Morgan Stanley

MORGAN STANLEY RESEARCH

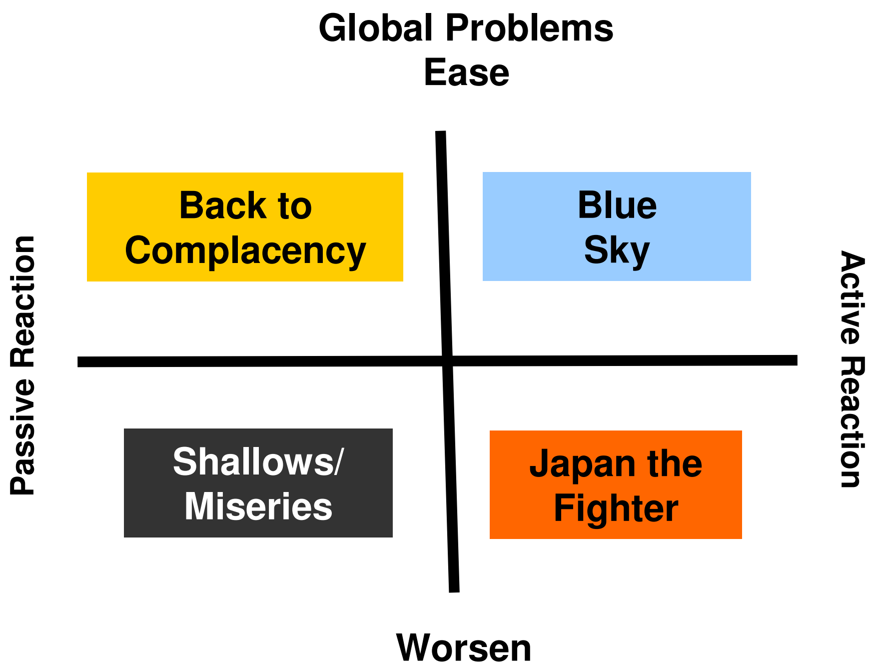
September 2008

Japan Economics

A Tide in the Affairs of Japan

Morgan Stanley Japan Securities Co., Ltd
Robert Alan Feldman, Ph.D
Head of Japan Economic Research
Robert.Tokyo.Feldman@morganstanley.com
+81-3-5424-5385

Japan Economics



Source: Morgan Stanley Research

There is a tide in the affairs of men
Which, taken at the flood, leads on to fortune.
Omitted, all the voyage of their life
Is bound in shallows and miseries.
On such a full sea are we now afloat
And we must take the current as it comes,
Or lose our ventures.

Julius Caesar IV, iii

September 2008

Printing: 9/10/2008

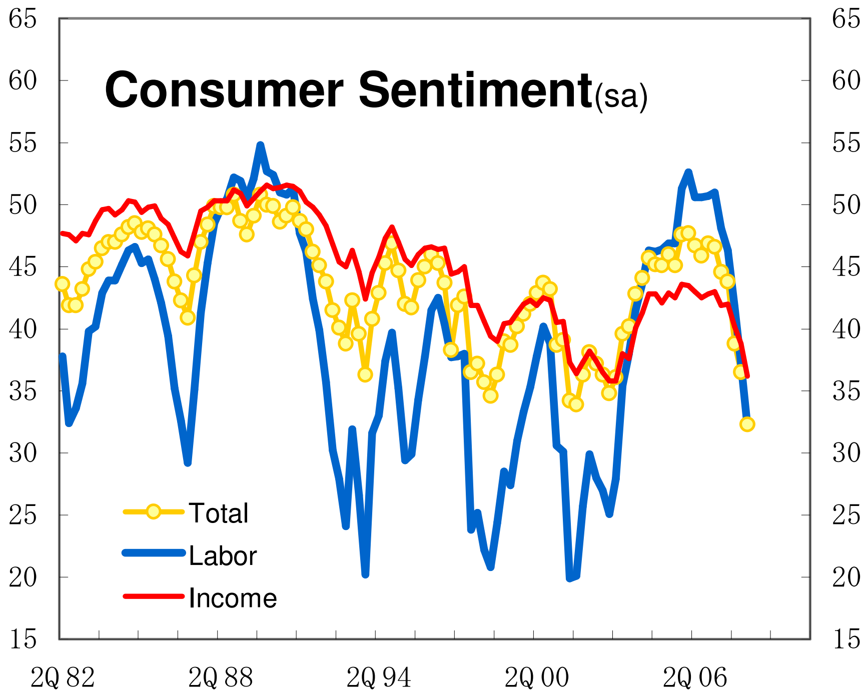
Morgan Stanley's Economic Outlook (1)

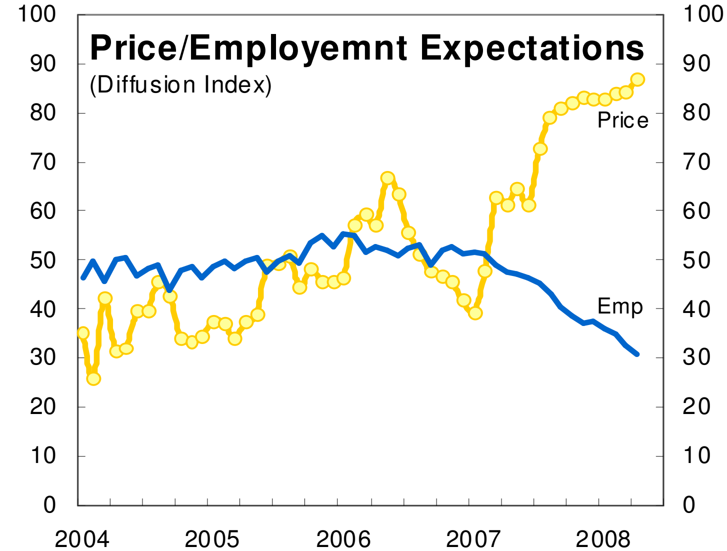
Economic Forecast

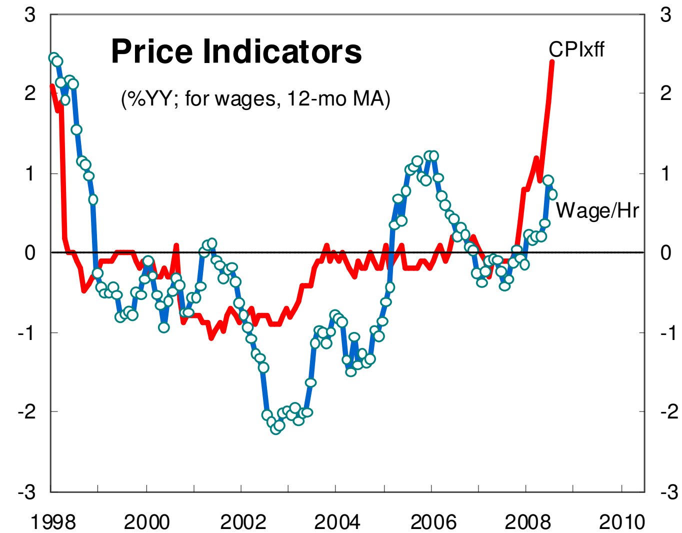
	Calendar Year				Fiscal Year			
	2006	2007	2008e	2009e	F3/07	F3/08	F3/09e	F3/10e
GDP Growth	2.4	2.1	1.0	0.2	2.5	1.6	0.6	0.6
Domestic Demand	1.6	1.0	0.1	0.2	1.8	0.4	0.0	0.5
Fgn Demand (Contr.)	0.9	1.1	0.9	0.1	0.8	1.2	0.5	0.2
Private Demand	2.7	1.2	0.3	0.3	2.8	0.4	0.3	0.7
Private Consumption	2.0	1.5	0.8	0.0	1.8	1.4	0.3	0.4
Residential Investment	0.9	-9.5	-7.3	2.5	0.2	-13.3	-2.2	1.4
Business Investment	4.3	2.1	0.7	1.6	5.6	-0.1	1.3	2.1
Inventories (Contr.)	0.2	0.1	-0.1	-0.1	0.2	0.0	-0.1	-0.1
Public Demand	-1.9	0.1	-0.6	-0.5	-1.8	0.3	-0.9	-0.3
Gov't Consumption	-0.4	0.7	0.4	0.7	0.1	0.7	0.4	0.7
Public Investment	-8.1	-2.5	-5.3	-6.0	-9.1	-1.8	-7.2	-5.1
Exports	9.7	8.6	6.1	2.7	8.4	9.5	3.3	4.2
Imports	4.2	1.8	0.5	3.6	3.1	2.1	-0.1	4.6
GDP Deflator	-1.0	-0.8	-0.9	0.9	-0.8	-1.0	-0.4	0.9
CPI (Core)	0.1	0.0	1.9	2.3	0.1	0.3	2.3	2.0
Nominal GDP	1.4	1.3	0.0	1.1	1.7	0.6	0.2	1.5
C/A as % of GDP	3.9	4.8	2.8	2.4	4.1	4.8	2.2	2.4
¥/US$	116	118	103	104	117	114	101	107
Crude Oil Prices (WTI)	66.2	72.2	119.4	130.5	64.9	82.1	127.7	130.0
Industrial Production	4.5	2.8	-0.8	-1.3	4.6	2.6	-2.6	1.2
Global Growth	5.1	5.0	4.0	3.6	--	--	--	--

Note: e=Morgan Stanley Research forecast, as of August 13, 2008. Global growth and ¥/US$ assumptions are based on forecasts by our global economics team and FX strategy team, respectively. Crude oil price (WTI) outlook is an assumption, based on the preceding three-month average of the forward contracts of WTI as of July 30, 2008.
Source: Cabinet Office, METI, MIC, BoJ, Morgan Stanley Research

