

## Economic Outlook for FY2008 and FY2009

May 2008

The Mizuho Research Institute Ltd. (MHRI) has revised its economic outlook for FY2008 and FY2009 subsequent to the release of *The First Preliminary Quarterly Estimates of GDP (1<sup>st</sup> QE*) for the Jan-Mar quarter of 2008. The key points are as follows.

### <The US Economy>

US growth will remain weak due to the credit crunch and inflation

**2008** 1.4% (previous outlook) → 0.9% (current outlook)

**2009** 1.6% (previous outlook) → 0.5% (current outlook)

### <The Japanese Economy>

**FY2008** The economy will remain stagnant due to corporate sector downturn and rise of prices

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

Nominal GDP: 1.3% (previous outlook) → 0.0% (current outlook)

**FY2009** Japan's growth will remain weak due to sluggish export and capital investment growth in the first half of the year

Real GDP: 0.9% (previous outlook) → 1.1% (current outlook)

Nominal GDP: 0.9% (previous outlook) → 1.3% (current outlook)

This English-language translation is based upon the outlook in Japanese released on May 20, 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.

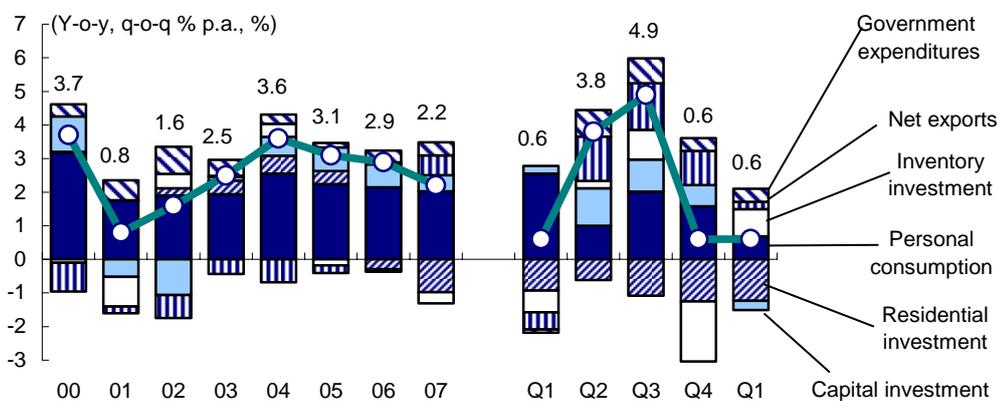
# I. The current state of the US economy

**The US economy continued to moderate in the Jan-Mar quarter of 2008. Domestic final demand fell into negative territory**

According to the US Department of Commerce, US gross domestic product (GDP) in real terms stood at 0.6% q-o-q p.a. in the Jan-Mar quarter of 2008 (“advance” estimates), marking the second consecutive quarter of slow growth subsequent to the Oct-Dec quarter of 2007 (**Chart 1**). Even though US economic growth managed to stay in positive territory, domestic final demand (in real terms, hereinafter the same) fell 0.4% q-o-q p.a. In addition to a further deterioration of residential investment, personal consumption slowed to 1.0% q-o-q p.a. Corporate capital investment - thus far charting firm grounds - also worsened (-2.5% q-o-q p.a.) The contribution to growth by external demand also shrank from 1.02% in the Oct-Dec quarter to 0.22% in the Jan-Mar quarter. Even though this was due largely to the rise of import growth, exports also grew 5.5% q-o-q p.a., underscoring the fact that overseas economic growth and the weak dollar are serving to underpin the US economy.

Judging from subsequent data releases for the Jan-Mar quarter since the advance estimates, the rate of US real GDP growth may be revised upward to around 1% q-o-q p.a. Even so, the overall assessment that US growth will remain “weak for the second quarter in a row” will remain unchanged (US preliminary real GDP estimates are scheduled for release on May 29th, to be reflected in our forecast in June).

[ Chart 1: US real GDP growth ]



Note: The line represents real GDP (calendar year data on a y-o-y basis and quarterly data on a q-o-q basis). The bars represent the contribution to the line.

Source: US Department of Commerce.

**Actual conditions indicate a slide into recession**

While it will still take some time until it can be discerned that the US economy has indeed slipped into a recession according to official releases, actual conditions indicate a slide into recession.

Turning first to labor productivity data, total labor hours fell for the third quarter in a row and the breadth of the drop is widening. Total labor hours in the Jan-Mar quarter fell 1.8% q-o-q p.a. (nonfarm private sector). With the exception of periods of economic recession, it is the first time since 1947 when relevant statistics are available, that labor input has continued to decline for such a

prolonged period.

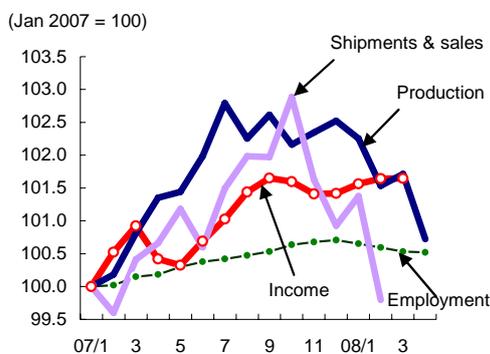
The Business Cycle Dating Committee of the National Bureau of Economic Research (NBER), a private non-profit organization, officially determines whether or not the US economy has fallen into a recession. According to the NBER, a recession is “a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales”. While real GDP would be the best indicator to assess overall economic activity, since it is only measured quarterly, the Business Cycle Dating Committee places emphasis upon the five following indicators to determine business cycle turning points: (1) personal income less transfers stated in real terms, (2) employment (nonfarm payrolls), (3) industrial production, (4) volume of sales of the manufacturing and trade sector stated in real terms, and (5) monthly real GDP (estimates by private forecast institutions).

