

Section 2 Globalization and Japan’s economy

As mentioned in section 1 of this chapter, it is evident that globalization has had various impacts on Japanese companies, household finances, and the economy, as the cross-border movement of products and production factors becomes more active. As Japan has long been a trading nation and now faces a declining population, it is indispensable for the country to continue to extend cooperation with Europe and the United States, other Asian countries, etc., and actively introduce favorable factors, mechanisms, etc. that can work as an engine for new development. This requires the formation of a new economic structure to create a virtuous circle of the nation’s economy while positively using the dynamism of the globalizing world economy.

With these issues in mind, this section discusses both the negative and positive impacts of globalization on the nation’s economy and the possibility of creating a virtuous circle of the nation’s economy in the midst of globalization.

1 Globalization and the nation’s economy

(1) Relationships between globalization and the nation’s economy

(National accounting and globalization)

The relationships between national accounting and globalization, which records overseas transactions involving labor, goods, capital, etc., are shown in the rest of the world account in Table 2-2-1. The rest of the world account is divided into the current transaction account (which records income transfers arising from imports and exports of goods and services and cross-border movement of labor and capital) and the capital transaction account (which records all the financial transactions). The surplus of the nation in the current transactions account arising from yearly current transactions is transferred to the capital transaction account, where it is recorded as a net increase in foreign financial assets. Thus, the current and capital transaction accounts are interlocked.

Table 2-2-1 Overall picture of the rest of the world account

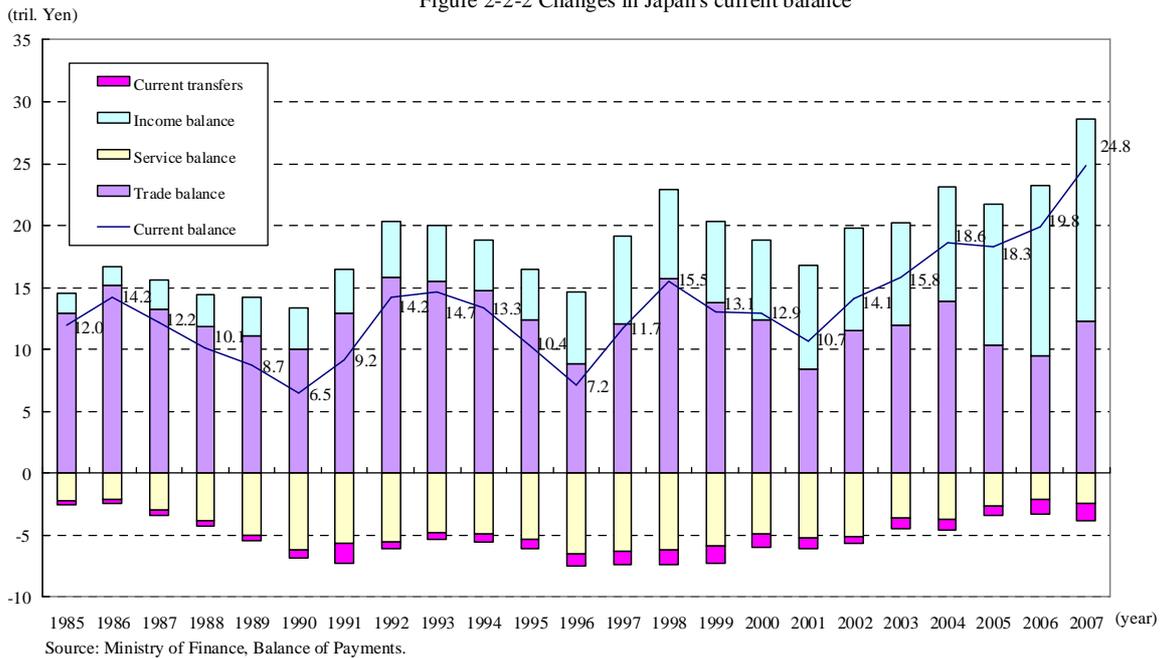
Current balance		Capital transaction	
Exports of goods and services	Imports of goods and services	Surplus of the nation on current transactions	Net increase of foreign financial assets
Employees' income from overseas	Employees' income to overseas	Capital transfers from overseas	
Property income from overseas	Property income to overseas	Net increase of foreign liabilities	
Other current transfers from overseas	Other current transfers to overseas	Credit	Debit
	Surplus of the nation on current transactions		
Credit	Debit		

Source: Ministry of Economy, Trade and Industry

The current transactions in the rest of the world account almost correspond to the current balance in the balance of payments account (= Trade Balance + Services Balance + Income Balance + Current Transfers). This implies that the relationships between national accounting and globalization are reflected in the current balance. Consider the changes in Japan’s current balance. The trade balance has leveled-off in the past 20 years, while the income balance has been on the rise along with a growing

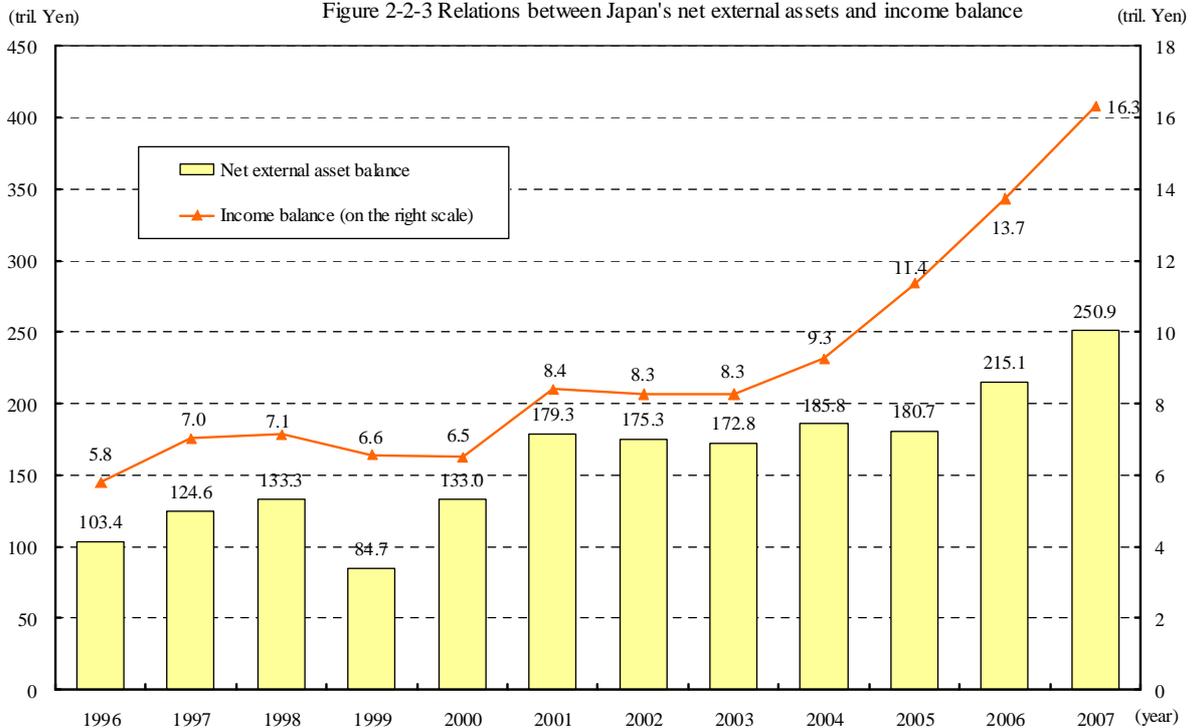
surplus (see Figure 2-2-2).

Figure 2-2-2 Changes in Japan's current balance



With the ongoing current account surplus, Japan's net external assets have been increasing. Japan's net external assets stood at about 250 trillion yen as of 2007 and have ranked first in the world for seventeen consecutive years. The income account surplus is continuously increasing as net external assets grow, because the former constitute the principal of income balance (see Figure 2-2-3).

Figure 2-2-3 Relations between Japan's net external assets and income balance



Note: The data for the net external asset balance of 2006 is the first estimated figure.
 Source: Ministry of Finance, Bank of Japan, Balance of Payments, Japan's net external assets and debt.

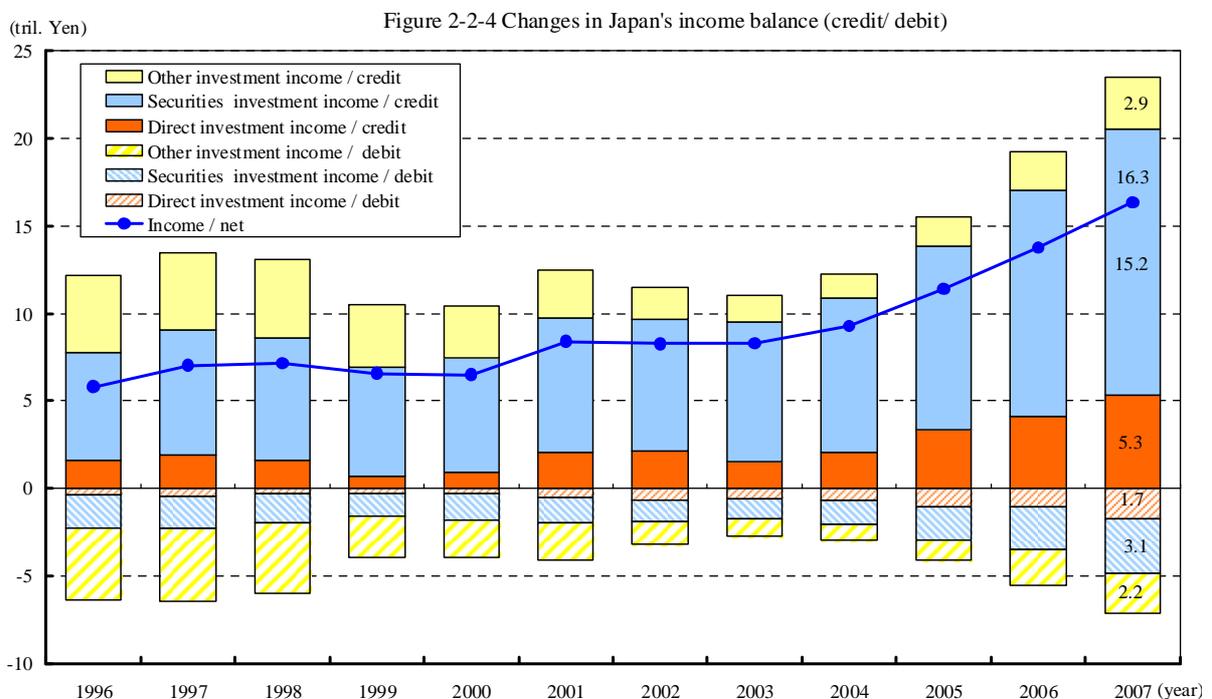
As income balance increases, the income account surplus grows. Note that in 2007, the income account surplus accounted for 65% of the current account surplus. Thus, a virtuous circle is created in this manner.

Increase in income account surplus → increase in current account surplus → increase in net external assets → increase in income account surplus → ...

If this cycle continues for the time being, the income balance will become much more important in the nation's economy.

(Japanese companies are aggressively expanding business overseas, and this reflects the shift to the income balance)

The breakup of the income account, which is considered to be more important than ever, clearly shows that direct investment income has been increasing in recent years, with the portfolio investment income constituting the largest share (see Figure 2-2-4).



Note: To be exact, compensation of employees / credit (receipt of compensation paid to resident workers overseas) and debit (payment of compensation by residents to non-resident workers) should be included in income balance. But, it stood at less than 0.5% during the period of survey and so was omitted.

Sources: Ministry of Finance and Bank of Japan, Balance of payments statistics.

Direct investment income is increasing as Japanese companies are eagerly and successfully expanding business overseas. Japanese companies once promoted exports to boost foreign demand; however, due to the various factors, discussed in section 1 of this chapter, that contribute to the creation of the global value chain, Japanese companies began to extend their businesses overseas and move their production and sales bases to other countries in the mid 1990s.

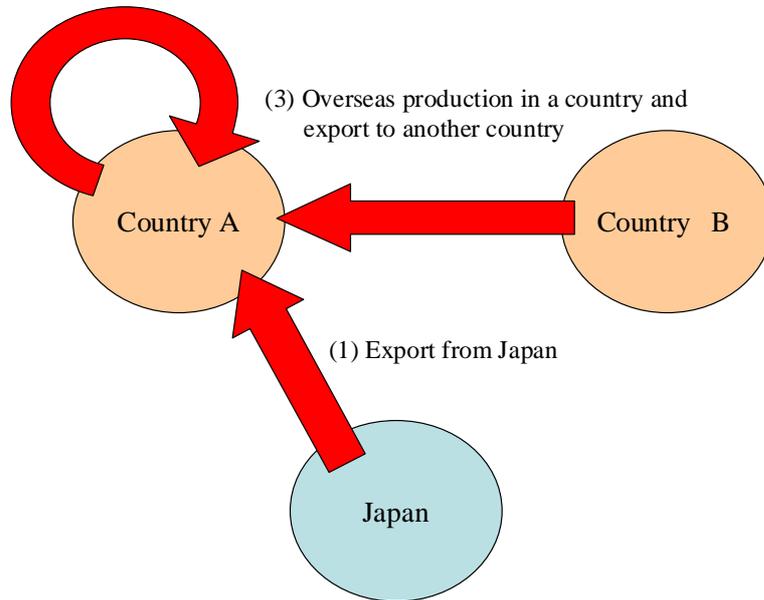
Overseas sales are classified as follows:

- 1) exports from Japan,
- 2) local production and sales, and

3) production in one country and sales in another country (see Figure 2-2-5).

Figure 2-2-5 Types of overseas sales by corporations

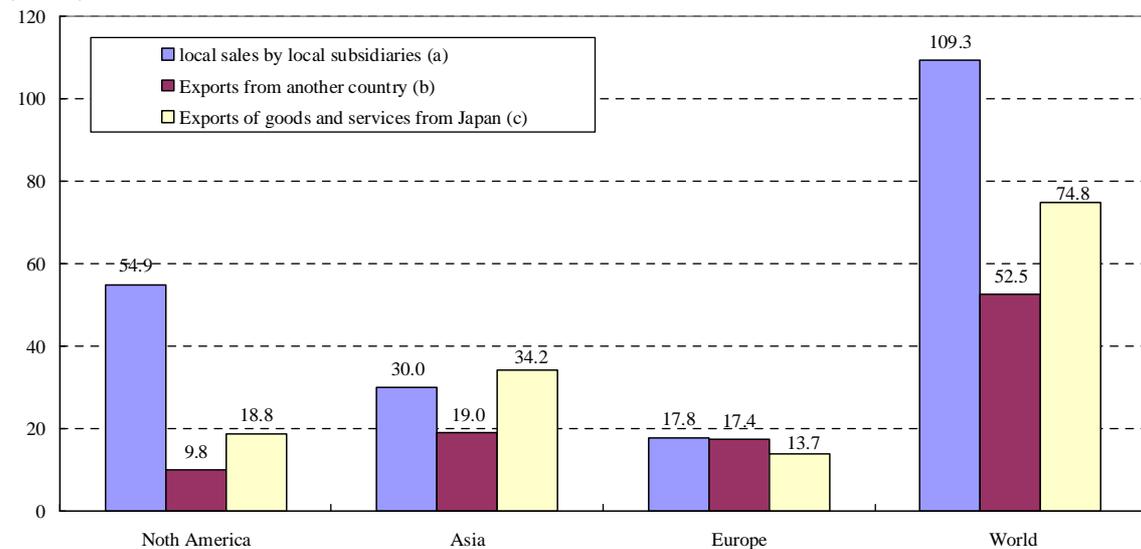
(2) Local production and sales



Source: Ministry of Economy, Trade and Industry

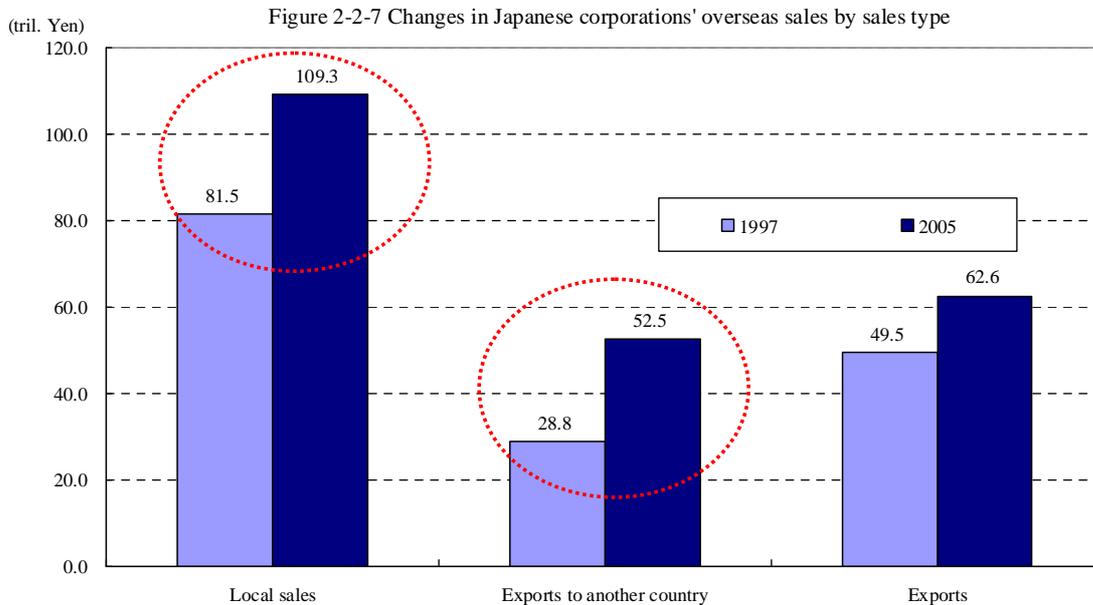
As of 2005, the second and third categories accounted for 68% of the total overseas sales (see Table 2-2-6). Thus, the business model where production and sales activities take place overseas accounts for more than two-thirds of the overseas sales made by Japanese companies. Furthermore, we observe that the “overseas-overseas transaction” model, where both production and sales activities are carried out overseas, is being increasingly adopted in recent years. Category-wise comparisons of the sales figures for the year 1997 with those of 2005 show that “local production and sales” and “production in one country and sales in another country” registered much faster growth than “export” (see Figure 2-2-7).

Figure 2-2-6 Comparison of Japanese corporations' overseas sales by sales type (Year 2005)



Source: Ministry of Finance and Bank of Japan, Balance of Payments; Ministry of Economy, Trade and Industry, Survey of Overseas Business Activities.

As a result of the expansion of the “overseas-overseas transaction” business model, wealth obtained by companies is now recorded in the income balance account as direct investment income, instead of in the GDP as export income. As mentioned in chapter 1, robust economies in the emerging markets, improvements in logistics, and information and communications technology will help reduce service link costs for business activities. The cost reduction will accelerate the shift to overseas operations, while, income balance will become increasingly important.



Source: Ministry of Finance and Bank of Japan, Balance of Payments; Ministry of Economy, Trade and Industry, Survey of Oversea Business Activities.

(An index of national affluence “Real GNI”)

In the white paper on International Trade and Economy 2006, nominal gross national income (GNI) is used as an index of national affluence, as it is recognized that the increases in “disposable income” are fundamental to sustainable growth in an aging society with fewer children. Recently, with resource prices soaring, the terms of trade¹ have been worsening; this has caused the outflow of income (trading loss) to surpass the income from overseas (income balance surplus) (see Figures 2-2-8 and 2-2-9). Subsequently, the nation’s companies and households have been hard hit; this will be discussed later in detail. Under these circumstances, it is considered reasonable to use real GNI, which is more appropriate than nominal GNI (used in the 2006 white paper), because real GNI also includes trade gains and losses². Real GNI is defined by the following formula:

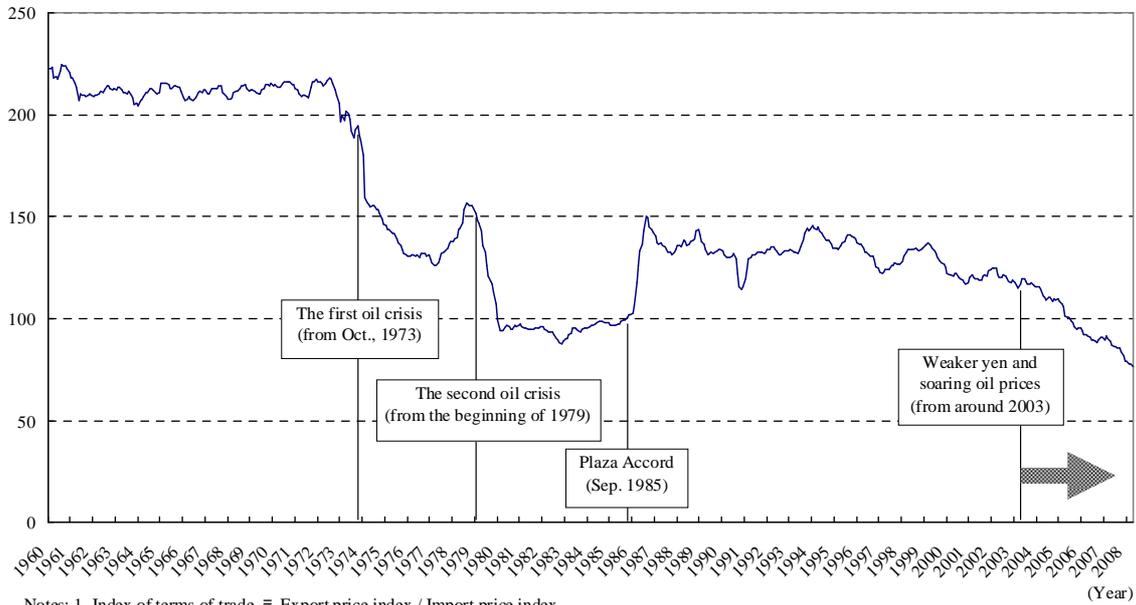
¹ The terms of trade indicate the amount of goods and services a country can purchase from overseas in return for one unit of its goods and services. More concretely, it is defined as the export price/import price. Deteriorating terms of trade payments for imports increasing faster than the receipts from exports, resulting in an outflow of income.

² Trade gains and losses are defined by the following formula:
 Trade gains and losses = (Nominal exports – Nominal imports)/Numeraire deflator – (Real exports – Real imports)

Numeraire originally means the measure of value. In Japan, the weighted average of export and import prices based on real exports and imports is used as a deflator, which, as mentioned above, is the measurement of value for nominal net exports. For example, if only import prices increase with the import

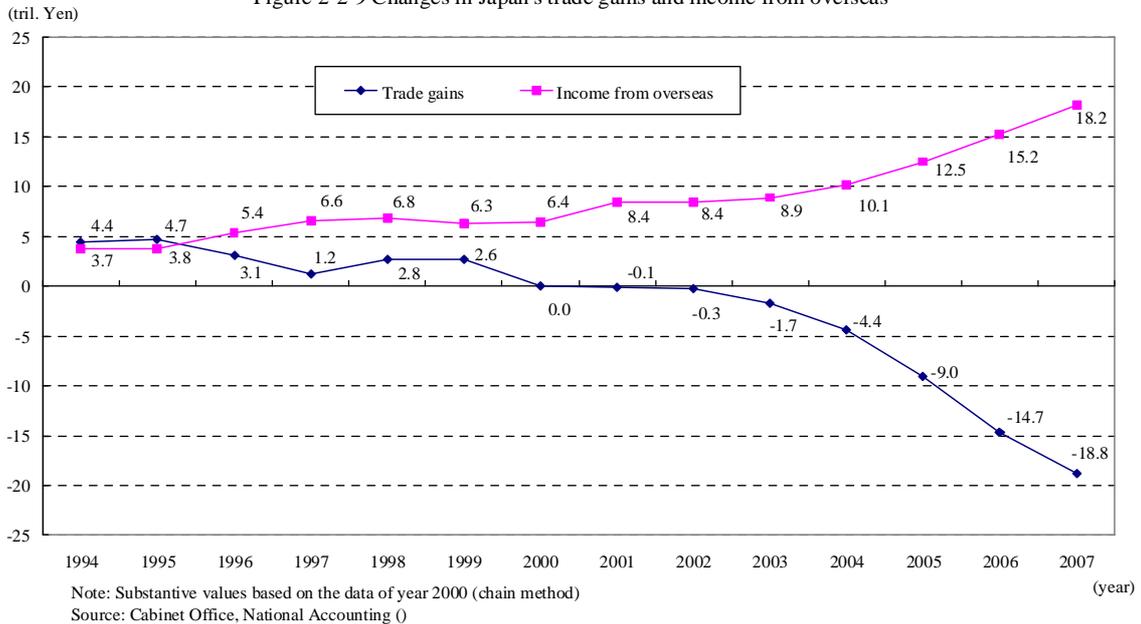
$$\text{Real GNI} = \text{Real GDP} + \text{Income from overseas (real)} + \text{Trade gains and losses}$$

Figure 2-2-8 Changes in the index of terms of trade in Japan (Year 2005 = 100)



Notes: 1. Index of terms of trade = Export price index / Import price index
 2. Both export and import prices are measured in yen terms.
 Source: Bank of Japan, Statistics of Corporate Goods Price.

