

Economic Outlook for FY2008 and FY2009

February 2008

The Mizuho Research Institute Ltd. (MHRI) has revised its economic outlook for FY2007 (estimates), FY2008 and FY2009, the key points of which are set forth as follows.

<The US Economy>

The outlook on US growth has been subject to a sharp downward revision reflecting the spread of the credit crunch

2008	2.4% (previous outlook) → 1.4% (current outlook)
2009	1.6%

<The Japanese Economy>

FY2007 Given the weakness of domestic demand, Japan's economic growth will be dependent on external demand

Real GDP: 1.3% (previous outlook) → 1.6% (current outlook)

Nominal GDP: 0.7% (previous outlook) → 0.8% (current outlook)

FY2008 Slowdown in the second half of the year partly due to IT-related inventory adjustment

Real GDP: 1.9% (previous outlook) → 1.4% (current outlook)

Nominal GDP: 2.1% (previous outlook) → 1.3% (current outlook)

FY2009 Weak growth because of sluggish export and capital investment growth in the first half of the year

Real GDP: 1.0%

Nominal GDP: 0.9%

This English-language translation is based upon the outlook in Japanese released on February 18, 2008. 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 MHRI believes to be reliable and correct, MHRI 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.

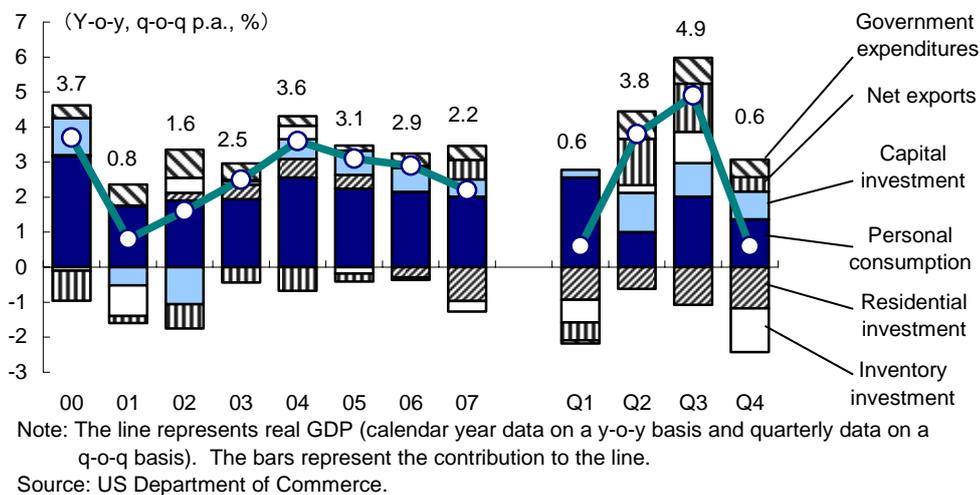
I. The current state of the US economy

The US economy slowed sharply in the Oct-Dec quarter of 2007. Full-year 2007 growth: 2.2%

US gross domestic product (GDP) in real terms slowed to 0.6% q-o-q p.a. in the Oct-Dec quarter of 2007 (“advance” estimates as of January 30, 2008), compared to the strong growth in the two preceding quarter (**Chart 1**). Looking closer at the components of growth, the sharper fall of residential investment (-23.9% q-o-q p.a.) and slowdown of personal consumption to 2.0% q-o-q p.a.(constituting about 70% of nominal GDP) served to drag down growth. Exports slowed to 3.9% q-o-q p.a. in a backlash to the strong growth (nearly 20% q-o-q p.a.) in the previous quarter, leading to a sharp contraction of the contribution by external demand. Even though capital investment held up well, the growth of domestic final demand slowed to 1.4% q-o-q p.a., dropping below the 2%-level. Looking back at 2007, even though the US economy grew strongly above 3% in the middle of the year, economic growth stood at 2.2% on a full-year basis. In comparison to 2006 (2.9% y-o-y), the deterioration of residential investment served as a drag despite the upturn of the contribution by external demand into positive territory.

Judging from subsequent data releases for the Oct-Dec quarter since the advance estimates, US preliminary real GDP is estimated to remain unchanged from the advance estimates at 0.6% q-o-q p.a. (US preliminary real GDP estimates is scheduled for release on February 28th, to be reflected in our forecast in March).

[Chart 1: US real GDP growth]



Core inflation was hovering slightly above the price stability zone

Turning to US price developments, the year-on-year percentage change of the core personal consumption expenditure (PCE) deflator stood at 2.2% y-o-y as of December 2007, rising slightly above the “price stability zone” (1.0%~2.0%).

2008 growth outlook revised down sharply from 2.4% to 1.4%. Stagnant growth to persist in 2009 (1.6%)

The “monoline crisis” and the spread of tighter lending standards among US banks

There have been a significant shift in the US economy and financial markets since the release of our previous *Economic Outlook for FY2007 and FY2008* on December 11, 2007. Among the negative factors are the development of the subprime mortgage crisis into the problem regarding monoline insurers and the deterioration of employment-related indicators. On the other hand, the faster-than-expected pace of interest rate cuts by the Federal Reserve Board and the Congressional enactment of a major US economic stimulus package are positive factors for the economy. In this *Economic Outlook for FY2008 and FY2009* (the “*MHRI Outlook*”), we have revised down our outlook in view of the foregoing developments, adopting the view that “the deterioration of the economy in the first half of 2008 is inevitable” and “that the subsequent recovery cycle will turn out to be weak”. We thus forecast that US real GDP growth will slow down to 1.4% (previous outlook: 2.4%) in FY2008 and that growth in 2009 will remain at 1.6% (**Chart 6**).

