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# Japan Economic Adviser

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## Too early to expect an end to corporate deleveraging in Japan?


- Corporate debt outstanding to cash flow on an all firm basis has recently declined to the level seen in the late-1970s, having suggested that Japan's corporate deleveraging has made substantial progress
- The progress in corporate deleveraging by this measure during 2000s is largely attributable to expansion of corporate cash flows, even amid the deflationary economic environment; the so-called corporate profit share has been on a rising trend as growth of labor productivity has essentially outpaced that of real wages
- Reduction in total hours worked, driven by an increasing share of non-fulltime workers, has been the main contributor to the higher growth rates of labor productivity and hence to the progress in corporate deleveraging
- Looking ahead, we believe that there will be two headwinds preventing corporate profit share from rising continuously, namely 1) peaking-out of the share of non-regular workers under the government's initiatives, and 2) shrinking labor supply, mainly due to the exit of baby-boomers from the labor markets, which would likely lead to a rise in the unit or hourly wage
- Should corporate expectations that profit share will continue to rise be reversed, incentives to deleverage would strengthen and corporate capital expenditure would remain depressed; what's worse, this could lead to even weaker growth of labor productivity and probably even a lower corporate profit share
- Such a vicious circle remains a possibility as the prospect for strong goods inflation is gloomy for the foreseeable future, in our view, even though we think that a deflationary output gap may shrink gradually as the capital stock ages

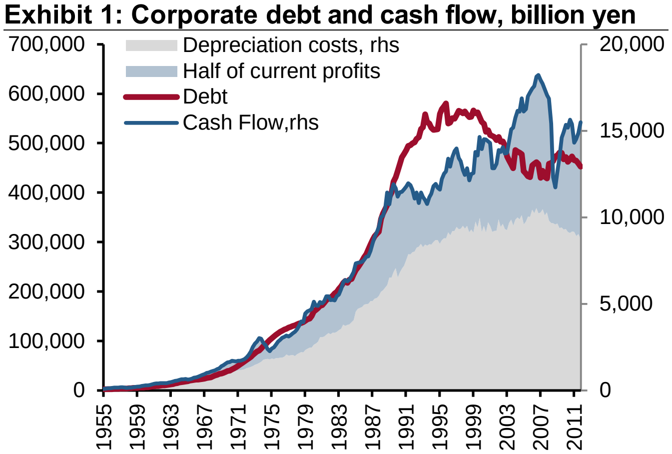
## 1. Japanese corporate deleveraging has made progress

The total amount of interest-bearing debt[1] owed by Japan's nonfinancial corporate sector moved into a downtrend after peaking in 1995, just as the economy began to recover from the collapse of the asset bubble in the early-1990s (Exhibit 1). The ratio of interest-bearing debt to cash flow[2] also started falling in 1995 (Exhibit 2).

The ratio had been on a stable uptrend since the 1950s, except for swings during the second half of the 1970s, but it rose substantially toward the mid-1990s following the collapse of the asset bubble as corporate profitability deteriorated and many firms increased borrowing in the face of liquidity shortages. The banking sector meanwhile failed to address their nonperforming loan problems. This procrastination ultimately resulted in several financial institution failures from late 1997 through 1998, and it was around this time that the corporate sector moved into deleveraging mode.

