



Confronting Heightened Strategic Challenges

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Executive Summary

THE GLOBAL ECONOMIC PICTURE AND ITS IMPLICATIONS FOR JAPAN

The session started with opening remarks from Mr. Nishimura Yasutoshi, Former Minister in charge of Economic Revitalization, Former Minister of State for Economic and Fiscal Policy, Former Minister in charge of Social Security Reform. He emphasized that the vaccination process has been moving ahead in a successful way but that there is a need to ensure that there will be enough hospital beds available in case of a resurgence of cases. The government is also taking additional economic measures to support activity and to strengthen the country's national economic security in terms of supplies whether regarding masks or vaccines – as they were in short supplies last year – or now regarding the situation with semiconductors or parts from other countries. Japan needs to have these necessary resources onshore. Legislative measures and systems must also be designed to support SMEs in their need to adapt to the new conditions created by the pandemic, and also to support the disadvantaged categories of the population. There is a clear awareness of the need to accelerate the digitalization of the economy and society, for instance with respect to the use of robots and drones. In Prime Minister Kishida's view of a "new capitalism" the priority of increasing growth and improving the distribution of wealth and social goods have to go hand in hand to create a virtuous cycle and this should characterize an approach to "reform with a human touch".

ON GOING TRENDS AND NEW ONES

The global economy has escaped the worst after the emergence of the Covid pandemic. However, we have now to cope with many structural challenges in the supply side of the economy with major disruptions in supply chains, the availability of the needed workforce, global value chains, and shortages in energy and prices going up. On the demand side there are major changes happening with demand in manufacturing going up while demand in services is going down.

There is also the acceleration of pre-Covid trends such as the green transition, digitalization and changes in business models. Additionally there is an underlying trend of recognizing huge wealth inequalities as a crucial problem in major economies, but also between different countries, with a big vaccine divide among the countries. At time of writing, only 4% of the population in poor countries has been vaccinated against at least 65% of the population in rich countries. This explains why, according to the IMF, by 2025 the rich economies will be over and above their pre-Covid level while the developing economy will be minus 5.5% their pre-Covid trend growth.

INFLATION...AND GROWTH?

We are in a period where we don't know what will happen regarding inflation, especially in the US, but also in Europe and this requires great attention and prudence. It is imperative to be ready to act quickly if signs multiply that inflation is becoming more permanent and to do what is necessary for un-anchoring inflation expectations. All central banks are keen to stabilize inflation around the famous 2% threshold to ensure stability. If they don't succeed, we will be in a very dangerous world.

Japan is a special case as it is a unique opportunity for the country to re-anchor inflation expectations in line with the definition of the BOJ.

The Federal Reserve is now going into tapering its extremely loose monetary policy but the route from tapering to interest rates increases is very uncertain. Looking at the last time when this move - from tapering to raising rates happened from 2013 to 2015 - this was a smooth process. This will most probably not be the case this time, given extraordinary uncertainties in the outlook. It is very hard to know what new variants of Covid may develop and the impact they will have. There is no model for assessing what the impact of the extraordinary fiscal policies in the US and in Europe will be over time. The Brookings institution calculated that this extraordinary fiscal policy in the US contributed 5.5 points of growth over the four quarters ending earlier in 2021 and will subtract 2.5 points of growth rate next spring.



So, we should expect to see a sharp decrease in growth in the winter 2022 with an impact on investments and on consumer spending. This could mean a very slow return to what we may call “policy normality”. The Fed policy is not on a pre-set course given the tremendous uncertainties we are facing. The European Central Bank has indicated from the very beginning that it will be very flexible in adjusting to new developments whether on the inflation front or on the impact that new variants may have on economic activity. We are definitely not yet in a post-Covid situation.

HOW IS JAPAN POLICY DOING IN THIS EXTRAORDINARY GLOBAL CONTEXT?

The economy has been in quasi persistent deflation for quite some time because of low growth. Even if we have had a 1.5% productivity growth average the impact of the declining population has meant that this actual productivity growth has just been 1% per year. The BOJ has tried many things in terms of expansionary monetary policy, such as yield curve control. If there is now imported inflation, for instance because of higher oil prices, this will be negative for the Japanese economy because the GDP deflator will go down even if the CPI is up and the BOJ will not be able to raise interest rates. So, the Japanese situation is quite deep-rooted with its deflationary pressures because of the demographic issue.

Additionally, the government cannot have a more activist fiscal policy, allocating money to the poorer categories of population as this will increase the ratio of public debt to GDP which is already at 260%. What is being done now is to utilize the savings of corporations and households for current spending such as social security, medical costs and so on and this is not healthy. If Prime Minister Kishida wants to do something useful to prepare for the future he needs to allocate spending for growth.

Markets first reacted negatively to the appointment of Mr. Kishida as leader of LDP because his policies were seen as unfavorable to investors. Another factor was the change in the composition of the Nikkei index at the end of September with new big stocks included in the index moving it down. And a third factor in the decline of the Nikkei following the evolution of the situation in China.

CHINA

China has now more than 14 trillion dollars of GDP and its growth remains quite high. However, there are three risks: Over-investment after the global financial crisis, a still unsound pension system and the over-indebtedness at almost all levels of the Chinese economy and society, with the government still concerned by the persistence of financial risk, particularly in the real-estate sector. The government has a lot of tools at hands and a lot of policy space to help manage this risk, but their concern is that the economy will slow down and the impact of the rapid aging of the population will be fully felt before China becomes rich enough to sustain this new situation.

