

## Economic Outlook for FY2008 and FY2009

*(revised to reflect the Second Preliminary Quarterly Estimates of GDP for the Oct-Dec quarter of 2007)*

March 2008

The Mizuho Research Institute Ltd. (MHRI) has revised its economic outlook for FY2008 and FY2009 subsequent to the release of *The Second Preliminary Quarterly Estimates of GDP ("2<sup>nd</sup> QE")* for the Oct-Dec quarter of 2007. The key points of the outlook are as follows.

### <The US Economy>

Credit crunch spillovers will keep the US economy in the doldrums

**2008** 1.4% (previous outlook) → 1.4% (current outlook)

**2009** 1.6% (previous outlook) → 1.6% (current outlook)

### <The Japanese Economy>

**FY2007** Japan's economic growth will remain dependent on external demand due to weak domestic demand

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

Nominal GDP: 0.8% (previous outlook) → 0.8% (current outlook)

**FY2008** Corporate profits fall for the first time in seven years, intensifying the risks of an economic downturn

Real GDP: 1.4% (previous outlook) → 1.3% (current outlook)

Nominal GDP: 1.3% (previous outlook) → 1.3% (current outlook)

**FY2009** Growth will continue to be driven mainly by external demand

Real GDP: 1.0% (previous outlook) → 0.9% (current outlook)

Nominal GDP: 0.9% (previous outlook) → 0.9% (current outlook)

This English-language translation is based upon the outlook in Japanese released on March 14, 2008. 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. Although this publication is compiled on the basis of sources which we believe to be reliable and correct, Mizuho Research Institute does not warrant its accuracy and certainty. Readers are requested to exercise their own judgment in the use of this publication. Please also note that the contents of this publication may be subject to change without prior notice.

# I. The current state of the Japanese economy

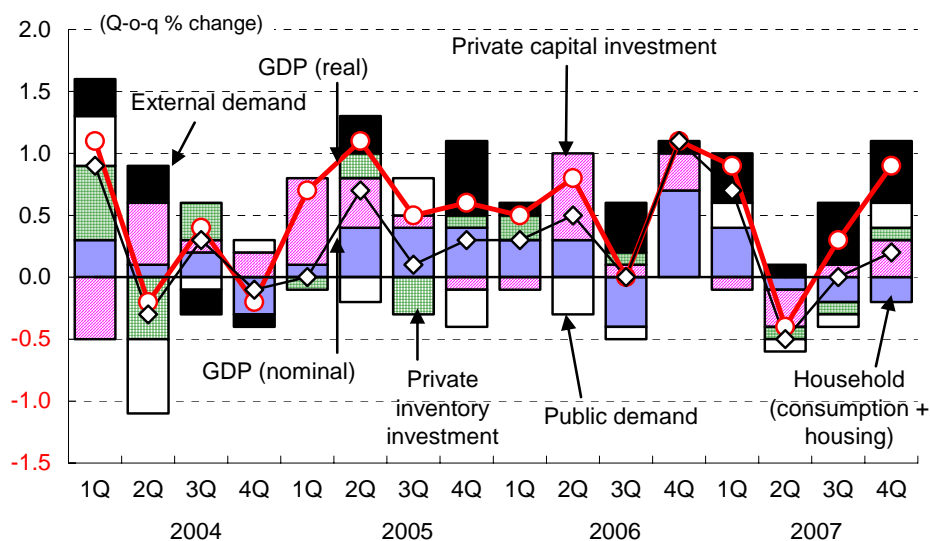
Despite the strength of the 2<sup>nd</sup> QE figures for the Oct-Dec quarter, domestic private demand was revised downward

Capital investment served as a drag

The *Second Preliminary Quarterly Estimates of GDP* (“2<sup>nd</sup> QE”) for the Oct-Dec quarter of 2007 revealed that Japan’s real GDP grew 0.9% q-o-q (3.5% in annualized terms), slowing slightly from 0.9% q-o-q (3.7% q-o-q p.a.) in the *First Preliminary Quarterly Estimates of GDP* (“1<sup>st</sup> QE”) (**Chart 1**). Even though the results were just as strong as the 1<sup>st</sup> QE – both surpassing 3% p.a. – a breakdown of the components reveal a downward revision of domestic private-sector demand in contrast to the upward revisions of both external and public demand. The economy is dependent upon external demand and still a far cry from what can be described as a self-sustained recovery. Despite the strength of the headline figures, the state of the economy remains unchanged from conditions up to the Jul-Sep quarter of 2007.

