

Japan

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The Japanese economy has faced many structural adjustments in the past. For a country that pulled itself out of the ashes of World War II to achieve the kind of prosperity it enjoys today in an unprecedentedly short time, adjustments in economic structure would seem to be commonplace. With its dependence on foreign suppliers for most of its energy, adapting to changes in the international economic environment is Japan's fate, as the two oil crises of the 1970s illustrated. Indeed, the government's annual white papers on the Japanese economy are filled with references to structural adjustments.

Since the 1980s, however, and particularly after the stratospheric rise of the yen in the late 1980s, adjustment of the domestic economy has become the subject of a larger policy debate. The increased global interdependence of economies has driven this debate. These issues affect not just Japan but also the entire world. Both developed and developing countries must adjust their structures to take advantage of new opportunities for development in newly competitive markets.

There are also unusual factors at work in Japan's economy, and these factors have an undeniably large influence on the domestic policy debate over structural adjustment. As

globalization deepens the interdependence of economies worldwide, it exposes the contradictions and problems in domestic economies and societies, generating domestic debate.

This chapter surveys the domestic adjustments that Japan will require to adapt to globalization and the policy debates that have taken place so far. We examine the basic factors behind the policy debates from three perspectives: (a) the perception of the Japanese public that its economy is “small and frail,” (b) the existence of a two-tiered economic structure, and (c) the decline in the potential growth rate caused by a combination of structural factors. These factors have been extremely influential in the domestic policy debate on globalization. We examine four aspects of globalization that are deeply intertwined with economic structural adjustments: (a) volatile exchange rates caused by the increase in capital movements, (b) active outgoing direct investments and the consequent international linkage of production, (c) the growing pressure from all sides for freer trade, and (d) technological change, particularly the rapid advances in communications and information, and the paradigm shifts in production technology.

The domestic policy debate is surveyed in five areas: (a) deregulation, (b) the Big Bang reforms for financial market liberalization, (c) jobs, (d) macroeconomic balances, and (e) taxation. The domestic Japanese debate on globalization in the 1980s has leaned toward the resolution of external economic friction. In the 1990s, new difficulties have led to recognition of the need to be actively involved in globalization to revitalize the Japanese economy.

WHAT IS GLOBALIZATION TO JAPAN?

Three factors in the Japanese economy and society are important background issues to the domestic adjustments required by globalization.

Perception of the Japanese Public that Its Economy Is “Small and Frail”

Many Japanese perceive that they live in a “small and frail country.” This may seem odd in light of the Japanese economy’s large presence on the world stage, where it accounts for one-quarter of total production. Whether measured in terms of per capita income, trade values, or official development assistance, the Japanese economy is undeniably mammoth. Moreover, a large domestic sector supports this economy. Japan depends on trade for only 14.4 percent of its economy (1994), which is low in comparison with the rest of Asia and even with the other developed countries. Wakasugi (1988) has analyzed the relationship between the appreciation of the yen in the late 1980s and trends in the industrial structure and corporate behavior. He finds that the Japanese economy is, essentially, a self-sustained and autonomous entity and argues that even before the yen appreciated Japan’s dependence on foreign economies was not high.

Nishikawa (1985), on the other hand, claims that Japan is resource-poor and must therefore promote exports to be able to import the raw materials that it needs. This, he says, has caused the people of Japan to heed foreign economic relations ever since the Meiji Period (1868–1912).

Something in the mentality of the Japanese people makes them anxious over their economic future because the majority of their energy and natural resources are imported.

This perception of frailty gives debates on Japanese economic policy two different biases. First, the Japanese accept that internationalization and globalization cannot be avoided because it is impossible to cut off economic interaction with the outside world. When used in Japan, the terms *internationalization* and *globalization* have a progressive and advanced nuance and have become part of the daily lexicon. Second, there exists a form of anxiety and at times panic—even flat-out rejection—over domestic adjustments. The debate over the need for structural adjustments has not always been adequate. Some sectors, such as agriculture, reject the need for internationalization and globalization, and argue that Japan’s resource dependencies require them to be as self-sufficient as possible.

Nakatani (1987) sees the reaction of the Japanese public to internationalization and globalization as a sensibility that has been with Japan since it sealed itself off to the outside during the Edo Period (1603–1868). Nakatani says:

The Japanese have a surprisingly deep feeling for “Japan.” . . . The Japanese are enormously concerned about “Japan,” to the point that how Japan is perceived by other countries is a question of intense interest to them. Japan is probably the only one among the developed countries . . . that can use the word “internationalization” so frequently and feel such romance in this strange (?) coinage. . . . The reason the Japanese are so extraordinarily interested in foreign countries and indeed exhibit such tension about the subject is that they have never really had any interaction with foreigners on a day-to-day basis and therefore have

never really experienced the truism that foreigners are, ultimately, members of the same tribe as the Japanese themselves. (62)

Two-Tiered Structure of the Japanese Economy

A second factor that must be understood to make sense of the domestic Japanese policy debates on economic globalization is the two-tiered structure of the economy. All economies have some industrial sectors that are extremely productive and enjoy a high degree of international competitiveness and others that are less productive and less internationally competitive. In Japan, the contrasts between these groups historically have been pronounced. A handful of highly competitive industries (for example, textiles in the 1960s, steel in the 1970s, and transportation and electrical equipment since the 1980s) have accounted for a large portion of exports. Having started to industrialize later than other developed countries, Japan refined competitive industries by concentrating its resources in specific promising sectors (however, the experts disagree about whether this was successful) while protecting domestic industries. Because of this two-tiered structure, there are large differences in the content and direction of the economic policy debate depending on which sectors of the economy are considered. More important still is the fact that as international competitive pressures increased in the 1980s and beyond, the contrasts became more manifest between those industries that adapted to competition positively and those that have felt greater need to hide behind the regulations of the past.

