

Economic Outlook for FY2004 and FY2005

November 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 Jul-Sep quarter of 2004 by the Cabinet Office. The key points of the outlook are as follows.

<The Overseas Economies>

The US Economy	Moderate expansion around its potential rate of economic growth (4.4% in 2004, 3.5% in 2005)
The Euro Zone Economy	Crude oil prices serve as a drag upon sluggish growth (1.7% in 2004, 1.7% in 2005)
The Asian Economies	Growth will slow down in 2005 given the ebb of demand for IT and digital-related goods (7.3% in 2004, 6.3% in 2005)

<The Japanese Economy>

FY2004	Japan will remain on recovery track despite slower growth in the second half of the fiscal year (real GDP growth 2.9%, nominal GDP growth 1.0%)
FY2005	Japan will draw closer to a self-sustained recovery driven by domestic private-sector demand (real GDP growth 2.1%, nominal GDP growth 1.4%)

This English-language translation is based upon the outlook in Japanese released on November 17, 2004. This publication is compiled solely for the purpose of providing readers with information and is in no way meant to encourage readers to buy or sell financial instruments.

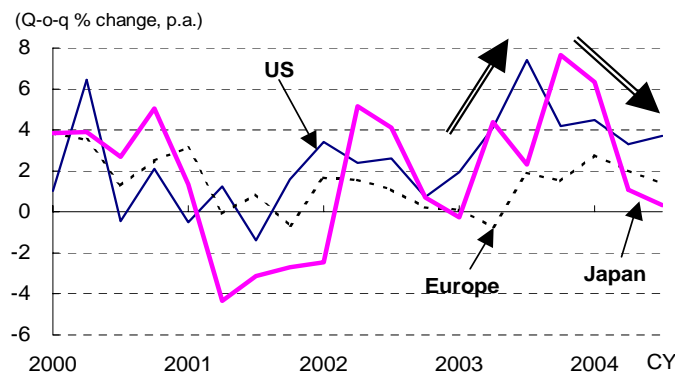
I. Overview

1. The global economy

Global growth is gradually losing momentum due to soaring crude oil prices and inventory adjustment of IT and digital-related goods

The global pickup since the spring season of 2003 is gradually losing momentum (Chart 1). The rate of economic growth in the US is declining due to the fading effect of the tax cuts and the rise of crude oil prices. Likewise in the euro zone, the rise of inflation stemming from the surge of crude oil prices is serving as a damper upon consumer spending. In areas such as the euro zone and Japan that have a heavy reliance upon exports to fuel their economic recovery, the US economic slowdown is serving as restraints upon growth because of the slowdown of US-bound exports. In Asia (including Japan), inventories of certain IT and digital-related goods are piling up, triggering an adjustment of production activity. The Chinese economy is also showing signs of a mild slowdown given the government's tightening measures.

[Chart 1: Global economic growth]



Source: Cabinet Office, US Department of Commerce, Eurostat.

The impact of the rise of crude oil prices is relatively benign and de-stocking of IT and digital-related goods is progressing

Nevertheless, the global economy will most likely avoid a loss of momentum and gradually start to pick up in 2005. Although the rise of crude oil prices will serve as negative pressures upon growth for net importers of crude oil due to the decline of their purchasing power, the impact is not as serious as in past oil crises. Furthermore, despite the rise of inventory adjustment pressures regarding certain IT and digital-related goods, the chances are slim that the IT sector will fall into a serious adjustment experienced in the aftermath of the IT bubble because of precautions and measures taken by companies at an early stage.

The US economy will continue to expand, relatively unscathed by high crude oil prices

Although the surge of crude oil prices is serving as a damper upon US economic growth, we are inclined to believe that the negative impact upon the economy will be limited because of the following factors: (1) the total incremental cost due to the rise of crude oil prices since early 2004 is far less than the past two oil crises, and (2) the current price level of crude oil is not necessarily high from the perspective of purchasing power when considering the rise of wages. Since companies are now better-equipped

Euro zone economic growth will remain sluggish despite the benign impact of crude oil prices

Asian economic growth will ebb given the cool-down of demand for IT and digital equipment

to absorb higher costs due to productivity gains, the chances are slim that the rise of crude oil prices will lead to a loss of momentum of the US economy. Even though a dramatic acceleration of economic growth is unlikely because of a cautious inventory investment stance in the corporate sector, the US economy will most likely grow at a moderate pace matching its potential rate of growth in 2005, driven by the steady rise of personal consumption reflecting the improvement of the income environment.

The euro zone economy is also relatively unscathed by the rise of crude oil prices. Given the hollowing out of the labor market in major euro zone countries such as Germany due to the expansion of the EU to central and east Europe, the rise of inflation stemming from the rise of crude oil prices is not passing through to the rise of wages. At this juncture, it is unlikely that the rise of crude oil prices will trigger a price-wage spiral witnessed in past surges of crude oil prices. However, the rise of crude oil prices will serve as a further depressant upon the euro zone's sluggish economic growth reflecting the stagnation of domestic demand. The euro zone economy will remain in the doldrums in 2005.

In the Asian economies, inventory adjustment pressures are rising with respect to IT and digital-related goods such as semiconductors, electronic parts and liquid crystal panels because of the ebb of demand in connection with the replacement of personal computers with newer models and the Olympic games. However, the inventory overhang is smaller in comparison to the IT bubble as a result of steps to adjust production at a relatively early stage. Judging from the move to curb the rise of supply capacity such as the postponement of capital investment, it is unlikely that an inventory adjustment of IT and digital-related goods will trigger a serious economic slowdown. The slowdown of the Chinese economy – implementing its first interest rate hike in nine years – should also turn out to be mild as a result of careful tightening measures by the regulatory authorities. Although the pace of Asian economic growth will slow down in 2005 reflecting background factors such as restraints upon output and the cautious stance toward capital investment in the corporate sector, the slowdown will turn out to be a mere adjustment of the blistering speed thus far.

The Japanese economy will avert a major adjustment and remain in expansion mode

The Japanese economy is also slowing down due to the adjustment of inventories of IT and digital-related goods, the ebb of capital investment among manufacturers and the slowdown of exports. Nevertheless, the surge of crude oil prices is only pushing up consumer prices by a small degree and thus has a limited impact upon the economy. Japan should also avoid a serious adjustment since Japanese companies – like their Asian counterparts – have taken steps at an early stage to work off the inventory overhang of IT and digital-related goods. In 2005, the Japanese economy will remain in expansion mode, driven mainly by private sector demand given prospects of the ongoing rise of consumer spending backed by the sustained improvement of the income environment.

[Chart 2: Global GDP growth (real)] (%)

	CY2003	2004	2005		2005	2005	
			1H	2H		1H	2H
US	3.0	4.4	4.1	3.6	3.5	3.4	3.7
Euro Zone	0.5	1.7	2.2	1.4	1.7	1.4	2.4
Asea	6.1	7.3			6.3		
NIE s	3.0	5.8			4.3		
ASEAN4	5.3	5.6			4.8		
China	9.3	9.2			8.6		
Japan	2.4	4.0	5.3	0.9	1.9	2.2	2.3

Note: The shaded areas are forecasts.

CY = change over previous year, half year = annualized percentage change over previous term.

In addition to crude oil, the weak dollar is a new risk factor

The odds are high that the global economy will avoid a loss of momentum stemming from the rise of crude oil prices. Nevertheless, crude oil will still remain a risk factor for the global economy. Given the US economic slowdown, the focus of attention is shifting once again to the structural shortcomings of the US economy, namely the “twin deficit”, leading to market concerns regarding a weak dollar.

2. Crude Oil Prices and the Foreign Exchange Rate

Crude oil prices drop after reaching a historical high

The West Texas Intermediate (WTI) near-term futures contract (the crude oil benchmark) fell back to the high \$40s range given the restoration of US crude oil stockpiles after soaring at a pace of 70% since the beginning of the year and momentarily touching a historical high of \$55/barrel toward the end of October.

Supply-side uncertainties in the background to high oil prices

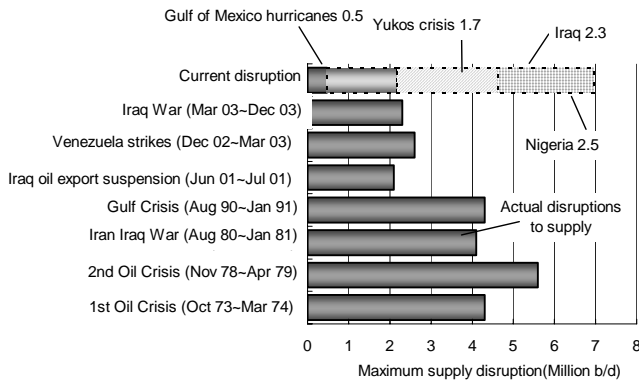
Although the rise of crude oil prices since the beginning of this year stems from complex factors comprised of the global crude oil squeeze and speculative investment, the most noteworthy factor is the strong and persistent worries regarding crude oil supply. As a result of aggressive output-boosting measures by the Organization of Petroleum Exporting Countries (OPEC) such as raising the production quota (excluding Iraq) to 27 million barrels/day from November, OPEC's remaining excess capacity has fallen below 1% of global demand. Even though the world today does not face a major disruption of crude oil supply (Chart 3) as in past oil crises, uncertainties regarding supply amid dwindling reserves are driving up the price of crude oil to levels which may not be explained by actual supply and demand. In addition to uncertainties regarding the cessation of output such as the terrorist attacks upon Iraqi oil pipelines, the financial crisis of Russian oil giant Yukos Oil Co., civil unrest and labor disputes in Nigeria, the successive hurricanes since September dealt a debilitating blow to the oil refineries in the Gulf of Mexico, leading to the decline of output by approximately 500 thousand barrels/day (roughly equivalent to OPEC's remaining excess capacity) and hence served to amplify the worries on supply.

Crude oil prices will remain high until early spring and gradually decline in 2005

Amid the difficulties to dispel the above-mentioned uncertainties, the WTI near-term contract will most likely remain at the high \$40s-\$50s until early spring (Chart 4) because of (1) concerns regarding the shortage of heating oil supplies in the US during the peak winter season and (2) the further rise of geopolitical risks in Iraq aiming to hold the elections for the Transitional National Assembly in January 2005. Crude oil prices should gradually decline from then onward along with the fading impact of seasonal factors and the slowdown of global crude oil demand. China's demand for crude oil is expected to fall sharply from 14% y-o-y in 2004 to 6% y-o-y in 2005. On a global scale, crude oil demand should ebb sharply from 3.3% y-o-y in 2004 (a historical high since 1978) to 1.8% y-o-y in 2005. Meanwhile, despite the decline of production by OPEC members, the contribution to crude oil supply by non-OPEC countries will remain unchanged from 2004 and keep global crude oil supply around 2.0% y-o-y. Judging from prospects on the rise of investment on the back of improving fiscal conditions of oil-producing countries and profitability of investments as a result of high crude oil prices,

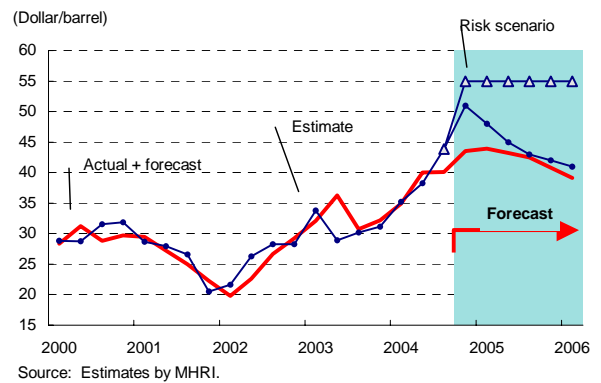
OPEC's remaining excess capacity should recover and also lead to the alleviation of bottlenecks in oil refineries and transportation.

[Chart 3: The current concerns on crude oil supply compared to supply disruptions in the past]



Source: MHRI, on the basis of IEA, *Stocks and Emergency Response*.

[Chart 4: Forecast on crude oil prices (WTI near-term futures)]



Source: Estimates by MHRI.

Increasing price spreads between geographic locations and different grades of crude oil

The rise of crude oil prices at the present juncture is also characterized by the increase in price spreads between different grades of crude oil and different geographic locations. The price spread between the West Texas Intermediate (WTI, a light, low-sulfur crude which is the benchmark grade in the US) and Dubai (the benchmark crude oil in Japan which is a medium to heavy grade with a high-sulfur crude content) rose close to a historical high of \$18/barrel (Chart 5). In contrast to the rise of WTI, Dubai crude is currently trading in the mid-\$30s subsequent to its rise to around \$40/barrel in August. Even in the same grade of crude oil, taking for example Arabian light (a light to medium grade with a high sulfur content), there is an unusual distortion where the price of Arabian light bound for the US is higher than shipments toward Asia.

In the background to the widening price differential is a distortion of the supply and demand balance in different geographic regions and grades of crude oil. The crude oil crunch is relatively mild in Asia because it imports much of its crude oil from the Middle East where oil-producing countries are stepping up their output. Japan imports approximately 80%, and China 40%, of their crude oil from the Middle East. In contrast, the US does not benefit as much from the pickup of Middle East crude oil output because it imports only 20% of its crude oil from the area. In addition, global bottlenecks in oil refineries and transportation capacity and the reinforcement of environmental regulation are leading to the concentration of demand upon high-quality light crude oil with low sulfur content (Chart 6). In the US, more than 40% of oil

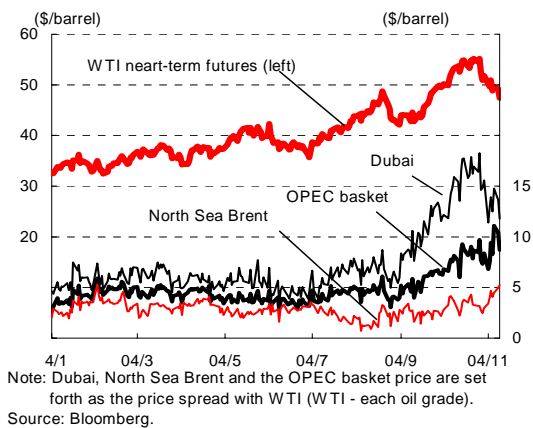
demand is comprised of demand for gasoline. In addition to the rise of demand for reformulated gasoline due to more stringent regulations on sulfur content, the limited capacity of oil refineries and the shortage of secondary refining

facilities are leading to a marked distortion of the supply and demand balance.

