



**Roundtable
apan**

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Executive Summary



In the post-financial crisis landscape, emerging markets will be at the forefront of global economic growth. Is Japan prepared and equipped to compete in this changing global environment? Japan has experienced a record plunge in its exports and industrial production from the last quarter of 2008 until the end of May 2009. Rising unemployment and high exchange and interest rates did not help the situation. With policymakers caught in political gridlock and everybody focused on the next election, due to happen before mid-October 2009, the outlook for the Japanese economy remains grim despite the improvement noticed in June.

Yet, in many ways, the global economic crisis is creating a strategic opportunity for Japan to reassert its economic and political voice on the global stage.

A recovery? A “V”, “U”, “L” or “W” shaped? Japan’s to do list

While many are desperately trying to find “green shoots” in the current global economic situation, the best that can be said so far is that there are now signs that the economic deterioration has stabilized and that the economies in a number of countries are bottoming out.

In looking at Japan, analyzing the domestic and external factors that will impact the recovery will be crucial to identifying the type of recovery that can be expected: Whether it be L-shaped, W-shaped, U-shaped or V-shaped.

For **Robert Feldman**, Director of the Economic Research Department and Managing Director at Morgan Stanley Japan Securities, the recovery looks U-shaped in the United States and W-shaped in Japan as the situation in this country is complicated by economic and political paralysis. Why will Japan’s recovery be different and more arduous? The drop in industrial production has been far steeper in Japan due to its specialization in durable equipment and

consumer goods, and to the fact that the country has been far less aggressive and more sluggish on its reform agenda in the last two years. Because of these factors, when the crisis hit, Japan’s economy was less vibrant and not as well equipped to confront the great difficulties it encountered. .

The risk is that the present rebound generated by the stabilization policies will wane as time goes on, particularly if there are no further stimulus packages implemented. In the longer term, emphasis must be placed on

achieving higher productivity growth. As labor participation rates decrease due to the ageing population, policies aimed at accelerating productivity increase will be critical to ensuring sustainable growth.

Productivity in Japan grew by 3% on average in the 1980s, but only by 1% in the 1990s. Japan must move back toward the 3% range. However, rapid policy adjustments are difficult and time consuming and it is unlikely that there will be much change by the end of the year. Such kind of change would necessitate strong and decisive leadership, and as both parties are split and lack direction before the general

While there is noticeable improvement due to the impact of stabilization policies, this impact will wane as time goes on, particularly if there are no further stimulus packages implemented.

elections, it is very unlikely that there will be a strong leader emerging from the elections to take the helm.

Mitsumaru Kumagai, Senior Economist at the Daiwa Institute of Research Holdings, sees the US as remaining the driving engine of Japan's economy for the foreseeable future while China will confirm its role as an auxiliary engine for Japan's recovery. The large stimulus packages in the US and China have had a positive impact on GDP growth which will continue throughout the course of 2009. However, by 2010, public spending will begin to decline and the US economy is likely to slow down again, negatively impacting Japan's exports once more. Deleveraging and the credit crunch are causing concerns about the US economy in the long-term, as mobilizing financial resources will raise long-term rates - which will in turn negatively impact the housing market.

China has increasingly asserted that it will reach its 8% growth target for 2009, and this optimism over China's prospects has a positive impact on Japan. Given that its debt to GDP ratio is much lower than Japan, China can afford to spend far greater amounts of government funds to spur growth and stimulate the economy. So, there is plenty of room for monetary and fiscal policies to be implemented. Increased fixed investment will be focused on infrastructure and will have a limited impact on Japan's economy. For this reason, China will only be an auxiliary driver for growth in Japan.

The key to Japan's recovery will be increased retail sales in the United States on which it is dependent for its exports. However, there are strong signs that consumer spending psychology in the US has been affected by the crisis in a way that could last beyond an eventual recovery: the US negative savings rate before the crisis which has now turned positive may very well remain so after the recovery. Consequently, the

prospects of a "www" recovery for Japan cannot be ignored.

Takahide Kiuchi, Chief Economist at the Financial and Economic Research Center of Nomura Securities, who had previously considered that maybe Japan could emerge a winner from the crisis has now revised this analysis: While countries such as Korea, Singapore, Taiwan and Malaysia have also showed serious signs of deterioration in the last few months, Japan has fared even worse, due in part to its high dependency on exports and on its production of intermediate goods. Structural changes in the Japanese economy are a necessity to surmount this downturn.

Deregulation will be key to stimulating domestic demand and supporting entrepreneurial activities which are necessary sources of future growth.

The rebound noticed since June is due to an increase of exports of intermediate goods to China which has depleted inventories and thus spurred production, and to the stimulus packages. However, although these packages will contribute to 1.2% economic growth, this will most likely not lead to recovery as they will only have a short-term positive influence that will start to weaken in the coming months, as will the growth from the production of intermediate goods - hence the risk of a W-shaped recovery.

As corporate profitability is very low, companies will have to restructure over the next year by reducing their production capacities. Fixed costs must be reduced by as much as 11% on average and labor costs will have to be cut by reducing regular and full time employees. This trend will continue into the second half of 2010, with an intensity dependent on the way the US economy will evolve over the coming months.

While the United States is trying to send an optimistic message and is showing signs of recovery, domestic demand is not picking up yet, and the financial uncertainties have not been fully resolved.

The cost of credit will most likely go up, impacting the real estate market even further. With unemployment at 9.7%, and still rising, default on credit card debt has gone up and there are doubts that consumption could be restored to past levels.

Japan was affected more heavily than other Asian countries because of its high dependence on exports, which were focused on a smaller range of durables and dominated by a small number of companies with decreasing international competitiveness. Japan today needs a lot of soul searching in order to learn from past lessons and to restore its position on the international stage.

The lack of long-term scenarios for switching to more emphasis on domestic demand and to diversify away from China and US toward other countries, is a major issue that needs to be addressed urgently. Deregulation is also key to stimulating domestic demand and supporting entrepreneurial activities, which are necessary sources of future growth.

This global financial crisis has highlighted numerous structural challenges that will remain even after the situation stabilizes. Like many other countries, Japan will need to rethink its growth model. With the future of the financial industry and the structure of the monetary regime in question, and the fate of the US dollar hanging in the balance, the foundations of the world economy will undergo major changes in the next 10 years – and Japan has to prepare itself to be playing in a new global economic context. Political and business leaders need to be ready for challenges that will sorely test their capabilities.

Kathy Matsui, Managing Director and Chief Japan Strategist and Co-Director of Pan Asian

Investment Research at Goldman Sachs Japan, emphasized how structural reforms will be critical to Japan's future amid the rapidly-changing global economy. "The BRICs represented 29% of G6 GDP in 2008 and will likely represent 78% of G6 GDP by 2025. At this rate, China and India could overtake Japan's GDP by 2010 and 2027, respectively."

There will also be a shift in the next decade as China, with its population of 1.3 billion, will account for a greater proportion of Japan's exports, exceeding that of the US and Europe. In addition to China, India and Indonesia are also likely to grow steadily via domestic demand as opposed to exports, so these are also potential export markets for Japan.

