

JAPAN ECONOMIC CURRENTS

A COMMENTARY ON ECONOMIC AND BUSINESS TRENDS

Eradicating Japan's Deflation through Corporate Effort

BY YOSHIKIYO SHIMAMINE, DAI-ICHI LIFE RESEARCH INSTITUTE INC.

Since bottoming out in January 2002, the Japanese economy has been in an expansionary phase for 39 months. This unbroken expansion trend has lasted longer than average; in business cycles since the end of World War II, upturns have averaged about 33 months.

In the years that followed the bursting of the speculative bubbles in the early 1990s, the Japanese economy has gone through expansionary phases. The first was a relatively long upturn of 43 months lasting until April 1997, when a hike in the consumption tax and other factors caused growth to stall. The subsequent downturn was a severe one marked by financial instability (including the collapse of major financial institutions) and the onset of deflation. Growth resumed in 1999, but because it was driven primarily by the worldwide information-technology (IT) bubble, the benefits it brought were not evenly distributed. The IT bubble popped about a year after that.

Personal spending remained weak as a direct result of sagging consumer confidence and stagnant household income, which were, in turn, driven by the high rate of unemployment.

As a result, the upturn was a mere 22 months, making it the shortest of the postwar growth phases.

Unemployment Moves Down

During these two earlier recovery phases, people in Japan did not assume that the good times had returned, particularly because the unemployment rate remained quite high. Although unemployment typically rises only during recessions, Japan's jobless rate failed to move down during the two expansions. As chart 1 shows, it continued to worsen or, at best, held flat. Evidence collected in Western countries confirms the fact that trends in joblessness can have a profound impact on consumer psychology. Because the country's employment picture did not improve during the two expansionary phases, most Japanese did not feel that the economy was really on the rebound.

Further, personal spending remained weak as a direct result of sagging consumer confidence and stagnant household income, which were, in turn, driven by the high rate of unemployment. This weakness in domestic demand brought downward pressure on prices at the consumer level, and it pushed the Japanese economy into a deflationary spiral.

The latest expansionary phase from an employment perspective is altogether different from the two earlier upturns. Whereas the jobless rate had previously failed to show any sign of improvement, now it has been moving down since peaking in the third quarter of 2002, and consumer confidence has begun to return at the same time. Joblessness as of last March was still at 4.5 percent—much higher than the 2 percent level of the bubble years—because the balance of labor supply

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The Competition Solution

5

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Eradicating Japan's Deflation through Corporate Effort

and demand is improving, consumer sentiment is as upbeat as it has ever been since the bubble's collapse.

nature. That is, they rushed to straighten out their balance sheets by channeling cash flows mainly into loan repayments, not into new equipment or labor.

firms have established an earnings structure that can generate profits without GDP growth.

In the post-bubble economy, the cash flows accumulating in Japanese businesses were not being channeled into new investments because firms' projected growth rates were quite low. With the economy now in the midst of a sustained expansion, however, corporate managers are anticipating faster growth, and they have started to boost capital investments and take on new personnel.

Arguably the improvement in corporate profitability is the most important factor behind the recent upturn. After the bubble's collapse, Japanese firms adopted a course of action that was defensive in nature.

Firms Boost Profitability

The primary reasons for the recent improvement in employment are the ongoing business recovery and positive trends in corporate profitability. When production begins to expand, inputs of labor also increase. This remained true throughout the post-bubble years, but because the earlier upturns lacked vigor, companies were able to sufficiently expand production by having workers put in longer hours, without hiring additional personnel. Now that working hours have already been stretched to their limit, however, companies are beginning to take on more employees.

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As a result, especially among big businesses, the pressure to make further adjustments in balance sheets gradually abated. As corporate performance improved, cash flows began to build up, and a financial structure suited to generating profits was established. As chart 2 shows, the ratio of current profits to sales has now regained a level matching the peak during the bubble years.

