Economic Outlook for FY2004 and FY2005

September 2004

The Mizuho Research Institute Ltd. (MHRI) sets forth its economic outlook for FY2004 and FY2005 subsequent to the release of *The 1st Preliminary Quarterly Estimates of GDP* for the Apr-Jun quarter of 2004 by the Cabinet Office. The key points of the outlook are as follows.

<The Overseas Economies>

The US Economy	More definite signs of self-sustained growth in the second half of 2005 (4.3% in 2004, 3.6% in 2005)
The Euro Zone Economy	Lingering structural adjustment pressures will continue to serve as a drag upon recovery (1.7% in 2004, 1.8% in 2005)
The Asian Economies	Growth will slow down in 2005 due to inventory adjustment of IT-related goods (7.1% in 2004, 6.2% in 2005)

<The Japanese Economy>

FY2004	Although Japan will remain on recovery track, growth will slow down in the second half of the fiscal year (real GDP growth 3.5%, nominal GDP growth 1.6%)
FY2005	Japan will look for stable growth driven by domestic private-sector demand) (real GDP growth 2.1%, nominal GDP growth 1.4%

Mizuho Research Institute

I. The Overseas Economies

○	**The US Economy**	More definite signs of self-sustained growth in the second half of 2005 (4.3% in 2004, 3.6% in 2005)
○	**The Euro Zone Economy**	Lingering structural adjustment pressures will continue to serve as a drag upon recovery (1.7% in 2004, 1.8% in 2005)
○	**The Asian Economies**	Growth will slow in 2005 due to inventory adjustment of IT-related goods (7.1% in 2004, 6.2% in 2005)

1. The US Economy

The US economy is forecast to slow down to its potential rate of growth in the second half of 2004. Despite a generally favorable income environment amid the steady growth of wages, the slower growth of disposable income due to the fading impact of the tax cuts and the rise of the inflation rate will serve as a drag upon consumer spending. The pace of US gross domestic product (GDP) in real terms is forecast to stand at 4.3% in 2004 (our previous forecast was 4.4%).

In 2005, the US economy should remain on a self-sustained growth track as the inflation rate calms down due to a pause in the surge of crude oil prices and high productivity gains. The steady rise of real income will serve to buttress personal consumption. Nevertheless, the economy will pause on the landing in the first half of 2005 as the fading impact of the tax cuts and rising household debt burdens dampen the rise of consumption and serve as a drag upon economic growth. However, the economy should regain momentum into an autonomous growth path in the second half of the year, reflecting the sustained pickup of real income in the household sector. Our forecast on US real GDP growth in FY2005 is 3.6% (previous forecast: 3.6%).

Although consumer prices will rise temporarily in the second half of 2004 due to high crude oil prices, the rise will be subdued because of a pause in the rise of crude oil prices and productivity gains in 2005.

Chart 1: Forecast of the US Economy

(%)

	2003 (Actual)	2004 (Forecast)	2005 (Forecast)	2004 1st-half (Actual)	2004 2nd-half (Forecast)	2005 1st-half (Forecast)	2005 2nd-half (Forecast)
GDP (real)	3.0	4.3	3.6	4.0	3.4	3.6	3.8
Personal consumption	3.3	3.4	3.1	3.2	2.7	3.1	3.6
Housing investment	8.8	9.8	3.2	8.7	6.7	2.5	1.2
Capital investment	3.3	9.2	8.8	7.0	9.5	8.9	8.1
Inventory investment ($100 million)	-7	389	445	438	340	405	485
Government expenditures	2.8	2.2	1.6	2.2	1.9	1.4	1.8
Net exports ($100 million)	-5,185	-5,514	-5,598	-5,515	-5,514	-5,553	-5,642
Exports	1.9	10.7	9.1	11.2	11.0	8.7	8.0
Imports	4.4	9.3	6.6	11.8	7.3	6.4	6.5
Domestic final demand	3.4	4.0	3.4	3.7	3.4	3.4	3.6
Consumer price index (y-o-y % ch)	2.3	2.5	2.0	2.3	2.7	2.2	1.9
Core CPI (y-o-y % ch)	1.5	1.8	2.0	1.5	2.0	2.0	1.9
Current account balance ($100 million)	-5,307	-6,053	-6,332	-2,978	-3,075	-3,118	-3,214
<as a percentage of nominal GDP>	-4.8	-5.2	-5.1	-5.2	-5.2	-5.1	-5.1

Notes: 1. CY = rate of change from the previous year. Half-year term = rate of change per annum from the previous term.
2. The shaded columns are forecasts.
3. With respect to the current account balance, only the the actual figures for 2003 are original data. Half-year figures for 2004 and 2005 are adjusted for seasonal factors and full calendar year figures are totals of the half-year figures. The percentage of nominal GDP are annualized.

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

2. The Euro Zone Economy

The euro zone economy remains dependent upon external demand due to lackluster domestic demand stemming from persistent structural adjustment pressures.

Looking forward, exports are headed for a gradual slowdown reflecting the ebb of economic growth in major export destinations such as the UK, Asia and the US. In contrast, there are signs that domestic demand is picking up due to a virtuous cycle triggered by the rise of export-oriented production. However, the recovery will lack strength because of (1) forecasts of a slowdown of exports, (2) a lagging improvement of labor market conditions amid a labor overhang due to pressures from a hollowing-out of the euro zone economy stemming from the slow rise of productivity and the expansion of the EU, and (3) the capital stock overhang and the belated reduction of corporate debts serving as a drag upon capital investment. We expect real GDP growth in the euro zone to grow mildly in 2004 (1.7%, unchanged from our previous forecast) and 2005 (1.8%, unchanged for our previous forecast).

The year-on-year percentage change of consumer prices should remain pinned at a high level due to special factors during 2004 such as the cigarette tax hike and the rise of public utilities and high crude oil prices. However, the rise of prices should slow down in 2005 along with the gradual fall of crude oil prices and the fading impact of the special factors because of limited inflationary pressures from the perspective of wages amid a high level of unemployment and the hollowing out of the labor market.

Chart 2: Forecast of the Euro Zone Economy

(%)

		2003 (Actual)	2004 (Forecast)	2005 (Forecast)	2004 1st-half (Forecast)	2004 2nd-half (Forecast)	2005 1st-half (Forecast)	2005 2nd-half (Forecast)
Real GDP	Euro zone	0.5	1.7	1.8	1.1	0.8	0.8	1.0
	Private-sector consumption	1.0	1.3	1.6	0.9	0.5	0.8	1.1
	Government consumption	2.0	1.4	1.4	0.4	0.9	0.7	0.6
	Investment	-0.6	1.0	1.5	0.6	0.3	0.8	1.2
	External demand (1 bil euro)	144.5	161.0	135.6	79.7	81.3	74.6	61.0
	Exports	0.1	3.5	1.8	2.0	1.0	0.9	0.8
	Imports	1.9	3.0	3.0	1.8	0.9	1.5	1.9
	Inventories (1 bil euro)	1.8	19.4	60.6	6.5	12.9	22.9	37.7
	Germany	-0.1	1.4	1.4	0.8	0.8	0.6	0.7
	France	0.5	2.3	2.4	1.5	0.9	1.1	1.5
	Italy	0.4	1.4	1.7	0.6	1.2	0.8	0.8
	UK	2.2	3.4	2.6	1.7	1.4	1.3	1.3
Euro zone consumer prices		2.1	2.1	1.8	2.0	2.2	2.0	1.7

Notes: 1. Rate of GDP growth. Yr = rate of change over the previous year. Half-year term = rate of change over the previous term.
2. The shaded columns are forecasts.

Sources: Eurostat, ECB, ONS.

3. The Asian Economies

Despite the Chinese economy's recent rise in prominence among the Asian economies, our forecast looks for a gradual slowdown of the Chinese economy from the second half of 2004 due to: (1) a slower pace of export growth along with the slowdown of US and Japanese economic growth, and (2) the deceleration of fixed asset investment as a result of the continuation of regulatory controls. China's real GDP growth is forecast to fall from an estimated 9.4% in 2003 to 8.9% in 2004 and 8.3% in 2005.

Turning to the rest of Asia (excluding Japan), exports – thus far the main driver of growth – is predicted to slow down after peaking in mid-2004 because of (1) restraints upon production accompanying the unintentional accumulation of inventories of parts and intermediate goods related to information technology (IT) appliances, and (2) the slowdown of fixed asset investment in China. Meanwhile, we are inclined toward the view that domestic demand will remain strong due to (1) the high level of capital investment accompanying the replacement of products in the semiconductor, liquid crystal panel and related parts and materials sectors in a bid to reinforce competitiveness, and (2) strong personal consumption driven by the improvement of labor market conditions reflecting the rise of corporate profits in the first half of 2004. In 2005 however, capital investment growth should slow down as a result of (1) the decline of corporate profit growth along with the fall of prices for semiconductors and electronic parts and liquid crystal panels, (2) the deceleration of exports to China, and (3) the gradual rise of interest rates in Asia. Furthermore, the odds are high that the growth of personal consumption will slow down because of a pause in the improvement of labor market conditions reflecting a slower pace of corporate profit growth. We expect real GDP growth of the Asian economies to rise to 7.1% (previous forecast: 7.1%) in 2004 and slow down to 6.2% (previous forecast: 6.2%) in 2005.

Chart 3: Forecast of the Asian Economies

(%)

	2002 (Actual)	2003 (Actual)	2004 (Forecast)	2005 (Forecast)
Asia (average)	6.3	6.2	7.1	6.2
NIEs (average)	4.9	3.0	5.7	4.4
S. Korea	7.0	3.1	5.2	4.8
Taiwan	3.6	3.2	5.6	4.0
Hong Kong	1.9	3.2	6.1	3.9
Singapore	2.2	1.1	7.8	4.4
ASEAN4 (average)	4.6	5.3	5.5	4.8
Thailand	5.4	6.8	6.5	5.4
Malaysia	4.1	5.3	6.4	4.7
Indonesia	4.3	4.5	4.7	4.6
Philippines	4.3	4.7	4.6	4.3
China	8.3	9.4	8.9	8.3

Notes: 1. Real GDP growth (rate of change over the previous year). The shaded columns are forecasts.
2. Growth rates for China are estimates by MHRI in consideration of the revision of GDP statistics (the official GDP growth released is 9.2%).
3. The averages are weighted averages on the basis of each country's nominal GDP in 2000.

Source: Government data disclosed by each of the relevant countries.

II. The Japanese Economy

1. The current state of the Japanese economy

Positive real GDP growth for the fifth consecutive quarter in the Apr-Jun quarter of 2004

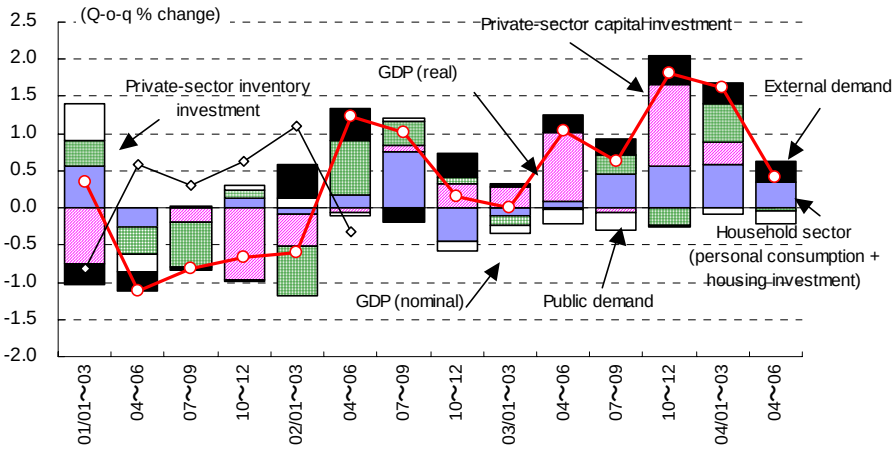
The Japanese economy continued to show signs of steady progress toward its emergence out of deflation amid the rise of exports and solid domestic private-sector demand driven mainly by consumer spending and capital investment.

