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Japan's Missing Economic Link: Lagging Consumption and the China Factor

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By Stephen S. Roach

[*The international press has focused attention on the Abe Shinzo administration's high profile China and Korea diplomacy. Little noticed has been the fact that the Japanese economy is slipping back into trouble. One strong signal is found in Japanese press reports from October 21 that the Abe Shinzo people basically kicked Hitotsubashi University Emeritus Professor Ishi Hiromitsu off the Government Tax Commission and replaced him with a supply-side true believer. Ishi's term was up, but according to the Nikkei he wanted re-appointment. Not in the cards, especially after Ishi put out a very public and explosive call for equity and tax increases last year. The new chief of the Commission is to be Osaka University's Honma Masaaki, who's keen on cutting the corporate tax and following the new Abe regime's line of low taxes despite Japan's stratospheric debt, skimpy social investment and mounting needs for elder care.*

The Abe regime face very important elections next summer, so they are unlikely to initiate any serious tax reforms for at least a year. And the ousting of Ishi also comes at a time of declining bureaucratic influence inside the Tax Commission itself. This indicates that the Ministry of Finance (MOF)'s campaign for consumption tax increases has been derailed. The politicians and their neoliberal academic advisors (of which Honma is a prime example) are still talking about making spending cuts and boosting revenues through increased growth. But the MOF people are dubious that there are many significant places left to cut, and they are also wise to what Morgan Stanley's Stephen Roach describes below.

As Roach shows, Japan's domestic economy is not really generating growth from expanding consumption. This is no surprise, as incomes are not rising in Japan and (unlike the US) there's no housing or related bubble to afford an alternative fuel for consumption. Japan is officially in its longest postwar expansion, but it's driven by exports and corporate investment. And that is a story of American consumers and Chinese producers. With the American housing bubble now in decline, the Abe people are basically banking on the China boom. Yet if Roach is correct, China's overheated economy may also be entering a cooling period

In spite of Japan's stagnant domestic demand, there's still no serious debate on such public finance essentials as more spending on education (Japan's level is lowest among the big OECD countries) and increased financing for basic research in information technology, alternative energy, and other promising areas. Like the just-finished Koizumi regime, the Abe people appear ready to have the cake of growth and eat it too, without investing in the ingredients. They and their appointees to head top committees give little thought to the role of public investment in human capital. Instead, they believe that deregulation will spread a growth magic from accelerating sectors to the lagging areas of the economy. In other words, all the state need do is step back, eyes wide shut.

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The thing is, absent any serious strategy, if you keep stepping back at some point you find you're up against a wall or you're going over a cliff. That's the sort of year 2007's shaping up to be. AD]

The mood has shifted in Japan. When I was last there six months ago, a clear sense of euphoria was in the air. Conviction was deep that the long nightmare was over — deflation was coming to an end and economic recovery was finally viewed as sustainable. Today, the view is more granular and disconcerting. After extensive meetings with investors and business leaders, I detected two sets of concerns — one internal and other external: Worries were deepening over Japan's lack of a personal consumption dynamic, and its excessive dependence on China was increasingly viewed as a potential risk. No one feared the type of relapse that frequently punctuated the rolling recessions of Japan's 15-year deflationary nightmare, but there was certainly a more cautious assessment of the staying power of the growth miracle that was so widely celebrated just a few months ago.

The private consumption story has long been the most important missing link in the current Japanese recovery dynamic. Since the onset of the current economic upturn in the first quarter of 2002, private consumption has risen at just a 1.6% average annual rate — well below the 2.3% growth rate in overall GDP. As a result, the consumption share of Japanese GDP has fallen from 58% in early 2002 to 56% in mid-2006. Nor are there any signs in the recent data flow of any material improvement in the prospects for Japanese consumption. In July and August, our calculation of what can be called a synthetic gauge of Japanese consumption, which incorporates data from both the supply and demand side sides of the consumer equation, fell 0.8% below the April-June reading for retail sales and 1.1% below the three-month earlier reading for shipments of consumer goods. At the same time, the Cabinet Office's quarterly index of consumer confidence slipped for a second quarter in a row in the three months ending September 2006 — a disappointing fallback after a hopeful rebound in late 2005 and early 2006.

These trends are quite consistent with our Japan team's recent assessment of the Japanese consumption prognosis (see R. Feldman and T. Sato's 18 August 2006 essay, "Moby Consumer"). While they have had an upbeat call on the overall economy for most of the past three years, it has been much more of a capital export and exports story than one driven by organic growth in consumer demand. Their cautious assessment of consumption is tied to the likelihood that sluggish real wages will remain a persistent drag on household purchasing power. That very much dovetails with what has been a most disappointing performance on the Japanese wage front in 2006. After compensation per employee improved to a 1% y-o-y comparison during 2005, there has been a deceleration to just +0.5% growth over the course of this year; moreover, this slowdown has occurred in the context of a long-awaited rebound in core inflation (i.e., consumer prices excluding fresh food have moved up to +0.6% y-o-y in recent months) — underscoring a meaningful compression of any expansion in real wages. Nor do Sato and Feldman believe that that this lingering stagnation in real wages will be offset by developments elsewhere in the Japanese economy; in particular, they reject the possibility of a spontaneous rebound in Japanese consumption driven by a declining personal saving rate, newfound wealth effects, or a shift in the distribution of income generation from capital to labor.