Of these indicators, industrial production (note: we focus upon the non-energy sector which is unaffected by weather factors) and the volume of sales have clearly peaked out and nonfarm payrolls and real personal income are showing signs of a shift from “flat growth” to a “gradual decline” (**Chart 2**). Moreover, monthly real GDP stood at a low level of 0.7% as of March in contrast to the peak in January 2008.

**Core inflation is moving around the upper end of the price stability zone**

Turning to US price movements, core inflation (personal consumption expenditures (PCE) deflator excluding food and energy) stood at 2.1% y-o-y as of March, hovering close to the upper end of the so-called price stability zone (1.0% to 2.0%) (**Chart 3**). Even so, given the sharp rise of food (4.3% y-o-y) and energy (16.5% y-o-y) prices, the risks of its ripple effect upon core inflation are persisting. Crude oil and gasoline prices are soaring above expectations, leading to forecasts of a sharp rise of headline inflation in the Apr-Jun quarter.

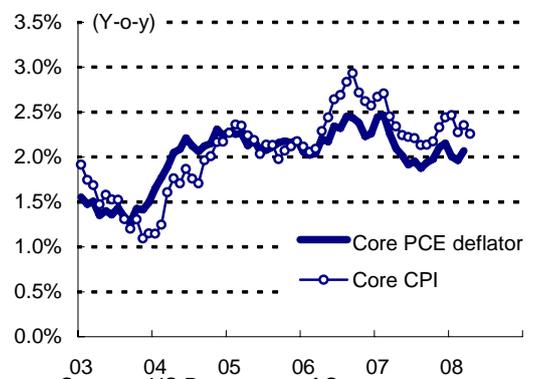
[ Chart 2: Trends in coincident indicators ]



Note: Shipments & sales, income are set forth in real terms. Production refers to production in non-energy sectors to eliminate fluctuations due to weather factors.

Sources: US Department of Labor, Federal Reserve Board, US Department of Commerce

[ Chart 3: Price developments ]



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

**More measures to stem the financial crisis**

The subprime crisis reached a major turning point just after the release of our previous *Economic Outlook for FY2008 and FY2009* (March 14, 2008).

Bear, Stearns Companies Inc. (“Bear Stearns”), a major US investment bank, fell into a liquidity crisis, prompting the Federal Reserve Bank of New York to provide an emergency loan via JP Morgan Chase. In tandem with the foregoing, the Federal Reserve Board (“Fed”) established provisional liquidity boosting measures for primary dealers such as the Term Security Lending Facility (“TSLF”) and the Primary Dealer Credit Facility (“PDCF”) in a bid to quell the financial market turmoil (**Chart 1**). Furthermore, it was decided that part of the assets held by Bear Stearns would be managed separately, backed by the emergency loan provided by the Federal Reserve Bank of New York (the “JP Morgan Chase Facility”) and that the remainder would be merged by JP Morgan Chase.

The financial market has started to show signs of stabilization subsequent to “recommendations to be implemented within 100 days” by the Group of Seven (G-7) meeting of finance ministers and central bank governors on April 11<sup>th</sup> to disclose information regarding losses related to the subprime crisis and to reinforce capital bases.

**That said, the financial market is still a drag upon the US economy. Mounting concerns regarding a vicious cycle.**

Nevertheless, as indicated by Fed Chairman Ben Bernanke, financial market conditions are far from normal (May 13<sup>th</sup>), precluding reasons for premature optimism. According to the Fed, US banking institutions are taking an increasingly strict lending stance. Furthermore, business results of US banks reveal a shift from losses stemming from subprime mortgage loans and related securitized financial products to the spread of losses related to a broader range of credit such as credit card loans, commercial real estate & corporate loans. In contrast to concerns thus far that the financial market problems would serve as a negative impact upon macroeconomic conditions, the deterioration of macroeconomic conditions are starting to serve as a drag upon the financial sector, providing reasons to be worried about a vicious cycle.

**Downward revision of US growth: a dip into negative territory in the second half of 2008.**

Judging from the weakness of demand to date and the higher-than-expected rise of food and energy prices, we have revised our outlook on the timing when the tax cut will start to show effect. Accordingly, we have revised downward our outlook on US economic growth, slashing the rate of real GDP growth from 1.4% in our previous outlook to 0.9% with respect to the year 2008 and from 1.6% to 0.5% with respect to the year 2009 (**Chart 4**). In the second half of 2008, the fading effect of the tax cut, inflation and credit crunch will weigh heavily upon the US economy, dragging down the rate of growth into negative territory.

[ Chart 4: Outlook on the US economy ]

(%)

