

The Travelling Economist: Perspectives on Japan

Economic Research paper

14 October 2010

- Japan, where this Travelling Economist spent most of last week, is a very wealthy nation, despite no significant economic growth for around 20 years due to the combined effects of an ageing and declining population, low productivity and deflation.
- Two key issues dominate discussion in Japan: the unwanted strength of the Yen (hurting the important export sector) and increased tensions with China.
- While Japan has a very high level of government debt, almost all this debt is owned by Japanese institutions and retail investors. Current trends suggest this will remain the case for some time to come, despite increased signs of appetite for international investments, including into Australia.
- If this Travelling Economist was the Japanese PM for a day he would: implement policies to increase the population (via both immigration and a higher birth rate); support more aggressive policy action from the Bank of Japan; reform the tax system to raise the consumption tax rate and lower income taxes; encourage exports, including intervention to weaken the Yen and increase spending on the self-defence force.

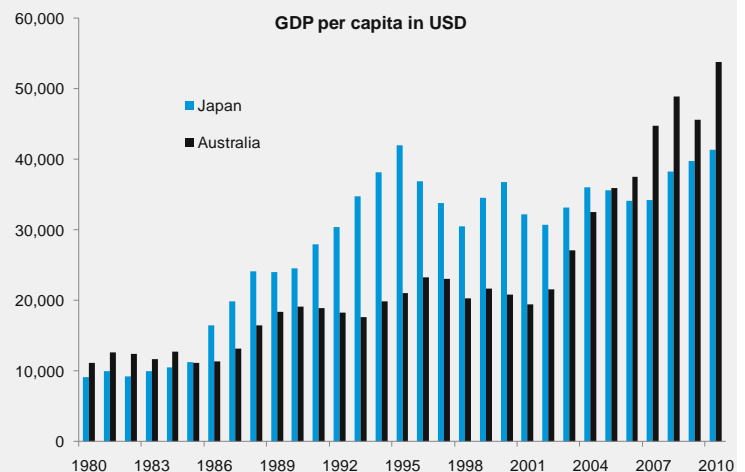
Highlights:

This Travelling Economist has just returned from five days in Japan, the third visit to this nation since starting work at CFSGAM in early 2009 (although I had been there many times before in my previous roles).

Japan is a fascinating place – I always enjoy travelling there. Culturally it is very different from our lives in the western world (including Australia), but also driven by the same economic fundamentals that impact all of us.

Japan is a very rich country – GDP per capita is over \$US41,000, one of the highest in the world. Japan developed significant wealth in its boom period from the 1950s to the 1980s. In this rapid growth phase Japan grew to be the second largest economy in the world – a significant feat given its relatively small population of only 127 million. (Note: as at 30 June 2010 Japan lost its mantle as the second largest economy to China – more on this below).

Australia and Japan GDP per capita



Source: IMF

However, Japan has not been growing in a meaningful way for over 20 years and the wealth that had been built up over many years is now being eaten away and spent. With almost no economic growth, a declining population, low productivity and deflation, the prospects for a return to a period of strong economic growth seem remote. As the chart above shows, after lagging behind for many years, GDP per capita in Australia now exceeds that of Japan.



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In many ways this decline in economic wealth and prestige is a choice by the Japanese people. Essentially, as this Travelling Economist sees it, the Japanese people (or perhaps more accurately, the post-WWII generation) have chosen cultural purity and their “way of life” over economic growth.

That is fair enough for them. They amassed significant wealth in the post WWII development phase and are now using up (enjoying) that wealth. But it is not such a great outcome for future generations. This Travelling Economist wonders how long it will take for the next generation – say all those under the age of 45 or so – to have sufficient resources and confidence to take charge of the economic and political agenda.

