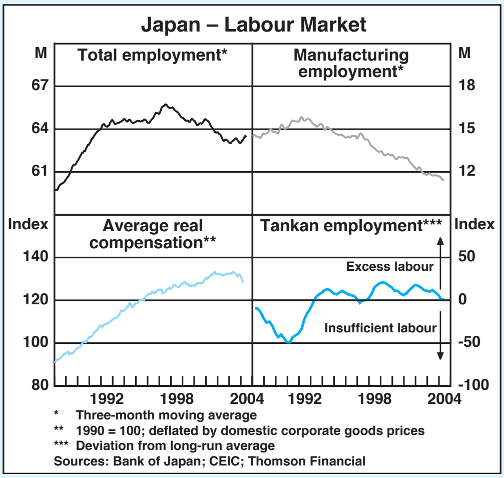
Box A: Corporate Recovery in Japan

The current period of growth in Japan is the third cyclical upswing since the bursting of the asset-price bubble in the early 1990s. The two previous upswings, in the mid and late 1990s, proved to be short-lived, with ongoing balance-sheet stress weighing on the performance of Japanese businesses. It is not possible to predict the course of the current upswing but there are a number of signs that the prospects of a durable recovery are better now than they were on the two previous occasions. One indication of this is that, unlike the brief episodes of growth in the 1990s, the current expansion is more broadly based and less reliant on public expenditure. Instead, it is being driven by a combination of private consumption, business investment and exports. The current period of growth has been characterised by improved conditions in the corporate sector, where profits increased by 20 per cent over the year to March 2004, reflecting strong external demand and greater efforts to control costs. This compares with an average annual decline in aggregate profits of nearly 3 per cent between 1990 and 2002. Firms (including larger financial institutions) are also better placed to withstand future shocks given the ongoing progress in balance-sheet repair.

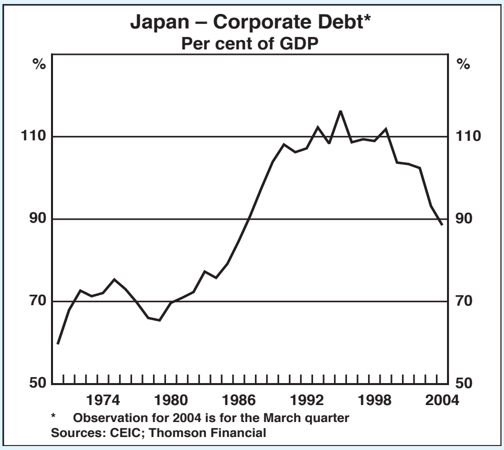
One of the important elements of the corporate restructuring process over the past few years has been the reduction in labour costs. This has been achieved by significant labour shedding, as firms overturned the traditional system of full-time and lifetime employment (Graph A1). Most notable has been the 30 per cent decline in manufacturing employment since its peak in 1992 – a fall that is twice the magnitude of the decline in the US and the euro area over the same period. Aggregate employment has also declined over this period, though by a much smaller amount. Associated with this, there was a sharp slowing in the growth of labour compensation, further helping to contain costs. Compensation per employee in real terms had still been rising consistently up to 1998, but since then the trend has been relatively flat. There are signs, however, that labour market conditions are improving during the current economic expansion, with aggregate employment rising since late last year and a steady decline in measures of excess labour.

Graph A1



Another key element of the corporate restructuring process has been the increased repayment of outstanding debt. Notwithstanding the adverse impact of deflation, the ratio of corporate debt to GDP has fallen from a peak of 116 per cent in 1995 to 89 per cent – its lowest level since 1987 (Graph A2). Coupled with the reduction in interest rates and the recent recovery in profits – which are up about 40 per cent since their recent low in late 2001 – this has brought the debt-servicing burden down from a peak of 77 per cent of operating profits in 1993 to 17 per cent in the March quarter 2004. Still, corporate leverage remains high by international standards and further adjustment is likely, especially among the more highly geared smaller non-manufacturing firms.

Graph A2



Balance-sheet restructuring is also apparent within the banking sector, particularly with regard to non-performing loans. Despite a decline in the level of bank lending, official estimates suggest that non-performing loans have fallen from a peak of 8½ per cent of bank lending in 2002 to a little under 6 per cent, the result of a decline in new non-performing loans, and disposal of existing non-performing loans. Bank profitability has also risen, following a rise in the valuation of equity holdings, lower loan loss provisioning and further reductions in operating costs. Even so, considerable scope remains for improvement, with core operating profitability relatively weak (at only 0.8 per cent of assets for the major banks).

While the Japanese corporate sector has made significant progress in cleaning up its balance sheet in recent years, there remain impediments to the restructuring process. In particular, generalised deflation persists, though its pace has eased, and property prices are still falling. Data from the Japanese Real Estate Institute show that land prices nationwide fell by about 8 per cent over the year to the March quarter. As land remains an important component of collateral, this continues to discourage banks from lending. Nevertheless, there are a few tentative signs of a turnaround in the property market, including a rise in equity prices of real estate companies relative to the overall share market. ✠