

# New Lease of Life for the Japanese Economy

By Wakatsuki Mikio

At the outset of the new century, Japan is at a very important crossroad which will determine whether it endures another lost decade or enjoys a new lease of life in the coming decade. Thus far, the new decade appears to have started well as Japan has a new government seemingly intent on a radical departure from the past under its slogan of "reform without sacred cows." But the road ahead is by no means smooth or untroubled, as the complete overhaul of a regime that was successful in the past requires undaunted courage and determination. Moreover, Japan needs to review and recast its international role in the light of a rapidly changing global economy. What strategy is required to ensure a new lease of life for the Japanese economy?

## Perspective of the International Environment

At the outset, it may be useful to envisage the sort of international environment Japan will have to navigate in the coming years.

First of all, what we are going to see is a conflict between the relentless movement towards globalization and an intensifying backlash against it. The move towards globalization, which accelerated throughout the 90s, has entered a new phase since around the turn of the century. Developments which marked that change were the turbulent Seattle World Trade Organization (WTO) meeting in November 1999 and the tragic assault in New York. These backlashes were the culmination of a strong undercurrent against globalization. Such globalization no longer commands simple faith and unreserved support without enough attention being paid to such issues as environmental protection, reduction of poverty, income equality and human rights. Thus the global economy will need to seek a fair balance between

Table 1 Impact of Disposal of Non-Performing Loans (NPLs) on Employment

Tangible fixed assets (¥ trillion, 1999)	495.9
Fixed liabilities (¥ trillion, 1999)	462.7
Loans from financial institutions (¥ trillion)	264.4
Number of employees (10,000 persons, 2000)	5,356
(Labor force, 10,000 persons)	6,766
Disposed NPLs (risky loans) (¥ trillion)	15.3
< Loan reduction = Assumed to be tangible fixed assets requiring reduction >	
Decrease in tangible fixed assets (%)	▲3.1
< Labor equipment rate is assumed to be constant >	
Decrease in latent employment (10,000 persons)	▲165
Increase in unemployment (10,000 persons)	
Number of jobless workers = Decrease in latent employment x (1) rate of reduction in personnel during reduction of business x (1 - (2) rate of success in job change before discharge), where (1) is assumed to be 40% and (2) is assumed to be 20% according to the case of Sogo Inc.	▲53

Sources: Ministry of Finance "Financial Statements Statistics of Corporations by Industry," Ministry of Public Management, Home Affairs, Posts and Telecommunications "Labor Force Survey"

these two conflicting currents.

Likewise the value standards of Anglo-Saxon capitalism which comprise the dominant core of globalization – such as market mechanisms, competition, privatization and small government – will also need to seek some compromises with other value standards such as equity, community life and human security and rights.

Secondly, on the technological side, the information technology (IT) revolution – or more broadly, the digital revolution – will continue and remain as a major driving force generating changes in the economy and society in spite of the temporary setback borne of the irrational exuberance in the late 90's. But it will soon be joined by further technological breakthroughs in such areas as biotechnology, nanotechnology and new materials, all of which will provide opportunities and new frontiers for growth.

Thirdly, a strong undercurrent of regionalism will surface with the progress of globalization. In the 90s, we saw the great success of the North America Free Trade Agreement in expanding trade within North America and now a broader bloc covering the whole Western hemisphere, a Free Trade Area of the Americas, is being drafted. In Europe, following the successful transition to a single currency in

1999 and the ensuing introduction of "euro" notes and coins in 2002, the stage for further deepening and widening of the European Union (EU) is set. Economic, financial and political integration together with the large number of new entries slated for 2006 will enhance the importance of the EU in global affairs. The euro will add its weight as an international currency to rival the dollar, as the de facto euro zone extends itself into non-EU Europe and North Africa.

In Asia, there is a latent fear that it would be isolated from other blocs and disseminated by their regionalism. Though many Asian countries still basically stick to a multilateral approach, they feel the need to counterbalance the other blocs by forming a group of their own. They believe an increased economic interdependence among them would justify the need. China's WTO entry will enhance its status as a new global economic power, and the question of how to secure her orderly transition into a fully fledged market economy under WTO rules will be one of the most important focal points for the regional and world economies.

