

VIEWPOINT

Simple Is Best

The September 11 terrorist attacks in New York and Washington, which wiped out over 6,000 lives in an instant, constituted a horrifying and unprecedented disaster. My heart goes out to all who lost friends and loved ones.

These events dealt a major blow to the world economy, which was already slowing down, raising the specter of worldwide recession. Meanwhile, they have had a widespread impact on politics and society as well as the international situation, bringing to the fore such issues as doubts about American-led globalization, the accentuation of post-cold-war ethnic and religious tensions, the increasing fluidity of nations' diplomatic relations in regard to dealing with terrorism, and the balance between security and freedom. As the September 15 *Economist* put it, September 11 was truly "the day the world changed."

In Japan, too, the terrorist attacks have prompted debate on the best way to respond. On September 19 Prime Minister Jun'ichiro Koizumi, mindful that although Japan contributed \$13 billion to the multinational force during the Gulf War a decade ago this won it precious little grati-

tude from the international community, issued a seven-point list of "measures in response to the simultaneous terrorist attacks in the United States" emphasizing logistic support by the Self-Defense Forces. Debate on the pros and cons of overseas dispatch of SDF units has begun in the National Diet, but it gives the strong impression of being both intricate and picky, focusing on the arcane issue of the right of collective self-defense as well as such points as the conditions under which the supply and transport of weapons and ammunition and the use of weapons are permissible.

Times of crisis call for instant judgments. It goes without saying that putting in place thoroughgoing crisis countermeasures and conducting drills during normal times is crucial. When faced with crisis people tend to fall back on instinctive reactions. This means that countermeasures need to be simple and clear; countermeasures that cannot be understood without a lot of thought simply do not work in a pinch.

In September Heizo Takenaka, minister for economic and fiscal policy, delivered a lecture to the board of directors of the Japan For-

eign Trade Council in which he revealed the difficulties he had had in drawing up a reform schedule as part of the government's program of structural reform. He noted that one of Japan's problem is that policies are overly detailed and hard to understand; for example, he said, there are more than 60 legal regulations dealing with unemployment insurance, each of which has its own "policy." Complicated policy, he declared, is bad policy, adding that it is necessary to streamline policies if structural reform is to succeed.

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Generally speaking, Japanese laws stipulate what may or should be done, whereas American laws stipulate what may *not* be done, everything else being left to interpretation of the law in individual cases. Given the quickening pace of globalization and the increasing complexity and diversification of society, it is important to realize that

it is impossible to lay down rules for each and every contingency.

The same point applies to the de-regulation considered necessary for Japan. The continued existence of outworn and elaborately overlapping regulations in a changing society and the constraints these impose on all kinds of economic activities are among the major factors standing in

the way of innovation leading to the creation and development of new businesses, something Japan badly needs today. Security policy and economic policy alike demand simplicity and clarity. When formulating policy, simple is best.

■ *Akio Okawara, October 5, 2001*

REPORT

Globalization and the Japanese Economy

The collapse of the cold-war structure brought the entry of new countries into the market economy and contributed to the further intensification of global economic competition. This can be seen, for example, in the fact that, while the world's economic growth rate during the 1990s averaged 3% a year, trade grew at an average 7% clip. In Japan, however, the progress of globalization, combined with the prolonged domestic recession, has intensified deflationary pressures by causing imports to increase and has raised fears of a hollowing out of the manufacturing sector as firms shift their production bases offshore. Here I will try to determine the actual extent of the negative impact of globalization on the Japanese economy and suggest how Japan should cope with this inexorable process.

How globalization has hurt Japan

The expansion of economic frontiers, of which today's globalization is the most recent and most prominent example, is a process that has always tended to push prices down. In Japan, whose market was long said to be closed, the appreciation of

the yen following the 1985 Plaza accord and the progress of economic globalization have caused the share of imported goods to rise. If we look at the import penetration rate (imports/supply) in Japan's mining and manufacturing sector, we find that it rose from 6.8% in 1990 to 11.7% in 2000. And in industries like electrical machinery and textiles, where the rise in the import penetration rate has been especially pronounced, imports have clearly tended to push prices down (Figure 1).

