

Economic Outlook for FY2007 and FY2008

August 2007

The Mizuho Research Institute Ltd. (MHRI) has revised its economic outlook for FY2007 and FY2008 subsequent to the release of Japan's GDP statistics for the Apr-Jun quarter of 2007. The key points of the outlook are as follows.

<The US Economy>

The economy will continue to slow down due to spillovers from the housing market correction

2007 2.0% (previous outlook) → 1.9% (current outlook)

2008 2.4% (previous outlook) → 2.4% (current outlook)

<The Japanese Economy>

FY2007 Industrial production and personal consumption will start to pick up in the second half of FY2007

Real GDP: 2.1% (previous outlook) → 2.1% (current outlook)

Nominal GDP: 1.9% (previous outlook) → 2.0% (current outlook)

FY2008 Continuation of a self-sustained recovery

Reversal of nominal GDP and real GDP normalized for the first time in 11 years

Real GDP: 2.1% (previous outlook) → 2.1% (current outlook)

Nominal GDP: 2.7% → 2.6% (current outlook)

This English-language translation is based upon the outlook in Japanese released on August 15, 2007. 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. Although this publication is compiled on the basis of sources which we believe to be reliable and correct, Mizuho Research Institute does not warrant its accuracy and certainty. Readers are requested to exercise their own judgment in the use of this publication. Please also note that the contents of this publication may be subject to change without prior notice.

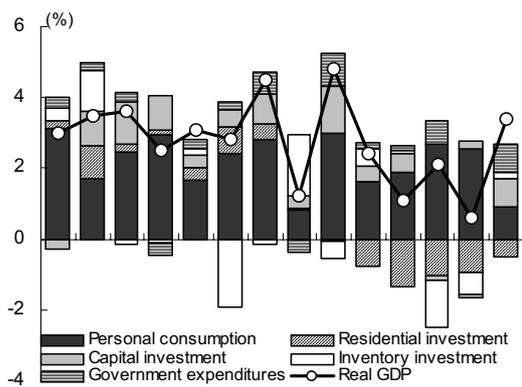
I. The current state of the US economy

The US economy staged a dramatic recovery in the Apr-Jun quarter of 2007, driven by external demand, capital investment and government expenditures. However, domestic demand is still slowing down

US gross domestic product (GDP) in real terms grew 3.4% q-o-q p.a. in the Apr-Jun quarter of 2007 (“advance” estimates as of July 27th), in a dramatic recovery from the previous quarter (0.6% q-o-q p.a.) (**Chart 1**). In addition to the strong growth of business capital investment (8.1% q-o-q p.a.) and government expenditures (4.2% q-o-q p.a.), the contribution to growth by external demand rose to 1.18% pt as a result of export growth (6.4% q-o-q p.a.) and decline of imports (-2.6% q-o-q p.a.). The downturn of residential investment has also abated somewhat. Nevertheless, the weak growth of domestic final demand (falling short of 2%) indicates that the US economy is slowing down.

Judging from the subsequent data releases since the advance estimates (the June results of various indicators and revised data on April and May), the odds are high that the preliminary real GDP estimates (to be released on August 30th) will be revised dramatically upward to over 4% q-o-q p.a., as a result of an upward revision of personal consumption, nonresidential investment, inventory investment, local government expenditures and net exports.

[Chart 1: US real GDP growth]



Note: Q-o-q % change, p.a. The bars represent the contribution to the line.

Source: US Department of Commerce.

Q-o-q % ch, p.a.	2007.Q2	Contribution	2007.Q1
Real GDP	+3.4	—	+0.6
Personal consumption	+1.3	+0.89	+3.7
Residential investment	-9.3	-0.49	-16.3
Capital investment	+8.1	+0.83	+2.1
Inventory investment	+3.6	+0.15	+0.1
Net exports	-577.9	+1.18	-612.1
Exports	+6.4	+0.73	+1.1
Imports	-2.6	+0.45	+3.9
Government expenditures	+4.2	+0.82	-0.5
Domestic final demand	+1.9	—	+1.7
GDP deflator	+2.7	—	+4.2

Note: The q-o-q % change (p.a.) of inventory investment and net exports are expressed as the level (unit: billion dollar).

Source: US Department of Commerce.

The corporate sector recovery is coming to a pause and consumer spending is also stalling. Payrolls are set to slow down despite the current uptick due to the housing sector's slow response in shedding excess workers

Looking closer at the US economy, the corporate sector recovery is coming to a pause and personal consumption is stalling. In addition to the persistent supply glut in the housing market, the financial market – mainly the credit market – is destabilizing, triggered by the subprime mortgage loan crisis.

Meanwhile, jobs and income conditions are still favorable, with exports riding on the tailwinds of the expanding overseas economies. In particular, employment in housing-related sectors (construction, housing sales and finance) remains unexpectedly strong, suggesting these sectors' slow response in shedding excess workers. However, housing-related employment should gradually slow down, based on forecasts that overall domestic demand will continue to slow down.

The US economy will continue to slow down until mid-2008

Our view on the US economy remains unchanged from our previous outlook (released on May 21, 2007) that “a full-fledged recovery will be delayed due to spillovers from the housing market correction.”

In the second half of 2007, residential investment will be poised to slow down again given the tepid demand for new homes and pressures to reduce inventories. Furthermore, as a result of additional downward pressures – the destabilization of the financial market and the tightening of credit – we expect the US economy to keep slowing down through a cool-down of personal consumption and capital investment. It will be necessary to keep a close eye on the corporate sector, given the possibility of that it might soften again subsequent to driving the recovery in the Apr-Jun quarter. During the period from mid-2006 to early 2007, the corporate sector grew cautious reflecting the rise of future uncertainties, leading to the slowdown of production activity and orders. There is a considerable chance of the corporate sector falling into a similar state in the second half of 2007.

The downturn of residential investment and mortgage loans and the accompanying instability of the financial market should persist in the first half of 2008. It will be some time in the second half of 2008 that the US economy starts to show signs of recovery when the residential investment correction comes to a pause.

US growth in 2007 revised down to 1.9% to reflect statistical revisions. No changes to 2008 growth forecast

Simultaneously with the release of US GDP statistics for the Apr-Jun quarter, the estimates of real GDP from 2004 to 2006 have been revised downward. Given a smaller carry-over of growth to 2007 accompanying the downward revision, we have revised down our forecast on US real GDP growth in 2007 from 2.0% to 1.9% in this *Economic Outlook for FY2007 and FY2008* (the “Outlook”). Meanwhile, we have kept our forecast on growth in FY2008 unchanged at 2.4% (Chart 2).

