

JAPAN ADDRESSES CHALLENGES TO FUTURE GROWTH AND DEVELOPMENT

JUNE 2006

Over the past few years, the Japanese economy has become an increasingly strong performer. Corporations are enhancing their competitiveness, consumers are becoming more confident, and investors—both foreign and domestic—have been pouring money into plant, equipment, land, financial securities and equity investments, in order to profit from Japan's increasingly attractive economy..

Changing circumstances, however, are always the precursors to new challenges—which must be addressed if sustainable progress is to be achieved. For this reason Japanese leaders have begun to identify possible hindrances to future growth as well as the policies that will best help to address these potential constraints. Examples include an aging population, large public sector debt, the need to move away from an overly accommodative monetary policy and the social adjustments that are an inevitable byproduct of reform and corporate rationalization.

While these challenges merit attention, the good news is Japan's increasing economic strength and stability, bright corporate profit picture, and favorable employment situation are a few of the many factors creating an environment conducive to tackling these important issues.

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Recent Data Indicates Japan is Maintaining its Strong Performance

In the first quarter of 2006, Japan's GDP increased by an unexpectedly high 0.8%. This equaled an annualized rate of 3.1%, twice the rate analysts had expected. Japan's solid performance led the Governor of the Bank of Japan (BOJ) Toshihiko Fukui to comment, "we think there will be a long-lasting recovery." While it is possible that Japan's rate of growth will slow in the future, there is an increasing acceptance that the present economic expansion will continue. One example of this optimism is comments by Glenn Maguire, chief economist at Société Générale in Hong Kong, who noted "this is the long-awaited sustainable recovery."

Further evidence was seen in the BOJ's March Tankan survey. It revealed that confidence levels among Japan's large non-manufacturing groups were at their highest levels since the early 1990s. Moreover, the survey revealed that large manufacturers are planning to increase their investment in 2006 by 5%. Aside from these positive aspects, the survey revealed, in the opinion of Richard Jerram, economist at Macquarie Securities, "signs of a pick-up in retail, real estate, and consumer services" and that "Japan's structural domestic revival is progressing smoothly."

Surging exports are one reason behind Japan's continuing economic progress. In April, they were 11% higher year-over-year (YOY) as a result of double-digit increases in exports to the U.S. and China. Imports also surged, which analysts such as NLI Research Senior Economist Taro Saito viewed positively "as evidence of solid domestic demand." The state of private consumption, representing 55% of Japan's GDP, is extremely important, providing further evidence that Japan -- which remains the second largest economy in the world -- is again becoming an important source of global demand.

Retail sales did dip in April, falling by 0.6%, but many analysts dismissed this as a result of poor weather. Moreover, most are optimistic about the long-term trend. Mamoru Yamazaki of HSBC Securities Japan told the BBC News, "given favorable job and income conditions, I think consumption will likely recover." Seiji Adachi of Deutsche Securities added, "the environment surrounding consumption, such as employment, has been improving for some time and raising hopes of a further pickup in spending."

Additionally, the hiring picture in Japan is extremely positive. Government figures show that in March, Japan maintained the 4.1% unemployment rate it achieved in February. This is an almost 10% decrease from the 4.5% registered in January -- the lowest unemployment level seen in Japan in almost eight years. Reflecting further strength, the jobs-to-applicant ratio remains above 1. This indicates there are more vacancies than applicants. Japan's striking employment statistics led Ray Attrill, Director at the economic consultancy firm 4Cast, to remark that the data was "as impressive as meets the eye." Not only is the unemployment rate declining, but wages are rising and more full time employees are being hired.

