

## Economic Outlook for FY2006 and FY2007

*(Revised to reflect the Second Preliminary Quarterly Estimates of GDP for the Apr-Jun quarter of 2006)*

September 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 Apr-Jun quarter of 2006. The key points of the outlook are as follows.

### <The US Economy>

	The downturn of the housing market will drag down growth
<b>2006</b>	3.5% (previous outlook) → 3.5% (current outlook)
<b>2007</b>	2.9% (previous outlook) → 2.8% (current outlook)

### <The Japanese Economy>

<b>FY2006</b>	Despite an ongoing autonomous recovery, exports will slow down slightly in the second half of the fiscal year Real GDP: 2.3% (previous outlook) → 2.3% (current outlook) Nominal GDP: 2.3% (previous outlook) → 2.1% (current outlook)
<b>FY2007</b>	Capital investment will serve as a drag, due to slower corporate profit growth Real GDP: 1.7% (previous outlook) → 1.6% (current outlook) Nominal GDP: 2.3% (previous outlook) → 2.2% (current outlook)

This English-language translation is based upon the outlook in Japanese released on September 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

### US economic outlook revised downward: a growth recession in 2H2006

The key factor in the recent revision of our economic outlook stems from a grimmer outlook on US housing investment. While our previous outlook did factor in a downturn of housing investment in the US, we have revised downward our outlook because of a faster-than-expected pace of downturn and the absence of signs that the housing market will bottom out any time soon.

Thus, even though the revisions of our forecasts on US real GDP growth appear minimal on a calendar year basis (2006: 3.5%→3.5%, 2007: 2.9%→2.8%), the pace of growth from the second half of 2006 to the first half of 2007 have been revised downward by -0.3% pt and -0.1% pt (**Chart 1**). In comparison to our previous *Economic Outlook for FY2006 and FY2007*, there is a greater possibility of a “growth recession” (a state where the economy is very weak but not technically in a recession) in the second half of 2006.

### The US economy will avoid a recession and start to pick up in 2H2007

Even though US housing investment has been declining for three consecutive quarters, building permits (said to be a leading indicator of housing investment) and the Housing Market Index (which gauges confidence among home builders) are falling at a faster-than-expected pace. Judging from these conditions, the housing market downturn is far more serious than initially expected, with no signs of an upturn any time soon. Moreover, there has been increasing media coverage that cash-strapped households purchasing homes with complicated unconventional mortgage schemes are starting to have a negative impact. The risks of the overheated housing boom serving as negative pressures upon marginal household expenditures which in turn spread to the entire household sector, require close attention.

[ Chart 1: The US Economy]

(%)

	2005	2006	2007	2006		2007	
	(Actual)	(Forecast)	(Forecast)	1H	2H	1H	2H
GDP	3.2	3.5	2.8	3.9	2.6	2.7	3.1
Personal consumption	3.5	3.1	2.8	3.2	2.9	2.8	2.9
Housing investment	8.6	-2.8	-4.4	-2.9	-12.3	-3.7	2.7
Capital investment	6.8	7.4	4.3	9.2	5.7	3.6	4.2
Inventory investment (\$100 million)	197	505	526	500	511	513	539
Government expenditures	0.9	2.2	2.9	2.4	2.5	3.0	3.0
Net exports (\$100 million)	-6,192	-6,233	-6,221	-6,301	-6,166	-6,169	-6,273
Exports	6.8	8.5	4.9	10.6	6.5	4.0	5.0
Imports	6.1	5.8	3.2	7.9	2.9	2.7	4.5
Domestic final demand	3.6	3.0	2.6	3.3	2.2	2.6	3.1
Core personal expenditures deflator <y-o-y ch>	2.1	2.3	2.4	2.1	2.5	2.6	2.3
Current account balance (\$ 100 million)	-7,915	-8,520	-8,440	-4,240	-4,280	-4,120	-4,330
<as a percentage of nominal GDP>	-6.4	-6.4	-6.0	-6.5	-6.3	-5.9	-6.0

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.

