Economic Outlook for FY2005 and FY2006

August 2005

The Mizuho Research Institute Ltd. (MHRI) announces its outlook on the economy for FY2005 and FY2006 subsequent to the release of *The Preliminary Quarterly Estimates of GDP ("QE")* for the Apr-Jun quarter of 2005. The key points of the outlook are as follows.

* MHRI released its previous economic outlook on June 14, 2005.

<The Overseas Economies>

The US Economy	Moderate expansion around its potential rate of economic growth 2005: (previous outlook) 3.5% → (current outlook) 3.7% 2006: (previous outlook) 3.3% → (current outlook) 3.4%
The Euro Zone Economy	Structural adjustment pressures will linger and serve as a drag upon the pace of economic growth 2005: (previous outlook) 1.7% → (current outlook) 1.4% 2006: (previous outlook) 2.0% → (current outlook) 1.8%
The Asian Economies	Regional economic growth will pick up from mid-2005 as the region emerges out of an inventory adjustment cycle 2005: (previous outlook) 6.4% → (current outlook) 6.4% 2006: (previous outlook) 6.5% → (current outlook) 6.4%

<The Japanese Economy>

FY2005	Moderate economic recovery driven by domestic private-sector demand Real GDP: (previous outlook) 1.5% → (current outlook) 1.9% Nominal GDP: (previous outlook) 0.8%→ (current outlook) 0.9%
FY2006	Ongoing strength of domestic demand will lead to the end of deflation Real GDP: (previous outlook) 1.8%→ (current outlook) 1.9% Nominal GDP: (previous outlook) 1.4%→ (current outlook) 1.6%

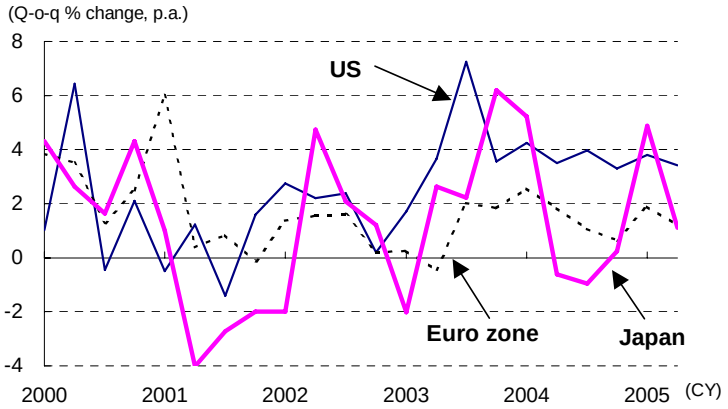
Mizuho Research Institute

I. Overview of the global economy

The global economy slowed slightly in the Apr-Jun quarter of 2005

The global economy slowed slightly in the Apr-Jun quarter of 2005 (**Chart 1**). Despite solid domestic private sector final demand and exports in the US, the sharp decline of inventory investment served as a drag down the pace of US gross domestic product (GDP) in real terms. Euro zone economic growth also slowed down due to sluggish exports. Turning to the Asian economies, China's real GDP continued to grow a strong 9.5% over a year ago (o-y-a) and the newly industrialized economies (NIEs) also picked up on the back of expectations that demand for IT and digital electronic appliances would recover. Nevertheless, the ASEAN economy appears to have slowed down, given the surge of crude oil prices. Even though the Japanese economy slowed sharply due to the adjustment of inventories piled up during the Jan-Mar quarter, the economy as a whole exhibited solid growth given ongoing expansion of domestic private sector final demand and the upturn of exports.

〔 Chart 1: Global economic growth 〕



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

The economies around the world will likely avert a serious inventory adjustment and continue to grow

The temporary soft patch of the global economy is due, most likely, to the fact that all the economies were standing at the brink of an inventory adjustment cycle.

In the US, the inventory cycle (**Chart 2**) indicates that the economy had fallen into an inventory adjustment phase in the Jan-Mar quarter of 2005. Nevertheless, the ongoing strength of demand (shipments) are keeping inventories from piling up and hence keeping the economy from falling into a serious inventory adjustment. The euro zone inventory cycle also indicates that the economy is at the brink of an adjustment phase in the Apr-Jun quarter of 2005 (**Chart 3**). However, given the presence of other indicators signaling the ebb of sentiment that there are excessive inventories, a sharp adjustment is not yet necessary at this juncture. In Asia, there are signs that unsold stocks of certain goods are piling up in China. Nevertheless, the inventory cycle is

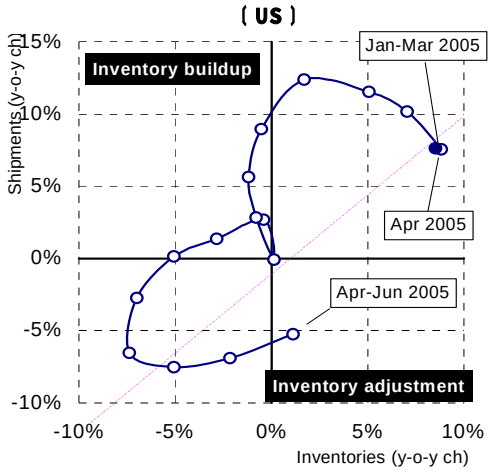
reversing course (shifting backward across the 45 ° line) due to the export drive and steady growth of domestic demand, hence keeping the inventory adjustment benign. While Japan is in an inventory adjustment phase, some of these movements are stockpiling efforts of a positive nature. Inventory adjustment pressures are indeed abating in Japan (for details, refer to Section II. The Japanese Economy).

As shown above, even though the major economies of the world are at the brink of an inventory adjustment phase, they are still standing firm and averting a major adjustment. Barring the emergence of the following risk factors, the odds are high that the global economy will continue to expand.

The surge of crude oil prices is the greatest risk to the global economy

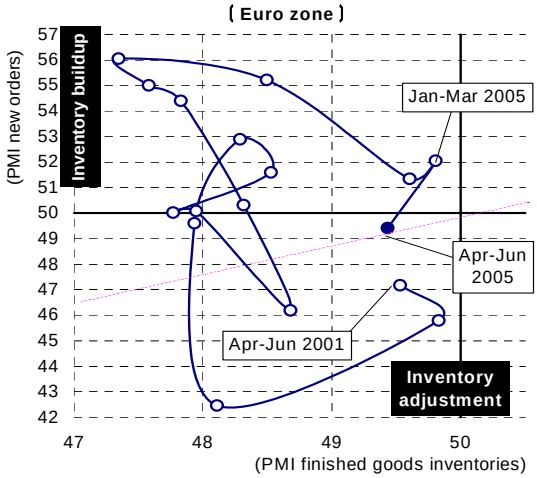
The surge of crude oil prices is the greatest risk to global economic growth. The West Texas Intermediate (WTI near-term contracts) – a benchmark crude oil futures price – has surged from $35/barrel at the beginning of 2004 to a historical high at the upper $60s/barrel in August 2005.