	2007	2008	2009	2007		2008 (Forecast)		2009 (Forecast)	
		(Forecast)	(Forecast)	1H	2H	1H	2H	1H	2H
GDP	2.2	0.9	0.5	1.8	3.5	0.5	-1.1	0.7	1.7
Personal consumption	2.9	1.1	0.8	3.2	2.3	1.5	-0.8	1.1	1.8
Residential investment	-17.0	-24.7	-15.2	-15.5	-19.6	-26.6	-26.1	-13.6	-5.1
Capital investment	4.7	0.9	-3.4	3.4	8.9	-0.1	-4.8	-4.3	-0.0
Inventory investment (USD100 million)	46	-73	-110	30	62	-19	-128	-144	-75
Government expenditures	2.0	2.1	1.3	1.6	3.4	1.9	1.4	1.0	1.7
Net exports (USD 100 million)	-5,556	-4,713	-4,151	-5,930	-5,182	-4,933	-4,494	-4,161	-4,140
Exports	8.1	7.0	3.3	5.9	12.9	5.6	4.4	2.7	3.5
Imports	1.9	0.7	-0.3	1.6	1.1	1.5	-1.1	-1.3	2.5
Domestic final demand	1.8	0.2	0.0	1.9	2.1	0.2	-1.6	0.1	1.5
Unemployment rate	4.6	5.3	5.9	4.5	4.8	5.1	5.5	5.8	6.0
Nonfarm payrolls (per month, 1,000 persons)	127	-86	-43	119	28	-44	-129	-66	-20
PCE deflator <y-o-y ch>	2.5	3.7	2.2	2.3	2.8	3.5	3.8	2.5	2.0
Core PCE deflator <y-o-y ch>	2.1	2.2	2.1	2.2	2.0	2.1	2.3	2.2	2.0
Current account balance (USD100 million)	-7,386	-7,425	-6,588	-3,883	-3,504	-3,800	-3,625	-3,275	-3,313
<as a percentage of nominal GDP>	-5.3	-5.2	-4.5	-5.7	-5.0	-5.3	-5.0	-4.5	-4.5

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, MHRl (May 18, 2008).

**The tax cut will start to show effect one quarter earlier than expected**

We have moved forward our outlook regarding the timing of the effect of the tax cut from the Jul-Sep quarter to the Apr-Jun quarter. According to the Internal Revenue Service, the procedures regarding the tax rebates commenced at the end of April and should be completed by July 11<sup>th</sup>. Although we had initially predicted that the tax cut would be implemented and start to show effect during the Jul-Sep quarter, we now believe that the timing will be moved forward to the period between May to July.

Assuming that the tax rebates will start to appear evenly in the statistics regarding personal income in the May-Jul period, the tax cut would serve to increase personal income by USD312 billion p.a. (USD117 billion × 2/3 × 4) in the Apr-Jun quarter, thus pushing up nominal disposable income by approximately 12% p.a. At the time of the tax cuts in 2001 and 2003, nominal disposable income rose 12.1% q-o-q p.a. and 8.9% q-o-q p.a. in the Jul-Sep quarter of each year when the tax cuts were implemented. A similar phenomenon should be observed in the Apr-Jun quarter of 2008. However, since the tax rebates reaching households in the Jul-Sep quarter would shrink from the previous quarter, its impact upon nominal disposable income would be negative. Similarly, when households no longer receive rebates in the Oct-Dec quarter, nominal disposable

**Effect of tax rebates will be eroded largely by inflation**

income would continue to be subject to negative pressures. Personal consumption in nominal terms will most likely move in tandem with the foregoing movements in nominal disposable income (**Chart 5**).

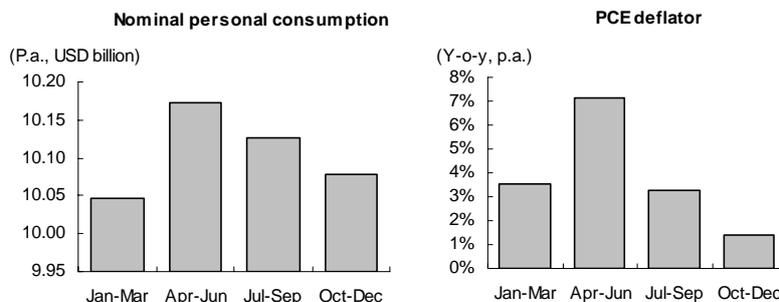
We have also made a major revision to our outlook on inflation. Given the higher-than-expected surge of crude oil and gasoline prices, the rise of food prices is also unabated. Judging from the current conditions, the personal consumption expenditures (PCE) deflator is predicted to rise sharply in the Apr-Jun quarter. As a result, the effect of the tax cut moved forward will be eroded to a large extent by inflation. According to a questionnaire survey conducted in May by the National Retail Federation (NRF) on how consumers plan to spend their tax rebate checks, 27% of the respondents said that they would use the rebates to “pay down debt” while 39.9% said that they would use the rebates on “spending”. Furthermore, the items consumers plan to buy has shifted from the results of the NRF survey conducted in February, with a higher percentage of planned spending on gasoline and necessities (food etc.) of which prices have been rising and a lower percentage on discretionary spending. The results indicate that the tax rebates would either be used to pay down debt or be offset by the rise of food and energy prices.

On a quarterly basis, the inflation rate will most likely decline in the second half of 2008. However, note that there are upside risks to inflation. The rise of energy, resources and food prices stem from the expansion of emerging economies and there are no signs of the emerging economies losing momentum anytime soon. Moreover, even though the emerging countries are starting to feel the impact of inflation, it is unlikely that the central banks of such countries will take monetary tightening steps at the expense of economic growth.

**Smoldering concerns regarding inflation will keep US monetary policy on hold**

The Fed appears to be caught in a quandary with persisting downside risks to the economy on the one hand and a greater need to watch the rise of inflation pressures on the other. The successive interest rate cuts since last year should come to an end, giving way to a period during which the Fed will keep monetary policy on hold.

**[ Chart 5: The timing of the tax cuts & nominal consumption and the inflation outlook ]**



Note: Trends from the Jan-Mar Qtr to the Oct-Dec Qtr of 2008. Based upon the assumption that the growth of personal consumption without the tax rebates would be zero and that marginal consumption propensity would be 0.3 from April onward.

Source: MHR.