There is, though, one striking difference in the new financial structure. Whereas the high profit rates previously came in the context of brisk economic growth, with nominal gross domestic product expanding at a rate close to 8 percent, they are turning up now at a time when the nominal rate is expanding hardly at all. In short,

The Bank of Japan's latest *tankan* survey of business sentiment supports this assumption. It shows that while the upward trend in assessments of business conditions has tapered off, managers remain upbeat about capital investment and employment conditions. Interesting, among companies of all sizes, more reported concerns of a labor shortage than of excessive staffing for the first time since 1997, and that in large companies in particular, a sense of having too many employees has virtually disappeared.

The members of Japan's baby-boom generation (those born between 1947 and 1949 period) will reach retirement age over the next few years, and their impending departure has prompted a reformulation of long-term employment strategies. This demographic factor provides another reason for expecting the growth trend in employment to last for some time.

There are a number of ways to define the end of a deflationary phase, but if we use the measure of consumer prices, 2006 should be the year when deflation is finally vanquished in Japan.

Beating Deflation

The expansion has been leveling off since 2004 due to sluggish exports and inventory adjustments in the high-tech sector. Thanks to resilient domestic demand, though, a slump has been held off thus far. In the high-tech sector, the balance between shipments and inventories should soon get better, bringing the inventory-adjustment phase to an end.

Since leading indicators released by the Organization for Economic Cooperation and Development (OECD) are showing signs of bottoming out, exports may grow faster in the second half of the year. This means that the Japanese economy should resume its expansion in the third quarter and further accelerate in 2006.

What businesses are currently waiting for is a shift to positive growth in consumer prices. The gap between real GDP and long-run potential production capacity has been gradually narrowing, and once faster growth resumes, it should become narrower yet. Given such

factors as recent cuts in public utility charges, consumer prices could show negative growth for 2005 as whole. Nonetheless, a shift to price increases can be anticipated when the effects of these cuts wear off—probably in the final quarter of this year or, at the latest, early in 2006.

There are a number of ways to define the end of a deflationary phase, but if we use the measure of consumer prices, 2006 should be the year when deflation is finally vanquished in Japan. Even so, prices will probably increase only slightly, by an average of less than 1 percent, and many consumers will continue to harbor deflationary expectations. And if business begins to slump in this atmosphere, prices may start falling once more.

In such a phase of weakly rising prices, any hasty move by the central bank to terminate its policy of quantitative monetary relaxation will court the risk of alarming financial markets and causing growth to decelerate. Even if the authorities decide to shift course

from a quantitative to an ordinary relaxation policy, accordingly, they will be expected to take steps to curb excessive hikes in interest rates.

Risk Factors

A number of risk factors need consideration. Sharply climbing oil prices could cause overseas interest rates to rise and demand to falter, and the authorities could misread the situation and adopt misguided policies. Because Japanese public finance is badly out of balance, there is no way to avoid austerity in government spending in order to rein in deficits.

In the event of an unanticipated downturn in business overseas, however, the government will need to postpone its plans for phasing out the fixed-rate cut in income taxes. This cut was introduced several years ago to stimulate domestic demand, and ending it prematurely would knock a prop out from under the economy.

