

## Challenges Before Japan in 2012

*Rajaram Panda*

*Dr Rajaram Panda is Senior Fellow at the Institute for  
Defence Studies and Analyses, New Delhi*

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## Summary

Delivering his New Year address to the nation on television, Prime Minister Noda Yoshihiko showed optimism about his country's future saying that the year 2012 will be the year of Japan's rebirth. The year that just ended saw Japan struck by a mega earthquake, followed by a giant tsunami that destroyed an entire coastline, killed nearly 25,000 people with many more missing, and culminated in the meltdown in the Fukushima Daiichi nuclear power plant. While considering what the coming year holds for Japan, the Japanese people seem quietly determined to recover from the tragedy. As their leader, Noda understands the resilience of his people and bases his optimism on such an understanding. This Issue Brief assesses the pitfalls and opportunities as well as the likely course of action that the Japanese political leadership is going to define in the coming months.

## Introduction

Delivering his New Year address to the nation on television, Prime Minister Noda Yoshihiko showed optimism in his country's future and said the year 2012 will be the year of Japan's rebirth. The year that just ended saw Japan struck by a mega earthquake, followed by a giant tsunami that destroyed an entire coastline, killed nearly 25,000, with many more missing, and culminated in the meltdown in the Fukushima Daiichi nuclear power plant. While considering what the coming year holds for Japan, the Japanese people seem quietly determined to recover from the tragedy. As the leader, Noda understands the resilience of his people and bases his optimism on such an understanding. This Issue Brief attempts to assess the pitfalls and opportunities as well as the likely course of action that the Japanese political leadership is going to define in the coming months.

There are several domestic and foreign policy issues that Noda will have to contend with, and not all of them are smooth. The economic issues impinging upon domestic politics are important, as is dealing with immediate neighbours. Noda's foreign policy will also be shaped by the changing strategic environment in Japan's neighbourhood.

## Economic Factors

Noda's optimism faces the threat of being derailed by the sky-high Yen and the global economic downturn that will exert downward pressures on the economy in 2012. On the upside, the domestic demand linked to post-disaster reconstruction work could underpin growth. Recently, news released by the Bank of Tokyo – that a record ¥84 trillion was left undeposited at year-end as people chose to keep cash at home or in office safes – does not cheer the planners of economic policy. It was for the second straight year that people kept such record amounts at home. Even though the people are deterred by ultra-low interest rates, preferring to hoard cash at home, the Bank of Tokyo continues to supply a large amount of cash to the market in keeping with its monetary easing policy. Given an uncertain economic outlook, it is believed that companies too have large amounts of cash stashed in their office safes for emergency use.<sup>1</sup>

Revitalising an economy that has been heavily affected by the triple disasters of March 2011 is a huge challenge for the Noda government. Noda is unlikely to see early success in removing the deep scars on the national psyche. Cleaning up of the debris from the earthquake and tsunami is still underway and the reconstruction of disaster-hit communities is a long-drawn task.

The negative impact of Europe's sovereign debt crisis on the Japanese economy has also been huge. The last quarter of 2011 saw the trade balance going into the red due to a

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<sup>1</sup> 'Record Amount of Cash Kept at Home, Offices', *The Yomiuri Shimbun*, January 1, 2012, available at <http://www.yomiuri.co.jp/dy/business/T111231003083.htm> (accessed on January 1, 2012).

slump in the shipment of auto and electronic parts to other Asian economies. These economies build products for exports to Europe where consumer sentiment remains depressed. The rise of the Yen by almost seven per cent since May 2011 put more pressure on exporters as a strong Yen cuts off manufacturers' overseas profits when repatriated. Under the circumstances, Japan cannot expect external demand to support the economy, at least in the first half of 2012, and therefore domestic demand linked to reconstruction work in the Northeast of the country can probably help it avoid negative growth.

If European leaders succeed in taming the long-running Eurozone debt crisis, Japan's economic recovery may get a fillip. If they fail to resolve the continent's debt woes, there will be little or no demand for Japanese products. This will result in weakening exports, thus prolonging Japan's economic downturn.<sup>2</sup> Noda's task is daunting as the country's gross government debt approaches 230 per cent of gross domestic product (GDP) in 2013, which is far higher than that of Greece or Italy and which had contributed to the deepening of the Eurozone crisis.

