

Japan Manages Recovery While Addressing Challenges of the Future

November 2011

On March 11, 2011 Japan was hit by a massive earthquake and 30-foot tsunami. This natural disaster caused a tragic loss of life and severe damage, including a partial meltdown of the Fukushima Daiichi Nuclear Power Station. Electricity shortages, supply chain disruptions and a host of other problems caused a severe strain on the nation's social, political, economic and physical infrastructure.

Over the past six months Japan has thrown its full weight behind addressing the effects of this disaster and the results have surpassed most expectations. As of August, Japanese industrial production rose for five consecutive months as the transportation, steel and electronic component sectors regained their footing and in September exports increased 2.4%. While more needs to be done, Japanese manufacturers have now largely overcome post-quake production disruptions and the threat of power shortages. As a result, business sentiment reflected in the most recent September Tankan survey shows growing business confidence. Additionally, the nation's unemployment rate fell from 4.7% in July to 4.3% in August, improving for the first time in three months.

Despite this progress, domestic pressures arising from the after-effects of the tsunami, a lack of consensus as to how to deal with key structural issues, and general anxiety over the state of the Japanese economy led to the resignation of Naoto Kan in favor of Yoshihiko Noda, the nation's sixth prime minister in the last five years. External circumstances have also been troubling for Japan. Economic and political turmoil in Europe and the US has contributed to a historically strong yen, which has raised the price of Japanese-sourced products in foreign markets.

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While Japan is well on its way to bringing its economy back to where it was before the earthquake and tsunami struck last March, restoring the status quo is not sufficient to yield sustainable economic momentum. Japan must address the country's pre-crisis challenges -- namely its insular industrial focus, stagnating economy, and soaring public debt. To accomplish this, the nation must redouble its efforts to pass a number of key reforms. These include the need to promote innovation, to revitalize its economy through greater competition and trade, to develop a viable energy policy, and to further expand into emerging growth markets, including an increasingly integrated Southeast Asia.

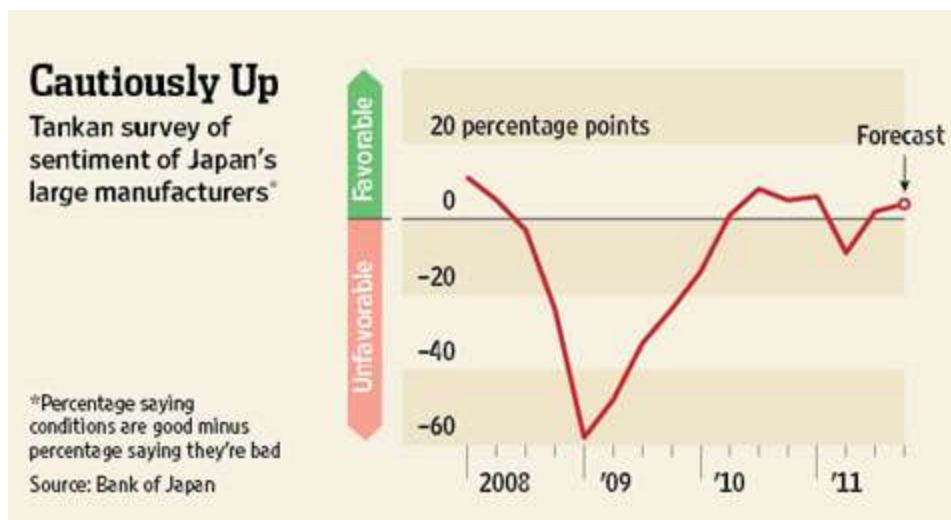
Japanese Recovery Effort Surpasses Expectations Though More Needs to be Done

The catastrophic effects of the March 11 triple disaster of an earthquake, tsunami, and nuclear crisis caused severe trauma to Japan. According to *The New York Times*, the natural disaster tragically claimed over 22,000 lives including 4,000 people who remain missing six months later. Tens of thousands of people have been dislocated or evacuated from their homes and remain housed in temporary shelters. The northeast coastal areas have been devastated and operators at the Fukushima Daiichi nuclear power plant continue to struggle to get the reactors into cold shutdown and to halt radiation leaks. Experts [estimate](#) the cost for reconstruction could be as much as 23 trillion yen, nearly 6% of Japan's GDP.

