SEB ECONOMIC RESEARCH 2007-02-26

Japan: A strong but ageing giant

- **The Japanese economy has reawakened, thanks to structural reforms and with an assist from the global economy. Japan's export industry can be expected to reap continued success based on superior engineering skills.**
- **But significant challenges lie ahead. Central government debt will require tighter budgets over a long period. The population is shrinking, and pension and health care costs are rising.**
- **There is heavy pressure for continued structural reforms, but the new government headed by Shinzo Abe is more traditionalist than its predecessor.**
- **One conclusion is that the Bank of Japan is likely to keep its key interest rate low, thus helping maintain a weak yen in the period ahead.**

Many doors, many keys

During February 2007, a group of Nordic business representatives took a trip to Japan, organised by SEB. The delegation — led by Marcus Wallenberg — met a broad array of economists and businessmen in a short period.

This memo summarises my own impressions from the trip, but it was unusually difficult to write. Ambassador and Japan expert Lars Vargö has said that analysing Japan is like opening a door with a certain key only to find that behind it is yet another door that requires a completely different key — and that even if you can manage that, you soon discover a third door, and so on.

A Westerner finds Japanese society hard to understand, not least because people in Japan so systematically filter information — what they do not wish to see is not mentioned. The nuances of Japan's language — as finely calibrated as its bowing customs — also create obstacles to frank communication.

Yet Japan has become much more open. Since the bottom of the economic crisis — around 1995 — the reporting and inventorying of problems has become clearer, debate freer, the grip of the bureaucracy weaker and English language skills vastly better.

Back after a lost decade

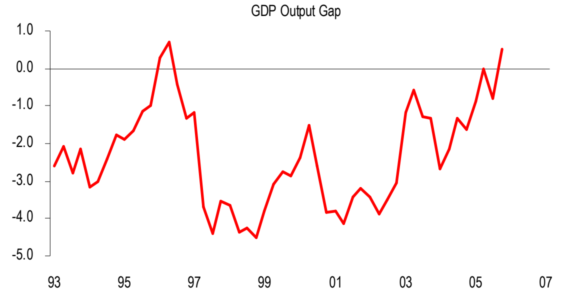
People in Japan speak of the 1990s as a "lost decade". Although their crisis was extremely mild compared to that of many other affected countries — deflation propped up real wages and expansive fiscal policy served as a shock absorber — their earlier pride in the "Japanese model" was thoroughly shaken.

The past four years have nevertheless seen a gradual normalisation of the situation. In

January, Japan noted its 60th consecutive month of positive growth — actually the **longest uninterrupted upturn** since the early 1950s. Four factors underlie this recovery:

- The **Bank of Japan's expansive policy**, which pumped large quantities of liquidity into the economy starting in 2001.
- A **progressive streamlining process in manufacturing**. Corporate balance sheets were gradually restored to health, thus also reducing the credit losses of banks.
- A **gradual loosening of the rigid Japanese model.** Lifetime employment has become less widespread, strong cross-ownership ties in corporate groups (keiretsu) have been dismantled and ministry-based bureaucrats have lost some of their clout. Large-scale mergers have created powerful new companies, not least in the banking sector.
- The **growth of the U.S. and Chinese economies** in recent years has provided Japan's export industry with expanding markets for its products as well as opportunities to make large-scale direct investments in low-cost regions.

The output gap is closed



Source: Ministry of Finance

The result has been a renaissance for Japan's traditional engineering-heavy, precision-oriented and high-tech export industry. Japanese companies are miles ahead in the international patent leagues, and their country is showing an enormous trade surplus. The big output gap (the difference between potential and actual GDP) has slowly narrowed; according to official definitions it has now in fact been entirely eliminated.

Japan's self-confidence has slowly returned. Tokyo is in the process of regaining its position as a global centre of architecture, fashion and design. Traffic is more intensive and new agglomerations of skyscrapers — with extremely expensive earthquake-proofing systems — have popped up. After 15 years of falling real estate values, the trend has reversed. In Tokyo, property prices climbed 10 per cent during 2006.

