

Economic Outlook for FY2007 and FY2008

(revised to reflect the Second Preliminary Quarterly Estimates of GDP for the Jul-Sep quarter of 2007)

December 2007

The Mizuho Research Institute Ltd. (MHRI) has revised its economic outlook for FY2007 and FY2008 subsequent to the release of *The Second Preliminary Quarterly Estimates of GDP* ("2nd QE") for the Jul-Sep quarter of 2007. The key points of the outlook are as follows.

<The US Economy>

The US economy will grow more dependent upon external demand given the slowdown of overall domestic demand

2007 2.1% (previous outlook) → 2.2% (current outlook)

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

<The Japanese Economy>

FY2007 External demand and capital investment will drive growth while the household sector will slump in the second half of FY2007

Real GDP: 1.5% (previous outlook) 1.3% (current outlook)

Nominal GDP: 1.0% (previous outlook) 0.7% (current outlook)

FY2008 Growth will continue to be driven mainly by external demand

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

Nominal GDP: 2.2% (previous outlook) → 2.1% (current outlook)

This English-language translation is based upon the outlook in Japanese released on December 11, 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 Japanese economy

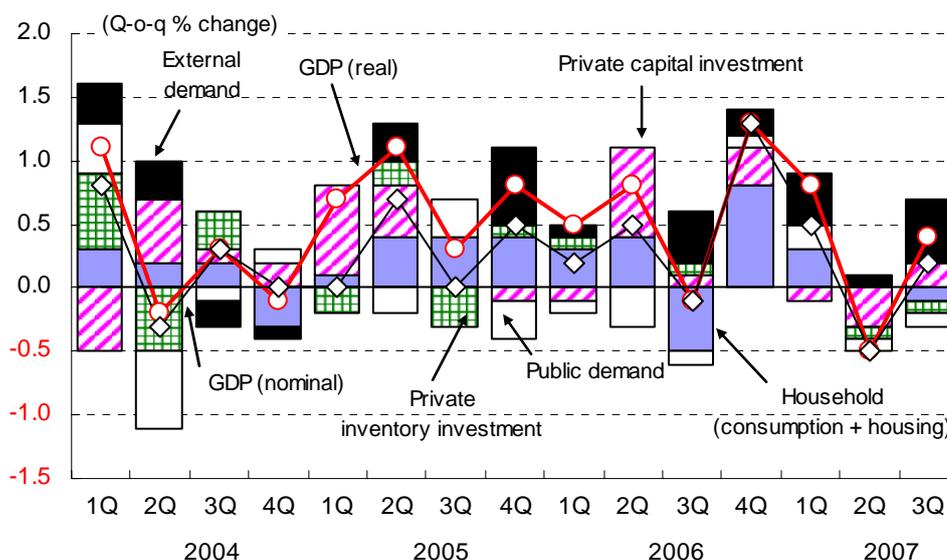
Japan's real GDP growth in the Jul-Sep quarter revised down to 1.5% q-o-q p.a.)

Domestic demand was revised down due mainly to slower capex and inventory growth

The *Second Preliminary Quarterly Estimates of GDP* (“2nd QE”) for the Jul-Sep quarter of 2007 revealed that Japan’s real GDP grew a slower-than-expected 0.4% q-o-q (1.5% in annualized terms) in a downward revision from 0.6% q-o-q (2.6% q-o-q p.a.) in the *First Preliminary Quarterly Estimates of GDP* (**Chart 1**). Given a downward revision of private-sector inventory investment, in contrast to the rise of contribution by external demand, growth has turned more external demand-driven than in the 1st QE.

Looking closer at each of the components of demand, private-sector inventory investment served as a major drag upon growth. Given a smaller-than-expected rise of inventories of works in process in the *Financial Statements Statistics of Corporations by Industry*, the contribution by inventory investment to quarterly real GDP growth was revised down from 0.1% pt to -0.1% pt. Since both capital investment (1st QE 1.7% → 2nd QE 1.1%) and residential investment (1st QE -7.8% → 2nd QE -7.9%) were revised downward, the contribution by domestic private-sector demand to quarterly real GDP growth was slashed sharply from 0.3% pt in the 1st QE to 0.0% pt in the 2nd QE. Despite a minor upward revision of public investment (1st QE -2.6% → 2nd QE -2.3%), the contribution by public demand was unchanged from the 1st QE at -0.1% pt because of a downward revision of government consumption (1st QE 0.3% → 2nd QE 0.2%). In contrast, external demand made a larger contribution to growth (0.5% pt) than in the 1st QE (0.4% pt), because the breadth of the downward revision of imports (1st QE 0.5% q-o-q → 2nd QE % -0.2% q-o-q) was larger than the downward revision of exports (1st QE 2.9% q-o-q → 2nd QE 2.6% q-o-q).

