Wharton
UNIVERSITY of PENNSYLVANIA

Knowledge@Wharton

現代ビジネス
Gendai Business Web Magazine

Special Report:

Japan Boldly Resets Its Economy

http://knowledge.wharton.upenn.edu

Special Report:

Japan Boldly Resets Its Economy

Japan is recovering from far more than the tsunami, the Fukushima nuclear plant disaster and the global financial crisis. It also is attempting to bounce back from a 1990s domestic financial crisis and two decades of lost economic vigor.

The country faced a similar period in the 1920s and early 1930s when a devastating earthquake in Tokyo and a global banking collapse dragged it down. Back then, like today, Japan had deflation, a stalled economy and a high, export-blunting yen. But in 1931, finance minister Korekiyo Takahashi loosened monetary policy, drove down the yen and increased spending. The economy quickly reversed course.

Today, Prime Minister Shinzo Abe is taking similar steps. Whether the results will be positive remains to be seen. Critics say his policies risk hyperinflation and a financial meltdown. Supporters contend that bold action is needed to counter economic malaise. All agree that gains will be short-lived without structural reforms to address long-term issues, such as the shrinking and aging population, fading competitiveness, "zombie" companies (which are insolvent but propped up by government subsidies) and over-regulation.

This special report looks at the implications of the new economic policies, including what they mean for currency markets. It also analyzes two problem areas where change is needed — finance and higher education.

Contents

Japan's 'Abenomics': A Last Ditch Effort to Turn the Economy Around

"Abenomics" has been likened to the decision to attack Pearl Harbor, to throw a Hail Mary pass and to undertake a bold experiment. Its mix of monetary, fiscal and reform policies championed by Japanese Prime Minister Shinzo Abe, who took office in late December, has won praise from Japan's major trading partners and the World Bank. But will it work?

As leader of the long-ruling Liberal Democratic Party (LDP), Abe wasted no time in implementing his platform of aggressive monetary easing and stimulus spending aimed at jolting Japan out of its two-decades-long economic slump. The weakened economy has been accompanied by crippling deflation that has discouraged consumption and investment and weighed down wages and growth. Abe needs fast results to ensure a strong showing in upper house parliamentary elections in July that would give the LDP the kind of electoral mandate it wants to push ahead with economic reforms as well as other priorities on its conservative agenda.

So far, the results are mixed, though it is still too early to predict the final outcome. Some of the most important monetary-loosening steps had to wait until April for final approval. But the currency has already weakened considerably since the announcement last fall of the new direction the government wants to take on the economy – down from about 77 yen to the U.S. dollar last October to nearly 100 more recently. That has helped to end a spell of "endaka" or "high yen" rates that further eroded the competitiveness of Japan's export manufacturers. By April, share prices had surged to their highest level in nearly five years, with investors flooding into the market anticipating an economic turnaround and better performance by major exporters like Toyota and Sony.

The End of Recession?

Japan appears to have edged out of recession late last year and may have turned the corner toward recovery. Still, economists are divided over whether Abe's effort to "reflate" the economy and stimulate stronger demand, which is intended to bring a virtuous cycle of consumer spending and increased business investment, will actually work. Some experts believe Japan will only achieve sustainable growth if it endures a deeper recession that might force it to make structural changes to deal with long-term issues such as its shrinking and aging population and fading industrial competitiveness. Others are cautiously optimistic about Abe's initiatives.

The LDP, in past years faulted for building "bridges to nowhere," has long relied on robust fiscal policy — stimulus spending to spur demand through public works construction. But if larding the economy with pork barrel spending alone was going to work, Japan's economy would have bounced back long ago, some analysts note. Monetary easing has likewise failed in the past: Interest rates have remained near zero for years, but have not enticed the kind of investment boom needed to spur growth. Consequently, Abe pushed the Bank of Japan (BOJ), despite its ostensible autonomy, to commit to achieving a 2% inflation target within two years. Supporters of this approach further contend that former BOJ governor Masaaki Shirakawa, who stepped down in late March, had failed to ease monetary policy quickly or boldly enough to break out of deflation and that his predecessors withdrew easing efforts too soon — before the economy was sufficiently jump-started.

Finance Ministry veteran Haruhiko Kuroda, who replaced Shirakawa as central bank chief, surprised many in Japan and elsewhere by announcing plans in April to expand the BOJ's asset purchases so as to double the monetary base — the amount of cash in circulation plus bank reserves — to hit that 2% target. Kuroda also declared that, instead of conducting market operations based on interest rate targets, the price or inflation target would determine BOJ policy. Kuroda has been a long-standing critic of what he believes were timid BOJ monetary policies, and while the general direction he wanted to take the BOJ was clear before he was appointed, observers were nevertheless a bit surprised by just how aggressive an easing stance he has promoted.

The central bank is now buying a wider variety of assets and increasing purchases of longer-term government bonds, with maturities of up to 40 years, to help ensure lower long-term interest rates and to achieve "price stability." The BOJ is also planning to buy ETFs (exchange-traded funds, which track an index) and Japanese real estate investment funds (REITs). "This is an entirely new dimension of monetary easing, both in terms of quantity and quality," Kuroda said in announcing the plan. The impact on financial markets was swift: The benchmark Nikkei 225 stock index finished the day up 2.2%, while the dollar gained 3 full yen in currency trading.

A Dramatic Departure

Julian Jessop, chief global economist at Capital Economics in London, likens the Abe-Kuroda shock strategy to a poker player who bets all his chips. "What they have done is basically played all their cards at once," Jessop says. "There is a risk if broad money and credit aggregates do not pick up and inflation does not pick up. Then, the policy would begin to fail," he says. But desperate times call for desperate measures, and Jessop says he is cautiously hopeful. "I think the plans they have announced are exactly what is required to get Japan out of deflation and keep the economy growing, even if the demographics turn much less favorable. On paper at least, the policies proposed are exactly the right ones."

