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Japan Rebooted

Are you ready?

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Introduction

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Many believed that it would be the March 11, 2011, earthquake and tsunami – and the resultant nuclear disaster – that finally shook Japan from its insular political and economic inertia.

Instead, things actually got worse on these fronts.

It took an election to achieve what a magnitude 9.0 earthquake could not: a seismic shift in Japan's economic and fiscal policy settings, and its ways of engaging with the world.

In December 2012, Shinzo Abe's Liberal Democratic Party surged to power and immediately implemented a new print-and-spend economic doctrine quickly dubbed 'Abenomics'.

The result has been a surge in Japanese stocks, a rapid – and so far sustained – depreciation of the yen, and green shoots of economic growth with a return to inflation possibly on the horizon.

Coupled with a more muscular foreign policy and a renewed pursuit of economic diplomacy, it has served to put Japan back on the map, even for a hard-to-impress corporate and investor community seduced by the potential of emerging markets and the BRICS economies.

Japan's history has been one of sudden and dramatic reinventions of itself: from the feudal era to the Meiji restoration, and the country's eventual expansion as a military power; then from post war ruin to becoming an economic and industrial powerhouse.

This time, though, the pundits had pretty much counted Japan out, consigning the world's third-largest economy – surpassed by China in 2010 – to a diminished and increasingly obscure future.

But the change of government, the new economic settings and the government's consolidation of power in both houses in the upper house poll in July last year have at least sown the seeds for Japan to have another try at reinventing itself.

The country took one important symbolic step to a more internationalised future when Prime Minister Abe announced it would join the negotiations on creating an Asia-Pacific free-trade bloc through the US-backed Trans-Pacific Partnership.

There seems little question that a new Japan will emerge from the current circumstances – a 'Japan Rebooted' to use the parlance of today. Exactly what shape it will take is yet to become completely clear, although PwC plans to use this series of articles on the new Japan to stimulate a debate about what comes next for the country, and what it means for Australia, the region and the world.

Success for Japan Rebooted is far from guaranteed, but the effects of the country's attempts to transform itself will be felt throughout the globe for years and decades to come.

Japan's industrial and electronic giants – and its trading houses – are accelerating their plans to diversify abroad. While Japan's economy and manufacturing sector remains heavily dependent on China, Japanese investment in ASEAN nations is rising, in part due to the political friction being generated as Asia's two giants rub up against one another.

Japan's best firms are striving – and in some cases succeeding – at becoming truly international powers and global brands. But others lag behind, hamstrung by ageing and short-sighted management and a lack of international savvy and globally capable staff.

The so-called third arrow of Abenomics, structural reform of the economy, is yet to strike its target, although the Prime Minister has promised measures to boost firms' competitiveness through labour-market reform and increasing female participation in the workforce.

For Australia, the political change in a nation that is our second-largest trading partner and second-largest export market, as well as a key security partner, was followed by a change of government at home.

The new Coalition government, under Prime Minister Tony Abbott, has made it clear that the Australia-Japan relationship is the pillar of its Asia policy and has moved quickly to cement ties and push for finalisation of the Australia-Japan free trade agreement.

The Abe and Abbott governments find themselves in sync on economic diplomacy, engagement with Asia, collective defence and many other issues, and are keen to crown the deep economic engagement between the two countries with the long-awaited FTA.

Politics is one thing, but it's money too that makes the world go round. The challenge is for the business and corporate community of both countries to both broaden and deepen the scope of their activities in each other's markets, and in third countries.

This won't be easy. Rising costs, red tape and industrial disputation in Australia have diminished its attractiveness as an investment destination in the eyes of some Japanese companies.

And for foreign firms, operating in Japan still means punching through regulatory, language and other barriers that are yet to be pulled down by the Abe government.

On the other hand, there is great scope for collaboration in third markets, where Japanese firms have, in many cases, done much of the legwork. But this is being held up by the reluctance of the majority of Australian firms to invest in Asia – despite the rhetoric – and the unwillingness of many of Australia's most talented workers to work abroad.

The pace of change in Japan, and in North Asia more broadly, has caught even seasoned observers by surprise, so it seems appropriate for PwC to ask in this series of articles as the new Japan Rebooted takes shape: are you ready for change?

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It's the economy…

Japan Rebooted: It's the economy...

AT the heart of the emergence of a Japan Rebooted is a collection of radical – and as of now unfinished – economic policies collectively known as 'Abenomics'.

