Is a Hollowing Occurring in Japan?

By Naoyuki Haraoka

What Is a Hollowing Out?

"Hollowing out" is a term often heard in Japan these days. The rise in energy costs, concerns about stable energy supply due to the crisis at the Fukushima Dai-ichi nuclear power station, and a large wage differential between Japan and other Asian countries are all feared to reduce Japanese industrial competitiveness, forcing firms to transfer their production facilities to countries where they can enjoy cheap labor and energy costs or set up business subsidiaries to expand their sales.

Chart 1 clearly shows this trend. The ratio of Japanese manufacturing firms' overseas subsidiaries' sales to the total of their domestic sales and overseas subsidiaries' sales has been increasing since 2001 and finally reached 18.3 % in the second quarter of 2012. Likewise the ratio of Japanese manufacturing firms' overseas subsidiaries' private investment in production equipment and facilities to the total of such investment domestically and by overseas subsidiaries has been increasing steadily since 2001 and eventually reached 20.7 % in the second quarter of 2012.

Concerns about a hollowing out of industries are ultimately concerns about the shifting of job opportunities overseas through foreign direct investment (FDI) from Japan. *Chart 2* shows that Japan's unemployment rate is lower than that in the United States and some major European nations. In September 2012, the unemployment rate of Japan was 4.2%, compared to the US rate of 7.8%. The unemployment rate in Japan has actually been falling slightly these past couple of years, suggesting that the steady and significant increase in activities by the Japanese manufacturing industry's overseas subsidiaries has not been leading to fewer employment opportunities inside the country and thus a hollowing out.

Future Prospects for Japanese Overseas Subsidiaries

METI's quarterly statistical survey of Japanese overseas subsidiaries' activities covered their performance by region as well as by industry in terms of sales, private investment in equipment and facilities, employment and future prospects. According to the latest survey for the second quarter of 2012, issued on Dec. 20, 2012, sales in North America rose by 13.0% over a year ago, registering a fifth consecutive quarterly increase. In particular, the transportation machinery industry's sales marked a 25.8 % increase over a year ago, whereas the electric machinery industry's sales fell by 14.2%, registering negative growth for four consecutive quarters.

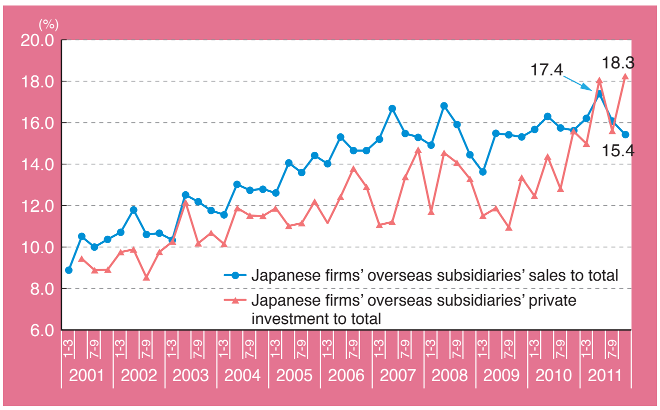
In Asia, their sales increased by 3.7%, a third consecutive quarterly rise. Transportation machinery sales increased by 19.9%, also rising for the third quarter in a row, while electric machinery sales dropped 9.9% for a fourth straight quarterly decline. In Europe, sales declined by 8.7% over a year ago, dropping for a second successive quarter. Transportation machinery sales showed the first decline after 10 quarters of growth by falling 6.4% over a year ago, but electric machinery sales dropped by 10.6% for a fifth straight quarterly decline.

The current business situation in each region is reflected in the performance of Japanese overseas subsidiaries, with the data showing that the EU currency and government debt crises have affected their business activities.

Data on private investment by these Japanese subsidiaries show a significant increase in investment in Europe as well as in North America and Asia. In all the three regions, there was a marked increase in private investment in the transportation machinery sector in particular, although in the electric machinery sector there was negative growth in private investment in North America and Europe. In Asia, however, investment

CHART 1

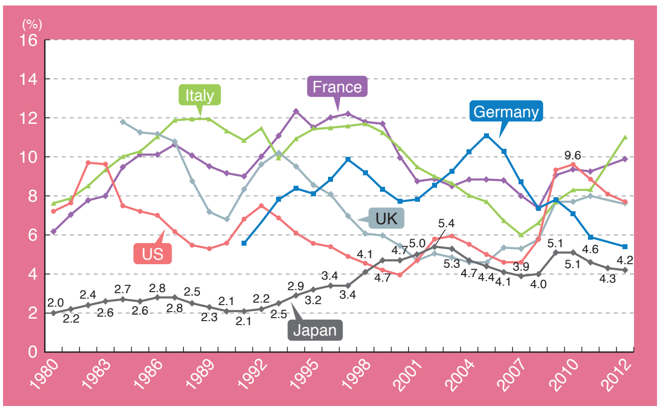
Increase in Japanese firms' overseas activities



Source: METI "Quarterly Statistical Report on Overseas Subsidiaries' Activities", MOF "Quarterly Statistics on Corporate Business"

CHART 2

Unemployment rates among developed nations



Source: Ministry of International Affairs and Communications of Japan, "Statistical Report on Labor Face" World Bank, IMF. etc.

in the electric machinery sector saw a significant rate of increase.

