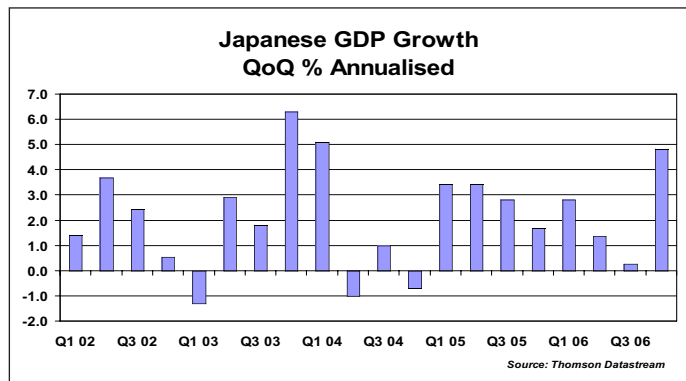
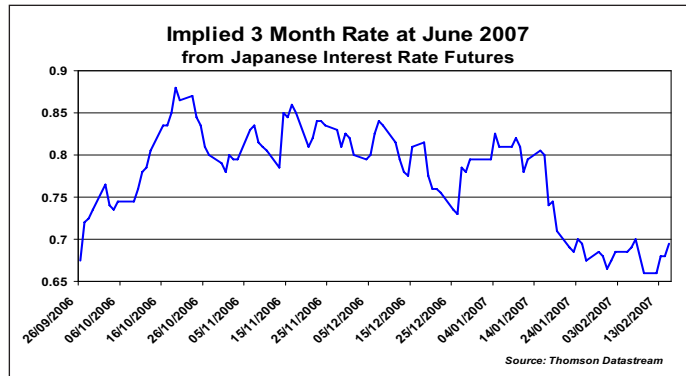


Japanese GDP Rebounds in Q4 But ... Still Only a Slow Pace to BoJ Rate Hikes and Carry Trades Look Set to Continue

The Japanese economy grew by 1.2% in Q4 2006, according to last night's preliminary data, an annualised rate of 4.8%. This is the strongest growth since Q1 2004. It is also a significant improvement on the downwardly revised 0.3% annualised rate seen in Q3 and marks the eighth consecutive quarter of positive growth. This is now Japan's longest post war economic expansion.



The data were stronger than market expectations for a 3.8% annualised growth rate in Q4. Thus, they revived speculation that the BoJ will soon move to increase interest rates. These have now been left on hold for eight months since the hike that marked the ending of the BoJ's zero interest rate policy in July last year. With the BoJ failing to hike rates at either its December or January meetings, market expectations of a near term rate hike had gradually eased in recent weeks.



The BoJ has expressed its desire to remove some of the current excess liquidity. **The Q4 GDP data, and notably a recovery in personal consumption, probably gives the BoJ the excuse to hike rates in the next couple of months if it wants to do so.** However, there is little sign of any upward pressure on prices and forward looking indicators continue to cast doubts on the strength of the domestic economy. Thus, **a Japanese rate hike in the next couple of months remains hard to justify on economic grounds alone.** Further, the government is applying pressure on the BoJ to leave rates on hold. **A rate hike next week is a close call.**

Even if the BoJ does decide to hike rates at the February or March meetings, this is unlikely to mark the beginning of a series of rate hikes. Rather, the BoJ may not move again until towards the end of the year.

Thus, **Japanese interest rates are set to remain at low levels for some considerable time. This is likely to continue to undermine the yen and give encouragement to those using the currency for carry trades.**

Rebound in personal consumption drives Q4 growth

Q4's GDP data showed a recovery in private consumption, which grew by 1.1% in the quarter. However, this reflects a rebound from largely weather related weakness in Q3 last year, when consumption fell by 1.1% qoq as adverse weather conditions suppressed consumption, with typhoons keeping shoppers at home. Thus, despite this rebound, personal consumption remains weak in yoy terms, rising by just 0.6% in Q4.

Capital spending was strong in Q4 last year as housing investment (+2.0% qoq) and public works spending recovered (+2.7% qoq). Meanwhile, inventory adjustments depressed growth by just 0.1% in the quarter, which is less than had been expected.

Export growth, though, eased to 1.1% in the quarter, reflecting in part slower US economic growth. Thus, net trade contributed just 0.2% to overall GDP growth in the quarter compared to 0.4% in Q3, but it still accounted for over one third of GDP growth in 2006 as a whole.

