A New Dawn

Japan’s Recovery & Its Global Impact

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What’s Different?

• Political Economy Stable & Focused
  – Koizumi Rules Until September 2006
  – Clear Policy Goal - End Deflation With BoJ Action
  – New Generation Ruling Elite Ambitious & Patriotic

• Forced to Act
  – Fiscal Position Close To Bankruptcy
  – Asia / China Competition Relentless
  – U.S. Structural Problem = Weak Dollar “Productivity Stick”

• Market Power
  – M&A ; Hostile Takeover Bids ; MBOs ; TOBs

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# What’s The Same?

## Export Strength vs Domestic Worries

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>Q2/04</th>
<th>Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP_{nominal}</td>
<td>498.3 trn</td>
<td>504.4 trn</td>
<td>6.1 trn.</td>
</tr>
<tr>
<td>C</td>
<td>284.8</td>
<td>287.4</td>
<td>2.6</td>
</tr>
<tr>
<td>I</td>
<td>71.7</td>
<td>78.7</td>
<td>7.0</td>
</tr>
<tr>
<td>H</td>
<td>18.0</td>
<td>18.2</td>
<td>0.2</td>
</tr>
<tr>
<td>X</td>
<td>55.8</td>
<td>65.6</td>
<td>9.8</td>
</tr>
<tr>
<td>M</td>
<td>49.4</td>
<td>55.6</td>
<td>6.2</td>
</tr>
<tr>
<td>X-M</td>
<td>6.4</td>
<td>10.0</td>
<td>3.6</td>
</tr>
<tr>
<td>Public</td>
<td>118.7</td>
<td>110.2</td>
<td>-8.5</td>
</tr>
<tr>
<td>Inventory</td>
<td>-1.3</td>
<td>-0.1</td>
<td>n/a</td>
</tr>
</tbody>
</table>

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Still A Powerful Export-Machine

19% of All Industrial Output Is For Export -- Up From 13% In 1990; 18% In 2002
Capital Goods Drive The Cycle Up -- Japan’s Consumer Goods Export Machine Stalling

Production for Export as % of Total Production

Source: METI

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Japan Is Back: A Trade Surplus With China

True China Trade Balance Back In Surplus
(True China Trade equals Exports/Imports With Both Peoples Republic and Hong Kong).

Source: MoF, Datastream

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Real Structural Change

Cross-Shareholdings Have Halved
The End Of “Keiretsu” & Bank-Centered Corporate Governance

Cross- and Stable Shareholdings as % of Market Capitalization

Notes: Figures are based on yen values of holdings of listed stocks, excluding the holdings of life insurers; figures for FY3/04 and beyond are estimates

Source: Merrill Lynch Japan Securities, based on the Shareownership Survey, the Trust Companies Association of Japan data, and Toyo Keizai’s major shareholder data
Restructuring Success

Record High Operating Profitability

TSE 1st section, non-financials

Source: TSE and Merrill Lynch Calculations; sample is TSE 1st section, non-financials

Operating Profits (RHS)
Profit Margin (LHS)

Refer to important disclosures starting on page 60
Broader Profits Recovery

Domestic Companies Now Drive Profits Growth

% Contribution To TSE Non-Financial Profit Growth

Source: TSE and Merrill Lynch Calculations; sample is TSE 1st section, non-financials
Exporters = Transportation + Electrical Machinery + Precision Machinery

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Balance Sheet Recession is OVER

Corporate Japan Has Paid-Back Its “Bubble Economy” Debts

Total Corporate Sector Interest Bearing Liabilities as % of Nominal GDP

Source: ESRI of Cabinet Office
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Managing For Shareholders

Corporate Net Equity Buying and Executed Share Buybacks

Note: Cash transaction by non-financial corporates within TSE, NSE and OSE
Source: TSE

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Structural Up-Cycle #1: Capital Investment

**Bubble-Excess Capacity Now Cut**

*Production Capacity*

- Years: 80, 82, 84, 86, 90, 92, 94, 96, 98, 00, 02, 04, 06
- Production Capacity Values: 75.0, 95.0, 105.0
- Source: METI

**Vintage of Capital Stock**

*Years:*
- 60, 70, 72, 74, 76, 78, 80, 82, 84, 86, 88, 90, 92, 94, 96, 98, 00, 02, 04, 06
- Vintage Values: 6.0, 7.0, 8.0, 9.0, 10.0, 11.0, 12.0, 13.0
- Source: ESRI of Cabinet Office

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Globalization Success

Off-Shore Production Capacity Now More Than 40% Of Global Total. Japan’s “De-Industrialization Is Complete?!?

