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by David Pilling

In recent months, officials at the Bank of Japan have been scratching their heads at a puzzling phenomenon. In spite of nearly three years of robust economic growth, a run of dazzling corporate profits and recent signs of a tightening labour market, wages have been falling.

Even in the second quarter of 2004, when the economy was growing at an exhilarating 6 per cent a year, total remuneration was still falling by 1.1 per cent. This has been the seventh straight year of decline. If the US has experienced a largely jobless recovery, Japan is going through a wageless one.

The failure of economic growth and corporate profits to feed through to higher remuneration, stronger demand and rising prices has short-circuited what many economists had assumed was a straightforward path to inflation. In August, the wholesale price index rose 1.8 per cent year on year, but in the same month consumer prices fell 0.1 per cent. Consumer prices have been falling since 1997.

In the careful language of central bankers, the BoJ registered its surprise at the continued fall in remuneration, warning that failure to re-establish the profit-wage-inflation transmission mechanism could threaten the bank's fairly rosy economic outlook and its forecast of mild inflation next year.

"If firms continue to restrain labour costs persistently, delayed improvement in household income could cause household consumption to deviate below the (bank's expectations)," it said.

A few streets from the Bank of Japan's stately offices in Nihonbashi, central Tokyo, are the sparkling new headquarters of a company whose thriving business helps shed light on the puzzle. Pasona, which occupies several glitzy, football-pitch size floors of a modern office block, is one of dozens of temp agencies -- agencies that place temporary or contract workers with companies -- that have sprung up to satisfy corporate Japan's seemingly insatiable appetite for part-time staff.

Since 1997 when just 15 per cent of the workforce was part-time, use of non-regular staff has nearly doubled to between 25 and 30 per cent, depending on the definition.

Figures from the public management ministry, which only go up to 2002, show that in the five years from 1997, the number of full-time workers fell by more than 4m to 34.6m. Over that period, those classified as part-time rose by 1.7m to 12.1m; the number of contract workers leapt from 966,000 to 2.5 m; and the number of temps sent from agencies such as Pasona rose from 257,000 to 721,000.

By March last year, a separate survey showed the number of temps registered at staffing agencies had jumped again to more than 2m.

The dramatic shift from a principally full-time workforce to part-time labour helps explain why companies have been able to keep a lid on wage bills.

"If you look at wages of regular workers, they have gone down to some extent," says Seike Atsushi, professor of labour economics at Keio university and a leading expert on Japan's labour market. "But the major source of the decline in the average wage is the very large increase in the number of temporary, part-time and contract workers." Because of Japan's cultural and legal restrictions on firing workers, the slow death of Japan's postwar labour system -- half- correctly characterised as the lifetime employment model -- has been carried out almost surreptitiously. Since 1997, when a series of financial crises persuaded corporate Japan that it needed to restructure or die, companies have executed a combination of hiring freezes, early retirement plans, outsourcing and employment of part-time and temporary staff to slash their wage bills.

Call centres, an almost unknown phenomenon just a few years ago, have sprouted up in prefectures from Okinawa to Hokkaido as companies quietly shift work from permanent staff to those hired on short term contracts.

The transformation has been helped along by legislation, which until fairly recently discouraged flexible labour practices. Only in 1986 did the government pass a law recognising temporary work. At that time, only 13 categories of temporary jobs were permitted, a figure that rose to 26 in 1999. In March this year, almost all restrictions were lifted and, for the first time, manufacturing companies were able to hire part-timers.

Toyota, considered a poster boy for Japan's job-for-life culture, promptly said it would hire 500 temporary workers. More than a fifth of Japan's factories are hiring temporary staff, according to a recent survey in the Nihon Keizai newspaper, while more than four-fifths are considering doing so.

Takenaka Heizo, the former academic turned economy minister, says: "By increasing part-time labour, companies are decreasing the average cost of labour. Our lifetime employment system is becoming more flexible and the average wage is decreasing. We are in the middle of a process that is bound to continue." Most economists say the change to a more flexible labour market, in which a large portion of the workforce moves easily between jobs, is long overdue. Japanese companies, they say, have for decades given a disproportionate share of income to labour compared with other countries. That practice was sustainable only in the fast-growth catch-up era, and even then was aided by a culture of passive shareholders who did not demand their cut.

