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JAPAN'S NEW DYNAMIC

Capitalising on Change

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Reform and the new Abe Cabinet


Shinzo Abe unveiled his new Cabinet on September 3

As Japan's new Cabinet sets to work ahead of the new Diet session, *Philip Howard* and *Natsumi Ishino* profile the critical changes ahead

> "ABENOMICS IS NOW ENTERING A FAR MORE DIFFICULT PHASE. WITH THE FIRST AND SECOND ARROWS ALREADY FIRED, CRITICS INCREASINGLY QUESTION THE PACE OF THE THIRD – STRUCTURAL REFORM"

In 2013, PublicAffairsAsia named Prime Minister Shinzo Abe its Communicator of the Year, noting how he had "transformed the public mood in Japan from an entrenched sense of decline to one of optimism and vitality". Abe's economic program, first released while he was still leader of the opposition, struck a chord both at home and abroad because of its comprehensive vision for economic recovery.

Twenty months on, and with criticism of the pace of structural reforms, it is easy to forget that Abe has already implemented many radical policy measures, including some that had proved too much for his predecessors, especially in the monetary and fiscal arenas. Implementation of the first and second arrows of Abenomics – monetary and fiscal reforms – required a number of controversial and hard-won policy changes, including a shift in the goal of Japan's monetary policy from price stability to 2% inflation; the introduction of a massive asset-buying program (quantitative and qualitative easing) which has since expanded the Bank of Japan's balance sheet from ¥167 trillion to ¥277 trillion by September 2014, and a doubling of the monetary base, which has seen the yen fall, with remarkably little criticism from Japan's trading partners, from ¥77.5 to the dollar in September 2012 to ¥107.5 today.

Despite doubts about his ability to deliver, and some predictions of disaster, it has to be said that many key elements of Abe's program have gone according to plan: a steady rise in inflation, from minus 0.2% to plus 1.3% (temporarily plus 3.3% in July due to the consumption tax hike); a sustained rise in asset prices across the board; substantial increases in profits and business confidence; and a huge net inflow of foreign investment. Since the advent of Abenomics, the Nikkei 225 has almost doubled, from 8,661 in November 2012 to just under 16,000 today. And Japan has virtually achieved the holy grail of full employment – with unemployment standing at just 3.8%.

Taken together, these achievements have been enough to keep Abe securely at the helm, with public support above 50% more than 18 months after he became prime minister – quite a feat by itself given the recent record of Japan's prime ministers.

The same positive indicators have allowed Bank of Japan governor Haruhiko Kuroda to stand by his confident statements that Japan is "on course" to achieve sustained inflation of around 2% by FY2015. The fact that the Cabinet inaugurated in December 2012 became the longest serving Cabinet in Japan's post-war history – 617 days – added to the unfamiliar but welcome sense of political stability.

However, Abenomics is now entering a far more difficult phase. With the first and second arrows already fired, critics increasingly question the pace of the third – structural reform. Some wonder whether the country can be weaned off of the comforts of monetary and fiscal stimulus. And others fret at the nationalistic aspect of Abe's agenda fanning tensions abroad and distracting him from the urgent economic tasks at hand.

> “SOME WONDER WHETHER THE COUNTRY CAN BE WEANED OFF OF THE COMFORTS OF MONETARY AND FISCAL STIMULUS. AND OTHERS FRET AT THE NATIONALISTIC ASPECT OF ABE'S AGENDA”

Abe also now has an economic record to be analyzed and challenged. For all the positives, some of his promises have clearly failed to materialize. Despite inflation, rising profits and a tightening of the labor market, real wages have continued to fall. And Kuroda himself has admitted his surprise at the lack of response from the export sector to the falling yen.

With Japan waiting nervously to learn the long-term impact of April's consumption tax rise, especially since a rash of disappointing data for Q2, Abe's Cabinet reshuffle earlier this month presented him with a chance to re-vitalise his administration, and push Japan towards more enduring change.

