a.)	2006.Q3	Contribution	2006.Q2
Real GDP	+ 1.6	-	+ 2.6
Personal consumption	+ 3.1	+ 2.13	+ 2.6
Housing investment	-17.4	-1.12	-11.1
Capital investment	+ 8.6	+ 0.88	+ 4.4
Inventory investment	+ 50.7	-0.10	+ 53.7
Net exports	-639.9	-0.58	-624.2
Exports	+ 6.5	+ 0.70	+ 6.2
Imports	+ 7.8	-1.28	+ 1.4
Government expenditures	+ 2.0	+ 0.37	+ 0.8
Domestic final demand	+ 2.2	-	+ 1.6
GDP deflator	+ 1.8	-	+ 3.3

Note: The q-o-q % change (p.a.) of inventory investment and net exports represent levels (unit: billion dollar).

The core inflation rate is showing signs of stabilizing

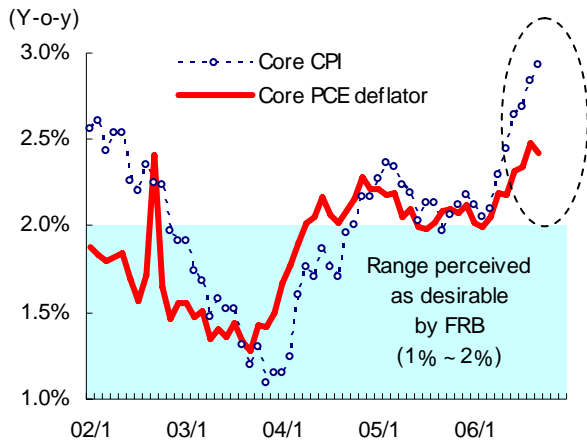
Turning to price movements, the core inflation rate – a measure of fundamental price rises – remains far above levels deemed as the price stability zone (+1% to +2% y-o-y). However, note that certain parts of the core inflation rate are starting to show signs of stabilization.

Both the core personal consumption expenditures (PCE) deflator (a measure of inflation favored by the Federal Reserve Board (the Fed)) and the core CPI are

continuing to surge, rising 2.4% y-o-y and 2.9% y-o-y respectively in September (**Chart 2**). That said, the core inflation rate on a month-on-month basis is stabilizing around 0.2%, indicating a pause in the rise of inflation. Inflation expectations – monitored closely by the Fed as an inflation factor – is also starting to calm down (**Chart 3**).

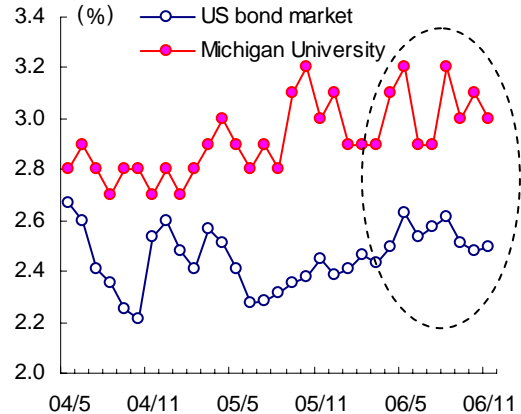
However, as the flip side of the strength of jobs and income, the unemployment rate is stabilizing at a low level while labor costs are continuing to rise. Thus the probability of a sharp fall of the core inflation rate still remains low.

[Chart 2: The core inflation rate]



Sources: US Department of Commerce, Department of Labor.

[Chart 3: Inflation expectations]



Note: Expected inflation rate 5 to 10 years from now.
Sources: Bloomberg, Michigan University.

2006: forecast on growth revised down from 3.5% to 3.3%
2007: forecast revised down from 2.8% to 2.4%

Reflecting the worse-than-expected downturn of housing investment, the housing investment correction should turn out to be somewhat longer than initially expected. As a result of the housing investment downturn serving as a drag upon growth, the US economy will continue to grow at a pace falling below the potential growth rate deemed to be approximately 3% p.a. throughout the first half of 2007.

That said, the odds are high that personal consumption will remain on solid footing, since the fall of petroleum prices since the summer and the bullish stock market are serving as fresh drivers of consumer spending and the employment slowdown is turning out to be relatively mild. Given the support by strong consumer spending, the slowdown of business capital investment should also turn out to be benign.

We have revised downward our outlook on growth in 2006 from 3.5% to 3.3% and our outlook on growth in 2007 from 2.8% to 2.4%.

