

# RAM

# COUNTRY ASSESSMENT REPORT

September 2010

## JAPAN

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1990 - 2010

# COUNTRY ASSESSMENT REPORT

## PUBLIC FINANCE RATINGS

SEPTEMBER 2010

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### Japan at a Glance<sup>1</sup>

#### Population:

127.6 million (2009);  
Median age 44.6 years

#### Nominal GDP:

JPY474.2 trillion or USD5.1  
trillion (2009)

#### Nominal GDP per capita:

USD39,731 (2009)

#### Real GDP growth:

2004-2008 (average): 1.6%  
2009: -5.2%  
2010 (official forecast):  
2.6%

#### Unemployment rate:

5.1% (2009)

#### Inflation rate:

-1.4% (2009)

#### Government debt:

217.6% of GDP (2009)

#### Government net debt:

111.6% of GDP (2009)

#### Interest rate:

Overnight call rate: 0.1%  
(June 2010; unchanged  
since December 2008).

#### Official foreign reserves:

JPY96.8 trillion  
About 17 months of (pre-  
crisis) imports

## ASIA

### – Japan

### ■ Summary

Japan stands among the world's 3 largest economies, with a nominal gross domestic product ("GDP") of USD5.1 trillion in 2009. The country is also one of the wealthiest in the world, with a per capita GDP of about USD39,700.

Not surprisingly, the past 2 years (2008 and 2009) have been particularly challenging for the Japanese economy. Exports, a key driver of its economic growth, fell sharply towards the end of 2008 and remained weak through 2009 amid the worldwide slump. On the brighter side, the global contraction was – as it turned out – not as severe as initially forecast, and the outlook for 2010 (for the world in general, and also Japan) - while tempered by uncertainties - is brighter than a year ago.

Japan registered an annualised annual growth of 5.0% in 1Q 2010. We believe that exports will remain an important engine of growth for Japan. As the world's fourth-largest exporter, Japan is well poised to benefit from a recovery in external demand. Nonetheless, its anaemic GDP performance in 2Q 2010 highlights the uncertainties still looming over the global economy, as well as weak domestic demand in the Land of the Rising Sun. The recent strengthening of the Japanese yen could also affect its export competitiveness and/or dampen corporate earnings. All said, Japan is not likely to stage a strong turnaround in the short term. The Japanese authorities have projected an overall expansion of about 2.6% for FY 2010 (April 2010 to March 2011), which is rather moderate against the 1.9% to 2.4% growth charted in the 3 years before the triggering of the global financial chaos in 2008.

Meanwhile, Japan's medium-term prospects are supported by its competitive and innovation-driven economy; the country's competitive edge lies in the "high availability of scientists and engineers, high company spending in research and

<sup>1</sup> Sources for *Japan at a Glance* (sidebar): IMF, CEIC Data, Bank of Japan, Japan Ministry of Finance, CIA World Fact Book.

**System of government:**  
Constitutional monarchy

**Head of state:**  
Emperor Akihito  
(since January 1989); the  
monarchy is hereditary

**Head of government:**  
Prime Minister Naoto Kan  
(since June 2010)

**Parliamentary elections:**

- (i) House of Councillors  
(last held in July 2010;  
next expected by July  
2013)
- (ii) House of  
Representatives (last  
held in August 2009;  
next expected by August  
2013)

development, and an excellent capacity for innovation”<sup>2</sup>. Although this is an edge that would not be lost overnight, it could be blunted in the longer run if issues vis-à-vis the nation’s ageing population and ballooning public debt are not addressed.

As it stands, the Japanese government is among the most heavily indebted in the world, with a gross debt equivalent to almost 2 times of its GDP. Factors that support Japan’s considerable debt-absorption capacity – such as sizeable domestic savings and low interest rates – are expected to diminish over the medium to long term. Fiscal adjustment is becoming increasingly urgent (and arguably more so as the recent global recession has focused attention on sovereign finances and economic strategies worldwide).

The incumbent government’s recent loss of its majority in the Upper House of the Japanese Parliament (or Diet) makes “implementing changes” that much more challenging, as legislative bills need to be approved by both chambers of the Diet before they can become law. Lack of continuity in government leadership in Japan, which has seen 5 different Prime Ministers in office since September 2006, also does not help in the implementation and continuation of long-term policies.

