‘Three Ds’ pose worry as Tokyo barriers begin to crumble

ECONOMIC VIEWPOINT

The picture may never be the same again as Japan finally opens its doors to competition from overseas, says **Dr Gerard Lyons**

JAPAN is undergoing one of the most dramatic changes in its recent economic history. On the face of it, much appears calm. The unemployment rate is only 2.9%, industrial production has risen throughout the last year and exports are still growing strongly. The yen remains strong and interest rates are at an all-time low.

But tremendous pressures are affecting all aspects of the economy. As Japan is the world's second largest economy and one of the largest investors in Britain and Europe, changes there could be of vital importance to us all.

The country is suffering from the "three Ds" — deregulation, deflation and de-industrialisation.

Deregulation means the opening up of the Japanese economy to foreign competition. The economy is the mirror opposite of the British economy.

In Britain, the retail, distribution and financial sectors are incredibly efficient and are among the best in the world.

Meanwhile, the manufacturing sector is efficient but too small. By contrast, Japan's manufacturing sector is huge and efficient but its retail, distribution and financial sectors are relatively inefficient.

This stems from the way the Japanese economy has been protected. After the Second World War when the Japanese economy was small and weak, many regulations were introduced aimed at promoting and protecting industry.

These succeeded in their task but now they are seen as defending the status quo, stifling competition and making it difficult for foreign firms to break into the Japanese market and sell goods there. Japanese firms have thus been able to sell goods almost free from foreign competition.

Last autumn, the Japanese Government said there were 11,402 rules in place affecting just over two-fifths of the economy. It plans to remove these regulations, but only slowly.

The main initial pressure for Japan to open its economy came from abroad, and in particular from the Americans who were alarmed by the sizable trade deficit. But in recent years, there has also been increasing pressure from within Japan for deregulation. Consumers have felt that they have not shared enough in the country's industrial success.

This is ironic. While many people in Britain wish to achieve Japan's success, many in Japan envy what they see as better living standards in the West.

Deregulation will have two dramatic consequences. It will result in deflation and de-industrialisation.

Opening up the Japanese economy will allow imports greater penetration into Japan. This is already happening. At the end of last year, the volume of imports into Japan rose by a phenomenal 18.6% from a year earlier.

In coming years, this will reduce the trade surplus. But the more telling immediate impact is that foreign competition will push prices in Japan lower.

Headline inflation in Japan is currently 0.2%. But in reality, deflation is occurring. That means that actual prices are falling, not just their rate of change. And that can cause tremendous economic problems.

If firms are cutting prices, their profit margins are being squeezed and this, in turn, could force them to cut costs, resulting in higher unemployment.

We have not reached that stage yet in Japan. Instead, consumers are reaping the benefit of deflation through their increased purchasing power.