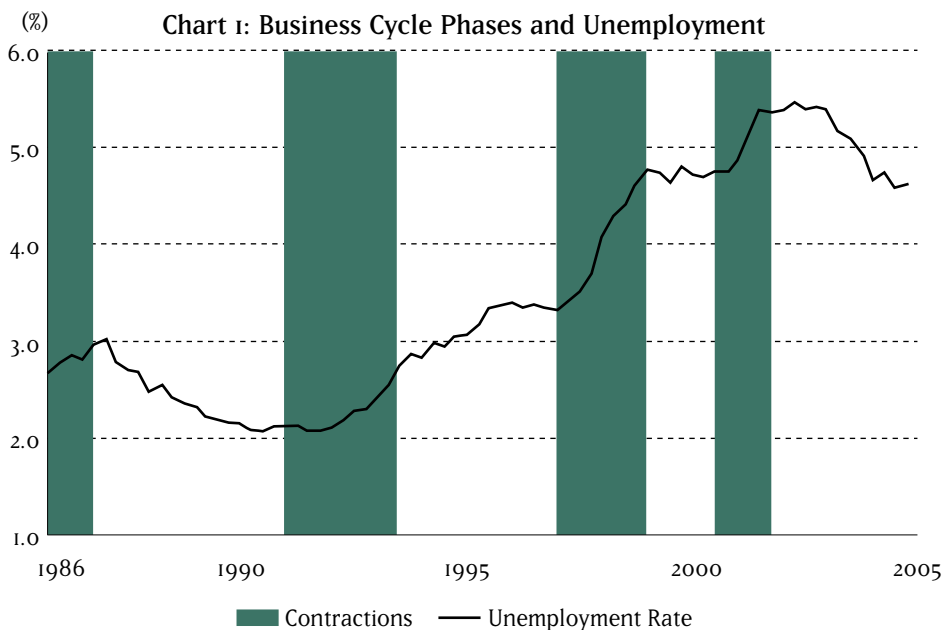
We also must bear in mind that while Japan's real economy has been gaining resilience, its assets markets have moved in the opposite direction in some respects. In the stock market, for instance, foreign investors have moved ahead of Japanese individuals and non-financial businesses to the second-ranking position in stock ownership, and the trends in their buying and selling

Eradicating Japan's Deflation through Corporate Effort

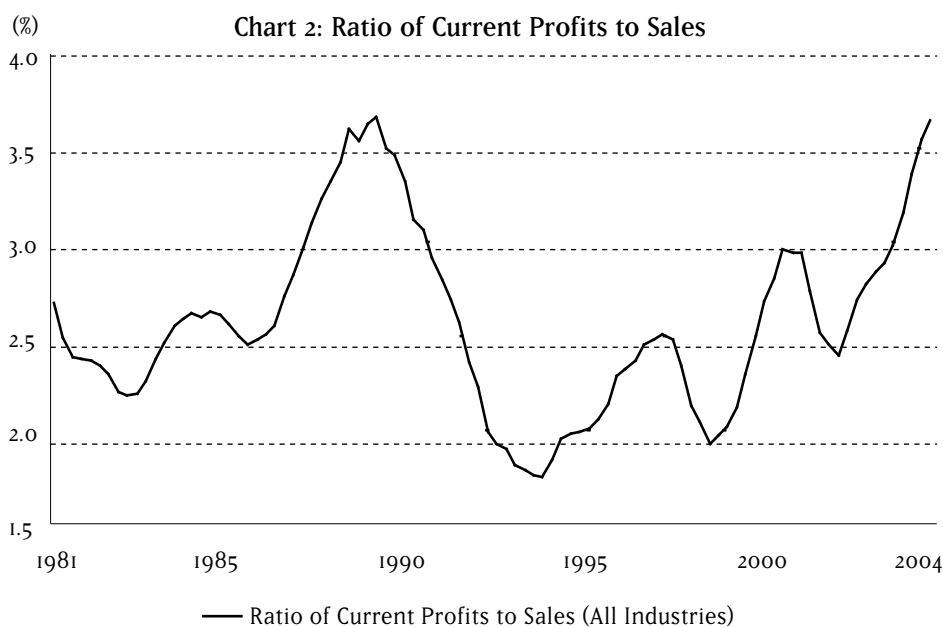
have a powerful impact on prices. This has raised the concern that if overseas stock prices begin to fall for one reason or another—perhaps because of a rise in overseas interest rates—foreign investors might start to unload their Japanese assets even if interest rates in Japan remain low. And if shares begin to be traded at unduly low prices, Japanese companies and individuals would be likely to become more cautious in their behavior. The risk of a business downturn would then grow larger.

The Japanese economy is today on the threshold of beating deflation, but some years may have to pass before falling prices become truly a phenomenon of the past. Until that happens, Japan will need fiscal and monetary policies that can enable domestic demand to withstand possible adverse changes in the external environment. Conversely, if the government moves decisively to get domestic demand on an expansionary track, the economy will be able to shrug off the pressures of mild deterioration in external conditions, and eradicating deflation may be accomplished straightaway.