Although Japan's stock of savings is large, the household savings rate is collapsing and –at less than 2%– Japan's savings rate is now below that of the US 6.9%. This is being driven primarily by the aging of the population, and when you combine this

with Japan's shrinking current account surplus and its burgeoning fiscal deficit, it is obvious that the country must quickly find solutions to its economic and demographic crises.

Because meaningful immigration reform appears unlikely near-term, Japan must learn how to use half of its population—i.e. women—more efficiently. **By using only half of its available labor pool, the Japanese economy is trying to run a marathon with just one leg. We estimate that closing Japan's employment gender gap could raise the level of Japan's GDP by as much as 16%.** Moreover, the common myth that more working women will translate into lower birth rates is completely inaccurate, since empirical evidence shows that there is, in fact, a positive correlation between higher female labor participation and higher birth rates globally. Indeed, this is even true within Japan,

By taking advantage of only half of its population, the Japanese economy is running on one leg. Closing Japan's employment gender gap could raise GDP by as much as 16%.

where Okinawa is the prefecture that boasts the highest female labor participation rate and the highest birth rate in the country.

The high dependence of the Japanese stock market on foreign investors creates levels of volatility that resemble those of emerging markets. While Japanese stocks appear undervalued, their overall profitability is also quite low, with a normalized ROE of around 4%-5% versus 8%-13% for the US, Europe and non-Japan Asia markets. In order to entice more Japanese investors to invest in their own stock market, companies need to raise ROEs and shareholder returns in the form of higher dividends. (For example, it is difficult to explain why Japan's dividend yield is only 1.5%, which is half that of higher-growth non-Japan Asia, and far lower than Europe's 4%).

The global financial crisis is highlighting the changes needed in Japan's political and economic leadership and should be used as an accelerator for the structural changes that Japan so desperately needs. Addressing these changes is a race against time especially because of Japan's demographic crisis.

It is important for Japan to articulate a long-term vision for itself and to find a solution to its structural problems, particularly given its high export dependency. Japan should focus on increasing domestic demand, while at the same time continuing to export goods in sectors where it is globally competitive. Japan needs to cope with its shrinking population by boosting female labor participation and overhauling its immigration laws. Growth-oriented policies which ought to be considered by the government include: fostering secular growth industries such as alternative energy technologies, healthcare/nursing care, financial services/asset management, and tourism. Japan should also foster closer economic, political and social ties with neighboring Asia, which is likely to generate the bulk of Japan's growth for the foreseeable future.



From left to right: Takahide Kuchi, Kathy Matsui, Toyoo Gyohten, Claude Smadja

Some priorities for immediate action

While the Japanese banking system has not been as severely affected as its Western counterparts, if the contraction in the global economy were to continue in the last part of 2009 this would have a very severe impact for Japan. The recent thriftiness of American consumers could translate into a permanently smaller market for Japanese products, essentially rupturing Japan's financial architecture. Should it occur, massive unemployment would cause serious structural changes in the Japanese society; consequently, the government is pushing through a safety net for those who risk losing their employment.

What should Japan do go forward? For **Masajuro Shiokawa**, Former Minister of Finance and Chancellor of Toyo University, Japan should firstly be more assertive and should play a more active role in the region as well as on the global map. Building on its vast economic assets in terms of money, manpower and know-how, Japan is an important participant in conflict prevention and peace-building in South East Asia. At the end of the last G20 Summit in London, the Japanese government was asked to

host the next meeting, an offer it unfortunately declined – which was a missed opportunity.

Secondly, politics should regain the confidence of the people as this confidence has plummeted in view of successive prime ministers being unable to advance on critical domestic reforms. A way to achieve this goal would be to organize the next electoral campaign not on counting on political contributions, but rather on mobilizing volunteers using the example of Obama's presidential campaign. As Japanese politicians are so reliant on contributions, Japan should introduce measures to limit those contributions as a step toward regaining the electorate's trust. Thirdly, the government should ensure fiscal consolidation through changes in the tax system.

Fourthly, Japan needs to change its traditional mindset of "respecting the public sector and despising the private sector". If the "Plan-Do-See" scheme is considered to be the rule of the game in the Japanese administration, the "see" part is weak, and therefore, oversight and surveillance of government action does not function well. Indeed, the recent blockage of some public work in Osaka is a striking example of how uncoordinated the government processes currently are: the regional government refused to pay its portion of the cost for the work since the central government could not produce a precise enough breakdown of the expenditure estimates.

Japan urgently needs to change the way public finances are handled, which will in time lead to the evolution of the entire economy. The country needs a profound change in the political system that would allow for faster decision



making, otherwise Japan will return to its pattern of recession followed by sluggish growth as its population shrinks.

Finally, Japan must deal with growing concerns over the country's isolation. As former US Defense Secretary

William Cohen recently advised, Japan should consider its international relations not as friendships but more as partnerships with a more acute international sensitivity. Japan's ability to weather the economic downturn in the long-term will determine the evolution of one of its most important strategic relationship – that with Washington. This is even more important given the fact that the US government's attitude toward China is changing, placing more importance on this country's new centrality to the world economy.

The need to improve Japan's global engagement is clearly reflected in the technology domain. While the US thinks highly of Japanese technology, it fears that US technology might be leaked to other countries through Japan: Japan should thus abide by international rules, to protect its partnership with the US. In order to remain innovative and not to impair its global competitiveness, Japan must pursue its growth

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strategy by establishing a low carbon society and investing in ecological technology.

However, the possibility of the right policies being devised, of the necessary actions being implemented and of the capacity to bring the public opinion on board remain more than ever dependent on how the country's political leadership will be able and ready to assume its responsibilities in view of the unprecedented nature and scope of the challenges Japan is facing.

Japan's crunch time: Can the country deal with the worst economic and political crisis since WW II?

Japan is currently facing the conjunction of unprecedented economic and political crises, a crunch time from which it can hope to emerge stronger only if the structural causes for the present political stalemate and for some key economic weaknesses impacting on its long-term sustainable prosperity are addressed. While the country remains the second largest economy in the world and has an important role to play in the international arena, the changing global economic and geopolitical context need to be met with an in-depth assessment of policy options, and concrete actions and changes that will take time to implement in a country as rich in tradition as Japan.

How can Japan deal with the most difficult situation it has faced since 1945? Exports decreased by 38% in March, down from the 50% decrease in February, with the economy contracting 3.8% in the first three months of 2009, after a 3.6% decline in the last quarter of 2008. This was the most important decrease in GDP since the measurement data has been recorded. While the expectation is that GDP will have returned to growth by the end of the second quarter, this does not signify that Japan

is yet at the recovery stage: **Chances are that the pick-up in industrial production might reflect more a rebound than a genuine recovery. In fact, it could take quite a few years before the economy gets back to the level of the first quarter of 2008.**

For **Atsushi Saito**, President & CEO of the Tokyo Stock Exchange Group Inc., the government should attempt to connect companies and investors rather than investing directly in companies in need of capital, using the opportunity of the crisis to move another step towards the further strengthening of Japan's long-term competitiveness in the global capital markets. This would go against the present trend of state capitalism that the crisis has generated in many countries.

