Challenges Facing Japanese Economy

By Kobayashi Keiichiro

Current State & Prospect of Economic Recovery

Japan's economic expansion, which started in February 2002, has surpassed the record uninterrupted postwar boom of *Izanagi* from November 1965 to July 1970, but compared with an annual economic growth rate of 11% during the *Izanagi* boom, the current annual rate is only 2.4%.

The problem is a weak recovery in household consumption and wages. A year ago, many economists, including this writer, thought that wages would rise around mid-2006, and consumption would achieve a strong recovery. Despite continuously improving corporate earnings performances, however, wage hikes have remained unexpectedly slow. As a result, recovery in consumption has been delayed, and consumer prices have not risen.

The current economic upturn, led by brisk foreign demand, centers on manufacturers and big businesses, and the business confidence of medium- and small-size companies is still poor. Especially in bad shape are smaller textile, service and construction firms. There remains a large question in the regional nonmanufacturing sector, badly affected by sagging construction demand in local economies following reductions in public works projects.

But despite the unexpected delay in the recovery of the household sector, the effect of the economic expansion will spread to households in full swing soon, possibly later this year. Actually, the market for recruiting new graduates has turned to a sellers' market for the first time since the collapse of the asset-inflated bubble economy in the late 1980s because of a tightening labor market. As public opinion seeking to rectify the income gap has been mounting since last year, businesses will be pressed hard to raise wages considerably. As a result, a new phase of economic expansion boosted by increased consumption is expected to be realized this year unless there arise risk factors from overseas economies.

It appears that ultra-low interest rates will likely continue for a long time in view of the current economic and fiscal factors that affect interest and price trends. As for the economic factors, rapid expansion in consumption seems unlikely based on the assumption of changes occurring in the structure of the Japanese economy, as discussed below. Therefore, it appears unlikely for a while to face a situation in which the Bank of Japan is prompted to raise interest rates by a large margin to prevent the economy from overheating. On the fiscal front, both the central and local governments are heavily debt-laden, as is well known, and are expected to wage stiff political resistance to rises in interest rates. Considering this, the low interest rate policy is expected to continue in and after 2007.

Structural Changes in the Economy

The reason for weak consumption and low wages despite the economic expansion is believed related to changes in the economic structure. The so-called Japanese-type economic system that had supported the country's economic growth until the 1980s has undergone drastic changes due to the recession in the past 15 years.

The Japanese economic system featured a lifetime employment system on the labor front, a system of particular banks acting as main lenders for corporate borrowers on the financial front and cross-shareholdings in corporate governance. (Some economists emphasize other aspects such as intra-company labor unions that prevailed over industry-wide unions.) Under the lifetime employment system, Japan used to have workers holding a strong sense of belonging to their employers, accumulating company-specific human capital. Companies also put emphasis on investment in the education of employees as there was no fear of their workers switching to other firms. As a result, labor productivity was high, enabling Japanese companies to produce high-quality goods. And, on the financial front, the main lending bank system and cross-shareholdings (friendly companies and banks owning shares in one another and refraining from intervening in management as shareholders) left corporate governance only in name and functioned as a framework in which banks disciplined corporate borrowers for a long time. In the old Japanese economic system, it can be concluded that both companies and workers acted under long-term strategies, showing high performances.

But the Japanese system (especially the lifelong employment system) is based on the premise of high economic growth and long-term corporate growth, and such a system cannot be maintained in the age of slow economic growth with an inflation-adjusted rate of growth hovering around only 2%.

Amid sluggish economic growth in the 1990s, the problem of nonperforming loans worsened, and at the end of the decade, commercial banks faced crisis. As a result, banks strengthened their credit-collecting activities, and financially depressed companies dismissed their employees and curbed recruitment.

Part-timers, temporary workers and other nonpermanent employees sharply increased in number, virtually collapsing the lifelong employment system. Behind the increase in nonpermanent employees was relaxation of regulations on temporary workers. If companies had not turned to employment of such workers, many of them would have gone bankrupt as their business performances deteriorated.

