Medium-Term Prospects for the Japanese Economy and for U.S.-Japan Relations

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Summary

Current State. The Japanese economy shows no strong signs of recovery through early 1994, but some indicators are showing gradual improvement.

Prospects for 1995 and 1996. Real GNP growth rates for the years ending March 31, 1995 and 1996, are expected to remain around 1% unless much stronger monetary and fiscal policies are adopted.

Background for Current Conditions. One of the principal causes for continued slow economic growth is the aftereffects of problematic management of monetary policy which led first to the "bubble" in asset prices, then contributed to the rise in nonperforming loans, and subsequently has resulted in overly conservative bank lending policies. Other factors include the delays in formulating and implementing fiscal policies because of the paralysis stemming from the political scandals and instability, the slowness to make needed structural changes that will enable the banking sector to deal with bad loans, and the overvaluation of the yen.

Revitalization of the Economy. One of the principal requirements will be to improve the effectiveness and timing of monetary and fiscal policies. Specifically, this will mean taking much more aggressive steps to write off nonperforming bank assets as well as formulating the proper level of fiscal stimulus and implementing it with the proper timing. Another major requirement will be to take better advantage of the strength of the yen. Many large Japanese companies have adjusted very adeptly to the rising yen, but this had been at the cost of putting a squeeze on smaller companies and restraining growth in incomes. A much more concerted program of expanding imports will be necessary to realize the full benefits of the strong yen. Otherwise, Japanese consumers, and by extension, companies, will face continuing yen appreciation and a squeeze on incomes. In parallel, a continually strengthening yen will raise the cost of Japanese goods to foreign purchasers, and much of the benefits of increased productivity in Japan will accrue neither to Japan nor to its trading partners.

Improving U.S.-Japan Relations. If Japan takes the measures noted above to revitalize its economy, this will have a major beneficial impact on relations between the two nations. For its part, the U.S. government and American corporations need to examine much more carefully the

opportunities that are opening up or can be opened up for exporting to and investing in Japan. While significant improvements have been made in U.S. product competitiveness, much more effort is needed to break through remaining barriers that include not only various kinds of resistance in Japan but also the results of inadequate attention to investment in Japan by U.S. companies.

Current State of the Japanese Economy

The figures in Exhibit 1 suggest there is little evidence that the Japanese economy has entered a period of robust recovery, notwithstanding recent newspaper reports indicating the next economic upward trend is imminent. Gross domestic product (GDP) declined 0.6% in the October-December quarter of 1993 because of further shrinkage in capital investment and in net exports of goods and services. This follows three consecutive quarters of decline in 1992 and a drop in the second quarter of 1993.

As Exhibit 1 indicates, the strongest components of GDP are residential investment, public investment, government consumption, and private consumption. The rise in private consumption in the July-September and October-December quarters of 1993 and the upward trend in residential investment since the April-June quarter are the principal private-sector components where recovery seems to be in progress.

Growth in real consumption has been fueled mainly by moderate increases in annual compensation of employees and the decline in consumer price inflation. As Exhibit 2 shows, however, even with recovery in the last two quarters of 1993, real private consumption on an annual basis has been on a steady downtrend since 1989. A major factor behind this, shown in Exhibit 3, has been the steady drop in the growth rates of both current price and real compensation of employees since 1990.

Developments contributing to this downtrend have included the deterioration in labor market conditions. As indicated in column five of Exhibit 4, the ratio of job openings to applications has dropped from over 1.0 in 1992 to only 0.67 in January 1994. This is comparable to levels during the 1986-87 slowdown that followed the sharp appreciation of the yen. Similarly, the number of persons receiving first payments of unemployment insurance has also risen sharply over the past three years (Exhibit 4). Interestingly enough, as in past recessions, there has

Exhibit 1: Quarterly Movements in Principal GDP Components (1985 Prices, Seasonally Adjusted)

(% Change from Previous Quarter)

Calendar Years Quarterly	Private Consumption (C)	Residential Investment (H)	Nonresidential Investment (I)	Government Consumption (G_C)	Public Investment (G_I)	Net Exports (NE)	Exports (E_X)	Imports (I_M)	GDP
1991									
I	0.0	2.0	2.2	1.2	-0.1	**	0.9	-2.3	1.2
II	1.5	-6.1	0.2	-3.0	3.8	**	-0.7	-2.0	0.9
III	0.5	-4.1	0.3	2.0	-0.4	68.4	3.3	2.6	0.7
IV	1.0	-4.5	-0.7	1.9	4.5	191.2	2.3	-0.8	0.7
1992									
I	0.5	-1.3	-0.7	0.4	3.0	15.8	0.9	0.2	0.5
II	-0.4	2.7	-1.7	-0.7	8.0	23.2	-0.2	-1.5	-0.5
III	0.5	-0.3	-2.0	0.5	-0.3	13.8	1.8	0.9	-0.1
IV	-0.3	-2.2	-3.2	1.9	3.4	19.4	1.0	-0.5	-0.3
1993									
I	1.3	-2.2	-0.8	0.2	7.0	-5.8	1.1	1.8	0.9
II	-0.6	2.7	-3.0	1.1	4.2	-39.4	-1.9	1.4	-0.5
III	0.4	9.0	-2.0	0.6	0.9	11.9	0.8	0.2	0.3
IV	0.7	1.8	-3.5	0.9	1.5	-72.9	-2.2	2.0	-0.6

Source: Economic Planning Agency, *Quarterly Estimates of National Expenditure*

Notes: (1) ** indicates a large percentage change in a small figure.

(2) Figures for exports and imports are for goods and services only and exclude factor incomes received and paid.

Exhibit 2: Annual Movements in Principal GDP Components (1985 Prices)

(% Change from Previous Quarter)

Calendar Years	(C)	(H)	(I)	(G_C)	(G_I)	(NE)	(E_X)	(I_M)	GDP
1989	4.3	0.5	16.6	2.0	-2.2	-610.4	9.0	17.6	4.7
1990	3.9	4.7	11.4	1.9	4.5	**	7.3	8.6	4.8
1991	2.2	-8.2	6.6	1.6	4.7	**	5.2	-4.1	4.3
1992	1.7	-6.7	-4.0	2.2	14.6	309.4	5.2	-0.4	1.1
1993	1.1	3.7	-8.4	3.2	15.9	-27.1	1.0	3.2	0.1

Source: Economic Planning Agency, *Estimates of National Expenditure*
Notes: (1) ** indicates a large percentage change in a small figure.
(2) Figures for exports and imports are for goods and services only and exclude factor incomes received and paid.

Exhibit 3: Annual Compensation of Employees

(% Change)

Calendar Years	At Current Prices	At 1985 Prices
1989	7.4	5.4
1990	8.6	5.9
1991	7.8	5.3
1992	4.1	2.0
1993	2.3	1.2

Source: Economic Planning Agency, *Estimates of National Expenditure*

Exhibit 4: Indicators of Consumer Spending, Housing, and Labor Market

Calendar Years	Retail Sales Index (1990=100, S.A.) (1)		Department Store Sales (YOY growth) (2)	Car Sales (YOY growth) (3)	New Housing Starts (YOY growth) (4)	Job Openings to Applicants (Ratio) (5)	First Recipients of Unemployment Insurance (1000 persons) (6)
Quarterly							
1992							
I	105.8	-0.6 %	-0.4 %	-5.1 %	-8.4 %	1.24	88
II	105.0	-1.6	-2.3	-7.1	0.5	1.13	114
III	104.0	-3.6	-3.7	-9.7	8.9	1.03	109
IV	101.5	-5.6	-6.1	-12.6	8.0	0.94	100
1993							
I	101.7	-4.7 %	-6.4 %	-2.2 %	5.8 %	0.89	110
II	100.5	-4.8	-7.2	-9.4	2.0	0.80	141
III	100.2	-4.1	-5.9	-6.2	8.6	0.71	128
IV	98.1	-3.2	-6.9	-5.5	7.1	0.66	119
Monthly							
1993							
J	99.7	-3.8 %	-6.2 %	-10.0 %	4.6 %	0.73	129
A	100.0	-3.3	-4.6	-4.7	10.9	0.71	135
S	100.8	-5.1	-6.7	-2.7	10.6	0.69	120
O	99.2	-5.2	-6.5	-6.8	7.8	0.67	108
N	98.1	-2.2	-8.3	-4.2	8.7	0.66	126
D	96.9	-2.1	-6.2	-5.7	4.9	0.65	
1994							
J	101.3	-0.2 %	-2.5 %	-1.4 %	20.7 %	0.67	121
F				-6.8			125

Notes: (1) Ministry of International Trade and Industry; S.A. (seasonally adjusted)
(2) Japan Department Store Association; YOY (year-over-year)
(3) Japan Automobile Dealers Association; YOY (year-over-year)
(4) Ministry of Construction; YOY (year-over-year)
(5) Ministry of Labor; job openings divided by job applicants
(6) Ministry of Labor; monthly average. Average for 1985, 110; for 1986, 121; for 1987, 118.

been only a marginal increase in the rate of unemployment, presumably because of the practice of keeping redundant employees on the payroll as part of the career-long employment system. The percentage of the labor force unemployed in December 1993 was 2.8%, virtually the same as in the previous slowdown in 1986-87. Estimates of actual unemployment, including underemployed remaining at work, range between 5% and 6%.

