Japan Repositioning in Face of a Challenging World Economy

October 2012

Since the devastating March 2011 earthquake, tsunami and nuclear disaster, Japan has led an incredible reconstruction effort. Through collective strength and resilience, debris has been cleared, roads rebuilt, and supply chains restored. Many hoped the reconstruction process would not only rebuild the nation, but also provide the impetus to pass policies that would revitalize Japan's economy. While progress has been achieved and previously intractable policy decisions reframed, the intricacies of Japan's deliberate political decision-making have inhibited adoption of necessary reforms on the scale that some had envisioned.

Japan continues to struggle with one of the most paradoxical economies in the world. Despite twenty years of economic stagnation, the Japanese people live in relative prosperity. The nation's sovereign debt to Gross Domestic Product (GDP) ratio surpasses the rest of the developed world, yet it remains a critical global lender and a secure "safe haven" investment for investors who continue to purchase Japanese government bonds. The strength of Japan's currency also threatens to hollow out critical industry, but plays a crucial role in the nation's continuing prosperity and the comfort of the country's vast and growing elderly population.

To resolve these issues, Japan needs to face a number of critical challenges. If confronted boldly, they provide an opportunity to stabilize and secure the nation for decades to come. First, Japan must evolve with the global economic landscape and look beyond its domestic market, embracing opportunities in Southeast Asia and other emerging economies. Not only should Japan enhance regional integration, but the Japanese government also needs to encourage increased foreign direct investment within Japan. Finally, Japan's shift in energy policy away from a reliance on nuclear power offers an opportunity to become a global leader in the clean energy technologies. This can help to achieve domestic energy security and a robust export industry.

To examine these and other key issues, the Japan External Trade Organization (JETRO) recently organized a Japan Business Forum. CLICK HERE to view a summary of the proceedings and presentations that were delivered.

Japan "Struggles" Between Relative Prosperity and Difficult Domestic Fundamentals

Since the bursting of Japan's bubble economy over two decades ago, the nation has been facing a range of deflationary pressures. Growing sovereign debt, an aging population, and slow economic growth threaten its continued vitality. Despite numerous changes that have helped to transform the Japanese economy, the nation has failed to regain the momentum needed to generate strong, sustainable growth.

The current state of Japan's economy is as confounding as ever. Despite over two decades of stagnation, the Japanese people continue to live in relative prosperity. GDP per capita is greater than France, Germany, and the United Kingdom and Japan's modest annualized GDP growth of 1.4% is stronger than most G7 countries.

As a result, while Japan's potential remains strong given its many sophisticated competitive companies, well-educated labor force, and worldwide leadership in technology, manufacturing and other fields, troubling fundamentals threaten its economic health.

Sovereign Debt

Japan's sovereign debt hovered in 2011 over 220% of GDP, far outpacing the ratio of any other major economy. Unlike most of its peers, however, this debt is almost entirely financed domestically. With 93% held in domestic hands, interest rates remain very low—a 10-year Japanese government bond (JGB) yield stands at around 0.810% compared to 1.625% on comparable U.S. Treasury bonds—reflecting the willingness of Japanese citizen to invest $15 trillion in household savings into the debt of their government.