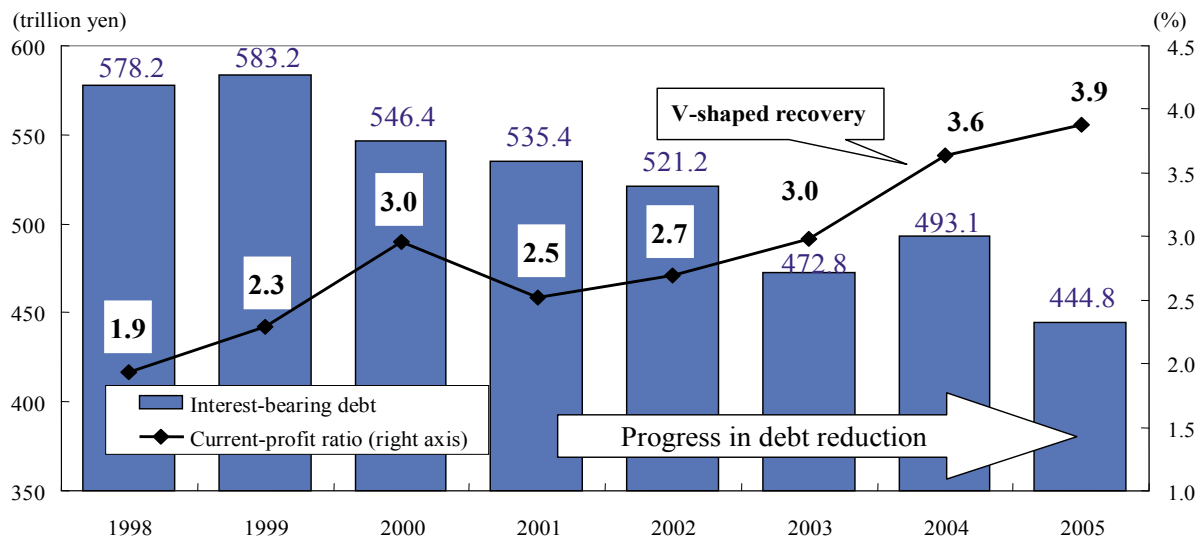
CHART 1: GROWTH OF FULL TIMES VERSUS PART TIME EMPLOYMENT



Source: Japanese Ministry of Economy, Trade and Industry (METI)

Shrinking corporate debt and improving corporate profitability are also likely to lead to additional gains in employment moving forward. According to the Japanese government, both the manufacturing and non-manufacturing sectors are "realizing robust profit growth." Moreover, hundreds of Japanese firms are recording the highest profits they have ever recorded.

CHART 2: THE DEBT LOADS AND PROFITABILITY OF JAPANESE CORPORATIONS



Source: Japan External Trade Organization (JETRO)

Rising profits, debt reduction, and other improvements are also leading credit rating agencies such as Moody's and R&I, a Japanese agency, to raise their ratings of many Japanese firms. Pekka Laitinen, for example, Head of Corporate at Fitch in Japan, recently noted that credit quality was improving "across the board." Echoing this, Standard & Poor's said the large number of upgrades relative to downgrades showed there was "a fundamental improvement in credit quality throughout corporate Japan." In addition, when one considers the reluctance many Japanese firms have traditionally shown toward initiating the painful reorganization and rationalization efforts common in the U.S., even the double-digit rise in bankruptcies seen in April is viewed by many as an encouraging sign. This is because it indicates that companies are taking steps to overcome their problems, while banks continue to clean up their loan portfolios, and the government continues introduce measures to facilitate this necessary transition.

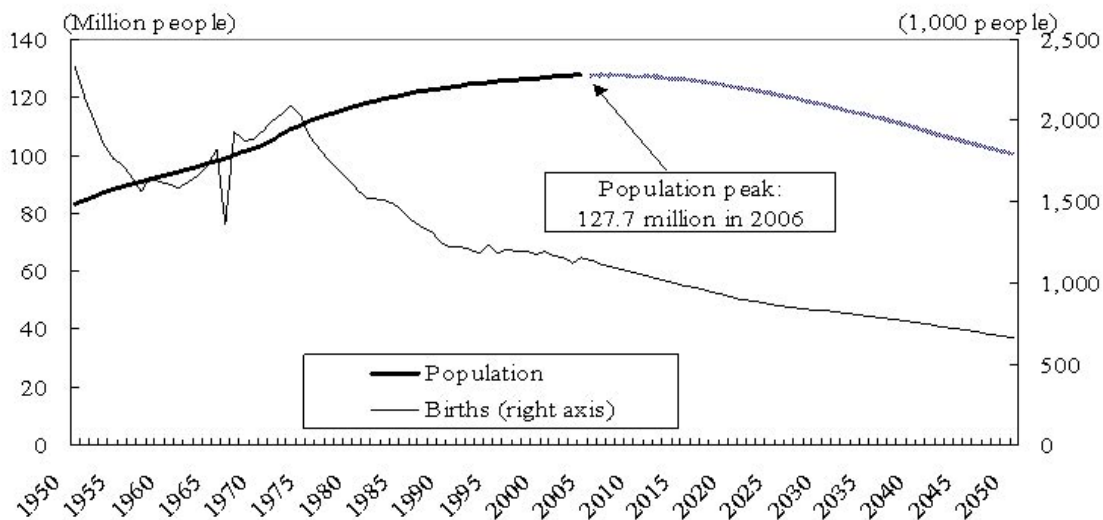
Aside from solid GDP and employment data, government figures also suggest Japan continues to make progress in beating deflation. Statistics on Japan's core CPI, which excludes food,

show a 0.5% rise in March YOY. This represented the fifth consecutive increase and follows a similar 0.5% increase in February. These price increases are reflected across a wide range of economic activity including land prices, which rose for the first time in 15 years. Rent for top quality office space, and even golf course membership fees are also rising.

