

cabinet installed in August 2000, the Ministry for Investment and State-Owned Enterprises was abolished and a new Ministerial Board was established to oversee the privatization program.

Under the Megawati government no new initiatives on privatization have thus far been made. In FY 2001, proceeds from privatization was far below the target. Privatization appears to have come to a halt.

*Other Reforms.* In the course of implementing the series of recovery programs, a few other reforms were undertaken. Amongst the important ones were the reforms to overhaul the bankruptcy system and the establishment of a commercial court. The Parliament ratified a revised bankruptcy law on 24 July 1988. However, the operation of the commercial courts needs significant improvement to gain credibility. In the course of the development many strange decisions have been made by the commercial court. There is the allegation that the new commercial courts are not free from bribery, as shown in the notorious Manulife case.

Another major initiative was the introduction of competition policy and the enactment of the Law regarding Prohibition of Monopoly Practices and Unhealthy Competition (Competition Law) in March 1999. A Commission for Business Supervision was set up in 2000. It is still too early to judge about the performance of this Commission. However, if it continues to strengthen its capacity to perform its role, the Commission will become one of the important new economic institutions in the country.

The bankruptcy law, commercial court, competition law and the competition commission as discussed above have all been created by the IMF-supported program. In a sense, they can be regarded as being introduced due to IMF conditionality. A policy question has been raised as to whether their creation in a haste could result in their being discredited as something that is imposed from the outside and cannot be

implemented successfully in Indonesia. The Commercial Court gives an illustration at its best of the relevance of this question.

## **MACROECONOMIC PERFORMANCE: FINAL NOTES**

This final section attempts to describe macroeconomic developments during the immediate years of the crisis (1997 and 1998) and the following years, so as to be able to make an assessment of the impact of the recovery and reform programs introduced since October 1997. A few microeconomic results have been discussed in the previous section.

As can be seen from Table 2, GDP growth declined from 7.8% in 1996 to 4.7% in 1997. The economy was still growing at 7% in the first semester of 1997. The deepening of the crisis and the political and social unrest in 1998 led to a severe contraction of the economy. It has been said that such a situation has not been experienced by any other economy in recent history.

Growth in 1999 was less than 1%, driven largely by household consumption. In 2000, the economy showed a strong sign of recovery. The peaceful general elections in June 1999, the first democratic elections in 40 years, and the election of Abdurrahman Wahid as President created a turn-around on the general sentiments of the people. Exports picked up. Investment was growing for the first time since the crisis by a strong 22%. It mainly consisted of domestic investments. By and large, foreign investors kept a wait and see attitude. Indeed, it was unfortunate that the encouraging prospect was short-lived. The earlier session has highlighted the problems during the Wahid presidency.

**Table 2. Annual Growth of GDP By Expenditure**  
(at 1993 constant prices)

	1996	1997	1998	1999	2000	2001
Consumption	8.65	6.97	-7.11	4.26	3.89	6.15
Household consumption	9.72	7.82	-6.17	4.63	3.63	5.94
Government consumption	0.65	0.06	-15.37	0.69	6.49	8.24
Gross fixed capital formation	14.51	8.57	-33.01	-18.20	21.92	3.96
Export of goods and services	7.56	7.80	11.18	-31.80	26.48	1.88
Less import of goods and services	6.86	14.72	-5.29	-40.68	21.09	8.05
<b>Gross Domestic Product</b>	<b>7.82</b>	<b>4.70</b>	<b>-13.13</b>	<b>0.79</b>	<b>4.90</b>	<b>3.32</b>

Source : Central Board of Statistics

The change in sentiment was reflected in the 2001 growth figures. Household consumption remained strong, but investment grew by a mere 4 %. As the world was experiencing a slow down, Indonesia's exports was also affected.

As can be seen from Table3, the recovery in 2000 was experienced in all sectors, including manufacturing, which performed better than in 1997. The continued weak rupiah was an important competitive factor in 2000. There was a slowdown in all sectors in 2001, but the mining sector again experienced a contraction. Security problems in the mining regions, and the proliferation of illegal mining, as well as the impact of the regional autonomy project have all resulted in declining mining activities. Some investors have closed down their mines and other have left the country.

Table 3. Annual Growth of GDP By Industry of Origin  
(at 1993 constant prices)

	1996	1997	1998	1999	2000	2001
Agriculture	3.14	1.00	-1.33	2.16	1.70	0.63
Mining and Quarrying	6.30	2.12	-2.76	-1.62	5.06	-0.64
Manufacturing Industry	11.59	5.25	-11.44	3.92	6.10	4.32
Electricity, Gas & Clean Water	13.63	12.37	3.03	8.27	8.78	8.43
Construction	12.76	7.36	-36.44	-1.91	5.50	3.96
Trade, Hotel & Restaurant	8.16	5.83	-18.22	-0.06	5.58	5.11
Transportation & Communication	8.68	7.01	-15.13	-0.75	9.38	7.51
Fin., Leasing & Business Services	6.04	5.93	-26.63	-7.19	4.34	2.99
Services	3.40	3.62	-3.85	1.94	2.20	1.97
<b>Gross Domestic Product</b>	<b>7.82</b>	<b>4.70</b>	<b>-13.13</b>	<b>0.79</b>	<b>4.90</b>	<b>3.32</b>

Source : Central Board of Statistics

Table 4. Monetary Indicators

	1996	1997	1998	1999	2000	2001
<b>Consumer Price Inflation</b> (Average annual rate in %, 1996=0) 12.55		6.63	10.31	77.63	2.07	9.18
<b>Exchange Rate</b> (Average market rate, Rupiah per US\$)	2348	2953	9875	7809	8527	10410
<b>Money Supply Growth :</b>						
Base Money (Mo)	33.08	33.95	63.00	35.50	23.41	1.74
M1	21.66	22.24	29.17	23.16	30.13	9.58
Currency	8.07	26.40	45.63	40.97	24.02	5.49
Demand Deposits	30.54	19.99	19.80	10.83	35.51	12.89
Quasi Money 13.93		32.11	23.50	71.72	9.53	12.13
M2	29.64	23.22	62.35	11.92	15.60	12.99
<b>Commercial Banks' Outstanding Credit Growth</b>	24.76	29.09	28.90	-53.81	19.48	14.35
<b>Deposit Rate</b> (Average 1 month deposit rate, % p.a.)	16.92	23.01	51.67	23.97	11.16	14.54
<b>Lending Rate (% p.a.)</b>						
Working Capital	19.21	21.98	32.27	28.89	18.43	19.19
Investment	16.42	17.34	23.16	22.93	16.59	17.9

Source : Bank Indonesia and Central Board of Statistics (various editions)

Table 4 shows developments in the monetary field. The above story seems to be confirmed by developments of credit growth, which almost reached 20% in 2000. It has since weakened again. Inflation, which hit a record high of 78% in 1998 was brought down drastically to 2% in 1999. It went up again in 2000 and 2001, partly because of upward adjustments in domestic fuel prices, electricity, transportation charges. Political instability nearing the end of the Wahid government also contributed to this.

The currency, which began to strengthen in 1998 continued to decline in the years that followed. By the end of 2001, the exchange rate stabilized at about Rp 10,000/\$. It

then strengthened at the beginning of 2002 to around Rp 8,400/\$ for a while, but since mid-2002 tended to stabilize at about Rp 9,000/\$.

Developments in the base money, and problems encountered by the monetary authority to control base money growth was discussed earlier. Efforts at controlling base money growth became more successful in 2001. Interest rates increased in 2001 after experiencing significant reductions in 2000. Problems of monetary management remain a major challenge for the government and BI.

The significant increase in the country's outstanding debt can be seen from Table 5. The earlier discussion has examined the reasons for the increase. Total government debt increased from \$54 billion in 1997 to \$141 billion in June 2001. This was caused mainly by the increase in domestic debt, as discussed previously. Domestic debt increased from zero in 1997 to \$69 billion in June 2001, whereas external debt increased from \$55 billion to \$72 billion. Total government debt reached above 100% of GDP since 1998, but was about 95% in June 2001. The target of the recovery program is to reduce government debt to 65% of GDP in 2004. Total private debt remained high, but lower in June 2001 compared to pre-crisis (1996), because of the dramatic reduction in domestic debt. External debt was highest in 1998 but has since declined.

The cost of the crisis and the way it was handled can be said to be borne by the government. However, as the interest on bonds is being paid through the budget, in the end the burden is with the people. It is only logical that the people demands that the government implement a recovery program with a strong reform component.

Table 5. Debt Indicators  
(Outstanding Debt US\$ bill)

	1996	1997	1998	1999	2000	Jun-01
<b>Total government Debt</b>	<b>55.2</b>	<b>53.9</b>	<b>77.3</b>	<b>139.7</b>	<b>151.9</b>	<b>140.7</b>
Domestic	0.0	0.0	10.0	63.8	77.0	68.7
External	55.2	53.9	67.3	75.9	72.0	
<b>Total private debt</b>	<b>182.2</b>	<b>154.4</b>	<b>128.4</b>	<b>134.8</b>	<b>126.8</b>	<b>129.7</b>
Domestic	127.3	72.2	44.8	62.6	60.0	62.8
External	54.9	82.2	83.6	72.2	66.9	
<b>Total Debt</b>	<b>237.4</b>	<b>208.3</b>	<b>205.7</b>	<b>274.5</b>	<b>278.7</b>	<b>270.4</b>
Domestic	127.3	72.2	54.8	126.4	137.0	131.5
External	110.1	136.1	150.9	148.1	138.9	
<b>(As percent of GDP)</b>						
<b>Total government Debt</b>	<b>27.0</b>	<b>48.7</b>	<b>112.2</b>	<b>106.1</b>	<b>111.5</b>	<b>94.8</b>
Domestic	0.0	0.0	14.5	48.5	56.5	46.3
External	27.0	48.7	97.7	57.7	48.5	
<b>Total private debt</b>	<b>89.1</b>	<b>139.6</b>	<b>186.3</b>	<b>102.4</b>	<b>93.1</b>	<b>87.4</b>
Domestic	62.3	65.3	65.0	47.6	44.1	42.3
External	26.8	74.3	121.3	54.9	45.1	
<b>Total Debt</b>	<b>116.1</b>	<b>188.4</b>	<b>298.4</b>	<b>208.6</b>	<b>204.6</b>	<b>182.2</b>
Domestic	62.3	65.3	79.5	96.0	100.6	88.6
External	53.8	123.1	219.0	112.5	93.6	

Source : Feridhanusetyawan, Pangestu and Roesad (2001)

The above discussion has shown that the Indonesian economy has began to loose steam in 2001 the economy grew by about 3.3%, driven mainly by domestic consumption. Indeed it was a better performance than in some other Asian economies. However, as stated before, this is not good enough for Indonesia in view of the need to create job opportunities for the 2.5 million people entering the work force each year. The Indonesian economy can be said to be recovering if it can grow again by 6 percent or more per annum. However, this higher growth rate must be accompanied by its

sustainability and improved social justice and greater equity. That is why Indonesia's agenda for economic recovery must include wide-ranging reform measures, covering improved economic governance and the establishment of new economic institutions. This is not an easy task.

