Japan Retains Oil Interests in the Middle East

Photo : Kyodo News

The Khafji oil field in the former neutral zone between Saudi Arabia and Kuwait

The Middle East is perhaps more different from Japan in natural conditions, climate, customs and culture than any other area in the world. But Japanese ventured into this unfamiliar land in the 1950s to find oil. In 1958, Arabian Oil Co., Japan's first company to engage in full-scale development of oil fields overseas, started drilling in the Khafji oil field in the former neutral zone between Saudi Arabia and Kuwait. For resource-poor Japan, possessing an oil field of its own had great implications for its energy policy. Given that the Organization of Petroleum Exporting Countries (OPEC) has seized initiatives of setting crude prices in world markets, it can be said that Japan had the wisdom to see into the future.

In February 2000, Arabian Oil Co. lost its oil drilling rights in the Saudi Arabian sector when its contracts signed with the country in 1957 expired. The loss of the Khafji oil interests plunged the company into the deepest crisis since its establishment. It temporarily climbed out of the predicament in July after it managed to reach a basic agreement with Kuwait to renew the contracts originally signed in 1958.

Yet, Arabian Oil Co. remains in dire straits, since the quality of Khafji oil is low and Japan's independent oil development overseas is losing relevance given the establishment of global crude oil markets.

Arabian Oil Co. may be severely criticized for its failure to renew the Saudi Arabian contracts despite long preparations for the contract renewal negotiations. Detractors said the company started the preparations more than 20 years ago, and the failure meant nothing but its complacency. The fiasco reminded Japan of the importance of maintaining and further strengthening friendly relationships with Middle Eastern countries spanning half a century.

A basic agreement on the extension of the Khafji drilling rights with Kuwait beyond the current deadline of January 2003 was reached between Japanese Minister of Economy, Trade and Industry Hiranuma Takeo and Kuwait Oil Minister Adil Khalid al-Subih during the former's visit to Kuwait on July 7. A formal agreement will be signed in September when al-Subih visits Japan in early September after specific terms are thrashed out between officials of the Kuwait Oil Ministry and Arabian Oil Co.

Under the new contract, Arabian Oil Co. will operate the oil field on behalf of the Kuwaiti government, instead of owning drilling concessions as under the old agreement. The new formula is based on the Kuwaiti Constitution which stipulates that underground resources belong to the state.

During the Hiranuma-al-Subih talks, the Kuwaiti side agreed to a Japanese request for daily supply of 140,000 barrels of crude as under the current agreement. Kuwait will allow Arabian Oil to retain initiatives in drilling operations, which will guarantee the company adequate profits. In essence, the new agreement would amount to an extension of the current agreement.

The conclusion of the negotiations with Kuwait more than a year and a half before the expiry date showed that both sides, reflecting on the failure of negotiations with Saudi Arabia, tried hard to respect each other's positions, Japanese officials said. Progress in Japan's oil concession negotiations with Iran and the United Arab Emirates (UAE) also contributed to the early conclusion of the negotiations with Kuwait.

Japan's failure to extend the concession agreement with Saudi Arabia resulted from Japan's insistence on

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virtual ownership rights as in the old agreement. On the back of the emergence of resource nationalism, most Middle Eastern countries allow foreign companies to operate oil production on a farm-out basis. Japan's insistence on virtual ownership prompted Saudi Arabia to demand construction of railways, which involves such a vast sum of money that Japan could not accept the proposal.

In the negotiations with Kuwait, Japan proposed from the outset the renewal of the agreement in the form of operation rights, as well as the development of natural gas which Kuwait wants to export to Japan. Kuwait, for its part, was friendly throughout the negotiations, mindful of the cooperation Japan extended to the country during the Gulf War.

Some Japanese officials take the view that Japan's talks with Iran and the UAE on large-scale oil development projects convinced the Kuwaiti government of the advisability of an early conclusion of the negotiations.

Insurance Powerhouses' Woes

Japan is known as an "insurance powerhouse" with insurance policies accounting for more than a quarter of the financial assets held by individuals, but the life insurance industry faces increasingly bleak business prospects. For one thing, life insurers are being pressed hard by a "negative spread" – the difference between what they earn on safe investments and what they must pay out to policyholders. With interest rates at record lows, investment returns have been running well below the yields which life insurers promised to pay policyholders, forcing the companies to pay out far more than what they earn on investments. Furthermore, flight from the insurance sector has been fanned by the recent spate of insurance company failures, which has added to public distrust in the industry. This, coupled with a steady decline in the birthrate, the aging of the population and the protracted economic slump, has led to a fall in the balance of individuals' insurance contracts.

More than 90% of Japanese consumers have life insurance policies. They pay about ¥400,000 (US$1 ≒ ¥120) a year as insurance premiums on average, far more than the figures of ¥280,000 in the United States and ¥170,000 in Europe. Indeed, Japan is an "insurance big power" where insurance policies total ¥368 trillion, or 28% of personal financial assets aggregating close to ¥1,400 trillion, accounting for the largest portion of the assets after cash (55%).

A total of seven life insurers have collapsed since 1997, when Nissan Mutual Life Insurance Co. went under, with the latest case being Tokyo Mutual Life Insurance Co., which was declared insolvent in March 2001. They are trying to resuscitate themselves by reducing guaranteed yields and thus lessening the financial burden on their business operations. Five of the collapsed insurers have fallen under the control of foreign companies. Individual insurance policies and pension contracts held by Japan's 10 large and medium-size life insurers at the end of March 2001 dropped 2.9% from a year before to ¥1,192.5 trillion, marking the fourth straight annual decline. Insurance policies canceled or invalidated were smaller than the previous year, but stayed at a high level, indicating no halt to the flight from the insurance sector.