## II. The Japanese economy

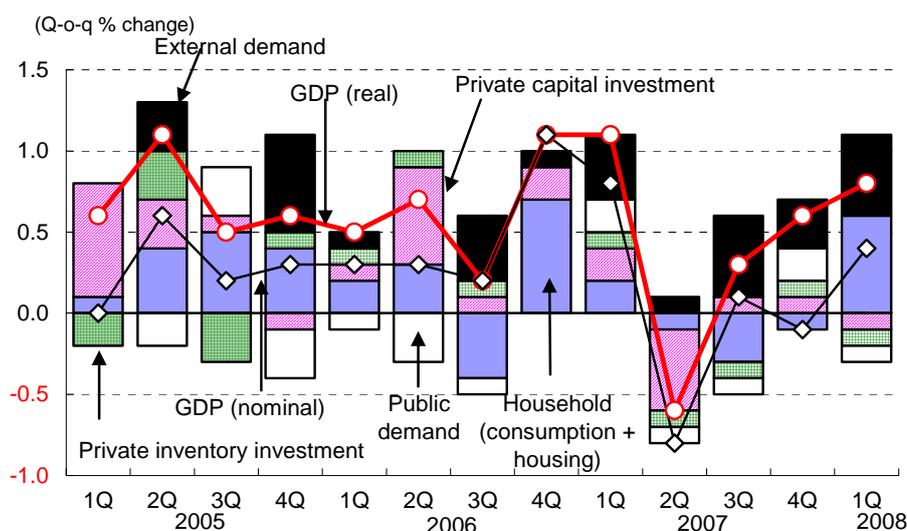
### (1) The current state of the economy

**Japan's economy grew strongly, above 3% q-o-q p.a. in the Jan-Mar quarter of 2008 driven by external demand**

Japan's real GDP grew 0.8% q-o-q (3.3% q-o-q p.a.) in the Jan-Mar quarter of 2008, far above the potential rate of growth rate estimated to be slightly below 2% (Chart 6).

Looking closer at each of the components of demand, personal consumption grew a stronger-than expected 0.8% q-o-q. This, however, was due partially to a special factor – the leap year effect - in 2008. According to estimations by MHRI, the leap year effect pushed up personal consumption by 0.4% pt in the Jan-Mar quarter. Residential investment grew 4.6% q-o-q, rising for the first time in five quarters, rebounding from the slump stemming from the amendment of the buildings standards law. Corporate sector growth moderated. Capital investment fell 0.9% q-o-q, dropping for the second quarter in a row and private-sector inventory investment shrank mainly with respect to inventories of finished goods, thus pushing down the rate of growth by 0.1% pt. Together with the household sector, the contribution to growth by domestic private demand reached 0.4% pt, rising from 0.2% pt in the Oct-Dec quarter. Even though public investment grew 1.5% q-o-q, rising for the second quarter in a row, the contribution by public demand turned out to be negative (-0.1% q-o-q) due to the fall of government final consumption expenditures (-0.8% q-o-q). As a result, the contribution by domestic demand remained unchanged from the Oct-Dec quarter at 0.3% pt. Meanwhile, since exports grew strongly (4.5% q-o-q), outpacing the growth of imports (2.0% q-o-q), the contribution by external demand (0.5% pt) served as a major driver of Japan's economic growth.

[ Chart 7: Japan's quarterly GDP growth ]



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

**Nominal GDP grew 0.4%  
q-o-q**

The GDP deflator, a broad measure of price changes, sank deeper into negative territory (-1.4% y-o-y) from the previous quarter (Oct-Dec quarter -1.3% y-o-y). Accordingly, Japan's GDP growth on a nominal basis stood at 0.4% q-o-q (1.5% q-o-q p.a.), falling sharply below growth in real terms. Given the rise of the personal consumption deflator to 0.3% y-o-y (Oct-Dec quarter: -0.2% y-o-y) reflecting the higher prices of gasoline and heating oil, the domestic demand deflator rose 0.5% y-o-y (Oct-Dec quarter: -0.1% y-o-y). Meanwhile, the export deflator fell (-4.2% y-o-y) due to the appreciation of the yen, revealing that the rise of the import deflator (7.1% y-o-y) served to push down the GDP deflator.

**The actual state of the  
economy indicates a  
“lull”**

While the Japanese economy grew strongly above 3% p.a. in the Jan-Mar quarter, its sustainability is questionable since Japan's growth was affected largely by special factors such as the leap year and the rebound from the drop stemming from the amendment of the building standards laws. The current state of the economy may be described as a “plateau”, judging from factors such as the drop of industrial production in the Jan-Mar quarter (-0.7% q-o-q) for the first time in four quarters and the deterioration of corporate business results stemming from the strength of the yen and soaring crude oil prices.

**The rise of commodity  
prices serve as burdens  
totaling nearly JPY7  
trillion**

Since our previous *Economic Outlook for FY2008 and FY2009* in March, the largest change in external factors affecting the Japanese economy is the surge of commodity prices such as crude oil. The price of crude oil (WTI) is currently soaring above USD120/bbl. In FY2008, the price of iron ore is set to increase approximately 65% y-o-y, the price of metallurgical coal (mainly for steel production) will treble and the price of fuel coal (mainly for electrical power generation) is poised to increase 2.3-fold. The price of imports of major raw materials including crude oil, iron ore, coal and non-ferrous metals total JPY18.6 trillion (3.6% of GDP) as of FY2007, a 2.7-fold increase from JPY6.8 trillion in FY2003 (**Charts 7 and 8**). Even when assuming that the strength of the yen will mitigate the rise of import prices and that the quantity of imports will remain more or less unchanged from the previous year (based upon the assumption that the value of imports of nonferrous metals will remain unchanged from FY2007), the value of imports of major raw materials is estimated to reach JPY25.4 trillion (4.9% of GDP). The value of imports of raw materials as a percentage of GDP is nearing the past peak near 6%, last reached during the 1<sup>st</sup> and 2<sup>nd</sup> oil crises. Note that an additional burden of JPY6.8 trillion (1.3% of GDP) will weigh down upon the Japanese economy during the year from FY2007 to FY2008.

