I. ECONOMIC ENVIRONMENT

(1) MAIN ECONOMIC DEVELOPMENTS

1. Exports have often been a main source of growth for Japan's economy. Between 2002 and 2007, real GDP grew at an average annual rate of approximately 1.8%, underpinned by exports, which grew at an average annual rate of over 9% during the same period. In the aftermath of the global economic crisis in 2008, exports collapsed, resulting in the Japanese economy contracting in 2008 and 2009. Recovery in 2010 was again export-led. The earthquake and tsunami in 2011 resulted in sharp declines in private consumption and stock building, and widespread supply chain disruptions affecting production across the country, particularly in export dominant sectors, such as automobiles and electronics. Production was also affected by the shutdown of nuclear power plants, while exports were impacted by the floods in Thailand. Against this background, exports declined and the economy contracted in 2011 (Table I.1).

Table I.1
Selected macroeconomic indicators, 2007-11

	2007	2008	2009	2010	2011
	(% change, unless otherwise indicated)				
National accounts					
Real GDP	2.2	-1.0	-5.5	4.5	-0.8
Domestic demand	1.1	-1.3	-4.0	2.8	0.1
Private consumption	0.9	-0.9	-0.7	2.6	0.1
Government consumption	1.1	-0.1	2.3	2.2	2.0
Gross fixed investment	0.3	-4.1	-10.6	0.1	0.8
Exports of goods and services	8.7	1.4	-24.2	24.3	-0.1
Imports of goods and services	2.3	0.3	-15.7	11.2	6.3
Exports of goods and services (% of GDP)[a]	17.8	17.7	12.7	15.2	15.2
Imports of goods and services (% of GDP)[a]	16.1	17.5	12.3	14.0	16.1
Employment	0.5	-0.4	-1.6	-0.4	-0.1[b]
Unemployment rate (annual average)	3.9	4.0	5.1	5.1	4.5[b]
Household disposable income (% change)	0.2	-0.9	-1.1	0.4	..
Prices and interest rates					
Consumer prices (CPI) (% change)	0.0	1.4	-1.4	-0.7	-0.3
GDP deflator (% change)	-0.9	-1.3	-0.5	-2.2	-2.1
Basic discount rate and basic loan rate (%)	0.8	0.3	0.3	0.3	0.3
Exchange rate (annual average, ¥ per US$)	117.8	103.3	93.5	87.8	79.8
	(% of GDP)				
Fiscal balance					
Revenue	31.2	31.6	29.6	29.6	30.6
Expenditure	33.3	35.7	40.0	39.0	40.7
Balance	-2.1	-4.1	-10.4	-9.4	-10.1
Primary balance	-2.1	-3.8	-9.9	-8.7	-9.2
Excluding social security	-1.1	-2.7	-8.1	-7.1	-7.3
Government debt, gross	183.0	191.8	210.2	215.2	229.8
Saving and investment					
National saving (gross)	27.5	25.9	22.1	22.9	..
Domestic investment (gross)	22.9	23.0	19.7	19.8	..

Table I.1 (cont'd)

	2007	2008	2009	2010	2011
Current account balance	4.9	3.3	2.9	3.7	2.0
Goods balance	2.4	0.8	0.9	1.7	-0.3
Exports	15.5	15.4	10.9	13.3	13.4
Imports	13.1	14.6	9.9	11.6	13.7
Services balance	-0.5	-0.4	-0.4	-0.3	-0.4
Income balance	3.2	3.2	2.7	2.6	3.0
Net transfer balance	-0.3	-0.3	-0.2	-0.2	-0.2
Capital and financial account balance	-4.4	-3.7	-3.0	-3.7	0.3
Capital account	-0.1	-0.1	-0.1	-0.1	0.0
Financial account	-4.3	-3.6	-2.9	-3.6	0.2
Direct investment	-1.2	-2.2	-1.2	-1.1	-2.0
Reserve assets	-0.8	-0.6	-0.5	-0.8	-3.0

.. Not available.

a Percentage distribution in annual nominal GDP.
b Devastated quake-hit prefectures (Iwate, Miyagi and Fukushima) are not included in the figures for 2011.

