

Prospects for Japan's Economy

– Change and Continuity –

By James C. Abegglen

The economy of Japan is being shaped by three great transitions – from very high growth to economic maturity, from an industrial to a service driven economy, and all of this with a very rapidly aging population structure. Each of these transitions has a deep impact on the economy and on society. No surprise then, that economic growth slows with the painful, difficult and time consuming working through of the transitions.

Properly viewed, the past 10 years have not been a “lost decade” with a “stagnant economy” as the current clichés would have it. Gross domestic product (GDP) real growth for the ‘90s averaged 1.6%, about the same growth rate as that of Germany, France and Italy over the decade, somewhat below the 2 to 2.5% expected of a mature economy. Unemployment remains low and savings high by international standards, with Japan’s international asset balance much the highest in the world as Japan continues to be the principal world source of new capital. The Japanese workforce shares with the workforce of Germany the distinction of being the world’s best paid. Japan is a very wealthy nation.

That there are economic problems in Japan is clear enough; where is the economy without problems? The current fashion, both in Japan and abroad, to be hypercritical of Japan’s economic performance is, however, something of a puzzle. A general Japanese tendency to belittle oneself and one’s groups? Foreign gratification at the sight of problems in the nation that had been billed as taking over the world? The media rule that the only news worth reporting is bad news? Whatever the cause, the negatives are much overdone, at home and abroad, and are no aid to understanding the current situation or prospects.

From Historic High Growth to Economic Maturity

In assessing the current situation, it is necessary to recall the unprecedented growth of the economy as Japan went from poverty to wealth in the span of little more than a generation. From the mid-’50s to the mid-’90s, in 40 years, GDP growth was about 60 times, and in U.S. dollar terms nearly 200 times. Japan’s has long been a very dynamic economy as this growth required constant and rapid industrial change. No nonsense about “convoys:” not only companies, but whole industries have disappeared, from labor intensive coal mining to capital intensive but energy intensive bauxite smelting. These shifts to higher value-added sectors are harder to do now with slow growth – but happening still as labor intensive and energy intensive industries move off-shore, especially to East and Southeast Asia.

The change in the 1990s from very high growth to economic maturity has had both industrial and corporate strategic consequences. Under conditions of very rapid growth, large numbers of competitors survived in most industries. Growth was an umbrella over the less efficient producers as the high share, low cost leaders invested to take growth. As a result, Japan’s industries had, and most have still, an unusually large number of producers. However, as growth slows, the most efficient producers go for share, and the marginal producers go to the wall, driven to sell the business or into bankruptcy.

Japan’s vehicle producing industry serves as a good example of this phenomenon. There have been 11 producers of trucks, buses and autos in Japan for many years. Surely three would be ample. The industry is technologically mature, with little or no growth in its major markets. No surprise then that

Japan’s vehicle industry is now consolidating, as the marginal firms are savaged by the leaders, Toyota and Honda. Nissan, Mitsubishi Motors, Mazda and others have been kept alive thanks largely to injections of foreign capital. No doubt Japan’s workers should be grateful for the willingness of foreign companies to invest in otherwise bankrupted Japanese firms, thus minimizing unemployment. But the involvement of General Motors in Isuzu over three decades, and Ford Motors in Mazda over two decades, have done little to rescue these marginal competitors who continue to perform badly in an overpopulated and slow-growing market. Conclusion: In most Japanese industries, now mature in growth and in technology, consolidation is inevitable as the leading companies push out or take over the high cost, low share competitors.

Another industrial consequence of sustained high economic growth has been a tendency to over-diversify. When growth is high, entering a new business is relatively easy; there will be some increase in sales and perhaps enough profit to warrant continuing. As growth slows and competition intensifies, companies must focus their resources of staff and funds in their main businesses, now under pressure. And they must slough off the non-core businesses accumulated during the period of easy growth. Most conspicuously Japan’s electrical machinery companies – Hitachi, Toshiba, Mitsubishi Electric, Fujitsu, NEC and the like – massively over diversified and now with slowed growth need to concentrate their resources. This has been rather widely carried out over the past several years, led in many ways by Nishimuro Taizo, then president and now chairman of Toshiba, who in only two years in the late 1990s dealt with a dozen of that company’s non-core businesses

through various forms of disinvestment.

