

JAPAN ECONOMIC CURRENTS

A COMMENTARY ON ECONOMIC AND BUSINESS TRENDS

Looking at China: A Japanese Business Perspective

by Tadashi Hayashi, Keizai Koho Center

China's nominal GDP has averaged an astonishing growth rate of more than 9 percent since 1978 when its government adopted a new line of reform and market-opening. As shown in Figure 1, the Chinese economy quintupled in the past 24 years – no other country has boasted such fast growth for such a sustained period.

China's share of the global economy ranks sixth today, roughly the same size as the UK and France, as shown in Figure 2. And by all accounts, it is expected to keep growing fast—by at least 7 percent annually for the next 10 years. If the Chinese government achieves its goal of quadrupling its GDP by 2020, the size of China's economy will rival Japan's.

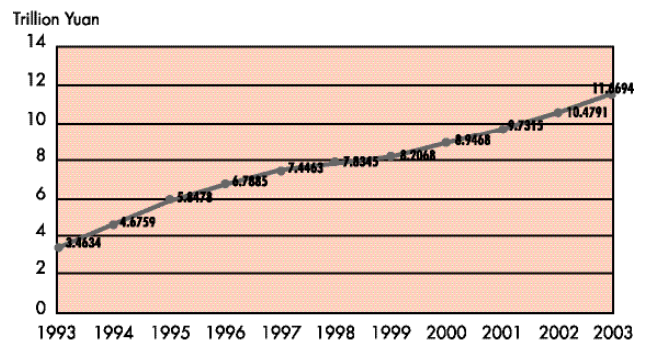
With China being nearly as important a trading partner as the United States, Japanese companies naturally see China as a highly attractive market. Japan-China interdependence has deepened in line with China's rapid economic growth. Indeed, China is already Japan's number one trading partner (Figure 3).

Thanks in large part to the rise in Japanese exports to China of late, Japan's economy has been steadily recovering. As shown in Figure 4, about one-third of Japan's growth in 2003 was due to exports to China, compared to just 2.1 percent of Japan's total exports in 1990. Japan's overall exports grew 4.7 percent in 2003, even though exports to the United States fell by 9.8 percent because of a US economic slowdown. Increased exports to China rose an offsetting 33.3 percent.

Not so very long ago, Japan had a large bilateral trade deficit with China, and some Japanese

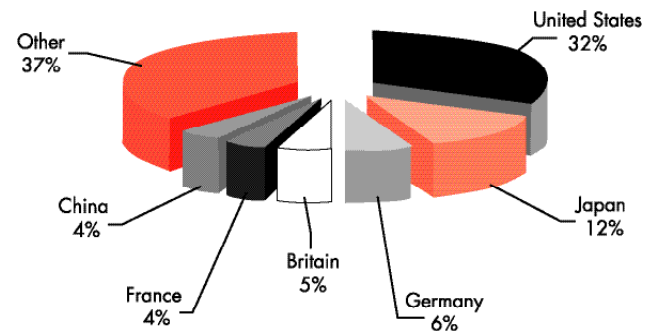
1 CHINA'S NOMINAL GDP

SOURCE: CHINESE GOV'T STATISTICS



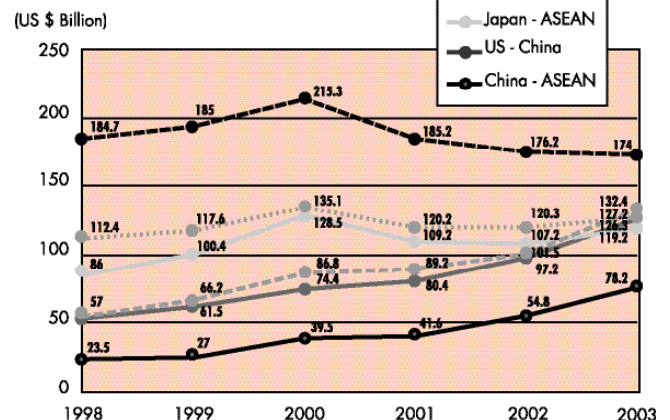
2 SHARE OF GLOBAL GDP, 2002

SOURCE: WORLD BANK



3 TRENDS IN BILATERAL TRADE

SOURCE: JETRO; CHINESE GOV'T.; US GOV'T.