Japanese Demographic Trends Present Both Challenges and Opportunities

The Japanese government estimates that Japan's population -- currently estimated at approximately 128 million people -- will fall to roughly 120 million by 2025 and 100 million by 2050. It is also believed Japan will have the world's second largest percentage of people aged 65 and over by 2050.

CHART 3: POPULATION TRENDS



Source: Japan External Trade Organization (JETRO)

If these twin developments transpire, they will present a number of important challenges. For instance, they will reduce the productive or working age population. Furthermore, they necessitate a significant increase in social safety net expenditures such as pensions, medical

care, and welfare. As a result, they will increase the average social safety net burden on individual workers. Finally, declines in Japan's productive population have the potential to negatively impact growth rates.

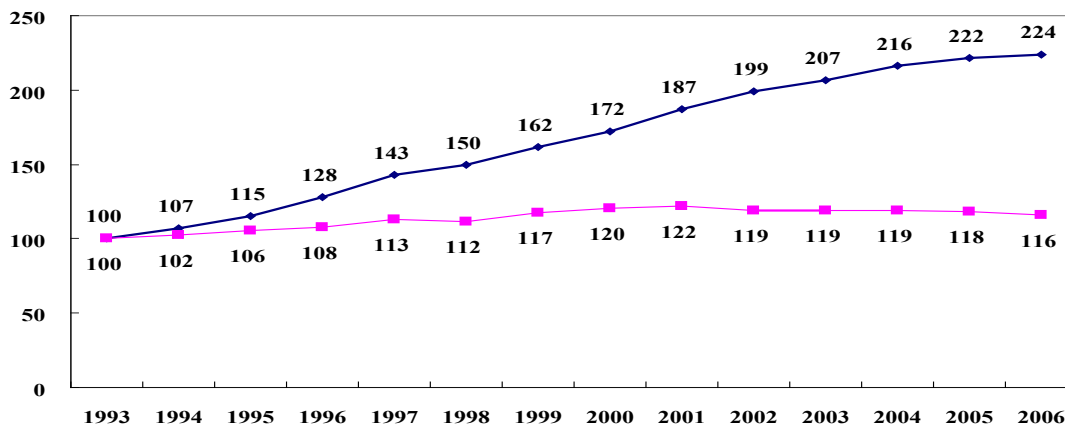
To counter these trends, Japan will need to invite greater female participation in the workforce. Moreover, Japanese companies must become more accepting of non-traditional employees such as working mothers and the elderly and the nation may even need to open its borders to more immigrants. Recent movement in the government to try to extend the allowable stay of foreign workers from three to five years can be seen as one good example. In addition, it is encouraging that the number of women in the workforce rose by 220,000 over the past three years and workers aged 60 or over grew by 450,000 over the past five years. Some companies, such as Toto Ltd., Dai-Ichi Mutual Life Insurance Co. and Shonai Bank are even implementing special programs to enhance their ability to recruit female and other non-traditional employees.

To address Japan's demographic challenges, policy changes are needed as well. As a result, the Japanese government is taking steps to stabilize its social security expenditures and to bolster labor participation rates. More specifically, it has raised premiums for the national pension system and increased health care deductibles. To enhance labor participation, it is working to provide a better environment for female workers. This is truly critical not only to help enlarge the size of Japan's workforce, but also to introduce the valuable talents, skills and perspective that these female workers can provide. To achieve this goal measures are being developed to enhance the availability of child-care and to prohibit discrimination against women. Japan is also taking steps to encourage female entrepreneurship. For example, the Japanese Ministry of Health, Labor, and Welfare publishes manuals for female entrepreneurs and hosts seminars for females who wish to start their own business.