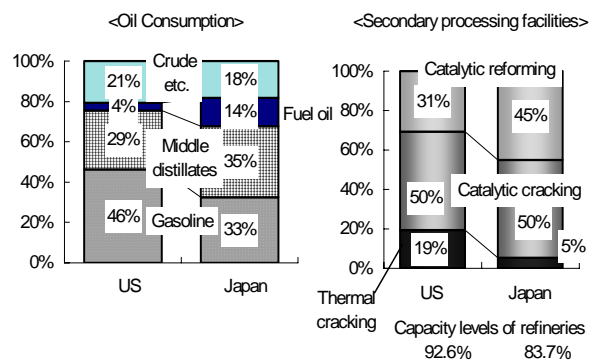
Although the price spread between geographic regions and grades of crude oil should gradually contract since the demand-supply distortion in the US also stems largely from temporary factors such as the impact of the hurricanes, the demand for low-sulfur light grade crude oil should remain high in regions such as the US and Europe where more stringent environmental regulations are expected.

The impact of the rise of crude oil prices would be relatively mild in consideration of the fact that (1) the degree to which a country or region is resistant to the rise of crude oil prices depends upon its energy consumption structure, (2) there is a significant disparity in the rise of crude oil according to the benchmark grade of oil in each geographic region, and (3) the appreciation of the yen. Even so, it is necessary to pay attention to the possibility that the disparity in economic impact may grow wider.

[Chart 5: Crude oil price spreads]



[Chart 6: Crude oil demand and refining capacity in the Japan and the US]



If crude oil prices remain pinned at high levels, negative pressures upon the economy will intensify mainly in the US

The impact upon the Japanese economy may not be ignored when considering the indirect impact of crude oil

In the event fresh uncertainties regarding crude oil supply in the Middle East, Russia and Nigeria lead to another bout of speculative investment in crude oil, the odds are high that the price of crude oil will remain at the \$50 level (the risk scenario in Chart 4). In such a case, the negative impact particularly upon the US economy is worrisome given its high dependence upon crude oil in economic activities and price gap between different grades of crude oil.

In the event the price of crude oil stays at the mid-\$50/barrel level, the impact upon the Japanese and US economies calculated using the Mizuho Macroeconomic Model is set forth in Chart 7. In comparison to the main scenario, real GDP growth in the Jan-Mar quarter of 2006 would be 0.1% lower in Japan and 0.6% lower in the US due to the rise of prices and the fall of corporate earnings. In the full fiscal year 2005 (ending in March 2006), the level of real GDP would be approximately 0.1% lower in Japan and 0.2~0.5% lower in the US, bringing down the rate of growth by approximately 0.1% pt and 0.3% pt in Japan and US respectively (Chart 7).

As far as the Mizuho Macroeconomic Model simulations are concerned, the direct impact upon the Japanese economy is relatively small. Nevertheless, the US economic slowdown will lead to the fall of Japan's exports to the US and thus serve as negative pressures upon the Japanese economy. Furthermore, in consideration of a similar effect upon the euro zone and Asian economies, the indirect impact upon the Japanese economy through exports would double or triple, posing a grave risk upon the Japanese economy.

[Chart 7: The impact of the rise of crude oil prices upon the Japanese and US economies]

		2004		2005			2006
		Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar
Crude oil price (WTI: \$/barrel)	Main scenario	51.0	48.0	45.0	43.0	42.0	41.0
	Risk scenario	55.0	55.0	55.0	55.0	55.0	55.0
	Breadth of deviation	4.0	7.0	10.0	12.0	13.0	14.0
Import prices (Rate of deviation: %)	Japan	0.9	1.7	2.5	3.0	3.3	3.6
	US	0.2	1.0	0.9	0.9	0.9	0.8
Corporate goods prices (Rate of deviation: %)	Japan	0.1	0.1	0.2	0.2	0.2	0.3
	US	0.3	0.6	1.0	1.2	1.4	1.6
Consumer prices (Rate of deviation: %)	Japan	0.0	0.0	0.0	0.1	0.1	0.1
	US	0.3	0.6	1.0	1.2	1.4	1.7
Corporate earnings (Rate of deviation: %)	Japan	-0.2	-0.3	-0.4	-0.4	-0.5	-0.5
	US	0.0	-0.1	-0.1	-0.3	-0.5	-0.6
GDP (real) (Rate of deviation: %)	Japan	-0.01	-0.02	-0.04	-0.06	-0.08	-0.10
	US	-0.1	-0.2	-0.3	-0.4	-0.5	-0.6

Note: Estimates based upon Mizuho Macroeconomic Model. The results may differ from the previous outlook due to revisions to the model.

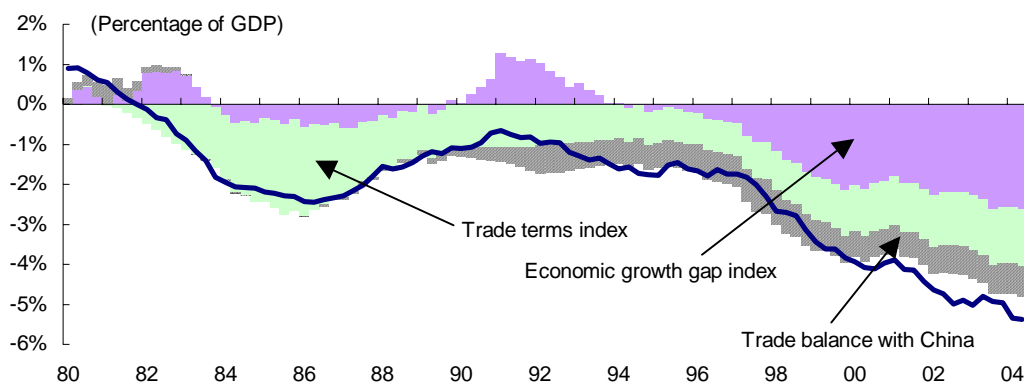
Rising concerns regarding the soft dollar

The dollar continued to weaken last year, reflecting the lack of momentum of the US economy even after the tentative cessation of assaults upon Iraq by the US-British troops in the spring season and the US "twin deficit" (the current account and budget deficits). Despite a temporary recovery of the dollar along with the acceleration of US payroll growth and the upturn of the long-term interest rate, the focus of attention is shifting once again to the

twin deficit from around early autumn in the run-up to the presidential election, reflecting concerns regarding the new administration's foreign exchange policy and the deceleration of the US economy.

The focus of attention upon the twin deficit is weakening the dollar because of speculation on the revival of the Plaza Accord of 1985. In 1985, the major countries of the world agreed to reduce the US trade deficit through the adjustment of foreign exchange rates, leading to a sharp fall of the dollar through coordinated intervention in exchange markets. A factor analysis reveals that the terms of trade (the foreign exchange rate) are a comparatively smaller factor and that much of the recent US trade deficit is caused by the economic growth gap between the US and its trade partners (Chart 8). Thus, even if steps are taken to weaken the dollar, it would only have limited effect, leaving most of the trade deficit untouched. Note also that there is a geographic shift in the trade deficit. The US trade deficit at the time of the 1985 Plaza Accord was comprised mainly of the trade deficit to trade partners such as Japan (37.3% as of 1985), Canada (17.6% as of 1985) and Germany (9.0% as of 1985). Today, the trade deficit to these countries is declining in contrast to the rise of the deficit to non-G7 countries such as China (23.3% as of 2003). This implies that the amount of the trade deficit which may be reduced through coordinated intervention is limited.

[Chart 8: Factors causing changes in the US trade deficit]



Source: US Federal Reserve Board, Department of Commerce.

Rising concerns regarding a yuan appreciation

Amid the foregoing circumstances, the euro is trading at a historical high to the dollar and the yen strengthened to around 105 yen/dollar. In addition, prospects are rising that China – America's largest trade partner – may let the yuan appreciate. The non-deliverable forward rate (NDF) of the yuan is rising sharply given comments by Chinese government officials hinting at the preparation of a shift to a floating foreign exchange rate regime and other factors lending credibility to such speculation.

High hurdles remain for concerted efforts to weaken the dollar

However, it is unlikely that the relevant countries will take policy steps to weaken the dollar. Since the sluggish growth of exports is a negative factor upon economic growth in Japan and Europe, it is unlikely that these countries would agree unconditionally to a disadvantageous move to strengthen its own currency which would undermine the price competitiveness of its exports. A more likely move would be to advocate independent efforts by the US such as the reduction of its budget deficit.

On the part of the US government authorities, the weakening of the dollar could induce a capital flight from the US and have a serious impact upon US long-term interest rates and stock prices, leading to a situation where the depreciation of the dollar may no longer be hampered. We are thus inclined to believe that US government authorities will carefully weigh the pros and cons of a dollar weakening policy. Furthermore, judging from the rise of inflationary pressures stemming from the rise of crude oil prices, a dollar weakening policy having the potential to accelerate inflation would not be a realistic option at the current juncture. The US fiscal policy stance in the State of the Union Address and the Budget Message in January and discussions at the next G7 meeting expected in February will be watched closely.

In the absence of dollar-weakening pressures stemming from policy initiatives, we are inclined to believe that the dollar will strengthen reflecting the relatively high rate of economic expansion and the rise of interest rates.

II. The Japanese Economy

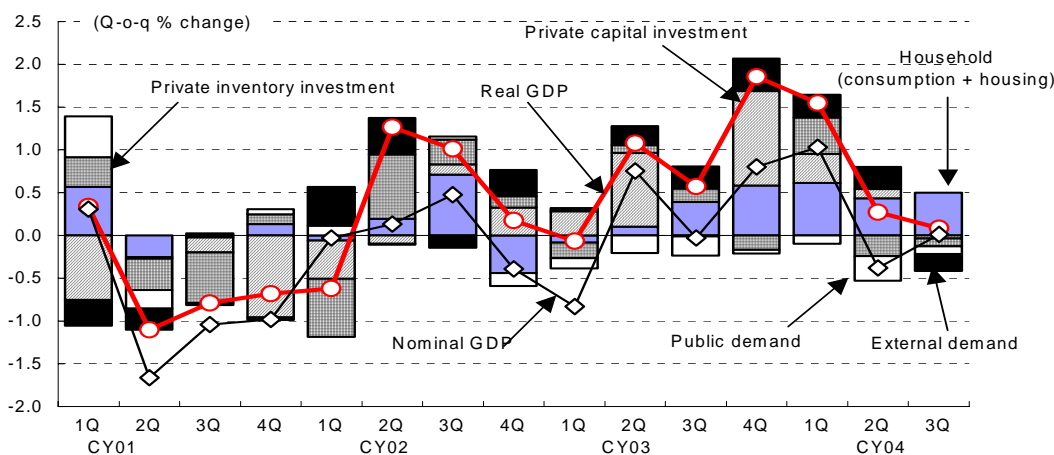
1. The current state of the Japanese economy

Japan's real GDP growth slowed, remaining barely in positive territory in the Jul-Sep quarter

The Japanese economy has been showing signs of a slowdown since summer, given the ongoing deterioration of economic indicators.

Japan's real GDP in the Jul-Sep quarter of 2004 grew at a pace of 0.1% q-o-q (translated into an annualized rate of 0.3%), barely remaining in positive territory but slowing from the previous quarter (Chart 9). Despite the overall strength of domestic private demand propped up by the ongoing strength of personal consumption, the downturn of capital investment from the previous quarter and the ongoing negative contribution by private inventory investment revealed a conspicuous slowdown of the corporate sector. Furthermore, public investment continued to drop sharply and net exports fell into negative territory for the first time in two years since the Jul-Sep quarter of 2002 due to the ebb of export growth, thereby serving to push down the rate of Japan's economic growth.

[Chart 9: Japan's real GDP growth (quarterly)]



The industrial production index in the Jul-Sep quarter fell from previous quarter for the first time in five quarters

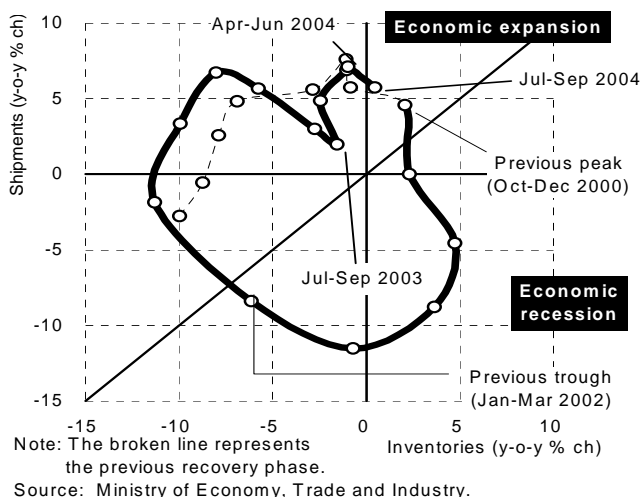
Production activity in the manufacturing sector is coming to a standstill. The industrial production index fell 0.7% q-o-q in the Jul-Sep quarter, registering a decline for the first time in five quarters. Looking at recent trends, the industrial production index fell 1.3% m-o-m in June, flattened out in July and August and dropped 0.4% m-o-m in September. Reflecting these circumstances, the diffusion index (DI) of coincident economic indicators remained below the boom-or-bust threshold of 50% in September after falling below the 50% level for the first time in 16 months in August. Moreover, the odds are high that the DI will drop further in the month of October given the high level of economic indicators in the month of July (October data will be compared with those of July), marking a reading below 50% for three consecutive months which is said to signal a slide into recession. Signs of economic slowdown will tend to intensify in the coming months.

