Japan: From Long, Slow Decline to Long, Slow Recovery

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After 15 years of stagnation and decline following the spectacular collapse of its 1980s bubble economy, Japan is finally showing some signs of a recovery. The Nikkei index is trading at five-year highs. Real estate prices are rebounding. Deflation appears to be under control and interest rates, effectively at zero for more than five years, may soon begin to rise.

Although there have been false starts in the past, much of today's optimism stems from the September reelection of Prime Minister Junichiro Koizumi, who ran on a platform of continued economic reforms. Those reforms -- including new discipline for the banking system, the less rigid lifetime employment guarantees and a proposal to privatize the country's 200-trillion-yen postal savings system -- are crucial to reviving the world's second-largest economy, according to Wharton faculty. And while the pace of change seems glacial by American business standards, the recovery may have come at the right speed for Japan.

"There is more optimism about the economy than there has been for some time," says Wharton management professor John Paul MacDuffie. The country has experienced "growth and an expansion of manufacturing employment, which is very new."

The end of Japan's so-called "lost decade" -- which began in 1990 and stretched into the millennium -- is rooted in political change, suggests Wharton finance professor Ayako Yasuda. "The Japan problem has been a political economy problem. Bureaucrats and special interest groups hoarded public money to support ailing, non-competitive domestic sectors which provided employment and political support for the status quo politicians, but resulted in misallocation of credit and prevented corporate restructuring."

The effect of political interference in the Japanese economy is evident when comparing the dismal performance of domestic firms, such as banks, to Japan's export powerhouses, such as Toyota Motor Corp. and Nissan Motor Co., notes Yasuda, adding that Nissan underwent a successful restructuring with French investors.

This fall, the International Monetary Fund raised its projection for Japan's economic growth in 2005 and said it expects a "strong rebound." Japan's real GDP will grow 2%, up 1.2 percentage points from the April estimate, according to the IMF, which forecasts the same growth rate in 2006.

A core change in Japan's economic structure is new labor flexibility, which has rocked the nation's job-for-life social compact. That older system created generations of salaried employees willing to put in grueling hours for employers in return for long-term financial security. Contract, or part-time workers, made up 18% of Japan's labor force in 1990, but that figure rose to 30% of the nation's 65 million workers by early 2005.

Despite new labor laws allowing them to hire lower-paid, temporary employees, many of Japan's companies have found ways to focus on high-end products that can support high-wage workers, says MacDuffie, who specializes in the transportation industry. He points to Nagoya, where Toyota is headquartered, as a thriving manufacturing center. "In the Nagoya area and across the country, you are seeing industries that are doing extremely well. They have found a niche producing high-tech goods, such as advanced-materials products, that still make sense to manufacture in Japan. So employment and economic growth are up."

MacDuffie also sees recovery in traditional manufacturing industries, which might have been expected to migrate to other parts of Asia where production costs are lower. Companies did not adopt harsh restructuring plans and instead waited out the long downturn. "These are industries that didn't quickly change their management practices to a more Western style," with its emphasis on pay-for-performance and cost-cutting through layoffs, for example. Now, with the economy picking up, he says, executives in those companies feel a sense of redemption after remaining true to their traditional business culture -- balancing loyalty between employer and employee with the need to produce profits.

Banking Reform

According to Yasuda, banks are a good illustration of what is going on in Japan's labor market in that they are hiring more workers on an outsourced or part-time basis, especially women who work in sales. Under labor legislation passed in 2003, companies in certain industries can employ workers as temps for up to three years. Companies are now reaching the time limit on their first crop of part-timers. "Instead of firing them and hiring new temp workers," banks decided to retain the most productive employees and make them permanent, says Yasuda. "This shows the extent of banks' recovery and also the new evolution in labor markets that is more performance-based and less rigid."

Reform of Japan's banking system has been critical to the financial recovery, she adds. After the collapse of the real estate and stock markets in the early 1990s, Japan's banks were stuck with so much bad debt that they would have been insolvent by international standards. Instead of forcing them to work out their problems, the Japanese government tolerated lax definitions of non-performing loans. As a result, banks approved additional loans to their weakest borrowers to avoid having to write off bad loans. That only made the problem worse, says Yasuda. "Rather than monitor the health of their borrowers and allocate credit to the most creditworthy firms, banks granted credit disproportionately to their least creditworthy clients."

Slowly, and only after years of continued economic decline, the government began to see the need for change. Yasuda points to the collapse of Long-Term Credit Bank, which was nationalized in 1998 before eventually being purchased by foreigners and renamed Shinsei Bank. Shinsei means "new life." In 2000, Shinsei shocked Japan when it refused to rescue Sogo, a venerable but struggling department store. Sogo ultimately closed. "This heralded a new era in which no firm was too big to fail," says Yasuda. "Although other banks resented Shinsei for being a non-conformist, its actions helped them start cleaning up their own bad loans."

Since 1999, the government has provided public money to boost the capital of major banks, made it easier for banks to reduce non-performing loans on their balance sheet, and allowed banks to swap loans into preferred convertible stock. The banking recovery also was helped by an industry consolidation into three major groups: Mizuho, Mitsubishi-UFJ, and Mitsui-Sumitomo. "I suspect that the consolidation shook up the stability of bank-firm relationships; it allowed banks to stop 'evergreening' problem loans," says Yasuda.

