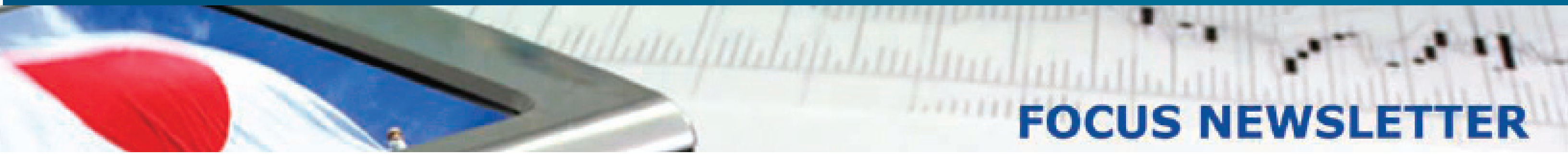

Japanese Fundamentals Drive Adoption of New Industrial Structure Vision

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Since the collapse of Japan's bubble economy in 1990, the country has delivered sluggish economic performance despite holding a significant technological advantage over many competitors. To restore its national dynamism, major reform efforts have been initiated. While substantial progress has been achieved, Japan remains embroiled in a severe deflationary situation with important structural consequences.

Dissatisfaction with the existing system led Japanese voters to award power to the Democratic Party of Japan (**DPJ**) last September -- after 50 years of Liberal Democratic Party (**LDP**) rule. Promising a new approach, Japan's incoming administration commissioned a Special Task Force, which released "The Industrial Structure Vision 2010" last May. It was adopted by the Japanese Cabinet as the basis for a New Growth Strategy on June 18, 2010.

The Vision objectively recognizes the very serious problems and issues that currently impinge on the performance of Japanese industry and its domestic economy. It establishes long-term goals, strategic areas of focus, as well as policy recommendations, milestones and timelines. These measures are designed to strengthen Japan's ability to develop more globally-orientated firms and to provide a more hospitable, open and attractive business environment.

Industrial Structure Vision Takes into Account Severity of Current Situation

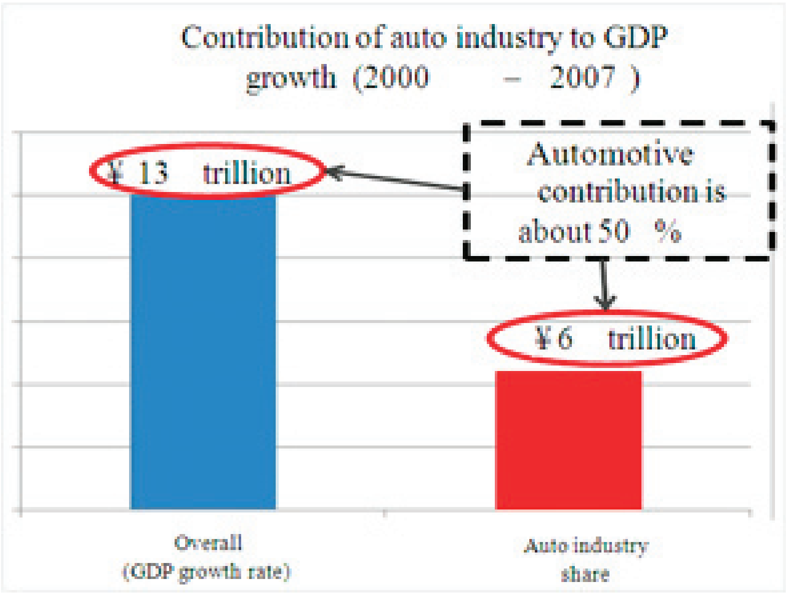
Former Minister of Economy, Trade and Industry Masayuki Naoshima highlighted the need to devise a comprehensive plan in a recent address which urged Japan to "shake off the sense of stagnation among the people". Recognizing honest assessment is essential to revive Japan's economy and to restore the confidence of its society, the Vision begins with the introspective analysis needed to define the core problems that constrain its economic viability.

Chief Japan Strategist Naoki Kamiyama further examined these thoughts in a recent Deutsche Bank report stating "If there is such a thing as Japanese-style capitalism, it cannot mean simply maintaining the status quo. Japanese companies must analyze Japan's strengths and capitalize on them amidst the nation's shrinking and graying population and globalization."

The Vision is therefore based on an understanding that Japan's industrial structure, its corporate business model, and business infrastructure are all highly interconnected. This makes it essential to formulate a comprehensive plan that employs a system-wide approach.

Problem Areas of Japan's Industrial Structure

Postwar Japan has relied heavily on its automobile industry for both domestic and export consumption. As a result, almost 50% of Japan's GDP growth from 2000-2007 can be attributed to the automotive industry. Although Japan's success in the automotive sector was a major factor in its development as a global economic power, and continues to represent a source of competitive strength, this overdependence is no longer sufficient to sustain growth in a complex, mature economy that requires a broader base.



Source: Japanese Ministry of Economy, Trade and Industry

This year's Toyota recall, for example, demonstrates the effect that significant problems in one sector can have on secondary and tertiary industries. As Patrick Cronin of *Foreign Policy* magazine explains, "Toyota's crisis serves to further highlight the fragility of Japan's current position: If your soft power dissipates, it leaves you feeling very vulnerable indeed." Incidents like these underscore the vulnerability of the country's economic status within an industrial structure that remains overly focused on one industry.

