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Profit Seeking Model and the Monetary Policy in Japan: cross-border asset holdings via Offshore Financial Centers

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Resumen

Recientemente, la administración de Junichiro Koizumi y Shinzo Abe ha adoptado reformas laborales, y las autoridades monetarias han actualizado las políticas monetarias no convencionales: la expansión cuantitativa de la oferta monetaria y el control de los tipos de interés negativos. Se puede identificar que la política de flexibilización cuantitativa y la política de tipos de interés negativos han introducido y estimulado nuevos estilos de búsqueda de beneficios mediante transacciones bursátiles, lo que aumenta únicamente los beneficios de las empresas y los bancos bajo una tasa de crecimiento de la productividad laboral estancada. Bajo dicho contexto, este artículo analiza la fase cambiante de los modelos de búsqueda de beneficios del sector financiero y no financiero en Japón. La hipótesis es que el sector empresarial a gran escala ha creado un nuevo paradigma de búsqueda de beneficios y que este ha sido apoyado por el control monetario de las denominadas "Abenomics".

Abstract

Recently, the Junichiro Koizumi and Shinzo Abe administration has adopted labor reforms, and monetary authorities have updated unconventional monetary policies: quantitative easing of money supply and negative interest rate control. It can be identified that quantitative easing policy and negative interest rate policy have introduced and stimulated new styles of profit-seeking through stock market transactions, which only increases corporate and bank profits under a stagnant labor productivity growth rate. Under such a context, this paper analyzes the changing phase of the profit-seeking patterns of the financial and non-financial sector in Japan. The hypothesis is that the large-scale corporate sector has created a new profit-seeking paradigm and that this has been supported by the monetary control of the so-called "Abenomics".

Japanese society, over the past thirty years, has been characterized by economic recession and rising income inequality. The real Gross Domestic Product growth rate downed to minus 5 percent in 2009, after the negative inflation rate during 1999 and 2005. Paradoxically, since the international financial crisis, the corporate sector enjoys a rising profit index and a higher utility share.

In the framework of mainstream economics, the recession is explained in the lines as follows: 1) in the short-term, it is attributed to the shortcoming of effective demand; 2) in the long-term, the recession is explained by lack of supply-side capacity. A large part of economists stresses the necessity of innovations to raise labor productivity (which may lead to a rise in wage level) and to make advance in external competitiveness. The administration of Junichiro Koizumi and Shinzo Abe has adopted labor reforms, and the monetary authorities have actualized unconventional monetary policies: quantitative expansion of money supply and the negative interest rate control.

This article hypothesizes that the corporate sector has produced a new regime of profit-seeking model, which is supported by the continued economic reforms. The points are: i) Distribution between profit and wage cost; ii) Larger stock market transactions by non-financial sector; and iii) Cross-border asset holdings via Offshore Financial Centers. We reveal that the new profit-seeking model stimulates higher income concentration in financial groups. Today, some financial and non-financial firms invest in asset holdings in the Cayman Islands and Luxembourg and enjoy special utilities by price appreciation of the funds.

