

Japan at a crossroads

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1. Changing face of London

Thirty one years ago in 1977, I came to London for the first time in my life. I was a member of a Japanese delegation to the G7 Economic Summit to accompany a senior official in the Ministry of International Trade and Industry (MITI). At that time, London was crowded with shoppers from all over the continent. The British Pound went down to a historic low level. Literally, London was at a bargain. It was obvious that the English industry lost its basis to international competition with other European countries, the US and Japan. It was at this time that Fujitsu began its relationship with ICL(International Computers' Limited), the forerunner of Fujitsu Service, which is one of the key organizers of today's event. The word "English disease" is still remembered by many people of my generation.

2. Trading places

The last three decades has seen our two countries having traded places. At its height in 1993, Japan ranked second in per capita income. Last year, she slipped to as low as eighteenth, below most European countries. As an economist, I must point out that it is very much due to artificially cheap Yen and deflation and overstating the problem of Japan. But still, it remains that our economy is not performing as well as it should. Looking to the future, our long-term growth potential will be less than two percent per annum, and continue to be the slowest growth economy. Our population will age at a very fast speed. Fifteen years ago, Professor Paul Krugman called the United States as "country of diminished expectations" Today, this word seems more fitted to Japan. The Euro and British Pound are the most expensive currencies in the world. Japanese visitors to London and Paris are surprised with the high prices for hotels, restaurants and many other services here. More surprisingly, such high exchange rates do not seem to do any damage to the UK business. We cannot but wonder why this trading of places has happened.

3. Revival of Europe

Europe rejuvenated itself from decade long ailments by creating a large united economic region in which firms were compelled to compete. The UK came back by removing protections for its industry and by inviting foreign investments. While the manufacturing industry contracted, the financial and service industry has more than compensated. The European economy is growing at a speed much faster than Japan's. Today, large cities in Europe have had facelifts compared to thirty years ago. In London, we see many Asian, Indian, African and Arabic people on the streets. More recently, immigrants from Eastern Europe are adding to the cosmopolitan face of large European cities. About one half of the population of London is now foreign-born people and their children.

4. Model for Asia?

On our side, long term prospects are much more subdued. At the bottom, lies an aging population. Already, three working men and women support one aged person. By 2025, this will be only one and half people to support one senior person. The pension and national health insurance programs are certain to collapse. The domestic market stopped growing. Companies are moving factories abroad. While bringing more foreign workers into Japan makes a good deal of sense, Japan has been cautious to do so. On the contrary, since the departure of Mr. Koizumi as Prime Minister two years ago, the call for reform has met many negative reactions and has lost its steam.

In my view, one reason why reform is difficult is that, after all the Japanese economy is not so bad. Japan still carries a high level of external surplus. Government debt, while high, is financed by domestic savings, not by borrowing from foreign countries. The country is generally safe, although not as safe as it used to be. The unemployment rate is still around 4%, much lower than most industrialized countries. Corporate profit has kept expanding over the last six years. Japan needs to become even worse before people will begin to take change seriously. I do not know of any country that embarked on major reforms when their unemployment rate was less than 10 %.

5. Foreigners as the source of new blood for old economy

However, in the long run, Japan cannot continue this lackluster economic

performance. A turnaround must come in the next ten years. It is in this context that I look at the experience of Europe and UK. First, Japan needs an Asia-wide economic region, where not only trade and money, but peoples are also allowed to move freely and competition and specialization will take place. While there is some truth that foreigners may cause social tension and insecurity, the European experience confirms that movement of people across borders benefits more than it may hurt. Generally speaking, Asian countries are far stricter in controlling the inflow of foreigners. In Japan, only a small number of skilled workers, such as doctors and professors, have been allowed to come and work in Japan. The total number of foreigners living in Japan is around one percent, compared to ten in Europe and the US. Japanese software industry may regain its power, if young, brilliant engineers in neighboring Asian countries are allowed to come and work in our laboratories.

6. Service sector can sustain a large economy

Second, the integration of the European market, where European companies were forced to compete on a much wider scale, must have had a positive impact. While this forced the United Kingdom to abandon the manufacturing sector, it made it possible for London and the UK to become the global financial and IT service center. The significance of the financial sector to the overall economy is much greater today than thirty years ago. The flow of money has increased at much greater pace than the size of national economies or volume of international trade. During the last few years, this trend has only intensified and it creates an even greater advantage for London as an international money center over its rival, New York. London siphoned oil money from the Middle East and funneled it to the US that was in dire need of financing external debt. Today, Russia and former Soviet Union countries like Khazafstan are sending their oil revenue to London.

