

JAPAN ECONOMIC CURRENTS

A COMMENTARY ON ECONOMIC AND BUSINESS TRENDS

Tasks to Tackle After Japan's 10-year Slump

BY AKIRA KOJIMA, JAPAN CENTER FOR ECONOMIC RESEARCH

The ongoing expansion of the Japanese economy will enter its fifth year in February, becoming one of the longest since World War II. Indeed, the upturn is close to breaking the record 57-month expansion which stretched from October 1965 to July 1970. To be sure, the current growth phase hardly compares to the high-growth period, when the economy was expanding at an annual rate of some 10 percent. Still, it looks likely to continue through 2006, even if only at the modest pace of 2 percent.

Japan's "bubble boom" came to an end in 1991. In one of the ironies of history, 1991 was also the year when capitalism, or what is called the market economy today, scored a smashing victory with the disintegration of the Soviet Union, bringing the Cold War to an end. That same year, the United States worked its way free of the stagnation that had bedeviled it in the 1970s and 1980s and entered its longest expansion since World War

II, a phase marked by a strong upward trend in productivity. Elsewhere around the world, in 1991 India launched a program of reform and opening, thereby getting back on track for the first time in decades. In 1992 China, which began its own reform and opening campaign more than 10 years ahead of India and was, as a result, growing with blinding speed, accelerated the pace of its reform program. In those days institutional reforms were moving into full swing around the world, as countries raced to make their economies more dynamic. Set against this international background of what has been dubbed a decade of "megagrowth," Japan's slump of the 1990s was highly conspicuous.

The end of the tunnel

Why did the stagnation of the Japanese economy last more than a decade? The direct answer is that the extreme overheating of the second half of the 1980s triggered the formation of the bubble economy and produced some serious aftereffects that took a long time to straighten out. They were not, however, the only factors involved. The development model of

the previous decades could no longer cope with the external and internal environments of the 1990s or with the paradigm shift in technology. Still operating in the catch-up mode, Japan lacked a development model suited to the new age.

Over the course of the economic recovery, which started in February 2002, the aftereffects of the bubble years have more or less been remedied. Last year the government stated that the "three excesses"—employees, facilities, and debts—have nearly been eliminated.

The financial crisis that hit Japan toward the end of 1997 alarmed people around the world with the specter of a global financial panic originating from a meltdown in Japan. But banks thereafter went through a major realignment, and now many of them are enjoying unprecedented profitability. This has laid the financial unease to rest. Nonfinancial corporations have also made progress in managerial reforms, and they have significantly lowered their break-even point and recovered management vitality. In fact, corporate profits are higher than ever before.

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With the corporate sector standing tall once more, foreign investors are channeling funds into Japanese securities.

This has reversed the trend of a withering entrepreneurial spirit and prompted corporate managers to think strategically again. Companies have lifted cash flows to record-setting levels, and they are pumping money into plant and equipment investments.

With the corporate sector standing tall once more, foreign investors are channeling funds into Japanese securities. During 2005 these investors engaged in net buying of Japanese shares to the tune of ¥10.3 trillion. Japanese firms have received a stamp of approval from the four major credit-rating agencies including R&I (Rating and Investment Information) and Moody's Investor Services; altogether, these agencies have upgraded the ratings of 302 Japanese companies.

Pay hikes in the offing

To some extent, though, the recovery of Japan's corporate sector came at a high cost to the household sector. In order to lower expenses, companies resorted to so-called restructuring.

To be more specific, they lowered staffing levels by slowing down the intake of recruits and encouraging early retirement, increased the share of part-timers and other nonregular employees (whose wages are lower than those of regular employees), and imposed a regimen of wage austerity including wage cuts. This restructuring proved to be remarkably effective in reducing costs, lowering the break-even point, and increasing profitability. But it also meant less income for the household sector and more employment insecurity. In effect, there was a major redirection of income away from families and toward businesses. This income transfer has led to a record-breaking saving surplus in the corporate sector, but it has also sharply lowered the saving rate of the household sector.

Fortunately, consumer demand did not dry up. On the contrary, families have continued to channel more money into spending, opting to put less money into savings accounts.

Given the graying of Japan's society, though, this trend will not be likely to continue. If the flow of income into the corporate sector persists, families will at some point decide to consume less. Personal consumption accounts for more than half of gross domestic product (aggregate demand), and if it does not continue to expand, the overall economy's sustained growth will reach a limit. Now that the current upturn is moving into its fifth year, the prospects for its continuation hinge on another shift in income, this time from the corporate sector back to the household sector.