The three general indicators of consumer spending in Exhibit 4—the retail sales index, year-over-year changes in department store sales, and year-over-year changes in passenger car sales—all reflect the impact of slower growth in incomes. Retail sales in the last quarter of 1993 were about 8% lower than in early 1992. Among retailers, department store sales have been most affected by the recession because of their greater emphasis on higher-cost luxury items, which consumers have tended to shun since 1991. Passenger car sales have also been seriously affected by the recession and continued to be down more than 6% year-over-year in February 1994. As some optimistic analysts have pointed out, however, the same three indicators show signs of moving out of negative territory, suggesting the beginning of a weak recovery.

For housing investment, continuation of low mortgage rates, latent demand for upgrading of the housing stock, and falling land prices have been the main factors driving the recovery. As the fourth column in Exhibit 4 indicates, new housing starts have been the strongest single component of GDP in terms of year-over-year expansion[1].

A careful reexamination of Exhibit 1 suggests, however, that besides the anemic recovery in private consumption and the uptrend in residential investment, there is unfortunately little evidence that the Japanese economy is about to stage a strong comeback.

To illustrate, nonresidential investment (private capital investment) is still declining, having fallen 4% in 1992 and then 8.4% in 1993 (Exhibit 2). The figures in Exhibit 5 do not argue for an early recovery in capital investment. The manufacturing production index was still about 10 points below the 1990 level in late 1993 and fell further in January 1994. The same was true for the producers' shipment index. The producers' inventory index has declined, but remained more than 10 points above 1990 levels in early 1994. The inventory ratio index (based on the ratio of inventories to shipments) has shown little improvement and remained more than 22 points above 1990 levels. The capacity utilization index

Exhibit 5: Indicators of Industrial Production

(1990=100, % change, year-over-year)

Calendar Years	Manufacturing Output		Producers' Shipments		Producers' Inventory		Inventory Ratio	Capacity Utilization
Quarterly	Index	%	Index	%	Index	%	Index	Index
1992								
I	96.6	-4.5	98.6	-2.6	114.1	9.9	113.7	93.2
II	95.0	-6.2	94.4	-5.4	112.3	5.6	116.8	90.9
III	95.1	-6.1	96.8	-5.4	113.0	3.9	117.5	89.2
IV	95.2	-7.7	95.6	-6.9	112.0	0.6	121.3	86.4
1993								
I	91.8	-5.0	94.8	-3.9	111.3	-2.5	118.1	87.0
II	90.9	-4.3	90.9	-3.7	106.9	-4.8	117.2	85.8
III	91.5	-3.8	93.6	-3.3	109.0	-3.5	119.3	84.2
IV	90.7	-4.7	91.5	-4.3	108.1	-3.5	124.9	80.4
Monthly								
1993								
J	95.6	-4.4	96.2	-4.0	111.5	-3.9	119.6	84.5
A	83.6	-2.6	84.8	-1.9	110.2	-3.3	121.7	83.6
S	95.2	-4.4	99.8	-3.8	105.2	-3.6	116.6	84.6
O	90.5	-6.6	91.0	-5.8	107.5	-3.7	124.6	79.4
N	91.3	-3.3	91.4	-3.3	109.8	-3.2	124.0	81.5
D	90.2	-4.4	92.0	-3.8	107.1	-3.4	126.0	80.4
1994								
J	80.6	-3.0	80.4	-3.1	110.6	-3.1	122.3	81.5
F								

Source: Ministry of International Trade and Industry shows about 20% excess capacity on average for the manufacturing sector, assuming capacity was near full utilization in 1990[2].

After strong growth through 1992, export expansion fell to only 1% in 1993. Imports, after declining in 1991 and 1992, were up 3.2% in 1993. As a result, net exports now account for less than 1% of gross domestic expenditure[3].

The government has maintained growth in its consumption expenditures and substantially increased public investment expenditures. As Exhibit 2 shows, government consumption was up 3.2% in real terms in 1993, the highest figure in several years. Public investment rose sharply in both 1992 and 1993, reflecting the economic stimulus packages. These figures would have been higher if reports that many projects were delayed by the construction industry scandals are correct.

Despite these government efforts, however, as the figures examined thus far suggest, the economy has responded only weakly. As the data on inflation rates in Exhibit 6 show, however, there is probably considerably more room for adopting expansionary monetary and fiscal policies. Wholesale prices are more than 3% below those of the prior year and consumer prices only about 1% higher.

Prospects for 1995 and 1996

Let us take the major components of GDP individually:

• **Consumption.** The base wage increase for the spring of 1994 is expected to average about 3%, but cutbacks in overtime and bonus payments will continue, thus lowering the overall average. With consumer price inflation continuing at about 1%, growth in real consumption for the fiscal year ending March 1995 is likely to average under 2%. The scheduled reduction in individual income taxes of ¥6 trillion will help to sustain the moderate upward trend in consumer spending, but this cut in income taxes is for only one year and the impact of the tax cut will be diluted by the scheduled increase in social insurance premiums, which will amount to ¥4 trillion on an annual basis, and hikes in a broad range of charges for public services, such as rail fares and communications charges. Some estimates indicate that the impact of higher social insurance and public service charges will actually reduce the income of households below the average annual income of approximately ¥7 million. Most of the beneficial impact will be in the upper-income categories where propensities to consume are lower.

Exhibit 6: Wholesale and Consumer Price Indices

(1990=100, % change, year-over-year)

Calendar Years	Wholesale Price Index		Consumer Price Index	
Quarterly	Index	%	Index	%
1992				
I	98.2	-2.0	104.1	1.9
II	98.2	-1.5	105.5	2.2
III	97.9	-1.4	105.1	1.8
IV	97.1	-1.5	105.5	1.0
1993				
I	96.6	-1.6	105.5	1.3
II	95.2	-3.1	106.4	0.9
III	94.3	-3.7	106.9	1.7
IV	93.9	-3.3	106.6	1.0
Monthly				
1993				
J	94.7	-3.4	106.7	1.9
A	94.1	-4.1	107.0	1.9
S	94.1	-3.7	107.1	1.5
O	93.9	-3.2	107.0	1.3
N	93.8	-3.4	106.4	0.9
D	93.9	-3.3	106.5	1.0
1994				
J	94.0	-3.1	106.6	1.2
F	93.5	-3.2		

Source: Bank of Japan

Growth in incomes and real consumption will probably not exceed 2.0% in fiscal 1995 and 2.5% in fiscal 1996, even assuming an optimistic scenario.

• **Investment.** Some leading corporations have announced that their restructuring activities will begin to pay off in net income gains for the fiscal year ending March 31, 1995. If so, this will put an end to a four-year slide in corporate profits and may stimulate some recovery in capital investment. But the recovery may very well be quite weak. Excess capacity in manufacturing varies widely from industry to industry, but is estimated to still be about 20% overall[4]. In addition, private capital investment is continuing at an annual rate of more than ¥76 trillion, or US$700 billion, compared to the peak of ¥89 trillion in 1991. A rough calculation shows that, even at this reduced level, investment per worker is still twice the level in the United States[5]. Another point to bear in mind is that estimates of rising profitability are generally based on exchange rates of between ¥100 and ¥105 to the dollar. Appreciation into the ¥90s could erase profits for export-oriented companies and necessitate another round of cost-cutting and restructuring. Investment in commercial properties is gradually shrinking, as projects planned and under way in the early 1990s are completed. The current vacancy rate for office space in Tokyo is estimated at 8% (versus 1% in the late 1980s) and is expected to rise to 16% as projects in progress are completed by 1996. A leading Japanese bank has estimated that excess office space will not be fully occupied until after the year 2000. A serious slump in construction activity therefore appears likely from 1996 through the end of the decade. Overall, private capital investment is likely to continue to decline about 5% each in 1995 and 1996.