Meanwhile, our forecast on the core inflation rate (the rate of rise of the core PCE deflator) remains unchanged from our previous outlook, at 2.3% in 2006 and 2.4% in 2007. We should be able to discern a peak-out of the core inflation rate on a year-on-year (y-o-y) basis some time around the Apr-Jun quarter of 2007.

The key points in the current state and outlook on the US economy in this outlook are as follows. On the demand side, (1) even though the housing

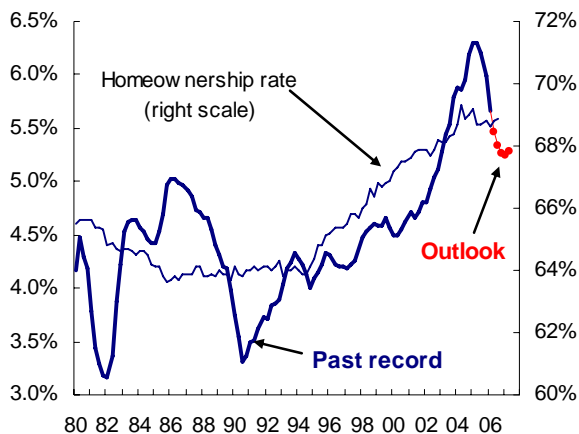
The housing investment correction will continue until the end of 2007. Even so, there are more signs that home prices are bottoming out

investment correction will turn out slightly longer than initially expected, (2) the housing investment downturn will only have a limited impact on other components of demand, and (3) consumer spending and business capital investment will remain on solid footing. On the supply side, (1) the housing investment decline will continue to have a negative impact and (2) sluggish auto sales among domestic automakers will generate inventory adjustment pressures and hold down production activity at low levels.

A reliable indicator of the degree of housing investment correction is the housing investment ratio (ratio to nominal GDP). The housing investment ratio surged during the housing boom (of owner-occupied residences) in the second half of the 1990s and the rise of speculative housing investment since 2003 (Chart 4). Reflecting the end of the housing boom last summer, the ratio has been declining at a rapid pace after peaking at 6.3% in the Oct-Dec quarter of 2005. As evidenced by the pause in rise of the home ownership rate and media reports that residential prices are starting to fall on a year-on-year basis in certain areas, the housing market faces a stiff resistance and the housing investment ratio should continue to follow a downtrend for some time. If the housing investment ratio declines to the average level in the past, there is a high probability that the US economy may not avoid a major slowdown.

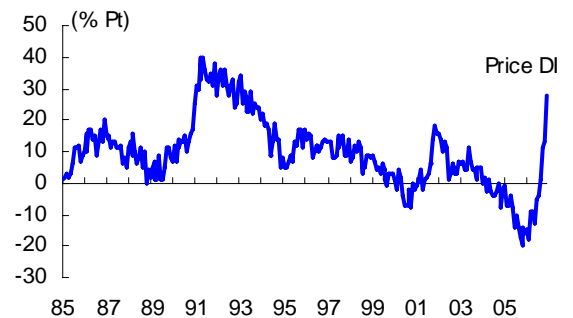
However, note that there is a silver lining in the clouds. In addition to a slight recovery in the number of home sales and construction starts in September, consumers are starting to feel that residential prices are undervalued. According to a Michigan University survey, more consumers are feeling that residential prices are undervalued. Since August this year, those feeling that home prices are undervalued have surpassed the percentage of those feeling that prices are overvalued (Chart 5).

[Chart 4: US Housing investment]



Note: Nominal housing investment as a percentage of GDP.
Sources: US Department of Commerce, MHR.

[Chart 5: Consumers' perception of home prices]



Note: Price DI = Percentage of those feeling that "prices are undervalued and that conditions for buying are good" minus percentage of those feeling that "prices are overvalued and that conditions for buying are not good". (compiled by MHR)

Source: Michigan University.

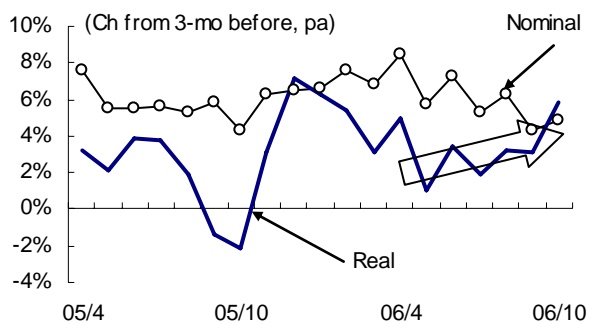
Employment and income conditions remain firm. Lower oil prices and stock market strength serve to buffer the impact of the slower rise of residential prices upon consumer spending

Judging from the foregoing, we have revised downward our outlook on housing investment and now predict that the housing investment slowdown will persist for a slightly longer period than initially expected. Even so, given that the housing market has weathered its worst moments, the pace of market slowdown should gradually start to ease.