However, we are still inclined toward the view that it is unlikely that the housing market downturn will dampen consumer spending and push the US economy into recession. Even though residential prices are about to peak out along with the slumping sales of homes and the rise of the inventory-to-sales ratio, it is unlikely that these movements will work as a “reverse wealth effect” to serve as significant downward pressures upon consumer spending. What matters most for each individual household is whether their homes have increased in value from “the point in time of home purchase”. Residential prices taking into consideration such factors (the existing home index of the Office of Federal Housing Enterprise Oversight (OFHEO)) indicate that prices are past the peak but still rising at a pace of 10% y-o-y as of the Apr-Jun quarter of 2006. There is still a positive wealth effect, and it is unlikely that the rise of residential prices in terms of the existing home price index will take a downturn.

Furthermore, the government’s recent revision of GDP statistics revealed that payrolls have grown at a faster pace than initially expected. In turn, this suggests that consumer spending will be less dependent upon the “wealth effect” of homes than first expected.

The US economy will pick up toward the second half of 2007 as the housing market emerges out of a downturn around mid-2007.

## II. The Japanese economy

### 1. The current state of the Japanese economy

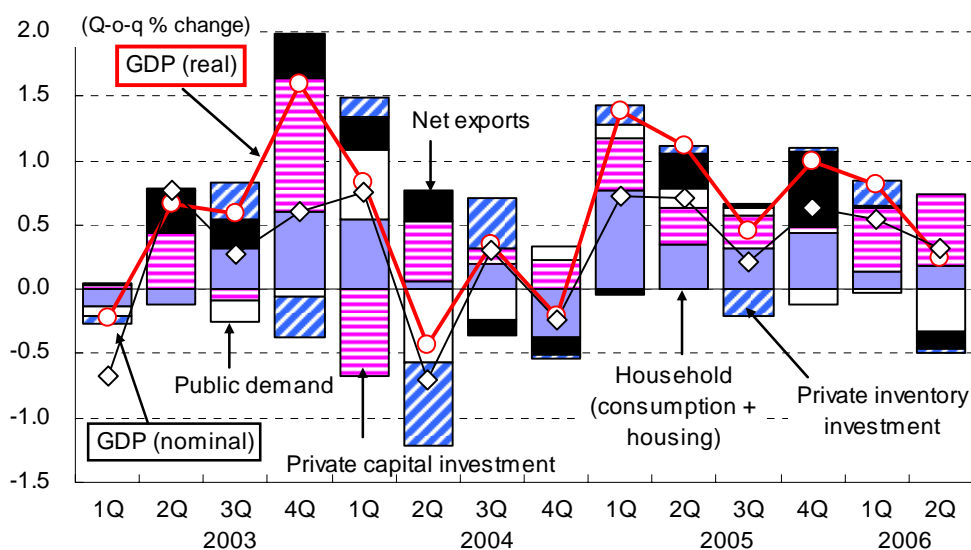
**The Japanese economy slowed to 1.0% q-o-q p.a. in the Apr-Jun quarter of 2006**

**Brisk domestic private sector demand**

The *Second Preliminary Quarterly Estimates of GDP* (“2<sup>nd</sup> QE”) for the Apr-Jun quarter of 2006 revealed that Japan’s real GDP grew 0.2% q-o-q (1.0% q-o-q p.a.) (Chart 2), revised upward by a marginal degree from 0.2% q-o-q (0.8% q-o-q p.a.) in the *First Preliminary Quarterly Estimates of GDP*. Although the pace of growth fell short of the rate of potential growth estimated to be around the upper end of the 1%-level, domestic private sector demand continued to expand, indicating that the self-sustained recovery of the Japanese economy is still continuing.

Looking closer at the components of demand, personal consumption grew 0.5% q-o-q (0.2% q-o-q in the previous quarter). Business capital investment grew a dramatic 3.7% q-o-q (3.3% q-o-q in the previous quarter), surpassing 3% for the second quarter in a row, given the ongoing improvement of business performance and high rate of capacity utilization. Meanwhile, in the public government sector, public investment fell a sharp 6.3% q-o-q (-0.6% q-o-q in the previous quarter). Since government consumption also dropped 0.2% q-o-q (0.0% q-o-q in the previous quarter), the contribution by public demand to quarterly growth fell to -0.3% pt, serving as a drag upon growth. As a result, the contribution of domestic demand to quarterly growth dropped to 0.4% pt from 0.8% pt in the previous quarter. The contribution by external demand to quarterly growth fell into negative territory (-0.1% pt) as a result of the slowdown of exports to 0.9% q-o-q (2.2% q-o-q in the previous quarter) and the ongoing rise of imports to 2.0% q-o-q (2.4 % q-o-q in the previous quarter) backed by solid domestic demand.

