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Japan – Emerging emerging-market ties

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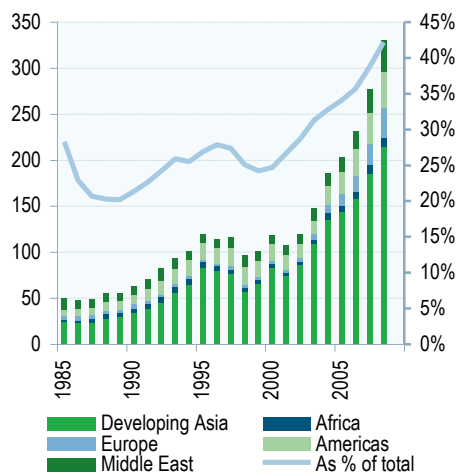
- Emerging markets offer opportunities in difficult times
- Ties are strengthening in many areas, from trade to corporate activity
- This could bring structural change to the Japanese domestic economy

A flourishing relationship in troubled times

With the most acute stage of the crisis likely behind us but a full global recovery still far off, Asia’s economies will face the question of where they can find the next growth engine in coming years. While many, like China, have resorted to stimulating domestic demand to substitute for exports, Japan’s already-mature domestic economy and fast-ageing society mean this option is limited unless there is far-reaching social reform. We believe pursuing external growth will remain a core element of Japan’s economic strategy going forward. But with its peers among industrialised economies expected to remain in consolidation mode in the coming years, the focus will likely shift to Japan’s economic ties with emerging markets.

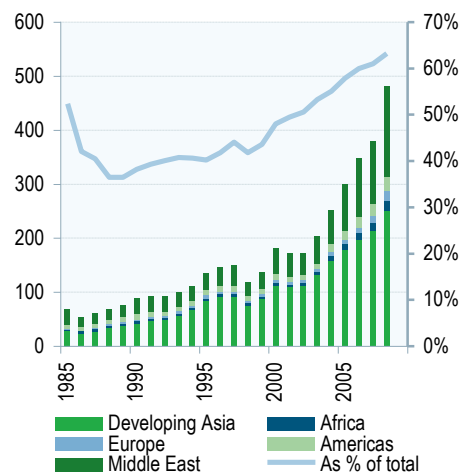
Indeed, increased trade with emerging markets was a distinguishing feature of Japan’s latest growth cycle, starting in 2003; the trend continued until the final months of 2008 (see Charts 1 and 2). Emerging markets are now the buyers of 40% of Japan’s exports and the source of 60% of its imports. This relationship has strengthened continuously over the past two decades, except during a brief period at the apex of the Asian crisis.

Chart 1: Japan’s exports to emerging markets



Source: CEIC

Chart 2: Japan’s imports from emerging markets



Source: CEIC

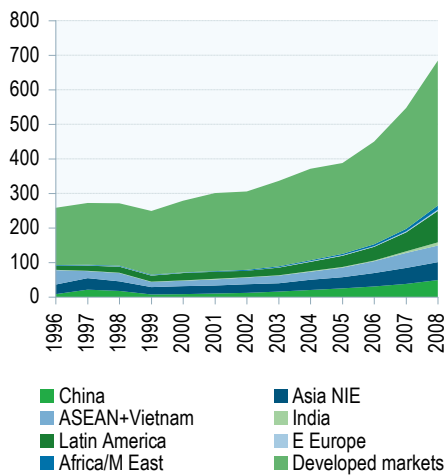
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Japan Inc. finds a safe haven in emerging markets

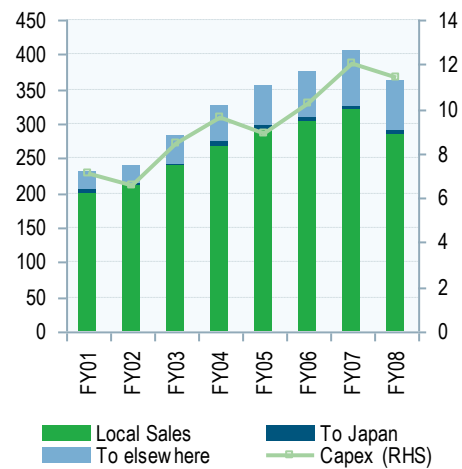
Yet Japan's current foray into emerging markets goes far beyond the trade in goods. Foreign direct investment (FDI) data suggests that Japan Inc. has rapidly built up its capacity in these regions in recent years (see Chart 3). From 2003-08, its stock of FDI in industrial economies gained 70%. This compared with 150% in Asia (led by India at 526% and China at 220%), 313% in Latin America, 230% in Eastern Europe, and 289% in Africa and the Middle East. As a result, emerging markets accounted for 38.7% of Japan's total FDI stock in 2008, up from 25% at the start of the decade.

Chart 3: Japan's outbound FDI stock, USD bn



Source: JETRO

Chart 4: Sales of Japanese companies' subsidiaries (N. America + Europe), USD bn



Source: METI

Statistics on Japanese companies' overseas subsidiaries offer another glimpse of Japan's spreading economic network in emerging markets (see Charts 4 and 5). Their total global sales peaked at USD 777bn in FY07 (ended on 31 March 2008), close to 18% of Japan's GDP, before retreating to USD 753bn in FY08. A breakdown by geographic area reveals that the decline was concentrated in the developed regions of North America and Europe, and that sales excluding these two regions – mainly in Asia but also in other emerging-market regions – continued to increase in FY08, driven by growth in local demand. Equally revealing is the amount of capital investments these subsidiaries made overseas, which declined in North America and Europe but surged elsewhere in FY08.

