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Abstract

This paper considers a range of issues affecting Japan's contemporary economic well-being. Japan has continued toward sustained, full-employment growth, though its path has been idiosyncratic and its pace has been erratic. GDP growth in 2006 was a respectable 2.2 percent, driven by business fixed investment and exports. Private consumption has failed to support demand, which reflects very low wage increases. The combination of economic expansion with mild deflation is the big idiosyncrasy of Japan's economic performance. The decoupling of growth and deflation is explained primarily by the ongoing structural transformation of the labor market. Slow growth in wage income and consumption imply that inflationary pressures will not emerge in the near future, despite economic growth. The likelihood that wage stagnation will persist and consumption's share of GDP will also continue to decline presents inadequate aggregate demand as a major constraint on growth and Japan's most important macroeconomic policy issue. Corporate performance continues to improve, but faces new restructuring challenges that involve divestitures, mergers, and acquisitions. Activist shareholders are playing an increasingly important yet controversial role in evolving Japanese companies. Export growth, propelled by a weak yen, has continued to be a major source of aggregate demand and corporate profits. Recent appreciation of the yen, as a result of the global credit crunch and financial turbulence, is a major concern only if it persists. Japan's trade has shifted away from the United States to Asia. East Asian economic cooperation is increasingly promoted, though the main impetus is political, not economic. Obstacles are currently too great for significant bilateral or regional PTAs, which is not a bad thing. I remain fundamentally optimistic about Japan's ability to solve its basic problems.

Japan's march toward stable, full-employment growth has continued. While progress has been sustained, the path has been idiosyncratic and the pace erratic. In many respects, Japan's economy is now a good story. Per-capita growth is comparable to the United States and the European area, and the 3.7 percent June unemployment rate is the lowest, especially relative to France (8.0%) and Germany (9.0%).

However, despite these predominant similarities, Japan's economic situation has several significant differences. First is the persistence of mild deflation for a decade, and inflation expectations continue to be very low. Second, the labor market has been tightening, yet nationwide average wages have not been increasing; indeed, the total cash earnings index again slightly decreased in the first half of 2007. Third, interest rates are extraordinarily low. Fourth, the yen has been weak in terms of economic fundamentals. Moreover, given relatively elastic supply conditions, inadequate aggregate demand continues to be the major constraint on more rapid growth. The Liberal Democratic Party's huge losses in the July Upper House elections increase economic policy uncertainty.

The August shock of a global credit crunch and financial turbulence has created significant financial and economic uncertainty. Even though Japanese exposure to U.S. risky financial assets is relatively low, its financial markets are being roiled since financial markets are so integrated globally. The biggest impact has been yen appreciation; a sharp reduction in the yen carry trade has been one element in the global flight to safety. I expect a return soon to stability in financial markets as much-needed adjustments in the pricing of risk are made. Nonetheless the possibility of significant, sustained yen appreciation has now moved to the forefront of issues Japan faces.

But there are always problems and challenges, and Japan has managed to prevail. I remain fundamentally optimistic about Japan's ability to solve its basic problems, albeit at its own pace and in its own ways.

In the following sections, I consider recent economic performance; the decoupling of growth and inflation; Prime Minister Abe's economic policies; macroeconomic policy; corporate restructuring, control, and governance; and external economic relations.

RECENT ECONOMIC PERFORMANCE

GDP growth in 2006 was 2.2 percent: respectable though not exciting, and below the consensus expectation of 2.5 percent a year ago. Growth slowed in the spring and summer quarters but then achieved a dramatic 5.4 percent (seasonally adjusted annual rate) in the final quarter and was a strong 3.3 percent in the first quarter of 2007. However growth slowed significantly in the second quarter.

Since the early 2002 trough, the major sources of aggregate demand have been business investment and exports. The hope has been that private consumption would support demand, but it increased at only a 1.3 percent annual rate, and its share of GDP has continued to decline. This reflects very low increases in wages. Reduction of the extraordinarily high government deficits has reduced demand growth by 0.5 percent a year.

Even more than in previous years, 2006 growth was propelled by business fixed investment (increasing 7.5% and contributing 50% of aggregate demand growth) and exports (up 9.6%, with net exports 36% of demand growth). Consumption disappointingly rose only 0.8 percent (23% of demand). Government spending continued to be a modest negative factor, as a decrease in public investment outweighed a small increase in ordinary (consumption) expenditures. Employment and hours worked have risen modestly, and labor productivity per hour continued its 2 percent average annual increase.