The Vision also highlights problems related to domestic competition. In comparison to overseas rivals, Japanese companies face significantly more competitors in their economy and therefore in the words of the vision are "exposed to the preliminary round of the war of attrition in Japan."

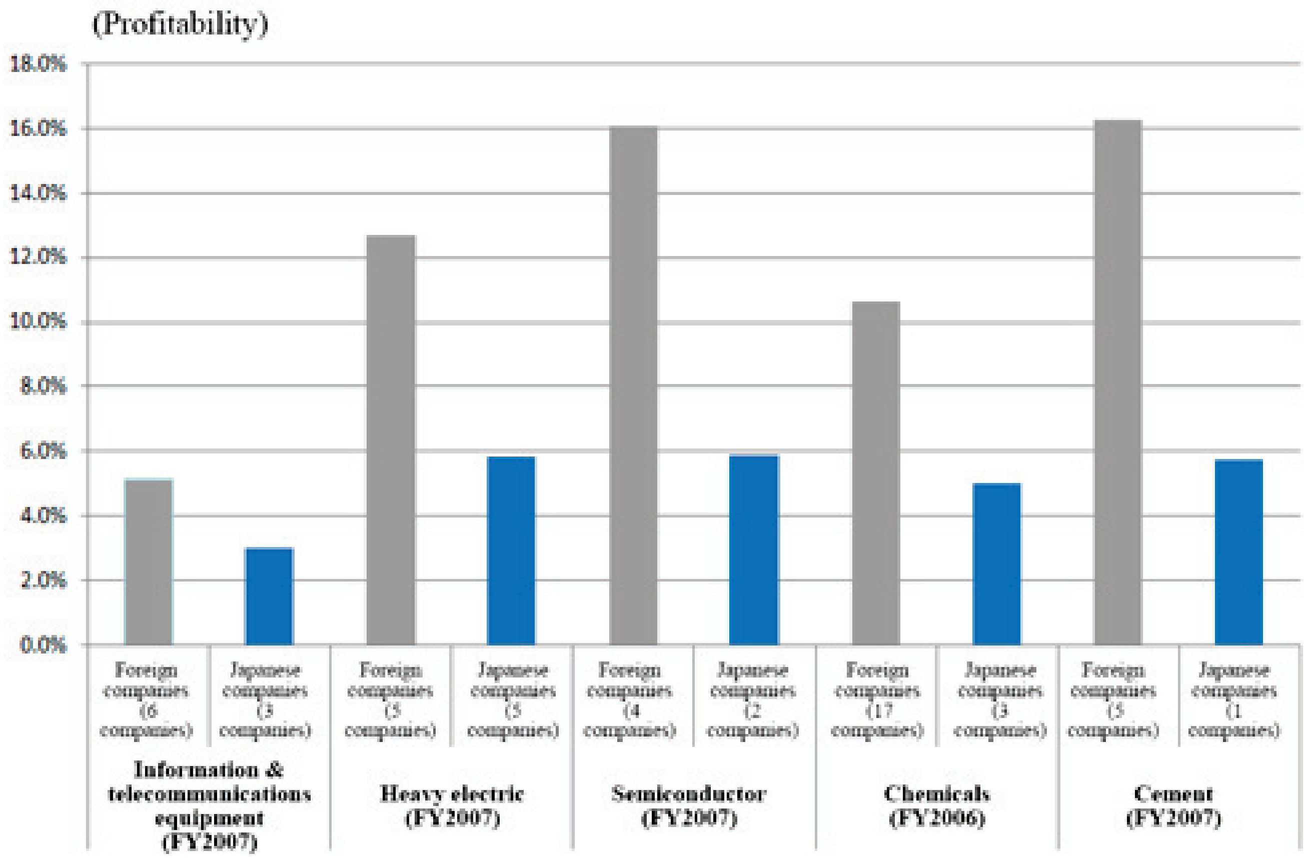
Outline of main players in each industry

	Japan	North America	Europe	Asia & others
LCD TVs	Sony; Sharp; Toshiba; Panasonic; Funai Electric	Vizio (U.S.)	Philips (Netherlands)	Samsung (ROK), LGE (ROK), TCL (China)
Railways	Nippon Sharyo; Hitachi, Kawasaki Heavy Industries; Tokyu car corp.; Kinki Sharyo	Bombardier (Canada)	ALSTOM (France), Siemens (Germany)	Hyundai Rotem (ROK)
Nuclear Power	Toshiba (WH), Hitachi, Mitsubishi Heavy Industries	GE (U.S.)	AREVA (France)	Doosan Heavy Industries & Construction (ROK)
Water business (Drinking water & sewerage)	oray; Metawater; Ebara; Kubota, others *The number of leading companies is 16 in equipment, 9 in plant construction, and 3 in operation and maintenance management.	GE (U.S.), Nalco (U.S.)	Veolia (Europe); Siemens (Germany), Suez (France)	Thames Water (Australia)
Diagnostic imaging equipment	Toshiba Medical systems, Hitachi Medical, Shimadzu; ALOKA	GE (U.S.)	Philips (France)	?

