

## Economic Outlook for FY2005 and FY2006

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

December 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 Jul-Sep quarter of 2005. The key points of the outlook are as follows.

\* MHRI released its previous economic outlook on November 15, 2005.

### <The Overseas Economies>

#### The US Economy

Stable economic growth will continue, as anticipated

2005: (previous outlook) 3.6% → (current outlook) 3.6%

2006: (previous outlook) 3.4% → (current outlook) 3.4%

#### The Euro Zone Economy

Revised upward to reflect recent strength of the economy

2005: (previous outlook) 1.4% → (current outlook) 1.5%

2006: (previous outlook) 1.8% → (current outlook) 1.9%

#### The Asian Economies

Outlooks on NIEs and ASEAN are revised upward

2005: (previous outlook) 6.4% → (current outlook) 6.8%

2006: (previous outlook) 6.4% → (current outlook) 6.5%

### <The Japanese Economy>

#### FY2005

Revised upward to reflect the recent strength of domestic private final demand

Real GDP: (previous outlook) 2.5% → (current outlook) 2.7%

Nominal GDP: (previous outlook) 1.4% → (current outlook) 1.4%

#### FY2006

Slight upward revision, considering the depreciation of the yen

Real GDP: (previous outlook) 1.8% → (current outlook) 1.9%

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

This English-language translation is based upon the outlook in Japanese released on December 12, 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

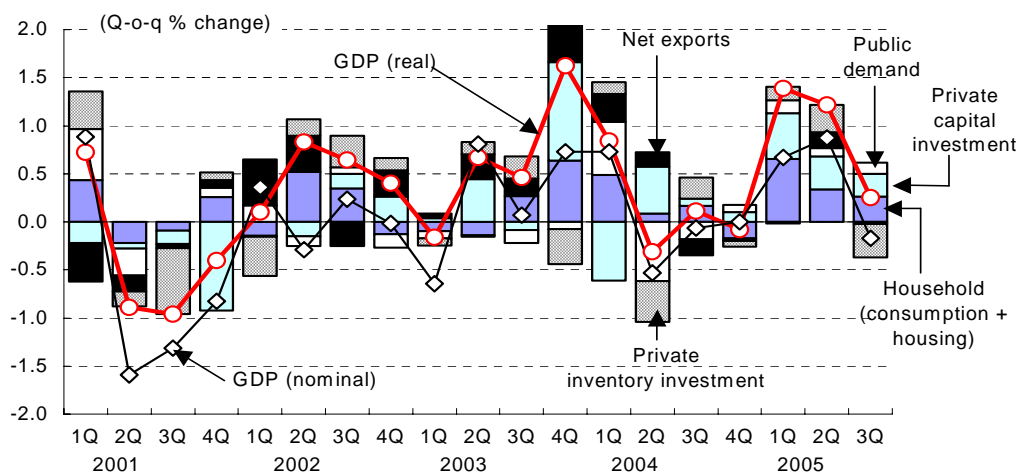
## 1. The current state of the Japanese economy

**Japan's real GDP growth slowed sharply in the Jul-Sep quarter of 2005**

The *Second Preliminary Quarterly Estimates of GDP* (“2<sup>nd</sup> QE”) for the Jul-Sep quarter of 2005 revealed that Japan's real GDP growth during the quarter slowed sharply to 0.2% q-o-q (1.0% per annum) after two quarters of growth at the 5%-level (q-o-q, p.a.) (Chart 1). Even though the economy grew for the third consecutive quarter, the results turned out lower than Japan's potential rate of economic growth estimated to be around 1.5%. The seasonally-adjusted GDP figures up to the Apr-Jun quarter of 2005 have also been revised along with the revision of Japan's preliminary quarterly GDP estimates up to FY2004 (Note). In particular, the rate of GDP growth in the Apr-Jun quarter has been revised upward to 1.2% q-o-q (5.0% p.a.) from 0.8% q-o-q (3.3 p.a.) prior to the revision. As a result, growth in the first half of FY2005 has been revised upward to 2.0% over the previous term from 1.8% over the previous term prior to the revision.

Note: The framework of Japan's national accounts is rebuilt every five years when basic source data become available, at which time compilation methods and concepts are also improved and updated. (Cabinet Office, *Results of the Annual Revision for FY2004 and the 2000 Benchmark Revision of GDP (expenditure series)*.)

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



Note: Seasonal adjustments by MHRl.  
Source: Cabinet Office, *Preliminary Quarterly Estimates of GDP*.

