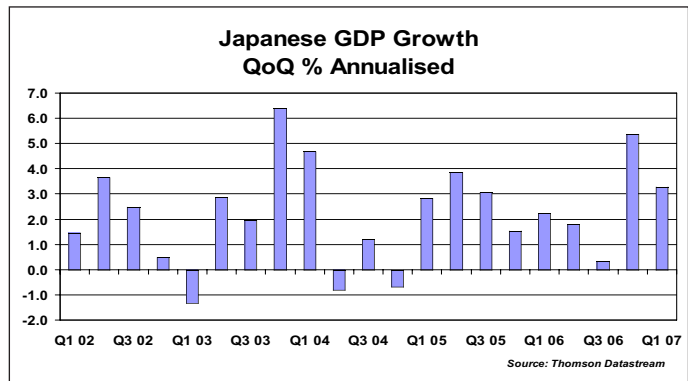


Gradual Rising Trend to Japanese Rates

August Move Still on The Cards - Though Data Dependent

There was no surprise in last week's decision by the Bank of Japan to keep rates on hold for another month. The fact, though, that only one dissenter voted for a July rate hike did surprise many. However, **it is just a matter of timing as to when rates will be increased again, though overall the pace of monetary tightening will remain very gradual.**

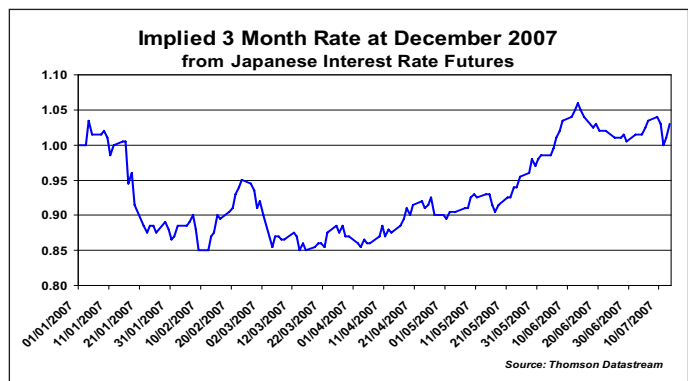
The economic recovery continues. The economy has now grown for nine consecutive quarters. Indeed, this is now Japan's longest post war economic expansion. **GDP grew by 0.8% in Q1 2007**, an annualised rate of 3.3%. While this is a significant slowdown from the 5.0% annualised rate recorded in Q4 2006, it is **well above the potential growth rate for the economy** (estimated by the OECD at around 1.7%).



Inflationary pressures, though, remain subdued with the nationwide core inflation rate for May still in negative territory. Other data, though, indicate that prices outside the consumer sector are rising. Furthermore, the Bank of Japan **Governor, Fukui, has indicated that sluggish consumer prices will not be an impediment to a rate rise, as the BoJ believes they will gradually rise over time.**

Activity data continue to paint a somewhat mixed picture. However, Fukui noted, following last week's policy meeting, that none of the MPC members were worried that the economy would undershoot the BoJ's forecast. Furthermore, he said that the Bank would undoubtedly hike rates if its economic scenario is met.

The tone of BoJ rhetoric has cemented expectations of a 0.25% rate hike in the coming months, bringing the OCR to 0.75%. While we continue to believe that the pace of monetary tightening will remain gradual, **an interest rate hike as early as next month is certainly on the cards, provided the data continue to support the BoJ's view of a gradual economic recovery.**



There are risks that could delay a move, notably a sharp slowdown in growth in Q2 growth, with GDP data due in mid-August, even though Fukui has already said that he expects the data to be soft. The strength of the US economy is also very important for external demand. However, assuming that the BoJ does hike rates in August, or if not in September, we anticipate one further rate hike before the end of the fiscal year in March 2008, provided the data confirm that the economy remains on a solid growth path and that deflationary pressures have eased.

Personal consumption and exports drive Q1 growth

GDP data confirm that consumer spending (which accounts for more than half of overall GDP) remained firm in Q1 2007. It grew by 0.8% in the quarter after the 1.1% growth in Q4 2006. Strong service sector spending would appear to be a significant driver of personal consumption, helped by warm weather. Meantime, the launch of Microsoft's Windows Vista operating system encouraged people to replace their personal computers.

Corporate sector capital spending, which has been one of the engines for growth, also remained firm in Q1, increasing by 0.3% in the quarter. However, other aspects of domestic demand were weak. Private residential investment declined by 0.5%, government spending by 0.1% and public investment by 1.2%. Thus, domestic demand contributed just 0.3% to growth in the quarter.

Meanwhile, external demand contributed 0.5% to GDP growth in Q1 2007. Exports remained strong (+3.3% in the quarter), with a slowdown in exports to the US more than offset by continuing support from Asia.

Consumer sector recovering

Private consumption now appears to be gaining a firm footing and, along with exports, is likely to continue driving economic expansion. However, in Q1 this year consumer spending was boosted by some once off factors and growth is likely to slow in the coming quarters. An increase in local "residence" tax, which takes effect in June, may further depress spending. Its impact, though, will be limited to the extent that it, in part, represents a transfer from other forms of taxation.

