

Economic Outlook for FY2004 and FY2005

(Revised to reflect the Second Preliminary Quarterly Estimates of GDP for the Apr-Jun quarter of 2004)

September 2004

The Mizuho Research Institute Ltd. (MHRI) announces its economic outlook for FY2004 and FY2005 subsequent to the release of *The 2nd Preliminary Quarterly Estimates of GDP* for the Apr-Jun quarter of 2004 by the Cabinet Office. In comparison to MHRI's previous *Economic Outlook for FY2004 and FY2005* released on August 20th, we have made minor revisions to some of the components of demand with respect to Japan, the US and the Euro zone to reflect data releases during the interim period. Nevertheless, we have not changed the overall forecast on the rate of real GDP growth since our assessment on the current conditions and outlook of the economy remains unchanged.

<The Overseas Economies>

The US Economy	Subsequent to a temporary slowdown, the economy will start to show 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	The economy will remain on recovery track, though growth will slow temporarily in the second half of the fiscal year (Real GDP growth 3.5%, nominal GDP growth 1.6%)
FY2005	The economy will grow at a more stable pace through a pick-up of domestic private-sector demand in the latter half of the fiscal year (Real GDP growth 2.1%, nominal GDP growth 1.4%)

This English-language translation is based upon the outlook in Japanese released on September 13, 2004.

Mizuho Research Institute

I. **The Overseas Economies**

The US Economy Subsequent to a temporary slowdown, the economy will start to show 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)

1. The US Economy

Latest data on US gross domestic product (GDP) for the first half of 2004 revealed a downward revision of exports and an upward revision of imports, resulting in a downgrade of the contribution by external demand. In contrast, domestic demand such as personal consumption, capital investment and inventory investment were revised upward. The overall rate of growth remains unchanged from 4.0% over the previous term (on an annualized basis). In view of the foregoing, our fundamental outlook on the US economy remains unchanged from our previous *Economic Outlook for FY2004 and FY2005*.

Although we expect a generally favorable income environment in the second half of 2004 given 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. We forecast the pace of US real GDP growth to stand at 4.3% in 2004 (our previous forecast was 4.3%).

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 ongoing high productivity growth. The steady rise of real income will serve to support personal consumption. Nevertheless, we are inclined toward the view that the US economy will remain near its potential growth rate in the first half of 2005 because rising household debt burdens will dampen a rapid growth of consumption. Meanwhile, capital investment will also start to decelerate on a cyclical basis. However, the economy should regain momentum and enter a more accelerated growth trajectory in the second half of the year, reflecting a virtuous cycle of a sustained pickup of real income and production under a still-accommodative monetary policy environment. Our forecast on US real GDP growth in FY2005 is 3.6% (previous forecast: 3.6%).

Although consumer prices will surge in the second half of 2004 due to high crude oil prices, the inflation rate should slow down next year because of a gradual fall of crude oil prices and productivity gains.

Chart 1: Forecast of the US Economy

(%)

	2003	2004	2005	2004		2005	
	(Actual)	(Forecast)	(Forecast)	1st-half	2nd-half	1st-half	2nd-half
GDP	3.0	4.3	3.6	4.0	3.3	3.6	3.8
Personal consumption	3.3	3.5	3.2	3.4	3.0	3.2	3.6
Housing investment	8.8	9.7	3.2	8.5	6.6	2.5	1.2
Capital investment	3.3	9.7	8.9	7.8	9.7	8.9	8.1
Inventory investment (\$100 mil)	-7	474	589	489	460	555	623
Government expenditures	2.8	2.2	1.7	2.3	1.9	1.4	1.9
Net exports (\$100 mil)	-5,185	-5,810	-6,044	-5,694	-5,925	-5,992	-6,097
Exports	1.9	9.2	8.4	9.4	8.5	8.5	8.0
Imports	4.4	10.2	6.9	13.1	8.5	6.4	6.5
Domestic final demand	3.4	4.2	3.5	3.9	3.6	3.4	3.6
Consumer price index (y-o-y % ch)	2.3	2.7	2.0	2.3	3.0	2.3	1.8
Core CPI (y-o-y % ch)	1.5	1.7	1.8	1.5	1.8	1.8	1.9
Current account balance (\$100 mi)	-5,307	-6,331	-6,437	-3,107	-3,224	-3,220	-3,217
<as a percentage of nominal GDP>	-4.8	-5.4	-5.2	-5.4	-5.4	-5.3	-5.1