The length of Japan's current economic expansion is at par with past expansion cycles

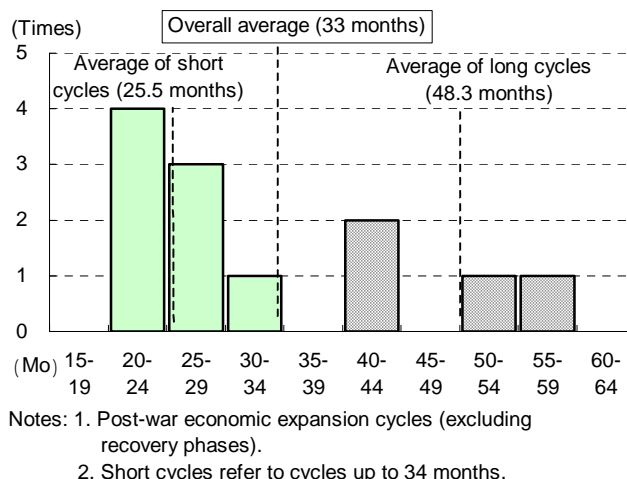
Judging the current state of the economy from the perspective of the economic cycle, Japan's current economic expansion bottoming in Jan 2002 would reach 33 months as of October 2004 assuming that the expansion continues through October. This is equivalent to the average span of Japan's past expansion cycles since the end of World War II. From an empirical viewpoint, the inventory cycle (Chart 10) indicates that the recovery tends to lose momentum along with the maturation of the economic cycle.

However, a word of mention is necessary that this applies only to average expansion cycles. Of the twelve post-WWII economic expansion cycles (excluding the current expansion), eight lasted for a period between 21~31 months. Only the four remaining expansion spans lasted longer than 42 months (the shortest of the four was the fourth cycle dubbed the "Iwato Boom"), revealing that expansion cycles extending for a period of 30~40 months are an exception (Chart 11).

[Chart 10: The inventory cycle]



[Chart 11: Post-WWII economic expansion]



Japan's economic recovery may last longer if the adjustment turns out to be benign

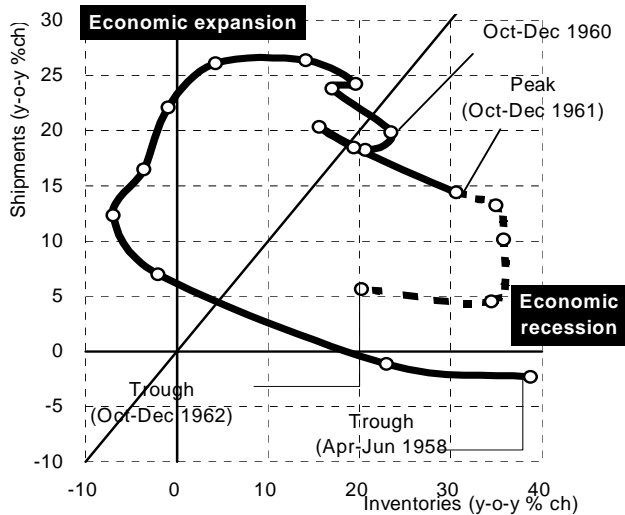
Taking the fourth expansion (the Iwato Boom) (Chart 12) as an example of the relatively longer economic expansion cycles, the economy showed tentative signs of a possible slide into recession, crossing over the 45-degree line during the 30-month period between the trough in the Apr-Jun quarter of 1958 to the peak in the Oct-Dec quarter of 1960, due in part to precautionary monetary tightening. However, the loss of momentum only turned out to be a mild inventory adjustment and the expansion phase extended for another year as a result of monetary easing and an inventory adjustment stance by companies from an early stage.

The 12th cycle, which was the first recovery cycle after the collapse of the asset bubble, headed into an inventory adjustment phase crossing over the 45 degree line during the 21-month period from the trough in the Oct-Dec quarter of 1993 to the peak in the Jul-Sep quarter of 1995 (Chart 13). Even so, the recovery phase continued until the Apr-Jun quarter of 1997 with the adjustment

ending in a relatively short period of time on the back of massive fiscal spending and the correction of the strong yen as a result of monetary easing.

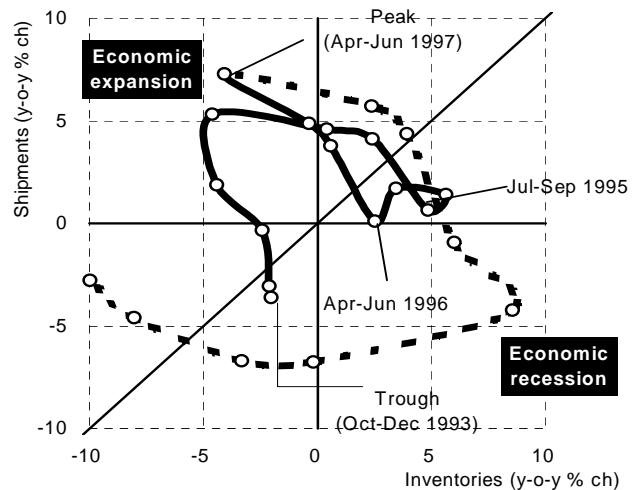
In view of the foregoing examples, although the economy normally slides into an inventory adjustment in 20~30 months, the expansion phase may double in length if the adjustment turns out to be mild.

[Chart 12: The fourth cycle (2Q1958~4Q1961: Iwato Boom)



Source: Ministry of Economy, Trade and Industry.

[Chart 13: The 12th cycle (4Q1993~2Q1997)



Source: Ministry of Economy, Trade and Industry.

The economic slowdown stems from the adjustment in the IT sector and high crude oil prices

If this hypothesis applies to the current situation, the fate of the economy would depend upon whether or not the current economic slowdown turns out to be mild. For a careful assessment of this question, it would be necessary to reach into the background of the current economic slowdown. Among other factors, the current slowdown stems from: (1) the ebb of the temporary rise of output in anticipation of Olympics-related demand such as demand for consumer electronic appliances, (2) restraints upon personal consumption and production activity due to natural disasters such as the successive typhoons, (3) the adjustment of output because of the accumulation of inventories in certain IT and digital sectors, (4) the rise of concerns regarding the negative impact of soaring crude oil prices, (5) the ebb of exports due to the US economic slowdown, (6) the ongoing fall of public investment, and (7) the pause in capital investment among manufacturers.

The risks of a loss of momentum are small, judging from the short and limited nature of the underlying causes

All the underlying causes of Japan's economic slowdown listed above are short and limited in nature.

As for (3), the inventory adjustment in the IT and digital sector, inventory levels are declining steadily and nearing the end. The surge of crude oil prices set forth under (4) would have a negative impact in the form of the overseas outflow of income accompanying the rise of crude oil import costs

and the fall of real income through the rise of prices. However, the negative impact of the overseas outflow of income is small in macroeconomic terms since crude oil import costs have only risen by approximately 0.1% of GDP (in annualized terms) from the beginning of the year (Chart 14). Thus, barring a further rise of crude oil prices, the impact would be limited. As for the rise of prices, the contribution to the overall rise of consumer prices stemming from the rise of crude oil is approximately 0.26%. This, however, is offset by price falls of durable consumer goods and is not leading to the rise of overall prices. The impact of the rise of inflationary pressures is also benign.

Turning to exports (5), Japan should avert a sharp decline of its domestic economy, judging from prospects that the US economy will continue to expand at its potential rate of growth. The decline of public investment (6) should also bottom out given the pickup of leading indicators. As for capital investment in the manufacturing sector (7), a dramatic rise thus far is unlikely. The rise of capital investment among nonmanufacturers would be indispensable for overall capital investment to gather fresh momentum. However, since the *Financial Statements Statistics of Corporations by Industry* indicates the steady improvement of corporate business performance, we may look forward to the rise of capital investment in the nonmanufacturing sector as long as the recovery of personal consumption continues.

[Chart 14: The outflow of income due to the rise of crude oil]

	Crude oil price Yearly average (Yen/Kl)	Import volume Annualized (Thousand Kl)	Cost rise Annualized (100 mil yen)	Percentage of GDP
1973	5,611			
1974	19,749	278,391	39,359	+ 2.9%
1979	26,120			
1980	47,188	254,448	53,607	+ 2.2%
1985	42,433			
1986	17,696	188,839	-46,713	0
1999	12,139			
2000	19,233	249,813	17,722	+ 0.3%
2003	21,338			
Jan-Sep 2004	23,957	241,043	6,312	+ 0.1%

Note: The percentage of GDP for 1974 is based upon 68SNA.

All data on 2004 are based upon 2003 actual GDP.

Sources: Japan Tariff Association, Cabinet Office, *National Income Statistics*.

**A virtuous cycle
triggered by the upturn
of business
performance is making
the economy more
resistant to shocks**

The recovery of corporate business performance is the major reason which is keeping the economy in expansion mode and avoiding a slide into recession in the presence of numerous downside factors – albeit short and limited in nature. The corporate upturn is leading to the improvement of household income, and triggering a virtuous cycle where the demand thus created is serving as a further driver of corporate business performance. The virtuous cycle in the domestic private sector is making the economy more resistant to temporary external shocks and contributing to the stable expansion of the economy.

Corporate earnings and financial conditions have been improving due to the positive effect of restructuring efforts. Current profits (all-industries basis) in the *Financial Statements Statistics of Corporations by Industry* have reached an all-time high subsequent to the rise of profits for seven consecutive quarters. Furthermore, in contrast to the early stages of the upturn of corporate profits in the second half of 2002, when the reduction of labor costs and variable costs amid the fall of sales – in other words restructuring – provided the main source of profits, the driver of profits is shifting from restructuring to sales because of the steady rise of earnings along with the recovery of the economy. The labor share is also declining, indicating a rapid abatement of corporate sentiment on a labor overhang (Chart 18). In the Bank of Japan's (BOJ) *Short-Term Economic Survey of Enterprises in Japan (Tankan)* in September, the employment conditions of enterprises of all sizes and sectors declined to +2. The December forecast stood at –1, indicating a shortage of labor for the first time since 1992. The environment is clearly ready for the fruits of recovery to spread from the corporate to household sector.

Early steps to avoid risks preclude a major adjustment

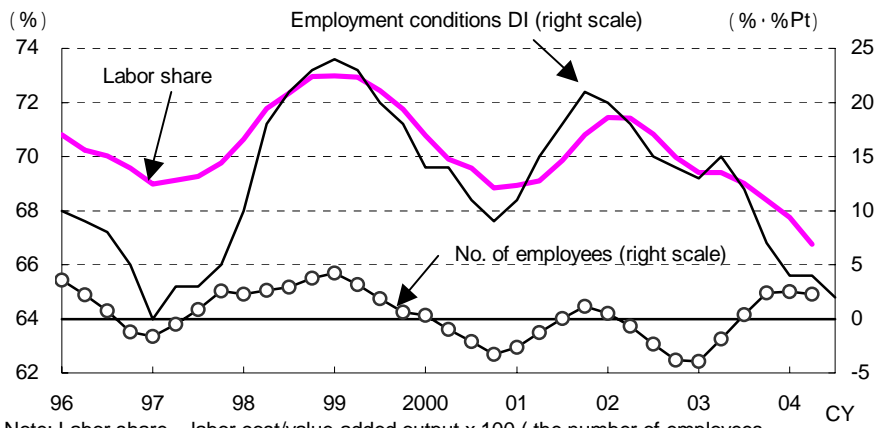
The decidedly fast response to risks is another characteristic of the risk averse behavior observed during the current economic cycle. A symbolic example is the inventory level among manufacturers. The inventory index in the *Indices of Industrial Production* has mostly remained in negative territory with the exception of September when the index turned positive year-on-year due to a temporary rise of automobile inventories (refer to Chart 10). The corporate stance to curb the rise of inventories through early production adjustment – a phenomenon in the IT and digital sector which was cited as one of the causes of the recent economic slowdown – is also intensifying throughout the manufacturing sector.

As indicated by the sharp slowdown of capital investment planned in the second half of FY2004, the cautious stance to avoid excessive capital investment is also evident in the manufacturing sector. These tendencies may lower the possibility of a major adjustment by reducing the breadth of economic swings.

The current pickup may develop into the first full-fledged recovery since the collapse of the asset bubble

As long as the budding signs of the virtuous recovery cycle are not stemmed, the current pickup may develop into the second recovery cycle driven by the twin engine of consumer spending and nonmanufacturers subsequent to the first recovery cycle driven mainly by the manufacturing sector.

[Chart 15: The employment conditions DI and labor share]



Note: Labor share = labor cost/value-added output x 100 (the number of employees is based upon an all-industries and all sizes basis and are 4Qtr moving averages.

Sources: Ministry of Finance, *Financial Statements Statistics of Corporations by Industry*, Bank of Japan, *Short-Term Economic Survey of Enterprises in Japan (Tankan)*.

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

Japan's real GDP growth will reach 2.9% (1.0% in nominal terms) in FY2004, marking the second consecutive year of strong growth

The Japanese economy will remain sluggish in the second half of FY2004 due to lingering inventory adjustment pressures upon IT-related goods and the ebb of capital investment in the manufacturing sector. Even so, the economy should remain in recovery mode given the gradual pickup of exports on the back of the ongoing economic expansion in the US and China and prospects that public investment will stop falling because of the increase of reconstruction works to repair the damages done by successive natural disasters. Despite downward pressures upon personal consumption due to the erosion of demand spurred by the summer heat wave and Olympic games, the sustained recovery of the income environment – for example, the prospects of a rise of winter bonus payments from the year before – leads to expectations that consumer spending will remain strong.

Although the rate of real GDP growth will slow down to 0.7% over the previous term (translated into an annual rate of 1.5%) in the second half of FY2004 from 1.1% (2.2% p.a.) in the previous half-year term, the economy should continue to cruise around its potential rate of growth. Thus, Japan's GDP will grow a strong 2.9% (our previous forecast was 3.5%) in real terms and 1.0% (previous forecast: 1.6%) in nominal terms due in part to a substantial carry-over of 2.1% from FY2003.

The economy will gradually gather momentum in the first half of FY2005

In FY2005, the sustained recovery of labor market conditions reflecting the ongoing upturn of corporate profits should lead to a gradual recovery of personal consumption matching the rise of income. The sustained growth of personal consumption should lend support to capital investment, which will avoid a loss of momentum, with the main engine shifting from the manufacturing to the nonmanufacturing sector. Exports, albeit less than spectacular, will keep growing and serve to prop up the economy.