Japanese citizens and business people are rapidly becoming familiar with what Abenomics entails as these policies are already beginning to affect their lives in profound ways, just as they have been roiling financial markets.

The 'Three Arrows' of Abenomics

Overseas though, the understanding is not so deep, although those with their eyes on Asia are probably familiar with the new 'Japan is back' motto of the man who has lent his name to Abenomics, Japanese Prime Minister Shinzo Abe.

So what exactly is Abenomics? And just as importantly, what opportunities will it present for businesses?

The so-called first and second 'arrows' of the policy, to borrow the terms the government uses to describe the policy, are a massive round of quantitative easing, working in symphony with a large fiscal stimulus package totaling 10.3 trillion yen ($95 billion).

Soon after assuming office, the Abe government replaced the incumbent conservative governor of the Bank of Japan and replaced him with easy-money devotee Haruhiko Kuroda.

Mr Kuroda immediately embarked on an ongoing round of asset purchases that is bigger than that of the US Federal Reserve relative to the size of the two economies.

The monetary stimulus program saw the Bank of Japan commit to 'open ended' monetary easing that would inject an unprecedented 135 trillion ($1.29 trillion) into the Japanese economy in less than two years through asset purchases.

The BoJ expanded its balance sheet by the equivalent of 1 per cent of GDP every month since the program began this year, and will expand it by 1.1 percent per month in 2014.

This is around double the rate of expansion of the US Federal Reserve's holdings, which are growing by about 0.54 per cent of GDP each month under its QE3 program, which is in the process of being gradually scaled back.

At the same time, the stimulus package boosted government spending as a proportion of GDP by 2 per cent last year, and has increased the forecast deficit by 11.5 per cent.

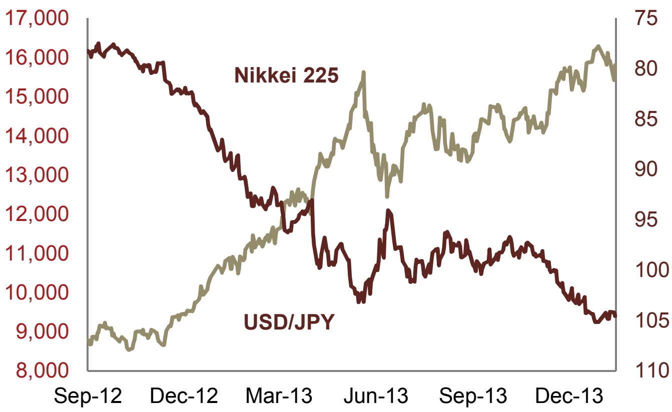
It's a powerful, if dangerous, cocktail for a country still groaning under a government net debt that is equivalent to 140 per cent per cent of annual output.

There is no doubt, though, that it has lit a fire under financial markets.

Since December 2012, when the Abe government came to power, Japan's Nikkei index of stocks has risen from about 10,000 to begin 2014 at a level of more than 15,000 – a 50 per cent gain. Most of the buying has been from foreign investors who used to avoid Japan's once moribund stock market like the plague.

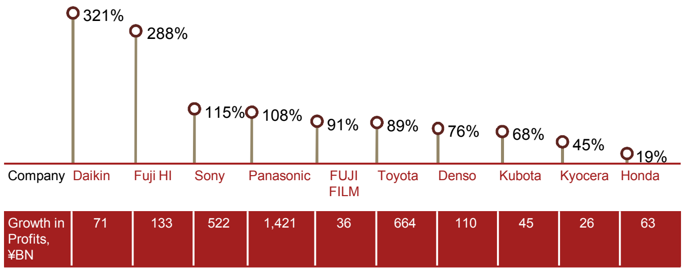
Over this same period, the yen has weakened from about 80 yen to the dollar to more than 100 yen to the dollar, reigniting the earnings of Japan's hitherto struggling export manufacturers. Profits among the 225 firms in the Nikkei index have risen by 130 per cent in the past 12 months compared to the same period a year earlier.