Figure 2-2-9 Changes in Japan's trade gains and income from overseas



Note: Substantive values based on the data of year 2000 (chain method)
 Source: Cabinet Office, National Accounting ()

volume remaining unchanged, the second term of the above equation (or real trade balance) will remain unchanged while the first term (or a substantive value of nominal trade balance) will decrease. This implies losses due to deteriorating trade gains. As the formula shows, the value of trade gains and losses varies depending on the reference year for the substantive value of import and export.

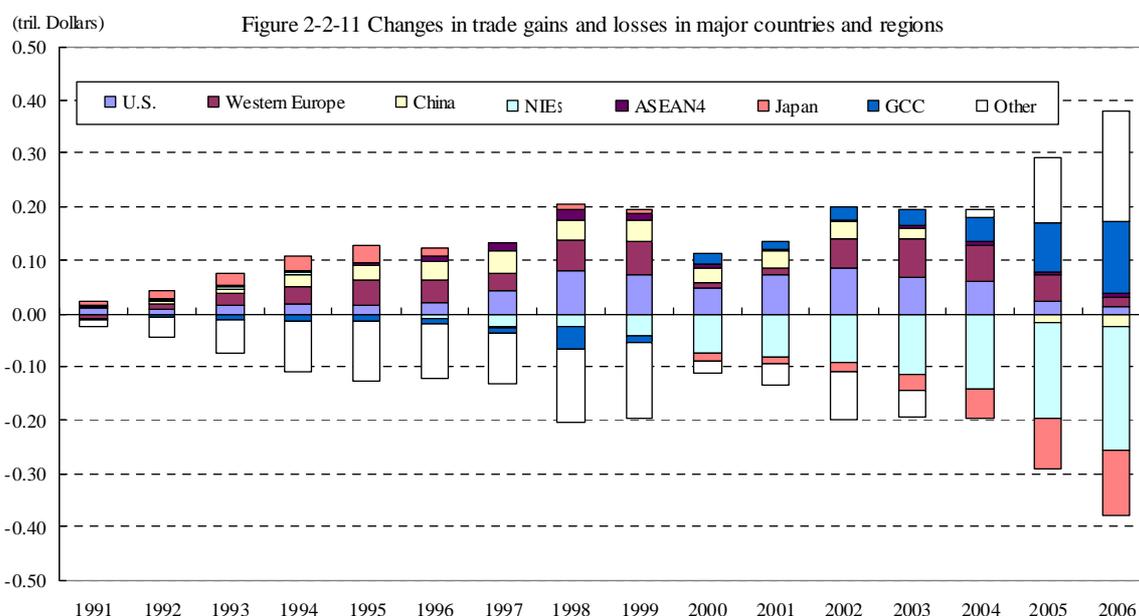
(Stagnant real GNI in Japan)

However, in Japan, the growth rate of real GNI is low. Comparing the rate of growth in Japan from 1996 to 2006 with those of major industrial countries (U.S., Britain, Germany, and France), we can find that Japan's growth has been the slowest, with the average yearly growth standing at 0.96% (see Table 2-2-10). One of the factors behind the low growth of real GNI in Japan is the outflow of income triggered by the deteriorating terms of trade. Consider the changes in trade gains and losses in major countries and regions in Figure 2-2-11. It shows that Japan has suffered the most from the deteriorating terms of trade in the world. On average, the outflow of income pushes down the annual growth of real GNI by 0.29%, seriously affecting Japan's economy.

Table 2-2-10 Average growth of Real GNI in major industrial countries (1996 - 2006)

	Britain	U.S.	France	Germany	Japan
Real GNI growth	3.63%	3.27%	2.29%	1.43%	0.96%
Effect of trade gains and losses	0.60%	-0.01%	-0.04%	-0.23%	-0.29%

Source : World Bank, *WDI* ; IMF, *IFS* ; United Nations, *National Account Main Aggregates*.



Note: Values with the reference year of 1990

Source: United Nations, National Accounts Main Aggregates Database.

(2) Influences of globalization on Japan's corporate and household sectors

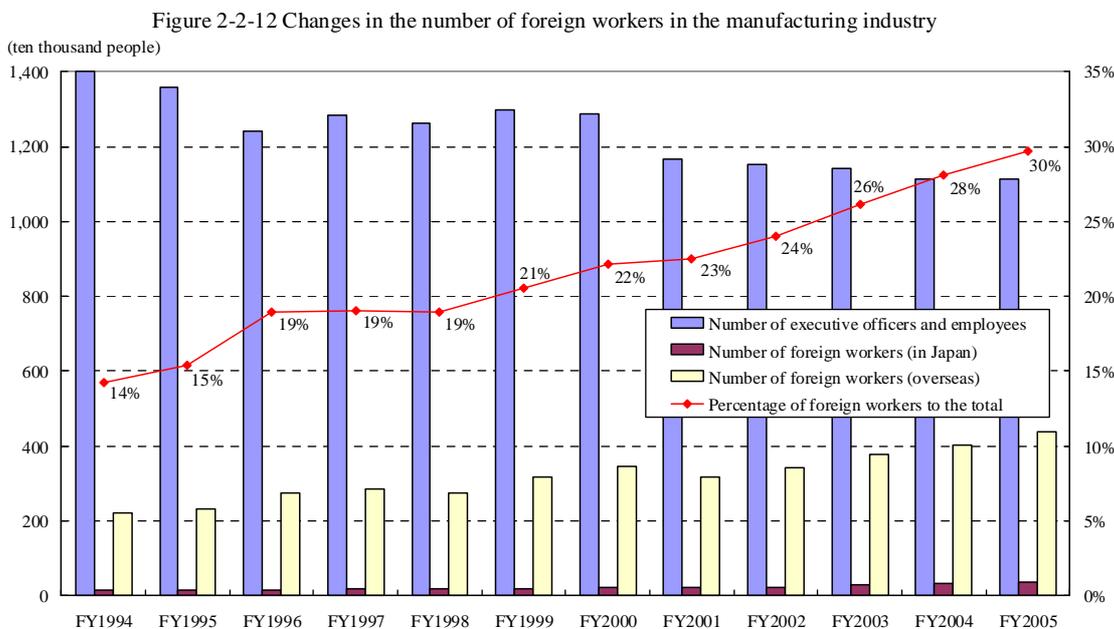
(a) The Japanese corporate sector is increasingly depending on other countries for both production and demand.

As mentioned in part (1) of this section, Japanese companies have been shifting operations to other nations and expanding their global value chains. In other words, the Japanese corporate sector, to a large extent, depends on other countries for both production (input of production factors such as labor, capital, and intermediate goods) and demand (sales of produced goods and services). This section discusses the progress of globalization and its impact on the nation's economy in terms of both production and demand.

(Progress of globalization in terms of production)

Production factors are roughly classified into labor, capital, and intermediate goods, and the Japanese corporate sector is increasingly becoming dependent on other countries for all of these.

First, we consider labor. The manufacturing sector relies more on foreign workers in Japan and local people in other countries; in fiscal 2005, these employees accounted for 30% of the total employees (see Figure 2-2-12).



Sources: Ministry of Economy, Trade and Industry, Survey of Overseas Business Activities; Ministry of Finance, Financial Statements Statistics of Corporation by Industry; Ministry of Health, Labour and Welfare, Report on Employment Situation of Foreigners.

Next, we consider capital. We find that foreign investors have dramatically increased investment in Japanese stocks listed on the Tokyo Stock Exchange, especially after 1990, accounting for 28.0% of the total stock investment in Japan in fiscal 2006³. This indicates that foreign investment in Japanese stocks has been active (see Figure 2-2-13). Japan's direct inward investment balance as a share of GDP is also on the rise⁴, indicating that direct investment in Japan has become more active as well.

Lastly, with regard to intermediate goods (materials, parts, etc.), greater dependence on other countries is found in the input of intermediate goods, as well as in technological improvements⁵ in newly developing countries in Asia and modularization of product architecture.

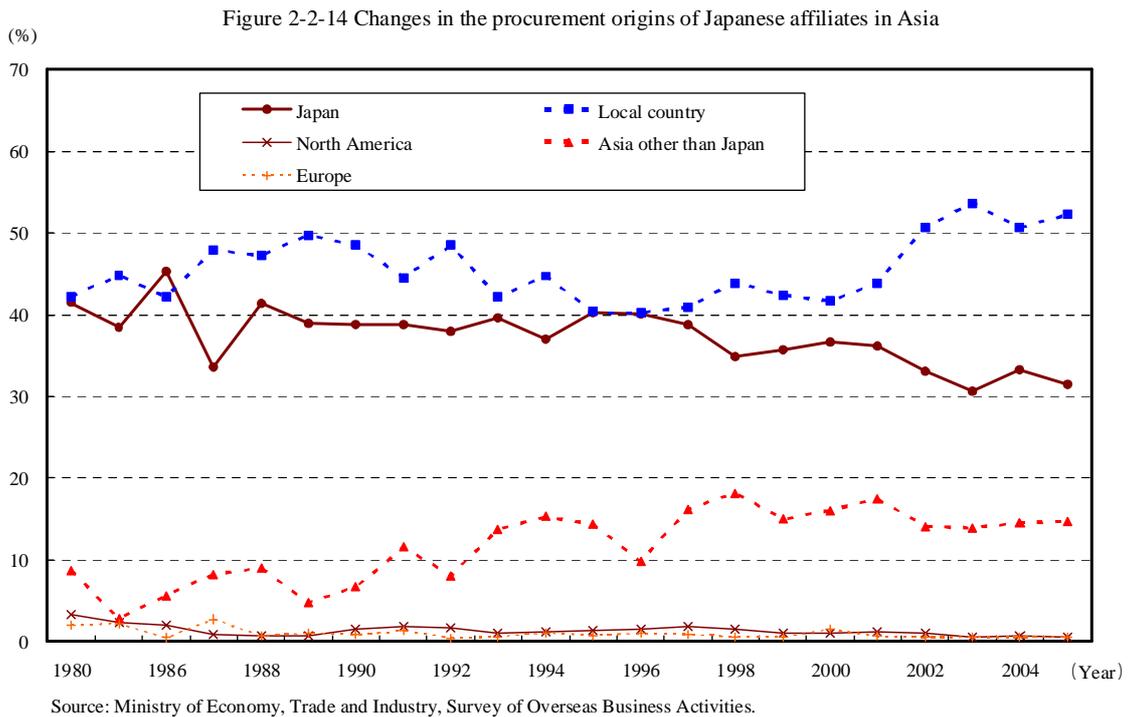
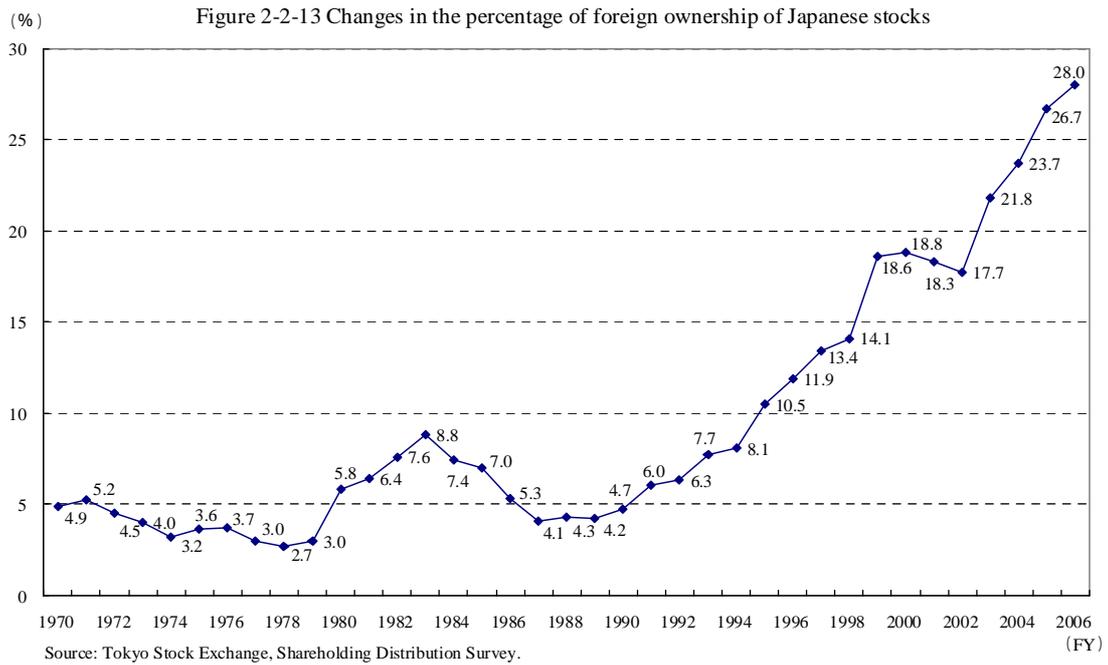
In fact, as the indices of industrial domestic shipments and imports indicate, the import penetration ratio (percentage of imports to domestic shipments) of production goods (which is almost synonymous with intermediate goods) increased from 18.7% in January 1998 to 23.4% in January 2008. This shows that the domestic bases depend more on other countries for the input of intermediate goods. This tendency is also true for overseas production bases. In Asia, where the production network has been

³ Therefore, it is inferred that approximately 30% of the dividend from listed stocks goes to other countries.

⁴ Japan's direct inward investment balance as a share of GDP more than tripled from 0.7% in 1996 to 2.5% in 2006.

⁵ How emerging Asian countries such as China and South Korea have been catching up is discussed in section 3 of this chapter.

expanding and becoming stronger, the ratio of local procurement has been rising.



(Progress of globalization in terms of demand)

The growth of the domestic market has slowed due to the aging and declining population and falling birthrate, while the rise of emerging economies contributes to the expansion of overseas markets. The domestic market is shrinking, and Japanese companies are now looking toward external demand. In fact, the overseas sales ratio (ratio of export sales by domestic companies plus overseas sales by overseas subsidiaries to the total sales) has been growing steadily in both manufacturing and

nonmanufacturing sectors. The overseas sales ratio in the manufacturing sector is particularly high, reaching 40.4% in fiscal 2006 (see Table 2-2-15).

Table 2-2-15 Changes in overseas sales and its percentage to the total

	FY 2001	FY 2006
Overall industry	90 tril. Yen (20.8%)	129 tril. Yen (25.4%)
Manufacturing industry	81 tril. Yen (34.6%)	115 tril. Yen (40.4%)
Non-manufacturing industry	9 tril. Yen (4.5%)	14 tril. Yen (6.3%)

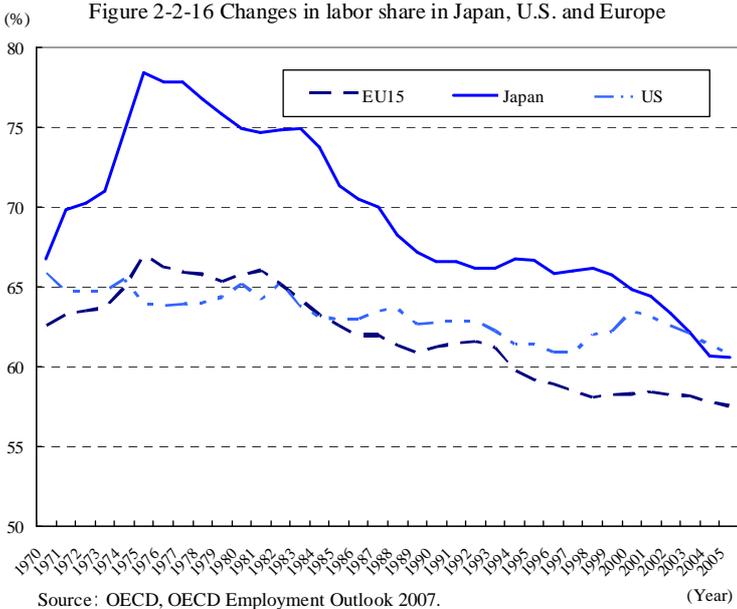
Notes: 1. 1,236 companies, which are listed on the first section of the Tokyo Stock Exchange and whose date can be collected continuously, were analyzed.
 2. Overseas sales are the total of (1) overseas sales by domestic corporations and (2) overseas sales by overseas subsidiaries.
 3. Percentage of overseas sales = Overseas sales / Total sales
 Source: Nikkei Publishing Inc., NIKKEI NEEDS KIGYOU ZAIMU DATA.

(b) Impact of globalization on the Japanese household sector

The household sector earns wages by providing labor to companies, while it gains investment income such as interest and dividend incomes by providing funds to corporations and financial institutions. These activities of the household sector are subject to globalization. This section discusses how the household sector as a source of labor and investment is affected by globalization.

(Wage reduction in association with other production factors)

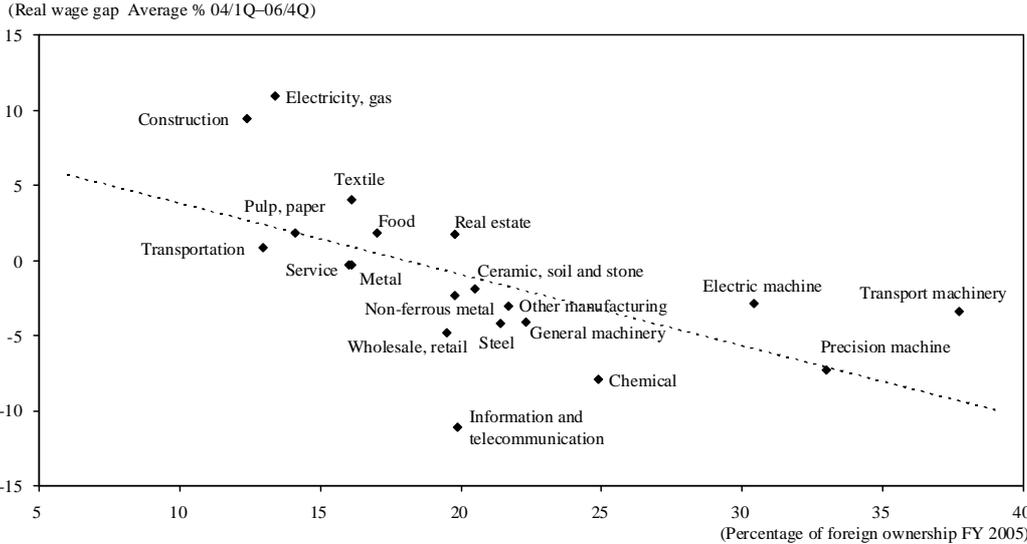
A decrease in the money paid in compensation for labor is obvious when you look at the decreasing labor share in Japan. In fact, the labor share in Japan has been declining significantly recently, although it used to be higher (see Figure 2-2-16). OECD (2007)⁶ points out that the labor share has been decreasing in Japan partly because the bargaining power of labor has been weakening with the ongoing globalization⁷.



⁶ OECD (2007c), *OECD Employment Outlook 2007*.
⁷ It also points out that the emergence of capital and technological intensive industries is another factor.

As discussed earlier, foreign investors have significantly increased their investments in Japanese stocks. Their entry into the Japanese market affects people’s wages, as they tend to look for higher payouts⁸, thereby causing a change in corporations’ dividend payments. We now consider the relations between the real wage gap⁹ and the ratio of foreign investors owning Japanese stocks by industry. The following can be observed. There is a tendency that the higher the ratio of foreign investors owning Japanese stocks in an industry, the bigger is the negative margin of the wage gap, indicating that capital globalization works against domestic wage growth (see Figure 2-2-17).

Figure 2-2-17 Percentage of foreign investors and real wage gap



Source: Bank of Japan (2007), KINEN NO WAGAKUNI NO YUSHUTSUNYUU DOUKOU TO KIGYOU KOUDOU.

(Financial globalization and opportunities to earning interest and dividend incomes)

As discussed above, globalization intensifies competition between domestic and overseas production factors, and increases the risks (uncertainty) to employment and wages in the household sector. At the same time, it contributes to the reduction in the expected rate of return, which is brought in by labor¹⁰. Under these circumstances, the idea of compensating for an income through the

⁸ Kobayashi, T (2007) in his “KIKANTOSHIKA GA CORPORATE GOVERNANCE NI ATAERU EIKYO,” uses a regression analysis to show that the higher the number of stocks foreign investors own, the higher is the dividend payout ratio. Further, the possibility of foreign investors influencing wages in Japan is pointed out in “WAGAKUNI NO YUSHUTSUNYU KOZO NO HENKA NI TSUITE” by the Bank of Japan.

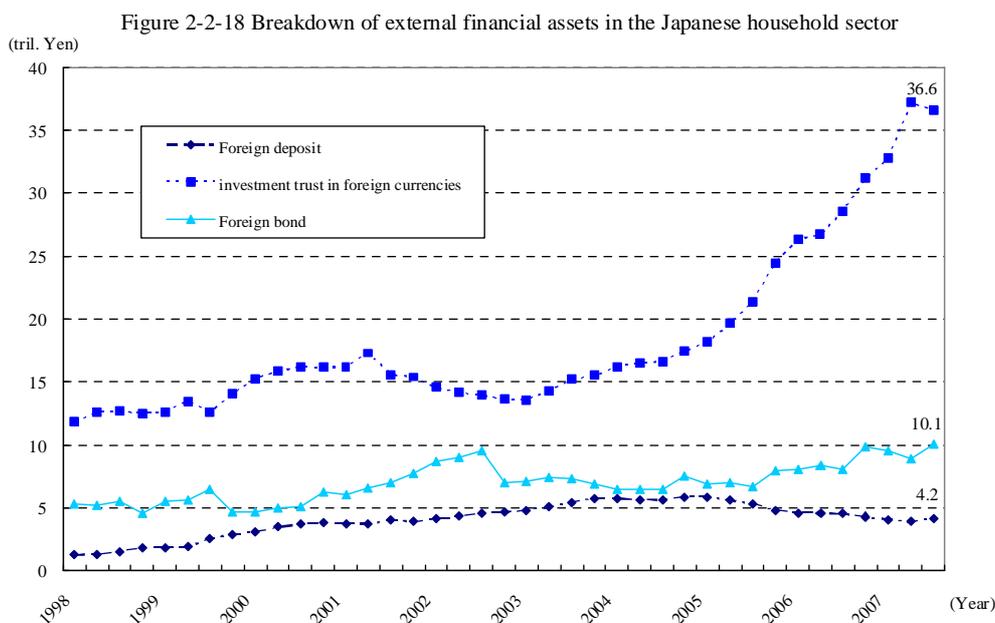
⁹ Real wage gap = Real wage growth rate – Neutral wage growth rate. Neutral wage growth rate is the wage growth rate that stabilizes the labor share. In other words, if the real wage gap is negative, the labor share lowers.

¹⁰ The Nomura Research Institute has confirmed that recently, with the continuous expansion of the standard deviation of wage change, the expected wage growth rate has been decreasing. The institute also points out that the risks (uncertainty) to labor as invested assets are increasing. According to the Nomura Research Institute, the expected rate of return brought in by labor was high until the end of 1990, while the risks of job loss and wage reduction were low under the prevailing employment practices such as lifetime employment and seniority payment. However, these risks have increased since 1998, leading to a reduction in the expected rate of return brought in by labor. As a result, the loss must be compensated by using financial assets for investment activities.

appropriate management of financial assets, instead of depending solely on wages, becomes more important.

Globalization may have advantages in terms of the improved performance of financial asset management it brings about. As discussed in section 1 of this chapter, the rapid financial globalization has enabled the household sector to easily invest in external financial assets online, although this used to be difficult earlier.

Next, we examine the changes in external financial assets (foreign currency deposits, foreign bonds, the level of trust with regard to investing in foreign currency) owned by Japanese households. We find that the level of trust with regard to investing in foreign currency has increased significantly, while that with regard to foreign bonds and foreign currency deposits is diminishing. This shows that foreign investment through institutional investors is becoming increasingly active (see Figure 2-2-18). It is impossible to find high-yield stocks and bonds in Japan, because Japan is a mature economy with low interest rates. In the meantime, financial globalization has enabled people to invest in foreign financial products with high rates of return. The household sector in Japan benefits greatly from the changes¹¹.