[Chart 2: Outlook on the US economy]

	2006 (Actual)	2007 (Forecast)	2008 (Forecast)	2006		2007 (Forecast)		2008 (Forecast)	
				1H	2H	1H	2H	1H	2H
GDP	2.9	1.9	2.4	3.3	1.7	1.7	2.4	2.4	2.6
Personal consumption	3.1	2.7	2.2	3.1	2.9	3.1	1.4	2.5	2.3
Residential investment	-4.6	-15.4	-12.2	-3.3	-17.5	-14.9	-14.3	-14.8	-4.4
Capital investment	6.6	3.1	3.4	8.5	3.2	2.7	4.0	2.7	4.0
Inventory investment (\$100 million)	403	47	41	449	357	19	75	-12	93
Government expenditures	1.8	1.9	2.9	2.2	1.5	1.7	2.9	2.9	3.0
Net exports (\$100 million)	-6,245	-5,658	-5,060	-6,334	-6,156	-5,950	-5,366	-5,036	-5,084
Exports	8.4	6.5	7.1	9.8	7.8	5.6	7.0	7.9	5.7
Imports	5.9	1.3	2.0	7.6	3.3	1.6	-1.2	2.2	4.7
Domestic final demand	2.7	1.6	1.8	3.1	1.5	1.8	1.3	1.9	2.4
Core personal expenditures deflator <y-o-y ch>	2.2	2.0	1.9	2.1	2.3	2.2	1.9	1.8	1.9
Current account balance (\$100 million)	-8,115	-7,306	-6,445	-4,062	-4,053	-3,832	-3,474	-3,222	-3,222
<as a percentage of nominal GDP>	-6.2	-5.3	-4.4	-6.2	-6.1	-5.6	-4.9	-4.5	-4.4

(%)

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 of Labor.

Slow adjustment of housing-related labor. However, the necessity to slash housing starts will lead to increased pressures to reduce excess labor

Firstly, a note of mention is necessary that the current US economic trends differ greatly from the state of the economy assumed in our previous *Outlook*. In contrast to our previous assumption, the housing-related sectors are still behind in shedding excess workers. Despite the sharp fall of residential investment, layoffs have been relatively benign in the housing-related sectors. Even though payrolls in the housing-related sectors continued to decline in June (-16.5 thousand workers m-o-m), the drop is still smaller than the peak in November last year (-39.6 thousand workers m-o-m). Payrolls in the housing-related sectors refer to total payrolls in the following sectors combined: residential construction, residential furnishings, manufacturers and retailers of furniture, retailers of construction materials and financial institutions dealing with mortgage loans. In particular, note that the residential construction and the residential furnishings sector are taking time in the adjustment of excess labor. The residential construction sector is estimated to have more than 600 thousand excess workers, resulting in a sharp deterioration of productivity.

However, considering that a sharp decline of housing starts appears inevitable, labor market conditions in the housing-related sectors is expected to worsen.

As of June, the inventory ratio of new homes was pinned at a high level of 7.8 months worth of inventories. Assuming the average inventory ratio (4.1 months) during the period from 1997 to 2004 (a period during which the inventory ratio was stable) as the appropriate level of inventories, **Chart 3** sets forth a simulation on the time necessary for the inventory ratio to fall to the appropriate level. Case ① represents an optimistic scenario where the housing market downturn will come to an end by the end of 2007 (the inventory ratio reaches the level in the Jan-Mar quarter of 2008). For events to unfold in accordance to this scenario, there would have to be an unrealistically strong recovery of residential sales (with the level of housing starts flat) or a sharp reduction of housing starts (with the level of residential sales flat). Even though the possibility of the latter may not be ruled out entirely, such an event would mean that domestic demand would fall below 1% and that the US economy would move dangerously close to the brink of recession. The optimistic scenario of a housing market recovery by the end of this year is unrealistic. Given the rise of risks of a slide into recession, a more apt description of this scenario would be “pessimistic”.

More likely scenarios would be Case ② where housing starts drop amid flat residential sales and Case ③ where both residential sales and housing starts gradually decline. In both cases, inventory ratios would return to the appropriate level and more sanguine signs would start to emerge in the housing market some time around the Apr-Jun quarter to the Jul-Sep quarter of 2008.

Even though the residential investment downturn alleviated in the Apr-Jun quarter, the alleviation is most likely temporary, given prospects that the pace of

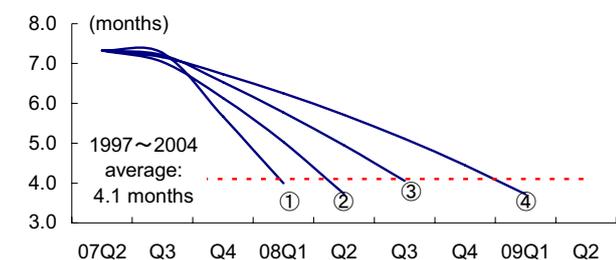
Given its deep-rooted nature, the odds are high that the subprime mortgage crisis will continue to smolder as a destabilizing factor in the financial markets

residential investment downturn will speed up again. Full-fledged layoffs in the housing-related sectors are also expected ahead.

Amid the adjustment of housing inventories, the mortgage loan crisis will worsen and keep smoldering as a destabilizing factor in the financial markets.

Lenders of subprime mortgages (mortgages toward borrowers with weak credit conditions) continued to provide mortgages even during the period from the Oct-Dec quarter of 2005 to the end of 2006 when the housing market fell into a correction. The total amount of subprime mortgages is estimated to reach \$560 billion, the majority of which are loans referred to as 2/1ARM (mortgages in which preferential interest rates are applied for the initial two years and are reset to variable interest rates from the third year onward) of a speculative or investment nature (**Chart 4**). When these loans reach the point in time when the terms of payment are reset from the Jul-Sep quarter of 2007, the rise of delinquencies and foreclosures accompanying the reset appear inevitable. While it is unclear how much of these mortgages (\$23 billion per month in terms of 2/1ARM to \$35 billion per month in the event all the subprime mortgages are reset) will turn out to be nonperforming, the recent financial market destabilization and tightening of credit appear to be a mere introductory chapter of the crisis.