Economic Maturity and Changing Corporate Strategy

As another major effect, the shift from high growth to maturity calls for major changes in the strategic approach to management. High growth requires rapid increases in assets, as capacity must expand rapidly to hold market share. These investments are funded by high levels of debt, since debt being cheaper than equity allows lower costs and thus the competitive pricing to continue growth. Moreover, under conditions of very rapid growth, the true measure of success is market share. Undue preoccupation with near term profitability risks fatal loss of market position; market share is critical with very fast growth. And more basically, very high levels of household savings are required to provide the growth funding. The Japanese housewife, who controls the family budget, has been long-trained to be an assiduous saver and has done that job well.

All this changes with slow growth. Highly leveraged balance sheets must be brought back to earth and the debt drastically reduced. Increases in assets risks over-capacity. The measure of success becomes profitability, since market shares change only with difficulty in mature markets. No less important, the housewife needs to be reeducated toward consumption rather than savings. The hard-learned ways to success with high growth must be abandoned. The process is not easy. Teaching Mrs. Suzuki and Mrs. Watanabe to spend rather than save, and teaching their husbands new strategies for managing their companies, takes rather a long time, as the past years here in Japan have shown.

As if all this were not enough pressure, managements have been further challenged by changes in accounting requirements – consolidated returns, marking of assets to market values, and full accounting of pension liabilities – all of this in a deflationary, slow-growing economy. It is a quite extraordi-

nary testimony to the strength of Japanese management and companies that in the year ending March 2001, the top 1,863 companies reported a sales increase of only 2.2% from the year before, but an astonishing increase in profit after tax of 335%. Of all companies listed on the first section of the exchange, 20%, one in five, reported the highest profits in their history. Corporate debt is back to the 1990 level, cash flow being used to clean the balance sheet. The restructuring to deal with a mature economy is largely completed in the manufacturing sector, with some debris still to clear away.

Toward a Services-Focused Economy

With rapid economic growth, the focus of concern shifted from agriculture, once central but now marginal in policy matters, to manufacturing, once nurtured and protected but now left largely to its own devices, to services which have long been closely regulated and are now the focus of concern and change – utilities, retail distribution, finance and insurance. Agriculture is now only 1% of GDP, with nearly half of agriculture workers aged 65 or older, and 60% of total calorie supply imported. Manufacturing remains for Japan, like Germany, about a quarter of GDP, its strength attested to by continued massive trade surpluses. Services, especially finance, insurance and brokerage, have long had relatively low productivity levels, being closely regulated and largely sheltered from world competition. The regulation and rationalization of services is Japan's second great transition, and the transition is, as might be expected, a difficult and messy process.

The deregulation of retail distribution has largely been completed, with changes in retailing now being led by specialist discount stores, like Fast Retailing, whose Uniqlo shops feature low-priced Japan-designed apparel made in China, with current sales of over ¥230 billion, more than double the year before. The entry to Japan of France's Carrefour as a very large scale outlet is further testimony to effective



Fast Retailing, whose Uniqlo shops feature low-priced Japan-designed apparel made in China

retail deregulation.

The moves to deregulate the financial sector – banking, brokerage and insurance – came late with the initiation of the “big bang” program in 1996. Despite doubts, the deregulation has gone steadily forward and is now largely in effect, although a great deal remains to be done before the sector reaches competitive good health. Two main trends mark the process of deregulation. One is rapid consolidation in the banking sector, with four massive financial groups emerging, among the world's largest banks in total assets. Since these merging groups bring with them a trailing of trust banks, insurance companies and brokerage firms, parallel mergers of these businesses are taking place as well. The result is a massive concentration in the financial sector of Japan, if not yet significant improvements in efficiency or profitability. The end story in banking will be written politically, not economically, as government must intervene to deal with the overhang of bad debt remaining from Japan's bubble era.

