



## **Report on Wilton Park Conference 933**

### **JAPAN: CHALLENGES AND OPPORTUNITIES IN THE GLOBAL ECONOMY**

**Wednesday 22 - Saturday 25 October 2008**

**in association with The Foreign and Commonwealth Office, The Japan Foundation, The Great Britain Sasakawa Foundation, The Department for Business Enterprise and Regulatory Reform (BERR) and support from Virgin Atlantic Airways Ltd.**

#### **Executive Summary**

A group of senior Japanese, EU and US policy makers, opinion leaders and corporate sector representatives gathered at Wilton Park against the background of the deepening international financial crisis to discuss challenges and opportunities for Japan in the global economy.

The key conclusions of the conference were:

- The current financial crisis has highlighted the interconnectivity of the global economy which many believe requires a shared international response. There is a growing realisation that the global financial crisis is increasingly impacting negatively on the Japanese economy. This reinforces the feeling that 'we are all in this together'.

- The rapid and concrete response by both the US and EU governments to the current credit suggests they have already learned from Japan's 1990s credit crunch experience. There are further direct lessons for the US and EU including the need to ensure prompt

disclosure of and disposal of bad debts to prevent further economic weakening.

- Japan, with its huge cash reserves, is in a strong position to take advantage of global business opportunities resulting from the current global economic turmoil.
- Despite the growth of China, Japan will remain a dominant player in the Asian region and may emerge as a 'global balancer' in the trilateral relationship between the US, EU and Asia.
- Japan needs to re-engage globally with a more strategic mindset and awareness of its national brand. It could demonstrate greater multilateral leadership on key global issues such as climate change. If Japan is to 're-emerge', a critical factor will be the nature of its bilateral relationship with China. Japan and China need to resolve a number of bilateral issues to create a real partnership of equals. Its relationship with China needs to be conducted separately from relations with the US.
- In spite of some domestic opposition to globalisation, Japan's democratic values and respect for the rule of law, ensure that it will continue to be valued as a reliable, long term partner by the EU, US and Asian partners.

### **The Credit Crunch: Japan's Experience and Response**

1. The 1990s is known as the 'lost decade' for the Japanese economy. One of the main reasons why Japan performed so poorly in the 1990s was that financial institutions were slow to disclose and write off non-performing loans caused by the collapse of the asset price bubble. To that extent, one of the lessons from the Japanese experience is that failure to disclose and dispose promptly bad debt will result in ongoing weakness in economic activity. Many believe US and European countries are disposing of bad debts more rapidly than Japan did in the 1990s as disclosure frameworks are generally already in place. Furthermore, the market will be able to put a value on the portion of bad debts that have been securitised. Even so, the US and European countries are

probably in for several years of weak growth.

2. With the turmoil in the global financial system, the global economy faces the most dangerous crisis since the 1930s. The International Monetary Fund (IMF) World Economic Outlook's forecasts for 2008 and 2009 have been revised sharply downward. Whilst there is a low likelihood of another Asian financial crisis, an international response to stabilise financial and money markets requires an ample injection of liquidity, whilst avoiding excessive regulation.

3. Japan almost uniquely has been through a financial meltdown closely resembling what most western economies are undergoing now. Japan's experience suggests aggressive monetary easing and the concentrated provision of large injections of public funds into financial institutions can go a long way towards helping resolve financial crises. However, compared with the Japan experience in the 1990s, US and European responses to the current economic turmoil have been more rapid.

4. Some regard the current economic crisis as having ended the liberal international economic system and globalisation. Nevertheless, globalisation will continue. Competition and free open markets will remain core principles. The US's global standing has been tarnished, and it appears a paradigm shift to a new multi-power international system may emerge reflecting the growing economic power of Brazil, Russia, India and China (BRICs). As part of this process, a shift in the balance of global wealth to Asia in particular is underway. Although Japan's economy will constitute less than 5% of global GDP by 2020, it is critical for Japan's future success to accept the inevitability of globalisation.

5. The extraordinary current market turmoil may in fact prove an opportunity for Japan. Japan's economy is in relatively good shape given its limited exposure to sub-prime lending. Japanese banks and companies have large capital reserves and Japan's financial institutions are relatively stable. Japanese financial institutions have by and large managed to keep their balance sheets in order. Japan's overseas financial assets

now total \$5.4 trillion. Japanese financial institutions, as big players in both Japan and globally, will be able to make a major contribution to the global economy in the future. In the current economic crisis, Japan will increasingly be seen as a 'white knight' capital provider. Japanese firms have the advantage of being regarded as co-operative, long term partners, as witnessed by Nomura's rescue of critical operations of Lehman Brothers and Mitsubishi's significant investment in Morgan Stanley.