The UK is not the only one which benefited from European integration. Germany and Spain are also benefiting in different ways. German economic growth has accelerated, as a result of the large Eastern European market which is now open to the German manufacturing industry. Overall, European integration is a clear success and has brought Europe back to the forefront of global competition.

7. Asian integration is business driven

Can Asia do the same? This is the main topic of my speech tonight. The idea of creating a great economic region has been around for twenty years. Asia-Pacific Economic Community, is meant to be such a region. Originally, this was thought of by trade officials in the Japanese government. But Japan abstained from taking a high-profile initiative because of the risk of bringing back the war-time memory of the "Greater Pacific Co-prosperity Sphere". Japanese diplomats were reluctant to do something that might be seen as excluding the United States. In addition, strong agricultural lobby disturbed any effort that might lead to opening up of agricultural market. At a more theoretical level, there was some doubt whether regional integration was the right idea, as it would discriminate against non-members. Japan quietly instigated Australia to take the lead, but at that time, the country was not been regarded as a genuine Asian nation. As for china, due to lack of established track record as free trader, the country is not yet seen as credible leader. ASEAN, an Association of South East Asian nations, is expected to play a drivers role, but wide diversity among them makes it hard for ASEAN to act as one united force.

This lack of leadership is the fundamental weakness of Asia. The progress made so far has been modest. In spite of this, East Asia has gained gravity in the world economy. It is largely Japanese, American and to some extent, Chinese businesses that united Asian economies across borders, rather than deliberate government policies. Production chains are now divided into several stages, each one of which is produced in a different country and assembled into one final product. This fragmentation of production is particularly noticeable in automobiles and electronics.

8. The time has come for policymakers to do their jobs

While these Asian countries share a desire to become affluent, there is not much common institutional framework. Some countries have market based economies, others maintain vast state control over a wide range of business activities. Some have solid democratic political regimes, but many countries still remain under dictatorships. There is no firmly shared conviction that open trade is good. Given this diverse situation, Asian countries have made it a rule, although it is not a written rule, not to intervene into domestic matters. This tradition of Asia makes frank exchange of opinions impossible thus making mutual learning difficult.

Since the turn of the century, however, a new situation is gradually emerging. China

became a member of WTO in 2000. After China, a few other Asian nations have followed suit. This means that most Asian countries now commit to the same trade rules as us. In addition, over the last two years many Asian countries successfully concluded bilateral negotiations on free trade, or are under negotiations to be concluded before the end of this year. If these Asian countries bind them to open trade, it would become feasible to establish an Asia-wide free trade area. There is no doubt that the time is ripe for government officials to move forward in that direction.

9. Two initiatives on the table

If Asian countries agree on free trade on a bilateral basis, the next logical step is to agree on a single region-wide multilateral free trade agreement. To achieve this goal, Asian governments decided to let independent economists from each country to come together and explore the possibility of region-wide integration. They deliberately evaded formal governmental negotiation. At present, two initiatives are under discussion. One is the East Asia Free Trade Agreement (EAFTA) and the other is the Comprehensive Economic Partnership in East Asia, CEPEA, for short. EAFTA was proposed by China. The idea was to establish free trade zones among ASEAN 10 (Thailand, Philippine, Indonesia, Singapore, Malaysia, Brunei, Cambodia Laos, Myanmar (Burma), Vietnam) and three large players in northern Asia, namely Japan, China and Korea. Japan made a different proposal, to include yet another three countries, Australia, New Zealand and India, all of which used to be former British colonies. The scope of CEPEA goes beyond free trade and covers economic assistance, human capacity building and the environment. India may compete with China for a leadership role in CEPEA. The presence of Australia and New Zealand makes agriculture a contentious issue, as most Asian countries fear a possible effect on their domestic agriculture. There are many complicated issues ahead of both EAFTA and CEPEA. At present, these initiatives are at the stage of intellectual brainstorming among independent economists. I am the chair of the CEPEA. My group will produce an interim report later this month that suggests a possible scope of CEPEA and roadmap to achieve the goal.

