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## Country Analyses: Japan after the Crisis – From Recession to Permanent Decline?

■ Japan probably provides one of the best cases for anyone looking for clues on how to deal with the current economic crisis. Unfortunately, this report serves rather as a guide to what should be avoided. Japan's misery over the past two decades, since its own »bubble« burst in 1991, offers a strong warning that major reforms are necessary, both during and after any major crisis, and that neglect, in combination with deficit spending, may lead to permanent decline.

■ Despite its past experience, the global economic crisis has come as a perfect storm for Japan. The country has not been hit by a financial crisis, but the »real« economy has crumbled. The main reason for this mess is that Japan has failed to reform its domestic service industry, focusing instead on half-hearted supply-side reforms to squeeze one more drop of productivity out of its »old industries«, such as cars and TVs, thereby remaining dependent on exports and vulnerable to crises abroad.

■ Surprisingly, as least as important is the failure to adjust to the challenges of demographic ageing. A policy deadlock is blocking necessary reforms, suffocating Japan's productive firms, producing ever more public debt and putting Japan's flexible governance model and strong social partnership at risk. The result is that Japan's major companies are actively seeking a new future in businesses abroad. This opens up opportunities for further economic integration in Asia and beyond, but also carries the risk of future »investment wars« and protectionism, particularly involving Europe and the United States.

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## Japan in Figures

	2005	2006	2007	2008	2009
Real GDP Growth <sup>1</sup> , %	1,9	2	2,4	-0,68	-8,8
Yearly CPI Inflation <sup>2</sup> , %	-0,3	0,2	0,6	0,4	-0,1
Fiscal Balance <sup>3</sup> , % GDP	-7,1	-6,2	-5,4	-4,9	-6,5
Unemployment <sup>4</sup> , %	4,4	4	3,7	4,3	4,4
Current Account Balance <sup>5</sup> , % GDP	3,6	3,9	4,8	3,2	2,7

Exchange Rate <sup>6</sup>	2005	2006	2007	2008	2009
1€ in Yen	139	157	163	127	123

Demography <sup>7</sup>	2005	2006	2007	2008	2009
Inhabitants in 1000	127.537	127.464	127.468	127.288	127.079
Percent of over 65-years old	19,5	20	20,6	21,6	22,2
Percent of under 15-years old	14,3	14,2	14,2	13	12,5

Gini-Coefficient <sup>8</sup>	Mid 1980s	Mid 1990s	Mid 2000s
Japan	0,278	0,295	0,314
OECD-Average	0,286	0,305	0,307
Germany	-	0,283	0,277

	Japan	USA	Germany
<b>Military Expenditure in 2005<sup>9</sup></b>	44,17 Mrd. US-Dollar (1,0 % GDP)	504,64 Mrd. US-Dollar (4,1 % GDP)	38,06 Mrd. US -Dollar (1,4 % GDP)
<b>Corruption Perception Index 2008<sup>10,11</sup></b>	7,3	7,3	7,9

<b>Women in leading positions in Japan<sup>12</sup></b>	10 % (Ø 1999 –2005)
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### Remarks

- 1 Retrieved June 25, 2009, from: <http://www.tradingeconomics.com/Economics/GDPGrowth.aspx?Symbol=JPY&File=05192009223736.htm>
- 2 Retrieved June 25, 2009 from: <http://www.tradingeconomics.com/Economics/Inflation-CPI.aspx?Symbol=JPY>
- 3 CEIC Database, retrieved May 05, 2009 from: <http://www.ceicdata.com/>
- 4 Retrieved May 05, 2009 from: [www.Bloomberg.com](http://www.Bloomberg.com)
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- 6 Retrieved May 05, 2009 from: [www.Bloomberg.com](http://www.Bloomberg.com)
- 7 Retrieved May 05, 2009 from: [www.Bloomberg.com](http://www.Bloomberg.com)
- 8 OECD Factbook 2009: Economic, Environmental and Social Statistics. Retrieved June 25, 2009 from <http://ocde.p4.siteinternet.com/publications/doifiles/302009011P1T137.xls>
- 9 Data from the World Development Report of the World Bank. Retrieved June 25, 2009, from: [http://hdrstats.undp.org/en/countries/data\\_sheets/cty\\_ds\\_JPN.html](http://hdrstats.undp.org/en/countries/data_sheets/cty_ds_JPN.html)
- 10 Transparency International: Corruption Perception Index. Retrieved June 25, 2009 from: [http://www.transparency.org/policy\\_research/surveys\\_indices/cpi](http://www.transparency.org/policy_research/surveys_indices/cpi)
- 11 CPI Score relates to perceptions of the degree of corruption as seen by business people and country analysts, and ranges between 10 (highly clean) and 0 (highly corrupt).
- 12 Data from the World Development Report of the World Bank. Retrieved June 25, 2009, from: [http://hdrstats.undp.org/en/countries/data\\_sheets/cty\\_ds\\_JPN.html](http://hdrstats.undp.org/en/countries/data_sheets/cty_ds_JPN.html)
- 13 Further Reading on Developments in Japan's Social Partnership: Martin Pohl, Deutsche Botschaft Tokyo: Monatlicher Bericht aus Japan Arbeit, Gesundheit und Wohlfahrt in Japan.

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## Japan in Crisis – What’s Different this Time?

Of all the major industrial nations, the global crisis has hit Japan the hardest. Japan’s GDP looks set to shrink by an astonishing 6 percent this year. Even to a country prone to crises, the force of this recession has come as a shock. To make things worse, the slump is not coming in the aftermath of a major domestic boom, which currently pushes the United States and the United Kingdom down to sustainable growth levels. Rather, it is a brutal fall into depression.

Just nine months ago, Japan still felt comparatively virtuous. The major banks had been rehabilitated, after Japan’s own financial bubble in the 1990s, and the export sector had been rationalized to attain the world’s highest productivity levels after a very painful process of structural reforms. Also, the slump did not find Japan entirely unprepared. Japan had been following the build-up of the financial and real estate bubble in the United States closely and often commented on it based on its own painful experience. Even overheating China, now causing a serious slump in exports, had been carefully monitored and bets on investment in that country were hedged by »China-plus-one« strategies in Southeast Asia. Europe’s large market, at the same time, was thought to be emerging as an important counterbalance to Japan’s dependence on and growing risks in the US market.

It was all an illusion, however, as Japan now faces the worst depression in recent memory. Part of the problem is hardly surprising in a major export nation facing a global recession. The traditionally strong focus on the US market, the growing integration into the highly cyclical Asian growth market, and the rapid appreciation of the yen are producing additional problems in Japan that are even worse than those in, for example, Germany. But Japan’s real problem is a domestic, not an external one.

During the long, slow upturn from 2002, domestic demand never gained momentum. Sales of durable consumer goods remained flat or even retreated. Car sales, for example, remained on a strong declining trend, even during the good times. As a result, when external demand faltered, the domestic economy could not pick up the slack. The main reasons for this heightened dependence on external demand are well known: the aging of society and employees’ stagnating incomes. While retiring employees were cutting back to make sure that their (remaining) life savings would last, younger employees struggled to cope with a whole batch of supply-side reforms that were meant to improve the productivity of Japanese industry to offset the costs of retirement of an entire generation.

