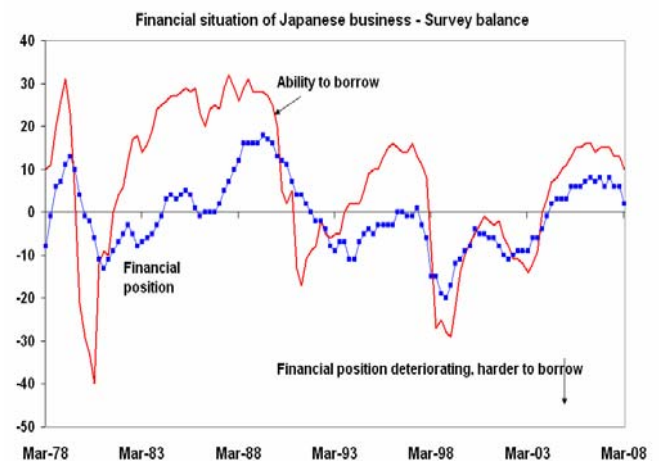
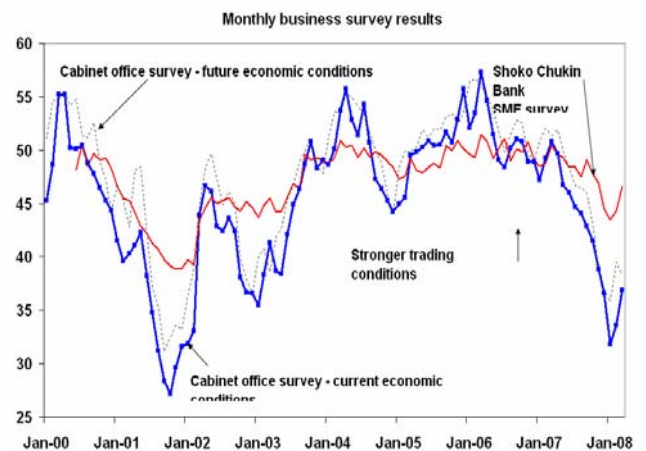


Japan - sluggish growth but no credit crunch

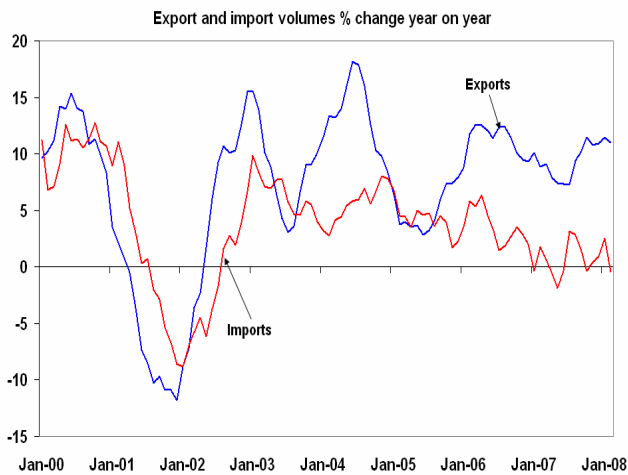
Key trends

- Even the official assessments now agree that the pace of growth in Japan is slowing and that the economic recovery could be pausing. The economic upturn that Japan has experienced through the last few years has been largely reliant on exports and these are starting to suffer from the slowdown in the global economy.
- The government hoped an export-led upturn in the industrial sector would lead to higher household income and that - in turn - would boost consumer spending. The likelihood of such a self-reinforcing lift in output, income and spending seems to have faded. The real problem has been the lack of flow-through from the upturn in business activity and profits into household income - consumers never actually got extra money to spend.
- As a result, consumer spending has stayed weak and the economic expansion has remained narrowly based - exports and business investment have been the mainstays. Now the labour market seems to be no longer improving, although conditions are still much better than they were a few years ago.
- We expect growth to average only 1¼% this year and 1½% next year with domestic spending almost flat through 2008. Recent monthly business surveys have been stronger than initially appeared likely, suggesting that while growth is slowing there is a floor under demand. The lack of as much impact from the credit crunch in Japan as elsewhere should also prevent too steep a slide in activity - although the financial conditions facing business are clearly tightening.

