Economic Outlook for FY2006 and FY2007

(revised to reflect the Second Preliminary Quarterly Estimates of GDP For the Jul-Sep quarter of 2006)

December 2006

The Mizuho Research Institute Ltd. (MHRI) has revised its economic outlook for FY2006 and FY2007 subsequent to the release of *The Second Preliminary Quarterly Estimates of GDP ("2nd QE")* for the Jul-Sep quarter of 2006. The key points of the outlook are as follows.

<The US Economy>

	Slow growth followed by an upturn toward the second half of 2007
2006	3.3% (previous outlook) → 3.3% (current outlook)
2007	2.4% (previous outlook) → 2.4% (current outlook)

<The Japanese Economy>

FY2006	Exports to slow down toward the end of the fiscal year
	Real GDP: 2.3% (previous outlook) → 1.9% (current outlook)
	Nominal GDP: 1.8% (previous outlook) → 1.6% (current outlook)
FY2007	Sustained growth around the potential rate of economic growth
	Real GDP: 1.7% (previous outlook) → 1.8% (current outlook)
	Nominal GDP: 2.6% (previous outlook) → 2.5% (current outlook)

Mizuho Research Institute

I. The current state of the US economy

Despite solid consumer spending, the US economy will remain sluggish due to the housing market downturn and the lull in production activity

US economic growth in the Jul-Sep quarter, measured in terms of real gross domestic product (GDP), was revised upward by 0.6% pt from 1.6% q-o-q p.a. (advance estimates) to 2.2% q-o-q p.a. (preliminary estimates). .Even after the upgrade, the fundamental picture remains unchanged that growth has slowed from the previous quarter from April to June (2.6% q-o-q p.a.).

Production activity in the mining and manufacturing sectors is falling into a lull reflecting the ongoing housing market downturn and weakness of domestic automakers. The Institute of Supply Management(s (ISM) manufacturing index stood at 49.5 in November, falling below the boom-or-bust threshold for the first time since April 2003. That said, the employment and income environment remains favorable, underpinning the strength of consumer spending which holds the key to US economic growth. In addition to the unemployment rate trending around 4.5%, non-farm payrolls are growing around 13 thousand workers per month. The widely-watched Christmas shopping season has started out on a brisk note on the tailwinds of strong employment income growth and stable crude oil prices. The wage index (hourly wages multiplied by the total work hours index) – a proxy variable of employment income – continued to rise a solid 5.1% p.a. from three months before. Even though the housing market downturn is not rippling through to consumer spending yet, the odds are high that the US economy will remain sluggish in consideration of the lull in production activity.

Judging from the current state of the US economy, we have kept our forecast on US real GDP growth unchanged (2006: 3.3%, 2007: 2.4%) from our previous *Economic Outlook for FY2006 and FY2007* (November 2006).

[Chart 1: Outlook on the US economy]

(%)

	2005 (Actual)	2006 (Forecast)	2007 (Forecast)	2006 1H	2006 2H	2007 1H	2007 2H
GDP	3.2	3.3	2.4	3.9	2.2	2.3	3.0
Personal consumption	3.5	3.1	2.8	3.2	2.8	2.8	2.9
Housing investment	8.6	-3.7	-7.7	-3.2	-15.1	-7.6	0.5
Capital investment	6.8	7.9	6.0	9.1	7.7	5.9	4.5
Inventory investment ($100 million)	196.5	499.8	338.8	474.5	525.0	292.5	385.0
Government expenditures	0.9	2.1	2.8	2.4	2.1	3.0	3.0
Net exports ($100 million)	-6,192	-6,302	-6,416	-6,304	-6,301	-6,337	-6,495
Exports	6.8	8.6	4.6	10.9	6.2	4.0	4.2
Imports	6.1	6.2	3.7	8.1	4.1	3.1	4.5
Domestic final demand	3.6	3.0	2.6	3.2	2.1	2.6	3.0
Core personal expenditures deflator <y-o-y ch>	2.1	2.3	2.3	2.1	2.4	2.4	2.3
Current account balance ($100 million)	-7,915	-8,814	-9,021	-4,316	-4,498	-4,426	-4,595
<as a percentage of nominal GDP>	-6.4	-6.7	-6.5	-6.6	-6.7	-6.5	-6.6

