

JETRO

“Cool” Japan's Economy Warms Up

March 2005

**Economic Research Department
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“Cool” Japan's Economy Warms Up

McGray's “Gross National Cool”

It has never been easy to live up to Socrates' exhortation “Know thyself.” Sometimes we come to know ourselves less through our own efforts than through the actions of others. This is the situation in which Japan finds itself today.

Following the collapse of the asset-inflated economic bubble at the early 1990s, Japan entered a long-term recession that caused many Japanese to lose self-confidence and do a great deal of soul searching. Not long ago, the American journalist Douglas McGray wrote: “Instead of collapsing beneath its widely reported political and economic misfortunes ... from pop music to consumer electronics, architecture to fashion, and animation to cuisine, Japan looks more like a cultural superpower today than it did in the 1980s, when it was an economic one” (“Japan's Gross National Cool,” *Foreign Policy*, May/June 2002).

In a play on words, McGray suggested that during this time Japan became a major nation in terms of “gross national cool” (GNC), an index of cultural power, rather than in terms of gross national product (GNP), an index of economic power. This may have sounded a lot better to the angst-ridden Japanese than the reality warranted, but eventually even mainstream media in Europe and North America were reporting on the issue of “Japanese cool.” *Le Monde* carried an article titled “Cool Japan: le Japon superpuissance de la pop” on December 18, 2003, and the *Washington Post* printed an article entitled “Japan's Empire of Cool” on December 27, 2003. The lively pictures they painted suggested that people outside—but not inside—Japan had come to know and appreciate the cultural assets that the nation was sitting on. Socrates would have been disappointed.

What, exactly, is GNC? McGray sees it as a form of “soft power” (derived from the word software, but broadly referring to culture and intellectual property). The concept was first put forward by Professor Joseph S. Nye Jr. of Harvard to describe the power of one country to attract the people of other countries through its culture, its values, or its diplomatic policies.

McGray was first alerted to this soft power by the tone adopted by newspaper reports on Japan. While the pessimistic articles about Japanese politics and economics filling the business sections preached the need for reform, he also found plenty of articles in the fashion and culture sections describing how Japan was giving birth to a variety of new trends in technology, art, and pop culture. The paradox was so extreme that he decided he would try to learn more about it. When McGray subsequently visited Japan, he saw this soft power wherever he went, and has since described his experiences in the above-mentioned article and elsewhere:

- Japanese *anime* (animation) dominates Saturday morning television in the United States, *Pokémon* is broadcast in 65 countries around the world, and both *manga* (Japanese comic books) and *anime* have served as a source of inspiration for such Hollywood movies as *The Matrix*.
- JPOP (Japanese pop music) has built up a broad base of fans centered on East Asia.
- Japanese lifestyle magazines—available in their original, un-translated versions

only—hit the newsstands in places like Hong Kong, South Korea, and Taiwan within a few days of their release in Tokyo. East Asian teenagers hunger for the latest Tokyo fashions. The *New York Times* says that “Tokyo is the real international capital of fashion.”

- Sushi is now available at ordinary supermarkets and ballparks in the United States, even though the Japanese long believed that such cuisine would never enjoy popularity overseas.

Some of these phenomena retain their original, authentic essence overseas, while others do not. But the point is not if they are authentic, but if they are “cool.” Being cool turns people’s heads and attracts them, becoming more a form of power than a simple set of values.

Japan’s Other Face

If Japan is viewed through McGray’s eyes, it is certainly possible to see a very different face on a nation that suffered chronic economic stagnation for so long. From *anime*, video games, and character goods to fashion and music, the influence of Japan’s soft power is rippling around the world. Starting in Taiwan and spreading throughout East Asia, more and more young people have joined the so-called *harizu* or “Japanophile tribe” by mimicking Japanese fashion and enthusiastically following Japanese *anime* and *dorama* (TV dramas). Japanese *manga* and video games have spread across Europe and North America at a remarkable rate.

Animation

Japanese *anime* has held the number-one position in the world of animation for nearly two decades. Over 60% of the animated cartoons broadcast around the world are made in Japan. The Japan External Trade Organization (JETRO) estimates that the U.S. market alone for Japanese *anime* is worth 4.35 billion dollars, which indicates the strength of its global presence. In fact, serious *anime* films like *Gundam*, *AKIRA*, and *Ghost in the Shell*, which captured the imaginations of youngsters around the world starting in the 1980s, probably formed the basis for the perception of a “cool Japan.”

- In 2002, *Spirited Away* became the first *anime* feature film to win the Golden Bear award at the Berlin International Film Festival. It later took the Oscar for best animated feature film at the Academy Awards.
- Japanese *anime*-style cartoons currently fill most of the weekday after-school timeslots and monopolize Saturday mornings on U.S. TV networks.
- The *Sailor Moon* TV series for young girls debuted in 1991 and is now broadcast in 20 countries, has been translated into many languages, and boasts millions of fans around the world.
- FOXBOX of the United States started broadcasting *Kinnikuman Nisei (Ultimate Muscle)* in September 2002. It has ranked among the top three most popular programs in its timeslot ever since.
- TV films of *Pokémon* have been broadcast in 68 countries and feature films have been shown in 45 countries worldwide.
- In 1995, the *anime* film *Ghost in the Shell* directed by Mamoru Oshii was number

one in U.S. nationwide video sales. Oshii's latest work, *Innocence*, was scheduled to be released in Europe and North America before debuting in Japan. Steven Spielberg, the Wachowski Brothers, Quentin Tarantino, James Cameron, and many other famous directors are fans of Oshii's work.