Consolidated net profit at six major banks reached a record 1.3 trillion yen for the half-year ending in September, she adds. Non-performing loans of all financial institutions have decreased in each of the past three years. As of March 2005, bad loans totaled 24.9 trillion yen, down 28% from the previous fiscal year-end. In all, the government has invested 12 trillion yen to shore up the banking system, and half will be paid back by March 2006.

Baby Boomers Retirement

Still, Japan's financial problems are not fully resolved, cautions Wharton finance professor Franklin Allen. The country "has a huge fiscal problem at the moment. What they did for 15 years was go out and borrow; consequently, taxes haven't covered much of what the government spent for the last decade and a half. Japan went from being one of the countries with the lowest public debt to being one of the highest. That's fine when interest rates are zero, but when interest rates go back to normal levels, which is part of this reemergence, it is going to be huge problem." Japan's public debt is more than 150% of GDP and is the highest in the industrial world. By comparison, U.S. government debt is estimated at 65% of GDP.

Making matters worse, Allen adds, is that much of Japan's public debt is in low-rate 10-year Japanese government bonds (JGBs) that will be coming due as baby boomers begin to retire and draw down on savings. At the same time, Japan's population is shrinking, which means fewer workers are paying into government savings plans. "It's a big problem. I'm glad things are going better, but this is going to be tough to get over."

In November, Japan's Ministry of Finance announced a plan to cut debt by using 12 trillion yen to buy back bonds beginning in April 2006. Japan has pledged to bring its debt into balance early in the next decade. The ministry also said it will try to cut down on the issuance of public debt in the fiscal year starting in April by more than 2.2 trillion yen, which is the amount it cut in 2005.

According to Allen, when countries get in trouble with too much debt, the best solution typically is to grow the economy faster so that debt becomes a smaller part of the pie. "That would probably be the best way for the Japanese," he says, "but the question is, how long can they grow quickly without pushing interest rates up? If they can grow at 3%-4% and keep inflation low, that will be fine, but it is not clear that is feasible."

A second way to solve the budget problem is to tolerate low to moderate inflation, which could erode the value of Japanese household savings, but help wipe away the budget deficit. Another possibility would be to create a new tax to pay off the debt faster than waiting for Japan's economy to grow its way out of the deficit. A more worrisome, though unlikely scenario, Allen says, is the development of hyperinflation, which erodes spending power and can breed political instability. "That happened in Germany, Austria and Japan between the two world wars. Hopefully it will not happen again. Another alternative, which is also drastic and unlikely, is that the government could default on some of its debt."

According to Allen, the irony of Japan's long 15-year economic slump is that it was triggered in 1990 with an interest-rate hike designed to curb inflation. That led to the fall in asset prices, which ultimately left share prices at 25% of their peak level and real estate values cut in half. In the years since, Japan's government and corporations have talked about reform, but many moves forward were followed by periods of retrenchment.

As for changes in the banking sector, Allen believes the new, more rational credit practices will remain in effect, preventing Japan's banking sector from reverting back to its old ways. Reforms that have led to more labor flexibility will also remain in place, he predicts, although at a cost in financial security to younger workers. Companies "have substituted a lot of part-time jobs for full-time jobs, but it's unfortunate because you now have a generation" of part-time rather than full-time employees.

The Next Big Reform

Meanwhile, Japan is now bracing for its next huge reform: privatization of the postal savings system [See related article in this section]. For more than a century, Japanese savers have contributed week-by-week to the system, which is believed to be the world's largest financial institution.

In Japan the postal system delivers mail, but also serves as a national savings bank. Japanese households have amassed savings gradually, handing cash over to mail carriers or making deposits at neighborhood post offices spread throughout the country. With generous tax incentives, the Japanese savings rate was among the highest in the world, although in recent years it has declined. In the early 1990s, Japanese households saved 15% of household income; that figure is now 5%.

The Diet has approved a plan to divide Japan Post into four pieces -- mail delivery, over-the-counter service, savings and insurance -- then spin them out of government control by 2017. Critics of Japan's economic structure have argued the government has used the postal system's assets to pay for politically popular projects that were not wise investments.

Despite political obstacles that remain, particularly opposition from employees fearful they will lose their jobs, the post office proposal is likely to take effect, but slowly, says Allen. "The post office is a very important reform. I think it will happen, but it's going to be over a decade. It's going to be glacial."

Japan's notoriously slow pace of reform may have prolonged the length of its economic downturn, but it also may have led to a better result in the end, Allen adds. "When things go wrong, you have a chance to reverse them."

The 'Plateau Decade'

Wharton adjunct management professor Adrian E. Tschoegl suggests that as Japan ages and baby boomers start to retire, changes in productivity may improve the nation's economic climate. "As people in the various mom-and-pop groceries are replaced by convenience stores and larger operations, per capita productivity will rise." Tschoegl lays out another example: "As various farmers retire and lease farmland to a particularly good local farmer, agricultural productivity will rise. You can get productivity improvement out of the changing demographics."

Tschoegl also argues that in the end, Japan's long decline and slow recovery may ultimately have suited the country's cultural and economic character. While the nation did suffer a shocking drop in the value of its real estate and stock market assets during the 1990s, those assets had only become hugely inflated in the 1980s. Today, Japan is the world's seventh richest nation and its citizens live relatively comfortable lives, particularly when compared to their Asian neighbors, he points out.

"One has to remember that despite there being a lost decade, it was a lost decade at a very high level," says Tschoegl. "Unemployment is a little worse than in the U.S., but not massively, and incomes are pretty high. The lost decade was more of a plateau decade than a dip."