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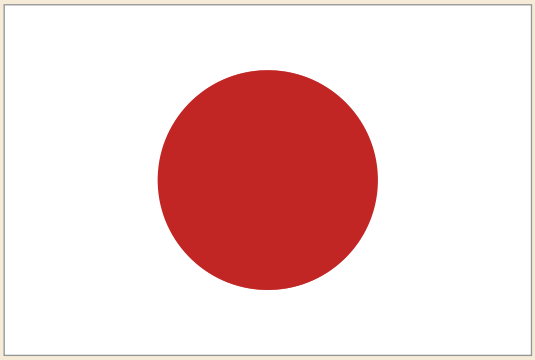


Is the Japanese Recovery for *Real*?

After all, for more than a decade, Japan's economy has experienced a series of false starts on the road to recovery. Is the current economic upswing for once the real thing? If so, to what extent is Japan's expansion too dependent on exports to China? If China experiences a bursting of an economic and financial bubble, to what extent would the Japanese economy be affected? For a number of years, the Bank of Japan has targeted the yen/dollar exchange rate through currency intervention within a relatively narrow range. If the current economic upswing is real and lasting, to what extent should the G7 community pressure Japanese policymakers to change their approach to foreign exchange matters? On all these questions, *TIE* asked twenty well-respected experts.

Yes, and most important is that deflation shows signs of easing.

HOWARD BAKER
U.S. Ambassador to Japan

Japan's economic recovery will prove durable if government and business leaders maintain momentum on corporate restructuring, economic reform, and ending deflation. If Japan continues the reform efforts of the past several years, the foundations for sustained strong growth will be in place.

The Japanese government has made major progress in addressing the problems that limited Japan's economic growth in recent years. It has forced banks to value their assets and capital more accurately, and the resolution last year of the situations at Resona and Ashikaga showed that the recent reforms have real teeth. The government has also made steady progress in improving accounting and financial disclosure standards and taken other measures to improve corporate governance and facilitate corporate restructuring. In addition, regulatory reform is opening more and more sectors of the economy to domestic and foreign competitors. And perhaps most important, deflation shows signs of easing thanks to aggressive monetary stimulus by the Bank of Japan.

Japan's private sector has also done its part. Japanese banks have accelerated the disposal of their nonperforming loans, and the corporate sector has made steady progress in strengthening its balance sheets and improving its operating efficiency.

The process is not yet complete. Banks and large parts of the corporate sector remain weak, too many regulatory barriers to competition have yet to fall, and deflation persists. But I am confident that, under Prime Minister Koizumi's leadership, Japan will avoid the trap of complacency and continue on track toward a brighter economic future.

This time things look different.

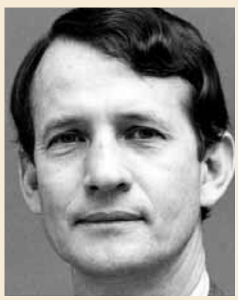
BARTON BIGGS
Managing Partner, Traxis Partners

I think (and hope) Japan's economy is in the early stages of a sustained recovery. I am not going to repeat the economists' gibberish. My conclusion is based on going to Japan again just recently for perhaps the fiftieth time in the past twenty years. This time it was different. Under the force of leveraged buy-out and private equity pressure from U.S. firms, Japanese companies are changing. Restructuring is beginning to pay off. Already these efforts are showing up in profits. The Takenaka plan for financial institution reform is happening.

Yes, Japan's recovery depends to some extent on China, and if the much-discussed bubble does burst (which I doubt) and capital equipment demand collapses, Japan would be affected. Already China is a bigger export market for Japan than the United States. A real bust in China might subtract one full percentage point from Japanese GDP, which is a lot when real GDP is only growing at 1.5–2 percent annually. However, the main engine of the Japanese recovery story is a domestic demand recovery which the most recent retail sales numbers suggest is already underway. I am convinced there is massive deferred demand for consumer durables because of the long period of deflation which encouraged the deferral of purchases.

