Facing Up to Reality
The Path to a Genuine Growth Strategy

Author Kazumasa Oguro

By Kazumasa Oguro

Rapid Growth of Emerging Economies in Asia & Elsewhere

The most important structural change that the Japanese economy faces is the rapid growth of emerging economies in Asia and elsewhere. The rise of these economies has several implications for the Japanese economy. First, the growth of businesses based in these economies, particularly in manufacturing, is eroding the competitiveness of Japanese businesses and eating away at their profitability. For example, Samsung Electronics held an overwhelming advantage in flat-screen TV sets with a 23.8% market share in 2011, while LG Electronics followed with 13.7%. Japan's Sony, Panasonic, and Sharp followed these South Korean multinationals in third, fourth, and fifth place at 10.6%, 7.8%, and 6.8%, respectively. This state of the flat-screen TV market is reflected in the overall well-being of these companies, as Sony, Panasonic, and Sharp each registered hundreds of billions of yen in losses in the business year ending in March, sending shockwaves through the Japanese economy.

The growth of emerging economies also has positive effects on the Japanese economy, the most obvious being rapid market expansion, particularly in Asia. The Asian market, given its proximity, can be a major opportunity for Japan, where the domestic upside for increasing demand is limited because of aging demographics and a decreasing population. However, if Japan fails to secure this market and enjoy the fruits of the expansion of the emerging economies, its global status will continue to slip as it has been doing for the last couple of decades.

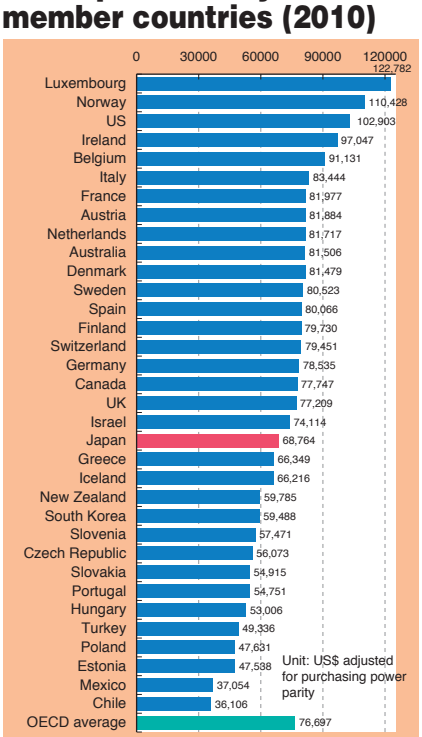
Stagnating Labor Productivity

Stagnating labor productivity is another important challenge that deserves mention when considering the growth of the Japanese economy. Labor productivity in Japan saw its growth rate fall significantly in the post-bubble era between the early and late 1990s, and is by no means at top international levels, currently in 20th place among the 34 OECD member countries *(Chart 1)*. Labor productivity is essentially determined by two factors: the amount of capital stock per worker and total factor productivity (TFP), the latter being an indicator of the level of technological progress. In contemporary Japan, there is excess capital stock per worker, which means that raising TFP, in other words technological progress and innovation, is the key to enhancing productivity. It is important in considering a growth strategy for the Japanese economy to bear in mind the need to continuously generate technological progress and innovation.

A look at the industrial level shows that labor productivity is lower in services than in other industries *(Chart 2)*. The proportion of service industries is rising, which means that the low labor productivity there is a major problem for the Japanese economy. It is important to note when we compare sectors for sales per worker

