The 21st Century World Economy and the Challenge for Japan

―Aiming at a Strategy for Renewed Dynamism―

January 2001

Japan Economic Research Institute

Foreword

Since rallying strongly in the 1990s, the U.S. economy has enjoyed the longest period of expansion in history. In contrast, the Japanese bubble burst, and the economy has been enduring a prolonged period of stagnation.

A key factor in this growing economic gap is considered to be the difference in how the two countries have responded to the challenges of a changing economic environment amid the various differences in their political, economic and social systems.

In February 1999 the Japan Economic Research Institute (JERI) established the Investigative Committee on Japan-U.S. Economic Relations (Miyauchi Committee). The Committee compiled a report of its findings under the title "*21st Century World Economy and the Challenges for Japan — Aiming at a Strategy for Renewed Dynamism*".

The Committee comprised Chairman Yoshihiko Miyauchi (Director of JERI, and Chairman and CEO of Orix Corporation), Chief Coordinator Heizo Takenaka (Member of JERI Research Council, and Professor, Faculty of Policy Management, Keio University), Coordinator Tetsuro Sugiura (Chief Economist, Economic Research, Fuji Research Institute Corporation), and many other prominent members of the financial and business community.

From its comparison of the U.S. and Japanese economies within the international economic framework, the Committee has recognized that Japan faces many issues in effectively utilizing the superior aspects (institutions, norm, etc.) of a fair competitive system to raise its competitiveness in global markets, and has made a range of recommendations regarding important medium-term issues. It is hoped that this report can contribute to a deeper understanding of the U.S., and to debate on how Japan can best meet the needs and challenges of the 21st century.

Moreover, considering the importance of the U.S. economy in the world and the close ties it has with the Japanese economy, the Committee will continue its invaluable work in this area.

In closing, I should to express my sincere gratitude to Chairman Miyauchi, Chief Coordinator Takenaka, Coordinator Sugiura, Committee members and the many other people concerned who found the time in their busy schedules to play an important part in the formulation of this report.

January 2001

Toru Hashimoto

Chairman of the Board of Directors
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Preface

This report brings together the findings of the Investigative Committee on Japan-U.S. Economic Relations (Miyauchi Committee), which was organized in February 1999 by the Japan Economic Research Institute, under the title *"The 21st Century World Economy and the Challenges for Japan."*

The world economy in the 1990s was overwhelmingly dominated by the U.S. economy, while the standing of the Japanese economy plunged. Throughout this decade the macroeconomic performance of the U.S. remained strong, and at the microeconomic level as well, American industry and companies elevated their competitiveness through the widespread introduction of IT. Meanwhile on the other side of the Pacific in Japan, businesses were forced to endure a prolonged recession following the bursting of the bubble economy.

Taking note of the lessons to be learned from U.S. economic supremacy, Europe also sought to hasten economic growth through the extensive use of IT and revitalize its industrial base by improving the supply side. In Asia as well, countries started to emerge from the shadow of the economic and financial crisis that struck in summer 1997, and began aggressively tackling economic growth, deregulation and technological development under an IT banner.

What seems to have caused a gap to open up between Japan and the U.S. in the world economy is that the U.S. response to massive environmental change, such as globalization and revolutionary technological innovation in IT, under an open market economy has been both precise and prompt, whereas Japan has failed to recognize the true scale of this change and its impact, and has therefore been slow to take the necessary drastic action in response. A key factor contributing to the delay in Japan's response is an inadequate functional capability to shift resources to efficient fields promptly, which was caused by various government regulations, business management style, inflexible employment relations, and a financial structure that relies on indirect financing. These deficiencies are, however, currently under review.

Having started with studies on a comparative analysis of the U.S. and Japanese economies, the Committee has come to share a strong sense of crisis that unless Japan quickly reforms its economic system, and corporate management and political policy-making structures in line with the rapid changes taking place in the domestic and external business environment, the nation's revival within the global economy of the 21st century would indeed be difficult.

Based on such fundamental perceptions, this report makes policy recommendations on priority issues that Japan must tackle in the medium term under the heading *"Aiming at a Strategy for Renewed Dynamism",* such as the utilization of the "Big Bang" formula, and construction of "soft power" and "risk taking" societies, with a view to Japan's economic revival. Recognizing that the U.S. provides an especially valuable model for Japan to deal with the issues it is facing, the report also points to the need for a permanent research organization focusing on the U.S.

As we enter the 21st century, Japan faces a historical turning point, but the government has initiated a new structure with the reorganization of its ministries and agencies. We hope that these recommendations will help to give new direction to the government and the private sector, and to the division of roles and responsibilities between them.