I also heard directly from the big real estate people that the Tokyo and Osaka office markets have turned around after a ten-year bear market. This is an important straw in the wind for the economy, the banking system, and for confidence. Furthermore, a rise in real estate prices will be another signal that the deflation which has debilitated the economy is finally ending.

As for the yen, the Bank of Japan made it clear to me that their intervention is because a strengthening yen is deflationary. Once the recovery is sustained and nominal GDP growth is rising at 5 percent, I suspect they will step aside.



Yes, yes, yes! The only question is who gets rich in the process.

GARY HUFBAUER
Reginald Jones Senior Fellow,
Institute for International Economics

When Chris Flowers, a former Goldman Sachs banker, can personally scoop $1 billion from Ripplewood's bargain acquisition of Shinsei (formerly the Long Term Credit Bank), the question is not whether Japan's recovery is for real. The question is who is going to be the next Chris Flowers. In fact, despite the avalanche of negative press, Japan's economy was never close to collapse. So long as Japan kept adding to its mountain of foreign reserves, so long as markets wanted to drive the yen higher, and so long as the monetary problem was deflation not inflation, the Ministry of Finance could run massive budget deficits at near zero interest cost, and the Bank of Japan had almost unlimited power to refinance the banking system. Under these circumstances, there was no similarity between Japan and the crisis countries of recent years—Korea, Russia, Brazil, Argentina. Indeed, throughout the 1990s, Japan's real per capita GDP never really declined, but just stagnated at a comfortably high level. The real problem was that asset prices took more than a decade to fall to realistic values. As Ripplewood's bonanza shows (multiplying a $1.2 billion initial investment six times in three years), Japan has reached a magic trifecta: distressed assets, zero interest rates, and tremendous human talent. With this combination, the true question is not the speed of recovery, but who gets rich reorganizing Japanese corporations and real estate.

This is a false dawn and Japan now finds itself vulnerable to a bursting Chinese bubble.

TADASHI NAKAMAE

President, Nakamae International Economic Research

Amid the deflation of Japan's post-bubble era, every upswing in real GDP growth has proved to be a false dawn. This one will be no exception. What is more significant amid deflation is nominal GDP, which grew a meagre 0.2 percent in 2003, and would actually have contracted if not for a contribution of 0.3 percentage points from net exports.

Exports to China accounted for 80 percent of the total increase in Japanese exports in 2003. The Chinese bubble in fixed capital formation, both by increasing demand and by raising commodity prices, has been a boon to Japanese producers, especially of materials and construction machinery. Against these temporary benefits, Japan must weigh the costs of increased vulnerability to a bursting of the Chinese bubble, as well as the ongoing deflationary impact of the expansion of Chinese supply capacity.

In spite of deflation, Japanese corporations saw profits increase in the two years to Q4 2003 by ¥11.4 trillion (+38.8 percent). This figure, equivalent to more than 2.2 percent of GDP, represents an unusually strong profits recovery. If only it heralded a sustainable recovery in return on capital, leading to growth of capital investment and the creation of new and more productive jobs, leading in turn to sustainable consumption growth. In fact, it heralds nothing of the sort. Corporations have increased profits not in a way that augurs well for sustained economic growth, but rather by reducing the quantity and quality of the jobs they provide. In particular, they have turned to part-time workers, whose average wage is less than a quarter of that for regular workers. Hence, during the two years in which they increased profits by ¥11.4 trillion, Japanese corporations slashed wage costs by ¥11.0 trillion (-6.2 percent).

The scope for genuine economic recovery lies in underdeveloped demand for services, which still account for only about 30 percent of GDP in Japan, compared with 40 percent in the United States. So structural reform, centered on deregulation of the service economy, continues to be vital. Deregulation must go hand in hand with an end to zero interest rates, which continue to hinder structural adjustment by sustaining moribund firms.

Could the disappointment that will follow this latest false dawn trigger a flight of capital from Japan that will be sufficient—regardless of the will of the authorities—to force a decisive and lasting rise in interest rates? For the long-term good of Japan, I hope so.

