

# THE ORIENTAL ECONOMIST

## REPORT

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## Would a DPJ-run Japan be any different? Stealth economic plan

**W**hat would the Democratic Party of Japan (DPJ) do about the economy if, as now seems increasingly probable, it wins this year's Lower House elections? Would it act any differently than the ruling Liberal Democratic Party (LDP)? A simple question. Yet, we've found very few who could answer it. Neither businessmen, nor people in the media or bureaucracy, nor even some of the reporters covering the DPJ felt that they had a very clear idea. Naturally, the DPJ has published "manifestos" and "financial action plans." It has detailed a two-year ¥21 trillion (\$218 bil., or 4% of GDP) plan to stimulate the economy by raising household disposable income via tax cuts and transfer payments. This, says the DPJ, would shift the economy from export-dependence to consumer-led growth (more on this below). Yet, these do not necessarily tell us what the DPJ will actually do if it wins. (As for foreign policy, see our exclusive interview with Ichiro Ozawa on pg. 5 and the article on pg. 7).

One problem is that, at a time when voters are anxious over the most severe recession in the postwar era, the DPJ says surprisingly little about its economic program. Even when Yukio Hatoyama, the DPJ's candidate for Prime Minister, got his chance for a national audience during his May 27 Diet debate with Prime Minister Taro Aso, he chose to focus on bureaucratic power and wasteful spending by the LDP, rather than presenting a positive alternative. "This country's system is all in the hands of bureaucrats," declared Hatoyama. "Let's clean up all the wasteful spending and stop such an extra budget," referring to the ¥15.4 trillion (3% of GDP) stimulus budget passed by the Aso administration." Hatoyama spent much of this time explaining his slogan, "fraternalism," saying, "I want to create a society in which people can feel others' happiness as their own happiness." If the DPJ wins, it will be because of discontent with the LDP, not because it has gained a policy mandate.

One DPJ Diet member told me that the DPJ hesitated to publicize its proposals for fear that the LDP would steal them. For example, he argued that Aso's highly popular and economically effective 2-year reduction of highway tolls on weekends and holidays to a maximum of ¥1,000 (\$10.40) was taken from the DPJ's proposal last fall to end permanently most such tolls. Normally, a 600-kilometer trip can cost an exorbitant ¥24,000 (\$250), which is a gift to the country's road-building lobby. The DPJ proposal would save the public ¥2 trillion (\$21 billion) a year. What does it say if the DPJ really thinks it more effective to hide its light under a bushel basket rather than claim pride of authorship?

A more serious problem is that, like the LDP, the DPJ is divid-

ed internally. Some of its Diet members are former members of the Socialist and Democratic Socialist Parties. Others are former LDPers. Still, others stem from the bureaucracy, local politics or business. What brings them together is a desire to end LDP rule. In general, they are more amenable to reform than most of the LDP. Yet, many of them dream the impossible dream of returning Japan to its pre-"lost decade" ways. Instead of risking division by hashing out these differences, the party prefers to focus on unifying issues, e.g. reducing the power of bureaucrats, promoting decentralization, supporting the environment, and Hatoyama's "fraternalism."

Then there is the question of whether the DPJ could actually carry out its campaign pledges. In the aftermath of the scandal surrounding former party chief Ichiro Ozawa (see pg. 3), the DPJ no longer expects to win a majority on its own. It may have to rely on a coalition with various die-hard anti-reform elements, including "postal rebels" in the People's New Party (PNP) thrown out of the LDP by Junichiro Koizumi. The DPJ has already announced plans to draw up a common election program with both the PNP and the Socialists. Reform is likely to be watered down.

### Shifting to consumer-led growth

Assuming that the DPJ can and will do what its campaign documents say, then the DPJ actually has a rather interesting economic strategy. The core concept is the same one that drove the famous Maekawa Commission plan for economic reform way back in 1986, a plan that was rejected in favor of policies that led to the bubble. The notion is that insufficient household disposable income forces Japan to rely inordinately on exports and wasteful public works to drive growth. Therefore, instead of using government money for boondoggles that favor the politically-connected, spending and tax cuts should be used to pump up disposable consumer income. That is not a new concept for readers of *TOE*.

In a document issued last November ([http://www.dpj.or.jp/english/financial/f\\_crisis.html](http://www.dpj.or.jp/english/financial/f_crisis.html)), the DPJ declared, "It is now essential for Japan to make a transition from an economy that is over-reliant on exports to an economic structure led by domestic demand, an issue that has been on the table for the past 20 years. In order to achieve this, we need to implement bold policies that will increase...disposable household income."

The DPJ proposes to spend ¥21 trillion in transfer payments (like child allowances and tuition reimbursement) and tax cuts over the next two years to fight the economic recession, but then to continue many of the same measures as a permanent way of life. The



DPJ says that it does not want to spend more than the LDP, just to spend the budget on different things.

Unfortunately, the DPJ is cavalier on how to finance its plan, something that the LDP and media are hammering home. The DPJ neither acknowledges that this would mean a big hike in the budget deficit—a necessary temporary stopgap when actual GDP is 8.5% below potential GDP—nor does it propose any eventual tax hikes to raise the funds. On the contrary, the DPJ promises that it will not raise the consumption tax for at least four years.

In pursuit of evasion, the DPJ offers even more cuts in public works, cuts in civil servant salaries, and various sorts of financial accounts held by the government as a kind of “buried treasure,” a gimmick also being used by the Aso administration. This can hardly fund the DPJ’s notion of a long-term shift in budget policy. So, is the DPJ plan really feasible? When challenged on this in a recent interview in *Nikkei*, the DPJ’s new secretary-general Katsuya Okada said it would be a priority to provide a clear answer. Everyone is still waiting.

Much of the public and the elite have been left with the impression that the DPJ “just wants to spend money,” just like the old-style LDP. The DPJ’s argument that it wants to spend money on people whereas the LDP wants to spend money on vested interests has, so far, not proved persuasive. Part of the problem lies in how the DPJ commu-

nicates its message, but part lies in ambiguities of the message itself.

### Tax cuts and money for families

Of the total ¥21 trillion, two-thirds would go directly to households, particularly households with children in an effort to make raising children more affordable and thus help to increase the birth rate. The DPJ points to France as a model. This would boost disposable income by 4% over two years (2% each year). In addition to the ¥2 trillion in highway toll cuts already mentioned, as well as tax cuts for small and medium firms and the self-employed, here are some key details:

- A payment of ¥312,000 (\$3,250) per child each year until the child reaches the end of compulsory education. This allowance would boost household income by ¥4.6 trillion a year, or 1.3%.
- Reimburse all expenses at public high schools and provide ¥120,000 to ¥240,000 (\$1,250 to \$2,500) per year to support to pupils attending private high schools. At present, families spend ¥516,000 (\$5,360) per child per year at public high schools on tuition, fees, etc. even when tuition is, in principle, free. It’s twice as high at private high schools. Education costs at all levels of education take up 7% of the family budget.
- Provide interest-free loans to finance tuition at both public and private universities to children from households with yearly incomes of ¥8 million (\$83,000) or less; provide scholarships equal to living expenses to children from households with yearly incomes of ¥4 million or less. Increase financial assistance to universities that reduce tuition fees for low-income students. A growing number of high school graduates are abandoning plans to attend college due to inability to afford tuition.
- Exempt children from medical costs until they graduate from junior high school.
- Reduce the tax burden by ¥2.6 trillion (0.5% of GDP) by abolishing taxes dedicated to funding road-related projects. Since this would also take away some of the allowance for the construction lobby, it will be interesting to see whether the DPJ follows through despite its alliance with the pro-“road tribe” PNP (see above).
- Reinstate tax exemptions on pension benefits for some of the elderly, exemptions that were removed in 2004.
- For an indefinite period of time, halve the corporate tax rate for small and medium-sized businesses to 11%.

- Provide a new 1-trillion yen system of subsidies for farming families who sell their produce (see article on pg. 13).

### Wage issues

One of biggest causes of insufficient household income is falling real wages. They’re down 7% from 2001. As documented in a recent International Monetary Fund study, “Why Are Japanese Wages So Sluggish,” a major factor is the rise of “irregular workers” (part-timers and temporaries) from 20% of the workforce back in the early 1990s to a third today, a process enabled by a number of deregulatory steps taken in the 1990s in the name of labor flexibility. Typically, irregulars get lower hourly pay even they are doing the same work alongside regular workers, and they lack certain critical fringe benefits, such as bonuses and pensions.

Seeing deregulation used as a tool to drive down wages, some in the DPJ, such as labor issues spokesman Osamu Fujimura, say the answer is to reverse much of the deregulation and reinforce excessive protection of a worker’s job at his current firm. Others recognize that better economic growth requires increased labor mobility, but that this must be combined with a better safety net as well as good wages to fund consumer spending. Avoiding this debate, the DPJ has issued planks that promote unity:

- Ban discrimination regarding wages and other working conditions between regular and irregular workers.
  - Raise the minimum wage over three years to ¥1,000 from its current level of ¥703. Japan has one of the lowest minimum wages among rich countries, at only 30% of the average wage vs. 40% for 21 rich countries. Until 2008, 12 prefectures had a minimum wage below the level of welfare. Typically, raising the minimum wage boosts income not only those earning the minimum but other workers earning somewhat more. As long as the hike is done in a gradual fashion, job losses are minimal. Whether the DPJ can do this in three years at a time of economic weakness remains to be seen.
  - Make unemployment insurance available to irregular workers, and raise the government’s contribution to unemployment insurance payouts to 25% from the current 13.75%, so as not to overburden firms and employees.
- A party always out of power can say anything it wants. This year, the DPJ may have to show what it can do. (RK)

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### REPORT

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## TOKYO INSIDELINE

by Takao Toshikawa

### Revived DPJ looking to name names

# A Hatoyama cabinet

**N**ow that Ichiro Ozawa has stepped down as President of the Democratic Party of Japan, it looks increasingly likely that the DPJ will win this year's Lower House election. Barring a surprise equivalent to the February arrest of Ozawa's chief aide, the question is whether the DPJ will win by a landslide, or squeak by with just enough of a margin to make it the largest party. In the latter case, the DPJ would be forced to ally with the anti-reformist People's New Party (PNP) and the Socialists. The DPJ has already announced plans to draw up a common campaign platform with these two parties.

#### Ozawa's departure revives DPJ

On May 11, Ozawa finally removed an albatross from the DPJ's neck by stepping down. Prior to the arrest of Ozawa's Chief Public Secretary over alleged illegal contributions from Nishimatsu Construction, the DPJ had been heading toward a big victory. As long as Ozawa refused to step down, DPJ support kept sinking. Defeat was in the air.