Offshore Capacity as % of Total Capacity

Imports as % of Total Production

Source: METI & Merrill Lynch

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Structural Up-Cycle #2: Human Capital Investment

New Job-Offers Now Running At 700,000/month -- More Companies Are Looking To Hire More Workers Than Ever Before In Japan’s History.

Source: MHLW
Worker Competition Is Rising

End Of The Middle Class: Companies Need - and Pay Up for - Specialists, Not Salarymen ---> “Winners” Lead The Recovery

Earnings Gap: Wage Earnings of Male Employees, top 10% to bottom 10%

Source: OECD
A Workers’ Paradise No More

Labor Compensation Policy Now Favors Shareholders: In Past Cycles, 7-quarters After Profits Hit Bottom, Workers’ Compensation Was Up 4% -- This Cycle It Is Down 2%
A Powerful Echo

Passive Benefit: Expensive “Baby-Boomers” Are Replaced By Inexpensive “Echo Boomers”

Source: NIPSSR

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A Meaner, Leaner Japan Inc.

Employment Costs Down To Historic Lows

Worker Compensation In Natl.Income

Source: TSE and Merrill Lynch Calculations; sample is TSE 1st section, non-financials

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Households Now A Debtor

Japan Has A Negative Household Savings Rate:
Generation Transfer of Jobs and Income plus Desire To Maintain High
Standard of Living Drives Down Savings Flow.
Households Now A Net Borrower - A New Credit Cycle

Household Savings - Yen Trillion per Quarter. Flow Of Funds Based

Note: Flow-based, four-quarter accumulated.
Source: BoJ

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Sweet-Spot For Profits

Structural Decline In Unit Labor Costs

Unit Labor Cost % YoY - All Economy

Source: METI, MoL & Merrill Lynch

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Productivity: Nothing Special Yet

Productivity Boost Still Mostly Cyclical

Productivity % YoY - All Economy

Source: METI, MoL & Merrill Lynch

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### Japan Lags

**Japan Leads In IT-Productivity, But Lags Everywhere Else**

<table>
<thead>
<tr>
<th></th>
<th>Contribution (% YoY)</th>
<th>GDP</th>
<th>IT Capital</th>
<th>Non-IT Capital</th>
<th>Labor</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Japan</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1990-95</td>
<td>1.2%</td>
<td>0.4%</td>
<td>1.0%</td>
<td>-0.2%</td>
<td></td>
</tr>
<tr>
<td>1995-00</td>
<td>1.0%</td>
<td>0.9%</td>
<td>0.3%</td>
<td>-0.2%</td>
<td></td>
</tr>
<tr>
<td><strong>US</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1990-95</td>
<td>2.2%</td>
<td>0.5%</td>
<td>0.6%</td>
<td>1.1%</td>
<td></td>
</tr>
<tr>
<td>1995-00</td>
<td>3.5%</td>
<td>1.0%</td>
<td>1.1%</td>
<td>1.4%</td>
<td></td>
</tr>
</tbody>
</table>

Source: Motohashi, METI & Merrill Lynch

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Refer to important disclosures starting on page 60
## Boost Only For IT-Manufacturers

Outside of IT Manufacturers, Only Little Productivity Improvement. Services Dismal