Notes: 1. CY = rate of change from the previous year. Half-year term = rate of change per annum from the previous year.
 2. The shaded columns are forecasts.
 3. With respect to the current account balance, only the actual figures for 2003 are original data. Half-year figures for 2004 and 2005 are adjusted for seasonal factors and the full calendar year figures are totals of the half-year figures. The percentages 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. According to recent data releases on real GDP growth in the first half of 2004, personal consumption and investment turned out weaker than initially expected in our previous forecast. On the other hand, exports grew strongly, highlighting the characteristics of a typical export-led recovery. However, the rate of overall growth and our future outlook remains unchanged from our previous *Economic Outlook for FY2004 and FY2005*.

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 output. However, the recovery will lack strength because of (1) forecasts of a slowdown of exports, (2) the lagging improvement of employment and income conditions due to the slow rise of productivity and the expansion of the EU which is causing a hollowing-out of the Euro zone economy, and (3) a capital stock overhang and the belated reduction of corporate debts serving as a drag upon capital investment. Our forecast, which is unchanged from our previous forecast, looks for a mild rise of real GDP growth in the Euro zone: 1.7% in 2004 (1.7% prior to revision) and 1.8% in 2005 (1.8% prior to revision).

The year-on-year percentage change of consumer prices should remain

pinned at a high level due to high crude oil prices and special factors during 2004 such as the cigarette tax hike and higher public utility fees and charges. However, the rise of consumer prices should slow down in 2005 along with the gradual decline of crude oil prices, the fading effect of one-off factors mentioned above and limited inflationary pressures from wage growth amid a high level of unemployment and the hollowing-out of the labor market.

Chart 2: Forecast of the Euro Zone Economy

(%)

	2003	2004	2005	2004		2005	
	(Actual)	(Forecast)	(Forecast)	1st-half	2nd-half (Forecast)	1st-half (Forecast)	2nd-half (Forecast)
Real GDP							
Euro zone	0.5	1.7	1.8	1.1	0.7	0.8	1.1
Private-sector consumption	1.0	1.2	1.6	0.7	0.6	0.8	1.1
Government consumption	1.7	1.4	1.4	0.6	0.6	0.7	0.7
Investment	-0.6	0.6	1.5	0.3	0.3	0.8	1.1
External debt (1bil euro)	143.5	172.5	146.0	85.0	87.5	74.3	71.6
Exports	0.1	5.8	3.5	3.4	2.3	1.1	2.4
Imports	2.1	4.9	4.9	2.7	2.3	2.3	2.7
Inventories (1 bil euro)	-6.2	7.2	49.5	1.0	6.3	22.6	26.9
Germany	-0.1	1.4	1.4	0.8	0.8	0.6	0.8
France	0.5	2.3	2.4	1.5	0.7	1.1	1.8
Italy	0.4	1.2	1.7	0.5	1.0	0.7	1.0
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 fact that fixed capital investment is surging once again in China, the unwavering stance of the regulatory authorities to curb excessive investment activity leads to our view that there is no need to revise our outlook on the Asian economy on the basis of a slowdown of the Chinese economy.

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 capital investment as a result of the continuation of regulatory tightening. 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 to adjust the unintentional accumulation of inventories of parts and intermediate goods related to information technology (IT) appliances, and (2) the slowdown of fixed capital investment in China. Meanwhile, we are inclined to believe that domestic demand will remain strong due to (1) the high level of capital investment accompanying the replacement of production facilities to manufacture a new generation of products in the semiconductor, liquid crystal panel and related parts and materials sectors in a bid to reinforce competitiveness, and (2) robust consumer spending 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 rate of consumer spending will slow down because of a pause in the improvement of labor market conditions reflecting a slower pace of corporate profit growth. We expect the pace of 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	7.2	6.3
NIEs (average)	4.9	3.0	5.9	4.5
S. Korea	7.0	3.1	5.2	4.8
Taiwan	3.6	3.2	5.9	4.2
Hong Kong	1.9	3.2	7.3	4.3
Singapore	2.2	1.1	7.8	4.4
ASEAN4 (average)	4.6	5.3	5.6	4.8
Thailand	5.4	6.8	6.3	5.4
Malaysia	4.1	5.3	6.7	4.7
Indonesia	4.3	4.5	4.7	4.6
Philippines	4.3	4.7	5.2	4.5
China	8.3	9.4	8.9	8.3

- Note: 1. Real GDP growth (rate of change over the previous year). The shaded columns are forecasts.
2. The rate of China's real GDP growth in 2003 is an estimate by MHRI in consideration of the revision of GDP statistics.
3. The averages are weighted averages on the basis of each country's nominal GDP in 2000.
- Sources: Government data disclosed by each of the relevant countries.