Employment and income conditions remain firm even amid the housing market correction. Given tailwinds such as lower crude oil prices and the strength of the stock market, consumer spending should continue to expand at a moderate pace.

According to latest data on employment, the August and September nonfarm payrolls were subject to a sharp upward revision. Compared to initial estimates of payroll growth around 120 thousand workers per month, payrolls actually grew 150 million. Taking the wage index (hourly wages multiplied by the total work hours index) as a proxy variable of employment income, the percentage rise of wages (compared to three months ago, in annualized terms) was revised upward by 1% pt in September. As of October, the wage index is still high at 4.8% p.a. compared to three months ago (**Chart 6**). Furthermore, the index is probably even higher in real terms, around 5% p.a., given a lower rate of inflation (general) stemming from the fall of crude oil prices since the summer season. The combination of falling crude oil prices and a mild slowdown of employment income leads to our view that real purchasing power among US households will remain firm. Moreover, even though the rise of home prices is slowing down and the asset effect upon consumer spending is contracting, the strength of the stock market should serve as a buffer. Coupled with the aforementioned firmness of real purchasing power, consumer spending should continue to expand at a moderate pace.

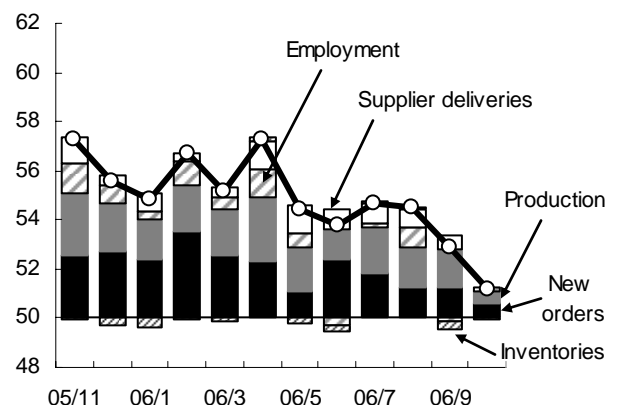
[Chart 6: Trends in employment income]



Note: Wage index = hourly wages x total work hours index. Nonfarm private sector. Converted into real terms by the personal consumption expenditures deflator (forecast for October).

Sources: US Department of Labor, US Department of Commerce.

[Chart 7: ISM manufacturing index]



Note: "50" is the boom-or-bust threshold.

Source: Institute of Supply Management (ISM).

Inventory adjustment pressures will start to rise. Capital investment growth will moderate

Core inflation will decline in 2007. Monetary policy will remain on hold

Turning to corporate business activity, the Institute for Supply Management's (ISM) manufacturing index dropped to 51.2 in October, marking the lowest point since June 2003 (50.5) (**Chart 7**). The fall of the production and new orders indexes served as a drag upon business activity among manufacturers. Judging from the plausible background factors – the slumping production of construction goods stemming from the housing market correction and sluggish auto sales among US car makers – the conditions should persist for some time.

The inventory cycle also indicates that US companies are shifting from an “inventory build-up” phase to an “unintentional rise of inventories” phase. We expect production activity to remain sluggish amid the rising inventory adjustment pressures.

Business capital investment should moderate, amid cross-currents of strong consumer spending and downward pressures from production and inventories.

Note that price movements have improved in several ways such as the decline of oil and natural resource prices and the stabilization of inflation expectations since our previous *Economic Outlook for FY2006 and FY2007* (the “*Outlook*”) released in June 2006. On the other hand, the employment cost index and unit labor costs are rising, reflecting the firmness of employment conditions, making it difficult to dispel concerns regarding wage inflation. In addition to the employment cost index rising high for two quarters in a row (1.0% q-o-q in the Jul-Sep quarter and 0.9% q-o-q in the Apr-Jun quarter), unit labor costs also remains pinned at a high level of 3.8% q-o-q p.a. Given these conditions, the Fed officials remain extremely cautious regarding inflation.

Looking forward, the rate of real GDP growth should remain below the potential growth rate for some time and the core inflation rate is predicted to fall after peaking in the Jan-Mar quarter of 2007. However, the pace of growth will likely remain sluggish. Even though comments by high-ranking Fed officials suggest that price stability is the core inflation rate around 1%~2% p.a., it is unlikely at the moment that the core inflation rate will reach the “price stability zone” during the forecast horizon.