<table>
<thead>
<tr>
<th></th>
<th>Total Productivity</th>
<th>IT Factors</th>
<th>Capital Factors</th>
<th>Utilization Factors</th>
<th>Other Factors</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Industries</td>
<td>1.5%</td>
<td>0.4%</td>
<td>0.6%</td>
<td>0.2%</td>
<td>0.3%</td>
</tr>
<tr>
<td>IT Manufacturers</td>
<td>6.2%</td>
<td>0.9%</td>
<td>1.2%</td>
<td>0.4%</td>
<td>3.7%</td>
</tr>
<tr>
<td>IT Users - Industry</td>
<td>1.3%</td>
<td>0.3%</td>
<td>0.6%</td>
<td>0.1%</td>
<td>0.3%</td>
</tr>
<tr>
<td>IT Users - Services</td>
<td>-0.2%</td>
<td>0.3%</td>
<td>0.4%</td>
<td>n/a</td>
<td>-0.9%</td>
</tr>
</tbody>
</table>

Source: Historic Averages 1995 until 2002; Motohashi, METI & Merrill Lynch
**Focus On Logistics**

*66% of All Japanese Wholesalers Do Not Have A Customer Who Is A Retailer Or Producer*

<table>
<thead>
<tr>
<th>Number of Employees</th>
<th>1994 Companies</th>
<th>1999 Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td>1 to 2</td>
<td>90</td>
<td>21.1</td>
</tr>
<tr>
<td>3 to 4</td>
<td>103</td>
<td>24.0</td>
</tr>
<tr>
<td>5 to 9</td>
<td>120</td>
<td>28.0</td>
</tr>
<tr>
<td>10 to 19</td>
<td>68</td>
<td>15.8</td>
</tr>
<tr>
<td>20 to 29</td>
<td>21</td>
<td>5.0</td>
</tr>
<tr>
<td>30 to 49</td>
<td>15</td>
<td>3.4</td>
</tr>
<tr>
<td>50 to 99</td>
<td>8</td>
<td>2.0</td>
</tr>
<tr>
<td>over 100</td>
<td>4</td>
<td>0.8</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>429</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: METI
A “War Economy”

Surge In Public Deficit Forces Public Debt Monetization
Inflation Is Always A Fiscal Phenomena ?!

Source: BoJ and Mikuni & Company

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Refer to important disclosures starting on page 60
The China Challenge

Compared to Past Economic Empire Transitions, The China Challenge Is Huge....BUT: it’s Not just about who is the cheapest producer, it is Who Owns The Customer

<table>
<thead>
<tr>
<th></th>
<th>Wage Gap</th>
<th>Population Gap</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>England versus America</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1881</td>
<td>1.21</td>
<td>1.61</td>
</tr>
<tr>
<td>(England was 1.21 times more expensive)</td>
<td>(America was 1.61 times larger)</td>
<td></td>
</tr>
<tr>
<td><strong>America versus Japan</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1979</td>
<td>1.37</td>
<td>0.51</td>
</tr>
<tr>
<td>(America was 1.37 times more expensive)</td>
<td>Japan was 0.51 times as large</td>
<td></td>
</tr>
<tr>
<td><strong>Japan versus China</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2002</td>
<td>32.5</td>
<td>10.1</td>
</tr>
<tr>
<td>(Japan is 32.5 times more expensive)</td>
<td>(China is 10.1 times larger)</td>
<td></td>
</tr>
</tbody>
</table>

Source: IMF
China Challenge: End Of Cost Competition

Brand Value

Lower Cost

Refer to important disclosures starting on page 60
China Challenge: Start Of Brand Competition

Brand Value

Benetton

Uniqlo

Lower Cost

Refer to important disclosures starting on page 60
Cool Nippon

Do You Think This Country’s Products Are “Cool”? Response By Consumers In Different Cities

Source: Nikkei
Note: China=Beijing, Shanghai, Guangzhou

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Refer to important disclosures starting on page 60
The Pacific Century Gets Going