[ Chart 2: Japan’s quarterly GDP growth (2<sup>nd</sup> 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 -0.8% over a year ago (o-y-a) from -1.3% o-y-a in the previous quarter. In particular, the domestic demand deflator rose into positive territory (0.1% y-o-y), indicating the steady ebb of the risks that the Japanese economy will fall back into deflation.

**The CPI fell due to a rebase and reshuffling of the components**

A notable change since the release of our previous *Economic Outlook for FY2006 and FY2007* on August 15<sup>th</sup> is the revision the base year and components of the consumer price index (CPI). Given the addition of flat-panel TVs subject to steep price falls, a larger weight of mobile telephone charges, the consumer price index (general, excluding fresh food) rose only 0.2% y-o-y as of July, revised downward by 0.4% pt prior to the revision. Even so, judging from the fact that the year-on-year change of the core CPI is rising on a chronological perspective, our view remains unchanged that the Japanese economy has already emerged out of deflation reflecting the upturn of the output gap into positive territory. Note that the new rebased CPI will start to be reflected in the GDP statistics from the *First Preliminary Quarterly Estimate of GDPs* for the Jul-Sep quarter to be released in November.

## 2. Forecast of the Japanese economy in FY2006 and FY2007

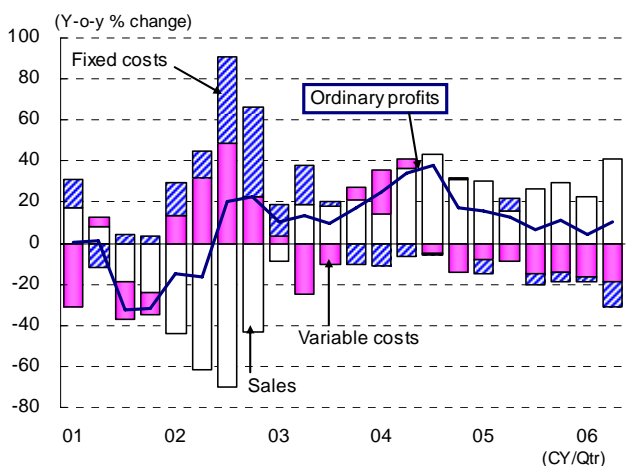
**The corporate sector regained double-digit profit growth in the Apr-Jun quarter**

**Corporate performance will slow down in the second half of FY2006**

Ordinary profits (based upon the *Financial Statements Statistics of Corporations by Industry*) grew 10.1% y-o-y in the Apr-Jun quarter of 2006 (4.1% y-o-y in the previous quarter), regaining double-digit profit growth (**Chart 3**). Looking at the chart, the rise of variable costs due to higher raw material and fuel costs are serving as a greater drag upon profits. Furthermore, as shown by fixed costs (such as labor costs) starting to push down profits, cost pressures are rising. Since businesses are covering the higher costs by increasing sales volumes and shifting the burden of costs to prices, the rise of sales is resulting in higher profits.

In the second half of FY2006, the pace of profit growth should slow down along with the moderation of exports accompanying the slowdown of the overseas economies particularly in 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 6.6 % 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 ]



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

[ Chart 4: Corporate profits (forecast) ]

		(Y-o-y % change)			
		FY2004	FY2005	FY2006 (Forecast)	FY2007 (Forecast)
Total	Sales	5.6	4.6	5.0	3.0
	Ordinary profits	24.6	8.4	6.6	3.7
Manufacturing	Sales	5.3	6.1	4.4	1.8
	Ordinary profits	28.3	12.4	6.9	3.5
Non-manufacturing	Sales	5.7	3.9	5.3	3.6
	Ordinary profits	22.2	5.7	6.3	3.9
Large corporations	Sales	5.8	6.5	5.1	2.9
	Ordinary profits	24.8	13.9	9.1	4.6
Manufacturing	Sales	5.5	7.1	5.5	1.9
	Ordinary profits	26.6	14.7	7.7	3.6
Non-manufacturing	Sales	6.0	6.0	4.7	3.8
	Ordinary profits	22.8	13.0	10.8	5.6
Small and medium-sized corporations	Sales	5.4	3.2	5.0	3.1
	Ordinary profits	24.5	2.4	3.4	2.6

Note: "Large corporations" refer to corporations with capital of 1 billion 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 Statement Statistics of Corporations, Quarterly*.

