

Economic Outlook for FY2008 and FY2009

(revised to reflect the Second Preliminary Quarterly Estimates of GDP for the Apr-Jun quarter of 2008)

September 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* (“2nd QE”) for the Apr-Jun quarter of 2008. The key points of the outlook are as follows.

<The US Economy>

US growth will remain weak given the impact of the credit crunch and inflation

2008 1.2% (previous outlook) → 1.5% (current outlook)

2009 0.6% (previous outlook) → 0.7% (current outlook)

<The Japanese Economy>

FY2008 Worsening terms of trade will serve as a drag upon domestic demand and exports

Real GDP: 0.7% (previous outlook) → 0.6% (current outlook)

Nominal GDP: -0.4% (previous outlook) → -0.2% (current outlook)

FY2009 The economy will gradually pick up as a result of the improvement of trade terms

Real GDP: 1.0% (previous outlook) → 1.0% (current outlook)

Nominal GDP: 1.7% (previous outlook) → 2.0% (current outlook)

This English-language translation is based upon the outlook in Japanese released on September 16, 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

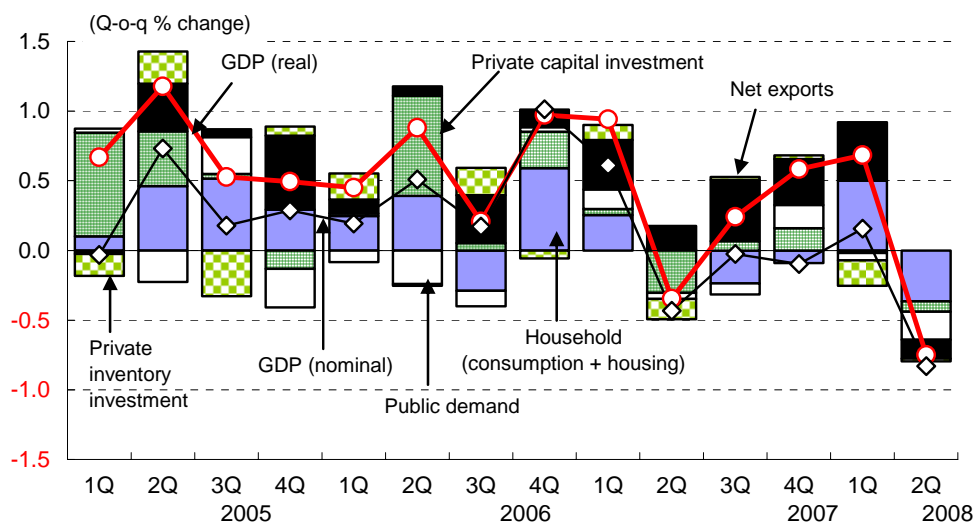
Japan's real GDP was revised downward in the 2nd QE for the Apr-Jun quarter of 2008

The *Second Preliminary Quarterly Estimates of GDP* ("2nd QE") for the Apr-Jun quarter of 2008 revealed that Japan's real GDP growth was subject to a slight downward revision to -0.7% q-o-q (-3.0% in annualized terms), from -0.6% q-o-q (-2.4% q-o-q p.a.) in the *First Preliminary Quarterly Estimates of GDP* ("1st QE") (Chart 1). Both domestic and external demand were revised downward, reconfirming that the Japanese economy stands at a critical juncture.

Looking closer at each of the components of demand, capital investment was revised down from -0.2% q-o-q in the 1st QE to -0.5% q-o-q in the 2nd QE to reflect the results of the *Financial Statements Statistics of Corporations by Industry*. As a result of slight downward revisions of both inventory investment (its contribution to growth was unchanged at -0.0% pt) and residential investment (-3.4% q-o-q → -3.5% q-o-q), the contribution by domestic private demand to quarterly real GDP growth was revised down from -0.4% pt to -0.5% pt. The revisions of both public investment (-5.2% q-o-q → -5.1% q-o-q) and government consumption (0.1% q-o-q → -0.0% q-o-q) were minimal, thus keeping the contribution by public demand unchanged at -0.2% pt. The contribution by domestic demand (the total of private demand and public demand) was revised downward from -0.6% pt to -0.7% pt. As a result of a downward revision of exports (-2.3% q-o-q → -2.5% q-o-q) and an upward revision of imports (-2.8% q-o-q → -2.6% q-o-q), the contribution by external demand was revised down from -0.0% pt to -0.1% pt.