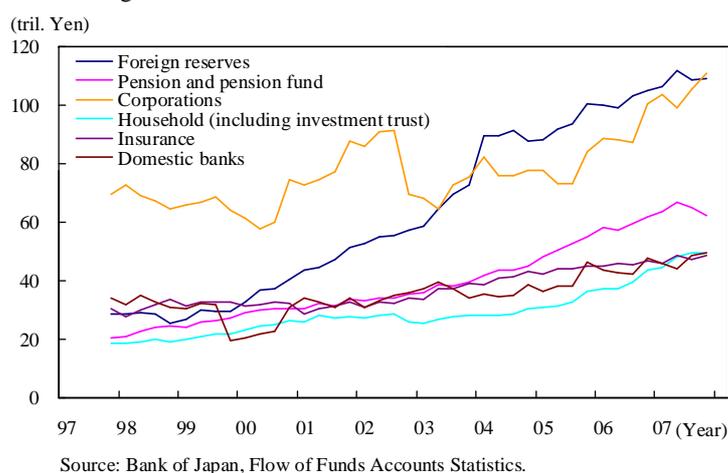


Source: Bank of Japan, Flow of Funds Accounts Statistics.

Upon investigating the breakup of Japan's external financial assets (354.6 trillion yen), we find that the assets owned by pensions and pension funds amount to approximately 60 trillion yen; this exceeds the amount of assets owned by the household sector (see Figure 2-2-19). Eventually, such planned asset investments will be a source of income for the households. Therefore, it can be said that the households may be depending more on external financial assets than what the current data on external financial assets owned by the households shows.

¹¹ The trust-level vis-à-vis investment in stocks of rapidly growing Asian economies is also increasing gradually. See section 4 of this chapter for details.

Figure 2-2-19 Breakdown of external financial assets



(Globalization and disparity)

Since the 1980s, Japan has also seen an increase in its Gini coefficient, which indicates the income gap in a society. Moreover, Japan's Gini coefficient has been rising sharply since the mid 1990s¹². At the same time, the relative poverty rate¹³ has been growing¹⁴ along with the number of welfare recipients¹⁵. Furthermore, the increase in low-income non-regular workers in the labor market has become a significant social problem¹⁶. These low-income workers are present in other countries; meanwhile only a few rich individuals gain wealth in the global market. The widening disparity between the two is often pointed out¹⁷.

An increasing number of people say that the disparity in household income is due to globalization, which intensifies the competition with overseas production factors, thereby widening the gap between the winners and losers in the competition. In the global economy where the monetary economy has been rapidly evolving, it matters whether or not the return on investment has potential for growth.

¹² This can be stated if we take into account the data from "SHOTOKU SAIBUNPAI CHOUSHA" by the Ministry of Health, Labor and Welfare on the basis of initial income. "NIHON NO SHOTOKU SAIBUNPAI – KOKUSAI HIKAKU DE MITA SONO TOKUCHOU" (Economic and Social Research Institute, Cabinet Office, Government of Japan, ESRI Discussion Paper Series No. 171) by Ota, K. (2006) says that redistribution through taxation and social security also helps increase the relative poverty rate in Japan (for example, working-age people receive less social security benefits, and there is only a small difference in tax rates between middle-income and low-income groups).

¹³ The percentage of people who earn less than 50% of median income

¹⁴ As of 2007, the relative poverty rate in Japan was 15.3%, which is the second-highest among major industrial countries, following the United States.

¹⁵ Tachibanaki, T. (2006), *KAKUSHA SHAKAI – NANI GA MONNDAI NANOKA*.

¹⁶ The so-called "working poor," who work hard but earn little, have become a social issue.

¹⁷ UNDP (the United Nations Development Program) estimates that the 50 richest people in the world earn more than the 416 million who are categorized as the world's poorest. More and more people are becoming concerned that the disparity might continue to widen. Financial Times conducted a survey in the United States, Britain, France, Germany, Spain, Italy, Japan, and China and carried an article on its research in the May 19, 2008, issue of the magazine. It says that when asked whether or not the gap between rich and poor will expand, 70 to 80% of the people in all the countries surveyed except for China stated that it will. It also shows that redistribution by taxation is the most preferred option of Japanese people, like people in other countries; further, nearly 80% of the Japanese think that wealthy people should pay more tax.

Although there are many theories regarding the impact of globalization on income disparity, this report will discuss the current situation based on existing research findings.

○ **Factor analysis of the changes in income distribution in Japan**

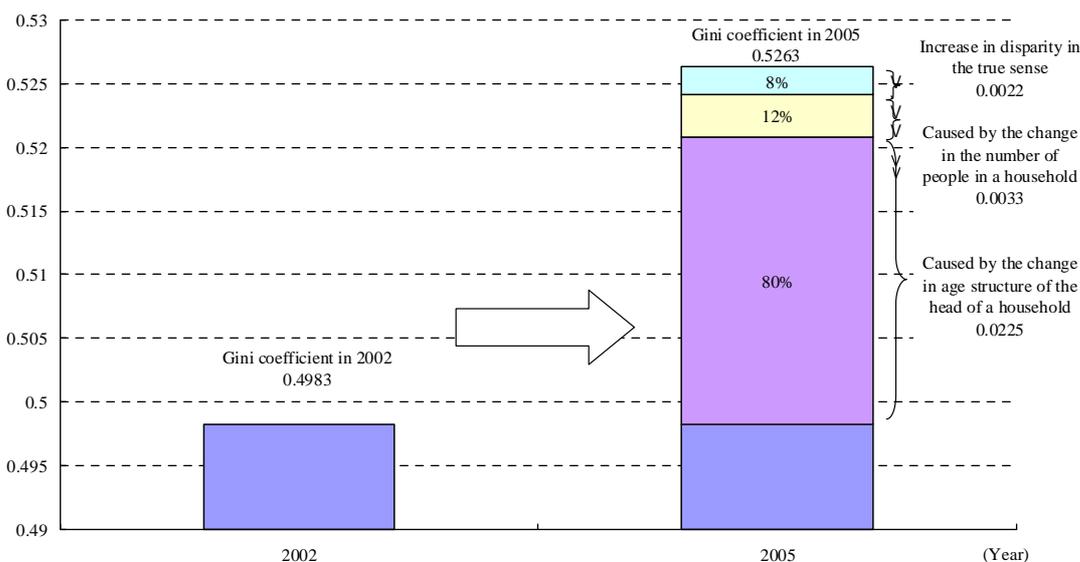
Generally, Gini coefficient is used as an indicator of income disparity. In the report “HEISEI 17 NEN SHOTOKU SAIBUNPAI CHOUSA HOUKOKUSHO” by the Ministry of Health, Labor and Welfare, a factor analysis of the increase in the Gini coefficient shows that the increase (by household on the initial income basis¹⁸) between 2002 and 2005 stems mainly from the prevailing changes in social structure, such as

- 1) the increase in the number of elderly households along with demographic aging and
- 2) the shrinking household size with the share of single households on the rise.

Further,

- 3) the widening disparity (in the true sense of the word), which is not subject to the changes in social structure, is actually responsible for less than 10% of the total increase in the Gini coefficient (see Figure 2-2-20).

Figure 2-2-20 Factors of rise in Japan's Gini coefficient



Source: Ministry of Health, Labour and Welfare (2005), SHOTOKU SAIBUNPAI CHOUSA.

○ **Factors behind the widening disparity in the true sense**

Globalization and technological progress are cited as the two main factors behind the actual widening disparity.

The factor price equalization theorem theoretically supports the mechanism of the gap caused by globalism. As discussed in section 1.3 of this chapter, there is a tendency wherein the prices of traded commodities are equalized along with the expansion of trade volumes (known as “law of one price”). As a result, the sectors producing the traded commodities are forced to equalize wages as well.

¹⁸ Initial income is the total amount of employees’ income, business income, agricultural income, livestock income, property income, homework income, miscellaneous income, and private benefits (the total amount of allowances, corporate pensions, retirement pay, life insurance money, etc.)

However, according to the factor price equalization theorem, the demand for skilled workers is high in advanced countries, which exceeds that in developing countries in terms of the number of skilled workers. Thus, the wages of high-skilled workers vis-à-vis the less skilled workers increase¹⁹. Thus, the impetus to equalize the wages varies according to the skill (proficiency level) of individual workers, thereby causing income disparity to expand.

Technological innovation such as the development of information technology also causes widening income disparities. Technological advance makes the industries more capital-intensive and technologically-intensive and widens the gap in productivity between those who can utilize technologies and those who cannot, again leading to a disparity in wages.

A positive analysis is conducted to quantitatively define the following two factors: globalization and technological improvement. For example, in IMF (2007b)²⁰ report, the factors behind the changes in the Gini coefficients in each region are classified as follows:

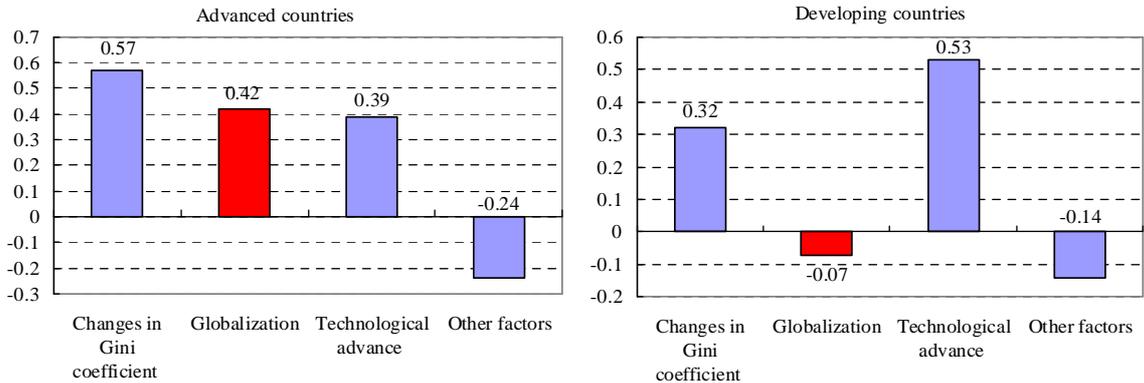
- 1) globalization²¹,
- 2) technological advancement²², and
- 3) other factors.

Further, the ratios of their contributions are calculated to analyze the causes of the widening gap in each region.

The results show that

- 1) globalization contributes to the widening disparity in industrialized nations, while it helps narrow the gap in developing countries²³ and that
- 2) technological improvement is responsible for the widening gap in both developed and developing countries (see Figure 2-2-21).

Figure 2-2-21 Factor Analysis which contributed to changes in Gini coefficient



Source :IMF, *World Economic Outlook 2008 April* .

¹⁹ This mechanism works in developing countries, where skilled workers’ wages relative to those of less skilled workers’ have been lowered and the gap between the two narrowed.

²⁰ IMF, *World Economic Outlook April 2007*.

²¹ The explanatory variables include trade openness (trade value/GDP), internal and external asset balance as a share of GDP, etc.

²² The explanatory variable is the ICT capital stock ratio (ICT capital stock/total capital stock).

²³ This result is also consistent with the factor price equalization theorem.

It can be inferred from the results of this analysis that globalization (open trade investment system) helps widen the income gap at least in advanced nations.

○ **Response to the technological advancement that is necessary worldwide and the importance of education and training**

The abovementioned IMF analysis shows that technological improvement is considered a factor in the widening income disparity in both developed and developing countries. In other words, people who are able to keep up with technological advances can increase their income, while those who cannot find it difficult to do so. This is true for the whole world²⁴.

If both sustainable growth and the correction of disparities are to be achieved while skill-intensive technological change continues, it is necessary to accumulate human capital and advance the nation's industry so that everybody is able to keep pace with the advances in technology²⁵. Satisfactory education and training is required to produce skilled personnel in adequate numbers; at the same time, skill training programs must be open to the workers who suffer a loss as a result of the changes in the economic environment caused by technological advances^{26,27}.

²⁴ For example, consider the changes in the income levels of the five groups into which US households are classified on the basis of their income. Income levels have increased only for the top 20% of the households, while other income brackets have earned less income since 2000. This kind of uneven growth was unseen during the 1970s, 1980s, and 1990s, and in all likelihood, skill-intensive technological change, such as progress of the IT revolution, have contributed to the phenomenon.

²⁵ Income disparity (gap between agriculture and industry) between urban and rural areas is becoming obvious, even in the developing countries of Asia. Even in middle-income Asian countries, the rural population is enormous and the correction of this disparity is a pending issue. ("ASIA NO KADAI TO NIHON by the National Institute for Research Advancement (2008)). Therefore, the correction of income disparity through the accumulation of human capital and industrial advancement will become a challenge for Asian countries as well.

²⁶ In "Globalization and the Problem of Income Polarization" by Gary Burtless, the following three are cited as suitable measures to compensate for the loss that workers suffer due to economic changes:

- 1) introduction of income insurance for workers to provide unemployment benefits during the period between two jobs,
- 2) compensation for low-income earners, and
- 3) general training programs for young workers.

²⁷ The United States and European countries have implemented support measures for corporations and workers who suffer from trade liberalization. One such measure is the provision of educational and training programs that encourages workers to find a different type of job or a job in a different industry. See section 4 of this chapter for details.

[Column 6] The story of Denmark, a small European state²⁸ (Denmark's economy benefiting from the globalizing economy)

There is a growing backlash against economic globalization in advanced countries. The results of a questionnaire survey²⁹ show that most people have a negative view of economic globalization, claiming that trade, investment, and other economic activities are globalizing at an extremely rapid pace. Supporters of this opinion account for an average of 57% of the population in Britain, the United States, France, Germany, Canada, Italy, and Japan. There is even a conservative movement in industrialized countries as people are concerned about losing their jobs.

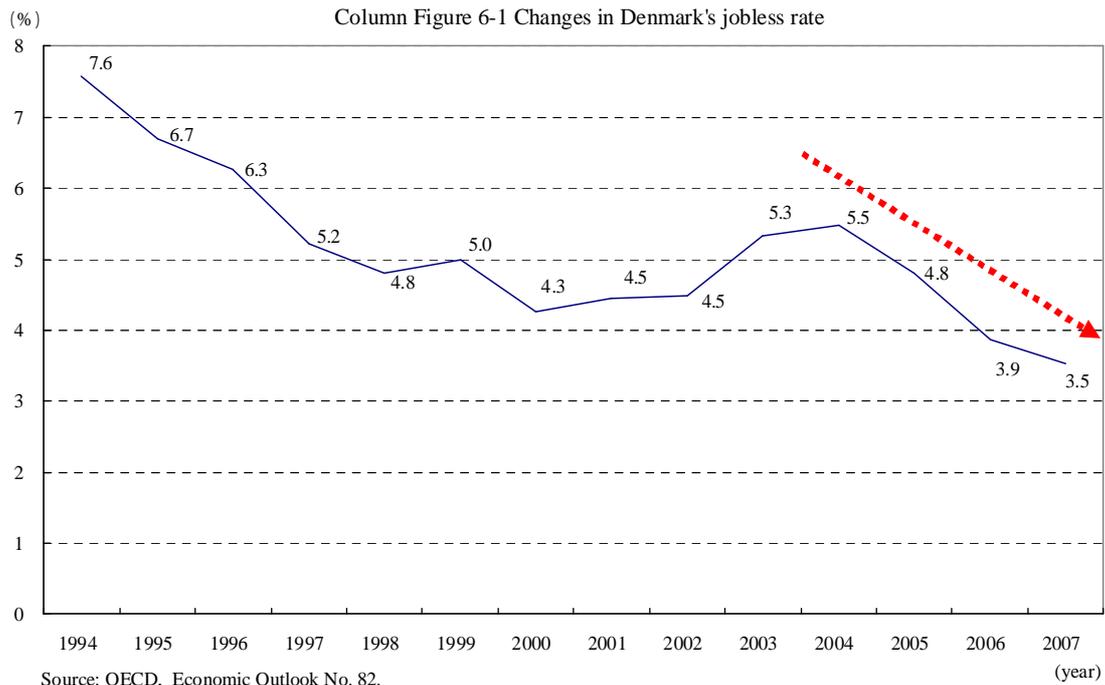
However, there are no negative sentiments about globalization in the Scandinavian countries, which are regarded as being even more welfare-oriented than other European countries. Despite the steep prices levels and high costs of living and welfare, Scandinavian countries as a whole are considered to constitute a new competitive region and have been attracting greater attention in recent times. Nordic countries surpass other OECD members in terms of labor productivity by around 17% on average and have high employment rates, partly because more women in these regions are employed³⁰.

Denmark, among other countries, is well-known to have successfully implemented a model called "flexicurity," in achieving both the flexibility of the labor market and employment security. Many welfare-oriented states place a limit on dismissal by law and labor management agreement, whereas other European countries are critical of this policy, claiming that this practice causes high unemployment rates and prevents free labor movement in Europe. However, at present, a look at the situation in Denmark will reveal that it is mandatory for employers to give a notice before lay-offs, but there are no other regulations for furlough. Danish employers have the freedom to fire people, even though labor unions are in control. On the other hand, Danish workers including middle-aged and older people can find other jobs within about six months. One in three Danish people change jobs every year. The country's labor market flexibility is reflected in its low joblessness rate, which is especially low in the case of OECD members (see Column: Figure 6-1). Furthermore, the number of workers employed on a short-term basis continues to decrease.

²⁸ The title of this column originally comes from "DENMARUKUKOKU NO HANASHI" (which first appeared in "SEISHO NO KENKYUU," issue No. 136, (1911)), an article that was written by Kanzo Uchimura based on a lecture he had given at Imai Hall in Kashiwagi, Tokyo, with some modifications presented in the writing style. The story tells of how Denmark managed to become one of the richest countries in the world on a per capita basis by producing dairy products, despite losing the best part of its land in the war with Germany and Austria in 1864, which devastated the economy and left its people to live in dire poverty. The country successfully rebuilt itself, transforming the wasteland into a fertile land, thanks to those individuals who kept faith in nature and God and worked hard to plant trees by using irrigation and reforestation technologies.

²⁹ Peel Q. (2008), "Nordics stay hot for globalization," Financial Times, April 11, 2008.

³⁰ Denmark's employment rate (the percentage of employees to the labor force population) stood at 78.6% as of 2006, placing it in the third place among the OECD members.

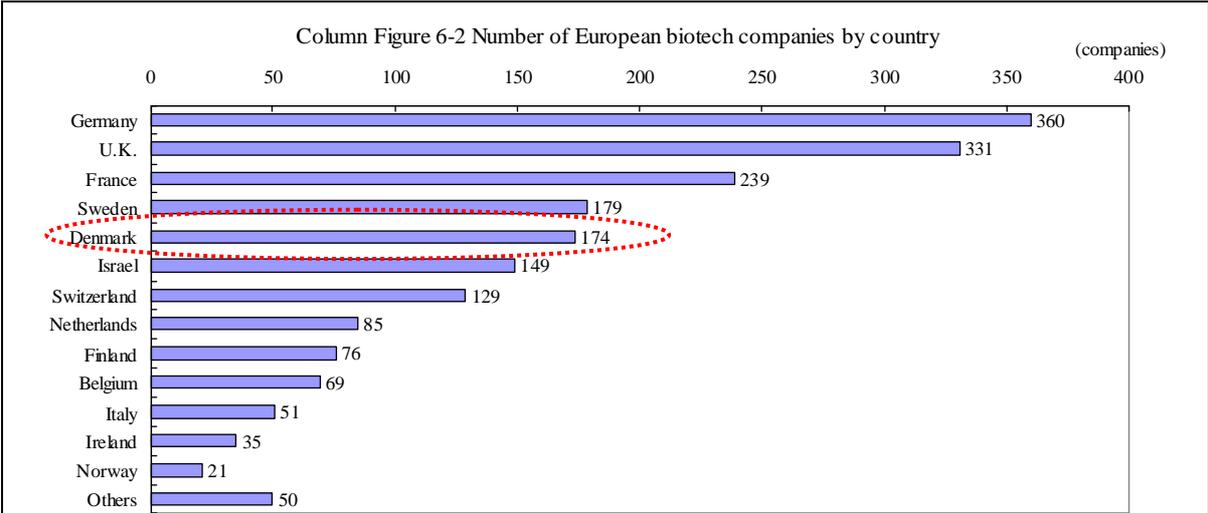


A consideration of the Danish economy reveals that the country cannot be ignored. The economy has been growing steadily since the country's financial reconstruction and labor market reforms during the first half of the 1990s. Denmark benefits more from the globalizing economy than any other country. This small country buys cheap parts in the global market and produces high value-added products, thus benefiting from the free trade. Some point out that Danish manufacturers purchase parts from China and Eastern European countries, while they work hard to become more competitive, such that all they engage in is highly intellectual endeavors. This is what constitutes their strategy. In fact, this country has many niche businesses that export high value-added products, such as hearing aids, insulin, environmental technologies, etc. In addition, Denmark is known as a maritime economy, with its shipping firms being recognized as blue-chip global companies. It has also ranked first in the world for the second consecutive year in terms of the development of information and communications technology, according to one report³¹. The country has a reputation for its rapidly growing information and technology field.

(Human capital policy and the influence of globalization)

Denmark's "flexicurity" model has been highly evaluated because it has made the nation competitive in the globalizing world. One of the notable characteristics of this model is the achievement of full employment. Further, this model is characterized by close-knit labor unions, which are recognized as social partners. Labor unions sometimes even request that jobs be outsourced to other countries to make the company more competitive. Thirdly, the model makes it easy for employees in Denmark to switch jobs. As employment protection regulations are more lax here than in other countries, the labor environment makes switching jobs easy (Column: Figure 6-3).

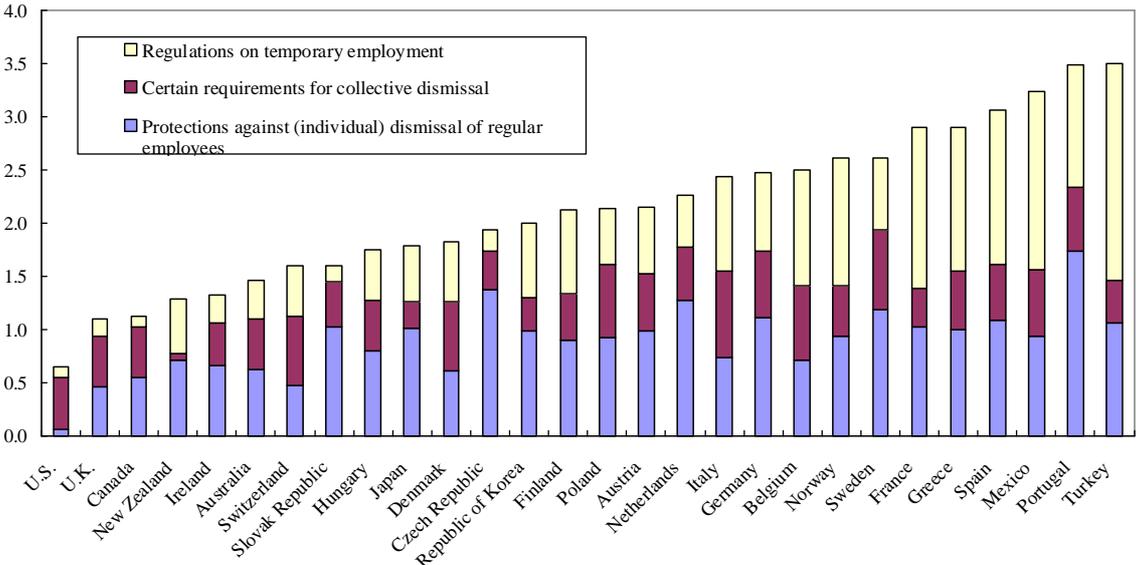
³¹ World Economic Forum (2008), *WORLD IT REPORT*.



Notes: 1. The number of Danish biotech companies almost tripled from 61 in 1997 to 174 in 2003, ranking fifth in Europe.
 2. According to a report released by the Danish Center for Studies in Research and Research Policy (CFA) at the end of 2003, another 86 Danish companies including pharmaceutical companies conduct biotech activities, other than 174 companies above-mentioned.

Sources: JETRO, Copenhagen Office, "DENMARK NO BIOTECHNOLOGY SANGYO - MEDICONVALLEY NO GAIKAN/HYOUKA, EURO TREND" Jul. 2006 (http://www3.jetro.go.jp/jetro-file/BodyUrlPdfDown.do?bodyurlpdf=05001345_001_BUP_0.pdf) Ernest and Young with some changes by Danish Center for Studies in Research and Research Policy.

Column Figure 6-3 Degree of strictness of employment protection regulations in OECD members (Year 2003)



Source : OECD, *OECD Employment Outlook 2004*.