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Sources: Ministry of Internal Affairs and Communications; Cabinet Office.



Source: Ministry of Finance.

The Competition Solution

BY PAUL LONDON, AMERICAN ENTERPRISE INSTITUTE

JAPAN
ECONOMIC
CURRENTS

The spectacular American economic expansion of the 1990s was largely unexpected, and it is very important to understand why this was so, and what we can learn from that long period of prosperity.

Unemployment fell to 3.8 percent at the end of the decade from over 7 percent in 1992, but there was no inflation. Indeed, inflation fell to 2 percent as unemployment moved to the lowest level in 30 years, defying economists who for two decades had said this would be impossible.

The behavior of investment was also a surprise. It grew at over 10 percent per year during the expansion despite interest rates that were quite high—around 5 percent in real terms for the whole period. Fiscal stimulus from government spending also declined sharply during the decade because tax increases and spending cuts that Presidents Bush and Clinton courageously pushed through in 1990 and 1993 took demand out of the economy.

So neither monetary nor fiscal policy were expansionary during the 1990s but the American economy soared anyway. The question is why that was so, and what are the lessons for Japan and other countries as well as the United States? These are the questions that my book, *The*

By the 1990s, the "old boy" relationships in formerly regulated monopolies—airlines, trucking, railroads, telecommunications, and energy—also had been broken up or sharply limited. United, American, Delta, and the other dominant airlines of the post-war period face new competitors.

Competition Solution, the Bipartisan Secret behind American Prosperity sets out to answer.

What my investigation shows is that the reason for this stellar performance is primarily owed to more competition. Competition increased in almost every sector of the American economy between the 1970s and the 1990s, and this drove investment and growth while holding prices down.

The proof is found by looking at four key sectors and how much they had changed between the 1970s and the 1990s.

Manufacturing is a good place to start. At the beginning of the 1970s, three car companies—General Motors, Ford, and Chrysler—produced almost all the automobiles sold in America. By the 1990s, Toyota, Honda, Nissan, Mazda, Isuzu, Subaru, Hyundai, BMW, Mercedes and other foreign-owned companies were building

cars in America, and many other makers like Volvo, Audi, Suzuki and Kia were exporting them to the US market. Where once there was a three company oligopoly, now there are 16 or more competitors.

Similarly, in the 1970s a few large integrated steel companies following the lead of US Steel dominated the domestic market, and imports were modest. But by the 1990s, imports were a significant factor and, more important, a half-dozen new steel makers like Nucor Steel and other "minimills" using electric furnaces were producing over 50 million tons of steel per year in the US, half of the country's output.

Other areas of manufacturing were more competitive too. The auto companies, facing competition, had stopped paying list prices for steel in the 1980s and began to force the mills to compete for their business.

The Competition Solution

In the same way, car companies were forcing parts makers and machine tool builders to compete more strenuously, transforming the whole manufacturing economy.

By the 1990s, the "old boy" relationships in formerly regulated monopolies—airlines, trucking, railroads, telecommunications, and energy—also had been broken up or sharply limited. United, American, Delta, and the other dominant airlines of the post-war period face new competitors. Southwest Airlines, JetBlue and other newcomers with different business plans are fighting for market share everywhere.

The trucking companies and the Teamsters lost the right to set freight rates in late 1980, under President Carter's administration. In the 1970s, AT&T lost its virtual monopoly of telecommunications services and was forced to face the upstart MCI; today, dozens of telecommunications providers compete in AT&T's old space.

American financial markets have been transformed since the mid-1970s in the same way. Fixed commission rates on stock transactions were declared illegal. New competitors including the NASDAQ, junk bonds and powerful regional banks challenged the old New York financial institutions. All these new financial institutions were

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sources of financing for newcomers in other economic areas.

The US's huge retailing sector also is being transformed by Wal-Mart and Target, Home Depot and Lowe's, Office Depot and Staples, and Ikea and Pottery Barn to name a few. Wal-Mart, it is sometimes said, did more to fight inflation than the Federal Reserve.

