Policy Goals and Measures for the Revival of Japanese Industry
–"Select and Focus" Strategy–

By Ezaki Tadashi

[1] Footsteps left by the Japanese economy and policy measures taken by the government since the collapse of the bubble economy

(1) Since the collapse of the asset-inflated "bubble economy" in the early 1990s, the government has implemented a series of pump-priming measures to rev up demand from the policy side. While the favorable effects of these measures have shown up to some extent, the economy has remained sluggish. The continued slump of the past decade stems largely from the fact that Japanese businesses - both financial institutions and general companies - have not seriously grappled with the fundamental task of disposing of the "negative assets" left behind after the collapse of the bubble. As a result, the Japanese economy has plunged into unprecedented difficulties, dragged down by three unfavorable factors that showed up successively in 1997.

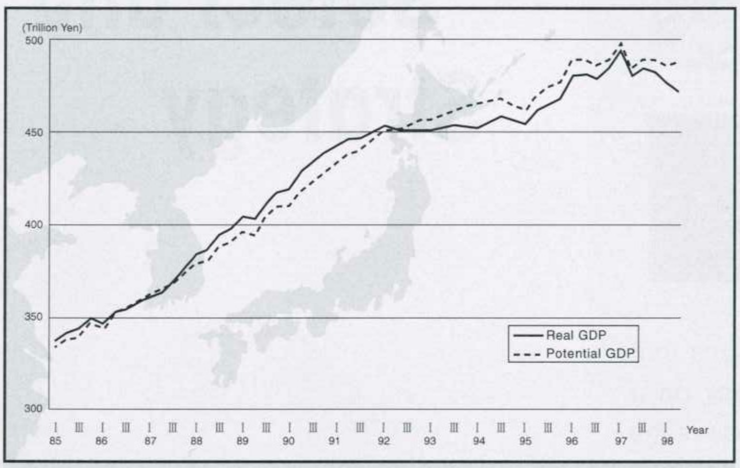

Figure 1 : Trend in Real GDP and Potential GDP

First, the measures taken by the government have had deflationary effects on the economy. Specifically, the government raised the consumption tax from 3% to 5% in April 1997 and discontinued income tax cuts that had been implemented ahead of the increase of the consumption tax. Moreover, it carried out reforms of the charges for medical treatment.

Second, Asian nations faced an economic crisis, notably a steep fall in the value of their currencies. The Asian economic crisis broke out in Thailand in July 1997 and spilled over to Malaysia, Indonesia, South Korea and Hong Kong. The successive turmoil in these Asian nations had a severe impact on the already feeble Japanese economy. The Asian crisis had a major adverse effect on Japan's exports to Asian nations while at the same time driving a large number of Japanese businesses operating there into a tight corner. Some of their parent companies in Japan were greatly affected.

Third, some major financial institutions collapsed under the heavy weight of the bad assets left behind after the collapse of the bubble economy. Some local financial institutions had already gone bankrupt. In the fall of 1997, however, such major financial firms as Sanyo Securities Co., Hokkaido Takushoku Bank and Yamaichi Securities Co became insolvent. The collapse of these major institutions created a shock wave in Japan because the Japanese people generally believed that even if they faced a financial crisis, private creditors and financial authorities would never let such struggling institutions go under since they were "too big to fail." But they actually collapsed - a fact that threw Japanese consumers into a psychological quagmire, leading to a steep fall in consumption. This in turn cooled off corporate enthusiasm about capital spending, resulting in a gradual fall in capital expenditure. Corporate sentiment was dampened further by banks' reluctance to lend. Ahead of the introduction in Japan in 1998 of capital-to-asset restrictions set by the Bank for International Settlements (BIS), financial institutions began to slash their assets. To this end, they became increasingly reluctant to lend to general companies.

The bad shape of real economic activities, combined with the collapse of public confidence in the financial system, sent the Japanese economy into a vicious circle in the latter half of 1997.