II. The Japanese Economy

FY2004 Outlook: The economy will remain on recovery track, though growth will slow temporarily in the second half of the fiscal year (real GDP growth 3.5%, nominal GDP growth 1.6%)

FY2005 Outlook: The economy will grow at a more stable pace through a pick-up of domestic private-sector demand in the latter half of the fiscal year (real GDP growth 2.1%, nominal GDP growth 1.4%)

1. Key points and assessment of the 2nd QE

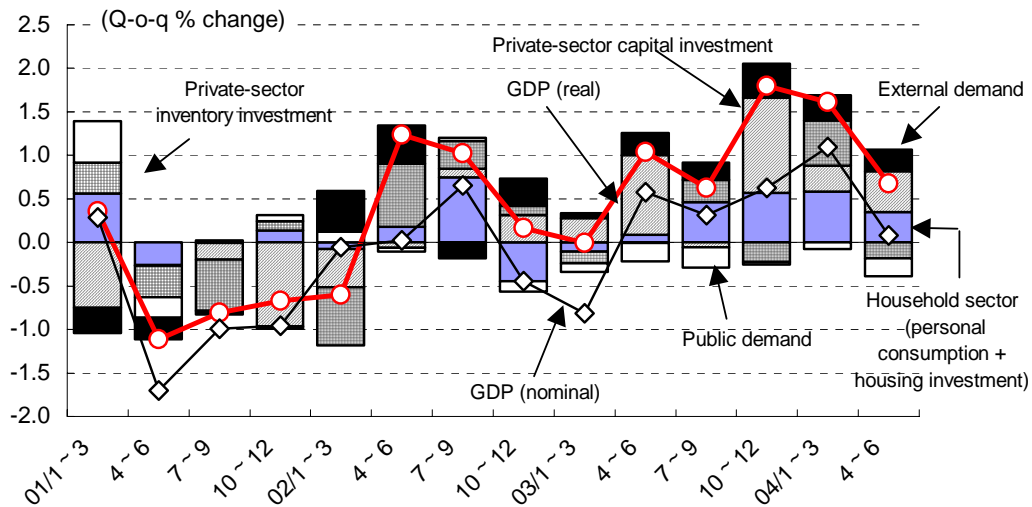
The Cabinet Office released its *Second Preliminary Quarterly Estimates of GDP (2nd QE)* for the Apr-Jun quarter of 2004, revising downward its estimate for real GDP growth by 0.1% pt (0.4% pt per annum) to 0.3% q-o-q (1.3% p.a.) from 0.4% q-o-q (1.7% p.a.) in the *First Preliminary Quarterly Estimates of GDP (1st QE)*. Japan's nominal GDP for the same quarter was also downwardly revised to -0.5% q-o-q (-2.1% p.a.) from -0.3% q-o-q (-1.3% p.a.) in the *1st QE*.

A closer look at Japan's real GDP growth in terms of the major demand components reveals an upward revision of capital investment to 1.2% q-o-q from the flat quarterly growth in the *1st QE*. Personal consumption remained unchanged from 0.6% q-o-q. The contribution by personal consumption combined with capital investment to GDP growth is 0.55% (2.2% p.a.). The contribution to quarterly growth by private-sector final demand (including exports) reached 0.85% (3.4% p.a.), resulting in growth above the potential rate of growth estimated to be around 1.5%. Inventory investment, the greatest factor causing the recent sharp downgrade, reflected a lull from the sharp accumulation in the previous quarter (the contribution to real GDP was 0.4%). Since a rise of inventories comparable to the Jan-Mar quarter would amplify the risks of an inventory adjustment, the restraints upon inventory investment in the Apr-Jun quarter should be viewed as a positive factor from the perspective of the sustainability of Japan's expansion phase. Public investment also dropped sharply due to (1) the curtailment of supplementary budget by both the central and local governments in FY2004, and (2) the ongoing reduction of public construction spending in the initial FY2005 budget. Since public works contracts - a leading indicator of public investment - has stopped decreasing, the negative contribution by public investment should contract in FY2004.

