



***Recovery or Recession? The Japanese Economy in 2005 and
EU-Japan Economic and Business Relations***

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Outlook

Introduction

The analysis of the Japanese economy is part of the EPC's EU and Asia Work Programme and is a first paper in a series of policy-oriented analysis monitoring Japan (politics, economic and security) and its political and economic relations with the European Union. Further in-depth analysis of EU-Japan relations, thus far neglected in academic literature and the press, will be one of the priorities of the EPC's EU and Asia Work Programme.

Japan's economic recovery: True or false? Temporary or sustainable? These questions currently occupy economists and analysts worldwide analysing Japan's, as yet, uneven economic recovery that began at the end of 2002. Encouraged (or misled as it turned out later) by reports on rising corporate profits in Japan, soaring exports to China and Europe and structural economic reforms which seemed to finally show the desired results, analysts and economists became increasingly optimistic throughout 2004 that Japan's economy had finally turned the corner and would soon enjoy sustainable growth rates again.

That optimism, however, turned out to be premature. Towards the end of last year, when Japan's government announced that economic growth rates had to be revised downwards as Japanese exports to China and the US were growing at a significantly slower rate than initially predicted, economists began to realise that they had been overly optimistic. Assessing the state of the Japanese economy and calculating economic growth rates became even more difficult in November 2004 when the Japanese cabinet introduced a new method calculating the country's GDP (see below).

Predictions of another possible Japanese recession issued in January and February 2005 were followed by reports that Japan might not be confronted with a recession after all in light of rising household spending.

Some of the commentators and economists who warned of a new recession in Japan at the beginning of 2005 now (as of March 2005) say that the economy experienced a "soft patch" in the first two months of 2005 (as opposed to recession). Given the still fragile recovery of the economy (at least on that most analysts agree) contradictory and incoherent reporting on the state of Japan's economy is likely to continue in 2005.

Twice in the recent past the Japanese government announced that it was on the path to economic recovery, after it injected massive amounts of money into the banking sector and the stock market. Contrary to conventional economic theories (and practice), the Japanese government believed that it could create the basis for the country's economic recovery through cash injections and by bailing out banks that should have been "allowed" to go bankrupt years ago. Misguided as they

were, these policies continued until the end of 2002 and only when a cash injection into the Japanese stock market did not produce any positive results, did the Koizumi government decide to abandon these policies. Without exception, cash injections turned out to be short-lived and unsustainable since these were mainly supported by short-lived capital injections into the economy or the stock market. Structural reforms of Japan's economy were not addressed and Japan was on the brink of becoming one of the least competitive economies among industrialized nations.

The scope of these interventionist policies over a decade is impressive. Since 1992, the Japanese government has fed roughly 120 trillion yen (roughly 860 billion euro) into the Japanese economy. This is an equivalent of 25% of the country's GDP, which has not only distorted only competition, but also "deterred" foreign investors from investing in Japan.

Currently, Japan is undertaking its third (and so far most successful) attempt at economic recovery since the burst of the country's economic bubble in the 1990s. The current recovery, however, is largely supported by increased external demand, increased investment and exports to China and the US. Although exports to China and the US are very likely to remain strong throughout 2005, a slowdown (three consecutive quarter since September 2004) of exports had an immediate impact on Japan's economic growth figures.

Recent (January 2005 onwards) news about negative economic growth ("recession" in other words) over three-quarters of a year in 2004 has confirmed pessimistic analysts' views that Japan's economic recovery is still far from sustainable.

The first part of this Issue Paper focuses on the analysis of the current state of Japan's economy, in an effort to determine whether or not Japan will be able to achieve greater economic recovery in 2005 and beyond. This part of the paper seeks to provide the reader with an overview of the most pressing problems of the Japanese economy and will analyse how current global economic trends are likely to impact the Japanese economy.

Among others, the following issues will be analysed:

- Japan's labour market problems/high unemployment rate amongst young workers (twice the national average)
- The prospects for economic growth in 2005
- Japan's sluggish domestic consumption
- Japan's massive public debt
- Japan's ongoing deflation
- The Bank of Japan's Monetary Policy
- Japan's labour market problem
- The role of exports seeking to achieve sustainable economic growth rates
- The state of play of Japan's de-regulation and de-centralisation efforts

In the second part of the paper, the analysis of the current state of the Japanese economy will be put into the context of EU-Japanese economic and business relations. The paper will conclude that a sustainable recovery of the Japanese economy is imperative to expanding EU-Japanese economic and trade relations and securing the interest of European investors to invest in Japan. The Japanese government has realised that new Japanese recession or even slow economic growth in 2005 and 2006 will continue to make the Japanese market relatively less attractive to European investors making them invest elsewhere in Asia – most frequently in China.

To make investing in Japan lucrative, Japan needs to move ahead with economic and structural reforms and make progress with the deregulation and decentralisation of its economy.