(2) This economic crisis turned out to be the worst in Japan's postwar history. The nation's economic activity deteriorated in 1998, with its gross domestic product (GDP) shrinking 0.1% in real terms in fiscal 1997, which ended in March 1998, and contracting 1.9% in fiscal 1998. The Japanese economy thus posted negative growth for the second year in a row. The worst economic crisis in postwar history prompted the government to take extraordinarily drastic economic measures.

First, the government implemented measures to restore stability in the nation's financial system. Specifically, the measures called for (i) stepping up efforts to make the financial system sound by strictly implementing inspections and supervision of financial institutions (including injection of funds into their depleted capital bases), (ii) improving mechanisms to deal with collapsed financial institutions (such as temporary nationalization, establishment of bridge banks and protection of depositors), (iii) measures to cope with the credit crunch, and (iv) making funds available to carry out these measures. The government adopted these measures one after another. In February and October 1998, it took legal steps in the Diet (parliament) to implement these measures and set aside funds in national budgets.

A wide array of financial measures included not only emergency steps but also those aimed at restructuring the financial system so that the financial authorities would be able to switch their policy from protecting the interests of financial institutions as a whole to putting priority on market mechanisms.

Second, the government implemented pump-priming measures to boost demand from the policy side. The Japanese economy was beset with a sizable oversupply due to a fall in consumption, lackluster capital spending and sluggish exports, with the manufacturing sector saddled by falling capacity utilization. In order to remedy the situation, the government decided to take measures to boost effective demand. In April 1998, it adopted a comprehensive economic stimulus package, including income tax cuts, totaling 16 trillion yen, followed by an emergency economic package, including tax cuts, totaling 24 trillion yen in November that year and another package totaling 17 trillion yen in November 1999. With these economic packages, the government now aims to get the economy back on a sustainable recovery track, with the real GDP growth rate projected at 0.6% in fiscal 1999. It intends to get the economy back on a full-scale recovery path in fiscal 2000 and to achieve real GDP growth of around 2%, led by private-sector demand, in fiscal 2001.

(3) These two emergency measures - which were aimed at restoring public confidence in the nation's financial system and limiting the fluctuations of the business cycle as much as possible - were needed to prevent a meltdown of the Japanese economy. As it turned out, the measures have begun to have a favorable effect on the economy. The GDP - total output of goods and services produced domestically - posted positive growth, albeit slightly, in the January-March and April-June quarters after shrinking for five consecutive quarters through the end of 1998. At long last, the Japanese economy is extricating itself from the worst period. However, the GDP contracted by 1% in the July-September period due in part to the fading effects of public investment. This means that private-sector demand remains weak and the economy has yet to enter a phase of self-sustained recovery. It faces the risk of following a downward trend again unless it is underpinned by policy aid.

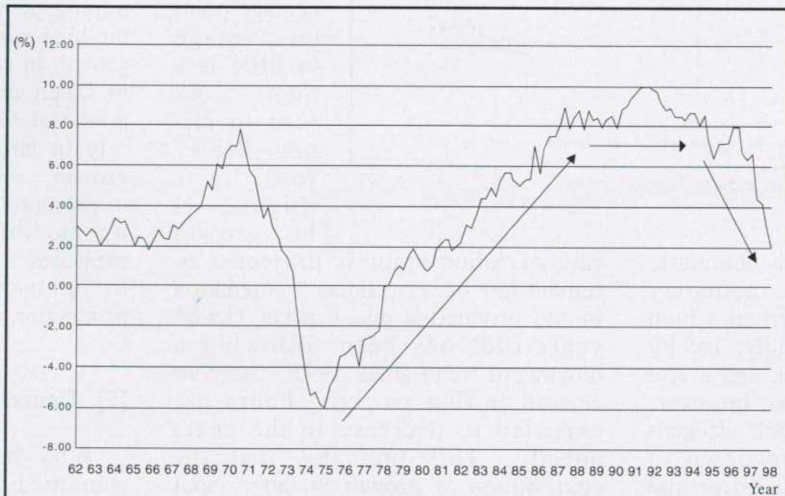

Figure 2 : Change in Growth Rate of Potential GDP

[2] Need for Supply-side measures - Medium- to long-term viewpoint -

A nation's long-term economic growth trend is undoubtedly determined by potential GDP growth.