Tame wage growth needs to pick-up if the recovery in personal consumption is to continue. However, labour market conditions continue to tighten. The unemployment rate dipped to 3.8% in April, the first time it has fallen below 4% since February 1998, and held steady at this low level in May.

Provided this gradually tightening of labour market conditions continues, then wages should start to pick-up, bolstering consumer spending. Some structural factors, such as the retirement of baby-boomers, along with public-sector pay cuts, are acting as a drag on overall wage growth, though. Encouragingly, against the background of still sluggish wage growth,

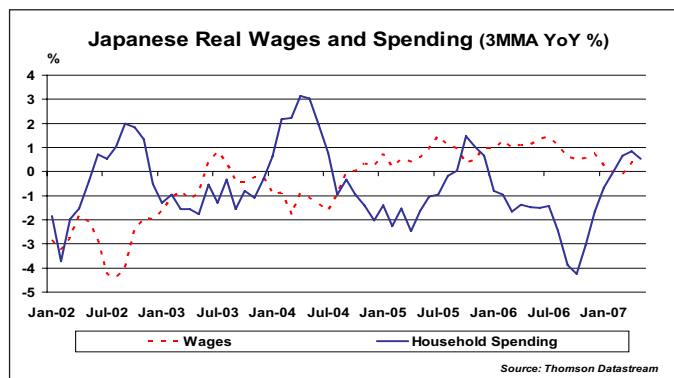
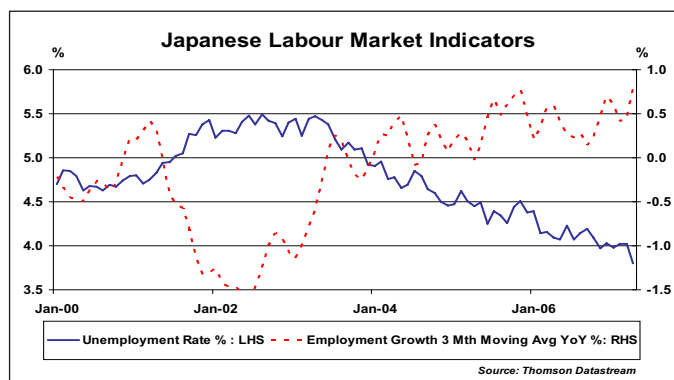
Breakdown of Japanese GDP Growth

	Q4 06		Q1 07	
	QoQ	QoQ	Contrib to Qtr	YoY
Personal Consumption	1.1	0.8	0.4	1.4
Private Residential Inv.	2.2	-0.5	-0.0	-0.4
Private Capital Spending	2.3	0.3	-0.0	7.0
Government Spending	0.1	-0.1	-0.0	1.2
Public Investment	4.0	-1.2	-0.1	-8.0
Exports	0.8	3.3	0.5	7.4
Imports	-0.1	0.4	-0.1	1.3
Net Trade *	0.1		0.5	
Inventory Change *	-0.1		0.0	
GDP	1.2	0.8	0.8	2.6

Deflators	Q4 06 YoY	Q1 07 YoY
- GDP	-0.5	-0.3
- Domestic Demand	-0.1	-0.1

* Contribution to Growth

Source: Japanese Cabinet Office



household spending is beginning to pick-up, growing by 0.5% year-on-year in real terms in the three months to May. Apart from wage growth, consumer spending should also benefit from lump-sum payments to the retiring baby-boomer generation. Some pick-up in land prices should also be supportive of consumer sentiment.

Economic growth rate to weaken back below trend in Q2

As the consumer sector recovers there have been concerns, though, about the corporate sector's continued contribution to growth, particularly in terms of investment. However, machinery orders, though still not particularly strong, rose for the second month in a row in May with, notably, a recovery in electrical machinery. Furthermore, the June Tankan report showed that companies plan to increase their capital expenditures. Spending plans, though, point to only a gradual increase in business investment.

The June Tankan survey showed that large companies maintained their optimism about business conditions seen three months earlier. However, sentiment amongst smaller companies appears to have deteriorated somewhat. Overall, the corporate sector recovery would appear to be continuing but, as yet, without any strong upward momentum. The trend in industrial production also bears careful watching. Output fell in May for the third month in a row, again led by a decline in production of electronic parts and devices. A continuing weakening trend in the production of IT related goods would raise concerns about Japan's economic outlook.

However, the weak yen should continue to provide support to the external sector of the economy. Nevertheless, a slowdown in exports is likely in Q2 after the very strong performance in Q1 this year and as the slowdown in the US economy impacts.