**Declines in inventories served as the main cause of economic slowdown**

In terms of major demand components, the main drags upon growth stem from: (1) the contraction of the contribution to real GDP growth by private-sector inventory investment (-0.4% pt q-o-q) and (2) the slight drop of the contribution by net exports (exports minus imports)(-0.0% pt) due to the rise of imports. On the other hand, even though personal consumption growth slowed to 0.4% q-o-q during the Jul-Sep quarter from 0.7% q-o-q in the previous quarter, it nevertheless marked the third straight quarter of expansion. Likewise in the corporate sector, capital investment remained in expansion mode despite a slowdown from the previous quarter (2.4% q-o-q → 1.6% q-o-q). Since housing investment also

**The 2<sup>nd</sup> QE confirmed the ongoing expansion of the economy despite slowdown of headline figures**

**The fall of the GDP deflator is a temporary phenomenon**

**Production activity among manufacturers is also picking up since October**

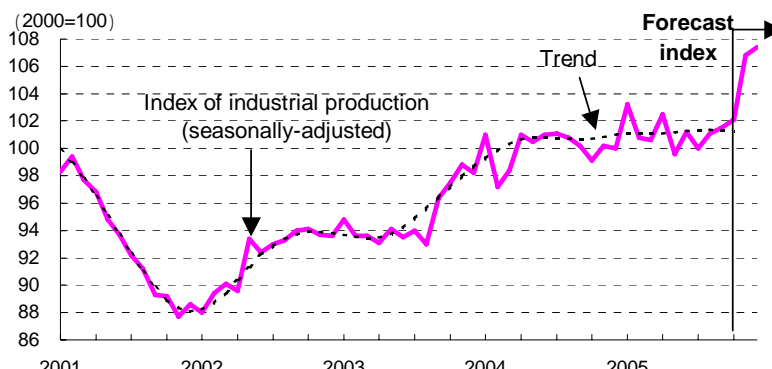
picked up (1.6% q-o-q) for the first time in two quarters, the contribution by domestic private demand to quarterly real GDP growth stood at roughly the same level as the previous quarter (0.5% pt q-o-q).

Even though real GDP growth in the Jul-Sep quarter of 2005 slowed from the previous quarter, the figures still portray the economy in strong expansion mode as follows: (1) domestic private-sector final demand is still strong, (2) exports grew for the second quarter in a row, serving as confirmation that exports are picking up, and (3) private-sector inventories decreased, dispelling concerns regarding its unintentional buildup since the turn of the year in 2005.

The GDP deflator, a measure of broad price trends, was revised downward to -1.4% over a year ago (o-y-a) from -1.1% o-y-a in the previous quarter. The drop is a temporary phenomenon, stemming from the rise of crude oil prices (reflecting the current circumstances where prices of domestic value-added products are still subject to downward pressures since the price of crude oil is not adequately passed through to domestic prices) and do not indicate the rise of deflationary pressures. Looking forward, the progress of price shifts amid the rise of demand should lead to a gradual contraction of the negative breadth of the GDP deflator.

The Japanese economy is continuing to follow a recovery track in the months following October. The industrial production index rose 0.6% m-o-m in October, rising for the third month in a row. Industrial production activity continued to pick up amid the ongoing expansion of domestic demand and the recovery of exports (**Chart 2**). Since the production index is projected to rise a dramatic

**[ Chart 2: Index of industrial production ]**



Notes: 1. Figures from May 2005 are m-o-m changes of the forecast index.

2. The trend is filtered using the Henderson moving average.

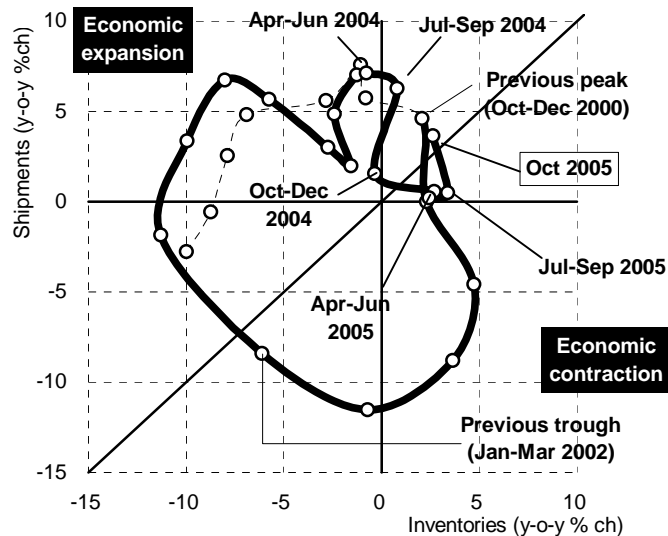
Source: Ministry of Economy, Trade and Industry, *Indices of Industrial Production, Producer's Shipments, Producer's Inventory of Finished Goods and Producer's Inventory Ratio of Finished Goods (Index)*.

