

### Economic

**Nominal GDP (2006):**  
USD 4,367 bn

**Population (2006, mn):**  
127.5

**Share of Global Economy:**  
6.4%

**Trade Dependency (2006):**  
26%

**Merchandise imports from Canada (2006):**  
CAD 9.2 bn

**YTD Merchandise Imports from Canada: (Jan-Apr 2007)**  
CAD 4.0 bn

**Largest Merchandise Export Destination:**  
United States (23%)  
China (14%)

**Main imports:**  
Petroleum  
Machinery  
Food  
Chemicals

**Main exports:**  
Autos  
Electrical Machinery  
Mechanical Machinery  
Industrial Goods

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October 2007

**Market Spotlight:** Japan scored yet another trade surplus in August. ■ Industrial production increased strongly (3.4%) after a hard drop in July (-0.4%) ■ Retail sales and Household expenditure were positive after three months of very poor performance. ■ Business sentiment remains positive among large corporations and negative among medium and small sized firms ■ CAPEX fell by 4.9% y/y in the second quarter ■ Unemployment rose to 3.8% in August versus 3.6% in July. ■ CPI fell by 0.2%. ■ Japanese government Leading Indicators Index fell abruptly from 72.7 to 30.0 in August, a key signal of impending near term economic slowdown.

**Overview:** Exports will continue to be the main driver of Japanese growth, as the consumer remains weak overall and capital investment keeps slowing down. Much of this year's strong growth has already happened and even though we expect a small rebound in the third quarter, GDP will moderate over the forecasted horizon. We have revised down our GDP forecast to 1.9 % in 2007 and 1.7% in 2008.

**Consumption:** August retail sales rebounded 0.5% y/y and household expenditure increased by 0.4% m/m over the same period. However this is nothing to get too excited about as it is expected that the consumer will remain very weak for the rest of the year and 2008. A good indicator of that is the fact that Consumer confidence remains low with the benchmark index dipping to 44.6 in August versus 45.2 in July. The index has been trending down since the beginnings of the year. Moreover, real income fell 1.4% y/y and the unemployment rate increased from 3.6% in June to 3.8% in August. This suggests consumer's precautionary behavior is probably not going to be reversed any time soon.

Deflation continues being a burden for Japan and a factor which will keep a lid on consumption. CPI fell by 0.2% in August y/y. Weak consumer spending and lower input prices have seen the index fall in each of the last seven months.

**Investment:** Machinery orders increased 17% m/m (SA) in July, the biggest increase in almost a year. However, cumulative figures show that machinery orders have actually dropped 4.2% y/y for the period between Jan and July. Moreover, Capital expenditure dropped by 4.9% y/y in the second quarter. On net, data suggest that Japan's economy may be facing a cyclical downturn. It is expected that investment will keep decelerating over the rest of the year before slowly picking up in 2008.

**Manufacturing:** August manufacturing output increased an outstanding 3.4% m/m (SA), more than offsetting a 0.4% drop in July. The strongest performance was in the electronic parts and devices industry (13.1%). Demand for manufactured goods continues to come mostly from overseas, in particular from China and EU. We expect that as the European consumption slows down, so will exports to the EU. The Tertiary sector activity Index was weak for July, falling by 0.5% y/y, as a result of decreased activity in consumer goods and services.

Overall results from the Tankan Survey show that business confidence remains very strong in the third quarter (+23). However a closer look reveals that these results reflect mostly the opinion of the large export oriented corporations. Medium and small sized firms (mostly domestic market oriented) have actually seen confidence drop from +13 to +10 and from +6 to +1 respectively.