1. Economic Growth in 2005?

The Organization for Economic Development (OECD) predicts that Japan's growth in 2005 will continue to be slowed down by its "dualistic economy." Japan's economy is composed of restructured (and efficient) manufacturers and typically smaller non-manufacturers. The relative weakness of Japan's non-manufacturing sector will continue to limit improvement of the labour market. According to the OECD, Japan's export-led economic recovery will continue to be supported by a limited number of manufacturing industries while economic growth will be encumbered by the non-manufacturing sector and its excessive debt. Japan is a "divided" economy. On one side there is a high-performing and booming export sector. On the other side, there is an inefficient small business sector operating mainly in the domestic market, insulated from foreign competition. Productivity in this sector is low and unlike in the past, regional banks have become more reluctant to feed those businesses with low-interest rate credits.

In the course of 2004, the government had to revise Japan's GDP growth rates downwards. Whereas Japan's Cabinet Office predicted annual growth rates of 7.6% during the quarter between October and December 2003 and 6.4% in January-March 2004, in September 2004, the government acknowledged that annual growth in 2004 would slip to a mere 1.3%, based on quarterly growth rates from April-June 2003. As a result, a number of international research institutes revised their growth predictions and warned of a sharp drop in Japan's economic growth rates in 2005 (depending on the sources, this represents a drop of between 4.25% to 2.5% of the figures that were initially projected). Some sources even foresaw quarters of negative growth ahead for Japan (a prediction that turned out to be true, see below).

In the second half of 2004, household spending began again to fall gradually (for three consecutive months at a rate of 2.5% per month). This is of particular concern to Japan, as domestic consumption accounts for more 50% of Japan's

economy. Although Tokyo's numerous shopping districts remain crowded, Japanese consumers have become more cautious and less willing to spend their disposable income in Tokyo's exclusive department stores. Foreigners, however, visiting the bustling streets of downtown Tokyo on any given day of the week between eight in the morning and midnight find it difficult to be convinced of Japan's fledging economic recovery after a decade-long economic crisis. Department stores, once the flagship of Japan's domestic consumption, are still struggling and suffering from sharp decline in profits.

In December 2004, the OECD predicted that Japan would not be able to achieve a 2.25% growth rate until 2006, if it continued to remain unable to reduce the country's massive public debt. Unlike other economists who argue that raising taxes and cutting spending during a period of deflation is counterproductive, the OECD urges the government not only to cut spending but also raise taxes in 2005.

2. Export-led Economic Growth

Throughout the 1990s it was widely acknowledged among economists that "restructuring" and "economic reforms" were the key to Japan's economic recovery. Although domestic consumption seems to be picking up again (at least judging by the figures published in Mach 2005), Japan's economic growth will mainly depend (with structural reforms implemented) on the country's ability to increase its exports to China and the US and keep them at a very high level over the next couple of years. Strong demand from China in particular has been vital to Japanese industries such as steel, paper, shipbuilding and chemicals.

Record exports, as the case of Germany shows, however, do not necessarily lead the way out of an economic crisis. Germany is the world's biggest exporter, but reported record numbers of unemployment and economic growth rates that hardly exceed 1% demonstrate that economic recovery cannot be achieved through exports alone.

Data from the IMF and the OECD indicate that China accounted for 35% of Japan's total export growth in 2003 (similar data are expected for 2004). Moreover, Morgan Stanley estimated in mid-2004, that China accounted for roughly 30% of Japan's annualised economic growth rate. However, the positive effects of increased exports and capital investments have been partly neutralised by rising oil prices, the slowdown of the US (and Chinese) economy and the devaluation of dollar against the yen.

At the end of January it was reported that Japanese exports to China in 2004 have surpassed exports to the US for the first time. According to Japan's Finance Ministry, Japanese exports to China amounted to ¥22.200 billion (\$214 billion) while exports to the US amounted to ¥20.479 billion. China is now Japan's largest trading partner.

Economic growth figures published in March 2005 point to an export-linked economic slowdown in Japan. While the Japanese government maintained that that the export-linked slowdown of Japan's economy is typical for an economy in an adjustment period, the Economist recently pointed out that the slowing exports to China (and the US), will be less dramatic for Japan's economic growth than the media has claimed over recent months.

Japan's "exposure" to the Chinese economy, the paper maintains, often gets "overstated." Many of Japan's machinery and electronic components exports to China, the Economist points out, go to Japanese companies setting up factories in China from where they export products around the globe. According to the paper, Japanese exports would therefore not necessarily slow down if China's economic growth slowed.

Figures published in December 2004 indicate that Japan's trade surplus has shrunk by more than 40%. While exports increased by 13%, imports to Japan increased by 28% from a year ago amounting to US \$43.6 billion according to the Financial Times. Although Japan's shrinking trade surplus (The Financial Times referred to it as a "mirror of the US deficit") gives some reason for concern, the 13% rise in exports over 12 months and the record value of exports in November 2004 give little reason for pessimism with regard to Japan's trade. Currently, Japan's trade balance is influenced by high commodity prices, above all for petroleum. Petroleum imports to Japan rose by more than 50% over the last year.

