

# Chapter 3 New Challenges Presented by Globalization and Structural Reform

## Section 1 Japanese Economy and Globalization

### 1. Significance of Globalization

- Globalization stands for advancement of economic integration (cross-border movement of capital and labor force, dynamic implementation of trade and foreign investment).
- One of the benefits of globalization is the enhancement of profitability through division of labor (benefits for consumers in each country over the long term result in improvement in living standards).
- Structural reform is important in the context of globalization as well (systematic reforms implemented in response to economic and technological changes are necessary in order to draw maximum benefits from globalization).

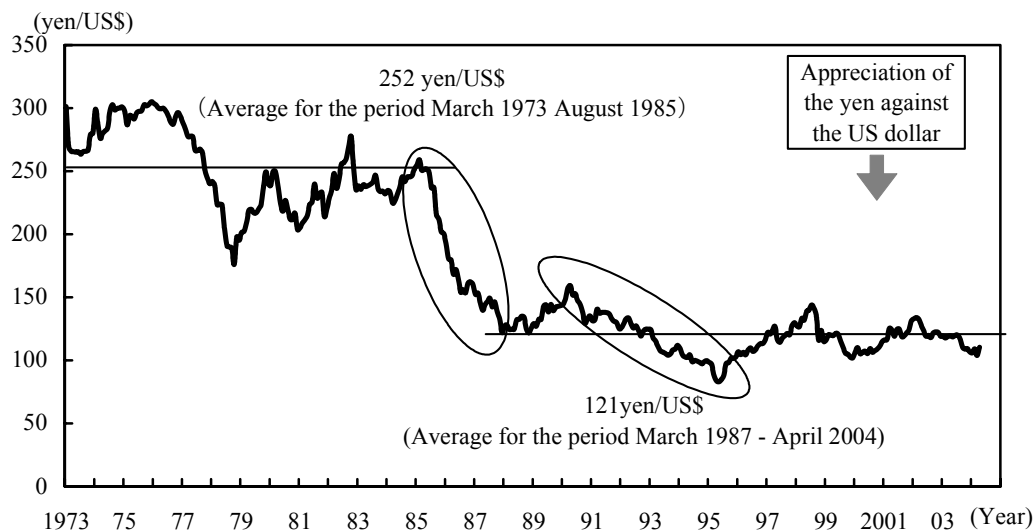
### 2. Characteristics of the Economic Development with Focus on the Period after 1990s

#### Four characteristics

#### (Changes in exchange rates)

Fig. 3-1-1 Trends in the yen/dollar exchange rate

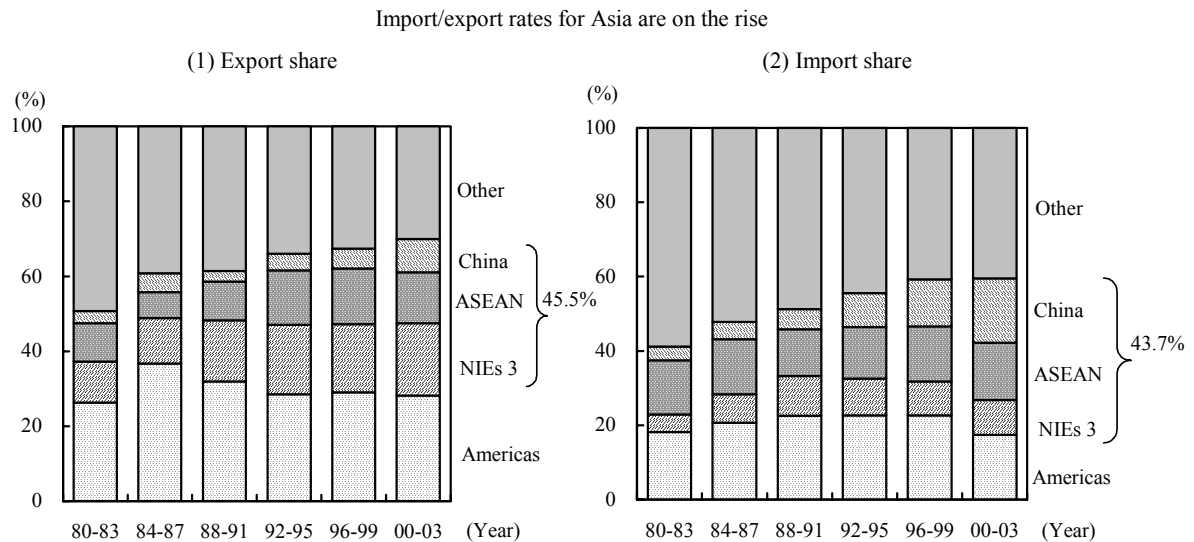
The yen significantly gained in value against the US dollar in the late 1980s.



- Notes:
1. Source: Bank of Japan.
  2. End-of-the-month spot central rates on the Tokyo Interbank Market.

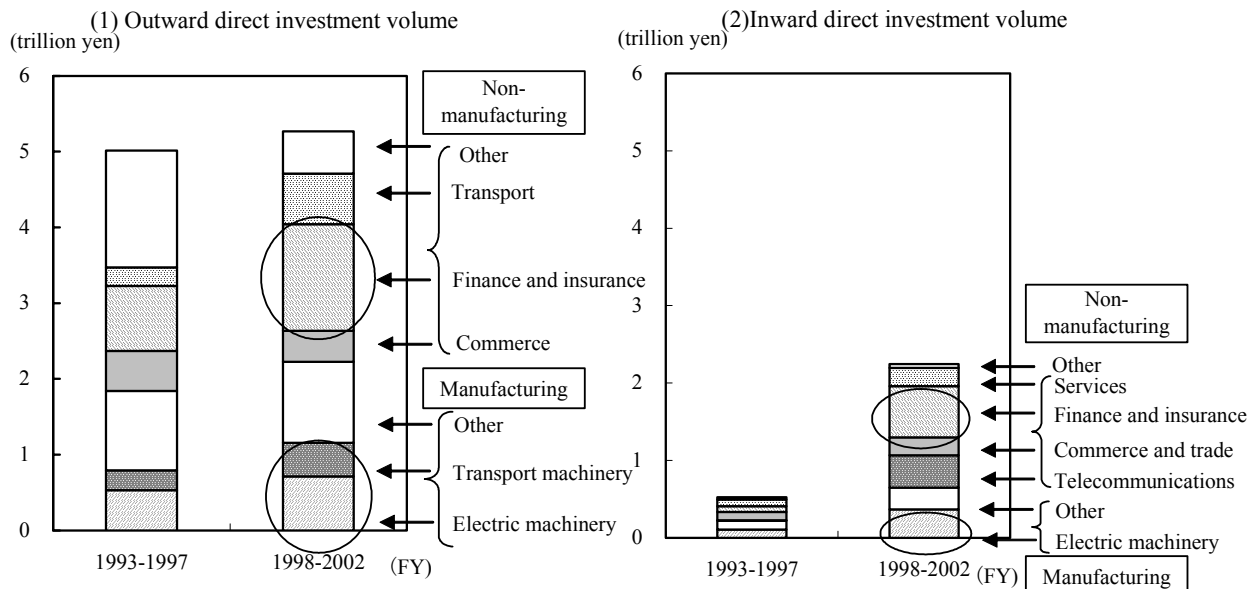
**(Increased significance of East Asia in terms of trade and investment)**

**Fig. 3-1-2 Changes in Export/Import Share by Region**



- Notes:
1. From *Trade Statistics*, Ministry of Finance.
  2. NIEs 3 includes Republic of Korea (ROK), Taiwan and Hong Kong.
  3. ASEAN includes Indonesia, Malaysia, Philippines, Singapore, Thailand, Brunei Darussalam, Vietnam, Laos, and Cambodia.
  4. Export/import shares are average annual for a period of four years.

**Fig. 3-1-5 Trends in direct outward and inward investments**



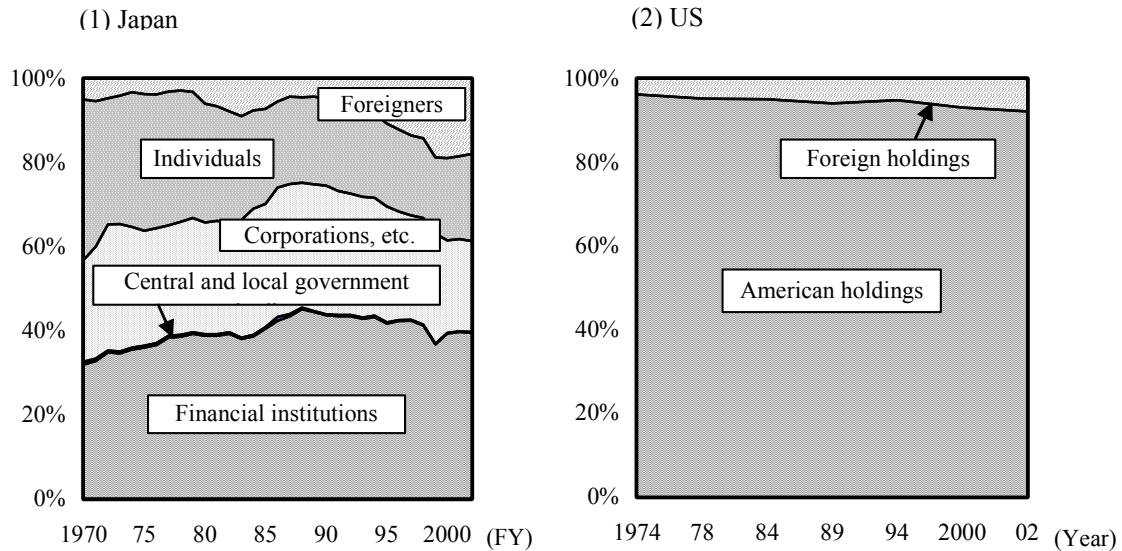
- Notes:
1. From *Foreign Direct Investment*, Ministry of Finance.
  2. All figures are based on reports and submitted documents.
  3. Amounts are rounded to the nearest trillion.
  4. Amounts are average.

**(Stagnation in Japan's international financial and capital transactions)**

- Some of the reasons for the lack of dynamics in international financial and capital transactions excluding the stock markets are the prolonged economic stagnation and the ongoing low interest rates. Therefore, it is important to put the economy back on the path of sustainable growth.

**Fig. 3-1-6 Composition ratio of foreign investors on the stock markets in Japan and the US**

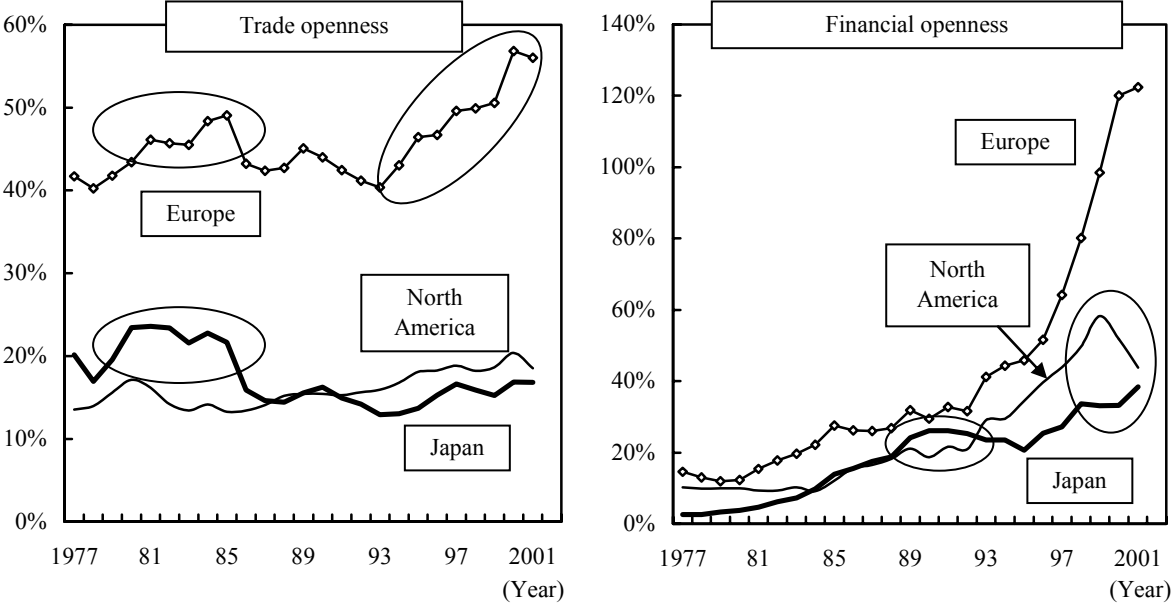
The ratio of foreign investors in Japan is on the rise in the 1990s and has exceeded that in the US.



- Notes: 1. From *Surveys on distribution of shares*, National Stock Exchange and *Report on Foreign Holdings of U.S. Securities*, Department of the Treasury January 2004.  
 2. The data from the US for 2000 is from a survey conducted in March, and for 2002 from a survey conducted in June.