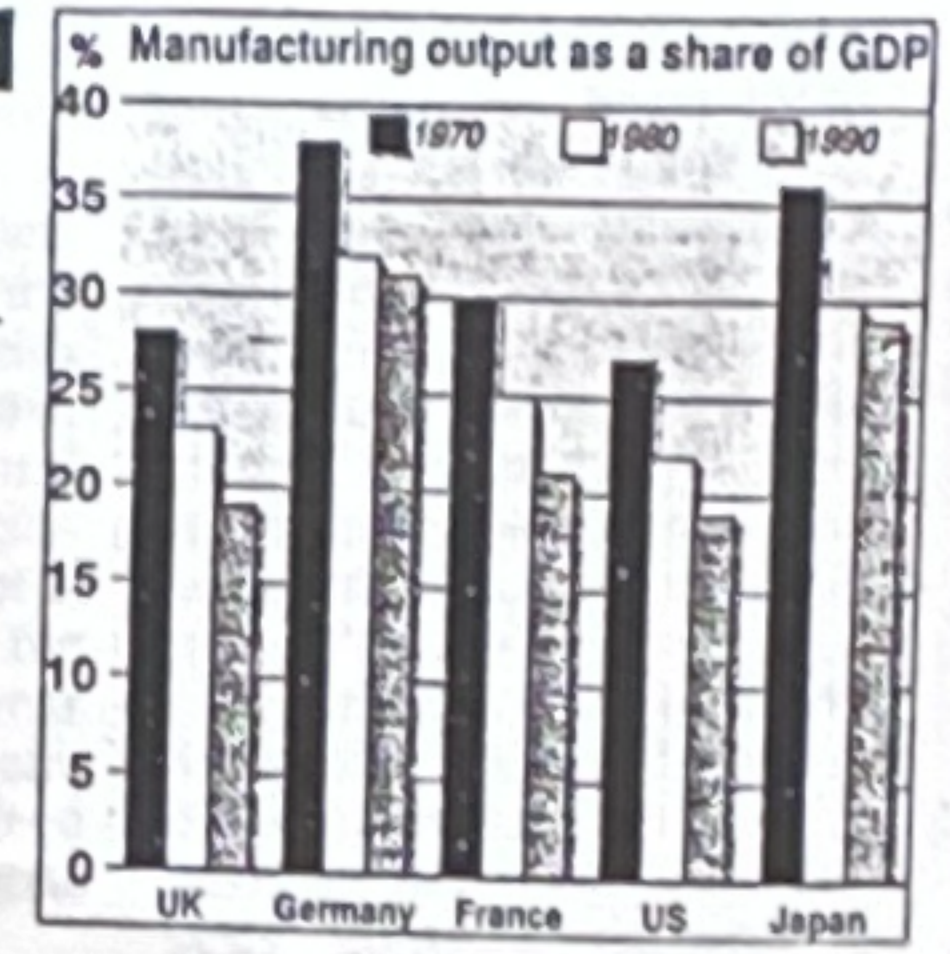
This also gives rise to the most dramatic change, de-industrialisation. The strong yen and increased competitive pressures at home are forcing Japanese companies to move production offshore. Industry is moving out to lower-cost centres elsewhere in Asia.

The latest data, from 1993, shows that the hourly cost for a manufacturing worker in Japan was $19.20 (£11.90), considerably higher than Korea's $5.37, Taiwan's $5.23 and Thailand's 71 cents.

BUT IT IS NOT just costs. Demographics also explain the move. Japan has a rapidly ageing population. In 1990, one person in eight was over 65; by 2020, it will be one in four.

The pressures for Japanese companies to react immediately are great. South-east Asians are trying to replicate Japan's industrial success, investing in education and the infrastructure. This is contributing to rapid growth throughout the region.

Labour costs have always been low in those countries. But whereas countries like Taiwan and Hong Kong 10 or 20 years ago produced



just low-price, low-quality goods, increased investment means they are producing higher quality goods at low prices. And Japanese investment will reinforce this process.

While Japanese firms will benefit from lower costs, one sufferer will be the Japanese economy. Although it is recovering from recession, the pace of growth in future years will be very weak by Japanese standards.

Large firms plan to cut investment at home by 1% in the coming year. Small firms plan a 24.5% reduction. Furthermore, the amount of production and investment Japanese firms will undertake overseas is increasing.

This year, a quarter of investment and a fifth of production by Japanese firms will be outside Japan. The Japanese call this "hollowing out".

The financial sector is not escaping the impact of deregulation, as last week's merg between Mitsubishi Bank and Bank Tokyo showed.

The combined impact of the recession, a co lapse in the stock market and a fall in lar prices since 1990 has left many financi firms nursing large bad loans that will ta some years to write off.

On top of this, banks and financial instit tions are being exposed to increased compe tive pressure as the barriers that separat them are removed and as foreign firms a allowed greater access into Japan.

DKB, for instance, was allowed to open up securities subsidiary in Tokyo last Noven ber. All this points to greater competitio further rationalisation and mergers throug out the financial sector.

THERE ARE two schools of thought i Japan. The first assumes that once th economy recovers, Japan will a usual experience strong future rate of growth. I would include myself i the other school of thought, which believe the economic future will not be the same i Japan.

Deflation will favour consumers at th expense of industry while de industrialisation will see firms shift offshore

The result is a move towards the servic sector in Japan, similar to previous trends i other industrial countries. This inevitabl points to slower growth and to Japan livin off the interest, profits and dividends of it overseas assets, much as Britain did at th turn of this century.

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