

# THE ORIENTAL ECONOMIST

## REPORT

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## The battle over Daiei Convoy capitalism cracking

Japan is the land where the term for corporate buyout, *nottori*, is also the term for hijacking. And yet, battles for corporate control are beginning to break out. Last month, we saw Sumitomo Mitsui Bank challenge Mitsubishi Tokyo to take over UFJ Bank (see August *TOE*, pg. 6). This month, we are seeing a fight not only between the near-bankrupt Daiei retail chain and its banks, but also between Japan's Aeon and America's Wal-Mart, among others, for who gets to take over Daiei.

True, no hostile takeover has yet succeeded. On the other hand, the old "convoy capitalism" that kept moribund banks and borrowers afloat is starting to come apart at the seams. Banks, their big borrowers, the government and investors are no longer marching in lockstep. Conflicts of interests are emerging and being fought out in public. Moreover, there are some new players in town: domestic and foreign investment funds, as well as foreign corporations.

All of this is a true milestone, one which should hopefully lead to greater efficiency down the road. But let's not get ahead of ourselves. The banks are interested in reducing their risk, and thus want troubled borrowers like Daiei to reduce their debt. From this standpoint, the retailing sector has shown progress: its liabilities have fallen 10% from a peak ¥82.2 trillion (\$745 bil.) in March 1998 to ¥74.3 trillion as of March 2004 (\$675 bil.). However, as we'll detail below, this debt reduction does not necessarily translate into greater efficiency. On the contrary, when it comes to measures like sales per square meter or sales per employee, the retail sector is less efficient today than in the mid-1990s.

### The case of Daiei

The long-suffering Daiei is a case in point. Daiei is in trouble because its main bank, UFJ, is going down. The Mitsubishi Tokyo Financial Group (MTFG), which is seeking to take over UFJ, wants it to clean up many of its troubled loans before the merger. And Daiei is one of the biggest of the "zombie borrowers".

Back in 2001 and 2002, Daiei received a total of ¥640 billion (\$5.2 bil.) in financial aid from its banks, including ¥400 billion (\$3.6 bil.) loan waivers. In return for the aid, it promised a big restructuring

plan. Despite a halving of its debt load, Daiei's plan is not working. In July, sales fell 6% from the year before—the sixth month in a row that Daiei failed to meet its target of only 1% year-on-year sales declines. So, Daiei went hat in hand to the banks for another ¥300 billion (\$2.7 bil.).

Meanwhile, Daiei has suffered the classic problem of the zombie. Forced to use any positive cash flow to pay down debt and shed unprofitable businesses, it has not been able to match healthier competitors like Aeon and Ito-Yokado in replacing failing outlets with new, more lucrative outlets, such as suburban stores with big parking lots.

### The last straw

Two years ago, Daiei had political protection from Prime Minister Junichiro Koizumi, who was told by officials that Daiei's downfall would wreak financial havoc. Today, that protection is gone.

The banks have had it. They want no more promises. Rather, they insist that Daiei undergo a much more radical downsizing than Daiei's management is willing to concede. Among other things, they want to force Daiei to focus on the food supermarket business and pull out of clothing and household goods, as well as non-retailing properties like the Daiei Hawks baseball team. That means Daiei will not be able to keep all of its current employees.

To ensure enforcement, the banks want Daiei to apply for restructuring help to the government's Industrial Revitalization Committee of Japan (IRCJ). IRCJ has much more power to pressure Daiei to accept harsh remedies, including the possible dismissal of

many current executives. There is another incentive for the banks of an IRCJ plan. If the IRCJ sponsors Daiei's rehab, the remaining debt owed to the banks by Daiei after any haircut will be regarded as normal, thus helping them reduce their total of nonperforming loans (NPLs).

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In keeping with its usual practice, the IRCJ would seek a corporate sponsor willing to help Daiei revive core operations and get rid of others. This means Daiei's incumbent management would lose much of its power, even if they kept their jobs.

Daiei management is fiercely resisting both the drastic downsizing and the IRCJ route. It is seeking to retain its independence by seeking help elsewhere. One candidate is Phoenix Capital, a turnaround fund that has also invested in Mitsubishi Motors. Deutsche Securities has offered a plan involving cooperation with Marubeni trading company and Tokyu Land Corporation.

Meanwhile, other retail giants are trying to take over Daiei to increase their market power. One candidate is Aeon, which previously took over failed retailers like Mycal and Yaohan. Aeon wants to pick up the Daiei assets whether or not the IRCJ is involved.

Another rival is Wal-Mart, which previously expanded into Japan by taking a 37% share in Seiyu, another troubled retailer. Buying into Daiei would add 266 outlets to 404 garnered through Seiyu deal.

### Nonetheless efficiency is down

Presumably, this kind of shakeup and contest for corporate control should eventually lead to greater efficiency and greater attention to profits and cost control.

And yet, we have a puzzle. When it comes to measures like sales per employee or sales per square meter, the industry is

actually becoming less efficient. Worse yet, even as sales per square meter keep dropping, the industry keeps building more floor space.

Given that retailing employs 8 million people, about 12% of all workers, improving productivity in this sector is critical to the whole economy. Since the industry is widely known as a haven of "disguised unemployment," it would seem to provide inordinate possibilities for leaps in efficiency.

There is no doubt that the industry is consolidating. Moreover, this has been going on for quite a long time. The number of outlets peaked at 1.7 million way back in 1982 and has since fallen by about 24%. Much of this is due to a dropout by "mom and pop" stores as the owners retire and none of the descendants want to take it over.

Consequently, from 1976 through 2002, the share of establishments owned by corporations more than doubled from 21% to 45%; the corporate share of sales rose from 70% to 90%.

At corporate outlets, sales per square meter are 2 to 2.5 times as high; and sales per employee are about 2.7 times as high. Thus, it would seem that, as retailing become more and more dominated by corporations, overall efficiency should improve. But, surprisingly, the opposite has occurred.

Let's look at the industry's use of capital, as measured by sales per square meter. On an industry-wide basis, sales per square meter peaked out at the end of the bubble in 1991 at ¥1,280,000 (\$11,360). Since then, sales per square meter have fallen 25%!

The problem is that, even as the corporate sector increases its share of retailing, it is becoming less efficient. Among corporate retailers, sales per square meter fell 23% between 1991 and 1999, the latest year for which we have data.

One might think that, if sales per square meter are dropping, then firms would build less new floor space—especially since some of the giants that overexpanded in the past are now suffering the consequences. But that's not so. Between 1999 and 2002, floor space expanded around 5% a year. Among corporate retailers, floor space expanded 41% between 1991 and 2002.

### Half-way deregulation

Some of this apparent paradox may be the result of Japan's halfway deregulation. Prior to 1990, the Large-Scale Store Law enabled

the Ministry of Economy, Trade and Industry (METI, formerly MITI) to restrict construction of new large stores in order to protect the mom and pop retailers and keep overall supply and demand in balance. Reform of that law reduced these governmental barriers to entry. But unofficial barriers to exit—from banks that kept lending to local retailers and loan guarantees by the government—means that new entrants have not been able to force less efficient players to exit. The result is overcapacity, with less profit for everyone. Eventually, beginning in 2000, that situation led to a spate of spectacular failures and near-failures. Daiei is but the latest example.

If capital is not being used more efficiently, how about labor? Retail employees peaked in 1999 at 8.03 million. From then through 2002, they fell only 1% to 7.97 million. Monthly figures through May 2004 show a decline of about 2% from year-earlier figures. But there was a drastic change in where these workers worked. The number of workers at mom and pop stores fell by a third from 1982 to 2002 (from 3 million to 2 million). However, new hiring by corporate stores more than made up for this fall. Only recently have corporate stores slowed additions to their workforce.