On a more positive note, Japan has very strong external liquidity. The Japanese people’s propensity to save, coupled with the nation’s strong capacity for generating foreign exchange (via exports), has led to the accumulation of a large stock of assets abroad. Japan’s external assets amounted to JPY554.8 trillion as at end-2009 (including JPY96.8 trillion of official foreign reserves, equivalent to over a year of pre-crisis imports). These factors are envisaged to provide a strong cushion against currency shocks, besides allowing Japan the flexibility to tap the international capital markets vis-a-vis meeting its external payment obligations, if necessary.

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<sup>2</sup> Source: Report on Global Competitiveness Index Rankings 2009-2010 by the World Economic Forum.

## ■ Economic Structure & Performance

- GDP advanced at an annualised rate<sup>3</sup> of 5.0% in 1Q 2010.
- On the other hand, a relatively anaemic performance in 2Q 2010 points to the uncertainties still lingering over the global economy, and the sustainability of its turnaround.
- The Japanese authorities expect GDP growth to come in at 2.6% for FY 2010 (1 April 2010 to 31 March 2011).
- Japan continues to face challenges vis-à-vis its hefty public debt, ageing population, and the effects of deflation on domestic consumption.
- We believe that Japan's innovation- and technology-driven industries remain strengths.

### ➤ Recent Performance

In 1Q 2010, Japan's GDP increased at an annualised rate of 5.0%. This also marked the first quarter that its GDP had expanded on a y-o-y basis since 2Q 2008. The better showing had been driven by both internal and external factors. Exports had led the way with a 4.1 percentage point contribution to the country's 4.7% y-o-y GDP growth; domestic private consumption weighed in with a 2.1 percentage point contribution.

On the other hand, weakness in private investment continued to detract from its GDP growth. All things considered, however, the recent uptick in GDP growth provides cause for some optimism. After an extended period of deflation in the 1990s, Japan's CPI<sup>4</sup> inflation and economic growth had initially appeared to have turned positive in 2007. The momentum had, however, been derailed by the ensuing global slump; Japan's real GDP contracted 1.2% in 2008, followed by another 5.2% decline in 2009.

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<sup>3</sup> This is approximately equivalent to an annualised quarter-on-quarter expansion.

<sup>4</sup> Consumer price index.

**Short-term growth outlook looks better than a year ago**

## ➤ Outlook

The sustainability of the aforementioned "turnaround" remains a pertinent question not only for Japan, but the world in general. Japan's relatively anaemic 1.5% annualised rate of growth in real GDP in 2Q 2010 underlines the uncertainties still looming over the global economy, as well as weak domestic demand in the Land of the Rising Sun. The recent strengthening of the yen could also affect export competitiveness and/or dampen corporate earnings. All said, Japan is not likely to stage a strong turnaround in the short term.

On balance, if we compare the economic forecasts – for Japan and the world in general – made this year to those of a year ago, the general scenario appears to be brightening. In June 2010, the Bank of Japan raised its forecast for real GDP growth in FY 2010 by 0.8 percentage points to 2.6% (the previous projection was made in April 2010). In July, the International Monetary Fund ("IMF") also revised its 2010 GDP growth projection for Japan to 2.4% (from the 1.9% estimated in April 2010, as shown below). On the whole, however, these numbers remain moderate against the 1.9% to 2.4% growth achieved in the 3 years before the global crisis hit in 2008. The main short-term risk for Japan (or any export-oriented economy in general) is a double-dip recession for the world economy.

**Table 1: Selected economic indicators**

	2005-2008	2009	2010p	2011p
World GDP growth (% change)	4.4 (avg)	-0.6	4.2	4.3
Japan real GDP growth (% change)	1.3 (avg)	-5.2	1.9	2.0
Japan, CPI (% change)	-0.2 to 1.4	-1.4	-1.4	-0.5
Japan, unemployment rate (%)	3.8 to 4.4	5.1	5.1	4.9
<b>Real GDP numbers of Japan's top export destinations (% change)</b>				
USA	2.1 (avg)	-2.4	3.1	2.6
China	11.1 (avg)	8.7	10.0	9.9
EU	2.4 (avg)	-4.1	1.0	1.8
Korea	4.1 (avg)	0.2	4.5	5.0
Taiwan	4.2 (avg)	-1.9	6.5	4.8

Source: IMF World Economic Outlook database (April 2010)

Note: avg = arithmetic mean of the annual average growth rate

**Must address  
medium-term issues**

**Japan's competitive  
edge still intact...**

**... but not immune to  
erosion**

Assuming the global recovery does not falter, and exports are able to continue lifting the Japanese economy, the country still has to address several medium- to longer-term issues. These include its ageing population, hefty public debt, and the possibility of another period of deflation<sup>5</sup>.