Japan's real GDP (on the basis of *The 1st Preliminary Quarterly Estimates of GDP)* grew at a slower-than-expected rate of 0.4% q-o-q (translated into an annualized rate of 1.7%) in the Apr-Jun quarter of 2004, slowing sharply from the two preceding quarters when the economy grew around 7% p.a. (Chart 4). However, in view of the possibility that part of the investment in plant and equipment may have been postponed until the Jul-Sep quarter (or upwardly revised in the 2nd QE), actual capital investment may well be stronger than what the data suggest. Furthermore, the very fact that growth managed to stay in positive territory for five consecutive quarters despite the negative contribution of public demand stemming from the sharp fall of public investment, may be interpreted as signs of the strength of the economy.

The economy is still expanding

There are concerns that capital investment - a key factor in the future course of the economy - may be peaking out in view of the flat quarterly growth of capital investment in the Apr-Jun quarter. However, the strong 10.3% q-o-q rise of machinery orders (orders in the private sector excluding orders for ships and orders by electric power companies) in the Apr-Jun quarter should be interpreted as signs that capital investment is still expanding. It appears that the strength of personal consumption in the Apr-Jun quarter is continuing in the ensuing period from July, driven mainly by the Athens Olympic Games and Japan's hot summer weather this year. The economy is still maintaining its growth momentum over the summer season.

Chart 4: Japan's Real GDP Growth



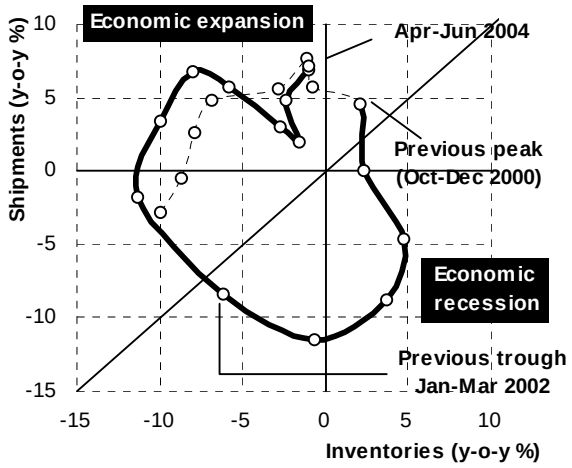
Source: Cabinet Office, *Preliminary Quarterly Estimates of GDP (QE).*

Japan's economic recovery is losing steam

Nevertheless, it is also true that a recent spate of economic indicators suggest that Japan's economic recovery momentum is losing steam.

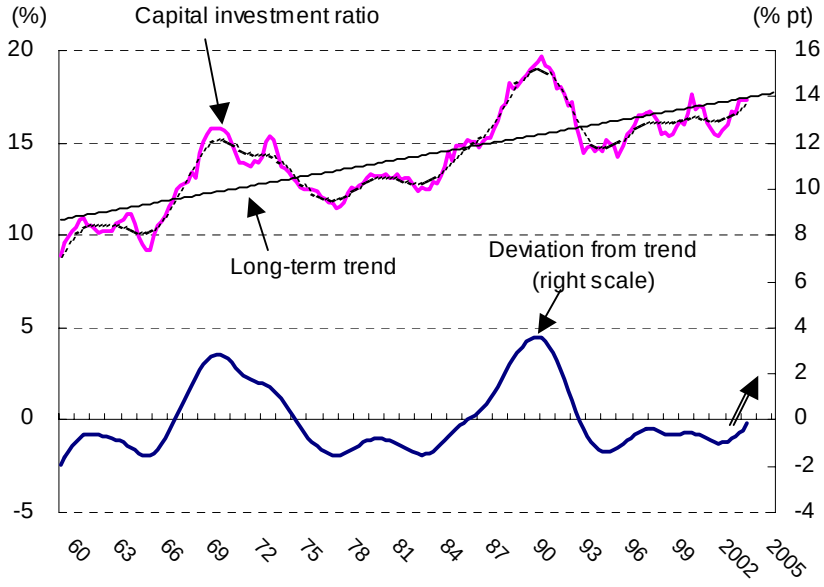
Judging the current state of the economy from the perspective of the economic cycle, the economy as of July 2004 is already 30 months into its current expansion phase (bottoming in January 2002), thus edging closer to the average of past expansion cycles (33.1 months). If history is of any guide to future events, the expansion phase may be nearing an end. In the area of IT-related producer goods that leads overall trends, the accumulation of inventories is generating pressures to adjust output. The inventory cycle of the entire industrial spectrum is also nearing the end of an expansion cycle (Chart 5).

Chart 5: The Inventory Cycle



Source: Ministry of Economy, Trade and Industry, *Indices of Industrial Production.*

Chart 6: The Capital Investment Cycle



Notes: Capital investment ratio = capital investment (real) / GDP (real). (CY)
Smoothing by HP filter (parameter 100). Long-term trend = 1980~2004.
Source: Cabinet Office, *Annual Report on National Accounts.*

A major reduction of production is unlikely, judging from the low level of inventories

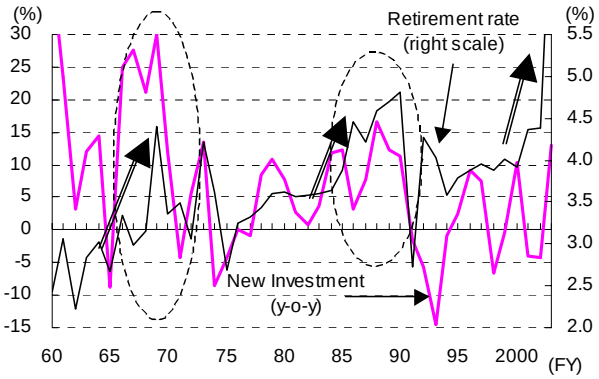
Nevertheless, it should be noted that the fluctuation of inventory levels is growing smaller because of the recent behavior among corporations to limit inventories to a minimum. Inventory levels are still pared down in spite of the fact that the economy has been in an expansion phase for two and a half years. Thus, even if there were an unintentional accumulation of inventories, the resulting production adjustment would be relatively benign, and will not serve as a serious drag upon the economy. As long as there are no major external shocks, the chances are remote that the economy will slip in to a recession anytime soon.

The capital investment cycle is headed upward in the long run

Meanwhile, the capital investment cycle over a longer period of time indicates the possibility that capital investment may enter a prolonged period of recovery seen in the second half of the 1960s and the second half of the 1980s (Chart 6). Lending support to our view is the recent rise of the retirement rate. As shown in Chart 7, a cyclical rise of the retirement rate leads to a prolonged expansion of capital investment. There are also signs of recovery in construction investment (Chart 8). A rise of construction investment - having a cycle of approximately 20 years - is said to be indispensable for a long-term expansion of capital investment.

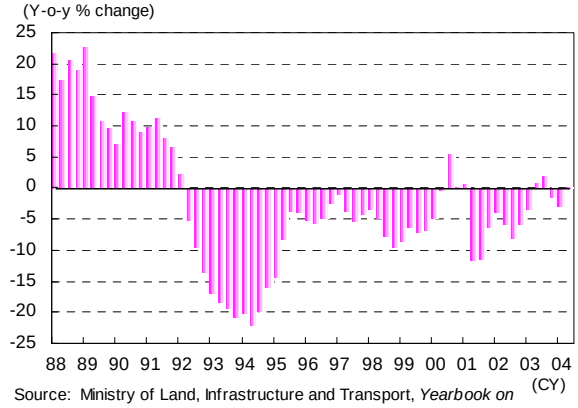
Although there is every reason to be concerned regarding the ebb of Japan's economic recovery momentum along with the maturation of the short-term economic cycle, we believe that its negative impact may be absorbed by the ongoing rise of capital investment, thus averting a slide into recession.

Chart 7: Capital Investment – Retirement Rate and New Investment



Notes: Retirement rate = (new investment - increase of stock) / capital stock x 100. All-industries basis. Capital stock after adjustment for privatization.
Source: Cabinet Office, *Gross Capital Stock of Private Enterprises*.

Chart 8: Real Construction Investment



Source: Ministry of Land, Infrastructure and Transport, *Yearbook on Construction Statistics*.

2. Overview and risk factors in the forecast of the Japanese economy in FY2004 and FY2005

Japan's GDP is forecast to rise 3.5% in real terms and 1.6% in nominal terms in FY2004

Looking forward, Japan's economy is expected to remain strong, driven mainly by personal consumption and capital investment. Consumer spending should remain robust up to early autumn because of the hot weather and the Olympic Games in Athens. Capital investment is also poised to grow, because companies in the IT and digital electronics sector are front-loading their capital investment plans in a bid to secure competitiveness and small- and medium-sized companies are taking an upbeat investment stance to maintain and renew plant and equipment reflecting the upturn of their business performance.

In the second half of FY2004 however, exports are predicted to wane, due to a slowdown of the overseas economies. Personal consumption is also poised to fall given the ebb of the positive effect stemming from the hot weather and the Athens Olympic Games. Furthermore, capital investment is also expected to fall into a temporary lull until the revival of investment activity in the non-manufacturing sector because of a pause in investment among manufacturers, which have thus far acted as the driver of capital investment growth (Chart 9).

The rate of real GDP in FY2004 is forecast to slow from 1.6% over the previous term (3.2% p.a.) in the first half to 0.9% (1.7% p.a.) in the second half. However, full year growth is forecast to climb higher than the previous year, reaching 3.5% in real terms (our previous forecast was 3.4%) and 1.6% in nominal terms (previous forecast: 1.7%) due to a large 2.2% carry-over from FY2003.

Sluggish growth in the first half of FY2005

In FY2005, personal consumption should gradually gather momentum matching the rise of income because of prospects of a sustained improvement of income on the back of an ongoing rise of corporate business performance. Capital investment should also maintain its momentum as the main driver of growth shifts from manufacturers to non-manufacturers with the continuing expansion of consumer spending serving as tailwinds. Exports will also continue to rise albeit at a slower pace and buttress the economy. However, the growth of the economy will most likely be sluggish in the fiscal first half, given the absence of the strong growth of personal consumption and capital investment needed to offset the decline of public investment.

A reentry into a growth trajectory the second half of FY2005

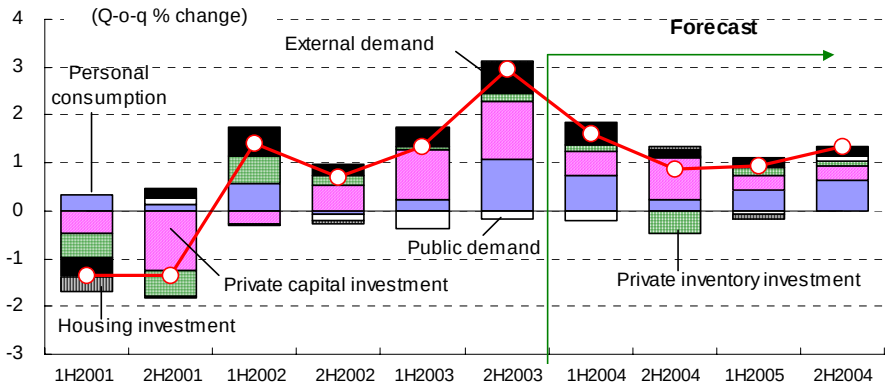
The economy will search for the chance to enter a stable growth trajectory driven by domestic private-sector demand in the second half of FY2005 on the back of the following factors: (1) a gradual recovery of personal consumption (2) the growth of capital investment among non-manufacturers, and (3) the rise of expectations

FY2005 real GDP growth is forecast to reach 2.1% (1.4% in nominal terms)

toward the end of deflation coaxing companies to abandon their practice of keeping inventories to a minimum.

Although real GDP growth in first half of FY2005 is expected to remain at 1.0% over the previous term (1.9% p.a.), the growth should pick up and reach 1.3% (2.7% p.a.) in the fiscal second half. Full year GDP growth is forecast to reach 2.1% (our previous forecast was 1.7%) in real terms and 1.4% (previous forecast: 0.6%) in nominal terms.