I got the distinct impression that concerns are mounting over this important missing piece to the Japanese economic recovery story. A Japan that is lacking in support from a self-sustaining internal consumption dynamic is, by definition,

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more dependent on capex and external demand. Significantly, external risk assessment suddenly looks a bit murkier as the Japanese peer into 2007 and worry about possible shortfalls in two of most important foreign sources of its recovery — the American consumer and the Chinese producer. While US consumption has held up quite well so far — providing ongoing support for Japan's largest export market — there is understandable concern that such support may diminish in a post-housing bubble climate. And now there are concerns that a China slowdown may finally come to pass — undermining support for what has now become Japan's second largest export market. Collectively, the US and China currently account for fully 37% of total Japanese exports — by far, the largest and most concentrated piece of Japan's external demand. Moreover there has been a very important shift in the mix of Japanese exports to its two largest trading partners in recent years — a declining share to the US (from 29.7% in 2000 to 22.5% in the first eight months of 2006) offset by a sharply increasing share to China (from 6.3% in 2000 to 14.1% thus far in 2006). Increasingly, China is the most powerful engine behind Japan's long important export machine.

Japan's tilt toward China is on everyone's mind in Tokyo these days. Over the past couple of years, the topic of China has become an increasingly important subject of exchange during these sessions. On this visit, the China focus was literally off the charts. Recent events certainly explain part of the increased interest: Newly elected Prime Minister Abe's first foreign mission was a quick trip to Beijing — underscoring the potential for a meaningful improvement in what had turned into a rather prickly relationship between these two Asian powerhouses in the Koizumi era. Moreover, the North Korean missile crisis has certainly heightened the attention on the strategic relationship between the two nations.

But there is an important economics angle at work as well: Leading Chinese officials have recently refocused the debate on the off-again-on-again "cooling off" campaign for this overheated economy. The latest statements of Ma Kai, China's leading central planner and Chairman of the all-important National Development and Reform Commission are particularly important in that regard (see Denise Yam's 18 October dispatch, "China: Not Done with Tightening, NDRC Says"). And then there's China's just-released third quarter GDP report — a still very rapid 10.4% y-o-y increase but a downshift, nevertheless, from the blistering 11.3% pace of the second period. This could certainly be interpreted as the first installment on the road to a more meaningful slowdown — underscoring the potential for an important shift in one of Japan's major external sources of economic growth.

The big puzzle in all this is Japan's lack of internal support for private consumption. I am struck by the similarities between the Japanese predicament and conditions in other major industrial economies. In my view, this is an unmistakable manifestation of one of the great paradoxes of globalization — a powerful global labor arbitrage that continues to put unrelenting pressure on the labor-income generating capacity of high-wage industrial economies (see my 5 September 2005 dispatch, "The Global Growth Paradox"). Japan is hardly alone in feeling this pressure — it's a serious constraint in Germany and even the United States. By our calculations for the "G-7 plus," the real compensation share of national income fell to 53.7% of gross national income in early 2006, fully 2.3 percentage points below peak rates in early 2002. Until, or unless, the industrial economies figure out how to convert productivity improvements into enhanced labor income generating capacity, their private consumption dynamic should remain under pressure. That may be an uphill battle. To the extent that the fixation on intensified global competition and productivity enhancement rests on the tactics of increasingly aggressive

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corporate cost cutting ongoing — and that labor continues to account for the lion's share of business costs — it is hard to envision a spontaneous improvement in internally-driven income generation.

Sure there are some unique aspects of the Japanese consumption experience that separate this economy from that of other industrial nations — namely, the ending of lifetime employment, a more urgent demographically-driven aging problem, and, of course, the very vivid recent memories of 15 years of rolling stagnation and deflation. But I don't think it is a coincidence that Japan is suffering from the same problem of labor income compression that afflicts the rest of the industrial world. The initial euphoria of recovery tends to swamp those concerns — especially, since in Japan's case, it came after such a long nightmare. But as recovery matures and gives way to expansion, reality often sinks in and there is a perfectly natural refocusing of attention to any economy's lingering stresses and strains. That refocusing is now under way in Japan. The mood in Tokyo is very different than it was six months ago. With the American consumer and the Chinese producer in play, the missing link of the Japanese economy suddenly seems more problematic.

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