

Japan's Recovery Is a Tailwind for California

I recently had the pleasure of discussing the state of Japan's economy with one of the foremost authorities on the subject. Koji Fukaya, who is the chief economist at the Bank of Tokyo-Mitsubishi UFJ, Ltd. (BTMU), flew in from Tokyo last month to attend a meeting in San Francisco. BTMU is the majority shareholder of UnionBanCal Corporation, Union Bank's holding company.

If you can meet and chat with an economist working for a leading financial institution in the world's second-largest economy, you'd better not let that opportunity slip by. So, using a dinner at a local bistro as bait, I snagged an opportunity to hear his observations on the Japanese economy.

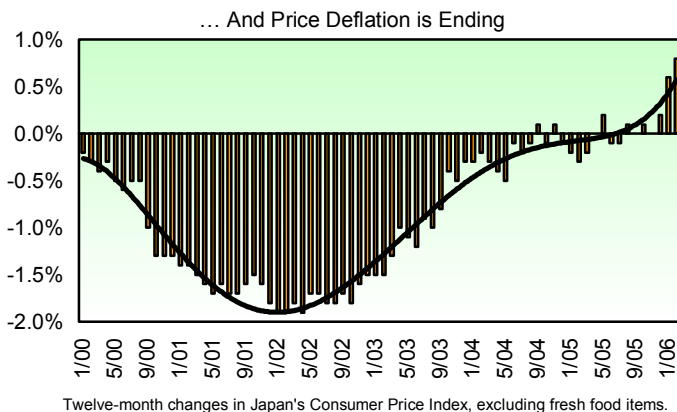
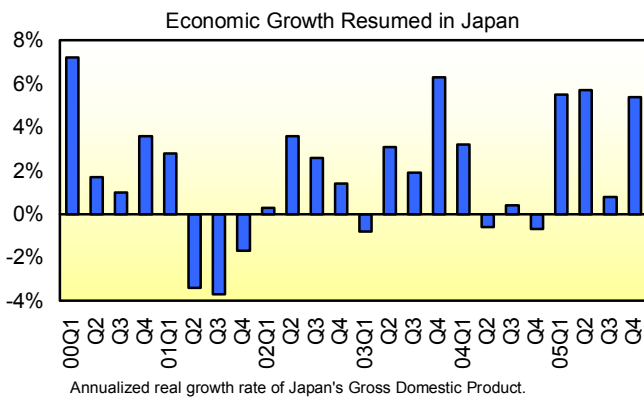
processing equipment. Those activities will most likely keep the economy humming in coming quarters.¹

As you can see in the top chart on the left, Japan has had a couple of false starts in recent years. Those expansions could not be sustained, because they were primarily export-driven. Concerns about China's growth or the appreciation of the Japanese currency derailed those earlier recoveries. This time around, the expansion is driven by domestic demand, such as personal consumption and business investment.

Another sign of Japan's firmer economic footing is the end of price deflation. (See the bottom chart on the left.) Koji believes that the Bank of Japan will end its zero-interest policy soon, maybe after this summer. In short, Japan's recovery is real, and, in my opinion, that is indeed good news for California.

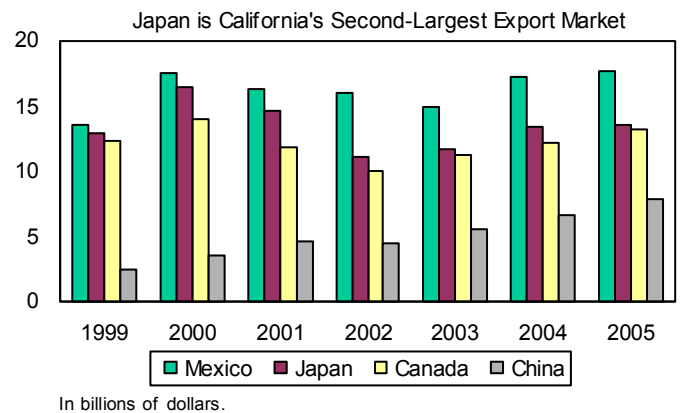
Japan is California's major export market.

Why does Japan's economic health matter to California? Simply put, Japan is one of the state's most important economic partners. The following chart shows that Japan has been the second-largest market for California's exports for the past several years.



Japan's recovery will likely continue.

