Deflation Forces Companies to Contain Labor Cost

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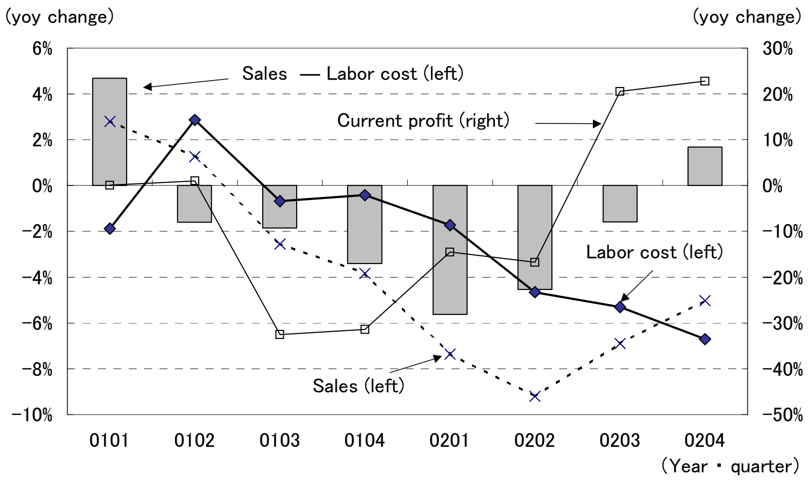
1. Mounting Pressure to Contain Labor Cost

While this year's spring labor offensive managed to secure a periodic wage increase for employees, companies continue to intensify their efforts to contain labor cost. According to the *Financial Statements Statistics of Corporations* by the Ministry of Finance, in the fourth quarter (October-December) of 2002, labor cost across all industries and company sizes declined –6.9% from the previous year, and the pace of decline has been accelerating.

Pressure to cut labor cost has grown against the backdrop of the persistent deflation and declining sales. In the fourth quarter of 2002, corporate sales declined again by –5.0% from a year earlier, forcing companies to further trim costs to protect profit margins. The impressive current profit growth of 22.5% (yoy) in the fourth quarter and almost comparable third quarter gain are in no small part due to labor cost cuts (Figure 1).

Figure 1 Decline in Sales and Labor Cost



Source: Ministry of Finance, *Financial Statements Statistics of Corporations by Industry*.

2. Changes in Labor Cost Containment Method

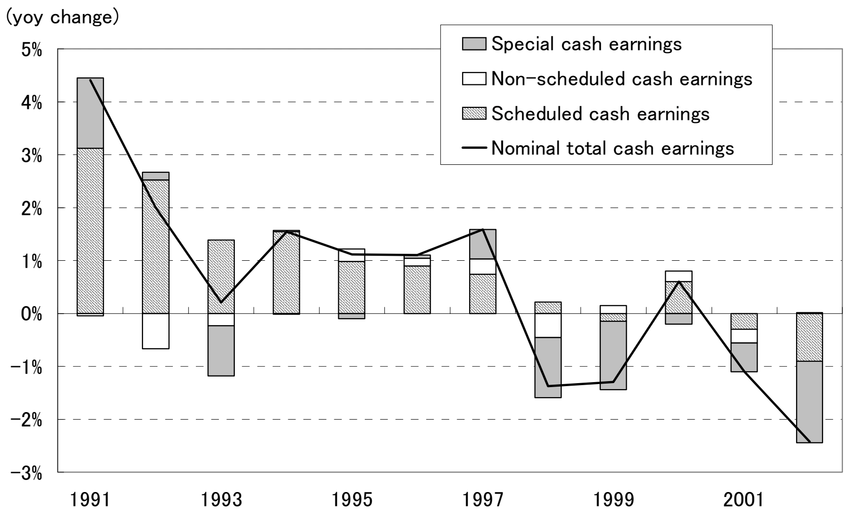
(1) Decrease in Scheduled Cash Earnings

Labor cost cuts consist of wage cuts and reduction in employment levels. Recently, a growing part of the decrease in wages can be attributed to a decrease in special cash earnings (bonuses). As the recession drags on, companies are reducing bonuses and other cash earnings linked to the company's performance (Figure 2).