The March 11 crisis not only affected Japan, but also the global economy through supply-chain disruptions, especially in the automotive, electric, and computer industries. There were concerns that if Japanese firms failed to restart manufacturing, foreign competitors would try to supplant their market position, permanently damaging these industries.

While supply-chain disruptions did impact Japanese industries in the short-term, the worst fears were not realized. For example, while the car industry [is expecting](#) a revenue decrease of 3.3% -- its worst year since 1978 -- sales are expected to rebound as output returns to normal. Shortly after the crisis, Paul Cutbush, property treaty line manager for Swiss Re Canada, [estimated](#) contingent business interruption losses arising from the crisis would total between \$5 billion and \$15 billion. Now, Cutbush predicts losses at the low end of this estimate.

Japanese manufacturers have rapidly recovered and by July 1, 80% were up to pre-earthquake production levels. The latest [Tankan survey](#) released on October 3rd also indicates corporate sentiment and business confidence is rebounding and exports increased 2.4% in September. The median estimate of 26 economists surveyed by Bloomberg was for a 1% increase after a 2.8% gain in August. Employment statistics also provide hopeful news, as the unemployment rate fell from 4.7% in July to 4.3% in August, the first decline in three months.



Source: Wall Street Journal

While these metrics indicate Japanese industries and infrastructure are being restored, and the worst fears concerning damage caused by the crisis were not realized, Japan still faces immense challenges stemming from the March 11 crisis. These include questions about Japan's reliance on nuclear energy, the need for permanent relocation of displaced people, and concerns over the effects of radiation leaks to both Japanese residents and food.

New Japanese Government Moves to Complete Recovery and Address Important Challenges

Former Prime Minister Naoto Kan entered 2011 preparing to reform Japan's economy and to lead the nation along a bold, new path. The March 11 earthquake and tsunami and subsequent recovery efforts rightfully shifted his focus. The difficulties, however, of mounting an effective response to this unparalleled disaster led to an erosion of public support for the Prime Minister and his government.

In June, Kan narrowly survived a parliamentary no-confidence vote, which intended to remove him from power. His survival was achieved in part by his promise to resign once he fulfilled his duties to handle the worst of the disaster. Specifically, Naoto Kan wanted to remain in office until three key pieces of legislation -- the financing of post-disaster reconstruction, a bill promoting renewable energy, and a second budget bill -- were passed through the opposition-controlled upper house of the Diet.

On July 25th, Japan's parliament passed a [second budget bill](#) of 1.99 trillion yen allocating payments for damages suffered by victims of the nuclear crisis, as well as financing disaster relief and reconstruction. On August 26th, the upper house of parliament approved the renewable energy reform bill that rewards green energy investments, and a bill which permits the government to issue bonds to help cover the current main fiscal budget. Achieving passage of this legislation, Prime Minister Kan fulfilled his promise to resign.

Japan's governing Democratic Party of Japan (**DPJ**) elected Finance Minister Yoshihiko Noda as its leader, and he was confirmed by parliament to become Japan's sixth prime minister in the past five years. Noda has called for unity as he faces a gridlocked Parliament.