[Chart 1: Japan’s quarterly GDP growth (2nd QE for the Apr-Jun quarter of 2007)]



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

The GDP deflator was revised down by 0.1 point

The GDP deflator was revised down by 0.1 point to -0.4% y-o-y from -0.3% y-o-y in the 1st QE. The domestic demand deflator was also revised down from 0.0% in the 1st QE to -0.1%.

Sharp deterioration of corporate earnings environment

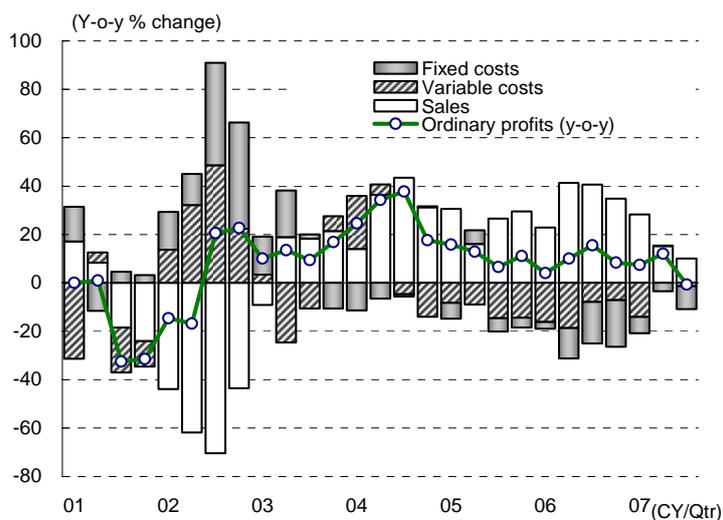
Corporate business performance cooled sharply in the Jul-Sep quarter. The growth of ordinary profits (based upon the *Financial Statements Statistics of Corporations by Industry*) fell to -0.7% y-o-y (Apr-Jun quarter 12.0% y-o-y), recording a profit decline for the first time in approximately five years since the Apr-Jun quarter of 2002. In addition to slower sales growth due to sluggish domestic demand and the ebb of the benefits of a weak yen, the rise of costs such as raw material and labor costs are pushing down profits. The sharp fall of profits among medium-sized corporations – from -1.3% y-o-y in the Apr-Jun quarter to -16.9% y-o-y in the Jul-Sep quarter – stems largely from a sampling change from the Apr-Jun quarter. Still, even after taking this statistical issue into account, it is important that the profit growth rate showed a sharp decline due to the slowdown of earnings growth and the rise of various costs. Dark clouds are spreading over the heretofore sunny corporate horizon, leading to the rise of uncertainties regarding the future course of the Japanese economy.

II. Forecast of the Japanese economy in FY2007 and FY2008

Weak corporate business performance in the first half of FY2008

A closer look at the ordinary profits of corporations (**Chart 2**) reveals that the slowdown of sales growth and the rise of variable costs served as a drag upon earnings in the Jul-Sep quarter. Due in part to the fact that the price of crude oil fell below the previous year in the first half of 2007, variable costs did not serve as such a large drag as of the Jul-Sep quarter. However, the larger variable cost burdens accompanying the rise of crude oil prices should serve as greater downward pressures upon earnings and profits from the second half of FY2007 to the first half of FY2008. The corporate sector will be facing a more severe profit environment amid the sluggish growth of sales reflecting the weakness of domestic demand. In particular, ordinary profits among small and medium-sized corporations are predicted to fall below the previous year because of their high dependence upon domestic demand and the difficulty to price in the higher costs. While the rate of profit growth will slow down even among large corporations, they should be able to maintain the rise of profits due to the ongoing rise of exports (in terms of volume) and their ability to price in the higher costs. Given forecasts that the rise of cost pressures will come to a pause due to the year-on-year fall of crude oil prices in the second half FY2008, corporate business performance should gradually pick up. Even though current profits (based upon the *Financial Statements Statistics of Corporations by Industry*) are predicted to rise in both FY2007 and FY2008, the rate of profit growth will remain at a mild 2%-level (**Chart 3**).