In closing, we should like to express our sincere gratitude to the Committee members and various other people concerned for their valuable cooperation in the preparation of this report.

January 2001

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1. Toward an era of complete U.S. economic domination

In the 1980s and 1990s, Japan's standing in the world economy plunged while the U.S. climbed to a position of unrivalled economic supremacy.

After Japan's economic bubble burst, growth plummeted to below 1%, and many industries that had until then boasted of their strong competitiveness and extensive presence in the world's markets were suddenly faced with a broad range of problems and difficulties. High-tech industries could not keep up with the rapid pace of IT (information technology) innovation, while the automobile industry lost considerable ground in price competitiveness. Financial institutions were left holding massive amounts of bad debt, and were therefore stripped of the capacity to meet the challenges posed by financial technological innovation, such as globalization and derivatives. Consequently, when the collapse of many financial institutions in autumn 1997 gave rise to credit uncertainty, Japan was enveloped in a severe business downturn. Japan endured two consecutive years of real negative growth, unheard of since the end of the war, and there was a perception that Japan's recession and credit uncertainty could trigger worldwide economic and financial turmoil.

In contrast, the U.S. economy, which had stagnated from the latter half of the 1970s through the 1980s, turned around in the 1990s. Economic growth greatly exceeded the level considered to be the maximum (potential growth rate) at that time, while business enjoyed the longest period of expansion in American history, resulting in a drop in the unemployment rate to levels not seen for three decades. At the same time, inflation was under control, and interest rates remained low. Reflecting such an unprecedented economic performance, stock prices soared, and this in turn lifted business confidence even higher.

Along with its strong macroeconomic performance, the U.S. also returned to a position of dominance in industrial competitiveness. Cost competitiveness improved against a backdrop of labor cost restraint and rising productivity, and accelerating technological innovation centering on the Internet and other areas of the broad IT field boosted productivity, and led to the development of pioneering products and services. The U.S. formed an innovative business model, which displayed its strength in corporate management and its supporting systems. Corporate restructuring concentrating on management resources in areas of comparative advantage, management innovation that realizes a strong customer base and profitability through M&A, management models that make effective use of IT to link vast amounts of information with earning opportunities, and corporate governance that aims at maximizing stockholder worth and management transparency and an accounting system that underpins this are among the many factors contributing to the rising stock prices and increases in the value of companies, and from this, the expanding U.S. corporate supremacy. The aggressive investments in high risk companies or businesses with the potential for substantial growth and a fluid labor market that enables talented people to assemble in growth fields have supported U.S. economic, industrial and corporate growth. In this way, the U.S. economy, industry and companies established their supremacy — or complete domination — over their international counterparts in the 1990s.

Countries in Europe and Asia are taking note of this domination, and are seeking to survive global competition and realize their own economic prosperity by following the U.S. model. Europe is looking to IT as a trigger to promote economic growth, create demand and revitalize industry through the “e-Europe initiative”. Germany is endeavoring to expand risk money by lowering corporate tax rates and abolishing tax on stock transfer profits as a means of accelerating industrial and corporate revitalization.

In Asia, governments are speeding up their disposal of the mountain of bad debt left by the economic and financial crisis from summer 1997, and actively tackling deregulation and technological development with a view to IT-centered economic growth. We can therefore say that the world economy is now clearly entering the “American era”.

2. Causes of the U.S. revival and Japan’s failure

What caused this shift from the Japanese era to the American era? Why did the Japanese era in the 1980s end after only a short time, and, conversely, why was the U.S. able to achieve its rapid revival after enduring such a prolonged period in the economic wilderness?

On the U.S. side, both the government and the private sector had the capacity for self-reform in which they accepted change, and quickly revised and adjusted strategies in response, rather than sticking to and prolonging past failures. The nation had the socioeconomic base that could support this. What led to the manufacturing industry recapturing its former industrial competitiveness was extensive research by MIT (Massachusetts Institute of Technology) on the Japanese manufacturing industry (*”Made in America”*), and the active adoption of Japanese style production methods by U.S. companies. Company management also underwent substantial and flexible change from the pursuit of economies of scope through diversification, to the selection of and concentration on business areas to raise competitiveness, pursuit of economies of scale in response to market globalization, and realization of economies of network utilizing the Internet and IT technology. What made this possible was the aforementioned efficient financial market and the fluid labor market, and universities that produce creative and talented personnel especially in the IT field (a brain drain from Asia to the U.S. also contributed greatly to this). The government backed up technological development and the development of a market environment through deregulation to make IT the driving force of the economy, and a revised tax system contributed to revitalization in various aspects.