Since Ozawa's resignation, the DPJ has been rebounding. A *Mainichi Shimbun* poll asking, "Who is better suited to be Prime Minister?" saw DPJ standard-bearer Yukio Hatoyama beat Prime Minister Taro Aso 34% to 21%. Asked who they want to win the Lower House election, 56% said the DPJ, while only 29% said the LDP. Experience shows that, with the exception of the era of former Prime Minister Junichiro Koizumi, as the election draws near, more uncommitted voters move towards the DPJ. The media will conduct new polls on June 6-7.

The Aso Government has "no clever schemes" to raise its popularity (according to one of the Prime Minister's own Secretaries). So, some hasty folks in Hatoyama's home district in Hokkaido are already beginning to anticipate the advent of "Prime Minister Hatoyama." Some even predict DPJ victories in every electoral district in Hokkaido, including those of former Chief Cabinet Secretary Nobutaka

Machimura (Hokkaido District No. 5), former Finance Minister Shoichi Nakagawa (Hokkaido District No. 11), and former LDP Secretary General Tsutomu Takebe (Hokkaido District No. 12).

That makes it time for us to look at a potential DPJ cabinet. Before getting to that, let's take a look at Ozawa's departure and assess Hatoyama's strength.

#### Engineering the succession

Faced with the possibility that he could be blamed for costing the DPJ its election victory, Ozawa resigned. At his press conference, he stressed that his chief motivation was to achieve "victory in the Lower House election and a change of Government." That is why, "I have decided to sacrifice myself and resign my position." He emphasized it was not a resignation to take responsibility for the indictment of his aide.

It is clear that he engineered the timing and mode of his departure to ensure the succession of his ally, Hatoyama. Ozawa made the decision to resign on May 3. Originally, he intended to convene an emergency meeting of the DPJ's Standing Officers at 5:00 p.m. on May 5 to inform them of his decision. On the following day, a meeting of party members in both Diet houses was to be held to select Hatoyama as Ozawa's successor. For whatever reason, the timing was extended to May 11.

As is typical of Ozawa, he kept almost everyone out of the loop. Even party Vice President Hajime Ishii and Upper House Caucus Chair Takeo Nishioka, who had consistently supported Ozawa, were only notified three hours before the May 11 press conference. Two days earlier, on May 9, Ozawa met with Kyocera founder Kazuo Inamori, an old friend and an enthusiastic DPJ supporter. Inamori agreed that Ozawa had no choice but to resign.

The candidates in the party presidency election that will choose the DPJ's post-Ozawa leader were Hatoyama and former party President Katsuya Okada. Even though

polls indicated that Okada is twice as popular with the public, the Ozawa-Hatoyama axis engineered procedures to ensure a Hatoyama victory. The vote was set a mere five days after Ozawa's resignation. Local party leaders, as well as party rank and file, were excluded from the voting. On the 16th, the party's Diet Members voted at a Tokyo hotel, giving 124 votes to Hatoyama versus 95 for Okada.

Officially, Ozawa is Acting President in charge of elections, while Okada is Secretary General. However, the media are saying that the DPJ has a "dual power structure," in which Ozawa pulls Hatoyama's strings. Most of the public has little interest in whether Ozawa is the power behind the throne. They are glad that the party's face is no longer the aggressive Ozawa, but instead is Hatoyama, who at first glance seems gentle and well brought up and likes to use the word "friendship," like his grandfather, former Prime Minister Ichiro Hatoyama.

These days, Ozawa is happily making the rounds in support of DPJ candidates in the Lower House election. He has been in a very good mood, telling the reporters who accompany him, "I'll answer any question about the election, but if you want to know about anything else, you'll have to ask someone else." Ozawa's close associate, DPJ Supreme Advisor Hirohisa Fujii, told a friend, "Ozawa's feeling more fulfilled now than he has in 15 years. He's fine as long as he holds the real power. As head of the party he found press conferences, the party representatives' questions and party leaders' debates in the Diet, and chairing party council meetings to be annoyances. Ozawa has two ultimate goals: changing the government and destroying the LDP [Liberal Democratic Party]." Right now, he is probably in the best possible position to do just that.

#### "Space alien"?

As for Hatoyama, political pros do not rate him all that highly. Assessments such as "He's past his freshness date" and "I don't understand the things he says and does. He's like some kind of space alien" have taken hold, along with charges that he's just Ozawa's puppet.

Hatoyama's first major appearance as the head of the DPJ came on May 27 at a Diet debate. On that day, the LDP bought an unprecedented full-page ad with the title "Questions for Mr. Hatoyama" in the

*Yomiuri Shimbun*. The ad—said to cost ¥30 million (\$312,000)—questioned where the resources for the DPJ's economic policies would come from (see pg. 1).

Aso cut straight to the chase, saying, "I want to debate who is better suited to be Prime Minister, and which party has the ability to run a Government," calling into question the DPJ's competence. When Hatoyama emphasized the necessity of changing governments, Aso went in a new direction, criticizing Ozawa, focusing on the illegal contributions. "The person who supposedly took responsibly is now second to Mr. Hatoyama as Acting President of the party. From the public's point of view, that's hard to understand." To this, Hatoyama retorted, "Mr. Ozawa is not the only one [under suspicion]. It has fallen on you [the LDP] as well."

Their exchanges were widely regarded as mere mudslinging. An LDP leader lamented, "They should have debated fiscal policy. Neither one is any good. It was as dull as I thought it would be." Another LDP leader let slip his opinion that Hatoyama did better than expected. "He used to act like some kind of space alien, but his experience as Secretary General has polished up his debate technique."

#### Who's who for Hatoyama cabinet?

With spirits high in the DPJ, those around Hatoyama and Okada are beginning to whisper names for the Kantei (Prime Minister's office) staff and the Cabinet. If one listens carefully, the following names can be heard.

One of the most critical posts is Chief Cabinet Secretary, the prime minister's point man. Sakihito Ozawa, a longtime Hatoyama ally, is angling for the post, but lacks the ability. So, even though he is detested by Ichiro Ozawa, the position will probably go to Yoshito Sengoku (Minister of Health, Labor and Welfare in the DPJ's Shadow Cabinet), a veteran of many battles as well as a policy expert.

The equally critical post of Deputy Chief Cabinet Secretary for Administrative Affairs—who has responsibility for presiding over meetings of Vice-Ministers and other administrative aspects of the Kantei—will probably go to Supreme Advisor Hirohisa Fujii, a former Finance Ministry bureaucrat who was Minister of Finance in the Morihiro Hosokawa Government in 1993. Despite his advanced age of 76, Fujii would be able to stare down the bureaucrats, an asset of pivotal importance given the

DPJ's stance of diminishing the bureaucracy's power.

Moving to the Cabinet, Okada is certain to become Finance Minister. The Ministry of Finance (MOF) would have no objection to him. Despite all the DPJ's anti-bureaucrat talk, the MOF has networks within the DPJ. The Ministry of Finance's "Nagatacho commander," Deputy Vice-Minister Eijiro Katsu, was Secretary to Chief Cabinet Secretary Masayoshi Takemura in the Hosokawa Government. Budget Bureau Deputy General Director Kyosuke Kagawa was Secretary to Ozawa when the latter was Deputy Chief Cabinet Secretary Ozawa in the Noboru Takeshita Government.

For the Foreign Minister post, Hatoyama is likely to turn to the private sector and appoint Japan Research Institute Chairman (and Tama University president) Jitsuro Terashima. Hatoyama trusts Terashima implicitly, and is likely to ask him to choose his own position from among Foreign Minister, Environment Minister, and State Minister for Energy. The Foreign Ministry would not welcome Terashima. The Ministry's mainstream holds tightly to the Japan-US alliance, but Terashima's pet theory is that Japan should move away from the US somewhat, and improve relations with Asia. This would make him difficult for the Ministry to handle.

Akira Nagatsuma, known as "Mr. Pension" for his exposure of the government's misplacing of nearly 50 million pension premium payments, will undoubtedly become Minister of Health, Labor and Welfare. Acting President Naoto Kan would be a good fit as Minister of Land, Infrastructure and Transportation with its enormous budget. With their ability to get things done as well as to debate, Nagatsuma and Kan could take an axe to the bureaucratic structure. They are both popular with ordinary voters, which would help maintain the Hatoyama Cabinet's support rate.

Although there would be some concern about the direction of relations with the USA in terms of foreign policy and security, a 180-degree turn under the DPJ Government is inconceivable (see article on pg. 7). Appointing DPJ Vice President Seiji Maehara, whose positions on security are close to those of the LDP, to Defense Minister would help unify the party. So, Hatoyama is likely to make that choice.

If the DPJ really wants to reduce the power of the bureaucrats, then it has to con-

tinue the buildup of power at the Kantei (Prime Minister's office) begun under Koizumi. That requires depth of personnel among the various assistant cabinet secretaries. On the foreign affairs side, the new assistant would likely be University of Tokyo Visiting professor Hitoshi Tanaka, a former Deputy Foreign Minister. Tanaka gained fame for setting the stage for the summit meeting between Koizumi and North Korean dictator Kim Jong Il. To deal with finances, Hatoyama will likely choose Haruo Funabashi, a former Deputy Commissioner of the National Tax Administration. Currently an author and the head of a non-profit organization, Funabashi is not well-known in Nagatacho. The younger brother of the *Asahi Shimbun's* famous Editor-in-Chief Yoichi Funabashi, he worked as an assistant examiner at the Ministry of Finance under Fujii, who was then Budget Examiner.

Deputy Chief Cabinet Secretary for Political Affairs might be Hirofumi Hirano, head of the Party President's Office, or Yori-hisa Matsuno, Deputy Finance Minister in the DPJ's Shadow Cabinet. This post serves as a liaison between the ruling party and the Kantei, so it requires deft footwork.

#### A gloomy Aso

Meanwhile, Aso is in a gloomy mood, with no signs of rising spirits. The Prime Minister's Secretary told me half-seriously, "In three months or so, I'll be able to enjoy relaxing on my weekends."

Already, a lack of focus in the Aso Government has become apparent. Although Aso did not order it, it was reported that Kaoru Yosano (who is minister for three separate economic ministries) was told to draw up a plan to immediately break up the Ministry of Health, Labor and Welfare. A few days later, the idea had to be withdrawn. On the verge of an election, this wavering creates a very bad impression.

Once again, the view that Aso cannot lead an election is flaring up inside the LDP. It is not impossible that the party will carry out a party presidency election to choose a new face in August. It's also possible that Aso could try the gambit of a reshuffle of the Cabinet and LDP executives. In the end, however, it would still be Aso's cabinet. With Ozawa out of the spotlight, this election has returned to being a referendum on LDP rule, rather than DPJ readiness. That suits the DPJ campaign just fine.

## INTERVIEW

by Daniel Sneider

Ichiro Ozawa:

## Ozawa in his own words

This interview with **Ichiro Ozawa** was conducted by **Daniel Sneider**, Associate Director for Research of the Shorenstein Asia-Pacific Research Center at Stanford, on March 3, 2009 at the headquarters of the Democratic Party of Japan, just hours before news broke of the arrest of Ozawa's secretary for alleged violations of political funding laws.

