

Opening New Era with Innovation: Ways of Achieving Growth Amid Shrinking Population

By Saito Keisuke

Japan's Economic Goal

Although the Japanese economy is in an expansionary phase, it is fraught with problems. Uncertainties include surges in energy prices, the economic conditions in the United States and China, and the lukewarm pace of recovery in domestic consumption, just to name a few. In particular, the largest problem Japan faces is a decline in its population, which began in 2005. It shakes the foundation not only of the Japanese economy but also of the entire social system that has been built on the assumption that the population will continue to grow.

The Ministry of Economy, Trade and Industry (METI) released a "New Economic Growth Strategy" in June 2006, exploring challenges facing this country with a rapidly aging population and the future direction it should follow. This strategy was later integrated with the "Rising Tide Policy" formulated by the Liberal Democratic Party (LDP), the "Strategy in the Globalizing Economy" by the Cabinet Office and other economic growth policies by other ministries and agencies – the end result was an "Economic Growth Initiative," which was adopted in July 2006 at a conference for integrated fiscal and economic reforms, a body consisting of senior officials from the government and the ruling coalition camp. This initiative, combined with the policy of "integrated reform of expenditures and revenues," has set the direction of Japan's economic strategy for the next 10 years.

Basic Philosophy for Economic Growth

Seen from the supply side, economic growth should be considered in terms of labor force, plant and equipment investment, and "total factor productivity" (TFP), which addresses any effect on

total output not caused by capital input or productivity. According to a Ministry of Health, Labor and Welfare study, the Japanese labor force is projected to decline by approximately 4 million in the next 10 years. Translated into an economic growth rate, this is equivalent to a decline of about 0.4% on average per year. Meanwhile, the increase in the ratio of elderly people should result in a dramatic decline in the savings rate, making it difficult to expect much in terms of capital investment.

To sustain economic growth under the conditions of an aging and declining population, it is necessary to increase value created by each individual and to improve TFP. The key to achieving this is "innovation." This keyword also appears in the Palmisano Report ⁽¹⁾ in the United States and the 11th Five-Year Plan ⁽²⁾ of China. What is the magic power of innovation? My answer: its power to change latent demand into real demand. Competition among companies is fierce in every phase of history and in every country. However, if companies compete solely in terms of price, it will sap corporate strength and may lead to bankruptcy. This is why innovation is necessary. Consumers are interested in novelties in products and services, and buy them. Companies selling novel products make money, and this makes it possible for them to conduct R&D and translate their ideas into new products. This is known as a "virtuous circle of innovation and demand" and plays a major role in economic expansion.

Note:

(1) The formal title of the report is "Innovate America: Thriving in a World of Challenge and Change," compiled by Samuel J. Palmisano, chairman and CEO of IBM Corp. and released in December 2004 by the Council on Competitiveness, a private US organization. The gist of the report is that in the past 25 years, the United States placed the greatest emphasis on improving efficiency, but for the next 25 years, it must optimize its society to create innovation.

(2) "The Recommendation for the Formulation of the 11th Five-Year Plan for the Development of the National Economy and Society," adopted by the Central Committee of the Chinese Communist Party in March 2006

Why Economic Recovery Is Not Widely Felt

At present, the Japanese economy is experiencing the longest expansionary phase since the end of World War II, even longer than the *Izanagi* boom, which ran from November 1965 to July 1970. Yet, complaints are often heard, especially among people in provincial areas, that there is no real sense of economic recovery, that income is not growing, and that the income gaps are actually widening. Why is this so? One reason is that the current economic recovery is centered primarily on the manufacturing sector, and not a small part of it is sustained by external demand, particularly exports to such markets as the United States and China.

Public works used to play a major role in boosting regional economic and business activities. But since Koizumi Junichiro assumed the premiership in April 2001, the public works budget has been cut by 3% per annum. As a result, the regions without promising export industries have been left behind, and because of this a sense of economic growth has not been felt as a whole.

Future Direction

I have looked at the factors of economic growth from the supply side. Now, let's take a look from the demand side.

As Japan's population continues to decline, domestic demand will shrink in principle. Since a diminishing population means fewer customers, industry

Photo: Kyodo News

will not be able to expand. If we turn our eyes to Asia as a whole, there are potentials for new demand.

In Japan, the service industry, which accounts for 70% of total employment and of gross domestic product (GDP), has a much lower growth rate in productivity compared with the manufacturing sector or the service industries of the United States and other countries. I believe the low-productivity service sector has a big potential to become a new engine of economic growth once productivity rises. Problems are mother to opportunities, as the saying goes.