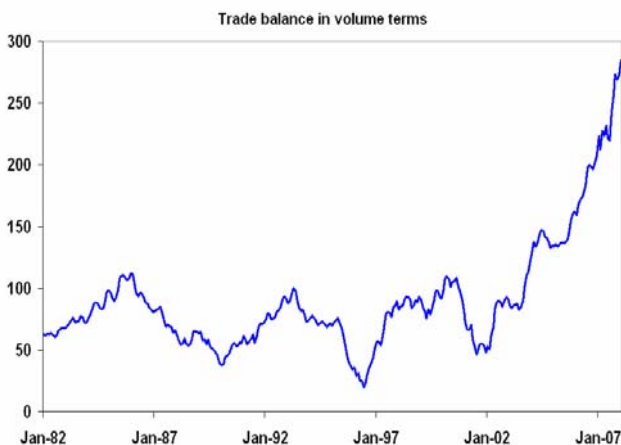


Exports still the key driver of growth

Exports are still the main driver of growth in Japan. We expect economic growth of only 1¼% in 2008 with the external sector contributing 1 percentage point of that growth. Slow growth in domestic spending is holding down import volumes while export volume growth remains strong.

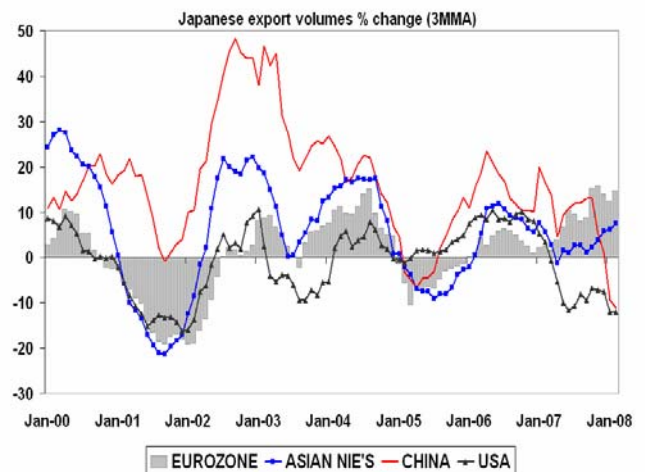


The outcome of this has been a burgeoning trade surplus in volume terms and as that surplus expands, net exports continue to add to growth. We can track this surplus on a monthly basis and the January outcome was a record that stood around 25% above the year-earlier surplus.



Despite this, Japanese exports have not been unscathed by the sharp slowdown in the rate of growth in world trade. In particular, the slide in US demand growth combined with the weakness in the US\$ have taken a toll on export volumes to that market. Export volumes to the US were down by around 12% yoy in early-2008.