Today, more than a third of employees and more than half of younger employees therefore find themselves in irregular, limited, and temporary work, which is often not covered by social security. A strong focus on productivity in export industries and a reluctance to initiate necessary changes on the demand side and in the tax system, with regional transfers and service sector reforms, have left the country much more vulnerable than expected.

The slump in domestic demand may even have initiated a vicious circle. Japan’s large and extremely productive corporations are increasingly looking for opportunities abroad. Instead of focusing on new opportunities in the large domestic service sector, they have rationalized their »old« industries to meet booming demand in the world market, especially China and emerging Asia. On the back of the crisis, this imbalance between potential demand and actual production has increased even further. Ironically, the situation has worsened because Japan’s corporations now have an opportunity to demonstrate just how international and flexible they have become. Instead of building up stockpiles in warehouses at home, they have cut production (by as much as 10 percent of industrial production per month between October and April) and reduced costs with unprecedented vigor. While in the »old days« a global recession would have seriously dented profits as production and wages were gradually restructured, the current crisis has led to an almost immediate standstill of the economy which will almost certainly induce a severe slump in domestic demand and raise unemployment beyond Japan’s usual rate of below 5 percent.

In Japan, therefore, this global crisis is not merely a »financial« or imported »real« crisis, but a domestic crisis in an economy that sees the world market as pre-eminently important and focuses on industries that have very little chance of finding increased demand at home. While from abroad Japan still seems so closed, difficult, and introverted, it has actually been married to the global economy for more than a decade. Without sweeping – but very unlikely – structural reforms at home, the only way ahead is further internationalization, foreign investment, and global production. Indeed, Japan’s major corporations are already pushing into global markets, especially Asian growth markets and the large European market, more than ever before. Even traditionally domestic-oriented firms such as Fujitsu and Panasonic are actively expanding abroad and looking for partnerships with European companies through cooperation, joint ventures, and, increasingly, takeovers.

This analysis has implications for the future. Japan’s »multinationals« will probably be among the first to

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gain when the world economy stabilizes. They have the capital and the will to expand internationally. However, they cannot do this alone or on the basis of a comparatively closed country. They will have to rely increasingly on experienced partners abroad for supplies, business services, market penetration, and management. Cooperation that develops from partnerships to full mergers, such as Fujitsu-Siemens in Germany or NSG-Pilkington in England, is likely to lead the way and become much more normal in the future. But unlike Japan's major corporations, who see globalization as an opportunity, Japan's SMEs are facing such prospects of depression at home and challenges abroad with a deep sense of crisis. So far, smaller companies in Japan have largely relied on their larger global partners as an interface to sales in the world market. This will no longer be sufficient in the future because multinationals need partners in all markets and technologies that can readily be applied in them. Similar to the German »Mittelstand« in the 1980s, the current crisis is therefore a make-or-break time for SMEs in the global market. Without more foreign partners, abroad as well as in the domestic market, it seems highly unlikely that Japan's SMEs will be able to handle this challenge, with potentially disastrous consequences for the job market.

For policy and social partnership the challenge is even greater. After the dust of the world economic crisis has settled, Japan will not find itself back where it was. During the boom in the United States and China, Japan's policy-makers blew the chance to substantially reform the domestic economy, while Japan's »old industry« products, from steel to cars and TVs, got a second wind. As a result, only supply-side reforms that served the competitiveness of export industries were carried through. Reforms that might have increased domestic demand and the attractiveness of the service sector, such as postal privatization and retail and construction deregulation, however, were stymied. Opportunities were not taken, and a better balance between income and social security structures was not achieved. The balancing of market conditions between temporary workers in increasingly flexible labor markets and »life-time« employees in old industries was not achieved either. Frustratingly, today and for the foreseeable future, the chances of such »structural« reforms are even lower.

After the crisis, Japan will sit on a pile of public debt amounting to 200 percent of GDP. Ironically, it may be that this burden will be sustainable only as long as the economy continues to stagnate and interest rates remain close to 0 percent. So far, Japan has had the highest debt burden, but also one of the lowest levels of financing costs in the world. Already this

year, however, the government will probably seek financing by issuing new debt for more than 50 percent of the budget, severely increasing the risk of spiraling out of control. A real recovery, with higher interest rates, therefore, has the potential to push up financing costs for the government faster than tax income. This is shifting the public burden even more onto the younger generation, which already has to carry the largest number of pensioners in the world while struggling to make ends meet in temporary and low-productivity jobs.

But certainly there is opportunity as well. Repairing the mess at home will become almost impossible unless Japan manages to integrate more deeply in Asia's greater growth story. Unlike during the crisis before, when former Prime Minister Junichiro Koizumi tried to prepare the nation for »painful« structural reforms with vaguely nationalistic undertones and by lashing out against Japan's main competitors in Asia, the way ahead seems to be greater openness and better international partnership this time. It is unclear in which direction policy is shifting and what solutions might eventually emerge, but more than ever before, Japan will have to focus on earning its income abroad. Assuming things do not go badly wrong, Japan's aging society and economy will therefore have to focus on the soft-power appeal that current Prime Minister Taro Aso talks so much about. Japan will have to try to build up close relations in Asia, push for continued free trade and investment flows, and play a much larger role in US and European markets.

## History: A Forerunner in Both Growth and Decline

Japan used to be the poster child of Asian growth and success, but after two decades of stagnation it seems unable sustainably to pull out of recession. After the burst of a homegrown bubble in 1991, policy, especially fiscal, tried to reignite growth with one fiscal package after another. It worked only during times of strong overseas demand; the economy resumed its stagnation when exports started to sputter. After another economic low a decade ago, frustration among the Japanese public was already sufficiently ingrained for the phrase »Japan passing« (i.e. giving up on Japan) to become widespread in the Japanese media and for *The Economist* to talk of »Japan's amazing ability to disappoint.« The country has been unable to find its way back into the economic and political driver's seat. What has happened?

The most important change from the »glorious past« is certainly that Japan has changed from the

world's youngest emerging country into the oldest industrial nation at precipitous speed. The share of the productive population between 15 and 60 years of age has already fallen by almost 10 percent compared to previous decades. By 2025 the median age in Japan will be 50, and by 2050 two employees will have to support one retiree. These are not just abstract numbers; the effects are clearly felt today. Last year alone, corporations took the »opportunity« to eliminate 6.4 percent of high-paying senior jobs in the 55–59 age group. In Japan's seniority-based system, in which even top-notch university graduates rarely start with salaries of over 2,000 euros a month, the income squeeze at the top of the age pyramid is an especially big problem because it serves to turn one of the core advantages of Japan's business model on its head.

After World War II, employees started young in companies that rewarded them with little more than the promise of participating in future growth. By keeping consumption low, employees invested heavily in their companies which, in turn, needed to tap global markets in pursuit of buyers of their products and heavy investment. As we now know, these companies kept their promises and reimbursed their lifetime employees with bonuses, perks, and retirement packages. A major part of the strong performance of Japanese corporations during the 1960s and their underperformance in the 1990s can be explained by this long »business cycle« of low costs and investment at first and high pay outs at last. Similarly, their return to profitability and low unit labor costs coincided with the retirement of their lifetime employees from the mid-2000s.