[Chart 3: Simulations on housing inventory ratios]



- ① Recovery by the end of 2007 (Housing starts flat and sales up 64%, or flat sales and housing starts down 34%)
- ② Flat sales and sharp fall of housing starts (-20%)
- ③ Mild correction (sales up 5% and housing starts down 5%)
- ④ Prolonged correction (both sales and construction starts fall 10%)

Note: The percentage change of sales and housing starts are q-o-q p.a.

Source: Mizuho Research Institute Ltd. (MHIRI).

[Chart 4: Subprime mortgages subject to resets]

	Subprime loans		of which are 2/1 ARM	
	New loans	Share	Share	Reset
05Q4	\$138.9B	39%	64%	07Q3
06Q1	108.0	34%	70%	07Q4
06Q2	121.1	28%	70%	08Q1
06Q3	98.3	25%	62%	08Q2
06Q4	99.0	31%	61%	08Q3
Total	\$565.3B			\$370.6B

Note: The share of subprime loans refers to the percentage in mortgages (for purchase of homes) during the relevant period. The share of 2/1ARM refers to the percentage in subprime loans.

Sources: Standard & Poor's, Mortgage Bankers Association.

Concerns regarding a sharp slowdown of corporate activity

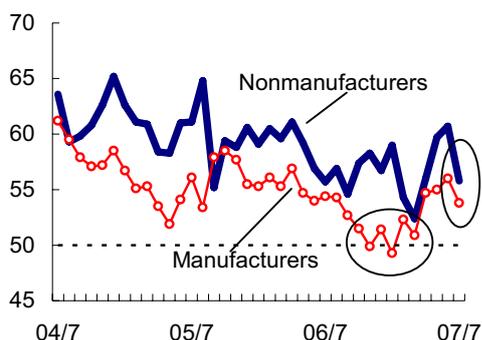
Considering that the problems surrounding the housing market will continue to cast doubts regarding the future, the stagnation of corporate activity is a source of concern.

The US corporate sector unexpectedly fell into a lull from the second half of 2006 to the first half of 2007 despite its strong earnings results and sound balance sheets. The Federal Open Market Committee (FOMC) at the time revealed that one of the downside risks to the economy along with the housing market was a stronger wait-and-see stance in the corporate sector. The corporate sector's cautious stance stems most likely from the housing market's fall into a correction and the rise of the subprime mortgage problem.

Considering that the current state of the US economy resembles the foregoing conditions, the possibility of corporations turning cautious again may not be ruled out.

The corporate sector recovery is already showing signs of a temporary pause. Corporate capital investment and production activity is expected to slow down in the second half of 2007. Even though both the ISM manufacturing and nonmanufacturing indexes remained high in July, they are still headed downward (**Chart 5**). Orders and shipments of capital goods (ex defense and aircraft) remain flat as of May. Capital investment appears to be headed for a slowdown from the perspective of the stock cycle and is unlikely to sustain the strong growth in the Apr-Jun quarter. Furthermore, despite signs of progress in reducing inventories, production activity is still weak since the manufacturing sector as a whole is still lingering in an adjustment phase. In the event the corporate sector takes a more cautious stance due to uncertainties regarding the future, it is necessary to keep a close eye on the possibility of the rise of downside risks which may not be disregarded by the US economy or the FOMC.

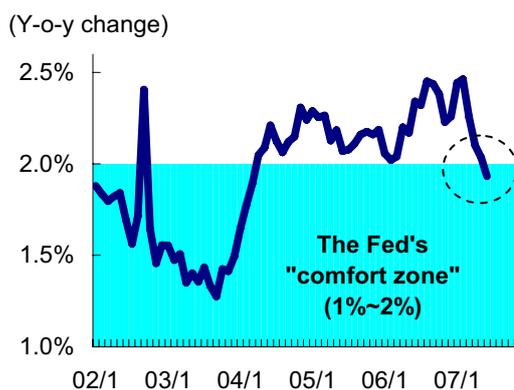
[Chart 5: ISM Indexes]



Note: A reading over 50 indicates an improvement from the previous month and a reading up to 50 indicates a deterioration from the previous month. Refers to business conditions among manufacturers and business confidence among nonmanufacturers.

Source: Institute of Supply Management (ISM).

[Chart 6: The core inflation rate]



Source: US Department of Commerce.

Core inflation should hover around the upper end of the price stability zone. A further dip expected some time after the turn of the year in 2008

Amid prospects of an ongoing economic downturn, the core inflation rate is predicted to move around the upper end of the price stability zone (1%~2%). It will be sometime after the turn of the year in 2008 that the core inflation rate starts to follow a gradual downward curve.

Price movements are stabilizing in comparison to the past. In June, the year-on-year percentage change of the core personal consumption expenditure (PCE) deflator fell to 1.9% y-o-y (**Chart 6**). However, in terms of monthly trends, the core PCE deflator continued to rise gradually at the 0.1%-level for the fourth consecutive month. In the backdrop to this trend, note the price falls of clothing items and the stabilization of prices related to medical services and housing rent.

Meanwhile, there are still reasons to be concerned from the perspective of inflationary pressures. For example, even though unemployment inched up 0.1% pt m-o-m to 4.6% in June, the unemployment rate is still lingering at a low level, and the unit labor cost (nonfarm sector) rose a dramatic 4.5% y-o-y in the Apr-Jun quarter. The FOMC on August 7th said in its statement that while the downside risks to growth have increased somewhat, a sustained moderation in inflation pressures has yet to be convincingly demonstrated, and therefore that the FOMC's predominant policy concern remains the risk that inflation will fail to moderate as expected.

MHRI's outlook forecasts that the core inflation rate will continue to hover around 2% y-o-y for the time being, amid the relaxation of the output gap. That said, the core inflation rate will most likely start to fall after the turn of the year in 2008 reflecting the further relaxation of the output gap amid the ongoing slowdown of the US economy.

