

Economic Outlook for FY2008 and FY2009

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

December 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 Jul-Sep quarter of 2008. The key points of the outlook are as follows.

<The US Economy>

Balance sheet adjustment in the household sector will drag growth into negative territory

2008 1.3% (previous outlook) → 1.3% (current outlook)

2009 -0.8% (previous outlook) → -1.0% (current outlook)

<The Japanese Economy>

FY2008 Exports and capital investment will fall at a faster pace in the second half of the fiscal year

Real GDP: -0.5% (previous outlook) → -0.8% (current outlook)

Nominal GDP: -1.2% (previous outlook) → -1.6% (current outlook)

FY2009 Negative growth looks unavoidable, reflecting the global economic slowdown

Real GDP: -0.9% (previous outlook) → -1.0% (current outlook)

Nominal GDP: 0.1% (previous outlook) → -0.5% (current outlook)

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

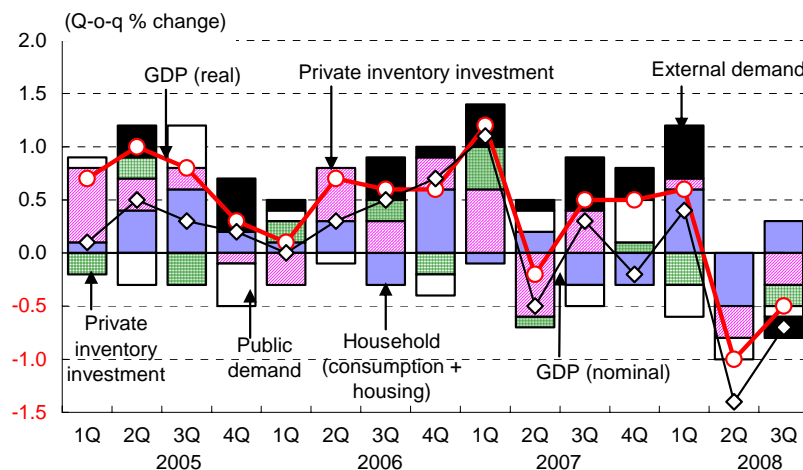
Japan's real GDP was revised downward in the 2nd QE for the Jul-Sep quarter of 2008

The *Second Preliminary Quarterly Estimates of GDP* (“2nd QE”) for the Jul-Sep quarter of 2008 revealed a slight downward revision of Japan’s real GDP growth from -0.1% q-o-q (-0.4% q-o-q p.a.) in the *First Preliminary Quarterly Estimates of GDP* (“1st QE”) to -0.5% q-o-q (-1.8% in annualized terms), (**Chart 1**), portraying a clear picture of the Japanese economy at a critical juncture.

Looking closer at each of the components of demand, capital investment was revised down from -1.7% q-o-q in the 1st QE to -2.0% q-o-q in the 2nd QE to reflect the results of the *Financial Statements Statistics of Corporations by Industry*. Due also to a slight downward revision of inventory investment (its contribution to growth was revised from 0.0% pt to -0.2% pt), the contribution by domestic private demand to quarterly real GDP growth was revised down sharply from 0.1% pt to -0.2% pt. Given the downward revision of government consumption (0.1% q-o-q → -0.3% q-o-q), the contribution by public demand was revised down from 0.0% pt to -0.1% pt. The contribution by domestic demand (the total of private demand and public demand) was revised downward from 0.1% pt to -0.3% pt. As a result of slight upward revisions of exports (0.7% q-o-q → 0.8% q-o-q) and imports (1.9% q-o-q → 2.3% q-o-q), the contribution by external demand remained unchanged from the 1st QE at -0.2% pt.

The GDP deflator remained unchanged from the 1st QE at -1.6% y-o-y and nominal GDP growth was revised down from -0.5% q-o-q (-2.1% p.a.) in the 1st QE to -0.7% q-o-q (-2.7% p.a.). Gross domestic income (GDI) in real terms, taking into consideration trading gains due to changes in terms of trade, was revised down from -2.5% y-o-y to -2.9% y-o-y. Real GDI dropped deeper into negative territory from -1.4% y-o-y in the Apr-Jun quarter, indicating that the fall of trading gains due to the deterioration of trade terms had depressed economic conditions as early as the Jul-Sep quarter.