The second issue is the relationship with other countries and regions such as the US, Japan or Europe - which helped a lot the development of China - has deteriorated in the recent period. This could have a negative impact on the technological and business interaction between Beijing and its partners, then contributing to a slowdown in China’s economic progression.

The third issue is the new emphasis put by the leadership on the notion of “common prosperity” in view of the huge wealth distribution gap which has developed in the country among people and among the regions. They are trying to address this issue through fiscal policies and new rules towards the private sector and this is damaging confidence in the business community. These policies should be implemented in a very smooth and predictable manner, and this does not seem to be the case so far. Another element to take into consideration is the cost of the green transition which is very heavy on China given their high reliance on coal.

There is no underestimating the impact that the evolution in China may have on markets. One key issue for the national economic security of Japan is how much the Japanese financial institutions are connected with Chinese financial institutions and their links to the Beijing government.



GLOBAL RISKS

In terms of global economic stability one “black swan” development could be a big wake-up call from the markets as the extraordinary loose monetary policies begin to be tightened with the possibility of rates increases in the medium term, the impact of the unprecedented levels of indebtedness created by the cumulative impact of the financial crisis and the pandemic, and the possibility of high inflationary pressures evolving from a transitory to a longer lasting element shaping expectations and fiscal and monetary policies. There is definitely a significant risk that would be created by a poor management of this accumulation of debt and of the transition from a loose to a tighter monetary policy.

One needs also to think of the rising geopolitical risks that we see in the aggravation of tensions and the confrontation between the US and Russia, the US and China, or the nuclear ambitions of Iran.

POST OLYMPICS, POST SUGA...STILL COVID

The Kishida cabinet is starting its mandate with three priorities:

- Tackling the Covid 19 crisis
- Formulating economic policies to target growth and income distribution
- Continuing the security and foreign policies set by the previous administration

Prime Minister Kishida has also stated that more money will be spent on Research and Development, as well as on economic security to promote some strategic industries to improve the sustainability of Japan’s supply chains. Mr. Kishida’s policies will not change much from Mr. Suga’s on digitalization and green economy. He will not reverse the measures taken so far and we can expect some results. In that context, the Prime Minister has put in place a stable administration with a very solid cabinet and staff members.

Many people in Japan are talking about the tradeoff between economic growth and income distribution, however the more important issue is the policy instruments available to tackle the crisis. A lot of countries are emphasizing income distribution policies as the recovery of economy activity can negatively impact distribution. With a two-prong target - economic growth and fair income distribution - and only one policy instrument – fiscal policy - there will have to be a tradeoff. Two policy instruments – monetary and fiscal policies - may allow to achieve both targets.

Despite a strong stimulus on the demand side Japan growth rate has been disappointing due to low productivity. Capital stock has not been expanding. This situation has led to some supply side problems. Prime Minister Kishida may have to introduce more supply side stimulus. However, the kind of supply side stimulus that could be used is a very controversial issue.

Should Japan think about restarting an industrial policy? There are issues – such as the environment and the safety of supply of semiconductors - that cannot be solved through conventional market mechanisms. Industrial policy is a controversial issue. Historically the government tried to act in shaping the orientations of the automotive industry and that did not work. Green policy is the most important challenge and it should be addressed in a way that will contribute to – and not hamper - economic growth.

The Kishida administration is also talking about tax breaks for companies to support R&D activities and thus enhance productivity - as companies have not been investing enough in this domain. Despite the stimulus measures implemented through Abenomics, productivity did not grow. There is however a limit to what the government can do. A lot of Japanese companies are conservative and sticking to past business models.



The pandemic has widened the income distribution gap in the country with the middle class becoming poorer and the rich getting richer. The election pressure explains some of the focus on wealth distribution. The Prime Minister is also trying to lessen the confrontation between his office and the non-ruling parties. It is worth noting that – as opposed to

Abe and Suga – he is not using the word reform in his messaging - thus creating a perception that he is not interested in reform, but this may well be just a cautious position before the elections in the Lower House.

Supporting more the weakest segments of the Japanese society is now the emphasis of the government policy, as well as focusing on education and reskilling. The administration may need to modify the income tax system to redistribute to lower parts of society to support them. This is essential for the economy. Most advanced countries have seen a widening gap in the past twenty years and growth and wealth distribution must be addressed with more than two policies. They are equally important. If the focus is only on growth the gap might widen further. The right policies have to be combined. In addition to growth and distribution policies, effective policies in education and some others not directly connected to growth will achieve the desired results for a more balanced society. There is not enough debate in Japan with respect to the policies that can address more efficiently wealth distribution inequalities.

The administration and its bureaucrats need to provide the appropriate environment for entrepreneurs to operate easily. The corporate governance code falls in that category. One very important issue affecting domestic demand is the stagnation of wage levels in the past twenty or thirty years. Dividends are up but employees' compensations have not increased. The private sector has a lot of cash on hand, but the question is still about how to motivate companies to invest? Prime Minister Kishida needs to make a commitment on wages to push domestic consumption up. If People are able to spend more, companies will then not hesitate to invest more because they will know there is more domestic demand waiting to be satisfied.