On a brighter note, we believe that Japan still has factors in its favour. As the world's fourth-largest exporter (a position which, in our opinion, underscores the robust demand for Japanese goods), the country should benefit from any recovery in external demand. Meanwhile, Japan is still regarded as one of the most competitive global economies; it was ranked 8<sup>th</sup> out of 133 countries in the Global Competitiveness Index 2009-2010<sup>6</sup>. Japan scores particularly well vis-à-vis its capacity for innovation, which captures (among others) the public's perception of the nation's ability to obtain technology through research and development (as opposed to licensing and imitation), and the availability of scientists/engineers to support such efforts.

In our opinion, the 270 Japanese corporates considered among the most prominent public companies in the world (as compiled by Forbes<sup>7</sup>) underscore the resilience of the Japanese people. We believe that the capacity to innovate is an edge that will not be lost overnight. Nonetheless, this advantage may yet be eroded if there is no one to take over the mantle after the older hands retire. According to IMF data, the Japanese population shrank in 2008 and 2009 (-0.1% per annum) – a trend that is unlikely (and not easy) to reverse in the short term.

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<sup>5</sup> In an environment where prices are falling, consumers may be inclined to hold back purchases/consumption, on the expectation that prices will continue easing. Business profitability will be affected as a result, which in turn will affect wage growth and capital-investment decisions. Prices will continue to fall as demand ebbs, and the cycle will persist. This contrasts against inflationary pressures, under which consumption may be retarded because prices become too high.

<sup>6</sup> Published annually by the World Economic Forum.

<sup>7</sup> This list ranks public listed companies worldwide based on 4 measures: sales, profits, assets and market value.

**Among world's 3 largest economies**

➤ **Size, Structure & Stability**

Japan is one of the world's 3 largest economies; consumption potential still looks solid. Setting aside the challenges mentioned earlier, the country is among the wealthiest in the world, has one of the largest populations (top 10), and stands among the 4 largest global exporters (Table 2).

**Table 2: Selected indicators for certain Asian countries**

	CHINA	HK	JAPAN	KOREA	MYS	SING
Nominal GDP (USD billion), 2009	4,909	211	5,068	833	192	177
GDP per capita (USD), 2009	3,678	29,826	39,731	17,074	6,897	37,293
Population (million), 2009	1,334.7	7.1	127.6	48.8	27.8	4.8
CAB (USD bil), 2009	283.8	23.4	141.7	42.7	32.0	33.8
CAB (% of GDP), 2009	5.8	11.1	2.8	5.1	16.7	19.1
Share of world exports (%)	8.9	2.3	4.9	2.6	1.2	2.1
Rank	2	13	4	12	21	14
Export composition (%)						
Agricultural exports	3.0	1.8	1.1	1.8	13.9	2.1
Fuels and mining products	3.8	2.0	4.8	11.3	20.0	19.8
Manufactures	93.1	94.0	88.6	86.5	65.1	70.0
Main export destinations	EU-27	China	USA	China	S'pore	MYS
	USA	EU-27	China	EU-27	USA	INDO
	HK	USA	EU-27	USA	EU-27	HK
	Japan	Japan	Korea	Japan	Japan	EU-27
	Korea	Taipei	Taipei	HK	China	China

Source: World Trade Organization, IMF World Economic Outlook database (April 2010).

(1) Abbreviations used

HK = Hong Kong

MYS = Malaysia

INDO = Indonesia

SING = Singapore

EU-27 = European Union

CAB = Current account balance

(2) Total global merchandise exports were valued at about USD15.7 trillion in 2008.