Yes, the difference is this recovery is not driven by a large-scale fiscal expansion.

KEN YAGI

Executive Director for Japan, International Monetary Fund

The current economic upswing in Japan is different from the ones that took place in the last decade in the sense that this time it has been brought about without a large-scale fiscal expansion. Rather, it has been driven by the private sector's initiative, such as in restructuring, innovation in management style, and the equipment investment partly due to high increases in exports to China. So the present economic upswing has a more sustainable nature compared with past ones. The Chinese economic boom will not be so short-lived for two reasons: It will continue—at least for sometime—because China will host the 2008 Olympic Games in Beijing as well as the 2010 Shanghai Expo, both of which continue to be driving forces behind Chinese economic growth, and the authorities have been very cautious and conservative in their policy implementation.

The Japanese economic growth has set in motion the momentum to maintain the present economic upswing as described, although it cannot be as strong as the one in the 1970s or 1980s, as Japan is already a matured economy.

As a pessimist, I admit Japan is on a new course.

L. WILLIAM SEIDMAN
Chief Commentator of CNBC-TV

Japan is at long last on the real road to recovery. The trend lines are moving in the right direction—banks are really reducing their non-performing loans, public ownership in the economy is being reduced, government is committed to controlling deficits, and the reform of their tax system is underway. After more than ten years of economic stagnation, something important has happened to change the direction and more importantly the attitude of the country. Is it due to the skilled leadership of Prime Minister Koizumi, or is it a new generation taking control, or is it the ten years of advice which I have offered on my many visits? Except, of course, for my advice, all of the above have had some influence over the improvements, but they are not the fundamental reasons things are getting better.

The economy continues to rely primarily on exports for growth, and therein lays the basis for change. The "credit" for the basic change in Japan's approach to its economy is the emergence of the new China and the challenge it presents to the self-satisfied Japan. As the Japanese said to me many times on my visits, "Even though our economy is not growing much, we still are very wealthy and the situation is not causing us much pain."

Once China started to become an (or the) important new exporter of manufactured products, Japan saw that the old status quo game was over. No longer would rigging a low value for the yen and improving productivity be enough to sustain their export dominance. They had to get competitive by shifting manufacturing and exports to China and this required putting the home front economy into a new mode of competition and job creation.

Foreign ownership of banks, once frowned upon, suddenly became a good idea, because it mandated change in the system. As it always does, competition brings pain and reality to those subject to its beneficial effects. But most of all, it causes complacency to become activity.

So Japan is on a new course and one that should lead to a stronger economy. China won't go away and of course India and someday Africa stand in the wings as low-cost producers. The Japanese may even allow the yen to float when their huge surplus trade balances are corrected as their export economy becomes more balanced.

All the foregoing is from one who has been pessimistic for years on Japan's future and the likelihood it would fundamentally change its ways.

Yes, it's real. And with so much slack, Japan can grow above potential.

ADAM POSEN
***Senior Fellow, Institute for International Economics, and Executive Editor,* The International Economy**

Yes, the Japanese recovery is real. In fact, the previous two recoveries (in 1996–97 and in 1999) were real, too, until policy mistakes aborted them. And the Japanese economy should be at least as capable now as it was in 1990, when responsible estimates of Japanese potential were in the 2.0–2.5 percent range. If anything, the economic potential is higher today:

- Deregulation of price-setting in Japan's retail, telecommunications, and energy sectors, while partial, has increased efficiency;
- The benefits of the "Big Bang" in financial deregulation have been hidden by the banking and insurance sectors' difficulties, but have made possible the recent investment boom funded largely without costly intermediation;
- The encouragement by the Japanese government of unraveling cross-shareholdings, making and taking in foreign direct investment, and easing the laws for starting up companies are promoting innovation;
- Leading businesses' commitment to "Made by Japan" (not "Made in Japan") thinking has generated higher returns on their investments, with a healthy shift of production to China;
- And, finally, labor markets are starting to become more flexible, allowing younger Japanese to experiment with new opportunities and even foreign employers.