REALIZING THE "GREEN SOCIETY": WHAT THE GOAL OF CUTTING EMISSIONS BY 46% FROM 2013 LEVELS MEANS

Climate change risk is an enormous threat to mankind, and a historical challenge for Japan as for all other countries. However, the scarcity of natural resources, delayed power sector reform and delayed renewable development hinder a smooth transition to net zero emissions. In addition, more innovation in decarbonization technologies is required to make an electricity system based on renewable energies function. This can increase the cost of electricity. While not sufficient discussion has occurred regarding possible reactivation of remaining nuclear power generation, there is no easy answer to solve this complicated equation.

After the Fukushima nuclear accident, JERA - a 50-50 joint venture between TEPCO Fuel & Power, and Chubu Electric Power - was established with the objective of procuring fuel – LNG - to meet Japan's electricity demand. JERA started out as a fossil fuel and thermal power generation company, but JERA has two faces: one as the largest power generation company in Japan, producing 30% of the country's electricity and, as such, JERA has a natural social responsibility. The other face of JERA is that it is engaged in global business where the commitment to achieve net-zero by 2050 is an admission ticket.

DECARBONIZATION

JERA's basic policy is to draw up feasible transition scenarios to ensure decarbonization. This requires three policies:

- Combining renewable energy with zero-emission thermal power (mixing with ammonia and hydrogen).
- Creating an optimal decarbonization roadmap for each country and region with different conditions
- Implementing what we can do now and moving forward in a step-by-step manner to achieve decarbonization.

With regard to policy 1, decarbonization can be achieved more practically and economically by combining zero-emission thermal power with renewable energy. Zero-emission thermal power plants take advantage of existing power generation facilities to generate electricity using ammonia and hydrogen, making it possible to control output, and by



combining these two sources, it is possible to create stable decarbonized energy. Existing power generation facilities can be used to generate CO₂-free energy using ammonia and hydrogen with only minor renovations. Existing transmission networks, such as grids, can be used as they are, resulting in minimum social cost.

With regard to policy 2, each country and region is at a different stage of economic growth, and the renewable energies that can be introduced and their potential are also different. It is impossible to promote decarbonization in a one-size-fit-all way.

With regard to policy 3, do what we can with current available and proven technology. As global warming is happening now, we need to do everything we can to reduce carbon emissions as much as possible, and as new technologies emerge, utilize them to accelerate low- and decarbonization.

Hydrogen is becoming more popular for decarbonization, but it has to be imported from overseas at a high cost. Since it is not domestically produced, there is also the issue of energy security. The only domestically produced, high-capacity power source, aside from nuclear power, is offshore wind power. It is only now that Japan has begun to take this up in earnest. Even if the number of offshore wind turbines increases in the future, it will take 10 years before the first unit becomes operational.

RENEWABLE ENERGIES

Why didn't Japan start developing offshore wind power sooner? After the Fukushima accident and until recently there was a failure to take the necessary policy decisions to start developing offshore wind. Now there is an ambitious target for producing 45 million KW on offshore wind in the next 40 years. A decisive factor seems to be the change on the demand side. Companies are now demanding carbon neutrality in their supply and value chains.

From the perspective of Japan's industrial competitiveness, this is a major policy turning point. The government has set a high target ratio of 36-38% for renewable energy in its 6th Basic Energy Policy renewed in October 2021, with wind and solar as the biggest contributors. To accelerate the investment, it is important to present a clear long-term policy for the development, especially for large initial investments, such as for offshore wind power. We also need to make sure to have an electricity system that allows renewable energy to become the main source of power. One of the challenges is to reduce the system costs when introducing large amounts of renewable energy. In the context of decarbonization, how to integrate the social cost of carbon emissions into the power system is important, for the promotion of new decarbonized energy technologies.

NUCLEAR

In order to maintain its international competitiveness, Japan cannot afford not to consider the use of nuclear energy. There still exists a relatively strong anti-nuclear sentiment in the public. It might be difficult for Japan to consider nuclear power in a positive manner again under the current situation. How should Japan overcome the Fukushima trauma and move forward? What kind of system is necessary for Japan, as a resource-poor country, to make positive use of nuclear power a base load in the future?

Nuclear power is necessary to achieve net-zero emissions, as it is questionable whether it is possible to install large numbers of solar and wind power farms in Japan where suitable land is very limited. Re-activating the existing nuclear power plants is a cheaper option. Another problem is the tritium contaminated water that became apparent after the Fukushima nuclear accident. Discharging it into the sea would cause reputational damage. Existing Russian technology can separate 99.8% of the tritium, but disposing of the separated tritium will increase cost. Japan should join the Treaty on the Prohibition of Nuclear Weapons but cannot ratify the treaty for the moment because it is under the American nuclear umbrella. However, public sentiment in Japan will not allow a country that suffered the atomic bombings of Hiroshima and Nagasaki not to ratify the treaty. If Japan ratifies the Treaty on the Prohibition of Nuclear Weapons and names the treaty as 'Hiroshima-Nagasaki Treaty' the U.S. will not be able to oppose.

Japan must make this commitment and be able to define nuclear energy as one of the sustainable energies. If we want to reduce the risk inherent to nuclear technology, we can utilize small module reactors (SMR). We need to change the



paradigm and explain to the people that the government will take proper responsibility, that large Light Water Reactors will be ended, and that small module reactors will be operating in more decentralized power system.

FINANCING THE GREEN SOCIETY

On September 22, the Bank of Japan (BOJ) issued the modalities of its climate change new scheme, targeting activities aimed at combating climate change, to align itself with a global push toward a greener society. In other countries, green and sustainable finance have been widely used to bring funds into projects and technologies for decarbonization, but what is the status of demand for such funds in Japan? What criteria are required to implement sustainable finance? What is needed to make this a facilitator of decarbonizing Japanese industry and society?