Publishing (Comics)

Manga are also extremely popular worldwide. Pirated editions of *manga* have long been available in East Asia, although their publication has declined since the conclusion of agreements on translation and publishing in East Asian countries beginning around 1992. Japan's five major *manga* publishing companies have signed contracts for an estimated 10,000 titles covering 250,000 volumes. According to estimates, these contracts generate approximately 4 billion yen in license sales and some 80 billion yen in sales of original *manga* in East Asia (*Dejitaru kontentsu hakusho 2003* [Digital Content White Paper 2003]).

Although literary works such as novels still lag far behind *manga*, their reputation in the West has grown in recent years with the publication of translated works by popular novelists like Kenzaburo Oe, Haruki Murakami, and Banana Yoshimoto. In the mystery genre, Japanese literary entertainment is also gaining in stature. In 2004, Natsuo Kirino's thriller *Out* was nominated by the Mystery Writers of America for the prestigious Edgar Allan Poe Award for best mystery novel.

- The U.S. edition of the weekly comic magazine *Shonen Jump* was launched in November 2002, aiming at a circulation of 1 million copies within three years.
- *Dragon Ball* was the top search term on a popular Internet search site in 2002.
- Japanese publishers held their first large-scale exhibition of *manga* at the Frankfurt Book Fair in 2004.
- In France, *manga* is widely recognized as part of the French vocabulary.
- Bootleg copies of Japanese lifestyle magazines are sold throughout East Asia.
- Novels written by Japanese writers such as Nobel Prize-recipient Kenzaburo Oe and Haruki Murakami are developing a broad following throughout the world.
- Shufunotomo Co. prints 400,000 copies of its Ray fashion magazine for distribution in China, which is more than it distributes in Japan.

Video Games

Japan also dominates the world's video game market. Microsoft has entered the market on the hardware side, but Japanese products continue to hold an overwhelming share of the world market. Japanese video games have spread around the world and are particularly popular in Europe and North America. On the content side, Japan ranks alongside the United States as a top producer of game software, meaning that its international influence on children, the main users, is particularly strong. Game software has given birth to globally popular characters such as *Super Mario Bros*, *Pokémon*, and others. *Pokémon* even evolved from a video game into a business encompassing *anime*, *manga*, and character goods worth about 2 trillion yen overseas.

- A live-action Hollywood movie of the video game *Biohazard* was released in 2002.
- Characters from the *Pokémon* video game have had an economic ripple effect worth 1 trillion yen in the Japanese market and 2 trillion yen in overseas markets. Of the 2

trillion yen in sales overseas, about half has been derived from the U.S. market and a quarter from the European market.

- *Super Mario Bros* has also been turned into a Hollywood-financed movie.

Character Goods

Many of the internationally popular characters created in Japan derive from the nation's strengths in content, including video games, *anime*, and *manga*. Well-known examples include toys spun off from *Pokémon*, *Doraemon*, *Gundam*, and *Mazinger Z*. Others were developed as characters right from the start, including Sanrio's globally popular *Hello Kitty*, a little white cat.

Pokémon is the supreme example of success in the character goods business. Originally no more than one of the games sold by Nintendo Co., it evolved into a card game and then *manga*, *anime*, character goods, and eventually a multimedia character product with a worldwide following.

- *Hello Kitty* generates annual sales of 1 billion dollars worldwide.
- In 1999, *Pokémon: The First Movie* generated box-office revenues of approximately 17 billion yen in North America and Europe, the largest overseas take of any Japanese *anime* feature film.
- In 2002, *Time* magazine selected baseball player Ichiro Suzuki, soccer player Hidetoshi Nakata, and *manga* character *Doraemon* for its special feature "Asian Heroes."
- The *Qoo* character adopted by Coca Cola (Japan) for its *Qoo* juice drink has now been introduced in six markets of East Asia, including China, South Korea, Singapore, and Taiwan, and by Coca-Cola GmbH in Germany.
- Toy maker Bandai, as a result of its strategy to tie in character merchandising with TV program sponsorships, has reaped sales worth 28.5 billion yen in the United States and 15.3 billion yen in Europe.

Movies and TV Programs

Japanese movies enjoy a somewhat stronger reputation in Europe than in the United States. Works by Takeshi Kitano have proven highly popular, winning prizes at the Venice Film Festival and the Cannes Film Festival while exerting quite an impact on European movies.

But American interest in Japanese movies is also rising, as seen in the success of *The Ring*, a U.S. remake of a Japanese movie. Moreover, Japanese *anime* have had an indirect impact on the works of many of Hollywood's most illustrious directors, who also happen to be fans of the genre, while *The Last Samurai* and *Lost in Translation* represent a growing body of movies set in Japan. Not only are Japanese movies having an international impact, "cool" Japanese culture is influencing foreign movies.

Director Hayao Miyazaki's *Howl's Moving Castle* also proved to be an unprecedented hit for a Japanese movie shown in the South Korean market, where audiences passed the 2 million mark just 18 days after the late-2004 premiere. *Howl's Moving Castle* won the Ozerra Prize at 2004's Venice International Film Festival. Meanwhile, Miyazaki will be awarded the coveted Leone d'oro alla carriera (Golden Lion for Career Achievement) at the sixty-second Venice Film Festival in August 2005, the first *anime* director to be so honored.