Chart 9: Forecast on Real GDP Growth



Note: Figures from 2H2004 are forecasts by MHRI.
Source: Cabinet Office, *Preliminary Quarterly Estimates of GDP.*

Chart 10: Forecast on the Japanese Economy

(%)

	FY2003 (Actual)	FY2004 (Forecast)	FY2005 (Forecast)	FY2004 1st-half (Forecast)	FY2004 2nd-half (Forecast)	FY2005 1st-half (Forecast)	FY2005 2nd-half (Forecast)	FY2004 (Contribution) (Forecast)	FY2005 (Contribution) (Forecast)
GDP (real)	3.3	3.5	2.1	1.6	0.9	1.0	1.3	-	-
Domestic demand	2.5	2.8	1.8	1.2	0.8	0.8	1.2	2.7	1.7
Private sector demand	4.0	3.9	2.2	1.8	0.9	1.1	1.4	2.9	1.7
Personal consumption	1.5	2.5	1.6	1.3	0.5	0.8	1.2	1.4	0.9
Housing investment	0.3	1.5	-1.1	-0.2	2.7	-2.5	0.2	0.1	-0.0
Capital investment	12.3	9.2	4.9	3.0	5.0	1.7	1.8	1.6	0.9
Public sector demand	-2.5	-1.3	-0.1	-1.0	0.1	-0.4	0.6	-0.3	-0.0
Government consumption	1.0	1.6	2.0	0.8	0.6	1.1	1.2	0.3	0.3
Public investment	-12.1	-10.8	-7.5	-7.2	-1.9	-5.8	-1.8	-0.6	-0.3
Net exports (contribution)	0.8	0.9	0.4	0.5	0.1	0.2	0.2	0.9	0.4
Exports	11.0	12.9	6.4	6.6	2.7	3.3	3.3	1.6	0.9
Imports	4.9	8.3	5.2	4.2	2.3	2.5	2.8	-0.8	-0.5
GDP (nominal)	0.8	1.6	1.4	0.8	0.2	0.8	1.0		
Industrial production	3.5	5.4	3.0	5.8	1.7	3.1	3.9		
Unemployment rate	5.1	4.6	4.3	4.7	4.7	4.5	4.2		
Current account balance (trillion yen)	17.3	18.9	21.5	19.0	19.1	20.1	22.1		
as a percentage of nominal GDP	3.4	3.7	4.1	3.7	3.7	3.9	4.3		
Corporate goods prices	-0.5	1.0	-0.2	1.3	0.9	-0.2	-0.3		
Consumer prices	-0.2	-0.2	-0.1	-0.2	-0.2	-0.2	0.0		
Long-term interest rate (%)	1.12	1.73	2.10	1.65	1.80	2.00	2.20		
Nikkei stock average (yen)	9,938	11,550	12,750	11,350	11,750	12,500	13,000		
Exchange rate (yen/dollar)	113.0	110	116	109	111	115	117		
Crude oil price (dollar/barrel)	31.4	39.5	36.9	39.2	39.8	36.8	37.0		

Notes: 1. FY = rate of change from the previous year. Half-year term = 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 the same period 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 translated 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, *Production, Shipment and Inventory Indexes,*
Ministry of Public Management, Home Affairs, Posts and Telecommunications, *Labor Force Survey, Consumer Price Index,*
Ministry of Finance, *Balance of Payments,*
Bank of Japan, *Corporate Goods Price Index.*

Crude oil and the Chinese economy continue to pose risks to the Japanese economy

Meanwhile, it is still necessary to pay attention to the risks of external shocks derailing the sustained recovery of the Japanese economy. As we pointed out in our economic outlook for FY2004 and FY2005 in June 2004, the negative impact stemming from the surge of crude oil prices or demand shocks due to a sharp downswing of the Chinese economy would amplify the possibility of a full-blown inventory adjustment amid forecasts of a temporary slowdown of Japan's economic recovery momentum.

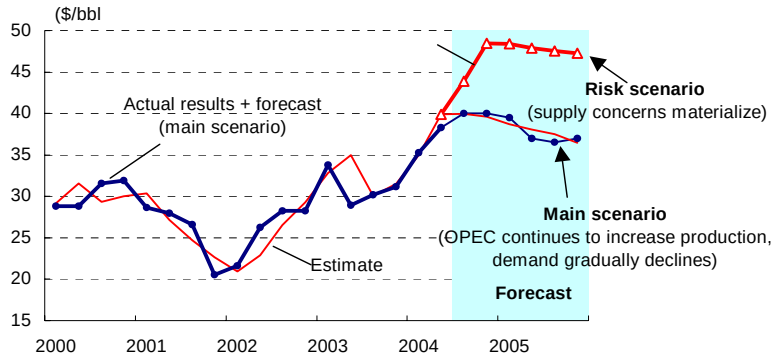
Crude oil prices surge to record highs

Crude oil prices are soaring to record levels because of the ongoing rise of demand mainly in China and the US and declining crude oil reserves among the Organization of Petroleum Exporting Countries (OPEC) nations. WTI futures (near term contracts) are rising to the upper half of the $40/barrel level, because of additional factors such as (1) the rise of supply-side uncertainties due to frequent terrorist attacks in Iraq and the financial failure of a Russian oil giant, (2) the upward revision of demand forecasts by the International Energy Agency (IEA), and (3) the inflow of speculative funds.

Crude oil prices will gradually decline because of the ebb of negative factors regarding demand

Looking forward, the temporary supply-side uncertainties should gradually abate, as evidenced by the absence of large-scale strikes after Venezuelan President Hugo Chavez survived a recall referendum. On the demand side, the demand for crude oil should decline reflecting the slowdown of the US and Chinese economies. We are therefore inclined to believe that crude oil prices will cool down along with the ebb of negative factors upon the demand-supply balance (the main scenario in Chart 11). However, uncertainties regarding supply will linger due to factors such as the unstable conditions in Iraq.

Chart 11: Forecast on Crude Oil Prices



Note: Forecast by MHRI.
Source: New York Mercantile Exchange.

Crude oil prices will remain high if supply uncertainties materialize

In the event the uncertainties regarding supply materialize, such as a further escalation of violence in Iraq, the price of crude oil may edge closer to $50/barrel and enter a prolonged period at the upper half of the $40 level (the risk scenario in Chart 11).

Compared to Japan, crude oil prices will have a greater impact upon the US economy

We estimated the impact of the price of crude oil near $50/barrel upon both the Japanese and US economies using the Mizuho Macro Model. According to this estimate, the rate of real GDP growth would be dragged down by approximately 0.4% (an approximately 0.5% decline in terms of the level) in the US in contrast to a mere 0.2% decline (also about a 0.2% decline in terms of the level) in Japan's case (Chart 12).

The rise of crude oil is absorbed by corporate profits in Japan

The different results stem most likely from the difference in how much of the rise of crude oil prices is filtered through to domestic prices. At the import price level, there is a deviance of more than 3% in Japan whereas the deviance in the US is limited to the 2%-level, revealing that the rise of crude oil prices has a greater impact upon the Japanese economy which has a greater dependence upon crude oil imports. However, further downstream reaching the level of consumer prices, the deviation is about 0.2% in the case of Japan compared to 1% in the US. Judging from the fact that the impact upon corporate profit is greater in Japan, the rise of crude oil prices is absorbed to a significant degree by corporate profits, thereby preventing price rises from being directly transmitted to the final price of goods.

Chart 12: The Impact of Crude Oil Prices Upon the Economy

		2004		2005				2006
		Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar
Crude oil prices (WTI: $/barrel)	Main scenario	40.0	40.0	39.5	37.0	36.5	37.0	37.0
	Risk scenario	43.9	48.4	48.4	47.9	47.6	47.3	47.2
	Breadth of deviation	**3.9**	**8.4**	**8.9**	**10.9**	**11.1**	**10.3**	**10.2**
Import prices (Rate of deviation: %)	**Japan**	**1.3**	**2.6**	**2.8**	**3.6**	**3.6**	**3.4**	**3.3**
	US	0.8	1.7	1.9	2.4	2.4	2.2	2.2
Corporate goods prices (Rate of deviation: %)	**Japan**	**0.1**	**0.2**	**0.2**	**0.3**	**0.3**	**0.3**	**0.3**
	US	0.4	0.9	1.0	1.3	1.5	1.5	1.6
Consumer prices (Rate of deviation: %)	**Japan**	**0.0**	**0.1**	**0.1**	**0.2**	**0.2**	**0.2**	**0.2**
	US	0.4	0.9	1.0	1.4	1.5	1.6	1.7
Corporate earnings (Rate of deviation: %)	**Japan**	**-0.6**	**-1.2**	**-1.2**	**-1.6**	**-1.5**	**-1.2**	**-1.2**
	US	-0.1	-0.3	-0.5	-0.6	-0.8	-0.8	-0.8
GDP (real) (Rate of deviation: %)	**Japan**	**0.0**	**-0.1**	**-0.1**	**-0.1**	**-0.2**	**-0.2**	**-0.2**
	US	-0.1	-0.2	-0.3	-0.5	-0.5	-0.5	-0.5

Note: Estimates using Mizuho Macro Model.

The gap between the US and Japan will narrow in consideration of secondary effects

However, in the event the US economy – the major destination of Japan's exports – slows down, its impact upon the Japanese economy may not be underestimated. According to calculations using MHRI's export function, a 0.4% slowdown of US economic growth would depress Japan's US-bound exports by approximately 1%. Furthermore, according to estimations by the IEA, a $10 rise of the price of crude oil would drag down the rate of economic growth by 0.5% in the euro zone and 0.8% in Asia. In consideration of the foregoing, an estimation of Japan's exports using the export function as we did for the US, reveals that in the event the price of oil remains high, it would depress Japan's growth rate by another 0.1~0.2% as a result of the fall of exports. If the high price of crude oil persists, both the

Japanese and US economies would slow down considerably, leading to the rise of risks of a premature loss of momentum.

The slowdown of the Chinese economy as a result of excessive regulatory controls is also a risk

Another major risk factor is the slowdown of the Chinese economy that has contributed greatly to Japan's economic recovery. The Chinese regulatory authorities have tightened financial controls and administrative guidance in order to reign in rampant capital investment in a bid to secure the long-term stable growth of its economy. Given the Chinese government authorities' careful guidance, the Chinese economy is gradually slowing down as we write this report. However, the risks of a resurgence of fixed asset investment still linger due to the tremendous investment drive among companies and local governments. Meanwhile, given the government's delicate balancing task, any mishap in government control may lead to a sharp cool-down of the economy stemming from the fall of fixed capital investment.

While the direct impact is limited, its impact via the deterioration of market conditions should not be underestimated

Since the bulk of China-bound exports by neighboring countries and regions such as Japan, the NIEs and ASEAN rely upon demand outside China such as Europe, and the US, we are inclined to believe that the plunge of Chinese domestic demand such as fixed asset investment will only have a limited impact in direct terms (Chart 13). However, it is necessary to keep in mind that the impact upon each other may reverberate due to a deepening horizontal division of labor in Asia. Furthermore, the deterioration of market conditions of iron & steel, chemical products and non-ferrous metals which have soared as a result of strong Chinese demand, would have a dire impact upon neighboring countries and regions such as Japan, the NIEs and ASEAN.

Chart 13: The Impact of a 5% Drop of Chinese Domestic Demand

(%)

	Rate of decline of China-bound exports	Proportion of China-bound exports in total exports	Rate of decline of total exports
NIEs	-2.1	18	-0.38
ASEAN	-6.3	7	-0.44
Japan	-3.4	12	-0.41

Note: Estimates by MHRI.