Even if the government has to invest in companies that are "too big to fail" in the short-term, public funds could also be used to stimulate domestic demand if there is further contraction. However, this would come at the cost of crowding out many companies looking for capital, with the consequence, also of increasing the public debt which is already at 200% of GDP. Rather than continuing to make public funds available to stimulate the economy, Japan should give public guarantees in order to diminish the risk of rising interest rates, another recession down the road and higher unemployment.

Japan needs a domestic demand centered strategy with targeted increased fiscal expenditure that focuses on two objectives: unemployment and growth strategies.

In that context, as a sustainable recovery requires political vision and a coherent government action, Japan's situation raises the

question of the extent to which a sustainable recovery is hostage to a political change; in other words to what extent is a turning point needed in the political system and practices to ensure long-term sustainable recovery? Striking a new balance in Japan's political system will be crucial to avoiding a dichotomy between capitalism and socialism, between a free economy and a managed economy. Japan's traditional "middle of the road" approach has been one of its important strengths and is the approach that will win the most support among voters.

In that respect, it is clear that China and India will significantly impact market capitalism as these two countries continue to emerge. As the financial crisis underlined the importance of having dynamic control systems in the future, market capitalism needs to be redefined in order to rebuild the firewall between banking and securities activities, and to mobilize concerted collaboration at a global level in creating a global clearing house to centralize OTC transactions.

Shareholders also have a critical role to play in economic recovery and growth and they must be given more say and more control in overseeing corporate decision-making processes for developing sustainable corporate policies. While the size of the injection of government funds in the US financial markets would be inconceivable in Japan, companies must develop successful strategies to revitalize and re-capitalize their businesses. This is particularly important as there may be a slowdown in the pace of privatization, and a delay in dealing with non-performing loans until the crisis is over.

Because of Japan's electoral system of small constituencies which borders on populism and socialism, bold policies entail political risk that many politicians are unwilling to take on. Japan Railways is an example of a company which continues to have unsustainable employee benefit programs due to powerful lobbies in small constituencies. Reducing expenditures

and increasing revenues will be essential in making a company like this self-reliant and, thus, decreasing the tax-payer burden.



The Japanese economy will have to undergo numerous structural changes as it cannot expect to emerge from this crisis the same as before. This crisis was preceded by a long period of expansion with a low growth rate of 2% on average. This was coupled with unprecedented reliance on export-driven growth at the expense of promoting a higher domestic demand. As the GDP increase was driven by export growth, Japan's exposure to the global market increased. As the crisis unfolded, Japan's economy started to slowdown faster than that of the United States due to its excessive dependence on external demand. In order to boost growth and fight the recession, particularly in the manufacturing industry, Japan must succeed in increasing domestic private demand and capital expenditure.

Confronted with the crisis, the government did not remain inactive and responded by investing ¥12 trillion – the equivalent of 5% of GDP – in stimulus packages. However, the economy continued to contract despite the three rounds of economic stimulus measures. A supplementary budget of ¥15 trillion was voted in April to help fight the downward economic spiral, which – despite the present rebound – could lead to an economic output gap of up to 10% by 2010. An increase in this gap will spur deflation and could push unemployment up to 7%. The number of part-time or non regular

workers already accounts for 33-34% of the workforce, and they are its most vulnerable segment. Without an improvement in the labor market, an adjustment in the unemployment subsidy will be necessary to cope with the problems of this growing subset of the labor force.

Japan needs a domestic demand-centered strategy with targeted increased fiscal expenditure that focuses on two objectives: reducing unemployment and engineering growth strategies. Unemployment, particularly for non-full-time workers, should be tackled through employment adjustment subsidies and training as well as increased efficiency, all of which are needed to increase domestic demand.

Growth strategies should focus on developing the infrastructure and healthcare industries, taking advantage of opportunities in the green growth sector where Japan has a comparative advantage, and addressing much needed structural reforms in the agricultural sector where 60% of workers are over the age of 65. Managing monetary and fiscal policy will be crucial to restoring the country's growth potential in the medium to long-term.

While there were many rounds of investment during Japan's "lost decade", it is estimated that over half of what was spent during that time has already been spent in less than one year on the current financial crisis. However, public investment has not yet strengthened domestic consumption. Although Japan will suffer from deflation in the medium to long-term, the OECD 2010 forecast indicates a 0.7% GDP growth for the year.

Is political change possible in a period of economic uncertainty? While the Japanese system has been very responsive in times of crises the type of change produced was never of a structural nature, because of the holistic character of the nation's political economy. Realizing structural change and paying off past debt will be costly; however, if this imperative is

ignored today, the cost for Japan in the future will be significantly higher. There is no easy way out – the political parties in Japan need to come up with clear platforms and realistic changes to end the political and economic stalemates.

Yuko Kawamoto, Professor at Waseda Graduate School,

considers that, although political reshuffling will not be necessary, political discipline will be critical to a successful recovery. Lack of public discipline will lead to a lack of private sector discipline because inefficient companies that receive public money will remain so unless they are forced to change. Corporate sector efficiency has to be increased, especially in the services sector, ultimately leading to a recovery in the household sector. Great fiscal discipline will be needed in the future, particularly from local governments, given the surge in government debt and the tax burden. As government's debt inflow now exceeds 200% of GDP, delaying the burden to future tax payers will serve only to increase the disparity between the generations.

For **Shunpei Takemori**, Professor at the Faculty of Economics at Keio University, while no single industry will drive Japan's future economic growth, the healthcare and nursing industries have important growth potentials in light of Japan's demographic changes and will thus continue to expand in spite of the economic situation. The issue of reducing waste in healthcare industry is becoming crucial for most countries, and Japan is facing many of the same challenges that Europe faces in transforming a source of economic decline into a source of economic dynamism and a source of renewed economic activity and growth.

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LDP or DPJ: Will it make a difference the morning after?

With Japan's next upcoming general election, the much debated question is whether the long-term rule of the Liberal Democratic Party (LDP) will finally come to an end. While the competition between the LDP and the DPJ is intensifying, strong manifestos are needed on both sides to outline party positions and delineate clearer campaign platforms.

As **Jun Iio**, Professor at the National Graduate Institute for Policy Studies points out, there are a number of uncertainties in Japanese politics: the LDP has been Japan's dominant party for most of the post-war period since 1955, with a short exception in 1993, and would lead to systemic continuity should it win in the general elections. However, if the DPJ wins, the lack of party cohesion will lead to greater uncertainty - as many DPJ members are former LDP members with different ideological and policy positions.

The upcoming election could be a turning point for Japan's political scene, but the public will have an active role to play. To counter Japanese voter passivity, policy options need to be clearly explained and delineated as the electorate is interested more by which policies will be implemented rather than by which party wins the election. Prime Minister Koizumi was very popular and good at communicating with voters. He contributed to prolonging the life of the LDP and still remains in the public's memory even though it has been three years since he left office.

Since Koizumi's retirement in 2006, the LDP has returned to its traditional style of formulating policies, with little consideration for change or the urgency of certain social and economic

issues. A key problem involves the government's tendency to provide short-term remedies for economic downturns such as deficit-spending stimulus measures. This failure to deliver more long-term sustainable growth has led to party leadership instability, resulting in three Prime Ministers in the span of three years, thus paving the way for possible electoral defeat.

