The Japanese Economy:
Sustained Recovery and Growth Not Yet Assured

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Abstract

This paper reviews Japan's recent economic performance through the summer of 2004. It notes the strong cyclical recovery and its slowdown. I note several problems about the economic data, particularly about the GDP deflation's bias which results in an overestimate of real GDP growth by about 1 percent point. I consider inadequate aggregate demand; persisting deflation and monetary policy; unemployment and underemployment, adversely affecting the young particularly; ongoing financial system reform; government economic policy; longer run growth and economic transformation; and changes in corporate governance. The key issue is whether the generally positive economic ending has finally put Japan onto the path of self-sustained growth. I am cautiously skeptical; it depends whether growth in 2005 is close to 3 percent or to 1 percent.

In contrast to the pessimism of a year ago, in early summer 2004 optimism about the Japanese economy prevailed. And with good reasons. Economic performance, broad-based, has been the best since the bursting of the stock and real estate price bubbles in 1990-91. Since summer 2002 Japan's official GDP recorded eight successive quarters of increasing growth rates, and the 2003 growth rate of 2.5 percent will be substantially exceeded in 2004. The Economist August consensus forecast is 4.5 percent, with a range of 4.0 to 5.0 percent. In July the government virtually doubled its forecast for fiscal 2004 (to March-end 2005) to 3.5 percent growth. As reflected in the very positive June Tankan survey, business sentiment is the best since 1992. The stock market has risen by some 48 percent from its April 2003 bottom. Business profits are up significantly. Moreover, this cyclical recovery differs from the previous ones in two major respects: there has been no fiscal stimulus contribution and exports, especially to China, have been booming.

However, surprisingly poor GDP growth in the April-June quarter, at only a 1.7 percent seasonally adjusted annual rate, announced in early August, was a shock. Moreover, the September 10 downward revision, not upward as expected, to 1.3 percent, has been an additional shock, inducing further caution. Nonetheless, optimists argue it is only a temporary set-back, reflecting a series of one-off adjustments. They note the GDP estimates are inconsistent with the METI economic activity data; suggest first quarter growth may have been over-estimated and second quarter accordingly under-estimated; and point to evidence that third quarter growth will rebound, in part reflecting consumption increases due to the very hot summer. Pessimists interpret this performance, far below expectations, as casting doubt on the strength and sustainability of the recovery; they suggest GDP growth peaked in the first quarter; and express concern that this is the beginning of a significant slowdown. The evidence of early October suggests the economy is slowing down but only moderately. The September Tankan indicates business confidence continues to be quite strong, and policy-makers seem to be sanguine. I think that the economy will rebound somewhat the rest of this year, but growth will slow.

What does the current, generally positive, economic evidence tell us about Japan's near-term and longer-term future? Is Japan now finally on the path to self-sustained growth, or is it simply having its third cyclical recovery since 1991 – the best, but not sufficient to break out of the decade-long pattern of mediocre economic performance? Despite the current optimism in many circles, and despite my own optimistic proclivities, it is premature to assert that the economy is embarking on self-sustained recovery and growth. Too many serious problems persist and must first be overcome.

Let me note several cautions about the economic data. GDP growth, while nonetheless good, is probably over-estimated by at least 1 percentage point because the strong deflationary bias of the business investment deflator estimate leads to an over-estimation of both the GDP deflator and real growth. This technical problem is due to be resolved next year with the new GDP estimates (and growth rates will be revised downward), but by then that will be history.

The high volatility of monthly and even quarterly estimates of various economic measures of output and demand, coupled with seasonal adjustment problems, make it difficult to separate trend substance from noise. Business optimism in the June and September Tankan is driven by large manufacturers, especially exporters; the small business survey (Shokochukin), while improving, has yet to achieve break-even levels**,** and in mid-2004 had even declined slightly. Analysts were mislead by the very positive Ministry of Finance Corporate Survey report in August showing that business investment in the April-June quarter rose at a 10.7 percent annual rate. It turns out these results were probably due to sampling errors; almost half the reported increase was attributed to very small service firms, usually a negligible share of business investment. That was a sample of only 120 of some 74,000 such firms, and the sample changes annually in the spring quarter.

Finally, in my view, the real gap between actual and potential output is larger than the measured gap, because the latter does not attach adequate weight to the realities of labor unemployment and under-employment. A further puzzle is that high gross business investment persists, but Japan's capital stock remains flat.

My substantive concerns are more important. While there has been some improvement, the problems essentially are no different than those discussed in last year's Center Annual Report essay. My main concerns are about the future adequacy of aggregate demand and, relatedly, when deflation will end; the profound, persistent weaknesses in labor markets; the still weak banking system, coupled with an ongoing decrease in bank loans; the unremitting decline in land prices; and the need for continued restructuring both of businesses and, especially, of government financial institutions and special enterprises. There are improvements in all these areas, but the uncertainty is whether they will be sufficient to overcome the existing obstacles to achieving sustained full-employment growth. To all this is added my fear of complacency: that business and government policy-makers will be deluded into believing the economy is doing so well that there is no need to persist in restructuring efforts, and that inertia and forbearance can once again be the dominant mode. The danger lies is the attitude of those policy-makers who, one year ago felt that nothing could be done, and who now feel nothing needs to be done.

There are other concerns, but they are less important; each might slow growth marginally, but none will force Japan back into recession or growth under-performance. Japan is a very efficient energy user; it could absorb the direct impact of a sustained rise in the price of oil to $50/barrel, with only a modest negative growth effect, in part because the yen would weaken in response. A Chinese hard landing (4 percent rather than 7 percent growth) would have an adverse effect, but not as serious as some doomsayers proclaim. I do not know how the exchange rate will move in coming months, but any yen appreciation will be limited and absorbable, and substantial depreciation unlikely because of probable US and EU responses.