The other main trend in the financial sector is the move of foreign financial firms to invest in failed Japanese insurance companies and banks, as well as in other types of financial businesses. A half-dozen of Japan's too numerous life insurance companies have been acquired by French, Canadian and U.S.



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firms, all while in or on the verge of bankruptcy. Banks, leasing firms and consumer finance companies, similarly troubled, have been acquired by foreign firms as well. Merrill Lynch of the United States acquired a good part of the bankrupted Yamaichi's retail brokerage operations. How well these firms will do under foreign ownership remains to be seen. Merrill Lynch has already announced three years of continuing losses, the closing of several branches and a drastic cut in advertising budgets. Foreign entry may bring greater competition and improved efficiencies. So, at any rate, it is hoped.

The Graying of Japan

Along with the great shift from high growth to economic maturity and from a focus on industry to a service-dominated economy, the third of Japan's great transitions is the demographic change, the graying of Japan. The general outlines are familiar, and similar to Western Europe. In the past year or two, for the first time in Japan's history, the number of persons over 65 years of age has exceeded those under 15 years, with the shift to be increasingly marked over the next decades as Japan's population declines by a quarter in the next four decades after increasing by more than half in the previous five decades.

Something of the magnitude of the demographic change can be seen in one statistic. In the past 50 years, life expectancy for women in Japan increased by 29 years and in the same 50-year period by 26 years for men.

The achievement is stunning, but the consequences of this aging pattern are vast. The work force reduces in size, consumption patterns change as housing investment for example drops, leisure activities expand and health/medical expenses surge. Driven by pension costs and public health expenditure, government expenditure is likely to rise toward the OECD (Organization for Economic Cooperation and Development) average of 50% of GDP. Education shifts from a focus on youth to continuing education and programs for the semi-retired. Some of the economic consequences are captured in the phrase, "the death of demand."

The impact of the changes in labor force age and size will be slowed by several factors. One will be a further extension of the retirement age, now generally about 60 years to 65 years, deferring the pension problem while recognizing much increased longevity. Another factor is the widespread use of robots. Japanese industry has more than half of the world robot population, some 400 thousand, each equivalent to nearly two laborers. This focus on automation will only increase in Japan's high labor cost, low capital cost economy. And finally Japan's industry will be making full use of the massive labor forces of China and Southeast Asia, China's labor some one-twentieth of Japan's in price. Immigration, with its many attendant social problems, is a poor substitute for effective off-shore investment. In sum, demographic change is not itself a fatal problem but rather is a part of the total complex of factors that make Japan's a mature economy, with a growth potential in the 2 to 3% range – a wealthy, rather dull, economy.

In all this change, the continuing capacity of Japanese industry to innovate will serve as a major positive factor in economic performance. In their analysis of innovative capacity, Michael Porter and Scott Stern rate Japan first in the world for 1999 and

project a continuation of that leadership position for Japan still in 2005, with the United States third in 1999 and dropping to sixth place in 2005.⁽¹⁾ The general accuracy of this analysis is borne out by data on patents granted in the United States by company, as shown in Table 1. In contrast to only two decades ago, when only one Japanese company was in the top 10, over the past decade half of the top 10 corporate recipients of U.S. patents have been Japanese companies, while the total numbers of patents granted have increased greatly. Another of the many curious myths regarding Japan is that it is a nation of copiers, lacking in invention. Again, the data at hand disprove the myth – which again will no doubt die hard as is the usual case with myths about Japan.

The Corporation as a Social System

In all this environment of economic change, the most encouraging evidence for the view that Japan's economy will continue to do well is the high degree of continuity in its social structure and values. Just as Japan's economic success was made possible by remaining true to its own history and culture while introducing foreign technologies, so its continued success requires building its own special systems of organization, relationships and reward, rather than attempting an unreformed market capitalism in the Anglo-American fashion.