It is unsettling that growth slowed in 2007 spring and summer, though, as usual, the monthly data are mixed, imprecise, and rather volatile. The August 13 first estimate of April–June growth is a 0.5 percent annual rate, a slowdown somewhat worse than expected. Business investment slowed but to a good 5.6 percent annual rate, and consumption continued to rise at a 1.4 percent rate, but net exports were flat and government investment was negative. While slow growth will probably persist in the third quarter, I think this is no more than another soft patch.

Private-sector forecasts of GDP growth are 2.2 percent to 2.4 percent (average 2.3%) for 2007, and about that again for 2008. Both are a bit better than the Bank of Japan’s April forecast of 2.1 percent for fiscal 2008, and what was projected a year ago. Expectations are that business investment and export growth will slow, consumption growth will improve somewhat, and the reduction of the government deficit will slow.

About 90 percent of household disposable income comes from worker compensation. While wage rates will remain flat, employment will increase slightly, and baby-boomer lump-sum retirement allowances will start to kick in, amounting to half of the 1.6 percent projected gain in employee income in 2007. Rising interest and dividend income will contribute a further 0.7 percent, but taxes will be a negative 0.3 percent. If this projected 2 percent rise in 2007 disposable income, and an even slightly greater projected increase in 2008, are realized, and if households do not increase currently low savings rates, this will be good news for consumption and GDP growth.

Deflation Has Persisted

The big idiosyncrasy in Japan's ongoing economic performance is the combination of sustained good growth and persistent mild deflation. Even though labor markets have been tightening and full employment is close, wages for the economy as a whole are not rising, consumption growth lags, and mild deflation has not ended. The only good price news is that the deep, traumatic decline in Japanese asset prices finally ended in the mid 2000s, though regional disparities in land price movements continue.

An ongoing policy debate is how to define price stability and how to measure it accurately. The major policy measure of price stability is the core Consumer Price Index (CPI), defined in Japan as the overall (headline) CPI excluding the highly volatile movements of food prices. The Bank of Japan (BoJ) position since early 2006 is that price stability is defined by a 0 percent to 2 percent range of core CPI. This is about a 1 percentage point lower than U.S. Fed and European Central Bank (ECB) definitions.

The BoJ asserts there is no upward measurement bias in the CPI. Like many economists, I feel there is: my guess has been about 0.5 percent in core CPI. Core CPI rose only 0.1 percent in 2006, has been very slightly negative for the first six months of 2007, and is expected to be essentially 0 percent for the year. Forecasts for 2008 are very low, only 0.5 percent by the BoJ and 0.4 percent in August 2007 *Economist* and *ESP* surveys. In other words, an end of deflation will not actually be achieved until sometime in 2008.

My colleague David Weinstein and Christian Broda have recently jolted the debate on CPI measurement and, by implication, on monetary policy. They find that Japan's core CPI estimate has an even greater upward bias than previously thought. This means deflation has been greater than currently estimated. By applying the more comprehensive U.S. estimation methodology to Japanese data, they conclude the bias is about 0.8 percent. Moreover, they estimate the U.S. CPI has an upward bias of 1.0 percent. This implies Japan's true cost-of-living index growth has an upward bias of 1.8 percentage points. (See Broda and Weinstein, "Defining Price Stability in Japan: A View from America," Center Working Paper 252, June 2007.) Like many countries, Japan underinvests in data collection and especially in highly qualified statisticians; the United States spends ten times as much as Japan to estimate its CPI.

This is unwelcome news for the BoJ and others who think Japan's extended mild deflation is finally ending. But it also means that real GDP, productivity (both labor and total factor), and real wages have been growing somewhat faster than officially estimated. How much faster is unclear, as the personal consumption expenditure component of Japan's GDP deflator is estimated by a different methodology—and has been more negative than core CPI movements. This poses a puzzle important for policy: how can the economy have been recovering and growing so well when mild deflation persists?

Why mild deflation has not been more harmful to growth since 2002 is unclear. It has not significantly impeded business investment, but it has had other consequences. Low interest rates have made structural reform easier but sometimes have delayed it, especially by small businesses. Mild deflation may have made it politically possible to reduce government employee wages and to constrain other government expenditures, even though growth since 2002 has generated significantly increased corporate and other tax revenues. The most significant cost of deflation may be long run: it is undermining the assumptions the 2004 pension-tax increase was based on.

