

# **The Key Drivers of Future Growth in Japan**

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**Prepared for a press conference on the  
ACCJ Growth Strategy Task Force White Paper,  
*Charting a New Course for Growth:  
Recommendations for Japan's Leaders,***

**June 10, 2011**

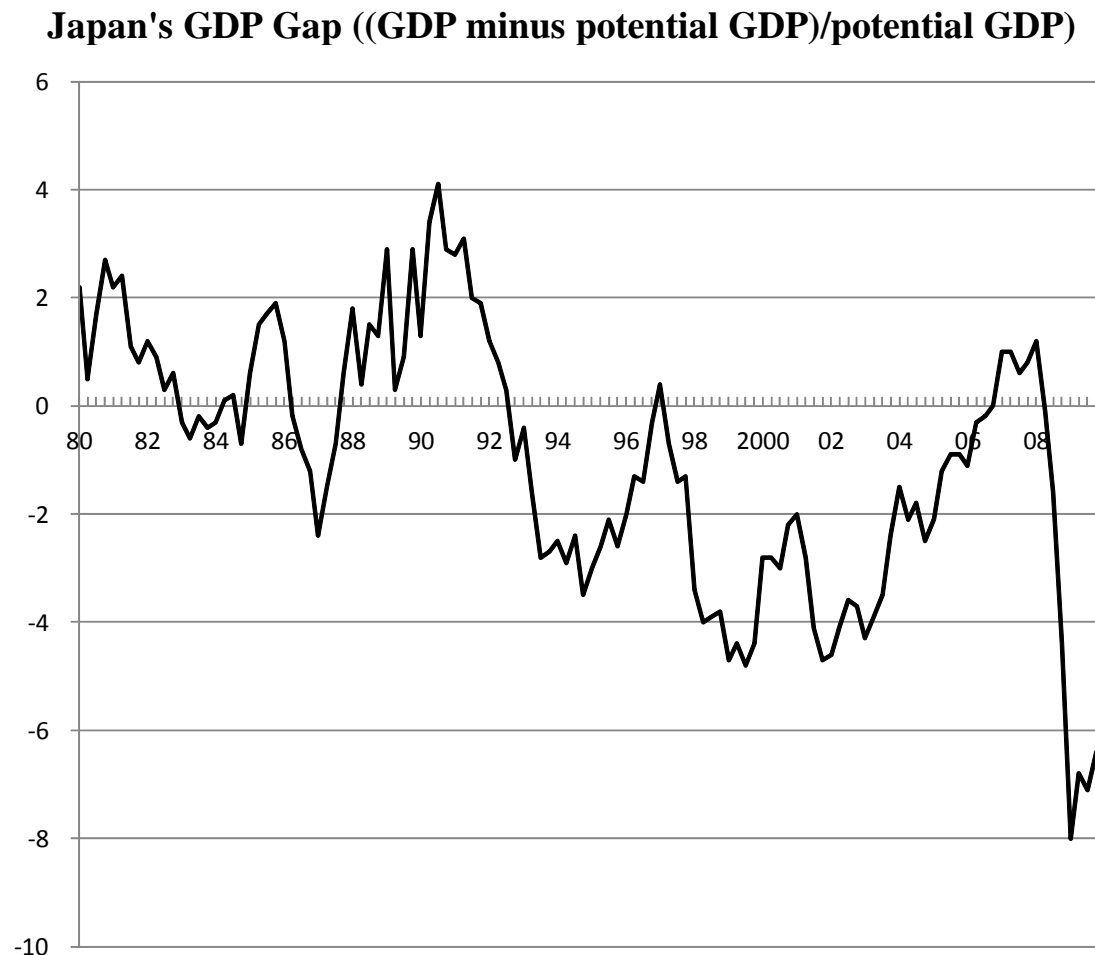
# Agenda

- 1. Japan's Urgent Problem: Demand Creation**
- 2. What Is Needed to Accelerate Innovation and TFP Growth?**
- 3. Who is Creating New Jobs?**
- 4. Policy Implications**

# 1. Japan's Urgent Problem: Demand Creation

The “GDP gap”, (i.e., (actual GDP minus potential GDP)/potential GDP), is minus 3.5 percent. Only 57.6 percent of college students graduating this year had received job offers as of October 1<sup>st</sup>.

The New Growth Strategy of the Japanese government is not based on an analysis of the two lost decades and does not present a concrete plan to reduce the GDP gap by increasing demand.



# **Japan Has Been Suffering from Scarcity of Demand During the “Two Lost Decades”**

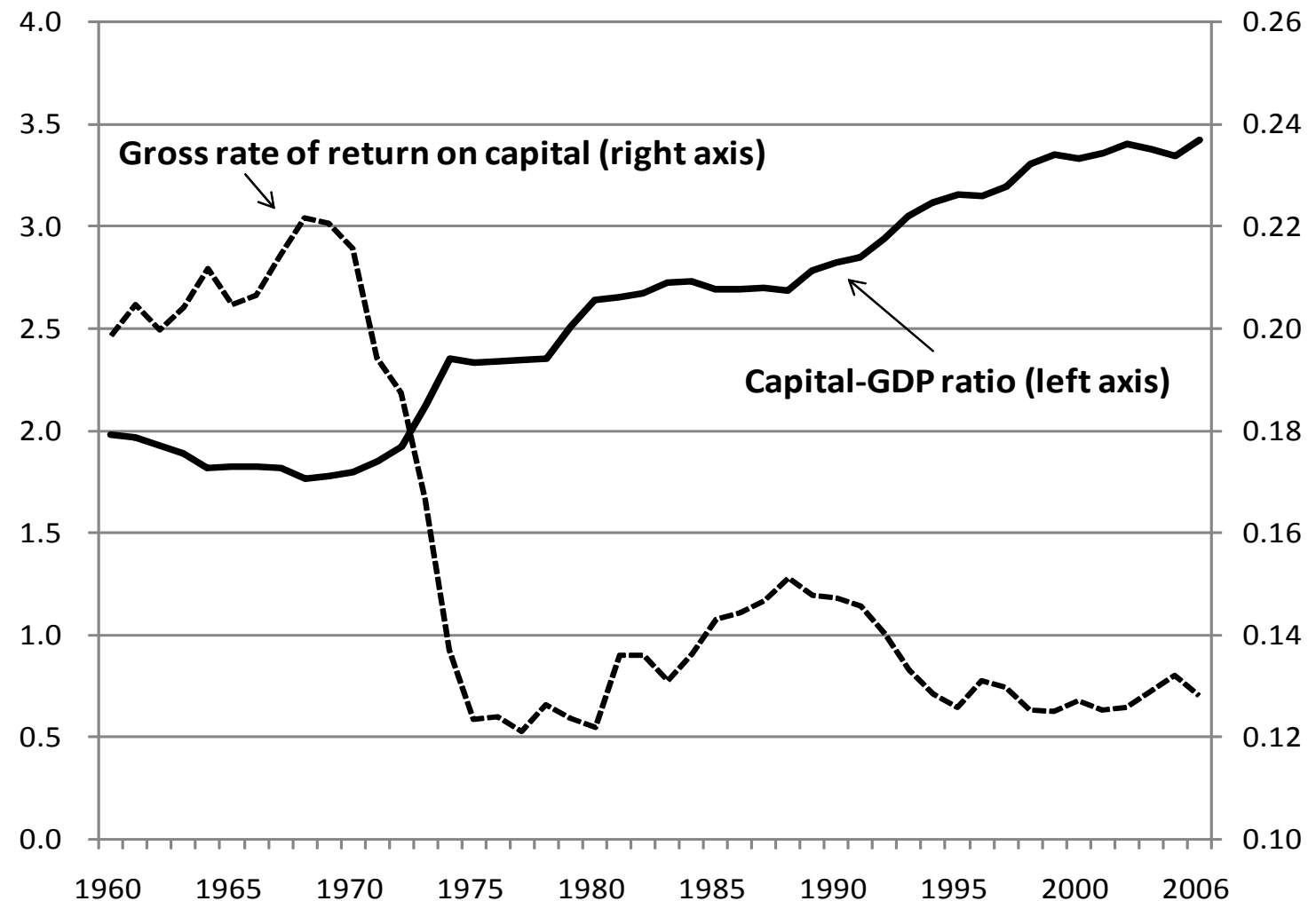
**Expansion of net exports and fiscal expenditure are important in the short run, but unsustainable. Expansion of private investment and consumption is more important for Japan's future growth.**