USD/JPY & Nikkei 225



Source: Thomson Reuters

Japanese corporate profits growth, TTM



Source: Thomson Reuters

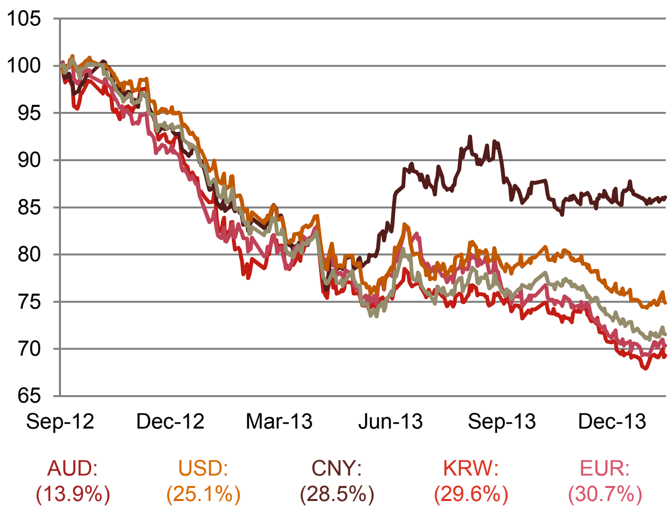
Abenomics, of course, has had its share of naysayers from the start. Critics say that it's a confidence trick that will explode in Japan's face. They say such an unorthodox blend of economic policies has never been tried before and that Mr Abe risks driving the Japanese economy off the cliff of a debt default.

But in the financial sector the policy has been welcomed with open arms with broking houses scrambling to restaff Japan trading desks that had long been left to wither.

International reaction

Foreign governments – particularly fellow exporters such as South Korea and China – have been watching the policy keenly. But it seems to have won broad – if grudging in some cases – acceptance by global economic powers. By making the goal of the policy inflation-targeting (the aim is to reach 2 per cent inflation by April 2015) rather than a fixed level of devaluation of the yen, it seems to have escaped direct criticism in an era where the major powers are each battling to keep their currencies low.

The Yen vs Major Currencies



Source: Thomson Reuters

Mr Abe has also clinched celebrity endorsement for his policies with Nobel laureates Paul Krugman and Joseph Stiglitz lending their backing to Abenomics.

Professor Krugman takes the view that it is imperative to reflate Japan first, before turning to fiscal consolidation. "By signaling that the Bank of Japan has changed, that it won't snatch away the sake bottle just as the party gets going, that it's going to target sustained positive inflation — and also by signaling that some fiscal stimulus is forthcoming despite high levels of debt — Japanese authorities have achieved a remarkable turnaround in short-term economic performance," he wrote in September last year.

Professor Stiglitz, Krugman's stablemate from the school of liberal economics (from which many of Mr Abe's advisers also hail), has said the expansionary settings of Abenomics are just what Japan needs in an era of competitive currency devaluation.

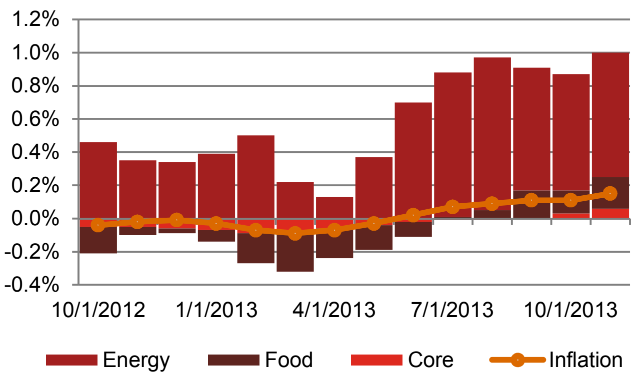
A true test

The renewed sense of confidence from Japan's establishment, from Mr Abe down, and the extent of the swings on financial markets, has caused even cynics to wonder if Japan really is back this time.

But the doubters caution that it is worth watching the real economy (rather than financial markets) where Abenomics, on the numbers alone, is finding it far harder to gain traction.

Take inflation, for example. Japanese core inflation (excluding fresh food) rose 0.7 in July last year from a year earlier, and then rose again by 0.8 per cent in August, 0.7 per cent in September and 0.8 per cent in October. However much of this can be accounted for in rising energy import costs.

Japanese inflation, Y/Y % change



Source: Ministry of Internal Affairs and Communications

Abenomics and Australia

Australia quickly threw its support behind Abenomics reckoning that a stronger Japan – the country's second largest trading partner and export market – was good for its interests, putting aside concerns the yen devaluation was not helping an overvalued Australian dollar.

