

BACK TO SUB-POTENTIAL GROWTH

Japan will be affected by both the expected slowdown in the global economy and rising oil and food prices in 2008 and 2009. Consequently, after reaching 2.1% in 2007, Japanese growth is set to grow slightly below potential GDP, estimated at 1.5%. The two growth drivers since 2002, exports and business investment, will slow and consumption will remain slack, based on the assumption of slow wage growth. Barring an unforeseen shock, the BoJ will not be able to resume its gradual process of monetary normalisation until the second quarter of 2009 when, according to our outlook, the economic environment will improve. At the same time, fiscal consolidation will continue at a very slow pace.

An inevitable slowdown in economic activity from the second quarter onwards

While the economy grew at a faster pace than initially forecast in the first quarter (+1% versus Q4 2007), it will tail off considerably from the second quarter onwards. The leading economic index has been below the neutral mark since last August (27.3 in April) suggesting that the economy is poised for a slowdown. Growth will be slightly below 1.5% in 2008 and 2009 versus +2.1% in 2007. Furthermore, the risks are clearly to the downside given the uncertainties besetting the international environment (possible recession in the United States, slowdown in the economies of emerging Asia, the chance of further increases in commodity prices and another, possibly sharp rise in the yen).

Exports to the United States, Japan's second biggest trading partner, have decreased substantially since the beginning of 2007, the worst affected sectors being automobiles and electrical and electronic equipment. This adverse trend is set to continue over the next few quarters, despite the temporary impact of the economic recovery plan in boosting US household consumption in the second and third quarters. Moreover, the appreciation of the yen against the dollar, which began last summer, is putting pressure on Japanese firms export margins.

Nevertheless, the Japanese economy continues to benefit from buoyant demand from Asian countries (half of all Japanese exports go to the region) particularly China, with exports to the country rising in value terms 12.2% yoy in May. Exports are being redirected from the United States to the European Union, encouraged by the strength of the euro, and strong sales to the Middle East are also being recorded. All in all, export growth will slacken in 2008 and 2009 (less than 7% in volume terms) while remaining relatively robust.

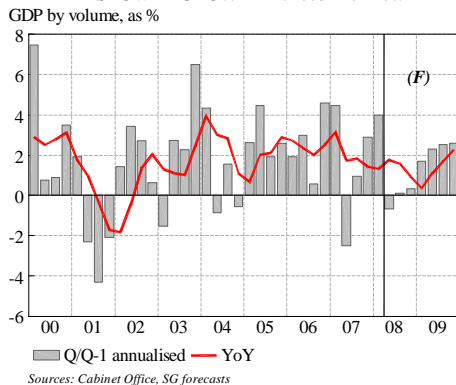
The trade surplus and therefore the current account will decrease, continuing the trend that began in October 2007, as a result of the sharp rise in the price of basic materials, while remaining substantially in surplus at 4% of GDP in 2008-2009.

However, this projection is subject to a major risk, namely a severe dwindling of demand from Asian countries due to the combination of: i) lower export revenues from industrialised countries; ii) falling consumer purchasing power following rising food and, to a lesser extent, oil prices; iii) the tightening of monetary policy and rising exchange rates aimed at counteracting inflationary pressures.

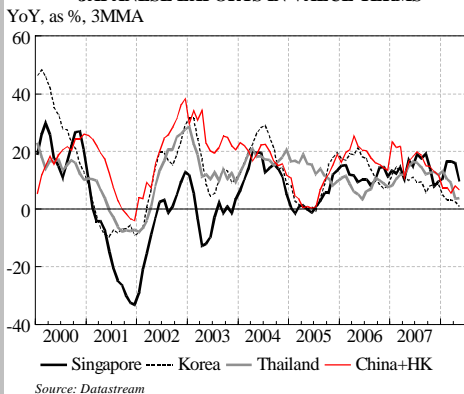
Domestic demand is slowing

- Corporate profits have been shrinking from a high base since late 2007 and recorded their biggest drop since 2001 in the first quarter of this year (-17.5% yoy). This erosion of profits is set to continue (13.9% drop in H1 of FY 2008 according to the MoF's Business Outlook Survey; -4.4% for FY 2008 according to the June Tankan survey) owing to the slowdown in exports and worsening terms of trade, which will stifle investment (shrinking margins on sales to the dollar zone and the rising cost of basic materials, which is only partly passed on). Wholesale prices experienced their biggest rise in 27 years in May (+4.7% on the previous year). The Tankan also shows that the business confidence slumped to a four-year low at Q2. Demand for business loans¹ is falling even though access to financing remains good. Industrial activity is slowing. Companies foresee a 10.3% decline in machinery orders* in Q2 and a 1.4% drop in capital expenditure for FY 2008. Overall, business investment is set to rise by a mere 1% per annum in 2008 and 2009.

