

“End to Corporate Restructuring” is a Prerequisite for Ending Zero-Interest Rates

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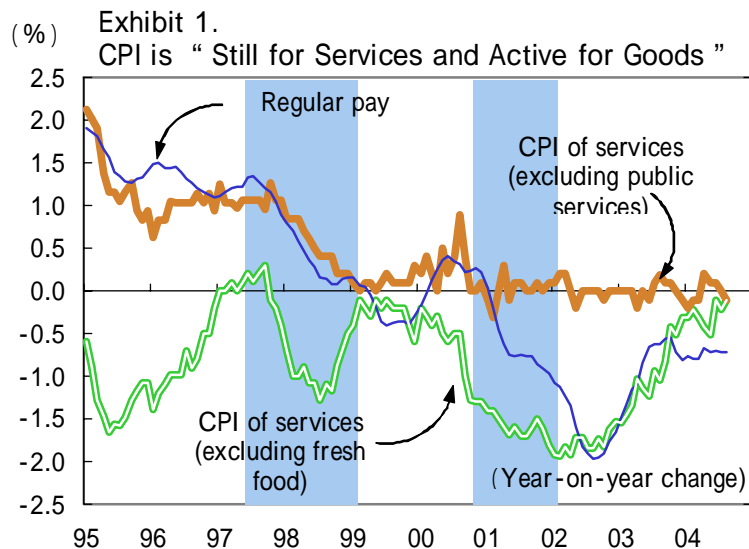
Steep Increase in Households Without Savings

“For the first time since the asset bubble,” “For the first time in more than 10 years,”—these are expressions one frequently sees in recent news items dealing with economic statistics. It makes one think that perhaps the Japanese economy has finally recovered from a long illness. Nevertheless, it seems that the time is not yet ripe for lifting the zero-interest rate policy, an extraordinary antidote administered to the ailing Japanese economy. This paper examines the reasons why ultra-low interest rates are likely to stay.

“Positive Increase in Prices over an Extended Period” Hinges on Wages

In its “Outlook for Economic Activity and Prices” released at the end of October, the Bank of Japan forecast that the consumer price index (CPI) would increase 0.1 percent in fiscal 2005, which will start next April. Although this suggests that the Japanese economy will take a step out of deflation, the Bank of Japan plans to maintain the present policy, because the condition for ending the quantitative easing, namely “a greater-than-zero-percent CPI increase over an extended period,” will not be met. The market has also remained quiet as if it had forgotten that it had pushed the yields on 10-year government bonds up to 1.94 percent in June in anticipation of “the end to the period of low interest rates.” Meanwhile, as whispering is rife that the economy will decelerate toward the next fiscal year, the market seems to believe that prices will also reach a ceiling.

I have examined the view that prices will reach a ceiling by breaking prices down into two components: prices of goods and prices of services (Exhibit 1). Roughly speaking, it can be said that while the fluctuation in prices of goods is linked to business conditions, prices of services remain more or less flat. Since the weight of labor cost is greater in services, their prices tend to be affected more by wages than by the supply-demand balance. As expected, before 2000 or thereabout, prices of services moved more or less in step with wages (regular pay). However, in the past four years, while the rate of increase in wages has plunged below zero percent, that in service prices has remained unchanged at around zero percent, suggesting that perhaps there is a downward rigidity in service prices.



Sources: The CPI is from the Ministry of Internal Affairs and Communications, Consumer Price Index (Nationwide). The impact of the increase in consumption tax has been removed (the estimate of the impact by this writer). Regular pay is from the Ministry of Health, Labor and Welfare, Labor Statistics Monthly, 6-month moving average. The shaded areas denote the periods of recession.

One can envisage the following three scenarios from the findings in Exhibit 1.