Meanwhile, sales per employee peaked out at the end of the bubble in 1991 at ¥20.1 million (\$181,000) and maintained a plateau through 1997. Since 1997, industry-wide sales per employee have fallen 16%. At corporate outlets, sales per employee have fallen even more steeply during the same period, by 20%.

In short, Japan's retailers have yet to respond sufficiently to market or financial signals. Eventually, we believe that they will have to—or pay the price in failure. But that has not yet happened.

Retail sales fell again in 2003. So, the recovery alone has not solved the retailers' problem. While consumer spending is up, more of the household yen is being handed over to the service providers rather than at retail store cash registers.

If efficiency is going to improve in Japanese retailing, consolidation alone will not do it. Enhanced competition and an end to barriers to exit are going to have to be allowed to play their role. A few individual giants may be making big improvements, but this has yet to occur on the scale necessary to raise efficiency for the sector as a whole. (RK)

## THE ORIENTAL ECONOMIST

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## TOKYO INSIDELINE

by Takao Toshikawa

Politics will heat up in September

# Summer time blues

Prime Minister Junichiro Koizumi took a two-week summer vacation, choosing to stay in a Tokyo hotel, where he watched the Athens Olympics on television, wandered out to attend Kabuki plays, and otherwise spent his time being moved to tears, displaying a “lump-in-the throat syndrome” (*kangeki shoukougun*).

In Athens, Japan captured the most medals it has in any Olympics, so no doubt the prime minister shed many a tear. During this extremely hot summer in Tokyo, the Athens Olympics and the South Korean TV drama “Winter Sonata” (broadcast by NHK on Saturdays at midnight) were the highest rated television programs in Japan.

There is an eight-hour time difference between Tokyo and Athens, and those who were glued to their TVs in the predawn hours suffered from a lack of sleep.

Nihon University Professor Tetsuya Koteki analyzes the Japanese social phenomenon of “lump-in-the-throat syndrome” as follows. “Internationally and economically as well as on the level of personal lifestyle, a sense of blockage continues for the Japanese people. They have lost their sparkle and are unable to confirm their own identities. Therefore, a psychology that desires ‘simple heroes’ and ‘simple, pure love’ as a means to be easily moved is at work. However, the feeling of being moved is used up in a moment. Their political consciousness is the same. When they ask themselves if they have been moved by Koizumi, they are bored with him.”

After spending the hot summer “dozing” (in Koizumi’s words), politics returns to full-blown action this month. There is to be a Cabinet shuffle, and changes in the Liberal Democratic Party (LDP) leadership, as well as an election to choose the Democratic Party of Japan (DPJ) party president.

In October, an extraordinary Diet session is expected. Before domestic politics begin in earnest, Koizumi will spend 11 days traveling overseas beginning September 13.

He will visit Brazil and Mexico. In Mexico, he will sign a bilateral free trade agreement (FTA).

He will then visit New York to attend the 59th Session of the United Nations General Assembly, where he will appeal for international cooperation for the reconstruction of Iraq. At the same time, he will argue that Japan deserves a permanent seat on the UN Security Council. Koizumi is also scheduled to meet with US President George Bush.

### Cabinet change

Upon returning to Japan, Koizumi must immediately begin work on his planned Cabinet reshuffle, as well as on changes in the LDP leadership.

Traditionally, politicians use the hot summer months to prepare for the expected autumn fights. During the summer the Diet was closed, and with the reporters who usually follow them around taking their summer vacations, powerful politicians were able to meet for secret discussions. They looked at the prospects for this autumn’s politics, bounced opinions off each other, and drew up scenarios for the political agenda.

With the problem of a lack of transparency having been increasingly pointed out, the tradition of such backroom politics has gradually faded. But former party Secretary-General Koichi Kato says that it’s gradually returning. Why? Because there is no longer any individual within the LDP capable of drawing up strategy.

Consider this comment from Tokyo University Professor Takashi Mikuriya, which appears in the September issue of *Gendai*:

“In the past, Kakuei Tanaka was the LDP’s chief strategist from before he became Prime Minister until about 10 years after he resigned. Subsequently, Yasuhiro Nakasone attempted to put himself forward, but the Takeshita Faction headed him off. During the past 10 years, there were some occasions where that faction was replaced by the YKK

trio (Taku Yamasaki, Koichi Kato, and Junichiro Koizumi). However, there is no one in the LDP at this time, either self-appointed or recognized by others, who can speak authoritatively about strategy. Already, the former Hashimoto Faction (including the inflow received from the Takeshita Faction) no longer has this power.”

### Counsel of elders

It’s doubtful that Koizumi’s self-appointed guardian, former Prime Minister Yoshiro Mori, or Mikio Aoki, head of the LDP caucus in the Upper House, are real strategists. At most, they might rise to the level of tactician. On August 7, those two hosted Koizumi at a restaurant in Tokyo. They may have tried to follow the backroom tradition, but a good number of citizens observed the meeting. The meeting, at a minimum, seems to have been a prelim to September’s “personnel politics.”

At that meeting, the quiet Aoki reportedly said the following while drinking cold sake: ‘Privatization of postal services (the next big issue in politics) is not a question of who wins and who loses. We must calmly find common ground. For that reason as well, I want you to listen to the party’s suggestions for the September Cabinet reshuffle and party leadership changes.’

Mori also peppered Koizumi with his opinions, reportedly saying: ‘The privatization of Postal Services will depend on what happens with the Cabinet shuffle and LDP leadership changes. I wrote some points I want you to bear in mind in this note. In any case, you should take care with the core Diet members rather than with the junior members and get the party as a whole to feel cooperative.’

Mori then handed Koizumi the note he mentioned.

What was in the note? Reporters don’t know for sure, but here is the ‘informed speculation’: 1) Handling LDP Secretary General Shinzo Abe, who strongly intends to resign, 2) How to treat former Chief Cabinet Secretary Yasuo Fukuda, who resigned over a failure to pay pension premiums, 3) The post of Minister of State for Economic and Fiscal Policy and Financial Services Heizo Takenaka, 4) Bringing in former LDP Secretary-General Makoto Koga and former policy council head Shizuka Kamei, the faces of the anti-Koizumi forces in the LDP, 5) ‘Clearing the inventory’ of Diet members who have been elected five or six times and

want Cabinet posts but have been left stagnating outside the Cabinet.

That's a long list of complaints and demands. As he usually does, Koizumi answered, "I see, I see," but made no promises.

Koizumi-style "surprise personnel moves" are essentially incompatible with the kind of party-unity moves that Mori and Aoki favor.

### Koizumi's magic

Keep in mind that Koizumi's popularity among average voters began when he ignored the lists of recommended personnel sent to him by the various LDP factions in making his appointments. The Japanese people applauded Koizumi for more or less smashing the LDP's *ancien régime*.

Unlike his predecessors, Koizumi appointed women, younger people, and individuals from the private sector; he ignored the faction recommendations.

The big question: what is on Koizumi's mind? Some say he prefers popularity over policy. Others say he thinks that breaking up the traditional LDP style of ruling is his route to popularity. In any case, there seems little doubt that the expected September Cabinet reshuffle will tell a lot. Is Koizumi controlled by the traditional LDP, in which case he will likely not last long in office? Or, will he continue his maverick style, in which case he may last longer?

In the end, the entire political landscape grows uneasy as personnel changes approach. Those in the Cabinet hope against hope they will be retained. Those on the 'outs' want to get 'in'.