Beyond these measures, the Japanese government is taking steps to increase productivity, moves which the International Monetary Fund (IMF) sees as essential. This includes substantial augmentation of its support for science and technology activities. As shown below, a major component of this support is extensive financial assistance for scientific research. For the next five fiscal years, Japan intends to spend 25 trillion yen or,

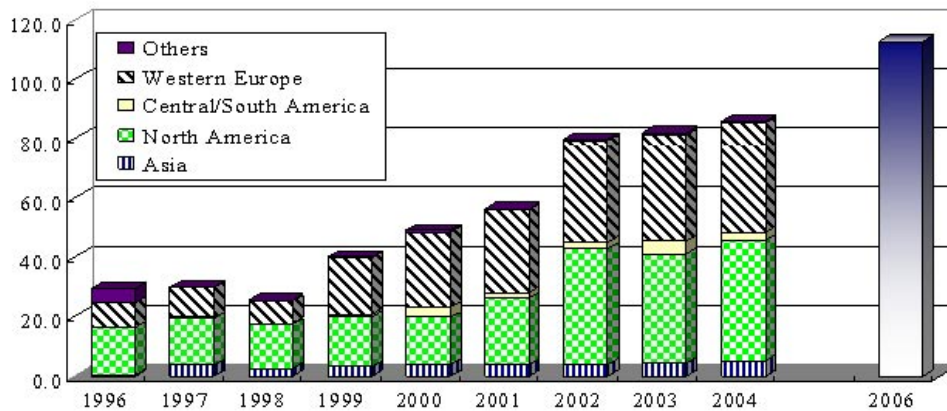
approximately \$215 billion, to support science and technology activities. Japan is also striving to enhance the output of research and development (R&D) activities by eliminating redundancies and fostering collaboration among industry, government, and academia.

CHART 4: SCIENCE & TECHNOLOGY VS. GENERAL EXPENDITURES (FY1993=100)



Source: Japan External Trade Organization (JETRO)

Similarly Japan continues to encourage foreign investment to enhance efficiency, growth and new business practices. Japanese Prime Minister Junichiro Koizumi's 2003 call to double cumulative inward foreign investment has led government agencies to offer incubation offices and provide consulting services on issues such as intellectual property and marketing. These initiatives coupled with Japan's large markets, skilled labor, and technological capabilities have attracted significant investments by Eastman Kodak, Google, and DuPont. On a broader level, aggregate statistics show cumulative inward FDI will top \$110 billion in 2006.

CHART 5: CUMULATIVE INWARD FDI (BILLIONS)

Source: Japan External Trade Organization (JETRO)

Although these demographic trends present serious challenges, it should be emphasized they are also creating major opportunities for companies in the leisure, health care, financial and other service sectors. According to the Boston Consulting Group, the post-war Japanese baby boomer population has substantial discretionary wealth that it is willing to spend on upscale items and leisure activities. They are also an increasingly receptive audience for financial and investment products. In the health care arena, the ageing of Japan will create numerous opportunities in nursing and geriatric care, the sale of dietary supplements and other health-oriented products, including pharmaceuticals and medical equipment.

Economic Growth Will Require Changes in Fiscal and Monetary Policy Orientation

During the 1990s, the Japanese government committed large amounts of capital to public works projects and other initiatives to stimulate economic growth and temper the pain resulting from economic restructuring and rationalization. While this brought various benefits and helped to ease this transition, Japan's fiscal stimulus policy also produced

record levels of public indebtedness. The BOJ's zero interest rate policy (ZIRP) and massive injection of reserves into the banking system (quantitative easing or QE policy) allowed the nation to better carry this debt. Additionally, it gave Japanese financial institutions the room to work off the record amounts of non-performing loans that resulted from the excesses of the bubble era.

As Japan's economy gains increasing strength, however, it is increasingly apparent that the time for such policies has passed. Public works projects no longer are needed as a stimulus and banks have dramatically reduced non-performing loans. So much progress has been achieved that Japanese government officials as well as the BOJ are now turning their attention to improving Japan's fiscal position and returning monetary policy to normalcy.

In the view of the IMF, the time is indeed "right for a significant and sustained effort [by Japan]...to arrest the rise of the debt burden." Along these lines, the Japanese government passed the country's toughest budget over the last eight years in March. This fiscal year 2006/07 budget, lowers expenditures by 3% to 80 trillion yen and includes measures to improve revenue collections. To reduce the government deficit, the budget lowers public works spending and reduces or eliminates various income and real-estate tax credits that the Japanese government enacted to advance the country's economic recovery. Japan's tight budget will allow the government to decrease its new borrowings by 12.8% from the prior fiscal year. Japan's economic strength coupled with a solid foundation for future economic growth are leading decision makers such as Economics Minister Kaoru Yosano and Finance Minister Sadakazu Tanigaki to seriously discuss potential tax increases. Nonetheless, Japanese policymakers recognize they must move carefully on any increases in taxes or changes in monetary policy to ensure continuing improvements in domestic consumption and the economic recovery now underway. It will also be necessary to consider the impact of any policy changes on the global economy at large.