Looking closer at each of the components of demand, private-sector capital investment served as the major drag upon growth. Capital investment was revised down from 2.9% q-o-q in the 1<sup>st</sup> QE to 2.0% q-o-q in the 2<sup>nd</sup> QE to reflect the results of the *Financial Statements Statistics of Corporations by Industry*. Residential investment was also subject to a slight downward revision (1<sup>st</sup> QE -9.1% q-o-q → 2<sup>nd</sup> QE -9.3% q-o-q), dragging down the contribution by domestic private demand to quarterly real GDP growth from 0.3% pt to 0.2% pt. Public investment (1<sup>st</sup> QE -0.7% q-o-q → 2<sup>nd</sup> QE -0.4% q-o-q) and government consumption (1<sup>st</sup> QE 0.8% q-o-q → 2<sup>nd</sup> QE 0.9% q-o-q) were also revised upward, lifting the contribution by public demand from 0.1% pt to 0.2% pt. Furthermore, since the upward revision of exports (1<sup>st</sup> QE 2.9% q-o-q → 2<sup>nd</sup> QE 3.1% q-o-q) was larger than that of imports (1<sup>st</sup> QE 0.5% q-o-q → 2<sup>nd</sup> QE 0.6% q-o-q), the contribution by external demand rose from 0.4% pt in the 1<sup>st</sup> QE to 0.5% pt.

[ Chart 1: Japan’s quarterly GDP growth (2<sup>nd</sup> QE for the Oct-Dec quarter of 2007) ]



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

**Stronger downside risks**

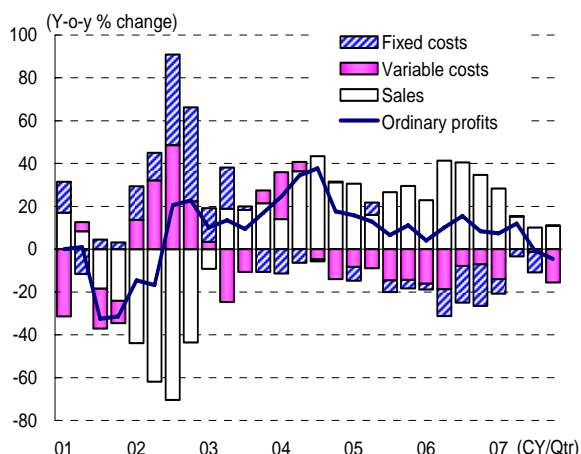
Up to the year-end in 2007, the Japanese economy had managed to remain in expansion mode by relying upon external demand. However, there are rising concerns in the US and Europe that the financial market turmoil stemming from the subprime loan crisis will spread to the real economy through a tighter lending stance among financial institutions. Furthermore, the stock markets of emerging countries are also bearish due to concerns regarding the impact of the US economic slowdown upon the global economy. Given the rise of uncertainties regarding the future course of overseas demand, export-oriented firms in Japan are turning more conservative regarding their production plans. Thus, it now looks certain that industrial production in the Jan-Mar quarter of 2008 will fall sharply (approximately -2% to -3%) from the previous quarter. Moreover, conditions surrounding the Japanese economy are turning more dreary such as the appreciation of the yen against the dollar and the ongoing surge of crude oil prices. The Bank of Japan (BOJ) and the Japanese government have downgraded their assessment of the economy. The Japanese economy is standing at a crucial juncture as to whether the prolonged economic expansion starting in January 2002 will be able to maintain momentum during FY2008.

## II. Forecast of the Japanese economy in FY2008 and FY2009

**FY2008 corporate profits fell for the first time in seven years**

Ordinary profits (based upon the *Financial Statements Statistics of Corporations by Industry*) fell for the second quarter in a row (Oct-Dec quarter: -4.5% y-o-y, Jul-Sep quarter: -0.7% y-o-y). A breakdown of ordinary profits (**Chart 2**) reveals that (1) the slowdown of sales growth in the Oct-Dec quarter, and (2) the rise of variable costs served to push down earnings. The stagnation of domestic demand and the fall of export prices due to the appreciation of the yen are serving to drag down the pace of earnings growth. Moreover, the rise of raw material and fuel costs reflecting the surge of crude oil prices are raising the ratio of variable costs, serving as negative pressures upon corporate business performance. Judging from the rise of both the yen and crude oil prices since the turn of the year, the odds are high that corporate business performance will continue to fall in the first half of FY2008. In FY2008, ordinary profits are predicted to fall (-2.4% q-o-q) for the first time in seven years (**Chart 3**). The basic premise for a self-sustained recovery driven by personal consumption and capital investment is the ongoing expansion of corporate earnings and profits. The fact that corporate earnings and profits are starting to sputter out presages the end of the current economic expansion.