A return to growth in Japan will help Australian mineral and agricultural exports at a time when the two countries work to finally clinch the long-awaited free-trade, or economic partnership, agreement.

A recent essay from Australian bank Westpac's senior international economist, Huw McKay, predicted that the direct impact of Japan reaching its 2 per cent growth target between now and 2020 would be an extra $4 billion in Australian export revenues.

McKay, a veteran observer of the Japan-Australia relationship, wrote in his Asialink essay that strong Japanese growth would boost a range of sectors in Australia including finance, agribusiness, fisheries, resources, technology, food and beverages, tourism and advanced manufacturing.

Professional services and Australia's higher education sector, would be other beneficiaries, McKay wrote.

If Abenomics continues to succeed, Japanese firms eyeing Australia are likely to find a less China-fixated business environment and arguably more interest in exploring opportunities with Japanese partners.

While the rapid depreciation of the yen may have chilled the merger and acquisition market for now, expectations are that Japanese firms will soon be looking abroad for acquisitions and partnerships again, including in Australia.

The other area in which Abenomics is relevant to the Australian market is in structural reform, or the so-called third arrow. In committing to joining the TPP, of which Australia is also a participant, agricultural tariffs and barriers to entry for service firms are likely to be reduced even if the two countries can't agree on the FTA.

The 25 per cent depreciation of the yen has made energy more expensive by a roughly equivalent amount. Meanwhile, as a result of the Fukushima accident, and the shutdown of almost all nuclear plants, fuel import quantities remain high in spite of energy saving drives by both households and industry.

Still, in a speech in November last year, Mr Kuroda largely stuck by the Bank of Japan's earlier forecasts tipping inflation would be 0.7 per cent in fiscal 2013, 1.3 per cent in fiscal 2014 and hit 1.9 per cent in fiscal 2015.

However, three of the bank's nine policy board members declined to endorse this scenario and one board member lodged a prediction inflation would be as low as 0.7 per cent in 2015.

Mr Kuroda's position was boosted by November data in which core inflation rose by 1.2 per cent, the biggest monthly rise in five years.

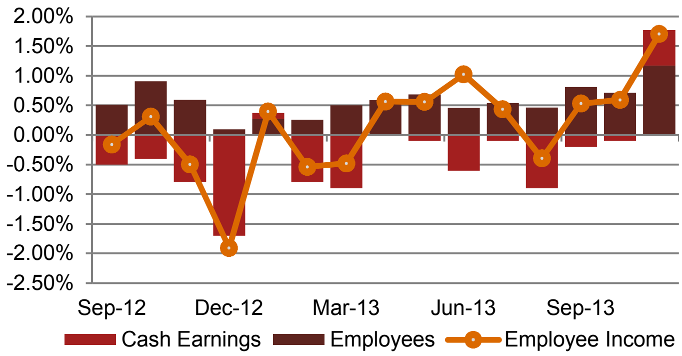
This last reading has thrust the focus on to wage rises, which must go hand in hand with inflation in the kind of 'virtuous cycle' envisaged by Mr Abe if Abenomics is to succeed.

Mr Abe and his team have been pushing hard to get employers to commit to wage rises, but with limited success outside of Toyota and convenience store chains.

Overall wages have continued to post declines, with recent figures showing that September 2013 was a 16th straight month of decline in regular wages with a fall of 0.3 per cent compared to a year earlier. October figures showed a fall of 0.4 per cent, while November saw Japan finally snap the long streak of declines with a flat reading.

Mr Kuroda attributes this softness to the growth in female and elderly participation in the workforce dragging down per capita wages. He says total employee income (the number of workers times wages paid per employee) has turned positive and "the income situation as a whole is improving" with the unemployment rate and the job openings to applicants ratio also improving.

Employee income, Y/Y % change



Source: Ministry of Health, Labor and Welfare; Ministry of Internal Affairs and Communications
Note: Employee income = number of employees (Labor Force Survey) ×total cash earnings

When it comes to confidence, the picture is similarly cloudy with big firms bullish, but small firms and consumers keeping their optimism in check.

Whichever side of the Abenomics debate people are on, spring in Japan (April through to May) looms as the key test of the policy. That's when the outcomes of the majority of wage claims will become clear and the consumption tax will increase from 5 per cent to 8 per cent.

