16th Edition

Roundtable Japan

Securing Japan's strategic interests in a post Covid world

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Executive Summary

POST COVID GLOBAL ECONOMY: THE WINNERS AND THE LOSERS IN AN EMERGING NEW BALANCE OF FORCES. WHAT DOES IT MEAN FOR JAPAN?

The pandemic has unleashed a global recession, unprecedented in terms of depth, with all economies – except China's - sinking by minus 5 to 12% growth, global debt levels jumping to the roof and worldwide rising unemployment. Nobody expects a return to a 2019 level of growth and activity before 2022 or even 2023 in the best of circumstances.

The disease cannot be overcome with fiscal and monetary policies alone. Demand side action on the fiscal and monetary fronts has to be complemented by supply side action in the sanitary and hygiene domains. Beside leadership, followership – ie. the capacity of people to make the sacrifice required in order to ensure safety - is crucial. Moving forward, how do we get better followership whether it involves Covid, AI, aging, climate change or water issues. As Covid has widened income differences with labor intensive, low-skill, industries taking the biggest hit, the lower 50% of income distribution is hurting more than the top end and thus followership becomes problematic. China is different as the lower 50% has experienced a regular minimum of 4% increase in income as opposed to the US which has not experienced this sort of progress in the last 40 years.

Countries that have done a better job at dealing with the disruptions linked to globalization have done better on followership and have performed better fighting the disease.

Dealing with the post Covid world will require a very different approach on how we cope with the downside of capitalism, a different thinking on how to allocate fiscal spending. The vicious cycle to break is: low education, low skills, low income. Basic income or negative income tax schemes can help as experiences around the world have shown that basic income schemes do not affect work hours very much. More has to be invested in education, new technologies, R&D, raising skills and find ways to encourage people to get the skills they need. This will help deal with some of the post-Covid world problems.

The Eurozone will probably end the year with about minus 8% growth and will not be back to pre-Covid levels before 2022 at best. The policy response was early, strong and well targeted, aimed at protecting employment and skills. The ECB released a huge amount of "pandemic emergency financing facility": 1350 billion euros in almost one shot and, most importantly, it was flexible. Looking at the future, much will depend on the evolution of the pandemic. If vaccines can be distributed efficiently in the course of 2021 things will look completely different. **The risk is to have a very slow recovery from the present level**. Another source of uncertainty is Brexit with a major risk of no agreement – or one which will be minimal which will mean administrative formalities, more costs and trade hassles. There may be no agreement in the financial sector. This will mean a big economic hit for the UK and a lesser one for the EU but certainly an aggravating factor for the recovery, at least in the short term. In the medium term, the shock will be absorbed as many activities which used to go to the UK will then progressively go to the continent.

One lesson from the pandemic has been the danger of over-reliance on trade to a point that important value chains are endangered because of component supply disruptions coming from China. This is considered to be too much of a risk and countries will have to depend much less on China in the future. That could mean relocation of some value chains somewhere in Europe.

Japan has been able to avoid a full-scale lockdown thanks to its relative success compared to the US or Europe in containing Covid 19. While there was a severe drop in economic activity in the first part of the year, it has been less acute than in Europe or the US. So, relatively speaking, Japan is in better shape both in terms of the pandemic and of the economy. However, most experts expect a very slow recovery next year, with GDP lower by 2 % at the end of 2021 than in 2019. One reason is that Japan's potential growth rate is lower than the ones of Europe or the US.

Four factors should play in favor of Japan and help improve this forecast:

- China's growth is impressive in the context of Covid 19 and, as one of its closest neighbors and partners, Japan should be in a position to benefit. In September, the cargo leaving Narita airport for China was 15% larger compared to the same period one year ago.
- The Tokyo Olympic games have been rescheduled for the summer of 2021. If reasonably active Olympic games can take place this will certainly be a plus.
- A number of companies are revisiting their supply chain and are now investing in Japan. This on-shoring will also be a plus for the economy.
- Last, but most important is digitization as people are working remotely, benefiting from online education, online banking and trying to make government decisions online as well. They now understand the importance and necessity of digitization, how much Japan is lagging behind and how outdated the government is in this domain. This is why Prime Minister Suga has made digitization one of his top priorities. Japan has been struggling for years with low productivity, with a number of sectors – including government- being notoriously inefficient. This is going to change with digitization. Top executives will have to use ICT themselves and think about strategies to leverage the technology. Beyond productivity improvements, this may help women participation in the workforce through the ability to work from home thus potentially driving higher growth for the Japanese economy. Digitization will also have an impact on the demand side as there will be a substantial increase in IT investment from the corporate sector.

