FX Market Focus

- Japan Cross-border Flows and the Yen

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European Central Bank
December 2009
DPJ Yen Policy Shift – Shifting Again?

- Fujii – “Weak yen policy is finished”. Oct 13th
- Fujii – “I never voiced support for a strong yen”. Oct 27th
- Fujii – “I never stated that intervention was unthinkable”. Dec 1st
- Gyohten – “Japan and China carry a heavy responsibility to stabilise the dollar. We need to work together with the US to achieve this”. Oct 16th
- LDP shifted FX Policy in 2004. The last intervention was in USD/JPY on 16th March 2004.
- BOJ policy measure on 1st December – another cautious step with little consequence for the yen
Institutional Investor Flows
Substantial Japanese Investor Outflows Have Eased

- JPY 11.6 trillion worth of purchases in 12mths to Oct
- JPY 6.3 trillion worth of purchases in 12mths to Oct
Banks & Life Insurance Companies Active Bond Buyers

### FOREIGN BOND PURCHASES BY JAPANESE BANKS

<table>
<thead>
<tr>
<th>(JPY 100mn)</th>
<th>Bonds - Japan Inv</th>
<th>Banks</th>
<th>Securities</th>
<th>L Insurance</th>
<th>Inv Trust</th>
<th>Trust Acs</th>
<th>Eqty Out</th>
<th>Japan Inv</th>
<th>Bonds For Inv</th>
<th>Eqty In For Inv</th>
</tr>
</thead>
<tbody>
<tr>
<td>12mth to Oct 08</td>
<td>-65403.00</td>
<td>-6018.00</td>
<td>-54769.00</td>
<td>3281.00</td>
<td>-12468.00</td>
<td>-17482.00</td>
<td>-33081.00</td>
<td>-11354.00</td>
<td>-67772.00</td>
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<tr>
<td>12mth to Oct 09</td>
<td>-116018.00</td>
<td>-82558.00</td>
<td>-23778.00</td>
<td>-11227.00</td>
<td>-15395.00</td>
<td>-6639.00</td>
<td>-62736.00</td>
<td>-79907.00</td>
<td>-32852.00</td>
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<tr>
<td>Since Eq mkt turn</td>
<td>-63992.00</td>
<td>-33184.00</td>
<td>-15164.00</td>
<td>-14687.00</td>
<td>-19589.00</td>
<td>895.00</td>
<td>-16882.00</td>
<td>-51182.00</td>
<td>11841.00</td>
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<td>Last 3mths</td>
<td>271.00</td>
<td>14038.00</td>
<td>-5022.00</td>
<td>-4922.00</td>
<td>-8226.00</td>
<td>-1942.00</td>
<td>-392.00</td>
<td>-18856.00</td>
<td>9344.00</td>
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</tbody>
</table>

### FOREIGN BOND PURCHASES BY JAPAN LIFE INSURERS

Bank of Tokyo-Mitsubishi UFJ
Japan Equity Market Under-performance
Not Just an Issuance Story

- Muted (JPY 1.2 trillion) purchases since March trough
- Estimated JPY 5 trillion of net issuance in 2009
DPJ Triggering Foreign Investor Concerns

### DPJ Manifesto "Democratic Party of Japan's Platform for Government"

#### Funding Source

<table>
<thead>
<tr>
<th>Item</th>
<th>Description</th>
<th>JPY/TRN</th>
</tr>
</thead>
<tbody>
<tr>
<td>①</td>
<td>Eliminate Wasteful Spending&lt;br&gt;PUBLIC WORKS&lt;br&gt;Personnel Costs&lt;br&gt;Consignment / Facility Costs&lt;br&gt;Others</td>
<td>9.1</td>
</tr>
<tr>
<td></td>
<td>Cancel Kawabegawa River, Yamba Dam Project, cost benefit analysis of road projects</td>
<td>1.3</td>
</tr>
<tr>
<td></td>
<td>Transfer authority to local regions, review staffing and benefit levels, revise pay scales</td>
<td>1.1</td>
</tr>
<tr>
<td></td>
<td>Review government contracts, reform subsidies, review and abolish independent administrative institutions</td>
<td>6.1</td>
</tr>
<tr>
<td></td>
<td>Reduce the number of Diet seats, stricter budget assessments</td>
<td>0.6</td>
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<tr>
<td>②</td>
<td>“Buried Treasure” and govt costs&lt;br&gt;Buried Treasure&lt;br&gt;Planned Sales of Govt Assets</td>
<td>5.0</td>
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<tr>
<td></td>
<td>Portion of Foreign Exchange Fund Special Account, special accounts in the FY2009 supplementary budget</td>
<td>4.3</td>
</tr>
<tr>
<td></td>
<td>Selling unused land, official residences, shares in privatized companies</td>
<td>0.7</td>
</tr>
<tr>
<td>③</td>
<td>Tax System Reforms&lt;br&gt;Review special taxation measures, abolish spouse and dependent income tax deductions</td>
<td>2.7</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>16.8</td>
</tr>
</tbody>
</table>