The March 2006 edition of the JETRO Focus Newsletter previously discussed the end of the BOJ's QE policy and the potential accompanying end of ZIRP. Japan's increasingly solid economic results as well as higher consumer prices, rising energy and raw material costs, and wage improvement suggests that the BOJ is likely to end ZIRP this year. According to

Naoki Iizuka of the Dai-Ichi Life Research Institute, recent data suggests a “high possibility that the Bank of Japan could start raising rates in July.” Even so, the Japanese Central Bank is likely to move cautiously. In May, BOJ Governor Fukui stated, “we are at a state where we must be careful for a while.” Moreover, in its April Outlook for Economic Activity and Prices, the BOJ states that “it seems probably that the accommodative financial conditions ensuing from very low interest rates will be maintained for some time.”

SOCIAL ADJUSTMENTS ARE ACCOMPANYING JAPAN’S MOVEMENT TOWARD GREATER COMPETITIVENESS

Japan’s post-war economic model emphasized business expansion, controlled competition and the acquisition of ever-larger global market shares rather than profit maximization and efficiency. At the level of the individual employee, it stressed lifetime employment, loyalty to one’s employer, and promotion on the basis of seniority rather than individual initiative and drive. Although it had certain limitations, this led to a society that had far less income divergence than that experienced in the US and a population that proudly viewed itself as largely middle class.

The maturation of the Japanese economy, the need to eliminate the excesses of the bubble years, and rising global competition all exposed the limitations of the old system and placed it under considerable stress. As a result, it is now being replaced by a modified system that places an emphasis on economic efficiency and competitiveness. This shift – which been marked by numerous changes in regulatory, corporate, legal and other practices -- has been instrumental in helping Japan to reverse its decline and to record more than four years of economic expansion. Many of these developments have been covered in past JETRO Focus Newsletters and recent examples include the passage of a new commercial law enacted on May 1, 2006, as well as a Japanese version of the Sarbanes Oxley act enacted in the U.S. in 2004. This measure is designed to enhance corporate governance and reporting in Japan and will be approved during the current Diet session, which ends this month.

hievment over “consensus” has not been without pain. One example of the difficulties that are being encountered is an increasing number of part-time and temporary workers and

a rising number of individuals on welfare. On the other hand, per capita income in Japan is still quite high and it continues to possess a far more egalitarian society than the US or Great Britain.

In the final analysis, Japanese policymakers are seeking to develop an economic system that promotes both egalitarianism and efficiency. In so doing, they are being responsive to parliamentary and public sentiment, which while embracing the need for reform and change, wants the government to manage this process in a way that minimizes gaps and the creation of permanent “winners” and “losers.” Policymakers understand that to sustain the reform process, deregulation, restructuring and fiscal tightening, they need to ease the transition to a modified system in a manner that preserves social cohesion and public support. Consequently, last March, the government established a task force to develop measures to help jobless workers and bankrupt companies.

JAPAN CAN NOW ATTEND TO REMAINING CHALLENGES TO FURTHER ENHANCE GROWTH & MOMENTUM

Japan’s ability in recent years to address its most urgent problems now allows business and government leaders to identify additional challenges in an effort to accentuate the progress that has been achieved. By confronting obstacles such as those outlined above, Japan is seeking to further enhance efficiency and to implement the measures and maintain the social consensus necessary to make Japan an even more attractive business and investment environment.

Recognizing the progress that has been achieved, foreign investors are maintaining their enthusiasm for Japanese investments over both the short and longer term. While many analysts are reexamining their allocations as a result of recent downturns in global financial markets, there is a continuing recognition that Japan is moving in the right direction. Lehman Brothers Asia economist Paul Sheard, maintains “an uptrend in manufacturing output (in Japan) is likely to continue in the near term,” while the strength in the job market means, according to Daisuke Yamazaki, an economist at Goldman Sachs, that “there’s little reason for consumption to deteriorate in coming months.”

Long-term investors also remain quite optimistic. News reports reveal, for example, that the Guardian Group of Funds Global Diversified Fund, launched in early March, was likely to afford a big place to Japanese equities. According to Mark Headley, president and chief executive officer of Matthews International Capital Management LLC and co-manager of the Fund, this was because Japanese deflation was ending and growth was “surprisingly robust.” Ray Mills, portfolio manager of the T. Rowe Price International Growth and Income Fund, also took the position that the Japanese bull market has further room to run. In remarks given to the Christian Science Monitor, he remarked “the troubled banking system has been cleaned up, government reforms have made companies more shareholder friendly... deflation appears to be ending” and there a large amounts of Japanese household financial assets that could be redeployed into the Japanese stock market.

Investors looking to boost their returns and to expand their corporate and portfolio investments within Japan’s increasingly attractive and robust economy should pay attention to these important developments.

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