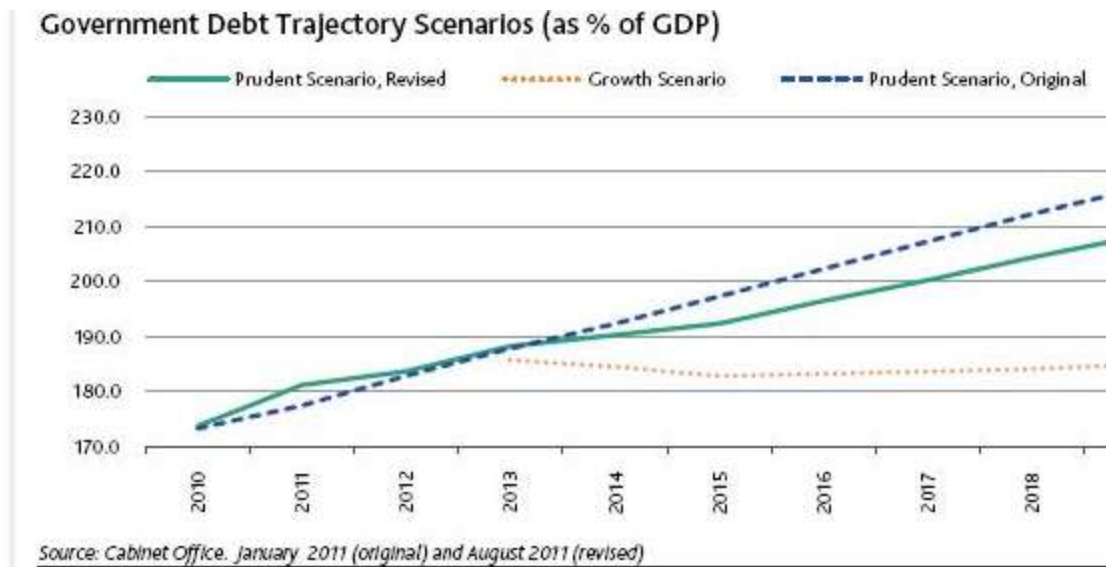
In assembling his cabinet, Prime Minister Noda is moving to confront the political infighting that hampered prior efforts to pass comprehensive reforms. He has appointed people with ties to rival DPJ factions in addition to the leading opposition Liberal Democratic Party (**LDP**) to key cabinet posts. Noda hopes by limiting political gridlock, Japan's government can regain the public's trust.

Japan Must Continue to Reduce Debt and Transition from a Deflationary Environment

Prime Minister Noda has announced he aims to pass a third supplementary budget for disaster reconstruction. It is expected to amount to more than 10 trillion yen. This will further expand Japan's massive public debt, which has risen to 225% of the country's GDP. In Noda's first press conference as prime minister, however, he emphasized that ongoing expansion of this borrowing is not sustainable, and noted debt alleviation would be a priority of his administration.

While Japan's debt is troubling, nearly 95% of Japanese debt is held by local investors. This makes it less of a problem than debt held by Western economies. Japanese investors have routinely bought government bonds even at extremely low interest rates permitting the nation to finance its own debt internally. Increasing deficits and an aging, shrinking population, however, makes this approach increasingly infeasible moving forward.

On August 23, Moody's Investors Service [lowered](#) Japan's credit rating by one notch to Aa3, the fourth-highest rating, citing large budget deficits, slow growth, and frequent changes in administrations that have prevented the implementation of long-term economic reforms.



Noda has a reputation for being a fiscal hawk. Long before his election, he consistently called for a reduction of public debt. As Kenichi Kawasaki, senior political analyst at Nomura Securities, [stated](#), "Noda is the most aggressive about tax increases among the candidates [for prime minister], so his win would fuel expectations that fiscal reforms will progress."

Noda [promised](#) to "no longer spend wastefully as if we are pouring buckets of water into a sieve" and to swiftly enact fiscal reforms to cope with the debt. He asked, "for the participation of each party in policy debate on social security and tax reforms, so we can form a consensus necessary for the Bills' passage". Furthermore, he has not retreated from a

pledge he made as Finance Minister to raise the consumption tax to 10% by the middle of the decade to reduce deficits.

