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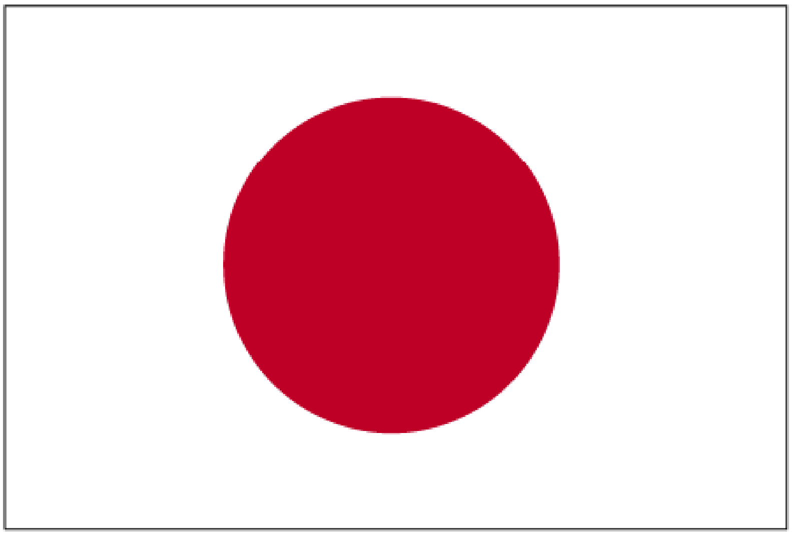
Country report **JAPAN**



Summary

Recent macro data suggest that Japan's economic activity is picking up, and supply chains are being restored faster than expected. The economy is expected to grow robustly in the short- to medium-term amid reconstruction efforts following the triple disaster in March 2011. However, the long-term prospects are far less rosy. The country is still grappling with a shrinking labor force that is making it increasingly difficult for the government to lower the public debt-to-GDP ratio. Against this backdrop, structural reforms are absolutely necessary to raise the potential growth rate. Fiscal policy will also need to chart a path between increased spending to facilitate a swift recovery and longer-term reforms to restore public debt sustainability.

Things to watch:

- Reconstruction efforts
- Medium-term fiscal consolidation measures, especially legislation on raising the VAT
- Government bond yields

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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 (PM)	Yoshihiko Noda
Monetary unit	JPY

Social and governance indicators	rank / total
Human Development Index (rank)	12 / 187
Ease of Doing Business Index (rank)	20 / 183
Index of Economic Freedom (rank)	22 / 179
Corruption Perceptions Index (rank)	14 / 183
Press Freedom Index (rank)	22 / 178
Gini index (income distribution)	24.85
Population below $1.25 per day (PPP)	n.a.

Economy		2011
Economic size	*bn USD*	*% world total*
Nominal GDP	5866	8.50
Nominal GDP at PPP	4354	5.52
Export value of goods and services	934	4.27
IMF quotum (in mln SDR)	15629	7.19
Economic structure	*2011*	*5-year av.*
Real GDP growth	-0.9	0.3
Agriculture (% of GDP)	1	1
Industry (% of GDP)	27	28
Services (% of GDP)	72	71
Standards of living	*USD*	*% world av.*
Nominal GDP per head	46370	430
Nominal GDP per head at PPP	34419	279
Real GDP per head	36349	447

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
China	19	China	22
US	16	US	10
South Korea	8	Australia	7
Hong Kong	5	Saudi Arabia	5

Main export products (%) 2011	
Capital Equipment (% share)	53
Industrial Supplies (% share)	26
Consumer Durable Goods (% share)	14
Consumer Nondurable Goods (% share)	1
Main import products (%) 2011	
Industrial Supplies (% share)	56
Capital Equipment (% share)	21
Food & Direct Consumer Goods (% share)	8
Consumer Durable Goods (% share)	6
Openness of the economy 2011	
Export value of G&S (% of GDP)	16
Import value of G&S (% of GDP)	17
Inward FDI (% of GDP)	0.0

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

Economy

Japan’s economy bounced strongly following the steep recession post-crisis (2008/09). However, the earthquake and tsunami on March 11, 2011 brought the recovery to a halt. The Cabinet Office estimates that direct damages could amount to JPY 16.9trn or 3.5% of GDP. Of course, one must not forget that the disaster was in the first place a human tragedy.