To achieve the objective of restoring economic stability, Japan's political class needs to rise to the challenge. The capability of the Democratic Party of Japan (DPJ) to address this is being questioned by the Japanese people. Noda has the onerous task of setting an agenda that would raise the consumption tax rate, which, in turn, will help address the issue of funding social security programmes. Besides, Noda has to find new means of promoting trade, which is key to economic growth, and establish a realistic energy policy. With a divided Diet, Noda has no option but to build consensus if this strategy has to be taken to its logical end.

Japan is faced with the worst fiscal crisis among the developed countries with nearly ¥900 trillion in combined national and local government debt; this is twice the country's GDP. However, as compared to the European countries which depend heavily on foreign investment, Japanese government bonds are seen as less risky. The personal financial assets of the Japanese people are worth nearly ¥1.5 quadrillion. More than 90 per cent of government bonds are owned by domestic institutional and individual investors. If the government continues to issue bonds and the aging population begins to withdraw long-term savings to live on, the financial assets of the Japanese people will not be able to cover government bonds.<sup>3</sup>

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<sup>2</sup> Shinya Aima, 'Few Growth Options in 2012', *The Japan Times*, December 31, 2011, available at <http://www.japantimes.co.jp/print/nb20111231a2.html> (accessed on January 1, 2012).

<sup>3</sup> 'Japan Faces Many Challenges in 2012', *The Yomiuri Shimbun*, January 1, 2012, available at <http://www.yomiuri.co.jp/dy/editorial/T111231002838.htm> (accessed on January 1, 2012).

As the Japanese currency enjoys strong international confidence, raising the consumption tax from the current 5 per cent to the 15–25 percentile range, similar to rates in many European countries, could be an attractive option to wipe out the national debt. The Noda government is considering this possibility, which will restore Japan's fiscal health. Yet, this will be a challenge. The government needs to compile a 'rough draft' on the consumption tax hike and place it before the opposition parties – the Liberal Democratic Party (LDP) and New Komeito – for discussion.

In the coming months, Noda's political mettle will come under severe test. A slew of problems await him as he tries to carry out a comprehensive reform of the social security and tax systems. Noda needs to demonstrate his real leadership qualities if his objective of achieving the country's fiscal rehabilitation is to be achieved. As it transpires from discussions among the political parties, both ruling and opposition, there seems to be a consensus on raising the consumption tax rate. The differences are about the percentage of the increase. The DPJ wants to adopt a two-step plan: raise the tax from the current five to 8 per cent by April 2014, and then to 10 per cent by October 2015. Noda plans to submit bills for this purpose to the Diet before the close of fiscal year 2011-2012 on 31 March.

The Japanese media endorses Noda's consumption tax hike plan. Recently, *The Yomiuri Shimbun* bemoaned that the DPJ delayed such an increase by six months from the initial plan in deference to tax hike opponents in their own party. The newspaper observed: 'We applaud the DPJ for resisting the temptation to resort to a vague statement. Noda should not compromise on his basic stance to submit necessary bills in March next year to realize the tax hike.'<sup>4</sup> However, the issue could become messy if Noda fails to obtain the understanding of the public. He therefore has to explain to the people that a consumption tax hike is the only way to achieve a sustainable social security system, which includes public pensions as well as medical and nursing care programmes.

A consumption tax hike will hit low-income earners the hardest. As compensation, Noda's reform agenda stipulates the introduction of a refundable tax credit system, under which the amount of tax paid by the low-income category of people will be compensated by income tax cuts. This seems to be another arduous task as it is difficult to draw a cut-off line that demarcates low-income earners from others. However, Noda has little choice. Working on an individual identification number designation system could be a start to this process.

The Noda government can draw some lessons from the consumption tax or similar tax rates maintained by the US and European countries; these taxes are lower for products of

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<sup>4</sup> 'Noda Mustn't Compromise on Consumption Tax Increase', *The Yomiuri Shimbun*, December 30, 2011, available at <http://www.yomiuri.co.jp/dy/editorial/T111230004452.htm> (accessed on December 31, 2011).

daily consumption and necessity than for other products and services. If Japan adopts a similar approach, the rich will bear a bigger tax burden. The DPJ too has a plan to raise the income and inheritance taxes, which will increase the tax burden of the wealthy people. This can be seen as a populist idea aimed at deflecting criticism of the consumption tax hike. The flaw in this proposal is that there will be limited taxpayers in the higher income tax category, and this may not boost revenue in real terms.