**Sneider:** In your meeting with Secretary of State Hillary Clinton, you told her that you wanted to have a more equal relationship between Japan and the United States. What do you mean by "more equal?"

**Ozawa:** The same concept as you and I are equal as human beings. Each individual has his own character, his own abilities, his own posture, and differ from one another—yet individuals are equal. By the same token, nations should be thought of in the same way. I put the blame not on the US but on the Japanese government. The problem is that the Japanese government doesn't have its own global policy. Its governing rule is that they should not offend the US and spend as little money as possible. Those are their two objectives rather than developing their own independent policy. You have to start with figuring out what the goal of policy, and then determining what the role of Japan should be and what the role of the US should be within that policy and how they should allocate their respective responsibilities. Once we create that foundation, then we can talk about the role of the US military.

If Japan is attacked, Japan has its own self-defense forces and will defend itself, and would expect the US to support it in that self defense. With respect to disputes or conflicts that involve other countries, Japan is limited by its constitution and cannot get involved directly. That is beyond the scope of self-defense. It can only act through the United Nations.

As a result, with respect to conflicts with other countries, Japan is not in a position to be able to assist US policy. If there is an action that is sanctioned by the UN, either because there is a United Nations force, or, as in the case of the Gulf war, the United Nations delegated to the US and other

armies the ability to go to war, then if I become Prime Minister, I would fully support participation in those US actions.

**Sneider:** An advisory commission to Prime Minister Abe recommended that the constitution be reinterpreted to allow for collective self-defense.

**Ozawa:** It's not impossible to interpret the constitution as already permitting collective self-defense, if we think of it in the context of joining UN activities. But that re-interpretation goes against the basic spirit of the constitution.

**Sneider:** Doesn't your principle make Japan a prisoner of the UN?

**Ozawa:** The Bush administration took the position that the Afghan war and the Iraq war were their wars, those weren't UN wars, and took independent action. But when it didn't go well, then they asked for help from others. You can't just act on your own; that's one of the lessons of the Vietnam war. I intend to tell President Obama, if I become Prime Minister, that no matter how many troops you put in to Afghanistan, you are not going to be able to win. You are just going to shed American blood as in Vietnam.

**Sneider:** The Obama administration knows perfectly well that simply adding more troops is not the solution. They are trying to find some combination of political action, counter-insurgency, military, development aid, not to win a war but to stabilize the situation. Obama's feeling is that this is the most important conflict because this is where the real threat comes from, and that Iraq was a distraction from the central conflict against al-Qaeda.

**Ozawa:** My basic political philosophy is

that you can't govern by force. I would participate in ISAF [International Security Assistance Force, in Afghanistan] but I think it is fundamentally flawed because it seeks to resolve problems by force.

**Sneider:** The remarks you made about the role of the US 7th Fleet in the Pacific have caused a lot of controversy. Could you explain exactly what you meant?

**Ozawa:** My fundamental emotional feeling is that Japan should do things for itself and not rely on others. That is a core belief. The US already seems to be taking the position that it is no longer as necessary to have large military forces already deployed on the front lines. In Okinawa, for example, the US military is reducing its deployment. And the new policy seems to be that, when a crisis occurs, it would deploy troops to the front line. That is the U.S. military's policy, not my policy. Within that context, to the extent that Japan can replace the function of US forces, isn't it natural that the US should have fewer forces deployed in Japan?

**Sneider:** Do you mean ground forces?

**Ozawa:** It would apply to both ground forces and air forces. To the extent that Japan maintains facilities to which US forces would deploy, wouldn't that be sufficient to achieve the same objectives of US policy? With respect to Japan's own defense, it's natural that Japan should take on that responsibility as much as possible. I understand the need to have a system in place for emergencies and that the US might have access to bases. But with respect to having military forces in the region for the purpose of defending Asia, isn't the Seventh Fleet sufficient for that purpose?

**Sneider:** US military people have always said that the two most important bases for defense of the entire Western Pacific region are Yokosuka (naval base) and Kadena (air base) in Japan. So they would probably disagree with you.

**Ozawa:** It would be fine to maintain Kadena air base if it is important for regional defense. But the helicopter base at Futenma in Okinawa is not being used for that purpose.

**Sneider:** One big part of your party's platform has been to improve Japan's relationship with Asia, with China and Korea. In concrete terms, what would you do that is

different from what the LDP has been doing?

**Ozawa:** When I met Clinton, I told her that there is no way North Korea is ever going to give up its nuclear weapons. The reason why they can do that is they have China at their back. Whether China actually approves or not of North Korea, the fact is they want to maintain the status quo. Therefore, I believe to deal with the North Korea issue, we have to establish a relationship with China; so we have frank discussions with them. Clinton told me, "You believe the US-Japan-China triangle is the key." She complimented me on my insights on that issue.

**Sneider:** There is also a China-Japan-Korea triangle. There was a summit meeting held in Fukuoka last December. There were some grounds for cooperation among China, Japan and South Korea, not only on North Korea but also about how to respond to the global financial crisis. How important to Japan are these relationships within Asia?

**Ozawa:** It is very important. The Japanese government has not only been left out in the cold by the US but also by China and Korea because we had nothing to offer in terms of policy. For example, there are issues between Japan and China that need to be resolved through frank discussion: the history issue and the territorial issue. Until we sit down and honestly discuss these issues, we can't resolve them.

**Sneider:** On the history issue, what would the DPJ do differently from the LDP? Historically, the only times Japan has made forward movement on this issue have been with the non-LDP governments, i.e., the Hosokawa cabinet (1993) and the Murayama cabinet (1995).

**Ozawa:** First of all, in the war Japan caused terrible harm to China and others on the continent. We need to first honestly acknowledge that past. I would immediately resolve the Yasukuni shrine problem. We would remove the people who were not actually victims in the war, but people who were put in there later. The Class-A war criminals will be removed from the Shrine; that's the issue that caused the Emperor to change his position about visiting it. It would be just a shrine for the war dead.

**Sneider:** Isn't that decision that the shrine authorities have to make?

**Ozawa:** [Waves his hand in dismissal]. The Ministry of Health and Welfare put them

those people in and they can take them out.

**Sneider:** Would you have a different approach to issues like reparations and the "comfort women"?

**Ozawa:** Based on the facts, we should do what is necessary. One of the complications is doing what is based on facts.

**Sneider:** General Toshio Tamogami, the former chief of staff of the Air Self Defense Force, wrote an essay on World War II that is not only anti-Chinese and Korean but also anti-American. It says the US tricked Japan into attacking Pearl Harbor. I find it somewhat disturbing that someone with such views could reach that high a level in the Japanese military. I wonder what you personally think about that.

**Ozawa:** It is terrible thing, very unfortunate. It is because politicians are irresponsible. He's a military officer. That was a political statement. Officers in the military are not allowed to participate in politics. That's been the basic principle since the Meiji era. If he wanted to write this essay, he should have resigned from the military first and then write the essay. People who forget that basic principle of the Meiji era were the military leaders of the Showa period [which included the 1930s-40s].

**Sneider:** So you are comparing Tamogami to the military officers of the 1930s?

**Ozawa:** It is the same type of thinking that we had in the Showa period. If I become Prime Minister, I will lay down the law on this issue, both to civilian defense officials and to the military personal in the SDF. Personal views are fine but you can't be going public.

**Sneider:** I know how you feel about Americans because I have known you for a long time. I know what you did for the trade negotiations when you were chief cabinet secretary. But many people in Washington want to know: what is your personal feeling about the relationship between Americans and Japanese?

**Ozawa:** I like the American people very much. I love Americans, but they need to be a little more sophisticated. The illogic of the Bush administration, for example, concerns me the most. Even though Iraq kept saying they had no weapons of mass destruction, Washington kept on insisting they had WMD. But in the case of North Korea,

which admitted they had WMD, Washington is following a different policy. America needs to be more logical. Why invade one country and then decide to talk to another? What is the logic of that?

**Sneider:** Now we have a global financial crisis in which the US is epicenter. As the second largest economy, what should Japan's role be?

**Ozawa:** America has the greatest responsibility for the crisis. The fundamental cause of the crisis is that the American society and economy were pursuing market fundamentalism ("the money game") in a way that was detrimental.

Finance is not my area of expertise, so I can only speak in general terms. But since [the administration of Prime Minister Junichiro] Koizumi, things in Japan moved more in the direction of the US. We were influenced by the US and there were changes in the structure of Japanese labor and financial markets which effectively lessened the safety net available to people. As a result we are now experiencing higher unemployment and suffering by ordinary people. There were certain cases where they went too far but it's not as if everything has to be reversed. There were some excesses in deregulation but not all deregulation was wrong. There is common ground between Japan and America but there are different issues in terms of the social contract.

Our first priority if we gain power is to restore the health of the Japanese economy. That would contribute to the health of the global economy as a whole. But the focus will be on what we can do here in Japan.

For Japan, like the US, 60% of GDP is dependent on individual consumption. Until we restore the welfare of individuals and improve individual consumption, the economy is not going to recover. For example, part of our election platform is to adopt France's system of child support. That is very important to raising individual incomes. Japan has the most expensive highway system in the world. We should make highway tolls free; that would help by lowering the cost of distribution in the country and it would also remove a tax on individuals, leave more income in their pockets. Another example is what we call an environmental new deal, to subsidize the installation of solar panels. That is an example that promotes green policy but also spending to promote employment throughout the country.

## The DPJ's foreign policy

# A Japan that can say maybe

Daniel Snieder is Associate Director for Research of the Shorenstein Asia-Pacific Research Center at Stanford

If the opposition Democratic Party of Japan (DPJ) takes power in this year's Lower House elections, will it make much of a difference in the country's foreign and security policy? Even within the DPJ itself, the answer to that question differs. Some major leaders deny any major change is in the offing, an assertion meant in part to reassure both Japanese voters and American allies. Certainly a radical shift is not likely, but there could be a subtle, but significant, tilt in emphasis, one that looks to bring Japan more in tune with its Asian neighbors.

Foreign policy is by no means the focus of the DPJ's campaign. Instead, it is focusing on the economy and the power of the bureaucracy and allied special interests. Nonetheless, any major shift by the DPJ would have region-wide consequences.

### Center-left vs. center-right

The ruling Liberal Democratic Party (LDP) depicts the DPJ as reckless and inexperienced, of undermining the U.S.-Japan alliance, of being ready to subordinate Japanese security to the United Nations, and not ready to cope with challenges posed by a rising China and a nuclear North Korea.

The LDP and the Japanese media also point to divisions within the DPJ, from former Socialists to conservative former members of the LDP, to suggest that the party cannot form a coherent policy. To some degree, these perceptions are echoed among Japan-hands in Washington, who maintain close ties to the LDP and the Foreign Ministry, which fears losing its authority.