Still fragile domestic economy

A sustained recovery in the domestic Japanese economy relies heavily on growth in employment and household incomes feeding through into rising household spending. Real wages grew by just 0.1% in Q4 last year with wage earners' spending down 2% yoy in the quarter.

Employment growth is running at just over 0.5% per annum. Meantime, while the unemployment rate remains close to November's eight year low of 4%, it appears to be levelling off at this level. It needs to decline further if it is to feed into wage growth, boosting household spending.

It is hoped that there will be a gradual tightening of labour market conditions over the course of 2007, boosting wage levels and spurring a pick-up in household spending. There is a risk, though, that wages may not pick-up in any meaningful way, even if employment growth strengthens. Overall wage growth is being constrained as retiring baby boomers are being replaced by younger workers on lower salaries and by global competition.

Breakdown of Japanese GDP Growth

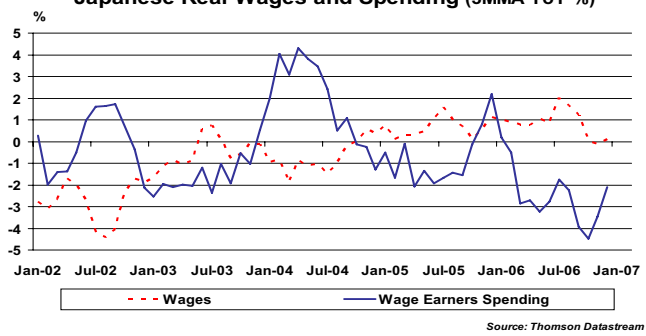
	Q3 QoQ	-----Q4-----		
		QoQ	Contrib to Qtr	YoY
Personal Consumption	-1.1	1.1	0.6	0.6
Government Spending	0.7	0.0	0.0	1.1
Investment	-0.3	2.3	0.5	3.5
Exports	2.4	1.1	0.2	6.8
Imports	-0.5	0.0	0.0	2.7
Net Trade *	0.4		0.2	0.8
Inventory Change *	0.2		-0.1	0.1
GDP	0.1	1.2	1.2	2.1

Deflators	Q3 YoY	Q4 YoY
- GDP	-0.7	-0.5
- Domestic Demand	0.2	-0.1

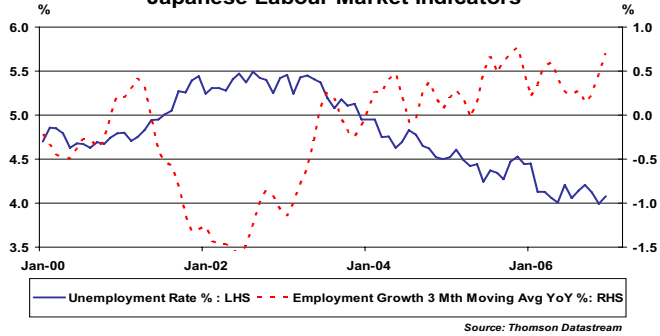
* Contribution to Growth

Source: Japanese Cabinet Office

Japanese Real Wages and Spending (3MMA YoY %)



Japanese Labour Market Indicators



Moderate economic recovery should continue

Thus, the jury remains out on the strength of personal consumption. Indeed, it may well have been dampened by the unseasonably warm weather at the start of 2007. The fact that the economy continues to struggle to pull out of its deflationary phase is also giving consumers little incentive to spend.

However, exports (which remain crucial to economic expansion) should continue to benefit from the weaker yen and from the strength of the global economy, with net trade providing a boost to overall growth. Meanwhile, the corporate sector remains robust, and should also benefit from the weakness of the exchange rate and decline in oil prices from last year's highs.

On the assumption that consumer demand begins to pick-up over the course of 2007, we look for GDP growth this year of 2.2%, as is 2006.

Economy struggling to pull out of deflation

While the Q4 GDP deflator remains well into negative territory, it did though pick up to -0.5% yoy from -0.7% in Q3. Further, nominal GDP exceeded real GDP in Q4 2006 for the first time since Q4 2004. The domestic demand deflator, meanwhile, hovers at close to the zero level, at -0.1% yoy in Q4 last year.

However, the core inflation rate (the BoJ tends to focus on the CPI rate excluding fresh foods) having edged above zero, appears to have stalled. Thus, as yet, there is little sign of any upward pressure on prices. In the absence of a resurgence in oil prices, it is possible that inflation on this measure could dip back into negative territory over the summer months as last year's increases in oil prices and some processed food prices fall out of the calculation.