<u>Macroeconomic Performance and Aggregate Demand</u>

Aggregate demand remains a major problem. Growth in recent quarters has been driven by burgeoning exports at a 10-12 percent annual rate and, relatedly, rapidly expanding business investment close to 14 percent. Given the huge size of the Japanese economy and its small reliance on exports (now up to about 12.5 percent of GDP), export growth cannot sustain GDP growth over the longer run. This is quite aside from the reality that Japan’s export and burgeoning current account surplus growth rates will not persist. World GDP and trade will slow in 2005; US economic growth is slowing, and so too is China’s growth and demand for imports.

In order to prevent excessive yen appreciation and thereby sustain export growth, between July 2003 and March 2004 the government continued its extraordinarily large purchases of dollars, about $280 billion. This intervention then ended, at least temporarily, as the yen weakened to its current 108-112 range once it was understood the US Federal Reserve Board would begin to raise the benchmark interest rate, as it did in June. Japan's foreign exchange reserves at August-end were $828 billion, some 18 percent of GDP. I expect that if the yen were to strengthen quickly to 105 or 100, intervention would start once again.

Business investment growth will slow from its current torrid pace despite rising profits and better balance sheets. Corporate performance has improved substantially, particularly profit increases and reduction of debt, but profits remain significantly below other advanced industrial nations. The return on equity (ROE) of Japan's largest companies, the Topix 500, was 6.4 percent for the fiscal year ending March 2004, better only than Germany. Three-quarters of the companies had a ROE of less than 10 percent, the poorest among major industrial economies. The best news about improving corporate performance is that it is so widespread. Small and medium-sized enterprise (SME) performance was better than that of large firms, particularly in non-manufacturing, albeit from lower levels. SME operating profits rose more rapidly, and debt was reduced more. Most problem loans are to SMEs, so this recent performance suggests substantially reduced bankruptcy and non-performing loan problems. However, the data on SMEs are considerably more murky than for companies listed on the stock exchanges.

Japan's economic structure has not changed as much as might have been expected. In part that is because Chinese investment demand generated major increases in exports by Japan's traditional heavy industries of steel, construction equipment, and chemicals. At the same time, differential responses to market competition and demand growth have been widening the spread in performance between sectors, and between more and less successful firms in each sector. Japanese firms in export industries, notably automobiles and electronics, are world leaders; in contrast, the relative productivity in most service sectors is low. Much of Japan's improving economic performance is due to the ongoing successful process of corporate restructuring and cost cutting, gradual but sustained. Nonetheless, substantially more needs to be done, and corporate balance sheets, whose problems were exacerbated by deflation replacing earlier mild asset inflation, need to strengthen further.

Consumption expenditures have been growing surprisingly well in 2004. With slowing growth of exports and business investment, aggregate demand will depend even more on increases in consumption in the coming months and years. But consumption growth, too, will slow. The key factors are the growth of household income and their choices between spending and saving. The past pattern of maintaining consumption and living standards by reducing the saving rate has probably come to an end, so consumption growth will depend on income growth, and that appears to be only modest. Income growth depends upon wage increases and the nature and quality of employment increases. While the summer 2004 semi-annual bonus for regular workers on average increased some 1-2 percent, wages have not increased despite the rise in corporate profits. Labor's bargaining power remains weak as firms continue to cut costs and downsize.

The decline in the household saving rate has been dramatic, as stressed in my essay last year: from 16.5 percent of GDP in 1986, to 12.0 percent in 1995, to 9.8 percent in 2000, to 5.9 percent in 2002. In macro perspective this has been desirable since it reduces the aggregate demand gap (the paradox of thrift), more than offsetting the government's slightly restrictive fiscal policy. In the longer run, in order to achieve macroeconomic equilibrium the private saving rate must continue to decrease, both to reduce the need for fiscal deficits to maintain aggregate demand and to offset appropriate decreases in the share of investment in GDP.

Given the time lags in the GDP (national accounts) data, analysts have used Bank of Japan (BoJ) flow of funds data to estimate more recent household saving trends, based on changes in holdings of financial assets. In 2003 it was a deficit figure for the first time ever. However, rather than measuring a further decline in the household saving rate, it probably is due to household land purchases as corporations have sold land. The buyers are small businessmen and wealthy families.

This may be a useful indicator of possible changes in land prices, though the most recent data (for July 2004) show a persistent decline in all categories nationwide, averaging 6.5 percent for commercial properties. Real estate price increases in some affluent Tokyo, Osaka, and Nagoya wards do not constitute a trend; the value of property in Tokyo amounts to only 16 percent of the national total, and while perhaps bottoming, the contrast with Osaka, with an 8.0 percent decline in 2003, and Nagoya, a 6.0 percent decline, is stark. Since firms by fiscal 2005 will have to mark-to-market substantial losses on real estate, some have begun selling unneeded holdings in order to smooth balance sheet adjustments, required by this impairment accounting.

Macroeconomic policy has been inadequate to restore aggregate demand and end deflation. Despite the huge budget deficit, due mainly to revenue shortfalls and scheduled social security payments, fiscal policy has been slightly tight, not easy, as the government has been substantially reducing public works expenditures since 1998. Monetary policy has continued to be quite stimulative. BoJ policy has been much more effective under Governor Toshihiko Fukui in communications and policy coordination, with explicit emphasis on managing expectations about monetary policy (more on this below).