The Japanese economy grew robustly in the third quarter of 2011 buoyed by reconstruction efforts. The supply chain disruptions were also resolved relatively quickly. In the second half of June, 93% of manufacturers reported the complete restoration of quake-damaged production sites. Unfortunately, the economy took a step back in the fourth quarter (GDP:-0.2% q-o-q) due to a number of factors. First, floods in Thailand hampered production, damaging supply chains for Japan-based manufacturing of cars, electronic and IT industries. Second, weakening global demand and the appreciation of the yen depressed exports. Third, delays in carrying out public works to reconstruct and rehabilitate disaster areas smothered a rebound in domestic demand. Going forward, we expect growth to be robust (by Japanese standards) amid reconstruction efforts. The government estimates that the reconstruction costs, excluding those related to the nuclear disaster, amount to JPY 19trn (around 4% of GDP) spent during 5 years. Obviously, several risks still threaten economic recovery, including weaker global demand and future movements in the value of the yen against other major currencies.

Over the longer-term, the economy's prospects are less rosy amid an aging population. Against this backdrop, raising productivity is key to boosting potential growth. Policy priorities include reducing barriers to entry to improve productivity in services, removing distortions that impede investment and raising labor force participation. As regards the latter, Japan has the lowest level of female labor force participation among OECD economies, reflecting, in part, the lack of childcare services and unfavorable tax treatment that discourages women to find work.

Achieving a higher potential growth rate is extremely important given the dire state of the country's public finances. Last year, the net public debt-to-GDP reached 127% and the IMF expects this figure to rise to an eye-watering 166% within 5 years. The gross debt-to-GDP is expected to surpass the 250% mark by the middle of this decade! Even at such elevated public debt levels, the government manages to fund itself at very attractive rates, which keeps debt affordability in check. But this does not mean Japan is insulated from a debt crisis. Naturally, borrowing in yens and having an independent central bank (BoJ) willing to monetize the government's deficit through quantitative easing (QE) programs helps. But this policy has its limits. The country's large pool of domestic savings that results in low share of foreign ownership of domestic debt is also not going to persist forever. The market's capacity to absorb new debt will diminish as population aging reduces saving. Given that more Japanese workers will retire and reduce their holdings of government bonds (e.g. through their pension funds), the share of non-resident holdings of public debt may need to increase significantly in the future (unless the government tightens its belt). This might push long-term interest rates upwards since foreign investors will be less content with the very low interest rates if the yen starts depreciating. For that matter, the deflationary environment that ensured a positive real return for domestic investors will be of less importance. Another problem with greater exposure to foreign funding is that it can be a risky strategy since 'footloose' foreign investors rush quicker for the exit when panicked in comparison to their domestic counterparts. We must also not exclude the possibility of shifts in portfolio preferences of Japanese investors in the future. Short of outright financial repression, the government will have difficulty financing itself through domestic savings if investors move their capital to other countries for higher (expected) returns or fear of domestic inflation. This means the Japanese government bond market has been relatively immune to sudden shifts in global or domestic sentiment until now, but the authorities cannot count on this to continue forever. Once confidence in sustainability erodes, authorities could face an adverse feedback loop between rising yields, falling market confidence, a more vulnerable financial system, diminishing fiscal policy space and a contracting real economy. Naturally, these risks are more likely to materialise in the medium-term if worsening public finances are not adequately addressed.