Strong Yen Leads to Challenges as well as Opportunities

Another issue Japan's government will have to address is the strength of the yen. This has been detrimental to Japan's export-led economy. Following the March earthquake and tsunami, the yen experienced a six-month period of continuous growth and reached a post-World War II record in large part due to external causes.

Economic issues in both the U.S. and Europe are causing their currencies to weaken. The U.S. is suffering what economist Richard Koo named a "balance sheet recession," similar to that which has afflicted Japan. This is a phenomenon where the private sector seeks to minimize debt rather than maximize profits. Meanwhile, Europe is addressing a sovereign debt crisis that is affecting the entire global economy.

The strength of the yen creates a challenging circumstance where Japanese industries are encouraged to expand their businesses overseas, yet find it difficult to compete because of the relatively higher cost of goods and services sourced from Japan. Addressing a special session of the Diet on September 20, Noda warned of the "hollowing out" of Japan's industrial heart and stated, "We hear screams from exporters and from the small and mid-sized companies that have led our country's industries. If things carry on like this domestic industries could go downhill and jobs could be lost... it would be almost impossible to break out of deflation and reconstruct areas hit by the disaster."

Some Japanese companies, however, are taking advantage of the increased purchasing power of the yen by expanding or diversifying their businesses overseas. The combination of a strong yen, inexpensive financing, and strong corporate balance sheets leaves Japanese companies well positioned to fund foreign acquisitions. In the three months following the March crisis, Japanese companies bought twice as many assets overseas as they did in the same period in 2010. This is highest quarterly total in three years. For example, the beverage company [Asahi bought](#) Independent Liquor of New Zealand for \$1.3 billion to offset

shrinking domestic demand. The Japanese clothing designer, manufacturer, and retailer Uniqlo has also funded expansions of their businesses by opening retail stores overseas. This includes a new North American flagship store on Fifth Avenue in New York City.

Noda has also promised to extend funds to key industries that create jobs and expand financial backing to small and medium-sized enterprises. Seiji Maehara, policy chief for the DPJ, believes Japan should take advantage of the stronger yen by aiding companies in purchasing foreign companies and natural resources. By doing so, Japanese companies can strengthen their individual standing in the global economy, while indirectly contributing to the weakening of their currency by selling yen for the foreign currency needed to buy foreign assets.

Japan Must Promote Greater Innovation and More Dynamic Business Environment

Despite the challenges of a strong yen, one vital goal of Japan should be to improve the countries ability to benefit from its innovative capacity. The nation's ability to develop intellectual property has never been questioned; however, to fully profit from its innovations, it must finally end the so-called "Galapagos effect." This refers to the tendency to apply Japanese innovations in an insular manner, focusing on the preferences of Japanese consumers over those necessary to succeed in international markets.

For example, NTT DOCOMO helped to launch the mobile telecom revolution with its i-mode™ service in 1999, which allowed e-mail, browsing, downloading and other services. This was followed in 2001 with the introduction of the world's first 3G commercial mobile service. While NTT DOCOMO continues to possess more than 58 million subscribers in Japan, it has not been able to duplicate its success overseas and lags many foreign competitors who got a later start.

Robert Dujarric of Temple University Japan highlighted this problem [in an article for the Japan Times](#), noting "If so few Japanese conglomerates have managed to establish themselves in the premier league outside of manufacturing, it is partly due to their mono-cultural and exclusively Japanese manufacturing. It puts them at a severe disadvantage when competing

with foreign rivals run by multinational and multicultural staffs.”

Similarly, as Gerhard Fasol, president of the Tokyo-based IT consulting firm, Eurotechnology Japan stated to The New York Times, “Japan is years ahead in innovation. But it hasn’t been able to get business out of it.” Japan has allowed domestic markets to drive its focus in technological advances. While this strategy was profitable when the Japanese market was robust, it does not allow for the economies of scale needed to make Japanese companies globally competitive. It is especially problematic when the Japanese economy is in a downturn.