But after settling this »debt« incurred in the growth years, the economy is not automatically shifting to a new equilibrium with slightly lower growth, but higher consumption on the part of the aged and higher productivity on the part of the young. Japan's now rich older generation sits on the world's largest stock of financial assets, but does not seem inclined to spend it. According to regular surveys, more than 80 percent of the population is scared of the potential instability of the pension and healthcare system. As voters, they fiercely defend their savings and support policies that keep inflation as low as 0 percent, consumption tax as low as 5 percent, and corporate taxes as high as 40 percent; as investors, they keep about 50 percent of their money in cash; and as parents, they like to keep their grown-up children at home. All this has the potential to kill demand in the long term.

Similarly, corporations have adjusted to the new situation by shifting production abroad and hiring new staff on temporary contracts without bonuses

and often no social security. The result is even lower consumption than before. Companies, therefore, need not only to look overseas for their products; they must also invest, produce, and earn their money overseas. Already four years ago, the »income balance« of profits earned abroad rose above Japan's famously strong trade balance. Clearly, even if international trade shrinks as a result of the crisis, the world market and overseas earnings will remain the main pillar of Japanese companies' profit projections and strategies for the foreseeable future.

The second most important obstacle to Japan's continued growth is the country's inability to adjust to such structural changes with timely structural reforms. In the course of becoming one of the world's leading industrial powerhouses, Japan went through a phase of equally astounding economic and social changes with admirable flexibility and stability. But little was due to miraculous government policy. Similar to China today, transformation in Japan was for the most part achieved by concentrating capital, resources, and people in Tokyo and Osaka, which emerged as huge industrial clusters. The rest of the country was supposed to follow, with some delay, financed by ample cash transfers from the export centers to the regions. While the economy was growing strongly, the system, which evolved into the world's largest regional transfer system during the 1970s, actually managed to produce a high level of regional income equality. But it did not turn Japan's countryside and provincial capitals into centers of self-sustaining growth. Today, Japan's growth center in Tokyo, with a GDP the size of France, therefore remains dependent on income earned abroad, while the rest of the country depends on transfers from the center in Tokyo.

## **Two Waves of Structural Reform, Resulting in two Financial Crises**

One sustainable way out of such external demand dependency would be to focus on potential domestic demand, and turning the country from an industrial powerhouse into an equally efficient service economy. So far, productivity in the tertiary sector (services), which already accounts for more than 70 percent of the economy, remains a third below US levels. Potential for growth and gains from increasing productivity in services – from retail to finance – by effective demand-side reform is therefore much greater than that of attempting to squeeze one more drop of productivity out of manufacturing by supply-side, labor-market reforms in this sector only. So far, the government

has made two serious attempts to break out of the domestic deadlock and to deregulate the service economy, starting from the financial industry. Both attempts ended in a major financial crisis, however, and have seriously diminished the chances of further reform and deregulation.

The first major wave of deregulation – during the late 1980s – was initiated out of necessity, to open up capital markets to international investment and to help finance the growing social security burden with the aid of a more flexible financial system. Interest rates, corporate bonds, and stock markets were deregulated, public spending was cut, and finance from a bewildering number of government investment programs were more deeply integrated in market processes. As a result, major corporations were finally free to raise capital where they wanted; they could cut their dull banking ties and securitize their assets, mainly real estate in the ever growing city centers. Major banks, while losing their major industrial customers, started to chase new customers in smaller corporations and provided credit against their assets, mainly industrial real estate holdings.

Unfortunately – and very much as in the United States over the past decade – this wave of new financial opportunities was not matched by an equally large number of profitable investments. As a consequence, a major bubble with strong credit-based valuation gains and investments in booming real estate, ending in a subsequent collapse of value and corporate balance sheets, emerged. By the mid-1990s, not only was Japan's financial heart at the risk of failure, but the entire industrial landscape was seriously hit. Banks became technically bankrupt, while bad debt from insolvent corporations kept increasing. For the first time, Tokyo's economy had stopped growing, while the countryside started to fall apart when taxes and transfers receded.

But instead of bailing out the banks and starting over with a better balanced set of banking regulations, as governments in the United States and Europe are trying to do today, the Japanese government tried to stabilize the economy by putting together one public works package after another. The reasons for this mistake had as much to do with public resistance to a bank bailout – Japanese households were hostile to the banks because they had focused only on corporate borrowers and not on services for private savers – as with the traditional role of the Japanese government, which was used to channeling funds into regional public works projects. Instead of reigniting growth, crisis management therefore cemented regional transfer dependency and creeping nationalization of the financial sector. The buzzword of the time

was »financial socialism.« By the time this policy ended in 2002, Japan's public debt had increased to 160 percent of GDP and industrial productivity had collapsed.

The second attempt at major structural reforms came in 2002, after Japan's economy had become even more dependent on finance from public financial institutions and public works. By 2001, public financial institutions had become responsible for most financial transactions and fully one-third of overall credit allocation. New prime minister Junichiro Koizumi therefore tried to get to the root of Japan's stagnation and ever-increasing public debt by (re-)privatizing the financial system, bailing out the banks, reducing the transfer drain to the regions, and helping ailing corporations with labor market deregulation and corporate governance reforms. These reforms were an enormous success at first, especially because they came at the same time as the boom in the United States and China, which administered plenty of Japan's traditional medicine: export demand. Japan seemed to be back on track, productivity was growing again, profits started to flow, the economy crawled out of deflation, and unemployment receded to below 5 percent. It seemed only a matter of time before wages and domestic demand would start to increase as well, which should have caused a virtuous cycle of growth with the potential even to balance the government's primary budget (the budget excluding interest payments) by 2011.

Unfortunately, the global crisis put paid to such wishful thinking. Already before external demand collapsed, doubts were increasing concerning the sustainability of the tough reforms of the labor market and regional transfers. Within the ruling LDP, the reforms were never popular because they hurt their traditional voters and lobbies in the countryside and the construction industry. Nevertheless, the public remained largely supportive, despite predictable »short-term pain« (in the words of Koizumi), because they promised a sustainable future for younger voters and increasing returns on the savings of older voters. In 2005, Koizumi even managed to win a two-thirds majority on the back of his reform platform and against much resistance in his own party.

Over the past two years, however, the tide has begun to turn because domestic wages, in the middle of a global boom, remained largely flat, while inflation and a weak yen started to eat into incomes again. At the same time, the boom in temporary jobs has not resulted in better working conditions or the gradual promotion of younger workers into more senior positions. On the contrary, only the jobs and incomes of employees in senior lifelong positions seemed to sta-

bilize, while younger workers saw the chances of a career fade away. Japan has therefore become embroiled in a major debate on income inequalities, the winners and losers of reform, and appropriate burden-sharing between generations. Today, the Koizumi »supply-side« reforms are virtually a thing of the past.