### The new Cabinet

Consider this: There will be 15 happy people in the new Cabinet, and about 60 despondent ones who were not chosen. That is always

the case; such is the nature of personnel changes.

The best bet is that personnel changes will not restore cohesion to the Koizumi Cabinet. The mood in Tokyo is that Koizumi has accomplished whatever positive achievements he could; from now on, it is down hill. Someone else has to carry the reform torch.

Indeed, the personnel plans of Mori and Aoki do not necessarily match exactly. For executives, they apparently want to begin with a party-unity system, with Nukaga, who

Abe, he is saying that he will take responsibility for losing the Upper House election, shown by not entering the Cabinet and refusing all party posts. However, some are saying he will retain his current position. In any event, if Abe resigns as secretary-general and steadfastly declines a Cabinet post, that will be a declaration of his intent to enter the Cabinet 'next time'.

### Real partners?

Meanwhile, the LDP's coalition partner, New Komeito, announced that it decided at its recent board meeting that Takenori Kanzaki would continue as Chief Representative and that Tetsuzo Fuyushiba would stay on as secretary-general.

However, the information was leaked by Kanzaki, and the appointments apparently are not settled. Some within the party's supporting parent organization, Soka Gakkai, and especially its women's division, are waiting for a clean sweep of party leadership, with Toshiko Hamayotsu becoming chief representative and Akihiro Ohta secretary-gGeneral. The opinion of Soka Gakkai Emeritus President Daisaku Ikeda will take priority in the final judgment on what kind of executive division will be created and who will enter the Cabinet.

So, who are the candidates to join the Cabinet? Koizumi's tendency to spring surprises has lost its luster. People want to know

what he really thinks and really plans to do. Given the continuing economic troubles in Japan, and the paralyzed political system, Koizumi has lost his image as a master leader for change. He accomplished much, simply by establishing the notion that real change in Japan is possible. For that, Koizumi will forever be remembered.

But concerning change, is Koizumi now a vehicle or an obstacle? Unfortunately, the answer seems clear.



is close to Aoki, as Secretary-General; Mori's close aide Nakagawa as head of the policy council; and former policy council head Shizuka Kamei, who has long been out in the cold with the anti-Koizumi forces, as head of the General Council. Acting Secretary-General Fumio Kyuma will likely be demoted to Diet Affairs Committee Chairman for committing the "war crime" of losing the last Upper House election.

As for LDP Secretary-General Shinzo

# ECONOMIC OUTLOOK

## GDP growth slackened in April-June

# We now pause

April is the cruelest month, says a famous poem. We're not sure that's true, but we do note that the April-June figures for Japanese economic growth were a lot "crueler" than most economists had forecast. Gross Domestic Product (GDP) in April-June was up only 0.4% from January-March (an annualized growth rate of 1.7%). This was less than half of the consensus forecast for 1.1% quarter-on-quarter growth (4.3% annualized).

It was also a far cry from the ebullient 7% annualized growth rates seen in October-December and again in January-March.

Most economists believe that the April-June figures are a temporary pause, not a harbinger of a continuing deceleration of the recovery. The thing to keep in mind is that Japan's monthly and quarterly figures are notoriously volatile. In any case, the 7% annualized rate of GDP growth shown in the last two quarters is simply not sustainable—even in the context of recovery. Hence, some sort of correction is only a matter of time (see top chart).

A genuine downshift to more sustainable growth levels is still expected to occur, but in 2005 rather than 2004.

### Oil prices not that big a threat

One of the risk factors going forward is the price of oil. Fortunately, Japan's direct vulnerability to higher oil prices is a lot less than during the oil shocks of 1973 and 1979.

This is partly due to conservation measures and partly due to a natural shift from energy-intensive smokestack industries to less energy-intensive machinery industries and services.

The amount of oil Japan needs to produce each yen of GDP has fallen by more than half since the 1973 oil (see bottom chart).

Moreover, a rise in the value of the yen translates into a smaller rise in oil prices since the latter are dollar-denominated. Back in 1980, it cost Japan 5% of its nominal GDP buy all the oil it needed. Today, that's down

to about 1%.

According to calculations made by the Cabinet Office a few years ago, even a 20% rise in crude oil prices would lower Japan's GDP by only 0.08%. Back in 1974, a similar rise would have cut growth by nearly 0.5%.

However, higher oil prices could affect Japan indirectly—by slowing growth in Japan's key customers like China where oil dependency is much higher.

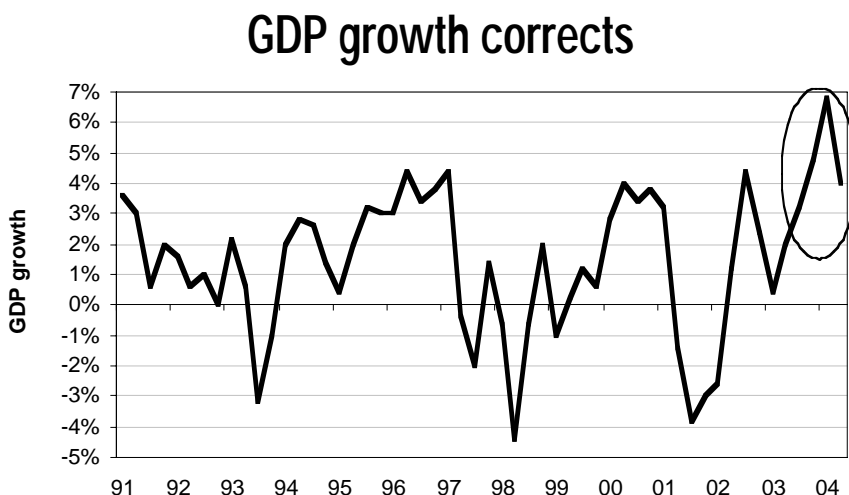
### Investment boom not yet over

The biggest cause of the disappointing GDP

figures was also one of the most unreliable components: business investment. In the preliminary report, investment showed absolutely no growth from the previous quarter. If this were the signal of a new trend, it would be very worrisome since business investment accounted for almost half (44%) of GDP growth in fiscal 2003.

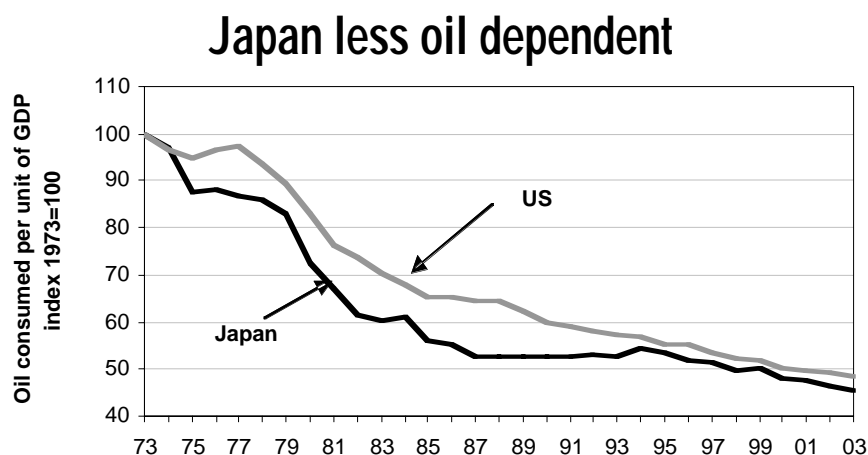
However, many forecasters expect the investment figure—and thus GDP as a whole—to be revised upward in the second GDP release on Sept. 10 since some key data are missing. This includes the all-important Finance Ministry statistics on corporate activity to be released on Sept. 6. Moreover, even if the investment figure is not revised in this quarter, many forecasters still argue that various temporary trends caused the problem.