(The pace of globalization of the Japanese economy is somewhat slow compared to the European and North American countries)

**Fig. 3-1-7 Trade and financial openness in Japan, North America and Europe**



- Notes:
1. From *International Financial Statistics (IFS)*, International Monetary Fund.
  2. Trade openness = (imports + exports)/nominal GDP
  3. Financial openness = (portfolio investment + the stocks of external assets and liabilities of foreign direct investment)/nominal GDP
  4. Europe includes Austria, Belgium, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Luxemburg, the Netherlands, Norway, Portugal, Spain, Sweden, Swiss, and the UK (a total of 18 countries).

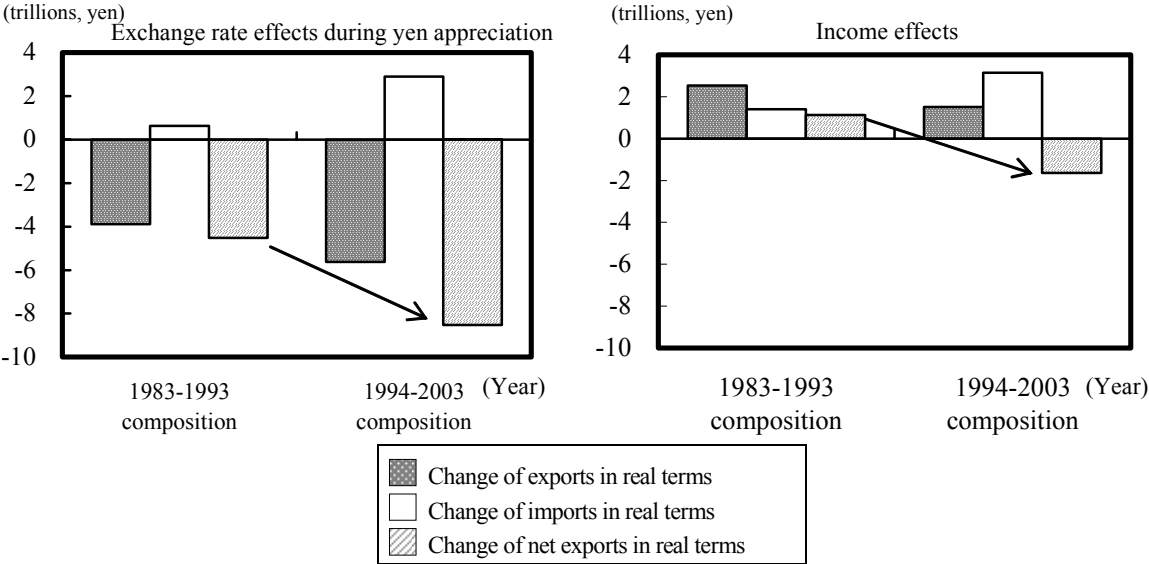
## Section 2 Economic Impact of Globalization

### 1. Macroeconomic Impact of Exchange Rates

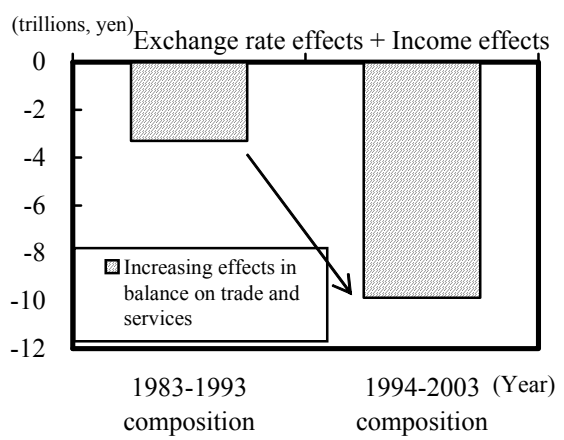
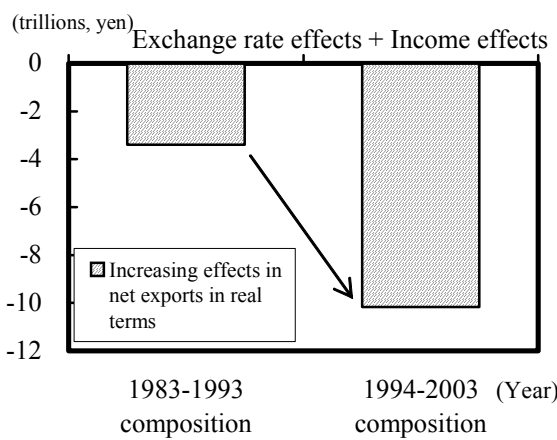
(Comparison with the 1980s)

- Surplus reduction effects increase during appreciation of the yen.  
Competition on the international markets intensifies and exports decline substantially.  
Domestic consumers are sensitive to price declines.
- Export increase effects driven by greater foreign demand decline, and import increase effects induced by greater domestic demand increase.

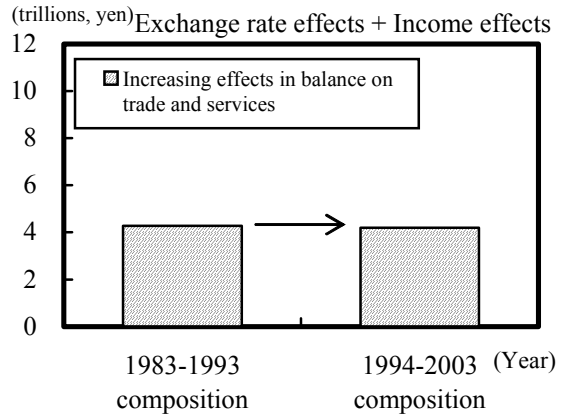
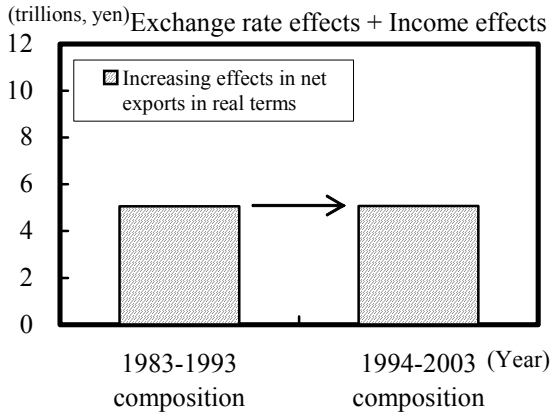
Fig. 3-2-7 Impact on balance of payments for goods and services



During yen appreciation



During yen depreciation

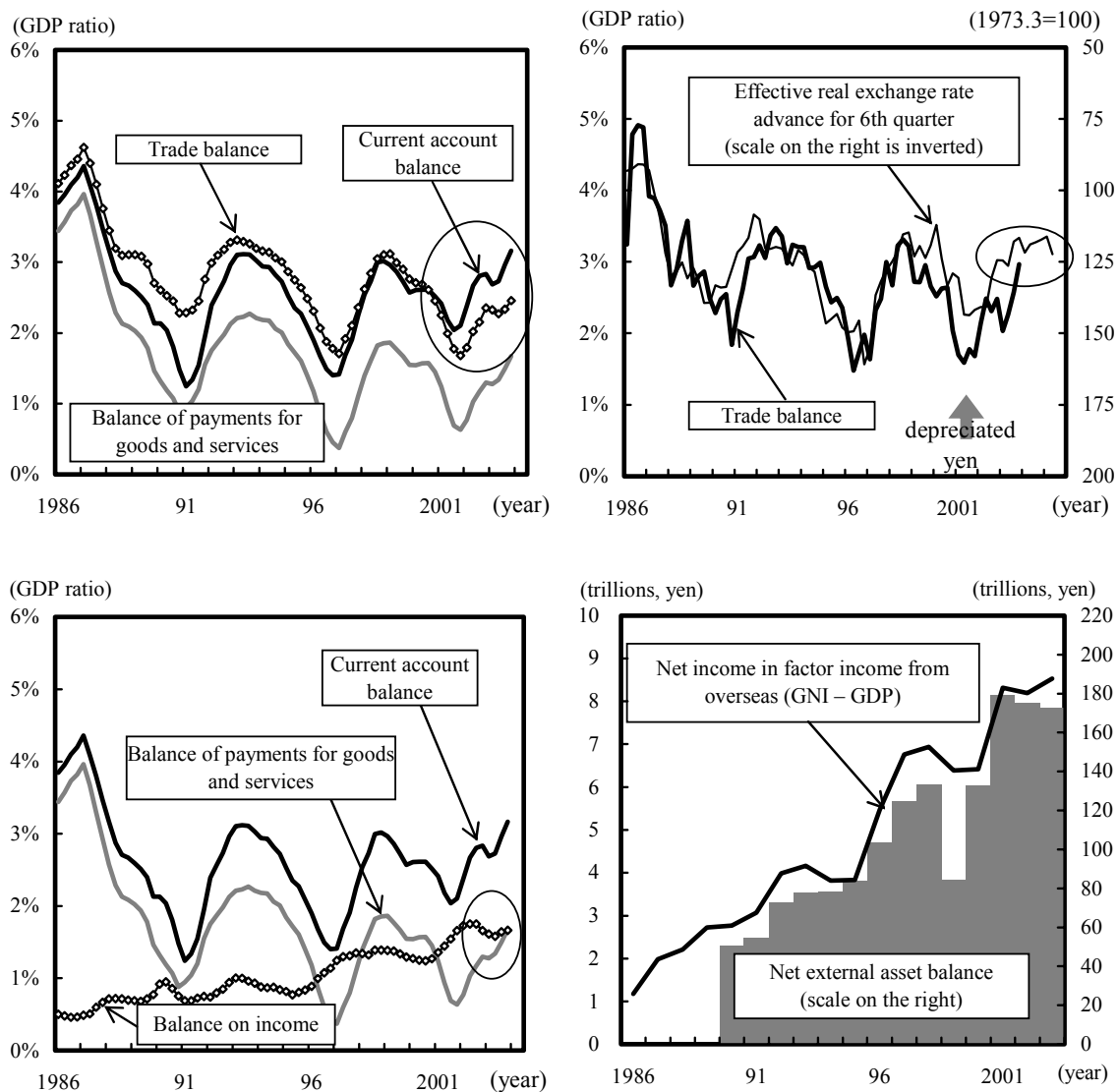


- Notes:
1. From *System on National Accounts*, Cabinet Office, *Corporate Goods Price Index*, Bank of Japan and *Survey on Current Business*, US Department of Commerce.
  2. When based on export and import in real terms and exports and import deflators for 2003, the exchange rate effect indicates impact on volume of import and export when the nominal exchange rate increases by 10% during yen appreciation and when it decreases by 10% during yen depreciation, while income effects indicate impact on volume of import and export when the real economic growth rate both for Japan and overseas has increased by 2% each.
  3. The difference in the rate of change between net exports in real terms and balance of payments for goods and services is due to the greater rate of change in nominal net exports, as the export deflator for 2003 is smaller than the import deflator.
  4. For method of calculation, refer to Note 3-1.

- Background of current-account surplus increase
  - 1) Increase of trade surplus
  - 2) Increase of balance on income against the backdrop of expansion in net external assets.
- It is necessary to strive for sustainable economic growth, while paying sufficient attention to the impact of exchange rates.

**Fig. 3-2-8 Background of current account surplus increase**

The contribution of trade surplus is decreasing while the contribution of balance on income is increasing.



- Notes:
1. From *System on National Accounts*, Cabinet Office, *Balance of Payments and International Investment Position of Japan*, Ministry of Finance.
  2. Data for balance of payments is raw numbers, and for the fourth quarter the moving average.
  3. For data on current account balance before 1995, profit from reinvestment is not included in balance on income, so strictly speaking this data lacks continuity.
  4. For net external asset balance from the end of 1990 onwards, data is from the end of each year.
  5. GNI stands for Gross National Income and is the same as GNP.