Source: prepared by METI on the basis of assorted materials

As long as its domestic market possesses an excessive number of competitors in the same industry, Japanese firms will lack the scale and profitability levels of foreign counterparts. This adversely impacts their ability to compete overseas and leads to a negative feedback cycle of lowered lower investment, integration, expectations and overall competitiveness.

Comparion of profitability (5 categories of industry)



Source: Japanese Ministry of Economy, Trade and Industry

Flaws in Japan's Corporate Business Model Discourages Globalization

Given their diminished ability to compete overseas, Japanese firms try to compensate by focusing on their domestic market. This means they miss opportunities in global markets. In particular, Japanese firms have been slow to expand into the emerging and developing regions that will increasingly drive global trade and investment moving forward.

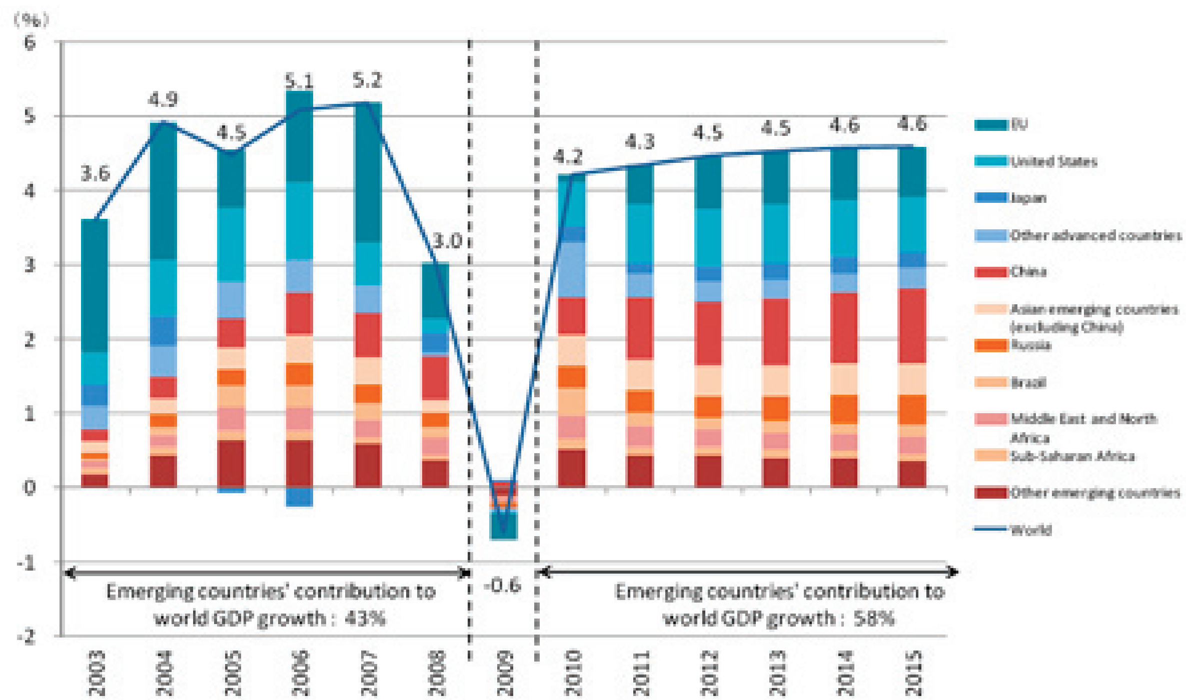
Nevertheless, even with this hesitancy, one can see movement toward greater activity in the emerging markets firmly in place. Over the last ten years there has been a dramatic shift in the composition of Japanese exports. Whereas in 2000 the US comprised about 30% and China 10% of Japanese exports, today the US constitutes less than 15% and China has risen to about 25%.

Growth rates in emerging Asia are forecasted to remain strong for some time, and geographic proximity and a continuing technological edge provide Japanese firms with an especially attractive opportunity to expand their competitiveness and global market share. Without concerted engagement, however, they will not benefit to the extent warranted by their capacity and potential, even in areas where they extremely competitive. This includes infrastructure, cultural exports, industrial machinery and a wide range of advanced technologies.

Shares of Major Countries/Regions in the World's Nominal GDP				
		2005	2009 (partly estimated)	2015 (estimated)
EU		30.3%	28.4%	23.8%
United States		27.8%	24.6%	22.3%
Japan		10.0%	8.7%	7.6%
Emerging Countries		23.7%	30.9%	38.8%
	China	4.9%	8.5%	11.5%
	Other Asian Countries	3.9%	5.0%	6.3%
	Brazil	1.9%	2.7%	3.2%
	Russia	1.7%	2.1%	3.7%

Note: Converted into real GDP based on Year 2000.
Source: IMF "World Economic Outlook, April 2010."

Asia and other emerging countries will lead world's economic growth in the years ahead.