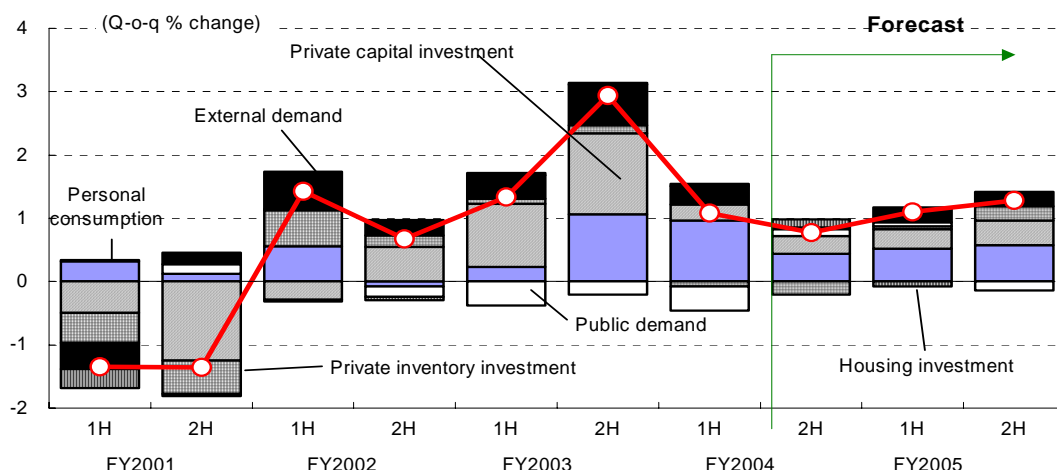
The Japanese economy will move closer to a self-sustained recovery in the second half of FY2005

The rate of Japan's economic growth should rise further in the second half of FY2005, as the corporate sector emerges out of adjustment. In addition to forecasts that the sustained rise of personal consumption will push up business performance and capital investment among nonmanufacturers, the rise of expectations toward the end of deflation will generate forward-looking inventory investment.

FY2005 GDP will grow 2.1% in real terms and 1.4% in nominal terms

In the first half of FY2005, Japan's real GDP is forecast to grow 1.1% from the previous half-year term (2.2% p.a.). In the second half of the fiscal year, Japan's real GDP growth should reach 1.3% from the previous half-year term (2.6% p.a.), bringing full-year real GDP growth to 2.1% (previous forecast: 2.1%) in real terms and 1.4% (previous forecast: 1.4%) in nominal terms.

[Chart 16: Forecast on real GDP growth]



Note: Forecast by MHRI from second half of FY2004.

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

[Chart 17: Forecast on the Japanese economy]

(%)

	FY2003 (Actual)	FY2004 (Forecast)	FY2005 (Forecast)	FY2004		FY2005		FY2004 (Contribution) (Forecast)	FY2005 (Contribution) (Forecast)
				1H (Actual)	2H (Forecast)	1H (Forecast)	2H (Forecast)		
GDP (real)	3.2	2.9	2.1	1.1	0.8	1.1	1.3	-	-
Domestic demand	2.5	2.3	1.8	0.8	0.8	0.9	1.1	2.3	1.7
Private sector demand	4.0	3.6	2.3	1.6	0.8	1.1	1.6	2.7	1.7
Personal consumption	1.4	3.1	1.9	1.8	0.8	1.0	1.1	1.7	1.0
Housing investment	0.3	3.2	-0.4	1.0	3.6	-2.3	0.2	0.1	-0.0
Capital investment	12.3	5.9	3.7	1.5	1.6	1.7	2.2	1.0	0.6
Public sector demand	-2.6	-2.0	0.1	-1.8	0.5	0.3	-0.7	-0.4	0.0
Government consumption	1.0	1.8	2.0	0.9	0.7	1.0	1.2	0.3	0.3
Public investment	-12.5	-13.9	-7.1	-11.1	-0.1	-2.6	-8.0	-0.7	-0.3
Net exports (contribution)	0.8	0.6	0.4	0.3	0.0	0.2	0.2	0.6	0.4
Exports	11.0	12.1	6.2	6.0	2.4	3.0	3.9	1.5	0.8
Imports	4.9	9.8	4.9	5.2	3.1	1.7	3.2	-0.9	-0.5
GDP (nominal)	0.8	1.0	1.4	0.1	0.4	0.8	0.9		
Industrial production	3.5	4.8	2.5	2.5	0.3	1.4	1.8		
Unemployment rate	5.1	4.5	3.9	4.7	4.3	4.1	3.8		
Current account balance (trillion yen)	17.3	18.0	19.7	18.7	17.7	19.4	20.5		
as a percentage of nominal GDP	3.4	3.5	3.8	3.7	3.5	3.8	4.0		
Corporate goods prices	-0.5	1.5	0.0	1.4	1.7	0.3	-0.2		
Consumer prices	-0.2	-0.2	-0.1	-0.2	-0.3	-0.1	0.0		
Long-term interest rate (%)	1.12	1.60	1.90	1.60	1.60	1.80	2.00		
Nikkei stock average (yen)	9,938	11,413	12,600	11,326	11,500	12,400	12,800		
Exchange rate (yen/dollar)	113.0	108	111	109.7	107	110	111		
Crude oil price (WTI \$/barrel)	31.4	45.3	42.8	41.1	49.5	44.0	41.5		

Notes: 1. FY = rate of change from the previous year. Half-year = rate of change from the previous term (excluding the unemployment rate, current account balance and prices).

2. Half-year corporate goods prices and half-year consumer prices = rate of change over 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 converted into annualized rates.

4. Crude oil price = near-term contract for WTI crude futures. The long-term interest rate = newly-issued 10-yr government bonds.

Sources: Cabinet Office, *Annual Report on National Accounts*,

Ministry of Economy, Trade and Industry, *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 prices remain the greatest risk to the economy

Meanwhile, the risks remain that external shocks may dampen the sustainable recovery of the Japanese economy. As noted earlier, while the direct impact stemming from the rise of crude oil prices is mild, it may not be overlooked when taking into consideration the indirect effect. Given the likelihood of mild, albeit persisting, adjustment pressures, a further rise of crude oil prices and thus a major shock upon demand would serve to magnify the adjustment pressures and increase the risks of pushing the Japanese economy into recession.

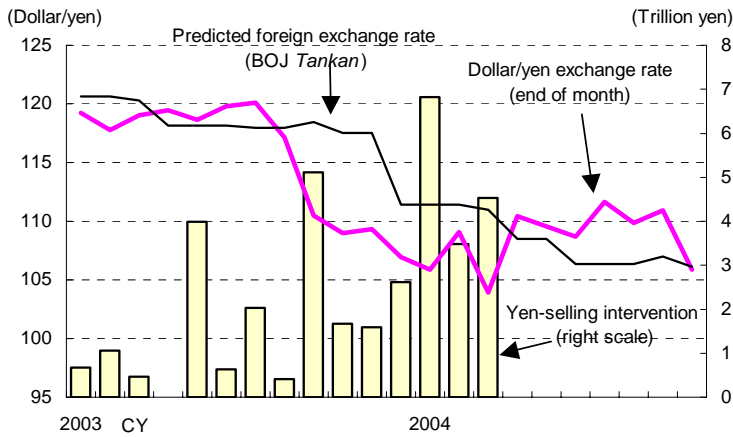
The risks of the appreciation of the yen

Furthermore, the recent decline of the dollar is also a source of concern. Although the dollar was trading at a stable rate around 110 yen to the dollar since the spring season, the sharp appreciation of the yen since early October the dollar/yen rate has driven down the dollar to around 105 yen as of the end of October to early November (Chart 18).

In the BOJ's *Tankan* survey in September, the average of predicted exchange rates expected by manufacturing enterprises in the second half of FY2004 is 106.2 yen/dollar. A further appreciation of the yen would serve as negative pressures upon the business performance of export-oriented enterprises and depress the level of production activity along with the decline of export volume. Although the rise of the yen has the merit of mitigating the yen-based impact of soaring crude oil prices, the negative impact of the strong yen surpasses the merits from an overall perspective. According to the Mizuho Macroeconomic Model, a further appreciation of the yen to 100 yen/dollar would depress the rate of FY2005 GDP growth by 0.2% pt. Likewise, the appreciation of the yen to 90 yen/dollar would send the rate of FY2005 GDP growth 0.6% pt lower (Chart 19).

Even though the appreciation of the yen led to a sharp gap between the actual yen/dollar exchange rate and the expected exchange rate among corporations on several occasions in the second half of 2003, it only had a limited impact upon the economy due in part to the government's massive yen-selling intervention in the currency market to stem the further appreciation of the yen. Nevertheless, in view of criticisms toward the massive currency market intervention last year totaling 33 trillion yen, it remains uncertain whether flexible yen-selling intervention measures are forthcoming. Since the main driver of Japan's nascent economic recovery has not yet shifted from exports to domestic demand, the economy may lose steam in the event of an excessive appreciation of the yen before personal consumption and capital investment in the nonmanufacturing sector gathers momentum.

[Chart 18: The expected Dollar/Yen exchange rate and the amount of currency intervention]



Source: Bank of Japan, *Tankan*, Ministry of Finance.

[Chart 19: The impact of the appreciation of the yen upon the Japanese economy]

	Upper line: GDP growth rate (%) Lower line: deviation from main scenario (% pt)	
	FY2004	FY2005
Main scenario	2.9	2.1
10-yen appreciation (110 yen → 100 yen)	2.8	1.9
20-yen appreciation (110 yen → 90 yen)	2.7	1.6

Note: The case of a 10-yen appreciation is based upon the assumption that \$1=100 yen from the Oct-Dec quarter of 2004. The case of a 20-yen appreciation is based upon the assumption that the yen strengthens to \$1=90 yen in the Jan-Mar quarter of 2005. Both based upon the Mizuho Macroeconomic Model.

Although fiscal rehabilitation is inevitable, it may have a damaging impact upon the economy depending upon its timing and method

Although the burdens are smaller than in 1997, its impact upon consumer confidence may not be overlooked

The government's fiscal rehabilitation steps may have a damaging effect upon the economy depending upon the scope and timing of the measures.

Japan's fiscal conditions are in dire straits. Government debt - such as government bonds - has already surpassed nominal GDP. Once Japan achieves its top priority issue of overcoming deflation, the remaining major task will be to restore its fiscal health.

Given the foregoing circumstances, the government has already started to take specific steps toward fiscal rehabilitation such as the partial abolishment of the spousal income tax deduction. Furthermore, the government is taking a more definite stance toward raising taxes upon individuals as shown by the commencement of discussions toward a gradual scale-down of the fixed-rate tax cuts (the so-called "permanent tax cuts") implemented in 1999 under extremely strong deflationary pressures. The household sector is also subject to heavier burdens such as the rise of medical costs shouldered by patients and the ongoing rise of premiums on the government pension plan and the employees pension insurance in a bid to cope with rising social security-related expenditures along with the aging population.

Looking back upon FY1997, the consumption tax hike, the abolishment of the special tax cuts, the rise of medical costs shouldered by patients, the rise of health insurance premiums and the sharp reduction of public investment resulted in a concentration of deflationary pressures totaling 10 trillion yen and served to push the economy into recession (Chart 20). This time around, as far as the two-year period from FY2005 to FY2006 is concerned, the rise of burdens stemming from taxes and the social security system turned out to be much smaller and the amount of public investment cuts was more or less unchanged in comparison to FY1997.

According to simulations using the Mizuho Macroeconomic Model, a

gradual scale-down of the fixed-rate tax cuts during a two-year period from 2006 would drag down the rate of real GDP by 0.24% pt in FY2006 and 0.35% pt in FY1997 (Chart 21). If the fixed-rate tax cut is completely abolished by the end of 2005, the rate of real GDP growth would be pushed down 0.41% pt in FY2006 and 0.28% pt in FY2007. Furthermore, if public investment continues to decline from FY2006 onward, this would depress the rate of real GDP growth another 0.2~0.3% pt.

However, note that the portion of medical costs shouldered by patients and health insurance premiums have already been raised in FY2003 and that the government is considering a consumption tax hike in FY2007. The combined burden of the foregoing would be roughly equivalent to the burden in 1997. In comparison to 1997, when the burdens were concentrated in a short time span of approximately 18 months, the impact upon the economy would be milder today given the gradual rise of burdens. Nevertheless, since labor compensation is rising at a rate below 1% (compared to 3% in 1997), the burden may have a far larger impact today. In the absence of a stronger pass-through mechanism distributing corporate sector income to the personal sector through wages and employment, the burdens may serve a serious blow upon the personal sector. The government must take care in its method and timing of implementation so that the intermittent rise of burdens does not dampen household sentiment and hamper the sustained expansion of personal consumption toward the autonomous recovery of the economy.

[Chart 20: Deflationary pressures stemming from policy measures]

(Trillion yen)

	FY1997	1998	Total	2005	2006	Total
Rise of burdens due to tax reform	5.87		5.87	0.44	1.65	2.08
Abolition of tax cuts	2.00		2.00	0.31	1.62	1.93
Partial abolition of spousal tax deduction				0.13	0.03	0.15
Consumption tax hike	3.87		3.87			
Rise of burdens due to changes in social security system	0.74	0.74	1.47	0.30	0.29	0.59
Rise of medical costs shouldered by patients	0.49	0.49	0.99			
Health insurance premium hike	0.24	0.24	0.49			
Employee pension premium hike				0.26	0.25	0.51
National pension premium hike				0.04	0.04	0.08
Reduction of public investment	2.58	0.14	2.72	1.63	1.04	2.67
Total deflationary pressures due to fiscal policy	9.18	0.88	10.06	2.37	2.97	5.34

- Notes: 1. Based upon the assumption that the fixed-rate tax cuts will be scaled down in a two-year period from 2006.
 2. The rise of burdens due to the rise of medical costs shouldered by patients and the rise of health insurance premiums is based upon estimations by the Ministry of Health, Labor and Welfare.
 3. The rise of burdens accompanying the rise of premiums for employee pensions and national pensions from FY2005 onward are based upon estimations by the MHRI.
 4. The reduction of public investment is based upon data regarding FY1997~FY1998. FY2005 figures are MHRI forecasts. Figures regarding FY2006 is based upon the assumption of a 5% y-o-y reduction.