Ever since the end of 2007, there has been a focus of attention upon the fragile business foundation of monoline insurance companies which have engaged in the guarantee of structured financial instruments backed by subprime mortgages (USD249 billion as of the end of 2006). The attention stems from concerns regarding the spread of the crisis to the financial markets via the municipal bond market which has thus far maintained high credit ratings (total market value USD 2.4 trillion, of which 50% are monoline-backed municipal bonds) because of their guarantee by monoline insurers. Total subprime-related losses incurred by monoline insurers are estimated to total USD13.6 billion (Standard and Poor’s, January 17th). On the other hand, monoline insurers’ equity capital (statutory capital) as a whole is only USD22 billion (as of the end of 2006). Despite recent efforts to reinforce the capital bases of monoline insurers, there are concerns that final (subprime-related) losses would run up to astronomical levels and that monoline insurers would not be able to maintain their high credit ratings even if the capital reinforcements are realized (Fitch, February 14th).

In the event the credit ratings of monolines are downgraded, municipal bond ratings would also be subject to downgrades because of their guarantee by monolines. According to Patrick M. Parkinson’s (Deputy Director, Division of Research and Statistics of the Federal Reserve Board) Congressional Testimony on February 14, 2008, the recent heavy demand for short-term securities from money market funds has generated a large market for facilities that transform long-term, tax-exempt bonds into short-term securities which typically have credit support from monolines and liquidity support from large banks or security firms. If the monoline guarantors are downgraded, the banks and securities firms which provided liquidity support would have to buy back the relevant short-term securities, thereby leading to an unexpected expansion (resulting in downward pressures on capital adequacy ratios). The monoline downgrades involve

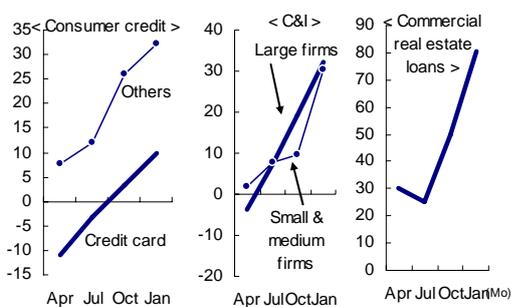
problems akin to on-balance sheet transactions of SIVs in that it leads to the decline of lending capacity.

The tighter lending standards among US banks are already spreading to a wider range of credit beyond residential mortgage loans. According to the FRB, the percentage of US banks tightening their lending standards is rising rapidly even with respect to consumer credit such as credit card loans, commercial and industrial (C&I) loans and commercial real estate loans (**Chart 2**). Given the strong correlation between financial institutions' lending stance and capital investment, the recent developments presage the spread of dark clouds over capital investment.

Economic data indicate that the economy is nearing the peak

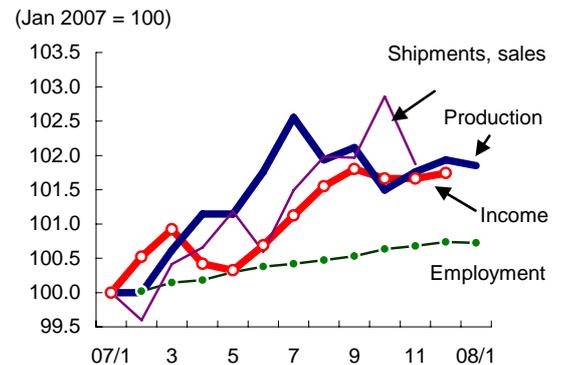
Economic indicators are starting to reveal that the US economy is nearing the peak of the business cycle. According to the four following indicators watched closely by the Business Cycle Dating Committee of the National Bureau of Economic Research (NBER) to determine business cycle turning points, the US economy has either "reached a peak" or "was about to peak" at the end of 2007 (**Chart 3**). The four key indicators are (1) employment (nonfarm payrolls), (2) production (industrial production), (3) income (personal income less transfer payments, in real terms) and (4) shipments and sales (the volume of sales of the manufacturing and wholesale-retail sectors adjusted for price changes). In particular, note that employment which has a direct link with consumption and the performance of credit card and automobile loans, fell on a month-on-month basis in January.

[Chart 2: Lending stance among US banks]



Note: DI derived by subtracting the percentage of banks responding that they had "eased their lending standards" from the percentage of those responding that they had "tightened their lending standards" during the past 3-mo period. The higher the DI in positive territory, the stricter the lending standards.
Source: US Federal Reserve Board.

[Chart 3: Trends in coincident indicators]



Note: Refer to text for details.
Sources: US Department of Labor, Federal Reserve Board, US Department of Commerce.

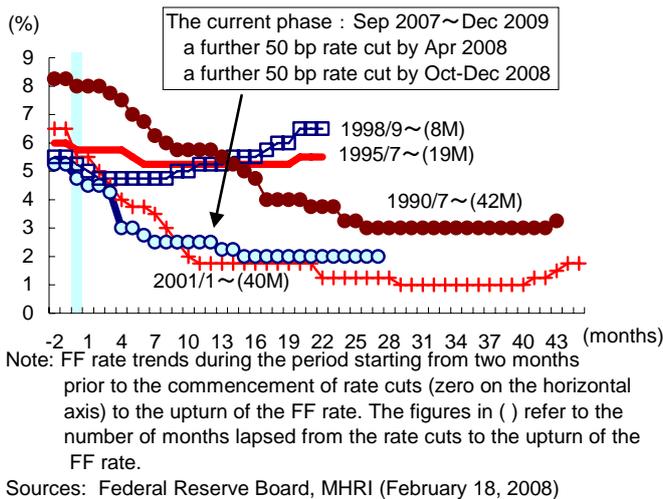
Impact of interest rate cut will start to emerge from mid-2008. The credit crunch will dampen the effect of interest rate cuts