According to Harada (1996), statistics show there are only four industries in Japan—transport machinery, electric machinery, primary metals, and chemicals—that are more productive in absolute value than the same industries in the United States. These highly productive industries occupy only 20 percent of the overall economy, while the remaining 80 percent of the economy comprises low-productivity industries shielded by various protective measures and regulations. Harada clearly shows the negative correlation between the degrees of restrictions and the growth rates of productivity in Japanese industries.

Lower Potential Growth Rate

Since the 1980s, the Japanese economy has gone through several structural adjustments that have had nothing to do with globalization per se. These adjustments have lowered its potential growth rate (Japan Development Bank Research Department 1994), and that lower growth rate—the third factor—now serves as an important macroeconomic assumption in discussions of globalization and the economy. Unlike other countries, Japan has experienced this decline in the growth rate during the most intense period of globalization. During the high-growth period of the 1960s, Japan had average annual real growth of 10.1 percent. The twin oil crises of the 1970s brought down the annual rate to 4.6 percent for that decade, still fairly high as growth rates go. In the 1980s, the rate slid to 4.0 percent, and the latest government economic plan, the 1995 interim report by the Subcommittee of the Economic Council, forecasts a potential real annual growth rate of 3.5 percent.

These large declines in the potential growth rate coincided with the formation and collapse of the bubble economy in the late 1980s and early 1990s, and therefore the actual growth rate fell even faster. During the bubble period (1986–1991), the average real economic growth rate was 4.7 percent, and stock prices grew by an average of 5.3 percent per year. From 1992 to 1995, economic growth slowed to 1.2 percent per year, and stock prices declined by 6.2 percent annually. In other words, it was not just a slowdown, but a strong negative acceleration. Furthermore, during this period the population aged far faster than previously predicted, further reducing growth expectations (Obuchi 1997). The National Institute of Population and Social Security Research (1997) finds that the decline in the birthrate is far more dramatic than had been forecast, which has meant that the aging of the population is also proceeding more rapidly. The institute predicts that total population will peak in 2007 and begin to decline thereafter.

Meanwhile, Japanese companies' use of lifetime employment and seniority wage systems has kept the unemployment rate extremely low. This, in turn, has caused Japan to be inordinately wary of job losses. The result has been to increase public anxieties about the structural adjustments that are being triggered by globalization, and to possibly blunt the country's willingness to move forward positively with domestic adjustments so as to improve overall economic welfare.

ASPECTS OF GLOBALIZATION

The term *globalization* is commonly used in Japanese economic debates, but its meaning is extremely complex and nebulous. Four aspects, however, appear most closely related to economic structural adjustment.

The first is the volatile exchange rates caused by the increase in capital movements. It is axiomatic that changes in relative prices will be the most influential factor in economic structural adjustments. In the 1980s and 1990s, changes in exchange rates were the most important factor in altering the relative prices of economies around the world. In Japan, this involved an incredible 224 percent rise, from ¥260.24 against the dollar just prior to the Plaza Accord of 1985 to ¥80.3 at the peak in 1995. The yen also appreciated against major Asian currencies, as is seen in the 608.1 percent rise against the yuan.

Over the short term, volatile foreign exchange markets became a policy problem because export industries were depressed and a high-yen slump ensued. In concrete terms, the government was forced to resort to frequent stimulus packages to alleviate the slump. These economic programs eventually expanded the fiscal deficit and produced problems in the fiscal structure. Longer term, the rise of the yen has become an important force in promoting changes in consumption and industrial structures.

Outgoing direct investments and the consequent international linkage of production constitute the second aspect. The new activity in outgoing direct investments and the consequent international linkage of production is directly related to exchange rates. Kojima provides a

comprehensive analysis and explanation of globalization in which he states, “Economic globalization, especially after the eighties, was sharply accelerated by the rapid expansion of international capital movements, including outgoing direct investments. . . . Under the GATT system, free trade expanded and the economies of the world became more interdependent, but capital movements, and particularly direct investments in offshore production, integrated the world more than even trade” (1990, iv). Indeed, Japan’s offshore production rate (the ratio of foreign production to domestic production) has reached 8.6 percent (1994), which is lower than the United States’ 25.2 percent (1993) or Germany’s 21.3 percent (1993), but a vast expansion from only 3.2 percent in 1986. In essence, Japan transferred a large portion of its productive facilities to other countries in a short period of time.