Developments to date are encouraging. A general tendency to egalitarianism in industrial organizations continues. While U.S. chief executives received 475 times the average wage paid workers, the spread in compensation in Japan is 11 times.⁽²⁾ Stock options are possible now, but little used still. Exploitation of the workforce to a degree even approximating the United States is simply inconceivable. This is only one, but a critical one, of the ways in which the Japanese business firm remains a social organization, a "village," rather than a collection of physical assets to be bartered in the market place. Since Japan's *kaisha* are social organizations, acquisition is rare. Sale

Table 1: Number of Patent Approvals by Company in the United States, 1978-2000

| | 1978 | | 1990 | | 2000 | |
|----|--------------|-------|---------------------|-------|----------|-------|
| | Company | Count | Company | Count | Company | Count |
| 1 | GE | 820 | Hitachi | 908 | IBM | 2,922 |
| 2 | Westinghouse | 488 | Toshiba | 891 | NEC | 2,034 |
| 3 | IBM | 449 | Canon | 868 | Canon | 1,897 |
| 4 | Bayer | 434 | Mitsubishi Electric | 862 | Samsung | 1,442 |
| 5 | RCA | 423 | GE | 785 | Lucent | 1,415 |
| 6 | Xerox | 418 | Fuji Photo Film | 767 | Sony | 1,394 |
| 7 | Siemens | 412 | Eastman Kodak | 720 | Micron | 1,306 |
| 8 | Hitachi | 387 | Philips | 637 | Toshiba | 1,264 |
| 9 | Du Pont | 386 | IBM | 608 | Motorola | 1,203 |
| 10 | Philips | 364 | Siemens | 506 | Fujitsu | 1,169 |

Source: The United States Patent and Trademark Office

Japanese company

of the company is less damaging to its members than the alternative of bankruptcy. Not surprising, despite a good deal of noise, there have still been no hostile takeovers in Japan.

Thus the Japanese corporation continues to view as its primary responsibility the well-being of its employees. The peculiar Anglo-American view that all assets of the company are the entire property of the shareholder (after the chief executive officer takes his dominant share) is not a Japanese notion, who see the worker, suppliers, the community and customers as all having legitimate claims. Directors are inside directors, directorship still the reward for long and good service to the company.

A standard by which to gauge this continuity is the so-called life-time employment system. A recent study notes, "According to the media at least, the 'old' labour market, offering stable (if not 'lifetime') jobs, seems to have vanished for good. ... (Instead however) labour markets are more stable than is usually assumed, including over the longer term. ... Job stability as measured by employment tenure seems to be generally stable in the great majority of industrialized countries, even in the

light of the latest available data for 1999."⁽³⁾ What has been true for all of the OECD economies is notably true for Japan, where there has been a steady increase in job tenure for males and females, high school and college graduated, for the past 20 years. "Support for long-term employment practices currently remains high among both companies and workers."⁽⁴⁾

There has been no end to the employment system of Japan. No mass layoffs. No mass dismissals. No real changes since this writer first used the term "Life-time employment" in the mid-1950s. Only misleading media reports. Changes in the total personnel system have of course been taking place, and continue. Pay and promotion depend less on seniority than before, although seniority is still a major factor. The role of the trade union is much diminished, as in other advanced economies. Thus in some ways, "Japan-style management" is changing. Young employees feel more free to make a job change or two. But the rate of change is slow, and the basic social contract between employee and organization remains intact.

One observer recently concluded, "Many old systems will be replaced

with new ones, and other will survive with greater or smaller modifications. Two things, however, are clear: Far from declining, the Japan model of production and the life-time employment system will continue to evolve; and the work-based wage system that ultimately emerges will probably differ significantly from the Western-style performance-based wage system."⁽⁵⁾

For Japan, progress over the past decade or so is proving to be a long, tedious and tortuous road through a mine field of potentially explosive changes. The journey is nearing its end as Japan's economy restructures to a mature, low growth mode, strengthening the services sector while retaining industrial strength, and adjusting to the needs of an aging population. Fortunately, it appears that the journey is being made without abandoning the social values and systems on which Japan economic success has been based, and which are so greatly to be prized.

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