**The end of inventory adjustment will serve as tailwinds upon production activity**

4.5% q-o-q in the Oct-Dec quarter on the basis of Nov-Dec production projections, manufacturers' production activity which has been largely flat since early 2005 is poised for a strong recovery. Given the sharp decline of the actualization rate of the forecast index from September to October, the pace of production should accelerate in comparison to the lackluster recovery thus far.

The progress of the inventory adjustment process provides evidence for the views set forth above. The inventory cycle of the entire mining and manufacturing sector (**Chart 3**) crossed over above the 45-degree line in the upper right hand quadrant in October, indicating that Japan's industrial sector has emerged out of the inventory adjustment phase continuing from early 2005. Even though inventory levels are still above previous-year levels, inventories are moving to more appropriate levels given the rise of shipment growth amid the sustained expansion of demand. Despite lingering production adjustment pressures in certain basic material sectors such as iron & steel, negative pressures stemming from inventories are abating, as evidenced by the end of inventory adjustment in the domestic IT and digital appliance sector reflecting the pickup of global demand for IT and digital appliances.

[ **Chart 3: The inventory cycle (mining & manufacturing)** ]



Source: Ministry of Economy, Trade and Industry.

**Corporate profits are still growing in the Jul-Sep quarter despite high crude oil prices**

Even though the negative impact to corporate business performance stemming from the surge of crude oil prices was a source of concern, the impact upon the economy appears limited since it is outweighed at least for the time being by the positive impact from the growth of demand.

According to the *Financial Statements Statistics of Corporations by Industry (Quarterly)*, even though the growth of corporate profits (current profits) slowed sharply to 6.6% o-y-a in the Jul-Sep quarter of 2005 from 12.9% o-y-a in the previous quarter, businesses still managed to maintain profit growth. The strong sales during the Jul-Sep quarter (4.6% o-y-a) from the previous quarter (3.0% o-y-a) contributed greatly to corporate performance. Current profits among non-manufacturers dropped sharply to 2.4% y-o-y from 11.9% y-o-y in the previous quarter, dragged down by the deterioration of profits among transportation companies and electrical power companies due to the rise of energy costs. However, sales among manufacturers grew 6.1% y-o-y, up from 4.4% y-o-y in the previous quarter, resulting in an ongoing double-digit growth of current profits (12.6% y-o-y). The depreciation of the yen also appears to have added extra momentum.

**Corporate earnings and profits should continue to grow**

Looking forward, corporate earnings and profits should continue to grow, reflecting the solid expansion of demand and the ebb of deflationary pressures (Chart 4).

[ Chart 4: Forecast on corporate business performance ]

(Y-o-y % change)

		FY2004	FY2005 (Forecast)		FY2006 (Forecast)	
			1H	2H		
All industries	Sales	5.6	4.3	3.8	4.7	4.0
	Current profits	24.6	8.8	9.8	8.0	8.8
Manufacturing	Sales	5.3	5.4	5.3	5.4	3.7
	Current profits	28.3	10.1	13.4	7.2	7.4
Non-manufacturing	Sales	5.7	3.8	3.2	4.4	4.1
	Current profits	22.2	7.9	7.2	8.5	9.7
Large corporations	Sales	5.8	5.7	5.7	5.8	4.6
	Current profits	24.8	8.7	9.4	8.1	9.8
Manufacturing	Sales	5.5	5.7	5.7	5.8	4.1
	Current profits	26.6	8.9	11.7	6.4	8.0
Non-manufacturing	Sales	6.0	5.7	5.7	5.8	5.0
	Current profits	22.8	8.5	7.0	10.1	11.9
Small & medium corporations	Sales	5.4	3.3	2.5	4.0	3.6
	Current profits	24.5	8.9	10.4	7.8	7.6
Manufacturing	Sales	4.9	4.9	4.7	5.0	3.2
	Current profits	32.1	12.4	17.8	8.6	6.2
Non-manufacturing	Sales	5.5	2.9	1.9	3.8	3.7
	Current profits	21.8	7.5	7.5	7.5	8.2

