Chapter I

The Economy, Industries and Corporations

1 The Japanese Economy: Current Situation and Outlook for the Future

Japan's Phenomenal Postwar Economic Recovery

Though the Japanese economy had been virtually destroyed by defeat in World War II, the government made institutional reforms and implemented far-sighted policies, achieving a recovery that is remarkable by any standard. During the so-called period of high economic growth (1955 to the early 1970s), the economy expanded at an average rate of 10% or higher per year.

Since the 1970s, the world economy has been shaken by profound changes in the international monetary system and by two oil crises. However, the Japanese Government has managed to maintain a relatively strong economic performance among advanced nations by adopting effective macroeconomic policies. Labor and management have made contributions also, by agreeing to set wages voluntarily. The industrial structure has been transformed through technological innovation, and Japan has succeeded in staving off inflation and keeping the unemployment rate under 2%.

Astoundingly Low Growth Rate

In the early 1980s, economic theories stressing the importance of the market mechanism gained support in Japan, as in other industrialized nations. Informed by these theories, the Japanese Government implemented administrative and fiscal reforms, and privatized some state-run corporations. However, during this period, trade imbalances among the advanced nations worsened, leading to the Plaza Accord of 1985, after which currency reform was carried out amid growing demands for Japan to open its markets. Accordingly, the yen rose sharply against the U.S. dollar, resulting in a recession. Japanese companies, manufacturers in particular, sought to remedy this by moving some of their operations overseas.

The Japanese Government attempted to promote domestic economic growth by lowering interest rates to stimulate demand. Its macroeconomic policies were influenced by negotiations with the United States, at which the removal of structural barriers to imports and the reduction of Japan's huge trade surplus were discussed. Unfortunately, this resulted in excess liquidity, which induced speculation in land and securities. The prices of land, securities, and other assets soared to abnormal levels, thereby creating the "bubble economy" of the early 1990s. When the bubble burst, the economy entered into crisis and was saddled with an enormous volume of bad debts. Japan has since struggled to dispose of these bad debts and to counter what the OECD (Organization for Economic Cooperation and Development) has described as "astoundingly and exceptionally low economic growth.'

Temporary Self-sustained Economic Recovery

Since 1997, the Japanese economy has experienced, among other things, a rise in the rate of consumption tax aimed at fiscal reconstruction, reduced public demand, an Asian currency crisis, and the insolvency of major financial institutions, which contributed to an acute downward economic spiral from the end of 1997.