Key appointments stress continued push for reform

Through his new Cabinet appointments, Prime Minister Abe has sought to address some of the previous Cabinet's shortcomings, while at the same time stressing policy continuity, keeping six of his key ministers in place, including Minister of Finance and Deputy Prime Minister Taro Aso, Minister of Foreign Affairs Fumio Kishida, and the minister responsible for Trans-Pacific Partnership negotiations, Akira Amari.

The reshuffle clearly had a party political dimension too. One important change was the appointment of Shigeru Ishiba (a former Minister of Defence seen as Abe's main rival for leadership of the LDP). Moving Ishiba from LDP secretary-general into Cabinet as minister for regional revitalization was intended to undermine Ishiba's ability to snipe from the sidelines in advance of a party leadership contest next year.

Appointing former LDP president and Justice Minister Sadakazu Tanigaki in Ishiba's stead was another canny move, designed to assuage Diet members from the LDP's centrist factions frustrated at their exclusion from the policymaking process, which they see as being increasingly concentrated in the Prime Minister's Office. Tanigaki's appointment is also seen as a way to maintain a line of communication to Beijing despite the hawkish tinge of several new Cabinet members.

The biggest surprise in the reshuffle was the appointment of rising star Yuko Obuchi as the new Minister of Economy, Trade and Industry. Obuchi, a popular politician and political moderate, is tasked with making the case for restarting some of Japan's nuclear reactors, all of which are currently offline, and for seeing through fundamental reforms of electric power markets. With the Nuclear Regulation Authority having finally given its first approval for a nuclear reactor to restart, this is sure to be a politically challenging portfolio.

Abe's focus on empowering women, starting with the appointment of a record-equaling five women in the new Cabinet, is in part an attempt to reconnect with grassroots and women voters, especially ahead of regional elections next year. While practical policy measures have been limited to improvements in the provision of childcare facilities, the message is welcome, and there are important but sensitive tax reforms under way to remove Japan's incentives on married women to stay at home.

Another key appointment was that of Yasuhisa Shiozaki as Minister of Health, Labor and Welfare. Shiozaki, a Harvard graduate and former BOJ official, regarded as a leading reformer, will oversee a shake-up of the Government Pension Investment Fund, the world's largest pension pot – designed to have the fund take more risks and boost its lackluster returns.

Shiozaki also takes responsibility for highly contentious but crucial labor market reforms, including proposals >>>

All smiles now? Bank of Japan Governor Haruhiko Kuroda

>>> to modernize Japan's stultifying rules on over-time and severance pay. The World Economic Forum ranks Japan 140th out of 148 countries for ease of hiring and firing, but despite the urgent need for improvement, reform in this area is not something that can be achieved without a fight.

The reshuffle thus sets the stage for the next phase of Abenomics. If successful, the new Cabinet will have a profound impact on Japan's business environment.

140th

Japan is ranked 140th out of 148 countries when it comes to restrictions on hiring and firing staff

New legislative agenda

The Extraordinary Diet session starting at the end of September has a packed agenda. In addition to labor market reforms and the next phase of restructuring of Japan's electricity markets, the session will consider draft legislation to improve shareholder rights and reform corporate governance. It will also see the modernization of Japan's rules on personal information protection and cyber-security. In addition, there will be intense debate over reform of the healthcare system, including changes to reimbursement pricing.

Tax reform crucial

Initial debate will focus on tax reform – including lowering the rate of corporation tax and the crucial decision on whether to raise the consumption tax again next year. It will also focus on nuclear restarts, regional growth initiatives, and draft legislation to establish integrated resorts, which would lift the current ban on casinos in Japan. With regard to taxation, a possible extension of the carry forward period for net operating losses – a critical issue for long-term foreign investors in Japan – will also be part of the debate.