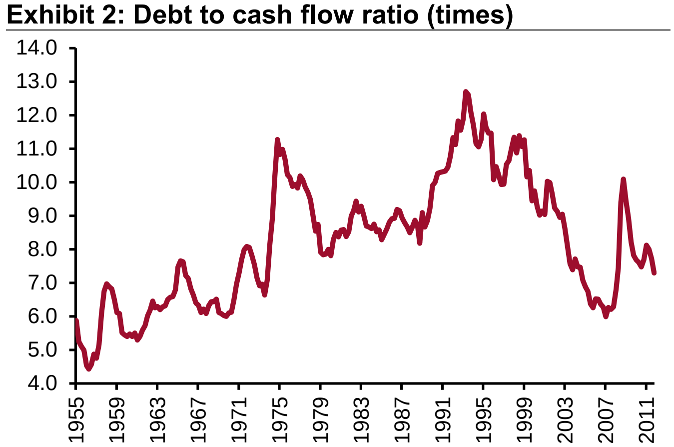
Japanese firms (particularly exporters) saw quite remarkable profit growth during the 2003–2007 boom years as they benefited from robust global economic growth, but continued to pay down debt in quite substantial amounts rather than stepping up their capital spending. The ratio of debt to cash flow dropped materially then, followed by a rise in late-2008/early-2009 due to the post-Lehman Brothers plunge in corporate profits. Yet, the ratio soon moved back into its ongoing downtrend. With the ratio of debt to cash flow now back at pre-bubble levels or at late-1970s levels, it may indeed seem reasonable to conclude that so-called "balance sheet adjustments"—the reversal of previous overleveraging—are now largely complete[3].

**Exhibit 1: Corporate debt and cash flow, billion yen**




Source: MoF, BoJ, Credit Suisse

**Exhibit 2: Debt to cash flow ratio (times)**




Source: MoF, BoJ , Credit Suisse

[1] The sum of short-term borrowings, long-term borrowings, and outstanding bonds based on data from the Ministry of Finance's *Financial Statements Statistics of Corporations by Industry.*

[2] Using data from the *Financial Statements Statistics of Corporations by Industry*, we have defined cash flow = 0.5 * ordinary profits + depreciation.

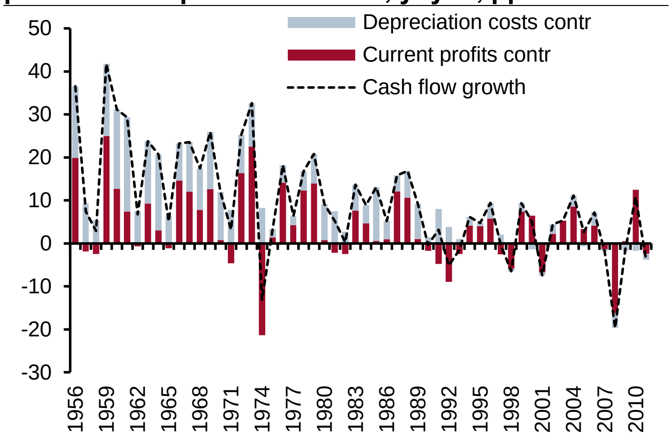
[3] Looking at the "lending attitude of financial institutions" diffusion index from the Bank of Japan's Tankan survey on an all-enterprises basis, we note that the post-bubble increase in nonperforming loans only resulted in a tightening of lending standards from 1997 through 2003 (Exhibit 5). If balance sheet adjustments by the nonfinancial corporate sector were primarily aimed at overcoming difficulties in raising funds externally (and the associated liquidity problems and default concerns), then one might reasonably expect such adjustments to have been completed by now. The fact that the ratio of debt to cash flow continues to decline for nonfinancial firms suggests that deleveraging has also been driven by some factor other than "ordinary" balance sheet adjustments, with this factor particularly influential over the past few years.

## 2. The progress in deleveraging resulted from a reduction in hours worked

The progress in corporate deleveraging by this measure during the 2000s is largely attributable to expansion of corporate cash flows, even amid the deflationary economic environment. Importantly, the so-called corporate profit share (corporate current profits to GDP) has been on a rising trend as growth of labor productivity has essentially outpaced that of real wages.