10. Is the political will there?

How fast will East Asia move towards a full scale integration? I am not entirely optimistic about something significant can be achieved over a short period of time. It is still doubtful if all Asian nations are convinced of the benefit of free trade. Japan is today

too much preoccupied with mounting internal problems. The developmental gap is much wider in Asia than in Europe or North America. Countries like Vietnam, Cambodia, Laos are arguing that narrowing the developmental gap should come before anything else, to say nothing about trade liberalization. Australia and New Zealand want greater access for their agricultural exports. Still, CEPEA may have a greater chance of success than EAFTA, as it encompasses a broader set of problems, such as developmental assistance, aid for human resource development and environmental protection. There is a wide margin of cutting deals with the least developed countries.

11. A case for an OECD in Asia

As a former OECD official, I feel strongly the need for an international organization in this region like OECD. This organization should provide a forum to discuss issues faced by governments, ranging from macroeconomic, financial issues to more structural ones, such as trade, industry, environment, developmental aids and transport infrastructure. Government officials from Asian countries can discuss these issues, not in isolation from each other, but from a mutually-linked perspective. They also understand how a policy taken by one country can affect others, and if necessary, can make changes. Such processes of policy coordination, peer review, and mutual learning will facilitate the capacity building for government officials of Asian countries. Having served as a chairman of CEPEA, I find that Asian government officials need to strengthen administrative skills, improve communication and documentation skills, and agenda setting and process managing skills. Asia needs an independent secretariat, like OECD or European Commission. I know people dislike bureaucrats, but international cooperation is impossible without competent bureaucracy. Building strong human capability for Asian governments is the ultimate goal that I wish to achieve in CEPEA.

12. Hard lesson: technology is not a panacea

I am very aware that tonight, there are many CIOs and CTOs in this room. While I am an economist by education, between 1995 and 2001, I was the Director for Science Technology and Industry of the OECD, and I have strong views on technology, particularly information technology (IT). Japanese are staunch believers in technology. We never doubt that the Japanese success in the postwar period has been due to its technological prowess. While we were sometimes accused of having stolen technologies from abroad, we have spent much higher proportion of our wealth on R&D than any

country in the world. In the same manner, Japan has invested 15 % of its GDP in plants and equipments, much higher than Europe or US. IT accounted for a lion's share of such investment.

But since the 90s, suddenly, the Japanese IT industry began to lose its position. For example, in the middle of 80s, Japan produced more than 50% of semiconductors in the world, but a continual slide has left its market share at less than 20% today. The US regained the market position which was once lost to Japan. Korea and Taiwan also broke into the Japanese monopoly.

13. Fallout of the IT industry

Why did all of this happen? It is largely due to the unique nature of IT. Technology necessary to produce high quality semiconductor chips was in the end embodied into semiconductor producing equipments and was rapidly spread to neighboring countries. Korea and Taiwan could easily learn how to make chips by importing such producing equipments. In addition, they aggressively recruited Japanese engineers to their laboratories who flew to Korea and Taiwan Friday evening without the knowledge of their companies, and came back Monday morning in time for office hours. This is the way Asian countries learned information technology. Of course massive government subsidies did contribute to their success.

Unlike other industries, most of the IT products, such as personal computers, mobile handsets, and flat panel displays are produced by assembling a few key components. And these key components are easily purchased at open markets. The assembly stage does not call for special technology. This is why new entry is so easy, commoditization is so inevitable and price competition is so fierce. Technology is no longer a defining factor. The key factor is how we can produce products cheap without producing cheap products. One obvious solution is to move factories to Asia. But, Japanese IT companies insisted on producing at home under their close supervision. They did not want to compromise their quality for low cost. This was a fundamental mistake.

Other mistakes were made. Japanese mobile handsets are far more versatile and equipped with too many functions and features, very few of which are actually used by ordinary people. They are made on a technology standard unique to Japan that is incompatible with the global standard of second generation GSM. Today, most of the

handsets used in Japan use third generation CDMA, capable of handling moving pictures. In China and India, they buy much simpler and cheaper handsets. This incompatibility of technical standards and mismatch with the market inflicted a fatal blow on the Japanese mobile set producers. Their products could not find a market outside Japan.