Over the course of dinner, Koji generously shared his insights on Japan's economic outlook. From his vantage point in Tokyo, the improvement in Japanese consumer sentiment is quite evident. He has also noticed the corporate sector, supported by its strong cash flow position, increasing investment in manufacturing facilities and information



In 2005, the Golden State exported \$13.5 billion worth of goods across the Pacific to Japan. The volume rose 1.3% between 2004 and 2005. Japan ranked first for many years in terms of the value of its purchases from California, but was overtaken by Mexico in the late 1990s. As Japan nosedived into its more-than-a-decade-long economic stagnation and as

¹ If you would like to remain abreast of the Japanese economic trends, be sure to read economic outlook reports prepared by Koji Fukaya's team in Tokyo. They are packed with useful data. You can access those reports at <http://www.bk.mufg.jp/english/research/index.html>.

its citizens reluctantly tightened their purse strings, California's exports also suffered.

But here lies a reason for optimism. The state's exports to Japan decreased because of what was happening to the economy over there. It was not due to the loss of California's competitiveness in the global market, as the steadily rising volume of its total exports attests. The main reason for weak exports was Japan, not California. Therefore, it stands to reason that Japan's renewed economic vigor will spur exports from the state.

In fact, Japanese consumers are once again having a yen for imports (pun intended). The *Wall Street Journal* reported a few months ago that in the year ending March 31, 2005—the most recent fiscal year for which data is available—imports were 10.6% of Japan's Gross Domestic Product, up from 6% a decade earlier. The same paper speculated that the figure probably reached 11% in the fiscal year that ended a little over a month ago.

The aerospace and tourism industries will benefit.

California's top three export items (with their respective percentage shares) to Japan in 2005 were: 1) Computers and Electronic Products (25.9%), 2) Machinery (15.2%), and 3) Transportation Equipment (13.4%). The first two categories are likely to benefit from the previously mentioned increase of fixed investment by Japan's corporate sector.

Renewed interest in overseas travel has prompted Japanese airlines to order a large number of passenger planes in recent years. This offers a lift for our aerospace industry, which accounts for about 60% of transportation equipment manufacturing jobs in California.

Because of its proximity and excellent travel value, Asia (especially China) has emerged as a particularly popular destination for Japanese tourists over the past few years. But

International Visitors to California

From	Aug. 2005 YTD Arrivals	% Change 2004–2005
Japan	397,507	-2.7
United Kingdom	316,436	+3.8
Mexico	239,944	+11.6
Australia	229,560	+7.5
South Korea	172,327	+1.6
Germany	133,807	+10.9
Taiwan	132,253	+2.4
France	105,318	+19.7
China (excluding HK)	81,987	+20.9
Philippines	58,979	-6.4
TOTAL	2,310,259	+5.2

Source: U.S. Department of Commerce, ITA.

the Golden State also continues to attract a great many visitors from Japan. (Please refer to the above table.)

For Japanese tourists, Los Angeles and San Francisco are logical gateways to the United States and convenient jumping-off points for further travel elsewhere in the country. The recent appreciation of the yen against the greenback should make the United States look like a bargain to Japanese visitors.

We may even see a resurgence of foreign direct investment coming from Japan into the state. Currently, close to 100,000 Californians work at firms (excluding banks) where Japanese capital owns majority shares.

In March, the California unemployment rate dipped to 4.8%—a level unseen since the height of the dot-com boom. Job growth is now statewide. In summary, the California economy now has good momentum, and a tailwind coming from Japan will perhaps allow it to gain additional altitude.

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Economic Forecast – May 2006

UNITED STATES	2004	2005	2006	2007
Real GDP Growth (%)	4.2	3.5	3.5	3.2
Unemployment Rate (%)	5.5	5.1	4.8	4.8
Consumer Prices Change (%)	2.7	3.4	2.9	2.2
Federal Funds Rate (%)	1.3	3.2	4.8	4.8
CALIFORNIA				
Real GSP Growth (%)	5.6	4.0	4.0	3.5
Nonfarm Employment Growth (%)	1.0	1.8	1.7	1.3
Personal Income Growth (%)	6.6	6.0	6.0	5.5

Bold: Actual. GSP stands for Gross State Product.

The information in this report is based on data available as of May 2, 2006, and has been obtained from sources believed to be reliable, but its accuracy, completeness, and interpretation are not guaranteed. We do not think it should necessarily be relied on as a sole source of information and opinion.