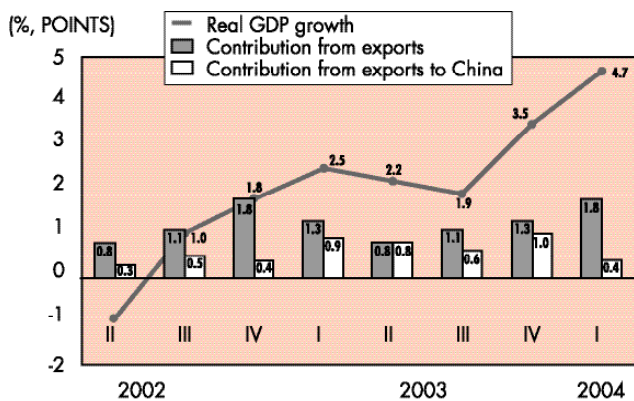
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4 ECONOMIC CONTRIBUTION OF JAPANESE EXPORTS TO CHINA

SOURCE: CABINET OFFICE; MINISTRY OF FINANCE. COMPILED BY ZHU YAN, FUJITSU RESEARCH INSTITUTE.



people regarded China as a threat. But today, sharp contrast, according to Chinese statistics, Japan actually has a surplus in trade with China. Accordingly, an evolving view taking hold in Japan is that China's economic development creates opportunities for Japanese companies.

Investment in China by Japanese companies is growing steadily. China is now the number-three investment target for Japan while Japan is now China's number-three source of investment, following Hong Kong and the Virgin Islands.

It is especially interesting to look at the number of investments. As shown in Figure 5, of the new subsidiaries set up overseas by Japanese companies last year, 302 were established in China, compared to just 62 in the United States (though the value of Japanese investments in the US is much higher).

Also notable is the number of employees working for Japanese subsidiaries overseas – some 830,000 of them are based in China, compared to 600,000 employees at Japanese subsidiaries in the United States.

Mutual Interdependence

The results of a *Nihon Keizai Shimbun* survey of businesspeople in Japan and China (Figure 6) shows that more than 40 percent of Japanese respondents believe that China's GDP will rival or exceed Japan's by 2020. Figure 7, drawn from the same survey, provides respondents' answers to the question, "With which country or region should Japan develop better ties?" Fully 43 percent of respondents picked China, much larger than the 21 percent who named ASEAN and the 19 percent who said the United States.

5 JAPANESE FOREIGN DIRECT INVESTMENT: SITES OF NEW SUBSIDIARIES, 2003

SOURCE: TOYO KEIZAI INC.

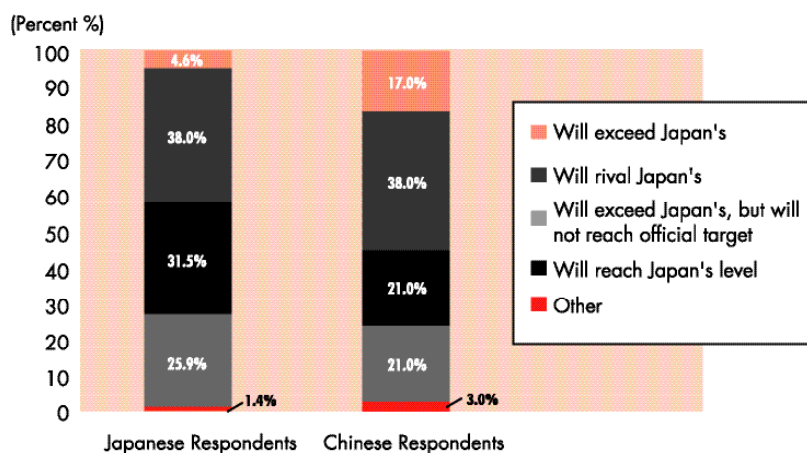
RANK	COUNTRY	NEW SUBSIDIARIES
1	China	302
2	United States	62
3	Thailand	36
4	South Korea	22
5	Hong Kong	19
6	Germany	14
7	Indonesia	13
8	Taiwan	12
9	Britain	11
10	Vietnam	10

Starting in the 1980s, Japanese companies invested in China mainly to set up export production plants. Export production is still important, but now Japanese companies are also focusing on increasing their domestic sales in China – in 1994, local sales constituted 32 percent of their total sales, but jumped to 58 percent in 2000. The share is undoubtedly higher today. A JETRO study found that most Japanese companies rank China top in their most important sales market (Figure 8) and an important market for development (Figure 9).

