

VIEWPOINT

Services: Focus on the User

The biggest recent piece of news in Japan was the November 9 election for the House of Representatives. The top opposition party, the Democratic Party of Japan, made substantial gains, but the ruling coalition held on to a stable majority, and Prime Minister Jun'ichiro Koizumi retained his post. The key issue now is whether it will manage the economy so as to allow a full-bodied recovery.

This month, however, I want to look at a different sort of issue, namely, services. I recently attended a session where nursing care was discussed. There I was surprised to learn that residents of nursing homes in Denmark get all dressed up every day. This is quite different from Japan, where seniors of both sexes in nursing homes commonly wear sweat suits, which make it easier for the staff to change their undergarments and clean their private parts when they get soiled. How do the Danes manage? The answer was that they have a setup under which the caregivers can take full note of the continence level of each resident.

I was reminded of a story I heard about the president of a large Japanese company who went to the United States for a difficult heart

operation. The operation was successful, and the grateful patient invited the chief surgeon for a meal at a fancy French restaurant. The surgeon asked if the anesthetist and chief nurse could join the party, and so it turned into a group of four. They had a lively conversation while enjoying the delicious meal, and when it was over, the president asked for the check. When the surgeon objected, the president told him, "This is to say thank you for taking care of me." To this the surgeon retorted, "You're an important customer for me, and I can't let a customer buy me a meal." He jokingly added, "That doesn't mean that I want you to be a repeat customer!" So in the end the surgeon picked up the tab. This presents another contrast with the situation in Japan, where there is a widespread but murky custom of offering gratuities to senior doctors; it seems to highlight a basic difference in ideas about the provision of services.

Among efforts to improve medical care in Japan, one approach that we have been hearing much about recently is "tailor-made" care designed to match the characteristics of each patient. But going to a hospital of-

ten means spending a long time sitting in a waiting room before seeing a doctor for just a couple of minutes. Here again we see a service setup designed to suit the providers rather than the users. The same problem is evident in public services, which are widely criticized for making light of users' needs. The desire to make government more responsive is also behind the drive for decentralization of power. In the field of education, meanwhile, we have recently been hearing about the need to reconsider the educational reforms of recent

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decades, but here too the discussion seems to be from the perspective of those providing the education rather than those receiving it.

As of September this year, the number of people employed in Japan came to 63.46 million, of whom

11.76 million had jobs in manufacturing and 48.66 million were employed in service industries. Of course the production of goods is important, but as the weight of the service sector continues to grow, we need to achieve a shift from a mass-

production, provider-centered paradigm to one in which services are provided in response to the requirements of the individual user. The rapid aging of the Japanese population makes this shift all the more essential.

■ *Akio Okawara, November 14, 2003*

REPORT

Decentralization and the “Trinity” Reform Package

As part of the program of structural reform in Japan, moves are underway to overhaul the relationship between the national and local governments. This month we will review the relationship between Tokyo and the regions in post–World War II Japan and consider the need for the “trinity” reform package, which focuses on the transfer of revenues to local governments.

A tradition of control by Tokyo

The present system of government in Japan retains the strong influence of the highly centralized administration implemented during the Meiji era (1868–1912), when the country embarked on a sweeping program of modernization based on Western models.

Under the new Constitution adopted after World War II the control of the central government was loosened on paper. In practice, however, Tokyo continued to dominate local government bodies under the “agency-delegated function” system, whereby the national government required local governments to perform designated tasks on its behalf. Even as of the 1990s, some 80% of the permits and licenses handled by prefectures and 30%–40% of those

handled by municipalities are said to have involved such delegated functions. Similarly, the postwar tax system carried on the prewar system of fiscal adjustment among the regions by Tokyo, serving as a supplementary tool of central control.

In the period of postwar recovery, as the country was working to achieve a higher “national minimum” in terms of income levels and government services, it made sense to have the central government take care of raising revenues and allocate the funds to the regions, taking their respective financial conditions into account. But the issues facing local administration have clearly changed since the 1980s with the achievement of the desired national minimum and with the demographic shift to a low birthrate and rapidly aging population.

