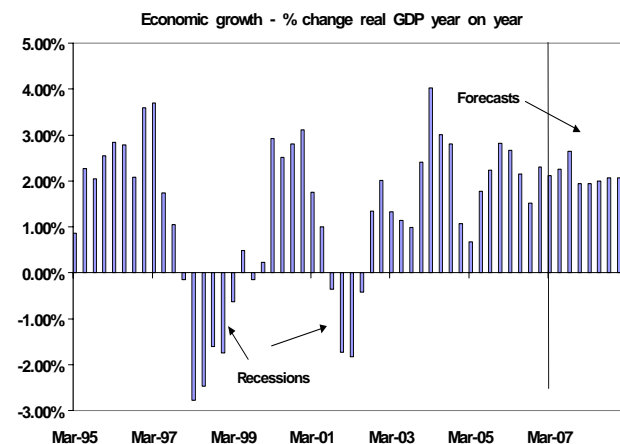
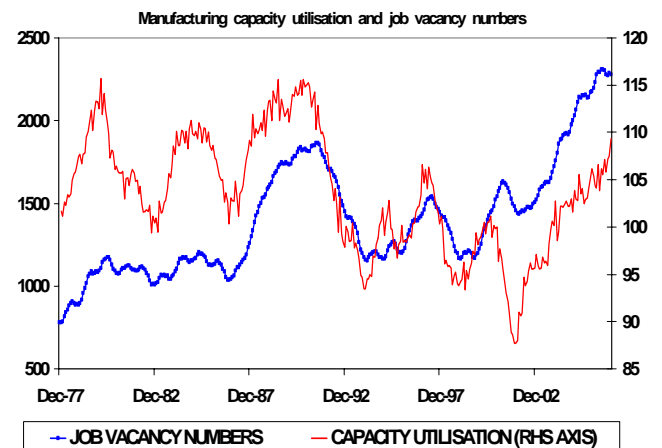


Japan - activity “normalises”, interest rates rise

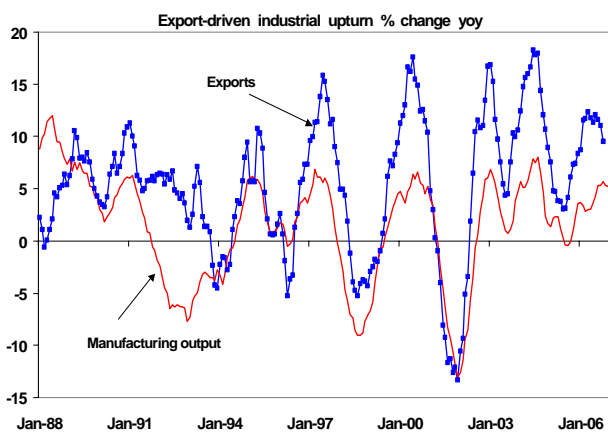
Key trends

- Economic activity levels have returned to normal in Japan as persistent economic growth soaks up once-massive amounts of idle capacity.** Capacity utilisation rates in manufacturing are back at levels last seen in the early 1990's and job vacancies have risen too.
- Economic growth accelerated sharply in the closing months of 2006 after a soft period in the middle of the year.** Growth reached around 2¼% in 2006 and we expect the same for 2007 (revised up from 2%) followed by a slowing to 2% in 2008.
- Economic growth is still very lop-sided with strong export-led growth in manufacturing alongside stagnation in consumer spending.** The weakness in consumer spending reflects the lack of much growth in household incomes, even though employment has picked up. There are a few signs that things could be improving here - but nothing conclusive.
- Although the Bank of Japan (BOJ) has made it clear that it intends to “normalise” its still very low interest rates, it has also emphasised that it plans to do so gradually.** We think that the BOJ will increase short-term rates from their current 0.5% to 1% by the end of the year and 1¾% by the end of 2008.



