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Financial Crisis Report

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Advancing in a Time of Crisis

Inside this issue:

Except for the Great Depression, economically we are experiencing the most unstable period in the history of the modern world. This period will be marked with extreme fluctuations in the stock, commodity and currency markets accompanied by severe and sometimes violent social disruptions. As is typical of such times, many fortunes will be made and lost during this period. After talking with many business owners, executives, professionals and government officials from around the world, the writer believes that for the financially astute investor, this is a time of unprecedented opportunity given the global trade unbalances and distortions in the commodity and currency markets. The *Financial Crisis Report* is a free compilation of the opinions of David Miyoshi as well as of those advisors he himself subscribes to (with appropriate credits given) on how to benefit during this time of crisis. The writer receives no compensation of any kind from any advisors whose articles or ideas may appear in this report. The reader is welcomed to check on all sources of information mentioned herein. Because the opinions and observations of this writer and other advisors are provided herein without charge, the reader is asked to make his/her own judgment on the contents.

JAPAN'S FUTURE

Japanese Prime Minister Yoshihiko Noda has had his hands full since taking the reins of government. In addition to dealing with the aftermath of the Great East Japan Earthquake he now is under increasing U.S. pressure to join a Pacific Rim wide free trade agreement known as the Trans-Pacific Partnership (TPP). This group consists of the United States, Australia, Brunei, Chile, Malaysia, New Zealand, Peru, Singapore and Vietnam. It is clear that the U.S. wants Japan to join to act as a counter balance to China's growing economic dominance in the region. The question is will Japan join?

Initially, Noda seemed receptive to the idea, stating in September that he would join TPP negotiations and proceed aggressively with other free trade discussions. However, Noda is facing stiff opposition to the initiative, both from domestic lobbies that do not want to see increased foreign competition and a trend in the Japanese population toward insularity. According to the latest account, Noda has indicated he will participate in the TPP negotiations.

Japanese prime ministers have been unsuccessfully attempting to reform the domestic economy for more than a decade. Noda has pledged to implement fiscally conservative measures, to liberalize Japanese trade and to restructure the bureaucracy to rejuvenate the economy. However, his efforts have been hindered by a lack of political authority — he is the sixth Japanese prime minister in five years — and his administration is already burdened with dealing with the aftermath of the Great Earthquake and ensuing disaster at the Fukushima nuclear power plant.

Arguably, the TPP would benefit Japan's economy. The Pacific Rim has some of the world's most dynamic economies, all of which are trending toward trade liberalization, and Japan stands to lose its economic leadership to other developing economies, including its historical rivals South Korea and China. Korea's industries are gobbling up Japanese manufacturers' market share abroad, and last year China overtook Japan as the second largest economy in the world. However, an agricultural lobby resistant to opening agriculture to foreign competition has divided Japanese opinion on the TPP issue and forced Noda to take a highly restrained position.

The debate over the TPP reflects a classical Japanese divide between those proponents who favor opening Japan to the world and those who support closing off foreign influence. Those who favor opening Japan tend to be younger voters and allies of the competitive manufacturing industry with those against being older voters and allies of the agricultural lobby. Although Japanese views on this debate are complex, several factors are now contributing to a perceptible shift toward introversion and insularity.

First, Japan's population is rapidly aging, with the population of those over 60 nearly doubling between 1970 and 1990. This was a crucial element to the economic crash of the 1990's, as more retirees began to put greater burdens on the economy. With the Japanese people vanishing and growing gray, Japan faces the evisceration of its economic, political and military capabilities. The economy will continue to decline as the workforce and consumer base shrink. Government finances will worsen beyond their already dismal states, as the fall in corporate profits and private incomes translates to smaller tax revenues and as social spending balloons to care for the aging population's pensions and health care. While these changes cause social and economic dislocation, Japan's national defense capabilities will also weaken as the military budget shrinks and as recruitment becomes more and more of a challenge.

Second, Japan's prolonged economic stagnation has made international study expensive and burdensome. In the mid 70's when the writer lived in Japan the term "international" was the social and commercial catch phrase of the day. Now, the term is noticeably considered passé. As gaining international experience becomes more disadvantageous for Japanese seeking to enhance their career opportunities, they increasingly turn their attention away from the international sphere. This poses significant problems for the Japanese business community because this will result in a dearth of human resources capable of dealing with and understanding the needs of international consumers.

JAPAN'S FUTURE (continued)

Fortunately, Japan's economy is driven by a robust, albeit sluggish domestic market, so it will not go bust in the near term from a decline in international trade. However, this trend does pose a long-term threat to the country's international competitiveness and its ultimate survival.