The previous examination has shown that efforts to rehabilitate the failed banking and financial system have not been all that successful despite their high cost, particularly to the government. The burden to rescue failed banks and to recapitalize others is carried by the government through its budget that is already very tight. And this burden will be felt for many years to come. It is the government that bears the costs of the financial crisis of 1997/98 which largely originated with the private sector.

In addition, private debt restructuring has been extremely slow. Many private companies have been trying to get out of the problem by being bailed out by the government. A few, politically connected business groups have been rather successful in soliciting the government's helping hand. However, this too resulted in higher contingent liabilities on the part of the government.

Private assets that fell into the hands of the government in exchange for the government's assistance to banks are being handled IBRA. It is the policy of the government to dispose of these assets as quick as possible. The process has been extremely slow and frustrating. Apart from problems of non-cooperation by previous owners, the agency itself suffers from a deficit of competence and transparency, perhaps also honesty, and the inherent difficulties of restructuring. But equally problematic has been the problem of political interference. The sale of these private assets is one source of funding political activities. The Bank Bali scandal during the Habibie presidency exemplifies this problem.



The government's policy to finance up to a significant portion of the budget deficit with domestically mobilized resources is a good way to force IBRA to expedite the process of assets disposal as well as to accelerate the program of privatization. Both asset sales and privatization are expected to finance about 70 percent of the budget deficit, the remaining 30 percent being financed through foreign assistance.

The tight budget has also been helped by the willingness of donor governments to reschedule public external debt service payments. This rescheduling exercise through the Paris Club has been repeated for three times and in all likelihood will have to be repeated again in the years to come to give Indonesia the necessary breathing space to overcome the bunching of debt, both external and domestic, in 2003 to 2006.

Central government development outlays have significantly decreased in the last few years. This is also caused by fiscal decentralization as part of the implementation of regional autonomy. It is as yet unclear as to how local governments will allocate their spending for infrastructure, education and health, expenditures that have impacts on the country's future growth potentials.

In the first few years, there are likely to be problems in the implementation of regional autonomy. Capacity in the regions is still weak, but problems in the implementation are caused to a large extent also by the absence of clear implementation regulations. In addition, local governments are trying to maximize local revenues in the short term by introducing new taxes and other user charges. Many of these new taxes and user charges do not make sense and result in a high cost economy. Efforts are being made by the central government to control this but with mixed results. There is also the problem of the sharing of revenues from natural resources between the central and regional governments. Disputes on this matter have caused problems for investors in particular in mining and forestry. The weak government at the center is not helpful to resolving this problem.

These problems do affect the country's investment climate. But the country will learn how to overcome them by going through the bad experience and learning from the mistakes. They can be costly, but perhaps that is the cost to pay. External pressures, such as in the Manulife case, are sometimes necessary.

Notwithstanding the above, there also is a positive side of developments in the Indonesian economy. This refers to the so-called "healthy" sector of the economy. This sector has not been affected by the financial crisis and has grown faster since the crisis. It consists of medium-sized enterprises that have not relied on bank credits for their investments. It also consists of a whole array of small scale activities. However, it also consists of a wide range of export-oriented manufacturing activities. The increase in investment since 2000 has been accounted for by a large number of new small investments within this sector as well as expansions of existing large investments, including foreign direct investment (FDI). In the medium to long term the health of this "healthy" sector of the economy depends on the overall economic and political environment in the country. But for now, it is a major engine for growth and helps the economy to be afloat.

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# **International Conference on Economic Recovery and Reforms**

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# **Japan**

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**Implications of the Japan's Lost Decade to Asia  
Perspectives from Japanese Trade  
and Investment Relationships\***

**Shigeyuki Abe  
Center for Southeast Asian Studies  
Kyoto University**

**ABSTRACT**

Japan has been struggling to get out the decade long depression. Koizumi government changed its stance of economic policy from the former governments to emphasize reforms rather than fiscal expansion. In this paper a short history of the current Japan's depression will be explored first. Specific problems of recent economic policies will be discussed next. Bad debt problems, industrial restructuring, inflation targeting issues, record high unemployment situation, changing Japan models, and etc. are such issues. Lastly, Japan's role in Asia will be discussed.

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## 1. Introduction

In the 1980s, *Japan Bashing* was a key term to explain the relationship between Japan and the United States. Japanese exports to the United States were so strong that the United States constantly bashed Japan to open her market<sup>1</sup>. One could see the products of Toyota, Nissan, Honda, Sony, Panasonic, and other Japanese firms in every corner of the world. In Japan's heyday, eight of the ten largest banks in the world were Japanese. This resulted in the enforcement of BIS regulations. This enforcement has been plaguing Japanese banks ever since and has resulted in a credit crunch. During the era of Japan bashing, both countries acted harshly and sometimes confronted each other emotionally. These worrisome and yet happy days did not last long. *Japan Passing* became the new term to represent the situation during the following decade. The United States started to neglect Japan and to consult more with other Asian countries, particularly China. When President Clinton entered office, this trend intensified and the new key term became *Japan Passing*. Japan seemed to become invisible. In fact, in one of Clinton's speeches to congress, Japan was not mentioned at all, while China was mentioned six times and other countries mentioned include North Korea, South Korea, and Russia<sup>2</sup>.

Japan is now in the midst of the *Lost Decade*. The *Lost Decade* used to be a term reserved for Latin America. But no matter how hard Japan has tried to escape the current depression syndrome, there seems to be no way out. Depression in Japan has been affecting Asia negatively. Thus, Japan must be currently regarded as a kind of *virus*. It has been exporting its depression.

Although Japan has endured the trauma of going from being the leader of Asia to the virus of Asia, she is now on the verge of rebounding from hardship to attain

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<sup>1</sup> Prior to this the relationship between Japan and the United States was characterized by the following phrase, "If the United States coughs, Japan will catch cold," or "If the United States catch cold, Japan will suffer from pneumonia."

<sup>2</sup> Tetsuya Tsukushi, "From Bashing to Passing to Nothing", News23 TODAY'S COLUMN Jan.30(Thu), 1997.

new heights in the future. The real question is how soon this can be achieved. Where Japan will go from here will inevitably have important impacts upon other Asian countries because the economic ties have become much tighter than they were before.

In order to assess all these matters, we will briefly review the economic growth history of Japan in the next section. We will analyze also how the Japan system has been formulated. Since Japan has large impacts on China and other Asian countries through her trade and investment, we will review the trade and investment relations in this section. In section 3, although the recent Asian crisis is often explained by volatile international capital markets, we will look at it from an alternative perspective, i.e., real side stories. We then discuss the current status of the Japanese economy in section 4. In the concluding section, we will touch upon possible policies that Japan might adopt to once again lead Asia and the world.

## **2. History of Japanese Economic Growth**

### **Postwar Period**

When Japan was defeated in World War II, her industrial production decreased to about a half of its prewar level, exports to one fifth, and imports to one half. With 13.1 million jobless, grave shortages of energy and food, and high inflation, Japan endured the hardship and successively democratized the country in accord with the orders of the SCAT, or the U. S. occupation forces. *Zaibatsu* were dissolved, drastic land reform was implemented, and labor democratization was promoted. At the start, though, the United States and its allies intended to leave Japan as poor as the other Asian countries which Japan had invaded. Fortunately for Japan, this policy stance changed 180 degrees when the Korean War broke out. With special procurement demand from the United States, Japan started to enjoy an economic boom.

### High Growth Period

During the period 1955 to 1970 Japan achieved an annual growth rate of about 10 percent in real terms (Fig.1). During this High Economic Growth Period, many Japanese management characteristics were formed, such as seniority wage, lifetime employment, company labor union, just-in-time *kanban* system, TQC, industrial policy, sub-contracting system, and government-private sector collaboration. In the days of high economic growth with abundant labor, this system functioned nicely<sup>3</sup>. Japan engaged in a vertical trade system, importing raw materials and processing them to export manufactured goods. Cheap oil prices and a fixed exchange rate (at 360 yen to the dollar) worked out very well for Japan. Government interventions were often made and the private sector reacted even better than expected.

### Nixon Shock and Two Oil Crises

In the 1970s, Japan encountered the Nixon shock and then the two oil shocks. In the early years of the 1970s, the U.S. economy weakened. Then President Nixon suspended the convertibility of the dollar into gold in 1971. He also initiated a new relationship between the United States and China. The combined effect of these two acts is called "the Nixon shock." Also, the exchange rate system shifted from fixed to floating in 1973. During this period, Japan suffered not only from trade frictions internationally but also from environmental pollution problems domestically. These problems generated growing pressure to change Japan's industrial structure. The first oil crisis was a devastating blow to Japan, and Japan was forced to change its structure from one centered on heavy industry and chemicals to one centered upon energy saving. Japan managed to remain competitive by effectively cutting energy consumption, conserving resources and electric power, and further up-grading their structures to more technology and knowledge based ones.

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<sup>3</sup> Noguchi criticized the traditional Japanese bureaucrat driven system as 1940 system. See Yukio Noguchi, "The 1940 System :Japan Still under the Wartime Economy," *American Economic Review*, May 1998.