The DPJ, in return, accuses the LDP of being a blind follower of US policy, particularly in Iraq, and of neglecting relations with China, South Korea and other Asian nations. While the DPJ supported the expansion of Japan's security role, including the initial dispatch of a refueling flotilla to the Indian

Ocean to support the anti-terrorist war in Afghanistan, the DPJ opposed the extension of that mission to what it considered to be support for the Iraq war. While some in the DPJ emphasize a diplomatic approach to North Korea, the party leadership echoes the tough talk of the government.

There are significant differences within the DPJ but they are not wider than those found within the ruling party. Broadly defined, the DPJ tends to lean toward a center-left approach, while the LDP remains very much a center-right party.

Earlier this spring, I conducted interviews in Tokyo with a number of key DPJ leaders, including Ichiro Ozawa (see pages 5-6); Seiji Maehara, who anchors the conservative end of the party and is widely seen as the next defense minister; Yoshito Sengoku, a former Socialist and a powerful voice on the left of the party on policy issues; Yoshio Hachiro, the party's "shadow foreign minister;" as well as official and unofficial advisors.

### Erosion of "Yoshida doctrine"

As background, it is important to understand the gradual evolution of Japanese policy away from the approach shaped at the start of the Cold War by Prime Minister Shigeru Yoshida (the grandfather of current Prime Minister Taro Aso). The Yoshida doctrine subordinated Japan's security to the US, focused on economic growth and reconstruction, and prescribed a passive role on the world stage. The Yoshida doctrine has been attacked by both left and right nationalists. The left (including the once-powerful Socialist Party) rejected the U.S.-Japan security alliance while the right (including parts of the LDP) sought to remove the US-imposed constitutional restrictions on Japan's military role.

In recent years, only in part due to US

pressure, Japan has expanded its security role beyond narrow self-defense, from participation in UN peacekeeping operations to logistical support for US military operations in Iraq and Afghanistan. Japan has become more activist, but within the bounds of the US-Japan alliance. This evolution enjoys broad support in Japan. The U.S.-Japan security alliance is almost unchallenged anymore, even on the left, in part because of Japanese fears of a rising China and a nuclear North Korea.

### Would DPJ rule make a difference?

Because of this, some argue that regime change in Japan will not have a huge impact. "There will not be significant change on the security and diplomatic scene," Maehara told me. "When Secretary [Hillary] Clinton came and met Mr. Ozawa, they agreed that Japan-US relations will not change and the US-Japan alliance will remain the essential basis for Japanese foreign policy."

The DPJ's embrace of the US-Japan alliance does not preclude areas of friction. Party leaders articulate a desire for a more "equal" relationship. "Japan has just followed in US footsteps so far," shadow foreign minister Hachiro told me.

Kiyoshi Sugawa, a foreign and security policy expert in the party's Policy Research Committee, contends that, in the post-Cold War era, the value of the US-Japan alliance shifted to its role in coping with a rising China and North Korea. The LDP mistakenly tried to deal with China by getting even closer to the US, prompting the decisions to send troops to Iraq and the Indian Ocean. But the US-China relationship is totally different from the US-Soviet one. Given the economic interdependence and overlapping strategic interests with China, the US will never form an anti-China front, Sugawa continues. Japan too needs China, though they don't have to be friends. And the LDP now feels betrayed by the US willingness to talk to Pyongyang and talk of forming a "Group of Two" with China.

The DPJ is far from articulating an alternative strategic vision. But there are elements of a broader policy in three areas: deploying Japanese forces overseas; structuring US forces in Japan; and improving ties within Asia.

### Deploying the Self-Defense Forces

Since its formation in 1998, the DPJ supported key decisions expanding Japan's

overseas security role, including the initial dispatch of Japan's naval support group in the aftermath of 9/11. Even leftists like Sengoku still support non-combat military missions in the Indian Ocean. But the DPJ objected to the extension of that deployment to what it considered support for the war in Iraq, though it is still labeled an "anti-terrorist" mission.

The DPJ position calls for Japan to participate only in peacekeeping operations authorized by the UN. When he was still in the LDP, Ozawa was responsible for the 1992 law that first authorized participation in UN peacekeeping operations. He saw this as the only acceptable route to taking on a more responsible global security role, given the constitutional ban on collective self-defense, which he still regards as inviolable. Only such peacekeeping operations, he argued back then, would be acceptable to both the Japanese public and Asian neighbors wary of Japan's militarist past. Ozawa asserted during the Indian Ocean debate that Japan should back the war in Afghanistan, which has UN backing, unlike the war in Iraq. But many in the DPJ disagree and the party now emphasizes a non-military role in Afghanistan and Pakistan.

### US military forces in Japan

The most obvious point of friction with the US is the DPJ desire to renegotiate the agreement on realignment of US forces in Japan. The party has raised questions about Japan's share of the cost of redeploying the US Marines from Okinawa to Guam. It opposes the deal to move Marine helicopters and other aircraft from the Futenma base to a new base on Okinawa.

That stance lies behind controversial remarks made by Ozawa suggesting that the US 7th Fleet was sufficient to help defend Japan from attack. The LDP seized on those comments to feed charges of DPJ irresponsibility. In his interview with me, Ozawa argued that Japan should take on more of the role of its own defense. When challenged about the role of the US air forces for regional security, he supported the continued role of forces based at Kadena airbase, but was quick to distinguish that from Futenma.

The bases and force structure in Okinawa are hardly new problems for the alliance. Nor are Ozawa's views found only in the DPJ. While Pentagon officials would hardly welcome a re-opening of this can of

worms, this does not threaten the core of the alliance relationship.

### "Asianism"

A potentially more profound challenge is posed by the growing popularity of Asianist ideas in the Japanese foreign policy establishment. At its core, this is a debate over how to manage the complex relationship between China and Japan, which simultaneously includes interdependence and rivalry. Rather than rely solely on the US-Japan security alliance to deal with a rising China, Japanese Asianists argue that Japan must actively improve its relations with its neighbors and be more assertive in leading the creation of an East Asian regional structure, whether a broad East Asian Community or a new security system.

The Asianist camp is not confined to either party. But the DPJ sees this as a key area of differentiation from the LDP mainstream. Its platform proclaims the goal of "Japan as a member of Asia." Philosophically the party harkens back to the late Tanzan Ishibashi, who served only briefly as Premier in the late 1950s and was a long-time advocate of "Small Nipponism," an anti-imperial version of Asianism. Ishibashi was allied within the LDP to Yukio Hatoyama's grandfather, former Prime Minister Ichiro Hatoyama, who sought to improve Japan's ties to both the Soviet Union and Communist China.

For some in the DPJ, this advocacy of Asianism is a form of retreat from a global security role. "Japan does not have enough power to deal with global issues," says ex-Socialist Sengoku. "What Japan can do is play more of a role in Asia." He advocates the need for an Asian regional security structure, including joining with Korea and China to create a peacekeeping training center in Asia, as well strengthening institutions to deal with problems such as pandemics.

Those views are a minority in the DPJ. But the mainstream of the party, and their allies in the policy community, believe they are more able than the LDP to improve significantly relations with China and South Korea because the conservatives remain imprisoned by a rightwing that holds frankly unapologetic views about Japan's wartime aggression in Asia.

### The "history" question

The past is still present in Asia. The LDP has been struggling to deal with the aftermath of

Prime Minister Junichiro Koizumi's decision to visit the Yasukuni shrine to the war dead, which set off an anti-Japan boycott in China in 2005, because the shrine includes the souls of Class-A war criminals convicted by the Allied war crimes tribunal. While former Prime Minister Shinzo Abe broke the freeze in relations with China, he holds revisionist views of the wartime era and advocates constitutional revision. Most recently, Abe and others offered moral support to the Japanese Air Self Defense Force chief of Staff, General Toshio Tamogami, who was forced to resign for his essay defending both Japan's 1930s-40s aggression in Asia and its war with the US.

Ozawa says the DPJ will not only halt official visits to Yasukuni but also reverse the enshrinement of the Class-A war criminals. Across the board, DPJ leaders are unambiguous in their readiness to acknowledge past misdeeds and to be proactive in promoting reconciliation. Hachiro cites the example of France and Germany publishing a joint history textbook.

The DPJ charges that the LDP is simply incapable of dealing with this past. It is notable that both Aso's father (Takakichi Aso) and Abe's grandfather (Nobusuke Kishi) were directly involved in some of the notorious aspects of that era. Historically, the most important steps toward reconciliation have been taken by non-LDP Prime Ministers—the brief opposition government of Morihiro Hosokawa and the Socialist-LDP coalition government led by Socialist Tomiichi Murayama whose 1995 statement on war responsibility remains the clearest Japanese official apology.

### Not anti-US

The Asianist orientation of the DPJ may lend credence to what some see as a latent anti-Americanism, but party leaders and officials reject such charges. "What does anti-American mean?" responds party policy official Sugawa. "If pro-American means always saying yes to Americans, certainly the DPJ is not pro-American. If anti-Americanism is insisting on the abolition of the alliance, then no one in the DPJ is anti-American...Seven or eight times out of ten, we will say yes to the United States. But one or two times, we may say no, or let's see."

In short, a DPJ-led Japan will not be a Japan that says no to the US, or a Japan that always says yes. It will be a Japan that can say maybe.

# ECONOMIC OUTLOOK

by Richard Katz

## GDP drop of stunning dimensions Unbelievable!

The latest GDP figures show Japan in a recession of truly stunning proportions. During the four quarters of recession so far, Japan's GDP has fallen an unprecedented 9.1%. That's the kind of plunge one expects to see only in emerging markets. By contrast, Japan's GDP fell "only" 3.4% in the entire 1997-98 downturn.

Japan's decline is, by far, the worst among all the rich countries in the OECD (Organization for Economic Cooperation and Development). It is double the 4.5% fall in the European Union and almost three times the 3.6% fall in the US in the three quarters of its recession so far. The second worst fall was in Germany at 7.1%.

Interestingly, Korea, which has been even more dependent than Japan on a rising trade surplus to drive growth, has not suffered as badly. Korea has suffered only one quarter of decline, a 5.0% drop in October-December. Its GDP managed to eke out a smidgeon (0.1%) of growth in January-March. Korea's tiny rebound in January-March adds to the evidence that the worst of the global downturn is probably over, and that's certainly good news for Japan.

Some forecasters, pointing to signs of bottoming out (see pg. 11), are treating the January-March GDP figures as "old news." We beg to differ. The fundamental trends that produced this plunge will continue to act as an anchor on future growth until they are at long last addressed.

### How much damage

In just four quarters, 75% of the entire gain in GDP that Japan had made during its seven years of post-2001 recovery has now been wiped out (see top figure). GDP is now back to where it was in mid-2003. Amazingly, GDP today is only 2.3% above the level it first reached a dozen years ago in the first quarter of 1997. 2.3% is the kind of growth one hopes to see in one year, not in twelve. As of the most recent quarter, Japan's average annual growth rate over the 18 years since the bubble popped is a meager 0.6%.