Amid the increasing downside risks to the US economy, the federal funds rate target has dropped from 5.25% in August 2007 to 3.00% as a result of the FRB's successive rate cuts (**Chart 4**). According to FRB Governor Frederic S. Mishkin, in the event it is presumed that "residential prices are falling sharply, accompanied by a significant negative wealth effect", the FRB's economic model prescribes a "2% rate cut in the subsequent 10-quarter period". The pace and degree of the

recent rate cuts surpass by far the rate cut prescribed by their model, ranking second place in terms of the pace and size of interest rate cuts after the collapse of the IT bubble in the early 2000s (under former FRB Chairman Alan Greenspan). The time lag between the implementation of monetary policy tools and the emergence of its effect in macroeconomic indicators would be approximately six months at the shortest. The first half of 2008 coincides with the time in period when the initial effect of the rate cuts implemented last fall start to appear. However, as mentioned above, US banks are starting to take a stricter lending stance in a wide range of loans, serving as a monetary policy bottleneck. Furthermore, the credit crunch is a global phenomenon not limited only to US banks. The number of global M&As, issuance of global stocks and corporate bonds and global loan syndications has fallen sharply since the second half of 2007, with no signs of recovery from the turn of the new year (Thomson Financial).

Amid the difficulty to discern when the subprime crisis will subside, we are inclined to believe that the US corporate sector will face a severe financial environment in both banking and capital market during the forecast horizon.

[Chart 4: Trends in the federal funds rate]



[Chart 5: Contents of the economic stimulus package]

USD billion	Total in 10 years	FY2008 - FY2009
Rebates	117.0	117.0
For companies	7.5	51.0
Increase Sec. 179 Expensing and Phaseout Amounts	0.1	1.5
Bonus depreciation	7.4	49.5
Housing GSE and FHA Loan Limit Increase	[Note]	
Total	124.5	168.0

Note: Economic Stimulus Act of 2008. Housing-related outlays of less than USD50 million.
Source: US Joint Committee on Taxation.

Despite the enactment of a major economic stimulus package, providing a shot-in-the-arm to consumer spending in the Jul-Sep quarter, its sustainability is questionable

On February 13th, US President George W. Bush signed into law the Economic Stimulus Act of 2008 totaling USD168 billion (for FY2008 and FY2009). The major part of the economic stimulus package takes the form of recovery rebates for individuals, with a total of USD117 billion worth of checks (a certain portion to be sent by transfers) to be sent out to 128 million households during the period around May to December 2008 (Chart 5). In providing an outlook on the economy, it is extremely important to assess when and to what extent the huge rebates will be spent. In the current *Economic Outlook*, we assume that the rebates will be spent entirely during the Jul-Sep quarter and that approximately 30% will be channeled to actual consumption expenditures (a marginal consumption propensity of 0.3).

Compared with the 2001 tax cut, the rebates this time are skewed to the lower

and middle-income groups which are said to have a higher marginal consumption propensity. Furthermore, according to empirical research, the marginal consumption propensity of the 2001 tax cut has reached approximately 0.67 (the cumulative total of the two quarters including the quarter when the rebates were received). Therefore, considering the distribution of the current rebates in terms of income groups, more than 70% of the rebates should be channeled to consumer spending.

However, judging from the emphasis that the current rebates are “provisional and temporary” measures, its marginal consumption propensity should decline in comparison to the 2001 tax cut which had more of a permanent nature. Note also that US households – including those in the subprime bracket – are laden with high levels of financial debt burdens. Amid an increasingly grim financial environment, it would not be far-fetched to assume that many of the households would use the checks to repay debt (raising the savings rate) and adjusting their balance sheets (reducing debt).

While personal consumption and real GDP in the Jul-Sep quarter would be pushed up by the rebates, its backlash would occur in the Oct-Dec quarter. Based upon forecasts that the credit crunch toward consumers will persist and that companies will continue to slash employment, it is unlikely that consumers will keep spending at the same level as the Oct-Dec quarter in the Jul-Sep quarter.

The reverse wealth effect and employment downturn will serve as a drag upon personal consumption during the forecast horizon. Given the ongoing decline of residential prices until 2010 (-17% from mid-2007 based on the S&P/Case Shiller Home Price Indices), the reverse wealth effect should serve as restraints upon personal consumption. Moreover, as in the episodes in the early 1990s and early 2000s, the incentive to hire more workers among US corporations should fall sharply along with the adoption of a stricter lending stance among banks and lead to a full-fledged employment downturn.

The weakness of personal consumption is expected to spread to capital investment. Of particular concern is that lax lending standards are being applied with respect to commercial real estate. There is a significant risk that commercial real estate investment will no longer serve as a driver and turn instead into a drag upon capital investment.

Amid these developments, although prices will trend above forecasts for some time due to high energy prices, they should regain stability as a result of a prolonged slowdown of the economy.

**A full-fledged
employment downturn
along with a persistent
reverse wealth effect**

[Chart 6: Outlook on the US economy]

(%)

	2007	2008	2009	2007		2008 (Forecast)		2009 (Forecast)	
		(Forecast)	(Forecast)	1H	2H	1H	2H	1H	2H
GDP	2.2	1.4	1.6	1.8	3.6	-0.3	2.7	0.8	2.0
(O-y-a ch of final quarter)	2.5	1.1	1.7						
Personal consumption	2.9	1.1	1.1	3.2	2.3	-0.1	2.5	0.1	1.6
Residential investment	-16.9	-19.5	-8.6	-15.5	-19.2	-21.0	-16.3	-8.1	-0.8
Capital investment	4.8	0.9	-4.5	3.4	9.3	1.8	-8.5	-4.6	-0.3
Inventory investment (USD100 million)	83	-125	568	30	136	-463	213	486	650
Government expenditures	2.1	3.1	3.0	1.6	3.6	2.9	3.0	3.0	3.0
Net exports (USD100 million)	-5,600	-4,546	-4,244	-5,930	-5,271	-4,729	-4,363	-4,254	-4,234
Exports	7.9	5.2	2.2	5.9	12.2	3.6	1.8	1.7	3.5
Imports	2.0	-1.6	0.1	1.6	1.5	-2.8	-2.4	0.2	2.5
Domestic final demand	1.8	0.6	0.6	1.9	2.1	-0.2	0.9	-0.0	1.6
Unemployment rate	4.6	5.3	5.9	4.5	4.8	5.2	5.5	5.8	6.0
Nonfarm payrolls (per month, 1,000 persons)	127	-110	-43	119	91	-118	-101	-66	-20
PCE deflator <y-o-y ch>	2.5	2.5	1.6	2.3	2.7	2.8	2.2	1.7	1.5
Core PCE deflator <y-o-y ch>	2.1	2.3	1.7	2.2	2.0	2.3	2.4	1.9	1.6
Current account balance (USD 100 million)	-7,595	-6,450	-5,810	-3,860	-3,735	-3,425	-3,025	-2,900	-2,910
<as a percentage of nominal GDP>	-5.5	-4.5	-3.9	-5.7	-5.3	-4.8	-4.2	-3.9	-3.9