GROWTH AND INFLATION DECOUPLED

Japan's economic expansion since 2002, accompanied by mild deflation, is contrary to standard textbook analysis. There are a number of explanations, mostly complementary, for this growth-without-inflation phenomenon.

Economic slack was substantial, but it has now narrowed; labor markets have tightened significantly, and the government output-gap estimate has become positive. However, both the output gap and potential growth are difficult to measure; I put greater emphasis on employment, wages, prices, and consumption. The still-flat CPI, minor wage increases, and slow growth of consumption suggest full utilization of labor and capital has yet to be achieved.

Profits were very low during the 1990s, and recovery was slow because firms were under price pressures. However, productivity growth enabled firms to hold prices down and now to increase profits. Labor productivity has risen 2 percent annually since 2002, from the 1991–2001 average of 1.5 percent. Unit labor costs continued to decline in 2006 and at a slightly more than 2 percent annual rate in the first half of 2007. Still, while corporate structural reforms have been important, productivity acceleration is due also to cyclical recovery.

The explanation for decoupling that I stress here is the ongoing transformation of the labor market. It is my conjecture that, for the next several years, growth and inflation will continue to be decoupled, primarily because of ongoing major structural changes in labor markets.

Employment and Wages

With unemployment at its lowest level since February 1998, it is surprising that economy-wide wages (total cash earnings) have not been rising. Instead, total cash earnings and total hours worked in establishments with five or more employees have been essentially flat since 2003—that is, throughout the recovery from the 2002 trough. Total cash earnings increased only 0.3 percent in 2006, decreased 0.7 percent in the first quarter of 2007, and fell again in the second quarter.

The annual spring wage increases in 2006 were 1.79 percent in large firms and 1.47 percent in small and medium enterprises (SMEs). However, adjusting for sex, educational level, age, and years of service, an index of wage increases has been negative. While performance has been given greater weight in total compensation, seniority continues to be the dominant component of annual wage increases. Semiannual bonuses continue to comprise a large share of total compensation, particularly for large firms. Large-firm summer 2007 bonuses rose by 3.0 percent, continuing a five-year pattern of increases; bonuses, which are flexible, have continued to substitute for basic wage increases. SME bonuses apparently decreased 2.3 percent.

Starting salaries for new college and high school graduates in 2006 rose slightly but were essentially the same as in 2003. Even in today's competitive labor market, large firms have not increased wage offers. To do so would raise base salaries throughout their seniority-based wage structure: employees aged 50 to 54 in large firms earn three times what young new entrants earn. Their response to labor market tightness has been to cast their recruiting nets more widely.

Wage stagnation is due primarily to changes in labor force composition. This has two major aspects: substitution of lower-wage contract, part-time, and temporary workers for full-time regular, lifetime employees; and replacement of retiring workers by young workers. Only the central and local governments have cut employee wages. In periods of poor performance, companies have reduced overtime or semiannual bonuses but—with few exceptions—not basic hourly wage rates for existing employees.

Of Japan's 2006 labor force of 66.6 million, 63.7 million were employed. After earlier declines, the labor force participation rate of those aged 15 to 64 has remained at 60.4 percent since 2004. Most Japanese work as employees; the share of self-employed and family workers has continued its steady, gradual decline and is now 14.3 percent of total employment. Total employment increased by 0.4 percent in 2006, with employee numbers rising 1.4 percent.

The share of full-time regular workers among those employed has continued to decrease and is now 67 percent. As to the other 33 percent, two-thirds are part-timers, the rest temporary workers, contract employees, and workers dispatched from temporary labor agencies. Nonregulars have lower hourly wage rates, fewer benefits, and less job security. The share of such workers has risen dramatically since 1990.

More than half (52.8%) of female employees do not have full-time regular employment, though most are in relatively stable part-time jobs. More than a sixth (17.9%) of male employees, disproportionately young and older workers, do not have regular full-time positions.

In addition to the 2.8 million counted as unemployed, 4.8 million (3.5 million women) have said they wish to work. A major social and economic cost of more than 15 years of mediocre economic performance has been the creation of a large cohort of young people 25 and older who never got on the bottom rung of the traditional job-advancement ladder, and now will be among the last to obtain good jobs.

The good news is that temporary employment agencies are having difficulty attracting new recruits, are losing some employees to regular employers, and are having to increase wage-related benefits. Those not in the labor force but wishing to work decreased 500,000 from 2004 to 2006, further evidence of labor market tightening. Still, there is a supply overhang of young, unemployed, temporary, and part-time workers who want full-time jobs. This has held down the starting salaries of those entering the labor force from school.

