



# Changing Mindsets in a world of disruptions

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## Executive Summary



# JAPAN IN A DISRUPTED WORLD

## Geopolitics

The security environment for Japan has become more tense. The rules-based international order is challenged, protectionism is rising, inward looking and nationalist tendencies are present everywhere. The values which underpinned the world stability and prosperity are being questioned.

The Kim/Trump Singapore Summit has ended with very vague results as it did not emphasize the objective of complete verifiable irreversible destruction of weapons of mass destruction (CVID). It is now crucial to keep China on board with the sanctions as Pyongyang is getting more astute at evading them. Japan continues to seek normalization with North Korea, even pledging economic assistance, but only if the nuclear and abductions issues are resolved.

Another challenge is how Japan responds to the rise of China. Establishing a stable relationship with Beijing is crucial for the region and the world. Tokyo wants to expand this relationship, building up high level exchanges but takes a resolute approach to attempts to change the status quo in the South China Sea. Japan is not ready to accept unilateral changes to the international order. It remains a status quo country while China's rise is putting this status quo into question.

Japan stands for a free and fair international trade system in the face of rising protectionism. It is working for an early implementation of the TPP11 and of the Japan/EU Economic Partnership Agreement. Tokyo's foreign policy recognizes that economic growth does not lead automatically to the expansion of democracy. Some Asian countries are still under authoritarian regimes and they will lean towards China if pushed too far. Japan is pursuing an Indo Pacific Strategy to promote stability in a region at the core of the world vitality. This entails:

- the upholding of fundamental international principles,
- the building up of economic prosperity through connectivity,
- the development of peace and stability initiatives in the region

Trump's policies are compelling Japan to make autonomous choices, thus expanding its margin of maneuver, like TPP11 where Japan emerged as a leader on its own right in the region.

As we enter an extended period of readjustment of the international order, Japan has a crucial role to play and needs to take increased responsibilities in ensuring a stable global order. Tokyo and Delhi are collaborating on many strategic issues such as the freedom of sea links.

Japan can play a crucial role in terms of how a great economic power can partner up with developing nations for sound and sustainable infrastructure projects.

## Trade

The Trump administration's trade measures against China are calibrated to hurt China's economic aspirations as the first wave of tariffs was targeted at high end goods while the second set of tariffs, due by August 30, is hitting low end intermediate goods with the objective of forcing the re-shoring of US manufacturing from China to the US. This will disrupt global supply chains with serious implications for Japan. Japanese corporations need to prepare through scenario planning, with flexibility, agility and speed. At the same time, Trump wants to change where things are being in the world and bring back manufacturing to the United States with potential strong implications for Japanese industries and the rest of the world.

It might be risky to bet on a boomerang impact of Trump's measures on US consumers that would put pressure on the administration to change its policies because this effect will take time to be felt and might even not be felt at all in the US.

## Can Japan continue to rely on the US?

Japan is now ready to step in to protect its security and it is now possible for Japan self-defense forces to defend its assets alongside the United States. For instance, Japan is now developing its own intelligence community, but it still needs to count on the US in that domain. The key question is: what should Japan do now to stabilize the US commitments in view of the security challenges in the region? However, it is not a matter of spending more on defense, as the military budget is quite high, but actually to spend more on education. The trend now is to consider extending the security arrangement to Australia and India. For example, Japan and India are now collaborating on many strategic issues with actual commitments and actions on the maritime side as was also illustrated in the Malabar military exercise between the US, Japan and India.

Policy makers are worried that what is happening between the US and Europe will happen between the US and Japan as this is a transition in the US relationship with its allies since the collapse of the USSR. For Japan it is a transition from “free riding” to “cheap riding”, towards a more equal partnership.

On trade, the US is asking Japan what it was already asking since the 1980s. It is on the security side, that change is happening and this is accelerated by Trump in a brutal way. For the first time, there is now a clear linkage between security and economic issues.

Japan is hedging and finding other options: EU, UK, India, Africa, South East Asia, Australia and Latin America.

In fact, it is more a matter of interdependence than reliance in the US/Japan relationship as the US needs Japan and Korea because of China. This is a unique opportunity for Japan to play a leadership role and it is the right time to get over the animosity between Japan and Korea.

### What looms ahead for Trump's America: some Assumptions, Insights, forecasts

During dinner remarks, Harald Malmgren provided some thoughts on America's future under President Trump:

- Trump wants to bring production back in the US. He is doing with German automakers what Reagan did with Japanese automakers and German brands are now negotiating to bring some manufacturing to the US.
- Trump has decided he wanted a confrontation with China but the Chinese know where the buttons are in Washington while Trump just tries and see what the responses are.
- One third of the Senate to be elected in the November mid-term elections will have 6 years in front of them. This will allow some of them, on the Republican side, to feel more independent from Trump.
- The Democrats might very well win the House thanks to the increase of women candidates in the wake of the MeToo movement. A Democrat controlled House will multiply hearings about the people around Trump on various issues.
- Trump might not last beyond one term.
- We might well see a new financial crisis in the next 18 months. The banks in Europe are in a vulnerable situation to face this eventuality as the level of bad loans is higher than officially recognized in some countries. If there is a crisis in Europe, money will flow to the US.
- J. Powell, Governor of the FED is a lawyer, he is all about compliance. He thinks that his predecessors were too activist. He is mentioned as having told some of his friends that the US needs a recession.