14. Classical case of Innovators' dilemma

The theory of innovators' dilemma fits most to the Japanese telecommunication equipment industry. When the internet came into commercial application, the opportunity was greatest for Japan, since Japan had the best telecommunication equipment industry. But they were reluctant or at best cautious, because they had high stakes in the existing landline telephone network, which was operated by the NTT, by far the most important clients for them. They feared that the internet would "cannibalize" the telephone business and decided to take the strategy of "wait and see", rather than trying to lead the transition to the Internet. This happened not only in Japan, but many other industrialized countries. Well-known telecom equipment manufactures like Lucent, Siemens, and Alcatel all fell into the same trap.

15. Scarce entrepreneurship

What made the United States, and for that matter the UK, different from Japan and Germany, was that in these countries there were many new ventures and start-ups that tried to take advantage of these new opportunities. It was not old large firms like IBM that led the internet revolution in the US, but young ventures like Microsoft, DELL, Cisco Systems, Yahoo, e-Bay and Google, to name a few. All of these companies are less than thirty years old. Unfortunately, such ventures did not come about in Japan. So, one thing which Japan must take seriously is to how to create an environment conducive to risking start-ups. While the number of start-ups and university spawn ventures increased this decade, so far very few of them have reached the stage of public offering.

16. University –industry collaboration

Universities are called upon to make greater contributions to the vitalization of Japanese industry. Japanese universities, particularly state-owned top-notch universities were traditionally not interested in working with private company engineers. They even looked down on research for money. They were slow to understand what companies

wanted. Japanese companies, for their part, preferred to work with foreign universities, because they were much more receptive and flexible to meet their needs. Today, they spend about two times as much money to foreign universities as to the Japanese ones on scientific and engineering research.

But, this old attitude of Japanese universities is now steadily changing. University-industry cooperation is now very rigorously pursued. The intellectual property regime was modified in 2000 to allow universities to use their intellectual property for joint research with private companies. Movement of scientists between university labs and company are on the steady rise.

17. Old industry remains strong

Setting aside IT, other manufacturing industries strengthened their position even further. Steel, automobile, petrochemical, construction machinery, are all recording record high profits during the last three years. In these sectors, innovations have been relatively slow and continuous. In this type of industry, the Japanese approach, which is very well known as KAIZEN (continuous improvements), works well. Even in the IT industry, the Japanese raw material industry is strengthening their base. For example, while Japan lost semiconductors, the silicon wafer remains largely in the hands of Japanese suppliers. Glass plates and color filters for LCDs (liquid crystal display), spindle motors for HDD, lead frames of semiconductors; these are all a stronghold for Japan. One worry is that so far, we do not see a sign of new service industry arising.

18. Soft power

With all these, I do not mean to say that Japan's future depends solely on technology. We are beginning to realize that we have other powers which we have not been fully aware of. Soft power. Japanese animated movies, Manga, and sushi are now loved everywhere in the world. Japanese rice and apples that cost ten times the world price are now being exported in increasing volume to China. Widespread trust in the quality and reliability of Japanese products is of course the basis of a good image of Japan. Asian leaders are beginning to mention publicly that Japanese economic aid has been very helpful in their economic development. Japan is the only industrialized country in the world that has not exported weapons at all during the last half century. Japan's Self Defense Force has not been sent abroad to engage in combat. Not a single bullet has been

fired by them outside Japan. In the past this was seen as sign of weakness. But now it is admired as proof of a sincere commitment to peace. The global Peace Index of this year ranks Japan fifth in the world. UK ranks 49th, China 67th and the USA is 97th.

19. Changes start with young people

I see signs of important change not in the corporate board room, but in the attitudes of young university students looking for jobs. In my generation, top notch students went into public service, then banks and large firms. Not a single student ever thought of going to a foreign company or an unknown venture business. Today, the most popular companies are foreign companies like Mckinsay, Goldman Sachs and JP Morgan. The Ministry of Finance, METI and Bank of Japan are having trouble in recruiting good students. These students believe that they have a better chance of testing their talents in these foreign subsidiaries than in the traditional large firms. Japanese companies cultivate young people patiently over a ten to twenty year period. They do not have such patience and want to take risks at much younger ages. Over the next ten years, the post-war baby boomers, who currently fill up senior management posts in large corporation, will leave and new types of Japanese people will take over. The next ten years will be a very interesting time to watch Japan. (over)