Nonetheless, macroeconomic policy has not been sufficient to stop the five years of mild but sustained deflation. The costs of deflation to business and financial institutions, and hence aggregate demand, are well established. While the core consumer price index (CPI) inflation rate is now close to 0, that may well be temporary, since the one-time effects of cost-push price increases in medical fees, electricity and gas rates, and 2003's poor rice crop will come to an end by October; increases in oil-related prices are beginning to show up in the CPI but the effect will be small. (Japan's definition of core CPI excludes only perishable foods, unlike the broader U.S. definition which excludes all food and energy prices because of their short-run volatility.) In any case, a focus on whether Japan's core CPI change is 0.1 percentage points above or below 0 is misguided. It is well recognized that the upward bias in the index is about 1 percentage point, so price stability and the ending of deflation will be achieved only when the CPI rises about 1 percentage point annually. By this metric, the ending of deflation will probably take another year or longer.

Growth will almost certainly slow in 2005. The government July forecast is "slightly more than 2 percent" for fiscal year 2005. The Economist August consensus forecast for calendar 2005 is 2.3 percent, and the range is quite wide, from 1.1 to 3.8 percent, reflecting considerable uncertainty about export, business investment, and consumption prospects. A key issue is whether this will be another business cycle slowdown returning Japan to its pattern of mediocre 1.3 percent growth with under-utilized labor and other resources, or growth will be sufficient to maintain the current momentum toward sustained growth. We are probably a year away from making that judgment.

Monetary Policy and "Exit" Strategy

A key macroeconomic policy issue is the timing of the Bank of Japan's exit from its ongoing liquidity-based monetary policy of quantitative ease, which maintains a zero interest rate policy (ZIRP) for the bank overnight call market, analogous to the US Federal Funds market. To exit its current policy and re-create normal financial market conditions in a normally performing economy, the BoJ must sequentially manage two financial market transitions. The first is the final lifting of full guarantees of bank demand deposits, scheduled to return to the previous ¥10 million ceiling by April 2005. That should not be too difficult for more than a few smaller, local banking institutions. Moreover, a potential huge loophole persists: zero-interest-earning settlement deposits for business transactions will continue to receive an unlimited guarantee.

The more difficult, and trickier, transition will be switching the Bank of Japan's operating target from liquidity (quantitative easing) to interest rates. Quantitative easing is based on the BoJ's creation of financial institution huge excess reserves, which are currently deposited in the BoJ because the banks have no better use for them. The BoJ policy target for these current accounts is ¥30-35 trillion, of which the required reserves component is only about ¥6 trillion. Once the BoJ terminates ZIRP, financial institutions quite rationally will withdraw excess reserves and invest in safe, short-term, interest-yielding government bills, or even in more risky assets.

There are two policy issues: timing, and sequencing of the exit process. The expansion of excess reserves (quantitative easing) has had no direct economic effect on spending, but has usefully served as an expectations signal to financial markets, indicating the central bank's commitment to its policy of extreme monetary ease. Presumably the expectations effect works the other way as well. Well before the BoJ raises its benchmark interest rate, it probably will reduce somewhat the overhang of the current account excess reserves, with the termination of ZIRP occurring late in the process. Bond market reactions will be important in managing the process.

What are the conditions determining when the quantitative ease targets will be reduced, signaling the beginning of the exit process? The BoJ conditions are clearer than before, but still somewhat vague: when core CPI increases remain at or above 0 for several months and a majority of the Policy Board members expect its positive value will persist, and presumably when the economy continues to perform reasonably well. Many, including me, believe this is too low a threshold. The CPI should be sustained at about 1 percent increases as a reference point, and should be due to demand-pull rather than cost-push price increases, before the BoJ exits its current extraordinary but essential policy position of great monetary ease. The economy needs to re-enter normal economic conditions in which full employment and potential real GDP growth are sustained, nominal growth is positive, the CPI increase is in a 1-2 percentage point range, and interest rates are positive with normal spreads correctly reflecting credit risk and term maturity.

Given its bad experience in exiting ZIRP in 2000, the Bank of Japan is likely to continue to be cautious about the timing of exit, and that is good. It is not inconsistent for the BoJ to become increasingly positive about Japan's economic prospects while holding off on ending the current policy of monetary ease. We will obtain a better sense of BoJ policy when it releases its semi-annual report on October 29 with forecasts of CPI and GDP growth; as last October, they may well use that as an opportunity to define their exit strategy more clearly and precisely. I do not expect the BoJ to tighten its policy before late 2005, and that assumes the CPI will have been increasing for some time and the economy is performing well.

Even before ZIRP ends, reductions in the excess reserves financial institutions hold in their current accounts at the BOJ will generate expectations of its termination, and markets will drive longer-term interest rates up. Banks and other private-sector holders of fixed-rate interest assets, notably Japanese government bonds (JGBs), will suffer mark-to-market losses as their prices decline commensurately. However, presumably interest rates will not rise significantly until the economy is continuously improving, so bondholder losses will be offset by gains in their equity holdings and by reductions in the credit risks of their borrowers. Bank lending rates will increase, but borrowers will be better able to afford them. Increases in saving deposit rates, beneficial to savers, are likely to lag somewhat, and interest rate spreads will become more normal. Despite some rough spots, this transition to a more normal financial market and economy is not only to be expected but desired once full-employment sustained growth is restored.