**The government should focus on:**

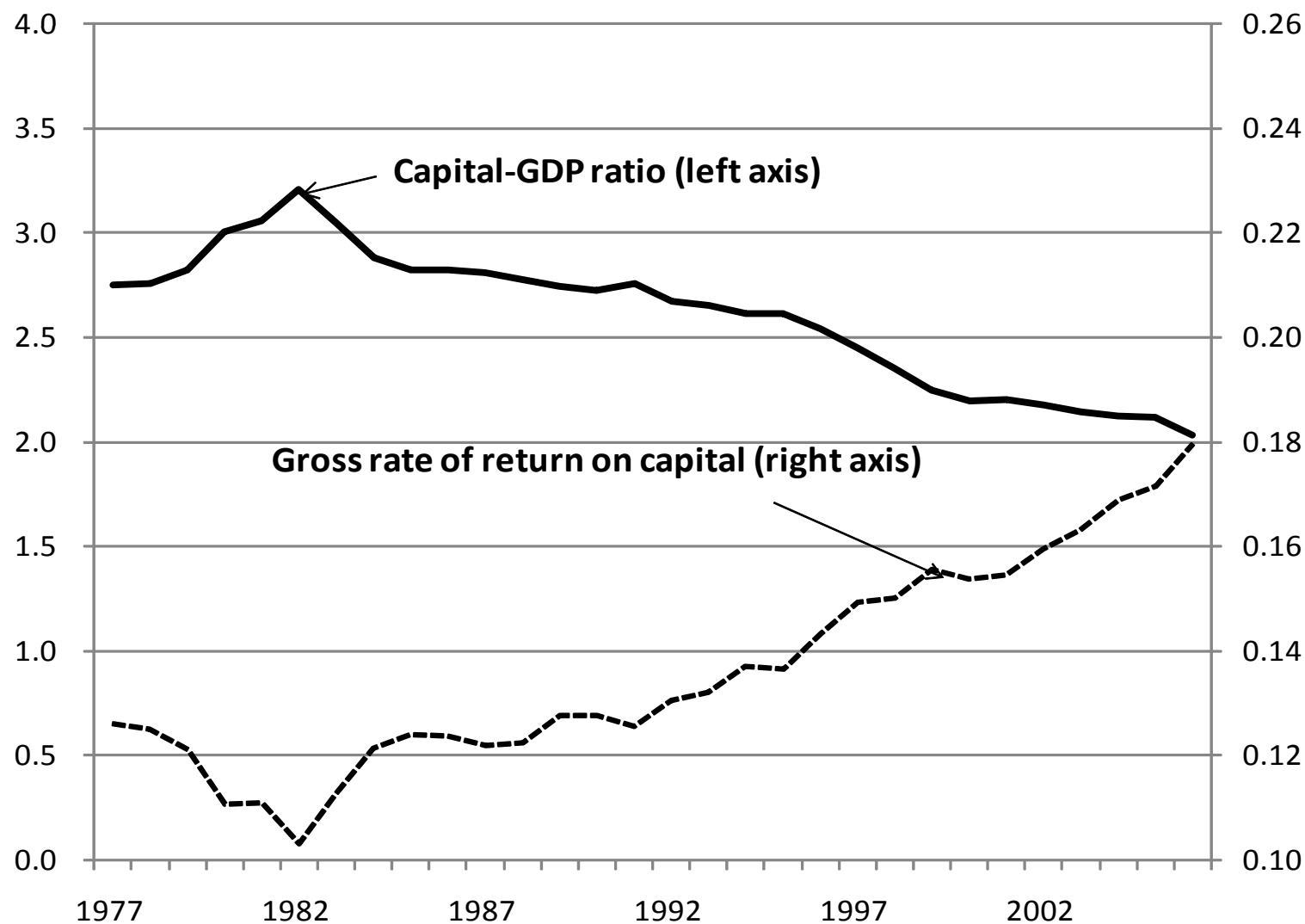
- 1) raising the rate of return on capital through an acceleration of total factor productivity (TFP) growth and the promotion of firms investing in promising areas, and**
- 2) the promotion of private consumption through job creation, productivity improvement, and income growth.**

**(Stimulation of private investment through real interest rate cuts is not sustainable.)**

**Japan has continued rapid capital accumulation, but its capital-GDP ratio has increased substantially. That must have contributed to the continuous decline in the rate of return on capital in Japan.**



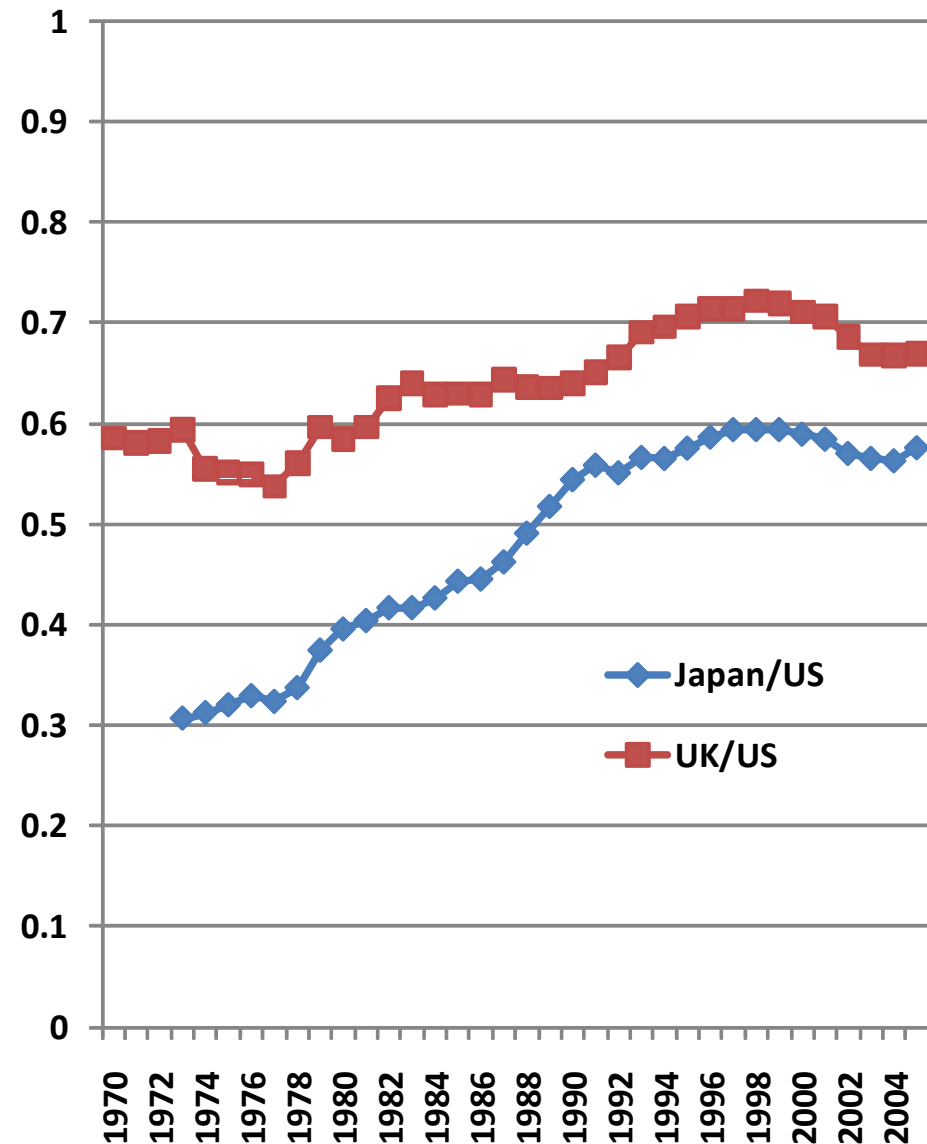
**Contrary to Japan's case, the US has experienced a continuous decline of the capital-output ratio and an increase in the rate of return on capital.**



- Japan's catch-up in labor productivity with the US stalled in the 1990s.
- Japan's labor productivity is only 60 percent of the US level.
- The labor productivity gap is caused not by a gap in the capital-labor ratio but by a gap in TFP (total factor productivity).