Is there a green premium for companies? Is there an economic benefit to cover the additional cost associated with green/sustainable finance? Individual companies do not currently have the scale to cover the additional costs of green bonds at this time. With interest rates at an ultra-low level right now, it is conceivable that a rise in interest rates could open up this gap. The market appetite will naturally lean toward green. In that case, the green premium is expected to increase. In fact, the difficulty to obtain financing for coal-related projects will increase. In 2004, DBJ was the first to introduce environmentally rated loans, in which environmental considerations are rated and reflected in the terms of the loan. In some cases, customers are asked to take the assessment every year and the assessment is used to improve the management of the company through the rating process, leading to higher stock prices and helping to strengthen the company's long-term credibility.

The Bank of Japan was originally cautious about getting involved in climate change risk measures, but it has changed its position due to the fact that major foreign banks have deepened their involvement in climate change risk measures, and because of the government's request for cooperation with carbon neutrality. Sustainability-linked loans, bonds, and transition finance have just begun to be discussed in Japan, and if the Bank of Japan is directly involved in the screening process when lenders and issuers greenwash their loans, the Bank of Japan itself bears the risk. The framework of these Green Operations is that the financial institutions themselves are responsible for their own classification, assessment, and judgment.

The conditions for a financial institution to apply for Green Operations are the ones mentioned by the Task Force on Climate-related Financial Disclosures (TCFD): governance, strategy, risk management, and disclosure of indicators and targets. With regard to transition finance in particular, the Financial Services Agency and the Ministry of Economy, Trade and Industry (METI) have taken the lead in formulating a basic policy. Currently, transition roadmaps are being presented for each designated industry, starting with steel and chemicals. The key is how much can engagement between companies and investors be strengthened by indirect financial institutions that do not have the coercive power of voting rights. How can individual financial institutions understand the nature of their customers and projects, and how can they ensure the commitment of companies?

As Japan moves toward decarbonization the vertical division of ministries and agencies in silos may be a major problem. The UK created the Department for Business, Energy and Industrial Strategy (so-called BEIS), merging the previous Department for Business, Innovation and Skills and the Department for Energy and Climate Change. Even before that, the same ministry was responsible for energy and climate change policy-making and implementation. In Japan, three ministries are dealing with decarbonization: METI, the Ministry for Land, Infrastructure, Transport and Tourism and the Ministry of Environment.

The quickest way to bring in new wisdom and ideas is to change the organization. Now is the time for a new structure to promote an industrial strategy for green, to achieve growth and green. Decarbonization has to be done with multiple tools on the demand and supply side. We need to change the way we build our society and towns. We need to change the way we build infrastructure. Creating a decentralized, locally-produced and locally-consumed energy community is synonymous with creating a city that is locally complete and has its own unique character. In order to do this, we need to create something like the Social Infrastructure Agency and send a clear message that we will build infrastructure in a completely different way.



CAN JAPAN AFFORD TO ALIGN ITSELF SO MUCH WITH THE US ON THE CHINA ISSUE

While the country is aligning ever more closely with the Biden administration's anti-China policy, Japan's economy is increasingly dependent on China – which has now replaced the United States as Japan's largest export destination accounting for 22.9% of Japan's total exports. Until recently Japan's China policy had been successful at not provoking China too brashly thus ensuring Beijing's acceptance of a hedging policy with the two super-powers. This was also made possible by China's keen interest in Japan's investments and technology. However, this balancing act is becoming increasingly difficult to sustain as Tokyo has aligned itself more fully with elements of America's China policy – notably the Taiwan issue - which are most offensive to Beijing.

There is no doubt that this rapprochement/alignment with the US China policy is increasing the risk of a backlash from China and is creating a difficult situation for Japan. During his tenure former Prime Minister Abe handled the situation very well because he was a very skilled negotiator but Japan's balancing act between the two super-powers is becoming much harder to perform. The situation was complicated later by the fact that - contrary to Mr. Abe - Prime Minister Suga was unable to adopt a piecemeal approach towards China.

Prime Minister Kishida will try and hope to continue the present status quo with Beijing as much as possible but Taiwan has re-emerged again as a central issue and it is almost certain that, at some stage, Beijing will react very negatively to Japan's latest rapprochement moves with Taiwan as the Taiwan issue is absolutely central for China. The Chinese leadership is now seeing the US and Japan as enablers for Taiwan independence, and this is very dangerous. It is not sure at all that China will back down if the US, Japan and even other countries take a much tougher stance on the Taiwan issue.

There is no underestimating the increasing risk of a downward spiral in the Japan-China relationship. It is in this context that Japanese corporations are trying to recalibrate their policies towards China, although they want nothing more than being able to continue to benefit from the status quo. However, corporate Japan has come under growing pressure to take sides. On the one hand Japanese companies are now unable to continue their relationship with Huawei, but on the other hand they face the increasing risk of being punished by Beijing for any boycott against Chinese companies given the recent law that stipulates sanctions against foreign companies that would engage into a boycott of Chinese corporations or products.

At the same time, Japanese corporations are increasingly concerned about China's self-reliance policies which look at the elimination of marginalization of foreign participation in key supply chains. Such a policy is now being pursued with even more energy and efficiency, as a response to America's containment policy towards China and this will increasingly impact on Japan business prospects in China. Beijing considers that its domestic market is now so important that it can dictate the terms of engagement to foreign companies This will not happen overnight but, over the medium term, we are going to see Japanese companies – large and small – having to adapt to a new era of doing business with China and how to operate in this country. While there is no underestimating the challenges facing the Chinese economy, these challenges will be managed by the leadership, and it would be foolish to bet on a collapse or even a weakening of this economy.