THE JAPANIZATION OF THE GLOBAL FISCAL AND MONETARY SCENE: WHAT DOES IT MEAN FOR THE COUNTRY'S FUTURE SUSTAINABILITY?

To what extent is Japanization prevailing in the global economy? Is it a temporary situation or a longer-term phenomenon?

What has been labelled as Japanization can only happen in countries which have the ability to finance their monetary expansion domestically, otherwise it will create a huge asset inflation, or currency devaluation, putting an end to the monetary expansion. So, for many observers there are limitations about who can follow this Japanization way and how long it can be done.

If Japan continues its Quantitative Easing for a long time it will lead to devaluation of the Yen. The government should issue perpetual notes - essentially equity - which could be bought by people and would produce a dividend. The government balance sheet would become healthier and this would stabilize the yen.

Japanization has meant a lot of different things to different people. It has been used to characterize deflation, aging and shrinking population and very low or negative interest rates. Specific macro-economic policies are linked to Japanization: Big government deficits, mounting public debt, Quantitative Easing and other unconventional monetary policies.

Japan's GDP deflator is still 12% below its 1994 peak, while in the US it is 60% above its 1994 level. This deflationary environment is a unique feature of Japan. In other aspects such as very low interest rates, Japanization has come to the rest of the world. Larry Summers has revived the 1930s notion of secular stagnation, with the equilibrium level of real interest rates around zero, or even negative. This is due to a glut of savings compared to global investment demand, which comes from aging societies in different countries - with Japan leading the pack. It is the concentration of wealth in the top 5% of the population, which has more money than it can spend. An important factor is also the virtualization of the economy with Moore's law driving the cost of most IT services basically to zero. All of this is creating a very un-intensive capital investment environment.

Some other economies could be "good candidates" for Japanization, economies which have "fallen" and cannot "get up" with conventional tools. South Korea is one of them: since 2008 three presidents have been talking a lot about structural reforms, creating a vibrant startup scene, not protecting the chaebols, but with very little success. South

Korea has been treating the symptoms, not the causes of its problem, much like Japan. Thailand offers the same picture. China is an open question. Europe has a huge problem with demographics.

Recently, Japanization has mostly been identified with low growth, big debt, big central bank balance sheets and zero interest rates. Over the last ten years, governments have been indulging in the notion that public debt does not matter. By the end of 2020 the global sovereign debt will have increased from US$50 to 70 trillion in one year. Nobody has thought of an exit strategy from QE. So if Japanization means a monetary policy where a central bank owns 20% of a country's GDP and has 80% of its assets in government bonds we are facing major risks.

How to overcome / stop this Japanization process or secular stagnation?

Aging, inequality and digitalization are creating deflationary pressures, not only in Japan but in other countries. This is an unprecedented situation with deflation on the one hand and huge creation of money on the other hand. It is bound to create asset inflation, with stock prices going up without justification from the usual economic indicators, quite simply because there is a lot of money flowing. This asset inflation will aggravate the wealth inequality with pressures to reduce it, for instance by introducing a wealth tax.

If the issue is lack of aggregate demand because of the successive shocks in the global economy starting with the financial crisis, then we need to mobilize fiscal and monetary policies very aggressively and rethink the relationship between the two. We still have a 20th century conceptual framework, but the situation is different now, particularly with very low natural interest rates. Government debt is in reality a form of purchasing power, an asset for the people who hold it. If the private sector is holding savings higher than what is being invested, then the public sector has to run a deficit of the same size. The bigger the excess savings over investment in the global economy, the bigger total governments deficits, and thus debt. Monetary policy, when interest rates are already at zero or below zero, is not enough when there is a big shock on the demand side. We thus need to forget about the fear of government debt getting too high.

Similarly, we need to think in a different way with respect to low interest rates driven by inequality, aging, and the virtualization of the economy. Some think that the retirement age should be raised, as people can work much later into their lives. On immigration, Japan has great ability and scope to draw a younger, skilled, population particularly from Southeast Asia. A serious discussion should be had on inequality to devise the right kind of safety nets coupled with market economy dynamism so that the digital divide does not create a second-class citizenry.

