

Exclusive Interview

LEADERS IN JAPAN

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Chairman of the Japan Chamber of Commerce and Industry (JCCI)

Ken Kobayashi



The Future Growth of Japan's Small & Medium-Sized Enterprises

By Noyuki Haraoka

In the third installment of our exclusive interviews with leaders in Japan, Ken Kobayashi, Chairman of the Japan Chamber of Commerce and Industry (JCCI), shares his perspectives on small and medium-sized enterprises (SMEs), which account for 99.7% of all companies in Japan. He offers insights into the future of SMEs amid the current economic landscape.

(Interviewed on June 12, 2024)

Current State of the Japanese Economy

Haraoka: Japan's GDP is expected to grow 1.2% in real terms in FY 2023, which is well above the initially predicted growth rate of 0.5%. But inflation is a concern because of the rise in prices of raw materials and other items, plus the depreciation of the yen. However, wages are also rising, and a virtuous cycle of increasing wages and prices may be on the verge of being achieved. Would you say that the Japanese economy is emerging from deflation?

Kobayashi: I would like to focus mainly on SMEs. While the Japanese economy is currently moving toward overcoming deflation, it still has a long way to go. We recognize that complete recovery requires sustained efforts to achieve a virtuous cycle of growth and distribution.

The positive GDP in FY 2023 can be attributed to two main factors: a recovery in consumption following the pandemic and a significant boost in tourism-related consumption due to the weak yen. Additionally, domestic investment in FY 2023 is projected to reach 100 trillion yen for the first time in 30 years. We are optimistic about aiming for over 115 trillion yen in FY 2027 through public-private partnerships.

However, there are concerns. Consumer spending in real GDP for the January-March 2024 period was down by 0.7% from the

previous quarter. This indicates a mixed economic situation with both positives and negatives. If the yen's depreciation stabilizes and income tax cuts take effect, the economy could gain momentum.

SMEs are crucial to Japan's economy, accounting for 99.7% of all enterprises. Of the 47 million private sector workers (excluding government employees, teachers, and primary industry workers), 33 million are employed by SMEs. Including family members and others, SMEs support the livelihoods of 60 to 70 million people. In other words, more than half of Japan's population derives its livelihood from SMEs and the vitality of them is essential for a robust economic cycle.

At the Japan Chamber of Commerce and Industry, we take our responsibility seriously. The wage increase rate for companies with less than 300 employees is 3.62% as of April 2024, a notable improvement compared to previous years. This trend must continue to ensure wage growth for SMEs.

In addition, approximately 70% of SMEs have either increased wages or plan to do so. However, 60% of these wage increases are "defensive", aimed at retaining human resources rather than reflecting rising earnings.

Productivity Growth to Maintain a Wage-Price Virtuous Cycle

Haraoka: Productivity must be increased in order to continue a wage-price virtuous cycle. It is not good if

real wages do not grow because of inflation, so I think it is very important to improve productivity, including for SMEs, in order to improve real wages.

Kobayashi: That is correct. For SMEs to thrive, they must transform, boost productivity, add value, and pay wages from their profits, creating a favorable cycle. However, high raw material prices and elevated electricity and gas costs, coupled with the impact of the weak yen, pose significant challenges. I fear that the second half of this year could be very difficult for SMEs.

There is a perception in the media that SMEs have low productivity. However, the “SME White Paper 2023” reveals that in the manufacturing industry, real labor productivity has increased by 2.4% per year for large enterprises and by 2.3% for SMEs (Chart). The difference lies in price pass-through: large companies have a 0.9% pass-through rate, resulting in a nominal value-added growth rate of 3.2%. In contrast, SMEs face a -2.3% price pass-through rate, meaning their productivity gains are not reflected in price increases but are instead absorbed by larger enterprises. To break this cycle, SMEs must enhance their ability to pass on prices.