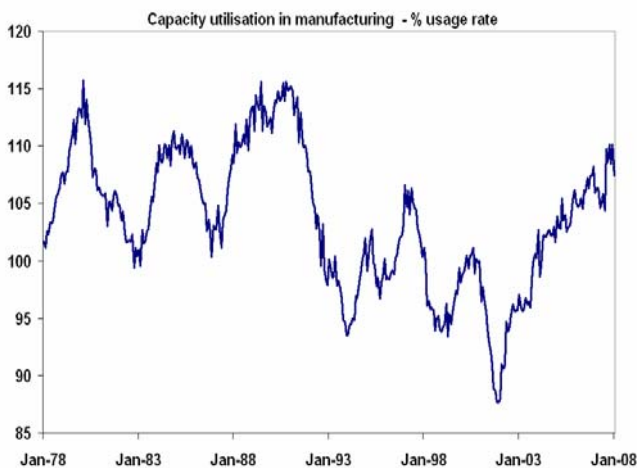
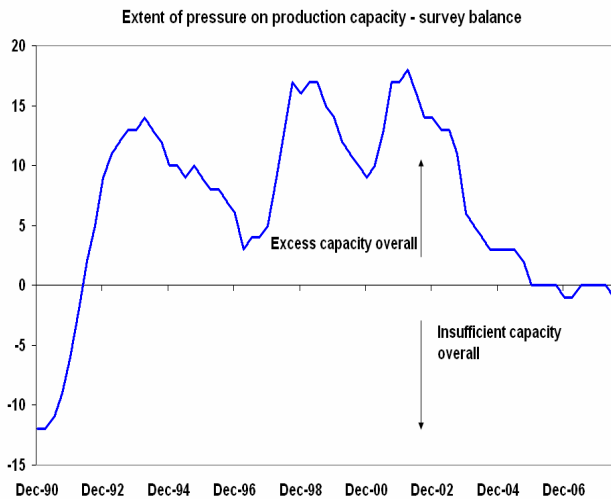
Shipments to other markets had been able to more than compensate for this slide in sales to the US, however we will need to watch the recent slip in Japanese exports to China. This could merely reflect the timing of the Chinese New Year along with weather-related disruption to freight movements but Chinese demand is now so important to the Japanese economy that any weakness in bilateral trade would be an important setback to the Japanese economy.



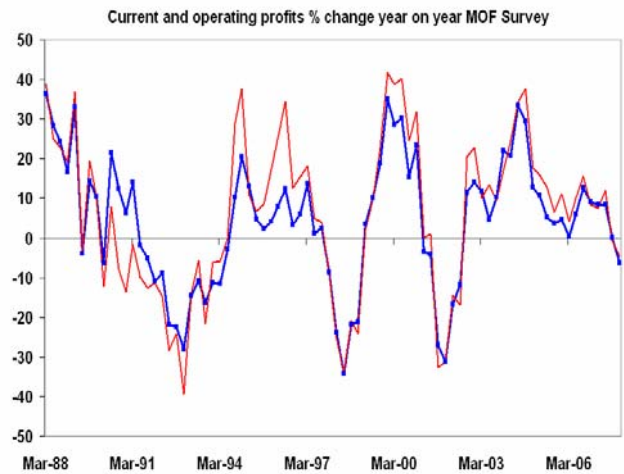
The government is counting on a continued solid performance by the export sector to aggregate economic growth. While an anticipated slowing in the pace of growth in East Asia and the appreciation of the yen against the US\$ are expected to have some adverse impact on the pace of growth, it is clearly not expected to do too much damage to Japan's export machine. The business surveys are not pointing to a sudden deterioration in overseas market conditions either - so the export-led pattern of growth seems likely to continue as before.

Business investment set to slow

The other big driver of growth has been business investment. As rising exports lifted industrial production the outcome was higher rates of capacity utilisation and enhanced profitability. The reduced margin of idle capacity provided the incentive to lift capital spending and the improved profits provided the retained earnings to fund it. Recently, the long upswing in capacity utilisation seems to have levelled off with a flattening out in manufacturing plant usage rates and a stabilisation in survey results for businesses reporting excess/inadequate capacity.



Profitability is suffering as higher input costs squeeze margins as yen appreciation and slack domestic demand make it harder to pass on cost increases. The Tankan survey shows profits falling in the 6-months ended March 2008 by 7½% yoy and another 1.9% in the 6-months ended September 2008. Some recovery is then expected through late-2008 and into early-2009 with a 7% yoy rise in current earnings. The Finance Ministry data on earnings suggests that the downturn has indeed started with profit results in the second half of 2007 already down by around 5% yoy.