It was around this period that the auto and the electrical machinery industries made a quantum leap forward and played a leading role in propelling the economy.

### **Plaza Accord, Trade and FDI**

After overcoming the crises of the 1970s, Japan became more efficient and more competitive. In 1985 Japan faced a sharp yen appreciation when the Plaza Accord came into effect. Transformation of industrial structure was again necessary. The yen rose from 240 to 120 per dollar in just one year. In response, Japanese firms sought to rationalize their operations. Some of them moved their production facilities to overseas markets. Meanwhile, foreign made goods poured into Japan, made affordable by the strong yen. This accelerated the emergence of a more horizontal division of labor between Japan and low-cost countries.

Since 1985, Japan's trade structure has undergone profound changes. While the share of goods shipped to the United States and the EU has declined, those going to East Asian countries have increased. In terms of categories of goods, while the share of durable consumer goods (notably, automotive vehicles) has decreased, those of capital goods (about 60%) and parts of machinery and transportation equipment (about a third) have risen. The share of capital goods and parts of machinery and transportation equipment shipped to East Asian countries in their worldwide exports has increased, and parts of machinery and transportation equipment exported to these countries accounted for a little less than 50%. (Figure 2)

Japanese imports from East Asian countries have been rising since 1990, and have accounted for about one third of Japan's total imports in recent years. In terms of categories of goods, the share of industrial supplies (petroleum, etc.) in the total imports which had accounted for nearly 60% in the second half of the 1980s dropped to about 40% by 2001, while those of capital goods and parts of machinery and transportation equipment have risen. (Figure 3)

As the production by Japanese transplants in overseas markets has expanded, Japan's exports of finished goods, notably, durable consumer goods (*export substitute effects*) have decreased, while there has been an increase in exports of parts of machinery and transportation equipment and capital goods which are necessary for overseas production (*export-inducing effect*).

Thus, Japan's trading pattern is now more horizontal. This is a departure from the earlier vertical trade pattern, when Japan imported raw materials and exported only industrial products. Intra-industry trade has been expanding.

Regional ties have been tightening since 1985. With the development of regional trading arrangements trade intensities underwent substantial changes. Japan has been growing less dependent on the United States and European markets and trading more with Asia (Figure 3). For China the trade intensity is strong with Japan, 2.89, and with Asian NIEs, 3.02. It is 2.08 with ASEAN4. In case of Japan the intensity is 1.77 with China, 2.67 with Asian NIEs, 2.82 with ASEAN4 while it is 1.61 with the United States. Both Japan and China have stronger ties with Asian countries. It should be noted at this juncture that both Singapore and Hong Kong are hubs of the Asian trade. Their trade intensities with Asian neighboring nations are larger than those of any other pairs. This has quite an implication for regional trading zones. (Table 1)

Prior to the Plaza Accord, FDI from Japan was directed mostly toward the United States and Europe. Since 1985 the direction has shifted more to Asian countries. The participation of newly industrializing economies, especially Asian ones, has intensified competition in the manufactured-goods markets, while industrialized countries have shifted their industrial and export structures more to the knowledge-intensive industries such as high-tech and software. (Figure 4-7)

## **Bubbles**

Japan took all possible measures to revive its economy and this in turn contributed to the creation of a bubble economy. As Japan encountered international difficulties, the government tried to help the private sector by pumping public works and other projects into the economy, which resulted in ever-increasing public debt. It was natural for private enterprises and individuals at that time to invest in real assets. When the bubble burst, this brought massive non performing loan (NPL) problems.

Since the bursting of the bubble, the Japanese economy has never come back to a normal growth pattern. Japan obviously mismanaged its economy by adopting a succession of wrong policies in the recent past.

## **View from per capita GDP**

To sum up the above brief historical overview, let us look at changes in Japan's per capita GDP. Japan's industrial growth can be described as a process of constant upgrading of its industrial structure in order to catch-up to the United States and Europe. In 1955 per capita nominal GDP of Japan was just one tenth that of the United States. By 1987 Japan's per capita GDP had surpassed that of the United States. Japan attained the world's highest per capita GDP in 1996, reaching a level more than 20 percent higher than the United States (Figure 8). This achievement was made possible by productivity increases.

## **Total Factor Productivity**

Behind this growth in per capita income was a constant increase of technological development, which can be measured by TFP (total factor productivity)<sup>4</sup>. Figure 9 shows a growth in the TFP – namely, qualitative improvement of labor and capital

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<sup>4</sup> The calculation of the TFP is from METI, *White Paper on International Trade*, 2000.

inputs in addition to a qualitative increase in capital input, technological advance, and the expansion of economies of scale. This has contributed to the growth of the Japanese economy. A sharp fall in the percentage contribution of capital and changes that occurred in the TFP were factors that braked the forward momentum of the Japanese economy from the rapid growth of the 1960s to a slower and more stable growth during the 1970s and beyond. Growth in the TFP slowed sharply during the 1990s, due in part to a cyclical downturn in the economy. This explains the nature of the *Lost Decade* very well.

Figure 9 traces the technological advance that has underpinned the economic growth of Japan. During the rapid economic growth period, technology introduced from overseas contributed to the growth. Original technological innovations accounted for only a small part of this technological advance. Technological advances made by Japan largely consisted of developing refined applications of imported technology. In the 1980s, however, R&D activities undertaken by Japanese firms began to pick up, and their technology exports also increased.

### **Trade Issues in Retrospect**

The worldwide recession that occurred in the 1970s triggered a movement toward protectionism, and the number of import restrictions and antidumping lawsuits increased sharply in many countries<sup>5</sup>. Particularly, trade friction involving Japan, the United States, and the EU--which together account for 60% of the world's GDP and more than a half of the world's exports--intensified.

Trade frictions involving Japan's exports started with the exports of textile goods in the 1960s. But by the 1970s the focus had shifted to higher value-added products, such as steel, color TV sets, and automotive vehicles, in line with the greater sophistication of Japan's industrial structure. Such frictions arise inevitably

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<sup>5</sup> For example, Edward J. Lincoln, *Japan: Facing Economic Maturity*, Washington D.C.: The Brookings Institution, 1988.

as the export structure and domestic industrial structure of different countries become more alike and as the number of areas of competition grows larger. Japanese exports of highly specialized products to Western countries had been surging, even when the recipient markets were struggling with a recession. This poured oil on the flames of protectionist sentiment in the recipient countries. To put the matter another way, during the high growth period Japanese manufacturers engaged in “cut throat” competition domestically, and they adopted the same tactics in exporting their products in the United States and Europe.

By the 1980s, the trade imbalance of many countries had widened. Trade frictions no longer involved only individual goods. The economic structure as a whole became the issue. The United States attempted to impose Super 301 under the new trade policy of 1985, and trade frictions started to escalate. Japan continued to record current-account surpluses and became the world's largest net creditor country. Japan, as a country running the world's largest trade surpluses, was asked to increase imports and to recycle funds to needy countries. In an effort to deepen mutual understanding between the two countries, Japan and the United States held Structural Impediments Initiative (SII) talks, followed by a Framework Talk. In my opinion, these were not really trade talks, but rather discussions of international industrial policy, or exercises in policy coordination. On repeated occasions Japan and the United States exchanged views on matters relating to one another's savings and investment structure and non-tariff trade barriers.

### 3. Asian Crises: Real Side View<sup>6</sup>

[I'm not sure "Real side view" communicates effectively what you have in mind]

In July 1997 Thai currency (baht) fell down suddenly. The immediate reason was the sudden outflow of short term capital, which exhausted the international reserve at the Bank of Thailand. Thailand kept domestic interest rates high and kept the dollar peg system in order to invite foreign investments. Foreign investors moved their capital to earn secured high interest. But when the prospect of baht devaluation became likely, a sudden outflow resulted, which in turn triggered a fall in the baht. The movement of Asian currencies before and after the crisis is shown in Figure 10.

We should note, however, that there's a real side view of the Asian currency crisis. The world wide depression pulled down the Southeast Asian economies, especially Thailand. These countries' dependence on electronics products is very high and this particular depression attacked their economies directly. Under such circumstances, China, India and Vietnam started to intrude into labor intensive product markets. In early 1994 China's Yuen was devalued and this made China even more competitive. The relative competitiveness of Southeast Asian countries fell. Thailand in particular recorded substantial balance of payment deficits in 1995 and 1996 (more than 8 percent of GDP). Thus, Thailand's economy revealed its fragility to world currency speculators.

Another negative factor was that the short-term funds did not go into real production. Instead it was invested in real estate, i.e., the construction of office buildings, residential apartments, and golf courses. Non banks played an intermediary role to funnel the funds to this sector. This, of course, created bubbles. When the bubbles burst, these non banks suffered from accumulated bad

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<sup>6</sup> This section is based upon Shigeyuki Abe, "Asian Currency Crisis 1997 and Japan", a paper presented at the Western Economic Association Annual Meeting, Bangkok.

debts. Stock prices of these firms plummeted, and this affected other stock prices.

Since this was commonly known, speculators naturally thought that Thailand could not maintain the dollar peg system.

Competition in Asia is tough, not only in semiconductors but also for many other products. Southeast Asian countries are competing with each other. During the 20 years of the industrialization process, each country has possessed similar industrial and export structures. Electronics products in particular became the most important export items. Thus, when the Thai baht was devalued, other countries were forced to devalue their currencies to remain competitive.

Figure 11 shows Asian countries exports of SITC 2digit products to Japan for the period between 1988 to 1995. From these figures we can safely argue that most of the Asian countries have similar export structures. For SITC 74 (other industrial machinery and parts), 75 (office machines and computers), 76 (telecommunication and sound recording apparatus), 77 (electrical machinery), Korea, Singapore, Philippines, Thailand and Malaysia have been expanding their trade. China seems to be pursuing a similar but somewhat different path, while Indonesia is clearly different.