Despite substantial downward pressure by the government sector, Japan's real GDP in the Apr-Jun quarter managed to grow around its potential rate of growth as a result of the positive contribution by private sector demand. Judging from the well-managed state of inventory investment, which will enhance the sustainability of the

economy, Japan's economic growth in the Apr-Jun quarter should be viewed in a positive light.

Chart 4: The Second Preliminary Quarterly Estimates of GDP (2nd QE) for the Apr-Jun quarter of 2004



Source: Cabinet Office, 2nd Preliminary Quarterly Estimates of GDP (QE).

2. Forecast of the Japanese Economy in FY2004

Information-related production goods will enter an inventory adjustment phase

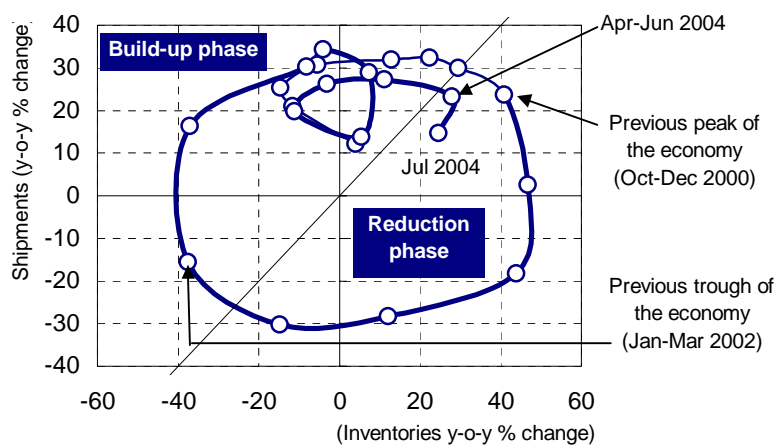
Nevertheless, there are some who are concerned that the Japanese economy might fall into a recession. The unexpected downgrade of the 2nd QE for the Apr-Jun quarter was interpreted as another negative surprise adding to a spate of downbeat data releases starting with the 1st QE for the Apr-Jun quarter (released on August 13th), the below-consensus *Industrial Production Index* for July (August 31st) and the *Monthly Labor Survey* for July (August 31st) indicating the lagging improvement of labor market conditions and the *Machinery Orders* for July (September 9th) signaling the slowdown of capital investment.

Admittedly, recent industrial production activity provides us with reasons to be concerned. Japan's current economic expansion was driven by information-related producer goods and inventories are currently piling up at a rapid pace because of over-production. The inventory cycle shows that information-related producer goods have entered an inventory adjustment phase since the Apr-Jun quarter of 2004. The adjustment pressures upon information-related producer goods constitute a major cause for the sluggish pace of overall industrial production since May. Concerns regarding the risks of recession are rising inevitably since these events are reminiscent of the collapse of the so-called information technology (IT) bubble in 2001 triggered by the unintentional inventory buildup of IT-related goods.

Note, however, that the current situation differs from the collapse of

the IT bubble in two major aspects. Firstly, the accumulation of inventories of information-related production goods are already slowing down given the curtailment of production activity at a relatively early stage as a result of lessons learned from past mishaps. Secondly, in comparison to the previous IT-boom spurred mainly by mobile telephones, demand for IT-related goods at this juncture is spreading more widely to digital consumer electronics such as flat-panel television sets, leading to prospects that demand will rise over the medium-term perspective as prices decline. In view of the foregoing, we believe that the current inventory adjustment cycle of information-related production goods will be relatively benign and that it will not serve as a major downside risk to the Japanese economy.