〔 Chart 2: US inventory cycle 〕



Source: US Department of Commerce.

〔 Chart 3: Euro zone inventory cycle 〕



Sources: Reuters, NTC Research.

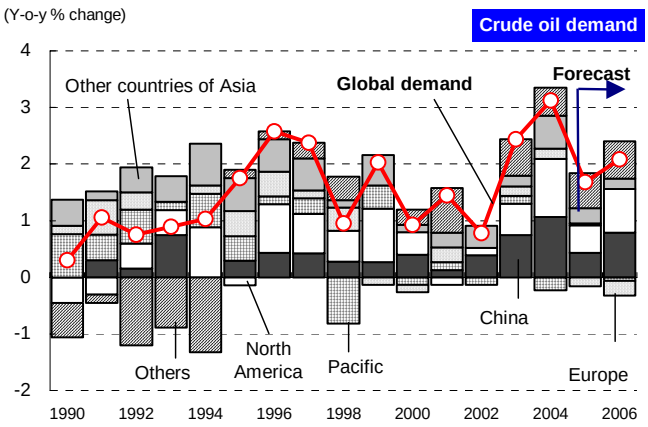
Tight supply-demand and speculators are driving up the price of crude oil

The recent surge of crude oil prices stems from the coincidence of multiple factors including the following: (1) the rise of demand accompanying solid growth of the global economy, driven mainly by the US and China, (2) the OPEC's scant output capacity, (3) the risks of supply disruptions due to the approaching hurricane season in the Gulf of Mexico where there is a concentration of oil supply bases, and (4) the rise of the risk premium due to Middle East political uncertainties. In addition, the influx of speculative money to the crude oil market, spurred by risk factors such as (3) and (4), amid tight supply conditions are driving up prices above the level determined by supply and demand.

To provide a forecast on crude oil price trends with the foregoing factors in mind, we expect crude oil demand to following a relatively strong uptrend.

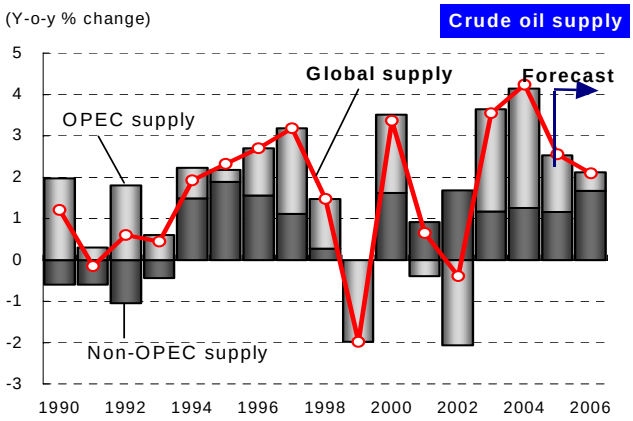
However, since higher prices will serve as a drag upon demand and the global economy is predicted to grow at a slower pace than in 2004, the rise of crude oil prices should slow sharply in 2005. As for crude oil supply, expectations toward the rise of the OPEC's output capacity stemming from its development of oil fields and prospects of a sustained rise of crude oil production in non-OPEC oil regions such as the former Soviet Union provide us with reasons to believe that the supply of crude oil will sufficiently cover the rise in demand at least during the forecast horizon until 2006.

〔 Chart 4: Global crude oil demand 〕



Note: Demand up to 2Q2005 are actual results based upon the International Energy Agency (IEA). Demand from 3Q2005 are forecasts by the MHRI.
Source: International Energy Agency, *Oil Market Report.*

〔 Chart 5: Global crude oil supply 〕



Note: Compiled by MHRI on the basis of data released by the International Energy Agency and others.
Source: International Energy Agency, *Oil Market Report*.

The price of crude oil will remain high during 2005 and follow a gradual decline in 2006

However, there are lingering risks of supply disruptions by oil-producing countries such as political uncertainties in Iraq and strikes in Nigeria. Given the inflow of speculative investment focusing on these risks, crude oil prices will tend to come under upward pressures during 2005. We are thus inclined to believe that the price of crude oil (WTI) will trend high at a level between the higher end of the $50/barrel to the lower half of the $60/barrel. However, the tight supply and demand of crude oil will gradually ease with the peak in 2004 and lead to a gradual decline of crude oil prices in 2006.

Movements in crude oil prices will serve increasingly as a risk to the global economy and hamper global economic growth in 2005. Nevertheless, our forecast predicts a gradual decline of crude oil prices and hence the gradual ebb of risks that the global economy will lose momentum due to the rise of crude oil prices.

China moves from a dollar-peg to a managed floating exchange rate regime

In addition to crude oil prices, the yuan is gaining importance as a factor influencing the global economy. On July 21st, the People's Bank of China abandoned the yuan's *de facto* peg to the dollar, moving to a managed floating exchange rate regime with reference to a basket of seven currencies (the pound sterling, Malaysian ringgit, Russian ruble, Australian dollar, Thai baht and

Canadian dollar). On the same day, the People's Bank of China announced that (1) the exchange rate of the US dollar against the yuan will be adjusted by 2.1% from 8.28 yuan/dollar to 8.11 yuan/dollar, and (2) the daily trading price of the US dollar against he yuan will float within a band of 0.3% either side of the central parity published with reference to the currency basket comprised of the above-mentioned currencies.

Yuan volatility is confined to a narrow range even after revaluation

Since July 22nd, the yuan has fluctuated within an extremely narrow range. Even though on first glance, the yuan's movement to the dollar closely resembles the yen when comparing the yuan's fluctuation to the dollar with that of the yen and the euro, the correlation coefficient indicates the yuan's close similarity with the euro. Even so, the yuan strengthened by 2.6% and 2.0% to the euro and yen respectively during the period from July 21sth to August 11th, in contrast to a paltry 0.1% to the US dollar, revealing that the yuan is still moving in lockstep with the US currency.