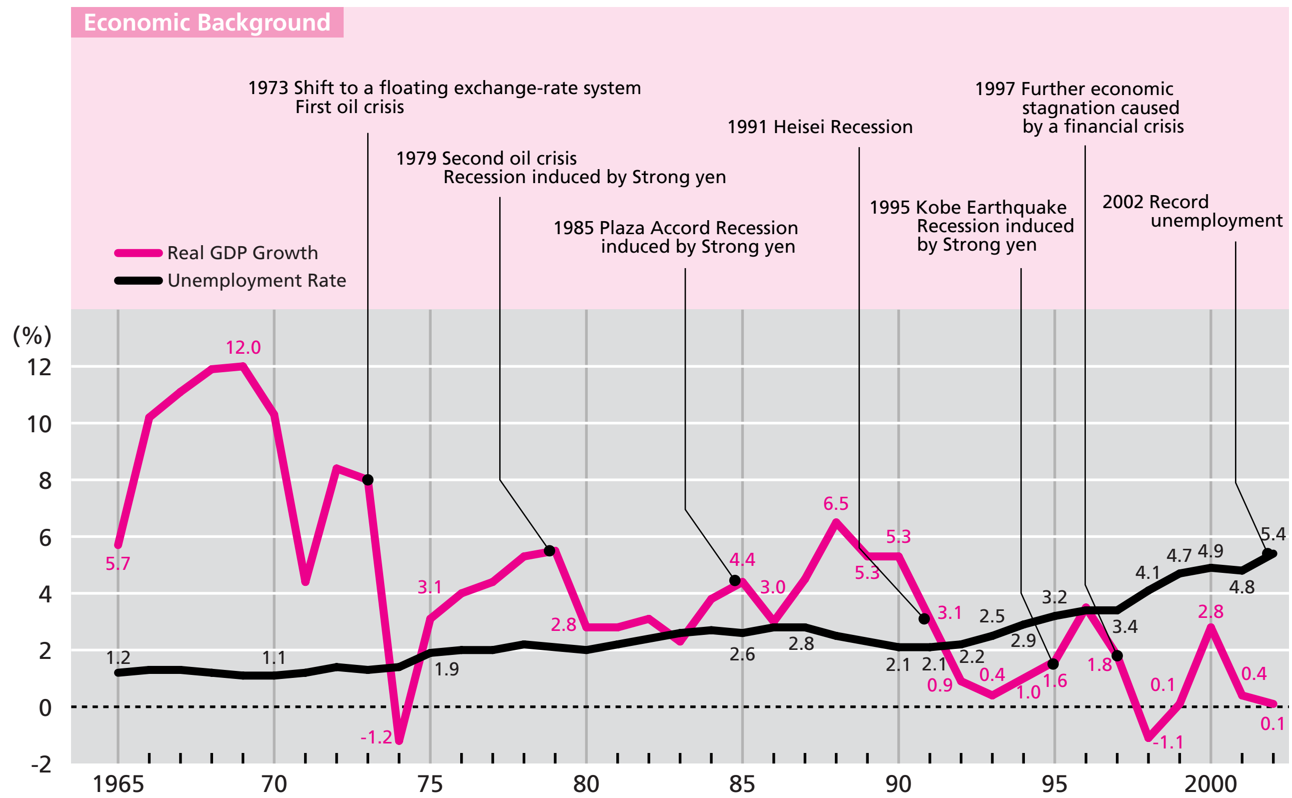
In response, the Japanese Government has attempted to shift from "administrative policies aimed at financial protection" to one of introducing market principles into financial administration. It has also supplemented public works projects by emergency economic measures and has taken measures to expand demand through steps toward permanent tax reductions. The effect of such policies brought a halt to the bottoming out of the Japanese economy in Spring 1999, and since the later half of 1999 the recovery of the Asian economy has also been partly responsible for the subsequent succession of moderate improvements.

Ongoing Deflation and a Rising Unemployment Rate

However, the economic recovery that started in the spring of 1999, was short-lived. The Japanese economy has been in a state of "slow deflation" (Cabinet Office) since 2001, and under that influence, the business situation is deteriorating further. Factors behind this deflation during the past few years include structural factors in terms of trade such as an increase in low-priced imports, demand factors arising from the weakness of the economy, and financial factors due to weakened intermediary functions of banks. It is highly possible that changes in the trade structure (exports and imports), in particular, have led to the decrease in employment in Japan mainly in the manufacturing industry (the so-called hollowing out of industry). There was a rapid increase in imports from China from 1995-2000 onward, and with this, the unemployment rate rose significantly, hitting a record high of 5.4% in FY2002. Moreover, there seems to be a trend toward a prolonged period of unemployment.