### **An Exporter's Vulnerability: The Failure of Increasing Domestic Demand**

The current crisis shows how unbalanced and vulnerable Japan's economy still is. When overseas demand subsided last year, Japan's economy almost imploded. At first, the impact of the global recession seemed to take the form only of falling external demand for Japan's exports, lower earnings of Japanese companies abroad, and the appreciation of its safe-haven currency (further reducing demand and lowering overseas profits). For the Japanese media, therefore, the »Lehman Shock« was followed by a more serious »Toyota Shock«. Additional negative momentum has been building in finance and real estate because the Japanese tried to catch up with their falling international competitors too early, and because foreign fund investors, a major driving force in Japan's real estate market, had to leave. All this is bad enough, but broadly speaking the decline in overseas demand would probably have resulted »only« in negative GDP growth of around -3 percent for 2009.

The »real« shock, however, is only just unfolding, and it comes from domestic demand. During previous recessions, private demand remained fairly stable. When the economy deteriorated, Japanese households started to dig into their savings, so that the »propensity to consume«, or the share of consumption in incomes, increased, while the savings rate declined. However, since most Japanese people feel that they have been more in than out of recession for the past 20 years, the household savings rate gradually has, recession by recession, declined to about 4 percent. It seems unlikely that households will dig any deeper this time, especially because they face the risk of serious unemployment without an effective safety network for the first time.

Households are cutting back on spending as never before because they know that corporations will use their newly won freedom that came with Koizumi's supply-side reforms to cut employment among the ranks of temporary workers. By June this year, 500,000 temporary workers will probably have lost their jobs. In the absence of an established safety network for these – mostly young – workers, public con-

cern about the state of the economy has reached an entirely new level. The ILO estimates, for example, that 77 percent of the unemployed are not eligible for benefits. Even if the government steps in and provides more support for the unemployed, as is currently planned, few people have illusions about the leverage of such support. Public coffers are empty, and public works, which provided paying jobs in previous crises, have been discredited. If this happens, the economy will probably shrink by 6 percent this year.

Why have Japanese corporations found it so surprisingly difficult to produce reasonable profits on the basis of domestic demand, even during good times? Retailers are sitting on huge operations, but seem unable to figure out what customers want to buy. Foreign branded goods, at the same time, have been selling robustly. One reason certainly is that inefficient wholesaler activities add as much as 30 percent to sales prices before products get from producers to retail outlets. The financial industry, at the same time, sits on the world's largest pool of financial assets but pays out only the lowest rate of return, and seems to be unable to lure potential investors into higher yielding products than savings accounts. Japanese household investors (often housewives), in contrast, have started to speculate in foreign currencies on their own online accounts without much involvement or support by banks. Similarly, utility companies seem unable to break Japan's dependence on foreign oil imports or to ensure sufficient safety of nuclear power plants. Real estate agents are unable to convince people to spend more than 12 percent of their incomes on housing, even in Tokyo, one of the world's most expensive cities. In major cities in Europe and the United States, by contrast, households are regularly willing to pay more than 30 percent of income on housing. The result of these failures combined is that domestic consumption remains depressed and the overall non-manufacturing profit rate (profit over sales) remains below 3.5 percent, even during good times.

During any of Japan's crises, of course, consumers were even more difficult to convince to shop more, so the government has taken up the slack again and again. Some economists in Japan have even started to argue that this is fine, at least for the time being. When consumers are unwilling to buy and save too much, the government has to do the consumption work for them, and for the greater good. So as long as households are willing to buy public bonds (at low prices) and pay their taxes, it does not really matter who pays for additional nursing care; if households will not do it, the government will do it for them. In Japan, after all, public debt is financed entirely by do-

mestic credit. The Japanese government, which still consumes less than 30 percent of GDP, even still has a long way to go until it swallows as much as 50 percent of GDP as many European governments do.

The problem with this argument is, however, that the government has shown a remarkably different spending preferences than the general public and has been unable to spend on products or services that would have increased domestic growth in the long term. The famous »bridges to nowhere«, for example, did not add to economic growth after their construction but resulted in constant maintenance costs. The government has therefore been unable to convince the public to pay for its (consumption and investment) services through higher taxes. It has had to cover investments with public bonds and meet costs with a confusing and opaque network of finance and investment agencies that have grown to the size of an additional public budget.

Even where government spending is widely accepted, as in the low-cost and efficient health sector, the results remain problematic. Almost all of Japan's hospitals are technically bankrupt because tightly regulated insurance payments do not cover their costs. To keep the hospitals operational, local governments have to bail them out at the end of each fiscal year, and then ask the central government for additional transfers to cover their spending. The positive side of this system is that health care costs have not run out of control, as in the United States, for example. The big and increasingly frustrating problem is, however, that the hospitals are unable to plan ahead and invest in new services or specific community needs. Costly pediatrics, for example, have almost ceased to exist at many hospitals; many effective medicines remain out of reach; and hospitals keep their patients waiting in lengthy queues, or hospitalize them for as long as possible to increase much-needed fees.

The solution to Japan's domestic demand problems is, therefore, as clear as it is difficult to implement: the service sector must become more productive and profitable. Only when services become more productive will they start to create opportunities for young people to focus their careers and innovative ideas in the sector. And only when services become more profitable will businesses become willing to refocus their plans on new or improved services. Unfortunately, the price of higher productivity and profitability, at least initially, is potential job losses. More rational security regulations in construction, for example, where work often requires more security guards than workers, would lead to lower construction prices and higher housing demand, but also to a huge wave of job losses. More liberal zoning regulations in retail

would force a whole swathe of mom-and-pop stores out of business, pharmaceutical deregulation would threaten the one-room pharmacies found next to every doctor's office, and so on.

Certainly, nobody would like to push such policies during a crisis, in which job losses need to be avoided and the best policy seems to be the one that produces or maintains the most jobs. Even during normal times productivity reforms in services are a tough challenge for governments. This is because, unlike in manufacturing, in which global competition pushes for the best prices and technologies in return for the chance of additional sales, services are easy to protect from more competition and gains seem less tangible. In services, a productive retailer's gain appears to be a small shop owner's loss. Consumer gains, on the other hand, might be offset by losses in inherited lifestyles.

Though slow progress in service reform is therefore understandable, Japan's deteriorating economy no longer allows for many stops or public works frenzies. The potential growth market for Japan's economy is now services, not manufacturing. Furthermore, some of Japan's most significant industrial success stories now tend to come from better services. Japan's huge convenience store chains, for example, have become the world's most efficient retail network, and Japan's logistic operations, including home delivery, are also unmatched.

A final point goes back to Japan's problem with demographic aging and its policy deadlock in reforms. New and often larger service operations (in retail, wholesale, logistics, and so on) are usually run by younger workers and often threaten older outlets, which usually sustain the lifestyles of older people. Here again the government feels stretched between creating opportunities for greater efficiency, which is necessary to support the young and the sustainability of the aging society in the long term, and protecting aging structures so that the older generation remain in business for longer. In Japan's aging society, actually both are needed; the status quo, however, keeps the young in unproductive or crisis prone lines of business and the old afloat only on credit.

## Governance and Social Partnership

Japan has its own style of governance and it is important to understand its characteristic features before attempting to draw meaningful comparisons.

- Bureaucracy is widely regarded as exceptionally powerful and reaches into many areas of life. Japan has often been tagged »the only functioning so-

cialism on earth«. But the government is not large in terms of numbers or consumption. In fact, it is fairly small, with Japanese civil servants representing only 3.5 percent of overall employment. In contrast, the percentage is 12 percent in Germany, 16.4 percent in the United States, and as high as 20.3 percent in the United Kingdom. Government consumption, at below 30 percent of GDP, is also far below that of Germany and even the United States.