Japan's potential GDP growth rate began to plummet following the collapse of the bubble economy. Since 1997, the growth rate is believed to have remained unchanged or moved into negative territory. It is clear that the critical fiscal constraints do not allow the government to continue to take measures to increase demand from the policy side. Even if the government takes additional measures, the measures would be nothing more than filling a supply-demand gap. As long as potential GDP fails to grow, real GDP does not grow beyond the ceiling of production capacity. The constraints on the supply side may, sooner or later, put a dent in Japan's medium - to long-term economic development. Moreover, it will take some time before the effects of supply-side measures crop up significantly. This indicates the need to analyze the factors behind sluggish potential GDP as soon as possible and steadily implement measures to buoy up potential GDP. (Figure 1: Trend in Real GDP and Potential GDP)
(Figure 2: Change in Growth Rate of Potential GDP)

[3] Factors that expand potential GDP

(1) The growth rate of potential GDP is the total of (i) the growth rate of capital input, (ii) the growth rate of labor input, and (iii) the change in the

growth rate of total factor productivity (TFP).

(Note) The total factor productivity as mentioned above is defined as the growth rate of potential GDP minus the growth rate of capital input and the growth rate of labor input. TFP is a broad perception that includes improvement of quality in capital stock due to technological innovation, improvement of labor quality due to the development of ability, organizational reforms, managerial reforms and other improvements of managerial efficiency.

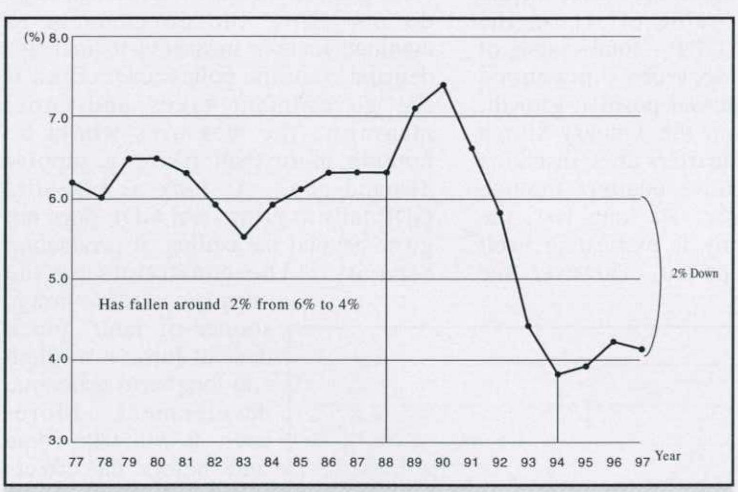

Figure 3 : Change in Growth Rate of Capital Stock

During the era of high economic growth, the Japanese economy followed a growth pattern in which potential GDP grew strongly, led by an increase in capital stock and a rise in TFP. The first oil crisis, however, sent growth of capital stock slackening. This led to a slowdown in economic growth in and after the latter half of the 1970s. More recently, the growth rate of capital input slowed down by 2 percentage points (from around 6% a year to around 4% a year) on average in and after 1994, compared with the pre-bubble period up to around 1988. (Figure 3)

Growth of capital input in the future is considered below.

With the rapid graying of its population, Japan's savings rate is expected to fall gradually to below 10% in about 2010 from the current 13% - a financial factor that tends to slacken growth in capital stock. In addition, the expected transition to a consumer-oriented society reflecting the diversification of people's value will make it difficult to follow capital expenditure-led economic growth. Therefore, it is unlikely that the contribution of growth in capital stock to the growth of potential GDP will remain high.

