

Reconnecting with an economic superpower

Japan the partner of choice in pursuit of our corporate objectives

Written by: Joseph Caron, Ambassador of Canada to Japan

For a country as open to the world as is Canada, foreign relations is as much a matter of concern to business, the media, educational institutions, art and performance groups, as it is to governments, both national and provincial.

As a country, we seek to have mutually beneficial relations with just about every other nation in the world. But the reality is that our relationships with perhaps a dozen or so countries provide us with most of the benefits that we can obtain from abroad.

In every sense, the US is by far our most important partner, because we can pursue just about all of our objectives through relations with its governments, companies, institutions and people. However, the US cannot provide for all of our needs, nor would most Canadians want that. More importantly, human ingenuity and scientific progress, not to speak of artistic endeavour and intellectual energy, are found virtually everywhere on the planet. For anyone, any group, any company to limit itself to one market, even the largest one, is to risk not achieving one's potential. Among other things, such neglect can cost real money and real jobs.

I am writing to make the argument that, in the pursuit of our broad interests and individual goals, Japan deserves our renewed attention. As I will demonstrate, Japan has turned the corner on a painful and lengthy period of readjustment and reform. Secondly, there are benefits beyond Canadian border interests that we can best pursue in and with Japan.

Throughout my career, I have had several opportunities to work in Japan. In fact, this is now the fourth decade during which I am living in Japan having had public and private sector assignments there in the 70s, 80s, 90s and now in the second half of the first decade of our new millennium. Based on this experience, I can say in all honesty that I have seen more change in Japan in the last decade, than in any other period over the last 30 or so years. Let me describe some of this for you.

The old Japan

Two decades ago, the 1985 Plaza Accord on exchange rates helped launch a spectacular rise in asset values in Japan, one that led to six years of unprecedented domestic growth, international expansion, and excitement and promise. It was an era of virtually free money lent by banks that had forgotten notions of Return on Investment and moral hazard.

It was an era of Japan as number one: the Tokyo Stock Exchange outdistancing New York and London; Japanese purchase of the Rockefeller Center, the Burning Tree Golf Course, Columbia Pictures. Japanese corporations seemed unstoppable, having invented new corporate cultures and employer-employee relations. The Japanese, caught in a cycle of unprecedented hubris, thought that they had invented an anti-gravity machine, and for a while, we thought so too.

However, in Japan like everywhere else, there is gravity. The turn-around was precipitated by a Bank of Japan decision to increase interest rates and reduce the flow of loans to the real estate sector, combined with a weak international trading environment.

Asset prices stopped rising and began a precipitous decline. Free money had led to bad investments and bad debts. Irresponsibility on the part of borrowers and lenders also led to serious problems of corruption, both political and corporate. Return on investment suddenly mattered. Loans had to be repaid. Badly-run companies could only be kept on life support for so long. The ruling Liberal Democratic Party, heavily dependent on a shrinking rural population, could only manipulate the electoral system so much. Urban voters could only put up with so much and were upset over stagnating employment and loss of national momentum.

As a result of this change in national mood and circumstance, Japan found it difficult to respond to other challenges that hit at the same time. To address the challenges and stop the deflationary stagnation, many in Japan felt that fundamental changes were necessary. By now, all of the reforms have, largely, been implemented.

In 1996, the introduction of a single constituency electoral system reduced the influence of the most anti-market interest groups in the country: the organized farming community and its agribusiness partners; the health industry; the construction industry and others.

In 1998, the “Big Bang” bank reform package sought to reduce non-performing loan portfolios to sustainable levels.

In 2001, the LDP chose Junichiro Koizumi as its leader. Mr. Koizumi had campaigned, interestingly, on the promise to destroy the traditional LDP. Rather than acting as a scripted fall-guy, Mr. Koizumi actually launched the process that has transformed the party and led to three majority electoral victories, all the while significantly changing both the political landscape and the rules of the game in Japanese politics.

Let me just describe some of the economic reforms that have been put in place, and their consequences, to make the case that Japan has changed very significantly in the last decade and that these changes have made the current economic turn-around sustainable.

Reform of the micro-economy

Micro-economic reform, while being incomplete, is nevertheless the most transformative element in today’s Japan. The Takenaka Plan aimed at 50% debt reduction by 2004 was easily met by banks. The 1998 “Big Bang” in the banking sector and creation of the new regulatory financial services agency have also resulted in the reduction of corporate debt.

Some of these results are due to the fact that there has been substantial deregulation in the telecoms, transportation, energy and retailing sectors. There are major reforms to anti-trust laws and a stronger fair trade commission to administer them. There is greater readiness by the Tokyo Stock Exchange to discipline its members. The commercial code is being overhauled to facilitate more rational movement of assets, including those of bankrupt companies; foreign firms may, later this year, be allowed to use their shares as currency in acquisitions in Japan.

Changes in ownership patterns are transforming the commercial landscape in Japan. In 1991, 46% of all listed equities were held as cross-shares, by one friendly Japanese company to protect the management of another. Today cross-shares represent approximately 20% of shareholdings. A decade or more ago, only 6% of shares were held by foreign investors. Today, they hold 24%. Foreign and domestic investment funds and partnerships are daily challenging existing managements, and signature companies such as Nissan and Sony are headed by foreigners.

Recovering economy

The Japanese economy expanded by 0.3% in 2002, 1.4% in 2003, 2.3% in 2004 [and] 2.8% in 2005 (including 5.5% in the last quarter of 2005). It is worth noting that a 2.8% increase in GDP adds \$140 billion to the economy, which in turn is about 20% of the size of the Canadian economy as a whole.

