# Submission No 7

## Inquiry into Australia's trade and investment relationship with Japan and the Republic of Korea


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Joint Standing Committee on Foreign Affairs, Defence and Trade

# Comments on Australia's Trade and Investment Relationship with Japan

## Section 1: Review of Continuing Influences

In our publication Australia and Japan Beyond the Mainstream, produced for the Australia-Japan Foundation in 2008-09 (http://repository.australia.or.jp/ajf/files/20090625_AJF_Manuel_Panagiotopoulos_Business.pdf), Andrew Cornell and I made some points about the Australia-Japan relationship that remain relevant today:

- Australia will continue to be a key strategic supplier for Japan for many decades. Japan will remain a key strategic market for Australia as its accumulated wealth and continuing advantages in technology and R&D investment counteract the looming challenges of demographic change. Despite the dynamic environment of the global economy, Japan will continue to be one of the largest economies and Australia will increase its own presence over time.

- A new complementarity extends across conventional business relationships, exploits Japan's emergence as a major source of capital beyond resource investment, draws in cultural economics and soft power and increasingly extends to the new concerns of the 21st century, the environment and regional geopolitical security.

- The New Complementarity is best discovered and applied through rich communications. "**Rich**" communications are those that occur through frequent personal contact and include far more than what can be exchanged via written or digital means. This includes not only non-verbal communication, which is the dominant part, but also informal aspects, which establish trust and bridge cross-cultural hurdles, creating anticipatory communication that provides new possibilities.

- All Asian markets depend to a greater degree than Western markets on well developed human capital networks. The 50 years of formal Japan-Australia ties means these networks are into third and even fourth generations.

- Established networks are real assets, which provide the base for new commercial linkages and are very hard to duplicate. They also provide adjacency, the strength of connections between existing successful ventures that builds success for new ventures.

- The economic relationship is also complementary to the social, political and strategic relationship. There are many institutional elements, covering cultural, commercial, diplomatic, academic, political and legal fields. However, they exist in a silo fashion, with little if any collaboration or communication. Their impact is thus much reduced and would be greatly enhanced if integrated.

- We mentioned cooperation in third countries. One of the most exciting opportunities is the pursuit of joint ventures by Japan and Australia in other Asian regions, multiplying the strong existing regional presence of each country. This is becoming a quick reality, as the Australia-Japan Business Cooperation Committee and its Japanese counterpart have organized extensive joint missions to India and Indonesia to look at infrastructure and PPPs.

The core economic relationship remains firmly founded on Japan's lack of energy and raw materials and Australia's abundance of same and reliability of supply. This last should not be considered as an afterthought: even raw materials are a service and reliability is a key component of a service. It is well understood that Japan is dependent on these imports but perhaps it is overlooked that Australia is also dependent on exports for its economic growth, now more than ever. Therefore, for Australia, too, to have a wealthy and reliable buyer is a key national interest.

## Section 2: The Future Centrality of Japanese FDI

Trade and investment used to be thought of as substitutes, then as two sides of the same coin. But actually that metaphor is also misleading because they are, once again, complementary, in the sense that more of one tends to produce more of the other.

**In the future and built on the foundation of the core relationship, the most important contribution to the marginal increase in wealth will come from Japanese direct investment into Australian industries.**

Mechanisms which promote the facilitation of FDI from Japan would be the most significant components of a Free Trade Agreement.

Japanese investment into Australia not only boosts exports to Japan but to the Asian region, which has the highest potential long-term growth. Inward investment flows of capital and transfer of technology also promote productivity growth.

**There are many statistics referred to below which make the point that Japanese FDI has been large and the share of overseas production has been rising. However, it is still low compared to other advanced economies and there are factors that will cause an acceleration of Japanese FDI.**

According to the UNCTAD *World Investment Report 2010*, at the end of 2009 Japan had a total stock of outward FDI of US$740 billion (all figures are in US$). That placed Japan in 6$^{th}$ place, behind the USA ($4.3 trillion), France ($1.7 trillion), UK ($1.7 trillion), Germany ($1.4 trillion) and the Netherlands ($850 billion).