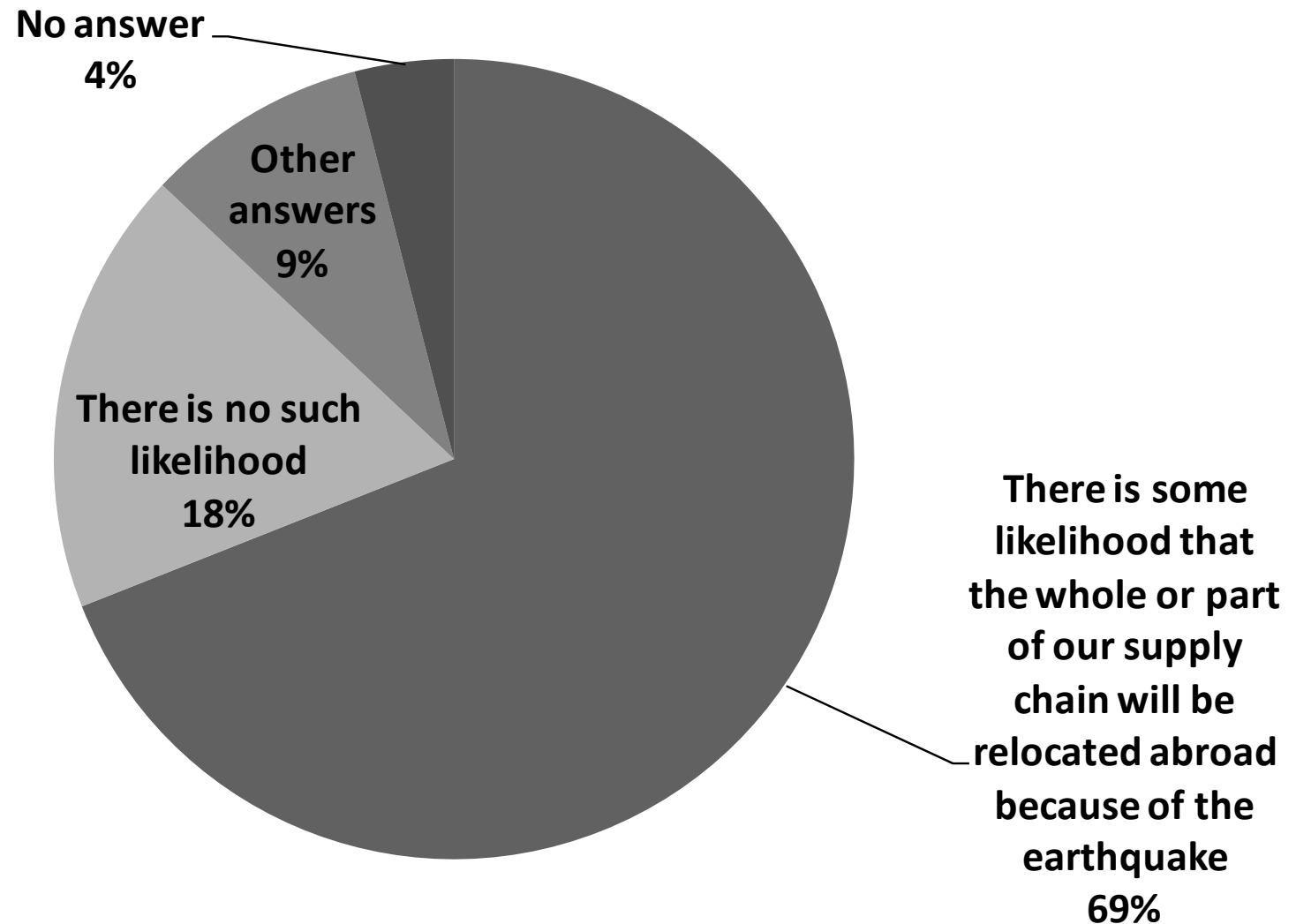
→ There is huge latent potential for TFP growth in Japan.

**Labor Productivity Level in Comparison with the US (PPP Adjusted GDP/Total Working Hours): Japan and the UK**



# Because of the earthquake and electricity shortages, an acceleration in hollowing-out is expected.

## Results of METI's special survey on Japan's supply chains after the Great East Japan Earthquake



Source: "The Present Situation and Problems to Be Solved of the Japanese Economy after the Great East Japan Earthquake," METI, June 2011. The figure is based on METI's special survey on supply chains after the earthquake.

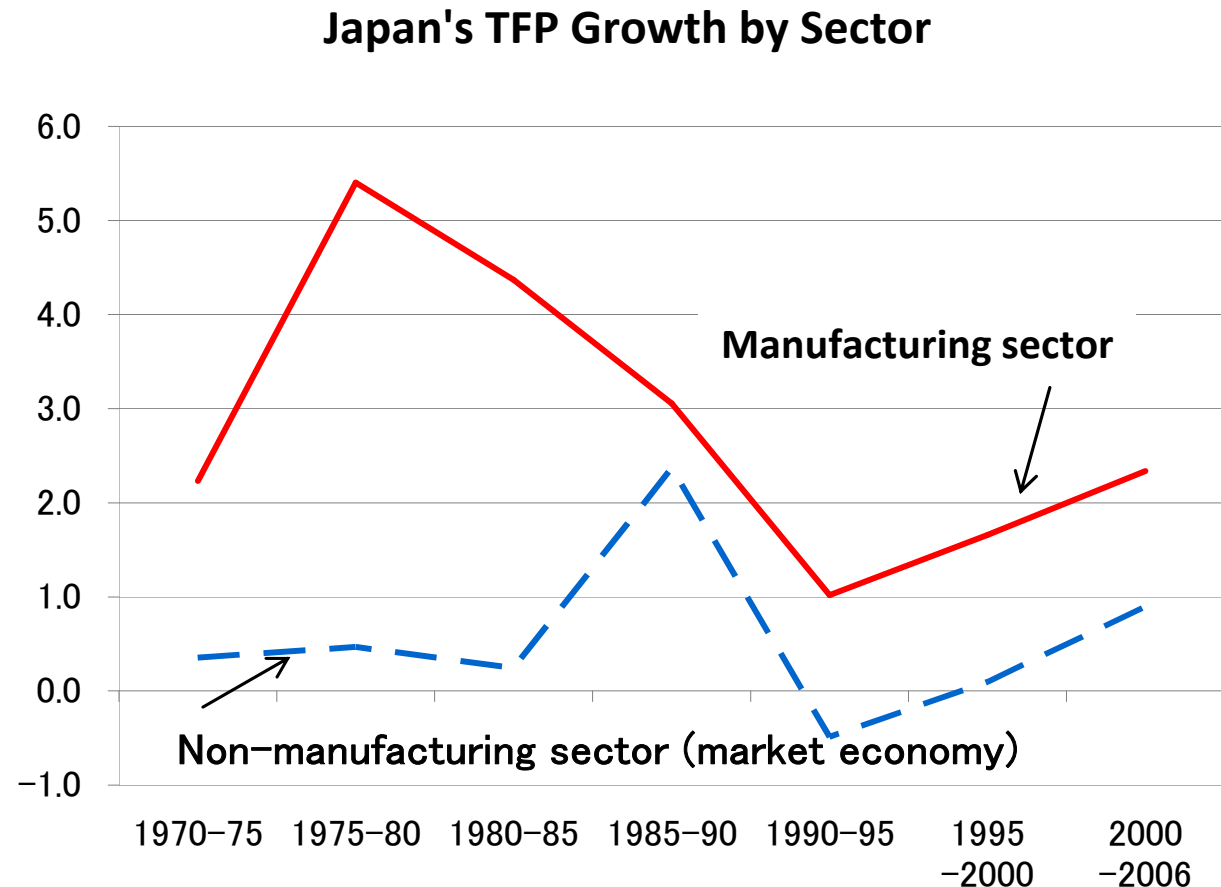


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## 2. What Is Needed to Accelerate TFP Growth?

- TFP growth in the manufacturing sector has declined sharply.
- TFP growth in the non-manufacturing sector has been very low for a long time.



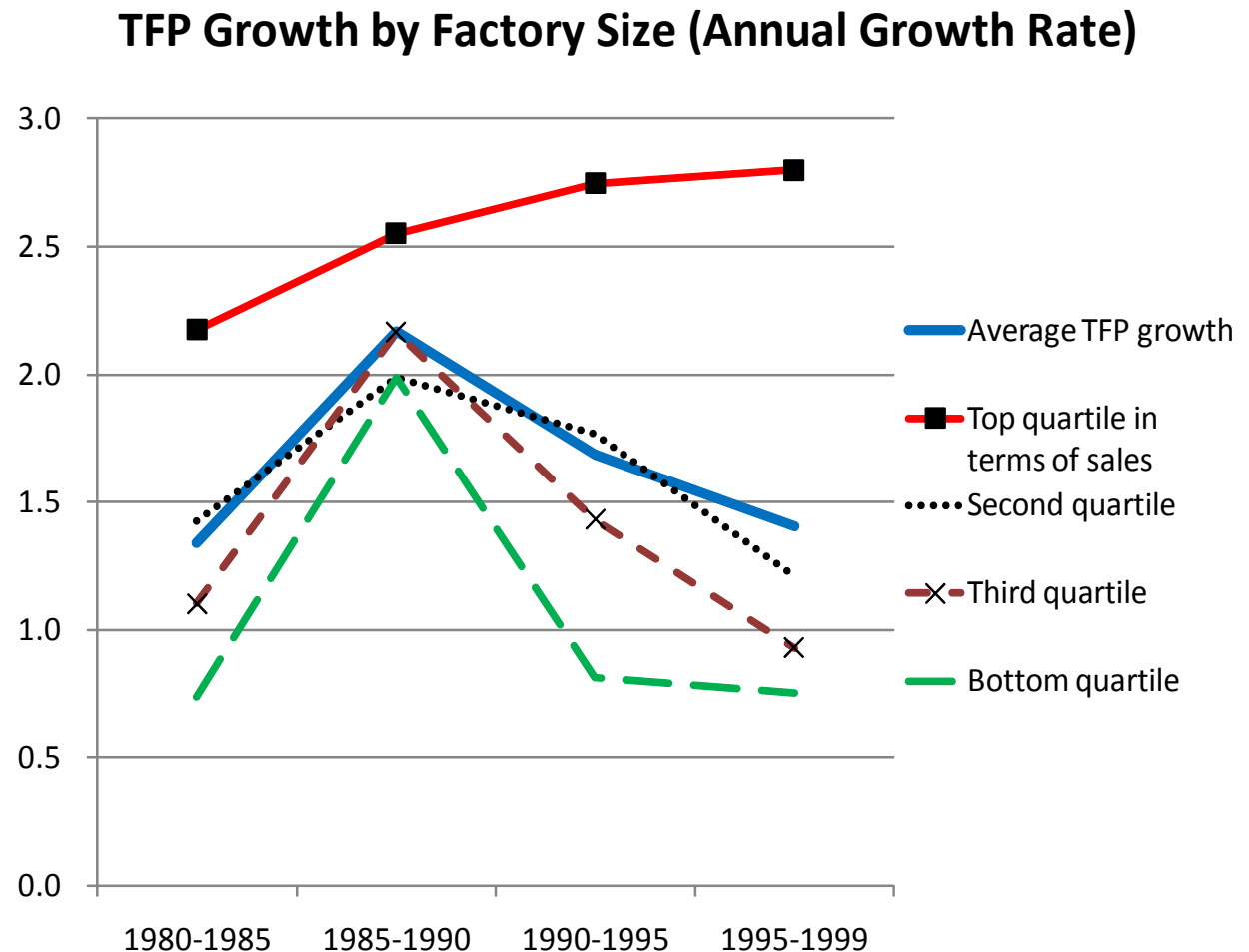
# Large Manufacturers Still Achieve Rapid TFP Growth