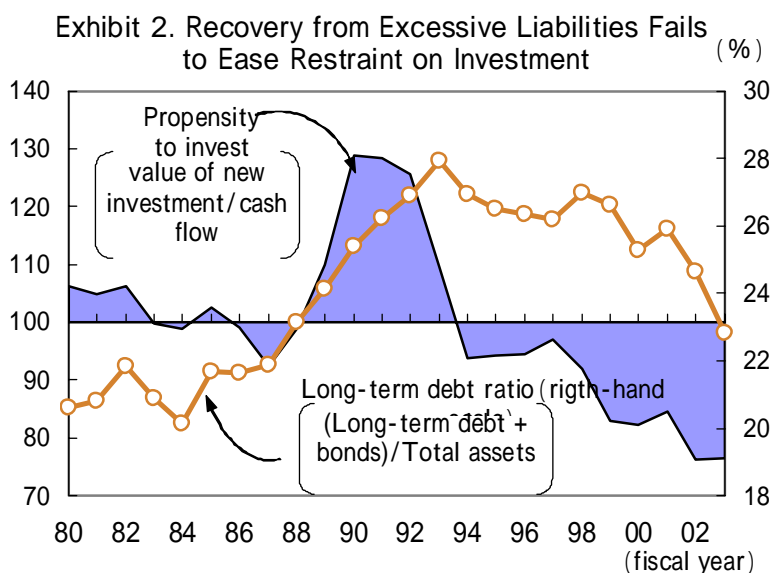
- (1) If wages continue to decline, service prices will at most remain unchanged. If prices of goods increase thanks to recovery in business conditions, the CPI as a whole will mark a positive increase.
- (2) If business conditions deteriorate, prices of goods will revert to a downward trend and the CPI as a whole will decline.
- (3) The prerequisite for an extended increase in the CPI is an increase in wages accompanied by an increase in service prices.

Businesses Intent on “Slimming Down”

Thus, the key to future movement of the CPI lies in wages. In the past, it was safe to assume that during a period of economic recovery, an increase in corporate profits was always followed by an increase in wages. This time around, however, while business conditions are strong with profits in the corporate sector definitely rising for the third consecutive year in fiscal 2004 and firms chalking up record profits are not exceptions, wages keep falling. The last time the zero-interest rate policy was lifted, those who argued for the lifting presented the so-called “dam theory,” which said, “When dams (businesses) are filled with water (profits), water will eventually run downstream (to the household sector).” This time, however, the dams are not discharging water.

A similar irregularity in the functioning of “dams” is also observed in the propensity to invest, or the ratio of funds on hand used for investment. Investment in plants and equipment is definitely on the rise, but it is still being “restrained” in the

sense that enterprises are saving some profits and not using all the profits for investment (Exhibit 2). This is in spite of the fact that corporate balance sheets with liabilities exceeding assets, which had been designated as a problem, have been remedied to a great extent.



Sources: The Ministry of Finance, Financial Statements Statistics of Corporations by Industry Quarterly. Cash flow was obtained by the following formula: Recurring profits before extraordinary items x (1 - effective tax rate) + depreciation expense.

To what should we attribute this phenomenon? One of the answers is likely to be that the relative share of capital in income distribution has not yet fully recovered. Given the present increase in corporate profits, capital share should return to the pre-bubble level in fiscal 2004 (Exhibit 3). Thus, it does not fully answer the question why wages are being reduced further.