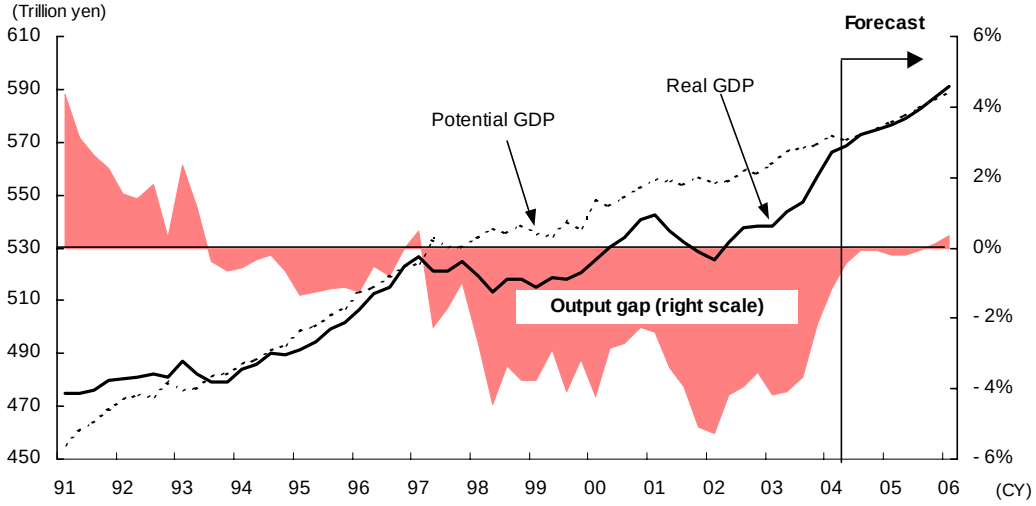
The CPI may turn positive again by the end of FY2005 if the risk factors may be averted

If Japan can avert these risk factors and maintain the current domestic demand-led recovery of the economy in the second half of FY2004 onward, Japan's economy will gather momentum again in the second half of FY2005 and edge closer to the end of deflation. The output gap has narrowed considerably as a result of the rapid economic recovery since the end of 2003. Although the contraction of the output gap will remain extremely slim since the economy is only expected to growth at its potential growth rate around 1.5%, it will

only be a matter of time until the output gap is eliminated once the recovery momentum is rekindled.

While the elimination of the output gap will not lead immediately to the rise of prices because of a lag between the output gap and consumer prices, there is historical evidence that prices start to rise after a definite period of time when the output gap shrinks to a certain level. In FY2005, we expect a gradual buildup of upward pressures upon consumer prices as a result of the contraction of the output gap. Since the negative pressures upon wages are also easing, we expect the year-on-year change of the CPI to turn positive by the end of FY2005 (March 2006).

Chart 14: The Output Gap



Note: Estimates by MHRI.
Sources: Cabinet Office, Ministry of Economy, Trade and Industry,
Ministry of Public Management, Home Affairs, Posts and Telecommunications, and others.

Deflation will end sometime after the turn of the new fiscal year in April 2006

In the event prices begin to rise on a sustainable basis, companies will cease to take an excessively restrictive stance regarding inventory investment and consumers will resume spending which they had put off in anticipation of a further fall of prices. In short, the economy will enter a normal recovery cycle resting upon a positive inflation rate and achieve a genuine "elimination of deflation". These symptoms should be confirmed sometime after the turn of the new fiscal year in April 2006 when the year-on-year change of the CPI starts to chart positive territory on a stable basis.

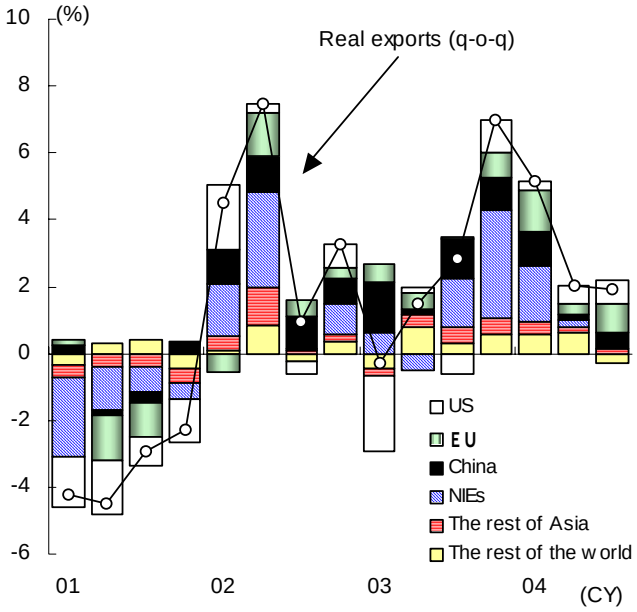
In the following sections, we shall elaborate on each of the components of the Japanese economy.

3. External Demand

Exports continue to rise, driven by the expansion of external demand

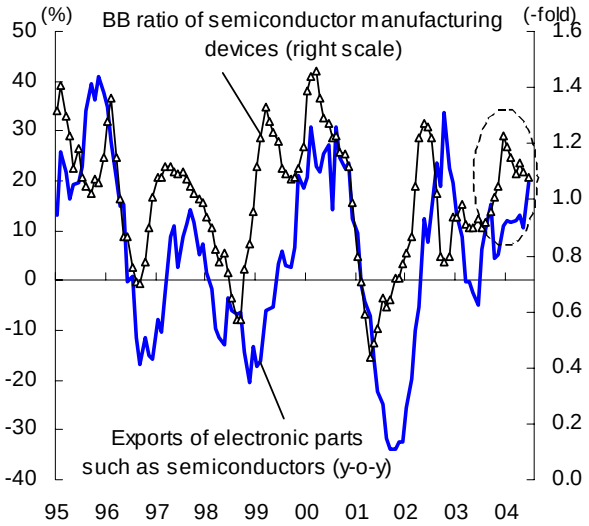
Although real exports (SNA-based) remained on an uptrend, growing 3.5% q-o-q in the Apr-Jun quarter of 2004, the pace has slowed in comparison to the Jan-Mar quarter. While exports to virtually all geographic destinations slowed down (Chart 15), Asia-bound exports slowed down in contrast to brisk exports of automobiles and consumer goods such as digital household electronic appliances to the US. In addition to the sharp decline of construction machinery exports to China, adversely affected by the slowdown of fixed asset investment in the country, exports of IT-related goods flattened out due to an unintentional accumulation of inventories.

Chart 15: Exports in Real Terms (by geographic destinations)



Note: Seasonal adjustments by MHRI.
Sources: Ministry of Finance, *The Summary Report on Trade of Japan,* Bank of Japan, *Corporate Goods Price Index*.

Chart 16: The BB Ratio and Semiconductor Exports



Sources: Ministry of Finance, SEMI.

Demand for IT-related goods is forecast to decline

Exports of electronic parts such as semiconductors – a typical IT-related good – have kept rising so far due to the growth of demand for digital appliances (Chart 16). However, as indicated by the decline of the BB ratio of North American semiconductor manufacturing devices, the odds are high that the silicon cycle is starting to peak out and that exports of electronic parts will start to weaken. However, even though global semiconductor sales are predicted to slow down after peaking in 2004, they should still remain on an upward trajectory according to World Semiconductor Trade Statistics (WSTS). We are thus inclined to believe that the fall will not be as serious as the collapse of the IT-bubble in 2000 and 2001 when semiconductor sales fell by a maximum of 40% from the previous year.

Export growth will decline from the second half of FY2004 along with the slowdown of the US economy

Looking forward, export growth should gradually decline along with the ebb of demand for IT-related goods and the slowdown of the US economy. While the potential slowdown of the Chinese economy stemming from tighter regulatory controls provides reasons to be concerned, the impact will most likely be benign due to the following factors: (1) the tighter regulatory controls are limited to certain segments of fixed asset investment, and (2) a large percentage of Japan's exports to China are ultimately headed for third countries such as the US and Europe, indicating that the final destination of Japanese products (including those manufactured overseas) are overwhelmingly the US and Europe (Chart 17).

Judging from the foregoing, despite the slowdown of real exports (SNA based) in the second half of FY2004, export growth in FY2004 should still remain in positive territory (1H FY2004: 6.6% over the previous term → 2H FY2004: 2.7% over the previous term). In FY2005, export growth should pick up, reaching 3.3% over the previous term in both the first half and second half of the fiscal year as manufacturers of IT-related goods emerge out of an inventory adjustment cycle.

Chart 17: Overseas Sales of Japanese Corporations (FY2003)

(Billion yen, %)	China (including Hong Kong)	NIEs3	ASEAN4	North America	Europe	Global Total
Exports from Japan (a)	10,522	9,802	5,169	14,219	8,578	56,061
Share	**18.8**	**17.5**	**9.2**	**25.4**	**15.3**	**100.0**
of which are sold locally overseas (b)	4,651	5,205	2,176	13,039	5,884	n.a.
of which are re-export overseas	5,871	4,597	2,993	1,180	2,693	n.a.
Overseas production (c)	4,883	3,047	7,016	19,358	9,199	46,616
Share	**10.5**	**6.5**	**15.0**	**41.5**	**19.7**	**100.0**
of which are sold locally overseas (d)	2,160	1,619	2,951	17,755	6,311	33,462
Share	**6.5**	**4.8**	**8.8**	**53.1**	**18.9**	**100.0**
of which are exported to Japan	1,416	623	1,658	332	163	4,325
Share	**32.7**	**14.4**	**38.3**	**7.7**	**3.8**	**100.0**
of which are exported to third countries	1,303	805	2,400	1,264	2,721	8,799
Share	14.8	9.1	27.3	14.4	30.9	100.0
Sum of exports and overseas production (e=a+c)	15,405	12,849	12,185	33,577	17,777	102,676
Share	**15.0**	**12.5**	**11.9**	**32.7**	**17.3**	**100.0**
Sum of overseas local sales (f=b+d)	6,811	6,824	5,128	30,794	12,195	–
Ratio of overseas local sales (f/e*100)	**44.2**	**53.1**	**42.1**	**91.7**	**68.6**	–
Share in total overseas sales	**6.6**	**6.6**	**5.0**	**30.0**	**11.9**	–

Notes: 1. "Overseas production" = overseas local sales minus imports from head office.
2. "Share in total overseas sales" does not add up to a total of 100% because exports to Japan and third countries are not included in overseas production.

Sources: Ministry of Finance, *The Summary Report on Trade of Japan,*
Ministry of Economy, Trade and Industry, *Quarterly Survey of Overseas Subsidiaries.*

Imports will also start to slow down

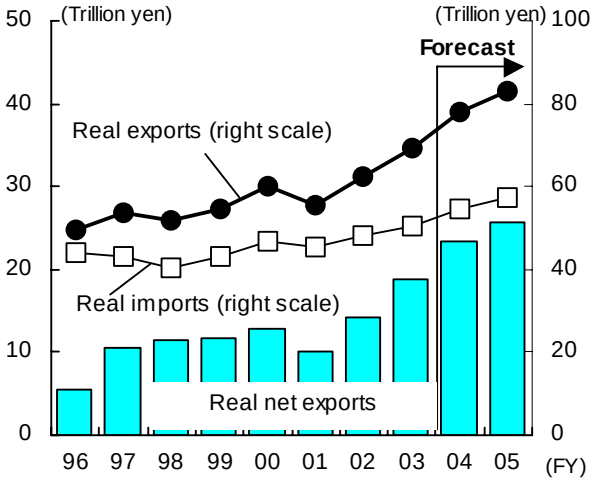
Imports are also poised to decline gradually from the second half of FY2004, reflecting the slower growth of exports and domestic demand. We expect the growth of real imports (SNA based) to slow down from 8.3% y-o-y in FY2004 to 5.2% y-o-y in FY2005.

Furthermore, since the slowdown of exports will outpace the slowdown of imports, the degree of contribution by real net exports to Japan's real GDP growth will fall from 0.9% pt in FY2004 to 0.5% pt in FY2005.

The current account surplus will continue to expand

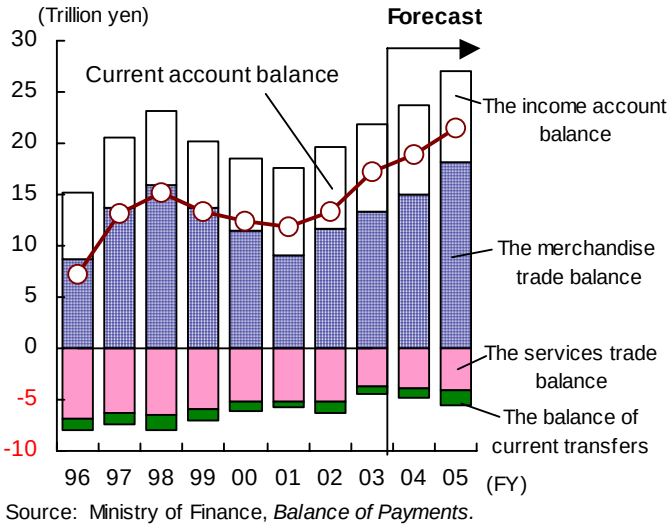
Amid the ongoing rise of exports, the slowdown of nominal imports in FY2005 stemming from the cool-down of crude oil prices should lead to the expansion of the trade surplus. Meanwhile, despite forecasts that the services trade deficit will continue to grow reflecting the upturn in number of persons traveling overseas, the expansion of the merchandise trade deficit will be greater, providing us with reasons to believe that the current account surplus will expand from 18.9 trillion yen (3.7% of nominal GDP) in FY2004 to 21.5 trillion yen (4.1% of nominal GDP) in FY2005.

