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## THE HOLLOWING-OUT OF JAPAN'S ECONOMY:

MYTHS, FACTS, AND COUNTERMEASURES

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**PANEL 1: THE HOLLOWING-OUT DEBATE: DOMESTIC CONSTRAINTS, OVERSEAS RELOCATION:**

**Panelists:**

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**PANEL 2: COUNTERMEASURES AND THE FUTURE OF THE JAPANESE ECONOMY:**

**Panelists:**

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P R O C E E D I N G S

MIREYA SOLIS: Good afternoon, everybody. Welcome to this event: "The Hollowing-Out of Japan: Myths, Facts, and Countermeasures." I'm Mireya Solís, Senior Fellow and the Knight Chair in Japan Studies here at Brookings. And I just want to introduce the event, tell you, what are some of the questions that are behind this event today?

And as you probably know, this concern that Japan's manufacturing base may become hollow, as Japanese companies shape their production facilities or production operations overseas, is certainly not new. This issue of hollowing-out, *kudoka*, has been discussed in Japan for many years. But it does seem that there is now added urgency. This topic has come back with a great resurgence, and people are now talking about the many great disadvantages to domestic manufacturing in Japan, and they feel, therefore, that this topic has become far more pressing.

So, what are these adverse factors/disadvantages that people bring up when they think about why it may be hard for Japan to keep a very robust manufacturing base domestically? Different things come to mind. For example, a skyrocketing energy import bill and, quite frankly, uncertainty about the supply of electricity in the aftermath of the Fukushima nuclear accident -- also, the high value of the yen. And we know, of course, that there has been remarkable movement on that front, but that doesn't mean that that issue is over, because we don't know what will be the long-term value of the currency. But in the past, many Japanese companies have felt great pressure in their exporting capabilities because of the high value of the yen.

Another issue frequently mentioned as hindering the competitiveness of Japanese businesses is overregulation. And I think it's really interesting to note, for example, that last fall, the International Financial Corporation in the World Bank group released its survey, "Ease of Doing Business." And, basically, Japan slid in this ranking. It now occupies position 24. And what this measures, really, is how much overregulation is constraining the activities of companies and manufacturers in Japan.

Other constraints frequently mentioned are rigid labor markets, high corporate taxes, delay in signing free trade agreements, deflation, and the expected contraction of the domestic market as the Japanese population decreases in size because of demographic trends. So, it's a list of, you know, very significant disadvantages that people bring forward to say why this may actually compromise the ability to maintain a robust manufacturing base in Japan.

So, the purpose of this seminar is, really, to address what I think are four fundamental questions. One is, to what extent are these fears of hollowing-out warranted? Is this a real phenomenon, or not? And what is the impact of these so-called push factors that I have just mentioned in encouraging the exit of Japanese companies away from the Japanese market? Two, what is the extent of internationalization of Japanese business? And should we think of domestic manufacturer and foreign production as substitutes or complements? That's a very important thing that we need to establish. Third, what are some possible countermeasures to strengthen the domestic manufacturing base in terms of deregulation, promotion of inward direct investment, and the encouragement of innovation? And fourth -- and this is the big picture question and obviously, a very challenging one -- what can we expect will be the future of Japan's economy? What shape, what structure? Will Japan move towards a postindustrial economy mostly around the service sector, or will it retain a very robust, high-end manufacturing capability at home?

Now these are very important topics, and we decided to divide the analysis and discussion in two different panels. The first panel is called "the Hollowing-Out Debate: Domestic Constraints, Overseas Relocation." And I have asked the panelists to address a number of issues in this first panel. First of all, how should we understand the phenomenon of hollowing-out? What is it exactly? How do we measure it? What produces it? Second, to what extent are these negative factors that I mentioned compromising the competitiveness of Japanese domestic manufacture? Third, is hollowing-out a myth? Are Japanese companies really abandoning domestic manufacturers because they are exiting, because they're going overseas in their production strategies? And fourth, how are Japanese companies navigating the disadvantages of domestic manufacturing, as well as the risks of foreign production? It's not easy, either, to undertake foreign production. So, how do they navigate these different challenges?

And I think we're very fortunate that we have a terrific -- a number of panelists to address these different issues. I'm going to introduce them very briefly, because we have also prepared their full bios, their copies of their bios, and I would encourage you to pick a copy of those so that you can see, really, how talented and remarkable are the panelists that we have the good fortune to be here today.

So, in this panel, we have Barry Bosworth, who's Senior Fellow in the Economic Studies Program at Brookings, Tsunehiko Yanagihara, Senior Vice President and General Manager of Mitsubishi International Corporation, the Washington office, Tomohiko Inui, Professor in the College of Economics at Nihon University in Japan, Chuck Ernst, Chief Engineer at Honda's North America Engineering Center, and Jim Fatheree, President of the U.S.-Japan Business Council and Senior Director for Japan and Korea in the U.S. Chamber of Commerce. And Mr. Fatheree will act as a discussant for this panel.

Now I know I'm being very unfair, because I have laid so many issues for the panelists and given them each 10 to 12 minutes to address these topics. And you will see -- Jennifer's going to be in charge of keeping track of time. On purpose, I avoided that task. And when you see her raise her hand or show you a piece of paper, that means you have one minute left, and then the second time, it's time to please wrap up.So, thank you so much, and, Barry, if you want to get us started, that'd be great.

BARRY BOSWORTH: Thank you. This was a rather long list of questions she started with, and, so to try to save some time, I've prepared a handout, which you could pick up in back, I think, although most people have it -- sort of more of background information, and I hope it allows me to be brief about this.

I'll start, I think, with a few general observations. First of all, I think that what's going on in Japan is of great interest at the present time here in the United States. And the major reason is because we face a lot of exactly the same challenges. The two countries look surprisingly similar. Number one, monetary policy is exhausted as a tool in both countries. Interest rates are zero. Both countries have experimented with quantitative easing, and that really hasn't done much. Both of us have huge degrees of fiscal stimulus, which have left us with very large budget deficits. I think the third one is, both of us seem to have completely dysfunctional political systems.

So, there are a lot of comparisons. And I think the worries that we have in both countries is that these difficulties are going to push us in the direction of stagnation, with respect to economic growth. And so because Japan preceded us with a lot of these issues, I always thought it was interesting to focus on Japan, to get some clues as to how the United States might evolve.

But there is, I think, in one area, at least, here in the United States, a perception that Japan has done a lot worse than it has. And I think it frequently gets overstated. The Japanese economy has actually performed quite well, compared to other G7 countries. It's performed badly if you compare it against itself. Economic growth has drastically slowed down since the 1980s, but the growth rate in Japan is almost exactly the same as the growth rate here in the United States.

How did Japan manage this dramatic slowing of economic growth without a lot of disruption? Basically, by cutting the workweek dramatically. When I first went to Japan, I couldn't believe the number of hours -- I guess I wouldn't say people worked -- I would say people reported for work -- because I was in the Ministry of Finance, and I didn't think they were working all those times, but they were certainly there a lot, right?

And Japan used to have, by far, in the OECD, the largest number of hours per year, of any country. Today, it's almost exactly the same as United States. So, Japan adjusted, particularly during the 1990s and the first part of this last decade, by cutting the workweek, as a means of, in effect, spreading the adjustment over time. I think it was really quite successful.

Productivity growth in Japan's been almost the same as here in the United States. There's no real significant difference between the two countries in that regard. But where Japan stands out in difference from the United States, particularly going forward, is it has a dramatically shrinking labor force. We like to talk about economic growth, in terms of increases of the labor force each year, of, say, like, one to one-and-a-half percent, and then improvement in productivity. Japan starts with an improvement in productivity of one, one-and-a-half percent, maybe, then it starts subtracting off, because labor force growth is negative.

So, I think the future growth of Japan, realistically, is about one-and-a-half percent a year, going forward. And that's going to be composed of labor productivity of about two percent a year, which will be equal to the United States, but the labor force will shrink at about a half of a percent per year, leaving you with a net growth rate of about one-and-a-half. This implies for Japan, because of the speed with which the country's aging, a major increase in economic burden, about how it's going to provide for an aging population. Japan is going to be aging much more rapidly than the United States does. This is a problem that, for us, is still, like, 20 years in the future. And, in part, because of that and the slow rate of growth of the labor force, Japanese companies are going to have to move abroad in the search for workers, given the policies that Japan has inside.

I think the major surprise from outside when you follow Japan economy, though, what stands out about it, is the complete collapse of savings and investment in Japan. We have, decades, talked about Americans don't save very much, and Americans don't invest very much. Japan was always known as a high-saving, high-investment country. It has transformed itself in 20 years into a low-saving, low-investment country. Household savings rate in Japan is now below that of the United States. Japanese save even less than we do.

The savings that takes place in Japan takes place in the corporate sector, which makes very good rates of return, but then just hoards the money, and has piled up huge financial reserves. Savings is very high, but corporate investment is extremely low. The government then turns around and borrows all that money from the corporations in order to spend it, and to finance its large budget deficit. So, I think on the handout, I tried to illustrate this. There's just been a revolution with respect to the savings/investment balance in Japan. And from an economic point of view, I think that's the biggest macroeconomic event.

But then to turn more specifically to these issues of competitiveness, in Asia, certainly, Japan faces dramatic increase on competition -- faces from China and from Korea. And I think the improvement in information technology that's taken place worldwide just makes it so much easier to outsource all that production. And so Japan has been doing what the United States has been doing: moving its production facilities abroad. I think Japan tends to move its own facilities abroad; the United States just tends to abandon production, and we arrange with contractors to do it for us. So, we have more -- the model, I think, for the U.S. would be Apple Computer -- that doesn't own a single factory in the United States or abroad. It's not even a manufacturing firm anymore.

The other aspect, I think, is that without immigration, capital and management skills have no choice in Japan, except to move abroad. And I think that's the major driving force behind it. Japanese companies, I think, will continue to be global leaders, but they'll be doing more and more of their production overseas, outside Japan. It's just an inevitable aspect of the demographic changes that occur.

Other one to remember is, Japan's got an extraordinary external balance. Remember that Japan is the world's largest creditor nation. We always hear about all the reserves that China has piled up, but Japan's far ahead of China. It has very large financial reserves and investments abroad. And as a result of that, it earns a very large net return on its foreign overseas investments. And so a lot of factor income comes in from those overseas.

And last couple of years, the trade deficit -- or trade balance -- has declined to about zero, mainly because of the tsunami, the global recession. It's hard to say exactly where it's going in the future, but regardless of that, China's got a surplus just from this capital income pouring into the country every year -- return on their investments of about two-and-a-half to three percent; net will probably grow as world interest rates recover. So, I think it starts with a pretty strong external position. Contrast that with the United States, which is the world's largest debtor nation, by a very large margin -- the two countries on the opposite side.

Deindustrialization -- declining share of manufacturing -- that has definitely occurred in Japan. But I would only point out, it's inevitable. It's occurred in every single major country in the world. Once your income reaches a certain level, you're going to see your manufacturing share go down. And the fundamental reason is, productivity in the manufacturing sector is faster than it is in the rest of the economy, so to produce the same share of GDP, you need a smaller share of the workforce. And that's what's happened in the United States; that's what's happened to Japan. And Japan is right in the middle of the pack. Decline in the employment share in Japan is exactly equal to the G7 average.

But it starts with a somewhat higher share of GDP and manufacturing. So, it's still a relatively large manufacturing country, but it's experience the same pattern as we see in the rest of the world when people talk about the reduced importance of employment.

The share of employment and the total economy in 2001 was about 20 percent. Today, it's about 17 percent. You compare that to a G7 average of about 17 percent; it's come down to 13 percent -- so nothing very dramatic.

The second one we always hear about is, Japan's suffered from changes in the exchange rate -- and particularly, large appreciations of the change rate. And what has always bothered me -- instead of ever talking about exchange rates on a multilateral basis, people want to talk at a bilateral basis. And you have to look at, I think, multilateral, and you have to look at it in real terms, not nominal terms.

Japan has a depreciating nominal exchange rate, but prices in Japan are falling, compared to those of the rest of the world. So, the only way to actually look at this is on a real exchange rate basis. And there, Japan's exchange rate has been drifting down on a trade-weighted real basis for over 15 years, rather continuously.

Then, when the financial crisis hit, and Japanese citizens got a little worried about what was going on in the rest of the world, they tried to take their money back home. And, for a period of time, the yen appreciated in real terms, but nothing particularly dramatic; it's in the same range that it was at the low point a couple of decades ago. So, I don't think there's a real fundamental change in Japan's exchange rate at all. Its relative competitiveness in that regard is about the same as it was over the average of the last two decades.

But now, what's come along -- I guess what we'd call Abe economics, for lack of a better name -- another round of huge fiscal stimulus in Japan, of about $110 billion. I think a reasonable estimate of the effect that that's likely to have on the Japanese economy will lift the growth rate during that period by about two-and-a-half percent. Monetary policy, another round of stimulus -- somehow, we've heard all that before. To me, it just gives you a big feeling of déjà vu; we've been there before. We've heard it all before, and nothing has fundamentally changed. It has the same conflict that the United States has; you can't make up your mind whether you want to have economic recovery or balance the budget. So, you flip back and forth between one and the other about every couple of years, and the U.S. has now started that same cycle that's been going on for 20 years in Japan.

I think the other point is that none of these changes have fundamentally changed any of the economic challenges that Japan faces -- because nothing is going to be done about trying to get rid of this dual economy, of the super efficient export-orientated sectors, and in inefficient domestic sectors. The domestic sectors are overregulated and protected against competition, and that seems to be continuing. And I think it also has no way of resolving this issue of this enormous accumulation of corporate savings that's not being channeled into productive investment.

But I would argue that export promotion, then, is not a viable policy for Japan over the next few years. Japan has to, inevitably, broaden out its economic base, improve its service sector industries, and look forward to the future in which most of the jobs will be in the service sector, not in the goods-producing sector. Thank you very much.

TOMOHIKO INUI: Thank you, Brookings, for allowing me to speak in front of so many of my colleagues and friends in D.C. today. I'll be using some slides to go through what Barry has placed or put together -- very comprehensive view of what the Japanese situation is. Given that I have 12 minutes, I have 13 pages I'll go through rather quickly.

First, I will just lay out what this hollowing-out trend of Japan's manufacturing industry is about, and then I will go through some of the push factors, some of which Barry has already mentioned -- and they'll be discussed throughout today's discussion, I think. And then I would argue that, in addition to the push factors I'll be mentioning, there'll be a pull factor. In fact, push is rather a sort of strange word; it feels like you are pushed out of Japan, without your choice. But there are certain choices that companies are making, and that's what I'd like to argue.

So, what's happening with this hollowing of Japan's manufacturing industry? If you look at the numbers, overseas production ratio of Japanese manufacturing companies is rising. If you look on the left side, that red in the middle is manufacturing total. From 1990s on, it's consistently on the increased side, up to about 18.4 percent. Some of the industry that we call process types -- on the bottom, you see some of the machinery, electric appliances, and some transportation equipment -- those are much higher in percentage in terms of the overseas production ratio.