II. The Japanese economy

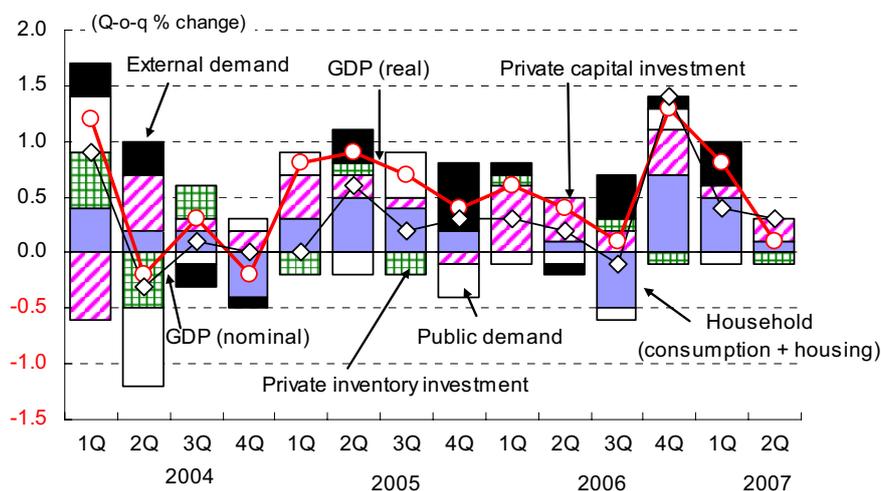
(1) The current state of the economy

The Japanese economy slowed to 0.1% q-o-q (0.5% q-o-q p.a.) in the Apr-Jun quarter of 2007

Japan's real GDP grew 0.1% q-o-q (0.5% q-o-q p.a.) in the Apr-Jun quarter of 2007, falling below the potential growth rate estimated to be slightly below 2% for the first time in three quarters (**Chart 7**). Personal consumption slowed down from the previous quarter and the contribution by external demand fell to zero, serving as a drag upon Japan's economic growth.

Looking closer at each of the components of demand, personal consumption (0.4% q-o-q) slowed down from the Jan-Mar quarter of 2006 (0.8% q-o-q). Capital investment, the second pillar of domestic private demand, grew 1.2% q-o-q, picking up from the previous quarter. However, given the sharp fall of residential investment (-3.5% q-o-q) and contribution to quarterly growth by private inventory investment (-0.1% pt), the contribution by domestic private demand stood at a mere 0.1% pt. On the other hand, the contribution by external demand fell to zero as a result of the slowdown of exports (0.9% q-o-q) to a level on par with imports (0.8% q-o-q). The foregoing reveals the stagnation of the Japanese economy due to the flat growth of both domestic and external demand in the Apr-Jun quarter. Even so, the fact that the twin pillars of private demand – personal consumption and capital investment – continued to grow and kept the economy in expansion mode for the tenth quarter in a row, illustrates the strength of the Japanese economy in the current expansion.

[Chart 7: Japan's quarterly GDP growth]



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

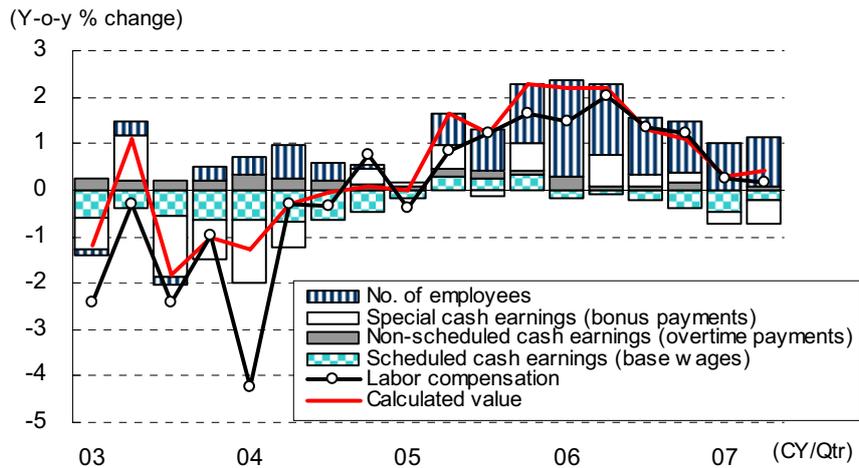
The domestic demand deflator rose for the first time in three quarters

Although the GDP deflator, a broad measure of price changes, stood in negative territory (-0.3% y-o-y), the domestic demand deflator rose into positive territory (0.2% y-o-y) for the first time in three quarters. In addition to the contraction of the negative breadth of the personal consumption deflator, both the capital investment deflator and the public investment deflator rose higher into positive territory reflecting the rise of raw material prices.

Labor compensation remained weak

According to data on labor compensation released simultaneously with the GDP statistics, labor compensation continued to slow down, declining to 0.2% y-o-y in the Apr-Jun quarter, from 0.3% y-o-y in the Jan-Mar quarter (**Chart 8**). This stems from the persistent decline of nominal wages despite the ongoing rise in number of employees at a rate of approximately 1% y-o-y. Despite the solid growth of personal consumption in the Apr-Jun quarter, the sluggish rise of labor compensation and the rise of the local inhabitants tax will serve as a drag upon disposable income in the Jul-Sep quarter. There are substantial downside risks to personal consumption over the summer months.

[Chart 8: Labor compensation]



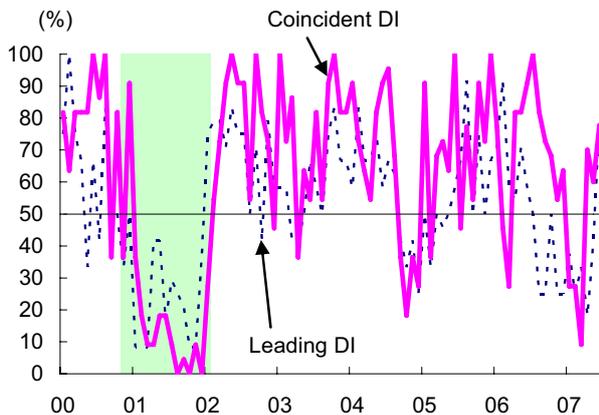
Note: Calculated value = nominal wages x no. of employees. The bars represent the contribution to the line.

Sources: Ministry of Health, Labor and Welfare, *Monthly Labor Survey*, Ministry of Internal Affairs and Communications, *Labor Force Survey*, Cabinet Office, *National Accounts*.