Prime Minister Abe and the BOJ targeted 2% inflation. But deflation is the symptom - not the cause - of Japan's malaise, which is demographics. Instead of 2% inflation, why not target yearly 2% wage gains, aiming for the size of yearly GDP increase? Instead of increasing its balance sheet the BOJ should think about ways to put more money into households. The government gave each household 100'000¥ but more of these payments are needed. The BOJ should buy less ETFs and buy instead corporate bonds from companies which agree to increase wages by a certain amount.

Over the last 10 years the S&P index has increased 300%, but corporate profit has been overall flat. The market does not reflect the economy any longer. Policies have been looking at growth for the wealthy when there are so many people below the poverty line. Only 7% of US government revenue comes from the corporate world and more than 50% comes from households. We need to go back to policies that will grow the wealth of the poor because they will consume.

We now discover that the problems that Japan has been facing over the last twenty years are much more common. Japan is not the odd man out. The country has a very good macroeconomic framework to deal with these issues with lots of coordination mechanisms for monetary and fiscal policies. Japan may have been the front runner with unconventional policies and could lead in re-thinking monetary and fiscal policy. The country benefits from an incredibly high level of social capital. As Japanese corporate governance is moving in the Anglo-American direction, some suggest that there is a Japanese way of solving the social corporate responsibility (ESC) issue. Last but not least Japan provides a nice hedge in a global investment portfolio.

THE JAPAN-CHINA RESET IN THE CONTEXT OF THE US-CHINA DE-COUPLING: WHAT BALANCE BETWEEN ECONOMIC INTERESTS AND OVERALL SECURITY AND STRATEGIC PRIORITIES

As the US and China are crucial to Japan's security, prosperity and future, it needs to have equally good relationships with both. However, the confrontation developing between the US and China is putting Tokyo in a delicate balancing act, complicated by the fact that there are now some questions about the reliability of the US as a strategic partner - not only for Japan - but for many of the US traditional allies. Prime Minister Suga is expected to continue Mr. Abe's policy of improving the relationship with China while continuing to strengthen Japan's security position.

Japan has, so far, avoided siding openly with Western countries in their tougher stance against Beijing, for instance refusing to exclude Huawei for its telecommunications enhancement plan. Are European countries joining the US wholeheartedly in its position on China?

Will Japan be able to pursue this middle of the road position, depending on the course that the Biden administration will adopt towards China?

The US and China will continue to compete for the number one position in the world. The confrontational relationship is inevitable and predates Donald Trump's presidency with a systemic deterioration not a cyclical one. The notion of great power competition – with China being the primary competitor – keep on framing US policy and strategy. There will continue to be a hard line against what is seen as Chinese misbehaviors. The key question is how far the definition of economic security will go, as there is no longer a distinction between military and civilian technologies. However, the method and approach could be different with a Biden administration and we need to wait to see what this administration will actually do and if it tries to restrict Japan's margin of maneuver pressuring it, and its other allies, to choose between the Chinese market and the military protection offered by the US.

Japan's values are similar to those of Western countries and are reflected in its constitution. However, it differs on how to actually deal with China and is reluctant to take any action that could affect China's standing.

Does America continue to be a reliable partner?

Some would say that America has behaved like a bully since the fall of the Berlin wall and the collapse of the Soviet Union. Japan, and other countries, have not had to ponder this question in a serious way since the end of WW II. The European countries are already moving gradually away from the United States.

The Biden administration will have to work hard to earn back the trust of its allies in a context where the pandemic will force a more domestic focus. The domestic consensus on foreign policy has been destroyed by excessive overseas engagement

Japan is limited in its margin of maneuver and should strengthen non-governmental relationships with China to build mutual trust through informal channels, abstaining from actions that would close doors. Japanese also need to combat bias and prejudice towards China which also has an interest in a good relationship with Japan.

Chinese FDI into Japan has been growing steadily over the years and Japanese FDI into China has been most profitable. China is the only country where sales from Japanese subsidiaries have already recovered this year after the downturn caused by the pandemic. There is a huge potential for further collaboration between China and Japan. For instance, over 10 million Chinese tourists visited Japan in 2019, accounting for the largest share of inbound visitors to the country. The Northeast Asia economic collaboration should be strengthened, and the conclusion of the Regional Comprehensive Economic Partnership is a great step forward. Japan is already leading the Comprehensive and Progressive Agreement for Trans-Pacific Partnership and it would make a lot of sense for China to join. China and Japan signed an investment treaty in 1989 which is now outdated and should be updated. A State visit from President Xi Jinping in 2021 could be quite successful.

