Weekly Perspectives

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A Weekly View of Global Economies

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The Japanese economy has been looking more robust in recent months, on the back of firming domestic demand and a stronger global economy. Rising consumer and corporate spending point to a sustainable path of recovery in Japan, even as leading indicators of the global economy presage a pickup in activity and therefore a better outlook for Japanese exports.

There are also prospects of positive developments on the issue of structural reform. Premier Koizumi's election victory in September gave him a mandate to implement reforms at a faster pace than previously. He is expected to maintain his objectives of cutting back on payrolls and subsidies, and generally trying to reduce the size of the public sector in the economy.

The restructuring is in the interests of better resource allocation through greater efficiencies and the generation of faster productivity growth. Japan has been lagging the United States significantly in this regard and needs to boost productivity as a partial solution to alleviating the government's debt burden, as well as addressing the looming pension problem. It is projected that in the future a large retired population will have to be supported by a relatively small workforce.

Unlike the United States, Japan does not have the sort of society and culture that will welcome or readily integrate large-scale immigration of younger workers from overseas, to offset an older demographic profile. So to meet the demands of higher pension payouts it has to rely on faster productivity growth, as well as its foreign investments. Japan continues to be a net creditor nation and has built up sizable assets abroad.

The Japanese economic and organisational model that worked so well in the post-war period lost something of its relevance in the 1990's, as the country sunk into a long period of deflation. During this period, there have been one or two fragile recoveries that were aborted by policy mistakes, but this time it looks like recovery is real and sustainable.

Curiously enough, a decade and a half ago, the Japanese model was still being touted by business school gurus as a desirable framework, just at the time when its inadequacies were about to be revealed. Some of the major characteristics of the model were consensus decision-making, lifetime employment for salaried men, large conglomerate structures using non-market signals to determine resource allocation and disdain for the interests of the shareholder.

At the beginning of the nineties, after the bursting of the financial bubble, it was still expected that the Japanese economy would stage a reasonably rapid recovery after an adjustment period. But it was the much-criticised American model that went on to beat its far-eastern rival handily over the decade, in terms of a number of measures including employment and productivity growth, as well as innovation.

Japan faltered because there was unwillingness to change structures and patterns of behaviour that were no longer working adequately. But as we have said before, structures are hard to change. People will go on practising the old and unsuccessful methods before trying new ways, and there must be a period of pain before a degree of change is accepted. And, not least of all, the privileged old guard will fight tooth and nail to maintain the status quo however inefficient it may be.

In recent years, Japan has slowly adopted some aspects of the American model, making corporations more flexible as well as more efficient in allocating resources. There has been a reduction in decision-making based on non-economic signals and more flexible labour market practices. But they are still struggling with solving the problem of fostering the sort of creativity that is at the source of innovation - - a Silicon Valley mentality.

The system of consensus-building is at odds with individualism and the willingness to stick to contrary opinion that is often at the source of original thinking. And, not just contrary opinion, but also the willingness to take risks, be wrong, and learn from mistakes. It can be argued that in the current global economy there are higher rewards for those capable of rapid innovation, as well as the flexibility and adaptability to recognise opportunities and exploit them. An organisational system that promotes risk aversion, offers little incentive to innovators and takes an inordinate amount of time to reach decisions is at a disadvantage in a competitive marketplace.

The Japanese economy can be divided into several major parts. Manufacturing is the most innovative and dynamic sector, while services and agriculture are notoriously high-cost and inefficient. Promoting change where it is most needed will be a major challenge faced by the government. Meanwhile, the economic recovery has helped to put the formerly rickety financial system on a sounder footing.

After a long period of deflation, expectations are rising for the consumer price index to move into positive territory. Certainly, the trend is encouraging. Since 2001 the Bank of Japan has maintained a policy of quantitative easing, which has involved furnishing plentiful liquidity to the economy and keeping interest rates near zero. Once inflation establishes a consistently positive trend, there may no longer be any major reason for the BoJ to maintain its current stance. Not surprisingly, policymakers have started to signal a coming shift in policy, well ahead of the implementation date. Clearly, the intention is to pave the way for a smooth transition.

It is unlikely that the Bank will be proactive in implementing tighter monetary policy. They suffer from the stigma of having moved too early on a previous occasion and compromised a budding recovery. So they will wait until a positive inflation trend takes hold. The government is also keen to ensure continued economic expansion. But a recent comment by Prime Minister Koizumi that it was too early for the BoJ to end quantitative easing only helped to drive the yen lower against the greenback. Investors are only too aware of the wide gap that exists between Japanese and US interest rates.

The Japanese stock market has risen substantially since May, largely as a result of foreign buying. But there are now signs of some lassitude among the buyers. Meanwhile, domestic institutional investors such as insurance companies and pension funds appear to be sellers. As for local retail investors, they are still cautious about buying stocks. So the market's direction continues to depend on foreign interest.

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