Inadequate Job Creation

Perhaps Japan's most serious problem, cyclically and structurally, is unemployment, under-employment, and misallocated labor. The reduction in the seasonally adjusted unemployment rate from 5.3 percent last summer to 4.6 percent in June 2004 was an improvement, but in July the rate slipped to 4.9 percent, where it had been at the beginning of 2004. The reported labor force size declined in the spring but increased in July. Month-to-month swings in data are not uncommon, so I do not interpret this as a sudden worsening of labor conditions; the August unemployment rate of 4.8 percent is consistent with this view.

However, the employment data mask the major decline in the quality of jobs and the withdrawal of persons of working age (15-64) from the labor force. Between 1997 and 2003 the labor force participation rate dropped to its lowest level ever. During this period, employment declined by 2.4 millions persons: 1.2 million withdrew or never entered the labor force, and 1.2 million became unemployed. Worse, ever since 1997 full-time regular employment has continually decreased, while part-time and temporary employment has risen steadily, and now comprises more than a quarter of total employment. Many of these part-time workers, especially young men and women, want full-time regular jobs. Part-time male workers earn only 51 percent of their full-time counterparts; female full-time workers earn only 66 percent of males, and part-time female workers only 44 percent of full-time males. Department stores now rely substantially on part-time workers; more broadly, firms with more than 1000 employees are replacing retiring full-time workers with part-timers, rising on average from 3.9 percent of their employment in 1995 to 8.6 percent in 2002, and higher today. Total cash earnings, including regular wages, overtime and semi-annual bonuses have been declining for several years, and now finally appear to be flattening out. Obviously, poor employment and wage patterns retard consumption expenditures.

In longer-term perspective, the weak labor market is harming young Japanese disproportionately. The unemployment rate for those 20-24 and not in school in 2002 was 9.3 percent, in 1990 only 3.8 percent; for those 15-19 the rates were higher, going to 12.8 percent from 6.6 percent. The “idle labor” rate (those neither in school nor in the labor force) for those 20-24 was 17.0 percent in 2002, up from 11.3 percent in 1990; for those 15-19, it was 24.3 percent, up from 14.6 percent. Equally serious have been the increases in young part-time workers. In 2003, 45.5 percent of all young part-time workers (ages 15-24) were male. These male part-timers comprise 28.3 percent of their age group, up from 14.9 percent in 1990. Some 35.2 percent of young female workers were part-timers in 2003, up from 18.4 percent in 1990.

Some of these young people have voluntarily chosen alternative lifestyles made possible by the wage rates of an affluent society. Nonetheless, survey data indicate most would prefer full-time regular jobs. The substantial rise in the proportion of part-time workers, not limited to but especially among young people, significantly reflects the still weak demand for labor. In the longer run, this means young workers are not obtaining the benefits of skill development through on-the-job training. This is a major cost of Japan’s mediocre economic performance since 1991.

Financial System Reform

The likelihood of a systemic banking crisis has now ended. All of the 8 big banks except UFJ increased profits, asset quality and capital adequacy. They also reduced non-performing loans in line with (or better than) the Financial Services Agency (FSA) March-end 2005 requirement that they be no more than half of the NPLs reported at March 2002 peak levels. The banks benefited significantly from the rise in the prices of their substantial holdings of shares in client borrowers. Nonetheless, the banking system remains weak, with extraordinarily low capital, low operating profits, weak loan demand, excessively narrow interest rate spreads, and huge government bond holdings exposed to price declines once interest rates do rise.

The most dramatic event has been the decline and fall of UFJ Bank, one of the four mega-banks, and the ongoing drama of its merger either into Mitsubishi Tokyo Financial Group (MTFG) or Sumitomo Mitsui Financial Group (SMFG). UFJ's still-high NPLs, particularly their heavy concentration in a few large distressed firms, and especially its misleading reports to the FSA, led the FSA in late spring to take severe regulatory and administrative measures, including the removal of top management and imposition of stringent requirements to increase NPL provisioning sharply by March 2005. UFJ's initial response was to negotiate the sale of its trust bank to Sumitomo Bank and Trust Company. In mid-July UFJ reported that it would merge by October 2005 with MTFG, the least weak Japanese mega-bank. Then SMFG announced it wanted to be UFJ's merger partner, initiating an unprecedented, revealing contest.

The initial issues were how much capital the new partner would inject by a September 10 deadline into UFJ to maintain capital adequacy when the September-end balance sheet and profit statements would require massive NPL provisioning; and what positions UFJ board members and senior managers would receive. The contest was fought simultaneously in the courts, with Sumitomo Trust and Banking Company (not a part of SMFG) arguing that it had a prior commitment to purchase UFJ's trust business. Following a favorable court decision on August 12, MTFG and UFJ the next day announced a basic merger agreement; the proposed name is Mitsubishi UFJ Holdings. However, on August 24 SMFG made a bid to UFJ management at a premium of 23 percent over the then-current share price. While this is not yet hostile in the sense of appealing directly to UFJ shareholders through the market, UFJ management have made clear it prefers a merger with MTFG.

On September 10 UFJ Bank announced a ¥780 billion projected loss for the first six months, and accepted MTFG's offer to inject ¥700 billion ($6.4 billion) by purchasing nonvoting preferred shares, convertible only in an event such as a hostile bid into 35 percent of voting preferred shares. That would provide MTFG veto power over UFJ management decisions. This poison pill may well end the contest for control of UFJ. However, MTFG has not yet announced its price for UFJ, citing the need for due diligence into UFJ's NPL and other problems; presumably it will do so soon.

UFJ's merger into either MTFG or SMFG will create the world's largest bank in assets, though certainly not in profits or profitability. To be successful and make the new bank competitive, the merger will require massive cost-cutting, improved lending decisions, exploitation of potential synergies, and the development of new revenue sources, in addition to dealing effectively with their different corporate cultures.