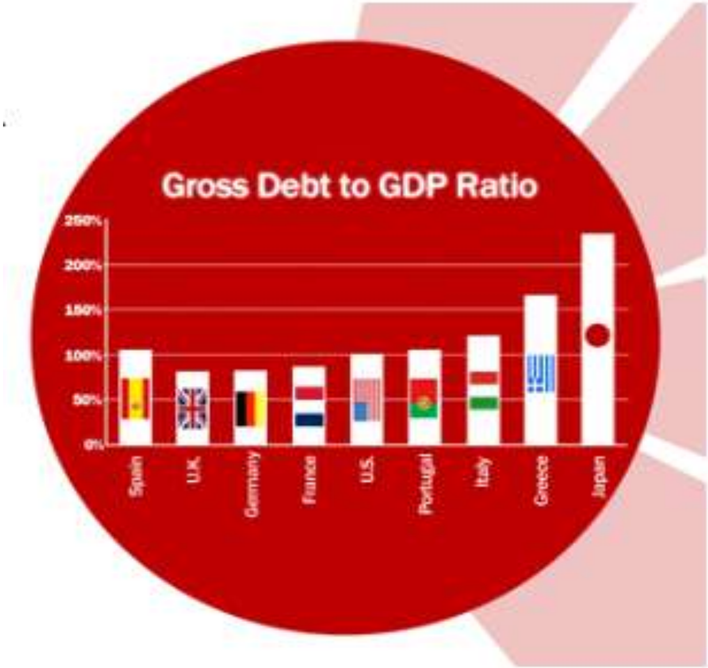

Figure 1. Source: Seeking Alpha

In fact, despite rating downgrades from Standard & Poor's and Fitch Ratings, the cost of buying protection against the potential of Japan defaulting on its debt has decreased—suggesting investors have confidence in Japan's ability to pay back its debt. Tomoya Masanao, managing director at Pacific Investment Management Co., explained to The Wall Street Journal, "Japanese bonds are a cleaner dirty shirt," meaning while Japan's debt situation is worrisome, at the moment the nation is seen as more stable than many peers. For this reason, investors seeking stable investments have purchased Japanese government bonds (JGBs) as a source of security.

Despite its debt, Japan remains the world's largest lender—playing crucial roles in the International Monetary Fund (IMF) and contributing to European rescue efforts. Currently, Japan maintains the world's largest capital surplus, including $890 billion in U.S. Treasuries and over $3.19 trillion in foreign holdings.

Strength of the Yen

Tied to Japan's growing sovereign debt is the strength of the yen, Japan's currency. For years, the yen has risen based on Japan's export competitiveness and resulting trade surpluses. Domestic companies selling abroad bring a steady stream of yen back to Japan, which strengthens the currency. Additionally, in the wake of the 2008 global financial crisis, investors have perceived the yen as a safe investment and raised their exposure. In spite of the low yields, investors have done well investing in JGBs, given currency appreciation has resulted in capital gains, though there is of course no guarantee this trend will continue.

Another beneficiary of the strong yen is Japan's aging population. The nation has the world's highest proportion of its population over 65 years old. Elderly citizens are often reliant on fixed income derived from their personal savings or pensions. While one might imagine the elderly would be displeased over the low fixed income returns generated, the strength of the yen has contributed to deflation. This has reduced the relative price of imported products as well as many costs in Japan, providing retirees with greater purchasing power. Yutaka Harada, a professor at Waseda University in Tokyo, told The New York Times, "Japan's tolerance of the strong yen and deflation is rooted in a clash of generations, and for now, the seniors are winning."

Recognizing the dangers of a continuing deflationary bias, Japanese banks have taken steps to end this trend and establish a 1 to 2% inflation rate target. With this in mind, the Bank of Japan expanded its asset-purchase program by 10 trillion yen and announced a loan program for high-growth sectors; however, external factors like the Euro crisis have sustained the strength of the yen despite these efforts.

There is also concern that persistent yen strength will debilitate the foundation of Japan's economic strength—namely, manufacturing and exports. Japanese products from automobiles to stereo systems are becoming increasingly expensive abroad and are at risk of being displaced by cheaper goods from countries like China and South Korea. To counter this problem, Japanese companies have been moving production to lower-cost countries. The concern is that Japanese industry is being "hollowed out" and reduced export-driven growth will result in fewer jobs within Japan and damage its economic viability.

While increased production outside of Japan has resulted in some displacement, a recent survey reveals that Japanese companies, who understand the potential of emerging markets, not only increase their overseas production, but also expand jobs in Japan due to expanded demand for their products. It is true, however, the nature of the jobs are changing as these companies tend to concentrate R&D in Japan and production abroad. Even SMEs, however, which initially reduce employment in Japan after investing overseas, tend to increase domestic jobs over time.