Source : Compiled from IMF "World Economic Outlook," April 2010

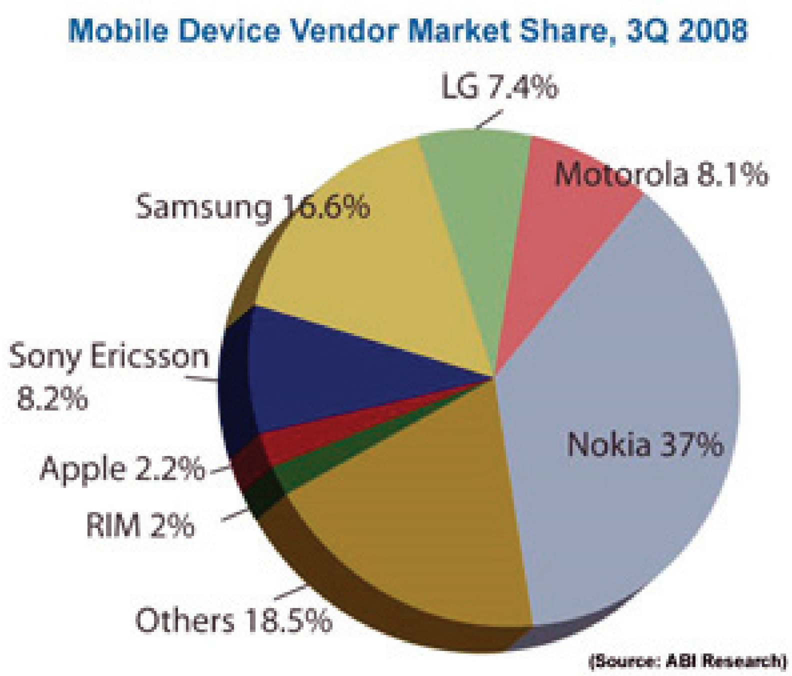
The positive effect of an increased focus on emerging markets can be seen in the performance of Panasonic. The *Economist* reports that in the most recent quarter emerging market sales helped the firm post a profit of 84 billion yen as opposed to a 52 billion loss the prior year. This same coverage reported that Toyota has designed a car named Etios for India, which will sell for $10,000 and Nissan builds a car named Match in India and Thailand with 87% of the parts sourced locally. Shiseido, Japan's largest cosmetics maker has also doubled its sales in China over the last five years and is now entering Mongolia and the Balkans. It has also opened a factory in Vietnam and plans to have 50% of its revenues coming from overseas markets by 2017 – up from 40% today.

The Galapagos Effect - How Japan Wins in Technology, but not in Business

Observers of Japan have widely acknowledged the nation is an island where highly advanced technology has often evolved to meet very specific domestic applications. Embracing the "uniqueness" of Japanese society, many of the resulting products have limited appeal in foreign markets. This paradoxical phenomenon has been termed "The Galapagos Effect". It describes Japan's evolution as a technological leader as well as its inability to globalize demand due to the "unique" and isolated nature of its market.

A good example of this phenomenon is Japan's mobile phone industry. As explained in the *New York Times*, "[Japan's] cell phones set the pace in almost every industry innovation: e-mail capabilities in 1999, camera phones in 2000, third-generation networks in 2001, full music downloads in 2002, electronic payments in 2004 and digital TV in 2005".

However, because these products were produced before infrastructure was fully available and insufficient attention was devoted to developing, or coordinating with, international standards, Japanese manufacturers such as NEC, Panasonic, and Toshiba turned to domestic demand to drive innovation. As a result, the Galapagos Effect has bound many Japanese firms to a negatively reinforcing cycle. This causes producers to become ever more reliant on domestic consumption, as they tailor business strategies and product design with little regard to the preferences of global consumers.