Thus, overall, the pace of growth may dip back to around 1-1.5% annualised in Q2 this year, below its trend rate. However, growth should recover to around 2% in the second half of 2007. **Fukui has said that he expects the Q2 growth figures to be soft. However, if the data disappoint, particularly personal consumption, then this may still be enough to persuade the BoJ to stay its hand for another couple of months.**

Key Japanese Economic Forecasts

	2006	2007f	2008f
GDP	2.2	2.4	2.2
CPI- Headline	0.2	0.1	0.5
CPI - Core	0.1	0.0	0.5

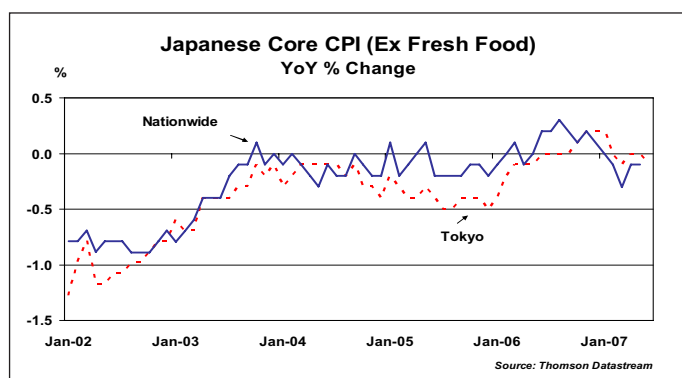
Source: Thomson Datastream, forecasts AIB ERU

Deflationary pressures are easing

Meanwhile, inflationary pressures remain subdued. Having ended 2006 in positive territory, **nationwide core prices have fallen in year-on-year terms in recent months** and they declined by 0.1% in May. **The core CPI rate is expected to remain at around, or possibly below ,zero in the near future.** However, after the recent strong rise, oil prices (in yen terms) are now higher than they were a year ago. Thus, should oil prices continue at current levels this will begin to put upward pressure on the year-on-year inflation rate. This is in contrast to the negative basis effects from lower oil prices, earlier in the year.

Despite the current negative consumer price inflation rate, the BoJ remains of the view that deflationary pressures are gradually easing. Indeed, corporate services prices were stronger than expected in April, rising by 1.1% year-on-year, the biggest increase in nearly a decade.

Wholesale prices also continue to increase, rising by 2.3% year on year in May, on the back of high crude oil and gasoline prices as well as the weak yen. Furthermore, a rise of





1.4% year-on-year in the prices of final consumer goods indicates that companies are gradually passing on higher wholesale prices to consumers.

Meanwhile, the pace of decline in the GDP deflator slowed to -0.3% in the Q1 this year from -0.5% in Q4 2006. Furthermore, the GDP deflators indicate rising prices outside the consumer sector. Across all sectors, though, price rises are patchy, with many companies reluctant to risk still fragile pricing power.

The Cabinet office reported that there was a positive output gap in Q1 2007, for the second successive quarter. Indeed, it widened to 0.7%, from 0.5% in Q4 2006, underpinning the BoJ view that deflationary pressures should gradually ease.

A rate hike as early as August is possible - though move remains data dependent

While economic trends remain the main catalyst for tightening, the BoJ cannot ignore the impact of its policy on asset prices and currencies. The BoJ is undoubtedly wary that by keeping interest rates too low for too long this could hurt the economy through the excessive build up of both yen carry trades and real estate investment. Land prices have been picking up in the big cities recently.

With the economic recovery continuing and indications that deflationary pressures are easing, the BoJ has adopted a more hawkish tone, underlining a desire to continue with its policy of gradual monetary tightening. Indeed, the central bank appeared to lower the barrier for a rate hike earlier in the year, by saying that rates could be raised while consumer prices are still falling.

Japanese Interest Rate Forecasts					
	O/N Call Rate	3 Mth	1 Year	2 Year	5 Year
Current	0.50	0.75	1.00	1.22	1.68
Sep 07	0.75	0.95	1.05	1.25	1.70
Dec 07	0.75	1.00	1.10	1.30	1.75
Mar 08	1.00	1.20	1.30	1.50	1.90

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

Thus, provided there are no shocks from the data over the next few weeks to change the view of a sustained recovery in private consumption and easing in inflationary pressures, the BoJ could well hike rates as early as its 22nd/23rd August meeting. The tone of BoJ rhetoric would support the view of a rate hike in August or September. Even though the core CPI inflation rate could still be negative at this point, the BoJ has indicated that this would not to be a deterrent to a rate hike, provided it remains convinced that deflationary pressures continue to ease.

By the August meeting, the BoJ will have the benefit of preliminary Q2 GDP data. While these are likely to show that the overall growth rate has slowed significantly, the BoJ has already stated that it is anticipating soft data. Even if overall growth is weak, provided that consumer spending remains firm, this will add to the argument for higher rates. The BoJ will also be looking to the strength of external demand, and of growth in the US in particular, which is a key risk factor for the Japanese economy.

Some risk the market will again be proved wrong

As yet there is no case for anything but a gradual monetary tightening in the months ahead. Indeed, the risk is that markets are anticipating too fast a pace of Japanese rate hikes and they could be proved wrong if, despite its rhetoric, the BoJ stays its hand until later in the year rather than risk stifling the economic recovery. However, assuming, that the BoJ does hike rates over the August/September period, we anticipate one further rate hike before the end of the fiscal year in March 2008, provided the data confirm that the economy remains on a solid growth path and that deflationary pressures have eased.

16 July 2007