In the face of such a crisis in the life insurance industry, a government advisory panel on financial affairs is discussing the possibility of rescuing insurers by allowing them to reduce guaranteed yields before they become insolvent. The advisory panel came up with an interim report in June, proposing to tolerate a yield cut, if endorsed by insurers and policyholders, as one of the industry's self-help efforts. But the report noted that there is skepticism about such a measure in some quarters, saying it may not work eventually with policy cancellations suddenly rising once procedures for a yield cut are initiated. In unusual action, the council pledged to seek public comments on the matter and then continue discussing it on the basis of opinions thus collected.

Behind the cautious approach by the panel is the fear that a yield cut implemented before an insurer is declared insolvent could infringe on policyholders' asset rights guaranteed by the Constitution. The advisory panel is also concerned that it would be difficult to convince policyholders of the advisability of a yield reduction when disclosure of business data by insurers is still insufficient. In what is regarded as a first step toward greater transparency of financial conditions, the life insurance industry made public previously undisclosed data for the first time this year. Unveiled were the industry's "fundamental profits" for fiscal 2000 that ended March 31, 2001. Fundamental earnings result from three sources of profit, including mortality profit stemming from the difference between expected insurance benefit payout – based on a projected mortality rate – and actual benefit payout based on an actual death rate. The industry's fiscal 2000 fundamental profits, equivalent to earnings from regular business operations, more than offset losses from the negative spread to reach more than ¥2 trillion in terms of a tally of the 10 life insurers.

All these companies have declared that they have no intention of reducing guaranteed yields for fear that any indication of a yield cut would trigger a wave of policy cancellations. Any yield cut would be practically impossible even if an official mechanism permitting such a reduction has been introduced. This means that financially less sound life insurers face a rise in the risk of insolvency if the spread remains in negative territory and if the balance of insurance policies keeps declining. A further reorganization of the life insurance industry appears inevitable.

Brand Fever Bucks Recession

The Japanese economy remains mired in the dual woes of recession and deflation. Gross domestic product has shrunk for two consecutive years, with the government virtually admitting that the economy is slowing down. Consumer prices continue to drop, putting a squeeze on corporate earnings. Reform-minded Prime Minister Koizumi Jun'ichiro has been riding a wave of high public approval ratings with his call for painful economic and financial restructuring under a "no reform, no recovery" platform. But his initiative is meeting with resistance from politicians within his own Liberal Democratic Party, who stand to lose their vested interests through the reform. With the deepening recession, Koizumi can expect to see the political backlash pick up momentum and faces a greater risk of losing his public support.

Amid such developments, consumer spending is not losing steam, judging from the booming sales of luxury brand-name goods in Japan.

In late June, Hermès of France opened its first direct Japanese outlet in Tokyo's ritzy Ginza district. The 11-story opaque glass-covered tower boasts 1,150 square meters of sales space. Hundreds of shoppers, mostly fashion-conscious young women, formed a long queue stretching around the block on the opening day. Thanks to the popularity of its products among young Japanese women, Hermès boosted its sales in Japan to ¥32.5 billion in 2000, up 3% from the previous year.

Hermès is just one of a number of European fashion houses opening extravagant outlets in Tokyo's swankiest shopping districts such as Ginza and trendy Aoyama despite the sluggish Japanese economy.

Louis Vuitton is building a 10-story shop on Omote-sando Street in Aoyama slated for completion in the autumn of 2002. Louis Vuitton's sales in Japan jumped 16% from the previous year to ¥100.3 billion in 2000, accounting for one-third of its global turnover. Chanel will also open a 700-square-meter outlet on Omote-sando.

Japanese women with a keen interest in luxury items are continuing their buying binge of expensive European brand-name products even after the burst of the asset-inflated bubble economy.

For foreign luxury makers, the Japanese market, including Japanese tourists' purchases of such brand-name goods on overseas trips, is now so important as to dictate their bottom lines. With the U.S. economy stagnating, European luxury goods makers will have to focus on Japan.

Japan remains the world's most expensive country to live in despite being in the grip of deflation. A cost-of-living index for expatriate executives compiled by the Economist Intelligence Unit in March put Tokyo, Osaka and Kobe at 140 against New York's 100 and even higher than Hong Kong's 116 as well as the 97 for Taipei and Singapore.

But Japanese cities may see their rankings fall in the future in view of markdown wars under way in various sectors. In the fast-food industry, for example, McDonald's Japan recently halved the price of its hamburgers to ¥65, boosting the chain's market share. Yoshinoya D&C Co., which operates a chain of beef bowl (known as *gyudon*) restaurants, slashed the price of its ordinary gyudon serving by 30% to ¥280 from ¥400 in July, which the company hopes will boost sales by 50% from the previous year. The markdown of gyudon, one of the most popular fast-food items among male Japanese salaried workers, is expected to spread to other businesses.

The recent spending patterns among Japanese consumers show that low-priced products that offer value for money and expensive goods that offer quality are selling well, while those in the middle have failed, according to analysis by Japanese economists. Dejected male workers, hit by corporate restructuring, dine at low-budget restaurants, while carefree young women with deep pockets hunt for brand-name goods. This may be a facet of structural reform.

Photo : Kyodo News

People waiting in a long queue in front of the newly opened Hermès outlet in Ginza