Overseas investment is growing due to emerging countries' high GDP growth and Japan's low GDP growth, and that's also fact. That's something Barry has mentioned. If you look at the right-hand side of the chart, what you see is the sort of light blue -- in my case, it's light blue, but it's green on the screen. I guess Brookings is a very green place. GDP is on the increase. That's emerging countries. But similarly, if you look at the overseas investment, which is the red -- sort of the wide red lines -- Japan's investment overseas is definitely on the increase side. And if you look at the bottom on the yellow, that's Japan's domestic investment. So, as you can see, farther Japan's domestic investment is on the decrease side, since the Lehman shock of 2008. Japan's overseas investment has dropped, and the Lehman shock has, again, increased back again. And it's definitely taking on the similar pattern as the GDP of the growth of the emerging countries, and that's a very important fact.

Despite relatively steady unemployment rate on the left, manufacturing employment is down. If you look on the left side, the file in the U.S. election, we talked often about the unemployment rate. Japan's sort of general trend on the unemployment rate, overall, it's about five percent file -- if this is a problem -- 15 to 24 years old is relatively high -- about 10 percent.

On the bottom, clearly, labor force employed by sectors is changing, as Barry mentioned. The tertiary service sector is definitely on the increase -- 70 percent. In 1950s, many years ago, you had the agricultural sector; the primary sector, the green, topping at 39.8 percent. So, there definitely is industrialization taken its toll. And in the secondary sector, manufacturing is on the middle side.

Technical skills among new graduates are declining. This is a quality of the labor. That's another factor that's very important here. Declining while employees, age is rising. If you look on the right-hand side, file the specialized courses -- that's sort of the bar chart on the right-hand side, sort of pinkish -- you can see the constant decline of the specialized course takers, while the general courses are peaking in the '90s and still relatively high. In other words, the younger people are taking much more general courses, rather than specific technical/commercial courses, while, on the bottom, aging employees in Japan -- I'm also aging, too, I'm about 50 -- the below 29-year-old is on the decline, up to 15.7 -- similar to 1989. The above age -- 55 -- is 22.1 percent to 25.2 percent. So, what this shows is that while the younger people focusing less on focused technical skills and commercial skills, the people who have them, those which are the elder people are aging. So, that's a combination of very important factors.

So, now going to the post factors. The first, we asked the Japanese companies what they are feeling the products -- the reason for why they are going overseas, and they said that the main factors being, first, the yen appreciation, which is uncontrollable in many ways, high labor costs, energy uncertainty, and corporate taxes. And this theme comes back over and over again.

So, first, the yen appreciation -- still, the increasingly end value negatively impacts price competitives of Japanese export in foreign markets -- while file -- I say that most of our companies feel the yen appreciation/depreciation to be uncontrollable from a business perspective. It does, in fact, affect our way of marketing and operation strategies.

A rise in the exchange rate from 100 yen to 80 -- strengthening of yen -- that's 20 percent. It raises the price of car manufacturer in Japan, exported to the U.S. -- for example, 20,000 car becomes 24,000. Although it's not instantaneous, that's an automatic sort of translation of what the value is when brought into the United States. So, without your doing anything -- just by virtue of exchange rate -- the pricing, all of a sudden, becomes 20 percent up, and hits you right away.

So, as you can see on the chart, the other time, when we had 250 yen per dollar -- that's in the '80s -- and then went down all the way to 100 in 1995 -- and then went up again, and then went down -- appreciated up to about 79.8 yen per dollar on the average of 2011. As of today, I think we're 93.4 yen, as of this morning. So, as you can see, the exchange rate has played quite a huge impact on Japanese companies, in many ways.

The second issue is labor rigidity and high wages. This is very complicated, because, as the industrial nation grows, obviously the rise of the labor cost happens. If you look at this chart -- and it's quite a busy chart on the left -- these are the compensation costs in manufacturing setting, 2011. No way in Switzerland, Belgium, Denmark being very high labor cost nation. Japan is just above the United States, at 35.71 in U.S. dollar basis. And if you look at some of where Japan is going to -- for example, in Asian nations like Singapore, Korea, and so forth, on the right-hand side, they are significantly lower than the Japanese labor costs. And that's really -- again, if you just compare apple to apple in labor cost, that has an impact on how we think about the core structure.

Another interesting is low mobility of labor market in Japan. That has something to do with competitiveness, too. We always believed that having consistent labor force in one particular field or the strength in the Japanese companies -- but now, perhaps it's clear that some of the lack of mobility is triggering such export of the skills to outside of Japan, for example.

And if you look at the numbers -- and it's interesting how this is measured, but I won't go into that -- but if you compare to the U.S. of 126.2, that's the mobility rate, and Japan is about a fourth of that -- 31.9. Germany, interesting, is about double Japan -- the 60.2.

And it is uncertain. This has been discussed at Brookings, as well post- Fukushima, the cost of Japanese energy, why Japan has long been highly dependent on energy imports; energy supplies have been further constrained by the shutdown of nuclear power plants, naturally. If you look at the chart on left -- and this was made in 2009, pre-Fukushima -- but that had two chart, blue being the dependence of import, with nuclear running -- and 96 is the number without nuclear. So, only four percent is covered independently by the Japanese own supply -- being hydropower and some of geothermal. So, basically, most of Japanese energy source is imported. And as a result, it's very high cost.

If you look on the right-hand side, the chart shows that a place like Denmark is very high, but Japan is the fourth highest. And the U.S., pretty much on the bottom of chart, at blue. And I'm sure U.S. will be much lower in the long run, because you're now having an energy revolution with shale gas and tight oil.

Another factor of high taxes -- and that does hit to the corporate net income -- the more you earn, more you hit, and, therefore, tax does play a large role. High corporate taxes increase domestic production costs -- and especially companies to developing countries. And here, again, something interesting to note -- Germany used to be very high in terms of corporate tax structure, but they went down, I think, as a result of a number of measurements they have taken. And now, under EU, they are back to about 30 percent. Japan is up 39.5 percent.

Then the market change -- and that's naturally one of the issues that's always been talked about. Domestic markets are shrinking as demographic trends progress. If you look on the left side, population declined in Japan; it's about 120 million people today, and large number is 65 plus. And then in the middle, sort of the purplish area, is 15 to 64, who are really producing in industrial society. They are shrinking down. And under 14, it's not also expanding. So, you have a shrinking younger generation, while you have a relatively thick layer of elder people who tend to live rather long -- which is a good thing, but then again, they have to have some input into economy.

Finally, I brought this up because this does show some of the interesting example of what manufacturers and also trading companies like us have been struggling, trying to reduce costs. It's a logistics cost. It may not be a large part of your core structure in things, but even if it's two or three percent, it is a controllable factor; it's something you can choose to reduce by picking right partners, right ports. But what is this?

In the circle is the cost of domestic land right, and export. When you try to export any product, and you put in place in port, and you place on the ship. Then if you would dissect this land right into summer comparisons -- well, Japan has this relatively high toll -- highway road toll fee -- and it's of 100. If you compare that to USA, almost zero. In China, about 16, Korea 20 -- that's the toll fee differences. Even though toll fee may not be the large -- it's a very small percentage of your product -- but it does have some difference. In comparison, to continue, on the right-hand side, Japan is 100, Kaohsiung -- that's Taiwan -- and Busan in Korea is about half. So, this kind of a structural cost difference does play, when you really are trying to squeeze some cost reduction in the process.

And then I speak very briefly about pull factor, because it's an important factor. And the value of sales in overseas market is growing, while profits are rising. So, companies looking for higher sales and high profits naturally look for markets where things are growing, and that's a very natural tendency. And there's nothing wrong, I believe, with that.

If you look at the top chart -- and by trends overseas -- that's North America, Asia and Europe, and the Asian portion, which is sort of black-shadowed, is definitely increasing. If you look at the Asia wall on the right-hand side, China is definitely high up there, and you have ASEAN four and these three.

So, naturally, Japanese companies are looking for higher revenue basis, and which you are gearing toward Asia -- and that's, obviously, changing manufacturing strategy, as well. And if you go to profit, also, on the bottom side -- profit trends for overseas affiliates of Japanese companies are definitely on the increase, too.

So, what I'm saying is, if this is on decline, and then you're trying to move away from Japan, you're making huge mistake. But if the numbers are falling exactly while your strategy of moving into Japan is falling, then you are still making the right choice.

But there are differences between large and small companies, and that's a very interesting phenomenon. The overseas production ratio is higher for large companies, compared to small and medium size enterprises. Large companies, about 66 percent they say they are on doing overseas production, whereas the SMEs are 22 percent, you see -- and no overseas production is large company -- 34 -- SMEs, 80 percent. So, the key is when, and how, and whether these SMEs are moving out of Japan or not. That may become a big issue. And if you ask them what are their reason for their overseas production by company size, the most important reason for moving operation overseas are different, and overseas market development's the most important factor for large firms, while low labor costs are most important for SMEs. So, how the managers view the differences in why they're moving out is different. And, obviously, their risks are different, too.

So, in sum, there are obviously these push-and-pull factors in play here, and I will definitely argue that while there are certain push factors that are placing companies in very difficult positions -- but at the same time, growth in the Asian market, particularly, are pulling some of these companies away from Japan, as well. And, also, there are some differences in motivations and activities between large companies and small companies -- which, obviously, we do have to look very carefully upon. Thank you very much.

TSUNEHIKO YANAGIHARA: So, good afternoon, ladies and gentlemen. It is my great pleasure that I can have opportunity to discuss about the hollowing-out -- either myth or fact. This is actually a title given for this discussion. And especially I'm involving in the project for the last two years at a research institute called Research Institute of Economy, Trade, and Industry, which is one of the government-owned research institutes in Japan. And the central focus of this project is on the effect of Japanese problems overseas activities on the domestic economy -- especially I am the most interested in how overseas activities affects the productivity of domestic firms. In my talk, therefore, I'd like to discuss the result drawn from our research project by comparing the result among the various countries.

My presentation proceeds as in this writing up front. I'm discussing about the increasing overseas activities by Japanese firms, it has already been discussed by the last presentation, but I will compare the overseas activities between Japan, U.S., and Germany. Then I'm going to discuss about the effect of Japanese problems overseas activities on domestic economy performance -- especially people very much interested in the labor market, so I will discuss about the effect of the labor market. Then the investment, and, lastly, I will discuss about how the overseas activity affected the productivity of the Japanese economy. Then I will conclude, and then I would like to discuss the necessary research topics, in order to understand fully about the effect of the overseas activities to the domestic economy. And then I will show differences.

So, this is the outward FDI investment by U.S., Japan, and Germany, and that bar shows the U.S., and the green bar is Japan, and blue bar is Germany. As you can clearly see, Japan is actually increasing the FDI stock, but comparing to the other two countries, stock is relatively small. And this is that which you have already seen from the last presentation. As last presentation, we can see that the clearly increasing trend of the overseas activity.

For example, in case of manufacturing, in degrees from 14 percent in 2001 to 80 percent in 2010. But I compared this overseas production ratio with Germany and the U.S. I cannot get the most recent data, but if I compare the overseas production ratio in 1994 in U.S. and Germany -- and they are 26 percent and 23 percent, respectively -- so comparing to that, we have 18 percent in 2010. But Germany and the U.S. has already achieved more than 20 percent overseas production ratio in 1994. So, we are still behind in the overseas activity, comparing those two countries. Among the manufacturing industry, the transportation equipment industry has the highest overseas production ratio. It has already reached almost 40 percent.

So, then I would like to discuss about the effect of the overseas activity on the domestic market, domestic economy, but first, I would like to discuss about the effect of the labor market, especially the effect of the number of employment. This is reprinted from a METI Report. METI wrote a whitepaper on examining about the effect of the overseas activity on domestic economy, and they compare more countries, like Japan, U.S., Germany, Korea, other countries. But I just pick out two countries -- Japan, Germany.

And if you see that this is the line of employment, the blue lines are total employment of Japan in the right-hand side, and the green lines are the manufacturing industry, and the green line are non-manufacture industries. And as you can see, the total number from it is decreasing in Japan. And this comes from the chart declining the number of employment in the manufacturing industries.

But we have some increase in the non-manufacture industry, but it is very slow. It is actually a very sharp contrast to Germany. In Germany, as you can see, this is, again, the blue color is auto industries. German industry's total number of employment is increasing like this. But the Germans also experience the decline of the manufacturing industry -- like that top of the line. But the difference is actually -- no-manufacture industry employment is increasing. So, I think, as Barry pointed out in the first presentation, the problem in Japan is that most countries experience the deindustrialization, especially the manufacturing sector, but in the case of Germany, the non-manufacture industry expanding and absorbing this other employment. But in case of Japan, we have a very sluggish service, non-manufacture industry, so they cannot fully absorb the employment in the this time. So, this is one of the problems.

But, as you can see, we have the most country has declined number of employment in the manufacturing industry, but we have to examine whether this comes from the overseas activity or not. So, in order to do this, just simply figures you cannot do anything. So, you have to do an econometrical analysis -- the way that overseas activity reduces the number of employment domestically.

So, actually, I reviewed the many papers, and most of the previous empirical work show that there's no very strong negative impact from the offshoring overseas activities of the parent employment, especially -- this is the Harrison -McMillan is a very recent paper, examining the effect of overseas activity to the U.S. employment, and they actually find that sometimes the overseas activity has a kind of complementary effect to the number of employment in domestic.

And total, there's small negative effect, but it's actually negligible. So, the Harrison-McMillan find out that there is not very strong -- weak negative effect to the employment -- and Wagner, actually, he's also surveyed the studies about the relationship between the overseas activity and domestic number of employment, and he also could not find any strong negative effect on the employment. And also, the other thing they examined the Japanese case, and, also, they found a complementary effect of the overseas activity to the domestic employment. So, different from the popular view -- I think that empirical studies find out that overseas activity actually promote -- at least, not decrease the number of employment domestically.

But one other important issue is domestic investment. This is, again, reprinted from the METI report and here, we have, actually, as we already have seen in the previous papers, we have a declining trend in domestic investment in Japan -- and, also, some increasing trend in the overseas investment. In case of Germany, this is actually a sharp contrast when comparing to Japan, again. Germany has a relatively large FDI, but they're actually increasing investment. So, Japan seems to have some negative impact from the overseas investment to the domestic investment, but Germany does not have such experience.

Again, this simple figure doesn't show the clear impacts, so we have to see the more rigorous empirical result, and, unfortunately, in this area, a number of empirical studies are very much quite limited. But we have some recent papers, examining the impact of the overseas investment to the domestic investment. And Disai, Foley and Hines, this is an empirical paper using U.S. data. They actually find that the U.S. overseas investment is a complementary effect of the domestic investment. So, most overseas investment and the domestic investment increase in the case of U.S. multinational firms.