[Chart 21: The impact of the abolition of fixed-rate tax cuts]

	Decline of % change (% pt)		
	FY2005	FY2006	FY2007
Gradual scale-down from 2006			
Disposable income (nominal)	-0.11	-0.65	-0.89
Personal consumption (real)	-0.15	-0.35	-0.43
GDP (real)	-0.03	-0.24	-0.35
Abolition by end of 2005			
Disposable income (nominal)	-0.25	-1.08	-0.68
Personal consumption (real)	-0.13	-0.57	-0.26
GDP (real)	-0.07	-0.41	-0.28

- Notes: 1. Estimates by MHRI.
 2. "Gradual scale-down" refers to a 50% reduction from 2006 and abolition by the end of 2006.

The percentage rise of the CPI will turn positive toward the end of FY2005

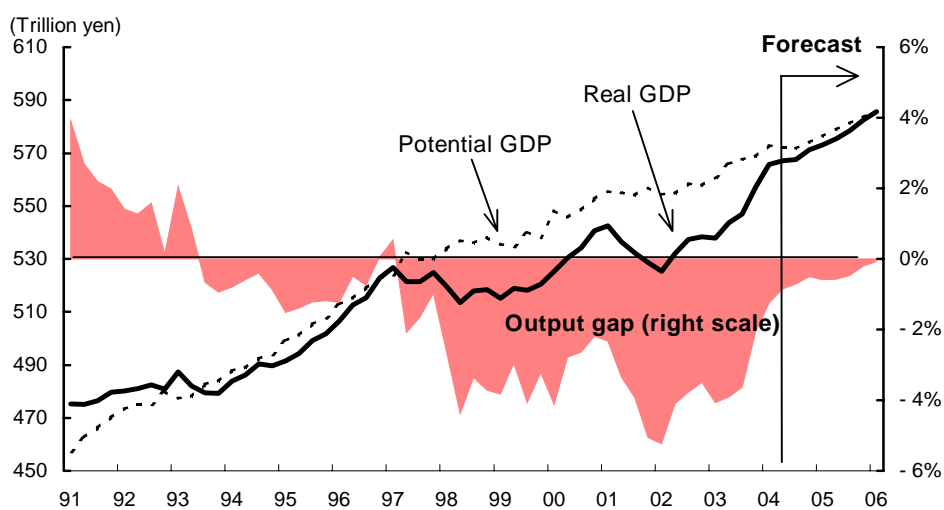
More time is necessary in order to lift the quantitative easing policy

If the Japanese economy can avoid these risks and remain on a recovery driven mainly by domestic private demand from the second half FY2004, the rate of economic growth will rise again in the second half of FY2005 and approach the end of deflation. The output gap has already narrowed considerably given the rapid economic recovery since the end of 2003 (Chart 22). Given the prospects that the economy will continue to grow at its potential rate of growth which is estimated to be around 1.5%, a further contraction of the output gap is unlikely for the time being. However, once the economic recovery grows stronger, it will only be a matter of time until the output gap is dissolved. Furthermore, in view of the gradual alleviation of the downward pressures upon wages, the year-on-year change of the consumer price index (CPI) should turn positive toward the end of FY2005.

However, Japan will need more time until “the consumer price index registers stable a zero percent or an increase year on year”, one of the preconditions necessary for the BOJ to lift the quantitative easing policy. This is because a sharp positive upturn of the output gap is unlikely because of a combination of lackluster demand and the rise of supply capacity reflecting the ongoing rise of capital investment. Japan will only be liberated from a negative spiral in which price falls lead to the contraction of economic activity – namely a genuine emergence out of deflation – sometime in or after FY2006.

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

[Chart 22: The output gap]



Note: Estimates by MHRI.

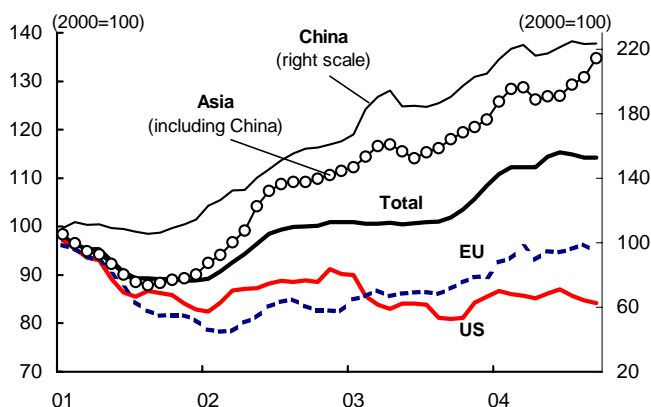
Sources: Cabinet Office, Ministry of Economy, Trade and Industry, Ministry of Public Management, Home Affairs, Posts and Telecommunications, and others.

3. External demand

A more definite loss of export momentum

Although real exports (SNA-based) remained on an upward track, growing 0.4% q-o-q in the Jul-Sep quarter of 2004, the rate of growth fell from the Apr-Jun quarter, resulting in a more definite loss of momentum from the peak in the Oct-Dec quarter of 2003. As shown by the export volume index by geographic destinations, despite the strong rebound of Asia-bound exports (6.1% q-o-q) from the soft patch in the Apr-Jun quarter due to the rise of exports of electronic components for digital consumer electronic appliances and semiconductor manufacturing devices, exports to the US comprised mainly of consumer goods such as audiovisual equipment and automobile parts fell 3.3% q-o-q, dragging down overall export growth to -0.9% q-o-q (seasonal adjustments by MHRI). The 6-month rate of change of the OECD Composite Leading Indicators (CLI), having a close correlation with the export volume index, has been slowing since the peak in early 2004, indicating that the global economic slowdown mainly in the US is the main reason for the slowdown of exports.

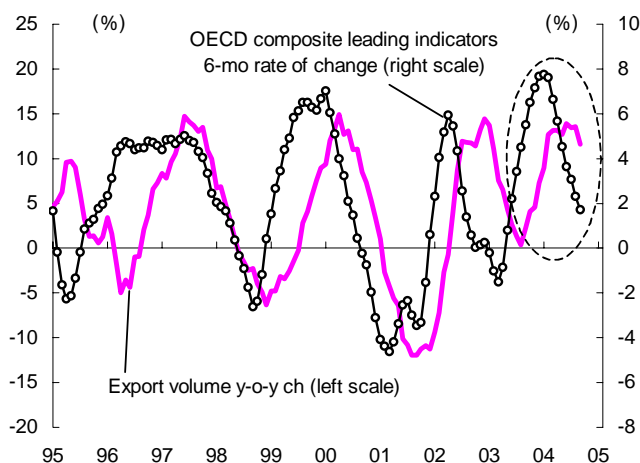
[Chart 23: Volume of exports]



Notes: 1. 3mma, s.a.
2. EU 25 nation basis.

Source: Ministry of Finance, *The Summary Report on Trade of Japan*.

[Chart 24: The OECD CLI and export volume]



Note: Export volume (3MMA), OECD composite leading indicators (annualized).

Sources: Ministry of Finance, OECD.

Since the Chinese government's tightening measures will only have limited effect, Japan will avoid a sharp fall of overall exports

Although the current deceleration of export growth was widely anticipated from our forecast on the US economy, the impact of China's economic tightening measures is a risk factor in the forecast of Japan's exports. Despite the ongoing rise of China-bound exports, a breakdown in terms of export items reveals a slight slowdown of materials such as chemicals and iron & steel, automobile-related goods and general machinery, indicating that the impact of the tightening measures are starting to emerge (Chart 25). However, in addition to the fact that China is still a major production site for electric machinery and precision instruments, forecasts that China's tightening measures will only have a mild impact in terms of the slowdown of fixed asset

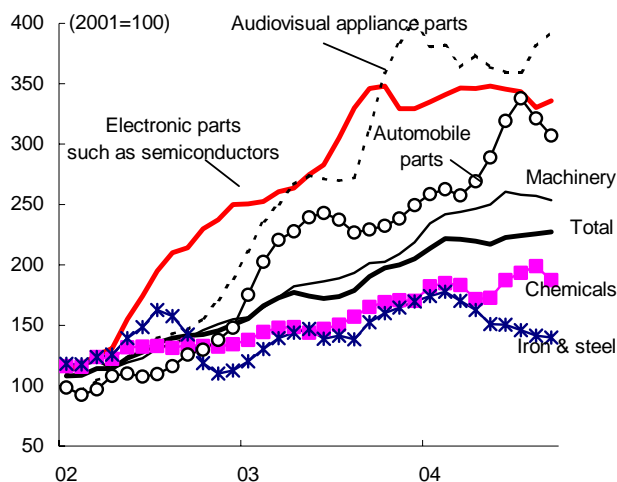
Exports will lack momentum from the second half of FY2004 to the first half of FY2005

investment and automobile demand leads to our view that Japan's exports should avoid a sharp loss of momentum due to the slowdown of the Chinese economy.

Looking forward, we are inclined to believe that exports will lack momentum for the time being because of the ebb of demand for IT-related goods along with the peak-out of the silicon cycle and the lingering effect of the US and Chinese economic slowdown. Leading indicators and overseas economic forecasts provide us with reasons to believe that the year-on-year rate of growth of the export volume will remain at a low level until around mid-2005. From then onward, the rate of export growth should pick up along with the rise of the US economy.

Judging from the foregoing, Japan's real exports (SNA-based) should slow in FY2004 (1H FY2004: 6.2% over the previous term → 2H FY2004: 2.5% over the previous term). In FY2005, export growth should gradually pick up from the summer season as manufacturers of IT-related goods emerge out of an inventory adjustment cycle (1H FY2005: 2.9% over the previous term → 2H FY2005: 3.8% over the previous term).

[Chart 25: Exports to China (in real terms)]



Sources: Ministry of Finance, *The Summary Report on Trade of Japan*, Bank of Japan, *Corporate Goods Price Index*.

[Chart 26: Imports of goods and services (in real terms)]



Sources: Cabinet Office, Ministry of Finance.

Imports will also start to slow down

In comparison to the Apr-Jun quarter, imports in real terms (SNA-based) rose 2.7% q-o-q in the Jul-Sep quarter of 2004. In addition to the ongoing rise of services imports stemming from the increase of persons traveling overseas reflecting the Athens Olympic Games and the surge of demand and interest in Korean pop culture, firm domestic demand led to the growth of imports comprised mainly of crude oil and IT-related goods. From the second half of FY2004 onward, the pace of import growth should gradually ebb due to the slowdown of exports and the slower – albeit firm – growth of domestic

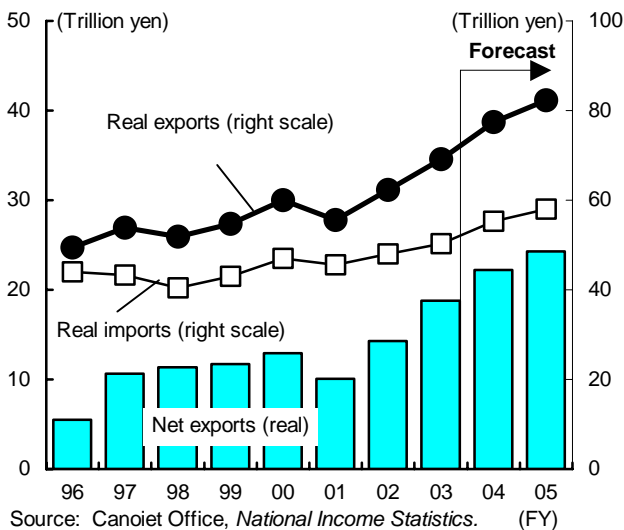
The current account surplus will continue to expand

demand. Real imports (SNA-based) should slow from 9.5% y-o-y in FY2004 to 5.0% y-o-y in FY2005.

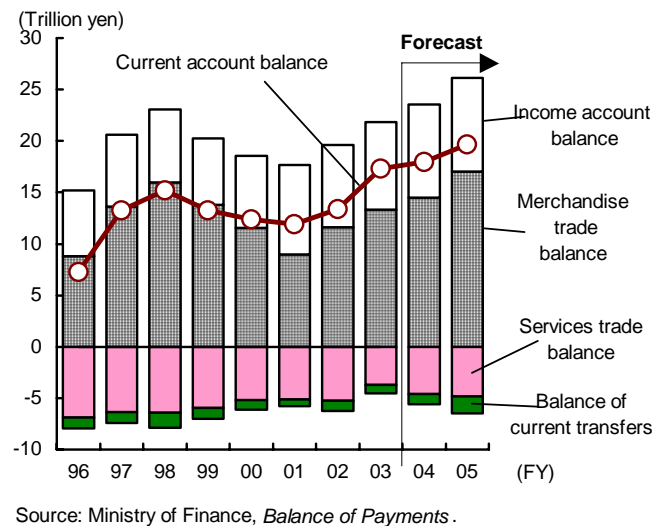
Furthermore, since the slowdown of exports will outpace imports, the contribution by net exports in real terms to Japan's real GDP growth will decline from 0.6% pt in FY2004 to 0.4% pt in FY2005.

Despite forecasts that both export and import growth will slow down, the impact of the deceleration of imports, on a nominal basis, should surpass that of exports, resulting in the expansion of the trade surplus. The expansion of the services trade balance should slow down, as the rebound of overseas travel runs its course and the technology trade balance expands. The foregoing provides us with reasons to believe that the current account surplus will expand from 18.0 trillion yen (3.5% of nominal GDP) in FY2004 to 19.7 trillion yen (3.8% of nominal GDP) in FY2005.