<table>
<thead>
<tr>
<th>Region</th>
<th>GDP</th>
<th>Growth</th>
<th>$ Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>11 trn</td>
<td>3%</td>
<td>330 bn</td>
</tr>
<tr>
<td>Japan</td>
<td>4.8 trn</td>
<td>1.5%</td>
<td>72 bn</td>
</tr>
<tr>
<td>ASIA</td>
<td>4.3 trn</td>
<td>6%</td>
<td>258 bn → 330 bn</td>
</tr>
<tr>
<td>China</td>
<td>1.4 trn</td>
<td>9%</td>
<td>125 bn</td>
</tr>
<tr>
<td>A-Tigers</td>
<td>1.8 trn</td>
<td>6%</td>
<td>110 bn</td>
</tr>
<tr>
<td>India</td>
<td>600 bn</td>
<td>5%</td>
<td>30 bn</td>
</tr>
<tr>
<td>Australia</td>
<td>500 bn</td>
<td>3%</td>
<td>15 bn</td>
</tr>
<tr>
<td>W.Europe</td>
<td>10.2 trn</td>
<td>1.5%</td>
<td>153 bn → 200 bn</td>
</tr>
<tr>
<td>Accession E.</td>
<td>535 bn</td>
<td>5%</td>
<td>27 bn</td>
</tr>
<tr>
<td>Russia</td>
<td>400 bn</td>
<td>5%</td>
<td>20 bn</td>
</tr>
</tbody>
</table>

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China FDI Boom - The End Of Profits?

Comparison of China and U.S. Passenger Vehicle Prices
Percent (%)

100
-10-20
5-10
20-30
0-5
10-20
20-25
160
10
170

Higher Profits margins for OEMs and Suppliers


Source: McKinsey Global Institute
Refer to important disclosures starting on page 60
Appendix
FX Policy: De-Facto Dollar Peg

New Budget Authorizes $580 billion of Possible Intervention:
2003 was about $15bn/month - 2004 could be $48bn/month

FX Intervention Funding Bills - Budget & Actual

Note: bar chart is the actual amount of FX intervention bills outstanding; the line is the budget limit.
Source: BoJ, MoF
Fiscal Realities

• 82 trn. Expenditures
• 42 trn. Revenues
• 40 trn. Borrowing
Towards A Fiscal Debt Trap

To Stop Debt-To-GDP From Rising, Japan Needs A Primary Budget Surplus of 2% of GDP --- Today’s Deficit is 6% --- A Swing of 8% is a Herculean Task:

8% of GDP = Y40 trillion ; Total Tax Revenues are Y42 trillion.

Cyclically-adjusted general government primary balances as % of Nominal GDP

Source: OECD
## Going For Growth

*For Every 1% Growth Japan’s Primary Deficit Improves about 0.26%. So Japan Must Grow about 32% Just To Stop Debt-To-GDP Ratio From Rising*

### Impact of Growth on Budget Deficit

<table>
<thead>
<tr>
<th>Cyclical Elasticities YoY%</th>
<th>Japan</th>
<th>US</th>
<th>Germany</th>
<th>OECD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Corporate</td>
<td>2.1</td>
<td>1.8</td>
<td>0.8</td>
<td>1.26</td>
</tr>
<tr>
<td>Personal</td>
<td>0.4</td>
<td>0.6</td>
<td>1.3</td>
<td>1.03</td>
</tr>
<tr>
<td>Indirect</td>
<td>0.5</td>
<td>0.9</td>
<td>1.0</td>
<td>0.89</td>
</tr>
<tr>
<td>Social Security</td>
<td>0.3</td>
<td>0.6</td>
<td>1.0</td>
<td>0.81</td>
</tr>
<tr>
<td>Expenditure</td>
<td>-0.1</td>
<td>-0.1</td>
<td>-0.1</td>
<td>-0.29</td>
</tr>
<tr>
<td>Total Impact on Budget % of GDP</td>
<td>0.26</td>
<td>0.25</td>
<td>0.51</td>
<td>0.49</td>
</tr>
</tbody>
</table>