On the other hand, Belderbos, Fukao, Ito and Letterie did similar empirical exercise using Japanese data, and in case of Japanese data, some present a negative effect on the domestic investment -- in particular, in case of low wage-seeking FDI. So, if the Japanese firms make an investment in the China or other low-income countries, then the domestic investment have a negative impact from that investment. But I think I will talk to you later about that. I think that the empirical studies are quite limited, so we should have more study on that area.

And this is actually the -- I am very much interested in the effect on the productivity, because the overseas investment may have a negative impact to the employment or investment, but maybe the overseas investment have a positive impact of the productivity. So, Hijzen, Inue and Todo examine the effect of the overseas investment to the productivity development, and we found out some positive effect, but it's limited.

And, also, the other thing that we found is that during this the productivity jump between the large and small firms among Japanese manufacturing, which is enlarging. So, seems that firms who can make overseas investment can increase their productivity, but if the firm cannot make an overseas investment, seems that productivity is very much slowing down. This is actually my empirical result, examining the catching-up process of the firms, and we found out some negative impact to the small and no productivity firm from the overseas activities. And, also, we examined the front, and we found out the import competition from especially the low-wage countries have some negative impact to both the high-productivity firm, the low-productivity firm, but the impact is much larger for the low-productivity firms.

So, we found out no clear evidence of the negative effect on the domestic economy performance from firms' overseas activities, but globalization seems to have a negative impact only to the small and the low-productivity firms in Japan. So, I have some future research in -- but I'm sorry; I have no time. Time has run out, so I would like to discuss later about those things. Thank you very much.

CHARLES ERNST: Good afternoon. I'd like to thank Dr. Solís for the opportunity to speak in front of this group today. I'm representing Honda in this discussion, and I want to be very clear upfront. You've heard from some good economic people. A lot of good information is shared. I'm learning something all afternoon today. I am not a policy expert, either. I'm a manufacturing engineer, and I've been a manufacturing engineer for about 35 or 40 years.

So, last week, in his State of the Union address, President Obama proposed the creation of manufacturing hubs across the country, in an effort to boost manufacturing in America. Without getting into the specifics of his policies and ideas or proposal, but as someone who spent the last 30 plus years dedicated to that effort, I'd like to think that we've established, in Ohio, something of a manufacturing hub.

After all, what we started in Ohio 34 years ago has led directly to nine major production facilities or operations in the States, including Alabama, Georgia, Indiana, North and South Carolina, as well as a few more operations that are on the way. Most of these plants were established -- and some are currently led -- by Honda associates who got their start at one of our manufacturing operations in Ohio.

Now, after 30 years of building cars in America, a milestone our Marysville auto plant reached last fall, our North American production and R&D operations are taking on lead roles in the launch of key global products or models, like the next-generation Civic. More on these details in just a moment. Viewed at a distance, this direction might seem to support the premise that investment and growth in the U.S. could weaken the industrial base in Japan. That, however, is not our experience.

As I hope to explain today, our strength doesn't make their weakness. And even as we continue to grow and advance our capabilities in the U.S., Japan remains the critical base for our global R&D, purchasing, and production/engineering capabilities. The reality is that we have an ambitious growth plan that will require strong contribution of all six regions of our global Honda operations. By the fiscal year ending March 31st of 2017, we're challenging to achieve global automobile sales of 6 million units. That's up from 4 million currently.

Based on our philosophy of building products close to our customer base -- which first led Honda to build products in America, starting in 1979 -- each region will make major contributions, with a focus on the unique needs of the local environment. Here in North America, with a new plant now under construction in Mexico, as well as expansions underway at our plants in Ohio, Indiana, and Alabama, we will increase capacity to more than 1.93 million units next year. This will represent almost a third of our challenging global sales target.

But it's not in response to changing economic conditions. The truth is that we've been producing more than 80 percent of our products we sell here in the United States for a number of years. Today, I work in the North American engineering center, which is based in the hub in Ohio that I described earlier. The center serves as something of a technical expert operation, supporting all of our manufacturing facilities in North America, particularly as it relates to developing production technologies required to launch new products in our markets, in our region. Our work there makes me think back to how dependent we were upon the Japanese engineers when our operations in Ohio were still relatively young.

I joined Honda in 1985, as you can see. As we were constructing the engine plant, which is now the highest-volume engine factory within global Honda, I can still remember our project office in the old farmhouse that's illustrated here, on land that Honda had purchased to build the plant upon. Each room was devoted to a different area of the plant, if you can believe it. The drafting tables were common-use to everybody. We didn't have PCs or computers at the time. Each room was devoted to a different area of the construction project team.

For instance, drafting tables in the living room were common for everybody to use. The facilities engineers occupied the kitchen, because they got there first. Each bedroom housed different departments -- assembly, machining, casting, and quality, and so on. Sometimes, we had to dodge livestock as we moved back and forth from the construction site to our project office. We welcomed a number of Japanese engineers to our team in Ohio. I also did training in Japan -- and this was true for many, many associates at the time, because we had no facilities to work within. We were not only learning the basic skills of manufacturing and how to achieve Honda's high quality levels; we were also learning about Honda's corporate culture, and the way they do business.

These Japanese engineers were our mentors, our trainers, our coworkers, and some of them became our friends. It was an extraordinarily valuable relationship, particularly for me, and I like to think that the role we are now playing is paying off in their investment in us back then. Now American engineers like me serve as trainers and mentors ourself. For instance, about 15 years ago, in Ohio, in the year 2000, I was asked to move from Columbus area to Alabama, to help construct and bring to mass production an all-new automobile and engine production facility on 1,500 acres. And many of the experts working with me to develop our new team in Alabama and to build our business there were also experienced Honda associates from Ohio. We followed a very similar approach with our auto plant in Indiana that recently opened four years ago, and a transmission plant in Georgia, as well.

This kind of organic growth has been key to our success, and it has led to increasing responsibilities. Last year, we announced the new role for Honda in North America that calls on our associates to play an unprecedented role for an international automaker. We will have the lead responsibility for developing processes to build key global models, then taking that product know-how and transitioning it to other plants throughout the world.

To give you an understanding of what that means, historically, our production associates in North America went to our global new model center in Tochigi, Japan, to learn how to launch and build new models. Along with the associates from other Honda facilities, they would then gain the know-how and refine the processes used to build products in their plants, in their regions. Now more of this activity will occur in North America.

Further, our U.S. R&D operations are taking on increased responsibilities for our global six-region operations. And they take focus on two things: optimizing the needs of our customers into the product design, and they need to take an even more active role in working with our local parts supply chain. We already developed the majority of our light truck models here in the U.S. Now our U.S. organization for R&D is leading the development of both the next-generation Honda Civic, which is a global model, in North America, as well as the Acura NSX sports car.

Certainly, this evolutionary growth of our production and R&D operations in North America -- and in other regions around the world -- means a changing role for Honda in Japan. For one thing, our auto plants there are being reoriented around local market needs themselves, such as minicars, like our popular N Box series that was introduced last year. But Japan continues to serve as the technical hub for new technologies. Honda R&D in Japan is home for our core power train technologies, as well as our advanced electromotive technologies for hybrid, fuel cell, and battery electric vehicles.

Japan is also key to advancing new production technologies. The new Yori plant in Japan will begin production this year, and is leading the establishment of more efficient, and more effective, and environmentally responsible production technologies. These systems will then evolve to other Honda plants around the world, including the new Honda plant in Mexico that will come online next year. This is the key to increasing sales of small cars that is so critical to our global sales growth. So, the creativity and ingenuity of the Honda R&D purchasing operations and production engineering in Japan has never been tasked with greater responsibilities.

At the same time, in the face of new safety, and fuel economy regulations, the hypercompetitive marketplace, and Honda's continued growth in emerging markets, the larger role we are taking in North America is vitally necessary to the company. In that respect, we are smartly leveraging the investment in our people and our facilities in North America to increase our global competitiveness.

The successful launch of the all-new 2013 Honda Accord is a good example. The Accord has been well-received by our customers, and one of the key challenges was to achieve a big improvement in fuel economy while still meeting the needs of our customers for a car that is fun to drive. This required a new approach that includes the first direct fuel-injected engine that we've produced in America, along with a new CVT -- or continuously variable transmission. We invested more than $120 million in Ohio, the transmission plant in Russells Point, to add a new assembly line, as well as aluminum casting, equipment, and processes, and machining.

In addition to producing the new four-cylinder engine at the engine plant where I got my start, invested almost $100 million to begin production this year of high-tech poly components for the CVT. CVTs have been criticized in the past for a rubber band feel that undermines sporty driving character, but our engineers in Japan developed a great new CVT transmission with a natural shift feel, and then collaborated closely with our transmission plant project members, to enable us to assemble it well in Ohio.

In the past, the durability and testing strategies were all developed in Japan, where the technical expertise was based. This time, instead of producing it in volume in Japan for two years, and transferring it over to the U.S., they did testing on a mini-line, and then they sent the mass production volume to the Russells Point facility, to start.

It's amazing to me how quickly we can introduce those technologies in such a short amount of time, and with such high quality. You will see more of this in the future, with Honda operations in regions around the world playing a more pivotal role. Yet, with the core competence of key areas, including power train and production engineering, remaining quite robust in Japan -- and, in fact, you'll see another example of this collaborative output this fall, when we begin production of the Honda Accord hybrid in Ohio.

Like everyone else, we struggled during the global recession, and then we faced some additional challenges two years ago, with the earthquake in Japan, and flooding in Thailand. But we never stopped challenging to compete more effectively, and to try and develop better efficiencies with our products and the methods that we use to build them. In fact, we used these challenges to get even better, and even more competitive. Now, as customer and regulatory demands increase, and the competitiveness of the industry intensifies, automakers must be prepared to act with greater speed and efficiency to meet the challenges of the marketplace.

But based on our longstanding approach to building products closer to the customer, our entire business model doesn't need change. Rather, our role in the U.S. will continue to grow and evolve through global teamwork that is a win/win for both sides of the ocean. So, I'm excited about the new challenges, and what that will mean in terms of greater opportunities for growth, greater personal responsibility and development for Honda engineers, both here in America, as well as in Japan.  Thank you for your attention this afternoon.

JAMES FATHEREE:  Hi.  I now have the unenviable task of trying to summarize or comment on the previous presentations.  The easy part is to say, all of the panelists made excellent presentations.  The other easiest part -- and I could keep this short and simple -- is just to say I agree.  But I might elaborate a little bit more than that.  So, what I'm going to try to do is try to integrate a little bit of what they said, trying to artfully summarize their points, but, also, get to what I really want to say.  So, it's the balance between what they talked about and what I really want to say.

So, here we go.  A couple of things -- I would highlight maybe five major areas.  First, Mr. Bosworth and others, I think, made really relevant points about the similarities between United States and Japan, in terms of our economic structure, our demographics, and some of the challenges that we face, particularly on the pension and the healthcare fronts.  I particularly noted his comment about the comparability of political dysfunction in both countries, and I frequently joke with my Japanese friends that it's neck-and-neck in terms of whose politicians are the worst -- theirs or ours.  Depending on the day or the week, that's still open for debate, but I think we both have big problems that our political leaders need to really grapple with in a mature way.  At this point in time, Japanese politicians are coalescing around a new leader, and they've got some opportunities that I'll talk about in a minute.

One thing I would note that I don't know that anybody really focused on was that in Japan -- and indeed, the case in the United States -- in some manufacturing industries, there is just really overcapacity.  And I think in Japan, particularly with the declining demographics, that's a problem, and you see it played out in the auto industry, but you see it played out in other industries.  So, the market solution for that sort of thing is consolidation and elimination of some of the excess capacity.  That can often take forms that are politically and socially difficult, but I think those are some of the challenges that both countries have to deal with -- but I'd say particularly Japan.

A note on productivity, which Mr. Bosworth talked about -- and it was touched on elsewhere -- Japan is very, very productive in certain industries, particularly the automotive industry, which Mr. Ernst is a practitioner in.  And I think that maybe helped drive up their overall productivity levels.  I think if you look at some other, non-auto manufacturing industries, productivity in Japan relative to the United States or Germany would be somewhat lower -- and in that, I would mean, like, chemicals, some basic materials, and things like that.  So, I think that's where they have some structural issues that could be addressed, which would help enhance productivity overall.  I'll talk about that in a minute, also. But I think, particularly in services and agriculture, that's where Japan really does have problems with its overall productivity.  And that bleeds into the economic growth. I agree with Mr. Bosworth. I mean, if you look at, on a year-by-year basis, or if you look at a trend line over time, Japanese economic growth is not substantially worse than it is in the OECD or the G7 countries, but Japan has had more recessions than any other G7 economy, and that's because of export dependency and some other things that I think are problems that they need to get with. But I'm sort of of the structural view -- that there are just some basic things that Japan can do, that will help them endure these cycles, but also create opportunities for higher growth levels, maybe closer to potential, going forward.

I do want to make a positive comment. I think Mr. Bosworth and others talked about this. You know, we talk a lot about the problems in Japan, but Japan is a big economy. It's a $5 plus trillion economy. It's a rich society, and American companies with which I work in a range of industries still see Japan as a market with lots of opportunities. Now there are problems. There's slow growth. There's things that could improve the environment, but it is still a top-three market for many American multinationals. And that's both in terms of consumer products, agricultural, but also, in the way that Americans find opportunities to partner with Japanese companies on technology. Japan's got a lot of technological capacity. It's got a highly educated and skilled population and workforce. So, there are many, many advantages on which Japan can build, if certain steps are taken. And I think that's the challenge for the new government.

So, to get to some of this -- I think the problems that were referenced in all the presentations -- I think that these are really solvable kinds of issues and solvable kinds of problems. They do require some political expertise. They do require some political will -- or, in some cases, considerable political will. But, again, this puts it back on the political dysfunction point that Mr. Bosworth raised, which is that, at a certain point, the leaders have to step forward and do the things that are difficult, because it's in the interest of the economy, and it's in the interest of the citizen of the country. So, I think that's really essential, that that go forward.

So, now where are we? Mr. Bosworth mentioned Abenomics. If you're not familiar with this term, the new Prime Minister, in his second go-round, Shinzō Abe, from the Liberal Democratic Party of Japan -- a term has been coined by one of his advisers, Abenomics. And in its essence, Abenomics has three points. It's a three-pronged integrated strategy. They talk about three arrows. The first is dramatic fiscal expansion. Mr. Bosworth said that's already been tried in Japan, and I would agree.

Secondly, it's monetary expansion. And that's been tried pretty extensively, but I think Prime Minister Abe has a different expectation about amping that up, and even a different level, and maybe doing some things differently with the Bank of Japan, in terms of purchases of long-term bonds versus short-term. And I won't get into all the weeds on that, because it's pretty nuanced.

But the third leg is what -- or the third arrow, really -- is what they call these structural measures or growth measures, and I think that's really where the proof is going to be in the delivery here. And I think that's really the critical element.