Assuming the economy continues to grow at better than 2 percent, labor market tightening will persist. This suggests the shift from regular to nonregular workers has reached its limit and may even gradually reverse.

However, even if the changing labor composition effect ends or reverses slightly as labor demand generates higher proportions of regular and full-time workers, an aging effect—replacing retiring workers with low-wage young workers—will become larger at least until 2010. Between now and 2010, some 3.6 million males will be retiring at the company-mandated age of 60. Many will continue working, often with their same employer, but for lower wages and benefits, and for fewer hours. To the extent that a higher proportion of those over 60 continue to work at relatively low wages, this demographic effect will persist even longer.

The greater diversity in type of employment reflects, in part, changes in worker composition and preferences—married women, part-timers, freeters, and contract skilled specialists such as computer programmers. However, much is the consequence of companies' policies to replace departing full-time regular workers with nonregular workers from the 1990s period of mediocre growth, cost cutting, and labor market slack.

Macroeconomic Implications

The combination of structural changes in labor force utilization and baby-boomer retirements suggest that overall average wages (total cash compensation) will not increase significantly for several years. The macroeconomic implications of this are significant. If individual household income growth is constrained by flat cash earnings, and aggregate increases are primarily from modest employment growth, then consumption expenditure will grow only slowly for the next several years. This means consumption’s share of GDP will continue to decline. Japan could well have an aggregate demand problem.

Slow growth in wage income and consumption imply that inflationary pressures will not emerge in Japan as growth proceeds, in stark contrast to the United States and Europe. Indeed, in this scenario the CPI will not rise significantly but rather, at best, reach the lower end of the price stability policy range, which I define as 1 percent to 2 percent. Mild deflation may even persist for a considerable period.

Accordingly, market interest rates will remain low. On August 24, the yield on the 10-year Japanese Government Bond (JGB) was 1.60 percent and on 20-year JGBs, 2.07 percent. The enduring persistence of at least a 2-percentage point gap between JGBs and foreign government ten-year bond yields is telling. My best guess is that neither a modest narrowing of the interest rate differential through monetary policies nor global capital market hiccups are likely to halt Japanese capital outflows; and the yen carry trade will pick up again. I do not think that the August global credit crunch will result in yen appreciation to anywhere near what its economic fundamental estimates imply, but admit to some uncertainty. A relatively weak yen will continue to support Japan’s ongoing export boom in this scenario.

PRIME MINISTER ABE’S ECONOMIC POLICIES

Prime Minister Abe readily inherited Koizumi’s economic reform policies and programs and benefited from an economy no longer in crisis and seemingly well on its way to full recovery. This initially enabled him to focus more on longer-run issues, notably raising the GDP growth rate and improving the education system. Koizumi's definitive, charismatic, idiosyncratic leadership has been a hard act to follow, even though Abe's early visits to China and South Korea achieved a major improvement in relations.

Abe's economic policies have been long on rhetoric and short on concrete proposals, specific targets, and implementation measures. Abe has continued Koizumi's efforts to centralize decision-making power in the Prime Minister's official residence *(Kantei)* and away from the major ministry bureaucracies, which have considerable autonomy and strongly defend their turf.

Abe's major economic policy strategy was laid out in the Cabinet's June 19 "Economic and Fiscal Reform 2007." A major goal is to increase Japan's potential growth to about 2.5 percent over the coming five years by a range of approaches to boost labor productivity growth to 2.4 percent. The focus is on the supply side, with little concern about sustaining aggregate demand. The 2006 commitment to ongoing reduction in the fiscal deficit is continued, but without specifics. The guidelines are disappointing in that they lack a clear, coherent, concrete strategy and process for implementation. In part this reflected LDP unwillingness to enunciate specific targets, or even address important but sensitive issues, until after the Upper House election. However, that only enhanced the perception that Abe's commitment to economic policy is weak.

The devastating July 29 Upper House election loss has seriously weakened Abe and the LDP. However, most power resides in the Lower House, where the LDP plus Komeito continue to hold a two-thirds majority. While a series of scandals and gaffes by Cabinet members were important, the pension system fiasco hijacked the LDP agenda for the Upper House election. The Social Insurance Agency's incompetence and mismanagement in the handling of individual pension payments took place over several decades and were not of Abe's making, but his mishandling of this increasingly prominent issue contributed to his election failure. More fundamentally, the LDP was defeated in the least urbanized, least prosperous prefectures, its traditional stronghold. The Democratic Party of Japan (DPJ) promises of support for farmers, construction workers and SMEs in the provinces may have not only won an election but created new priorities in formulation of the government budget.