[Chart 8: Outlook on the US economy]

(%)

	2005 (Actual)	2006 (Forecast)	2007 (Forecast)	2006		2007	
				1H	2H	1H	2H
GDP	3.2	3.3	2.4	3.9	2.1	2.3	2.9
Personal consumption	3.5	3.1	2.8	3.2	2.9	2.8	2.9
Housing investment	8.6	-3.4	-7.0	-3.2	-14.1	-6.8	0.5
Capital investment	6.8	7.8	6.1	9.1	7.4	6.2	4.5
Inventory investment (\$100 million)	197	481	295	475	488	265	325
Government expenditures	0.9	2.1	2.7	2.4	1.9	3.0	3.0
Net exports (\$100 million)	-6,192	-6,357	-6,534	-6,304	-6,411	-6,454	-6,614
Exports	6.8	8.6	4.6	10.9	6.3	4.0	4.2
Imports	6.1	6.6	4.0	8.1	5.3	3.1	4.5
Domestic final demand	3.6	3.0	2.6	3.2	2.1	2.7	3.0
Core personal expenditures deflator <y-o-y ch>	2.1	2.3	2.4	2.1	2.4	2.4	2.3
Current account balance (\$100 million)	-7,915	-8,799	-9,109	-4,316	-4,483	-4,409	-4,699
<as a percentage of nominal GDP>	-6.4	-6.6	-6.6	-6.6	-6.7	-6.4	-6.7

- Notes: 1. Calendar-year figures refer to the rate of change from the previous year. Half-year term figures refer to the rate of change from the previous half-year term (annualized).
2. The shaded columns are forecasts.
3. As for the current account balance, figures for the half-year terms are adjusted for seasonal factors and the calendar-year figures are the totals. The percentages of nominal GDP are annualized.

Sources: US Department of Commerce, US Department of Labor.

Given forecasts that consumer spending and capital investment will remain strong despite the housing market downturn, it has become possible for the Fed to retain a cautious stance on inflation for a slightly longer period than initially expected. Although we have maintained our view that the next monetary policy step would be a “rate cut”, we now think that the timing will be in the Apr-Jun quarter of 2007.

II. The Japanese economy

(1) The current state of the economy

The Japanese economy grew 2.0% q-o-q p.a. in the Jul-Sep quarter of 2006

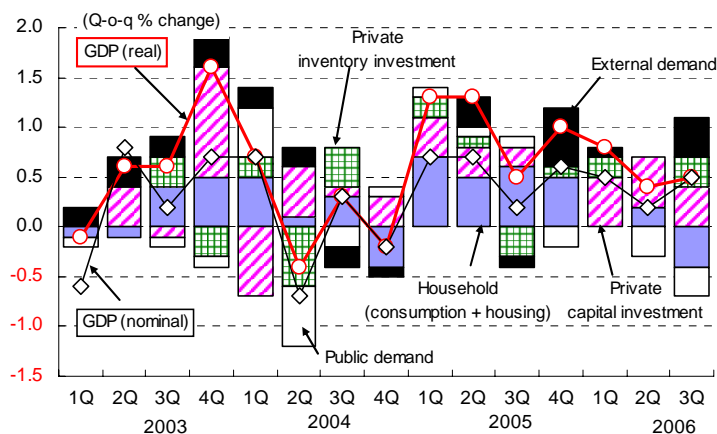
Japan's real GDP picked up, growing 0.5% q-o-q (2.0% q-o-q per annum) in the Jul-Sep quarter of 2006, compared to 0.4% q-o-q (1.5% q-o-q p.a.) in the previous quarter from April to June (**Chart 9**). Despite concerns that Japan's economic growth might dip into negative territory, the recent data underscored the resilience of the Japanese economy in the current expansion. Even so, it is undeniable that growth was principally export-driven as private consumption – one of the twin pillars of private-sector demand – took a downturn.

Looking closer at each of the components of demand, personal consumption fell sharply (-0.7% q-o-q) while capital investment continued to grow strongly (2.9% q-o-q), depicting a sharp contrast between the household sector and the corporate sector. Personal consumption was dragged down by the fall of labor compensation to 1.3% y-o-y in the Jul-Sep quarter (previous quarter: 1.9% y-o-y) due to the sluggish growth of wages. The weak sales of summer clothing items stemming from weather factors such as the long rainy season also served as a damper. In contrast, capital investment continued to grow strongly, reflecting solid corporate business performance and rise of capacity utilization. External demand served as a major contributor to growth (0.4% pt), as a result of the acceleration of exports (2.7% q-o-q) and the virtually flat growth of imports (-0.1% q-o-q). Inventory investment in the private sector grew strongly, contributing 0.3% pt to growth. Meanwhile, given the ongoing plunge of public investment (-6.7% q-o-q), the contribution by public demand fell by 0.3% pt, recording a decline for the fourth quarter in a row.

