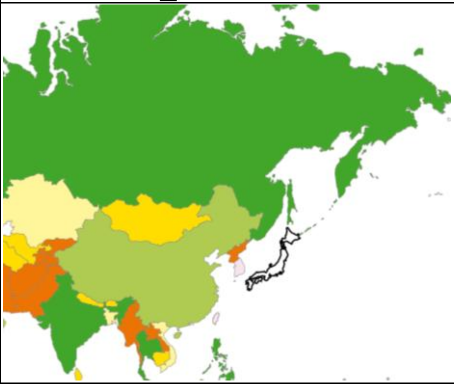
COUNTRY RISK ANALYSIS

Japan

CREATING CONFIDENCE IN YOUR EXPORTS

ekn



COUNTRY RISK CATEGORY

0/7

The country risk categories range from 0 to 7. The lower the number the better the credit rating the country has.

0 1 2 3 4 5 6 7

EKN'S OUTSTANDING GUARANTEES ON THE COUNTRY

SHORT-TERM TRANSACTIONS: -

MEDIUM AND LONG-TERM TRANSACTIONS:
SEK 6,420 MILLION

DATE

25-09-2014

Revitalisation of the Japanese economy

Japan is the world's third-largest economy and its currency is the most traded currency in the world after the dollar and the euro. High GDP per capita, gigantic international reserves and a strong external financial position has given the country a high credit rating. But the Japanese economy has stagnated. The political scene in Japan is characterised by constant Prime Minister changes, government reshuffling and recurring corruption scandals. The recurring government shifts have contributed to the country having trouble coming to grips with the structural problems that have hampered its economic growth for a long time. The relatively new government faces big challenges. Growth is low, public debt is high and the national budget has run large deficits for a considerable time. A sustained period of deflation and well-anchored deflation expectations has resulted in previous stimulus measures failing to increase demand. The sitting government with Prime Minister Abe at its head has been trying to kick-start the economy with very expansionary economic policies in order to break the deflation spiral and get growth moving. However, the country's high public debt is limiting its fiscal scope. It is still too early to judge whether the policies of the government will succeed in creating a permanently higher rate of growth. It is highly likely that the deflation spiral has been broken, but a vast majority of the structural reforms needed to strengthen the Japanese economy remain to be implemented.

THE COUNTRY'S STRENGTHS AND WEAKNESSES

Strengths

- A large and diversified economy with high GDP per capita.
- High domestic savings and a strong external financial position
- Advanced credit market and large domestic holdings of the public debt.
- Low borrowing costs for the public debt.

Weaknesses

- High public debt and large national budget deficits.
- Long period with low potential growth and major structural problems on the labour and product markets.
- Limited fiscal scope for meeting rising public expenditure as a result of an ageing population.

EKN'S POLICY

General risk assessment

Similarly to most high-income countries in the OECD, EKN has placed Japan in country risk category 0. There are no other financial and economic circumstances that justify any restrictions on the country policy. Instead, each transaction is assessed on its own merits. In accordance with the EU's competition regulations, EKN and other export credit institutions may not cover any payment risks for transactions where the risk term is less than two years. Euro zone countries and other high-income countries in the OECD are not categorised within the scope of the OECD's country risk categorisation.

WHAT MIGHT CAUSE A CHANGE IN THE COUNTRY POLICY?

The policy may be made more restrictive

- If the positive growth effects of the government's stimulus measures turn out to be temporary and if no reforms are made to increase investments and private consumption and permanently break the deflation spiral.
- Rapidly rising market interest rates and reduced domestic interest in investing in Japanese government bonds could lead to a rise in the financing costs for the national debt in a situation with limited fiscal scope. In the long term, this could run the risk of leading to a crisis of confidence and an unsustainable public finance situation.

EKN'S OBLIGATIONS AND EXPERIENCE

Increased exposure as a result of the financial crisis

EKN's exposure to Japan was at a very low level before the financial crisis. The inflow of new transactions increased significantly during the crisis and has remained at a high level ever since. EKN's total exposure to Japan is approximately SEK 13.5 billion, with offers and guarantees each accounting for half. Japan is thus one of the largest countries in EKN's guarantee portfolio. EKN mainly has exposure to transactions in the telecom market. EKN has very solid experience overall with respect to transactions in Japan.

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Misguided economic policies and lost years

The Japanese economy has been characterised by weak growth, deflation and falling asset prices for a long time. This weak economic growth has its roots in misguided economic policies that aimed to cope with the imbalances that emerged just over two decades ago. The deregulation of the credit market in the late 1980s led to competition stiffening in the banking sector, which drove a trend toward increased lending, especially to households and property companies. The value of properties rose dramatically while the equity index on the Tokyo Stock Exchange soared, which led to speculative investments and increasing risk exposure. When the economic climate took a sharp turn downwards in the early 1990s, the value of equities and properties fell and the collateral of banks was impaired. The situation in the banking sector had strong similarities to the situation in the banking sector in Sweden at the same time, but loans were not written off in Japan. Instead, they were allowed to remain in the system. This has contributed to making the problems permanent. Since the 1990s, growth in Japan has been significantly lower than in other comparable OECD countries and the attempted measures to stimulate growth have only led to a temporary increase in economic activity. High public debt is the only lasting effect of the policies pursued. The political climate is characterised by constant Prime Minister changes, minister resignations and corruption scandals. Constant government shifts have contributed to the loss of a long-term perspective in the country’s economic policies.