Exports/industry still the drivers

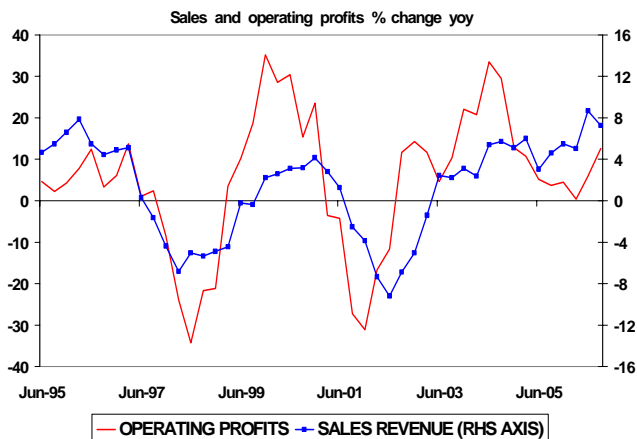
A combination of strong growth in Japan's Asian trading partners with the competitiveness benefits of the low Yen have underpinned rapid export growth through the last few years. This, in turn, has enabled the export-dependent industrial sector to recover from the very deep recession recorded through 2001 and 2002. Recently industrial output growth has been running at around 5% yoy while export volume growth was still around 10% yoy in the latter half of last year.



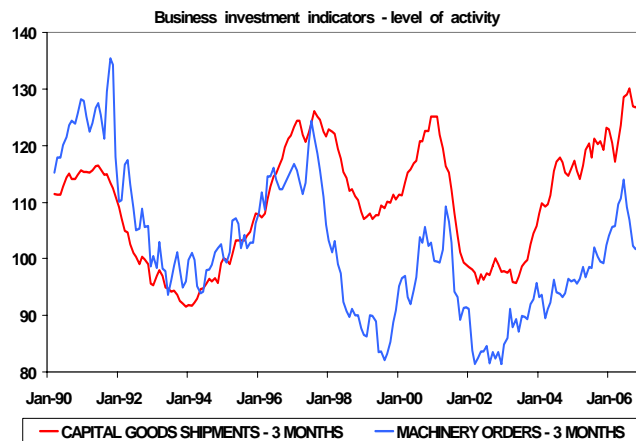
The upturn in industrial activity has fuelled an expansion in business profitability through the last few years but the business surveys are divided on what happens next. Company profits were up by 12 to 15% yoy in the latter half of 2006 but the business surveys suggest that they should level off or even drop slightly in the latter half of the fiscal year.

The December Tankan survey saw profitability growing by 4.7% in fiscal 2006 but that annual average is made up of an increase of 12.8% yoy in the first half of the year and a 2.2% fall in the second half. The Finance Ministry's survey also shows a big drop in earnings growth through late 2006 and early 2007, particularly in the services industries. Finally the Cabinet Office's survey also shows a drop in both sales

and ordinary profits in the same period. It is hard to know what to make of these survey results as profits have often turned out well ahead of business expectations in surveys through this industrial upturn.