[Chart 27: Forecast on exports and imports]



[Chart 28: Forecast on the current account balance]



4. The corporate sector

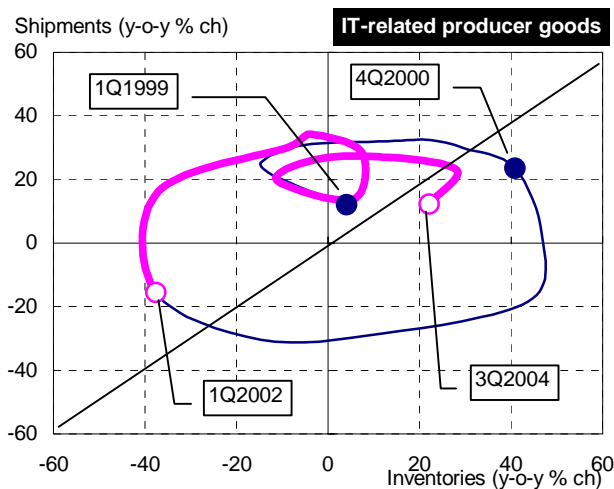
The industrial production index drops for the first time in five quarters

Output adjustment in IT and digital electronics sector should run its course during FY2004

Despite the rapid rise of the industrial production index since mid-2003 reflecting the increase of exports, the rise of demand for IT and digital electronic appliances and the growth of capital investment, there are signs of a loss of momentum. The industrial production index fell 0.7% q-o-q in the Jul-Sep quarter of 2004, recording a downturn for the first time in five quarters. The slowdown is attributed mainly to the adjustment of output accompanying the accumulation of inventories in the IT and digital electronics sector. Although demand for IT and digital electronic appliances is continuing to grow, the demand falls short of the overly optimistic supply-side projections, resulting in the adjustment of output. Nevertheless, in view of the fact that the inventory buildup is limited in comparison to the buildup during the IT bubble of 2000 and that companies have taken steps to adjust output at a very early stage, the production adjustment in the IT and digital electronics sector should remain benign and run its course during FY2004 (Chart 29).

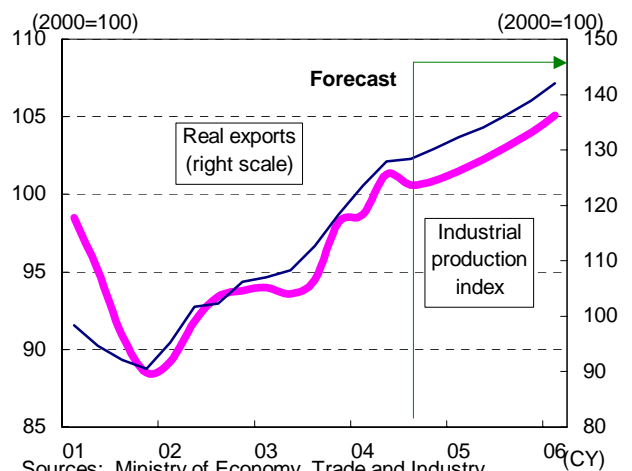
Meanwhile, the pace of inventory buildup remains slow elsewhere in the industrial sector. Although the inventory rate index rose for two quarters in a row (Apr-Jun quarter: 1.5% q-o-q, Jul-Sep quarter: 2.0% q-o-q), this can be explained for the most part by the trends in specific sectors such as the electronic parts & devices industry in the Apr-Jun quarter and the transportation equipment industry in the Jul-Sep quarter. Signs of an inventory overhang are not yet evident in the manufacturing sector as a whole. Furthermore, note that the rise of the inventory rate in the transportation equipment sector in the Jul-Sep quarter is due to the launch of new models and the lead time before shipment and thus should be eliminated in a short while.

[Chart 29: The inventory cycle of IT-related producer goods]



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

[Chart 30: The industrial production index and exports]



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

The industrial production index will pick up in the second half of FY2005

Ongoing signs of a mild recovery in the nonmanufacturing sector

Earnings and profits among nonmanufacturers are starting to rise

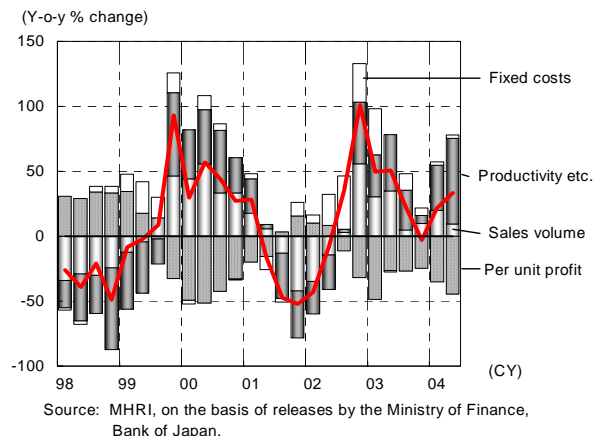
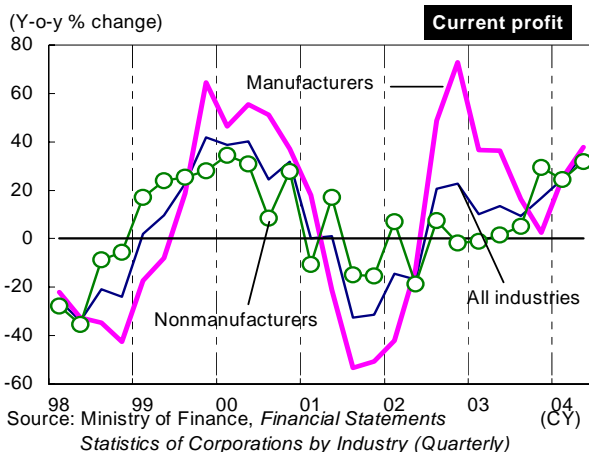
The industrial production index will most likely lose momentum from the second half of FY2004 to the first half of FY2005 along with the adjustment of output in the IT and digital electronics sector and the slowdown of exports. However, prospects of an upturn of exports reflecting the mild recovery of the overseas economies and the slow but steady rise of domestic demand lead to our view that the industrial production index will regain momentum from around mid-2005. Judging from the foregoing, we believe that the industrial production index will rise sharply, reaching 4.8% y-o-y in FY2004 and subsequently slow down to 2.5% y-o-y in FY2005 (Chart 30).

Despite the lack of spectacular activity, nonmanufacturing sector activity is continuing to grow at a moderate pace. Wholesalers and cargo distributors are enjoying brisk business amid the pickup of corporate business activity and cargo movement while the services sector serving corporate clients such as information service providers are benefiting from the move toward outsourcing in line with the trend to streamline back-office sections. In addition to the strong growth of business among service providers serving clients in the household sector amid the rising proportion of services in overall consumption, medical and nursing care services are growing steadily reflecting Japan's aging population. Furthermore, public investment is bottoming out, leading to a long overdue improvement of confidence in the construction sector.

Corporate business performance is continuing to improve. According to the *Financial Statements Statistics of Corporations by Industry*, corporate earnings rose for five consecutive quarters while corporate profits on a current profit-basis rose for seven quarters in a row as of the Apr-Jun quarter of 2004. Although the rise of profits was driven initially by manufacturers which benefited from the upturn of exports in the early stages of economic recovery, earnings and profits among nonmanufacturers have also started to rise from around mid-2003 along with the spread of the economic recovery.

[Chart 31: Current profits]

[Chart 32: Current profits of large manufacturers]



Since corporate earnings are considerably stronger, the rise of crude oil prices is not a fatal blow

The upturn of corporate business performance will come to a pause in FY2005

A factorial breakdown of large manufacturing enterprises' current profits reveals that in contrast to the period up to mid-2003 when the main factor in the background to the rise of profits was fixed costs, the major factor today is the rise of productivity. The forgoing indicates that companies have not only improved their financial conditions using their abundant cash flow but have also upgraded the efficiency of their production sites. At the moment, the rise of crude oil prices is a source of concern as a downside risk for corporate earnings. However, the current level of crude oil prices would not serve as a fatal blow to corporate earnings because companies are considerably more resistant to external shocks as a result of the rise of productivity (Chart 34).

The upturn of corporate business performance should come to a pause in FY2005 due to prospects that the rise of earnings and profits will slow down along with the deceleration of domestic and overseas economic growth. Nevertheless, we still believe that profits will remain on an upward path given the rise of earning capacity. Among manufacturers, companies in the materials industry should retain high earnings given the rise of pricing power. In contrast, companies in the processing industry may suffer a drop of earnings due to the slowdown of exports, the ongoing fall of product prices and the appreciation of the yen. Meanwhile, earnings among nonmanufacturers should continue to rise, albeit at a slow pace, reflecting the mild improvement of consumer spending.

[Chart 33: Corporate earnings forecast]

(Y-o-y % change)

		FY2003	FY2004 Forecast	FY2005 Forecast
All industries	Sales	2.5	2.4	0.6
	Current profits	16.9	14.8	3.7
Manufacturers	Sales	3.1	2.3	0.5
	Current profits	18.4	15.8	3.4
Nonmanufacturers	Sales	2.3	2.5	0.6
	Current profits	15.9	14.1	3.9
Large enterprises	Sales	0.8	1.7	0.5
	Current profits	13.8	12.4	3.2
Small and medium enterprises	Sales	3.8	2.9	0.7
	Current profits	20.5	17.3	4.3

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

[Chart 34: The impact of high crude oil prices upon current profits]

	Profit fall stemming from rise of crude oil price	Covered by increase of earnings	Covered by rise of profit ratio
10% rise of crude oil	-1.9%	1.9%	0.1%
40% rise of crude oil	-7.4%	8.0%	0.2%

Note: Estimations by MHRI on the assumption that (1) there is no change in demand, and (2) there are no cost transfers from the corporate sector to other sectors.

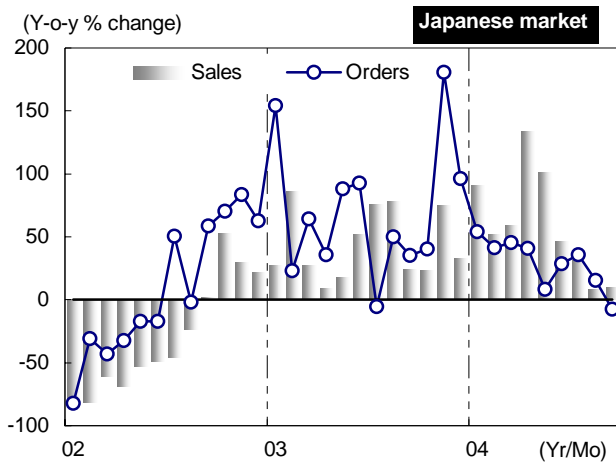
Source: Ministry of Economy, Trade and Industry, *Updated Nationwide Input-Output Tables*.

More definite signs of slower capital investment growth

Private-sector capital investment grew at a lower-than-expected 1.5% over the previous term in the first half of FY2004 as a result of a downgrade of capital investment growth to -0.2% q-o-q in the Jul-Sep quarter and 0.6 % q-o-q in the Apr-Jun quarter (1.2% prior to the downgrade). As exemplified by the downturn of orders for semiconductor manufacturing devices, the deceleration of investment to upgrade capacity in the IT and digital electronics sector –the driver of business fixed investment thus far – makes it unlikely that

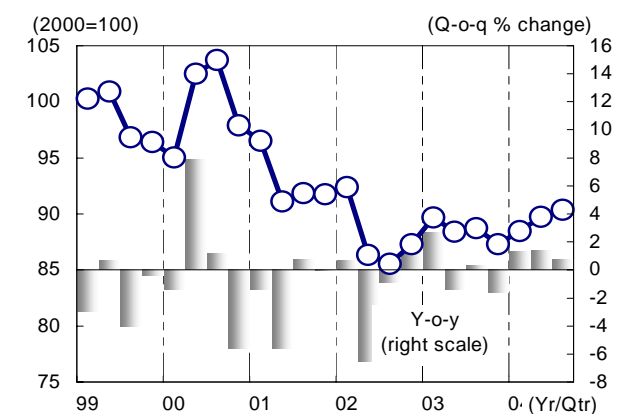
capital investment growth will pick up in the second half of the fiscal year.

[Chart 35: Orders and sales of semiconductor manufacturing devices]



Source: Semiconductor Equipment Association of Japan.

[Chart 36: Private-sector construction investment (in real terms)]



Notes: 1. Private construction investment = private non-residential construction + private civil engineering.

2. Latest quarter data = average of July and August.

Source: Ministry of Economy, Trade and Industry, *Index of Construction Activity*.

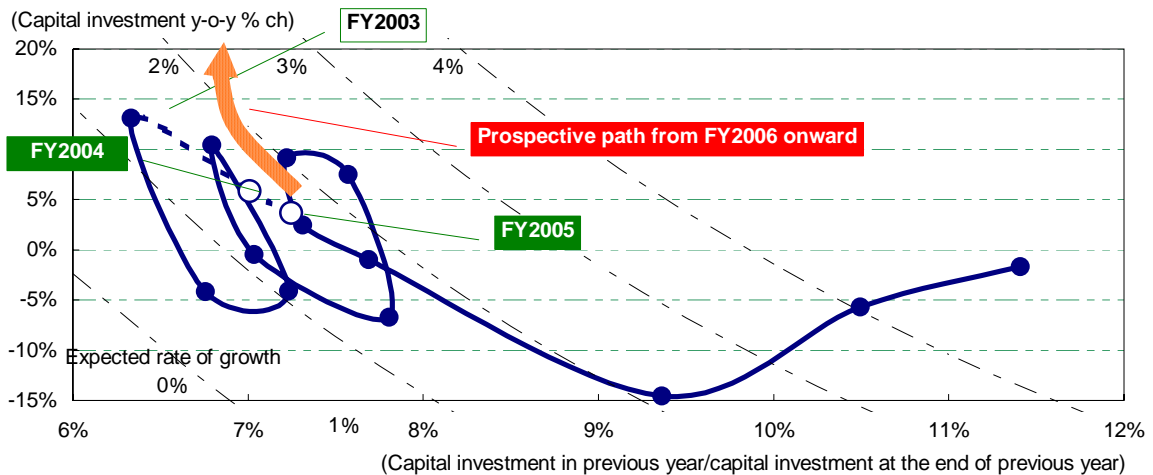
The expected rate of economic growth will gradually rise, driving capital investment once again into expansion mode in 2H of FY2005

Nevertheless, the following factors provide us with reasons to believe that a large-scale adjustment of capital investment may be avoided.

