

## Economic Outlook for FY2008 and FY2009

*(revised to reflect the Second Preliminary Quarterly Estimates of GDP for the Jan-Mar quarter of 2008)*

June 2008

The Mizuho Research Institute Ltd. (MHRI) has revised its economic outlook for FY2008 and FY2009 subsequent to the release of *The Second Preliminary Quarterly Estimates of GDP* (“2<sup>nd</sup> QE”) for the Jan-Mar quarter of 2008. The key points of the outlook are as follows.

### <The US Economy>

US growth to remain weak given the spread of the credit crunch

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

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

### <The Japanese Economy>

**FY2008** Stagnant growth due to deterioration of corporate profits and rise of prices

Real GDP: 1.5% (previous outlook) → 1.4% (current outlook)

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

**FY2009** Weak growth due to slumping exports and capital investment in the first half of the fiscal year

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

Nominal GDP: 1.3% (previous outlook) → 1.4% (current outlook)

This English-language translation is based upon the outlook in Japanese released on June 13, 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 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

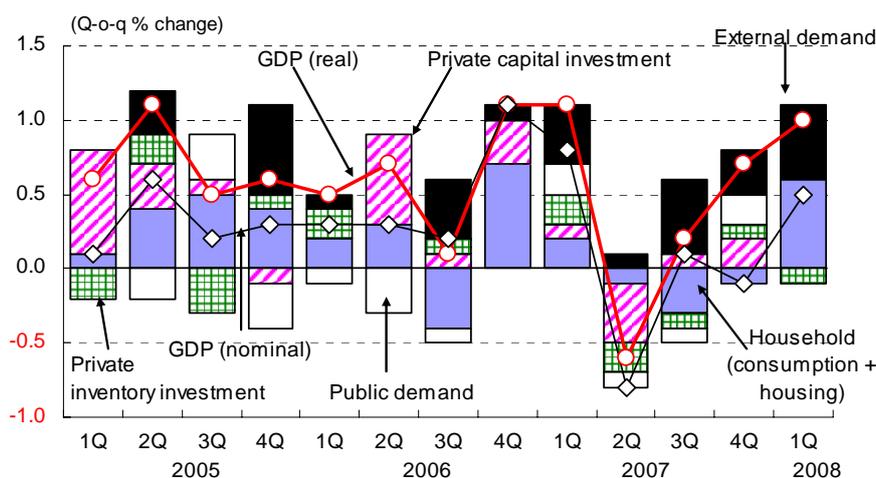
Japan's real GDP grew a strong 4% p.a. according to the 2<sup>nd</sup> QE for the Jan-Mar quarter of 2008

Capital investment contributed to the upward revision

The *Second Preliminary Quarterly Estimates of GDP* ("2<sup>nd</sup> QE") for the Jan-Mar quarter of 2008 revealed that Japan's real GDP grew 1.0% q-o-q (4.0% in annualized terms), in an upward revision from 0.8% q-o-q (3.3% q-o-q p.a.) in the *First Preliminary Quarterly Estimates of GDP* ("1<sup>st</sup> QE") (Chart 1). Even though the Japanese economy is still driven by a large contribution by external demand, the figures regarding domestic and external demand are slightly more balanced than in the 1<sup>st</sup> QE as a result of a slight upward revision of capital investment which was initially reported as marking negative quarterly growth.

Looking closer at each of the components of demand, private-sector capital investment was the major contributor to the upward revision. Capital investment was revised up from -0.9% q-o-q in the 1<sup>st</sup> QE to 0.2% q-o-q in the 2<sup>nd</sup> QE to reflect the *Financial Statements Statistics of Corporations by Industry*. As a result, the contribution by domestic private demand to quarterly real GDP growth was revised up from 0.4% pt to 0.5% pt. Despite a slight downward revision of public investment (1.5% q-o-q → 1.3% q-o-q), the contribution by public demand was subject to a slight upward revision from -0.1% pt to -0.0% pt due to a slight upward revision of government consumption (-0.8% q-o-q → -0.4% q-o-q). The contribution by domestic demand (total of private sector and public sector demand) was revised up from 0.3% pt to 0.5% pt. Since both exports (4.5% q-o-q → 4.0% q-o-q) and imports (2.0 % q-o-q → 1.4% q-o-q) were subject to downward revisions, the contribution by external demand remained unchanged at 0.5% pt in the 1<sup>st</sup> QE.