Gnawing concern

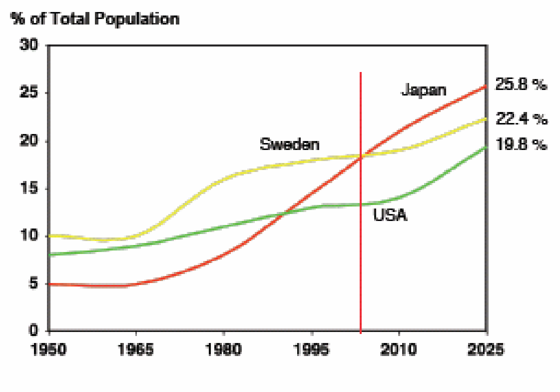
Yet the typical Japanese — "Mrs Watanabe" — is concerned about the future. Few dare to believe that the upturn will continue, and almost no one dares to believe that the old Japanese model of firm social control, low unemployment, lifelong security and stable social relationships can be restored.

The reason is that **Japan is caught in a squeeze between two unpleasant realities**. On the one hand, there is **demography:** An ageing population with a low birth rate will mean sharply rising pension and health care costs as the number of working people meanwhile shrinks. On the other hand, Japan has by far the biggest **central government debt** among developed countries: 160 per cent of BNP (four times more than in Sweden).

This combination of major obligations and growing fiscal problems is creating palpable concern for the future. One of our lecturers, Kenneth Courtis, expressed the dilemma thusly: There are two welfare models, the Anglo-Saxon model of low taxes and low government payments, and the European model of high taxes and high government payments. But Japan has low taxes and high government payments. This is unsustainable. Japan will have to choose one of these paths.

Japan's own solution will probably be gradual and will avoid all extremes, but everyone assumes that it will include **both higher taxes and lower expenditures.** Former Prime Minister Junichiro Koizumi began trimming Japan's big public infrastructure investments, but the necessary cuts in transfer payment systems remain. The consumption tax (a kind of Japanese value-added tax) is likely to be raised sharply from today's low 5 per cent. The new prime minister, Shinzo Abe, has avoided the issue, however; the interpretation is that gradual tax hikes will begin, but not until after the election to the upper house of Japan's parliament in July.

People aged 65 or older



Is one engine enough?

Uncertainty about the future and the feeling that unpleasantness lies ahead are pulling a wet blanket over Mrs Watanabe's optimism. Consumer confidence is low and household savings have recently climbed to 14 per cent of disposable income. As a result, **private consumption refuses to take off**. Japan is thus missing the most important engine for broad, rapid continued growth; the economy is flying on just one engine — the export industry.

The question is how long that will last. Another of our lecturers, Merrill Lynch's chief Japan analyst Jesper Koll, maintained that over the next 4-5 years, the country's GDP growth should be able to reach 2-2½ per cent annually. However, this is a very optimistic scenario, clearly above consensus. The IMF estimates Japan's potential growth is about 1½ per cent a year; the figure is so low largely because the number of hours worked is shrinking. Koll's forecast thus implies that Japan will continue to grow clearly above trend for another long period, even now that the output gap has closed.

In order for this to happen, however, several developments must coincide. The construction sector must experience a sharp upswing — which is not impossible, given that its starting position is comparatively weak. But beyond that, productivity in the service sector must surge — which will be more difficult.

Japan's service sector is large and low in productivity. The contrast between service and manufacturing productivity is larger than in any other country, has deep roots and applies even in otherwise efficient organisations. It should thus be noted that the provision of services is inefficient even *within* goods-producing companies.

Why this is the case goes far beyond the scope of this trip report. But a not unreasonable interpretation is that the causes lie in deep traditions. Due to high population density and strict hierarchies, on the one hand, the Japanese have a long tradition of precision work and miniaturisation. On the other hand, they have clearly defined private spheres that are not to be encroached upon; both language and rituals underscore the rigidity of relationships between people. The outcome, according to this amateur sociological analysis, is industrial and engineering brilliance but a rigidly functioning and bureaucratic service sector.

The old Japanese model is slowly loosening. Reforms of the service sector are a huge potential. But personally I find it hard to believe that there is such a far-reaching cultural revolution is imminent that service productivity will suddenly take a giant leap.