Third is trade liberalization. Increased pressure for freer trade has been brought to bear by three routes. First was liberalization through international organizations such as the General Agreement on Tariffs and Trade (GATT) and its successor, the World Trade Organization (WTO). Second was the promotion of more liberal trade by regional economic arrangements such as the North American Free Trade Agreement (NAFTA), the European Union, and the Asia-Pacific Economic Cooperation (APEC) forum. Third were bilateral negotiations on freer trade. The debate still rages on which of these is the most desirable technique for promoting free trade, but the most cogent view is probably that the “triple track” approach of global, regional, and bilateral negotiations supplement each other to contribute to greater liberalization overall. Clearly, other countries will use all three to pressure Japan.

The pressure for liberalization grew as former socialist states began to move toward market economies, expanding the size of the global market. Takenaka (1995) estimates that in the mid-1970s the market economy had a population of about 2.7 billion people and finds that it has roughly doubled today to about 5.5 billion. In Japanese policy debates, talk of greater worldwide pressure for trade liberalization and the expansion in the size of the market economy is often accompanied by the term *megacompetition*. The increase in competitive pressure works through market mechanisms to expose, in different forms, the distortions in systems and policies, and therefore has the effect of underscoring for society the need for structural adjustment.

Technological change, particularly rapid advances in communications and information technology and the change in production technology paradigms, is a fourth dimension to globalization. Advances in communication and information technology have vastly changed the nature of market transactions in the financial sector by making it possible to move large amounts of capital instantaneously. In addition, today's high-tech industries, and indeed many other important industries, are subject to economies of scale and economies of networks that give a predominant advantage to those companies that are successful in capturing and expanding their share of a market early and using that position to reduce their average costs. Furthermore, this competition for market share takes place on a global scale and creates in its wake global standards and benchmarks. This, in turn, necessitates changes in competition and technology policies.

The paradigm shift for production technology has both accelerated the competition in global markets and changed the nature of that competition. A first movers' advantage creates technology

lock-ins that bring positive feedback to competition. Recognition of these changes caused Kojima to conclude, “Changes in the economic and eventually political structures of the world will necessitate changes in the rules that govern this system. The most important change will be the revisions that are mandated in the concepts of the traditional state and sovereignty. The system of interdependence and globalism is a system that demands a partial relinquishment of sovereignty” (1990, v–vi).

DOMESTIC POLICY DEBATE ON GLOBALIZATION

Globalization influences the Japanese economy in many different ways and is central to many domestic policy debates. This is particularly true of those structural adjustments that rest primarily on deregulation. There is recognition that the top priority must be to adapt the economy to globalization and restore its vigor, but there is also deeply ingrained skepticism about the market mechanisms on which the deregulation argument is based.

Deregulation

Reforms to Japan’s economic structure have been debated since the early 1980s. The initial impetus to the argument that emphasized the need for deregulation-driven structural reform came from the Maekawa Report, published by a private advisory group to then-Prime Minister Nakasone Yasuhiro in 1986. This report focused on how to deal with Japan’s external surpluses, and it was much criticized for its attempt to posit external surpluses as a policy objective. The

Japanese economy performed well during the late 1980s, so there was no pressing need perceived for the structural reforms advocated by the report. The situation changed dramatically when the economy began to slow in the 1990s. Reinvigorating the economy with deregulation-driven structural adjustments became the most important challenge for Japanese policymakers. Today, structural reform is discussed not because of the need to remedy external imbalances, but from the broader perspective of how to adapt the Japanese economy to the march of globalization.

Markets versus Regulations Many commentators emphasize the need to deregulate the economy, but Ito (1992) provides perhaps the most succinct positioning of deregulation within the larger Japanese framework. In examining deregulation's theoretical underpinnings, he points out that there are reasons for regulation other than market failure. Excessive competition, for instance, may serve as a reason for regulations that limit market entry. Ito also argues that the Japanese economy is clearly overregulated, but a large gap exists between seeking to move in the direction of deregulation and the simplistic arguments that ascribe all power to the markets.

Many of those who argue in favor of deregulation share Ito's perceptions. In contrast, Uchihashi (1995) has consistently opposed deregulation. He criticizes simplistic faith in all-powerful markets, and uses the deregulation of the U.S. airline industry to argue that the facts do not support the contention that deregulation lowers prices. Uchihashi (1997) has compiled a collection of dialogues between himself and other economists who are either negative or skeptical about deregulation. Among them, Sawa Takamitsu argues that "we should get rid of regulations on market entrance, but there are other regulations like those on the environment that we should

tighten” (85). This is in one sense an objection to the idea of “universal deregulation.” Uzawa Hirofumi contends that “there is a mechanism for maintaining the stability of society that exists somewhere between state management and market functions. . . . Social overhead capital should be managed according to community standards and at the community level, as close to the residents as possible” (20). Sawa’s position is not all that far from Ito’s, and Uzawa too takes issue with regulation led by the central government.

Others consider deregulation from the position of comparative institutional analysis. Aoki and Okuno (1996) note that systems and institutions are dependent on their history and that even the U.S. economy, which seems to take deregulation as its goal, is still regulated (if in a different form than Japan). They then argue, “The most important message of comparative institutional analysis is that there are many different kinds of systems—the current system is not set in stone, it changes” (12). When moving to a new system, “the most important point to emphasize is the dynamism that exists within the system” because this “produces competition, which enables new institutions and mechanisms to be discovered and built” (13). Although Aoki and Okuno emphasize competition, they do not limit themselves to the competition created by neoclassical market mechanisms.