- In the manufacturing sector, TFP growth of large firms has actually accelerated. Small and medium-sized firms (SMEs) have been left behind.

→ Possible reasons:

(a) SMEs left behind in R&D and internationalization

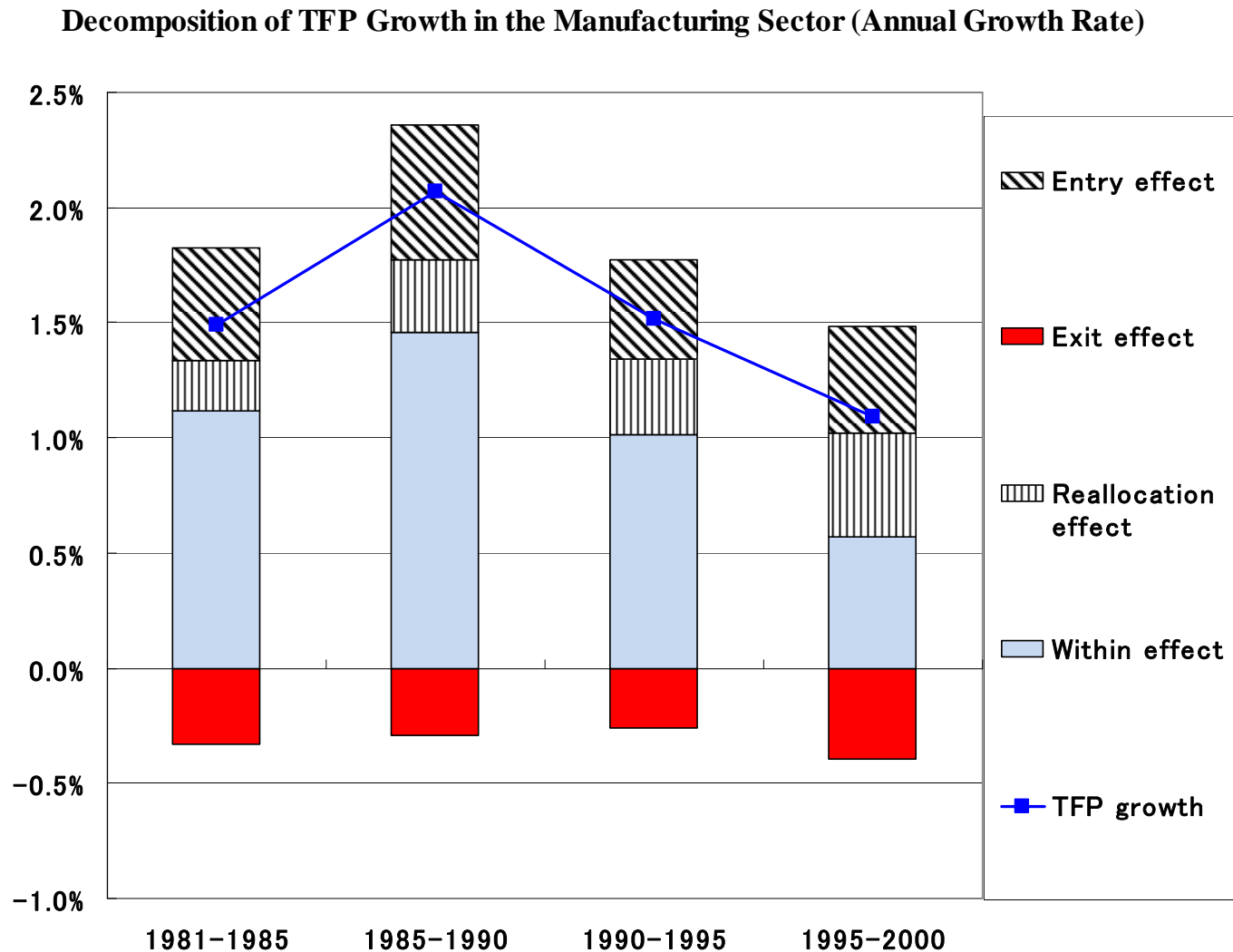
(b) decrease in technology spillovers from large firms.



# The Market Selection Process Is Not Working

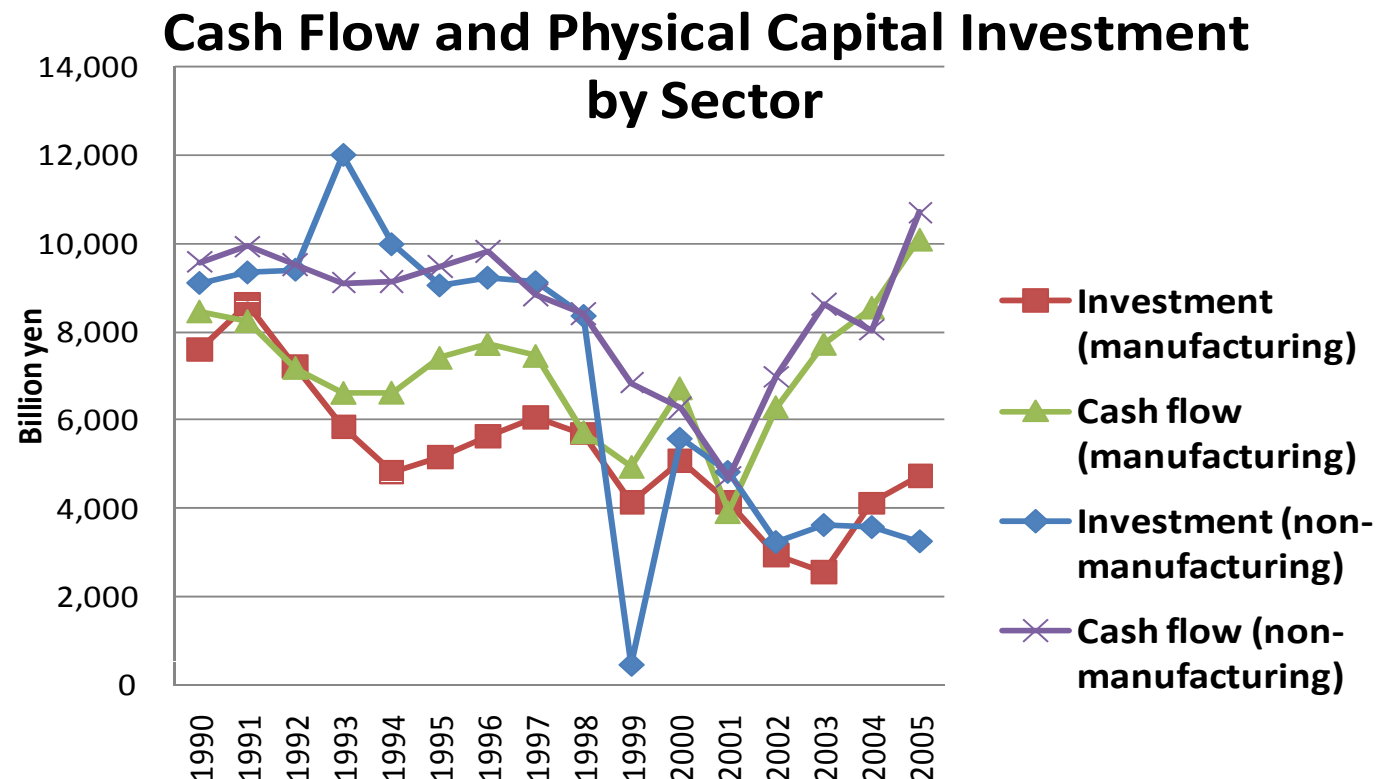
The “exit effect” is negative. It is a drag on TFP growth. This is low “metabolism”.

→ It is the productive factories that are being shut down. Less productive factories remain.