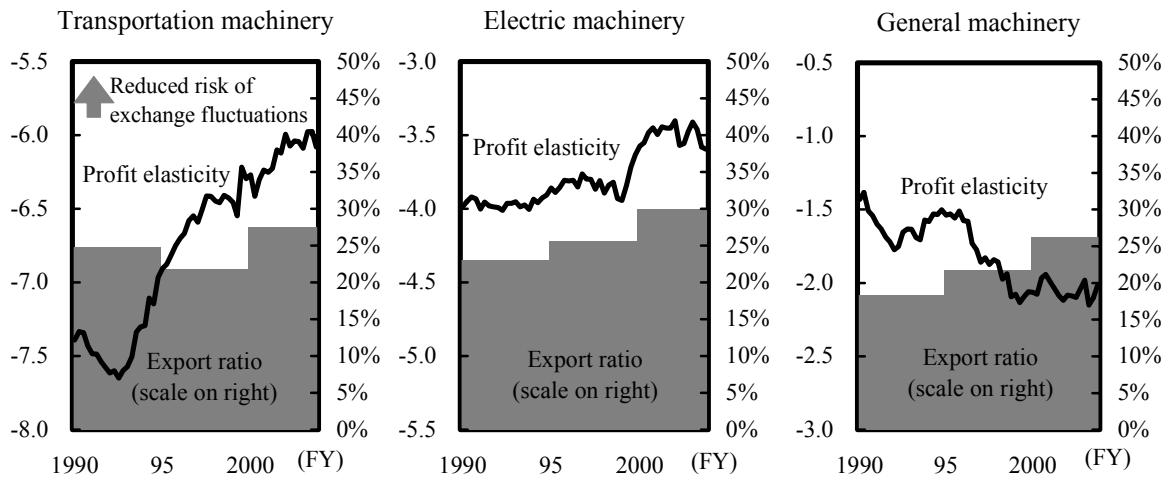
## 2. Impact on Corporate Activities

### (Impact of yen appreciation on profits of exporting companies)

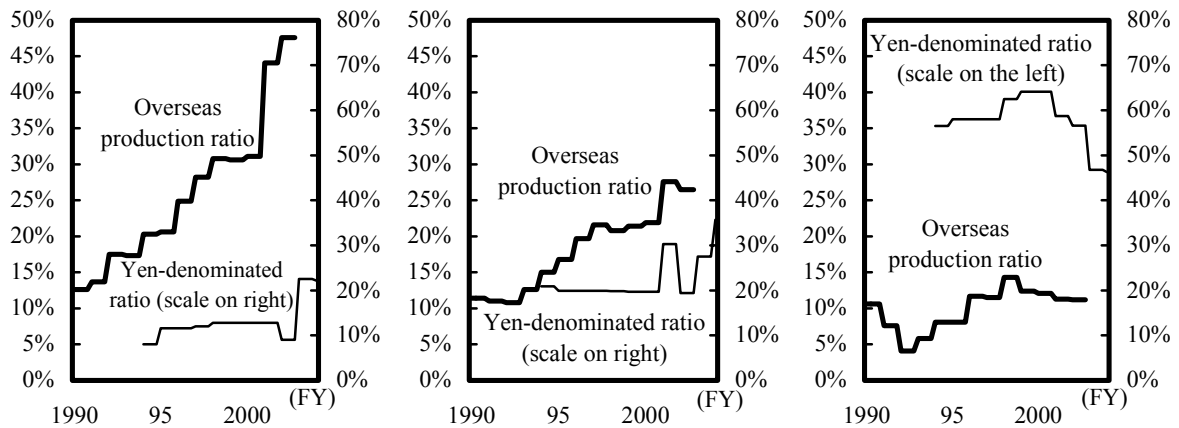
- Avoid negative impact by increasing in overseas production ratio and yen-denominated export ratio, etc.

**Fig. 3-2-10 Impact of exchange rate on corporate profits**

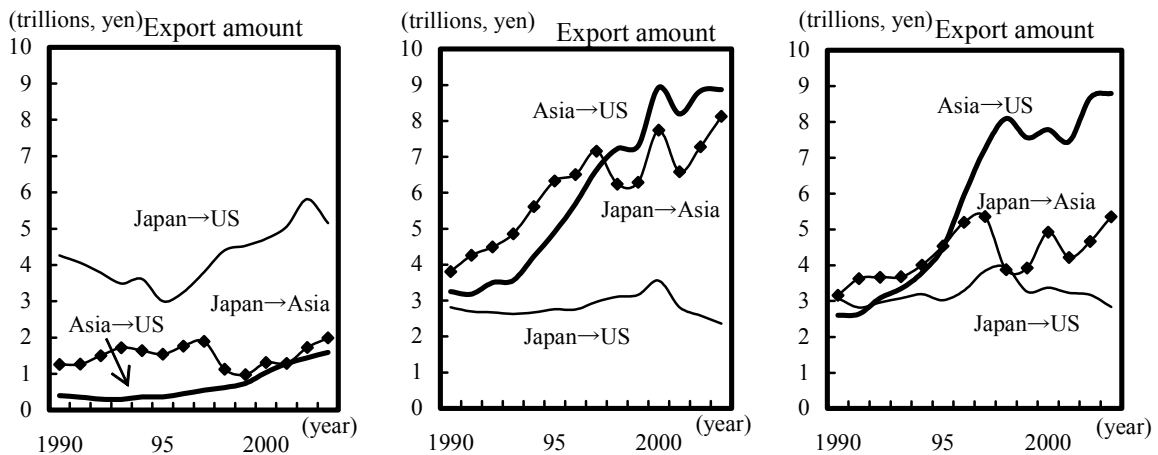
The risk of exchange fluctuations for transportation machinery and electric machinery has decreased.



[Keep in mind that the standard for indicating profit elasticity on the left axis (alternative index for exchange fluctuation risks) is different for each graph.]







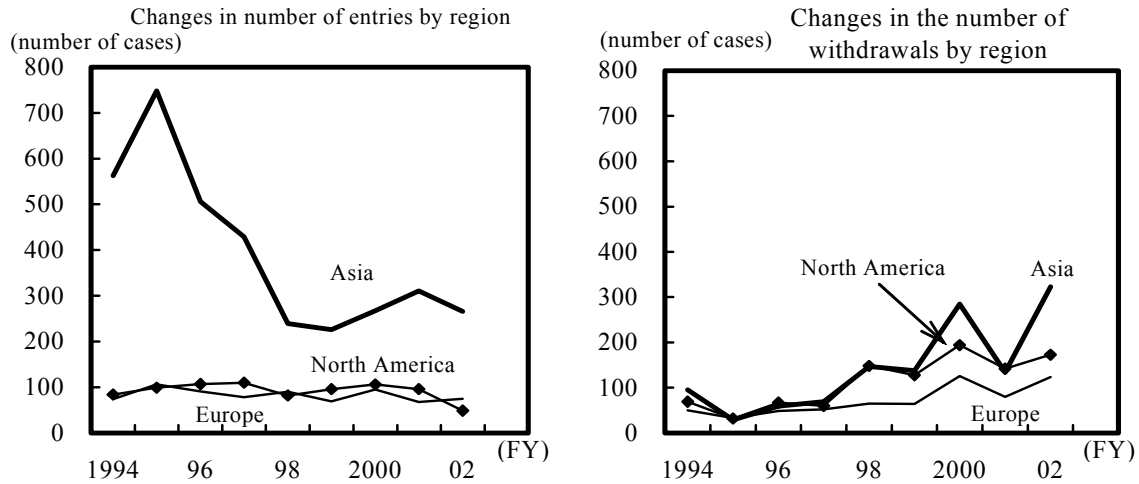
- Notes:
1. From *Financial Statements Statistics of Corporations by Industry*, Ministry of Finance, *Corporate Goods Price Index*, Bank of Japan, *Input-Output Table*, *Basic Survey of Overseas Business Activities*, Ministry of Economy Trade and Industry and *Survey of Current Business*, US Department of Commerce.
  2. For estimation method of profit elasticity, refer to Note 3-2.
  3. Export ratio is for 1990, 1995, and 2000.
  4. Overseas production ratio (on overall domestic corporate base) = sales volume of local corporations (manufacturing industry)/sales volume of domestic corporations (manufacturing industry) x 100
  5. "Electric machinery" includes "telecommunications equipment."
  6. Yen-denominated ratio is from the end of 1994 onwards.
  7. Asia includes the four NIEs countries and regions (ROK, Taiwan, Hong Kong and Singapore), 10 ASEAN countries (Thailand, Philippines, Indonesia, Malaysia, Singapore, Brunei Darussalam, Vietnam, Laos, Myanmar, and Cambodia).
  8. For yen exchange rate in export volume from Asia to the US, average exchange rate in bank transactions was used.

### **(Expansion of overseas operations with focus on Asia)**

- 1) Up until the mid-1990s, companies established overseas production bases, and engaged in local sales and exports to Japan.
- 2) From the second half of the 1990s onward, a new structure was adopted that involves decentralization of production bases, reduction of local sales ratio, and a system for division of labor through import/export networks.

**Fig. 3-2-11 Trends in corporate overseas entries and withdrawals by region**

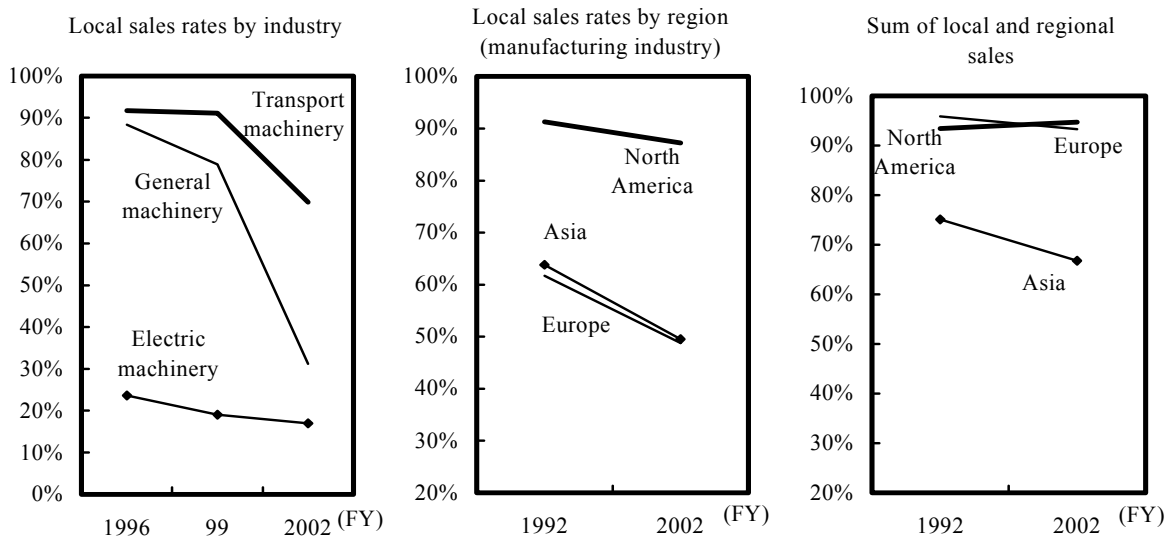
Asia is the region where most companies establish or withdraw overseas branches, with a high level of contribution of transport machinery, electric (including telecommunications) and general machinery.



Notes: From 33rd Survey on Overseas Business Activities (July 2003), Ministry of Economy, Trade and Industry.

**Fig. 3-2-12 Downward trends in local sales rates**

Low local and regional sales rates in the Asian region



- Notes:
1. From *Basic Survey on Overseas Business Activities* (micro survey data) and *33rd Survey on Overseas Business Activities (July 2003)*, Ministry of Economy, Trade and Industry.
  2. Local sales rate by industry is a median for local sales rate of each company affiliated with the respective industry. Local sales rate by region and the sum of local sales and regional sales are based total amount realized by local affiliates of companies in the manufacturing industry.
  3. "Local" refers to a country, etc. where a Japanese company has entered and established business. "Regional" refers to the region of the country, etc. where a Japanese company has entered and established business, excluding the country of entry, etc.

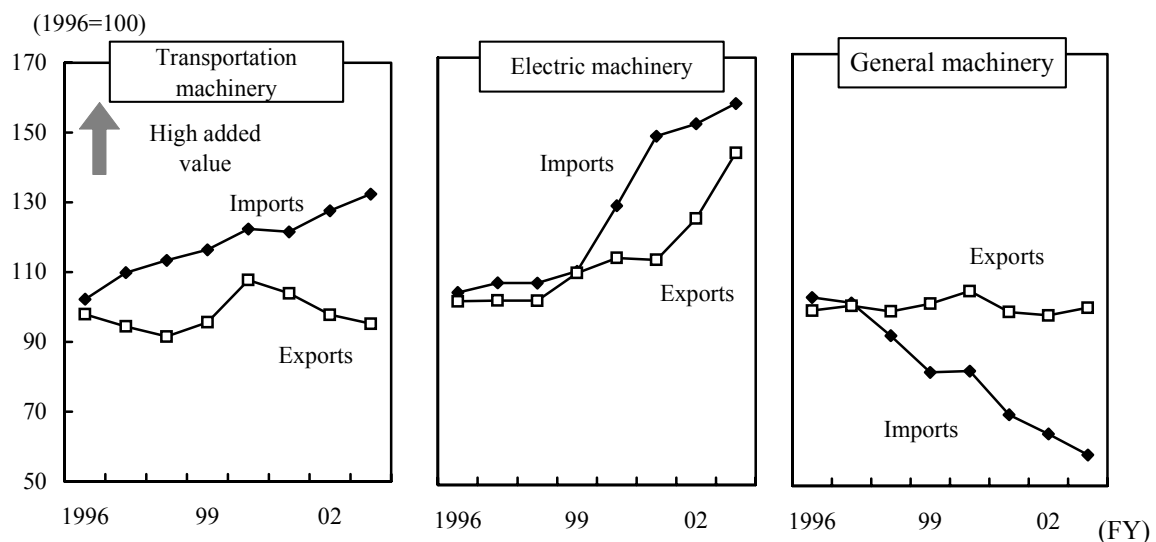
**(Advancement of vertical intra-industry trade)**

- Division of labor for different processes in the Asian region
  - Manufacturing of products with even higher added value in the NIEs in Asia
  - Advancement of vertical intra-industry trade among China, the ASEAN member countries, and the NIEs in Asia
- Impact on Japan of activities by “cross-border companies”
 

Consistent structural reforms are necessary in the field of regional economic partnership and in the international economic field.

