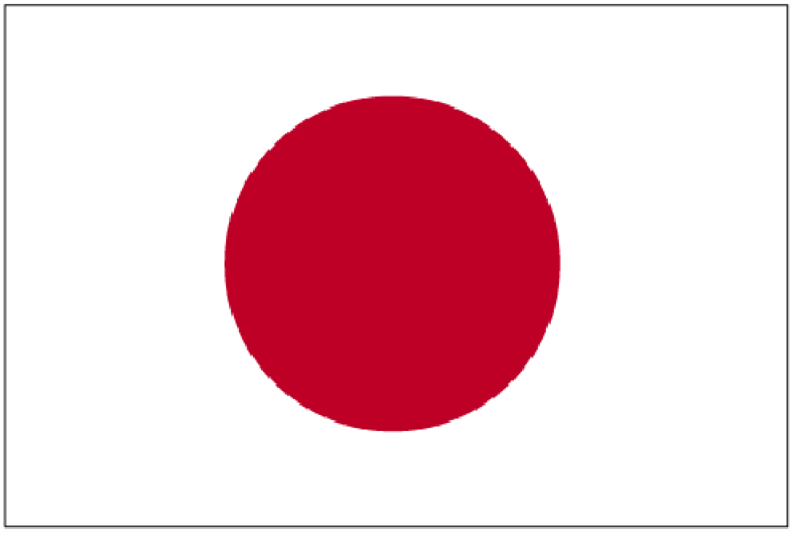
Rabobank

Country report

JAPAN



Summary

Japan is an economy running high-speed into uncharted territory. It has boosted growth potential to the maximum relative to its ageing population, boasting among the highest rates of labour force participation and effective retirement age among the industrialises world. Public finances have nevertheless become more unsustainable, rather than sustainable, with deficits up as a result of the global crisis and the resolve to bring them down severely hampered by the recent natural and ongoing nuclear disaster. Of course, Japan still has a national saving surplus and a positive net international investment position. But with an ageing and eventually dissaving population, both inevitably change in the decade ahead. And of course, with the nearly full domestic absorption of government bonds, the probability of an imminent international funding crisis is not present. But the deplorable state of the public accounts inevitably awakens domestic bond vigilantes as well at some point.

Things to watch:

- Recovery from the March 11 earthquake / tsunami and concomitant nuclear disaster
- Development regarding much-needed and credible fiscal consolidation plans
- The strength of domestic (household) demand beyond the reconstruction impulse

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Japan

National facts	
Type of government	parliamentary government
Capital	Tokyo
Surface area (thousand sq km)	364
Population (millions)	127.1
Main languages	Japanese (100%)
Main religions	Shintoism (83.9%)
	Buddhism (71.4%)
	Christianity (2.0%)
Head of State (president)	Emeror Akihito
Head of Government (prime-minister)	Naoto Kan
Monetary unit	JPY

Economy		2010
Economic size	*bn USD*	*% world total*
Nominal GDP	5461	8.76
Nominal GDP at PPP	4282	5.78
Export value of goods and services	871	4.69
IMF quotum (in mln SDR)	13313	6.13
Economic structure	*2010*	*5-year av.*
Real GDP growth	4.0	-0.2
Agriculture (% of GDP)	1	1
Industry (% of GDP)	25	26
Services (% of GDP)	74	73
Standards of living	*USD*	*% world av.*
Nominal GDP per head	43068	438
Nominal GDP per head at PPP	33770	289
Real GDP per head	36103	451

Social and governance indicators	rank / total
Human Development Index (rank)	11 / 169
Ease of doing business (rank)	18 / 183
Economic freedom index (rank)	20 / 179
Corruption perceptions index (rank)	17 / 178
Press freedom index (rank)	11 / 178
Gini index (income distribution)	24.9
Population below $1.25 per day (PPP)	N/A

Foreign trade			2009
Main export partners (%)		*Main import partners (%)*	
China	19	China	22
US	16	US	11
South Korea	8	Australia	6
Hong Kong	5	Saudi Arabia	5