[ Chart 1: Japan's quarterly GDP growth (2<sup>nd</sup> QE for the Jan-Mar quarter of 2008) ]



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

Downside risks are intensifying

However, note that the Japanese economy is actually subject to stronger downside risks. Personal consumption most likely slowed and flattened out on a quarterly basis in the Apr-Jun quarter due to a reaction to the leap year effect. Furthermore, considering the sharp decline of real exports in April from the

Jan-Mar average, the odds are high that exports in real terms will dip into negative territory on a quarterly basis in the Apr-Jun quarter. Given the slowdown of personal consumption and the decline of the contribution by external demand, Japan's real GDP growth is predicted to slow sharply in the Apr-Jun quarter.

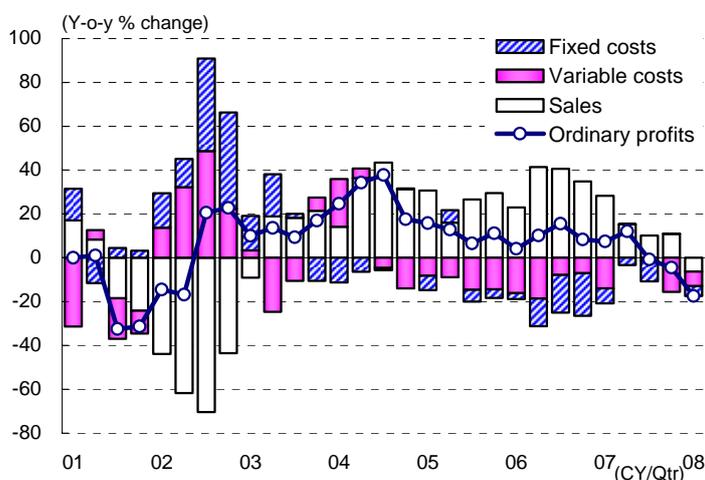
The deterioration of corporate profits and rise of prices stemming from the surge of natural resource and food prices may serve as further drags upon domestic demand. Given the global rise of inflation, many countries are starting to tighten monetary policy, leading to uncertainties regarding the future course of Japan's exports. Judging from the fact that the coincident CI compiled and released by the Cabinet Office has been unable to surpass the peak in August 2007, there are rising risks that the economy may fall (or has already fallen) into a recession for the first time since 2001.

## II. Forecast of the Japanese economy in FY2008 and FY2009

It now appears certain that FY2008 corporate profits will fall for the second year in a row

Ordinary profits (based upon the *Financial Statements Statistics of Corporations by Industry*) fell a sharp 17.5% y-o-y (**Chart 2**). The weakness of domestic demand and the slowdown of exports accompanying the strength of the yen served to push down sales (-1.5% y-o-y), resulting in a fall of earnings for the first time in five years. Furthermore, the rise of raw material and labor costs also served as drags upon corporate profits. Even on a fiscal year basis, ordinary profits fell (-3.3% y-o-y) in FY2007, marking a decline for the first time in six years since 2001. Given the surge of crude oil prices, the sharp fall of corporate profits should continue in the first half of FY2008. Even though the crude oil market should cool down in early autumn and mitigate the deterioration of corporate business results, we are inclined toward the view that ordinary profits will fall at a faster pace in FY2008 (-9.9% y-o-y), marking the second consecutive year of profit decline (**Chart 3**). Considering that corporate profits serve as the source of wages paid to workers and investment in plant and equipment, the deterioration of corporate profits will intensify the downside risks to domestic demand.

[ 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*.