In this respect, it is worth noting that during 2005 companies began to hire more regular full-time employees. At the end of the year the Committee on Management and Labor Policy of Nippon Keidanren (Japan Business Federation) released a position paper encouraging companies to adopt flexible wage policies henceforth, since the corporate environment has considerably improved. "Flexible" in this case represents a Keidanren desire for management to make a positive response to labor's calls for more pay in the spring round of contract negotiations.

Back in 1993, not long after the speculative bubbles burst, business circles adopted a stance of opposing

hikes in wage levels, and they stuck to this stance after that. But 13 years later, a return to annual wage hikes is in the offing. The adoption of this flexible wage policy can be expected to engender a virtuous circle for sustainable growth, one in which rising household income boosts consumption, rising sales lift corporate earnings, and investment grows in production facilities, research, and development. In this light, the new tune management is singing is welcome, since it is good news for the economy overall.

Beyond the catch-up model

Japan's business cycle has finally begun a long ascent. But two non-cyclical, structural questions on the economic agenda must be addressed. The first is what to do about the radical transformation of the nation's demographic structure, which is shifting to a large share of senior citizens and a small share of children. The second is how to replace the catch-up model that served Japan in the past. Because of vast changes at home and abroad, a new development model must be constructed.

The Japanese population began to contract in 2005, two years earlier than demographers predicted. Since the tendency of families to have few

children shows no sign of ending, Japan has evidently entered an era of a long-term population decline. Indeed, the working-age population shifted to a downward trend several years ago. An equation used in economic growth accounting provides one useful perspective:

$$\begin{aligned} \text{Economic growth rate} = \\ \text{Labor input growth rate} + \text{Capital} \\ \text{input growth rate} + \text{Total factor} \\ \text{productivity growth rate} \end{aligned}$$

This equation holds that economic growth is the combination of three variables: labor inputs, capital inputs, and productivity. If a society's population is on the decline, the growth rate of labor inputs will be negative. And if the share of the elderly is swelling at the same time, the growth rate of capital inputs will slow down or turn negative, since people will be spending more and saving less, thereby reducing the supply of funds for capital investment. In this way, two of the three variables on the right-hand side of the equation will shift in the negative direction, and economic growth will slow down to that extent. Under the circumstances, it is critical to find ways to boost the growth rate of total factor productivity, or the productivity of all the inputs into production.

The catch-up model was built for the days when Japan lagged behind other industrial countries. It brought about economic growth and industrial development through the import and refinement of technology and know-how developed in Western countries. The development of brand new technologies and the pioneering of industrial frontiers entail risks, but if industrially advanced countries have already taken these risks, all a late-developing country needs to do is import the results.

The task facing latecomer Japan involved coming up with ways to use already developed technologies more efficiently and cleverly. This was a matter of technological refinement, not technological development. The key was to foster the general abilities of a high-quality, diligent, and homogeneous workforce, not the exceptional abilities of truly gifted individuals. In macroeconomic terms there was a saving shortage, and thus a system of indirect finance was created in which banks pooled the savings of families and funneled them into industries lacking sufficient capital.

Eventually, after the September 1985 Plaza accord on currency realignment, the yen began a steep climb, and per capita income rose to the world's top level. Naturally, labor costs measured

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in dollars also rose, and workers in plants found that their paychecks were among the largest in the world. Japan's industrial technology, meanwhile, was reaching the level of the forerunners in development. At that point, the fundamental conditions suitable for the catch-up model ceased to exist. After all, this model depended on imports of technology and low wages for a diligent and homogeneous workforce, which mass-produced inexpensive, high-quality products.

The post-catch-up model must be one in which Japanese assume the risk of developing new technologies and opening up new industrial frontiers. The system supporting this new development model must supply risk money to risk takers, to creative individuals and to firms with a willingness to assume risks. Naturally, there must be a shift away from the system of indirect finance, in which banks take the lead in collecting funds and financing companies; greater weight must be placed on the capital market, which is the primary source of investment funds supplying risk money.