(2) The growth rate of labor input has also been declining in recent years. A comparison of growth rates in the pre-bubble and post-bubble periods shows a fall of around 1 percentage point on average (a little less than 1%/year to minus 0.5%/year). (Figure 4)

The growth rate of labor input is projected to remain low because Japan's population in the productive age bracket (15-64 years old) has been following a downward trend since 1995. Another reason is that working hours are expected to decrease in the years ahead. This indicates that the contribution of growth in labor input to growth in potential GDP may decline.

(3) Looking at growth in total factor productivity, no significant growth has been seen in Japan's productivity in recent years. Specifically, during the pre-bubble period of 1978-1989, the average growth rate was 1.3% a year. The figure compares with 0.5% a year for the post-bubble period of 1994 to 1996. The latest average figure represents a fall of nearly 1 percentage point. (Figure 5)

In addition, an international comparison shows that Japan has low productivity growth. For instance, an international comparison of TFP for the 1950-1993 period by the Organization for Economic Cooperation and Development (OECD) showed that Japan's average growth rate of TFP for 1987-1993 was at a record low of 0.8% a year, falling below the OECD's average of 0.9% a year. (Figure 6)

[4] Productivity needs to increase

The pivotal goal of a nation's economic policy is to improve its people's living standards. Whether or not this goal will be achieved is determined by the rise in productivity of domestic and foreign businesses operating in the nation. Thus the rise of productivity is the fundamentally important, decisive factor for determining people's living standards over the long run. Given the constraints on growth in capital stock and labor input in Japan mentioned above, growth in potential GDP has no choice but to rely in large part on productivity-led growth. This means that Japan needs to promote supply-side policies as part of medium to long-term policy measures to bolster productivity so as to jump-start growth in potential production capability (potential GDP).

[5] Causes of anemic productivity

Why has Japan's productivity remained at a low ebb for a long period of time? In order to sustain growth in potential GDP, it is essential to identify factors behind the sluggish productivity and take measures to reinvigorate it. The slack performance of productivity apparently stems from a combination of several factors.

(1) First, during the bubble-economy period many Japanese businesses

easily diversified and expanded their business areas, prompted by optimistic business prospects and swollen funds that could be raised at low cost. As a result, they rushed to make investments with low profit margins. After the collapse of the bubble, unprofitable business divisions were left unattended, with equipment, labor force and funds remaining there. The resultant distortion of production and earnings structures is one of the main factors behind sluggish productivity. To kick-start productivity, businesses need to transfer as soon as possible managerial resources (personnel, funds, equipment, technology, etc.) in unprofitable divisions with few prospects for growth to profitable divisions with high growth potential.

(2) Second, venture businesses have so far found it hard to flourish in Japan. This starkly contrasts with the United States and Europe where energetic venture businesses with high growth potential are growing steadily one after another. The steady birth and growth of such businesses help firms put new technologies to practical use, boost earnings and create opportunities for employment, thereby raising productivity in the nation as a whole. In Japan, various bottlenecks in terms of funds, personnel and technology have hindered the growth of venture businesses, with the opening rate of businesses running at below 4% a year in recent years, falling sharply below the figure of 13% for the United States. In order to make it easier to foster venture businesses, policy measures need to be taken in a broad range of areas.

(3) The third question lies in technological innovation. Obviously, technological innovation is a major factor behind the substantial improvement of total factor productivity. Japanese industry's innovative capability has reportedly been declining in recent years. Especially in the cutting-edge areas of information technology and biotechnology, Japan has lagged far behind the United States. If the current situation is left unresolved, Japanese industry is expected to face serious difficulties in the 21st century. The decline in innovative capability apparently results from several factors. First, specific, strategic results-oriented research and development have not been carried out in the private sector and national research institutes. Second, the outcome of research and studies at universities has not led to technological innovation by businesses. This stems from the content of research at universities and a lack of means to transfer the results of technological research to the private sector. The third problem is related to the government's policy of protecting intellectual property rights. The policy for protecting intellectual property rights taken by the government so far is not necessarily adequate from the viewpoint of creating technological innovation. A review is now being made in various policy areas.