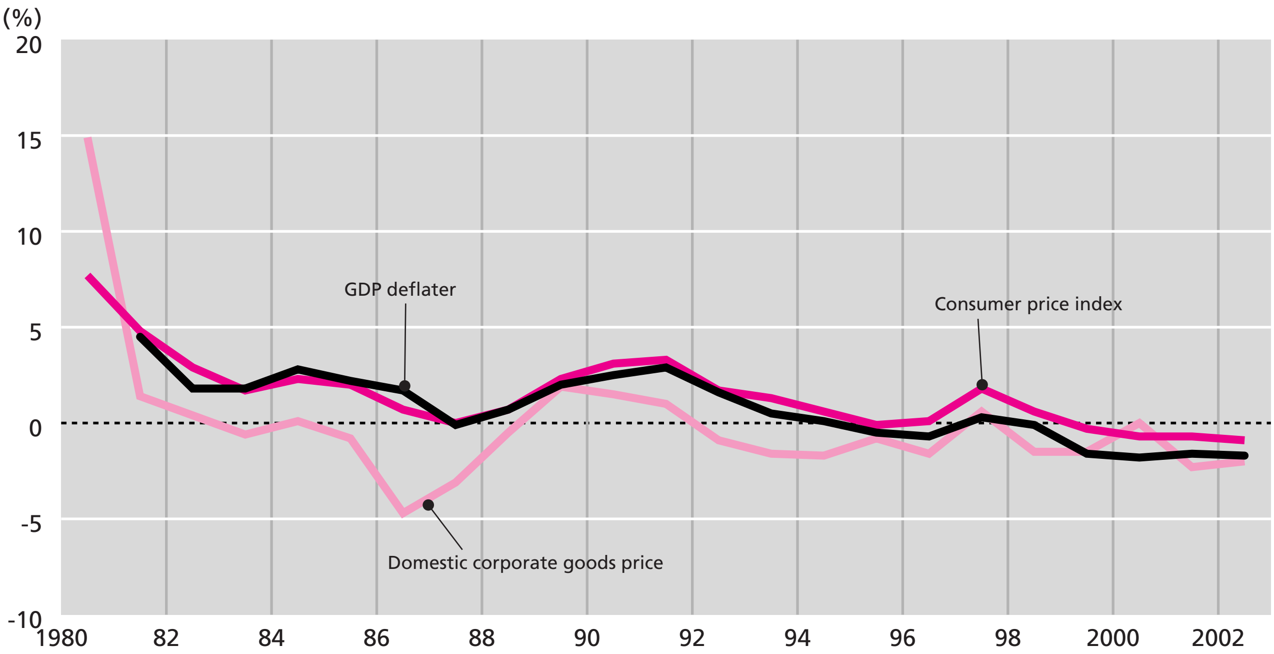
Therefore, under the circumstances, for the purpose of increasing employment in Japan, improving productivity and competitiveness in the area of high value-added products is required. In addition, as the hollowing out of industry continues, it is important to provide support for workers leaving domestic manufacturing industries so that they can make a smooth transition to other industries.

I-1 Real GDP Growth and the Unemployment Rate



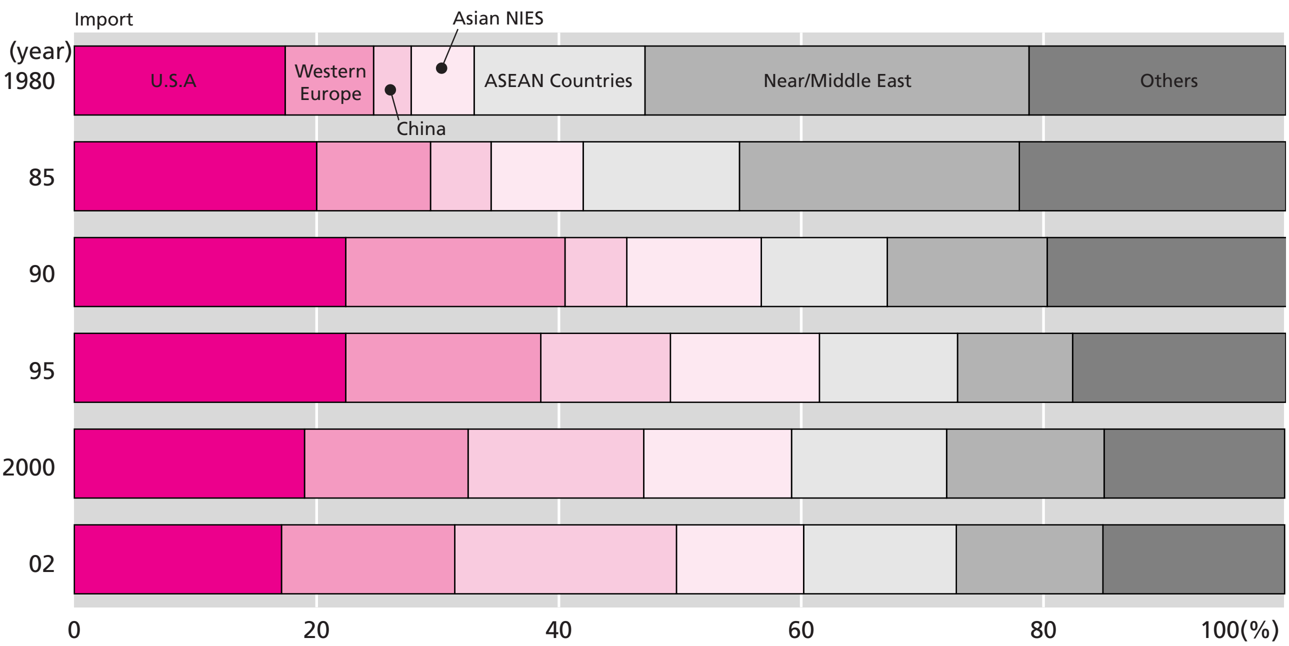
Sources: Cabinet Office; Ministry of Public Management Home Affairs Posts and Telecommunications
Note: Concerning the growth ratio in GDP, since 1981, this is based on the figures of the 1995 Standard Amended System of National Accounts (93 SNA), before 1981, the figures used are based on the 1990 Standard Amended System of National Accounts (68SNA).