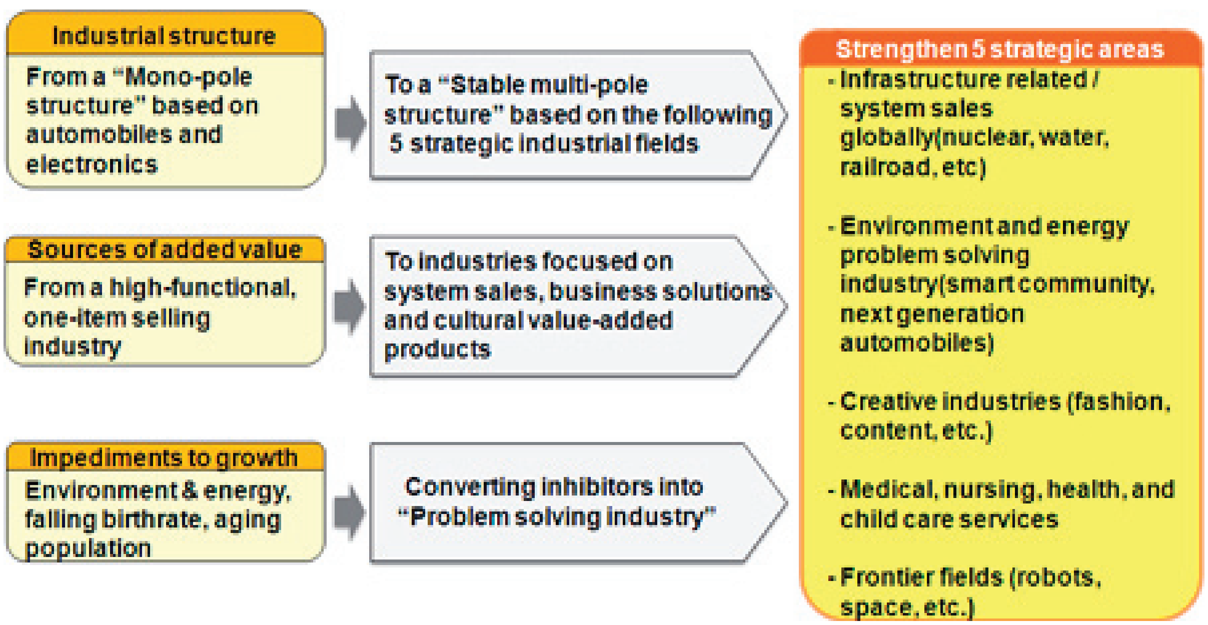


While this may prove a viable approach in the short term, it is hardly sustainable as foreign competitors, such as Motorola, Nokia and Samsung develop the scale and competitiveness needed to establish dominant global market share. As journalist Michael Zielenziger succinctly stated "this is an object lesson in the benefits of free trade. If you learn to compete globally, you can also succeed locally. But as long as you believe you are "unique" and "different," and choose not to commune with others, the lack of integration will someday come back to bite you."

Enhancing Competitiveness through New Drivers of Growth & Employment

As suggested in a Harvard Business School research study, Japan will have to initiate significant institutional change to harness its technological advantages to become more globally competitive. The report notes "Japan has to adopt legislation in several areas in order to address these inefficiencies and capitalize on its innovation: strengthening antitrust and intellectual property rights enforcement; improving the legal infrastructure; lowering barriers to entry for foreign investment and facilitating the development of the venture capital sector."

Aims of the Industrial Structure Vision



Source: Japanese Ministry of Economy, Trade and Industry

The Vision aims to rectify this imbalance through four shifts in government and corporate practices:

- **Industrial Structure**: Take Advantage of Technological Superiority;
- **Corporate Business Models**: Incorporate More Globally Accepted Standards;
- **Globalization**: Increase Openness to Improve Investment and Job Creation; and
- **Role of Government**: Create Partnerships Between Public and Private Sectors.

These shifts will enhance the competitive strength of Japanese firms and help them to become more effective global competitors in growth areas including:

Five Strategic Areas to Enhance Japan's Industrial Competitiveness

Area:	Examples:
Infrastructure-Related Systems	Nuclear Power, Water, High-speed Rail, etc.
Environment and Energy	Next-Generation Vehicles, Green Technology, etc.
Creative and Cultural Exports	Fashion, Design, Food, Media Content, etc.
Medical and Healthcare	Pharmaceuticals, Biotechnology, Natural Products, etc.
Frontier Fields	Robotics, Nanotechnology, Space, etc.

Improving Competitiveness through Changes in Industrial Structure

The first shift called for within the Vision is a change from an industrial structure that is heavily reliant on the automobile industry to one that has a more stable, diversified structure based on the five strategic areas highlighted above.

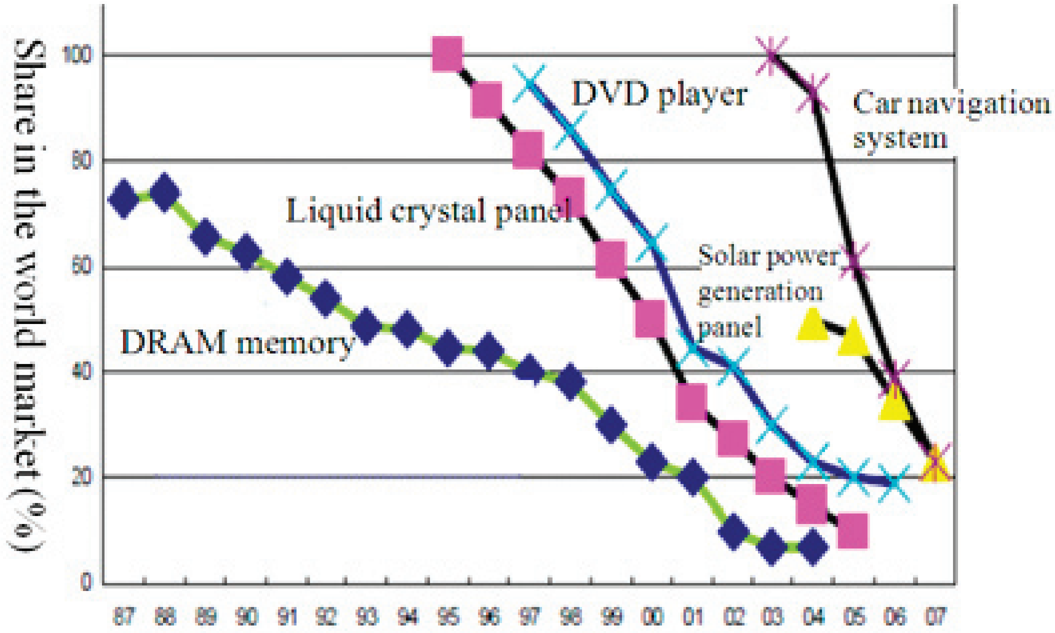
As part of this change, Japanese firms will need to better apply cultural value models in areas where they have traditionally excelled within a more global context. These include the provision of high quality and movement toward "system sales". Japan can also improve its global economic standing by attracting more foreign input, and adopting a more global approach to staffing, business and marketing practices.