Just as growth in the trade surplus and business investment led Japan on the way up, so they have driven it on the way down. Japan had put all its eggs in two very risky baskets— business investment and a rising trade surplus together accounted for about two-thirds of GDP growth during the recovery—and now the eggs are scrambled.

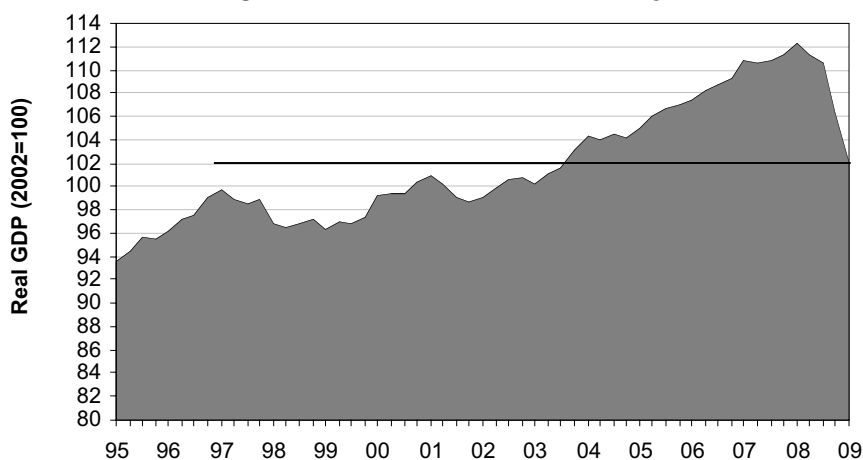
Over the past four quarters, business investment fell 22%, thereby erasing 92% of the growth in the previous seven years has been erased. More astoundingly, business investment is now 15% below where it

stood nearly 20 years ago in 1991 (see bottom figure).

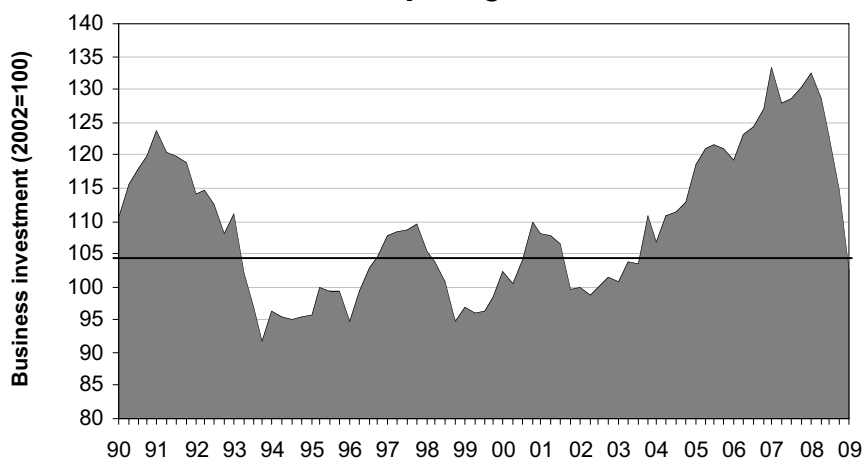
Exports had nearly doubled during the recovery. As a share of GDP, they had soared from 10% to 16.6%. In fact, by late 2007, for the first time ever, exports played a larger role in GDP than did business investment. But in the last four quarters, exports have plunged 37%, losing 80% of their entire recovery-era gains (see top figure on pg 10).

Since exports have fallen even faster than imports, the trade surplus, which had provided another third of all GDP growth during the recovery, has plunged 83%, wiping out virtually all of the gains achieved since the end of 2001. As a share of GDP, the trade surplus had exploded to 5.7%, a record level that we have long felt was unsustainable. Now, it has collapsed all the way back to 1% (see middle figure on pg. 10). That's below its 1980-2007 average of 1.7%. Since Japan can only enjoy a big trade surplus when someone else is running a counterbal-

### 75% of GDP gain in post-2001 recovery wiped out



### Business investment plunges to sub-1991 level



Source: Cabinet Office

ancing trade deficit, the big shrinkage of the US trade deficit makes a quick rebound in Japan's surplus very unlikely.

### No spending without income

Consumption has been the big laggard throughout this recovery, and now it is falling. Total consumption is down 2.7% over the past four quarters. Excluding "imputed rent," it is down 3.6%. (Imputed rent is a synthetic figure, the government's estimate of what homeowners would pay to rent an equivalent unit. Excluding it gives a better sense of the actual outlays of money people are currently making.)

This drop in consumption has wiped out half of all the expansion achieved since the recovery began. For years, consumption has risen slowly despite stagnant worker income (the total compensation, wages and benefits, of all workers). By the end of the recovery, this was only 2% higher than it had been way back in 1997. Nonetheless, consumption ex-imputed rent rose 8% above 1997 levels. Consumers had achieved this by cutting their savings drastically from double-digit levels to less than 3%. Now, with the recession, the law of gravity is back in fashion: spending is dropping back down to a level more commensurate with income, just 4% above 1997 levels (see bottom figure).

Government spending is up a bit, 0.8%, due to the first two stimulus packages. But most of the impact of the latest ¥15 trillion yen (3% of GDP) stimulus package has yet to kick in. There has been a slight uptick in government spending, but nothing yet comparable to the efforts made in the first half of the 1990s. From 1991 until early 1997, when Prime Minister Ryutaro Hashimoto prematurely pulled back, government spending rose 27%.

### Whither demand?

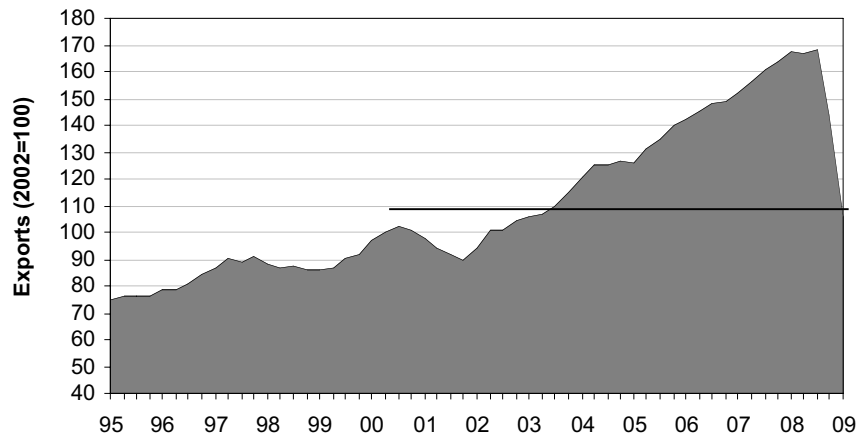
Over the coming several years, it seems unlikely that the US consumer will act as a locomotive for Japanese growth to the same extent as in 2002-07. So, what will drive Japanese growth? Unless Japan finds a way to get more of the national income into the wallets of households via higher wages, and returns on savings/investment, it is hard to envision a vibrant recovery for some time to come. If so, that would leave Japan once again dependent on repeated injections of fiscal stimulus and never-ending ultra-low interest rates. Indeed, the International Monetary Fund and many private econo-

mists predict that, unless the latest stimulus package is followed by yet another, a few quarters of rebound will be followed by a mild relapse. Its April World Economic Outlook predicts that Japan's GDP will actually fall 0.6% from the fourth quarter of 2000 to the fourth quarter of 2010. During

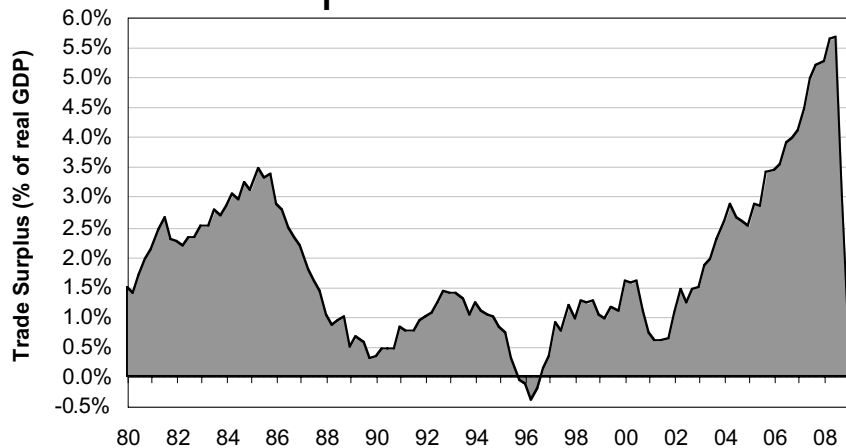
that same period, every other major rich country is predicted to grow.

The Democratic Party of Japan (DPJ) has raised the issue of boosting consumer income (see pg. 1). Whether or not one agrees with all of their answers, it's the right question.

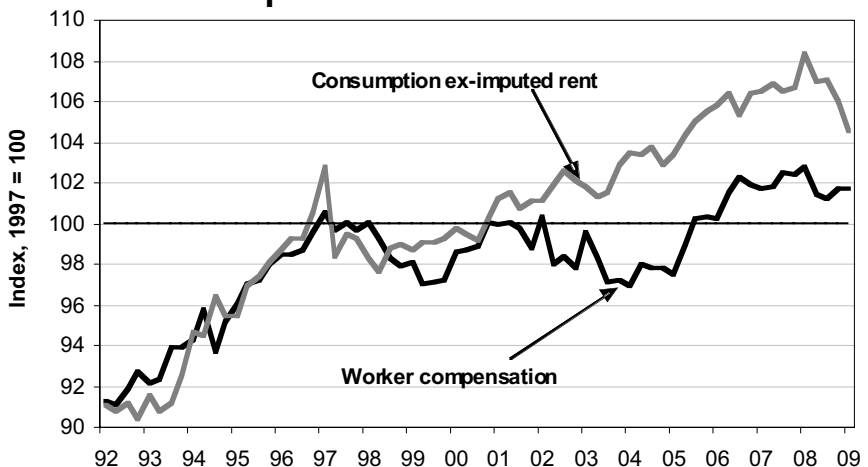
## 80% of export gain since 2001-IV wiped out



## Trade Surplus Back to 1% of GDP



## Consumption back to mid-2005 level



Source: Cabinet Office  
Note: See text for explanation of imputed rent



## Economy Watch

### Green shoots

April showers are bringing, if not quite economic flowers, at least the famous “green shoots” ratifying the sense that the worst is over. Industrial production, which had fallen 36% from its October 2007 peak, rebounded 5% in April. The Ministry of Economy, Trade and Industry (METI) is predicting another 8.8% rebound in May, to be followed by 2.2% in June. Meanwhile, exports are now trending upward. After having fallen by 50% in January compared to their late 2007 peak, exports in April were down “only” 38% from the peak.