6. If Japan is to succeed globally in this new era, it will need a new and more open strategic mindset. The current crisis gives Japan a chance to access new, especially developing country, markets. Investment and partnership are part of a competitive race for leadership with China, South Korea and India which are moving aggressively into new markets. More than 45% of Japanese exports now go to emerging economies, where both infrastructure investment and consumer spending are likely to continue growing solidly.

7. To address the future challenges of the global economy, Japan needs to attract more Foreign Direct Investment (FDI) and promote Tokyo as one of the three major global financial centres. Japan carried out a comprehensive reform plan for enhancing the role and competitiveness of its financial market in 1998. The Japanese government has set a target of increasing FDI to 5% of GDP by 2010.

### **Japan and Regional Challenges**

8. Emerging economies are not 'emerging', but simply recovering their past importance. In 1820, two thirds of total world GDP was generated in Asia (India accounted for 40% and China 20%). By 2005, developed economies and emerging economies' share of global GDP was split 50/50.

9. The shift towards Asia will provide more opportunities than challenges for Japan. Currently 60% of total Association of East Asian Nations (ASEAN) +3 trade is intra-regional, and by 2010-2015, a vast free trade area will be a reality. However, the

outsourcing of production presents a challenge to Japan with, for example, more than 30,000 Japanese firms operating in China alone.

10. Today, there is renewed 'Japan bashing', but this time primarily by the Japanese themselves. Japan is experiencing political gridlock as it needs to deal with a new global landscape. Japan should end the introspection detrimental to Japanese national interests and which undermines Tokyo's credibility with allies. The reluctance to embrace economic reform is matched by a similar hesitation to assume a higher international profile. There is little domestic support for playing a leadership role internationally. This ambivalence is evident in the failure to develop an effective regional strategy. Japanese diplomacy in Asia is generally perceived as being reactive and hamstrung by domestic political constraints. Japan must learn to develop and communicate its own strategy. Tokyo must embrace a more creative diplomacy that plays to Japan's strengths: creative, highly skilled individuals, innovative technological solutions, and skilled and patient diplomacy. Realism is an essential element of this approach. A policy that disregards the conservatism of the Japanese people and its policy-making community will not succeed.

11. Four key threats face the Asia-Pacific region: a major global socio-political backlash driven by inequality and the absence of democracy; war; climate change and other environmental disasters, and the resurgence of protectionism. Japan must do its part to mitigate these threats out of enlightened self-interest. Each of these threats poses serious consequences for Japan. It is more vulnerable than the US or EU.

12. China, Laos, Myanmar, North Korea and Vietnam in particular are at threat from growing inequality and authoritarian rule. Arguably the key long-term challenge is building democratic structures and a pluralist political culture. Growing internet and mobile phone usage nurtures more a sophisticated political culture and greater calls for political freedoms.

13. Another key challenge is building an efficient security architecture for regional co-

operation. Stability in the region, particularly in the Sea of Japan, is crucial for Japan's long-term economic well-being. There are already multilateral bodies, but regional security organisations are needed. Greater stability in bilateral relations between Japan and China as well as with North Korea need to be forged. The Japan-China relationship obviously has the greatest strategic importance, but a truly equal partnership remains elusive. With the gradual emergence of China as the dominant economic power within the region, Japan (as a major economy with a mature democracy) will nevertheless be an indispensable economic and political 'balancer'. Japan should engage robustly in regional initiatives in which it has vital national interests. Japan should view regionalism as a way of engaging and restraining China. Japan needs to engage actively in regional fora such as Asia Pacific Economic Co-Operation (APEC) and ASEAN + 3. With the critical supportive role of Japan, an effective East Asian Community becomes a greater possibility.

14. In the early 1960s, Japan was one of the world's most stimulating intellectual environments and many regarded it as highly 'open'. Today, Japan is ironically regarded as one of the most blatant globalisation 'rejectionists'. History demonstrates globalisation does move forward over time, but is temporarily thrown off track by wars and other calamities. Given the potential to generate protectionist tensions, large trade and financial imbalances between Asia and US are currently major concerns. If protectionist pressures grow markedly as a result of the current recession, this will adversely affect Japan given its large export sector.