Japan’s Ministry of Economy, Trade and Industry (**METI**) is proactively seeking to diminish the “Galapagos effect” through a [campaign](#) aimed at promoting Japanese goods, with an emphasis on creative industries. METI’s “Cool Japan” campaign aims to provide information about Japanese products, restore confidence in Japanese brands, and facilitate international expansion by the country’s small and medium enterprises. “Cool Japan” will focus its efforts on crucial foreign markets including the growing markets of China, Brazil, India, South Korea, and Singapore, as well as the major markets of the United States, France, and Italy.



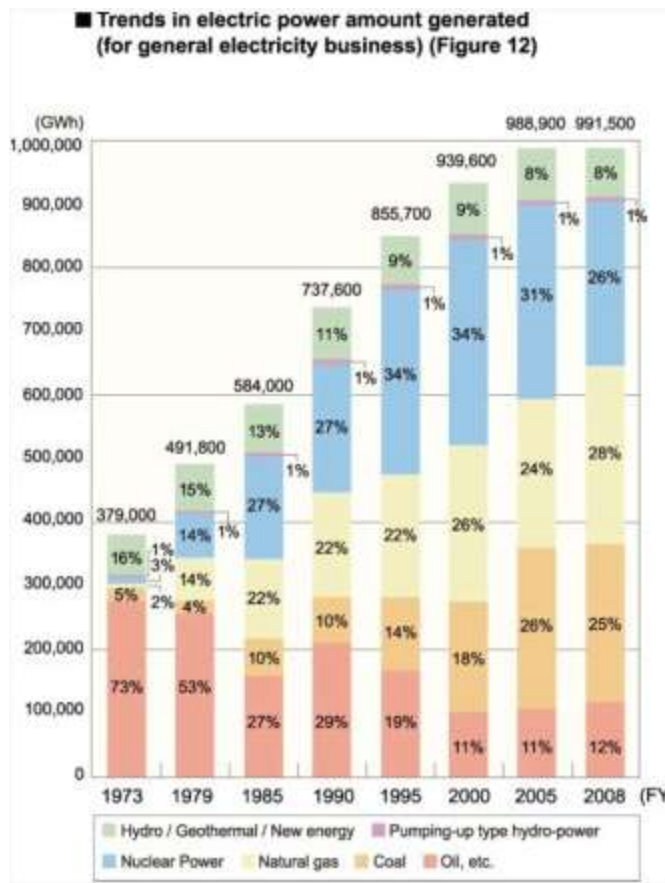
A logo for “Cool Japan,” created by prominent designer Kashiwa Sato.

The campaign will localize its focus based on demand in specific markets. For example, in Singapore, where Japanese cuisine is very popular, METI will promote Japanese foods, including products from region’s most affected by the tsunami and nuclear emergency to reduce fears over their safety. Additionally, Japan’s government has launched a “Creative Tokyo” campaign, which involves a number of art, fashion, music, and food events, to increase tourism and showcase Tokyo as a creative hub.

Tetsuya Watanabe, director for the creative industries division at METI, explained, “The Japanese population is aging and in the economy itself, domestic demand is shrinking. So, we have to extend our businesses in the growing markets, especially in Asia.”

Japan Must Develop Sustainable Growth Model and New Energy Policy

Possibly the most important long-term repercussion of the March 11 earthquake and tsunami will be its effect on Japanese energy policy. Since Japan lacks domestic energy resources, nuclear energy was a central component of energy procurement and it was perceived as a cost-effective way to secure a clean energy future. The country’s 54 reactors provide 30% of the country’s electricity, and there were plans to build 11 new plants. This would have eventually provided 50% of the nation’s electricity needs by 2030.



