

The Longest Recovery of the Japanese Economy: Prospects and Challenges*

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Japan has been enjoying the longest recovery in recent years. The business boom is called the "Izunami Boom." Actually, Izunami is the name of the god who created Japan. In Japanese history, Izunami got married to Izanagi, and then Japan appeared. The Izunami Boom was the biggest business boom that we had during the rapidly growing period from the 1960s to 1970. But at that time, it lasted about five years or so, and the growth rate was more than 10%. In terms of growth rate, that's nothing to do with that type of boom, but in terms of length of the period that we are enjoying expansion of business, it has already been longer than the Izunami Boom. The growth rate is 2.4%, but 2.4%, by the Japanese standard of recent years, is quite a good and comfortable pace for expansions.

There are a couple of features of the growth this time. First, it is the private sector, unlike the public sector, that has led the growth. That is a total difference from the lowest decade period, when the government was pressuring and expending so much budgetary expense on stimulating the economy, but it didn't work at all. The leading sector has changed totally.

Secondly, especially in the recent two years, the balance between the household sector and business sector has been getting better balanced. The business sector has recovered quite a lot, and the household economy has been stimulated by the gradually but steadily increasing wage and income of salaried workers. During the past five years, there have been tremendous structural changes in the supply side, especially from the business side. But still, as I will talk about later, we have mounting problems, and lots of challenges that we have to tackle, especially on the demand side; private consumption has remained relatively weak. We've got to boost consumption through the further structural reforms. Japan has come back to the normal growth period since 2002. This is the fiscal year growth rate. Until 2001, we suffered a lot, and then we started to record the ???? growth for the GDP, and after 2004, the economy

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grew at the level of 2%, which is almost the potential growth of the Japanese economy now. This year, we are probably going to have around 2% growth, and in 2007, we'll expect to have another round of 2% growth. If nothing happens to the global economy, the probability is very high that we will continue to grow at 2% for another couple of years.

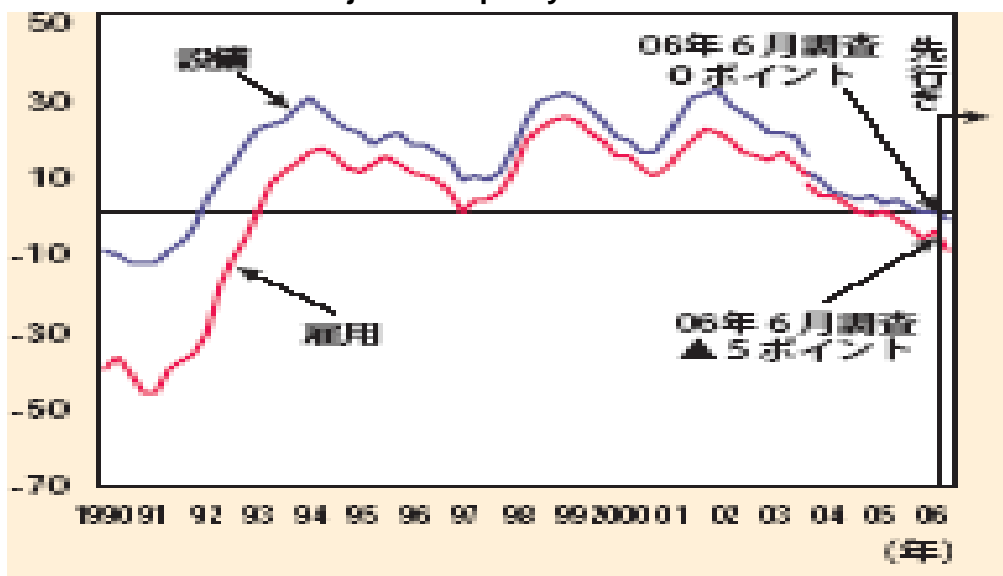
As I said, the demand has been changed a lot, as you see in the left part. There has been a change in private sector demand, which is the red part of the graph, has been recording the positive growth in the last few years, whereas the dark blue one, which is public demand, has started to sometimes record negative values, because we have to reduce the budget expense. We have to tackle huge government debt in the public sector. Usually Japanese dependencies on export have been quite minor compared to South Korea's; our trade dependencies are somewhere around 20-25%, which is exactly the same as the United States. So the Japanese economy itself should be pretty much led by private consumption in the domestic market. But consumption has still remained relatively weak. We've started to record more and more dependencies on the external demand, which is usually led by both the US and China. That is similar to Korea.

One of the striking features in the recovery period is the active investment by firms. Facility investment was negative until 2002, but it has started to pick up. Then, after 2005, it has been going upward, encouraged by the finished restructuring of financial sector, thanks to the strong demand, especially from the external side. During the last five years, the business sector has been restructured, and it is relatively better, at least compared to the public sector. After the last decade, the Japanese business sector suffered a lot with the excess capacity: excess production capacity, excess labor, and excess debt. These were the main targets of the Japanese restructuring process. But after that, firms started to record the greatest profit ever in the post war period. Debt issues are almost gone. Export has always been very supportive, except the certain period of time when the Yen was much higher, but now in recent years, the Japanese Yen has depreciated, and it has boosted the economy. For that structure, almost all of the manufacturing sector, but even the service sector as well, have gone back to full operation now. That has stimulated the facility investment of the firms.

The upper line of <Figure 1> is the result of questionnaires asking the business sector whether they feel that the production capacity is in an excessive position, or whether

they feel some shortage of capacity. People are all answering that capacity is too much, but it's getting lower and lower, and it started to be almost zero in 2006, meaning that the businessmen feel quite comfortable with the production capacity now in Japan. The red one is asking whether you have too many people working for your company or not. This trend is almost follows the facility investment questions. If you see that, what's important is that since 2006, many people are answering that they need more people, and are under a shortage of labor. That has tightened the recruitment situation now in Japan. This is probably in contrast to Korea.