It is also important to ask ourselves this question: Where does Japan's strength lie? It is, I believe, in our small land area. This reality also fits into the "problems as mother-of-opportunity" concept. One special feature of the Japanese economy is that a wide variety of industries are packed into a very small land area. Japan's land area is only about the size of the State of California, but the number of companies in Japan is approximately two-thirds that of the entire United States. Japan has many first-rate businesses and great universities that can engage in collaborative work and conduct joint R&D in close proximity. This environment cannot be easily duplicated in the United States, or in China for that matter. To produce high-quality products at a high yield rate, it is necessary for engineers from many companies to get together to improve things, day in and day out. This environment is possible in Japan precisely because, cultural and historical factors apart, the country's land area is small.

Hence, two major directions lie ahead for the Japanese economy to sustain further development. One strategy is to further strengthen Japan's alliance with the rest of Asia and contribute to its growth so that the entire region can develop hand in hand. The other strategy is to encourage the autonomous development of regional economies in Japan.

For the purpose of the first strategy, we must first of all remove institutional roadblocks to increase exchanges with the rest of Asia. This means forging free-trade agreements and strengthening vertical regional cooperation. Japan itself must also push ahead with innovation and create an environment where

internationally competitive industries can operate more freely.

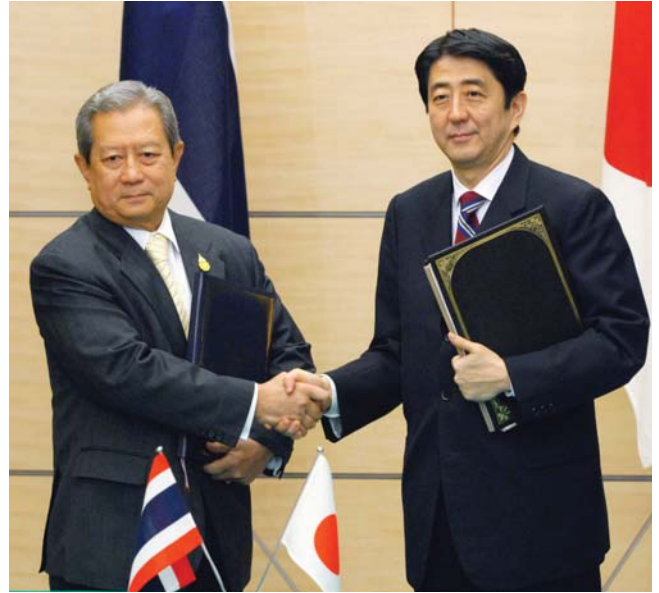
For the second, the industrial structures of Japan's regional economies must be transformed so that they can stand on their own. While those regional industries that are bracing themselves must work harder, efforts should also be made to attract investment from outside. The "hollowing out" of manufacturing industries used to pose a problem for Japan. This trend, however, seems to have reversed itself as Japanese businesses are increasingly inclined to build plants at home. METI will seek to encourage this trend. We will also try to create a framework whereby many autonomous industries that do not depend on public works, however small they may be, can be created in provincial areas so that new industries can constantly emerge in the economically deprived regions.

How to Bring the Economic Growth Initiative to Life

Former Economy, Trade and Industry Minister Nikai Toshihiro used to say, repeatedly: "The Economic Growth Initiative should not be a pie in the sky. We must turn the initiative into concrete action in the spirit of 'respecting every sentence.'" Since the initiative was adopted last year, METI has been working from various aspects to turn the program into reality.

(1) ¥300 bil. budget requested

The government's guidelines for fiscal 2007 budget requests, which were approved by the Cabinet on July 21, 2006, call for a sum of ¥300 billion to



Prime Minister Abe Shinzo shakes hands with his Thai counterpart Surayud Chulanont in Tokyo on April 3 after signing an economic partnership agreement which will eliminate tariffs on more than 90% of bilateral trade in 10 years.

be set aside for the promotion of strategies for economic growth. The funding is designed to cover expenditures for projects having particularly large effects on productivity, a policy specified in the Economic Growth Initiative.

Because public expenditures have to be curbed to rehabilitate government finance, no large budget can be allocated to enhance economic growth. On the other hand, without public funding, it would be impossible for the government to take measures to strengthen growth potential. Under the circumstances, the requested ¥300 billion appropriation can hopefully provide an incentive for government departments to use their own budgets toward growth policies.