On the basis of the foregoing, along with comments by senior Chinese officials, we are inclined toward the view that the Chinese government will keep the fluctuation of the yuan subdued and guide the currency to an appropriate level by (1) relatively large adjustments around once a year in consideration of the balance of international payments and foreign currency reserves, and (2) minor adjustments once in several months in view of the balance of international payments and the currency basket.

Yuan revaluation will be confined to a narrow range

Looking forward, further yuan revaluations during 2005 will likely be confined to a narrow range in view of the gradual slowdown of the Chinese economy and the time necessary – several months to half a year – to assess the trends in the balance of international payments.

However, in the event the revaluation has a negative effect upon China's domestic financial conditions such as a further rise of foreign currency reserves, China's central bank will most likely take further steps such as guiding the yuan to a higher level and widening the breadth of the fluctuation band.

The yuan revaluation will not have much of a positive impact upon the US economy

The impact of the yuan revaluation will likely be miniscule for the US, which had been the most ardent proponent of the yuan's revaluation. On the basis of the Mizuho macro-econometric model ("Mizuho Macro-econometric Model"), in the event the real effective exchange rate of the US dollar declines by 10%, the rate of US real GDP growth in the second year will be pushed down 0.86% (**Chart 6**). Considering that the weight of the yuan in the real effective exchange rate of the dollar is only around 10%, US real GDP

growth will only rise 0.1% even if the yuan is revalued 10% higher.

In reality, since the Chinese economy would be negatively affected by the yuan revaluation, a significant rise of exports is unlikely. On the other hand, as long as goods imported by the US from China cannot be produced in the US, imports will not decline because the imports from China will only be substituted by imports from other parts of the world.

Thus, a revaluation of the yuan on such a small scale would have virtually no impact upon the contraction of the US-China trade gap.

〔 Chart 6: The impact of foreign exchange fluctuations on the US economy 〕

(% point)	1st year	2nd year	3rd year
GDP	0.12	0.86	0.81
Exports	1.07	3.29	3.82
Imports	-0.17	0.70	0.54
Nominal trade balance (in proportion to GDP)	0.10	0.27	0.35
CPI	1.85	3.18	3.33

Source: Mizuho Macro-econometric Model.

The impact upon the countries of Asia depends upon currency exchange rates and trade structure

For the countries of Asia including Japan, the impact of the yuan revaluation hinges upon the exchange rate of its own currency to the dollar and the degree of competition of its exports with Chinese products.

If a country's currency strengthens against the dollar along with the revaluation of the yuan, it would stand neutral with respect to exports and imports with China. However, as for countries other than China, the country's currency would appreciate and lead to the contraction of both exports and imports. As a result, the revalution of the yuan would have a negative impact upon countries with a trade surplus and conversely a positive impact upon countries with a trade deficit. Meanwhile, in the event a country's currency does not fluctuate against the dollar and, as a result, weakens against the yuan, both exports and imports in trade with China would increase and thus have a positive impact when the country has a trade surplus against China. On the other hand, since the country would stand in a superior position in terms with price competition in trade with countries other than China, the yuan revaluation would have a positive effect in the form of the rise of exports with respect to countries competing with Chinese products. However, in either case, the impact of a minor revaluation would be negligible.

【 Chart 7: The impact of higher crude oil prices and the revaluation of the yuan 】

	Impact of the rise of crude oil prices		Impact of the yuan revaluation (assuming a 10% appreciation of the yuan)	
US	×	Despite a substantial negative effect through the decline of purchasing power in the household sector, the negative impact would be offset by the rise of residential prices.	—	Exports will languish since the appreciation of the yuan would have a negative impact upon the Chinese economy. However, imports from China can be substituted by imports from other areas.
Euro zone	×	Coupled with a weaker euro, higher crude oil prices will push up prices and serve as a drag upon consumer spending through the fall of purchasing power in the household sector.	—	Even though imports from China account for almost 10% of total imports, the impact would be benign since a large part of imports from China can be substituted by imports from other areas.
Asia (excluding China	×	Mainly in the ASEAN countries, negative pressures upon corporate earnings and rise of prices will serve as a drag upon domestic private demand.	△	Even though the appreciation of the yuan would have a positive impact upon Thailand and the Philippines which are in competitive positions with China, the NIEs would be affected negatively through the fall of exports.
China	×	Although the impact of higher crude oil prices may not be underestimated because of China's low energy efficiency, the impact is currently veiled by China's high rate of economic growth.	×	In the short run, the appreciation of the yuan would have a negative impact upon the economy due to the decline of exports and inward direct investment. However, the rise of purchasing power in the medium term will serve to stimulate demand.
Japan	—	As far as the price of crude oil stays at the current level, the negative impact may be absorbed by the rise of corporate earnings and household income.	△	Even though the appreciation of the yuan against the yen would have some positive effect upon Japan, if the yuan revaluation leads to the appreciation of the yen to the dollar, it would have a large negative impact through the decline of exports .

Note: × : negative impact, △ : both positive and negative impact, — : benign impact

As reiterated above, even though the impact of soaring crude oil prices and yuan revaluation are risk factors for the global economy, it is unlikely that they will have a significant negative impact in view of the temporary easing of the crude oil supply-demand balance and the reduction of speculative money inflows with respect to the former and the Chinese government's strict controls with respect to the latter. Looking forward, the global economy will start to gather momentum along with the ebb of inventory adjustment pressures.

The US economy: steady growth followed by slowdown in 2H2006 due to the higher interest rates

The US economy will gather momentum along with the ebb of inventory adjustment pressures amid the steady growth of demand. Nevertheless, in view of the high possibility of an interest rate hike under such circumstances, the fall of demand due to the rise of interest rates will push the US into a serious inventory adjustment cycle and push down the rate of economic growth below 3% in the second half of 2006 (**Chart 8**).

The euro zone economy: gradual pickup driven by exports

The euro zone economy will gradually pick up along with the upturn of exports spurred by the weak euro. However, the rise of inflationary pressures due to the weak euro and expensive crude oil may serve as restraints upon domestic demand (mainly personal consumption) and keep the pace of economic recovery subdued.

The Asian economies: gradual recovery as the IT and digital appliance sector emerges out of an inventory adjustment phase

Despite the benign impact of the yuan revaluation upon the Chinese economy, which is growing in presence in Asia, investment growth will gradually slow down due to the continuation of policy measures to curb investment in fixed assets and lead to the decline of the economic growth in the first half of 2006. However, the appetite for investment among companies will rise in the second half of 2006 in the run-up to the Beijing Olympic games, leading to our view that the Chinese economy will regain momentum.