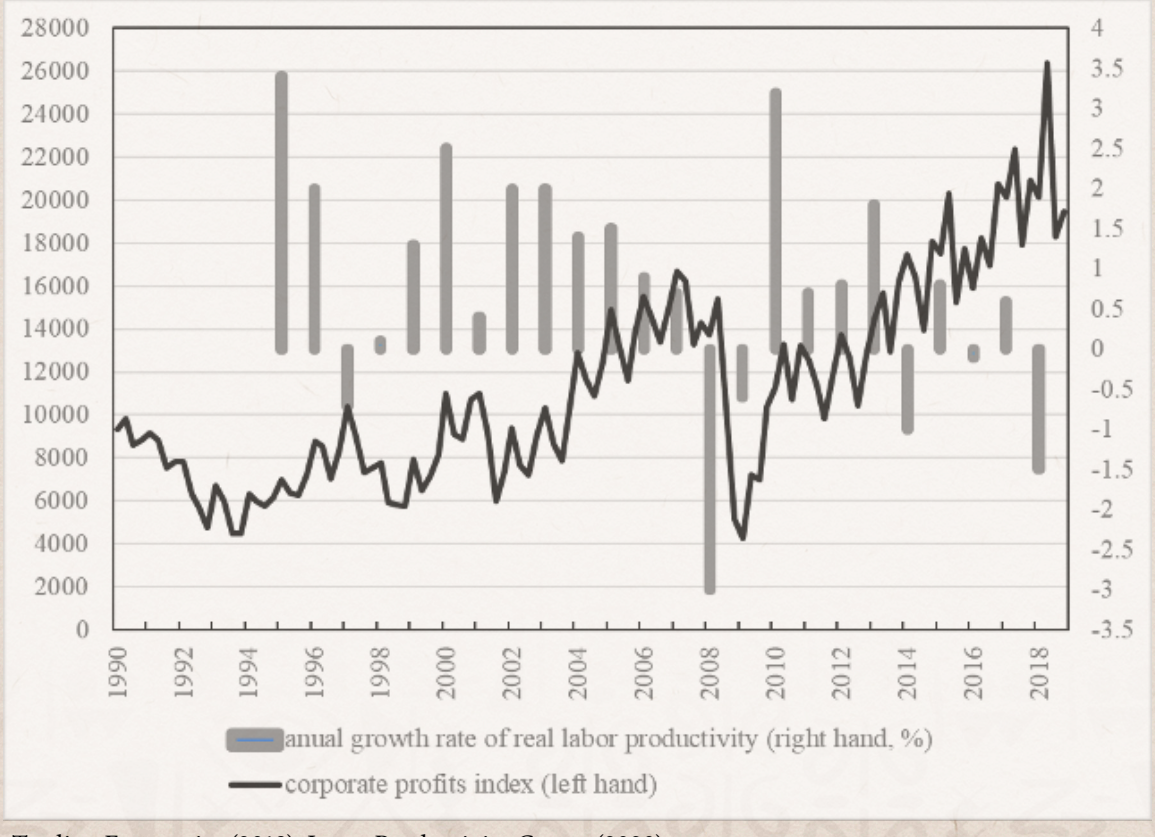
Labor Reform under Koizumi Administration

The traditional growth model has experienced drastic change during the recent 30 years. The percent of working people in the whole population decreased from 64 percent in the 1990s to 59.3 percent in 2012. The difficult employment performance is more serious because the percent of regular employees in the working population reduced from 63 percent in 1992 to 56.7 percent in 2012. The firms have cut wage costs, which yields a shortcoming of effective demand as a vicious circle of stagnation.

The wage cost per hour in the manufacturing industry stayed less than 25 U.S. dollars in 2000 and 2010, meanwhile, the number of full-time workers has diminished 13 percent from 1991 to 2007. The Koizumi administration (2001-2006) authorized a series of labor system reforms that permitted outsourcing employment and part-time workers in the whole manufacturing and service sectors.

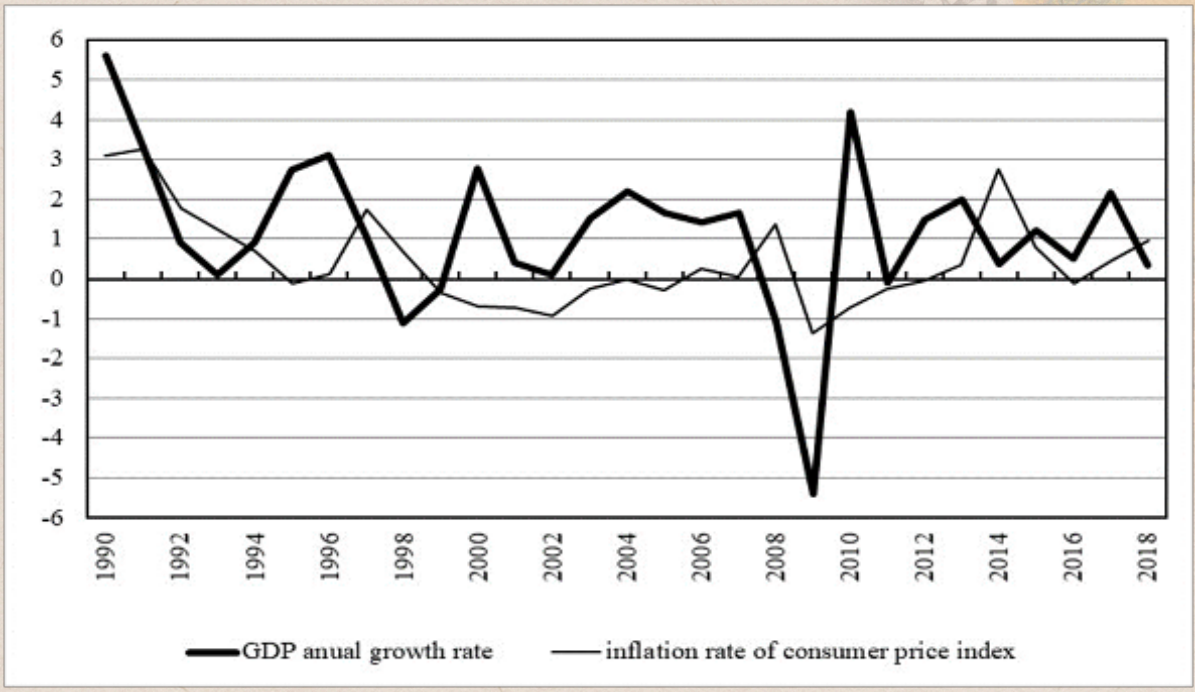
The labor reforms contribute to cutting down labor costs of firms and to increasing profit scale (Graph 1). The increasing outsourcing labor force makes it an obstacle to labor skill learnings and negatively the productivity growth rate. Since 2015, real labor productivity summarizes an annual growth rate of minus 0.4 percent on average.

