Premature applause for Japan’s one quarter of promising economic growth

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The international financial world was impressed last month when Japan’s economy registered an annualised growth rate of 5.5 percent for the last quarter of 2005.

After 15 years of economic stagnation, the figure was unexpected. It came together with other surprising statistics: private consumption which accounts for over half Japan’s gross domestic product (GDP), increased at an annualised 3.2 percent. Fixed-capital investment grew at an annualised 7.2 percent.

Unemployment dropped to 4.4 percent last year, down from 4.7 percent in 2004. Consumer confidence, as measured by the ratio of household spending to disposal income, reached 74.7 percent in 2005—the highest in 15 years.

These statistics have prompted a wave of enthusiasm among economists and financial commentators, seemingly reassured that world economic growth is being driven not just by a heavily indebted American economy and uncertain investment bubbles in China.

A Bank of Japan policy board member, Kiyohiko Nishimura proclaimed on February 16: “Japan’s economy is no longer a sick patient.” Massaki Kanno, chief economist at JP Morgan Securities Asia, declared: “The strength of domestic demand seems real. I believe Japan will achieve roughly 3 percent growth this year.” Stefan Worrall, an economist at Credit Suisse First Boston in Tokyo, enthused: “Japan’s economy is back, and with a vengeance.”

The Japanese government removed the word “mildly” from its February economic report to highlight its claim that a strong recovery is underway.

However, the apparent strength of this economic growth, which is heavily dependent on exports to China and new interest by foreign investors in Japan, is far from sustainable.

Martin Wolf, the chief economic commentator for the *Financial Times*, pointed out on March 6 that Japan’s free market restructuring still lags far behind other major industralised economies. Its corporate sector is hugely inefficient and indebted by international standards. Japanese corporate investment as a share of GDP is 40 percent higher than in Germany and the US. An average Japanese company requires 70 percent more capital to produce a given value than a US one.

The reduction of Japan’s corporate debt (from 125 percent of the GDP in 1996 to around 80 percent at present) was largely achieved at the expense of the growing public debt as the government bailed out the banks. At the same time, the net debt of Japanese households in 2003 reached a massive 317 percent of disposable income—compared to 185 percent in the US in 2004. These huge debts are one reason the Bank of Japan is still reluctant to lift interest rates, even after officially declaring the end of its zero interest rate policy last week.

Wolf commented: “It is still a Japan whose growth depends heavily on exports and investment, whose private sector saves far more than it can profitably invest at home and whose corporations waste capital. Japan is not recovering because it has a brand new economy: what has been achieved is a partial clean-up of the legacy of the bubble years.”

Corporate investment in building new plant and the creation of more full-time jobs—the bright spots that the Japanese government proudly announced—are largely driven by growing exports to China in recent years. In 2004, Japan’s imports from and exports to China grew 25.3 percent and 29 percent respectively.

Many Japanese companies are using China as a cheap labour platform—a process that has, in turn, stimulated manufacturing and engineering activities in Japan, in order to supply parts and equipment for operations in China or to Chinese manufacturers dependent on Japanese technologies. Partly as a result, capital spending has been a major factor in Japanese economic growth since 2003, coinciding with a wave of internal retooling. Even so, Japanese factories are still on average 12 years old, as compared to the historical average of 8-9 years.

According to the Japan External Trade Organisation (JETRO), Japan-China trade increased 12.7 percent to $US189 billion in 2005. However, Japanese exports to China grew just 8.9 percent to $80.36 billion—down from 29 percent in 2004. Japanese imports from China rose 15.7 percent to $109 billion, largely due to imported goods manufactured or outsourced in China. As a result, Japan recorded its largest bilateral trade deficit with China of $28.66 billion.

JETRO warned that Japanese exports to China remain uncertain because of large excess capacity in that country. Important categories of Japanese exports to China experienced declines last year: construction machinery was down 27.5 percent, integrated circuits 8.7 percent and finished automobiles 21.4 percent. By volume, plastics and steel declined 6.3 percent and 16.4 percent respectively. The increased export of auto parts, power-generating machines and metalworking machinery in 2005 is likely to slow down due to massive overcapacities building up in China’s auto and steel industries.