## THE NEW MINDSET THAT JAPAN NEEDS

A common thread throughout most of the discussions in previous roundtables, and this one, is the necessity for a change of mindsets at all levels:

- *Corporate culture and organization*: need to be more flexible, agile and nimble which means flattening organization's structures, getting rid of the seniority system as the new technologies do not require the accumulation of knowledge and experience, bringing new blood and global talents, combining top-down and bottom-up decision making, enhance job mobility. Change the risk/reward equation to counter the risk aversion mentality.
- *Government*: procedures, bureaucracy and regulations should be streamlined to avoid being obstacles to nimbleness and entrepreneurship.
- *Education*: the education system needs to be geared towards Society 5.0 where, according to some studies 50% of the jobs might be replaced by AI over the next two decades, which means developing survival skills (creativity, scientific approach, curiosity) and leadership (technology innovation, human side of sciences and ethics). Mathematics needs to be made mandatory in university entrance exams. There is a need to go beyond cognitive skills and to promote the development of horizontal skills.
- *Individual*: Japan needs more assertive women, more entrepreneurial people – importance of mentors and role models.

This change in corporate and individual mindsets is also translating in the recent development of a startup ecosystem. However, a lot more needs to be done:

- Increasing the flow of funding especially for early stage seed money despite the fact that, over the last three years, VC funding has been multiplied by five.
- Finding more angel investors and mentors
- Developing a risk-taking culture
- Increasing the diversity of human resources, entrepreneurs from overseas.
- More attractive packages for talent

In 2017 there was a record number of more than 2000 university spin-offs. However, Japan still lags behind other countries, including the US, in this domain.

## JAPAN'S GROWTH DRIVERS

The diminishing returns and increasing risks of the BOJ quantitative easing policies are more acutely felt. With a healthier economic growth, full employment, stabilized short term interest rates and a weak Yen, one could consider that QE has now outlived its necessity. However, the 2% inflation target is far from being achieved and the risks of a hasty exit are quite significant with respect to the possible impact on stock markets, public finances and the huge losses that the BOJ could incur on its balance sheet. A stealth exit process might in fact have already started in terms volumes of bond purchasing and now the official objective being to have long term interest rates at zero. Should the inflation target be reset at "between 1 and 2%"? Should the interest policy be revisited? One element is the fact that by avoiding talking about an exit policy, Governor Kuroda is making the situation more uncertain. Any exit strategy must avoid the triple evil of hyper-inflation, asset price collapse and surging Yen. With the stimulus impact of QE fading away the role of other growth drivers is becoming even more crucial.

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## **Tourism**

With close to 29 million inbound tourists in 2017, Japan is on course to reach the 40 million target by 2020. The impact of tourism revenue on the economy is now becoming quite significant and tourism could prove to be a useful way to help revitalize areas outside of the urban centers.

The passing of the integrated resort bill is now opening the way for a new touristic attractiveness for Japan with potential huge benefits to the communities where they will be located and for the economy at large. Duty free sales at department stores show an impressive growth which offset the decrease in sales to traditional customers. Integrated Resorts should become innovation hubs and parts of new experiences that Japan offers.

It is crucial to make regional tourist sites more accessible not only to international visitors but also to national tourists.

One priority should be to diversify the sources of tourists as 74% come from China, Taiwan, Hong Kong and Korea. Just over 13% tourists come from Europe and North America.

## **Disruptive Technologies**

The government has made the leveraging of new technologies a key element of its growth strategy. IoT, AI, advanced robotics and smart cities represent some of the areas where significant investments are being made. Are developments in these domains enough to ensure that Japan will be able to optimize the benefits from disruptive technologies to address its economic and social challenges?

Japan has some advantages in the leveraging of disruptive technologies as, contrary to other countries, there is no Union opposition to their introduction. However, Japanese CEOs tend to be less able to follow recent technological trends than their foreign counterparts. These technologies are sometimes seen as too expensive and embracing them could mean the risk of doing away with a working existing system and replacing it with an unknown one.

Japanese universities are in general very effective in basic research in materials, chemicals and algorithm but these innovations are sometimes disconnected from the needs of the industrial world. Japan is still lagging behind in terms of disruptive innovations such as connected and self-driving cars or even e-accommodation. Japanese research is also relatively isolated from the rest of the world and failing to be involved in bilateral or multilateral research projects.

## **Fintech**

While a major step was achieved with the legislation allowing the use of APIs in the banking sector, there are still obstacles to the development of Fintech in Japan: the “cash is king” culture, the payment system infrastructure lagging behind, the system legacy and the lack of in-house IT capabilities in major banks.