[Chart 2: Ordinary profits]



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

[Chart 3: Corporate earnings forecast]

		(Y-o-y % change)			
		FY2005	FY2006	FY2007 (Forecast)	FY2008 (Forecast)
Total	Sales	4.6	7.3	2.5	2.6
	Ordinary profits	8.4	10.0	2.5	2.6
Manufacturing	Sales	6.1	4.8	6.6	4.0
	Ordinary profits	12.4	12.7	3.9	3.3
Nonmanufacturing	Sales	3.9	8.4	0.7	2.0
	Ordinary profits	5.7	8.1	1.5	1.9
Large corporations	Sales	6.5	5.0	3.9	3.3
	Ordinary profits	13.9	12.8	4.9	3.9
Manufacturing	Sales	7.1	6.5	5.6	4.2
	Ordinary profits	14.7	13.7	5.1	4.0
Nonmanufacturing	Sales	6.0	3.8	2.4	2.6
	Ordinary profits	13.0	11.7	4.7	3.8
Small and medium corporations	Sales	3.2	8.9	1.5	2.1
	Ordinary profits	2.4	6.7	-0.6	0.7

Note: "Large corporations" = corporations with capital of 1 billion yen or over
"Medium corporations" = corporations with capital of 100 million to 1 billion yen,
"Small corporations" = corporations with capital of 10 to 100 million yen,
Source: Ministry of Finance, *Financial Statements Statistics of Corporations by Industry, Quarterly*.
Compiled by M/RI.

Forecast on growth revised downward for both FY2007 (1.3%) and FY2008 (1.9%)

We have revised down our forecast on Japan's growth for both FY2007 (1.5% → 1.3%) and FY2008 (2.0% → 1.9%) from our previous forecast (as of November 15th) (**Chart 4**). As for FY2007, our forecasts on personal consumption, capital investment and private-sector inventory investment have been revised downward to reflect the results up to the Jul-Sep quarter. Thus, our forecast on overall domestic demand has been revised down from 0.6% y-o-y in our previous forecast to 0.3% y-o-y. In contrast, the contribution by external demand has been revised upward from 0.9% pt to 1.0% pt. The Japanese economy will rely upon external demand for much of its growth in FY2007. Turning to FY2008, we have revised down our forecast on residential investment from 9.8% y-o-y in our previous forecast to 7.0% y-o-y, on the basis of our views that it would be difficult for the current drop of housing starts due to the revision of the building standards law to climb back to previous levels. Our forecast on all other components of demand remains unchanged from our previous forecast.

Inflationary pressures will remain subdued despite a positive output gap

The output gap (the gap between demand and supply) estimated by MHRI stood at 1.3% as of the Jul-Sep quarter (**Chart 5**). Even so, inflationary pressures should remain subdued, considering the weak rise of wages in FY2008 due to restraints upon labor costs among corporations amid a grim business environment. Although the rise of energy prices stemming from the soaring price of crude oil will serve as upward pressures, the year-on-year percentage change of the CPI (general, excluding fresh food) will remain virtually flat at 0.1% in FY2007 and 0.3% in FY2008.

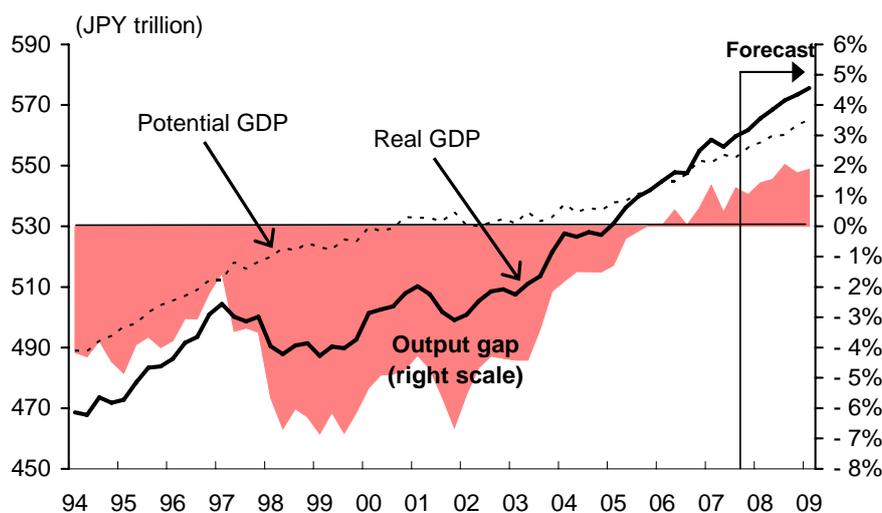
[Chart 4: Outlook on the Japanese economy]

(%)