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

In terms of business sectors, business performance among manufacturers should benefit from the recovery of exports reflecting the strength of the overseas economies. Even so, given prospects that the yen will start to appreciate by mid-2006 at the latest, the positive effect of the weak yen will start to fade and

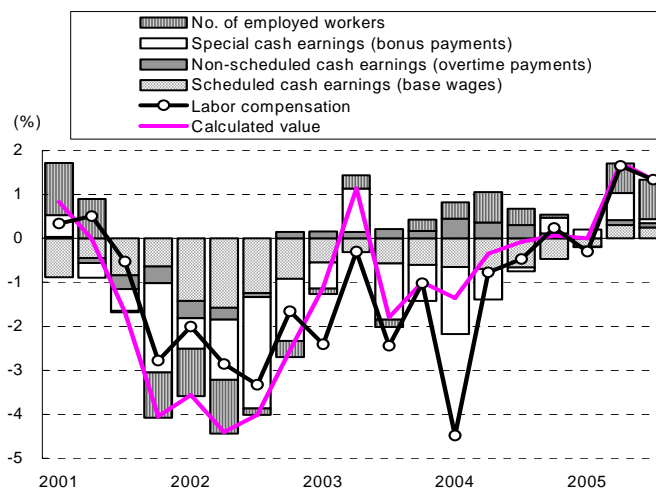
**Japan is continuing to follow an autonomous economic recovery originating with the improvement of corporate business performance**

serve as a drag upon profit growth. Meanwhile in the non-manufacturing sector, the strong growth of domestic demand such as consumer spending will serve as the engine for the improvement of business performance. Furthermore, prospects of the decline of crude oil prices provide us with reasons to believe that the current negative pressures upon profits upon certain business sectors will fade and lead to a higher profit rate. Looking forward, we expect the profit rate among non-manufacturers to surpass those of manufacturers.

Starting from the trough in January 2002, Japan is into its 47<sup>th</sup> month of economic expansion as of December 2005. This makes the current expansion the third longest in Japan's post-World War II history, after the so-called Izanagi Boom (57 months from October 1965 to July 1970) and the Heisei Bubble (51 months from November 1986 to February 1991). The current prolonged expansion stems largely from the continuation of a virtuous cycle where the improvement of corporate business performance is leading to the rise of capital investment and the expansion of consumer spending via the improvement of household income, which are in turn fueling a further pickup of corporate business performance.

The revised labor compensation figures for the Jul-Sep quarter of 2005 – revised along with the GDP figures – continued to rise as in the previous quarter, rising 1.3% o-y-a (**Chart 5**). This provides further evidence that the improvement of corporate business performance is filtering through to the improvement of household income in the form of jobs and wage increases. In addition to the rise of winter bonus payments above the previous year according to various surveys, the income environment appears to be improving steadily. The improvement of corporate business performance is rippling through more broadly to household income. Capital investment also appears to be growing steadily, considering the ongoing rise of machinery orders (private-sector demand excluding orders for

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



Note: "Calculated value" = nominal wages x number of employed workers. The bars represent the contribution to the calculated value.

Sources: Ministry of Health, Labour and Welfare, *Monthly Labour Survey*, Ministry of Internal Affairs and Communications, *Labour Force Survey*, Cabinet Office, *Annual Report on National Accounts*.

ships and orders by electric power companies), which is a leading indicator of capital investment trends.

Judging from the continuation of a virtuous cycle originating with the improvement of corporate business performance, we do not see the need for a major revision of our *Economic Outlook for FY2005 and F2006* released in November 2005. Unless the virtuous cycle is interrupted, the Japanese economy will continue to progress on a path out of deflation.

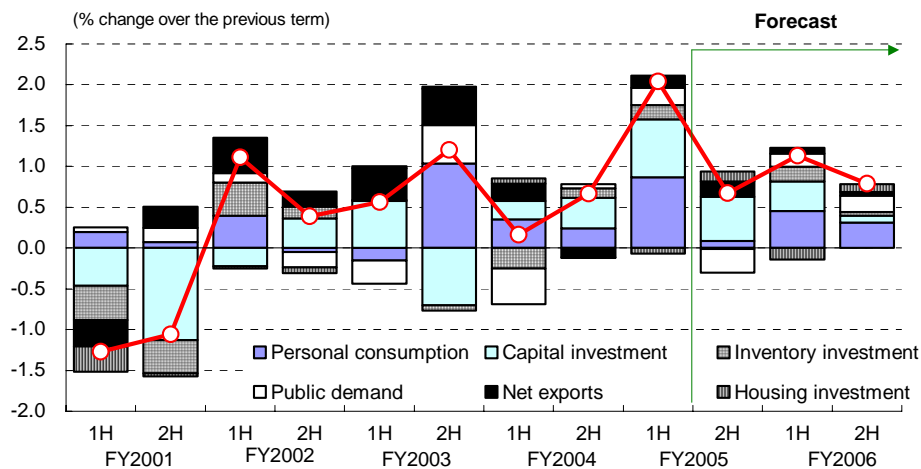
## 2. Forecast of the Japanese economy in FY2005 and FY2006