CHART 1

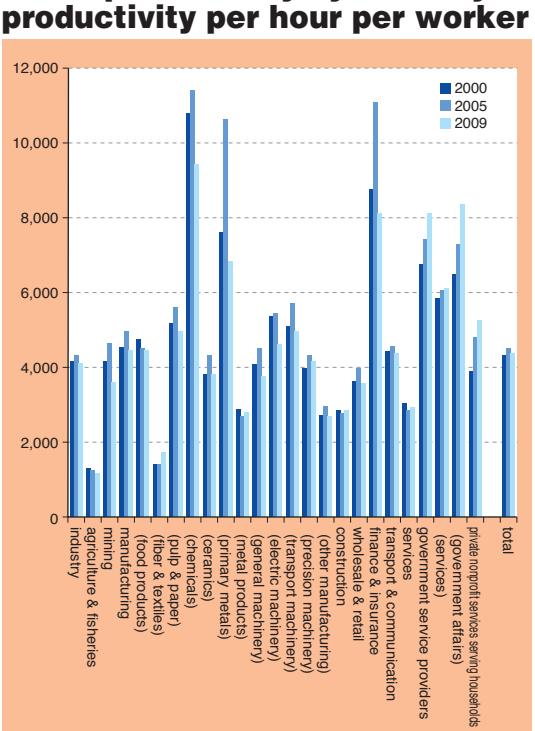
Labor productivity in OECD member countries (2010)



Source: Japan Productivity Center, "International Comparison of Labor Productivity 2011 edition"

CHART 2

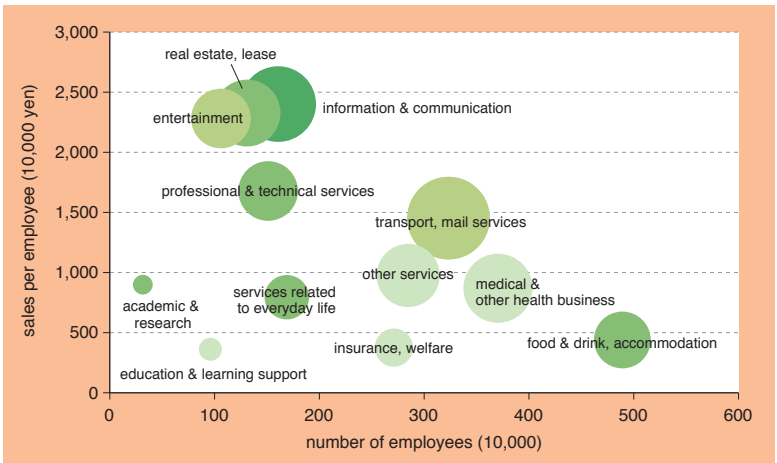
Labor productivity by industry productivity per hour per worker



Source: Cabinet Office, "Annual Reports on National Accounts"

CHART 3

Sales per worker & number of employees in service industries



Note: The circle sizes denote total sales for each industry.
Source: Cabinet Office, material for the ninth session of the Council of Experts concerning the Socio-Economic Structure

(labor productivity as expressed as "value added per hour by a worker" is not equal to sales per worker but it is safe to say that there is a close correlation between the two), that the level is high in entertainment and the information and communication industries but low in medical care and insurance and social work, where aging demographics and a declining birth rate are expected to generate growth *(Chart 3)*.

Measures to Pursue for Growth

We have looked at the structural changes and issues surrounding the Japanese economy. If we take a dispassionate view of this situation, it will be understood that it is not one that is as simple as some pundits claim, that "financial easing is all that is needed for growth" or that "growth can be achieved by fiscal stimulus", but that a structural undertaking is necessary to reinforce growth potential on a sustained basis. To put it another way, the Japanese economy has stagnated for so long because the Japanese government and businesses have not properly understood this need for structural change and failed to effect the necessary measures to achieve it.

What follows is an exposition on the direction that the Japanese economy should take in order to achieve growth, based on the above understanding of structural changes and challenges, while touching on individual industries and on some details of the substance of the measures that should be taken.

Growth Strategy for Manufacturing

As we have already seen, in order to achieve economic growth while the working population declines due to aging demographics and a low birth rate, it is essential to keep generating technological innovation and enhancing productivity. Of particular importance is the need to promote technological innovation that produces products and services that offer new value to consumers and creates new markets and demand. What, then, are the strategies that manufacturers, who have served as the backbone of the Japanese economy all these years, should be pursuing?