**Fig. 3-2-13 State of added value of exported and imported products**

The state of added value of exported and imported products indicates progress in international vertical specialization.



- Notes:
1. From *Trade Index*, Ministry of Finance and *Corporate Goods Price Index*, Bank of Japan.
  2. The vertical axis is the index that shows level of added value. In it, the import/export price index of the Ministry of Finance that does not incorporate changes in quality of products is replaced with the import/export price index of the Bank of Japan that takes into consideration such changes. The index is 100 for 1996, and the value is for fiscal year, calculated by summing data for each month.
  3. Regarding *Corporate Goods Price Index* by the Bank of Japan, data for the period before 1999 is based on *Wholesale Price Index*.

### 3. Impact on the Household Sector

(The benefits of globalization are shared by a broad spectrum of economic entities, while the setback is concentrated on a limited group of the entities)

- Imports of inexpensive products from China and other countries increased. Domestic prices declined for goods with high import penetration level (foods and clothing in particular).
  - Expenses for daily necessities were reduced (spared income was spent on other fields of consumption).
  - The household sector can gain more benefits from further import of inexpensive products. The size of such benefits, as of year 2000, were calculated by measuring price gaps between domestic market and overseas markets. (10.8 trillion yen for foods and 6.5 trillion yen for textiles)

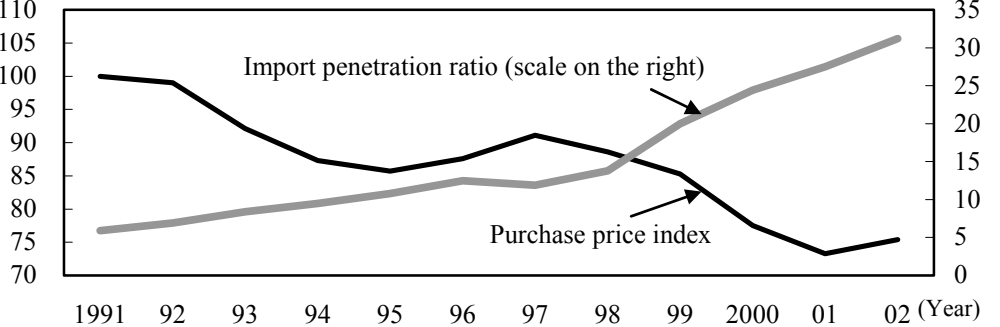
**Fig. 3-2-16 Import penetration ratio and purchase price index**

(1) Clothing

Prices of clothing dropped as imported products increased.

(Purchase price index, 1991=100)

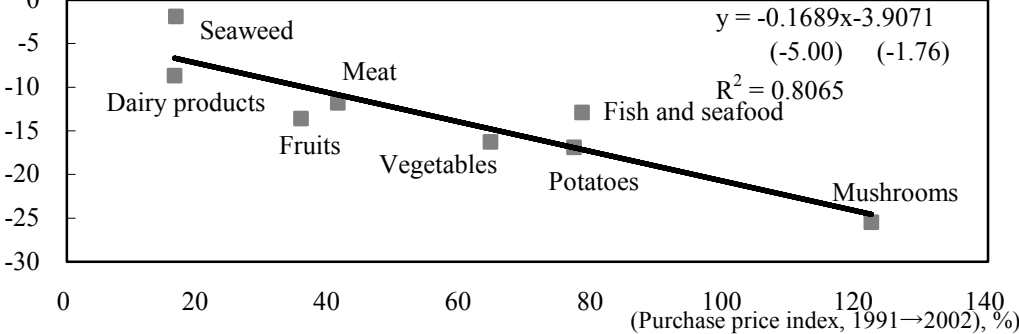
(Import penetration ratio, %)



(2) Foods

Drop in prices was particularly high for products, whose imported equivalents increased.

(Import penetration ratio (1991→2002), %)



Notes: 1. Source: Household Survey (targeting households with more than two members and excluding households engaged in agriculture, forestry and fisheries), Ministry of Public Management, Home Affairs, Posts and Telecommunications, Food Balance Sheets, Ministry of Agriculture, Forestry and Fisheries, Aggregate Supply Table, Ministry of Economy, Trade and Industry.

2. For calculation method for purchase price index, refer to Appended note 3-5.  
 3. Import penetration ratio = volume of imports/(domestic production volume + volume of imports)  
 4. Figures in parentheses ( ) are t value.

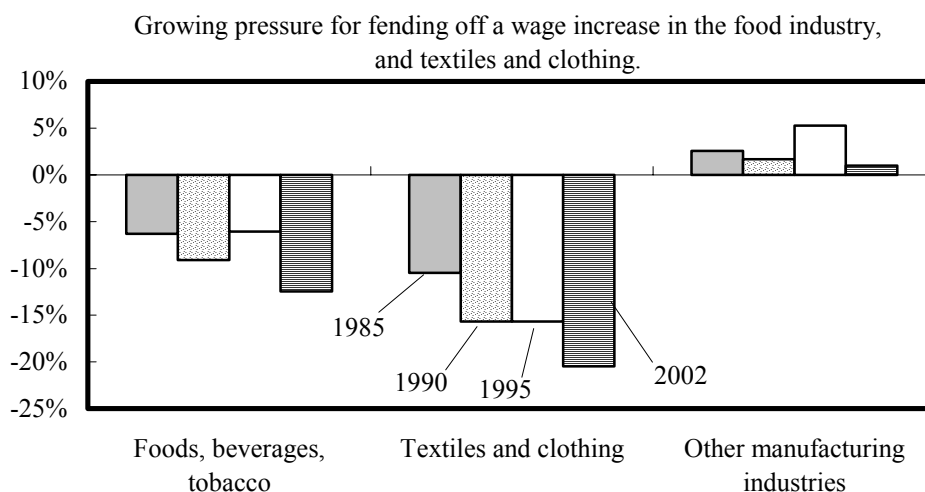
- Globalization has caused concerns with regard to “industrial hollowing-out”. The concerns have grown, given the reduction of employment through exports and imports (the reduction is estimated to reach 1.96 million people). The impact is concentrated on a limited number of industries (foods, clothing, etc.)
- There is growing pressure for fending off a wage increase in the field of foods and clothing.

**Table 3-2-20 Changes in the number of employed persons (1985-2000)**

	Actual increase/decrease in the number of employed persons (10,000 people)	Impact of exports and imports (10,000 people)
Foods, tobacco	16.3	-21.6
Textile industry products	-57.4	-10.3
Clothing and other textile products	-24.9	-31.8
Metal products	-17.6	-10.4
Electrical machinery	-14.3	-36.5
Transportation machinery	2.4	-22.5
Total for manufacturing industries	-163.5	-195.9

- Notes:
1. Source for the actual increase/decrease of employed persons is the *National Census*, Ministry of Public Management, Home Affairs, Posts and Telecommunications
  2. The impact of exports and imports was calculated by the office of the Counselor for Macroeconomic Analysis at the Cabinet Office on the basis of *Linked Industrial Tables 1985-1990-1995* and *National Census*, Ministry of Public Management, Home Affairs, Posts and Telecommunications and *Simple Extended Industrial Linkage Table*, Ministry of Economy, Trade and Industry.
  3. Impact of exports and imports indicates the impact on the number of employed persons caused by decline in domestic production due to drop in export rates (export amount/domestic demand amount) associated with the reduced exports from Japan, and to the rising import rates (import amount/domestic demand amount) associated with increase of imports to Japan.
  4. Please refer to Appended note 3-7, for the method of calculating the impact of imports and exports, the results for industries not shown above, and the change in the number of employed persons in proportion to those who were employed in 1985.

**Fig. 3-2-22 Gap in wages by industry**

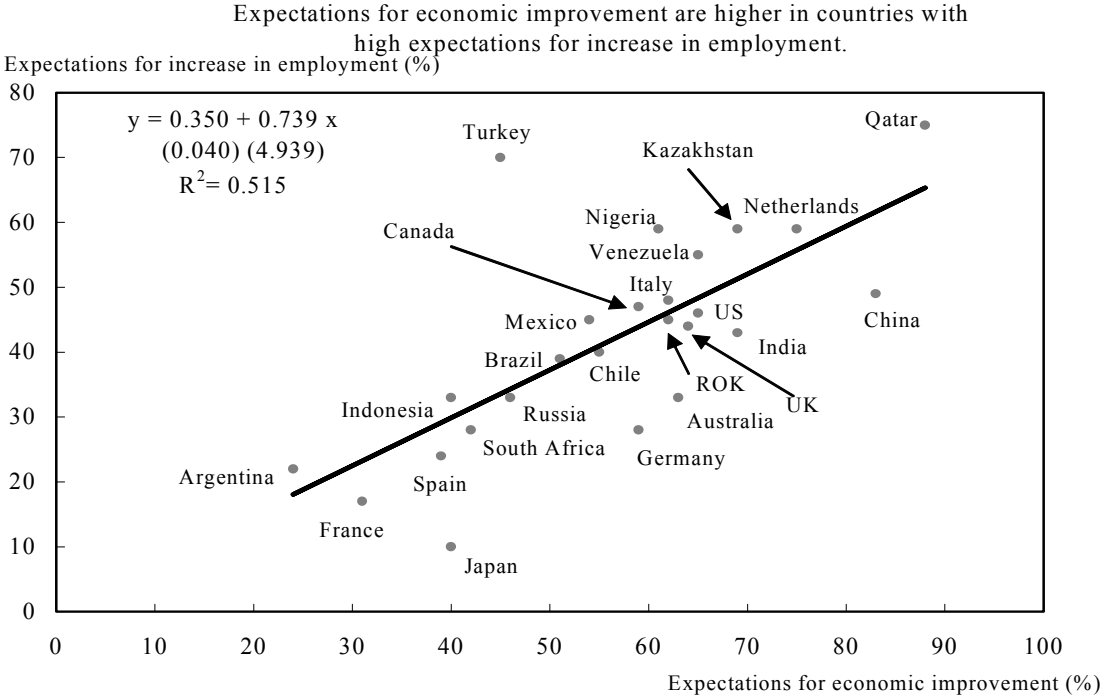


- Notes:
1. Calculated by the office of the Counselor for Macroeconomic Analysis at the Cabinet Office, on the basis of *Basic Survey on Wage Structure*.  
For calculation method, refer to Appended note 3-8.
  2. At business offices with more than 10 employees, the data refers only to ordinary employees (part-time workers are excluded).
  3. Wages in transportation machinery industry are used as benchmark for measuring the gap between wages in different industries.

**(Japanese people are wary of globalization)**

- According to a public opinion survey on globalization carried out by the World Economic Forum, expectations for economic improvement are higher in countries with high expectations for increase in employment.
- Expectations for increase in employment are higher in countries where the level of openness (ratio of export and ratio of import to GDP) is higher. (The higher the ratio of export, the more the increase in production and employment. The higher the ratio of import, the more the job opportunities in import-related industries, etc.)

**Fig. 3-2-23 International comparison of awareness with regard to impact of globalization**



- Notes:
1. From *Global Public Opinion on Globalization*, World Economic Forum.
  2. The poll was conducted in 25 countries (1,000 persons in each country, carried out in the fall of 2001), of which 13 are OECD member countries.
  3. Both the vertical and the horizontal axis indicate percentage of respondents who expressed positive expectations.
  4. Globalization is defined as an increase in transactions in goods and services among countries.

**(Need for structural reform)**

- The household sector can gain from potential benefits in the field of foods and others. Drawbacks related with employment and wage must be dealt with through reinvigorating industries and increasing labor mobility.
- Structural reform is necessary so that benefits from globalization can be fully enjoyed.

**4. Regional Economy and Globalization**

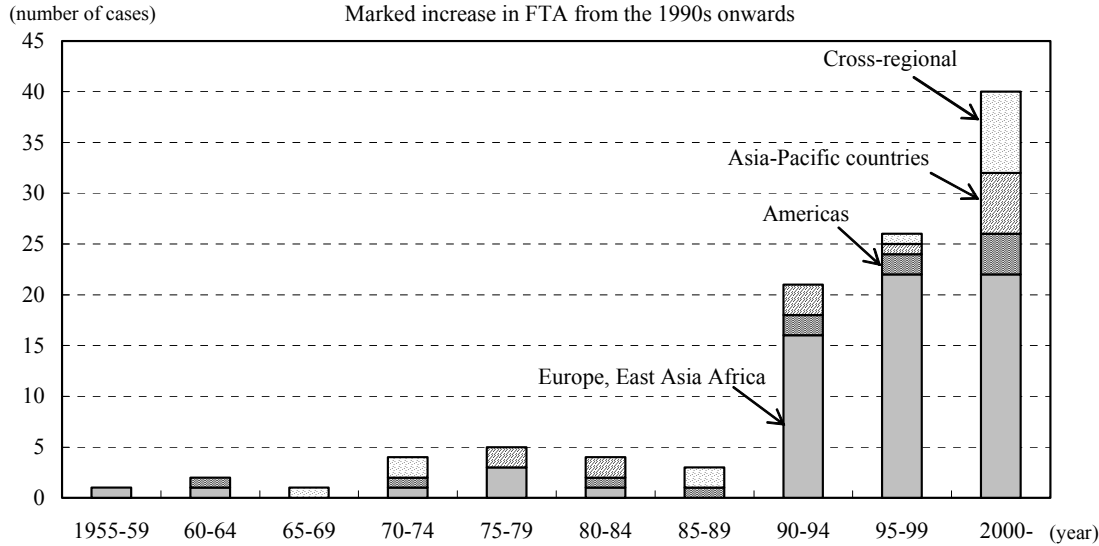
- As foreign companies enter into Japan, they have created jobs not only in major cities but also in regional areas.  
-Foreign companies' technology are know-how revitalize regional economies.
- In the areas of tourism and agriculture, benefits of globalization are enjoyed by reaching out to overseas consumers.
- Regional initiatives take into account globalization, in launching Special Zones for Structural Reform and formulating plans to promote inward foreign direct investment.