Using the measurement of the 100 largest Transnational Corporations (TNCs), UNCTAD created a Transnationality Index (TNI). This is the average of the ratios of foreign assets, sales and employment to total assets, sales and employment. Japan's TNI in 2008 was only 50.0, which is remarkably similar to the TNI of developing economies. In contrast, the TNI for the USA was 58, for France 67, Germany 57 and the UK 76.

Similar comparisons can be made for specific ratios (2008, Top 5,000 TNCs): foreign sales: Japan 14%, USA 29%, EU 41%; foreign assets: Japan 13%, USA 30%, EU 40%.

According to the UNCTAD *Statistics Handbook 2010*, for the 5 years 2005-2009 Japan's FDI total was $371 billion, the 6$^{th}$ largest. But in 2009 Japan was the third largest source of FDI behind the USA and France.

In a report on Japan's FDI trends, HSBC Japan Securities (9 November 2010) calculated that the balance of Japan's cumulative FDI had grown rapidly in the past decade. At the end of 2009 it was 14.6% of Japan's nominal GDP but remained low compared to the USA (28.7%), UK (78.3%), France (62.8%) and Germany (40%). The report also makes this useful comment: "Much of this FDI is facilitated by multinational trade agreements, such as the European Union and the North American Free Trade Association, which Japan is not a party to." That comment suggests that Asia-wide FTAs could provide a real boost, independent of other factors, to future Japanese FDI.

Using the Japanese statistics, the total amount of Japanese FDI was 67.7 trillion yen. Asia had received 25.6% and Australia 4.8%. However, in recent years there has been an increased interest in Australia. In the period 2007-2010 Japanese FDI amounted to 33.8 trillion yen. The amount invested in Asia was 7.6 trillion yen or 22.4% of the total. In Australia, Japanese FDI was 2.2 trillion yen or 6.6%.

In 2009 Japanese FDI in Australia was 9.4% of the total and in 2010 it was 11.4%. The recent investments have been in a variety of industries: mining and energy, financial services, food, paper, real estate construction, services. The names include Kirin Holdings, Asahi Breweries, Suntory Holdings, Dai Ichi Life, Sekisui House, Nippon Paper.

In addition to any boost from possible free trade agreements, there are fundamental economic forces which will lead to much more Japanese FDI in the future. Demographic change in the form of an aging, shrinking population and a highly competitive domestic market means that the major growth opportunities for Japanese companies will be found outside Japan. The Asian region is especially attractive due to its adjacency and potential.

All the companies mentioned above based their investment decisions on the push factor of low growth in Japan and the pull factor of Australia's economic strength.

Australia is highly attractive, both in its own right and as a base for sales to Asia. Both Australia and Asia provide Japanese companies with better returns on their investment than other regions.

The *2010 JETRO Global Trade and Investment Report* states: "the domestic market ripened and with expectations for expansion of the market thinned by the low birthrate, the shift to overseas has speedily progressed. The Asia/Oceanic areas are attracting attention as they recovered comparatively quickly from the financial crisis." (page 40).

These factors are also highlighted in the JETRO Report (page 41) by comparing the 2009 figures for sales and profits in domestic and overseas markets. The domestic sales of Japanese listed companies were 65% of their total sales but domestic profits accounted for only 56.5% of total profits. Overseas sales, accounting for 35% of total sales, accounted for 43.5% of profits. The Asia/Oceania region was the stellar performer, with 12.9% of sales and 23.6% of profits.

In addition to benefiting from Japanese direct investment into Australia, there will be opportunities in the extensive and expanding operations of Japanese companies in the Asian region.

## Section 3: The Human Capital Dimension: Cultural Capability

While I expect Japanese FDI to grow rapidly in the future, I also expect the far greater use of non-Japanese employees in those overseas operations. There is a growing aversion amongst Japanese younger people to working overseas and living the expatriate life.

There is a clear imperative, then, for Australia to produce Japan-literate Australians. This is not limited to Japanese language study, but essentially refers to cultural capabilities. Japanese corporations have begun the process of promoting non-Japanese to senior positions in their overseas operations, but this is a gradual process and will benefit from cultural capabilities.

