

Rejuvenating Japan: Back to the Future

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Introduction:

In the midst of the ongoing global economic turmoil involving the world's richest economies, the most dynamic emerging markets, and a revolving cast of countries in crisis, Japan has featured in neither the causes of the crisis, nor its solutions. This is indicative of the degree to which Japan has been sidelined in the global economy, two decades after the burst of the bubble economy.

In spite of an initial wave of enthusiasm and high hopes when the Democratic Party of Japan (DPJ) gained power three years ago, unseating the long ruling Liberal Democratic Party of Japan (LDP), the outlook for economic and political reform today has certainly dimmed. Once again, huge spending increases are being directed at farmers and households, with the share of tax revenue to total spending in this fiscal year expected to slip below 50%. This is something that has never been seen before in Japan's entire post-war history. The fact is that all political parties, to varying degrees are dependent on an aging constituency. This effectively neuters their urge to call for radical change, even when they are tempted to do so.

Throughout Japanese history, seismic disasters have seemed to mark the dramatic end of an era. For example, shortly after Commodore Matthew Perry's conclusion of a trade treaty in 1854 to open up Japan to foreign trade, (signed by the Japanese literally under the guns of American warships) came the Ansei Great Earthquakes of 1854 and 1855. The advent of Japan's lost decades coincided with the Great Hanshin Earthquake in 1995. Today, speculations are rife of what momentous changes the March 2011 triple disasters may bring.

This Insights report argues that in spite of its turbulent political leadership and change-resistant

government, there is a viable and sustainable path to social and economic rejuvenation in Japan. This process of rejuvenation, however, will not come from radical reforms as advocated by many, the March 2011 earthquake and tsunami notwithstanding. Instead, the way forward to a more sustained, stable, and broad-based economic rejuvenation in Japan is ironically in its past. Recasting Japan's traditional strength in the context of a high tech future is one of the keys to unlocking the potential of the domestic consumer market, boosting business activities and sustaining employment at the grassroots level. In the aftermath of the March 2011 triple disasters, the behavior of ordinary Japanese people highlighted some of Japan's most abiding strengths that provide the most promising grounds for charting a course for future rejuvenation. In their behavior we could see a pattern of self-reliance, resolve, and creativity at the grassroots level that suggest a way forward.

The patience, courtesy, and the fortitude of the Japanese who lost homes and loved ones in the earthquakes and tsunami is truly impressive. Their ability to maintain social order even as the whole world seemed to crumble about them is nothing short of inspirational; and the rest of Japan also seems to have gained a newfound sense of unity and solidarity. In the aftermath of disasters in many other countries military forces are mobilized because of the need to prevent looting and other opportunistic crimes. On the contrary, in Japan, soldiers were mobilized for rescue and relief operations, not to patrol the streets and impose curfews.

The stories, appeared one by one, but gradually coalesced into a general pattern showing how the people coped with the devastating aftermath of the disasters. In many affected towns in the days immediately after the earthquake, people queued patiently to buy limited supplies of essentials, knowing that the supplies could not possibly meet everyone's needs. Yet no one tried to jump the queue or hoard the supplies. Many store own-



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Despite an initial wave of enthusiasm with a change of government three years ago, the outlook for economic and political reform today has dimmed due to huge increases in both taxes and spending.

ers sold goods to customers who had lost everything, accepting their IOUs on scraps of paper as payment. Operators in stores where the power supply had been cut off moved their perishable goods that required refrigeration to other stores where the power supply was uninterrupted for safekeeping, even though some of these stores are technically competitors. This pattern of spontaneous mutual assistance and generosity speaks volumes about the resilience and social trust at the community level.