- Corporations face a tax rate of 40 percent, but 70 percent of corporations do not pay any taxes. Income taxes, with the peak rate of 40 percent starting from the relatively low income of 140,000 euros, seem high, but there is a wide range of deductions, which brings effective rates down to roughly half the level of German income taxes. In addition, most citizens, including most self-employed, do not pay any income taxes; something difficult to believe even for the most free-trade-oriented American. Japan has one of the lowest tax bases in the OECD.
- Japan seems to be mired in red tape. Regulations are inflexible and are rarely reviewed. Having said that, few regulations are actually enforced or subject to onerous fines. As long as citizens and market participants follow some – and not necessarily written – »rules of the game«, Japan's market economy can be considered as among the freest in the world.

So far, the opaque nature and large grey zone of regulations have served Japan well, and the system has proven to be cost effective and flexible. But disadvantages of the approach have started to haunt the economy. Japanese governance tends to favor the status quo and prevents sweeping reforms. Innovative domestic corporations often run into trouble when they want to do differently, beyond exploiting minor (legal) loopholes. Foreigners regularly run into trouble when trying to contact ministries for information or evaluation after setting up operations. They often trigger cumbersome reviews of their operations usually not imposed on Japanese companies (because they do not ask and remain off the radar). A typical Japanese company, for example, runs the risk of an auditing by the tax office about every 50 years, a foreign company, asking for advice, has a good chance to be checked immediately. Especially to Americans, the Japanese governance system therefore often seems to be the opposite of what they are used to. Instead of making sure that potentially survival-threatening law suits do not occur, and instead of using government (information) services as a hedge against legal problems, it seems smarter in Japan to learn about

the »rules of the game« from other sources and to keep the government at arm's length. If things go wrong, a serious, often public apology and a comparatively mild fine will often be sufficient. If things go seriously wrong, however, help is in short supply. Japan still has comparatively few lawyers, and public prosecutors are used to winning almost 99 percent of their cases.

Japan's system of governance has proven to be very effective in protecting jobs and keeping income inequalities at bay. Regular employees are rarely fired and layoffs are considered a sign of severe corporate underperformance; often a company that fires employees is already several steps along the way to declaring bankruptcy. This close social partnership allows Japanese trade unions to work on the basis of labor–management consultation at the corporate level of larger corporations (the unionization rate is above 14 percent in companies with 100–999 employees). It has also helped them to become closely integrated in the senior management of major corporations (with a unionization rate of about 50%), although Japanese unions are not directly represented on the board, as in Germany. But the unions have failed to gain any influence in smaller companies (below 100 employees), with unionization rates of just above 1 percent. Collective bargaining at the National Trade Union Confederation (Rengo) level usually covers only basic wage levels and general, policy-oriented issues, such as current negotiations on work-sharing and short-time working.

As in most industrialized countries, unionization rates declined constantly until 1990, before stabilizing at around 20 percent. The rates fell slightly again during the 2000s, but have now stabilized at around 18 percent. A specific problem in Japan during the current decade has been the strong trend towards non-regular employment, which covers about 38 percent of employment today. The trade union confederation (Rengo) has not been able to prevent this deterioration of labor market contracts; they have only succeeded in protecting existing regular employees and their contracts. This has led to a split labor market, with regular, older employees on well-protected contracts with social security and bonus benefits on the one hand, and younger workers with irregular or temporary contracts without bonuses on the other. About 50 percent of younger workers are on temporary contracts.

Rengo has therefore changed course and in its »vision« for the twenty-first century declared that »it is essential for trade unions to concentrate their resources on unionizing efforts, to stop neglecting part-time and temporary workers, and to embrace retired

workers within their great circle of solidarity. To this end, initiatives for ›cyber unions‹ and ›life-time union membership‹ must be realized« (RENGO's Declaration for the Twenty-First Century). In reality, the focal point of action, as outlined in its »Action Policy No. 1«, is to »focus on part-time, fixed-term, contract and agency workers, and employees in smaller and local enterprises, in order to strengthen the social influence of the RENGO movement«.

So far, however, the dire situation of SMEs in the regions and difficulties in establishing union organizational structures at local level have stymied any bid to attract small corporation workers. Temporary workers, on the other hand, are unionizing in significant numbers. Membership has been increasing by more than 10 percent per year over the last five years (about 5 percent last year). However, their organization rate is still only 5 percent (their share of total membership is 6.2 percent), so they are unlikely to become a significant political force anytime soon. Even strategically, Rengo's turn towards temporary workers is a double-edged sword because any improvement in their working conditions might cut into the benefits of regular workers. For Rengo, attracting members from the growing ranks of temporary workers may therefore be much easier than actually pursuing their interests.

This is the first year in which there has been major layoffs of temporary workers, with no prospects of finding new jobs. Rengo president Takagi has recognized the situation and declared, »now is the time for the union to justify its existence«. How far will Rengo go to support its temporary-worker members? To date, there have been consulting initiatives for unemployed temps, demands that employers retain temporary staff, and policy requests to the government for the integration of temps in the social safety network, as well as work-sharing initiatives at the corporate level. However, rallies held in support of these issues have attracted just over 2,000 union members at most.

Ultimately, securing jobs and increasing pay levels for temporary workers will require bringing wages and contract conditions into line with regular workers. So far, the incomes of temporary workers are only 40 percent of those of regular employees, employee pension coverage is only 47 percent, health insurance coverage is 49 percent, and the evasion rate of public pension payments is 33 percent. But the fight for regular contracts for all temporary employees already seems to have been lost during the »good times«, and no significant resumption seems realistic. Labor market reforms were carried out when the jobs of regular workers were threatened by exploding overseas pro-

duction. During the subsequent boom, after 2003, companies retained jobs at home and were still able to reduce unit labor costs and boost competitiveness, not least because of their flexible and low-cost temporary staff. If these reforms are rolled back now, they will surely shift even more jobs abroad or go out of business for good.

The »same pay for similar work« would therefore require integrated and flexible health insurance and pension funds for all workers, more general job training, and the opening up of corporate career tracks, especially for women (who make up the majority of temps). Most likely it would also result in more flexible contracts and fewer perks for lifetime employees. As a first and very careful step in this direction, Rengo has asked only for a basic pay rise and not a bonus increase this year, for the first time in eight years. If it had been accepted (it was not), the new policy stance would have helped to support the incomes of irregular workers because they do not receive bonuses.

The difficulties being experienced by Japan's unions in finding a new balance in the changing social partnership are matched by the problems faced by employers in getting their organizations back on a sustainable growth track. So far, employers have been the winners of the labor-market and mostly supply-side economic reforms. They have been able to extend the already high degree of labor flexibility within their corporations to external labor markets. For them, the explosive growth of temporary employee agencies has helped them enormously in their efforts to cut labor costs and improve the availability of specialists.