### Section 3 Promotion of Economic Partnership

**(Marked increase in FTA from the 1990s onwards)**

- FTA is liberalization with a limited area: exemption from the most favored nation principle.
- Characteristics of advancement of liberalization as eliminating tariffs.
- The World Trade Organization imposes conditions for concluding an FTA: 1) liberalization in all areas in real terms; 2) liberalization within 10 years, etc.
- There has been a marked increase in the number of FTA since the 1990s. Recently, an increasing number of developing countries or trans-regional groups of countries have concluded FTA.

**Fig. 3-3-1 Number of FTA that went into effect around the world by year and region**



- Notes:
1. Source: List uploaded to the WTO homepage ([http://www.wto.org/english/tratop\\_e/eif\\_e.xls](http://www.wto.org/english/tratop_e/eif_e.xls)) (as of May 1, 2004).
  2. Of the 208 regional trade agreements listed on the WTO homepage, 101 agreements, for which the conditions below are applicable, were excluded.
    - 1) Agreements that lost effect after the expansion of the EU on May 1, 2004.
    - 2) Overlaps associated with new entries to existing FTA.
    - 3) Overlaps associated with reports to both GATT and GATS, etc.

**(Expansion, enhancement and stagnation of WTO)**

- Negotiations under the WTO have grown somewhat stagnant in recent years. The Fifth WTO Ministerial Conference held in Cancun (September 2003) collapsed.
- Factors of stagnation are: (1) Expansion of membership. An increasing number of developing countries in particular, (2) Expansion of liberalization issues (goods trade → services trade and investment)



### **(Expansion and enhancement of liberalization through FTA)**

- FTA cannot be positive without reserve. The most important point is to maintain the WTO principles.
- In the most recent trends, the areas for application of FTA have expanded to include investment, government procurement, competition policies, smooth movement of human resources, e-commerce environment, and harmonization of labor-related systems, leading to the creation of Economic Partnership Agreements (EPA).
- Negative aspects: entanglement of rules of origin (spaghetti bowl phenomenon) would cause administrative costs.
- In advancement of FTA, it is necessary to pay sufficient consideration to promotion of multilateral liberalization through the WTO.

## **2. Economic Effect of Economic Partnership**

### **(Deepening relations with the East Asian economies)**

- FTA that are currently under consideration are mainly ones with Asian countries: geographical closeness and deepening economic relations.
- FTA i) has significant positive effect on the economy, and ii) do not change the existing trade trends.
- The share of exports for Asia has increased from around 30% in 1990 to 40% in 2003.
- The tariff ratio in the Asian countries is generally high compared with developed countries.

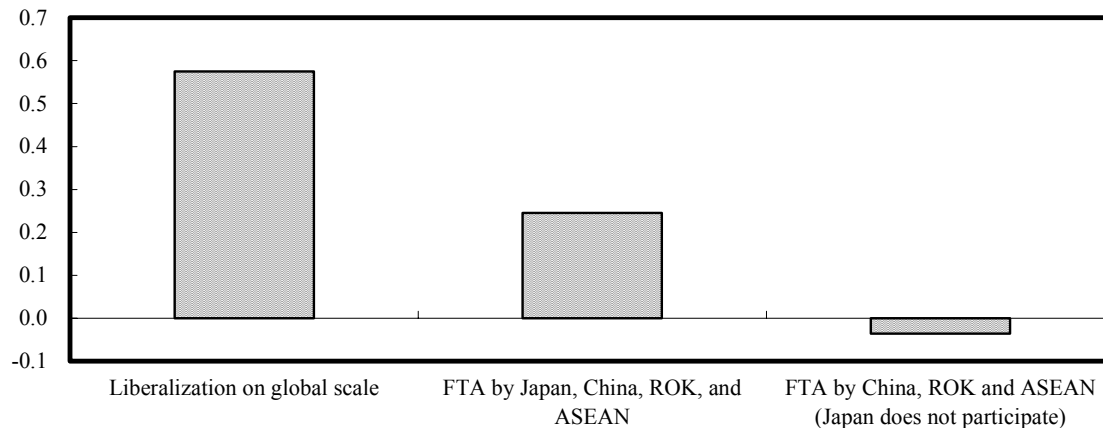
### **(Economic effect of trade liberalization)**

- Static effects: creation of trade due to eliminating tariffs, benefits for consumers — low-price and good-quality products; shift of resources to highly productive industries
- Estimation of the static effects: 1) positive economic effects by liberalization in the global scale, 2) positive effect on conclusion of FTA with Asian countries = reflection of closely related trade structures, 3) negative effects in case of Japan's non-participation in FTA.
- Dynamic effects: 1) economic benefits of scale, 2) increase of productivity due to competitiveness, 3) effects of reform of domestic systems

**Fig. 3-3-2 Impact of elimination of tariffs on Japan's economy**

Maximum benefits can be drawn from trade liberalization if it is implemented on a global scale. FTA between Japan and Asia are also expected to produce positive effects.

(%, rate of consumer surplus increase against the nominal GDP)



- Notes:
1. From GTAP model, and *System of National Accounts*, Cabinet Office.
  2. Equivalent variation (EV, variation in welfare status of consumers measured through comparing prices before and after changes in welfare status associated with changes in prices) was used to calculate consumer surplus rates.
  3. For the GTAP model and prerequisites for calculation, etc. refer to Appended note 3-9.

## Section 4 Structural Reform to Draw Benefits from Globalization

The benefits of globalization cannot be gained passively. A proactive approach by economic entities is required. It is necessary to establish, through structural reform that takes into account global perspectives, an environment that will enable Japan's economy to draw the maximum benefits from globalization.

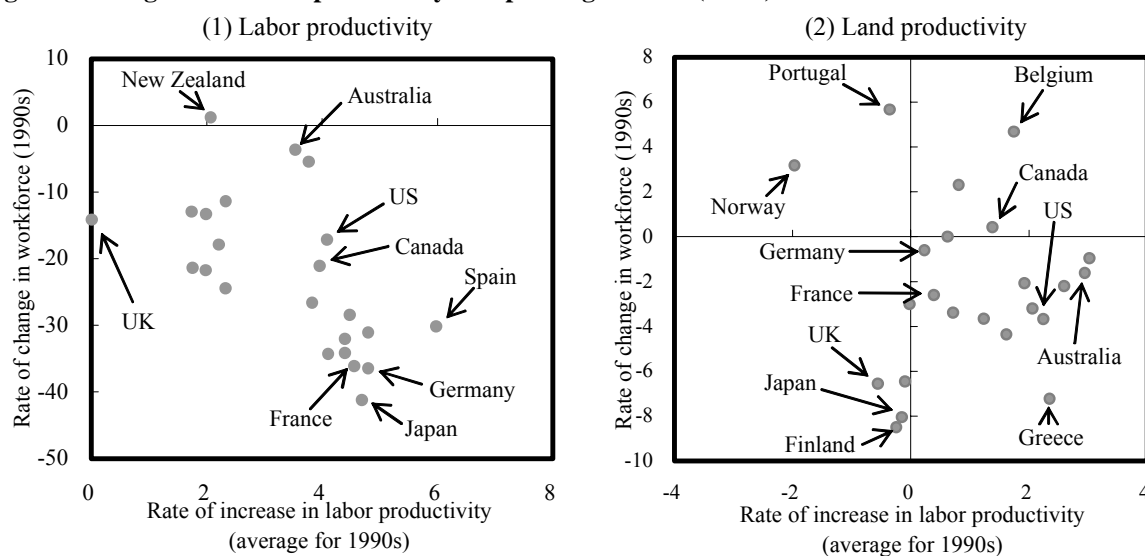
### 1. Required Structural Reform in Agriculture

- Advancement of global liberalization in the 1990s through WTO and FTA
- Benefits of globalization: i) consumers will be able to purchase inexpensive imported products that have comparative advantage, ii) the principle of market mechanism will come into force, and it will stimulate improvement in the productivity of domestic agriculture.

#### (Characters of agriculture in Japan compared with other advanced countries)

- Agriculture in Japan is faced with: 1) significant decline in labor force, and 2) decrease in agricultural land and stagnation in land productivity.

Fig. 3-4-1 Stagnation in land productivity in Japan's agriculture (1990s)



- Notes:
1. Based on FAO statistics for agriculture productivity index, persons employed in agriculture, and land.
  2. In order to obtain average figures for productivity for each year, average figures for the period 1991-2001 were compared. For labor and land, changes in 1991 and 2001 were reflected.
  3. The figure compiles data for advanced countries.

#### (Decline in labor force and land due to the aging of population)

- Decline in labor force in agriculture due to the advancement of the aging of the population and the deficiency of successors

- It is difficult to separate labor force from land and therefore aging of the population has an impact on land utilization.
- In 2000, 340,000 ha (approximately 4% of all arable land) were lands on which cultivation was abandoned, and areas equivalent to one-fifth of Lake Biwa was further abandoned in 2003.

**(Decline trend in productivity in land-intensive agriculture)**

- In areas with high rice cultivation ratio, land productivity and total factor productivity (TFP) are on a downturn trend.

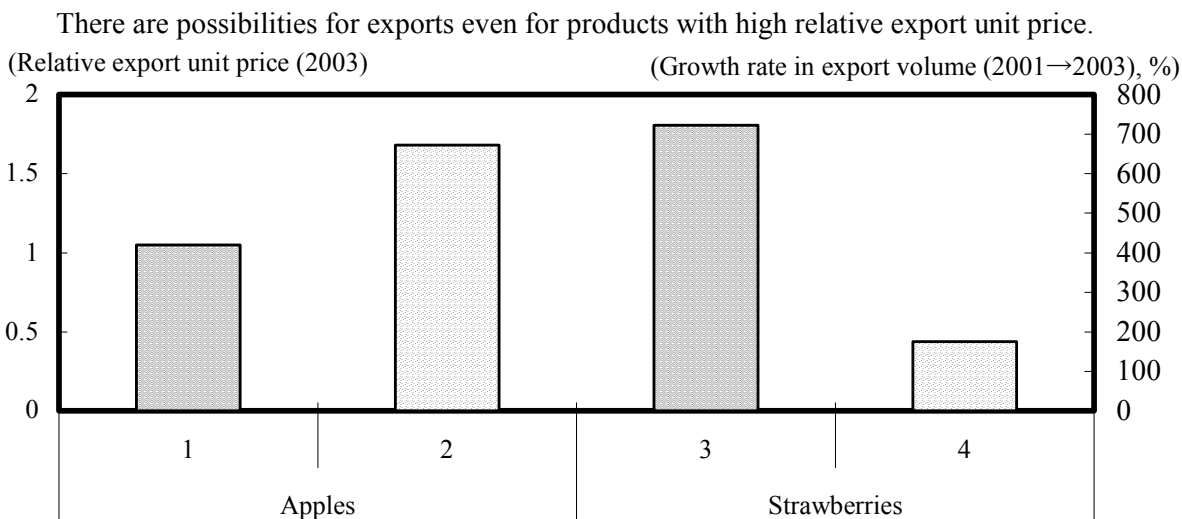
**(Necessary to foster motivated human resources and effective use of land)**

- The future tasks are fostering of motivated human resources and consolidation of agriculture land.
- In special zones for structural reform, joint stock companies can rent agriculture land and carry out agricultural activities. It is necessary to extend the measures in special zones into a national scale, where appropriate.

**(Possibilities for adding high value to Japanese agriculture)**

- Efforts for high added value: farming with reduced use of chemicals, traceability, etc.
- In recent years, Japanese agricultural products have been exported overseas, even though expensive.