The Impact of Deregulation Another economic debate focuses on the domestic-foreign price differential, which is one of the primary reasons given for deregulation. Here, there is a significant empirical literature. For example, Maki (1996) uses a consumer demand function to verify how high Tokyo price levels are in comparison to those of cities in other countries. He found that in

1993, prices in Tokyo were about 30 percent more than those in New York and about 40 percent higher than in London, Berlin, and Paris. In a similar vein, Sazanami, Urata, and Kawai (1995) find that if the gap between import prices and domestic producer prices is considered to be a handicap—that is, a trade barrier—then in 1989 alone tariff and nontariff barriers cost Japanese consumers ¥10 trillion to ¥15 trillion. When producer profits and tariff revenues are deducted, the total loss to the Japanese economy was ¥1.1 trillion to ¥2.4 trillion.

Kimura, Kawai, and Tanaka (1996) use a similar technique as Sazanami et al. to find that imperfect competition and trade barriers exist for the domestic production of materials industries such as chemicals, petroleum and coal products, glass and ceramics, and steel. Moreover, these broadly defined barriers have expanded over the past 10 years for most imported goods. This finding indicates that Japan has not made any progress in opening its markets.

Most empirical analyses view deregulation as contributing greatly to reinvigorating the Japanese economy because of the productivity gains engendered. The Economic Planning Agency (1994) says that competition promotion would raise productivity to four-fifths of the U.S. levels in five years and add 1.6 percentage points to Japan's gross domestic product (GDP) growth rate. The Industrial Structure Council (1994, 1995) says that Japan could expect real GDP growth rates of 3.0 percent per year from 1996 to 2000, but warns that growth will be only 1.6 percent if reforms are postponed. The Economic Planning Agency (1997) argues that from fiscal 1998 to fiscal 2003, deregulation would increase growth by an average of 0.9 percentage point a year, which would add 5.8 percent to real GDP levels in 2003. Meanwhile, the consumer price

growth rate would decline by an average of 1.2 percentage points a year, so that consumer prices would be 7.3 percent lower in 2003. This would occur without any change in the unemployment rate, the agency says, because deregulation of the labor market would enhance the adjustment function for the supply and demand of labor.

Kawai (1996, 1997) performs detailed analyses of the impact of deregulation on specific sectors. Simulations with his general equilibrium model, which includes 162 industrial sectors, yield the following conclusions: First, deregulation will increase productivity in all industries, bringing down prices and expanding consumption and investment. This will add 10.8 percent to the GDP, or the equivalent of an ¥800,000 per household increase in the consumer surplus in the long run. Second, the effects of deregulation will be greatest in the agriculture, forestry, and fishing; wholesaling; and transportation and telecommunications sectors. It will also have an income redistribution effect because the price reduction will most benefit low-income households. Third, there will be labor movement involving 8.4 percent of the total work force. If movement is impossible, however, this will translate directly into unemployment. In particular, the elderly will lose jobs in the agriculture, forestry, and fishing, as well as wholesaling sectors.

Incoming Direct Investment Globalization has brought an increase in cross-border activities, and many Japanese companies have been quick to move overseas. Few foreign companies, however, have set up operations in Japan. Inasmuch as foreign companies have different kinds of expertise and strengths than Japanese companies, their movement into Japan would invigorate domestic markets. Their absence presents a serious problem for the future of the Japanese economy. Two

chief analyses have been done on this point. Urata (1996) did a cross-country analysis of Organization of Economic Cooperation and Development (OECD) members to confirm that direct investment into Japan from 1990 to 1993 was only 18 percent of expected levels. Shinozaki and Endo (1997) use cross-country data in a regression analysis that confirms that from an international perspective, investments into Japan are indeed low. Both studies point to the same factors as possible impediments: high costs (for rent, wages, raw materials, and taxes); demanding user standards; culture (language), business practices, and other customs; difficulty in attracting talented staff because of the illiquidity of the labor market; and the lack of specialist institutions and people to provide mediation, support services for the public (legal, regulatory), and business information.

Financial Market Liberalization: Japan's Big Bang Reforms

A more specialized debate focuses on the financial sector. There has recently been much talk of the need for financial system reform and many recommendations have been made. This activity stems from recognition of the potential for instability and regulation to hollow out Japan's financial markets. Japan's Big Bang reforms are a policy response to this argumentation.

The Economic Council (1996) recommends a detailed and comprehensive liberalization and deregulation program, contending that globalization necessitates the removal of the barriers that compartmentalize the financial services industry, financial holding companies being allowed, the regulations on asset transactions being lifted, and the government moving to a rules-based administrative style. It calls on the government to complete all of these reforms by 1999.