Against this international backdrop, the question will be raised as to whether Japan will be able to continue making its fair contribution to the

Table 2

## Effect of Reduced Public Works Investment on Construction Industry Employment (2001 to 2005)

Amount of reduced public works investment (¥2 trillion/year in 2002 and later)	▲¥9.3 trillion
Number of construction industry workers (2002, based on Labor Force Survey)	6.53 million workers
Decrease in construction industry workers	▲650 thousand workers

Sources: Ministry of Public Management, Home Affairs, Posts and Telecommunications "Labor Force Survey," Ministry of Land, Infrastructure and Transport "Integrated Statistics of Construction Works" and others

Notes: 1) The estimation formula (method of least squares) used for the trial calculation is as follows:

$$\ln(L) = 1.264 + 0.264 \cdot \ln(X) + 0.0108 \cdot \ln \sum (w, t \text{ to } t-1) \\ (-1.25)(2.47) \quad (0.0524) \\ + 0.847 \cdot \ln(Lt-1) - 0.014 \cdot T1 + 0.0197 \cdot T2 \\ (3.71) \quad (-1.44) \quad (1.59)$$

where L = number of construction industry workers, X = total construction investment, w = nominal wage, T1 = time trend, T2 = time trend in 1991 and later. The time trend is 0 before 1991.

Decision coefficient with degree of freedom revised = 0.973. Estimation period: 80 to 2000 years  
Items in parentheses are t values. Derbin's h statistic = -1.15.

2) Preconditions for trial calculation are:

- (1) Public works are reduced by ¥2 trillion every year between 2002 and 2005,
- (2) Private construction investment remains unchanged from the 2000 level,
- (3) The wage level remains unchanged, and
- (4) T1 and T2 remain flat in 2001 and later

world economy. In particular, since the Sept. 11 incident and with the threat of global recession looming, Japan's protracted economic slump has drawn international concern and dissatisfaction. At the same time, Japan's cooperation with U.S. military operations in the fight against terrorism has stirred some apprehension among neighboring Asian countries about Japan's new international initiative. It is incumbent upon Japan to redefine its role in the international arena.

### Towards the Resurgence of the Japanese Economy

The 90s were a period of disillusionment and despondency for the Japanese economy. The average annual rate of real growth declined to 1.3% from the 3.9% recorded over the proceeding several years. During this period, stimulatory fiscal packages amounting to ¥120 trillion were implemented and the Bank of Japan lowered its official discount rate from 6.75% to virtually zero. But the effects of these measures were both limited and short-lived, as they were implemented for the sake of preserving the status quo rather than revitalization. As a result, the downward trend of the economy remains unchanged in the early years of the 21st century, and signs of economic malaise are now hard to conceal.

What has become apparent over years of muddling through is that there is no quick fix to revive the Japanese economy and only fundamental reform will cure the malaise. It is also realized that such reform takes time and is not without pain. The reform needs to cover the whole system rather than taking a piecemeal approach, but among others, four areas are of crucial importance. They are: (1) the financial system, (2) the industrial structure, (3) the fiscal system and (4) labor and employment.

#### (1) Restoration of Confidence in the Financial System

Currently, Japan's financial system is not functioning properly due to procrastination over past problems, in particular the non-performing loan (NPL) problem. Japanese banks claim that they have consolidated some ¥72 tril-

lion of NPLs during 1992-2000, and yet ¥66 trillion of NPLs still remain unresolved as of the end of March, 2001. This means that the speed of resolution is not keeping pace with new additions. The persistence of the NPL problem may be explained by the protracted slump in the economy and the continued asset deflation. But more fundamentally, it should be attributable to the lack of speed and determination in dealing with the initial problem. The resultant procrastination worsened the problem by instituting a kind of vicious circle, as the magnitude of these NPLs hinders the banks' ability in terms of credit intermediation and leads to a fall in stock prices, which in turn depletes banks' resources for write-offs. The negative effects of the shaken confidence in the financial system drag the whole economy down.

The basic approach to the resolution of NPLs should be through a self-help effort by the banks. But if their progress is unsatisfactory, the use of taxpayers' money should not be delayed. The implication is that nationalization of some banks may be inevitable, and more mergers and consolidation may follow.