Growing international investment in Japan may also have played a role in its economic recovery. In the past, Japan resisted calls to open up to foreign capital; now it is the government's top priority. According to JETRO, total foreign direct investment (FDI) into Japan in 2004 was $US37.4 billion—higher than the cumulative figure of $34 billion for the four decades from 1950 to 1994.

Between 2000 and 2004, Japan's manufacturing sector received more than $21 billion in foreign direct investment, higher than the total of $18.8 billion for the period from 1950 to 1994. The telecommunication sector received over $19 billion from 2000 to 2004. The financial and insurance sectors gained $29 billion from 2000 to 2003. Other Japanese industries experienced large increases in FDI from the late 1990s.

The economic section of the Japanese Ministry of Foreign Affairs website features an appeal to "Invest Japan!" as part of the government's policy in 2003 of doubling inward FDI in five years. Last year, Prime Minister Junichiro Koizumi even appeared in a commercial advertisement aired in Europe and the US, inviting investors to Japan.

Koizumi's privatisation of Japan Post—the world's biggest financial institution—last year has stimulated optimism in Tokyo's commitment of market reform. The prospect of huge quantities of new capital being injected into financial markets has been one factor contributing to rising values on the Japanese stock exchange. The average share price on the Tokyo Stock Exchange rose by 40 percent in 2005. At the end of last year, the Nikkei 225 index topped 16,000 for the first time in five years and has largely remained at that level.

Some economic analysts have argued that rising corporate profitability will lead to wages growth and have cited increased consumer spending as evidence. In reality, increased corporate profits in Japan have been achieved at expense of workers.

An article entitled "The Sun Also Rises" in the *Economist* magazine last October pointed to the massive growth of low-paid part-time and contracted labour as a major source of company profits. In 1990, "non-regular" workers made up just 18.8 percent of Japan's workforce; in 2005 the proportion rose to 30 percent or more than 20 million people. Most are young, unskilled female workers.

Canon, a major Japanese electronic firm, for instance, now employs 70 percent of its factory staff as "non-regular" workers—up from 50 percent just 5 years ago and 10 percent a decade ago. The casualisation of the Japanese workforce has cut the corporate wage bill. In 1998, workers' pay accounted for about 73 percent of corporate earnings—by 2004, the ratio had dropped to 64 percent.

As in other countries, Japanese companies are increasingly reliant on cost cutting and streamlining to remain competitive. Japan's traditional keiretsu business system based on closed "stable shareholdings" held by major domestic banks, financial institutions and corporate management has been largely replaced by market-determined share ownership. "Stable shareholdings" have dropped to about 22 percent of market capitalisation from a peak of 53 percent in 1987.

In the past, Japanese managers were bound to consult keiretsu members over appointments, distribution and other corporate decisions. Now management acts more independently and aggressively, restructuring company operations with an eye to profits and share prices.

Last year, Sony, an icon of Japanese capitalism and the world's second largest electronic company, appointed a foreign chairman, Howard Stringer, for the first time. The company had lost 60 percent of its market value over the previous five years. Sony then announced unprecedented plans to slash 7 percent of its workforce or 10,000 jobs by 2008 and to cut back on unprofitable products such as Walkman. Sony's share price has risen sharply. On January 27, the corporation registered its biggest one-day share price rise in 15 years after issuing a forecast for the 2006 financial year that revised a predicted $90 million loss to an expected $450 million profit.

What is taking place in Japan is the type of slash-and-burn economic restructuring that was carried out in the US and Britain in 1980s. The *Economist* magazine commented that the past 15 years "has been a more painful period than any visits limited to prosperous Tokyo would suggest. Provincial cities and rural areas have suffered greatly, with shuttered-up streets and rising levels of poverty. Suicides have soared, up more than 50 percent since 1990 to 34,500 in 2003. By Japan's standards, crime has risen too... Still, compared with what might have happened in most other developed countries had they gone through the same prolonged experience, Japanese society has remained remarkably stable."

Even if economic growth in Japan proves to be more sustained than one promising quarter, this social crisis will only deepen. Continued growth depends on the uncertainties of the Chinese and world economy as well as further savage restructuring to make Japanese companies "competitive" with their international rivals. Japanese workers are in for major shocks as the corporate giants backed by the Koizumi government seek to make up for lost time by slashing wages, conditions and full-time jobs, while demanding further cutbacks to public spending, particularly on already limited social programs.