The fundamental nature and thrust of economic policy are unlikely to change significantly in the near term. However, the reform process will probably slow further, caught in policy gridlock between the LDP and the DPJ. Much depends on how Abe, or his successor, responds to the election's implication that bread-and-butter economic policy is top priority. The 2008 budget negotiations will test LDP fiscal austerity against DPJ proposals. Paradoxically, this might make possible a major shift in agricultural support to a system of direct subsidies of farm family incomes for some years, coupled with significant import liberalization, but I would not bet on it.

MACROECONOMIC POLICY

The residue of inadequate aggregate demand and mediocre growth in the decade to 2002, despite unprecedented macroeconomic policy ease, continues to be a huge overhang. Even with good GDP growth since 2002, interest rates are still abnormally low, monetary policy is very easy; the government budget deficit is still large, gross government debt is extraordinarily high, the yen is relatively weak, and mild deflation persists.

How to achieve adequate rates of aggregate demand growth continues to be Japan's most important macroeconomic policy issue. The basic fiscal policy objective is to reduce the primary deficit to zero by 2011 and achieve a budget surplus by 2015. Good progress has been made: corporate tax revenues have increased more than anticipated and 1999 income tax cuts were reversed last year and this. The IMF projects that Japan's budget primary deficit, 5.7 percent of GDP in fiscal 2003, will be reduced to 2.1 percent in 2006 and 1.3 percent in 2007. The budget deficit of the general government (central plus local) will drop to 3.6 percent in 2007.

However, these trends probably will not persist. Government current expenditures will continue their small rise, public works investment cuts may be approaching a plateau, and tax revenue increases will slow. The DPJ victory adds the possibility that public works and other expenditures will rise, rather than being cut further. The government in early August stated that January fiscal consolidation projections are too optimistic because they were based on assumptions that the GDP deflator would turn sufficiently positive and that high nominal GNP growth (at current prices) would be achieved.

The ongoing debate on budget deficit reduction, termed fiscal consolidation, supposedly will come to a head this fall when tax reform, notably increasing the consumption tax, is supposed to be addressed. The majority LDP view has been that, in the long run, government expenditures on health care and pensions will have to increase as the population ages, so taxes as a share of GDP must eventually rise. An increase in the consumption tax in 2009 had seemed likely. However, the DPJ and the Komeito oppose an increase, so consideration will almost certainly be postponed.

Pension financing, presumably substantially taken care of in the 2004 reform, is becoming a major, though still not widely recognized, problem again. The projected income and expenditures earlier used to formulate the reforms are increasingly unrealistic. Demographic assumptions regarding fertility rates, and hence the pace of population decline and the share of those under 65, were too optimistic. Probably more important, the forecasts of nominal GDP and CPI increases were too high. Already, the long-run fiscal burden probably is significantly greater than projected.

Most media and capital market discussion has focused on monetary policy: the timing of BoJ increases in short-term interest rates. Given the huge size of Japan's bond and other fixed asset markets, expected and actual changes in BoJ interest rates have immediate asset price effects. However, the precise monthly timing of increases has little overall significance, given the state of Japan's economy.

Like other economists, and the IMF and OECD, I prefer that the BoJ not raise interest rates until it is clear that deflation has been conquered. I consider a 1 percent or so annual increase in an unbiased measure of core CPI a desirable economic lubricant. The BoJ may be too concerned about the possibility of excessive inflationary pressures two to three years hence, rather than the persistence of mild deflation now. Global financial turbulence precluded any BoJ decision to raise its overnight call rate of 0.5 percent at its August 23 meeting, even though only weeks earlier a 0.25 percent increase had been widely expected. While the BoJ longer-run objective to raise interest rates gradually to more normal levels is unchanged, increases will be delayed until both financial markets and underlying economic conditions make them feasible.

The Prime Minister's decision as to who will replace Toshihiko Fukui as BoJ Governor when his five-year term expires March 19, 2008, will be important, especially if the new governor has very different views about monetary policy. The appointment must be approved by both houses of the Diet, so the DPJ will have an important role in the selection. It has already rejected at least one of the front-runners.