In terms of the Asian economies as a whole, prospects are that the IT and

digital appliance sector will reach the end of an adjustment phase and lead to the upturn of capital investment along with the recovery of exports. However, a sharp acceleration of economic growth is unlikely since the surge of crude oil prices will dampen the recovery of domestic demand. Even though the rate of Asia's economic growth should pick up by the time the rise of crude oil prices comes to a pause, the Chinese economy will slow down in the first half of 2006. However, the Asian economies will gather fresh momentum in the second half of 2006 despite sluggish export growth due to the slowdown of the US economy, and thus, maintain growth at more or less the same pace.

The Japanese economy: steady growth, leading to the end of deflation

Looking forward on Japan, signs of a self-sustained recovery will become evident during 2005 as a result of (1) the continuing growth of consumer spending and business fixed investment amid a virtuous cycle where the rise of demand leads to the growth of corporate earnings and household income, and (2) the ongoing rise of exports as the foreign economies emerge out of an inventory adjustment and start to recover. In 2006, the Japanese economy will shake off the last vestiges of deflation as the year-on-year percentage change of the consumer price index rises into positive territory as a result of the sustained rise of demand.

〖Chart 8: Global economic forecast (calendar year basis)〗

(%)

	2004			2005			2006		
		1H	2H		1H	2H		1H	2H
US	**4.2**	**4.1**	**3.6**	**3.7**	**3.6**	**3.8**	**3.4**	**3.5**	**2.7**
Previous forecast				3.5	3.4	3.5	3.3	3.4	2.7
Europe (Euro zone)	**1.7**	**2.2**	**1.2**	**1.4**	**1.3**	**1.6**	**1.8**	**2.1**	**1.4**
Previous forecast				1.7	1.6	2.3	2.0	2.2	1.2
Asia	**7.5**			**6.4**			**6.4**		
Previous forecast				6.4			6.5		
NIEs	**5.8**			**3.9**			**4.4**		
ASEAN4	**5.9**			**4.9**			**5.3**		
China	**9.5**			**9.0**			**8.3**		
Previous forecast				8.8			8.5		
Japan	**2.7**	**4.0**	**-0.6**	**1.9**	**3.1**	**1.6**	**1.9**	**2.0**	**2.0**
Previous forecast				1.5	2.5	1.3	1.7	1.9	1.9

Note: The shaded areas are forecasts. The upper row of figures are the latest forecasts and the lower row of figures are previous forecasts.
Calendar year figures refer to the % change over the previous year and the half-year figures refer to the % change over the previous term (p.a.)

II. The Japanese Economy

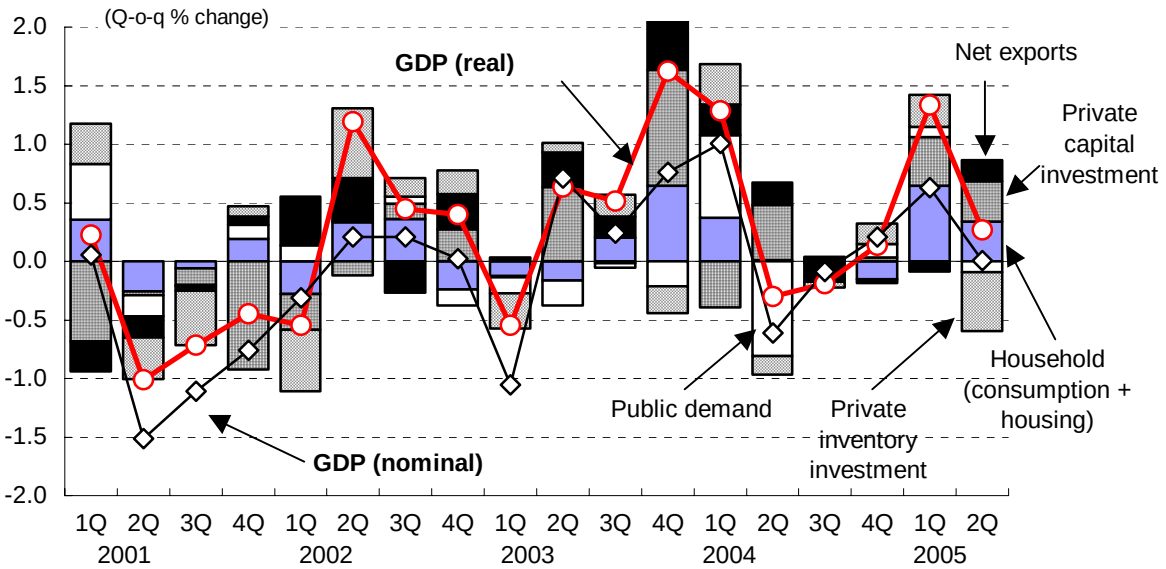
1. The current state of the Japanese economy

The Japanese economy continued to grow for the third straight quarter in the Apr-Jun quarter of 2005

Japan's real GDP grew 0.3% q-o-q (translated into an annualized rate of 1.1%) in the Apr-Jun quarter of 2005, slowing sharply from the previous quarter from January to March. The economy nevertheless recorded positive growth for the third quarter in a row, underscoring its ongoing expansion (**Chart 9**). The Japanese economy is continuing to expand after emerging out of the doldrums in the second half of last year.

Looking closer at the components of demand, personal consumption and corporate capital investment – the twin pillars of domestic private demand – grew a solid 0.7% q-o-q and 2.2% q-o-q respectively. Japan's exports, which were a source of concern, turned out to grow 2.8% q-o-q, rising into positive territory for the first time in two quarters. Net exports contributed positively to GDP for the first time in four quarters, helping the overall strength of domestic final demand. In contrast, inventories served as a drag upon economic growth. Due in part to the rise of domestic inventory investment since the Oct-Dec quarter of 2004, the contribution by inventory investment fell 0.5% in the Apr-Jun quarter. Public demand also dragged down the rate of GDP growth as a result of quarterly declines in both government consumption and public investment.