Nominal GDP growth was revised down from -0.7% q-o-q (-2.7% p.a.) in the 1st QE to -0.8% q-o-q (-3.3% p.a.). Furthermore, real gross domestic income (GDI) taking into consideration trading gains/losses due to changes in terms of trade was revised down from -0.9% y-o-y to -1.2% y-o-y.

[Chart 1: Japan's quarterly GDP growth (2nd QE for the Apr-Jun quarter of 2008)]



Note: The bars represent the contribution to the line.
Source: Cabinet Office, *Preliminary Quarterly Estimates of GDP*.

**The economy is
continuing to recede**

The Japanese economy has slipped into a recession after peaking at the end of last year. Data releases since July reveal that personal consumption is continuing to slump as higher prices – mainly of resources and food – squeeze household income. Moreover, corporate bankruptcies are rising, reflecting the deterioration of the corporate earnings environment due to the high price of raw materials. Industrial production is also softening, due partially to lackluster exports stemming from the slowdown of overseas economies. In particular, IT-related production is subject to stronger inventory adjustment pressures, providing reasons to believe that the adjustment of production will persist for some time. Judging from the loss of support from external demand amid the stagnation of domestic demand due to the deterioration of terms of trade, it appears that the Japanese economy is continuing to recede.

II. Forecast of the Japanese economy in FY2008 and FY2009

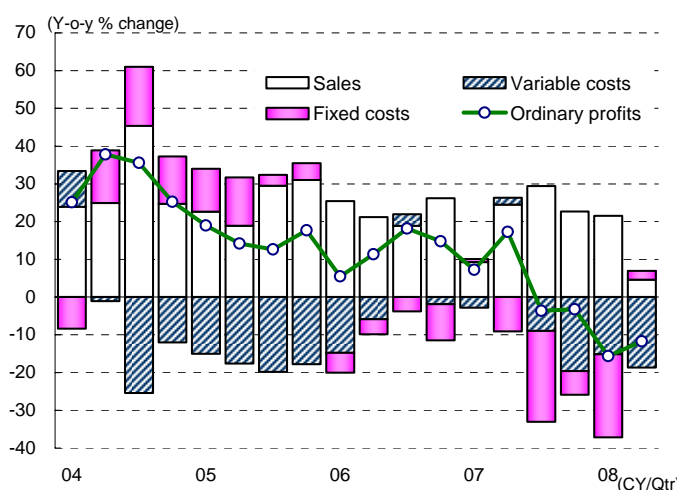
It now appears certain that corporate profits will fall sharply in FY2008

Forecast on growth in FY2008 revised down to 0.6%, FY2009 growth forecast unchanged at 1.0%

According to the *Financial Statements Statistics of Corporations by Industry* for the Apr-Jun quarter, sales fell 0.7% y-o-y and ordinary profits shrank 5.2% y-o-y (-10.5% y-o-y when excluding financial holding companies which were added to the survey group from the current survey), marking the fall of earnings for the second quarter in a row. A factor decomposition of ordinary profits among manufacturers (**Chart 2**) indicates that amid the sharp slowdown of sales, the rise of variable costs due to worsening terms of trade is serving as a drag upon profits. Given the negative impact of Japan's worsening terms of trade, the odds are high that corporate business results in FY2008 will fall for the second consecutive year and that the breadth of the fall will widen (**Chart 3**). The deterioration of corporate business performance should serve as a drag upon domestic demand during FY2008. In FY2009, Japan's terms of trade should improve from the year before as a result of factors such as the stabilization of crude oil prices, leading to the rise of corporate profits. As corporate earnings stop falling, domestic demand will also bottom out, leading to a gradual recovery of the economy.

We have revised down our forecast on Japan's economic growth in FY2008 by 0.1 pt to 0.6% (previous forecast: 0.7%) and have kept our forecast on growth in FY2009 unchanged at 1.0% from our previous forecast as of August 15th (**Chart 4**). The downward revision of growth in FY2008 is a minor revision reflecting the weaker-than-initially-expected 2nd QE for the Apr-Jun quarter and does not represent a change in our fundamental view of the economy.