A section within the DPJ argues that administrative reforms should come before tax hikes. This long-running argument has resulted in keeping the country's fiscal health in limbo. The DPJ has faulted in keeping its pledge to eliminate wasteful use of taxpayers' money. If Noda is serious in his resolve to slash the number of lawmakers (ministers) and cut the salaries of public servants before raising the consumption tax rate, he needs to put this in practice.<sup>5</sup>

In a recent television programme of TV Tokyo Corp., Noda said that he was ready to risk his political life for comprehensive social security and tax system reforms and would keep the future survival of the country above the DPJ administration. By this announcement, Noda left open the possibility of dissolving the House of Representatives for a snap election in order to push through a consumption tax hike.<sup>6</sup>

## Political Impediments

It must be kept in mind that political compulsions may prevent Noda from executing his proposed plans, howsoever lofty they may be. The younger party members within the DPJ do not approve of Noda's tax hike plans. Nine such members have already quit and are toying with the idea of launching a new party. They criticise Noda on the grounds that the DPJ leadership is reneging on the party's 2009 election pledges. It is a different matter that the pledges were made without proper thought on their long-term feasibility. In particular, no plans were made for how the childcare allowance and education subsidy, among others, were to be met and how they would be funded. Post-election, the Japanese people learnt that these pledges were already broken. It must be noted that most of the legislators who quit the party won their seats in the proportional representation race in the House of Representatives election owing to the surge in the DPJ's popularity in 2009. By quitting, these legislators betrayed their own party, and Noda now needs the support of the opposition to pass bills related to comprehensive reforms.

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<sup>5</sup> Ibid.

<sup>6</sup> 'Noda Signals Possibility of Snap Election for Tax Hike', *Jiji Press*, January 14, 2012, available at <http://jen.jiji.com/jc/eng?g=eco&k=2012011400203> (accessed on January 14, 2011).

## Demographic Challenge

The declining birth rate, which accelerated in 2011, is another concern for the Noda government. The birthrate in Japan in 2011 was the lowest since World War II and the fifth straight annual decline since 2007. The birth of 1.57 million babies in 2011 was a drop of about 14,000 from the previous year. The number of deaths in 2011 was estimated at 1.2 million. Though this was an increase of 64,000 over the previous year, it was attributed to the March disaster which claimed many lives. According to the Ministry of Health and Family Welfare, Japan's population is expected to continue shrinking and the country ought to be prepared for an increasingly graying society.<sup>7</sup> With declining birthrate, the size of the younger generation will shrink.

According to government statistics, the number of people aged 20 years on January 1, 2012 was estimated at 1.2 million. This was less than half its peak of around 2.4 million in 1970. Of the 1.2 million, 620,000 were men and 600,000 women. The new adults<sup>8</sup> accounted for 0.9 per cent of the total population of 127 million.<sup>9</sup> This shows that Noda also has to address to the issue of declining birthrate and increasing rate of elderly population, which calls for greater social security burden on the government.

Thus, the Noda government faces the challenge of integrated reforms of the social security and tax systems, which can be achieved only with the cooperation of the opposition.

## TPP and Reforms in the Farm Sector

Noda has taken the bold decision to enter into negotiations over the Trans-Pacific Partnership (TPP) multinational trade agreement. The initial talks on whether or not to join the TPP were put on hold due to the March 2011 disasters. Noda is now pushing for progress. He made this announcement on November 12, 2011 in Hawaii, at a summit meeting with President Barack Obama during the Asia-Pacific Economic Cooperation leaders' gathering. The TPP framework aims to harness the economic vitality of Asia, and Noda realizes that if Japan enters into the TPP it will contribute to the revival of its growth strategy. If Noda can make this possible, Japan will commit itself to the formulation of new trade rules as a start. His government needs to take a strategic approach so that the new rules strengthen Japan's national interests.

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<sup>7</sup> 'Japan's Population Decreasing at fastest postwar rate', *The Mainichi Daily News*, January 1, 2012, available at <http://mdn.mainichi.jp/mdnnews/national/archive/news/2012/01/01/20120101p2g00m0dm030000c.html> (accessed on January 14, 2012).

<sup>8</sup> Twenty years is the legal age of adulthood in Japan.

<sup>9</sup> 'Number of New Adults Sinks to All-time Low of 1.2 Million', *The Japan Times*, January 1, 2012, available at <http://www.japantimes.co.jp/text/nn20120101a1.html> (accessed on January 1, 2012).