# Large Firms Do Not Expand Their Production

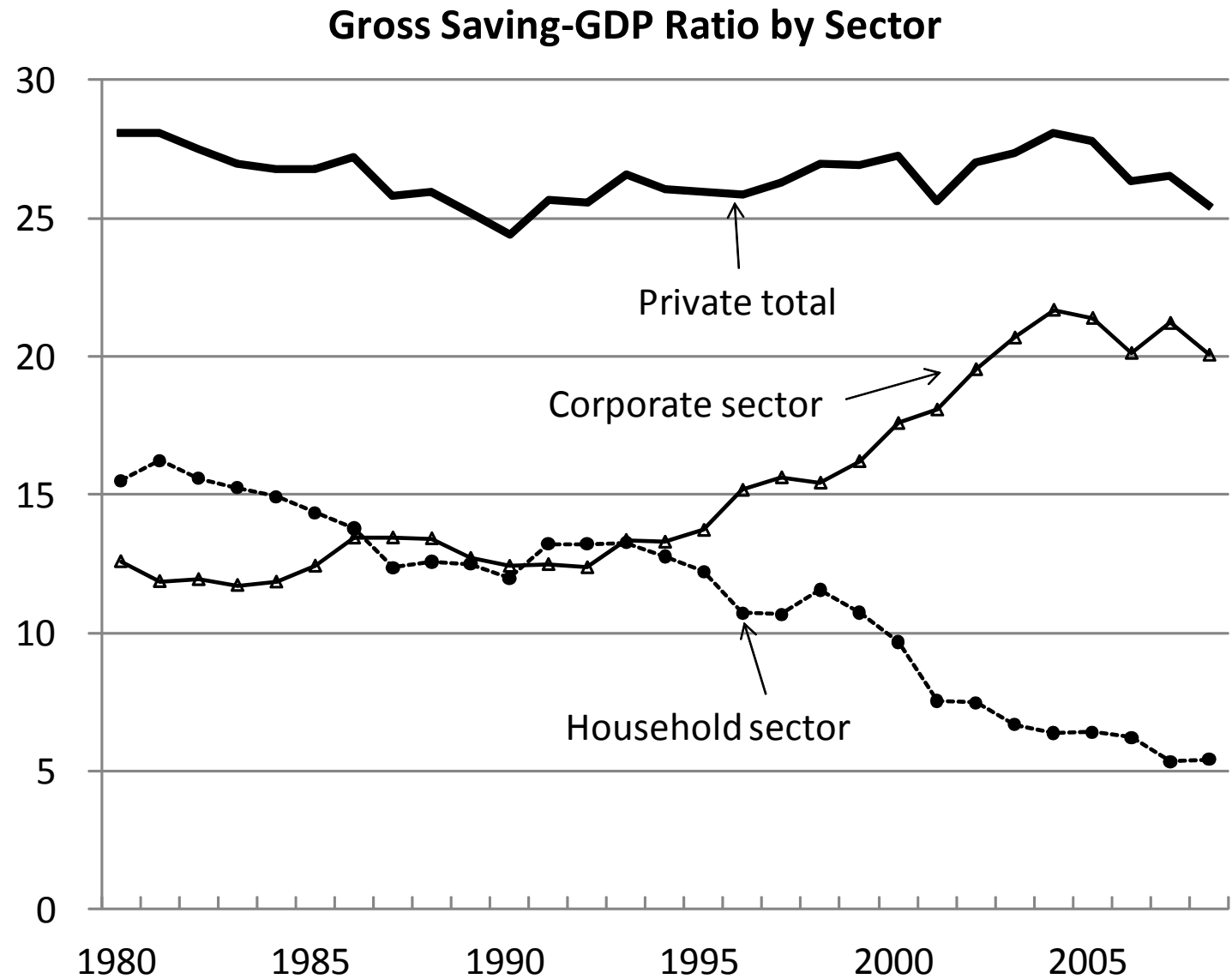
- Despite ample cash flow, large firms do not expand their own production (excess cash is used for debt repayment, portfolio investment, outward FDI, and the expansion of the production capacity of their domestic affiliates.)



Source: DBJ databank.

# Corporations Became the Principal Savers

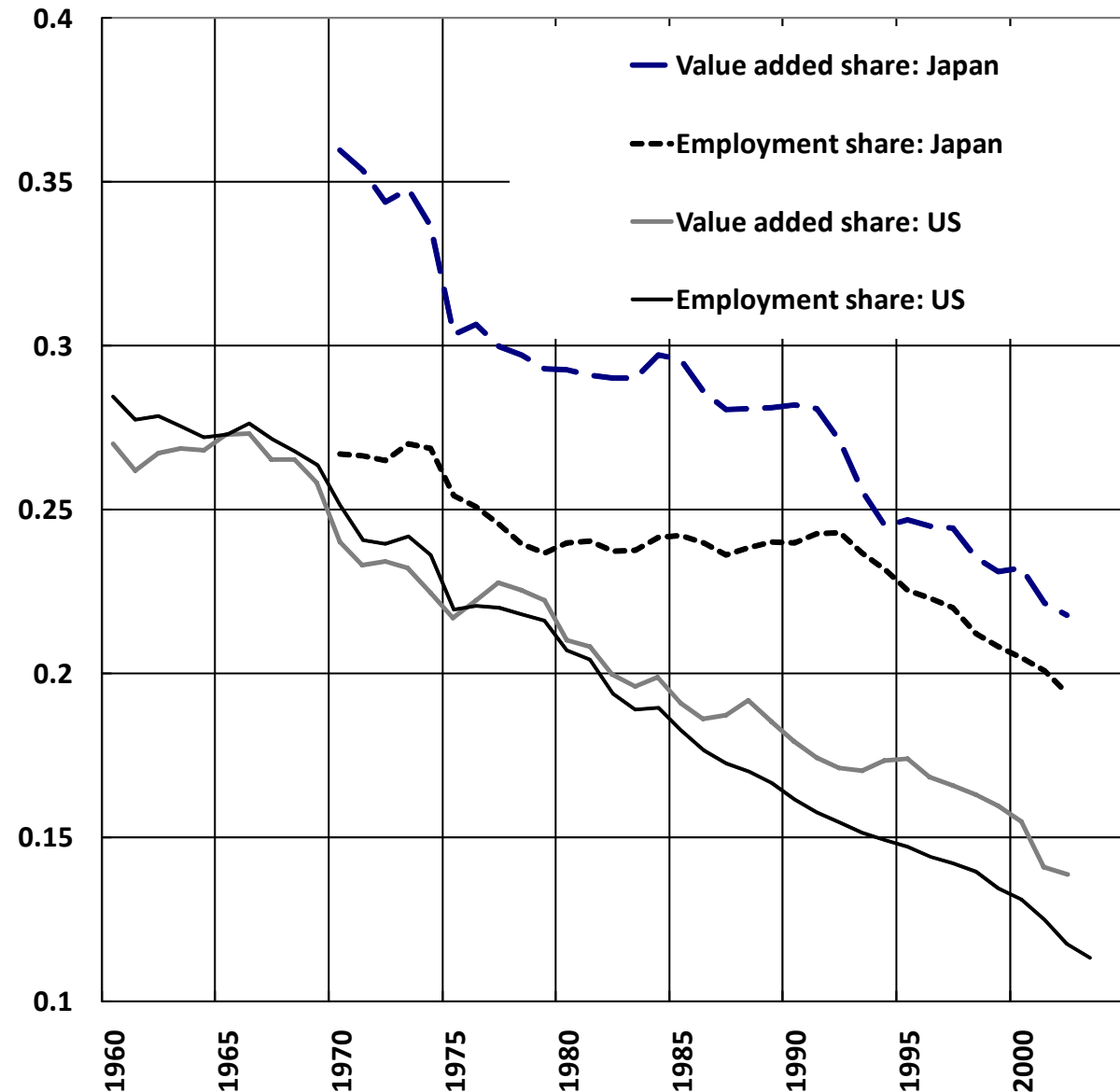
Despite a decline in liabilities and debt repayment, firms did not increase dividend payments much.



- The employment and value added shares of manufacturing in the economy have declined to around 20%.

→ TFP growth in the non-manufacturing sector has become much more important.