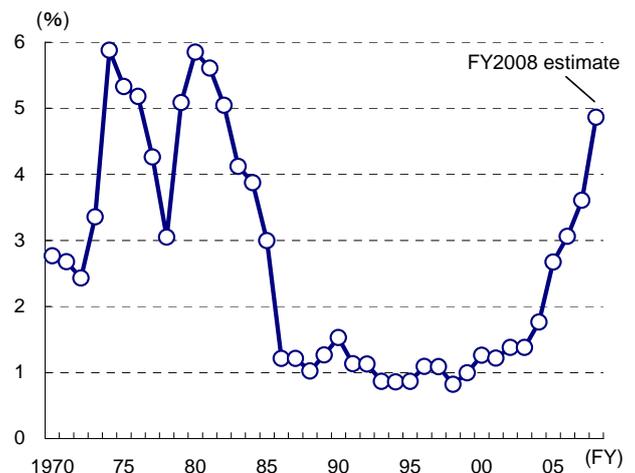
[ Chart 7: Imports of major raw materials  
(estimate) ]

Fiscal year		2003	2004	2005	2006	2007	2008
		(Actual)	(Actual)	(Actual)	(Actual)	(Actual)	(Estimate)
Imports (value)	Crude oil	5.1	6.4	10.0	11.4	13.7	17.5
	Iron ore	0.4	0.4	0.7	0.9	1.1	1.6
	Coal	0.8	1.2	1.6	1.6	1.8	4.2
	Nonferrous metals	0.5	0.8	1.2	1.8	2.0	2.0
	Total	6.8	8.8	13.5	15.7	18.6	25.4
Imports (change)	Crude oil	0.0	1.2	3.6	1.4	2.3	3.8
	Iron ore	0.0	0.1	0.2	0.2	0.2	0.5
	Coal	0.0	0.4	0.4	0.0	0.2	2.5
	Nonferrous metals	0.1	0.3	0.4	0.7	0.2	0.0
	Total	0.1	2.0	4.7	2.2	2.9	6.8

Note: Premises: FY2008 WTI = USD118/bbl. USD-based per unit import price of iron ore will rise 65% y-o-y. USD-based per unit import price of coal will rise 167% y-o-y. Quantity of imports of crude oil, iron ore and coal will remain flat from the previous year. USD/JPY rate = USD102/JPY. Imports (value of nonferrous metals will remain around the level in FY2007.

Sources: Compiled by MHIRI based upon Ministry of Finance, *Trade Statistics*.

[ Chart 8: Imports of major raw materials (as a  
percentage of GDP) ]



Sources: Ministry of Finance, *Trade Statistics*,  
Cabinet Office, *National Accounts*.

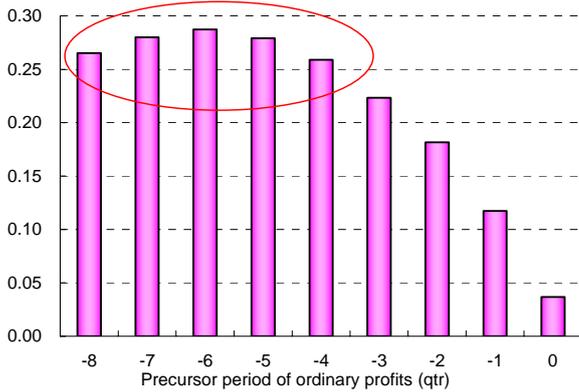
**It now appears certain  
that corporate profits  
will fall in FY2008**

**Capital investment will  
also decline in the  
second half of FY2008**

Given Japan's dependence upon imports for raw materials, the rise in value of raw material imports will have to be absorbed by either the corporate or household sectors. What cannot be priced in by the corporate sector will serve as downward pressures upon corporate profits while the portion priced in will serve as a burden upon household via the rise of inflation. Assuming that half is priced in, the burden upon the corporate sector would be JPY3.4 trillion. This is equivalent to approximately 6% of ordinary profits (estimates for FY2007 based upon the *Financial Statements Statistics of Corporations by Industry*: approximately JPY60 trillion). Since the appreciation of the yen, as well as the rise of raw material costs, will serve to pare down the profits of companies in the manufacturing and processing industries, it now appears certain that corporate profits will fall in FY2008.

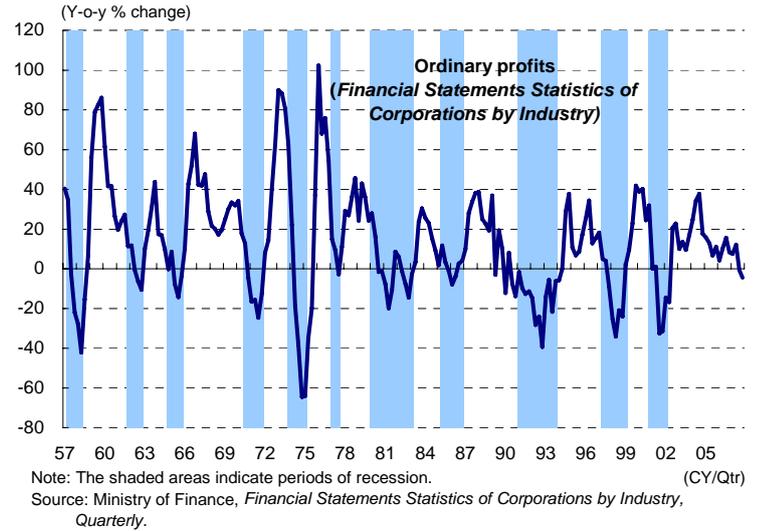
Given the downside risks to corporate profit performance, the odds are high that capital investment will also soften in the second half of FY2008. Machinery orders (orders in the private sector excluding orders for ships and orders by electrical power companies), a leading indicator of capital investment trends, rose for three quarters in a row up to the Jan-Mar quarter. Capital investment in progress should remain firm up to the first half of FY2008. However, past correlations between corporate profit results and capital investment indicate that capital investment tends to trace movements in ordinary profits by approximately four to eight quarters (**Chart 9**). Considering that ordinary profits (*Financial Statements Statistics of Corporations by Industry*) took a downturn in the Jul-Sep quarter of 2007, downside risks regarding capital investment would intensify from the second half of FY2008. Note also that past downturns of ordinary profits were invariably followed by recessions due to factors such as the fall of capital investment (**Chart 10**).