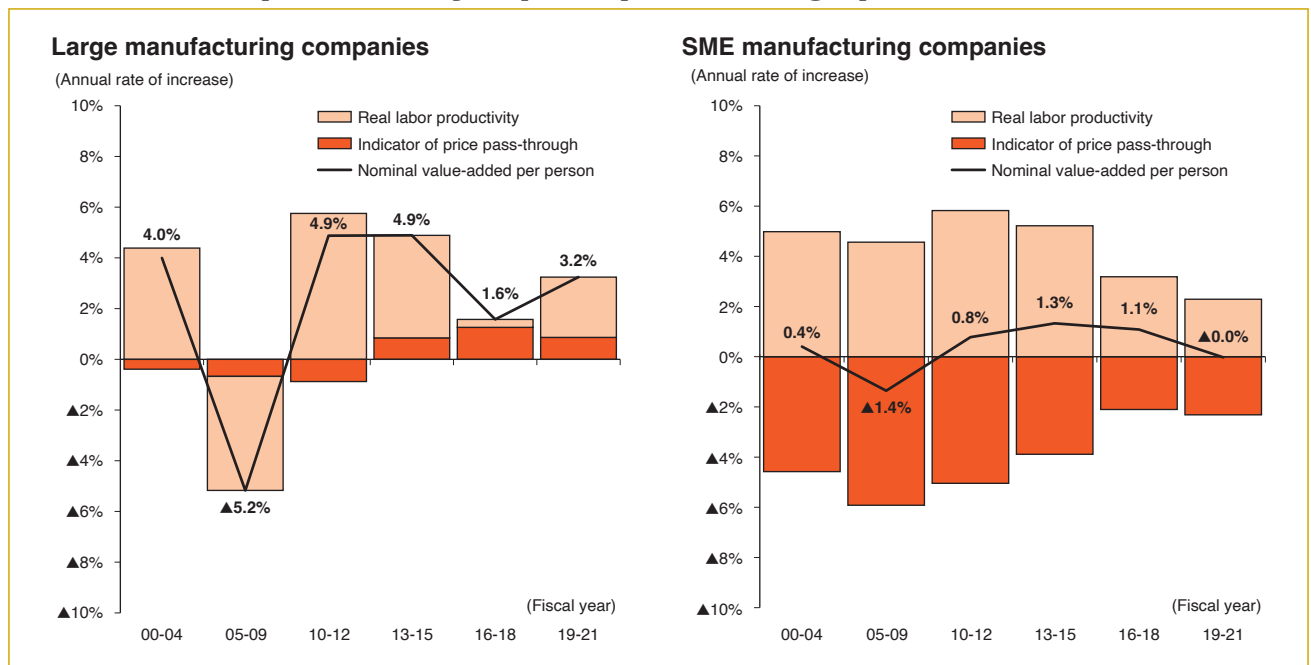
Gross profit is necessary to raise wages. To boost productivity and improve SMEs ability to pass on prices, we launched the “Partnership Building Declaration” in 2020 with the government and Keidanren. This initiative promotes coexistence and co-prosperity between large and small companies. Since I took office in November 2022, the number of companies registered for the declaration has grown 2.7 times, reaching 50,000 by July 11, 2024.

Historically, Japan’s technological prowess has been bolstered by collaboration between large and small companies, enhancing skills and competitiveness – a concept known as the “Ishigaki Theory” by Shigeo Nagano, the 15th chairman of the JCCI. He compared such collaboration between large and small companies to the stone wall of Japan’s Imperial Palace that was solidly built up with a combination of small and large stones collected from all over Japan. However, there has been a recent focus on cost reductions, neglecting the need to pass on added value throughout the supply chain.

We aim to create a nationwide movement to ensure prices trickle down to subcontractors, which are becoming increasingly multi-layered. Out of approximately 12,000 large companies in Japan, only about 2,300 have registered their declarations, with the rest being

CHART

Trends in real productivity & price pass-through power



Source: White Paper on SMEs in Japan 2023

SMEs. The Japan Fair Trade Commission is significantly supporting our efforts. To strengthen SMEs, we must improve productivity and enhance their price pass-through capability from -2.3% to at least zero.

Additionally, it is important for consumer-facing businesses to raise prices courageously. The nation must understand that quality products, services, and food come at a cost, and price increases will ultimately benefit everyone. This mindset will positively impact the economy.

Haraoka: In order to create strong SMEs, in addition to fostering venture businesses and promoting entrepreneurship, we should implement policies to enhance metabolism, by which I mean having companies that are losing competitiveness exit the market promptly and have new companies enter the market.

Kobayashi: The JCCI is well aware of the situation. We are not merely providing subsidies to struggling companies. Instead, we support those aiming to reform and grow. Metabolism is becoming a reality, particularly with the aging management members of the baby boomer generation, now over 75 years old, making business succession a pressing issue. Many companies see business succession as an opportunity for growth, and we support them with various options, including M&As.

When I took office, there was a reluctance to discuss business succession due to continuity concerns. However, nearly two years later, this attitude has changed dramatically. We now emphasize the urgency of generational change and the need to consult and discuss business options as soon as possible. The JCCI provides a comprehensive range of options for business restructuring and productivity improvement using digital technology, as well as support for business succession, entrepreneurship, startups, and M&As.

