



An Agenda for Horizon 2020

Tokyo, 1-2 July 2019, 15th edition

Executive Summary



THE GLOBAL ENVIRONMENT

The three key centers of economic activity are facing major uncertainties with two clouds hanging over the global economy:

EUROPE: All indicators show a trend of strongly declining economic momentum with Germany struggling to avoid a recession and most indicators in other major European economies moving downward, to the point that the ECB plans to keep rates at their present levels at least until the end of Spring 2020. There is now a strong expectation towards reviving quantitative easing by that time or even before.

Beyond the impact of Brexit, three major worries:

- The weakness of some key elements of the European banking sector.
- Italy's increasing indebtedness and breach of budget commitments that could trigger a crisis.
- The lack of political consensus on the future of the integration process with the difference between Paris and Berlin becoming more pronounced leading a paralysis risk and of not fully efficient answers to the next crisis.

United States: Although GDP figures still look positive, the declining trend is getting more pronounced. Key fundamentals – new housing data, declining car sales, the inversion of the yield curve – are pointing towards a sharp slowdown, or even a recession in the US by the beginning of 2020, or even still at the end of 2019 as the impact of the US/ China trade war and of Trump' trade policies is starting to bite.

China: The Leadership is trying to keep growth at the officially targeted level of around 6.2% and has to manage the challenge of finding the best mix of fiscal and monetary policies to achieve its objective, while continuing to fight persistent financial risks in the context of severe head winds in the international environment. Another key challenge is to make a reality out of the pledge to provide a demoralized and cash-starved private sector with the capital needed to allow it to play its crucial role as a job and growth creator at a time of rising youth unemployment.

Two looming clouds:

- The destabilizing impact of the rise of protectionism and the weaponization of trade acting as constraints on investment and business decisions all over the global economy.
- With interest rates close to "0" or even negative in many countries, and quantitative easing entering the phase of diminishing returns, central banks are running out of tools to act if the present slowdown gets more pronounced or turns into a recession.

COPING WITH THE NEW GLOBAL TRADE PARADIGM

The multilateral trade system is under attack with the spread of protectionism, the escalation of trade wars and the risk of "tit-for-tat" measures getting out of hand. Moreover, the International institutions were not prepared to deal with a new economic superpower functioning according to a different system - China - and the big uncertainties around BREXIT are adding to increasingly destabilizing volatility.

The US going it alone "strategy": The current US administration is working without any concern for allies and does not seem to have any clear strategic vision. Trade imbalances are a top concern for President Trump even though most economists agree that they are not an important factor for bilateral relationships. Trump favors a trade restrictive solution and the use of tariffs, weaponizing trade and acting unpredictably - as he sees predictability as a weakness.

Four factors that could limit damages:

- Business community influence on President Trump's actions.
- Republican members of Congress are traditionally free trade oriented ... but so far this Congress has not been assertive.



- US economy: if domestic growth decreases and this is attributed to the President's policy, it will affect his margin of maneuver as he has his re-election as a priority concern.
- Traditionally US presidents have not come from a business background, however Trump keeps on combining his personal business with economic issues, but this element is very difficult to assess.

US/Japan: In 2018, Japan accounted for 8% of the \$880 billion US trade deficit. Trump's moto for the US/Japan relationship has been "Free, fair and reciprocal". The first round of negotiations for the US-Japan trade agreement were held in April. The agreement should solve the agriculture export issue. However, Japan has difficulties understating why President Trumps sees the automobile issues as a national security threat. Japan produces one third of the vehicles in the US. The negotiations might end up in 35% tariffs, or voluntary restrictions. The tariff increase would affect consumer durables (i.e. PCs and smart phones).

The *Structural issues between the US and China* are manifold and have an impact on Japan, which exports to China have been declining from November 2018 to May 2019, with the exception of February. Japan is not an export base for China anymore. Companies doing business with the US have to reexamine supply chains and assess the effects of the US-China confrontation. This could lead to the decoupling of the American and Chinese economies, dividing the global economy into two big spheres, with some companies having to split their supply chains into a US or a China centered one. What is produced in China will more and more be consumed in the country as its domestic market keeps growing. The other big concern is the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA) that will subject foreign investors to new restrictions on deals providing foreign access to sensitive data or weakening U.S. technological superiority.

The Japanese market: The Japanese market is strong because of the size of the country's middle class but with the widening of the wealth gap and baby boomers - who were the biggest consumers - now in their 70s, the market will shrink. Chinese consumers are hugely important for Japan and their tastes are evolving depending on the tariff categories imposed by China. In 2018, 30 million people visited Japan out of which eight million were from China.