The main push for the TPP is coming from the United States, where the administration of U.S. President Barack Obama has recently undertaken a policy of re-engagement in East Asia as a means of confronting growing Chinese economic and political clout. To this end, the Obama administration has increased contacts with countries near China and initiated a deeper dialogue with the Association of Southeast Asian Nations, the East Asia Summit and the Asia-Pacific Economic Cooperation Forum.

The inclusion of Japan in the TPP would represent a huge economic enlargement of the agreement; the Japanese and American economies combined would make up 90.4 percent of the TPP's total gross domestic product. This economic might would both bolster the effectiveness of the treaty as a counterbalance against China and provide a platform for U.S. influence in the region due to Japan's strategic position off the east coast of Asia, its longstanding alliance with the United States and its rich market economy. Thus, the Japanese trend toward introversion, and specifically its aversion to the TPP, has implications for the U.S. strategy in the region.

Japan is not necessarily retreating from the world, as recent overtures to countries in the region and its increasing involvement in the South China Sea show, and Japan's geographic position means the United States always will have interests there. However, this reluctance to engage internationally means Japan likely will become less of a factor in U.S. strategic planning for the region.

Thus, Japan has reached another historical crossroads. On the present path, the country will slowly diminish in population and economic power over the coming decades and the result will simply be a much smaller, older and more isolated social-welfare state, with little ability to preserve its minimal strategic imperatives. This path essentially leads to another of Japan's historic periods of introversion and insularity.

An alternate path would require Japan to return to the extreme extroversion that is has demonstrated before in the 1930's. With a failing economy and a shortage of labor, Japan could eventually unleash its formidable military power and once again seize the labor and resources it needs to rejuvenate itself. To do so would almost inevitably mean going out in a blaze of glory, but historically Japan has not shrunk from daring all or nothing moves. A budding indication of this path is Japan's recent decision to deploy its Self Defense Forces (JSDF) into South Sudan to deal with Chinese influence in the tumultuous Sudanese-South Sudanese oil industry framework. The move into South Sudan appears to signal a renewed effort to gradually reintroduce JSDF operations into strategic foreign policy initiatives, in this case, energy security. With a normalized military force, Japan will increasingly use the JSDF to reinforce its positions overseas. This is particularly important for Japan's business interests in South Sudan, which will become a crucial part of Japan's energy plans both because of its increased reliance on imported energy after the Fukushima disaster and its need to diversify its sources of energy (82 percent of Japan's imported oil currently comes from the Middle East).

There also remains a third possibility: that Japan could pioneer a technologically advanced society for the post-consumer age in which it manages both a sustained increase in production despite decreasing consumption and sets an example for many other countries facing similar demographic declines.

Ultimately, Japan is in a period of transition with its current strategies falling short of meeting its core imperatives. Shifts in domestic politics are only a surface reflection of this underlying fact. And much of Japan's future will depend on the evolving global environment. Nevertheless, throughout history Japan has shown an ability to change tack quickly and rejuvenate its national energies. If history is any indicator, the next change will come with the suddenness and force of a Japanese earthquake.

PER CAPITA INCOME US$

Qatar	88,222
Luxembourg	81,466
Singapore	56,694
Norway	51,959
Brunei	48,333
U.A.E.	47,439
U.S.A.	46,860
Hong Kong	45,944
Switzerland	41,950
Netherlands	40,973
Australia	39,764
Austria	39,761
Ireland	39,492
Canada	39,171
Kuwait	38,775
Sweden	38,204
Iceland	36,730
Denmark	36,443
Belgium	36,274
Germany	36,081
Taiwan	35,604

PER CAPITA INCOME US$ (cont.)

U.K.	35,059
Finland	34,918
France	33,910
Japan	33,885
Euro Union	30,455
Bahamas	30,049
Korea S.	29,997
Spain	29,830
Israel	29,480
Italy	29,480
Cyprus	28,960
Greece	28,496
Slovenia	28,073
New Zealand	27,130
Bahrain	26,932
Oman	25,492
Czech Repub	24,950
Malta	24,833
Seychelles	23,308
Portugal	23,262
Saudi Arabia	22,607

WHAT WILL HAPPEN TO THE YEN?

Currently, the big question on the minds of Japanese businessmen, economists, bureaucrats, politicians and investors is will the strong yen weaken against the other currencies, especially the U.S. dollar?

This answer to this has huge implications for Japan and its economy. This writer believes that only in the long term (defined as years) will the yen (the third most traded currency behind the American dollar and the Euro) weaken against the other currencies.

<u>In The Short Term</u>

We all know the health of Japan's economy is based heavily on exports. A stronger yen can wipe billions of dollars off corporate balance sheets. For example, Toyota loses 30 billion yen, roughly $380 million, for each uptick of one yen against the dollar.