- Every 10 years, the British Film Institute's *Sight and Sound* magazine polls the world's leading film critics on the best films of all time. In 1992, the magazine also began polling directors. In 2002, *Tokyo Story* was number-five among the critics, while *Rashomon* and *The Seven Samurai* tied for ninth among the directors.
- Director Takeshi Kitano's film *Zatoichi*, in which he also played the leading role, won the Special Director's Award at the Venice Film Festival in 2003.
- At the 2004 Academy Awards, Ken Watanabe was nominated as best actor in a supporting role for *The Last Samurai*, while *The Twilight Samurai* was nominated for best foreign-language film.
- Hollywood moviemakers have acquired the rights to make live-action movie versions of Japanese *anime*, such as *Neon Genesis Evangelion* and *Lupin III*.
- Hollywood has released several movies set in Japan, including *Kill Bill*, *Lost in Translation*, and *The Last Samurai*.
- A remake of the Japanese horror movie *The Ring* by DreamWorks SKG, the U.S.-based film production and distribution company, took in 129 million dollars at the box office in the United States.
- Director Sam Raimi is to remake the Japanese horror movie *Juon* (The Grudge) in Hollywood. Hollywood moviemakers have been looking carefully at Japanese movie content and acquiring remake rights.
- Director Shunji Iwai's movie *Love Letter* has been such a hit in South Korea and Taiwan that the location, Otaru city on the island of Hokkaido, has become a popular destination for East Asian tourists.
- The popular Fuji Television program *Iron Chef* is broadcast in 11 countries and regions in North America, Europe, and East Asia. In addition to exporting the program itself, the network has enjoyed success with format sales of rights to the program's concept and ideas.

Music and Entertainers

Japanese pop music (JPOP) is more popular in East Asia than in the West, particularly in Hong Kong, Taiwan, and mainland China, according to Japanese advertising giant Hakuhodo. There was a time when Japanese music was rarely heard in countries where the import of Japanese culture was restricted, such as South Korea, as well as in East Asian countries geographically separated from Japan by large distances, such as Thailand. Since the lifting of restrictions in South Korea, however, the popularity of JPOP has soared.

- When the Japanese rock group GLAY performed in Beijing in October 2002, the relatively exorbitant ticket prices of 10,000 yen did not prevent the concert from attracting some 30,000 young people, almost 50% more than expected.
- Namie Amuro, the JPOP diva of the 1990s, built a huge following in East Asia and her trademark platform shoes influenced fashion throughout the region.
- JPOP singers Ayumi Hamasaki and Takuya Kimura are currently very popular in East Asia.
- Pirated copies of Japanese content accounted for 17% of the music software market in Hong Kong and 32% of the market in Taiwan, according to a 2002 survey by the

Copyright Research and Information Center.

- Some 150,000 copies of pirated VCDs of the TV drama *Hero* starring Takuya Kimura were in circulation in China, which helped to fuel explosive sales of Japanese-made mobile phones (“Kontentsu sangyo no kokusai tenkai to keizai hakyu” [International Development and Economic Influence of the Content Industry], Ministry of Economy, Trade and Industry).

Fashion

Japanese street fashions attract attention around the world. They are especially noted for the way they fuse Western and Japanese (East Asian) elements to create original styles that exist nowhere else. Distinct fashions, such as wearing loose, baggy socks with platform shoes, have originated among Japanese young people, who dress freely and in ways that often reject prevailing styles. This is what young people overseas perceive as cool. Such fashions typically find their way into East Asia when popular Japanese entertainers introduce them, given that, for example, local editions of Japanese fashion magazines are published in China and sell well. Two commercial facilities specializing in Japanese brands opened in Shanghai in 2004. Such factors account for the considerable influence that Japanese fashions wield among young people in East Asia.

- Local editions of Japanese fashion magazines *Ray*, *ViVi*, and *Oggi* are published in China.
- Bootleg copies of Japanese lifestyle magazines circulate throughout East Asia.
- Young people in Hong Kong, Seoul, Shanghai, Taipei, and elsewhere are fascinated by Japanese street fashions.
- The For You fashion building selling Japanese brands opened in Shanghai in April 2004. The management, Japanic, issues a free paper on Japanese fashions. Another location, Nihonjo (Japanese Castle), a fashion complex with shops featuring top Japanese design labels, opened in September 2004.
- International Japanese designers, such as Yohji Yamamoto, Rei Kawakubo of Comme des Garçons, and Issey Miyake have larger followings overseas than in Japan.
- The Russian pop duo t.A.T.u. became popular wearing the high school uniforms of Japanese teenage girls.
- MUJI now has 21 stores in Europe, centered on the United Kingdom, and three in Hong Kong. The MUJI name is spreading in the United Kingdom, where its simple, monochrome image has proven popular.

Japanese Food

Instant ramen, sushi, and soy sauce were among the Japanese foods to spread worldwide. Instant ramen is an especially international product, selling over 44 billion servings worldwide each year, primarily in East Asia but also in the West. Sushi is a classic example of the way Japanese food spreads in East Asia, first becoming popular in South Korea and Taiwan, then spread throughout the region. In the West, sushi’s image as “exotic” cuisine is fading. Sushi first gained popularity in the United States in the 1970s, when the attraction of low-calorie Japanese foods dovetailed with growing health consciousness. The spread of sushi-making machinery, known as “sushi robots,”

has made sushi so widely available that it has become a popular takeout food. Soy sauce is no longer seen as being restricted to Japanese cuisine (Makoto Matsudaira, “Kaigai ni okeru Nihonshoku bunka no tenkai” [The Spread of Japan’s Food Culture Overseas], *Seikatsu bunkashi*, September 2003).

- Some 44 billion servings of instant ramen are consumed worldwide annually.
- In South Korea, sushi has become a popular alternative to *kimbab*.
- Sushi is now seen as a simple and convenient takeout lunch in the United States.
- Soy sauce is no longer considered a seasoning unique to Japanese cuisine and is now used widely in local styles of cooking.
- The beef-on-rice chain Yoshinoya has 82 outlets in the United States and 50 in Taiwan.