FROM AMERICA FIRST TO AMERICA STAND ALONE

President Trump is a populist "who wants to get people more and have them pay less". The tax cuts that he has introduced will increase growth but will not be sustainable, especially if the government maintains its spending policy.

On trade, Trump's most important issue is his focus on the trade deficit. He does not understand that America's trade deficit is exactly offset by America's investment surplus, even though, others in the administration understand the offset element and are less worried about the trade deficit. However, the president has fundamentally changed the trade debate as most Republicans and more and more Democrats are seeing China as a strategic competitor or even a threat. This might open up a role for Japan in helping to contain China's influence.

Most nations in the developed world are going towards Greek style fiscal crisis, if they do not reform their entitlement programs, ideally by moving towards funded systems where people pre-save like the Singaporean system. The US is no exception in the long run as its population pyramid is becoming a population cylinder.

On monetary policy, Trump is a Keynesian. He wants the Fed to have artificially low interest rates. He is irresponsibly pushing an easy money policy on the assumption that there is no inflation and that this sustains economic growth in whatever context. According to Claudio Borio, Chief Economist at the Bank for International Settlements, easy money does not necessarily translate into high consumer prices but could trigger asset bubbles. The US could be heading towards an asset and debt bubble added to the unfunded liabilities that the government has because of the population changes.

On a potential recession, the volatility of the stock market is indicative of the nervousness of the business and financial communities. It might be a medium-term scenario but when the recession will hit, it will be hitting quite hard. Indeed, the traditional response to a recession is the use of fiscal or monetary policy, however interest rates are already very low, or even negative, and QE has already been used thus there might be no other tools left. Yet, the US is "at the end of the domino line" and has some protections:

- flight capital usually goes to the US
- the US has its own currency which also serves as the world currency



ASSESSING CHINA'S UNCERTAINTIES

“China is like a great pendulum, when it swings to the right it is synonymous with reform and opening and when it swings to the left it becomes more nationalist and conservative”. The pendulum has been swinging back and forth throughout history. At the moment, it is on the left but some analysts think that it will go back to the right as the country needs to address its financial woes: non-performing loans, declining investment returns leading to the soaring of outstanding debt and the forecasted increase of pension liability in the years ahead which could reach 80% of GDP by 2050.

The Chinese government has put a clear priority on the Digital Economy which represents about 38% of GDP and keeps growing. The greatest factor is China's gigantic market with 820 million people having access to mobile devices. It is in this context that the Trump administration policy to stop or delay China's technology drive is destined to fail. It can have a slowdown impact in the short term, but it is spurring Beijing to accelerate its efforts towards technology self-sufficiency. In addition, China has an unlimited supply of data as well as a huge talent pool – one million engineers out of seven million graduates per year.

As of now, China is ahead in some categories and the US is ahead in others. In the next 15 years, China will be the largest economy in the most comprehensive sense but, presumably – while it wants to be the equal of the US - it has no desire to be the “top dog” in the world as it sees a lot of liabilities being in this situation.

FOREIGN POLICY CHALLENGES...TOWARDS A HIGHER PROFILE FOR JAPAN

- Japan is the only Asian country represented at the G7 where it is important to have a non-European, non Anglo-Saxon perspective on a number of international issues.
- The Middle East remains crucial for oil and gas. Japan is working at avoiding a nuclear Iran.
- Japan also supports the Kushner Initiative as it is crucial to give some hope to young Palestinians.
- The reinvigoration of the US-North Korea Dialogue is positive, but it is important to maintain the impact of sanctions on Pyongyang and, in that respect, ship to ship transfer by North Koreans in the South China Sea are becoming more difficult to prevent. Japan is ready to provide economic cooperation once the nuclear and abduction issues are addressed.
- The Japan/China relationship is getting back to normal with Xi Jinping having accepted Mr. Abe's invitation for a state visit in 2020.
- On the Japan/Russia front, Mr. Abe and Mr. Putin agree on the need for a peace treaty but the islands issue remains very difficult to solve and Ministers Kono and Lavrov have been asked to resume the negotiations on the issue.
- The North Korea and China factors make the US/Japan/Korea relationship more important than ever, but the Korea/Japan relationship is at its worse because of the Korean Supreme Court Ruling on the issue of “Wartime Labor”.
- However, people to people interactions are very strong with 7.5 million Koreans visiting Japan and two million Japanese visiting Korea last year.
- The UN, now 75 years of age, does not reflect the reality of the 21st century and needs to be reformed.