The domestic demand deflator turned positive on a year-on-year basis

The GDP deflator, a broad measure of price changes, narrowed to -0.8% y-o-y, compared with -1.2% y-o-y in the previous quarter. The domestic demand deflator rose to 0.1% y-o-y, indicating that the risks of a backslide into deflation are gradually receding.

[Chart 9: Japan's quarterly GDP growth]



Source: Cabinet Office, Preliminary Quarterly Estimates of GDP.

The current expansion will likely surpass the *Izanagi* Boom

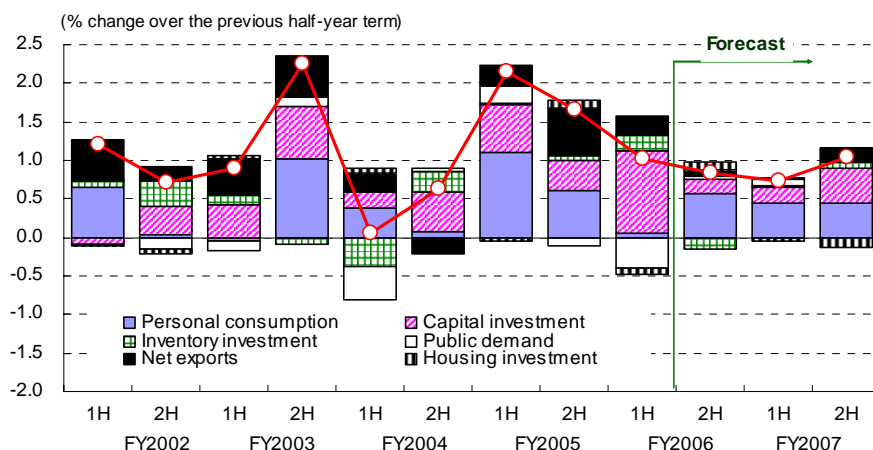
If the Japanese economy continues to expand until November, the length of the current expansion cycle would reach 58 months and surpass the longest post-WWII expansion referred to as the *Izanagi* Boom. Despite concerns such as the US economic slowdown and the accumulation of unsold inventories in IT-related sectors, the Japanese economy still remains in expansion mode as far as the latest data releases are concerned. In the Oct-Dec quarter, the rise of year-end bonus payments provides us with expectations toward an upturn of consumer spending. The current expansion is inching closer to surpassing the *Izanagi* Boom.

(2) Forecast of the Japanese economy in FY2006 and FY2007

The Japanese economy will come to a temporary lull for the third time during the current expansion

In the second half of FY2006, exports are predicted to moderate along with the US economic slowdown, the Chinese government's tightening measures and the inventory adjustment in IT-related industries. Given the slower growth of business fixed investment as a result of stagnant production and corporate profits along with the slowdown of external demand, the Japanese economy will most likely come to a "temporary lull" very much like the second half of FY2004. As a matter of fact, the forecast index on industrial production has been virtually flat in October and November. Machinery orders (a leading indicator of capital investment referring to orders for machinery in the private sector excluding orders for ships and orders placed by electrical power companies) decreased 11.1% q-o-q in the Jul-Sep quarter, falling sharply even in consideration of a backlash to the Apr-Jun quarter which grew a dramatic 8.9% q-o-q. A slowdown of capital investment now appears certain in the Oct-Dec quarter. In contrast, personal consumption is predicted to pick up in the second half of FY2006 given prospects of higher year-end bonus payments. Since the current weakening of the yen and stabilization of crude oil prices will also ease the slowdown of corporate profits, we are inclined to believe that a sharp fall of production and capital investment may be avoided.

[Chart 10: Forecast on Japan's real GDP growth]



Source: Cabinet Office, Preliminary Quarterly Estimates of GDP.

FY2006: the Japanese economy will continue to grow a solid 2.3%

Judging from the foregoing, we expect full-year GDP growth in FY2006 to reach 2.3% in real terms (previous forecast: 2.3%) and 1.8% in nominal terms (previous forecast: 2.1%), growing strongly above 2% for the second year in a row subsequent to FY2005. Reflecting the rebase and reshuffle of the consumer price index (CPI), we have revised down our forecast on the GDP deflator to -0.5% y-o-y from our previous forecast (-0.2% y-o-y). Even so, our fundamental view remains unchanged that the negative breadth of the GDP deflator will gradually shrink toward the end of the fiscal year.