This powerful sense of mutual assistance and social trust has also led to many instances of creative solutions and business innovations in addressing the needs of the community, a kind of self-reliant “can do” spirit that is completely at odds with the stereotypes of conformity, inertia, and herd behavior. In many small rural communities in affected prefectures, suppliers that delivered food and other necessities to the elderly in their homes (often with only a single elderly woman living alone), abandoned their regular delivery schedules, to find ways to stay in contact with these elderly households on a daily basis, sending them supplies of fresh food and other essentials as soon as they were available. Rural households in remote areas or in places isolated by destruction of transport links; self-organized into relay networks that sent food orders to the nearest supermarket on a daily basis for delivery. Delivery workers improvised to reach more remote households by motorbikes or even bicycles when road access was blocked. Many delivery workers doubled up to operate as healthcare providers when they visit elderly households, quickly learning enough for them to collect basic information on their customers’ health situation which they in turn reported to the nearest hospitals or clinics. No one from the government ordered these improvisations. These are spontaneous acts by businesses and workers in seeking solutions to their customers’ problems in order to care for them. These are spontaneous innovations at the grassroots.

We believe that the rejuvenation of the Japanese economy could be made successful by tapping into this deep source of resilience and traditional strength embedded in local communities. Such an approach differs and contrasts sharply with the standard diagnoses of Japan’s stagnation. It is an alternative narrative that suggests a very different future for Japan. However, to understand why such an alternative approach is necessary, we need to make clear why the remedies offered by the standard diagnoses won’t work.

Problems with the Standard Diagnoses

Since the burst of Japan’s bubble economy, a growth industry has sprung up that addresses the causes of and remedies for Japan’s economic stagnation. While there are competing interpretations of the causes of Japan’s stagnation, there is surprisingly little disagreement on what has to be done to turn Japan around. It is clear that Japan has a leadership challenge today. In order to change, Japan needs new and bold leadership, infusing it with younger leaders with bright ideas who are ready to challenge the status quo. Japan’s domestic economy has been made feeble as a result of too much protection from competition, thus competitive pressure has to be ratcheted up sufficiently to get the gale of creative destruction blowing. The Japanese corporate sector is coddled by the government— an unhealthy link that has to be severed. Japan’s aging population means that Japanese families will have to have more children. The shrinking workforce on the other hand will have to be supplemented with more immigrants. The rigid education system that emphasizes rote learning has to be reformed to empower students who can think independently and creatively. Japan’s public sector debts are also too high, and may soon reach the threshold where further government borrowing would become problematic— the government must curb spending and start paying down its debts. If Japan can implement even parts of this assortment of remedies, it would be making headway in terms of economic growth,

These remedies are not wrong. In fact, from a purely diagnostic point of view, they are all spot on. They are marred by just one small detail, no one has been able to come up with the idea of how to implement them. Take for example the problem of leadership shortfall. In the next few years, the first wave of baby boomers, born in a burst of procreative enthusiasm between 1947 and 1952, will hit sixty-five. Leaders of the two key political parties, the ruling DPJ and opposition LDP, are elected and supported by this boomer generation, who arrived at the peak of their careers just as Japan's economic bubble burst in the early 1990s. This boomer generation is therefore a traumatized one, worn down by two decades of rising insecurity and anxiety. Their political leaders merely reflect their inward-looking orientation and risk-averse approach to life. There may well be younger aspiring leaders waiting in the wing who think differently and are prepared to introduce radical reforms, but with Japan's aging population, they are probably not going to get the necessary electoral support to take over Japan's political leadership.

A more open immigration policy could certainly mitigate Japan's labor shortage. But obstacles to implementing such a policy are likely to be insurmountable. The first is language barrier. Very few of the prospective immigrants are fluent in Japanese, a language not widely taught outside of Japan. Lacking fluency in Japanese, immigrants are unlikely to perform well in Japanese society, regardless how skilled and well educated they may be. Then the Japanese society itself is not well positioned to deal with strangers, especially when they are there to work and live among them; a situation not to be confused with foreigners visiting Japan for short duration, who are invariably treated with gracious courtesy and hospitality. Elderly Japanese, particularly in rural areas and small town Japan, find it even harder to assimilate with foreigners. So an open immigration policy is simply a non-starter for Japan.