Forming the backdrop to Japan's protracted and serious economic slump was the fact that when faced with major environmental change, such as economic globalization and IT innovation, in Japan unlike in the U.S., the government, companies and individuals failed to properly grasp the realities of the change and the impact it would have, so their response took too long. Even once countermeasures had been prepared, their implementation lacked any urgency. The accelerating pace of economic globalization and IT innovation demands greater efficiency through market competition, and a shift from traditional organizations that are a pyramid of multistage mediating functions to organizations that can make prompt decisions. However, while the various systems that have formed the foundation of the Japanese economy contribute to the stable expansion of industries, companies and employment, they do not necessarily enable an adequate response to the kinds of major environmental changes mentioned above.

The entrenched business ties between companies under a corporate grouping (*keiretsu*) umbrella, such as a main bank and company, parent company and subsidiary, and assembly company and parts supplier, were effective in reducing business risk and promoting the stable expansion of business, but in an increasing number of cases, such entrenched ties have in fact been a hindrance when a company attempts to slash costs under global competition. The recent growth of e-commerce on the back of the Internet and other areas of IT innovation is giving even greater momentum to this trend.

As for Japanese employment, lifetime employment and the seniority-based wage system, which have played a key role in building a stable employment relationship, undermine corporate profitability and competitiveness. They also hinder labor market fluidity and prevent the appropriate transfer of human resources into growth fields, while being an obstacle to workers' displaying their ambition and capabilities. In the financial aspect, many companies are still caught up in a financial structure heavily dependent on indirect finance centered on bank deposits and loans, and this is the underlying cause of massive amounts of bad debt. This also lowers the allowable investor risk level, so the efficient distribution of funds into growth fields is not always fully realized.

The delay in the response to the above change in the environment was largely due to government regulations. In the non-manufacturing industries in particular, government regulations protected the vested interests of specific groups, and prevented the proper competition-based distribution of resources. Even today regulations are still holding back the expansion of technological and market frontiers that first opened up under the IT revolution. Moreover, even if measures are taken to relax regulations, there have been more than a few cases where politicians or bureaucrats, or at times companies or individuals, work against their implementation, and often debate over deregulation itself reaches a stalemate in the face of fierce resistance to it.

3. Doubts about U.S. prosperity

On the other hand, many pundits have expressed doubts about U.S. prosperity and economic supremacy. While it is true that structural change to the American economy against a background of IT innovation and corporate restructuring has delivered long-term growth and rising stock prices, it has also been pointed out over the past several years that this has generated a "bubble-like" feeling of euphoria and excessive optimism regarding the U.S. economy and companies. There is also a deeply rooted wariness that while the so-called IT revolution has lifted productivity and brought high growth and low unemployment without inflation, it cannot continue forever.

In the process of this economic growth, the budget deficit, one of the twin deficits, was cleared, but the other, the current accounts deficit, has been climbing sharply. The possibility has been raised that if overseas investors financing this deficit were to hold back on their investment funds over doubts about the U.S. economy's potential for continued growth and concern about the credit risk accompanying the ballooning foreign debt, the value of the dollar would fall, interest rates would rise, and stock prices would drop, bringing an end to the U.S. economic growth mechanism. There are also concerns that the growing wages gap in the midst of this prosperity may have serious social consequences.

In any event, should U.S. economic expansion cease, or the prosperity mechanism have to be altered for reasons like those mentioned above, various other countries that have been trying to incorporate the factors contributing to the U.S. revival into their own economic development mechanisms will also have to rethink their growth strategies. This has led us to our view that rather than copying the American model or following the Japanese model of old, Japan should search for a third path.

4. The American era will still continue

However, the Committee and its corporate executive members share a strong sense of crisis that unless Japan quickly reforms its economic system and corporate management and policy structures in line with the rapid changes taking place in the business environment, and promptly implements the countermeasures it has formulated, economic revival will indeed be difficult. At the same time, even though the American model is not free from problems, we believe it is the most practical and effective model for resolving the various issues Japan is currently facing, enabling Japanese industry to survive global competition, and facilitating economic and business revitalization.