What we see in this transformation of the American economy between the 1970s and the 1990s is what is called in Japan "structural change," and what is striking is that fiscal and monetary policy played little role. Rather, the new environment was made possible in every case by political decisions that allowed new competitors to enter markets where competition had been limited before. The American car companies and the unions wanted protection, but got very little of it from American political leaders. The steel industry got some protection from imports but none from new domestic competitors.

AT&T and its union wanted to keep their monopoly, but the American

political system had been favoring MCI and a host of new competitors long before the famous court decision in 1982. By the same token, the old Wall Street brokerage houses and banks tried to stop competitive brokerage rates, junk bonds, the emergence of the NASDAQ, and new banking competitors, but the American political system favored newcomers who drove down costs and prices and powered growth.

Wal-Mart was and is opposed by status quo interests including manufacturers who want to keep prices up, wholesalers, retail competitors and their unions, and local "preservationist" interests, but it found the political support to grow from a less than \$100 million a year company in 1970 to become a retail behemoth today.

The lessons of this history for the United States and Japan are clear. What Adam Smith called "the wealth of nations" still is the result of freeing people to compete and create. Countries that have followed

the US example have generally prospered, even though established companies and interests have lost out. Established interests always are hurt by competition. But the countries that have political systems strong enough to stand up to these incumbent status quo interests always come out ahead.

In this context, it is clear that tax and monetary policies have been immensely oversold by economists of many ideologies. It was competition, not tax changes, that made the 1990s prosperity possible. Neither the tax reductions put in place by Ronald Reagan during the 1980s nor the tax increases pushed through by George H.W. Bush in 1990 and Bill Clinton in 1993 had as much to do with prosperity as did the more competitive climate of the decade.

Nor was monetary policy so important. The 1990s expansion withstood a substantial increase of interest rates from 1993 to 1997. Even more telling, inflation fell during the 1990s despite falling unemployment because of competition—not because of anything the Fed did.

The great economic problem is really a political one. Adam Smith said that the interests injured by competition would pull out all the stops to prevent political leaders from promoting it, and this certainly is the case.

The United States in 2005 is still struggling to deal politically with the political implications of increased competition. Some American companies like Caterpillar, which never developed a culture of monopoly, began three or four decades ago to make the adjustments that had to be made. Caterpillar never stopped exporting from the United States, fighting to hold markets that other American companies surrendered. It invested in Japan so that it would be able to challenge Komatsu in its home country and in other overseas markets, and after several painful strikes, it worked out a *modus vivendi* with the United Auto Workers that has allowed it to keep hiring and growing in the American Midwest.

The American auto companies on the other hand—namely GM, Ford and the UAW—developed a culture of weak competition, surrendered their foreign markets, were unable

to make sufficient adjustments in union contracts, and to make other adjustments to competition. Now, after decades of half measures their bonds have been downgraded to “junk” and they face the need to deal with the cost problems they put off without the cash cushion they once had.

Similarly, several of incumbent airlines and their unions have gone through round after round of retrenchment without ever fully dealing with the labor arrangements which are bloodlessly called the “legacy costs” of the pre-competitive world. Adjustments in the financial and retailing sector and in areas like oil and natural gas, on the other hand, have been easier to deal with because labor issues have been resolved more quickly.

The lesson of the 1990s is an old one. Prosperity and innovation are the result of competition, but competition is politically unpopular and painful.

The lesson of the 1990s is an old one. Prosperity and innovation are the result of competition, but competition is politically unpopular and painful. It takes courageous presidential leadership to protect new competitors and consumers against the power of established interests.

**JAPAN
ECONOMIC
CURRENTS**

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In the United States, the next industry that needs presidential leadership to open it up to competition is healthcare, which is still dominated by local monopolies that make it enormously costly. The burden of

high cost healthcare is a very serious macroeconomic problem because it is American industries and American workers who pay the bill for the local monopolies while facing tough competition themselves. If healthcare industry were opened to competition, the rest of American industry would be much more competitive on a worldwide basis.

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