

LEAN TIMES FOR "THE YEAR OF THE OX"

In the wake of the international economic and financial crisis, the recession is likely to be deep and lengthy in Japan, with a sharp contraction in exports and domestic demand. Real GDP is expected to fall by nearly 2.5% in 2009, after stabilising in 2008. The BoJ's support measures for corporate financing, the maintenance of the key rate at 0.10%, together with the implementation of economic stimulus plans during the 2008/2009 fiscal years, the financing of which will significantly increase the public deficit, should all help support industrial activity. Against this backdrop and assuming an average oil price of nearly USD 50 and the appreciation of the yen until the end of the first half, consumer prices look set to fall by 1% in 2009.

Japanese companies particularly affected by the global crisis

The deterioration in the global economic outlook points to a collapse in foreign demand in 2009. The downtrend in Japanese exports to the United States and the EU, under way since the beginning of 2007, is becoming more pronounced. Moreover, some Asian countries (China, Malaysia, Thailand) are expected to experience a very significant economic slowdown, with others in recession (Singapore, Hong Kong, Taiwan, South Korea). However, stimulus plans in China, Taiwan and South Korea, combined with an easing of monetary policy, should provide support for economic activity in the second half. In addition, hitherto resilient exports to the Middle East and Russia look set to decline mainly as a result of plummeting oil prices. Although all industrial sectors have been hit by the collapse of the major export markets¹, the automobile, electronic components and machinery sectors have been particularly affected. The sharp rise in the yen, both past (between August 2008 and end-January 2009: +60% against the Korean won, +42% against the euro and +22% against the dollar and yuan) and future, will also adversely affect the price competitiveness of Japanese industrial companies and squeeze the margins of exporting firms. Finally, exports in volume terms are likely to shrink by more than 9%, with the current account surplus falling back to 3% of GDP in 2009.

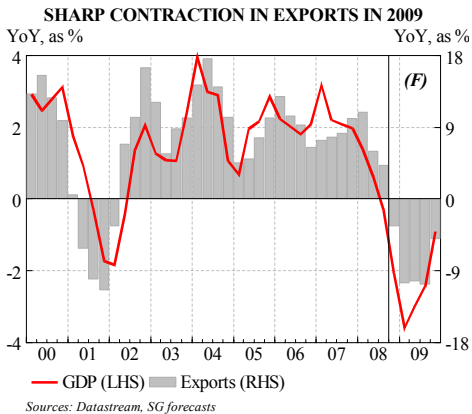
Consequently, many companies, which are also having to deal with declining domestic demand, have been forced to stop production for several weeks. In November, industrial production plummeted by 9.6% MoM, or -22.5% YoY, the biggest decline ever recorded. Shipments of industrial products fell by 8% MoM and stocks increased by 0.1%. The differential between 12-month shipment and inventory trends has grown in all industries, especially for high-tech products. The downward adjustment of stocks will accentuate the contraction in production. In these conditions, productive investment is in free fall: machinery orders have collapsed since mid-2008 (-25.8% YoY in November for domestic orders and -44.1% for foreign orders, a record rate) and the production capacity utilisation rate is on a sharp downward trend.

Despite the decline in production costs, companies have seen a drop in their profits since mid-2007 and are having to contend with the rapid tightening of credit conditions, a reflection of the vulnerability of the banking system. In particular, financial institutions (FI) have been heavily impacted by the downturn in the equity markets and the increase in credit costs. A rise in doubtful loans and losses on structured products can be expected, while company bankruptcies are already mounting (+8.6% since last August). However, guarantees given by the government for certain loans together with the temporary cut in the corporation tax rate (SME) from 22% to 18% are likely to limit the number of bankruptcies among SMEs.

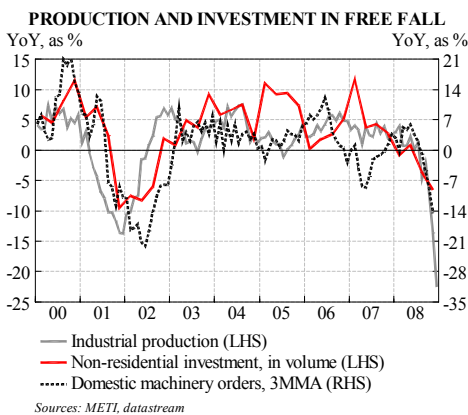
The sharp deterioration in all economic indicators and the very negative tone of the December *Tankan* suggest that the country has been plunged into the longest recession ever known since the end of the war, with companies being particularly hard hit. Hence the sharp contraction in productive investment this year.