With regard to employment data, whereas in North America and Europe there was an increase in employment, in Asia there was a slight decline. In all three regions employment in the transportation machinery sector has increased, while jobs in the electric machinery sector have declined.

In order to assess the prospects for such firms, we can use a Diffusion Index (DI), defined as the percentage of firms assuming an increase in performance for each product minus the percentage of firms assuming a decrease in performance. For sales, the DI in North America was 11.2, with that for the transportation machinery sector being positive and that for the electric machinery sector negative. In Asia, the DI was 2.6 and in Europe 8.2, and again in both regions transportation machinery was positive and electric machinery negative.

For private investment, the DI was positive in all the regions, with that for transportation machinery again being positive and for electric machinery negative, while for employment the DI was also positive in all the regions. In North America it was positive in both transportation machinery and electric machinery sectors, whereas in Asia and Europe it was positive for transportation machinery but negative for electric machinery.

This survey indicates that most Japanese overseas subsidiaries see their future as positive in all three regions and are assuming they will increase their private investment and employment in all these major regions.

However, the IMF World Economic Outlook published in January 2013 suggested that global growth has not strengthened further, and its estimated world economic growth rate for 2013 is 3.5%, 0.1% lower than the estimate announced last October. This pessimism may be reflected in DIs in the future.

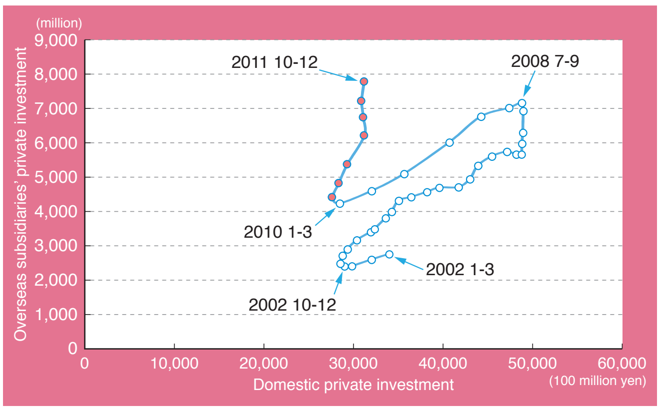
Another Indicator for Judging Hollowing Out

We cannot deny that these positive DIs will lead to further increases in transfers of production and business facilities overseas. An increase in FDI could bring about a hollowing out, though as suggested by the unemployment data it is not currently happening in Japan. It is difficult to predict whether a hollowing out is likely to happen or not. However, *Chart 3* shows another indicator which could help in predictions.

This is a comparison between Japanese domestic firms' private investment in production equipment and facilities and their overseas subsidiaries' investment in the same. Private investment is carried out to strengthen future production and business activities, so if overseas subsidiaries' private investment growth is positive whereas domestic firms' investment growth is negative it would mean overseas production facilities will increase and domestic production facilities will decline in the future, and as a result job opportunities will be transferred overseas. In that event, the unemployment rate in the domestic economy will rise, which would mean a hollowing out by our definition.

CHART 3

Domestic private investment & overseas subsidiaries' private investment



Source: METI "Quarterly Statistical Report on Overseas Subsidiaries' Activities", MOF "Quarterly Statistics on Corporate Business"

According to *Chart 3*, from the first quarter of 2010 until the second quarter of 2012, Japanese overseas subsidiaries' private investment grew rapidly, but domestic investment also increased, though at a lower rate. It is noteworthy that from the third quarter of 2008 until the first quarter of 2010 both domestic and overseas investments declined simultaneously, which can be put down to the impact of the Lehman shock

As far as we can interpret such data, Japanese firms' domestic and overseas private investments have increased or declined simultaneously so far. This means when Japanese firms decide to strengthen their overseas production facilities, they also decide to increase their domestic production facilities. Therefore employment opportunities must have increased in both Japan and overseas.

It should also be understood that Japanese firms' overseas investment has largely been in response to positive predictions of expansion in the overseas markets and not to negative assumptions about the worsening business environment in Japan.

But there have been concerns about smaller growth in domestic investment recently, so government policy should be aimed at creating new business opportunities inside Japan in order that FDI and domestic investment can grow at the same speed.

Another business survey announced by METI at the end of 2012 suggests the reason for the low unemployment rate in Japan. The number of part-time employees in Japanese companies has increased significantly and reached the highest level since the survey was started about 15 years ago. According to the latest survey, the number of employees per firm in Japan is 456, of which the number of part-time employees is 128. In particular, more than 60% of employees per firm in the retail sector are part–time workers.

I believe such diversification of types of employment contributes to the low figure for Japan's unemployment rate. A company can employ part-time workers on a contract for a limited period instead of firing permanent employees. Since these part-time workers are usually paid less due to limited working hours, this expansion of part-time employment could also lead to a reduction in total wage costs for Japanese firms, which would be one way of competing against Asian firms that enjoy the benefits of a cheap labor force.

A hollowing out of the Japanese economy can thus also be avoided by such increased employment of part-time workers. However, this could also lead to the destruction of Japanese management customs, lifetime employment and an employee's remarkable dedication to one firm, which have hitherto given a competitive edge to Japanese industries by enhancing corporate coherence and coordination, since it is easier to achieve business goals with a homogeneous workforce.

The new mission and challenge for Japanese management is to convince those part-timers of the merits of sharing business goals. Whether the Japanese economy hollows out or not could be influenced by how effective Japanese managers are in establishing common targets to be shared by all their employees. JS

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