Today the DPJ as the opposition party is much stronger than the coalition of seven political parties that it was several years ago when it was quickly put together after the LDP's 1993 defeat. Although the DPJ has not clearly defined its position on economic reforms and social welfare, strong manifestos from its leaders would be important to reducing uncertainty.

While the democrats have some program suggestions, they have not yet developed a strategy about how to cut Japan's deficit. The DPJ can count on the support of over 50% of the bureaucrats, but this comes with a price as politicians cannot control the bureaucracy and must

therefore favor keeping a low profile over direct confrontation.

For **Robert Feldman**, the differences between the two parties' economic policies are nuanced and complex. Moreover, the lack of numerical analysis combined with cost of public opinion polls makes it difficult to promote political debate; however, at the current levels the LDP will win 197 seats and the DPJ will win 220 seats. The real question is whether the LDP can survive a defeat and the DPJ a victory. In a way, the best case scenario for Japan is that the next election serves as a trigger for real political realignment between the two parties.

If the LDP cannot survive a defeat and the DPJ cannot survive a victory, will this election be a real turning point?

Japan needs to find ways to have a system that allows for strong political leaders to emerge to be able to address the country's growing problems in order to construct and reinforce the type of country that Japan will leave to its future generations. A strong leader like Koizumi managed to extend the life of a dying party and was a success in the short-term; however, Japan is now paying the price of reforms that did not go far enough or deep enough.

Christopher Lafleur, Vice Chairman of JP Morgan Securities Japan, noted that there is currently little enthusiasm and a lot of criticism for most Japanese political figures. Moreover, Japan's young voters are outnumbered three to one by seniors and frequently do not vote - giving rise to a key question: will Japan's political and social landscape be determined by people in their 60's and 70's? One way of balancing out this discrepancy would be to lower the voting age from 20 to 18. Most importantly, politicians have to find a way to recapture the interest and attention of Japan's young and apathetic voters through the education system and the media.

The leadership's success is largely dependent on communicating with and delivering a clear message to voters. Japanese people want both a set of new faces and new policies. Traditionally, Japanese people used to vote for individuals rather than programs or political platforms. With the rise of new trends and greater attention being paid to political manifestos, this is beginning to change.

To have a chance at winning this election, the LPD needs to emphasize its commitment to one particular issue such as the discussion of the consumption tax once the economy picks up. While the DPJ has announced its commitment to tax cuts and spending money on households and social welfare rather than investing in infrastructure projects, it has not spelled out where the money would come from. In addition, Yukio Hatoyama, the President of the DPJ, has clearly said that the party would not

address the consumption tax for at least 4 years, nor will it discuss the pension system reforms which might prove to be a problem in light of the demographic changes facing Japan.



From left to right: Christopher Lafleur, Jun Iio, Claude Smadja, Robert Feldman, Ryosuke Harada

The LPD finds itself in the minority in the Upper House and there is no sign of the party winning a majority in the Lower House. For **Ryosuke Harada**, Senior Editor at Nikkei Inc., the coming elections might be the beginning of the political change and of a long political season. Even if the LDP wins, it will be difficult for it to push a political agenda forward as it will not have the majority in the Upper House. This situation has the potential to lead to political chaos, except if a double election were to be held and the influence of different groups might become clearer.

Will the steady decline of the LDP lead to the complete extinction of the party and to the creation of a new political system? If the LDP cannot survive a defeat and the DPJ cannot survive a victory, will this election be a real turning point? If the DPJ wins, the voters might not be prepared for such a change and the DPJ might find it a challenge to survive. The party has made it clear that it would place less importance in bureaucrats, but the financial crisis has had a large impact on the government's structure and Mr. Ozawa might have to join hands with the bureaucrats. A successful DPJ government will be one that actually gives power to a few bureaucrats

although it might be bashing them on the surface.

Exploring Japan's new green frontiers of growth

The current structure of the economic crisis is unique in that while the market for durable goods in developed countries has become saturated and demand is mainly for goods replacement, the potential remains quite great in emerging market economies. The market in the United States is somewhere between both poles as it is a developed country but has a large percentage of first and second generation immigrants from developing countries that are stimulating demand, particularly as large amounts of credit were made available to them. The challenge now facing Japan, Europe and the United States is how to create new demand in order to keep their industries afloat.

The new 21st century paradigm in these countries has two aspects: the world is becoming smaller in terms of water shortages and economic capacity as well as heightened pandemic risks; and society is ageing as birth rates decrease and life expectancy increases. These factors and limitations must be taken into account when launching new industries, and green growth is proving to be an opportunity that balances these limitations with new opportunities.

Energy consumption in Japan can be broken down into 3 sectors: energy transformation 30%, manufacturing 31% and daily life which includes the movement of people and goods 39%. Of the electric power generated, 45% is used in manufacturing and 55% is used for daily life – a proportion representative of most developed countries. The error that Japan has made is that it has focused on reducing CO2 emissions on the manufacturing side to the detriment of daily life which uses a greater percentage of energy. It is

particularly important as there are significant potential reductions to be made in consumption. **Japan should take the lead by proposing self-sustained bonds that would, for instance, help buy solar panels and collect electricity charges until the redemption of the bonds after which people would receive “clean” electricity for free.**

While for developed countries this is an efficient way to have greener growth, it is an entirely different matter for developing countries. From the 1960s-1990s, the consumption of energy needed to produce a ton of cement was reduced by half due to process improvements in industrialized countries. China today makes half of the world's cement and uses 70% more energy to produce the same amount of cement. This is an excellent opportunity for a technology transfer with the initial investment made through international financing and free market mechanisms.



From left to right: Hiroshi Shimizu, Hiroshi Komiyama

Technology transfers would be particularly useful in China as it would allow improved energy efficiency in production and manufacturing and would help this country to move away from coal-based electricity generation. Similarly, electric cars would have an important impact in moving along a green growth model; however, financing ability will play a crucial role in the viability of green growth projects and new business models will be needed for what would be a win-win process for everyone involved.

However, as **Kazuhiko Toyama**, President & CEO of Industrial Growth Platform Inc., pointed out, the financing aspect is crucial for a green growth strategy. Between 2003 and 2007, his company teamed up with the Japanese government to intervene and invest in the market. What they discovered is that the Silicon Valley model does not work in Japan, and that venture capital investment is problematic due to the relatively small market where high risk is rewarded only by low returns on investment, thus failing to reward investors. In Silicon Valley, there are universities and tax payer money involved in the investment process and there is an eco-system that has been established between the for-profit and the non-for-profit sectors.

Japan suffers from a shortage of patient risk money players, compared to Europe and the United States; unfortunately, risk money is not very patient by nature. When Japanese venture capital is available, it is provided by the subsidiaries of big banks which are risk averse. There are also institutional deficiencies in terms of capital market governance, taxation, fund management legislation that are quite problematic in Japan. The traditional “death valley” that exists between the basic research phase, the high-risk transition phase and the medium to high risk commercialization phase has become deeper with the financial crisis.