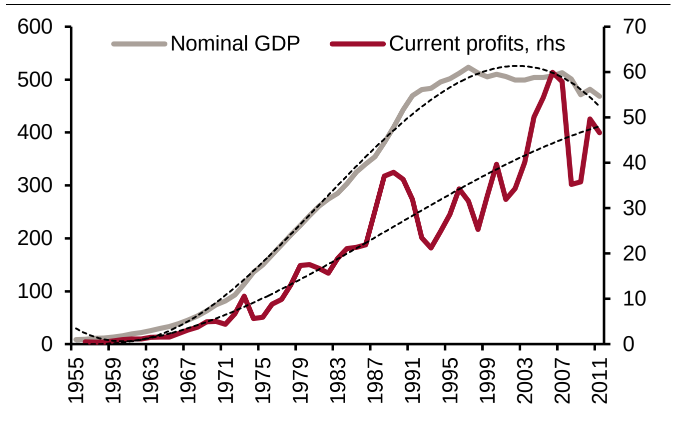
In the simplest terms, corporate cash flow at the macroeconomic level is composed of after-tax profits (assumed to be equal to 50% of pre-tax current profits) and depreciation costs (Exhibits 1 and 3). Expansion of corporate cash flow has been mainly due to growing profits, since depreciation costs have trended down. It is worth noting that profits have "decoupled" from nominal GDP in recent years (Exhibit 4), as current profits have kept climbing (albeit at a slowing pace) despite a relatively steady contraction to nominal GDP and hence the ratio of current profits to nominal GDP ("corporate profit share") has been rising since 2003.

**Exhibit 3: Breakdown of cash flow growth into profits and depreciation costs, yoy %, pp**




Source: MoF, Credit Suisse

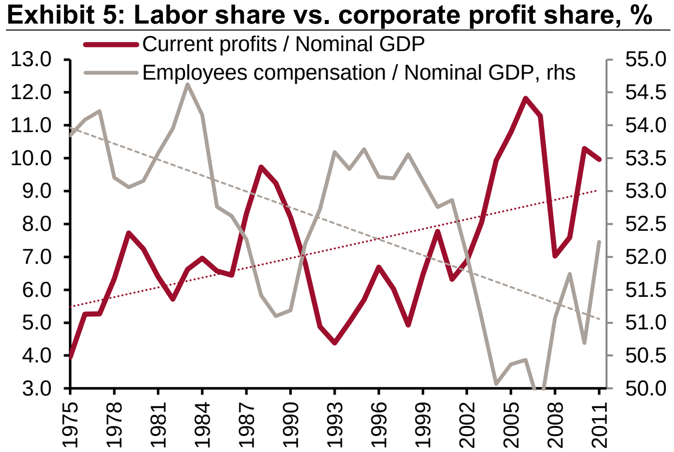
**Exhibit 4: Nominal GDP and current profits, trn yen**




Source: Cabinet Office, MoF, Credit Suisse

During an increase in corporate profit share, the labor share of profits (employees' compensation to GDP) tends to decline (Exhibit 5). Given that the labor share is equal to the real wage multiplied by the reciprocal of labor productivity[4], corporate profit share rises as long as real wage growth is kept lower than labor productivity growth (see the equation on the next page). This phenomenon has actually occurred on the background of expanding corporate cash flows since 2003.

**Exhibit 5: Labor share vs. corporate profit share, %**




Source: Cabinet Office, MoF, Credit Suisse

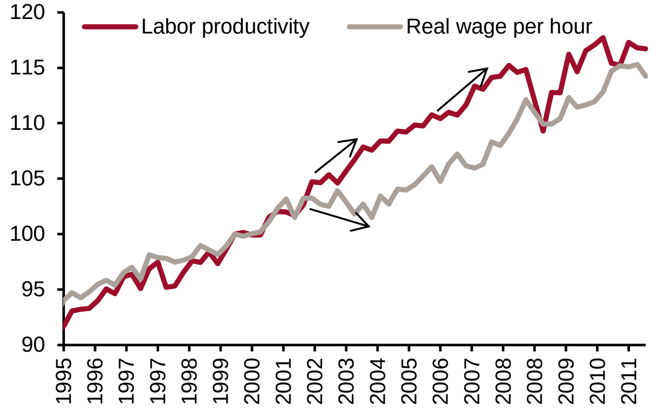
[4] Here we have divided the hourly wage (nominal employee compensation / man-hour labor inputs) by the GDP deflator to obtain the real wage, and have divided real GDP by man-hour labor inputs to obtain our measure of labor productivity.

