The Changing Landscape of Japanese Business

By Yutaka Endo

Over the last year, we have seen major currency realignment, a collapse in oil prices and other changes marking a major upheaval in the way the world economy is organized. Now, the gap between expectations and reality is showing up, and nations are being forced to rethink their policy mixes just as companies are having to redesign corporate strategy. Having suffered an especially severe buffeting, Japan, for example, is engaged in ambitious industrial restructuring. Japanese industries, rather than just hunkering down and waiting for the storm to blow over, are moving to weather these climatic changes and to ensure their continued growth with accelerated internationalization and stronger ties of horizontal integration with trading partners worldwide. This response by Japanese companies obviously has major ramifications for the growth potential of countries that already are or are likely to become closely linked to the Japanese economy.

It is thus worthwhile to examine the changes wrought by the yen's appreciation and lower oil prices and to look at where Japanese companies and the Japanese economy are heading.

Yen up

The process of currency realignment initiated by the G-5 meeting last September was intended to rectify the balance of trade disequilibriums among the major trading countries, especially the U.S. trade deficit estimated at $170-180 billion in 1986. However, it is clear from the events of the past year first that there is an asymmetry to the impact of currency adjustments and second that there are limits to what can be done to rectify trade imbalances with currency adjustment alone.

In Japan's case, the impact of the yen's appreciation has shown up in trade with negative export volume growth since March set against import volume growth typified by the August 1986 12.6% increase over the previous year, primarily in manufactured products. The yen's appreciation is having an increasingly deflationary impact. On the other side of the Pacific, the United States is seeing continuing lethargy in its exports and unabated expansion in its imports, and there is increasing pessimism about the economic future of the United States.

The major reason put forth to explain this asymmetry in how currency realignment has affected the Japanese and U.S. economies is the difference in the two countries' trade structures. In Japan's case, 90% of its trade is with countries whose currencies are linked to the dollar, such that the impact of the dollar's depreciation comes right through to trade figures. By contrast, while the dollar has depreciated sharply against the Japanese and European currencies, U.S. trade with these countries accounts for only 36% of the total. Thirty percent is with countries with dollar-linked currencies, and the rest is with countries such as Canada, Latin America and elsewhere where currencies are even weaker than the dollar. Consequently, depreciation against the Japanese and European currencies alone is inadequate to fully rectify the dollar's worldwide misalignment.

What of the future? In the United States, while there are signs of a short-term upturn, there is concern at the lack of progress being made in resolving the twin trade and federal deficits. So long as these structural problems remain unsolved, further adjustment will be needed sooner or later. Looking at next year in particular, there is a very good likelihood of deeper recession as the purchasing cycle for automobiles and other consumer durables enters a downward phase and as the people hurt by tax reform defer expenditures in anticipation of higher tax bills. Thus it is impossible to hope the United States will resume its former locomotive role in the world economy anytime soon, and calls on Japan and Europe to take up this slack can only increase in their intensity.

Issues for the Japanese economy

Here in Japan, domestic demand is holding firm even as the yen's appreciation has an increasingly deflationary impact. While the decline in export volume is expected to be more pronounced toward the end of the year, the government has moved to keep the economy alive with accelerated implementation of public works projects in the first half of the fiscal year and a ¥3.6 trillion (about $23 billion at the rate of ¥155/$) stimulative package in the second half.

This does not, however, mean that the economy is in robust health. With the decline in exports and the upturn in imports, it is unlikely that the economy will be able to do any better than about 2% real growth for this fiscal year. In the medium term, considering the ongoing efforts that will be needed to overcome the twin deficits in the United States, export demand's contribution to Japanese GNP will inevitably drop as a result of the yen's sharp appreciation and the increasing U.S. shift to managed trade. The growth rate will naturally suffer as a result.

While this may be slower growth than in the past, there is some question about the validity of comparing current and future performance with past growth rates in light of the altered circumstances facing the Japanese economy. Growth per se is no longer the goal. Rather, the need is now for the Japanese economy to discard its early 1980s pattern of relying upon exports to power growth and to instead contribute positively to the balanced expansion of the world economy, including the implied need to exercise the purchasing power earned through strong exports for improving the quality of Japanese life. This should be possible, even though the economic growth rate may slip a bit, so long as Japan provides a growing market for the rest of the world by importing more and enhances the standard of living with a better quality of consumption and improved infrastruc-

Yutaka Endo is a senior economist in the Research Division of the Industrial Bank of Japan.

ture amenities for industry and private citizens alike.

Contributing to a stronger world economy

It is thus highly significant that Japanese companies themselves have taken the initiative in moving to wean the economy from its overdependence on exports and to further open the Japanese market for imports.