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, MHIRI (February 18, 2008).

II. The Japanese economy

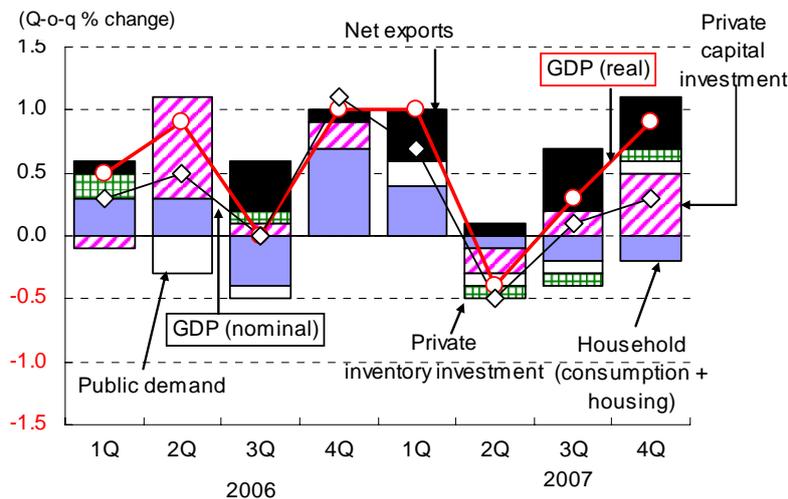
(1) The current state of the economy

Japan's economy grew strongly, above 3% q-o-q p.a., in the Oct-Dec quarter of 2007

Japan's real GDP gained momentum from the Jul-Sep quarter of 2007 and grew 0.9% q-o-q (3.7% q-o-q p.a.) in the Oct-Dec quarter of 2007, above the potential rate of growth rate estimated to be slightly below 2% (**Chart 7**). In addition to the ongoing contribution to growth by external demand, domestic demand picked up and rose into positive territory for the first time in three quarters and served as a driver of the Japanese economy.

Looking closer at each of the components of demand, personal consumption growth remained a weak 0.2% q-o-q. Personal consumption has been stagnant (0.1%~0.2% q-o-q) since the beginning of FY2007. Even though the primary cause was the weak growth of labor compensation reflecting the lackluster rise of wages, it appears that the larger local inhabitants tax burdens accompanying the abolition of the fixed-rate across-the-board tax cuts have served as restraints upon personal consumption. Residential investment fell at a faster pace (-9.1% q-o-q) than the Jul-Sep quarter (-8.3% q-o-q) given the persisting drag stemming from the amendment of the buildings standards law. Even though the number of housing starts climbed to 18.5% q-o-q, rising into positive territory, in the Oct-Dec quarter, the impact of the sharp fall of construction starts in the Jul-Sep quarter has started to appear in residential investment after a time lag since residential investment is expressed in terms of work in progress.

[Chart 7: Japan's quarterly GDP growth]



Source: Cabinet Office, Preliminary Quarterly Estimates of GDP.

Capital investment grew a strong 2.9% q-o-q

Capital investment grew 2.9% q-o-q, rising for the second quarter in a row. As in the case of residential investment, construction investment softened due to the amendment of the buildings standards law. That said, it appears that demand for investment in automobiles, software and general industrial machinery gathered momentum. Despite the temporary weakening of capital investment in the first half of 2007, the second quarterly increase subsequent to the Jul-Sep quarter underscored that corporate willingness to invest in plant and equipment is still strong.

Even so, there is still a modicum of doubt whether the strong growth of capital investment surpassing 12% in annualized terms in the Oct-Dec quarter should be taken at face value. Private-sector corporate capital investment in *The First Preliminary Quarterly Estimates* (“1st QE”) is derived by subtracting residential investment (estimates based upon data on construction starts) and public investment from “gross domestic fixed capital formation” based upon supply-side data. Under circumstances in which residential investment has fallen as much as 30% from the previous quarter (p.a.), the impact of its estimation error upon capital investment may not be ignored. While it would be necessary to ascertain the results of the *Financial Statements Statistics of Corporations by Industry* to be released on March 5th, the odds are high that actual corporate capital investment is slightly weaker. Due in part to the expansion of private-sector inventory investment (contribution: 0.1% pt q-o-q), the contribution by domestic private-sector demand rose to 0.3% pt. Moreover, the contribution by public demand turned positive for the first time in three quarters due to the rise of government consumption to 0.8% q-o-q reflecting the rise of medical costs.

External demand is continuing to push up growth

The contribution to growth by external demand (0.4% pt) continued to drive the Japanese economy as in the Jul-Sep quarter. Despite concerns regarding the negative impact stemming from the US economic slowdown, the shortfall of exports to the US was offset by exports to emerging countries. A closer look at the export volume index in terms of geographic destinations indicates that the volume of US-bound exports took a downturn while the volume of exports to Asia (ex China) and other areas have been accelerating since 2007 (**Chart 8**). Even though the negative impact of the economic slowdown in the US and EU would be inevitable because these areas continue to be major destinations for Japan’s exports, the odds are high that Japan’s exports will retain its upward momentum in the first half of 2008 given its support by the higher purchasing power of emerging countries fueled by their strong growth.