In this context, a survey by the Japan-China Investment Promotion Organization provides some interesting information about the profits made by Japanese companies in China, measured as the ratio of ordinary income to sales. As shown in Figure 10 "Under 0%" indicates the company suffered a loss while

6 OUTLOOK FOR CHINA'S GDP IN 2020 (SURVEYS IN JAPAN AND CHINA)

SOURCE: NIHON KEIZAI SHIMBUN.



“Above 6%” means that it was very profitable.

The companies have been divided into two types: export-oriented and local-sales-oriented. As shown on the left, 29.1 percent of the export-oriented firms suffered losses in 1998, and the share for local-sales-oriented firms was 37.1 percent. Just three years later, in 2001, only 18.3 percent of export-oriented firms had losses while the number for the local-oriented firms fell even further, to 17.5 percent.

Of the companies with large profit ratios (i.e. “Above 6%”), more than one-third of local-oriented firms had big profits in 1998, compared to about one-quarter of export-oriented firms. And in 2001, almost half of the local-oriented firms enjoyed sizeable profits, compared to about one-third of exporters. As survey results like

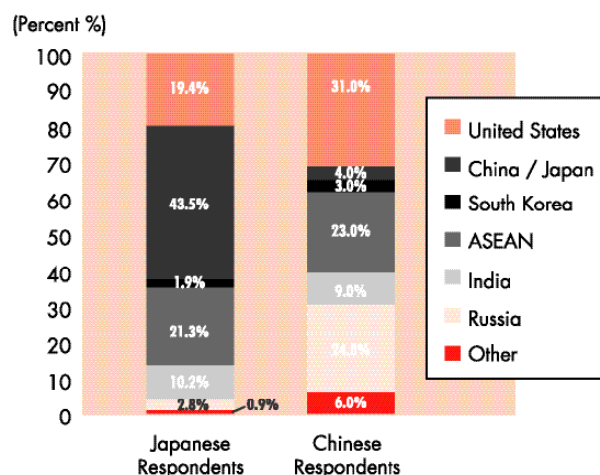
these indicate, China is becoming a profitable market for Japanese companies.

Consumer demand in China is stronger than in Japan. As Figure II shows, private-sector consumption has recently been growing by less than 2 percent annually in Japan, but above 8 percent in China. Booming consumer demand is largely driven by China’s middle class (the 50 million or so with an annual income of 50,000 yuan), who can afford both a car and home. There are also many affluent people with annual incomes exceeding 100,000 yuan. In Shanghai, for example, there are over one million upper-income residents, some 7 percent of the population.

According to a survey of Japanese subsidiaries in China, localized management is absolutely

7 WHICH COUNTERPART SHOULD WE DEVELOP STRONGER TIES WITH? (SURVEYS IN JAPAN AND CHINA)

SOURCE: NIHON KEIZAI SHIMBUN.



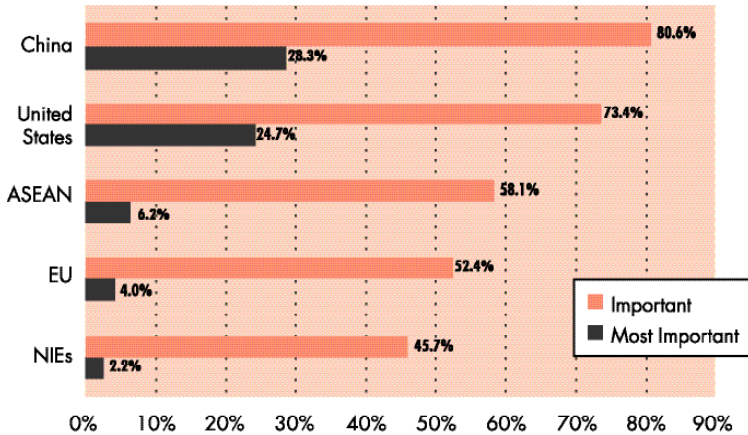
necessary. To succeed, four elements are needed: First, respondents said, is the need to improve marketing in order to increase local sales because the demands of Chinese consumers are constantly changing. To track these changes and respond with effective marketing, companies need input from local employees and quick decisions from local managers.

The second need is to cut production costs by procuring parts and materials locally. Many companies feel that they must expand the share of local inputs in order to manage the intense price competition in the Chinese market. Alternatively they must help local companies improve and build an efficient supply chain by providing them with technological support.