The "smile curve" provides hints for considering future strategies for the manufacturing sector. The smile curve is a graph that takes value-added as the vertical axis and plots from left to right on the horizontal axis the upstream-to-downstream business flow from design and development, to materials and parts, to assembly, to sales, and to after-sales services. It gets its name from its U-shape, which is the result of the fact that value-added is lowest in the middle, at the assembly process. Japanese manufacturers had excelled at vertically integrated production, which covered the entire smile curve by incorporating everything from materials to parts and devices, and to the sale of final products within *keiretsu* corporate networks. However, as products became commoditized, the modular model for production, which uses transnational division of labor to produce parts and components and assemble final products, became the standard mode of operation overseas. Confronted with fierce competition in cost reduction from emerging economies enjoying labor cost advantages in the middle of the smile curve at the assembly and parts and components stages and with a stronger yen eating away at export competitiveness, Japanese firms lost global share to the competition. Apple Inc., by contrast, which continues to run away with the smartphone and tablet markets with its iPhone and iPad, secures high profitability by outsourcing the middle of the smile curve and its low profit margins to Japanese, South Korean, and Chinese firms and concentrating on the high-value-added processes *(Chart 4)*.

In light of this situation, the basic strategy of Japanese manufacturers should be to steadily earn profits at the far ends of the smile curve, where value-added can be secured, by avoiding being tied down to the vertical integration model and adopting as required the modular production model based on division of labor. Specifically, strategies are important at the right-hand edge of the curve to enhance non-price competitiveness such as innovative interfaces and attractive designs and to sell "designs" that can be marketed overseas, and at the left-hand edge of the curve to earn profits not through sales of individual products but by delivering value to clients through an interrelated package of systems, solutions, and after-sales services, a business strategy called the shift to quinary industries (as a business model combining the secondary and tertiary industries). Note also that there are materials and components that are difficult to commoditize and that give a competitive edge to Japanese technological prowess and quasi-artisan, distinctly Japanese manufacturing aptitude. One possible strategy — a global niche-top strategy — is to secure high global shares and maintain pricing power in such areas through hard-to-copy technology. Either way, Japanese businesses must recognize that there is little chance for success in steaming ahead to compete on price while sticking to the vertical integration model, and must

CHART 4
Image of the "Smile Curve"

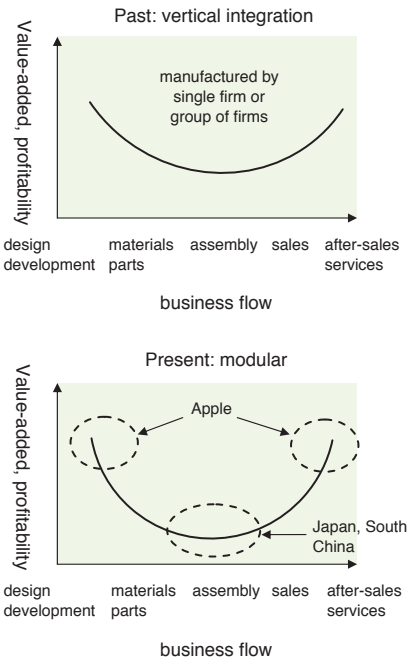
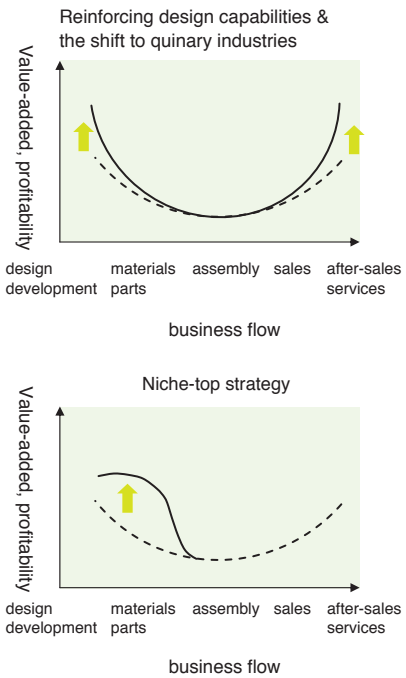