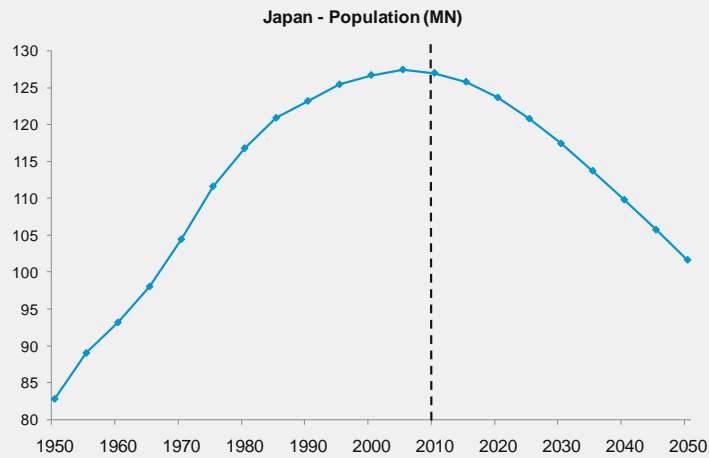
Population:

One of the most significant issues for Japan is its declining population. The 2010 population is estimated at 126.8m. The population is now falling by 0.22% per year and has been declining since 2006.

As shown in the chart below, the population of Japan is expected to decline quickly and is estimated to be around 100m by 2050, well down from its peak near 128m.

It is significant to note that with the ageing population, roughly 30% of all Japanese households now have a “head” of the household that is retired and over the age of 60 years.

Japanese population on the way down



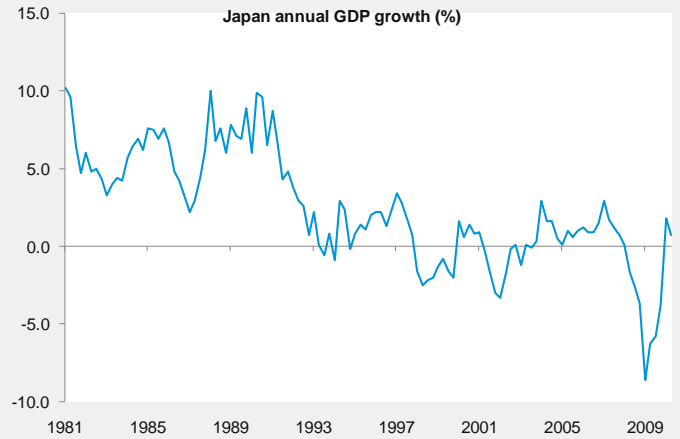
Source: IMF, forecasts from 2005

Economic performance:

This declining population and dramatic increase in the number of retired people per worker can explain a significant part of Japan's economic underperformance over many years.

As shown in the chart below, the annual GDP growth rate of Japan has been declining on a trend basis for the past 20 years, including a massive hit from the global financial crisis. The recovery in economic growth in Japan now looks like it has run its course and despite further policy stimulus (both monetary and fiscal) GDP growth in Japan is expected to slow in 2011 to around 1.5%/yr from closer to 3.0%/yr in 2010.

Japan annual GDP growth rate

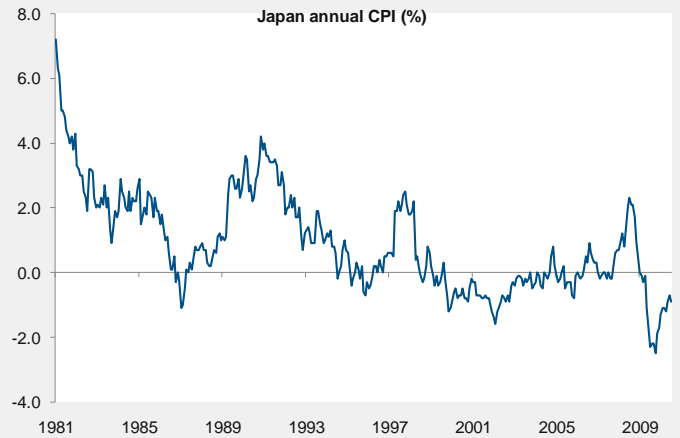


Source: Bloomberg

This extremely poor economic growth performance and other economic factors have led to a seemingly persistent state of deflation in Japan. As shown in the chart below, the annual inflation rate has been on the decline for 20 years, with a state of deflation existing for most of the past decade. There seems little prospect of this situation improving in the near-term.

This Travelling Economist can attest to the effect of deflation and the strength of the AUD – with a number of purchases being made, mostly clothing and kids’ toys, that were much cheaper than the equivalent product in Australia.