Chart 18: Forecast on Exports and Imports (in Real Terms)



Source: Cabinet Office, *National Income Statistics*.

Chart 19: Forecast on the Current Account Balance



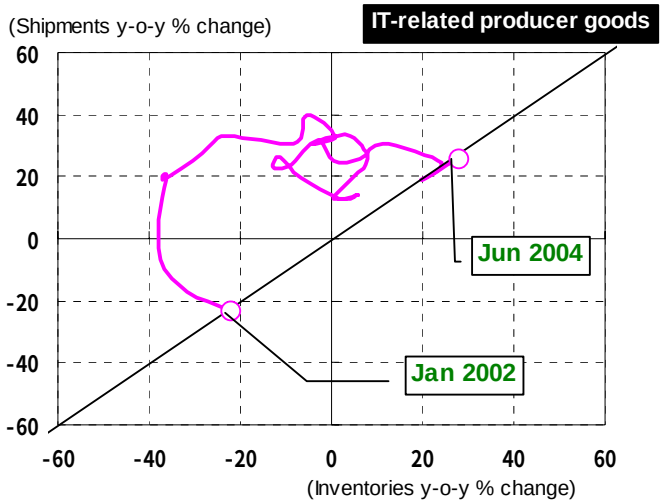
Source: Ministry of Finance, *Balance of Payments*.

4. The corporate sector

Production activity in the IT and digital electronics sector slips into a mild adjustment phase

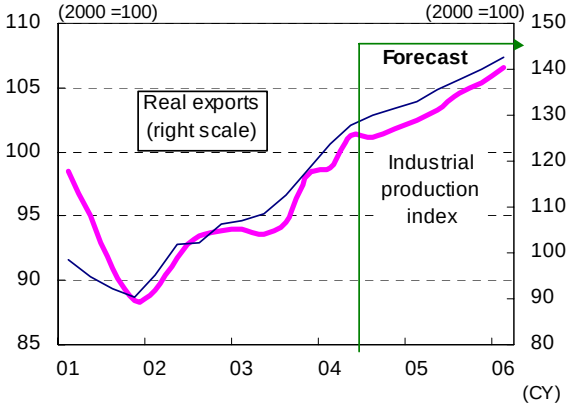
Signs of a slowdown in demand for IT-related goods are starting to emerge in domestic production activity. The industrial production index surged from the Oct-Dec quarter of 2003, driven by the sharp rise of exports, the expansion of demand for IT-related goods & digital appliances, and strong capital investment in Japan. However, a spate of economic data since May suggests a mild adjustment of production activity stemming from an unintentional buildup of inventories as a result of actual demand falling below supply-side forecasts. The inventory cycle of IT-related production goods (Chart 20) is following an ebb and flow pattern across the 45 degree line since May 2004, indicating a tug of war between the buildup of inventories and the adjustment of production. Although the industrial production index should rise 1.7% q-o-q in the Jul-Sep quarter according to a simple projection using the production forecast index, the odds are high that the actual outcome would be flat growth or a slight dip from the previous quarter because of the adjustment of production activity with respect to IT-related goods and digital appliances.

Chart 20: The Inventory Cycle of IT-Related Producer Goods



Source: Ministry of Economy, Trade and Industry, *Indices of Industrial Production.*

Chart 21: Industrial Production and Exports



Source: Ministry of Economy, Trade and Industry, *Indices of Industrial Production,*
Cabinet Office, *Preliminary Quarterly Estimates of GDP.*

The self-sustained rise of domestic and external demand will lead to reenergized production activity

Even so, the current production adjustment cycle should be relatively benign due to: (1) the accumulation of inventories limited to certain goods, (2) the curtailment of production activity at an early stage as a result of lessons learned from past mishaps such as the collapse of the IT bubble, and (3) the unexpected hot summer weather mitigating the negative effect in other areas. Production indices should gradually return to an upward trajectory in the Oct-Dec quarter, amid the steady rise of domestic and external demand such as exports, capital investment and consumer spending (Chart 21). Furthermore, the wider demand for IT-related and digital appliances leading to a long-lasting expansion of peripheral demand should also serve as tailwinds to the sustained rise of production. We expect the industrial production index to remain on an upswing reaching 5.4% y-o-y in FY2004 and 3.0% y-o-y in FY2005.

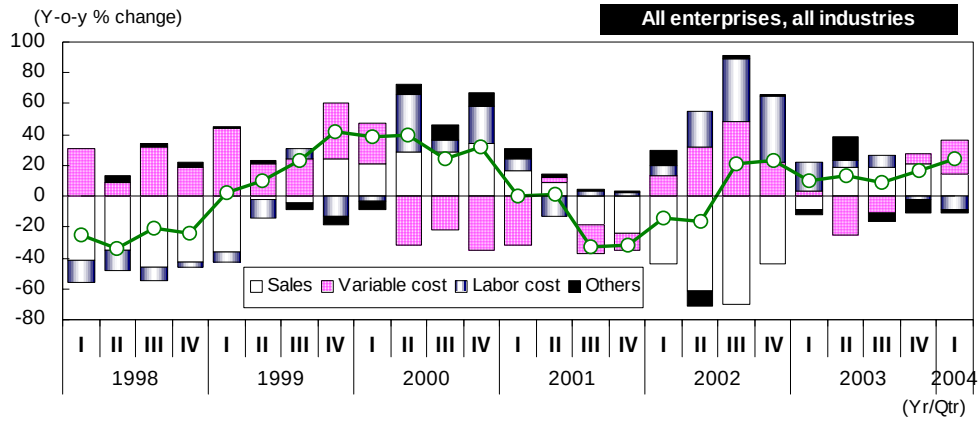
Non-manufacturers remain on a mild recovery track

Given the rise of corporate activity, the non-manufacturing sector is driven by companies serving corporate clients. In addition to booming business among wholesalers and cargo distributors, information services and professional services are also growing strongly due to the ongoing trend to outsource back-office operations. The overall recovery among companies with a client base in the household sector is confined to a moderate recovery despite the expansion of medical and welfare services amid the graying of the population because of the sluggish growth in the retail sales sector. Elsewhere, the recovery is patchy. For example, in contrast to the maintenance of strong performance among securities companies reflecting the bullish stock market, business has slowed considerably among communications-related companies facing fierce competition as the market for mobile phones nears saturation point. From an overall perspective, non-manufacturers are on a mild recovery.

Profitability will continue to rise as a result of restructuring efforts

As evidenced by the rise of current profits (based upon the *Financial Statements Statistics of Corporations by Industry (Quarterly)*) on a year-on-year basis for the seventh consecutive quarter, business performance is improving dramatically along with the acceleration of corporate activity (Chart 22). In the second half of FY2002 when profits turned positive for the first time, profits were generated through restructuring – namely by cutting labor costs and variable costs amid the decline of sales. However, the main driver of profits is shifting from restructuring gains to sales as a result of the reinforcement of profitability, thus stabilizing the rise of sales and profits.

Chart 22: Corporate Earnings



Source: Compiled by MHRI on the basis of Ministry of Finance, *Financial Statement Statistics of Corporations by Industry (Quarterly)*.

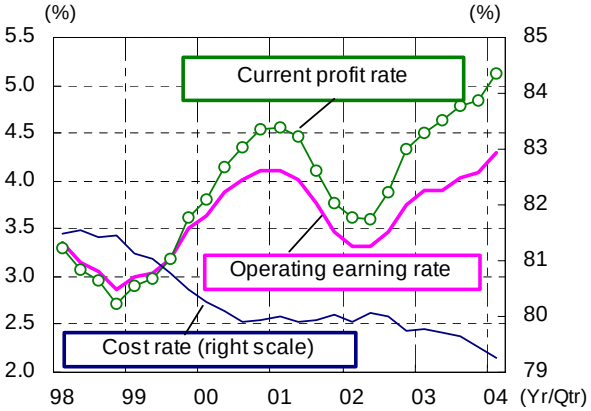
Greatly enhanced corporate profitability

Profitability among major corporations are surpassing levels during the IT bubble because of the positive impact of restructuring (Chart 23). Despite signs that the labor cost ratio is bottoming out, the cost percentage is declining consistently, resulting in an ongoing improvement of corporate profitability.

Sales and profits will continue to rise despite a slower pace of profit growth

Coupled with the reinforcement of profitability, corporate sales and profits should continue to grow in FY2005 due to a continued rise of sales against a backdrop of easing deflationary pressures (Chart 24). However, profit growth among manufacturers of basic materials will be slower than the dramatic rise in FY2003 that was propelled by a combination of "restructuring + rise of sales volume + wider price gap", leading to a gradual decline of the rate of profit growth. The rate of profit growth should also decline in the processing industries due to the rise of costs burdens such as higher raw material prices and the trend among IT-related manufacturers to reduce inventories. Profit growth in the non-manufacturing sector will likely continue in FY2005 due to the suppression of labor costs as companies hire more part-timer workers to assume positions and duties formerly fulfilled by full-time workers. Nevertheless, the pace of profit growth should decline in FY2005 due to a slower rise of sales volumes.

Chart 23: Indicators on Profitability Among Large Corporations



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

Chart 24: Corporate Earnings Forecast

(Y-o-y % change)

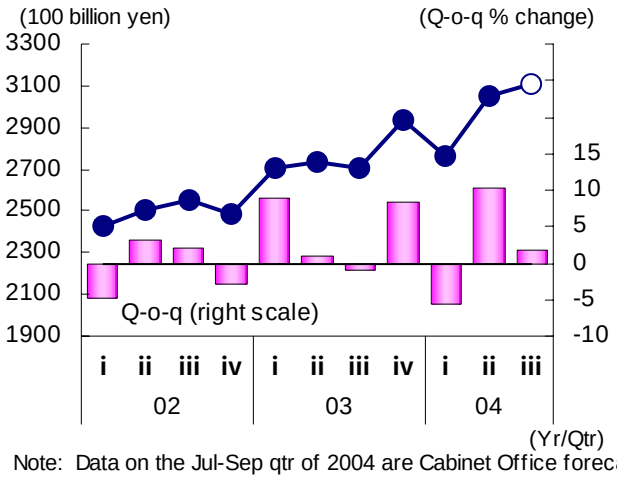
		FY2001	FY2002	FY2003	FY2004 (Forecast)	FY2005 (Forecast)
All industries	Sales	-3.3	-5.6	2.5	1.8	0.6
	Current profits	-19.6	7.2	16.9	13.1	3.8
Manufacturers	Sales	-6.4	-0.5	3.1	2.3	0.5
	Current profits	-42.5	32.8	18.4	13.3	3.5
Non-manufacturers	Sales	-1.9	-7.6	2.3	1.6	0.6
	Current profits	-1.3	-4.6	15.9	13.1	4.1
Large enterprises	Sales	-3.9	-0.4	0.8	1.3	0.5
	Current profits	-23.6	23.6	13.8	10.2	3.4
Manufacturers	Sales	-5.6	1.9	2.7	2.3	0.6
	Current profits	-41.2	40.6	19.6	13.4	4.2
Non-manufacturers	Sales	-2.6	-2.1	-0.6	0.6	0.4
	Current profits	-0.6	10.4	8.2	6.6	2.5
Small and medium enterprises	Sales	-2.8	-8.9	3.8	2.2	0.7
	Current profits	-15.7	-7.1	20.5	16.4	4.3
Manufacturers	Sales	-7.5	-3.7	3.7	2.4	0.4
	Current profits	-44.8	18.8	15.9	12.9	2.0
Non-manufacturers	Sales	-1.6	-10.3	3.8	2.1	0.7
	Current profits	-1.8	-14.1	22.2	17.6	5.0

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

Capital investment will regain momentum in the Jul-Sep quarter

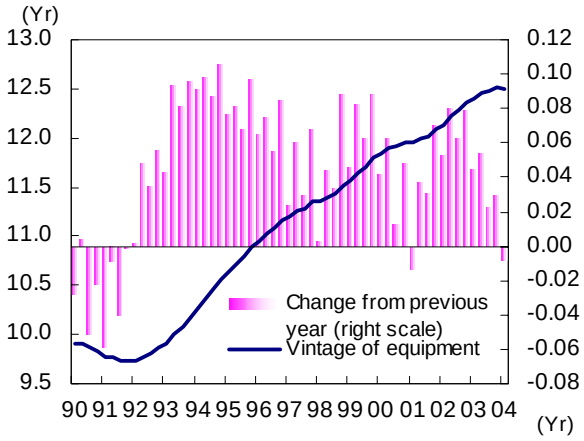
Private-sector business fixed investment in real terms turned out flat from the previous quarter in the Apr-Jun quarter, raising concerns that the recovery is losing momentum. However, it should be noted that capital goods shipments (excluding transportation equipment) – a coincident indicator gauging capital investment – grew a strong 5.6% q-o-q in the Apr-Jun quarter. Furthermore, machinery orders (those in the private sector excluding orders for ships and orders by electricity companies) – that is said to lead capital investment trends by approximately 0~1 quarter – also surged 10.3% q-o-q in the Apr-Jun quarter (Chart 25). None of the indicators related to capital investment signal a peak-out of business fixed investment, leading to our view that capital investment will regain momentum in the Jul-Sep quarter.