The economy stood in a temporary lull in the Apr-Jun quarter

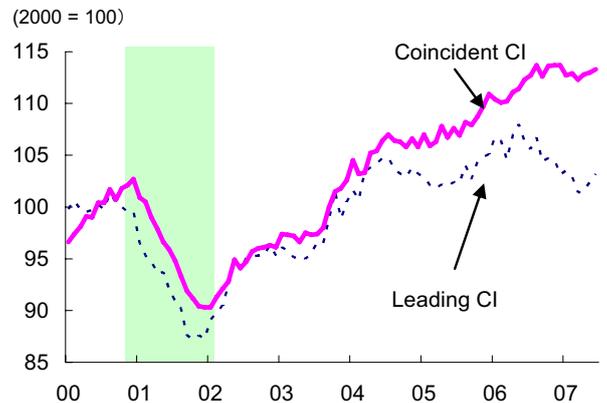
Judging from the *Indexes of Business Conditions*, the Japanese economy remained in a “temporary lull” for two consecutive quarters in the Jan-Mar and Apr-Jun quarters. Even though the diffusion index (DI) of coincident indicators fell below the boom-or-bust threshold of 50% for three months in a row up to March, the coincident DI surpassed 50% for three consecutive months in the Apr-Jun quarter

[Chart 9: Diffusion Index of business indicators]



Source: Cabinet Office, *Indexes of Business Conditions*.

[Chart 10: Composite Index of business indicators]



Source: Cabinet Office, *Indexes of Business Conditions*.

The Chuetsu-oki Earthquake disrupted car production

(Chart 9). Furthermore, the leading DI rose above 50% for the first time in a year, showing signs of improvement. However, the composite index (CI) of coincident indicators – gauging the level of the economy – stood at 113.3 in June, falling below the past peak last December (113.7) (Chart 10). The *Indexes of Business Conditions* tells the story that “even though the economy picked up in the Apr-Jun quarter, the pace of recovery is still slow and that the peak of the current recovery cycle is still December last year.”

The 2007 Niigataken Chuetsu-oki Earthquake (“Chuetsu-oki Earthquake”) which hit the Niigata prefecture on July 16th should serve as drag upon automobile production in July. Furthermore, the spread of harmful rumors resulting in the drop of tourists to the region is a serious blow to the regional economy. However, the drop in July may be covered to some extent by boosting production in August onward. Furthermore, the budget outlays for disaster contingencies and reserves in the FY2007 initial budget should be able to cover the demands for reconstruction and recovery for the time being. We are thus inclined toward the view that the Chuetsu-oki Earthquake will only have a benign impact upon the Japanese economy as a whole.

The results of the Upper House election will not have a major impact upon MHRI’s forecast scenario

The Liberal Democratic Party (LDP) suffered a crushing defeat in the Upper House (House of Councilors) election at the end of July, resulting in the opposition party’s majority in the Upper House. In the aftermath, the administration led by Prime Minister Shinzo Abe is expected to face opposition to the passage of various bills in the Diet in addition to current demands for a cabinet reshuffle. Among the issues said to have a large impact upon the future course of the economy, there has been substantial media coverage on the difficulties to raise the consumption tax from FY2009 onward. Since MHRI’s previous *Outlook* stood on the premise that “the consumption tax will not be raised until FY2009”, the recent election results will not have a major impact upon our forecast scenario. If the consumption tax is raised by 2% in FY2009, the rate of GDP growth in FY2008 would be raised 0.5% pt as a result of a rush of last-minute demand before the tax hike.

Although the impact of the US economic slowdown is benign at the moment, the subprime mortgage problem requires close attention

Despite the current sharp fall of Japan’s exports to the US, total exports are still on solid footing since the strong growth of exports to other regions such as China is covering the shortfalls in US-bound exports. However, should the financial market turmoil triggered by the US subprime mortgage problem persist, its impact upon the Japanese economy may not be ignored. Looking forward, the focal point will center upon how the subprime mortgage crisis will affect the real economies of the US and other parts of the world and to what extent it will affect the Japanese economy.

(2) Forecast of the Japanese economy in FY2007 and FY2008

Below-potential growth expected in the Jul-Sep quarter due to stagnant personal consumption

Personal consumption is expected to stall in the Jul-Sep quarter. Amid the tepid rise of labor compensation, many households are suffering from shortfalls in disposable income from the previous year due to the rise of local inhabitant tax burdens. Furthermore, events serving as negative pressures also occurred such as the Chuetsu-oki Earthquake in July and typhoons hitting Japan during the weekends. Although the scorching weather in August may benefit consumer spending to some extent, personal consumption in the Jul-Sep quarter is expected to slow down and flatten out from the previous quarter due to stagnant income growth. As a result, the rate of real GDP growth in the Jul-Sep quarter is predicted to fall short of the potential rate of growth as in the Apr-Jun quarter. The rate of growth in the first half of FY2007 combined with the Apr-Jun quarter is expected to remain around 1.4% p.a. (**Chart 11**).

Production activity will start to pick up from the Jul-Sep quarter

Subsequent to the fall of production for the first time in six quarters in the Jan-Mar quarter (-1.3% q-o-q), industrial production turned out virtually flat in the Apr-Jun quarter (0.2% q-o-q). Even though production – mainly of automobiles – is expected to sag in July due to the Chuetsu-oki Earthquake, industrial production should start to pick up in August. On a quarterly basis, signs of recovery should become more evident from the Jul-Sep quarter, given the progress of IT-related inventory adjustment.

The economy will pick up gradually in the second half of FY2007

In the second half of FY2007, personal consumption should start to grow stronger after emerging out of a soft spot due to the rise of tax burdens over the summer months. In addition to the stable expansion of capital investment, exports should also grow strongly with exports to regions other than the US covering the weakness in US-bound exports. On the supply side, the IT sector will emerge out of an inventory adjustment phase and serve as the driver of industrial production. Japan's economy will gradually recover after emerging out of a temporary lull and reach 2.3% p.a. in the second half of FY2007.