At the global level, various elements of conflict have become more conspicuous and Japan needs to reinforce its alliances with other countries: While the US, North Korea talks have resumed, the global community needs to work together to enforce existing sanctions. The major source of concern with respect to China is authoritarian nationalism and the expansion of its military capability but at the same Japan needs to manage its economic interdependence with China.

The 3 pillars of Japan's Self-Defense remain:

- Enhance the Defense capabilities
- Improve the reliability of the US/Japan Defense and Security Agreement



- Collaboration efforts: Japan needs to collaborate with India, Australia and ASEAN countries on the China issue and has to work to reverse the deterioration of the multilateral systems and the rise of nationalism and populism.

North Korea: Kim Jung Un is very different from his father as his ambition is “normalization” of North Korea which implies economic development and positioning of the country between the US and China.

Possible Expectations

- A deal within this year to limit Pyongyang’s nuclear capabilities and the closing of the Yongbyon nuclear facility?
- More summits with equal drama (Moon Jae-In invitation to Kim to visit South Korea).
- A Trump invitation to Kim to come to the White House or Trump visit to Pyongyang (with the US presidential election in mind).

Prime Minister Abe is the only major leader who has not yet met with Kim. “Unconditionally” is now the new code word used for a possible Abe/Kim agreement to meet, although the abduction issue remains crucial and there will be no money flowing from Tokyo to Pyongyang without this issue being solved.

DOMESTIC CHALLENGES

JAPAN’S OPTIONS AND CHALLENGES

The persistent lack of inflation is a key issue for Japan however, 2% is not an absolute target, 1% might be enough according to some. Other priorities are to enhance competitiveness and to solve the labor and low productivity issues. Some structural issues are hindering Japanese companies’ innovation capabilities such as minimum wages that are burdening SMES. Japanese companies need to be able to raise their prices to be able to invest in innovation. Japan still needs to create its “Japanese style” ecosystem including universities alongside companies helping to foster an innovative environment. Top ranking universities in Japan need to become competitive with global top universities. Others should be more specialized locally. It might help to not segregate Liberal Arts, Innovation and technology as synergies promote innovation.

MAKING JAPAN’S EDUCATION SYSTEM PROVIDE TOMORROW’S SKILLS AND EXPERTISE

Some say that the Japanese education system is not what it used to be but, if one looks at the OECD Program for International Student Assessment (PISA) scores, Japan is actually doing quite well ranking 5th for Math (US is 40th), 2nd for science and 4th for reading. However, Japan is lagging behind in English language skills, ranking quite low on TOEFL scores. The English Educational reform is set to happen in 2020, as of now, English teachers in Japan are not native speakers. “Katakana” needs to be eliminated. Korea has made enormous progress in English teaching and could provide some best practices. Japan needs a whole new education plan that innovates and does not only provides patches and piecemeal reforms.

While the quality of education has not necessarily deteriorated, the curriculum is not anymore adapted to domestic and international realities. The Japanese system is not producing curious and innovative individuals. The curriculum is focused on memorization, with no incentives for children to think on their own or debate. Most entrance exams are multiple choices, and there is no training to write or think for oneself. The problem starts in pre-school. Children need to be taught problem solving and independence.

Lifelong learning is another issue for Japan. An OECD study on adult skills shows that Japan is first in terms of literacy but only 30th for problem solving. Lifelong education is one of the focus of Society 5.0, including for teachers. The government needs to provide incentives to broaden the pool of teachers.

Concrete steps:

- The role of teachers needs to be redefined to adapt to current realities and include technology use.
- Central government funding needs to be redirected from the elderly to education, schools need to be equipped with computers.
- Teachers need to be trained to deal with “Monster parents”.



ENTREPRENEURSHIP ECOSYSTEM

Japan ranks 33rd in terms of the number of unicorns in the country with only 2 startups valued over \$1 Billion. The funding for startups has increased significantly but Japanese companies go public on small capital and with inexperienced management which often results in premature IPOs. There are lots of small-scale venture companies with few exits. Growth funds do not exist in Japan and large corporations are the main focus with lifelong employment. The SMEs model is not as successful in Japan. There is a lack of competition. Young Japanese people are not motivated to start businesses, especially as unemployment declined under Abenomics. Women in particular are facing handicaps in terms of venture financing.