The tax hike is part of what Mr Abe calls the third arrow of Abenomics – which most agree will be the hardest to implement and the most decisive. It consists of structural reform – an urgent and dauntingly large task in an economy that is being dragged down by over-regulation and inefficiency, despite Japan's strengths in innovation, engineering and automation.

Markets turned on Mr Abe in June last year when his long-awaited speech outlining the third arrow was judged as inadequate and not ambitious enough and lacking commitments to labour market deregulation, immigration and other key initiatives.

The Nikkei index of Japanese stocks – which had been driven up largely by foreigners buying – slumped from around 15,000 right down to 12,500, before eventually regaining its momentum.

What's next for reform?

The list of structural reform priorities is long and the highest priority for many firms is labour market reform, something of an untouchable in Japan with its penchant for near full employment meaning many unproductive employees are retained doing little or no useful work.

Mr Abe still seems reluctant to embark on this, noting in an interview with *The Financial Times* last year that it would take time to explain moves to raise labour mobility to the populace. Instead he's talked of boosting female participation and setting up special economic zones. Increasing immigration – which would be a truly significant reform – is not even really countenanced in Japan today, except in terms of baby steps towards a skilled migration program.

These emerging signs of flagging reformist zeal within government ranks recently prompted a rare angry comment from a top corporate leader in Japan. The CEO of online sales giant Rakuten, Hiroshi Mikitani, questioned Mr Abe's appetite for reform and threatened to quit a government body if a decision to restrict deregulation of drug sales was not overturned.

His was a specific and self-interested gripe, but his criticisms were seen as symbolic of emerging concerns that Mr Abe was failing to follow through on the third arrow of Abenomics.

If he doesn't push ahead with a substantial lowering of Japan's 38 per cent corporate tax rate, expect criticism from corporate ranks in Japan to spread.

The Prime Minister's supporters, though, argue that Mr Abe has already earned his reform stripes with perhaps his boldest decision of all – taking Japan into the negotiations for the US-backed Trans-Pacific Partnership (TPP) free-trade bloc.

By announcing the decision before coming to power, Mr Abe went against modern electoral orthodoxy as well as his party's key rural constituency, which remains staunchly opposed to the kind of sweeping deregulation envisaged under the TPP.

His commitment to the promised tax hike is another feather in the Prime Minister's reformist cap.

That said, Abenomics remains a work in progress and the ending could be a Greek tragedy, or a national triumph. So far though, the winners seem to be exporters, finance sector workers, shareholders, high-end retailers and Mr Abe himself – his personal rating remained a sky-high 60 per cent as he marked a year in office in December 2013.

Those shaping as the losers, at this stage, are ordinary wage earners whose salaries remain frozen while prices begin to rise. Add to that deposit holders and pensioners who will see a portion their savings inflated away if Abenomics is successful.

Tokyo Olympics 2020

While having the Olympic Games rarely proves to be the bonanza that optimistic consultants' reports predict, Tokyo's victory in the race to host the 2020 Games is seen as a stimulant to growth hopes and has been quickly dubbed the fourth arrow of Shinzo Abe's Abenomics policy.

Tokyo pledged a compact, cost-efficient Games in keeping with an era of comparative austerity, but the government nevertheless predicts a 0.5 per cent boost to GDP in 2020.

It believes that the Games will add 3 trillion yen ($28 billion) to the economy in the lead up and create 150,000 jobs.

The overall spend for the Tokyo Games is modest, though, at just over 1 trillion yen (9.5 billion), thanks to Japan having most of the necessary infrastructure in place, although it is lashing out on a new stadium.

The opportunity that the Olympics really offers Japan, though, is the chance for it to reinvent, or at the very least, rebadge itself by proving that it has recovered from the March 2011 tsunami, and is on top of the clean-up efforts at the Fukushima Daiichi nuclear power plant and is rebounding from years of economic stagnation.

Although you can't put a dollar figure on it, the 2020 Games offers Japan the chance to prove it really is back.

In describing the Games as the 'icing on the Abenomics cake', investment bank Nomura said the event would come at a critical time for the government's economics policies.

"If the government's growth strategies go according to plan, the benefits should be obvious to all by the time that the Tokyo Games are held in summer 2020. Economic partnerships will have restored Japan's international competitiveness, women will be much more active in society, and the Japanese labor force and university system will have become more global in outlook, giving the Japanese people more of a spring in their step," a recent Nomura research report found.