In June 1993 both houses of the National Diet passed a resolution calling for decentralization of government authority, which helped get moves in this direction underway. In July 1995 the government launched a Committee for the Promotion of Decentralization, which came out with an interim report in March 1996 declaring: “Administrative services beyond the national minimum should be left up to the independent

choice of local residents in line with their own needs. Even if differences arise among the regions as a result, these should be viewed not as gaps to be closed but rather as distinctiveness to be respected.”

In April 2000 an omnibus law on decentralization went into effect. Aiming to reduce the involvement of the national government in local administration, it revised some 475 existing laws and abolished the system of agency-delegated functions. But there has not been adequate progress in shifting revenue sources to local governments to match the transfer of authority, and this shortcoming now poses a major obstacle to further progress toward decentralization.

As of fiscal 2001 (April 2001 to March 2002), government expenditures in Japan came to ¥153 trillion, consisting of ¥57 trillion in central government spending and ¥96 trillion in local government spending. In terms of the share of local government in total public spending, Japan ranks high among the major industrial nations; its figure is close to that of countries like Germany and the United States, which have federal systems of government. The problem is on the revenue side,

where the central government is heavily involved. In fiscal 2001 national taxes brought in ¥50 trillion and local taxes only ¥36 trillion.

The national-local gap between spending and revenues is covered mainly through so-called local allocation taxes and direct subsidies from the national treasury to local governments. Such funds from Tokyo account for 37% of local governments' revenues.

The local-allocation-tax system is an arrangement whereby the national government collects what are fundamentally local taxes and distributes the revenues to local governments on the basis of a certain set of standards. The aim is to even out regional differences so as to guarantee that all local governments have a certain amount of revenue. The funds that local governments receive under this system are "general revenues," meaning that they are free to use them at their own discretion. Subsidies from the national treasury, by contrast, are provided with the idea of compensating local governments for carrying out activities on behalf of the national government, and they can only be used as designated. Two-thirds of the total provided in the form of subsidies goes toward covering the costs of ordinary construction, compulsory education, and livelihood protection.

People have cited a number of problems with this set of arrangements, notably that (1) it blurs the respective responsibilities of the national and local governments, (2) it leaves too much up to the discretion of the national authorities, and (3) it makes it hard for local governments to grasp the costs involved in raising funds.

The current decentralization program

The current administration of Prime Minister Jun'ichiro Koizumi is undertaking what it calls a "trinity" reform

package in the area of decentralization, involving the reduction of subsidies (on the order of ¥4 trillion by fiscal 2006), the reduction of local allocation taxes, and the transfer of tax sources to local governments. The objectives of these reforms are (1) to enhance the financial efficiency and autonomy of local government bodies by clarifying the relationship between benefits and costs and (2) to improve the sustainability of government finances through streamlining at the national and local levels. It is also hoped that they will shift the role of fund allocation from Tokyo to the regions, away from the guarantee by the national government of the full amounts of local expenditures to the adjustment of differences in the fiscal strength of local government bodies.

Decentralization turned into a major issue in the campaign for the November 9 House of Representatives election. Koizumi's Liberal Democratic Party announced its aim of cutting back subsidies by ¥4 trillion, as noted above, while the opposition Democratic Party of Japan promised that, if elected to power, it would eliminate ¥18 trillion of the subsidies (out of a total of about ¥20 trillion), replacing them with the transfer of ¥5.5 trillion of revenue sources to local governments and the payment of ¥12 trillion in local allocation taxes (with no strings attached). Though the numbers in their proposals were quite different, we can see that the leading parties on both the government and opposition sides recognize the need for reform in this area.

Local government bodies are also actively seeking change. In October the national associations of mayors and of prefectural governors came out with formal calls for reform, citing a figure of about ¥1 trillion for the savings that could be achieved in expenditures by transferring revenues to local governments.

It is unlikely, however, that revenue sources will be transferred as recommended by these associations. For one thing, the policies advocated by both the ruling and opposition parties at the national level are still lacking in specifics. Furthermore, some local government bodies are deeply concerned that the national government may go ahead with spending cuts and put off the transfer of revenue sources, while others, with weak local economic bases and heavily dependent on the guarantee of fiscal resources through local allocation taxes, fear that their financial health will be adversely affected.