Notes: 1. Calendar-year figures refer to the rate of change from the previous year. Half-year term figures refer to the rate of change from the previous half-year term (annualized).
2. The shaded columns are forecasts.
3. As for the current account balance, figures for the half-year terms are adjusted for seasonal factors and the calendar-year figures are the totals. The percentages of nominal GDP are annualized.

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

II. The Japanese economy

(1) The current state of the economy

The *2nd QE* revealed that Japan's economy grew a slower-than-estimated 0.8% q-o-q p.a.

The *Second Preliminary Quarterly Estimates of GDP ("2nd QE")* for the Jul-Sep quarter of 2006 revealed that Japan's real GDP grew 0.2% q-o-q (0.8% q-o-q p.a.) in a downward revision from 0.5% q-o-q (2.0% q-o-q p.a.) in the *First Preliminary Quarterly Estimates of GDP* (**Chart 2**). The downward revision of personal consumption, capital investment and inventory investment is a clearer indication of sluggish economic growth - mainly domestic private-sector demand - over the summer months.

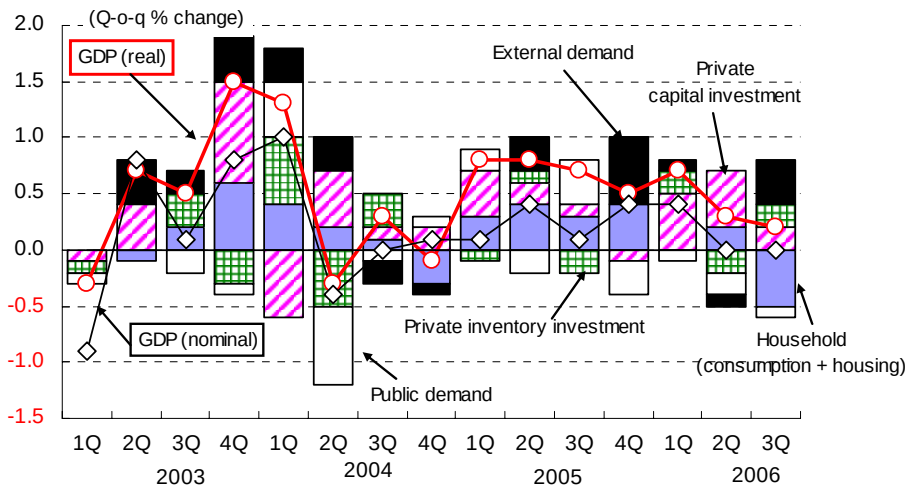
Domestic demand components were all revised downward

Looking closer, all components of domestic private demand were revised downward: personal consumption (*1st QE* -0.7% → *2nd QE* -0.9%), housing investment (*1st QE* 0.1% q-o-q → *2nd QE* -0.3% q-o-q), capital investment (*1st QE* 2.9% q-o-q → *2nd QE* 1.5% q-o-q), private-sector inventory investment (contribution to growth *1st QE* 0.3% pt q-o-q → *2nd QE* 0.2% pt q-o-q). As a result, the contribution to quarterly real GDP growth was revised down sharply from 0.3% pt in the 1st QE to -0.1% pt. On the other hand, public investment (*1st QE* -6.7% q-o-q → *2nd QE* -5.3% q-o-q) and government expenditures (*1st QE* % 0.1%q-o-q → *2nd QE* 0.7% q-o-q) were revised upward, resulting in an upward revision of the contribution by public demand from -0.3% pt to -0.1% pt. The contribution to growth by external demand remained unchanged from the *1st QE* at 0.4% pt, given the

The GDP deflator was revised upward by 0.1% pt

The GDP deflator, a broad measure of price changes, was revised upward by 0.1% pt to -0.7% over a year ago (o-y-a) from -0.8% o-y-a in the *1st QE*. The domestic demand deflator was also revised up from 0.1% o-y-a to 0.2% o-y-a, inching into positive territory.