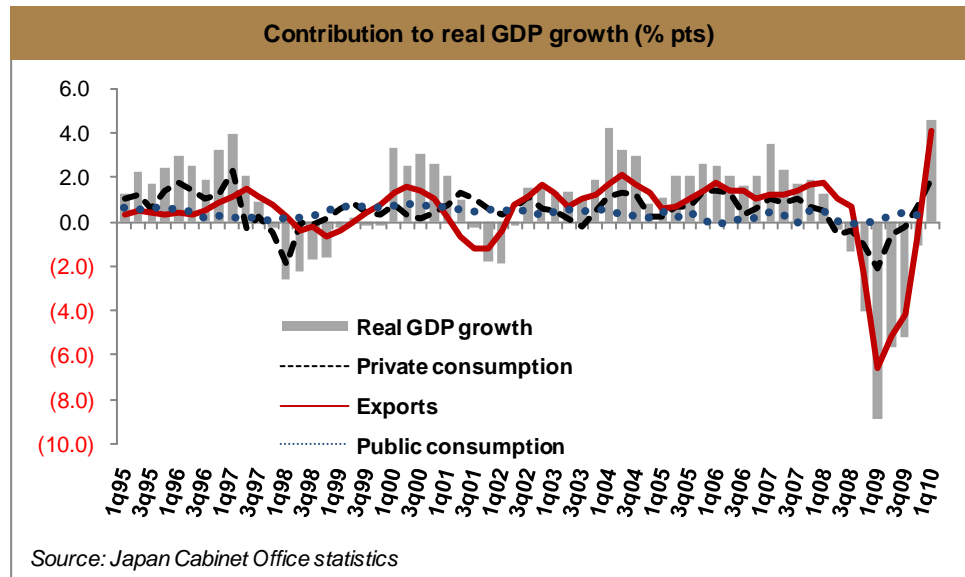
**Manufacturing sector – bedrock of Japanese exports**

The manufacturing sector is the single largest component of Japan's supply-side GDP, accounting for about a quarter of its total. On the demand side, manufacturing makes up the bulk of Japan's merchandise exports (Table 2). Notably, exports have been a vital growth driver for the Japanese economy. Other prominent segments include wholesale and retail trade and real estate, which each account for about 10%-13% of its real GDP.

**External demand – important growth driver**

Japan experienced an extended period of depressed prices from the late 1990s to the mid-2000s<sup>8</sup>. Nevertheless, robust external demand for the country's goods had been able to compensate for the comparatively restrained contribution by domestic private consumption to its overall GDP growth (Chart 1, which also illustrates how this condition had left the Japanese economy susceptible to the slump in global demand in 2009). During this period, government spending had provided some lift to the economy – although this had also pushed up its sovereign debt level (refer to **Government Finances**).

**Chart 1: Comparison of contributions to GDP growth by private-sector consumption and exports**



<sup>8</sup> This period in the 1990s is also commonly referred to as Japan's "lost decade".

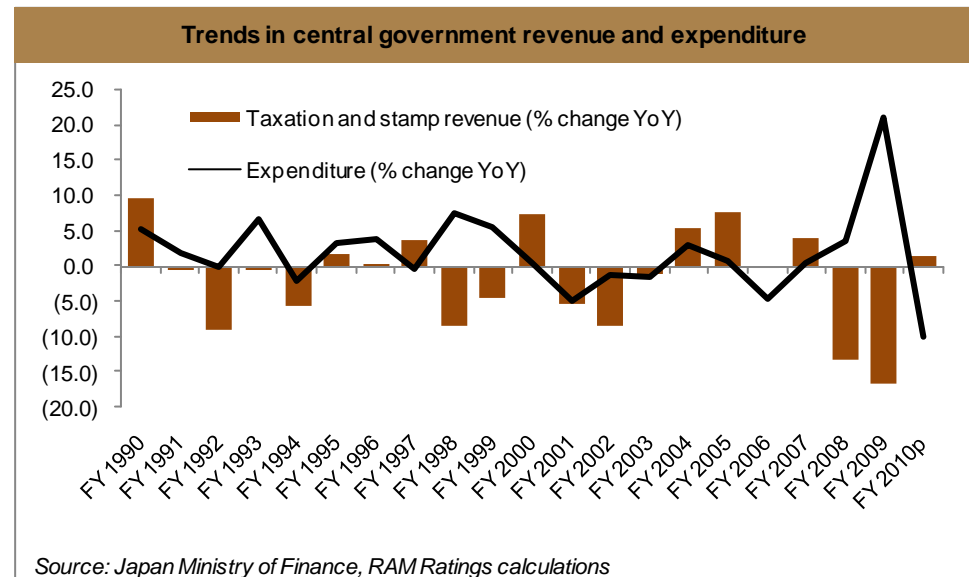
**Spending failed to expand revenue base**

■ **Government Finances**

- The Japanese government’s fiscal health, characterised by a hefty debt burden equivalent to about 2 times its GDP, elicits concern.
- Japanese political leaders are in an unenviable position, caught between a rock and a hard place, so to speak. A hefty debt burden limits its fiscal space. On the other hand, cutting public expenditure and/or raising taxes may be unpopular and could also affect economic activity.

