Prepared for the IIPS Symposium on

Upcoming Changes in Japanese Society and the Future Shape of the Nation

Tuesday, 6 December 2005
Tokyo

Session 2

Sources of Competitiveness—Japan's Strengths and Globalization

Akio Mikuni
CEO, Mikuni & Co., Ltd.

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CEO, Mikuni & Co., Ltd.

In 1983 the author founded Mikuni's Credit Rating and began providing credit rating information on Japanese companies and banks. This presentation describes the author's observation and understanding of the competitiveness of the Japanese economy, based on his analysis of company financial statements.

After World War II, Japanese companies raised their international competitiveness, rebuilt the post-war economy, and achieved a high level of economic growth by relying more heavily on debt and actively engaging in capital investment. Some Japanese companies secured the power to set prices and emerged as internationally recognized brands, for example Toyota, Panasonic, Sony, and Honda. As a result, from the mid-1960s Japan's balance of trade remained firmly in the black, and in 1970 it became a net creditor nation, as its external credit exceeded its foreign debt and it became effectively free of debt. As Japanese corporations competed strongly on the international stage, their finances improved and the credit ratings of their bond issues looked set to rise. Hence, the author decided to begin rating them.

Japan's current account surplus subsequently grew larger every year and, in the latter half of the 1980s, Japan surpassed the United States as the world's largest creditor nation [see Figure 1, Comparison of Cumulative Current Account Balance (versus Nominal GDP) between Japan and the USA]. In the process, the yen continually increased in value against the dollar, wages increased in comparative international terms, costs soared, and in the labor-intensive manufacturing industry, Japan began to lose its competitive edge in the international arena. In order to maintain their international competitiveness, Japanese companies sought to deeply cut costs by moving domestic production overseas. This transition to local production catapulted the Chinese economy to even greater prominence in the international market.

As a result, the level of industrial production in Japan has scarcely registered any increase since 1990 and remains essentially flat [see Figure 2, Index of Industrial Production for Japan]. Japanese manufacturers and other companies have since enjoyed significantly higher profits in overseas markets than in the domestic market.

Since the latter half of the 1990s, the accumulated current account surplus has exerted deflationary pressure on the Japanese economy, precipitating an economic slump. Since the war the Japanese economy had been rapidly closing the gap with the US economy, but in 1995 this trend reversed and the US economy began to pull away again [see Figure 3, Comparative Sizes of the US and Japanese Economies Year-on-Year]. This graph illustrates the strength of the US economy as compared with deflation-stricken Japan.

The reasons why the current account surplus may be viewed as the root cause of deflation are as follows.

In 1971 US President Richard Nixon fundamentally changed the rules of the international currency game when he severed the link between gold and the dollar, and switched to a floating exchange rate system instead. Because Japan wanted to preserve its exports in spite of this move, it resisted increases in the value of the yen and attempted to prop up the dollar. Instead of converting dollars into yen and bringing them back to Japan, Japan simply lent the excess dollars, which it accumulated through its trade surplus, back to the United States—that is, it exported the surplus in the form of capital. This meant that the capital that was needed for export manufacturing back in Japan never materialized, which led to a domestic shortfall in capital. This was the root cause of deflation. In an attempt to make up for the lack of capital caused by capital exports, the Bank of Japan instigated a system of indirect financing to ease the credit situation. In the 1980s this credit easing did not lead to increased consumption, but instead created a bubble in the securities and real estate markets. The period from 1990 onwards saw a sharp rise in the amount of bonds issued by the government, as it increased fiscal spending. However, because this spending occurred at the same time that the Bank of Japan was trying to dispose of a great number of non-performing loans resulting from the bursting of the bubble, the period has witnessed emerging signs of deflation despite the bank's Herculean efforts at deregulation.

Although money has reached the export manufacturing industry and related sectors (the beneficiaries of deregulation by the Bank of Japan), it has not filtered through to sectors that focus on domestic demand, and there has been little increase in employee compensation or growth in consumption. Hence, capital investment in domestic-oriented markets, such as electrical power, has declined sharply. Although Japanese companies have remained competitive on the international scene, Japan's economy has undeniably deteriorated in competitive terms. Partly as a result of this, over the past 20 years Mikuni's Credit Rating has downgraded credit ratings in 1,318 cases, and upgraded credit ratings in 747 instances. Contrary to the optimistic outlook that existed when the author began evaluating credit ratings, downgrades subsequently continued to exceed upgrades by a wide margin. However, this hitherto unbroken trend was reversed last year (due in part to a revitalization in business activity), and upgrades greatly exceeded downgrades [see Figure 4, Changes in Credit Ratings from 1983 to 2004].