[Chart 2: Ordinary profits (manufacturers)]



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	1.4
	Ordinary profits	10.0	-3.3	-5.6	1.6
Manufacturing	Sales	4.8	6.7	-0.1	2.8
	Ordinary profits	12.7	-1.4	-10.4	1.7
Nonmanufacturing	Sales	8.4	-0.8	-1.5	0.8
	Ordinary profits	8.1	-4.7	-1.8	1.5
Large corporations	Sales	5.0	4.0	3.0	2.6
	Ordinary profits	12.8	-0.7	-2.7	0.4
Manufacturing	Sales	6.5	5.1	3.3	3.5
	Ordinary profits	13.7	-2.2	-9.0	-1.0
Nonmanufacturing	Sales	3.8	3.1	2.9	1.9
	Ordinary profits	11.7	1.0	4.5	1.7
Small and medium corporations	Sales	8.9	-0.3	-4.0	0.5
	Ordinary profits	6.7	-6.6	-9.7	3.4

Note: From FY2008, large nonmanufacturing corporations include financial holding companies.

Source: Compiled by MHRl on the basis of Ministry of Finance, *Financial Statements Statistics of Corporations by Industry, Quarterly*.

The output gap is dipping into negative territory

The risks: financial market turmoil due to resurgence of a financial crisis and Japan's political turmoil

The output gap (the gap between actual GDP and potential GDP) estimated by MHRI stood at -0.2% as of the Apr-Jun quarter of 2008 (**Chart 5**). If Japan's economy grows in accordance with our outlook, the output gap should remain slightly negative during FY2009. Upside risks to inflation are minimal since the shift of costs to prices due to the rise of raw material prices is only expected to occur with respect to energy and food products. Monetary policy should remain on hold during FY2008, with discussions on the next rate cut taking place some time after the summer of 2009 when the Japanese economy starts to show signs of recovery.

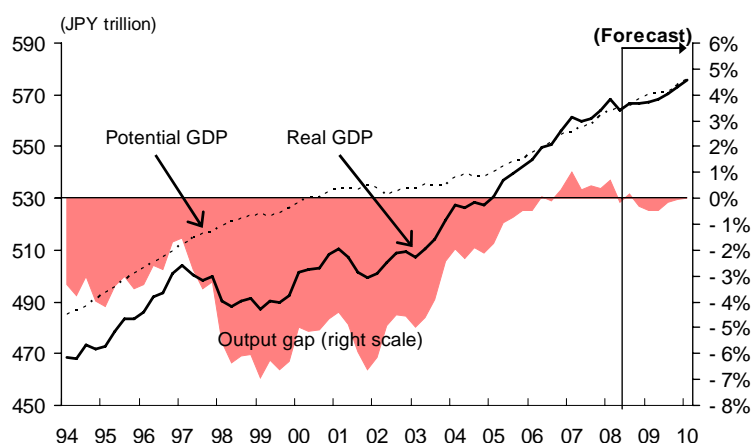
As written above, MHRI forecasts a gradual recovery of the economy in FY2009. However, the outlook is far from optimistic, given the current resurgence of a financial crisis triggered by the collapse of a major US securities firm and its impact upon the stock market and the strength of the yen. Even though the government of Japan announced an economic stimulus package (named the "Emergency Integrated Measures to Achieve Public Security"), details such as its implementation schedule and the size of the fixed-amount tax cut remain unclear. In view of growing uncertainties both with Japan and overseas, it will be necessary to keep a close eye upon the downside risks to the economy.

[Chart 4: Outlook on the Japanese economy]