That situation got even more out of kilter in the early 1990s, say economists, when corporate profits collapsed after the burst of the bubble, but wages continued to rise. "Even now Japan's income distribution is extremely favourable to wage -earners compared with other countries," says Kuroda Haruhiko, economics adviser to Koizumi Junichiro, the prime minister.

"In the 1990s, we saw a substantial fall in prices but wages continued to rise, compressing profits. It is natural and not unfair that we should see an adjustment."

Not only has Japan's corporate wage bill been higher than in other countries, it has also been less flexible. A seniority based pay system meant staff tended to be promoted and remunerated strictly according to their age. Suzuki Masako, senior managing director at Pasona, detects a big change. "What's altered from the old system is that people are getting hired and promoted based on their ability," he says.

Robert Feldman, senior economist at Morgan Stanley in Tokyo, says the labour transformation

is welcome, rewarding specialists and high-performers and rendering the corporate wage bill more rational. In the old system, he says, because wages went up smoothly over time, middle-aged experience was undervalued, while young recruits and senior staff were overpaid.

"That was OK, as long as it was efficient to stay with one firm your whole career. But when the age productivity curve shifted such that young, well-trained people became more valuable the whole thing fell apart. Particularly with the speed-up of technological change, the lifetime employment system became unsustainable."

Demographics has played its part in the destruction of the old system. Because post-war baby boomers are now in their 50s, corporate Japan has a bulge of very highly paid staff at the top. Even outsized Japanese boardrooms cannot accommodate them all.

This month, Shiseido, Japan's biggest cosmetics group, announced a voluntary redundancy scheme. It aims to lose 1,000 senior staff. Ohori Takeshi, chief financial officer, says: "If you look at Shiseido's workforce, we have many people in their 50s and far fewer in their 20s. In the long-term, this is not a sound composition of labour for our company."

Mr Seike of Keio university says a radical shift in the labour system is inevitable as Japan finally comes to grips with the reality of its slow-growth economy and rapidly aging society. "The so-called Japanese employment system of lifetime employment and seniority pay was really a post-war innovation," he says. "It was a very rational system under the circumstances of high growth and a pyramidal age structure."

Japan has not always had a rigid labour structure, he says. Before the war, it was flexible, and in the 1940s and early 1950s, some 60 per cent of the workforce were self-employed.

Even the post-war lifetime employment system was never quite as it was portrayed, Mr Seike says. Flexibility was built in as the necessary counterpoint to the rigidities of big companies. Instead of working part time, women left their jobs when they had children. That was financially possible because their husbands had secure jobs and ever-rising pay.

Since the mid-1990s, women's participation in the labour market has risen quickly, as women need to work to supplement the family income and to insure against the possible redundancy of their spouse. No fewer than half of working women work part time.

Economists say that these changes, though socially painful, are inevitable and economically beneficial. They have helped workers move between industries. Japan has slowly shifted jobs from the manufacturing sector to the services industry.

Yet advisers to Mr Koizumi say persistent rigidities in the system are still slowing the process. About 5 million service sector jobs could be quickly created if workers could move freely where they were needed. There are some dissenters. Peter Tasker, consultant strategist at Dresdner Kleinwort Wasserstein, says labour flexibility has done wonders for business margins, but not a lot for household spending and hence the economy as a whole. "Corporations have raised profits essentially by reducing wages but income growth is pretty low, particularly considering the recovery is pretty advanced now."

That means, says Mr Tasker, that the next stage of recovery, in which consumer demand becomes an engine of growth, is never likely to happen because of the low wages of part-time workers. "The result of this corporate restructuring is that the Japanese economy is now even more dependent on external demand than it was before. By 'casualising' the workforce, all you're

doing is taking out a huge chunk of domestic demand," he says.

Nor is this pattern fleeting, say other pessimists. One category of workers, nicknamed "freeter", flit from low-paid job to low-paid job with little prospect of joining the permanent workforce or collecting a decent pension on retirement.