Meanwhile, a process of hollowing out has definitely been occurring, particularly in the manufacturing sector. In the latter part of the 1980s, as the yen rose sharply against the dollar, companies started rushing to move their production facilities to other countries. The share of offshore production by Japanese manufacturers, which was only 3% as of 1985, reached nearly 15% in 2000.

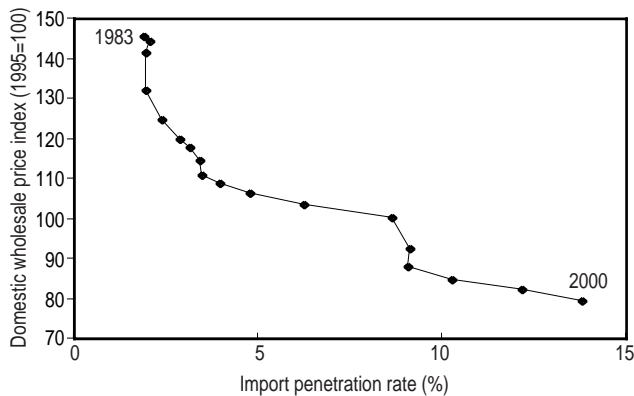
It is possible, however, to explain these negative effects as being due to structural problems within the Japanese economy. The downward pressure on prices from increased imports reflected the fact that Japan's domestic price levels were high by

international standards. And the shift to offshore production can be attributed to the change in the domestic cost structure.

The gap between domestic and international price levels can be seen as the difference between the equilibrium exchange rate for tradable goods and services (in other words, the actual exchange rate) and the equilibrium rate for all goods and services (in other words, purchasing power parity). The price gap arises from the presence of tariff and nontariff barriers to trade and from the existence of the service sector, which tends to be relatively immune from international competition.

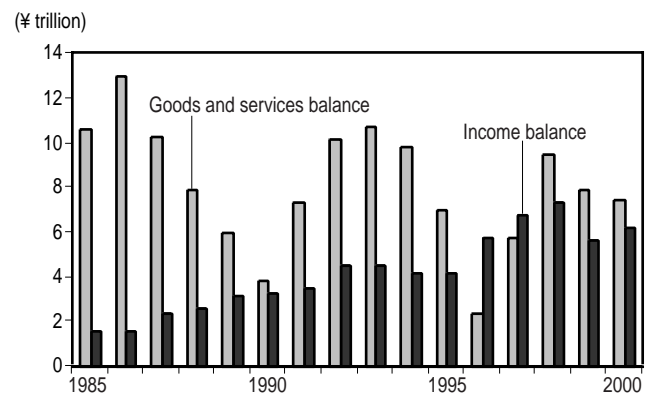
The situation that prevailed for a long time in Japan's case was one in which certain export industries held leading positions in the global market while industries with relatively little competitive strength were protected by regulations and other arrangements, as a result of which the trade surplus was larger than justified by the economy's overall strength, and this meant that the actual exchange rate constantly stayed above purchasing power parity. And the high exchange rate served as a medium for the transfer of income

Figure 1. Import Penetration Rate and Domestic Wholesale Prices, Electrical Machinery



Sources: Ministry of Economy, Trade, and Industry; Bank of Japan.

Figure 2. Japan's Surpluses in the Goods and Services Balance and the Income Balance



Source: Bank of Japan.

from export industries to nonexport industries.

Next let us consider the change in Japan's cost structure. It is frequently observed that Japan's labor costs are among the highest in the world, but we must also note that the rate of increase of these labor costs is much greater than that of the cost of capital. The cost of capital has been held down by the fact that Japan has the world's lowest interest rate levels, which is due in turn to the fact that it has the world's biggest saving surplus.

