

# Economic Outlook for FY2004 and FY2005 (Summary Translation)

February 2004

Mizuho Research Institute Ltd. (MHRI) sets forth its economic outlook for FY2004 and FY2005 subsequent to the release of the *Preliminary Quarterly Estimates of GDP* for the Oct-Dec quarter of 2003 by the Cabinet Office. The key points of the outlook are as follows.

## <The Overseas Economies>

**The US Economy** Although the economy will follow a steady recovery in 2004, growth will most likely slow in 2005 (4.4 percent in 2004, 3.3 percent in 2005).

**The Euro Zone Economy** The recovery of the euro zone economy will be sluggish due to structural adjustment pressures (1.6 percent in 2004, 1.6 percent in 2005).

**The Asian Economies** Despite the recovery of domestic demand along with the rebound of exports, a slowdown of exports will serve as a drag upon the rate of economic growth in 2005 (6.4 percent in 2004, 6.0 percent in 2005).

## <The Japanese Economy>

**FY2004** The Japanese economy will remain on a moderate recovery, maintaining growth at the 2 percent level (real GDP growth: 2.5 percent, nominal GDP growth: 0.6 percent).

**FY2005** Although the economy will undergo a slight adjustment, it will seek the chance to return to a stable growth trajectory (real GDP growth: 1.4 percent, nominal GDP growth: 0.0 percent).

This English-language translation is based upon the summary of MHRI's outlook in Japanese released on February 20, 2004. 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.

## I. The Overseas Economies

- **The US Economy** Although the economy will follow a steady recovery in 2004, growth will most likely slow in 2005 (4.4 percent in 2004, 3.3 percent in 2005).
- **The Euro Zone Economy** The recovery of the euro zone economy will be sluggish due to structural adjustment pressures (1.6 percent in 2004, 1.6 percent in 2005).
- **The Asian Economies** Despite the recovery of domestic demand along with the rebound of exports, the slowdown of exports will serve as a drag upon the rate of economic growth in 2005 (6.4 percent in 2004, 6.0 percent in 2005)

### 1. The US Economy

The US economy is poised for further growth in 2004, driven by a twin engine comprised of a pickup in capital investment and consumer spending on the back of improving labor market conditions. The upturn of net exports along with the global economic recovery and the weak dollar should also serve as a tailwind. MHRI forecasts that the growth of US real GDP will gather further momentum and reach 4.4 percent (revised from our previous forecast of 3.9 percent) in 2004 and 3.1 percent in 2005. Even so, we are also inclined to believe that disinflationary pressures will linger due to an unresolved output gap. The Federal Reserve will most likely maintain an accommodative policy stance.

Looking forward, the US economy will start to lose steam in 2005. In addition to a cyclical slowdown of capital investment, consumer spending will most likely wane due to negative pressures stemming from such factors as the sluggish improvement of employment, fading effect of the tax cuts and growing household debts. Judging from the foregoing, we believe that US monetary policy will remain accommodative. Our forecast predicts that the rate of US real GDP growth will trend around 3.3 percent in 2005, near the potential rate of growth.

**Chart 1: Forecast of the US Economy**

	2003	2004	2005	2003		2004	
	(Actual)	(Forecast)	(Forecast)	1st-half (Actual)	2nd-half (Actual)	1st-half (Forecast)	2nd-half (Forecast)
GDP	3.1	4.4	3.3	2.1	5.9	4.2	3.3
Personal consumption	3.1	3.8	2.9	2.7	4.9	3.8	2.8
Housing investment	7.6	4.7	0.6	5.1	14.5	3.0	-0.8
Capital investment	2.8	8.7	9.2	1.4	9.8	7.9	9.3
Inventory investment (\$100 million)	-15	223	255	-16	-14	160	285
Government expenditures	3.4	1.6	1.5	3.4	2.9	1.1	1.4
Net exports (\$100 million)	-5,055	-5,032	-5,054	-5,080	-5,030	-5,008	-5,057
Exports	1.9	10.4	8.8	-2.2	9.3	11.3	9.9
Imports	3.7	6.8	6.6	0.7	5.4	7.3	7.4
Domestic final consumption	3.3	3.9	3.2	2.8	5.5	3.7	3.0
Consumer price index (y-o-y % ch)	2.3	1.6	1.3	2.6	1.5	1.6	1.4
Current account balance (\$100 million)	-5,473	-5,391	-5,494	-2,781	-2,692	-2,681	-2,710
<as a percentage of nominal GDP>	-5.0	-4.6	-4.5	-5.2	-4.8	-4.7	-4.6