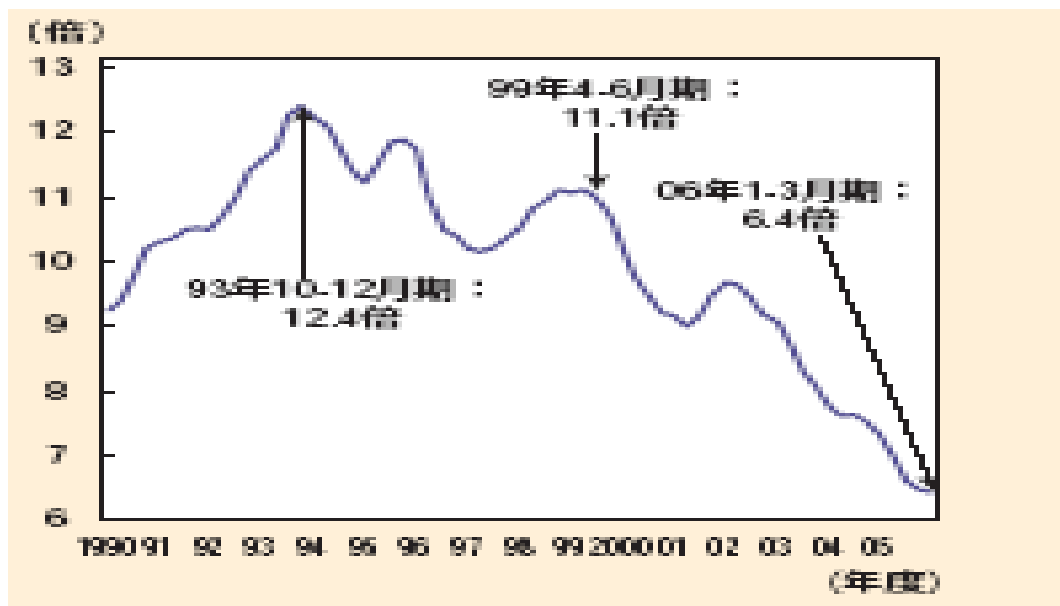
**<Figure 1>
Adjusted Capacity and Labor**



What happened to debt? The cash flow of the business firms has been pretty much well-shaped in recent years too. The < Figure 2> is also asking how much cash flow you have against the debt. Cash flows were too huge. In 1992, when the bubble economy collapsed, and the people started to suffer from debt, the ratios of the cash flow against the debt recorded the peak, at about twelve times, or even nearly thirteen times. Then they started to go down after all the restructuring, and then we are now almost five or six times or so. That is a very comfortable range for Japanese firms. In the profits, the business sector has been recording the biggest profit ever, even compared to the peak of the bubble economy. Again, if you see that the peak of the current profits, the current profits versus sales, it recorded the peak in the late 1980s to the 1990s, then we had the bubble crash, and it started to fall, but it has again picked up. But as you see in 2005, the ratios are almost bigger than before. Now the

Japanese business sector is full of cash, very rich, and very profitable. But one of the political complaints that people have against the business firms is, "You are so rich, but why don't you do something for us?" Because some of the SME sectors, as well as the relatively uncompetitive service sectors, still suffer. That's the situation.

**<Figure 2>
Improved Cash-flow for the Debts**

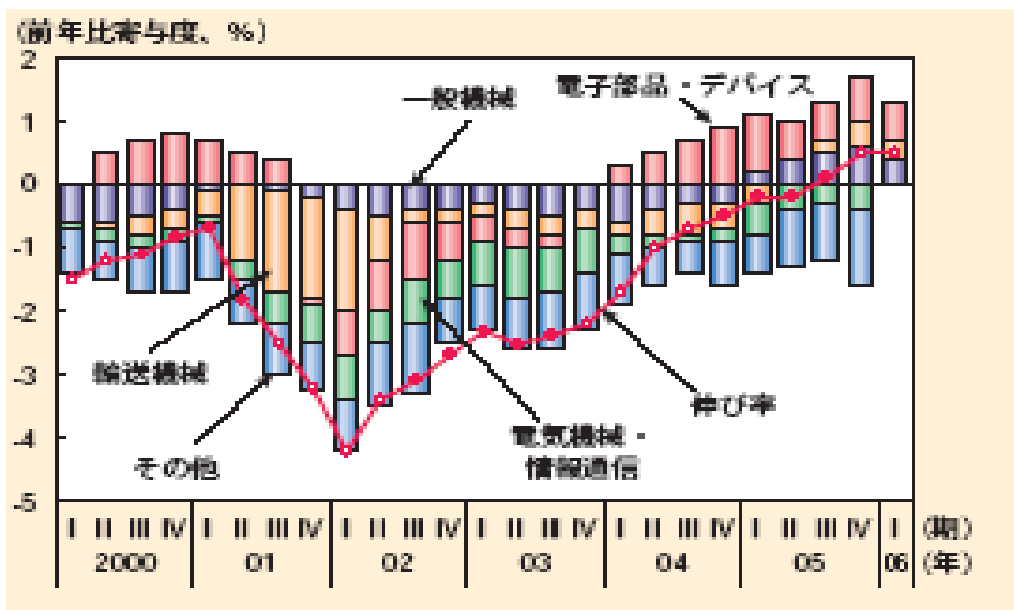


The operation rate is also in good shape. This starts with the point of 2000, and continues to reduce the inventory stock. The operation rate got smaller and smaller, and then it started to get higher in 2006. This is a sample of general machinery. Actually, general machinery is very important, even compared to the digital kind of equipment, like IT or the IT related sector, because the recent strategy that Japanese businesses are now seeking is more for the analog, more for the integrated kind of technologies unlike the digital world. General machinery is the strategic part, and general machinery is enjoying an export boom, especially in China, and other Asian countries.

The <Figure 3> shows the production capacities of major industries in Japan. The bars over the horizon are the electronic part and devices. This sector has recovered most quickly after 2004. But the capacity of the other industries has also started to increase, including general machinery. Also, the transportation industries, mainly the automobile, production capacity has started to increase, instead of scrapping the facilities. The

reason why the business sector has recovered the confidence is that there seems to be a confidence of the divisions of labor with China. Originally, many journalists from Korea rushed to me why Japanese companies feel so confident against China, especially after Mr. Gun-Hee Lee of Samsung Group said that Korea is almost in a sandwich structure between Japan and China. People ask me these questions.