• **Residential investment.** The continuing demand for upgrading of the housing stock, low interest rates, and declining construction costs will sustain residential investment at a high level, but the real growth of 3.7% in calendar 1993 will most likely decline to about 3% in fiscal 1995 then rise to 5% in 1996.

• **Government current account expenditures and capital formation.** Current account expenditures of local and national governments are expected to continue to move upward at between 2% and 3% annually. Public works spending would appear to have room for further growth given continued high savings rates and low inflation, but a variety of political and other considerations may intervene. Japan gave a loose commitment during the Strategic Impediments Initiative talks under the Bush administration to invest more than ¥400 trillion in public works projects. There are still many potential infrastructure projects in transportation and other fields that might be undertaken. With a continuing shortfall in revenues, however, the Ministry of Finance (MOF) is not likely to alter its stance for restraining government expenditures and minimizing reliance on deficit financing, especially since its hand, if anything, has been strengthened by the recent political turmoil. An optimistic scenario calls for growth of 5% each in government capital formation expenditures in fiscal 1995 and 1996.

• **Net exports.** Despite often accurate descriptions of closed markets in Japan, imports of goods and services in real terms in the GDP accounts have risen steadily in recent quarters and were up 3.2% in calendar 1993 versus a 1.0% gain in real exports. Barring any sharp drop in the value of the yen, this trend will continue, and the contribution of net exports to Japan's GDP will remain on a downward trend, exerting a slightly negative effect on overall real growth.

These considerations suggest GDP growth of just under 1% in real terms for fiscal 1995 and slightly more than 1% for fiscal 1996.

Background for Current Conditions

A number of developments have contributed to the current weakness in the Japanese economy and should be given attention in examining recommendations for fiscal and monetary policies.

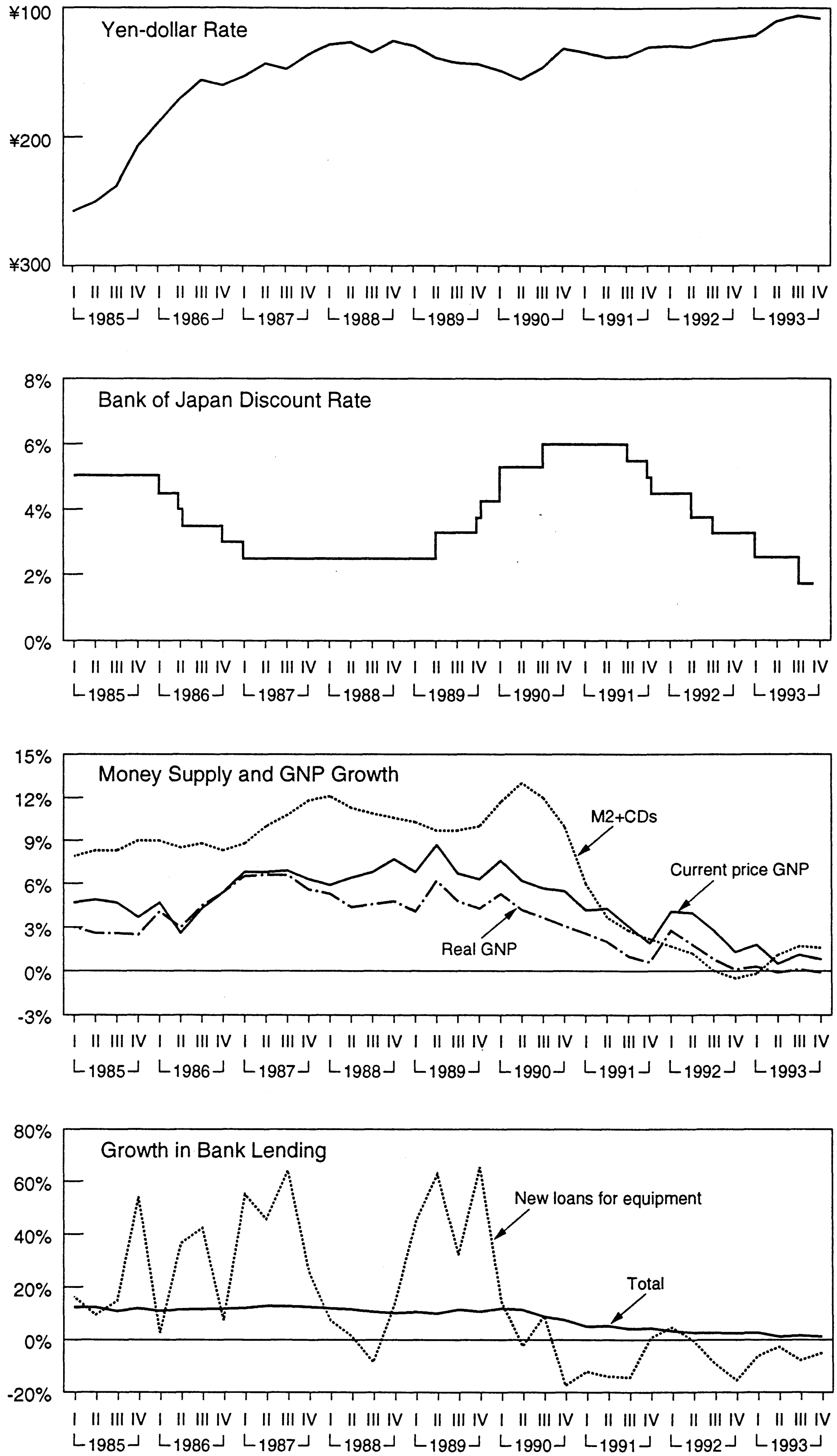
The aftereffects of problematic management of monetary policy from the mid-1980s.

Exhibit 7 shows trends in the yen-dollar rate, Bank of Japan discount rate, money supply, and growth in current price and real GNP. Following the Plaza Accord in September 1985, the yen appreciated from about ¥250 to the U.S. dollar in mid-1985 to ¥144 in 1987 and then to ¥128 in 1988. This sharp upward revaluation of the yen brought a dip in real GNP growth from the 4.5% to 4.8% range in fiscal 1983 and 1984 to 2.8% in 1985. Growth quickly recovered to 4.9% in 1986 and 5.9% in 1987.

Industrial production growth took a deeper drop than GNP, from 8.4% expansion in 1984 to 2.5% in 1985, then to minus 0.2% in 1986. But it too staged a speedy recovery, growing 5.9% in 1987 and 8.8% in 1988.

Despite what proved to be a short economic slowdown, the mood in 1986 and much of 1987 was one of panic as the yen doubled in value and the profitability of exports dropped sharply. I vividly remember being taken to task when I opposed the consensus view that the Japanese

Exhibit 7: Currency and Monetary Indicators[6]



economy was still in "free fall" at a newspaper economic symposium in mid-1987. I pointed to the improvement in industrial inventories and other economic indicators and to the absence of any significant decline in Japan's merchandise trade surplus. But the consensus view at that time was that even more aggressive monetary and fiscal policies would be needed.

In reaction to what, compared to the last few years, was a mild slowdown, the Bank of Japan lowered its discount rate from 5.0% in January 1986 to 2.5% in February 1987. This was followed by a pronounced rise in new loans for capital equipment, a more gradual upward trend in total loan growth, and a rise in money supply growth, which had already been running above current price GNP growth since the early 1980s[7].

Surprisingly, this highly expansionary monetary policy had little noticeable impact on wholesale or consumer prices, apparently because the strength of the yen kept import prices low and no bottlenecks developed in any major industries. The impact, of course, was felt on asset prices. The index of land prices prepared by the Japan Real Estate Institute (based at 100 in 1955) rose from 5,481 in 1985 to a peak of 7,674 in 1990. The Nikkei stock average rose from 12,565 in 1985 to 34,058 in 1989, with one short plunge in October 1987, and price-earnings ratios for the First Section of the Tokyo Stock Exchange jumped from about 35 in 1985 to 70 in 1989.

Equally surprising was the apparent lack of concern about the rise in asset prices. A Ministry of Finance Vice Minister declared his opposition to a tightening of monetary policy in his speech to a Euromoney Conference in late 1988 on the grounds that the Japanese people deserved to enjoy their newly found wealth.

But as the president of the German Bundesbank, Helmut Schlesinger, noted in a conference in Tokyo in 1993, increases in asset prices of more than 20% annually are most likely a reflection of underlying problems, since few real economic factors can justify such inflation.