On the negative side, 600,000 jobs were lost in March, nearly half of the 1.4 million jobs that have been lost since they peaked in December 2007 (see figure). Up until March, Japan Inc. followed the traditional approach of “sharing the pain,” by cutting wages and hours but trying to preserve jobs. Since monthly figures are so volatile, we’ll need another couple months of data to be sure whether or not this marks a new trend. In April, another 60,000 jobs evaporated.

### Clunking protectionists

Trade protectionists just suffered another defeat, this one in the debate over the pending “cash for clunkers” bill. The bill is intended to stimulate sales of new autos by offering a bonus of up to \$4,500 for those who trade in an old car or truck for one getting better gas mileage, e.g. at least 4 mpg better for cars and 2 mpg better for light trucks. Originally, some of the sponsors wanted to limit the full benefit only to vehicles made on US soil, provide a smaller benefit those made in Canada or Mexico, and no subsidy at all for those made elsewhere, such as the Toyota Prius. The Obama administration opposed this idea, as did the Alliance for Automobile Manufacturers, a lobbying group that represents both the Detroit Three and foreign automakers. So, the provision was taken out.

### They’re baaack!

The dreaded nonperforming loans (NPLs) are rising once again. For Japan’s Big Six megabanks, the total losses from disposing of NPLs rose in fiscal 2008 to ¥1.7 trillion (\$17.7 billion), the highest level in four years, although still a far cry from the worst years of the banking crisis. On top of the NPL loss, the megabanks suffered another ¥1.44 trillion (\$15 billion) in losses on falling prices of the corporate shares that they own, and which they use to buffer their capital.

Behind the rise in NPLs is a rise in bankruptcies and near-failures. In fiscal 2008, 16,000 firms went belly-up with total debts of ¥14 trillion (\$146 billion), or nearly 3% of GDP. That’s the fifth highest figure since the end of World War II.

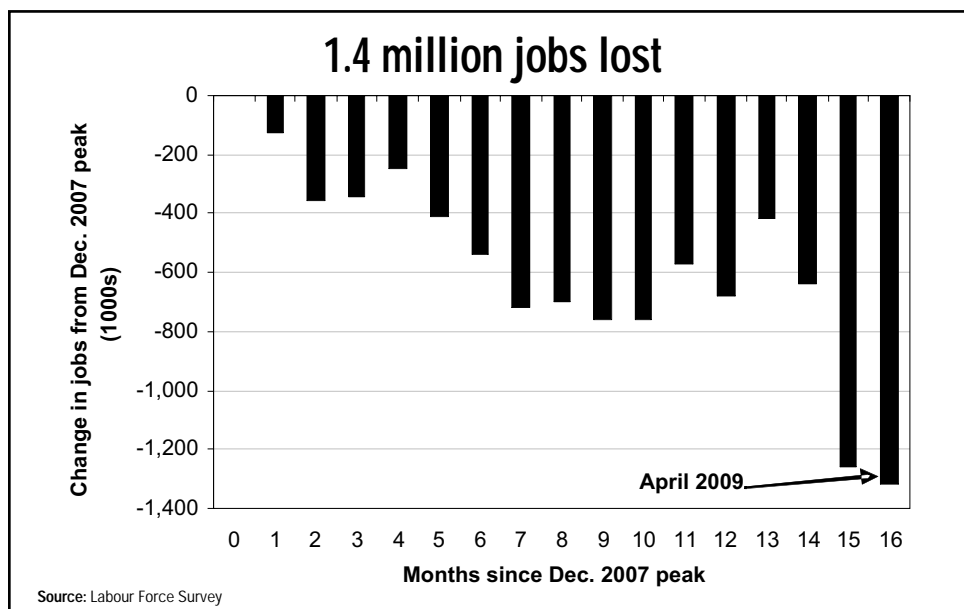
Losses to the banks would have been even greater except that, in the sixth months since the government put up new money to guarantee loans at small-to-medium-sized firms, a half million loans totaling more than ¥10 trillion (\$104 billion) have been guaranteed (i.e. the government will pay the lender if them firm defaults).

### Shotgun brides

They call it a “Japanese engagement.” A couple has been dating, or even living together, for a while, but the man never gets around to popping the question. Suddenly, the woman finds herself pregnant. The question is not only popped, but automatically answered. A stunning 27% of Japanese babies are now conceived before marriage (see top chart on pg. 12)—a figure that rises to a shocking 58% among women in their early 20s. And yet only 2% are born after marriage (see bottom chart). There is no longer any shame in being a pregnant bride. But Japan remains one of the few rich countries where birth outside of marriage remains nearly inconceivable (pardon the pun).

A caveat is in order. Out-of-wedlock births are not synonymous with single motherhood. In many countries of Europe, the prevalence of cohabitation and “civil unions” (originally used for gay couples but later extended to heterosexual couples) means that most children born out of wedlock still have two parents. In France, for example, 50% of the births registered in 2007 were to unmarried parents, up from 40% a decade ago. In the same year, there were more civil unions than marriages.

In Japan, unlike many other countries, the laws discriminate against children born out of wedlock. “Illegitimate children” have a lesser right to inherit; their birth status is listed on documents important to gaining employment and marriage partners (thereby exposing them to possible discrimination); in their parents’ ability to get tax deductions, etc. Court decisions have generally upheld



this discrimination, although this may be in the process of changing. So, parents who want to protect their children and themselves have a big incentive to go through a legal marriage. Thus, virtually all pre-marital pregnancies in Japan result in abortion or else marriage and birth.

One might think that couples in Japan choose to marry because of a stronger hold of cultural traditions. But it is not clear how strongly such traditions hold. The rise in pre-marital conceptions is one piece of evidence. Another is the rise of cohabitation among unmarried couples. According to a study by Miho Iwasawa of the National Institute of Population and Social Security Research, "Among females aged 25-29, those currently cohabiting is less than 3%, but more than one in five have some unmarried partnership experience including premarital cohabitation...Among females with a first partnership and aged 20-39 at the time of the survey, one-fourth of them are first cohabited."

The rate of cohabitation is a lot higher than previously suspected because many surveys only asked single women about their experiences. Iwasawa argues that, it's important to ask married women because, in Japan, most instances of cohabitation are a prelude to marriage, rather than a substitute.

Iwasawa and Prof. James Raymo compared the marriage patterns of women who became pregnant before marriage and those who waited until after marriage to see if the former group married "less desirable" mates. This would be one test of whether the pregnancy was a tool to "force the issue" or an accident that compelled a true shotgun marriage to someone they would not have otherwise married. What they found was that, while the differences were "statistically significant," there were not large.

Most women, whether pregnant or not at the time of marriage, marry someone at the same or higher educational level as themselves. Since the career opportunities of even educated women are still limited in Japan, women find it important to marry a "good provider."

Among women with a high school diploma, 90% of those not pregnant at the time of marriage marry someone with an equal or higher educational attainment. Among those pregnant at the time of marriage, the figure is slightly lower at 85%.

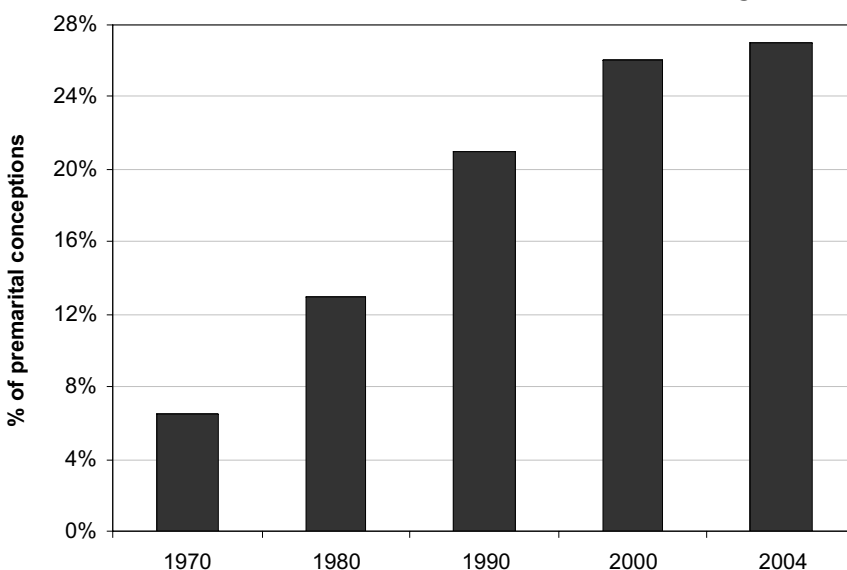
Among those with junior college education, 65% of those not pregnant marry someone with equal or higher educational attain-

ment; among those pregnant, the figure is 67%—virtually the same.

The biggest difference is among those

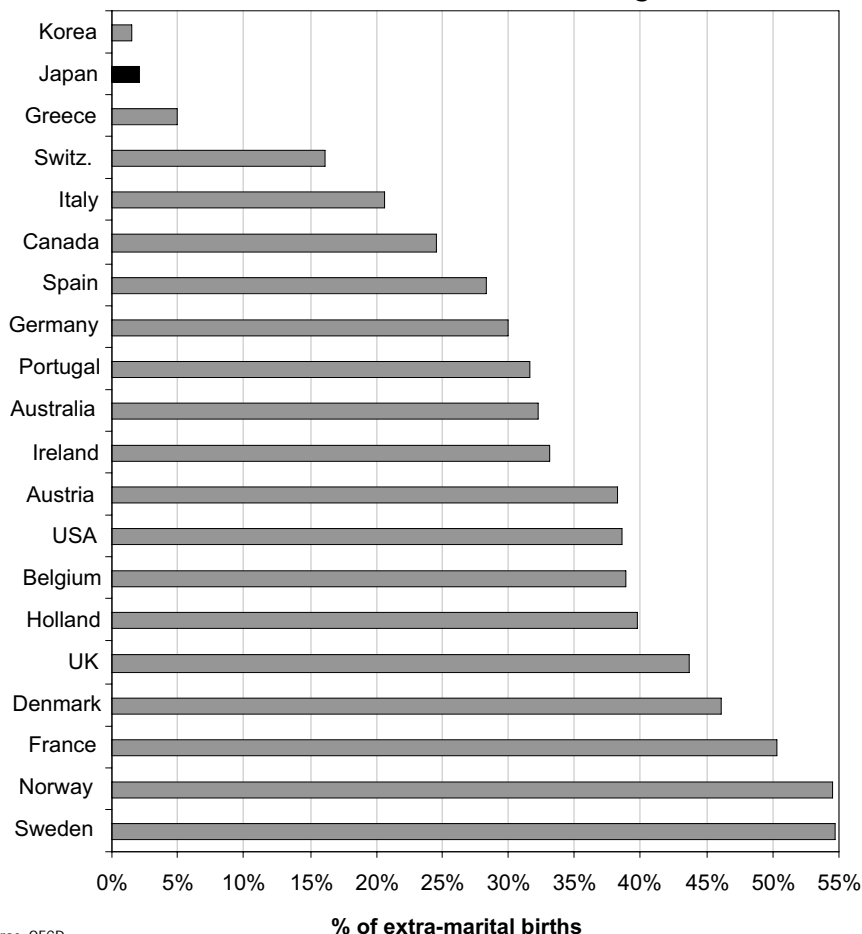
with college education. 87% of those not pregnant marry someone with a college education, vs. 77% of those pregnant.