So, as I look at this, if you don't get the structural measures that change some of these things that all the panelists have talked about, we're just going to have another round of fiscal stimulus that's going to drive up Japan's overall debt level. We'll get more monetary expansion. We don't really know the impact of the feds' monetary easing longer term, and I think the same can be said in Japan, depending on how it goes. And so I think those are the dicey areas. What I would suggest is that what I would call the Abe opportunity is to use these dramatic measures to ease the transition to structural reforms in the economy that are going to help the longer term growth profile -- or help the economy reach potential.

Some of the things that I think are essential have been mentioned. But in my discussions with Japanese corporate people -- and you look around, you talk to government officials, they talk about the six handicaps or the six hurdles. And they've all been referenced today. I think Yanagihara-san did an excellent job of that. The yen appreciation, the lack of really strong trade agreements for Japan, both regionally in Asia, but also globally, the high corporate tax rate -- which, on a statutory basis, is the highest in the world -- we're a very close and not enviable second, burdensome and high costs of employment.

And I think, in some ways, the way to think about that is, it's difficult politically and socially; I grant that. But corporations hire because they had demand for their products or their services, but they also hire if it's relatively easy to do so, and in Japan, the employment rules make it difficult for them to add long-term employment. You have this perverse system now where a third of the workers in Japan are either part-time, temporary, or contract. And so that actually hurts, because it keeps wage levels relatively low, and I think that's a problem for Japan, in terms of low consumption levels and all kinds of things.

You've got environmental regulations, which some consider pretty onerous, relative to competitors. And then lastly is the energy situation, which everyone talked about, and it's really critical that they figure out a way forward on the nuclear front, in order to get a sufficient level of nuclear power. They're going to be importing more thermal fuels, particularly LNG or oil and gas, possibly from the United States, I should say, which is going to drive up their trade deficits. So, you've got all those problems.

In a couple of minutes, I would summarize a couple of structural reforms that I would hope the policymakers going forward will focus on. One is to open the economy further to trade and investment. And there, I think the most significant thing that the Abe government can do is to make a firm commitment to Japan to participate in the Transpacific Partnership negotiations -- highest possible standards in trade agreements, comprehensive terms. You have to include agriculture; not excluding anything.

The trick here for the government, in terms of the politics, is to say, "We understand that the tariffs on Ag items don't go to zero tomorrow." You can negotiate that, so don't talk about expectations before you enter a trade negotiation that you haven't been accepted into. But understand that you can negotiate longer phase-in periods for some of the sensitive Ag items, and you can deal with your structural reforms in the ag sector at the same time.

Secondly, Japan hasn't really attracted that much attention, but Japan has signed up to participate in the International Services Agreement, which negotiations are going to go forward sometime later this year. That's very significant. 70 percent of the Japanese economy is services. It is a relatively inefficient part of the economy, so you can do things in the Services Agreement that can actually help the Japanese economy.

The third thing I would emphasize is to increase foreign investment. At 3.9 percent of GDP, the ratio in Japan is the lowest in all the OECD. They have made efforts to increase incentives, but if you look at the incentives that are offered in Japan relative to those that are offered in Singapore, in Japan, they're relatively short or temporary, and they're not even as high as they are available in other Asian markets. So, Japan, given where it is, it needs to sort of go the extra mile, and really do more to attract foreign investment.

And the other part of that, which we could maybe talk about in Q&A, is changing the attitude towards inbound merger and acquisition activity. You don't see that in Japan at anywhere near the level that it probably should be, given the size of the economy, and certainly relative to the amount of outbound M&A in which Japanese companies are acquiring U.S., or European, or Asian companies. So, there are some things that could be done in a friendly manner there that I think would help Japan. It would help foreign companies trying to do business in Japan.

One other thing to open the economy is -- and it's been alluded to -- in terms of global R&D operations, in terms of the globalization of the economy, Japan needs to get more engaged in the sort of open standards movement. There's been a tendency to want to develop Japan-specific standards, because, for years, it had a large domestic economy. Now they need to learn to either accept or -- you know, through mutual acceptance agreements or even work collectively with European, and U.S., and Asian companies to develop common global standards. I think that would help Japan significantly.

Regulatory reforms -- those have been talked about. You know, if you look at the WTO, the OECD, the IMF, Japanese government, they all say that there's too much regulation that hinders business flexibility. It hinders entry and exit from markets, et cetera, et cetera. It drives up the compliance cost. Japanese companies agree, I think, in a very large degree with all of this, and so that's part of the burden that they face.

Tax and financial reforms -- lower the tax rates, increase the reliance on capital markets, as opposed to a bank-centered financial system. Corporate governance, I think, is a key element here, because in Japan, you get lower returns on capital; whether you look at a return on investment or return on equity, there just needs to be higher performance requirements. Stop. Okay, I'm done. Labor markets and energy certainty are the other things that I would highlight as being some critical structural reforms. So, thank you.

DR. SOLIS: Okay. Well, thank you very much. Very rich presentations -- a lot on the table. And before I open it up to questions from the audience, I'm going to ask the panelists if they have any reactions to the comments from Mr. Fatheree -- but, also, to remind them that we have another panel that's going to look in much more detail at the issues of structural reform, foreign direct investment in Japan innovations. So, we don't want to reach into those presentations yet, but there's plenty to talk about, regarding what are the strengths and weaknesses of the Japanese economy, and how the foreign manufacture and domestic manufacture interact, and so forth. So, reactions from the panel to the comments from Mr. Fatheree? I guess not. I guess they want to leave you all the time.

SPEAKER: So do you agree or do you think I am crazy?

DR. SOLIS: I agree. All right. So, now, then, the floor is open, and we have some mics going around. And if you can raise your hand, and when you get the mic, identify yourself, and please keep your, you know, comments short, and most desirable are questions. Thank you very much. So, who has a question? Man over there.

QUESTION: Good afternoon. My name is Jacob Votter. I'm a masters student at Georgetown University, and my question is for Mr. Fatheree. You mentioned that Japan should enter into negotiations for TPP, and that they should do so -- that we should let them without allowing any exceptions. I think that Prime Minister Abe, at some point, said that Japan wouldn't join if that was a requirement, and I was wondering what your thoughts are on allowing an exception for, specifically, rice -- rice alone. Could we do that, and what are the dangers or benefits of doing that? Thank you.

MR. FATHEREE: How much time do we have? Here's the deal with TPP: It's a multiparty negotiation, and you have to be granted the right to participate. But in order to do that, you have to sign up for the deal at the outset of the negotiations. And so it's not the United States only that determines whether or not Japan can participate; it's the other 11 partners now. And the condition that everybody, including Brunei, and Vietnam, and Mexico, and Canada, most recently, all signed up for was that it's a high-standard agreement -- meaning it's going to cover substantially all trades in order to comply with WTO standards. It's comprehensive in nature, because it's going to include goods, services, agriculture, investment. It's going to cover a range of what they call 21st century issues.

Japan is focused only on the negative aspect of this, and they're focused only on the fact that, you know, over a period of 10 years, they might have to lower rice tariffs or something. And I think what Japan needs to think about is the very substantial benefits to the Japanese economy. I think Yanagihara-san or someone talked about logistics cost. Logistics is one of the issues in TPP -- or one of the areas in TPP where they're going to sort of integrate supply chains, and, you know, harmonize customs rules and things. And that has immense value for Japanese manufacturers who are exporting to the United States or to the rest of Asia.

Secondly, you get, you know, some commonality of standards and rules. And that doesn't mean that everybody's going to accept the U.S. standard, but it means that all the parties understand that Japan might have certain safety standards, United States might have certain safety standards, but they're going to recognize the processes, and so they're not going to exclude trade based on these differences. They'll try to work them out where they can.

As to the specific point about rice -- it's, you know, culturally sensitive. We understand that, but Japan has a 778 percent tariff on rice. There's got to be some way that that can come down. And I think what's happened is that the main agricultural cooperative in Japan, the JA, has stirred up opposition, and talking about it's going to destroy Japanese agriculture, et cetera. Okay, a couple of facts -- Japan currently produces only 40 percent of its food on a caloric basis now under the current system. So, the current system is not working well. Average age of a farmer is almost 67. They're part-time. They farm the plots. They're small plots. They're not very efficient. You know, that's difficult in the Japanese context, but it's all factual. And so what I hope that the new government will do will figure out a way to solve that problem. It's a political problem. It's not a technical problem. So, you can do that by providing direct income support to rice farmers, and you can condition it in ways that won't allow rice farmers who aren't serious rice farmers, like part-time/weekend people. They shouldn't be eligible for subsidies in my view. This is my personal opinion. That creates all kinds of distortions in the system, and I think you can change that if you go to the Japanese people and you say, "We have an opportunity here to reform our system so that we produce more of our food, and you consumers will actually get food at the lower cost. Isn't that good?"

I think that's the kind of messaging that's not being done at all, because it's all being talked about in these very negative, destructive kind of terms, which I think are just factually incorrect.

DR. SOLIS: Great. Yes, please?

QUESTION: I'm Barry Wood, from RTHK in Hong Kong. I would like to ask about the impact of a cheaper yen on employment and investment in Japan -- particularly, let's say, in the auto industry. When you gave all those figures, Mr. Ernst, about Japan still being the center, what has happened to Honda employment and production in Japan, over the last few years, and how would you project that out?

MR. ERNST: I don't have all the facts and figures for that. My focus has been on, primarily, North America and my experience. I can tell you from my own personal experience working there that we tend to work in the regions more and more than we did when I first joined Honda. And the reason we do is so that we can specifically zero in on the regional requirements and the new regulations -- fuel economy, safety, and so forth -- and then, also, to try and make sure that we're making products that the customers want. And what I see happening in Japan is that they tend to be more advanced in terms of what they're trying to do. You saw the numbers of sales from one of the previous charts, and they're decreasing over time. I think the products that they're selling are getting smaller, they're more fuel-efficient, they emit less pollutants.

And then for us, we try to look at, how do you want to maximize your resource? So, my experience has been that they tend to have a very good creative vein, if you will, for Honda, in developing new product and more technical product. And that's how I see -- inside our company, that's how we're moving -- toward more technical product, more computer-driven, electrically-controlled type of devices.

I can't speak for the sales side in Japan and what their strategy is. I know for each of the regions, they're trying to grow -- we talked a little bit about the global growth. We're trying to increase the volume of our global production, using the regional units to try and do that. I don't know if I'm answering your question or not, but we're trying to focus on our global region, and then utilize or leverage the investments that we have around the world to our best advantage.

DR. SOLIS: Thank you. Other questions? Yes, on the way back?

QUESTION: Thank you for a very interesting presentation. My name is Kunio Kikuchi and I think the main part is Mr. Bosworth's comments about the initial comments. And I have some questions.

Savings, for example -- with very low interest rates, many people find it uninteresting to put money in the banks, and, also, that means people know how much money you have. So, instead, I think there's a huge increase in home safes, and I'm wondering if a lot of the cash savings are now outside of the market. That is one point.

The other -- you have said that the service and retail industries are still backward. And during the past 10 years, I've been going to Japan three times a year, but lately, I am very much impressed by the efficiency of the so-called convenience store chains, which, I think, by comparison with what I see around the world, is the most advanced that one can imagine, in terms of the way the shops are organized, cleanliness, service, and at night, the clerks are Chinese.

But that aspect, plus the domestic home delivery shipping services -- what we call *takkyubin* -- where people come and pick up your suitcase, deliver it to Tokyo from Osaka in one day, for a mere price of $15 -- that is something I haven't seen anywhere else. So, I'm wondering perhaps those aspects might not have been caught in the statistics, and would appreciate your comment. Thank you.

DR. SOLIS: Want to take that Yanagihara-san?

DR. BOSWORTH: Let me just go to one of the data questions. I don't know that much about commenting on –

DR. SOLIS: I don't think they can –

DR. BOSWORTH: -- convenience stores. But the savings does capture. If people save in the form of paying off their mortgage, for example, and accumulating wealth inside their house, that's fine. That's caught in the national statistics.

Think of savings as just being a measure of people's income, minus their consumption. And in concept, all forms that savings takes gets included in the statistics, so there's nothing about investing in your home in any way kind of unique. I would point out that home values have continued to decline in Japan, and investment in housing has continued to fall off. I believe it's now negative after adjusting for depreciation. So, I don't think there's a big problem with the statistics, but I can't comment on the 7-11s.

DR. SOLIS: Yanagihara-san, and then Inui-san.

MR. YANAGIHARA: Maybe I comment on 7-11s and Lawsons part of Mitsubishi. Mr. Kikuchi, the question I think is very correct. I think many of us who are here, who have been to Japan, who have worked in Japan, feel that there's somewhat of a discrepancy between what the macroeconomic factors and what we see to be some problems.

When you're in Japan, you don't really feel that. In fact, you see much more efficiency, much more competition, much more improved society -- in some ways; not necessarily all. So, what's that difference? I guess that's because, as I mentioned, there are companies -- let's assume if the national power or national level of strength is on the decrease -- and accordingly, if the company is also declining, then you don't have Japanese companies surviving anymore, correct? So, in that sense, companies are struggling, trying to survive in this environment -- through which they are gaining some competitive advantage, including things like Lawsons and 7-11s, and they're very much aware of that.

So, what I'm saying is while we always sort of look at and see -- there are a lot of factors that's pushing people out of Japan -- or companies out of Japan. There are a lot of new things that are nurtured through this downturn period, which, to me, is a very large potential -- not many people looking at it.

And that's why I think this week, Prime Minister Abe's views are very interesting, because he may twist that view, in that we may able to take some of the things that are developing competitively among the Japanese companies to be exposed to this new environment, when competition definitely is going on. So, that's what I'm trying to say, is there's a sort of feeling gap -- of what do we see, versus what numbers, and, also, the feeling from macroeconomic point of view, looking at it.

DR. SOLIS: Thank you. Inui-san?

MR. INUI: Yes. So, I'd like to discuss about the quality of the services. Actually, it's been a difficult question, because usually, we have to adjust the quality of the service between the countries. But it's quite difficult to adjust this. So, statistically, it is very difficult to compare the productivity or efficiency of the service industry between U.S. and Japan.

And the other thing I would like to mention -- that as I showed in the slides, the one important problem in Japan is the discrepancy of the product between the large firms and small firms. As you mentioned, we can find very efficient firms, like 7-11 and Lawson's. They are very efficient, I think in international comparable efficiency. But we also have very small firms, very low productivity in those firms, and they survive, and their share is still large in the economy. So, in the aggregate level, we found that productivity is very low in the service sector. So, this is actually the problem in Japan, I think.

DR. SOLIS: Thank you. This gentleman here had his hand up.

QUESTION: Thank you. Just interested in a quick poll of the panel -- whether you think the logic of joining the TPP is beginning to gain momentum, in relation to the political problems it might cause at home for Prime Minister Abe. And second, whether you have any insight into expected progress on this discussion at the summit Friday.

DR. SOLIS: Jim?