FY2007: slower growth due mainly to weak capital investment

In the first half of FY2007, the pace of economic growth will likely remain sluggish due to the lingering effect of the overseas economic slowdown from the second half of FY2006 (**Chart 10**). Even though crude oil prices peaked out in the summer of 2006, providing a pause in the rise of raw material and fuel costs, the increase of fixed costs such as labor costs and financial costs will start to weigh down upon corporate profits and lead to a sharp slowdown of profit growth. Even though personal consumption should continue to grow amid the ongoing rise of employees' income, the ebb of corporate profits growth should lead to a sharp drop of capital investment.

Although the pace of economic growth will pick up slightly in the second half of FY2007 reflecting the upturn of the overseas economies, we expect full-year GDP growth in FY2007 to stand at 1.7% in real terms (previous forecast: 1.6%). (**Chart 11**) The FY2007 GDP deflator should rise into positive territory (0.9% y-o-y) due to a decline of the import deflator stemming from the gradual rise of consumer prices and fall of crude oil prices. As a result, Japan's nominal GDP growth should rise a strong 2.6% (previous forecast: 2.1%).

[Chart 11: Outlook on the Japanese economy]

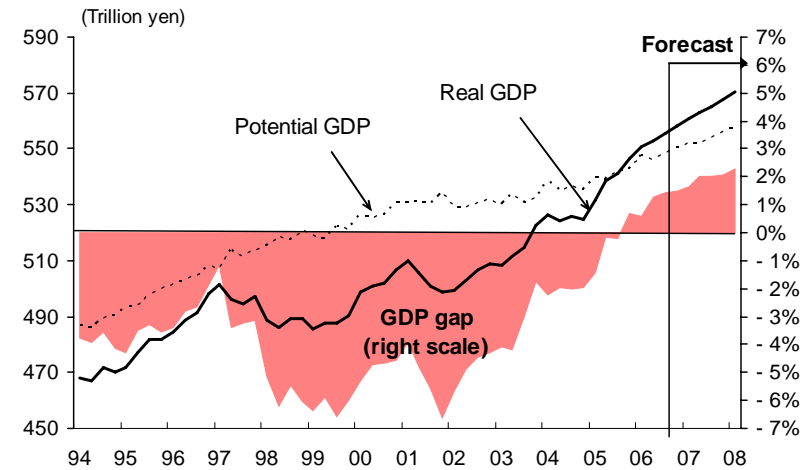
	FY2005	FY2006	FY2007	FY2006		FY2007		FY2006	FY2007
	(Actual)	(Forecast)	(Forecast)	1H	2H	1H	2H	(Contribution)	(Contribution)
				(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)
GDP (real)	3.3	2.3	1.7	1.0	0.8	0.7	1.0	-	-
Domestic demand	2.9	1.8	1.6	0.8	0.8	0.7	0.9	1.7	1.5
Private sector demand	3.5	2.9	1.9	1.6	0.9	0.8	1.1	2.1	1.4
Personal consumption	2.6	1.2	1.7	0.1	1.0	0.8	0.8	0.7	1.0
Housing investment	-0.2	0.8	-1.7	-1.9	2.8	-1.3	-3.7	0.0	-0.1
Capital investment	7.3	8.7	3.2	6.9	1.1	1.3	2.7	1.3	0.5
Public sector demand	0.8	-2.0	0.5	-1.9	0.2	0.4	0.0	-0.4	0.1
Government consumption	1.4	0.6	1.2	0.2	0.4	0.5	0.9	0.1	0.2
Public investment	-1.4	-11.7	-2.7	-10.0	-0.4	-0.4	-3.8	-0.5	-0.1
Net exports (contribution)	0.5	0.6	0.1	0.2	0.1	0.0	0.2	0.6	0.1
Exports	9.1	7.7	3.6	3.5	1.7	1.3	2.9	1.1	0.5
Imports	6.5	4.4	3.5	2.5	1.5	1.6	2.3	-0.5	-0.4
GDP (nominal)	1.8	1.8	2.6	0.7	1.3	1.7	0.5		
GDP deflator	-1.5	-0.5	0.9	-1.0	0.0	1.4	0.4		
Industrial production	1.6	3.2	2.1	1.6	0.3	1.0	2.2		
Unemployment rate	4.4	4.0	3.7	4.1	4.0	3.8	3.6		
Current account balance (trillion yen)	19.1	21.0	23.9	18.1	23.3	22.0	25.2		
as a percentage of nominal GDP	3.8	4.1	4.5	3.5	4.5	4.2	4.8		
Corporate goods prices	2.1	2.9	0.9	3.3	2.6	1.2	0.5		
Consumer prices	-0.1	0.2	0.4	0.1	0.3	0.4	0.4		
Long-term interest rate (%)	1.42	1.80	2.08	1.80	1.80	2.00	2.15		
Nikkei stock average (yen)	13,549	16,200	17,100	15,900	16,500	16,900	17,300		
Exchange rate (yen/dollar)	113.2	116	112	115	116	112	112		
Crude oil price (WTI \$/barrel)	60.0	65.9	53.7	70.6	61.1	53.7	53.6		

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, Indices of Industrial Production, Producer's Inventory of Finished Goods and 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.