Note: Yr = rate of change from the previous year. Half-year term = rate of change per annum from the previous term. Shaded columns are forecasts.

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

## 2. The Euro Zone Economy

Lagging in economic recovery in comparison to Japan and the US, the euro zone economy will likely remain tepid in 2004 given the appreciation of the euro and adjustment pressures stemming from structural problems. Although the global economic upturn will serve as a tailwind for exports, the pace of export growth will gradually start to falter due to the appreciation of the euro. Moreover, the recovery of capital investment and personal consumption will also lack momentum given the slow improvement of the debt overhang and excess labor in the euro area. Countries with fiscal deficits such as Germany and France will also be bound by the Stability and Growth Pact to curb the rise of government expenditures. Our forecast on the rate of real GDP growth in the euro zone is 1.6 percent in 2004 (revised from our previous forecast of 1.8 percent and 1.6 percent in 2005).

**Chart 2: Forecast of the Euro Zone Economy**

		(%)							
		2003 (Actual)	2004 (Forecast)	2005 (Forecast)	2003		2004		
					1st-half (Actual)	2nd-half (Actual)	1st-half (Forecast)	2nd-half (Forecast)	
Real GDP	Euro zone	0.4	1.6	1.6	-0.1	0.5	0.9	0.9	
	Private consumption	1.2	1.3	1.5	0.7	0.2	0.7	1.0	
	Government consumption	1.7	1.5	1.4	0.8	0.9	0.7	0.7	
	Investment	-1.7	0.8	1.5	-1.3	-0.2	0.5	0.7	
	External demand (1 billion eu)	170.7	189.1	185.0	76.0	94.7	94.0	95.2	
	Exports	0.3	2.8	1.6	-1.9	2.0	1.3	0.9	
	Imports	1.4	2.2	2.0	-0.4	0.5	1.5	0.9	
	Inventories (1 billion euro)	1.0	7.4	18.1	5.8	-4.8	3.8	3.6	
	Germany	-0.1	1.4	1.2	-0.3	0.2	0.8	0.9	
	France	0.2	1.6	1.5	-0.3	0.4	1.0	0.9	
	Italy	0.4	1.6	1.5	-0.1	0.4	0.9	0.9	
	UK	2.3	2.8	2.5	0.7	1.6	1.5	1.2	
Euro zone consumer prices		2.1	1.8	1.7	2.1	2.0	1.8	1.7	

Notes: 1. Rate of GDP growth. Yr = rate of change over the previous year. Half-year term = rate of change over the previous term.

2. The shaded columns are forecasts.

Sources: EUROSTAT, ECB, ONS.

## 3. The Asian Economies

The Asian economies should enjoy a moderate growth of consumer spending and private demand in 2004 along with the rise of exports. Due partially to a rebound from the SARS-induced lull in the previous year, we expect real GDP growth to grow slightly above 2003 and reach 6.4 percent (revised from our previous forecast of 6.3 percent) in 2004. In South Korea, the growth of exports and a policy mix of fiscal and monetary measures should succeed in lifting the economy out of the doldrums into a cyclical recovery. Meanwhile in China – showing signs of an overheating economy – we predict (1) a slowdown of fixed asset investment stemming from measures to tighten monetary policy and restrain investments, (2) a lower tax refund rate, and (3) a deceleration of exports reflecting the fact that the shift of production sites overseas has run its course. Judging from the foregoing, we expect the rate of China's real GDP growth to slow to 8.4 percent in 2004.