[Chart 1: Japan’s quarterly GDP growth (2nd QE for the Jul-Sep quarter of 2008)]



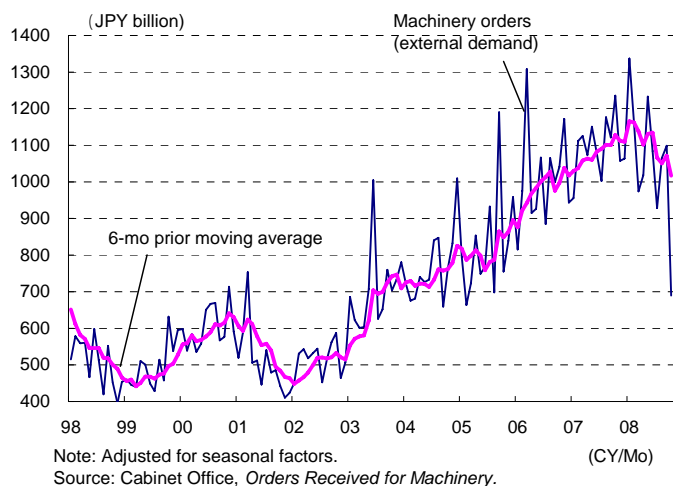
Source: Cabinet Office, *Preliminary Quarterly Estimates of GDP*.

Larger production cuts in the manufacturing sector

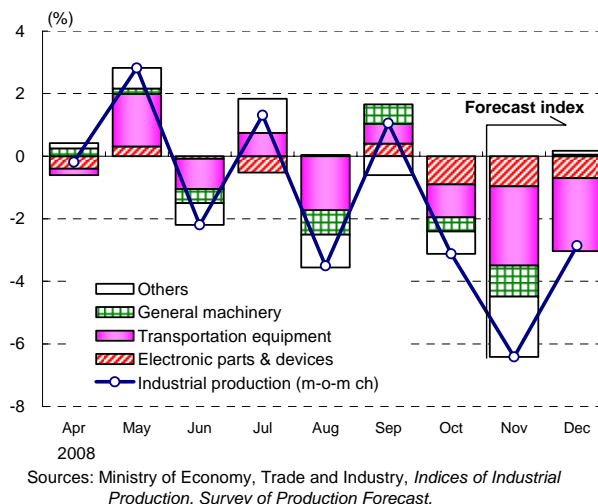
Since the Oct-Dec quarter, the main cause of the economic slump has shifted completely from the deterioration of trade terms to the ebb of demand. Given the sharp slowdown of overseas economies stemming from the financial crisis, the decline of exports and the accompanying cuts in output are serving as the principal causes of Japan's current economic downturn. Export growth (in terms of quantity) fell further into negative territory from -0.2% y-o-y in September to -6.4% y-o-y in October. Considering that machinery orders (external demand) – a leading indicator of exports – took a nosedive in October (37.2% m-o-m), a further fall of export (quantity) appears inevitable from November onward (**Chart 2**).

Manufacturing output is falling sharply along with the decline of exports. Subsequent to the fall of industrial production in October (-3.1% m-o-m), forecast indexes (November: -6.4% m-o-m, December: -2.9% m-o-m) predict a sharp decline in output among manufacturers in the Oct-Dec quarter (-8.6% q-o-q), recording the deepest cut in quarterly terms since the such statistics were first collected in 1955. A closer look at the components of industrial production reveals that the sharp downturn of transportation equipment – reflecting the worldwide decline of car sales – served as a major drag upon overall production (**Chart 3**). Furthermore, upstream producers of materials such as iron & steel and chemicals are also slashing output at a faster pace along with broad production cuts among processing industries with large weights upon exports such as general machinery, electronic parts & devices.

[Chart 2: Machinery orders (external demand)]



[Chart 3: Industrial production (m-o-m change)]