[ Chart 2: Ordinary profits ]



Note: Fixed costs = labor costs + depreciation costs + non-operating expenses.  
Source: Ministry of Finance, *Financial Statements Statistics of Corporations by Industry*.

[ Chart 3: Corporate earnings forecast ]

		(Y-o-y % change)				
		FY2005	FY2006	FY2007 (Forecast)	FY2008 (Forecast)	FY2009 (Forecast)
Total	Sales	4.6	7.3	2.4	2.0	2.7
	Ordinary profits	8.4	10.0	0.1	-2.4	3.5
Manufacturing	Sales	6.1	4.8	7.0	3.2	3.0
	Ordinary profits	12.4	12.7	1.1	-3.5	4.2
Nonmanufacturing	Sales	3.9	8.4	0.4	1.5	2.5
	Ordinary profits	5.7	8.1	-0.7	-1.6	3.0
Large corporations	Sales	6.5	5.0	4.0	2.6	2.9
	Ordinary profits	13.9	12.8	2.6	-1.7	3.7
Manufacturing	Sales	7.1	6.5	5.5	3.0	3.2
	Ordinary profits	14.7	13.7	1.4	-2.6	4.6
Nonmanufacturing	Sales	6.0	3.8	2.9	2.4	2.8
	Ordinary profits	13.0	11.7	4.0	-0.6	2.8
Small and medium corporations	Sales	3.2	8.9	1.2	1.6	2.5
	Ordinary profits	2.4	6.7	-3.2	-3.5	3.2

Note: "Large corporations" = corporations with capital of 1 billion yen or over  
"Medium corporations" = corporations with capital of 100 million to 1 billion yen,  
"Small corporations" = corporations with capital of 10 to 100 million yen,  
Source: Ministry of Finance, *Financial Statements Statistics of Corporations by Industry, Quarterly*.  
Compiled by MHRl.

**Forecast on growth revised downward for both FY2008 (1.3%) and FY2009 (0.9%)**

We have revised down our forecast on Japan's growth for both FY2008 (1.4% → 1.3%) and FY2009 (1.0% → 0.9%) by 0.1 pt from our previous forecast as of February 18<sup>th</sup> (**Chart 4**). The downward revision stems mainly from a slightly lower forecast on personal consumption in consideration of the impact of the surge of crude oil prices. We have revised up our premise on crude oil prices (WTI) as follows: FY2008 (USD80.7/bbl → USD84.9/bbl), FY2009 (USD75.1/bbl → USD81.9/bbl).

**The Japanese economy will start to pick up in FY2009**

As we indicated in our previous *Economic Outlook for FY2008 and FY2009*, the current state of the Japanese economy is not subject to adjustments on the stock-side such as inventories, production capacity, employment and debt. Even if the US and EU economies show more definite signs of slowdown, the chances are slim that the expected growth rate among corporations will drop and lead the economy into a stock adjustment, considering the relatively high growth of emerging economies such as those of Asia. We are inclined to believe that the economic slump in FY2008 will turn out to be short and benign and that the economy will start to pick up in FY2009. The current surge of crude oil and the yen will most likely stabilize in the first half of 2008 and corporate profits should recover in FY2009.

**That said, the economy will fall further if the surge of the yen and crude oil go unabated**

However, in the event the surge of the yen and crude oil prices go unabated, the Japanese economy will fall deeper into a slump. The current surge of crude oil prices (WTI) due to the inflow of speculative money should cool down and fall to the USD80/bbl-level, based upon prospects that the supply and demand balance will start to ease in the second half of 2008. Our current *Economic Outlook for FY2008 and FY2009* is based upon the premise of the average price of crude oil in FY2008 at USD84.9/bbl. According to MHRI's macroeconomic model, in the event the price of crude oil averages at USD100/bbl in FY2008, ordinary profits (based upon the *Financial Statements Statistics of Corporations by Industry*) will be pushed down by 1.4% pt and the rate of real GDP growth would also fall by 0.1% pt (**Chart 5**). Furthermore, in the even the yen advances to JPY90/USD, in comparison to our exchange rate forecast of JPY101/USD, ordinary profits would drop by 1.4% pt and the rate of real GDP growth would be pushed down by -0.3% pt (**Chart 6**).