FY2007 real GDP growth: 2.1%

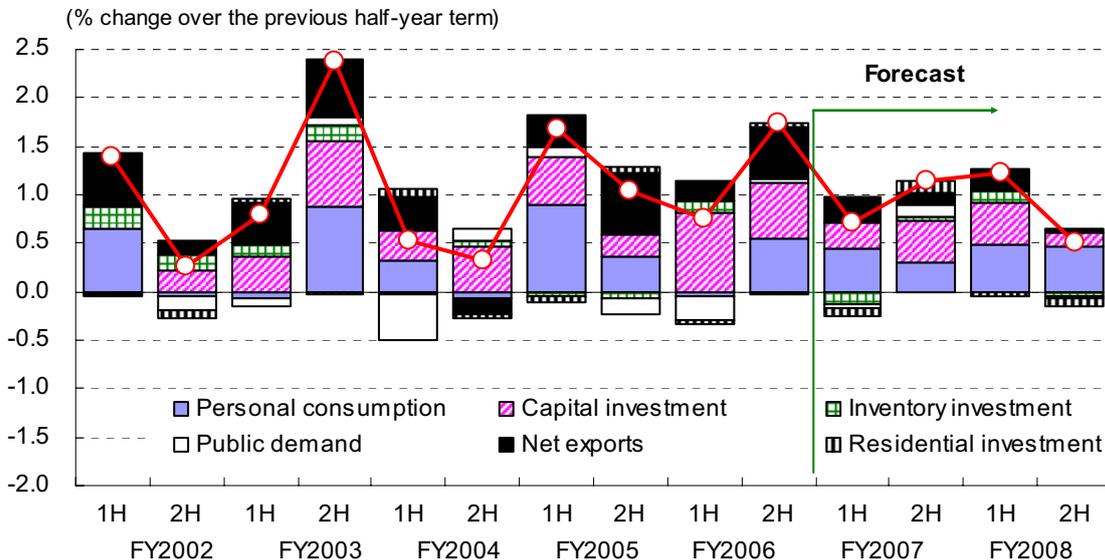
Judging from the foregoing, we expect full-year GDP growth in FY2007 to reach 2.1% in real terms (previous forecast: 2.1%), achieving growth comparable to FY2006. In FY2007, the GDP deflator is predicted to remain in negative territory (-0.1% y-o-y), for the tenth year in a row. As a result, growth in nominal terms is only expected to reach 2.0% (previous forecast: 1.9%), falling below the rate of real economic growth.

1H FY2008: more definite signs of self-sustained recovery

In the first half of FY2008, the Japanese economy is predicted to show more signs of self-sustained recovery, given the rise of personal consumption and capital investment amid the recovery of exports and production activity continuing from the second half of FY2007. The expansion of corporate activity should trickle down to the household sector, albeit at a slow speed, leading to the rise of personal consumption reflecting the recovery of wages and income. Furthermore, business

capital investment should also continue to grow, backed by the corporate sector's strong performance. Given the well-balanced contribution by personal consumption, capital investment and external demand, Japan's real GDP should rise to 2.5% p.a. in the first half of FY2008.

[Chart 11: Forecast on Japan's real GDP growth (half-year basis)]



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

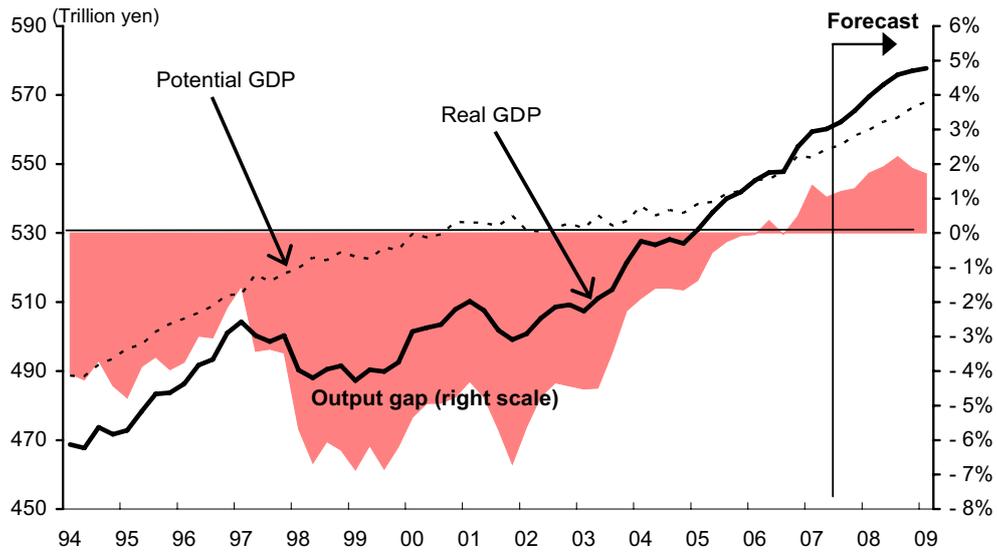
The economy will slow down again in the second half of FY2008

In the second half of FY2008, exports are predicted to soften given the slower pace of China-bound exports due to the slowdown of the Chinese economy after the Beijing Olympic Games. Production activity is also expected to stall over the end of FY2008 and serve as a drag upon the economy again. Although business capital investment should continue to grow, the high level of fixed investment in the manufacturing sector over the past few years should gradually slow down. The rate of real GDP growth in the second half of 2008 should slow sharply to 1.0% p.a. On a full-year basis in FY2008, the economy should continue to grow 2.1% in real terms (previous forecast: 2.1%), expanding at a pace comparable to FY2007. Growth in nominal terms should reach 2.6% (previous forecast: 2.7%), surpassing the rate of growth in real terms for the first time in 11 years.

Price fall risks will gradually ebb as the output gap rises further into positive territory

The output gap (the gap between demand and supply) estimated by MHRI stood at 1.6% as of the Apr-Jun quarter of 2007 (Chart 12). In the first half of FY2008, the positive breadth of the output gap should widen to around 2%, leading to the gradual ebb of price fall risks. The GDP deflator should turn positive, reaching 0.5% y-o-y in FY2008, rising into positive territory for the first time since FY1997.

[Chart 12: The output gap]



Note: Estimates by MHR.

Sources: Cabinet Office, Ministry of Economy, Trade and Industry, Ministry of Internal Affairs and Communications, and others.

