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# RISKS TO WATCH

# JAPAN

Japanese Prime Minister Naoto Kan, his popularity sinking, is struggling with huge public debt and a divided parliament where the opposition can block bills as Japan's recovery grinds to a standstill. Besides domestic headaches, Kan must deal with threats from North Korea after it attacked a South Korean island, try to repair ties with China and Russia strained by territorial feuds, and patch up relations with key security ally the United States.

## FISCAL DILEMMA

At twice the size of the \$5 trillion economy, Japan's huge public debt is a pressing policy problem. In an effort to curb its debt, the government has imposed a cap on fresh bond issuance for 2011/12 at the current fiscal year's level of about 44 trillion yen (\$527 billion) and general spending excluding debt-servicing costs at the current amount worth 71 trillion yen. Economists say raising the 5 percent sales tax is crucial. Kan has championed a sales tax hike, but he is vulnerable after the ruling Democratic Party of Japan (DPJ) lost in a July poll.

The [finance ministry usually compiles a draft state budget in December](#). Once approved by the cabinet, the government will submit budget bills to parliament in January to have them enacted by April 1.

### What to watch:

- Whether the draft budget's spending is within the government's pledged spending cap of 71 trillion yen. Spending requests from ministries reached 72.6 trillion yen.
- Signs that Kan will concede to the combative opposition and weaken his austerity stance.
- Signs that the budget process might be delayed. A delay could unnerve some investors and push up bond yields.
- Signs the economy is deteriorating faster than the government expects. Many economists expect the economy to slow, or even contract, in the fourth quarter as a temporary boost from stimulus-driven consumption tapers off.

## POLITICAL INSTABILITY

The DPJ could push budget bills through parliament given its majority in the powerful lower house, but opposition parties that control the upper chamber can block enabling laws, including those needed to implement the budget. Kan's support ratings are nearing 20 percent after taking a further hit in November when [a cabinet minister resigned over a gaffe](#). Though embarrassing, his resignation [cleared the way for parliament to enact a 4.4 trillion yen extra budget for the current fiscal year](#), after the opposition had refused to vote until he quit.

Emboldened by Kan's unpopularity, the opposition-controlled upper house has censured Chief Cabinet Secretary Yoshito Sengoku, urging his resignation. Kan is unlikely to fire the cabinet's No.2, and some in the opposition have threatened to boycott debate in parliament if Sengoku is not replaced. The opposition parties are also calling on DPJ powerbroker Ichiro Ozawa, who faces indictment over a funding scandal, to give sworn testimony in parliament.

Kan, Japan's fifth leader in three years, could seek deals with opposition parties including the LDP and the Buddhist-backed New Komeito for help in enacting bills. If he can't win support, he may face a March crisis and call a snap election, though no poll is mandated until 2013.



### What to watch:

- Whether opposition parties will refuse or delay policy debate in parliament, and whether the DPJ can manage to forge deals with the opposition to enact bills smoothly.
- Whether Ozawa agrees to appear in parliament to talk about his funding scandal. He has so far rejected calls to do so.

## DIPLOMATIC HEADACHES

Japan's ties with China and Russia remain fragile after a flare-up in longstanding territorial feuds. Kan faced domestic criticism for [appearing to have caved in to demands by Beijing](#) to release a Chinese boat captain whose trawler collided with Japanese patrol boats near disputed isles in September. The tensions [raised concerns about fallout for business with China](#) as it surpasses Japan to become the world's second biggest economy. Tokyo had worried that [China is holding back on exports of vital rare earth minerals](#), but shipments were recently confirmed, signalling an end to a de facto suspension.

North Korea's recent shelling of a South Korean island adds to the government's list of headaches. If Kan fails to convince the public that he can handle the North Korean issue properly, his support ratings could sag further.

Ties with the United States have been frayed by a dispute over a U.S. airbase on Okinawa. Kan has agreed to implement a 2006 deal to move the base to a new site on Okinawa, but local residents want the base off the island entirely. However, worries about North Korea and China may push the allies closer together.

### What to watch:

- Signs of new diplomatic friction between China and Russia.
- Public perception of Kan's handling of the North Korea.

Japan's Prime Minister Naoto Kan attends a news conference at the Democratic Party of Japan election headquarters in Tokyo July 12.  
REUTERS/Toru Hanai

## RISK DATA

Sovereign foreign currency:	
S&P	AA (negative)
Moody's	Aa2 (stable)
Fitch	AA (stable)
World Governance Indicators:	
Voice & Accountability	81.0
Political Stability	83.5
Govt Effectiveness	86.7
Regulatory Quality	81.0
Rule of Law	88.2
Control of Corruption	87.1
IHS Global Insight	
Country risk	1.76
Sovereign	AAA (stable)
Economist Intelligence Unit	
Sovereign risk	BBB
Political risk	AA
Country risk	A

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**STRONG YEN, MONETARY POLICY**

Japan intervened in the foreign exchange market for the first time in more than six years in September. The yen has retreated from the 15-year highs against the U.S. dollar scaled in early November, but it is still more than 10 percent higher than it was at end-December in 2009, threatening to further dent the export-oriented economy.