Abe: More traditionalist than innovator
The political situation also makes major shifts unlikely. Under Koizumi, economic policy swung towards reform and privatisation, while the prime minister managed to rally the voters against the rigid structures and bossism of his own Liberal Democratic Party (LDP), thanks to his personal charisma.

But Koizumi the innovator has retired. His successor as prime minister, **Shinzo Abe, is much more of a traditionalist**. He comes from an influential political family, with several ministers in previous generations. Abe has been conciliatory towards traditionalist party colleagues who protested against Koizumi's privatisations, and he shows far greater sympathy for the LDP faction system that his predecessor wanted to break up. His foremost goal is to reshape the constitution (why and how are not quite clear) and to restore respect for Japan abroad. But his economic policy strategy is diffuse. Tax increases are likely to materialise, but in small steps.

It is difficult to see this government prepare major reforms that, within the foreseeable future, might lead to a surge in bureaucratic efficiency and service productivity. Nor do I believe that the current government would like to carry out major cutbacks in transfer payment systems. My conclusion is that the Abe government is more likely to be dominated by **muddling through** than by bold reforms, provided it survives this summer's election. Abe's popularity has fallen in recent months; a government crisis after any election loss cannot be ruled out.

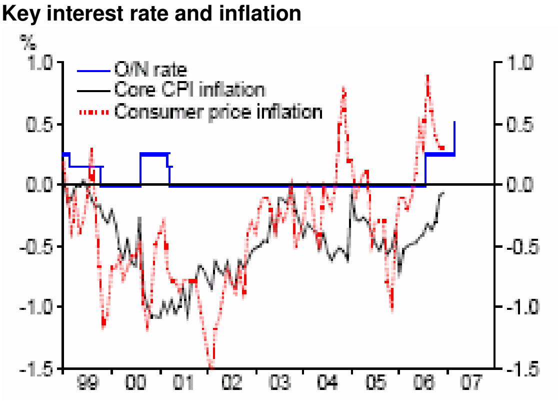
Heavy pressure on the Bank of Japan
Against this backdrop, it is obvious that the central bank finds itself in a difficult situation. If central government debt is to be brought down to manageable levels (below 100 per cent of GDP) over the next 6-8 years, a number of jigsaw bits must fall into place at the same time.

The **consumption tax must be raised** by ½-1 per cent a year, while public infrastructure investments are further scaled back, privatisations continue and **social insurance systems are reformed**. But — and here is the hard part — this must not destroy consumer confidence or strangle economic growth.

The optimal scenario for Japan would be annual GDP growth of 2½ per cent and inflation of 2 per cent. This would lead to decent nominal growth and create more wiggle room for both the government and households. Such low, stable inflation is also compatible with continued low interest rates, which are vital given Japan's debt burden.

But in light of all the problems listed above — including shrinking population and weak service sector productivity — it is difficult to foresee even a theoretical chance that this scenario could be realised except if the Bank of Japan continues to pursue a low interest rate policy. This is also quite obviously what the government wants — and is clearly signalling.

Key interest rate and inflation



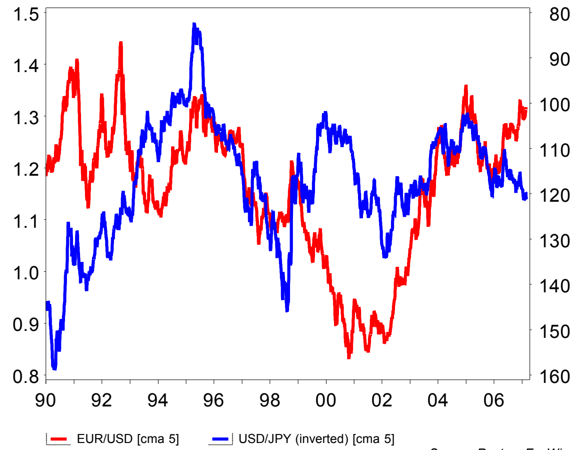
Continued **low key interest rates will have two positive effects,** viewed with Japanese eyes: enabling inflation to rise to the desired level and making a continued weak yen possible.