The closed system on the technology and business side, the lack of professionalism on the venture capital side, and the lack of risk capital in the financial markets are socio-economic handicaps that stem from traditional problems in the Japanese society. In order to address the problems discussed, the Innovation Network Corporation of Japan INJC, a public-private for-profit partnership, will soon be established to ensure availability of a more patient and lower-

cost capital; it will not be a traditional cash distribution from the government.

For **Tetsuro Nagata**, President of Eurus Energy Holdings Corp., investing in green technologies is an important economic opportunity for the 21st century. Founded in 2001, Eurus energy has become one of the top 10 wind energy companies in the world, with half of its capacity located in Europe and a quarter located in Asia. Since last year, the United States has been the top generator of wind power in the world as its new “green” new deal has a target of producing 8 giga-watts of energy.

Financing for wind-generated power, as well as other forms of green energy, is being set up by governments in Europe as well as in Korea. However, financing has dropped in importance in Japan and there has been little increase in investment due to the low purchase price of regular electricity which is less than half the purchase price of wind power. The cost of the latter has increased significantly due to the higher cost of steel needed to construct wind turbines and returns on investment are becoming more difficult to obtain.

From the investor's perspective, promoting venture and private capital investment will be essential to the success of new green technologies. While there are alternatives to the stock market in the United States, venture businesses in Japan are owned in larger proportion by their founders. Whereas investors can vote and are a part of the decision-making process in most US startups, investors in Japan are only given observation rights and are not a part of management decisions. This lengthens the time between initial investment and IPO, and makes investing in Japanese startups less attractive.

The closed system on the technology and business side, the lack of professionalism on the venture capital side, and the lack of risk capital in the financial markets are socio-economic handicaps that stem from traditional problems in Japanese society.

Wind power fluctuates according to wind stability and therefore causes stability of supply issues. Having a better connection between different power companies with monopolies over their region through the expansion of a power grid could enhance efficiency of decreased costs for consumers. Developing batteries to store the generated power would also help increase supply stability.

However, the battery would increase the cost as it would need to store from 20-30% of the power generated. How much consumers want renewable energy and what prices they are willing to pay for cleaner energy remains unclear and the added cost of storage may decrease readiness to invest. Investing in solar power is also an interesting opportunity, but like wind power, fluctuations need to be diminished.

For **Hiroshi Shimizu**, Professor at the Faculty of Environment and Information Studies at Keio University, one of the first to develop a commercially exploitable electric car, new methods of transportation are primordial to the infrastructure of a green society. Sharing the battery between two or three groups could greatly decrease costs of the battery and CO2 emission could be cut up to 90% by using electric cars.

This is because the most important challenge to commercializing electric cars on a large scale is the battery. As of now, battery performance is low compared to the high cost associated with the relatively small levels production. It takes 7 years for markets to mature in developed countries and 20 years in developing countries. Ultimately, if 100,000 car batteries were to be produced on a single production line, unit costs could be brought down significantly.

How can essential reforms be addressed? Tax system and social security system reforms

While promoting its goal of sustainable development by transitioning to a low carbon economy, Japan also needs to address its two important demographic challenges: its ageing population and low fertility rate. The choices made will have a decisive impact on Japan's future.

With 22% of the population over the age of 65, Japan is ageing at an unprecedented speed and studies currently show that by 2050, Japan's population will have dropped to less than 90 million, a decline of approximately 1 million people per year. Despite Prime Minister Aso's statements on pension reforms, the current administration is not moving forward on this issue. Increasing the consumption tax - the most critical reform - requires a level of political determination that has not yet been witnessed in the Japanese political system. No notable progress will be made as long as the LDP and the DPJ do not find a middle ground on this issue.

Fundamental discussion is needed to change the system before it is too late and collapses.

As **Naohiro Yashiro**, Professor of Economics at the International Christian University, sees it, the collapse of the social security program is a striking example of the regime's failure to respond to the electorate's demands for social security and job creation and is indicative of the political mess and stalemate in which the system now finds itself. The scandal triggered by the loss of records of payments of 50 million people showed how the system established 40 years ago has become obsolete. People have

lost their trust in the government's ability to deliver the necessary change to existing social programs. Indeed, the Japanese pension system, reformed in 1995, is complicated and inequitable as every person over the age of 20 must pay the same tax, regardless of age and income levels.

Japan's ageing society and the increasing percentage of pensioners in the population are creating a generation gap in which the young are paying increasing amounts for future welfare but can only expect 60 or 80 % returns at most. For **Kazuhiko Nishizawa**, Senior Researcher at the Japan Research Institute Ltd., this situation – and the need for reforms – has not been made clear to the Japanese electorate which has now less confidence in its elected representatives.

The consumption tax was introduced in 1989 to broaden the tax base, and was increased from 3 to 5 % in 1997. The 1996 reform gave the public the impression that reducing expenditures would be

sufficient to fill the ¥60 trillion shortage in the primary budget balance. However, such a plan meant increasing contributions as well as taxes, and better communication on the government's part would have ensured increased public debate and dialogue. Unfortunately, the discussion was side-tracked to the issue of the controversial consumption tax, leaving aside the income tax issue.

Today, the system's imbalance and structural problems are in urgent need of restructuring as past "patchwork" remedies are clearly not working. While the strategies advocated by the LDP and the DPJ have little visible differences,

little more than superficial reform can be expected. For **Zentaro Kamei**, LDP Member of the House of Representatives, new solutions must be explored in pension reform discussions, including greater participation on the part of the electorate, functionality of the pension system, and redefinition of the wealth redistribution system. The proposals presented by the LDP in December 2008 and supported by numerous business groups in Japan is currently the only option on the table; however, it is currently on stand-by until the elections.

When Prime Minister Koizumi shaped the consumption tax reform and pension program, he focused on reducing spending and waste

rather than on increasing taxes. This was also the case for the medical system in which Koizumi only looked at special-interest groups such as doctors and social insurances, but not the patients themselves. For **Shigeki Morinobu**, Professor at Chuo University, the dissatisfaction with the system explains why a large number of people are not paying their required contributions.

Today, Japan needs to find a balance between contributions and benefits. Tax rates have been reduced numerous times to continue to bolster government support: however, the income distribution needs to be considered in order to define social security benefits for all, especially lower income categories.

This new package should also include progressive social security payments and would mean a basic change in the pension program. However, this might prove challenging to implement as there is very little possibility for debate and discussion in the committee on health and welfare.

The collapse of the social security program is a striking example of the regime's failure to respond to the electorate's demands for social security and job creation and is indicative of the political mess and stalemate in which the system now finds itself.

Having the consumption tax pay for costs associated with Japan's ageing society is not a sustainable solution because of the speed of the demographic change and ensuing economic implications. Today, progress is needed on the stalled policy reforms in order to reduce corporate tax rate as well as widen the tax base. What kind of new mechanisms are needed to make decisions on tax?

Instead of letting the government committees take care of this issue, political parties should intervene and come up with strong manifestos that they can use as a campaign platform. Indeed, committees appointed by the government generally represent the views of the chairman and advisory councils are inefficient as they represent narrow interests. The party tax committee currently has the upper hand on the revenue side while bureaucrats of the budget bureau protect their budget and plan spending. The budget should be decided by politicians. The vertical compartmentalization of the Japanese bureaucratic system needs to be broken down and separated from the Ministry of Health and Welfare as well as other ministries.