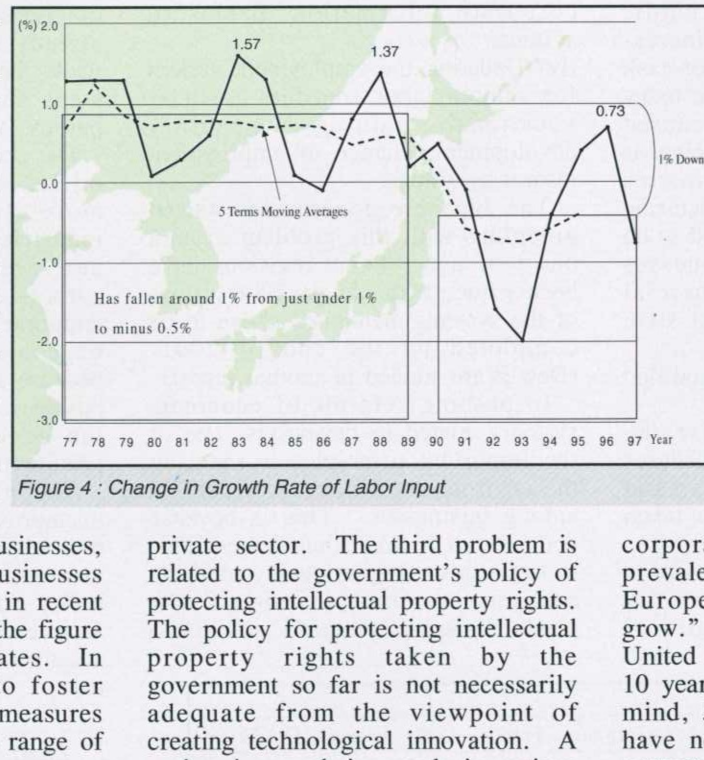

Figure 4 : Change in Growth Rate of Labor Input

[6] Policy measures to boost productivity
- "Select and Focus" Strategy -

(1) Of the three factors behind lackluster productivity in Japan, the second and third factors are studied on another occasion. This report focuses on the first factor - managerial resources such as equipment, labor force, funds and technologies left behind in unprofitable business divisions with few prospects for growth. For individual companies, the question is how to make the best use of their own managerial resources. To this end, individual companies need to recognize that they themselves are the main players for the improvement of productivity. Based on this, individual companies need to sort out business areas that will become the core of strong competitive power and focus their managerial resources on these potential areas. During this process, they have to transfer managerial resources from unprofitable divisions to the core areas. This is the policy of the "Select and Focus" Strategy. The "Select and Focus" Strategy, if implemented thoroughly, requires not only in-house reorganization but also dynamic organizational restructuring, including the transfers of individual divisions and the takeover of divisions from other companies, the utilization of holding companies, and the spinning off of divisions, joint ventures and corporate alliances. Such corporate restructuring is already prevalent in the United States and Europe, and is called "shrink to grow." Japan has lagged behind the United States and Europe by around 10 years. With this serious delay in mind, Japanese business executives have now begun to tackle business restructuring earnestly. The shrinkage of business divisions often involves managerial woes such as severing long-established business ties and tensions with labor unions. But executives have begun to make decisions and implement restructuring measures. (Details are studied in

another report)

(2) In this connection, the Japanese government has a big role to play. The government has thus far implemented policies toward businesses on the premise that Japanese businesses would face no need to carry out the bold organizational reforms that are required today.