All of these developments have taken place in the last few years, and Japan has not forgotten or lost any technology in those same years, so these all raise potential from what it was before. In fact, for the next few years, Japan could grow faster than potential, perhaps in excess of 3 percent per year on average. There is so much slack in the Japanese economy—under- and unemployed workers, deflationary pressures, forgone investment opportunities, savings being left in accounts at near-zero returns—that there can be above-potential "catch-up" growth until the underutilized resources are nearly fully employed.

Yes, Japan is like the United States in 1992–93, about to take off.

MAKOTO UTSUMI
President, Japan Center for International Finance

A ray of sun has come filtering through the dark clouds covering Japan since the beginning of 1990s. It came from the corporate sector.

In the fiscal year ending March 2003, the total of the listed companies' operational profits increased 71 percent compared with the previous year. The increase was realized under an environment where the total turnover increased only 1 percent. It shows that the severe restructuring and cost-cutting in the Japanese corporate sector are finally bearing fruit. This trend continued in April–December 2003, with operational profits showing an increase of more than 40 percent compared with the same period of 2002.

This situation is similar to what happened in the United States in late 1992–93, where corporate restructuring made it possible to realize very positive profits. Then, the U.S. corporations began to make use of these profits to invest to improve their productivity and it was the beginning of the recovery of the U.S. economy. Consumers needed another two or three years to catch up with this upward trend of the economy because they were suffering from severe job insecurity.

Returning to Japan, there have been good signs for the corporate sector to be positive about investment. It was the major contributing factor to the very positive growth in the fourth quarter of 2003.

As far as Japanese consumers are concerned, the lag of their performance might be shorter than in the case of the United States, given the fact that their savings are much greater in the case of Japanese consumers and, consequently they seem to have already started to spend as their confidence gradually recovers.

Yes, and without large fiscal or monetary stimulus.

TOYOO GYOHTEN
President, Institute for International Monetary Affairs

The Japanese economy is clearly recovering. The outstanding feature of the current recovery is that it happened without the support of fiscal or monetary stimulus. It is also remarkable that it is taking place in spite of the widespread corporate restructuring. Five factors have contributed to the recovery. First, the economy has entered the upward phase of the investment cycle. Second, exports, particularly to China and the United States, are strong, although the contributing share of exports to the overall growth is not more than one-quarter. Third, corporate profits have improved greatly thanks to strenuous restructuring. Fourth, household consumption is holding up although wages are not increasing. And fifth, the non-performing loan problem of major banks has very much ameliorated. The systemic risk has been dispelled. Near-term prospects, both at home and abroad, are sanguine.

As for long-term prospects, there are two major challenges. One is how to cope with the demographic change, particularly with respect to the viability of the social security system and the maintenance of an adequate labor force. Another is how to carry out fiscal consolidation.

The Ministry of Finance will continue to intervene whenever it considers, rightly or wrongly, a too-rapid strengthening of the yen may jeopardize the recovery. The G7 community's pressure to give up intervention cannot be strong because the biggest beneficiary of the intervention and the resulting purchase of Treasury bonds is none other than the United States.

No, because there is little risk-taking with an eye toward the future.

DR. PHILIPPA MALMGREN
President, Canonbury Group

Is the recovery for real? No. It can never be for real because no one in Japan is building the economy of tomorrow. The focus has been on cleaning up yesterday's problems—the non-performing loans and the indebted balance sheets. The economy cannot recover on a diet of cost-cutting, cleaning-up, and exporting alone. Risk-taking is essential. But the managers in big companies are still afraid to take risks for fear of losing their jobs. The managers of small companies are just trying to survive. That means a shortage of the risk-taking that leads to the innovation and competition that are essential to sustainable growth.