Based on the author's study of corporate finances, it is clear that significant changes in policy will be necessary in order to fully revive and strengthen the competitiveness of the Japanese economy[see Figure 5, Japanese Economic Competitiveness=a High Growth Rate). That is, in order to re-invigorate economic growth, it will be necessary to increase domestic demand and consumption, and achieve greater added value, rather than continue increasing production that relies on exports. This will require offering increased value to the consumer in the form of products and services with a high degree of added value, in addition to lower production costs.

Since the current economic framework puts a premium on increased production, measures to improve profitability and productivity—essential for economic growth driven by domestic demand—are being neglected. For example, since industry still clings to the dysfunctional system of life-time employment (regarding it as a fundamental tenet), there is little mobility within the labor market. In addition, the practice of whole industries acting en bloc remains entrenched, and there is little attempt to improve business efficiency through competition between individual companies. Furthermore, an enormous money supply system based on bank deposits and post office savings—the indirect financing system—exists to promote increased production through capital expenditure. Since money is distributed to manufacturers at low interest rates through this system of indirect financing, capital expenditure and production can easily be increased, irrespective of whether or not such investment will prove profitable. This also enables exports to be facilitated through the buying of dollars to support the currency (thus encouraging a weak yen).

Given this status quo, four major changes need to be made to the economic framework in order to make Japan properly competitive. These are listed below [See Figure 6, Measures for Strengthening the Competitiveness of the Japanese Economy].

First, abandon the dependence on exports and a surplus, and pursue a strong yen. Specifically, promote the use of the yen internationally and let the market determine exchange rates. Yen capital from abroad must be put to good use and yen-based securities must be made appealing. In particular, stop the practice of having the Bank of Japan support the price of government bonds and leave it entirely up to the market. Making the yen a more user-friendly currency will make matters easier both for Japanese companies and individuals, at home and abroad.

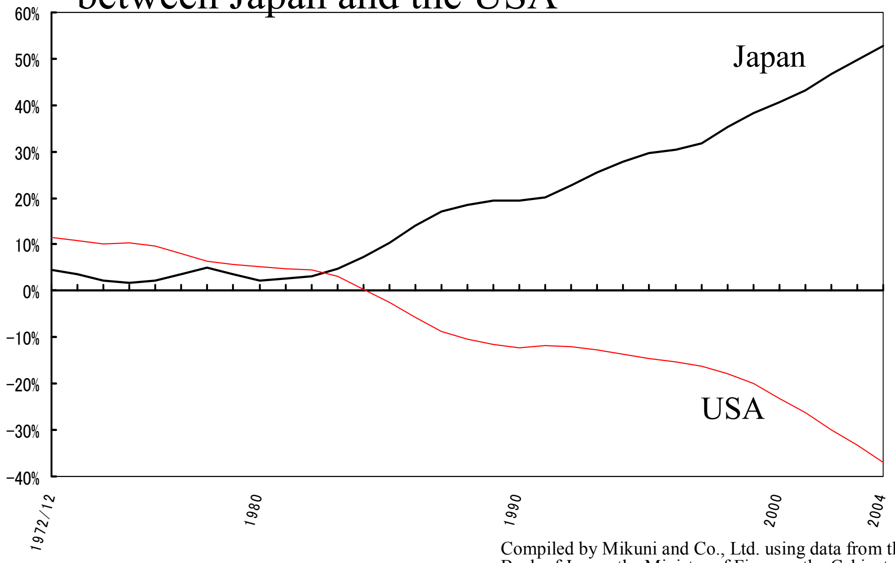
Second, the pursuit of richer lifestyles will promote Japanese culture, and will in turn give rise to new products and services that reflect the unique values of the Japanese. Around two years ago the Wall Street Journal published an article describing how delighted the president of US elevator manufacturer Otis was that the company had succeeded in supplying ultra-high-rise elevators in Japan for the first time, when it supplied elevators for Roppongi Hills. In the 1930s Otis had the distinction of installing the world's first ultra-high-rise elevator in the USA in the tower of the Waldorf Astoria Hotel. It had taken Otis a long time to win acceptance in Japan because in contrast to users in the United States, Japanese customers disliked the swaying motion of the elevators, and it had taken the company a long time to develop sway-suppression technology on a par with that of Japanese manufacturers. This impressed the author as an example of how Japanese sensibilities could give rise to a higher standard of technology. At one time, consumption was despised as extravagance, and saving was encouraged. Nowadays, however, consumption ought to be viewed as an investment that yields new technology and products.