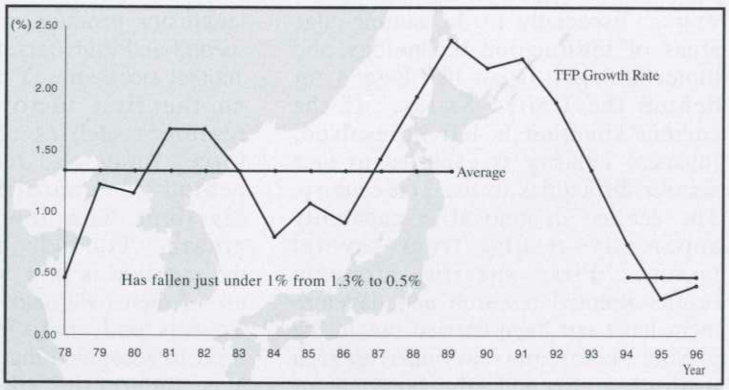

Figure 5 : Change in Growth Rate of TFP

Therefore, various systems concerning Japanese business corporations, including laws and other public systems, have now become increasingly inadequate. The major task facing the Japanese government today is to do away with system-caused barriers to corporate restructuring as soon as possible so that businesses will be able to carry out restructuring easily. Some barriers may need to be removed by private businesses themselves, such as commercial customs. But many of them stem from outdated public systems.

The areas that should be modified follow:

(i) Legal measures to revise the Commercial Law so that procedures for organizational changes and corporate rehabilitation can be taken speedily and flexibly.

(ii) Introduction of tax payments on a consolidated basis and other tax measures so that organizational changes would not put the businesses involved at a disadvantage.

(iii) Bringing Japanese corporate accounting rules in line with international standards and improving corporate information disclosure systems.

(iv) Updating the employment system for smooth labor transfers (such as vocational training, capability development, change of employment insurance system).

The Japanese government started grappling with this problem around one year ago. Some revisions have been made, with almost all revisions of the systems mentioned above to be completed by the end of 2001. (Details are studied in another report)

In pushing reforms of economic systems related to businesses, one of the important principles is securing the environment for free competition among businesses. This is because competition between businesses leads to lower costs, higher-quality products and services, the creation of new products and production processes, and prompting business innovation, thereby raising productivity. Inadequate rules and exclusionary transaction practices that hamper fair competition need to be removed in order to improve economic efficiency.

(3) A broad range of activities to raise productivity as referred to above can produce favorable effects if the private and public sectors carry out them boldly in a way that is commensurate with their roles. The Japanese government set up the Industrial Competitiveness Council in March 1999. This blue-ribbon council, chaired by Prime Minister Obuchi Keizo and made up of main cabinet ministers, and representatives from business circles, is energetically discussing ways to strengthen productivity. Based on the outcome of discussions, the private sector has already embarked on restructuring while the government has taken legal steps and set aside funds for that purpose at an unusually high speed.

The active efforts by the public and private sectors are expected to ensure more efficient, highly productive industrial activities in existing and new areas nationwide and at the corporate level. Restructuring may temporarily have deflationary effects on economic activity as a whole because it involves the shrinkage of business. To wipe away such fears, the government has taken pump-priming measures.

The effect of supply-side measures to improve productivity is expected to crop up while the effect of additional measures to boost demand from the policy side continues, thus getting the Japanese economy back on a self-sustained recovery path in a year or two. JJTI

(%) Year	Japan	U.S.A.	Germany	France	U.K.	Average of OECD
1950-73	4.6	1.5	2.5	3.8	2.5	2.7
1973-87	1.1	0.2	1.0	1.3	1.0	0.8
1987-93	0.8	0.6	1.0	1.4	1.5	0.9

Japan's productivity growth rate (0.8%) has dropped below the OECD average of 0.9%

Table 1 : International Comparison for "Productivity"

Ezaki Tadashi graduated from the Law Faculty, the University of Tokyo. He is a former Director-General of the Industrial Bureau of the Ministry of International Trade and Industry, and is currently an Advisor to the Japan Economic Foundation.