Both critics and supporters of Abenomics agree Japan needs more than just the fiscal and monetary policy changes announced so far to achieve long-term growth. "In the medium and longer term, structural reforms will be needed for Japan to have sustainable growth despite the fact that its working population is steadily getting smaller," Jessop says.

Therein lies the predicament, according to Masamichi Adachi, senior economist of JP Morgan Securities Japan. "The root of the problem is that Japan has not been and is not able to adjust socially and economically to the shrinking and rapid aging of its population, and to the changing outside world environment, such as globalization," he suggests. Instead of launching the monetary easing and boosting spending at a time when Japan's public debt is nearing 250% of its GDP, Abe should have immediately embarked on structural reforms and deregulation — the kinds of tough changes needed to spur innovation and entrepreneurship, create new business opportunities and boost employment, says Adachi, who is also a former BOJ official. He thinks there may be yet more easing if the BOJ's latest tactics fail to push prices higher within the coming half-year or so.

Masayuki Kichikawa, chief economist and managing director at Merrill Lynch Japan Securities, is more upbeat about the prospects for Abenomics-style progress. Now that Japan has put monetary easing ahead of financial consolidation — expanding liquidity and weakening the yen — there is a greater chance of success, he says. "Japan had more than 15 years of deflation. Even if Japan can achieve a 1% inflation target, that would be a great achievement. In the past 15 years, the central bank and government administrations failed to achieve that. I am confident that Japan will turn its deflation into inflation of 1%, though I am not sure Japan can achieve 2%."

Risks and Downsides

Apart from the issue of whether Abe and succeeding administrations will actually summon the political wherewithal to push through difficult job market and regulatory reforms over the medium and long term, questions remain about whether the reflation strategy will actually work. "What they are doing is very risky, and it is difficult to make those changes (in Japan)," says Franklin Allen, a Wharton finance professor.

Others, such as Jessop, question whether the monetary moves will be sufficient. "The plan to double the monetary base is absolutely the right thing to do, but my concern is it may not be enough. Japan increased its monetary base by 50% during the earlier experiment of quantitative easing 10 years ago [2001 to 2007]. That had no effect on the broad money aggregate and no effect on inflation either," he notes.

There are limits to the central bank's ability to manage long-term interest rates through asset purchases, since ultimately the market is subject to other influences, too. While yields for Japanese government bonds (JGBs) are bound to decline as the price rises due to the surge in purchases by the BOJ, if the 2% inflation target is reached, the central bank has said it will adjust policy for the sake of price stability.

"The first question that comes to mind is, 'What will happen to the yields of 10-year JGBs?'" asks Allen. "Presumably, they will go up to something like 3% to 4%. The first effect of that is banks are going to be in trouble because they hold a very large amount of government bonds." As of March 2012, a year before Kuroda's bombshell, Japanese banks would face a combined 8.3 trillion yen in losses if the benchmark interest rate were to rise by 1 percentage point, according to the BOJ.

Moreover, since Japan's public debt is well over 200% of its GDP — the highest among OECD (The Organisation for Economic Co-operation and Development) nations — the costs for servicing the debt will skyrocket as interest rates rise. "If the interest rate goes from 50 basis points to 3% to 4%, that means they may have to come up with an additional 6% or 7% of GDP to pay debt forward," Allen points out. "So that would create a significant fiscal problem. I do not think they (the BOJ and the Japanese government) have provided very good explanations for how they will deal with those problems."

Costs of a Lower Yen

Meanwhile, the weakening yen is eroding returns on yen-denominated investments and is already leading many investors to seek higher returns by selling their holdings of JGBs. "Kuroda overdid the monetary easing on April 4, which has made many people worried about the future of Japanese government bonds," says Seki Obata, a professor at Keio Business School and a former Finance Ministry official. Japanese life insurance companies that hold longer maturities of JGBs are worried about the future of JGBs because of recent wild fluctuations in prices. "If life insurance companies think that the yen will continue to weaken, they will start buying foreign bonds without hedging foreign exchange risks. This will cause capital flight from Japan. Now I feel there is a greater possibility for this scenario," says Obata, author of a popular book titled, *Reflation is Dangerous*.

Though such trends are uncertain, their potential impact would be massive: While Japanese mega banks hold short-maturity two-year government bonds, the life insurance companies carry JGBs with average maturities of 11 years to 12 years. About 44% of the life insurers' 332 trillion yen in total assets, or 146 trillion yen, are in JGBs.

So far, officials have explained the wild swings in the JGB market after the BOJ's April 4 announcement as just temporary adjustments to the central bank's new buying strategy. On April 5, the yield on the benchmark 10-year government bond fell to an all-time record low of 0.315%, then rocketed to 0.620% before settling at 0.460%. But the BOJ has adjusted its purchasing plans, increasing the number of times per month to eight from six to help smooth out volatility.

Since about 90% of JGBs are held by Japanese and all are yen denominated, the risks of major disruptions or a collapse are limited, says Kichikawa. However, while he supports Abe's approach, he is among the many who emphasize the imperative to reduce the government's debt load in the medium to long term. "You have to balance economic growth and restoring fiscal health," Kichikawa notes.

Meanwhile, the weaker yen already is helping Japanese companies increase their price competitiveness, and it is boosting the value of corporate profits, notes Kichikawa. But those short-term consequences must be fortified with longer-term changes to sustain growth, Adachi and Obata contend. "What Japan needs to attain a higher, sustainable growth rate is for each Japanese to be more productive, more innovative and more competitive," Adachi says.

Structural reforms, such as allowing greater job mobility, bringing in more migrant labor, encouraging more stable employment for women and fostering more entrepreneurship are the most urgent measures Abe needs to undertake, Adachi adds. "Structural reforms will take a long time but would create real changes in Japan and boost Japan's longer-term economic growth potential. This is different from fiscal and monetary policy, which immediately helps the economy." Details of Abe's reform strategies are due to be announced in June. "That will be just a beginning," says Adachi, who notes that Japan has made many attempts to deregulate and implement structural reforms before, but failed.