Japan has a debt governance not an equity governance, this is the reason for the lack of risk taking as well as the fact that failure is still very much taboo in the Japanese culture. Japan is still a victim of its post WWII economic success, but that generation is on its way out. The younger generation who has not experienced these successes is hungrier. Attracting foreign entrepreneurs is also crucial, as seen in Silicon Valley where half of the startups are created by foreigners. Incubators also need to be supported and there is an important role for regional governments to play there. Japan has the second largest capital market in the world, a large amount of private equity funding and a good micro-cap market. There is a view that the government should not regulate until the ecosystem is mature enough. There are no natural buyers in Japan as opposed to the US. "Japan is a lukewarm environment". Japan may be too defensive to bring in foreign business and activist investors are also discouraged by its shrinking market.

One of the issues affecting tech startups in Japan is regulations as AI is fed by data and regulations are limiting data collection and use in Japan.

Structural challenges:

- Japan's government debt is the largest in global history as a result of the lost two decades.
- The tax structure needs to be adapted to foster and not hinder economic growth. A major issue is how to shift from direct to indirect taxation. The Inheritance tax in Japan is also a big issue as it is currently very high. Reverse mortgages could be a solution. If the retirement age was raised this would increase the tax base.
- Social security: The October raise of the consumption tax to 10% is not enough. Pension money should cover the basics, but luxuries should be paid by supplemental income.
- Medical care cost in Japan has reached 43 Trillion Yen of which 5 trillion is paid by the patients, and the rest by public finances. If the share paid by the patient is not increased, public finances will become unsustainable. A Private sector medical care insurance system should be introduced.

LABOR REFORM

The demographic trends will shrink the labor force as well as the market size and increase social costs in the context of a national debt already at 224% of GDP and rising. Labor shortage and productivity gains are thus the central issues for Japan's economic growth. The government has worked at increasing productivity, changing the remuneration system (outcome linked pay) and increasing mobility. However, this has been met by resistance from the Unions and the Left, as workers will be threatened, and skills need to be updated.

High tech and Artificial Intelligence can help enhance productivity and help solve the labor shortage. 5G will be fully available next year.

Japan is actually not lacking in potential workers but is still not succeeding at involving more women, older people or foreigners in the workforce and productivity remains too low. Proposals are made for the retirement age to be extended past 70 or linking it to life expectancy. Japanese workstyle also needs to change.

The changes made so far to the immigration policy are still insufficient:

- Naturalization: The rules are still very opaque which prevents Japan from attracting talented foreign people.
- Japan immigration policy changes involve specified skills visa (345,000 over the next 5 years), extension of the stay with family, supporting services (Japanese language and education for foreign residents). Unfortunately, Immigration is still a taboo issue and there are challenges to the new policy, but attitudes are starting to change. The number of foreign workers has doubled in the past 5 years. 2.7 million foreigners live in Japan and that



number is expected to increase by 200'000 a year, mostly from Southeast Asia but this will diversify in the next 10 years. Foreign workers need to enjoy 7 basic rights: unemployment insurance, medical insurance, injury insurance, education, no housing discrimination, pension scheme, and local voting ability.

The key questions:

- Can Japan introduce a full-fledged immigration policy soon?
- Can Japan attract able foreign workers in the new visa system?
- What will happen to Japan over the next 30 years?

JAPANESE CORPORATE GOVERNANCE: EVOLUTION AND FUTURE CHALLENGES

A year has passed since the implementation of the corporate governance reform. Senior executives think that the code has been a good opportunity for change, but some passive companies do not willingly comply with the code. In recent years, the pace of reform has accelerated, and information diffusion has increased. The quality of board meetings has gone up. The level of data disclosure has risen but there is still too much boilerplate information and genuine dialogue is not necessarily taking place. Disclosure needs to keep pace with corporate governance reform. Another device is risk and Management Discussion & Analysis disclosure. Principle based guidance was added in March. Management executives need to take the initiative. Best practices in disclosure are necessary. Management performance also need to be disclosed to investors. Answers to frequently asked questions need to be included in the Reports. Negative information is important for investors.

The number of independent Board members has significantly increased in 2018. The pool of independent directors in Japan is not big and not made of young people versed in the digital world. Diversity is critical, people who can disrupt the current status quo, innovative people. Diversity includes women but also expats.

The management mindset is changing in Japan and if corporate governance was first led by the government it is now spearheaded by companies with a power shift towards shareholders. Despite these positive changes further revision of the stewardship code is needed as well as more substantial changes and a longer-term vision and strategy. More companies are taking significant measures, but the gap is widening between those who do and those who don't. The dialogue with investors needs to be promoted as well as transparency of audits.