The first step being taken in this direction is that toward local overseas production by Japanese companies. Although the automobile, electrical machinery, general machinery and other industries had already planned considerable overseas production to alleviate trade friction, this trend has been further accelerated as the yen's appreciation has sweetened its attractiveness. There has been an especially sharp upturn in production investment in Korea, Taiwan and other countries with dollar-linked economies. Behind this shift, of course, is the triple-decker attraction of lower oil prices, a lower dollar and lower interest rates, and this combination has drastically enhanced the potential for growth in these countries. Lest any Japanese doubt the attraction of investing in Southeast Asia, the yen's latest appreciation has made Japanese dollar-equivalent hourly wages in manufacturing eight times those in Korea and more than six times those in Taiwan. Thus even though the higher quality offered by Japanese labor may justify paying higher wages in Japan, it is often definitely to industry's advantage to produce in these other countries. In addition, these governments are very hospitable to Japanese investment, having relaxed their foreign exchange regulations in a drive to expand exports to North America and Europe, to upgrade their economic potential and even to export to Japan.

The second step being taken is that to strengthen the companies' competitive positions and ensure their survival by importing inexpensive parts from overseas for local assembly and sale in Japan. While there had been some of this before, it has now escalated beyond simply importing parts to providing production technology and capital resources for these overseas suppliers and integrating them into the companies' long-term strategies.

According to the results of an Industrial Bank of Japan survey of plant investment trends this September, most Japanese companies are focusing on Asia (46.9%) and North America (41.4%) as the prime regions for overseas development. While Korea and Taiwan are regarded as the key countries in Asia, over 10% of all companies cited China as their important strategic focus. By industry, the automobile companies, both auto parts and vehicle manufacturers alike, are looking to North America. By contrast, the majority of the shipbuilding, textile, electrical machinery and foodstuffs companies put their top priority on Asia. These are also differences by corporate size. While all companies of whatever size are moving overseas, the majority of the big companies are interested in North America for direct market access and the smaller companies tend to be more interested in lowering their production costs by gaining access to Asia's low-cost labor.

This change in Japanese companies' international strategies is bound to alter the Japanese trade structure. Exports will be replaced in large part by overseas production and there will be a major increase in parts imports. In fact, parts imports were already 16.7% more in the April–August period of 1986 than in the same period of 1985, but the full impact on imports and trade has yet to be felt. By 1990, assuming that the yen stays at its current high level, Japan should be not only a major supplier of manufactured goods for the world but also an important market as well.

Hollow corporations?

This corporate response to the changing international economic environment is imperative both for the individual companies involved and for the Japanese economy as a whole. However, it must be noted that this shift to overseas production is fraught with the danger of hollowization. Some Japanese companies are already having a difficult time of it, and it is expected that others will also be forced to make painful adjustments as they lose their competitive edge. It is essential that these companies constantly scale down and reorganize their less competitive businesses and move their resources into developing new lines if they are to continue as going concerns, and the struggle for corporate survival is expected to become increasingly harsh in the years ahead.

Growing domestic demand is essential both in support of these corporate adjustment efforts and to sustain strong employment macroeconomically. As such, the expansion of domestic demand is one of the most important issues facing the Japanese economy over the next few years. While this is obviously easier said than done, there are two points that suggest it is possible.

First, it should be noted that Japanese GNP was approximately $1.4 trillion as of fiscal 1985, making it the second-largest market in the free world (behind the United States' $4 trillion). Of this, domestic demand accounts for fully 84%, and thus it should be possible to offset the anticipated decline in export demand with only a 1.5% increase in domestic demand. At the same time, it should be possible to maintain strong employment by judiciously fostering the information-processing, telecommunications and other service-sector industries that are expected to be the growth leaders of the future.

Second, Japanese society itself seems to be in a time of transition, and there are increasing opportunities for expanded domestic demand. In part, these changes are being propelled by the technological revolution wrought by advances in microelectronics and information processing, and in part they are because society is becoming more information and service oriented. Investment in information-processing and related facilities, for example, is growing steadily every year, recording nearly 50% real growth in 1984 to account for approximately 20% of all private-sector capital investment. In addition, social infrastructure investment is another powerful force sustaining domestic demand. With the easing of regulatory restrictions and increased government recognition of the need to mobilize private-sector energies, there has been a spate of new public-interest projects involving private capital and management participation.

Even with the most favorable circumstances, industrial restructuring and economic adjustment will be a long and painful process. Nevertheless, Japan has a responsibility to promote these changes and to transform its economy and society into one beneficial to the global community at large as well as to domestic interests. There is no reason why the country's best minds should not be able to engineer such a soft landing.

Yet perhaps even more important than the details of these changes themselves is the issue of how to make this understood overseas—how to make people realize that a vast market is emerging in the Far East increasingly open to foreign participation and that it is those entrepreneurs bold enough to seize the opportunities presented who will survive and prosper in the years ahead—so that the peoples of all countries can join together in truly integrated world economic development. ●