To facilitate this overseas expansion, in August 2011, the Japan Bank for International Cooperation began lending U.S. dollars at low yields to Japanese companies to help them buy foreign resources.

Challenge of Reconstruction and Changing Global Economy Creates Imperative for Change

Following the disastrous earthquake in March of 2011, many analysts believed the tragedy created a unique opportunity for reform. Evoking a common if not cynical sentiment, "Never waste a crisis," proponents of reform hoped the magnitude of the reconstruction effort would create the opportunity to pass policies previously perceived as politically impossible. Many of the great transformations experienced by Japan occurred in the aftermath of crisis. These include the 1923 earthquake and World War II. In these instances, Japanese citizens collectively and resolutely united to rebuild and reshape their society. In the wake of the earthquake, Japan has successfully achieved the former by making incredible progress clearing debris, resuming operations on rail services and airports, and restoring supply chains.

Despite impressive success rebuilding the country from widespread destruction, political change has proceeded at a slower pace and the structural reforms Japan's government had begun to institute before the crisis—agricultural, trade, and immigration reform, as well as entry into the Trans Pacific Partnership (TPP), a multilateral free trade agreement—have not yet come to pass.

However, while analysts predicting major change in the aftermath of the crisis may have been premature in their assumptions, Prime Minister Noda recently achieved passage of an increase of the consumption tax through a divided Diet. This offers hope other challenging reforms may still be passed.

This YASUYOSHI CHIBA/TORU YAMANAKA/AFP/Getty Images combination of pictures shows a catamaran sightseeing boat washed by the tsunami onto a two-storey tourist home in Otsuchi, Iwate prefecture on April 16, 2011 (top) and the same area on January 16, 2012 (bottom).

Figure 2. Source: Getty Images.
http://news.nationalpost.com

In addition, many pressing issues have been reframed since the 2011 disaster and steps taken to address these deficiencies. For example, as a component of reconstruction, Japan's government developed special zones where regulation is reduced and rebuilding efforts focus on new ideas such as smart energy grids and smart cities. If these zones are successful, Japan may extend the strategy throughout the nation.

Japan has also made strides recognizing that demand within its national borders will no longer be sufficient to drive economic growth by itself. This is due to the maturation of the Japanese economy and the shift toward incremental global growth from emerging markets, especially in developing Asia. New policies promote investments by small and medium-sized enterprises investing and increasing sales abroad. In a presentation by Japan's National Policy Unit, policy recommendations were outlined that would facilitate international SME expansion through funding support, loan guarantees, and establishment of more business friendly policies.

To address structural problems such as the demographic factors that are shrinking Japan's workforce, Prime Minister Yoshihiko Noda is encouraging foreign direct investment (FDI) through a variety of programs. For example, qualified companies, especially in growth sectors like information technology, electronics, medicine, and finance, have been offered substantial tax incentives. In addition, qualified firms that set up facilities in Tokyo will also have property and local taxes waived for five years and corporate taxes decreased over 10%. Some zones even offer business development support uniting foreign firms with Japanese companies. In addition, to attract high-skilled foreign workers, Japan has a new system that encourages residency after only five years and minimizes bureaucratic obstacles related to work visa issues.

Japan Seeks Growth Through Greater Investment and Business Activity in Emerging Asia

Over the past decade the global economic landscape has changed dramatically and emerging economies now outpace developed economies in economic growth. In 2011, emerging economies in Asia accounted for close to 60 per cent of global growth and are anticipated to repeat such levels in coming years. At the annual gathering of the Asia-Pacific Economic Cooperation (APEC), Secretary of State Hillary Clinton stated, "This region of the world is the economic engine in what is still a fragile economy." Japan is ideally positioned near countries experiencing the greatest economic success; namely, the Four Tigers (Hong Kong, Republic of Korea, Singapore, and Taiwan), China, India, and countries of the Association of Southeast Asian Nations (ASEAN).