Chart 25: Private Sector Machinery Orders



Note: Data on the Jul-Sep qtr of 2004 are Cabinet Office forecasts.
Source: Cabinet Office, *Machinery Orders*.

Chart 26: Vintage of Equipment Among Manufacturers



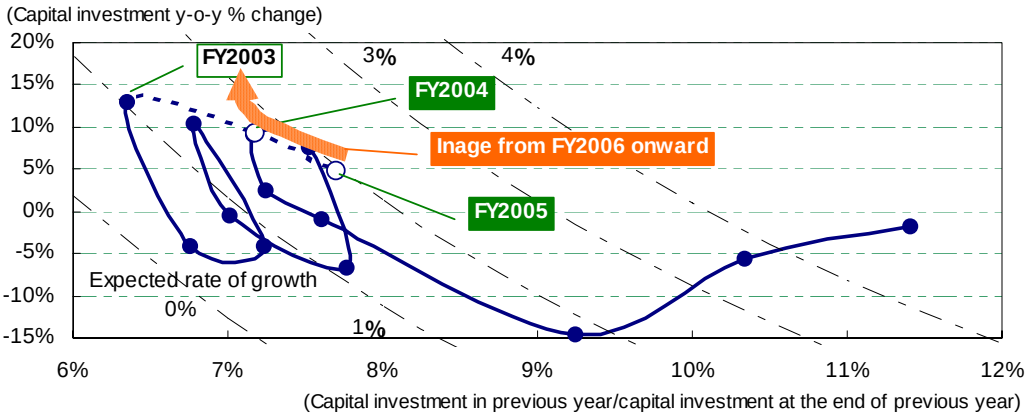
Source: Compiled by MHRI on the basis of Cabinet Office data.

Capital investment will continue to grow due to the gradual rise of the expected rate of economic growth

As mentioned above, we expect capital investment to keep growing from the Oct-Dec quarter onward given the improvement of corporate earnings and the sustained rise of demand. The manufacturing sector – thus far the driver of the recovery of capital investment – may not avoid a slowdown in the second half of FY2004 due in part a reaction to the front-loading of capital investment to maintain competitiveness among manufacturers of IT-related and digital appliances amid concerns regarding a slowdown of the US and Chinese economies.

Meanwhile, given the stable expansion of consumer spending, investment among non-manufacturers should to grow and buttress the overall level of capital investment. Neither is the manufacturing sector anywhere close to curbing investment in plant and equipment in view of the downturn of capital stock as a result of the depreciation of equipment exceeding new investment, reflecting the rising vintage of equipment (Chart 26). In FY2005, capital investment should regain momentum after an initial slowdown reflecting the rise of expectations on economic growth (Chart 27). We expect private-sector capital investment in real terms to grow 9.2% y-o-y in FY2004 and 4.9% y-o-y in FY2005.

Chart 27: The Capital Stock Cycle



Note: MHRI estimates on the basis of a retirement rate of 4.3% and capital coefficient of 1.8%.
Source: Cabinet Office, *Gross Capital Stock of Private Enterprises*.

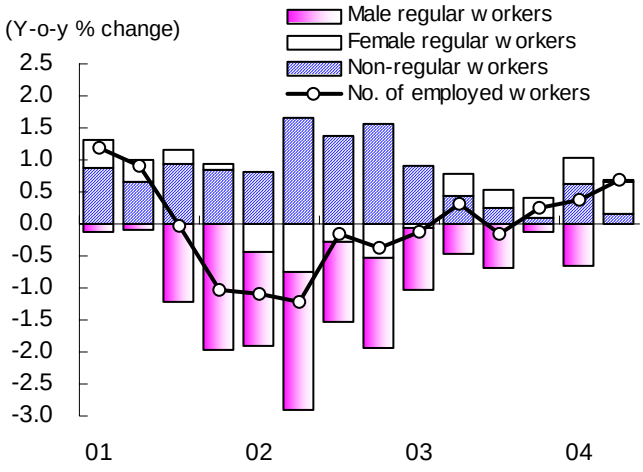
5. The household sector

Employment and wage conditions are improving slowly

Labor market conditions are slowly improving reflecting the expansion of Japan's economy. New job-offers are continuing to rise mainly in the services sector, with a notable increase of female regular workers (Chart 28). The unemployment rate - pinned at the 5% level during FY2003 - fell to 4.6% as of June 2004. However, it is necessary to note that (1) the decline of the unemployment rate is due largely to a rising trend among male job-seekers to exit from the job market by abandoning their search for employment opportunities and (2) the increase of employed workers is still comprised largely of non-regular employment. Despite the improvement of the labor market, a closer look reveals destabilizing factors such as the high proportion of part-time workers.

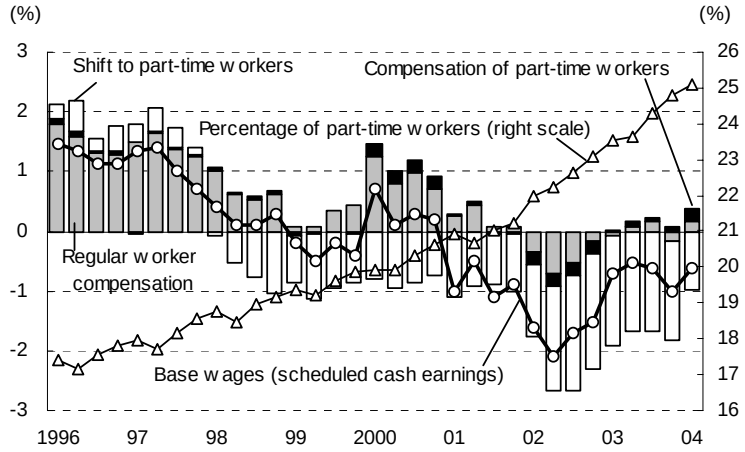
As exemplified by the breadth of the year-on-year fall of payrolls narrowing in the Apr-Jun quarter, the environment surrounding wages is also showing a mild recovery amid the steady upturn of overtime payments stemming from the rise of corporate activity. Nevertheless, the rise in proportion of part-time workers is still pushing down base wages (Chart 29), resulting in a slow pace of recovery.

Chart 28: A Breakdown of Employed Workers



Note: The bars represent the degree of contribution to the line.
Source: Ministry of Public Management, Home Affairs, Posts and Telecommunications, *Labor Force Survey.*

Chart 29: The Percentage of Part-Time Workers and Base Wages



Notes: 1. The bars represent the degree of contribution to the lines.
2. The totals do not necessarily add up to 100% since some of the components do not fall under any of the categories.
Source: Ministry of Health, Labor and Welfare, *Monthly Labor Survey.*

The mild improvement of labor market conditions should persist

Restructuring pressures should gradually subside amid strong corporate business performance, leading to the improvement of the demand-supply of labor. Due in part to a reaction to the significant reduction of regular employees in the course of restructuring since the 1990s, we look forward to a gradual upturn of regular employment along with the retirement of the baby-boomer generation. Going forward, regular employment among male workers will finally start to improve. Furthermore, the materialization of the currently-debated social security coverage of part-time workers shouldered by corporate employers should serve to hamper the shift toward part-time workers. The number of employed workers will continue to increase amid the ongoing expansion of the economy and the rise in proportion of part-time workers is poised to slow due to the recovery of regular employment. Our forecast also looks for a fall of the unemployment rate to the lower half of the 4% level toward FY2005 judging from the exit of workers from the labor market as the population grows older.

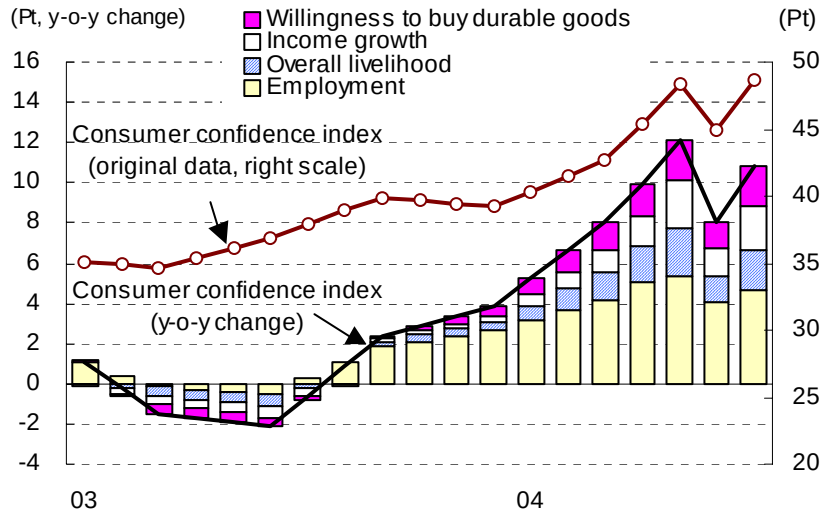
Labor compensation rises above previous year

We expect the steady rise of wages due to (1) a halt to the fall of base wages (scheduled cash earnings) due partially to a pause in the shift toward part-time workers, (2) the high level of over-time payments (non-scheduled cash earnings) amid the expansion of the economy, and (3) the expected upturn of bonus payments (special cash earnings) reflecting strong corporate business performance. In FY2005 however, bonus payments should take a downturn along with a lull in the recovery of corporate business performance, and serve as a drag upon the rise of wages. Labor compensation should start to rise in comparison to the previous year, reflecting the upturn of employment and income (Chart 33).

Confidence-led personal consumption remains strong

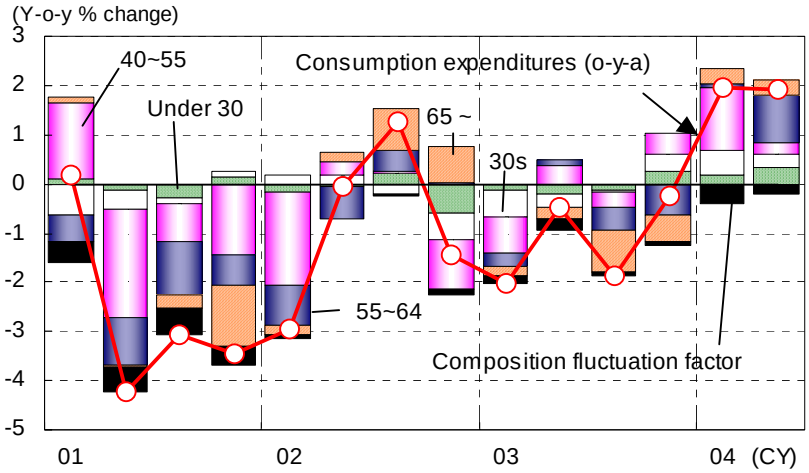
Consumer confidence is improving considerably in Japan as indicated by the June consumer confidence index reaching post-Bubble highs (Chart 30). Among the factors in the background are the recovery of labor market conditions, the bottoming of wages, the wealth effect due to the rise of stock prices since the beginning of the year and expectations toward economic recovery. Reflecting the upturn of consumer confidence, personal consumption is continuing to grow at a pace surpassing the upturn of the income environment since the end of last year. Apart from the brisk sales of durable consumer goods such as digital household electronic appliances and air conditioners due to the Athens Olympic Games and the hot summer weather, the consumption of recreational services such as overseas travel grew strongly due partially to a rebound from the SARS (severe acute respiratory syndrome) epidemic last year. In terms of the population structure, the consumption of digital electronic household appliances is spreading to a broader demographic spectrum. Consumption among spenders in the 40~55 age group, hit hardest by restructuring pressures thus far, is starting to pick up from 2004 along with the improvement of the employment environment (Chart 31).