Japan's powerful Ministry of Finance (MOF) has accepted the government's plan to lower corporation tax in Japan "to the 20s" in the next few years, although the pace and final percentage are yet to be settled. The price for this MOF "concession" was a

> "ENGAGING NOW IN DEBATE OVER KEY SECTORAL REFORMS OFFERS AN UNRIVALLED OPPORTUNITY TO SHAPE JAPAN'S BUSINESS ENVIRONMENT FOR YEARS TO COME"

requirement to broaden the tax base, by reviewing Japan's surfeit of sector-specific tax breaks and possibly introducing new taxes. There is sure to be a heated discussion as the debate within the LDP Tax Committee hones in on concrete proposals.

Closely linked to this is the decision over whether to raise the consumption tax again in October 2015. Here the government faces a dilemma: raising the tax will dampen economic activity, but any decision to delay will cause international investors to question Japan's commitment to fiscal discipline and the sustainability of Japan's public finances. Abe is expected to reach his decision in November or December, despite it being too soon at this moment to fully understand the long-term effect of the first rise.

Integrated resorts on the way

Another area to watch is the Basic Integrated Resorts Promotion Bill, which promises to open Japan to legalized casinos for the first time at a small number of yet-to-be-decided locations. Though expectations are that the bill will pass during the upcoming Diet session, the full schedule of the LDP Cabinet Affairs Committee, where the bill will undergo formal scrutiny, means that the timing will be very tight.

In sum, we expect the pace of reform to accelerate under the new Abe cabinet. Engaging now in debate over key sectoral reforms offers an unrivalled opportunity to shape Japan's business environment for years to come.

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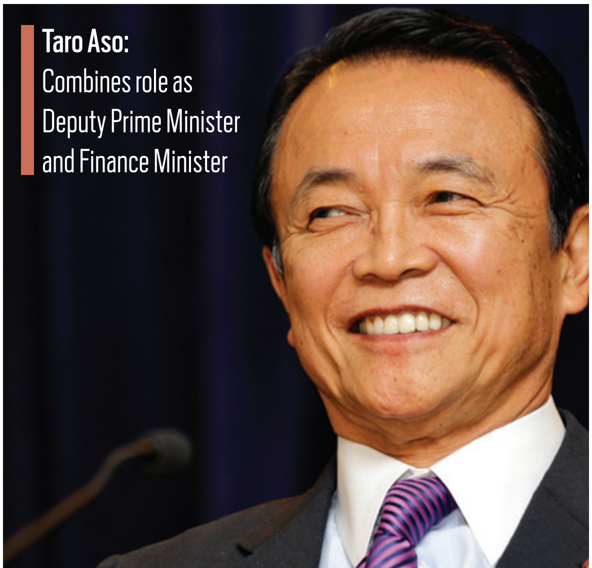

Taro Aso: Combines role as Deputy Prime Minister and Finance Minister

Energy is vital: Japan needs to secure its future energy supplies to achieve lasting economic growth

Energizing Abenomics

Assessing what impact Abenomics will have on Japan's energy policy, *Dr Llewelyn Hughes* says a period of negotiation beckons as the government seeks to drive competitiveness through liberalised energy markets

The success of the third arrow of Abenomics is tightly bound to reform of Japan's energy sector. Successful reform of the power market, in particular, promises to foster greater competition and innovation. It might also help to limit increases in power bills that sap the competitiveness of Japanese industry.

The Abe Administration has kept to its timetable for introducing greater competition into the energy sector. The power sector reform bill was passed into law last year, and full competition in the retail power sector will begin next year. Meanwhile, implementation of Japan's feed-in-tariff scheme has already helped a large number of firms enter the Japanese renewable energy market.

But many of the detailed rules that will govern Japan's changing energy landscape remain open to negotiation. Now is the time for potential entrants into the Japanese energy market to focus on new business opportunities. Resource companies should also track how the demand for different fuels is being influenced by the regulatory changes being put in place.

“RESOURCE COMPANIES SHOULD ALSO TRACK HOW THE DEMAND FOR DIFFERENT FUELS IS BEING INFLUENCED BY THE REGULATORY CHANGES BEING PUT IN PLACE”

Japan's once-in-a-generation reforms

Japan's energy sector is going through a once in a generation reform process. Changes began under the previous government in response to the triple disasters of 11 March 2011. Electricity market reform now takes pride of place within the structural reforms of Abenomics – its comprehensive plan for revitalizing Japan's economy.

