October 2004

A New Dawn

Japan's Recovery & Its Global Impact

Merrill Lynch Japan Securities

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Refer to important disclosures starting on page 60

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***

What's The Same?

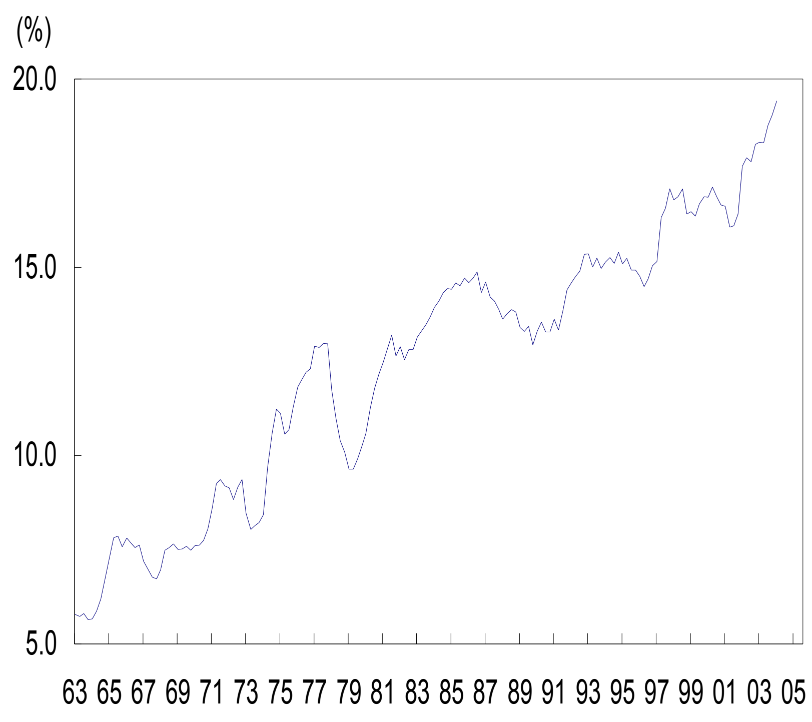
Export Strength vs Domestic Worries

	2002	*Q2/04*	*Growth*
GDP(nominal)	498.3 *trn*	504.4 *trn*	6.1 *trn*.
C	284.8	287.4	2.6
I	71.7	78.7	7.0
H	18.0	18.2	0.2
X	55.8	65.6	9.8
M	49.4	55.6	6.2
X-M	6.4	10.0	3.6
Public	118.7	110.2	-8.5
Inventory	-1.3	-0.1	n/a

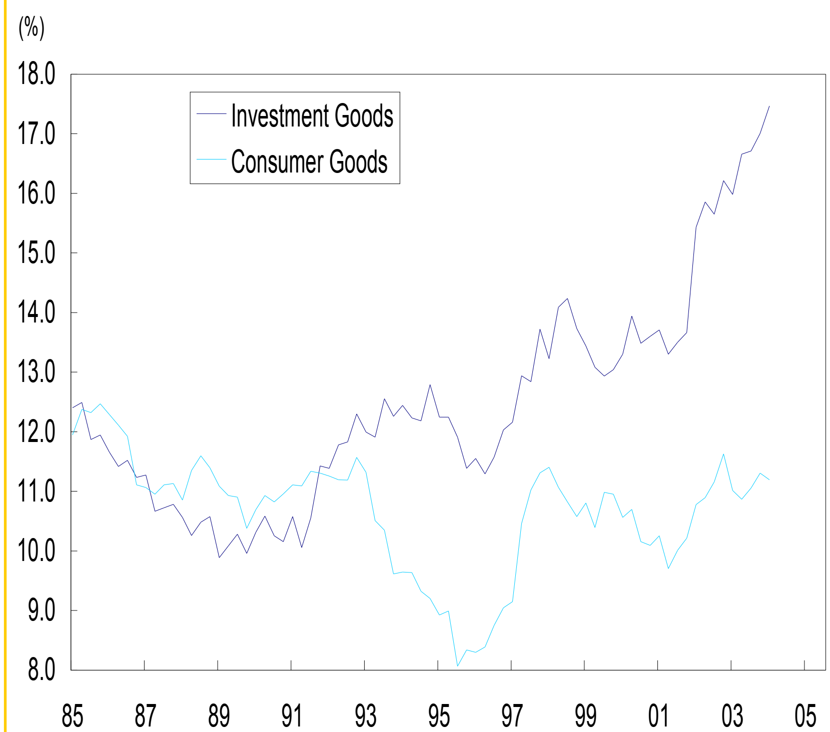
Still A Powerful Export-Machine

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

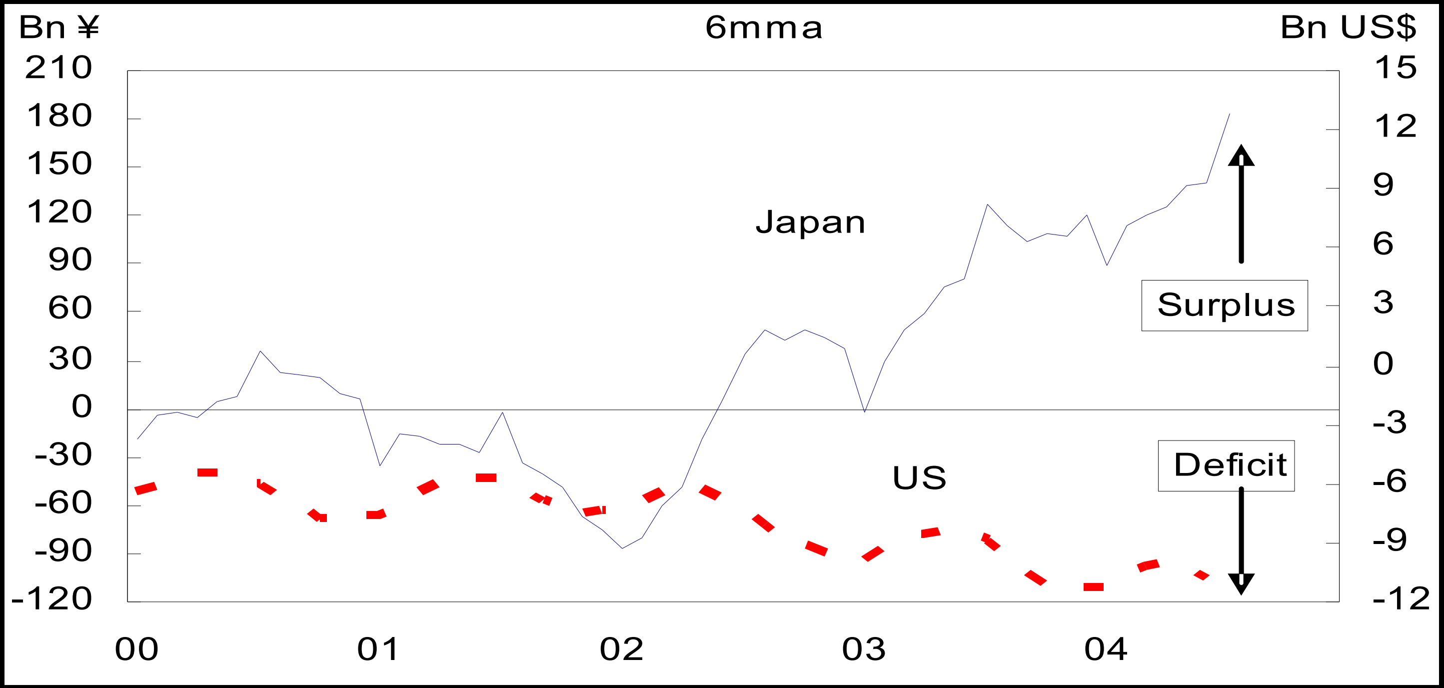


Source: METI

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).