Political leadership is critical to a successful implementation of reforms, thus the rapid turnover of Prime Ministers represents a major hurdle to continued progress and structural change. Fundamental discussion is needed to change the system before it is too late and collapses. Bipartisan councils are needed like those initiated by Koizumi but they were unfortunately immediately disbanded after the departure of Mr. Koizumi. Today, the LDP mindset is starting to change, but Japan's ultimate contradiction remains: while everybody knows that it is not good for Japan to be controlled by bureaucrats, would control by one party or the other be better?

Deregulating the economy: how to break the deadlock

Economic growth is generated by either an increase in the factors of production or by total factor productivity increase in terms of innovation and efficiency gains from resource reallocation. Today, necessary GDP growth in Japan must be achieved either by increasing the diminishing workforce or by increasing productivity.

The service sector represents about 70% of Japan's GDP. An increase in the very low productivity in this sector would spur future economic growth. By 2030, if productivity continues to increase at an estimated 1%, the economy would grow by 1.22 times rather than 1.64 times if productivity increase was brought to 2.5%, creating an important difference in the potential size of the economy.

While supply side policies are critical, they alone cannot generate growth in the service sector. The

Japan needs to increase its productivity, decrease its debt and better utilize its workforce, focusing on job creation rather than job protection.

government must also focus on increasing domestic demand and consumption, which have considerable potential for growth. The amount of financial assets in Japan is approximately four times, higher than in the United States and the United Kingdom where the ratio is three, and France and Germany where the ratio is two.

Middle aged and elderly citizens have an estimated ¥100 trillion in saving but are less likely to spend this due to heightened feelings of insecurity and concerns about the future. Generating domestic demand despite the insecurity of Japan's ageing population will nevertheless be critical to boosting GDP growth.

In that respect, social security reform will be crucial to changing people's mindsets and lowering aversion to risk. And, in addition to financial restructuring, one option for increasing support for the social security system would be to increase the value added tax rate.

Rules and regulations are engrained in Japanese culture, remarked **Ken Shibusawa**, Chairman of Commons Asset Management Inc. The question facing Japan today is whether current regulations work as a foundation for society or for a system that is functioning less and less efficiently and needs to be overhauled. Regulations should be analyzed in function of their impact on society and who the winners and losers will be, a dialogue that is not currently taking place.

There is no quick fix for the systemic problems facing Japan and the process will be all the more time consuming as public sector experience is lacking for the reform process. While a number of people are moving from the public sector to the private sector, the reverse flow is negligible. The mandatory retirement age is exacerbating this problem as skilled workers are being forced out of the workforce rather than being able to continue to contribute their talent to the rapidly shrinking workforce.

Investing in education is crucial in the long-term as this is a long term investment that will pay-off in the next 30 to 40 years. Japan currently spends 4-5% of GDP on education, while over 6% is spent in countries like Korea and Singapore. It will be important to educate future generations to "think outside the box". However, while the next generation of leaders from different countries is being admitted to a number of foreign universities, particularly in the US, students from Japan are not even applying. This trend needs to change in order to form future leaders capable of addressing Japan's economic and social issues.

Okii Matsumoto, President & CEO of Monex Group Inc., said that deregulation in the

financial sector will become increasingly critical as the decline in Japan's population continues to drive down demand for financial services. Banks and financial institutions should not be protected through the injection of public money. The financial and telecom sectors are the weakest but the most protected, and do not provide a reasonable return on the assets that the government invested in them.

In so far as the government should not invest in financial institutions, it should not heighten protection of private assets. The behavior of imprudent traders should not impact the ability of regular investors to leverage opportunities that come across. This system is creating distortions as big opportunities are shifting out of Japan toward the United Kingdom. The government's administrative branch is not looking at the overall view; by delaying the unavoidable, this will incur higher costs in the future.

Deregulation in Japan will involve making rules that open up and liberalize the domestic market with a more *laissez-faire* attitude. Empowering investors will be important in decreasing the cost of deregulation as well as increasing productivity and job creation.

Mitsuko Shimomura, Journalist and Special Adviser to the Center for Health Care and Public Concern, believes that the recent backlash against deregulation and the Koizumi reforms is exactly what is at the heart of Japan's problems. The century of tradition embodied in the Japanese postal system was impossible to break within a short period of time by the Koizumi reforms which today are viewed as insufficient and ineffective.

Healthcare expenditures represent approximately 8 % of GDP, an insignificant amount in the face of Japan's aging population. Both deregulation and re-regulation are needed in a country that spends far less than most other developed OECD countries on healthcare, with the lowest number of doctors and nurses per

capita. The ageing population and a low birthrate are increasing opportunities in a service market for the segment of Japan's population that holds most of the nation's savings. Maintaining the health, particularly the mental health, of the elderly may help decrease costs and increase their contribution to the workforce and the economy. Increasing activities in the private sector while allowing for individual patient participation toward expenses, through various private insurance plans, is critical in addressing Japan's growing needs.

The current implementation of small changes is very much like putting a band-aid on a wound without cleaning it. Advanced medical therapies involve lengthy approval processes in a heavily bureaucratic sector. The 10-year timeframe for introducing new drugs and medical technologies as well as the often outdated procedures and lack of experience in publicly-owned hospitals is becoming more and more problematic.

Fundamental reforms are needed in order to decentralize and consolidate the numerous hospitals providing general care in order to increase efficiency and provide the lacking advanced medical care. Doctors should be allowed to focus on their specialized areas of care while highly qualified managers focus on taking care of the day-to-day management of the institutions, which is not the case today.



From left to right: Motoshige Itoh, Oki Matsumoto, Sachio Semmoto

For **Sachio Semmoto**, currently Founder, Chairman & CEO of EMOBILE Ltd., who created the first private-sector telecom carrier KDDI, trying to survive in the highly regulated and monopolistic telecommunications industry has been a constant battle for entrepreneurs in the midst of the numerous regulations and protectionist measures. However, companies have been able to make significant progress and penetrate the market in competing against NTT-family of monopolies which represent 4-5 million employees. The private sector did not wait for deregulation but pushed for it against companies that have clout and influence, in order to establish more equitable rules and allow for more transparency in the industry.

However, the mobile phone industry in Japan is not competitive vis-à-vis worldwide standards, ranking lowest among OECD countries. The failure to introduce GSM standards is an example of the consequences of poor bureaucratic government choices that are impeding development within the entire sector.

Japan needs to increase its productivity, decrease its debt and better utilize its workforce, focusing on job creation rather than job protection. There was no fundamental change in Japan during the Koizumi era, but coming to power in an era where the country needed leadership gave the former Prime Minister the opportunity to address tax policy, education and the ageing population; however, he never finished the job.