CORPORATE RESTRUCTURING, CONTROL, AND GOVERNANCE

Japan's business environment continues to improve quite rapidly, due to sustained recovery and growth and to structural changes in the institutional environment. Balance sheets have been restored, prolonged attrition has sharply reduced redundant labor, and profits have soared from earlier low levels. Financial markets and institutional shareholders are more actively pressing management to give higher priority to profitability, to provide more information, to be more responsive, and to restructure. Corporate reform and other structural changes related to corporate law, governance, and markets, including these for corporate control, have proceeded rapidly, but from a low base; they still have a considerable way to go. Such broad generalizations are of course subject to qualification.

Corporate performance varies among industries and among firms within industries. Despite considerable business complacency, the reality is that many firms, large and small, have not completed restructuring and continue to use assets inefficiently. Even when large firms have distinguished between core and noncore activities in principle, in practice many have not dealt effectively with noncore assets. Many firms hoard cash resources or underutilized land. Some 450 (22%) of 1,729 companies in the TOPIX (Tokyo Stock Price Index) have market capitalizations below book value. In contrast, while not strictly comparable, the ratio for the U.S. Russell 1000 index is 1.4 percent and for the Europe Dow Jones Stoxx 600 Index 1.5 percent.

Most of Japan's output, and even more employment, is generated by SMEs, all privately owned. SME restructuring has proceeded more slowly than for large firms, and has much further to go. Returns on assets are now positive, but still low. Sales per worker are flat and so, too, are wages. Productivity growth is slow. Many of the smallest firms are in deep trouble. There is extraordinary variance among SME performance, and levels of transparency and disclosure are low. The widening economic gap between urban, industrial areas, and the rest of the country is particularly exemplified among nonmanufacturing SMEs.

The Japanese management system continues to be one of deep entrenchment at most, though certainly not all, listed companies. The president, chair, and other members of the board of directors still are almost all internally promoted. Many firms now have one or two outside directors, but in practice they have little independent power. Typically, they are not well briefed: management provides limited information, and that only shortly before meetings.

Now that reductions in employees and labor costs have approached their limit, restructuring primarily involves divestitures, mergers, and acquisitions (M&A). Many opportunities exist for divestment of noncore activities; for acquisition of firms with a market value below book value or of private firms whose owning families are willing to sell; and for mergers between strong and weak firms within many industries. This is especially true in electronic components, machinery, construction, department stores, and pulp and paper.

M&A and private equity are growing rapidly, but from very low bases; they remain far below U.S. and European levels. In the first half of 2007, 338 M&A deals involving publicly traded companies took place, a record high and 20 percent greater than a year earlier. Some 46 tender offers for listed companies reflected a 60 percent increase over a year earlier. The average tender premium was 24.4 percent, but with a wide dispersion, including four offers at a discount to market price. By far, most M&A activities were friendly.

Shareholder Activism

Although most restructuring programs are initiated by management, activist institutional shareholders have played an increasing role. Shareholder activism is generated by both domestic and foreign institutional investors and takes various forms. While unfriendly efforts have generally not been successful, they have attracted extensive media coverage. The message is clear, and managements are responding in ways they never have before.

Activism has been led by foreign institutional investors. As of March 2007, the share of foreign ownership of all listed companies had inched up to 28.0 percent from 26.7 percent a year earlier. The proportion held by friendly, stable shareholders, has declined significantly over the past decade. The largest stable Japanese shareholders are industrial corporations and trust banks, including their fiduciary management of pension funds. Cross-shareholding, which was 32.9 percent of shareholding in March 1991, declined every year until 2006, when it rebounded very slightly to 11.2 percent, with some notable new cases of company shareholding alliances.

Activist investors proposed large dividend increases and related measures at a record 30 shareholder meetings; all were rejected. Even so, many firms have been increasing dividends, though pay-out ratios continue to be lower than in the United States or Europe. And more stock buy-backs are taking place. Managements have gone on the offensive to defend themselves. Poison pills were approved at 210 companies at June shareholder meetings, though in some instances with significant negative votes. While management won the 2007 round at annual stockholder meetings, what is important is that for the first time a substantial number of such contests have been initiated.

Government messages have been mixed. The Minister of Economy, Trade, and Industry (METI) applauded the passage of antitakeover defensive measures. However, the Cabinet Office Annual Report on Japanese Economy and Public Finance, issued in early August, expressed concern that the introduction of defensive measurements by inefficient managements could negatively affect productivity and fail to raise corporate efficiency.