The GDP deflator sank deeper into negative territory

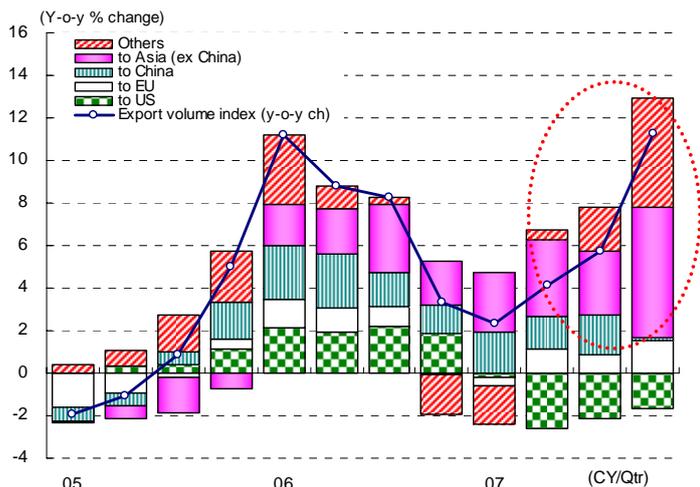
The GDP deflator, a broad measure of price changes, sank deeper into negative territory (-1.3% y-o-y) from the previous quarter (Jul-Sep quarter -0.6% q-o-q). This stems from the decline of the export deflator due to the strong yen and the rise of the import deflator because of the surge of crude oil prices. The domestic demand deflator climbed to 0.1% y-o-y, rising above the previous year for the first

Labor compensation continued to crawl at snail's pace

time in five quarters. GDP growth on a nominal basis stood at 0.3% q-o-q (1.2% q-o-q p.a.).

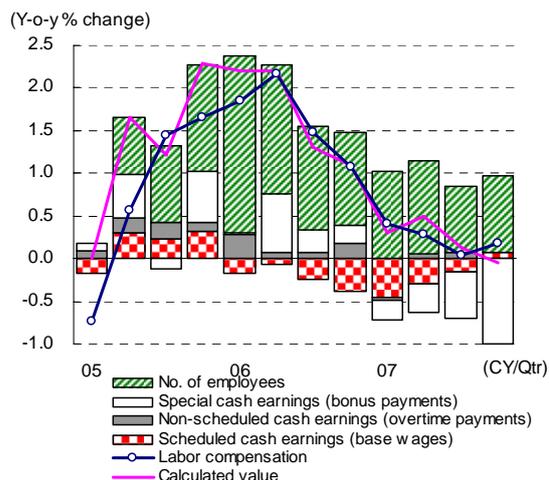
According to data on labor compensation released simultaneously with the GDP statistics, labor compensation rose slightly to 0.2% y-o-y in the Oct-Dec quarter, from +0.0% y-o-y in the Jul-Sep quarter (**Chart 9**). Nonetheless, this only means that labor compensation is crawling at snail's pace. The pace of labor compensation growth in 2007 slowed to 0.2% y-o-y, falling 1.4% pt from 2006.

[Chart 8: Export volume index (by geographic destinations)]



Note: Based upon export volume indexes by geographic areas and the weight of trade by geographic areas in 2000.
Source: Ministry of Finance, *Trade Statistics*.

[Chart 9: Trends in 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*.

Growth will slow sharply to near-zero levels in the Jan-Mar quarter of 2008

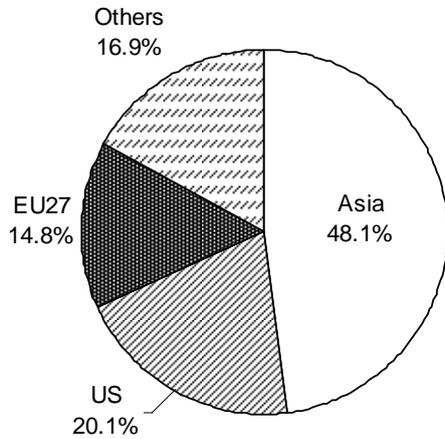
Despite the strong growth of Japan's real GDP for the first time in four quarters in the Oct-Dec quarter of 2007, the pace of growth should slow sharply to near-zero levels in the Jan-Mar quarter of 2008. Our view stems from forecasts that export growth will shift down to 1.2% q-o-q reflecting the US economic slowdown, serving as a major drag upon the contribution by external demand. Furthermore, domestic demand, which had turned positive for the first time in three quarters, should also soften due to a backlash to corporate capital investment (-1.0% q-o-q). In the absence of momentum stemming from domestic and external demand, Japan's economy should face growing uncertainties. In full-year FY2007, we expect the rate of Japan's real GDP growth to stand at 1.6%.

The slowdown of US and eurozone economies will depress exports

Furthermore, there is a large possibility that the rate of growth will moderate in FY2008 and FY2009 in comparison to FY2007 as a result of the slowdown of the US and eurozone economies. Considering the large share of Japan's exports to the US and the EU (approximately 40%), the slowdown of the US and eurozone economies will have a negative impact upon exports (**Chart 10**). To be sure, amid the decline of the composite leading indicators of the OECD (compared with the rate of change six months ago) for the fifth month in a row, Japan's export

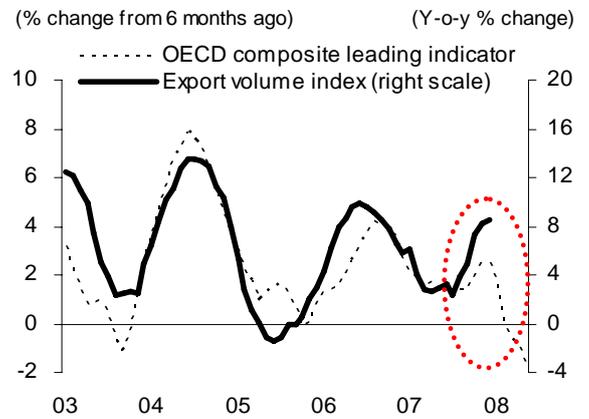
volume index is also starting signs of peaking out (the composite leading indicator of the OECD leads Japan's export volume index by approximately six months) (**Chart 11**).