To fill the gaps in wages across industries, the government subsidizes housekeeping and other businesses to help increase the employees' wages. Furthermore, measures are taken to comprehensively guarantee income and provide training programs for the unemployed. For instance, 4.5% of the total GDP is spent on programs in the interest of the labor market. The country's efforts to protect its workers make the Danish labor market flexible, but also important for this flexibility is to ensure public awareness of job switching. Surprisingly, 70% of the Danish population believe that "job switching is a good thing," while in the neighboring Germany, where such efforts to protect the workers are not made, less than 30% of the people share this opinion. Of the total Danish working population, 47% are continuously engaged in some sort of lifetime

education program, indicating that education among people holding jobs is more popular here than in any other country.

Ironically, however, the influx of immigrants caused by globalization is undermining this country's success. The Danish model has been built on a heavy tax burden. Middle-class people who pay taxes complain about immigrant workers, who are less skilled but benefit from public services. In the 2007 election, the Danish People's Party, which introduced the policy for lower taxes and against immigration, gained public support to some extent. According to some, the Danish government tries to cut expenditures by promoting the use of private insurance and facilities in health, education, and other fields. This notwithstanding, the issue of immigrants and social integration is too big a challenge for the country, and the government still does nothing to regain the support of the middle class. The issue is now one of the major concerns of this country.

As discussed above, the Danish model adopts "flexicurity" with respect to labor. Can this be a case of success in the globalizing world? Does this factor shed light on the situation of the industrialized nations that are now concerned about economic globalization?

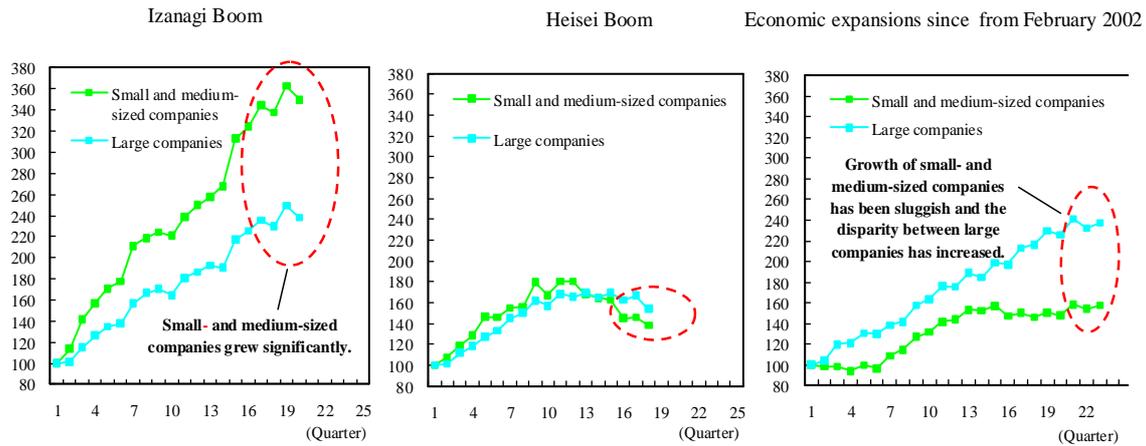
It would be difficult to introduce the Danish model in a country with a different historical background and culture, such as Britain, France, the U.S. and Japan, unless it is adapted to each country.

2. Increasing disparity between companies in the wave of globalization

As mentioned in Section 1, the impact of globalization on the national economy, corporate sector, and household sector is increasing. On the other hand, the disparity between companies in particular is becoming increasingly apparent with collapse of the structure in which every economic entity grew in unison, owing to the progress of the globalization of the national economy in recent years. In fact, a comparison between the changes in the real corporate earnings of large companies and small- and medium-sized companies during the three periods of economic expansion—namely, the Izanagi Boom (between October 1965 and July 1970), the Heisei Boom (between November 1986 and February 1991), and the current economic expansion (from February 2002)—shows that the disparity between the two is evident. This may be due to the steady growth in the income of large companies as compared to the slight growth of the small- and medium-sized companies in the current economic expansion phase (see Figure 2-2-22).

The increased disparity between the companies is considered to be the result of the imbalance in the size of impact of globalization on companies in terms of both demand and supply. In order to verify this observation, the following section analyzes the impact of globalization on companies, respectively from the perspective of demand and supply.

Figure 2-2-22 Changes in Corporate Earnings by Company Size



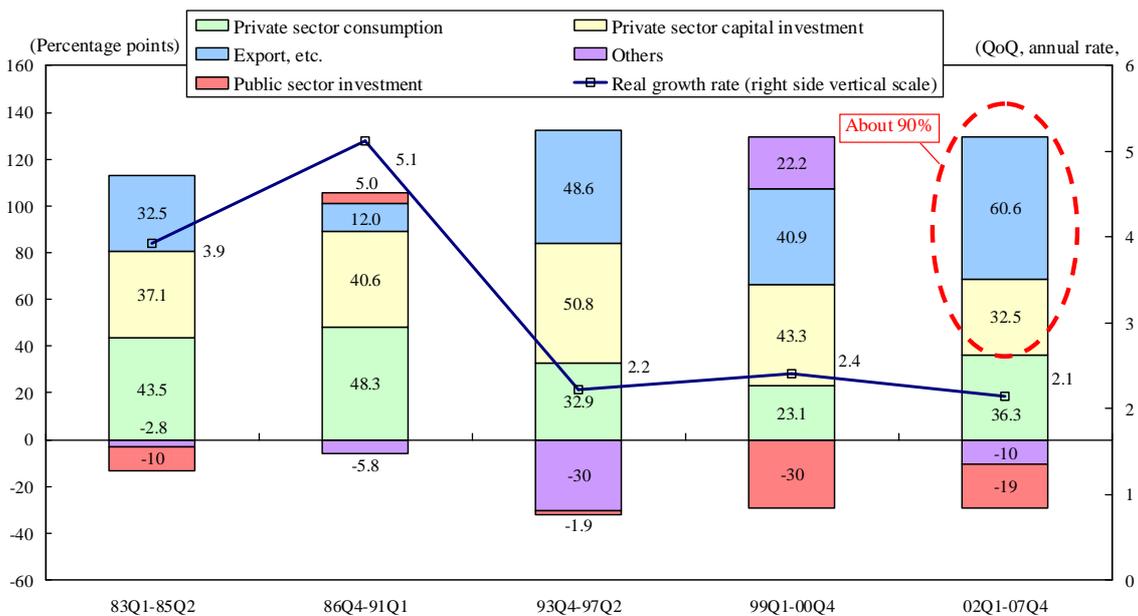
Sources: Cabinet Office, Annual Report on National Accounts; Ministry of Finance, Financial Statements Statistics of Corporations.

(1) Disparity caused by demand factors

(Structure of growth driven by foreign demand and capital investment and the sluggish domestic demand)

A characteristic aspect of the current economic expansion phase is that it is driven by export and capital investment. Moreover, the breakdown of the real GDP growth rate due to the contribution of demand components shows that the rates of contribution of export and capital investment are 60.6% and 32.5%, respectively—the sum of the two measuring up to more than 90% (see Figure 2-2-23). Thus, we can conclude that the current phase of economic expansion is characterized by the remarkably high rate of the contribution of export, as compared to the previous economic booms.

Figure 2-2-23 Real GDP growth rates by contribution of demand components during the phases of economic expansion



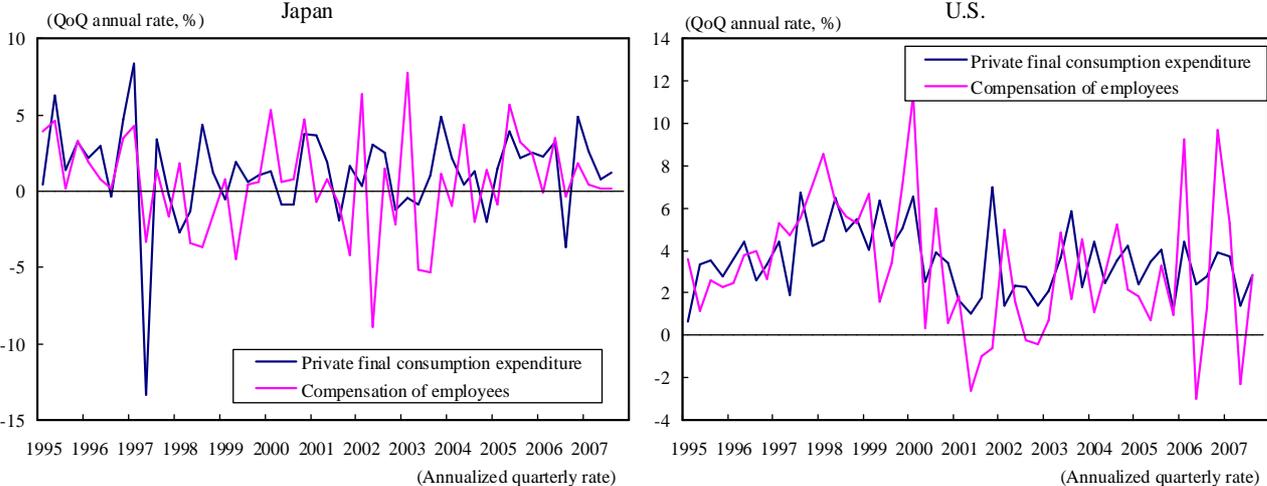
Source: Cabinet Office, Annual Report on National

As mentioned above, foreign demand and capital investment have grown steadily, while the growth of the other demand components has been slow. In fact, the investments in the public sector

have decreased due to the fiscal restraint in the 1990s and the subsequent period, and their contribution to the GDP growth rate has been negative. Moreover, the contribution of private sector consumption has been on the decline from the 40% range in the 1980s to the 30% range; in other words, there has been a decrease of about 10 %.

The biggest factor responsible for the declining contribution rates of private sector consumption is presumed to be the sluggish growth of wages in recent years. According to the Annual Report on National Accounts, the compensation of employees in the household sector in Japan has been on the decline since the past several years. As will be discussed later in the paper, Japanese households are not particularly dependent on dividends and interest earnings, and most of their income comes from wages. Therefore, it can be presumed that a decrease in the compensation of employees leads to a decrease in the disposable income, which in turn results in lower consumption. In order to identify the impact of the compensation of employees on consumption, we determined the correlation between the rate of change in the compensation of employees in Japan and the U.S. The results revealed a tendency wherein the increase and decrease in the compensation of employees strongly affects the increase and decrease in consumption in Japan (see Figure 2-2-24)³². In other words, the Japanese consumption function is similar in structure to the Keynesian consumption function³³, where the current disposable income determines the level of consumption and the effect of decrease in the compensation of employees plays a significant role in the decrease in consumption.

Figure 2-2-24 Relationship between the rate of change in employees' compensation and consumer spending



Sources: Cabinet Office. Annual Report on National Accounts; U.S. Bureau of Economic Analysis. National Accounts.

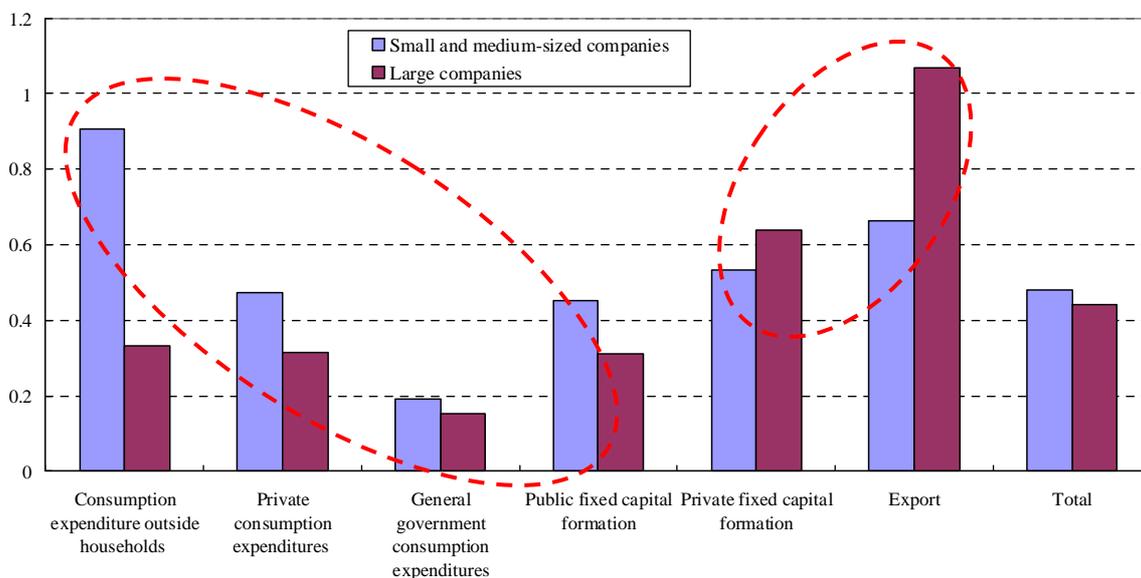
³² The change in consumption due to the change in the compensation of employees is more stable in the U.S. than in Japan. It is presumable that in the U.S., the decrease in wages is compensated for by dividends, interest earnings, loans, etc. (IMF, 2007b). The World Economic Outlook (April 2007), analyzes the relationship between the stability of consumption and the maturity of the financial system of specific countries from a similar viewpoint.

³³ It says that consumption is a linear function of current income. Other theories of the consumption function include the permanent income hypothesis (consumption is based on the anticipated average income on a long-term basis) and the life-cycle hypothesis (consumption is based on the expected lifetime income.).

(Disparity between companies due to the structure of growth directed by foreign demand and capital investment)

The structure of growth directed by foreign demand and capital investment is responsible for a disparity in the earnings of companies whose sales and earnings are dependent on foreign demand/capital investment (export dependent companies, machinery equipment manufacturing companies, etc.) and those whose sales are not. A comparison between the production ripple effects of specific demand components on large companies and small- and medium-sized companies, based on the inter-industry relations table by company size, shows that export and capital investment have larger production ripple effects on large companies, while the private sector consumption and public fixed capital formation have larger production ripple effects on small- and medium-sized companies. Thus, it is presumable that the growth directed by export and capital investment inevitably increases the disparity between large companies and small- and medium-sized companies (see Figure 2-2-25).

Figure 2-2-25 Production ripple effect coefficient by contribution of demand components
(Large companies, small- and medium-sized companies)



Source: Small and Medium Enterprise Agency, 2005 *Inter-industry Relations Table by company size*.

(2) Disparity caused by the supply factors

On the other hand, globalization also seems to have a significant impact on the economic structure of Japan with respect to the supply aspect. As mentioned in Section 1, compared to 2000, Japan's terms of trade have deteriorated considerably in recent years and the income flow out of the country in 2007 amounts to almost 18.8 trillion. This outflow will ultimately have to be incurred by the Japanese companies or households. Here, the focus will be on the terms of trade as an impact of globalization on the supply, so as to confirm the impact of the deteriorated terms of trade on specific economic entities.

(Deterioration in the terms of trade having an uneven impact on companies)

The current deterioration in the terms of trade can be explained by the significant increase in the

import price due to the rising resource prices and depreciation of the yen. The impact of deterioration in the terms of trade first appears in the upstream industry (basic materials industry), and then spreads to the midstream industry (parts industry), and finally goes on to the downstream industry (finished product industry). The size of the ripple is determined by the percentage of the price passed on in the vertical trade between the upstream and midstream as well between the midstream and downstream industries.

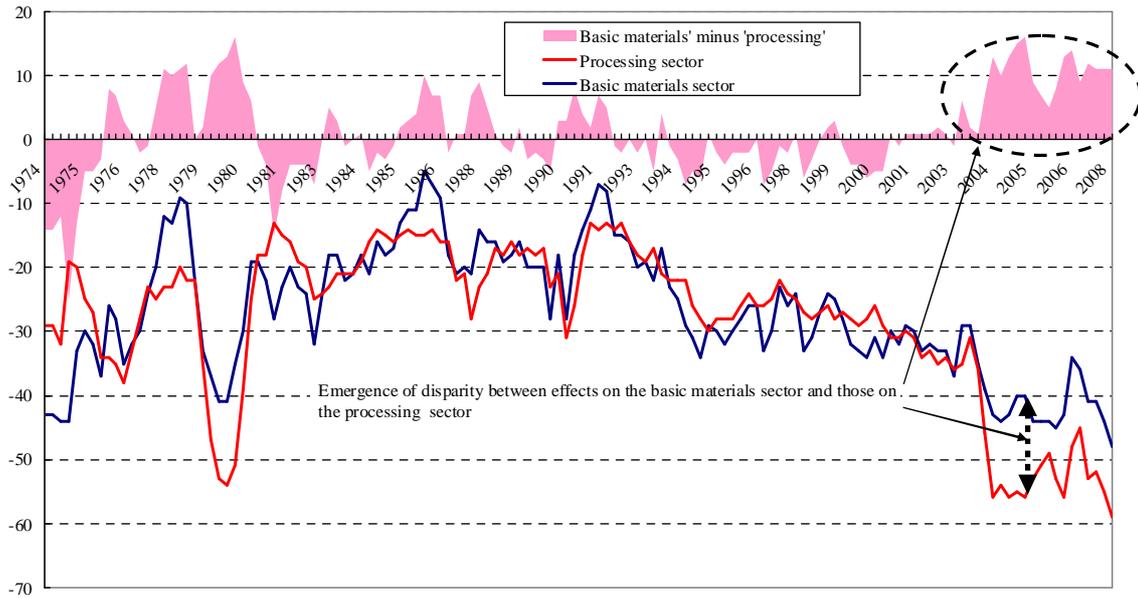
Now, the changes in the terms of trade diffusion index (D.I.) (sales price D.I. deducted by purchase price D.I.³⁴) show that the disparity between the D.I. of the basic materials industry and the processing industry became evident sometime around 2004, when the deterioration in the terms of trade began (see Figure 2-2-26). The result shows that while the basic materials sector has been relatively successful in the passing on of prices, the processing/assembling sector is finding it hard to pass them on due to the sluggish growth of the consumer price index and is thereby negatively affected by the deteriorating terms of trade.

Next, the changes in the terms of trade D.I. by company size show that the disparity in the terms of trade D.I. in the large companies and small- and medium-sized companies is similarly to the relationship between the basic materials and processing sectors (see Figure 2-2-27). The low price negotiating ability of the small- and medium-sized companies can be highlighted as one of the factors of the widening disparity. The small- and medium-sized companies generally have little say in negotiating prices with buyers, and it is difficult for them to pass on the higher material costs. Actually, the results of a questionnaire survey³⁵—conducted with 6,907 manufacturing companies in Japan as the subjects—show that the percentage of small- and medium-sized companies that responded that their price negotiating ability was lower than that of large companies, which was as high as 75.3%. Thus, it is apparent that the deteriorating terms of trade have considerable effects on the small- and medium-sized companies due to their low price negotiating ability, among other factors.

³⁴ The source of the data is the “Short-term Economic Survey of All Enterprises in Japan,” conducted by the Bank of Japan. Sales price D.I. refers to the percentage of companies that answered: “Sales price rose.” Purchase price D.I. is defined in a similar manner.

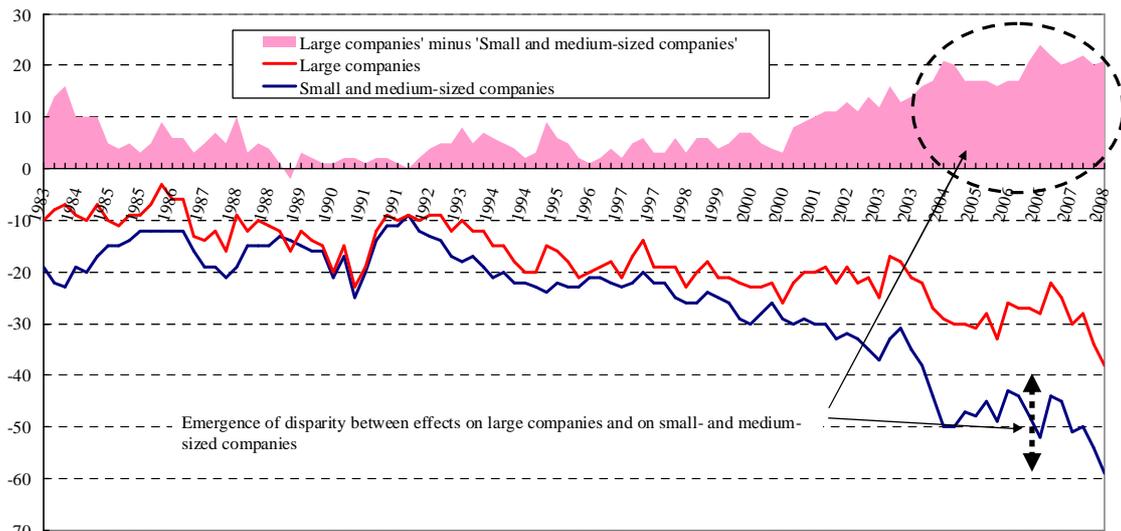
³⁵ Mizuho Research Institute and Kyoto University (2007), “CHUKEN/CHUSHOU KIGYOU NO TORIHIKI KOUZOU NI KANSURU JITTAI CHOUSHA.”

Figure 2-2-26 Changes in the terms of trade D.I. of the basic materials sector and the processing sector



Note: Terms of trade D.I. = Sales price D.I. deducted by purchase price D.I.
Source: Tankan (Bank of Japan)

Figure 2-2-27 Changes in the terms of trade D.I. by company size



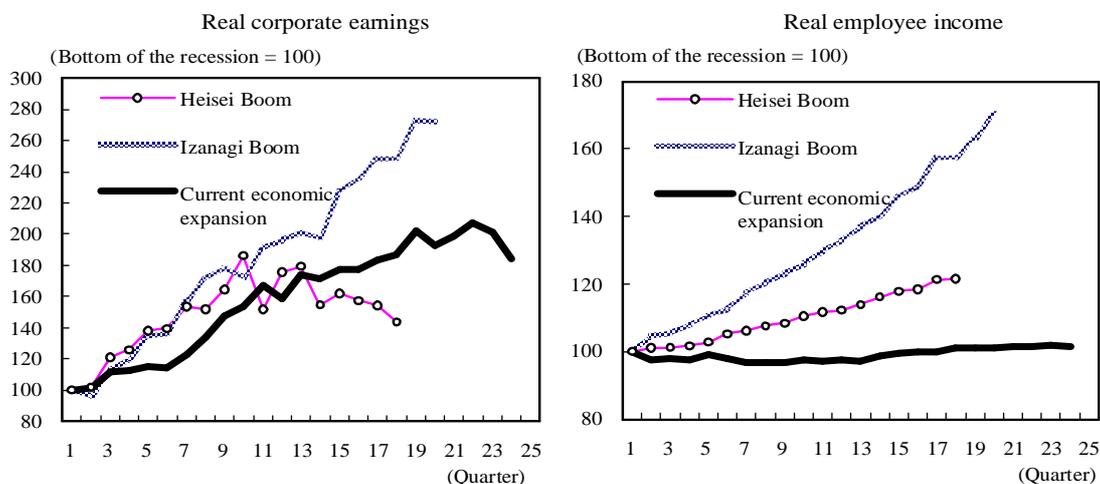
Note: Terms of trade D.I. = Sales price D.I. deducted by purchase price D.I.
Source: Tankan (Bank of Japan)

[Column 7] The widening disparity in the income of companies and households and the impact of the deteriorating terms of trade on households

The Japanese labor distribution rate has been on the decline in recent years, and the balance of income distribution between companies and households is changing. Actually, corporate earnings have increased while employee income has remained stagnant during the current economic expansion phase (see Column Figure 7-1). The unbalanced growth structure, such as the above, was nonexistent during the previous economic booms (namely, the Izanagi and Heisei Booms). It is presumable that

the fact that the income of the household sector has not increased is the main reason why the current economic expansion phase is labeled the “economic expansion without any felt benefit.”