[ Chart 9: Ordinary profits and capital investment ]



Note: Based upon the seasonally adjusted ordinary profits and investment in plant and equipment in the *Financial Statements Statistics of Corporations by Industry*.  
Source: Ministry of Finance, *Financial Statements Statistics of Corporations by Industry, Quarterly*.

[ Chart 10: Ordinary profits and business cycles ]



**Rise of exports to emerging countries will underpin Japan's growth in the medium to long-term horizon**

On the other hand, exports (in terms of quantity) continued to grow strongly (9.8% y-o-y) in the Jan-Mar quarter due to the strength of exports bound for emerging countries and regions such as the ASEAN, Russia and the Middle East. Corporate expectations on economic growth remain more or less unchanged since many believe that the rise of demand among emerging countries is sustainable. According to the *Annual Survey of Corporate Behavior FY2007* (Cabinet Office, surveyed in January 2008), the expected rate of economic growth during the coming three years is 1.7% among manufacturers and 1.4% among nonmanufacturers (growth expectations were 1.9% and 1.4% respectively in the previous year). Judging from the foregoing, Japan is not in an environment which would trigger a capital stock adjustment as in past periods of recession and the odds are high that a significant drop of capital investment may be averted.

**Prices of necessities are rising**

In FY2008, the Japanese economy is predicted to stagnate due to the deterioration of corporate business performance and the accompanying decline of capital investment. However, it is unlikely that Japan will suffer a sharp fall of capital investment and fall into a serious recession.

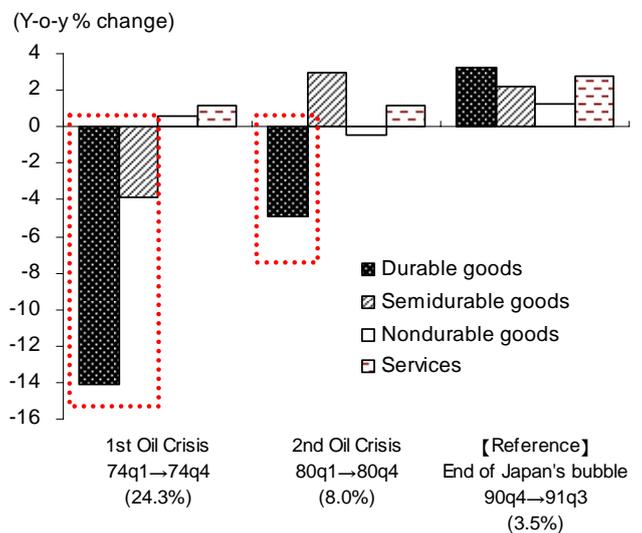
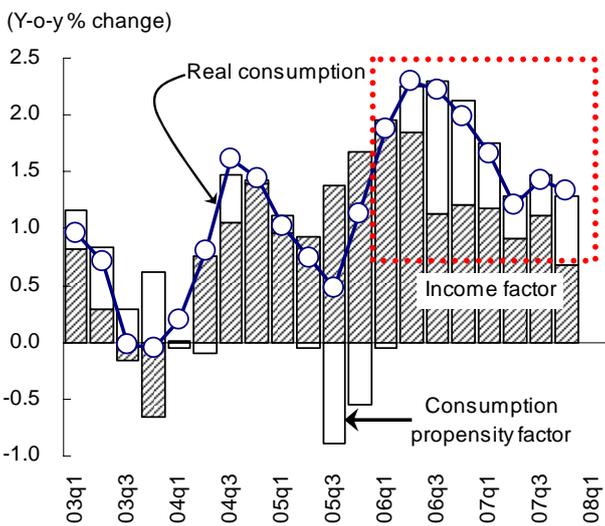
Domestic prices are rising at a faster pace reflecting the higher prices of grain and dairy products around the world in addition to raw materials such as crude oil, iron ore and coal. The consumer price index (CPI) rose 1.2% y-o-y in March, driven mainly by energy and food prices. Given the concentration of higher prices in items considered as daily necessities such as gasoline, heating oil, electricity costs, bread and milk, households are feeling a heavier burden. Due to the difficulty to reduce purchases of these items even when prices climb higher (indicating a lower price elasticity), the household sector is liable to feel pressured amid the lackluster rise of wages.