Chart 30: The Consumer Confidence Index



Note: Since the consumer confidence index (nationwide) was only released on a quarterly basis up to March 2004, the intervals have been interpolated.
Source: Cabinet Office, *Consumer Confidence Index*.

Chart 31: Demographic Structure of Consumption Trends



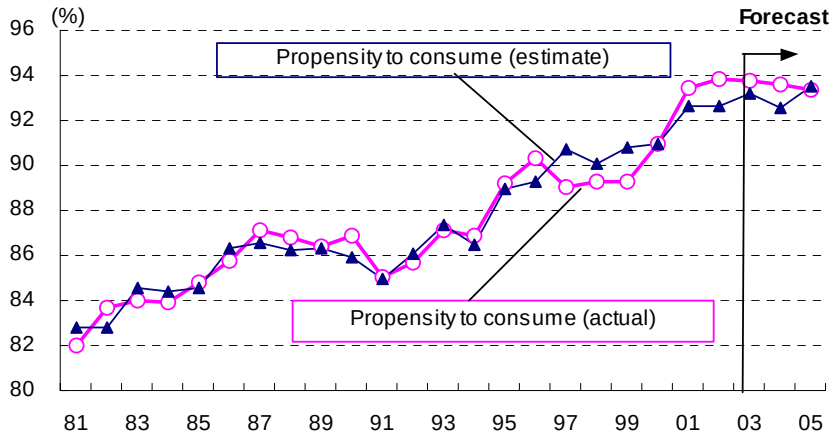
Note: The "composition fluctuation factor" refers to the change in consumption expenditures as a result of the change in demographic composition. The change stems from the difference in level of consumption among different age groups.

Source: Ministry of Public Management, Home Affairs, Posts and Telecommunications, *Family Income and Expenditure Survey.*

In FY2005, consumption will return to a pace consistent with the rise of income

However, note that the improvement of consumer confidence is coming to a pause given the impact of higher gasoline prices reflecting the surge of crude oil prices, making it unlikely that personal consumption will continue to grow at a pace surpassing the improvement of income. Furthermore, the ebb of the positive impact of the Olympic Games and the hot weather, leads to our view that consumer spending will start to wane in the second half of FY2004. Even so, since income conditions will continue to improve albeit at a moderate pace, personal consumption should return to a stable pace of growth consistent with the rise of income.

Chart 32: Consumption Propensity



Note: Propensity to consume = 1.79 × ln (NIKKEI stock average) + 0.733× habit factor + 0.30 × dependent population ratio - 8.02
(2.253) (15.706) (1.712) (-0.505)

Time span of estimate FY81～FY02 R*R=0.9322

Habit factor = propensity to consume necessary to maintain the level of consumption during the previous period with the level of income during the current period.

Dependent population ratio = (young population + old population) / working-age population.

Source: Compiled by MHRI on the basis of Cabinet Office, *Annual Report on National Accounts,* Nikkei FQ.

Chart 33: Personal Consumption

(%)

	FY2003 (Actual)	FY2004 (Forecast)	FY2005 (Forecast)
Labor compensation	-1.0	1.0	0.7
Per worker	-1.2	0.4	0.3
No. of workers employed	0.2	0.5	0.4
Disposable income	0.0	1.7	1.4
Household consumption expenditure deflator	-1.5	-1.1	-0.5
Real disposable income	1.5	2.8	1.8
Nominal consumption expenditures	-0.1	1.5	1.1
Private sector consumption expenditure deflator	-1.5	-1.1	-0.5
Real consumption expenditures	1.4	2.6	1.6
Propensity to consume	93.8	93.6	93.4
Change from previous year (% point)	-0.1	-0.2	-0.2

Notes: 1. All figures other than the propensity to consume are represented as the percentage change from the previous year.
2. The houshold consumption expenditure deflator does not include imputed rent.
Source: Ministry of Public Management, Home Affairs, Posts and Telecommunications, *Labor Force Survey*, Cabinet Office, *Annual Report on National Accounts*.

Housing starts weaken due to a backlash from the demand rush last year

Housing starts are falling since mid-2003. This is due most likely to a backlash to the surge of last-minute demand peaking in mid-2003 in view of the extension of the mortgage loan tax break decided last December (the tax relief was scheduled for expiration as of the end of last year) and the new construction standards law that includes measures to deal with the so-called “sick house syndrome”. In terms of home-ownership, the decline was most prominent among owner-occupied houses and houses for rent. In contrast, housing starts of built-for-sales houses continued to growth strongly such as the rise in demand for lower-priced homes by those in the 30s constituting the bulk of first-time buyers. Moreover, housing starts of owner-occupied houses of those aged 60 and over is increasing, indicating a pick-up in demand to rebuild old homes.

Persistent demand will continue to drive housing starts of owner-occupied houses

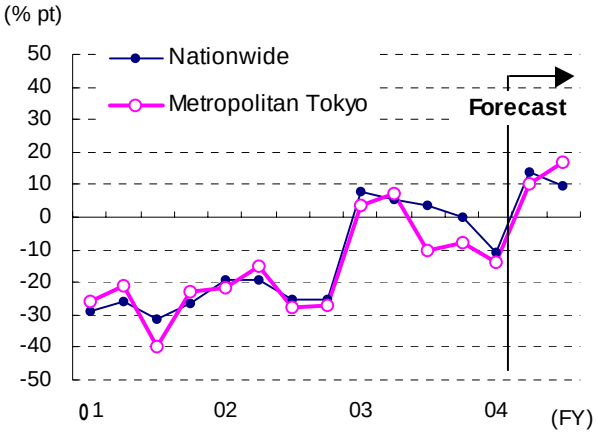
Looking forward, housing starts of owner-occupied houses (owner-occupied houses + built-for-sales houses) should remain strong, propped up by persistent demand fed by (1) the neo-boomer generation reaching home-purchasing age and (2) the pick-up of demand to rebuild old houses amid the fall of land prices. Notably, housing starts during the rest of FY2004 will be characterized by the strong growth of housing starts of built-for-sale houses and the upturn of demand for owner-occupied houses reflecting the improvement of labor market conditions and expectations on higher interest rates ahead. The gradual phase-out of the mortgage loan tax break scheduled from 2005 onward may also stimulate prospective buyers to accelerate their purchases and push up the number of housing starts during FY2004. Nevertheless, housing starts should decline slightly in FY2005 because of a further rise of interest rates and a backlash from the last-minute surge of demand stemming from the reduction of the tax break.

Housing starts of houses for rent will also stay strong for the time being

Meanwhile, recent surveys on housing predict a sharp upturn of orders for rental housing in the coming six-month period (Chart 34). Among the plausible factors in the background are: (1) the percentage of houses for rent in existing houses that will be replaced in the course of rebuilding has been rising since FY2001, indicating the growing demand for rebuilding, and (2) the smaller percentage fall of the rent for condominiums in comparison to the drop of the rent for offices reveals that the construction of rental condominiums provides a more profitable way to utilize real estate. Although a fall in demand for houses for rent may not be avoided in the long run in consideration of the ensuing decline of the young-age population, the factors above provide us with reasons to believe that housing starts for rental housing will remain strong.

Judging from the foregoing, we expect housing starts to fall from 1.170 million units in FY2004 to 1.158 million units in FY2005. Housing investment in real terms should decline from 1.6% y-o-y in FY2004 to –1.1% y-o-y in FY2005 (Chart 35).

Chart 34: Orders for Houses for Rent



Source: The Government Housing Loan Corporation.

Chart 35: Housing Starts and Housing Investment

		FY2003 (Actual)	FY2004 (Forecast)	FY2005 (Forecast)
New housing starts	(10,000 units)	117.4	117.0	115.8
	(Y-o-y % ch)	2.5	-0.3	-1.0
Owner-occupied houses	(10,000 units)	37.3	37.2	36.6
	(Y-o-y % ch)	2.1	-0.3	-1.5
Houses for rent	(10,000 units)	45.9	45.1	45.4
	(Y-o-y % ch)	0.9	-1.6	0.6
Houses built for sale	(10,000 units)	33.4	34.0	32.9
	(Y-o-y % ch)	5.6	2.0	-3.1
Private-sector housing investment (nominal)	(Y-o-y % ch)	0.3	1.8	-1.4
Deflator	(Y-o-y % ch)	0.0	0.2	-0.2
Private-sector housing investment (real)	(Y-o-y % ch)	0.3	1.6	-1.1

6. The public sector

Expenditures will be kept below previous-year level in the FY2005 budget

Both the central and local governments are keeping an expenditure-cutting stance in the shadow of a massive budget deficit. By a Cabinet decision on July 30th passing the *Guidelines for FY2005 General Expenditure Budget Requests ("Guidelines")*, the government set forth an overall budget framework to cap the general account budget (total of general account expenditures and revenues) at the FY2004 level. A closer look at each of the budget items reveals that the government is still intent on trimming expenditures by (1) cutting public investment related expenditures by 3% from the level in the FY2004 budget, (2) keeping non-discretionary expenditures at the same level as in the FY2004 (although additional budgeting will be available for certain budget items) and (3) cutting discretionary expenditures by 2% from the level in the FY2004 budget (Chart 36). The government also intends to hold down the natural increase of expenditures attributed to the aging population at 860 billion yen by paring down the natural increase by 220 billion yen. Furthermore, the *Guidelines* also include a three trillion yen reform of the treasury charge toward local governments in FY2006, indicating that there will be more pressure upon local government bodies to restrain expenditures.

Public investment will continue to dwindle

Public investment should remain on a downhill trajectory, given the budget restraints. Real public capital formation fell a steep 5.1% q-o-q in the Apr-Jun quarter, due primarily to the sharp reduction of the FY2004 public investment related budget among local governments. The decline may also be attributed to the fact that few localities engaged in additional capital investment by budget supplementation in FY2003. The current mild rebound of public works contracts (Chart 37), a leading indicator of public investment trends, suggests that the fall of public investment may come to a temporary halt. Nevertheless, given the likelihood that both central and local governments will keep cutting their public investment related budgets, we are inclined toward the view that the fall of public investment will remain unbridled. We expect real public fixed capital formation to fall sharply in both FY2004 (-10.8% y-o-y) and FY2005 (-7.5% y-o-y).

Government consumption will grow at a slightly faster pace due to an aging population

Government consumption should continue to rise because of the combined effect of (1) the ongoing decline of labor compensation (public servants' salaries) as a result of the reduction in number of public servants and the abolishment of various allowances, (2) the fall of the consumption of fixed capital accompanying the reduction of capital investment, in contrast to (3) the rise of medial costs shouldered by the government (social benefits in kind) amid the rapid aging of the population. In real terms, the rise of government consumption should rise from 1.6% y-o-y in FY2004 to 2.0% y-o-y in FY2005.