Share of the Manufacturing Sector in the Economy: Japan-US Comparison



# Why Has TFP Growth in the Non-manufacturing Sector Been So Low for Such a Long Time?

- Slow selection mechanism (entry and exit rates are low)
- Stagnation of ICT investment
- Stagnation of investment in intangibles

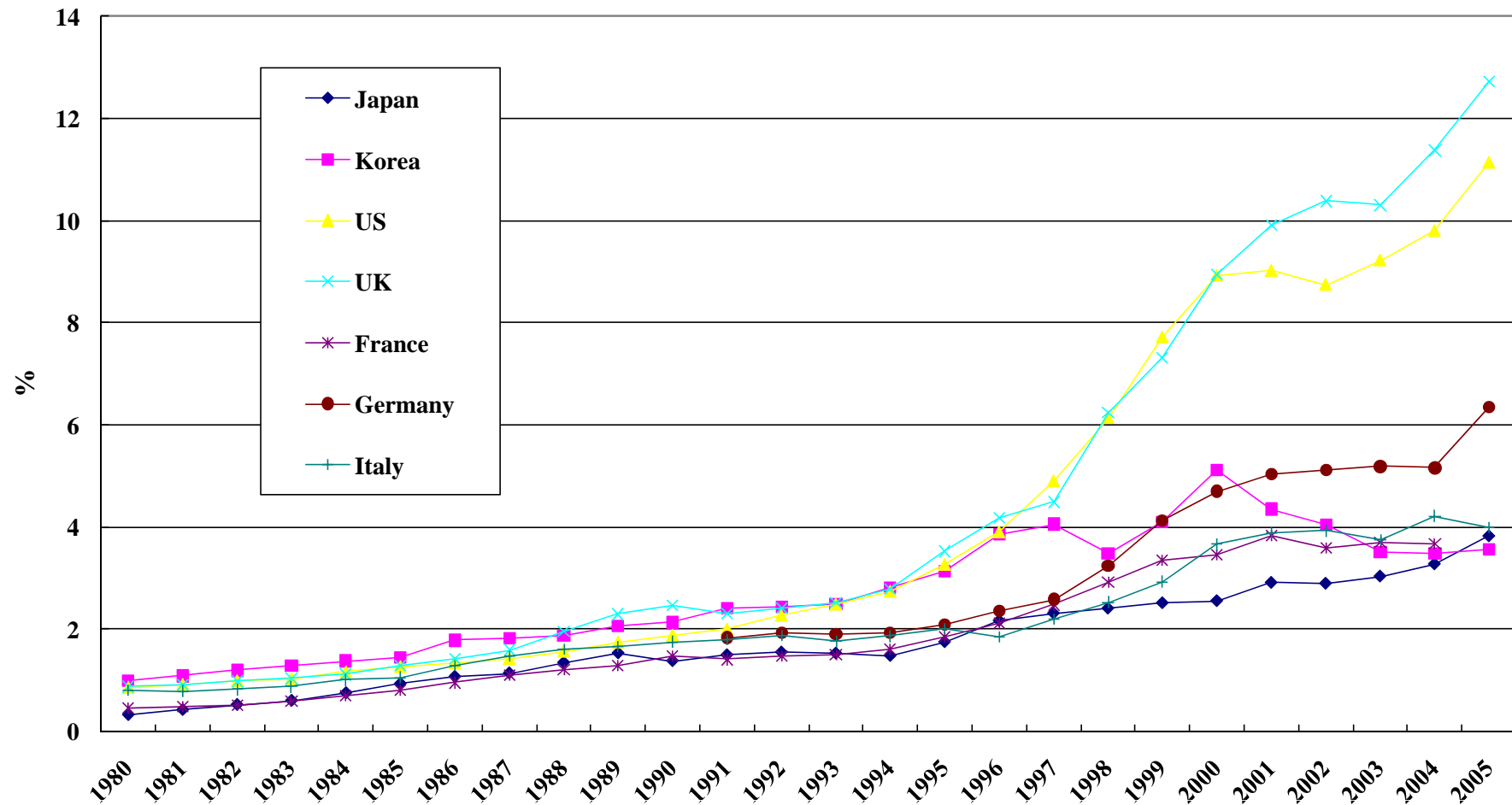
**These factors are closely related with labor market issues.**

- Example: in order to avoid changes in corporate structure, employment adjustment, and training of workers, firms choose to purchase custom software rather than packaged software.
- Expected high closure cost of firms decreases incentives for starting-up of new businesses by all parties.
- Firms usually do not train their part-time workers.
- Because they avoid employment adjustment (e.g., terminations), firms do not or cannot expand their outsourcing.



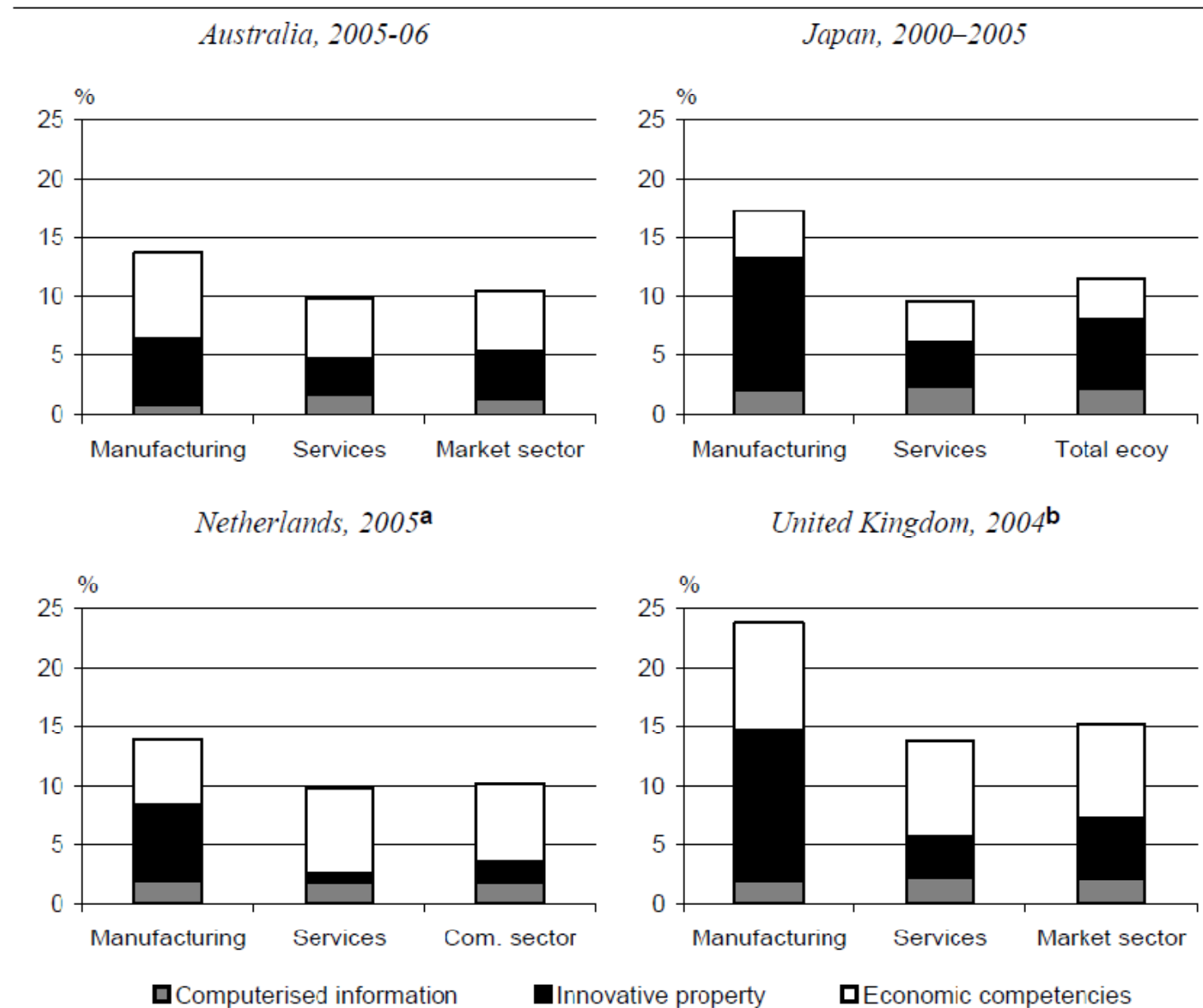
# Japan's ICT Investment-GDP Ratio is Very Low in Comparison with Other Major Developed Economies

ICT Investment-GDP Ratio in Major Developed Economies



Source: Fukao, Miyagawa, Pyo and Rhee (2009).

# Japan Has Been Left Behind in “Intangible” Investment in Economic Competencies (Corporate Organization, Off-JT, Advertising, etc.)



## What Is Needed to Accelerate TFP Growth and the Selection Mechanism (i.e., Resource Reallocation)?

- Promotion of **ICT and intangible investment**.
- Promotion of **young firms** which are active in innovation and internationalization\*, and **enhancement of inward FDI**.
- More rapid restructuring of firms left behind in innovation and internationalization, through **M&A** and other measures.
- Promotion of **entrepreneurs and startups**.
- Promotion of startup of domestic establishments by Japanese multinationals through **improvement of regional logistics, FTAs, reduction of corporate taxes**, etc.)
- **Restructuring of the labor market** (improvement of social safety-net, enhancement of labor market liquidity, reduction of unfair gaps between regular and part-time workers).

\* Such firms often have higher productivity than large firms, and expand more aggressively.