<Figure 3>
Improved Production Capacity



Of course, we still have huge competition with China in terms of price, but Japan is struggling to get away from that by promoting more innovation and integrating technologies (as I touched on) with more complicated integrations of each independent technology. So especially in the IT sectors, the main strategy is making a black box of knowledge and technology so that no one will be able to copy. Well, of course, the Japanese government is so desperate in negotiating with China, saying, "Please protect out intellectual property rights!" Even though the Chinese government is making such a great effort, it doesn't work. The real strategy is to follow some other strategies. That's the kind of black box strategy. So, in semiconductors, computer networks, and usability of software, many strategic prospects are supported in part by the government expense, which has already started.

But more strategic sectors are probably in life science. In terms of life science, Japan

has the relative competitive advantage because we are the fastest aging society. In Japan, all generations are rich enough to offer a bigger experimental market for the Japanese industries. So Medicare is the most important part of our society, and there are a lot of chances for diagnosis, regenerating medicines, and many kinds of medical services. Life science is quite an important sector.

The other field that people are more interested in other than IT is the environment. Of course, as the major member of the Kyoto protocol, Japan is under severe regulations for environmental protection. But in another sense provided us a big chance to become more sophisticated in our environmental technologies to fit into the regulation, including many technologies such as CO2 fixations, anti-fluorocarbons. The "Three Rs" are Recycle, Reduce, and Reuse the materials. Those technologies are key technologies that the business sector is moving towards quickly.

The other manufactures are still doing a lot of R & D activity, in robots, nanotechnology, NEMS, etc., but those two sectors, life science and the environment will be quire a front for the Japanese economy.

What happened to the household sector? The household sector lags behind the business sector, but it has picked up somewhat after the restructuring of the business sector. What is striking in recent years is that the job market has changed a lot, and in terms of quantity, there are more and more jobs, and the unemployment rate has been getting lower and lower. But still, there are a lot of problems with the quality of jobs, which are quite similar to Korea. The regular jobs have increased, and the temporary, irregular jobs have decreased in number, and are changing in a better direction, but still we suffer problems. The business sector actually enjoyed a huge profit after adjusting the wage. Japan is very different from Korea, in that it has very peaceful, and probably too flexible, attitudes by the unions. We accept the withdrawal of the wage. That's while the business sector could make such an adjustment in so short a period time. Actually, it took quite a long time, anyway. That has stimulated a little bit of consumption, but it is still stagnant. But another macro issue is the deteriorating saving ratios because of the deteriorating population. People cannot save anymore, because they are too old to do this.

The income gap is still a problem, and actually, the income gap between is nothing totally different from Korea, but people are not complaining about it so much. There

may be a different social situation if compared.

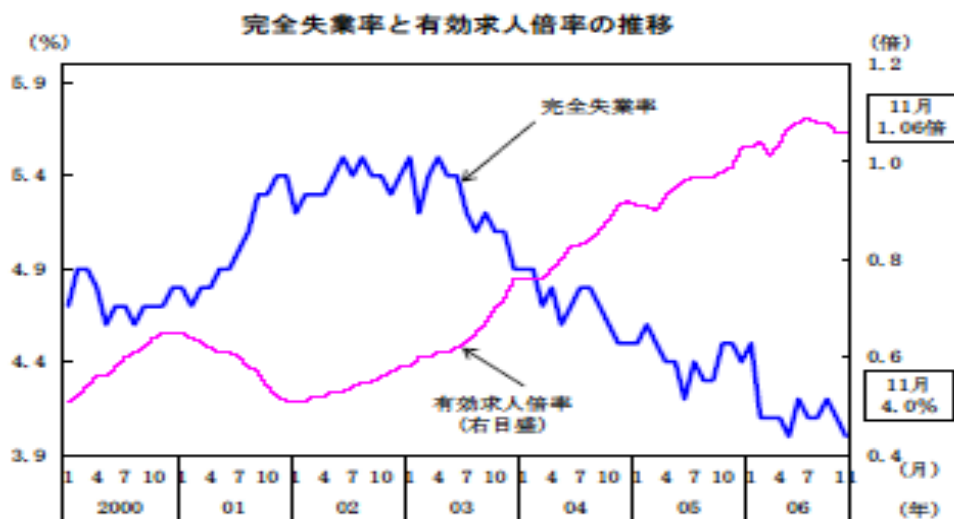
Employment has been getting better and better, which is the brightest part of the Japanese economy, and if you see the recruitment ratios of jobs against people seeking the job. It has continued to pick up, and it has gone over one, which means that the jobs provided are more than the people that are trying to get the jobs. People are able to choose their job. Still, there is a huge mismatch of demand and supply, but another bright part is that especially young people who have enough computer skills or some kind of foreign language don't have much difficulty in finding jobs in the Japanese economy. In the universities, we are also having a lot of graduates. If you graduate at least at the Waseda level, people have no difficulty finding jobs; they are rather trying to choose their job. This is too beneficial a situation for young students, and we've always been pressuring students to study hard, even though the job opportunities seem so easygoing. The situation is very different.

Also, the unemployment is getting lower and lower. It's almost around 3.2 or 3.4%, which is almost the lowest one after the crash of the bubble economy. In the socialist sense, 3.0% is perfect employment, so 3.4-3.5% is almost full employment in the city areas. The <Figure 4> shows another difference in the quality of jobs. The black line is a regular job, and the gray line is an irregular job, which means daily workers, and other unstable types of jobs. If you see that, it continues to grow, even in the restructuring period of 2000. The people who have to go to the irregular jobs are many more than the people with the regular jobs. But thanks to the recovery in the strong business sector, from almost the third quarter of 2006, last year-- as you see on the right hand side, the situation changed in November-- people having regular jobs started being many more than the people with regular jobs. The market is watching whether this trend will continue to stimulate further private consumption.