Japan annual CPI inflation rate



Source: Bloomberg

Infrastructure:

There are, however, some positives in Japan (apart from the excellent food). Unlike Australia (and especially Sydney), Tokyo has fantastic infrastructure. The most impressive transport infrastructure is the rail system, with two features that stand out.

First is the *Shinkansen* or bullet train system. The bullet train system began in 1964 with a 210km/h train. The system now covers 2,459km with trains that can travel up to speeds of 300km/h. The Tokyo-Osaka line is the busiest high-speed train line in the world – transporting 151m people in 2008.

As this Travelling Economist can attest to, the *Shinkansen* is an extremely efficient, fast, comfortable, reliable and relatively inexpensive way to travel around Japan. In addition, the bullet train system is extremely safe – with not one fatality from derailment or collision in the nearly 45 year history of the system. The only derailment of a train occurred in 2004 – during an earthquake. In addition, as shown in the photo below, the trains are very cool!

Japanese *Shinkansen* trains 2009



Source: JR East

The second stand-out feature of the rail system is the Tokyo-Metro and its ticketing system. The Metro is one of the best subway systems in the world – especially compared with London and New York, two other very large cities. The Metro system is vast – with 203km of tracks. It is the most used subway system in the world, carrying 6.3m people each day in 2009.

In a city of 13m people, the Metro is the most efficient and reliable way to get around. It is also very, very clean – there must be an army of people cleaning the stations and trains each night – there is no sign of rubbish, dirt or graffiti anywhere. All the stations and signs are in English, as is the ticketing system (more below) and directions and if you miss a train – don't worry, another one will be along in a few minutes.

The Metro is also extremely safe. As this Travelling Economist can verify, travelling at 2am on a Sunday morning back to your hotel from an evening in Roppongi there is probably no safer place in the world – I wouldn't want to try and do the same thing from the "entertainment" districts of NY, London or, for that matter, Sydney.

The cost of fares for travel on the Metro is also very reasonable. An Y190 fare (about \$A2.35) will get you from most stations in the system to another station during peak hour.

The other great positive of the Tokyo Metro is the ticketing system. The easiest option is to purchase a Pasma pre-paid card (about the same size as a credit card). You load the card with a few thousand Yen (say approx \$A20) and the Pasma card will then allow you to catch on any train in the Tokyo area (both public and private lines), any bus and any tram. The Pasma card can also be used in some vending machines and in some taxis. As at early 2009 there were over 11m Pasma cards in circulation.

In short, Tokyo has a single ticketing system for a vast city that no Australian city has been able to provide! How or why is it possible for a wealthy country such as Australia to fail its commuters in this regard and why do the taxpaying commuters of Australia, not to mention the politicians, think this is acceptable?

The other positive infrastructure feature of Tokyo is its Wi-Fi internet network. This Travelling Economist was able to use his newly purchased iPad to connect to the free Wi-Fi system at the airport, in my hotel and in various coffee shops around town. This made keeping up with developments in markets and at home extremely easy. Again, why does Australia accept a lower standard of IT infrastructure?

Japan & China:

When this Travelling Economist was last in Japan (in October 2009 and March 2010), I asked a number of people what they thought of the rise of China. The general consensus was that they saw China's advancement as inevitable and with 10 times the population of Japan, it was only a matter of time before China displaced Japan as the dominant Asian nation – they didn't like it, but seemed to accept it.

But on this trip the Travelling Economist detected a much harder line towards China and a real sense of concern about the implications for Japan, economically, politically and territorially. This change can likely be put down to two recent events.

Firstly, in the GDP data for the year to June 2010, China has officially replaced Japan as the world's second largest economy. So "expectations" of the rise of China have now transferred into "reality" in the minds of the Japanese. One story that really resonates with the locals is that Chinese buyers now have the spending power to out-bid locals at the Blue Fin Tuna auctions!

Secondly, but more worryingly, has been the recent political/territorial/diplomatic tensions between the two nations. The issue here was over the Senkaku Islands. The Islands, in the South China Sea, are claimed by Japan, China and Taiwan, but are administered by Japan. (Note: the US has recently confirmed that they consider the Islands to be part of Japanese territory under the US-Japan security pact).