Column Figure 7-1 Changes in corporate earnings and employee income

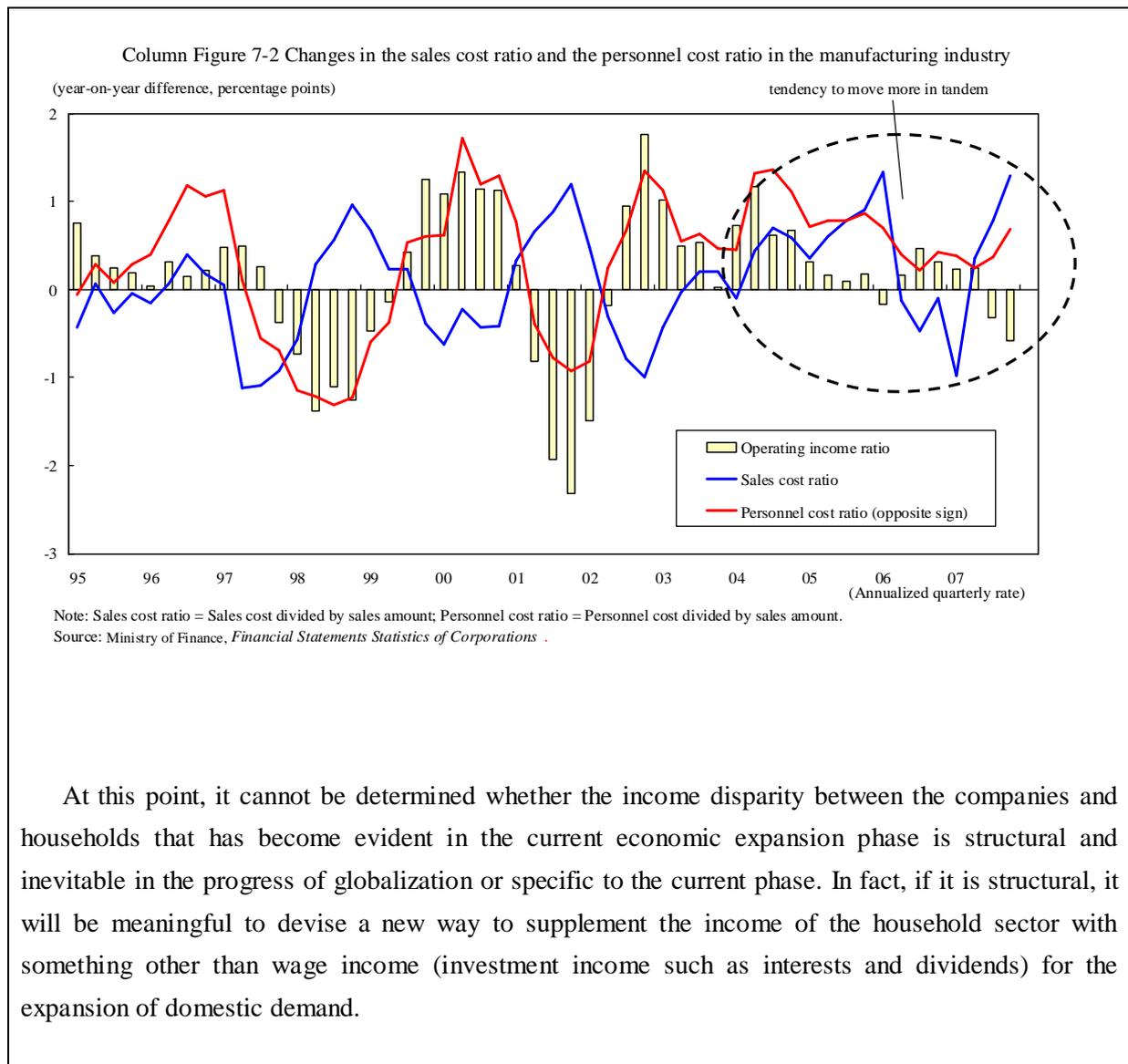


Sources: Cabinet Office, Annual Report on National Accounts; Ministry of Finance, Financial Statements Statistics of Corporations.

It can be assumed that the cause of the sluggish growth of income in the household sector in the current economic expansion phase includes not only the impacts of globalization, as pointed out in Section 1 ((1) lowering negotiating ability of laborers and (2) progress of capital and technology intensification in industries), but also the deterioration in the terms of trade due to the crude oil price rise that almost coincided with the commencement of the current economic expansion phase (February 2002). The uneven impact of the deteriorating terms of trade on specific companies has been confirmed in this paper. However, it is conceivable that the deteriorating terms of trade have a negative impact on the household income as well as the corporate income through the suppression and reduction of personnel cost.

Accordingly, we take a look at the relationship between the rate of change of the sales cost ratio (sales cost divided by sales amount) and personnel cost ratio (personnel cost divided by sales amount) in the manufacturing industry, which is considered to be significantly affected by the deterioration in the terms of trade. Conventionally, when the sales decreased and sales cost ratio increased, the personnel cost ratio tended to increase with the downward rigidity of wages. However, since 2003, with the rise in the price of crude oil, a relationship has been apparent, in which the personnel cost ratio decreases to compensate for the increased sales cost ratio against the backdrop of the lower rigidity of wages due to the mobilization of employment that accompanies the increase in non-regular employment³⁶. Thus, it can be assumed that the deterioration in the terms of trade has a significant impact on the household income (see Column Figure 7-2).

³⁶ It can be presumed that the dawn of the lower rigidity in wages such as the above is the main motivating factor for the rapidly decreasing labor-distribution rate in recent years.



At this point, it cannot be determined whether the income disparity between the companies and households that has become evident in the current economic expansion phase is structural and inevitable in the progress of globalization or specific to the current phase. In fact, if it is structural, it will be meaningful to devise a new way to supplement the income of the household sector with something other than wage income (investment income such as interests and dividends) for the expansion of domestic demand.

3. Toward building a virtuous economic cycle in the midst of globalization

In order to achieve real GNI growth in the midst of globalization, while at the same time spreading the fruits of such growth broadly throughout the economy and building an affluent national economy, it will be necessary 1) to acquire external demand through aggressive trade investment (expand real GDP through growth in exports, expand income earnings overseas through greater overseas investment), 2) improve terms of trade (improved trading gains/losses) and 3) achieve a smooth repatriation of wealth acquired overseas into Japan (generation of domestic demand). Here we'll take a look at the current situation regarding these points and discuss the direction of future response.

(1) Importance of acquiring external demand through aggressive trade investment (Importance of aggressive acquisition of resource rich country demand)

As was stated previously, there has been a massive outflow of income accompanying the worsening of Japan's terms of trade, and this outflow to resource rich countries such as in the Middle East, Russian and Brazil, is contributing to higher purchasing power in those countries. However,

compared to the time of the oil shocks, in the current deterioration in the terms of trade the positive degree of income received from overseas (actual net exports + net receipts from overseas) is greater than the negative degree of trade loss (see Figure 2-2-28).

Thus, compared to the oil shock period, acquiring demand from resource countries should redirect back to Japan the income outflow from Japan that accompanies worsening terms of trade. The ratio of exports to oil producing countries (OPEC, Russia) of Japanese total exports has been expanding steadily since the turn of the century, and in 2007 reached a record 6.0%, the highest among the main developed countries (see Figure 2-2-29).

However, in April 2008, exports to the Middle East (preliminary basis) expanded 17.7% YoY while imports grew by 45.9% YoY as exports failed to match the growth in imports accompanying the rise in oil prices³⁷. Japan has an extremely small share of oil producer country direct investment income.

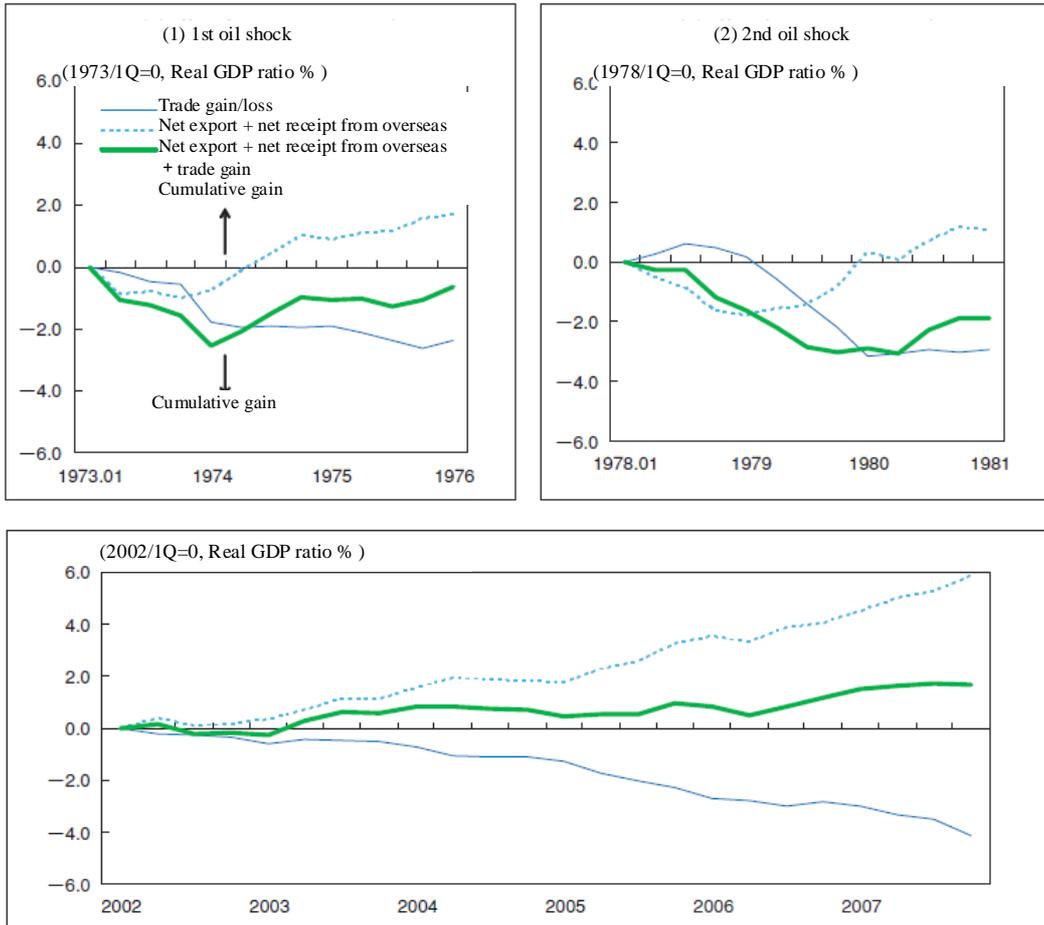
Direct investment income from the Middle East in 2007 was ¥68.1bn and from Russia ¥4.1bn, for a total of merely ¥72.2bn. Out of a total direct investment income of ¥5.3093tn this is no more than 1.4%³⁸, which suggests potential for acquiring resource country demand through increased exports and direct investment³⁹.

³⁷ The April 2008 trade surplus (preliminary) was ¥479.5bn, roughly half the ¥903.1bn recorded a year ago. Export growth of 3.9% YoY was maintained but high oil prices boosted import growth to 11.9% (contribution rate from crude oil and hydrocarbon oil was 8.4% points). This is how higher oil prices have, in a tangible manner, affected Japan's exports and imports.

³⁸ Bank of Japan, "International Balance of payments by region"

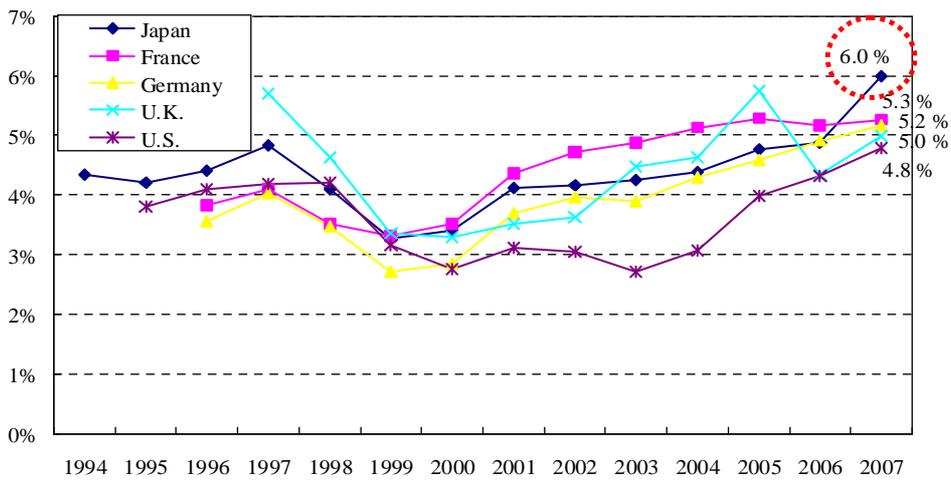
³⁹ Attention must also be given not only to direct exports and investment but also to acquiring demand via third countries. For example, some exports of cars to the Middle East could be carried out from Japanese car factories in ASEAN, which also happen to be geographically closer.

Figure 2-2-28 Income from overseas and trade gain/loss during high oil price phase



Source: Bank of Japan, "Outlook for the Economy and Prices (April 2008)"

Figure 2-2-29 Ratio of exports from main developed countries to oil producer countries

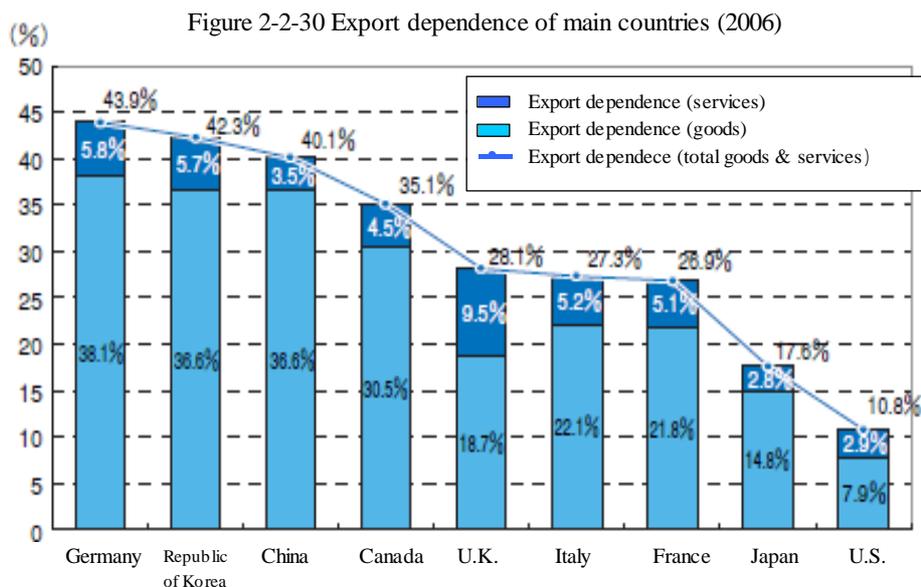


Note: Here oil producer countries are taken as OPEC plus Russia.

Source: World Trade Atlas.

(Japan's dependence on external demand not necessarily high)

Greater effort by Japanese industry in acquiring external demand is necessary in order to expand real GNI and, as was mentioned in Section 2, in order to overcome differences between companies. As seen in Section 1, active acquisition of external demand by industry is largely limited to companies listed on the stock exchange, external demand acquisition by industry overall is not always that active. For example, in exports of goods and services as a ratio of nominal GDP Japan has the second lowest ratio after the U.S. (see Figure 2-2-30). Because exports of services are at such a low level, what is required is export reinforcement that includes the service industry.



Note: export dependence = exports/GDP.

Source: IMF "World Economic Database"; WTO "Trade Statistics".

(Trade investment structure concentration in large companies and necessity for small and medium companies to advance overseas)

Japan also has a problem in that external demand acquisition through trade and investment is, by value, concentrated in a handful of companies. According to the Company Activity Basic Survey by METI, the top 10 and top 30 companies in direct exports by value account for 29.3% and 44.2%, respectively, of Japan's total exports (2006). The top 10 and top 30 companies respectively account for 28.9% and 48.1% of Japan's overseas investment lending. This indicates that Japan's trading activities are limited to a handful of large corporations (see Figure 2-2-31)⁴⁰.

⁴⁰ The gradually declining degree of concentration indicates that small and medium companies are expanding their export activities.

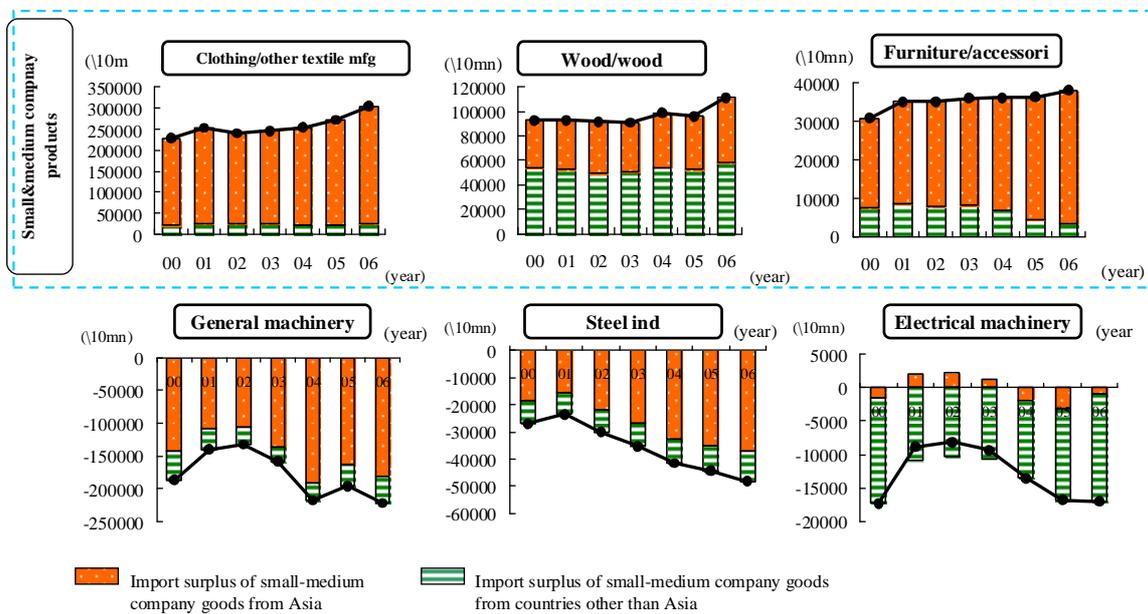
Table 2-2-31 Ratio of direct exports and direct overseas investment of top 10 and top 30 companies

	Export (¥tn)				Overseas investment (¥tn)		
	1997	2001	2006		1997	2001	2006
Direct export (top 10 company total)	30.2	17.4	22.1	Overseas investment (top 10 company total)	6.6	8	8.4
Share of total export	59.4%	34.1%	29.3%	Share of total investment	33.7%	32.1%	28.9%
Direct export (top 30 company total)	43.7	28.3	33.3	Overseas investment (top 30 company total)	10.2	12.6	13.9
Share of total export	85.8%	55.5%	44.2%	Share of total investment	52.5%	50.3%	48.1%
Export total	50.9	49	75.2	Overseas investment total	19.5	25.1	28.9

Note: Overseas investment regard related companies
 Source: METI, "Company activity basic survey"

At present, small and medium companies in the manufacturing industry are having difficulty achieving sustained growth due to severe international competition. In many of the products of small and medium companies⁴¹ there is a substantial import surplus (imports – exports), a trend that is expanding (see Figure 2-2-32). As a result, shipments of small and medium company products declined substantially (see Figure 2-2-33). Competition from China and Republic of Korea in what was the core of Japan’s manufacturing industry as well a source of pride in the country’s strong technology, the mold industry, increased and the import penetration ratio (imports/(shipments + imports – exports)) rose from 1.9% in 1996 to 6.0% in 2006 (see Figure 2-2-34). In view of this severe business environment within Japan, it is important that the domestic demand related industry, including small and medium companies, broaden the scope of their overseas activities by seeking to differentiate their products from overseas products and by seeking to reduce dependence on domestic demand in order to achieve sustainable growth.

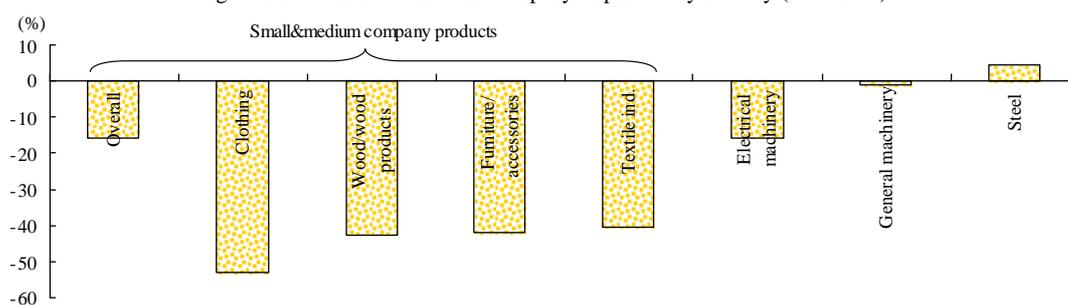
Figure 2-2-32 Import surplus by product



Source: Small and Medium Enterprise Agency, "Export/import value by scale"

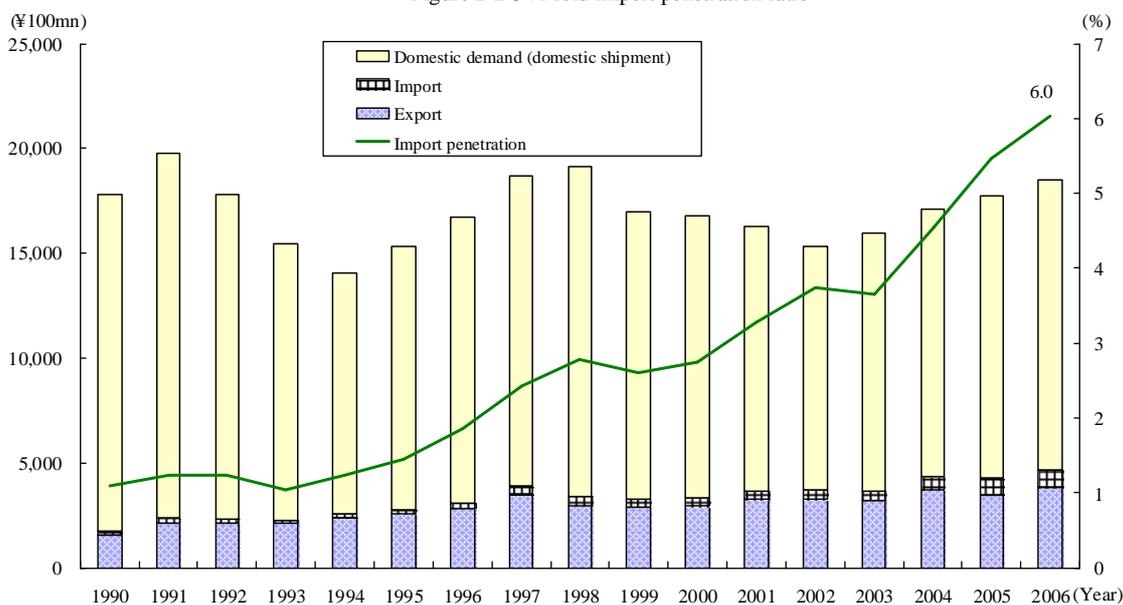
⁴¹ The products of small and medium companies with 300 or fewer employees where the products comprise over 70% of total shipments (more specifically textiles, clothing, other textile products, furniture/accessories, tanned leather/fur, etc.)

Figure 2-2-33 Small and medium company shipments by industry (1997-2005)



Notes: 1. Values are rate of change in shipments in 2005 with 1997 as 100
 2. Small & medium companies are companies with more than 4 and fewer than 300 employees.
 Source: METI, "Industry Statistics"

Figure 2-2-34 Mold import penetration ratio



Source: METI, "Industry Statistics", MOF "Customs cleared trade data"

(Further improvements required in direct investment rate of return)

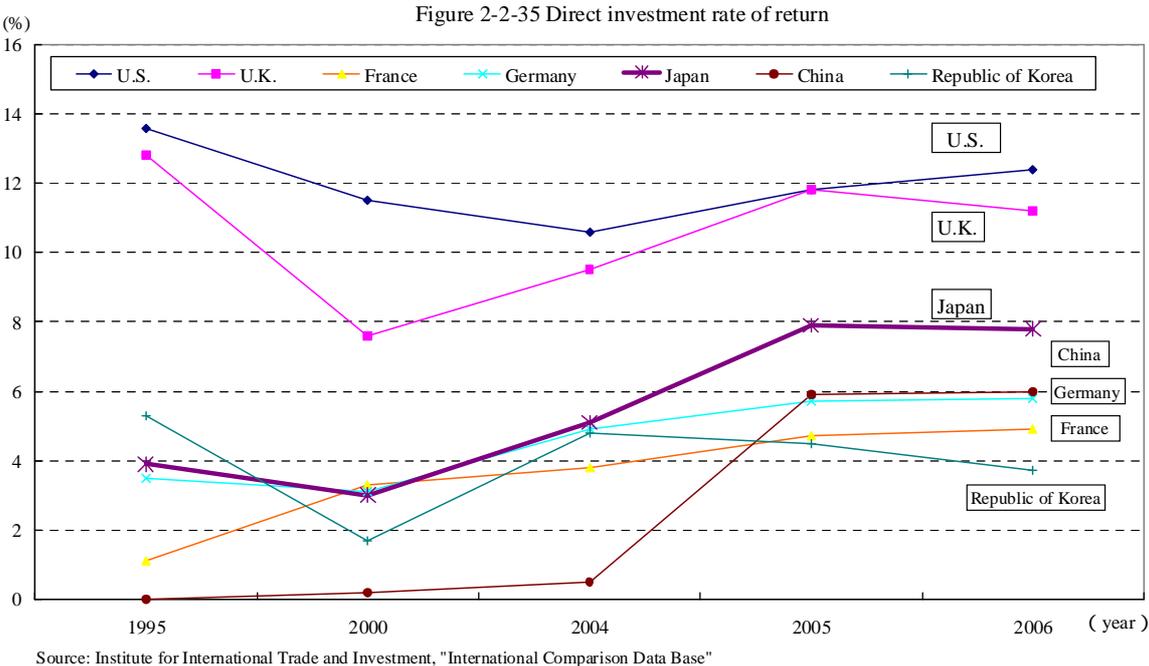
In order to expand income from overseas, aggressive foreign investment is required as well as improvement in the rate of return on such investment. An international comparison of the direct investment rate of return, which is the rate of return on overseas business activity, shows that Japan has a higher rate of return than Germany, France, China, and Republic of Korea but much lower than the U.S. and U.K. (see Figure 2-2-35)⁴².