Main export products (%)	
Capital Equipment (% share)	52
Industrial Supplies (% share)	26
Consumer Durable Goods (% share)	14
Consumer Nondurable Goods (% share)	1
Main import products (%)	
Industrial Supplies (% share)	49
Capital Equipment (% share)	23
Food & Direct Consumer Goods (% share)	10
Consumer Durable Goods (% share)	7
Openness of the economy	*2010*
Export value of G&S (% of GDP)	16
Import value of G&S (% of GDP)	15
Inward FDI (% of GDP)	0.3

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Tragic triple disaster

Japan experienced one of the most impressive recoveries amongst the industrialised world in 2010 with GDP growth posting an annual rate of 4.4%. The rebound resulted from the depth of the recession in 2008-09 on the one hand (10% peak-to-trough GDP contraction), and its geographical position (i.e. adjacent to fast-growing Asia) on the other hand. The Sendai earthquake, concomitant tsunami and resulting nuclear disaster have dashed all hopes that the strong 2010 performance would be repeated. Indeed, following the surprise contraction in GDP in 10Q4, 11H1 most likely results in further contraction of activity as a result of the immediate impact of the earthquake, resulting strains in the supply chain including the energy production as well as the distribution network and the depressing impact on sentiment. Beyond that immediate horizon, there is obviously substantial upward potential for GDP as reconstruction activity kicks in. Nevertheless, we expect the impact of the Sendai earthquake to act as a drag on activity growth for the year as a whole by around 1½%-2%, holding output constant relative to our last pre-earthquake forecast of 1½% GDP growth. At the time of writing this report, the government estimates the damage done to buildings, roads and other infrastructure to mount to about 5½%-GDP.

Sadly, the financing of the reconstruction activity falls largely upon the government. And that comes at a time when the Japanese government should be laying out plans for shrinking its bloated budget deficit (7.9%-GDP pre-quake forecasted deficit for 2011) and debt level (surpassing 200%-GDP in gross terms), rather than adding to it for reconstruction purposes. See Rabobank Special Report 2011/04 'Japan: Tragic triple disaster' for a detailed analysis of the economic impact of the

Sendai earthquake. Beyond the immediate impact, the Sendai earthquake will only make it more difficult for Japan to grapple with its longer term challenges, for which difficult political decisions should be made on rather short notice.

Medium- and long-term challenges

Japan faces the dual challenge of restoring order to public finances and raising its potential economic growth rate. Looking at the former, and considering the low level of government expenditure (which limits the scope for simple spending cuts) in combination with relatively low consumption tax rates and high corporate tax rates (40%), a consumption tax hike seems inevitable in any fiscal consolidation plan. Looking at the latter, and considering the low consumption share in GDP, policies to unlock consumption expenditure are key. There is a tension between these two challenges, to put it mildly. The easiest way out politically is to postpone the austerity measures. This against the backdrop of about 95% of government debt being held nationally, lowering the sense of urgency that foreign bond vigilantes usually cater to. With gross public debt breaching 200%-GDP in 2012 according to EIU estimates (pre-quake projections), this is clearly a high-risk strategy. Looking at net debt hardly provides comfort, approaching 150%-GDP in 2014 according to the IMF, in fact surpassing even the likes of Greece and Italy in that regard. Indeed, the IMF last year proposed a 10-year austerity plan to provide for a roadmap for fiscal consolidation while being able to smooth the adjustment somewhat over time.

Ageing changes the national savings convention

Japan has long been described as adhering to a social convention where households save and let the government do the spending by way of purchasing the bonds that cover the (sizeable) government budget deficits. Indeed, the volume growth of household consumption expenditure seems to have been rather muted in the years prior to the financial crisis. But this description does not recognise the fact that Japanese household savings (as a fraction of disposable income) have in fact been on a structural decline since the early nineties and have fallen to about 2% nowadays from about 15% in the early nineties. With savings ratios of the younger cohorts rather stable over time, Japan is experiencing the direct result of population ageing kicking in. Tokuoka (2010) presents statistical evidence of the share of 65+ population relating positively to the aggregate volume of private consumption expenditure. Put differently, weak Japanese consumption growth was actually even supported by its population on average growing into the 'spending' age cohorts.
The upshot is that Japanese national savings are increasingly being generated by the corporate sector, but this may prove to be a temporary solution.