In order to survive the intensifying global competition, Japanese banks need to enhance profitability by broadening their sources of revenue. Alliances and mergers with securities houses, insurance companies and non-banking finance companies need to be considered. The reform of public financial institutions such as the postal savings system and the housing corporation will help to restore banks' profitability by providing a fair and level playing field and reducing public sector encroachment on private business.

With these reforms, personal financial assets will be more efficiently mobilized and invested.

#### (2) Reform of the Industrial Structure

It is now commonly understood that the banks' NPL problem is the flip side of borrowers' non-performing assets; unless the non-performing assets are shifted to more productive and efficient use, money will not be recovered and the economy will not be revitalized. The resolution of NPLs by banks, therefore, will lead to the process of removing non-viable borrowers for the better reallocation of resources. It will also expedite mergers and consolidation of firms and encourage alternation from outdated and decaying industries to growing ones.

Since the late 90s, the number of bankruptcies has been rising, but in that process, the restructuring of business is also proceeding. The profit to sales ratio in non-manufacturing industries is approaching its highest level since the late 80s and the ratio of long-term financial liabilities to cash flow is falling to pre-"bubble" period levels, excluding the construction, real estate and retail and wholesale sectors. That indicates that the NPL problem is now more or less confined to these three sectors.

Notwithstanding the encouraging improvement, a new concern arises as the recent massive shift of factories abroad, especially to China, will lead to an industrial "hollowing out." Yet, the trend of this shift appears irreversible in view of the relatively high ratio of manufacturing industries in the Japanese economy compared to other industrial countries and the rapid emergence of China and other neighboring

Table 3

Effect of the Rise in Import Penetration on Manufacturing Industry Employment (2001 to 2005)	
Degree of import penetration (2000)	11.9%
Degree of import penetration (2005)	16.4%
Rising level (2000-2005)	4.5% point
Rate of alternative domestic production	▲5.1%
Number of manufacturing industry workers (2000, on the basis of Labor Force Survey)	13.21 million workers
Decrease in manufacturing industry workers	▲330 thousand workers

**Sources:** Ministry of Public Management, Home Affairs, Posts and Telecommunications "Labor Force Survey," Ministry of Economy, Trade and Industry "The Analysis of All Industrial Activities" and others

**Notes:** 1) The estimation formula (method of least squares) used for the trial calculation is as follows:  

$$\ln(L) = 0.406 + 0.220 \ln(X) - 0.0431 \ln \sum_{t=1}^T (w_t)$$

$$(0.960)(5.50) \quad (-0.398)$$

$$+ 0.841 \ln(L_{t-1}) - 0.0483 \cdot T$$

$$(8.41) \quad (-1.37)$$
where L = number of manufacturing industry workers, X = production index (manufacturing industry), w = nominal wage, T = time trend.  
Decision coefficient with degree of freedom revised = 0.949. Estimation period: 80 to 2000 years.  
Items in parentheses are t values. Derbin's h statistic = 0.662.

2) The precondition for trial calculation is that import penetration rises at a pace of 1999 to 2000

Asian countries as strong manufacturers. What Japan should do is to encourage a shift in resources to service industries based on knowledge and intellectual creation, while manufacturing industries focus on high value-added and high quality products.

### (3) Fiscal Restructuring

Until the early 90s, Japan was one of the more fiscally sound of the Group of Seven (G-7) countries. But the position quickly deteriorated through the 90s and now the accumulated debt has reached 130% of gross domestic product (GDP), the worst among the G-7. In fiscal 1999, the fiscal deficit was 7.4% of GDP, of which 6% was considered structural. It is apparent that the continuation of a large fiscal deficit cannot be sustained for long. In view of the difficult economic conditions, though, rapid elimination of deficits and any immediate reduction of debt are not practical. The heart of the matter is not a simple numerical reduction of deficit but the qualitative shift of resources into a more productive sector through fiscal reform. Realistically the deficit should be reduced over the medium term, first aiming for a surplus in the primary balance. In order to achieve the primary balance by fiscal 2010, the Japan Research Institute (JRI) simulation shows that assuming a nominal rate of growth of 2.5% per annum, public work expenditures need to be reduced by 35% and the increase in government costs of social security benefits need to be restrained within the rate of nominal GDP growth. Any increase in discretionary expenditures should be based on a "pay-as-you-go" principle. Fiscal relations between national and local governments need to be reformed, particularly an overhaul of

the tax transfer and subsidy system, which tends to result in inefficient spending.