3. Still no Inflation

A "healthy" dose of inflation, most economists argue, is a precondition for Japan's economic recovery. Toshihiko Fukui, who became the governor of The Bank of Japan (BOJ) last year, made the fight against deflation one his main priorities when he took office.

Fukui, unlike his predecessors, realized that Japan needs inflation to assure long-term economic recovery. However, achieving inflation will not be easy as expectations of flat or falling prices have been part of Japanese life for a number of years. It is widely agreed that that Japan will not escape deflation in 2005. Those in Japan who are warning of inflation in times of fragile economic recovery fear that it might weaken Japanese domestic consumption even further when coupled with rising prices.

The decade-long economic stagnation has made Japanese consumers more cautious and less willing to spend disposable income on luxury goods in Tokyo's department stores.

A rising yen and a falling US dollar will not help Japan achieve inflation any time soon. At end of January of 2005, the BOJ publicly acknowledged this reality by officially announcing that 2005 would be another year of deflation in Japan (the

8th year in a row). Unlike the OECD and the BOJ, the Japanese government are still officially convinced that a level of necessary positive inflation can be to secure a sustainable economic recovery in 2005.

Japan's consumer price index (CPI) has fallen for six years and the BOJ recently announced that not even a very modest 0.1% rise in CPI will be achieved in 2005. Analysts agree that the CPI will not increase despite significant expansion of the BOJ's money supply.

4. Monetary Policy - More of the Same Required

In light of Japan's fragile recovery, the OECD agrees with most analysts that the BOJ needs to stick to zero short-term interest rates. The OECD urges the BOJ to raise the threshold by one per cent (a rise of the CPI), putting an end to its 'quantitative easing policy' from the current zero per cent.

A minority of analysts on the other hand maintains that both interest rates and taxes will have to rise, in an effort to tackle the problem of Japan's enormous budget deficit and public debt. Higher taxes combined with higher social security contributions to get the country's public finances under control, however, will reduce prospects for stronger domestic spending in 2005 and could be counterproductive.

The BOJ, it is hoped, will retain its expansionist and ultra-loose monetary policy, providing the market with excess liquidity to achieve price stability above zero.

However, the Bank of Japan indicated in February 2005 that it might not be able to maintain its ultra-loose monetary policy indefinitely to fight deflation. Unlike many analysts inside and outside Japan, the BOJ seems to assume that Japan's economy will return to sustainable economic growth and inflation, even after the end of its 'zero interest rate' policy. That indeed seems to be an overly optimistic assessment, as Japan's recovery still very much depends on rising external demand and exports. It cannot (yet) count on stronger domestic consumption to support economic growth.

A rise of nominal interest rates, if implemented in 2005, is very likely to lead to a rise in real interest rates, threatening the economy's fragile recovery. In March 2005, long-term interest rates already rose from 1.3 to 1.45%, leading analysts to fear that the BOJ might indeed consider raising short-term interest rates in 2005.

The envisioned lowering of the BOJ's liquidity target (currently between US \$286 billion-US \$333 billion) could be followed by a rise in short-term interest rates, it is being said, which could be another indicator that an end to ultra-loose monetary policies could no longer be excluded.

5. Domestic Consumption (or lack thereof)

Analysts first warned that economic recovery was not being supported by increased private consumption in 2004, as rising corporate profits did not lead to an increase in salaried workers' wages. The continued decline in nominal wages will continue to weaken private consumption which is of particular concern as personal consumption accounts for more than 50% of Japan's GDP.

Japan's policymakers, however, are still counting on increased consumer spending as a counterweight to "expensive" exports. Domestic consumption - or the lack thereof - will remain a major issue in 2005. Japanese companies (unlike the Korean multinational Samsung which has turned to rewarding workers after the announcement of record profits in January 2005), will continue to remain reluctant to share profits with workers beyond a modest annual bonus.

Salaries at Japan's major corporations are no longer internationally competitive and Japan's graduates are increasingly looking for more lucrative positions at foreign companies based in Japan and elsewhere.

Unemployment is still high by Japanese standards. The Japanese government had its own explanation for the recent rise in Japan's unemployment rate: "The economic recovery is prompting people to look for new or better jobs and is one reason the unemployment rate temporarily rose," a statistics bureau official said late August 2004 in an interview with a Japanese daily newspaper.

Already, the youth unemployment rate is 10% - twice as high as the national average (5%) and unlikely to drop drastically, even if Japan experiences robust economic growth in 2005 and 2006. Structural reforms are accompanied by internal restructuring within companies, which has led to (at least temporary) rising unemployment.

