

PRESENTATION: ABE AND REFORM

Introduction:

I am going to address four themes as questions:

- How did Japan succeed in meeting its post-war economic challenge, from the 1950s to the 1980s?**
- Why did it lose its grip?**
- What needs to happen to revive its proven dynamism?**
- What does it mean for Manulife?**

I promised Dick that I would do this in 15 minutes, so I will.

1. First of all, what went right:

'Consider Japan'

- on September 1st and 8th, 1962, The Economist published a remarkable series of articles entitled 'Consider Japan'. These**

served to alert its international audience about a) the performance of the Japanese economy over the previous decade, (over 9% from 1951 onward, and averaging 10% from the mid-50s, and on to the First Oil Shock of 1973) and b) argued that this was not just of local interest, as its growth had economic and policy lessons for the rest of the developed world;

- The Economist made what today can only be startling, to wit, that 'in the name of common sense, government economists and apostles of conventional wisdom from all the world should be coming to Japan to study just how to emulate it'.

- One doesn't hear much of that today.

- I'll mention just a few features of Japan Inc that captured The Economist's attention, and that of virtually all other commentators, Japanese and foreign, over the next three decades:

a. Educated population:

- firstly, Japan recovered from the effects of the war with a highly educated population, and the knowledge of how to build an modern economy.

- its highly developed primary, secondary and technical education system produced graduates with high numeracy and literacy rates, readily adaptable for additional training in manufacturing and services by their employers; it was largely credited with having the best educated blue collar work force in the world;

b. Labour stability:

- it enjoyed tremendous labour stability, from the 1950s onward.

- for about 40% of the labour force, larger companies and governments provided full-time white and blue collar workers with long-term if not lifetime employment, seniority based pay, salary increases generated by a national contract negotiation system (for labor) and annual bonuses;

- All of this guaranteed to the employers a stable and loyal workforce, and to the worker, security, status and eventually and rising income.

- for the majority of the labour force, hundreds of thousands of SMEs fed directly into the manufacturing and services sectors; generally, they did not offer life-time employments, but growth provided almost full employment, and the system facilitated labour mobility;

c. Government

- **Government provided highly directed, specific, preferential and influential policy guidance – directed to both the manufacturing and services sectors – on everything from directing where national savings were to be invested to various forms of support such as direct subsidies, tax preferences, R&D support, procurement schemes, and at the macro level, expansionary budgets and growth targets;**

- competition policy was aimed at limiting and channeling competition, to support and maintain oligopolistic markets – three or four or a half-dozen major players in each key economic sector, such as steel, chemicals, construction, autos and auto parts, electronics etc, and in scalable services, such as banking and insurance, construction and engineering; the organized travel industry; publishing and the media; retail distribution and so forth;

- think of it like the provincial liquor monopolies in Canada, with the involvement of provincial securities regulators, shipping rules, licensing and accreditation rules and so forth, and multiply this across large parts of the Japanese economy.

d. Banks

- the half dozen private 'city banks' (enjoying reserve ratios at 2% to 3%), channeled high savings rates (generated by the bonus system and the Government controlled Postal Savings Systems, among other) towards

government designated investment sectors, especially in heavy industry and manufacturing.

- **Japan also benefited from significant geopolitical realities:**
 - **the US/Japan security treaty and its American-drafted Constitution allowed Japan to maintain relatively low levels of military expenditures, thus providing lee-way to spend on infrastructure, education and health;**
 - **the global economy was largely limited, until the 1980s, to the First World: there was no competition from China, the USSR or other parts of the socialist world, or from the LDCs: Japan operated in a relatively homogeneous, developed, GATT world, with little pressure until the 1980s and onward, to effect changes in its economic system.**

All of this lead, in the 1980s, to a great deal of over-indulgence, over-confidence and over-investment.

- Those of us who lived in Japan in the 80s will remember this well (its being repeated today in China), manifested not only by the

Japanese, but by people like Ezra Vogel (Japan as Number One), Clyde Prestowitz (Changing Places) and Paul Kennedy (The Rise and Fall of the Great Powers), all of which encouraged Japan to think that they had developed an anti-gravity machine that could propel the economy in only one direction.

So what happened to bring all of this down?

Two sets of things:

- firstly, the system's strengths turned into rigidities, thanks largely to its evident material success, and lead to classic economic and market bubbles, in equities, in real estate, in art, in golf club memberships, and in FDI; each of these markets suffered slow-motion collapse starting with the BoJ's late 1989 tightening of credit markets to the drastic declines in the real estate and equity markets during the next two years;

- and secondly, the world changed, both dramatically and more rapidly than anyone could have imagined.