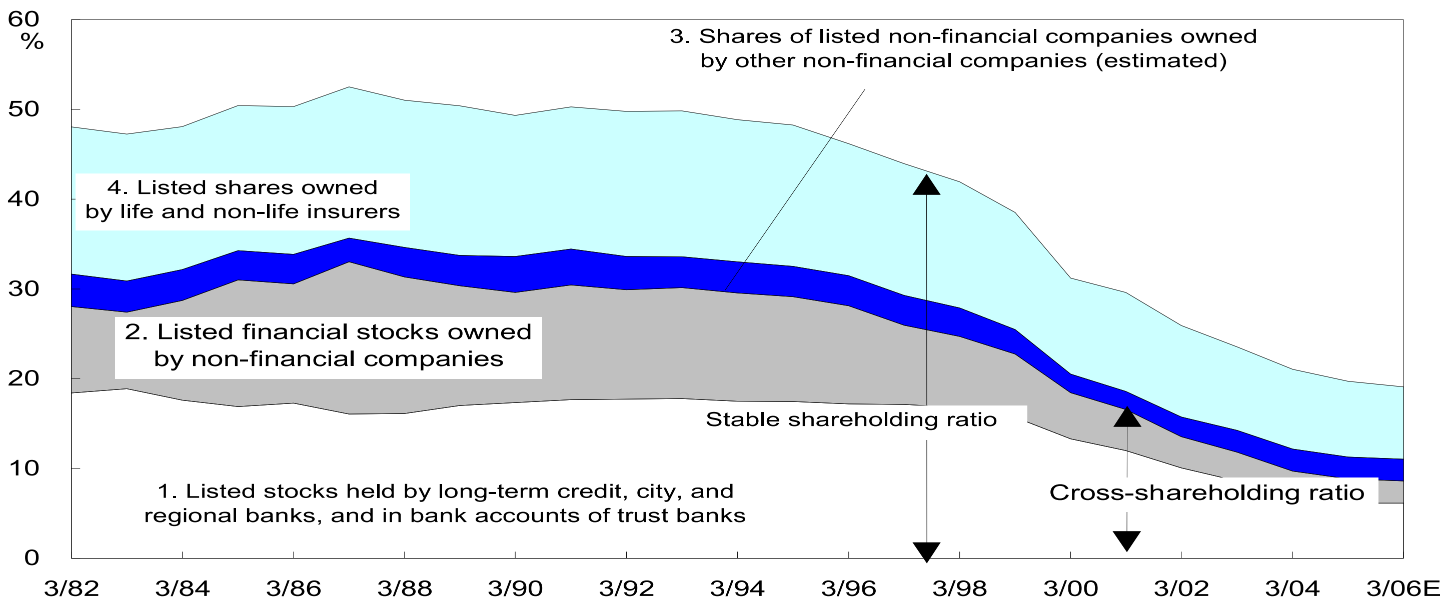


Source: MoF, Datastream

Real Structural Change

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

Cross- and Stable Shareholdings as % of Market Capitalization



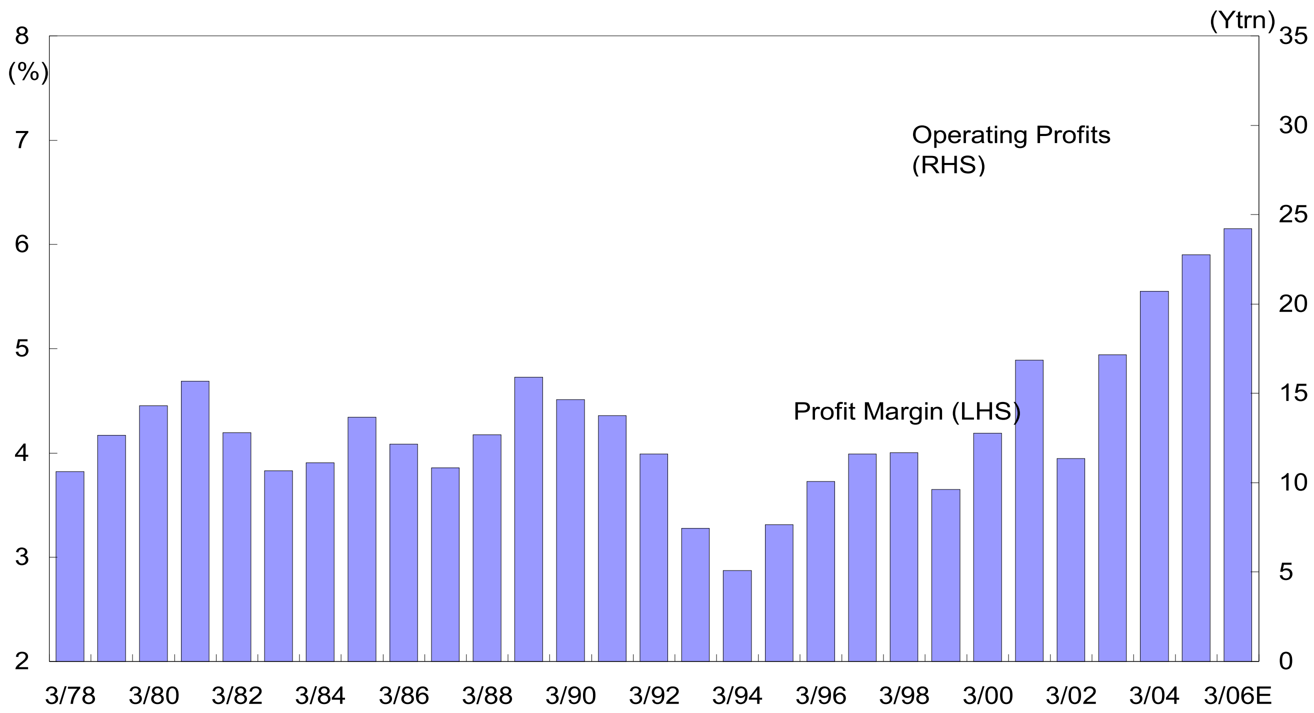
Notes: Figures are based on yen values of holdings of listed stocks, excluding the holdings of life insurers; figures for FY3/04 and beyond are estimates
Source: Merrill Lynch Japan Securities, based on the Shareownership Survey, the Trust Companies Association of Japan data, and Toyo Keizai's major shareholder data

Refer to important disclosures starting on page 60

Restructuring Success

Record High Operating Profitability

TSE 1st section, non-financials

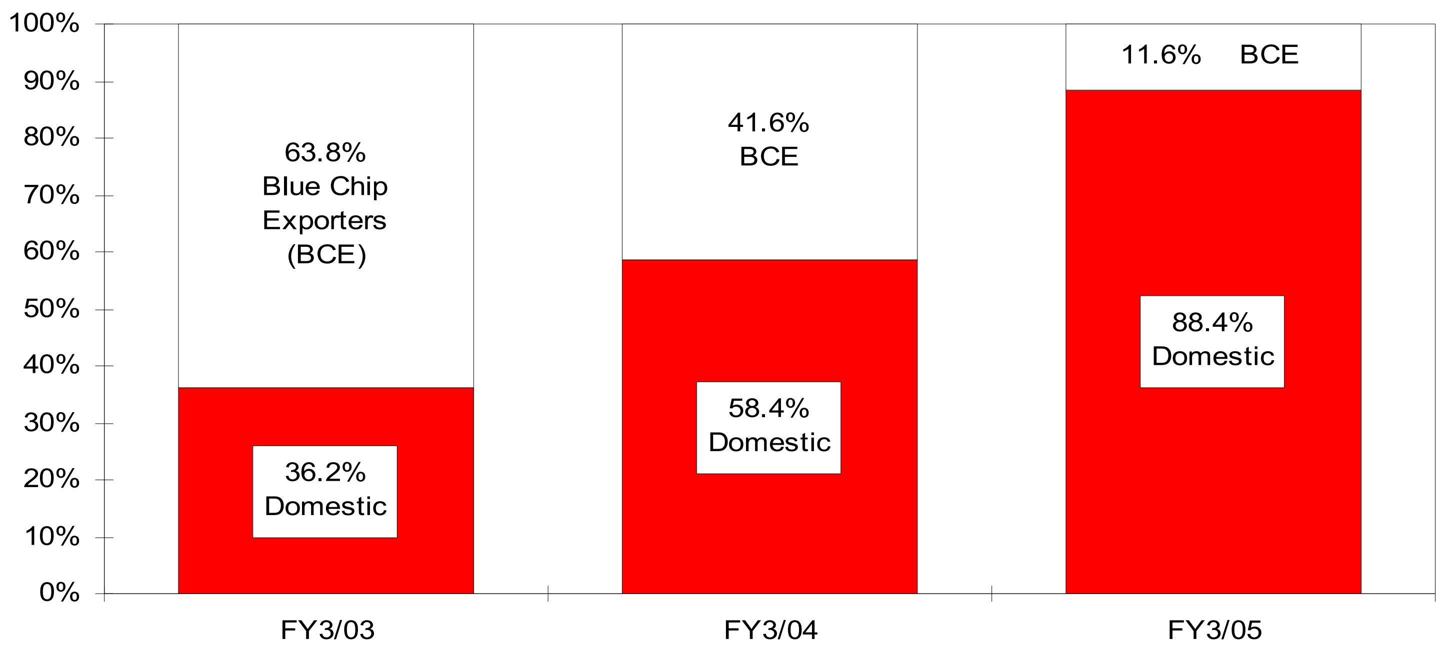


Source: TSE and Merrill Lynch Calculations; sample is TSE 1st section, non-financials

Broader Profits Recovery

Domestic Companies Now Drive Profits Growth

% Contribution To TSE Non-Financial Profit Growth

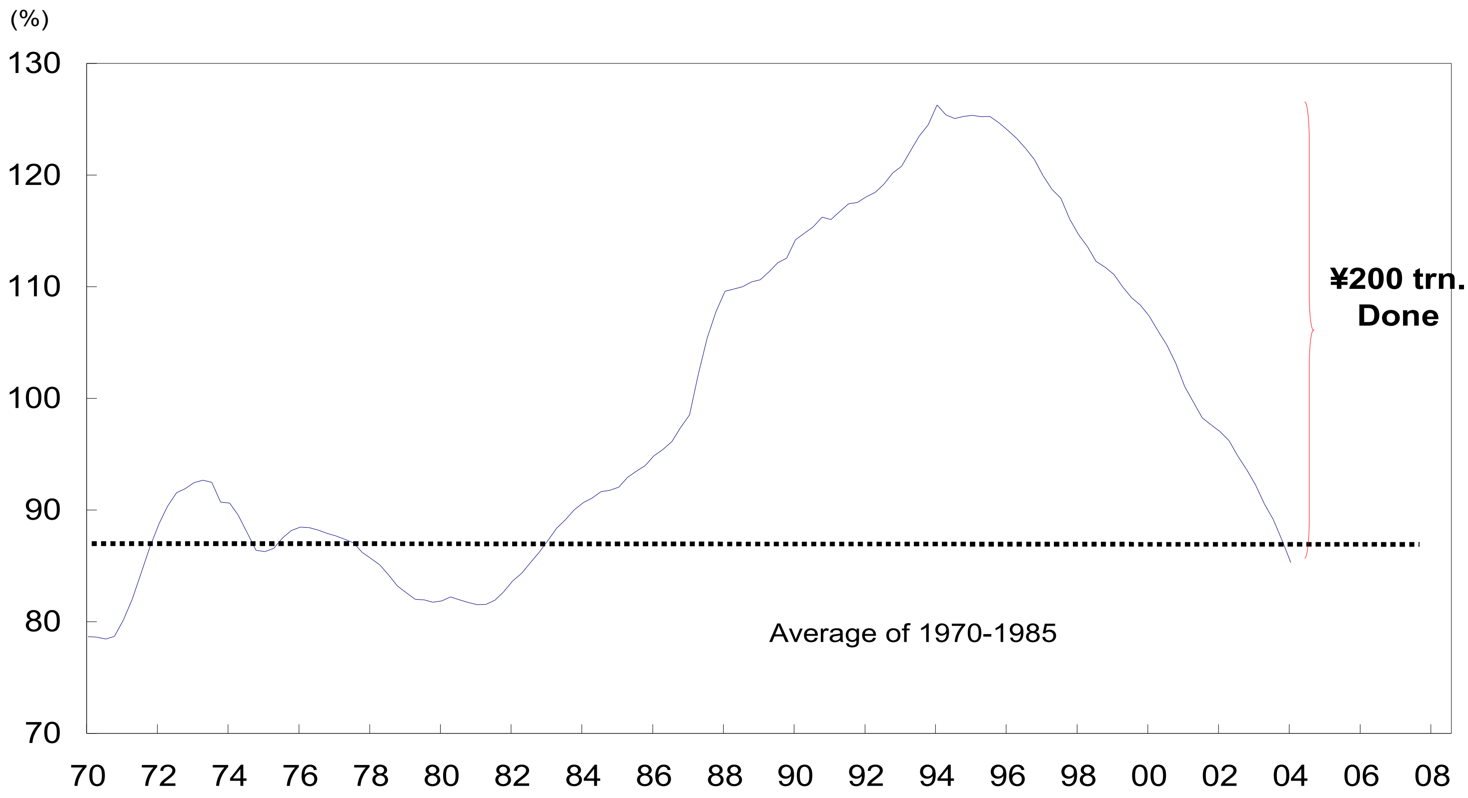


Source: TSE and Merrill Lynch Calculations; sample is TSE 1st section, non-financials
Exporters = Transportation + Electrical Machinery + Precision Machinery

Balance Sheet Recession is OVER

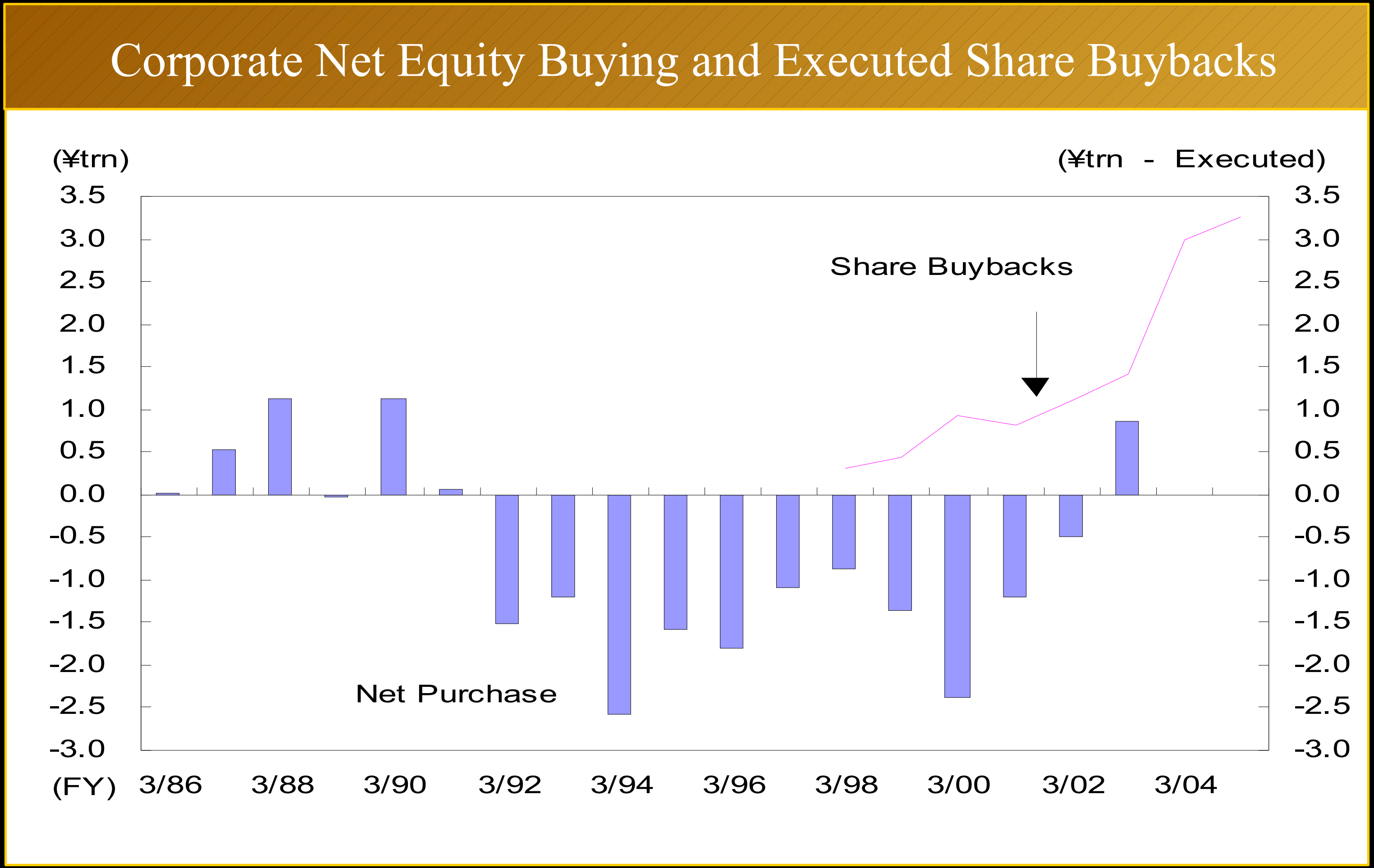
Corporate Japan Has Paid-Back Its "Bubble Economy" Debts