But the development has a down-side for employers as well, which has become clear during the current crisis. By moving to a strong reliance on part-time workers and offering few new opportunities for graduates, these »structural changes« in Japan's personnel governance and labor markets have produced a costly and, in the long run, unsustainable situation. While Japan's overall productivity has always been low because corporations employ too much capital and retain too many employees, their strength has always been a high level of »operational productivity« or processing excellence. On the back of supply-side reforms, companies were able to close the gap by cutting excess capital (including much cross-shareholding) and reducing the number of expensive lifetime employees. The flipside, however, is that corporations today are not only struggling with a shortfall in domestic demand because of falling wages and incomes, but they are also finding it difficult to manage motivation and quality control in their daily operations. Clearly, the young temporary employees who receive only short-term training are less productive

and reliable than their traditional counterparts, who have been integrated into the organization much more thoroughly. After initial neglect, corporations are therefore becoming serious about better integration, training, and job security for their »contract workers«.

Shifting benefits from lifetime employees to contract workers will not be easy, however, and can only work in an environment of cooperation and sustainable structural change. From the employers' federation's (Keidanren) point of view, this requires working even more closely with the unions. Today, almost all joint declarations of Rengo and Keidanren stress the need for better integration of labor structures and support for temporary workers. During the current crisis, one tool of such joint support has been the »work sharing« concept, which involves the sacrifice of pay (or reductions in overtime) to keep more employees on the payroll. Very much as in Germany, such cooperation depends heavily on subsidies from the government to keep employees on the payroll while they are idle (»*Kurzarbeit*«). So far, this has helped to keep the overall unemployment rate below 5 percent, but costs are skyrocketing. By March, 48,000 companies had already sought subsidies for 2.38 million employees, which will certainly deplete the government's budget of about 500 million euros for the system this year.

Employers therefore stress that reforms need to cut much more deeply. According to Keidanren, employees and corporations need to be relieved of a large share of social security costs, which make up by far the largest proportion of taxes in Japan and represent the biggest difference between lifetime and temporary employees. In a move that would be considered highly improbable not only in Japan, Keidanren has therefore called for a hike of the sales tax from the current 5 percent to 10 percent by 2015, and to 17 percent by 2025. The idea is to fund basic pensions and the necessary upgrades to existing social services entirely from indirect taxes. This move goes in the opposite direction of Keidanren's general demands for lower taxes and would clearly hurt the companies by further depressing demand for corporate products. But it would also relieve the current squeeze on (younger) employees. By shifting a large share of the tax burden from employees to consumers, more retirees would be taxed and young employees, who currently fall between the gaps of existing (segregated) pension systems, would become eligible for pension benefits. Obviously, even the employer's association thinks that it is time to bail out its employees.

Clearly, Rengo and Keidanren are on the same page on many important policy issues in the mean-

time, but there is very little they can do until the government decides to take the lead by introducing additional labor market, social security, and further training reforms. After some delay, the government is on high alert, which explains the size of two supplementary budgets totaling 5 percent of GDP. The nature of Japan's social partnership, which combines comparatively low wages and taxes with low unemployment and limited profit maximization, would be seriously at risk if unemployment were to shoot up for the first time. First, there is little money available for unemployment support (unemployment benefits are limited to between 90 and 150 days), and only a limited support network for the unemployed exists. The swollen ranks of the homeless during the last major recession are still in people's memories. Second, many young workers are being affected this time. About half of workers around 20 years of age are on temporary contracts. These workers have little savings, often live in company housing, and are usually not covered by unemployment insurance. Third, increasing unemployment among the younger generation undermines any prospect of sustainable financing of pension payments for the elderly (not to mention the retirement prospects of younger workers). Finally, increasing income inequality among the younger generation and between the generations is reducing domestic consumption even further and is likely to undermine Japan's social partnership model in the long term.

According to OECD data, in recent years income inequality in Japan has been increasing almost as fast as in the United States. These data have been strongly disputed (especially by the Japanese government), and a significant part of the explanation for growing inequality is the increasing number of retired households whose retirement income, including sources of income and ability to work after retirement differ much more from each other than those of younger households. At the lower end of the income pyramid, however, negative effects are clearly visible and measurable. Relative income poverty (that is, 50 percent of median equivalized disposable household income) has spread to 15 percent of households; this is almost as high as in the United States and about twice the level of Germany. In addition, almost 15 percent of households are below the poverty line, the child poverty rate is 14 percent, and single-parent poverty is as high as 50 percent. If these working poor were now to be hit by further unemployment, Japan would risk a serious social crisis.

## A Formidable Policy Deadlock

Beyond forking out supplementary budgets, major policy initiatives remain fairly unlikely. Public spending has reached its limits, while supply-side, cost-cutting reforms have become unpopular and would not be effective during a crisis. More visionary demand-side reforms, on the other hand, have not been brought forward for years. It seems that the lawmakers of both major parties, the LDP and the DPJ, are unable to deliver policy initiatives that could break the ice.

The LDP's traditional role was to distribute income from the growth centers in Tokyo, Osaka, and Nagoya to the regions, and not to force economic policy initiatives and major reforms on the public. Economic policy was drafted by the bureaucracy, especially the Ministry of Finance and the Bank of Japan (BOJ). For decades, therefore, Japanese lawmakers were able to handle policy as a kind of »family business« that had matured into second or third generations of »inherited« parliamentary seats (more than 50 percent of LDP seats). Today, they seem to have grown entirely out of touch with the economy and powerless outside of their constituencies and factions. The bureaucracy, on the other hand, can only tweak the system, push for a tax cut here and a change in labor market regulations there, but of course has no powers for major reform or change.

The result is a formidable policy deadlock, from top to bottom. Even the main tools of economic policy, fiscal and monetary policy are not effective anymore. During periods of high growth, monetary policy was expansionary when possible, and fiscal policy remained rather restrictive to make as many resources as possible available for corporate use. Today, the BOJ cannot provide an effective stimulus because its main role has become that of safeguarding the huge stock of monetary assets that Japan's retiring employees have been saving. Furthermore, any policy that looked remotely inflationary would not only hurt retired consumers, but would also be interpreted as a bailout of the indebted government, which would push long-term rates immediately to unsustainable highs.

But the biggest problem is certainly fiscal policy. At a ratio of public debt to GDP of almost 200 percent, interest rate payments have become a potential problem, accounting for a quarter of the government's budget, despite Japan's extremely low interest rates. Should the economy recover one day and interest rates shoot up, the government would be scrambling to fill the hole.

Another inherited problem is the tax structure. Up until the 1990s, the government obtained about 70 percent of its income from direct taxes on major cor-

porations and their employees. The self-employed contributed only about 10 percent and about one-third of smaller corporations did not pay any taxes. Smaller shops did not pay taxes, and when a value added tax was introduced in 1989 they were not required to pay them. The same applied to labor income, which was taxed and filed at major corporations, but much of the remaining workforce (about 50 percent) did not pay any taxes. Japan still has one of the smallest tax bases in the OECD and has traditionally taxed only a fairly small number of productive companies and employees.