Management by Crisis

In the end, the only way for Japan to truly emerge from its two decades of stagnation is through a crisis — such as a deep recession or a bout of hyperinflation if the BOJ's strategy gets out of hand, contends Allen. "In the medium term, Japan needs to raise interest rates to a more normal level. That will cause a big recession but is the best way out for Japan." By a deep recession, Allen means a significant increase in unemployment and bankruptcies for the legions of "zombie" Japanese companies that should go bankrupt, but haven't, due to subsidies and other forms of protectionism by a government wary of a possible domino effect and surging unemployment. "This would cause great pain for people. On the other hand, 20 years of no growth also caused a huge amount of pain," Allen says. Among those suffering are the many younger workers employed on temporary contracts, with low wages, scant benefits and few career prospects — who now account for more than a third of Japan's total labor force.

Perhaps most important of all is the tenuous link between growth and the inflation target. Abe and other LDP leaders argue that by fueling expectations of future higher prices, policymakers can change consumer sentiment, inducing people to make purchases now rather than deferring them – as they have been doing for years in the expectation of seeing lower prices in the future. The surge in stock prices likewise is adding to discretionary income, boosting purchases of luxury items at big department stores.

But critics of the Abenomics strategy question whether consumers, whose purchasing power and real wages also have been declining for more than two decades, are really willing or even able to change their behavior and begin spending more. Abe was grilled by the opposition Democratic Party of Japan's (DPJ) Banri Kaieda in Parliament in mid-April on the link between inflation and the higher wages and hiring needed to ensure that the economy takes off. Abe merely pointed to the change in atmosphere in Japan since he took over from the DPJ's Yoshihiko Noda as prime minister in December. Generally, LDP members sidestep such questions, though they say they will reconsider a planned increase in the sales tax if it appears likely that it would undo any progress toward recovery.

Wages, Investment Must Rise

Abenomics will work, but only if wages rise and if companies start investing more, says Kichikawa. "If Japanese companies don't start investing more or doing more M&A [mergers and acquisitions], then the structural problems will prevail."

Whether wages will rise will depend, in part, on how much greater demand companies will see as the economy recovers. A significant rise in demand may prompt companies to increase hiring and wages to attract or retain talent, some experts say. Skeptics note that in Japan, as in other industrial nations, labor's share of national wealth has been steadily declining, and that corporations have usually chosen to use their excess cash assets to expand through overseas M&A.

On April 19, Abe outlined several initiatives for his reform program, including a request to industries to expand maternal leaves to three years to enable more women to return to work after having a child. At present, about 60% of new mothers stop working at least for a few years, and when they return, very few get jobs at their old level. More often only low-paying part-time work is available, such as cashiering at supermarkets. Abe also proposed trial employment programs, increasing the number of students who spend time abroad and taking other steps to make Japanese workers better able to function in a global economy.

If the LDP does as well as expected in the July election — the DPJ was so thoroughly discredited in the lower house election that it is no longer viewed as a viable rival — Abe will gain extra time to carry out his economic agenda, notes Adachi. "We hope that his government will purse a 'regime change' of reform, and that the reform agenda will get better focused and articulated than the current cloudy rhetoric of the growth strategy," he wrote in a recent report.

Allen puts the likelihood of success for Abe's program at about 30%. "There is a significant chance things will stay as they are now," he says. However, doing nothing is not an acceptable alternative. Abenomics may be an experiment, but it is one supported by economic theory and by economic principle, says Jessop. "If you are designing the policy on paper, this is what you do. It is all sensible. It may not work, but these absolutely are the right things to try."

Global Currency Battles: A Waiting Disaster or a Win for All?

At the end of 2012, Japanese Prime Minister Shinzo Abe fired a loud salvo. In a forceful attempt to kick start Japan's economy from its decades-long stupor, Abe leaned on the Bank of Japan (BOJ) to set a 2% inflation target. He threatened to pass a law to limit the central bank's independence if it balked. "Countries around the world are printing more money to boost their export competitiveness," said Abe. "Japan must do so, too." The BOJ caved, vowing to step up purchases of government bonds.

Then Abe went a big step further by nominating Haruhiko Kuroda to the top post at the BOJ. Kuroda has been the highest-profile critic of the BOJ's conservative monetary policies for years. According to many analysts, Kuroda's nomination confirms that Abe is serious about injecting significant new liquidity into the system to help stimulate Japan's economy and reverse deflation. Such moves also apply downward pressure on a nation's currency.

The Prime Minister's actions immediately set off alarm bells. Japan's plans already have driven the country's currency down to about 100 to the dollar compared with about 77 yen to the dollar last fall. This precipitous drop looked like the spark that could ignite a global currency war — a series of competitive devaluations that, last century, helped plunge the world into the Great Depression, some economic historians say.

Jens Weidmann, president of Germany's central bank, warned that Abe's strong-arming of the BOJ could lead to "increased politicization of exchange rates. Until now, the international monetary system has come through the crisis without a race to devaluation, and I really hope that it stays that way." Central bankers from the U.S., Britain, Russia, South Korea and elsewhere added to the chorus.

Meanwhile, at G-20 meetings in mid-February and again towards the end of April, attendees soft-pedaled the threat. Japan's currency depreciation is the result of domestic monetary policy, not explicit exchange rate targeting, they concluded. "The talk of currency wars is overblown," said International Monetary Fund (IMF) managing director Christine Lagarde during the February meeting. "There is no major deviation from the fair value of major currencies. The international financial system can work if each of its members follows the right policies for their economy."

Or, as *Forbes* magazine put it after the April meeting: The G20 "… member nations seemed less concerned about currency wars and sovereign debt blowouts, and instead wanted to encourage economic growth initiatives.... Japan was not signaled out or blamed for overseeing the huge yen deprecation initiated last fall.... If there are any criticisms of Japan's aggressive monetary policy stance by any G20 member it has been hushed up…."