If we compare the rate of increase in domestic wages and the increase in the cost of capital (the nonresidential investment deflator), we find that the former has been roughly four times the latter over the past 30 years. Even without bringing a comparison of domestic and overseas costs into the picture, we can judge it only natural for rational Japanese companies to seek to replace human workers with machines and transform their operations from labor-intensive to capital-intensive ones.

Turning the minuses to pluses

Above we have noted the economic distortion that is made manifest by the domestic-international price gap and the shift in the cost structure.

How should Japan deal with these issues?

Up to now, individual companies, especially manufacturers, exposed to competitive pressures by an unfavorably high exchange rate have striven to survive by shifting to offshore production and by making use of cheaper foreign goods and services. But for Japan as a whole, surely a more rational choice in the context of today's economic globalization would be to hold on to those industries that can compete at an appropriate exchange rate. Otherwise all that will remain are the handful of industries that are superlatively competitive and other industries that are able to survive only because they are protected. Before that happens, we should reduce domestic production costs; this means opening up the market further and promoting competition in those sectors where it has been lacking, thereby lowering domestic costs, and at the same time lessening the upward pressure on the exchange rate by increasing imports.

Also, as long as Japan continues to run a current account surplus, it cannot avoid a corresponding outflow of investment and other capital (that is to say, a deficit in the capital account). On top of that, as a result of the overseas investments that have already been made, Japan's surplus

in its income balance (consisting largely of dividends and interest payments from abroad) is approaching the level of its surplus in the goods and services balance (Figure 2). In other words, the surplus produced by the combination of domestic capital and foreign labor is now close to the size of the surplus produced by the combination of domestic capital and domestic labor. What Japan needs to fear is not so much the hollowing out of its economy due to the outflow of industries as the hollowing out due to the inability to come up with industries matching the new structure of capital and labor costs. We need to achieve a more advanced domestic industrial structure by raising the capital-labor ratio and increasing labor productivity.

We should not focus on falling domestic costs, the shift to offshore production, and the decline of domestic rates of return as problems; rather, we should recognize the actual position of Japan within the world economy and take these conditions as given. In discussing the future of the Japanese economy, I maintain that we should take these realities as our starting point and consider what sort of industrial structure will match Japan's cost structure and serve the interests of its people.

■ *Fumio Oi, October 2, 2001*

INTERNATIONAL AFFAIRS

This section takes a look at major topics on the international scene, offering an outline of developments together with highlights of media commentary and reports from research institutes.

Terrorists strike the American homeland

Both in their shocking nature and in their huge political, economic, and social impact, the attacks by terrorists on September 11 against the World Trade Center in Manhattan and the Pentagon just outside Washington were unmatched by anything seen in the post-cold-war world.

Unprecedented shock, resolve to act: In their editorials on the morning after the attacks, U.S. newspapers expressed the nation's tremendous shock and its resolve to wage war against terrorism. The *Washington Post* declared, "The horrific terrorist attacks yesterday in New York and Washington will rank as one of the greatest calamities in American history," adding, "The Bush administration must move aggressively . . . to defend the country against possible follow-up attacks. And with soberness and determination, the nation must prepare itself to fight its first war of the new century." The *Wall Street Journal* stated, "The world is a different place after the massive attacks on the United States yesterday . . . ; a new kind of war has been declared on the world's democracies." And the *New York Times* titled its editorial "The War Against America," starting it with a section headed "An Unfathomable Attack" and observing, "What we live with now, beyond shock and beyond the courage witnessed on the

streets in New York and Washington yesterday, is an urge for reprisal."

On the other side of the Atlantic, the *Financial Times* took a slightly different tone. In an editorial on September 13, the British daily observed that the United States must "find and strike down those responsible for these deeds" and "take all steps possible to prevent them happening again," and it added that America's allies must provide "every assistance" in these efforts. But on the subject of striking back against terrorist targets, the paper cautioned, "Mr Bush will have to exercise extreme care not to make a bad situation worse."