World GDP growth
% change on previous year

	2010	2011	2012	2013	2014	2015
World GDP	**4.6**	**3.7**	**3.4**	**4.5**	**4.7**	**4.5**
US	3.0	1.7	2.4	2.6	3.0	3.1
EU-27	1.8	1.6	0.0	1.3	1.9	2.5
Japan	4.1	-0.5	1.7	3.3	2.4	1.5
Emerging Markets	**7.1**	**6.0**	**5.3**	**6.5**	**6.5**	**6.1**
Asia Pacific	6.9	4.0	4.7	6.2	5.7	5.2
China	10.4	9.0	8.1	9.1	8.8	8.3
India	8.7	7.1	6.8	9.5	9.2	8.6

Figure 3. Source: Ernst & Young

Growth in emerging economies has not been a zero-sum game. Companies in developed countries like Japan and the United States have increased their profitability by taking advantage of far lower cost structures and favorable labor supply in emerging economies. In turn, rising employment and wages in these markets are gradually giving rise to a growing middle class.

The Proximity of Japan to Greater Mekong Subregion

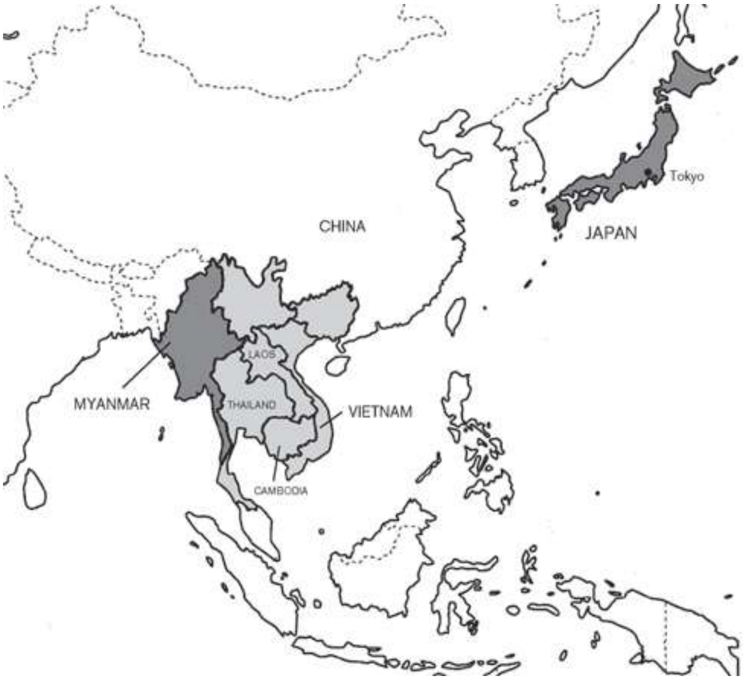

Figure 4. Source: [IFLR]

This phenomenon has a dual effect. First, rising per capita income within this emerging middle class is giving rise to a more consumer-oriented lifestyle by creating new sources of global demand for a wide range of products and services. Next, prices and operating costs in these economies have risen substantially and no longer provide as distinct an operating and cost advantage as they did even five years ago. This provides an opening for the rebirth of manufacturing in developed economies. By positioning itself as an ideal trading partner to emerging markets, especially those in rapidly growing Asia, Japan can attain access into a source of growth that can drive economic expansion in the coming decades.