Particularly noteworthy is the recent low rate of return earned on the active direct investment in China by Japanese companies. The level of investment in China surpasses that of the U.S. but the level of return on that investment (received) in the form of dividends paid to the parent company or

⁴² As was also stated in the White Paper on International Economy and Trade 2006, Chapter3-4, according to U.S. Department of Commerce data, profitability in companies operating overseas was substantially higher in the service industry than in manufacturing. Profitability in the service industry overall is higher than in the manufacturing industry but the higher profitability at U.S. and U.K. overseas companies is attributed to the concentration in services such as finance.

reinvestment funds retained at the local company is relatively low. The rate of return on direct investment (direct investment return divided by total direct investment) into China by Japanese companies showed signs of recovery after plunging due to the Asian currency/finance crises, but then again continued to decline starting in 2003, such that in 2006 this rate of return was 6.5% compared to 21.1% for the U.S.'s direct investment in China (see Figure 2-2-36)⁴³.

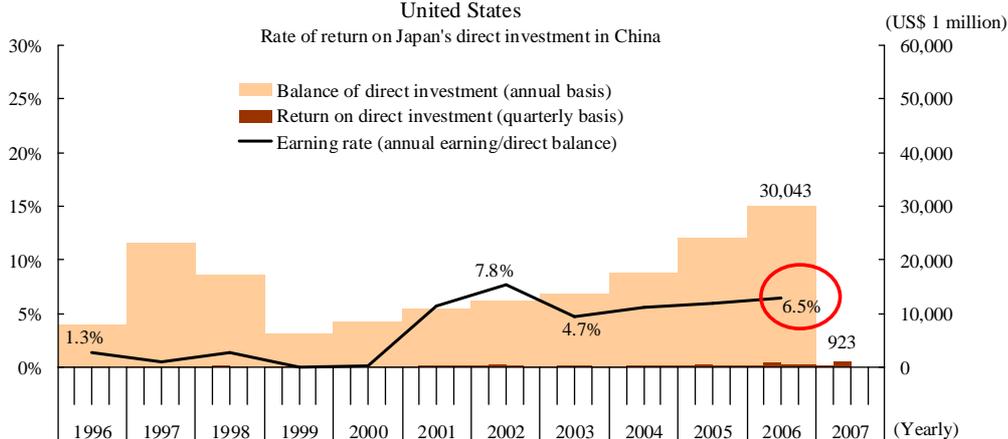
Thus, it is important that at the same time an environmental infrastructure for smooth overseas business activities such as EPA/FTA and investment agreements is being established, the direct investment rate of return be raised through more active and efficient corporate business activity overseas⁴⁴.



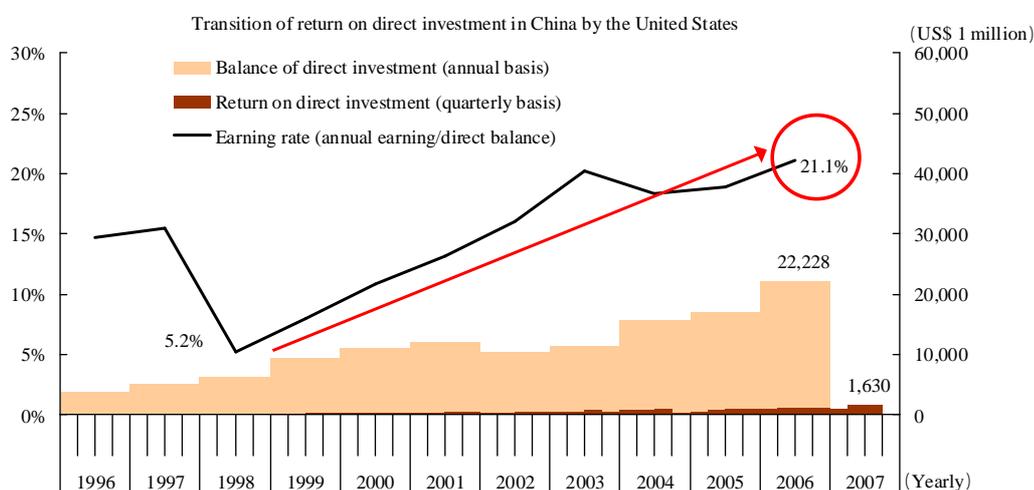
⁴³ While the rate of return on direct investment in ASEAN countries, where Japanese manufacturing invested early, is in decline, it is still 11.9% (2006), well above the rate of return for investment in China.

⁴⁴ It is important for the nation's economy that, together with improving the rate of return on direct investment, systems be established for the smooth return flow of overseas earnings. This topic is dealt with in (4) of this section.

Figure2-2-36 Transition of return on direct investment in China by Japan and the United States



Note: Return on direct investment includes return on local re-investment and internal reserves
Source: Bank of Japan



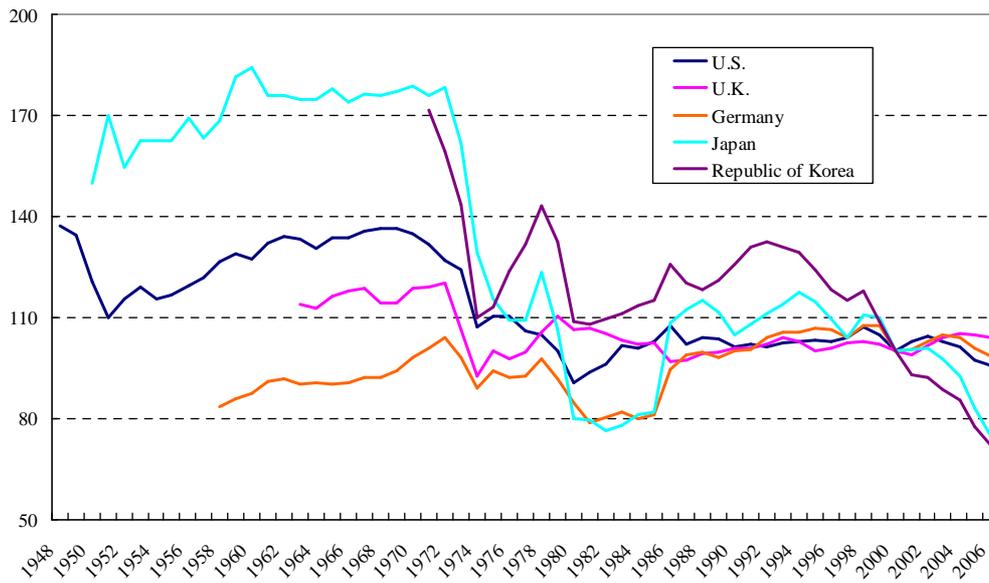
Note: Return on direct investment includes return on local re-investment and internal reserves
Source: Bureau of Economic Analysis, U.S. Commerce Department

(2) Relationship between Japan's import/export structure and terms of trade (International comparison of terms of trade)

As seen in Section 1, Japan's terms of trade have been deteriorating since 2002. In a comparison with other countries to determine whether this deterioration in terms of trade is in common with other foreign countries, we see that only Japan and Republic of Korea are currently experiencing worsening terms of trade, and the U.S., U.K. and Germany are not necessarily deteriorating (see Figure 2-2-37).

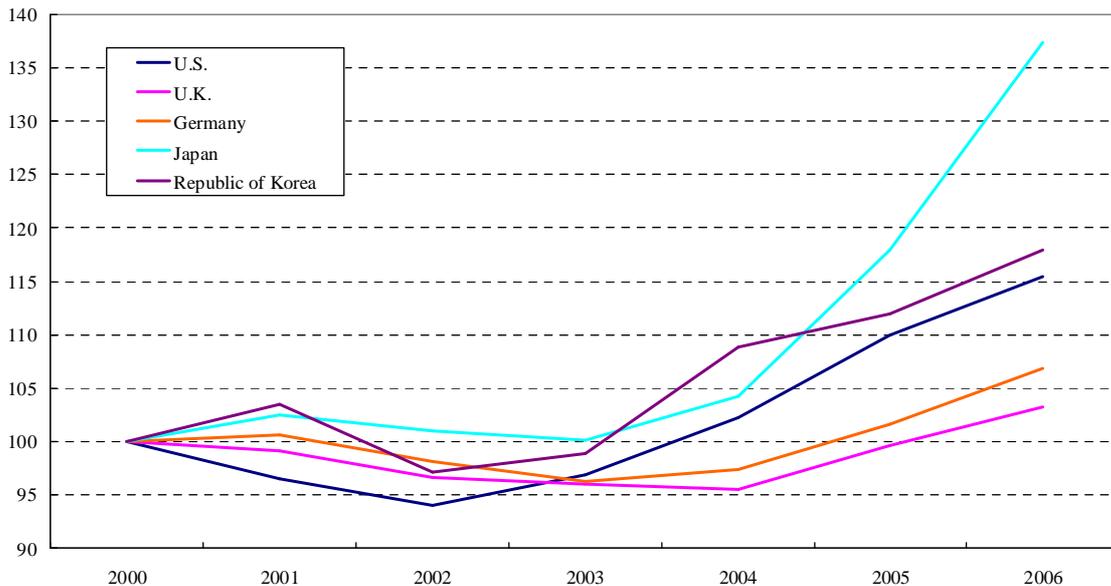
The export and import price indices show that 1) Japan's import prices have risen dramatically compared to other countries while 2) export price growth is low key, and indicate two factors behind the deterioration in the terms of trade (see Figure 2-2-38).

Figure 2-2-37 Other country terms of trade(2000 = 100)



Note: Export price index, import price index are dollar based.
Source:IMF, *IFS*.

Figure 2-2-38 Import price index (2000=100)



Note: Export price index, import price index are dollar based.
Source: IMF, *IFS*.

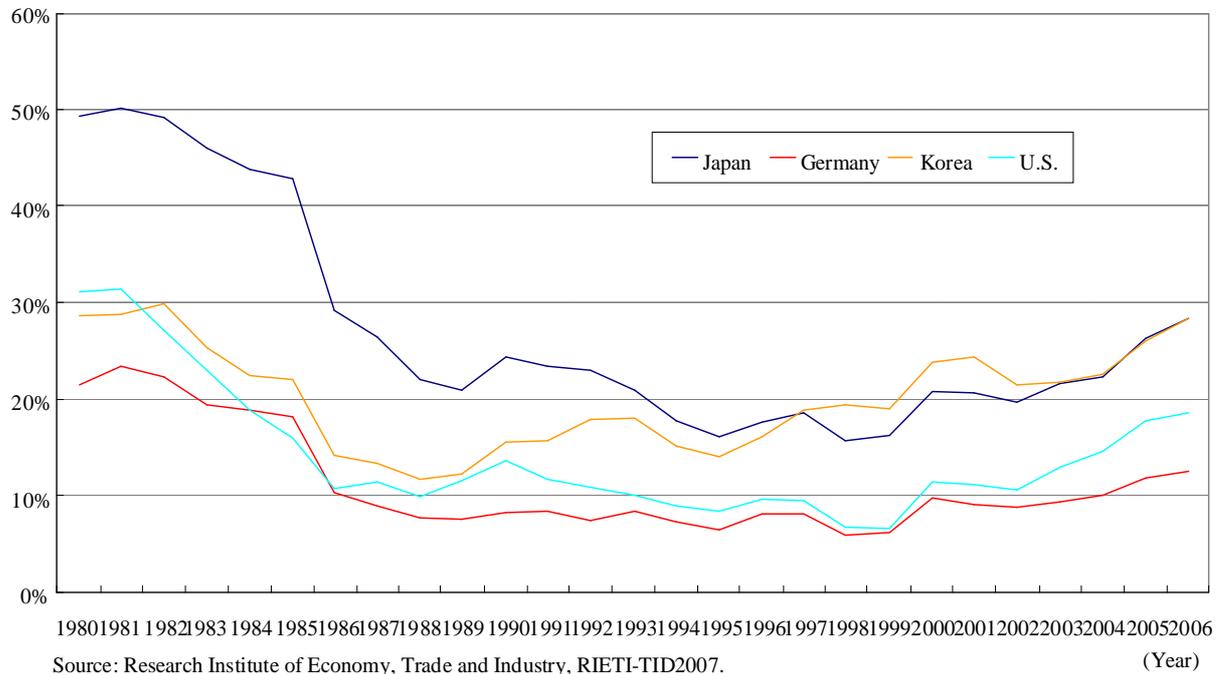
(Background to the deterioration in terms of trade)

○ **Continuing high dependence on resource imports**

Reasons for a greater rise in import prices than in other countries are firstly the high ratio of resources in Japan's total imports. This ratio declined sharply in the 1980's due to the advance in the international process specialization and the advance in energy conservation technologies, but since then the ratio has flattened and in 2006 still stood at 28% (see Figure 2-2-39). This is a high level when compared to not only the U.S. and Britain, which have highly developed service economies and

are also oil producers themselves, but also when compared to Germany, a similar industrial country to Japan (the ratio is the same for both Japan and Republic of Korea).

Figure 2-2-39 Ratio of coal and oil in imports



○Relationship between global demand structure and Japan's import/export structure

Assuming that prices are determined by the supply-demand balance, one country's export (import) price, and another country's export (import) price are determined by the degree of matching between that country's export (import) goods portfolio and the world import demand portfolio. For each good, the share of global spending is determined exogenously and, assuming the production volume of good of each country is fixed over the short term, changes in terms of trade can be explained by whether the expansion in global demand for a country's export goods is greater than the expansion in global demand for that country's import goods. In other words, the rate of change in the terms of trade matches the following formula, under the strong assumption: 1) relative prices vary only with demand shock, and 2) supply curves are vertical .

$$\sum_i v^E_i \hat{D}_i - \sum_i v^M_i \hat{D}_i$$

v^E_i : share of i goods of total exports

v^M_i : share of i goods of total imports

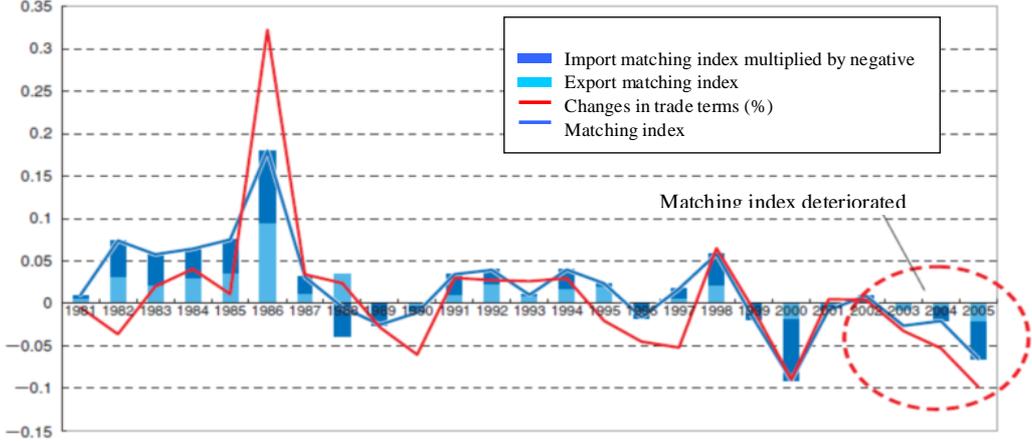
D_i : share or import demand of total global i goods

($\hat{\ }$) refers to rate of change

This equation is named a "matching index" because it shows to what extent a country's export goods structure and import goods structure match global import demand. The first term of the

matching index $\sum_i v_i^e \hat{D}_i$ is called the export matching index and the second term $\sum_i v_i^m \hat{D}_i$ the import matching index. Using this equation for Japan in a comparison of the change in terms of trade, we see that the trend in both terms generally match, which suggests the terms of trade are determined by changes in relative demand for goods (see Figure 2-2-40). Figure 2-2-40 shows the matching index separated into the export matching and import matching indices, and these indices show that 1) from 2003 the match between Japan's imports and global demand increased and 2) from around 2000 the match between Japan's exports and global demand declined.

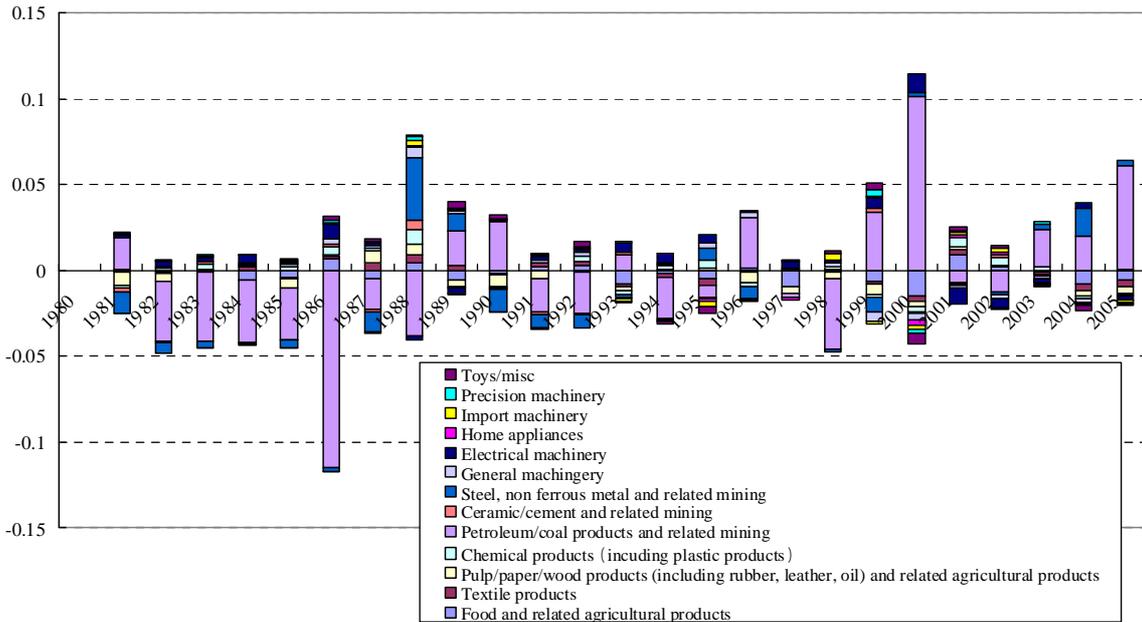
Figure 2-2-40 Matching of global export/import and relations of trade terms



Source: Research Institute of Economy, Trade and Industry "RIETI-TID2006"

The former requires further investigation. Breaking down the contribution rate of the import matching index by industry reveals the index is largely determined by contribution from petroleum/coal products and related industries (see Figure 2-2-41). For Japan, whose imports are comprised to a large degree by resources, the rapid expansion in demand in new emerging countries such as China and India accompanying rapid economic growth was a major factor driving up the import matching index.

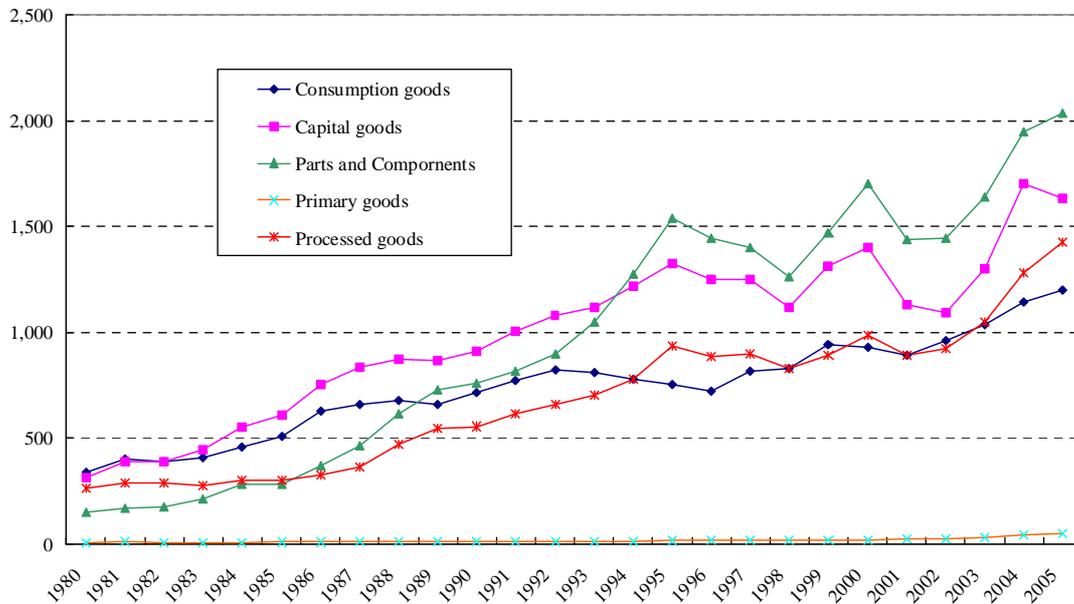
Figure 2-2-41 Breakdown of contribution rate to changes in import matching index



Source: Research Institute of Economy, Trade and Industry, "RIETI-TID2006"

On the other hand, the latter indicates that Japan is not supplying goods via exports in response to global demand. Due to greater international specialization in recent years, Japan's exports are weighted toward intermediate and capital goods (see Figure 2-2-42), but analysis of the decline in the export matching index indicates that since 2001 components⁴⁵, and since 2003 consumption goods and components, have pushed down the export matching index (Figure 2-2-43).

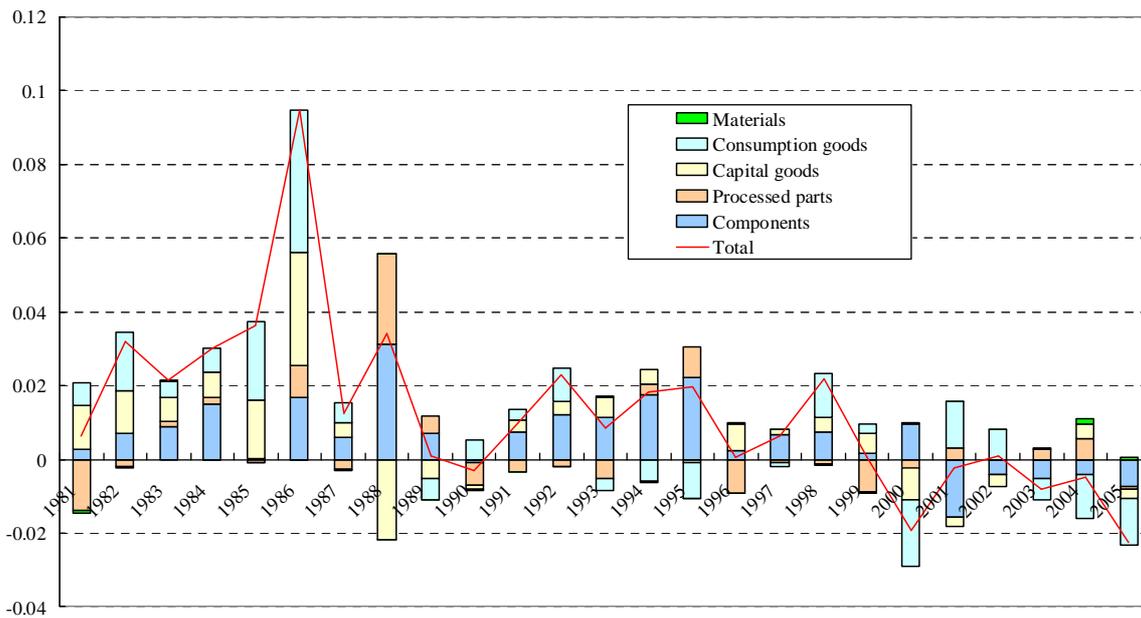
Figure 2-2-42 Japan's exports



Source: "RIETI-TID2006"

⁴⁵ Intermediate goods are divided into components and process goods.