Wharton finance professor Bulent Gultekin, a former governor of the Central Bank of Turkey, agrees that there isn't yet cause for alarm. "It's a very different world now," he says, noting that the Great Depression was the unique outcome of multiple factors, including the end of World

War I, pressures on the British pound and the decline of the gold standard. "That was a period when nations tried to outbid each other through competitive devaluation. Those 'beggar-thy-neighbor' policies led to tariffs and import restrictions impacting international trade. That was the real problem, unlike today."

Balancing Bad with Good

In contrast, today's depreciation of the yen, dollar and other major currencies is largely the result of expansionary domestic monetary policies after the recent global recession, experts say. The U.S. was the primary instigator, given that the Federal Reserve embarked on several rounds of quantitative easing starting in 2008, according to Wharton management professor Mauro Guillen. The Fed printed money to buy U.S. debt in order "to keep interest rates down and promote recovery," he notes. "But it goes without saying that the value of the dollar has gone down, in turn making U.S. exports go up." Says Gultekin: "I would not consider this an attempt to manipulate the currency. Expansionary policy will help other economies as well. When the U.S. dollar loses its value, it helps U.S. exports on the one hand. On the other hand, it expands the U.S. market, which can absorb imports of other countries. It could be a wash."

Uri Dadush, senior associate at the Carnegie Endowment for International Peace and former director of economic policy at the World Bank, concurs. "Among the big players (the U.S., Eurozone, China and Japan), there is very little currency manipulation," he says. But concerns about currency wars are understandable when the world's major economies and currencies experience weakness, he adds. "When the center of the system, the dollar and the euro, belong to economies that themselves are under pressure, everybody's sensitivities go up. Every country asks, 'How competitive am I [compared with] these economies?'"

Indeed, Brazilian finance minister Guido Mantenga coined the term "currency wars" in 2010 when the depreciation of the dollar — and of the dollar-pegged Chinese renminbi (RMB) — squeezed Brazilian exports and put inflationary pressures on its economy. James Rickards, senior managing director of New York-based merchant bank Tangent Capital Partners and author of the book Currency Wars: The Making of the Next Global Crisis, notes that U.S. monetary easing has not fanned inflation at home but exported it to other countries, paving the way for phenomena such as the Arab Spring.

Nevertheless, developing countries will benefit from the revival of the world's advanced economies, which are big buyers of emerging market exports, says Dadush. After all, large developing countries fared better than the advanced economies in the recent global recession. Developing countries' currencies appreciated. Though the appreciation harmed their exports, it also helped tame inflation and improve standards of living for consumers at home, Dadush points out. "That doesn't mean the Brazilian finance minister should not be concerned if his currency goes up 20% in a short time," he adds. "But overall, this is an orderly adjustment in the right direction."

Yet, the Japanese move on the yen struck a nerve, especially in the eurozone. Still struggling to climb out of the sovereign debt crisis in periphery member nations, Europe was the loudest in its protests. "The European Central Bank is not as free as others to expand," notes Gultekin. "They have a very strict mandate to keep inflation stable, which doesn't allow them to follow expansionary policy at the time they need it the most. That exacerbates their currency situation, so that the burden of adjustment [from currency devaluations around the world] is on the euro." Indeed, the euro appreciated against the dollar some 10% by early this year, making it more difficult for weaker members of the eurozone to recover via export sales, says Dadush. This year, the eurozone economy is expected to decline in growth for a second year in a row, with unemployment in Greece and Spain above 25%, according to the E.U.

Déjà Vu: China and the U.S.

While the present round of currency skirmishes features the dynamic between the yen and the euro, the last heated currency war of rhetoric involved the U.S. and China. At the time, U.S. policymakers and opinion leaders accused China of being a currency manipulator, claiming the country maintained an undervalued currency for more than 10 years by buying U.S. Treasuries to keep a steady yuan-dollar exchange rate. The goal, they said, was to stimulate Chinese exports, with the added effect of hurting U.S. exports and jobs. As a result, U.S. Senator Charles Schumer pushed legislation in 2005 to impose a 25% tariff on Chinese exports.

Since then, "that war has abated quite a bit, as China has let the value of its yuan appreciate as much as 40% in the last four years," says Guillen. Consequently, China's wage rates are rising, and its current account surplus is declining — helping China reach its goals of rebalancing its economy from export dependence to domestic drivers of demand and reducing income inequality. According to Rickards, the U.S.-China episode "was a popular way to blame other people for our problems [in the U.S.]."

As for the yuan's longer-term outlook, Wharton finance professor Franklin Allen says that it's unclear whether China really is keeping its exchange rate artificially low. "If they opened up their capital account [to let the renminbi trade freely in and out of the country], nobody knows if the renminbi would strengthen or weaken" — that is, if more money would flow in or out of the country.

In the case of Japan, efforts to stimulate its economy with monetary easing and yen depreciation are steps towards equilibrium, notes Bing Shen, a former Morgan Stanley executive director in Asia. "The Japanese yen stayed too strong for too long," he says. "This imbalance needs to be corrected." Allen agrees: The strong yen "was killing [Japan's] manufacturing and affecting the terms of competition with Korea. These competitive issues have a dynamic. If you don't have money, you can't invest in R&D and you lose competitiveness. That's why Sony, Sharp and Panasonic have so much trouble competing with [Korea's] Samsung and LG." Still, he is skeptical of any lasting economic impact on the Japanese economy from yen devaluation. "I would be surprised if Japan cured its economic woes this way. It still has a long-term problem" with competitiveness.

'Still Dangerous'

Though many agree that today's exchange rate adjustments are likely to help the global recovery, Wharton's Guillen warns that the political response around the world is worth monitoring in case devaluations turn into trade wars reminiscent of the Great Depression. "The situation is still dangerous," he says. "Nobody wants the rhetoric to go up in tone, because currencies, at the end of the day, are symbols of nationalism. Nationalism and protectionism are dangerous, and currency manipulation feeds into that dynamic. The IMF is trying to bring the temperature in the debate down in the hope that countries realize that while it may be good for them in the short run to engage in currency manipulation, in the long run, if everyone does it, everyone loses."