Looking under the hood, a major factor restraining disposable income (and thereby consumption expenditure) growth has been the steady decline in property income, which results from the low-interest and low-dividend-payout environment in Japan combined with the strong Japanese appetite for currency and deposits in portfolio allocation. That creates a potentially ironic situation where economic growth may be stimulated (and the risk of a fiscal crisis reduced) by a rise in (deposit) yields via the resulting boost of property and disposable income growth and unlocking of consumption growth potential. However, the environment in which (bond) yields are probably most likely to rise is precisely in one with mounting sovereign stress.

No room left to manoeuvre

Fiscal space is fully exhausted, as should be clear from the above. Monetary policy ammunition has been exhausted since 1995, when the policy rate last reached as high as 1%. All that has been left (and indeed been used) are various rounds of quantitative easing, the effects of which are subject to debate. Growth of the Japanese productive capacity in the past decade has actually been supported by increases in labour force participation. With labour force participation rates now among the highest in the industrialised world and the labour force itself shrinking due to ageing, the growth of the productive capacity is set to slow, being exposed to the full force of ageing. Hence growth cannot provide a way out as well.

Tokuoka, T. (2010), Rebalancing in Japan: The role of private consumption, IMF Working Paper 10/293, Washington D.C.

Japan

Selection of economic indicators	2006	2007	2008	2009	2010	2011e	2012f
Key country risk indicators							
GDP (% real change pa)	2.0	2.3	-1.2	-6.3	4.0	1.4	1.5
Consumer prices (average % change pa)	0.3	0.1	1.4	-1.3	-0.7	0.6	0.8
Current account balance (% of GDP)	3.9	4.8	3.2	2.8	3.6	3.1	3.2
Economic growth							
GDP (% real change pa)	2.0	2.3	-1.2	-6.3	4.0	1.4	1.5
Gross fixed investment (% real change pa), SA	0.6	-1.1	-3.6	-12.0	0.2	0.2	3.2
Private consumption (real % change pa), SA	1.5	1.6	-0.7	-2.0	1.9	0.9	1.0
Government consumption (% real change pa), SA	0.4	1.5	0.4	3.0	2.3	2.5	1.5
Exports of G&S (% real change pa), SA	9.7	8.4	1.7	-24.2	24.2	6.6	4.3
Imports of G&S (% real change pa), SA	4.2	1.6	0.4	-15.4	9.8	6.5	5.5
Economic policy							
Budget balance (% of GDP)	-1.6	-2.4	-2.1	-7.1	-7.7	-7.9	-6.9
Public debt (% of GDP)	172	167	174	193	198	202	204
Money market interest rate (%)	0.3	0.7	0.9	0.4	0.2	0.4	0.6
M2 growth (% change pa)	1	2	2	3	3	2	5
Consumer prices (average % change pa)	0.3	0.1	1.4	-1.3	-0.7	0.6	0.8
Exchange rate LCU to USD (average)	116.3	117.8	103.4	93.6	87.8	81.8	80.8
Recorded unemployment (%)	4.1	3.8	4.0	5.1	5.1	4.8	4.5
Balance of payments (mln USD)							
Current account balance	170520	210490	156640	142190	195034	186400	196000
Trade balance	81310	104760	38130	43620	91835	92300	106800
Export value of goods	615800	678090	746470	545280	730527	829300	866000
Import value of goods	534510	573340	708340	501640	638690	737000	759200
Services balance	-18250	-21240	-20790	-20380	-16745	-27600	-39900
Income balance	118150	138500	152330	131340	132227	135100	143000
Transfer balance	-10690	-11520	-13040	-12400	-12283	-13400	-14000
Net direct investment flows	-56950	-51310	-106260	-62780	-73410	-74650	-78830
External position (mln USD)							
Total foreign exchange reserves	879682	952784	1009360	1022240	1061490	N/A	N/A
International investment position	1808170	2194960	2484970	2891840	3070840	N/A	N/A
Total assets	4691940	5355230	5721010	6026770	6819140	N/A	N/A
Total liabilities	2883770	3160270	3236040	3134930	3748300	N/A	N/A
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	1.9	2.4	0.8	0.9	1.7	1.5	1.7
Current account balance (% of GDP)	3.9	4.8	3.2	2.8	3.6	3.1	3.2
Inward FDI (% of GDP)	-0.2	0.5	0.5	0.2	0.3	0.3	0.3
International investment position (% of GDP)	41.4	50.1	50.9	57.5	56.2	N/A	N/A

Source: EIU