The attacks on September 11 struck at the heart of America's economic and military nerve systems, and they are thought to have caused more than 6,000 deaths. On top of the tremendous shock that they generated, they have also given rise to debate from a variety of angles, including the issue of U.S.-led globalization, the "clash of civilizations" theory, the proper shape of crisis management in the face of terrorist threats, the effectiveness of multilateralism, and the impact on the global economy. Of particular concern are the questions the attacks have raised about the new face of war and about the balance between freedom and security.

What is the new face of war in the twenty-first century? It is a form of belligerency that pits superpower America (and the democratic camp of which it is the leading representative) against barely visible enemies who have neither territory nor borders and who have made no formal declaration of war. Furthermore, it is one in which there are no clear division between wartime and peace-

time and no rules of the sort that govern wars between states. For this reason, as the *Financial Times* noted in its editorial, "This is a war that cannot end in a formal victory for the US." Thomas Friedman, in a column published in the *New York Times* on September 13, wrote, "Does my country really understand that this is World War III? And if this attack was the Pearl Harbor of World War III, it means there is a long, long war ahead."

The day the world changed: The top leader (editorial) in the September 15 issue of the *Economist* was titled "The day the world changed" and carried the subtitle "After this unspeakable crime, will anything ever be the same?" It considered the global political and social impact of the terrorist attacks, focusing in particular on the balance between freedom and security and on the nature of security in the post-September 11 world.

One concern is that freedom will be forced to take a back seat to security henceforth, not just in the United States but through the world. The *Economist* observed that America and its allies will have to beef up their intelligence activities, including "old-fashioned human spying," but it noted, "Spying infringes everyone's freedom, everyone's privacy, not just that of the enemy." It seems likely that the liberties that citizens of democracies have enjoyed up to now will have to be restricted to some degree. And in the economic sphere the impact will not be limited to such short-term effects as the disruption of financial markets and the reining in of consumer spending; there is also bound to be a significant long-term impact

on the very nature of the economic setup built on market freedom and efficiency.

The *Economist* also touched on the issue of missile defense, which President George W. Bush has put at the top of his military and diplomatic agenda, noting, "Among the enemies of America and the West are men who do not fire missiles, but who hijack aircraft full of fuel and fly them into crowded buildings. The missile-shield programme, whatever its merits, must not militate against efforts to improve security against other kinds of threat." The terrorist attacks represent an "asymmetrical war" that pokes through the holes in existing and planned defense pro-

grams, raising the question of how countries should try to protect themselves. And ironically the effort to respond to the attacks has forced Washington to make diplomatic overtures to some of the countries that it previously shunned as supporters of terrorism.

Democratic societies, built as they are on a foundation of civil liberties and respect for privacy, are structurally ill suited to defend themselves against terrorists. Striking a reasonable balance between security and freedom while preventing terrorism is no simple task. And efforts at international cooperation—including, for example, coordination among different countries' intelligence and

law-enforcement agencies—are bound to run up against differences of values and national interests. But the attacks of September 11 have been followed by a series of steps within the international community that go beyond the traditional diplomatic framework in seeking to work together to eradicate the terrorist threat. Japan now faces the question of how it can responsibly participate in these international efforts, not from the sidelines in response to pressure from others but as a directly concerned party acting on its own initiative.

■ *Tadashi Takimoto, October 4, 2001*

INSIDE WASHINGTON

The New Diplomatic Yardstick

With the events of September 11 Washington's policy priority became the eradication of terrorism. The new yardstick of foreign policy articulated by President George W. Bush, "either you are with us or you are with the terrorists," promises to change America's relations with other countries greatly.