There is a risk that Japan's closer alignment with America's policy on China could lead not just to a boycott of some Japanese products or companies in China but to an anti-Japan mobilization as what happened in 2012. Then Anti-Japanese demonstrations and violent protest erupted in a number of cities across China after Japanese nationalists raised their country's flag on disputed islands.

As the Japanese government increasingly sees it in its interest to adopt policies which are viewed as hostile by Beijing, the greater the possibility that something like 2012 can happen again. Many circles in Japan now consider that Japan is



doing too much about Taiwan and that it would be time to tone down the rhetoric. If Japan takes a forward position that the Biden administration will not support, then the country will pay a price for that. But it could be that Chinese policies in Asia and Japan's periphery in the recent years have heightened a sense of insecurity in Japan and this is the motivation behind the emphasis now put by Tokyo on the Taiwan issue.

President Biden is trying to do a number of things to try and restore US leadership and America's credibility as reliable ally but, so far, his track record on the domestic as well as on the foreign policy fronts remains quite mixed and the US society has never been so polarized and the political system so dysfunctional. In addition to that, despite all the talks of decoupling US companies continue to expand their investment in China and China's exports to the US continue to grow.

In the present context, one can consider that any successor to Biden will be more to the right than any previous president. The Chinese leadership sees this situation as an opportunity to move forward as it considers that if China becomes strong enough it will have the ability to change the Western dominated global system. But looking at the Chinese political calendar with the Winter Olympics and the 20th Party Congress at the end of 2022. So, what Xi Jinping needs right now is stability and he is not going to take any precipitous action that would jeopardize the stability going into that period. The Chinese government sees the business relationship as the ballast for the US-China relationship and it is not going to take any action that would antagonize US businesses and reduces the role of this ballast. It has decided not to attack or to put pressure on American companies.

CORPORATE GOVERNANCE: TIME FOR A STATUS REPORT AS CORPORATE JAPAN GETS SERIOUS ABOUT ESG

Since the development of the Corporate Governance Code a lot of progress has been achieved on evaluating managers' performance based on ESG parameters. However, Japan is in a race to improve its governance and management skillset in order to retain its financial hub status, but the country is lagging behind in Asia in some of these areas. As one speaker remarked, "everybody knows in Japan that business as usual is not an option". The ecosystem has really changed. Investors have an incredibly diverse opportunity set in terms of unlocking the value that is in Japan. Monex set up the Japan Catalyst Fund to unlock Japan from the value trap that it is in.

Recent changes to Japan's regulatory environment:

- Second revision of Japan's corporate governance code in June 2021 with 3 important elements:
 - o The code aims to strengthen the board's monitoring role
 - Independent directors need to account for one-third or more for prime companies
 - Higher standard corporate governance required for companies listed on the Prime Market
 - Required establishment of nomination and compensation committees and the use of skills matrix
 - o The code focuses on diversity of core talent – diversity of management rather than diversity of board members
 - o Requirement for prime market listed companies to disclose climate change related information on the Task Force on Climate-related Financial Disclosure (TCFD).
- Over 3700 companies are listed on five market segments, they are being restructured into three markets segments: Prime, Standard and Growth. The Prime Market is targeted for global investors. About 2200 are currently listed in the first section and they wish to transfer to the Prime market which means they will need to qualify based on numerous criteria such as trading value, market cap etc... About 1800 companies are expected to qualify.
 - ⇒ There will be pressures to reduce core shareholdings as they will be excluded from the number of shares in circulation.
 - ⇒ There will also be pressure on smaller companies to keep the market cap of tradeable shares over 10 billion yen to maintain the listing
 - ⇒ Companies under 10 billion yen will be excluded over the next few years.



There have been remarkable changes since 2015; among them in the number and ratio of independent directors increased dramatically, 73% of TSE first section companies appoint one third or more of independent directors. Research shows that independent directors have raised the effectiveness of board meetings, enhanced the monitoring role of the board, invigorated discussions in the board room and improved governance in Japanese companies. The length of board meetings on average now exceeds two hours when it used to be under an hour. It is worth noting that there is a lot of disparity in Japanese companies based on the number of independent directors, split roles between CEO and Chairman and use of nomination and compensation committees. There are also disparities in the management of Board meetings such as time dedicated for discussions and the level of engagement of independent directors. The way independent directors see their role (more as advisor than monitor) also makes a difference.

Challenges:

- Diversity: Female directors are still less than 10%. The ratio of non-Japanese Directors is much smaller compared to Western companies. There is also a need to enhance diversity in background and experience since senior management is dominated by executives who have only worked for one company. Age diversity is also a problem. People in their 60s account for 47% of all directors of TSE first section.
- Another challenge is the responses to ESG issues. Japanese Executives have embraced the importance of ESG and over 600 companies publish integral reports, but the quality of these reports is mixed. Some companies need to improve disclosure especially on social issues. Many Japanese companies still look at climate change initiatives as a cost not a focal point for innovation.

Quality engagement is crucial to reinforce and speed up positive change. In Japan internal executives still control most boards and there are not that many truly active fund managers who take the time to properly engage.