[Chart 2: Japan's quarterly GDP growth]



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

A smaller carry-over due to revised estimates for FY2005

As a result of the annual revision of GDP data regarding FY2005 (the "revised estimates"), the rate of growth in FY2005 was revised down from the previously estimated 3.3% to 2.4%. Furthermore, given changes in seasonal adjustments also conducted at the same time, the carry-over from FY2005 to FY2006 shrank 0.3% pt from 1.3% to 1.0%. Moreover, growth in FY2006 has also been revised downward, making the achievement of the Cabinet Office outlook (2.1%) extremely difficult: Apr-Jun quarter of 2006 (1.5% q-o-q p.a. → 1.1% q-o-q p.a.), Jul-Sep quarter of 2006 (2.0% q-o-q p.a. → 0.8% q-o-q p.a.).

Corporate business performance remains strong

Despite the sluggish growth of the economy over the summer months, corporate business performance continued to fare well. Ordinary profits (based upon the *Financial Statements Statistics of Corporations by Industry*) grew 15.5% y-o-y in the Jul-Sep quarter (10.1% y-o-y in the previous quarter), continuing to grow at a double-digit pace. The factor decomposition chart (**Chart 3**) reveals that downward pressures upon ordinary profits stemming from variable costs such as raw material costs are ebbing along with the gradual increase of downward pressures upon profits due to fixed costs such as labor costs. Note that crude oil and non-ferrous metal prices peaked during the summer months and that the successful shift of costs to prices among materials industries served as a factor behind the improvement of their profit rate. In processing industries, foreign exchange gains from the weak yen served to absorb the higher raw material and energy costs. Looking at Japan's overall corporate sector, the rise of variable costs came to a halt, leading to the rise of profits.

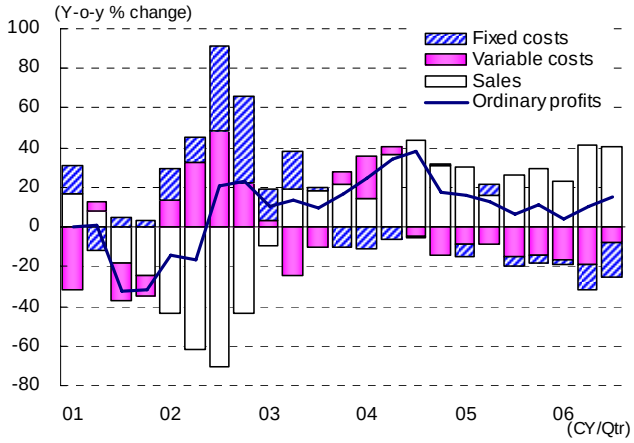
Manufacturers – mainly in the automobile and IT-related sectors – are stepping up production in the Oct-Dec quarter

Note also that it now appears likely that production activity will continue to rise in the Oct-Dec quarter. The industrial production index rose 1.6% m-o-m in October (-0.7% m-o-m in the previous month), surpassing prior expectations (forecast index: -0.2%). Given the upward revision of November production plans, industrial production in the Oct-Dec quarter should grow a dramatic 3.7% q-o-q (**Chart 4**) as long as output among manufacturers match the forecast indexes in November and December (2.7% m-o-m, 0.1% m-o-m). The drivers are the automobiles and electronic parts & devices industries, which are both expected to boost production around 7% q-o-q on the basis of calculations based upon the forecast indexes. In addition to brisk car sales in overseas markets such as the US, the increase of output accompanying the introduction of new models are the likely contributors. The boost in production in the electronic parts & devices industry most likely stems from the rise in production to cope with new mobile telephone models, new game consoles and digital consumer electronics targeted at the year-end shopping season.