Patent Royalties and Other Intellectual Property Rights

Japan’s international balance of payments in royalties and license fees posted its first-ever surplus in 2003 (Table), having doubled since 1996, according to the Bank of Japan. Japanese technology patents now exert a strong international impact, in part because Japanese manufacturers have actively transferred production and related technology offshore. The Bank of Japan has identified patent royalty income from overseas subsidiaries of Japanese manufacturers as a primary factor in the growth of royalties and license fees.

Table: Balance of Payments: Royalties and License Fees

(Unit: billion yen)

	1996	1997	1998	1999	2000	2001	2002	2003	03/94
Credit	725.7	883.9	965.9	931.0	1,102.4	1,268.9	1,306.5	1,418.5	19.55
Debit	1,068.4	1,163.4	1,170.6	1,121.3	1,186.3	1,349.0	1,379.7	1,267	11.86
Balance	-342.7	-279.5	-204.7	-190.3	-83.9	-80.1	-73.2	151.2	

Note: Because of changes in the statistical methods used for some items from 1996 onward, comparisons are not possible before that date.

Source: Bank of Japan

Other

- Tadao Ando received the Gold Medal, the highest honor presented to individuals by the American Institute of Architects. He was the second Japanese architect to receive this award, the first being Kenzo Tange.
- *Miss ko2 (Coco)*, a fiberglass sculpture by designer Takashi Murakami, fetched 567,500 dollars at an auction at Christie’s New York. Murakami is also known for his new Louis Vuitton bag designs.
- Japanese plastic food samples for restaurants are used on international cruise ships and at overseas expositions. Reflecting Japanese aesthetics, the samples are remarkably realistic and are extremely popular among foreign visitors to Japan, many of whom visit Tokyo’s Kappabashi district to buy them as souvenirs.

Japan’s Trendy Consumers

The Marubeni Research Institute has labeled the Japanese cool phenomenon the “third wave of *japonisme*.” The first wave occurred in the latter part of the nineteenth century, when displays of *ukiyo-e* prints, kimono, and hand fans at events such as the

Paris Exposition Universelle of 1867 fascinated Impressionist artists like Manet and van Gogh. The second wave lasted from the 1950s into the 1960s.

But the third wave is substantially different from its predecessors because it is more broadly based and has clearly influenced popular culture overseas, especially among young people. The fact that Japanese consumers are extremely conscious of new trends and tend to adopt new styles very quickly is another reason why Japanese cool has made such an impression at the popular level around the world.

Anyone walking through one of Tokyo's bustling shopping or entertainment districts cannot help noticing the incredible variety of highly creative products, from colorful mobile phones and phone straps to state-of-the-art digital appliances. New fashions are constantly being born in Urahara, a nickname for the back (*ura*) streets of the trendy Harajuku district (abbreviated to *hara*). Given the mixture of young people wearing the latest fashions and housewives and businesspeople toting luxury-brand products, as well as the sheer abundance of consumer goods on display in stores, foreign visitors to Japan like McGray find it hard to believe that the country was in the grip of a long recession. Ironically, Japanese consumers suffered from stagnating incomes under the recession and have become obsessed with the rising inflow of low-cost goods from East Asia and elsewhere, but they are still highly conscious of new trends and have no qualms about indulging themselves with high-priced products that catch their fancy.

The enormous purchasing power of Japanese consumers continues to encourage a steady stream of major Western brands to open new stores and expand floor space in large cities. Louis Vuitton's store in Japan boasts the highest sales of any of its stores worldwide. Even though the economy has continued to stagnate, Japanese incomes remain among the highest in the world, creating a pool of 120 million comparatively affluent consumers.

More recently, wealthy tourists from East Asia, such as Hong Kong, South Korea, China and Taiwan, have started to patronize high-end department stores in Japan to purchase luxury goods.

Japanese consumers' insatiable interest in anything new has transformed Japan into something of a test market and proving ground for new, state-of-the-art products. A prominent electronics manufacturer first releases its most technologically sophisticated products in Japan, rather than simultaneously releasing them in other major countries, and Japanese auto manufacturers used their home market to introduce the first hybrid vehicles and fuel cell-powered vehicles. Hybrid cars were subsequently introduced in the United States, where they are now so popular that production cannot keep up with demand.

The fact that products and services that have been proven to be successful in Japan are eventually introduced into other countries means that Japan is a source of new trends. In fact, the Japanese subsidiaries of some famous overseas brands in fields such as clothing and footwear have initiated product development in Japan, believing that products that satisfy the discerning eyes of Japanese consumers will probably do well in East Asia and the West. After developing lines of jeans to suit Japanese physiques and tastes, Levi Strauss Japan decided to sell them in the Far East because it believed they would be well received by other East Asians, who tend to have similar physiques and tastes.