15. Japan is ineluctably drawn into a nexus of political, economic and security ties that would make it difficult for Japan to reconcile with protectionism. Japan is caught in a tug of war between ties that increasingly bind it into regional and global operations versus its domestic constraints. Japan's approach to the liberalisation of its markets is fundamentally non-ideological, pragmatic and ad hoc in nature. As such, Japan will continue to seek and exploit opportunities to establish favourable trade opportunities. Japan will become an increasingly integrated member of the global community. As of November 2007, Japan had signed eight Free Trade Agreements (FTA) with countries

chiefly in Southeast Asia. Lower labour costs will continue to force Japanese manufacturing to seek host countries for the establishment of plants. As the economies of other Asian countries grow stronger, denying access to Japanese markets will become more difficult. Domestic fragmentation can paralyse political decision-making in Japan. The growing diversification of interest groups continues to make decision-making slow. Current domestic political and economic uncertainty makes any political platform advocating trade liberalisation untenable.

16. If Japan is to adopt an explicit stance in favour of trade liberalisation, the national mindset needs to change. It seems likely that Japan will follow a hybrid policy balancing fundamental tenets that underpinned its society during its high growth period, and the liberalisation of its markets which flow from its increasing global and regional ties.

## **Japan and the US**

17. Close co-operation in US-Japanese relations is particularly important in helping Japan address key international challenges. The US is Japan's largest trading partner and Japan is the largest export market for the US after Canada and Mexico. The US is the biggest investor in Japan and is Japan's largest destination for FDI. US-Japan economic relations are currently so 'calm' that it is rather difficult to maintain a high level of bilateral interest. Although there is little current trade friction, protectionist tensions may increase in the US if its economy continues to deteriorate significantly. Japan's share of the total US trade deficit has decreased from its 70.8% peak in 1981 to 10.5% in 2007. In contrast, China's share of US trade increased from around 20% in 2000 to 32.4% in 2007. Even if the US becomes more protectionist, the main target would be China, not Japan. Though in one sense positive for Japan, there is also a negative implication as the US loses its economic focus on Japan. The conclusion of a Japan-US Economic Partnership Agreement (EPA) would be an important symbol of stronger ties between the US and Japan.

18. Although Japan and the US have shared perspectives with regard to security

relations, the US-Japan alliance is underutilised and undervalued. It nevertheless continues to be the cornerstone of US engagement with Asia and will continue to be so under a Democratic Administration. New realities will oblige the US to work more closely with allies; this is an opportunity for Japan. Global insecurities are compounded by an assertive China, and a key issue for the US and China in their relationship is how to deal with China. Japan and the US should work whenever possible with China, and in so doing diminish Chinese apprehensions about the US-Japan security alliance.

19. Japan and the US can work together on modernising global organisations like the United Nations to reflect better today's, rather than the post-war, balance of power. The two countries should also aim to ensure the successful completion of the Doha Development Round of trade negotiations.

20. Japan's technological know-how and its experience in improving energy efficiency can contribute to an effective global climate regime. Japan's contribution could be most effective in this area, partly because it is the least political. Japan is a technologically powerful nation which should undertake more scientific and technological research in climate change. Asia is the most polluted part of the planet, and a major effort in green science and technology would be a major contribution to the planet and to Japan itself.

## **Japan and Europe**

21. The overall EU-Japan relationship is currently governed by an Action Plan which runs until 2011. Although the two sides have declared a 'strategic partnership' and continue to hold annual summit meetings, there is a sense that EU-Japan relations are not as dynamic and productive as they might be. The present economic context increases the need for international policy co-ordination with reliable partners. The EU-Japan economic relationship cannot be looked at in isolation from the political relationship. It consists of two global players with common values (such as the belief in democracy, human rights, the rule of law and the market economy), and facing common challenges. Both are economic and trading giants, and both are generally successful in



influencing global issues such as climate change and gradually making headway on peace and security and crisis management. Common challenges are: ageing societies, energy security, and the need to boost competitiveness while maintaining high levels of social, environmental and consumer protection.

22. In 2007, Japan was the EU's fifth largest trading partner, accounting for 4.6% of the EU's two-way trade. The EU is Japan's third largest trading partner with 13.4 % of Japan's two-way trade. Imports, exports and the overall trade balance have been remarkably constant for the last 5 years. Although the EU's deficit with Japan remains persistently high (€34 billion in 2007), it has not been a political issue for a number of years. Japan represents around a quarter of the EU's global trade in services. The EU has consistently been a net exporter of services towards Japan over the last 10 years. FDI accounts for a low share of overall Japanese GDP compared to other OECD countries, despite government targets to boost FDI. Japan accounts for less than 3% of EU outward investment (€75 billion in 2006 out of €2,700 billion), and is the only country with a FDI negative balance in 2006 (€13 billion).