The trinity reform package is an important step in the decentralization drive that has been the object of more than a decade of deliberation. Up to now a large share of government spending in Japan has been directed at projects seen as necessary to protect employment and achieve national minimum standards in terms of infrastructure. But henceforth a greater share will need to be directed toward enhancing the provision of welfare and other services. And this will make it even more important to achieve a local focus in planning and implementation of expenditures. This means the exercise of greater autonomy by local governments, which will inevitably require the transfer of revenues to them.

Of course, decentralization involves more than merely transferring revenues from Tokyo to the regions. The purpose of decentralization is to allow the choice of appropriate types and amounts of public services from a more local perspective. To achieve this, it will also be important to review the balance between the public and private sectors with respect to expenditures and, with respect to revenues, to consider ways of introducing the market mechanism in the issuance of local government bonds.

■ *Fumio Oi, November 12, 2003*

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.

The California gubernatorial recall

In the recall election for the California governorship on October 7, actor Arnold Schwarzenegger, running as a Republican, emerged victorious. Democratic Governor Gray Davis had just won reelection last year, but he was thrown out of office only 11 months into his new term, hurt by the impression that he was aloof and haughty, combined with the perceived inadequacy of his handling of the state's massive deficit and of the electricity crisis.

A majority of 54.9% of those voting approved Davis's recall, and in the ballot for a successor Schwarzenegger won decisively with 48.2% of the votes, topping his closest rival, Lieutenant Governor Cruz Bustamante, by 15 percentage points.

Declaring that he was running for governor in order to "bring the government back to the people," Schwarzenegger presented a fresh image differing from that of incumbent politicians, and he reached out to supporters beyond the Republican ranks with his liberal stance on issues like support for abortion rights and gun control. On the key issue of taming the budget deficit, he called for an approach based on spending cuts, pledging not to hike taxes or to reduce outlays for education. He also promised to roll back the recent tripling of the automobile registration tax on his first day in office.

As one British think tank notes,

the fiscal problems California faces are exacerbated by the fact that the state's income tax, which produces almost half its general revenues, depends heavily on levies on capital gains and stock options, which are highly variable, while its expenditures are largely fixed. So in order to cut the deficit without raising taxes, the new governor will probably have to make some tough decisions on key areas of spending, including education. The think tank also notes that the budget must be approved by a two-thirds vote in both houses of the state legislature, meaning that Schwarzenegger will be forced to make substantial compromises in order to win the backing of Democratic lawmakers.

In an editorial on October 9, the *Financial Times* called Schwarzenegger's victory "testimony to the power of celebrity politics" in the United States. On a broader note, it suggested that Democrats who "see the popular revolt against a fiscally irresponsible administration as bad news for President George W. Bush" and Republicans who "herald the Schwarzenegger victory as a signal that Mr Bush will take the huge electoral prize of California in next year's presidential race" may both be wrong, noting, "The recall verdict may be no more than the triumph of a populist over an incumbent."

The aforesaid British think tank has also observed that there is probably not that much linkage between Schwarzenegger's win and Bush's prospects, because American voters tend to keep the presidential and gubernatorial domains apart.

Will the new governor be able to "terminate" California's deficit? And will his performance turn into a plus for Bush in the latter's reelection

campaign next year? At this point we can only wait and see.

Malaysia's Mahathir bows out

After 22 years as Malaysia's prime minister, Mahathir Mohamad stepped down at the end of October and was succeeded by Abdullah Ahmad Badawi.

Mahathir's policies were consistently anti-Western and stressed "Asian values." Taking office at a time when most developing countries were looking to Europe and America for their models, he struck a different note with his "Look East" initiative, which sought to emulate the successes of Japan and South Korea. Under his leadership Malaysia achieved remarkable economic progress, transforming itself from an exporter of primary products to a newly industrialized country. His focus on Japan as a model of modernization hit the mark, particularly from 1985 on, when the rapid appreciation of the yen produced a dramatic influx of direct investment in Malaysia by Japanese companies, which rapidly turned the country into a production base. The Proton, a Malaysian car developed with help from Mitsubishi, helped boost national pride. And Malaysia came to be labeled a star performer among the members of the Association of Southeast Asian Nations.

Mahathir implemented a "Bumiputra" policy favoring the country's ethnic Malays in order to deal with the structure of economic domination by the Chinese minority. Some complain that this policy sapped Malays' will to compete, but supporters note that it alleviated the country's ethnic strife, which previ-

ously had led to fatal clashes, and helped improve the status of the Malays.