Consumption and Labor：Weakness Worsens





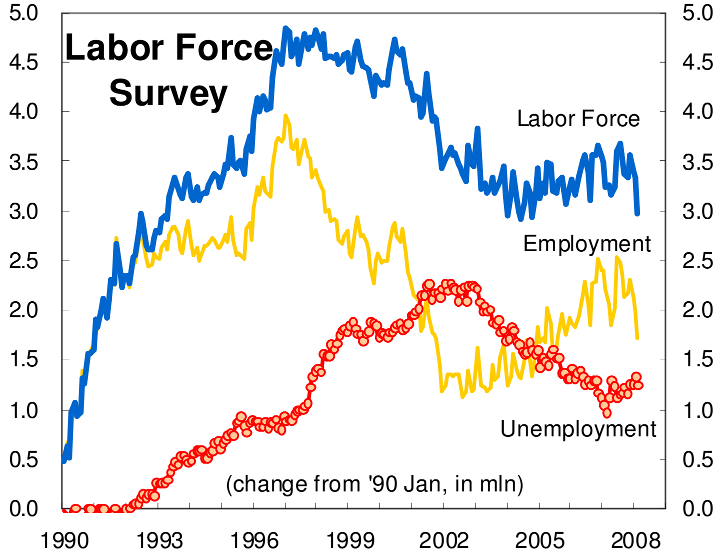


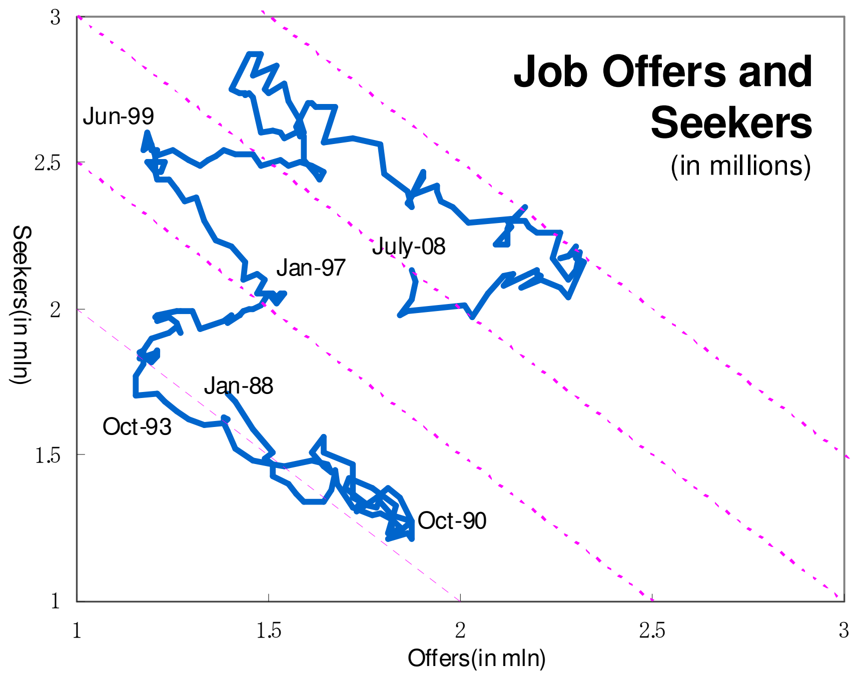
- Price expectations are up, but employment expectations are down. Nominal consumption has held up, while consumer sentiment is down, even while real wages are worsening.
- Consumption is likely to weaken sharply.

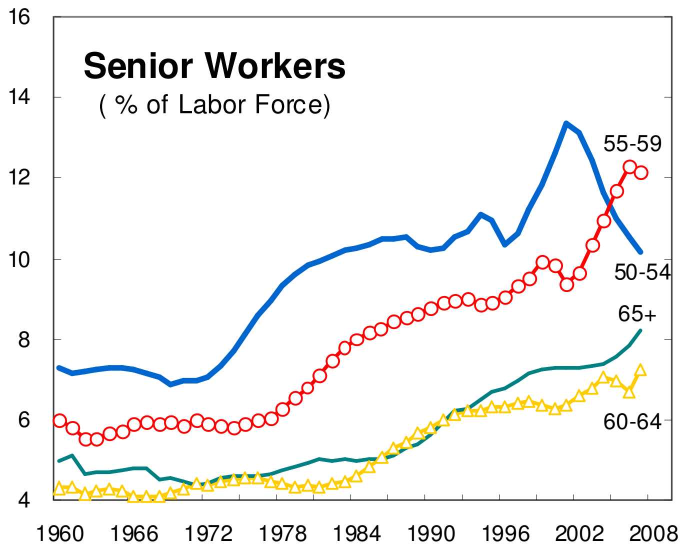
Update: August 29, 2008 Sources: Cabinet Office, MIC and MHLW

Robert Alan Feldman, (813) 5424-5385, robert.tokyo.feldman@morganstanley.com

Labor Markets Worsens as Aging Progresses







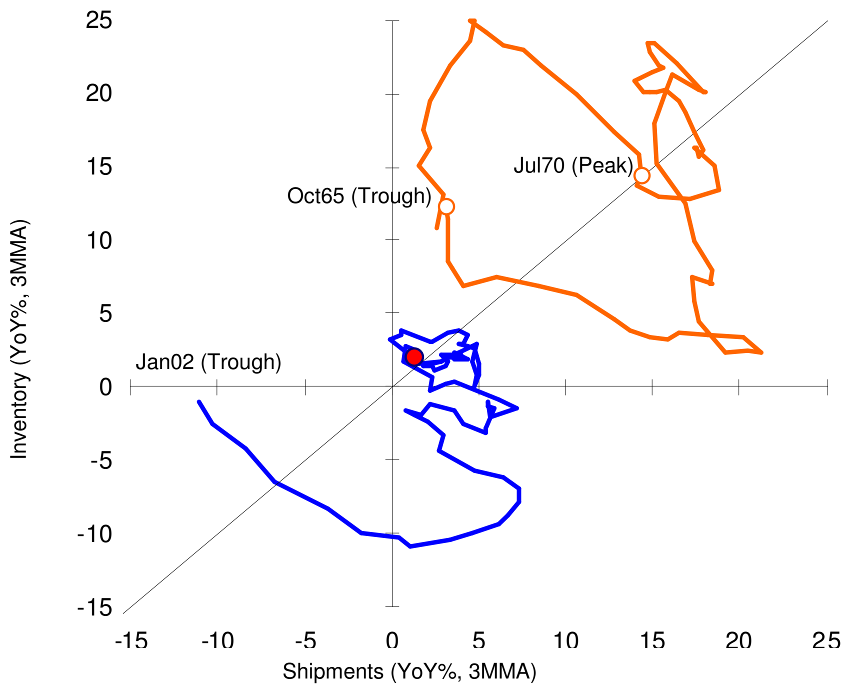
- Employment growth has stalled, while unemployment is starting to rise, and labor force growth stagnating. Moreover, both offers and seekers are down, and the work force ages.
- Wages and compensation are not likely to grow.

Update: August 29, 2008

Sources: Cabinet Office and MHLW

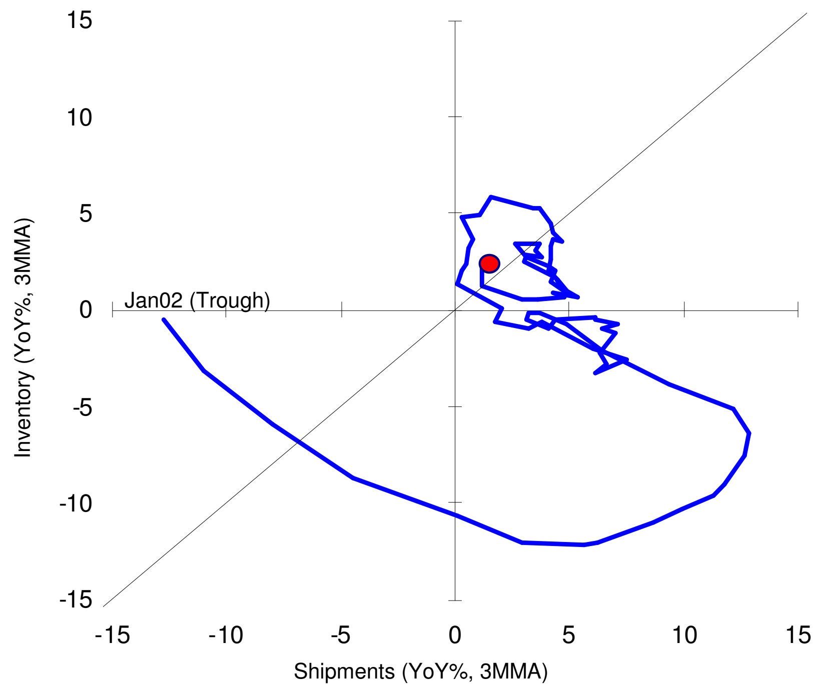
Inventory Cycles (Comparison with Izanagi / Production Goods)

Inventory Cycles (Current vs. *Izanagi* Boom)



Note: The red point indicates the most recent data. For details of inventory cycles, see " The Inventory Cycle Is (Nearly) Dead" by Robert A. Feldman (March 20, 2006).
Source: METI, Morgan Stanley Research

Production Goods



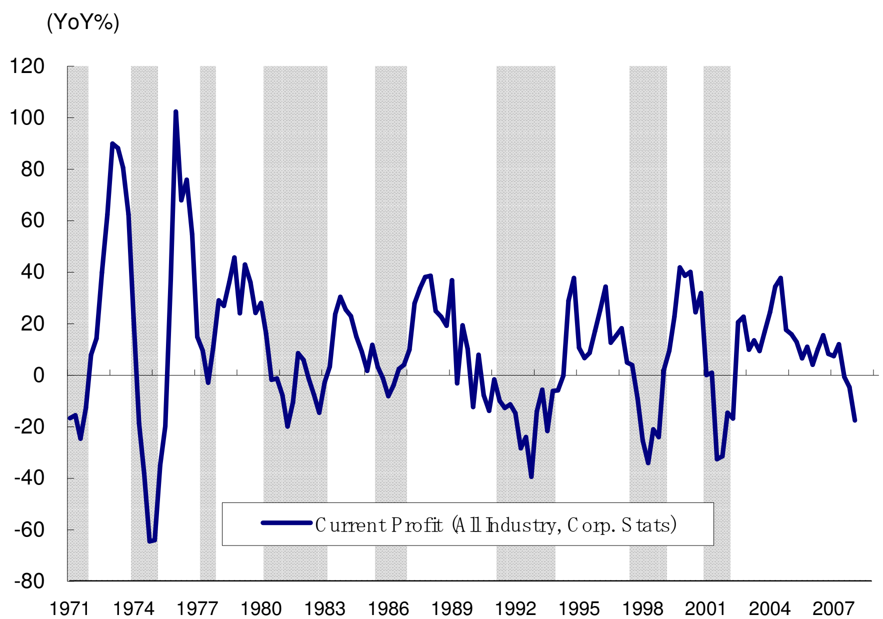
Note: The red point indicates the most recent data.
Source: METI, Morgan Stanley Research

- The production cycle becomes smaller than before, and we don't see a massive inventory build-up.