(2) Review of the depreciation system

For economic growth, plant and equipment investment is important, and the depreciation system, which determines how expenses for capital investment are treated under the tax system, plays a significant role in promoting investment. Japan has not undertaken a full review of its depreciation system for more than 40 years and dramatically lags behind other countries in this regard. Therefore, the fiscal 2007 tax reform outline contains provisions to 1) raise

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As one of innovative technologies to be realized by 2025, an interim government report issued in February lists a maglev train traveling between Tokyo and Osaka in 50 minutes against about 2 hours and a half currently.

the ceiling of depreciation from 95% to 100% of the amount of investment and 2) shorten the legal period of depreciation to five years for manufacturing equipment for flat panel displays and other information technology products, where technological innovation is very fast. In addition, we must also continuously study how the tax system as a whole can increase Japan's growth potential, such as tax cuts for investment in information technology and R&D.

(3) Review of antimonopoly law guidelines

As international competition intensifies, many companies have formed alliances to strengthen their competitive edge. Since mergers and acquisitions that constrain competition are restricted by the Antimonopoly Act, we have reviewed guidelines on the types of M&A that actually restrict competition. Specifically, it has been decided to take into consideration the picture of inter-

national competition and the effect of R&D efficiency, whereas in the past the size of market share was the sole standard in deciding whether a particular merger or acquisition violates the law. This is expected to clarify the criteria for companies contemplating M&A, and also to increase the speed of M&A procedures.

(4) 3 laws related to the Economic Growth Initiative

In addition to these measures to promote the Economic Growth Initiative, three statutes are in the works. The new laws are designed to support the acceleration of innovation as outlined in the Economic Growth Initiative through innovation in the service sector and the revitalization of regional and smaller businesses.

<1st law> Revision of industrial revitalization law

The Law on Special Measures for Industrial Revitalization, which was first enacted in 1999 and revised in 2003, used to place policy emphasis on measures for "selection and concentration" and against "excessive plant and equipment investment." Now it will give priority to "innovation."

To support business efforts to improve productivity, the law will be revised to facilitate its use for productivity improvement in the service sector. Specifically, it will take into consideration characteristics of different service industries in spelling out the approach for support and its criteria; in the past, measures provided under the law for the manufacturing sector were uniformly applied to the service sector. The reach of the revised law will also be expanded to include the use of technology and intellectual property in alliance with other businesses or universities

and to promote cooperation among companies in different business lines. The law will also introduce a system to protect the rights of non-exclusive patent licensees to promote the utilization of intellectual property.

At the same time, because the ratio of nonperforming loans is high at regional credit associations and *shinkin* banks and the number of small bankruptcies is on the rise, the revised law will support the revitalization of small and medium enterprises in provincial areas. It will contain special measures on credit guarantees for bridge financing provided by financial institutions at the time of business rehabilitation and increase the speed of rehabilitation in cooperation with law courts.

Meanwhile, the concept of "capability of technology-based corporate management" will be introduced to the Law to Strengthen Industrial Technical Ability, enacted in 2000, to promote innovation. With emphasis on the importance of reflecting corporate R&D in business operations, this law will expand the scope of reduction in or waiver of patent fees for universities, and expand the scope of transferring the fruit of government-commissioned research conducted by private businesses to these companies.