- the ROK, Taiwan, the 'Tigers' and most dramatically, China took over the product manufacturing end of the business, through aggressive pro-FDI policies and the supply of state of the art infrastructure;

- ICT/Internet, Communications and Telephony technologies helped shift corporate and industry interests and profits from the raw production of things to revolutions in everything from innovation and design, branding, distribution etc. You don't buy a home entertainment system: you buy equipment and services that connect you to the entire world's entertainment offerings. Apple could never have been born in insular Japan.

- now some Japanese companies understood these changes – Fanuc was the world leader in industrial robotics in the 80s and 90s; Sony and Nintendo hugely influenced the

birth of computer gaming; Japanese auto companies remain among the greatest innovators in their sector; and Japanese manufacturing companies continue to be among the largest investors in China.

- but domestically, Japan has largely preserved kept what Richard Katz has described as a 'Mainframe economy in a PC world'.

- Its strengths became weaknesses, exacerbated by the collapse of the speculation driven, free money environment of the 1980s:

- for example...

- investment-driven growth in manufacturing lead to over-capacity and could not be sustained;

- protection of employment in the services sectors drove service costs to some of the highest and uncompetitive levels among OECD countries;

- the bureaucracy could not be the top-down driver of industrial policies, when innovation

came increasingly from the desk-top-world, instead of Japan's oligopolistic and comfortable oligopolies;

- with the insistence of MoF, the banking sector was initially turned, under duress, into a 'convoy financial system' to hide and bail-out non-performing companies, to protect them from bankruptcy, which socially is an extremely and personally humiliating admission of failure, instead of a necessary tool to reallocate assets and wipe the slate clean;

- the education sector, which produced the world's most literate and numerate blue collar work force in the world, could not and even today by and large cannot, educate Japan's young to the realities of globalization, with its requirement for creativity, ambition, flexibility and knowledge of foreign languages.

- some of Japan's high technology provides another examples of Japan's problems, and what is often referred to as the 'Galapagos economy', because many of the creatures that live so well there do not survive as well - or not at all - in other environments;

Japan has some of the most sophisticated ICT technology in the world, but only a small part of it has been designed to meet international standards, so that you don't see many Japanese cell phones, computers and software, GPS systems and so forth outside Japan; Kirobo, the humanoid robot sent to the International Space Station last week only communicates in Japanese;

- And so forth...

3. What happens next?

- Japan is famous for its tremendous capacity to transform itself, the examples given being the Meiji Restoration, which moved Japan from feudalism to the advances of the 19th century, and post-war period, when it became a democracy and the world's second economy;

- what is often forgotten is the length of the gestation periods for these massive changes – they each took a generation – and the amount of conflict and discord that accompanied them; Meiji was only solidified after putting down a civil war

a decade after the Restoration period began; and there were still huge anti-government riots in Japan in the 1950s;

- what they also have in common is the requirement for strong political leaders with a vision that can be accepted by large swathes of the Japanese public.

- they may be what PM Abe has won in the succession of Lower House and Upper House elections of December last year, and on July 21. Public opinion polls indicate that his support was based on the initial success, so far, of his three policy 'Arrows', initially focusing on monetary and exchange rate policies, and more government spending on infrastructure.

- objectives include:

- an inflation target of 2%, to be achieved by the end of next year;

- unlimited easing of money supply: \$600B to date, with \$1T the target by the end of the year (like the USA);

- jawboning the exchange rate to 202 by the end of the year, and 206 by end 2014;

- \$100 in infrastructure spending.

- So far, the first two of these policy sets have had a positive impact. The economy is beginning to turn around, with a weaker yen, a rise in growth, to 4.1% annualized in the last quarter, and growing business confidence.

- But there are limits to what monetary policy can achieve, and those of us with long memories remember the Koizumi years – 2001 to 2006 – which also enjoyed a turn-around thanks to restructuring of the banking sector, increasing the money supply, and a lower yen. But this was brought to an end with the Lehman Shock, and the slow-down in global demand.

- And given the situation in China and Europe today, it isn't obvious that Japan can count on global growth to support its easy money policies.