Moreover, today's international system lacks the institutions to contain chaos, Guillen adds. In 1985, the G-7 succeeded in striking the Plaza Accord to devalue the dollar against the yen through coordinated intervention in the currency markets and domestic economic reforms. Today, the unwieldy G-20, including large developing economies such as China and Brazil, will have more difficulty reaching consensus, he notes. Instead, he suggests that a G-4 of the four largest economies — the U.S., Germany, Japan and China — devise an agreement, including a 10- to 15-year schedule by which China will adopt flexible exchange rates and a plan of coordinated action among central banks on stimulus plans.

As long as politicians around the world avoid hot-headed trade retaliation provoking an outbreak of truly dangerous currency wars, perhaps "currency realignments are not necessarily a bad thing," says Allen. "If prices are wrong for trade, it may make sense for everybody to have a better exchange rate."

(*This article has been modified from one originally appearing in Knowledge@Wharton*)

Japan's Reluctant Global Financiers

Since the golden age of the late 1980s, Japanese financial institutions have not lacked ambition, but they also have never become true global players. Now, just as in the 1980s and 1990s, Japanese banks, insurers and securities companies are expanding overseas, following their domestic clients and seeking more profitable business than can be found in their shrinking home markets.

The earlier international ventures largely ended with financial companies selling most of what they had bought in the 1990s. Even the handful of globally successful financial services companies like Tokio Marine Group and Mitsubishi UFJ Financial Group are still not truly global players, never having put a foreigner on their boards of directors or in senior management at their Tokyo headquarters.

Industry experts attribute the difficulties Japanese financial institutions have in globalizing to various factors, including a lack of foreign language ability and a very closed culture that is reluctant to accept or deal with things different or foreign. The huge gap between salary levels in Japanese and Western financial institutions also makes it hard for Japanese companies to attract and keep foreign talent. "Many failures of Japanese M&A are due to a lack of ability of Japanese executives to handle local management well," says Ryuji Yasuda, a professor at the Graduate School of International Corporate Strategy at Hitotsubashi University in Tokyo.

This lack of facility with the ways of the world may surprise some. After all, as one of the top two global automakers, Toyota exports first-rate vehicles and production processes. The Japanese services sector is second to none in many respects, especially when it comes to meticulously anticipating the demands of finicky customers.

Different Strengths

But that attention to quality and detail appears not to apply in the financial sector. Nomura Securities, Japan's giant brokerage and investment bank, and Japanese insurer Nippon Life Insurance, for example, have failed to market effectively overseas. Now that Japanese financial institutions, including small and medium-size regional banks, are expanding in Asia and overseas, is there any hope for them to succeed this time around and become real global players?

Tokio Marine Group is one of a handful of Japanese financial institutions that have made significant headway in expanding overseas. One key factor in that success was the insurer's decision to localize its management in the U.S., Europe and Asia. Mitsubishi UFJ Financial Group likewise has been running UnionBankCal in the U.S. for more than two decades. But when Nomura tried to localize its Asian and European businesses after buying Lehman Brothers' Asian and European units in 2008, it failed. "Nomura acquired Lehman Brothers' Asian business and European business and had to integrate them into Nomura," says David Threadgold, managing director of Keefe, Bryuette & Wood in Tokyo and veteran financial industry analyst.

Tokio Marine Holdings, a major non-life and life insurance company, bought Philadelphia Consolidated Holding, a U.S.-based property and casualty group, in 2008 and made it the company's U.S. holding company. "We put the top management team in Philadelphia in charge of the holding company, which also manages Tokio Marine's own operations and another unit in Hawaii," said a senior executive of Tokio Marine Holdings. Tokio Marine also bought Kiln, a U.K.-listed Lloyd's insurance group member, in 2008 and Delphi Financial Group, a U.S.-based life insurance and casualty group, in May 2012.

"Tokio Marine is the most successful company among life and non-life insurers in terms of globalization," says Teruki Morinaga, a director and insurance analyst at Fitch Ratings in Tokyo. "They bought good companies in the U.S. and the U.K. and were able to motivate their local management very well. The overseas revenue contribution to Tokio Marine group is fairly big because they bought companies in a big market like America or England, and were able to run them well."

Although the company had some failures in the 1980s and 1990s, it learned from them, Morinaga adds. "I think Tokio Marine is a model for other insurance companies to follow for overseas M&A."

Nippon Life Insurance, Japan's biggest life insurer, also got burned during its earlier foray into international markets. The insurer became a major market mover after buying huge amounts of foreign bonds and stocks in the 1980s and snapping up pricey Western art and real estate. But Japan's life insurance industry began to crumble as the country's financial bubble burst, and seven Japanese life insurance companies have gone bankrupt since 1997. These days, Japanese insurers like Nippon Life are not interested in expanding overseas because they enjoy the privilege of earning the highest margins in the global industry, thanks to premiums two or three times higher than in the U.S. or UK.

Different Strategies

Tokio Marine's strategy was to be a supportive partner of its overseas affiliates, allowing the U.S. and British management to run the companies, Threadgold notes. This may stem partly from the company's long history of operating in overseas markets due to its involvement in marine and cargo insurance, Morinaga adds. Just a year after it was set up in 1879, Tokio Marine Insurance was already operating in Britain, France and the U.S.

Tokio Marine Group began buying non-life and life insurance companies in Asia in 2000, and in the U.S. and Europe from 2008. Today, about 22% of its net insurance premium income comes from overseas. All of Tokio Marine's five life and 10 non-life insurance companies managed by Tokio Marine Asia, except one, are run by local management with local CEOs.

This contrasts with the tendency among most Japanese companies to send top executives from Japan to manage their foreign operations, because even their overseas operations are focused mainly on serving their Japanese clients and because they have a tendency not to trust local management.