I-2 Changes in the Price Increase Rate



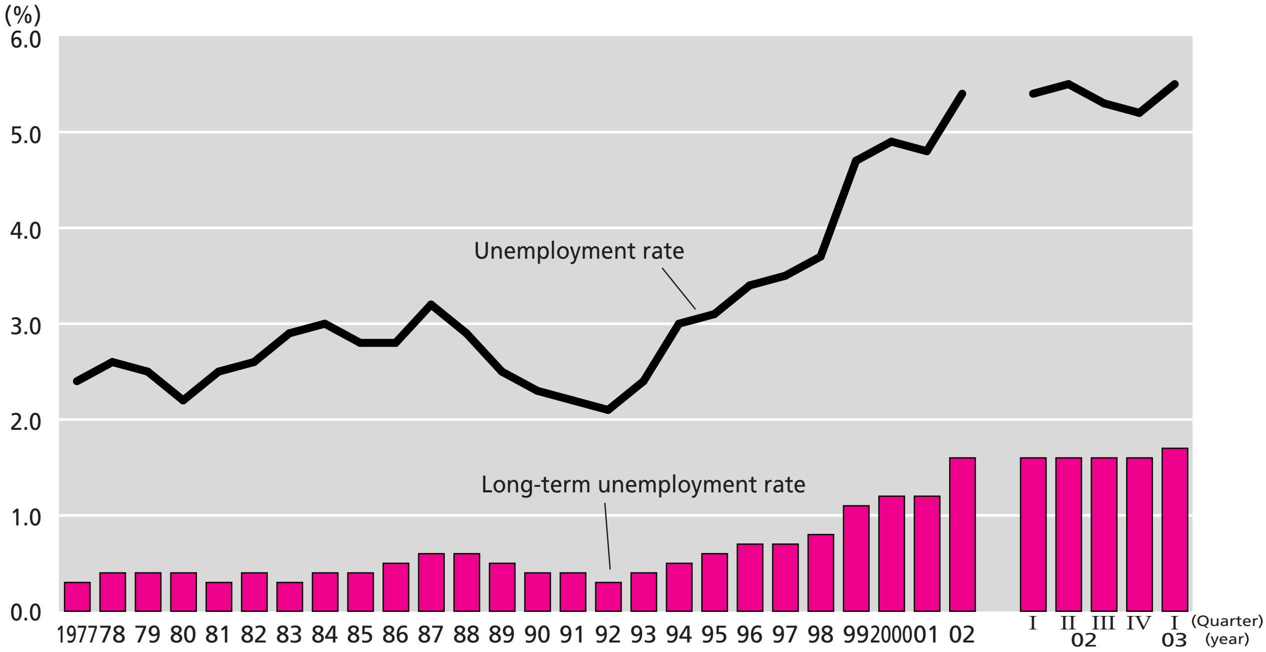
Source: *System of National Accounts,* Cabinet Office; *Consumer Price Index,* Statistics Bureau, Ministry of Public Management, Home Affairs, Posts and Telecommunications; *Domestic Corporate Goods Price Index*, Bank of Japan