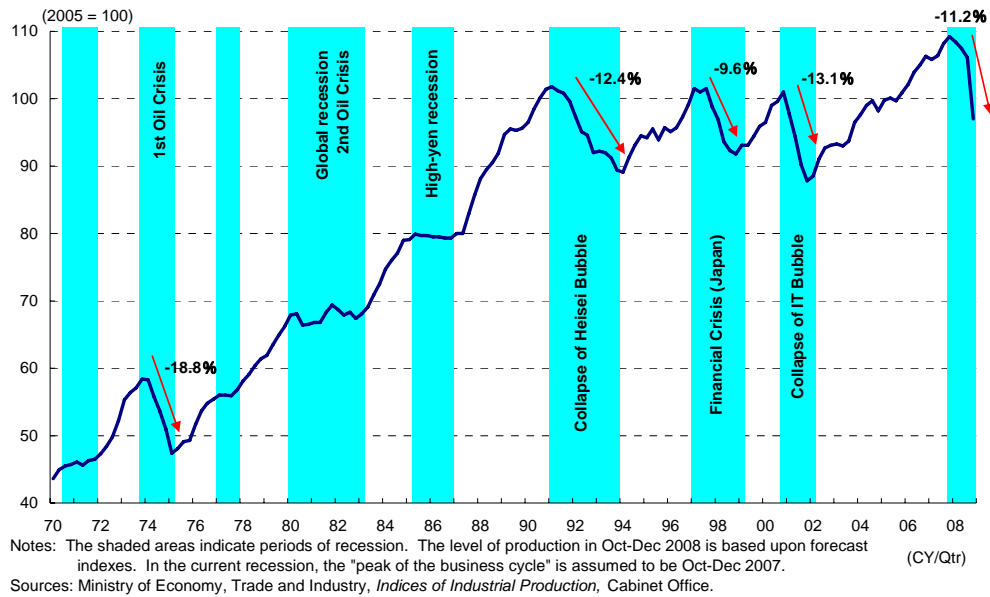


Looming possibility of the sharpest output cut since the 1st Oil Crisis

In the event industrial production in the Oct-Dec quarter plummets as expected according to the forecast indexes, output would fall as much as 11.2% from the most recent peak in the Oct-Dec period in 2007 (**Chart 4**). The breadth of the decline would be comparable to the falls subsequent to the collapse of the Heisei Bubble in the first half of the 1990s (-12.4%) and the collapse of the IT Bubble in 2001 (-13.1%). While the largest output cut (-18.8%) since 1955 occurred after the 1st Oil

Crisis (1974-1975), there is a looming possibility that production will suffer the sharpest decline since then.

[Chart 4: Long-term trends in industrial production]



II. Forecast of the Japanese economy in FY2008 and FY2009

Corporate earnings will continue to fall in FY2009

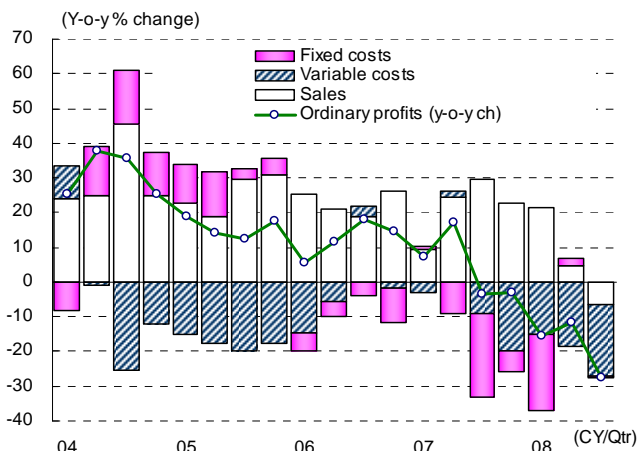
The *Financial Statements Statistics of Corporations by Industry* for the Jul-Sep quarter revealed the fall of both sales (-0.2% y-o-y) and ordinary profits (-22.4 % y-o-y) (-22.5% y-o-y when excluding financial holding companies which were added to the survey group from the current fiscal year), marking the decline of revenue and earnings for the third quarter in a row. A factor decomposition of ordinary profits among manufacturers (**Chart 5**) indicates that the rise of variable costs due to worsening terms of trade, amid the downturn of sales, is serving as a drag upon profits. Since Japan's terms of trade will start to improve in the second half of FY2008, the breadth of the negative effect upon profits due to variable costs should narrow. In contrast, given a sharper fall of earnings due to the decline of exports, corporate profits should continue to follow a downtrend in FY2009. Thus, as a result of the deterioration of trade terms in the first half of the fiscal year and the fall of earnings in the second half, a double-digit plunge of corporate business results looks certain in FY2008 (**Chart 6**). In FY2009, even though corporate profits are predicted to fall for the third consecutive year due to the fall of earnings stemming from sluggish domestic and overseas demand, the breadth of the profit fall should be smaller than in FY2008, considering the decline of raw material and fuel costs.