Horiuchi (1997) argues that the legal and regulatory frameworks that define the Japanese financial system and the mechanisms that actually operate on rapidly growing financial and capital markets lack consistency. He takes issue with traditional regulatory practices, for instance, seeking consensus on the introduction of new products; the tax system, as exemplified by the securities trading tax; insufficient information disclosure; and the firewalls between different sectors of the financial services industry. He also points to the moral hazard problem—the more serious the bad debt crisis becomes, the riskier it is for financial institutions to do anything at all, and the greater the chance that they will procrastinate, thus driving up the ultimate costs.

Komine (1997) believes that the globalization of finance has produced an international “competition among systems” that necessitates a shift from traditional financial services to areas requiring more advanced expertise. Japanese finance, he warns, is losing in this competition. He describes analytical findings that suggest that the economic effect of the Big Bang reforms would raise the total factor productivity of the financial services industry by 27.9 percent in four years. Finance would benefit more than other industries. Komine also suggests that Japanese finance has lacked international competitiveness because it has been too heavily regulated. Absent the regulations, it has the potential to be among the world leaders, just like Japanese manufacturing.

Suzuki (1997) sees grave problems with the sequencing of the liberalization measures. Suzuki asserts that the amendments to the Foreign Exchange and Foreign Trade Control Law, which took effect in April 1998, are essential to preventing the hollowing of Japanese finance and reestablishing Japan to a position alongside New York and London as one of the world’s three

most influential international financial centers. However, Suzuki contends that amending the Foreign Exchange Law as the first step of the Big Bang reforms could prove problematic. Interest rates will still be regulated (the fixed issuing rate for short-term government securities), stock trading fees and other fees will still be fixed at what by international comparison are high rates, the securities trading tax and the exchange tax will still raise trading costs, and withholding taxes will still be deducted from the interest received by nonresidents. In short, domestic markets will remain just as difficult and expensive to trade in as ever. Without other reforms, Japanese residents will be encouraged to transfer their assets to settlement and investment accounts overseas and this, Suzuki says, could indeed promote financial hollowing. He urges that domestic regulations should be relaxed quickly to avoid this.

Tachibanaki, Yamamoto, and Kasamatsu (1996) have made recommendations concerning the tax system that take a different approach than Suzuki's. They attempt to quantitatively verify whether the financial markets are hollowing. The value of trading handled by the Tokyo Stock Exchange was in excess of US\$1 trillion from 1987 to 1990, but has slumped in the 1990s and is now lower than that of the London market. Foreign companies turn to other markets for listing, and some have even delisted their shares in Tokyo. On foreign markets, Samurai bond (yen-denominated foreign bonds) issues have slumped, whereas Euroyen bond issues are up sharply. Foreign exchange trading in 1993 was only at about 70 percent of 1989–1990 levels. The authors find four reasons for this hollowing: (a) the high cost of doing business (wages, rent, fees, corporate taxes); (b) regulations and customs that make new product approvals and licensing

unbearably slow; (c) differences in accounting systems; and (d) other drawbacks such as language, lack of infrastructure, and lower living standards.

However, Tachibanaki et al. also point out that the effective corporate tax rate is low, as is taxation on interest and dividend incomes. Tax systems are, at any rate, determined by domestic conditions, and Tachibanaki et al. warn against facilely linking them to the debate on hollowing. They also look askance at arguments that companies are fleeing to the cheaper markets of Hong Kong and Singapore, or that Japan's securities trading tax is causing a problem. Singapore and Hong Kong, they point out, have little choice but to hinge their fortunes on finance. Japan has an internationally competitive manufacturing sector and is thus in a different position. Therefore, Japan does not need to follow Singapore and Hong Kong in making policy decisions. Rather, Japan should carve out a position for itself that is complementary to its markets. Tachibanaki et al. propose lowering listing standards and relaxing other regulations to bring down fees, and bringing accounting standards and disclosure requirements in line with international norms.

Employment Issues

Employment issues have already surfaced several times in this survey of the deregulation debate. As cited earlier, Kawai (1996, 1997) contends that one of the negative effects of deregulation will be the movement of 8.4 percent of the work force, and warns that unless labor movement is possible, this will translate directly into unemployment. The job losses will be heaviest among older workers in the agriculture, forestry, and fishery, as well as wholesaling sectors, which means that jobs for the elderly will be an important issue alongside facilitating labor movements,

diversifying employment patterns, and developing human resources. Yashiro and the Japan Economic Research Center (1995) find that if deregulation reduces the relative unit labor costs of nonmanufacturing compared with manufacturing to U.S. levels, it will result in 12.55 million excess workers. If these excess workers are absorbed by the new demand for labor created by deregulation, then real GDP will increase by 18.7 percent, they claim. Shimada's (1997) simulation analysis suggests that the rectification of the domestic-foreign price differential will result in 11.2 million excess workers, but the decline in prices (and other factors) will increase demand and create 10.1 million new jobs. The Economic Planning Agency (1997) likewise finds that productivity gains will reduce the demand for labor over the short term, and notes that the unemployment rate in 2003 will be slightly higher than it would have been had structural reforms not been made.