Japanese concerns about Chinese incursions into the Senkaku islands and the buildup in the South China sea are real. Japan's national security council has been restructured to include economic decision-making; the foreign affairs ministry has been re-organized, as well as METI, and the ministry of defense. There are also, new investment restrictions. All of this suggests growing skepticism towards China which needs to acknowledge the insecurities that its behavior have created within Japan.

A more sophisticated and comprehensive approach needs to be developed to accommodate the rise of China which wants to have a say in setting the rules of the game. Beijing needs to be engaged in terms of what the international community expects from it as a great power influencing every corner of the world. Chinese leaders have started to understand and accommodate to the new position China holds in the world. It is a process and China can adapt to its new role; however, the US has been antagonizing it and thus bringing the Chinese people and their leadership together. How to establish the balance between legitimate Chinese demands and those which are not? This challenge has not been well addressed so far.

COVID 19: HELPING OUR WAY THROUGH THE BIG UNKNOWNS

There were a number of warning signs in the past twenty years pointing to the inevitability of a global pandemic and there was an extended period of time at the outset of the pandemic when intensive testing and contact tracing could have mitigated the outbreak in Europe and the United States. As scientists are still figuring out why the virus spreads so quickly and affects people in such varied ways, we know that one key factor is its ability to mutate.
As of December, there are close to 700 drugs and vaccines at different stages of development.

Vaccines:

a. **Astra Zeneca & Oxford University: AZD1222** which is based on an adenovirus vaccine vector. Trials have been underway in Japan, UK, India, Brazil and South Africa and the U.S. Astra Zeneca has agreed to supply 120 million doses of AZD 1222 to Japan by June of 2021.
Update: Phase II trial data was published in November showing similar immunogenicity across all age groups after the second dose and showing fewer side effects in older adults.

b. **CanSino Biologies: Ad5-nCoV**, (with China State run Academy of Military Medical Sciences, Institute of Biotechnology): incorporates a non-replicating adenovirus type 5 vector. This vaccine is in phase III trial globally and Brazil has already declared it to be safe. It should be available by early 2021.

c. **Gamaleya Research Institute: Sputnik V** received the world's first regulatory approval for a Covid 19 vaccine back in August after just 39 patients participated in a single Phase I/II trial. Sputnik 5 consists of 2 components given 21 days apart.

d. **Moderna: mRNA-1273** is a Lipid nanoparticle-encapsulated mRNA vaccine encoding for a prefusion stabilized for of the Spike (S) protein. Moderna is in talks with the Ministry of Health, Labour and Welfare to distribute 40 million doses in Japan through Takeda starting in 2021.
Update: Moderna has just completed its phase III trial reporting consistent efficacy across age, race, ethnicity and gender. It requested emergency use authorization to the FDA and a European conditional approval.

e. **Pfizer and BioNTech: BNT162b2**: Messenger RNA (mRNA) vaccine, modified with a nucleoside, a molecule of sugar linked to a nitrogen-containing organic ring. This is a two-dose vaccine. Pfizer and BioNTech have agreed with the Ministry of Health, Labour and Welfare to supply 120 million doses to Japan starting in 2021.
Update: The Pfizer and BioNtech vaccine has started being inoculated in the UK on 8 December and the US on 15 December. There is also an agreement with the European Commission to supply 200 million doses to member countries with an option for an additional 100 million doses.

f. **Sinopharm** and an entity of its subsidiary, China National Biotech Group Co. are developing two vaccines using an inactivated SARS-CoV-2 virus isolated from a Wuhan patient.
Update: As of November 19, almost one million Chinese have been given an experimental version of one of these vaccines.

g. **Sinovac Biotech: CoronaVac** consists of inactivated virus with formaldehyde and alum adjuvant. On October 2, the Ministry of Health, Labour and Welfare approved the free distribution of a dose of CoronaVac to all Japanese citizens. The government of Sao Paolo, Brazil also bought 46 million doses of CoronaVac. Phase III in progress with results expected in December.

h. One other vaccine worth watching for: Novavax's NVX-CoV2373 funded by $1.6 billion from the US government and $388 million from the Coalition for Epidemic Preparedness Innovation (CEPI).
Update: Phase III trial started in Mexico and the US in November

Beyond vaccine, below are some leading candidates in development to treat Covid 19:

2) Antibody treatments.
   a. Eli Lilly & AbCellera:LY-CoV555
      Update: Granted emergency use authorization by the FDA on November 10
   b. Regeneron (REGN-COV2): antibody cocktail
      Update: Granted emergency use authorization by the FDA on November 23
   c. Also to watch: Distributed Bio: bioengineers broadly neutralizing antibodies.