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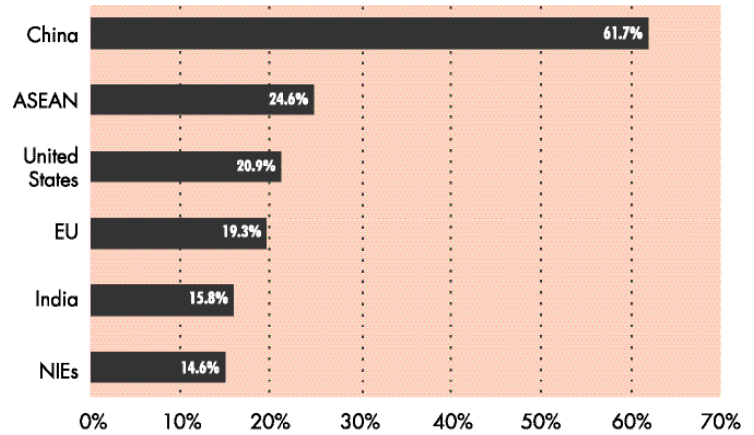
8 MOST IMPORTANT SALES MARKETS

SOURCE: JETRO



9 MARKETS FOR FUTURE DEVELOPMENT

SOURCE: JETRO



For this purpose, Japanese companies clearly need local managers who are familiar with Chinese business conditions and who can communicate well with other local business people.

Number three is to secure talented and motivated workers. To expand their production and sales in China, Japanese companies must build and manage efficient supply chains and sales networks. Doing so means hiring and retaining local employees who are intimately familiar with local market conditions and China's distinctive business practices.

Localization of management, particularly for the senior posts, is an important strategy for attracting and motivating talented people. Japanese subsidiaries must localize their management and demonstrate that talented Chinese employees can

realistically expect to be promoted to the top.

The fourth need is to boost local R&D activities. If Japanese companies in China want to cut product costs, it is important for them to develop and design their products in order to use locally available parts and materials. To date, Japanese subsidiaries have focused largely on exports, and so they have not actively conducted R&D to create products to meet the needs of the local market.

American and European subsidiaries reportedly make bigger profits than Japanese subsidiaries in China because they invest more in R&D to adapt their products to the Chinese market. Many Japanese subsidiaries are aware of this, and they are starting to set up R&D facilities in China, provide a quick response to market needs, reduce

costs, and develop local human resources.

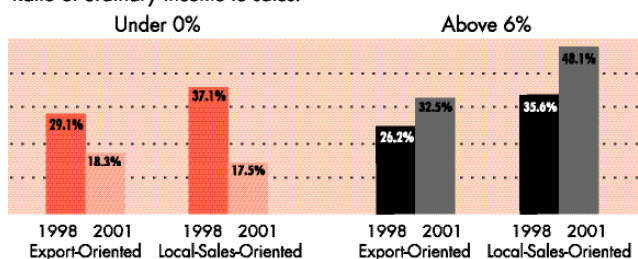
Regulatory Framework

The Japanese business community hopes the Chinese government will adopt key policy reforms aimed at making it easier for foreign companies to operate in China; our top priority is increasing the transparency and consistency of laws and regulations. Some say that in China the arbitrary "rule of man" at times takes precedence over the "rule of law" and that sometimes the regulations established in Beijing are not applied uniformly throughout the country. Nippon Keidanren has urged the Chinese government to improve its legal system, to accept public comments as input when drafting new laws, and to provide ample transition periods to implement new laws and regulations.

10 PROFIT RATIOS OF JAPANESE FIRMS IN CHINA

SOURCE: JAPAN-CHINA INVESTMENT PROMOTION ORGANIZATION.

Ratio of ordinary income to sales:



The second priority is more market opening, quickly, and to completely implement the commitments China made when it acceded to the WTO. It is especially important for the Chinese government to speedily grant foreign trade rights and distribution rights to all non-Chinese companies. Nippon Keidanren has also called for additional tariff cuts under the new round of WTO negotiations.

A second top priority is a liberalization of China's service sector. To operate smoothly, companies need to use supporting services. In China today, some services are inadequate, including as information technology, communications, engineering, transport, and finance. Liberalizing these industries would also go far in boosting Chinese companies.