The prime minister came under harsh criticism, however, for the authoritarian approach he took in muzzling freedom of speech and freedom of the press and repressing political opposition. And in his attempts to act as a spokesman for the developing world and for Islamic countries, he engaged in fiery anti-Western rhetoric. Just before stepping down, he delivered an address to the Organization of the Islamic Conference summit in which he declared that “Jews rule the world by proxy,” a statement that produced a sharp backlash from the United States and elsewhere.

The handover of power to

Abdullah went smoothly, having been preceded by a transitional period of almost a year and a half following Mahathir’s June 2002 declaration of his intention to retire. But unlike his charismatic predecessor, who exercised forceful leadership, Abdullah does not have a very strong base of support within the United Malays National Organization (the top party in the ruling coalition), and it remains to be seen how he will go about leading the country.

The *Asian Wall Street Journal* (November 2) observed, “Datuk Abdullah lacks the raw political clout to rule UMNO in the same manner [as Mahathir] and could be tested by rivals for party leadership. To preempt such a challenge, it is

vital that Datuk Abdullah lead UMNO and the 14-party National Front to a convincing election victory next year, political analysts say.”

Meanwhile, a British think tank has expressed the concern that business interests of Abdullah’s family members, which extend to the military, the national airline, and the oil and gas sectors, may hinder economic reform efforts.

In his inaugural policy address, Abdullah declared that he aimed to build on the base of Mahathir’s achievements, indicating that he would basically continue with his predecessor’s policies. Now his own political prowess will be put to the test.

■ *Michiko Shimokawa*
November 14, 2003

INSIDE WASHINGTON

An End to the “Job-Loss Recovery”?

Recently released U.S. government statistics reveal that the economy grew 7.2% in annual terms in the July–September quarter, far exceeding the market forecast of 6%, and the highest quarterly rate since January–March 1984. Meanwhile, the employment figures for October, announced last week, show a rise of 126,000 in total nonfarm employment—the third consecutive month of job growth. The October figure, following 125,000 new jobs in September, seems to indicate an improving employment picture.

Since jobs shrank from November 2001, when the economy began expanding, through the summer of 2003, this recovery has been dubbed the “job-loss recovery,” as opposed to the “jobless recovery” seen in the previous period of economic expansion beginning in March 1991. The loss of manufacturing jobs has been particularly severe

this time. Despite the general upturn, even the October employment statistics reveal a loss of 24,000 manufacturing jobs, the thirty-ninth consecutive month of job shrinkage in this sector. A total of 2.8 million manufacturing jobs have disappeared during this period.

A number of reasons have been advanced for the persisting slide in employment, including productivity gains, the shift to offshore production, and geopolitical uncertainty. It is true that in the July–September quarter productivity rose 8.1% over the previous quarter, indicating that businesses are relying on boosting productivity rather than hiring new workers to respond to growth in demand. Shifting production offshore has long been criticized as the major cause of job losses. Manufacturing industry associations and Congress also complain that the Chinese government is keeping the yuan undervalued by effectively pegging it to the dollar.

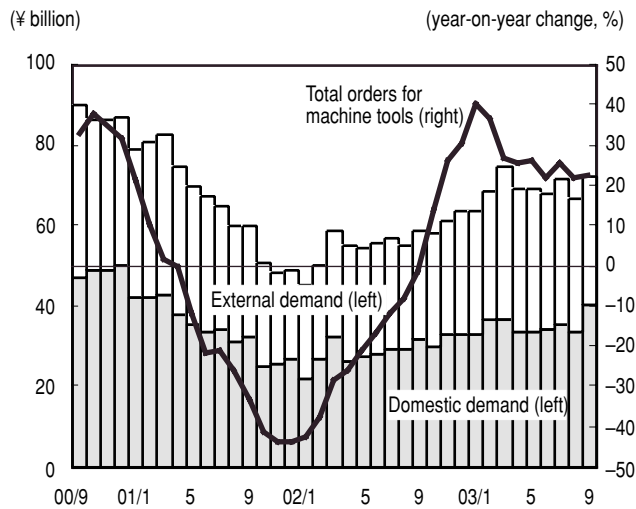
Surveys report that the most recent economic downturn has been characterized more by the permanent loss of jobs due to shifts in production bases and other major changes in business practices than by a temporary drop in employment from layoffs. In view of the imperative to keep down production costs, it is hard to see any diminution in the trend toward moving production to China and other foreign countries. The trend is now spreading to white-collar jobs, too.