America's strongest diplomatic offensive has been leveled at Pakistan. To gain the cooperation of the only country that still has diplomatic relations with the Taliban rulers of Afghanistan, who are believed to be harboring the mastermind of the terrorist attacks on the World Trade Center and the Pentagon, the United States swiftly lifted sanctions imposed after Pakistan's nuclear tests in 1998 and announced economic aid, including debt rescheduling.

Washington also put out feelers for cooperation with Iran, with which it does not have diplomatic relations, through third countries.

While Iran has refused to cooperate with military action by the United States and its allies, it has long been hostile to the Taliban regime, and the possibility of improved relations with America remains.

When Russia, which has a strong influence over the Central Asian countries that used to be part of the Soviet Union, made a fairly strong commitment to supporting the United States. China also announced that it would share intelligence on Islamic extremist organizations. One reason both nations were so quick to respond is probably their wish to have a free hand in dealing with troublesome minorities—the Chechens in Russia's case and Uighur separatists and the Tibetans in China's. America is likely now to soft-pedal such prickly issues as human rights, NATO expansion, and a missile defense shield.

America has exercised special care in dealing with Arab countries. Once again Washington has taken

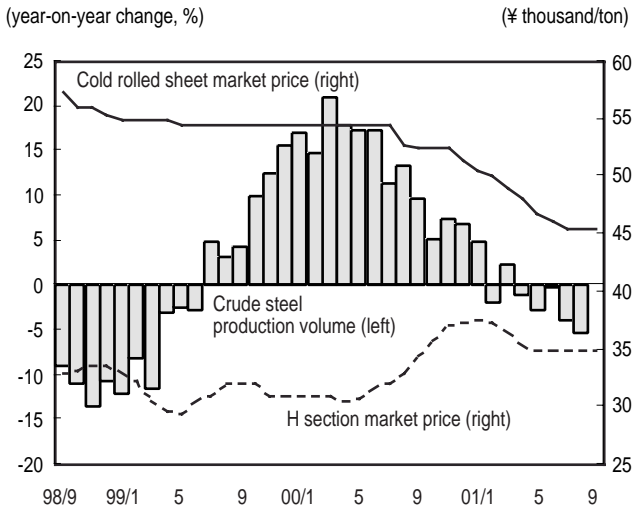
the lead in regard to the Israeli-Palestinian problem and urged both sides to resume dialogue. Meanwhile, a free-trade agreement with Jordan, which had been languishing in Congress, was quickly pushed through to reward Jordan for its model antiterrorist measures. The United States is also taking great pains to keep its antiterrorist campaign from being seen as anti-Islamic, including changing its name from "Operation Infinite Justice" to "Operation Enduring Freedom."

America's new diplomatic stance of trying to win the cooperation of as many countries as possible, using the yardstick of combating terrorism regardless of past relations, is changing U.S. policy priorities and could also open up fresh avenues of dialogue.

■ *Mutsuya Kamesaki, Washington
October 1, 2001*

JAPANESE INDUSTRY

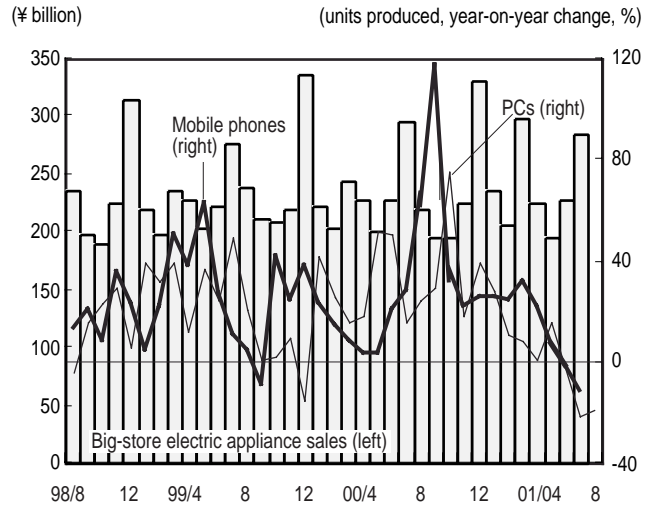
IRON & STEEL



Sources: Japan Iron and Steel Federation, etc.