Graph 1. Corporate profit index, and annual growth rate of real labor productivity



Source: Trading Economics (2018); Japan Productivity Center (2020).

Graph 2. GDP real growth rate and inflation rate of consumer price index

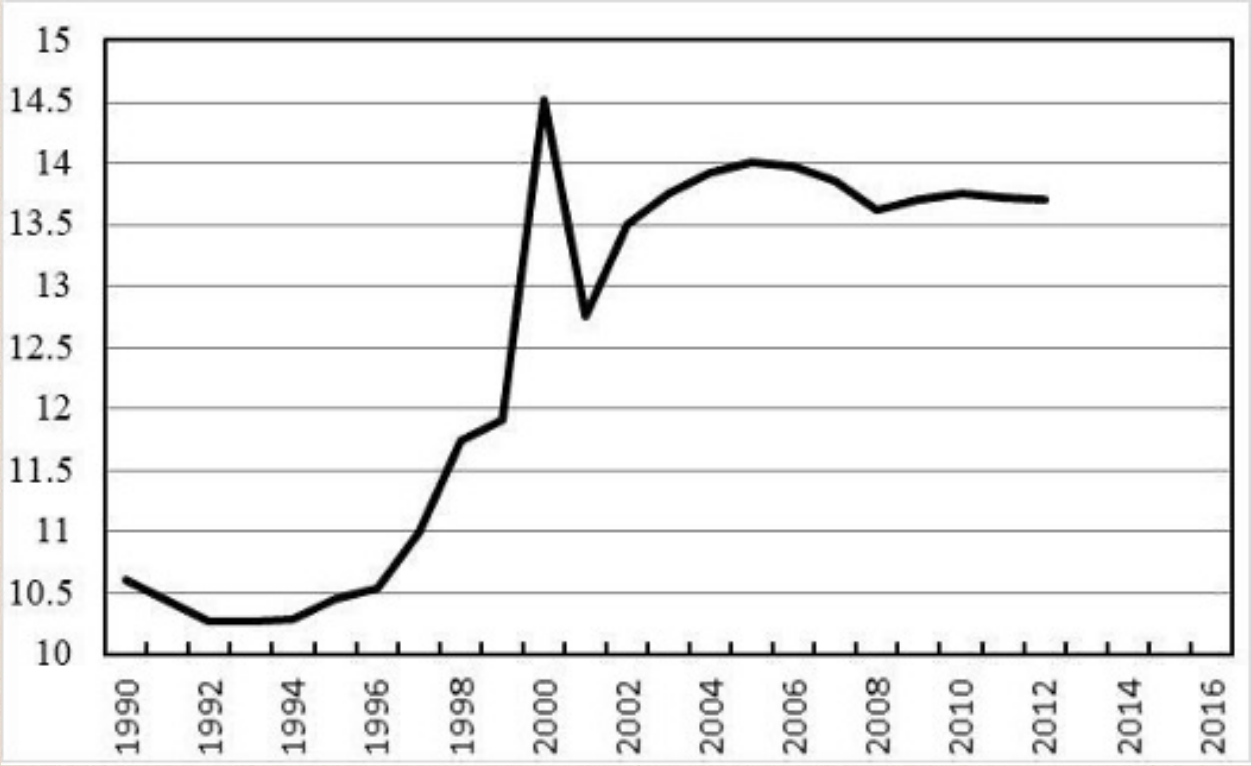


Source: International Monetary Fund (IMF) (2020b).

Koizumi reform concluded a relatively lower economic growth rate. The GDP real growth rate was stagnated at 1.40 percent in 1995-2001, and 1.18 percent in the next 5 years (Graph 2). In the manufacturing industry, many firms closed their production lines. A large part of outsourcing workers lost their jobs, even without unemployment insurance.