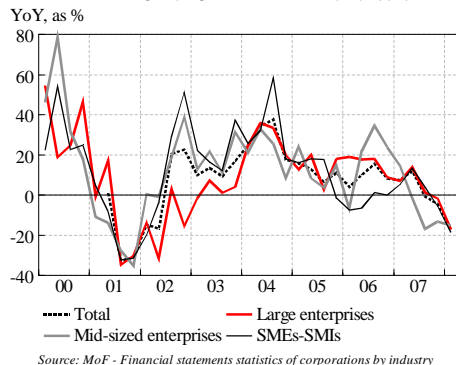
A SLOWER GROWTH IN 2008 AND 2009



JAPANESE EXPORTS IN VALUE TERMS



FALLING PROFITS, A RETURN TO THE PATTERN IN 2001?



¹ According to the Senior Loan Officer Survey of commercial banks conducted by the BoJ.

* Excluding volatile components.

- Household consumption will remain weak due to ongoing losses in purchasing power as a result of rising food and oil prices and the softening job market since August 2007. Consumer confidence is at low ebb. The unemployment rate is expected to stabilise at 3.9% in 2008 as the Japanese workforce continues to shrink. Wages are unlikely to increase significantly², given the pressures on company profits. The upshot is that consumption is set to rise by around 1% per annum during the two years under review.

- Housing investment will continue its recovery after declining as a result of the revision of the law of June 2007 tightening earthquake-proof building standards. Building starts rose 20% between July 2007 and April 2008. Residential land prices are likely to rise slightly having been virtually flat in 2007.

Interest rates will remain on hold in 2008 despite rising inflation

Inflation remained low in 2007 at +0.1%, after +0.2% in 2006, but has accelerated sharply since October (+1% in the first quarter). Energy accounts for two-thirds of this increase and food the other third. Assuming that the price of a barrel of Dubai crude levels off at around USD 105 in 2009 and that food prices are unlikely to drop significantly, consumer price inflation will increase to around 0.8% in 2008 and then go back down again to 0.6% in 2009 as a yearly average. However, inflation excluding fresh food and energy is virtually flat (-0.1% in May) and should rise very slowly.

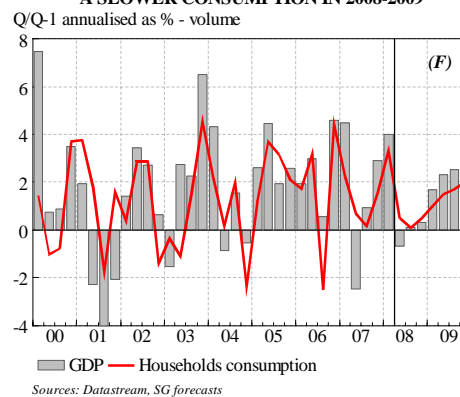
Therefore, the pick-up in inflation and increased inflationary expectations of consumers are unlikely to push the BoJ, which has abandoned its hawkish bias, to pick up where it left off from in February 2007 the process of "normalising" monetary policy. Barring an unexpected shock, it will gradually raise its key rate from 2009 onwards. An initial hike of 25 bp is expected in Q2 2009 at the earliest, if the goal of sustainable growth subject to medium-to-long term price stability is met (i.e. inflation between 0% and 2%). In the long run, the aim is to raise Japanese interest rates to a level in line with those of developed countries and prevent a new financial bubble from forming.

On the road to slow fiscal consolidation

While significant progress has been made, with Japan decreasing its public deficit from 8% of GDP in 2003 to around 3% in 2007³ (not including one-off measures) through a significant reduction in public spending and a favourable economic environment, gross public debt is growing steadily. The current political context makes it difficult for both Houses of Parliament to adopt reforms, particularly in the run-up to the Lower House elections, which should take place in September 2009. Against a backdrop of slowing growth, the rapid ageing of the population⁴ which is placing considerable pressure on social welfare spending and rising interest expenses (a trend that started in 2006 when the zero rate policy was abandoned and that is set to intensify when the process of raising interest rates resumes), further significant progress will prove difficult over the next few years. The public deficit is only expected to decrease very slowly in 2008-2009, whereas the gross debt looks set to peak at 171% of GDP. The target of a primary budget surplus for central and local governments by fiscal year 2011, as the first step in reducing the debt, appears more or less out of reach in the absence of new corrective measures⁵.

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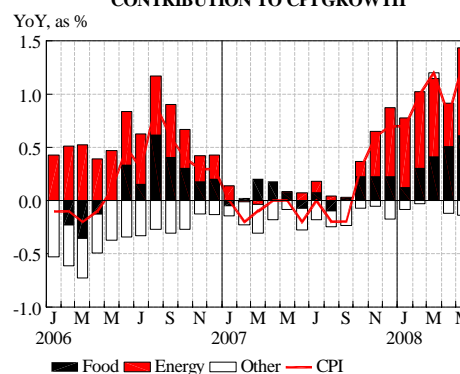
A SLOWER CONSUMPTION IN 2008-2009



Sources: Datastream, SG forecasts

² Wages rose slightly in Q1 2008, mainly because of the increase in full-time employment and levelling off of the number of baby boomers retiring. More substantial wage growth is possible in the long run if the structural factors behind the downward pressures disappear.