So why is the Yen so strong now? As it is with all commodities, the value of the Japanese Yen is driven by demand and supply of the currency. Historically, the Bank of Japan (BOJ), the country's central bank, has kept interest rates low in order to spur economic growth. Low interest rates since the mid 1990's combined with a ready liquidity for the Yen prompted investors to borrow money in Japan and invest it in other countries (a practice known as the Yen carry trade). That had helped to keep the value of the Yen low compared to other currencies. The Bank of Japan maintains a policy of keeping the Yen weak against other currencies and is generally expected to intervene should it rise above ¥90 per dollar. During the period though 2007, an extremely low inflation rate and weaker Yen helped the Japanese export sector flourish. In 2007, Japan had a current account surplus of approximately ¥25 trillion ($227 billion) of which ¥12.5 trillion ($113 billion) came from its trade surplus against other countries. The export sector had helped the value of the Yen to rise by maintaining a high demand for it. So it is that the natural strength of the Yen lies in Japan's trade surplus. Cars, electronic goods and other Japanese products sold abroad brings a healthy stream of Yen back home. Add to that the influx of cash investors who were brought back to Japan as the global economy crashed, and the yen continued to strengthen.

Another factor that added to the strength of the Yen was that countries and investors who wanted to diversify away from the dollar in the wake of the crisis thought the Yen to be a good choice. Most notably, China has been buying up a record number of Japanese government bonds instead of U.S. treasuries. This explains why recently the Yen has become so strong verses the other currencies, despite the dark economic news, difficult political situation and crushing natural disaster costs the country now faces. As a matter of fact, in the wake of this disaster, it appears that Japanese insurance companies are bringing their foreign investments home because they face insurance claims running into the tens of billions. They're selling their investments in the U.S. and in Europe and bringing the cash home. Converting that money into Yen is what's pushing up the Japanese currency. A strong Yen adds to the difficulties for Japan's recovery because it reduces the profits of its products abroad resulting in less money to pay its debts.

In an effort to reduce the value of the Yen, in August 2011 the Japanese government announced a $100 billion loan fund to spur Japanese spending on corporate acquisitions and resources overseas. "Taking into account that there is a lopsided rise in the Yen, I felt that swift measures were needed", Yoshihiko Noda, the then finance minister and now Prime Minister told reporters. Under this loan program, the government will send foreign currency reserves to the Japan Bank for International Cooperation, which will then make loans to commercial banks so they can help companies with overseas investments. By spending Yen for Dollars and other currencies, the ministry hopes that the Yen will weaken (somewhat). However, a company will only borrow the funds if they can locate viable investments overseas. Under the murky economic situation in the world now days, this is not a big certainty.

But this writer doubts that such government intervention will have any real short-term effect in weakening the Yen. We must note that Japan's trading partners in Europe and North American, on balance, would prefer a stronger yen. Thus, any governmental intervention on the part of Japan is likely to be unilateral in direction. It is doubtful that Japan's trading partners (i.e. the U.S. and Europe) will want to cooperate in such an intervention.

WHAT WILL HAPPEN TO THE YEN? (continued)

Advancing in a Time of Crisis

With the interest rate differential between the Japanese bonds and U.S. bonds becoming smaller, the Yen carry trade will diminish in its impact thus negating a major factor in keeping the Yen weak. Further, with the current economic crisis in Europe and the severe downturn in the U.S., international investors and countries will continue to look to the Japanese Yen as the preferable economic hedge in these uncertain times. Therefore, in the short term, the prospects are "long" that the Yen will continue its strength vis a vis the other major currencies.

In The Long Term

However, as is true of most phenomena, in the long-term everything changes…..including the strength of the Yen. Earlier this year, Nouriel Roubini, Chairman & Co-Founder Roubini Global Economics reported to CNBC that "the Yen should be much weaker against the U.S. dollar in the long run based on fundamentals".

Roubini went on to state "Japan is going to need significant depreciation of the Yen (currently at 77.22 Yen to the Dollar) to increase its net exports because domestic demand is going to be anemic for a while. Therefore, on a fundamental basis, the Yen is going to be much weaker rather than stronger because you need improvement of external balance given the shock to the domestic economy". Another factor that would pressure the Yen, according to Roubini, would be Japan's need to undertake a massive reconstruction effort. That in turn would further increase the country's fiscal deficit. Roubini said, The Bank of Japan will have to decide whether they want to monetize this additional fiscal deficit…I think if there's going to be a much larger fiscal deficit, the Bank of Japan might be induced to potentially buy more long term bonds" Japan's budget deficit currently stands at around 10 percent of GDP and its debt burden is around 200 percent, the highest in the industrialized world.

Roubini said authorities in Japan needed to be fully transparent in order to stem uncertainty and panic. And while there was still a lot of uncertainty, this crisis could present Japan with the opportunity to undergo a radical shake-up.

"Sometimes in a moment of crisis….the economic and political system reacts to the shock by actually having a radical change in its own economic policies, that might be the time for that to happen", Roubini concluded.

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