Although geopolitical uncertainty remains, business sentiment is better than before the Iraq war. One high-ranking official in the Bush administration has even predicted that 2 million jobs will be created by the November 2004 presidential election. The employment situation will be watched with great interest, since it will have a major impact on the election.

■ *Kunio Tsurumi, Washington*
November 11, 2003

JAPANESE INDUSTRY

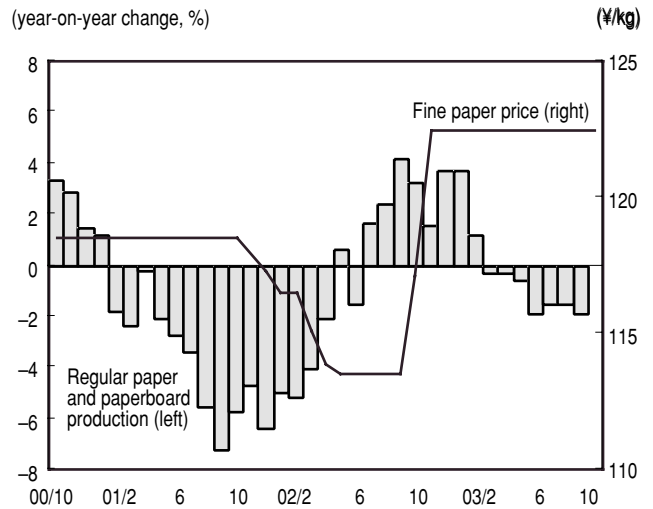
MACHINE TOOLS



Source: Japan Machine Tool Builders Association.

Machine tools orders advanced over year-earlier levels for the 12th straight month in September, rising 22.1%. Thanks to strong exports and replacement demand fueled by a domestic recovery, increases were seen in 8 of the 11 industrial categories. Domestic orders were up 28%, topping the ¥40 billion mark for the first time in 30 months.

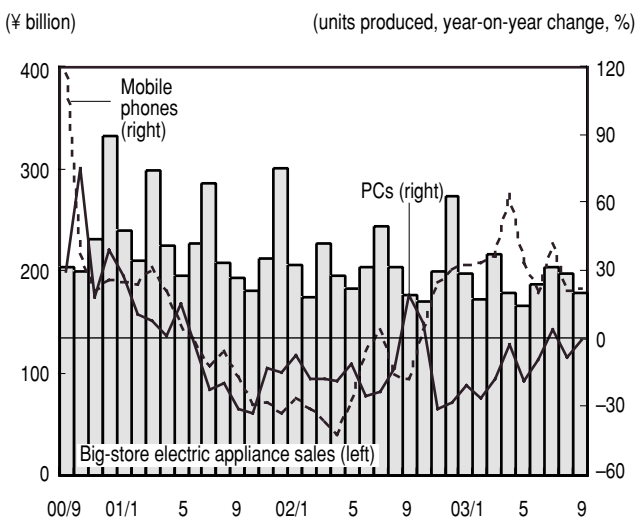
PAPER & PULP



Sources: Economy, Trade, and Industry Statistics Association; etc.

Production slipped 1.9% in September. Domestic shipments for printing and information uses were depressed by imports. Producer inventories of paper for containerboard hit an 8.5-year low at the end of September due to ongoing production cuts and a pickup in shipments as late summer heat boosted demand for beverage-package use.