In January 2005, Japan's Ministry of Finance warned that a rise in consumption tax would be necessary to reduce the country's budget deficit. This however could further weaken consumer confidence and consequently domestic spending. The Japanese government is currently seeking to avoid such a scenario and is putting significant pressure on the Ministry of Finance not to bring put this on the agenda.

Japan must fulfil the task of combining policies to achieve necessary inflation and stimulate and domestic consumption. Inflation (if it can be realised in 2005), however, means rising prices and possibly the continuation of sluggish domestic consumption.

6. Japanese Companies - Not Sharing the Profits Yet

Judging from the rhetoric, wage conditions on the one hand and salaries on the other hand do not seem to be a major issue for the Japanese government. In the

absence of pressure from the government on the corporate to adjust wages in times of rising corporate profits, Japan's major companies continue to take advantage of Japan's corporate culture that the company (and not the employee) "comes first."

Without sharing profits with workers, Japanese companies have over the last years cut costs and repaid trillions of yen worth of debt relatively quickly leading to rising profits. That turned out to be of particular importance as unprofitable companies were until the recent past being provided with massive credits and loans from the country's large banks and regional banks. This led to Japan's banking crisis bad loans worth trillions of yen.

7. A Soaring Public Debt

According to the OECD, Japan is heading for "fiscal disaster" if the government remains unable to reduce public spending. Confronted with a public debt of 160% of the country's GDP, (roughly 40% higher than Italy, Europe's "frontrunner" in terms of public debt) Japanese Prime Minister Koizumi is determined to reduce public spending in 2005 and has announced cuts for the coming year. However, recent figures indicate that the budget will increase by 0.1%, due to higher debt interest payments and increased social security expenditure. Cuts will be made in education, science, overseas development assistance (ODA) and public works. Furthermore, the government's "fiscal and loan programme," funding government agencies such as the housing loan corporation, will be cut by 16% in 2005. The programme, a *de facto* second budget for the government, has done its share to increase public debt to exorbitant levels over the last decade.

However, it remains yet to be seen whether these cuts are sufficient to reduce the budget to a sustainable level. To many analysts, the government's goal to have a balanced budget by 2010 is still entirely unrealistic, given that 69% of Japan's budget goes into the debt payment.

Currently, Japan's Ministry of Foreign Affairs and the Ministry of Finance are arguing over the scope and the areas of envisioned cuts in the country's budget. While the Ministry of Foreign Affairs urges the government to maintain the level of Overseas Development Assistance (ODA), the Finance Ministry is requesting sharp cuts in ODA payments. A cut in ODA payments, however, will weaken Japan's regional and global influence, given that Tokyo's so-called "foreign economic policy" (Jap. *keizai gaikô*) is still Japan's main foreign policy tool. The reduction of Japanese ODA would undoubtedly put Japan's strategy of exerting regional and global influence through "soft power," (including through financial and economic assistance provided through ODA) – into question.

Implementing regional and global foreign policies through "soft power" (as opposed to "hard power" and military means) is the concept Japan and the EU base their co-operation on, as formulated in the 2001 "EU-Japan Action Plan for

Joint Cooperation.” A cut of global Japanese ODA could indeed weaken an important (if not the most important) instrument of EU-Japan co-operation.

8. An End to the Banking Crisis?

Until the end of 2003, non-performing loans (or “bad loans”) issued by Japanese banks were one of the main blockages to Japan’s economic recovery. Now, this seems to have been overcome, thanks in part to an initiative by Japan’s Financial Services Agency’s (FSA), an initiative to force Japanese banks to write off their bad loans within a limited number of years (the government targets the year 2010). By mid-2004, it seemed realistic that the government could come close to achieving its target (announced in 2002) to cut the bad loan ratio to 4% of all loans by March 2005. Given the enormous amount of money involved, this government initiative can be described as the most successful in post-economic crisis Japan. The country’s biggest banks were able to reduce their stock of non-performing loans (NPLs) from 8 % of their total lending in March 2002, to roughly 4.5 % in September 2004.

The so-called “safety net,” a fund established by the Japanese government in the 1990s to bail out bankrupt Japanese banks has been abolished as well. The fund, equipped with cash taken from a total of roughly 60 trillion yen or roughly 452 billion euro, was cited by foreign investors and financial institutions as an example of unfair competition in Japan.

At the end of 2003, Japan’s banking sector had returned to operating profitability for the first time in more than 10 years, although the banks’ profitability rates still remained relatively low, measured by international standards.

Less progress on the other hand has been achieved in restructuring Japan’s regional banks, which play an important role in financing small and medium-sized enterprises (SMEs). The Japanese government has encouraged regional banks to continue providing SMEs with loans and low-interest credits and has still not completely given up of using the same strategy to bail out bankrupt regional banks. However, the government’s encouragement (and to certain extent pressure) to continue lending money to SMEs is likely to conflict with the banks’ responsibility to their shareholders and will lead to significant financial costs if SMEs (like in the 1990s) are unable to repay the loans.