Government banking policy, combining continued forbearance and increasing FSA pressure, will make sure the major banks achieve their non-performing loan reduction targets by March 2005, but will not solve their still extraordinarily weak capital positions. The FSA is finally pressing regional and local banking institutions to reform. On request, it can inject government capital into the restructuring and merging of weak local banks and credit associations without declaring them insolvent, utilizing the reform law passed in June 2004 that makes available an additional ¥2 trillion ($18 billion) in government capital.

Even under very optimistic scenarios of rising bank lending rates, widening interest rate spreads and increasing profitability, it would take many years for retained earnings to provide sufficient bank capital to make the system truly effective and competitive. One retrograde step would be for banks to use profits first to redeem their government capital (mostly convertible preferred shares) injected earlier, though that was the original expectation. Instead, this capital should be kept in the banks by having the government sell its shares in the market rather than back to the banks; the government would accrue capital gains in reward for the investment risks it has undertaken.

One concern is that bank lending continues to decrease, despite some increases in housing mortgages substituting for reduced government housing lending. Since 1998, bank loans have declined absolutely by almost ¥150 trillion: at the end of March 2004 they were ¥367.8 trillion, a sharp decline to only 73.4 percent of GDP. These trends reflect weak business loan demand, a persistent (though decreasing) unwillingness to take credit risk even at higher lending rates due to bank capital inadequacies, and bank management slowness in changing its business model. It is generally perceived that the economy will not achieve sustained growth in the medium term until bank lending increases once again. Large companies have gradually been substituting commercial paper and bond issue for bank loans for almost two decades. This will become considerably more important in the longer-run. Banks are still grappling with the problems of finding, evaluating, and developing business with good customers to replace those lost to the capital market.

Life insurance companies, weakened by the ongoing negative yield spread on policies, received a major reprieve this past year through the increased value of their holdings of shares. Otherwise, perhaps one or two more of them would have been forced into bankruptcy, or to reduce their promised yields to policy holders, as is now allowed. So long as market interest rates remain low and yield spreads negative, industry weakness will persist.

Government Economic Policy

The Liberal Democratic Party, led by Prime Minister Junichiro Koizumi, lost only one seat in the July Upper House election and maintains control of the Diet through its continuing coalition with the New Komeito Party. However, the LDP received fewer votes than the Democratic Party of Japan. These results imply the government's policies of gradual structural reform and deregulation will continue more or less unchanged, a view reinforced by Prime Minister Koizumi's unsurprising Cabinet changes on September 27. Policy making continues to be piecemeal and incremental rather than comprehensive and coordinated, with occasional inconsistencies. On the whole, private-sector reforms are now being left to firms and markets; the government's focus is mainly on the reform process for government institutions, central and local. The macro mix of slightly restrictive fiscal policy and very easy monetary policy will continue until deflation ends and sustainable GDP growth is reasonably assured.

A big political battle is shaping up this fall over Prime Minister Koizumi's decision to press for the privatization of the huge postal savings and life insurance system, long a top priority. The shifting of Heizo Takenaka, Koizumi's economic policy troubleshooter, from FSA Minister to Minister to head up postal reform, together with support of postal reform being a requisite for Cabinet membership, indicates how high a priority this is for the Prime Minister.

The reform of the postal system - indeed of all government financial institutions, special government enterprises, and government agencies - is structural and long-run in nature, both economically and politically. So, too, are local government reforms, including redefining the respective powers and responsibilities of central and local governments. Success in these reforms is very important to enhance Japan's long-run economic performance, but the process is too slow to have significant economic effects in the near term.

Japan's social safety nets are a mixed bag. The implementation of the five special laws passed since 1998 to enhance job training and employment have had little overall effect. The main policy focus will continue to be on assuring the long-run sustainability of public pensions and health coverage for the elderly. As my colleague David Weinstein has shown in a careful analysis, based on sensible and realistic assumptions, this long-term fiscal problem is serious but far less dire than the government's analysis. (This is one of the studies in the Center's comprehensive joint project "Solutions for the Japanese Economy", to be published next year as English and Japanese books edited by Weinstein, Takatoshi Ito of the University of Tokyo, and myself).

The interactions among central and local governments and their respective public corporations and agencies are very important, very complex, very opaque, and of course very political. Reforms over the past few years have brought about increased disclosure, some useful objective analysis, and the first steps of what is a fundamental, long-run restructuring process. One of the silver linings of the government's huge budget deficits is that it provides a rationale for reform of these government institutions in order to reduce inefficiencies, redundancies, and sheer waste, and thereby cut expenditures.

The Transformation Process Proceeds

As stressed in my previous Center Annual Report essays, the Japanese economy is in the midst of a fundamental transformation taking two to three decades, upon which have been superimposed the bursting of the great real estate and stock market bubbles in 1990-91 and the subpar, mediocre economic performance since then. Japan completed its rapid catch-up growth by the early 1980s and now has a mature, affluent economy of well-educated citizens. Given its under-utilized labor and other resources, the wide sectoral productivity gaps, and efficiency gains from comprehensive and sustained restructuring, Japan's annual growth potential over the next five years or so is on the order of 3-4 percent. Then, once full employment is reached, the potential growth rate will be no more than 2 percent, and probably less; it will depend heavily on productivity gains because labor inputs will decrease and additional capital per worker will make only a modest contribution. No high-income, advanced industrial economy has averaged more than 2 percent growth per capita over ten-year periods.