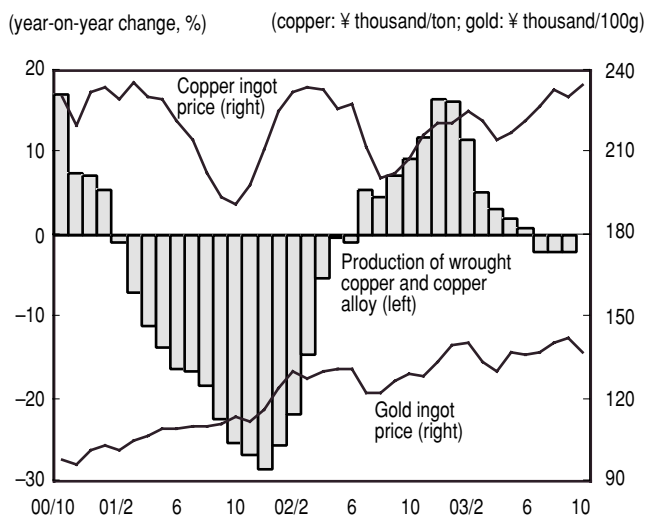
ELECTRIC & ELECTRONIC PRODUCTS



Sources: Nippon Electric Big Stores Association; Economy, Trade, and Industry Statistics Association.

Appliance sales rose 6.3% year on year in September, aided by the fast-growing demand for digital devices. Flat-screen LCD and plasma TVs have become popular more quickly than expected, joining DVD recorders and digital cameras in a new “trinity” of must-have items.

NONFERROUS METALS



Sources: Economy, Trade, and Industry Statistics Association; etc.

September wrought copper and copper alloy production slipped 2% year on year. October brought surges in international prices of nonferrous metals, especially copper, which rose to a six-year high partly due to speculation.

■ Takaya Mitamura and Etsuko Toyama, November 12, 2003

WORLD ECONOMY

Japan

Economic growth in **Japan** decelerated in the July–September quarter, but more recently it has shown signs of picking up again. The pickup in production levels has led to improvement in the employment situation; the question now is whether this will cause consumers to spend more freely.

The real growth rate of gross domestic product for July–September was 0.6% over the previous quarter; it was the seventh consecutive quarter of positive growth by this measure (Figure 1), though the pace of expansion was down from the 0.9% rate recorded in April–June. Consumer spending was held back by the unusually long rainy season and cool summer weather, but increases in capital investment and in net exports kept the economy growing. However, nominal GDP, after rising in April–June, fell back into negative territory in July–September; the figure for the quarter came to –0.0%

Figure 1. Real GDP Growth, Japan

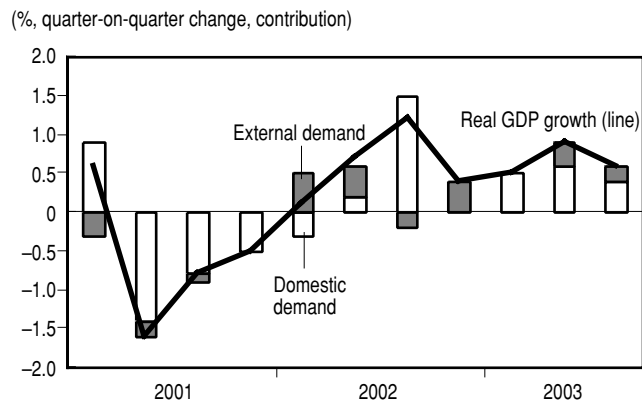
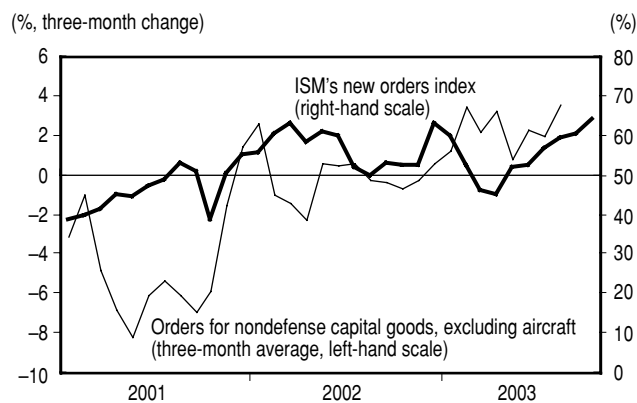


Figure 2. Capital Investment, United States



(meaning a minuscule contraction), or –0.1% in annualized terms.

Recent monthly statistics indicate that the recovery is regaining speed. Industrial production in September showed unexpectedly strong growth of 3.8% over the previous month. Buoyed by strong sales of mobile phones and personal computers, the electronic parts and devices industry and general machinery industry recorded especially large advances. Also the survey of manufacturing production forecasts showed manufacturers looking for further rises of 2.8% in October and 2.5% in November, suggesting that the upward trend will continue.