The conventional neoclassical economic view is that increasing productivity leads to wage growth, because, in a steady state, the wage rate equals the marginal productivity of the labor force. Hence, innovation and technological advancement are crucial to raising the real wage rate and productivity. The productivity growth guarantees a larger scale of the product, and a part of the product's added value should be distributed to labor income. However, the traditional growth theory presumes an arbitrary causality running from productivity growth to the wage rate because technological innovation is an exogenous factor. Indeed, Koizumi's labor reform has contributed to cutting down wage costs, nevertheless, the downsizing wage rate with limited productivity growth does not yield sustainable economic growth.

Graph 3. Percent of temporary workers



Source: Organization of Economic Cooperation and Development (OECD) (2018).

After the Koizumi administration, many short-term administrations continued. The second Abe administration (2012-2020) carried out economic policies named "Abenomics", which were characterized by three points: i) Quantitative easing monetary control; ii) Public investment in the infrastructure; and iii) Stimulation on private investment and labor productivity. The real wage rate per hour increased from 6.1 U.S. dollars in 2005 to 7.2 U.S. dollars in 2015, and some legal reforms have limited additional employment with outsourcing and/or temporary contracts (Graph 3). Despite many oppositions by the private firm sector, the corporate profit index has been expanded drastically under Abenomics. Comparing the labor wage performance, labor productivity growth rate, and the corporate profit index growth under the Koizumi reform and Abenomics, we need to illustrate an alternative viewpoint of the income distribution and firms' profit condition. Indeed, the higher profit increase since 2010 does not correspond to the changing wage-profit distribution. Our hypothesis is that the large-scale corporate sector has invented a new paradigm of profit-seeking, and that the monetary control under Abenomics has supported it.

Monetary Expansion to stimulate Stock Operations: Financialization

Quantitative Easing Policy of Monetary Control

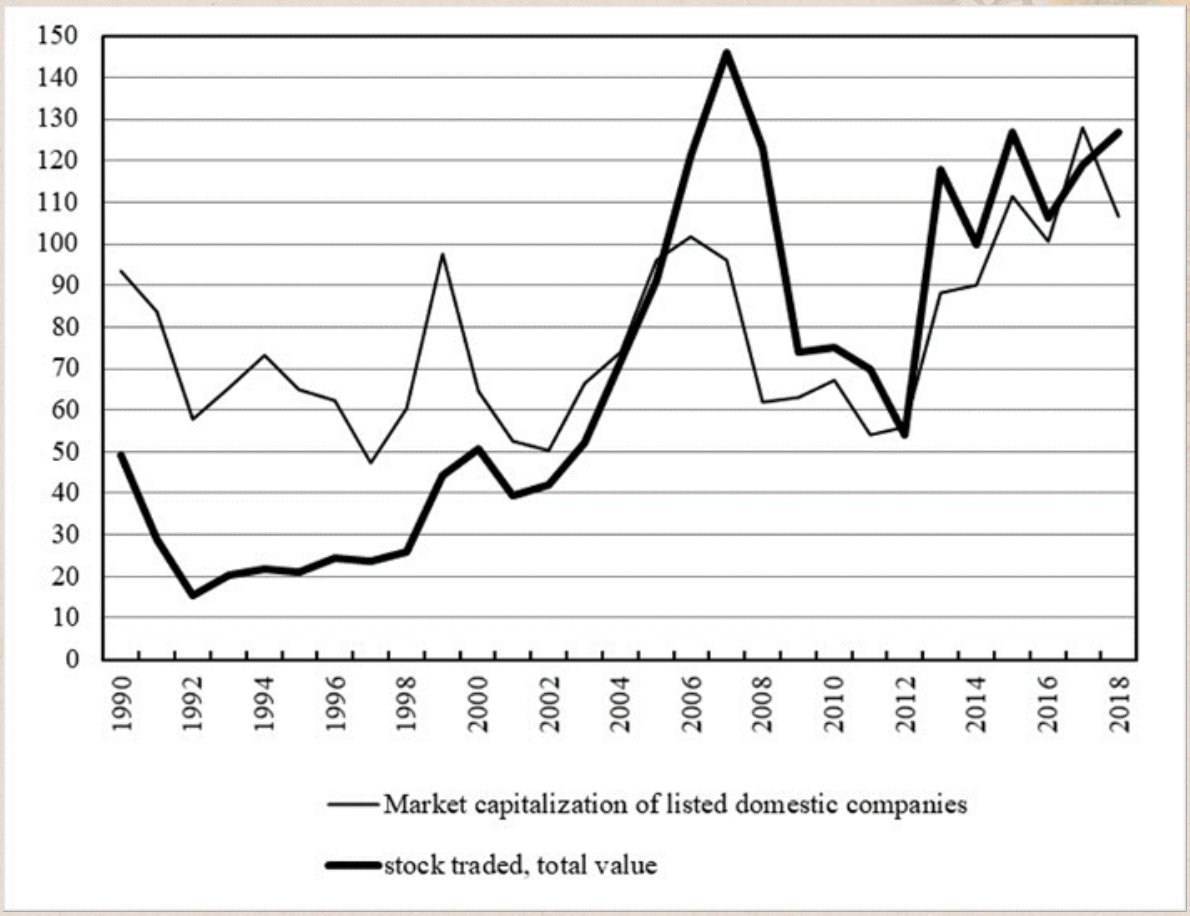
The international financial crisis made obstacles to Japan's economy. The lack of effective demand has driven restricted investment, which affects negatively the corporate profit. The short-term administrations which succeeded traditional monetary economic theories persisted in restrictive monetary control (World Bank Group, 2018). To prevent short-term capital outflows, the monetary authorities adopted restrictive interest rate control.