The tremendous popularity of mobile phones among Japanese consumers has

blossomed into a mobile culture, although opinion is divided on whether this is a good thing or not. For example, minors now believe that mobile phones are indispensable, with studies showing that approximately 50% of middle school students and as many as 90% of high school students having their own mobile phone. Mobile ownership was accelerated by the launching of NTT DoCoMo's i-mode platform, which allows users to access Internet sites with their mobiles. Users often prefer the convenience and lower cost of mobile email to voice calls, and they make extensive use of content as games, horoscopes, and personalized ringtones. Whereas youngsters on commuter trains used to bury their noses in *manga*, now they spend their time engrossed in games on their mobiles. This has had a strange effect on sales of youth-oriented items such as ice cream, which remained flat in the summer because youngsters were saving money to pay their mobile bills. In contrast to the United States, where mobiles are primarily used for business, the spread of mobiles in Japan has centered on individuals, particularly the younger age groups. It has also fueled the growing popularity of decorative phone straps. These are not simple cords or strings but fashionable items to which mascot figures and good-luck charms are attached. Thousands of these straps are on sale in stores and on the Internet. In the Edo period (1603–1868), netsuke—ornamental toggles of ivory, wood, and other materials—were used to attach purses, seal cases, and other articles to the kimono sash. In a sense, these mobile-phone straps are modern-day netsuke. It is almost as if the Japanese aesthetic or sense of play embodied in the desire to use small, inconsequential things to highlight individuality has been reborn in the form of mobile-phone straps. It is also an excellent example of Japanese consumption behavior.

Another change is a shift in foreign consumers' attitudes toward agricultural and other products, which they had long considered excessively expensive. Such products from Japan were once viewed as typical examples of Japan's high cost structure, and foreign people who purchased them were anomalies. Today, however, more and more foreigners see these products as "typically Japanese" value-added items. Certain Japanese agricultural products, mainly fruit, have started to become popular in other countries, such as *mikan* mandarin oranges in Canada, Orin apples in the United Kingdom, and *ryokucha* (green tea), which has attracted attention for its healthful properties. Rice cultivated in Japan using lower doses of agricultural chemicals is selling in Taiwan, despite the fact that it costs several times as much as rice produced locally. There is growing awareness that Japan has made use of biotechnology to create tasty, high-quality produce that is also safe and healthful. If anything, the higher prices have helped to reinforce the favorable brand image. In China's major cities, higher income earners are beginning to use expensive apples as gift items.

The sudden popularity of Japanese products in East Asia arises from changing circumstances in these countries, where sustained high economic growth has led to dramatic increases in personal incomes and the emergence of consumers who can purchase expensive Japanese products. Rising incomes have also encouraged a growing interest in Japan in general, providing the driving force behind the spread of Japanese cool.

It is difficult to measure the level of "national cool," but the Marubeni Research Institute has used various indices to come up with estimates of relative national cool. Specifically, the institute looked at trade data on records, tapes, and other recorded media, books, newspapers, pictures and other printed material, photographic plates and

film, cinematographic film, works of art, collectors' pieces and antiques, as well as data on invisible trade, including royalties and fees, and personal, cultural, and recreational services/credit. It was found that exports and receipts involving these items tripled from 500 billion yen to 1.5 trillion yen between 1992 and 2002. Compared with total exports, which increased by 21% over the same period, this growth was quite remarkable. Another feature of these "cool exports" was a shift away from tangibles and toward services and value-added sectors, such as sales of rights, as traditional Japanese trade items lost their price competitiveness to China and other economies.

Moreover, game software, movies, music software, and publishing have also played key roles in the creation of Japanese cool. METI estimates that if these sectors are included, the broader content industry is worth 11 trillion yen, making it double the sizes of the iron and steel industry and approximately half the size of the auto industry. Content has thus grown into a major industry, although very few Japanese are aware of this fact.

Resurrection of the Japanese Economy

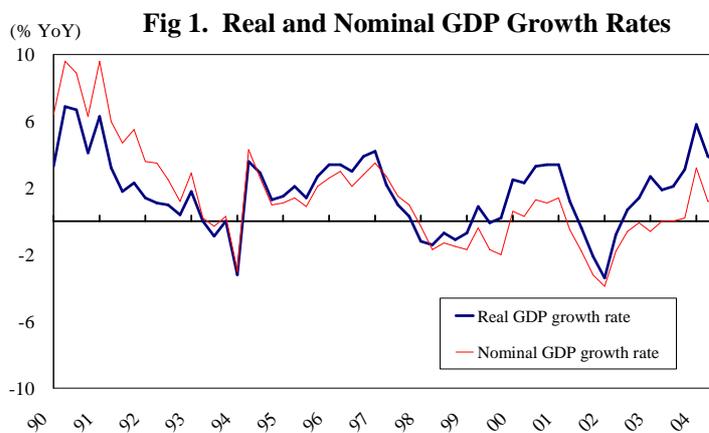
At a time when Japan has been strengthening its soft power in the form of national cool, what has been happening to the Japanese economy? The general image held by many companies overseas is that the world's second largest economy is still mired in a prolonged and chronic slump, yet in fact this is no longer true.

In the same way that national cool has transformed Japan's international image on the cultural front, the economy is also about to makeover Japan's international image. The nation has indeed pulled itself out of recession and is steadily repositioning its economy for long-term growth and stability as it works through the final stages of recovery.

The latent strength and dynamism of the Japanese economy, which provided the foundation for the birth of Japan's national cool, is once again back on track. Just as Japan has attracted global interest in its soft power, the nation's economy deserves a close reexamination by foreign companies looking for promising opportunities in the international arena.

After bottoming out in January 2002, the economy recovered and expanded through 2004 (Fig 1). The producer goods price index rose to the 2% level in 2004 and the consumer price index declined at a slower rate than previously, signifying a weakening of deflationary pressures (Fig 2).

Japan has experienced two other recoveries since the early 1990s, but both were short lived. The current recovery began in 2002, making it different from its immediate predecessors.