This system no longer works. The corporate cash cows of the high-growth areas are reeling, while high-income employees are retiring and the rest of the country continues to run on subsidies. Direct tax income is down to only around 50 percent, about 70 percent of corporations no longer pay taxes, and temporary employees often refuse to pay even obligatory social security contributions. The necessary consequence would be to reduce the corporate tax rate of 40 percent to much lower levels to provide some breathing room for the few productive and tax-paying corporations. Income taxes, at the same time, must be reduced in parallel with the exit of employees from the labor market by increasing the consumption tax. From an economic point of view, such reforms are almost unavoidable and have been discussed for a long time, but nobody seems able to do anything.

The high level of frustration with such policy deadlock and the changing mood against a ministry-dominated government has already resulted in major administrative reform. By January 2001, the central government had become integrated into one cabinet office with powerful cabinet ministers and 12 administrative units (ministries and agencies). To support the cabinet ministers, the new system also introduced senior deputy ministers and parliamentary secretaries (66 legislators) who are in charge of controlling the ministries and agencies but remain ruling-party legislators. This system is based on the proven British parliamentary system and is clearly designed to show that ruling-party politicians are responsible for implementing policies. To move the process forward, the most powerful ministry of all, the Ministry of Finance, lost its responsibility for financial regulation to a separate Financial Agency.

After the reform became effective, it almost immediately shifted the power balance from top ministry bureaucrats to cabinet ministers and, especially, the prime minister. The 2002 Koizumi government, which was brought into office by a presidential election within the LDP, made the most of the opportunity and selected fairly strong and independently selected

cabinet ministers for some key positions. The new setup resulted in significant corporate governance and market reforms, especially where stronger ministers were able to work closely with existing reform initiatives in the ministries.

Over the past decade, Japan has therefore been able to significantly upgrade its system of public and corporate governance. The goal has been to get regulations, standards, and procedures in line with so-called »international standards«. The focus is often US and, increasingly, EU regulations. In corporate governance, these reforms have been quite successful, although some of the new financial regulations – including securitization, stock options, and so on – will surely be reviewed once more in view of the global crisis. In April 2003 and 2005, a major reform of the Commercial Code of 1899, which had not been seriously revised for 50 years, became effective. Key changes were the introduction of stock splits, lower par values, outside stock options, and outside director requirements.

The reform allows companies to switch to a US-style corporate governance structure, among other things. One change requires companies to set up an in-house committee structure with independent directors in three committees dealing with executive nomination and compensation, as well as auditing. Companies that needed strong presidents (CEOs) to push through internal reforms, such as Sony, have adopted this option, while companies that remained on a growth track, such as Canon and Toyota, stuck to the old system. Furthermore, Japan's bankruptcy code has been revised to make rehabilitation easier. The tax code now allows corporate groups and the filing of single tax returns by offsetting the profits and losses of firms within the group, and an »accounting big bang« that requires mark-to-market accounting for major assets has greatly increased transparency.

Since 2000, Japan's »accounting big bang« has increased requirements for mark-to-market accounting for listed corporations. In addition to most assets, pension liabilities also have to be accounted at market value. A rule for an impairment accounting method that requires companies to register latent losses on fixed assets (especially real estate) as losses became binding for large corporations in fiscal 2005. During the current crisis, the rationality of such requirements has been questioned (again) because they tend to exacerbate downward cycles through distress sales of assets. So far, however, the debate has not become as heated as in other countries because, as is often the case in Japan, the regulations provide enough loopholes for distressed companies. Companies with capital of ¥100 million or less (most SMEs) – in other

words, almost all Japanese companies – remain exempt. In terms of implementation of fair value accounting standards, Japan clearly remains behind the EU, where listed companies have been required to adopt International Accounting Standards (IAS) since 2005, or the United States, where accounting standards have been shifting closer to the IAS. As a result, another »dual economy« has evolved between successful (international) major corporations, which have followed investor demand to provide profit and loss data on a timely quarterly basis and have voluntarily adopted IAS standards, and most (domestic) SMEs, which maintain their balance sheets (by and large) based on historical costs and subject to a great deal of discretion.

Another »accounting big bang« initiative that was feared at first but is currently producing positive governance results for major corporations is J-SOX (the Japanese version of the US SOX, the Sarbanes Oxley Act of 2002). From this fiscal year, J-SOX (officially the Financial Instruments and Exchange Law of 2006) requires a great deal of financial, IT, and governance reform, especially from companies with overseas subsidiaries, because executives have become accountable for mismanagement throughout the entire group. But unlike in the United States, where financial scandals and a crisis of confidence led to harsh restrictions on domestic accounting, the Japanese Ministry of Justice has focused on pushing for accountability of international operations. Similarly, after a string of domestic scandals the Financial Service Agency (FSA) initially planned a tough stance on investor protection, but instead of focusing on fines and strict management accountability they pushed for a top-down approach involving risk assessment and process transparency. With proper implementation, this should help to increase retail-investor confidence in Japan's corporations, which should result in higher market valuations in the long term. Finally, METI has kept a close eye on competitiveness and business risks. For them, IT innovation and top-down process innovation have been the most important tools of J-SOX governance reform. In this way, although J-SOX legislation has produced high initial costs for companies with complex governance structures and outdated IT systems, it has encouraged long-term reform that seems to be going in the right direction.

It is likely that such reforms will improve the international competitiveness and valuation of major Japanese corporations, and of the economy as a whole, in the long term. However, this amounts to little more than »tweaking« the system. Transparency and better governance are important, as the current crisis has demonstrated impressively, but they are not sufficient

to kick-start an economy out of a deep policy deadlock or fundamental imbalances in supply and demand structures. Until Japan's political parties produce enough combative and effective politicians to vivify the new electoral and administrative structures, significant progress seems unlikely. To date, the mostly second or third generation politicians among the ranks of the ruling LDP have shown little interest in breaking out of traditional closed-door factionalism by appealing directly to a wider public, as Koizumi did so effectively when venturing into structural reforms.

About five years ago, there was a fleeting hope that the governors of Japan's large prefectures would become challengers in Tokyo's policy arena. They had been disgruntled by the policy deadlock at the center for a long time and had become much more powerful because of administrative reform. But they remained stuck in local quagmires. High hopes have also been aroused by Japan's evolving major opposition party, the Democratic Party (DP). The DP already controls the – less powerful – upper house due to voter dismay at the lack of economic policy initiatives of Koizumi's successor, Shinzo Abe.

But hopes have already been dashed more than once. The DP initially attracted younger politicians when it originated as a spinoff of the LDP and pushed for structural reforms and more transparency in policy-making. But after integrating more and more diverse splinter groups and lobbies on its way to power, it seems to be mired in factional and (regional) lobby policies similar to those of the LDP. Just a few months ago, it seemed likely that the DP would finally win the upcoming lower house election this fall. But, as many times previously, it may have lost its opportunity due to a lobbying scandal involving a party heavyweight about which it failed to come clean.

### **Pushing for Asian Integration from the Bottom up**

Japan's economy remains ensnared at home and the current crisis should not be considered as an »opportunity«. It is unlikely that Japan will come out of this crisis »stronger« or better positioned for effective reforms. On the contrary, public finances have deteriorated, political capital has been wasted, and the unbalanced character of the economy will only deepen. Japan's major corporations are therefore »giving up« on their country as a market and looking for opportunities abroad, even more than previously.