The Importance of Innovation

Haraoka: Innovation is, I believe, the primary source of growth. What do you think is needed to promote the ability of SMEs to innovate?

Kobayashi: SMEs have significant potential to innovate, particularly with the adoption of technologies like generative AI. One of their key strengths is the proximity to management and the frontline, enabling

quick decision-making and swift action, unlike larger companies that require lengthy consensus-building.

SMEs are inherently interested in innovation as they strive for growth. They often collaborate with fellow companies, despite having fewer human, financial, and information resources than large companies. It is crucial for SMEs, especially in rural areas, to innovate and restructure their management to achieve growth. In rural areas, SMEs account for about 90% of total private-sector employment, compared to only 40% in Tokyo. They are vital to maintaining the local commercial infrastructure for daily life.

Many young people do not intend to live permanently in Tokyo; some move to other cities, while others return to their hometowns. However, if the local commercial infrastructure weakens, their daily lives become challenging. Supporting SMEs in these areas to innovate and start new business is a major mission of ours, as it helps sustain local economies and ensures a viable living environment for returning residents.

Labor Mobility as a Key to Development

Haraoka: I think it is very important for the Japanese economy that people move to the regions outside of major cities and that those regions are revitalized. I believe this is exactly the countermeasure for the declining birthrate and aging population. However, such labor mobility is not being greatly enhanced due to the still deeply-rooted Japanese management customs of lifetime employment, seniority-based promotions, and salary increases, although this does seem to have started to collapse, according to research. These customs provide a strong incentive for workers to continue to work for the same company all their life, and due to this, human resources are not easily transferred to sectors with robust growth potential and needs. In an age of declining birthrates, and an aging and shrinking population, is the mobility of the labor force sufficient, and if not, what should be done about it?

Kobayashi: Labor mobility naturally increases with changing economic conditions. Today's young people do not expect to stay with one company until retirement, and job-changing is becoming more common and accepted as a right of corporate workers.

On the other hand, we must also address the needs of the elderly. Many healthy elderly individuals could be reemployed to contribute

actively. Incorporating the elderly and women into the labor force requires various measures, including adjustments to social security and pensions.

Human capital remains the most important factor for SMEs. Many employees are mid-career hires, and managers are keen to attract talent from large companies. While Japanese-style employment, including lifetime employment, has its merits and has driven development thus far, it needs to adapt to contemporary changes. Managers must discern which aspects of the traditional employment system to retain and which to discard.

In a virtuous cycle of wages and prices, labor mobility will naturally increase, even without government intervention. Re-skilling and other supportive measures are necessary, but secondary. The labor force's desire to work more effectively will drive natural increases in labor mobility.

Investments and Profit Returns

Haraoka: There is a trend of Japanese companies not investing in new businesses as much as they used to, and holding on to their retained earnings and shrinking. In other words, as a result of the collapse of the bubble economy, risk-averse management has become widespread, and a kind of social norm. What do you think should be done to reverse this trend?

Kobayashi: One consequence of a strong yen and globalization has been the shift of corporate investments overseas. The problem is that these investments and the resulting profits have not returned to Japan. While tax reductions for repatriation exist, I believe that substantial tax exemptions and preferential treatment for reinvestments in Japan could change the current trend.

Intuitively, about 70% of Japanese companies' earnings are reserved overseas, which is a waste. In shareholder capitalism, our generation of business leaders cut costs, invested overseas due to the strong yen, and returned the profits directly to shareholders. This has been the dominant business behavior for a long time, explaining the lack of domestic investment.

I advocate for government policies that boost domestic investment and shift from a defensive to an offensive management mindset, particularly regarding domestic investments. Subsidizing companies like Rapidus and TSMC, which have bases in rural areas and make domestic investments, is beneficial, especially for regional revitalization.

Haraoka: In order to achieve this, I think it is important to create new demand. As you mentioned earlier, in terms of regional revitalization, Japan is potentially very rich in tourism resources, so there is new demand as a tourism-oriented country. At the same time, there are also growth strategies to solve social problems, such as green growth to solve global environmental problems, silver growth to support an aging society, and security growth to solve security issues, such as in the space industry, which will become more important in the future. What do you think about creating new demand by exploring such new forms of growth?