In fact, despite the various concerns mentioned above, the U.S. economy is still enjoying its longest period of growth in history, though rising interest rates have slowed down the pace somewhat. If, however, the economy can achieve a soft landing at sustainable levels, business will continue to flourish for quite some time. Moreover, there is increasing recognition that the American model of technological innovation, market efficiency and flexibility, and institutional structures and the educational system is playing a vital role in this long period of strong growth. The U.S. is amplifying its “soft power” — a persuasive power that can convince other nations to revise their views to the direction desired by the U.S. — through the power of information and its cultural appeal in addition to its economic and technological might, as the countries of Europe and Asia actively strive to adopt the U.S. growth model. American supremacy is becoming even more entrenched over an extensive range that includes not just macroeconomic performance and industrial and corporate competitiveness, but institutional structures and educational systems as well.

5. Catching up again through the construction of a renewed dynamism

We believe a critically urgent issue for Japan is to build a renewed dynamism by changing the systems and practices that are holding back economic revitalization and reform, and through this, foster an environment that will give Japan the momentum to catch up to the dominant U.S. This will also, in turn, arouse a new confidence and determination among companies, individuals and the government that has been lacking for some time. During Japan's period of high growth, the hunger to catch up to and pass the U.S. was the driving force to economic development. Today, Japan needs to feel a sense of crisis that unless it pushes ahead with reform, it will be left behind not just by the U.S., but by the countries of Europe and Asia as well. It therefore must once again strive to catch up to the U.S. by introducing a renewed dynamism, while maintaining its position of relative ascendancy over the countries and regions of Europe and Asia.

At the same time, the efforts made here must prepare Japan for the various risks that will arise in the future, and give full scope to Japan's strengths and distinctive qualities, rather than simply be directed to closing the gap with the U.S. As already mentioned, the American era is likely to continue for some time yet, but if the U.S. economy were to falter, it is crucial that Japan has the toughness and flexibility to be able to cushion the impact from this. This was our reasoning behind the subheading of "*Aiming at a Strategy for Renewed Dynamism*".

Moreover, it is important for Japan to consider the toughness and flexibility it needs to develop not just in the context of its bilateral relations with the U.S., but also with respect to its relations with the other countries in Asia.

Before reaching the above understanding of the issues, we the Committee members held active discussions in which many ideas and opinions were expressed, while dissecting in detail the process by which the U.S. has been able to breathe new life into its economy. We have made a number of recommendations to realize the views we hold based on this.

Recommendations

In the light of the preceding Fundamental Perceptions, the detailed analysis deliberated by the Committee concerning the mechanism by which the U.S. economy was revitalized, and a failure of Japan to move ahead despite widespread and repeated calls for structural reform, Japan must now overcome the substantial delay in its economic revival, and build a renewed dynamism that will facilitate a rapid "strategic catch-up". After examining important issues to this end from the perspective of corporate management, the Committee makes the following recommendations regarding medium-term objectives for Japan.

(1) Japan must reflect on its past failure to tackle drastic reform in the face of rapid economic and technological advances, and build a renewed dynamism that will facilitate a rapid "strategic catch-up". Japanese government should set the following medium-term objectives and key challenges, and carry out specific action programs swiftly.

1) Quickly bring Japan's economic and financial infrastructure up to global standards by accelerating deregulation under a "Big Bang" formula, and rapidly developing a competitive market environment.

2) Build a "soft power" society. This requires the creation of Japanese de facto standards, reform of higher education, and urban revitalization.

3) Build a "risk taking" society. This requires the development of an environment that promotes challenges to new frontiers, and an increase of risk capital.

4) Take the lead in the construction of an Asian network. This requires the realization of a free trade agreement within Asian region, construction of a

high-speed communication network, establishment of a regional financial support structure, and globalization of the yen leading to regional currency cooperation.

(2) To achieve the above objectives, there has to be a common understanding of crisis that Japan is indeed lagging well behind in global competition and IT innovation, and in the economic and industrial vigor that can take advantage of it, and a national consensus on building a renewed dynamism that will enable Japan to catch up to its overseas competitors. Accordingly, there is a need to establish the "U.S. System or New Economy Study Group" (tentative name) comprising businessmen and researchers primarily from the U.S. and Japan. This study group would comprehensively analyze the factors in and the risks associated with the U.S. revival, and make recommendations on the policies that Japan should adopt.

1. Reforming the economic infrastructure to global standards

Economic globalization is generating competition among countries and among systems. The most effective countries and systems are attracting the most companies, talented personnel, and investment funds from all parts of the world. Taking the lead in this is the United States, a nation structured on an open market economy.