Japan also seeks to transform growth constraints such as environmental concerns, lack of access to energy, falling birthrates and an aging population into "problem solving industries" derived from the solutions. This would promote leadership and innovation in sectors such as environmental engineering, alternative energy, other green technologies, and healthcare, which could be adapted for use in foreign markets.

Reorienting Business Mindset to Align with Global Trends

The second shift seeks to improve the ability of Japanese firms to combine their technological strength with global business and infrastructure standards. As indicated below, Japanese firms have held a commanding lead in many commercial technologies at the initial phases of marketing and development, which dissipates as foreign competitors demonstrate a greater capacity to design and sell products that meet the needs of global consumers.

Japanese Market Share in Select Emerging Technologies



Source: Japanese Ministry of Economy, Trade and Industry

The Vision therefore supports a shift toward more open policies and standards. This will make Japanese products compatible, and more responsive to the needs of global consumers. Japan hopes to encourage this transformation through programs such as the Trade Tie-Up Promotion Program (TTPP). As the Economist Intelligence Unit explains, this initiative is "designed to identify local partners meeting the profiles of prospective foreign ventures in Japan. The system now covers import and export, technology transfer, investment, business tie-ups, establishment of offices and factories, and business support".

Working with Globalization Rather than Against It

The third shift recognizes that as production centers are transferred out of Japan, the nation can only retain its competitiveness by making the country more attractive as a business destination.

Evaluation of stronghold functions by foreign companies
(Japan's location competitiveness)

FY2007

	Japan	China	India	Singapore
Integrated base in Asia	1st			
Manufacturing base		1st	2nd	
R&D base	1st	2nd		
Back office	2nd	1st	2nd	
Distribution center		1st		

FY2009

	Japan	China	India	Singapore
Integrated base in Asia		1st		2nd
Manufacturing base		1st	2nd	
R&D base	2nd	1st		
Back office		1st	2nd	
Distribution center		1st		2nd

Source: Survey on Attitudes of Foreign-Affiliated Companies toward Direct Investment in Japan
(Ministry of Economy, Trade and Industry, FY2009, FY2007)

Corporate tax reductions to international levels are one of the measures that will be introduced to encourage growth and investment and make Japan a more attractive place to form businesses and employ a workforce.

Corporate Tax Rate			Actual Corporate Tax Burden (2006-8 Average)			
	2000	2009	Sharp	38%	Canon	38%
OECD	34%	26%	Samsung	15.7%	LG	19.2%
Asia*	28%	25%				
Japan	42%	41%				
* Korea, Taiwan, Hong Kong, Thailand, Malaysia, Indonesia, Philippines						

Source: Japanese Ministry of Economy, Trade and Industry

Improved transparency and streamlined legislation and procedures for mergers and acquisitions will also facilitate corporate activity. Additionally, improvements in logistics infrastructure such as the creation of Special Economic Zones, the transformation of Haneda Airport into a 24-hour a day international operation, the pursuit of open sky policies and efforts to increase tourism to Japan from 7 to 25 million visitors will all help to make Japan a more vibrant and competitive international business destination.

Emphasizing the importance of developing Asia, the Vision builds on existing efforts to promote regional economic integration. Japan is already improving relations with countries such as Vietnam. According to the *Japan Times*, it has developed plans for a "Mekong-Japan Economic and Industrial Cooperation Initiative, a framework agreed on at the first Japan-Mekong summit last November". This framework is expected to "help Japan export its expertise in infrastructure development to the Mekong sub-region while opening business opportunities for Japanese companies. It is also expected to give a big boost to the region's economic development."

Facilitating Growth Through Private-Public Partnerships

The final shift seeks to change the role of government through greater use of public-private partnerships. This includes the formation of consortiums, financial institutions with enhanced functions, and new research and development centers jointly established by industry, academia, and government.

For example, the Innovation Network Corporation of Japan (**INCJ**) was recently launched to help Japanese firms "win in business as well as technology". The INCJ aims to support improvement of "open innovation," by facilitating the flow of technology and expertise beyond existing organizational structures.

This partnership enhances Japan's ability to achieve global growth through targeted investment and the sharing of expertise between state institutions and the private sector. It consists of an investment fund utilizing 90.5 trillion yen in capital from government as well as industry. These funds will promote growth in sectors such as health care and green technology -- where Japan has a technological advantage -- but has yet to find success in global markets. For example, Brightnews, a Japanese Private Equity News Journal reports the INCJ's investment in an electronic components unit spin-off from Alps Electric Company can be applied to advanced projects such as electric cars and smart grids.

In another instance, the Ministry of Economy, Trade and Industry (METI) has established a public-private forum called the "Smart Grid Promotion Council". This will help to formulate a roadmap to standardize smart grid technology. Other efforts will help to strengthen Japan's support system, technology development, overseas' operations, and information exchanges and partnerships with the United States, Europe and China.