Crude steel production fell year on year for the fifth straight month in August. Faced with sluggish demand, steel-makers operating electric furnaces have cut production with temporary plant closings, taking advantage of government subsidies for employment adjustments. Export orders were up, but domestic demand was off sharply.

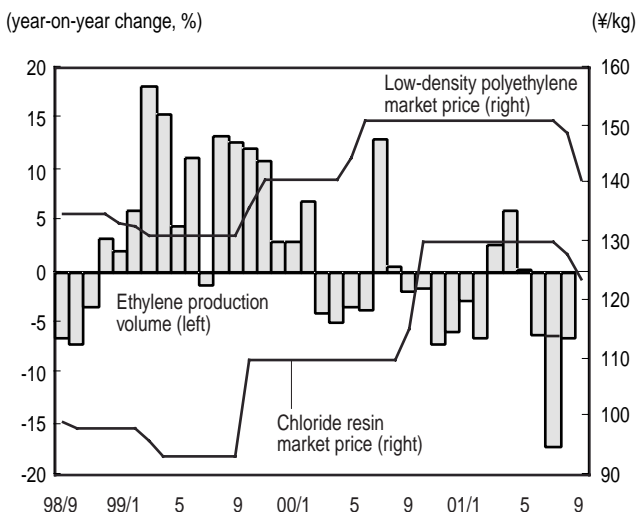
ELECTRIC & ELECTRONIC PRODUCTS



Sources: Nippon Electric Big Stores Association; Research Institute of Economy, Trade, and Industry.

Sales of electric appliances were down 6.5% from the previous year in August. Computer sales continued to lag, plunging 24.6% year on year. Washing machines were down 6.2% despite the appeal of washer-dryer units and of striking new models. Refrigerator sales also continued to fall, dropping by 19.3% from a year before.

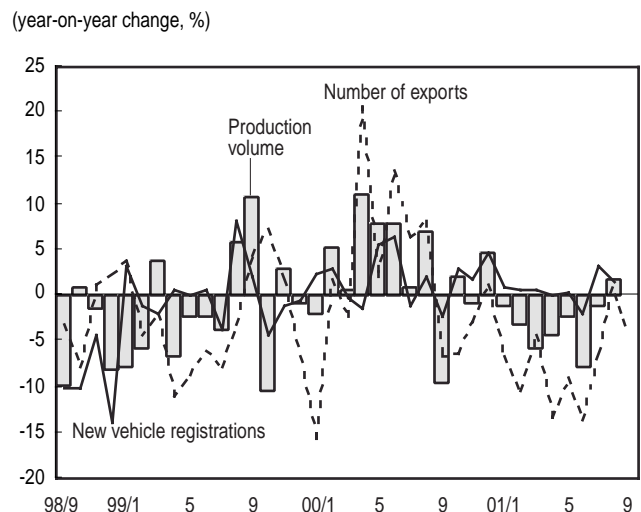
CHEMICALS



Sources: Japan Petrochemical Industry Association, etc.

Ethylene production in August was down 6.7% from a year before. Lagging demand is pushing manufacturers to cut back more severely on output. Production volume was off for all four major commodity resins, and exports registered double-digit declines across the board.

AUTOMOBILES



Sources: Japan Automobile Manufacturers Association, etc.

Passenger car sales, previously strong thanks to the introduction of new models, fell in September, pulling down new vehicle sales for the first time since June. But Honda sales advanced 28.6% year on year, led by small cars.

■ Kanji Ishitsuka and Yuko Furukawa, October 2, 2001

WORLD ECONOMY

The terrorist attacks of September 11 in the United States had a severe economic impact on the world, causing stock prices on major bourses to plunge (Figure 1). Monetary authorities in the United States, Japan, the European Union, Britain, and elsewhere responded with rate cuts and other moves aimed at lessening the blow to both real economies and financial markets.