By contrast, machinery orders declined for the third straight month in September, dipping 1.6% from the previous month, and the figure for July–September was down 2.9% from the previous quarter. But the industry is expecting a 12.0% quarterly surge in October–December, led by orders from the nonmanufacturing sector. The outlook is for the recovery trend in capital investment to continue, powered by a combination of improved business sentiment and the upturn in exports and production levels in response to stronger economic performance overseas.

Americas

Real GDP in the **United States** rose at an annual rate of 7.2% over the previous quarter in July–September, the highest such figure in about 20 years. The main source of the growth was consumer spending and other forms of domestic demand.

Encouraged by low interest rates and tax refunds, consumers spent an annualized 6.6% more than in April–June. Spending on durable goods, such as cars and furniture, was especially strong, surging 26.9%. Fixed nonresidential investment was even stronger than consumer spending, registering an advance of 11.1%. Investment in structures, which rose for the first time in seven quarters in April–June, slipped back in July–September, contracting by 2.4%, but investment in equipment and software jumped 15.4%, with outlays for computers in particular registering an advance of 46.3%.

Orders for nondefense capital goods, which are a leading indicator of capital investment, registered a strong monthly advance of 4.7% in September (Figure 2). Business sentiment has been improving, as seen in the rise of the Institute for Supply Management's purchas-

ing managers index to 57% in October, and corporations' will to invest is expected to continue running strong.

The job statistics for October revealed an increase of 126,000 in nonfarm employment, a much larger figure than anticipated. Service jobs have continued to increase, and the pace of the decline in manufacturing jobs has been decelerating.

In **Mexico** industrial production slipped 0.6% from a year before in September; it was the sixth straight month of such declines. In October the central bank lowered its growth forecast for this year from 2% to 1.5%.

Europe

The deterioration of economic sentiment in the euro area appears to be letting up: Business confidence has recovered somewhat, and consumer confidence has stopped falling. Both Germany and France recorded positive real GDP growth over the previous quarter in July–September, at 0.2% and 0.4%, respectively, following declines in April–June.

In **Germany** the major indicators of economic performance, including industrial production, manufacturing orders, and retail sales, have been presenting a mix of advances and declines. But the unemployment rate has been ceasing to get worse, and the upward trend in business confidence has been continuing. Analysts are watching to see if this improved business sentiment will translate into improved performance in the real economy.

Britain's real GDP grew by 0.6% over the previous quarter in July–September, just as in April–June, indicating that a gradual recovery was being sustained. Consumer spending has held firm. In November the Bank of England tightened its monetary policy for the first time since February 2000.

Asia

The recovery in Asian economies is again gathering strength, and most observers think it will keep going for a while to come.

Balance of International Accounts, China

(\$ billion)

	Jan.–June 2002	Jan.–June 2003
Current balance	13,630	11,120
Trade balance	20,720	13,533
Exports	143,341	190,419
Imports	122,621	176,886
Capital balance	12,247	44,403

Source: State Administration of Foreign Exchange.

South Korea is enjoying an export-led pickup. September exports rose 26.2% year on year, and industrial shipments for export were up 14.3%. Especially strong export performance has been seen in semiconductors, mobile phones, and automobiles. However, domestic demand has been slow to recover because of such factors as excess household debt, labor-management troubles, and political uncertainties.

In **Singapore** real GDP for July–September was up 15% from the previous quarter, although the gain was a much more modest 1.0% over the year-earlier figure. Given the strength of the U.S. economy and the robust demand for electronics products, the outlook is for on-going growth in manufacturing production.

China registered a year-on-year real growth rate of 9.1% in July–September, indicating that the country was back on the track of rapid growth after getting over the effects of the SARS outbreak. But the 21% year-on-year increase in the money supply in the same quarter and the fact that consumer prices have been running higher than year-earlier levels have fed concerns that the economy may be overheating. In October the figures for the January–June international accounts balance were released, showing that both the trade surplus and the current account surplus were smaller than a year before (see the table). Meanwhile, the surplus in the capital balance (representing net capital inflows) registered a large increase.

■ *Soichi Okuda, Fumio Oi, and Yuko Furukawa*
November 14, 2003

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