3) Antiviral drugs
   a. FUJIFILM: Avigan, broad spectrum antiviral. Fujifilm applied for approval in Japan on October 16 for Covid treatment (previously sold for novel or e-emergent influenza). Fujifilm licensed rights to Avigan outside Japan to Dr. Reddy (India) and Global Response Aid out of Dubai. Phase III trial in Japan showed that patients treated with Avigan recovered about 3 days before ones treated with a placebo.
   b. Gilead: Remdesevir: Broad spectrum antiviral drug, initially developed for Ebola treatment. Approved on May 7 in Japan to treat Covid 19 right after approval in the US. It is the first Covid 19 drug prequalified for manufacturing by WHO, despite showing little or no effect in WHO trial.

www.genengnews.com (tracker for vaccine and drugs)

3 NOVEMBER IN THE US…AND THE DAYS AFTER: SCENARIOS FOR THE OUTCOME OF THE ELECTION. WHAT THIS COULD MEAN FOR THE GLOBAL ECONOMY, FOR MARKETS AND FOR THE US-JAPAN RELATIONSHIP?

At the time of Japan Roundtable 2020, the polls indicated that the electorate was titling towards Joe Biden. This has now been confirmed and we have thus retained the elements pertaining to a Biden administration for this summary, highlighting some of the differences that are forecasted to emerge once the new administration takes office in a country that will remain extremely divided for the time being.

Foreign policy: it is expected that, under Joe Biden, the United States will return to a more active global leadership role in many multilateral institutions, strengthening its alliances, certainly with Japan, and renewing support to multilateral institutions. An acceleration of the Indo Pacific Alliance is also likely to happen, where Japan plays a strong leadership role. On the US front, reinvestment in the military (people, tools and capacity) will continue under Biden. The US / Japan relationship will be more important than ever both security wise and technologically. The security structure of the Western Pacific depends very closely on the two countries working together along with Australia, India and other countries in the region.

Trade: Most agree that the Biden administration will not pursue the confrontational tariff war with China started by President Trump. However, there is a strong bipartisan consensus on a tougher line against China and President Biden will work with US allies in trying to get Beijing to "play fair in international trade". Biden will normalize US trade policies with the rest of the world. He has talked about re-engaging with the new version of TPP, the "Comprehensive and Progressive Agreement for Trans-Pacific Partnership" (CPTPP), but the challenge will be to get the left of the Democratic Party to support re-engagement. If the US comes back to TPP it will request some revisions of the Pact.

Fiscal policy: Joe Biden will significantly increase government spending on education, infrastructure, healthcare, housing and child and elder care. He will increase taxes on corporations – which may be detrimental to US manufacturing - and people making over $400,000 per year. Biden also plans changes that should benefit lower- and middle-income households. He will also provide much needed support to States and Cities affected by the Covid 19 pandemic and may reinstate the deductibility of State and local taxes all part of a most likely big fiscal stimulus. These tax increases will however not pay for his program which will add to deficits and public debt.

Environment: President elect Biden will rejoin the Paris Global Accord. There is a substantial consensus among Democrats and some Republicans for a large green infrastructure bill that will provide much needed improvements and create jobs even though this will add to the national debt.

Immigration and racial divide: Biden will address immigration reform most likely re-opening the US to a higher number of immigrants and will try to heal the social divide that has deepened in the last four years.

Pandemic: The Biden administration will have a "much more cohesive, bold national policy" on what will be its first, immediate priority for action, with an emphasis on science, mask wearing, social distancing, expansion of testing and vaccination, appeals to national mobilization and social cohesion.

Industrial policy: There will be some continuity in terms of pushing for Public Private Partnerships, particularly on advanced technologies to compete with China, as the competition with China will increasingly center on the technological and ideological domains.

Monetary Policy: The Federal Reserve just changed its monetary framework, all but setting aside the 2% inflation target for the foreseeable future and excluding any rate increase until the US economy is back to full employment. This will be accompanied by an expansive fiscal policy that the Biden administration will pursue. Zero interest rate, Quantitative Easing and expansionist fiscal policy should provide good conditions for the equity market and for fixed income markets in terms of credit risk. It will be a mixed environment for the US dollar. One potential negative for equity prices is the prospect of higher corporate tax rates (21 to 28%, pre Trump it was 35%).