Both domestic and foreign institutional investors have initiated some M&A cases that have been high profile, with immense media coverage. While each has its own unique aspects, they are exemplary of the rapidly changing, mixed, complex environment and market for corporate control.

For example, Toshiba Ceramics in spring 2007 carried out a successful management buyout (MBO) from Toshiba, with the participation of one Japanese and one foreign private equity firm. In April, All Nippon Airways divested its hotel and property management businesses to Morgan Stanley. At Tokyo Broadcasting System’s (TBS) June stockholders meeting, Rakuten was thwarted in its attempt to elect two outside board members and increase its shareholding in TBS, but that saga has yet to end. In May, Hoya finally succeeded in taking over Pentax, with the assistance of Sparx Asset Management, a major Pentax shareholder. In a friendly transaction, Citigroup bought deeply troubled Nikko Cordial, a major securities company; it had to increase its initial offer to persuade hedge fund and institutional investors to sell. Following the founder Otani family's unsuccessful MBO for its TOC Company, the Japanese investment group DaVinci Advisors made a hostile bid for the property developer. Despite a considerably higher valuation, in July it failed. A significant hostile takeover bid (TOB) has yet to succeed in Japan.

U.S.-based Steel Partners is the best known activist investor in Japan. Its Japan Strategic Fund holds shares in some 30 listed companies, most rather small. It has vigorously proposed dividend increases and share buybacks in several highly publicized cases. Its effort to buy Bull-Dog Sauce failed in July following court rulings that Bull-Dog's antitakeover defense of warrant issues, for which Steel would receive only cash rather than new shares, is legal.

Japanese courts are in the early stages of making case law for hostile takeover bids and antitakeover defenses. The Bull-Dog case is important because Steel Partners was held to be an "abusive acquirer," a concept requiring further definition. Without addressing the "abusive acquirer" issue, the Supreme Court rejected Steel Partners' appeal on the grounds that an overwhelming majority (83%) of shareholders approved the warrant defense measure at the June stockholders meeting.

In another, perhaps more important case, the court ruled that Yoshiaki Murakami illegally engaged in insider trading. His behavior and practice seem to many to be little different from what many institutional investors have been doing in talking privately with company managements. Another controversial court decision was to allow TOC to not provide its shareholder list to DaVinci, even though Japanese law provides that right to a 10 percent shareholder, which DaVinci affiliate Algeve was.

Given management control, by far most mergers and acquisitions will continue to be friendly, despite the media hoopla about unsolicited, competing, or hostile bids. The likelihood of triangular M&A involving foreign company shares is very low because of still unresolved tax and legal ambiguities. If they do take place, they almost certainly will be on friendly terms with management.

As in Western markets, the most serious risk for shareholders is management buyouts, as both management and potential institutional investors have an incentive to set a low purchase price. Because of management's high commitment to its employees, the terms of Japanese M&A deals are likely to constrain acquirers to commit not to fire workers and to maintain employment and keep management.

Managers are sufficiently entrenched to ensure that the Japanese management system will persist as the dominant form of big business organization, even though firms now have available a wider range of organizational models. The primary commitment of managers is still to themselves and their (now more narrowly defined) regular employees. However, managers have become more responsive to shareholder, market, and other business-environment signals than in the past, and the Japanese system will evolve in its specifics.

EXTERNAL ECONOMIC RELATIONS

Export growth continues to be a major source of aggregate demand and corporate profits. In real terms, exports of goods and services, 10.9 percent of GDP in 2002, expanded to 15.3 percent in the second quarter of 2007, while imports increased from 9.6 percent to 11.0 percent. Adding to the trade surplus has been increasing financial inflows of dividend, interest, and profit income. Japan's current account surplus, 2.9 percent of GDP in 2002, steadily rose to 4.1 percent in 2006 and is expected to be 4.6 percent in 2007. More than half is net financial income receipts.

Japan's exports and imports continue their shift away from the United States to Asia, notably China—which has become Japan's largest trading partner. A decade after the 1997–98 financial crisis, afflicted Asian economies have recovered well: growth throughout the region (excluding Japan) has been averaging better than 7 percent. Led by China, Asia is now a major force in the growth of the world economy and international trade.