But, you say, the Nikkei has risen rather dramatically and the economic data is certainly better now than in the past. True. But the Nikkei has been almost exclusively driven by only three forces. First, it goes up or down on the backs of investors who lunge wildly from massively underweight to neutral holdings in the Japanese stock market. When they are underweight, the Nikkei shoots up on the slightest whiff of good news and the investors are forced to short cover. When they have a neutral weighting, any hint of bad news causes the Nikkei to collapse. This flailing about is hardly the stuff of a reliable recovery. Second, most of the profits in the Nikkei come from the sales of goods made overseas, mainly in Asia. That is why the government's efforts to prevent the yen from strengthening will do little to help the recovery. Exports are no longer the key to success. If Japan ever really recovers, then the yen will only strengthen. And finally, Japan's economy depends on the strength of others—the United States, China, Asia. As they recover, so Japan looks better too.

Yes, and we're no longer the prisoner of the past.

TATSUYA TERAZAWA
Special Advisor, Ministry of Economy, Trade and Industry, Government of Japan

The current upswing of the Japanese economy is real. While it is true that the Chinese demand is providing a boost to many companies, there are more elements to the current upswing.

The consumer electronic sector is now being transformed to digital: from film cameras to digital cameras, from VCRs to DVDs, from traditional TVs to digital and flat-panel TVs. This is generating a substantial domestic demand.

Internet is finally taking off among the Japanese consumers. The lack of fixed rate has been a serious impediment to dial-up connection. But the dramatic acceleration of DSL, expected to surpass availability in the United States, is providing both cheap fixed rates and speed.

The once-damaged balance sheets of Japanese companies have been greatly improved. For larger companies, the debt level is back to the pre-bubble level. The profitability for larger companies is better than at any time after the bursting of the bubble.

While more work remains, the worst fears about the financial system are behind us. The injection of public money into Resona was a turning point. The public's confidence in the financial system is back. The stock price of the major financial groups has risen 2.5 to 3 times from the lows last spring.

We find signs of recovery in consumption as well. The bonus payment, which had been constantly reduced in the last few years, will rise this year by 60 percent at the major companies. Domestic package trip sales for the "Golden Week" are expected to increase by more than 30 percent compared.

Considering the past decade, it is not the time to celebrate yet. Prudence is warranted, including the efforts to avoid abrupt appreciation of the yen. However, there are more positive factors about the Japanese economy than at any other point recently. It may be the time to stop being the prisoner of the past.

Probably, and the greatest factor for optimists is that the BOJ will keep its zero interest rate policy.

JIM O'NEILL
Head of Global Economic Research, Goldman Sachs International

This recovery in Japan does not seem to be overly dependent on exports, and consequently it is probably different. One has to be cautious given the peculiar nature of Japan, and the many false starts. However, there are certain grounds for optimism. The fact that this recovery has occurred at a time when fiscal policy is exercising restraint is particularly encouraging, and perhaps the fact that Japanese business and individuals now have to get by without the help of government is a good thing. Anecdotal evidence of stabilizing real estate prices, improving loan performances for the banks, and rising golf membership prices are all to be welcomed.

In so far as the global cycle has helped Japan, a big slowdown in China would clearly not be a good factor for Japan. In this regard, Japan still has vulnerabilities from overseas as in the past, just from a different region. We are quite sanguine about this risk, however, being optimistic about China for the next twelve months despite the obvious risks.

A major factor which gives cause for optimism on this occasion is that the Bank of Japan is likely to keep their zero interest rate policy even once the recovery has started. Indeed, their commitment to keeping the zero rates until both the core consumer price index and their forecast of future core consumer price index have turned positive implies that real interest rates will turn negative, which has to be quite positive for Japan, especially those with heavy debts. As for Japan's foreign exchange intervention, it seems to me that the Japanese authorities won't need too much public persuasion from the G7 about reducing it in the future. They are already nervous about the views of the G7 even while they are doing it! It is quite likely that the Bank of Japan will choose to reduce this activity in the new financial year, and we think that a move below a dollar-to-yen ratio of 100 is likely before this calendar year is over.

Not really. Japan needs a productivity revolution born of structural reform. That's not happening.

RICHARD KATZ

***Editor,* The Oriental Economist Report**

Any economy operating 4–5 percent below full capacity, as Japan was in late 2001, can show an impressive spurt of growth as long as new sources of demand arise. Japan showed this in 1995–96 and in 1999–2000, and it is doing so again.