Like comparable European nations, Japan is well along in its long-run demographic transition to very low births and deaths, an ageing society, and now absolute declines in the working force age group. Population is now expected to peak at 127.7 million in 2006. A reasonable long-run expectation (prediction is too strong a term) is that at a point some decades hence, as the country becomes ever-more wealthy with per capita incomes growing at 1-2 percent annually, Japanese will decide they can afford and enjoy having two or three children rather than one or two, and population levels will stabilize. Or, more controversially, immigration will become substantial and Japan will become much more ethnically heterogeneous.

The economic structure continues its inevitable shifts in response to the growth of incomes and demand, and changes in competitiveness. Agriculture is economically unimportant, but still has the political power to maintain high protection and subsidies. As in other high-income countries, the share of manufacturing is declining, particularly in now inefficient labor-intensive goods, but technologically sophisticated products, based mainly on substantial business

R&D, continue to increase. Most growth will continue to be in a wide range of business and personal services, notably IT and health care for the elderly.

With this transforming economic environment and amid increasing competitive market pressures, economic institutions and arrangements are inevitably changing. The strengths of the three major economic institutional pillars of Japan's big business postwar rapid growth era – the permanent employment system of industrial relations, the main bank system of corporate finance, and the entrenched management system based on separation of shareholder ownership and management control – became weaknesses once the economy matured to modest growth. They lacked the flexibility to carry through quickly and efficiently the major reallocations of resources made even more necessary by poor economic performance and a changing global competitive environment. Moreover, in most respects the postwar system was opaque; when scandals erupted in the 1990s, the public lost confidence and trust in business leaders and government officials. While weakened, these three institutions are evolving but by no means disappearing. Nonetheless, Japan's system of relational capitalism is evolving toward more market-based capitalism.

The essence of the permanent employment system has been management's overwhelming commitment to guaranteeing regular employees a job until retirement at age 60, and to seniority as a major element determining promotions and wage increases. These commitments were credible when the economy and companies were growing rapidly, but are considerably less so now. The employment commitment now may mean likely transfer later in one's career to a subsidiary or affiliated company. When firms do have to reduce their labor force, in all but extreme cases they provide an expensive "early retirement" buy-out package. Merit (performance) is becoming increasingly important in the determination of wages and promotions. Despite increased emphasis on shareholder interests, management's prime commitment remains to its regular employees. Nonetheless, managers are increasingly concerned with achieving good performance in order to keep their company's share price up as it becomes more of a determinant of their and the company's general reputation. Replacing regular full-time with part-time or temporary workers provides management a useful buffer.

By the 1980s the main banks were already reducing their independent monitoring capabilities for their large borrowers, and came to trust them too much. Relationships, and real estate as collateral, substituted for careful credit analysis. From the early 1990s the main banks have been overwhelmed by the sheer magnitude of the non-performing loans (NPLs) of their weak large corporate borrowers, too large and costly for banks to carry out rescue and restructuring responsibilities except in a slow, serial process that only now is beginning to be completed. Banks became prisoners of their major delinquent borrowers; they could not absorb quickly the NPL losses resulting from termination of relationships. The previously huge capital positions of banks, based on unrealized capital gains, evaporated as stock prices declined dramatically and banks realized gains to offset NPL provisioning. While capital markets have improved significantly, they have not yet adequately taken over the corporate monitoring functions. Weakened though it is, the main bank system will persist, especially for a smaller number of good, core clients (especially those in the same keiretsu), and as well as for middle-sized and smaller companies that have few alternatives to bank finance.

Changes in Corporate Governance

The essence of the Japanese big business management system is the combination of the separation of ownership and control (as in the United States); a self-perpetuating, entrenched management overwhelmingly promoted from within to CEO, top management, and corporate board positions; and a stronger commitment to regular employees, especially those on the management track, than to shareholders. In the early postwar period, managers succeeded in having a majority of their company's shares held, each in relatively small amounts, by a large number of other friendly companies – banks, insurance companies, suppliers, customers. The extreme subset of this stable shareholding is cross-shareholding between two companies, typically between banks and their large industrial clients.

The implicit agreement of these tacit alliances – exemplified at the extreme by the horizontal business groups (keiretsu) – was non-interference by one company's management in the management of the other company; and an understanding that shares would not be sold without the agreement of the issuer, and then typically through private placement rather than the open market. In this way, by the early 1960s company management had made itself immune to the threat of hostile take-over bids. This was an opaque system which effectively interacted with the main bank system and the permanent employment system.

This cozy management system has been under attack in recent years due to the poor economic performance of many firms, a variety of well-publicized corporate scandals, and a global focus on improving corporate governance. Formally at least, Japan's system of corporate governance has been changing significantly. In practice, most changes so far have been led by the government – changes in the rules of how the game is to be played, with firms and markets gradually adjusting. These include legal and institutional changes enhancing firm flexibility – stock options, M&A rules, holding companies, and share buy-backs – and changes that enhance external monitoring – mark-to-market, tougher accounting and auditing rules, stockholder derivative suits, and capital market liberalization. Outside auditors, now facing the possibility of shareholder suits if they certify misleading financial statements, have suddenly become potentially important corporate governance players, as the Resona Bank case in spring 2003 demonstrated.

One of the most interesting legal changes allows companies, since 2003, the choice of whether to continue their traditional board system of inside directors and statutory auditors (now with stronger functions and greater responsibilities); or to adopt what has been termed the US-style board committee system with a significant role for outside directors. Colleagues Curtis Milhaupt and Ronald Gilson have analyzed the 71 firms, 45 of which are listed, that adopted the board committee system in summer 2003, its first year. Of the total, more than half (36) were Hitachi and some 21 of its subsidiaries, of which 18 are listed, plus Nomura Holdings and 13 of its wholly owned subsidiaries. "Outside" directors elected to their boards were from the parent company. In contrast, a majority of the outside directors for the remaining 35 firms were drawn from unaffiliated firms or were lawyers, and so are apparently more independent. At only 19 firms were outside directors half or more of the board.