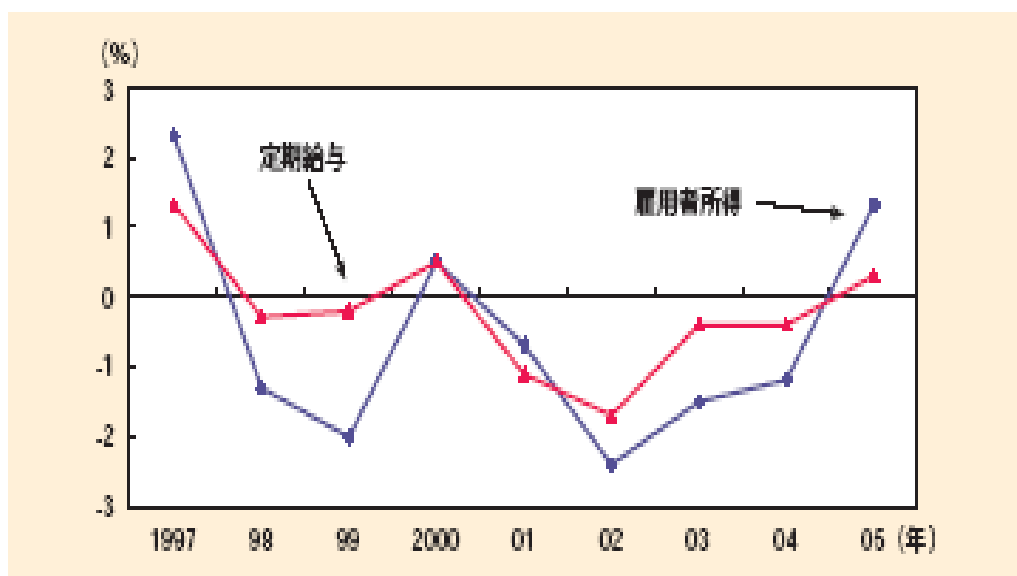
Finally, even the income has started to pick up. The gray line of the <Figure 5> shows the regular salaries, and the black one shows the income of the salaried people, not the people who are self-employed. It recorded negative growth for three or four years, until 2004, but the income of the salaried people has started to rise since 2005. It continues to go up, but Japanese labor unions' demands are very modest, compared to Korean unions. We are going to have spring negotiations in business sector with managers and labor unions. But even Toyota, who is recording the biggest profit ever, is only demanding 1000 yen of surplus. That's nothing compared to Korean unions.

Even the union people know that we have to continue all the R & D investment to survive the international competition, and we have to give up the short-term gains in wage.

<Figure 4>
Improved Employment (1)



<Figure 5>
Recovering Income



But actually, the speed in recovery of consumption has been somewhat stagnant. This is the index showing the private consumption in Japan, with 100 in the year of 2000. It picked up only 10 or 15 or something. The recovery of consumption has been very slow. Also, since we are aging very fast, and the labor market situation used to be very severe on the salaried people, it was painful enough on the SMEs and self-employed people, saving ratios are going down. I think it will further drop below 2%, which is quite a shocking event in Japanese society. As for the income gap and social structures, the Japanese GINI coefficient, which shows the income gap between the social classes, is actually nothing different from England, New Zealand, and even worse than Australia, and slightly better than the United States. I think this position is very similar to Korea. There is a wider and wider income gap between the people who survived, and who couldn't survive. There have been so many changes, but we still have mounting challenges and lots of problems.

One issue is the budgetary crisis. The public sector's reforms have been so slow. That is very much related to the slow pickup in private consumption, because most of the local economies were still quite dependent on public demand including public consumption and other public services. So unless the public sectors reach a certain level of reform, private consumption will have a downward pressure from the public sector. Since we are a great aging society, there is a tremendous argument on the reforms of pensions and Medicare. Now we have a very unfair treatment inter-generation, as well as intra-generation. As in any social welfare system in any country in the world, the Japanese system is dependant on the younger generations working hard, and paying the pensions for the older. But since the demographic structure has changes so rapidly, we have to change the pension system; otherwise, the young generation won't be able to pay enough in pension, which is a growing concern.

But the problem is not only inter-generational argument, but there is also an intra-generation gap. It's a typical political question that the wealthy always complain that they are paying so much. Those people who are enjoying the pensions still think that they have to be paid, because they have to get exactly the same medical service, and the same income as the wealthier people. We are only unlucky. There are always these kinds of problems on the political side. The real issue is that the pension fund system is not sustainable anymore. Everybody agrees with that. However much pain, and however much cost those generations will suffer is really up to the political structures. But besides that, Japanese pension covering services are very poor in quality. There

was a huge scandal in the ministry that covers the pensions. One of the big issues is how to privatize the pension services.

The second issue is the local government reform. Local government is now under severe investigations everywhere. We have such a nasty collusion of the general construction companies with the local government, and it's almost a daily business that you find that the police have arrested someone. They go to jail, and we have to have another election for the governor of certain prefectures all of a sudden. It's a daily event. We have to clean up the situation, and let the local people know that they cannot survive with public demand anymore. The budget is almost bankrupt, so you cannot do business with the government as before. The government people, especially the politicians are now so desperate to create jobs and new business in local areas, and that's why PM Koizumi started the special economic zones to boost the business seed. But so far, it's been a powerless policy too, so we have to do something about it.

Privatization is another issue that Japan is going to tackle. That is a very interesting experiment; we are almost following the British or Australian privatization. Postal saving was privatized after the almost-crazy leadership of PM Koizumi. All the state universities are now under the process of privatization. They are now under the status of agencies independent of the government. Still, their budget is heavily dependant on the government. There is also a tremendous complaint from the private universities. If we are to compete with the state universities, we have to find some equal footing with the competition standard; otherwise, they're so heavily supported by the government, how can they compete with them?

There were also other scandals in NHK and other media organizations. NHK was public media, so the privatization of ownership and leadership NHK was strongly demanded.