We now move to a further breakdown of SITC. As an illustration, I take Taiwan, Korea, Thailand, Malaysia, and China and their performance in exporting their products of SITC 7511 to 7868 to Japan for the years 1988, 1992, and 1995. In 1988, for most of the products, exports of China, Taiwan and Korea surpassed those of Malaysia and Thailand. There were almost no China exports. We see emerging exports from Thailand and Malaysia, but the products are different for these countries. For example, Malaysia showed its strength in SITC 7764 (ICs) and 7622 (radio receivers), while Thailand in 7527 (PC storage units) and 7599 (parts for PCs). China did not export many of these products. In 1992, changes can be observed. Exports from Taiwan and Korea shrank substantially in most of the

products. Malaysia increased its exports to Japan in products like 7622 (radio receivers), 7638 (sound recording), and 7649 (parts of radio, sound recorder, telecommunication etc.), all of which were already caught up by China. Thailand drastically increased exports of SITC 7599 (parts of office machines), and 7649, the latter was caught by China, 7752 (refrigerators). Malaysia and Thailand competed with each other in 7764 (ICs). (Figure 12)

In 1995, Taiwan and Korea were gone. China suddenly emerged as the top competitor. The catching up process was acute. And yet there's differentiation of products between Thailand and Malaysia except products like 7611(TV), 7638 (video), 7764 (Integrated Circuits).

By adopting this perspective, we can argue that in using FDI to building the same kind of industrial structure throughout Asia, and engaging in fierce competition, Japan was basically repeating the pattern of behavior it displayed in the earlier trade frictions.

#### **4. The Current Status of Japanese Economy**

As I outlined above, the growth of Japan after World War II left serious problems before us. Like other Asian countries, Japan now faces growing globalization. In this situation, Japan has three fundamental problems. First is the aging population. Second is the enormous public debt. Third is the continuing depression, or the *Lost Decade*.

Let me start with statistics.



### **National Debt**

Figure 13 shows the fiscal balance of Japan changing over time. As you can see, the fiscal balance became negative only after the first oil shock. The balance did not return to positive territory until 1988. Then the bubble collapsed in 1990 and once again the fiscal balance deteriorated. The end result of these successive government deficits is an accumulated national debt.

Figure 14 shows the growth of national debt. Until 1982 the level of the national debt remained under 100 trillion yen, or 20% of GDP. Currently it reaches almost 80% of GDP. These figures are only for central government national bonds outstanding. If we include other debts and local government ones, the ratio is now over 120% of GDP. Japan is most heavily indebted of all OECD countries. (Figure 15)

This simply implies that the government is reaching the limits of what can be done with fiscal expansionary policy. Koizumi has declared his intention to limit the amount of government issue to 30 trillion yen this fiscal year. The question remaining is how to use fiscal expansionary measures most effectively.

### **Deflation**

Deflation is another serious problem that Japan is currently facing. Prices of all kinds, including interest rates, are low. Land prices have suffered the most deflation, as shown in Figure 16. As one can see, inflation of land prices was more than 40% in 1988. In 1992 land prices recorded negative growth for the first time. And since then, there has been no reversal of the movement.

The Nikkei Stock Price Index, GDP deflator, and import price index are shown in Figure 17. All of them show a deflationary trend but the trend of Nikkei Stock Price Index is worst of all.

Another important price is the interest rate. The call rate is shown in Figure 18. As is shown there, the current level is a historical low of 0.002. This means that Japanese monetary authority has no remaining capacity to use interest rate management as a policy tool.

### **Aging**

Furthermore, a declining birth rate and an aging society present a long-term challenge to Japan's economy. According to estimates by the Ministry of Welfare, by 2050 only 55 percent of the population will be of working age, while the aged population will have increased to 33 percent. Together with the national debt problem, inter-generational distribution of income will be the real issue from now on. The burden of Japan's young population will become almost intolerable by 2050. This limits the scope of government macro policies even for the short run. (Figure 19-20)

### **Unemployment**

Unemployment has been increasing. We can regard this as a process of restructuring, but it is worrisome that new graduates cannot find jobs. (Figure 21)

### **Policies Taken**

Thus, both monetary and fiscal policies are reaching an impasse. Recently, however, the Japanese government has tried to improve the current status. The relevant policies are tabulated in the Figure 22 and Table 2

## 5. Conclusion: Future Course of Japan and Asia

### IT and Globalization

The current structural problems in Japan arise from adjusting to a new environment. They manifest the dynamism of the Japanese economy itself. The progress of information and telecommunications technology and the globalization of market economies has had a substantial impact on Japanese firms. The after-effects of the bursting of the bubble can also be recognized as a structural problem. Such significant changes in the business environment can make an existing economic system obsolete and reduce the profitability of the corporate sector.

Even excellent Japanese companies, major contributors to the export driven Japanese growth in the past, such as Sony, Panasonic, and Toshiba, recorded deficits and made drastic employment reduction schemes last year (Table 3). Fortunately, in the second quarter of 2002 most of these firms have shown sufficient recoveries. In the 1990s, with the improvement in productivity induced by the expansion of IT-related investment, the United States enjoyed a prolonged period of expansion and price stability, although we can observe such distortions as excessive consumption due to higher stock prices and a rising current account deficit. In Japan, too, it seems that the kind of mega-change which occurs only once or twice in a hundred years may already be underway.

### The Important Role of the Private Sector

To get out of the current depression, Japan needs to adjust to new environments and thus needs structural reform. The government announced *Basic Policies for Economic and Fiscal Policy Management and Structural Reform 2002* in June 2002. This proposes concrete measures to address such issues such as economic

revitalization, tax reform, and a review of government expenditure. We need to recognize that no matter what the government does, the propelling force is the private sector. In the area of finance, too, the main force in enhancing the financial intermediary function is the profit incentive of financial institutions and investors. Tax reform, deregulation, and the review of pension and medical systems currently being promoted by the government are indeed very important, but these should be combined with vital private sector activities.

As we discussed earlier, the Japanese economy has, over the years, overcome various hardships in the economic environment such as the Nixon shock, two oil shocks, and the Plaza Accord. All these severely changed the terms of trade in ways which caused Japan to suffer difficulties in exporting goods. In each of these adjustment phases, Japan experienced drastic restructuring, successfully achieving the exit of many weak enterprises. On the other hand, as a result of the efforts and ideas that arose from the need to overcome such 'pains,' Japan started to produce higher value-added products that satisfied the needs of the times. In turn, Japan became strong in energy-saving products, diversification of life styles, and environmental concerns. Still so far, Japan has readjusted only in the manufacturing sector.

The 1990s have often been called the "*Lost Decade*," but it is probable that in recent years Japan has in fact been undergoing structural change of great magnitude. In fact, reorganization and cooperation on a large scale have been occurring both in the industrial and financial sectors. Many elements of Japan's heritage--such as cross shareholdings, keiretsu relationships, and long-term employment--are being reviewed in response to recent changes in the economic environment. Corporate governance is steadily changing.

## Japan and Asia

### (1) Competition

Japan is surely going to change. Hopefully, it will get out of the depression. More importantly, the relationship Japan has with China and other Asian countries will become even tighter, year by year. Until the recent past Japan led the ladder of industries. But in the near future Japan might simply quit competing in some areas, or compete even more fiercely in others. There used to be a division of labor between Japan and other Asian countries. Japan produced more sophisticated industrial products and other Asian countries specialized in more labor intensive medium quality goods. But the world is changing.

With the IT revolution and rapid accumulation of both physical and human capital, many Asian countries have become capable of competing head to head with Japan. This phenomenon is exemplified by the current market share of leading electronic products. According to the *Nihon Keizai Shinbun*, August 13, 2002, China now produces 54.1 percent of DVD players in the world, while Japan produces only 7.7 percent (2002 projection). China produces 27.8 percent of mobile phones; Japan, 12.9 percent. For desktop PCs, China produces 29.6 percent; Japan, only 2.3 percent. China produces 43.7percent of air conditioners; Japan only 15.2 percent. (Figure 23)

Of course, there are some products where Japan leads in production such as notebook PCs (18.8%), large LCDs (28.9%), and digital cameras (51%). All these products used to be more or less Japanese monopolies. Japan needs to develop more and more front runner products. Otherwise, in the end, Japan will have nothing to export. In an encouraging trend, Japan is now beginning to earn money by developing technology herself. Figure 24 depicts the export-import ratio of patents trade. If this figure is larger than one, it means Japan earns more than she pays abroad. The trend is steadily sloping upward.

Although Japan is not particularly known for innovations in technology, Japan has had its successes in the past. Japan introduced a nylon-producing technology in 1951. Transistor technology followed in 1954, and a domestically-built rocket was launched and polyester textile manufacturing technology was introduced in 1957. Home use VCRs appeared in 1976, super LSI in 1978, and optical CDs in 1982. Current and future technological advancement is expected around nano technology and in other areas.

## (2) Japanese involvement in Asia

Even in the midst of the Lost Decade, at the time of the Asian currency crisis Japan suggested to create Asian Monetary Fund, to which the U. S. opposed. Japan gave up the idea and proposed the so-called *Miyazawa Plan*, by which Japan offered as much as 30 billion US dollars to Asia, 15 billion of which was allocated for medium to long-term financial support while the rest was for short-term financial support.

Japan became the biggest ODA donor in the world in 1989. Japan has been offering ODA worldwide, but has concentrated her ODA in Asia. Figures 25 and 26 show the recent trend in ODA and the top ten recipients in the past few years. See Table 4 also.

## (3) Increasing Imports of Manufactures

Japan has transformed its trade patterns from those of a vertical division of labor to a horizontal division of labor. Figure 27 shows the path of deepening intra-industry trade, demonstrating that Japan has become a big consumption market for Asian exporters. Although ASEAN climbed up from 30 % level in 1992 to more than 50% and the world average in 2000, China enjoyed a very high ratio from the beginning. And yet, the ratio has been constantly rising. This is a rosy sign for both Japanese consumers and Asian producers.