Chart 5: The Inventory Cycle of Information-Related Production Goods



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

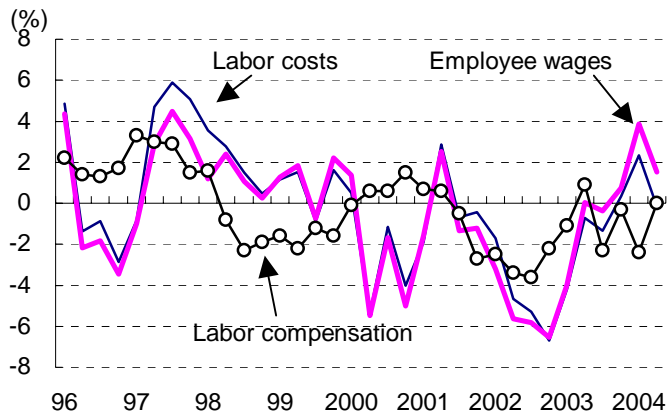
The improvement of corporate earnings is gradually spreading to the household sector

Even so, the current economic expansion has already lasted 30 months since the bottom in January 2002, thus edging closer to the average of past expansion cycles. An autonomous economic recovery mechanism needs to function in order to keep the economy from stalling amid the ebb of the recovery momentum. More precisely, if corporate earnings continue to rise and pass on the benefits of the economic recovery to the household sector through employment and wages, household sector demand such as personal consumption will serve to underpin the economy.

Even though the *Financial Statements Statistics of Corporations by Industry* for the Apr-Jun quarter - watched closely for the reasons above – revealed a slight dip (-0.2%) of overall labor costs, employee wages

(excluding welfare expenses) grew above the previous year for the third quarter in a row. The 2nd QE also revealed that labor compensation in the Apr-Jun quarter improved to flat growth over the previous year, indicating that the rise of corporate earnings is rippling through to household income.

Chart 6: Labor Costs and Labor Compensation



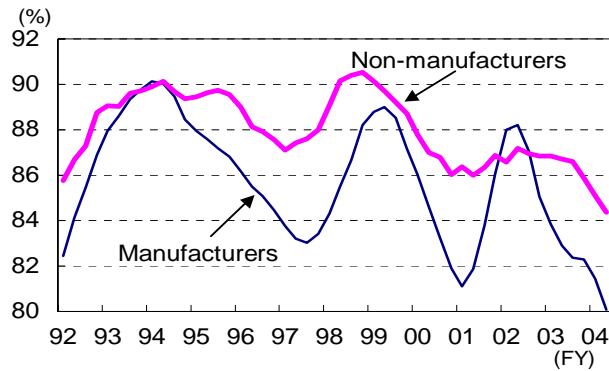
Note: Percentage change over the same period a year ago.
 Sources: Ministry of Finance, *Financial Statements Statistics of Corporations by Industry*,
 Cabinet Office, *National Income Statistics*.

Corporate financial conditions are improving steadily

Furthermore, the *Financial Statements Statistics of Corporations by Industry* also revealed that even with a declining cost to sales ratio (sales cost/sales), the current profit to sales ratio (current profit/sales) rose over 5%, reaching historical highs since the collapse of the asset-inflated bubble economy, thus indicating a significant improvement of corporate profitability. The break-even margin is also falling steadily both among manufacturers and non-manufacturers, thereby raising their profit stability against demand (sales volume) fluctuations. Note also that the labor share has been dropping sharply, leaving more room for corporations to reconsider the improvement of labor compensation.

Corporate balance sheets are also improving. The ratio of operational cash flow to outstanding debt (debt maturities) has dropped to the lowest level since 1980, indicating that the debt overhang has been resolved from a macroeconomic point of view. Debt maturities are falling sharply as a result of debt reduction - notably in the most-heavily indebted sectors thus far such as construction, real estate and retail sales.

Chart 7: The Break-Even Margin



Notes: 1. 4Q moving averages.
2. Due to statistical limitations, fixed costs refer to depreciation costs and labor costs.
Source: Ministry of Finance, *Financial Statements Statistics by Industry*.