**Fig. 3-4-5 Growth in relative export unit prices and export volume**



Notes: 1. From *Trade Statistics*, Ministry of Finance.  
 2. Relative export unit price = export unit price/import unit price

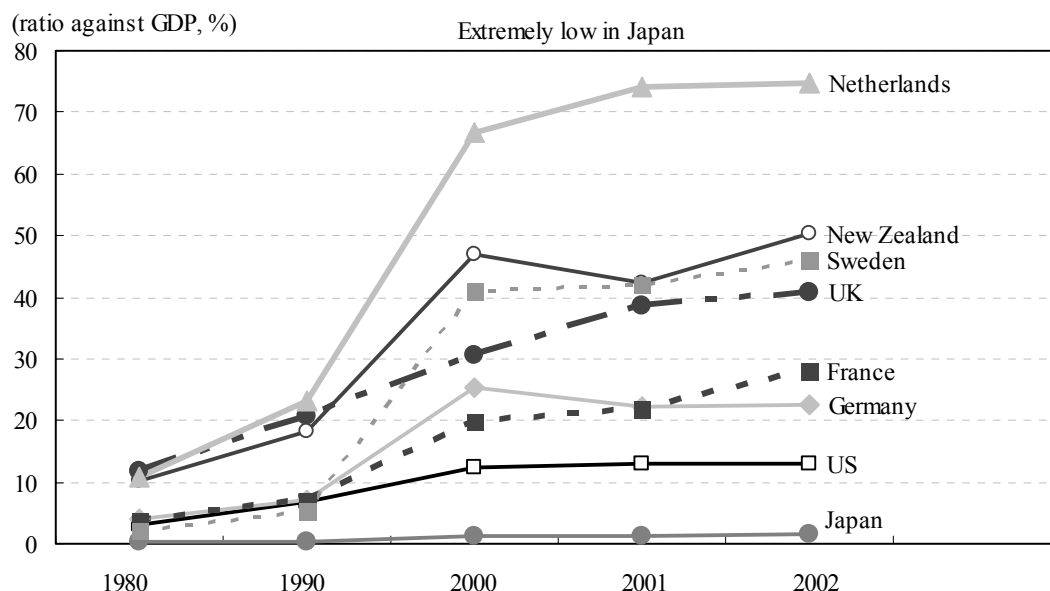
## 2. Need for Further Efforts Related to Foreign Direct Investment to Japan

### (Foreign Direct investment to Japan remains low.)

- Inflow of foreign capital will not only bring additional funds but also will enrich the economy and society of Japan through the transfer of new technology and know-how of management.  
→ Therefore, it is necessary to establish an investment-friendly environment that will enable effective utilization of foreign capital.
- The level of FDI to Japan is still low, although the investment is recently on the rise (in other developed countries, the level has significantly increased over the past 20 years).

**Fig. 3-4-6 International comparison of amount outstanding of inward foreign direct investment**

Fig. 3-4-6 International comparison of outstanding direct inward investment



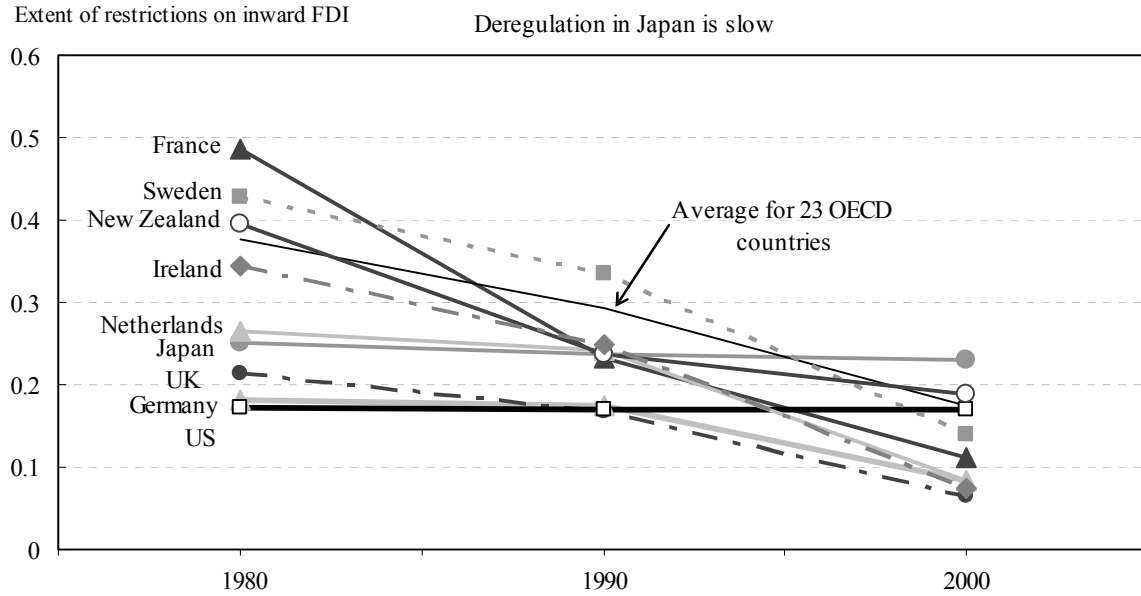
Notes: 1. From *World Investment Report 2003*, UNCTAD (2003).

2. Figures for Ireland are as follows: 155.6%(1980), 72.3% (1990), 124.4% (2000), 133.9% (2001), 129.1% (2002).

### (Amount outstanding of inward FDI is lower in those countries where regulations are more restrictive.)

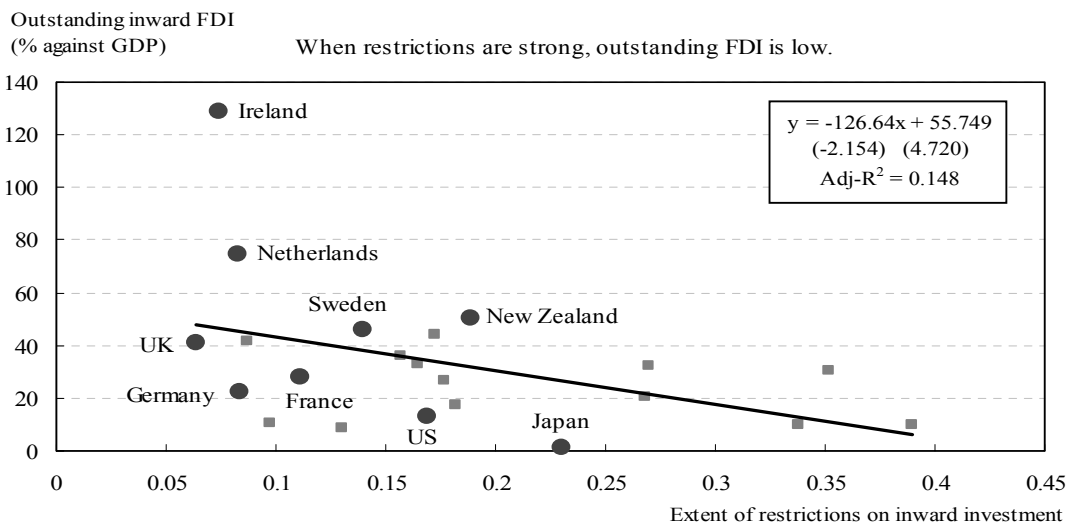
- Deregulation in Japan did not advance fast enough until recently. In other OECD countries, deregulation has advanced over the last 20 years.
- The more restrictive regulations are, the lower amount outstanding of inward FDI is.
- The Government of Japan is going to proceed with the “Program for the Promotion of Foreign Direct Investment into Japan” aiming to double the amount outstanding of FDI by year 2008.

**Fig. 3-4-7 Restrictiveness of regulations on inward FDI (international comparison)**



- Notes:
1. From "Measures of restrictions on inward foreign direct investment for OECD countries," Stephen S. Golub (2003), *OECD Economics Department Working Papers*, OECD Economics Department, Paris.
  2. Restrictiveness is determined by the numeral value of restrictions applied to the inward flow of foreign capital by the investment recipient country. Restrictiveness is 1 when inward investment is impossible.

**Fig. 3-4-8 Relation between restrictions and amount outstanding of inward FDI**



- Notes:
1. The source for the ratio of outstanding inward FDI against GDP is the same as in Figure 3-4-6 and the source for extent of restrictions on inward investment is the same as in Figure 3-4-7.
  2. Figures in parentheses ( ) are t value.

### **3. Utilization of foreign work force and other tasks**

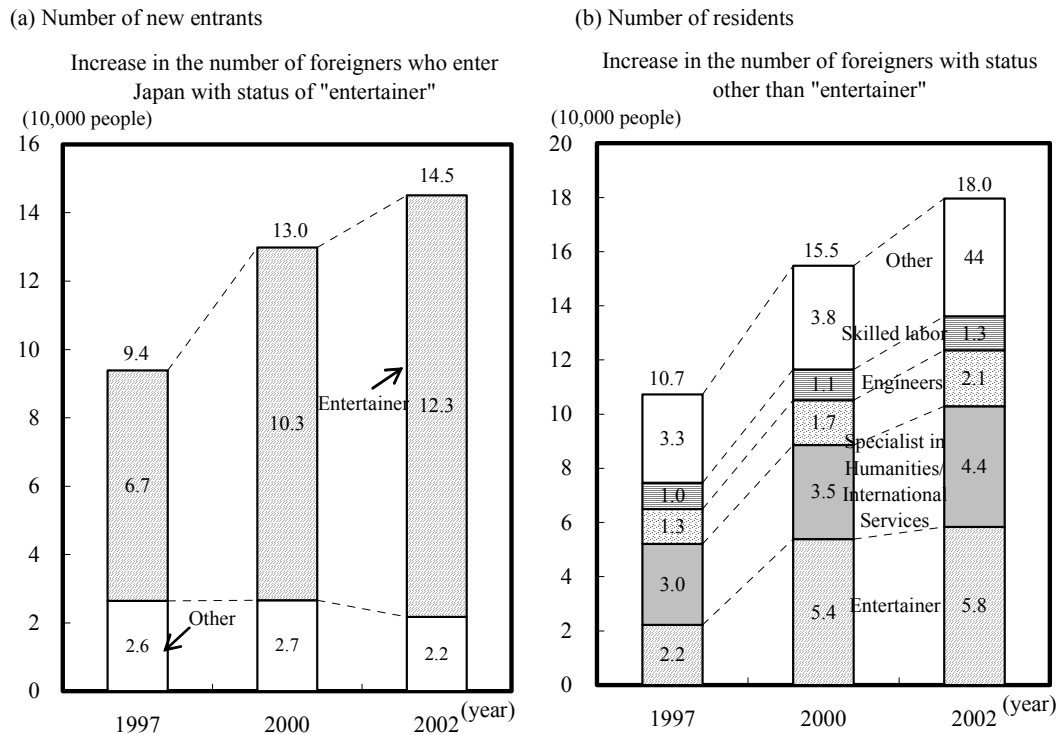
#### **(Foreign work force in the world and Japan)**

- Efforts in the developed countries to effectively accept foreign labor force: i) system of acceptance of specialized and technical workers (to accommodate common change in developed countries, such as liberalization of services trade, shift to knowledge intensive industries, aging population with fewer children), ii) in accepting immigrants, requiring certain levels of linguistic ability.
- Japan's acceptance of foreign workers: change in immigration control law of 1990, conditions for entrants with job purpose was widened and organized. Foreigners of Japanese origin was accepted as "inhabitants"
- There is no quota or period in acceptance in Japan, neither linguistic ability requirement.

#### **(Current situation of specialized and technical workers)**

- Some 140,000 people entered Japan in 2002 with the purpose of working (flow base), which is an approximately 50% increase from the previous five years. By status of residence, over 80% of the foreign workers are registered as engaged in the entertainment business. If they are excluded from the statistics, the number of foreign workers in Japan over the period of five years remains unchanged at about 20,000 people.
- The number of foreigners who reside in Japan (stock base) increased about twofold over the period of five years and the number of people changing their status is on the rise. By country, most foreign workers come from nearby countries such as the Philippines and China, and from advanced countries such as the US and UK.

**Fig. 3-4-10 Changes in the number of new entrants and residents by purpose of work**



- Notes:
1. From immigration control related materials at the Ministry of Justice.
  2. "Other" in (a) indicates status other than "entertainer" in appended tables 3-2 to 3-16.
  3. "Other" in (b) indicates status other than "entertainer", "specialist in humanities and international services," "engineer" and "skilled labor" in Appended tables 3-2 to 3-16. "Engineer" points to specialists in mechanical engineering, and "skilled labor" points to cooks of foreign cuisine.

**(Current situations of foreigners of Japanese origin)**

- The number of foreigners who enter Japan for reasons other than work, such as foreigners of Japanese origin, trainees, and foreign students, is increasing more than specialized and technical workers
- In the distribution by industry and nationality, in Shizuoka Prefecture and Gunma Prefecture, etc., there are many foreigners engaged in the manufacturing industry, and most of them are Brazilian and Peruvian. Foreigners of Japanese origin who enter Japan as long-term residents find jobs in the manufacturing industry through indirect employment.