Recommendations:

- The governance code should set the compliance bar for independent directors at a majority – this should be done for all listed companies so that internal directors cannot influence decisions.
- TSE should amend its own governance code to no longer permit companies to define their own criteria for independence as it is the case now. This would boost diversity and skillset by forcing companies to look more widely for candidates. The present practice is confusing for investors and makes comparisons hard.
- The governance code needs to set forth more specific criteria for the composition, responsibility and operations of Boards. For example, the CEO should not be a permanent Board member so that discussions on his/her performance can happen unhampered.
- Director training is crucial, more governance related training and learning is needed at both companies and investing institutions. Often, fund managers do not know enough about the dynamics of Japanese Boards and thus cannot engage effectively. Historically proxy voting did not have a lot of impact in Japan but this is starting to change and this would increase investors' influence on companies' strategies.
- There should be a merging and standardization of disclosure reports for TSE, FSA, MOJ to avoid redundant reports and for reports to be published before – not after - shareholders meetings. Reports should be machine readable to permit the use of AI. Disclosure rules should focus more on what companies actually did. If the ISSB manages to globally standardize ESE reporting requirements, it will increase pressure on Japanese regulators to further standardize their own disclosure framework and electronic formatting. Disclosure in Japan is uneven and the minimum level needs to be raised in order to allow for efficient comparisons.

A company's strategic goal must be communicated clearly. Japanese companies often set forth medium term plans for only 3 years. Otherwise, they have a really long-term plan for 2050. A more flexible period of planning is required.

From an investors perspective given that more than half of corporate Japan has net cash balances simple engagement strategies around improving return on equity and shareholder returns - or actually having a dividend policy - will achieve a lot. One issue is the "lethargy" of the traditional asset manager in Japan. Big Japanese asset management companies are content with ticking the various ESG requirements and diversity boxes but there is not much in terms of actually engaging with management to improve the well-being of all stakeholders in the company they are invested in. The allies are predominantly non-Japanese asset managers while Japanese asset managers are still very silent, passive and process-driven in their strategies.



Another issue is the lack of policy framework set forth by the government, for instance on climate change. Japan declared its 2050 net-zero goal but the government has not yet published a road map. Missing this kind of policy framework for both investors and companies causes some difficulties.

In the context of a global race for global best practices, there could be a risk of backpadding under the Kishida administration, where the Prime Minister may be looking for exceptions for mid and small companies rather than pushing for better governance, greater diversity, ESG, etc... It is crucial to keep momentum. In Japan, global companies are really ahead of the pack, putting pressure on the government to solve the energy problem, threatening to relocate factories outside Japan in order to meet investors demand, etc). Global companies and investors have a key role in applying pressure. There is a disparity with smaller companies. It is the JPIF, government pension system that was the front runner and help set the global standard on ESG investment. However, the Japanese industry associations have not followed through. If this does not improve, necessary changes will need to continue to come from foreign pressure and from big companies.

ACCELERATING DIGITALIZATION AS JAPAN PRIORITY IN THE FIGHT FOR PRODUCTIVITY GAINS

The use of AI, digitalization and new technologies can transform business processes and create additional value, increase productivity and provide new experiences. However, if the pandemic had not considerably accelerated the digitalization pace, Japanese companies were expecting a potential loss of up to 12 trillion yen by 2025.

There are three digitalization steps:

- Within the company with cloud and security as the infrastructure supporting the process
- The creation of a new business ecosystems with an evolution of business models
- A paradigm shift with digital technology as the new frontier to solve social issues.

87% of Dx, or digital transformation, initiatives fail because:

- There is too much emphasis on the technology
- People fail to realize that a change management process has to bring everyone along
- People fail to realize that mindsets have to be changed in addition to training people and getting the needed knowledge and technology.

Successful digital transformation is about an organizational change leading to business performance improvement. For some it can be process improvement and for others it can be product innovation.

Companies first start by piloting digital transformation in small business units (process, product or geographical unit level) and then scaling within the company. Some start with their core business like retail or service companies which usually start with product innovation. Others make a strategic decision to start with a periphery process or product innovation. Are corporations in Japan ready enough to make the necessary adjustments for successful digitalization? Role models and best practices are needed to show the way with success stories and a mix of top down and bottom-up approaches, addressing Japan's unique specificity and needs.

Digital transformation goes beyond the corporate framework, spreading across companies and industries and fostering collaboration. The issue is how to make the technology and data connected and open to all. The key is how to use technology and foster a collaborative culture critical to progress.

In terms of the labor market impact, digital transformation has brought in some positive elements such as handling repetitive and physically taxing tasks. In the hospitality industry for instance, humans are reallocated to higher value-added tasks, hence increasing productivity while not leading to an overall reduction of hires. Nomura Research Institute research has shown that 49% of work in Japan will potentially be automated in the next two to three decades. These



figures are not much different from those in the US, with the difference that Japan will experience a labor shortage. Digitalization will bring agility and speed but a sectoral approach is needed.

One concern with automation is de-skilling. With digitalization, tasks will be fragmented, and workers will only handle a small fragment of the process. This will lead to skills elimination and monotony accompanied with physical, mental and psychological issues. The other problem is wage drops as human and robot's performances are compared. Labor conditions could become more stringent and there could be a large discrepancy between highly skilled workers and so called 4K workers. In that respect, Japan has not seen wage increases in a long time.