Analysts widely agree that the regional banks, like the country’s main banks, must also be obliged to implement NPL-reducing strategies and decrease the level of lending to SMEs. SMEs are still struggling in Japan and the number of bankruptcies in recent years is an indicator that SMEs will remain risky debtors.

Despite Prime Minister Koizumi’s 2001 promise to stop using taxpayers’ money to inject billions of yen into quasi bankrupt companies and banks, a number of inefficient banks received massive government funding until the end of 2002. The

government showed itself equally generous with financially troubled (in many cases hopelessly indebted) construction companies, which in the 1980s and 1990s enjoyed quasi unlimited credit from (mainly regional) banks, building unnecessary roads and bridges throughout the Japanese countryside.

After taking office in April 2001, Prime Minister Koizumi made it his mission to reduce the number of unnecessary construction projects to a level that corresponded to actual demand. In 2002, Koizumi was able, - against the opposition of many of his fellow Liberal-Democrats - to scrap the 300 “most unnecessary” construction projects. Although widely perceived a successful initiative, it did not hide the fact a large number of superfluous building projects remained (above all in the countryside), largely underwritten by close relations between local politicians and construction companies.

The practice of bailing out the so-called “zombie companies” will remain part of Japan’s political culture, at least for the time being. Especially the construction sector still benefits from local politicians’ support and lobbying activities even if this practice (in many cases plain bribery) has been reduced in recent years.

9. Yet Another Recession?

In December 2004, the Bank of Japan (BOJ) downgraded its own assessment of Japan’s economic recovery, blaming the steel-shortage for the slump – or the “pause” of Japan’s economic recovery. Steel and iron imports doubled over the past year to make up for these shortfalls. The slowdown in overseas economies, above all in the US, and “excessive inventories” in the IT sector, the bank maintained, exacerbated current problems.

The steel shortage will undoubtedly have an impact on resource-heavy industries, like the car-manufacturing and shipbuilding sectors. In fact, it has already led to a temporary halt in production at Nissan Motor in December 2004. Experts at Suzuki Motor and a number of Japanese shipbuilders project it could lead to production cuts in the first quarter of 2005.

A drop in Japan’s industrial output by 1.6% between October 2004 - January 2005 aggravated fears of the onset of a new economic recession. According to the most recent government statistics, the information technology and digital product sectors suffered the highest output decline in the second half of 2004. This was of particular concern for Japan’s overall economy as these sectors helped to significantly to boost economic growth in 2004.

The most recent economic indicators (January 2005) indicate that the country’s economic recovery might have ground to a halt, albeit a temporary one. Government figures published in December showed that the country was once again at the brink of recession, having suffered from three consecutive economic quarters of gross domestic product decline.

Japan had zero growth between April and June 2004 and a negative growth rate (0.03%) from July to September 2004. At the very end of 2004, government figures indicated that Japan's economy had not grown at the predicted rate of 3.8% over the last two years. Instead, it had only increased by 2.6% over the previous twelve months.

This difference in predicted and real economic growth, however, is not necessarily a failure to accurately interpret economic data and indicators, but could also be explained by the fact that Japan applies other measuring techniques than the US and other western countries. Japan's very own measuring techniques and standards have been subject to criticism in the past. Tokyo has been accused of publishing indicators and data calculated by Japanese (as opposed to international) accounting standards.

As a result, Japan decided to revise its measuring techniques to make it more compatible with international accounting standards at the end of 2004. The new method forced the government to downgrade estimated economic growth by at least 1%, as Japan's old method exaggerated the GDP deflator and as a consequence did the same for real economic growth.

Additionally, Japan's GDP calculating method did not take falling prices into consideration, which is of particular importance given that Tokyo has been experiencing deflation for more than a decade. The Bank of Japan on the other hand has not yet adopted the new method (called "chain-linking") of calculating the country's GDP, as it would force the Bank to revise its own optimistic economic growth estimates significantly. These still differ from the estimates published by the Ministry of Finance. To guarantee transparency and accountability, however, the BOJ and the Ministry of Finance need to agree on a single method to calculate GDP.

Growth figures published in February 2005 indicate that Japan's economy shrunk by 0.1% from October to December 2004. Since the country's economy also was also reduced in two previous quarters, Japan is back in recession, defined as three consecutive quarters of negative economic growth (or three consecutive quarters of shrinking GDP). However, as the figures indicate, the fall in GDP from October to Dec. 2004 is only 0.1% compared to 0.2% and 0.3% in the previous quarters.

In January 2005, the OECD published a report predicting that Japan's economy was only likely to bounce back following six months of flat growth during the first half of 2005. The Japanese government, of course, interpreted this as encouraging news, claiming that the second half of 2005 would see solid economic growth rates in Japan.

