Why Japan Needs Higher Interest Rates

The first step toward shifting to a consumption-based economy.

BY TADASHI NAKAMAE AND TOMOKO SAITO

The biggest challenge facing the Japanese economy is to move toward consumption-led growth. When conventional monetary stimuli were ineffective following the bursting of the so-called "bubble" economy, the Bank of Japan rolled out its zero interest rate policy in February 1999 and initiated its quantitative easing strategy in March 2001. These emergency measures, however, accelerated the already excessive transfer of income from the household sector to the corporate sector, and have stifled a recovery in household consumption.

Meanwhile, thanks to the fall in borrowing costs and a decline in labor's share, corporate profits have improved dramatically. But with domestic consumption still weak, corporations have only had reason to pursue export-related capital investment. Sadly, this shows that Japan's economy is still heavily dependent on exports and export-linked investment as major growth engines.

The greatest harm from the ultra-low interest rate policy has been the transformation of the household sector into a net payer of interest. According to the Annual Report on National Accounts, the household sector received a healthy ¥12 trillion in net interest income in 1992. Due to the decline in interest rates, however, households became net payers of interest in 1996, and have remained so ever since. The latest available data show that the household sector received ¥5.3 tril-

Tadashi Nakamae is President of Nakamae International Economic Research, and Tomoko Saito is his associate.

THE INTERNATIONAL ECONOMY

THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
888 16th Street, N.W.
Suite 740
Washington, D.C. 20006
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com

lion in interest income in 2003, but made interest payments of ¥14.1 trillion. The ¥8.8 trillion deficit runs counter to the fact that households' net interest-bearing financial assets actually increased from ¥365 trillion to ¥525 trillion between 1992 and 2003.

Interest rates on financial assets held by households plummeted from 5.4 percent in 1992 to 0.6 percent in 2003. The average rate of interest paid by households on financial debts also fell, but only from 7.8 percent in 1992 to 4.3 percent in 2003. If we take the actual interest income received and interest payments made by households from 1993 to 2003 and compare them with hypothetical interest income and payments calculated using 1992 interest rates over the same eleven years, cumulative net losses total a staggering ¥218 trillion.

Against this, the cumulative gains in the net interest income of non-financial corporations and the government—sectors riddled with financial liabilities—stood at ¥140.6 trillion and ¥125.2 trillion, respectively. In the case of corporations, these cumulative gains equal about 40 percent of the current profits earned over the eleven-year period.

Japan's economy is still heavily dependent on exports and export-linked investment as major growth engines.

Another damaging trend has been untenable profit growth at corporations and corresponding cuts in employee compensation. Since 1997, when nominal GDP peaked in absolute terms, corporate restructuring has become a social norm and corporations have eagerly been cutting employment and wages—including the increased use of part-time over full-time workers. As a result, corporate profits have surged at the expense of wages, while total national income has stagnated or even shrunk.

Total gross income for full-year salaried employees has dropped annually since peaking at ¥211 trillion in 1997, according to the national tax agency. The total hit ¥190 trillion in 2004, the latest year for which data is available. Even though the gross income of female workers—who saw employment gains in 2003 and 2004—rose by 1.8 percent to ¥46 trillion in 2004, the falling number of higher-paid male workers kept the combined income figure in decline.

The zero interest rate policy has not only facilitated income transfer from households to corporations, but has also accelerated the polarization between big firms and small firms. Since large firms are generally capital-intensive and small firms labor-intensive, large firms have naturally derived greater benefits from capital cost declines under ultra-low interest rates. Meanwhile, small firms—which account for roughly 70 percent of private sector employment—have seen the negative impact of low interest rates. Their subsequent wage cuts are a major cause of the slump in consumption.

Rock-bottom interest rates have also allowed moribund firms to stay afloat, creating over-crowded markets, and encouraging inefficient and wasteful investment. The indifferent expansion of capital expenditures due to zero-cost financing has resulted in excessive competition and triggered a fall in prices, accelerating deflation. Large retailers that open more shops in response to falling sales perfectly illustrate this problem.

The METI's Current Survey of Commerce shows that sales at supermarkets have barely grown since 1998, but the number of stores has increased by 40 percent. As a result, sales per store are 38 percent below 1998 levels. Such aggressive expansion by large retailers has dealt a serious blow to local mom-and-pop stores. In rural areas, the number of "shutter streets" (streets lined with the shuttered storefronts of out-of-business local retailers) has been consistently rising.