[**Chart 10: Japan's export destinations (share in 2007)**]



Source: Ministry of Finance, *Trade Statistics*.

[**Chart 11: OECD composite leading indicator and the export volume index**]



Note: Trade volume expressed as the y-o-y ch of 6mma. OECD Composite Leading Indicator shifted backward by 6 months.

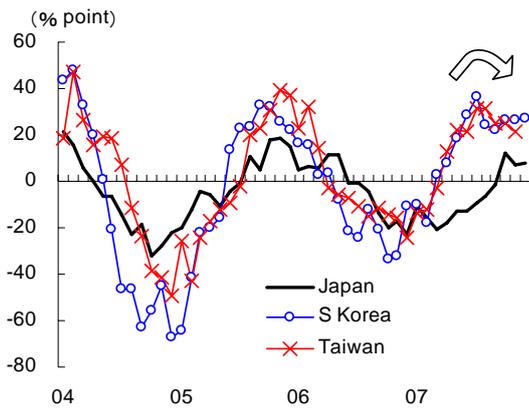
Sources: Ministry of Finance, *Trade Statistics*, OECD, *Composite Leading Indicators*.

Inventory adjustment of IT-related goods predicted to occur after the Beijing Olympic Games

Even though exports to the emerging economies should remain more or less strong and continue to underpin Japan's exports, what really requires attention is the emergence of inventory adjustment pressures upon IT-related goods on a global scale after the Beijing Olympic Games in 2008. Judging from the fact that the shipments-inventories balance is already peaking out, the odds are high that adjustment pressures will rise in the second half of 2008 (**Chart 12**).

Given the stagnant growth of the US and eurozone economies and IT-related inventory adjustment, exports would be subject to stronger downward pressures and production activity would also slide into the doldrums (**Chart 13**).

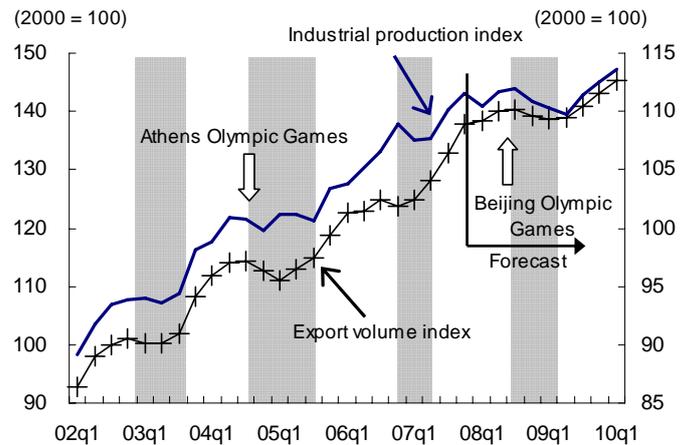
[Chart 12: Shipments-inventories balance of IT-related goods]



Note: Data on Japan refers to electronic parts & devices and information communication and data on S Korea and Taiwan refers to electronic parts.

Sources: Ministry of Economy, Trade and Industry, *Industrial Production*, Korea National Statistical Office, Ministry of Economic Affairs, R.O.C., Department of Statistics.

[Chart 13: Industrial production index and export volume index]



Note: Data from 2009 1Q are forecasts by MHR.

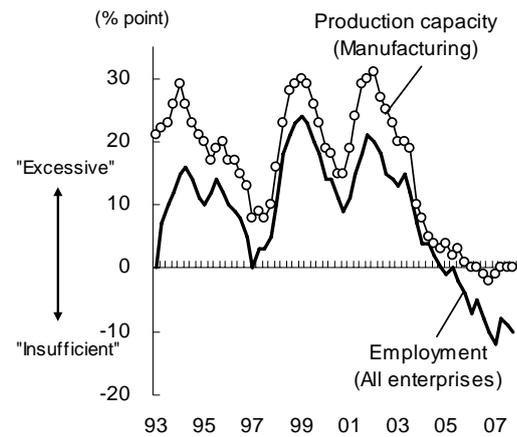
Sources: Ministry of Finance, *Trade Statistics*, Ministry of Economy, Trade and Industry, *Indices of Industrial Production*.

Despite the possibility of a slide into recession from the second half of FY2008, the downturn should prove benign and short-lived

The deterioration of the external environment such as US economic slowdown, tightening measures by the Chinese government and the IT sector inventory adjustment are reminiscent of the lull of the Japanese economy during the period from the second half of 2004 to the first half of 2005. Furthermore, the economy at the current juncture lacks the short-term cyclical tailwinds enjoyed during the previous lull such as the recovery of corporate earnings and renewal demand for capital investment after the “lost decade”. Therefore, depending upon domestic demand, there is the possibility that the economy may slide into a recession during the period from the second half of FY2008 to the first half of FY2009 (we expect near-zero growth in the Oct-Dec quarter of 2008 and the Jan-Mar quarter of 2009.)