- What Japan needs – and to Abe’s credit he is vocal and insistent on this – is as the ‘Third Arrow’: structural reforms in society, education, competition policies, taxation, and the default role of government, which means a change in the mentality of the bureaucracy;

- the reality is however, and this is in the nature of reform, that every change creates both potential winners and losers, and the potential losers, which are often identifiable, tend to be better organized than potential winners, which are often more amorphous as well as skeptical;

- as examples:

- in theory, everyone should be in favor of the full engagement of women in society, but in order for this to happen, Japan men have to look at women as having roles equal to those of men in the labor force, which is not currently the case; companies have to be serious and aggressive about promoting women up and down the organization, which will displace men who think that they should be the hunter-gatherers, and women should stay at home; day care availability has to be

universal, and somehow paid for when average disposable income continues to drop, and government expenditures must be reigned-in;

- in theory, everyone should be in favor of a more open education system, except that the Teachers Unions are among the most conservative organizations in Japan, and rote teaching is easier to do and to measure than promoting creativity and students who challenge the absolute authority of teachers; university hiring practices are riddled with constraining rules and regulations which severely limit the potential for hiring outsiders, and professors in a demographically declining student population are worried about their jobs; only the University of Tokyo is rated by the Times of London among the top 50 in the world – Canada has three – and only 2 out of the top 100; English language courses are given in Japanese in its schools, with only the DPRK in Asia have less foreign language ability;

- in theory, government regulations on business should focus on creating implementing environments, but the default mode for 70 years has been controlling and

limiting competition, domestic as well as international, not getting out of the way; its been focusing on technical standards rather than performance standards, thereby limiting the scope for creating new technologies and products from the ground up; it has interlocking but separate regulatory agencies whose officials guarantee their day jobs and post-retirement jobs.

- In order to move forward, Abe now has to do two sets of things in the coming months and years:

- His government has to legislate the reforms that he in fact has been promoting: drastically reduce and reform large parts of the regulatory framework; fix the tax system to make it more competitive internationally and promote risk capital; make starting a business easier; establish a business environment as open as that of the United States, Britain and the other leading economies; increase competition within Japan's oligopolistic structures by liberalizing trade through agreements such as the Trans-Pacific Partnership and new bilateral agreements; and increase foreign

direct investment, meaning foreign capital, management skills and foreigners;

- each of these initiatives will generate fierce opposition; none is a slam dunk;

- Secondly, he has to get the Japanese people themselves involved in the reform process, by legitimizing the language and arguments for change, in a sense licensing proponents of reform within Japanese institutions. That's what happened under Meiji and in during the post-war boom. Politicians can't do everything.

4. What will this mean for MFC?

- political stability is a good thing – it has a demonstrated positive effect on economies – but electoral stability and internal party stability are different things: Abe has to demonstrate that he has the political mojo to get things done. Let's assume that his three arrows gamble will be reflected in killing off the deflationary dynamic, and encouraging growing investment and progressive improvement in wages and income;

- this should provide confidence and free up some of the \$15T in private savings in Japan for increased consumption and additional investment in long term protection and wealth; given the high penetration rates in Japan, opportunities will continue to be in niche products, perhaps types of indemnity coverage in health, or opportunities in drugs and pharmaceutical space or in nursing care; or wealth products such as deferred income annuities;

- as the McKinsey book points out, despite the crash in the annuities market, the long-term drivers of the annuity products remain positive;

- the need to reduce government expenditures and reform the health and pension insurance programs will open up additional opportunities for the private sector; 40% of the self-employed today do not contribute to their designated public pension plan;

- demographic niches may be more easily targeted, the 'dankai' baby boomers; the post-dankai families in their 30s to 40s,

who are not as well covered as their parents; singles, who are increasingly numerous and have their own needs; even the 'FREETERS' who live with their parents and, if employed, spend all of their disposable income;

- if Japan can move from deflation to modest inflation, there will be more leeway for the BoJ to start to move interest rates upward which will improve the return on our assets and help with our guaranteed products;

- there will likely be changes to corporate taxes (lower), investment tax credits (increased) but also consumption tax, which admittedly could threaten growth, as it did in 1998;

- liberalization of the insurance and wealth markets through bilateral and multilateral trade negotiations may become easier, indeed be welcomed; the US has already gained benefits by allowing Japan's participation in the TPP; we have our own bilateral EPA in negotiation;

- there may be renewed openness to introduce changes to the Insurance Business Law that would benefit foreign insurers, particularly in areas that specifically benefit Japan Post Insurance;**

- the revitalization of the Japanese market, which is among the most dynamic markets in terms of innovations in distribution, may also provide successful ideas that we can use in some of our other markets;**

- on the other hand, renewed growth could also have negative business impacts on us; for example, real estate markets are already beginning to improve, reducing the kind of speculative opportunities that have created high quality foreign investment plays over the last two decades;**

- a cheaper yen will negatively impact on our dollar earnings, unless counter-measures are taken;**

- FX stability might reduce appetite for foreign denominated products that have been successful for us; and so forth.**

- we will no doubt get a much better grasp of this from Gavin and his staff in Tokyo.

- at best, political realities will only allow Abe to be only partially successful in his reform objectives; but maybe he will reset the dial.

For MFC, we should, as always, hope for the best, and know how to respond to renewed opportunity, while always preparing for the worst.

Thank you.

Joseph Caron

August 7, 2013