Source: Information provided by the Japanese authorities; Cabinet Office online information; and IMF (2012), *Country Report No. 12/208.*

2. The Japanese economy has rebounded since then and real GDP growth is expected to be 2.2% in 2012.[1] Recent growth has not been driven by exports, but has come on the back of reconstruction spending, consumer spending (helped by government subsidies for environmentally friendly automobiles), and inventory building in the wake of supply chain disruptions. However, the recovery is fragile, with the Japanese economy being susceptible to shocks in the global economic environment especially in key trading partners such as the EU and China.

3. To be able to sustain growth in the medium to longer term, domestic demand will need to continue to drive growth. Other challenges to longer term growth include very high public debt, the rapidly aging population, and deflation. To overcome these challenges, the Japanese economy will need to undergo structural reforms, *inter alia*, to improve productivity in the services sector, reform the labour market, and reform taxation.

(2) MACROECONOMIC POLICIES

4. In response to the earthquake and tsunami, the national and local governments have adopted FY2011 supplementary budgets and FY2012 initial budget amounting to approximately ¥17 trillion (about 3.6% of GDP).[2] Reconstruction is expected to be around 4% of GDP. Initially, reconstruction was financed through contingency reserves, reprioritized spending, and a temporary reduction in the Government's contributions to the pension fund.[3] However, under the Basic Guidelines for Reconstruction in Response to the Great East Japan Earthquake, reconstruction is to be financed through a combination of reduced government expenditures, non-tax revenues, and temporary tax measures. Nonetheless, expenditures rose to 40.7% of GDP in 2011, while revenues rose much more modestly to 30.6% of GDP; consequently, the fiscal deficit in 2011 was in excess of 10% of GDP, while gross government debt reached nearly 230% of GDP. The fiscal deficit is expected to widen slightly in 2012 on account of continued reconstruction spending.[4] Furthermore, over the longer term,

[1] Information provided by the authorities.
[2] Information provided by the authorities.
[3] IMF (2011).
[4] IMF (2012).

expenditures related to pension and health care are expected to continue to rise due to Japan's rapidly aging population.

5. Other than rebuilding the physical infrastructure, the focus of the Government's rebuilding strategy is on job creation. In this respect, the authorities have identified the creation of new innovative industries through the utilization of "reconstruction special zones" and private sector funds.[5] Industries targeted include: environmentally friendly industries, life sciences, science and technology, and information and communications sectors. The authorities are also focusing on small and medium enterprises (SMEs) as an engine of growth and revitalization. In this regard, the Government made sure that financing lines remained open after the disaster and is also considering making start-up capital more easily available. In order to realize the above, the Government has also consented to the Program for Promoting Japan as an Asian Business Center and Direct Investment into Japan (Chapter II). In the wake of the nuclear disaster, the Government is also in the process of reviewing its energy strategy and mix. This is also seen as an avenue for reconstruction and revitalization. In September 2012, the authorities issued the Innovative Strategy for Energy and the Environment. These policies are governed by three underlying principles: realization of a society not dependent on nuclear power; realization of a green energy revolution; and stable supply of energy.

6. With respect to monetary policy, the Bank of Japan (BOJ) maintained an accommodative stance during the period under review so as to stimulate domestic demand. The accommodative monetary policy was enabled by the deflationary environment in Japan. With a view to further increasing monetary easing, the BOJ increased the size of the asset purchase programme, which totalled ¥91 trillion in October 2012.[6] Other measures, including "special rules" such as the establishment of ¥0.5 trillion line of credit to encourage asset-based lending by financial institutions, have been instituted by the BOJ, to "strengthen the foundations of economic growth". Measures taken by the BOJ in response to the earthquake and tsunami were unprecedented. The BOJ introduced a new ¥1 trillion loan programme to support lending activities of financial institutions in the affected regions. In the immediate aftermath of the disaster the BOJ also made available ¥21.8 trillion yen of short-term liquidity, much more than that injected after the Lehman crisis. The BOJ announced in February 2012 that it would continue with a zero interest rate policy and implement an asset purchase programme until it judges that an annual inflation rate of 1% is "in sight". These announcements have signaled that Japan is moving towards making use of "inflation targeting". In October 2012, the Government and the BOJ released a joint statement, which stated that they would work together and make their utmost efforts to overcome deflation. "All items" CPI reached 0.4% in April 2012, due mainly to higher fresh food and petroleum prices; "all items" CPI was -0.4% in July 2012**,** as fresh food and petroleum prices dropped.