### (4) Labor Relations and Employment

One of the most important but difficult issues arising from the effort to reform the Japanese economy is the reallocation of human resources, i.e. unemployment and its absorption. According to estimates by the JRI, approximately half a million people are likely to lose their jobs over the coming two to three years in the course of NPL resolution by banks. (Table 1) The reduction in public works expenditure due to fiscal restructuring will make nearly 650,000 construction workers redundant. (Table 2) And in the wake of industrial "hollowing out" and the increase in imports of manufactured goods, around 300,000 jobs will be lost in manufacturing industries. (Table 3) That means that roughly 1.5 million people in total will become unemployed over the course of two to three years. They are expected to be eventually reemployed by the rise in growth potentials through structural reform (Table 4), but in the meantime, measures to encourage the start-up of new industries and to reduce mismatched employment ought to be contemplated. In addition, an expansion and improvement of the "safety net" for the unemployed is called for to facilitate structural reform and the reallocation of human resources.

Along with the unemployment problem, the establishment of new labor relations will become an important issue. The lifetime employment and seniority system which characterized Japanese labor relations in the post-war era will no longer remain in its traditional form in the age of global compe-

titution. A new system needs to be formulated by introducing such elements as more labor mobility, flexibility in labor contracts, meritocracy and incentives. In preparation for the forthcoming aging of society due in part to the low birth rate, the more active participation of women and senior citizens in the labor market needs to be seriously promoted.

### New Dynamism for Resurgence

As structural reform proceeds, the economic system will resume its proper function and uncertainty over the future will be erased. As confidence is restored, the Japanese economy will be ready for sustainable and stable growth. The major driving force for growth will come from the private sector instead of the triangular coalition of politics, bureaucracy and business, as the basic principle of leaving to the private sector whatever it can do becomes firmly established. For its part, the private sector should make itself a better and well-qualified player in the economy. Corporations should establish new business models with an effective corporate governance mechanism suited to the Japanese culture and society. Hopefully, the new model will not be a blanket transplant of the American one, but based on a fair balance between incentives and equality, and with a slant toward respect for human values rather than toward profits which the American model emphasizes, while remaining in balance with the reality of global competition.

Another driving force is technological innovation and knowledge creation. Although Japan lagged behind the United States in the IT revolution, the negative impact of the IT "bubble" was that much smaller. Now Japan hopes to catch up quickly in IT-related areas including telecommunications backed by its successful experience of i-mode mobile Internet exploitation. Investment in IT-related software continues to increase, as many firms are trying hard to rejuvenate themselves and enhance productivity. It is believed that Japan has a strong competitive edge in many technologies such as robotics biotechnology, new materials and nanotechnology, and there are

Table 4

Effects on Job Creation by Recovery of Growth Rate through Structural Adjustment				
Average real growth rate (2001 to 2005)	0.5%	1.0%	1.5%	2.0%
	(Baseline [See Note 2])			
Number of workers (2000)	6,446			
Number of workers (2005)	6,271	6,332	6,394	6,456
Change (2000 to 2005) (Baseline comparison)	-	61	123	185

**Sources:** Ministry of Public Management, Home Affairs, Posts and Telecommunications "Labor Force Survey," Cabinet Office "Annual Report on National Account" and others.

**Notes:** 1) The estimation formula (method of least squares) used for the trial calculation is as follows:  

$$\ln(L) = 0.227 + 0.194 \cdot \ln(X) - 0.0566 \cdot \ln(\sum(w, t \text{ to } t-1))$$

$$\begin{matrix} (0.419) & (7.25) & & (-0.166) \\ +0.693 \cdot \ln(Lt-1) & -0.0318 \cdot T \\ (8.50) & & & (-4.99) \end{matrix}$$
where L = number of workers, X = real GDP, w = nominal wage, T = time trend.  
Decision coefficient with degree of freedom revised = 0.997. Estimation period: 80 to 2000 years.  
Items in parentheses are t values. Derbin's h statistic = 0.248

2) The average growth rate in 1998 to 2000 was 0.4%

hopeful signs that some significant breakthroughs are in the pipeline.