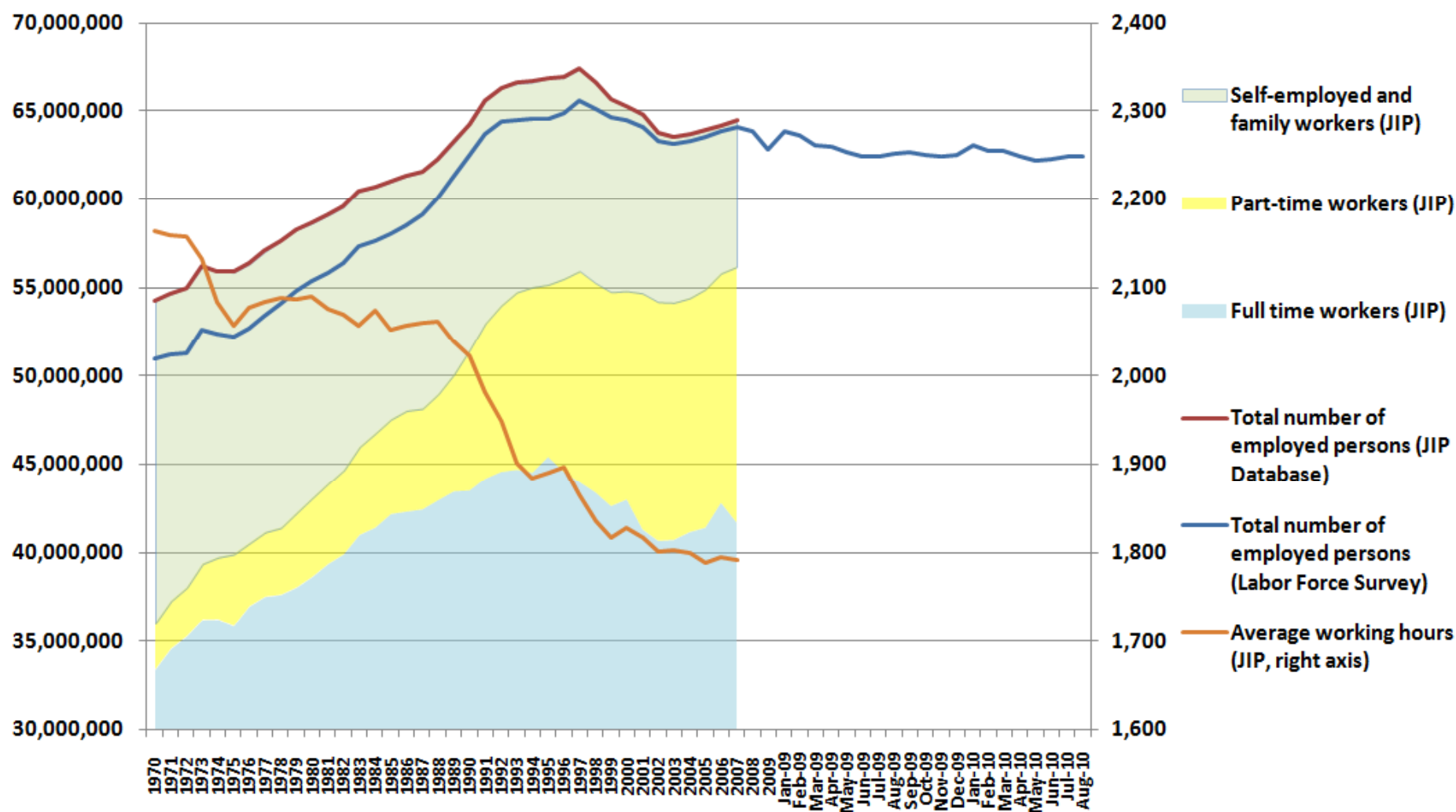
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# 3. Who Is Creating New Jobs?

Employment and working hours are shrinking.

Number of Workers by Employment Status and Average Working Hours in Japan



### **3. Who Is Creating New Jobs?**

#### **An Analysis of the Role of Firm Ownership**

Using microdata of the *Establishment and Enterprise Census* for 1996, 2001, and 2006, we examined net job creation (part-time and full-time regular employees) by firms, distinguishing between different categories of firm ownership.

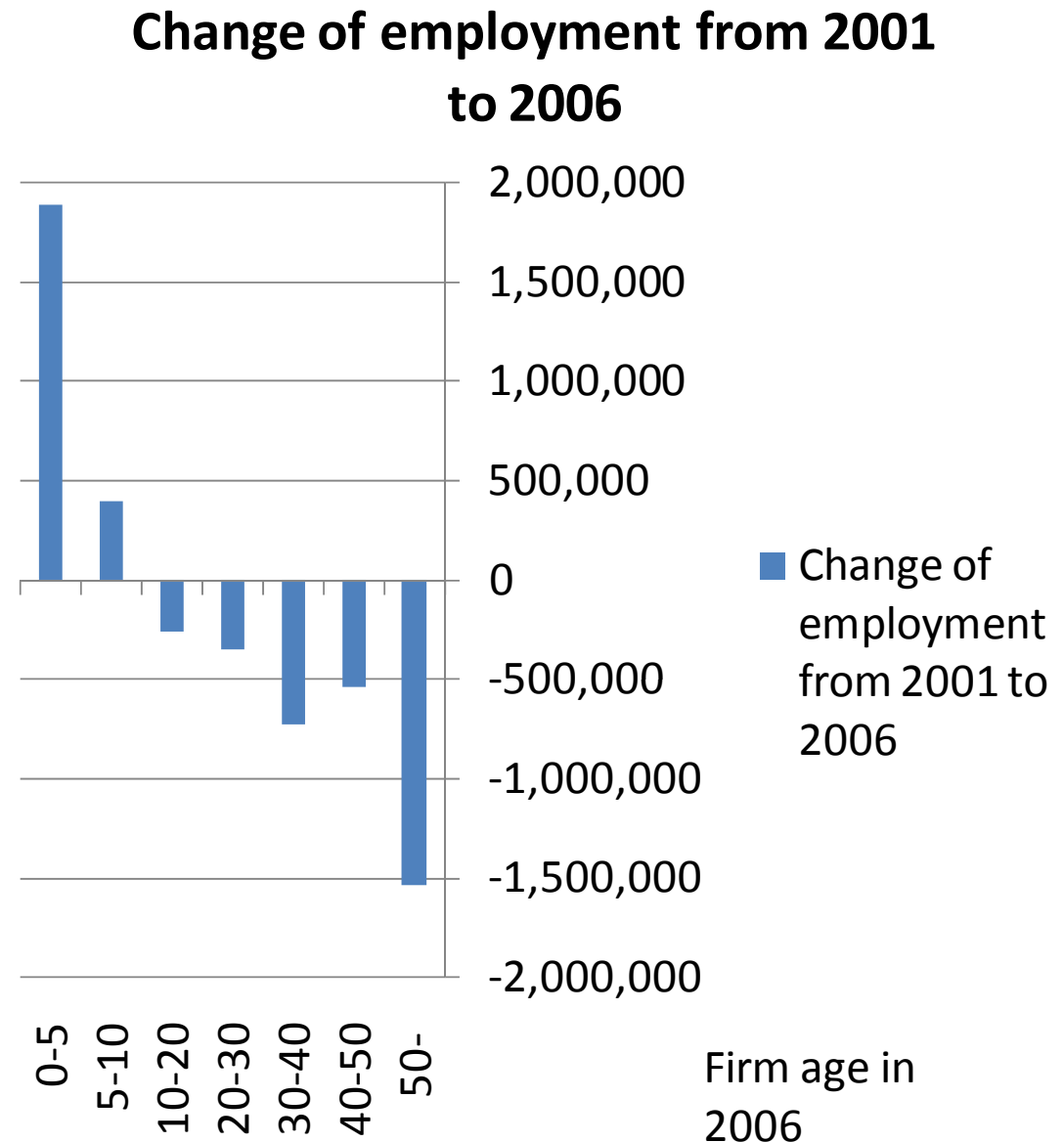
Net job creation between 1996 to 2006 for each category of firms (excluding employment increases resulting from M&As):

- Employment by independent (e.g., parent) companies fell by 3.75 million.
- Employment by affiliates of Japanese firms increased by 0.1 million.
- Employment by foreign firms-owned firms increased by 0.15 million. In addition to this, employment by foreign firms in Japan increased by 0.02 million through M&A transactions.

### 3. Who Is Creating New Jobs? An Analysis of the Role of Firm Age

Not only 0-5 year-old firms but also 5-10 year-old firms created jobs. Net employment by older firms fell, due to exits and reductions in firm size.