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

**Real GDP growth forecast: FY2006 (2.3%) and FY2007 (1.6%)**

In FY2007, the rise of fixed costs such as labor costs will serve as a heavier burden upon ordinary profit growth. Corporate profit growth will slow down further and businesses will take a more cautious stance in capital investment. As a result, business capital investment will serve as a major drag upon the pace of real GDP growth in FY2007.

We have revised our economic outlook up to FY2007 as set forth in **Chart 5**, to reflect the 2<sup>nd</sup> QE for the Apr-Jun quarter of 2006 and the *Financial Statements Statistics of Corporations by Industry*. In comparison to our previous outlook (as

of August 15<sup>th</sup>), the rate of real GDP growth in FY2006 remains unchanged at 2.3% y-o-y and the rate of real GDP growth in Y2007 has been revised from 1.7% in the previous outlook to 1.6%. Due in part to a downward revision of our outlook on the US economy, exports from the second half of FY2006 to early FY2007 has been revised downward.

[ Chart 5: Outlook on the Japanese economy ]

(%)

	FY2005	FY2006	FY2007	FY2006		FY2007		FY2006	FY2007
	(Actual)	(Forecast)	(Forecast)	1H (Forecast)	2H (Forecast)	1H (Forecast)	2H (Forecast)	(Contribution) (Forecast)	(Contribution) (Forecast)
GDP (real)	3.2	2.3	1.6	1.0	1.0	0.7	0.9	-	-
Domestic demand	2.8	2.3	1.7	1.1	1.2	0.7	0.7	2.2	1.7
Private sector demand	3.3	3.1	2.0	1.8	1.1	0.9	1.1	2.4	1.5
Personal consumption	2.3	1.9	1.8	0.9	1.1	0.9	0.8	1.1	1.0
Housing investment	-0.2	1.1	0.0	-1.8	3.0	-0.1	-2.8	0.0	0.0
Capital investment	7.5	7.4	2.4	5.7	0.7	0.9	2.2	1.1	0.4
Public sector demand	0.8	-0.6	0.6	-1.2	1.5	0.2	-0.5	-0.1	0.1
Government consumption	1.5	0.9	1.3	0.1	1.3	0.5	0.2	0.2	0.2
Public investment	-1.4	-6.1	-2.4	-6.0	2.1	-1.3	-3.5	-0.3	-0.1
Net exports (contribution)	0.5	0.1	-0.1	-0.1	-0.1	-0.0	0.1	0.1	-0.1
Exports	9.1	6.4	2.7	2.8	0.7	0.9	2.9	0.9	0.4
Imports	6.5	6.1	3.4	4.0	1.8	1.4	2.3	-0.8	-0.5
GDP (nominal)	1.8	2.1	2.2	1.1	1.0	1.4	0.7		
GDP deflator	-1.4	-0.2	0.6	-0.5	-0.0	0.6	0.5		
Industrial production	1.6	3.4	2.1	1.7	0.7	0.7	2.2		
Unemployment rate	4.4	4.0	3.7	4.1	4.0	3.7	3.7		
Current account balance (trillion yen)	19.1	18.0	19.5	18.1	18.0	19.3	19.8		
as a percentage of nominal GDP	3.8	3.5	3.7	3.5	3.5	3.7	3.7		
Corporate goods prices	2.1	2.5	-0.0	3.1	1.9	0.2	-0.2		
Consumer prices	-0.1	0.1	0.3	0.1	0.2	0.2	0.3		
Long-term interest rate (%)	1.42	1.85	2.15	1.80	1.90	2.10	2.20		
Nikkei stock average (yen)	13,549	16,200	17,300	15,800	16,600	17,100	17,500		
Exchange rate (yen/dollar)	113.2	113	109	115	112	108	110		
Crude oil price (WTI \$/barrel)	60.0	73.0	67.4	72.8	73.2	70.1	64.7		

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*.

\* \* \* \* \*

Mizuho Research Institute Ltd.  
 Makoto Ono, Senior Economist  
 makoto.ono@mizuho-ri.co.jp

**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', dips down, and then rises to end under the 'O'.