Firstly, the move to renew equipment in a bid to upgrade productivity and competitiveness is spreading from large enterprises to small enterprises. In addition to questionnaire surveys, the ongoing rise of machine tool orders underscore these trends. Secondly, it should be noted that there has been a dramatic improvement of financial conditions in the corporate sector, as symbolized by the abundance of cash flow. Since companies are almost through with eliminating their debt overhang, they are no longer hampered from new investments in terms of their financial conditions. Finally, there are signs that capital investment is picking up at last among nonmanufacturers which have thus far lagged in recovery. The maintenance of stable consumer spending growth will stimulate the expansion of business among nonmanufacturers and stimulate capital investment comprised mainly of construction investment, thus serving to underpin overall capital investment among private enterprises.

Despite a slowdown in the first half of FY2005, capital investment should pick up in the second half of the fiscal year reflecting the rise of the expected rate of economic growth (Chart 37). Thus, capital investment should continue to remain on an upward trajectory, growing 5.9% y-o-y in FY2004 and 3.7% y-o-y in FY2005.

[Chart 37: The capital stock cycle]



Note: MHRI estimates on the basis of a retirement rate of 4.0% and capital coefficient of 1.9%.
 Source: Cabinet Office, *Gross Capital Stock of Private Enterprises*.

5. The household sector

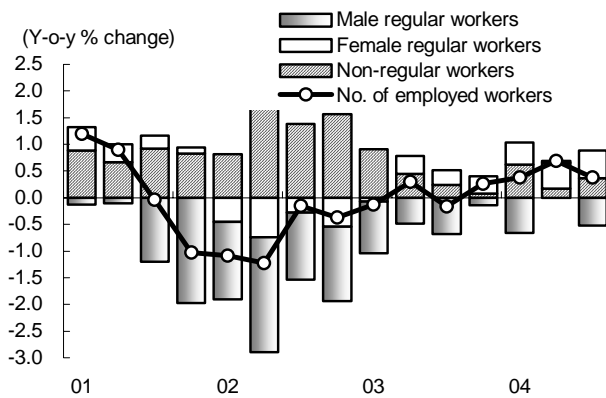
Mild improvement of employment conditions

Given the extension and spread of Japan's economic recovery, the fruits of recovery are finally reaching the doorsteps of the household sector. In terms of employment conditions, there are signs that persons who had given up the search of jobs are returning to the labor market along with the improvement of labor market conditions indicated by the drop of the unemployment rate below 5%. Companies no longer feel burdened by excess labor, leading to the need to hire new employees, thus resulting in the stable rise in number of employed workers. Although a breakdown reveals a conspicuous rise in number of non-regular employees, female regular workers are increasing on a year-on-year comparison, indicating a mild improvement of employment conditions (Chart 38).

Slow improvement of income

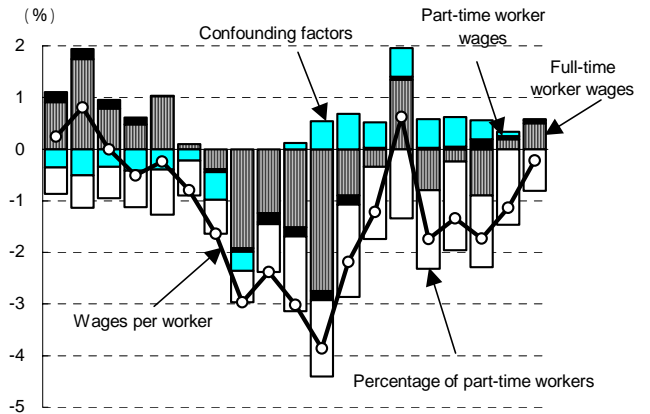
Meanwhile, the improvement of income has been rather slow. Although wages per worker are recovering, they are still under previous-year levels. Note however that wages of both full-time and part-timer workers are increasing on a year-on-year basis, showing that the rising percentage of low-wage part-time workers is pushing down overall wages per worker (Chart 39). The decline of wages per worker should be halted once the employment of full-time workers pick up and the rise of the percentage of part-time workers slows down.

[Chart 38: 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 39: Wages per worker]



Note: "Confounding factors" refer to factors which do not fall under any of the categories.
 Source: Ministry of Health, Labor and Welfare, *Monthly Labor Survey*.

Employment conditions should continue to improve

Looking forward, employment conditions should continue to improve slowly amid the sustained recovery of the economy. From a macroeconomic perspective, companies will continue to have strong needs to hire new workers as the labor overhang diminishes. In view of the limits to additional labor input through the extension of labor hours, we expect to see moves to increase labor input by hiring new workers. Given these trends, the number of employed workers should continue to follow an upward curve. As for the unemployment rate, there may be a temporary upturn due to the return of prospective job-seekers to the labor market. Nevertheless, the unemployment rate should follow a moderate decline to the upper half of the 3% level, reflecting the decline of the labor input stemming from the aging population and the increase in number of employed workers.

Labor compensation will increase on a year-on-year basis

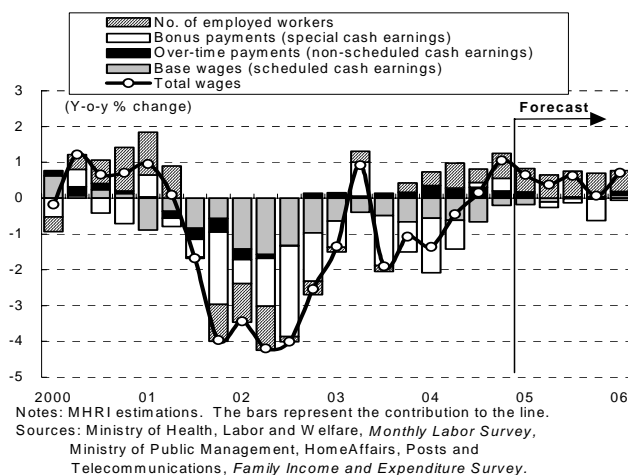
Wages per worker should remain below previous year levels throughout the forecast horizon. During FY2004, the ongoing increase of part-time workers should serve as downward pressures upon scheduled cash earnings (base wages) and special cash earnings (bonus payments). In FY2005, the slowdown of corporate activity should lead to the sluggish growth of scheduled cash earning while the slowdown of corporate business performance should cause the rise of special cash earnings to run its course. However, the increase of employed workers and the slower rise of the percentage of part-time workers leads to forecasts that labor compensation will continue to increase in both FY2004 and FY2005 (Chart 40).

Personal consumption will remain strong, reflecting the improvement of disposable income and consumer confidence

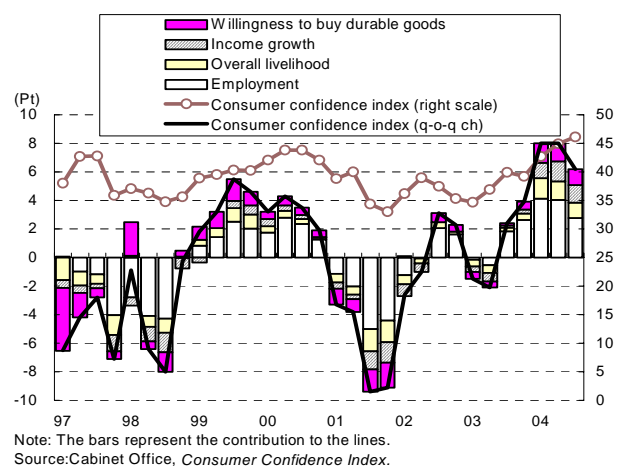
The growth of disposal income also appears to have picked up reflecting the recovery of labor compensation. Asset income such as dividends and income of self-employed workers (mixed income) looks to have increased along with the recovery of economic conditions, thus serving to push up the level of disposable income (Chart 42). Consumer confidence is also improving (Chart 41) reflecting the improvement of labor market conditions, driving personal consumption over the rise of income.

A characteristic of recent personal consumption is the sharp rise of spending on selective goods and services such as durable consumer goods, overseas travel and educational expenses. Apart from tailwinds provided by the Athens Olympic games, the prolonged restraint upon consumer spending thus far leads to our view that the improvement of labor market conditions served to stimulate pent-up demand.

[Chart 40: Labor compensation]



[Chart 41: The consumer confidence index]

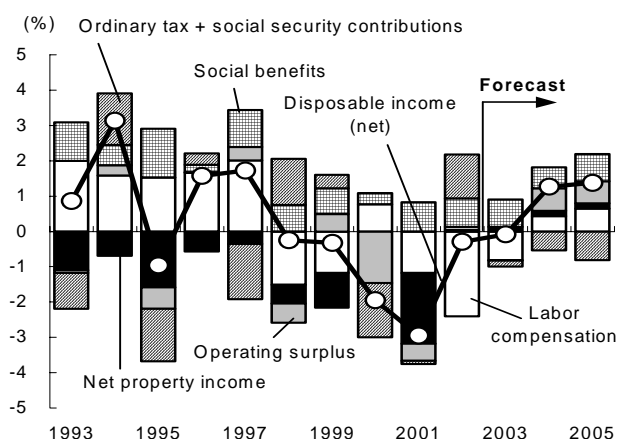


In FY2005, personal consumption should converge into cruise mode matching income growth

Nevertheless, personal consumption will most likely slow down in the second half of FY2004 due in part to limits upon the improvement of personal consumption driven mainly by consumer confidence. The demand for digital consumer electronics will run its course given the end of the Olympic Games, thereby serving as downward pressures upon personal consumption while the rise of social security premiums and gasoline prices will lead to the decline of purchasing power.

In FY2005, personal consumption should converge into cruise mode matching the rise of income amid the gradual improvement of the employment and income environment. Even in the event the currently-debated gradual phase-out of fixed-rate tax cuts (totaling 3.3 trillion yen) is carried out in the currently-debated scope and format, its impact would only last until the final quarter of the forecast horizon. Personal consumption should remain steadfast in FY2005, propped up by the growth of disposable income (Chart 43).

[Chart 42: Disposable income]



Note: The bars represent the contribution to the line.
Source: Cabinet Office, *Annual Report on National Accounts*.

[Chart 43: Personal consumption]

	FY2003	FY2004 Forecast	FY2005 Forecast
Labor compensation	-0.9	0.5	0.7
Per worker	-1.1	-0.1	0.1
No. of employed workers	0.2	0.6	0.6
Disposable income	-0.1	1.3	1.4
Household consumption expenditure deflator	-1.5	-1.4	-0.9
Real disposable income	1.4	2.7	2.3
Nominal consumption expenditure	-0.1	1.7	0.9
Private-sector consumption expenditure deflator	-1.5	-1.5	-0.9
Real consumption expenditure	1.4	3.1	1.9
Propensity to consume	93.8	94.3	93.9
Y-o-y ch (% pt)	0.0	0.4	-0.4

Notes: 1. All items other than the propensity to consume are represented as the percentage change from the previous year.
2. The household consumption expenditure deflator excludes imputed rent.

Housing starts are picking up

Housing starts picked up in the Jul-Sep quarter of 2004. In addition to the steady rise of housing starts of owner-occupied houses (owner-occupied houses + built-for-sales houses) spurred by a last-minute rush among prospective homebuyers before the current tax breaks on housing loans are scaled down, rental housing also grew stably given the rising preference for residences close to work, leading to the rise of housing starts in the Jul-Sep quarter over a year ago. In terms of geographic areas, there is an excessive concentration of housing starts in urban areas. In contrast to the surge of built-for-sale condominiums in urban areas mainly in Tokyo, construction starts remain stagnant in outlying areas. Thus, housing investment in real terms slowed down but continued to rise above the previous quarter for three quarters in a row.

Stable growth of owner-occupied residences stemming from forecasts of higher interest rates ahead

Looking forward, forecasts of higher interest rates ahead and signs that land prices in urban areas are bottoming out provide us with reasons to predict that housing starts of owner-occupied residences will follow a steady path. Although purchasers of residences during the so-called Bubble Era of the 1990s are unable to repay their mortgages even by selling their property and hence hampered from second-time home purchases, the creation and expansion of loss carryforwards regarding sales of residential property should facilitate second-time purchases to some extent. However, since a dramatic rise of housing starts is unlikely given the overall decline in number of households, we are inclined to believe that housing starts will remain flat during FY2004.

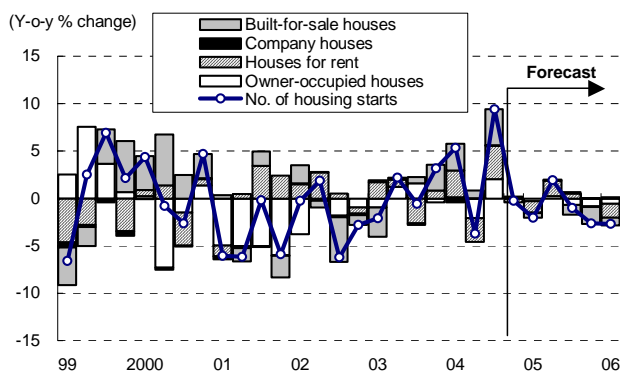
In FY2005, the further rise of interest rates and the scale-down of the scope of tax cuts will lead to the fall of demand, resulting in a gradual fall of the number of housing starts. Nevertheless, in view of positive factors for housing starts such as the fact that the neo-boomer generation will reach home-purchasing age, the adjustment should turn out to be benign.

Housing starts of rental housing will level out

Houses for rent will most likely decline year-on-year in FY2004 due to a reaction to the oversupply in FY2003. The stagnation of demand is inevitable from FY2005 onward, given factors such as the decline of the youth-age population. On the other hand, housing starts of rental housing will level out, underpinned by factors such as (1) the rise of demand to rebuild houses in view of the fact that more than 30% of existing rental housing were built before 1981, when the new building regulations for earthquake-proof structures was implemented, and (2) lifestyle changes such as the growing preference for the close proximity between residences and workplaces.