【 Chart 9: Japan's quarterly GDP growth 】



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

Although the headline figures were weaker, the contents actually improved

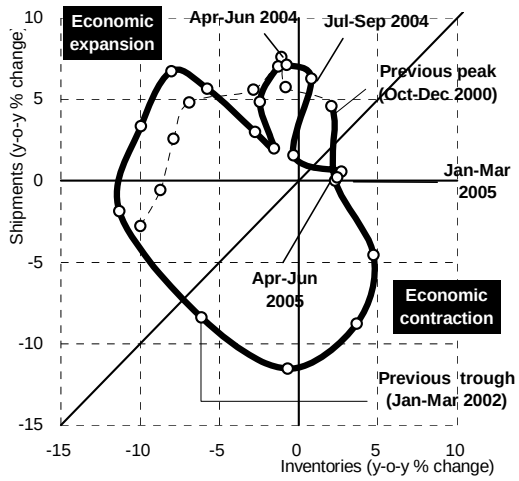
Even though Japan's rate of economic growth slowed sharply, a closer look reveals numerous positive aspects including the following: (1) domestic private-sector demand – indispensable for stable long-term economic growth – continue to grow, (2) concerns regarding the unintentional accumulation inventories were alleviated through the progress of inventory adjustment, and (3) exports picked up after languishing due to inventory adjustment overseas.

Furthermore, the GDP deflator, a measure of broad price movements, stood at –0.8% o-y-a, compared to –1.0% o-y-a in the previous quarter, indicating that the Japanese economy is progressing steadily toward the emergence out of deflation. The *Preliminary Quarterly Estimates of GDP* for the Apr-Jun quarter actually revealed the strong improvement of the Japanese economy.

Even though the inventory cycle is still in adjustment phase, the adjustment process is steadily progressing

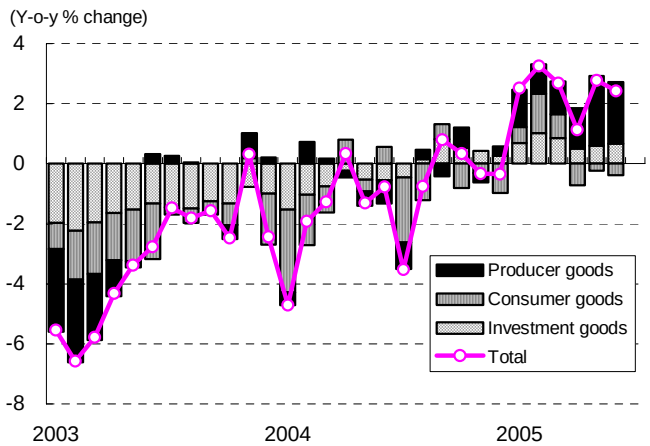
Although the GDP statistics indicate that Japan's industrial sector has more or less finished working off its inventories in the Apr-Jun quarter, the manufacturing sector is still in the process of inventory adjustment from the perspective of the inventory cycle (**Chart 10**). However, a breakdown of inventories indicates that in contrast to the large contribution by consumer goods in early 2005, the contribution by consumer goods has turned negative while the contribution by producer goods has grown larger in the Apr-Jun quarter (**Chart 11**). In the background to the increase of producer goods inventories, there are positive factors such as (1) the temporary intentional accumulation of inventories in order to conduct periodic refurbishments of production facilities in the chemicals industry, and (2) the intentional stockpiling of raw materials in anticipation of the recovery of demand. The steady rise of investment goods stems from the rise of capital goods for manufacturing facilities that are normally made to order. In view of these circumstances, the recent rise of inventories include intentional stockpiling, providing us with reasons to believe that the adjustment of inventories will end quickly along with the upturn of shipments.

【 Chart 10: Inventory cycle 】



Source: Ministry of Economy, Trade and Industry.

【 Chart 11: Breakdown of industrial sector inventories 】



Source: Ministry of Economy, Trade and Industry, *Indices of Industrial Production, Producer's Shipments and Producer's Inventory of Finished Goods.*

Sustainability is the key in forecasting the future course of the economy

As the Japanese economy shows definite signs of recovery from the soft patch in the second half of last year, the key in forecasting the future course of the economy is the sustainability of the recovery.

In a bid to ascertain whether or not the "autonomous recovery mechanism" – indispensable for sustained economic recovery – is starting to function, we shall look at the flow of corporate earnings to capital investment and household income mainly in the nonmanufacturing sector.

Appetite for capital investment is growing more broad-based and more intense among nonmanufacturers

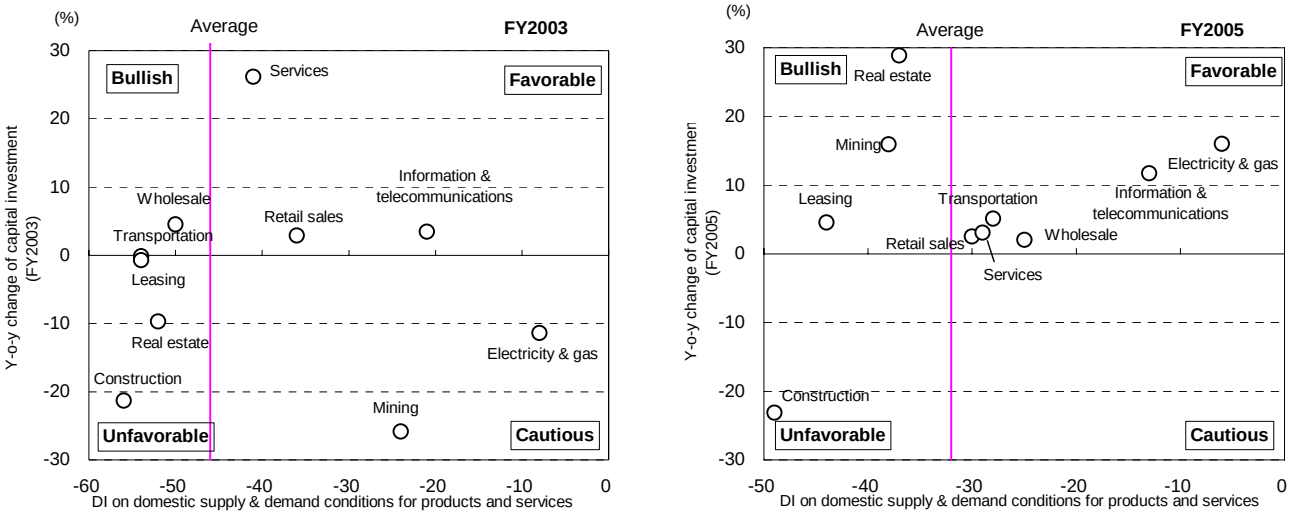
According to the Bank of Japan's (BOJ) *Short-Term Economic Survey of Enterprises in Japan (Tankan)* in June, capital investment on an all-industries basis increased 8.8% y-o-y (excluding land purchases and including computer software), surpassing investments during the previous year. In particular, capital investment in the nonmanufacturing sector increased a dramatic 6.8% y-o-y, revealing a sharp rise in positive attitude toward business fixed investment among nonmanufacturers. Investment in the nonmanufacturing sector had lagged the manufacturing sector and remained more or less flat during FY2003 and FY2004.