In 2005, we expect the export momentum to wane reflecting the slowdown of the US and Chinese economies, thus dragging down the overall growth rate of the Asian economies. Even so, the odds are high that the countries of the region will take economic stimulus measures such as cutting taxes and expanding public investment to address the deceleration of exports. We expect real GDP growth in the Asian economies to reach 6.0 percent in 2005.

**Chart 3: Forecast of the Asian Economies**

	2002	2003 (Estimate)	2004 (Forecast)	2005 (Forecast)
Asia (average)	6.0	6.0	6.4	6.0
NIEs (average)	4.5	2.9	4.6	4.3
S.Korea	6.3	2.9	4.8	5.0
Taiwan	3.6	3.3	4.5	3.9
Hongkong	2.3	3.0	4.5	3.4
Singapore	2.2	0.8	4.6	3.6
ASEAN (average)	4.4	4.9	5.0	4.7
Thailand	5.4	6.2	6.1	5.5
Malaysia	4.1	4.8	5.0	4.8
Indonesia	3.7	4.1	4.3	4.2
Philippines	4.4	4.5	4.3	4.4
China	8.0	9.1	8.4	7.7

Notes: 1. Real GDP growth (change over the previous year).  
 2. Weighted average on the basis of each country's nominal GDP in 2000.  
 Source: Government data provided by each of the relevant countries.

## II. The Japanese Economy

- **FY2004** The Japanese economy will remain on a moderate recovery, maintaining growth at the 2 percent level (real GDP growth: 2.5 percent, nominal GDP growth: 0.6 percent)
- **FY2005** Although the economy will undergo a slight adjustment, it will seek the chance to return to a stable growth trajectory (real GDP growth: 1.4 percent, nominal GDP growth: 0.0 percent).

### 1. Forecast of the Japanese Economy in FY2004

The Japanese economy is continuing to recover, fueled mainly by exports and capital investment. In the Oct-Dec quarter of 2003, Japan's real GDP surged 1.7 percent q-o-q (an annualized rate of 7.0 percent). Although the economy may slow somewhat in the Jan-Mar quarter of 2004 due in part to a reaction to the strong growth in the previous quarter, the ongoing rise of exports should keep economic growth in positive territory. Japan's real GDP is estimated to grow 2.8 percent in FY2003 (0.3 percent in nominal terms).

We do not expect the economy to slow down in FY2004 given the unlikely prospects of an escalation of negative pressures stemming from structural problems such as the debt overhang and excess capital stock. Exogenous factors also provide reasons to be upbeat. Despite negative factors upon economic recovery such as the appreciation of the yen, tax hikes and larger social security burdens upon households, there are positive factors that would spur demand such as the US-driven global economic expansion and the ongoing boom in information technology (IT)-related products and digital consumer appliances. In view of the foregoing, the economy will most likely remain on a moderate recovery and avoid peaking out during FY2004. We forecast that Japan's GDP in FY2004 will reach 2.5 percent in real terms (revised from our previous forecast of 2.3 percent) and 0.6 percent in nominal terms (revised from our previous forecast of 0.2%).

A closer look at the components of GDP reveals that the recovery of Japan's economy is still driven by exports (8.9 percent y-o-y) and capital investment (7.4 percent y-o-y). Although a sharp rise of consumer spending is unlikely given the weak recovery of labor market conditions and constraints such as greater tax and social security burdens upon households, the silver lining in the cloud is the incentive to renew durable consumer goods in the household sector amid the digital consumer electronics boom. This should keep personal consumption growth fairly strong at 1.7 percent y-o-y.