The trend in Japan’s government finances suggests that public-sector spending has not led to a corresponding growth in its tax revenue. Sovereign debt has accordingly risen, to finance the deficit. In the 1980s, issuance of government bonds had averaged about JPY11.4 trillion per annum, rising to JPY18.9 trillion per annum in the 1990s. Subsequent to that, the Japanese government had issued between JPY25 trillion and JPY55 trillion of bonds per year. For FY 2010, the authorities have projected the issuance of JPY44.3 trillion of government bonds. As it stands, Japan has one of the highest levels of government debt (as a percentage of GDP) in the world (Chart 3).

**Chart 2: Japanese government’s budgetary performance**



**Fiscal flexibility  
limited by already-  
hefty debt burden**

Several points to note in Japan's experience vis-à-vis its government debt levels: (i) all of the Japanese government's debts are denominated in yen; (ii) the bulk of it is held domestically<sup>9</sup>; and (iii) the debts carry very low interest rates. These factors combine to make the debt load more "affordable" than it otherwise might have been. The IMF notes that Japan's considerable debt-absorption capacity could be explained by the country's high level of household savings, stable institutional investors and a strong home bias. Nonetheless, the market's capacity to absorb the debt burden is likely to diminish as its ageing population reduces savings while financial reforms that have given institutional investors more flexibility could also crimp market demand. Over the longer term, fiscal consolidation will become critical for the smooth financing of government operations<sup>10</sup>.

➤ **Fiscal Space**

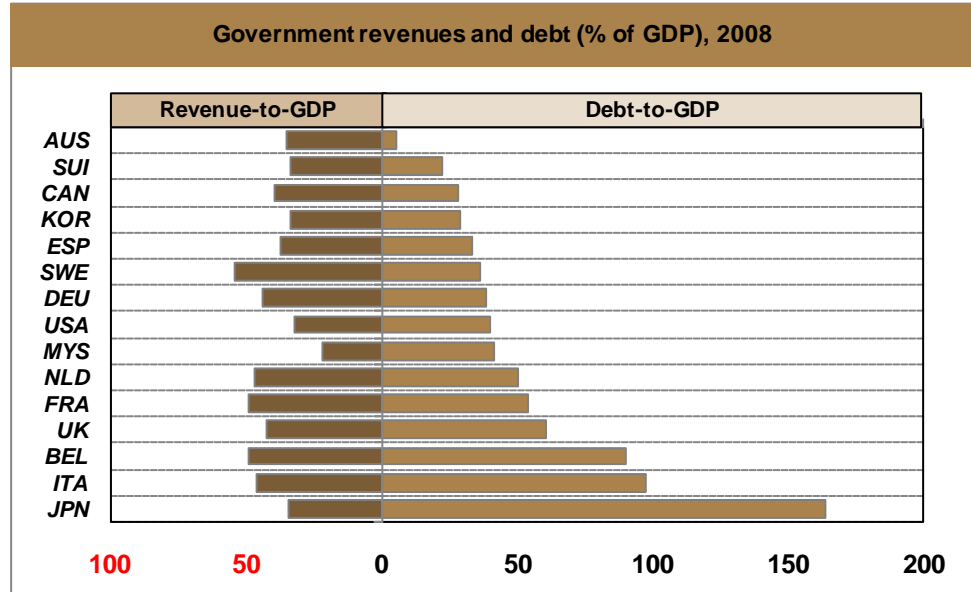
The Japanese government is in an unenviable position. Its flexibility vis-a-vis launching fiscal stimuli is limited by an already-hefty debt burden. At the same time, the moderate expansion expected of Japan's economy is not likely to provide the organic growth in tax revenue needed for the government to trim its borrowings. Although the government could raise taxes to boost its income, this would be at the risk of inciting the public's ire. In this regard, the incumbent government already faces a diminished position after the Upper House elections in July 2010 (see **Political Stability**). Meanwhile, higher taxes could also hurt domestic consumption and fuel another bout of deflation. Alternatively, the government could cut public expenditure which – depending on how much of public services this affects – may also not be a popular move<sup>11</sup>.

<sup>9</sup> As at end-2009, only 5.2% of Japanese government bonds were held by foreigners.