**Slower purchases of durable consumer goods presage the stagnation of personal consumption in FY2008**

Even though nominal wages have been softening and household income growth has been sluggish since FY2006, personal consumption has continued to grow to a certain extent through the rise of consumer propensity (**Chart 11**). In view of recent media coverage on the rise of crude oil and various price hikes, the rise of the CPI should accelerate over the summer months, serving as restraints upon household real income and lead to the stagnation of personal consumption. Consumer spending patterns at the time of the oil crises in the 1970s and 1980s reveal that higher prices of necessities led to a sharp fall of personal consumption through a sharp reduction of spending on durable goods (**Chart 12**). Spending on durable consumer goods is growing strongly at the moment, rising 2.9% q-o-q in the Oct-Dec quarter of 2007 and 2.8% q-o-q in the Jan-Mar quarter of 2008 against background factors such as the spread of consumer electronic products such as flat-panel TVs. The odds are high that the consumption of durable consumer goods will gradually slow down amid the rise of prices of daily necessities. Personal consumption will most likely remain stagnant, charting flat growth over the previous quarter during FY2008. Even so, so long as inflation remains around 1 to 2%, the chances of a sharp fall of spending on durable consumer goods as experienced during the previous oil crises appear slim. The Japanese economy will most likely avoid a sharp drop of personal consumption into negative territory.

[ Chart 11: Real consumption expenditures ]

[ Chart 12: Spending patterns during the 1<sup>st</sup> and 2<sup>nd</sup> Oil Crises ]



Note: 4Q prior moving average. Real consumption excludes imputed rent. FY2007 disposable income is extrapolated on the basis of the y-o-y change of labor compensation. Source: Cabinet Office, *National Accounts*.

Note: Consumption (by goods) are 2Q prior moving averages of seasonally-adjusted data. Figures in parentheses refer to the rate of inflation. Sources: Cabinet Office, *National Accounts*, Ministry of Internal Affairs and Communications, *Consumer Price Index*.

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

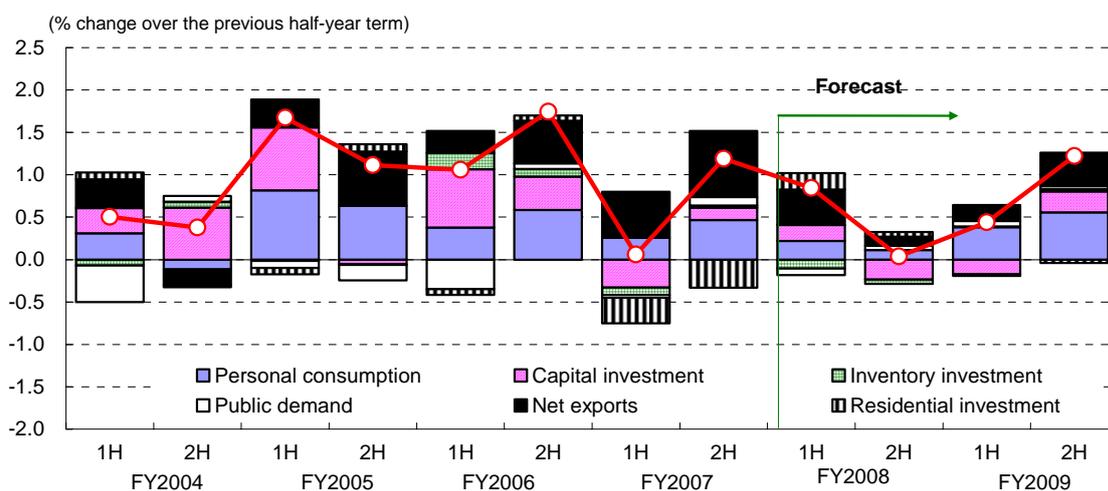
**The Japanese economy will remain stagnant during FY2008**

As explained in the preceding section, the deterioration of corporate profit performance, and the rise of prices (mainly food and energy) will serve as drags upon domestic demand in FY2008. Since household incomes in real terms will remain stagnant because of the rise of prices, personal consumption should continue to slump during FY2008. Judging from the rebound of residential investment from the slump due to the amendment of the buildings standards law and leading indicators which predict the strong growth of capital investment, the Japanese economy should maintain growth at 1.7% p.a. in the first half of FY2008 (**Chart 13**). However, capital investment will take a downturn in the second half of FY2008 reflecting the deterioration of corporate profits. Moreover, the growth of emerging economies will slow down due to the global rise of inflation. Thus the contribution to growth by external demand will gradually decline. In the second half of FY2008, the rate of Japan's economic growth will slow sharply to 0.1% p.a.

**FY2008 real GDP growth: 1.5%**

As a result, the rate of real GDP growth in FY2008 will stand at 1.5% (previous outlook: 1.3%) (**Chart 15**). The domestic demand deflator will rise to 0.5% y-o-y from 0.1% y-o-y in FY2007. Even so, given the decline of the export deflator and the rise of the import deflator due to the appreciation of the yen, the GDP deflator will remain in negative territory (-1.4% y-o-y) for the eleventh year in a row, resulting in 0.0% growth in nominal terms (previous outlook: 1.3%).

[ Chart 13: Forecast on Japan's real GDP growth (half-year basis) ]



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

**The economy will gradually pick up in FY2009**

The Japanese economy should gradually pick up in FY2009. The rise of crude oil will take a breather, alleviating the pressures upon corporate profits and domestic inflation. Given the alleviation of inflation pressures, household real incomes will grow slightly, leading to the upturn of personal consumption. Even though the recovery of capital investment will lag the upturn of corporate profits, capital investment will rebound in the second half of FY2009. Due in part to the