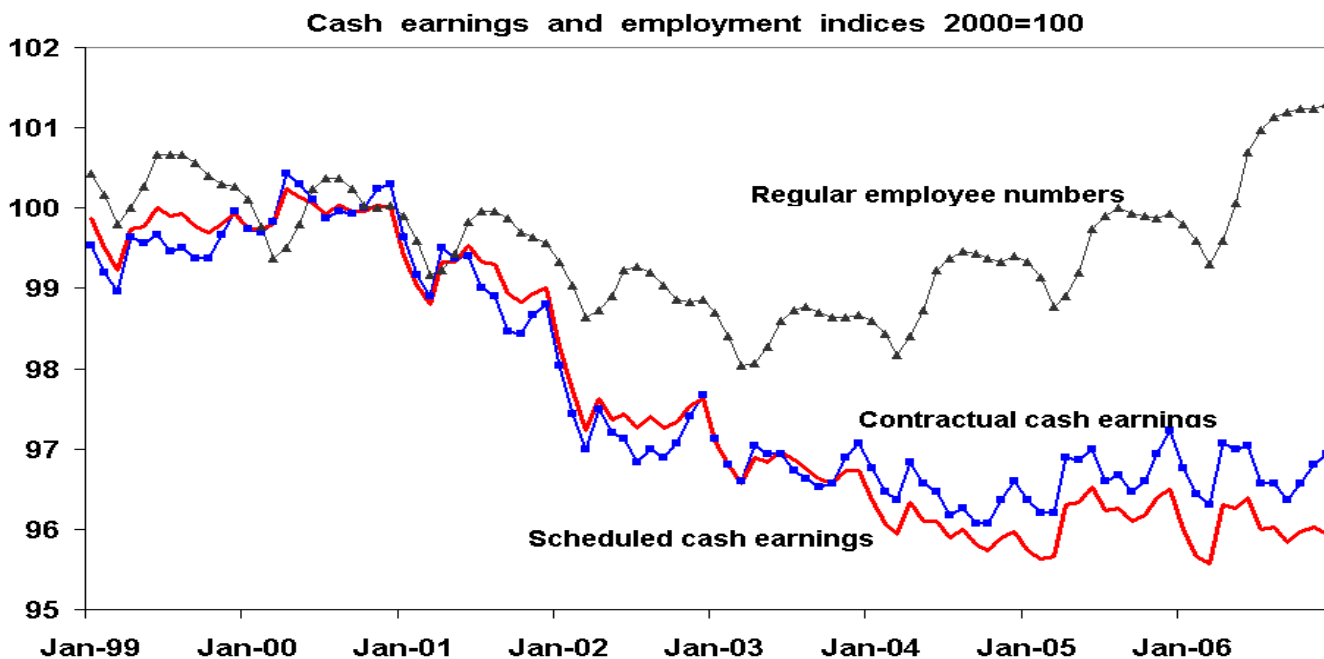
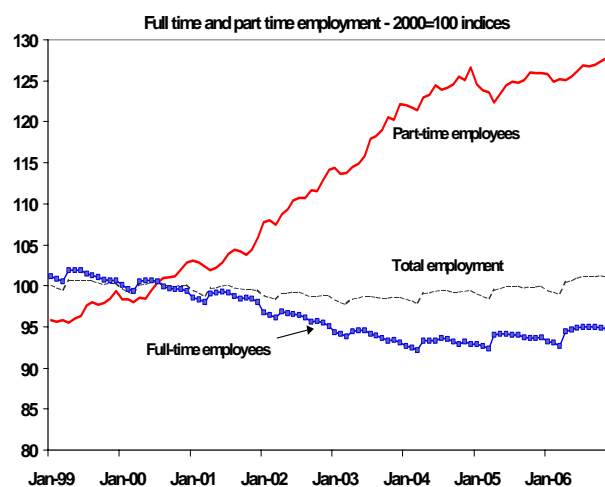
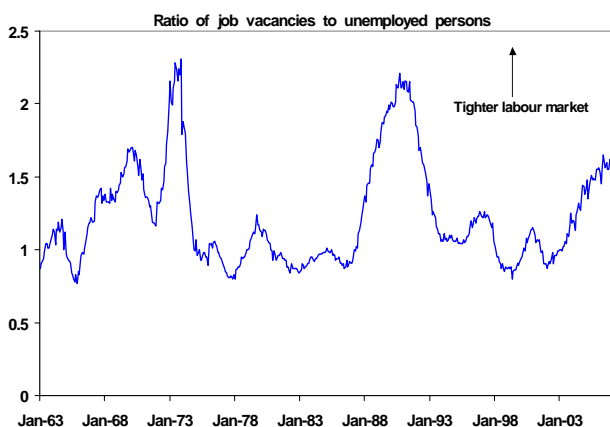
The increased level of capacity utilisation and higher profitability have boosted business investment and that driver of the economic upturn is still going. Business investment volumes grew by 7½% in 2006 and were up by over 2% in the final quarter. The surveys generally show continued resilience in capital spending. The Tankan has it growing by 10.6% yoy in late 2006 and early 2007 and the other two surveys have 8% growth. The monthly data shows capital goods shipments still trending up.