	FY2007 (Actual)	FY2008 (Forecast)	FY2009 (Forecast)	FY2008		FY2009		FY2007	FY2008	FY2009
				1H	2H	1H	2H	(Contribution)	(Contribution)	(Contribution)
				(Forecast)	(Forecast)	(Forecast)	(Forecast)	(Actual)	(Forecast)	(Forecast)
GDP (real)	1.6	0.6	1.0	-0.2	0.6	0.8	1.9	-	-	-
Domestic demand	0.3	-0.2	0.6	-0.8	0.3	0.5	1.1	0.3	-0.2	0.6
Private sector demand	0.4	-0.0	0.7	-0.4	0.4	0.5	1.2	0.3	-0.0	0.5
Personal consumption	1.4	0.5	1.0	0.0	0.6	0.9	1.4	0.8	0.3	0.5
Residential investment	-13.3	1.4	0.9	4.2	23.9	-1.9	-13.1	-0.4	0.0	0.0
Capital investment	-0.1	-1.3	-0.2	-1.5	-3.9	-0.0	3.0	-0.0	-0.2	-0.0
Public sector demand	0.2	-0.8	0.4	-2.0	-0.1	0.5	0.8	0.0	-0.2	0.1
Government consumption	0.7	0.2	0.9	-0.5	0.3	1.1	1.3	0.1	0.0	0.2
Public investment	-1.8	-5.3	-2.0	-8.5	-2.3	-2.1	-1.5	-0.1	-0.2	-0.1
Net exports (contribution)	1.2	0.6	0.5	0.4	0.3	0.3	0.8	1.2	0.6	0.5
Exports	9.5	3.4	3.6	0.2	2.1	2.5	7.5	1.4	0.5	0.6
Imports	2.1	-0.9	1.3	-3.0	0.1	0.6	4.1	-0.2	0.1	-0.1
GDP (nominal)	0.6	-0.2	2.0	-0.9	1.3	2.1	2.3			
GDP deflator	-1.0	-0.7	0.9	-1.5	-0.1	1.0	0.9			
Industrial production	2.6	-1.5	0.3	-1.9	-0.6	0.0	1.2			
Unemployment rate	3.8	4.1	4.0	4.1	4.2	4.0	4.0			
Current account balance (JPY)	24.6	18.8	26.2	17.9	19.7	22.9	28.7			
as a percentage of nominal GDP	4.8	3.7	5.0	3.5	3.8	4.4	5.5			
Domestic corporate goods prices	2.3	6.1	1.5	6.0	6.2	2.0	1.0			
Consumer prices	0.3	1.8	0.8	1.8	1.7	0.9	0.7			
Long-term interest rate (%)	1.59	1.50	1.68	1.60	1.41	1.60	1.75			
Nikkei stock average (JPY)	16,000	13,100	14,800	13,400	12,800	14,300	15,300			
Exchange rate (JPY/USD)	114.2	105	108	106	104	107	110			
Crude oil price (WTI)	82.2	115.2	99.7	121.6	108.8	102.0	97.3			

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	2.0	1.5	0.7	1.6	3.5	1.2	0.1	0.6	1.7
Personal consumption	2.8	1.0	0.7	3.3	1.7	1.1	-0.1	0.7	1.6
Residential investment	-17.9	-20.6	-10.4	-16.0	-20.0	-23.4	-15.0	-10.8	-4.6
Capital investment	4.9	2.5	-3.6	4.0	7.8	2.6	-2.6	-5.8	-0.0
Inventory investment (USD100 million)	-25	-309	-58	-89	40	-298	-319	-139	23
Government expenditures	2.1	2.3	1.4	1.8	3.1	2.1	1.9	1.0	1.7
Net exports (USD100 million)	-5,465	-4,028	-3,576	-5,949	-4,982	-4,193	-3,863	-3,611	-3,541
Exports	8.4	7.4	2.3	6.2	14.5	6.9	2.1	2.2	2.4
Imports	2.2	-1.9	-0.5	3.3	-0.0	-2.9	-1.8	-0.8	1.2
Domestic final demand	1.8	0.5	0.1	2.1	1.5	0.4	-0.5	-0.2	1.3
Unemployment rate	4.6	5.5	6.0	4.5	4.8	5.1	5.9	6.0	6.1
Nonfarm payrolls (per month, 1,000 persons)	127	-88	-58	119	89	-53	-123	-81	-35
PCE deflator <y-o-y ch>	2.6	3.6	2.4	2.4	2.8	3.6	3.6	2.7	2.1
Core PCE deflator <y-o-y ch>	2.2	2.3	2.3	2.2	2.1	2.2	2.4	2.4	2.2
Current account balance (USD100 million)	-7,312	-7,177	-6,483	-3,910	-3,402	-3,609	-3,568	-3,220	-3,263
<as a percentage of nominal GDP>	-5.3	-5.0	-4.4	-5.7	-4.9	-5.1	-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.
4. MHRI's outlook released on August 15, 2008, revised to reflect the preliminary estimates of GDP on the Apr-Jun quarter of 2008 and recent economic developments.

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

* * * * *