Regardless of whether deregulation goes forward, the movement of production offshore will have a serious impact on domestic jobs. Fukao (1995) analyzes the possible impact of overseas production on domestic employment. He finds that the long-term effects will be primarily on the labor share, and according to his calculations (which come with limitations and conditions) the effect will not be that large. Over the short- and medium-term, however, an analysis of the electrical machinery industry indicates that an increase in overseas production will have a negative impact on domestic production. This has not yet caused a serious job problem in Japan because the overseas production rate in the manufacturing sector is still low, but if Japanese manufacturers continue to move into Asia, there is indeed the potential for job problems. Fukao

also points out that serious adjustment problems from offshore expansion could affect specific industries, job categories, and geographical regions. By contrast, Kuwahara (1994) underscores the large impact that globalization has had on jobs, particularly those for unskilled workers, in other developed countries. Japan's performance has been comparatively good so far, but Kuwahara warns that jobs can no longer be taken for granted. The Industrial Structure Council (1996) says that if nothing is done, manufacturing will shed 1.24 million jobs in the next five years. In its 1994 report, the council calculated that if Japan failed to deregulate and make other reforms, 4.85 million people would be out of work in the year 2000; with reforms, there would be only 1.7 million without jobs.

All these studies indicate that globalization will likely have an impact on jobs. Although deregulation will have a negative impact on jobs, the Industrial Structure Council (1994) finds that the impact will be even more serious if deregulation and other reforms are not made. The development of programs to smooth out the employment adjustments must also be addressed.

To improve the supply-and-demand adjustment functions of the labor market, the Industrial Structure Council (1995, 1996) and Keidanren (Japan Federation of Economic Organizations) (1996) advocate encouraging paid job referral services, liberalizing temporary job agencies, and bringing greater flexibility to working hours. The Economic Council (1996) and Shimada (1997) support self-improvement programs for white-collar workers, who do not take well to group training and referral services, and the creation of a system to evaluate the aptitudes and abilities of these individuals and provide appropriate information based on these evaluations.

These programs to enhance the supply-and-demand adjustment functions of the labor market would also help to remove impediments to incoming direct investment, and would encourage foreign companies to set up operations in Japan. Deregulation-oriented labor market reform is also an important component in policies to adapt to globalization. Labor market reform will, of course, encourage changes in such Japanese-style labor practices as lifetime employment and seniority wages, but Seike (1996) argues that such reforms cannot be made all at once because they impinge deeply on the life planning of the individual. For example, under the seniority wage system, young workers tolerate low wages because they expect higher pay when they reach middle age. It would be unfair to these workers once they reach middle age to decide to pay them commensurate with their current contribution to the company. Seike advocates introducing employment and wage reforms as early as possible, but enacting them slowly.

Macroeconomic Balances

Structural reform that is driven by globalization and deregulation influences both macroeconomic balances and the effectiveness of macroeconomic policy. Here, we review structural reform as it affects the investment and savings balance, and look at studies of financial liberalization and macroeconomic policy, and of the need for policies to control total demand.

Investment and Savings Balance and Structural Reform The Maekawa Report advocated deregulation-driven structural reform to cut external surpluses. Komiya (1994) takes issue with this from the perspective of the investment and savings balance. He argues that the current

account can be divided into a “trend portion” and a “cyclical portion.” The difference between trend savings and investment will determine the trend current account, and the effective exchange rate (read, “terms of trade”) between two countries will have no influence in determining the investment and savings balances among countries. Were Japan to throw wide open its markets and imports increase as a result, the exchange rate would move in the direction of a weaker yen, which would offset the impact on the current account. Komiya therefore concludes that the current account surpluses posted by Japan since the 1980s are structural, and that they cannot be reduced by structural adjustments that promote imports or by an appreciation of the yen.

Komiya’s argument is countered by Akabane (1993a; 1993b), who claims that Japan has foreign surpluses because its industries are internationally competitive, and that these surpluses produce net savings. Koo (1995) also believes that the increase in net exports pushing up the GDP causes high savings. Both conclude that structural adjustments could be used to increase imports, which would shrink the current account surplus and relieve the excess savings.

Yoshikawa (1994) argues that the accuracy of the neoclassical investment and savings balance theory employed by Komiya depends on how great a role the trend portion of the current account actually plays. If the cyclical portion is greater, then Keynesian theory will be more effective, which would indicate that higher export competitiveness expands the current account surplus and import promotion will contract it. Hanazaki (1996) grants that the supply side determines the trend portion and the demand side the cyclical portion, but notes that both

sides are closely related and doubts that the clear divisions used by Komiya are theoretically viable.

Ultimately, the conclusions one reaches on the relationship between structural adjustment and external surpluses will depend on the economic model employed. Takenaka, Chida, Hamano, and Miyagaki (1987) use a world model in which demand-driven domestic models are linked to trade and capital matrixes in an attempt to quantitatively measure the effect of structural adjustment. They find that by changing the income elasticity of exports and imports, significant portions of the external deficits of the United States and the external surpluses of Japan could be erased.

The purpose of deregulation-driven structural adjustments has shifted from reducing external surpluses to reinvigorating the domestic economy (though even the Maekawa Report was not concerned exclusively with external surpluses). However, Japan's external surpluses remain huge, and although the argument about them may be on a back burner, no solution has yet been reached. External imbalances are an issue that cannot be ignored in discussions of deregulation.