Total Corporate Sector Interest Bearing Liabilities as % of Nominal GDP



Source: ESRI of Cabinet Office

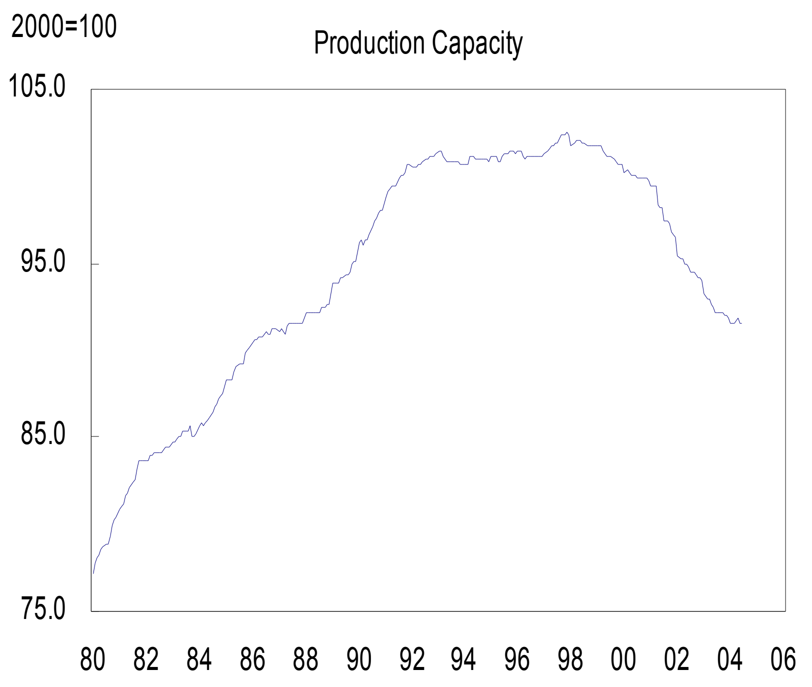
Managing For Shareholders



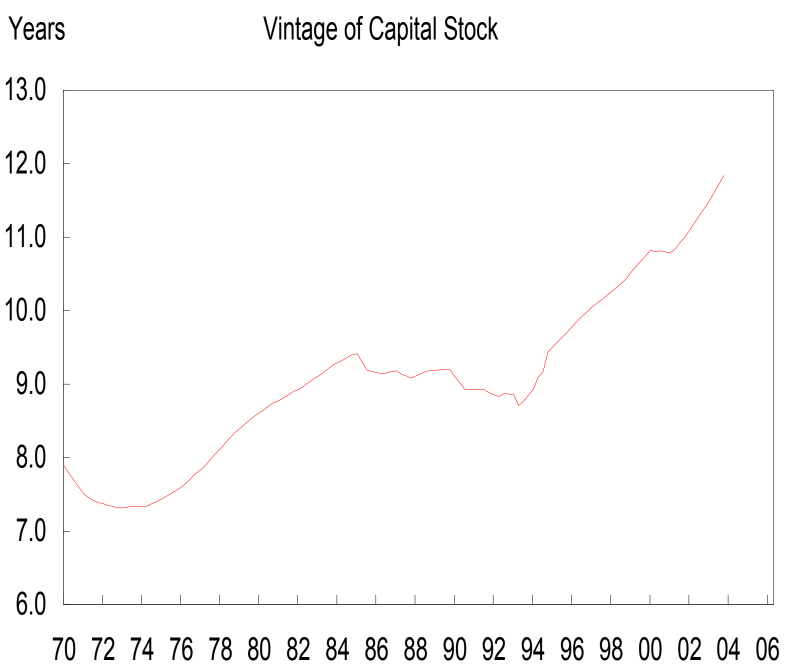
Note: Cash transaction by non-financial corporates within TSE, NSE and OSE
Source: TSE

Structural Up-Cycle #1 : Capital Investment

Bubble-Excess Capacity Now Cut	Very Old Capital Stock



Source: METI

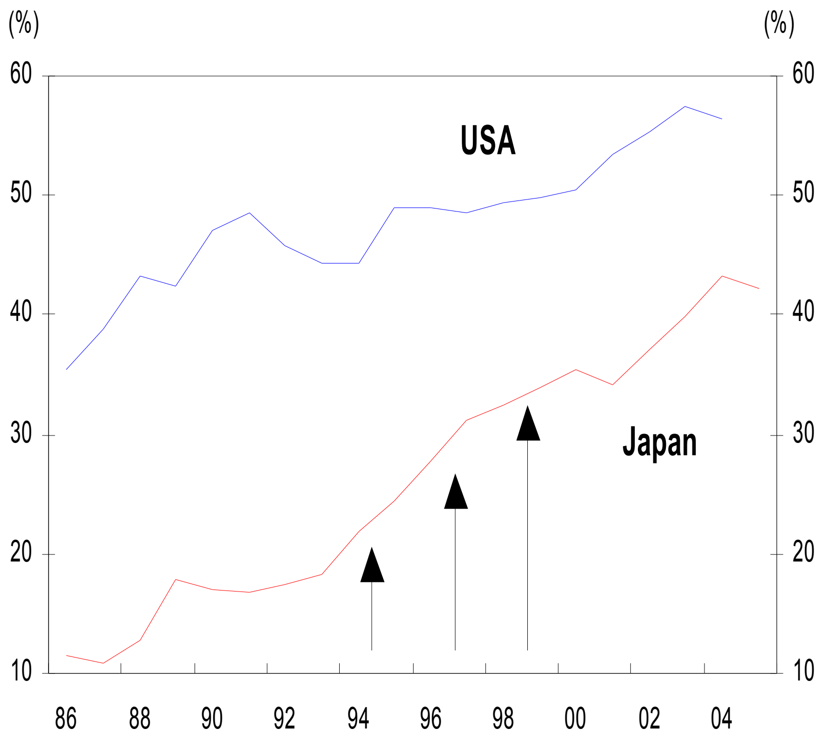


Source: ESRI of Cabinet Office

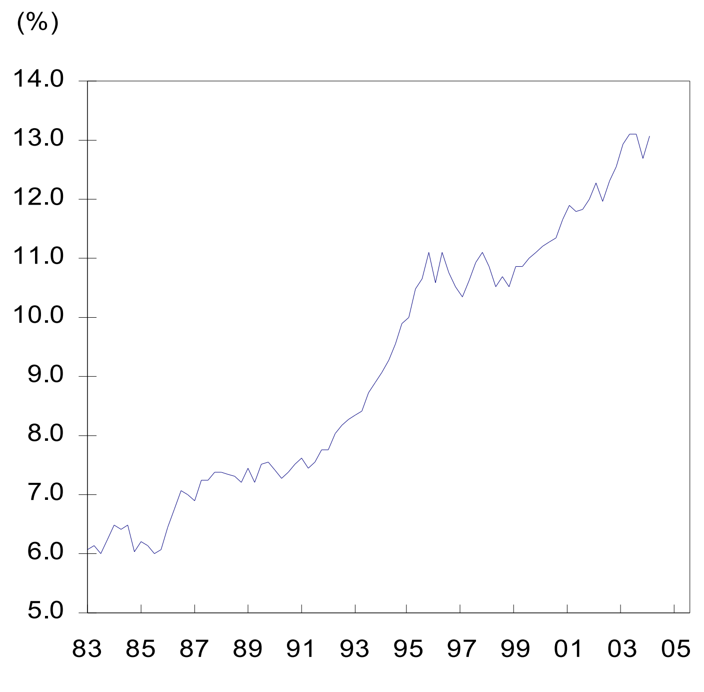
Globalization Success

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

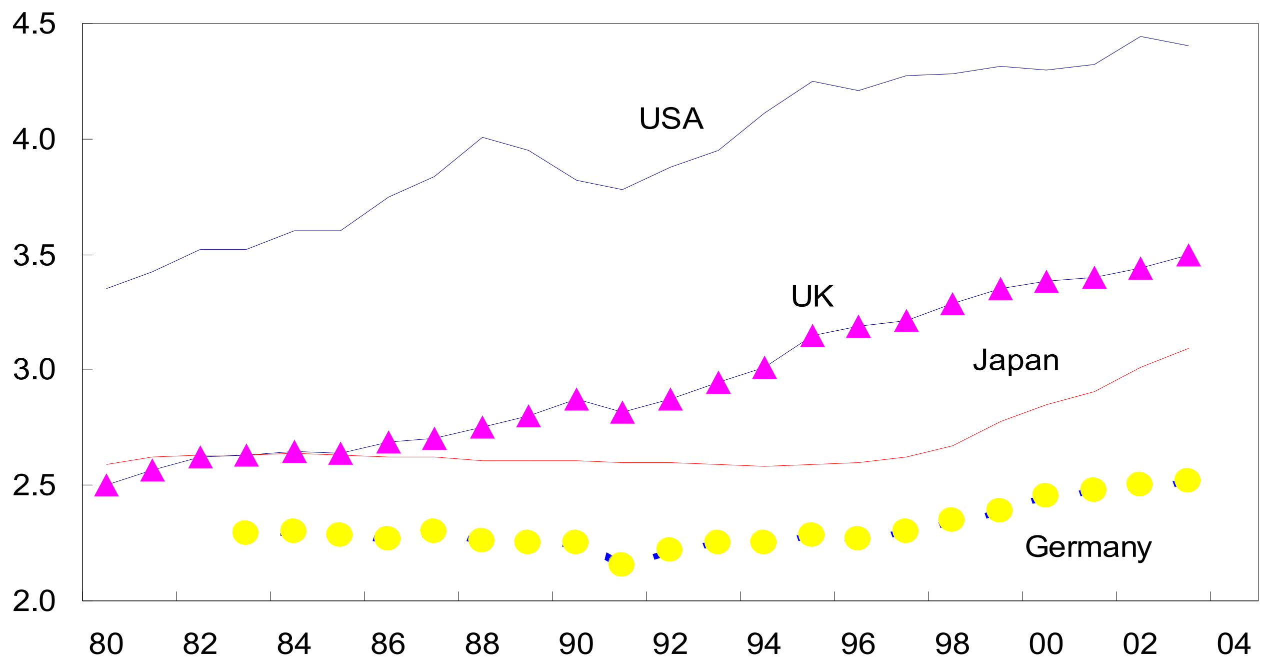
Structural Up-Cycle #2 : Human Capital Investment