Japan, on the other hand, still has many regulations that inhibit the creativity and resourcefulness of companies and individuals, and even where regulations have been systematically relaxed, often the implementation was delayed in the face of resistance from various vested interests. Moreover, Japan's taxation and accounting systems are at odds with global standards. This places an excessive burden on companies and makes it difficult for them to gain market confidence, and as a result, Japanese companies and individuals are not able to display their full potential and competitiveness. This, in turn, is hindering Japan's efforts to attract overseas companies and talented personnel.

Japan must expedite its efforts to ease regulations that are out of step with the demands of the times, or that stifle competitiveness and potential, and immediately reform the systems and mechanisms that are at odds with global standards.

(1) Realizing a series of "Big Bangs"

Under a banner of "free, fair and global", Japan's financial "Big Bang" pushed through in just 3–4 years the kind of financial market deregulation that the U.S. and Europe had been promoting for 10–20 years. Foreign exchange transactions were freed up in principle, restrictions separating banks, securities houses and insurance companies were lifted, and brokerage fees and nonlife insurance premium rates were liberalized, resulting in a substantial drop in the cost of financial transactions. Transactions became more efficient, foreign financial institutions showed new enthusiasm for the Japanese market, and restructuring and mergers among local financial institutions gained momentum. This marked the beginning of Japan's program of building a renewed dynamism that would raise the international competitiveness of the local financial markets and financial institutions, and enable them to catch up to the leading U.S. and European financial institutions.

There are many fields in Japan that require sweeping deregulation and the rapid development of a competitive market environment under the "Big Bang" formula. Public works is one area where the government must discard the principle of past performance that binds projects to vested interests, and pursue a scrap-and-build program based on efficiency and necessity. Telecommunications is another area where the interests of powerful companies with monopolistic influence must be overcome, and comprehensive and diverse reform must be tackled from the users' perspective and from the viewpoint of raising overall competitiveness of Japan to facilitate the effective use of the communication infrastructure and the entry of new market players. The government should review the overall public-sector business activities and organization of the postal service, fiscal loan and investment program, and other state-run enterprises whose operations have expanded beyond the original reason for their establishment of supplementing the private sector, or that are facing business difficulties, and examine the privatization of enterprises where this is considered the best option.

“Big Bang” reform would also be effective for the restructuring of Japan’s political system. There is an urgent need for a review of the structure of the Diet, where the disparity in the value of individual votes has become too large and the decision-making process is out of touch with the needs of the people, and of local government, where excessive centralization of power and financial resources has made it almost impossible to deliver the services demanded by the regions.

Such a bold and diverse series of “Big Bangs” carried out concurrently is indeed a necessity for Japan to build a renewed dynamism.

(2) Developing special economic zones to serve as models for reform

The active establishment of special economic zones is also an effective way of accelerating reform. When examining factors holding back Japan’s IT revolution, we realized that various minor regulations, such as the laying of power lines and the use of utility poles, are a major restriction on business operations. To overcome this, it is important for Japan to carry out a regional trial in which an area is set aside as a free and competitive zone similar to China’s special economic zones. In the U.S., the evolution of divergent systems from state to state, e.g. the completely different commercial laws in Delaware and California states, has resulted in a national framework that encourages competition. Japan does not have such a framework, so the government needs to take the lead and create special economic zones; for example, a special IT zone with an advanced telecommunication infrastructure where minimal business regulations and no financial or tax restrictions on investments guarantee the freedom of action by companies and workers, and where IT innovation and its application in business and in general life is actively promoted.

2. Building a "soft power" society

Just as in the case where "soft power" — economic, technological, information and cultural influence — played a key role in the U.S. position of strength within the world, Japan must also develop its own "soft power" to attract various competent resources, especially from Asia, and take Japanese standards to the rest of the world. This will breathe new life into the Japanese economy and industry, and pave the way for strong economic growth, as has been borne out by the American experience. The following are specific measures.

(1) Creating Japanese de facto standards

Holding de facto or global standards is an extremely important strategy for the growth of not just companies, but the entire national economy. The U.S. holds numerous de facto standards, ranging from Internet, software, CPUs and other areas of IT, and e-commerce business models which utilize that technology, to corporate management methods and the accounting system that underpins them, and finance-related technological innovation. This has been the driving force behind American economic prosperity.

Japan, too, has an abundance of resources that can become de facto standards. To make the fruits of the IT revolution widely available, and link this to greater productivity and the creation of market frontiers, highly functional and user-friendly information terminals and interfaces are essential. This is one area where Japan is very competitive. The ubiquitous cellular phone is expected to play a pivotal role as an

Internet data terminal equal to (or even greater than) that of the personal computer, and Japan holds a major share of not just the hardware production, but the interface for Internet connection as well. Japan is also extremely competitive in the manufacture of digital household appliances, which are expected to show strong future growth as information terminals. Supporting Japan's hardware competitiveness in the IT field are outstanding processing and parts production technologies, and other manufacturing technologies that Japan has nurtured over many years.

