

It's too early to count out Japan. Even after disasters, its people have always joined forces to rebuild

No sunset in Japan

ERIC LASCELLES

JAPAN'S ILLS OVERSTATED

The conventional wisdom goes that Japan, the once-mighty Land of the Rising Sun, now gazes helplessly into its own sunset. A two-decade malaise renders absurd the notion that Japan might rise again to great heights and threaten U.S. economic hegemony. Japan's demographics are unhelpful and its fiscal position is nightmarish. The strength of the yen is inopportune. And the latest earthquake-tsunami-nuclear trio adds to a long and tragic history. Given Japan's tiny land mass and few natural resources, perhaps the wonder is that it ever became a global power to begin with.

However, most of these ills are overstated.

To be sure, Japan has borne more than its share of challenges in the modern era. Some of these were self-induced — such as ill-advised imperialist excursions into foreign lands. Others were natural disaster-induced, most prominently earthquakes. Yet when confronted with calamity, the Japanese are unparalleled at uniting as a people and rebuilding. What makes Japan so good at this? Long experience and a collectivist culture suited to massive undertakings.

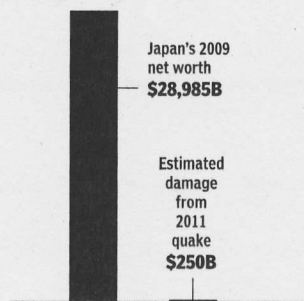
Japan is reeling from the earthquake in March, which provoked a giant tsunami and triggered radiation leaks. First and foremost, this constitutes an epic human tragedy. Second are the economic effects. The combination of displaced people, damaged ports, broken supply chains, patchy electricity and unsafe food and water suggests that near-term GDP growth should suffer a palpable hit. But there is still reason to believe reconstruction efforts and the scramble to make up for lost production will yield a roughly proportionate upswing in GDP growth later.

Clearly, then, GDP is not the right metric by which to measure the cost of the disaster. It is the nation's balance sheet that absorbs the main blow. Roughly \$250-billion in capital has likely been wiped clean from the slates of businesses, insurers, banks, households and governments. Tragic and massive though this is, it represents just 0.8% of Japan's net worth — a drop in the bucket. Natural disasters are awful, but do not substantially compromise Japan's long-term prospects.

It is harder to make light of Japan's demographic challenges. They do indeed weigh on economic growth and fiscal health. Since 1970, the rate of Japanese population growth has steadily slowed, tilting to outright decline in 2006. Some hope exists for rising fertility rates and via tweaks to the retirement age and the female employment

JAPANESE NET WORTH & EARTHQUAKE TOLL

BILLIONS OF U.S. DOLLARS



SOURCE: OECD, RBC GLOBAL ASSET MANAGEMENT

rate. And yet abstracting from the economic consequences, a smaller population has its charm for a country as overcrowded as Japan.

According to the usual narrative, Japan has spent two decades lost in the wilderness, unable to get its economic bearings. After real economic growth that averaged an amazing 10% per year through the 1960s and an impressive 5% through the 1970s and 1980s, Japanese real GDP growth plummeted to just 1% per year through the 1990s and

Even at \$250-billion, the capital loss is just 0.8% of Japan's net worth

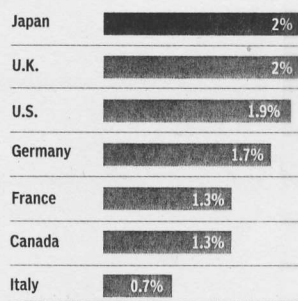
2000s. Japan's asset bubble of the early 1990s usually shoulders the blame for this subpar performance. Without question, it was a key catalyst.

But two things were actually happening at once. The second driver was a declining economic speed limit. The country's rising standard of living finally caught up to the G7 average in the early 1990s. Once at the cutting edge of global efficiency, nations are usually only able to advance their productivity at about 1% to 2% per year. This fate befell Japan as it bumped up against this new constraint. In fact, Japan's economy has performed passably over the past two decades, with the fastest labour productivity growth in the G7. Overall GDP growth has looked slow only due to its stagnant population.

Japan's fiscal position is another

JAPAN'S PRODUCTIVITY COMPARED TO G7 (1990-2009 avg.)

PERCENTAGE



RICHARD JOHNSON / NATIONAL POST

source of hand-wringing. The gross debt-to-GDP ratio is at an unprecedented 226%, more than double any other G7 nation, and rising. But this bad news is mostly skin deep. First, the Japanese government has a huge store of financial assets that offsets almost half of this debt. Second, while the Japanese government is heavily indebted, the country as a whole is not. Japan's external gross debt — how much the government, businesses and households collectively owe the rest of the world — is the lowest among major developed nations. And on a net basis, it owes nothing at all — the best fiscal position in the world.

The real imbalance, then, is entirely contained within Japan. Simply put, the Japanese government has chronically undertaxed its citizens, bestowing upon them an (ultimately illusory) high personal savings rate, and emptying its own fiscal coffers. This can be fixed either by raising taxes or by ratcheting up the too-low inflation rate.

The Japanese yen hit its strongest level ever versus the U.S. dollar right after the March earthquake, prompting co-ordinated intervention. However, when the yen is adjusted for inflation, trade flows, and the cost of labour, it is smack-dab in the middle of its historical range. In other words, Japan is still competitive with its peers.

None of this means that Japan will be the next investment hotspot. The country's long-term investment rates of return will be constrained by structurally slow economic growth. But some of Japan's woes are overstated and it deserves a place in a well diversified portfolio. For Japan, the sun also rises.

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