- The inventory cycle of production goods has recently worsened. Shipment of production goods is a coincident indicator of the business cycle.

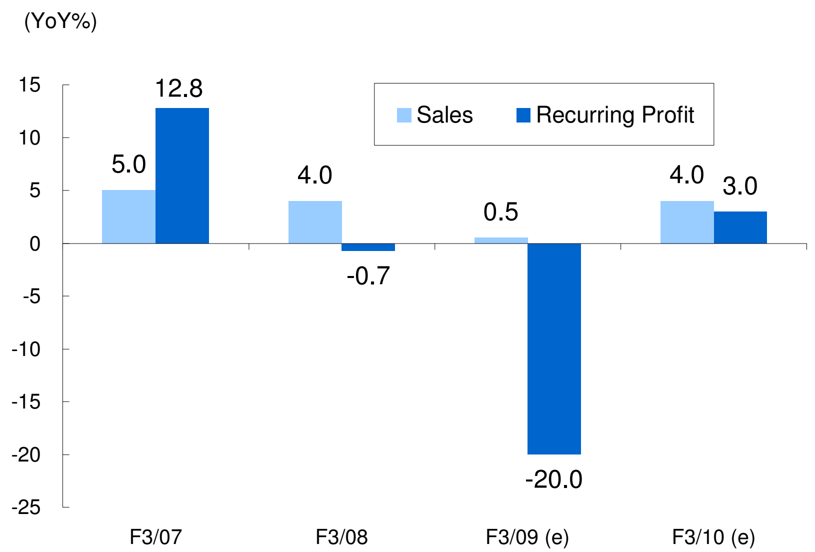
F3/09 Earnings May Sink Deeply

Recurring Profits (All Industries) and Past Recessions



Source: MoF's Corp. Stats, Cabinet Office, Morgan Stanley Research

Outlook of Corporate Profits and Sales

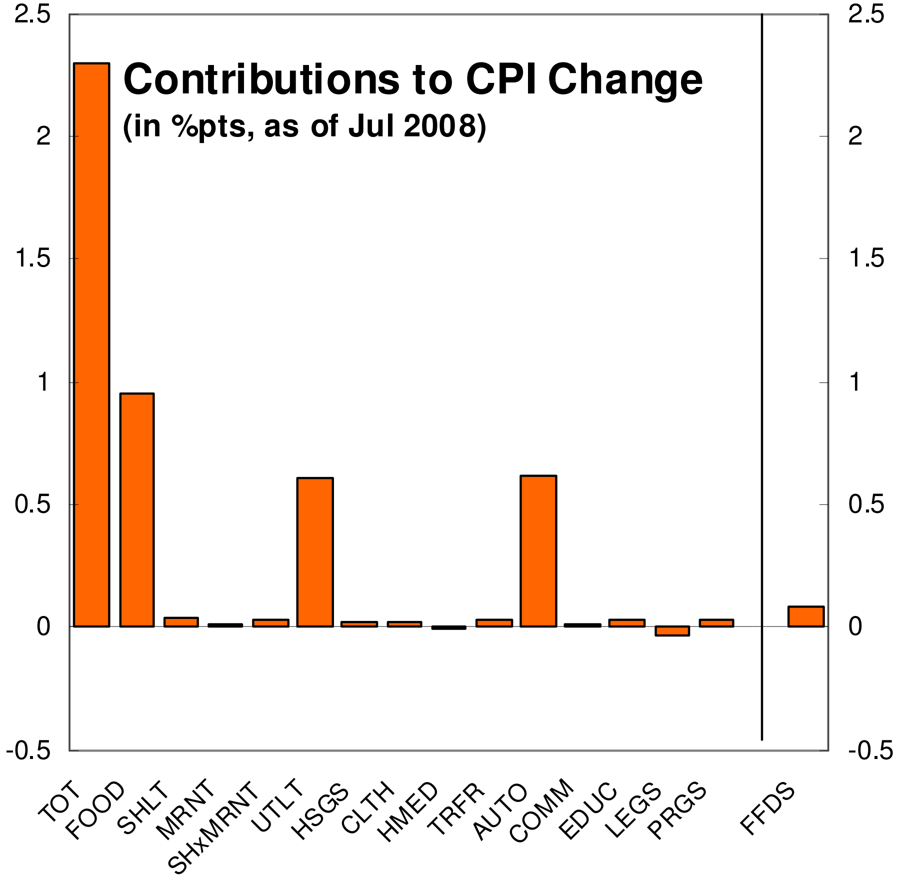


Note: Companies with JPY1 billion in capital excluding financials. Based on MoF's Corp. Stats (Last update: July 31, 2008).
Source: Cabinet Office, Morgan Stanley Research

- In the MoF's Corp Stats, recurring profits (all industries) fell YoY for the third consecutive quarter in Jan-Mar. Historically, Japan's economy has always fallen into a recession when recurring profits fell YoY for two straight quarters.

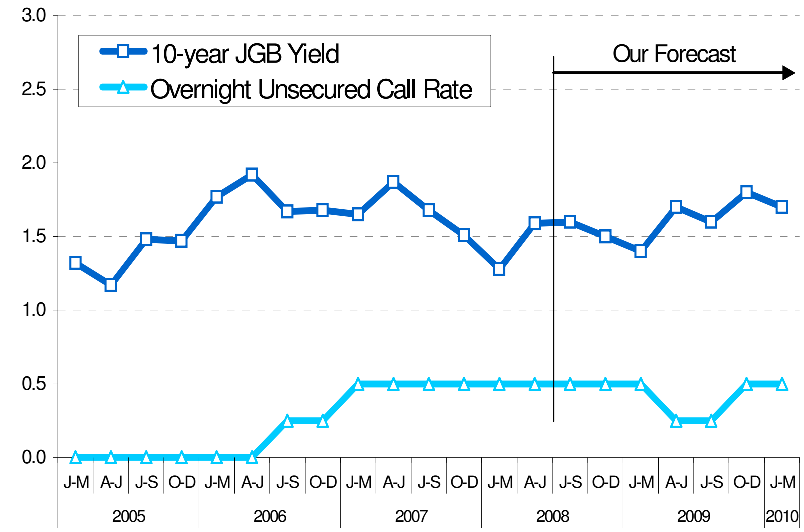
- The sharp rise in input costs with an inability to pass on these added costs by raising prices in a timely manner squeezes margins. Sluggish growth in sales also worsens earnings.

Monetary Policy: CPI Forecast and Interest Rates Outlook



Source: Morgan Stanley Research

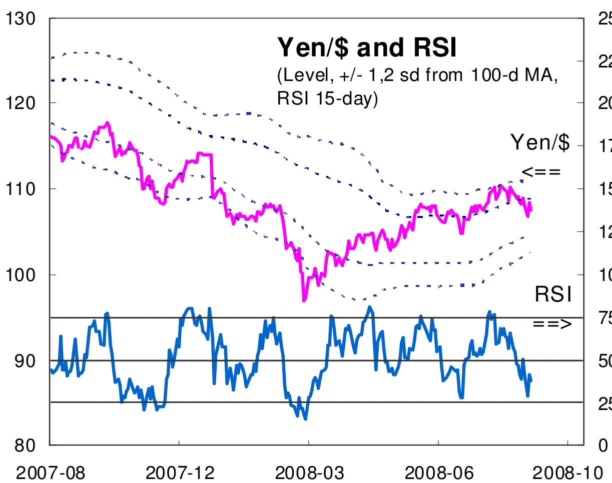
Our Interest Rate Outlook

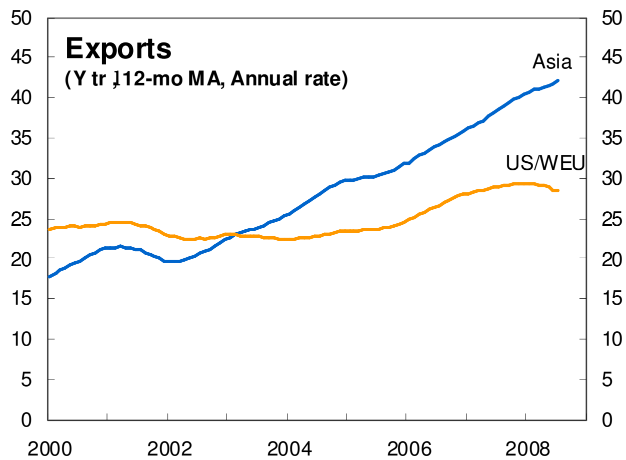


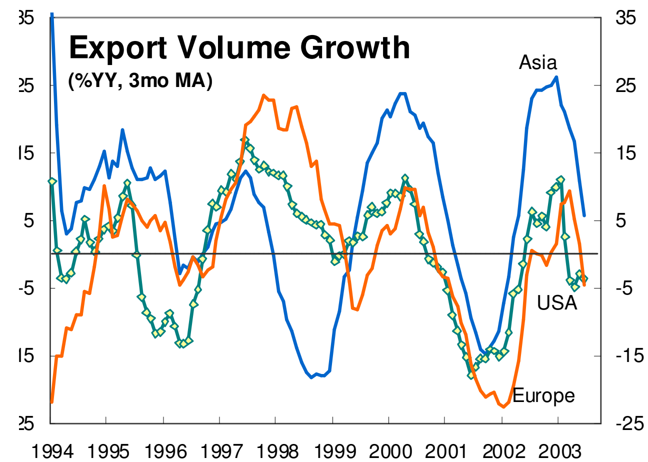
Source: BoJ, Morgan Stanley Research (Last update: July 31, 2008)