Prior to release of the *Indices of Industrial Production (Preliminary)* in October, MHRI had predicted that industrial production would flatten out in the Oct-Dec quarter and that the economy would fall into a lull since the forecast indexes for October and November turned out to be virtually flat from the previous month..

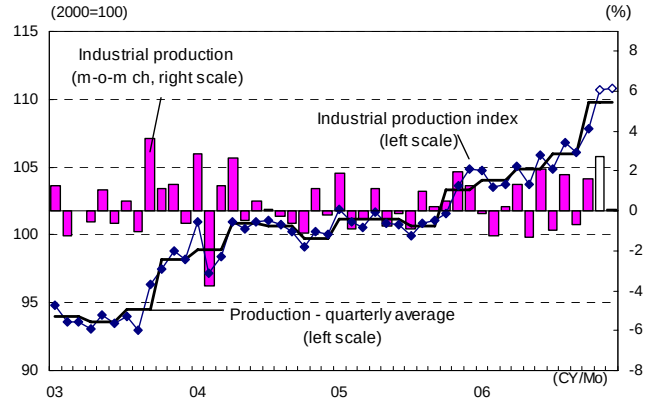
However, a lull in the Oct-Dec quarter is no longer likely given the sharp upward revision of production plans mainly in IT-related sectors.

[Chart 3: Ordinary profits]



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

[Chart 14: Industrial production]



Note: Figures regarding November and December are estimates based upon forecast indexes.
Sources: Ministry of Economy, Trade and Industry, *Indices of Industrial Production, Survey of Production Forecast.*

(2) Forecast of the Japanese economy in FY2006 and FY2007

The Japanese economy is picking up in the Oct-Dec quarter of 2006, driven mainly by personal consumption

The Japanese economy gauged in terms of real GDP is gathering momentum in the Oct-Dec quarter of 2006, driven mainly by personal consumption. Even though sluggish wage growth and unseasonable weather conditions had served as a damper upon consumer spending during the summer months, the rise of year-end bonus payments reflecting strong corporate performance lead to our view that personal consumption will pick up toward the end of the year. Despite the seemingly weak sales of winter clothing thus far given the warm weather during the month of October, the positive effect of the income gains should start to emerge toward the year-end shopping season. Likewise, capital investment is predicted to keep growing albeit at a slower pace of quarterly growth because of the high level of spending in the first half of the year. In the Oct-Dec quarter, Japan's economy is set to grow around 2~3% q-o-q p.a. driven mainly by domestic private sector demand.

A slip into the third lull after the turn of the New Year

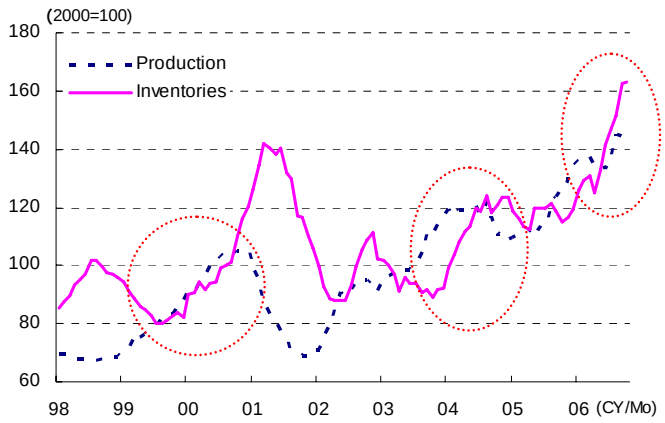
That said, the Japanese economy will likely slip into a lull for the third time in the current expansion due to an inevitable slowdown from the Jan-Mar quarter of 2007 because of the slowdown of overseas economies and inventory adjustment in IT-related industries. In the US, the odds are high that the housing market downturn will continue and IT-related demand will wane after the Christmas shopping season. Domestic investment in China will continue to weaken, given the Chinese authorities' measures to rein in investment. The euro zone economy is also predicted to slow, due to the impact of the German VAT hike. The foregoing leads to our view that the slowdown of exports will become more definite as the New Year progresses. Note also that the current aggressive