Focusing upon the change in investment plans in the nonmanufacturing sector by type of business, the June 2003 *Tankan* survey revealed a sharply contrasting picture. The four business sectors including services, wholesalers, retailers and information & telecommunications planned to increase capital investment whereas the four business sectors including real estate, construction, mining and electricity & gas planned to reduce investment. Capital investment plans remained flat in the transportation and leasing businesses. (**Chart 12**) Focusing upon the supply-demand balance of products and services, we found that businesses enjoying relatively favorable supply and demand conditions were the ones to show an increase in capital investment and conversely that relatively unfavorable supply and demand usually indicated a decline in investment. However, capital investment plans fell in the in the electricity & gas and mining industries, thus revealing a cautious investment stance despite relatively favorable supply and demand conditions. In contrast, all businesses with the exception of construction plan to increase capital investment in FY2005, indicating that Japan's economic recovery is spreading to a wider range of sectors. Furthermore, in addition to the absence of sectors showing a cautious stance, some business sectors such as real estate are starting to draw up extremely bullish capital investment plans in the light of supply and demand. The appetite for capital investment is growing more broad-based and more intense in the nonmanufacturing sector.

Thus far, the lingering concern was that business enterprises would restrain capital spending even amid the recovery of demand and stem the proper functioning of a virtuous cycle from "the expansion of demand" to "the recovery of corporate business performance", leading to "a further expansion of demand". At this juncture, the signs that businesses are starting to shed their overly cautious

stance on capital investment serves as positive incentive toward Japan's self-sustained recovery.

【 Chart 12: Supply & demand conditions for products and services and capital investment plans in the nonmanufacturing sector 】



Note: As of June *Tankan* survey. Data on capital investment exclude land purchases and include computer software.

Source: Bank of Japan, *Short-Term Economic Survey of Enterprises in Japan (Tankan).*

Businesses no longer feel burdened by excess labor, leading to ongoing improvement of household income

The fact that the upturn of corporate business performance is starting to spread to household income is already evident in various macroeconomic statistics. Among the noteworthy trends in household income conditions are: (1) the ebb of business sentiment on excess labor, (2) the decrease of part-time employees and the increase of full-time employees (permanent employees), (3) the fall of the unemployment rate and the rise of the ratio of active job openings to active applications (**Chart 13**), and (4) the rise of scheduled cash earnings (base wages) per employee. (1) and (2) most likely indicate that restructuring efforts are subsiding and that overtime hours are reaching a peak, underscoring that businesses are turning very enthusiastic about hiring workers. Amid these conditions, Japan's labor supply is decreasing due to its aging population and low birthrate, leading to a tightening of the labor market as shown by (3). As a result, corporate business enterprises are compelled to increase working hours in order to secure the quantity of labor input (meaning a preference for permanent employees over part-time employees), leading to (4) the rise of average wages stemming from the rise in percentage of permanent employees.

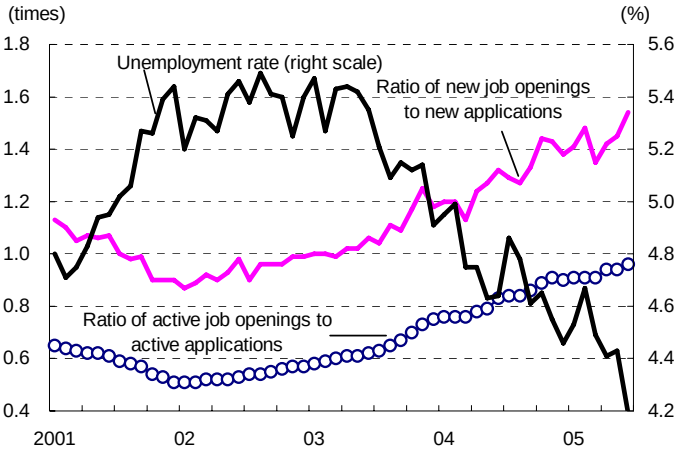
The ebb of restructuring efforts among manufacturers and the pause in shift to cheap labor among manufacturers are driving up household income

To shed light upon the environment surrounding household income, we shall look at the manufacturing sector and the nonmanufacturing separately. In the manufacturing sector, companies were cutting labor while wages were rising from a relatively early stage in Japan's current economic recovery (**Chart 14**). We suspect that bonus payments, which have become more closely linked to performance, drove up wages even amid ongoing restructuring efforts. Recently, employment is pickup up reflecting the ebb of restructuring efforts, leading to our view that the rise of corporate business performance will filter through more

readily to household income via the rise of employment. Meanwhile, in the nonmanufacturing sector, wages have continued to fall below the previous year despite the rise of employment since mid-2003. This probably reflects the fact that the rise of employment during this period was comprised mainly of relatively cheap part-time labor. In 2005, wages are rising along with the increase of employment, indicating the possibility that the shift to low-cost labor is coming to a pause.

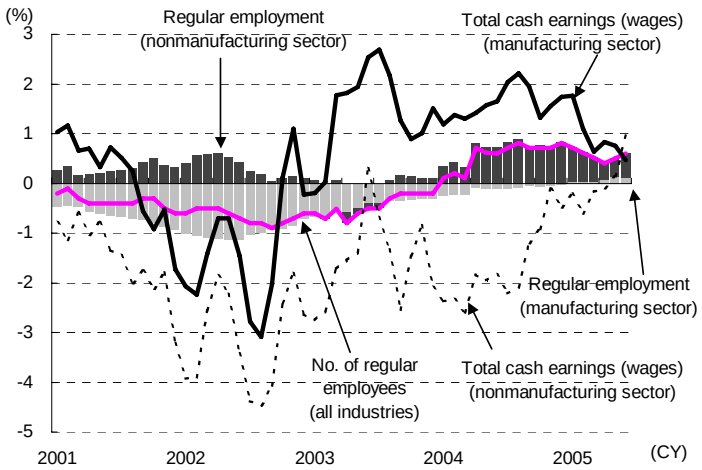
Given the excess supply of labor thus far, businesses have been above to adjust the flow of corporate profits to household income by cutting labor and shifting toward cheap labor. However, the recent tightening of the labor market will make it easier for the rise of business performance in the corporate sector to spread to household income. This also provides us with reason to believe that the autonomous recovery mechanism is improving.