Surveys of economic sentiment in Japan, the United States, and Europe reveal a downturn in the outlook. The danger of a simultaneous global recession, which had been feared even before the attacks, now seems increasingly real. This year's global economic growth rate is expected to be no more than 1%–2%.

Japan

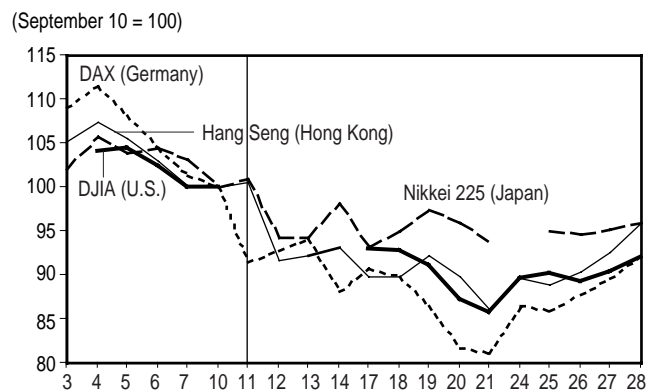
The economy in **Japan** was already losing steam before the terrorist attacks, but the events of September

11 quickly made the situation even worse, and on September 12 the Nikkei stock average fell below the 10,000 mark.

Consumer spending continues to be weak. Consumption expenditures by wage earners' households have fallen for five straight months; in August they were 1.7% below the previous year's level. And August retail sales fell 3.5% year on year, due in part to declines in purchases of consumer electronics.

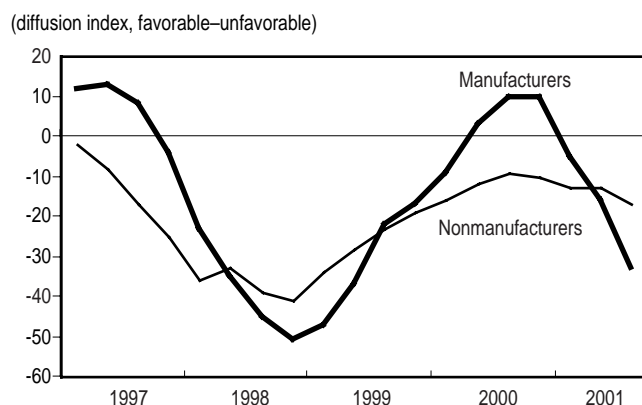
The corporate sector is also weak, as seen in the fall of industrial production. The Bank of Japan's September *tankan* survey of business sentiment revealed the heightening of concerns about future prospects in the wake of the terrorist attacks (Figure 2). The deterioration of sentiment was especially pronounced among major manufacturers, whose outlook plunged by 17 percentage points from the previous survey in June. Many export-dependent firms in particular have lowered their projections for sales and profits in the second half of fiscal 2001 (October 2001–March 2002).

Figure 1. Movements in Major Bourses, September 2001



Sources: *Wall Street Journal*, etc.

Figure 2. Business Sentiment at Major Japanese Corporations



Source: Bank of Japan *tankan* surveys.

Americas

The September 11 attacks have affected transport and production in the **United States**, and the economic growth rate figures for both the third and the fourth quarters are expected to be negative. In addition to causing the temporary closing of financial markets, the attacks interrupted air transport and dealt a blow to tourism and other service industries. Manufacturers were also adversely affected; many have been forced to cut back on production. Major layoffs by airlines and other companies are certain to push up the unemployment rate for September and following months. Surveys of economic sentiment conducted in September revealed a clear downturn in consumer confidence. Purchases of consumer durables are expected to fall, as is residential investment. The Federal Reserve Board lowered interest rates as an emergency countermeasure in September, and at the beginning of October it made another cut, reducing the federal funds rate by half a percentage point to 2.5%, the lowest level since 1962. Meanwhile, the administration and Congress are considering additional government spending measures.