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

Worker Competition Is Rising

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

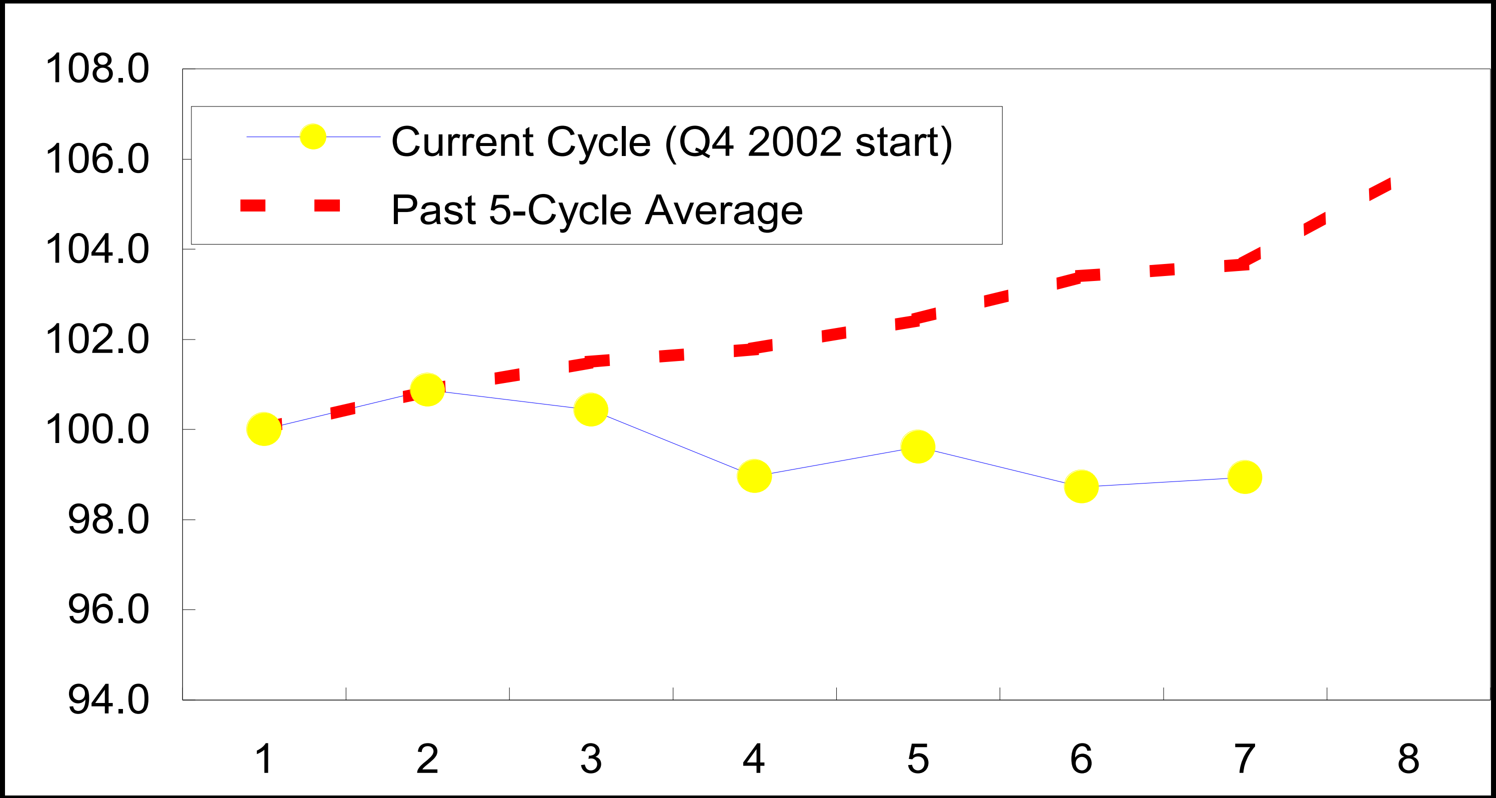
Earnings Gap: Wage Earnings of Male Employees, top 10% to bottom 10%



Source: OECD

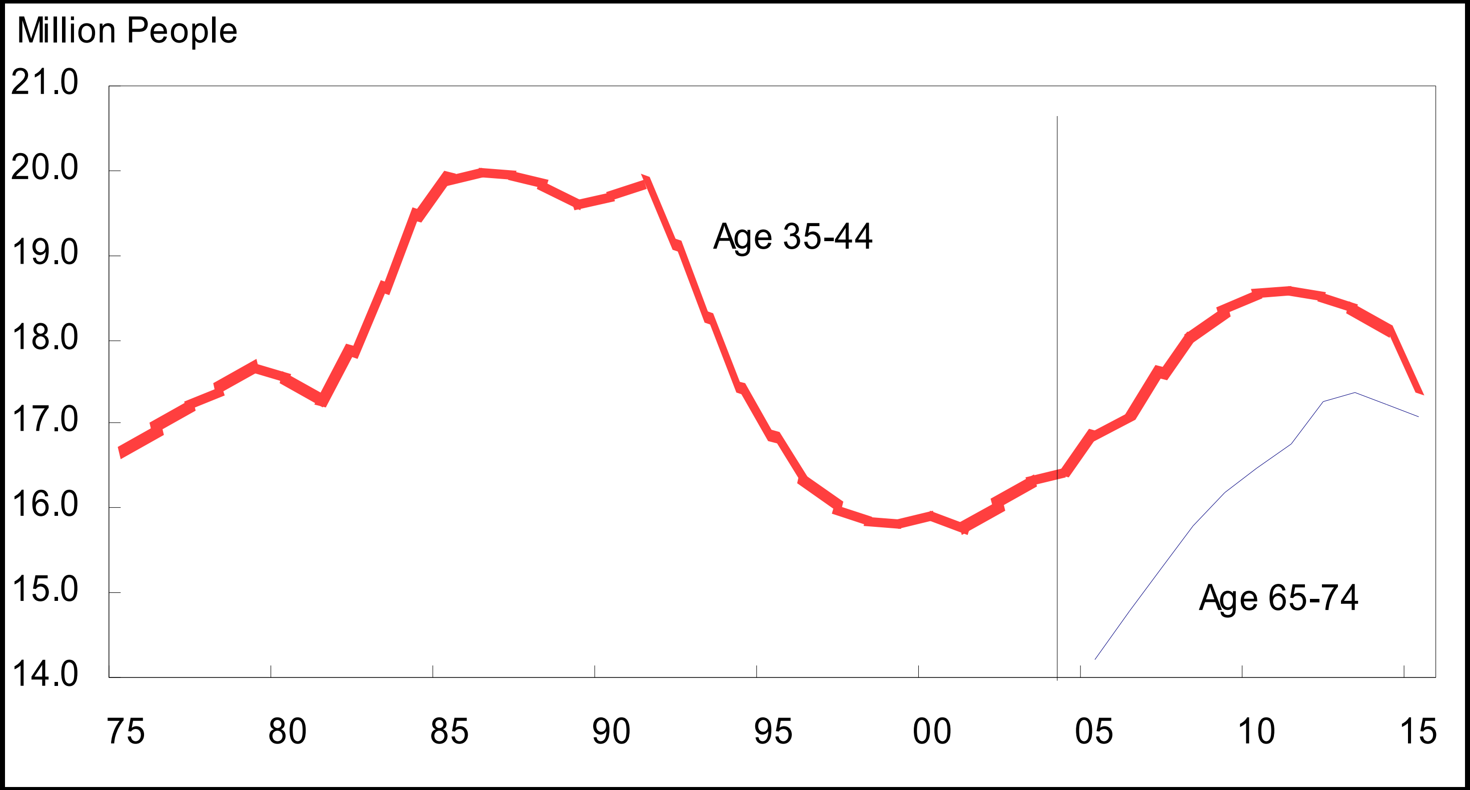
A Workers' Paradise No More

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

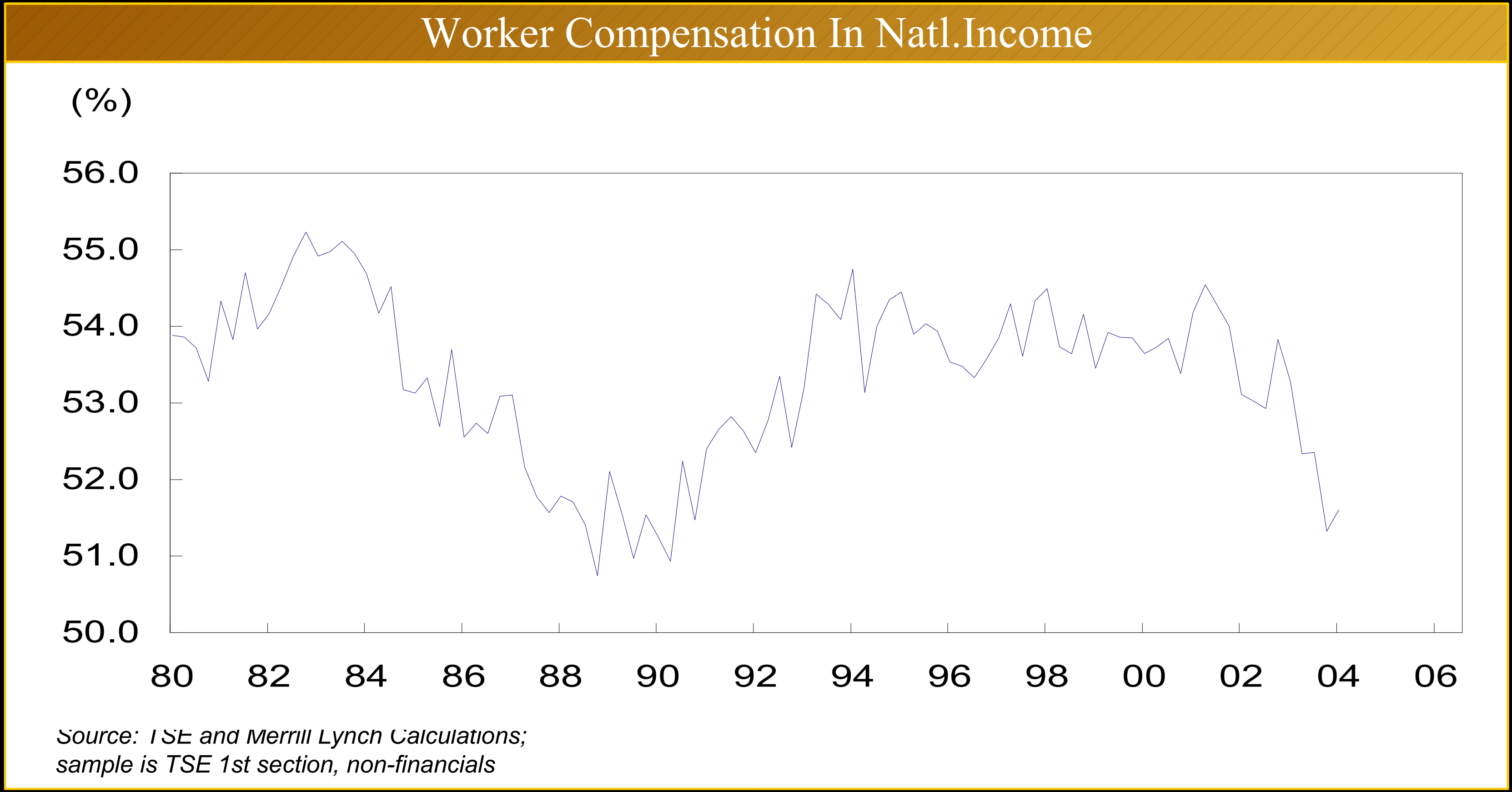
Passive Benefit: Expensive "Baby-Boomers" Are Replaced By Inexpensive "Echo Boomers"



Source: NIPSSR

A Meaner, Leaner Japan Inc.