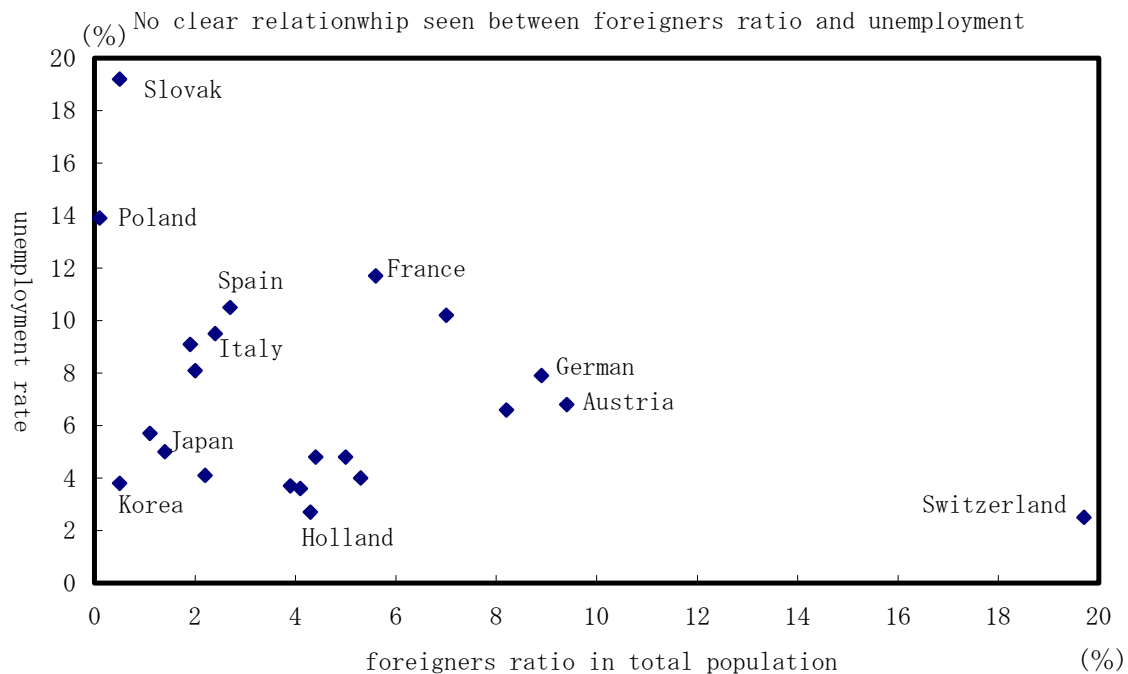
**(Issues arising parallel to the increase in the number of foreign workers)**

- First, inter-cultural communication in the corporate field.
- Second, in the economic field as well, possibility for impact on the domestic labor market. The overall trend in all advanced countries and in the OECD countries is that there is no correlation between the ratio of foreign workers and the unemployment rates. In Japan, there is no correlation between the share of foreign workers in the number of workers in each prefecture and the unemployment rate.



- The unemployment rate among foreign workers was 5.7% for 2000, which is 1% higher than the overall unemployment rate of 4.7% (2000). The unemployment rate among foreign workers by prefecture shows that the rates are lower where the percentage of specialized and technical workers is higher. Non-permanent employees in the manufacturing industry are most vulnerable to changes in the economic situation. Instability in employment could create social problems.
- Third, social issues such as i) employment of foreign workers who do not speak Japanese, ii) education of children, iii) joining the social insurance system, and iv) cultural and lifestyle-related frictions between foreign workers and the local community.
- The issues surrounding foreigners in Japan should be addressed on a broad scale by local communities.

**Fig. 3-4-11 Relationship between foreigners ratio and unemployment in OECD countries**



**(Examination of various issues in an positive and comprehensive manner)**

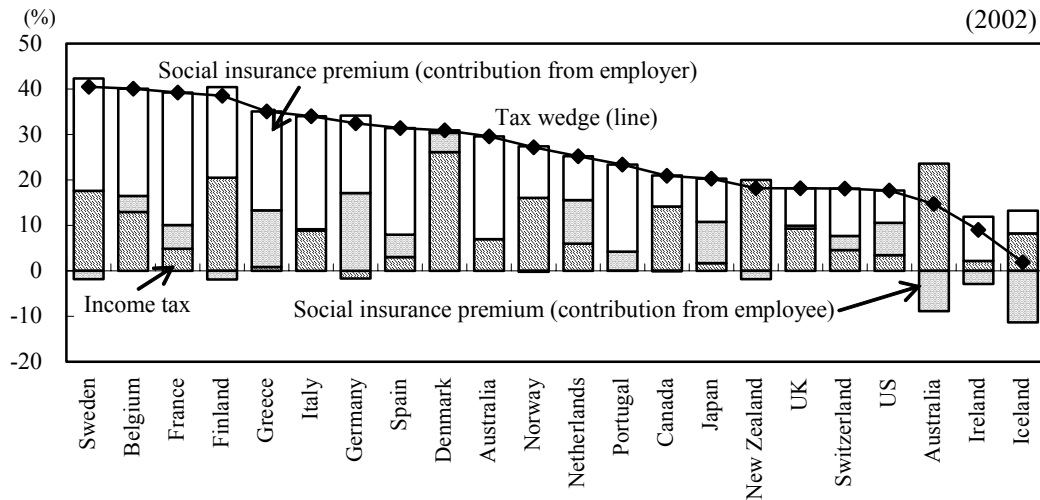
- The greatest challenge before Japan at the moment is to help foreign workers get integrated in the Japanese society and lead a meaningful life.
- It has been pointed out that structures for cooperation that will enable institutions in charge of immigration control, labor, children education, and others, to jointly deal with various issues surrounding foreigners, are still not established in Japan. Therefore, it is necessary to set up a system that will study these issues in a comprehensive manner.
- It is necessary to advance examinations on modalities of specific systems and measures for acceptance, taking into consideration the fact that foreign workers not only have their livelihood in Japan, but also their lifestyle.

**4. Concerns over Rising Labor Costs and its impact on International Competitiveness**

- It is expected that social insurance premiums will rise as the pension and medical care systems are reformed.  
→ This causes concerns that labor costs will rise and international competitiveness will decline.
- The rise of the social insurance premiums will increase the so-called “tax wedge”. Tax wedge is defined as percentage share to the total labor costs of the sum of income tax and social insurance premiums, contributed by employees and employers. If tax wedge is too high, it will discourage workers, squeeze corporate profits, undermine incentives to hire, and discourage companies to establish their business in Japan, etc.
- Japan’s tax wedge is still low compared with that of other OECD countries. So far, the impact of the tax wedge on the international competitiveness has been minimal.

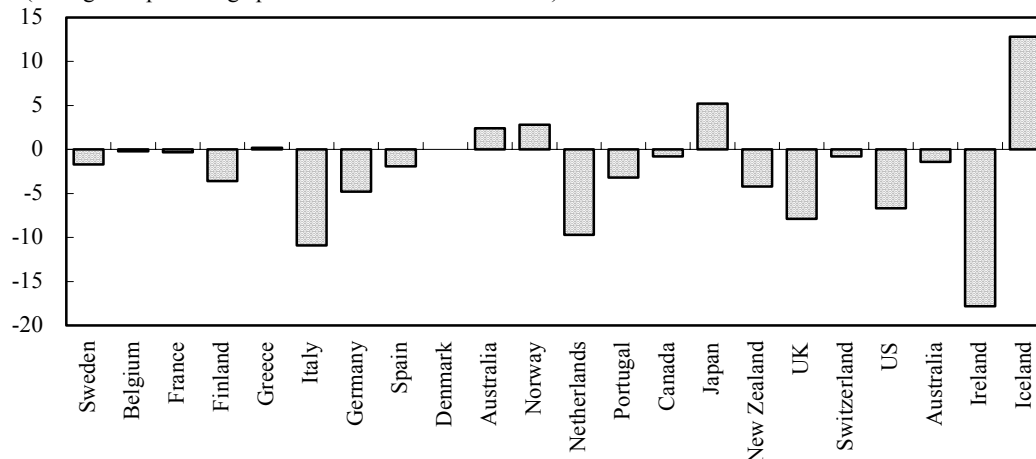
**Fig. 3-4-12 International comparison of tax wedge**

(1) Japan's tax wedge is still low when compared with other countries



(2) Tax wedge in Japan is on the rise

(Changes in percentage points between 1995 and 2002)



Notes: 1. From *OLIS*, OECD Database.

2. Tax wedge is the ratio against the total labor costs (pretax wage + social insurance premium contributed by employer) of the sum of income tax, social insurance premium contributed by employee, social insurance premium contributed by employer.

3. Government cash transfers are subtracted from the portion of social insurance premium contributed by employee.

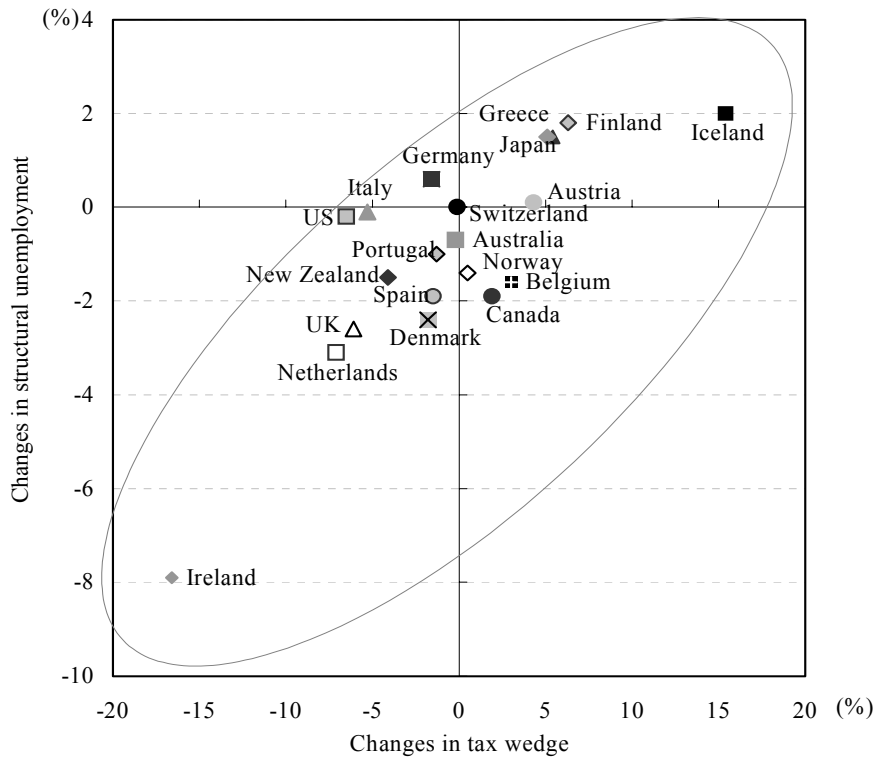
4. The standard for employee is married, with two children, whose income level is average for an employee in the production sector.

- There is a positive correlation between the increase in the tax wedge and the rise in structural unemployment.

→ Since the tax wedge is expected to increase as the ageing of the Japanese society continues, Japan must advance economic revitalization through implementation of structural reforms.

**Fig. 3-4-15 Relationship between structural unemployment and tax wedge (changes between 1991 and 2001)**

There is a positive correlation between the changes in tax wedge and the changes in structural unemployment.



- Notes:
1. For structural unemployment, OECD Employment Outlook 2003 (NAIRU calculated by OECD).
  2. Tax wedge is the ratio against the total labor costs (pretax wage + social insurance premium contributed by employer) of the sum of income tax, social insurance premium contributed by employee, social insurance premium contributed by employer.

## 5. Globalization and Competition Policies

- Competition policies consist of elimination and easing of regulations that restrict competition, and employment of the Antimonopoly Law to prevent corporate activities that restrict competition.
- The importance of enhancement and reinforcement of competition policies to put in place conditions required to ensure competition is increasing as a result of the advancement of economic liberalization on a global level.
- Coordination and harmonization of competition policies among countries will become necessary with a view to the dynamic implementation of international activities by companies.  
→ Movement for establishment of an international enforcement system
- The importance of competition policies is increasing in Japan as well, in line with the advancement of globalization and structural reforms.

## Conclusion

### ● Stronger Economic Recovery with Advancing Reforms

Thirty months have passed since the economy bottomed out in the beginning of 2002. During this period the average annual growth rate reached around 3%, of which the private demand contribution is more than 2%, indicating a private demand-led economic growth. Since the fall of 2003, a high growth rate of more than 5% was realized due to an increase in capital investment as well as a pickup in consumption, highlighting the dynamic recovery of Japan's economy against the other G7 nations.

The current recovery is driven by three forces. The first one is an increase in exports to the United States, China and other countries. External demand played a leading role in the early stage of the recovery. The second one is the structural reform centered on finance, regulations, tax system and public expenditure that achieved success in eliminating the pressure from the Japanese economy and contributed to the growth in private demand. The third one is the positive force achieved through a significant progress in the balance sheet adjustment, which took ten years following the collapse of the bubble economy, and an advancement of corporate reforms that have helped enterprises recover almost to the levels of the period prior to the collapse.