Forecasts on growth in FY2008 and FY2009 are revised down to -0.8% and -1.0% respectively

We have revised down our forecast on Japan's economic growth to -0.8% (previous forecast: -0.5%) in FY2008 and -1.0% (previous forecast: -0.9%) in FY2009 from our previous forecast as of November 19th (**Chart 7**). Even though the downward revision of growth in FY2008 is due to a retroactive revision of

Japan's GDP statistics, our forecasts regarding exports and capital investment in the second half of FY2008 to the first half of FY2009 have been revised down slightly in view of recent developments

[Chart 5: 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 6: Corporate earnings forecast]

		(Y-o-y % change)			
		FY2006	FY2007	FY2008 (Forecast)	FY2009 (Forecast)
Total	Sales	7.3	1.5	-1.7	-1.0
	Ordinary profits	10.0	-3.3	-17.2	-5.5
Manufacturing	Sales	4.8	6.7	-2.6	-1.7
	Ordinary profits	12.7	-1.4	-18.9	-10.0
Nonmanufacturing	Sales	8.4	-0.8	-1.3	-0.6
	Ordinary profits	8.1	-4.7	-15.9	-2.0
Large corporations	Sales	5.0	4.0	1.9	-1.3
	Ordinary profits	12.8	-0.7	-12.9	-1.9
Manufacturing	Sales	6.5	5.1	0.7	-1.9
	Ordinary profits	13.7	-2.2	-17.1	-9.4
Nonmanufacturing	Sales	3.8	3.1	2.8	-0.8
	Ordinary profits	11.7	1.0	-8.1	5.7
Small and medium corporations	Sales	8.9	-0.3	-4.2	-0.7
	Ordinary profits	6.7	-6.6	-23.2	-11.0

Note: From FY2008, large nonmanufacturing corporations include financial holding companies.
Source: Made by MHRI, based upon the *Financial Statements Statistics of Corporations by Industry, Quarterly* of the Ministry of Finance.

The output gap will fall deeper into negative territory to around -2.5%

Policy measures are necessary to quell rising uncertainties regarding employment

The output gap (the gap between actual GDP and potential GDP) estimated by MHRI stood at -0.5% as of the Jul-Sep quarter of 2008 (Chart 8). If the Japanese economy proceeds as set forth in our outlook, the output gap should fall deeper into negative territory, reaching the latter end of the -2%-level in FY2009. Consumer prices will be subject to downward pressures stemming from the easing of supply and demand conditions in addition to fall of raw material prices.

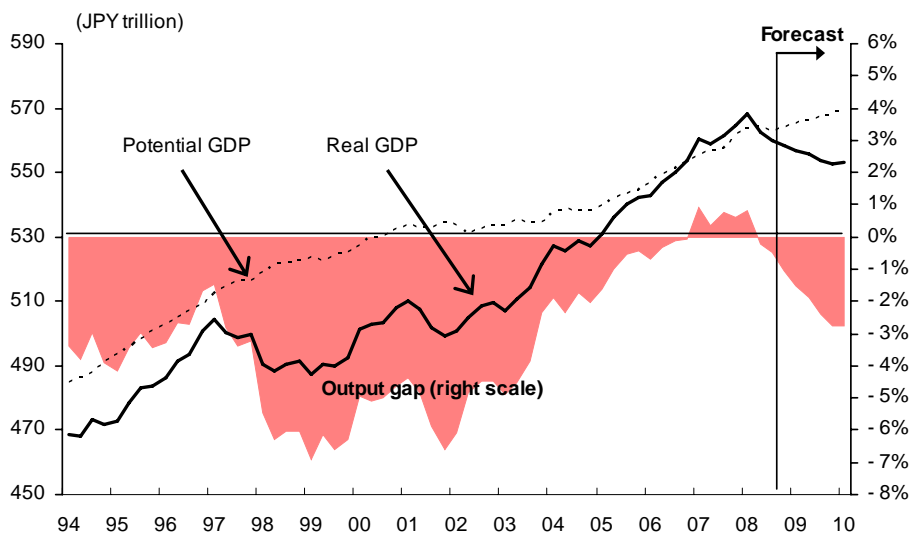
Amid the global economic slowdown, the Japanese economy may not avoid the second consecutive year of negative growth. As manufacturers slash output at a faster pace, labor adjustment pressures are rising mainly with respect to non-regular workers in the manufacturing sector. The rise of uncertainties regarding employment will serve as further downward pressures upon personal consumption. Considering the longstanding issue of the income gap between non-regular and regular workers since the period of Japan's economic expansion, it would be necessary to implement immediate measures such as the alleviation of requirements to receive unemployment benefits and the time period such benefits are paid, in a bid to assuage the employment uncertainties.