**FY2005 growth will surpass previous year: 2.7% (real GDP), 1.4% (nominal GDP)**

**2H FY2005** Judging from the foregoing, the Japanese economy is poised to grow strongly in the second half of FY2005 driven by the ongoing expansion of personal consumption, capital investment and exports (**Chart 6**). However, the growth of personal consumption and capital investment may slow down in a reaction to the strong rise in the first half of the fiscal year and the high level of inventory investment thus far may come under negative pressure and serve as a drag upon GDP growth. On the other hand, housing investment will rise into positive territory and the contribution by net exports will grow, providing us with reason to believe that the Japanese economy will continue to grow slightly above its potential rate of growth and progress toward the end of deflation.

As a result, even though Japan's real GDP in the second half of FY2005 will slow to 0.7% over the previous term (1.4% p.a.) due to a backlash to the first half of the fiscal year, we expect full-year GDP growth in FY2005 to reach 2.7% y-o-y (previous forecast: 2.5% y-o-y) in real terms and 1.4% y-o-y (previous forecast 1.4% y-o-y) in nominal terms (**Chart 7**).

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



Note: MHRI forecasts from 1H FY2005 onward.  
Source: Cabinet Office, *Preliminary Quarterly Estimates of GDP*.

**1H FY2006: the economy will gather fresh momentum**

**1H FY2006** The pace of economic growth will rise above 2% p.a. again, driven by the re-acceleration of personal consumption fueled by the ongoing improvement of the income environment and capital investment growth amid the rise of exports and personal consumption.

**2H FY2006: growth will slow down due to US economic slowdown**

**2H FY2006:** However, in addition to forecasts that consumer spending will flatten out because of the deterioration of consumer confidence stemming from the fall of disposable income due to the abolition of across-the-board tax credits and full-fledged discussion on consumption tax hikes, a significant contribution by net exports is unlikely judging from the sluggish rise of exports along with the US economic slowdown and appreciation of the yen. Since businesses will take a

wait-and-see stance regarding capital investment amid these conditions, we believe that the pace of economic growth will slow down to around 1.5% over the previous term (p.a.)

We expect Japan's real GDP growth in FY2006 to slow from 1.1% over the previous term (2.3% p.a.) in the first half of FY2006 to 0.8% over the previous term (1.6% p.a.) in the second half. As a result, full-year GDP growth in FY2006 will slow to 1.9% y-o-y (previous forecast: 1.8% y-o-y) in real terms while growth in nominal terms will stand at 1.6% y-o-y (previous forecast: 1.6% y-o-y).

[ Chart 7: Outlook on the Japanese Economy ]

(%)