【 Chart 13: Outlook on the Japanese economy (fiscal year basis) 】

(%)

	FY2005	FY2006	FY2007	FY2008	FY2005	FY2006	FY2007	FY2008
	(Actual)	(Actual)	(Forecast)	(Forecast)	(Contribution)	(Contribution)	(Contribution)	(Contribution)
	(Actual)	(Actual)	(Forecast)	(Forecast)	(Actual)	(Actual)	(Forecast)	(Forecast)
GDP (real)	2.4	2.1	2.1	2.1	-	-	-	-
Domestic demand	1.9	1.3	1.7	1.9	1.9	1.3	1.6	1.8
Private sector demand	2.4	2.1	2.0	2.3	1.8	1.6	1.5	1.7
Personal consumption	1.9	0.7	1.6	1.6	1.1	0.4	0.9	0.9
Residential investment	-1.0	0.4	0.1	-0.8	-0.0	0.0	0.0	-0.0
Capital investment	5.8	8.0	4.9	4.4	0.8	1.2	0.8	0.7
Public sector demand	0.4	-1.3	0.3	0.4	0.1	-0.3	0.1	0.1
Government consumption	0.9	0.9	0.9	0.8	0.2	0.2	0.2	0.1
Public investment	-1.4	-9.6	-2.3	-1.6	-0.1	-0.4	-0.1	-0.1
Net exports (contribution)	0.6	0.8	0.6	0.3	0.6	0.8	0.6	0.3
Exports	9.0	8.2	6.3	5.6	1.2	1.2	0.9	0.9
Imports	6.0	3.3	3.2	5.3	-0.6	-0.4	-0.4	-0.6
GDP (nominal)	1.0	1.4	2.0	2.6				
GDP deflator	-1.4	-0.6	-0.1	0.5				
Industrial production	1.6	4.7	2.4	3.6				
Unemployment rate	4.4	4.1	3.8	3.6				
Current account balance (trillion yen)	19.1	21.3	23.4	25.6				
as a percentage of nominal GDP	3.8	4.2	4.5	4.8				
Domestic corporate goods prices	2.1	2.8	2.0	1.8				
Consumer prices	-0.1	0.1	-0.0	0.2				
Long-term interest rate (%)	1.42	1.75	1.88	2.14				
Nikkei stock average (yen)	13,549	16,450	17,900	18,800				
Exchange rate (yen/dollar)	113.2	117.0	118	114				
Crude oil price (WTI/barrel)	60.0	64.9	66.0	63.1				

【 Chart 14: Outlook on the Japanese economy (half-year basis) 】

(%)

	FY2006		FY2007		FY2008	
	1H	2H	1H	2H	1H	2H
	(Actual)	(Actual)	(Forecast)	(Forecast)	(Forecast)	(Forecast)
GDP (real)	1.5	3.5	1.4	2.3	2.5	1.0
Domestic demand	1.2	2.4	1.0	2.2	2.2	1.0
Private sector demand	2.2	3.0	1.3	2.5	2.7	1.3
Personal consumption	-0.2	2.0	1.6	1.1	1.8	1.7
Residential investment	-2.3	2.7	-4.8	7.6	-2.6	-5.3
Capital investment	11.1	7.1	3.5	5.3	5.4	1.8
Public sector demand	-2.2	0.5	-0.2	1.2	0.2	-0.1
Government consumption	2.1	0.5	0.9	1.3	0.7	0.3
Public investment	-17.6	0.9	-5.2	0.6	-2.0	-2.3
Net exports (contribution)	0.4	1.1	0.5	0.2	0.4	0.1
Exports	6.1	7.6	6.2	5.2	6.7	3.7
Imports	4.1	0.4	3.7	5.2	5.6	4.8
GDP (nominal)	0.7	3.2	1.2	2.5	3.3	1.3
GDP deflator	-1.0	-0.4	-0.3	-0.1	0.5	0.5
Industrial production	2.2	2.2	0.2	2.5	1.9	1.0
Unemployment rate	4.1	4.0	3.8	3.7	3.6	3.6
Current account balance (trillion yen)	18.6	22.7	23.4	23.0	25.8	25.0
as a percentage of nominal GDP	3.7	4.4	4.5	4.4	4.8	4.7
Domestic corporate goods prices	3.3	2.3	2.2	1.7	1.8	1.8
Consumer prices	0.1	-0.0	-0.1	0.1	0.2	0.2
Long-term interest rate (%)	1.80	1.70	1.80	1.95	2.10	2.18
Nikkei stock average (yen)	15,900	17,000	17,700	18,100	18,600	19,000
Exchange rate (yen/dollar)	115.4	118.6	120	116	115	113
Crude oil price (WTI/barrel)	70.6	59.2	69.1	62.9	65.1	61.0

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*.

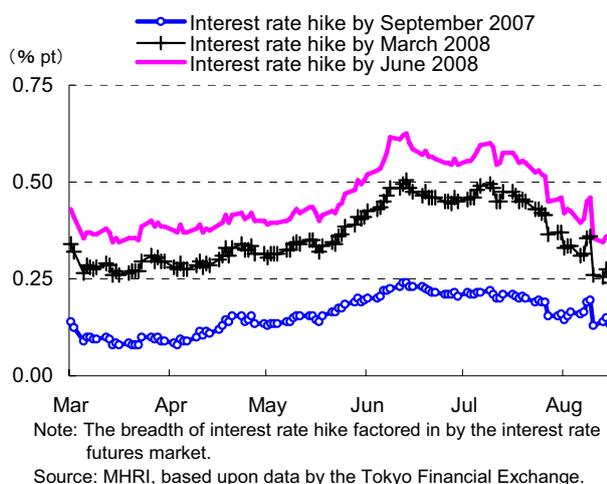
(3) Financial markets

Even though the BOJ's stance on an interest rate hike remains unchanged, the US subprime mortgage problem is a risk factor