*If Growth 1% Above Potential Primary Deficit Drops by 0.26 % of GDP*

*Source: OECD, ML Estimates*
## Consumer Challenge

<table>
<thead>
<tr>
<th>Year</th>
<th>Month</th>
<th>Amount (Yen billion)</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>Oct</td>
<td>320</td>
<td>hike in employee pension contribution</td>
</tr>
<tr>
<td></td>
<td>Dec</td>
<td>480</td>
<td>end special spouse tax deduction</td>
</tr>
<tr>
<td>2005</td>
<td>Jan</td>
<td>240</td>
<td>end special old people &amp; retirees pension deduction</td>
</tr>
<tr>
<td></td>
<td>Apr</td>
<td>40</td>
<td>hike national pension contribution</td>
</tr>
<tr>
<td></td>
<td></td>
<td>150</td>
<td>hike unemployment insurance contribution</td>
</tr>
<tr>
<td></td>
<td>Jun</td>
<td>180</td>
<td>end special spouse tax deduction (local tax)</td>
</tr>
<tr>
<td></td>
<td>Sep</td>
<td>320</td>
<td>hike in employee pension contribution</td>
</tr>
</tbody>
</table>

**Total 1,730 = 0.5% of disposable income**

Refer to important disclosures starting on page 60.
Koizumi Tax Reform Mistake?

• Fixed Tax Rate Deductions
  – Y2.6 trillion national income tax
    \((0.8\% \text{ of disposable income})\)
  – Y0.9 trillion local income tax
    \((0.3\% \text{ of disposable income})\)
• Implemented by PM Hashimoto, but technically still only temporary
• Likely to be extended into FY3/05, but need to see
<table>
<thead>
<tr>
<th>Japan</th>
<th>United States</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Largest Bank</strong></td>
<td></td>
</tr>
<tr>
<td>MTFG or SMFG</td>
<td>Citigroup</td>
</tr>
<tr>
<td>Total Assets: $1.7 trillion</td>
<td>Total Assets: $1.3 trillion</td>
</tr>
<tr>
<td><strong>Largest Deposit Market Share</strong></td>
<td></td>
</tr>
<tr>
<td>MTFG or SMFG: 33%</td>
<td>Bank of America: 9.6%</td>
</tr>
<tr>
<td><strong>ROA</strong>*</td>
<td></td>
</tr>
<tr>
<td>0.1 to 0.4%</td>
<td>1.5 to 2%</td>
</tr>
<tr>
<td><strong>NPA Ratios</strong>*</td>
<td></td>
</tr>
<tr>
<td>5 to 8.5%</td>
<td>0.5 to 1.5%</td>
</tr>
<tr>
<td><strong>Capital Ratios</strong>*</td>
<td></td>
</tr>
<tr>
<td>Total: 10 to 11%</td>
<td>Total: 11 to 12%</td>
</tr>
<tr>
<td>Tier I: 5 to 6%</td>
<td>Tier I: 7.5 to 9%</td>
</tr>
<tr>
<td><strong>Net Int Margins</strong></td>
<td></td>
</tr>
<tr>
<td>About 1%</td>
<td>3.5 to 5.5%</td>
</tr>
<tr>
<td><strong>Credit Spread</strong></td>
<td></td>
</tr>
<tr>
<td>Mizuho (Baa1/BBB-)</td>
<td>JPM (A2/A) 4.875%</td>
</tr>
<tr>
<td>5.79% ’14: T+123</td>
<td>’14: T+87</td>
</tr>
</tbody>
</table>

* Range for the Big 4 largest banks in Japan and top 30 banks in the US.
Source: company reports
When Will “Cold Money” Turn “Hot”?


Banknotes as % of Nominal GDP, 4qma

Source: BoJ, Cabinet Office
U.S. Consumer Headwinds


Source: Hayter Analytics & Merrill Lynch

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Key Forecasts

• **Sayonara Deflation**
  Positive Nominal GDP Growth --- Up 1.9% By End 05
  Consistently Positive core-CPI By Early-2005
  2005 Focus: A New Credit Growth Cycle

• **Domestic Demand Driven**
  Consumption Drives Growth --- 3.9% unemployment by mid-2005
  Positive Wealth Effects --- A Pick-up In Money Velocity

• **Pragmatic Policy**
  Pro-Growth BoJ --- Zero Rate Stays Until Early-2006
  No Fiscal Tightening
  De-facto “Dollar Down Peg”
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