Consumer demand growth much softer

The Government's hope has been that the upturn in the business sector would stimulate higher employment and incomes in the household sector and that would then flow into increased consumer spending - triggering a broader-based and more sustained economic upturn. So far, while we have seen the increase in jobs, there has not been much growth in consumer spending. The reason for this is that the growth in jobs has not led to much growth in household incomes - in effect, business earnings have secured a large share of the income gains from recent growth.

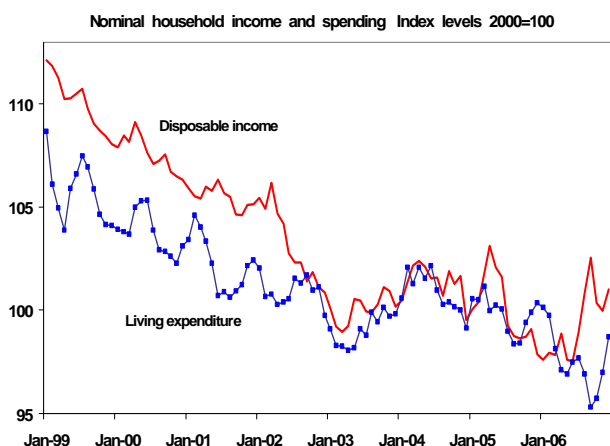
As the number of job vacancies has risen considerably, the labour market has tightened and the ratio of vacancies to jobless is back at levels last seen in the early 1990's. However, these new jobs are part-time jobs and they pay less than the full-time salaries that were once the norm. Full-time employment is actually still falling. That explains why we have the coincidence of higher employment levels with lower average cash earnings than was seen before the recession of the early 1990's.



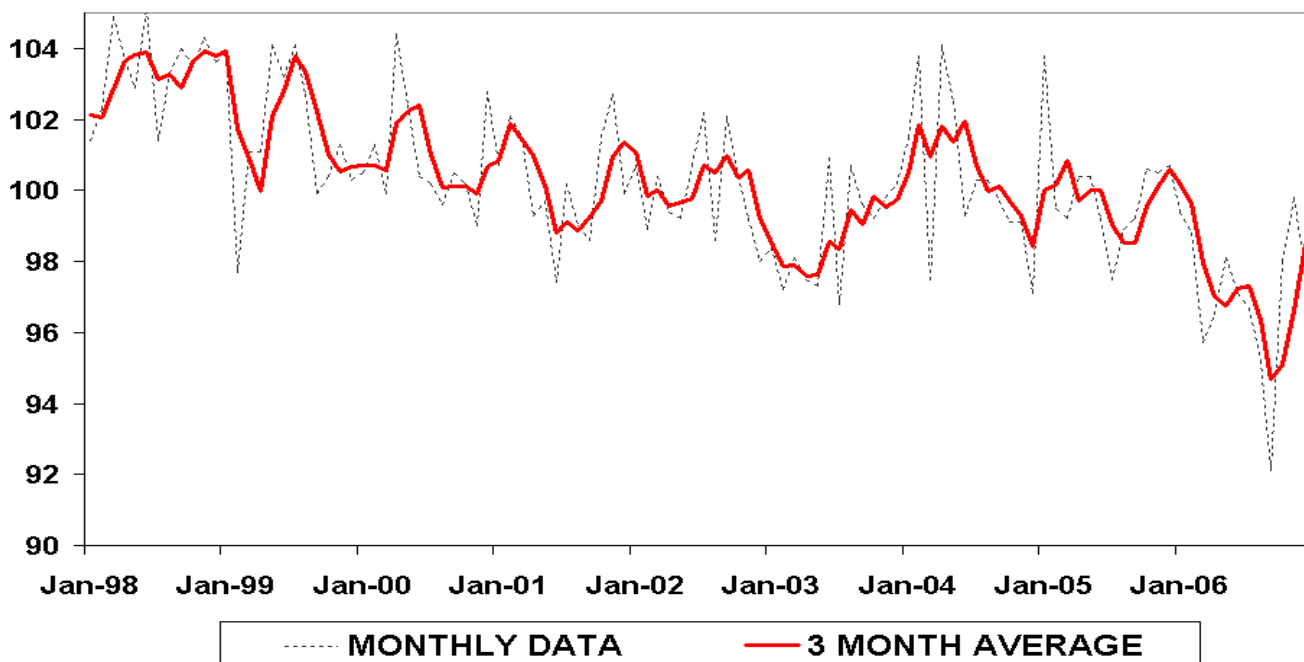
The lack of salary growth has come through in the official data on household incomes - which are finally showing some signs that income growth may be lifting. Average nominal household incomes trended down from 1997 onwards as price deflation and higher unemployment took effect. In the second half of last year both income and disposable income growth turned positive and they were up by 3 to 4% yoy in the closing months of the year. However, average household spending is still soft and it was down by 2 or 3% yoy in the closing months of the year.