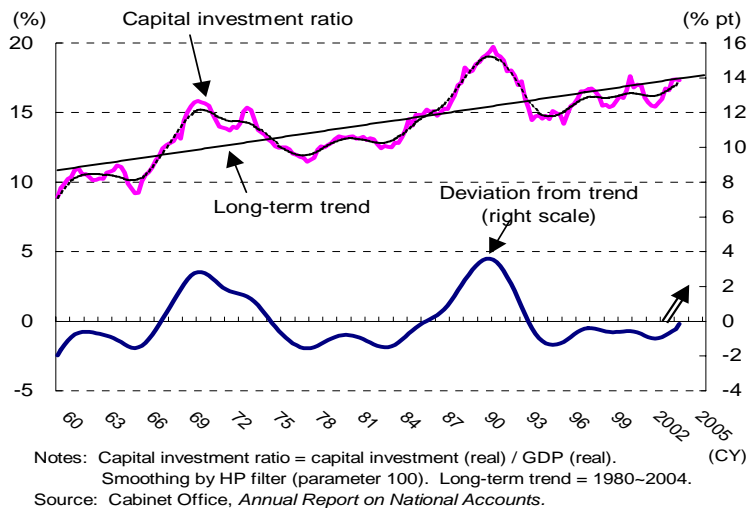
Construction investment should pick up and push capital investment into a long-term expansion

The gradual rise of economic growth expectations among corporations along with the prolonged expansion of the economy, coupled with the improvement of corporate financial conditions mentioned above, are serving as strong tailwinds for capital investment. Machinery orders (orders in the private sector excluding orders for ships and orders by electric power companies) – a leading indicator of capital investment – rose a dramatic 10.3% q-o-q in the Apr-Jun quarter. In particular, capital investment among manufacturers is poised for strong growth in the Jul-Sep quarter, judging from the fact that machinery orders by manufacturers grew almost 20% in the last quarter.

While the rise of capital investment among manufacturers will most likely come to a pause during the period from the second half of FY2004 to early FY2005, we still believe that capital investment among non-manufacturers may keep growing, given the strength of consumer spending reflecting the improvement of labor market conditions. We also expect a pickup of capital investment even among small and medium-sized corporations backed by the improvement of financial conditions. Looking forward, we believe that capital investment will keep growing with the main driver shifting from manufacturers to non-manufacturers and spreading to small and medium-sized corporations.

Meanwhile, the capital investment cycle indicates the possibility that capital investment is on the verge of a prolonged 20-year expansion cycle that is accompanied with the rise of construction investment. Such a long expansion cycle was last seen in the second half of the 1960s and the second half of the 1980s. Signs of an upturn of construction investment – comprised mainly of non-manufacturers – serve as credible symptoms to support this scenario.

Chart 8: The Capital Investment Cycle



The economy will avoid slipping into recession and continue to grow at its potential rate of growth

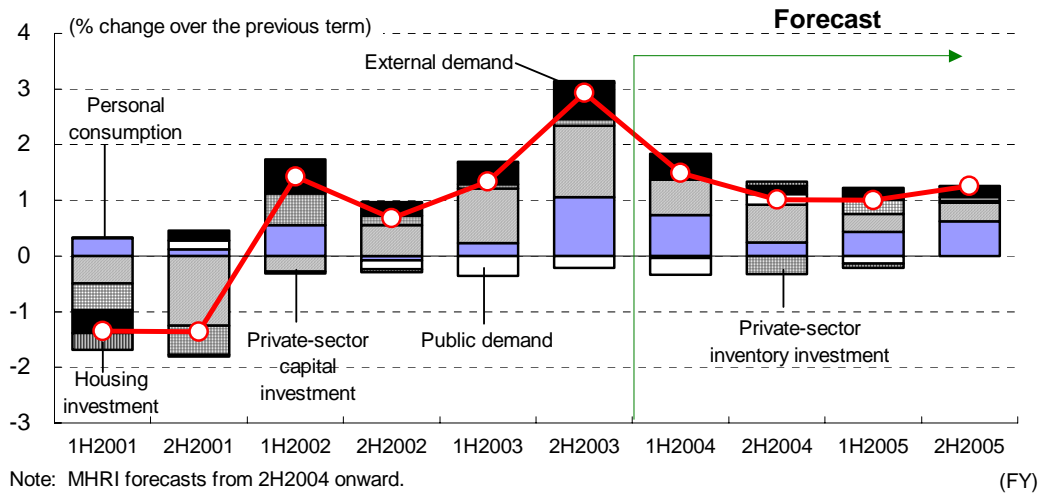
Moderate expansion expected in the second half of FY2004

Although the economic recovery is losing momentum, we believe that it would be overly pessimistic to forecast a recession because of the following reasons: (1) the inventory adjustment of information-related production goods should turn out to be benign, (2) the autonomous recovery mechanism of the economy is starting to function, (3) corporate earnings which generally provide the source of economic recovery should follow a stable trend at a high level, and (4) capital investment is most likely entering a prolonged expansion phase. Even though the pace of growth may slow down temporarily, we believe that the Japanese economy will avert a near-term recession and remain in expansion mode driven mainly by domestic private-sector demand.