This recovery is different from the past two ones that took place in the 1990s in the following ways. First, the contribution of government expenditure to the growth is negative, and the recovery is led by private demand. Also, share prices in industries related to non-performing loans, such as banks, real estate, construction, and wholesale and retail, continue their upward trends, reflecting the progress in non-performing loan disposal, excessive debt reductions and rise in profitability rates, etc. Furthermore, the unemployment rate is falling in the course of economic recovery, as the sense of over-employment is fading out, and movements for creating employment are coming to the fore in the corporate sector.

The positive effects of both cyclical and structural factors, which underpin the economic growth, is behind the strong growth rate.

### ● Strength of Recovery Continues

On the unexpectedly strong growth rate, there is a cool-headed view that Japan's economic recovery is driven by external demand, and that it might soon suffer a setback due to changes of trends in the US and Chinese economies. However, the contribution of external demand to the economic growth was less than 30% in FY2003. Compared with previous recoveries, the current one is characterized

by the large contribution of private demand to economic growth. It is not appropriate to call it “external demand driven.”

Furthermore, private demand has a strong potential for recovery. This can be illustrated by the effects of the growing consumption of digital home appliances. These effects not only support the increase in consumption, but they also lead investment. Flat-screen TVs and other products with high value added tend to be manufactured at home, thus broadening the base of related domestic industries and spreading the positive effects over to other areas of demand. In other words, a virtuous cycle of consumption and investment is at work. Such a trend is reflected in the first increase in three years in domestic establishment of Japanese companies. This situation is in contrast with the economic recovery in 2000, which was centered on the IT sector, including personal computers and the increase in demand flowed out of Japan to other countries. In order to ensure sustainable recovery, it is necessary for an improvement in employment to lead to an increase in household finances, as this is expected to result in steady increase in consumption.

As for the structural reform, the related initiatives will continue to be steadily implemented in the future and will gradually bear fruit. Economic relief measures in the past, which depended on public investment, used to be implemented as temporary demand-driven maneuvers. Unlike them, the structural reform aims to thoroughly reinforce the foundations of the economic structure. Disposal of non-performing loans is advancing in order to reach the target outlined in the Financial Revitalization Program: to reduce major banks’ non-performing loans ratio by half by the end of March 2005. Initiatives for regulatory reform, including the steady and successful efforts in the Special Zones for Structural Reform, invigorate the economy.

- **Broadening the Recovery is needed**

It is believed that the economic recovery will continue, but still there are a few points of caution.

First, there are discrepancies in the recovery trends of regional economies and small and medium enterprises (SMEs) are still in the severe environment. Since the economic recovery does not rely on public spending, the economic recoveries of such regions as Hokkaido, Tohoku, and Shikoku are falling behind that of the favorable Tokai and Chugoku regions, etc. Also, the SMEs, which are faced with competition with low-priced imported products and with rising prices of crude oil, steel and other materials, are in the severe economic situation. An important task will be to spread the effects of the overall economic recovery to the areas that still fall behind. Toward this end, it is necessary to promote economic revitalization measures tailored to the characteristics of each region.

Second, there is a risk that the deceleration of foreign economies will have a negative impact. At the current phase of development of Japan's economy, inventory levels are low and there are no big build-up of capital stock. However, it is necessary to consider the possibility that, if deceleration occurs in the US and Chinese economies, adjustment mechanism of capital stock and inventories will come into effect through slowing down of exports. Even though the economic recovery is driven by private demand, a change in trend of the external demand which supports manufacturing, will have a rippling effect that cannot be ignored.

Third is the issue of overcoming deflation. Regarding asset deflation, there are signs that the situation is changing. Stock prices are on the upturn since the spring of 2003, and land prices around central urban areas have bottomed out. However, moderate deflation still continues as indicated by the rate of increase in consumer price index which is below zero. In order for the rate of increase in consumer price to steadily keep levels above zero, further improvement of the GDP gap and steady growth in money supply will be necessary. The government projects a nominal growth rate of around 2% or more from FY2006 onwards. Further united efforts to overcome deflation undertaken by the government and the Bank of Japan will be still necessary.

#### ● Addressing Concerns over Rising Interest Rates

Another source of concern for the private demand-led economic recovery is the movements of interest rates. However, a large increase in interest rates might have some negative impacts on the economy, through investment cost increases, expansion of losses associated with bond holdings, and heavier burden on public finance due to increase of interest payments.

The financial situation in the US is entering a phase of increase in interest rates, and long-term interest rates are projected to rise against the backdrop of dynamic economic recovery. The average view is that consumer price will continue to decline moderately during this year. Also, quantitative deregulation in Japan will continue until the economy surely emerges from deflation,. Therefore, the possibility for interest rates to put pressure on the economic development in the near future is considered low.

On the other hand, according to the past experiences, when economic boom and monetary easing continue over the long term, they may trigger the bubble. The asset bubble occurred in Japan in the late 1980s. The expansion of IT investments grew into a global bubble at the end of the 1990s, and the implementation of restrictive monetary policies resulted in the collapse of the bubble. Therefore, the role of monetary policy is expected in order to avoid both boom and bust, and make the recovery sustainable. It is important to strengthen the confidence of the market that deflation will be overcome,

and to increase the transparency of monetary policy. After emerging from deflation, it is an important issue with respect to monetary policy to present directions as to the extent and the duration of the easy monetary conditions, which would lead to stabilizing market expectations through dialogue with the market. A variety of discussions are seen including one proposes to present the conditions “until the prices reaches a certain rate of increase or level.” At any event, a wide range of examination is needed.

- **Continued Implementation of Structural Reform in Public Finance to Cope with Aging and Declining Birthrates**

One of the characteristics of the economic recovery that started in the beginning of 2002 is that it is not supported by public spending. This is a rare case for the period that followed the end of the high economic growth. However, the situation is that public investment indeed does not boost the economic growth, but tax reforms implemented in FY2003, such as the reduction of taxes related to research and development and capital investment are propping up the recovery of the economy. Such fiscal policy has become a common practice for the major nations in Europe and America in recent years. In other words, direct demand-driven policies such as public investment are not considered economy-boosting measures, though revitalizing the economic society by tax reforms could be implemented.

Ensuring sustainable stability of expenditure and revenue is extremely important in order to address the issue of declining birthrates and aging society. Improvement in the combined primary balance deficit of the national and the local governments has been advancing during 2004. Reform of public finance can be launched in a wide range of areas: social security system, national and local governments, tax system and expenditure, but in order to break away from the current critical situation in public finance, it is necessary to implement steady reforms by FY2006 in line with the policy for realization of primary balance surplus outlined in “Reform and Perspectives.” Such reforms include continued efforts for thorough reduction of expenditure coupled with judgment of necessary tax measures.

- **Globalization of Japan’s Economy into Asia**

Globalization is advancing in every aspect of Japan’s economy, from goods and services, to finance and labor. The utilization of IT and its most representative example, the use of computers, is further accelerating this process.

In retrospect, the movement of international economy centered on Japan is characterized by an expansion from activities focused on the US to activities that encompass Asia. For instance,



regarding trade of goods, transactions with Asian countries exceeded transactions with the US in 1988. As for the flow of services and finance however, the relations with the US remain of greatest importance. Against this backdrop, a new type of relations with the Asian countries in the field of manufacturing industries, called fragmentation of production, is being established. In addition, the impact of the collapse of the bubble economy in the 1990s have reduced the importance of Tokyo as a global financial center.

One of the benefits of globalization is that it is a widely and thinly spread process that thoroughly permeates the economy. Therefore, it is very difficult to experience it instantaneously. On the other hand, one of the setbacks is that the effects of globalization occur swiftly and in a concentrated manner in one specific area, and could cause a sudden bankruptcy of companies and subsequent unemployment. By the world standards, the Japanese are cautious about globalization. Unfortunately, it is impossible to clarify which of the setbacks attributed to globalization is indeed a genuine cause of problems. The expansion of the income gap, rather than being an issue inflicted by globalization, is an employment problem caused by insufficient response to the technological innovation.

- **The Necessity of Structural Reform that Materializes Globalization Benefits**

In order to gain benefits through free trade, it is necessary to implement structural reform to eliminate the obstacles to generating benefits, and to achieve maximum results from the market economy by utilizing the functions of price mechanisms.

In the past, Japan's economy has ventured into the flow of globalization, and has achieved significant benefits. However, many latent benefits still remain to be gained. These include the existence of a gap between domestic and foreign prices, the low level of direct inward investment, and the possibilities for accepting more skilled foreign workers.

Looking at the initiatives for structural reform launched in the abovementioned fields, it can be judged that reforms in the 1990s were implemented with significant delay. Even the concerns over the hollowing-out of Japan's industry associated with the transfer of domestic companies to overseas location are in fact caused by stagnation in employment creation stemming from the delay in structural reform. It is necessary to implement further structural reform in the fields of regulations, tax system, employment and others, and to draw out the potential benefits of globalization. Economic partnerships with the Asian countries, including free trade agreements (FTA), will achieve even greater results if they are implemented in line with initiatives for structural reform.

There are concerns that the increase in the tax-social security contribution wedge against the

backdrop of the aging society and declining birthrates will sap the vitality of the economy. So far labor costs have had little reduction effect on international competitiveness. However, from now on, an increase in the wedge is projected, it is important to consider the relationship between benefits and contributions build sustainable public finance-social security system, as well as promote the structural reform to revitalize the economy.

Globalization can also be a tool for stimulating the development of the tourism industry. This cannot be achieved by simply attracting tourists to Japan. It is necessary to improve the appeal of local regions to make them attractive for foreign visitors. It is important to launch efforts, and not only in the economic field, but in the fields of society and culture as well, to transform local regions into places that even Japanese people would like to visit or live in. Local economies should strive to capitalize on their respective characteristics, and implement efforts for community-driven vitalization. Such initiatives are already being launched in some regions.

#### ● **Isolation Can Not be an Option for Japan's Economy**

By subsuming an ever-increasing number of countries in its flow, globalization multiplies the benefits for the participating nations. This is the basic principle of achieving benefits from transactions under the conditions of market economy. Therefore, Japan needs to further advance structural reform in order to obtain benefits. Isolation from the global trends is not an option for Japan's economy. The flow of subsumption is swiftly gaining in power in the world economy, and Japan must not be left behind. This requires expeditious decision-making in implementing policies.

Globalization universalizes economic activities that are carried out in countries and regions subsumed in the globalization flow, and transforms them into activities that share common global standards. Thus, production factors such as labor and capital and products such as goods and services become standardized, and can be interchangeably used throughout the world. This will result in more efficient economic activities and a stable increase in global income levels.

On the other hand, such trends are consistently backed up by pro-industrialization values and therefore incorporate elements that are incompatible with other trends which respect more intellectual-type of values and demand diversified evaluations. Against the backdrop of the aging society and declining birthrates in particular, education, nursing care, medical care and others are areas where standardized services alone cannot sufficiently meet the requirements of the people. In the industrial field as well, knowledge is priced even higher and further development of sophisticated intellectual abilities will enhance the comparative advantage of Japan. From this perspective, Japan is now at a point where it must implement reforms that will draw out the benefits

of globalization, and parallel to this foster talented human resources that can respond to the needs of the age.

### ● **From Outward Globalization to Inward Globalization**

Globalization can be likened to a wave. Some people fear that it might erode and wash away national wealth. On the other hand, there are great hopes that the wave of globalization will bring riches. Which way globalization will affect the economy depends on the domestic economic structure of the recipient country. If outdated systems are preserved unchanged and fail to catch the wave, it will gradually erode the country's wealth. The ideal approach will be to advance structural reform in order to ride the crest of the wave, and thus proactively take advantage of the benefits of globalization.

In the past, Japan's economy used to obtain benefits through outward activities. However, it is expected to strengthen initiatives for obtaining benefits through inward activities by opening Japan to the globalization flow. Towards this end, Japan must build a new economic structure tailored to the new challenges and take the leadership position that befits its status as an advanced Asian country. The importance of the globalization perspective was identified back in the 1980s. However, almost no progress was made in initiatives to open Japan to globalization. Proactive efforts are required in order to solve this issue.

### ● **Nurturing the Buds of Reform Further**

According to the Annual Survey of Corporate Behavior (2004) carried out by the Cabinet Office, more than 50% of the respondents think that Japanese companies as a whole need to strengthen their restructuring efforts. The majority of the companies intend to pursue further restructuring, which is a positive sign for the future structural reform.

It is necessary to realize that today, when the buds of structural reform are coming to be seen and the economic recovery continues, is the turning point that will decide the future of Japan's economy. The baby boom generation will start to retire in 2007. It is important to advance further reforms and to reinforce the economic structure. Also, the process of overcoming deflation is still halfway through, and the government and Bank of Japan must undertake joint policy efforts. Even after deflation is overcome, it will be necessary to continue efforts to facilitate the flow of capital, labor and other production factors into highly-productive areas, to establish an economic relationship of sustainable household finances, companies and public sector under the conditions of price stability, and to set the economy on the path of steady growth.

In this report, analyses are presented from two viewpoints: revitalization of regional economies, and taking advantage of the benefits of globalization. The key to realizing sustainable growth in Japan's economy will be to redouble efforts for structural reform and continue to implement successful initiatives one by one in the fields of both regional economies and globalization.