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Restoring Japan's Economic Competitiveness

—Regeneration and adaptation to globalization and digitalization is essential —

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〈Summary〉

◆ Regarding Japan's macroeconomic policies to date, while the economy can be said to have been hampered by a hint of fiscal tightening, substantial monetary easing, despite resulting in a significant depreciation of the yen, has not led to increased investment or exports. In light of this, the fact that it has been impossible to take bold measures to tackle micro issues and halt the decline in competitiveness is another factor that cannot be ignored.

◆ According to IMD, Japan's competitiveness has been declining rapidly since the late 1990s, and our GDP per capita has fallen in the rankings accordingly. The fundamental factors behind Japan's declining competitiveness can be identified as 1) slow pace of business management, 2) lack of enthusiasm for and understanding of digital technology, and 3) slow response to globalization. The slow pace of business management is due to insufficient regeneration (i.e., the replacement of the old with the new) on the corporate side, a labor market that lacks fluidity on the worker side, and personnel systems that emphasize seniority. Digitalization is problematic because of an attitude of prioritizing cost reduction over value-added creation, bias that favors hardware, etc. Globalization and the overwhelming dearth of opportunities for both firms and personnel to gain experience with import/export and investment are stumbling blocks.

◆ If Japan is to regain its competitiveness, it is imperative for firms and personnel to boost their regenerative capacity and bolster their responses to digitalization and globalization. First, the targeting of support needs to be shifted from firms to workers. Specifically, the conventional system of leaving employment matters up to firms needs to be replaced,

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support measures for small and medium-sized enterprises (SMEs) need to be scaled back, and government support for the labor market should be expanded. Second, it is necessary to change methods of supporting firms to provide incentives for value-added creation. Third, reform of the personnel and wage systems of firms is essential. This should include a revamping of the seniority system, the introduction of job-based employment, and the development of expert specialists. Fourth, effort should also be exerted in reforming the social security system to secure financial and human resources for growth areas.

◆ While it is essential to increase fiscal spending until the GDP gap is closed, the money needs to be directed at areas that contribute to the recovery of competitiveness. For example, there need to be investment tax cuts to promote digitalization, proactive labor policies such as recurrent education, and human resource investment to keep up with globalization.

- **This is a English version of "わが国経済の競争力回復に向けて― 新陳代謝、グローバル化・デジタル化への適応が不可欠 ―" in JRI Viewpoint (The original version is available at https://www.jri.co.jp/MediaLibrary/file/report/viewpoint/pdf/13514.pdf)**

1. Introduction

In the West, real GDP has recovered to pre-COVID-19 levels across the board as the spread of the disease has slowed. In addition, inflation is running high due to heightened supply constraints stemming from the spread of COVID and soaring resource prices in the wake of Russia's invasion of Ukraine. In contrast, Japan's real GDP has yet to recover to its pre-COVID level, and the inflation rate remains around 2%. Moreover, if increases in the prices of food and energy are excluded, inflation has not even reached 1%. This disparity in economic performance is largely due to differences in responses to COVID. The U.S. launched a massive support program that included large cash handouts, while the measures taken in Japan and Europe were more muted. In addition, the U.S. and Europe were swift in altering course to living with COVID, but Japan has remained cautious.

However, it is an undeniable fact that even before COVID, Japan's economic performance was far below that of the West. Japan's potential growth rate has been declining since 2014, and as for inflation, the economy's thermometer, Japan has been unable to shake off a disinflationary situation, with the inflation rate stuck at 1% at best pre-COVID, despite the Bank of Japan (BOJ) declaring that 2% is the target. In addition, Japan's GDP per capita, once one of the highest among OECD countries, has clearly stalled, having last been higher than the OECD average back in 2015.