production of electronic parts & devices is leading to a sharper rise of inventories than the period just prior to the collapse of the IT Bubble at the end of 2000 and the Athens Olympic Games in 2004. (**Chart 5**). Manufacturers will be faced with the need to adjust output amid weak demand after the year-end Christmas shopping season. Furthermore, corporate earnings growth will weaken due to the impact of slower export growth and IT-related inventory adjustment, leading to the slowdown of capital investment.

The domestic demand deflator will rise into positive territory for the first time in nine years

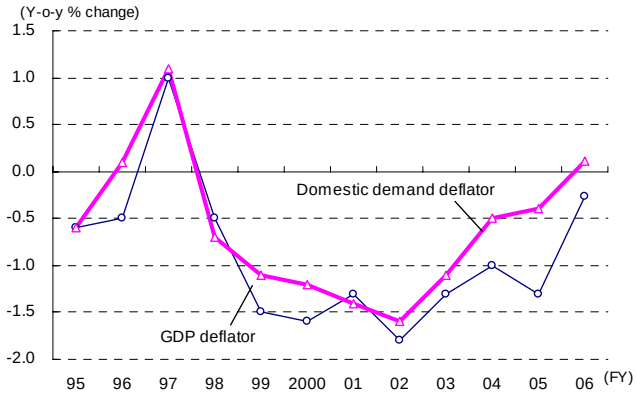
Judging from the foregoing, we expect full-year GDP growth in FY2006 to stand at 1.9% in real terms (previous forecast: 2.3%) and 1.6% in nominal terms (previous forecast: 1.8%), falling below the rate of growth in real terms in FY2005 (2.4%). Although the FY2006 GDP deflator is estimated to fall (-0.3% y-o-y), contracting for the eighth year in a row, this is due to the sharp rise of the import deflator. The domestic demand deflator is predicted to rise 0.1%, in an upturn for the first time in nine years since FY1997 (**Chart 6**). We have held the view that that Japan's economy has already emerged out of deflation due to reasons including the upturn of the output gap into positive territory. The rise of the domestic demand deflator into positive territory provides further evidence to back our views.

[Chart 5: Production and inventories in the electronics parts & devices industry]



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

[Chart 6: The GDP deflator and the domestic demand deflator]



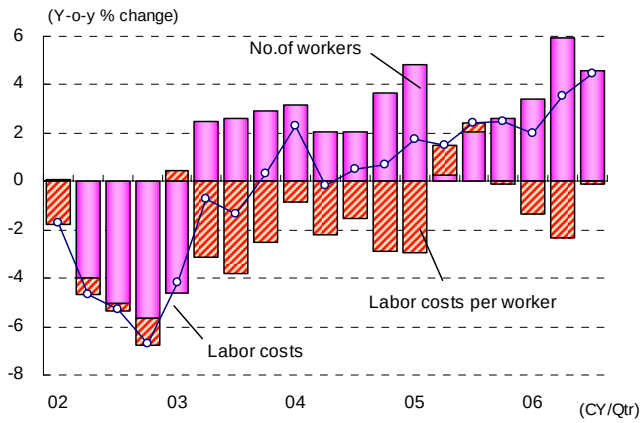
Note: FY2006 is based upon MHRI forecasts.
Source: Cabinet Office, *Annual Report on National Accounts.*