## **2. Forecast of the Japanese Economy in FY2005**

We are inclined toward the view that Japan's economic growth will lose momentum in FY2005, based upon prospects that the current IT-digital consumer electronics boom will come to a pause. The growth of capital investment comprised mainly of the replacement of old equipment will likely lose momentum and the reaction to the purchase of durable goods during the previous year will also dampen the growth of personal consumption. Thus the current economic recovery starting in January 2002 may slide into an adjustment phase without the chance to shift into a full-fledged recovery strong enough to provide prospects of an emergence out of deflation.

However, even in the foregoing scenario, we do not expect cyclical adjustment pressures such as the debt overhang and excess capital stock to build up in FY2005 given the corporate sector's cautious stance regarding inventory control and capital investment. Furthermore, as mentioned in more detail below, we should note a substantial progress in the mitigation of structural adjustment pressures and the improvement of the expected rate of growth. Thus, even if the Japanese economy peaks out, the government and the BOJ would still be able to lift the economy out of a relatively benign adjustment by taking appropriate measures to stabilize the economy. If the decline in growth rate turns out to be mild, the Japanese economy would be better positioned to achieve stable growth and emerge out of deflation in the ensuing recovery cycle.

## **3. The Current Recovery**

Japan's current economic recovery starting in January 2002 is proving more resilient than initially expected. Although the output gap (potential GDP minus actual GDP) causing deflation is still unresolved, it is shrinking as a result of Japan's economic growth during the past two years. Corporate and household concerns regarding deflation are also abating given the economic recovery and the contraction of the output gap. Moreover, the negative pressures stemming from structural problems of Japan's economy such as the debt overhang and excess labor, which are a drag upon growth, are easing. As for the fall of growth expectations that has hampered forward-looking investment activity by corporations, it should be noted that the extreme decline is coming to a halt. The restraints stemming from these negative factors should be alleviated as long as the economy continues to recover during FY2004. The events thus far are worthy of commendation for setting the backdrop for the Japanese economy's return to a sustainable growth trajectory.

However, note also that the current economic recovery is limited due to

several factors. First of all, the divergence along the corporate spectrum in terms of size and sector has widened to an unprecedented level. The recovery to date has been uneven with large manufacturers being the sole beneficiaries of export growth. The positive impact of the current economic recovery upon small and medium businesses and non-manufacturers has been extremely meager. The disparity is also having an adverse influence upon the progress in adjustment of excess labor and debt overhang. It is leading to a delay in improvement among small and medium companies and non-manufacturers (in particular construction companies, real estate firms and retailers) and a yawning economic gap among geographic regions stemming from the performance of local industries. Secondly, the autonomous recovery mechanism inherent in the economy is not functioning properly in Japan. Even though excessive concerns in the corporate sector regarding deflation and the expected rate of growth have abated considerably, corporate business sentiment has not yet improved to levels generating forward-looking investments to boost capacity and employ more workers. Even among large manufacturers who are enjoying comparatively favorable performance, the pickup in capital investment to upgrade capacity is only witnessed among IT-goods and digital equipment makers. From a macroeconomic perspective, the pace of capital investment growth is not yet strong enough to spur further industrial production. Furthermore, the recovery of consumer spending is still limited given the tepid recovery of labor market conditions and lingering concerns toward future tax hikes and pension system. Japan's economic recovery is still dependent upon external demand and remains vulnerable to exogenous shocks because of the inadequate recovery of domestic demand. The possibility of Japan losing steam again may not be overlooked depending upon risks such as a sharp appreciation of the yen, a slowdown of the overseas economies and a premature tightening of macroeconomic policy by the government. Moreover, there are numerous unresolved issues such as the management of the fiscal deficit, a sustainable social security system and a socio-economic system capable of coping with an aging and declining population. In short, we find scant reasons to be optimistic regarding the future course of Japan's economy. While it goes without mention that the private sector must continue its best efforts to reform, the government must provide appropriate policy steps and set forth a clear future vision in order to lift the Japanese economy out of deflation into a full-fledged recovery.