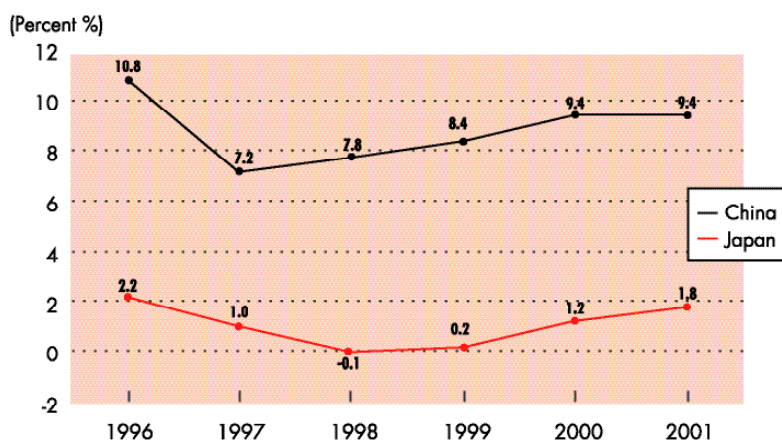
Number three is the protection of intellectual property rights (IPR). China has enacted IPR legislation but the penalties and the enforcement procedures are

inadequate and do not prevent the infringement of copy-righted goods. If Japanese subsidiaries are to increase their local procurement, a transfer of technology is required. But clearly this is impossible if intellectual property is not protected. IPR is essential for the development of both Japanese and Chinese companies.

The recovery that Japan now enjoys is due largely to the rise in exports to the fast-growing Chinese economy. But Japanese companies are also aware of the inherent risks, including fears the Chinese economy is overheating, producing bubbles that could burst and hurt Japanese companies too. The Chinese government is now trying to cool the economy; Japanese business people are watching carefully to see the impact of this policy.

11 GROWTH OF PRIVATE-SECTOR CONSUMPTION

SOURCE: CHINESE NATIONAL BUREAU OF STATISTICS; JAPANESE CABINET OFFICE.



Japanese companies in China face certain risks just because they are Japanese. Because of the legacy of the war between Japan and China, many Chinese people have negative feelings toward Japan and, in some cases, leads to protest movements against Japanese companies. Unless China's historic grievances are fully appreciated, Japanese business activities in China may fail.

Another problem is the risk of diseases like SARS (pulmonary tuberculosis). According to Chinese projections, without effective treatment, the number of people with this disease will rise to as many as 200-300 million over the next 10 years. For businesses, this presents the risks of temporary factory closures and the possible loss of valuable workers.

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Ratification of the US-Japan Social Security Totalization Agreement Nears Conclusion

by Mary K. Alexander, Panasonic

The final stage for approving a new Social Security Agreement between the United States and Japan is expected to begin shortly. When implemented, the agreement will provide a sizeable tax savings for both Japanese companies in the US and American companies in Japan and social security benefits for workers who do not meet the normal eligibility requirements.

On February 19, 2004, after nearly 30 years of on-and-off negotiations, the governments of the United States and Japan signed a bilateral Social Security Totalization Agreement. The agreement awaits President Bush's signature and transmittal to Congress, the final ratification step before implementation.

Nuts and Bolts

Under US law, the 200,000 Japanese long-term employees who work in the United States, and their employers, are subject to social security (Federal Insurance Contributions Act – FICA) taxes from the moment they are put on the payroll – even though the expatriates may not stay long enough to be eligible to collect social security benefits upon retirement.

Typically, these expatriates also are subject to social security

contributions in Japan. As a result, in the absence of a bilateral totalization agreement, a Japanese worker and the employer will pay social security taxes twice on the same earnings. According to Nippon Keidanren, the Japan Business Federation, Japanese employees in the United States pay a whopping \$8.3 billion (83.4 billion Yen) a year in duplicate premiums.

Under this agreement, short-term transferees assigned to the United States for five years or less (the Five-Year Rule) and their employers would continue to pay social security taxes in Japan, as most do now. But they would no longer have to pay social security (FICA) or Medicare taxes in the US where the transferees are assigned.

Due to tax reciprocity, of course, the same would apply to American employees temporarily working in Japan, if contributions continue in the US. Regardless of the duration of the assignment, social security and medical coverage taxes would be paid to only one country.

To protect benefit eligibility, the agreement also combines, or "totals" credits earned by a worker in both systems. Consider, for example, a worker who has earned some Japanese coverage but not enough to qualify for Japanese benefits. Under the agreement,

Japan would add US employment quarters of coverage to periods of Japanese coverage in order to determine whether the worker would meet the applicable coverage requirements for benefits under the Japanese social security system. If that Japanese worker had made US social security contributions for as little as six quarters, he/she also would be eligible for pro-rated partial benefits in the US, as long as the work record was at least 10 years in the US and Japan combined. Absent such an agreement, the Japanese worker would have to pay social security taxes for a longer period to become eligible for US benefits.