Realizing Growth and Employment Targets

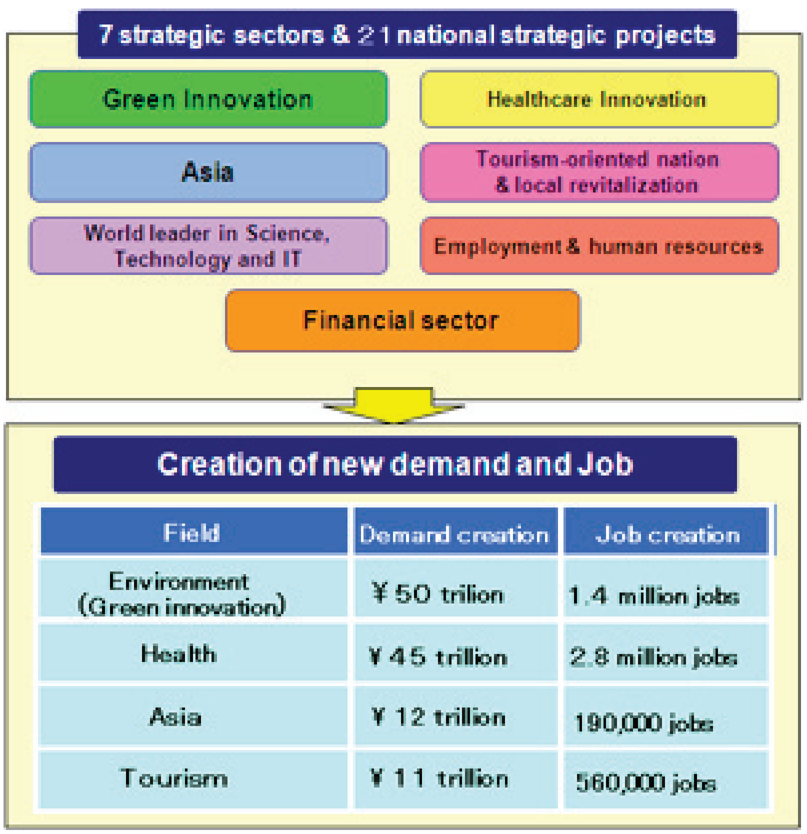
Over the past decade, real growth in Japan registered at a sluggish 1%. Improvements proposed within the Vision are expected to double this growth over the next ten years. The Vision also seeks to address the problem of deflation, recognizing that over the past twenty years, consumer prices have remained stagnant. By FY2011, it seeks to return Japan to positive increases. Finally, the unemployment rate, which has been averaging over 5% for the past two decades, will be targeted at a 3-4% range.

Identifying targets and the measures needed to attain them is a sign indicating Japan understands its underlying problems. Through adoption of the Vision and new Growth Strategy, the Japanese government has committed itself to the process needed to overcome a range of structural constraints.

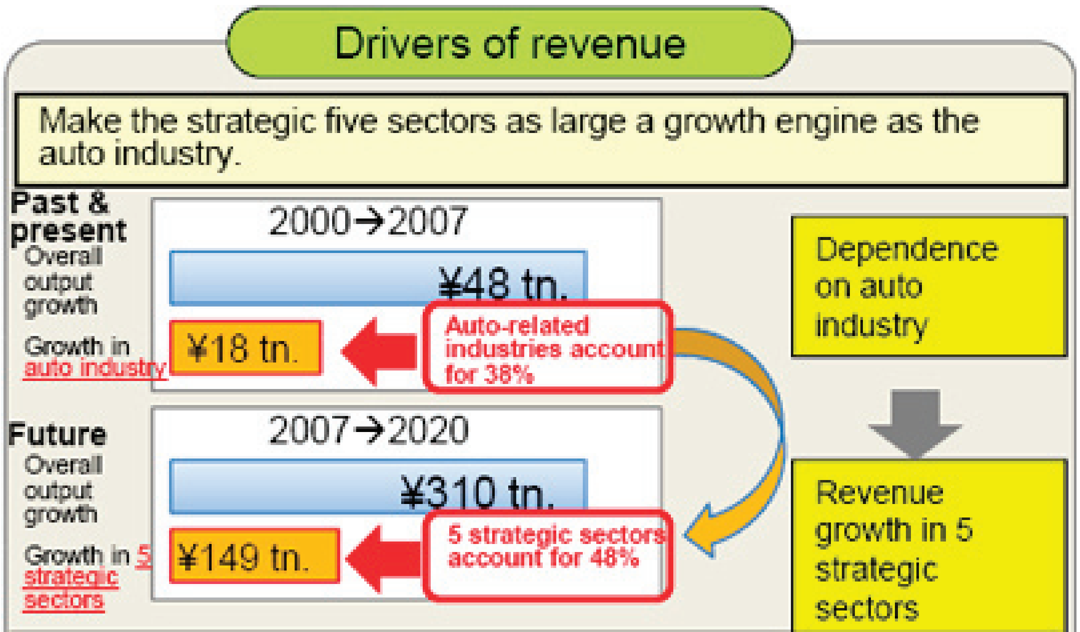
This includes development of a timetable strategy that includes tangible milestones and targets using a PDCA (Plan, Do, Check, Act) implementation model. Second, more prudent fiscal management will allow a comprehensive review of expenditure priorities, introducing budget reallocations and efficiencies.

Enhancing Japan as an International Financial Market and Business Center

Through this combined effort of initiating structural reform with more prudent public finance Japan hopes to generate more investment and business activity and to realize revenue gains, higher employment and a more diversified, balanced economy.