7. The nominal exchange rate of the yen against the U.S. dollar continued to appreciate during the review period (2011-12) albeit more slowly than in the previous review period (2009-10).[7] Initially the appreciation was due to the unwinding of the yen "carry trade" and later due to safe haven flows. Furthermore, the authorities intervened to the tune of US$120 billion in the foreign exchange market in October/November 2011 to counter volatility in exchange rates. It would appear that the appreciation in the exchange rate has eroded the international competitiveness of Japanese exports to some extent, as Japan recorded a trade deficit in 2011, the first time in three decades.

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[5] As of 28 September 2012, plans for 22 special zones had been approved.

[6] Bank of Japan online information. Viewed at: http://www.boj.or.jp/en/announcements/release_2012/k121030a.pdf.

[7] Between September 2008 and November 2010 the exchange rate rose from ¥109 per U.S. dollar to ¥81 per U.S. dollar; however, since then it has appreciated more slowly and was trading at ¥78 per U.S. dollar in September 2012.

(3) Structural Policies

8. To be able to sustain growth in the future, the Japanese economy will need to undergo far-reaching structural reforms focused on improving productivity in the services sector; and addressing the duality in the labour market between regular and non-regular workers, which has resulted in depressed incomes and increasing revenues through comprehensive tax reforms.[8] The authorities have initiated certain reforms that address the above concerns.

9. The Government's fiscal strategy is to put the public-debt-to-GDP ratio on a declining trend. To achieve this, the authorities aim to halve the primary deficit to GDP ratio by FY2015 and realize a primary surplus by FY2020. In this regard, the Diet has approved a bill that would increase the consumption tax rate from the current 5% to 8% in April 2014 and to 10% in October 2015. However, according to IMF estimates, this, together with a planned cut in expenditure, would only reduce the primary deficit to 5% of GDP by 2020, while a fiscal adjustment of 10% of GDP over the next decade is necessary to put the public-debt-to-GDP ratio firmly on a downward path. Japan has one of the lowest tax-to-GDP ratios in the OECD, which provides for ample space to broaden the tax base. Options that could be considered by the Government include: reducing the exemption for pension income; eliminating the tax deduction for dependent spouses; and reducing benefits provided to wealthy retirees.[9] However, the authorities state that they are not currently considering these options. In a bid to reduce expenditure, options to raise the pension retirement age (e.g. to 67) or collect contributions from dependent spouses have been debated publically in Japan.[10]

10. The authorities are also considering options to increase the labour force, these include increasing female participation by providing better and more childcare facilities[11]; promoting the employment of the elderly by obliging employers to ensure stable employment until the age of 65, and through the recently introduced "points-based preferential treatment for highly skilled foreign professionals in immigration procedure". In addition, labour market mobility and fairness could be facilitated by the recently revised Labour Contract Act, which introduces a new rule that promotes changing fixed-term contracts to open-ended contracts. This should facilitate the employment of young workers and help narrow the gap between regular and non-regular workers.

11. In addition to the Program for Promoting Japan as an Asian Business Center and Direct Investment into Japan, the authorities have announced a cut in the corporation tax rate in April 2012, to improve incentives to invest (Chapter III(3)). However, strict and complicated domestic sector regulations and the limited availability of risk capital continue to be cited as serious impediments to investment.