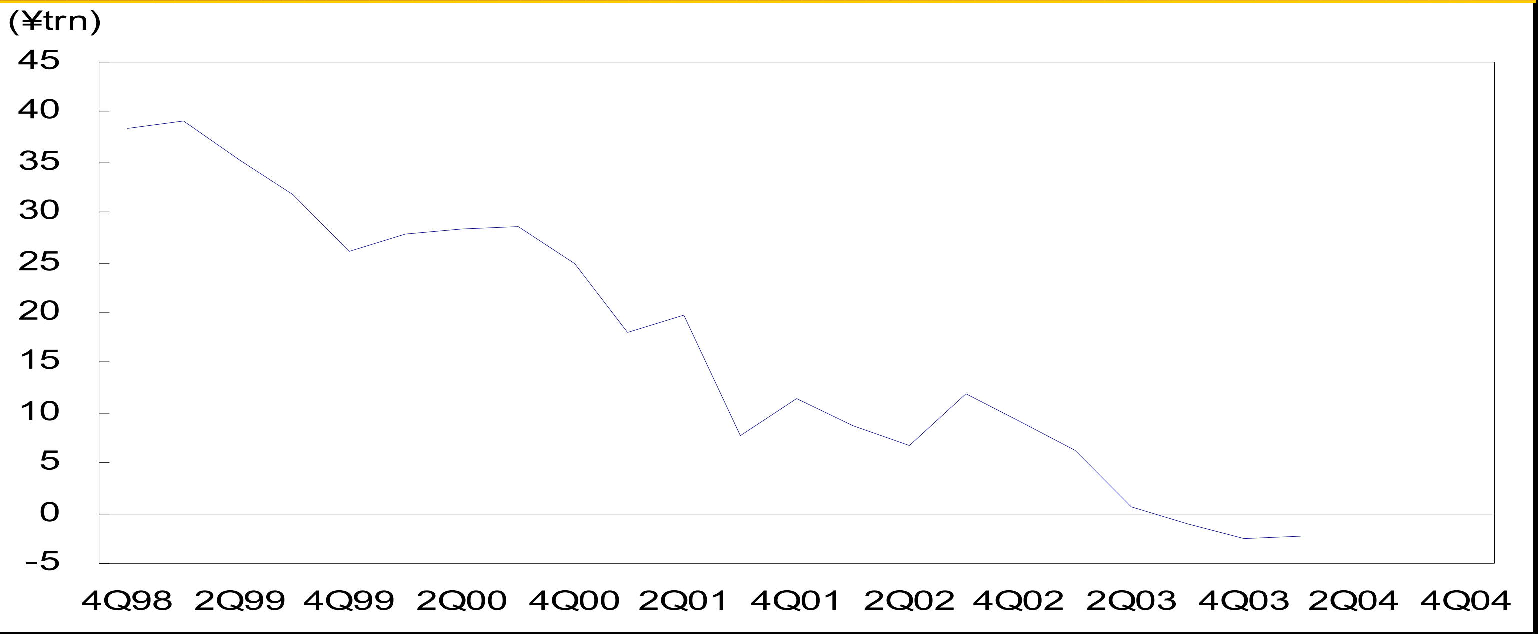
Employment Costs Down To Historic Lows



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

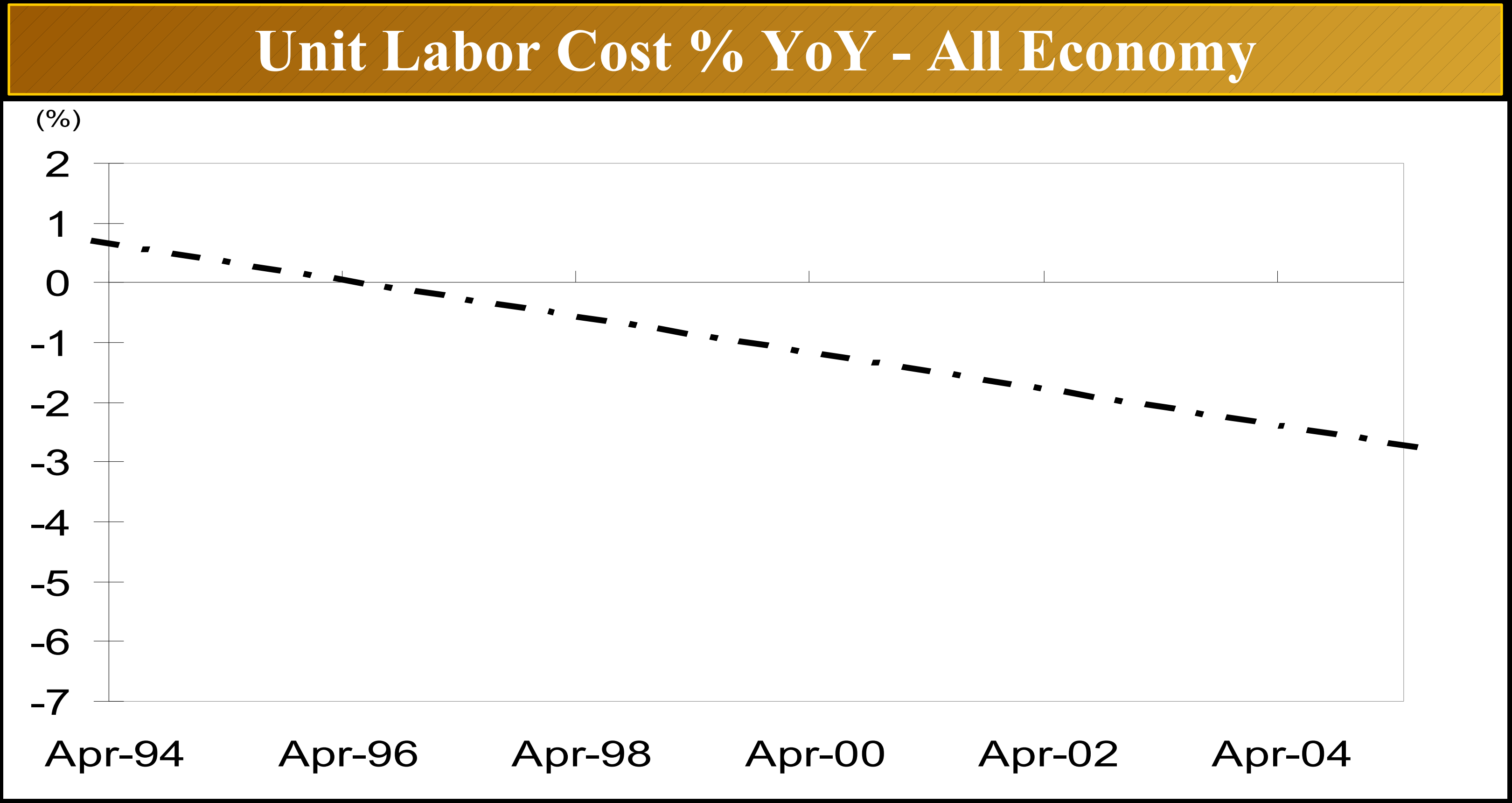
Household Savings - Yen Trillion per Quarter. Flow Of Funds Based



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

Sweet-Spot For Profits

Structural Decline In Unit Labor Costs

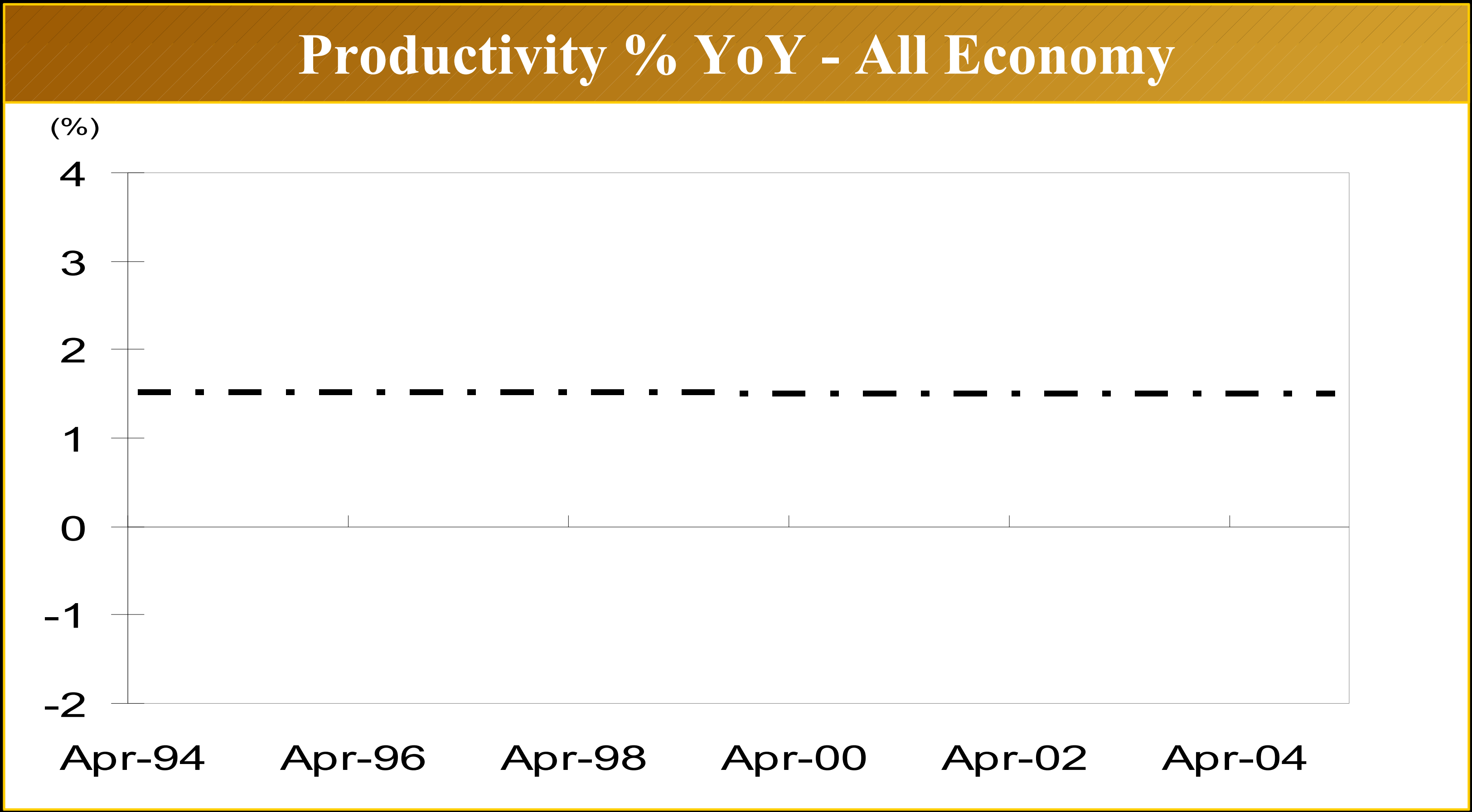


Source: METI , MoL & Merrill Lynch

Refer to important disclosures starting on page 60

Productivity: Nothing Special Yet

Productivity Boost Still Mostly Cyclical



Source: METI , MoL & Merrill Lynch

Japan Lags

Japan Leads In IT-Productivity, But Lags Everywhere Else

(% YoY)	GDP	Contribution IT Capital	Non-IT Capital	Labor
Japan				
1990-95	1.2%	0.4%	1.0%	-0.2%
1995-00	1.0%	0.9%	0.3%	-0.2%
US				
1990-95	2.2%	0.5%	0.6%	1.1%
1995-00	3.5%	1.0%	1.1%	1.4%