Figure 1. Japan's growth path

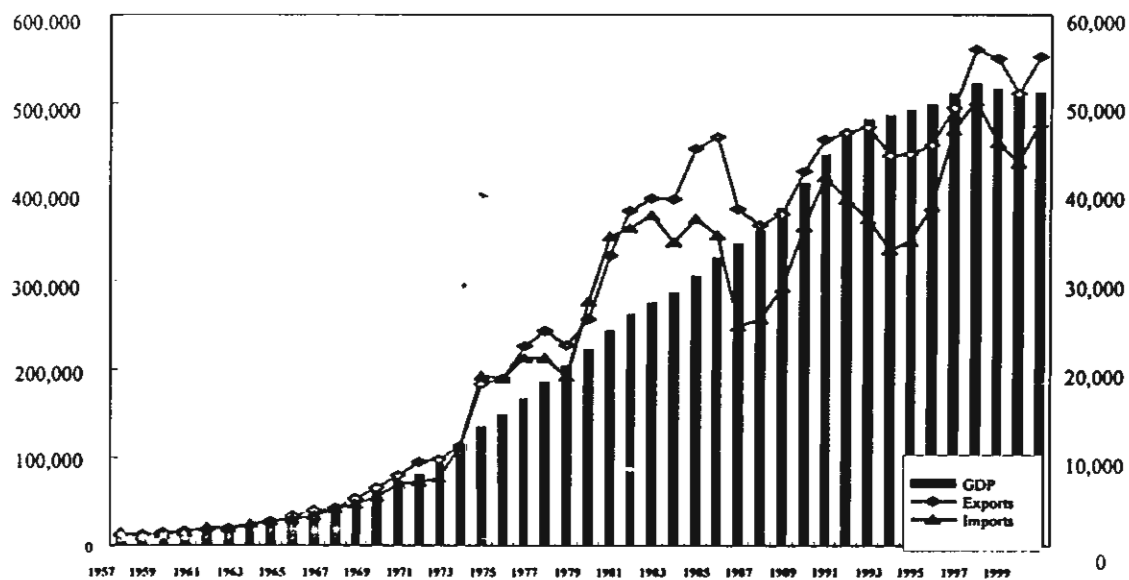
Source: IMF, *International Financial Statistics*

Figure 2 Export Destination

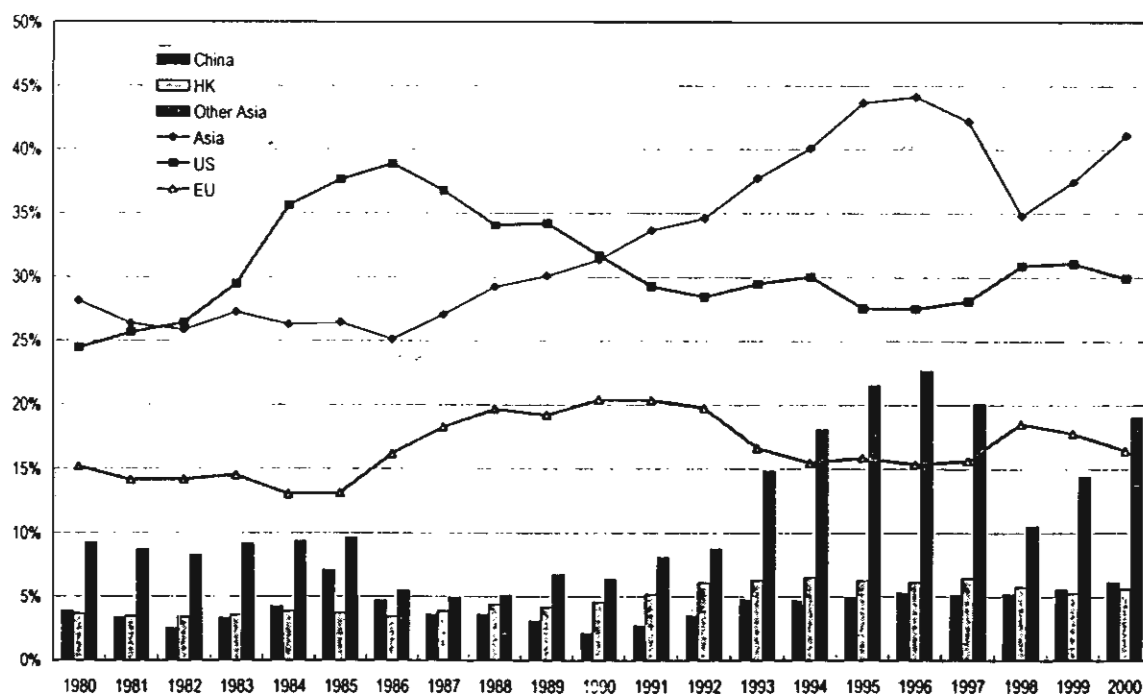
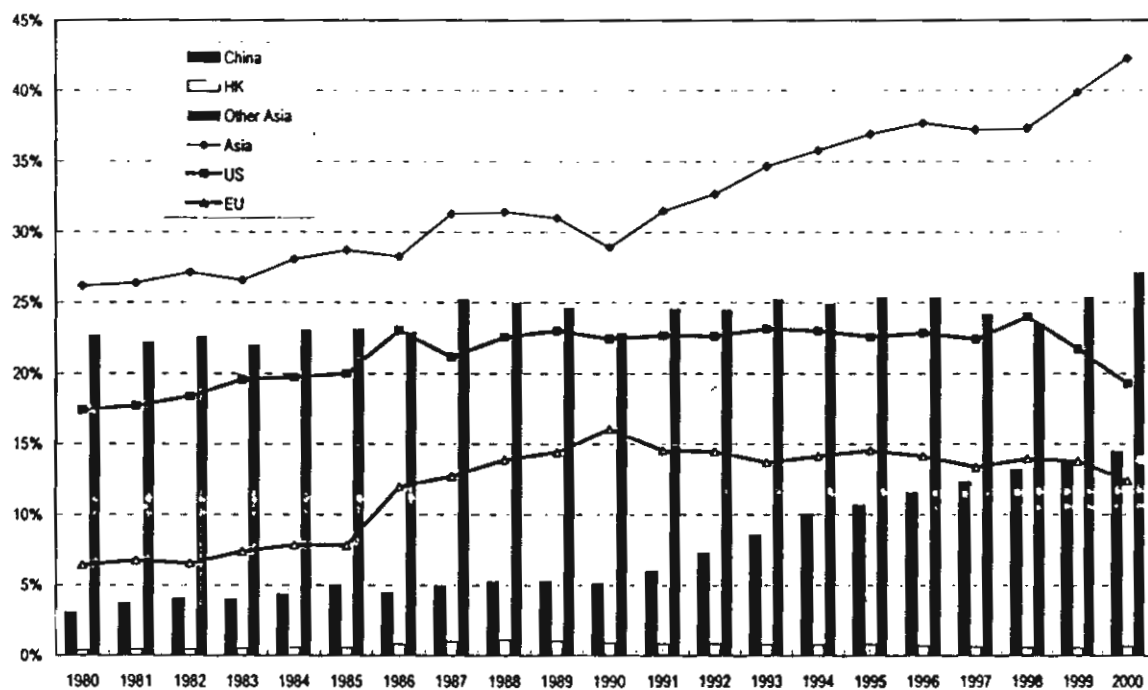
Source: IMF, *Direction of Trade*

Figure 3 Imports by Region



Source: IMF, Direction of Trade

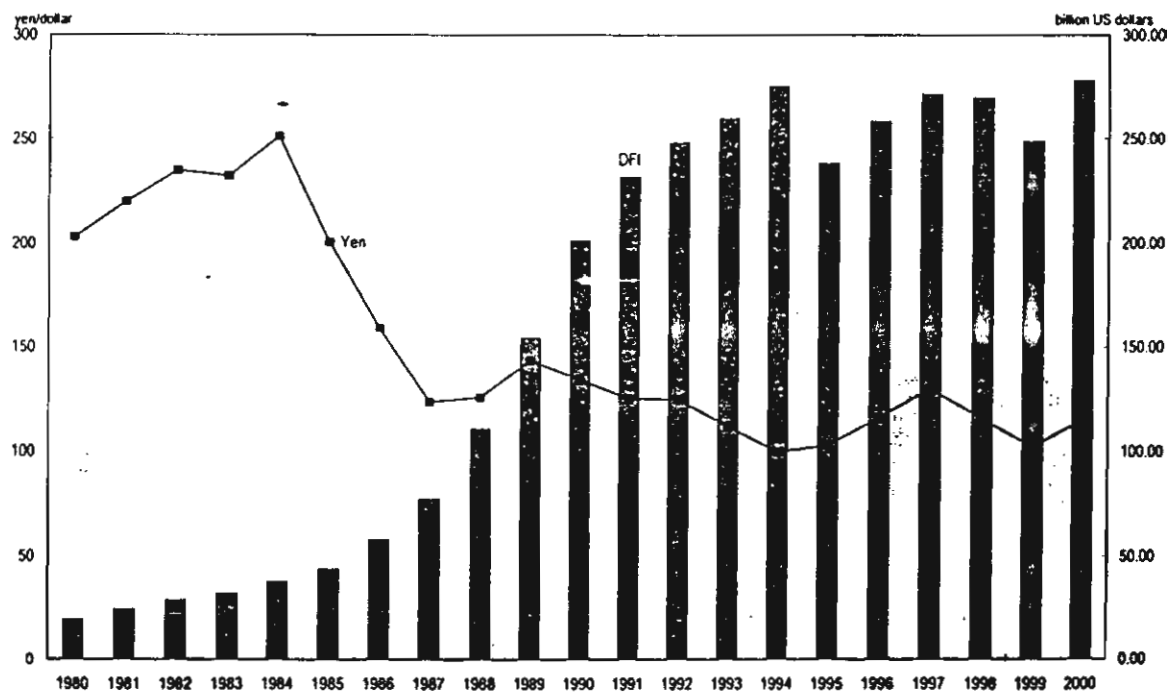


Table 1 Trade Intensity

	US	Japan	EU	East Asia	Asian NIEs	Chinese	Hong Kong	ASEAN4	China	AFTA
US	0.00	1.55	0.61	1.03	1.19	1.47	0.68	1.09	0.57	1.05
Japan	1.61	0.00	0.46	2.50	2.67	3.63	2.05	2.83	1.77	2.51
EU	0.51	0.34	1.73	0.30	0.30	0.31	0.29	0.29	0.30	0.29
East Asia	1.18	2.21	0.41	2.30	2.20	1.40	3.52	2.33	2.54	2.38
Asian NIEs	1.16	1.61	0.40	2.48	1.60	1.13	2.90	3.01	4.22	2.40
Chinese Taipei	1.27	2.07	0.42	2.33	2.98	0.00	7.65	2.19	0.79	2.18
Hong Kong	1.21	1.04	0.43	2.73	0.59	0.50	0.00	1.01	9.79	1.09
ASEAN4	1.14	2.93	0.42	2.27	2.81	2.41	1.50	2.06	1.10	3.63
China	1.27	2.89	0.42	1.92	3.02	1.02	7.00	0.99	0.00	1.09
AFTA	1.05	2.47	0.42	2.42	2.38	2.12	1.89	3.93	1.09	4.08