Field	Demand creation	Job creation
Environment (Green innovation)	¥50 trilion	1.4 million jobs
Health	¥45 trillion	2.8 million jobs
Asia	¥12 trillion	190,000 jobs
Tourism	¥11 trillion	560,000 jobs



Output (market size)	2020	Change from 2007
Strategic 5 sectors	¥179.3 tn.	+¥83.2 tn.
Infrastructure-related /system export (nuclear energy, water, rail, etc.)	¥13.4 tn. (¥19.7 tn. when including overseas output)	+¥12.3 tn. (+¥18.2 tn. when including overseas output) (*1)
Environment and energy problem-solving industry (smart grid, next-generation vehicles, etc.)	¥30.6 tn.	+¥23.7 tn (*2, 3)
Medical-, nursing-, health-, and child-care services	¥30.5 tn.	+¥12.9 tn. (*4)
Cultural industries (fashion, content, food, tourism, etc.)	¥56.6 tn.	+¥6.9 tn.
Frontier fields (robots, space, etc.)	¥48.2 tn.	+¥27.4 tn.
Above sectors' ripple effect on other sectors		¥65.8 tn.
	Total	+¥149.0 tn.

Source: Japanese Ministry of Economy, Trade and Industry

Enhancing Japan's position as an international financial market and as a place to base business activity will also improve Japan's overall economic well-being and its ability to compete in global markets.

Creating Constituencies that Benefit From Change and Reform

Japan's old model was highly successful and allowed it to develop into an industrial powerhouse and the world's second largest economy. Naturally, this created interests that benefitted from this system and created resistance to the changes needed to address the structural deficiencies that arose over time.

Specifically, fifty years of rule under Japan's LPD has created resistance to changes in the status quo. Therefore, it should not be surprising that last September's election of the DPJ contributed to expectations that are now being tested as new approaches and coalitions are being formed to lead Japan forward.

As in any democracy, however, success will be dependent on developing constituencies that benefit from forward movement in the areas identified by the Vision and therefore have confidence in the gains that can be achieved through these adjustments.

Political Climate Indicates Challenges & Benefits of Progressive Thinking

Recent developments concerning Japan's political climate are worth noting given their potential effect on implementation of the Vision and New Growth Strategy. As Arthur Mitchell, Chair of the Government Relations Committee of the American Chamber of Commerce in Japan stated, "The DPJ came in with a new approach but they were new and inexperienced and did not implement well."

The inability of the DPJ to quickly deliver on its campaign promises led to the downfall of former Prime Minister Hatoyama and poor performance in the Upper House of Councilors election last July. Although this presents a challenge to implementing the reforms advocated in the Vision and New Growth Strategy, it does indicate the sensitive nature of political economy and the necessity to act in a comprehensive manner.

On a positive note, there are indications the public supports the Prime Minister Kan and understands the challenge. As the Economist Intelligence Unit explains in its most recent country report on Japan, "recent opinion polls found that 80% of the electorate thinks that he deserves time to prove himself as leader of the DPJ and the country."

A further endorsement of Prime Minister Kan was seen in his ability to overcome a strong challenge during this month's election for the DPJ Presidency. In the word's of analyst Tobias Harris "Having successfully fended off Ozawa Ichirō's challenge to his leadership of the ruling Democratic Party of Japan — indeed, having defeated Ozawa by an unexpectedly large margin, not only winning the vote among Diet members but also receiving the support of 249 of 300 district-level party chapters and sixty percent of the vote among local representatives — Prime Minister Kan Naoto finally has an opportunity to govern."

Additionally, while it is true that different parties and factions in Japan have different agendas and interests, it is important to understand that all serious participants in the political process recognize the need for change. Therefore, while there are disagreements in respect to the scale and pace of reform as well as some of the steps that must be taken, there is basic agreement on the path forward.

Japan’s Transition has Important Consequences for the Foreign Investor

While it would be nice if this transition were seamless, “give and take” adjustment is an unavoidable and essential part of the political and economic process. This is particularly true within a major transformation, such as the one now taking place in Japan. It should therefore be recognized the DPJ is exploring new ground and will require time both to adjust to being the party in power and to translate their campaign promises into sustainable change.

At the same time, for the reasons highlighted above, Japan does not have time to wait out this process and for this reason the Prime Minister’s strong showing in this month’s election should be seen as a strong positive indicator that the nation is starting to generate the political will needed to initiate these important reforms.

Rebound from two decades of sluggish growth will in any case not be easy, though the analysis and changes proposed in the Vision both recognize the challenges as well as the changes that need to be realized. Debate over these proposals and development of consensus and constituencies who support the provisions that have been outlined can only help to move this forward.

Japan’s success in implementing these measures will have real impact and implications -- in its domestic economy as well as other business and financial markets around the world. Foreign corporate and portfolio investors are advised to closely monitor Japan’s progress so that they will be positioned to take advantage of the opportunities that result.

Data, statistics and the reference materials presented within this newsletter have been compiled by JETRO from publicly-released media and research accounts. Although these statements are believed to be reliable, JETRO does not guarantee their accuracy, and any such information should be checked independently by the reader before they are used to make any business or investment decision.

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