The new breed of Fintech entrepreneurs is now taking action to leverage technology to enhance user experiences and their capital is data. There could be a division of roles between incumbent financial players able to provide long term capital risk and Fintech startups agile at translating technology into new services for customers.

One major facet of the development of Fintech in Japan is blockchain and cryptocurrencies. The majority (59%) of crypto currency exchanges emanate from Japan. Japan is moving fast and boldly on blockchain and regulations are evolving at a satisfying pace. Two major hacks forced the government to react quickly and take measures. Crypto currencies have to be categorized as financial products instead of digital money.

The speculation phase should not constrain the need to continue developing the technology because it will have multiple uses. However, high frequency trading cannot yet happen because the technology does not allow for the necessary speed.

## The questions that count about China

To try to anticipate what will be the course of China's economy and the orientations that will shape Beijing foreign and security policy in the months ahead one needs:

- ✓ **To shake up some assumptions that are now being proven wrong:**
  - *"China's economy will somehow "converge" towards a free market, western style model".* China is doing what it has always been clear it would do, i.e. build a "socialist market economy with Chinese characteristics". Xi Jinping's objective is to make the system more efficient and to strengthen it, not to change it. This means a strong role for SOEs and the absolute guidance of the Party on economic activity. One key reason for the current economic and trade war is that global institutions were based on the assumptions that members would be operating under the market economy rules.
  - *"The authoritarian nature of the Chinese regime will constrain innovation and entrepreneurship capabilities and would delay the catching up process of the country".* Innovation is actually booming in China and the country has today what is probably the most vibrant startups ecosystem in the world.
  - *"The spread of social media in China and the high penetration of the Internet would compel the regime to move towards some kind of social liberalization".* In fact, the authoritarian grip of the regime has never been so tight since the Mao era. More than ever before, this government has mastered the art of monitoring and using social media to watch the mood of the people, to respond to some frustrations when it comes to daily life or environment issues, while ensuring that the key elements of the regime message, and the basis of its legitimacy are always present.
- ✓ **To understand the strategic objectives of President Xi Jinping and his top advisers**
  - *Putting China "close to the center" of the global stage and establishing it as the equal to the US.* This involves creating what Xi Jinping called a "new model of relationship between great nations" at his meeting with President Obama in California in 2015. This does not mean "replacing" the US as Number one but dealing with it on an equal footing. However, it means supplanting the US in Asia.
  - *Ensuring the long-term sustainability of the grip on power of the Chinese Communist Party.* This involves making sure that SOEs continue to play their role, not only as a key element of Beijing economic strategy but also as a crucial factor in maintaining the grip of the Party on China's society. This also means the shutting down of any potential dissenting voice and making sure that the private sector, while playing its role in economic development, operates in a perimeter defined by the state.
  - *Bringing China to the status of a moderately prosperous society by 2030* which involves shifting the country's growth model to one driven by technology and innovation, domestic consumption and a prominent position on the technologies which define the commanding heights of the 21st century economy. Here the Made in China 2025 and the Belt & Road initiatives are crucial elements.

President Xi Jinping sees the achievement of these objectives as his historical mission, the kind of feat that will ensure his place in the history books as, the equal of Mao, the leader who restored China to its true place in the world.

- ✓ **To identify the parameters according to which Beijing is operating and the "red lines" it will not allow to be crossed.**
  - 1) If Donald Trump limits himself to raising tariffs, Beijing will "only" retaliate in kind on tariffs on other trade and economic areas. This will be protracted low intensity economic and trade war. But if Washington takes measures that put in jeopardy China's long-term economic ambitions and future this will lead to a protracted high-intensity economic and trade war.
  - 2) If Washington continues the policy it has pursued with Taiwan since the establishment of US-China diplomatic relations, Beijing will be able to live with that. However, if the US shifts towards a policy supporting a greater distancing of Taiwan from China - or independence - such as the passing of the Taiwan travel Act or the inauguration of the new, huge, US liaison office in Taipei, then Beijing will accentuate pressures on Taiwan up to a breaking point.
  - 3) As long as the US continues to send from time to time military vessels to the South China Sea to illustrate that it does not recognize China's territorial claims on the area, Beijing will issue diplomatic protests and life will go on. However, if the US were to try to force China to dismantle the installations it has built in the South China sea, then China will use all the means at its disposal to reinforce its territorial claims.
  - 4) Beijing will be ready for a limited slowdown of the economy from the 6.7% growth last year to continue the deleveraging of the private sector, a better control of financial risks and also to move towards a higher quality of growth; however, if this slowdown gets the economy below 6% then Beijing will resort again to stimulative policies, especially on the monetary and fiscal fronts, to ensure that the economy keeps humming and that the impact of the trade sanctions does not affect in a serious way domestic consumption. This is beginning to happen as the leadership gets concerned that the second half of 2018 is decidedly slower than the first half.