The original TPP was signed in 2005 by Chile, New Zealand, Singapore, and Brunei. Now the US, Australia, Malaysia, Peru, and Vietnam are negotiating for an enlarged TPP. In principle, 'the TPP aims to abolish all tariffs within 10 years. Intellectual property and liberalization of investment and services are among the many areas to be covered by the TPP'<sup>10</sup>

Noda faces strong opposition from farmers and the agriculture industry on Japan's participation in the TPP. Opponents of the TPP argue that since the basic principle of its framework is the abolition of tariffs without exception, Japan's agriculture sector will remain unprotected if Japan joins the economic grouping. But the reality is that Japan's farm industry will suffer in the long run if the government continues to mollycoddle it with subsidies and other protective measures. Japan's participation in the TPP talks would lead, at least, to a discussion of much-needed agricultural reforms. These include farmland integration and government aid to those opting to remain in the industry. Japan can also benefit by way of expanding its rice market as well as expect growth in other high-quality farm products if it joins the TPP, and thereby strengthen international agricultural competitiveness.

The TPP-related arguments in Japan can be classified into three categories.<sup>11</sup> The first category includes anti-American sentiments which are deep-rooted among some Japanese people. Those belonging to this category argue that Japan's agriculture will collapse if Japan participates in the TPP and increase its dependence on the US economy. They also argue that TPP could trigger a massive influx of foreigners thus affecting Japan's traditions, culture, and even language. The second category of TPP-related arguments is cautious and seeks more information related to tariff reductions for specific products in consideration of Japanese national interests before giving a thumbs-up to the TPP framework. The third category endorses Japan's participation in TPP talks in consideration of international trends. This category represents the so-called counter-China strategy and toes the US policy that vacillates between engagement and hedging. As of now, there is no consensus among the political parties in Japan over the TPP issue, and Noda seems to be ploughing a lonely furrow.

Since the TPP is a US-driven initiative, there are strong supporters and opponents in Japan to the idea. Akira Kojima of the Japan Center for Economic Research is of the view that ever since the TPP idea pushed by the US surfaced in November 2009, TPP talks have proceeded at Washington's pace.<sup>12</sup> Takeshi Nakano of Kyoto University argues that Japan's

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<sup>10</sup> 'Informed Decision Needed on TPP', *The Japan Times* editorial, October 21, 2011, available at <http://www.japantimes.co.jp/print/ed20111021a1.html> (accessed on October 21, 2011).

<sup>11</sup> Tadae Takubo, 'TPP's Significance for Counter-China Strategy', *Speaking Out* #115, November 15, 2011.

<sup>12</sup> Quoted in Aurelia George Mulgan, 'Japan's Early Decision on the TPP: Pie in the Sky or Credible Commitment?', *East Asia Forum*, June 2, 2011 available at <http://www.easiaforum.org/2011/06/02/japan-s-early-decision-on-the-tpp-pie-in-the-sk...> (accessed on November 15, 2011).

position is very vulnerable and it finds it difficult to withstand the US pressure; moreover, because of its growing dependence on Washington, negotiating rules beneficial to Japan would be next to impossible. Nakano further says that if Japan joined the TPP, it would be tantamount to signing a free trade agreement with the US. It is believed that the US is proposing to include all items, without exception, on their list of liberalization of trade in goods, and this is not welcome news for Japan's agricultural lobby.<sup>13</sup> As Japanese economic analyst Mitsuhashi Takaaki argues, America's TPP goals amount to 'an extreme Japan-US FTA' and 'extreme structural reform' is the real spectre of the TPP.<sup>14</sup>

Noda's argument in favour of the TPP is based on the premise that as the Asia-Pacific is the region with great potential for economic growth, Japan will benefit if it joins the TPP framework. Opponents of the TPP say that this view is flawed as South Korea, which has a FTA with the US, has refused to join the TPP. Indonesia and Thailand are also not parties to the TPP talks. Both Japan and the US would try their best to keep China out of the framework, and the latter would see the TPP as a Japan-US economic bloc. If the TPP comes into being, the combined GDPs of Japan and the US will account for more than 90 per cent of the TPP members' total GDP, and the world will perceive the TPP as a Japan-US economic partnership.

During his visit to Singapore and meetings with Prime Minister Lee Hsien Loong and his predecessor Goh Chok Tong in September 2011, Japanese trade minister Yukio Edano expressed Japan's desire to decide as early as possible on joining negotiations for the TPP. Noda and Edano argue that unless Japan joins the negotiations at an early stage, it will not be able to take part in making rules for the TPP. Despite numerous discussions on the TPP, Japan has yet to join the talks because of staunch opposition from the agriculture sector.