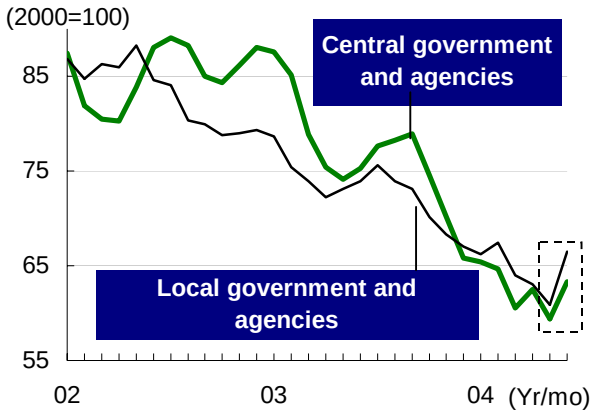
Chart 36: The FY2005 General Account Budget (Forecast)

(Trillion yen)

	FY2004			FY2005	
	Initial budget	Budget after supplementation		Initial budget	
			Change from initial budget		Change from FY2004 initial budget
Tax revenues	41.7	43.1	1.3	44.9	3.1
Non-tax revenues	3.8	3.8	0.0	4.2	0.4
Government bond issues	36.6	35.5	-1.1	34.6	-2.0
Surplus from previous fiscal year	0.0	1.5	1.5	0.0	0.0
Total revenues	82.1	83.9	1.8	83.7	1.5
National debt service	17.6	17.6	0.0	18.7	1.1
Local allocation tax grants	16.5	17.4	1.0	16.4	-0.1
General expendigures	47.6	48.4	0.8	47.8	0.1
Social security related expenditures	19.8	20.4	0.6	20.7	0.9
Public works related expenditures	7.8	8.0	0.2	7.6	-0.2
Miscellaneous	20.0	20.0	0.0	19.5	-0.5
Subsidies for redemption of "NTT interest-free loans" (B type)	0.4	0.4	0.0	0.8	0.4
Total expenditures	82.1	83.9	1.8	83.7	1.5
Primary balance	-19.0	-17.9	1.1	-15.9	3.1

Note: The FY2004 budget after supplementation and the FY2005 initial budget are forecasts by MHRI.

Chart 37: Public Works Contracts (Public Works Prepayment Surety)



Notes: Data on public works contracts are sesonally-adjusted, 3mma.

Source: Surety Association for Contruction Companies, *Public Works Prepayment Surety Statistics.*

7. Prices

The corporate goods price index climbs to post-Bubble high

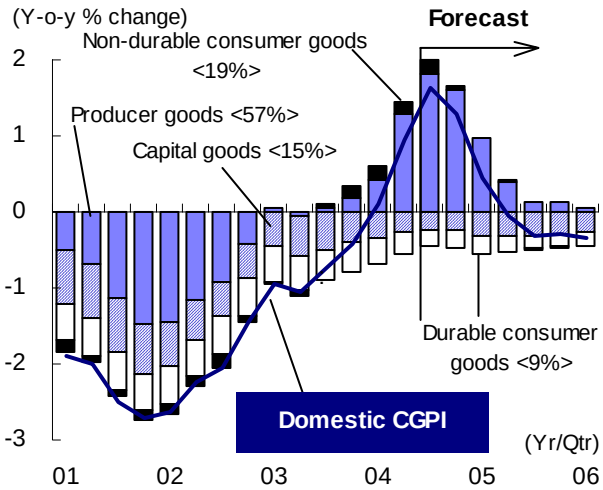
The corporate goods price index (CGPI) rose 1.6% y-o-y in July, rising at the highest rate in 13 years since May 1991 during the Bubble period as a result of (1) the sharp rise (3.0% y-o-y) of prices of intermediate goods such as iron & steel, non-ferrous metals and chemical products, in addition to (2) the resurgence of raw material prices despite signs of a cool-down. It appears that prices of iron & steel and non-ferrous metals were pushed up by robust demand mainly by China while prices of chemical products were driven up by the surge of crude oil prices.

The percentage rise of the CGPI will turn negative in FY2005 due to a slowdown of producer goods prices

Despite forecasts that iron & steel prices will remain pinned at a high level as iron & steel manufacturers continue to place emphasis upon market trends, prices of non-ferrous metals will start to show more definite signs of a peak-out reflecting the slowdown of the overseas economies. Furthermore, the rise of chemical product prices should also slow down given the cool-down of crude oil prices. Price falls of IT and electronic parts will also widen again amid the deterioration of the inventories-to-shipments balance. Judging from the above, the rise of producer goods prices is likely to slowdown from the Jan-Mar quarter of 2005.

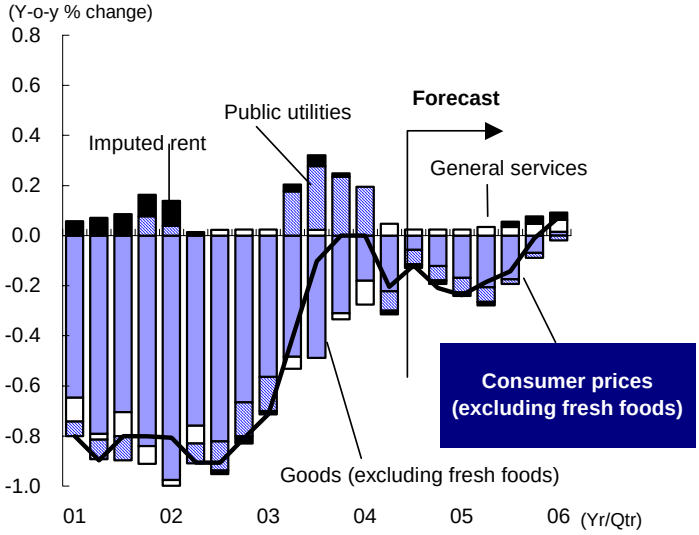
Even though the CGPI is expected to rise 1.0% y-o-y in FY2004 when there will be a sharp rise of producer goods prices, the CGPI should fall into negative territory (-0.2% y-o-y) when the rise of producer prices slows sharply in FY2005 (Chart 38) as price falls of final goods such as capital goods and consumer goods reach the surface.

Chart 38: The Corporate Goods Price Index



Note: Figures in < > refer to the percentage of the components in CGPI.
Source: Bank of Japan, *Corporate Goods Price Index*.

Chart 39: The Consumer Price Index



Source: Ministry of Public Management, Home Affairs, Posts and Telecommunications, *Consumer Price Index*.

The fall of the consumer price index (CPI) is slowing down due to special factors and soaring crude oil prices

It appears that special factors such as the rise of rice prices due to the cold summer weather last year, the cigarette tax hike and the rise of beef and beef-related products due to the impact of Bovine Spongiform Encephalopathy (BSE) are lifting the year-on-year percentage change of the consumer price index (nationwide, excluding fresh foods) by approximately 0.3% pt. In addition, prices of petroleum products such as gasoline are rising reflecting the surge of crude oil prices, narrowing the breadth of the fall to about –0.1% y-o-y as of June.

Looking forward, the fall of the price of rice and electric utility rates will drive prices down further

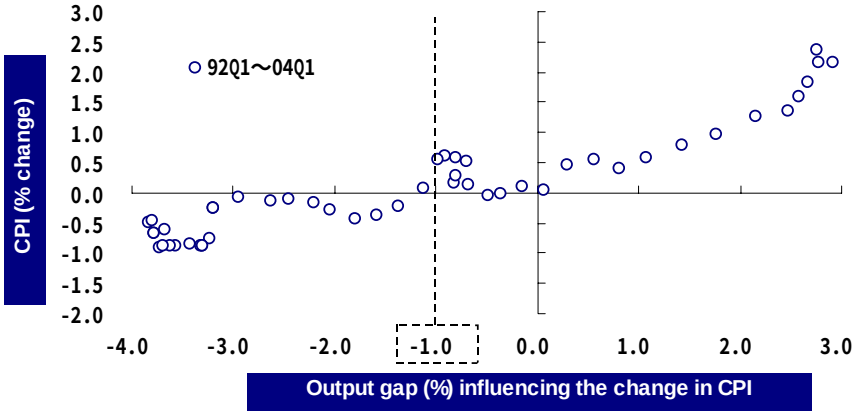
Considering the time it takes for the impact of higher crude oil prices to reach downstream prices, we are inclined to believe that consumer prices will remain subject to upward pressures via petroleum products. Nevertheless, since the impact of special factors will start to fade and the rice crop this year is expected to reach above-average levels, the odds are high that the price of rice will fall below the previous year level. Furthermore in October 2004, some of the electric power companies in Japan are planning a reduction of electricity utility charges surpassing the rise of electric utility rates attributed to the rise of crude oil prices. In view of the foregoing, the fall of the CPI may temporarily widen in the first half of FY2005.

The percentage change of the CPI should turn positive in the Jan-Mar quarter of 2006

In the second half of FY2005 however, the pace of economic expansion should pick up, leading to the dissolution of the output gap. Under normal circumstances, there is a time lag of 0~3 years between the contraction of the output gap and the rise of consumer prices. Furthermore, from an empirical point of view, the output gap would have to be approximately –1% of GDP for the rise of the CPI to be above zero percent (Chart 40). The output gap in consideration of the lag (the adjusted output gap) would contract to –1% of GDP in the second half of FY2005 (Chart 41). Considering also that the percentage

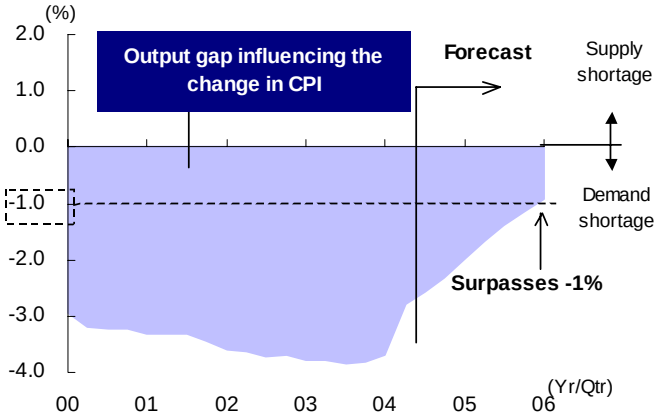
fall of the unit labor cost should start to contract (Chart 42), the percentage change of the CPI should turn positive by the Jan-Mar quarter of 2006 (Chart 39).

Chart 40: The Relationship Between the Adjusted Output Gap and the Percentage Rise of the CPI



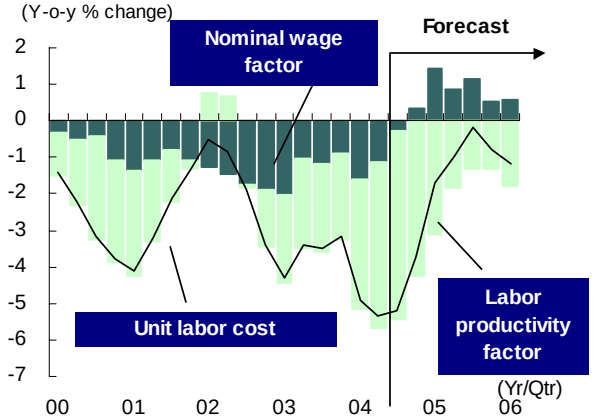
Notes: 1. CPI (% change) = nationwide prices excluding fresh foods. Special factors such as the cigarette tax hike, the rise of rice prices and medical costs are excluded.
2. Output gap = (real GDP minus potential GDP) / potential GDP. A further dip into negative territory indicates a demand shortfall. The output gap is weighted by the correlation coefficient derived by measuring the time lag correlation between the output gap and the change in CPI (the output gap precedes CPI by 0~3 years).
Source: Compiled by MHRI on the basis of data releases by the Ministry of Public Management, Home Affairs, Posts and Telecommunications, Cabinet Office and the Ministry of Economy, Trade and Industry.

Chart 41: The Adjusted Output Gap



Note: "Output gap influencing the change in CPI" = the output gap weighted by the correlation coefficient derived by measuring the time lag correlation between the output gap and the change in CPI.
Source: Compiled by MHRI on the basis of data releases by the Ministry of Public Management, Home Affairs, Posts and Telecommunications, Cabinet Office and the Ministry of Economy, Trade and Industry.

Chart 42: The Unit Labor Cost



Notes: 1. Nominal wages = labor compensation + mixed income.
Labor productivity = real GDP / employed workers.
2. 3QMA.
Sources: Cabinet Office, Ministry of Health, Labor and Welfare, Ministry of Public Management, Home Affairs, Posts and Telecommunications.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