By late 1987, however, the spiral had begun and inflation was feeding on inflation. Japanese banks—which usually insist on real estate or other collateral, such as securities, to back loans—fell into the trap of lending on real estate quotations that had little underlying economic backing. Real estate prices could be justified only by further appreciation. Price earnings ratios averaging 70 and ranging up to 200 for NTT and a number of other companies could be justified only by expectations of further stock value appreciation.

By the time this realization set in, the damage had already been done. The Bank of Japan expressed concern about a possible uptrend in consumer prices shortly after the introduction of a 3% consumption tax in April 1989. The discount rate was then abruptly increased from 2.5% in May 1989 to 6.0% in August 1990.

This tightening of monetary policy had the desired effect but with a lag of about two years. Inflation in consumer prices, which had dropped below 1% from 1986 through 1988, rose to 2.2% in 1989, to 3.1% in 1990, to 3.3% in 1991, but fell back to 1.6% in 1992. Money supply growth dropped from 12.6% in 1989 to 6.9% in 1990, then to 0.7% in 1991.

But this sharp and sudden tightening seems to have been undertaken without a full awareness of the implications. The word "bubble" did not come into common use to describe conditions in Japan in the late 1980s until about mid-1990. By that time, deflation of asset prices was well under way and irreversible. Stock prices peaked in December 1989 and entered a long, painful decline[8]. Land prices and rents in major cities were still declining in early 1994 and had already fallen between 30% and 50% from the 1990 peak levels.

By mid-1991, growth in industrial production was beginning to slip, marking the end to the long period of prosperity that began in the latter half of the 1980s. Inflation in consumer prices was coming down, and money supply growth was well below 5%. But as examination of the data today—with perfect hindsight—shows serious damage had already been done again by problematic monetary policy.

Apparently concerned about plunging the economy into recession, the Bank of Japan lowered its discount rate from 6.0% in July 1991 to 3.25% in July 1992. This had virtually no impact for the following reasons:

• The overall economy was slowing; corporations cut back sharply on capital investments as they watched operating ratios fall and real estate properties come onto the market with no prospects for tenants. The Bank of Japan found itself in the proverbial position of trying to "push on a string."

• As nonperforming loans rose, banks abruptly changed their lending policies and sought to restrain asset growth to meet BIS capital ratio requirements. Growth in total bank loans fell sharply from 10% in

1989, along with the credit tightening, but then continued to fall through 1992 and 1993 even though monetary policy had presumably been relaxed (Exhibit 7). There was an even more pronounced absolute decline in new loans for equipment. Money supply growth continued to drop through 1991 and 1992, with absolute year-over-year declines for some months in the latter half of calendar 1992.

• The slowdown in domestic demand led to a decline in imports and prompted corporations to seek to expand exports. The trade surplus therefore ballooned from US$76 billion in 1990 to US$134 billion in 1992. This, together with a decline in securities investments into overseas markets, contributed to appreciation of the yen, from ¥144 in 1990 to ¥126 in 1992. Although hardly surprising, the stronger yen contributed to declining profitability and further dampened investment spending.

Forecasts for economic recovery in late 1992 were revised to mid-1993, to late 1993, and more recently to late 1994. Pressures rose for further relaxation of monetary policy, and the Bank of Japan responded by lowering the discount rate from 3.25% to 2.5% in February 1993, then to the current historic low of 1.75% in September 1993.

This and a series of fiscal measures, however, proved to have only limited impact, as we saw in the previous section. Corporations made further reductions in their investment spending and proceeded with a thorough program of cost-cutting and restructuring. Growth in bank lending hovered between 1% and 2% in the latter half of 1993 and the volume of new loans for equipment investment fell, even though the percentage decline became smaller over the course of 1993. With the advent of the Clinton administration's harder line on trade, as well as with continued large surpluses and reluctance of Japanese institutional investors to make heavy commitments to dollar-denominated investments in the absence of stronger market-opening measures in Japan, the yen has moved closer to the ¥100 to the dollar mark, further depressing export-sector profits.

Political Scandals and Instability Slow Policy Initiatives.

The seemingly endless series of bribery and other political scandals involving the Liberal Democratic Party (LDP) finally led to the 1993 defection of some members of the LDP and the formation of a fragile coalition. The coalition under former Prime Minister Hosokawa clearly underestimated the magnitude of Japan's economic problems and opted to wait and see what effect the previous fiscal and monetary policy measures would have on the economy. Emphasis was therefore placed on political reform and other issues.

For its part, the LDP failed to rise above the precedents for opposition party obstructionism set by the Socialist and other parties in previous years. Virtually any debate between the coalition and LDP clearly revealed LDP party members' single-minded interest in one subject—how to overthrow the coalition and regain power. The national interest, as represented by bringing an early end to economic stagnation, took a back seat.

The bureaucracy appears to have gained additional power, if not status, because of the general confusion. This proved to be unfortunate because one of the early objectives of the coalition was to forestall what Naohiro Amaya described as letting the bureaucracy "go the way of the Kanto Army." This is a reference to the actions of the Kanto Army prior to World War II, when it took matters into its own hands and became virtually uncontrollable. As Mr. Amaya, a former bureaucrat, is well aware, one of the central problems of Japan's bureaucracy is its lack of clear accountability. The practice of allowing middle-level bureaucrats to move to director-level positions in industry has long been recognized as one of the principal obstacles to adopting meaningful market-opening measures and undertaking other reforms. Similarly, the *de facto* power exercised by middle-level bureaucrats has frequently made it possible for some ministries, or even bureaus within ministries, to make day-to-day decisions that effectively oppose certain policies which a broader perspective would indicate are in the national interest yet are not in line with the narrowly defined interests of that ministry or bureau.

A recent example has been the attempt at tax reduction undertaken by the coalition. Even though a ¥6 trillion tax reduction has been approved by the Diet, this approval occurred over the intense opposition of the Ministry of Finance, which has consistently fought against raising the fiscal deficit for any reason. To water down the effects of the tax cut, the Ministry has supported the ¥4 trillion increase in social insurance taxes and the sudden and broad-ranging set of increases in public charges that will essentially wipe out the effectiveness of the tax increase for the average household.

The resignation of Hosokawa, in part because of undisclosed financial indiscretions and in part because of the related delay in passing the budget, suggests that confusion and lack of direction in the political sphere continues to detract from prospects for more aggressive policies to deal with the economic slowdown.

Other issues

Other problems that have exerted a braking effect on recovery in Japan, some of which have been touched on briefly in previous pages, include the following:

• **The slow approach to dealing with nonperforming loans.** Securities analysts following Japan's banking industry estimate that nonperforming loans, under the definition used in the United States and much of Europe, are probably about three times the level currently disclosed[9]. This is because banks in Japan need not report loans as nonperforming until interest and principal are six months in arrears, as opposed to three months elsewhere. Similarly, Japanese banks are not required to list loans for which interest has been temporarily reduced or eliminated. Disclosure of loans to nonbanking financial institutions that in turn have large nonperforming loan portfolios is also not required, provided loans to nonbanks themselves are not in arrears. This implies that the currently disclosed volume of about ¥14 trillion, or US$140 billion, in nonperforming loans for the largest 21 banks is probably in excess of US$400 billion. Even though some writeoffs have been taken and some bad loans sold to the Cooperative Loan Purchasing Corporation,[10] the outstanding volume as of March 31, 1994, was virtually unchanged from a year earlier. The large volume of nonperforming loans continues to act as a damper on bank loan growth.

• **The overvaluation of the yen.** It is fashionable in Japan today to link the present high value of the yen with the policies of the Clinton administration. In some circles, Fred Bergsten has apparently gained the status of something approaching an archfiend among undesirable foreigners because his pronouncements about the value of the yen have apparently had some influence on the yen's value. But tracing the cause of the strong yen to the statements of politicians and others in the United States conveniently ignores the massive trade surplus, the lack of forceful action toward market opening, and the consequent reluctance of life insurance companies and other institutional investors to commit more funds to dollar assets. Granted that members of the Clinton administration and Fred Bergsten may have been influential in moving the yen from ¥110 to ¥105, this fails to account for the remaining ¥90-plus gap between recent yen-dollar exchange rates and the ¥200 to the dollar level that the Economic Planning Agency and other sources estimate as the parity yen-dollar rate.

Revitalizing the Economy

Improve Effectiveness and Timing of Monetary and Fiscal Policies

One of the most urgent requirements is to end the political turmoil and enact more effective monetary and fiscal policies. In monetary policy, one of the most important tasks is for government authorities to encourage banks to mark their nonperforming loans to market value, write off bad loans more rapidly, and assume a more liberal lending stance[11]. Even though banks argue that low growth in lending is a result of the lack of creditworthy projects and borrowers, the historically low rates of growth in bank lending in recent quarters suggest this is probably not the only explanation. If U.S. experience is any guide, banks will alter their lending policies substantially when they are clearly on the way to solving the nonperforming loan problem even though they may not have completely eliminated all nonperforming assets.