Third, increase consumption in the pursuit of affluence by increasing the level of healthy debt in household finances and put the focus on economic activity. For example, consider a tax system for the individual similar to the corporate tax system, allowing deductions for interest paid on housing loans. It will also be necessary to facilitate the mortgage backed securities (MBS) market by liquidated housing loans, enable individuals to obtain low-interest housing loans, and allow such loans to be used as multi-purpose capital, for example in the purchase of durable goods or in other expenditures.

Fourth, make the securities market, where values fluctuate with profits, the central source of corporate funding. If the supply of capital by individual investors, who set great store by profitability in the securities market, becomes the norm, cheap capital will be made available to companies that win the support of the consumer and increase their profits. This would involve a major shift from the existing system of indirect financing—which is used to increase production and in which the banks represent the main source of low-cost capital—to a system of direct financing via the securities market. Improved corporate productivity would thus become the very factor that drives higher employee compensation.

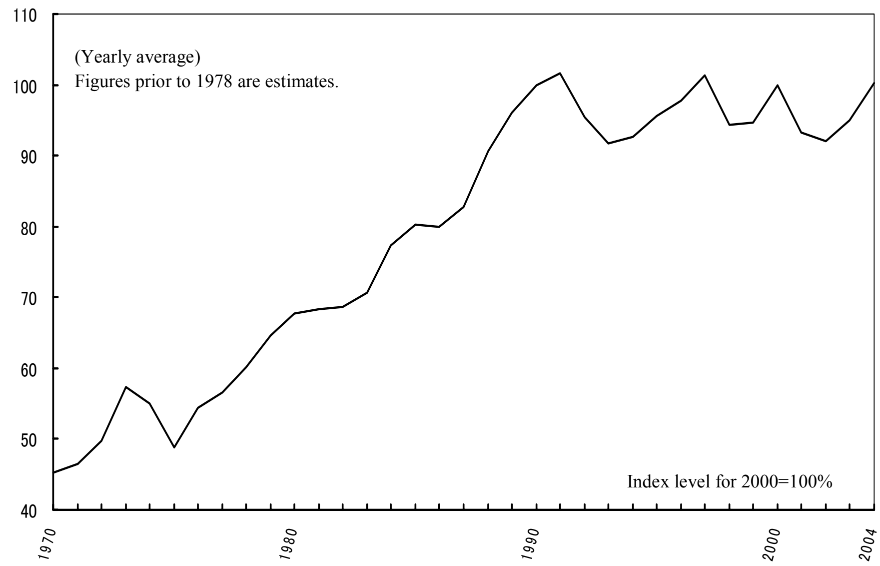
It is clear that implementing these four policies will stimulate lively economic activity, sow the seeds of innovation, and nurture the development of human resources. However, the existing top-down system of governance, which protects and coddles industry, is simply not up to the task of implementing the measures that this will require. With its commanding view of the entire nation, the Japanese government has yet to demonstrate firm leadership and this is probably the reason why the Japanese economy has lost its competitive edge.

Figure 1. Comparison of Cumulative Current Account Balance (versus Nominal GDP) between Japan and the USA



Compiled by Mikuni and Co., Ltd. using data from the Bank of Japan, the Ministry of Finance, the Cabinet Office, and the Bureau of Economic Analysis

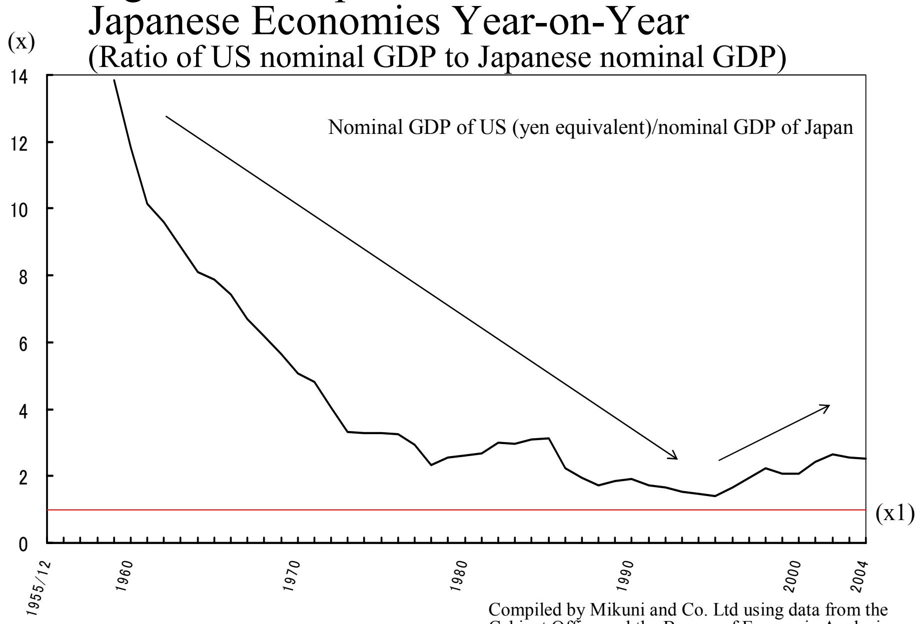
Figure 2. Index of Industrial Production for Japan