Japan's failure to make this shift left it dependent on the old development

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model, and this became one of the forces driving the bubble boom. In the midst of the euphoria of the bubble years, the corporate world, the government, and the public in general remained oblivious to the need for a new model. People reveled in the illusion that the bubble boom constituted proof of the excellence of the old model. Overconfidence reigned supreme. But then the bubbles popped and the mood of the nation swung wildly in the opposite direction. Everyone became overly pessimistic, and loss of confidence went to an extreme.

Today the aftereffects of the collapse of the bubble boom have, for the most part, been overcome, and the nation has acquired the leeway it needs to face structural problems squarely and dispassionately and to map out a

strategic response. In September 2006 the term of Prime Minister Koizumi will come to an end. Will the post-Koizumi leadership opt to carry on the assorted reforms that the Prime Minister has, however imperfectly, set in motion? Will it be able to make substantial progress in the building of a new development model? The answers to these questions will determine whether the current expansion becomes more than just an upswing in the business cycle and whether it can produce an upward shift in the long-term potential growth rate. In this light, 2006 will be a crucial year for the Japanese economy.

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A Japan-US Free Trade Agreement

BY BRUCE STOKES, NATIONAL JOURNAL

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An announcement on February 2, 2006 that the United States and South Korea intend to negotiate a free trade agreement (FTA)—hopefully by early 2007—has sparked new interest, at least in Japan, in the possibility of a US-Japan free trade agreement. In recent weeks, a host of Kasumigaseki officials have streamed through Washington taking the temperature of the Bush Administration, trade leaders on Capitol Hill and the American trade policy community, trying to ascertain US seriousness of purpose toward the South Korean deal, the likelihood Congress would actually approve such an agreement and Japan's options in its bilateral trade relations with the United States.

A Japan deal is not high on the Bush administration's trade agenda. But it is not lost on Washington officials that the initiative puts Tokyo in a difficult position, leveraging the Japanese in the Doha Round of multilateral trade negotiations and on other bilateral commercial issues. While a US-Japan free trade negotiation is not imminent, the time is ripe to begin planning for one. Going forward, the challenge is how to frame such talks to address mutual commercial and investment problems and real impediments to future trade.

The main argument against a US-Japan FTA—other than the obvious practical, technical and political negotiating difficulties—has always been that it would provide a sub-optimal economic outcome. Multilateral trade liberalization would always provide greater commercial benefits for both sides and other trading partners. Moreover, as the first major FTA between two major economies and one that would bridge two economic blocs rather than a deal within economic blocs, a US-Japan free trade agreement would pose a direct challenge to the future of the multilateral trading system.

Thus a trans-Pacific FTA has never proven advisable, despite its support by Fred Bergsten, head of the Institute for International Economics, this

author, while a senior fellow at the Council on Foreign Relations and, most recently, at the US-Japan Business Council.

But current events now afford Washington and Tokyo a unique opportunity to forge such a precedent setting economic arrangement.

Japan is no longer the trade boogeyman in Washington. That role is now being played by China. Tokyo benefits by not being Beijing. Moreover, the Bush Administration is increasingly concerned about counterbalancing China's influence in Asia. A US-Japan free trade agreement would permanently deal the United States into Asia's economic future. And, given its ongoing problems with China, Japan has its own reasons to reaffirm its ties with the United States.

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A Japan-US Free Trade Agreement

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In addition, the current Doha Round of multilateral trade negotiations is stuck. A minimalist outcome is likely at best. No one has the stomach to go through this disheartening exercise much longer; too many divergent interests are represented around the World Trade Organization negotiating table. Business sees little to gain from five or six year talks that produce little. In any event, the Doha Round will, successfully or unsuccessfully, soon be history.

A US-Japan free trade agreement, if timed not to begin until the Doha Round has been resolved, would pose no immediate threat to the multi-lateral process. But it would provide an opportunity to meaningfully liberalize trade over and above that accomplished in the Doha Round.

Moreover, the world may be approaching the end of the post-

World War II era of multilateral trade liberalization. Recent US bilaterals—such as the deals with Morocco and Bahrain or the Central American economies—produced little tangible commercial gain. Something bigger is needed to maintain business and political interest in trade liberalization.

