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JAPAN UPDATE

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ELECTRICITY SHORTAGES LIMIT RECOVERY; QE AND MORE COMPETITIVE YEN ARE A MODEST ECONOMIC BOOST

Energy shortages still a major bottleneck

The earthquake, tsunami, and nuclear disaster of March 2011 continue to drag on Japan's economy. The earthquake's biggest legacy may be its impact on energy policy – it spurred an intense backlash against nuclear energy, resulting in the shuttering of most of Japan's nuclear generators. Nuclear power generated 31 percent of Japan's electricity before the disaster. With its "mothballing," total electricity production has fallen by 9 percent year over year through January 2012 despite a rapid 21 percent increase in non-nuclear electrical production, (See Chart 1). Power shortages remain a severe supply constraint on industrial production and export-oriented firms. In addition, non-nuclear electricity production is close to an all-time high, meaning new plants will be needed to expand Japanese electricity production further.

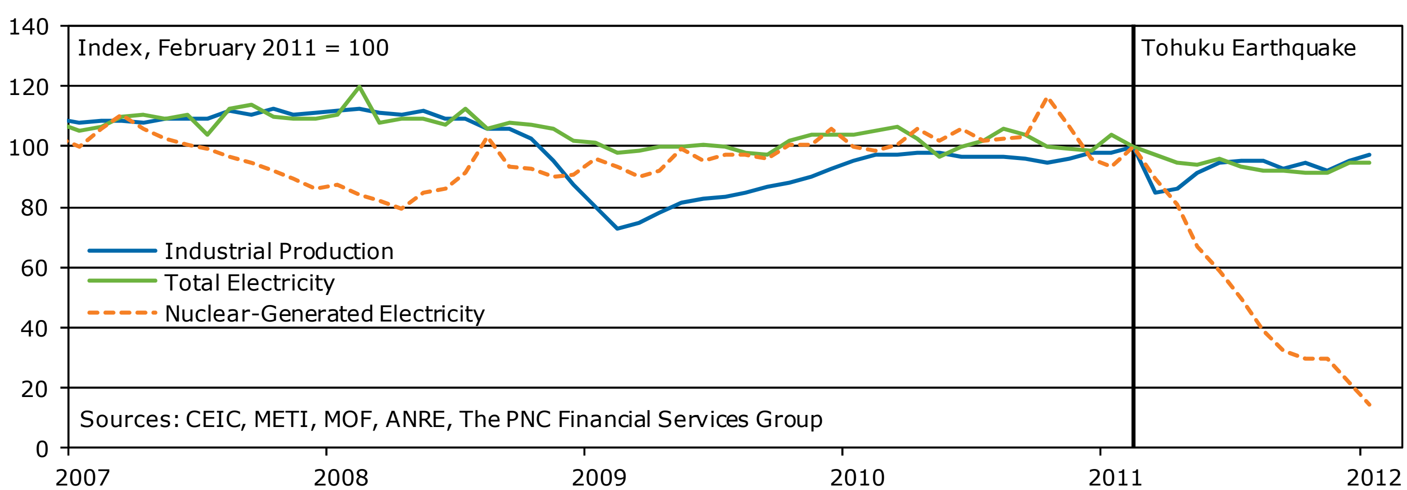
Disappointing post-earthquake rebound limits 2012 growth

Consensus expects Japanese GDP to grow by 1.7 percent full year in 2012, reflecting the investment planned for post-earthquake reconstruction. However, persistent energy bottlenecks makes this rate of GDP growth unachievable in our view. **We expect GDP to expand by 1 percent in 2012, close to the past 20 years' average of 0.8 percent.** Economic activity at year-end 2012 will remain below its 2007 pre-recession peak.

Increased fiscal restraint will drag on growth for years

Looking further ahead, tax hikes will drag on growth in 2014 and 2015 even after energy bottlenecks are finally resolved. Prime Minister Noda has proposed a bill to double national sales taxes from 5 percent to 10 percent by 2015. The last Japanese sales tax hike in 1997, from 3 percent to 5 percent, was followed by a two year recession (coinciding with, and arguably exacerbating, the 1998 Asian financial crisis). But as unfavorable to growth as it is, a tax hike is unavoidable – government debt to GDP is somewhere between 210 and 230 percent, according to the varying estimates of the OECD, IMF, and Japanese government. By comparison, Greece's government debts were 160 percent of its GDP before it

CHART 1: NUCLEAR POWER IS MOSTLY SHUTDOWN. ELECTRIC SUPPLY GRAVELY CONSTRAINED



restructured them this March. As domestic savings rates fall with an aging population this decade, Japan's government must raise taxes even further to close the financing gap. It is extremely difficult to imagine any scenario in which domestic demand returns as a driver of growth.