In fiscal policy, the key task will be to create incentives for the Ministry of Finance to act less like the Kanto Army and allow more flexible use of fiscal stimulus. With this greater leeway, the government should enact a much larger program of public works to augment Japan's infrastructure. Subsidiary measures would be to encourage the electric power companies to step up their investments and to create incentives for NTT and the new private telephone companies to accelerate investments in the information highway, an area where Japan lags behind the United States. Other measures to consider would be extending the cut in income taxes for several more years and not watering down its effectiveness by raising other public charges.

These steps would confirm the willingness and capabilities of Japan's government sector to act in line with not only its own long-term interests but also the interests of the goals agreed upon by the international community.

Take Better Advantage of the Strong Yen

As noted above, the yen appears to be seriously overvalued when measured by international purchasing power. Yet, as many in the United States and elsewhere have pointed out, if the yen remains strong, eventually imports will rise and the surplus will be reduced. This point of view, of course, assumes many things about corporate and public-sector behavior. Most importantly, it assumes that Japan is a free market economy operating along U.S. and European lines and that corporations are in business to maximize their profits with a fairly short-term planning horizon. If it is the case that currency adjustments will bring adjustment in international payments imbalances, why, as Exhibit 8 shows, has a doubling in the value of the yen since mid-1985, nearly a decade ago, resulted in a ballooning of Japan's trade surplus instead of a reduction? To show why this view of Japan as a market economy that will undergo balance of payments adjustments according to the theory of floating exchange rates is wide of the mark, let us review carefully the adjustment process that Japan has undergone in dealing with the stronger yen.

Japan's Adjustment to Currency Appreciation

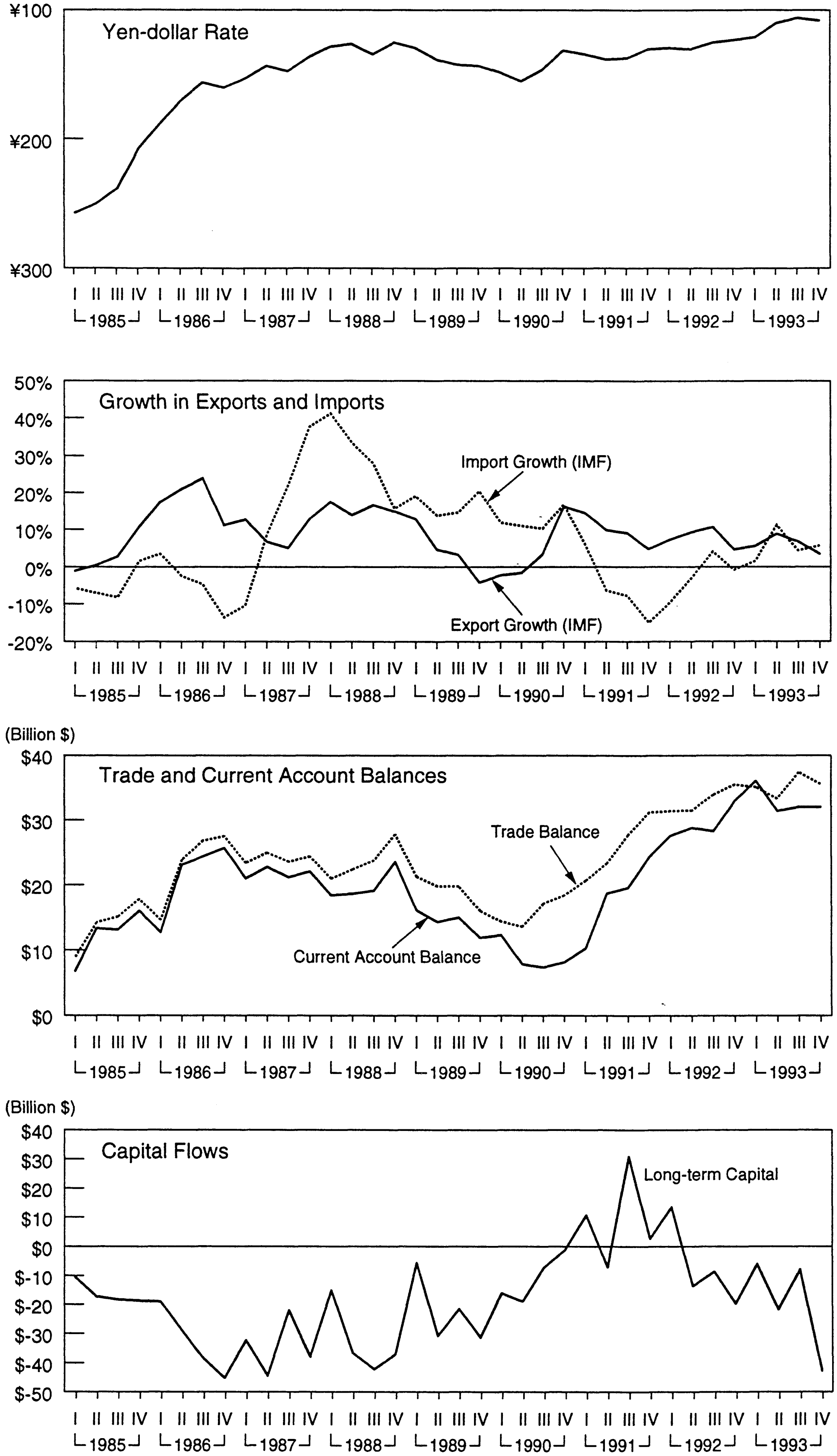
In an open, free market economy in which companies maximize profits with a time horizon of several quarters and are free to hire and fire resources from a pool at market prices, currency appreciation would probably have the following effects:

- Corporations unable to compete in export markets in certain product lines would exit or sell these businesses or move them to lower-cost countries and either downsize or reallocate resources to lines where they can be competitive.
- If unable to undertake this resource allocation process rapidly enough, companies would probably be forced to go out of business.
- In making decisions, corporate managements would be painfully aware of the views of stock analysts and shareholders. Failure to exit unprofitable businesses or move quickly enough to reallocate resources would lead to a drop in stock prices, a drop in the personal wealth of management owning stock in their companies, and possibly an unfriendly takeover.

Managements at corporations in Japan find themselves with a significantly different set of concerns. For example, the pecking order of shareholders, management, and employees prevailing in the United States and Europe is almost reversed in Japan. Shareholders, especially individual shareholders, are the least important group. Employees and their continued well-being come first. What difference does this make in the outcome?

For Japanese companies, the first response under yen appreciation has not been to exit businesses because of low profitability. Instead the

Exhibit 8: Currency, Trade, and Capital Flow Indicators[12]



highest priority goals have been to

• Survive. Take all measures necessary to ensure the continuation of the company, even if profitability suffers for several years.

• Keep the value added at home. Do not exit a business until all possibilities have been exhausted for cutting costs, raising efficiency, sourcing certain parts offshore in lower-cost countries, forcing domestic suppliers to cut their costs, and upgrading the features and value added of domestically manufactured products to enhance their perceived value.

• Maintain or increase export market share. Since a high percentage of costs are fixed, because of career-long employment at home, sell at or below cost in export markets to maintain operating rates.

• Keep sophisticated manufacturing knowhow at home. When conditions have stabilized, continue to target new, high-value-added products and manufacture as many as possible of these internally or in your group of companies to make sure that manufacturing experience is retained and that quality standards can be met. Be reluctant to source externally, but when doing so aim to master the outside suppliers' skills as quickly as possible.

From a slightly different perspective, the adjustment mechanism employed by Japanese manufacturing companies during periods of yen appreciation can be outlined as follows:

• Take full advantage of lower imported raw material costs by renegotiating contracts as quickly as possible.

• Invest in lower-cost overseas facilities to provide the more labor-intensive parts and assembly services.

• Cut or restrain wage costs by keeping company-based union demands low, minimizing new hirings, letting natural attrition (of about 5%) take its course, using early retirement bonuses to buy out older staff, assigning high-wage senior personnel to subsidiaries and affiliates at substantially reduced compensation, reducing overtime, and cutting back on part-time and contract employees.

• Cut production costs through high levels of investment in automated facilities.

• Require all subcontractors and suppliers to go through similar cost-cutting procedures; cease to use those who cannot comply.

• Constantly redesign products to attain higher actual and perceived value added.

• Sell at or below costs in overseas markets while maintaining a premium on domestic sales.