[ Chart 3: Corporate earnings forecast ]

		(Y-o-y % change)			
		FY2006	FY2007	FY2008 (Forecast)	FY2009 (Forecast)
Total	Sales	7.3	1.5	1.1	2.5
	Ordinary profits	10.0	-3.3	-9.9	3.5
Manufacturing	Sales	4.8	6.7	2.4	2.5
	Ordinary profits	12.7	-1.4	-10.2	3.6
Nonmanufacturing	Sales	8.4	-0.8	0.5	2.5
	Ordinary profits	8.1	-4.7	-9.6	3.4
Large corporations	Sales	5.0	4.0	2.1	2.5
	Ordinary profits	12.8	-0.7	-6.7	3.2
Manufacturing	Sales	6.5	5.1	1.7	2.3
	Ordinary profits	13.7	-2.2	-11.2	2.9
Nonmanufacturing	Sales	3.8	3.1	2.4	2.8
	Ordinary profits	11.7	1.0	-1.5	3.5
Small and medium corporations	Sales	8.9	-0.3	0.4	2.5
	Ordinary profits	6.7	-6.6	-14.3	3.8

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 MHL.

**Forecast on growth in FY2008 revised down to 1.4%, FY2009 growth forecast unchanged at 1.1%**

**The key to future growth - emerging economies and commodity markets trends**

**The positive output gap will shrink**

We have revised down our forecast on Japan's economic growth in FY2008 by 0.1% pt to 1.4% (previous forecast as of May 20<sup>th</sup>: 1.5%). Our forecast on growth in FY2009 remains unchanged at 1.1% from our May 20<sup>th</sup> forecast (**Chart 4**). The downward revision of growth in FY2008 stems primarily from the downward revision of exports from 7.0% y-o-y in our May 20<sup>th</sup> forecast to 6.0% y-o-y due to a more definite slowdown of the overseas economies reflecting the rise of global inflation.

The Japanese economy at this juncture is not in a state requiring a stock-side adjustment such as inventories, production capacity, labor and debt. As far as the external environment recovers, Japan's economic slowdown will turn out to be benign. Based upon the premise that the commodity markets will calm down and that the emerging economies will continue to cruise, we believe that the Japanese economy will start to pick up in FY2009 (note that the rate of growth will turn out to be lower than FY2008 because of a smaller carry-over from the previous fiscal year and that the rate of growth on a fourth-quarter to fourth-quarter basis for FY2008 and FY2009 will reach 0.3% and 2.1% respectively). However, in the event of a further commodity market surge or a significant slowdown of the emerging economies, the Japanese economy will most likely suffer a further decline in FY2009.

The output gap (the gap between actual GDP and potential GDP) estimated by MHRI stood at 0.8% as of the Jan-Mar quarter of 2008 (**Chart 5**, the output gap is approximately 1% lower than in the estimate as of May 20<sup>th</sup> because of a review of the time span of the estimate). If the Japanese economy follows the path set forth above, the breadth of the positive output gap will start to narrow and temporarily fall into negative territory at the end of FY2008. Considering that Japan's economic growth will remain below its potential rate of growth, upward price pressures should remain weak with the exception of items subject to the impact of the market surge. Since the chances are slim that imported inflation will turn into home grown inflation, monetary policy should remain unchanged during FY2008.

[ Chart 4: Outlook on the Japanese economy ]

(%)

	FY2007	FY2008	FY2009	FY2008		FY2009		FY2007	FY2008	FY2009
	(Actual)	(Forecast)	(Forecast)	1H	2H	1H	2H	(Contribution)	(Contribution)	(Contribution)
	(Actual)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Actual)	(Forecast)	(Forecast)
GDP (real)	1.6	1.4	1.1	1.4	0.2	0.9	2.5	-	-	-
Domestic demand	0.4	0.6	0.8	0.8	-0.1	0.8	1.7	0.4	0.6	0.8
Private sector demand	0.4	0.8	0.9	1.2	-0.3	0.8	2.2	0.3	0.6	0.6
Personal consumption	1.4	0.9	1.3	0.8	0.5	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	0.0	0.6	-1.0	1.3	-3.0	-2.2	3.3	0.0	0.1	-0.2
Public sector demand	0.2	-0.1	0.5	-0.8	0.4	0.8	0.2	0.0	-0.0	0.1
Government consumption	0.7	0.7	1.0	0.1	1.4	0.9	1.0	0.1	0.1	0.2
Public investment	-1.8	-3.6	-2.2	-4.9	-4.3	-0.4	-3.8	-0.1	-0.1	-0.1
Net exports (contribution)	1.2	0.8	0.5	0.7	0.3	0.5	0.9	1.2	0.8	0.5
Exports	9.5	6.0	5.0	4.7	2.3	4.5	8.7	1.4	1.0	0.8
Imports	2.1	1.3	2.7	0.7	0.6	2.5	5.3	-0.2	-0.1	-0.3
GDP (nominal)	0.6	0.0	1.4	0.2	-0.7	1.9	2.6			
GDP deflator	-1.0	-1.4	0.3	-1.7	-1.1	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 (JPY trillion)	24.6	18.7	24.3	18.0	19.3	21.2	27.1			
as a percentage of nominal GDP	4.8	3.6	4.7	3.5	3.8	4.1	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	1.63	1.68	1.70	1.55	1.60	1.75			
Nikkei stock average (JPY)	16,000	14,000	15,000	14,100	13,900	14,700	15,300			
Exchange rate (JPY/USD)	114.2	102	104	103	101	103	105			
Crude oil price (WTI/barrel)	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).