What has worked so far was the deregulation of job-search services. Job search services in Japan were totally dominated by the government. This is the legacy of the high-growth period, when the people were under the fear of losing their job, and were so weak. The government had to protect those poor guys. That's the concept of the monopolizing job-search services of Japan. Bureaucrats, of course, were very reluctant to give up these vested interests, because they've created a very complicated, but huge bureaucratic organization to monopolize these services. But actually, in these

levels of the economy, the jobs demanded in the market are getting more complicated, and of course, the government is in no position to have such information at all. Then they started to give up the service, little by little, and starting from professional jobs like IT engineers, and then scientists and lawyers and legal services, etc., they started to give in, and then the total privatization of the job search services (called, "Hello work" in Japan), is in the political agenda.

Another thing is the so-called market test, which is a process in which each ministry brings in certain public services to test the marketability, or the feasibility of the service, to then be taken over by the private sector. There are, for example, many research institutes that are owned and operated by the government, like the research institutes of economy or trade or whatever. They are under the screening for the private sector bid. So the market test is another issue.

What happened with the special economic zones is that they prepared a certain legal environment for further business expansion in local areas. But if you see that the major part of the special economic zones is logistics (the light blue one on the left-hand side). Logistics is a disgusting sector in Japan, where the private sector tends to invest so much in hardware in such uncompetitive small scales. Still, there are binding path-dependencies in Japan that in order to survive, the local construction companies will continue to build the express roads, and the hardware ports, airports, etc. so we have to get away from that.

Another one is education, which is in the middle with the red part. Education is quite similar to Korea. The government allowed certain local governments to establish very specialized kinds of schools, like English-teaching schools, etc. They invested large portions for that.

Other things are orchards and the IT industries, which are not so active, and so are scattered around. In terms of privatization, Japan has always been praised as one of the more successful countries for privatizations, once the government has decided to do it. Of course, in the view of consumers, we have a lot of complaints about NTT, but NTT and the Japan Railroad are two cases that are always picked up as one of the most successful privatization cases by the World Bank and the IMF. The sales have jumped by two times or so, and the employees have been reduced by 30-50%. The profit per employee as a result jumped by eight times, by ?????NTTKs?????. The

government earned such a big profit, four trillion yen, by selling equities to the private sector. JT is Japan Tobacco. Japan Tobacco was also privatized, and succeeded in reducing 60% of their employees. There are tremendous expectations about further privatization of the government-dominated sector in Japan.

Another challenge is the agriculture sector reform. This is very crucial. Even though agriculture has never been the leading sector in Japan, we have to negotiate Free Trade Agreements with many countries. Also, the agriculture sector is a field with very low productivity, and we have to do something about it. A major part of the agenda is changing incentives for the farmers, because it is quite similar with Korea. The Japanese agricultural lands are under heavy regulations, and farmers have had stronger incentives to keep their lands, not only because of the oriental sentiment that, "this is the land that I borrowed from my ancestors, so I have to keep this land until I die." This kind of mentality is not the major reason. But the Japanese tax system has provided more incentives for farmers to keep the land, even though the land is not really productively used for agriculture.

Agriculture corporations are another major issue for the Japanese reform, because Japanese agricultural coops are such huge organizations that dominate all the distribution of agricultural products, even the finance. This is because the farmers' saving ratios are usually much higher than the people in the city areas. Agricultural coops are huge financial institutions, but they don't know how to invest their money, because they are public entities.

More deregulation means more competition for the agriculture sector, especially rice or milk, etc. Actually, fruit and vegetables have lighter deregulation. They are less protected than rice and other things. They are doing just fine, but what happened to rice is quite a disgusting situation. So this shows the dark one as the average, and the light blue one as the areas besides the three biggest cities in Japan. This shows the profit for the farmers coming from the agricultural sector, versus the other profit. In some areas, especially remote areas, farmers are actually making more profit by leasing their land or gaining profit in other services, than by agriculture, after the bubble economy crashed in the 1990s. That's why they have no reason to concentrate on agriculture. That is the situation.

Also, regarding educational reform, the situation is quite common in any country,

especially in OECD members. We are so desperate for education reform for better human capital. We started to talk about the voucher system, because unless the government can provide some vouchers to certain lower income classes, the chances of better education, especially in public schools, seems to be very limited. The teacher evaluation system was also introduced recently. Not only college professors and higher education, but even the people in elementary schools, junior high, and high schools, those teachers are under the screening for about three to five years. If they are not qualified, they have to go away. Another trial is the variety of professions in the teaching staff. In recent years, it is a fashion to invite businesspeople to teach in elementary schools and junior high Schools. They are teaching how to invest money in the stock market and how to survive in the labor market, what kind of qualifications the business society needs in businesspeople. They are mostly teaching this very practical kind of knowledge. Still, the public's screws are not as standardized as Korea's. But the concept of service itself is lacking in Japanese bureaucrats who are covering education. They are super bureaucratic guys, and they have no sense of service, and no sense of international competition. So the public schools are still under their strong control. They reluctantly have started to give in, though. There should be more competition among public schools. Enhancing fair competition among public schools is very difficult to do, however, because if you go to lower income areas, the funds for the schools are very limited. Even some of the households don't pay enough for the children's meals, so there a lot of problems. The issue is how to balance the choice and the opportunities.

People are very threatened by all the bad news about the children's class. Young children commit suicide; their friends ignore them, and they are squeezed psychologically. There should be more discussions on the role of the household, and the roll of the schools: How much the school should have to do, and how much should be done by the parents. This is a very common comparison of private education among the OECD members, and of course, my Korean friends know that Korea has the highest private education burden on the household. The upper part is the elementary to middle school, and the lower one is higher education. On both sides, Korea has the highest burden on private education. Japan is somewhat similar with the United States in middle education, but it has gotten higher in higher education. If so much depends on private education, once households suffer from the instability of income, it will directly have an impact on the levels of education, which will decide the human capital in the end. There is no need to explain this to Korean people.