This focus on energy makes sense. The natural disaster resulted in the turning off of all of Japan's nuclear power plants, and even if some of the reactors are restarted the share of nuclear power in Japan's energy mix will inevitably fall. This makes it crucial to search for alternatives.

In the short term, Japan's power utilities have increased the share of oil, coal, and natural gas used to produce electricity. >>>

ENERGY POLICY

>>> This has increased Japan's fuel import bills, a trend exacerbated by the falling yen. Indeed, the scale of that change alone has been sufficient to push Japan's trade balance into the red. This gives the government an added incentive to pursue structural reforms to the sector.

Japan has engaged in a raft of policies designed to ensure secure supplies of energy resources, most notably supporting firms' attempts to secure a role of the development and export of US shale gas.

Another key part of the government's response is the Electricity System Reform Policy (ESRP), approved by Cabinet on 2 April 2013. This sets out a program to ease the transmission of power between Japan's regionalized power markets through a new "Organization for Cross-regional Coordination of Transmission Operators" (OCCTO). It also promises to introduce full competition to the residential sector, and unbundle the transmission and distribution of electric power from generation.

Taken together, the ESRP promises to loosen restrictions on Japan's regionally segmented power sector on both the supply side and demand side as firms begin offering new energy services to residential and other customers.

" JAPAN'S POWER PRICES REMAIN TOO HIGH GLOBALLY. THE SHARE OF NUCLEAR POWER IN JAPAN'S ENERGY MIX ALSO REMAINS UNCERTAIN "

These changes come on top of the already impressive performance of Japan's feed-in-tariff (FIT) system. Modeled on Germany, Japan's FIT has led to an unprecedented amount of large-scale renewable generation capacity being added to Japan's electricity mix. Many foreign firms have entered the market either by developing projects themselves, or by supplying established firms within the Japanese market.

Yet there are challenges in the midst of this progress. The FIT has faced teething problems, with a number of projects cancelled due to lack of progress. Japan's power prices remain too high globally, harming the country's export competitiveness. The share of nuclear power in Japan's energy mix also remains uncertain. And most importantly, the detailed rules governing the new power market structure remain to be negotiated. This represents a mix of opportunities and risks for investors and firms interested in entering the Japanese market. How ongoing energy market reform develops within Abenomics remains crucially important to Japan's economic growth and the business opportunities it offers. GR Japan

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HEALTH REFORMS

Remedies for the Healthcare Sector

Junta Asai and *Daniela Dimitrova* examine the next wave of healthcare reform in Japan

Over the past year and a half, the second Abe Cabinet has tackled reforms in several key sectors of the economy. In the healthcare sector – particularly pharmaceuticals and medical devices – these policies have brought a welcome measure of substance to Abenomics' third arrow.

Japan is the most prominent example amongst developed countries of the combined effect of increased longevity and declining birth rates. Since Japan has the fastest ageing population in the world, it is not surprising that healthcare has become a policy priority for the government over the past decades. These demographic trends, and Japan's response to them, have already helped to make the country the second biggest pharmaceuticals market globally, with a high and growing level of foreign participation. But growing healthcare needs in the future will require further concerted efforts both from the public and the private sector to ensure that the healthcare industry can meet the future challenges from Japan's aging population.

Successive government policies have had a marked impact on the healthcare sector, with Japan's drug and medical devices lag shrinking rapidly and a growing concentration of global activity in Japan, including R&D pipelines.

The sector has seen some exciting developments under Prime Minister Abe. The medical industry was tagged as an area of particular interest in Abe's June 2013 Economic Growth Strategy and featured even more prominently as an "engine of growth" in the revised strategy of June 2014. The government's twin vision is to spur innovation and growth of the domestic healthcare sector, while also improving the environment for foreign pharmaceutical companies and attracting more external investment.