One of the policy prescriptions from the *Australia and Japan Beyond the Mainstream* publication was: **"the promotion of personnel exchange or movement in order to develop on-the-ground experience and cultivate the essential interpersonal contacts which are the hallmark of the Japanese business modus operandi".**

This policy should aim to supplement existing programs, such as school and university exchanges, grants and scholarships. There should be expanded and targeted personnel exchange between Australian and Japanese corporations, which would enhance the cultural capabilities of both sides in a real-world setting. This should be considered in third country contexts as well, within Australian and Japanese overseas operations.

## Section 4: Understanding the Japanese Interest

There is natural tendency to understand bilateral relations from one's own perspective, which can lead to poor outcomes if there are divergences of interests. Happily, the interests of Australia and Japan, perhaps uniquely in the context of bilateral relations, converge in many areas:

- similar values of democracy, rule of law, contractual fidelity, etc (these shared values are often explicitly referred to by the Japanese);
- although members of the same region, they are not neighbours and have no territorial impingements;
- they are not economic competitors, but rather blessed by a high level of complementarity;
- they share a genuine mutual affection, which promotes the search for solutions under conditions of goodwill;
- they both depend on the continuation of the open global trading system for their prosperity.

Nevertheless, it is incumbent for the Australian side to understand that Japan's values and interests are not identical to Australia's. My personal opinion is that for the Japanese nation, the highest value is placed on the continued stability of its society and culture. For the Japanese people economic growth is the means to achieve such ends, not an end in itself. Hence the primacy of full employment over profitability, of the relatively smaller range of income distribution and other indicators.

Recent comments on the misunderstood nature of Japan's 'lost decade' of economic stagnation by several long-time Japan watchers are worth quoting:

- Peter Tasker, "The Island Nation", *Foreign Policy* March 24, 2011:"economic efficiency was never the end goal, whether Japan's economy was rising or falling. It was social stability. And this foundation has survived two tough decades and is now a national insurance policy being paid out in the aftermath of the recent disaster…The generation of Japanese brought up amid the postwar devastation was driven by a hunger to reconstruct everything -- their lives, their society, their country's standing in the world. Once Japan was strong enough to be left alone, the target had been achieved. After the collapse of the bubble economy in 1990, Japan did indeed descend into stagnation and banking crisis…With the hindsight offered by the global financial crisis, it is clear that there are no easy fixes to the damage caused by the implosion of a large-scale bubble…By the early years of this century, however, Japan had largely worked through its post-bubble malaise, and its economic performance started to improve. The Japanese corporate sector returned to record margins…If the well-being of the mass of citizens is the goal of policy, Japan's performance this century does not justify the "lost decade" sound bite.

- George Friedman, *The Next Decade* (2011) p 179, “Western economists dubbed the twenty years during which the Japanese economy stagnated the “lost decades,” but this is a misunderstanding of Japanese objectives, or rather the imposition of a Western point of view on Japanese values. Sacrificing growth in order to maintain full employment was for this highly cohesive society not to lose a decade but to retain a core interest.”

- David Pilling, “Japan Finds There is More to Life Than Growth”, FT.com Jan 5, 2011, “It is easy to make the case for Japan’s decline…If one starts from a different proposition, that the business of a state is to serve its own people, the picture looks rather different, even in the narrowest economic sense. Japan’s real performance has been masked by deflation and a stagnant population. But look at real per capita income…and things are far less bleak.”

By my own calculations, during the period 1990-1999 real per capita income in Japan increased by 7.9%, whereas for the US the figure is 20.2%. However, in the period 2000-2007 (to remove the external shock of the GFC), real per capita income in Japan increased by 9.5% and in the US by 10.2%, a close outcome.

The corollary of Japan’s socioeconomic preferences is that the highest priority is placed on the stable, continuing and secure supply of energy, resources and food. These are core and unchangeable priorities.

It also means that any large scale immigration is unlikely, which will further support the expansion of overseas production, i.e., capital will go to where labour is located.

Finally, it also means that Japanese corporations will continue to re-invest their sales into R&D to maintain their competiveness.

## Conclusion

The existing deep and extensive commercial relationship between Australia and Japan will provide a sound platform for the development of new opportunities, especially the attraction of direct investment by Japanese companies in Australia and the demand from Japanese production in Asia.