In any case, business investment figures are highly volatile. Beginning with the second quarter of 2003, quarter-on-quarter growth in business investment has gone from



Source: Cabinet Office

Note: The chart shows quarter-on-quarter growth at annualized rates, using a two-quarter moving average



Source: Morgan Stanley (Tokyo)

Note: The chart shows how much oil it takes to produce ¥1 of real GDP in Japan and \$1 in the US. It is an index with 1973=100

5.7% to -0.3% to 6.6% to 1.7% and now 0%.

Nonetheless, we believe the investment slowdown shown in the April-June figures represents more than just a statistical fluke.

Many economists have long been skeptical of the investment figures. The "real" investment figures are derived by taking the figures for growth in nominal investment and then adjusting them upward according to the pace of deflation. If the deflator is too big, then so will be the upward adjustment. For several quarters, we've seen an unusual gap between the general GDP deflator and the capex deflator (see December 2003 *TOE*, pg. 5). By the end of 2003, year-on-year growth in real investment was said to be 7% higher than nominal growth. In the most recent two quarters, these deflator gaps have been greatly reduced. Hence, one reason for the lower investment figures is a correction of past distortions.

Aside from the distortion issues, we don't think Japanese firms can productively use all the capital stock that would be created if current investment rates were to continue. Hence, at some point, we expect a slowdown.

However, various leading indicators suggest that it is too early to conclude that this anticipated slowdown has now arrived. For example, there is a very close correlation between core private machinery orders in one quarter and investment a quarter later. The investment slowdown in April-June was presaged by a big order slowdown in January-March. However, the same series shows a moderate rebound in machinery orders in April-June, suggesting at least some rebound in investment in July-September (see top chart).

Whether investment will resume its blistery pace of the past several quarters remains to be seen.

### Personal consumption

We and others have long argued that the recovery could not be sustained for long without a solid rebound in personal consumption. The good news is that the last few quarters have, at long last, shown solid growth in household consumption. In January-June, consumption ranged about 3.5% above year-earlier levels, rates not seen since the 1997 recession and financial crisis.

Unfortunately, this spending is not yet being supported by rising incomes. Instead, the gap between income and spending continues to grow (see bottom figure).

The same pattern holds if we include not just wages and salaries, but all real disposable income for worker-headed households. Real income is still 2% below the levels of 2000, while spending is more than 2% above 2000 levels. Households are spending a greater share of the income that they do receive.

There are several conflicting interpretations of these facts. The economy's path depends on which one turns out to be true.

One hypothesis is that households cannot and will not keep spending beyond their income. Once they realize that income will not catch up in the near future—because employers keep exerting wage pressure—then the propensity to consume will revert to past norms. July figures did show a decline in both income and spending from the April-June average. However, one month does not make a trend.

A second view is that households are spending now in anticipation of an eventual rise in income down the road. Indeed, it is

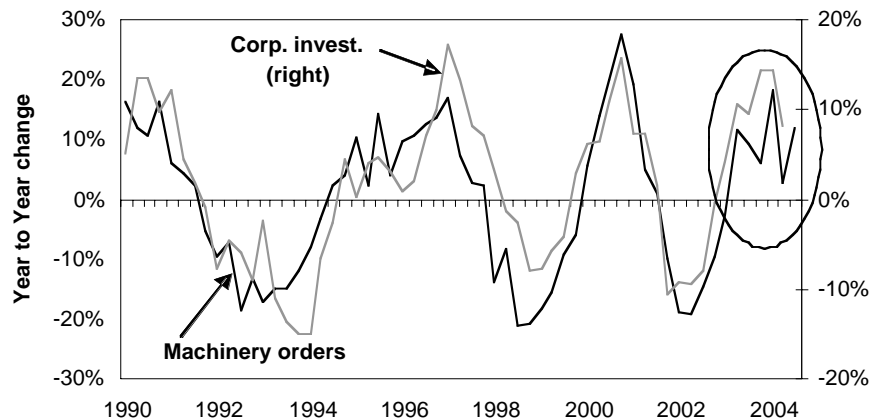
precisely their spending that will promote the later rise in jobs and income. So, all we are seeing is a temporary lag. If so, consumer spending will prove sustainable even if the propensity to consume falls to past norms.

A final, even more optimistic view is that there is a sea change in consumer attitudes. Savings rates have been falling for a couple decades. The current downward ratchet is just an acceleration of that trend. This pattern will continue to boost personal consumption for some time to come, even if it takes a while for wages and other income to revive.

### Exports

A quick note on exports. For some time there have been fears of an export slowdown due to a soft landing in China or other factors. This has not yet shown up. On the contrary, year-on-year growth figures continue to hold at high levels. Quarter-on-quarter growth was down a bit in April-June, but not enough to suggest a trend change as yet.

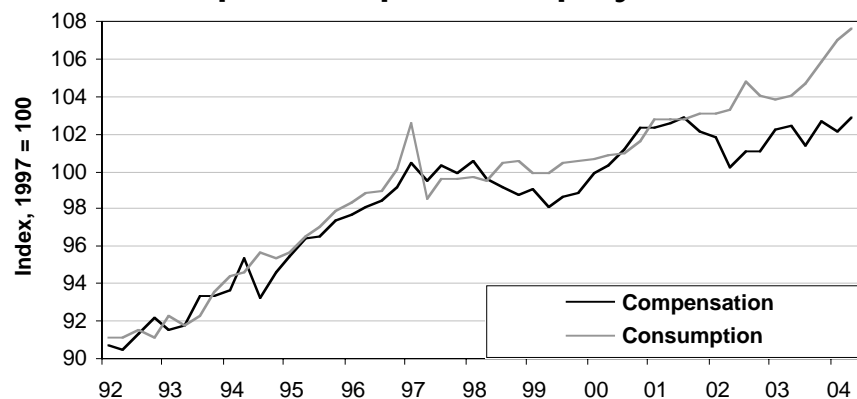
## Machinery orders say Capex slowdown is temporary



Source: Cabinet Office

Note: In the panel, private machinery orders (excluding volatile items) are pushed forward one quarter because orders today tend to forecast the GDP business investment figures in a quarter or two.

## Consumption outpaces employee income



Source: Cabinet Office

## But not until Koizumi departs

# MOF readying tax hikes

Under the motto of “financial reconstruction without tax increases,” Prime Minister Junichiro Koizumi has tried to reduce Japan’s mammoth budget deficits by cutting spending rather than raising taxes. Indeed, Koizumi has pledged that taxes will not increase while he is in office.

But that’s not the viewpoint of the Ministry of Finance (MOF). It feels that it will be impossible to bring Japan’s budget into balance without raising taxes. In fact, the MOF is already starting to hoist trial balloons for tax increases once Koizumi leaves office, which will be no later than the fall of 2006. One recent volley came from the powerful Hiromitsu Ishi, the President of Hitotsubashi University who has served for years as the Chairman of the Tax System Council. The latter is the MOF’s tax policy advisory board. Among other changes, Ishi recently proposed a big hike in the consumption tax from the current 5% level to 10% or even 15%.

### The dilemma

Here’s the dilemma: Japan’s general government sector deficits for central government, local government and social insurance hit a peak of 8.2% of GDP in 2003. Moreover, under the most likely scenario, the International Monetary Fund says the deficit will remain as high as 6% through at least 2009.