**Chart 4: Forecast of the Japanese Economy**

	FY2003 (Estimate)	FY2004 (Forecast)	FY2005 (Forecast)	FY2003		FY2004		FY2004	FY2005
				1st-half (Actual)	2nd-half (Forecast)	1st-half (Forecast)	1nd-half (Forecast)	(Contribution) (Forecast)	(Contribution) (Forecast)
GDP (real)	2.8	2.5	1.4	1.5	2.0	1.1	1.0	-	-
Domestic demand	2.2	2.0	1.2	1.1	1.7	0.8	0.8	2.0	1.2
Private sector demand	3.4	2.8	1.3	1.9	2.0	1.2	1.1	2.1	1.0
Personal consumption	1.3	1.7	1.1	0.7	1.2	0.8	0.6	0.9	0.6
Housing investment	0.0	-1.2	-0.0	0.9	-0.1	-1.4	0.6	-0.0	-0.0
Capital investment	10.5	7.4	3.4	5.5	5.3	2.6	3.9	1.2	0.6
Public sector demand	-1.8	-0.6	0.8	-1.6	0.4	-0.6	-0.3	-0.1	0.2
Government consumption	1.2	1.6	2.3	0.4	1.1	0.6	0.8	0.3	0.4
Public investment	-10.1	-7.4	-4.3	-7.6	-1.5	-4.6	-4.3	-0.4	-0.2
Net exports (contribution)	0.7	0.5	0.2	0.4	0.4	0.3	0.1	0.5	0.2
Exports	9.2	8.9	5.4	3.9	6.0	4.3	3.1	1.1	0.7
Imports	3.6	6.3	5.1	0.5	3.1	2.9	3.3	-0.6	-0.5
GDP (nominal)	0.3	0.6	0.0	0.6	0.1	0.7	0.0		
Industrial production	3.0	4.8	2.0	0.1	4.7	1.9	1.2		
Unemployment rate	5.2	4.9	4.4	5.3	5.1	5.1	4.7		
Current account balance (trillion yen)	16.4	18.7	21.7	16.7	16.5	18.4	19.4		
as a percentage of nominal GDP	3.3	3.7	4.3	3.3	3.3	3.7	3.9		
Corporate goods prices	-0.6	-0.4	-0.8	-0.9	-0.3	-0.3	-0.6		
Consumer prices	-0.2	-0.2	-0.3	-0.3	0.0	-0.2	-0.3		
Long-term interest rate (%)	1.11	1.35	1.30	0.90	1.33	1.40	1.30		
Nikkei stock average (yen)	9,889	11,200	11,300	9,178	10,600	11,400	11,000		
Exchange rate (yen/dollar)	112.5	104	109	118	107	103	105		
Crude oil price (dollar/barrel)	30.8	29.1	26.4	29.6	32.1	29.5	28.8		

- Notes:
1. FY = rate of change from the previous year. Half-year term = rate of change from the previous term (excluding the unemployment rate, current account balance and prices).
  2. Half-year corporate goods prices and half-year consumer prices = rate of change over the same period a year ago. Consumer prices = nationwide (excluding perishables).
  3. Half-year unemployment rate and half-year current account balance are adjusted for seasonal factors.
  4. Crude oil prices = nearest term contract for WTI futures. The long-term interest rate = newly-issued 10-yr government bonds.

Sources: Cabinet Office, *Annual Report on National Accounts*,  
 Ministry of Economy, Trade and Industry, *Production, Shipment and Inventory Indexes*,  
 Ministry of Public Management, Home Affairs, Posts and Telecommunications, *Labor Force Survey, Consumer Price Index*,  
 Bank of Japan, *Balance of Payments Statistics, Corporate Goods Price Index*.

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**MIZUHO**

The logo consists of the word "MIZUHO" in a bold, dark blue, sans-serif font. Below the text is a red, curved line that starts under the 'M', dips slightly, and then rises to end under the 'O'.