LOOKING BEYOND OLYMPICS 2020

Governor Yuriko Koike: The 2020 Olympics will feature the largest number of disciplines in history with 33 sports and 339 events. The Paralympics will feature 22 disciplines and 540 events with the largest number of athletes in history: 4000. A substantial effort is being made to promote tourism and make the events as democratic and safe as possible with innovative measures to manage traffic congestion and heat. The events will be shown on giant screens in Tokyo as well as in the four prefectures that suffered the most from the 2011 tsunami.

The latest IMD's World Competitiveness Report put Japan on 30th position, its lowest ranking in history. Tokyo should be the driver of Japanese economic growth. Governor Koike's strategy focuses on people, human resources and in particular women. Highways and the Shinkansen were the legacies of the 1964 Olympics. The 2020 Olympics aim at implementing policies for Safe, Diverse and Smart cities, while continuing to secure Tokyo as a global Financial City "FinCity Tokyo" with the establishment of a new eco and social friendly fund and programs promoting entrepreneurship - in particular female entrepreneurs. Leveraging data is a crucial way to implement Society 5.0 focusing on mobility (public and private data platforms), healthcare and government functions.

The governor is also focusing on "life work balance" ("life" 1st on purpose) and telecommuting. By 2020 35% of companies should have telecommuting systems (currently about 19% have them).

Only Tokyo, New York and Paris have declared that they would be "O" emissions by 2050. By 2030, 50% of the new cars sold in Tokyo should be "O" emission vehicles. Subsidies programs will be expanded.

Sustainable growth and mature city are two key words in the new long-term plan developed for Tokyo.



While the Olympics might not have a significant economic impact for Japan which is already too big and with sufficient infrastructure, 2020 is crucial in a different way, “to confirm Japan’s commitment to the goal of an open and diverse society with a prosperous and dynamic economy”. Japan needs to focus on its more fundamental growth elements: it is already the most active free trader in the world, which is exemplified by its commitment to continuing TPP without the US, by the recent free trade agreement with the EU, and the negotiation for an FTA with the US.

Six years ago, Japan received 8 million visitors, out of which about five million businesspeople. This number is expected to reach 35 million this year. Five years ago, the government decided it needed a tourism strategy because the population was about to drop drastically and a well thought through process was put in place. The Olympics are emotionally important because people believe that millions of people will be coming to Japan and thus, they decided to implement all the infrastructure buildouts that will actually make millions of people come to Japan. The Japanese hotel industry will also need to increase its competitiveness despite its natural rigidity.

THE FUTURE OF JAPAN’S MONETARY POLICY

With a general sense that a global recession is looming, signs abound of interest rates reductions which will generate distortions. The Japanese long-term interest rate is -0.195. In order to maintain rates at 0.2% the BOJ needs to stop purchasing JGBs. The US rate is neutral. Japan at 1% is not relaxing. There is a 1% natural gap between the US and Japan. Inflation is neutral at 1.4% so in the short-term the Japanese interest rates are still higher than neutral. The GDP gap in the future will be lower than the potential growth rate. In general, the BOJ is still in an easing mode (buying ETFs etc.).

In March 2013, the NIKKEI’s average stock price was 12400 yens, today it is over 21000. Non-Japanese investors are unwinding and buying JGBs but there is no liquidity available. The BOJ is weighing policy options in what is, in essence, an artificial market where the BOJ is the largest shareholder of major Japanese corporations. Even if Japanese stock prices are perceived as rather cheap, no overseas investors are aggressively buying. There is no sense of urgency in banks even though their situation is rather precarious as a result of the BOJ’s actions. Overseas actors who offer swap rates and other instruments have benefited. There are few new accounts created on Internet stock brokerages, only bitcoin operators are prospering. These are the results of the BOJ policy and they will have long-term catastrophic consequences.

Japanese major industries’ competitiveness has gone down dramatically compared to 2012. Critical key industry equity performers are underperforming. The Yen is weak which is affecting the Japanese industry. Some market distortions are emerging.

What are Japan’s options in case of a global recession? The modern monetary theory says that it is possible to go further in quantitative easing even though Japan has reached what is seen as a maximum negative interest rate. The alternatives are taxation on cash or on financial instruments. 2020 will be a very risky year with the consumption tax hike.

Can the BOJ keep its stance while the US and the European Union are easing? Short-term interest rates have to be addressed. Financial intermediaries are having difficulties. About 40% of the regional banks would not pass a stress test. There is a possible exit in terms of JGBs but not in terms of ETFs, which is why purchases of ETFs should be stopped immediately, and zombie companies should be eliminated. Companies have very large savings. The vicious circle needs to be broken. The BOJ policies might need to be reconsidered.