At the same time, Mitsubishi UFJ Financial chose to send top Japanese executives with strong management and international experience, and strong communication skills, to Union BankCal, which it acquired over many years beginning with then-Mitsubishi Bank's purchase of the Bank of California in 1984. Four years later, Mitsubishi Bank merged with the Bank of California, which later merged with Union Bank to form the Union Bank of California. The merger of Mitsubishi Bank and the Bank of Tokyo in 1996 created the world's largest bank, Bank of Tokyo-Mitsubishi UFJ, a wholly owned subsidiary of Mitsubishi UFJ Financial Group, which acquired the still outstanding 35% of Union BankCal, completing the acquisition.

The senior vice president that Mitsubishi UFJ appointed to be president of UnionBank had strong management skills, says Yasuda. "It did not matter even if he did not understand retail banking because all he had to do is to manage the local management team."

The degree of Japanese managerial involvement can vary, though, depending on the types of companies involved. "Mitsubishi UFJ's main purpose in buying Union BankCal was to use it as an acquisition platform to buy other banks in the

U.S.," Threadgold says. One such purchase was the Santa Barbara-based Pacific Capital Bancorp, acquired in March 2012. A Mitsubishi UFJ senior executive said the bank would like to expand its U.S. business further by acquiring some U.S. regional banks.

Other Japanese banks, such as Sumitomo Mitsui Financial Group and Mizuho Financial Group, also are keen to buy out U.S. and Asian banks to expand their overseas business as they increase their international lending. "Recent moves into overseas markets represent the second push by Japanese banks, which stepped up overseas strategies during the bubble economy from the second half of the 1980s until the start of the 1990s," Ken Takamiya, a Japan bank analyst at Nomura Seucrities Co. Ltd., wrote in a report titled, "Overseas Strategies of Japanese Financial Institutions." He said that Japanese banks and other financial companies appeared to have learned lessons from previous failures to gain a foothold overseas either geographically or in operational terms. "In this re-exploration or re-entry phase ... we think that risk management is much better this time around," he wrote.

So why did Nomura fail? Nomura's purchase of failed Lehman Brothers' businesses in Europe and Asia during the 2008 financial crisis was viewed as something of a coup. Nomura hoped the acquisition would win its entry into the elite group that competes with global investment banks. But the Japanese company has struggled, with nine consecutive quarterly losses at its operations outside Japan, in part due to the tough business conditions prevailing thanks to the European debt crisis. Hefty fixed expenses — mainly huge pay packages for Lehman bankers — have also eroded the company's bottom line.

Eventually, after the departures of top foreign Lehman veterans, former Nomura chief executive Kenichi Watanabe, who had sought to turn Nomura into a global investment bank, resigned. Nomura announced US$1 billion in cost cuts in August 2012 as it retreated from its plan to become a global financial player.

Both financially and culturally, Nomura may have bitten off more than it could chew. The staunchly Japanese company likely found integrating Lehman's Asian and European businesses into its own difficult, if not impossible, Threadgold notes. "Investment banking is a global business. The problem with that is you have to change your culture at the center. That is terribly difficult."

Other experts note that Nomura was unable to succeed because it could not buy the most important Lehman units, namely those in the U.S. "New York is the most important global business center for investment banks, but Nomura only was able to buy Lehman's units in Europe and Asia," says an expert on the Japanese financial industry.

More generally, another big problem in these situations is the huge difference in salaries and other employment policies between Japanese and global financial institutions. Unlike the highly disciplined, relatively modest players in the Japanese financial sector, international investment bankers are highly mobile, strong-willed individuals with very high expectations. "Often, you depend on a small number of sometimes extremely difficult people, who expect to be paid enormous amounts of money, or they are prima donnas who might take their business elsewhere," Threadgold said.

Nomura's thoroughly Japanese human resources approach is more akin to Toyota's. That works in manufacturing but not in global investment banking, says Franklin Allen, a Wharton finance professor. In manufacturing, "you do not need to have high-powered incentives. You can have a fairly egalitarian, flat compensation structure." Finance is an entirely different ball game. "In many places, successful financial companies have very high-powered financial incentives, so top traders can earn hundreds of millions of dollars. Top investment bankers can make sums which are inconceivable in Japan in most industries and financial services," Allen points out.

Nomura's chief problem with the Lehman units was the disparity in pay. The Lehman employees had guaranteed bonuses for the first year or two, but once they ran out and Nomura cut high compensation packages paid to the Lehman employees, they left. Says Allen: "How much do top Nomura people make, as much as US$2 million or US$3 million? In Japan, that would be a lot of money, but it is not big money in the rest of the world. If you look at the heads of financial services companies in the U.S., they are making much more than Nomura people. They make US$50 million to US$60 million a year."

Ultimately, the fundamentally conservative approach of Japanese financial institutions and their different corporate objectives have hindered their expansion overseas. "U.S. financial institutions are very global in the sense that they allow a lot of nationalities to be their CEOs. Citigroup had an Indian CEO until recently. I could not imagine a Japanese firm having an Indian CEO," Allen notes.

Yasuda agrees, and adds that, likewise, the Japanese have not excelled in overseas banks and other financial institutions. "There is no Japanese top executive at any global financial institution in the world. Why is it that there are so many Chinese and Indian executives?" he asks.

Part of the problem is the general Japanese lack of facility in foreign languages, though given the number of urbane, English speaking Japanese diplomats and business figures, that cannot entirely explain the situation. "Financial services are very much a global business, done in English, with all different nationalities. We have CEOs of all different nationalities. Japan has not got into that mode yet," Allen says.

Masamichi Adachi, a senior economist at JP Morgan in Tokyo, says the reluctance stems from a lack of confidence. "Japanese financial institutions think that they will have problems if they have foreigners as board members or senior executives.... If they had real ability and confidence, they would not be afraid of those with different opinions or those from different cultures."

So far, Japanese universities have failed in their efforts to cultivate truly international executives, despite setting up new special schools that teach only in English at Tokyo University and other top private universities like Waseda University.

"They are not successful because many teachers are not really good at teaching in English and tend to read from notebooks," said a finance professor at Waseda University, who declined to be named. "In Europe now, many colleges teach undergraduate courses in English. But Japan is a long way from that, too," Allen notes.