The output gap is widening

The output gap (the gap between demand and supply) calculated by MHRI has been charting positive territory since the Oct-Dec quarter of 2005 as Japan's economic growth continues to outpace its potential rate of growth (**Chart 12**). Even though the economy will slow down during the second half of FY2006 to the first half of FY2007, the positive output gap (indicating an excess of demand) should gradually expand on the basis of forecasts that the economy will keep growing at its potential rate of growth. There is a high possibility that the Bank of Japan (BOJ) will implement the next interest rate hike by the end of the year. From then onward, the central bank will likely keep raising rates at a gradual pace around once every half-year period.

[Chart 12: The output gap]



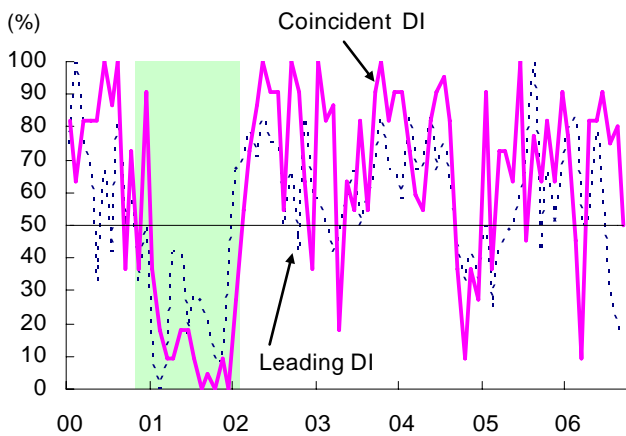
Note: Estimates by MHR.

Sources: Cabinet Office, Ministry of Economy, Trade and Industry, Ministry of Internal Affairs and communications, and others.

The Indexes of Business Indicators suggest a temporary lull

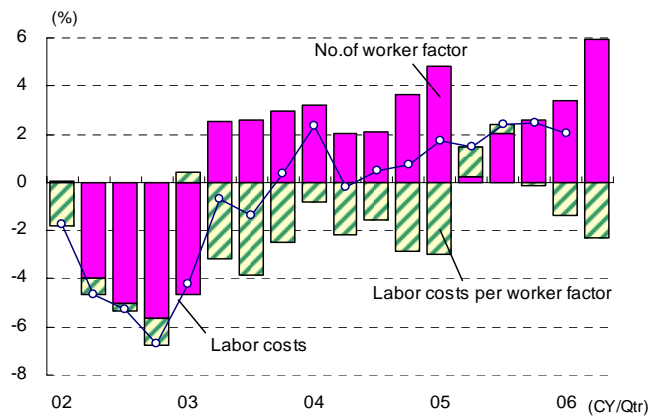
We have reiterated that the Japanese economy will come to a pause or “temporary lull” in the second half of FY2006 for the third time during the current economic expansion. The recent movements of the *Indexes of Business Indicators* provide evidence for our views. The leading diffusion index (DI) fell below the boom-or-bust threshold of 50% for three consecutive months up to September, presaging a future economic slowdown (**Chart 13**). The coincident DI, which had surpassed 50% for five consecutive months up to August, also fell to 50% in September on the basis of preliminary release data (the odds are high that the revised index on November 16th will fall short of 50% given the addition of data on capacity utilization). Judging from movements of the production forecast index, the coincident DI in October and November will likely fall around or slightly below 50%, gradually revealing that the economy is slowing down for the third time during the current expansion.

[Chart 13: The diffusion index (DI) of business indicators]



Source: Cabinet Office, *Indexes of Business Conditions*.