Another threatening thing about the Japanese economy is job training within the firms. It's not the schools or universities in Japan that have been training people, it's actually more the on-the-job and off-the-job training by firms. Firms have always been the kind of graduate school for Japanese firms under long-term commitments for employment. But after the crash of the economy in the 1990s, the job training within the firms has started to go down, especially the planned, regular on-the-job training (the red one), which almost reached the bottom in the late 1990s. So the business firms cannot afford to train the people anymore by investing such a huge amount into their people. That will also require more reforms on the schools, because it is now the schools that have to take over the educational roles. Also, the firm-specific knowledge is nothing once you decide to leave the firms. That is another reason the firms try to reduce the firm-specific training for the people.

Finally, the prospects. Actually, 2007-2010 is the last chance for Japan to do real reform, for several reasons. First, there is a huge baby-boomer generation who were born from 1947-1950. They were almost retired from the labor market. Since they've survived, they actually did survive. They are rich enough to have a retirement income, and they have almost no debt for the housing income. This is the final chance that we are going to stimulate consumption.

Another issue I discussed is the recovery of the local economy that is very crucial for the whole Japanese economy, but baby boomers interestingly have a desire to go back to the local areas. Some people really want to start agriculture, for several reasons. They might be very exhausted from the competition of city life, and wish to go back home. That's a nice opportunity for those rich guys who try to invest in agriculture to have totally different kinds of productive agriculture.

Another issue is their sons' and daughters' generation. Since they were such a huge baby boom, they also had a second generation of baby boomers, who are almost in their mid-30s. This is the last chance to get a slightly better situation for the demographic structure, so the government is desperate to get that generation to have children. Since they are only in their thirties, the next five years is almost the last chance to increase the population. That's another reasons. That's why we have to be desperate on all the reforms.

The financial modernization is also very important, especially in an aging society. Even

though the Japanese banks have recovered, the profits are still very low, compared by the very competitive US and European banking sectors. There is a kind of boom in mutual funds in Japan now, since baby boomers are retiring and investing such a huge amount of income and free time into the market. We have much room to improve the fund system, and also, consumer credit is another place for further reform.

For risk-taking finance, even though the government was desperate to do something for the SMEs or other guys, there is a serious lack of contingent debt, contingent equities, insurance derivatives, and CLT bonds. That risk-taking capital system is not well prepared in Japan, and that has left the relatively weaker sectors exposed to such a risky financial structure. We definitely need some more risk information centers opening, and we need some further total solutions offered by many financial institutions. And also the tax reforms for this sector.

This shows the banks' profits. The Japanese banks' profits are still very low- better than the negative profits in Germany, but nothing compared to the US and England. The reason is that the credit cost for Japanese banks are really high if compared to the United States, and so that has reduced the profits from lending tremendously.

So finance is another big issue, as well as higher educational reform and the innovation system. It is very crucial, because we have to raise the total factor of productivity. It is not like the Chinese economy or Indian economy. We have to invest more in the people, rather than the hardware, so in the restructuring of the universities, the government has started to select the support for the universities, but there is tremendous inefficiency in that. Now is the time for the M&A and restructuring in the major universities. We are also going to be restructured somewhat.

Professional schools like business schools and law schools are enjoying a boom, because Japan has changed the law system. We need more and more lawyers, so professional schools are providing more legal people.

Promoting science education is quite similar in Korea. We are so dependant on science and technology, but the younger generation's interest in science is getting worse and worse. We desperately need some other resources, including women, seniors, and foreigners to get into the science field.

The innovation system itself should be innovated, actually. The government has spent so much money on the R&D system, but the profit has been so low. There should be certain institutional innovations, like intellectual property rights protection in public universities. The services trying to marketize properties also need reform. Open collaboration between the businesses and the universities is another issue.

In terms of quantity and quality of scientists, there is some kind of mismatch. The vertical line shows quantitative shortage, and the vertical line shows the qualitative shortage. There is a shortage in both quantity and quality of people who are into intellectual property rights protection, interpreters, and the people who can recognize the good, marketable technologies in the capital market. That should be the place where the young people should try to make their careers. On the other hand, normal engineers are not really in shortage. We definitely have a big change for the supply.

Finally, what are the implications for Korea? The situation is very different. One of the most difficult parts for the reform of the Japanese economy is more the public sector, rather than the private sector. The private sector, as I showed you before, has done certain things, and is doing just fine. But public reform is very difficult. But one thing that we experienced, and can compare with the Korean situation now is how we muddle through the trials of indigenous growth, rather than just benchmarking or copying something. Since Korea was under the IMF pressure, you had no choice but to just follow the neoclassical US type of reform. But now there is a tremendous backlash from the society, which Korea has been suffering for the last five years. Those wall-street guys, who say that we are so slow, and are not qualified for reforms or anything, always criticize Japan. But Japan has muddled through, so that there are no political or social frictions in society. So it's always up to you, but the muddle through process is more important than just copying somebody.

Politically driven social policies are another area of big government in Japan, but they almost failed without examination, and without transparent accountability on the policies. The politicians are so desperate to piling up another social policy whenever something happens to business, but it didn't work. What did work is the desperate effort by the private sector. We have to go market friendly. Deregulations may be cheaper than the public spending. This is a typical Japanese experience that the government, based on the vested political interest to protect the construction companies, and the local economies, tries to spend so much on hardware, but nothing happens to

productivity. Deregulation, such as the deregulation of the job-searching monopolies in the labor market, has really done something to change the Japanese economy. Deregulation is much cheaper than just public spending.

Finally, in the Japanese experience, what we say to you is that the loss of this generation's human capital is the heaviest asset for the economy to recover. Even though the situation has gotten much better than before, now we still have a huge people who could not have a chance to be trained by the companies, and to be hired for regular jobs. This is a very huge negative asset on the Japanese economy. We have to grow in human capital.

I think, that you have definitely got to do something for the young people's unemployment in Korea. Otherwise they will just leave without any good experience in business firms, in any job market, and just continue to rely on their parents' income, or inherited assets. If the property situation continues like this, they may enjoy a certain easy-going life, but it won't last forever. I think job creation may be the first priority in the Korean economy, even based on job experience.