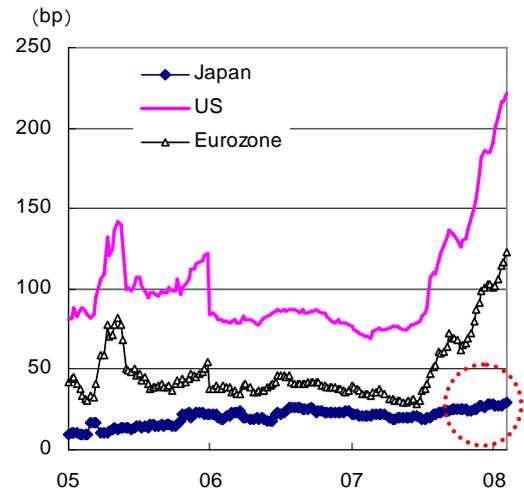
Nevertheless, even if the economy slips into a temporary recession, we expect that the deterioration will turn out to be benign. According to the Bank of Japan’s (BOJ) *Short-Term Economic Survey of Enterprises in Japan* (“TANKAN”), companies are not feeling saddled by excessive employment and capacity (**Chart 14**). Furthermore, note also that Japan’s corporate sector has weathered the prolonged adjustment of excess debt and is in a far better financial position than before to face economic downturns. Unlike the US and Europe where the adverse effect upon companies stemming from an increasingly risk-averse financial market is a source of concern, there are no signs that credit uncertainties are spreading in Japan (**Chart 15**). Thus, insofar as global economic trends – especially China – move in line with our main scenario outlook, the odds are high that the adjustment will turn out to be benign even if Japan falls into an economic recession over the short term.

[Chart 14: Corporate perception of employment and production capacity]



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

[Chart 15: Corporate bond spreads (Japan, US, EU)]



Note: Spread between 3–5-yr corporate bonds and government bonds.

Source: Merrill Lynch.

(2) Forecast of the Japanese economy in FY2008 and FY2009

FY2008 1H: despite the slowdown of external demand, the rate of growth will stay at the upper end of the 1%-level p.a. due to a rebound of residential investment

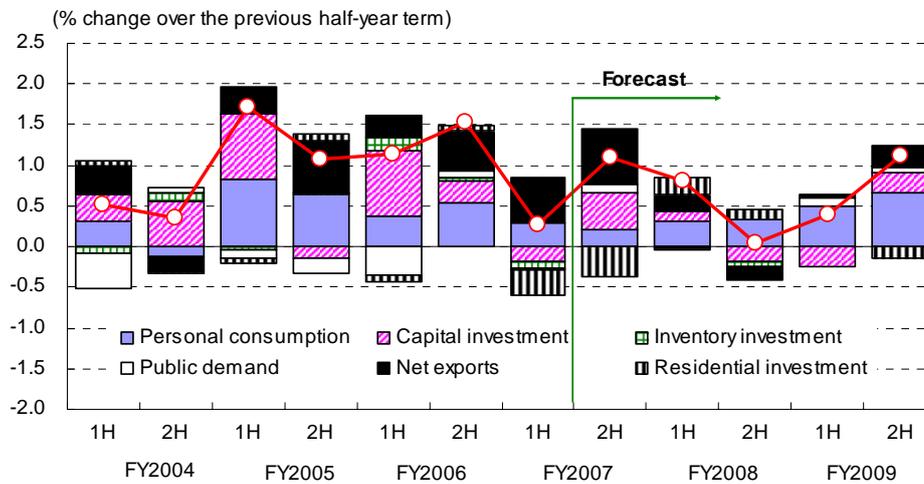
Exports and production activity will slow down in FY2008 2H

In the first half of FY2008, the rebound of residential investment should push up the rate of economic growth. Even though the environment surrounding corporate earnings is turning harsher due to the rise of crude oil prices and appreciation of the yen, leading indicators on capital investment such as machinery orders remain on solid footing, providing reasons to believe that capital investment will maintain its momentum after a temporary fall in the Jan-Mar quarter of 2008. Personal consumption – one of the two main components of domestic demand – should remain lackluster due to the sluggish growth of household income. Export growth, which has thus far driven the Japanese economy, will likely moderate reflecting the deceleration of the industrialized economies such as the US. Although exports should continue to follow an upward path, underpinned by exports to booming emerging economies, a slowdown to a certain degree will be inevitable. Turning to industrial production, output should continue to rise mainly in the IT sector because of the predicted rise of overseas and domestic demand for digital electronic appliances prior to the Beijing Olympic Games. The rate of growth in the first half of FY2008 should remain at 1.6% p.a.

In the second half of FY2008, crude oil prices should gradually decline, easing the cost pressures upon corporate earnings. Despite a mild upturn of wages from the previous year, leading to a slight rise of labor compensation, it will be insufficient to push up consumer spending. We are thus inclined to believe that personal consumption will remain weak. Furthermore, based upon forecasts that the demand for IT products and parts will ease after the Beijing Olympic Games,

industrial production and exports should fall into a period of stagnation. Business capital investment will also weaken reflecting the stagnation of production activity, leading to a sharp slowdown of growth in the second half of FY2008 to 0.1% p.a.

[Chart 16: Forecast on Japan's real GDP growth (half-year basis)]



Source: Cabinet Office, Preliminary Quarterly Estimates of GDP.

Full-year growth in FY2008 should fall to 1.4%

More definite signs of an autonomous recovery in the second half of FY2009

The positive output gap will contract in the second half of FY2008

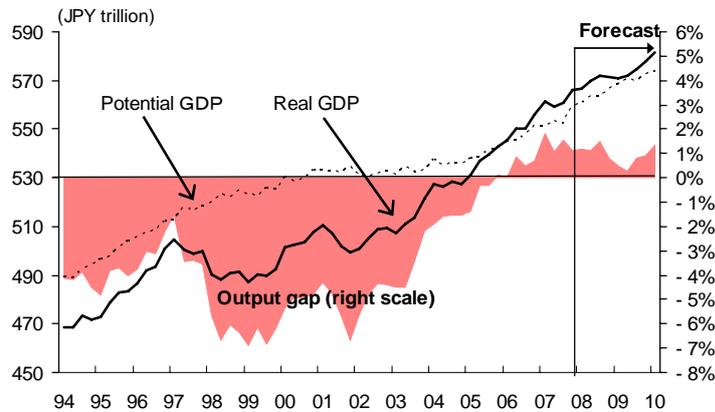
On a full-year basis, we expect the pace of real GDP growth in FY2008 to stand at 1.4% (previous outlook: 1.9%), falling slightly below growth in FY2007 (1.6%). Even though the breadth of the import deflator will narrow because of the fall of crude oil prices in the second half of FY2008, the GDP deflator should remain in negative territory (-0.1% y-o-y) in FY2008 as a result of the decline of the import deflator due to the strength of the yen. For the time being, growth in real terms will remain above nominal growth, a condition persisting since FY1997.