$$1 - CapS \doteqdot LS = \frac{W \cdot L \cdot H}{P \cdot Y} = \frac{W}{P} \cdot \frac{1}{LP}$$

*CapS* : Profit share 、 *LS* : Labor *share* 、 *W* : *wage per hour*、 *L* : *Working population* 、 *H* : *Total hours worked* 、

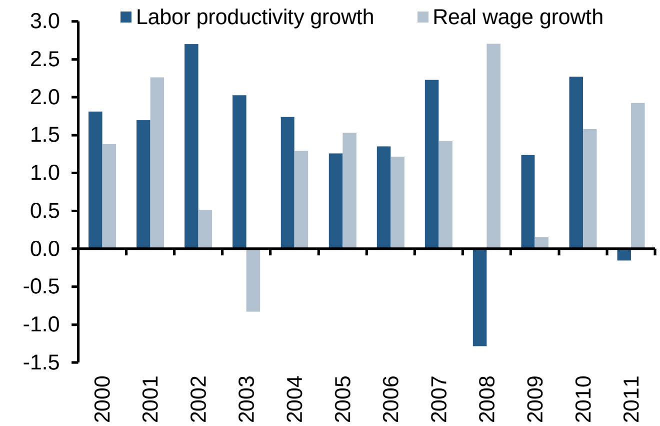
*P* : GDP *deflator* 、 *Y* : Real GDP 、 *LP* : *Labor profuctivi ty*

**Exhibit 6: Real wage and labor productivity (2000=100)**




Source: Cabinet Office, MIC, Credit Suisse

**Exhibit 7: Labor productivity growth and real wage growth**

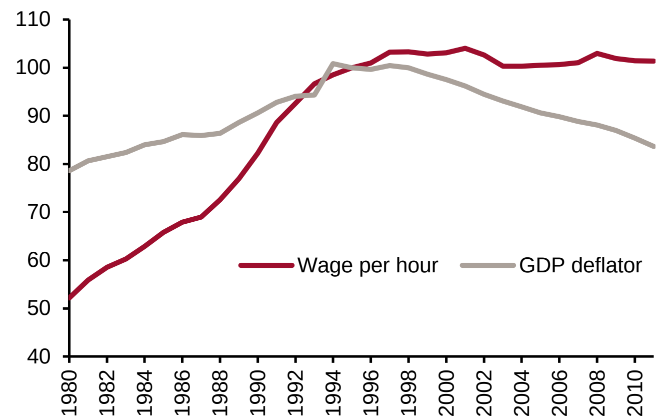



Source: Cabinet Office, MIC, Credit Suisse

Historical data actually show that the level and the growth rate of labor productivity have consistently exceeded those of real wages, with a major exception being right after the Lehman Brothers shock in 2008 (Exhibit 6, 7).

The rising trend of real wages has been mainly due to sticky nominal hourly wages (Exhibit 8) which forced companies to cut real labor input, with the goal of maintaining profitability. As seen from Exhibit 9, many firms have cut total hours worked.

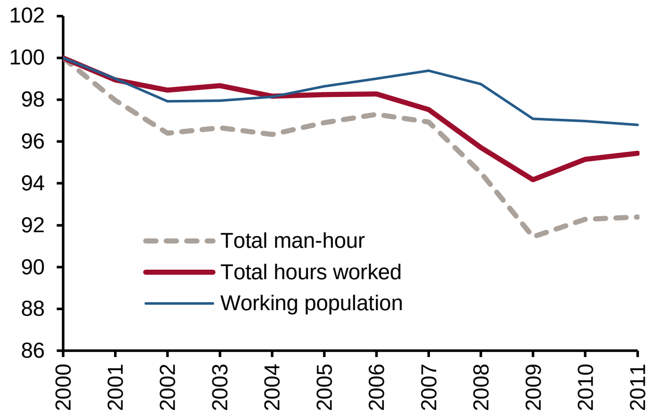
**Exhibit 8: GDP deflator and nominal wage per hour (1995=100)**