"In the same way that the 1964 Tokyo Olympics showed that Japan had entered the ranks of modern industrialized nations, the 2020 Tokyo Olympics could show that Japan is back. This would demonstrate the underlying strengths of Japan to a global audience."

The global exposure a successful Games would give Japan, as it is trying to stress its ability to open up to the world and play a more active role internationally, is valuable.

With much of the construction work done, the sectors that are likely to be boosted by the Games - hospitality, media, and above all, tourism - are those that will have to be future engines of growth for Japan as it transitions from being a manufacturing-based economy to a one having a large services base.

How can PwC help you?

Businesses need good intelligence to make informed, strategic and evidence-based decisions. Accurate assessments of the economic environment and the quantification of the impacts of business decisions provide a competitive edge, manage risk and helps hone investment decisions and rank priorities.

Our Economics and Policy team is PwC Australia's national centre of excellence in policy and strategic advisory services, based on advanced economic, financial and fiscal modelling. We provide evidence-based analysis that goes beyond the capability of traditional impact assessment, business cases and strategic business advice and robust economic and financial forecasting. Our approach is client driven, outcomes focused and to international best-practice. Our specialist capabilities are expertly and appropriately applied across a wide portfolio of private sector and government clients in Australia and internationally.

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- **Subject matter expertise** – we understand the issues affecting industry, government, households and the economy and do not require time or effort to "get up to speed."
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Integrated Forecasting Model (IFM)

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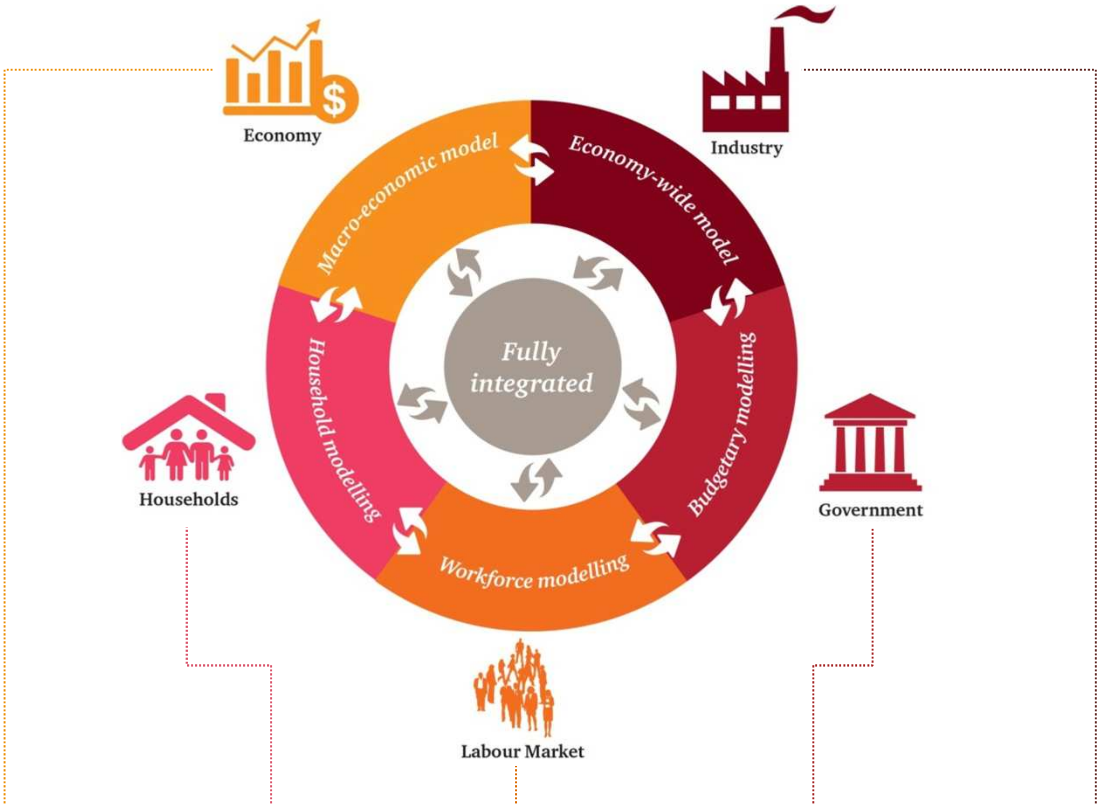

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- Comprehensive baselines generated
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