Japan Becomes Major Donor and Facilitator of Industrial Development in Myanmar

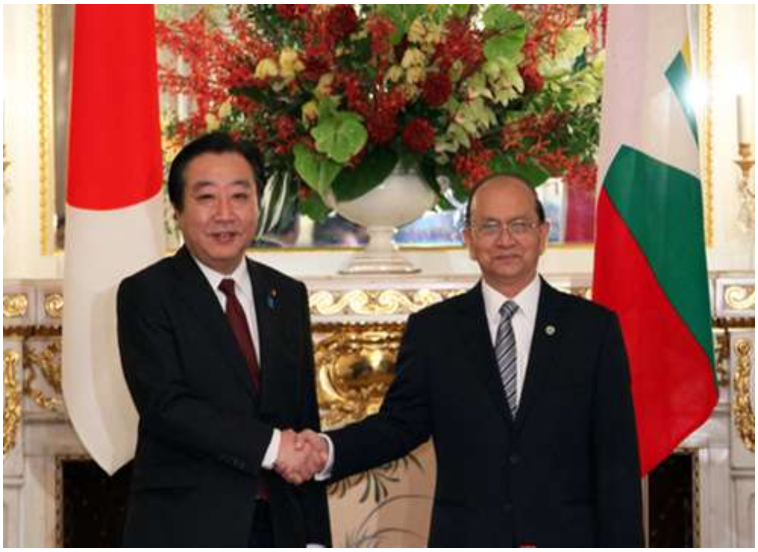

Figure 5. Source: Japanese Cabinet Public Relations Office

For example, according to a recent Reuters special report Japan plans to provide at least $18 billion in aid, investment and debt forgiveness to Myanmar from government and private sources to facilitate economic development and commercial activity. This includes development of a special economic zone at Thilawa, located near Yangon, Myanmar's largest city and former capital and a port on the Indian Ocean. Reuters also reports Japan will provide up to $3.2 billion in new lending to build another special economic zone and deep-sea port in Dawei, in southern Myanmar, which would be developed into Southeast Asia's largest industrial complex. According to the report, this dwarfs "the $76 million in aid from the United States in 2011 and 2012 and a two-year package of $200 million the European Union has pledged".

Further, to facilitate the entry of Japanese companies into Myanmar, JETRO established a Business Support Center in Yangon this September, which will offer free information and consultations to Japanese companies and investors as well as temporary office space. The center is the seventh of its kind opened by JETRO, which also has similar facilities in Thailand, the Philippines, India, and Vietnam.

FDI and Regional Integration Essential to Japan's Long Term Competitiveness

To take full advantage of regional and international opportunities and to expand its long-term competitiveness both within and outside Japan, the nation must become a more attractive destination for foreign direct investment (FDI). FDI provides job creation at a time when many Japanese workers are concerned over the hollowing out of its manufacturing industry and increased unemployment in this sector. Next, FDI can partner a foreign company's unique capital and technical knowledge with Japan's well-educated work force, creating the potential for innovative products and services. Greater FDI also would have the additional benefit of increasing competition within Japan and inspiring Japanese companies to adapt business models and management skills employed overseas.

Japan has many strengths that will help it to achieve this task. Japan ranks first for research and development per capita and a reputation for product and process innovation. Its geographic location also positions it as an ideal gateway connecting Asia to the rest of the world through the Pacific. In addition to its proximity to developing Asia, Japan's vast domestic market also provides potent growth opportunities for foreign companies.