## More children conceived before marriage . . .



Source: Ministry of Health, Labour and Welfare

## . . . But born after marriage



Source: OECD

Note: Extramarital birth does not necessarily mean a single-parent situation; in some countries, couples cohabit and have children but do not get married

# FARM POLICY

by Yoshisuke Inuma

## Rural districts key to Diet vote

# The fad of farm exports

Like other countries, Japan enjoys fads. Some concern “get rich quick” schemes that will somehow boost the economy out of its doldrums. A few years back, nanotechnology was all the rage. Today’s El Dorado is agricultural exports. Some young people who have been let go from manufacturing are excited about the possibility of finding jobs in the farming sector.

The press has ballyhooed the fact that farm exports in 2008 increased by 47% from four years earlier. We are offered stories of how apples, pears and other fruits fetch high prices as luxury goods, and how Japanese marbled beef enjoys cachet. Groups of highly motivated farmers have traveled as far as Dubai for food fairs. They are not just interested in exports, but want to build an international supply chain that uses Japanese agricultural skills.

All sounds very impressive—until we look at the numbers. Farm exports are a miniscule ¥244 billion (\$2.57 billion)—a figure that amounts to a mere 3% of all farm sales, a microscopic 0.3% of all Japanese exports, and an infinitesimal 0.04% of GDP.

Normally, one would not think so much of the nation’s attention would be focused on farming, an industry whose total sales of ¥8.2 trillion (\$86.5 billion) are no bigger than those of just one firm: Honda.

And yet, the May cover story of the influential weekly, *Nikkei Business*, was about agricultural issues. Another business magazine, *Shukan Toyo Keizai*, had an article about entrepreneurs who are launching new types of agricultural enterprises. *AERA*, a weekly publication put out by the *Asahi Shimbun*, also made agriculture its cover story. Robert Feldman, an economist at Morgan Stanley, commented, “Japanese agricultural products have the potential for large-scale export into the global market.” Economic journalist Seiichi Takarabe gathered great attention for a book he published last fall by calling it *Agriculture Saves Japan*. Takarabe discusses the fresh new agribusinesses that are sprouting in every

region and denounces factors that he sees as preventing an agricultural revolution: ossified policies, farmers’ egos, and a farmland system that enables these factors. Takarabe once worked at Nomura Securities, and is now a main commentator on the popular political talk show, “Sunday Project.”

### Political pivot

Why all this attention? Part of it is just politics. Even though the farm population is only 3.3 million, just 2.5% of Japan’s total, the rural sector plays an inordinate role in Japanese politics. Japan’s disproportionate districting system give rural districts 2-4 times as much voting power as city districts and the farm base has always been critical to the vote-gathering machine of the Liberal-Democratic Party (LDP). In the 2007 Upper House elections, Ichiro Ozawa led the opposition Democratic Party of Japan (DPJ) to a great victory by taking away so many of the rural districts from the LDP via an appeal to farmers. The DPJ hopes to do the same this year. So, in a close race, the rural districts could prove the pivotal swing factor.

But political machinations cannot be the whole story. After all, without an audience for these political appeals, they could not succeed. Many of the people talking up agriculture and buying magazines for these articles are younger urban people. They have genuine concerns about issues like Japan’s low self-sufficiency in food as well as food safety. Behind these concerns are deeper apprehensions about the environment. Politicians in the farm and construction lobbies may be successful in capitalizing on this sentiment, but it is a genuine emotion that cannot be dismissed or ignored.

### Who are the Japanese farmers?

For all the attention that they get, Japanese farmers are a vanishing breed. In 2005, Japan had 2.85 million farming households, a figure that is 17% less than ten years earlier and 50% less than forty years earlier. Japan’s farm population was 3.35 million

people, which is 19% less than ten years ago and one-third of what it was 40 years ago.

Not only are farmers disappearing; so is farmland. In 2005, just 4.09 million hectares (a hectare is 2.47 acres) were under cultivation, 7% less than ten years ago and 22% less than 40 years ago.

Each farm is amazingly small, just 1.65 hectares. This is 1% of the average landholding in the US and 10% of the average landholding in the EU. Obviously, Japan has many farmers with very small farms. Why? The answer, says Professor Yoshihisa Godo, is politics. The more farmers running inefficient farms, the more farm votes for the LDP. Creating larger farms with higher labor productivity would mean fewer farm votes.

Despite all the talk of the sacredness of farming, most farmers commute to jobs during the day and tend their land after they return home or on weekends. Many just raise produce for their own consumption; only 1.75 million farm households (60% of the total) market their own crops.

### Rallying cry for subsidies

The result of all this is a low level of food self-sufficiency. Japan can only provide 40% of its own food, as measured in calories. It is nearly 100% self-sufficient in rice, but this figure declines to 60% when major grain staples such as wheat are included. And, when livestock feed is added in, the self-sufficiency ratio declines to 28%. Vegetable self-sufficiency is 77% and fruit is at 37%.

The farm lobby uses this low level of self-sufficiency to raise alarms about the future safety and security of Japan’s food supply. So, whenever there is an issue of contaminated food imports, from “mad cow” pesticide-laced farm products and gyoza (dumplings) imported from China, there is a huge hue and cry in the press. If the real purpose were to raise food self-sufficiency, the answer would be to create larger, more efficient farms. Instead, the alarms are used to justify subsidies.

On average, 45% of farm income comes from a variety of subsidies. Almost all of Japan’s farmers rely on pensions, subsidies, and income from jobs unrelated to agriculture. And, when we look at farm households whose primary source of income is farming, we find that a mere 300,000 of these households (just one-tenth of the total) contain farmers under 65 years of age. If we look at families who cultivate rice as their primary crop, we find that no more than 70,000

households make a living solely from rice. Nearly 60% of the farming community is 65 years old or older. Japan has 390,000 hectares of land that lie fallow due to economic circumstances or because the owners are too old to work it. Overall, 10% or more of Japan's farmland is not being used.

Approximately 40% of Japan's ¥2.7 trillion (\$28.45 billion) fiscal 2007 farm budget was assigned to public works projects that were designated for agricultural use. Such projects include irrigation facilities for paddy fields, land readjustment for the paddy fields themselves, new reclamation, and road construction designated for agricultural use. It goes without saying that this is a gold mine for politicians and local vested interests. It also provides some construction jobs for part-time farmers.

### Exceptions that prove the rule

To be sure, there are some exceptions, some agribusinesses that show the potential now being blocked.

Shinpukeiseika is a major Japanese vegetable cultivator with 90 hectares of direct farm holdings and 78 employees. Using information technology (IT), it has been very successful in its production of high quality vegetables that can be sold for good prices. The crops are not distributed through a cartel structure such as an agricultural cooperative but are sold directly to major supermarkets. Taro, burdock, carrots, cabbage and other vegetables are now being exported to Hong Kong and Taiwan. Use of the Shinpukeiseika system has worked to expand independent farms.

Dole Food Company, the well-known American producer of fruits and juices, moved into the Japanese market in 2004 with its cultivation of broccoli and other vegetables. In its fourth year of entry, yearly sales were ¥2 billion (\$21 million). Utilizing the climate variations in different regions of Japan, Dole set up a system where seeding and planting technicians rotated through various farms, thus lowering labor costs and other expenses. Dole managed to break even by 2007.

Dole has also started a business directed toward other companies who want to enter farming. Acting as a proxy, it hires out farmland and the necessary workers. Dole uses the sales pitch that this avoids hassles for other companies by guaranteeing access to land and circumventing such matters as negotiations with local agricultural boards.

But the very fact that Dole finds a market in this kind of activity shows how land-use laws and practice block the broader proliferation of more efficient agribusinesses.

### Why?

Why has Japanese agriculture fallen into this state? To begin with, Japanese agricultural policy has been overwhelmingly slanted towards rice. Even now Japan maintains the high price of rice with supply-restriction policies such as planting quotas, suppressed production, and severe restrictions on imports. Consumers bear the burden of the high prices. When one includes the subsidy of ¥200 billion (\$2.1 billion) that is paid out to farmers who observe production restraints, it is estimated that consumers pay ¥850 billion (\$8.96 billion) per year.

But rice consumption is declining because of high prices and changing tastes. Reduced demand means that Japan has fallen into a vicious spiral and must once again reduce production to keep prices from falling. Approximately 40% of Japan's entire rice paddy acreage is being forced to halt cultivation or is being converted to crops such as wheat and soybeans that are unsuited to the soil of paddy fields. Japan's rice-based agricultural policy has collapsed.

A second factor is the monopolistic practices of the Japanese Agricultural Cooperative (JA). Its predecessor was the wartime Agriculture Regulation Association. Historically, the JA has had a close relationship with the Ministry of Agriculture, and acts hand-in-hand with the government in the implementation of agricultural policy, not to mention its traditional role as a support base for the LDP. The JA offers services that handle all the business affairs of its farmer members, from the purchase of seeds, seedlings and farming equipment to farming instruction, the purchase of crops, banking services, and management of farm economics. Because they rely on JA to provide for all their needs, most of Japan's farmers have lost their business acumen.

A third factor is land-use laws that tie up farmland by restricting the ability of non-farm corporations to buy such land and convert it to other uses, or even of agribusinesses to buy such land for more modern methods. These restrictions have been loosened in recent years, but many remain and they keep the price of farmland artificially high for the limited number of sales that do go through.

Consequently, one of the consistent

qualities of Japan's rapidly aging farmers is that they see farmland, not so much as a means of production, but as an asset to sell at a profit. As of now, agricultural public works have reclaimed 1.1 million hectares of farmland. Meanwhile, 2.6 million hectares have been removed from tillage and converted to housing, roads and other uses. Many farmers received large sums of money for selling their land for housing. These land-use laws and practices are a major reason why farms are so small and inefficient.

### LDP, DPJ proposals

What major reforms would produce change? Instead of keep rice prices high through import restrictions, or paying farmers to take land out of service, many commentators would free up imports, end production controls, let prices drop to market levels, and offer the aging farmers income subsidies (rather than production-based subsidies) to offset the loss of income. Those subsidies would cost the taxpayer and consumer less than current subsidies and high prices.