CHART 5
Japanese firms & images of their future business strategies



Source: Compiled by author

seek out strategies to survive the new competition environment *(Chart 5)*.

Securing Rapidly Growing Asian Market

Domestic demand in Japan will be limited demographically by the aging and declining population. This means that securing shares in the nearby Asian market with its voracious appetite for consumption will be essential to Japan's economic growth.

Seen from the other end, you could say that for more than a decade Japanese businesses and the Japanese government failed to develop a robust strategy to develop and secure a market that envisioned Asia's growth. In the manufacturing sector in particular, Japanese firms, represented by household appliance manufacturers, found themselves at a disadvantage in the fight with South Korean and Chinese firms to secure a share in Thai, Vietnamese, Indonesian and other rapidly growing markets. This situation calls for a reinforcement of overseas business development strategies that include changes in specifications and designs based on local needs — localization — combined with efforts to strengthen non-price competitiveness as well as value-added enhancement.

On the other hand, there is concern over the possibility that when businesses seek to expand their overseas activities, this will lead to the overseas transfer of production bases and eventual industrial hollowing-out. However, attempts to alleviate this concern by keeping Japanese firms at home may only result in obstructing their overseas expansion strategies and forgoing opportunities for economic growth. The important thing is to have the fruits of overseas production and direct investments by Japanese firms flow back to Japan and to connect them to reinvestment for strengthening domestic business operations and the enhancement of domestic employment. It is important to optimize location in Japan and abroad as a whole by maintaining at home business activities that enjoy a competitive advantage through their Japanese locations while moving forward with the expansion of overseas business activities.

In addition to preparing an appropriate environment through such means as the promotion of economic partnership agreements, the government could provide supplementary assistance for the overseas expansion strategies of these firms by such means as tax incentives for overseas direct investment and its repatriation. The "international strategy comprehensive special zone" is also a promising framework for focused application of special regulatory and taxation measures, serving as a turning point for firms and local governments to seize the initiative and consider international strategies while avoiding reliance solely on preferential treatment by the central government.

Recovering Dynamism of Domestic Economy

One factor obstructing enhancement of the productivity of the Japanese economy is the insufficient turnover of businesses due to the small number of business startups and closeouts. Capital and labor do not flow from areas with deteriorating profitability to growth areas where high profitability can be anticipated because market entries and exits do not go smoothly and mobility is low in the labor market. As a result, structural conversion of the Japanese economy in line with changes in the environment is being obstructed.

One particularly pernicious problem is the existence of "zombie" businesses: unproductive and low-profit businesses that should exit the marketplace but remain unculled because of government support and other causes. Zombie businesses have a negative impact on the productivity of the overall economy not only through their own low productivity but also by preventing high-productivity firms from entering the market and by retaining the human resources that should be flowing to those firms. In Japan, the financial authorities failed to deal resolutely with the post-bubble, nonperforming loan

issue in the banking sector, leading to the "zombification" of the banks. These zombie banks in turn have been accused of generating zombie businesses by supporting low-profit firms with low-interest loans and other means. Protective regulation and repeated economic stimulus packages are also believed to have been factors that kept zombie businesses in operation.

In order to enhance the overall productivity of the Japanese economy, it is necessary to construct a dynamic economy with high numbers of business entries and exits as well as high labor mobility. The government should revisit protective regulation benefiting preexisting industries and financial and other support for low-profit businesses, while tending to the social safety net (unemployment with time limits, education and training programs, job-labor matching services, etc.) in order to promote the exit of zombie businesses and the transfer of resources to high-growth sectors and businesses. Regulation of business reorganizations and mergers and acquisitions should also be reviewed concurrently.