The recent story on the Senkaku Island goes like this. On 7 September the Japanese Coast Guard intercepted Chinese fishing boats near the islands. One of the Chinese boats collided with the Japanese Coast Guard (or deliberately rammed it, depending on your point of view). The Chinese boat captain was promptly arrested by the Japanese authorities. In response the Chinese government froze ministerial level exchanges and restricted the export of much needed rare earth elements (albeit for only about a week) that are vital to the Japanese electronics and auto industry. The Japanese government was forced to return the arrested Captain, who received a hero's welcome back at home.

The Japanese people felt humiliated by the whole event and thought that their government was shown to be weak in the face of a newly emboldened Chinese government. The diplomatic tensions were soothed with the Japanese PM and Chinese Premier met at the sidelines of the recent Brussels Asia-Europe conference, but in the minds of the Japanese people the incident reinforced to them that China was growing not only in economic importance, but in political and diplomatic power.

For the first time in many years this Travelling Economist heard talk of the need for Japan to substantially increase its naval presence in the area to protect its territorial rights. One person even questioned why it was that China and India (the two other powers of Asia) were allowed nuclear weapons as a defensive deterrent and Japan was not! For the obvious reasons, this topic was previously seen as very taboo in Japan.

Clearly the Japan-China economic, political and diplomatic relationship is likely to be a source of tension in the years ahead, as Japan and China's economic performance continues to diverge.

As an aside on this topic, just prior to the trip to Japan this Travelling Economist attended a dinner in Sydney with a large number of Japanese business people. One of the Japanese business men present asked what I thought would "fail" first, the US economy or the Chinese political system? When the Travelling Economist replied, somewhat controversially I admit, "the US economy", the Japanese businessman did not seem too happy!

View from local economists:

While in Tokyo the Travelling Economist took the opportunity to meet with some Japanese economists, one from a local firm, one from a US investment bank and one from a UK bank.

All three had a similar message: the recent monetary policy easing by the Bank of Japan (BoJ) was a positive step, as was the latest fiscal policy package from the government, but both the short and medium term outlook for the Japanese economy is poor (as detailed above). Slower major trading partner growth, the stronger Yen, the ageing population, weak employment market and political uncertainty all added up to a very difficult outlook.

GDP forecasts for 2011 centred around 1.5%, down from closer to 2.5%-3% in 2010, with growth in 2012 forecast around 2%. Most of this growth was expected to be driven by the net export sector.

On the Yen, the general expectation was that given the expected quantitative easing (QE2) in the US was likely to be significantly bigger than the QE of Japan, the Yen would continue to come under upward pressure against a weaker USD. This would likely see the BoJ have to intervene in the market again, possibly defending the Y80 level – the high of the Yen last seen in 1994.

The economists also supported the government's planned tax reforms, which includes lowering the company tax rate from its current relatively high 40% to 35% in 2011 and with a target in the future of 25% (the OECD average). This policy target has strong support.

The GST rate, currently at 5%, is expected to be increased to 10% over time, but this policy measure has lost momentum since the government (the Democratic Party of Japan, DPJ) lost control of the Upper House (ie. the older people who pay no income tax, because they earn no income, are not keen on paying more tax on their consumption).

There was also a strong view that Japanese companies will continue to move more of their manufacturing base to other Asian nations. Currently about 18% of all Japanese manufacturing production is done offshore, up from closer to 4% two decades ago. Given the state of Japan-China