Source: Cabinet Office, MHLW, Credit Suisse

In other words, companies have been able to keep labor productivity growing by reducing per capita work hours. Importantly, the contribution from capital input should have been limited under deleveraging and declines in corporate capex. In addition, the total number of workers actually rose from 2003 through 2007 and has not been reduced significantly since then. Thus, reduction in the labor input has relied almost entirely on the shortening of work hours (greater use of part-time and non-regular workers). To summarize, the steady rise in the corporate profit share since 2000 has reflected improvements in hourly output made possible by increasingly flexible work practices and a more mobile work force.

**Exhibit 9: Labor input and its breakdown**



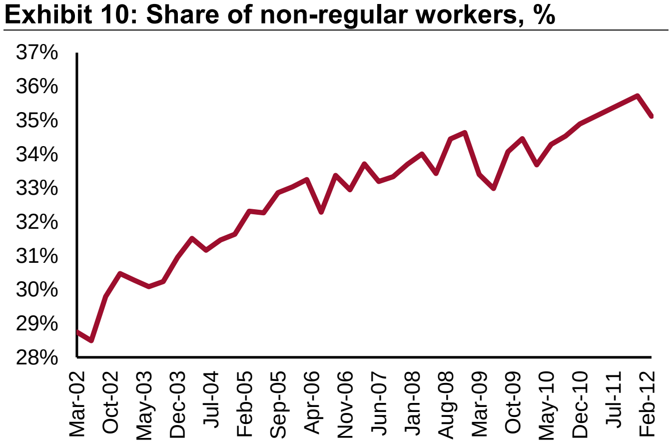

Source: Cabinet Office, MHLW, Credit Suisse

## 3. Too early to expect an end to corporate deleveraging in Japan?

Looking ahead, we believe that there will be two headwinds preventing corporate profit share from rising continuously, namely 1) peaking-out of the share of non-regular workers under the government's initiatives, and 2) shrinking labor supply, mainly due to the exit of baby-boomers from the labor markets, which would likely lead to a rise in the unit or hourly wage.

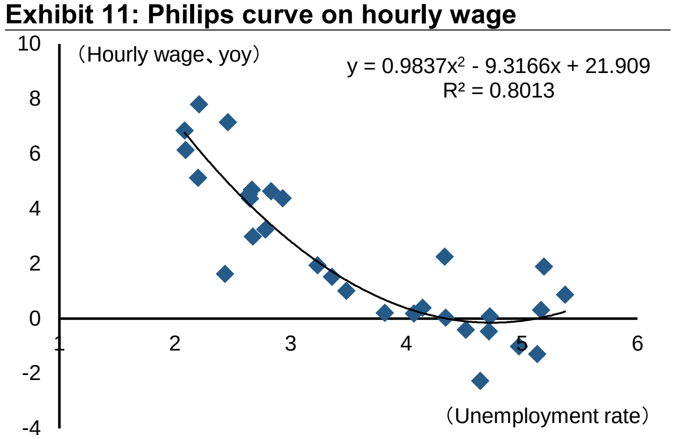
The share of cheaper non-regular workers may hit a peak soon (Exhibit 10), as social concerns for income disparity has put pressures on the government to initiate promotion of non-regular workers to regular positions. Also, the impact of an aging-driven decline in the number of workers is likely to be felt in the labor market sooner than in the goods market. Worker shortages can be expected to generate upward pressure on (nominal) hourly wages (Exhibit 11).