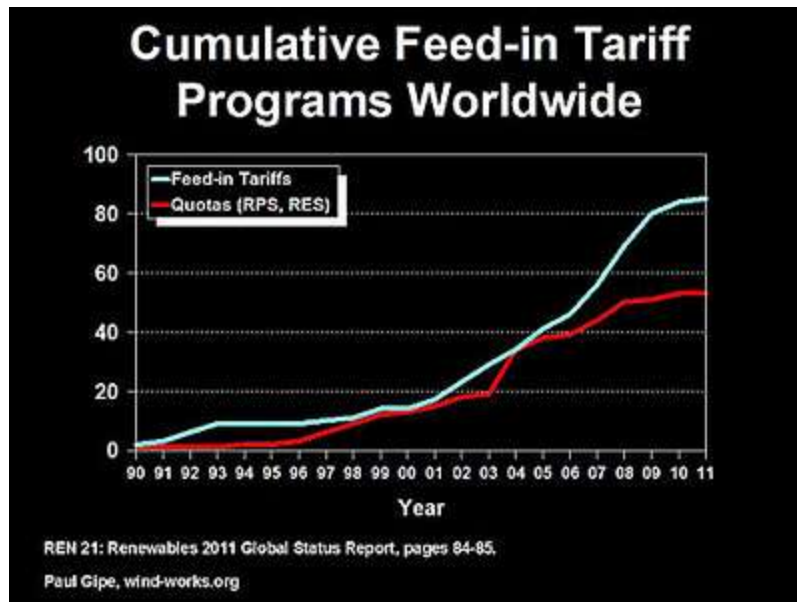
Source: Energy in Japan 2010 by the Ministry of Economy, Trade and Industry

Since the March 11 disaster, discussions concerning the role of nuclear power in Japan have changed considerably. Public confidence in Japan's nuclear industry has [greatly decreased](#). Prime Minister Noda said he was committed to reducing Japan's dependency through a gradual phase out. [In a speech to the nation](#), Noda stated, "To build new reactors is unrealistic, and we will decommission reactors at the end of their life spans. But it is also impossible to immediately reduce our dependence to zero."

Only 12 out of Japan's 54 nuclear power plants are currently in operation due to maintenance and stress-testing. In the short-term, Noda's challenge will be to persuade the Japanese public it is both safe and necessary to restart the reactors to end power shortages. He has promised, "Japan is determined to raise the safety of its nuclear power generation to the highest level in the world." In the long-term, however, with Japan's reliance on nuclear energy in question, the government must develop a comprehensive policy that can fulfill Japan's energy needs.

As a resource-poor nation, Japan has long understood the importance of renewable energy. For this reason, both government and the private sector are intensifying their commitment to this sector. Softbank CEO Masayoshi Son, for example, has created an initiative to work with governors and mayors to construct power plants that use renewable resources. He has promised to donate hundreds of millions of dollars to solar projects to reduce Japan's reliance on nuclear power.

Japan's government also has plans to reinvigorate the country's renewable energy industry. The Diet approved the "Renewable Energy Bill" which subsidizes electricity generated by renewable sources through a so-called feed-in tariff. It will become effective on July 1, 2012.



This bill provides incentives for wind, solar, and geothermal energy and requires utilities to purchase power generated from renewable energy sources. The Japanese government hopes this will stimulate investment in renewable energy and generate innovation in the industry. Not only would such innovations benefit Japan's domestic energy needs, but renewable energy technology could also become a substantial export industry.