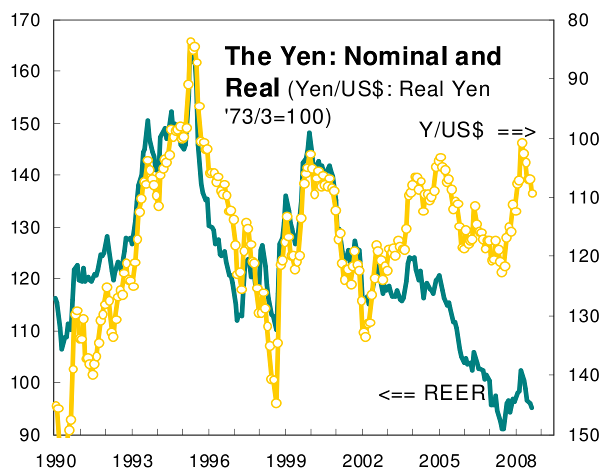
- The BoJ retreated from its normalization strategy in its April Outlook Report noting that fog had yet to clear, yet now that fog may thicken. Even with price upside, we think rate hikes will be on hold this year and through the 1H of 2009; if the recession deepens, a rate cut cannot be ruled out either.

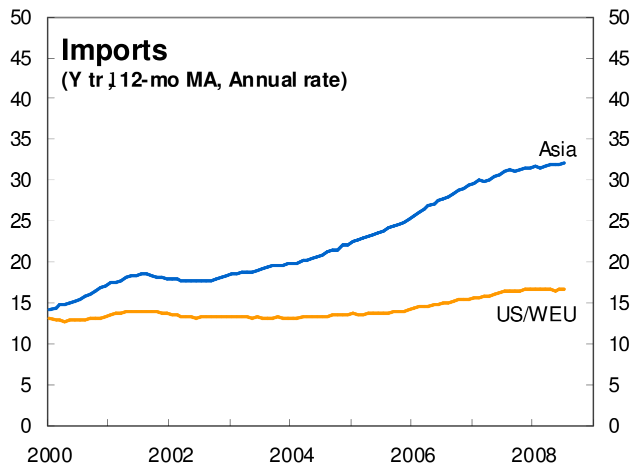
Trade and the Yen

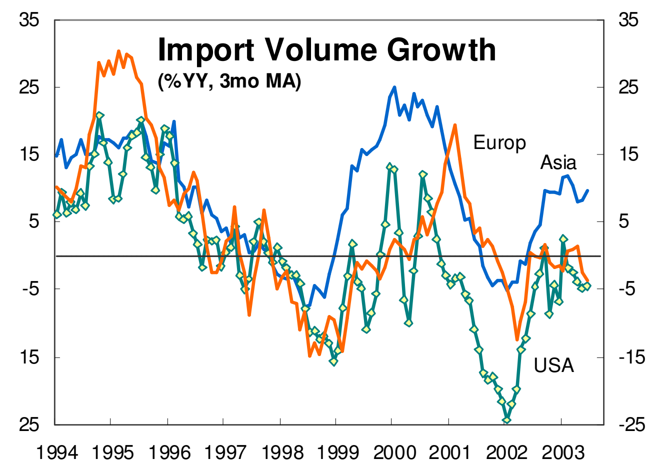












Update: September 10, 2008 Sources: MOF, FAME and Morgan Stanley research

US Forecast, at a Glance

Real GDP and Related Items, 2007A-2009E   *Forecast Date: August 8, 2008*

	Year over Year			4th Qtr/4th Qtr Percent Change		
	2007A	2008E	2009E	2007A	2008E	2009E
Real GDP	2.0	1.4	0.6	2.3	0.4	1.8
Final Sales+	2.4	1.7	0.4	2.5	0.7	1.3
Personal Consumption Expenditures	2.8	0.9	0.8	2.2	0.3	1.8
Business Fixed Investment	4.9	2.8	-0.9	6.4	-0.3	1.5
-- Structures	12.7	8.8	-1.3	14.5	2.3	1.0
-- Equipment	1.7	-0.1	-0.6	2.8	-1.6	1.8
Residential Investment	-17.9	-21.0	-7.9	-19.0	-19.7	4.1
Exports	8.4	7.9	3.7	8.9	5.7	2.8
Imports	2.2	-1.5	2.3	1.1	-1.3	3.8
Federal Government	1.6	4.2	1.3	2.3	4.1	0.5
State & Local Government	2.3	0.9	0.1	2.4	0.2	0.3

+GDP less inventory change   E = Morgan Stanley Research Estimates, A = Actual

Federal Budget Balance (Unified Budget)

	bil of US$	% of GDP
FY2001	127	1.3
FY2002	-158	-1.5
FY2003	-374	-3.5
FY2004	-413	-3.6
FY2005	-319	-2.6
FY2006	-248	-1.9
FY2007	-162	-1.2
FY2008E	-400	-2.8
FY2009E	-325	-2.2

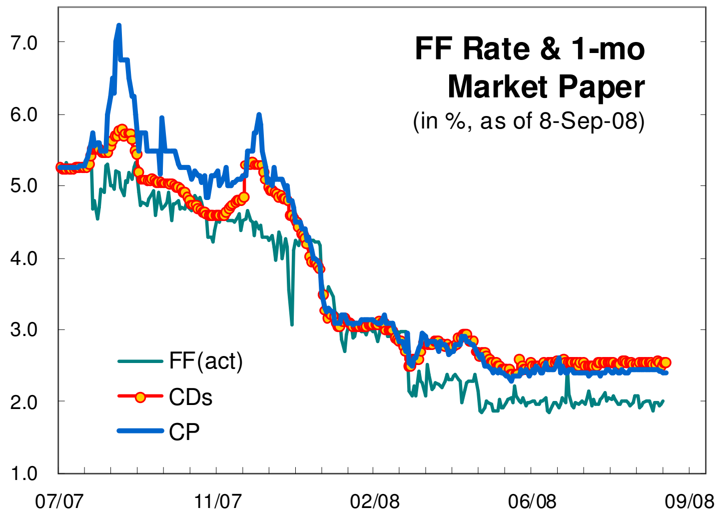
Interest Rate Outlook

	Fed Funds		LIBOR	Treasury Yield Curve					
Date*	Target	Prime	3-Mo.	3-Mo.	6-Mo.	2-Yr.	5-Yr.	10-Yr.	30-Yr.
August 08, 2008	2.00	5.00	2.80	1.66	1.90	2.47	3.21	3.99	4.65
08Q3	2.00	5.00	2.80	1.65	1.90	2.40	3.20	4.00	4.70
08Q4	2.00	5.00	2.85	1.65	1.90	2.35	3.18	4.00	4.75
09Q1	2.00	5.00	2.75	1.70	1.90	2.40	3.25	4.10	4.85
09Q2	2.25	5.25	3.10	2.25	2.40	2.80	3.73	4.65	5.40
09Q3	3.00	6.00	3.75	3.25	3.35	3.75	4.38	5.00	5.40
09Q4	4.00	7.00	4.65	4.10	4.15	4.25	4.75	5.25	5.50

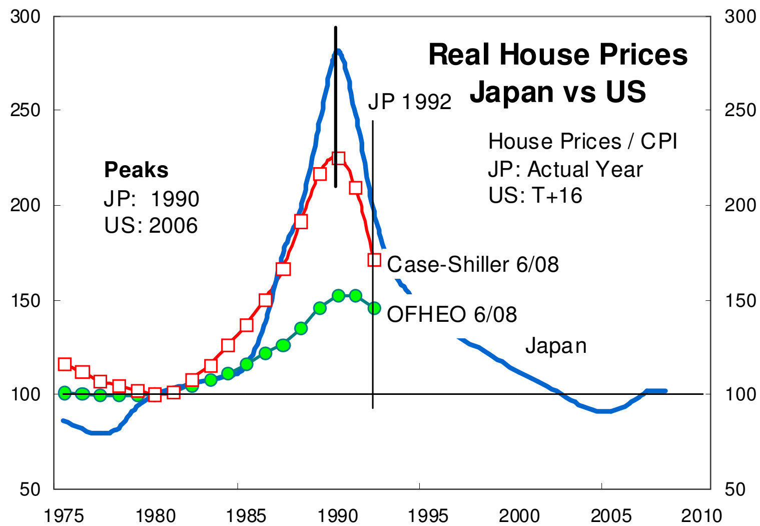
**All forecast values are for the end of the designated period.*

Sources: US Treasury, Morgan Stanley Research   Update: August 8, 2008

US: Sub-Prime, Credit, and Housing



Source: Nikkei NEEDS (*mone42.inp)*



Source: OFHEO, BLS

Main Issues:

1. **Mistakes:**

   Lenders, Borrowers, Regulators

2. **Capitalization of financials**

   Did BIS rules work?
   Are accounting rules adequate?
   Have losses been discounted?

3. **Moral Hazard vs. Market Stability**

   Have FRB/ECB been too easy?
   Too harsh? Too early? Too late?