Deficits are huge, not only because fiscal stimulus was used to keep the economy afloat, but also because much of the cost of reconstructing Japan’s post-bubble economy has been charged to the government sector. As Professor Kazuto Ikee of Keio University told *TOE*, “For over ten years, private enterprise has been shifting its excessive debts from the collapse of the bubble economy over to the government. In doing so, it scrambled free of excessive debt and laid the groundwork for Japan’s economic recovery. But in the end, these corrections won’t be complete if we don’t erase the massive debts

that have piled up in the government sector.”

The government would like to reduce the deficit. But, based on past experience, it rightly fears that a sudden reduction of fiscal spending and tax increases could put the brakes on economic recovery.

To try to square this circle, the government is planning a medium-term response. Specifically, it seeks to create a balance in the so-called primary budget beginning in the initial years after 2010.

A primary balance is defined as a zero deficit or surplus in spending and revenues, after we exclude interest payments and any revenues from financial operations (rather than taxes and fees).

Adding together central and local government, the primary deficit in fiscal 2004 is expected to run about ¥23 trillion (\$210 billion). That amounts to 4.6% of GDP. The respective deficits were 5.6% in fiscal 2002 and 5.4% in fiscal 2003. Bringing this to zero will not be an easy matter.

### Tax revenues lagging

Unlike in the past, economic growth these days is not producing a proportional hike in tax revenues. In fact, tax revenues have fallen by a third since 1990, despite the fact that nominal GDP rose by about 15%.

Looking at the entirety of tax revenues, tax yields continued to decrease even in fiscal 2003 when there were clear signs of economic recovery. Fiscal 2004 revenue is expected to remain almost at the same level despite even more robust GDP growth. Fiscal 2005 is seen by the MOF as producing, at best, an increase of ¥2 trillion (\$18 billion).

The reason is that, during the 1990s, a number of tax reductions were introduced and personal income tax rates flattened out. Furthermore, lower tax rates were applicable to a wider sphere of incomes. Most of this was done in the name of stimulating economic demand. Now the structure is such that, even if personal income grows, taxes

won’t rise as much as in the past.

Corporate taxes were also reduced in the name of keeping up with worldwide trends. This was said to be necessary to keep Japanese firms competitive. The corporate tax rate was cut from 42% in 1989 to 30% by 1999. With the introduction of the consolidated taxation system, tax payments decreased from companies with subsidiaries that were in the red.

The bottom line is that, without tax hikes, the government cannot count on economic growth to bring in enough new tax revenue to close the deficit.

### Limits to spending cuts

At the same time, there is a limit to how much the government can cut spending. The Koizumi administration opposes those who seek to expand public expenditures and continues its inhibiting fiscal management.

Most of the Koizumi budget-cutting has focused on public works. At the same time, local governments have insufficient funds and are decreasing their public works investments. Because of this, total government public works (central and local governments plus government-owned entities) fell from the fiscal 1995 peak of 8.4% of GDP to 5.1% in fiscal 2003.

During the same period, however, spending on things other than public works rose from 14.7% of GDP to 17.6% in 2002 and then a bit lower 17.3% in 2003.

The government is prepared to reduce public works investment even more, but demands for increased spending are intensifying within the ruling Liberal-Democratic Party (LDP). Even if strong cuts are continued in the future and public works spending is confined to about 4% of the GDP, even then this is only a fraction of the deficit reduction that is necessary for creating a zero deficit in the primary balance.

### Social security costs

The largest public expenditure category is social security costs (24.1% of the central government’s general account in the fiscal 2004 budget) which mirrors the growing number of elderly people. Far from contracting, social security costs are now going to balloon. Central and local governments’ public finance transfers to the social insurance fund (pensions, health insurance etc.) have started to rise sharply in recent years, and amounted to 4.1% of GDP in fiscal 2002. That’s up from 2% level in the mid-1990s. In

the future, the government's obligation—as opposed to the obligations of employees and employers—will rise from one-third to one-half of the pension's basic benefit.

The Japanese Communist Party (JCP) and the Social Democratic Party (SDP) insist on trimming defense costs, but the total defense budget amounts to no more than 6.0% of the national budget. Trimming it will not have much of an impact on the fiscal balance.

### Ishi on tax hikes

The conclusion reached by Ishi and the MOF is that, to solve the budget deficit, taxes will have to be raised.

Ishi recently told *TOE*, "Our objective is to have as many people as possible take responsibility for our much-needed financial reconstruction. Hikes in consumption taxes and social insurance premiums lie at the heart of fiscal reconstruction. The consumption tax should at first rise to 10% from the current 5% and possibly even go up to 15%." Each 1% hike in the consumption tax results in about ¥2 trillion (\$18 billion) in increased tax revenues.

With respect to personal income taxes, numerous tax cuts since the 1980s have left a relatively light tax burden. At present, 80% of the taxpayers pay no more than the lowest tax rate of 10%. One idea for making more of the nation pay a somewhat higher tax rate is to abolish the fixed-rate tax cuts instituted by the Obuchi administration in 1999. This was done in the form of a tax cut that deducts 20% of the amount of one's income tax from one's taxes. The cap for deductions is ¥250,000 (\$2,280).

A second idea is to cancel or scale down various tax deductions. The present system allows taxable income reductions according to the number of family members (spouse, children, etc.) who are supported in a household, and excludes a large portion of retirement benefits. Canceling or curtailing this deduction system lowers the minimum taxable income. That minimum threshold currently stands at a yearly income of ¥3.25 million (\$29,650). There would also be a further increase in tax payments from people who already pay taxes.

Such a tax increase would have the effect of again making taxes on income less progressive. (In a progressive system, richer taxpayers pay higher tax rates.) Income distribution is becoming less equitable in Japan, and in the future this will intensify the need

for using taxes to redistribute income.

One way to accomplish this, according to Professor Ishi, is by tightening up inheritance taxes. Japan's inheritance taxes are lax and target only 40,000 taxpayers and 5% of the deceased per year. It would strengthen the inheritance tax system if 10% were eligible.

With respect to corporate income taxes, Ishi feels that Japan's tax rate is very competitive by international standards and does not need to be raised or lowered.

To sum up: Ishi would like to raise all taxes with the exception of corporate taxes. He would also like to have a larger number of people share the burden. In his view, if tax revenues are not increased, Japan's financial reconstruction is not possible.

As for when to institute these tax increases, discussion of Obuchi's fixed-rate income taxes and the repeal or reduction of various deductions will probably start next year. With respect to the consumption tax, Ishi is waiting for Koizumi's term of office to expire before starting serious discussion in 2007. He'd like to raise the tax rate to 10% in 2010.

### Political hurdles

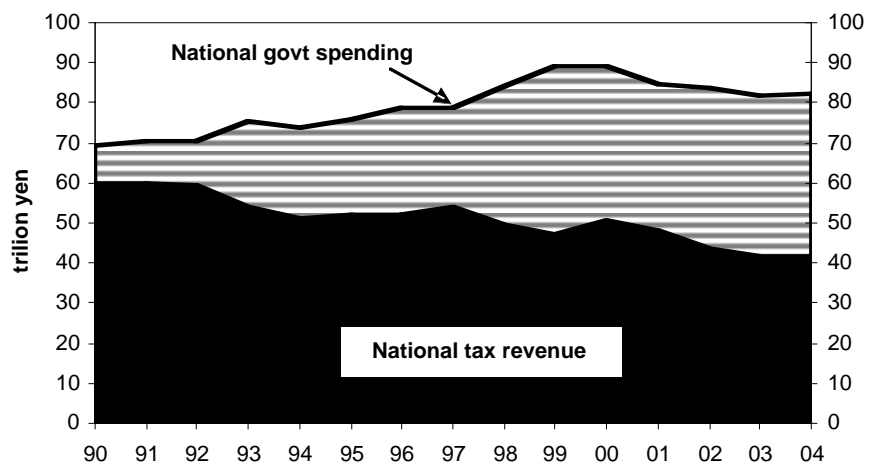
It has been agreed that increased pension contributions will precede these tax hikes. Moreover, pension benefits are likely to be revised downwards. Both measures are ones that will generate exceedingly strong political opposition. Certainly, Japan's tax burden is low internationally. Still, it will take powerful leadership to put in place these successive measures that seek an increased obligation from the public.