Developing Growth-Leading Human Resources

Finally, the presence of human resources capable of leading technological innovation that produces new, revolutionary products and taking up the challenge of assuming the risk of starting up companies or new business operations is essential to enhancing the growth potential of the Japanese economy.

Important in the first instance for human resources capable of leading technological innovation are the reinforcement of corporate investment in human resources that will be responsible for cutting-edge technology and the improvement of the institutional environment so that the potential of personnel with new ideas will not be nipped in the bud by the kind of stifling environment often seen in large corporations. Personnel exchanges with other industries and academia are also important, since bringing together people with different backgrounds is also a fertile source of new ideas that lead to technological innovation. Many of the engineers and scientists on the cutting edge in South Korea, China, India, and elsewhere have studied overseas, particularly in the United States, and are networked through the relationships that they developed on those occasions as well as through international academic societies. Japanese corporations are sending increasingly fewer employees to study abroad; it is imperative to undertake the development of globally-oriented human resources so that they are not orphaned by the international network of the intellect.

In order to develop the foundation for developing top-tier human resources able to take the lead in technological innovation, it is also necessary to strengthen the skills-improvement function of universities and colleges relative to their research function. The definition of "education" is "to develop the faculties and powers of (a person) by teaching, instruction, or schooling" (*Random House Dictionary*); making everyone a researcher has never been the purpose of education. The purpose of education for the general public should be to develop occupational skills and secure employability. Nevertheless, there is no clear distinction between research and skills development in Japanese college education and the latter is relatively underemphasized. This has led to inefficiencies in the human resource system encompassing universities and colleges on the one hand and businesses on the other. It is necessary to strengthen the human resource development capacities of the institutions of higher education by promoting functional separation, strengthening "research universities" responsible for cutting-edge research, and increasing the number of institutions of higher education that specialize in skills development.

Attracting Human Resources from Overseas

When it comes to attracting human resources from overseas, China and India, with their huge populations that are improving rapidly in quality, are of the utmost importance. Regarding these two countries as sources of cheap, low-skill labor is now an anachronism. The intellectual classes in China and India are generally superior to their Japanese counterparts in their English-language capabilities and are becoming suppliers of engineers and other globally-oriented human resources. Rounding out the figures, Japan has 100 million people while China and India each have 1 billion. If we assume that capabilities are similarly distributed, the top 10% in China or India are as numerous as the entire Japanese population. There is no reason why Japan should not avail itself of this potential. Key to attracting human resources from these countries is the establishment of a pathway from their studies in Japan to jobs in Japanese businesses. The current situation is one where employment opportunities in Japan for overseas students who study there is limited so that overseas students who have studied in Japan are not being utilized for the Japanese economy. Efforts to reinforce matchmaking activities between these overseas students and Japanese businesses and to support the students in entering the job market are required, as well as steps to get emerging economies to incentivize students to study in Japan.

It is not easy for Japan to achieve high economic growth, given the huge constraints imposed by an aging and declining population. However, rushing from excessive pessimism to the conclusion that a diminishing equilibrium is inevitable from here on will destroy the path to growth before we have even set foot on it. What is needed now is a serious undertaking by businesses, government, universities, and other players to objectively analyze the structural changes and challenges facing Japan and find out where opportunities for the growth of the Japanese economy lie and what strategies are necessary to pursue those opportunities. The measures that I have indicated in this report should be an important part of the orientation of businesses and the government in considering strategies for future growth. JS

Kazumasa Oguro is an associate professor of the Faculty of Economics at Hosei University and consulting fellow, Research Institute of Economy, Trade & Industry, Ministry of Economy, Trade & Industry.