In May the government approved the creation of a new research promotion headquarters to coordinate the budget for medical research funding, currently allocated separately by the Ministry of Education (MEXT), the Ministry of Health, Labour and Welfare (MHLW) and the Ministry of Economy, Trade and Industry (METI). It also passed a bill to create a Japanese version of the US National Institutes of Health, to improve the competitiveness of the domestic medical sector through intense and integrated research.

Equally important, however, are the efforts of the Abe Cabinet to engage foreign pharmaceutical companies, accelerating and incentivizing the introduction of innovative medicines to Japan, and facilitating new market entry, with the aim of focusing foreign investment on research and development. >>>

>>> The two most important reforms in the sector – the introduction of the premium maintenance price system and the reform of the Pharmaceuticals and Medical Devices Agency (PMDA) – have been in place since 2010. The former aims to ensure predictability and high reimbursement prices for innovative and high-value medicines, encouraging pharmaceutical companies to continue investing in new drugs development. Typically, the level of reimbursement under the National Health Insurance (NHI) system is decided in a biennial price revision based on the market value of drugs, conducted by the Drug Pricing Committee of the Central Social Insurance Medical Council (CSIMC) or *Chuikyo*. The premium maintenance price system guarantees high-reimbursement prices for a fixed initial period, regardless of market prices. Recognizing the importance of the system in providing stability and incentives for pharmaceutical companies, the Abe Cabinet reapproved it in 2014.

At the same time, the MHLW has worked hard to simplify the administrative requirements for new drugs' application and speed up the review process. Crucial for this purpose was restructuring the PMDA by increasing examination personnel and accelerating examination procedures. In November last year, the Cabinet also approved important changes to the Pharmaceutical Affairs Law (PAL), providing for faster medical devices registration.

Improving the business climate

Some of the other measures envisioned by the government to improve the business climate for the medical sector are an expansion of the over-the-counter (OTC) drugs market and, notably, the introduction of the mixed billing system, allowing patients to use drugs and procedures not covered by the National Health Insurance in combination with covered items. This last measure in particular, would lessen the pressure for some companies to secure reimbursement under the NHI and will improve the climate for non-reimbursable drugs and devices.

Recent discussions within the LDP to scale back tax deductions for corporate R&D spending appear to contradict the Abe Administration's focus on innovation. The move is being mooted as a way to fund a planned reduction in corporation tax. At the same time however, the government plans to offer even lower corporation tax for companies that increase their R&D spending. This policy would have a double effect – encouraging investment in R&D and increasing overall capital spending.

Shinzo Abe: Implementation is now key for his government's health reforms

While the Abe Cabinet continues to take Japan's healthcare policy in the right direction, there is room for improvement. For one, the premium maintenance price system for innovative drugs should be made permanent in order to provide predictability and confidence to pharmaceutical companies considering long-term investment in Japan. Another big question in recent months has been whether *Chuikyo* might return to the idea of annual drug price revisions (as opposed to the current biennial revision).

This would be an unwelcome change for research and innovation centered industry players, increasing their administrative burden and diminishing market stability and predictability. Furthermore, Japan still has work to do in streamlining the administrative process for turning preclinical research into new drugs. The Cabinet has developed a strategy package called *Sakigake* (meaning "pioneer" or "front-runner") aiming for the swift introduction of innovative drugs, medical devices and regenerative medicines, which can cure serious illnesses. However, the policy package is yet to be implemented.

Japan is aware that it is facing increasingly stiff competition in the region, as China, Singapore and other countries in Asia begin to encounter the same demographic challenges. As policies in those countries respond, they too become investment and market destinations for innovative pharmaceutical companies. The Japanese government feels the pressure to keep its market attractive and seems genuinely determined to stay ahead of the pack. That means providing for stability, predictability and a business-friendly environment, as well as reforming the system to attract more investment, particularly in the area of R&D. Structural reform in the healthcare sector so far has been as much about substance as about speed, and the new regulatory environment provides many opportunities for market entry.