MR. FATHEREE: I think it is gaining momentum. I think the Prime Minister seems personally committed to pursuing this. He's trying to work out the political dynamics of how this is going to unfold. I don't think he's going to announce tomorrow that Japan's going to join TPP. I have no idea. But, you know, I think they're trying, and they're having an internal political debate, which is very important in Japan. And I think he and a number of his advisers see the value of having Japan participate in this agreement, for the reasons that we've all talked about.

DR. SOLIS: Okay. I think I saw other hands. Do you want to say something on this?

SPEAKER: No.

MR. INUI: I think that, naturally, whether Prime Minister Abe, at this point, would commit, as of this week, is not known, and, as always, we have been waiting for some time in the past prime ministerships. But I think that the timing is definitely coming close to some decision-making, in terms of what Japan needs to do -- both from the fact that negotiation is ongoing, and that there has been so long of a waiting period for Japan to express that. So, from my personal perspective, I think there is an opportunity now being risen at this point.

DR. SOLIS: Mm-hmm. Other questions? In the back?

QUESTION: David Parker -- I'm from American University. And we hear a lot about the kind of politics of monetary policy at the elite level -- you know, what Abe wants versus Asa wants is kind of saying different things at the moment. But what about the kind of broader politics of inflation, given that there's really kind of a cross-generational impact of it, in terms of who's saved and who has debt? And also, kind of the implications of potential inflation for Japan's national debt.

DR. SOLIS: Very interesting. All right, so who would like to take that one? Don't rush. No takers?

DR. BOSWORTH: I would say one is that Japan should be worrying about the interest rate implications that might go along with an increase in the inflation. Right now, interest on the debt is not a particular burden, because the interest rate's essentially zero. One day, the global interest rates will change. I'm not going to give you a date. I'm not that dumb. But I think you have to think that, sooner or later, interest rates globally will go back up, and when you have a debt of the magnitude of Japan's, that's a serious issue. What will be the response to it, though? Some people in Japan businesses might like -- I think if the burden gets too high, what happens? The yen will depreciate and fall, because it will be too big a burden to pay.

So, usually, you think that countries that become overindebted are countries that suffer an exchange rate depreciation. And I guess there's some people in Japan who would think that that was a good thing, because they could sell their products cheaper than otherwise would be the case. So, it's going to have mixed effects across society, about what happens as a consequence of it. But it should be a concern. This is a very unusual period, both in Japan and in the United States, and we don't think it can last forever.

DR. SOLIS: Thank you, Barry. If I may ask a question, I would like to connect two running themes in this panel. One has to do with the dual economy in Japan -- the fact that you have very large, highly competitive companies, but you also have the small and medium size companies. And the other theme -- globalization.

And I think that many of the panelists here identified the challenge that the smaller companies have in taking advantage of these opportunities -- the so-called pull factors -- and they may actually be facing many more constraints when we talk about the push factor. So, I was wondering if you have any sort of prescriptions or ideas as to how you help these small and medium enterprises navigate better the challenge of globalization, so they're not the ones that are being left out, and they can also profit from these potential opportunities.

MR. FATHEREE: Well, I think that's a huge challenge for everyone. In trade negotiations, in trade agreements, increasingly -- and particularly in the TPP, they're talking a lot about how to help SMEs benefit from these agreements, and I think that's a really critical thing that governments have to think about, but I think it's very difficult in practice to actually do that, because SMEs often are not the ones who are going to be actively looking for export markets. I mean, you can look at UPS and FedEx, and they do these great studies where they figure out that an SME will export to one market, and then if you can get them to plus one or plus two, you know, it really helps them grow.

The other way to think about it is that SMEs are actually suppliers to the large companies that will eventually or ultimately take advantage of the trade agreement itself. So, there's a ripple effect there that I think is important. In Japan and a lot of other economies, you need to see probably consolidation in some instances, because you've got a lot of companies that are going to struggle, and if they don't have capital, and if they don't have familiarity with information technology, and if they can't compete in a global economy, that's a problem.

But, you know, if we believe in markets, they'll either sink or they will swim. So, they have to take the challenge upon themselves in order to do that, but I think there are ways that the government and their larger, ultimate customers can help them participate in these agreements, in a positive way.

DR. SOLIS: Thank you. Any other comments? Okay, we may have time for one more question, if there's one. Professor Urata?

QUESTION: Urata from Waseda University. I have a question to Mr. Fatheree, regarding TPP. Rice is, you know, attracting a lot of attention, but if I understand correctly, if Japan wants to come in, U.S. has to approve of it, and there are three conditions which are laid out. One is beef import, and the other is postal insurance, and then small car issues. How do you see the possibility of U.S. Congress accepting or -- I mean, well, how do they deal with these issues? Can Japan clear these three conditions, or how do you see that? Maybe, I mean, from the auto industry, maybe you can make points, too, about small car issues in Japan.

MR. FATHEREE: Thanks for the question. It's a great question. I think Japan can easily meet the challenges. It's going to take some things that they will need to do. On the beef issue, they've already done it. They've agreed to the 30-month age standard as of February 1, so now, 90, 95 percent of U.S. beef exports will be able to enter the Japanese market. That's important primarily because U.S. Senators and Representatives in Congress from beef-exporting states want to see that. And Senator Baucus from Montana is a big supporter of the Montana beef industry, but he's also someone of, for 30 years or more, has been involved in global trade negotiations from the U.S. perspective. He's very happy, so that's a good thing.

On the insurance issue -- this is often, I think, misunderstood in Japan. The question is not whether or not Japan Post is privatized or remains a public corporation. I think the issue is simply the competitive conditions that private competitors and Japan Post have to operate under, and the simple point is that there has be a level, competitive playing field, with equal competitive conditions for both the private and the Japan Post insurance and banking entities. This is not just the U.S. view. This is a view that's shared by Japanese insurers and Japanese banks, but it's also shared by Canadian insurers and those from Australia and New Zealand, who all agree to the same principle. So, it's not just a U.S. condition. It's important in the U.S. consultative process with Japan, and I think there have been multiple rounds of negotiations that are probably going on at this very minute about that and the other issue.

The auto issue is a very tricky issue, and it's a political issue, more than anything else. And I don't really want to say too much about it, other than that there have been ways to work around that problem. I would say one thing that complicates the dynamics right now -- and this may be unpopular -- but the Abe government's monetary expansion, even though they haven't actually materially done anything, it has weakened the yen. A weaker yen is only going to complicate the automotive parts of this discussion, because of the ongoing and longtime concerns of the U.S. auto industry about perceived currency manipulation and such in Japan. But I still think it's a very solvable problem, and there just needs to be a commitment, really, to think creatively and flexibly about how to address the problems perceived by the U.S. industry in a way that are consistent with the mandates of the agreement.

DR. SOLIS: Great. We're almost out of time. I can spare, like, one minute, if you want to ask your question super quickly, so I don't leave you -- the mic is coming, and if you want to identify yourself -- and then very concise answers, please.

QUESTION: Thomas Bailey, from Perry Capital. Just a quick question on the yen weakness recently -- a number of you cited the yen's strength as, you know, hurting Japanese competitiveness. How should we think about the yen's weakness also potentially raising energy prices? I know Mitsubishi Corporation imports a lot of Kokan coal, and iron ore, and the like. You know, that's going to have kind of higher kind of flow-through costs to a bunch of Japanese industries -- and also, in the energy sector. If we turn off all the nukes, you're going to have to use more LNG, and coal, and the like to power Japanese industry. So, how should we think about kind of the weaker yen actually having kind of a negative flow-through effect on Japanese competitiveness?

DR. SOLIS: Great. Yanagihara-san?

MR. YANAGIHARA: Yeah, that's a very good question, because in the Nikkei newspaper today, there's a issue about that this lower cost of importing of, for example, natural gas would do to electric costs -- which has certain link to the actual value of the import of the gas, and the oil, and so forth. So, while the price is on the increase side, people don't see that, because there's a devaluation factor built into that. So, it does correct it. While there's a benefit of stronger yen in importing and weaker yen in terms of exporting, what tradeoff? I can't speak for all the companies, but some companies who are very much earning euro profit outside of Japan -- weaker yen brings, you know, same dollar value/higher yen profit, right? So, that in itself is somewhat of a positive factor.

So, even though it's uncontrollable, a lot of companies who are export-driven -- one yen depreciation, for example -- in the investor relation, there's a lot of things written over -- could bring up to 10 to almost $100 million upward. So, you'll see over this quarter, a lot of Japanese companies who are much more export-driven would bring back some profit higher than what they had expected -- probably. Put simply, not because they have done better, but simply because of exchange rate. So, that's how that affects -- but I agree that certain companies -- when the import is major cost structure, that has a huge impact, interpreted negatively. But if it's export-driven -- and, also, you have much higher percentage earnings outside of Japan -- consolidate into Tokyo. The depreciation of yen helps. That's how it works.

DR. SOLIS: Thank you very much. So, we had a really fascinating discussion. It's time to take a break. We'll reconvene at 3:30, and I just want to tell you that in the second panel, we're going to discuss, how do we fix what needs to be fixed in the Japanese economy, and what is the long-term future for Japan? So, great topics, and, in the meantime, please enjoy the refreshments. And please join me in thanking the panelists.

*(Recess)*

DR. SOLIS: Okay. So I think I've created tremendous expectations about this panel when I said that they would be discussing how to fix what needs to be fixed in the Japanese economy. So I'm sorry. I'm sure I'm going to hear about this later from the panelists. But anyway, I have full confidence given how talented these presenters are.

Let me just tell you a little bit again to put this in context. This has already been mentioned, but of course, we know that the incoming Abe administration has paid a lot of attention to the issue on how to foster competitiveness and that actually it has reached out to the private sector and to very well-noted leading academics. And they're putting their brains together and we should be hearing about a new strategy and how to promote structural reform, how to promote economic growth in the next few months. So I think that this panel is indeed very timely. And I see it as part of that brain effort to try to discuss how can we address the issues that need to be addressed in Japan also, of course, taking into account the strengths of the Japanese economy, which is something that was also mentioned before.

I also asked the panelists to consider different issues as they were preparing their presentations. You know, again, going with the theme that there are very old issues but that we have not found the solutions. We have talked for so long about the need for deregulation, for how to promote inward direct investment into Japan, and we have not accomplished much, it seems. Japan has not accomplished much in these fronts. So the question is what could be done differently this time to achieve more on the goals of deregulation and promotion of foreign direct investment?

Another issue that I asked the panelists to consider is that, you know, the media frequently talks about the fact that Japan or many Japanese companies, especially in the consumer electronics sector used to generate trendsetting consumer products. Right? The Walkman, for example, comes to mind. And that recently it seems that that capability for innovation seems to be lost. And the question then is is this really representative to the difficult situation of Sharp and Panasonic and so forth representative of the state of industrial innovation in Japan or not?

And of course, the big picture question, and I think Mr. Saito is very courageous and he's going to take this one right on -- what will be the future of the Japanese economy? What sort of scenarios are realistic in terms of what will be the structure, its strength, composition of the Japanese economy in the coming decades?

And we have very talented panelists. Again, I'm not going to go into all the details about all the things that they've done. Their bios are available for you. So let me just mention who they are and what are their official affiliations. So we have Professor Shujiro Urata, professor of Economics in the Graduate School of Asia-Pacific Studies at Waseda University and research fellow at the Japan Center for Economic Research; Ulrike Schaede, professor of Japanese Business in the School of International Relations and Pacific Studies at the University of California San Diego; Jun Saito, senior research fellow at the Japan Center for Economic Research; and Hironori Kawauchi, senior economist of the Eastern Pacific Region in The World Bank. And Mr. Kawauchi will offer -- will act as discussant in this panel.

So again, you have a huge task ahead of you and just a few minutes to lay it all out. So I appreciate all your efforts. Thank you. And I think we'll start with Urata-san.

DR. URATA: Thank you very much for the introduction.

I'd like to discuss the low level of foreign direct investment in Japan. I'll begin by giving a very brief, say overview of the trend of global FDI first, and then I will look into the level of FDI in Japan, and then what does inward FDI in Japan -- what does inward foreign direct investment in Japan do to the Japanese economy? What kind of contribution can we expect from inward foreign investment in Japan? And I'd like to argue that there are lots of benefits that the Japanese economy can gain from attracting foreign direct investment in Japan. Having said that, there are many obstacles for foreign firms to enter into the Japanese market. I'd like to list some of them, and then I will turn to the government policies toward foreign direct investment, and then I will end up by giving some possible ways to promote inward FDI into Japan.

First, globally, foreign direct investment is growing very fast. Between 1990 and 2011, 21 years, global foreign direct investment increased more than sevenfold, and there are several factors which contributed to rapid expansion of FDI in the world. Liberalization of FDI policies by many countries in order to attract foreign direct investment and the objective of attracting foreign direct investment is to promote economic growth using FDI. Privatization of government enterprises contributed to expansion of foreign direct investment, and also abundant availability of funds globally for FDI contributed to rapid expansion of FDI. However, as I said earlier, and I'll show you some figures, FDIs into Japan are rather limited.

What we are looking at is the FDI flows. When we study foreign direct investment, there are two different measures -- one in terms of flows and the other in terms of stock. Here we are looking at the flows. The one at the bottom is Japan. This is in terms of U.S. billion dollars. The one on top is the United States. There are large fluctuations but throughout the period the U.S. has been the most attractive country for foreign direct investment, and then we have China growing rather fast, and then we have Germany. And Korea and Japan in this diagram are the two lowest countries in terms of attracting foreign direct investment.

This is stock -- inward FDI stock over GDP ratio. When we measure the presence of foreign firms at one point in time, we use the stock measure, so I did, too. As you can see clearly, Japan is the lowest in terms of FDI stock -- inward FDI stock to GDP ratio -- lower than China, India, and Korea, and of course, the U.S. is much higher and the U.K. is much higher.

Then, looking to the activities of foreign firms in Japan, well, first, 80 percent of foreign direct investment coming to Japan comes from developed countries such as the U.S. and the E.U., although FDI coming from Asia still is a rather small share but increasing very rapidly. As far as sectoral distribution is concerned, nonmanufacturing captured 65 percent and the rest is in manufacturing. Among nonmanufacturing sectors, financing insurance is on the top and also manufacturing electric machinery, transport machinery, and chemical products and so on. If you're interested I can send you the file, so just let us know your interest and your e-mail address.

Now, reasons for investing in Japan. Why do foreign companies invest in Japan? This is the result of a question or survey done for METI. The one on the top is a big market, a large market. Many foreign companies are interested in selling their products in Japan. And also, well-developed infrastructure is another attractive feature of Japan for foreign firms. High value added market, agglomeration of companies, and these are some of the factors which pull foreign direct investment into Japan.

In terms of functions, what kind of activities are foreign firms doing in Japan? As one would expect, sales and marketing is the largest. This is a number of affiliates in Japan doing sales and marketing and research and development and so on per firm. So sales and marketing is the most active activity by foreign firms in Japan, followed by manufacturing, distribution, and so on.