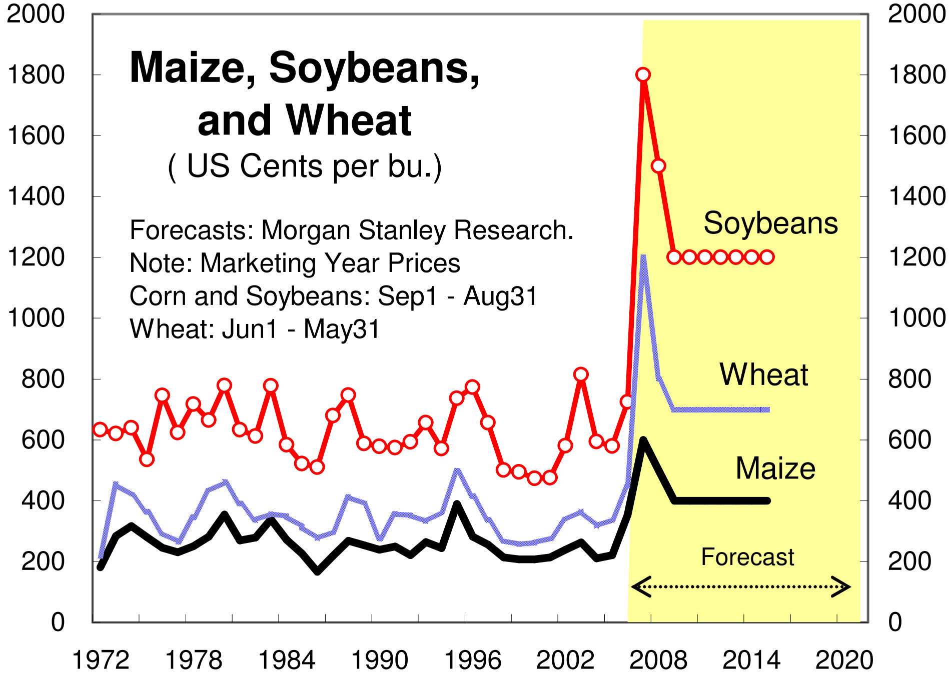
4. **Real economy impacts**

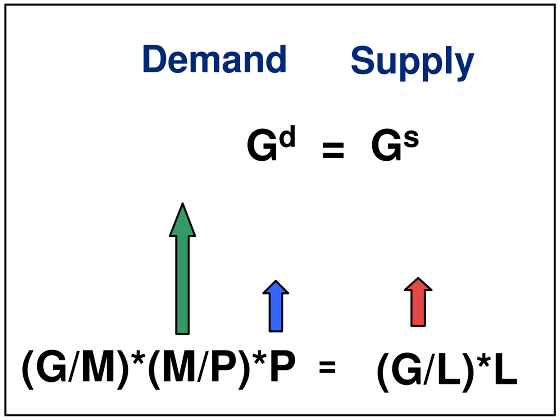
   Housing: How bad, how long?
   Consumer/Business sentiment?
   Recession probability?

5. **Impact on Japan**

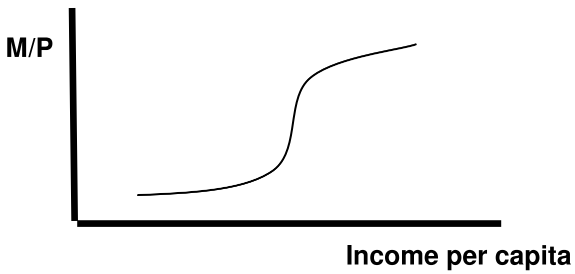
   Exports, global decoupling
   Interest rates and forex

Land to Mouth: How to Profit from the Food Chain in Food





G: Grain
L: Land
P: Population
M: Products derived from grain (e.g. biofuels, meat).



- Grain prices may well drop after recent disturbances, but are unlikely to revert to previous means.
- Supply cannot rise fast enough to meet surging global demand, as per capita income pass the "meat point." So prices should stay high.

Based on: Feldman, Robert Alan and Allidina, Hussein, "Land to Mouth: How to Profit from the Food Chain in Food," Morgan Stanley, January 14, 2008.

Source: CBOT, Morgan Stanley Research forecasts

Buy Chicken !!

(G/M)*(M/P)*P

		2007	2017S	
Total Derived Grain Demand (kg bln)	G	1517	1517	
Grain / kg of meat	G/M	4.2	3.4	-19.14%
Meat / Person	M/P	54.3	59.0	8.78%
People (bln)	P	6.6	7.5	13.64%

	G/M	4.3	3.5
Beef	7.0	33.3%	16.7%
Pork	4.0	33.3%	33.3%
Chicken	2.0	33.3%	50.0%

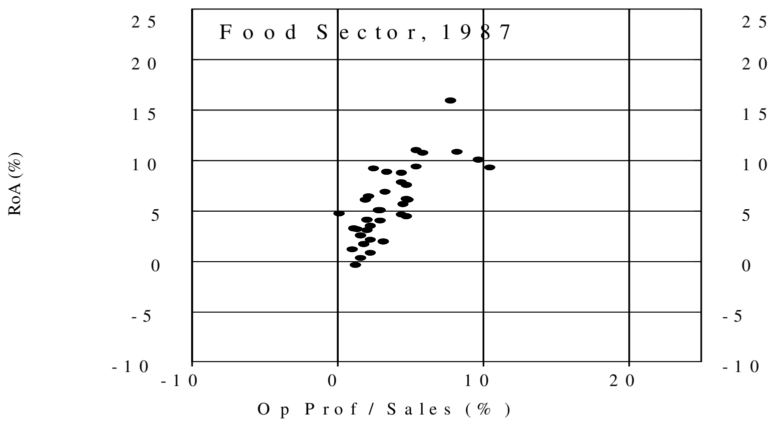
A big rise of the chicken share is needed to bring G/M down !

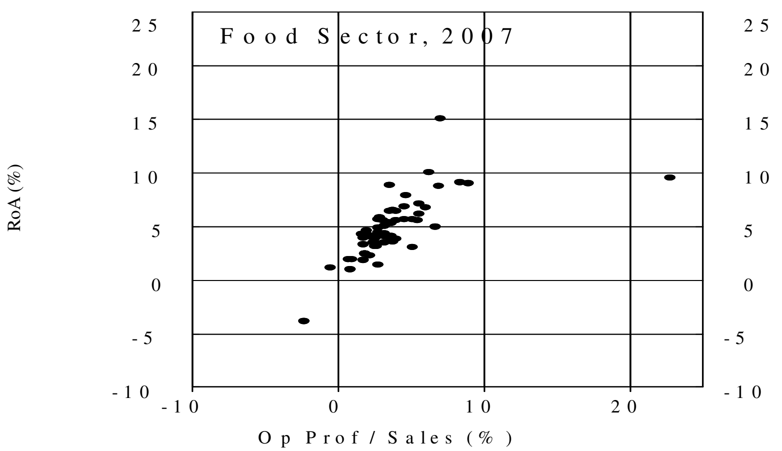
Based on: Feldman, Robert Alan, "Global Economics: Buy Chicken!!," Morgan Stanley, May 21, 2008.

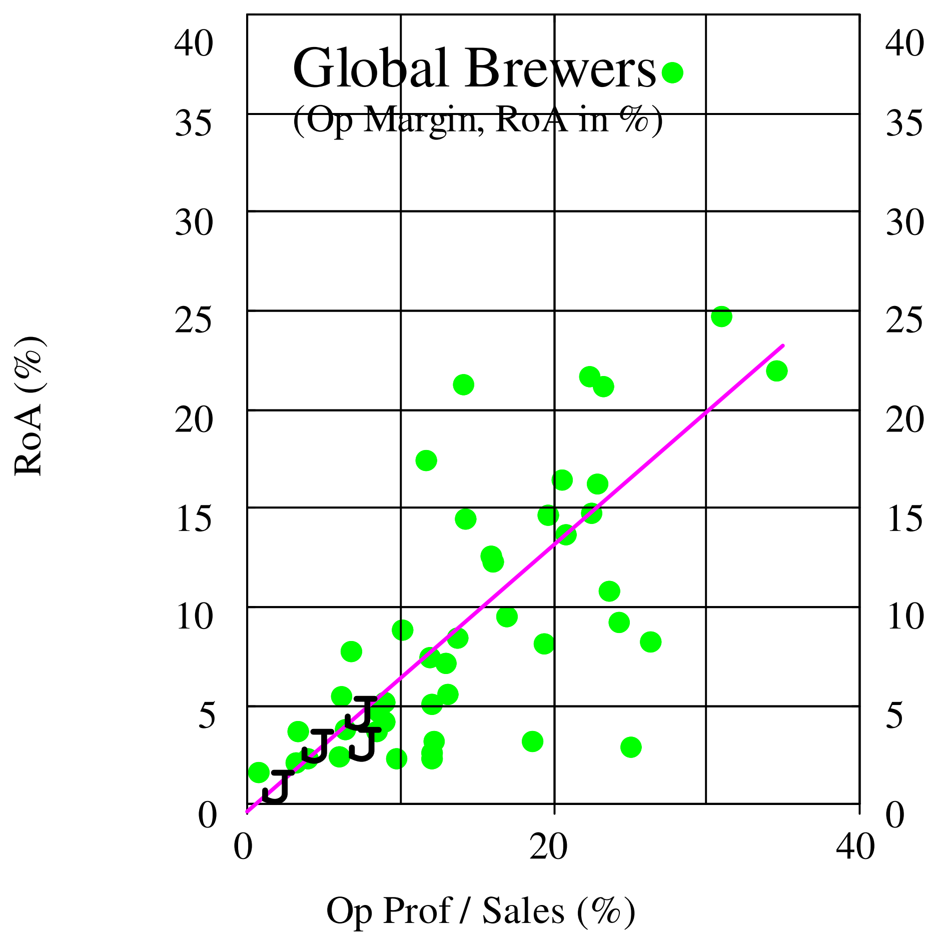
Update: May 21, 2008 Source: Morgan Stanley calculations

Micro Impact of Agro-inflation: Cost Pressure Could Trigger Reorganization

The food sector faces margin squeeze. Industry consolidation is likely to accelerate.