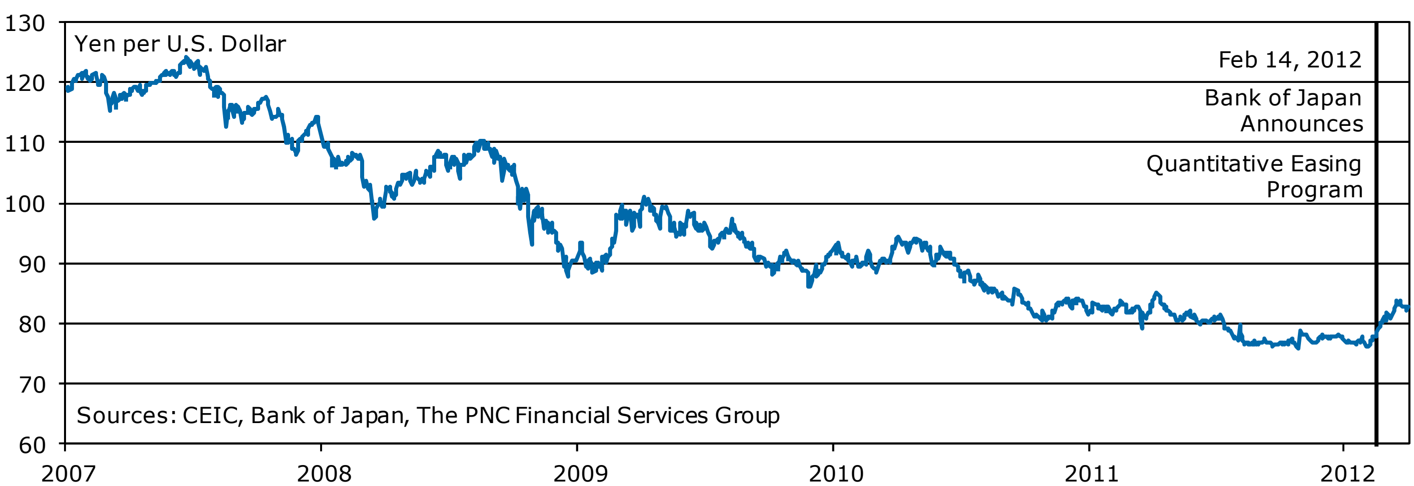
Bank of Japan (finally) launches quantitative easing program

Expansionary monetary policy is the one positive for the economy at present. On February 14, the Bank of Japan (BoJ) announced a ¥22 trillion Yen (5 percent of Japan's GDP) increase in the amount outstanding of its Asset Purchase Program (i.e. quantitative easing 'QE') over the course of 2012. This combines full implementation of the QE program authorized before the announcement (only 43 trillion of the 55 trillion authorized had been used), and a ¥10 trillion Yen increase in the authorization to a total of ¥65 trillion Yen. The BoJ also announced a price stability goal: CPI inflation of less then 2 percent over the medium to long term, centered around 1 percent, and a goal of 1 percent "for the time being." If the BoJ achieved its goal it would be a big change – CPI deflation averaged a negative 0.2 percent over the last decade. The Bank also announced it will continue QE until its inflation goal is "in sight," while qualifying this pledge by saying it is "on the condition that the Bank does not identify any significant risk, including the accumulation of financial imbalances, from the viewpoint of ensuring sustainable economic growth." This statement echos former Kansas City Fed President Thomas Hoenig's objections to the Fed's QE2 (he voted against it), and implies that some BoJ Board Members may be reluctant to exend QE more aggressively.

Look for Yen to depreciate to ¥86 per $1 by year-end 2012

The BoJ's QE program is moderately sized relative to those of other central banks. The Fed's QE1 was $1.8 trillion, or 13 percent of 2008 U.S. GDP, and QE2 was $600 bn, 4 percent of 2011 U.S. GDP; the Bank of England's QE program expanded by £125 bn between October 2011 and May 2012, 8 percent of U.K. GDP. But for the time being, the BoJ's QE and inflation target announcement have been enough to reverse the Yen's one-way appreciation against the U.S. dollar (See Chart 2). The Yen depreciated 5 percent since February 14, a slight reversal of its more than 40 percent appreciation over the preceding 5 years. If the BoJ follows through on its commitment to achieve 1 percent inflation, extending QE as necessary, we anticipate monetary expansion could lead the Yen to depreciate an additional 5 percent to roughly ¥86 per $1 by year-end 2012.

CHART 2: YEN DEPRECIATES 5 PERCENT AFTER QUANTITATIVE EASING LAUNCHED, REVERSING 5-YEAR TREND



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