This is a very interesting result of the survey done on foreign companies, and they asked -- this is again for METI. They asked which countries in Asia are very attractive in various activities -- R&D, regional headquarters, sales base, financial base, and so on. In 2007, Japan was the most attractive country for undertaking R&D and regional headquarters, but by 2011 Japan was replaced by China. In 2011, as you see, China is the most attractive country for all these functions -- R&D, distribution base, manufacturing base, and so on. So Japan lost its attractiveness over time.

Now, what can we expect from the presence of foreign companies in Japan? We can expect economic growth because if they expand while they set up their operations in Japan, hire people, undertake fixed investment, undertake foreign trade and so on, they'll contribute to the expansion of the Japanese economy. And that I call a quantitative contribution. I think more importantly, qualitative contribution -- that is to promote productivity growth through technology transfer and so on. So we can expect a lot from foreign companies in order for Japan to achieve economic growth.

How large is the presence of foreign firms in Japan? In terms of employment, more than half a million employees are employed by foreign companies in Japan, but it only accounts for 1.3 percent of Japanese employment. Foreign firms account for 1.7 percent of fixed investment, but in terms of foreign trade their contribution is much larger, about 10 percent. And it's very interesting to see how profitable the operations have been compared to Japanese companies' performance. Here, the profit-to-sales ratio is computed for foreign firms which are -- let's see, the one on the top is U.S. companies in Japan -- they are most profitable -- followed by Europeans and Japanese, and Asian companies are the least profitable. So if we can attract American and European companies to Japan, we can expect profit rates to go up and profit rates -- profitability very often reflects productivity. So once again, we can expect increasing productivity by attracting foreign firms into Japan.

But there are lots of obstacles. Here I have listed some from the survey. Here again are the survey results. According to the survey results, high business cost in terms of rental rates, wages, corporate income tax. That's number one. And then followed by closed nature markets, strict regulation, complex administrative procedure and so on. And very importantly, difficulty in securing capable human resources is a constraint. And shortage of investment incentives is sometimes recognized as one of the obstacles by foreign companies but I'm not quite sure whether providing incentives is the best strategy because we know if all the countries do provide incentives it's like race to the bottom, countries will lose at the end. So I'm not quite sure whether incentive is a good strategy to pursue.

This is a very interesting result of the OECD study. They looked at the regulatory restrictiveness index and they created this index. And the larger the number, the more restrictive regulatory regime is. China is number one, followed by Saudi Arabia and so on. Japan is ranked number five. So again, Japan is seen as a country with a lot of restrictions.

Now, the Japanese government has been interested in attracting foreign direct investment knowing that the foreign direct investment will contribute to the Japanese economy. And there are a number of programs which have been implemented and I just listed some here ranging from just forming a committee to discuss the ways to attract foreign direct investment, formulate a strategy to attract foreign direct investment, and so on. And these are some of the measures done by the central government, and local government also, some of the local governments are active in providing assistance and so on in order to attract foreign direct investment but they have not been able to really attract foreign direct investment as we saw earlier.

Now, given the time constraint, I guess I'd like to just give some of my ideas as to how to promote FDI into Japan.

First of all, we have to deregulate. There are many regulations. Some of them are industry specific. I have to say this is not just Japan. There are many regulatory restrictions in the United States as well. But in order to attract foreign firms you have to relax some of these regulations. And it's not just regulations on foreign direct investment. What is important is the liberalization of regulations on foreign trade but the inflow of foreign personnel and so on. For example, in order to open, say, a restaurant in Japan, you'd like to have a foreign chef. But in order for a chef to get a working visa they have to show that they have 10 years experience in their home country in a respectable restaurant. And that is a very difficult condition to satisfy, for example. And if you are a company interested in selling pharmaceutical goods, medical goods, of course, you have to get approval in order for you to sell these products, and very often it is not easy. So if you're a company interested in marketing your products in Japan, you may not be undertaking foreign direct investment because you cannot sell the products that you are interested in selling. So again, liberalization has to be done not only on foreign direct investment directly but other activities such as foreign trade and inflow of foreign people.

Then, developing human resources is very important. Being a university professor I'd like to really emphasize this. While the Japanese government and Japanese universities are trying to develop capable human resources, especially language capability, but it takes time and we just have to keep on doing this. And of course, one very good way of doing this is to open up the market -- for example, educational market -- to the foreign universities. That has not been done yet.

So again, there are many regulations which can be dealt with or to be liberalized in order to promote foreign direct investment into Japan. And what we need is the strong will on the part of politicians. We talked about the Koizumi politicians. That is really needed and at one time when Prime Minister Koizumi-san was a prime minister, he had this campaign. And I, myself, saw this advertisement, a promotion in the U.S. on the U.S. TV that he appeared on TV and then he said he welcomes foreign direct investment into Japan. And I don't know how effective that campaign was but the fact was FDI into Japan increased. I don't know whether that is really the reason for that but I'd like to see Prime Minister Abe to do the same so that he has a very good chance to do so when he comes here very soon. But anyway, so we need a strong push coming from the politicians in order to attract foreign direct investment in Japan. Thank you very much.

DR. SCHAEDE: I'm Ulrike Schaede from the University of California. I'd like to begin by thanking Professor Solis for inviting me. It is a great joy to be here and I'm delighted to be in a town where people still care about Japan. *(laughter)*

Professor Solis tasked me with the following question. She said, "Can you talk about innovation and what's your view -- can Japan produce the next wave of trendsetting products?" And I thought, oh, that's easy enough because Japanese companies already do this. So no problem. And I want to convince you of this in three steps in whatever 15 minutes or 10 minutes I have.

The first question or issue I want to talk about is what is a product or more precisely what is in a product? And what used to be a product is now suddenly a complicated thing. I want to talk about New Japan's role in the global supply chain. And we'll end on coming back to the question at hand which is, okay, if it is true that Japan has all this innovation going, will hollowing out threaten that?

So let me begin at the beginning, which is research I've been doing over the last couple of years about a repositioning of Japanese companies on what is sometimes called the smiley curve of profits. Now, you may have heard of this concept before. We chart operating margins, so show me the money, and the stage of production, and it looks like a smiley. This was developed by Acer CEO Andrew Sherr and he was complaining that the Taiwanese companies were all in the downstream businesses that were assembling and there was absolutely no money in assembly.

The Japanese companies that are clever, of which there are more than one, have known this for a long time and they have begun a process of positioning away from downstream products. So what that means is that the Japanese companies that are making a ton of money and are producing interesting things and developing innovative technologies that help the products of tomorrow are actually in the upstream sectors and no longer in assembly. So if you look around I notice that this is a Samsung screen -- it used to be a Sony -- and I will talk a little bit more about that screen in just a moment. So it might be easy just to think that therefore Japan has lost it and I want to convince you that that's not necessarily the case.

Let's start with what's in a product. This is one you know, the iPhone. And this is not at all my original research. This is actually from an article in *The Wall Street Journal* three years ago. When you look at what's in the iPhone, first of all there is Apple, who designs it and sells it, so Apple sits on both sides of that smiley thing which is the beauty of that business model. But if you look at who actually makes the iPhone, they cost about $180 in the old days; now the new i5 is I think $204. Out of that, 34 percent value added is produced in Japan and 17 percent in Germany. China accounts for 3.6 percent of the value added. And I will talk in a moment about what that value added is. China's value added in this is the assembly.

Now, the research was done by a team at the Asian Development Bank in Tokyo, and they then went along and said, well, if we figure this into our trade statistics and our trade statistics, of course, are 200 years old when Portugal made wine and England made cloth. If you were to actually figure out the value added of the iPhone and translated that into the trade statistics between Asia and the United States, the United States would actually have a trade deficit with Japan, Germany, and South Korea, and a trade surplus with China. But as it is, we count the iPhone as an import from China and therefore we're thinking that we have a trade deficit with China.

Let me get back to these panels because I want to talk about what is in the iPhone that is actually from Japan. So I ask my students this. It's kind of a trick question. Some people say it's Sony, and the answer is no. These panels, the screens that you're looking at when you look at your computer, these screens are made principally by South Korean and Taiwanese companies and Sharp is the lonely Japanese company left in this and they're selling out. So this is no longer made in Japan. However, a screen has some 24 layers. There are filters that make the black blacker and polarizing films that make the viewing angle wider and there are compensation films that allow you to look at it in sunlight, which to look at your iPhone could be very helpful. And the point of the story here is that these polarizing films, compensation films, and so forth and so on are made in Japan and they're expensive because they are what we really like.

METI did a study 10 years ago, and if we did this today it would be even better than what I'm going to show you now. They looked at the combination of Japanese companies in high-end household electronics as of 10 years ago, and they found that downstream, if you look at the end product market, so cameras, cell phones, DVDs and so forth, the combined Japanese market share in the world is 27 percent. Now it's probably closer to 20 percent.

However, if you look at the semiconductors of flat panel parts and cell phone parts that go into these things, Japanese companies combine to 51 percent. If you then look into the fine chemicals -- the glue, the layers, the adhesives that go into the semiconductors that go into the parts that make your phone, Japan occupies almost 70 percent now of world market share.

So you might say, okay, that's fine, the iPhone. This is not just a matter of electronics. We can see this in fine chemicals, for electronics in particular, but there are also auto parts -- certain auto technologies. There are camera shutters. There is carbon fiber which is the future technology for cars and now it's on airplanes. And many, many more. So this extends into green technology -- batteries, storage, and so forth and so on. And what we're talking about are the materials and the components. And they are high value added, high margin.

This is why, using the old trade statistics again, South Korea and Taiwan actually have a growing trade deficit with Japan because what's happening here is that Japanese companies make the goo and the layers and the chemical soup. And by the way, the machinery that's needed to make LCD panels and so forth. Then South Korea and Taiwan buy the chemicals and make the LCD panel, and then the LCD panel is put into a TV or a Smartphone or a personal computer in China.

So the new rule of global business is if you want to know where a product is from you have to ask where from at least three times. You can't just say where is this product from? China. Well, where did China get the parts? From South Korea. Well, they have to ask one more at least.

Looking at the audience I don't have to beleaguer this point -- there is something wrong with our trade statistics, so maybe we need to kind of figure out how we can account for this. So let me go to this hollowing out question then. And this chart has been shown; you've already kind of had all the data. So 20 percent of things that are made by Japanese companies are now made outside of Japan.

Now, will these chemical industries and these component makers and so forth follow that trend? So how does this connect to hauling out? How are we going to think about innovation and will it stay in Japan? In order to do that I have to move away a little bit from my shopping list of these other products and ask a deeper question. What is it that Japan is innovative at at this point? And I think there are three components to these industries.

One, they're a platform. They're part of a system. They're expandable. So they are, I mentioned upstream earlier, but the point is there's knowledge and innovation in, for instance, fine chemicals that are extendable to other products and important for other products. So they form a basis. Number two, they are innovative. They contain protectable intellectual property. And so that makes them valuable. And third, and this is actually an important part, is that they are difficult to manufacture. And because they're difficult to manufacture they cannot be easily copied.

So talking about chemicals, I talked to many of these companies in these industries and it actually turns out it is fairly difficult to make a certain photo resist, for instance, for semiconductor production, in high quantities at exactly the same quality without fail. It's not easy because it's kind of a volatile substance. And so many people in this industry think that maybe the innovation could also happen elsewhere, but the actual manufacturer of some of these items is significantly difficult enough that it cannot be easily copied. Okay, so that takes care of one problem.

Now, the question is will they stay in Japan? I'm not quite sure you can read this. This is from my colleague, Professor Tomiota, National Yokohama University. What he did is he charted -- I suspect that you couldn't read this -- he charted high foreign outsourcing, which is outsourcing over exports vertically, and high R&D intensity which is R&D over sales horizontally. And what we see is that the most important thing you see is you see nothing in the right hand corner. Empty. So the high R&D industries are actually not hollowing out.

Now, what are these little dots? Let me read them to you. On the high foreign outsourcing over exports arrow we have apparel, furniture, printing, timber, leather, and paper. These are not necessarily known as high intellectual property industries. On the horizontal side we see electric machinery chemicals, transport equipment, and precision instruments, which is basically the industries that I'm talking about. Okay, and they're not moving. Okay, the fact that they haven't moved so far doesn't mean that they will not move in the future.

So what is it that keeps them at home or not? The first thing is that if you talk to CEOs, any company, any industry, any country -- American, German, Asian -- going abroad is costly and difficult, so if it can be avoided, companies actually prefer to stay at home. So to the extent that going abroad is happening, it is happening in cost-intensive -- it's happening at the bottom of the smiley curve assembly. We heard from Mr. Ernst from Honda, the assembly is moving abroad; the R&D, if I understood you correctly in some important parts, at home it is done locally where it is needed to be done locally because of collocation or customer preferences that are different. So innovative Japanese leaders are actually happy to stay at home. And so that bodes well for these industries.

Now, what might push them to have to go? And there are three aspects that we might want to look at as we go forward. One is an important aspect of innovation as I just said is collocation with the buyer, the assembler, the user of the product. And so to the extent to which this is important then the question is what if the assemblers are moving abroad, which is of course the topic we're talking about here today? And the other is what if the assemblers or buyers are foreign? And so to the extent that I'm observing hollowing out in these very innovative industries, it is happening because the buyers are elsewhere. And that then could lead us to the policy recommendation.  The concern is actually not so much that these innovators are possibly leaving Japan.  The concern is that their customers are leaving.  And the previous section talked about energy costs and those sorts of things.

So if you believe everything that I've said so far then what does that mean?  By the way, I'm happy to discuss.  So there may be a negative feedback loop in the sense that if the carmakers or semiconductor makers and so forth and so on are abroad, then maybe these components and material makers also will have to move.  So it's important to keep those at home.  And I'm kind of repeating what people have said before so I can do this very fast.  There is deregulation of energy prices which is critically important, but I would like to add one more to that list, and that is it might actually help to leave these companies alone.

I'm currently conducting a study where I look at Japan's most profitable companies, and the joke is that it'll be a very short book but it's actually more than 10.  And so I've talked to the CEOs of these companies and they all share a number of interesting features, one being that they would really, really like to not be on the government's radar screen.  They would like to be just left alone.  They don't want a main bank.  They don't want to cater.  They don't want industrial policies.  Could we just simply do what we want to do?

And this is not something that Japan's government is necessarily known for, and even in economics there's now something called new targeting policy in Japanese.  So this new targeting is taking some interesting shapes.  It might actually be one valid course of action for Japan to just let their good companies compete.  So with that I will stop and wait for the discussant to refute.

*(Applause)*

MR. SAITO:  Good afternoon, ladies and gentlemen.  I'm Jun Saito, Japan Center for Economic Research. First of all, I would like to thank the organizers for inviting me to this very interesting conference.  Next, I would like to congratulate the audience because you have reached the final presentation before the discussant.

I hope that I can attract your attention to the very interesting theme that I have been assigned to make a presentation, and that is what model for Japan's future?  This is a very difficult issue but I have been brave enough to try to answer this question.