	FY2006	FY2007	FY2008	FY2007		FY2008		FY2007	FY2008
	(Actual)	(Forecast)	(Forecast)	1H	2H	1H	2H	(Contribution)	(Contribution)
				(Actual)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)
GDP (real)	2.3	1.3	1.9	0.3	1.5	2.3	1.6	-	-
Domestic demand	1.6	0.3	1.4	-0.7	0.6	1.8	1.2	0.3	1.3
Private sector demand	2.6	0.5	1.8	-0.7	0.8	2.3	1.7	0.3	1.3
Personal consumption	1.7	1.4	1.2	1.3	0.8	1.2	1.7	0.8	0.7
Residential investment	0.2	-11.8	7.0	-16.0	-16.7	21.2	7.1	-0.4	0.2
Capital investment	5.6	0.6	2.7	-2.7	4.3	2.7	1.4	0.1	0.4
Public sector demand	-1.8	-0.2	-0.1	-0.6	-0.2	0.0	-0.4	-0.0	-0.0
Government consumption	0.1	0.7	0.9	0.9	1.1	0.9	0.7	0.1	0.2
Public investment	-9.2	-4.3	-4.9	-6.8	-6.2	-4.0	-5.8	-0.2	-0.2
Nex exports (contribution)	0.8	1.0	0.6	0.9	0.9	0.5	0.5	1.0	0.6
Exports	8.2	7.6	6.1	7.9	7.0	6.1	5.0	1.1	1.0
Imports	3.0	1.6	3.1	2.2	1.7	4.0	2.9	-0.2	-0.3
GDP (nominal)	1.6	0.7	2.1	-0.2	0.5	3.0	2.0		
GDP deflator	-0.8	-0.6	0.2	-0.4	-0.8	-0.2	0.5		
Industrial production	4.8	2.8	2.8	0.6	2.5	1.6	-0.2		
Unemployment rate	4.1	3.9	3.7	3.8	3.9	3.8	3.6		
Current account balance (trillion yen)	21.2	24.5	26.6	18.6	22.7	25.4	23.0		
as a percentage of nominal GDP	4.1	4.8	5.1	3.6	4.4	4.9	4.4		
Domestic corporate goods prices	2.0	2.2	2.4	1.6	2.8	2.4	2.4		
Consumer prices	0.1	0.1	0.3	-0.1	0.3	0.4	0.2		
Long-term interest rate (%)	1.75	1.61	1.78	1.70	1.53	1.70	1.85		
Nikkei stock average (JPY)	16,450	16,650	17,000	17,300	16,000	16,600	17,400		
Exchange rate (JPY/USD)	117.0	114	111	119	109	109	114		
Crude oil price (WTI/barrel)	64.9	75.2	74.3	70.2	80.1	78.7	69.8		

Notes: 1. FY = rate of change from the previous year. Half-year GDP = rate of change from the previous term p.a. (the GDP deflator = rate of change from the previous year).
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 industrial production = rate of change from the previous term. The half-year unemployment rate and half-year current account balance are adjusted for seasonal factors and the 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 = yield on newly-issued 10-yr government bonds.
Sources: Cabinet Office, *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*.

[Chart 5: The output gap]



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

[Chart 6: Outlook on the US economy]

(%)

	2006	2007	2008	2007 (Forecast)		2008 (Forecast)	
	(Actual)	(Forecast)	(Forecast)	1H	2H	1H	2H
GDP	2.9	2.2	2.4	1.8	3.7	1.7	2.4
Personal consumption	3.1	2.8	2.0	3.2	2.1	2.0	1.9
Residential investment	-4.6	-16.9	-15.9	-15.5	-19.1	-18.7	-5.9
Capital investment	6.6	4.7	4.6	3.4	8.9	3.0	3.7
Inventory investment (USD100 million)	403	141	183	30	252	95	272
Government expenditures	1.8	2.0	3.0	1.6	3.4	2.7	3.0
Net exports (USD100 million)	-6,245	-5,579	-4,979	-5,930	-5,227	-4,981	-4,977
Exports	8.4	8.1	8.1	5.9	13.0	6.9	5.7
Imports	5.9	2.1	2.7	1.6	1.7	2.5	4.2
Domestic final demand	2.7	1.8	1.7	1.9	2.0	1.5	2.0
Personal consumption expenditures deflator <y-o-y ch>	2.0	2.6	2.4	2.3	2.8	2.6	2.2
Core personal consumption expenditures deflator <y-o-y ch>	2.2	2.0	1.8	2.2	1.9	1.8	1.8
Current account balance (USD100 million)	-8,115	-7,514	-6,575	-3,879	-3,635	-3,375	-3,200
<as a percentage of nominal GDP>	-6.2	-5.4	-4.5	-5.7	-5.2	-4.7	-4.3

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.

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