(4) Developments in Trade and Foreign Direct Investment

12. Japan's current account surplus decreased from US$147 billion in 2009 (2.9% of GDP) to US$119 billion in 2011 (2% of GDP), reflecting a narrowing of the gap between gross national savings and gross domestic investment (Table I.2). This decline mainly reflects the sharp fall in the trade account, where Japan recorded a deficit for the first time since 1980. The deficit was due to a disruption in exports because of the devastation caused to export industries situated in the area affected by the earthquake and tsunami, an appreciating yen, and floods in Thailand. In addition,

[8] For details see WTO document WT/TPR/S/243/Rev.1 May 2011.
[9] IMF (2012).
[10] IMF (2012).
[11] The authorities plan to increase childcare services, including by merging kindergarten and childcare systems.

imports rose on account of reconstruction spending and increased fuel imports due to the halt in nuclear power production.

13. In 2011, the share of exports of goods and services in GDP was 15.9% (15.8% in 2010), while the share of imports was 16.6% (14% in 2010).[12] These shares have increased since 2009, with imports rising faster (mainly due to higher fuel imports). Japan continues to be the world's fourth largest exporter (counting the European Union as one) and importer of goods. The deficit in services trade has increased since 2009. This is due mainly to higher travel and transport payments, as more Japanese travelled abroad because of the stronger yen. The deficit was US$22.3 billion in 2011 (0.4% of GDP). Trade in services as a proportion of GDP has remained slightly over 5% since 2009.

Table I.2
Balance of payments, 2007-11
(US$ billion)

	2007	2008	2009	2010	2011
Current account balance	211.7	159.4	147.0	203.9	119.1
Goods balance	104.8	38.1	43.6	91.0	-20.6
Exports	678.1	746.5	545.3	730.1	787.0
Imports	573.3	708.3	501.7	639.1	807.6
Services balance	-21.3	-20.8	-20.4	-16.1	-22.3
Credit	129.1	148.8	128.3	141.5	145.4
Transportation	42.0	46.8	31.6	39.0	38.3
Travel	9.3	10.8	10.3	13.2	11.0
Other	77.8	91.1	86.4	89.3	96.0
Debit	150.4	169.5	148.7	157.6	167.7
Transportation	49.0	54.0	40.6	46.5	49.5
Travel	26.5	27.9	25.2	27.9	27.3
Other	74.8	87.7	83.0	83.1	90.9
Income balance	139.7	155.1	136.2	141.5	175.8
Credit	200.7	214.8	180.0	181.8	227.3
Compensation of employees	0.1	0.2	0.2	0.2	0.2
Investment income	200.5	214.7	179.9	181.7	227.1
Debit	61.0	59.8	43.9	40.4	51.5
Compensation of employees, debit	0.2	0.2	0.2	0.2	0.3
Investment income, debit	60.8	59.6	43.7	40.2	51.3
Current transfers	-11.5	-13.0	-12.4	-12.4	-13.8
Credit	6.8	9.1	9.5	10.1	13.1
Debit	18.3	22.1	21.9	22.5	26.9
Capital and financial account	-227.8	-209.1	-162.1	-179.3	-93.7
Capital account	-4.0	-5.5	-5.0	-5.0	0.5
Credit	0.7	0.6	1.1	0.9	7.6
Capital transfers	0.2	0.2	0.2	0.1	5.1
Non-produced non-financial assets, credit	0.5	0.4	0.9	0.8	2.5
Debit	-4.7	-6.1	-6.1	-5.8	-7.1
Capital transfers	-3.0	-4.0	-2.8	-3.9	-4.6
Non-produced non-financial assets, credit	-1.7	-2.1	-3.3	-2.0	-2.5

Table I.2 (cont'd)

[12] Based on the most recent data available.