Source: Motohashi, METI & Merrill Lynch

Boost Only For IT-Manufacturers

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

(% YoY)	Total Productivity	IT Factors	Capital Factors	Utilization Factors	Other Factors
All Industries	1.5%	0.4%	0.6%	0.2%	0.3%
IT Manufacturers	6.2%	0.9%	1.2%	0.4%	3.7%
IT Users - Industry	1.3%	0.3%	0.6%	0.1%	0.3%
IT Users - Services	-0.2%	0.3%	0.4%	n/a	-0.9%

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

Wholesales by 1,000

Number of	1994		1999	
Employees	Companies	%	Companies	%
1 to 2	90	21.1	96	22.4
3 to 4	103	24.0	98	23.1
5 to 9	120	28.0	118	27.7
10 to 19	68	15.8	67	15.8
20 to 29	21	5.0	21	4.9
30 to 49	15	3.4	15	3.4
50 to 99	8	2.0	8	1.9
over 100	4	0.8	3	0.8
Total	429	100.0	426	100.0

Source: METI

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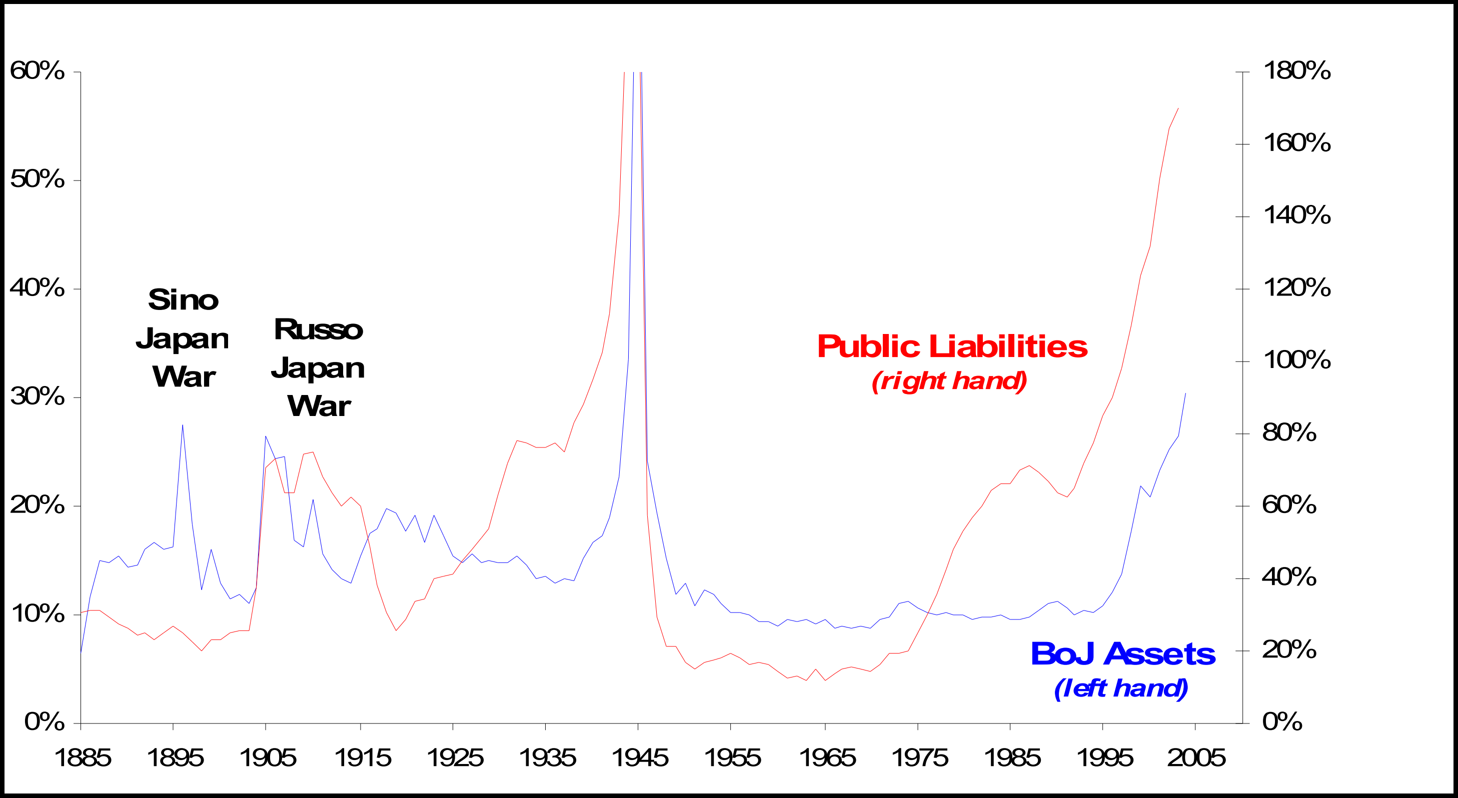
A “War Economy”

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



Source: BoJ and Mikuni & Company

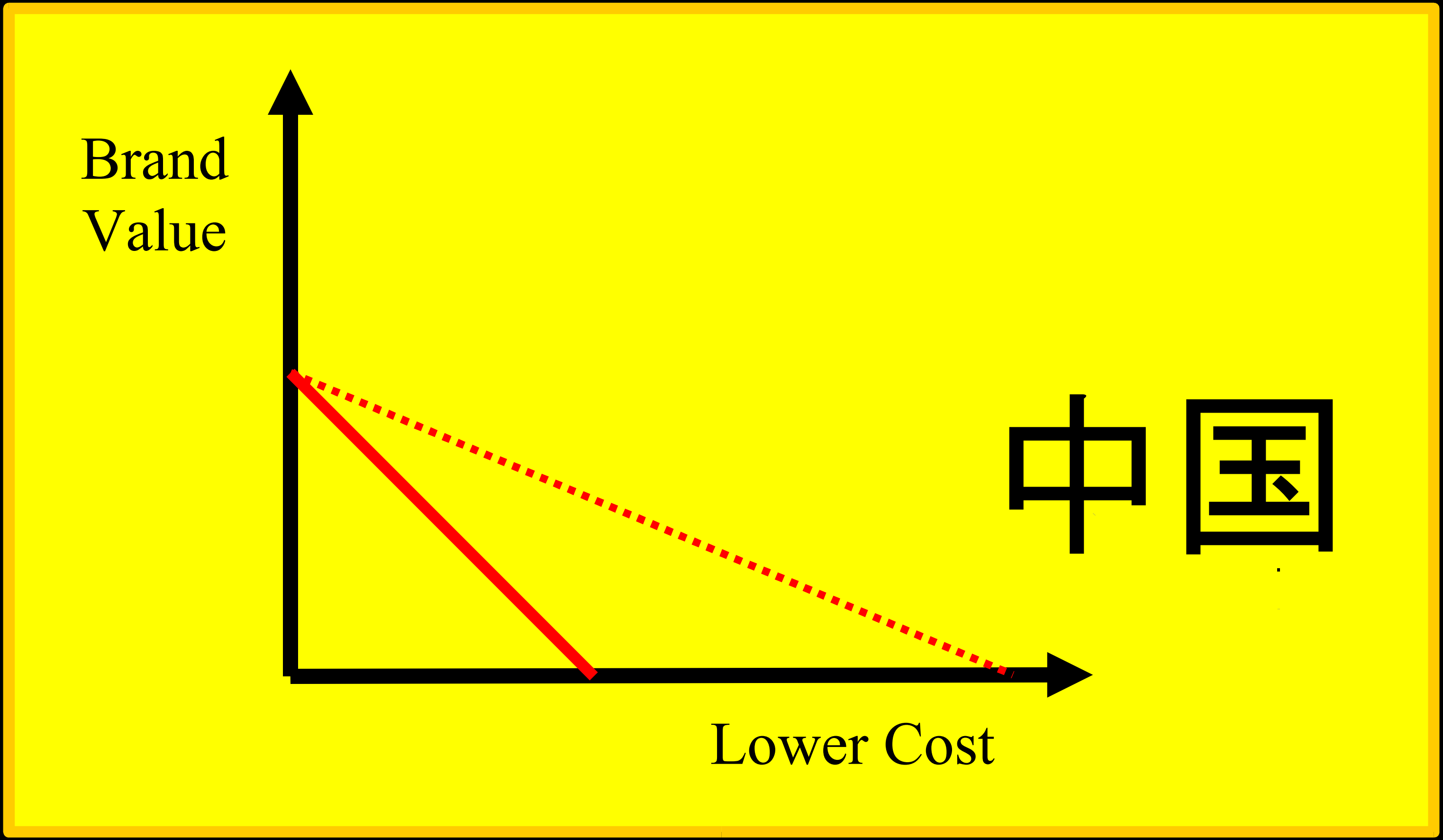
The China Challenge

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

	Wage Gap	Population Gap
England *versus* America 1881	**1.21** *(England was 1.21 times more expensive)*	**1.61** *(America was 1.61 times larger)*
America *versus* Japan 1979	**1.37** *(America was 1.37 times more expensive)*	**0.51** *Japan was 0.51 times as large)*
Japan *versus* China 2002	**32.5** *(Japan is 32.5 times more expensive)*	**10.1** *(China is 10.1 times larger)*