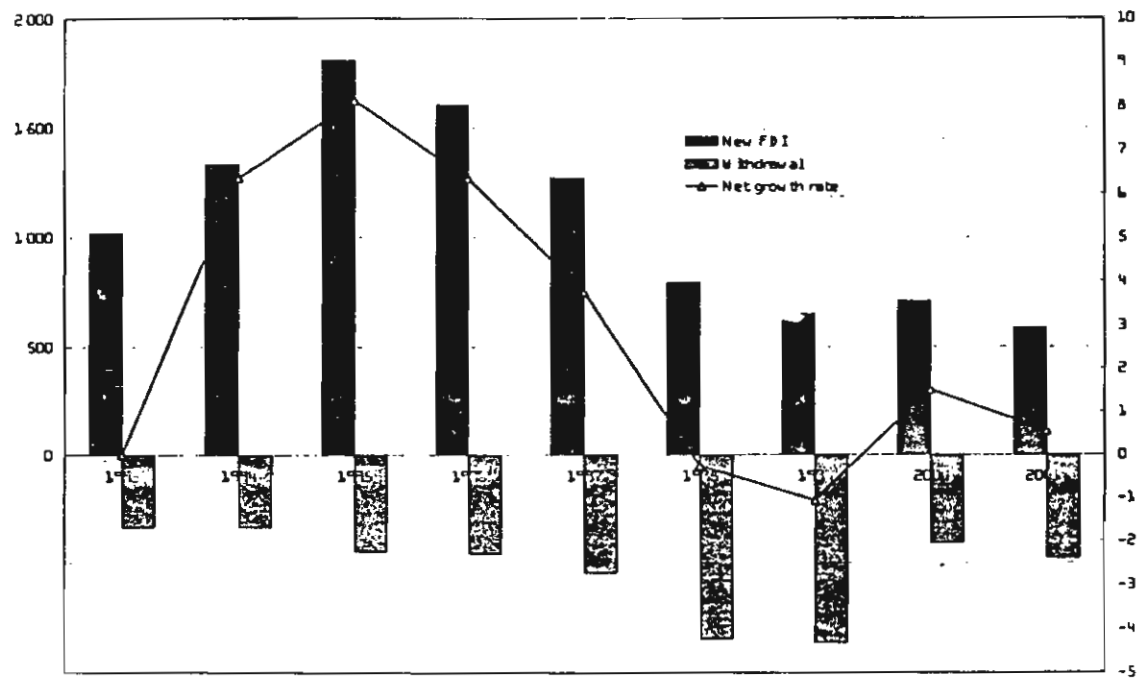
Source: Calculated using the data by IMF, *Direction of Trade*

Figure 4 Yen rate and growth of FDI



Source: IMF, *International Financial Statistics*; METI, *White Paper of International Trade*, 2002.