**The positive output gap will shrink in the second half of FY2008**

The output gap (the gap between demand and supply) estimated by MHRI stood at 1.2% as of the Oct-Dec quarter of 2007 (**Chart 7**). Assuming that the Japanese economy grows as predicted in our forecast, the breadth of the output gap in positive territory should shrink to around zero in the second half of FY2008. Since the rate of real GDP growth will remain below the potential growth rate for some time, upward pressures upon prices will remain extremely weak, with the exception of items affected by the surge of the crude oil and grain markets. Monetary policy will most likely remain on hold during FY2008, given the focus of attention upon the downside risks of the economy.

[ Chart 4: Outlook on the Japanese economy ]

	FY2006 (Actual)	FY2007 (Forecast)	FY2008 (Forecast)	FY2009 (Forecast)	FY2007		FY2008		FY2009		FY2007	FY2008	FY2009
					1H	2H	1H	2H	1H	2H	(Contribution)	(Contribution)	(Contribution)
					(Actual)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)
GDP (real)	2.4	1.6	1.3	0.9	0.5	2.3	1.4	0.1	0.7	2.1	-	-	-
Domestic demand	1.6	0.4	0.8	1.0	-0.7	0.8	1.1	0.5	1.0	1.6	0.4	0.8	0.9
Private sector demand	2.6	0.5	1.1	1.1	-0.9	0.7	1.5	0.6	1.0	1.8	0.3	0.8	0.8
Personal consumption	1.7	1.2	0.9	1.6	1.1	0.8	0.9	1.2	1.6	2.0	0.7	0.5	0.9
Residential investment	0.2	-13.6	2.9	-0.3	-17.1	-22.3	15.5	8.6	-0.0	-9.3	-0.5	0.1	-0.0
Capital investment	5.7	0.9	1.7	-1.3	-2.8	5.7	2.3	-2.6	-3.0	3.0	0.2	0.3	-0.2
Public sector demand	-1.8	0.2	0.1	0.6	-0.2	0.9	-0.3	0.1	0.8	0.8	0.0	0.0	0.1
Government consumption	0.1	1.0	0.8	0.9	1.0	2.0	0.3	0.7	1.0	1.1	0.2	0.1	0.2
Public investment	-9.1	-3.1	-3.3	-1.1	-5.2	-3.8	-3.1	-3.1	-0.6	-0.7	-0.1	-0.1	-0.0
Net exports (contribution)	0.8	1.2	0.5	0.1	1.1	1.4	0.4	-0.3	0.1	0.6	1.2	0.5	0.1
Exports	8.4	9.1	4.9	2.5	8.9	10.8	5.1	-0.8	2.3	6.2	1.3	0.8	0.4
Imports	3.1	1.7	2.9	2.7	2.0	2.0	3.8	1.8	2.5	4.0	-0.2	-0.3	-0.3
GDP (nominal)	1.6	0.8	1.3	0.9	-0.3	1.1	2.4	-0.8	1.2	1.8			
GDP deflator	-0.9	-0.7	-0.0	0.0	-0.5	-1.0	-0.1	-0.0	-0.1	0.2			
Industrial production	4.8	2.9	0.6	1.2	0.6	1.4	0.9	-1.1	0.2	3.0			
Unemployment rate	4.1	3.8	3.7	3.6	3.8	3.9	3.7	3.7	3.7	3.6			
Current account balance (JPY trillion)	21.2	24.6	25.6	26.9	25.5	24.2	25.9	25.8	26.3	27.8			
as a percentage of nominal GDP	4.1	4.8	4.9	5.1	5.0	4.7	4.9	4.9	5.0	5.2			
Domestic corporate goods prices	2.0	2.2	2.1	0.8	1.6	2.8	2.6	1.7	0.9	0.7			
Consumer prices	0.1	0.3	0.6	0.1	-0.1	0.6	0.9	0.3	0.0	0.1			
Long-term interest rate (%)	1.75	1.60	1.34	1.63	1.70	1.49	1.40	1.28	1.50	1.75			
Nikkei stock average (JPY)	16,450	16,000	13,000	14,500	17,300	14,700	13,000	13,000	14,000	14,500			
Exchange rate (JPY/USD)	117.0	114	101	104	119	110	101	101	103	105			
Crude oil price (WTI/barrel)	64.9	82.3	84.9	81.9	70.2	94.4	89.6	80.2	83.7	80.1			

Notes: 1. FY = rate of change from the previous year. Half-year GDP = rate of change from the previous term p.a. (the GDP deflator = rate of change from the previous year).  
 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 industrial production = rate of change from the previous term. The half-year unemployment rate and half-year current account balance are adjusted for seasonal factors and the 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 = yield on newly-issued 10-yr government bonds.  
 Sources: Cabinet Office, *National Accounts*, Ministry of Economy, Trade and Industry, *Indices of Industrial Production*, 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*.