Figure 2-2-43 Breakdown of contribution rate in export matching index (goods)



Source: Research Institute of Economy, Trade and Industry, "RIETI-TID2006".

This is attributed to the share of component exports out of total exports (30% level) and the share of consumer goods exports out of total exports (around 20%) remaining at a high level while world component demand since 2001 and consumer goods demand since 2003 continued to decline relative to other goods.

Accordingly, it is important to understand the concept of supplying products that have expanding global demand in order to improve terms of trade through higher export prices.

(3) Toward improving the terms of trade

(Relationship between terms of trade and foreign exchange rate)

Terms of trade are affected not only by the supply-demand trend in trade goods shown above but also by the foreign exchange rate. Regression analysis of Japan's terms of trade using the price of oil (WTI) and the exchange rate (yen-dollar) and breakdown of the contribution rate from oil price and exchange rate factors to changes in terms trade, reveals that while not as strong as from oil prices there is contribution from foreign exchange rate movements to changes in terms of trade (see Figure 2-2-44)⁴⁶.

⁴⁶ A weaker yen results in deterioration in terms of trade. Figure 2-2-44 suggests the decline in the yen that started in mid 2005 led the way to the current deterioration in terms of trade.

Figure 2-2-44 Breakdown of contribution rate to changes in Japan's terms of trade



In order to prevent the outflow of income due to worsening terms of trade in the midst of rising concern over possible long-term higher resource and food prices due to growth in new emerging economies, it is necessary to consider improving terms of trades by strengthening the exchange rate⁴⁷.

(Relationship between productivity and foreign exchange rate)

A number of factors, such as substantive factors (productivity, etc) and financial factors (interest rates, prices, capital movement, etc), affect foreign exchange rates but the Balassa-Samuelson theory in international economic theory may be used to explain long-term foreign exchange movements based on productivity trends. This theory, backed by empirical evidence, holds that the greater the increase in productivity in the tradable goods sector, the greater the rise in the actual foreign exchange rate. A greater increase in productivity in the tradable goods sector in one country compared to another country results in a comparably greater rise in prices, which in turn results in a rise in the actual foreign exchange rate, which incorporates price changes⁴⁸. Therefore, according to this theory, the greater the increase in productivity the more the actual foreign exchange rate will rise. As raising Japan's productivity is a top priority, it is important to build an economic structure which will receive the benefits of a stronger yen, such as improved terms of trade, while boosting the country's productivity.

A comparison of Japan-U.S. labor productivity rates in the manufacturing industry (Japanese labor productivity/U.S. labor productivity) and the actual yen-dollar exchange rate aimed at confirming whether the Balassa-Samuelson theory actually holds true between Japan and the U.S. shows a general

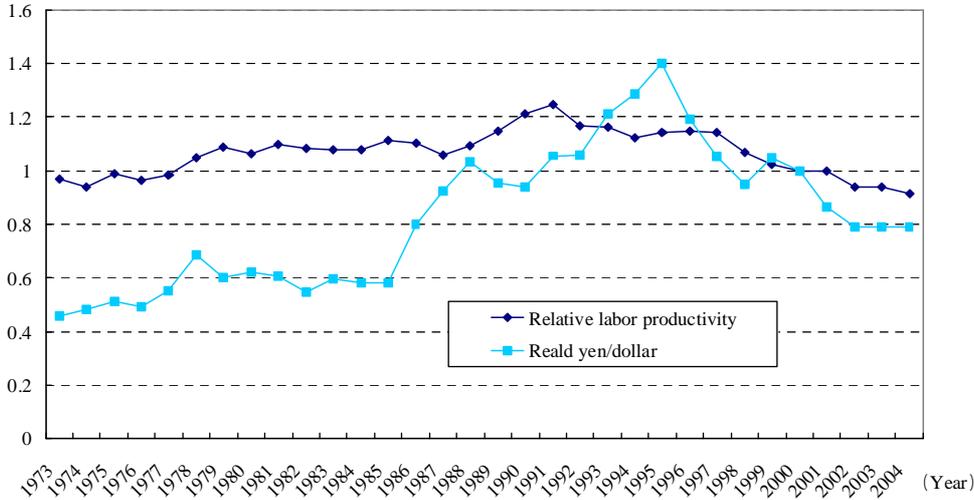
⁴⁷ Naturally, it is necessary to take into consideration the negative impact a stronger yen has on export industries and companies but, as shown below, the impact on the national economy of a strong yen for various reasons is less than it once was.

⁴⁸ For details refer to Supplementary Note 2-2-1.

Thus, a rise in Japan's productivity means there will be an accompanying rise in the exchange rate.

matching of the two, suggesting that the theory holds true in general (see Figure 2-2-45). Based on this result, it would appear that the foreign exchange rate will rise if our productivity increases⁴⁹.

Figure 2-2-45 Japan/U.S. labor productivity and real effective exchange rate



Notes: 1. 2000 is 1.
 2. Real effective exchange rate uses Japan/US wage comparison.
 Source: "EU KLEMS Database"

(Rising resistance to short-term fluctuations in the exchange rate)

The foregoing discussion was from a long-term viewpoint but in real life companies must deal directly with short-term fluctuations in the exchange rate. In the short term, a stronger yen results in temporary downward pressure on corporate profits and has a negative impact on export and related industries.

However, the impact from short-term appreciation in the yen has decreased compared to the past. Based on calculations using the Cabinet Office’s macro quantitative model of the impact on the economy from a stronger yen, it is clear that the downward impact on real GDP of a rise in the yen, has greatly declined compared to the past, indicating the structure of Japan’s economy has become resistant to foreign exchange fluctuations (see Figure 2-2-46)⁵⁰.

⁴⁹ Japan’s effective exchange rate has been in decline since the late 1990’s and is now at the same level as in 1980. The continuous fall in the effective yen rate is attributed to lower productivity growth due to the slump in economic activity.

⁵⁰ The impact on Japan’s exports from a weaker yen and expansion in overseas economies was examined by the Bank of Japan using quantitative methodology (export function stochastic), which showed that while a higher effective yen exchange rate dampened exports, over the long term the effect became small, indicating growing resistance in exports to effects from a stronger yen.

Table 2-2-46 Downward effect on real GDP from strong yen in Cabinet Office macro model

Model name	Release	Downward effect on real GDP (%)		
		1st year	2nd year	3rd year
World economic model 3rd version	1987	▲ 0.68	▲ 1.23	▲ 1.27
Short-term Japan economic quantitativ	1998	▲ 0.40	▲ 1.06	▲ 1.88
Short-term Japan economic quantitative model (2006)	2007	▲ 0.27	▲ 0.54	▲ 0.63

Note: In actual simulation, linearity is assumed and signs are reversed based on assumption of 10% decline in yen .

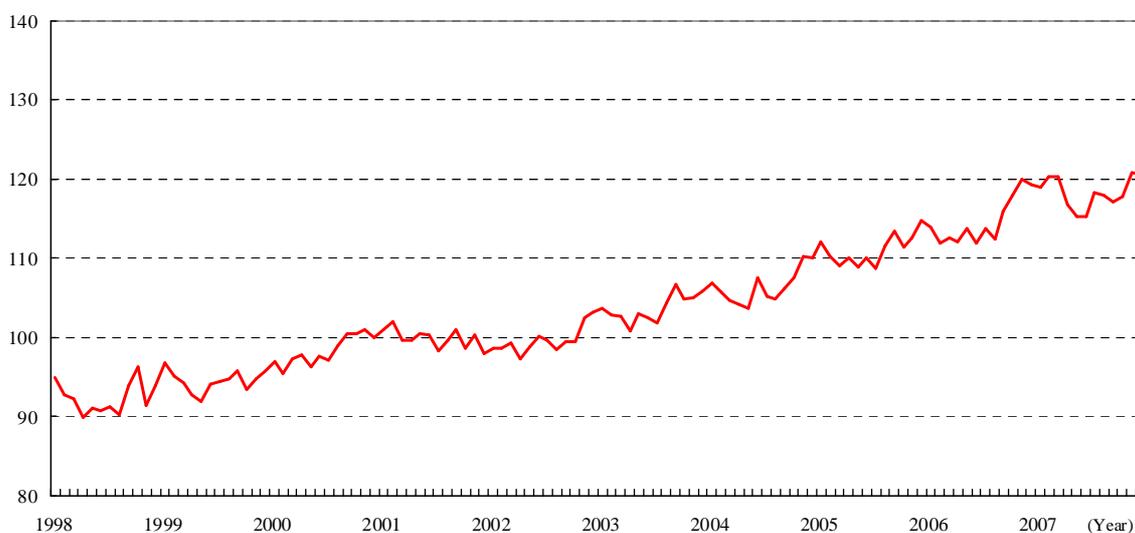
Sources: Cabinet Office , "World economic model"; "Short-term Japan macro quantitative model".

This resistance can be attributed to 1) a shift from price competition to non-price competition accompanying a trend to higher value added in export goods, 2) an increase in yen-based settlement due to rising exports to Asia, 3) changes in settlement methods accompanying a shift from exports to overseas production and sales, and 4) an expansion in intra company trade due to greater international specialization. These factors are discussed in greater detail below.

○ **Shift from price competition to non-price competition accompanying a trend to higher value added in export goods**

Japan's export value added index⁵¹ shows a steady rise over the past 10 years (see Figure 2-2-47). This rise in value added is believed to be behind the shift from price competition to non-price competition and makes it is easier to pass on prices in the settlement currency even if the yen rises.

Figure 2-2-47 Japan export value added index



Notes: 1. Value added index = export trade coefficient/export price index.

2. Export trade coefficient is based on 2000 average as 100, export price index based on 2005 average as 100.

Sources: Ministry of Finance, "Trade coefficient"; Bank of Japan, "Company price index"

○ **Increase in yen-based settlement due to rising exports to Asia**

The ratio of Japan's exports settled in Japanese yen as a percentage of world exports was 38.7% as

⁵¹ The value added index referred to here is the trade coefficient released by the Ministry of Finance divided by the export price index from the Bank of Japan. The trade coefficient is a price index that does not take into consideration the quality of export goods while the export price index is adjusted to account for changes in quality, thus changes in quality can be reflected by dividing one with the other.

of the 2H 2007 but 48.6%⁵² of Asian exports. If exports to Asia continue to increase, the share of yen-based transactions should also increase, creating a structure that is less affected by the exchange rate⁵³.

○ **Changes in settlement methods accompanying a shift from exports to overseas production and sales**

As seen in Section 1, there is an increasing trend for companies to shift operations from Japan to overseas, raising the ratio of overseas production and overseas sales.

As overseas production or sales are settled either in local currency or the lynchpin currency, the U.S. dollar, the impact on business of the yen exchange rate disappears. As Japanese companies are expected to continue their advance overseas, the impact from the yen exchange rate is expected to continue to shrink.

○ **Expansion in intra-company trade accompanying greater international specialization**

Greater international specialization is leading to greater intra-company trade. Exports to local subsidiaries as a ratio of total exports rose from 38.5 % in 1998 to 41.6% in 2004⁵⁴. As there is a trade off in intra-company trade between parent and local subsidiary regarding forex gain/loss, there is no impact of group total earnings.

[Column 8] Strong yen's impact on exports

There have been articles in the news of the negative impact a strong yen has on exporting company and industry profits, but what is the actual mechanism by which this impact works? Let's take a look at the actual numerical effect a stronger yen has on exports. Assuming the exports are to the U.S., we look only at the yen-dollar rate. We look at a case where the yen strengthens against the dollar from \$1/¥110 to \$1/¥100. Company A exports a product with price of \$100 to the U.S.. At \$1/¥110, the price is $\$100 \times ¥110 = ¥11,000$ but at \$1/¥100 the price is $\$100 \times ¥100 = ¥10,000$, a reduction of ¥1,000 per unit. If the dollar price is fixed, the higher the yen rises the greater the yen-based decline in price, negatively impacting company earnings (price effect).

However, the company has the choice of revising the dollar based price. If the yen based price is to remain fixed while the yen exchange rate rises, the dollar based price must be raised to \$110 ($¥11,000/100$ (yen/dollar) = \$110). As long as the price elasticity (changes in demand (volume) in relation to changes in price of Company A's product is not zero, the dollar based price increase will lead to lower sales volume (volume effect).

⁵² Ministry of Finance, "Trade transactions by currency"

⁵³ It is possible to force the other party in a transaction to bear the foreign exchange risk when the yen is used for trade settlement, thus, a rise in the yen has no effect on yen-based earnings.

⁵⁴ METI, "Overseas business activity basic survey"

Companies are believed to adjust their prices to minimize the overall price and volume effects from a higher yen⁵⁵. In order to minimize the effect of foreign exchange on exporting companies and industry, it is clearly important to 1) introduce hedging techniques such as forex contracts to offset forex risk, and 2) reduce the price elasticity of export products⁵⁶.

(4) Building an earnings distribution structure in response to globalization

(Importance of growth balanced between domestic and external demand – “dynamic efficiency”^{57,58})

Using the actual consumption expenditures per person⁵⁹ (purchasing power price basis) to determine Japan’s consumption level, Japan ranks 18th among OECD countries and is even under the OECD average (see Figure 2-2-48)⁶⁰. Thus, while Japan has the world’s second largest economy, the household level of consumption is internationally at a low level.

⁵⁵ This is a phenomenon that occurs when depending on the market structure, export companies dominate the market and set the price in the export destination currency (trickle-down effect). Companies are believed to determine the degree of pass through based on a comprehensive view of the price and volumes effect.

⁵⁶ In order to decrease the price elasticity of export products, it is important the goods not be readily replaceable with other goods, that is, to have higher value added.

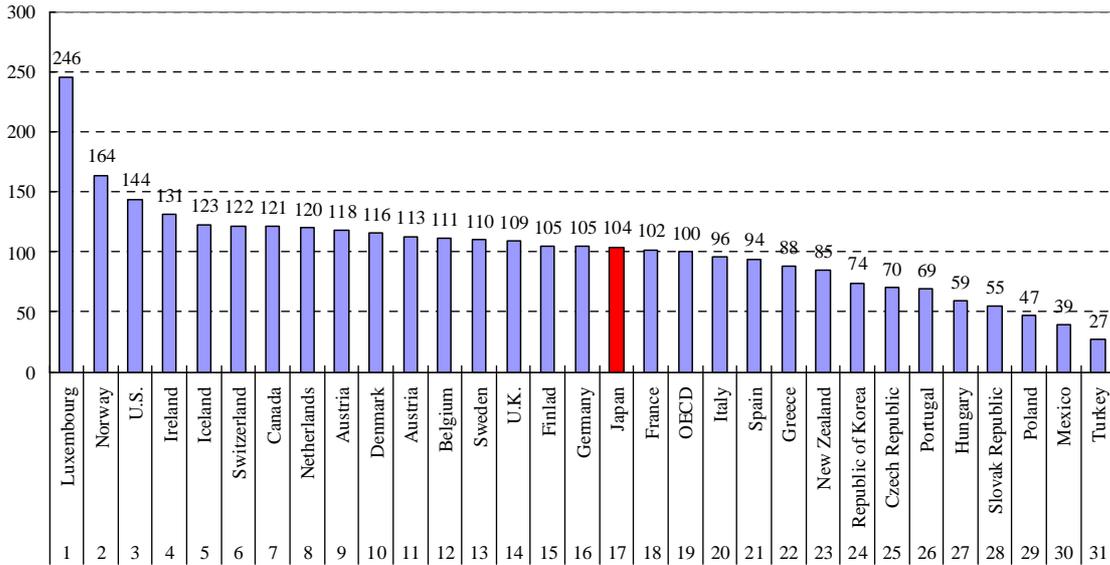
⁵⁷ Dynamic efficiency refers to maximization of economic welfare over the long term. Capital spending produces consumption goods in the next year and generates economic welfare but maximum economic welfare cannot be obtained even if capital spending is too high or too low every year. When the consumption loss this year and future consumption generated by capital spending match, the macro economy is said to be dynamically efficient.

⁵⁸ Makoto Saito (2006) indicated that enjoyment of a high level of consumption does not always mean a high level of GDP growth.

⁵⁹ Real consumption expenditure refers to household final consumption plus individual consumption expenditures in the government’s final consumption expenditure, and is used as an index for total household consumption.

⁶⁰ In GDP per person (purchasing power price basis) Japan is 17th (104 is the OECD average is 100).

Figure 2-2-48 GDP per capita in OECD countries (PPP base, 2005)

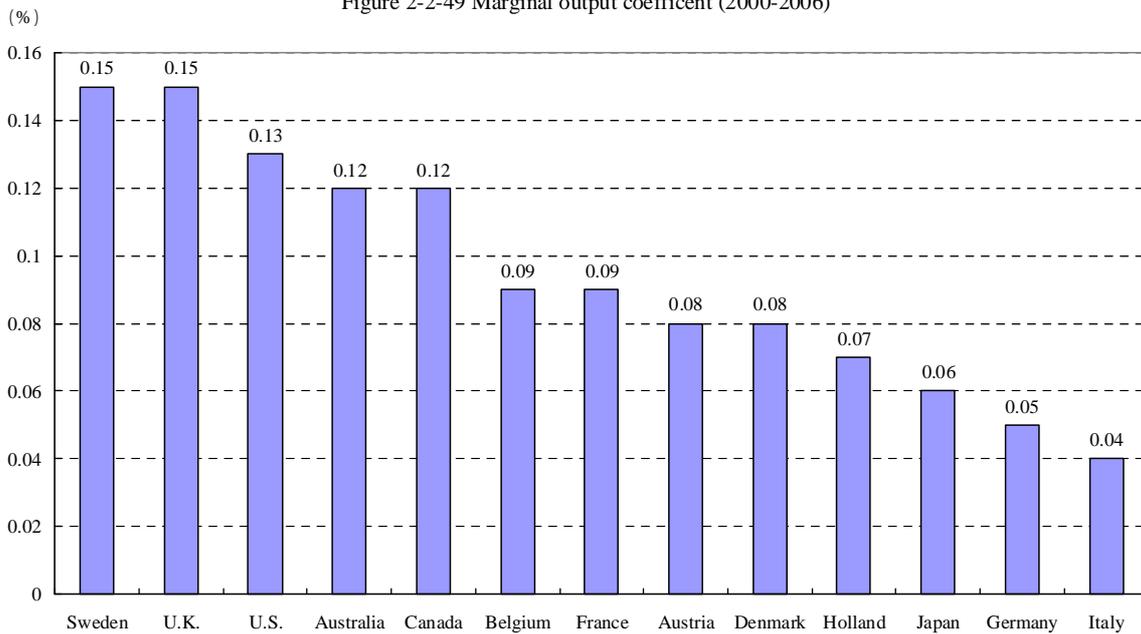


Note: OECD average as 100.

Source: OECD "New comparison of GDP and consumption based on purchasing power parities for the year 2005".

On the other hand, Japan's capital stock is at a high level internationally, and investment efficiency (marginal output coefficient) much lower than the U.S. and European countries such as U.K. (see Figure 2-2-49)⁶¹. This suggests Japan's economic structure may not be dynamically efficient.

Figure 2-2-49 Marginal output coefficient (2000-2006)



Source: OECD, "National Accounts".

While it is important to continue actively acquiring external demand, it is necessary at the same time to 1) raise the productivity of domestic business activity, such as capital spending, (improve investment efficiency), and 2) raise the level of consumption inside Japan. First, in order to raise the productivity in business activities such as capital spending it is necessary to both shift activity

⁶¹ In general, the greater the capital build up, the lower the capital efficiency (declining marginal capital efficiency rule).

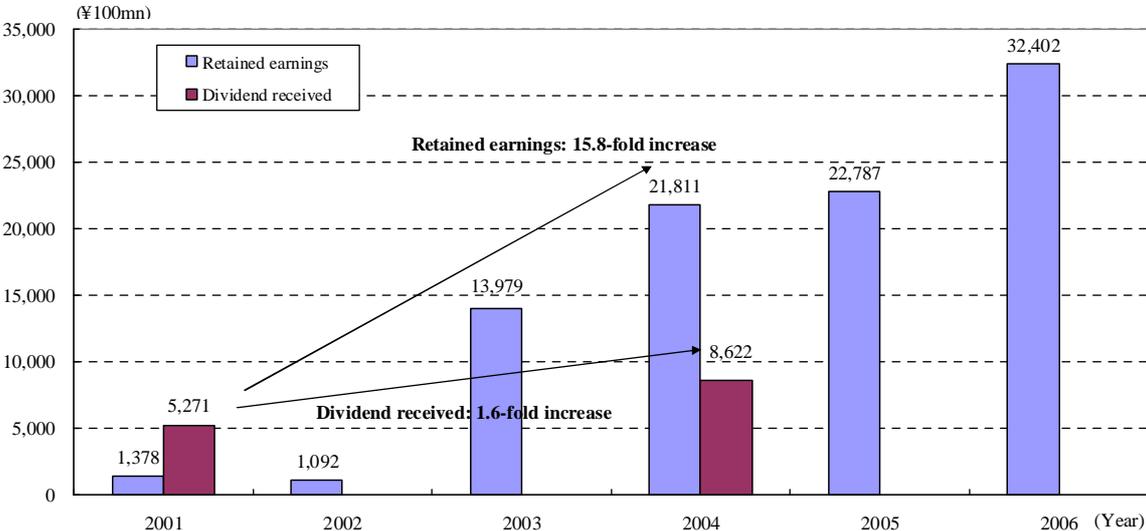
overseas through globalization and build a mechanism for active innovation domestically, such as investment in research and development. As can be seen from the following, although overseas earnings at Japanese companies is expanding, the flow back to Japan is not progressing smoothly, which could be a factor in suppressing R&D investment. What is required to raise the level of domestic consumption is revision of the income distribution structure for households. As rising globalization makes wages as a single source of income risky, it is important to build a sturdier income distribution structure that includes investment income. What is required is to solve these problems in building an economic structure for growth with a good balance between external and domestic demand and improved dynamic efficiency.

(Smooth return flow of funds from overseas for vitalization of domestic corporate sector)

In order to have both globalization and a strong national economy, it is important for there to be a smooth return flow of the income earned overseas back into Japan for the vitalization of the domestic economy. However, in recent years wealth from overseas has not been flowing back to Japan smoothly. According to METI’s “Overseas business activity basic survey”, while retained earnings at overseas subsidiaries of Japanese companies have increased substantially in recent years, dividends received by the parent have increased only slightly; much of the profit earned overseas is not being repatriated to Japan and is remaining overseas (see Figure 2-2-50)⁶².

There are various factors that could account for this, including the following.

Figure 2-2-50 Retained earnings and dividends received from Japanese local subsidiary and dividends received



Note: Inquiry regarding dividend received only once every 3 years. Thus, data limited to 2001 and 2004.
 Source: METI, "Overseas business activity basic survey"

(a) Impediment to repatriation of fund via capital transactions with overseas subsidiaries

Acquisition of parent company stock and third party underwriting of stock allocation by overseas

⁶² Internal reserves are over ¥17tn.

subsidiary are in principle forbidden, excluding exceptions under the commercial code⁶³.

(b) Difficulty in matching domestic demand for funds in a way that does not have tax consequences

Under the current tax code, dividends received from an overseas subsidiary may be taxed anew in Japan, leading companies to forego dividends.

(c) Withholding tax on dividends to domestic companies from overseas subsidiaries

Dividends paid by overseas subsidiaries to parent companies in Japan are subject to withholding tax in the country of the subsidiary.

(d) Regulations regarding royalty payments from overseas to company in Japan

Tax authorities in the country in which the subsidiary resides often deny the royalty level set by the company when trying to repatriate fund through royalty payments.

In regards to (2), Japan uses a total global income method that taxes all company income regardless of whether it was earned overseas or at home⁶⁴, and companies, in order to avoid double taxation, deduct the taxes paid abroad from the corporate tax paid in Japan (foreign tax deduction system). Although there are merits to adjusting the withholding tax in (3), the income of foreign subsidiaries is not taxed as long as it is not distributed as dividends to the parent company (tax deferment). However, the income of a subsidiary that pays dividend to the parent company in Japan may be taxed anew in Japan, providing an incentive for companies to leave profits overseas⁶⁵. In this way, if over an extended period of time funds are held overseas excessively, employment and research and development, which are the source of growth for Japan, which is also a cost center, will flow overseas, making it critical for Japan to promote the repatriation of funds to Japan. The funds that flow back to Japan are also important in that these funds become the seed money for generating wages and jobs through capital spending and have an economic effect such as increasing household incomes through dividends paid to shareholders. Repatriated funds are thus important in terms of generating domestic demand.