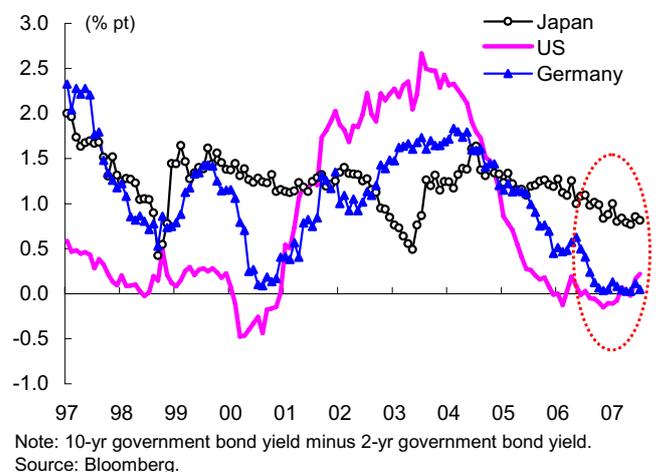
Although the Bank of Japan (BOJ) has held the target interest rate unchanged since the last rate hike in February 2007, the central bank remains positive about an interest rate hike. In addition to the BOJ's interim assessment of the *Outlook for Economic Activity and Prices (April 2007)* ascertaining that "both economic and price movements are as expected", BOJ Governor Toshihiko Fukui also commented that "the continuation of these movements would lead to the conviction that it would not be a mistake to go ahead with a policy shift", hinting that an interest rate hike is drawing closer. Since the market has factored in a rate hike either in August or September, the background is set for the BOJ to move steadily toward an interest rate hike, raising the chances that the BOJ will raise the target interest rate to 0.75%. From then onward, as long as the economy keeps growing at a gradually pace, the central bank will most likely keep raising the key interest rate at a pace of once every six months on the premise that prices will also turn positive.

That said, the US subprime mortgage crisis is a risk factor. As regards the imminent rate hike, there is the option of taking a wait-and-see stance on the grounds of financial market turmoil such as the US-led plunge of stock prices reflecting the subprime woes in the US. However, in such event, insofar as there are no major shifts in the BOJ's main scenario on the economy and prices, the chances are slim that the interest rate hike will be postponed until much later and should be implemented sooner or later along with the stabilization of the market. A matter which is much more uncertain is the timing of the subsequent interest rate hike predicted to occur sometime in the Jan-Mar quarter. In fact, while the

[Chart 15: Change in target interest rate factored in by the short-term market]



[Chart 16: Yield spreads in Japan, US and Germany]



market had factored in a rate hike after the next by the end of the fiscal year (by the end of March 2008), market speculation is ebbing sharply at the moment due to market turmoil and future uncertainties reflecting the subprime mortgage problem (**Chart 15**). Considering the possibility of an interest rate cut by the Federal Reserve sometime around year-end in 2007 or early-2008 reflecting downside risks to the economy stemming from the fallout from the housing market woes, the interest rate hike after the turn of the year will be a critical test for the BOJ. Furthermore, in terms of forecasting the future course of monetary policy, the market's attention will gather around the successor to Governor Fukui – whose tenure will end in March – to be determined around this time.

Long-term interest rates will only rise at a slow pace and the spread between long and short-term interest rates will narrow

The 10-year JGB yield – an indicator of long-term interest rates – moved in a narrow range around 1.6%~1.8% up to early June amid the rise of interest rates in Europe and the US. The yield subsequently rose to nearly 2% at one point in time, given the rise of upward pressures due to mounting speculation on an interest rate hike by the BOJ. However, the yield on US long-term government bonds fell sharply due to a “flight to quality” amid the subprime mortgage crisis, causing the yield on 10-yr JGBs to fall back to the 1.7%-level.

Considering that investors are excessively risk-averse at the moment, long-term interest rates should start to rise once the market regains composure. Japan's long-term interest rate is predicted to remain range-bound around 1.8%~2.0% until the end of the year. From then onward, the long-term interest rate in Japan should start to follow an upward path as the BOJ raises the target interest rate at a gradual pace. However, in terms of demand, the strong appetite for bond investment among major investors such as life insurers and pension funds should keep the rise of interest rates subdued. From a structural perspective, prospects of a lower pace of potential growth in the future reflecting the decline of Japan's population will serve as restraints upon the rise of long-term interest rates. Thus, the rise of long-term interest rates should remain subdued and the yield curve is expected to flatten out. Even in comparison to the global flattening of yield curves, Japan's conspicuously wide yield spread provides more room for the yield curve to flatten out (**Chart 16**).

Stock prices will inch up subsequent to a market rebound

Even though Japanese stocks were perceived as laggards in comparison to overseas stocks which were recording historical highs since the beginning of the year, the Japanese stock market recovered momentarily to the level prior to the global stock market fall in February on the back of net buying by overseas investors. However, the Nikkei average fell sharply thereafter to around 17,000 yen along with the nosedive of US stocks.

Looking forward on a short-term perspective, the Nikkei average is expected to rebound after the US stock market settles down. From then onward, Japan's stock market should rise along with the expansion of the economy and the

The yen will gradually gain strength

recovery of corporate earnings. Even so, the odds are high that the market will lack momentum since (1) the upside of the US stock market should remain heavy for some time due to uncertainties regarding the US economy, and (2) the anticipated upgrade of corporate earnings outlooks of Japanese companies will likely be pushed further into the future.

The yen lost ground to the dollar, retreating at one point to 124 yen/dollar, given (1) the widening interest rate differential due to the rise of US interest rates amid speculation on US economic recovery, and (2) demand for yen-carry transactions. However, a sharp reversal of the trend due to a massive unwinding of yen-carry trades reflecting the decline of US interest rates and global stock market fall subsequently drove the yen to the 118-yen level.

Even though the yen may temporarily weaken against the dollar, the upside of the dollar should remain heavy amid uncertainties regarding the US economy and the rise of speculation on an interest rate cut in the US. Over the course of FY2008, the strength of the yen should persist on the back of a shrinking interest rate gap because an interest rate hike is unlikely in the US while the BOJ will most likely raise rates at a gradual pace. Even so, since the absolute level of yen interest rates remain overwhelmingly lower than other countries, persistent demand for yen-carry trades will serve to keep the appreciation of the yen subdued.

[Chart 17: Market outlook]

	2007/ Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	2008/ Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	2009/ Jan-Mar
Uncollateralized call (overnight, %)	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.25	1.50
Euroyen TIBOR (3-month, %)	0.60	0.67	0.87	0.96	1.17	1.23	1.44	1.48	1.73
Interest rate swap (5-year, %)	1.35	1.48	1.61	1.66	1.81	1.86	1.96	2.06	2.11
Newly-issued JGBs (10-year, %)	1.67	1.74	1.84	1.90	2.00	2.05	2.10	2.15	2.20
Nikkei stock average (Yen)	17,400	17,700	17,600	18,000	18,200	18,500	18,700	18,900	19,100
Exchange rate (Yen/dollar)	119	121	120	117	115	115	114	113	112

Note: The shaded columns refer to actual results. The uncollateralized call rate refers to the end-of-term rates and the rest are averages during the term.

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