Deregulation efforts will necessitate more engagement from business leaders in order to change the nature of the debate and focus on attacking barriers created by Japan's administration, creating better outcomes for consumers. There are eight areas when deregulation is critical; however, none have been put on the table for election programs. The worry now is that the work being done on behalf of consumers will create a sort of "nanny" state in which those affected by regulation changes will be either too bored or

too scared to do anything. Japan needs a new generation of hungry risk-taking entrepreneurs to drive further reform and increase accountability.

Dealing with Japan's real problem: The mindset

All this effort at deregulation and engineering change, at creating a new generation of entrepreneurs able to think outside the box will require what could be called a "mindset shift" in Japan. While the world is a very different place than it was five or ten years ago, very little has changed in Japan. With deflation making a return and the LDP still in power, the nation's debt load is rising and the immigration debate is much the same as it always was.

Looking back over a decade ago, **Masaru Tamamoto** Senior Fellow at the World Policy Institute in the United States notes that the nation has experienced much political drift and has been slow to change. Given current trends, Japan's decline will have a tremendous impact on the younger generation. Over the last 15 years, Japan has been trying to preserve its traditional highly regulated society, keeping itself afloat with a debt now at 207% of GDP. By maintaining this traditional order, Japan will only continue to decline. However, there has been little societal anxiety about Japan's future due to general optimism that things will eventually work out. Today's Japan needs to move away from being the nation of lifetime employment, with a corporate system based on stable cross-holdings of shares, and a large middle-class population in which people are equal.

Unfortunately, Japan today is a political mess with a powerful bureaucracy that controls the

details of everyday life. It is so powerful that no political party is able to tame it or to put in place a coherent national agenda. Tamamoto points out that the crisis is not political, but psychological, something that most people in Japan are not conscious of.

Since WWII, Japan's rise to economic greatness was basically a catch-up game with the West. However, since catching up, Japan has spent the last two decades in utter paralysis, mistaking security and predictability – in exchange for personal freedoms – for progress. Today, signs of despair are omnipresent, from one of the highest suicide rates among developed countries, to the 12.5% single population living with their parents, to the serious problem of a declining and ageing population. Japan has not been a tolerant and open society and this has impacted current trends that predict a population decline from 120 to 90 million over the next 50 years, at which time 40% will be over 65 years old.

***The most important change needed
in Japan's mindset is in its attitude
toward risk-taking.***

The most important change needed in Japan's mindset is in its attitude toward risk-taking. Japanese people used to be satisfied with the nation's administration which ensured a risk-free environment. However, this has just become too costly, particularly in light of the important demographic shifts forecasted over the next decades.

But, how can and how will Japan change? Japan's goal is to develop a much needed but less popular kind of debate, of critical thinking and dissent within its social fabric, and particularly within the media.

Japan has yet to understand the role of liberalism in the context of modernity as it often confuses it with individual autonomy or selfishness. The notion of progress rests on establishing individual autonomy and liberty while Japan's bureaucratic rule has provided

security and predictability in exchange for this freedom. However, Japan's leaders today can no longer guarantee employment, health and retirement security and people are left feeling not only insecure but constrained.

While Japan is the world's second largest economy, it maintains low visibility in the international arena. **Kiyoshi Kurokawa**, Professor at the National Graduate Institute for Policy Studies, observes that Japan has an inward-looking mindset that needs to become a more outward-looking one. Japan today must focus on its core strengths, on its past history and culture, as well as on its manufacturing industry as it emerges from the global economic crisis. It has a strength and clear advantage in the area of clean technologies and should use this to its advantage in creating a production niche. However, its mindset is a source of weakness as there is a lack of creativity and entrepreneurial spirit – and when these qualities have been present, they have often been crushed.



From left to right: Shunya Yoshimi, Kiyoshi Kurokawa

It is interesting to note that there is no term in Japanese for “entrepreneur” and that individualism or individual identity, the driver of an entrepreneurial mindset, is lacking. Kurokawa believes that it is crucial for Japan to open up to the world and change, particularly when it comes to the participation of women in the workforce. For instance, in the United States 4 out of the 8 Ivy League universities

have women presidents while only one of the 80 national universities in Japan has a woman president.

For **Shunya Yoshimi**, Professor at the University of Tokyo, the Japanese mindset is much ingrained in its culture and history, with a pro-American mindset that took root in the post-World War II era and which has lasted up to the present. For instance, in the 1980s and just before the Iraq war, 72% of Japanese had a strong affinity with the United States; there has been little change in attitude since the 1960s. This is in sharp contrast to the affinity towards China, which dropped to 32% in 2002.

While nationalism reigned in the pre-World War II, this was balanced with feelings of pro-Americanism after the war. During the Cold War era when Japan was under the US umbrella, sentiments of comfort and security grew and many aspired to follow the convenient American way of life. Today this has become problematic in that Japan lacks its own long-term vision and strategy because it has been dependent on the United States for too long and has long believed that the United States would always take care of it.

For **Takehiko Koyanagi**, Senior Staff Writer at Nikkei Inc., this attitude was exemplified within the Japanese public education framework, as there was a change in mindset after the war in which nationalist sentiment in a very poor Japan was transformed into pro-US admiration. Approving the 2009 budget with ambitious programs that increase opportunities for intercultural and student exchanges, which requires universities to offer more comprehensive English courses and attract non-Japanese students and faculty is critical to keeping Japan economically robust and competitive.

It is important to note that there are fewer and fewer Japanese students applying to American graduate and undergraduate universities, from 45,000 in 2000 down to 35,000 in 2008. Applications for exchange programs have also

dropped dramatically and today 75% of applicants are women. Maintaining exchange programs and cultural exchange will be crucial to opening Japan up to increasingly interconnected global economy and community.

Does the political stalemate in Japan today derive from the mindset and lack of entrepreneurship? In the late 1990s-early 2000s, entrepreneurs were viewed as greedy and selfish, and a characteristic of the individualism that was developing in Japan. It is worth noting that the people most critical about Japan's inability to cultivate and promote entrepreneurship and openness to progress are those who have spent time abroad.

Further openness and a recognized need for change today are pushing the government to invest in and encourage entrepreneurship, by launching new programs in science and technology in Japanese universities and research, in a way similar to the ones the US government helped launch in Silicon Valley. However, a greater diversity of values is needed in the education system as even private universities receive 30% of funds from the government which has in the past encouraged standardized thinking.

There are many obstacles to startups in Japan and the probability of them thriving and becoming major presences is extremely low. As in nature, a large number of startups are needed in order for just a few to survive; unfortunately, Japan does not yet have a critical mass. The small number of startups is due in part to high value that society places on security and the penalties for failure.

The taxation system and financial institutions must change the rules of the game before attempts can be made to change the mindset. While there are reservations about success in the short-term, the much needed change should be forthcoming in the long-term. Foreign and

domestic investors, not just public funds, are needed for capital injections into small and medium enterprises and will force companies to become more transparent, enhance risk tolerance and encourage greater risk-taking.

The diversity within Japan has not been leveraged enough and liberating local mindsets will provide important opportunities for growth and decreased uniformity.

As observed during the discussion, that the Japanese are conformist and try to label themselves as a single people with a single culture. There are however tremendous differences and diversity within each of its provinces. The diversity within Japan has not been leveraged enough and liberating local mindsets will provide important opportunities for growth and decreased uniformity.