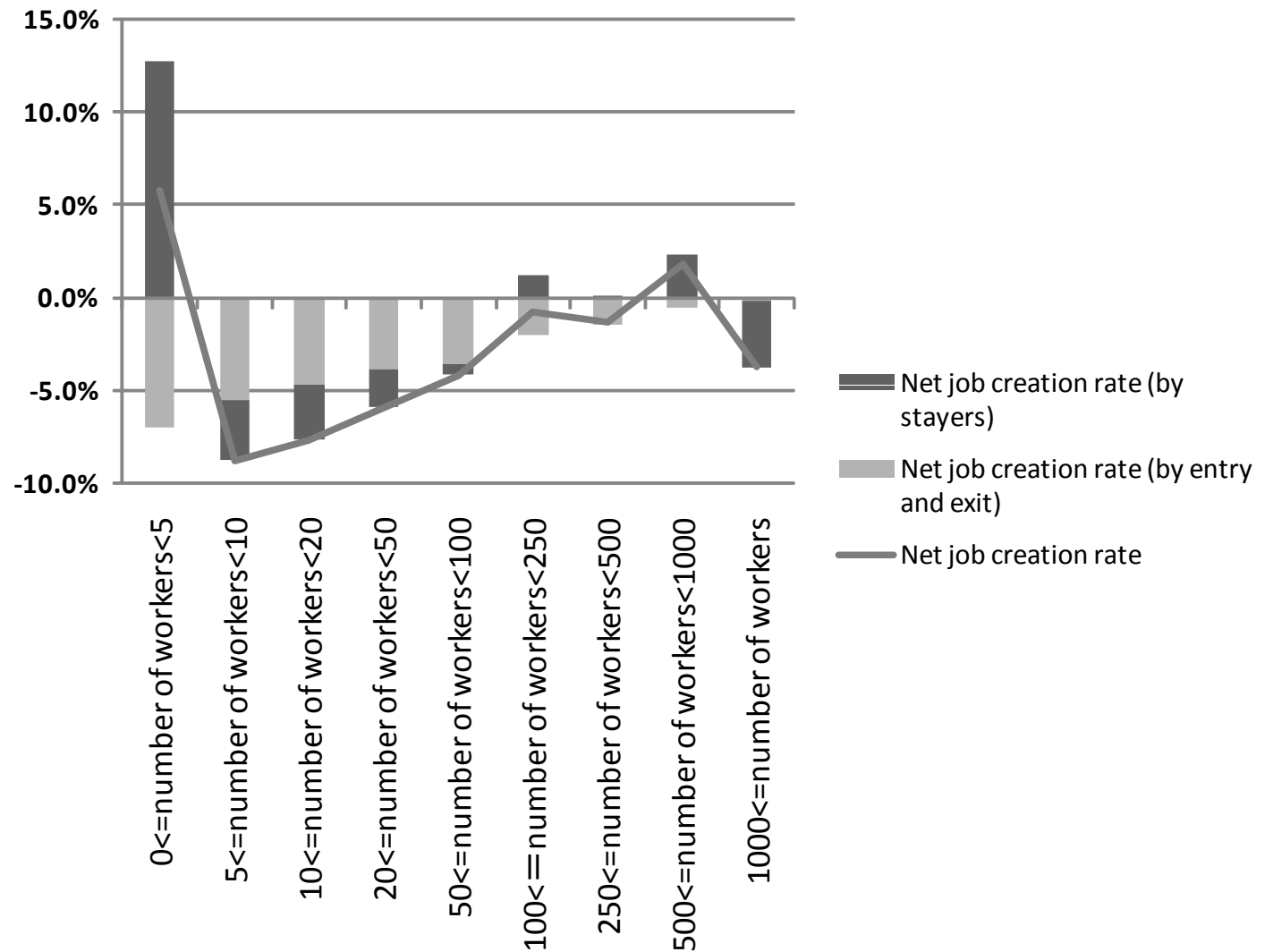
**Younger firms are the key to job creation. Research for the US by the Census Bureau comes to the same conclusion.**



### 3. Who Is Creating New Jobs? An Analysis of the Role of Firm Size

Net Job Creation by Firm Size: 2001-2006

**Firms with 0-5 workers and with 500-1,000 workers are most active in job creation.**



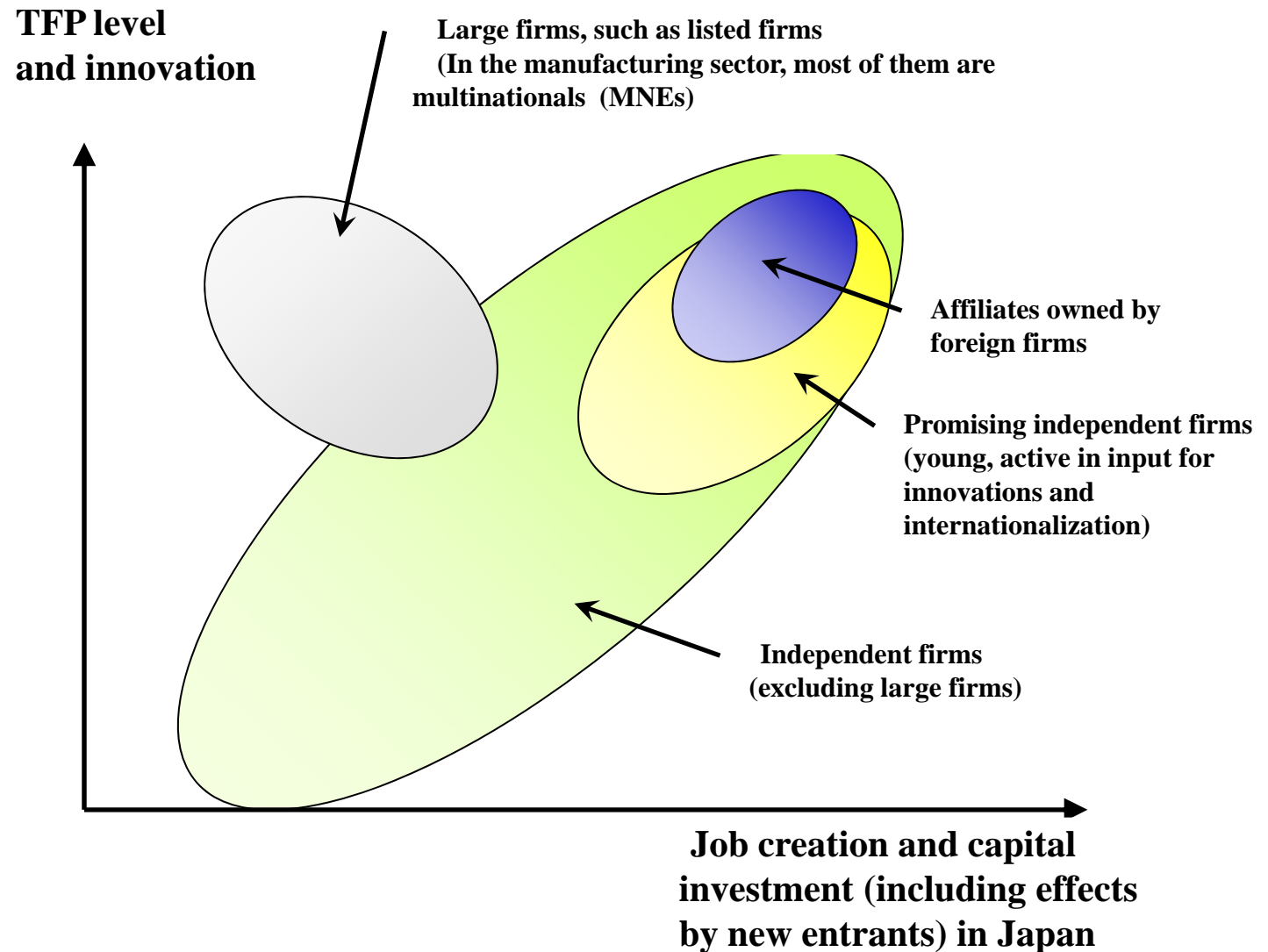


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## 4. Policy Implications

**We need policies focused on firms which are active in innovation and expansion of production and services in Japan.**



## **4. Policy Implications: Who Is Creating Jobs?**

**(Important Because Jobs Creation Increases Demand)**

- **Most older and larger firms have been reducing employment (partly through reallocating employment to their affiliates and relocating establishments abroad).**
- **Employment by affiliates of foreign firms increased by 0.17 million.** (Most of the employment increase resulted from entry and expansion. M&A deals roughly offset each other).
- **The younger firms were, the more new jobs they created. The older firms were, the larger was the net loss of jobs from exits and shrinkage.**
- **Firms with 0-5 workers and with 500-1,000 workers are most active in job creation. The key is for new firms to grow to the point where they have about 500 employees.**

## 4. Potential Policies and Their Expected Impact

	Necessary measures	Economic impact (continues every year)	
		Increase of potential GDP growth rate	Creation of final demand/GDP
Acceleration of innovation through ICT investment	Promotion of ICT investment, restructuring of labor market, promotion of Off-JT, and promotion of intangible investment	1.95%	3.00%
Reduction of negative exit effects and increase of reallocation effects	Promotion of entrepreneurs and startups, deregulation, reduction of corporate taxes, FTA/EPA policies, more active M&A market, promotion of technology transfer from the academia to the industry, and restructuring of labor market	0.75%	1.68%
Promotion of inward FDI	Deregulation, reduction of corporate tax, FTA/EPA policies, and restructuring of labor market	0.19%	0.46%
Promotion of intangible investment	Promotion of Off-JT, promotion of changes in corporate structure, and restructuring of labor market	0.25%	1.00%
Total effects		3.14%	6.14%

**We can expect large increases in GDP growth and final demand by promoting the private-sector activities in which Japan has been left behind by other developed economies.**