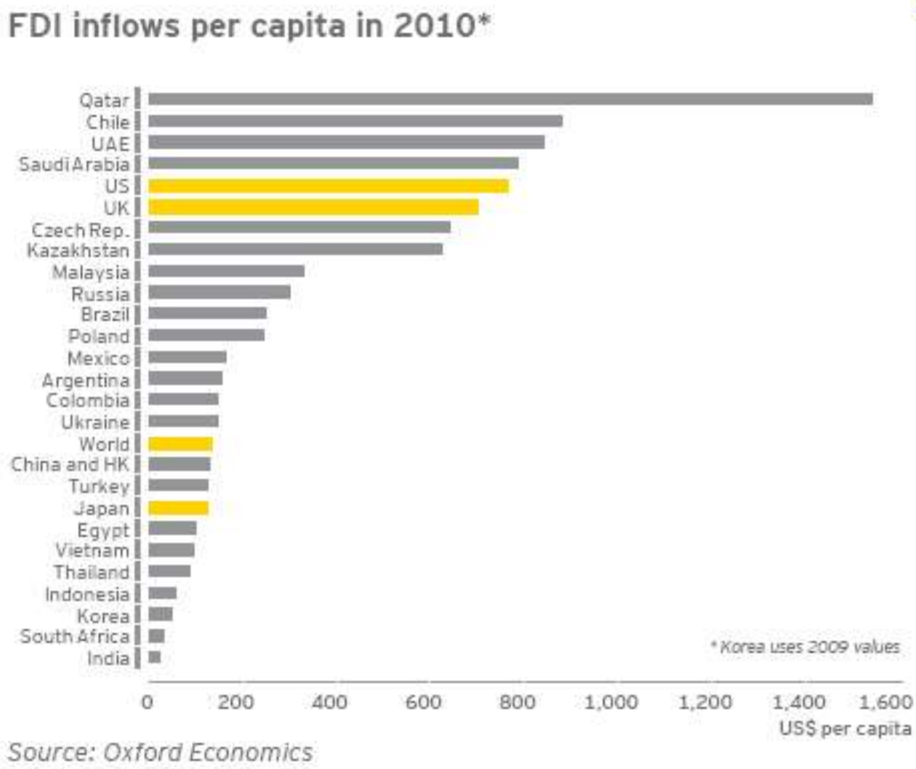

Figure 6. Chart from [Ernst & Young]

To increase FDI, Japan needs to consider further regulatory reform to reduce bureaucratic impediments to investment, labor mobility, and the creation of investment incentives. The tax incentives provided in Japan's Special Economic Zones combined with policies that simplify the immigration of highly-skilled foreign professionals were strong initial steps in this regard.

The Japanese government is also working to pass The Asian Business Location Law. This will broadly cut corporate tax rates for qualified businesses. It will reduce patent fees, and provide additional incentives. The law also demonstrates Japan's commitment to developing key economic sectors including clean energy, information technology, and healthcare. In addition, it strengthens Japan's ability to attract skilled foreign professionals by streamlining the visa application process and the length of working visas from 3 to 5 years for qualified professionals.

In fact, foreign companies are already increasing FDI in Japan, including in reconstruction areas. In February of 2012, Amazon established a customer service center in Sendai and plans to hire up to 1,000 people in the coming years. IKEA has also opened a new store in this region.

Japan's Energy Challenge Represents Opportunity for Future Growth

Prior to the earthquake and subsequent nuclear accident, Japan relied on nuclear reactors for over 30% of its electricity needs. Its 2010 Japan's Basic Energy Plan stated a goal of raising the share of electricity generated by nuclear power to 50% by 2030. For a country with limited domestic energy resources, nuclear energy was perceived as the central means to fulfill growing electricity demand without heavily relying on external sources.

The nuclear accident at Fukushima led to a shutdown of all but two of the nation's 50 nuclear reactors. This has created severe pressure on Japan's energy supply. In the first-half of 2012, Japan recorded a record trade deficit due to expanded demand for oil and liquefied natural gas (LNG) to compensate for offline nuclear reactors. In June, Prime Minister Noda ordered the restart of two idle nuclear reactors in western Japan and promised to "increase our efforts to restore the public's trust over nuclear safety regulation and atomic energy administration."

Noda believed that an immediate phase out of all nuclear power would be too traumatic and expensive for both Japan and the country's electric power companies. In addition to the financial strain, this would result in electricity shortages throughout the country. The decision, however, galvanized anti-nuclear activists leading to a series of protests including one estimated to include 75 thousand people in Tokyo.