<sup>10</sup> IMF report. *Japan: Selected Issues – The Outlook for Financing Japan's Public Debt* (July 2009).

<sup>11</sup> The IMF's Article IV Consultative report on Japan (July 2010) proposes that announcing an upfront increase in consumption tax could strengthen the credibility of a fiscal-consolidation plan. The report also notes that "given the limited scope for cutting expenditures, fiscal adjustment will need to rely mainly on new revenue sources and limits on spending growth". The adoption of fiscal rules (e.g. caps on debt levels) could also aid Japan's fiscal-adjustment efforts.

Chart 3: Government revenues and debts



Source: Organisation for Economic Co-operation and Development (or OECD)

(1) Abbreviations used:

AUS = Australia	SUI = Switzerland	CAN = Canada	KOR = South Korea
ESP = Spain	SWE = Sweden	DEU = Germany	JPN = Japan
NLD = Netherlands	BEL = Belgium	MYS = Malaysia	FRA = France
ITA = Italy	UK = United Kingdom	USA = United States of America	

(2) A lower revenue-to-GDP ratio suggests that a government has "space" to raise taxes, increase revenue and hence be able to support a heavier debt burden, although this may not be as straightforward in practice. A better way to increase revenue would be for the government to seek ways to enlarge its tax base, i.e. economic expansion.

Some of the measures/targets that the Japanese government has with regard to its fiscal position are as follows (announced in June 2010)<sup>12</sup>:

- **Short term:** Cap the issuance of new Japanese government bonds in FY 2011 at the current level (JPY44 trillion<sup>13</sup>); commit to ensuring that central government primary spending (i.e. excluding debt and interest payments) does not exceed the FY 2010 level over the next 3 years.
- **Medium to long term:** Government commits to halving its primary deficit (as a percentage of GDP) by 2015, and achieving a primary surplus by FY 2020 at the latest. It aims to stabilise the debt/GDP ratio by FY 2020, and targets a steady decline from FY 2021 onwards.

<sup>12</sup> IMF Consultation IV report (July 2010): The IMF generally welcomed the targets announced by the Japanese government, but opines that the strategy will "only become credible once details of the necessary revenue measures are agreed on, including the timing and scale of a consumption tax increase."

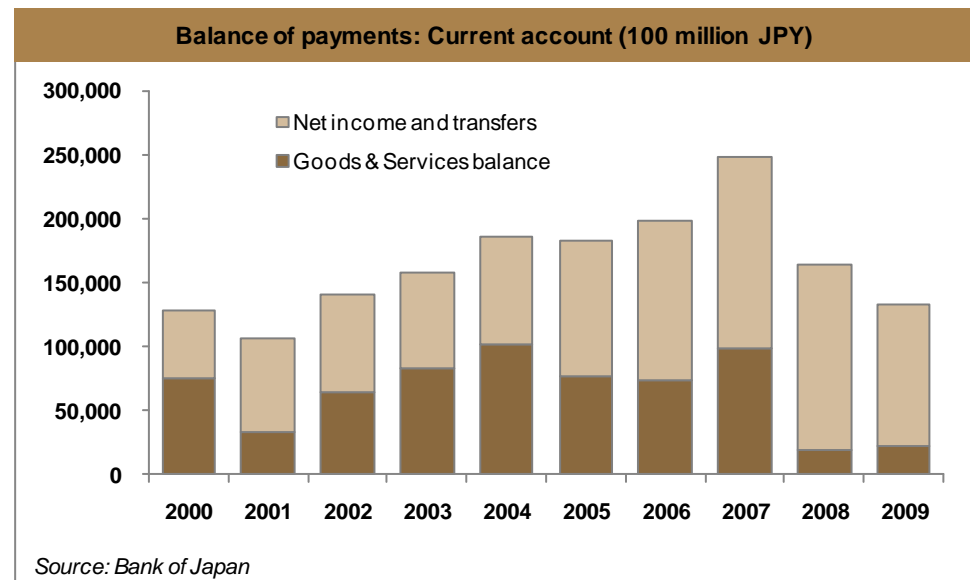
<sup>13</sup> Note: This was the budgeted amount. In FY 2010, the actual issuance was about JPY53 trillion.

## External Position

- Japan's external payment capacity is sturdy, underpinned by its still-strong export performance and position as a net external creditor.

