

Economic Outlook for FY2006 and FY2007

(Revised to reflect the Second Preliminary Quarterly Estimates of GDP for the Jan-Mar quarter of 2006)

June 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* (“2nd QE”) for the Jan-Mar quarter of 2006. The key points of the outlook are as follows.

<The US Economy>

	Slower pace of economic growth as the housing market cools down in 2007
2006	3.4% (previous outlook) → 3.4% (current outlook)
2007	3.0% (previous outlook) → 3.0%(current outlook)

<The Japanese Economy>

FY2006	Continuation of self-sustained economic recovery Real GDP: 2.3% (previous outlook) → 2.5% (current outlook) Nominal GDP: 2.4% (previous outlook) → 2.5% (current outlook)
FY2007	Capital investment will serve as a drag, due to slower corporate profit growth Real GDP: 1.5% (previous outlook) → 1.5% (current outlook) Nominal GDP: 2.0% (previous outlook) → 2.0%(current outlook)

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

The US economy: both inflation and economic slowdown are sources of concern

The US economy staged a strong rebound, growing 5.3% q-o-q p.a. in the Jan-Mar quarter of 2006 (revised upward from 4.8% q-o-q p.a. in our previous *Economic Outlook for FY2006 and FY2007*). However, in addition to the current softening of the housing market, recent data on personal consumption and employment show signs of slowdown. Note also that inflation pressures are lingering at the same time. Given the rise of both the core personal consumption expenditure (PCE) deflator and inflation expectations, the Federal Reserve Board (the Fed) appears to be shifting from a “forward-looking stance” with a close eye upon both the economy and prices to a stance concerned with inflation.

Looking forward, the US economy should gradually slow down toward the second half of 2006 due to a softening housing market and the impact of successive interest rate hikes and high energy prices. Despite brisk production and investment in the corporate sector, the possibility of the corporate sector being negatively affected by a slowdown of expenditure growth in the household sector should not be underestimated. Given the Fed’s strong concerns regarding inflation, the Federal Open Market Committee (FOMC) is expected to decide upon a minor interest rate hike at its meeting at the end of June. However, inflationary pressures should gradually subside as the economy slows down, leading to a “wait-and-see” stance in monetary policy.

US real GDP growth: 3.4% in 2006, 3.0% in 2007

As we wrote in our previous *Economic Outlook for FY2006 and FY2007*, the pace of US economic growth should slow down from 3.4% in 2006 to 3.0% in 2007. In particular, the economy will likely draw closer to a “gross recession” in the second half of 2006 (**Chart 1**). However, the economy should avoid a full-blown recession, with the Fed succeeding in bringing the economy to a soft landing.

[Chart 1: The US Economy]

	2005 (Actual)	2006 (Forecast)	2007 (Forecast)	2006		2007	
				1H	2H	1H	2H
GDP	3.5	3.4	3.0	3.7	2.9	3.0	3.0
Personal consumption	3.5	3.0	2.7	3.2	2.5	2.7	3.0
Housing investment	7.1	1.9	-3.0	1.7	-2.5	-4.5	-0.5
Business capital investment	8.6	8.9	4.3	10.3	7.6	2.7	4.2
Inventory investment (\$100 million)	203	98	185	287	-91	103	268
Government expenditures	1.8	2.6	3.0	2.8	3.1	3.0	3.0
Net exports ((\$100 million)	-6,331	-6,562	-6,404	-6,698	-6,427	-6,290	-6,517
Exports	6.9	7.7	5.4	9.8	6.3	5.1	5.0
Imports	6.3	6.3	2.7	10.1	1.3	2.0	5.7
Domestic final demand	3.9	3.5	2.6	3.7	2.9	2.3	3.0
Core personal expenditures deflator <y-o-y ch>	2.0	2.0	1.9	1.9	2.0	1.9	1.9
Current account balance (\$100 million)	-8,049	-8,680	-8,380	-4,380	-4,300	-4,040	-4,330
<as a percentage of nominal GDP>	-6.4	-6.5	-5.9	-6.7	-6.3	-5.8	-6.1

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 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.