Financial Liberalization and Macroeconomic Policy The liberalization and internationalization of financial markets will have a vast impact on the effectiveness of macroeconomic policy. Using the Mandel-Flemming model, which is the simplest available and assumes the perfect substitutability between domestic and foreign assets, fiscal policy has no effect whatsoever. Fiscal expansion will invite higher exchange rates, causing net exports to decline. The key point is, of course, whether domestic and foreign assets can be substituted for each other. Chida and

Takenaka (1986) confirm that whether fiscal policy expands or contracts, exchange rates will depend to a large extent on whether domestic and foreign assets can be substituted for each other. More open financial markets can be expected to increase the substitutability of domestic and foreign assets, which will probably reduce the effectiveness of domestic fiscal policy in controlling aggregate demand. However, Asako (1997) maintains that reasons other than those pointed to in the Mandel-Flemming model could explain the decline in the multiplier, so even were a decline to occur it would be difficult to identify the cause with any precision.

Aggregate Demand Control Policies Aggregate demand control policies are expected to play some role in alleviating the negative influence that globalization will have on jobs. Takenaka sees globalization as providing a positive supply shock to an economy and therefore finds an “undeniable need to manage aggregate demand in a manner that is commensurate with the increase in supply capacity” (1996, 156). He goes on to say that “proactive aggregate demand control policies will be required in order to take advantage of this (positive supply shock)” (157).

Shimada advocates “government support for the creation of demand” on a scale that would enable full employment to be maintained. This is necessary, he says, to shut out the deflationary effects of the falling prices that will be brought about by structural reform. Simulation analyses suggest that a ¥100 trillion increase in government investments between now and the end of the century would create more jobs than would be lost to reform.

Taxation

The globalization of the economy has made it easier for people, goods, and money to move across borders, and this makes it possible for companies to locate in countries with lower tax burdens. Therefore, countries where the tax burdens are markedly higher than the norm or where there are structural problems in the tax code risk industrial hollowing. Moreover, personal income tax rates that are extraordinarily high or extremely progressive will undermine the motivation to work and therefore impair economic vigor. In addition, the globalization of the economy and the liberalization of financial flows will diversify cross-border transactions and give them more of a service component. Customs officials, who have traditionally been concerned with taxing goods, are unable to fully monitor cross-border service transactions, and therefore new systems will be required.

In a globalizing Japan, the corporate tax code is seen as most in need of reform. Corporate taxes account for about 24 percent of Japan's tax revenues, which is extremely high compared with Germany, Great Britain, the United States, and other countries. There is little difference between France, Germany, Great Britain, Japan, and the United States in terms of the corporate tax rate, but Japan's effective tax rate, at 49.98 percent, when local corporate taxes are included, is extremely high by comparison. Studies indicate that Japan is high even when the marginal effective tax rate is considered (Business Policy Forum 1986).

Most of the newly industrializing Asian and Association of Southeast Asian Nations (ASEAN) countries have extremely low corporate tax rates, which makes it attractive for Japanese companies to move their operations there. Some worry that this may cause a hollowing

of domestic industry. Simultaneously, taxes inhibit foreign companies from locating and investing in Japan. For example, Maekawa (1997) analyzes the direct investments made by the Japanese electrical equipment industry in five ASEAN countries and China over a 10-year period extending from 1985 to 1994. She finds that the closer one comes to the present, the less important wage differences are as a determining factor in direct investments and the more important capital costs adjusted for corporate taxation become. This finding indicates that the hollowing caused by distortions in the Japanese tax structure could become serious indeed.

Industry has demanded a reduction in corporate tax rates, and the government has generally agreed to move in that direction. A report issued by the Corporate Taxation Subcommittee of the Tax Commission in November 1996 says that the current rate of 37.5 percent should be cut to about 35 percent. However desirable this may be, the report also points out that Japan is in difficult fiscal straits and “not in a situation that would allow substantial tax reduction policies to be implemented at this time.” Instead, the report advocates widening the tax base and reforming the Article 38 items (by, for example, eliminating the reserve against bonuses) so as to provide funding for a reduction in the basic rate. Reduction of the real tax burden is “an issue for the future.”

Although the current national corporate tax rate of 37.5 percent is somewhat higher than in other countries, it is not that much higher. The effective tax rate is high because of local corporate taxes and corporate residential taxes. Hashimoto (1996) argues that local corporate taxes should be included in any discussion of reducing the tax burden on companies. Given the mounting

pressure to decentralize authority to local governments, this will necessitate a debate on how tax resources are to be divided between the central government and individual regions. Others point out the need to widen the tax base from the perspective of economic neutrality as well as reducing the tax burdens on companies. Even the Tax Commission report notes the need to eliminate a plethora of reserves and to “organize and rationalize” tax breaks.

Another issue raised by globalization and corporate tax reform is the taxation of companies with losses. At present, the 37.5 percent tax rate applies only to the largest companies, which make up less than 1 percent of all incorporated entities (about 2.4 million). Nonetheless, the taxes paid by these large companies account for about 60 percent of total corporate tax revenues. Honma and Saito (1997) maintain that this tax structure has exacerbated industrial hollowing. Large companies that bear extremely heavy tax burdens have a strong incentive to move overseas, whereas it is advantageous for lightly taxed smaller companies to remain at home.