Another social issue is that it is never too late to prepare the so-called national minimum for the aging society. Korea is the fastest aging society, following Japan. Still, Korea needs a lot of social stock. If you just go walking around, you see that it would be very difficult for the aged or handicapped people to talk around Seoul. So that means you have another opportunity to invest.

I think the business sector in Korea is doing just fine. Their competitiveness is almost like that of Japan in the 1980s. Probably one thing that Korean firms, especially big firms need is more strategic alliances with global major companies. We are all facing a certain technological paradigm, and even for the big firms it will be difficult to have all the risk, while having no alliance with superpowers in other countries. Besides that, I think the business firms are doing fine. You have to concentrate on the economic structure reforms.

Thank you.

Q & A:

Q: I have a question related to the foreign exchange rate. In 2002, I think it was in March, if you compare the foreign exchange rate of the last five years, the US dollar has continued to depreciate by 50% against the Euro and the Korean Won. The Korean Won has appreciated 44%, the Yen appreciated 13% against the Dollar, and the RMB of China hasn't moved at all, but recently it has begun to increase in speed, so it has appreciated against the Hong Kong Dollar, and it's expected to appreciate by 7% this year. Professor Fukagawa, you have talked about the fact that Korea is sandwiched between Japan and China, but we prefer calling it "nut-cracked" between the two countries. In comparison with the Korean Won, it's 760 Won against 100 Japanese Yen. So the Korean Won has appreciated greatly, and the Japanese Yen is enjoying surplus and successful trade. When do you plan to increase the exchange rate for the Yen, and when do you plan to support the appreciation for the Yen so that there can be more global balance for exchange rates?

A: I'm not a financial or banking expert, but actually, we have a number of financial experts in this room, so it's kind of difficult for me to make any comment. But as you are well aware, Japanese banks have gained a high level of independence from the political circle. So, there are various opinions inside the Japanese banks but the consumption as you know, has weakened these days in Japan. When you look at the overall economic numbers, because of the weak numbers in general, I think that the weakening of the Yen is caused by the difference in interest rates. If the US economy is likely to soft-land this year, and since the income has began to go up, we believe that if the baby-boomers' consumption can be increased, the interest rates can go up sometime this year, and if that happens, then the Yen might once again be appreciated.

However, as was agreed at the previous G-7 meeting, the US position is comfortable with the weak Yen these days, because hedge fund managers can continue to carry trade in Yen due to the low interest rates. They're enjoying significant amounts of surplus. But since the Euro has gained dramatically, and since the Yen is weak and the Euro is strong, so it's some kind of balance for the US. Many countries are complaining about Japan's weak yen. They complain that the Japanese are going out of their way to support a weak Yen, but our position is that the Japanese government has not intervened in the foreign exchange market. They're just letting the market go on its way. I don't think the Japanese government will move in the near future. But if the interest rate stays at the current level, it will continue to cause some side effects. There are some people who want to increase the interest rate, so sometime later this year if the

situation is mature, I think the situation will be improved, in my personal opinion.

It's not only the weak Yen that is causing the problems. In fact, if trade stays the same, Korea's trade deficit against Japan will continue to go up because of extremely cheap Yen. It is cheaper to import from Japan than to produce in Korea. The trade deficit will continue to go up. Currently there has been no foreign exchange market, where the Won and the Yen could be directly exchanged. It has been difficult to stabilize the exchange rate between the two currencies. From the government's perspective, if they can agree to create a market in which the Won and the Yen can be freely exchanged, and if there are some mechanisms to stabilize the market, I think the situation will improve.

Q: Hearing your lecture today, I believe that Korea has three serious problems. I don't think they are shared by the Japanese economy, so it would be nice if you could compare Korea with Japan. You said that Korea's education expenses are extremely high. That is because Korea has a problem with the public education system. I was wondering why Japan does not have problems in the public education system. Japan does not have labor union problems, because it has a more flexible labor market. Is it because Japan has a good social safety net or social welfare system? You haven't mentioned anything about SMEs. The Korean SMEs are being hit hard because of low wages in China. Why don't you have this problem in Japan?

A: Regarding education, the Korean private education expense is so high because following the IMF crisis, Korean parents feel very serious about sending their children to good schools to have a chance of getting a proper job in the job market. However, in Japan, there is some structural difference, and I briefly mentioned this in my presentation. The Japanese corporations do not care so much about what kind of school the graduate has graduated from. Even if a graduate is from a third level school, or not from an outstanding educational institute, if a corporation finds this person interesting, the corporation might recruit this person. The Japanese corporations are looking for a variety in their employees. In Japanese schools, it's good to have hard studying students, but it's always beneficial for the students to have other kinds of qualities. And those kinds of qualities are well appreciated by Japanese corporations. The focus is not solely on studying harder.

In relation to your second question, the labor-management relations in Japan during

the high growth period used to be very contradictory and controversial, but the Japanese management have learned from this experience. They learned that labor-management relations had to be improved to promote predictability in corporate management, so the Japanese companies have invested huge amounts of money to improve their labor-management relationship. However, in Korea, because of the drastic collapse of the long-term employment structure following the IMF financial crisis, Korea did not have time to improve their labor-management relations. This is related to the democratization process. The labor unions came out with difficult requirements, so the management thought it was necessary to lay up some people because of the difficult demands from the labor unions. That has continued to increase the number of regular jobs, and the labor union people are coming up with drastic requests to protect their jobs. It's a very vicious cycle. The cause for this is that Korea continues to promote laborsaving technologies. In the LCD and semiconductor industries, for example, you don't need as much of a labor force. That will not create that many jobs, and because Korea is pushing laborsaving technologies instead of paying attention to labor-management relations, the focus was on promoting and facilitating the finance. There's no real incentive for the human resources manager of Korean corporations to improve labor-management relations, in spite of the difficult work, the manager has put into the labor-management relations. If his performance in this area is not properly evaluated, the HR manager will not see the need to improve labor-management relations, and he will put his efforts somewhere else for financing or something else.