**Full-year growth in FY2009 will recover to 2.0%**

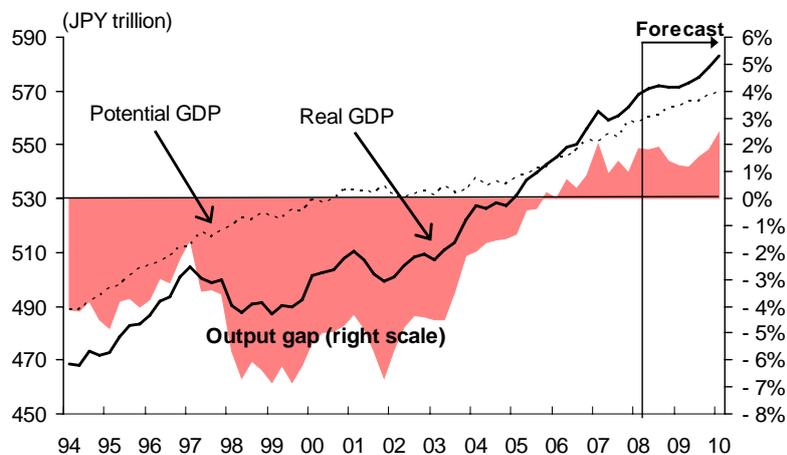
**The positive output gap will contract in the second half of FY2008**

upturn of the US economy, Japan's exports will most likely pick up in the second half of the fiscal year.

Full-year growth in FY2009 will reach 1.1% (previous outlook: 0.9%), slowing down from FY2008. This, however, is due partially to the small carry-over of growth (0.0%) to FY2009. In terms of growth in the final quarter of the fiscal year on a year-on-year basis, FY2009 growth should pick up to 2.0% from 0.5% in FY2008.

The output gap (the gap between demand and supply) estimated by MHRI stood at 1.8% as of the Jan-Mar quarter of 2008 (**Chart 14**). If the Japanese economy grows in accordance to our outlook, the breadth of the output gap in positive territory should narrow to around the lower half of the 1%-level in the first half of FY2009. We expect that consumer prices (core CPI excluding fresh food) will rise to 1.0% in FY2008 and subsequently decline to 0.3% in FY2009. The percentage change of the core CPI should also take a downturn since the rise of prices of items other than food and energy should remain limited and crude oil prices should decline. Insofar as the risks of inflation spreading to items other than food and energy are benign, there would be no need to rush an interest rate hike in view of the stagnant growth of the economy in FY2008. On the other hand, when considering the fact that the output gap is in positive territory, there would be no need for an interest rate cut anytime soon. This is clear from the results of the Bank of Japan's (BOJ) *Short-Term Economic Survey of Enterprises in Japan (Tankan)* of March 2008 which revealed that businesses feel neither short of capacity nor burdened by its excess and that they are feeling short of labor. Monetary policy will most likely be kept on hold during FY2008. Discussions on a rate hike will only emerge after the turn of the fiscal year in FY2009 when the economy starts to show signs of a gradual recovery.

**[ Chart 14: 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 15: Outlook on the Japanese economy ]

(%)

	FY2007	FY2008	FY2009	FY2008		FY2009		FY2007	FY2008	FY2009
	(Actual)	(Forecast)	(Forecast)	1H	2H	1H	2H	(Contribution)	(Contribution)	(Contribution)
				(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Actual)	(Forecast)	(Forecast)
GDP (real)	1.5	1.5	1.1	1.7	0.1	0.9	2.5	-	-	-
Domestic demand	0.3	0.6	0.8	0.9	-0.1	0.9	1.8	0.3	0.6	0.8
Private sector demand	0.3	0.8	0.9	1.3	-0.3	0.9	2.2	0.3	0.6	0.7
Personal consumption	1.4	0.9	1.3	0.8	0.4	1.4	2.0	0.8	0.5	0.7
Residential investment	-13.3	2.1	-0.5	15.2	3.8	-1.4	-2.8	-0.4	0.1	-0.0
Capital investment	-0.5	0.9	-1.0	2.4	-3.0	-2.2	3.3	-0.1	0.1	-0.2
Public sector demand	0.2	-0.0	0.5	-0.8	0.5	0.6	0.4	0.0	-0.0	0.1
Government consumption	0.6	0.7	1.0	0.2	1.5	0.8	1.1	0.1	0.1	0.2
Public investment	-1.7	-3.5	-2.2	-5.1	-4.1	-0.7	-3.4	-0.1	-0.1	-0.1
Net exports (contribution)	1.2	0.9	0.4	0.8	0.2	0.4	0.8	1.2	0.9	0.4
Exports	9.7	7.0	4.7	7.2	0.9	4.5	8.7	1.4	1.1	0.8
Imports	2.3	2.3	3.1	3.0	-0.6	3.4	6.1	-0.2	-0.3	-0.3
GDP (nominal)	0.6	-0.0	1.3	0.2	-0.8	1.8	2.4			
GDP deflator	-1.0	-1.4	0.3	-1.8	-1.2	0.1	0.5			
Industrial production	2.6	0.5	1.4	-0.2	0.1	0.8	1.2			
Unemployment rate	3.8	3.8	3.7	3.8	3.8	3.8	3.7			
Current account balance (JPYtrillion)	24.6	18.3	23.5	17.4	19.0	20.1	26.6			
as a percentage of nominal GDP	4.8	3.5	4.5	3.4	3.7	3.9	5.1			
Domestic corporate goods prices	2.3	4.5	1.0	4.5	4.5	1.6	0.3			
Consumer prices	0.3	1.0	0.3	1.3	0.8	0.3	0.2			
Long-term interest rate (%)	1.59	1.53	1.63	1.60	1.45	1.50	1.75			
Nikkei stock average (JPY)	16,000	13,500	14,500	13,700	13,300	14,000	15,000			
Exchange rate (JPY/USD)	114.2	102	104	104	101	103	105			
Crude oil price (WTI)	82.2	118.8	100.3	124.6	113.0	103.1	97.6			

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*.

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