This agreement incorporates a significant first-time Japanese concession: the inclusion of medical contributions in the five-year contribution-free period for Americans in Japan. The bilateral talks stalled in 2002-2003 because Japan wanted American workers temporarily living in Japan to pay into the Japanese Health Insurance Society (JHIS, the Japanese national health insurance system that covers all ages). During negotiations, the tax was equal to 8.5% of payroll and expected to double in the coming years.

The American Chamber of Commerce in Japan successfully argued, however, that coverage

would mean American expatriates would face a double burden – the cost of employers' private health insurance and the cost of Japanese health contributions.

Benefits

A social security totalization agreement would encourage increased direct investment and trade between the US and Japan and will reduce the financial burden on Japanese employers and expatriates in the US, as well as American employees in Japan. Such cost savings enhances the feasibility for Japanese companies to transfer manufacturing, sales, R&D, and service jobs to the US.

In recent years Japan has signed social security agreements with the United Kingdom and Germany, saving Japanese companies a total of \$3.4 billion (33.7 billion Yen) annually. The United States currently has agreements with 20 countries, including Canada and most Western European countries, and awaits final approval of agreements with Japan and Mexico. The annual US employer/employee foreign tax savings from these agreements totals more than \$800 million.

Japan also is negotiating SSTAs with France, South Korea and Belgium. Conclusion of bilateral agreements with these countries

would save Japanese corporations \$280 million (2.8 billion Yen) a year in duplicate social security premium payments. The Netherlands, Italy and Luxembourg, where the pension payments are relative high, as well as Canada and Australia, also have proposed bilateral agreements with Japan.

US Timetable

The US State Department received the agreement for view after formal negotiations concluded in February 2004. Late this summer the White House confirmed that the agreement had cleared all administrative hurdles and had been sent to President Bush for his signature. Once he does so, the agreement will be submitted to Congress for action.

Unlike other treaties, the US-Japan social security agreement does not need ratification by the Senate, nor is it even referred to a committee. Rather, it simply "lays on the table" for 60 legislative days (cumulative from one Congress to the next). During that time, Congress has the right to act to disapprove the agreement. But if it takes no action, the agreement becomes effective the first day of the third month after the 60 legislative days and the exchange of diplomatic notification. For instance, if October 6, 2004 were

the 60th legislative day, the SSTA would be effective January 1, 2005.

The Japanese Diet formally considered the agreement in spring 2004 under different procedures. The agreement, not surprisingly, was controversial because of the medical coverage exemption. With the strong support of Japanese business associations and nearly 60 visits to the Diet by business interests, however, the Diet approved the agreement on June 3, 2004. Hopefully, the US-Japan Social Security Totalization Agreement will come into effect early next year. ■

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Creation of an East Asian Free Trade Area

Clearly, the ties of interdependence between the Japanese and Chinese economies are growing and Japanese companies view China as a promising market. But up to now, Japanese companies have invested even more in the rest of Asia. Indeed, Japan's bilateral trade with ASEAN is similar in size to its trade with China and Japanese companies benefit from exports to ASEAN. Surveys, moreover, indicated that Japanese companies seek to avoid the risk of becoming over-dependent on China, so they hope to balance the development

of their business activities in China against their ties with ASEAN.

Japan, China, and ASEAN are already very dependent on each other economically. In 2000, the share of intra-regional trade in East Asia was 57.6 percent, higher than the share for NAFTA. And foreign direct investment within the region jumped from about \$4 billion in 1985 to just under \$70 billion in 1998.

To develop this relationship further, the so-called ASEAN+3 countries (ASEAN plus Japan, China, and South Korea) need to take another step forward.

15 POLICY ISSUES FOR CHINA: SMOOTHING THE WAY FOR FOREIGN BUSINESSES

- Greater transparency and consistency of laws and regulation
- Further marketing opening
- Protection of intellectual property rights

Creating an East Asian free trade area will contribute not just to our economies but also to our region's stability and peace. ■

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KKC fosters a deeper understanding of Japan's basic social structure. Furthermore, it conducts public affairs activities to improve the Japanese people's recognition of Japan's global role.

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