<2nd law> Promoting business location in provincial areas

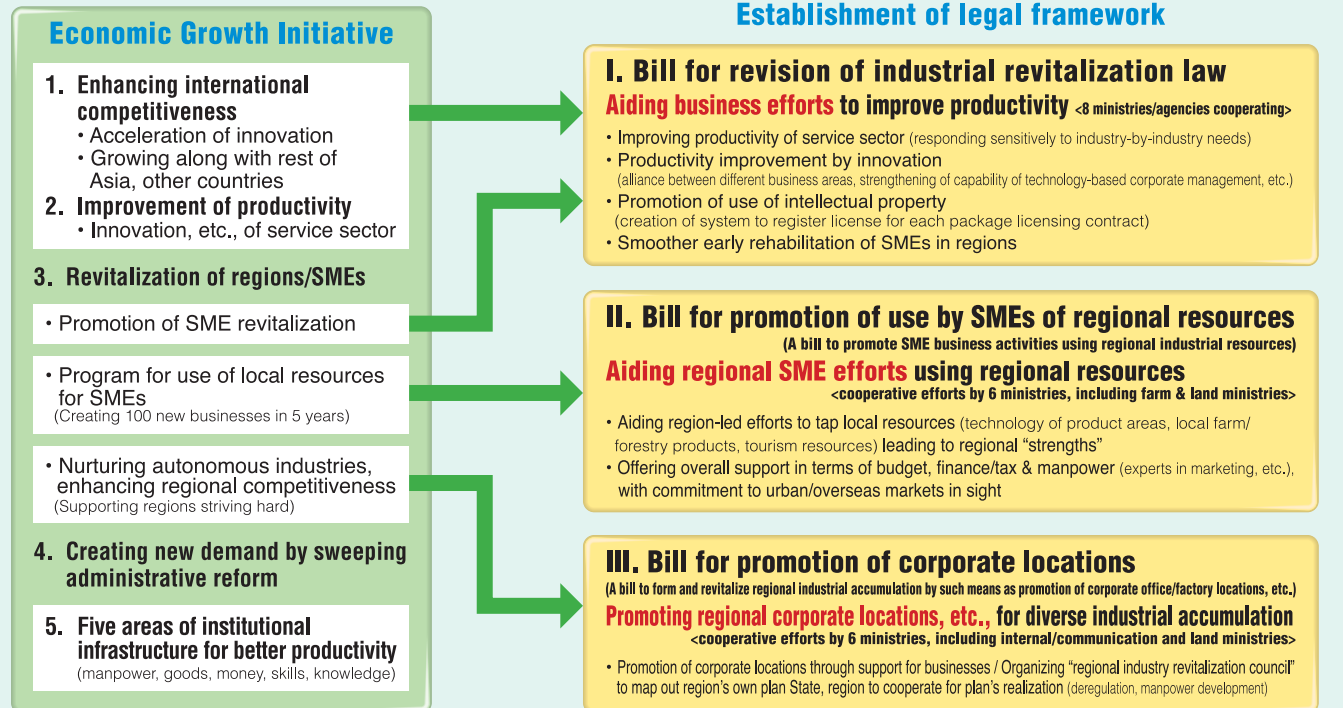
METI is working on a statute to promote the creation of industrial clusters in provincial areas. The law has been drafted with a view to encouraging businesses to locate their investment in Japan when choosing an investment location in rapidly developing Asia. For the purpose, the law seeks to create an environment in Japan comparable to the investment environment in Taiwan, China or in ASEAN countries. The key here is "speed" and "commitment."

Building a new plant requires a lot of administrative procedures. Quick decision-making and commitment through an improvement of communication within prefectures and municipalities are very important. For example, when there is an inquiry about setting up a large business operation in a particular

Overview of 3 bills related to “Economic Growth Initiative”

– Correcting disparities by growth & revitalization of regions/SMEs –

Legal framework eyed for productivity improvement & regional economic revitalization by innovation



*Key non-legal measures to realize the initiative

{ Budget: Request for FY 2007 appropriations of more than ¥300 bil.
 Tax revision: Sweeping reform of property depreciation system, etc.

prefecture, the new law will stipulate that the relevant municipalities and the governor of the prefecture promptly set up a forum for consultation. The forum will also include the participation of various stakeholders in the community. A prospective investor will feel more at ease if the governor, the mayor and other decision-makers in the community move forward once they get a presentation from the would-be investor. The focus of the new law is to create a system under which people with relevant authority can make commitments, and the ministries and agencies concerned will cooperate in the implementation of this law.

<3rd law>

Fostering new industries in provincial areas

Without doubt, the most effective means of regional development is to

attract large, state-of-the-art industrial plants capable of competing in Asia as a whole. Unfortunately, there are not many such projects. It is therefore necessary to nurture many autonomous industries able to take the place of public works through less ambitious but steady efforts. The Small and Medium Enterprise Agency is working on a law to support such efforts.

The new law is designed to support people who are fostering local industries by taking advantage of local resources. It has a numerical target of creating 1,000 such projects in five years. In recent years, many local industries have built their abilities to compete in the global market, while others have developed remarkable new products and captured large global market shares.

The focus of this law is to get people who understand the global market to

work in regions in an effort to make full use of dormant regional resources. In other words, this law is designed to create industries that will utilize regional resources and take products thus made to the global market. To assure that regional efforts are sustained and to prevent their efforts from being copied, the Trademark Act has been revised to allow the registration of regional trademarks as regional brands.

With a goal of achieving an average annual economic growth rate of 2.2% in real terms through 2015, we are taking many measures and hope to continue to take steady steps toward the realization of the New Economic Growth Strategy. **J.S**

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