The Japanese have the strategy to have black-box knowledge. If that is going to be the case, the human capital will be the core resource for growth. That's how the Japanese companies feel. The manager that makes it up to the CEO level are often from IT or HR systems, and more and more bureaucrats find it up to the top levels of the organization. In Korea, Korean corporations are looking for profits. They have greatly outsourced a lot of processes. They have not really felt the need to invest for their internal human resources. Outsourcing processes can be copied and imitated by competitors, so I think it's beneficial to look in the other direction, trying to absorb everything with their own budget.

This is closely related to SMEs as well. The Japanese SMEs can no longer produce that much in Japan. The very small Japanese SMEs that still remain in Japan have 50-60% in the global market. They have an outstanding technology that is totally black-boxed. Their recipe for technology remains in Japan because cannot be copied by

other people. Their biggest concern these days is that they have no other person to inherit their business. Because there is no manuals or business processes, the people who are trying to inherit their jobs need to be trained very hard, and remember the business processes by heart. It's very difficult for the young generation to take that kind of challenge. But in Korea I see that there are many young people who want to be in the venture business, and they need to create a unique business that cannot be easily copied by others. I think it's a matter of information, and not necessarily a matter of money. I think there should be flexibility in the companies that spin off from major corporations, so that they can find work in other SMEs.

Q: Regarding the privatization of NHK, will such a privatization improve the quality of news reports? Additionally, I understood that you studied the proposed Korea-Japan FTA extensively. What were the good points of this proposed agreement? We are now pushing for the Korea-US FTA. What are the implications of this on the Japanese economy? What are the implications of a possible Japan-US FTA?

A: When it comes to the Korea-Japan FTA, I believe that the expectation regarding this agreement was as follows. At any rate, Korea's market is quite sizable, but the more important thing is that we need to push forward the innovation side. For that, we need to open up the market, and we need the competition. That means that we need to make the FTA with our competitors. When it comes to our Chinese counterpart, it was quite a strategic issue, but we've had a lot of problems since the Koizumi government. Right now, I believe that there will be some sort of political decision. There are a lot of struggles, as you know, regarding Dokdo, or the past, and so forth, and I have to say that without mutual confidence, we cannot push forward any FTA.

I believe that from the Japanese viewpoint, the Korea-US FTA is quite positive, for two reasons. First, the Korea-US FTA means what is expected to Japan. So there is strong similarity between the Korea-US FTA and any Japan-US FTA. If there is a good effect coming from the Korea-US FTA, we have to learn this. That is the Japanese position. Also, making an FTA with the US is a very difficult task. This is the biggest challenge we can imagine! If Korea succeeds in making this agreement, we have to say that Korea will be the main champion of all the FTA makers. I believe that since this is such a challenging agreement to achieve, we can say that perhaps the Korea-US was made into a reality, so why couldn't the Japanese succeed as well.

When it comes to agriculture, I think that Korea is the only country with a competitive edge for the agricultural sector. I think there are many good ideas from Japan, but also from Korea. We can find a lot of similarities. For instance, an agricultural company can be established, and there can be some new products coming from the agriculture sector, and so forth. Those new ideas can come up in the future. Those can be an innovative expectation we can have. The Japanese perspective is that we are wondering whether the Korea-US FTA is somewhat political, because probably, the FTA between China and Japan may be more beneficial to Korea. That was our question. There is a totally different picture regarding China, in terms of price and FDI. What we think is that from the viewpoints of Americans, such sectors as insurance and finance should be first made into an agreement with Japan. Then, we could probably look at other sectors and other countries. If such a thing can be made between Japan and the US, a similar thing can happen with Korea as well. Again, the FTA between the US, Japan and Korea might work. This is not a one-country effort. In this effort, many other parties can join, perhaps even China.

In a nutshell, I believe that priorities are somewhat different. Personally speaking, I believe that we are at a loss as to what the priority of Korea is. I believe that one priority for Korea is Job creation. It seems that Koreans think that the FTA should be made with a country that will contribute to such Job creation. I believe that Koreans need to focus on the making of this agreement. The Kaesung Labor Complex should not be the issue. I'm really frustrated to see such non-productive discussion and struggle going on in this FTA discussion. I'm confused about your priorities. That's a really lucid point of view.

How about the Japan-US FTA? That's something that we have talked about for a long time, and many people have watched it very closely. Then there was the anti-dumping agreement, or super-dumping clause, and so forth. I believe that it needs to be clarified. The US never conceded with other countries like Mexico. If one country succeeds in making an FTA, then Japan will be interested. If not, I don't think Japan will have any benefit. Japanese insurance companies or other finance companies might have some interest in going into the US, but as you know, America is a federal system, so each state has different regulations. The US never proposed to change the federal law regarding finance industry. That means that Japan is at a full disadvantage for opening the market, so that is why Japan's position is that we need something such as the Japan-US alliance in mind. Then we can probably think about it, but it has no grat



benefit.

Also, if we can talk about the deregulation, in terms of media and other services, those are underway. So we don't really see the FTA with the US. For the Liberal Democratic Party, agriculture is something they have to protect, so I think that in the near future, a Japan-US FTA is not so probable.

As for Australia, we have already started the discussion. But Australia is exporting lots of beef to Korea and Japan. I believe that there will be strong lobbies from America to Japan in order to have their share of the beef market. If there is a true FTA with Australia, it will cause some big problems later on with the USA.

How about NHK? NHK privatization is not an easy task. However, NHK is a huge organization, and there are many problems with its governance. Many people criticize that. In contrast to KBS, Japanese NHK cannot really collect much of a fee from the audience. It's really voluntary for the Japanese audience. But then there are complaints from the audience if they do otherwise. Right now, people in authority think that they need to shrink their huge NHK organization a little bit, including the Japanese government. We lack English ability, and we have very limited tools for communication overseas. We are in need of these kinds of media organizations. That is why we need some kind of improvement. Such market pressure can be applied to NHK, and personally speaking, I would prefer a radical privatization of NHK, however, there is a very strong lobby coming from the government to protect NHK. Maybe it's similar to Korea. On the Internet, there are many movements for this, and IT companies with their innovation might increase or create that pressure.