Japanese electric utilities	Number of nuclear reactors	Total loss if reactors close	Net equity March 2012	Net equity If reactors close
Tokyo Electric*	13	$14.6 bil.	$6.7 bil.	–$7.9 bil.
Hokkaido Electric	3	4.8	3.6	– 1.3
Japan Atomic Power	3	3.3	2.1	– 1.2
Tohoku Electric	4	6.3	6.1	– 0.3
Hokuriku Electric	2	4.0	4.1	$ 0.1 bil.
Shikoku Electric	3	2.3	3.6	1.3
Kyushu Electric	6	5.6	9.7	4.1
Chugoku Electric	2	1.9	6.5	4.6
Kansai Electric	11	8.0	15.0	7.0
Chubu Electric	3	5.1	17.1	12.0
TOTAL	50	55.9	74.5	18.6

** Calculations exclude the four destroyed reactors at Fukushima Daiichi, which are marked for decommissioning.*

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Source: Agency for Natural Resources and Energy, Japan

A new policy proposal endorsed by Japan's Cabinet in September 2012 calls for a phase out of nuclear power by the 2030s. This will be achieved by adhering to the lifespan of existing facilities and not building any new reactors. The policy document states, "One of the key pillars of the new strategy is to achieve a society that does not depend on nuclear energy as soon as possible." The document reflects the challenge of this new direction—forecasting economic growth at a sluggish 0.8% annually under a nuclear free scenario. Prime Minister Noda noted, "We are only at the starting line. Now we are going to begin an extremely difficult challenge. No matter how difficult it is, we can no longer put it off."

The new energy policy calls for Japan to increase use of renewable energy by eight times 2010 levels by 2030. Japan's government has proactively encouraged investment in renewable energy sources by easing restrictions and regulations for land use employed to develop green energy. It also approved a feed-in tariff scheme in which power companies are required to purchase electricity generated from renewable energy sources such as solar, hydraulic, geothermal, and wind power on a fixed period contract at a fixed price. This guarantees demand for renewable energy as efforts are made to achieve greater cost efficiency and its viability as a primary energy source.

In addition to renewable energy, Japan is also determined to develop and implement new technologies that increase energy efficiency, an area where it has exhibited global leadership in the past. Smart grids and smart cities are two areas of emphasis, which employ computer technologies to integrate the activities of power generators and consumers to efficiently deliver electricity. By 'smartly' managing these resources, cities can increase conservation efforts, as well as their reliance on renewable energy. Seiji Nakata, a Mitsui Fudosan project manager, recognizes the development of smart cities will not only benefit Japan, but could also become an important export industry. He said, "The definition of smart cities is not yet fixed in the world, so we'd like to create a de facto standard".

Japan must also be open to developing bilateral and regional partnerships in its efforts to develop a comprehensive and sustainable energy policy. For example, on September 8, 2012, Russia and Japan agreed to move ahead with a $13 billion LNG project that would extend a pipeline from Vladivostok to Japan. Gas would be processed in this facility for shipment to Japan and other Asian markets. There is also movement in Japan to engage with other neighboring countries to develop cooperative policies. This includes development of a regional, integrated electrical grid to achieve energy security across the region.

The simple truth is that the Fukushima nuclear disaster dramatically changed the direction of Japanese energy policy. By embracing the challenge, Japan can increase its integration with regional countries, develop a clean energy sector and external trade, and guarantee a more secure, sustainable energy path.

Japan Demonstrates Relative Strength in an Anemic Global Economic Environment

As outlined above, Japan is moving to confront a series of challenges that can alter its economic trajectory. At the same time, Japan is exhibiting relative strength and stability in a trouble global economy that has yet to stabilize after the 2008 global financial crisis.

While significant political and economic challenges lay ahead, the nation's experience operating in the low-growth economic environment that is currently affecting the world at large, provides Japan with advantages and experience in navigating current economic circumstances. The nation also serves as a source of stability for companies and investors who seek exposure within the world's third largest economy, offering numerous opportunities both within its domestic market, as well as those of emerging Asia.

To examine these and other key issues that face Japan, and to gain input and understanding from US investors and executives, the Japan External Trade Organization (JETRO) recently organized a Japan Business Forum in New York. CLICK HERE to view a summary of the proceedings and presentations that were delivered.

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