Government pressure a restraint on BoJ

One of the reasons that the BoJ refrained from hiking rates in December and January, despite market expectations of such a move, was government pressure. Members of the government have been quite vocal in expressing their concerns about the weakness of the domestic economy and the need to keep interest rates low to foster growth.

Under the current BoJ Law, the Bank has independence on interest rate decisions. Although it has not chosen to exercise it in recent months, the government does have the right to ask the BoJ to defer a decision to change rates for one month. The BoJ then has to vote on whether to accede to the government's request.

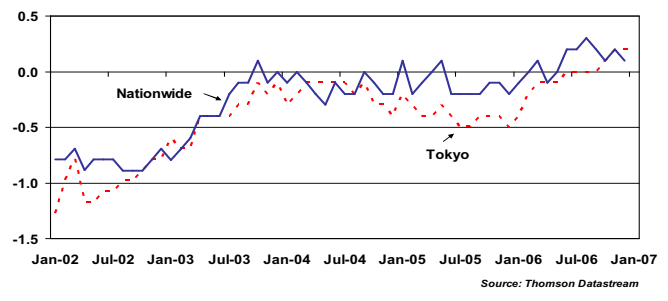
There has been some discussion in recent months by members of the ruling LDP party about the possibility of reforming the BoJ Law. This is likely to add to caution by the BoJ in its interest rate deliberations. Should it hike rates and then find that the economy slows, this would heighten the risk of a reform of the BoJ Law and loss of some of the Bank's autonomy.

Key Japanese Economic Forecasts

	2005	2006	2007f
GDP	1.9	2.2	2.2
CPI- Headline	-0.3	0.3	0.4
CPI - Core	-0.1	0.1	0.2

Source: Thomson Datastream, forecasts AIB ERU

**Japanese Core CPI (Ex Fresh Food)
YoY % Change**





Bank of Japan has excuse to hike rates

The Q4 GDP data, and in particular the recovery in personal consumption, though, probably gives the Bank of Japan the leeway to raise rates at next week's meeting. One third of the members voted to hike rates at the last meeting in January, an unusually large split for the BoJ. Since then, the global outlook has improved. There have been signs that the US economy may not be slowing as much as feared, while the European economy is performing strongly.

Japanese Interest Rate Forecasts					
	O/NCall Rate	3 Mth	1 Year	2 Year	5 Year
Current	0.25	0.52	0.61	0.92	1.39
Mar 07	0.50	0.70	0.90	1.10	1.50
Dec 07	0.75	0.95	1.05	1.25	1.70

* Swap rates beyond 1 year
Current rates are sourced from Reuters, forecasts from AIB ERU

However, given that there is little sign of any upward pressure on prices and that forward looking indicators continue to cast doubts on the strength of the domestic economy, a Japanese rate hike remains hard to justify on economic grounds alone. Further, the government is applying pressure on the BoJ to leave rates on hold. Despite the strong GDP data, a rate hike next week is a close call and, indeed, a move over the next couple of months is by no means certain.

Only slow pace to rate hikes

Even if the BoJ does decide to hike rates at the February or March meetings, this is unlikely to mark the beginning of a series of rate hikes. Indeed, on the assumption that the BoJ hikes rates in the next couple of months, they may well not move again until towards year end.

Weak yen no reason to hike rates

Bank of Japan policy is aimed at price stability and economic growth and not at moving the exchange rate. In any event, a 0.25% rate hike is unlikely to spark a strong yen recovery given that rates would still remain low on international comparisons. Only if a Japanese rate hike was seen as the beginning of a long tightening path, as was the case in the US for example, would it be likely to provide any lasting support to the yen.

Meanwhile, the tone of comments in the lead up to, and following, the recent G7 meeting indicate that intervention is a distant threat.



Japanese Exchange Rate Forecasts (mid-point of trading range +/- 2.5%)			
	Yen/EUR	Yen/US\$	Yen/GBP
Current	157.8	120.0	235
Q1-2007	157.5	120.5	237
Q2-2007	157.5	120.5	235
Q3-2007	154.5	117.5	229
Q4-2007	151.5	114.5	223

Current rates are sourced from Reuters, forecasts from AIB ERU

Carry trades look set to continue

With interest rates set to remain low, there will be continued encouragement to those wishing to use the yen for carry trades. The fact that the yen could remain relatively weak for some time serves to diminish the risk that these could unwind significantly in the near term.

Jenny Pollock
15th February 2007