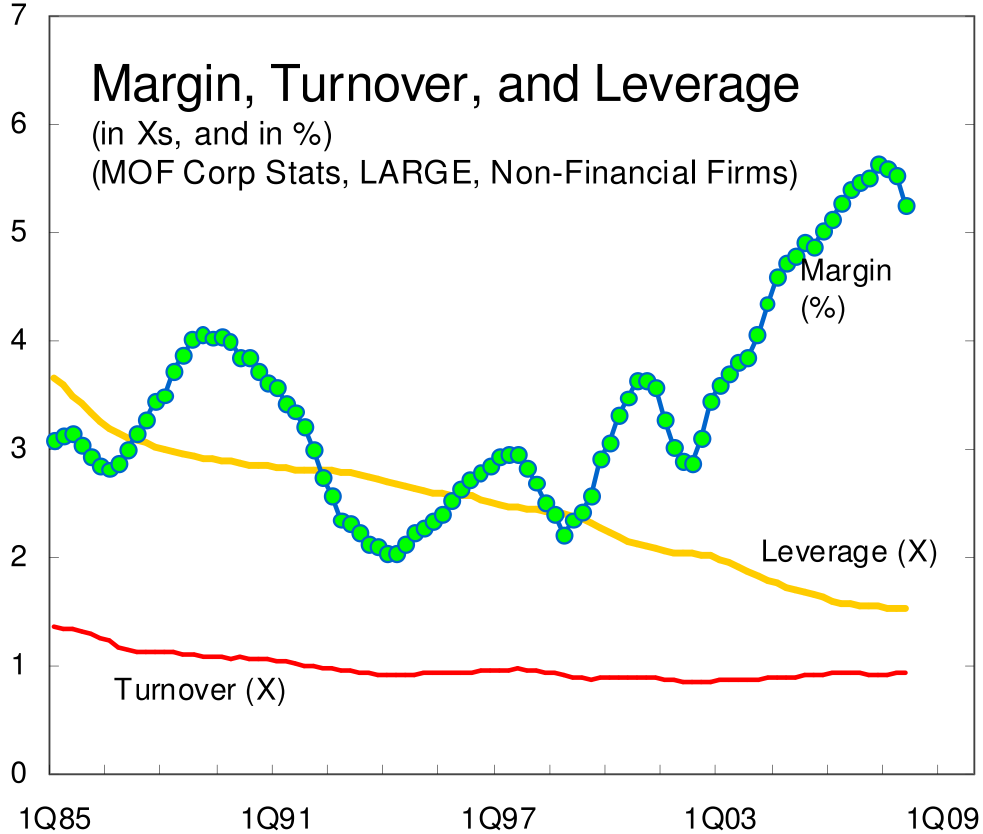


Source: Bloomberg. Function PVSP.

Industrial Reorganization : Raising RoE Is the Next Step

Determinants of ROE (Large Firms)

RoE = Margin * Turnover * (1 + Leverage)



The three determinants of RoE :

(a) Margins are at historical highs, but beginning to fall.

(b) Turnover fell with deflation.

(c) Leverage is at historical lows.

All three factors have upside potential.

Update: June 4, 2008

Source: MOF Corporate Statistics.

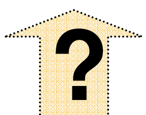
Robert Alan Feldman, (813) 5424-5385, robert.tokyo.feldman@morganstanley.com

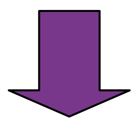
Morgan Stanley

Aging: Japan's Biggest Challenge

Demography, Productivity, and the Standard of Living

$$Y = (Y/L) \times (L)$$
$$Y/P = (Y/L) \times (L/P)$$





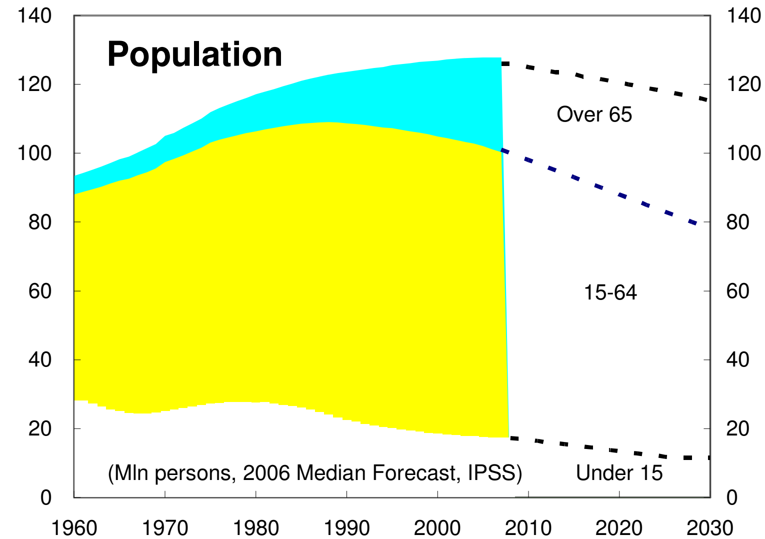
Y: Output
L: Labor
P: Population

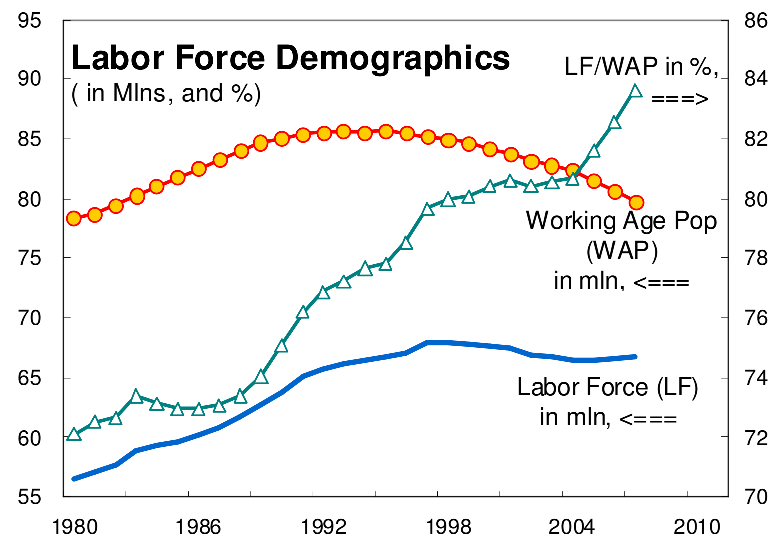
Y/L: Productivity
L/P: Participation
Y/P: Standard of Living

Aging will inevitably lower the labor participation rate.

As L/P drops, maintaining the standard of living (Y/P) will require higher productivity and softening the drop of participation. These needs determine...

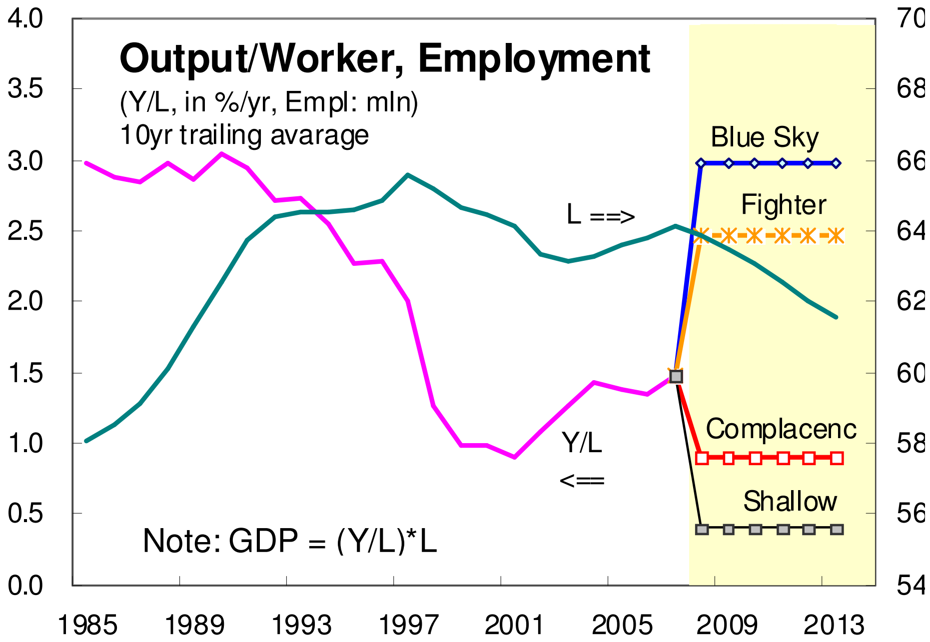
Sources: Institute for Population and Social Security Research, Morgan Stanley Research

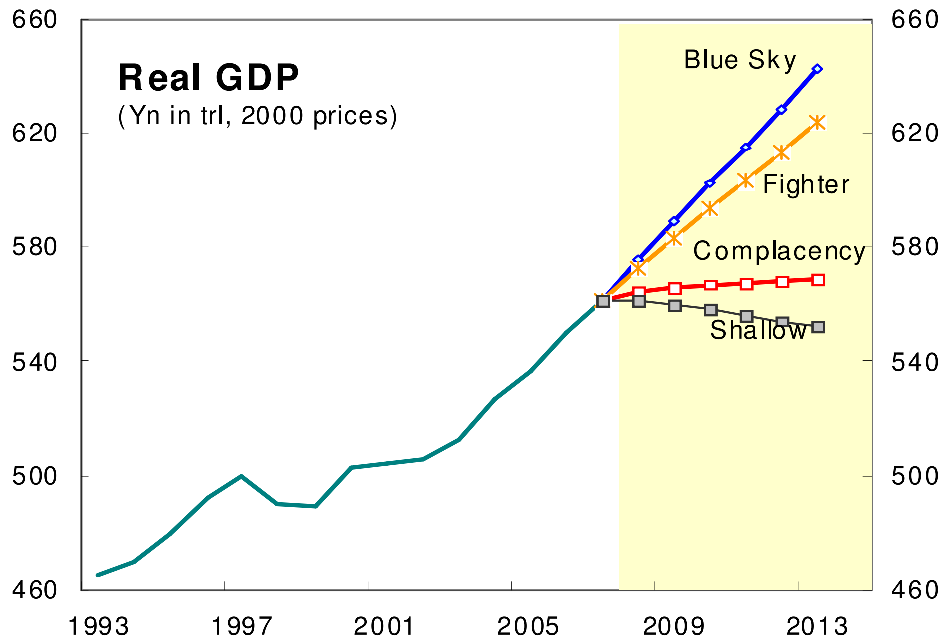




How Different Are the Scenarios? A Lot!