Japan Must Continue to Promote Competition and an Increasingly Integrated Asia

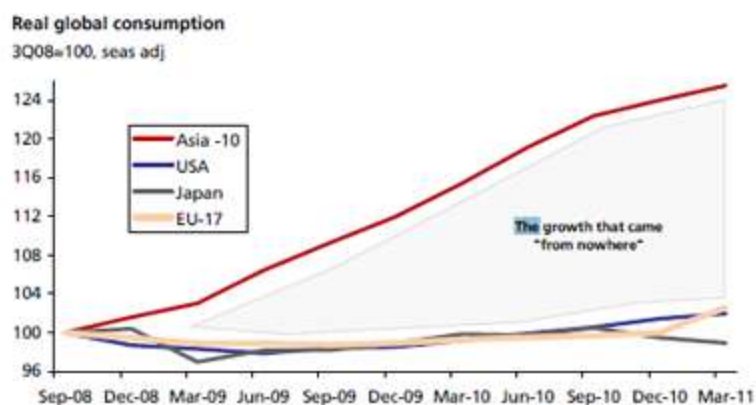
Prior to the March 11 earthquake and tsunami, former Prime Minister Kan was moving to enact a bold new economic vision to end stagnation and strengthen Japan's economy. Kan intended to initiate the reforms delineated in [METI's Industrial Structure Vision 2010](#), which aimed to diversify Japan's economy, fix weaknesses in business infrastructure, and better capitalize on technological developments. Central to Kan's vision was the need to create an "open Japan" that would be more welcoming to trade agreements even if that meant confronting the substantial electoral clout of the agricultural industry who have traditionally opposed such measures.

While the priorities of Japan's political leadership have rightfully shifted to the immediate needs of disaster relief and reconstruction, the necessity of enacting reforms to strengthen

Japan's long-term economic development has not diminished. Prime Minister Noda has signaled he recognizes this challenge through his balanced focus on both short-term relief and long-term reform.

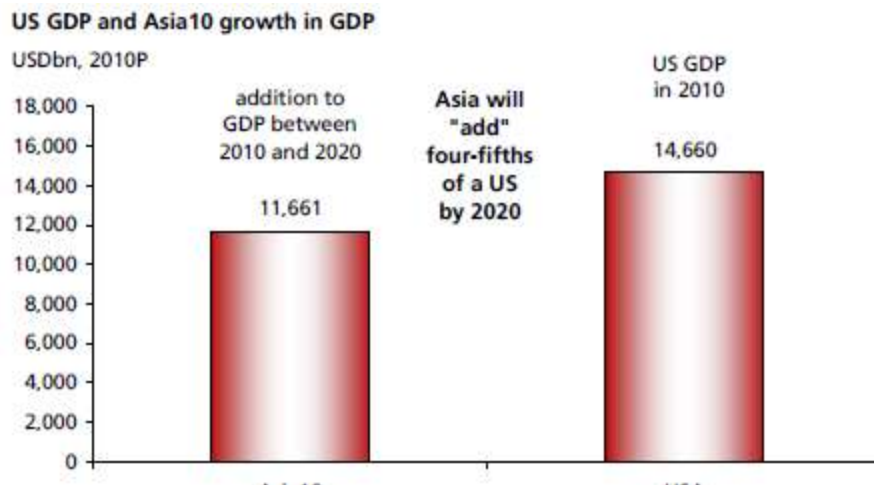
Following Kan's lead, Prime Minister Noda is pushing for Japan's participation in negotiations to enter Trans-Pacific Partnership Strategic Economic Partnership Agreement (**TPP**) talks. Participation in the TPP would provide a host of benefits to Japanese businesses and consumers. Many analysts view it as increasingly vital given the success other Asian economies have had in negotiating bilateral and multilateral free trade agreements (**FTA**). The Republic of Korea, for example has negotiated FTAs with both the U.S. and EU. These accords will help to increase trade between these markets and may displace both Japanese exports in these major trading partners, as well as investments that might have been made in Japan. Joining the TPP, therefore, will not only enhance Japan's competitiveness in the developed economies that have traditionally absorbed the major share of Japanese exports, but also increase its ability to expand in emerging Asian markets.

A study by DBS Group Research found that in 2010 the Asia-10 (China, Taiwan, South Korea, Hong Kong, Singapore, Malaysia, Indonesia, Thailand, Philippines, and India) surpassed the United States and now constitutes the primary source of incremental demand in the global economy. While the U.S. and EU, Japan's traditional trading partners, have experienced very slow growth over the past three years, Asians are consuming 25% more today than at the onset of the 2008 global financial crisis.



