



# *insight* **JAPAN**

**The quarterly  
magazine of  
today's Japan**

ISSN0966-8071 • MAY 1996 • Vol.5 No.1 • £2.50

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# Big becomes best

GERARD LYONS

**Y**es, the Japanese economy is finally improving. Signs of recovery are clear. Confidence is rising. The stock market has rallied. This is certainly a dramatic change from the start of last year, when the continued appreciation of the yen pushed the economy to the brink of recession and financial meltdown and confidence was low, in the wake of the Kobe earthquake, Tokyo gas attack and rising unemployment.

The weakness of the economy last year prompted a significant shift in policy. Interest rates were cut to an all time low of just 0.5 per cent; the Bank of Japan intervened aggressively in order to weaken the yen; and the Government announced another huge fiscal boost last September of over £90 billion. The policy seems to have worked: the economy has rebounded.

Despite this, there is widespread concern in Japan about economic prospects later this year, as the impact of last year's boost starts to fade away. As public spending slows the worry is that private spending will not take up the slack. These concerns are compounded by the fact that fiscal policy is to be tightened in spring 1997, when the consumption tax is set to rise from 3 per cent to 5 per cent and a recent temporary income tax cut is phased out.

Even though the economy is improving, recovery is weak by previous Japanese standards. This reflects the underlying changes affecting the economy, as deregulation takes place and firms reduce costs and become more efficient. Future Japanese growth may be more in line with the trend seen in western Europe, around 2.5 per cent.

**THE CLEAREST EVIDENCE OF CHANGE** is the way in which people are worried about jobs and wages. The Japanese labour market is changing, although large firms remain committed to the concept of jobs for life. If firms abandoned life time employment as many as two million people, the so-called window watchers, could lose their jobs. Even though this is unlikely to happen, changes are evident elsewhere: jobs are being lost in the manufacturing sector, graduate recruitment has fallen; and wages are growing at a very slow pace. This will limit any rebound in spending.

In particular, employment in the manufacturing sector has fallen by around 380,000 during the past year. This will continue, as large firms continue to move production out of Japan, to lower cost centres elsewhere in Asia. This year, large manufacturing firms expect 28.4 per cent of their investment and 21.2 per cent of their production to be overseas. This is sizeable. Although manufacturing jobs have been lost, they have been replaced by jobs in the service sector. This reflects the shift already under way in the economy away from manufacturing, and is likely to continue.

Although unemployment appears to have stabilised around 3.3 per cent, unemployment amongst graduates has risen as firms are reluctant to take on new recruits. This is one of the main economic concerns of the Government's Economic Planning Agency. They are also worried about

the continued fall in land prices and the continued difficulty experienced by small firms.

Confidence among small firms remains low. This is hardly surprising. Deregulation of the economy may eventually bring positive economic benefits, but the initial impact is mixed. Consumers are benefiting from increased choice, as imports into Japan rise sharply, and falling prices, which follows from increased competition. But small firms appear to be suffering. Some are losing valuable business as big firms shift production offshore. Others are receiving less support from the banks. In the past, banks would nurture small firms through difficult times. They are still helping them out now, but the banks are also overcoming their own difficulties and consequently appear less able to bail out small firms.

**BIG IS BECOMING BEST IN JAPAN.** Big firms seem better able to cope with present problems. The same is being seen in the financial sector. Big banks appear in good shape, reporting record operating profits, and writing off their bad loans. Most big banks will have fully written off their bad loans within two years. By contrast, many small banks and small financial institutions continue to face difficulties.

Perhaps the most interesting aspect is the outlook for investment. Investment plans for the coming year are poor. These, however, are likely to be revised higher in coming months, reflecting the recent improvement in confidence.

The yen has weakened recently against the dollar and this has helped business sentiment. Improved feelings about US economic prospects, alongside a large fall in Japan's trade surplus are the main factors pushing the yen weaker. Despite this, sentiment in Japan towards the yen appears to have improved since the end of last year. Big firms expect an 11 per cent rise in profits this year and are basing their business plans for fiscal 1996 on an assumed exchange rate of ¥:\$98. If the yen proves weaker than this, as appears likely, this will boost profits. Meanwhile, a government survey suggests small firms can make money at ¥:\$101.

The key to the yen's fortunes rests with Japanese fund managers, who control the country's huge savings. Presently they keep most of their money at home, and in recent years they have favoured bonds. However, these funds need to achieve higher returns than they have been able to in recent years. To do this, they will come under increasing pressure to invest more overseas. The continued past appreciation of the yen always deterred them from doing this; at some stage this will have to change. Japanese funds will then have to invest more overseas, in international bond and stock markets.

Once that happens, it would have a dramatic positive impact on global financial markets. But it is likely to take some time. For now, we should be relieved that the world's second largest economy has pulled itself back from recession and is now on the road to recovery – western style. □

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