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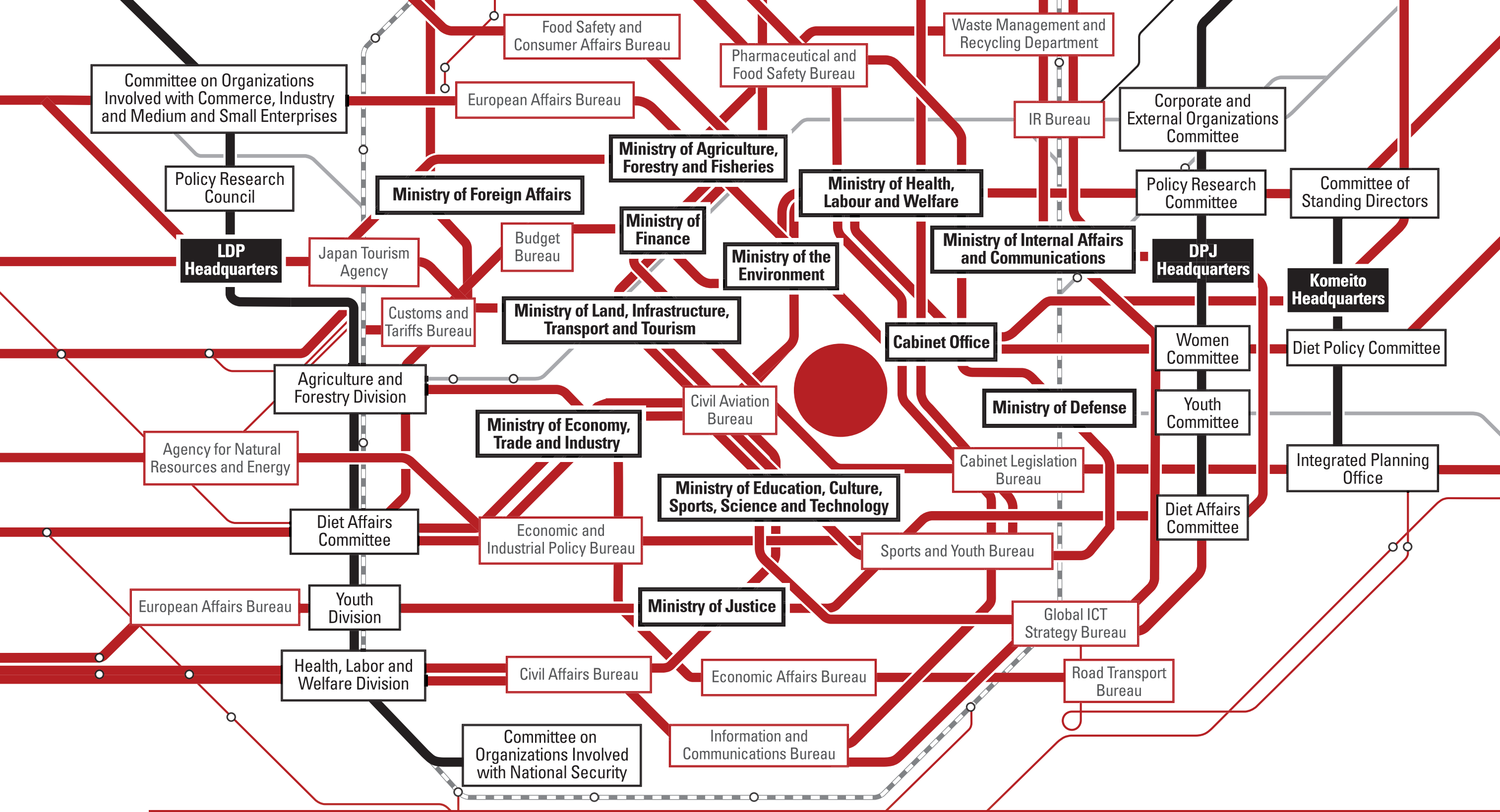

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