Exports are predicted to slow down in the second half of FY2004, reflecting the slower pace of economic growth overseas. Adding to sluggish exports, Japan's economic expansion will slow down as a result of: (1) a temporary deceleration of personal consumption due to the fading impact of the dog days of summer and the Olympic Games, and (2) a temporary lull in capital investment until there is a rise of business fixed investment among non-manufacturers subsequent to a pause in investment among manufacturers. We also expect a slight reduction of industrial output stemming from the accumulation of inventories, leading to our forecast that the rate of economic growth will decelerate.

In FY2004, we forecast Japan's real GDP growth to contract from 1.6% over the previous term (3.0% p.a.) in the first half FY2004 to 1.0% over the previous term (2.0% p.a.) in the second half of FY2004. However, full year growth will be higher than the previous year, reaching 3.5% in real terms (our forecast prior to revision was 3.5% and 1.6% in nominal terms (1.6% prior to revision) due to a large 2.2% carry-over from FY2003.

Chart 9: Japan's Real GDP Growth



3. Forecast of the Japanese Economy in FY2005

In FY2005, personal consumption should gradually return to a pace of expansion as a result of the sustainable improvement of the income environment stemming from the rise of corporate business performance. The ongoing expansion of personal consumption should also serve as tailwinds upon the rise of capital investment, as the main driver of capital investment growth shifts from manufacturers to non-manufacturers. Exports will also continue to grow albeit at a slower pace, and serve to buttress the economy. In the first half of FY2005, the economy will grow at a sluggish pace in the absence of strong personal consumption and capital investment growth necessary to offset the negative contribution by a further fall of public investment. In the second half of FY2005, the Japanese economy will come within reach of a stable expansion cycle driven mainly by domestic private-sector demand due to: (1) the gradual improvement of personal consumption, (2) the increase of capital investment among non-manufacturers, and (3) the ebb of the cautious stance among corporations to keep inventory levels at a minimum reflecting the rise of expectations toward the eradication of deflation.

Although the rate of real GDP growth in the first half of FY2005 is forecast to languish at 1.0% over the previous term (2.0% p.a.), growth in the second half of FY2005 should reach 1.3% over the previous term (2.5% p.a.). Our forecast looks for the full year rate of GDP growth to reach 2.1% (2.1% prior to revision) in real terms and 1.4% (1.4% prior to revision) in nominal terms.

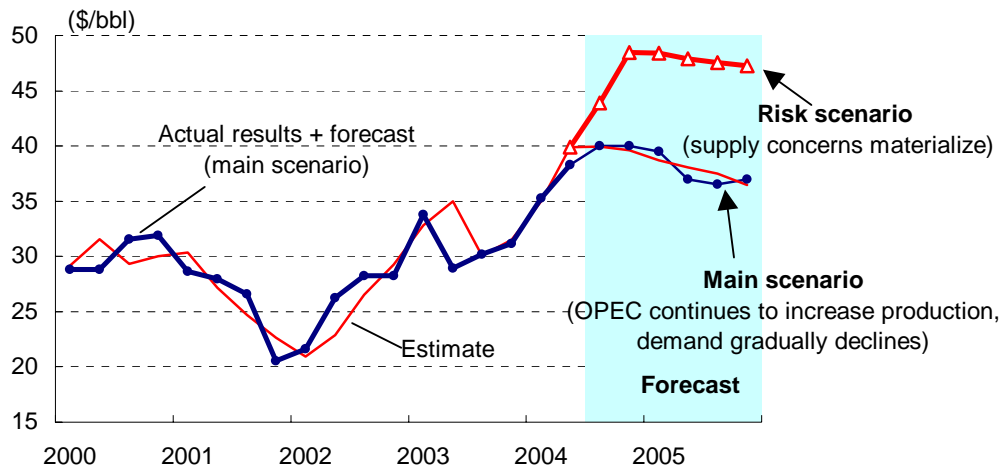
4. Japan's emergence out of deflation in FY2006

Note that the sustainability of Japan's economic recovery would easily be derailed by exogenous shocks. As we pointed out in our previous release, given the prospects that Japan's economic recovery may lose momentum, there is a risk that a full-fledged inventory adjustment would occur as a result of negative pressures stemming from a further rise of crude oil prices and demand shocks such as a sharp drop of the Chinese economy.