Japan's export growth has been propelled not only by Asian and global growth, but by the weak yen. With Japanese interest rates continuing at least two percentage points below other industrial countries, home bias has been weakening as Japanese have invested significantly in foreign financial assets. To that is added the yen carry trade: domestic as well as foreign institutions borrow yen, convert it to other currencies, and invest in higher-yield assets elsewhere. The big question is whether these trends will persist once the current credit crunch is over.

Low Japanese interest rates will persist. The new uncertainties are U.S. and European interest rates, given the fall-outs from the credit crunch and the slower growth of the U.S. economy. My guess is the interest rate gap will continue to be sufficiently large that capital (yen) will continue to flow out of Japan and that, while the yen may bounce around within a moderate range, it will not appreciate significantly, (say to 100 yen/dollar) any time soon.

Japan continues to push its recent trade policy of preferential trade arrangements (misnomered free trade agreements—FTAs), but with only limited success. That probably is not bad, as bilateral trade agreements are a third-best, after regional trade agreements. The first-best, the WTO Doha Round, has not yet been successful.

Japanese officials are promoting East Asian economic cooperation more for political than economic reasons. In August 2006, Japan proposed the Comprehensive Economic Partnership in East Asia, to include not only the ten ASEAN nations plus China, Japan, and South Korea (ASEAN+3) but also India, Australia, and New Zealand (the East Asian Summit members). The contrast between China’s ASEAN+3 approach and Japan’s East Asian Summit approach is indicative of their competition for East Asian leadership, as is Japan’s new foreign policy slogan of an “arc of freedom and prosperity” across Asia and to Europe. However, Japan and China’s deep, mutually beneficial trade and FDI relationship moderate the inevitable political tensions between them as China ascends.

An East Asian regional preferential trading agreement is unlikely: the economic, political, cultural, and institutional obstacles are too great. Japan is so handicapped by domestic agricultural, forestry, fishing, and health care vested interests that it cannot negotiate adequate FTAs bilaterally, much less regionally. Further small steps of regional financial cooperation are more likely, and desirable. I doubt that Japan and others will be willing to give up control of significant amounts of their foreign exchange reserves to any new regional authority.

Tokyo is not a global, or even major regional, financial center and is unlikely to become one, even though it is a major national center. Its financial markets are very large because Japan is the world's second largest economy, has high domestic saving and investment rates, and home-country bias remains strong. But Japanese markets are too regulated and the corporate tax rate too high to be internationally competitive. It is not surprising that many hedge funds involved in Japanese markets are based in Hong Kong and Singapore. Because Japanese is the language of Japan's financial markets, it is expensive to issue foreign IPOs and bonds. English is the global language of finance; and an international financial center requires language skills, institutions, regulatory systems, infrastructure, and a life environment that Tokyo is unlikely to achieve.

CONCLUSION

Japan's comeback from the stagnation and malaise of the 1990s has continued, and while it has been a sustained recovery since 2002, the path has been idiosyncratic and the pace erratic. The evolving mixture of good growth, significant structural change, persistent though mild deflation, quarterly economic slowdown each year, and fluctuations in Japanese moods and expectations have tempered my optimism from year to year. The effects and implications of the current global credit crunch shock increase near term uncertainties. Nonetheless, Japan is now in its best position in some two decades, and within a few years will once again become a normal economy.

But what if my optimistic expectations are wrong about the yen, exports and aggregate demand? Suppose the yen does appreciate significantly in coming months, as economic fundamentals imply is possible. That will be bad for exports and for the corporate profits of export producers. Given Japan's reliance on exports, aggregate demand inadequacy will become more serious. Macroeconomic policy once again will have to confront a slowing, poorly performing economy.

In addition to these new political, financial and economic uncertainties, Japan's longer-run challenges are formidable and are too many to consider here. Aging and population decline are a given. Productivity and income gaps continue to widen everywhere—between urban and rural areas, between sectors, industries, and by firm size. Narrowing these gaps constructively will accelerate labor productivity, which is essential for sustained, full employment growth. Innovation and technical change are key, not only in cutting costs but in creating new products and industries. Maintenance of sufficient aggregate demand, Japan's problem for some 15 years, will be as important as improvements on the supply side.

Japan is a stable democracy and society. Its economy is technologically sophisticated and capital intensive, well founded on a high degree of human skills. Japan has a high standard of living, with a GDP per capita in purchasing power terms of about $32,620. Japanese are able, ambitious, hard working, and creative. Incremental improvements will proceed; history demonstrates that has been a good path. Thus, I remain fundamentally optimistic about Japan's ability to solve its basic problems, albeit at its own pace and in its own way.