Source: DBS Group Research

Furthermore, DBS predicts the Asia10 will grow the equivalent size of 80% of the current U.S. GDP over the next eight years. To benefit from this growth, Japan must proactively improve the trade environment with these economies.



Source: DBS Group Research

As detailed in [previous issues](#) of JETRO Focus Newsletters, pushing Japan into engaging in negotiations for entry into the TPP is a politically challenging proposition. Joining the TPP would force Japan to reduce or eliminate tariffs now in place on many agricultural products. This is deeply opposed by the farming industry. Even some members of Noda's DPJ believe the trade agreement would devastate Japan's farming industry and oppose entry.

Noda has stated he supports opening up the agricultural industry and is planning to put together a series of reforms that will allow the agricultural industry to face increased competition. The farm ministry has also been proactive. In its requests for the 2012 fiscal budget, the farm ministry aims to include measures that discourage non-profitable farming and to provide grants so successful farms can increase in size.

Clearly, reforming the agricultural industry will be an immense political challenge -- but one that Japan's *Nihon Keizai Shimbun* recently characterized as a "Do or Die" moment for the Prime Minister. Participation in the talks is supported by much of Japanese industry. At a recent conference, the Chairman of Keidanren, Japan's largest business association, Hiromasa Yonekura went so far as to describe the current minister of agriculture, fisheries, and

forestry, Kano Michihiko, who has publicly opposed TPP accession, as “weak-kneed.” In reporting on this statement, [Forbes](#) noted “Yonekura’s point is that whether or not Japan accedes to the TPP, profound reform of Japanese agriculture to make it more competitive is inevitable”.

Agricultural reform would clearly introduce efficiencies into the Japanese economy. As Forbes states “Numerous independent think tanks in Japan have produced studies demonstrating that Japanese agriculture is vastly less productive and efficient than it can and should be, largely as a result of protectionist government policies and restrictions. They have proposed a comprehensive program of needed reforms.”

Entry into TPP negotiations would also bolster Japan’s trading relationships with emerging Asian markets. Gaining a foothold in these neighboring markets will provide Japan with opportunities that can drive economic growth for decades to come. It will also improve the nation’s relationship with the United States. As the U.S. prepares to host November’s Asia Pacific Economic Cooperation (**APEC**) summit after receiving hosting responsibilities from Japan, which hosted the annual meeting in Yokohama last year, it appears President Barack Obama will use the meetings to further transition Washington’s foreign policy focus toward the economic possibilities of Southeast Asia.

The TPP will clearly be a central component of this agenda. If Prime Minister Noda can form a consensus in Japan and joins entry negotiations for the TPP, Japan can work with the US to advance this trade and economic policy agenda at the APEC summit meeting.

Japan Remains Key Element of Global Business and Investment Strategies

Japan’s integral role in the global economy means its short-term recovery and long-term policy decisions will be closely monitored. Japan has already made great progress in its recovery efforts. Output and export levels have been growing, factories are reopening, and supply chains restored.

Questions concerning the attainment of sustainable power production still must be answered.

In the short-term Japan will look to phase-out nuclear energy while boosting efficiency efforts. The combination of Japan's lack of natural energy resources and anxiety over nuclear energy will likely yield robust investment in renewable energy technologies. Not only can renewable energy help provide for Japan's energy demands; it can also become a major export industry. Japan is also likely to increase purchases of traditional energy resources as well in foreign markets.

Japan has the third largest GDP in the world and is a leader in innovation. Its companies have accumulated great wealth and are in a strong position to expand overseas and acquire additional assets due to the value of the yen. While much needs to be accomplished, there are many reasons to believe Japan will be able to set itself along a path of prolonged economic success for many decades to come.

Foreign corporate and portfolio investors are in any case advised to closely monitor Japan's progress so that they will be positioned to take advantage of the many opportunities that result.

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<http://www.surveymonkey.com/s/SLB7SYW>

The above site will be closed on **December 7, 2011. Your understanding and cooperation is highly appreciated.**

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