10. A More Flexible Labour Market Needed

In some sectors, companies have begun to reduce or eliminate debts, close unprofitable divisions and cut workers' wages. The concept of lifelong employment, until recently the stronghold of Japan's employment system, has gradually been gradually eroded. This has led to a dramatic increase of part-time workers on the Japanese labour market over the last decade. The term 'part-time work' in the Japanese context, however, is misleading. It stands for full-time work (from 9 to 5 without overtime) on a relatively modest salary.

Whereas only a few years ago, 19% of the total workforce was part-time, the percentage has risen to 30% according to the latest statistics. This is, according to the OECD, creating a "dangerous divide between well paid, well-trained workers in permanent employment and a sub-class of poorly paid workers with low skills and fragile job security." Whereas the part-time system was initially understood as a new "flexibility" in the Japanese labour market, it is now creating a significant number of workers (mainly young) who move from job to job without improving skills and income. Although some of these workers earn more money doing 2-3 jobs at the same time than "regular workers," employed in a single company, this trend is increasingly creating a group of (permanently) inexperienced young workers with low human capital. On the other hand, the majority of economists welcome the government's initiative (formulated in a report titled "Japan's Vision for the 21st Century") to make it easier for workers to move between regular jobs without being considered "difficult" or "problematic" in the context of Japanese corporate culture.

Until recently, moving between regular jobs (especially when employed by one of Japan's major multinationals) was extremely unusual and unlike in Western countries, employees were put under significant pressure to "explain" the reasons for the change of job to a potential employer. In Japan's corporate world, it is still the employee's and not the employer's "fault" when the employee changes his or her job. This leads to an inconsistency between the accepted practice of switching jobs in the irregular/part-time sector and a resistance in the corporate world to consider changing more permanent jobs as part of a "normal" working life. This inconsistency needs to be addressed to contribute to the true flexibility of the Japanese labour market.

11. Deregulating and Decentralising, at last

The lack of the lack of regulatory reform in Japan has hindered sustainable economic growth.

Over the last five-ten years, Japan has made efforts (albeit too slowly and reluctantly, as the majority of economists now agree) to deregulate its economy both structurally in such areas as competition policy and transparency, and in

several key sectors including, telecommunications, housing, financial services, medical devices, pharmaceuticals and energy. However, progress is still slow in all of these areas, due to Japan's protectionist "instincts," its slow bureaucracy and decision-making progress. The Japanese government began addressing this problem in earnest in 1999, lifting barriers to market entry for both domestic and foreign companies. At the same time, both the Fair Trade Commission (FTC), responsible for competition policy, and the private-sector advisory Council for Promotion of Regulatory Reform have been strengthened and equipped with greater and more effective enforcement instruments.

The lack of market openness in Japan is still of particular concern to foreign businesses. Shortly after assuming office in 2001, Prime Minister Koizumi's government addressed this issue and two government bodies dealing with market access issues were moved to the Japanese Cabinet Office. The Office of Trade and Investment Ombudsman (OTO) and the Office for Government Procurement Challenge System (CHANS) came under Koizumi's direct control, but foreign investors are still confronted by a number of market entry hurdles, above all in the heavily protected and subsidised agriculture, telecommunications and automobile sectors.

A recent OECD report praises Japan's so-called "Special Zones Programme," a de-centralisation programme launched in 2002, as a positive initiative that has helped to stimulate growth in local economies. This programme has allowed local governments to ease regulations for foreign investors without interference or delays from the central government in Tokyo.

Further de-centralisation of the Japanese economy along with the transfer of responsibility and authority to local governments will be observed with great interest by European businesses, as it facilitates investments for small and medium-sized companies in Japan.

Japan's Kansai region (East Japan comprising Osaka, Kyoto and Kobe), in particular, would benefit from further de-centralisation. Already the Kansai region is the world's eighth biggest economy and comparatively low prices (compared with Tokyo) provide an added incentive for domestic and foreign businesses to invest in there.

12 .Getting Older and Saving Less

Japan, like a number of EU Member States, is in the middle of a demographic transformation which will have a significant impact on the country's economy in decades to come. Until ten years ago, a large part of Japan's population was middle-aged with a high savings rate. This generation, however, is now retiring which has a significant adverse effect on the country's overall savings rate. Worse, as mentioned above, Japanese companies have employed a growing number of part-time workers (mainly young university graduates and increasingly

society “drop-outs”) over the last decade, who, unlike their fathers and mothers, are less concerned with personal saving rates and long-term career planning.

Until a only decade ago, Japan’s private-sector saving rate was among the highest in the world. During the 1980s, a large number of workers entered the ‘high-savings’ age bracket (40-64 years), meaning that throughout the 1990s Japan’s gross national saving rates accounted for more than 30% of the country’s GDP (EU in comparison: 21-22%). This surplus capital, however, did not flow overseas and thus did not enable foreigners to buy more Japanese exports. Instead, Japan’s export capacities became too strong and the rest of the world could only import roughly one third of the goods Japan needed to export to grow in the 1990s.