In recent years the BoJ has spoken of beginning to "normalise" its key interest rate, and financial markets previously priced in hikes to well above 1 per cent during 2008. But the underlying weaknesses in the Japanese economy, together with heavy political pressure from the government, have led to a much more cautious rate-hiking process than expected.

A decent GDP figure for the fourth quarter of 2006 admittedly enabled the BoJ to raise its key rate from 0.25 per cent to 0.50 per cent in February. This temporarily dampens suspicions of political submissiveness. But looking ahead, I find it difficult to believe that **rate hikes will be anything but extremely cautious.**

Another hike, during the second half of 2007, is likely. But after that, nobody knows if there will be any more. In other words, I believe that in the foreseeable future, the key rate will stay below 1 per cent — lower than I had previously believed.

Weak yen



Source: Reuters EcoWin

Such low interest rates naturally mean a continued weak yen — which is exactly what the government wants. According to all available measures, the yen is greatly undervalued. This is apparent from the trade surplus, for example. Recently. it weakened further vs both the USD and the EER. A continued soft currency policy will thus encounter tough criticism, both from the United States and the European Union. But from a domestic Japanese perspective — with demographic and fiscal dilemmas looming ever closer — there is nothing remarkable about wanting the help of a weak yen both to maintain competitiveness and to avoid deflation.

A continued weak yen means that **the currency will continue to be a funding currency**, i.e. many borrowers will take out loans in yen and invest the money in other currencies. Recently there has been some concern that this "carry trade" would abruptly cease if the BoJ raised its key rate. In that case the yen would rise sharply, with accompanying turbulence — which is what happened in 1998 in the wake of the Russian financial crisis. However, the risks of such turbulence do not appear so acute right now, given the picture sketched here.

But more important than the short-term flows resulting from a more or less speculative carry trade is that **Japan will remain a major exporter of capital**. Large current account surpluses and relatively low return at home will continue to drive Japanese investors abroad — both when it comes to portfolio investments and direct investments.

Dazzling business opportunities

The macroeconomic picture of Japan is mixed. The country has left behind its acute crisis. But large long-term challenges remain.

This does not mean, however, that business opportunities in Japan are small or negative for Swedish companies. On the contrary.

Despite the challenges ahead, the fact is that the **Japanese economy is still one of the world's largest** (second largest after the US counting in current dollars; third largest, after the US and China, if adjusted for purchasing power). Greater Tokyo, with more than 30 million inhabitants, is by far the world's largest single concentration of purchasing power. In absolute figures, Japanese GDP has increased during the past few years more than that of the entire EU put together. Despite all the uncertainty about the future, consumption per capita is the highest in the world after Luxembourg. Real wages are high, and **the Japanese are a wealthy people.** Central government debt may be large, but the average Watanabe family has financial wealth of no less than SEK 3 million.

In other words, there is **a gigantic market here for those able to get a foot in** — which used to be difficult, but the chances are now increasing as the economy becomes more open.

Especially interesting to Swedish companies right now are the **shifts in consumer demand** that may conceivably occur due to demographics. The population is ageing, but meanwhile a more Western approach to marriages and divorces is causing the number of households to skyrocket. Life science, senior housing experience, production that supports the lifestyle of working women, environmental technology etc. — these are areas in which Swedish companies are hoping for success. One example is home furnishings retailer IKEA, which opened two large stores last year outside Tokyo — having strongly pushed the view in its marketing that home and family are the most important things in life — not work…

The **Japanese capital market** is also of interest. So far, its enormous financial wealth has been managed conservatively. There have been few mergers and the private equity market has been small. All this is now changing. New entrepreneurs are emerging, taking advantage of new financing mechanisms — and Japanese investors are continuing to export capital on a large scale. The coming privatisations of Swedish state-owned companies, not least, are viewed with interest in Tokyo's financial district.

Swedish companies have had a hard time establishing a presence in Japan, with its different culture, closed business community and perfectionist standards. But as the country increasingly opens up, opportunities will emerge for those who think in the long term.

Klas Eklund
klas.eklund@seb.se