Kobayashi: This is the direction that aligns with the evolution of Japan's economy and industrial structure, involving large and small companies. Over the past 15 years or so, the perception of companies has shifted – companies are now seen as social entities that must provide economic, environmental, and social value simultaneously. This shift is positive, moving away from a sole focus on shareholder capitalism. Pursuing policies for industries with a social dimension, such as the green or silver industries, is crucial. Companies must now balance providing economic value with contributing to environmental sustainability and social well-being. This holistic approach can drive new demand and foster sustainable growth.

Stabilizing Overseas Activities

Haraoka: Looking at the external activities of Japanese companies, geopolitical risks are increasing, and the concept of economic security is rapidly emerging. I think there are aspects of this that require cooperation between the private sector and the government. For example, regarding rules for economic security, if the WTO cannot be expected to function well and the rules are not sufficient, there will inevitably be protectionism and economic confusion. What do you think about restoring the WTO's dispute settlement function in order to build a rules-based international trade regime, expanding regional trade agreements, and expanding plurilateral agreements for advanced technologies?

Kobayashi: Japan, a trade-oriented nation with scarce natural

resources, must remain a trading nation in whatever form it chooses. Thus, external economic policy is crucial for Japan's national interests.

2024 is an election year with elections in Taiwan, Indonesia, Russia, South Korea, India, and some EU states, as well as Japan's LDP presidential election in September and the US presidential election in November. Election years often lead countries to turn inward, posing challenges for trading nations like Japan that rely on selling products and services abroad.

The WTO, TPP, RCEP, and various regional economic agreements will continue to emerge, but Japan needs to consider a multilateral trading system as the ultimate goal for its trade policy. The world population is now 8.1 billion, with one out of every three people being either Indian or Chinese. Japan must enter these massive markets to sell consumer goods and services, which requires maintaining good relationships. If political solutions are difficult, addressing economic security issues through cooperation and partnership with like-minded countries.

While the United States is not a member of the TPP, Japan is, and Japan is also a member of the RCEP, along with China. Japan must maintain a wide variety of channels with various countries, including active cooperation with the Global South. It is important to establish relationships with countries where the population growth and consumption will increase. China has achieved remarkable economic development, but India's per capita GDP is still only about US\$2,700 (2024 IMF Forecast), and motorization is just beginning. Once the per capita GDP exceeds US\$3,000, motorization will accelerate significantly. We must pay attention to Africa and other regions in the future, making cooperation with as many countries as possible crucial.

With the WTO dispute settlements barely functioning, Japan must respond bilaterally. However, it is essential to keep our options as wide as possible in the face of geopolitical risks and economic security constraints.

Haraoka: I think it is important to build stronger relations with the ASEAN countries.

Kobayashi: Having been stationed in Singapore from 2001 to 2004, I recognize ASEAN's significance. This region, with its diverse political systems and cultures, has its own national interests. Some ASEAN countries are still developing, and Japan can aid their environmental efforts by sharing transitional technologies on the path to carbon neutrality. This cooperative approach aligns with Japan's geopolitical strategy, fostering growth through co-creation with ASEAN.

Tackling Depopulation

Haraoka: Population decline is not only an economic issue, but also a security issue in the sense that a country's presence will become smaller as a result. In this context, some European countries maintain their populations through immigration. What do you think about the idea that Japan should be more proactive in accepting labor from overseas?

Kobayashi: Japanese SMEs face a significant manpower shortage and demand an expansion in overseas labor acceptance. However, human rights issues and language barriers must be considered. In Japan, language barriers can lead to isolated communities, as seen with immigration issues in Europe. Nevertheless, due to the serious labor shortage, we must accept some overseas labor. In rural areas, such as Hiroshima Prefecture's Seto Inland Sea, Filipino workers dominate the shipyards, while Chinese workers are prevalent in Shikoku. These communities are essential for the survival of the Japanese shipbuilding industry. In light of this reality, and taking into consideration the declining birthrate, we need to plan for the next 100 years, focusing on labor-saving measures while carefully considering the acceptance of overseas nationals.

Haraoka: In the United Kingdom and Canada, there is a points system, which makes it easier for those who have reached a predetermined level of language proficiency or specialized knowledge to enter.

Kobayashi: That is one way to do it, particularly for accepting highly skilled human resources. However, accepting a large number of immigrants requires significant readiness from Japanese society, historically a monoculture, to integrate and coexist with new arrivals.

Haraoka: Thank you very much.

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Interviewer: Naoyuki Haraoka is the executive managing director and editor-in-chief of *Japan SPOTLIGHT*. He translated this interview from the original Japanese.