Japan has the potential to generate global standards in information terminals and interfaces in this IT era. To consolidate this potential, Japan must quickly build an environment in which manufacturing technologies can be refined to such a degree that Japan is an unrivalled world leader, through the acceleration of IT development and human resources development..

(2) Reforming higher education to foster human resources with originality

In addition to the hardware technologies mentioned above, in today's IT revolution there is a rapidly increasing likelihood that new added value (driving force for growth) will be generated from specialist knowledge and its utilization, and original ideas and concepts and their actualization.

It goes without saying that outstanding ideas, concepts and technologies are generated by outstanding personnel. Both the prosperity of a company and the development of a nation depend on the presence of outstanding managers and leaders, and the core infrastructure for producing such personnel is the education system, and especially the higher education institutions (universities and postgraduate schools).

Higher education institutions played a crucial role in the revival of the U.S. economy. As can be seen in the close relationship between Stanford University and Silicon Valley, university and postgraduate school students and professors will often set up venture companies to market their own original ideas or technologies. Areas with prominent universities will accumulate R&D and technological development; a good example of this is the North Carolina capital of Raleigh, an education center with many fine universities, and the adjacent Research Triangle Park, which consists entirely of company R&D facilities. It is in places like this that new frontiers are created. MIT built the foundations for raising the competitiveness of the American manufacturing industry by extensively analyzing the strengths of the Japanese manufacturing industry. The theoretical base for technological innovation in finance, such as derivatives, was also developed at universities. U.S. universities and postgraduates schools such as these are a gathering ground for talented people from all parts of the world, which in turn further raises the level of American higher education, and so the cycle continues.

A diverse range of factors have contributed to the growth of such an excellent higher education system; for example, a labor market that stresses specialization, the competitive education environment, especially on the teaching side, students' desire to learn that is commensurate with the high cost of higher education, and elementary and secondary education systems that draw out students' talents and individuality from an early stage.

In contrast, in Japan the business community is gripped by a growing sense of crisis that the capability of Japanese universities and postgraduate schools to produce large numbers of outstanding personnel is diminishing. This can be attributed to superannuated research facilities, a weak funding base, and research themes and content that often fail to anticipate change, coupled with a lack of competition among and within universities. There is also growing criticism about a prominent decline in the scholastic level of university students. Against this backdrop, quality students and professors from Asia and other parts of the world are not necessarily coming to Japan.

To improve the standard of Japanese higher education, various reform issues have to be addressed, such as restructuring universities to raise competitiveness and expand their financial base, improving specialization through the establishment of distinctive curriculums at each university, promoting deregulation and competition at educational institutions, including the elementary and secondary levels, readily accepting overseas students, expanding higher education opportunities for adults, and building a system that can accurately evaluate and properly recognize original research achievements.

(3) Urban revitalization that can attract people and other resources from all countries of the world

Japan's prolonged recession since the 1990s has further lowered the capacity of its local economies to grow. In the 1980s, the machinery industry fuelled local economic growth, and with the high value of the yen and the progress of economic globalization, manufacturers aggressively expanded their operations through overseas production. Moreover, public investment (development of the social infrastructure), which formed the base for local economic growth in the 1960s and 1970s, is today used more as an employment measure than in its traditional role of driving the economy.

Nonetheless, there are still strong hopes for income transfer from urban to rural areas, as symbolized by the lavish spending on public projects. However, considering Japan's relative advantages from a global perspective, it would in fact appear to be the cities that are becoming tired. Without urban revitalization, there can be no economic revival. In this light, the government must inject a substantial level of resources into the cities, and especially the major metropolitan areas.

One survey indicates that only a mere 15% of the major foreign companies in Tokyo have their Asian head office in Tokyo. Compared with other primary cities in Asia, the number of international conferences held in Tokyo is only one-third the number held in top-ranked Singapore, and only one-half the number of second-ranked Hong Kong. Tokyo was overtaken by Seoul in international conferences several years ago, and is today only slightly ahead of Bangkok. Even in the midst of Japan's long recession, traffic jams slow down Tokyo's expressways to a crawl, the airport is inconveniently located far away from the city, and communication, transportation and freight costs are also among the highest in the world. We can therefore say that the attractiveness of large cities has put Japan at an overwhelming disadvantage.