[Chart 7: Outlook on the Japanese economy]

	FY2007	FY2008	FY2009	FY2008		FY2009		FY2007	FY2008	FY2009
	(Actual)	(Forecast)	(Forecast)	1H	2H	2H	2H	(Contribution)	(Contribution)	(Contribution)
				(Actual)	(Forecast)	(Forecast)	(Forecast)	(Actual)	(Forecast)	(Forecast)
GDP (real)	1.9	-0.8	-1.0	-1.8	-1.4	-1.0	-0.7	-	-	-
Domestic demand	0.7	-1.1	-0.5	-2.1	-0.5	-0.4	-0.7	0.6	-1.0	-0.5
Private sector demand	0.6	-1.2	-1.1	-1.7	-1.3	-1.0	-1.1	0.5	-0.9	-0.8
Personal consumption	0.9	0.3	0.3	-0.1	0.4	0.5	-0.3	0.5	0.1	0.2
Housing investment	-13.0	-2.4	-1.5	3.1	10.6	-4.4	-7.0	-0.4	-0.1	-0.0
Capital investment	2.3	-4.5	-4.9	-5.8	-8.3	-3.9	-3.5	0.4	-0.7	-0.7
Public sector demand	0.7	-0.7	1.5	-3.3	2.3	1.5	0.7	0.1	-0.1	0.3
Government consumption	2.2	0.1	1.6	-2.5	2.2	1.6	0.9	0.4	0.0	0.3
Public investment	-5.8	-4.1	1.0	-7.3	3.1	1.0	-0.4	-0.2	-0.1	0.0
Net exports (contribution)	1.2	0.2	-0.5	0.1	-0.8	-0.6	-0.0	1.2	0.2	-0.5
Exports	9.3	0.4	-4.8	-1.1	-7.0	-5.9	-0.1	1.4	0.1	-0.8
Imports	1.8	-1.7	-2.6	-2.8	-3.2	-3.6	-0.1	-0.2	0.2	0.3
GDP (nominal)	1.0	-1.6	-0.5	-3.1	-0.2	-0.0	-1.9			
GDP deflator	-0.9	-0.9	0.5	-1.5	-0.2	1.1	-0.2			
Industrial production	2.6	-6.9	-7.1	-1.8	-11.6	-0.9	-0.2			
Unemployment rate	3.8	4.2	4.6	4.1	4.3	4.5	4.7			
Current account balance (JPY trillion)	24.6	16.0	18.8	16.5	15.9	19.1	18.5			
as a percentage of nominal GDP	4.8	3.2	3.7	3.2	3.1	3.8	3.7			
Domestic corporate goods prices	2.3	4.0	-2.3	6.0	2.0	-3.0	-1.6			
Consumer prices	0.3	1.4	-0.4	1.9	1.0	-0.6	-0.3			
Long-term interest rate (%)	1.59	1.49	1.35	1.60	1.39	1.30	1.40			
Nikkei stock average (JPY)	16,000	10,900	8,800	13,300	8,500	8,500	9,100			
Exchange rate (JPY/USD)	114.2	101	96	106	95	94	97			
Crude oil price (WTI)	82.2	88.1	50.6	121.0	55.2	47.2	54.0			

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*.

[Chart 8: 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 9: Outlook on the US economy]

(%)

	2007	2008 (Forecast)	2009 (Forecast)	2008 (Forecast)		2009 (Forecast)	
				1H	2H	1H	2H
GDP	2.0	1.3	-1.0	1.1	-0.5	-2.1	0.9
Personal consumption	2.8	0.2	-1.7	1.0	-2.7	-2.4	0.7
Housing investment	-17.9	-20.7	-16.2	-22.9	-16.9	-18.5	-10.1
Capital investment	4.9	2.9	-5.5	2.7	-1.4	-8.3	-4.1
Inventory investment (USD100 million)	-25	-345	7	-304	-386	-174	189
Government expenditures	2.1	3.0	3.8	2.1	4.5	3.5	3.5
Net exports (USD100 million)	-5,465	-3,877	-3,644	-4,217	-3,538	-3,597	-3,692
Exports	8.4	7.5	-5.2	6.7	2.5	-9.0	-5.0
Imports	2.2	-2.7	-5.4	-2.8	-5.0	-6.8	-3.0
Domestic final demand	1.8	0.1	-1.5	0.4	-1.7	-2.3	0.5
Unemployment rate	4.6	5.7	7.7	5.1	6.3	7.4	8.0
Nonfarm payrolls (per month, 1,000 persons)	127	-156	-164	-55	-256	-260	-69
PCE deflator <y-o-y ch>	2.6	3.4	1.4	3.6	3.2	1.5	1.4
Core PCE deflator <y-o-y ch>	2.2	2.2	1.5	2.2	2.1	1.6	1.4
Current account balance (USD100 million)	-7,312	-6,929	-5,842	-3,588	-3,341	-2,878	-2,964
<as a percentage of nominal GDP>	-5.3	-4.8	-4.0	-5.0	-4.7	-4.0	-4.1

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.

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