Digital transformation brings four categories of relearning, reskilling, upskilling:

- 1) Technology: the type of digital tools that a person can learn such as AI or blockchain
- 2) Data: the ability to understand and extract data and work with different data sets
- 3) Processes: the understanding of different processes and the development of new processes related to technology
- 4) Change management: going from digitalization to digital transformation.

Companies are starting to focus on hiring digital talent which, added to the existing labor shortages in the digital service industry, is fostering a competitive environment. This is enhanced by workstyle changes, the ability to work from anywhere and the "cross skilling" brought on by new technologies allowing people to add new skills to their resume. The Japanese government is starting to focus on the digital talent shortage but unfortunately much of the labor market is not yet digitally oriented.

Companies usually deal with three different types of employees:

- 1) *Digital natives*: who have grown up with technology but need to understand change management.
- 2) *Digital immigrants*: who may not be completely comfortable with digital and are willing to learn but need the technology, data and process skills.
- 3) *Digital ignoranst*: who find digital technology alien, frustrating and have a negative attitude towards it. This population needs change management in addition to content skills.

IBM, as a pioneer Japanese company, introduced system development where the core system was outsourced and renewed every couple of years and the company focused on customizing the hardware and software. With the acceleration brought by technology, companies need more agile digital products developed in house which implies having the IT people in house. This is a confirmed trend and the issue is to keep talent evolving at the same pace of a constantly evolving technology.

IMD business school published in 2021 a world digital competitiveness ranking (capacity and readiness of countries to adopt and explore technologies as a key driver for economic transformation) in which countries are ranked in three categories: digital knowledge, digital technology, future readiness. Japan ranked 28 out of 64 economies. The ranking identified weaknesses in the Japanese digitalization process in the following areas: Digital technology and skills, individuals with international experience, understanding of the opportunities and threats linked to digital disruption and the use of big data and analytics. These areas should be of particular focus for the new Japanese Digital Transformation Agency.

Guidelines still have to be outlined in terms of digital governance and corporate digital responsibility: how to achieve digital transformation in a responsible manner? How to develop practices and behavior that can help an organization or a government use data and digital technologies in ways socially, economically and environmentally responsible. We need a holistic approach moving away from silos. The concept of digital governance and of corporate digital responsibility could help in terms of finding appropriate ways to spread resources – such as the ten trillion yen university innovation fund – amongst different priorities such as climate changes, digital transformation et.



THE LEAP FORWARD THAT ACHIEVING GENUINE GENDER DIVERSITY WOULD MEAN FOR JAPAN

Japan has implemented several policies to involve women more in the corporate and political domains with mixed success. For instance, the 2003 policy targeting women to reach 30% of management and leadership positions and the 2015 proposal to reach 10% of women board directors, both goals to be achieved by 2020, both unmet. Japan is now implementing its fifth basic plan for gender equality “where all women and girls can thrive and achieve their full potential”. The plan does not go as far as setting quotas but aims at increasing the number of women in politics as well as in managerial and director positions in corporations.

The issue is most acute in politics, as Japan is ranked 120th on the World Economic Forum general gender gap index, 117th in terms of economic participation and opportunity, 92nd in terms of educational attainment and 147th in terms of political empowerment. Japan is also lagging in terms of speed of change. As an example, in 2012 there were only 2% of female mayors in Japan and still only 3% in 2020. At the National level, only 10% of house representatives are women and only 23% of senators are women. These percentages have not changed in the past 10 years.

There is no pressure in the political arena. Voters are not discriminating but the system is skewed towards the incumbents who generally are men.

- ⇒ Pressure and change need to come from voters (majority of women).
- ⇒ Quotas may force change but come with a set of issues.

In the corporate world, there is an undeniable shift, and change has been faster thanks to tremendous outside pressure. For instance, Nissan’s Board now counts two women out of eight board members. The company has embraced diversity as a strategy aiming at better competitiveness and better profits. At Nissan, 7% of managerial positions were held by women 20 years ago. This has increased to about 11-12% nowadays. Change was initiated by a top down approach but has now morphed into a trend through initiatives such as the company’s women leadership program that has also made a difference in men’s attitude. Some of the bottlenecks are social pressures as women are expected to shoulder the responsibility for taking care of aging parents and raising children. However, mindsets are also changing on this front. For instance, in 2012 Almost 60% of women would quit their jobs after having children as they could not find childcare. This makes it difficult to find female talent that is willing and able to embrace new opportunities (like promotions abroad etc...)

The pandemic may be helping to create a women friendly work environment. In April 2020, female unemployment was double the male one because women were more likely to be part-time workers and thus easier to fire according to labor laws. Even though remote work existed before, it was a limited option. The pandemic has changed Japanese workstyle, democratizing telework with the potential to transform the Japanese society and help the employment of more women being involved through teleworking.

In terms of the role of Boards for diversity promotion, the revision of the corporate governance code in 2021 has generated tangible pressure and a sense of urgency even if it does not quite go as far as introducing quotas, so actions are being taken by many corporations. For instance, Itochu Corporation has set up a committee to promote women. For the sake of objectivity and transparency the committee is an external body, advising the Board of Directors and counting six members (half of them outsiders and half of them women).

Japan definitely needs to create a more women work friendly environment:

- ⇒ Investors and social pressure are paramount to change
- ⇒ Talent nurturing from school to the workplace: Only 6% of engineering students are women, and promotion campaigns could open new education paths for young women. Later, while employed in corporations, women need to be nurtured to develop managerial experience to become as competitive as men with comparable exposure.