The economy will regain momentum in the second half of FY2007

Growth is predicted to weaken in the first half of FY2007, given the effect of the overseas economic slowdown lingering from the second half of FY2006. The rise of fixed costs such as labor and financial costs will start to exert pressures upon corporate earnings. As of the Jul-Sep quarter of 2006, labor costs (based upon the *Financial Statements Statistics of Corporations*) among businesses rose 4.4% y-o-y, indicating an upward trend, stemming primarily from the increase of workers (**Chart 7**). Looking forward, labor costs should continue to rise given the gradual rise of wages amid the persistent shortage of labor. In the first half of FY2007, the rate of earnings growth should decline, given the slower pace of earnings growth stemming from the slowdown of exports. MHRI forecasts that

ordinary profits will stand at 4.8% y-o-y in FY2007, slowing down from 9.1% y-o-y in FY2006 (**Chart 8**). Capital investment is also expected to weaken due to the slower growth of earnings (cash flow).

[Chart 7: Labor costs]



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

[Chart 8: Corporate earnings forecast]

(%)

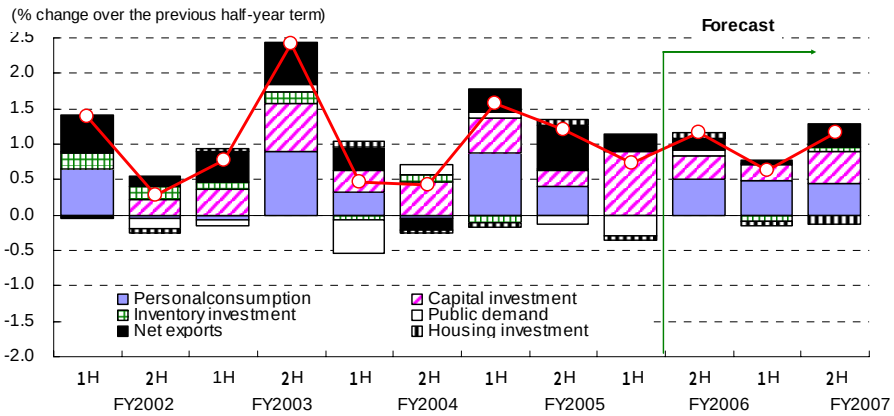
		FY2004	FY2005	FY2006 (Forecast)	FY2007 (Forecast)
Total	Sales	5.6	4.6	6.1	3.5
	Ordinary profits	24.6	8.4	9.1	4.8
Manufacturing	Sales	5.3	6.1	4.7	3.0
	Ordinary profits	28.3	12.4	10.5	4.6
Non-manufacturing	Sales	5.7	3.9	6.7	3.8
	Ordinary profits	22.2	5.7	8.2	5.0
Large corporations	Sales	5.8	6.5	5.7	3.9
	Ordinary profits	24.8	13.9	12.5	5.7
Manufacturing	Sales	5.5	7.1	6.1	3.3
	Ordinary profits	26.6	14.7	12.7	5.1
Non-manufacturing	Sales	6.0	6.0	5.3	4.2
	Ordinary profits	22.8	13.0	12.4	6.3
Small and medium-sized corporations	Sales	5.4	3.2	6.4	3.3
	Ordinary profits	24.5	2.4	5.0	3.7

Note: "Large corporations" refer to corporations with capital of 1 billion yen or over, "medium-sized corporations" refer to corporations with capital of 100 million to 1 billion yen, "small corporations" refer to corporations with capital of 10 to 100 million yen.
Source: Ministry of Finance, *Financial Statement Statistics of Corporations, Quarterly.*

However, the chances are slim that the slowdown from the end of FY2006 to the first half of FY2007 will lead to a serious slump (a recession). In the US, where rate of growth is declining, consumer spending remains strong with no signs of the housing market downturn spreading to other sectors. Even with respect to the negative impact of the VAT expected in Germany, the effect should fade away in matter of months. A sharp fall of domestic investment is unlikely in China in view of the scheduled Olympic games in Beijing. Judging from the above, we do not expect a significant decline of exports from Japan. Furthermore, the inventory adjustment in the IT and digital electronics sector should turn out benign given the ongoing strong demand for mobile telephones and digital consumer electronics. Note also that personal consumption is expected to remain on solid footing and underpin the economy, amid the gradual improvement of employment and income.