## Regional Tensions

On the foreign policy front, Noda is going to face difficult challenges in 2012. In the Asia-Pacific region, the seas are getting rougher. China's military build-up and deployment of ballistic missiles that are capable of striking Japan and other countries poses security challenges to Noda administration. More worrying is the fact that China is hurrying to

<sup>13</sup> Quoted in *ibid.*

<sup>14</sup> Mitsuhashi Takaaki, 'Composition vs Manufacturing Industries, Agriculture Outside Man's Effect', March 7, 2011 available at [http://translate.google.co.in/translate?hl=en&sl=ja&u=http://business.nikkeibp.co.jp/article/topics/20110303/218708/&ei=s9kGT\\_zLNHwrQe1q9TbDw&sa=X&oi=translate&ct=result&resnum=1&ved=0CCgQ7gEwAA&prev=search%3Fq%3Dhttp://business.nikkeibp.co.jp/article/topics/20110303/218708/%25F%26hl%3Den%26noj%3D1%26rlz%3D1R2ADFA\\_enIN372%26site%3Dwebhp%26prmd%3Dimvns](http://translate.google.co.in/translate?hl=en&sl=ja&u=http://business.nikkeibp.co.jp/article/topics/20110303/218708/&ei=s9kGT_zLNHwrQe1q9TbDw&sa=X&oi=translate&ct=result&resnum=1&ved=0CCgQ7gEwAA&prev=search%3Fq%3Dhttp://business.nikkeibp.co.jp/article/topics/20110303/218708/%25F%26hl%3Den%26noj%3D1%26rlz%3D1R2ADFA_enIN372%26site%3Dwebhp%26prmd%3Dimvns) (accessed on January 6, 2012).

develop a next-generation fighter jet. In the immediate neighbourhood, North Korea's nuclear programme is also worrisome. Kim Jong-Il's sudden death and the transfer of power to his inexperienced third son, Kim Jong-un, has raised the possibility of political turbulence, although a regime collapse in the near term does not seem to be on the cards.

The Noda government has to deepen Japan's alliance with the US. This comes at a time when the US focus has shifted to Asia with emphasis on improving defence capabilities in the Nansei Islands, which includes the Okinawa Islands. This puts additional pressure on the Noda government to resolve the relocation of the Marine Corps' Futenma Air Station to the Henoko district of Nago in the Okinawa prefecture. To realise this, the Noda government must regain the trust of the Okinawa prefecture by lessening its burden in hosting US military bases through noise reduction and other measures, including adopting regional development programmes.

### **Ensuring Energy Security and Nuclear Safety**

The Noda government faces daunting challenges in addressing the country's energy needs. After the accident at Fukushima in March 2011, there has been considerable debate in Japan and elsewhere on the future of nuclear energy. Japan's energy policy, including power generation, will play a central role in Japan's reconstruction and economic growth.

After the Fukushima crisis, other nuclear reactors around the country were unable to restart despite finishing regularly scheduled inspections, thus causing serious power shortages. If all of Japan's 54 nuclear reactors are kept idle it will have to look for alternatives for, the 30 per cent of the nation's electricity generation capacity currently met by nuclear plants. Even if power companies expand thermal power generation, rising prices of fuel such as natural gas will lead to increase in power generation costs. The generation of electricity through renewable energy sources such as solar and wind account for only one per cent of the total supply. These industries will take years to mature enough to replace nuclear power. If the power situation is not addressed properly by sound policy measures, businesses will be forced to move production bases overseas to avoid risks such as blackouts and power shortages. The relentless surge in the Yen has already triggered such thinking in businesses.

In contrast to his predecessor Kan Naoto's attempt to break with nuclear power, Noda's energy policy is more practical. In particular, his decision to promote exports of nuclear power plants and technology packaged with expertise in the form of specialized training programmes is laudable as this will help in regaining some of the confidence Japan lost in the aftermath of the nuclear crisis. If Japan pursues the policy to eliminate its domestic nuclear plants, its ability to export nuclear technology will be harmed. Noda has to define his policy clearly so that it helps Japan and aids the world's understanding of the policy at the same time.

## Future Prospects

To sum up, the challenges before Japan in 2012 are daunting for whichever party is in power. The issues of consumption tax hike, relocation of the military base issue in Okinawa, demographic change, energy policy, stance on the TPP, social security, and the security challenges posed by China's aggressive foreign policy posture as well as unpredictability in Pyongyang's nuclear programme – all need to be addressed with deftness and maturity. Japan and its people have proved their resilience in the past and emerged stronger from each tragedy. The world will be watching keenly how Japan rebuilds itself from the recent devastation and comes out from its prolonged economic slump. In the year 2012, Noda's leadership will truly be tested.