CONTRIBUTION TO CPI GROWTH



Sources: Statistics Bureau, OECD

³ The OECD substantially lowered the public deficit in 2006 because of other revenues published by the government (capital transfers). As a result, the 2007 deficit has been revised, since it ended up benefiting from more revenues and less expenditure than forecast.

⁴ The ageing of the population will weigh on growth in the medium-to-long term without the offsetting impact of labour productivity gains, notably via an improvement in service sector productivity, which has slowed significantly in recent years.

⁵ In order to speed up the pace of fiscal consolidation, the OECD recommends, firstly, increasing the consumption tax rate (currently 5% - the lowest rate among industrialised countries), simplifying local tax systems and broadening the direct tax base, and secondly, scaling back public investment and remuneration. Only one-third of businesses pay company tax and more than half of employees are not subject to tax.

As %	2005	2006	2007	2008(f)	2009(f)
Real GDP	1.9	2.4	2.1	1.4	1.4
Consumer prices (CPI)	-0.3	0.2	0.1	0.8	0.6
Unemployment rate	4.4	4.1	3.9	3.9	3.8
Current account (% GDP)	3.7	3.9	4.8	3.9	4.0
Public balance* (% GDP)	-5.7	-3.5	-3.0	-2.8	-2.7
* Excluding one-off measures					
	03/07/08	Sep. 08	Dec. 08	Jun. 09	Dec. 09
3-month interbank rate	0,86	0.80	0.80	0.95	0.95
10-year Gov. bond yields	1,66	1.75	1.75	1.85	1.90
USD/JPY	107	105	105	105	110
EUR/JPY	169	166	161	152	154

WORTH WATCHING

The financial markets: trend reversal since April. Inflation concerns in the United States and eurozone have intensified expectations of interest rate rises in these countries. As a result, 10-year Japanese rates, which are correlated to US rates, rebounded to 1.8% in June (versus 1.3% in March). Since monetary policy expectations have remained unchanged in Japan, the dollar reached its highest level against the Japanese currency in over three months at JPY 107 (against JPY 100.6 in March). Likewise, the yen depreciated against the euro and is now at its weakest level of the year. We expect the yen to stabilise at around 105 to the dollar this year, which means that the yen would appreciate to 161 against the euro at the end of the year. A sudden appreciation would penalise Japanese exports to the eurozone.



JAPAN

<i>% Change at annual rate, 2000 prices</i>	2006	2007	2008 (f)	2009(f)	2008 Q1	2008 Q2(f)	2008 Q3(f)	2008 Q4(f)
Private consumption	2.0	1.5	1.3	1.0	3.3	0.5	0.1	0.5
Public spending	-2.0	0.1	-0.3	-0.6	-0.5	-1.0	-2.7	0.4
Expenditure on construction	0.9	-9.3	-7.2	1.8	0.7	-3.0	3.0	5.0
Expenditure on capital goods	4.3	1.9	0.9	1.0	19.5	5.0	3.0	-5.0
<i>Contrib. of inventories to GDP growth</i>	<i>0.1</i>	<i>0.1</i>	<i>-0.1</i>	<i>-0.2</i>	<i>-0.3</i>	<i>0.2</i>	<i>0.5</i>	<i>-1.0</i>
Domestic demand (incl. inventories)	1.6	1.0	0.6	0.5	2.1	-0.1	0.6	0.0
Exports of goods and services	9.7	8.6	6.9	6.4	17.1	-4.0	-2.0	3.0
Imports of goods and services	4.2	1.8	2.3	1.2	5.6	-1.0	1.0	1.5
External trade contribution	0.9	1.1	0.8	0.9	2.0	-0.6	-0.4	0.3
Gross Domestic Product (GDP)	2.4	2.1	1.4	1.4	4.0	-0.7	0.1	0.3
<i>% change year-on-year</i>	<i>2.5</i>	<i>1.4</i>	<i>0.9</i>	<i>2.3</i>	<i>1.3</i>	<i>1.8</i>	<i>1.6</i>	<i>0.9</i>
Consumer prices (CPI)	0.1	0.0	0.6	0.5				
<i>% change year-on-year, end of period</i>	<i>0.1</i>	<i>0.8</i>	<i>0.1</i>	<i>0.6</i>				
Unit wage costs	-0.8	-1.8	-0.9	-0.5				
Employment	0.4	0.5	-0.2	-0.1				
Unemployment rate	4.1	3.9	3.9	3.8				
Growth saving rate	3.3	3.1	3.0	3.0				

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