The second Abe administration presented a new expansive monetary policy, recognized as the Quantitative easing policy. The Bank of Japan purchases Treasury bonds of 80 trillion yens each year from commercial banks (Bank of Japan, 2016b). The monetary authorities require banks to deposit the paid fund in the reserve account in the Central Bank, hence the result was a drastic expansion of the monetary base.

The results of the Quantitative easing policy are the increased stock market transactions by firms and the changed movement of the nominal exchange rate into overvaluation. The stock operations amount expanded 50 percent in 2013, after its reduction of approximately 40 percent between 2008 and 2011. The mechanism is that: Quantitative easing leads to an expanding amount of reserves in the balance sheets of commercial banks; and the banks invest larger funds in the stock market. The monetary control by the Bank of Japan does not affect the loan supply activities of banks, meanwhile, the policy has made banks dedicate a huge amount of money in the stock market operations (Graph 4).

Commercial banks' stock transactions positively affect the rising stock index in the market, which provides an alternative opportunity for non-financial firms. The non-financial firms take advantage of the stock market to accumulate equity capital by issuing the stock, and they obtain profits by stock transactions in the secondary market. They invest a larger amount of funds in such capitalization in the market. The private sector has invented some transformation of the profit-seeking model, from limiting the administration of wage cost to the financial transactions, which is recognized as the financialization of capital accumulation.

Graph 4. Stock market operations and the market capitalization (percent of GDP)



Source: World Bank (2020).

The financialization process has permitted banks and firms to transform the loan assets and stockholders' capital into tradable equities. The Abe administration has made the rising phase of the stock index for the purpose of establishing a new stage of the profit-seeking model of non-financial sectors. The inducement effect of the Quantitative easing policy is recognized as the large purchase of Treasury bonds drives the increase in the amount of reserve in the commercial banks' balance sheets, and the banks' investment in stock market transactions, then the rising stock index has generated a new profit-seeking model of non-financial enterprises.

A large number of studies from the viewpoint of heterodox economics illustrate the capital accumulation model under financialization. Boyer (2016, the Japanese version, pp.278-290), Galbraith (2016, p.116), Marchini (2017), and Palley (2013, p.5) explain the correlation between reduced labor cost and expanded (speculative) financial market.