The US-Korea FTA, if finalized, would disadvantage Japanese manufacturers in the Korean market, compared with their American competitors. So, just as NAFTA led Japanese industry to push for Japan's free trade deal with Mexico, a US-Korea agreement may increase pressure in Japan to do deals with both the United States and South Korea. Moreover, it is hard to imagine Tokyo passively accepting the public confirmation that Seoul has a closer relationship with Washington than Tokyo that a US-Korea FTA would symbolize. And outgoing Japanese Prime Minister

Koizumi could see launching FTA talks, or at least announcing a mutual interest in pursuing talks, as part of his international legacy.

Finally, Japan can't safely presume that it will permanently remain off Washington's trade-bashing radar screen. The US trade deficit with Japan was \$82.7 billion last year. This sum was dwarfed by the US imbalance with China, but, nevertheless, the US imbalance with Japan was up 9 percent from 2004 and 19 percent from 2003.

This trend has not gone unnoticed on Capitol Hill. On February 15, 2006, House Ways and Means Committee Chairman Bill Thomas told US Trade Representative Rob Portman that he believes "Japan has a long history of blocking US goods, devising non-tariff barriers that allow their farmers and their firms to operate while keeping out imports. We're not looking for any more apologists for Japan's behavior. We're looking for results."

Tokyo may need a free trade negotiation with Washington to change the ominous drift in bilateral relations and to demonstrate Japanese intent to remove the trade barriers that trouble Thomas.

The challenge facing US and Japanese negotiators would be the content of any free trade discussion. Most important would be for Washington

and Tokyo to articulate a vision of creating a US-Japan open marketplace by a date certain. This would include a commitment to eliminating most tariffs, minimizing regulatory impediments and creating a freedom to do business in this new single market through trade or investment.

As always, the devil will be in the details. Tariffs on most products between the two countries are so low that their removal alone would do little to spur trade. The principal tariff issue would be Japan's tariff of more than 400 percent on rice. Washington would push to lower this duty, but it is more of symbolic than tangible importance to the United States. Since significantly lowering rice import barriers would pose political problems for the Japanese government, some face-saving accommodation would be necessary for both sides.

The current bilateral regulatory reform and competition initiative could serve as the template for identifying and prioritizing regulatory impediments to creating an open marketplace. This initiative, launched in 2001, addresses key sectors, including telecommunications, information technologies, energy, medical devices and pharmaceuticals, financial services and agriculture. It also looks at crosscutting sectoral

issues, including competition policy, transparency, privatization, legal system reform, revision of Japan's commercial law and distribution.

In particular, Tokyo and Washington might usefully focus their attention on developing more pro-growth business norms in a number of areas where both the United States and the Japan have future economic interests.

intellectual property is broken and a new one is needed. Bilateral FTAs have traditionally been proving grounds for new concepts in trade liberalization.

Who has more of a stake in finding a better way to protect the interests of intellectual property holders than Japan and the United States? And what better place to try to sort that out than bilaterally in an FTA negotiation,

Japanese and American high tech producers will succeed or fail in the years ahead depending on their ability to safeguard and profit from their intellectual property.

For example, Japanese and American high tech producers will succeed or fail in the years ahead depending on their ability to safeguard and profit from their intellectual property. But software, CDs and DVDs have proven too easy to copy and distribute electronically. Tokyo and Washington can continue to pressure Beijing and Moscow to step up their crackdown on piracy, but recent experience suggests it is a losing battle. The old business model for protecting

developing new norms that could then be multilateralized?

Similarly, both Japan and the United States face rising health care costs as their populations age. The Japanese government pays for consumers' pharmaceutical expenses. The United States leaves that cost to the consumer. The American model is unsustainable because of the cost it imposes, particularly on the elderly. The Japanese model inhibits innovation because drug companies

lack incentive to develop new cures. Similar issues arose in and almost killed the US-Australia free trade negotiations, so how to price drugs will be an ongoing concern in international trade talks. Both Tokyo and Washington have an incentive to use a bilateral FTA discussion to develop a new hybrid model for paying for pharmaceuticals and for drug research and development.

Successful launch of a US-Japan free trade agreement will require careful preparation. With the Bush Administration otherwise preoccupied, the ground may best be laid through Track II discussions between interested

parties on both sides of the Pacific: business leaders, academics and others. These parties could flesh out agendas, discuss sensitive issues and set forth tentative timetables that could later be embraced by Washington and Tokyo.

It will prove a long process. But the launch of the US-Korea FTA foreshadows a new era in bilateral trade negotiations and signals the inevitability of a US-Japan free trade deal. It has been a long time coming.

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