Therefore, the government will need to chart a path between increased spending to facilitate a swift recovery and longer-term reforms to restore public debt sustainability (i.e. tough politicial decisions need to be taken). The good news is that Japan has room to raise additional tax revenue. At about 17% of GDP, overall tax revenue is one of the lowest among OECD economies. For example, compared to other countries, Japan's consumption tax rate (VAT) at 5% is the lowest among the advanced G-20 economies. The IMF's analysis indicates that a gradual increase in the VAT from 5% to 15% over several years could provide roughly half of the fiscal adjustment needed to put the public debt ratio on a sustained downward path within the next several years. As such, we are pleased to see that the Japanese Prime Minister took a long awaited step by submitting legislation to the Diet that would double the consumption tax by 2015. However, it is still unsure whether the legislation will be passed given fierce opposition from the ruling Democratic party of

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Japan. Equally uncertain is the consequence of such tax rise for consumer spending, which is a very important component of GDP growth (household consumption accounts for 57% of GDP).

Japan

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	2.2	-1.1	-5.5	4.5	-0.9	1.3	1.2
Consumer prices (average % change pa)	0.1	1.4	-1.4	-0.7	-0.3	-0.3	0.3
Current account balance (% of GDP)	4.8	3.2	2.8	3.6	2.1	2.1	2.1
Economic growth							
GDP (% real change pa)	2.2	-1.1	-5.5	4.5	-0.9	1.3	1.2
Gross fixed investment (% real change pa), SA	0.3	-4.4	-10.5	-0.1	0.0	2.2	1.1
Private consumption (real % change pa), SA	0.9	-0.9	-0.7	2.6	0.0	0.5	0.8
Government consumption (% real change pa), SA	1.1	-0.1	2.3	2.1	2.1	1.0	0.5
Exports of G&S (% real change pa), SA	8.7	1.6	-24.4	24.4	0.0	3.3	4.9
Imports of G&S (% real change pa), SA	2.3	0.4	-15.8	11.1	5.9	5.7	3.8
Economic policy							
Budget balance (% of GDP)	-2.4	-2.2	-8.7	-7.8	-8.9	-8.3	-6.2
Public debt (% of GDP)	167	174	194	200	212	224	229
Money market interest rate (%)	0.7	0.9	0.4	0.2	0.2	0.3	0.8
M2 growth (% change pa)	2	2	3	3	3	0	0
Consumer prices (average % change pa)	0.1	1.4	-1.4	-0.7	-0.3	-0.3	0.3
Exchange rate LCU to USD (average)	3.7	3.7	3.7	3.7	3.7	n.a.	n.a.
Recorded unemployment (%)	3.8	4.0	5.1	5.1	4.6	5.0	5.1
Balance of payments (mln USD)							
Current account balance	210490	156640	142190	195760	120500	127700	126200
Trade balance	104760	38130	43620	90980	-20400	-25200	11500
Export value of goods	678090	746470	545280	730080	788000	833300	874600
Import value of goods	573340	708340	501640	639110	808400	858500	863200
Services balance	-21240	-20790	-20380	-16120	-20600	-16400	-26700
Income balance	138500	152330	131340	133290	175800	184100	155800
Transfer balance	-11520	-13040	-12400	-12380	-14400	-14800	-14400
Net direct investment flows	-51310	-106260	-62780	-58580	-71190	-91710	-97090
External position (mln USD)							
International investment position	2194960	2484970	2891840	3087720	n.a.	n.a.	n.a.
Total assets	5355230	5721010	6026770	6918650	n.a.	n.a.	n.a.
Total liabilities	3160270	3236040	3134930	3830930	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	2.4	0.8	0.9	1.7	-0.3	-0.4	0.2
Current account balance (% of GDP)	4.8	3.2	2.8	3.6	2.1	2.1	2.1
Inward FDI (% of GDP)	0.5	0.5	0.2	0.0	0.0	0.1	0.1
International investment position (% of GDP)	50.4	51.3	57.5	56.3	n.a.	n.a.	n.a.

Source: EIU