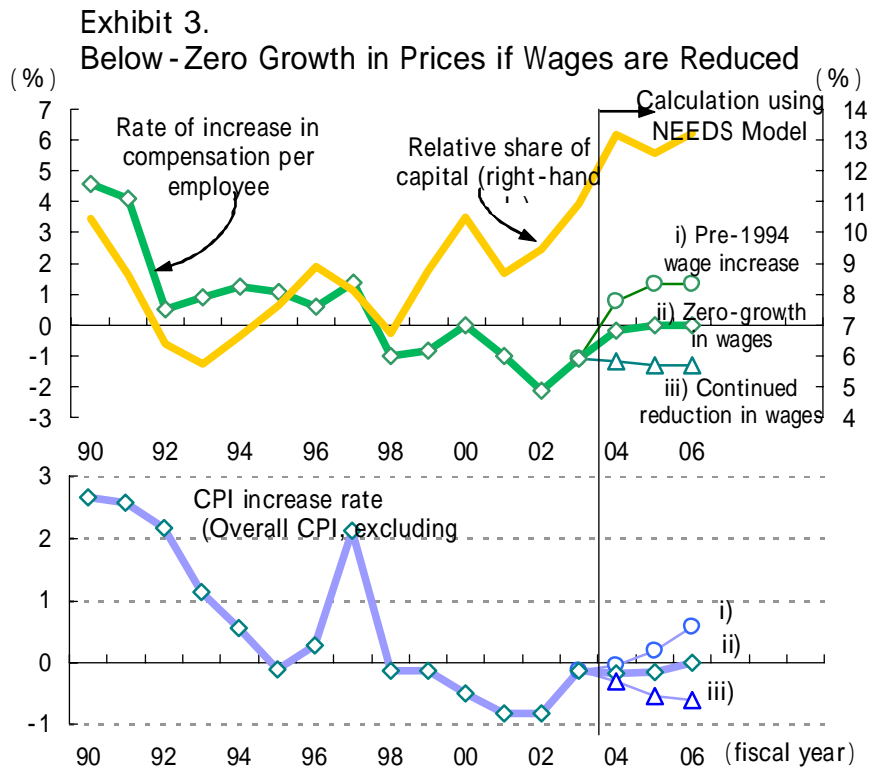
One argument is that the increase in the ratio of part-time workers to the total workforce, as exemplified by the sharp increase in young casual workers, is depressing the labor cost per capita. The structural change in the supply of labor is certainly a factor. However, it is suspected that a change in the “corporate constitution” may be behind businesses’ reluctance to spend money, including investment in plants and equipment. That is to say that “restructuring mentality” has seeped through firms, making them excessively nervous about spending money. One gets the impression that excessive slimming down is bringing on anorexia. Change in corporate governance may be another factor. In the new environment, investors make tough demands on management. It seems that whenever management tries to indulge in something sweet, it is promptly rebuked, “That is not good for you” from everyone around.

Zero-Interest Rate to End in the Next Business Boom

Then, how long will businesses remain intent on slimming down? The past process of overcoming “obesity” provides a clue. Japan’s “asset bubble” is thought to

have come to an end in late 1989, when share prices peaked out, or early in 1991, when the economy began to slide. However, it was only in 1994 that the corporate sector switched to restructuring in earnest in the sense that businesses began paying off debts before making investments. It had taken them several years to notice their excesses. This time, assuming that share prices reached a major bottom in the spring of 2003, it will also take five years or so from that point onward before businesses ease their pursuit of “restructuring.”

The following is the result of an examination of the difference in price levels between the case in which firms continue to slim down and that in which they regain appetite, calculated using the NEEDS (Nikkei Economic Electronic Databank System) Model (Exhibit 3). When the relative share of capital increases, there are three possible patterns of its effect on wages: i) the effect is similar to that prior to serious



Sources: The relative share of capital here has been obtained by dividing recurring profits before extraordinary items (from the Ministry of Finance, Financial Statements Statistics of Corporations by Industry Quarterly) by “national income” in the Office of the Cabinet, National Income Statistics, to allow the use of variables from the NEEDS Model. The forecast figures are based on standard forecasts (October 2004) by NEEDS.

When wages are regressed using the three variables of i) relative share of capital, ii) CPI increase rate and iii) hours of overtime worked, the coefficient of capital share for 1980–1994 stands at 0.58. Therefore, in the case of , the assumption is that the rate of pass-on of the 2.3-percent increase in capital share in 2004 to wages will be 0.58. For the case is vice versa.

“corporate restructuring,” which began in 1994; ii) zero effect; and iii) negative increases in wages (despite the increase in capital share). The analysis shows that for prices to clearly register positive increases, the relationship between wages and capital share must return to the pre-restructuring pattern and that such a relationship must be maintained for a number of years.

It has been approximately three years since the economy reached its latest trough. The optimists, including the Bank of Japan, appear to believe that the Japanese economy will maintain its momentum until next year. However, if the current growth lasts for another year or so at the most and fails to repeat the “Izanagi boom” (October 1965 - August 1970), which lasted for nearly five years, the chance for ending zero-interest rates is not likely to come. Ending zero-interest rates prematurely is a risky operation as was seen when interest rates were lifted in August 2000. Needless to say, if the economy begins to decelerate first, any increase in interest rates will be out of the question. Although opinion is divided as to the efficacy of zero-interest rates, this extraordinary antidote is being administered with the hope of whetting corporate appetite, even if just a little. The lifting of the zero-interest rate policy, therefore, may not come before the next major economic upturn, when firms will become aware of their excessive “dieting” and when their financial conditions are more favorable.