The DPJ accepts part of this program but rejects other aspects. The problem is that the DPJ has two coexisting goals: first, to make the farm economy more rational and second to garner farm votes. So, they propose to increase agricultural output and make Japan 50% self-sufficient in ten years, but do not spell out how to achieve this. They do say it has to be done in a way that would not create agricultural disincentives for World Trade Organization (WTO) and Free Trade Agreement (FTA) negotiations. The DPJ pledges to put an end to limits on rice production, to make tariffs much lower, and—to offset the drop in the market price of rice—to provide price-differential subsidies capped at ¥1 trillion (\$10.53 billion). The DPJ contends that revenue sources for this policy would be financed through decreased public works spending on agriculture and by the abolition of subsidy payments for suppressed rice production.

The LDP had proposed a plan to make rice farms larger via a change in the subsidy policy. The scale of farms that received subsidies would be four hectares or more for individually managed farms and twenty hectares or more for farmers who farmed as a group. Taking advantage of the unhappiness of small farmers over this policy, the DPJ adopted Ozawa's initiative and pledged, "We will guarantee an income for all farmers." The more things change...

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end-users. The best illustration of this is the PC industry. Microsoft (software) and Intel (microprocessor) are the multi-sided platforms leading the entire PC ecosystem.

The advantage of these horizontal structures is that they provide more flexibility and generate distributed innovation, which are critical in industries with short product-life cycles and a rapid pace of technological change. Firms enter and leave the ecosystem as their products either serve a need or are overtaken by newer ones. By contrast, hierarchical structures create stronger “lock-in” effects. While that can have advantages in certain industries, like autos, where quality depends on repeated cooperation of supplier and buyer, they tend to slow down innovation in these new types of industries. In horizontal ecosystems, even the leaders are under constant threats from competitors, making it harder for them to lock-out innovation (Linux, Corel’s Office suite, Google docs and spreadsheets, AMD, and Apple force Microsoft and Intel to keep innovating at a fast pace in order to maintain their positions).

Throughout the information and communications worlds, we see developments that generate growing opportunities for the growth of new ecosystems. Though iPod and the iTunes store form a closed system based on Apple’s proprietary technology, the development of this channel to sell songs is redefining the music industry away from its domination by the big labels. Similarly, Amazon’s Kindle might transform the publishing business by allowing best-selling authors to sell their works directly to Kindle owners through Amazon.com without resorting to a publisher.

Therefore if Japan is to strengthen its ability to capitalize on its capacity for innovation in the global market, it will need an “industrial ecology” where non-hierarchical ecosystems can thrive. Even traditional industries where, so far, Japan’s vertical pyramids work well, may one day be under threat from new forms of industrial organization. For example, Apple’s iPhone and Google’s Android might end up disturbing Japan’s mobile phone hierarchies.

#### **What is to be done?**

There are several causes for Japan’s handicaps in horizontal ecosystems. Fortunately, these handicaps can be remedied.

Rapid innovation is a threat to large companies. The US electronics industry is

littered with the corpses of once mighty giants that failed to evolve. Therefore monopolies and oligopolies are particularly nefarious in these industries since they prevent the demise of the obsolete and thus hinder the rise of the fittest. This is where the scope for antitrust legislation and enforcement is greatest—in order to ensure that the dominant players do not abuse their positions and thereby prevent new ways of doing business and new firms from emerging.

Another issue related to anti-trust is foreign investment. Despite positive changes, Japan remains a difficult market for FDI and acquisitions. This further strengthens domestic oligopolies and raises additional obstacles to new forms of industrial organization.

Ecosystems require a sophisticated financial and legal infrastructure to function. In hierarchies run by huge conglomerates financing is straight-forward. The corporate giant borrows on its own and, if need be, assists smaller suppliers in getting funding. In non-pyramidal situations, however, there is a need for a dynamic and diversified venture capital industry staffed by professionals who combine financial skills with an understanding of technology. Despite years of effort by the Ministry of Economy, Trade and Industry, this is still sorely lacking in Japan.

In Japan’s vertically integrated sectors, there is little need for lawyers. Transactions are either intra-company or involve vendors that have symbiotic ties with their customers. But in places such as Silicon Valley, thousands of businesses directly or indirectly trade in goods, licenses, funding, and services, with customers, contractors, investors, partners, and competitors. This works thanks to the multitude of attorneys who master the complex issues involved in the industry Barack Obama just nominated one of them, John V. Roos, as ambassador to Japan. Equally essential is a court system that adjudicates contractual disputes as quickly and efficiently as possible.

Finally, firm mortality rates are far higher in horizontal ecosystems than in pyramidal structures. Thus, there is a need for bankruptcy regulations that allow entrepreneurs to start again. Moreover, an effective bankruptcy system also makes exit easier, since the financial and reputational costs of throwing in the towel are lower. Making exit easier turns out to make entry easier as well. It’s crucial to entrepreneurship.

One key to the success of the PC ecosystem is high labor mobility. This makes

it less risky for entrepreneurs to start a new business or for talented managers and staff to take a chance on a startup company. Furthermore, thanks to inter-company turnover, businesses find it relatively easy to understand the workings of the entire ecosystem since many of their employees and managers have experience working for other players. That diffuses knowledge throughout the ecosystem. Unfortunately for Japan, despite improvements, its labor market is still fairly rigid.

World-class firms have undergone rapid internationalization of their ranks, from engineers to executives. But Japan remains isolated. With a few exceptions, the headquarters of Japanese corporations are overwhelmingly Japanese. A surprisingly small number of Japanese work overseas for foreign companies. When they do, they are frequently confined to Japan-related positions to handle Japanese clients. As for academia, very few Japanese teach overseas while Japanese universities are, by international standards, inward-looking institutions.

This insularity has not prevented Japan from developing outstanding export industries. But producing, marketing, and selling soft goods and services demands more cultural sensitivity than exporting machinery. Firms whose professional staff includes men and women from dozens of countries are at a big advantage when competing against Japanese ones where the under-representation of women further reduces diversity.

#### **Resistance is futile**

Some will argue that Japan should play to its strengths and continue to focus on vertical integrated manufacturing. But Japan cannot escape several facts. First, lower-cost but technologically advanced countries such as Korea are increasingly competitive in this niche. Second, some previously vertically integrated industries, like cell phones, are moving towards modular and horizontal structures. Third, services and soft goods are capturing a growing share of the value chain even within manufactured goods. Fourthly, as economies mature, manufacturing inevitably comprises a smaller share of GDP. Finally, the demographic crunch limits the growth of purely domestic firms.

It is true that, since the collapse of the bubble, Japan has changed more than is often realized. But the rest of the world has evolved even faster. To keep pace, Japan needs to accelerate its transformation.

## Japan's next hurdle

## Capitalizing on innovation

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In the long run, it is firms that produce a nation's growth. And that presents a problem for Japan, now that services are replacing manufacturing as the leading edge of rich country growth. Most people are quite familiar with names like Toyota and Sony. Those with a deeper knowledge of Japan are familiar with the small and medium-sized companies that provide high-technology components embedded both in "made in Japan" goods and in products that flow out of Korean and Chinese factories.

Unfortunately for Japan, the very features of industrial organization—the hierarchical structure of production/distribution conglomerates—that gave Toyota and Sony a global edge are proving to be a hindrance in generating global leaders in services.

At 68% of GDP, Japan's service sector is not small. Still, Japanese firms are conspicuously absent from a list of the new American and European household names in services and soft goods: Google and Skype, Amazon.com and iTunes, Bloomberg, Ryan Air, EasyJet, and T-Mobile (an old German domestic monopoly now a large multinational).

#### Software, anime and cell phones

Japan's hierarchical forms of industrial organization have limited Japan's ability to innovate and compete in the service sector. In several instances, the products are remarkable but, like the colorful fauna of the Galapagos, are confined to their native archipelago.

The problem is not a systemic inability to innovate. Japanese firms have been world-beaters in innovation, from the Toyota production system to the Sony Walkman. The problem is an institutional anchor on the

ability to commercialize and capitalize on those innovations in some of the new growth industries.

In our Harvard Business School Working Paper we analyzed three sectors: software, anime, and wireless telephony.

One key reason for Japan's weakness in software is that large conglomerates—the likes of Hitachi, Fujitsu, NEC—historically treated software as entirely subordinate to hardware, an add-on which was usually bundled for free with computers in order to tie customers to these hardware providers. These integrated companies hindered standardization as well as the emergence of smaller and more nimble software companies—two vital elements for an innovative software sector.

Anime and cell phones are even more striking examples because, unlike in software, Japan's home-grown innovation and technology are world-class. Japanese anime productions are superb. And Japan's mobile phones lead the way in hand-held wireless internet and email. They also function as subway passes and electronic money to pay for cab fares or purchases at convenience stores—services unparalleled as of yet in the United States.

Yet, Japan has failed to spawn an entertainment multinational that can compare to Disney or Pixar. In mobile telephony, Japan's operators (NTT DoCoMo, Softbank, and KDDI) are marginal players on the global stage, while Japanese mobile handsets lag far behind foreign competitors in overseas sales (though many foreign phones contain Japanese-made components).

#### Hierarchy

What these three sectors have in common is

an inappropriate hierarchical industrial structure. At the top of the pyramid lies a company (or business group) which controls key aspects of production, technological development, marketing, and finance. In software, the major systems integrators are at the top of the chain of command, with smaller subcontractors dependent on the specifications designed by the conglomerates. In the anime sector, distributors and sponsors (TV stations, movie and DVD chains, and advertising agencies) dominate, imposing their will on over 400 small production companies that lack the scale and resources to secure funding, distribution rights, and licensing on their own. In mobile phones, DoCoMo and the other operators supply handset manufacturers with detailed specifications, market the phones, and brand them.

In some industries, this pyramidal order is remarkably effective. Toyota's leadership is an asset to its suppliers; they benefit from Toyota's commitment to R&D, which makes it possible for its subcontractors to continuously improve their technological skills and export under Toyota's umbrella.

But all too often in the newer industries, this model is inappropriate. If a hierarchical organization generates successful innovation for an industry but the leader is incapable of international expansion, then the entire sector itself remains secluded inside Japan. Mobile phones are a case in point. The operators are inward-looking enterprises. Even though operators failed to expand overseas, shouldn't we have expected the handset manufacturers to export their first-rate phones? The problem was that they were so dependent on the telecom companies to guide them on design, standards, pricing, etc. that they lacked the in-house skills required to succeed overseas on their own.

In anime, the Japanese TV networks, DVD chains, and advertising agencies are also domestic. But since the atomized production companies are so small, they cannot develop the critical mass necessary to expand overseas on their own.

In technology sectors across the globe, we are seeing a shift from vertical hierarchies towards horizontal ecosystems. Rather than having companies produce highly integrated hardware-software systems, the key to value creation and value capture is to create "multi-sided platforms" connecting various types of "complementors" (suppliers, allies, producers of related products) along with

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