The structure of the presentation is as follows:  First, in the introduction I'm going to explain why hollowing out is a problem for Japan. Then, on the alternative scenarios.  This part looks into the alternative scenarios available to Japan and discuss what needs to be done to realize these scenarios.  I will end my presentation with some additional remarks.  I will touch up on the implications of the scenarios on the development of the future of the advance of payments but I don't think I'll be able to reach this because of the time constraint.

Please forgive me. I may have to skip some of the slides. First is on the introduction. The purpose of this introduction is, as I said, to explain the hollowing out. Why hollowing out is a problem for Japan. If hollowing out can be defined as a decline in domestic manufacturing production due to the deterioration of the competitiveness of the tradables, Japan has experienced a similar situation in the past. In those days, Japan has been successful in handing over the labor-intensive industries to Asian developing economies while expanding capital and technological intensive industries in their place.

Since mid-1980s, Japanese firms are facing more significant competition from Asian economies, and this time firms in the manufacturing sector have been increasing FDI and shifting production sites abroad. Difficulties have been reinforced more recently by the rapid appreciation of the yen. They provided pressures that exceeded the ability of the market adjustment and policy response to take place. So that negative impact on employment has been of a great concern to Japan. I believe that over the longer term, especially when the rapid appreciation of the yen is behind us and also no more negative shocks occur, the adjustment can be expected to take place so that more balanced macroeconomic condition is restored.

However, that is not the end of the story. It does not mean that hollowing out does not have problems in the longer term. To the contrary, I think it is going to have a great impact, and that is because first, aging decline in the population is going to lead to slower growth of the Japanese total GDP in the longer term, and second, if Japanese competitiveness remains low, a larger share of production is going to take place in the services sector where labor productivity is lower than the manufacturing sector. As a consequence, per capital GDP growth rate is also going to stay low, and this is going to be of great concern for the welfare of the Japanese people.

This figure shows projection of changes in labor productivity in the medium term. Labor productivity is shown by a line is expected to grow only modestly over the projection period. This is because while improvement in labor productivity takes place in each of the industries as shown in the blue bar, there is going to be a shift of shares from the manufacturing sector with high productivity to the nonmanufacturing sector with low productivity. Therefore, changes in industrial competition as shown in the green bar are going to show negative contributions.

I have some detailed breakdown but I'll skip this. So this brings us to the alternative scenarios. In order to become this kind of situation, what kind of alternative scenarios can be fought for for Japan? I have listed five scenarios. Namely, (a) alleviation of hollowing out pressures by depreciation of the yen; (b) increase in exports by improvement and competiveness of goods; (c) increase in exports by improvement in competitiveness of services; and (d) increase in factory income by growing receipts from abroad; and finally, (e) increase in output capacity of high value-added sectors by receiving more foreign workers.

Now, let's start with scenario A. This is a scenario where depreciation of the yen takes place. In this sense it is already taking place since last December. However, there are factors that provide upward pressures on the yen. Differentiation is one thing; current account surplus is another. You may add another factor, namely relative sounders of the financial sector. Moreover, newly industrialized economies will continue to improve their competitiveness and challenge the Japanese export market. So this scenario, even if it may occur, will only give Japan a short breathing space.

So this brings us to scenario B. This is a scenario where improvement in the competitiveness of the manufacturing sector is brought about by product innovation or achieving higher quality and uniqueness in its products. Past records show that exports have shown higher value added production. This figure shows the export quality improvement. It consists of a shift of each product to higher value-added ones. This is shown in the brown or orange bar. And changes in composition of goods, which is shown in the green bar. It shows that export products have become higher value-added ones over the years. So the orange bars have been in the positive area.

However, Japan's national innovation system, which was once regarded as the best practice, is losing its competitive edge. That is because as Figure 4 shows, R&D expenditures are rapidly increasing in Korea, shown in the blue line, and China, shown in the purple lines. Korea has overtaken Japan in the recent years. Also, Japan is witnessing a widening gap between the United States in innovation in some very important areas. Figure 5 shows registered patents at the U.S. Patent and Trademark Office. It is shares by country, and because there is always a home country bias, what is important in this figure is not the shares but the shape or the balance of the pentagon. You can see that Japan has a weakness in biotechnology compared to more balanced innovations by the United States.

So in order to overcome the situation and realize scenario B, the National Innovation Service needs to be reformed. More R&D should be done by ventures which have become very important players in some important technological advancement, such as in the biotechnology areas. And for that purpose there needs to be a change in the system of employment, education, and finance. This has to take place in order for the ventures to be more active in Japan.

Now, scenario C. It is related to improvement in competitiveness in services. However, Japan's National Innovation System does not meet the needs in this area as well. Product innovation in services is not so successful in Japan. This figure shows the result of a survey on the differences in the realization of innovation by amounts of R&D expenditures and innovation types. It shows that relatively speaking product innovation in services, which is shown in the red lines, is less successful compared to other innovations.

I'll skip this. One promising area is export in technology service. As you can see in this figure, balance of loyalties and license fees is now showing a surplus. However, in order to maintain this lead in technology, overhauling of the National Innovation System is necessary as I have said earlier on.

Scenario D. This is a scenario where factor income increases by growing receipt from abroad. This corresponds to the popular argument of targeting GNI instead of GDP. However, caution is needed because factual income receipts from abroad recorded in BOP statistics include reinvested incomes as well as repatriated earnings. As this figure shows, only about 50 percent of total receipts are repatriated to Japan. This is shown in the blue part or gray part. Moreover, the problem remains even though repatriated incomes increase because the firms are already cash rich and they may not have much impact on the economy. That is because firms are not investing, not because they don't have enough money but because they don't see business opportunities in the domestic market.

More important than repatriation may be the potential benefits to households if they hold shares directly or indirectly through mutual funds. In this way they will be able to gain dividends, interest payments and/or capital gains, and they could use them for consumption. However, as this figure shows, Japanese households have only a limited portion of their financial assets in shares. Shares are shown in the purple line, and the majority is held in bank deposits.

In turn, as this figure shows, the banks are increasingly investing these collected funds into government bonds, which is shown in the red lines, rather than lending to firms, which are shown in green lines. So as a consequence, only a limited amount of risk money is going to the venture firms which I consider is very important. So it shows that the flow of funds need to be challenged as well.

Scenario E. This is the last scenario. This scenario is one that more foreign workers are received by Japan. The need for more foreign workers is as follows: aging of the population with increased demand for health and medical service. Since they cannot be imported, large portions of the labor force has to engage in supplying such services. This leaves only a limited amount of labor force for the high productivity manufacturing sector. Consequently, macro labor productivity growth would fall. The constraint could be alleviated if productivity in the service sector is raised and the labor force is increased by reversing the productivity rate trend which takes a long time and accepting more foreign workers which could happen in the short run. But in order to accept more foreign workers, Japan needs to be an attractive destination. Japan has to be more acceptable and has to establish necessary infrastructure. In this regard, I'm afraid Japan may be missing the opportunity because it is so late in taking action in this area.

So I'll skip the additional remarks, but the discussion on the alternative scenario provides me with this main message, and that is for the scenarios to sustain the Japanese economic system one way or the other has to be reconstructed. It is a difficult task but something which cannot be detoured. And this is the end of my presentation. Thank you for your attention.

*(Applause)*

MR. KAWAUCHI: Thank you very much. First of all, I want to thank Mireya-san for all these opportunities. As a discussant, I want to raise a few issues for discussion based on these rich presentations and also by showing some of the facts on the data from myself.

The first issues of discussion would be I want to take the earthquake. My question is does the earthquake still have some impact on the hollowing out movement from the Japanese economy? Two years ago the earthquake had a huge impact. Ms. Schaede mentioned the global supply chain under Japan's dominance. I agree with that. Most or part of the manufacturers which joined the global supply chain have been destroyed by the earthquake. So I want to ask whether this kind of disaster still has some impact on this movement. Most of them are reconstructed and recovering but one exception is energy imports. After the earthquake, our trade balance is at a huge deficit under the depreciation of the yen, this is much much costly. So I want to ask the panelists about the impact of this disaster.

The second issue for discussion is what Mireya-san raised at first. Is there any real phenomenon? There is no doubt there is a real phenomenon as many presenters already expressed. This is the data from the Development Bank of Japan and it shows many large firms planning to invest abroad, much more than previous years and in the current year, maybe in the future. And this is another data by JABC and it is clear that the overseas sales ratios and overseas products and ratios are going up and up.

But I want to ask one question, one issue. Is this a specific phenomenon movement in Japan. This is data from the cabinet office under the share of the domestic manufacturing. In Japan it is, of course, declining but it's not only the phenomenon in Japan. The other developed countries -- like U.S., U.K., France, or Germany -- their share of the domestic manufacturing is also declining. And also the share of the manufacturing export in the world is also declining in Japan or other advanced countries. China is enjoying the increase of the shares of exports in the world, and also the emerging countries, like Malaysia, Philippines, Thailand, Indonesia, Vietnam, these are the Asian countries -- they are the emerging countries also enjoying their increasing share of the manufacturing exports. This means that this kind of movement hollowing out may be the global phenomenon, not only in Japan but also the other countries.

Professor Urata showed the FDI outflow data and this is -- sorry, FDI inflow data on Japan's not so high positions and so the FDI outflow in Japan is not so higher ranked countries in their aspect of the FDI outflow compared with GDP scales.

So another question I want to raise is Japan so restrictive, especially for their inward accepting of FDIs or the other issues? Professor Urata showed very interesting data by OECD. In this one Japan was higher ranked as a very restrictive countries. I have one reserve on this data. In calculating this ranking, the specific industries, like agriculture, forestry, fisheries, and mining, which are very, very traditional industries in Japan and which consist of only 1 percent of the total GDP has a huge impact in calculating this data. So that means that it's not calculated by weight. It is equally weighted. So I have to say this data may be a little bit biased but it doesn't mean Japan is not restrictive in accepting the inward FDIs.

This is data from the World Bank that Mireya-san mentioned at the beginning during the business report by the World Bank. The ranking under ease of doing business, Japan is not that bad but Japan is not that good. The ranking is 24th , like this and the bottom three or the lower countries are like this. Under this doing business report we can see which part would be the obstacles or the problems in my country. We see there is a very low ranking in starting a business or dealing with construction permits or registration property or paying taxes -- most of the deregulation issues. So it is right that Japan is very restrictive in the aspect of regulations. That is a fact, I guess.

The other questions or the other issues for discussion would be what the government or the private sector should do to deal with the hollowing out issues. Japan's new prime minister, Mr. Abe, is coming to Washington, D.C. tomorrow and maybe he will talk about Abenomics, his economic policies. In the panel round it was a little bit introduced. The Abenomics consist of the three arrows -- the borrowed monetary policy and the flexible fiscal policy under growth strategy for promoting investment. And mainly the second arrow and the third arrow contain many key words to deal with these hollowing out issues.

So far we don't have a clear picture under Abenomics. This is only one output for the government. Emergency economic measures for the revitalization of the Japanese economy which was introduced last month and this has a lot of interesting issues like stimulating private investment or the measures for small- and medium-size enterprises, small scale businesses, and the human capital development. And these economic measures are coming with a supplemental budget under next year's budget, and it is estimated that it will have an impact on the real GDP by 2 percent and job creation of 600,000. So we need to see how the government will deal with these economic measures that's hollowing out.

And this is the message from the government about the new growth strategy which will be coming in the middle of this year. This is a statement by Minister Amari, who is in charge of the economic revitalizations made in the World Economic Forum in Dallas. He says a lot of interesting and important words as I highlighted the innovation platform or domestic institutional obstacles, including regulation should be removed and deregulations or tax reforms or the expansion of Japanese businesses in overseas market, high-level economic partnerships -- maybe this means TPP. Under internal investment there are a lot of important words so we should look closely at what is coming next from the government measures.

And based on that, I want to raise a little bit negative factors in implementing the policies by the Japanese government. One is, of course, the Japanese government's fiscal situation. I think some of them are very familiar with these figures. It's an accumulation of public debt. It is going up and up. And in the middle I mentioned Kobe. This is the year 1995 when the Kobe earthquake has happened. In this year, the Japanese government needed a lot of cost for reconstruction but at that time their public debt was less than 100 percent of Japan's national GDP. Now it is almost coming to 200 percent of national GDP. That is right at hand.

So under these circumstances Japanese government's budget has a very, very interesting picture. The bottom line is discretional spending. So that is around 20 percent or 26 percent. It's discretional spending and above that the social security or local allocations, National Debt Service, they are mandatory expenditures. So we have nothing to do with that. The Japanese government has nothing to do with that. So the government has many important issues raised by the presenters, like innovations or science R&D kind of things have to be financed in this bottom, around 20 percent of the total budget.

Such restrictions are shown in this picture also. Now, Mr. Saito expressed the R&D data and Japan is enjoying a very high volume of R&D but it has to be said that it is private-driven R&D, so the R&D expenditures by the government is not so high compared with the other countries. This is also because of the restrictions -- fiscal restrictions, fiscal disciplines.

The last point is personal financial asset. The presenters mentioned the personal financial asset and some presenters expressed trendsetting products. Some presenters expressed the private financial assets is not going to the risky asset; it is going to the cash or the safe asset. I think part of them are explained by this figure. In Japan, this is 10 years ago -- the data 10 years ago so maybe this is much more drastic now -- 10 years ago private, not company but personal financial asset was over 1,400 trillion yen and more than half of that was owned by the people over the age of 60 years old. Over 80 percent of their personal assets were held by the people above 50 years old. So in this situation I want to raise -- to discuss who can expect that this kind of financial asset is going to the risky and speculative transactions. This is one of the demographic issues. Very, very serious demographic issues in my country, I think.

And the last point is what would be the future of the Japanese economy? I have nothing to add to Mr. Saito's excellent scenarios. I personally think that scenario C would be the most preferable, but I think scenario C or D might be probable.

So anyway, based under these circumstances what should be done under what would be the future of the Japanese economy. That is to be discussed among the presenters. Thank you very much.

*(Applause)*

DR. SOLIS: Thank you very much. Those were really insightful presentations and I think also from the discussant, he really brought up so many issues that I would like now to ask the panelists to engage in that conversation and discuss these very interesting items. Thank you, Kawauchi-san.

Would you like to respond to any of the comments from Kawauchi-san?

DR. SCHAEDE: Well, on your last point I would like to point out that in the United States we have people called venture capitalists and angel financers, and they use their financial assets to invest in risky companies.

SPEAKER: How do you do that?

DR. SCHAEDE: Well, I mean, the fact that 80 percent of the money is owned by people over 50 is probably the same in the United States. But there is venture capital around. There are people in this country that are willing to invest in risky startups. So that's not a foregone conclusion. There's something else going on there that is in the way. But that's just a comment.