Private consumption and housing investment will provide no help

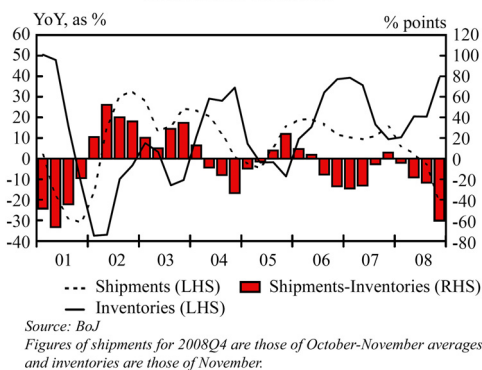
The deterioration in the labour market is getting worse. The job-offers-to-seekers ratio has been below 100% for more than a year. The decline in employment (the unemployment rate is expected to go back up to 4.8% in 2009) affects first and foremost precarious and temporary jobs. The decline in profit margins results in a drop in wages and bonuses. The real manufacturing wage fell 5.8% YoY in November. Admittedly, the fall in the inflation rate generates, in the short-term, gains in purchasing power, but since confidence is at a low, households will continue to postpone their purchases of consumer



¹ In particular, 27% of automobile/spare parts exports go to the US and 62% of electric machinery deliveries to Asia.



SHIPMENTS AND INVENTORIES OF ELECTRONIC PARTS AND DEVICES



durable goods, especially as plummeting share prices are having a negative impact on their financial wealth. Private consumption therefore looks set to shrink slightly in 2009, with planned government measures are likely to provide some support (JPY 2 trillion of immediate direct aid for households and JPY 550 billion of tax cuts). However, a large proportion of this financial aid will be saved.

That said, the property sector is expected to experience a rebound on a very limited scale after the sharp decline in housing starts and orders received by construction companies observed for more than a year and a half. Construction spending looks set to rise by nearly 0.5% in 2009, driven by the drop in land prices which began at end-2008.

Overall and after stabilising in 2008, real GDP is likely to decline by 2.5% in 2009, with the first half proving to be disastrous. A slight recovery is expected in 2010.

Return to deflation and BoJ support for corporate financing

Inflation has slowed sharply since August, as a result of the downturn in commodity prices. It is expected to become rapidly negative until next October at least, with strong energy-related base effects coming into play in the first half. Moreover, the yen's appreciation will result in a decline in the prices of imported products. Finally, the global recession and the widening output gap, largely negative, will also push consumer prices into negative territory (after three years of rising). Overall and as an annual average, prices look set to fall by 1% in 2009. The BoJ fears that the return of deflation signals the lapse into a vicious deflationary circle².

With the key interest rate practically zero, the BoJ is endeavouring to stabilise financial markets and facilitate corporate financing. Since January 8, it has been providing an unlimited amount of cash to FIs at its target rate, accepting corporate debt as collateral and, now, debt securities issued by real estate investment corporations. It has also announced the purchase of commercial paper and corporate bonds (with a residual maturity of less than 1 year) and an increase in its acquisitions of JGBs. Therefore, like the Fed, the BoJ is implementing an "unconventional" policy, by accepting to incur a limited credit risk.

An unprecedented 2009 budget for financing stimulus plans

In order to finance the three stimulus plans that have been successively announced, the projected budget for the 2009 fiscal year is a record JPY 88.55 trillion, up 6.6% on the planned budget for 2008. It will be financed to the tune of JPY 46.10 trillion by tax revenues (-14%), JPY 9.15 trillion by other revenues and JPY 33.30 trillion by bond issues (i.e. 37.6% of the expenditure), up 31.3%. According to the government, the stimulus plans total JPY 75 trillion. However, only JPY 12 trillion (2.4% of GDP) concern fiscal measures³, with the balance covering the government guarantee for loans to SMEs (JPY 30 trillion), the financing of the *Banks' Shareholdings Purchase Corp.* aimed at acquiring, outside the market, shares held by the banks (JPY 20 trillion), the recapitalisation of the banks (JPY 10 trillion) and JPY 3 trillion for expanding loans and purchasing commercial paper. Therefore, the total impact on activity will be relatively limited.

Finally, after many years of budget consolidation, the public deficit looks set to increase, probably exceeding 5% of GDP in 2009, especially as the government anticipates a further rise in interest expenses (to JPY 9.4 trillion). The target of a primary budget surplus by the 2011 fiscal year is out of reach; however, once growth returns, the high level of debt (181% of GDP in 2009), the highest among OECD countries, and social security expenditure, due to the ageing population, will force the authorities to raise the tax rate on consumption (currently at 5%).

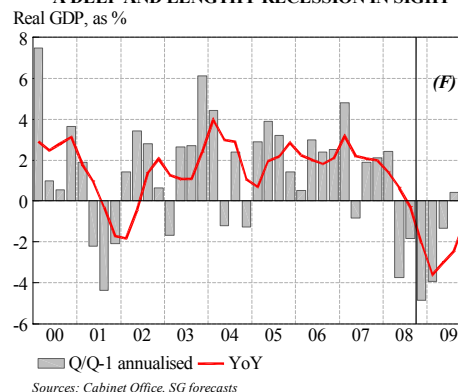
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As %	2005	2006	2007	2008(f)	2009(f)
Real GDP	1.9	2.0	2.4	0.0	-2.5
Consumer prices (CPI)	-0.3	0.2	0.1	1.4	-1.0
Unemployment rate	4.4	4.1	3.9	4.0	4.8
Current account (% GDP)	3.7	3.9	4.8	3.4	2.9
Public balance (% GDP)*	-5.7	-3.5	-2.9	-3.2	-5.2