Source: IMF

China Challenge: End Of Cost Competition



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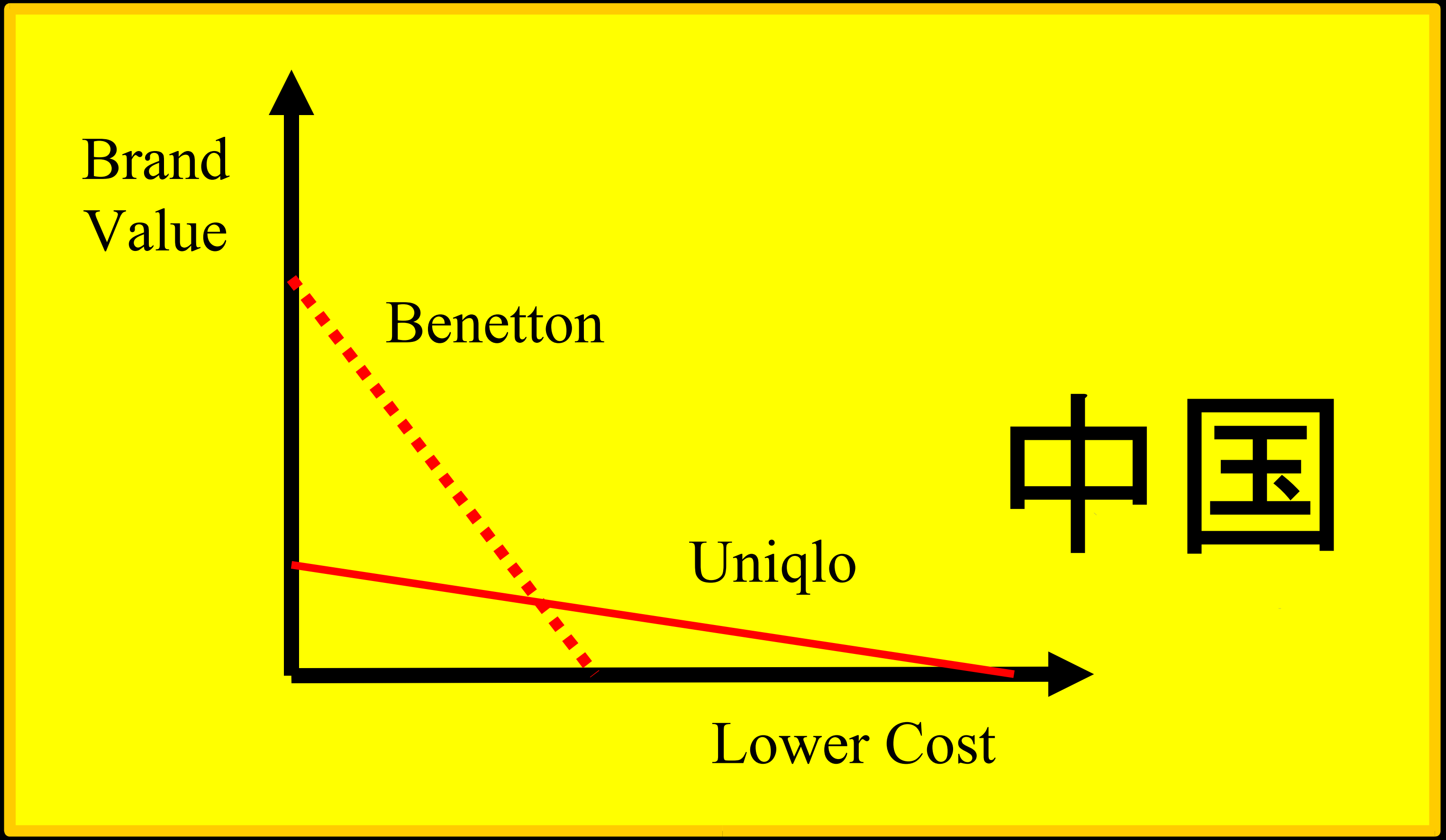
China Challenge : Start Of Brand Competition



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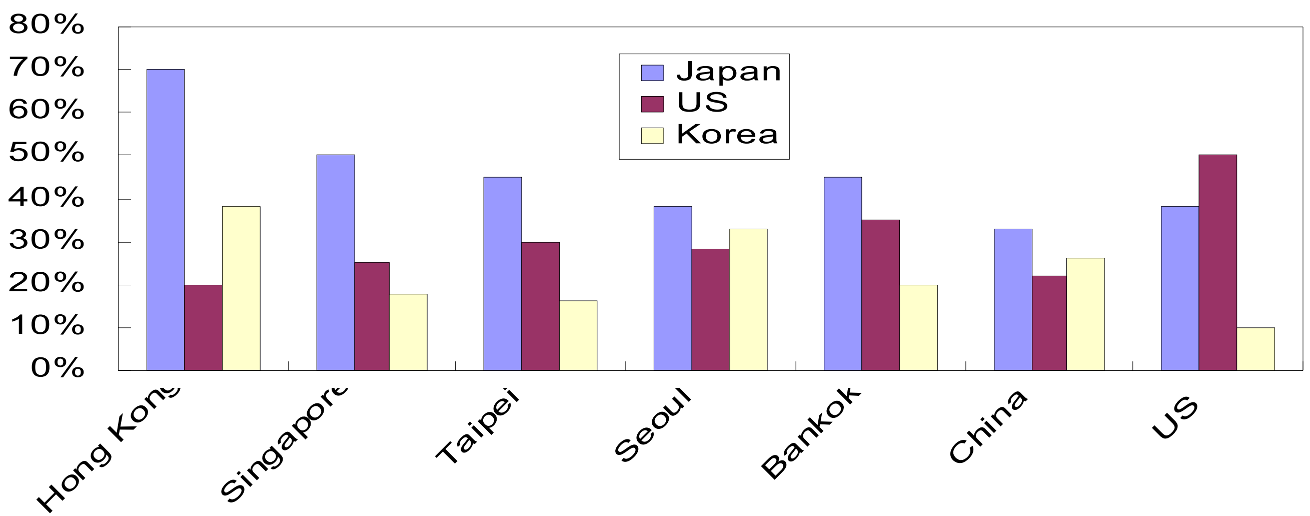
Cool Nippon

Do You Think This Country's Products Are "Cool"? Response By Consumers In Different Cities



Source: Nikkei

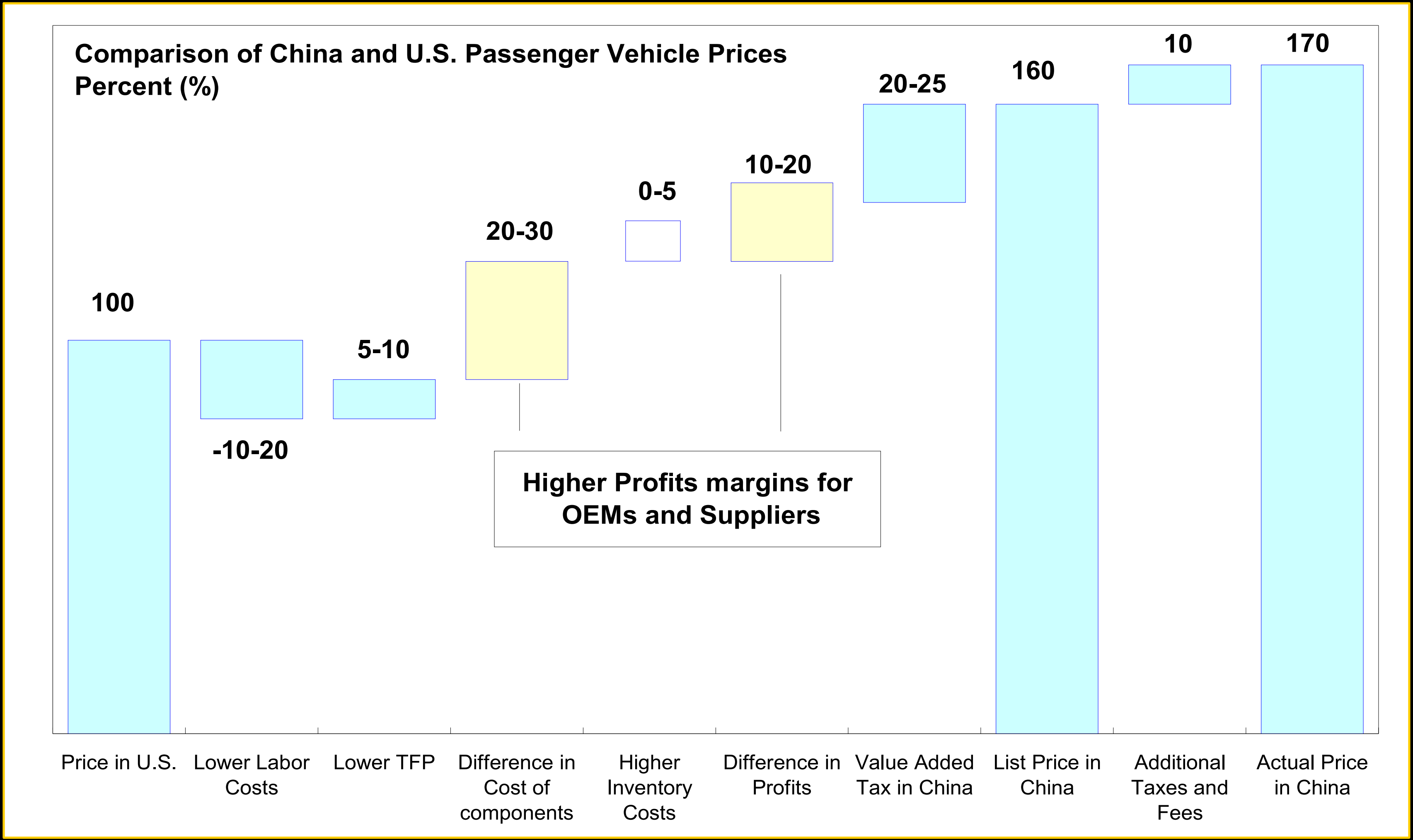
Note: China=Beijin, Shanghai, Guangzhou

Refer to important disclosures starting on page 60

The Pacific Century Gets Going

	GDP	*Growth*	*$ Growth*	
US	**11 trn**	**3%**	**330 bn**	
Japan	**4.8 trn**	**1.5%**	**72 bn**	
ASIA	**4.3 trn**	**6%**	**258 bn**	**330 bn**
China	1.4 trn	9%	125 bn	
A-Tigers	1.8 trn	6%	110 bn	
India	600 bn	5%	30 bn	
Australia	500 bn	3%	15 bn	
W.Europe	**10.2 trn**	**1.5%**	**153 bn**	**200 bn**
Accession E.	**535 bn**	**5%**	**27 bn**	
Russia	**400 bn**	**5%**	**20 bn**	

China FDI Boom - The End Of Profits?