This process has enabled Japan to adjust to the appreciation of the yen. As the yen has gained in value, exports in value and volume terms and the trade surplus, with some ups and downs, have grown larger and larger.

Factors Restraining Import Growth

In addition to the adjustment process by Japanese companies described above, the other piece to the puzzle of rising surpluses is what happens on the import side. The key data regarding imports and exports are shown in Exhibit 9. In summary, growth in imports on an IMF basis, as shown in Exhibit 8 has dropped below the levels prevailing in the late 1980s. As Exhibit 9 indicates, imports in dollar terms on a customs clearance basis were virtually level from 1990 through 1992, then expanded in 1993. In contrast, exports have been expanding between US$10 billion and US$20 billion annually. This divergence has been just as pronounced, if not more so, in yen terms. In volume terms, growth in imports from 1987 to 1993 was higher than in exports.

When Herbert Hax, professor of Köln University and chairman of the German Council of Economic Experts, was asked following a speech in Tokyo recently how Germany managed to conduct its economic affairs so harmoniously with the United States and other countries, without trade altercations, he pointed to certain key differences:

- While the mark has appreciated and Germany has frequently recorded surpluses, these have not been so heavily concentrated with the United States, and Germany has also recorded current account deficits, for example, in 1992 and 1993.
- Germany's trade is characterized by a higher percentage of intra-industry trade than Japan's. In other words, in any given industrial category, such as machine tools, Germany manufactures certain types and imports other types.

The structure of Germany's trade is probably not the consequence of hands-on economic management, since alternative surpluses and deficits as well as significant intra-industry trade appear to be the norm for industrialized countries. This results from competition among domestic and foreign companies, with the more competitive industries and companies winning and the less competitive ones being replaced.

Over the past 20 years, we at IBI have written reports on a broad spectrum of Japanese industries and have a few generalizations I would like to share that may shed some light on the differences between

Exhibit 9: Trends in Trade Volumes and Values

Calendar Years	Imports (Billion $)	Imports (Trillion ¥)	Import Volume Index (1990=100)	Exports (Billion $)	Exports (Trillion ¥)	Export Volume Index (1990=100)	% of Manufactured Goods in Imports (%)
1985	129.5	31.1	62.2	175.6	42.0	86.3	31.0
1986	126.4	21.6	68.1	209.2	35.3	85.7	41.8
1987	149.5	21.7	74.4	229.2	33.3	86.0	44.1
1988	187.4	24.0	87.7	264.9	33.9	91.1	49.0
1989	210.8	29.0	94.6	275.2	37.8	95.0	50.3
1990	234.8	33.9	100.0	286.9	41.5	100.0	50.3
1991	236.7	31.9	104.0	314.5	42.4	102.5	50.8
1992	233.0	29.5	103.6	339.7	43.0	104.0	50.2
1993	240.7	26.8	107.9	360.9	40.2	102.3	52.0

Source: Ministry of Finance

Notes: (1) Exports and imports are on a customs clearance basis.

(2) Manufactured goods includes semifinished products, which account for about half of the total.

Japan's trading behavior and that of other industrialized countries:

• Japan has had and continues to have an industrial policy which encourages companies to move into increasingly higher-value-added industries and products. This general thrust of industrial development is not unique to Japan, but details of the development process noticeably differ from those in the United States in particular in a number of respects, including the means employed to overcome such barriers as high initial entry costs and other externalities.

• The fundamental mind set in Japan is often described in Japanese as *jimae shugi*, implying that undertaking production domestically, as opposed to importing, is preferable even if initial costs are higher. The typical behavior pattern of Japanese corporations is therefore to (a) buy new technologies when these are available from foreign corporations and when they are not, invent around them; (b) adapt features and services carefully to Japanese user requirements; and (c) move down the manufacturing learning curve as quickly as possible to achieve cost advantages and achieve dominance first in the domestic market and then overseas.

• Government ministries are fully in agreement with this approach and orchestrate, when needed, many forms of assistance to promote the development of new, high-value-added industries. This includes encouraging financial institutions to provide long-term loans, organizing joint research consortia, and keeping a close watch on foreign competition to be sure that their activities provide a competitive stimulus but remain essentially confined to an easily controllable niche.

For readers interested in pursuing this subject in greater detail, I recommend two publications of the American Chamber of Commerce in Japan: *Trade and Investment in Japan: The Current Environment*, 1991 and *United States-Japan Trade White Paper*, published annually. These two books set out many of the remaining problems in expanding exports to and direct investments in Japan. While much progress has been made over the last two decades, as one investment banker put recently, "Alright, I agree we have a level playing field now. But unfortunately, there are these incredibly dense patches of fog that suddenly appear just as we are about to kick the ball for a winning goal."

The Outcome: Surpluses Persist and the Yen Rises

The principal outcomes of Japan's approach to economic management are that Japanese industries tend to become competitive across a wide range of products, leaving only some niche markets for foreign competitors. This combination of industrial policy and strategy and effective restraints on imports of higher value added manufactured products appears to account for much of the difference between the trade structures of Japan and Germany:

- Japan chronically runs a merchandise trade surplus.
- The market share of foreign companies in many medium-to-high-technology sectors is considerably lower than in other industrialized countries.

As a consequence of these and other factors, Japan experiences upward pressure on its currency. The pattern which began in the early 1970s, is familiar:

- Japan implements its industrial policy, becoming internationally competitive in a broader range of higher-value-added industries.
- Imports also rise but generally fail to keep pace with the growth in exports.
- The merchandise trade surplus expands, leading to pressures for upward revaluation of the yen.
- The yen strengthens against the dollar and other currencies, and Japanese products temporarily lose their competitiveness.
- But through the adjustment process described earlier, involving such measures as increasing capital investment to automate production processes, upgrading product features, cutting costs, moving some production offshore, and requiring subcontractors and other suppliers to go through a similar slimming down exercise, Japanese corporations typically regain their competitive edge and export growth recovers.
- Again, however, the growth in imports tends to lag that of exports, not only because of built-in resistances but also because raw material imports, *ceteris paribus*, are cheaper because of the stronger yen.
- The trade surplus rises and pressures for yen appreciation grow again.

Presumably this process cannot continue forever. Some of the problems already evident are as follows:

- Even though leading companies have begun to indulge in self-congratulation about the success of their "restructuring," some of this success has been achieved at the cost of reduced wages in smaller companies that supply these companies. The Shoko Chukin Bank, for example, released a report in mid-April indicating that while a gradual upward trend appeared to be emerging in the Japanese economy as a whole, recovery among smaller companies would be delayed at least several quarters.

• Further yen appreciation will place pressures on leading corporations again as well as on smaller companies, thus bringing further deflationary pressures and delaying the recovery.

• The growing number of Japanese factories overseas will very likely lead to a leakage of manufacturing and other forms of knowhow, thus hastening the closing of the gap between Japan and the industrializing countries. This process has certain very positive aspects, as it is bringing rising incomes in the developing countries. But from the point of view of corporate strategy, the issues are what forms of knowhow should be transferred and how quickly. The process described above has, to a very real extent, taken the decision-making power on these two strategy issues partially out of the hands of corporations.

• The continued growth in the purchasing power of the yen overseas (but not domestically), while a great boon for those with the time to take trips overseas and for consumers of those items that have actually dropped in price, is not really reflected for the most part in the areas where the standard of living in Japan is most in need of improvement. The awareness of this issue in Japan is still not very great because, as one economist puts it, "Even with the recession, the Japanese people as a whole are still probably better off than they have been since the beginning of their history."

• A more recent problem is the growing loss of value of securities and other overseas investments as yen appreciation continues. Institutional investors in Japan are reportedly already sitting on large undisclosed losses on U. S. bond investments. This is a key factor in restraining their activity in recycling the dollars that Japan is earning from exports. Unfortunately, this is also a destabilizing factor, tending to push the yen higher.

In other words, Japan is not taking full advantage of the appreciation of the yen. At the same time, yen appreciation is also working to the disadvantage of overseas consumers. Japanese corporations spend enormous sums of money on capital investment and implement other measures to become more competitive. Since this additional value is not used to the extent it might be in purchasing imports and bringing the benefits of improved terms of trade to Japan, the yen appreciates and Japanese companies must raise their prices in overseas markets.

In the most recent adjustment phase, Japanese workers have been obliged to try even harder but at reduced wages as the yen appreciates. At the same time, overseas consumers are obliged to pay higher prices for Japanese goods. This appears to be a lose-lose situation.