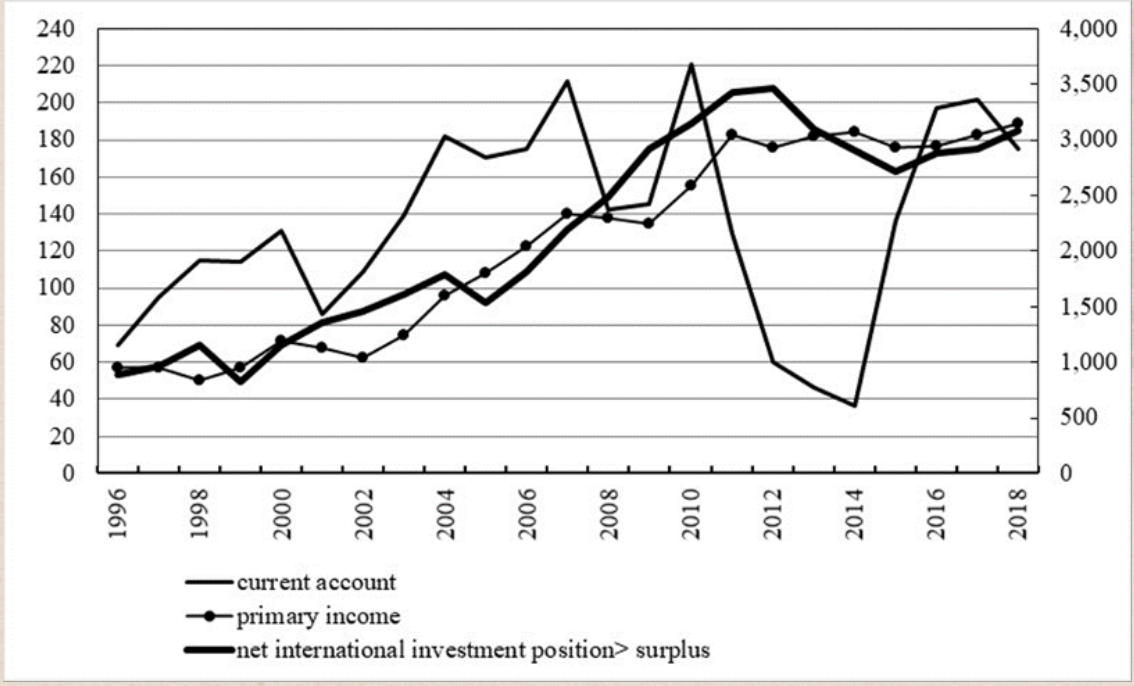
On the other hand, Quantitative easing policy insufficiently stimulates credit supplies by commercial banks and does not significantly influence productive investment. The expanding monetary control has not exerted pressure on the banking system to offer additional credits. Another result is the undervaluation phase of the nominal exchange rate against dollars. The appreciation trend continued until 2012, but it has been changed into an undervaluation phase as a result of the Quantitative easing.

The long-term interest rate represented by the interest rate of Treasury bonds has stayed in reducing evolution since 2007, showing the rising phase of the bond index. We investigate this mechanism in the next section.

A Structural Change in International Investment Position

The Balance of Payments and the International Investment Position support us to interpret the structural change of capital flows. In the traditional framework, current account surplus, capital account deficits, and surplus of assets in International Investment Position may illustrate the same evolutions of increase. However, such correspondence between Balance of Payments and International Investment Position is not identified clearly since 2010. Foreign asset holdings may produce additional capital gains/losses because of overvaluation or undervaluation of asset values, and the capital gains/losses provoke cross-border payments in the income balance. The capital flows realized as payments of capital gain/loss do not reflect the interest rate gap, on the other hand, the overvaluation or undervaluation of asset value depends on the asset price in the market (Caldentey, 2017).

Graph 5. Balance of Payments (billion U.S. Dollars, left hand), and International Investment Position Surplus (billion U.S. dollars, right hand)



Source: International Monetary Fund (IMF) (2018a); International Monetary Fund (IMF) (2018b).

The structural change in the cross-border payments registered in the International Investment Position reflects new profit-seeking models. The effective demand in domestic and external markets experienced drastic stagnation, and the labor cost per hour increased temporarily 40 percent in the manufacturing industry. The corporate profit index recovered nevertheless in 2011 and 2012 to the level before the crisis. The main determinant factor is the expanded amount of stock market operations because a large number of entities in financial and non-financial sectors participated in stock trade.

Negative Interest Rate and the Asset Holdings in Offshore Financial Centers

The monetary authorities introduced a new "unconventional" monetary policy style, recognized as the Negative Interest rate policy (Bank of Japan, 2016a). Before that, the monetary expansion policy has supported stock market transactions. The Bank of Japan's documents explains that the monetary authorities have recognized sluggishly the (un)expected influence on theTreasury bonds: price and long-term interest rate, in 2014 (Bank of Japan, 2016a).