〔 Chart 13: The unemployment rate and the ratio of active job openings to active applications 〕



Note: Adjusted for seasonal factors.
Sources: Ministry of Internal Affairs and Communications, *Labour Force Survey* , Ministry of Health, Labour and Welfare.

〔 Chart 14: Employment and wages (by type of business) 〕



Note: Data on employment are represented as changes over the same month a year ago and data on wages are changes over the same month a year ago (3mma).
Source: Ministry of Health, Labour and Welfare, *Monthly Labour Survey.*

2. Forecast of the Japanese economy in FY2005 and FY2006

FY2005: 1.9% real GDP growth, 0.9% nominal GDP growth

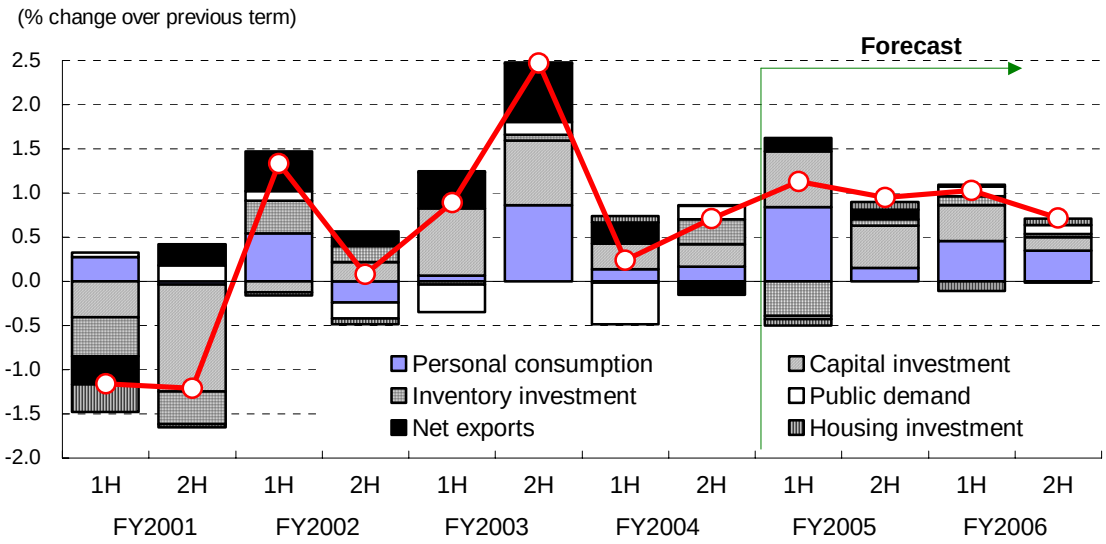
1H FY2005 We expect the solid growth of private sector demand as a result of (1) the upturn of personal consumption reflecting the improvement of the income environment, (2) continued growth of capital spending as it spreads to the nonmanufacturing sector, and (3) the recovery of exports given the progress of inventory adjustment overseas (**Chart 15**). Amid these positive trends, private-sector companies will be able to shed their stocks of unsold goods, thus assuaging concerns regarding a pile-up of inventories and leading to the stable growth of the economy.

Economy will grow around 2% during FY2005, driven mainly by domestic private-sector demand

2H FY2005 The economy will grow steadily given the ongoing expansion of personal consumption, capital investment and exports. The Japanese economy will enter an autonomous recovery as a virtuous cycle takes hold, in other words, the upturn of corporate business performance fueling business capital investment and personal consumption through the rise of household income, thus leading to a further improvement of business performance in the corporate sector. Real GDP will grow around 2% p.a. throughout FY2005. As the economy keeps growing at a pace surpassing its potential growth rate, the economy will draw nearer to the end of deflation.

As a result, we expect Japan's real GDP to keep growing at a relatively solid pace of 1.1% over the previous term (2.3% p.a.) in the first half of FY2005 and 1.0% over the previous term (1.9% p.a.) in the second half of FY2005. This brings full-year GDP growth in FY2005 to 1.9% (previous forecast: 1.5%) in real terms and 0.9% (previous forecast: 0.8%) in nominal terms.

【 Chart 15: Forecast on Japan's real GDP growth 】



Note: Figures from FY1H FY2005 are MHRI forecasts.
Source: Cabinet Office, *Preliminary Quartery Estimates of GDP.*

1H FY2006: the economy will keep growing around 2% per annum

1H FY2006 The economy will continue to follow an autonomous recovery track given the steady growth of domestic and external demand. Even though the contribution by net exports will fall sharply due to the growth of imports reflecting the rise of domestic demand and a stronger yen, the Japanese economy will continue to grow around 2% p.a. given the strong growth of domestic private sector demand.

2H FY2006: negative factors such as the appreciation of the yen will serve as a drag upon growth

2H FY2006 Exports will fall along with the US economic slowdown and the appreciation of the yen, tipping the contribution by net exports into negative territory. Turning to domestic demand, (1) personal consumption is also predicted to slow down due to the abolition of across-the-board tax credits, while (2) concerns regarding future demand stemming from the strong yen and sluggish consumer spending will dampen the growth of capital investment.

Judging from the foregoing, MHRI forecasts that Japan's real GDP in FY2006 will slow from 1.0% over the previous term (2.1% p.a.) in the first half of FY2006 to 0.7% over the previous term (1.4% p.a.) in the second half. This brings full-year GDP growth in FY2006 to 1.9% in real terms and 1.6% in nominal terms (**Chart 16**).