The Chinese regulatory authorities have tightened financial controls and administrative guidance in order to reign in rampant fixed capital investment and secure the long-term stable growth of its economy. The recent resurgence of fixed capital investment, reflecting the strong investment incentive among companies and local governments, is leading to the focus of attention upon the Chinese government's policy measures. Any mishap in government guidance may lead to a sharp cool-down of the economy. A sharp slowdown of the Chinese economy would have a potentially damaging impact upon the neighboring countries and areas including Japan, the NIEs and the ASEAN region through the decline of Chinese imports and the market fall of relevant goods such as iron & steel, chemical products and non-ferrous metals.

Crude oil prices (near term contract for WTI futures) are settling down at the lower end of the \$40/barrel level after climbing to the upper end of the \$40/barrel level. However, in addition to the ongoing rise of demand mainly in China and dwindling crude oil reserves among the members of the Organization of Petroleum Exporting Countries (OPEC), there are lingering concerns regarding a temporary suspension of crude oil output by Russia and uncertainties regarding the supply of Iraqi crude oil amid the ongoing turmoil of the country. Another upturn of crude oil prices stemming from supply-side factors would lead to (1) the rise of the inflation rate in Europe, the US and the countries of Asia resulting in sluggish consumer spending in those areas, and (2) downward pressures upon the Japanese economy as a result of the deterioration of corporate earnings due to higher costs and the fall of exports bound for Europe and the US.

Chart 10: Crude Oil Prices (WTI Near Term Contracts)



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

If the Japanese economy can avoid these downside risks and remain on a recovery driven mainly by domestic private-sector demand from the second half of FY2004 onward, the economy should gather momentum again in the second half of FY2005 and come within reach of the end of deflation. It should be noted that the output gap has narrowed considerably as a result of the rapid economic recovery from the end of 2003. Despite the extremely mild contraction of the output gap since the economy will only grow around its potential rate of growth around 1.5% for the time being, the dissolution of the output gap will only be a matter of time once the economy returns to a recovery track. Given the prospects that the negative pressures upon wages will gradually start to ease, we expect the year-on-year change of consumer prices to turn positive around the end of FY2005.

In the event prices start to rise on a sustainable basis, (1) companies will cease to take an excessively cautious stance regarding inventory investment stemming from the risks of price falls under deflationary pressures, and (2) 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 “eradication of deflation”. We expect to see these symptoms of the economy 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.

Chart 11: Forecast of the Japanese Economy

(%)

	FY2003 (Actual)	FY2004 (Forecast)	FY2005 (Forecast)	FY2004		FY2005		FY2004 (Contribution) (Forecast)	FY2005 (Contribution) (Forecast)
				1st-half (Forecast)	2nd-half (Forecast)	1st-half (Forecast)	2nd-half (Forecast)		
GDP (real)	3.2	3.5	2.1	1.5	1.0	1.0	1.3	-	-
Domestic demand	2.5	2.7	1.8	1.1	0.9	0.8	1.1	2.6	1.8
Private sector demand	4.0	3.8	2.4	1.8	0.9	1.2	1.3	2.9	1.8
Personal consumption	1.4	2.5	1.6	1.4	0.5	0.8	1.2	1.4	0.9
Housing investment	0.3	1.6	-1.1	-0.1	2.7	-2.5	0.2	0.1	-0.0
Capital investment	12.2	9.5	4.6	3.6	3.8	1.8	1.8	1.6	0.8
Public demand	-2.5	-1.3	-0.1	-1.4	0.9	-0.7	0.4	-0.3	-0.0
Government consumption	1.0	1.6	2.0	0.8	0.8	1.0	1.2	0.3	0.3
Public investment	-12.1	-10.8	-7.6	-8.8	1.4	-6.6	-2.8	-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	8.2	5.2	4.1	2.3	2.5	2.8	-0.7	-0.5
GDP (nominal)	0.8	1.6	1.4	0.6	0.5	0.7	0.9		
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	4.2	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 annualized rates).
 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*.

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', goes up to touch the 'U', and then goes down to end under the 'O'.