Instead, surplus capital was used by Japanese companies (above all by construction companies, (supported by low interest rates, questionable banking practices and pressure from national and local politicians, who had overly close relations with the construction sector) to produce over capacity causing a short-term rise in GDP. In the longer term, however, as Robert Madsen writes in the Financial Times, it created industrial distortions and led to over capacities, further cementing the negative effect of the ‘bad loan’ problem, as companies were longer able to repay credits.

Given its ageing society and the demographic challenges the country finds itself confronted with, Japan needs to change its immigration policy and allow more foreign workers in to partly compensate the obvious negative societal impact. The rate of foreigners living and working in Japan amounts to a modest 0.9% - by far the lowest rate amongst industrialised countries.

13. Recovery or Recession: Implications for EU-Japan Economic and Business Relations

The question whether Japan’s economy will return to sustainable economic growth in 2005 and beyond will naturally matter to EU-Japanese economic and business relations.

Japan’s economic crisis throughout the 1990s undoubtedly had a negative effect on economic and business relations between the EU and Japan. Whereas China’s economic growth figures seem to indicate that it is on a steady path to replacing Japan’s as Asia leading economy, the negative economic headlines from Japan until recently have certainly “deterred” European investors from increasing their investment levels. .

Japan is the fourth largest export market for the EU (after the US, Switzerland and China). According to EU statistics, Japan accounts for more than 8% of EU agricultural exports, 6% of textiles, 5.4% of chemical products and 4.6% of transport materials. After the US and China, Japan is the third largest source of imports into the EU. In other words: EU-Japanese economic and business

relations are significant and the EU has a strong interest in the return of sustainable economic growth in Japan.

However, the expansion of economic and trade relations between the EU and China currently dominates the headlines, giving the impression that EU-Japan economic relations are not of primary concern to the EU and its Member States. The EU and China have increased bilateral trade steadily and significantly over the last years. Since December 2004, China has become the EU's (EU-25) second largest trading partner after the US. According to Eurostat, EU-China trade has more than doubled between 1999 and 2003, with exports rising from 19.6 billion euro to 41.2 billion and imports growing from 52.4 billion euro to 105.3 billion euro over the same time frame. In theory at least, Japan should have a competitive advantage over China given the fact that Japan is a politically stable and does not suffer the negative consequences of industrial disputes. It is a developed country able to provide a business and investment-friendly environment. Reality, however, seems to be different and foreign investors still complain about the difficulties of investing in Japan and the 'red tape' that needs to be overcome to conduct business in Japan.

14. EU-Japan Imbalances

Inward and outward foreign direct investment (FDI) has influenced the restructuring of the Japanese economy and can be expected to continue to do so in the future. Outward investment has helped Japanese firms to sustain foreign market shares and contributed to the restructuring of the Japanese economy. However, Japanese outward FDI still does not have sufficient impact on the Japanese economy, despite rapid growth since the mid-1980s, and there is still scope for a significant increase, when compared with the levels of most other OECD countries.

Although the stock of Japanese inward foreign direct investment is still relatively small, there important changes have been introduced since Mr. Koizumi took office in 2001. In recent years, Mr. Koizumi has emphasised numerous times that efforts to overcome "suspicions" of foreign ownership in Japan are essential to doubling inward FDI within five years.

The EU Commission has repeatedly urged the Japanese government to address the over-regulation of the Japanese economy which has led to a significant imbalance between Japanese inward FDI flowing into the EU and EU outward FDI flowing into Japan.

Whereas by the end of 2002, 4.6% of EU inward FDI came from Japan, only 1.3% of EU outward FDI went to Japan. However, the EU is still the largest source of FDI in Japan even if EU investments in Japan are mainly limited to a small number of what the EU Commission refers to as "big ticket operations" or "rescue

acquisitions.” Renault’s acquisition of Nissan and DaimlerChrysler’s (temporary) acquisition of Mitsubishi Motors are examples.

As the figures over recent years indicate, European investors seeking to invest in Japan were less willing to engage in time-consuming negotiations with Japanese authorities and instead chose to invest elsewhere in Asia.

The EU has repeatedly emphasised the need for Japan to take corrective measures to reduce trade and investment imbalances. While Japanese exporters to the EU enjoy the possibility of selling to a single market of 450 million consumers, Japanese domestic regulations are effective barriers to foreign exporters in many sectors, especially where some of the regulations require a long-term presence or peculiar exposure to the market before being able to engage in new business sectors or expand existing business.

15. EU-Japan “Regulatory Reform Dialogue”

The EU is critical of the problematic and above all time-consuming procedure to receive legally-binding guidelines from Japanese authorities concerning regulatory issues. This lack of transparency still creates insecurities for European investors and stands in the way of providing an open trade and investment environment between Japan and the EU.

The EU maintains that Japan upholds, excessive regulations in many areas, including agriculture, transport services, telecommunications and others.