##### Foreign Investor Purchases JGBs

- Net Purchases JGBs Total, JPY 100mn

##### Sovereign Default Risk Ratio vs USD/JPY

- CDS 5 Year, Japan / CDS 5 Year, Treasury, United States (Right)
- USD/JPY (Left)
Foreign Investor Participation in JGB Market Modest and Now Reversing

Domestic Investors’ behaviour key for JGB yield

Steady expansion of foreigners’ JGB holdings now reversing
Trend Decline in JPY Reserve Holdings

- 8% of FX Reserve increase since 1999 accounts for other currencies and valuation
- JPY holdings down from peak of 6.1% in 2000
Retail Investor Flows
Retail Appetite for Investment Trusts Yet to Recover Notably

- 46.8% of Publicly Quoted Inv Trust total in foreign currency denominated assets as of Oct 2009
- But retailers’ net new flows 3mth average just JPY 360bn – risk appetite is muted
Retail Sector Diversifying from Major Developed Markets

- In December 2004 USD assets was 47% of total
- Emerging markets benefit most – Brazil in particular
Retail Margin Flows Chasing Yield Again

- Retail FX Margin traders shift to directional focus in USD/JPY

- Yield focus still firm with AUD/JPY which accounts for 61% of total TFX yen short positions
Japanese Corporate Flows
Japanese Corporate Hedging Activity Yet to Pick Up

- Internal Corporate flows yet to replicate upturn in exports, Oct 2009 a new post-crisis low
- Annual export growth to Asia rebounding most notably
HIA Repatriation Impact Evident but Yen Impact Modest

Retained Foreign Earnings FY 2007
JPY 20,321bn

<table>
<thead>
<tr>
<th>Income tax rate</th>
<th>Japan</th>
<th>Ireland</th>
<th>Hungary</th>
<th>Hong Kong</th>
<th>Singapore</th>
<th>Malaysia</th>
<th>Vietnam</th>
<th>UK</th>
<th>Mexico</th>
<th>Poland</th>
<th>Australia</th>
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</thead>
<tbody>
<tr>
<td>N/A</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
<td>10.00%</td>
<td>0.00%</td>
</tr>
</tbody>
</table>

| Corporate tax rate | 40% | 12.50% | 16.00% | 17.50% | 18.00% | 26.00% | 28.00% | 28.00% | 28.00% | 19.00% | 30.00% |
| Total             | 40.00% | 12.50% | 16.00% | 17.50% | 18.00% | 26.00% | 28.00% | 28.00% | 28.00% | 29.00% | 30.00% |

| Tax rate differential with Japan | N/A | -27.50% | -24.00% | -22.50% | -22.00% | -14.00% | -12.00% | -12.00% | -12.00% | -11.00% | -10.00% |

Bank of Tokyo-Mitsubishi UFJ
USD/JPY Outlook
Fed Policy Turn in 2010 will Prompt USD/JPY Rebound

- Yield based short-term model implied fair value at approximately 90.00.
- Fed induced flattening will mark turn for USD/JPY
Yen Carry Unwind Complete & Retail Investor Outflows to Re-emerge

- Massive reversal (JPY 31trn) appears complete

**Chart 2: Financial assets held by households (End of June 2009)**

- Japan: Currency and deposits (35.2%), Shares and equities (7.1%), Insurance and pension reserves (32.2%)
- United States: Currency and deposits (14.8%), Shares and equities (14.3%), Others (1.9%)

Source: BOJ
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