This pattern becomes more alarming when workforce distribution is taken into account. Companies with paid-in capital of ¥10 million to ¥100 million employ 52 percent of the workforce, while another 21 percent work at very small firms with paid-in capital of less than ¥10 million, according to the FY2004 Annual Report of Statistics on Incorporated Enterprises (SIE).

The survey, which covers 45.6 million workers at private non-financial corporations in Japan, also showed that annual personnel costs per employee at large firms (those with paid-in capital of more than ¥1 billion) were ¥7.32 million in FY2004. This compares with just ¥3.68 million in annual costs per employee at small firms and a mere ¥2.83 million at very small firms. Moreover, recent declines in personnel costs at small and very small firms far outpace those at large firms. Between FY1997 and FY2004, personnel expenses at large firms dropped 2.1 percent, while the costs plunged 11.5 percent at small firms and 14.5 percent at very small firms. Under these circumstances, it is hard to believe that consumption can achieve a broad-based and sustainable rise.

Turning back to profits, the SIE shows that it is large firms that account for most of the recent profit recovery. Operating profit per employee at large firms was ¥3.75 million in FY2004, up 50 percent from ¥2.5 million in FY1997. On the other hand, small firms earned only ¥0.45 million in operating profit per employee in FY2004 and very small firms saw only ¥80,000. Both figures have hardly grown since FY1997.

Capital investment per employee provides further evidence of the dichotomy between prospering large firms and squeezed small companies. The SIE shows that capital expenditure per employee in FY2004 at small and very small firms registered ¥0.4 million and ¥0.28 million, respectively. In stark contrast, large firms' capital expenditure per employee was ¥3.3 million. Clearly, as only large firms have carried out capital spending on a meaningful scale, they have led the rise in capital expenditure during the current recovery.

Worse, further scrutiny of the SIE data reveals that small firms would be unable to expand capital expenditure even if they wanted to. Labor's share (the ratio of personnel costs to added value) at large firms has plummeted in recent years due to restructuring drives. The ratio hit 56.4 percent in FY2004. However, labor's share at small firms, which have seen a more gradual fall, stood at 77.6 percent. In the case of very small firms, personnel costs ate up 81.6 percent of their added value, leaving little resources for capital expenditure.

Since investment at home will look unattractive due to floundering Japanese consumption, surplus cash will inevitably flow overseas in search of better returns.

Though the end of the bubble era in 1990 hobbled corporations and paralyzed financial institutions, household savings were relatively unscathed. As a result, laying a foundation for economic recovery on the backs of households—via zero interest rates—has been the main strategy of post-bubble structural adjustments. Corporate efforts to streamline operations have additionally led to a fall in labor's share and wages. Now is the time to abandon the emergency measures that have spurred these trends. Unless this is done, Japan will be unable to foster a consumption-led economy.

Beyond the damage they have already done, ultra-low interest rates threaten further harm to the Japanese economy. If zero interest rates persist, the cash hoards at corporations will continue to swell. Since investment at home will look unattractive due to floundering Japanese consumption, surplus cash will inevitably flow overseas in search of better returns. The result will be an acceleration in yen depreciation.

A rapidly weakening yen will lower living standards via higher import prices. Perhaps more importantly, a falling yen will run the risk of asset inflation (i.e., a real estate bubble), which would be a mortal blow to a quickly aging society like Japan.

In sum, we need to restore market functions and normalize interest rates in order to reverse the current flow of income from households to companies. This is essential to establishing a sustainable domestic demand-led growth structure. Once current emergency monetary measures are suspended, the next step will be to revive households' interest income via higher rates on deposits.

With 3 percent interest on deposits, ¥1,000 trillion of net financial assets held by households would yield ¥30 trillion of interest income. Even after paying 20 percent in taxes, households would receive ¥24 trillion—which is equal to 10 percent of personal consumption, excluding imputed rent. The revival of households' interest income would certainly stimulate consumption. Once consumption starts to recover and corporate sales began to rise, then companies of all sizes will finally be able to raise wages.

Such a virtuous circle needs to be established. Although large firms can carry economic growth as long as zero interest rates and strong exports last, a drop in overseas demand would send the Japanese economy spiraling back into another recession. In retrospect, shifting to a consumption-driven economic structure has been the paramount challenge for the Japanese economy since the 1980s. The first step toward meeting that challenge is raising interest rates. ◆