	2007	2008	2009	2010	2011
Financial account	-223.8	-203.5	-157.1	-174.3	-94.2
Direct investment	-51.3	-106.3	-62.8	-58.6	-117.4
Direct investment abroad	-73.5	-130.8	-74.6	-57.2	-115.7
Direct investment in Japan	22.2	24.6	11.8	-1.4	-1.7
Portfolio investment	73.1	-292.6	-216.5	-151.0	161.1
Assets	-123.5	-189.6	-160.2	-262.6	-103.1
Liabilities	196.6	-103.0	-56.3	111.6	264.1
Financial derivatives	2.8	24.8	10.5	11.9	17.1
Assets	188.5	271.9	333.9	403.5	407.5
Liabilities	-185.7	-247.2	-323.3	-391.5	-390.4
Other investment	-211.9	201.5	138.6	67.2	21.8
Assets	-260.8	139.5	202.7	-130.1	-92.7
Liabilities	48.9	62.0	-64.2	197.3	114.4
Reserve assets	-36.5	-30.9	-26.9	-43.9	-176.6
Net errors and omissions	16.1	49.6	15.0	-24.6	-25.4

Source: Information provided by the Japanese authorities.

(i) Composition of merchandise trade

14. Manufactures continue to dominate Japan's exports, accounting for 88.1% of total merchandise exports in 2011, up from with 87.5% in 2009 (Chart I.1). During 2009-11, machinery and transport equipment remained Japan's most important merchandise export, accounting for 58.3% of the total in 2011 (Table AI.1). Within manufactures, the shares of office machines and telecommunication equipment declined considerably, while the shares of other non-electrical machinery and automotive products increased. Going forward, export performance might be adversely affected as the slowdown in East Asia, Japan's largest export market, sets in; the authorities believe that the weak state of Japan's real exports is due to the global economic slowdown.

15. The share of primary products in total merchandise imports increased from 46.2% in 2009, to 51.4% in 2011. The increase was due to an increase in fuel imports, which were necessitated by the halt in nuclear power production in the aftermath of the earthquake and tsunami in March 2011. On the other hand, the share of manufactures declined, with machinery and transport equipment declining from 23% of total imports in 2009 to 20.8% in 2011 (Table AI.2).

(ii) Direction of merchandise trade

16. China remains Japan's largest export market, attracting 19.7% of total exports in 2011, up from 18.9% in 2009 (Chart I.2). The share of Asia as a whole as an export destination also continued to rise, which in turn helped to increase APEC's share to 76.1% (from 74.8%). In contrast, the shares of both the United States and EU (27) declined, owing mainly to the global economic crisis. China's share has increased steadily since 2007 (Table AI.3).

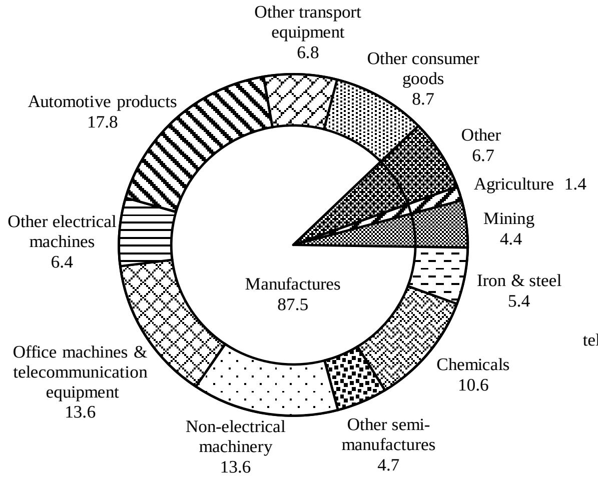
17. China's share in Japan's merchandise imports decreased to 21.5% in 2011 (22.5% in 2009), but it remains Japan's largest trading partner. The share of goods imported by Japan from Asia increased, although not as much as exports, while the share of imports from the Middle East showed a considerable increase, mainly due to increased fuel imports. On the other hand, the share of imports from the United States and EU (27) declined (Table AI.4).