You asked about the earthquake and I think that was actually a question addressed to me so let me just, while I have the mic I'll just answer that. Of course, I was in Tokyo doing research on my profitable companies when the earth started shaking, and that was a major concern because what would happen to these companies? What would happen to the fabric of the Japanese industry? I was impressed that the companies that I was watching that are sitting at these sweet spots in the global supply chain are very strategic and they're very clever and very smart and very driven and they knew exactly -- they know exactly where they're sitting in the supply chain, and that if they did not get their act together very fast that there would be a great threat of replacement by competitors by other countries. And within a matter of three to six months they were all back online or had put into place mechanisms to make sure that the buyers would happily stay with them.

Now, it helps if you are the best in the world. Buyers don't switch easily. There's great costs of switching for buyers but the companies were also excellent in just making sure that earthquake did not disrupt. Now, that doesn't mean that the earthquake didn't disrupt but it didn't disrupt the global supply chain as badly as expected. That was kind of a three to six month sort of period and then that was solved. So thank you for giving me an opportunity to say that.

DR. URATA: A few observations. Since Mr. Kawauchi is from the Ministry of Finance, I guess maybe I have some questions or responses.

I read in the newspaper the Japanese government is going to reduce or try to promote transfer from say old people to young people by treating special kind of gift tax, lowering gift tax or exemptions, I guess. That kind of policy should be quite, I mean, good in order to promote transfer of income from rich old people to young, maybe poor, couples. I just wonder if they can even lower, I mean, the beneficiaries, it would be a very small number of very rich people. If we can increase this beneficiary of such policy that should really I guess promote the transfer of income from rich old to young poor people. That's one.

And then inheritance tax, I understand that they're going to increase inheritance tax, and I think that's a good policy because that may give incentive for rich people to use their money, to spend their money. That will inflate the economy. So I there are I think various measures that our government can take, particularly in the form of tax policies. And one of the policies which I'd like to see happen -- this is about agriculture – Mr. Yamashita knows much better than I do about the agriculture policy but farmers are given preferential tax treatment. If they claim agriculture land that they own, they don't have to pay as high say taxes compared to residential tax for good reasons. And inheritance tax is much lower. And these preferential treatments given to farmers are, in my view, the reason why they keep this farmland uncultivated, just abundant, and that should be taken away. So if I were a finance minister person I'd raise taxes on farmers and then try to get rid of these unused uncultivated farmland.

So there are a number of tax policies that they can do in order to raise tax revenue and to overcome some of these policies. I'd like to hear Mr. Kawauchi's views on my observations. And I'd like to make some more comments on other issues which I guess he raised.

For example, yes, OECDs, this index, simple average, they didn't really care about -- they didn't pay attention to the weights given to agriculture where lots of regulation is present. But there are pluses and minuses using simple average versus weighted average. If you use weighted average, because of very strict regulations the sector is very small, maybe. So restricted sectors are given very small weight if we use weighted average. So that will distort the picture. So maybe what they should do is to give maybe both -- simple average and weighted average and see what happens. Just one observation on that point.

But what I think is a problem is again regulation. That's very pervasive in Japan, and one very interesting indicator is the entry rate and exit rate of companies. Very small in Japan. You know, there are a number of births versus deaths we call it. Like births of companies and deaths of companies. If I remember correctly, in Japan entry rate is about 2 percent or less; exit rate is about the same. And now exit rate is larger than entry rate and the number of companies declining in Japan. And for the U.S., they are both about 13 or 14 percent a year. And this kind of dynamic is very vibrant environment and is the one I think Japan needs to try to get. And for that, again, regulation -- deregulation is what we need. So I'd just like to emphasize the importance of pursuing deregulatory policy.

And the final point, this comes back to agriculture. Weights of a vote. Political reform is what I think we need. Rural votes are given higher weights than urban votes; we know that. And according to the Supreme Court decision, one, two, three difference is legally acceptable, and I think that has to be changed. If a city vote, urban vote, is given the same weight as countryside or rural votes, young people in cities start voting and then their views will be reflected in the policies. So what I think I'd like to see happen in Japan is a political reform which DPJ started talking about it and Abe-san in my view promised that he will do it but he never talks about this political reform anymore once he got the position. There are a number of things that Japan can do to revitalize its economy. Sorry that I spoke too long.

DR. SOLIS: Oh, no. That's fine. Saito-san and then Kawauchi-san.

MR. SAITO: Just one thing. Mr. Kawauchi showed us the figure on the personal financial assets by age, and I think he tried to say that because aged people have a lot of savings, financial assets, it's very difficult to supply risky assets to the system. But I'm not quite sure whether that applies to the United States, for instance. The United States old age people, do they only have cash deposits, bank deposits? I don't think so.

I'm not saying that the household should have shares. It could be held by mutual funds and it could be ways that you would have less -- take risk, less risk and you can diversify risk. But in any circumstance I think it's very important that you supply risky assets in order to promote more venture firms. And if the venture firms are the core problem, it's not only the financial assets -- financial sector that is the problem. You need to review the employment system because it's very hard for one person to try to start a firm and then you fail. It's very difficult to go back to the labor market.

So this kind of situation shows that the labor market needs more mobility and it evolves into a more complete overhauling of the economic system. Thank you.

DR. SOLIS: Thank you. Kawauchi-san, do you have any comments to the questions? No? Okay. So now the floor is open. Questions from the audience. Yes, this lady here, please.

QUESTION: My name is (inaudible). I'm a graduate student from Georgetown University, and I'm very interested in the unemployment issue in Japan, specifically youth unemployment. And I remember Mr. Urata mentioned that it might not be a good idea for the Japanese government to choose risk to the bottom path, but it will probably generate more job opportunities for those people with a low education level. So my question is that if the Japanese government's goal is to focus on technology and service-based industries, how can they guarantee that people with a low education level can get jobs?

DR. URATA: Poorly educated persons, they are not given appropriate opportunities to work. Is that what you're saying?

QUESTION: Yes. Okay, so for those in like technology service-based industries probably they're looking to hire people with high education level. So I just don't know what are the methods used by the Japanese government to create job opportunities for people with lower education level.

DR. URATA: Well, in my view what the Japanese government should do is to give chances for them to be more educated or be given training and so on so that they can upgrade their skills so they can work for more productive jobs than what they are doing now. I guess they are unemployed. So to skill up their capability and the Japanese government can help do so. Maybe that will be the policy.

DR. SCHAEDE: You know, we could have a whole conference on this issue. It's very complicated because it used to be that part of corporate welfarism was the education of an individual in the corporation through lifetime employment and being rotated on the job into good positions. And that's still happening to some but not to all. So there are two questions really. One is the one that you're asking directly, which is, okay, so we have a set of low-skilled -- lower-skilled -- by the way, the average educational level of Japanese is very high. So what's low-skilled in Japan is pretty high-skilled somewhere else.

So but still, within Japan, I don't think there's actually a problem for jobs. Somebody mentioned in the earlier panel at 7-Eleven and so forth, the cashiers are from China. And so there are more jobs there and that's great. That's the service economy and some of it is very highly efficient.

But the larger question that you're asking is how can Japan replace the learning on the job, education on the job program. And I think there are two issues. One is the provision of opportunities but there is also, as a huge next task, a rethinking by large corporations on how they hire because what large corporations do is they go down the top universities and then they hire so many from Tora and so many from (inaudible) and whatever, Waseda. I'm sorry. My apology. And so there's this pecking order. Japanese that study abroad and come back with a master's degree or foreign degree often have a hard time getting into the (inaudible) kind of sort of applying for jobs, you know, rotation. It would probably be a good idea if you wanted to really solve the problem it would probably be a good idea to solve the way in which large Japanese corporations hire people and how the HR offices and large companies select people. And if they could take more risks then I think young people would happily pick up opportunities of studying abroad and doing more things.

DR. SOLIS: Great. Yes.

QUESTION: Thank you for the speech. Jennifer Lee with Hong Kong Phoenix TV. My question is regarding the Prime Minister Abe's recent relatively aggressive monetary policy. So as we know, the action he is taking after he took office has raised some concerns around the world, such as currency war. So I wonder what are your thoughts on the impact of the action he is taking on Japan's economy. And second is what do you think the action will have the impact on the economy of surrounding countries such as Korea or China? Thank you.

MR. SAITO: I'll try. On the monetary policy adopted by Prime Minister Abe, there are a number of issues involved. One is that he has persuaded the Bank of Japan to adopt the inflation targeting. And I think this is a good thing. This is common wisdom now all over the world and I think it is very important for the transparency, credibility, accountability of the monetary policy to get involved in information targeting. So I think that is a good thing.

Maybe an issue is how you're going to achieve the inflation target. And there I think the Bank of Japan could do some more things in the future. For instance, they are injecting liquidity mainly through the commercial banks, but as I mentioned in the presentation, the commercial banks are investing in government bonds. So the commercial banks are now an intermediary between the households and the government, not the household and the corporate sector. So I think the Bank of Japan needs to reach out to the market directly by purchasing more risky assets. That is very important.

And for me I think the monetary policy which is now being done is a necessary condition. It's not sufficient. For it to become sufficient I think you need to couple the monetary policy with growth strategy and that would create more real activity which would use up the liquidity injected by the Bank of Japan. So I think there has been recently an accord between the Bank of Japan and the government. People tend to see the Bank of Japan being forced to go into an accord, but I think the issue should be both ways. The issue should be read both ways. The government also is committed in making and implementing growth strategy.

Because of the easing of monetary positions, I think it has implications in many ways. One is overcoming deflation domestically, but in the course there may be implications on the exchange rate. But monetary policy has implications on many things including the exchange rate. I think it could have other implications on other countries. But now the other countries could do things.

I hope that this kind of monetary policy, which is undertaken by the government and the Bank of Japan, would be successful in putting Japan out of the deflation and contribute more to the global economy. Thank you.

DR. SOLIS: Jim and then (inaudible).

QUESTION: Sorry, I've probably talked enough today but I can't resist asking a couple of questions because the presentations were really excellent.

Professor Urata, with regard to foreign investment in Japan, you talked about the need for the Japanese government to take a more active promotional role. One of the things that strikes me is that M&A in Japan is a very, very low level. Is there a possible role for the government of Japan in sort of creating an atmosphere where it becomes more acceptable for Japanese companies to sell off non-core divisions if it's a friendly kind of strategic transaction because there's big companies with many, many subsidiaries and they can't sell these things. And I talk to people in the private sector who would like to do deals but they can't because there's just resistance to it. The Japanese government seems to be promoting Japanese M&A abroad. Could they not take a comparable role in Japan by setting an appropriate tone?

And I would highlight one case that was in the case, and you may know more about this than I do I'm sure. I think it was in the case of Renesas, the semiconductor company. Foreign bidders were rumored to be looking at acquiring the company but then there was sort of a cohesive effort by the government of Japan and the private sector to get a Japanese effort to acquire that company. That would send the wrong tone in line with the question I'm asking.

That would have been an opportunity actually to let it go to a foreign acquire because then that sets expectations for future possible deals which I think would be possible. Thank you.

DR. URATA: I don't know the details of this case that you just indicated, I mean, but there are views that Japanese M&A markets are very closed. And I looked at the figure. I mean, FDI, inward FDI and part of it, of course, is M&A. What I found is not only M&A but, of course, FDI in general are very low. So I mean, it's not just particular on M&A alone but the other green-fields and FDI are quite low.

As far as the legal, I think, treatment of say mergers, M&A is concerned, this triangular M&A, this was now -- this became allowed a couple years ago but there are certain treatments or tax treatment as a matter of fact which is only available to Japanese firms, not to foreign firms. There are discrimination vis-à-vis foreign firms in favor of Japanese firms, and there are some known problems. And I know the Japanese government is trying to deal with some of these problems. Indeed, I'm a member of this kind of group which was formed under METI to look into the ways to expand FDI into Japan. And one of the issues is exactly on this M&A issue. And so there are some treatments which are discriminatory. And this discrimination has to be corrected.

Other than that, again, this kind of mentality on the part of Japanese, you know, old Japan, kind of we say old Japan, no foreigners. Although, some of the measures are not discriminating at all towards foreign but this kind of mentality really gives not only the impression but also some messages to foreigners that Japanese markets are very difficult to go into. I guess the example you cited is exactly that kind of thing. There are tacit understandings among Japanese that some companies should be owned by Japanese and I think it's incorrect. But it is true that there are these kind of not only mentality but also some of the practices I just mentioned.

And here what it comes down to is this competition policy. If competition policy is implemented and adopted as it should be equal not only among Japanese but foreign, then the situation would be much better. So in my view competition policy is very important and so far I guess there are still some of the problems remaining and that should be corrected to make a level playing field for not only among Japanese but foreign firms.

DR. SOLIS: Thank you. Mr. Kikuchi, you get the last question. If you can be very concise, please. So you can ask it. Thank you.

QUESTION: Okay, well, first I'd like to thank Professor Urata because the idea of the pinnacle and the niche industries is an important one. The days for young ladies assembling semiconductors are gone from Japan as well as shipbuilding industries. But my one question then to Professor Saito is you mentioned a number of times growth, and Japan is already at about $50,000 per capita. What is your idea? Where should we go? Do you think we'll be happier at $60,000? As you know, we are both old and we eat less, we drink less, we carouse less, and we don't want to spend that much money anymore. What do we do? Perhaps there's a limit to growth. Thank you.

DR. SOLIS: Do you have any comment on that?

DR. SCHAEDE: It's your question but I completely agree with you. I think there's a fascination with growth that is probably, you know, misguided. The truth, the truth and nothing but the truth is that economists don't know how to talk about stock. We can only talk about growth. We are trained how to talk about growth, how to think about growth, how to measure it, and how to extrapolate it and all kinds of things. We have no tools in the economics toolbox to assess stock. And so that's why we're doing what we're doing. But I completely agree with you. If we could just take stock of Japan and say Japan's next task should not be economic growth; Japan's next task should be to make sure that all of these rich people are happy.

DR. SOLIS: Saito-san?

MR. SAITO: Okay. Recently, happiness has become very popular and it's very important that happiness nationwide is assured. But I still believe that growth is necessary for happiness. And in addition to that I'm afraid we can't afford but grow because we have a big fiscal problem, and we have to get -- we have to solve this problem in many ways, including increasing revenues and cutting expenditures, like in the United States, but also by growing. And I think this is one important aspect that we have to keep in mind.

DR. SOLIS: Okay. Last comment. Very brief.

DR. URATA: It's maintaining what we have. I think we need growth. Look at the infrastructure in Japan. We had the terrible accidents; the ceiling coming down from the tunnels and so on. So just maintaining what we have, you know, infrastructure. We need economic growth.

DR. SOLIS: Okay. I think you can tell that our conference was very successful if you end on a philosophical note about growth, happiness, and what will make other Japanese people happy.

Before you go, I just wanted to express my thanks. This is the first formal conference I organized here as Japan chair, so I wanted to express my gratitude to Mr. Knight and to the Center for Global Partnership for the very generous financial support, and also to the Japan Center for Economic Research for sharing several of their very talented experts. And I would like to ask everybody in the audience if you could please join me in thanking everyone of the panelists. They did a terrific job today.

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