Figure 5 FDI



Source: MOF

Figure 6 FDI by Region

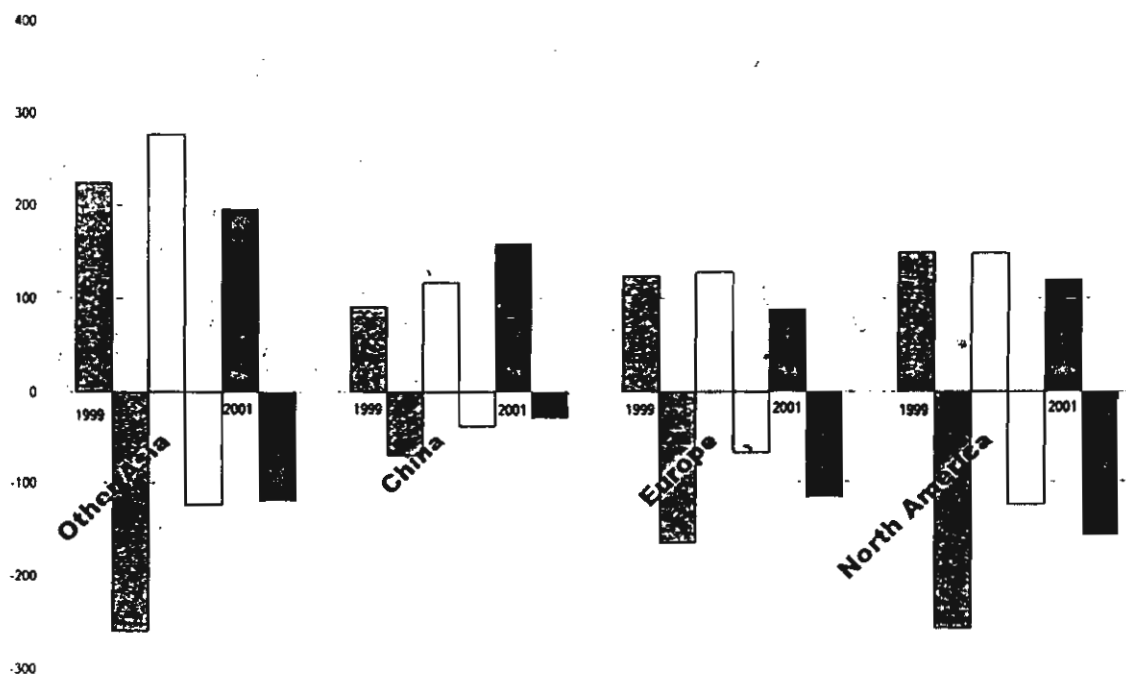


Figure 7 FDI by Industry

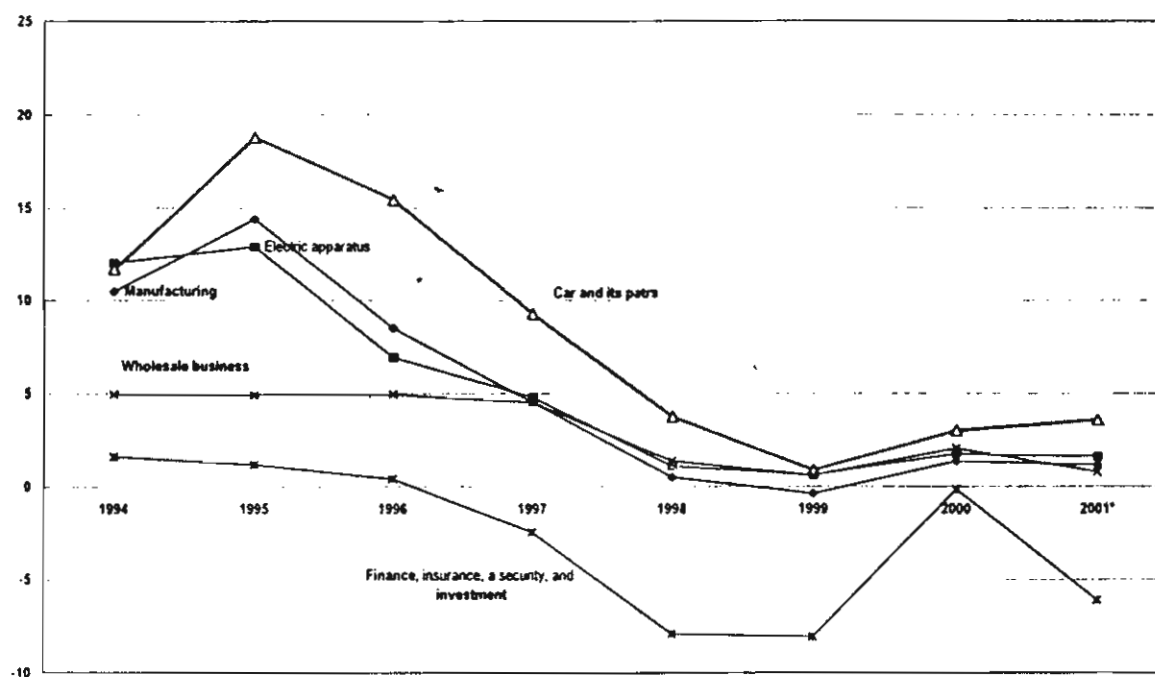


Figure 8 GDP per capita: industrial countries

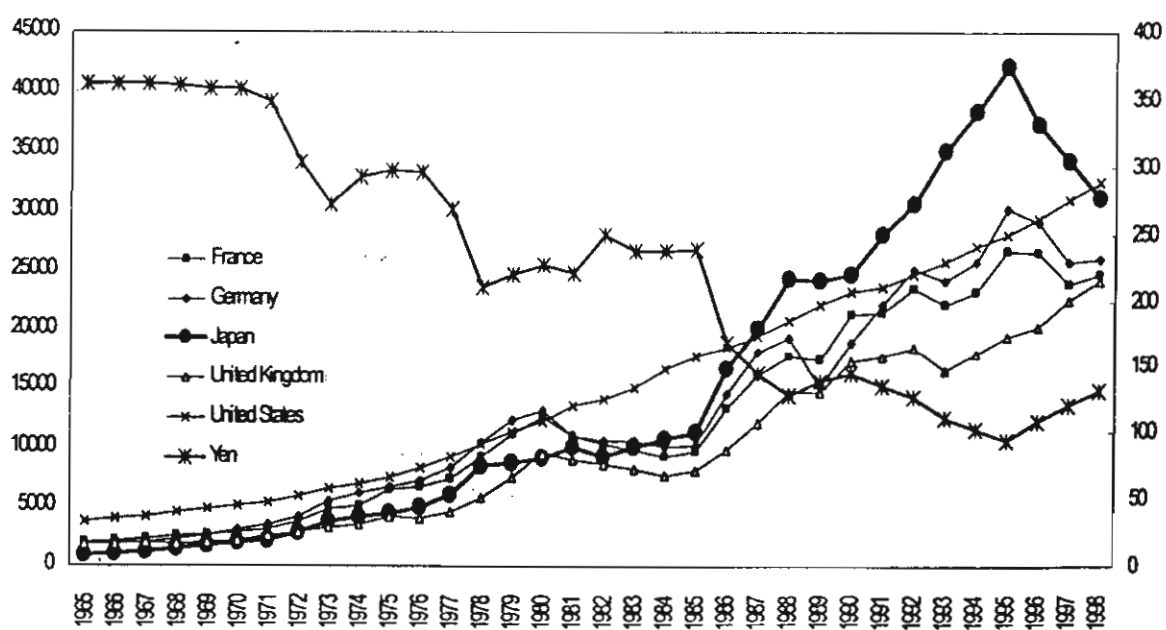
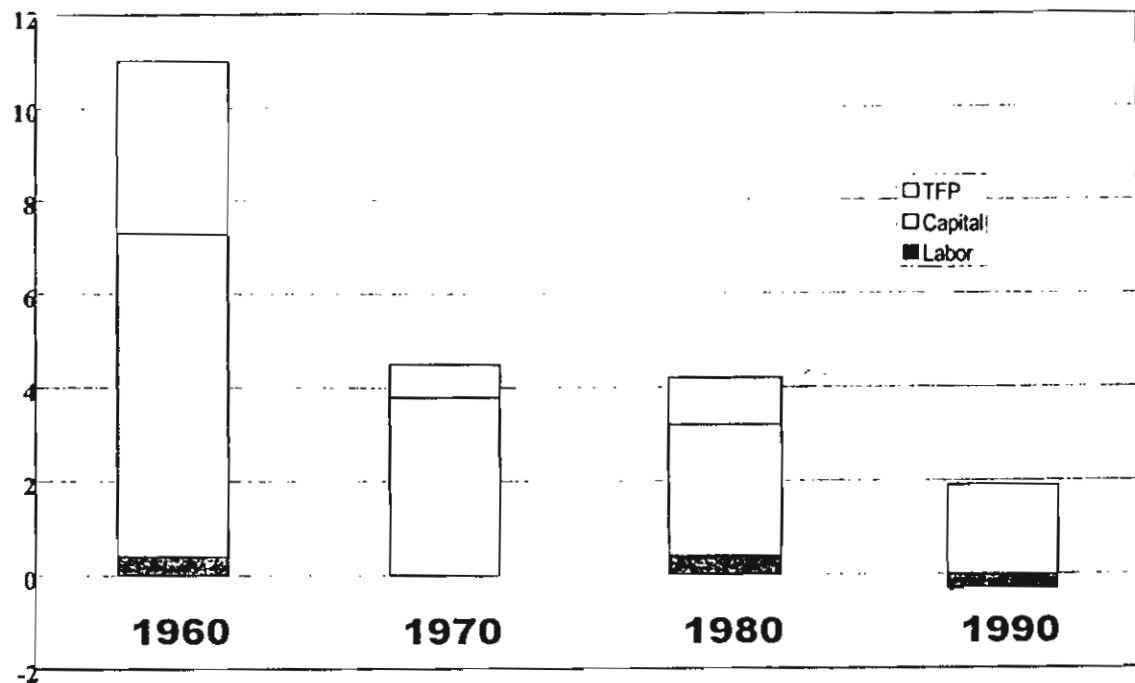
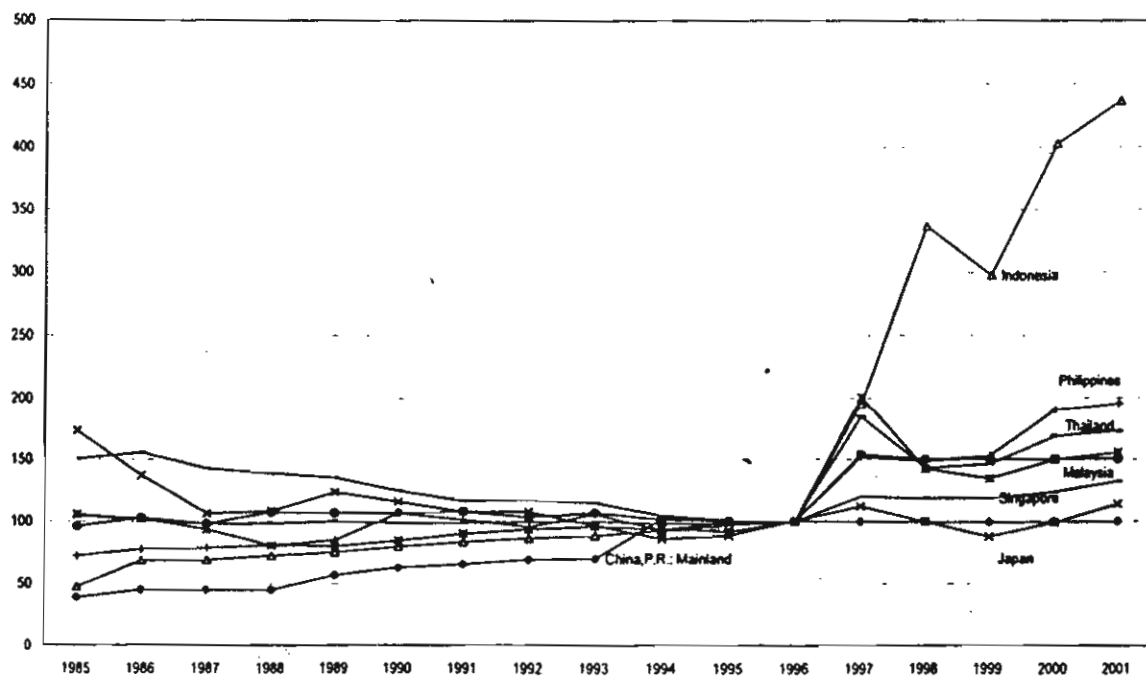
Source: IMF, *Direction of Trade*

Figure 9 Total factor productivity



Source: METI, *White Paper on International Trade*, 2000

Figure 10 Asian Crisis: Exchange Rates



Source: IMF, *International Financial Statistics*

Figure 11 Asian Crisis: Real Side Story (1)

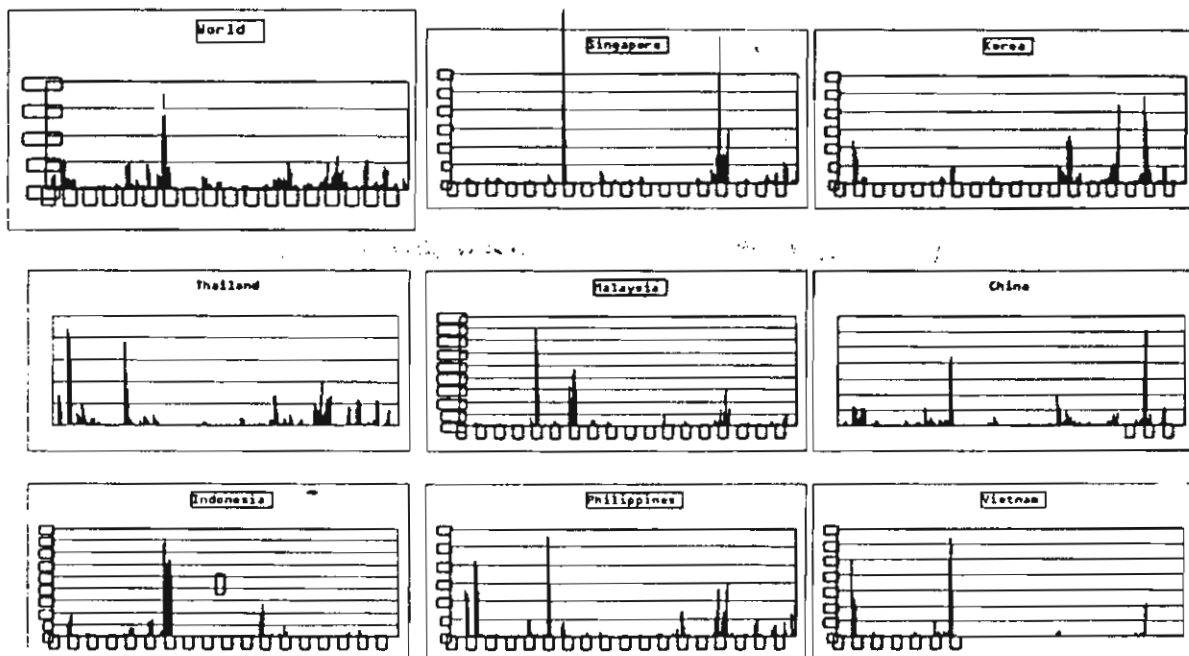


Figure 12 Asian Crisis: Real Side Story (2)