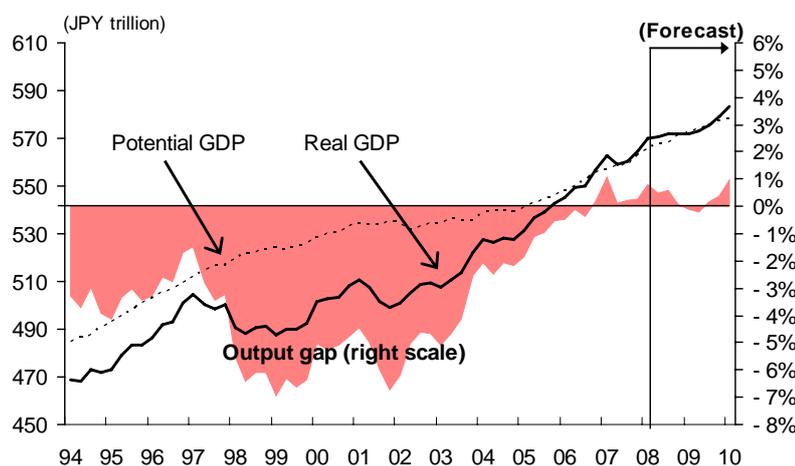
2. Half-year corporate goods prices and half-year consumer prices = rate of change over a year ago. Consumer prices = nationwide (excluding fresh foods).

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.

[ 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 ]

(%)

	2007	2008 (Forecast)	2009 (Forecast)	2007		2008 (Forecast)		2009 (Forecast)	
				1H	2H	1H	2H	1H	2H
GDP	2.2	0.9	0.5	1.8	3.5	0.7	-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	-24.4	-15.2	-15.5	-19.6	-26.0	-26.1	-13.6	-5.1
Capital investment	4.7	1.3	-3.4	3.4	8.9	0.8	-5.0	-4.3	-0.0
Inventory investment (USD100 million)	46	-220	-120	30	62	-197	-243	-158	-83
Government expenditures	2.0	2.1	1.3	1.6	3.4	1.8	1.4	1.0	1.7
Net exports (USD100 million)	-5,556	-4,551	-4,103	-5,930	-5,182	-4,747	-4,355	-4,114	-4,092
Exports	8.1	5.9	3.1	5.9	12.9	3.7	3.5	2.7	3.5
Imports	1.9	-0.9	0.1	1.6	1.1	-1.7	-1.4	-0.4	2.5
Domestic final demand	1.8	0.3	0.0	1.9	2.1	0.3	-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	27	-44	-129	-66	-20
PCE deflator <y-o-y ch>	2.5	3.6	2.2	2.3	2.8	3.5	3.7	2.4	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	-7,313	-6,488	-3,883	-3,504	-3,788	-3,525	-3,213	-3,275
<as a percentage of nominal GDP>	-5.3	-5.1	-4.4	-5.7	-5.0	-5.3	-4.9	-4.4	-4.4

Notes: 1. Calendar-year figures refer to the rate of change from the previous year. Half-year term figures refer to the rate of change from the previous half-year term (annualized).  
 2. The shaded columns are forecasts.  
 3. Regarding 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, MHRI (May 18, 2008).

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