I-3 Changes in Trade by Region



Source: *Trade Statistics,* Ministry of Finance
Note: Western Europe includes EU and EFTA member countries.
Asian Newly Industrialized Economies (NIEs) refers to the four following territories/countries – South Korea, Taiwan, Hong Kong, Singapore.
ASEAN countries refer to the four following countries – Thailand, Malaysia, Philippines, Indonesia.

I-4 Changes in Unemployment and Long-term Unemployment Rate



Sources: *Labour Force Survey* (1977-2001) and *Labour Force Survey (Detailed Tabulation)* (2002–), Statistics Bureau, Ministry of Public Management, Home Affairs, Posts and Telecommunications

Notes: 1) Long-term Unemployment rate = the number of persons unemployed for one year or longer ÷ labor force

2) Figures are from every March up to 1982, every February from 1983 to 2001, and the annual average for 2002.

2 Japanese Corporate Management Systems

The Essence of Japanese-style Management

The international competitiveness of Japanese companies grew stronger in the 1980s, and Japan began exporting huge quantities of industrial products. This phenomenon was particularly recognizable in processing and assembly industries such as electrical machinery/appliances and automobile industries. Due to this, "Japanese-style management" began to gain attention abroad, and its essence was recognized as lifetime employment, seniority-based wages, and company unions. Together, these management methods served as a mechanism in which both managers and employees could develop their knowledge and ability within the company in the security of the practice of long-term stable employment. The result was that expertise and know-how was accumulated within the organization.

Corporate Groups and Keiretsu

The accumulation of expertise and know-how did not stop within each individual company, but extended to a wide range of companies in the corporate group including subsidiaries, affiliated companies and partner companies, leading to the formation of "Keiretsu", typically in processing-and-assembly type industries such as electrical and auto manufacturing. The Keiretsu is a system for social division of labor in which manufacturers of end products and of parts share information on management and technology on the premise of a long-term relationship and joint work on the development of new products and other projects on a continuous basis.

Corporate groups and Keiretsu provided ample funds to companies through financing from the main financing bank and other means, allowing the diversification of operation and the expansion of the corporate group. In addition, cross-shareholding allowed companies to receive capital gains as stock prices continued to rise, and prevented hostile takeovers. The bonds among companies in corporate groups were further strengthened by personal connections such as appointment of a company's executive as a board member of another.