Varying costs and benefits will emerge for the public. The elderly and the young will have opposing interests, as will the wealthy and those in low-income brackets. The younger generation faces an increasing burden under the present system, while the elderly have a higher voter turnout rate and are a strong political force. The tax weight will mount sharply with the highly regressive consumption tax, and the gap between rich and poor will widen. In such a situation, what will become of Japan's traditional orientation toward equality? Will there really be support for the decision to increase individual tax burdens while continuing tax cuts for financial income and corporate taxes that are intended to strengthen the capital market and lure foreign business? The LDP and DPJ have not yet confronted these issues head on.

Trust in public administration of taxes is also lacking. Almost 100% of a white-collar worker's salary is known by the government, but only an exceedingly small portion of independent business and farming income is tracked and taxed. Would it in fact be possible to introduce a taxpayer ID system that could dispel suspicion?

The Social Insurance Agency (SIA), which collects insurance premiums, is now feeling the full brunt of public censure for its irresponsibility. The idea of integrating the SIA and the National Tax Administration (NTA) into one IRS-style structure engenders intense resistance in the MOF, which does not want to lose the NTA and its right to subject politicians to tax collection inspections. Politicians must bring the bureaucracy under control before rushing to make the public swallow tax increases.

## Tax revenues fall despite GDP growth



Source: Ministry of Finance, "Highlights of the budget for fiscal 2004"



## INTERVIEW

Kenneth Quinones

## North Korea has the bomb

**Dr. Ken Quinones** is Director of Korean Peninsula Program International Action and one of Washington's top experts on North Korea. A retired foreign service officer, he played a key role in the negotiation of the 1994 'Agreed Framework' that temporarily froze North Korea's plutonium-based nuclear weapons program. Dr. Quinones holds a doctorate in East Asian Languages from Harvard University.

**TOE:** You've spent a long time working on Korean affairs.

**Quinones:** Yes. I started off as a US Army soldier studying Korean at the Monterey Language Institute. I was assigned to help break North Korean army codes beginning in 1962. I went to graduate school, and was in South Korea as a State Department political affairs officer from 1981-1987. I spent three years in Washington, and then was in the US Embassy in Tokyo from 1990-1992. I then became the North Korean affairs officer for the State Department. I made my first trip to North Korea in December, 1992.

**TOE:** At that point, the nuclear weapons issue had just begun to heat up, right?

**Quinones:** The controversy emerged in August of 1992, with indications that the North Koreans were hiding how much plutonium they had produced. I had my first off-the-record meetings with North Korean officials in September of that year. Later, the Clinton administration appointed Bob Gallucci to be chief negotiator with North Korea, and I joined his team. I became chief liaison between the US and North Korean governments from June 1993 until the conclusion of the Agreed Framework. Any contact between the North Korean government and the US government was through me. This was formalized through the so-called New York channel, which involved North Koreans at the United Nations and myself. That continued until the Agreed Framework was signed.

Once the Agreed Framework was concluded in 1994, I moved from State's Office of Korean Affairs to State's Bureau of Intelligence and Research, which kept me involved in the process. Essentially, I became the US liaison to the North Korean

government in North Korea, living and working in North Korea during 1995-1996. I later started working with the Department of Defense. I was the State Department advisor to the DOD team working on soldiers missing in action from the Korean War.

At the time, there was no US government liaison office in North Korea. The State Department relied on me to perform that function. I traveled every other month to North Korea, back and forth for four to six weeks at a time. I was based in Washington, at the State Department Intelligence and Research Bureau, but I spent half my time in North Korea.

**TOE:** Where would you stay?

**Quinones:** In 1995, I lived for five months at the Yongbyong nuclear research center. KEDO had not yet been formed. Bob Gallucci sent me in to coordinate all US government activities, beginning with the spent fuel project.

**TOE:** You later shifted to the POW/MIA issue?

**Quinones:** Yes. By 1996, I was no longer living and working in the nuclear research facility. I was in downtown Pyongyang, commuting daily with a US Army official to Korean War battle sites, seeking the remains of the Americans who had died in the Korean War.

**TOE:** What was your status?

**Quinones:** I was the only person in the State Department who spoke Korean fluently, who had the trust of the South Koreans, and who had established a working relationship with the North Koreans.

**TOE:** What was it like to be in Yongbyong?

**Quinones:** There was no precedent. I had to

define everything. There was no other US government official in the country. There were other Americans, but they were contract employees.

**TOE:** Did you agree with the 1994 Agreed Framework?

**Quinones:** I thought it was the best agreement we could get at that time. Almost from the beginning we encountered serious problems in Washington, especially concerning funding from Congress. This disrupted the entire process.

Also keep in mind that in December of 1994, the North Koreans shot down a US Army helicopter, which sapped the momentum for the agreement. The idea of a liaison office was dead from the beginning.

**TOE:** What was President Jimmy Carter's role?

**Quinones:** Every month, Carter's people would call and say that the former president wanted to go to North Korea. I would write a memo to the secretary of state, and the response would be: "Tell him no." So, I would call up the Carter Center, and say: "President Clinton is not ready for you to go."

Finally, Carter went around the bureaucracy. He called President Clinton and simply said: "I am going." Clinton said "Fine, but you are not going to negotiate." He insisted on a briefing, and four of us did that. Gallucci headed the briefing, and he made clear to President Carter that President Clinton did not want him to go. But President Clinton knew that Carter intended to go. So Gallucci made clear President Clinton's perspective: 'Under no circumstances are you to negotiate'.

**TOE:** Did you go with Carter?

**Quinones:** No. We had made clear that that would not be a negotiating session. So it would not have been appropriate for me to go, since I was the principal liaison with North Korea. Instead, Carter picked up Dick Christianson, a very able Korea specialist who was then the top US envoy on Okinawa.

**TOE:** OK. Let's move to the present. Does North Korea have nuclear weapons?

**Quinones:** Since 1992, the US government has agreed that North Korea has at least one or two nuclear devices; not necessarily deliverable bombs. I agree with that view.

In the past, the US intelligence community concluded that North Korea may have

nuclear weapons. Now, the conclusion is that North Korea does have nuclear weapons. The ambiguity has been deleted. And the North Koreans themselves now say that they have nuclear weapons.

**TOE:** Just because the North Koreans say they have nuclear weapons, we conclude they do? Are they our source?

**Quinones:** Let's not be stupid about this. The North Koreans say they have nuclear weapons. And the US government says they have nuclear weapons. Since July 2003, the US interagency has reached a clear conclusion, complete agreement: North Korea has nuclear weapons. There is a clear consensus. The only question remaining is just how many nuclear weapons North Korea has. We all can quibble about the number of weapons. But there is no exaggeration. North Korea has nuclear weapons.

**TOE:** What are the North Koreans saying now?

**Quinones:** I was recently in North Korea. They say very clearly that they have nuclear weapons. We can be arrogant and say that they don't. Or we can take what they say at face value, and take that into our overall strategic perspective.