Although capital spending has been holding up well, the surveys are now pointing to a slowing. The Finance Ministry survey shows a fall in investment of around 9% expected in fiscal 2008 (which ends in March 2009) with the latter half of the year bearing the brunt of the slide (down 20% yoy). The Tankan also shows a drop of around 6% forecast for fiscal 2008 with the weakness concentrated in the latter half (down 11% yoy). However we note that these surveys have been overly gloomy in the past and there is no sign yet of this slowing with core machinery orders still up in March quarter 2008. Given this, we have partly discounted for the weakness in these surveys and have based our forecasts on a stalling in numbers rather than outright declines.

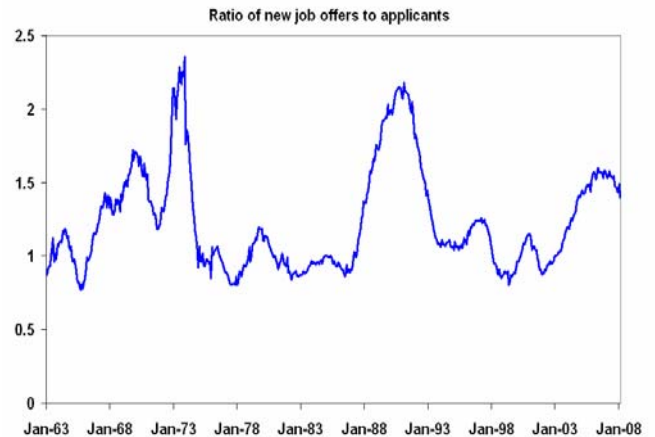
Consumer income and spending weak

Although the business sector has experienced a marked lift in earnings through the last 5 years, household income growth has remained weak. Compensation of employees provides one of the most timely indicators of how aggregate incomes are faring and - according to this measure - they have been going sideways for the last few years in nominal terms and are well below their levels in 2000.

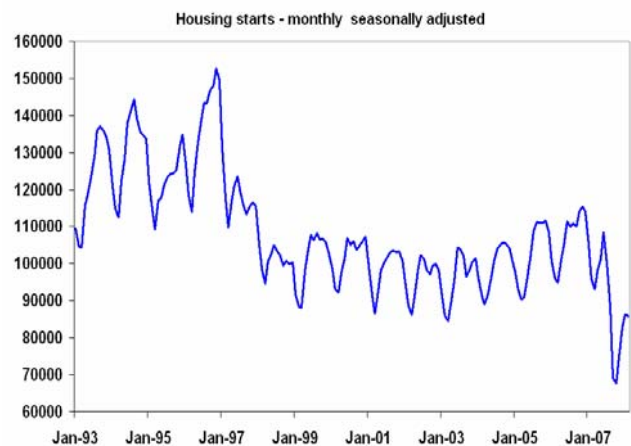


The Labour Ministry numbers confirm the weakness of household incomes. In 2007, late in the economic upturn when there should have been plenty of time for it to spread into wages, cash earnings fell by 0.7% in 2007, real wages were down by 0.8%. While there was a jump in employment of 1.8% it was mainly in part-time jobs and so total hours worked fell by 0.6%.

While wage growth has been very slow, the improvement in the labour market had done rather more to support what modest growth in income and spending that there was. Now it looks as if that improving trend is fading. The jobless rate has stopped falling in recent months, employment levels are dropping slowly and the number of new job vacancies looks to have peaked and be trending down. The ratio of job vacancies to applicants for unemployment insurance is dropping - so the market is softening.



The various data sources give diverging pictures of consumer trends. Given that uncertainty, the safest course is to conclude that on balance consumer spending has been weak and expect it to get even softer through the next year. Accordingly, we expect growth of under 1% in private consumption in 2008, down from last year's 1½%. There should be better news when it comes to housing spending, however, where a regulation-related collapse in building seems to have bottomed out, removing a big drag on growth. Going forward we expect modest growth.



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