Source: McKinsey Global Institute

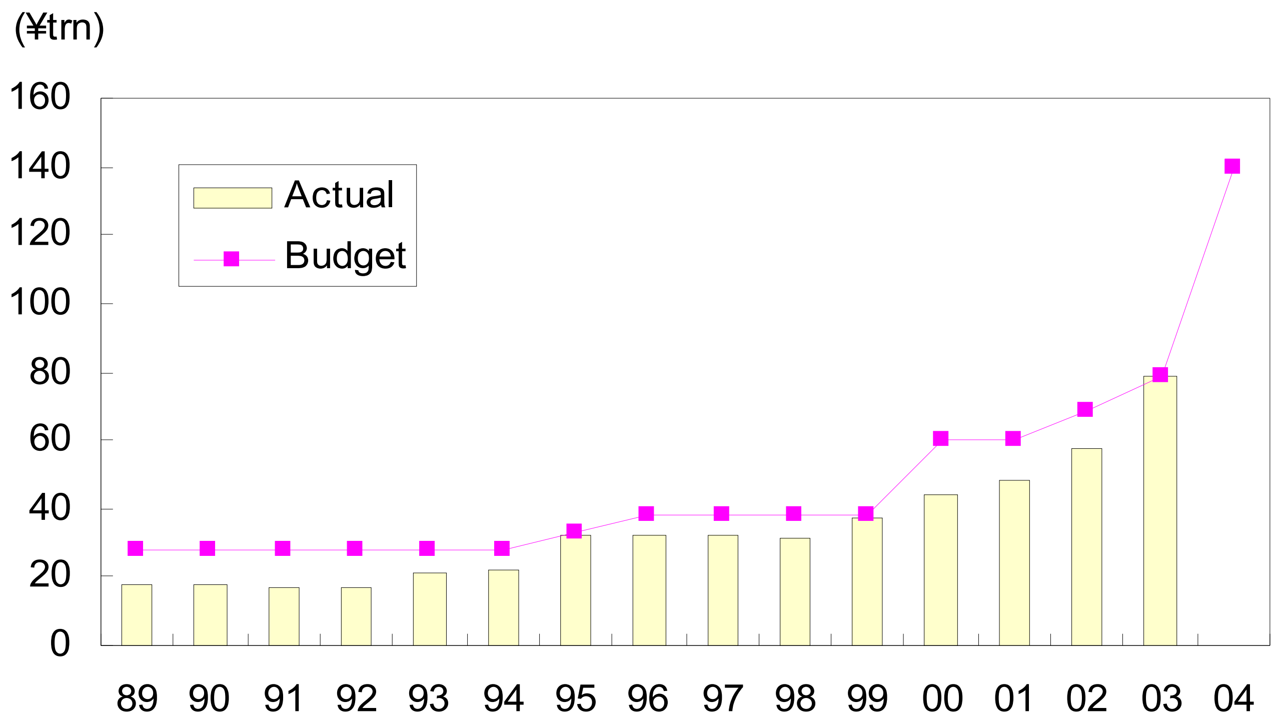
Appendix

Refer to important disclosures starting on page 60

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



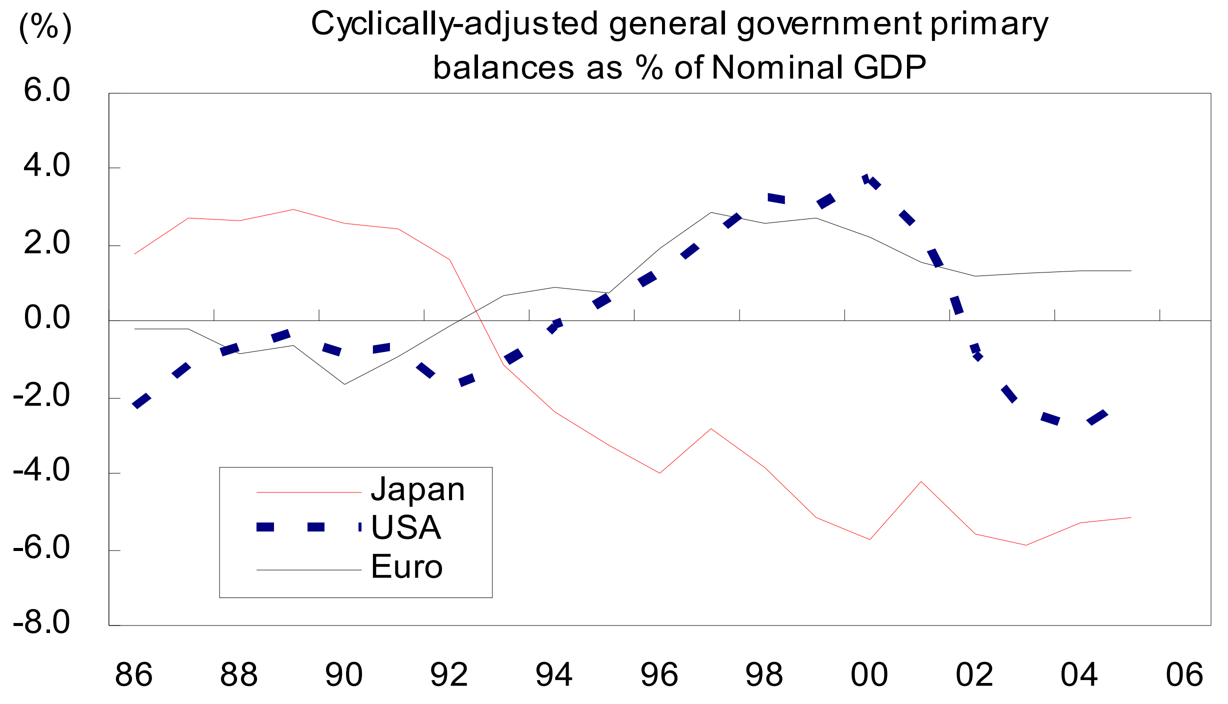
Note: bar chart is the actual amount of FX intervention bills outstanding ; the line is the budget limit.
Source: BoJ, MoF

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.



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

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

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

Source: OECD, ML Estimates

Consumer Challenge

		(Yen billion)	
2004	Oct	320	hike in employee pension contribution
	Dec	480	end special spouse tax deduction
2005	Jan	240	end special old people & retirees pension deduction
	Apr	40	hike national pension contribution
		150	hike unemployment insurance contribution
	Jun	180	end special spouse tax decuction (local tax)
	Sep	320	hike in employee pension contribution

Total 1,730 = 0.5% of disposable income

Koizumi Tax Reform Mistake?

- Fixed Tax Rate Deductions
  - Y2.6 trillion national income tax
    (0.8% of disposable income)
  - Y0.9 trillion local income tax
    (0.3% of disposable income)
- Implemented by PM Hashimoto, but technically still only temporary
- Likely to be extended into FY3/05, but need to see

Banks: Japan *Versus* U.S.

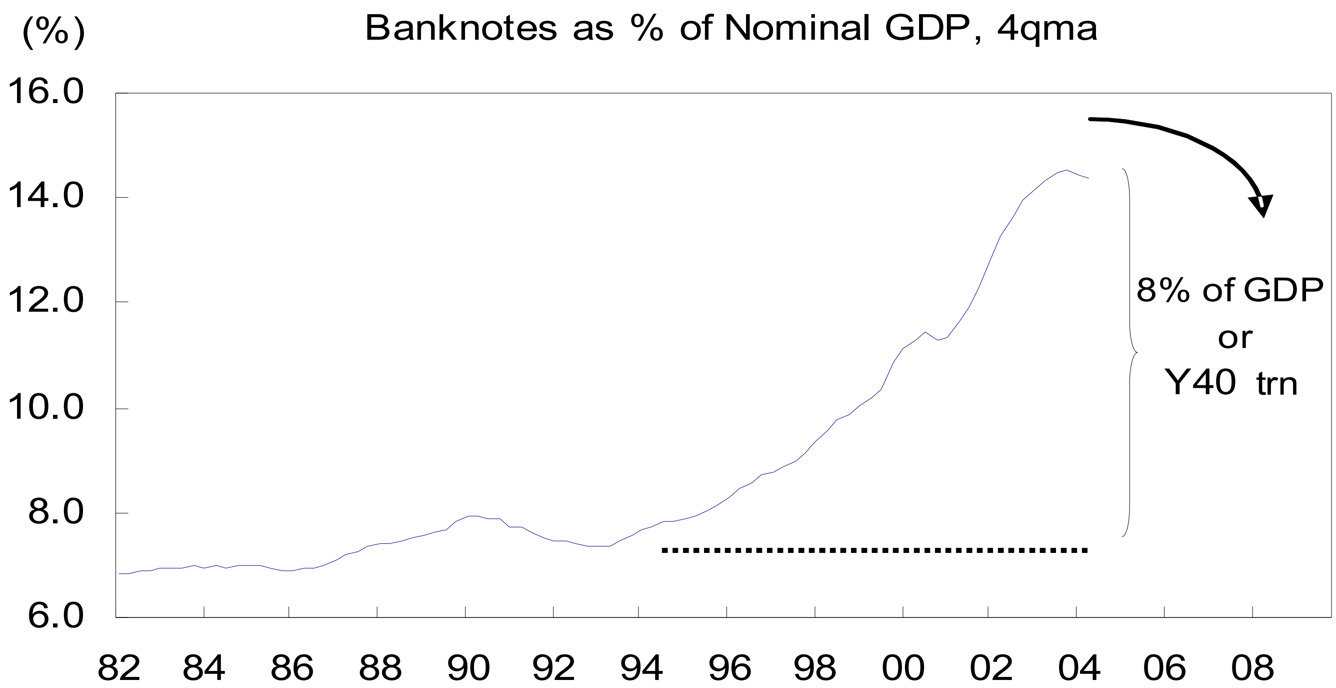
	Japan	United States
Largest Bank	MTFG or SMFG Total Assets: $1.7 trillion	Citigroup Total Assets: $1.3 trillion
Largest Deposit Market Share	MTFG or SMFG: 33%	Bank of America: 9.6%
ROA*	0.1 to 0.4%	1.5 to 2%
NPA Ratios*	5 to 8.5%	0.5 to 1.5%
Capital Ratios*	Total: 10 to 11% Tier I: 5 to 6%	Total: 11 to 12% Tier I: 7.5 to 9%
Net Int Margins	About 1%	3.5 to 5.5%
Credit Spread	Mizuho (Baa1/BBB-) 5.79% ’14: T+123	JPM (A2/A) 4.875% ’14: T+87

* 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"?

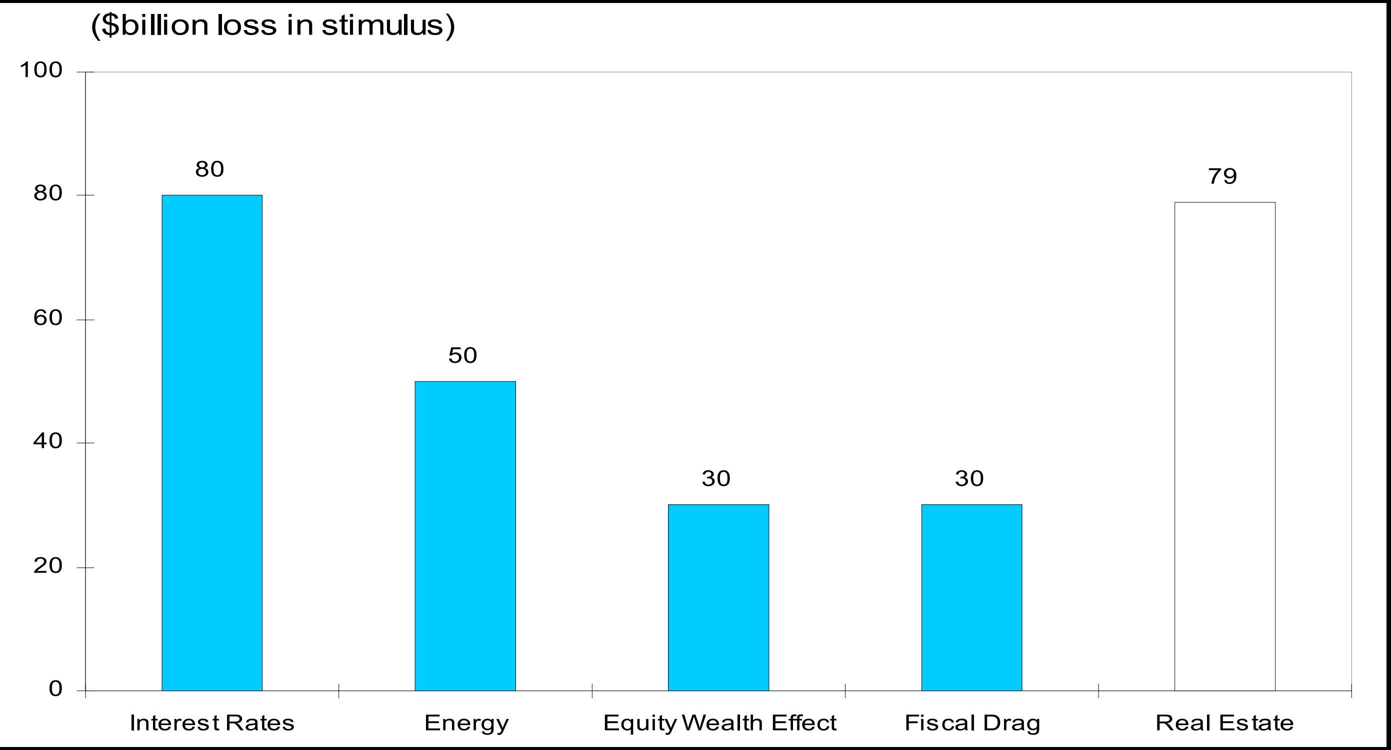
Monetary Policy Now Working : Cash Velocity Picking-Up.
Mobilization of Record-High Cash Balances Bring Positive Demand & Asset Price Effect



Source: BoJ , Cabinet Office

U.S. Consumer Headwinds

$190 billion of U.S. Household Cash-flow Needs To Be Replenished By End-2004. Another $79 billion If U.S. Home Prices Stop Rising.



Source: Hayer Analytics & Merrill Lynch

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"

Important Disclosures

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