Yasuo Kofuji, a finance professor at Sent University, says the issues extend well beyond language ability to an inability to socialize comfortably with non-Japanese. "Even if they are good managers in Japan, they are not able to communicate well with local staffs," he points out. "We may have to let local management run the businesses rather than trying to control local people."

From a foreign perspective, the list of the World's Most Attractive Employers 2012's Global Top 50, by Universe, a Sweden-based consulting company, includes Sony (ranked 15th) and Toyota (45th) but does not list any Japanese financial institutions. However, many Western financial institutions are included, such as J.P. Morgan, Goldman Sachs and Morgan Stanley.

In a paper titled, "Can Japanese Financial Institutions Take on the Challenge of Globalization 3.0?" Yasuda suggests that Japanese financial institutions must hire more senior foreign executives, as well as more Japanese with experience at foreign financial institutions overseas, to help make their management more global minded. Those Japanese know Japan but have succeeded in global financial institutions.

An apt role model would be Deutsche Bank, Yasuda says. "They have foreign board members and conduct meetings in English. Japanese financial institutions may want to become more like Deutsche Bank in the future."

Oversupply, Lax Standards Weigh Down Japan's Higher Education System

The stagnation of the Japanese economy has taken a severe toll on the nation's businesses and its lifetime employment system. It also has hit the university sector, especially private colleges, which are beginning to go bankrupt because they cannot attract enough students.

This issue popped to the surface last autumn, when newly-named education minister Makiko Tanaka, the outspoken daughter of former Prime Minister Kakuei Tanaka, tried to block approvals for three schools seeking university status. Tanaka lost that battle, as the schools and their bureaucratic backers went on the warpath. She also was among several members of the Democratic Party of Japan's (DPJ) Cabinet to lose their parliamentary seats in a December electoral defeat for the DPJ that has returned the old-school Liberal Democratic Party (LDP) to power. Still, the issue of how to balance the growing tertiary educational sector with shrinking demand remains an urgent one as Japan struggles to reshape its labor pool to suit the needs of a mature, slow-growing economy.

The image of Japan as a land of salarymen with lifetime jobs was always somewhat deceptive, as a significant share of the workforce has always been either self-employed or working under much less stable conditions in the farming, services or manufacturing sectors. However, the economic slump since Japan's financial bubble burst in the early 1990s has clearly eroded opportunities for workers and expanded the number of part-time contract employees with little or no job security or benefits. Many university graduates make relatively low annual salaries of ¥2 million to ¥2.3 million yen (less than $30,000), limiting their prospects for getting married or having children. Japanese women now have an average of 1.39 children, about on a par with Italy and other mature countries. Yet, while the overall population is aging and shrinking, the number of Japanese universities is still rising.

Inevitably, the excess of supply to demand for spots at the country's 783 four-year colleges is hurting. Already, a few schools have gone bankrupt and many university education specialists expect at least 100 of Japan's 605 private universities to go under in the next decade. "I am so puzzled by why they are setting up more universities in Japan. If you understand simple economic principles, [the colleges] will not be able to survive when Japan has a smaller number of students entering university," says Yutaka Morohoshi, a professor at J.F. Oberlin University's graduate school of education administration in Tokyo. He notes that about half of all private universities cannot gain enough students to meet quotas set by the Ministry of Education, Culture, Sports, Science and Technology (MECSST). This has prompted many schools to lower standards, accepting any student who applies.

Simple math dictates that the problem will only get worse. In 2010, there were 12.14 million 18-year-olds in Japan, 6.19 million of whom were enrolled in universities. Japan's National Institute of Population and Social Security Research predicts that the population of 18-year-olds will fall to 12.02 million in 2015; 8.91 million by 2030 and 6.81 million by 2050. The institute forecasts that Japan's total population will drop to 117 million by 2030 from 128 million in 2010; to 99.13 million in 2048 and 86.7 million by 2060. But Japan is building more universities every year. There were 512 private universities in 2000 and 605 private universities in 2012.

Many of the new universities are two-year women's junior colleges that are having a hard time attracting students and thus are upgrading to four-year, co-ed universities, says Morohoshi, who has written many books on the crisis in Japan's higher education system. "It is not easy for them to get more students, though, even if they become four-year colleges. They are having a hard time surviving."

Most of the new schools are located outside of Japan's biggest cities — Tokyo, Osaka and Nagoya. Most students, however, prefer commuting to university in Tokyo or other big cities rather than attending local schools near their homes, Morohoshi adds.

Makiko Tanaka ended up apologizing after her failed attempt to cancel the three schools' approvals, which, despite the logic of her stance, had violated ministry procedures. In Morohoshi's view, however, only one of the schools really should have been approved: the Sapporo University of Health Sciences, located on the northern island of Hokkaido, which will provide urgently needed professional training for nurses. "I am not sure about the other two universities being approved," he notes. The other two are Akita Municipal University of Arts and Crafts, a two-year junior college funded by Akita City, and Okazaki Women's Junior College, which educates kindergarten teachers. Both are typical of the type of school having a hard time getting by.

An Error of Design?

While the government officials who defeated Tanaka are well aware of the population trends in Japan, they have their own reasons for creating more universities. Without a growing number of colleges, there will be a shortage of "amakudari" — post-retirement positions for bureaucrats who "descend from heaven" once they reach a certain age, says Yasuo Kofuji, a finance professor at Senshu University. "The ministry officials are counting on taking up positions on boards of trustees or other administrative or teaching jobs," notes Kofuji, author of the book, *The Realities of University Management and Finance Analysis*.

By failing to address the university business model problem, Japan is missing a good opportunity to promote revitalization of the economy, Morohoshi says. "The problem now is there are too many inferior universities that lowered standards to attract students. This has become a vicious circle. The more they do this, the more they will be disregarded and forced into bankruptcy," adds Gregory Clark, former president of Tama University in Tokyo and a trustee of Akita International University. Despite Japan's high rankings on international tests for younger students, "The real problem is the poor education in here in Japan [in higher education]," he says.