As of the end of April [2006], Japan has seen steady growth during all of the last 51 months, 14 of the last quarters, making this era the second-longest growth period since the 1960s.

Surveys of business attitudes show that business confidence has been rising steadily and is at its highest level in five years. Confidence is also reflected in the stock market indices, which have been rising since 2003.

Above and beyond these indicators, there is something to be said about popular psychology. I lived in Japan during the 1980s. I have just spent four years in China. I am now back in Japan. What I sensed in these various places and periods and what I sense now is a kind of public confidence, a kind of optimism, a

kind of expectation that problems can be managed and opportunities abound, and that it's a good time to be planning and investing in the future.

The impact of globalization

Perhaps even more significant is the impact of globalization on Japan. In my view, the country has been transformed from a trading nation to an investing nation and increasingly an invested nation. Japan's FDI stock is roughly on par with that of Germany or France, but it is concentrated in Asia. Combined with Japan's technological lead, Japan is at the centre of many of the Asian region's supply chains. Its companies are lead players in China [and] throughout Southeast Asia, even in Korea.

Inward investment is also significant, especially portfolio investment. This has brought a degree of internationalization to Japan that cultural imports through media and the movies had not earlier achieved. Japan is thus more obviously international than it has ever been and more open to new ideas, products and partners.

Yes, there are problems. The Japanese believe that Koizumi's five years have resulted in real progress in addressing the issues that arose during the 1990s, but they also feel that there is a growing inequality in Japan. They know that government debt is now 95% of GDP and that serious tax reform is essential. They understand that reform is not complete. They realize that demographics are not in their favour.

However, it is clear that structural problems have or are being solved, and thus, they are confident in their prospects for the future.

The Canadian dimension

It is in the interest of Canadians that we acknowledge and share this confidence. We have to recalibrate what it is that we can obtain from Japan, in pursuit of our national, corporate, institutional and personal objectives from these new realities.

We have to remember that, in discussing Japan, we are talking about the world's second-largest economy; bigger than all of Asia; twice as large as China. The region around Tokyo alone has a bigger economy than that of Canada. The Kansai and Nagoya regions have a higher GDP than that of Germany. We are talking about the USA west of the Mississippi; the country with the highest individual assets in the world; the world's biggest creditor nation.

So, going back to our starting point, and at the risk of putting it crudely, what is it that we, as Canadians, can get from this renewed Japan? What interests can we profitably pursue?

Future trade potential

I will mention some other areas of interest, but let me focus on future trade and economic potential. Canadians are now selling about \$1 billion in goods and services to Japan every month. Similarly, our imports from Japan are over \$1 billion per month. Counting in both directions, trade in goods and services between Canada and Japan account for about 10% of our total non-USA trade.

The fact of the matter is that the Japanese are among the wealthiest people in the world, with some of the broadest distribution of income. Thus, if you are in resources or in high tech or in services or just about everything in between, Japan has opportunities that you can find in few other markets, if any.

It is worth thinking of Japan as the country with the highest R&D expenditures in the world, on a per capita basis, almost twice the level of the USA and much higher than in Canada. Japan files more patents than does the USA.

Like in just about every area of endeavour, we have to think again. If you are in the life sciences, you have to deal with Japan, which has the lead genomics, molecular immunology, brain science and toxicology.

If you are in environmental goods or engineering services, Japan has the lead, especially in such areas as fuel efficient vehicles and hybrid cars. It is cutting edge in the geosciences, for example, in simulation of

climate change.

Everyone knows that in ICT, Japan is the world leader in inserting technology into products. But it is also cutting edge in new internet protocols, wireless applications and in such new areas as molecular transistors and filters.

Japan is where you want to pursue your partnerships in nanotechnology, in high energy physics, ceramics, new materials [and] polymers. Japan has the lead in electronic gaming and animation, with about 30% of the world market. It remains the world leader in industrial and personal robots.

Because of Japan's aging population and a 60% dependence on imported foodstuffs, it is becoming the world's leading market for organic, gourmet and functional foods, nutraceuticals and other prepared foods.

Japan is also interested in arts and culture. Last year, 55 new CDs were release by Canadian artists in Japan, and over 40 rock bands toured the country or participated in music festivals. Universal, Sony, Warner Music and other majors have released Canadian music in Japan in the last 12 months.

In the last 16 months, 15 Canadian films have been released on the Japanese market as well. Toronto's own NIV Fichman has just finished shooting a Japanese-Canadian co-production of "Silk," based on the best seller of the same name (by Alessandro Baricco). In spring 2006, Cirque du Soleil began constructing a permanent facility in Tokyo.

Conclusion

Every day we read in the newspaper that China's economic growth is one of the most transformative features of our new century. I agree. There are few indices or charts describing China's economic development that don't show a seemingly inexorable vertical, upward movement. Just about everything in China is going up.

Having experienced both China and Japan firsthand, I would describe Japan's re-emergence as growing horizontally; as broadening the reach of its domestic markets, through regulatory reform; as opening itself to foreign influence through the works of inward FDI and market opening measures; as increasing its influence through its investments abroad; as expanding its domestic markets because of the demands of a wealthy and an aging population.

The opportunities that are developing are available to those who make the effort to learn about this new, international, re-emerged Japan. It is my job to insure that you are aware of this new reality. It is your job to insure that you determine how to take advantage of it.

Ambassador Caron was formerly ambassador to the People's Republic of China with dual accreditation to the Democratic People's Republic of Korea and to Mongolia. He has had three prior postings in Japan along with other tours of duty in Asia and Canada. This article was first published in the Fall 2006 issue of *The Japan Society Quarterly*.