For Japan's producers, expansion in emerging East Asian markets has been a top priority for some time. But the focus has traditionally been on cost-cutting

and building efficient production networks. Largely overlooked in the West, a triangular trade pattern on the basis of production networks has therefore evolved in East Asia. High-skill technology and capital come from Japan, Taiwan, Korea, and Hong Kong, and processing plants are located in China (and gradually also in lower-cost Vietnam, and so on). However, final demand has largely remained in the United States and Japan.

As a result of the burst of the bubble in the US and of the world economic crisis, a driving force of this triangular relationship, the final demand from the United States has collapsed and will not return any time soon. It therefore seems unlikely that Asia will recover soon as well or would be able to become an engine of growth to the world economy. But East Asia's manufacturing boom, although it was triggered by a bubble, will probably have a more lasting and positive effect on growth and integration in Asia. Asian international corporations have been expanding and linking up their various local production sites with their final assembly plants in China with a view to the long term. These vertically and horizontally integrated production networks now not only provide efficiency gains, but have also increased Asian trade in general and brought many new corporations into the world market. The result is a process of »bottom-up« Asian integration that is still suffering from imbalances due to insufficient investment frameworks, but at the same time is producing opportunities for growth and regional integration that did not previously exist.

The key to further development and regional integration in East Asia, including Japan, is certainly the development of China. As recently as the early 2000s, the increasing competition from and economic prowess of fast-growing China were largely feared throughout the region. In Japan, which was still stuck in a crisis of its own making, increasing imports from China and the drain of industrial jobs added economic tension to traditional political uneasiness and unhealed wounds from World War II. In this environment, the painful domestic reforms of then Prime Minister Koizumi were packaged with a new sense of nationalism that held out the prospect of returning Japan to the glory of world class productivity and superiority over China. Ironically, the situation in China was not too different at the time: the Chinese government tried to balance the push for market reforms and incoming FDI with nationalistic rhetoric, often at the expense of its Japanese neighbor.

Behind all the political theatrics, however, corporations were quickly building up business ties and partnerships, while ministries in Japan and China were busily spinning free trade agreements (FTAs) and

more far-reaching economic agreements throughout the region. The result was a very different scenario from what had been feared early on. China has become Japan's most important market; and it is importing more from Japan than it is exporting to it. Japan's »old technology«, from steel to chemicals and cars, seemingly in terminal decline during the 1990s, was rescued by demand from China. Much of Japan's earlier recovery was built on this demand. At the same time, China has not evolved as a political threat in the region. The Chinese government remains focused on its domestic economy, which is being built up with the inputs of its Asian neighbors, from technology to raw materials, and requires improved political relations. For both countries, the future rests on cooperation, with slightly different but largely complementary roles. China has become the political driving force in East Asia and is actively courting Japan for closer collaboration throughout the region, while Japanese corporations are betting more of their future on successful investment in and around the Chinese market.

Japan has, therefore, become a keen supporter of international cooperative platforms and institutions. In Asia, all of these institutions, including ASEAN and APEC, still lack binding commitments and visions for cooperative policy action. But, as already mentioned, governments have been actively spinning FTAs with clear-cut and binding regulations. These bilateral agreements are now attaining wider impact with the development of negotiations on economic partnership agreements (EPA), which also include investment frameworks and target governance improvements.

In the longer term, such investment frameworks – which include dispute settlement procedures, service sector liberalization beyond the WTO, and financial service liberalization – can be expected to become important tools of regional integration. Together with improvements in intellectual property rights protection (IPR), competition and commercial law, higher-grade and knowledge-based investment in technology, services, and R&D can be expected to spread throughout the region, which would greatly increase Asia's market potential.

Japan will benefit greatly from these developments, and it has every reason to remain an active supporter of the WTO and to push EPAs in Asia. To date, concepts of increasing economic integration in Asia remain unbalanced and flawed, however. One problem is that the region's emerging countries need foreign demand for their excess production and growing exports because domestic demand cannot catch up quickly enough with advances in production technologies. Japan, as Asia's major mature economy, would therefore need to import more from these

countries in exchange for its capital and technology. But even the trade balance with China remains positive, which makes it almost impossible to build well-balanced trade and investment structures within Asia in the near future.

Japan and the rest of Asia are therefore extremely interested in fixing the US economy as fast as possible, and they are willing to pay for it. US dollar currency holdings are still at peak levels, the bulk of Asian money is being invested in US treasuries on an enormous scale, and investment in US companies will increase again after the fallout from the crisis has been digested. It is unlikely, however, that this will be enough to push US consumption of Asian produce to former levels and reestablish the former unbalanced, but convenient trade patterns. For additional markets, companies are therefore looking towards Europe, which has already become China's most important trade partner. Japan sees Europe as an increasingly important market in which gaining market share could better balance the overdependence on final demand in the United States and buffer the growing risks of cyclical demand swings in emerging Asia. But Europe almost surely will not be willing to accept as high a level of imports as the United States did during the bubble, and the risks of increasing protectionism are running high. Furthermore, a key plank of bubble-years trade patterns was pegged exchange rate relations between Asian currencies and the US dollar. In a multi-currency world, with more balanced trade and a stronger role for the euro, the undervaluation of Asian currencies cannot be so easily sustained. The risk of strong currency appreciations in Asia has therefore increased considerably and is a great concern for Asian exporters.

Japan and its neighbors, while growing rapidly as a region, are therefore likely to focus less on exports and more on foreign investment in the United States and Europe. From their perspective, foreign investment prevents their exchange rates from rising too quickly, reduces overly high investment and export rates at home, and diversifies risk. For years already, between one-third and one-half of total Japanese FDI has been flowing into Europe. These numbers have been somewhat inflated by financial flows passing through Europe only for tax reasons, but Europe has clearly become a focus of investor interest.

Increasing investment from Japan and China and the related takeovers of corporations in the EU will certainly raise strong concerns when the economies start growing again. Already a few years ago, when Asian public »sovereign wealth funds« started to invest in the West to better employ their export dollars, a wave of protectionist legislation spread through Eu-

rope (with Germany and France in the lead). This time, confrontation on a much larger scale seems likely because the coming wave of Asian investment will be driven not only by recycled export dollars, but also by the necessity of successful corporations to diversify their business bases beyond limited domestic economies.

But the bottom line for Europe and Germany should rather be that it makes a lot of sense to engage much more closely with their partners in the East. After the crisis, Japan's major corporations will become even more significant players in world markets – not because Japan will emerge strengthened from the crisis, but because Japan's multinationals are basically giving up on the domestic market and looking for growth elsewhere. At the same time, China, while still emerging, has become an important part of Asian production networks and try to use foreign investment as a tool to secure market share, procurement, and technology for its corporations, just as Japan, Korea, and Taiwan did at the intermediate stage of their development.

Since such investment from East to West cannot and should not be contained by protectionism, the current crisis should lead to the development of a new set of international financial regulations, as well as deeper investment frameworks with clear-cut rules of transparency and sensible stakeholder protection for international investment. Unfortunately, it seems unlikely that Asia's main powers, Japan, China or India will be politically able to grow into a role of international leadership on financial regulation and improved international corporate governance as fast as their overseas investment is already growing. But they will certainly be supporters of sensible plans of financial regulation at the G20 level that lay the regulatory groundwork for sustainably increasing global investment flows.