The companies were classified into the following types: global market players such as Sony; firms with large foreign institutional shareholders such as Columbia Music Entertainment and Orix; distressed firms such as Resona Holdings and Manulife; and foreign-controlled firms such as Vodaphone and Seiyu. In contrast, no core firms in bank-centered keiretsu have shifted to the committee-based system. All the board committee companies are required to have at least two outside directors, and many have more than that. In contrast, only 630 of 2108 publicly traded companies surveyed in summer 2004 have any outside directors, and about half of those have just one; nonetheless, this does represent a 28 percent increase over a year ago. The Japanese definition of outside directors is weak, so the difference between outside directors and independent directors (defined in US law but not Japanese law) is even greater. In practice, achieving a system of truly independent directors is a problem in all countries.

Only 11 more companies have, as of August 2004, decided to adopt the board committee system. While it increases diversity in corporate governance arrangements, the board committee system is unlikely to become a major feature of Japanese corporate governance. Nonetheless, the discussion about boards and the roles of directors appears to be affecting management attitudes and board structures in a far larger number of firms, as the increase in firms with outside directors attests.

The restructuring of large troubled companies brings to the fore a range of management and corporate governance issues, and provides insights on how they are being handled. The authorities have required that restructured firms such as Resona and Kanebo adopt board committees. When DaimlerChrysler refused to maintain its controlling share of scandal-ridden Mitsubishi Motors Company by providing an additional required $4 billion in capital, Mitsubishi group companies rallied around to provide the funding, albeit raising shareholder concerns in some of the companies. As noted, the hostile competition for UJF Bank is unprecedented. It appears that Daiei will be taken over by outside investors; its management has resisted its banks taking the company to the Industrial Revitalization Corporation of Japan (IRCJ). The restructuring of other large, deeply troubled UFJ borrowers such as Daikyo, Sojitz, Misawa, and Towa Real Estate will provide further evidence both of the restructuring process and how corporate governance is being handled.

Another significant change which enhances the governance role of capital markets has been in stock ownership: bank and life insurance company sales of their holdings of corporate shares, and the rising share of foreign ownership. The Nippon Life Insurance Research Institute estimates that at the end of March 1991 stable shareholding comprised 45.6 percent of all listed company shares; by March 2004 it was down to 24.3 percent. Cross shareholding, 18.1 percent in 1991, declined to 7.6 percent in 2004. On the other hand, foreign shareholding, 4.7 percent in 1991, increased to 17.7 percent by March 2003, and to 21.8 percent by March 2004. Nonetheless, many shares remain held by stable shareholders, especially those of larger keiretsu-member companies. Interestingly, there does not appear to have been any significant decline in corporate holding of bank shares. Corporate holdings have actually risen in each other, which may reflect parent company purchases of the shares of their subsidiaries being sold by banks and insurance companies.

Foreign Portfolio Investment

There is no single pattern of foreign institutional portfolio investment in Japanese stocks. Global funds hold a representative portfolio of investment-grade Japanese companies; their important decision is whether to underweight, overweight, or hold a neutral position relative to other countries. Some Japanese companies with good performance, good corporate governance, and activist investor-relation programs have more than 30 percent of their shares held by foreigners. A number of foreign funds focus on Japan, and a few funds have been established explicitly to enhance corporate governance. Foreign investors of course are primarily driven by expectations of share price increases, not the development of relationships. The sharp increase in foreign holdings of the shares of major banks from 10.0 percent at March-end 2003 to 22.6 percent at March-end 2004 was due more to the Resona Bank case signal that shareholders of major banks would probably not be harmed by any government-funded restructurings, and to the subsequent soaring of bank share prices, than to substantial improvement in bank performance or governance.

A quite different foreign investment target has been the many smaller listed companies whose market capitalization has been substantially below their holdings of cash and liquid securities. They have been the target of hostile takeover activities, epitomized by the case of Steel Partners and its bid for Sotoh Corporation. While the bid failed, management was forced to make a major dividend pay-out, and the share price rose sharply. This triggered higher dividend payments and share price rises for a number of other small, cash-rich, listed companies. While these have been important first steps, they seem more reminiscent of earlier greenmail attempts in Japan rather than engendering a significant improvement in Sotoh's corporate governance. Sotoh and similar companies may now have fewer excess financial assets, but management remains entrenched and probably its operating behavior has not changed significantly.

The Kanebo Case

The roles of both the market and the government in enhancing corporate governance are important in the complex problems of restructuring major firms in difficulty. In some respects, the last-minute cancellation this spring of ailing Kanebo's sale of its cosmetics business to Kao is prototypical. Kanebo had a traditional management, negative equity, a huge debt (some ¥513.6 billion of non-performing loans), and many unprofitable divisions being internally subsidized by the profitable cosmetics division. Kao is successful: profit-oriented and profitable, sensitive to financial market signals, with an effective management. One predecessor of the merged Sumitomo Mitsui Banking Corporation (SMBC) had been the main bank for Kanebo, another the main bank for Kao. SMBC proposed Kanebo sell its cosmetics division to Kao, which made good business sense and would enable Kanebo to pay off ¥400 billion of its non-performing loans from the bank. The reason given by Kanebo for the cancellation of the sale was the opposition of its militant union. Certainly the union was not happy about the proposed sale, and on these issues workers have considerable power. However, I have the impression that many senior managers also opposed the sale, fearing they would lose their jobs.