The Leontief Paradox is a well-known proposition in economics. Professor Wassily Leontief (former professor at Harvard University) conducted a detailed study on America's dominant industries. The U.S. has the largest supply of capital in the world, and in his study Leontief expected to find that capital-intensive industries were dominant. However, he found that the opposite was the case — America's dominant industries were in fact the urban labor-intensive industries.

The advanced high added value industries we picture in our minds, for instance the finance industry dealing in the latest products such as derivatives, the software industry, and the consultancy industry, are all overwhelmingly urban and labor-intensive. In short, people and money are drawn to attractive cities. Information can be accumulated only when people gather together. It is for economic revival that urban revitalization is so important.

The government must give its highest policy priority to urban revitalization, including local core cities, and set up a structure for injecting substantial resources into that revitalization. Hastening the accumulation of urban industries and research centers by increasing social infrastructure investment in cities, alleviating congestion on city expressways, improving access to airports, and rethinking conventional urban planning will make cities more attractive, which in turn will facilitate Japan's economic revival.

3. Building a "risk taking" society

(1) Environment that can challenge new frontiers

Economic globalization and IT innovation are opening up diverse and rich frontiers for the economy. The U.S. faced these challenges with drastic business restructuring and the formation of venture companies, and has been enjoying the fruits of this effort. In other words, a preparedness to challenge new frontiers was an important key to America's economic revival.

Japan, on the other hand, may have a similar understanding of this, but it does not necessarily have an environment conducive to risk-taking by companies or individuals. Companies are still often held back from seizing the challenge of new business ventures by government regulations. Once an entrepreneur fails in a business, financial restrictions and a loss of social credibility make it very difficult for that person to restart a new business. Trying to display originality within a labor or educational environment that has placed so much importance on homogeneity is still a difficult task indeed. Even if a person succeeds in a new venture, progressive income tax and high rates of inheritance tax deprive the person of much of the fruits of his or her efforts, and limit the scope to pass the business on to successors.

To build a climate that grants an entrepreneurial spirit, the government needs to foster free market mechanism through deregulation, reform the tax system so that entrepreneurs are able to keep the fruits of their success to spur them on to new challenges, and realize a financial structure and bankruptcy legislation that allows entrepreneurs to learn from failure and renew the challenge. Specifically, it would desirable for the government to lower income tax rates and make the system as flat as possible, and also lower inheritance tax. On the financial side, there is a need to promote an expanded supply of funds based on the profit of the business, such as non-recourse loans and project finance.

(2) Increasing risk capital

Underpinning this entrepreneurship is risk capital. Japan's financial structure to date has placed too much emphasis on indirect financing, while the flow of funds to venture businesses and other enterprises with high potential but with an equally high level of risk was hardly more than trickle when compared to the situation in the United States.

This is, however, changing, and bringing about this change is a vast pool of private capital amounting to ¥1,300 trillion. In Japan's low-interest climate, the rise in bank and postal savings deposits has leveled off, and those funds are now being directed toward investment trusts and the stock market. This has prompted companies to look more to direct financing when procuring funds, and, coupled with the advent of new stock markets such as the Tokyo Stock Exchange Mothers and Nasdaq Japan, has increased the availability of funds for venture companies.

The introduction of a Japanese version of the 401k scheme in company retirement plans and a reduction of capital gains tax are essential to increase the supply of risk capital. The government should also examine without delay a system in which tax is levied on earnings after losses arising from stocks or other investments have been deducted.

4. Building and strengthening an Asian network

As stated earlier, the Committee believes it is highly likely the "American era" will continue for some time. Despite the growing gap between Japan and the U.S. in economic growth, judging from the close interdependent network built up between the two countries, especially in industry, and Japan's geopolitical significance, there can be no doubt that bilateral ties will remain important to both sides.

However, the potential growth of the Asian economy is extremely high, notwithstanding the rapid plunge caused by the economic and financial crisis from 1997 to 1998, and with the progress of economic globalization and the IT revolution, Asia will undoubtedly play a role in the expansion of the world economy on a par with that of the U.S. The Committee recognizes that as Japan strives to catch up, securing an important position within the fast-growing Asian region has become a crucial issue in that it will act as a driving force for Japanese growth, improve Japan's economic and financial flexibility and safety, and strengthen its economic security. The Committee also shares a concern that Japan's standing in Asia seems to be falling relative to America's and Europe's standing in the region. We therefore believe that as a medium-term goal, Japan must play an active role in building and strengthening an Asian network.