There are a number of measures of the value of consumer spending and they generally do not show much growth either. The most comprehensive is the Bank of Japan's index which showed no growth at all through 2006. The other indicators of retail sales, department store sales, chain store sales supermarket sales and car registration numbers do not show any growth either. Some of them, however, do indicate that things are not falling as fast as was the case before.

Price changes affect all of these measures and the chart below shows the only monthly series that provides volume measures for household spending. It is taken from the monthly household income and expenditure survey and it indicates that there was a recovery in the level of real spending through the closing months of 2006. The other type of data illustrating household spending intentions are the consumer confidence surveys. The ESRI measure of confidence has been trending up and is above its long term average level. Taken overall, there is no clear evidence yet that a sustained lift in consumer spending has begun, although the chances that it has look better than they have for years.



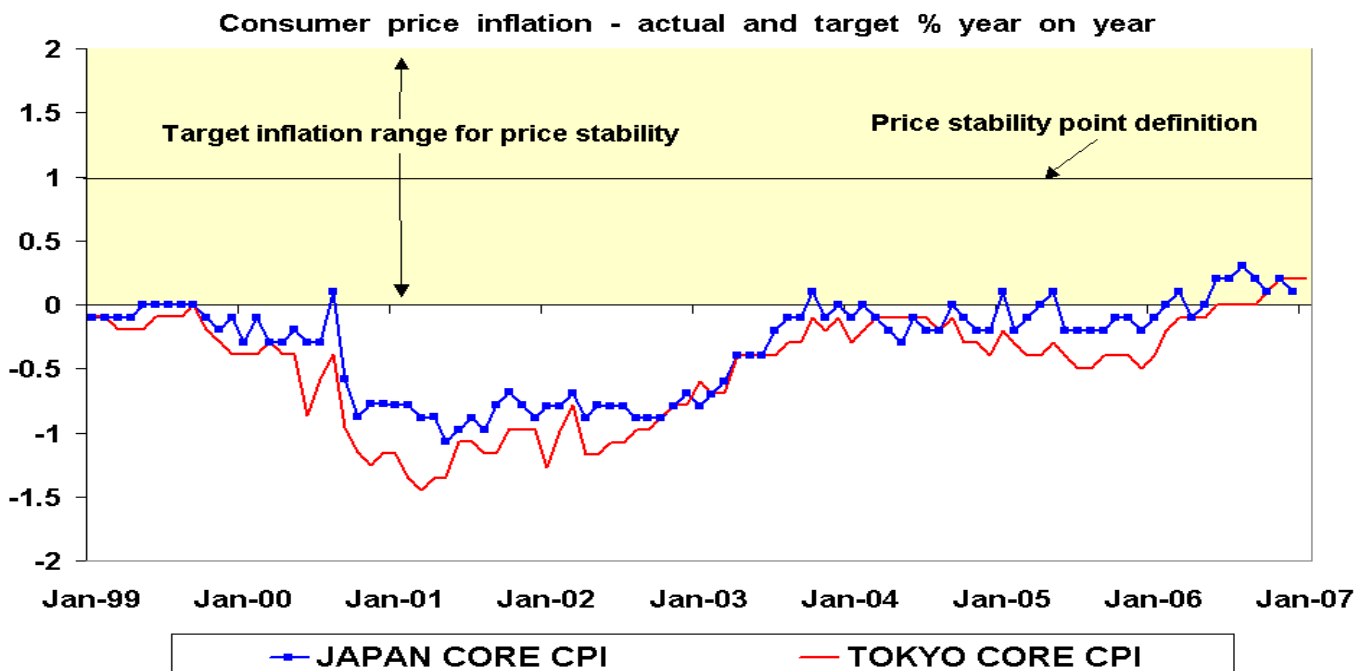
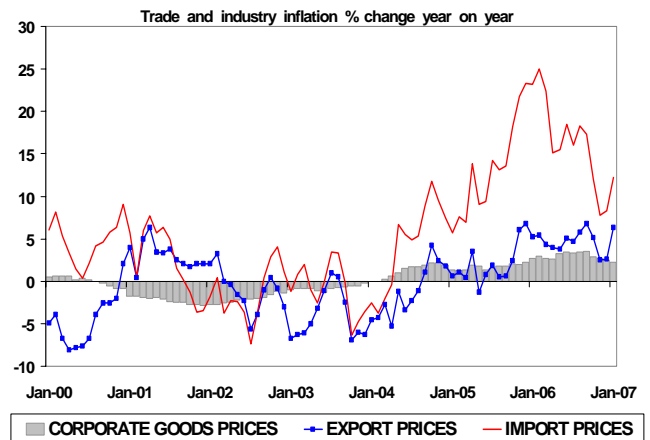
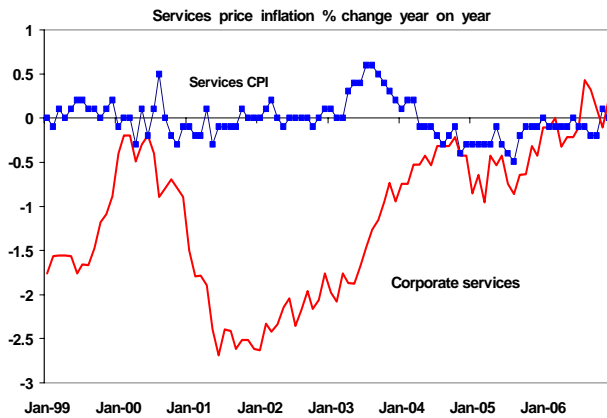
Volume of household spending 2000=100 index



Inflation still very low

The Bank of Japan's aim is to maintain price stability, defined as zero and 2% yoy with most Board members definitions around 1%. Recent outcomes have been under that with core inflation of around 0.1% in December and a Tokyo figure of 0.2% in January - so there is no urgency in lifting interest rates. The Bank still predicts that inflation will rise from 0.3% in fiscal 2006 to 0.5% in fiscal 2007 and in its recent announcement of higher interest rates it stuck to its guns that trend inflation would continue as capacity use increased. There is considerable variation between sectors with little evidence of much inflation in services.

There has been more inflation in other areas of the economy, reflecting higher commodity prices and the weak Yen. Recently, however, inflation has slowed in manufacturing. The average monthly change in corporate goods prices in the last 6 months has been negative and there has been - on average - practically no increase in manufacturing output prices. While output price inflation has slipped to around 2% yoy, there are still much more solid rates of increase for exports with average monthly growth of around ½% a month in average yen prices for each.



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