Recognizing Japan's continued dependency on exports to drive economic growth, which shackles Japan to overseas demand, many policy analysts and economists have long advocated wholesale deregulation and liberalization of the domestic economy. They think promoting competition to streamline Japan's notoriously cumbersome and rigid supply chains would also be beneficial. Making the domestic economy more competitive would raise productivity, which would in turn support higher incomes for workers in the domestic sector. This accounts for more than 80% of total employment. Again, a sound remedy for a serious problem that is a primary contributor to Japan's stagnation. But implementing such a policy means pitting domestic businesses against one another in head-to-head competition, and driving out those that are less inefficient. This means asking Japanese domestic businesses, (most of them are small and medium-size enterprises and often family-owned) to possibly ditch their long-time suppliers with whom they may have dealt with for generations, or to undercut businesses owned by people in their own communities, and perhaps even by their neighbors. Thus, such a policy would amount to upending Japan's social order, unraveling long established social and communal bonds in Japanese lives which are the very fabric that holds them together. For most Japanese, the social costs of such a policy are simply too high, regardless of its obvious economic benefits.

The bottom line is that while the standard diagnoses of Japan's economic ills are not wrong, they are just impractical given Japan's social, cultural, and demographic realities. Last but not least, it has often been pointed out Japan is not good at dealing with gradual, long-term challenges, especially when the origin of the problems are home grown. The analogy of boiling a frog in a pot of water with the temperature being raised slowly, with the result that the frog stays in the pot barely aware of the rising temperature only to die later, has frequently been used to describe the apparent inertia that has gripped Japan. As



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severe a shock the March 2011 triple disasters has been, many observers do not think it was big enough to move Japan from its inertia. Thus, there is the fear that in Japan the collective choice is not to make a choice, but to opt for the devil that it thinks it knows— gradual decline instead of radical changes that come with great uncertainty and no guarantee of success.

Misleading Diagnoses

Compounding the difficulty of implementing the various remedies based on the standard diagnoses are misleading diagnoses. Take for example the fact that Japan's past is repeatedly referred to as the "lost decades." This implies that Japan wasted the decades after the burst of the bubble economy when it lost its way, the way in which it boomed in the 1980s. This characterization obscures a reality that is however, much more complex and nuanced.

The fact of the matter is that in the late 1980s Japan had become seriously inflated, in reputation and self-perception as much as in asset values. Japanese popular books and the media often asserted Japan would displace the United States as the world's leading economy by the turn of the century, and it became fashionable for Japanese bureaucrats and business leaders to crow that Japan had nothing left to learn from the West. Reinforcing such views are serious works by leading scholars, such as Ezra Vogel's well known and best selling *Japan as Number One, Lessons for America*.

In retrospect, it was a classic case of hubris before nemesis and by the time the bubble economy burst in the early 1990s, the moment of hubris proved to be relatively short-lived. The system that enabled Japan to achieve what some outside observers saw as superior performance actually worked for only a brief period in the 1980s, which also sowed the seeds of its demise. With hindsight, the kind of bureaucratic capitalism practiced in Japan at that time, often referred to as "Japan Inc.," and much admired by its cheerlead-

ers as superior to the classical Anglo-Saxon market capitalism, is very much part and parcel of the bubble economy itself. It is not an exaggeration to say that without Japan Inc., there would have been no bubble economy, hence no stagnation. By the late 1980s, this system had led to egregious misallocation of capital on a gigantic scale, rendering its collapse all but inevitable.

However, the "lost decades" characterization has the unfortunate connotation that Japan needs to find its way back to the boom years of the 1980s. The solution to stagnation is therefore to recreate and reapply the formula that seemed to have worked so well before. In the 1980s, there was ample financing by the banks to the corporate sector, so in the 1990s politicians working with the banks sought to provide even more liquidity to businesses. But there was a critical difference between the corporate sector in the 1980s and the 1990s; in the 1980s the Japanese corporate sector was expanding and investing, whereas in the 1990s the Japanese corporate sector was heavily in debt, and was either shrinking, relocating overseas in order to survive global competition in their exports, or both. So while cheap loans in the 1980s led to job creation and increases in household income, cheap loans on a much bigger scale in the 1990s merely led to bankrupt companies being kept on life support. This had disastrous consequences for the banking sector and the fiscal position of the government.