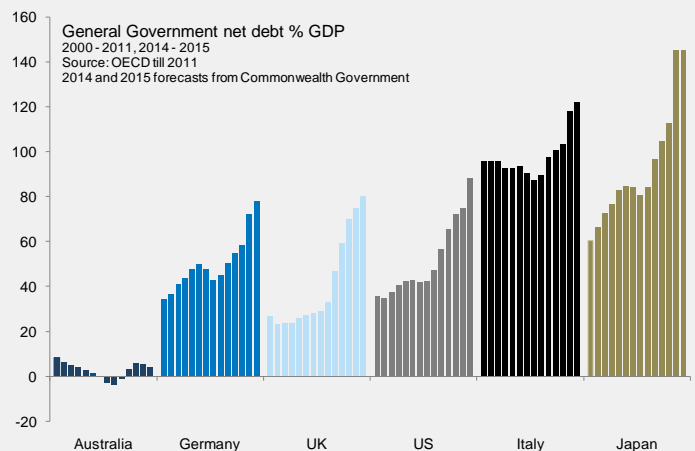
relations (see above) it was considered likely that Japanese firms would look increasingly to countries such as Thailand, Malaysia and Vietnam to expand their businesses.

The key for the government will be to try and implement reforms that encourage the Japanese companies to bring some of the profit made on these offshore businesses back onshore.

Japanese government debt and funding:

As shown in the chart below, Japan's net government debt is one of the highest in the OECD. It is also worth remembering, however, that around 94% of all JGBs on issue are owned by Japanese institutions (especially the banks) and retail investors. This situation is not expected to change any time soon, as Japanese corporates have large cash positions on their balance sheet and deposit growth in the banks is rising more rapidly than lending growth, with the excessive cash build-up being used to purchase JGBs.

Major nations general government net debt, % GDP

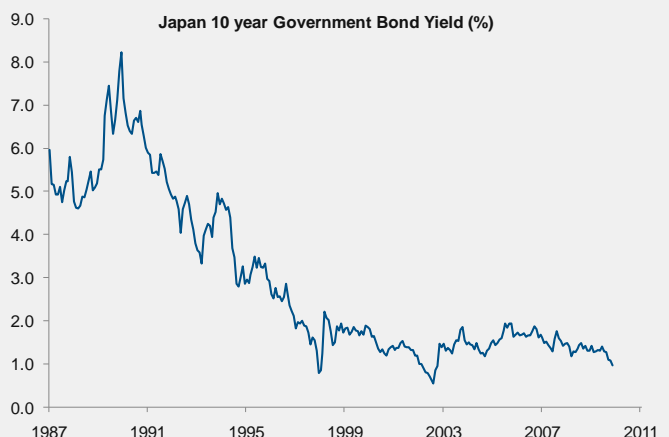


Source: Commonwealth Treasury and OECD

So it seems that the Japanese governments' very large debt position will continue to be recycled through the Japanese people – thus limiting credit rating risk and helping provide the Japanese people with the level of government services they have come to expect.

However, as a result of the persistent low economic growth and deflation, JGB yields have been trending sideways at very low levels, around 1%, for over a decade, see chart below, despite the ongoing increase in the supply of JGBs on issue.

10yr JGB yields



Source: Bloomberg

It is interesting to also note that Retail investors in Japan currently have a large 55% of their financial assets either on deposit at the banks or in the Postal savings system. This compares with 17.4% in the US and 29% in the UK.¹

On the flip side, only 3.6% of Japanese retail savings are invested in Mutual Funds that access global markets, while this figure is a larger 9.5% in the US and 2.6% in the UK.

For Institutional investors it is interesting to note a significant swing away from the USD for Investment Trust Funds offshore investments. At the end of 2001 just under 60% of offshore investments were in USD, with the remainder mostly in EUR and other G10 currencies. The AUD was barely on the radar screen. By June 2010 the weighting in the USD had declined to just over 35%, while the AUD had risen significantly to 15.4%. Investment into other Asian markets had also risen sharply, as had investments into the Brazilian Real.

If I was Prime Minister for a day:

It is easy to see, therefore, that Japan faces many economic (and geo-political) challenges in the future. Over a number of years the various governments of Japan and the BoJ have tried to stimulate growth on multiple occasions, but data shows that nominal GDP in Japan today is about the same as 20 years ago!