Ultimately, the change in Japan's mindset needs to encourage the development of more morally autonomous individuals who are ready to make decisions and take on responsibility. Without this, the political and economic stalemate will persist and the system will continue to breakdown.

The US, Japan and China: How is the triangle changing its shape? The implication for Japan

The US, Japan and China have become increasingly economically inter-dependent, particularly since the beginning of the global financial crisis. While both Japan and the United States seem to be suffering exceptional economic downturn, China's is fairing somewhat better and is likely to come out of the crisis with a balance of power change in its favor. What will shape this triangle of power between the three countries and what are the implications for Japan?

Japan needs to pursue strategies that will establish and strengthen its role in this

tripartite relationship where the dynamics are constantly changing. With the new economic and geopolitical Asian reality being reshaped by China's emergence as a rich and powerful neighbor, the bilateral relationship with the United States and a relationship with the new Obama administration will be a gateway to a huge pool of technology, credit, and markets.

If the Bush administration had elements of being the transforming agent in the relationship with Japan, Barack Obama is a system builder who believes in the power of dialogue and a multilateral approach. However, as is almost always the case, when the interests of three different parties are at stake, the triangle could easily turn into a competitive relationship with two of the members vying for better advantages vis-à-vis the third, or a fruitless battle of two against one. Jim Steinberg, Deputy US Secretary of State, is looking to develop a meaningful and pragmatic architecture in Asia, not only Japan and China but other countries such as Korea, in order to ensure the region's stability and global orientation. This multi-tiered dialog system is one of many that are taking place on climate change, terrorism and the global economy.

However, this triangular relationship is not equilateral since the three powers themselves are unequal. One side of the triangle, the relationship between the United States and Japan, has been bolstered until now by a strong security alliance. However, this configuration is changing as the country is becoming increasingly handicapped by its coalition government structure as well as the need to leverage its new friendly relationship with China.

With the Japanese political system in disarray and the perceived "China threat", it will be difficult to ensure that Japan's policymakers remain focused on the strategic interests in Asia that it shares with the United States.

On the second side of the triangle, China and the United States have begun to develop closer

diplomatic and economic relations, much to Japan's unease. Indeed, the new US administration is developing a new paradigm which has already led to an improvement in US-China relations; China continues to buy US bonds as it counts on the US to buy Chinese exports. Today, China's nominal GDP is 70% of Japan's and continues to catch up rapidly.

The current relationship between China and Japan - the third side of the triangle - is complex and brittle. While the United States and Japan have a security alliance, the US and China have begun to develop closer relations. Today, China is emerging with a different philosophy, pursuing its own interests while trying not to antagonize the US.

As China seems to be moving hand-in-hand with the U.S., how should Japan treat its Chinese neighbor?

The security relationship

between Japan and the United States is well established whereas China lacks transparency in its military efforts and doctrine. In this context, G2 talks between the US and China are not as strong as they could be and consequently Japan should be careful not to marginalize itself. While there is increasing concern about growing nationalism among Chinese youths, Japanese youths are characterized by their apathy. Japan should respond to China's military expansion by enhancing the security dialog between the two countries.

While this tripartite relationship represents 45% of the world's GDP and will affect the world order, other rising powers, such as India who

Multilateralism is a hard framework for Japan to work with as it implies a proactive approach when Japan seems to give priority to bilateral agreements.

will have the world's largest population by 2020, will also play a significant role in the future. With ASEAN's weak presence, the Japan-US-Australia and Japan-US-Korea are two other important alliances that should not be ignored, particularly since they could help position Japan at the center of economic and political security in the region.

So what does it mean for Japan? Multilateralism is a hard framework for Japan to work with as it implies a proactive approach when Japan seems to give priority to bilateral agreements. Bilateral alliances and relationships are nevertheless crucial for the triangular structures, especially in the areas of global warming, climate change and most importantly energy – the latter is an area where Japan is extremely strong and has a lot to contribute.

Nuclear-related issues such as the storage of nuclear waste and the safe use of nuclear energy are also of considerable importance and Japan needs to take a leadership role against nuclear power.

Indeed, the relationship between the three countries has entered an era of mutual military reassurance which is being put to test after North Korea's recent series of missile launches. Moreover, the US-Japan alliance is fundamental to the US positioning in the Pacific, but with the pressing issue of growing security challenges in Northeast Asia, is the United States currently in a position to reassure Japan?

For **Jangyong Liu**, Professor at Tsinghua University and an expert on the Japan-China relationship, there is a growing skepticism against the US model and Japan should feel more confident in the region and not only follow the initiatives taken by the US as a resident power in Asia. Indeed, Japan needs to maintain good relationships with the two other players whilst pursuing its own opportunities. Whilst Japan has benefited from the opening of China's economy, China remains more effective when it comes to exercising soft power: both

Japan and China should promote exchanges in terms of security issues.

Today, Japan could serve as a model to other Asian countries on a number of issues such as peaceful emergence, human rights, and green growth. However, when it comes to military issues, Japan is less exemplary even though it has the potential to strengthen its security dialog with China, as was the case when handling the piracy issue in Somalia when both countries agreed to cooperate in order to protect their vessels from further attacks.

A constructive approach towards confidence building measures between the United States, Japan and China is needed as there have been tremendous changes in the three relationships over the past three decades. While the Sino-Japanese economic base was small, trade relations have changed today. China has become Japan's largest trading partner and will continue to be a major export partner. The trade relationship between China and the US is also very important as the US is China's largest trading partner.

It is clear that important changes have weakened the ideological confrontation between the three powers which are now largely interdependent, but the historical legacy between Japan and China can still have a negative impact on future dealings. ●

The Roundtable Japan 2009

Thinking the future of Japan in the global context

PROGRAM

Friday 5 June, 2009

18.00-18.05 Welcoming Remarks

18.05-19.15 Opening brainstorming discussion *“Japan crunch time: Can the country deal with the worst economic and political crisis since WW II?”*

19.30-21.15 Opening dinner

Saturday 6 June, 2009

08.45-10.15 Opening plenary *“A recovery? When, how? What prospects for the world economy and Japan?”*

10.45-12.15 Brainstorming in parallel

- *“Dealing with Japan’s real problem: The mindset”*

- *“How can essential reforms be addressed? Tax system and social security system reforms”*

12.30-13.15 Networking Lunch

13.15-14.45 Brainstorming plenary *“LDP or DPJ: Will it make a difference the morning after?”*

15.00-16.30 Brainstorming in parallel

- *“The US, Japan and China: How is the triangle changing its shape?
The implication for Japan”*

- *“Deregulating the economy: how to break the deadlock”*

17.00-18.30 Closing brainstorming *“Exploring Japan’s new green frontiers of
growth”*

18.30-19.00 Farewell cocktail

About the conveners

Smadja & Associates Strategic Advisory, based in Switzerland and in the U.S. (President: Claude Smadja) works with global corporations and government entities on global trends and strategic issues. The firm creates platforms of contents designed to help its clients navigate and leverage globalization.

Forma Corporation, based in Tokyo (President: Yu Serizawa) advises major Japanese and foreign corporations and public entities on cross-border strategies and communications policies.