(1) Strengthening the product and service network — Promoting and expanding the free trade agreement (FTA) plan

Japan and the rest of Asia have been building up solid trade relations. In 1999, 44% of Japan's total overseas trade (monetary base) was with Asia, much higher than the 27% with the U.S. Though Japan makes more direct or securities investments in the U.S. than in Asia, the importance of the Asian region in Japanese investment strategies has certainly been on a rising trend over an extended period.

Forming a backdrop to these growing trade and investment ties linking Japan and Asia is an interdependent relationship in which both sides provide markets and supply products and parts to each other. An important factor in the Asian economic crisis was the severe business downturn in Japan and the resultant weak yen, while an equally important factor in Japan's business revival from 1999 was Asia's speedy economic recovery and expanded markets for Japanese exports. From this we can see that the macroeconomic and financial influence each side has on the other is becoming even stronger.

Promoting and expanding the FTA plan will play a vital role in further reinforcing these ties. The North American Free Trade Agreement (NAFTA) between the U.S., Canada and Mexico has raised the added value profile of the U.S. economy and industry, and contributed to a much more solid economic base for Canada and Mexico. It is obvious that FTA in Asia would become a driving force for strong economic growth in Japan, and throughout the entire Asian region, so this plan must be pushed at every opportunity.

(2) Strengthening the information network — Building the communication infrastructure

Along with products and services, the free flow of low-cost information will be essential in generating new added value and creating new frontiers. In all countries of Asia, IT is viewed as a springboard for economic growth, and efforts are being made to accelerate the pace of the IT revolution through high-speed Internet networks by lowering communication costs.

Metcalf's Law of Connectivity states that the value of a network is a function of the number of nodes connected to that network, and the value grows exponentially with each node, so if the information networks and infrastructures being developed in Asia were to be connected, the effectiveness and potential of this would be immeasurable. Building an extensive high-speed Internet network connecting the countries of Asia and reducing communication costs is therefore an urgent task for Asia as a whole.

(3) Strengthening the financial network — AMF, internationalization of the yen

One major cause of the Asian economic and financial crisis was the surge of massive sums of rapidly expanding global capital into the Asian market to create a bubble effect, followed by the massive and sudden exodus of capital to burst the bubble and stifle the flow of funds. As these countries rebuilt their economic and financial systems, and capital began to flow back in again enabling banks to resume their normal lending functions, domestic production and exports rapidly expanded, resulting in solid economic recovery.

As the world's largest creditor nation, Japan can play a major role in the still fragile Asian region. From a regional currency cooperation perspective, Japan should actively provide credit and funds to Asian governments, companies and financial institutions, promote the establishment of the AMF (Asian Monetary Fund) to help stabilize regional exchange rates, set up funds to expand investment in and loans to Asian growth enterprises, and internationalize the yen to reduce the Asian exchange risk that arises from the high dependence on the U.S. dollar.

5. Establishment of the “U.S. System or New Economy Study Group”

Before Japan can pursue a strategic catch-up, the nation as a whole must share a sense of crisis that Japan is lagging well behind in global competition and IT innovation, and in the economic and industrial vigor that can take advantage of it, and that unless something is done to rectify this, it will be left behind not just by the U.S., but also by the countries of Europe and Asia, which are following the U.S in accelerating the pace of reform. At the same time, a national consensus on the need for prompt implementation of sweeping reform that will enable Japan to catch up to its overseas competitors is essential.

Although such a sense of crisis and consensus has been shared by some businessmen and researchers, it is true to say that this has not gained widespread acceptance on a national scale. This has been due to inadequate interdisciplinary research on factors and risks associated with the U.S. economic revival, and the politics and policies related to it, and the belief, perhaps partly based on envy, that the U.S. is enjoying only a fleeting economic prosperity built on sand. Meanwhile in the U.S., both government and private organizations had conducted detailed research on various aspects of the U.S. economy, including the sources of Japanese strengths, and recommended necessary measures — e.g. the President's Commission on Industrial Competitiveness (Young Commission) looked at industrial technology strategies *"the Nation at Risk"* report examined education, and the MIT book *"Made in America"* analyzed competitiveness in the manufacturing industry.

We therefore believe there is a need to establish a private think-tank — "U.S. System or New Economy Study Group" (tentative name) — comprising businessmen and researchers primarily from the U.S. and Japan to analyze, debate and actively publish on the U.S. economic revival and how it relates to Japan's situation in an effort to generate a realistic sense of crisis in Japan and achieve a national consensus on the course of action that has to be taken.

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