

Japan's splendid isolation may be at risk

By David Pilling

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The world has fallen out of love with Japan and Japan with the rest of the world. Aside from discussions with Japanophiles - who wax with justifiable lyricism about the country's efficiency, marvellous cuisine and exquisite sense of beauty - mention of the country these days is likely to provoke a raised eyebrow or a gently suppressed yawn. Investors regard Japan as resistant to their attempts to spread the gospel of shareholder value and a place where a bull run is when equities rally to one-quarter their 1990 level. Such is the lack of interest that one Tokyo-based broker toyed with the idea of removing the word "Japan" from the title of his investment notes in order to lure more clients into reading them.

Meanwhile, Japan looks at the outside world with a certain gloomy detachment. It feels vindicated that it did not swallow the wilder notions of unfettered market capitalism, and yet let down that its export-dependent economy nevertheless suffered an even sharper contraction than its reckless rivals. It regards with nervous resignation a rising China that will shortly displace it as the world's second-biggest economy, and long ago trumped it as a diplomatic and geopolitical power. It even looks on with a degree of envy at South Korea, a former colony whose industry is fast catching up with its own and whose society has largely proved more adaptable to changes wrought by globalisation.

At home, only eight months after an opposition party finally wrestled power from the crusty Liberal Democrats, disillusion has set in. What some dared hope was a modern Meiji Restoration has turned out to be rather less inspiring. There is already chatter about when Yukio Hatoyama, the "revolution's" leader, might resign. Economically, and in spite of this week's formation of a ruling-party faction that favours inflation-targeting, the country's leaders nourish a fatalistic acceptance of deflation. True, 15 years of more or less continuously falling prices have not triggered the crisis some predicted. But falling nominal output has accelerated Japan's relative economic decline.

There are important countervailing trends. Apart from when its Imperial Army was rampaging around Asia, Japan has, in some senses, rarely been as plugged into the world. Businesses have concluded their future lies abroad. Nomura snapped up the Asian and European arms of Lehman Brothers in a bid to become a global investment bank. Daiichi bought Indian pharmaceuticals company Ranbaxy in a bold (read expensive) international foray.

Japan's cultural influence abroad has probably never been greater. Tokyo is far more international than it was a decade ago. The capital city is even becoming easier to get to now that some international flights are being transferred from the wilderness of Narita to the relative convenience of Haneda airport.

Yet many Japanese seem more at ease with the idea of stately decline and genteel isolation. One of Japan's most popular books in years, *The Dignity of a Nation*, even suggested Japan should stop teaching its children English and withdraw from the world trade system altogether. Short of such radicalism, many people ask what is wrong with being a backwater of wealth and civility in an out-of-kilter world.

Certainly, there are attractions. The country is, for example, largely untouched by international terrorism. The near absence of security at train stations, offices and even government buildings is, for the world ex-Japan, a charming throwback to a bygone era. It has also been able to avoid trade friction to a remarkable degree. Until its recent recall, Toyota was given a virtually free hand in its single-minded pursuit of Detroit's destruction. Japan has experienced nothing like the backlash visited upon China, even though it too maintains huge trade surpluses and mountains of US debt. For Japanese with jobs and access to savings, even deflation can be a boon. "We are just quietly enjoying our affluence," says one satisfied customer.

Japan, then, could plausibly glide for decades into a splendidly comfortable - even enviable - dotage. Yet there are at least two risks to this scenario. The first is economic. For 20 years, Japan has been able to recycle savings to pay for its fiscal deficits. That situation may not be sustainable indefinitely, particularly as the population ages and saves less. Its gross public debt - admittedly all domestically owned - is now approaching 180 per cent of national output. Martin Wolf points out with alarm that the UK government borrows one pound for every four it spends. This is child's play in Japan where, for every 200 yen spent, the government borrows more than 100.

The second risk is geopolitical. Japan lives in a rough neighbourhood. It has territorial disputes with nearly every surrounding country, most of which still harbour (or find it useful to harbour) resentment about Japan's pre-war aggression. The proximate cause of Japan's current diplomatic see-sawing with the US, its staunchest ally, is a dispute over where to place a Marine base. But the underlying friction is generated by long-building frustration at what Washington regards as Tokyo's unwillingness to engage fully with a volatile and dangerous world. None of this means that Japan's state of splendid isolation is untenable. But it may not be smooth-going either.

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