Even though graphs, like numbers, can be used to tell lies I believe that what these observations suggest, and what much of the world would like to say to Japan, can be expressed by the three-dimensional figure in Exhibit 10. The vertical axis represents the gains from trade, the additional welfare to be gained from engaging in international commerce. The axis pointing into the background is a measure of international competitiveness, while the third axis is a measure of openness.

Country A experiences the lowest gains from trade because it is neither competitive nor open. Country B, which is similar to Japan, is highly competitive but fails to enjoy the fruits of its investment and labor as these benefits "leak" away, because for one reason or another imports do not rise sufficiently. Country C is highest on the welfare curve because it has a better mix of openness and competitiveness.

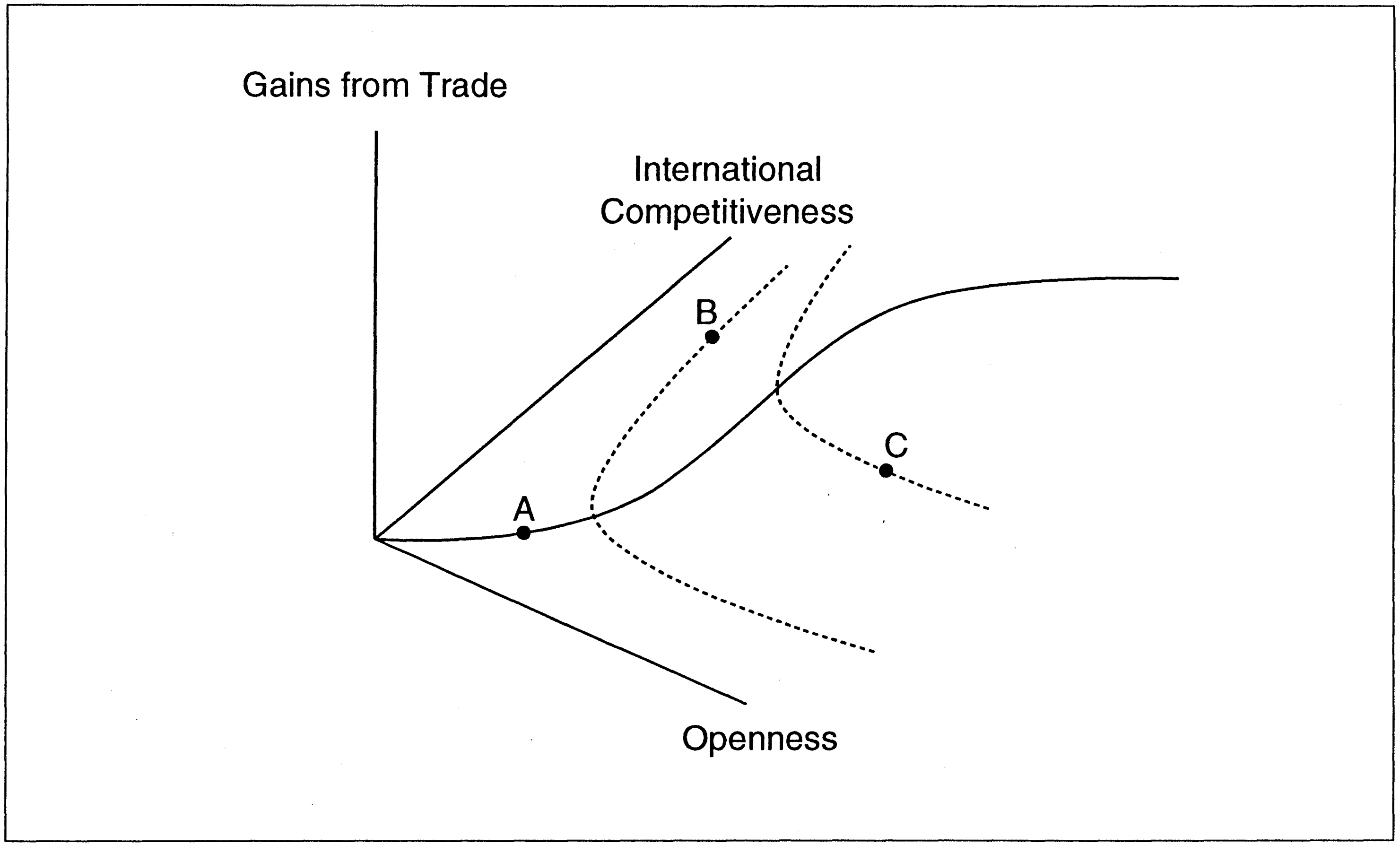
Making Japan's Trade A Plus-Sum Game Again

From the above considerations, it is clear that a key question for Japan at present is how to break out of the lose-lose cycle of yen appreciation and deflation. Some of the answers include:

• **Stepped up efforts to expand imports into Japan.** Japan has a long history of stating flatly that its markets are open, then preparing lists of new market opening measures. The publications of the American Chamber of Commerce in Japan cited above are an objective and reliable source of information on remaining barriers. Japanese government reports purporting to show that the United States is a closed market are red herrings intended to confuse the issue. Expansion of imports will be a difficult road that Japan should have begun decades ago. Many of the barriers to be overcome are political rather than economic. What promises have been made to bureaucrats about future positions in industry and other benefits and numerous other behind-the-scenes issues are among the real impediments to opening the Japanese market.

• **Changes in corporate strategy.** Long-term data on productivity and wages provide a telling picture of one of the key issues in the management of the Japanese economy. From 1953 through 1991, productivity in the manufacturing sector, as measured by real output per employee, has increased roughly 9.76 times. On the other hand, wages, adjusted for inflation, have increased 4.32 times[13].This should come as no surprise to those who are accustomed to hearing that Japan has

Exhibit 10: Gains from Trade, Competitiveness, and Openness



stressed production more than consumption in the interest of long-term growth. But one of today's central questions in Japan is whether this approach is appropriate in a nation with a mature economy the size of Japan's.

Given what been has said so far, it seems reasonable to raise the question of whether a better balance in corporate management strategies is needed. In the past, maximum emphasis has been placed on expanding market share and driving down costs to remain competitive. But if efforts to increase productivity are destined to lead to further yen appreciation, then rather than allow this effort to be offset by a stronger yen, refocusing strategies to sell a lower volume of higher-value-added products in overseas markets and refocusing attention on the domestic market might lead to a more profitable outcome. This in turn would allow higher rewards for shareholders and employees (employees also being consumers). Certain companies have actually begun to adopt this strategy for some products. This behavior, however, goes very much against the grain of Japanese managements who expect consumers (again, employees) to wait for their rewards.

• **A surcharge on exports.** Given the probable difficulty of persuading corporations to raise their prices and accept lower shares in overseas markets, another alternative would be to put a surcharge on exports, which would effectively raise export prices. The proceeds could be used to fund a further reduction in income taxes or fund increased public works spending. If the price elasticity of demand for Japanese exports as a whole is less than one in the price range covered by the tariff, this would imply an increase in export revenues rather than a decrease. This would place additional upward pressure on the yen, suggesting that the tariff should be even higher. If successful, export surcharges might stabilize or reduce the value of the yen, thereby increasing at least the unit profitability of exports.

Measures for the United States to Adopt

If Japan were to introduce any of the above three measures or take any other steps to move closer to a win-win scenario for yen appreciation, one of the principal causes of friction between the two nations would be removed.

But needless to say the solution to the problem of putting U.S.-Japan economic relations on a firmer footing does not rest entirely with Japan. One of the most important issues the United States must deal with is generating a greater willingness by U.S. corporations to invest in Japan. I use "invest" in a broad sense to include training staff who can do business efficiently in Japan, monitoring the activities of Japanese competitors and generating other basic information, building sales and service networks, and, where appropriate, locating manufacturing facilities in Japan.

Exhibit 11 shows the huge imbalance between Japan's outgoing direct investments and the direct investments of foreign companies flowing into Japan. U.S. investment into Japan, of course, is a subcategory of the latter. This imbalance is symptomatic of the reluctance of U.S. companies to invest in the world's second largest economy. Many factors have led to this very peculiar state of affairs, some of which have been discussed in previous pages. The strengthening of the yen since the mid-1980s has tended to further dampen enthusiasm for investment in Japan. While the rates of return on investment may be acceptable in many industries, initial costs of entry are high, creating the impression of higher risk. The unpredictability of government policies—the roving patches of "dense fog" noted above—creates further potential complications and risks of low return or even losses.

In a recent interview we conducted with the president of one of Japan's leading financial institutions, he stated quite bluntly, "So far as I know, there is really only one U.S. company that is pushing for more openness in the Japanese insurance market. The returns on insurance here are the lowest in the world. Any U.S. manager who put his company's funds at risk by making a big investment in Japan should probably be relieved of his position."