The Bank of Japan (BOJ) unveiled in October a new 5 trillion yen asset buying scheme to inject funds into the economy to lower longer-term rates and help Japan overcome deflation. Governor Masaaki Shirakawa has said topping up the plan was a clear option if the looming economic slowdown proved worse than expected.

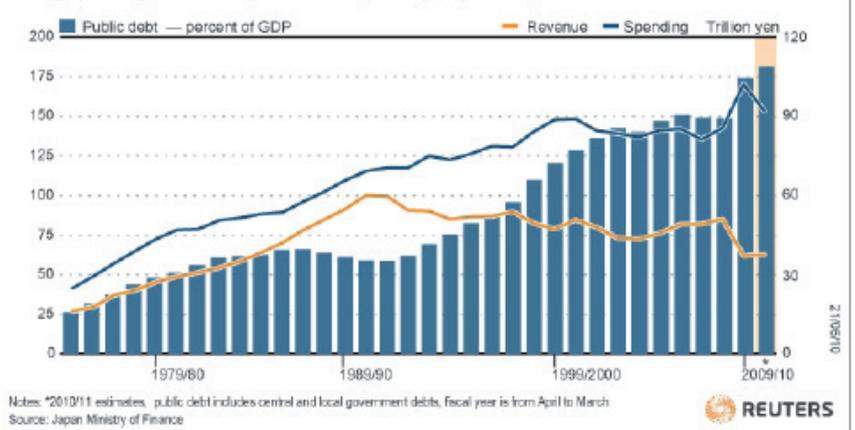
Japan is expected to unveil in late December its bond sales plan for the fiscal year from next April. While an increase in debt sales is expected to be modest, and unlikely to cause a major shock in the market, the plan could attract investors' attention as Japan has much bigger debt than euro zone countries that are smarting from debt crisis..

**What to watch:**

- Signs that the BOJ will boost its asset-buying scheme or if it will buy more government bonds.
- Whether Japan's bond plan in late December shows a jump in debt sales.

**Japan fiscal pain**

Rising spending and faltering tax revenue push up Japanese public debt

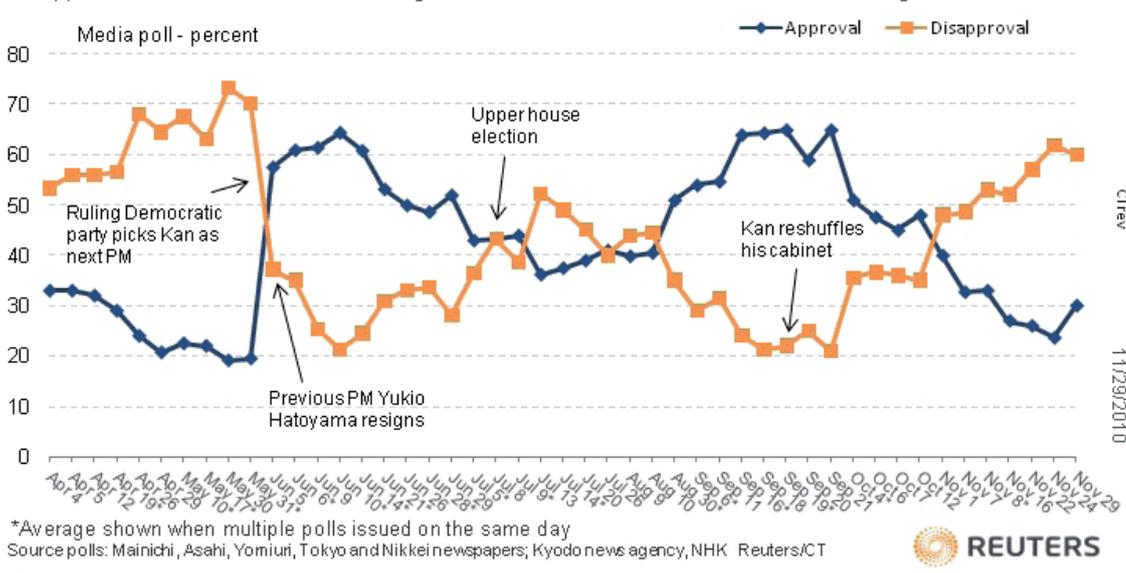


**KEY DATES**

- **December 6, 2010**  
Reuters tankan for December issued
- **December 21, 2010**  
Bank of Japan monetary policy meeting
- **Late December, 2010**  
Draft budget for next fiscal year completed.
- **Before April 1, 2011**  
Government must get budget bills passed, or will face a political crisis

**Support for Japan's government**

Support for Prime Minister Naoto Kan's government falls on China, Russia ties, minister's gaffe



**RISK DATA**

<b>JLT Group</b>	
Strikes, riots & civil unrest	3
Terrorism	1
War & civil war	2
Economic risk	4
Currency risk	1
Sovereign risk	2
Expropriation	1
Contract repudiation risk	2
Legal & regulatory risk	2
<b>Coface</b>	
Country rating	A1
Business climate	A1
<b>Transparency International</b>	
Corruption Perceptions Index Score	7.7
Rank (of 180)	17
<b>World Bank Doing Business</b>	
Rank (of 183)	15
<b>WEF Global Competitiveness</b>	
Score	5.37
Rank (of 133)	6
<b>Reporters Sans Frontières</b>	
World Press Freedom Index Score	2.50
Rank (of 175)	11