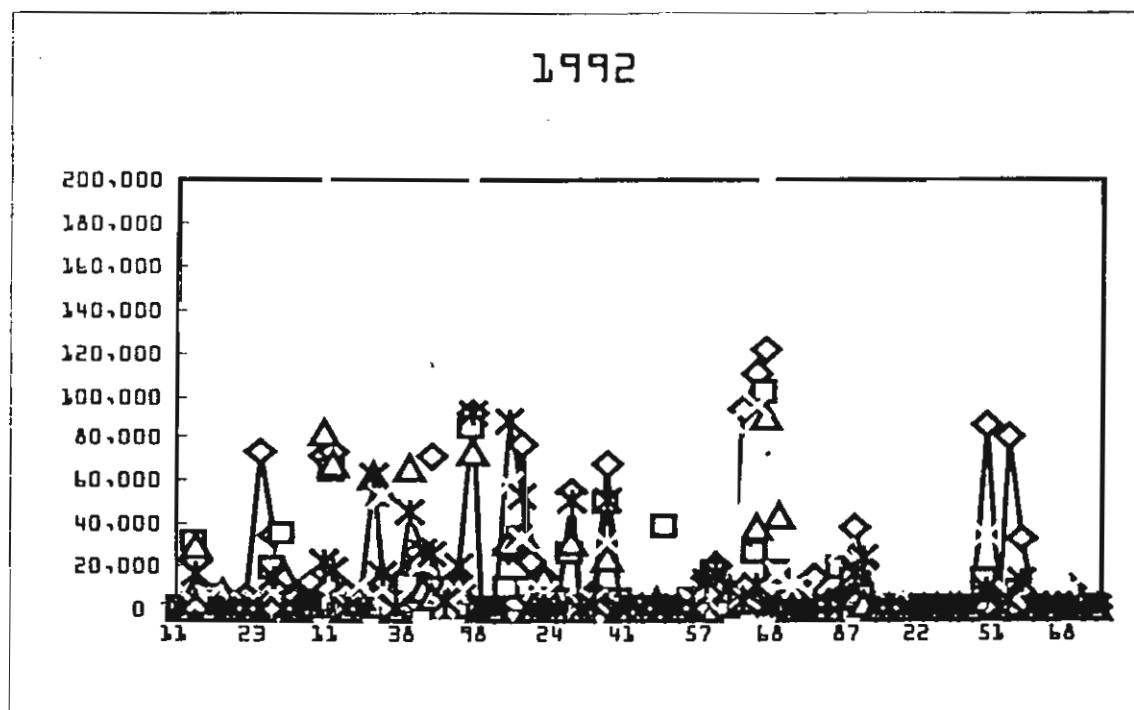
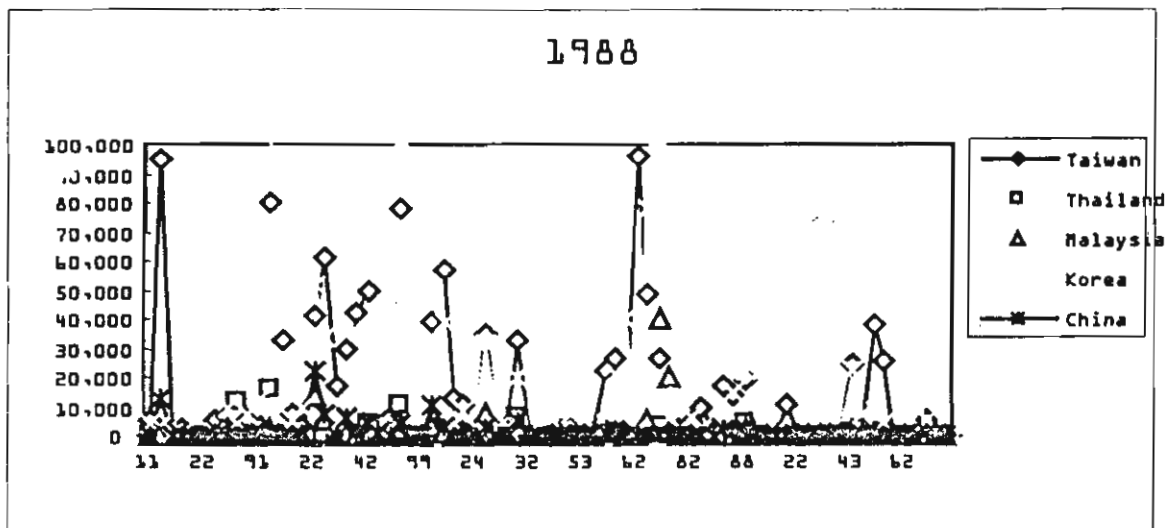


Figure 13 Fiscal Balance

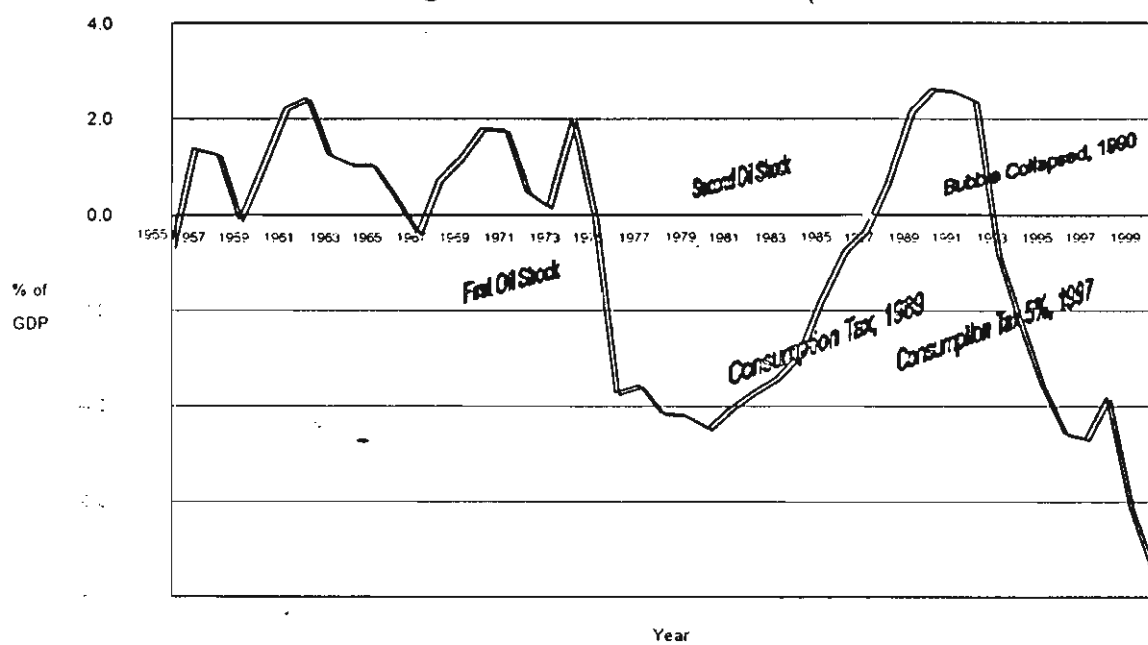
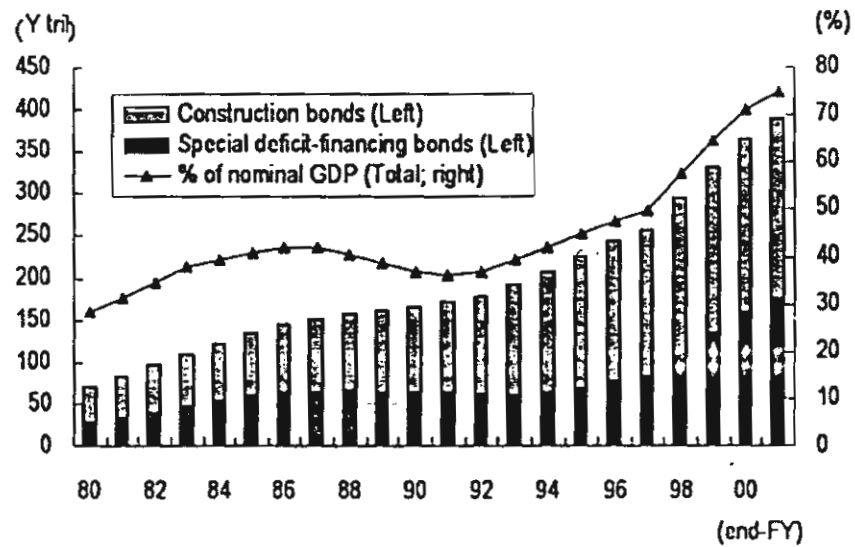


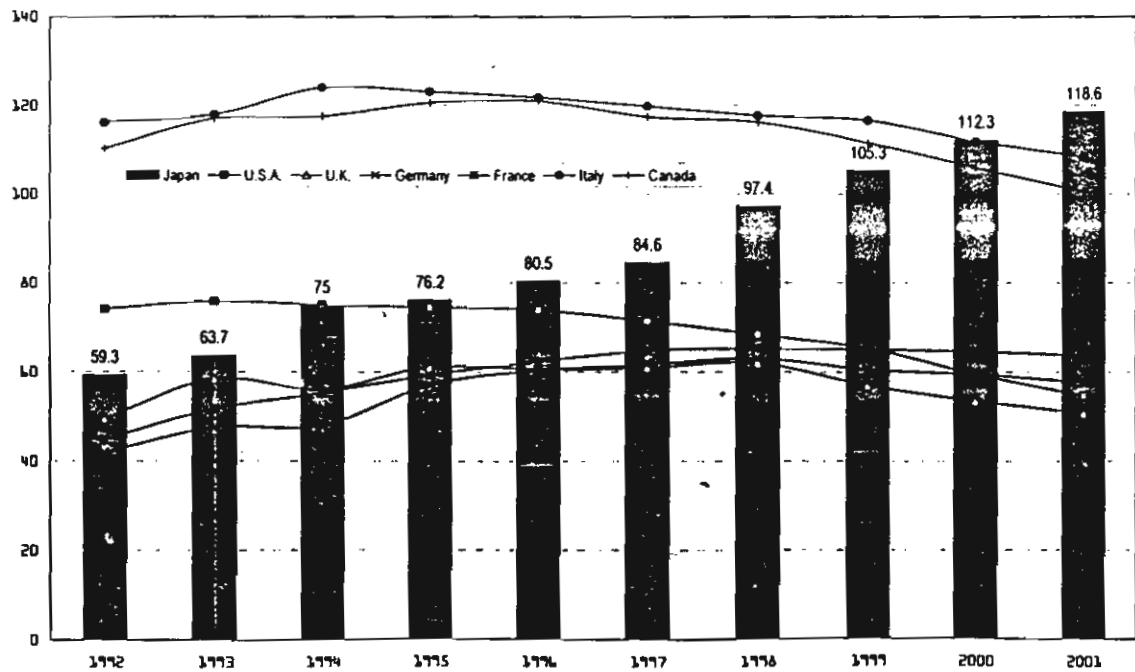
Figure 14 National Debt



Sources: MOF; CAO.

Note: FY80-89: Actual; FY00-01: Government estimation.

Figure 15 National Debt: International Comparison



Source: OECD