Chart I.1
Composition of merchandise trade, 2009 and 2011

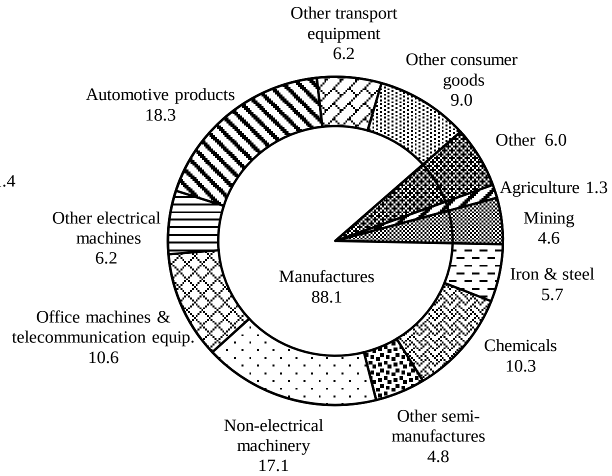
Per cent

2009 **2011**

(a) Exports (f.o.b.)

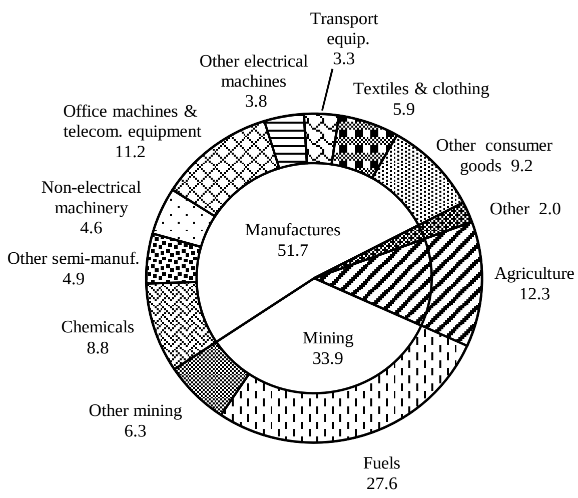


Total: US$580.7 billion

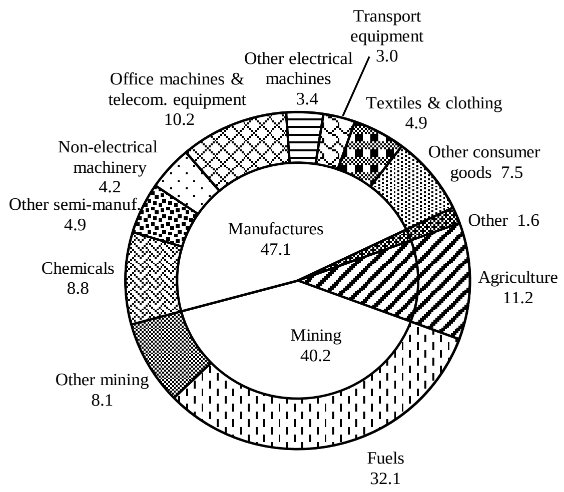


Total: US$823.3 billion

(b) Imports (c.i.f.)



Total: US$552.0 billion



Total: US$854.6 billion

***Source*: UNSD, Comtrade database (SITC Rev.3).**

(iii) Foreign direct investment

18. Japan's inward FDI remains substantially lower than outward FDI, and low compared with other developed economies.[13] After recording inflows between 2007 and 2009, inward FDI showed outflows of US$1.4 billion in 2010 and US$1.8 billion in 2011. On the other hand, Japan's outward FDI more than doubled in 2011, to US$116 billion, (from US$57 billion in 2010), presumably due to an appreciating yen and low returns in the domestic economy. The stock of inward FDI has remained static at approximately 3.9% of GDP since 2009, while the stock of outward FDI rose to 16.0% of GDP in 2011, from 14.5% of GDP in 2009.

19. The EU remains the largest investor in Japan, accounting for over 42% of inward FDI in 2011, while the United States accounted for over 31%. The largest recipient of FDI was the finance and insurance sector followed by the electrical machinery industry and the wholesale and retail sector.

20. The United States, the EU, China, and the Cayman Islands were the major recipients of outward foreign direct investment by Japan in 2011. The main industries/sectors invested were finance and insurance, wholesale and retail trade, chemicals and pharmaceuticals, and transport equipment.