Employment of nonpermanent workers functioned as a shock absorber of the recession. But nonpermanent employees could not become members of labor unions, and their wages could not be improved in negotiations between unions representing permanent employees and companies. As a result, the power relationship between workers and management underwent structural changes, weakening workers' bargaining power.

In the aftermath of the long recession and the collapse of the main bank system, companies, chastened by bank reluctance to lend and their forcible credit withdrawal, began to think that banks are not reliable in a crisis. As a result of the collapse of cross-shareholdings among businesses, shareholders' power has been strengthened, and they are increasingly demanding higher dividends. Especially, the shareholding ratio of foreign investment funds has become higher, allowing them to actively intervene in the management of Japanese companies.

Pressure from workers on management has weakened, but as a result of strengthened pressure from shareholders, businesses have tended not to increase wages but keep current capital on hand as much as possible for future capital investment and dividend payout to shareholders. Because of these structural changes, wage rises anticipated in a conventional business cycle have considerably been delayed.

Frequent scandals involving companies also appear to be related to the collapse of the Japanese economic system. In recent years, various such scandals have frequently been occurring, including falsified data on anti-earthquake strength of condominiums and hotels, the derailment of a West Japan Railway Co. train on the Fukuchiyama Line, sloppy sanitary supervision by Fujiya Co. and fabricated inspection data by operators of nuclear power stations.

These cases indicate that Japanese businesses are not properly maintaining their in-house discipline. This appears to be partly because, with corporate governance practiced chiefly by shareholders in place of banks, companies tend to seek short-term profits rather than long-term development, resulting in distorted corporate actions. But in a low-growth economy, businesses cannot return to the main bank system. Hereafter, they are required to heighten their discipline by building an outside framework in which administrative authorities and civic groups check accountancy services and safety measures practiced by companies. It is necessary to build a market environment, including economic administration, matching corporate governance in a new age.

For example, recent measures taken by the Ministry of Economy, Trade and Industry are worthy of attention. The ministry has come with a new posture keeping its eyes closely on corporate safety measures and protection of consumers by revealing information about fatal gas appliance accidents and doing on-site inspection of an English conversation school over student complaints on contract cancellations. One can say the ministry has changed its stance from an "industrial promoter" to an "economic policeman."

As long-term corporate governance by banks has collapsed, administrative authorities are now required to check corporate discipline. The shift of emphasis in the economic and industrial administration can be given a high rating as one complying with the needs of the age.

Future Tasks

At a time when the conventional Japanese economic system cannot be maintained, a future task is the building of a market system matching today's new environment, such as slow economic growth and the growing sophisticated use of information.

Corporate legislation and the financial system have drastically changed in the last 10 years. One urgent task is a revision in labor legislation. As nonpermanent employees account for about 30% of workers, the dissolution of employment disparity between permanent and nonpermanent employees is indispensable to realize an efficient and fair labor market. What is required for the purpose is the realization of a principle of equal pay for equal jobs. Also needed may be to work out a new form of labor-management bargaining different from the current style between labor unions chiefly made up of permanent employees and management.

If the lifetime employment system collapses, the long-term formation of human capital within companies cannot be fully done. The building of a system by educational institutions, such as vocational colleges, universities and career graduate schools, may be required to improve the quality of workers.

Monitoring by shareholders alone is insufficient in order to check corporate safety measures and in-house discipline from outside. In addition to strengthened supervision by administrative authorities, important is a major role to be played by consumer organizations with enriched human and financial resources.

Furthermore, there are still many structural problems in financing for smaller companies (especially the nonmanufacturing sector). One reason is that many financial institutions cannot extend loans without collateral. In the background is the question of low technical capability on the part of financial institutions. Such capability is said to be lagging behind US financial institutions for more than 20 years and its improvement appears to be a condition indispensable for the development of the Japanese economy. JS

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Photo: Kyodo News

Family management placing greater emphasis on cost cuts than on food safety is blamed in part for the crisis of time-honored confectioner Fujiya Co. (Photo: Fujii Rintaro, left, then president, bows at a news conference as he apologizes for the use of expired ingredients for sweets.)