Even before the attacks, the U.S. economy was showing signs of slowing down. The unemployment rate in August climbed 0.4 point from the previous month to 4.9%, and industrial production dipped sharply by 0.8%

from the July level. The growth rate of consumer credit outstanding was also decelerating sharply. Reflecting the sluggishness of domestic demand, the trade deficit has been declining since September 2000, and decreased imports by the United States are having a severe impact on the global economy.

In the wake of September 11, capital fled from financial markets in Latin America, pushing currencies and stock prices down. In **Brazil** the *real* fell to a record low against the dollar, and in **Argentina** the stock market dropped to the lowest level in 10 years. Severe economic repercussions are feared in **Mexico**, which relies on the U.S. market for 90% of its exports. The Inter-American Development Bank has lowered its forecast for 2001 growth in Latin America to 1%.

Europe

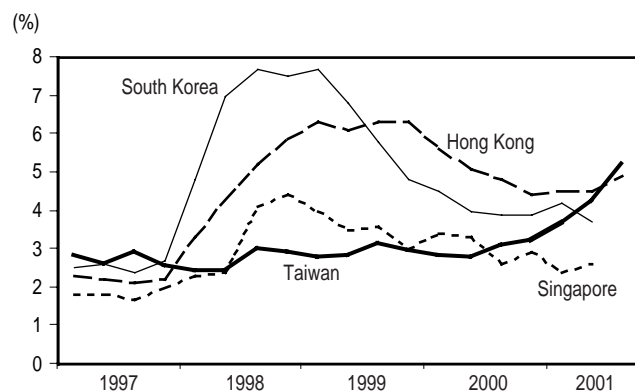
The terrorist attacks have also had a negative impact on European economies. The European Central Bank implemented an emergency 0.5-point cut in its benchmark interest rate in September, acting on the same day as the FRB made its cut.

The EU economy grew by only 0.1% from the previous quarter in April–June. Consumer spending was up by a solid 0.7%, but investment fell by 0.7%, pulling down the total figure. The growth rate for the third quarter may come in negative, and the rate for the year as a whole is now widely expected to be less than 2%.

In **France** the economy grew by only 0.3% over the previous quarter in April–June, reflecting the loss of steam in consumer spending, which had previously been powering growth. **Italy**'s economy did not expand at all in the second quarter, and prospects for achieving the target growth rate of 2.4% for 2001 as a whole have dimmed.

Economies in Central and Eastern Europe are also beginning to show signs of deceleration. **Poland**, **Hungary**, and the **Czech Republic** all depend on the EU for about 70% of their export sales, and as the economic picture in Western Europe has darkened, the export growth rates of these countries have started to fall.

Figure 3. Unemployment Rates, Asian NIEs



Sources: National statistics.

Asia

The effects of the slowdown resulting from weakness in the electronics sector have already started showing up in the employment figures for the Asian NIEs, or newly industrialized economies (Figure 3). And a number of countries have already lowered their growth forecasts to reflect the fact that the terrorist attacks have caused prospects for a U.S. recovery to recede.

The central bank of **South Korea** cut interest rates by half a percentage point, and the government revised its growth forecast for 2001 from 4%–5% to 2%–3%. In **Taiwan** the unemployment rate reached a record high of 5.18% in August; on top of this, the island suffered severe damage from a typhoon that struck in September. Unemployment has also started to rise in **Hong Kong**, and it is feared that this will put a crimp in consumer spending. The downturn is especially serious in **Singapore**, where industrial production plunged 21% from the previous year in August; observers are beginning to predict negative growth for 2001 as a whole.

Malaysia has decided on additional fiscal outlays and monetary policy relaxation, but the impact of these measures is expected to be limited because of the delay in achieving a recovery of demand in the electronics sector. The government has lowered its 2001 growth forecast to 1%–2%.

■ Fumio Oi, October 3, 2001

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