Asset Deflation and Non-performing Loans

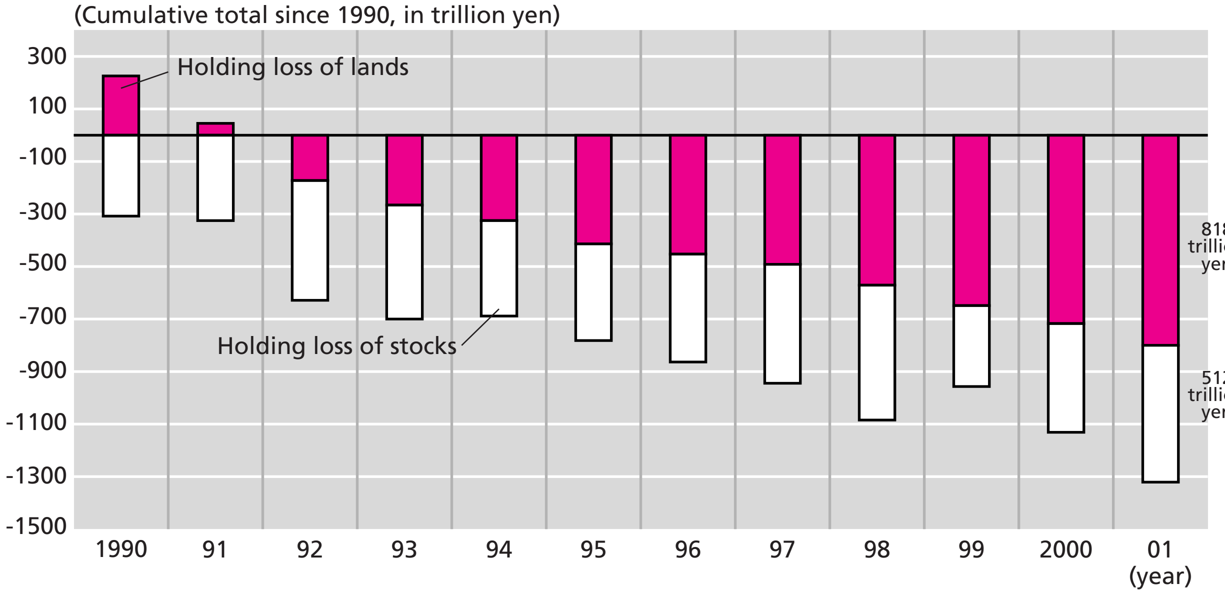
The management environment surrounding companies changed drastically after 1990 when the bubble economy burst. Asset deflation became a serious problem as land and stock prices fell, resulting in the capital losses of 1,330 trillion yen during the period from the end of 1989 to the end of 2001. These huge capital losses damaged the asset quality of banks; as of the first half of FY2002, the amount of remaining non-performing loans for all banks is approximately 40 trillion yen, and city banks and other major banks accounted for 60% of this amount. In addition, city banks accounted for nearly 80% of the 77 trillion yen in accumulated non-performing loans disposal losses from FY1995 to the first half of FY2002. Such deterioration of the asset quality of major banks has caused decrease in cross-shareholding practices and provision of funds, which is still ongoing, and management systems based on the corporate group and Keiretsu with the main financing bank at its core are changing rapidly.

The Progress of Corporate Reorganization

With main financing banks unable to provide corporate bailout functions as effectively as they used to and decrease in the profitability, more companies that have overcapacity and debts have begun to select and concentrate business domains, and the number of mergers and acquisitions (M&A) is on the rise. Moreover, the way these are done is changing: in the early 1990s, corporate acquisitions and capital participation were predominant, but recently, the proportion of mergers and business transfers is growing. The ratio of M&As between Japanese companies has also been on the rise. The increase of business restructuring has triggered a review of the practice of dealing exclusively within Keiretsu, and causing companies to deal more with companies outside