In addition, about 63 percent of these 2.4 million companies operate in the red. Some argue that companies with losses should also be taxed, but the reason why there are so many such companies in the first place is because Japan has an extremely progressive tax code that creates a marginal tax rate on personal income that is high by international standards. Thus, incorporation is a means of avoiding income tax. Therefore, a reform of corporate taxation will eventually entail a reform of the income tax as well (Miyaguchi 1997).

FUTURE TASKS

The Japanese economy contains sectors that have already been baptized into globalization and are making efforts to adjust to it and sectors that have yet to be globalized. This two-tiered structure has become more prominent in the 1990s. Manufacturing is the obvious representative of a sector that has already globalized. With expanding exports, the switch from exporting to overseas production, and the establishment of an international division of labor, the history of Japanese manufacturing parallels the history of Japan's adaptation to globalization. The financial services industry, on the other hand, is only now coming to grips with globalization as it prepares for the Big Bang reforms. The image of the Japanese banking industry being crushed by onerous Bank of International Settlement (BIS) burdens is an accurate reflection of the perception among the Japanese public that Japan has an economy that is small and frail. Even those banks for which international operations are not essential have found adapting to globalization (clearing BIS standards) unavoidable. The cost of the domestic adjustments has surfaced in the form of the recent credit crunch.

The extremely low levels of incoming direct investments point to the directions that will be taken in future globalization. Purely statistical comparisons show a large gap between Japan and other developed countries in terms of incoming direct investments. Therefore, any further globalization of Japan will likely bring with it an expansion in such investments. As Toys "R" Us has demonstrated, foreign companies can enter and have a vast impact on the domestic

market. Productivity gains are often pointed to as one of the positive effects of deregulation, but how much is gained will depend to a great extent on whether there are new entrants into the market in the form of foreign companies with superior managerial resources.

Three points are crucial to any discussion of globalization and the domestic adjustments involved: (a) declines in the long-term potential growth rate, (b) the timing and speed of globalization, and (c) the cost of domestic adjustments. All are interrelated.

We have examined the argument that falling long-term potential growth rates tracked the trend toward globalization in Japan. Indeed, Japan's potential growth path shifted lower during the prolonged low growth of the 1990s. The speed with which the population is aging makes it clear that low real GDP growth rates are to be expected over the long term. Japan has already experienced a downward shift in its potential growth rate following the high-growth period. That shift coincided with soaring energy prices, so Japan responded to the lower growth path by energy-conserving adjustments that allowed it to use scarce resources more efficiently. In the future, aging demographics will mean that labor is the scarce resource. If Japan can efficiently use its labor resources, it should maintain growth on a per capita GDP basis, even with no growth in total GDP. Domestic deregulation, international divisions of labor, and the entrance of foreign companies—in short, globalization—will contribute to the more efficient use of labor resources.

However, an argument persists over the short-term timing and speed of globalization. Unlike oil shocks, the aging population problem has emerged slowly, and there are options in the timing and speed of the response to it. The domestic adjustments required by globalization will

have a substantial short-term deflationary effect through employment and other mechanisms. Almost all empirical analyses agree on this point. Shimada (1997), for example, advocates a large government stimulus to create the demand that would mitigate these deflationary pressures. A recession is looming in Japan, and this may cause some to conclude that now is not the time to make domestic adjustments such as deregulation. Certainly, the costs of domestic adjustment would have been smaller in the late 1980s when the economy was roaring, but as long as the economy is expanding steadily there is little incentive to initiate adjustments that may well undermine the boom. We also examined the issue of technological change and noted that the speed of adjustment was an important factor in capturing a first mover's advantage. Ultimately, it will be difficult if not impossible to simultaneously achieve the three objectives of short-term economic stimulus, long-term structural reform, and the other long-term challenge, fiscal construction. A political judgement must be made on which receives priority. Shimada (1997), for example, advises that fiscal construction be temporarily deferred.

Even taking into account the deflationary effect of domestic adjustments, the costs of globalization will be large. The signs of this happening could already be seen at the end of 1997 when two large financial firms collapsed. However, if incoming direct investments increase and more foreign companies enter the Japanese market, there will also be new job opportunities. Unfortunately, the low liquidity in the labor market remains an impediment to incoming direct investments. Enhancing the labor market's ability to adjust supply and demand would contribute both to reducing the costs of direct investments in Japan and to easing the entry of foreign

companies, thereby mitigating the overall cost of adjustment. Labor market reform is therefore urgent. However, as Seike (1996) argues, care must be taken with the age groups who have accepted low wages under the traditional seniority wage system.

Globalization of the economy is not itself the ultimate goal. Rather, we must ask how much this will contribute to the stabilization and improvement of living standards. There are few who would completely reject the significance of globalization. But opinions differ as to the timing and sequencing of globalization, the costs of domestic adjustments to globalization, and how those costs should be paid. The globalization of the Japanese economy has so far involved expanding exports, expanding imports, and expanding foreign production. The globalization of the future will likely involve an increased presence in Japan of companies from other countries.

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