II. The Japanese economy

1. The current state of the Japanese economy

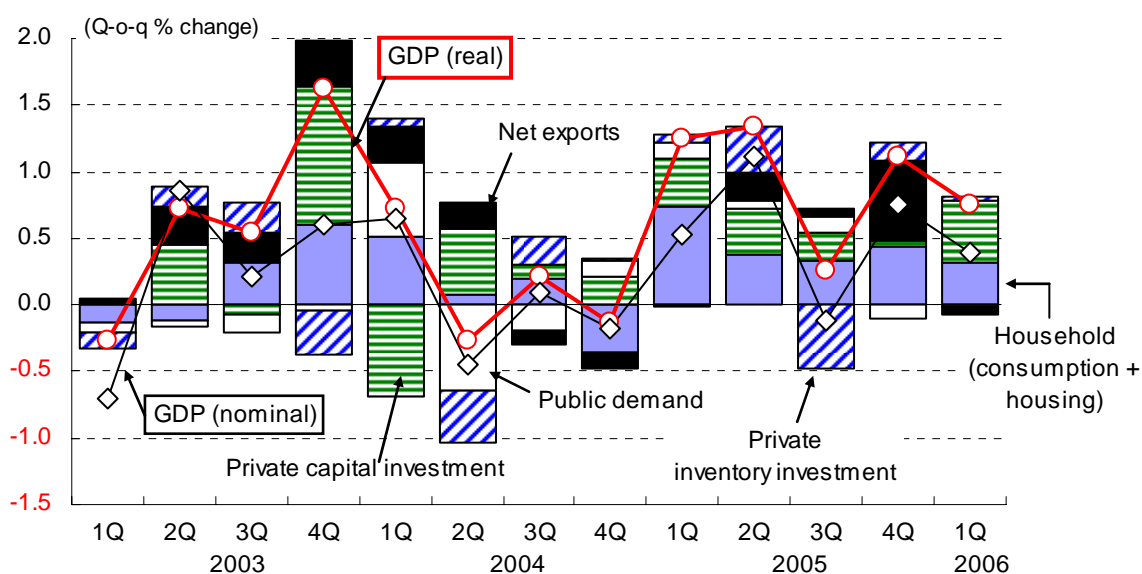
The Japanese economy grew a strong 3.1% q-o-q p.a. in the Jan-Mar quarter of 2006

Brisk domestic private sector demand

The *Second Preliminary Quarterly Estimates of GDP* (“2nd QE”) for the Jan-Mar quarter of 2006 revealed that Japan’s real GDP grew a strong 0.8% q-o-q (3.1% q-o-q p.a.) (**Chart 2**), revised upward from 0.5% q-o-q (1.9% q-o-q p.a.) in the *First Preliminary Quarterly Estimates of GDP*. Although the pace of growth did not reach the Oct-Dec quarter of 2005 (1.1% q-o-q, or 4.5% q-o-q in annualized terms), the Japanese economy still grew far above its potential rate of growth (slightly lower than 2% p.a.) for the second quarter in a row.

Looking closer at the components of demand, personal consumption grew 0.5% q-o-q (0.6% q-o-q in the previous quarter from October to December of 2005). Business capital investment grew a dramatic 3.1% q-o-q (0.2% q-o-q in the previous quarter), backed by the improvement of corporate business performance and the recovery of the expected rate of economic growth. Even though public investment continued its decline, falling 0.6% q-o-q (-2.5% q-o-q in the previous quarter), the breadth of the fall has narrowed. Given the 0.2% rise of government consumption (0.1% q-o-q in the previous quarter), the contribution by public demand stood at -0.0% pt. As a result, the contribution by domestic demand to quarterly growth rose from 0.5% pt in the previous quarter to 0.8% pt. Even though exports grew 2.7% q-o-q (3.8% q-o-q in the previous quarter) continuing to grow at a pace of approximately 3% for the fourth quarter in a row, imports also rose 3.5% q-o-q (-0.6% q-o-q in the previous quarter), offsetting the contribution by external demand (-0.1% pt).