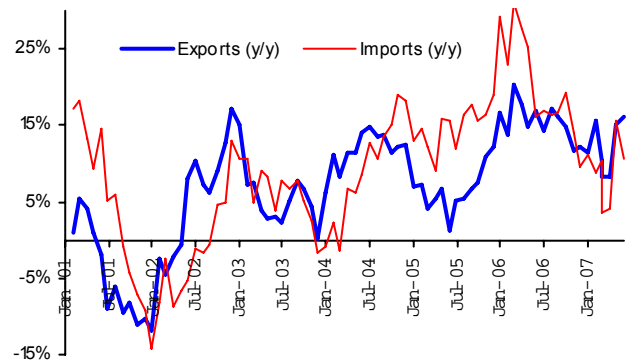
**External Sector:** Japan scored another trade surplus in August. Exports to China (+23.8% y/y) and the EU (+15.6% y/y) continue rising at a very fast pace. Exports to the US also increased by 4.7% y/y. Import growth however, slowed to 5.7% y/y, helping to boost the trade surplus.

#### Monthly Indicators

	Mar-07	Apr-07	May-07	Jun-07	Jul-07	Aug-07
CPI Inflation (y/y)	-0.1	-0.2	-0.1	-0.2	0.0	-0.2
Exports (SA, m/m)	0.3	0.4	2.9	1.1	1.1	1.1
Imports (SA, m/m)	-8.3	1.7	8.2	1.0	0.3	-1.9
Unemployment	4.0	3.8	3.8	3.7	3.6	3.8
Retail Sales (y/y)	-0.7	-0.6	0.1	-0.4	-2.3	0.5
Ind. Prod. (SA, m/m)	-0.3	-0.2	-0.3	1.3	-0.4	3.4
Housing Starts (y/y)	5.5	-3.6	-10.7	6.0	-23.4	-43.3
Nikkei 225 Index	17288	17400	17876	18138	17249	16569
Yen/USD	118	119.5	121.81	123.18	118.6	115.8

Sources: Bloomberg, EDC Economics

Trade growth coming off its peak



### Special Issues

#### Another Real State Bubble in Japan?

Nationwide, Japanese commercial land prices rose an average 1% between June 2006 and June 2007. This marked the first annual increase dating back 16 years when the real estate bubble burst. Land prices in the main urban centers (Tokyo, Osaka and Nagoya) are up a more impressive 19% over the same period while commercial properties in these centers are up about 5%.

Some big companies such as Goldman Sachs (200 bn YEN) and Morgan Stanley (281 bn YEN) are starting to invest heavily on Japanese real estate market. Assets in private real estate funds rose 40% in the 12 months ended in June 2007.

This is nothing to be worry about yet, since for now it is only a few isolated investors driving prices higher. However it is something worth to keep an eye on over the next few years.

With GDP growth slowing down, specially in Europe and the US, together with the recent strength in the YEN, it is expected that exports will decelerate in Japan, contributing to a slower GDP growth for the rest of 2007 and 2008. It can be seen in the data already that exports are coming of their peak.

**Monetary Policy** – Money supply grew 1.8% y/y in June and The Bank of Japan decided unanimously to keep its overnight interest rate unchanged at 0.5% one more time. We now think that rates will remain on hold for the next month given recent weak results for Capital Expenditure and in order to prevent any serious GDP slow down over the coming quarters.

Along with the implications of the recent increase in global risk aversion, which has driven up global bond yields, increased currency volatility, a stronger YEN, and uncertain expectations about Bank of Japan interest rates hikes are enhanced risks facing the YEN carry trade.

**The bottom line** – *The story remains the same for the Japanese economy. Weak consumer, reasonable level of investment and very strong external demand that will slowdown as the world economy slows down.*

#### Economic Indicators (% change)

	2005	2006	2007(f)	2008(f)
GDP (%)	2.4	2.2	1.9	1.7
Personal Consumption (%)	1.5	0.9	0.5	0.8
Business Investment (%)	6.6	7.7	5.0	5.0
Exports (%)*	6.9	10.0	12.0	10.0
Imports (%)*	5.8	5.0	8.0	6.0
Current Account (% GDP)	3.6	4.2	4.7	4.7
Consumer Prices (% avg.)	-0.3	0.2	0.0	0.2
Unemployment rate (%)	4.4	4.1	3.8	3.8

\* Balance of Payments

Sources: EIU, EDC Economics