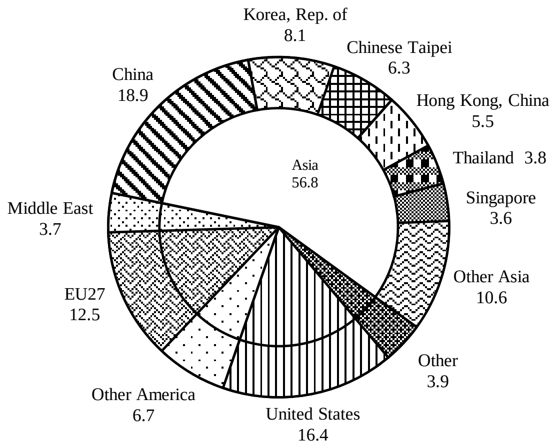
[13] UNCTAD (2012). FDI into Japan in 2011 recorded an outflow of approximately US$1.8 billion, while the United States and the European Union recorded inflows of US$227 billion and US$421 billion, respectively. Inflows into China amounted to US$124 billion.

Chart I.2
Direction of merchandise trade, 2009 and 2011

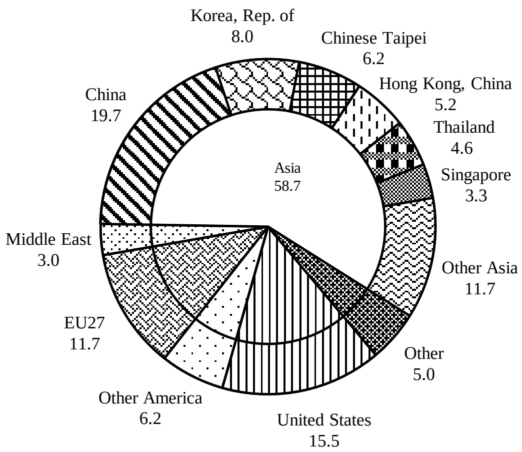
Per cent

2009 | **2011**

(a) Exports (f.o.b.)

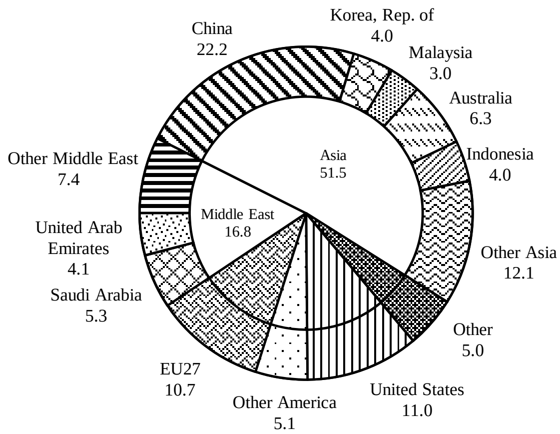


Total: US$580.7 billion

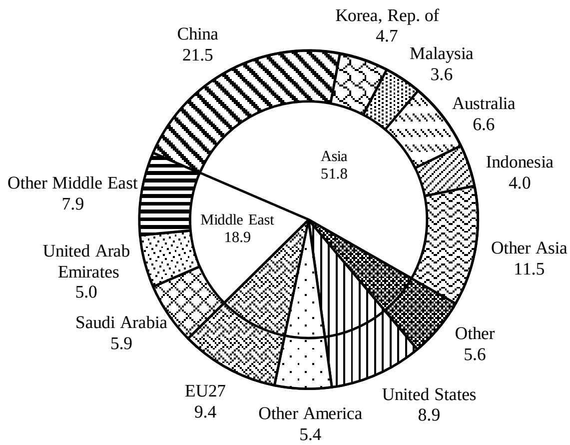


Total: US$823.3 billion

(b) Imports (c.i.f.)



Total: US$552.0 billion



Total: US$854.6 billion

***Source*: UNSD, Comtrade database.**