Compiled by Mikuni and Co. Ltd using data from the Cabinet Office and the Bureau of Economic Analysis

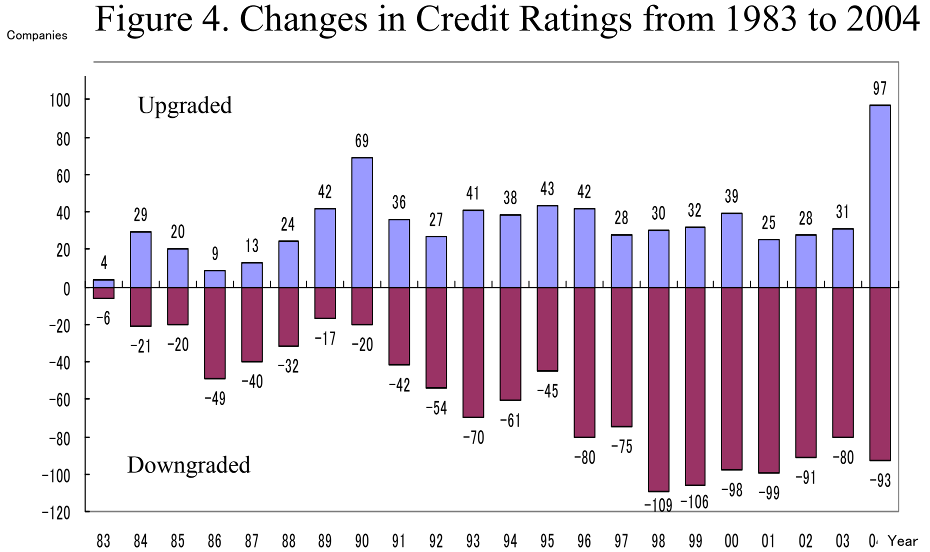
Figure 3. Comparative Sizes of the US and Japanese Economies Year-on-Year

(Ratio of US nominal GDP to Japanese nominal GDP)



Compiled by Mikuni and Co. Ltd using data from the Cabinet Office and the Bureau of Economic Analysis

Figure 4. Changes in Credit Ratings from 1983 to 2004



* Mikuni's Credit Rating began operations in July 1983.
* In all cases ratings apply to the company's most senior debt.

Figure 5. Japanese Economic Competitiveness=a High Growth Rate

The Past	The Future
Imitation of Western culture	Japanese culture
Increased production through exports and capital investment	Increased production through consumption and investment in housing
A strong dollar	A strong yen
Price cutting through cost reduction	Price rise through increases in added value
Increased productivity	Improved profitability & productivity
Static management resources	Mobile management resources
The "convoy system"	Competition in the marketplace
Lifetime employment	Labor market
Indirect financing	Securities market (direct financing)

Figure 6. Measures for Strengthening the Competitiveness of the Japanese Economy

(1) Pursue a strong yen.

(2) The pursuit of richer lifestyles and the promotion of Japanese culture will spark the creation of new products and services that reflect the unique values of the Japanese.

(3) Develop the market to facilitate mortgage backed securities (MBS) market by liquidated housing and use housing as security for household finances, enabling individuals to obtain low-interest housing loans. Consider changes to the tax system that facilitate and promote housing construction, moving to houses that better suit individual lifestyles, purchasing of durable goods, and other expenditure.

(4) Companies win the support of the consumer and increase their profits. The more profitable they are, the more cheaply they will be able to obtain financing. This will establish a link between profitability and higher compensation.