23. Over the last four decades, Europe and Japan have emerged as leading world powers, constituting between them around 40% of world GDP. The financial crisis makes it all the more important to implement appropriate economic rules and regulations. To achieve deeper economic integration, an Economic Integration Agreement (EIA) of substance would be a great step forward in EU-Japan economic relations. However, a fundamental problem lies with the fragmented nature of Japanese Ministries: for there to be a realistic hope of success in negotiating an EIA, there will need to be significant political will at the highest levels, building on good work between regulators, business, stakeholders and government officials.

24. There much economic dialogue, co-operation activity and policy interaction going on in different fields. The EU-Japan Regulatory Reform Dialogue (RRD) has the merit of mobilising a broad range of government stakeholders. In some cases, there are institutionalised in bilateral agreements. The Action Plan, for example, allows room for

new issues such as consumer protection and safety at the April 2008 EU-Japan Summit. The June 2007 summit focused on protection of intellectual property rights and on innovation policy. A growing area for co-operation is higher education programmes between universities.

25. There is still untapped potential in Japan for the EU to increase its investment in Japan and its exports of goods and services. Crude measures of two-way trade and two-way FDI flows as a percentage of GDP, confirms Japan is much less open towards EU trade and investment than equally distant major economies. Progress in the RRD sometimes feels slow but has contributed to a number of positive changes in Japan (e.g. adoption of new rules allowing triangular mergers; recent improvements as regards financial services regulation; increased Japanese interest in the 'Better Regulation' approach to law-making). In terms of broad economic co-operation, the picture is fairly dynamic with new issues such as consumer policy and innovation being added. The main focus remains on dialogue and exchange of information.

26. Japan remains an important partner for the EU but a focus on shared interests and mutual benefits should be translated into more concrete cooperation to deliver more together on the global stage. The RRD process can be made more forward-looking by ensuring a more predictable regulatory environment for companies operating in the two markets. A critical challenge is how to improve regulatory convergence, transparency and predictability between the two. The EU Commission publishes an annual legislative and work programme, but there is no equivalent initiative from the Japanese side (i.e. there is no centralised government legislative programme published in advance which is open to consultation; each Ministry is responsible for its own policy area). When considering possible new initiatives in the trade and investment field from a European perspective, it will be important to consider how to address the imbalances in terms of market access and investment whether by a new Action Plan or by legal tools such as a bilateral agreement.

27. Japan is one of the UK's most important global partners sharing democratic and

free market values and a key ally on many areas of foreign policy. The UK Government's 2006 strategy document for UK-Japan relations focused on climate change, development, international security and science. The aim is now to focus on why the UK-Japan relationship matters to the UK and drive the bilateral strategy forward on three key pillars: keeping the UK as Japan's top EU bilateral partner, encouraging Japan's engagement on global issues, and promoting Japan's role as a regional and multilateral player.

### **Future Co-operation on Global Challenges**

28. Japan's global visibility is declining. It needs a coherent foreign policy which reflects the inter-relationship between national interest and national brand. There seems to be a lack of country reputation management. Japan needs to move beyond being seen as the 'global banker'. Economically speaking, the nation is seeking a rent available only for those responsible for managing the global system. Hence Japan is pursuing a seat at the United Nations Security Council. Japan needs a more prominent, role and brand both in Asia and in Africa. It needs to contribute positively to any new global financial regulatory regime or climate change initiative. It should stress its peaceful and democratic credentials. Japan's continued prosperity and self-esteem will be based on maximising the potential of its young workforce.

29. Future global co-operation agreements will be driven by stresses on global supplies and a heightened need for economic security. Multilateralism will be strengthened by pro-activity on the part of one or more benign power players (e.g., Japan) and accommodating key emerging countries such as China and India. The world needs stronger leadership and co-operation in providing global public goods in adequate quantities. Japan's experience and track record provide a suitable base on which to build leadership in the critical areas of international financial stability and market efficiency; climate change; good governance in global institutions, and regional integration.

**Martin Murray**  
**December 2008**

Wilton Park Reports are brief summaries of the main points and conclusions of a conference. The reports reflect rapporteurs' personal interpretations of the proceedings – as such they do not constitute any institutional policy of Wilton Park nor do they necessarily represent the views of rapporteur.