In order to address these problems, the EU and Japan established the so-called “Regulatory Forum Dialogue,” in 1995, which addresses EU concerns regarding Japanese protectionist practices and over-regulation.

The objective of the regulatory reform dialogue to “find a non-confrontational way to deal with problems inhibiting the strong growth of the two-way trade and investment,” according to the EU Commission. However, given the obstacles European (and other foreign investors) are still facing in Japan (some of them have been addressed in the WTO context), one of the major goal of the dialogue is to address the problems caused by Japanese protectionism and over-regulation deterring European investors from investing in Japan.

The EU maintains that sectoral and framework condition reforms need to be adopted quickly to complete the transition from a state-led growth model to one that is driven by market concerns to secure the expansion of economic relations between Japan and the rest of the world, including the EU. The Japanese government officially agrees, but it remains to be seen in the coming years whether Japan will be able to live up to its promise and create the business environment European and others investors have been requesting for more than a decade.

Despite a number of still unresolved issues, the bilateral dialogue has led to some progress with regard to market access in Japan, including the asset management sector, a sector almost impossible to penetrate for foreign investors until only a few years ago.

In accordance with the government's newly implemented so-called "Three-year Plan and Programme for Regulatory Reform" (March 2004), Japanese ministries are now obliged to conduct so-called regulatory impact analysis (RIAs) to assess the success de-regulatory initiatives. However, - and this is not untypical for Japan (and other Asian economies) - the Japanese government maintains that formal and legally-binding obligations with regards to RIAs will only emerge after an "experimental" and "introductory" phase. EU officials and European business leaders await the outcome of both "phases" with great interest.

Prime Minister Koizumi's deregulation initiatives have indeed opened up much of the industrial and service sectors to foreign multinationals, at least in theory. However, suspicions of anything "foreign" is still deeply embedded in the Japanese society and Japanese domestic companies, financial institutions etc. will continue to take advantage of the public prejudice that anything "non-Japanese," - banks and financial institutions included - is to be avoided.

Despite the recent reforms in the financial, telecommunications and distribution sectors, foreign investment in Japan, compared to other industrialised countries, remains relatively low, amounting a to a modest 2.2%.

Outlook

The decade-long Japanese economic crisis has shown that Japan's economic development strategy was successful until the late 1980s, but is no longer successfully applicable in times of economic globalisation and global competition. Japan's strategy of government intervention and planning through the use of fiscal stimulus packages, increases in the monetary base, interest rate cuts, bailouts and the nationalization of bankrupt banks initially led to the burst of the economic bubble in the 1990s, which in turn led to an economic recession that only ended two years ago.

So far, the radical market-based overhaul of Japan's economy Japanese Prime Minister Koizumi promised upon taking office has not yet materialised.

The plan was to let market forces set in, letting weak and inefficient banks and companies go bankrupt. These policies and badly-needed structural reforms (unlike corporate restructuring, which led to the return of significant corporate profits amongst Japan's major companies relatively quickly), however, remain only partially implemented until the present day.

Analysts estimate that Japan's economy needs to grow at least another 18 months to overcome the negative effects of Japan's bubble economy years. The falling dollar will continue to hurt Japanese exports and it remains unlikely that the dollar's value will increase any time soon, given the massive US budget deficit and the costs for the war in Iraq.

To achieve long-term economic growth, the badly-needed structural reforms need to be implemented beyond the current level and the government needs to do more to encourage and promote competition, deregulation and privatisation.

Corporate profits need to be accompanied by the creation of new jobs to push Japan's unemployment rate below the 5% mark and to avoid a US-style 'jobless' economic recovery in the future. The most recent news on the creation of 470,000 new jobs are encouraging. Deregulation and improving labour productivity will remain a key issue in 2005, as Japan's labour productivity is more than 30% below US labour productivity.

As explained in detail above, sustainable economic growth in Japan depends on a number of key issues that need to be addressed in 2005 and beyond:

- an end to deflation with its negative implications for growth
- ensuring fiscal sustainability and implementing the public debts initiative
- improving relations between different levels of government in order to benefit more fully from de-centralisation and de-regulation
- increasing the fiscal discipline of local governments
- raising Japan's growth potential through structural reform and stronger competition and improving the functioning of the labour market
- achieving progress in regulatory reform and market transparency to attract foreign investors

None of the goals, however, are achievable in 2005 to the extent that they would guarantee a sustainable and long-term economic growth of the Japanese economy. Japan's economic recovery is likely to remain fragile and will continue to be an export-led growth regime for years to come.

Putting an end to the BOJ's ultra-loose monetary policies ("threatened" by the bank at the beginning of 2005) and raising taxes (as suggested by the Ministry of Finance) simultaneously could imply a temporary halt to Japan's economic recovery and should therefore be avoided.

"They are tip-toeing to another major policy error" an analyst from LehmanBrothers was quoted as saying in the Financial Times recently, indicating that these and other misguided economic policies might trip-up Japanese efforts at turning the economic corner.

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