Although unemployment has fallen recently, the medium term trend has been upwards. In the early 1990s, the jobless rate was 2 per cent. In 2001 it passed 5 per cent and is now 4.6 per cent. Because part of the labour force is still largely protected from redundancy, little room is created for younger Japanese workers. That has created a sub-set of the population with virtually no work experience. In 2003, the jobless rate for men aged 24 or younger rose by 0.5 percentage points to a record 11.6 per cent.

Jeffrey Young, economist at Nikko Citigroup, agrees that changes in the labour market mean that consumer spending is not likely to rebound strongly. As a result, he says, Japan's economy will continue to be lopsided, flying on one export-powered engine.

Mr Takenaka, the economy minister, says that even this view is too bleak. He points out that consumption has been rising, albeit slowly, even as wages have fallen.

This could point to a structural change in Japanese saving habits. Moreover, as the population reaches retirement age in greater numbers, it can be expected to run down its savings and spend more. Nor, say economists, is aggregate demand made up only of wages. Financial income, including dividends distributed by companies making higher profits, can also play an important role in household income.

In the long run, household spending may not be as vulnerable to falling wages and increasing "casualisation" of the workforce as might appear at first sight.

But even if that is true, it leaves the problem of the short term. As Mr Tasker says, the recovery is already in an advanced stage. Unless Japan's workers have more money in their pockets soon, it is hard to see them becoming a sustainable force for growth -- or for much-needed inflation.

A construction crew singing an early-morning pledge to dig its fastest, factory workers exercising to be better focused, and office staff refusing to take their meagre annual leave are just some of the lingering signs that Japan is not yet a hire-and-fire society.

Mitarai Fujio, the president of Canon, who is considered one of Japan's most modern managers, remains a devotee of lifetime employment. In return for a pledge to retain staff from graduation to retirement, the photocopier and camera manufacturer gets a workforce that is constantly retraining and that keeps Canon's industrial secrets.

Mr Mitarai, who turned around Canon's US operations, says hiring and firing works fine in a society where it is easy and socially acceptable to move from job to job. In Japan, he says, this is still not the case.

Some of those who have been fired (or persuaded to leave) in the waves of 1990s downsizing are now residents of the blue-tented cities of the homeless that clog the public parks of most large cities. Negishi Eiko, chief of employment data at the Tokyo labour bureau, says the state-run Hello Work offices that help people find new jobs used to be deserted. "Then there was restructuring, restructuring and more restructuring and people started pouring in."

Most of the people who have lost good jobs have had to settle for a big pay cut and a fall in status, she adds.

Ms Negishi says Japan's new kind of labour flexibility provides some advantages in terms of lifestyle choices, especially for women. But she pines for the old system, where "there was a sense of security and a knowledge that you could afford to raise a family".

Yet even the leaders of some of Japan's most established companies are moving on. Idei Nobuyuki, chairman of Sony, bemoans the persistent cultural and legal restrictions on firing.

"This lifetime employment creates loyalty to a company. And it produces a lot of social stability, with a rich middle class," Mr Idei concedes. "But now everything is going the other way, and Japan has to find a new social system and a new mindset."

Prof. Seike of Keio university says the post-war system was not a fixed Japanese creed but a consequence of rampant growth and full employment. Because of those circumstances, even in minor downturns, companies could not afford to get rid of excess labour because they knew they would be short of workers when the economy picked up again.

For some companies, especially big manufacturers, he says, lifetime employment may still be rational even in a low-growth era. "It may be true for the Canons and Toyotas. But if you look at the average corporation, they will no longer be able to sustain this system now that economic circumstances have changed so completely."

Ms Negishi says: "There are a lot of companies that are against this because they feel that their employees will lose their skills and their love of the company." But she realises there has been a fundamental shift. "Outsourcing is unstoppable," she says. "Things will never go back to the way they were before."

David Pilling is a Tokyo-based correspondent for The Financial Times. This is an expanded version of an article that appeared in the January 27, 2005 Financial Times.

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