Apart from the misguided attempt to "re-create" the Japan of the 1980s, there is yet another aspect of the misdiagnosis that is no less damaging. This has to do with how certain glib and superficial generalizations of Japan that have over time become self-evident truths. Journalists and pundits are forever quoting the Japanese aphorism: "the nail that sticks up will be hammered down," with the implication that Japan is irrevocably shackled by herd behavior. The Japanese media is quick to hurl charges against intransigent bureaucrats and change-resistant institutions. Its business culture is believed to be hidebound and

governed by groupthink. A society itself, that prizes harmony and homogeneity above all else, is believed to lack the DNA for change. Repeated characterization of the Japanese society and its institutions in such ways quickly leads to the conclusion that Japan is neither willing nor capable of change regardless of what happens. These are grossly superficial stereotypes. They are no more accurate for Japan than for other countries. In fact, similar stereotypes are found in all societies; take for instance popular sayings in English like “don’t stick your neck out,” and “don’t rock the boat.” Nevertheless, they are repeated so often in Japan that the perceptions of a conservative, change-resistant Japanese culture and its change-resistant society are by now deeply entrenched. This in turn leads to a sense of futility and hopelessness. In order to move forward to rejuvenate its economy and society, Japan needs to find the middle path between the two extremes of impracticality of radical reforms and fatalistic inertia.

Back to the Future: The New Rise of Old Japan

We believe Japan can change, and the time for change is now. The stability of Japan’s public finance, in spite of the inexorably rising government debts, has been due to the deep resource provided by household savings. Japan’s total public sector debt now approaches 200% of GDP; but household savings are still higher, hence the lack of panic. However that bedrock of private savings is becoming more shaky, being gradually undermined by endless government borrowing.¹ Depending on assumptions on tax revenues and fiscal outlays, it is projected that in as short a time as five years, but no more than ten years, the amount of Japanese government debt could exceed the total net assets of Japanese households. At that point, government debt will no longer be backed up by taxpayers’ assets, and confidence in the Japan Government Bond market would decline dramatically.

Japan’s aging population will add to the stress on government’s fiscal position. Japan’s elderly,

who have the longest lifespans in the world, will draw down their savings to fund their retirement, as a consequence the household savings rate will decrease in the coming years. This will make it more difficult for the domestic private sector to finance the budget deficit of the government in the coming decade. Japan’s aging population will in turn create new demands for more fiscal expenditures in areas of pension and healthcare, compounding the government’s fiscal difficulties.

The most urgent reason that Japan must change now, however, is the young. Persistently slow economic growth has produced millions of young Japanese who feel left out, unwanted, and alienated. Although overall unemployment rate remains low in Japan, youth unemployment has been rising. In recent years, it is estimated that 10% of the 15- to 24-year-olds and 6% of the 25- to 34-year olds are unemployed, much higher than the national average. Furthermore, these unemployment rates do not take account of the many young women dropping out of the workforce or the huge number of young workers who are employed as part-time workers, with lower and less stable incomes. In 2009, for instance, part-time workers accounted for 34% of the labor force, up from 20% in 1990. So the burden of economic stagnation has been disproportionately heavy for the young people of Japan, a situation that bodes ill for the long term if allowed to continue.

So the water temperature in the pot may well be rising faster than before, and the frog may begin to feel the heat, and be stirred to try to do something to get out of the pot. The question is what to do and how to do it. As argued earlier, instead of coming up with solutions that are at odds with Japan’s traditional values, the way forward is for Japan to tap into some of the abiding strengths embedded in its traditions and local community, and to make them serve the cause of Japan’s rejuvenation.

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lenges to their communities, precisely because of their deep sense of communal solidarity and trust. As described earlier, within their communal context, the rank and file of Japanese people has the wherewithal for self-directed spontaneous actions. This “can do” spirit is entirely consistent with their traditional strengths embedded in communal solidarity, trust, and mutual assistance. It is therefore a powerful platform upon which efforts to rejuvenate the Japanese economy and its society must be based.