Before we draw the conclusion that low profitability is the ultimate nontariff barrier and make this the next point to negotiate with Japan, I think is it important to stress that an economy the size of Japan's cannot be ignored by international corporations. But the problem is that it is being ignored as more and more U.S. and other companies skip over Japan and invest in Asia.

Contrary to the comments of the financial company president above, investing in Japan in the broad sense is essential to putting U.S.-Japan economic relations on a sounder footing. My first assignment as a consultant in Tokyo 25 years ago was to participate in a major study of the Japanese market for forestry and paper products. The client devoted substantial resources to the project, commissioning us to examine each major market in detail. The project included preparing a review of the size and growth of key market segments, demand forecasts, an analysis

Exhibit 11: Direct Investment Flows

	From Japan (Billion $)	Into Japan (Billion $)
1987	19.5	1.5
1988	34.2	2.6
1989	44.1	1.9
1990	48.0	2.6
1991	30.7	3.2
1992	17.2	2.8

Source: Ministry of Finance

of major qualitative trends including the impact of emerging technologies, and an analysis of customers and competitors as well as formulating strategic recommendations. Based on this research, the client made a major strategic commitment to the Japanese market and today derives a substantial share of its worldwide profit from its activities in Japan.

Almost immediately after completing this project, we were approached by one of the top foreign automobile manufacturers to do a "quick and dirty" study that would confirm or deny their belief that the small volume of exports to Japan was all they could continue to expect in this market. The budget was unbelievably small even in those days. Our conclusion was that further investment would probably lead to expanded sales. Shortly thereafter, the personnel in charge of the study were recalled to the United States and the case was closed. That company has only recently begun to expand its position in Japan, after being battered for years in its home market by competition from Japan and Japanese transplants.

When we say "investing in Japan" some businesspeople think mainly of building factories, hiring labor to operate the machinery, and massive commitments of management time and financial resources. For some companies this may well be appropriate. But "investing" should also mean making a careful initial study of the market to determine what level of commitment is appropriate. The key questions that should be addressed are Will a commitment to Japan add to corporate profits? What level of commitment is appropriate? Should we monitor the Japanese market for our product and be ready when an opportunity emerges? Should we make arrangements with importers and distributors to sell our product to Japan? Should we set up our own sales and service capability in Japan? Should we work toward ultimately having a manufacturing facility in Japan?

As these questions suggest, the principal factors for success are assessing the size of the opportunity and making the right level of commitment, based on an appropriately detailed feasibility study. A step in the investment process, for example, should be a thorough analysis and investigation of the market's potential and where a company might fit into the market. Another step would be monitoring developments, which is essential to keep companies alert and able to compete with Japanese companies not only in Japan but also in other markets. A third step may be making initial entry into the market, including organizing a distribution network; it could also be opening an R&D facility to provide development support for a sales effort in Japan.

A few of the other success factors include:

• Taking a close look at product suitability. Many products and services are suited to Japanese tastes and requirements without modification. Others need to be adapted.

• Choosing the mode of distribution and distributors carefully. Do not limit your examination of options to existing modes of distribution since practices are undergoing considerable change. Also do not overlook smaller businesses as tie-up partners and distributors.

• Setting realistic targets for sales and profits that management both in Japan and in the home country can agree upon.

• Managing results from a long-term perspective. Review progress periodically and make adjustments in strategy to meet changing market conditions.

• Avoiding abrupt changes in product, distribution, and other policies and work steadily toward building the confidence of customers. It takes time to become a qualified vendor. But if major changes must be made, considerable care should be taken in communicating the true intent of these to customers and the trade press.

• Being ready to meet quality standards. Examine how Japanese companies compete on quality. Keep promises and meet delivery schedules.

• Being responsive in remedying any problems that arise; formulate specific policies for correcting them and present these to your customers.

• Constantly monitoring competitors' products and work to improve your own.

Even though some may argue that it is too late or too complicated to enter the Japanese market, drawing this conclusion would be a mistake for most companies. Japan is the second largest single-nation economy. New consumer markets are appearing and existing ones are undergoing substantial change. In fact, so much is taking place in Japan in product development, technology, and manufacturing techniques that many companies worldwide are finding it essential to have some kind of presence here. Ignoring the Japanese market may close off important sources of ideas, stimulation, and profits that might contribute to a company's future growth.

As a place to invest, Japan is also attractive at present for many other reasons. These include lower real estate costs compared with the late

1980s; a growing ease of recruiting staff because of reduced hirings by Japanese companies and increased intercompany mobility; the availability of financing as Japanese banks seek to improve the quality of their lending portfolios; and the greater openness of the market.

While continuing to negotiate with Japan for greater market openness, the U.S. government, and U.S. corporations, should examine much more carefully the opportunities for exporting to and investing in Japan.

Footnotes

1. New housing starts were running between 1.6 and 1.7 million annually from the mid-1980s through 1990, then fell to 1.37 million in 1991. Starts, however, had climbed back to nearly 1.5 million in calendar 1993.

2. The "indexes of operating rate" are prepared by MITI by dividing the index of industrial production by the index of production capacity, so an assumption is necessary about the rate of utilization of capacity in the base year, which in this case is 1990 for both indexes. The actual level of industrial output was 100.0 in 1990, but 101.7 in 1991, so utilization rates in absolute terms are slightly higher than the figures in Exhibit 5 would indicate.

3. The actual figures for the last quarter of calendar 1993 were as follows: Total GNE at 1985 prices: ¥419,257 billion; net exports of goods and services: ¥939 billion; exports: ¥60,766 billion; imports: ¥59,827 billion.

4. The most recent data, for February 1994, show utilization rate indices ranging from a low of 66.4 for general machinery to 104.1 for oil and coal products. Industries with index figures near or over 90 include nonferrous metals, precision machinery, pottery and glass, pulp and paper, and textile products.

5. A comparison of capital goods prices in Japan versus the U.S. is not readily available, but the gap is believed to be smaller than for consumer goods.

6. Sources for Exhibit 7 are as follows:

Yen-dollar rate: Toyo Keizai, Inc.
Discount rate: Bank of Japan
Money supply: Bank of Japan
GNP growth rates: Economic Planning Agency
Growth in lending: Bank of Japan

7. The scale in the Growth in Bank Lending graph does not perhaps sufficiently highlight the year-over-year changes in total bank lending. The actual figures are as follows:

1984		
	I	11.0%
	II	10.8
	III	12.3
	IV	11.4
1985		
	I	12.4
	II	12.4
	III	10.9
	IV	12.0
1986		
	I	11.0
	II	11.5
	III	11.7
	IV	11.8
1987		
	I	12.1
	II	12.9
	III	12.8
	IV	12.5
1988		
	I	12.0
	II	11.6
	III	10.7
	IV	10.2
1989		
	I	10.6
	II	10.0
	III	11.5
	IV	10.7
1990		
	I	11.9
	II	11.4
	III	8.9
	IV	7.5

Source: Bank of Japan

8. The Nikkei stock average fell from 34,058, average for calendar 1989, to a monthly low of 15,790 in August 1992, then began an unsteady upward trend.

9. For example: *Japanese Banks: Paying for Profligacy*, James Capel

10. The Cooperative Loan Purchasing Corporation is an institution set up and funded by the banks themselves with the aim of removing some of the worst problem loans from their balance sheets. To date, nearly ¥4 trillion in loans have been sold to this corporation and less than ¥30 billion recovered.

11. One of the regulatory practices slowing the writeoffs of bad loans is that MOF will not permit banks to run losses.

12. Sources for Exhibit 8 are as follows:
Yen-dollar rate: Toyo Keizai, Inc.
Growth in IMF exports and imports: Bank of Japan
Trade and current account balances: Bank of Japan
Capital flows: Bank of Japan

13. Monthly wages in manufacturing were ¥15,322 in 1953 and rose to ¥368,594 in 1991. The consumer price index, 1990=100, rose from 0.186 to 1.033 over this interval. Real wages therefore expanded from ¥82,376 to ¥356,254, or 4.32 times.

The index of industrial production rose from 6.4 (1990=100) to 101.7, while the total working population rose from 39.13 million to 63.69 million. Adjusted for the size of the total work force, the index rose from 1.63 to 15.96, or 9.76 times. This calculation assumes the percentage of manufacturing workers was stable as a percentage of the employed population. Since this percentage has probably declined, the 9.76 figure is lower than the actual increase in the industrial sector, implying an even larger gap between growth in real output and real wages.