Furthermore, fresh dynamism for the Japanese economy will come from foreign capital and management. The Japanese economy has long been known for its homogeneity but in recent years, the whole landscape has changed, as the presence of foreign firms and capital has greatly increased. The large imbalance between outgoing and incoming direct investment is being corrected. Foreign capital and management are working as a salutary stimulus as they offer heterogeneous elements to the traditional management of Japanese firms. They also stir more competition and contribute to stimulating a culture of better corporate governance. What's more, they offer increased job opportunities.

The lost decade of the 90s cost Japan very dearly. Due to the procrastination, reform and adaptation to the new global paradigm will take nearly the whole of this decade, as in the case of the United States and the United Kingdom in the 80s. But a new Japan will not be a rebirth of the earlier Japan; it will be matured yet more resilient to changes; strongly competitive but more human-oriented; and humble but more confident.

### In Search of a New International Role

Over the past decade, the international perception of the Japanese economy has changed dramatically, from an economic juggernaut to an economic frailty with the potential to instigate a global financial crisis. The principal task for Japan is to reverse this perception by restoring its economic vitality and to contribute to the world's economic growth commensurate with its

status as the second largest economy in the world. Along with this effort, Japan should also take the initiative in strengthening cooperation and solidarity among Asian countries, in order to restore the region as a global growth center as well as a role model for constructive regionalism against the rising trend of regional protectionism.

In recent years, China's remarkable economic emergence has been the focal point for Asia and the world as a whole. Its WTO membership and the resultant massive inflow of foreign capital and technology will certainly make China a very powerful engine for the growth of the Asia-Pacific region. But for orderly transition to a market economy, China needs its neighbor, Japan, whose economy is five times as large. Since greater exposure to market forces and international competition means more volatility and instability for the Chinese economy, close coordination with Japan will certainly minimize its risks.

For its part, Japan also needs China's strong and orderly growth as the two economies have a complementary relationship. Japan should regard China's economic upsurge as an opportunity rather than a threat. Close cooperation between the two will definitely form the basis for a robust and sound Asian regionalism, and together with other members of the ASEAN plus Three (Japan, China and South Korea), will make the region into one of the three pillars of the world economy.

In the 90's, Asia experienced severe currency crises and through these turbulent throes came to realize the need for closer regional cooperation and mutual assistance. This bitter lesson led to the establishment of the Chiang-Mai Initiative and other arrangements for regional financial stability.

Although Japan played the leading role in the wake of the crises, more should be done to further advance this area such as setting up an Asian Monetary Fund and formation of an Asian exchange rate mechanism. Parallel with such monetary cooperation, Japan should also play a more active role in the move toward an Asian Free Trade Zone encompassing the ASEAN plus Three and eventually the whole Asia-Pacific Economic Cooperation region.

In the search for a new international role, Japan may undertake a different multifaceted approach toward global issues in contrast to the simplistic approach of the past. In order to reconcile the conflict between globalization and its backlash and ensure the benefit of plus-sum globalization, constructive dialogues among major stakeholders would appear to be of crucial importance. In this vein of thought, it would be useful to establish a framework for the four major stakeholders in globalization, i.e. states, international organizations, multinational corporations and non-governmental organizations (NGOs). The World Economic Forum in Davos, Switzerland, came close to this, but is itself one of the targets of NGO criticism. Already attempts have been made to organize dialogues between international financial organizations and NGOs but they should be extended to include the other two elements.

Japan has many advantages in promoting and arbitrating such dialogues since it is in a better position to bridge the interests of the economic superpowers and developing countries and has a considerable say in international financial organizations as one of the large shareholders. Japan's major corporations have a significant presence in the global economy and its NGOs are quite active in international causes. Japan's efforts to reconcile the claims of these four sectors will be a very positive contribution to preparing an eventual forum for better global governance in the coming years. 

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