	FY2004 (Actual)	FY2005 (Forecast)	FY2006 (Forecast)	FY2005		FY2006		FY2005	FY2006
				1H	2H	1H	2H	(Contribution)	(Contribution)
				(Actual)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)
GDP (real)	1.7	2.7	1.9	2.0	0.7	1.1	0.8	-	-
Domestic demand	1.3	2.6	1.7	1.9	0.5	1.1	0.7	2.5	1.7
Private sector demand	2.1	3.3	2.0	2.2	1.0	1.2	0.7	2.5	1.5
Personal consumption	1.7	1.8	1.2	1.5	0.2	0.8	0.5	1.1	0.7
Housing investment	1.7	-0.3	-0.9	-1.9	3.5	-3.9	2.7	-0.0	-0.0
Capital investment	5.4	8.2	4.4	4.9	3.6	2.4	0.6	1.2	0.7
Public sector demand	-1.4	0.2	0.7	0.9	-1.3	0.7	0.9	0.1	0.2
Government consumption	1.8	1.9	2.0	0.9	1.1	1.1	0.8	0.3	0.4
Public investment	-12.4	-5.4	-4.5	1.0	-9.6	-1.1	1.7	-0.3	-0.2
Net exports (contribution)	0.5	0.2	0.1	0.2	0.2	0.1	0.0	0.2	0.1
Exports	11.4	8.1	7.4	4.4	5.3	3.7	2.1	1.1	1.1
Imports	8.7	7.8	7.0	3.8	4.5	3.7	2.0	-0.9	-0.9
GDP (nominal)	0.5	1.4	1.6	1.1	0.3	1.1	0.6		
Industrial production	4.1	1.5	3.8	0.3	2.6	2.2	0.8		
Unemployment rate	4.6	4.2	3.9	4.3	4.1	4.0	3.9		
Current account balance (trillion yen)	18.3	17.8	19.2	17.2	18.3	18.8	19.6		
as a percentage of nominal GDP	3.7	3.5	3.8	3.4	3.6	3.7	3.8		
Corporate goods prices	1.5	1.8	-0.5	1.6	1.9	0.5	-1.5		
Consumer prices	-0.3	0.0	0.2	-0.1	0.2	0.3	0.2		
Long-term interest rate (%)	1.52	1.45	1.83	1.30	1.60	1.75	1.91		
Nikkei stock average (yen)	11,321	13,647	16,500	11,794	15,500	16,450	16,550		
Exchange rate (yen/dollar)	107.5	114	110	109.4	118	113	107		
Crude oil price (WTI\$/barrel)	45.1	60.2	56.3	58.2	62.2	57.6	55.1		

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*,

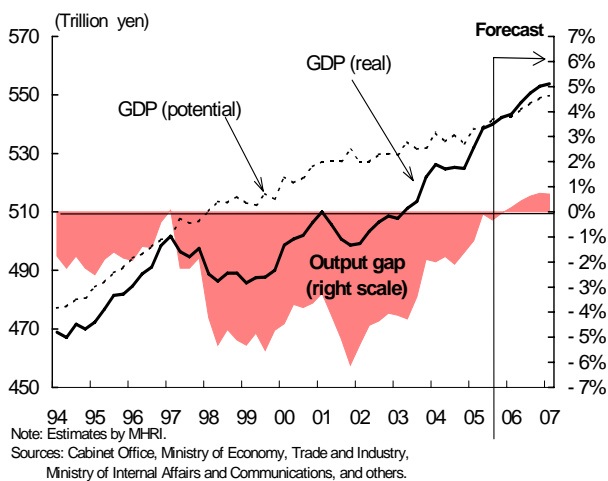
Ministry of Finance, *Balance of Payments*,

Bank of Japan, *Corporate Goods Price Index*.

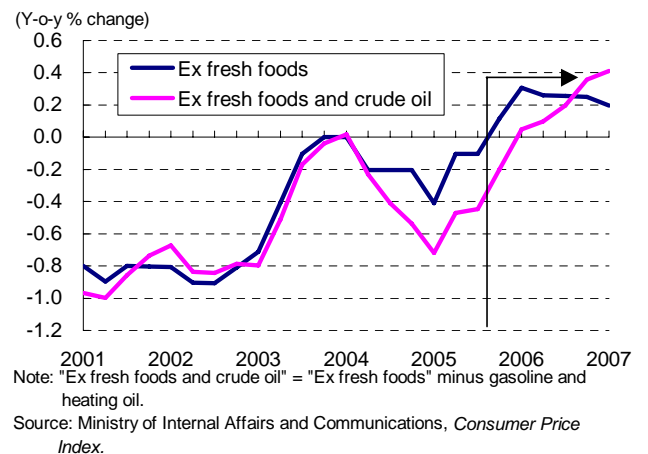
**The y-o-y rate of change in the CPI will turn positive by the end of 2005**

Projecting future price trends on the basis of MHRI's *Economic Outlook for FY2005 and FY2006*, the output gap (the gap between demand and supply) will continue to narrow and turn positive in early 2006 in the event the Japanese economy continues to recover as predicted, driven mainly by domestic private demand (**Chart 8**). Furthermore, higher prices of crude oil-related products will push the percentage rise of the consumer price index into positive territory by the end of 2005, ahead of the timing when the output gap turns positive (**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 in the Apr-Jun quarter of 2006 when the economic data for the Jan-Mar quarter of 2006 may be ascertained.

[ Chart 8: The output gap ]



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



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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', goes under the 'I', 'Z', and 'U', and then curves upwards under the 'H' and 'O'.