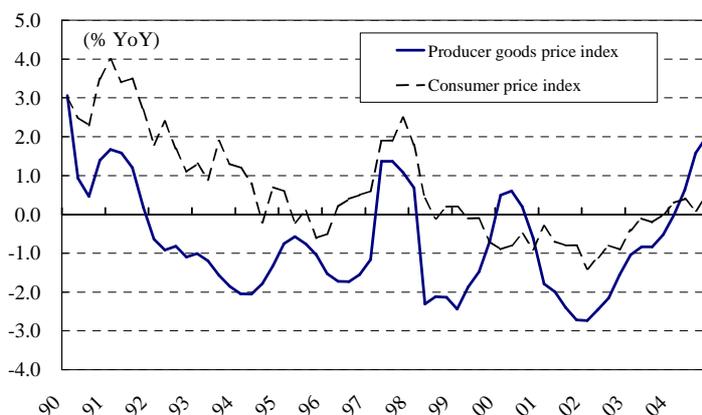
Source: Cabinet Office

When Prime Minister Jun'ichiro Koizumi took office in 2001, his administration knew that previous efforts to stimulate the economy by pumping enormous amounts of money into the system had been ineffective. Instead of mobilizing fiscal policies, the administration adopted restrictive fiscal policies and espoused the principle “no gain without reform.” The Basic Policies for Economic and Fiscal Management and Structural Reform were introduced to

reform regulatory, taxation, and social security systems, thus initiating structural reform of the economy, government finances, public administration, and society. It is highly significant that the economic recovery is taking place despite the absence of proactive, stimulative fiscal policies.

Two factors have underpinned the economy’s recovery. One is the effort of private enterprises to eliminate the so-called three excesses that have plagued many Japanese companies—overstaffing, surplus production capacity, and excessive debt. The other is the increased division of production operations throughout East Asia.

Fig 2. Producer Goods and Consumer Price Indices



Source: Statistics Bureau, Bank of Japan

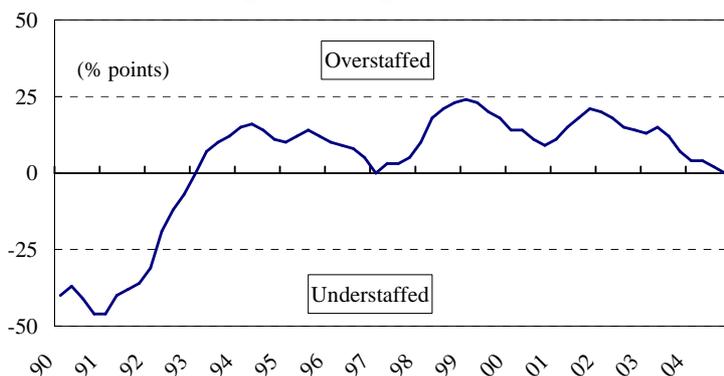
Elimination of the “Three Excesses”

The three excesses of overstaffing, surplus production capacity, and excessive debt emerged soon after the collapse of the economic bubble and proved to be a long-term hindrance to economic recovery.

According to the Bank of Japan’s regular *Tankan* business survey, the strong sense of understaffing in 1991 shifted to a strong sense of overstaffing within the space of only three years (Fig 3). Although the overstaffing sentiment declined in line with short-lived recoveries, companies generally felt they were overstaffed in the years that followed.

The perception of production capacity followed a similar trend, though the troughs and peaks were slightly larger (Fig 4). The third excess, outstanding corporate interest-bearing debt, slightly declined relative to the nominal GDP after peaking in 1993–‘95, but it remained very high compared with traditional levels (Fig 5).

Fig 3. Staffing Conditions D.I.



Note: The diffusion index of employment level sentiment is calculated by subtracting the percentage of enterprises that consider themselves understaffed from the percentage that consider themselves overstaffed.

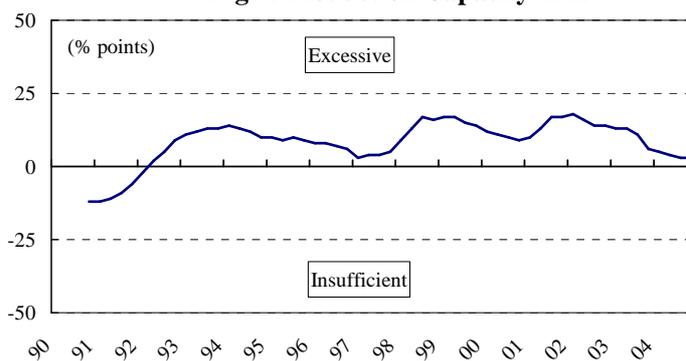
Source: Bank of Japan

Significant reductions in the three excesses began to occur in around 2002. Companies worked to reduce their labor forces, eliminate excessive capacity, and reduce their interest-bearing debt. By the end of 2004, overstaffing had almost been eliminated. Depreciation expenses finally exceeded capital investment due to the scrapping of unneeded facilities, and surplus production capacity had almost disappeared by the end of 2004. Excessive debt decreased consistently from 2000 onward and had returned to more traditional levels by 2003. There has also been a steady improvement in the nonperforming loan (NPL) problem that once affected financial institutions so badly that it shook confidence in Japan's financial system for a time. By September 2004, the NPL ratios of the major banks had fallen sharply from their peak of 8.4% to 4.7%. The government's Program for Financial Revival, announced on October 30, 2002, set the goal of halving the March 2002 NPL ratios by March 2005. It now looks as though this target will be achieved more or less.