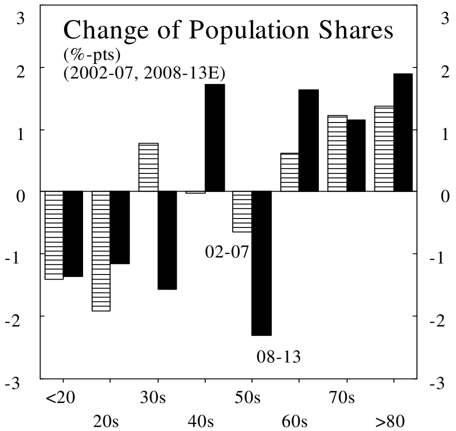
Y% = L% + Y/L %

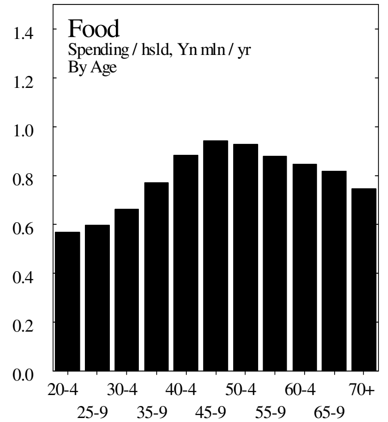


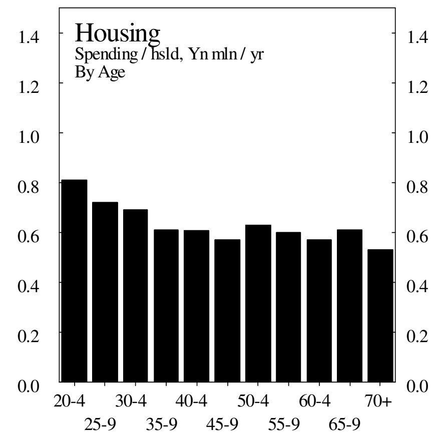


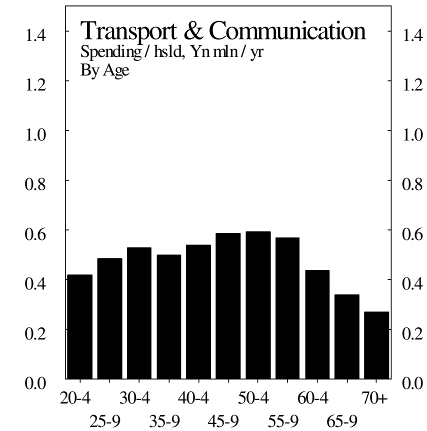
Sources: Cabinet Office and Morgan Stanley Research

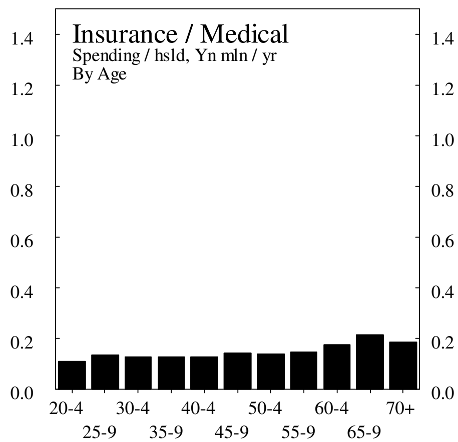
Consumption Profiles and Aging: Aggregate Shares Change Remarkably Little

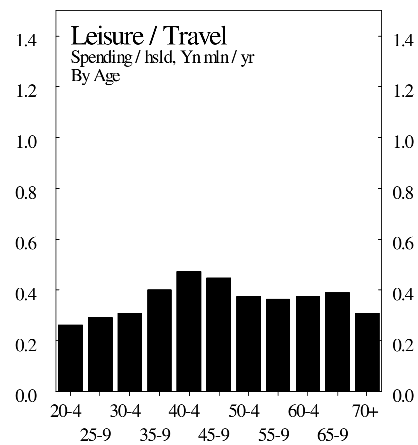


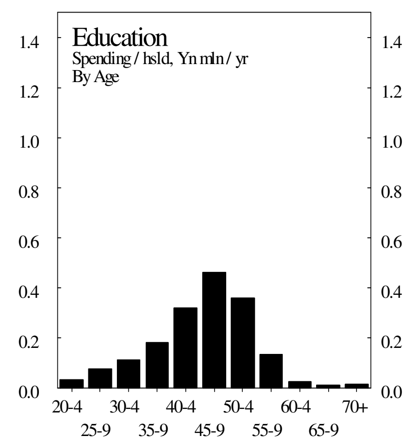










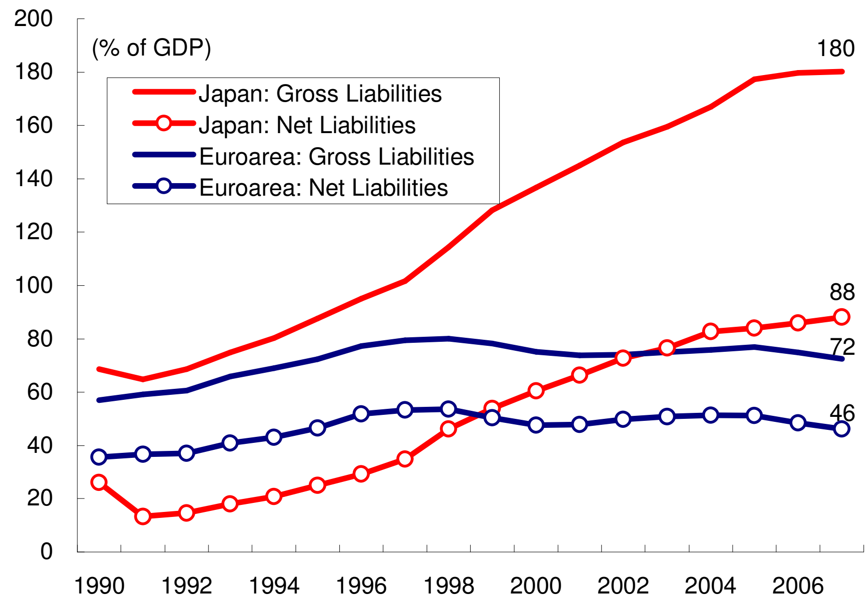


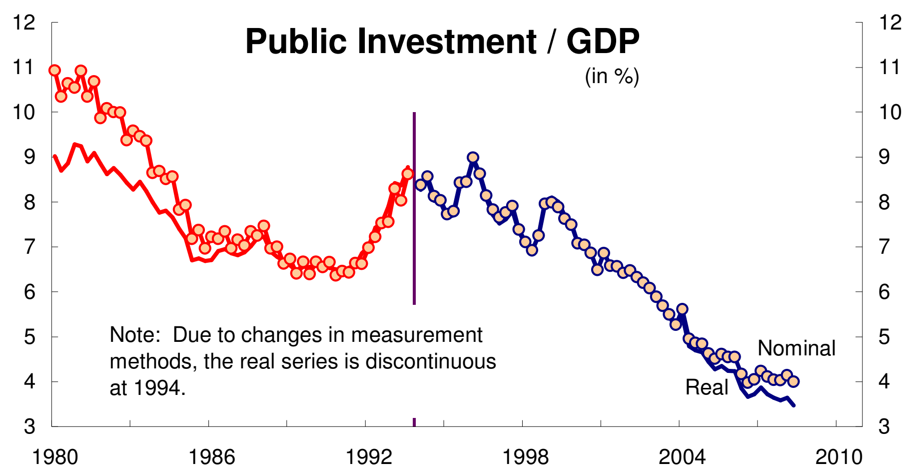
Impact of Demographics on Consumption Patterns

	2007	2013	Change
Food	25.61%	25.65%	0.04%
Housing etc	19.10%	19.01%	−0.09%
Clothing	3.51%	3.50%	−0.01%
Medical/Ins	6.23%	6.25%	0.02%
Tranport/Comm	9.64%	9.59%	−0.05%
Education	0.48%	0.47%	−0.01%
Leisure/Travel	10.60%	10.61%	0.01%
Gifts	13.56%	13.65%	0.08%
Per. Serv.	8.38%	8.39%	0.01%
Misc.	2.88%	2.87%	−0.01%
Total	100.00%	100.00%	0.00%

Sources: Institute for Population and Social Security Research, Statistics Bureau, and Morgan Stanley Research