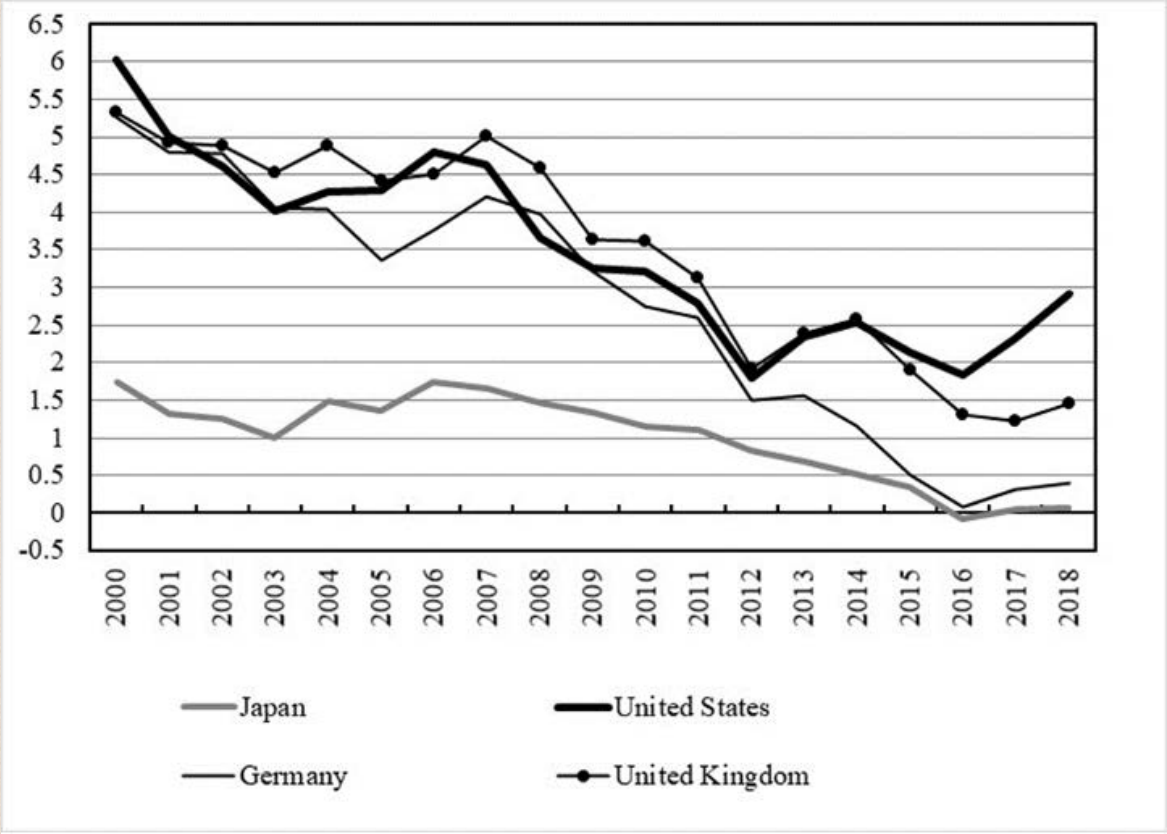
The monopolistic purchases of Treasury bonds by The Bank of Japan have excluded private banks from bond operations in the secondary market. Recognizing such a problem, the monetary authorities modified the monetary policy from increasing the number of bonds purchased to diminishing the same amount. The Bank of Japan announced modification of the policy as i) to diminish the bond-purchase amount, and ii) changing policy standards from monetary base to the interest rate.

The Negative Interest Rate policy started by keeping the short-term call rate at the level of minus 0.1 percent; and controlling the long-term interest rate represented by the rate of Treasury bonds to the target level around zero. The policy scheme is that: Bank of Japan claims fees (as a penalty) on commercial banks for depositing additional reserves in the account –in reality, they require fees only to local banks of smaller scales–. The new policy was designed to lead commercial banks to keep accumulating reserves in the Bank of Japan account to obtain interest payments, and the desired framework is to lead banks to increase the credit supply to the private sector.

Many neoclassical economists criticize the Negative interest rate policy, in the point that: i) the policy realizes distorted distribution of loanable funds because the households diminish incentives to accumulate savings and the banks must search for alternative profit source; and ii) the long-term interest rate may be reduced to a lower level in comparison with short-term interest rate, that suggests distinguished feature of recession. Palley (2018) from the Post Keynesian viewpoint claims that interest rate control does not solve aggregate demand shortage, because firms would invest only in portfolios with leverages. Japan's experience has provoked the results of drastic recovery of corporates' profit index, continued increase of market capitalization and the number of stock market operations. Nevertheless, the GDP growth rate continued to stagnate. Our observation is that the unconventional policy has established a new profit-seeking model only in the hands of the financial and non-financial sectors.

Indeed, the United States and the European economies have abandoned the negative interest rate policy after one or two years, and as a result, since 2017 Japan is the only one adopting this policy in the advanced economies (Graph 6).

Graph 6. Long-term interest rate in principal countries (%)



Source: Organization of Economic Cooperation and Development (OECD) (2021).

We identify some contradictions under the Negative Interest rate policy:

i) The Negative Interest rate does not induce short-term capital outflows. The interest rate gap is widening between advanced economies, but the exchange rate remains stabilized.

ii) The real economic activity is still stagnated, and banking credits remain decreased. However, the Nikkei stock index has been rising to reach a historical level, and the corporate profit index also reached a historical level.