Japan's external liquidity is underpinned by its large stock of external assets, valued at JPY554.8 trillion as at end-2009 (including JPY96.8 trillion of official foreign reserves, equivalent to over a year of pre-crisis imports). This was almost 2 times the country's external liabilities as at the same date; its net external assets came up to 56.1% of its GDP. Data on the country's international investment position indicate minimal repatriation of foreign capital from Japan in 2009, which we believe is a positive sign given that investors were likely seeking "safe havens" amid the global turmoil last year. At the same time, Japanese nationals had continued building up their foreign assets<sup>14</sup>. Net returns on these investments had been instrumental in buoying Japan's current-account balance amid the sharp drop in net exports (Chart 4).

Chart 4: Japan's current-account balance



<sup>14</sup> The bulk of these comprised portfolio investments, i.e. investments in foreign equity and debt securities.

## ■ Political Stability

- The 2008/09 global downturn has increased scrutiny on government finances and economic strategies worldwide; running on "auto pilot" is untenable in the longer term.
- The Japanese ruling coalition has lost ground in the latest Upper House elections, but retains its majority in the Lower House (secured through last year's elections). A "split" parliament could hinder the passage of legislation.

## ➤ Institutional Environment

Japan still has commendable positions in global indices vis-à-vis quality of governance and overall economic competitiveness.

**Table 3: Selected global benchmarks**

	SING	NZ	AUS	KOR	MYS	JAP
<b>World Governance Indicators (percentile rank 0 to 100; higher is better)</b>						
Voice & accountability	35	98	94	65	32	76
Political stability, no violence	96	89	85	60	50	79
Government effectiveness	100	95	97	86	84	89
Regulatory quality	100	97	98	73	60	86
Rule of law	94	97	95	74	65	89
Control of corruption	100	98	96	70	63	86
<b>Ease of Doing Business Index 2010</b>						
Rank (out of 183 countries)	1	2	9	19	23	15
<b>Global Competitiveness Index 2009/10</b>						
Rank (out of 133 countries)	3	20	15	19	24	8

Source: World Bank, World Economic Forum.

## ➤ Government Stability

Japan held its triennial Upper House elections in July 2010. The ruling coalition, led by the Democratic Party of Japan ("DPJ", which swept into power after the Lower House Elections in August 2009), was dealt a blow when it failed to defend its majority in the House of Councillors.

While the outcome of the latest election does not mean that the government has to step down, the absence of a clear majority in both chambers of the Diet (the Japanese Parliament) could make it difficult for the ruling government to push through certain legislation. Legislative bills require the nod from both the Lower and Upper Houses to pass as law. A rejection by the Upper House could be circumvented if the proposed bill receives the support of more than two-thirds of the members of the Lower House. The DPJ coalition is, however, short of a two-

***Ruling government dealt blow less than a year after coming into power***

***Split parliament could delay or complicate passage of legislation***

**Changes afoot, but  
may not be those  
sought**

thirds majority<sup>15</sup>. Moreover, we understand that Lower House members may not always vote in line with their parties.

Given the rising scrutiny on government finances and economic strategies worldwide in the wake of the 2008/09 global financial turbulence, the political uncertainties in Japan could not have happened at a more inopportune time. The DPJ-led government has only been in office less than a year, but is already serving under its second Prime Minister. The absence of continuity in government leadership in Japan, which has seen 5 different Prime Ministers in office since September 2006, also does not help in the implementation and continuation of long-term policies. The current premier, Naoto Kan – barely a month into the job at that time – was greeted by his party's unconvincing performance in the Upper House elections in July. As it is, Mr Kan faces the mammoth task of drumming up the requisite support to ensure that Japan's position as a major global economic force remains firm over the longer term.

Moving forward, we believe that 2013 could be an interesting year for the Japanese leadership/government. Assuming that the Lower House runs the full term (i.e. it is not dissolved any earlier by the Prime Minister), the next round of elections for both the Lower and Upper Houses are scheduled to be held that year, about a month apart (since 1992, elections have been separated by a period of at least 8 months). The last time the Lower House was dissolved much earlier than its full 4-year term was in September 2005<sup>16</sup>, by then-Prime Minister Junichiro Koizumi.

<sup>15</sup> As at 17 June 2010, the DPJ and its coalition partners held 307 of the 480 seats in the Lower House while the opposition coalition had 137 seats. To have a two-thirds majority, a party (or a coalition of parties) must command at least 320 seats.

<sup>16</sup> The last election before this was held less than 2 years earlier, i.e. in November 2003. The latter had been held about 3.5 years after the preceding session.

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