Although it is not a new trend, most Japanese universities demand little of their students once they are enrolled. Most schools do not use GPAs or other measures to decide whether to pass or fail students, who are seen as having expended a lifetime's worth of energy preparing for university entrance exams. Once students get into college, they do not study but play. For most, it is their only stretch of relative freedom and leisure before entering the workforce.

One of the few private universities in Japan to adopt the GPA system is International Christian University (ICU) in Tokyo, which has been using it since its founding by Japanese and North American Christian leaders in 1949. ICU, a liberal arts college, requires students to take half of their credits in courses taught in English after attending an intensive program in the language during their freshman year. "ICU makes students leave [if they have] three consecutive quarters [with] a GPA average below 2.0, so we are using a similar standard at Oberlin," Morohoshi notes.

While ICU, Oberlin and a limited number of other private schools can impose more rigorous standards, the finances of most Japanese private universities work against that approach. On average, those schools depend on tuition payments and entrance fees for 87% of their revenues, with the remaining 13% coming from government subsidies and other sources.

Morohoshi estimates that ICU depends on tuition and fees for about 55% of its revenue. The ICU Foundation, set up in 1949, provides much of the rest. State universities, meanwhile, get 45% of their funding from the government.

Lax university educational requirements give schools plenty of leeway to tinker with such issues as student-teacher ratios and so on, with the Education Ministry limiting class size for non-science courses to 70 students to a professor. ICU, by contrast, has an average of 19 students per instructor.

Summing up the various issues, in a paper titled, "Higher Education and the Japanese Disease," Takehiko Kariya, a professor of sociology at St. Anthony College at Oxford in the U.K., notes that large class sizes are not conducive to high standards. "This makes it hard for faculty to provide personalized guidance and feedback to students. On top of that, most classes have no reading assignments," says Kariya, who taught sociology of education at Tokyo University for more than two decades.

The lack of any tools to enforce academic discipline is another key issue, adds Clark. "The real problem is not so much that there are too many universities, but rather, poor education," he says. While the government finances universities in Australia, for example, and requires that the colleges admit many lower-performing students, the schools can expel those who consistently earn poor grades. "In Japan, there is no mechanism to force students to study," Clark says.

One Foot Out the Door

Pressure to find post-graduation jobs kicks in early, further hindering studies. Companies are allowed to begin recruiting students from the autumn (the second half of the academic year in Japan, which typically kicks off on April 1) of the third year. From then on, students spend a significant amount of time visiting companies and interviewing. "Japanese university students spend so much time looking for jobs during university" Kariya notes. "If private universities can show prospective students that their graduates are getting good jobs, then more students will apply. So universities [have no incentive to] hinder students from spending so much time job hunting. This has caused deterioration in the quality of university students."

Generally, young Japanese have only one chance to get full-time, permanent employment — immediately after graduation. Ironically, lifetime tenure at universities means Japanese professors tend to be lackluster. "Japanese universities and their teachers have never faced real global competition, and they are narrow-minded. Many are poor educators or researchers, except in the sciences," says a professor at a major university in Japan who, due to the sensitivity of the topic, declined to be identified. "The life-employment system caused a decline in quality," adds Kofuji.

While Japan could mitigate the consequences of this problem within a closed system, the declining competitiveness of Japanese corporations such as Sony, Panasonic and Sharp has been severely punished in the global marketplace, as the firms have been overtaken by U.S. and Korean electronics makers such as Apple, Samsung and LG. This has driven home the lesson that Japan needs more talented and global-minded college graduates. So far, however, there is no sign of progress on reforms to break out of this competitiveness trap, says Clark.

"There is nothing you can do.... If you have bad students, you have bad teachers. If you have bad teachers, you have bad students. It is the ultimate vicious circle and very difficult to break," he notes.

The closed nature of the Japanese workforce is another hindrance: Only about 0.7% of Japan's university-educated workers are non-Japanese, compared with an average of 10% non-native employees for all Organisation for Economic Co-operation and Development (OECD) countries, Kariya states.

"If you look at Oxford University, about 40% of the teachers are non-British. Tokyo University has only a few percent. The academic and labor markets are being protected for Japanese," says Kariya, who notes that schools in South Korea and Singapore have benefitted from the global nature of their businesses. "Their markets are small and they have to go overseas to survive. However, Japan still has a big market, if you look at the job market and universities. Japanese do not feel a sense of crisis yet because the country has such a big domestic market and its university market is also ... big."

The nature of how universities are managed reinforces the problem, experts point out, because schools are run not by professional administrators or boards of trustees, but by faculty councils that generally compete with each other rather than coordinate or cooperate. Meanwhile, each university department is a world unto itself, providing all classes in all subjects. "For example, the economics department has its own teachers for English and other subjects," says Morohoshi.

"None of the faculty councils consider how to effectively operate their university as a whole," Kofuji adds. "University presidents and boards are not able to do anything without approval of the faculty councils."

A Lack of Urgency

Given the slew of other issues Japan is facing, including recession, soaring public debt, questions about nuclear safety and frequent changes of government, it is unclear if those in a position to start making needed changes — the bureaucrats who regulate education and the politicians who generally act on their behalf — recognize the urgency of the problem.

Morohoshi proposes setting up three types of universities to suit the diverse needs of students and employers: those that focus on research; liberal arts schools, and vocational-oriented schools suited to students who are challenged by the mainstream educational system and need more support and time to master the material.

Kariya favors setting up a few new, top-quality universities. "Japan should carry out a long-term, 10-year project to set up excellent universities with top teachers from all over the world, to increase the number of global-minded and globally competitive university graduates," he says. "If you try to improve the existing universities without long-lasting, big government funding, it will not be that effective."

Special Report:

Japan Boldly Resets Its Economy

Knowledge@Wharton

http://knowledge.wharton.upenn.edu

現代ビジネス

Gendai Business Web Magazine