- ⇒ Role models: some companies do match-making between younger and older women but there are not enough older role models. Some sort of forum where younger women could meet older role models - men or women – to benefit from their experience would be helpful.
- ⇒ Changing mindsets: Europe got to 50% of female directors through the introduction of quotas which might help changing mindsets, making the presence of women on boards something that is expected as the norm. As a transitional solution this might help create a new reality.

LESSONS ON RESILIENCE AND BOUNCING BACK

Japan is still on the arduous road to recovery from the shock and crisis created by the pandemic – and once again the hope and expectation is to see Japan’s resilience prevailing over the challenges and difficulties, as has been the case on so many occasions in the past.

Of course, there have been many criticisms about the way the government in Tokyo has managed the crisis and this has led to the resignation of Prime Minister Suga. But it is interesting to note that, contrary to what was the cases in almost all other countries, the Japanese government did not act through edicts but rather proceeding with “recommendations” that the people, by and large, followed even with some grumblings.

What constitutes the basis of Japan’s resilience when facing challenges and disasters? How to characterize this resilience? How can it be strengthened further?

Is there any kind of “Japan exceptionalism”? Resilience is what is in stock among the Japanese and is in ample supply. It comes from people’s voluntary commitment. It is not the result of any societal engineering process. In fact, this societal system engineering was in scarce supply during the pandemic. Japan had no enforcement law to contain the pandemic even during the Olympic games. The government could not do anything to get the hospitals to provide more beds for the victims of the pandemic. Prioritization of policies could have been much more efficient had the country familiarized itself with the notion of social system engineering approach.

Resilience is founded in the civic spirit and the patience of the citizenry. However, one key lesson to be learnt now is to re-design the nation’s provision of resilience. If one relies only on the patience of citizens for societal resilience, the society will grow weary. According to a survey of the people of France, the US, Sweden, the UK and Germany from an international consultancy, Japan looks as an outlier as the Japanese people emerges as the most pessimistic people among those surveyed.

European governments took a very strong leadership approach in addressing the Covid crisis. They looked at it as a war against an unknown disease and this made people understand that they could not pursue their lives as before and that the cost of fighting this war will have an impact on the level of taxation that will have to be imposed on the citizens and that there would be a toll on the security of lives. They also emphasized that people should accept changes in policies because this a war against an unknown enemy. By setting this stage they ensured that there could not be too high expectations from the part of the people. This is a major difference with Japan where the government did not explain or emphasize enough the nature of crisis and people assumed that they could pursue their life as before. This made it difficult to take the necessary measures without mentioning the cost.

In a way, the resilience of Japan is the resilience of its people and it has played its role in sustaining the country throughout the crisis almost – one would say – despite the lack of proper leadership and of enough action from the part of the government. However, resilience is also the result of innovative and entrepreneurial spirit. It has been interesting to see the capability of some Japanese companies to invent and to re-invent themselves in the face of adversity. Startups were able to continue their business despite the restrictions and investment is now fully back. Revenues are going up again and we are going back to normal.



There are some worries about where Japan is going at the moment. Even before Covid hit in late 2019 the increase of VAT created a small recession. Prime Minister Abe had a blueprint for action, great popularity, and the longest time in office. There was an opportunity to modernize labor market, to rekindle innovation, to reduce bureaucracy, to create incentives for startups and innovation, to become a leader in renewable energy, to digitalize the economy and to invest in 2025 – as China is doing. China is investing in the future, Japan is focusing on today. So, the resilience of Japan is due to previous conditions and is not improving. And this should be a warning signal.

One can hope that Prime Minister Kishida will revitalize the economy but there is concern about the lack of new thinking. This new thinking could become more visible once – having won the elections for the Lower House - Mr. Kishida can bring about his own signature policies. Japan budget is bigger in scale and size than Saudi Arabia or Turkey's whole economies. 73% of which is for fixed expenditures such as paying back government's obligations, social welfare, etc.

The biggest task for any Japanese Prime Minister today is to rewrite the social contract, reduce social welfare for the elderly and give more to the younger generations. For any Prime Minister to be able to do that he, or she, must win elections consecutively. We will need to see whether Mr. Kishida will win the elections for the Upper House in the summer of 2022. One can hope that he could do that and come up with new plans for the future that will strengthen the long-term resilience of the country. He knows how to run the government and how to make best use of the bureaucracy.

Japan's resilience is difficult to fully understand for people who don't know the country well. For instance, there is no underestimating how Japan's knowledge about China and its understanding of how China works and operates – which is much better than European or American's understanding of China - is also part of this resilience.

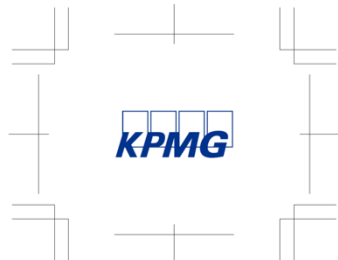
It is true that Japan is not investing enough in the future, contrary to China. In Japan only six out of one hundred new companies registered in the Tokyo Stock Exchange are hardware companies. We are losing diversity. We are losing the race towards digitalization, compared to some other countries.

Covid is an important test of Japan's resilience. One key element for the future resilience of Japan is to make active use of the ample amount of cash and deposits which represent 40% of Japan's GDP which are left sleeping. Covid is showing the urgent need to make full use of these financial resources to prepare the future and improve its resilience. The country has so much potential that Prime Minister Kishida could help unlock. No country is better positioned than Japan to provide the new sources of renewable energy that the countries around it, comprising three billion people, desperately need.



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