However, if the current rebound is not to suffer the fate of the last two, then Japan will need to raise its long-term potential growth, which is still hovering around 1.5 percent. That requires a productivity revolution born of structural reform.

While there are certainly many signs of reform, it still lacks critical mass. Worse yet, complacency is once again creating "reform fatigue." Reformers surrounding Prime Minister Junichiro Koizumi openly complain that he has lost interest.

Optimists point out that nonperforming loans are finally declining. That's important because it makes the banks less susceptible to meltdown. But it does nothing to weed out the hordes of nonperforming borrowers who act as an anchor on growth. On the contrary, these "zombie borrowers" are being kept afloat via government loan guarantees, debt waivers, and sub-market interest rates. Today, 10 percent of all loans charge less than 0.5 percent interest; nearly a quarter charge less than 1 percent.

As for corporate restructuring, there is less than meets the eye. The data for 2003 shows no trend recovery in dismal levels of return on assets, just another cyclical bounce. Moreover, at the small- and medium-sized firms that employ 90 percent of the workforce and produce most of GDP, almost all the profits growth in 2003 came from wage cuts rather than improved efficiency. Such wage cuts limit consumer demand.

Company inefficiency is, in turn, the product of weak competitive pressures. Yet in a majority of industries, the market share of the top three firms is increasing, partly due to the merger-and-acquisition activity that some observers mistakenly hail as reform.

Reform will eventually return Japan to sustained growth of 3 percent or more. But that will probably take another decade. As for this year, even a small flock of swallows doesn't make a spring.

Yes, but longer-run structural problems remain.

RICHARD N. COOPER

Maurits C. Boas Professor of International Economics, Harvard University

Japan has shown remarkable economic growth during the past year, particularly against the lackluster performance of the last seven years, and even against the (generally optimistic) forecasts of a year ago. The growth has been driven partly by exports, as usual, thanks to more buoyant markets in Japan's two largest trading partners, China and the United States. But it has also been driven by resumed investment, made possible by improved balance sheets and profits of the leading manufacturing firms, which rose by 14 percent from the fourth quarter of 2002 to the fourth quarter of 2003. Consumption continued to stagnate, due in part to declining personal income, as firms offered early retirement and substituted part-time labor for full-time workers.

How long can the recovery last? Robust U.S. and Chinese growth should sustain Japan's recovery during 2004, but some slowdown is expected (in China, desired) in 2005. Japan's continued dependence for growth on exports, and on export-related investment, remains uncomfortably high. With improved balance sheets, high investment should continue for some time, not to expand capacity but to replace and upgrade obsolete equipment, and to make new products, since investment has been weak for several years.

However, Japan suffers from some longer-run structural problems, related to the aging and declining labor force. The most flexible part of the labor force in any modern society is its new entrants, who are better educated than their elders and who are generally not committed to particular industries or even to particular locations. Modern economies are subject to constant change, from new technology and changing patterns of world demand. A decline in new entrants weakens an economy's ability to respond to these changes, particularly in a country like Japan with a tradition of "lifetime" employment and a relatively weak labor market for older workers. Japan's educational system, too, seems to have been redirected from an orientation toward work to a "lust for life," which may also reduce Japan's adaptability to new economic challenges and opportunities, thus slowing growth.

Yes, but strong Chinese demand can't last forever.

YONGHAO PU
Head of Asia Economics, Cazenove Global Equities

Japan's recovery is partly China-driven, with its exports to China almost doubling in the last three years. Admittedly, Japan is still running a trade deficit against China, according to its official statistics. But including Hong Kong, as some of Japan's exports to the mainland go through the island, Japan still holds a hefty trade surplus against China amounting to ¥1.2 trillion in 2003. China has now become the second largest overseas market for Japan, accounting for 18.5 percent of the latter's export share in 2003.