So the question remains, what can be done to help the Japanese economy to grow, rather than have the current generation, especially retired people, continue to eat into the wealth of the nation? Of course, the answers are never easy and often depend on your point of view, but this Travelling Economist would recommend a focus on the following five key areas:

1. Population:

- As noted above, Japan's population peak around 128m in 2006 and has been declining since then. Thinking long-term therefore, something needs to be done to slow the ageing of the population and increase the number of workers per retired. There are two ways to do this.
- Firstly, Japan needs to consider immigration (with official statistics currently showing net immigration of zero). As noted previously, in some ways the people of Japan have chosen 'cultural purity' over economic growth, by maintaining a very homogenous society (ie. 98.5% of the population is listed as Japanese with only 1.5% 'other'). But allowing skilled labour to immigrate to Japan is one way to improve the productivity of the labour force and to lift spending given the different culture towards savings.
- Currently, this Travelling Economist was told, the debate about immigration is more a concern that with the unemployment rate very high by Japanese standards (5.1% vs the 20 year average of 3.9%) that now is not the time to bring in more people looking for work – but at some point in time the decision will need to be made to allow more foreigners into the country.
- Secondly, Japan needs to increase its birth rate – although of course it takes around 20 years before children become 'productive' in the workforce. The

current 'children born per woman' ratio is only 1.2, down from 1.4 in 2006, while the life expectancy for a child born in 2010 is a very long 82.17 years.

- The Travelling Economist was told, however, that the current generation of young adults, say 25 -35 year olds, are reluctant to have more children because then they would be hit from both sides - having to care for both their ageing parents and their own children. So something needs to be done to make it easier and cheaper to raise children. The recent government stimulus of continued cash payment for every school age child was well received and did boost consumption.
- This could also include a large 'baby bonus' for the initial hospital costs of having a child, more child-care facilities provided at reasonable price, to encourage women back into the work-force, government subsidy or payments to help cover the costs of the school years education and income tax deductions that increase the more children you have.

2. BoJ policy:

- For the BoJ, policy actions must become more aggressive. Fortunately the recent decision to return to ZIRP (zero interest rate policy) is a good indication that this is the direction the BoJ is heading. QE should become more aggressive and, once again, the recent decision by the BoJ to set up a new internal account to purchase bonds is also a positive step.
- But the BoJ must also do more to encourage the banks to lend this money into the economy, to create credit and encourage growth in the economy.

3. Export development:

- The BoJ and government must do all they can to continue to encourage Japanese exports, which currently are one of the few sources of growth.
- In this sense the BoJ's recent effort to stem the strength of the Yen against the weaker USD makes a lot of sense. Further significant BoJ intervention selling the Yen would likely be beneficial.
- The government should work on becoming more involved in both bi-lateral and multi-lateral trade agreements, to ensure access to global markets for Japanese products.
- Further government support of the key exporting sectors, eg. auto & electronics would also likely be helpful.
- As noted, many Japanese firms are likely to continue to shift their production to lower-cost Asia nations. The government should support this initiative, but also provide tax incentives to encourage firms to repatriate some of their offshore earnings back into Japan.

¹ Source: Barclays Capital

4. Taxation policy:

- The ageing population poses a significant problem for government revenue. As a result the government needs to shift the burden of taxation away from income and more towards consumption.
- Although this is likely to be politically difficult, the government should significantly increase the current 5% consumption tax rate to 10% or 15% (a rate that would still be well below the rates that apply across Europe and the UK). With more and more of the population consuming and not earning, this would continue to help ensure revenue flow to the government.
- Income tax rates should be cut to encourage more income earning behaviour and productivity in the workforce. The highest income tax rate of 40% currently kicks in at an income of Y18million (approx \$A225k), with a 33% rate applies to incomes of Y9m-Y18m (\$A112.5k-\$A225k). These tax rates should be lowered to encourage more people to enter the higher income tax brackets.
- As noted, the current corporate tax rate of 40% is one of the highest in the world. The government plans to reduce this rate to 35% in 2011 and has a target of 25% in the years ahead – this plan should be supported.

5. Infrastructure/Defence.

- Japanese infrastructure spending is full of stories of building “bridges to nowhere” and they do exist. But further productivity enhancing infrastructure could be built, especially roads within the major cities.
- Perhaps more than a little controversially, the Japanese government could also look at increasing its self-defence force spending, especially on an expanded Coast Guard/Naval presence. Not only would this lead to some job creation it could also help send a message to some of Japan’s near-neighbours.

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