In the second half of FY2007, when the overseas economies such as the US are predicted to regain momentum and the IT-related sector should reach the end of an inventory adjustment phase, Japan will return to an autonomous growth track driven by the expansion of personal consumption, capital investment and exports (**Chart 9**). As a result, we expect the rate of real GDP growth to grow 1.8% y-o-y in FY2007 (previous forecast: 1.7% y-o-y), maintaining growth around its potential estimated to be the upper end of the 1%-level (**Chart 10**). Furthermore, given the decline of the import deflator due to the fall of crude oil prices amid the rise of consumer prices, the FY2007 GDP deflator is expected to rise into positive territory (0.7% y-o-y) for the first time in a decade since FY1997.

〔 Chart 9: Outlook on real GDP growth (half-year) 〕



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

〔 Chart 10: Outlook on the Japanese economy 〕

(%)

	FY2005 (Actual)	FY2006 (Forecast)	FY2007 (Forecast)	FY2006 1H (Actual)	FY2006 2H (Forecast)	FY2007 1H (Forecast)	FY2007 2H (Forecast)	FY2006 (Contribution) (Forecast)	FY2007 (Contribution) (Forecast)
GDP (real)	2.4	1.9	1.8	0.7	1.2	0.6	1.2	-	-
Domestic demand	1.9	1.3	1.6	0.5	1.0	0.6	0.9	1.3	1.5
Private sector demand	2.4	2.2	1.9	1.1	1.2	0.8	1.1	1.6	1.5
Personal consumption	1.9	0.8	1.8	-0.0	0.9	0.9	0.8	0.4	1.0
Housing investment	-1.0	0.6	-1.8	-1.8	2.6	-1.3	-3.7	0.0	-0.1
Capital investment	5.8	7.6	3.7	5.8	2.0	1.3	2.7	1.2	0.6
Public sector demand	0.4	-1.5	0.4	-1.3	0.4	0.2	0.0	-0.3	0.1
Government consumption	0.9	1.1	1.5	1.0	0.9	0.7	0.7	0.2	0.3
Public investment	-1.4	-11.6	-4.7	-10.3	-2.0	-2.1	-3.3	-0.5	-0.2
Net exports (contribution)	0.6	0.6	0.3	0.2	0.2	0.0	0.3	0.6	0.3
Exports	9.0	7.4	4.3	3.1	1.9	1.4	3.9	1.0	0.6
Imports	6.0	3.8	3.2	2.0	1.0	1.6	2.3	-0.4	-0.4
GDP (nominal)	1.0	1.6	2.5	0.2	2.0	0.6	1.9		
GDP deflator	-1.4	-0.3	0.7	-0.9	0.2	0.8	0.6		
Industrial production	1.6	4.4	2.8	1.6	2.5	0.6	2.2		
Unemployment rate	4.4	4.0	3.7	4.1	4.0	3.8	3.6		
Current account balance (trillion yen)	19.1	21.5	25.7	18.1	24.2	22.8	28.0		
as a percentage of nominal GDP	3.8	4.2	4.9	3.6	4.7	4.4	5.3		
Corporate goods prices	2.1	2.9	0.9	3.3	2.6	1.2	0.5		
Consumer prices	-0.1	0.2	0.4	0.1	0.3	0.4	0.4		
Long-erm interest rate (%)	1.42	1.75	2.00	1.80	1.70	1.90	2.05		
Nikkei stock average (yen)	13,549	16,200	17,100	15,900	16,500	16,900	17,300		
Exchange rate (yen/dollar)	113.2	115	112	115	115	112	112		
Crude oil price (WTI $/barrel)	60.0	65.9	53.7	70.6	61.1	53.7	53.6		

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

Sources: Cabinet Office, *Annual Report on National Accounts* , Ministry of Economy, Trade and Industry, *Indices of Industrial Production,*, 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.*

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