Ultra-loose monetary policy and expansionary fiscal policy to kick-start the economy

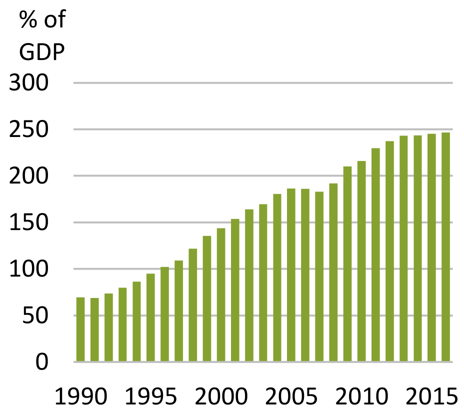
The country's current Prime Minister, Shinzo Abe, is a member of the conservative Liberal Democratic Party and took office in December 2012. He is Japan's eighth Prime Minister in almost just as many years. The governing party has a majority in both houses of parliament, which creates the conditions for a more stable political climate in the coming years. The government faces several major challenges. Prime Minister Abe's economic policies, called Abenomics, consist of three pillars: monetary expansion, growth stimulus and structural reforms. These economic policies aim to kick-start the economy and thus break the deflation spiral. The central bank is pursuing a very expansionary monetary policy and is aiming to double the monetary base via massive purchases of government bonds and thus stimulate bank lending and corporate investments. The central bank has raised the inflation target from one to two per cent to push up inflation expectations. The government has launched a stimulus package which includes infrastructure investments, mainly aimed toward rebuilding the areas affected by the catastrophic earthquake in 2011. Thus far, the government's policies have had positive effects, the stock exchange has gone up, consumer prices have risen and the currency has gotten weaker. A weaker exchange rate is expected to give the export industry a much-needed boost.

To speed up private consumption, the government wants to put in place a new form of wage settlement expected to generate a rise in the wage increase rate. Employers are emphasising that wages will not be raised until inflation has strongly taken root, while many economists assert that a rise in the wage increase rate is one of the main pre-conditions for the inflation target to be met. It will probably take some time before the wage increase rate goes up and it will probably not happen until unemployment goes down. When the fiscal policy in the future is gradually realigned toward austerity, the need for reforms that promote growth will increase. Overall, it is estimated that the economic policies will put the economy on a better footing. However, there is also a risk that this upswing will be temporary. The government's expansionary measures are essentially the same stimulus policies tried earlier, although in a somewhat new form. The government's ability to implement urgent structural reforms will be decisive for whether these economic policies will succeed this time. As the cost of weak growth and low government bond yields increasingly becomes evident to domestic investors, the opposition to a more extensive structural transformation will die down, which will give the government the ability to act.

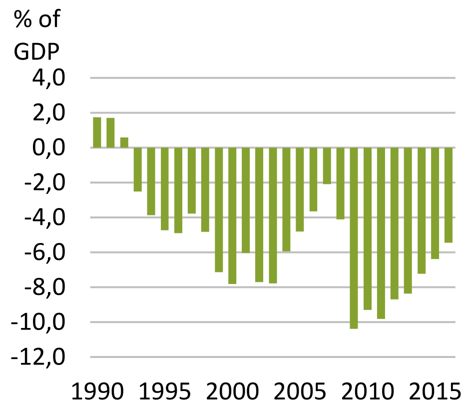
High debt at low interest rates

One of the biggest challenges for the government is getting the country's high public debt under control. The gross government debt is equal to approximately 250 per cent of GDP and there are major public budget deficits. However, the Japanese government enjoys a high credit rating and the interest rate for Japanese government securities is very low.

GROSS PUBLIC DEBT



PUBLIC NET LENDING



Source IMF, (forecast years are 2014-2016)

There are several underlying explanations for this. Japan is one of the world's largest lenders, which puts the country's net debt at a significantly lower level at 125 per cent of GDP. In addition, Japanese government securities are mainly held domestically. The deflationary environment has resulted in a low nominal interest rate on government bonds still yielding a positive real return. In recent years, the price drops for other assets such as equities and properties have also contributed to Japanese banks and pension funds choosing to invest in Japanese government securities. But if the preference of domestic investors for Japanese government securities changes or its relatively low return becomes less favourable, the government's financing costs could quickly become unsustainably high and have substantial consequences for its fiscal room for manoeuvre. A strong upswing in the interest rates would also lead to major losses in the banking system, as a result of the large number of government securities held by the banks, which would reduce the credit capacity of the banks. The most probable scenario is however that a shift in the willingness of investors and households to invest in domestic securities will gradually take place in an orderly fashion.

BUSINESS ENVIRONMENT

In the World Bank's business climate rankings of countries, Japan has long been a fixture among the countries with the most business-friendly business environments. Japan's regulations for starting companies and receiving building permits are however two areas where the business environment is considered relatively difficult. In addition, Japan has a relatively low ranking for corporate taxation, which is something the sitting government is planning to change in order to attract domestic companies to return to Japan after choosing to place their production in other, more expansionary parts of Asia.