I-5 Holding Loss of Lands and Stocks

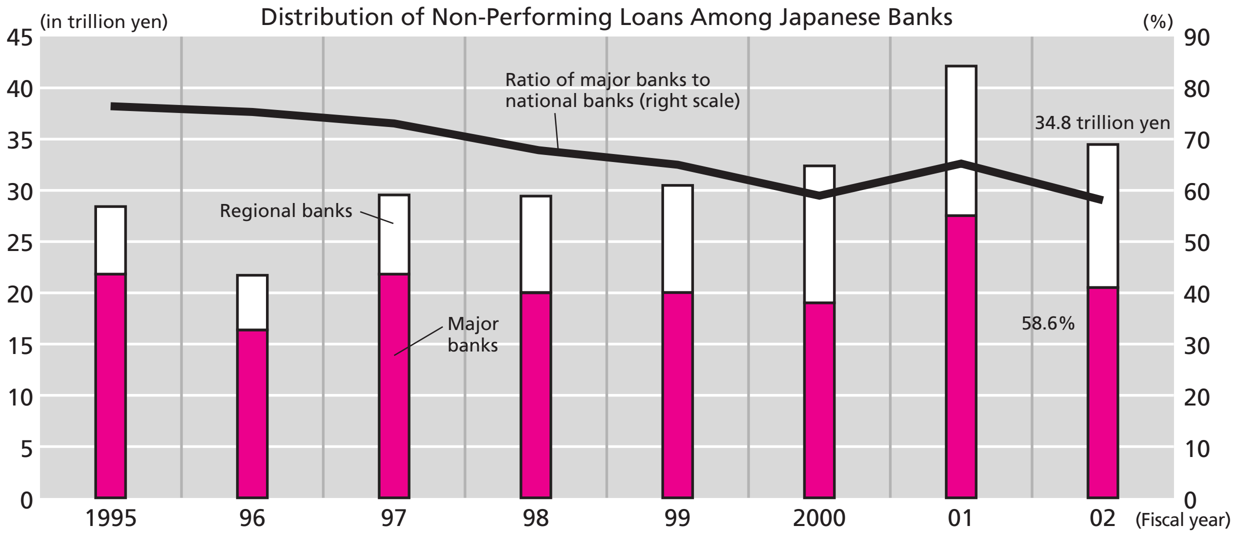
Capital loss in post-bubble Japan has been huge



Remarks: 1. Created from *System of National Accounts,* Cabinet Office.
2. Figures are based on 68SNA for 1990 and 93SNA since 1991.
3. The 1990 figure for lands includes forests.
4. Concerning figures for stocks, it must be noted that there are some differences between 68SNA and 93SNA, such as estimate methods for unlisted stocks.

I-6 Non-Performing Loans of Japanese Banks

Non-performing loans have been held and disposed largely by major banks



Remarks: 1. Created from the materials issued by the Financial Services Agency.
2. Figures for major banks are the total of figures for city banks, long-term credit banks and trust banks.
3. Figures for the following banks are not included: Hokkaido Takushoku Bank, Tokuyo City Bank, Kyoto Kyoei Bank, Bank of Naniwa, Fukutoku Bank, and Midori Bank since FY1997; Kokumin Bank, Kofuku Bank, Tokyo Sowa Bank since FY1998; Namihaya Bank and Niigata Chuo Bank since FY1999; and Ishikawa Bank and Chubu Bank since FY2001. In addition, figures for Shinsei Bank are not included in FY1998 and those for Aozora Bank are not included in FY1998 and FY1999.

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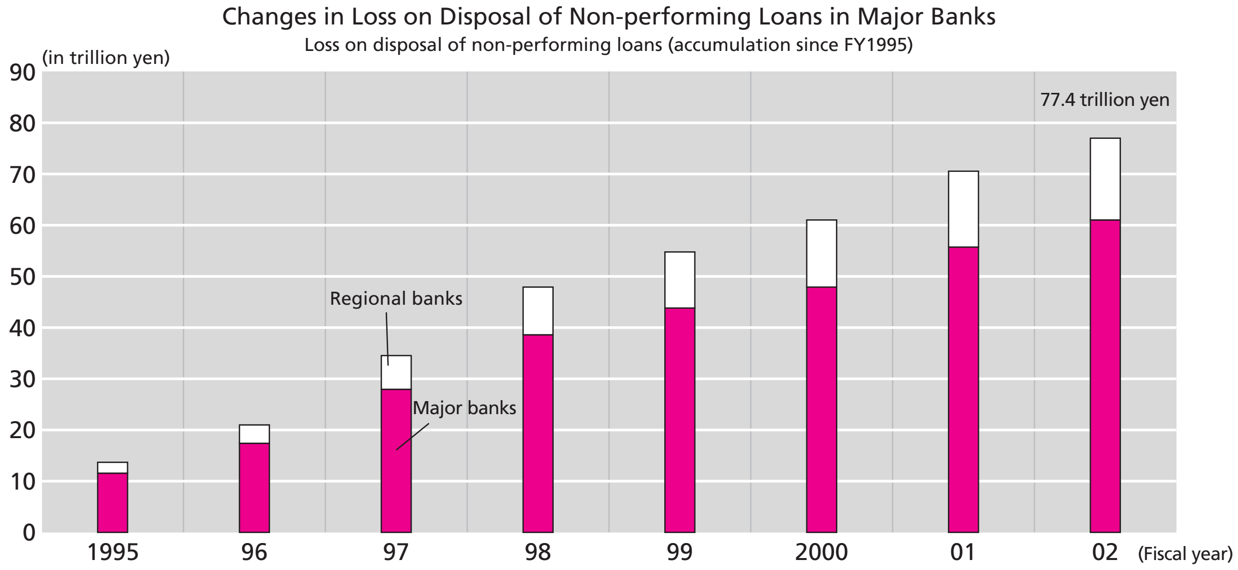