From a business perspective, small and medium-size enterprises (SMEs) are in the best position to leverage this source of strength by refocusing energies and deepening relationships with local communities. It has long been observed that Japanese consumers value quality and simplicity of services, more than consumers elsewhere. SMEs, in getting close and personal with local communities, can provide exactly such services based on deeper understanding of their customers. With a strong community focus, SMEs themselves can in turn tap into another one of Japan’s traditional strengths to create and innovate in serving local communities — their ability to excel in process. The Japanese are masters of continuous improvement, and no one executes like them. They embody focus, discipline, relentless effort, and uncompromising quality control. To the extent that SMEs can embed themselves in local communities, a synergistic relationship can evolve: local communities are being better served, and their demand in turn stimulates SMEs to improve and adapt to the needs of local communities through relentless process innovations.

Japan has a long cultural history of devotion to mastery in whatever they do. This single-minded focus on excellence transpires through in all sorts of products and endeavors; ranging from crafts to theater to food to factories. Even an ordinary bowl of noodles displays their attention to detail. There is a strong sense of pride in both doing something well and doing something uniquely different to distinguish their local com-

munity. Consumers in turn value such excellence in products and services. Businesses, SMEs especially, when strongly connected to their customers in local communities, can exploit this appreciation of, and devotion to, mastery to excel. When this happens, there is then business rejuvenation at the grassroots level.²

This is not a pipe dream. It has already happened in the luxury goods sector. Many industry analysts have noticed that Japanese consumers have become more frugal and are spending less on foreign designer brands and premium products, after two decades of stagnation. The reality is far more nuanced. Many former luxury goods consumers — the ones who transformed Japan in the early 1990s into the world’s second-largest luxury goods market, behind only the United States — have already migrated to a new consumption space. They have rediscovered the skills and traditions of Japan’s best craftsmen and a new generation of homegrown designers and producers. They are launching handmade brands that employ ancient manufacturing techniques and traditional materials. This has in turn led to the revitalization of many small and highly specialized craft workshops.

This is a phenomenon of return to authenticity. This almost obsessive search for the lesser-known, and often hard-to-get, yet exquisitely crafted local product has become a new trend in Japanese spending patterns. One direct consequence is that it is revitalizing the fashion scene in Japan, with home grown designers, often utilizing local materials and rediscovering traditional methods, taking center stage. These products and services are typically no less costly than foreign designer brands. It has the potential of bolstering a whole new generation of entrepreneurs, designers, craftsmen, and even chefs, all operating as SMEs, to turbocharge Japan’s creative industries. This is business innovation based on deep traditions.

Counter-intuitively, this process of business rejuvenation by leveraging traditional values and

strengths can be even stronger if SMEs embrace the internet. Recent research has shown that e-commerce has immense growth potential in Japan.³ The “Internet-GDP,” defined as the industry’s direct contribution to GDP through consumption, investment, government purchases, and trade via online activities, and “Indirect internet consumption,” defined as purchases researched online prior to buying them physically, is currently estimated at 7.7% of GDP, or 41.6 trillion yen (US\$547 billion). It has been expanding at around 8% a year in the past five years, outperforming all other industries which averaged only 5% growth per year.

As impressive as these figures are, Japan’s highly developed internet infrastructure is grossly underutilized by SMEs. Virtually every single household has an internet account, and survey data have consistently shown that elderly Japanese, both urban and rural, are no less avid internet users than the young. But businesses are still very slow to exploit the new opportunities offered, especially the SMEs. For instance, at present, it is estimated that only one in four SMEs hosts its own website. Websites can help give a face to small businesses, especially those in rural areas and in small communities, and open new sales channels cost-effectively. An online presence can deepen SME’s connections with their customers, allowing local customers, especially the elderly, to get in touch instantly and as frequently as they wish, thereby further strengthening their sense of solidarity with the local community. For some of the SMEs with the right products and capacity, building an online presence could also lead to new export opportunities.