[Chart 14: Labor costs]



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

**Businesses will face
higher labor costs**

In our previous *Outlook*, we predicted that the rise of fixed costs such as labor costs will serve as pressures upon corporate profit and that the sluggish rise of corporate profit would in turn serve as a drag upon capital investment in FY2007. A spate of data releases support our predictions. Labor costs based upon the *Financial Statements Statistics of Corporations* rose 3.5% y-o-y as of the Apr-Jun quarter, due mainly to the increase in number of employed workers (**Chart 14**). The employment conditions index of the Bank of Japan's *Short-Term Economic Survey of Enterprises in Japan* (the "Tankan") also indicate that a more acute shortage of workers among companies will lead to the increase in number of employees (salaried workers) and the gradual rise of wages in FY2007. The rising burden of fixed costs (such as labor costs) will serve as heavier pressures upon corporate profits.

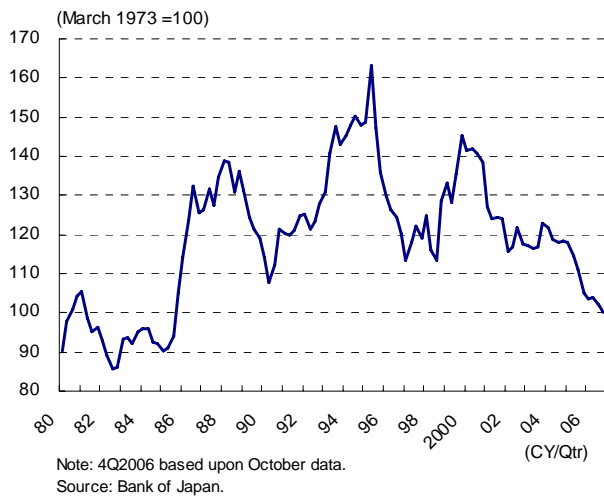
**The weak yen and fall of
crude oil prices
underpin corporate
profits**

Turning to the external environment, the yen has been weakening and the price of crude oil has been stabilizing since our previous *Outlook*. The real effective exchange rate of the yen has dipped to the lowest level since the Plaza Accord in 1985 (**Chart 15**). The benchmark price of crude oil (WTI) which surpassed \$70/barrel level in the summer is stabilizing around \$60/barrel. To reflect these changes, we have revised down our forecast on the yen/dollar exchange rate in FY2007 from 109 yen/dollar to 112 yen/dollar and the WTI from \$67.4/barrel to \$53.7/barrel. According to trial calculations using the Mizuho Macroeconometric Model (MMM), the change of the yen/dollar exchange rate and the downward revision of the price of crude oil would push up corporate profits in FY2007 by 0.7% and 1.1% respectively (**Charts 16, 17**). Although the depreciation of the yen would partially offset the impact of the fall of crude prices, it goes beyond doubt that the weak yen and cheaper crude oil will mitigate the slowdown of corporate profits stemming from weaker exports (corporate profit forecasts will be updated on the basis of the Jul-Sep quarter *Financial Statements Statistics of Corporations* when we revise our *Economic Outlook* in December). In particular, note that the fall of crude oil prices may have a positive impact upon business confidence among small enterprises that was deteriorating in the September *Tankan* survey.

The Japanese economy may not avoid a slowdown during the period from the second half of FY2006 to early FY2007 due to the adjustment of production among IT-related industries and sluggish exports stemming from the US economic slowdown, tightening measures by the Chinese government authorities and the VAT hike in Germany. That said, the weak yen and cheaper crude oil will serve as a buffer to the deterioration of corporate profits. As long as corporate profits continue to expand, the conditions for Japan's self-sustained economic recovery will remain intact. The current economic slowdown will not develop into a recession and the Japanese economy. Picking up after the third temporary lull, the Japanese economy will start to show more definite signs of expansion from the

summer of 2007.

[Chart 15: The effective exchange rate of the yen]



[Chart 16: The impact of the weak yen]

	Yen/dollar exchange rate (%)		
	112	115	120
Ordinary profits	0.7	1.4	2.5
Real GDP	0.2	0.3	0.6
Consumer prices	0.1	0.1	0.3

Note: Comparison with a case where US\$=109 yen.
Ordinary profits based upon the *Financial Statements Statistics of Corporations by Industry (Quarterly)*.
Estimates using the Mizuho Macroeconometric Model.

[Chart 17: The impact of the fall of crude oil prices]

	(%)
Ordinary profits	1.1
Real GDP	0.2
Personal consumption	0.1
Capital investment	1.0
Consumer prices	-0.2
Corporate goods prices	-0.6

Note: FY2007 crude oil forecasts are revised downward from \$67.4/barrel in the previous outlook to \$53.7/barrel (breadth of revision: -20.3%). The chart above sets forth estimates using the Mizuho Macroeconometric Model on the basis of the foregoing revision.

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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', goes under the 'I', 'Z', 'U', and 'H', and ends under the 'O'.