*Excluding one-off measures

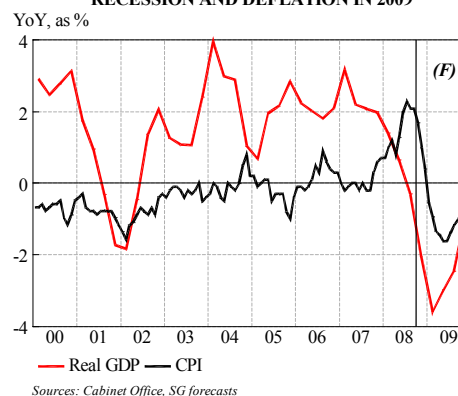
	04/02/09	Mar 09	June 09	Sept. 09	Dec. 09
3-month interbank rate	0.73	0.60	0.55	0.50	0.60
10-yr government bond yields	1.34	1.30	1.40	1.45	1.45
USD/JPY	89	85	85	95	105
EUR/JPY	114	106	106	124	142

A DEEP AND LENGTHY RECESSION IN SIGHT



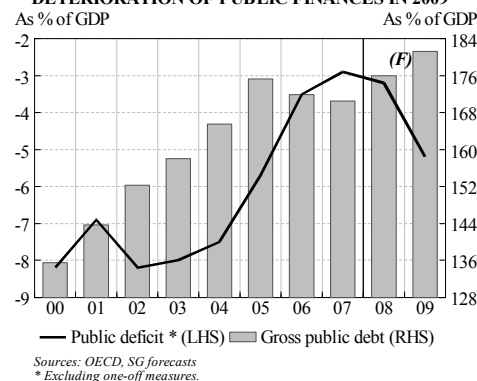
² The BoJ is forecasting two years of declining prices (-1.1% for the 2009 fiscal year and -0.4% for the 2010 fiscal year) and a contraction of the economy in the 2008 fiscal year (-1.8%) as well as in the 2009 fiscal year (-2%).

RECESSION AND DEFLATION IN 2009



³ Fiscal measures: measures for employment, investment, for social security, support to local governments and regions, benefits to households, tax reductions.

DETERIORATION OF PUBLIC FINANCES IN 2009



WORTH WATCHING

Numerous uncertainties could lead us to revise the central scenario downwards. In particular, the volatility of the financial markets and risk aversion, detrimental to the economy, have already driven the yen to a one-off 13½ year high against the dollar (at JPY 87.10). The BoJ could intervene to prevent any further appreciation. The rapid and marked increase in the yen has already contributed to the unprecedented collapse of exports (-35% YoY) in December. Although imports have plummeted (-21.5%), primarily on the back of lower oil and commodity prices, the trade balance was JPY 321 billion in the red, for the 3rd month running, in December.



JAPAN

<i>% change at annual rate, 2000 prices</i>	2006	2007	2008(f)	2009(f)	2008 Q3	2008 Q4(f)	2009 Q1(f)	2009 Q2(f)
Private consumption	1.5	0.7	0.6	-0.2	1.2	-1.5	-0.2	0.3
Public spending	-0.9	0.3	-0.5	1.6	-0.8	5.0	4.0	2.3
Expenditure on construction	0.6	-9.1	-8.8	0.5	-7.8	-11.0	-8.0	-5.0
Expenditure on capital goods	2.4	5.5	-2.5	-6.4	16.5	-2.0	-2.0	-1.0
<i>Contrib. of inventories to GDP growth</i>	0.1	0.3	-0.3	-0.5	-1.0	-0.3	-1.6	-0.2
Domestic demand (incl. inventories)	1.2	1.3	-0.7	-1.3	-1.5	-2.1	-2.3	-0.4
Exports of goods and services	9.7	8.4	4.3	-9.2	3.4	-18.0	-16.0	-9.0
Imports of goods and services	4.2	1.5	0.5	-2.1	9.6	-2.0	-7.8	-4.0
External trade contribution	0.9	1.1	0.6	-1.3	-0.5	-2.9	-1.8	-1.0
Gross Domestic Product (GDP)	2.0	2.4	0.0	-2.5	-1.8	-4.9	-3.9	-1.3
<i>% change year-on-year</i>	2.1	2.0	-2.1	-0.9	-0.3	-2.1	-3.6	-3.0
Consumer prices (CPI)	0.2	0.1	1.4	-1.0				
<i>% change year-on-year, end of period</i>	0.3	0.7	0.4	0.4				
Unit wage costs	-0.8	-1.8	0.5	-2.4				
Employment	0.4	0.5	-0.4	-1.4				
Unemployment rate	4.1	3.9	4.0	4.8				
Household saving rate	3.3	3.1	3.4	4.0				

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