(Active global management of financial assets to vitalize the domestic household sector)

In order to raise household incomes and vitalized domestic consumption, a review of Japan's income distribution structure, which has been centered on wages, is required as well as the building of a comprehensive income distribution structure that includes income sources such as investment income and social benefits. The following is a discussion of the meaning and possibility of global

⁶³ Forbidden because of fears the measures could be used to maintain company dominance, but are excluded in the exceptional case of company reorganization. (Commercial Code Article 135)

⁶⁴ The U.S. and U.K. also use this system.

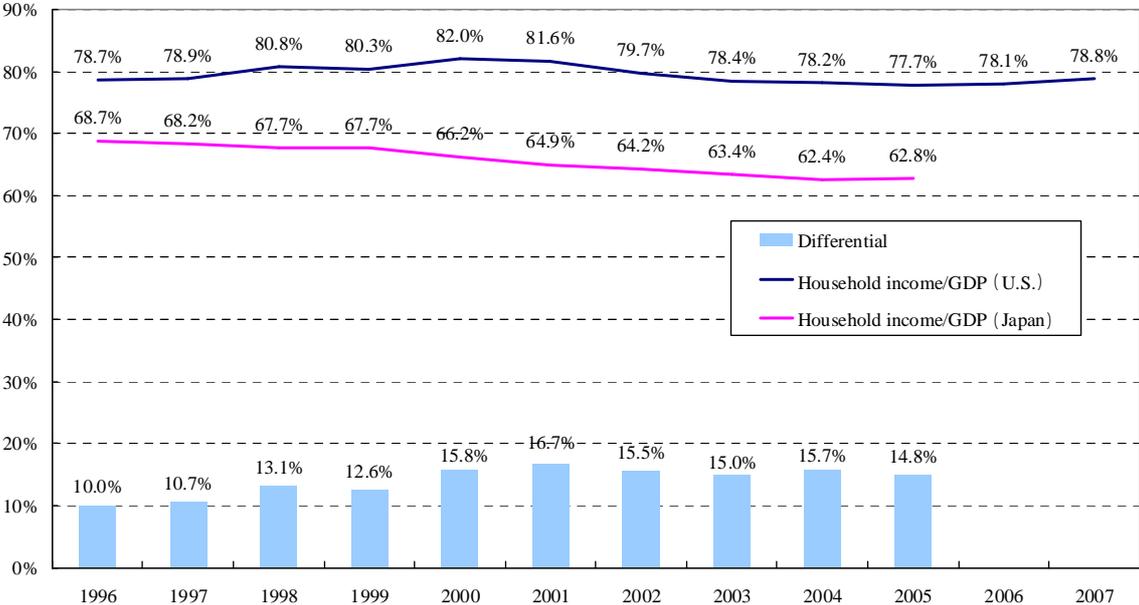
⁶⁵ Awareness of similar problems has recently led the U.S. and U.K., which also use a total global income system, to study revisions to the tax code. Refer to Chapter 4 for details on this study by Japan, the U.S., and U.K.

management of Japan’s household financial assets by way of a comparison between Japan and the U.S. that shows the characteristics of Japan’s income distribution structure in greater relief.

○ **Characteristics of Japan’s household income distribution structure as seen in Japan-U.S. comparison**

Here we look at the characteristics of Japan’s household income distribution structure through a comparison with the U.S. Household income distribution (household income/nominal GDP) in Japan has recently been in decline, even though it was low right from the beginning and reached 62.8% in 2005, while in the U.S. it has remained at roughly 80%. The distribution ratio differential between Japan and the U.S. rose to 14.8% in 2005, indicating the household share of income from the start has been low (see Figure 2-2-51).

Figure 2-2-51 Ratio of household income in nominal GDP (Japan, U.S.)



Sources: Cabinet Office "National economic accounts"; US Bureau of Economic Analysis, "National Economic Account".

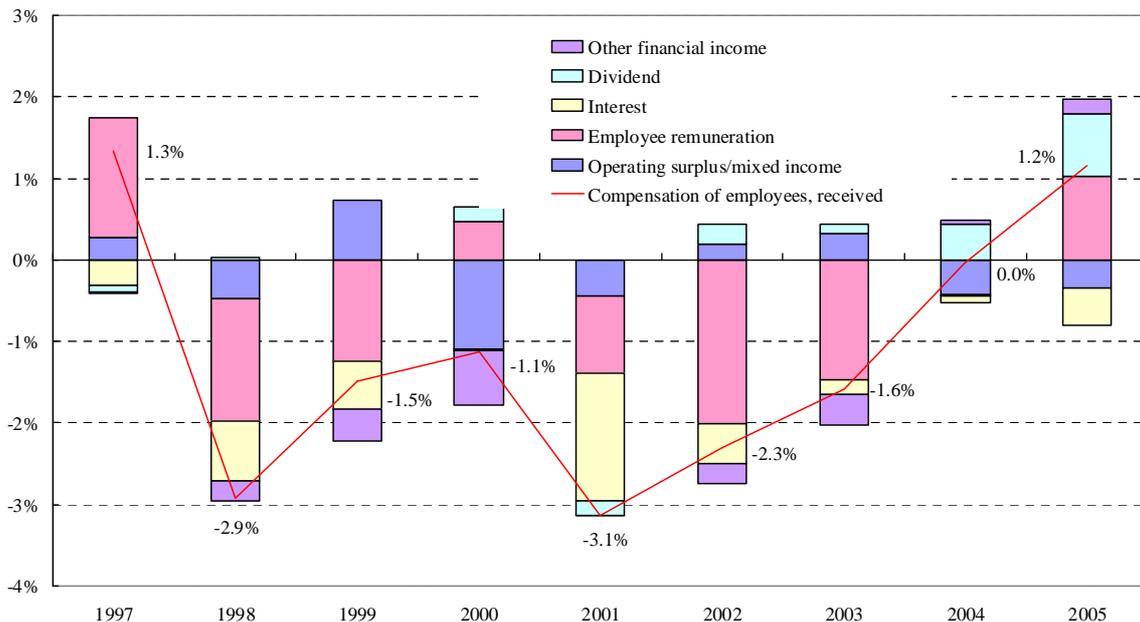
Next, a breakdown of the contribution rate by item to the growth rate in order to determine growth factors in household income reveals that in the U.S. contribution to growth is well balanced between employment remuneration, interest, and dividends while in Japan employment remuneration is substantially negative in contribution and interest income is also negative, reflecting the low level of interest rates in Japan (see Figure 2-2-52). A comparison of the two graphs shows balanced and stable growth while in Japan growth is not balanced and not stable.

In the foregoing, we saw household income before income redistribution (primary income). However, with geriatrication of society and reduction in the number of children, household incomes are being redistributed from employee remuneration to social benefits, and the like. A comparison between Japan and the U.S. of primary household income and social benefits reveals that in the U.S., which has a continuous inflow of immigrants into the U.S. and thus steady growth in the population of young people, both primary household income and social benefits are expanding equally, while in Japan, which faces aging and reduced family size, household income before redistribution is declining

and social benefit income is increasing rapidly (see Figure 2-2-53).

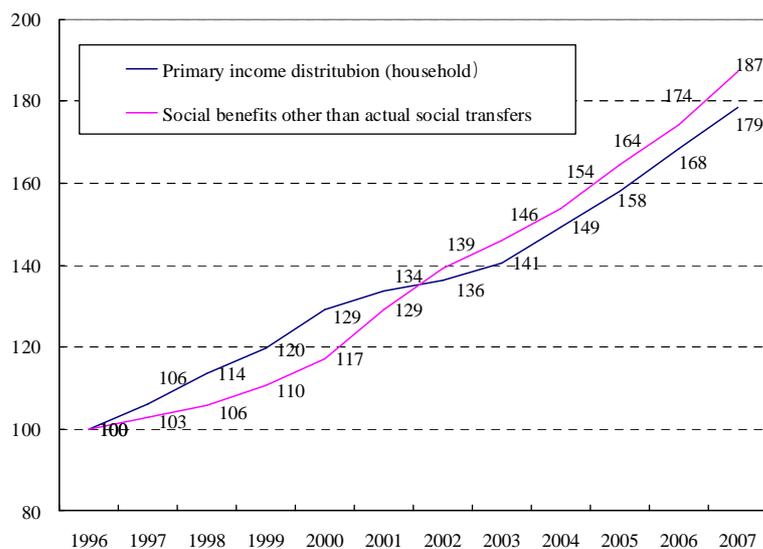
Thus, there are sharp differences in the level of income distribution to households and the channel through which such distribution occurs. Major changes in the social-economic structure brought about by globalization, geriatrification of the society and reduced family size require a review of what is the optimal income distribution structure for a country. In Japan, household incomes from the start have been at a low level and because globalization has further decreased the labor distribution ratio it is important to further strengthen the income distribution structure by expanding investment income, such as interest and dividends, as well as through more effective management of pension funds, which are the source of funds for social benefits.

Figure 2-2-52 Breakdown of contribution rate in household income (received) growth by item (Japan)



Source: Cabinet Office, "National accounts"

Figure 2-2-53 Household income and social benefits (US)

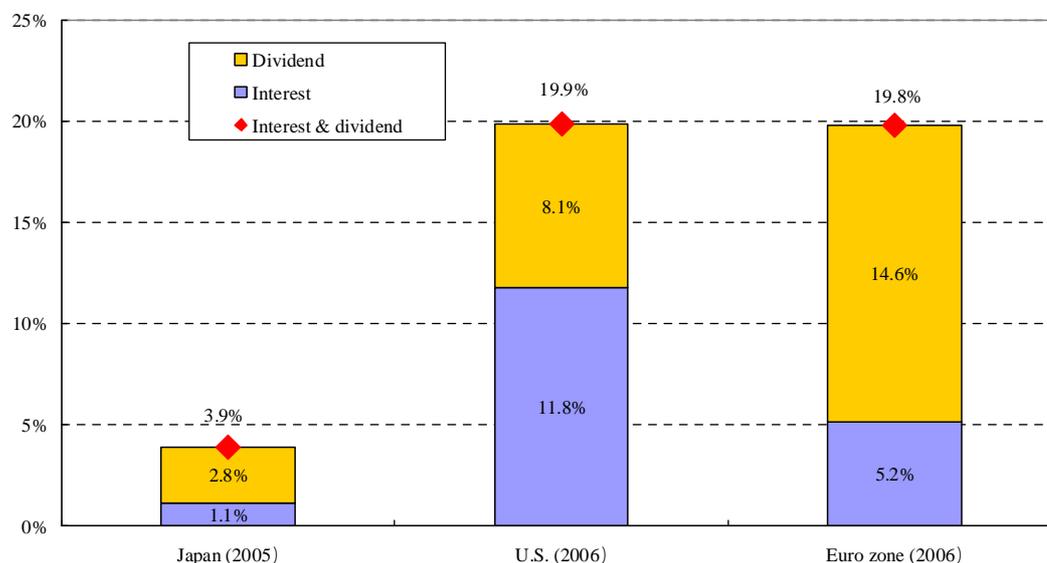


Source: US Bureau of Economic Analysis, "National Economic Accounts" prepared by METI.

○ **Environment infrastructure for global management of household financial assets**

A possible factor contributing to the low level of household income in Japan is a low ratio of interest and dividend income of household income. In the U.S. and U.K. the ratio is 20% while in Japan it is only 4%, meaning a 16% difference (see Figure 2-2-54).

Figure 2-2-54 Interest and dividend income within household income in US, Japan, and Euro zone



Source: Cabinet Office "National Accounts", BEA "National Economic Accounts", Eurostat.

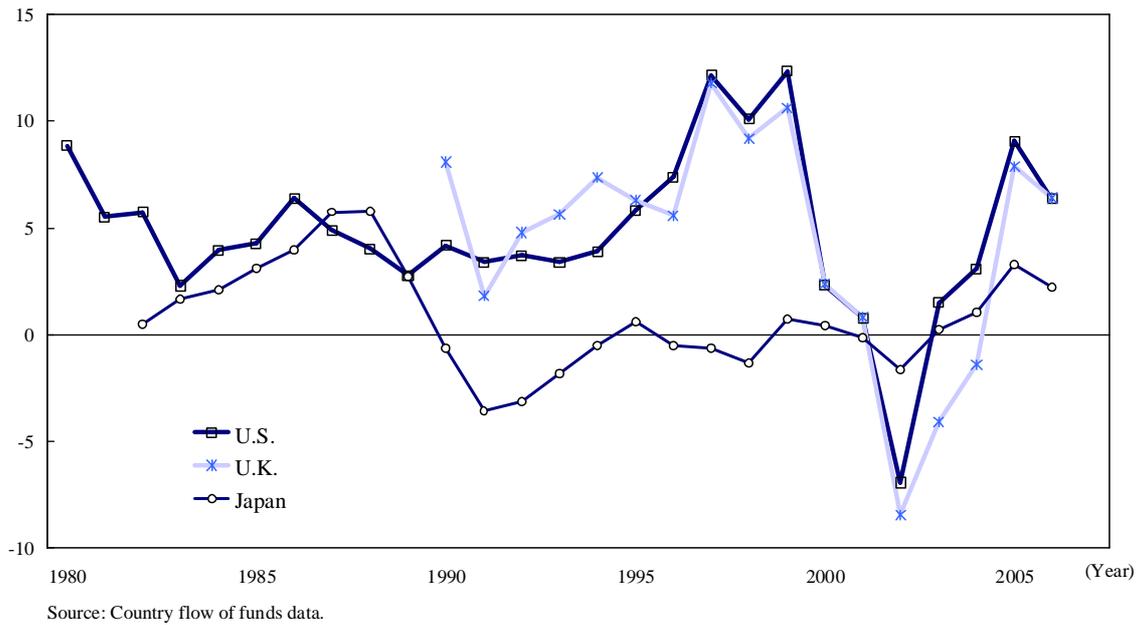
The low level of interest income in Japan's household sector is attributed to monetary easing policy in Japan in recent years⁶⁶.

The low level of dividend income is attributed to a low ratio of risk assets, such as shares and investment trusts, in household financial assets⁶⁷. A comparison of rates of return on household financial assets in Japan, the U.S., and U.K. reveals that as a result of having portfolios weighted toward low interest assets Japan overall has low rate of return, although there are some yearly differences (see Figure 2-2-55).

⁶⁶ According to national accounting data, household interest income in Japan dropped from ¥18.5tn in 1996 to ¥2.0tn in 2005.

⁶⁷ According to flow of funds data, shares account for 10.7% of total Japanese household financial assets (as of end December 2007). By contrast, in the U.S. the ratio is 29.4% (as of end December 2007).

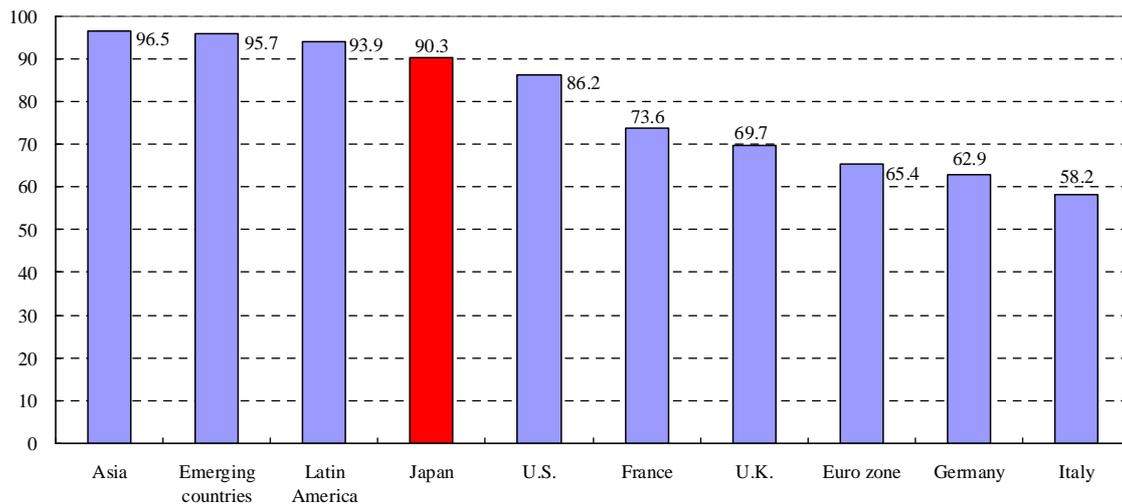
Figure 2-2-55 Rate of return on household financial assets in Japan, U.S., and U.K.



With the global economy, including new emerging economies, continuing to expand, Japan faces important choices in not only domestic financial products but also expanding investment to include overseas financial products in order to utilize effectively the ¥1,500tn in household sector financial assets, and in the stable acquisition of interest and dividend income. Through vitalization of overseas investment asset, it is believed possible to 1) improve investment efficiency through diversified international investment combined with domestic assets, and 2) obtain a difficult, high rate of return on current domestic financial products.

However, as shown by Michael Fidora et al (2006), Japan has the strongest home bias among developed countries in its financial assets (see Figure 2-2-56)⁶⁸.

Figure 2-2-56 Ratio of domestic equity investment



One impediment to investment in overseas assets is forex risk. The presence of the yen as an

⁶⁸ According to flow of funds data, foreign assets (foreign currency deposits, foreign bonds and shares, etc.) account for 3.3% of total Japanese household financial assets (for the U.S. the ratio is 13.1%).

international currency has declined substantially recently and yen-based investment in foreign assets is difficult. Accordingly, there is forex risk in any investment by Japan in overseas assets. Methods for reducing such risk can be broadly divided into 1) increasing yen based foreign assets and 2) decreasing forex volatility. The former involves promoting the listing of foreign companies on Japan's stock exchanges by creating a market for professionals⁶⁹ and by increasing the issuance of Japan Depository Receipts (JDR)⁷⁰. One solution regarding the latter is the Asian common currency region concept⁷¹ proposed by the Asian Development Bank. As Asia is expected to show high growth in the future, it is necessary for Japan to engage in this vitality through investments in Asia.

○ **Growth in household financial asset management**

In order to stably expand household income through suitable management of household financial assets, it is important to provide the environment infrastructure for smooth overseas investment including the role of institutional investors for the management of household financial assets.

Investment trusts, in particular, are expected to be the effective managers of these financial assets, including overseas investment. In fact, investment trusts are the vehicle for much overseas investment of household financial assets and, in contradistinction to listed stocks⁷², etc, it is possible to have small holdings corresponding to the investor's income and asset holdings. There is also the merit of wide household holdings regardless of age and income level.

A survey of household holdings of shares and equity investment trusts⁷³ in the U.S. shows there is no income or age strata bias in holding ratios of equity investment trusts and shares themselves, and that all households across the board benefit from investment trust earnings (see Figure 2-2-57). A similar survey of investment trust holdings by households in Japan⁷⁴, on the other hand, reveals a lower holding ratio than the U.S. but the same trend in that the holding ratio appears unrelated to income level (see Figure 2-2-58). Nevertheless, the spread of investment trust assets in Japan is lagging. The ratio of investment trust assets against GDP in an international comparison shows the U.S. at 86.6%, U.K. 34.05, France 77.7%, and Canada 48.7% while in Japan the ratio is only 16.3%⁷⁵.

In Japan, which faces an aging society and reduced family size, the problem of safe and effective management of pension fund assets is an important issue. Wide ranging discussions are underway by the Council on Economic and Fiscal Policy regarding the management of public pension funds. In this way, the management of public pension funds as a part of Japan's economic growth strategy is clearly specified in the statement "broad ranging examination from the nation's standpoint".

⁶⁹ Although there is no clear legal definition, ordinary transaction participants are limited to professionals (institutional investors), who are able to operate freely with minimal restrictions under their own responsibility.

⁷⁰ These measures are introduced in Chapter 4 – 4.

⁷¹ In March 2007, the Asian Development Bank announced the Asian Currency Unit (ACU) while keeping sight on a future common currency for the Asian region.

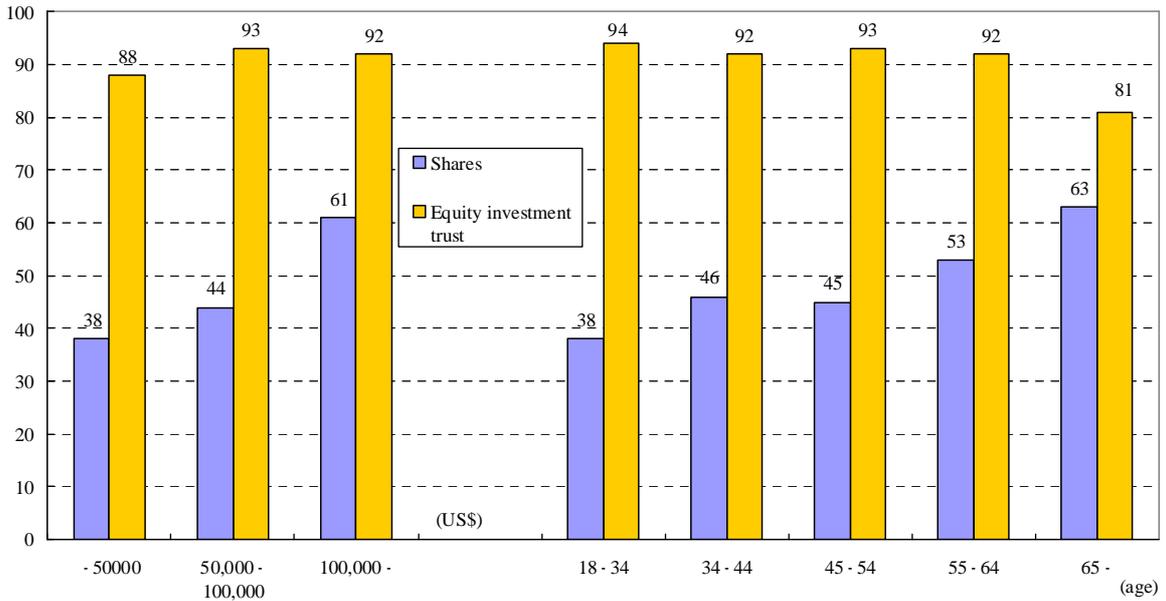
⁷² Normally, it is only possible to buy a fixed amount.

⁷³ Investment trusts that focus on shares.

⁷⁴ Investment Trust Association (2006), "Survey of Investment Trusts"

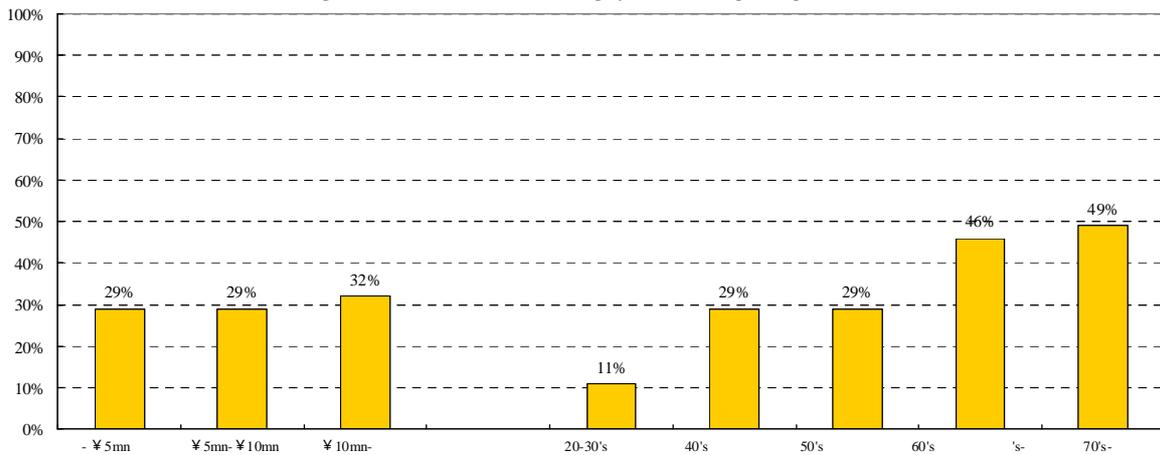
⁷⁵ Investment Trusts Association (2007), "Investment Trust World Statistics (4Q 2007)".

(%) Figure 2-2-57 US household asset holdings by income and by age strata (shares, equity investment trust)



Source: US Investment Company Institute; US Securities Industry Association.

Figure 2-2-58 Investment trust holding by income and age in Japan (2006)



Notes: 1. Survey of men and women nationwide over 20 years of age who indicated experience or interest in investment trusts.

2. Sample size 2200. Mail survey take between end August 2006 and beginning September. 1311 replies (sample reply rate: 59.6%).

Source: Investment Trust Association, "Survey regarding investment trusts".