Another important contributor that has grown in importance is the decrease in scheduled cash earnings. Scheduled cash earnings, which are often fixed salaries, are decreasing due to the introduction of performance-based compensation systems, decrease in base wage and periodic pay raises, and shift to hiring more part-time and temporary staff workers.

Recent wage trends thus indicate that companies are cutting labor cost by trimming bonuses, and reducing the average wage cost per employee through non-regular employment such as part-time and temp staff workers.

Figure 2 Declining Growth of Scheduled Cash Earnings



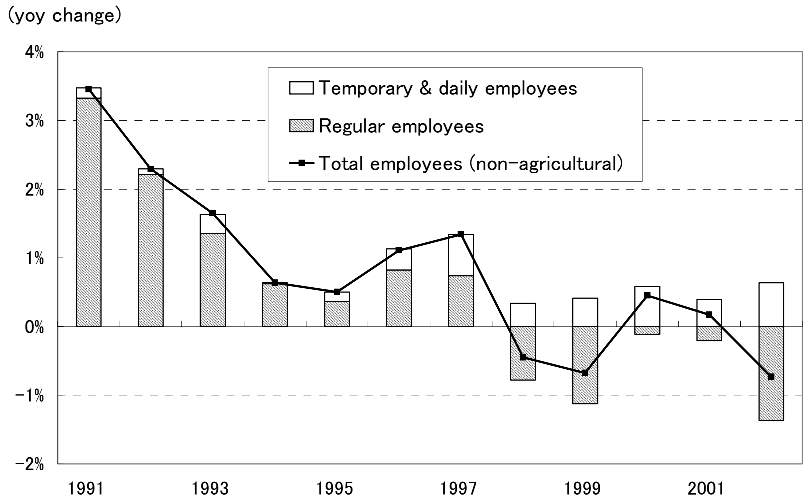
Note: Calculated for establishments with at least 5 persons, using various wage indexes.
Source: Ministry of Health, Labor and Welfare, *Monthly Labor Survey*.

(2) Shift to Non-Regular Employment

The labor data points to a growing trend in non-regular employment. According to the *Labor Force Survey*, the total number of employees (non-agricultural) began to decline in fiscal 2002, reflecting corporate measures to decrease labor cost. More interestingly, despite the decline in total number of employees, the number of temporary employees (1-year contract or less) and daily employees continues to grow (Figure 3).

Since temporary and daily employees in the *Labor Force Survey* roughly coincide with non-regular employees such as part-time, daily and temp staff workers, we can confirm that companies are employing fewer high-costing regular employees, and replacing them with non-regular employees.

Figure 3 Increase in Non-Regular Employment



Source: Ministry of Public Management, Home Affairs, Posts & Telecom., *Labor Force Survey*.

This shift has occurred against the backdrop of the downward wage rigidity of regular employees. To gain a better grip on labor cost, companies are hiring more non-regular employees because they not only cost less to employ but can be adjusted as needed.

Thus companies are containing labor cost by trimming bonuses, reducing the total number of employees, and hiring non-regular employees such as part-time and temp staff workers. According to the MHLW's *Summary of the Survey on Wage Increase (2002)*, the proportion of companies seeking to increase part-time workers has been growing in recent years (Figure 4).

Figure 4 Measures to Deal with Labor Cost

Note: Numbers in graph show results of 2002 survey.
Source: Ministry of Health, Labor and Welfare, *Summary of Survey on Wage Increase (2002)*.

3. Revision of Wage and Employment Systems

With economic uncertainties clouding the prospects for a quick recovery in sales, companies will continue their efforts to contain labor cost.

However, as deflation persists, real labor cost will continue to grow even if nominal labor cost remains unchanged. Thus as deflation pressures companies to continually cut labor cost, more companies are likely to overhaul their existing wage and employment systems. In fact, even after this year's spring labor offensive, companies have not stopped considering the revision of periodic pay raises, and cuts in the scheduled cash earnings of regular employees are becoming a real possibility.

The trend of reform in wage and employment systems—such as the shift from traditional seniority-based wage systems to performance-based wage systems, and abolition of lifetime employment—is sure to grow as recession and deflation drag on.