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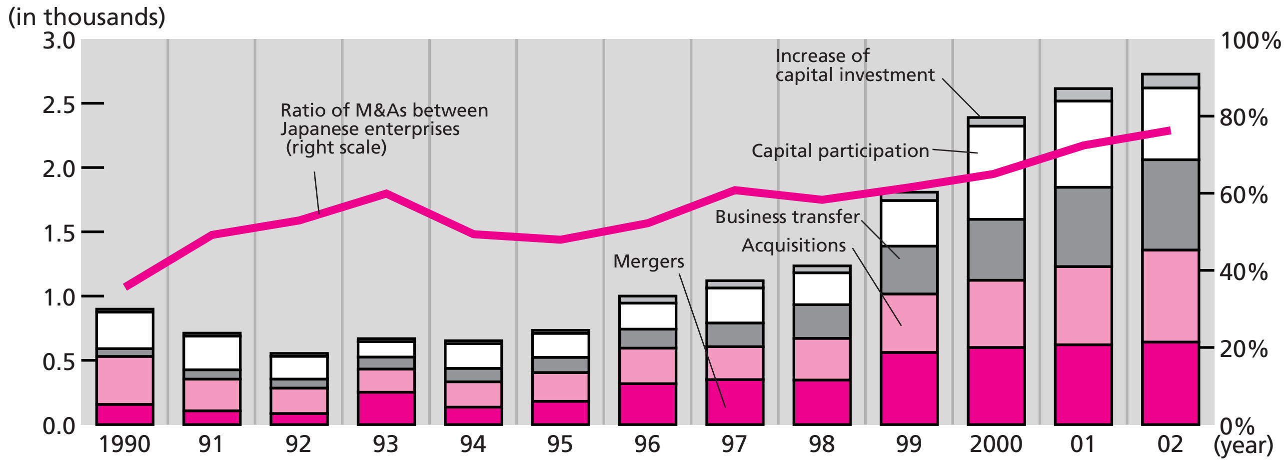
Ⅰ-8 Changes in the Number of Mergers and Acquisitions (M&As) by Type

M&As have been increasing since 1992



Remarks: 1. Created from *Databook on M&As of Japanese Enterprises 1988-2002,* RECOF Corporation.
2. According to the *Databook,* the definitions of M&A types are:
(i) Merger: Two or more companies become one company by concluding a contract.
(ii) Acquisition: The acquisition of over 50% of stock by stock acquisition, capital increase, stock exchanges, etc. or management buy-outs(MBO).
(iii) Business transfer: Sale/purchase of a company's operations including assets, employees and market areas, or integration of existing businesses.
(iv) Capital participation: Same as acquisition except that the stock acquired does not exceed 50%.
(v) Increase of capital investment: Additional acquisition of 50% or less by a party who is already a shareholder.

Sources of Figure I-5～8: Annual Report on the Japanese Economy and Public Finance, 2003, Cabinet Office

Keiretsu in an effort to achieve cost reductions. It has also had an impact on long-term stable employment practices such as lifetime employment and seniority-based wages, and led to the diversification of employment patterns, which include the review of seniority-based wages, increased mobility of workers by job change and employment adjustments, decrease of regular, full-time employees and increase of part-time workers.