**Exhibit 10: Share of non-regular workers, %**




Source: MIC, Credit Suisse

**Exhibit 11: Philips curve on hourly wage**



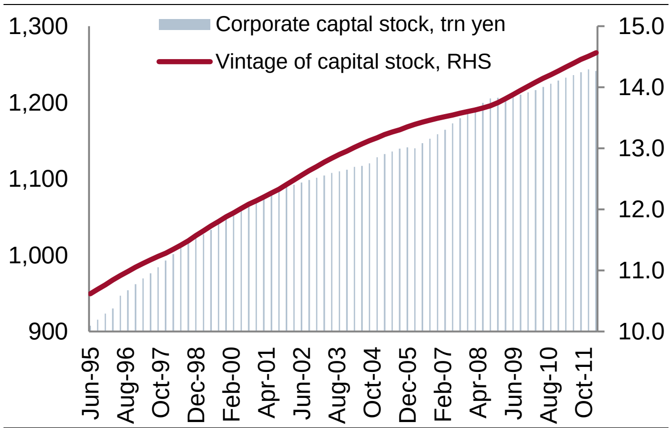

Source: MHLW, Credit Suisse

Should corporate expectations that profit share will continue to rise be reversed amid such a tightening labor market, incentives to deleverage would strengthen and corporate capital expenditure would remain depressed; this could lead to even weaker growth of labor productivity and probably even a lower corporate profit share.

Keeping corporate profit share on an uptrend may therefore be impossible without price increases. If the inflation rate for the GDP deflator can be driven up well beyond the likely pace of nominal wage growth, then this could limit real wage growth to levels commensurate with further increases in corporate profit share. Boosting the GDP deflator inflation rate in this way would require a higher inflation rate for the domestic demand deflator. Moreover, this increase would need to be sufficient to offset the negative impact of any imported inflation attributable to high international commodity prices or other factors.

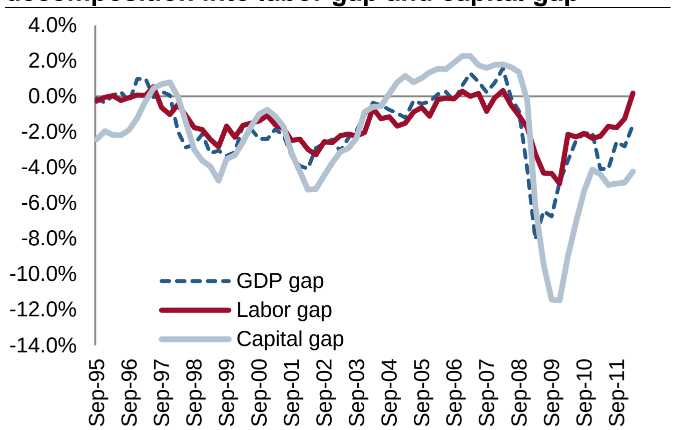
Such a vicious circle remains a possibility as the prospect for strong goods inflation (to reduce real wages) is gloomy for the foreseeable future, in our view, even though we think that a deflationary output gap may shrink gradually as capital stock ages (Exhibit 12). That is because we expect the deflationary gap to be filled sooner in the labor market (labor gap) than in the overall goods market (GDP gap, Exhibit 13).

**Exhibit 12: Corporate capital stock and its vintage**




Source: Cabinet Office, MIC, MHLW, Credit Suisse

**Exhibit 13: Estimated zero inflation GDP gap: decomposition into labor gap and capital gap**




Note: All gaps are rate of deviation between actual and potential levels
Source: Cabinet Office, MIC, MHLW, Credit Suisse

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## Disclosure Appendix

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Investment principal on bonds can be eroded depending on sale price or market price. In addition, there are bonds on which investment principal can be eroded due to changes in redemption amounts. Care is required when investing in such instruments.

When you purchase non-listed Japanese fixed income securities (Japanese government bonds, Japanese municipal bonds, Japanese government guaranteed bonds, Japanese corporate bonds) from CS as a seller, you will be requested to pay purchase price only.