Corporate health has improved in line with the elimination of the three excesses. Efforts to reduce costs and strengthen balance sheets have resulted in nine consecutive year-on-year increases in the quarterly operating incomes of corporations, beginning in the third quarter of 2002. According to the *Nihon Keizai Shimbun* newspaper, the number of companies posting consolidated operating income of 100 billion yen or more in fiscal 2004 is forecast to increase by 22 year on year to 60, a new record. After peaking at 92% in 1993, the break-even-point ratio (level required to show a profit) of listed companies declined to 85% by 2003. (The figure of 85% means that even if sales fall by 15%, the companies will be able to get by without showing a deficit.) Corporate earning power is higher than at any time since the bubble.

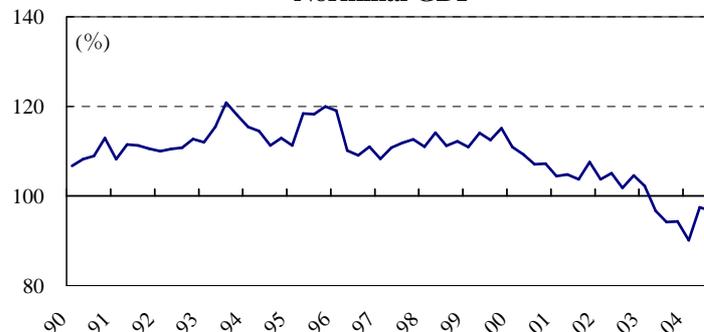
While existing companies have revived through restructuring and strategic allocation of resources, entrepreneurship has also made rapid progress. Although some major enterprises have been forced to withdraw from the market, the emergence of start-up companies in areas like information technology, distribution, and services has been remarkable. It has been pointed out that in the past 10 years or so over 1,500 companies have been listed on the over-the-counter market or the Tokyo Stock Exchange (TSE). Considering that previous TSE listings had totaled about 3,000 firms, start-up companies clearly have made a huge impact.

Fig 4. Production Capacity D.I.



Note: The diffusion index of production capacity sentiment is calculated by subtracting the percentage of enterprises that consider their capacity to be insufficient from the percentage that consider it to be excessive.
Source: Bank of Japan

Fig 5. Outstanding Interest-Bearing Debt Relative to Nominal GDP



Notes: GDP is seasonally adjusted. Fixed-base-year method for data until 1993, Chained method for data from 1994. Outstanding interest-bearing debt = discounted balance of drafts received + long-term borrowings + corporate bonds.
Source: Cabinet Office, Ministry of Finance

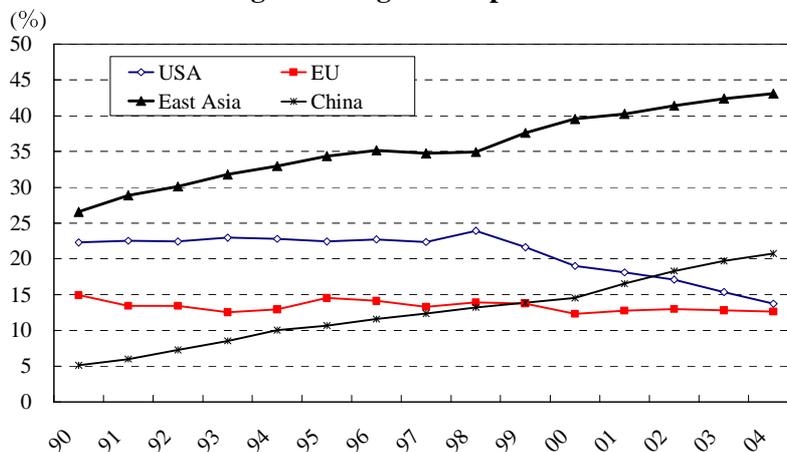
Division of Production in East Asia

The fact that Japanese companies are steadily establishing profit-generating systems by building overseas networks for optimized production and procurement activities centered on East Asia is another reason why the current recovery appears to be self-sustaining and long-lived.

Japan's economic relationships with East Asia have rapidly strengthened in the past 10 years or so. The trade relationship with China, for example, is expanding especially rapidly. The United States had been Japan's largest trading partner consistently throughout the postwar period, but in 2004 China and Hong Kong combined to overtake the United States in terms of total (two-way) trade. Imports from East Asia increased their share of total Japanese imports from 27% in 1990 to 43% in 2004 (Fig 6), while East Asia-bound exports increased their share from 30% to 47% (Fig 7).

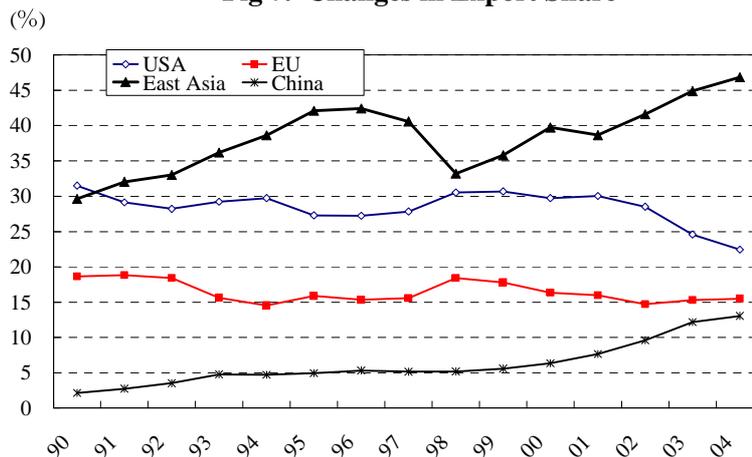
Between 1990 and 2003, cumulative Japanese investments in East Asia numbered 13,428, accounting for 34% of all overseas investments, compared with 29% between 1951 and 1989. The sharp increase in investments in China (4,713 in 1990–2003) helped to push up this share. In 1951–2003, however, Japan's cumulative 5,407 investments in China lagged far behind 13,771 total investments in the Asian newly industrialized economies (NIEs) and 10,892 investments in Indonesia, Malaysia, the Philippines, and Thailand, i.e., the "ASEAN Four." The fact that these two latter regions did not lose any importance suggests that Japanese companies are maintaining regionally balanced production networks. Exports of materials, components and production facilities grew in parallel with the establishment of production bases in East Asia through outward investment. Moreover, Japanese exports increased as a result of rapid economic growth in China and elsewhere in East Asia. At the same time, many of the products manufactured by these production facilities were exported to third countries, although some found their way back to Japan as "reverse imports." More