[Chart 2: Japan’s quarterly GDP growth (2nd QE results)]



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

Rise of the GDP deflator

The GDP deflator, a broad measure of price changes, improved to -1.2% over a year ago (o-y-a) from -1.6% o-y-a in the previous quarter. In particular, the domestic demand deflator rose into positive territory (0.1% y-o-y), indicating the end of deflation in Japan.

Sliding stock markets

Since the release of our previous *Economic Outlook for FY2006 and FY2007* on May 23rd, the stock market fall deserves mention as a notable change of the external environment. In the event the stock market slide should persist, the negative effect will gradually spread to the economy by dampening consumer and business sentiment. Even so, the current stock market slump in Japan should only turn out to be a short-term correction, dragged down by the fall of US stock markets due to speculation on further interest rate hikes. Indicators gauging the real economy are actually growing stronger, providing us with reasons to believe that the stock market will regain stability along with the emergence of more visible signs that economic conditions and corporate business performance are continuing to recover.

2. Forecast of the Japanese economy in FY2006 and FY2007

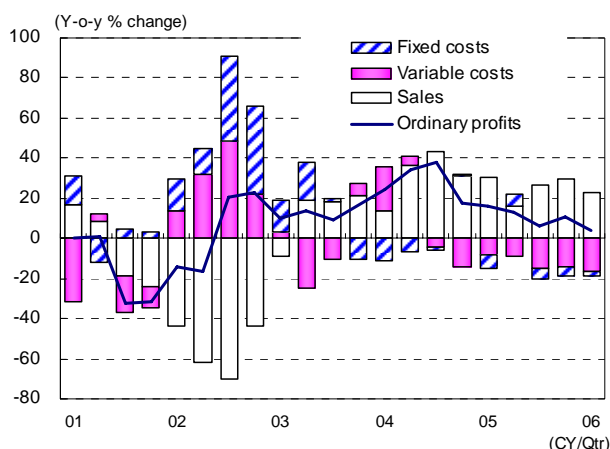
Corporate profits grew for the 15th consecutive quarter

The strong corporate performance is continuing in FY2006

Ordinary profits (based upon the *Financial Statements Statistics of Corporations by Industry*) grew 4.1% y-o-y in the Jan-Mar quarter of 2006 (11.1% y-o-y in the previous quarter), rising for 15 quarters in a row (**Chart 3**). Even though higher raw material and fuel costs accompanying the surge of crude oil prices are dragging down corporate profits, overall corporate business performance remains solid.

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. However, the pace of profit growth should slow down in the second half of FY2006 along with the moderation of exports accompanying the slowdown of the overseas economies (mainly the US). Furthermore, persistent high crude oil prices and the moderate appreciation of the yen will serve as downward pressures upon corporate profits. Thus, even though corporate profit should grow around 6% y-o-y on a full-year basis in FY2006, marking the fifth consecutive year of profit increase, we are inclined to believe that the pace of profit growth will be slower than in FY2005 (**Chart 4**).

[Chart 3: Ordinary profits]



[Chart 4: Corporate earnings forecast]

		(Y-o-y % change)			
		FY2004	FY2005	FY2006 (Forecast)	FY2007 (Forecast)
Total	Sales	5.6	4.6	4.1	3.0
	Ordinary profits	24.6	8.4	6.1	3.5
Manufacturing	Sales	5.3	6.1	4.0	1.7
	Ordinary profits	28.3	12.4	6.6	3.1
Non-manufacturing	Sales	5.7	3.9	4.1	3.6
	Ordinary profits	22.2	5.7	5.7	3.9
Large corporations	Sales	5.8	6.5	4.8	2.9
	Ordinary profits	24.8	13.9	7.6	3.9
Manufacturing	Sales	5.5	7.1	4.5	1.8
	Ordinary profits	26.6	14.7	7.4	3.3
Non-manufacturing	Sales	6.0	6.0	4.9	3.8
	Ordinary profits	22.8	13.0	7.9	4.6
Small and medium-sized corporations	Sales	5.4	3.2	3.6	3.1
	Ordinary profits	24.5	2.4	4.3	3.1

Note: "Large corporations" refer to corporations with capital of 1 billion yen or over, "medium-sized corporations" refer to corporations with capital of 100 million to 1 billion yen, "small corporations" refer to corporations with capital of 10 to 100 million yen.
Source: Ministry of Finance, *Financial Statements Statistics of Corporations, Quarterly*.