Available data provides a glimpse of a tantalizing potential. For example, in prefectures where 40% of SMEs have developed their own web sites, their annual sales are estimated to be 20-30% higher than SMEs in prefectures where less than 20% have their own web sites. SMEs with web sites tend to have more employees and pay them more. Thus the e-commerce potential in

Japan provides a contemporary context for recasting traditional strength with new technology in business rejuvenation. Combining the old with the new in this fashion could prove to be a practical and sustainable way forward— back to the future.

This back to the future strategy, fusing the traditional with the latest communications technology, is not confined to SMEs in rural and small town Japan. It can be applied just as effectively in large cities, including Tokyo. In urban Japan, most neighborhoods are effectively a local community. With appropriate modifications, SMEs offering local community-focused products and services can thrive. A powerful illustration of this trend is perhaps the 7-Eleven stores, which in Japan have evolved into something completely different from their foreign counterparts. In urban Japan, 7-Eleven stores function as the local neighborhood’s kitchen, post office, courier, ATM, in addition to being a convenience store. They are more like a neighborhood concierge.

Tokyo, by virtue of its size, complexity and cosmopolitan orientation, provides unique opportunities that aren’t available elsewhere in Japan. It is arguably easier to have selective immigration in Tokyo, targeting highly-skilled foreign professionals for well-paid positions, which are accepted with minimal social friction. Some recent trends may well be a harbinger of things to come, leading to a different kind of future for Tokyo, if not for all of urban Japan. Today, increasing numbers of foreigners dominate the top ranks of sumo wrestling, which is the most traditional of all Japanese sports, considered at one time to be a sacred combat with divine origin. The increasing numbers of swaggering Mongolian and European sumo grand champions have had no difficulty in being accepted in Tokyo. Less exotic is the growing presence of foreign staff in the service sector (mostly Chinese, Korean and Southeast Asian)— a novelty some two decades ago — is now so commonplace in Japan’s large cities that people barely notice it. In urban Japan, then, there is the



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Because it offers so many opportunities and freedom for talented people from other countries to follow their interests, dreams and passions, the best model for Tokyo is one of the most dynamic and creative capitals of the world—London.

possibility for a moderate influx of foreign talent to inject new vigor to its pool of human resource, generating new energy, fresh ideas, and more risk-taking appetite.

The best model for Tokyo is London. Once the imperial capital of an insular island nation, it is now one of the most dynamic and creative capitals of the world. The rapid internationalization of London was not the result of the government and the British people suddenly deciding to open up their culture and society to foreigners. London merely offers more opportunities and freedom for talented people from other countries to follow their own interests and passions, and build their dreams there. It is much easier for enterprising and gifted young people to start a business, sell art, open a studio, or launch creative enterprises in London than it is in other, more bureaucratic, more tightly-regulated cities in Europe. To be realistic, Tokyo is unlikely to become the London of Asia. However, even a very partial opening of Tokyo to an influx of foreign talent with new skills and ideas could make a huge difference.

The rejuvenation of Japan, based on a back to the future strategy, could therefore ride on a two-tiered transformation: Tokyo and rest of Japan. In both cases, traditional values and practices are to be honored and leveraged, not discarded. It is worth noting that in the Meiji Restoration, the so called “westernizers” of Japanese society were in fact no less nationalistic and traditional than the “traditionalists” who opposed changes modeled on the West. The “westernizers” believed that Japan’s traditions can adapt to changing conditions without losing their core value, whereas the “traditionalists” refused any modifications. History proved that the “westernizers” were right. Once again, in a new transformation, a new Japan can thrive in today’s economic and business environment by tapping into its traditional values and strong communal bonds. At the end of the day, all successful economies are built on thrift, hard work, and individual initiative. Japan’s traditions and values can be made to support and nurture these essential elements for success.

1. Japan has very little exposure to foreign debts. It is estimated that only some 7% of total public sector debts in Japan are held by foreigners, which is the fundamental difference between Japan and the Euro Zone crisis countries.

2. The potential impact of such business rejuvena-

tion is huge: some 99.7% of businesses are SMBs, employing around 70% of company employees.

3. Value of the Japanese Internet Economy. 2011. Joint report by Google Japan and the Nomura Research Institute.



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