〔 Chart 16: Outlook on the Japanese economy 〕

(%)

	FY2004 (Actual)	FY2005 (Forecast)	FY2006 (Forecast)	FY2005 1H (Forecast)	FY2005 2H (Forecast)	FY2006 1H (Forecast)	FY2006 2H (Forecast)	FY2005 (Contribution) (Forecast)	FY2006 (Contribution) (Forecast)
GDP (real)	1.9	1.9	1.9	1.1	1.0	1.0	0.7	-	-
Domestic demand	1.5	1.8	1.8	1.0	0.8	1.0	0.7	1.8	1.8
Private sector demand	2.3	2.4	2.1	1.3	1.1	1.1	0.8	1.8	1.6
Personal consumption	1.2	1.8	1.3	1.5	0.3	0.8	0.6	1.0	0.7
Housing investment	2.1	-0.6	-0.8	-2.0	2.7	-3.1	2.3	-0.0	-0.0
Capital investment	5.2	6.5	4.4	4.1	3.0	2.5	0.9	1.0	0.7
Public sector demand	-1.4	0.0	0.8	-0.1	-0.0	0.5	0.5	0.0	0.2
Government consumption	2.7	2.1	2.3	0.7	1.7	1.1	0.9	0.4	0.4
Public investment	-15.1	-7.5	-5.6	-3.2	-6.7	-2.1	-1.4	-0.3	-0.2
Net exports (contribution)	0.5	0.1	0.0	0.1	0.1	0.0	-0.0	0.1	0.0
Exports	11.9	6.8	6.4	3.6	4.2	3.1	2.2	0.9	0.9
Imports	9.3	6.8	7.0	2.9	4.0	3.5	2.7	-0.8	-0.9
GDP (nominal)	0.8	0.9	1.6	0.5	0.5	1.1	0.4		
Industrial production	4.1	1.7	3.9	0.8	2.1	2.5	0.8		
Unemployment rate	4.6	4.2	3.7	4.4	4.0	3.8	3.6		
Current account balance (trillion yen)	18.3	17.4	18.9	16.4	18.9	19.1	19.3		
as a percentage of nominal GDP	3.6	3.4	3.7	3.2	3.7	3.7	3.7		
Corporate goods prices	1.5	1.2	-0.6	1.5	0.8	-0.1	-1.1		
Consumer prices	-0.2	-0.0	0.2	-0.1	0.1	0.2	0.2		
Long-term interest rate (%)	1.52	1.46	1.93	1.30	1.63	1.85	2.00		
Nikkei stock average (yen)	11,321	11,850	12,600	11,550	12,150	12,500	12,700		
Exchange rate (yen/dollar)	107.5	109	102	110	109	103	101		
Crude oil price (WTI $/barrel)	45.1	56.2	52.2	55.2	57.3	54.0	50.4		

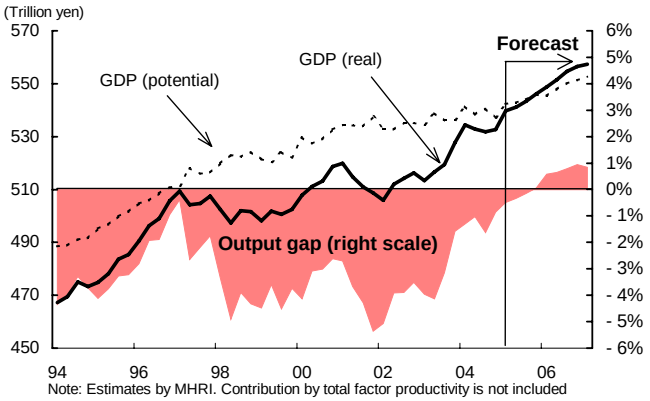
Notes: 1. FY = rate of change from the previous year. Half-year = rate of change from the previous term (excluding the unemployment rate, current account balance and prices).
2. Half-year corporate goods prices and half-year consumer prices = rate of change over a year ago. Consumer prices = nationwide (excluding fresh foods).
3. Half-year unemployment rate and half-year current account balance are adjusted for seasonal factors. Figures on current account balance are converted into annualized rates.
4. Crude oil price = near-term contract for WTI crude futures. The long-term interest rate = newly-issued 10-yr government bonds.

Sources: Cabinet Office, *Annual Report on National Accounts*,
Ministry of Economy, Trade and Industry, *Production, Shipment and Inventory Indexes*,
Ministry of Internal Affairs and Communications, *Labor Force Survey, Consumer Price Index*,
Ministry of Finance, *Balance of Payments*,
Bank of Japan, *Corporate Goods Price Index*.

The percentage rise of the CPI will turn positive in the first half of FY2006

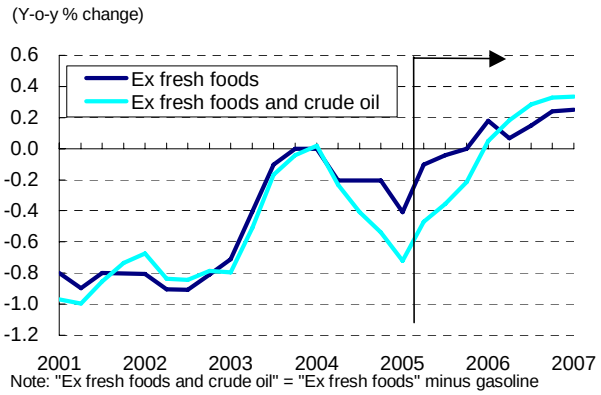
Looking forward on price trends on the basis of MHRI's forecast on the economy, the output gap (the gap between demand and supply) has narrowed considerably as a result of Japan's three-year consecutive expansion starting with the trough in January 2002 (**Chart 17**). If the Japanese economy continues to move forward on a domestic demand-led recovery, as set in MHRI's economic forecast, the output gap should rise into positive territory in early 2006 (**Chart 18**). One of the preconditions set forth by the BOJ for the termination of the quantitative easing policy, namely that "the consumer price index registers stably a zero percent or an increase year on year", should be fulfilled around mid-2006.

〔 Chart 17: The output gap 〕



Note: Estimates by MHRI. Contribution by total factor productivity is not included in potential GDP.
Sources: Cabinet Office, Ministry of Economy, Trade and Industry, Ministry of Internal Affiars and Communications, and others.

〔 Chart 18: The CPI 〕



Note: "Ex fresh foods and crude oil" = "Ex fresh foods" minus gasoline and heating oil.
Source: Ministry of Internal Affairs and Communications, *Consumer Price Index*.

If the surge of crude oil prices goes unabated despite our forecast that they would cool down, the percentage rise of the CPI could turn positive in 2005. However, since the current CPI level is pushed up by approximately 0.3% pt due to the rise of crude oil prices, discussion on how to assess the impact of the higher price of crude oil would be indispensable for a shift in monetary policy.

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