To put this into a more quantifiable way, in 2002–03, Japan's exports to China rose about 32 percent annually, contributing a quarter percentage point of GDP growth each year. In a broader sense, China's contribution is much bigger. For instance, Japan's exports to Taiwan and Korea also registered about 10 percent and 14 percent growth annually respectively in the last two years, and these are to a large extent riding on China's story too, since domestic consumption in these two economies has been very sluggish and import growth is largely from exported production-related machinery and equipment.

Although I am not convinced that China might undergo a "boom-bust" scenario in the coming years, strong demand certainly cannot last forever, and the Chinese government is already engineering a slowdown, targeting more balanced growth. This could make Japan's export-induced recovery vulnerable and short-lived. After all, China's machinery industry is upgrading fast, aiming to regain market share with low-cost advantage.

The banking and corporate restructuring in Japan has been carried out half-heartedly. The efficient companies have been swiftly shifting their production to China, while the government has ditched its last penny to keep those "die-hard" loss-making companies alive. Over the last quarter-century, Japan's neighbors, such as Hong Kong, Taiwan, and Singapore—and excepting Korea—all became less dependent on their own manufacturing industries to cope with China's emergence. Japan has been resisting necessary adjustments, holding its manufacturing output share of GDP virtually unchanged. The key questions are how long the Japanese government can afford to continue doing so and how big a bill the taxpayers are prepared to pay.

Yes, and the Chinese situation poses not that great a threat.

ULRICH RAMM
Chief Economist, Commerzbank AG

The economic recovery in Japan is real, as it is not the result of expanded government spending. It is in effect the result of—partly painful—structural adjustments combined with an expansionary monetary policy. But will the upswing last? Actually, the revitalization began in the second quarter of 2002. Yet looking two years ahead, we see few risks for a continuing upswing. One threat would be a grave recession in China. Currently, Japan is rigorously exploiting the economic boom in China for its own benefit. A retreat from Chinese markets would be a strategic mistake.

The impact of the boom in China on Japanese exports has been tremendous. From 2000 to 2003, exports from Japan to China doubled. Still, considering that China and Japan are among the five largest economies in the world, the share of Japanese exports going to China is rather modest—around 12.1 percent in 2003. If as a result of a "bursting bubble" exports to China were cut in half, total Japanese exports would thus shrink by around 6 percent, or 0.75 percent of GDP (not taking indirect effects into account). Japan's exposure in terms of foreign investment is minor—only 0.8 percent of Japan's foreign investment goes to China. But it is growing quickly.

Buying U.S. dollars against yen is, from the Japanese perspective, a welcome tool for monetary expansion. The G7 should not apply pressure. Other ways of monetary easing would at least in the medium term have the same effects on foreign exchange markets.

Yes, but after the current upward blip the rate growth is likely to be modest.

DAVID HALE
Hale Advisers LLC

There are a number of factors which suggest the Japanese upturn should be sustained. First, the growth rate of the United States and China is likely to remain at high levels through 2005. Such growth will support Japanese exports. Second, Japanese industry is now generating significant free cash flow and reducing debt rapidly. The improvement in cash flow and balance sheets will help to bolster capital spending. Third, the banks have greatly reduced their stock of non-performing loans. The four lending banks should have worked off most of their bad debt by 2007. The improvement in bank balance sheets will enhance their capacity to make loans. Finally, the Bank of Japan has suggested that it will continue with its low interest rate policy for at least one more year. The accommodative monetary policy has helped to nurture recovery in the equity market and should ultimately give a boost to the property market. The consumer sector has lagged the upturn in capital spending but there have recently been signs of an upturn there as well.

Japan still has major growth constraints which will limit the economy's recovery potential. The labor force is now shrinking while productivity growth is not as robust as in the United States. There are still a large number of low-profitability companies on the Tokyo exchange accounting for about 55 percent of corporate debt. These companies will have to be purged if the Japanese corporate sector is to allocate resources efficiently. As a result, the trend growth rate of Japan appears likely to be only about 1.0 percent after the growth blip now occurring as the economy emerges from recession.

A recovery, yes, but still inside the intensive care unit.