FY2007: increase of fixed costs will serve as a drag upon corporate earnings

Real GDP growth forecast: FY2006 (2.5%) and FY2007 (1.5%)

In FY2007, the rise of fixed costs such as labor costs will weigh heavily upon ordinary profit growth. Corporate profit growth will slow sharply, serving as a damper upon capital investment in the corporate sector. Therefore, business capital investment will most likely serve as the principal drag upon the rate of real GDP growth in FY2007.

We have revised our economic outlook up to FY2007 as set forth in **Chart 5**, to reflect the 2nd QE for the Jan-Mar quarter of 2006 and the *Financial Statements Statistics of Corporations by Industry*. The rate of real GDP growth in FY2006 was revised up from the previous forecast of 2.3% y-o-y as of May 23, 2006 to

2.5% y-o-y, due to the rise of the carry-over of growth due mainly to an upward revision of growth in the Jan-Mar quarter of 2006. Our forecast on real GDP growth in FY2007 remains unchanged at 1.5% y-o-y.

[Chart 5: Outlook on the Japanese economy]

(%)

	FY2005 (Actual)	FY2006 (Forecast)	FY2007 (Forecast)	FY2006		FY2007		FY2006	FY2007
				1H (Forecast)	2H (Forecast)	1H (Forecast)	2H (Forecast)	(Contribution) (Forecast)	(Contribution) (Forecast)
GDP (real)	3.2	2.5	1.5	1.2	0.9	0.6	0.9	-	-
Domestic demand	2.8	2.2	1.3	1.2	0.9	0.5	0.7	2.2	1.3
Private sector demand	3.4	2.7	1.5	1.4	1.0	0.5	0.9	2.0	1.2
Personal consumption	2.4	1.8	1.7	0.8	0.8	0.8	0.9	1.0	1.0
Housing investment	-0.2	0.7	-0.6	-0.9	-0.1	-0.5	-0.2	0.0	-0.0
Capital investment	7.5	5.4	1.7	3.3	1.8	0.5	0.8	0.8	0.3
Public sector demand	0.8	0.6	0.5	0.4	0.5	0.2	0.1	0.1	0.1
Government consumption	1.5	2.0	1.9	1.1	1.3	0.9	0.7	0.4	0.3
Public investment	-1.4	-5.1	-4.4	-2.4	-2.8	-1.9	-2.3	-0.2	-0.2
Net exports (contribution)	0.4	0.3	0.2	0.0	-0.0	0.1	0.2	0.3	0.2
Exports	9.2	7.9	4.8	3.7	1.5	2.2	3.5	1.2	0.7
Imports	6.8	6.8	3.9	4.3	2.0	1.5	2.7	-0.9	-0.6
GDP (nominal)	1.9	2.5	2.0	1.6	0.8	1.3	0.7		
GDP deflator	-1.4	0.0	0.5	-0.3	0.3	0.6	0.4		
Industrial production	1.6	3.8	2.3	1.9	1.0	0.6	2.6		
Unemployment rate	4.4	4.0	3.7	4.1	4.0	3.7	3.7		
Current account balance (trillion yen)	18.9	19.8	20.9	18.9	20.7	20.5	21.2		
as a percentage of nominal GDP	3.7	3.8	3.9	3.7	4.0	3.9	4.0		
Corporate goods prices	2.1	2.1	-0.2	2.7	1.4	0.1	-0.5		
Consumer prices	0.1	0.7	0.5	0.7	0.7	0.5	0.5		
Long-term interest rate (%)	1.42	2.00	2.25	1.90	2.10	2.20	2.30		
Nikkei stock average (yen)	13,549	16,700	17,600	16,300	17,100	17,500	17,700		
Exchange rate (yen/dollar)	113.2	109	107	112	107	106	108		
Crude oil price (WTI \$/barrel)	60.0	68.9	61.4	71.2	66.7	63.1	59.8		

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*.

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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 underline that starts under the 'M', goes under the 'I', 'Z', and 'U', and then curves upwards under the 'H' and 'O'.