**TOE:** The dispute about North Korea seems similar to Iraq.

**Quinones:** The two are as different as apples and oranges. Carl Ford resigned from his post as State Department intelligence director because of disputes over Iraq intelligence assessments. But there was a consensus concerning North Korea. It is unfortunate that some people are trying to combine the Iraq and North Korea assessments.

**TOE:** So, what are we to think?

**Quinones:** Intelligence emerged in 1991-1992 that North Korea probably had one to two nuclear weapons. The CIA did not like that assessment. The CIA was arguing that North Korea had more nuclear weapons. The State Department argued: 'No way'. By 2000, the State Department had a much better sense of what was happening in North Korea.

**TOE:** How does Pakistan fit into the picture?

**Quinones:** Last July, I was involved in a US government gathering in which we evaluated that. The details are not yet public, but suf-

fice to say that the key question was: how could the North Koreans acquire the nuclear technology to build nuclear weapons? Within the intelligence community, there is a great deal of confidence that the source was Pakistan.

Equipped with that technology, North Korea did not have to develop technology on its own. Nor have the North Koreans had to test their own nuclear weapon. It is the same as Pakistan's weapon. My argument is that North Korea and Iraq are very different. Unfortunately some analysts confuse the two. I am sure that North Korea has nuclear weapons.

**TOE:** What is North Korea's intention?

**Quinones:** North Korea is North Korea, and it is time for people to recognize that.

Secondly, just because the Bush administration made a huge mistake in Iraq does not necessarily mean the same thing has to happen in North Korea.

**US non-proliferation strategy is a total failure. There is proliferation on the Korean Peninsula. North Korea has at least the capability to produce nuclear weapons; they may not have the capability to deliver nuclear weapons, but production capability is clear.**

**TOE:** So you think the Bush administration made a big mistake in Iraq?

**Quinones:** Sure. The intelligence was flawed. The administration has admitted that it was wrong. Iraq did not have weapons of mass destruction. But North Korea does. That's the difference. I know Hans Blix very well, and I think the International Atomic Energy Agency (IAEA) does a very good job. I think more attention should have been paid to what the IAEA inspectors in Iraq were telling us. The Bush administration chose to ignore what the IAEA was telling us.

**TOE:** How do you evaluate the US plan to withdraw troops from South Korea? Is this part of a broad US strategy, or is punishment for South Korea's engagement policy toward North Korea?

**Quinones:** The US troop redeployment

plan goes back a long way. Paul Wolfowitz was just as arrogant in the past as he is now. The entire plan to redeploy US troops out of South Korea and Northeast Asia was postponed pending resolution of the North Korea nuclear weapons issue. Washington and Seoul agreed on this point. Now, jump ahead a decade. Rumsfeld and Wolfowitz have essentially said: screw the South Koreans, we are going to go ahead with this plan. There were no real consultations with the South Koreans; consultations amounted to the Pentagon telling Seoul: 'This is what we have decided; this is what we are going to do.'

**TOE:** What did the South Koreans say?

**Quinones:** The South Koreans said just what you would expect: we are allies, you are supposed to consult with us, and this is not consultation. The 'consultation' amounted to the Pentagon saying: 'This is what we have already decided'. So there is a lot of animosity.

Sorry to say, but that is essentially the state of relations between Washington and Seoul these days.

**TOE:** Ultimately, if North Korea proceeds with its nuclear weapons programs, what do you think we should do? One option is to accept a nuclear North Korea, and to use our deterrence capability to keep North Korea in check. Another option is to aggressively counter-attack a nuclear North Korea, working to wipe out Pyongyang's nuclear capability. What do you suggest?

**Quinones:** First point: US non-proliferation strategy is a total failure. There is proliferation on the Korean Peninsula. North Korea has at least the capability to produce nuclear weapons; they may not have the capability to deliver nuclear weapons, but production capability is clear.

**TOE:** Do you think North Korea now has a nuclear bomb?

**Quinones:** Yes. They probably have six to eight nuclear bombs, depending on how much plutonium they have produced. In my judgment, they have the bomb, but they don't have the delivery system, such as a ballistic missile. The only way North Korea could deliver a nuclear bomb at this point would be via a truck down a highway, or via a boat, which is why Japan is so closely investigating incoming North Korean ships these days.

# Off the Record

## Cabinet reshuffle

Word has it that the Koizumi Cabinet will undergo a major reshuffle on September 27. We might be wrong, but stay tuned.

Among the likely changes, look for current Foreign Minister Kawaguchi to have a new assignment. Word has it that she is on her way to New York, as Japan's new ambassador to the United Nations.

No one knows how long Prime Minister Junichiro Koizumi will be in office. But, true to his style, he seems intent on appointing more women, civilians, and younger Diet members to top government positions.

For example, Koizumi is reportedly considering Sophia University Professor Kuniko Inoguchi for a top Cabinet post. Also on the list is Lower House Diet Member Yuko Obuchi, third daughter of the late former Prime Minister Keizo Obuchi. Then there is former Minister of Posts and Telecommunications Seiko Noda. Koizumi may also retain current Environment Minister Yuriko Koike.

Among the younger politicians, Upper House Diet Member Yoichi Masuzoe has emerged as a top candidate. He has worked hard on Diet affairs in the Upper House and earned a good reputation. He is seen as a very likely candidate to succeed foreign minister Kawaguchi, who, as we said above, seems on her way to New York.

Some say that the best successor at the Ministry of Foreign Affairs would be former Chief Cabinet Secretary Yasuo Fukuda, who would probably provide a sense of continuity both for *Nagatacho* and for US-Japan relations. But that may not be the deciding factor. Fukuda himself wants the job, but his relations with Koizumi are delicate. Most analysts think the prime minister will not call upon him.

Who else is in the running for a Cabinet post? With Koizumi, no one knows for sure. But from the private sector, speculation is growing regarding economic critic Naoki Tanaka. And from the younger generation of politicians, much focus is on Lower House LDP Diet Member Yasuhisa Shiozaki, who formerly worked for the Bank of Japan.

Both Tanaka and Shiozaki are well

known and popular; neither would be a startling choice.

## Koizumi at night

Word has it that when he cannot sleep at night, Koizumi listens to the music of Anton Bruckner and looks through the *Kokkai Benran* ("Diet Handbook"), which lists the curriculum vitae of all Diet members. When he is struck by a flash of inspiration, Koizumi writes it down in the notebook he keeps beside his bed before he forgets.

The late Prime Minister Noboru Takeshita made no secret of the fact that the *Kokkai Benran* was a favorite of his, but Koizumi's repeated viewing of the book is not widely spoken of. Takeshita looked first at Diet members who had been reelected many times. But Koizumi is quite different. He begins with those who have been reelected few times. Koizumi still believes that his lot in life is to break up the LDP.

During crucial times, Koizumi seeks the opinion of his political mentor Raizo Matsuno, still hearty at age 86. During his prime, Matsuno served as minister of labor and agriculture, and also as chief of the LDP's policy council head; he was known as a political ruffian. Rather than engaging in frontal assaults, he specialized in taking down opponents with underhanded tactics. After he retired, he opened a personal office in *Nagatacho*, where he continues to instruct all new comers, telling them: 'This is the way it was then'.