Fiscal Reform: Good Start, Miles to Go





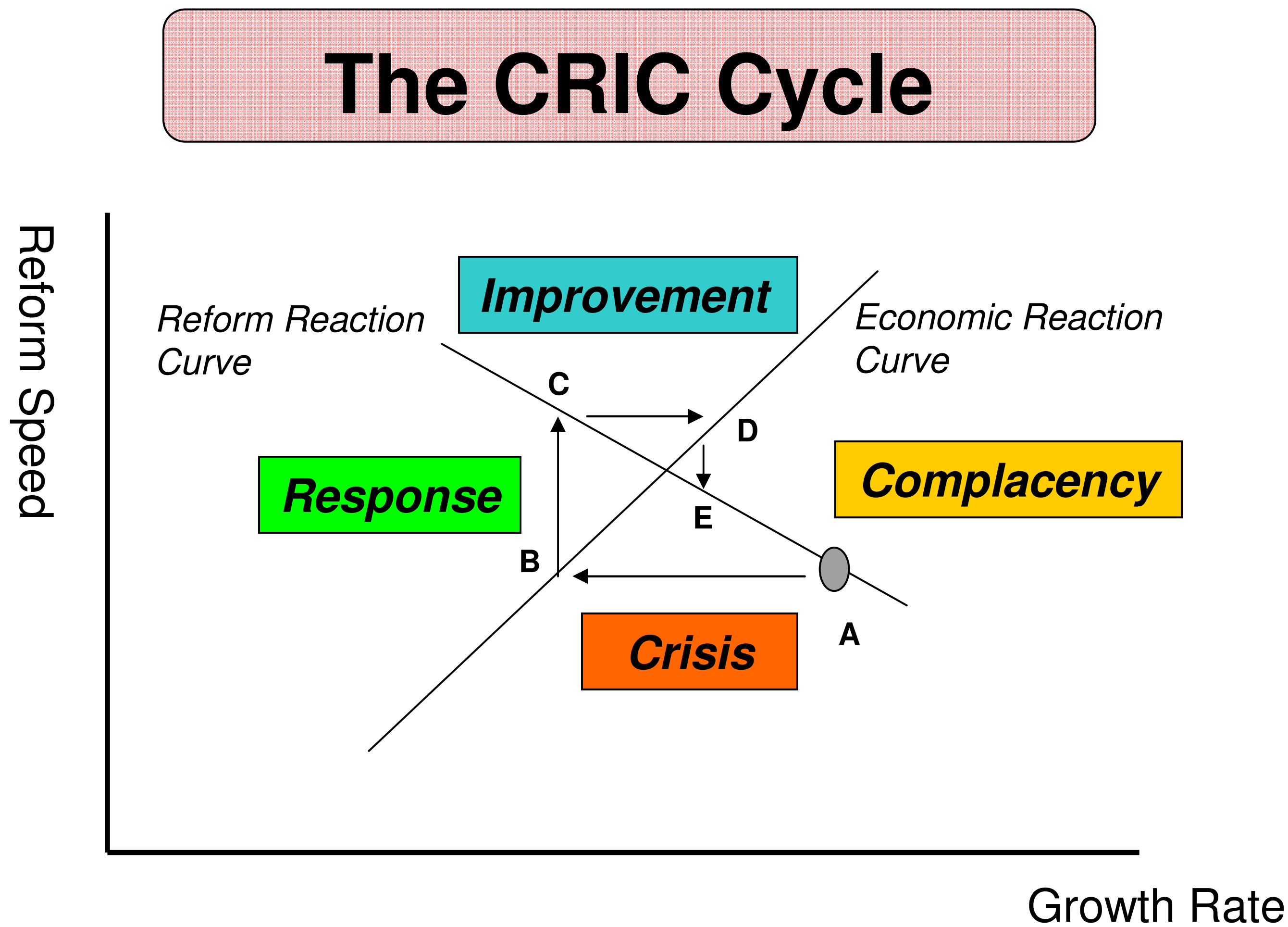
Fiscal deficits remain very large. A swing of about 6.5% of the primary balance is needed to stabilize the ratio of debt to GDP.

Huge progress has been made in cutting public works spending.

Update: August 13, 2008

Sources: OECD Economic Outlook Vol.82 (Dec 07), Cabinet Office, and Morgan Stanley Research.

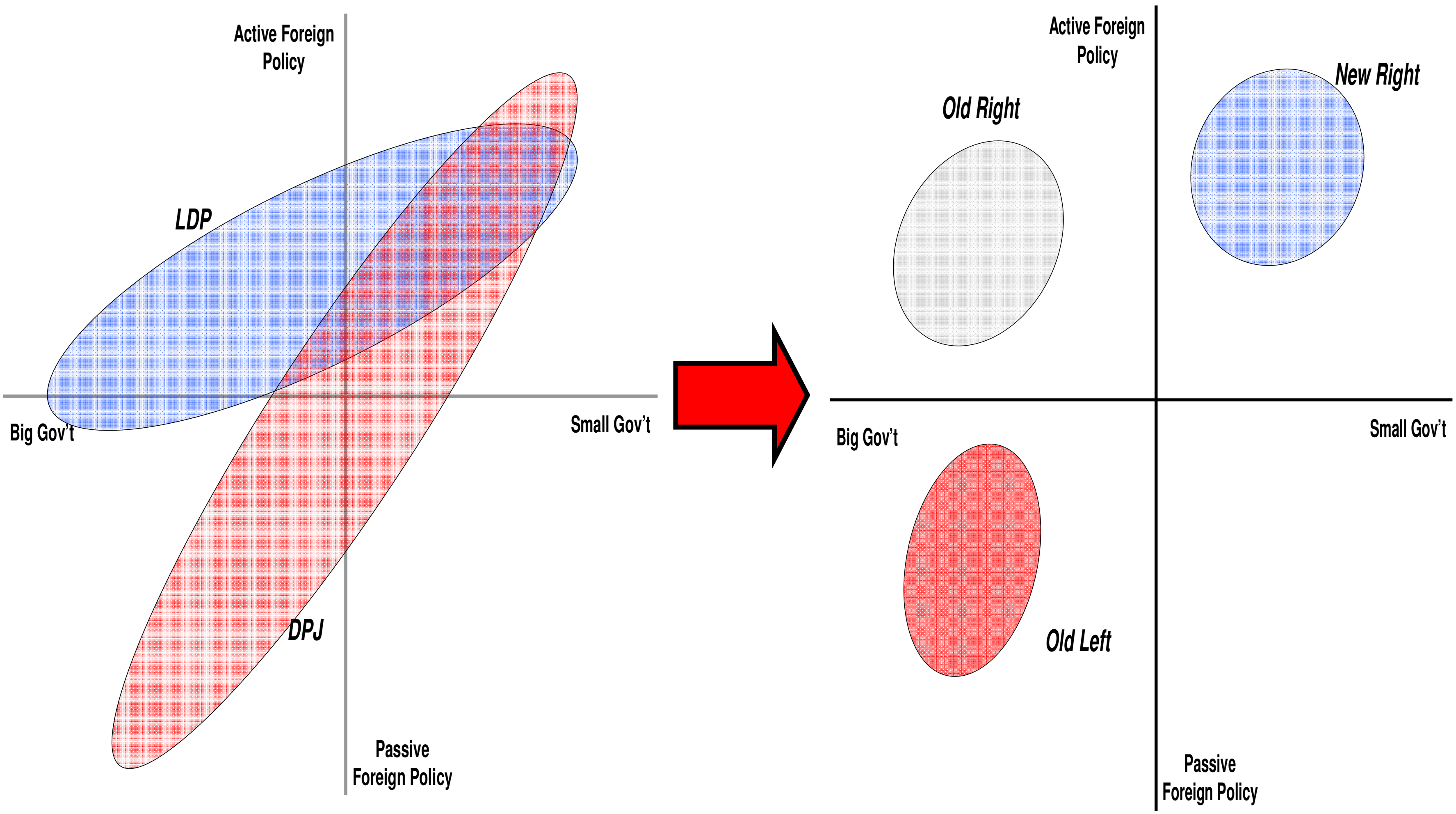
Political Sustainability: The Model



Source: Morgan Stanley Research

Morgan Stanley

Potential Party Realignment



Sources: Diet home pages, and Morgan Stanley Research

Concrete Ideas for Reform

Economic Reforms

Open Sky Agreement with EU
HK-Haneda route expansion
10 Mln Immigrants Program (H. Nakagawa)
Immigration Schools (Automatic entry rights)
Expansion of Special Economic Zones

Agricultural Reform

Liberalization of farm land trading
Abolish "Farm Committees" in regions
Promote Agricultural REITS
Raise taxes on unused land

Financial System Reform

Normalize inspection of regional banks.
Economic courts（special judges）
Separation of powers in Financial Regulation
Create a Soverign Wealth Fund
End bearer checks

Civil Servant Reform

Centralize personnel decisions
Personnel Agency decision on amakudari
Reallocate personnel among functions
（Ex: Raise medial approval personnel from 480 to 1300, and pay with a reduction of Hokkaido Development personnel by 1600. Raise staffing of statistics functions.
Require TOEFl of 650+ for promotion in ministries
Restructure central government dispatches

Pension Reform

Establish a Pension Agency (as part of SWF)
Retirement at 40 (End lifetime contract at 40)

Corporate Governance

Limitations on Treasury Stock
Limit cross holdings by listed firms
Mandatory compliance training for managers
Minority shareholders = Pension beneficiaries
End dual posts for holding company presidents
Dividend cuts for non-voters of shares.

Accounting Standards

Convergence with global standards

Political Reform

Reallocate Upper House seats (d'Hondt)
Cut seats in national, local legislatures by 1/2;
Diet appointments committee

Regional Gov't Finance

DCF valuation on local gov't B/S
Promotion of Public/Private Partnerships

Tax Reform

Taxpayer ID / Tax holiday lottery
Separate NTA from MoF
No Action Letter from NTA
M&A Tax： End revaluation taxes
SIV Rule: Revise application on revisions.
Personnel exchange of NTA and private sector
Tax simplification / E-tax filing expansion
Reform minority squeeze out taxation
Economic efficiency as principle of tax system.
Offset investment losses and gains.

Education Reform

Teach English from 1st grade
National e-education project
Privatization of national universities
Foreign study for univ degree

Medical Reform

Higher premiums for smokers
E-medical records
Hospital info network
Common medical terminology
Renew license for doctors
End fee control for doctors
Info network for med equip
Advertising for ethical drugs
Close low-use facilities

Media Reform

End press clubs
Abolish "Daily Newspaper Law"
Abolish newspaper price controls
Private licensing of financial reporters.

Based on: Feldman, Robert Alan, "Japan Financial Market Competitiveness: Concrete Ideas," Morgan Stanley, February 14, 2007.

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The Americas
1585 Broadway
New York, NY 10036-8293
United States
Tel: +1 (1)212 761 4000

Europe
25 Cabot Square, Canary Wharf
London E14 4QA
United Kingdom
Tel: +44 (0)20 7425 8000

Japan
4-20-3 Ebisu, Shibuya-ku
Tokyo 150-6008
Japan
Tel: +81 (0)3 5424 5000

Asia/Pacific
Three Exchange Square
Central
Hong Kong
Tel: +852 2848 5200