The key point is that international capital flows do not reflect the interest rate gap because they are composed of cross-border transmissions of capital gain generated by the overvaluation of asset values . The new profit-seeking model is to be interpreted as cross-border asset holdings and transmissions of capital gain yielded by transactions of equities and Treasury bonds. It is necessary to understand that a large part of cross-border transactions

by Japan's residents are invested in Mutual Funds and Hedge Funds issued in Offshore Financial Centers, such as the Cayman Islands and Luxembourg. Such regions have been well-known as Tax Haven, and in the financialization era, they became important as Offshore Financial Centers.

Table 1 shows a part of the Total Portfolio Investment assets and the liabilities of Japan. The asset amount held by Japan's residents in the Cayman Islands occupies 22 percent of the total amount of Japan's cross-border assets in 2018, and the liabilities held in Luxembourg summarize more than 10 percent of the total portfolio investments in the same year. Apart from the United States, Offshore Financial Centers residents have been more and more important holders and issuers of Japan's portfolios. The banking sector and institutional investors in Japan dedicate their tradable funds to Mutual Funds and Hedge Funds in Offshore Financial Centers. The larger operations lead to overvaluation of the stock index, then the investors obtain additional amounts of financial wealth.

Table 1. Total Portfolio Investment Assets by Sector and Economy of Nonresident Issuer, and Total Portfolio Investment Liabilities by Economy of Nonresident Holder (millions U.S. dollars)

	2013	2014	2015	2016	2017	2018
ASSETS						
Cayman Islands	530,230	524,657	617,814	690,386	822,953	876,487
Luxembourg	104,049	108,869	100,081	98,616	104,642	110,218
United States	1,182,322	1,233,568	1,370,877	1,551,475	1,595,104	1,516,255
Total	3,411,352	3,399,008	3,512,976	3,779,292	4,106,257	4,067,890
LIABILITIES						
Cayman Islands	54,047	49,427	60,284	69,129	66,147	74,604
Luxembourg	180,347	219,408	264,222	274,157	274,157	352,096
United States	758,812	793,172	940,125	999,206	1,273,912	1,151,437
Total	2,391,847	2,364,289	2,660,116	2,784,362	3,336,765	3,169,443

Source: International Monetary Fund (IMF) (2020a); International Monetary Fund (IMF) (2020c).

Recently, under additional regulations on financial sectors in Offshore centers, some part of investors prefers to operate another safe asset. Treasury bonds issued in the United States summarize lower price index in comparison with the bonds of other economies because the United States is the only economy under rising control of interest rate since 2016 (Graph 6). The capital flow between Japan, Offshore Financial Centers, and the United States are composed of cross-border holdings of Mutual funds, Hedge funds issued in the Cayman Islands and Treasury bonds of the United States, and the payments of capital gains.

Today's cross-border capital flows between industrialized economies are summarized as assets-holdings of equities and bonds. A larger amount of cross-border assets holdings leads to larger stock capital accumulation, hence additional stock operations stimulate a rising stock index. A negative or Lower Interest rate policy follows and stimulates such circumstances. Such mechanism is to be identified as the new profit-seeking model. The cross-border asset transactions yield higher profit in the hand of firms and institutions. The financialization generates a larger profit chance for financial and non-financial firms, which does not guarantee additional investment and employment. The profit sought through stock transactions and/or cross-border asset holdings is an important result of financialization and Negative Interest rate policy in Japan, nevertheless, such activities do not contribute to sustainable economic growth.

Conclusion

This article reveals the changing phase of profit-seeking models of the financial and non-financial sector in Japan. The cut-off of wage cost contributed slightly to increase corporate profit.

Abenomics is sometimes interpreted as a new scheme of the policy mix. We identify that the Quantitative easing policy and Negative Interest rate policy have introduced and stimulated new styles of profit-seeking by stock market transactions, which increases only profits of firms and banks under stagnated labor productivity growth rate.

Neoclassical economics explains that higher productivity leads to higher wage levels, hence in the intermediate process of innovations, only some sectors may obtain growing wages and larger profit at the same time. The wage rate must be interpreted as the strategic variable of the administration and firms, which is not the function of labor productivity.

The policy scheme based on monetary base control and the negative interest rate has induced the profit-seeking model of firms through stock market transactions and cross-border asset holdings in Offshore Financial Centers. On the one hand, a large part of international capital flow is realized as asset holdings, and on the other, the additional investments in the Funds issued in the Offshore centers drive appreciation of their prices. Newly produced profit-seeking models permit huge utilities exclusively in the balance sheet of large financial groups.

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