RICHARD C. KOO
Chief Economist, Nomura Research Institute

The current Japanese economic recovery is real, but it is still a recovery inside the intensive care unit. It is in an ICU because the real culprit of the decade-long recession and deflation—the nationwide effort on the part of companies to repair their balance sheets by paying down debt—is not only continuing, but is actually accelerating to the tune of 7.5 percent of GDP. The vast majority of Japanese companies have been minimizing debt instead of maximizing profits ever since the bursting of the asset price bubble some twelve years ago. With the corporate sector paying down debt and no longer borrowing and spending the household savings, even at near-zero interest rates, the blood flow in the private sector is either stopped or going backwards. Indeed, the only reason Japan has not fallen into a depression is that the government has been providing the life-support systems by borrowing and spending the excess savings in the private sector.

What is different this time around is that, in addition to recovery in exports, some companies have actually finished their balance sheet repairs and are returning to the profit maximization mode starting in fiscal 2003. Although they are still the minority, the fact that these companies are now moving rapidly forward is putting tremendous pressure on the rest to follow suit. That means more and more companies will be coming out of debt repayment mode in the coming years. In the meantime, however, it also means accelerated debt repayment by these companies and enlarged deflationary gap for the economy as a whole. The government therefore must be ready to step up its fiscal stimulus in order to offset the enlarged deflationary gap, so as to make sure that the economy will overcomes this one last hurdle before exiting the ICU.

Yes, but problems remain, including Japan's extensive dependence on exports.

YASUO KANZAKI
Special Advisor, Nikko Citigroup Limited

Japan's recovery already has matched the norms of the two "deflationary expansions" in the 1990s in key respects. Output gains are on par with past averages, and returns on assets have approached recent cyclical peaks. Unlike in past recoveries, these gains have resulted entirely due to private demand, not fiscal stimulus. Moreover, the current recovery appears to have greater staying power than recent cycles. Overseas demand, especially from China, is robust. Chances of a large fiscal or monetary policy tightening appear to be low, with the Bank of Japan having set out clearer conditions for ending its "quantitative easing" policy, and the Ministry of Finance tightening fiscal policy only little by little. In addition, risks of financial turmoil are lower than in the past. As long as the business cycle does not take a notable turn for the worse, the authorities are likely to gradually retreat from aggressive intervention, as in fact has been the pattern since September 2003.

However, a clear departure from the 1990s mold remains unlikely in coming years. Japan's long-term problems persist, including deflation, fiscal imbalances, inadequate intermediation, capital inefficiencies, and sluggish productivity. Furthermore, Japan's growth has been export-dependent, so any shift to lower growth abroad will pose a stiff test for the durability of the expansion.

How long will government intervention continue to support the export-driven economy?

YOSHIHIRO SAKAI
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Returning to an export-driven economy, an original Japanese economic style, and non-conventional government spending has led to Japan's recent economic recovery.

Japanese trade and production programs are greatly influenced by surrounding economies, with half of Japan's exports going to Asia including China. Recently, China has played an important role as a direct importer from Japan, indirect importer through other Asian countries, and an exporter to the United States, acting as a middleman for Japan and other Asian countries. Therefore, any downturn in the Chinese economy could have a negative impact on Japan's recovery. The magnitude could be similar to the effect caused by the U.S. economy's downturn.

During the past fourteen months, the Japanese government has purchased U.S. dollars totaling ¥31 trillion, or U.S. $293 billion, which is almost 60 percent of total intervention in the last decade, in order to protect Japan's profits from exports by keeping the yen at a specific foreign exchange range. As a result, the export-driven recovery has strongly depended on buying dollars, which is the largest of all government spending.

With corporate restructuring efforts to improve operations and revival in confidence, Japan's economy should start to accelerate, feeling the impact from its own efforts, not just external forces. With a huge national deficit and uncertainty over the resolution of non-performing loans, however, it is difficult to be certain that government intervention will continue to support the export-driven recovery, and exactly how long this can last without other internal forces playing a part in Japan's recovery. ◆