Ironically, Koizumi's appointments of Makiko Tanaka as foreign minister and Shinzo Abe as party secretary-general in his first Cabinet resulted from a combination of the prime minister's own bedside notebook and Matsuno's advice. Matsuno believes that because the momentum of structural reform and a high Cabinet support rate have faded, Koizumi must attend to party unity. Otherwise, Koizumi might not last out the slightly more than two years left in his term. Matsuno wants Koizumi to choose Makoto Koga, a member of the anti-Koizumi forces but one who would not immediately call for the prime minister's ouster, to be LDP Secretary-General. In that case, the likely Acting Secretary-General would be

Hidenao Nakagawa (currently Diet Affairs Chairman). In that case, Fukushima Nukaga would remain as the head of LDP's policy council. Ozato Faction Chairman Sadatoshi Ozato would become chairman of the LDP's general council.

## Kerry's Cambodia

It is almost certain that Democratic presidential candidate John Kerry was not in Cambodia on Christmas Eve of 1968. It remains a mystery why he thinks he was there, or whether he simply made up the story. But the notion that he might have been there is not so far-fetched.

Before the Nixon Administration began secret bombings in Cambodia in March 1969, the Johnson administration had been conducting military operations inside Cambodia.

Though there is no official confirmation, former Secretary of State Al Haig says that during his service in Vietnam, he went into Cambodia.

There seems little doubt that Swift Boats often dropped Navy SEALs off close to the Cambodia/Vietnam border. Officially, the US was not operating in Cambodia. Indeed, US military personnel were often frustrated at being fired upon by North Vietnamese and Vietcong soldiers operating from inside Cambodia, since they were under orders to not violate Cambodian sovereignty. Unofficially, the US was operating in Cambodia.

President Lyndon Johnson was extraordinarily concerned about not widening the war to Cambodia. In January 1968, Johnson had US ambassador to India, Chester Bowles, visit with Cambodian leader Prince Norodom Sihanouk, who offered to allow American military actions against the Vietnamese operating in his country.

The context of Kerry's now-famous 1986 speech about his supposed Cambodia experience is important. At the time, Kerry was arguing against the Reagan administration's involvement in Central America (the Iran-Contra affair), an operation that the Reagan White House initially denied, just as the Nixon White House initially denied involvement in Cambodia.

Shame on Kerry if he made up a story as a political tactic against the Reagan administration. But, as John McCain has pointed out, combat often leads to foggy memories.

## Toys "R" Us-Japan has little fear from former parent's trouble

# Child's play

It is ironic that 13 years after Toys "R" Us (TRU) successfully penetrated the forbidding Japanese market it is considering spinning off Babies "R" Us (BRU) and selling its toy division, while the Japanese company it created plans to open 104 new stores by 2010. Today, Toys "R" Us-Japan (TRUJ) is Japan's largest specialist toy retailer with 146 stores and no serious competitors.

It is unclear what impact TRUJ can expect from the woes of its American parent. Wal-Mart does not menace TRUJ as it does TRU—at least not yet.

The impact would be limited says UBS analyst Taketo Yamate. "There are only four Babies "R" Us stores in Japan, and TRUJ procures its own national and private brand items and distributes them itself. So the spin-off of BRU and the selling of US toy stores would not have a big impact on the current operation of TRUJ," Yamate told *TOE*.

Also, TRU is no longer a majority owner of its Japanese licensee, where FY2003 revenues were ¥189.1 billion (\$1.8 billion). In 2000 TRUJ went public and TRU reduced its share from 79% to 48%.

Still, 48% is substantial. Any impact depends on whether TRU sells its stake and who buys it. At present no one knows.

### Breaking the mold

When TRU entered the Japanese market in 1991 few guessed it would be so successful. Critics said the business model wouldn't work because of Japan's rigid distribution networks and convoluted regulatory system. Sure, prices were high, but Japanese consumers preferred to pay a premium for high quality and good service, they said. Consumers were never offered a choice.

At first manufacturers refused to deal directly with TRU, which was crucial to the company's ability to provide a large volume of goods at low prices. Also, Japan's Large Scale Retail Stores Law limited TRU's building of large, warehouse-style stores.

Eventually, Nintendo agreed to sell directly to TRU because TRU accounted for

30% of its worldwide sales. McDonald's Japan's decision to take a 20% stake in TRUJ also boosted the company's prospects. The late Den Fujita, then president of McDonald's Japan, found lucrative store locations for the toy company. Today, McDonald's Japan still owns 11% of TRUJ and receives 0.5% of sales in royalties for its store location service.

Ultimately, TRU proved that Japanese consumers do want low prices. And this success played a role in breaking down the distribution networks in Japan.

### Tailor-made toy retailer

Since 2000 TRUJ sales have increased each year despite recession and sluggish consumer demand. Tailoring business to the Japanese market, the company has changed the warehouse-style layout of stores to a circular race-track design, color-coded departments, introduced more customer service, offered online shopping, and added popular "specialty shops" in stores, like cosmetics counters for pre-teen girls.

The launch of stand-alone Babies "R" Us (BRUJ) stores, however, has met the greatest success. Although Japanese are having fewer babies than ever, nuclear families are on the rise. BRUJ offers anxious new parents goods for babies and even parenting

courses. BRUJ saw strong sales and higher profits margins than the toy division through FY2003 (ending January 2004). Baby goods account for 26% of consolidated revenues.

"It is very unusual in the retail industry for a new store to become profitable so quickly," reported Taketo Yamate.

TRUJ accelerated BRUJ openings this year. Of 12 new stores, half will be BRUJ.

BRU's success is timely because TRUJ is facing some hurdles. In FY2003 net sales increased 5.2% but only thanks to sales at new stores. Existing store sales declined 3.7% partly due to competition with new stores and partly to a poor retail environment.

Spring typhoons worsened the situation. The company now expects a pretax loss of ¥390 million for the first half ending July instead of a ¥700 million profit.

### TRUJ Outlook

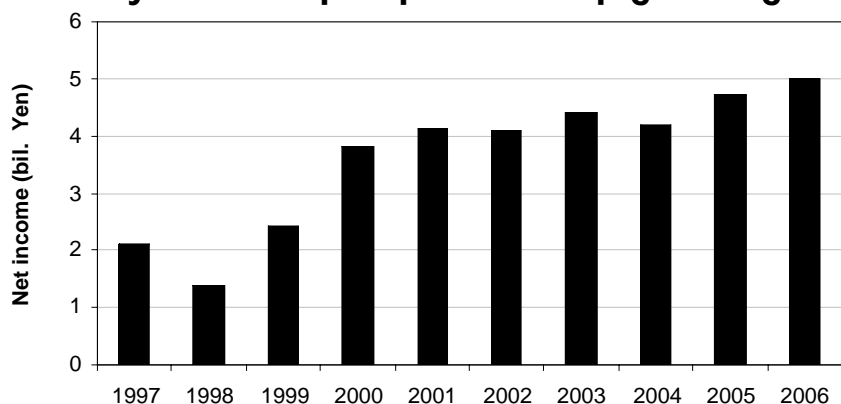
Even if fallout from TRU problems doesn't reach Japan, TRUJ will have to stay sharp. The rapid aging of Japan bodes ill for a toy company. And competition could tighten if consumer electronics retailers handle popular electronic toys more.

Even BRUJ, which is doing well now, will face increasing competition in the ¥1 trillion baby goods market.

To squeeze more profitability from existing stores, CEO Manabu Tazaki is either relocating stores or renegotiating rent at stores where 10-year leases are expiring. He's also increasing the range of "own-brand" goods (goods exclusively sold at TRU) which are more profitable, and streamlining TRUJ's procurement system.

He'll need to do this and more if Wal-Mart, which is now focusing on the operation of Seiyu food store, moves into toy retail.

## Toys R Us Japan profits keep growing



Source: Toys R Us Japan, UBS

Note: Profits (net income) for 2004-2006 are estimates by UBS