Judging from the foregoing, we expect housing starts to fall from 1.183 million units in FY2004 to 1.171 million units in FY2005. The growth of housing investment in real terms should decline from 3.2% y-o-y in FY2004 to -0.4% y-o-y in FY2005 (Chart 45).

[Chart 44: Housing starts]



Note: The bars represent the contribution to the line.
Source: Ministry of Land, Infrastructure and Transport, *New Dwellings Started*.

[Chart 45: Housing starts and housing investment]

		FY2002	FY2003	FY2004	FY2005
		Actual	Actual	Forecast	Forecast
New housing starts	(10,000 units)	114.6	117.4	118.3	117.1
	(Y-o-y % ch)	-2.4	2.5	0.6	-0.9
Owner-occupied houses	(10,000 units)	36.6	37.3	37.1	36.6
	(Y-o-y % ch)	-3.1	2.1	-0.4	-1.5
Houses for rent	(10,000 units)	45.5	45.9	45.7	45.9
	(Y-o-y % ch)	2.8	0.9	-0.4	0.6
Built-for-sale houses	(10,000 units)	31.6	33.4	34.7	33.6
	(Y-o-y % ch)	-8.1	5.6	3.8	-3.0
Private-sector housing investment (nominal)	(Y-o-y % ch)	-3.3	0.3	3.9	-0.5
Deflator	(Y-o-y % ch)	-1.0	0.0	0.7	-0.1
Private-sector housing investment (real)	(Y-o-y % ch)	-2.2	0.3	3.2	-0.4

Sources: Cabinet Office, *Annual Report on National Accounts*,
Ministry of Land, Infrastructure and Transport, *New Dwellings Started*.

6. The public sector

The contribution to real GDP growth by public demand will be neutral in FY2005

The contribution by public demand to real GDP growth is expected to fall sharply to -0.4% in FY2004. In FY2005, its impact upon growth should turn neutral (0.0% y-o-y) given a wider breadth of the year-on-year rise of government consumption and a narrower breadth of the decline of public investment.

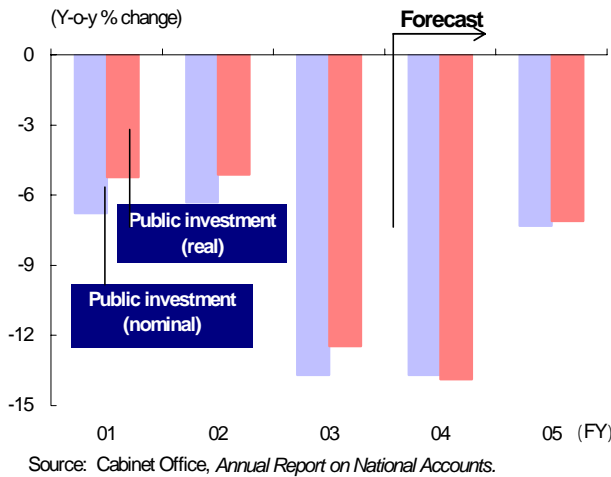
The breadth of the fall of public investment will most likely narrow

Public investment should basically remain on a downhill trajectory throughout the forecast horizon (Chart 46). Public investment has been falling sharply on a quarterly basis since early FY2004, dropping far below the estimated level based upon public investment related expenditures of Japan's general account budget and local government budget proposals. This is due most likely to the reduction of public investment among local government entities which account for 60~70% of total public investment on a final payment basis (Chart 47). Although prospects of additional public works expenditures in connection with the recent spate of natural disasters (typhoons and earthquakes) in Japan should curb the ongoing decline, full year public investment will still fall sharply below the previous year in FY2004.

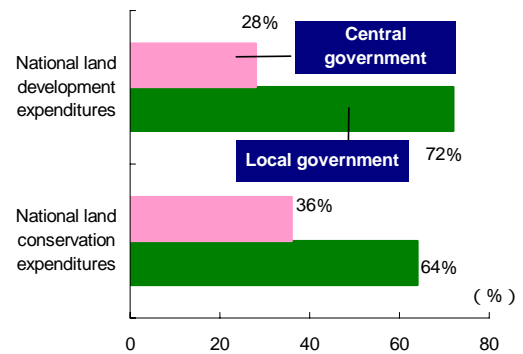
In FY2005, both central and local governments will most likely retain their stance to reduce their public investment-related budgets and keep public investment on a downward path, judging from (1) the reduction of the central government's public works related expenditures by 3% or more, set forth in the *Guidelines for FY2005 General Expenditure Budget Requests* and (2) the growing pressure upon local government entities to cut expenditures under the so-called trinity reform (which aims to boost the fiscal independence of local governments by giving them more taxation authority). However, since public capital formation in nominal terms is estimated to fall from 42.2 trillion yen in FY1995 to 22.3 trillion yen in FY2004, there would be very little leeway left to reduce expenditures if a certain amount of investment were to be made for maintenance and renewal.

Our forecast on public investment is -13.9% in real terms (-13.7% in nominal terms) in FY2004 and -7.1% in real terms (-7.3% in nominal terms) in FY2005.

[Chart 46: Public investment]



[Chart 47: A breakdown of public investment]



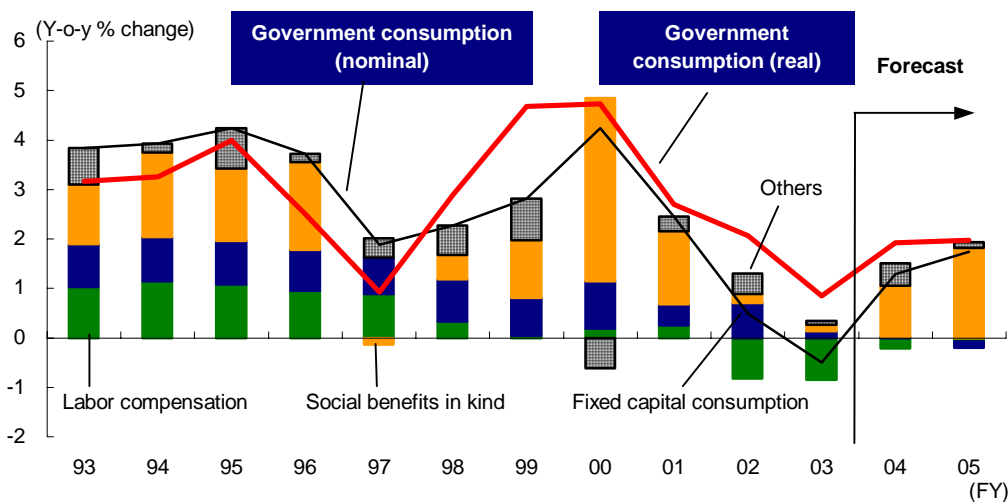
Note: Based upon budget expenditures, final expenditures basis.
Source: Ministry of Public Management, Home Affairs, Posts and Telecommunications.

Government consumption should continue to rise

Although the suppression of public employee labor costs and the decline of public fixed capital consumption should serve in the way of restraining the growth of government consumption, the ongoing rise of medical costs accompanying the aging population should lead to the rise of government consumption in FY2004 and FY2005.

Government consumption in real terms should grow 1.8% (1.3% in nominal terms) in FY2004 and 2.0% (1.7% in nominal terms) in FY2005.

[Chart 48: Government consumption]



Note: The breakdown for FY2003 are based upon calculations by MHR.
Source: Cabinet Office, Annual Report on National Accounts.

7. Prices

The percentage fall of the CPI will continue to contract

The year-on-year change of the CPI will rise above 0% sometime in 2006

According to the BOJ's *Outlook for Economic Activity and Prices*, the median forecast of the BOJ Policy Board members on the year-on-year change of the consumer price index (CPI) in FY2005 reached 0.1%. While further details are unavailable because a quarterly breakdown is not provided, the assumption that the year-on-year change of the CPI will turn positive on a full-year basis in FY2005 would mean that the percentage change of the CPI will be more than 0% in either the Jul-Sep quarter or the Oct-Dec quarter of 2005. In effect, the BOJ is indicating that the rate of change of the CPI will rise above 0% as early as a year from now.

However, the three factors explained in more detail below provide us with reasons to believe that the year-on-year change of the CPI will only rise above 0% sometime in 2006.

Firstly, the special factors, which have thus far contributed to the rise of consumer prices, will most likely fade and start to serve as downward pressures upon prices. Rice prices are falling already and meat prices should start to decline sooner or later as the mad cow-scare (BSE - bovine spongiform encephalopathy) calms down. As for oil-related products, the surge in FY2004 should drive down the rate of change of the CPI in FY2005. The ongoing reduction of electrical utility rates and telecommunications fees such as telephone charges should also continue. It would be no easy task for the year-on-year rate of CPI growth to override the decline of service prices and rise above 0%.

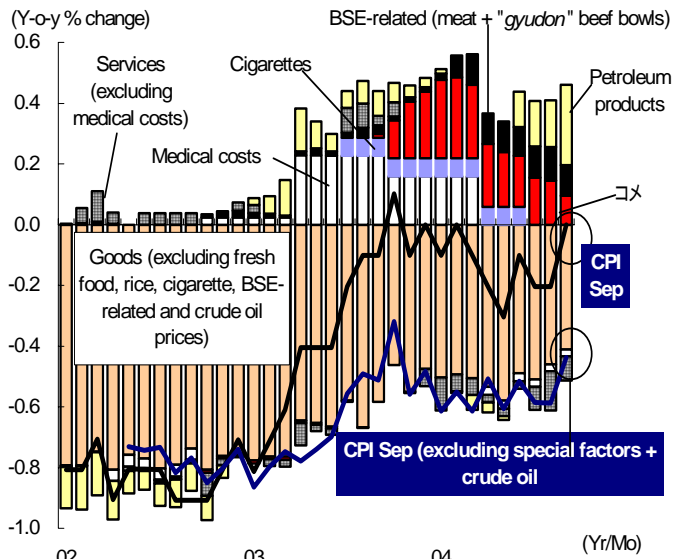
Secondly, companies in the final consumption goods and services market – monitored for the CPI – are still hampered from taking a bullish pricing stance. Manufacturers of materials now have more pricing power because of an oligopoly resulting from corporate mergers and acquisitions. In contrast, companies in the retail and services sector which are suppliers of final consumption goods still face severe competition and find it difficult to raise output prices because of their proximity to consumers who are the last to benefit from the recovery of economic conditions (Chart 50).

Lastly, even though the output gap is contracting sharply as a result of the rapid pickup of demand, it may still take some more time until the vestiges of the output gap are eliminated. Looking forward, the expansion of the output gap in the “positive sense”, referring to the rise of supply capacity surpassing demand stemming from the increase of capital stock through the rise of corporate productivity and capital investment will serve as impediments to the rise of consumer prices.

Judging from the foregoing, the percentage change of the CPI will only rise into positive territory some time in 2006 (Chart 51). Moreover, the year-on-

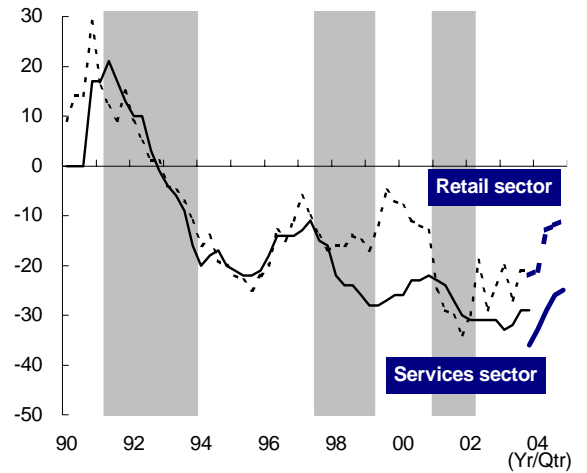
year change of the CPI will only register 0% or more “on a stable basis” only in or after FY2006.

[Chart 49: The CPI (nationwide)]



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

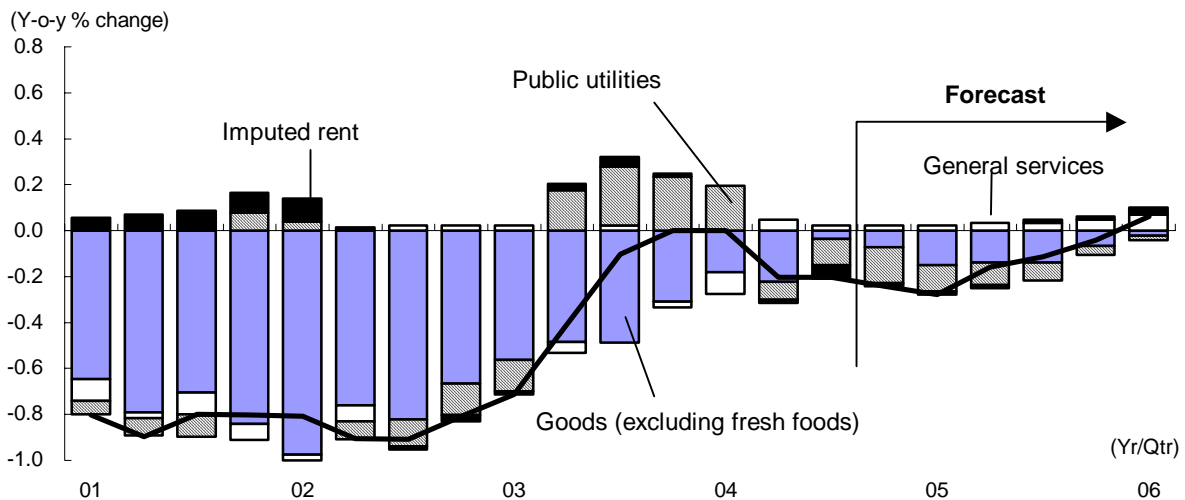
[Chart 50: DI on change in output prices]



Note: Data since 1Q2004 are noncontiguous due to change in sample data.

Source: Bank of Japan, *Tankan*.

[Chart 51: Forecast on the CPI]



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

MIZUHO

The logo for Mizuho, featuring the word "MIZUHO" in a bold, dark blue, sans-serif font. Below the text is a red, curved swoosh that underlines the letters.