This last point is also echoed by separate data covering mergers and acquisitions (see Chart 6). 2008 was a year of robust outbound M&A activity for Japan, with total deals rising to JPY 6trn from JPY 2.6trn in 2007. In monetary terms, 34% of this activity between Q1-2008 and Q1-2009 targeted emerging markets, the highest proportion in recent years. This percentage rises even higher to 48% in volume terms, as deal sizes are smaller on average in emerging economies. In line with the FDI trends mentioned above, Asia has been the top destination of these M&A flows, with Latin America also a favourite.

Trend could re-accelerate after a short pause

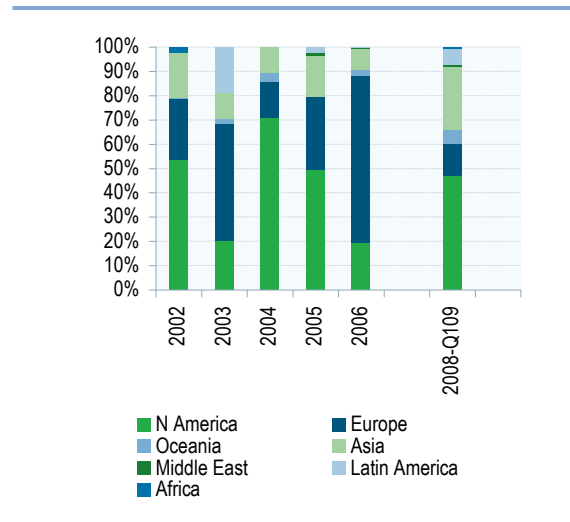
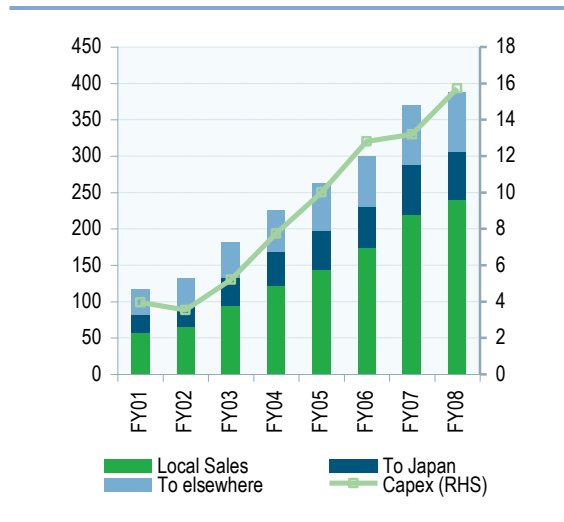
All of this suggests that the centre of gravity of Japan Inc.'s overseas activity was already shifting away from industrial regions towards emerging markets before the onset of the current crisis, and that the collapse in demand in the developed world last year quickened this development. This contrasts with the retrenchment in Japan's emerging-market investments in the aftermath of the Asian crisis (1998-2002), and testifies to our



long-held view that the current crisis is accelerating the shift of economic power to the East. As shown in Chart 4 above, most of Japanese companies' external operations in the West are set up with the purpose of selling in the host economies. Yet with most of the Western world now expected to suffer sub-par growth in the coming years, the *raison d'être* of these ventures could be questioned.

Chart 5: Sales of Japanese companies' subsidiaries outside of N. America and Europe, USD bn

Chart 6: Geographic split of outbound M&A from Japan by value



Source: METI

Sources: ESRI, Mergermarket

In contrast, Japan's investments into emerging markets play a more multi-faceted role. Aside from selling to their host economies, Japanese companies' overseas subsidiaries also engage more prominently in 're-imports' back to Japan – a phenomenon that reflects cheaper production costs abroad. This redeployment of overseas capacity allows Japan Inc. not only to benefit from the more resilient growth outlook among emerging markets, but also to enhance its cost competitiveness back home.

Extreme market volatility at the turn of this year reportedly caused Japanese companies to take a more cautious stance toward outbound investments. Yet we expect that, when the dust settles, the outlook remains favourable for the expansion of Japan Inc.'s emerging-markets presence. On top of the economic factors mentioned above, our current forecast of a broad weakening in the US dollar, if it materialises, could further increase the incentives for Japanese corporations to look outwards. Another impetus could come from the recent implementation of new tax laws that exempt 95% of dividends paid by foreign subsidiaries.

Ignore at your own risk

Finally, the above analysis suggests that Japan Inc.'s growing emerging-markets sector has reached a scale that could have a structural impact on the domestic economy. First, it will mean a continued strengthening of the corporate sector's re-import capacity, which is likely to be disinflationary and reduce the risk of sharp policy tightening in the long run. Second, the impact of the exchange rate on corporate earnings will continue to decline, which points to higher tolerance for JPY appreciation. Third, the benefit to the domestic economy will appear not in gross domestic product (GDP) but in gross national income (GNI), which takes extra account of net income from the rest of the world. In 2007 and 2008, this gap amounted to 3.3% of GDP, compared to 1.7% when the decade started. This testifies to a significant income injection from this sector.



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