[ Chart 5: The impact of the surge of crude oil prices ]

	WTI (USD/bbl)		
	100	105	110
Ordinary profits	-1.4	-1.9	-2.3
GDP (real)	-0.05	-0.07	-0.09
Consumer prices	0.07	0.09	0.12
Domestic corporate goods prices	0.3	0.4	0.5

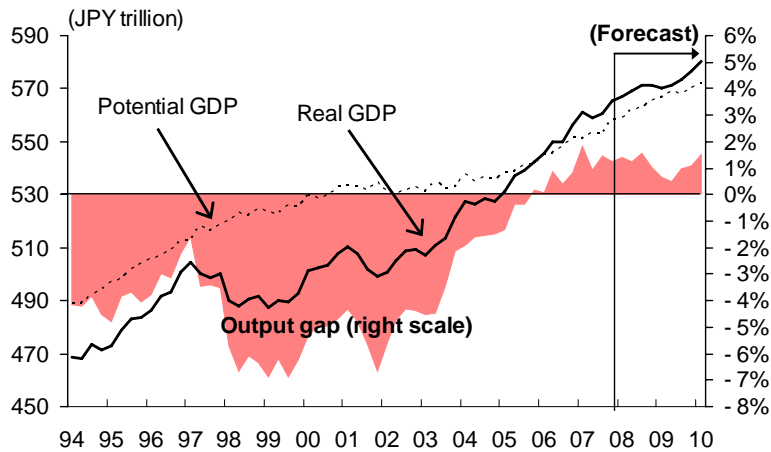
Notes: 1. Calculations based upon the Mizuho Macroeconometric Model (compared with crude oil at USD85/bbl).  
 2. Ordinary profits are based upon the *Financial Statements Statistics of Corporations by Industry, Quarterly*.

[ Chart 6: The impact of the appreciation of the yen ]

	Exchange rate (JPY/USD)		
	95	90	85
Ordinary profits	-0.8	-1.4	-2.0
GDP (real)	-0.2	-0.3	-0.5
Consumer prices	-0.2	-0.4	-0.5

Notes: 1. Calculations based upon the Mizuho Macroeconometric Model (compared with JPY101/USD).  
 2. Ordinary profits are based upon the *Financial Statements Statistics of Corporations by Industry, Quarterly*.

[ Chart 7: The output gap ]



Note: Estimates by MHRI.  
Sources: Cabinet Office, Ministry of Economy, Trade and Industry,  
Ministry of Internal Affairs and Communications.

[ Chart 8: Outlook on the US economy ]

	2007	2008	2009	2007		2008 (Forecast)		2009 (Forecast)	
		(Forecast)	(Forecast)	1H	2H	1H	2H	1H	2H
GDP	2.2	1.4	1.6	1.8	3.6	-0.3	2.7	0.8	2.0
Personal consumption	2.9	1.0	1.1	3.2	2.3	-0.4	2.5	0.2	1.5
Residential investment	-17.0	-19.7	-8.6	-15.5	-19.2	-21.4	-16.3	-8.1	-0.8
Capital investment	4.8	1.3	-4.5	3.4	9.3	2.6	-8.5	-4.6	-0.3
Inventory investment (USD100 million)	66	-109	519	30	136	-445	227	432	606
Government expenditures	2.0	3.0	3.0	1.6	3.6	2.8	3.0	3.0	3.0
Net exports (USD100 million)	-5,565	-4,457	-4,011	-5,930	-5,271	-4,639	-4,274	-4,048	-3,975
Exports	8.0	5.4	2.2	5.9	12.2	3.9	1.8	1.7	3.5
Imports	1.9	-1.8	-0.6	1.6	1.5	-2.8	-2.4	-1.0	1.9
Domestic final demand	1.8	0.6	0.6	1.9	2.1	-0.3	0.9	0.0	1.6

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.

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

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