Growth in the first half of FY2009 will lack momentum such as the lingering effect of the stagnation of exports and production continuing from the second half of FY2008 leading to the weakness of capital investment. However, we expect more definite signs of recovery in the second half of FY2009 based upon the assumption that (1) the IT-related inventory adjustment will be moderate, (2) the emerging economies, especially China, will grow autonomously, and (3) Japan's labor market will remain relatively strong, leading to the rise of wages. Even though the rate of real GDP growth in FY2009 will appear to slow down (1.0%), the rate of growth excluding the carry-over from FY2008 should rise from 0.7% in FY2008 to 1.1%.

The output gap (the gap between demand and supply) estimated by MHRI stood at 1.1% as of the Oct-Dec quarter of 2007 (Chart 17). If the Japanese economy grows in accordance to our outlook, the breadth of the output gap in positive territory should remain flat unchanged until the first half of FY2008 and subsequently narrow to around zero in the second half of the fiscal year. Even though we expect the consumer price index to trend in positive territory during the forecast horizon, this only stems from the rise of costs such as the surge of raw material prices. The upward pressures upon prices in terms of supply and

demand are extremely weak.

[Chart 17: 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 18: Outlook on the Japanese economy]

(%)

	FY2006	FY2007	FY2008	FY2009	FY2007		FY2008		FY2009		FY2007	FY2008	FY2009
	(Actual)	(Forecast)	(Forecast)	(Forecast)	1H (Actual)	2H (Forecast)	1H (Forecast)	2H (Forecast)	1H (Forecast)	2H (Forecast)	(Contribution)	(Contribution)	(Contribution)
GDP (real)	2.4	1.6	1.4	1.0	0.5	2.2	1.6	0.1	0.8	2.2	-	-	-
Domestic demand	1.6	0.4	0.9	1.1	-0.6	0.8	1.3	0.4	1.1	1.7	0.4	0.9	1.0
Private sector demand	2.6	0.4	1.2	1.2	-0.7	0.7	1.7	0.6	1.1	2.1	0.3	0.9	0.9
Personal consumption	1.7	1.2	1.0	1.8	1.1	0.7	1.1	1.2	1.8	2.4	0.7	0.6	1.0
Residential investment	0.2	-13.5	2.8	-0.3	-17.1	-22.1	15.3	8.7	-0.0	-9.4	-0.5	0.1	-0.0
Capital investment	5.7	1.2	1.6	-1.2	-2.3	6.0	1.7	-2.3	-3.0	3.0	0.2	0.3	-0.2
Public sector demand	-1.8	0.2	0.1	0.6	-0.2	0.9	-0.3	0.0	1.0	0.6	0.0	0.0	0.1
Government consumption	0.1	1.0	0.8	0.9	1.0	2.0	0.3	0.8	0.9	1.1	0.2	0.1	0.2
Public investment	-9.1	-3.2	-3.1	-0.9	-5.3	-4.0	-2.7	-3.3	0.6	-1.8	-0.1	-0.1	-0.0
Net exports (contribution)	0.8	1.1	0.5	0.1	1.1	1.4	0.4	-0.3	0.1	0.6	1.1	0.5	0.1
Exports	8.4	8.9	4.8	2.5	8.9	10.3	5.1	-0.8	2.3	6.2	1.3	0.8	0.4
Imports	3.1	1.7	2.8	2.7	2.0	1.8	3.8	1.8	2.5	4.0	-0.2	-0.3	-0.3
GDP (nominal)	1.6	0.8	1.3	0.9	-0.3	1.2	2.4	-0.8	1.2	2.0			
GDP deflator	-0.9	-0.7	-0.1	-0.0	-0.5	-1.0	-0.1	-0.1	-0.2	0.1			
Industrial production	4.8	3.1	0.8	0.6	0.6	1.9	0.8	-1.1	-0.0	2.3			
Unemployment rate	4.1	3.8	3.7	3.6	3.8	3.9	3.7	3.7	3.7	3.6			
Current account balance (JPY tril)	21.2	25.6	27.8	28.6	25.5	25.4	28.9	26.5	27.5	28.8			
as a percentage of nominal GDP	4.1	5.0	5.3	5.4	5.0	4.9	5.5	5.1	5.2	5.4			
Domestic corporate goods prices	2.0	2.1	1.6	0.7	1.6	2.7	2.0	1.2	0.7	0.7			
Consumer prices	0.1	0.3	0.5	0.0	-0.1	0.6	0.8	0.2	-0.1	0.1			
Long-term interest rate (%)	1.75	1.61	1.41	1.68	1.70	1.52	1.50	1.33	1.50	1.85			
Nikkei stock average (JPY)	16,450	16,100	14,150	15,300	17,300	14,900	14,300	14,000	14,800	15,800			
Exchange rate (JPY/USD)	117.0	115	103	103	119	110	104	102	103	103			
Crude oil price (WTI/barrel)	64.9	80.5	80.7	75.1	70.2	90.8	83.1	78.2	78.3	72.0			

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.

* * * * *

Mizuho Research Institute Ltd., Kazuhiko Yano, Senior Economist kazuhiko.yano@mizuho-ri.co.jp