SMBC then took Kanebo to the IRCJ. IRCJ took an even tougher position, providing less funding, forcing senior management out without retirement bonuses, and appointing one of its executive officers as Chief Restructuring Officer. Kanebo is by far the largest and most significant company brought to the IRCJ, which previously has had only a few, relatively unimportant cases. How the Kanebo restructuring works out remains to be seen. This case does provide insights into the behavior of major players: the main bank, top management, the union, and the government. Not surprisingly, shareholders took a 99.7 percent equity reduction.

Moral Hazard

The moral hazards of the Japanese corporate governance system lie in lack of oversight, not in extravagant compensation of top management or in an excessive focus on the short run. And, in isolated cases, while American managers may steal *from* the company, Japanese managers steal *for* the company. One form of moral hazard is that middle management expends considerable effort to protect the CEOs and senior management from exposure of company mistakes or personal scandal; opaqueness has its costs, as *sokaiya* blackmail earlier demonstrated.

There are two more important moral hazards. First, management has had a proclivity to invest surplus cash in new projects seemingly regardless of profitability. At the macro level, Japan's ratio of business investment to GDP is too high. At the micro level, the return on company assets is too low by international comparisons of returns to investors and to savers. This is particularly true of companies that earlier promoted diversification at the expense of focus, as the problems of some large electronics companies have demonstrated. Companies gave greater priority to sales growth and market share than to the profitability of investment.

Another form of moral hazard is that managers of Japanese firms in serious difficulty have delayed restructuring far too long, thereby significantly eroding the value of the company, its future, and the prospects for both current and potential future employees. Some say that using surplus funds for diversification, or holding large amounts of cash, or delaying restructuring, were not due to the bad behavior of management, but to mistaken optimistic assumptions about the future. Whether well intentioned or designed to maintain management power, those decisions have been very costly for those firms and all their stakeholders.

Appraisal

An important corporate governance debate is under way in Japan. A few major business leaders seek a more US-style, market-based system geared to the long-term interests of stockholders, while criticizing US short-run orientation and incentives. Most business leaders, however, seek to improve the existing Japanese system through greater disclosure and transparency and an outside director or two, or an outside advisory committee.

One key issue persists: is the company's primary commitment to its employees or to its shareholders? Management support of employees of course is to a substantial degree support of itself and those in the management hierarchy, beginning when college graduates enter the company. So far as I can tell, this mind-set of most Japanese managers has not fundamentally changed.

While Japan's management system and system of corporate governance are still evolving, my understanding is the following. First, Japanese managers have relearned the early postwar lesson that profitability is important in order to obtain finance and to keep all stakeholders reasonably happy. This is not a commitment to profit maximization, but it does mean that the weight assigned to shareholder interests will increase, even though the greater weight for regular employees will probably persist. It also means sales growth and market share will be less important as objectives in their own right.

Second, while most companies will come to have an outside director or two, they will not dominate, and only a small number of firms will adopt the U.S.-style board committee system. Firms will place primary emphasis upon internal governance reforms, stressing ethical behavior and more effective internal communications, controls, and processes.

Third, capital market institutions, instruments and prices have finally come to play a corporate monitoring role, but they have a long way to go before they are a major factor. A market for corporate control will emerge and, when it does, it will have a significant impact.

However, rather than a plethora of hostile take-over bids, I anticipate that concerned parties will negotiate arrangements to improve company performance and governance. It will be important to separate out cases of greenmail from those resulting in improved corporate governance.

Fourth, a hybrid set of corporate governance objectives, institutions, and practices will evolve out of the postwar system, with greater heterogeneity among firms, but few approaching the Anglo-American model.

In Japan, good corporate governance often seems simply to mean good corporate profitability performance. To the extent that industries and firms are facing an increasingly competitive environment, market pressures to improve performance are likely to be linked with measures to improve governance. While there is no proof that good corporate governance causes good corporate performance, companies that have superior performance as measured by return on assets, equity, and stock, and employment creation do score well on the nascent Japanese Corporate Governance Index. This suggests that corporate governance is one element of a business strategy package that generates superior performance, or at least is an outcome of such a package.

Concluding Comments

Japan's economic performance is certainly good this year, considerably beyond expectations. The key question is whether this momentum, while diminishing, will be sufficient to put the economy onto a self-sustaining growth path, first to utilize unemployed and under-employed labor and other resources and then to achieve Japan's long-term potential growth rate. Despite my optimistic nature, I remain cautious.

So long as Japan's economic malaise since 1991 has meant foregone growth rather than widespread declines in living standards, the country has preferred to avoid disruptive rapid change. Perhaps if there had been deeper concerns in the past, there would have been less forbearance and delay in government and business policy making and implementation, and there would be a better case for optimism now. Despite that, to term the 1990s (or longer) as the "lost decade" is a misnomer; while mostly below the radar screen, Japan's institutions, ways of thinking, and behavior have quietly been changing dramatically. Japan in 2004 in many respects is very different from Japan in 1990. Nonetheless much remains to be done, and periodic renewals of complacency are a serious inhibiting factor.

Until I have a better sense of whether real GDP growth in 2005 will be closer to 3 percent or 1 percent, and some sense of what is likely to happen thereafter, I deem it premature to judge whether this year's economic progress will maintain sufficient momentum to put Japan back on the path of sustained, full employment recovery and growth. Let's wait for another six months or a year to decide.