Fig 6. Changes in Import Share



Source: Ministry of Finance

Fig 7. Changes in Export Share



Source: Ministry of Finance

recently, sales have been increasing in the host economies of these production bases.

METI's *White Paper on International Economy and Trade 2004* provides an analysis of the electrical machinery industry, which has been responsible for a great deal of Japanese outward investment. According to the report, outward direct investment has fueled the division of Japanese production throughout East Asia. Locations are selected according to the level of desired quality, so, for example, component production and final assembly might take place in different countries. The process has been facilitated by supply chains that are linked through trade activities.

A common pattern has been for Japan to supply high-quality components, various areas of East Asia supply other components, and China handles the final assembly. Recently, however, Japan's roles and functions within this pattern have started to change. Previously, the division of production between Japan and East Asia simply meant that Japanese companies transferred production centers overseas, a process that aroused concerns about the hollowing out of Japan's industrial base. More recently, however, a more strategic allocation of resources, as well as other factors, has led some Japanese companies to strengthen domestic production of key, high-value-added components. Other companies, such as digital equipment manufacturers, are using Japan to develop new products and produce highly value-added products. Companies taking this approach believe Japan offers the following advantages as a production base:

- well-established market for end products,
- resources that enable core design functions to be conducted entirely within Japan,
- strong infrastructure for production of advanced components, and
- advanced production technologies, such as cellular manufacturing systems.

(JETRO White Paper on International Trade and Foreign Direct Investment 2004)

Japanese companies have generated increased profits by developing networks to divide up their production processes among East Asian locations. According to the *Nihon Keizai Shimbun*, overseas profits in the fiscal half-year ending in September 2004 increased by 40% year on year and accounted for 31.8% of total operating profit. East Asian operations saw operating profit grow about 30% for the third consecutive year, and now account for one-tenth of total operating profit. This has led to a new business model under which Japanese companies have increased profits by strengthening their involvement with East Asia. It is hoped that this trend will help to continue underpin the current recovery.

Expanding Inward Investment

After taking a fresh look at Japan, more Japanese companies have decided to stay home and increase their domestic activities. At the same time, an increasing number of foreign companies are investing directly in Japan. This does not signify, however, a fundamental change in Japan's long-time role as a key provider of foreign direct investment (FDI).

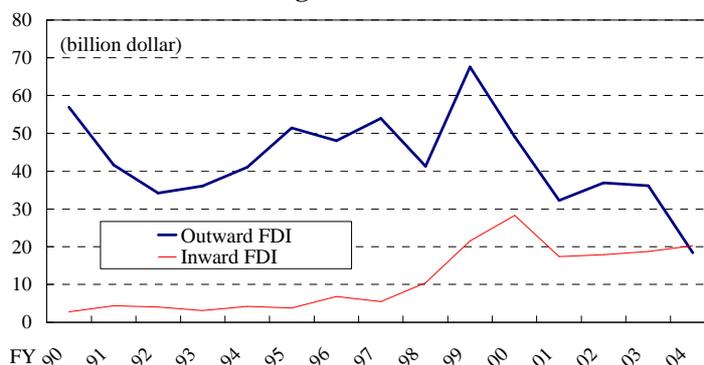
As in the case of East Asia, Japanese companies' dispersion of production around the region has basically been accomplished through a combination of outward investment and trade. As a result, outward investment has tended to be far greater than inward investment.

Nevertheless, inward investment began to increase toward the end of the 1990s and in the 2004 April–September half year it actually exceeded outward

investment for the first time in history, albeit temporarily (Fig 8). Although declining outward investment has been a major factor, inward investment itself has increased. The recovery of the Japanese economy has encouraged foreign capital in the form of investment funds and the like to take a more active approach to M&A involving Japanese companies. It is also worth noting that the increase in inward investment has run counter to the global slump in FDI. Some of this change can be attributed to the results of the Japanese government's efforts to improve the investment environment in Japan by, for example, relaxing regulations on foreign capital participation in the telecommunications and retail sectors and taking steps to reduce income taxes. In March 2003, Prime Minister Koizumi announced the Program for the Promotion of Foreign Direct Investment in Japan with a view to doubling cumulative inward FDI (6,600 billion yen in 2001) by the five-year period ending in 2006. It appears that this goal will be achieved.

Looking ahead, the ongoing introduction of high-quality foreign capital, technologies, and brainpower through inward investment will play an important role in the efforts Japan must undertake to advance its economy through more added value and continued transition toward a service economy. Japan should welcome any increase in the number of foreign companies that decide to invest in Japan following its long-term recession, and in fact will continue to reinforce efforts to attract direct investment. This, combined with the strategic division of production operations, should help to ensure the long-term health of the Japanese economy.

Fig 8. Japan's Inward and Outward Foreign Direct Investment



Note: 2004 figures are for April–September.
Sources: Ministry of Finance and Bank of Japan

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