In response to this economic slump, there are growing calls in some quarters for the need to boost the economy through a large-scale expansion of fiscal spending. However, Japan's economy has failed to achieve a full-fledged recovery despite repeated expansionary macroeconomic policies being implemented since the bursting of the bubble economy. In the 1990s, large-scale investments in public works were made, but as government debt swelled and the stimulative effect faded, in the 2000s advocates of the importance of monetary easing policies became more vocal. Since the latter half of the 2010s, the BOJ's so-called "extra-dimensional easing" approach has eliminated the capacity for monetary policy to respond to issues, and there are once again growing calls for economic stimulus measures in the form of tax cuts and increased fiscal spending. With the repeated implementation of expansionary macroeconomic policies not having demonstrated adequate effectiveness, is it really necessary to further expand macroeconomic policies such as fiscal stimulus measures? Are there any factors besides macroeconomic policies that have contributed to the prolonged stagnation of our economy? Here we will explore the true causes of Japan's economic stagnation to date by comparing its macroeconomic policies with those of the other G7 countries.

2. International comparison of macroeconomic policies and economic performance

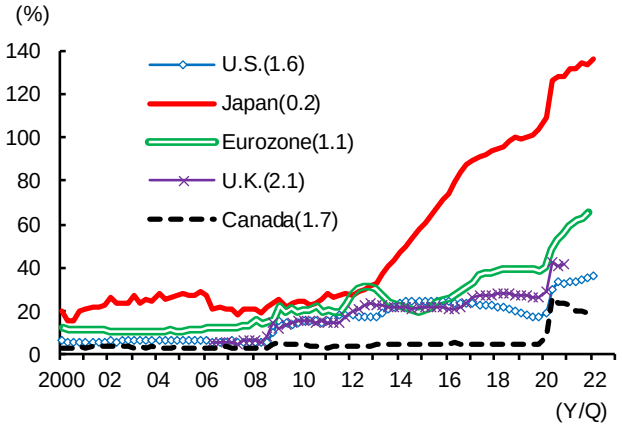
(1) Monetary policy

First, let us look at the degree of monetary easing. Looking at ratios of central bank assets to GDP for the G7 since 2000, we see that Japan's ratio has increased significantly, with the Eurozone following (Figure 1 on next page). On the other hand, the average core inflation rate since the financial crisis triggered by the collapse of Lehman Brothers (2010-2019), when many central banks embarked on quantitative easing (QE), was highest in Canada and the U.S., where there has been no marked expansion of central bank assets, and lowest in Japan,

where BOJ assets expanded significantly. In other words, central banks in countries with a strong deflationary tone have been aggressive in QE, while those in countries where deflationary concerns are small have limited their QE.

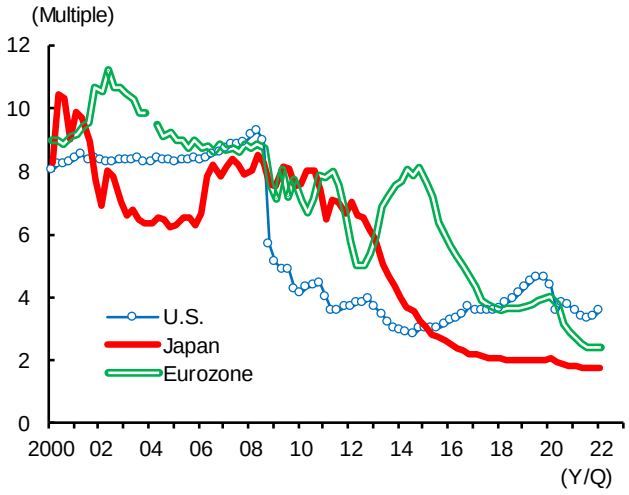
Two possible explanations for why the BOJ's massive monetary easing has not pushed up inflation are that either the BOJ has not yet done enough monetary easing even though it has brought its assets up to a level that exceeds nominal GDP, or that even though the BOJ has carried out monetary easing, the effect of this has not been evenly distributed across the real economy. Therefore, looking at the credit multiplier (money supply / base money) for Japan, the U.S., and Europe, we find that the credit multiplier in Japan has declined significantly each time the BOJ has embarked on large-scale monetary easing, suggesting that the BOJ's QE has not had a broad impact on the real economy (Figure 2). Theoretically, the fact that the money supply did not increase significantly despite the BOJ's extra-dimensional easing could be attributed to 1) restrained fiscal spending, 2) financial institutions being cautious about lending in light of the risks, and 3) firms themselves not actively conducting investments (lack of demand for funds) amid a decline in the expected growth rate and chronically ultra-low interest rates. As for 2) financial institutions being loathe to lend, given that the financial system instability had largely been resolved by the early 2000s, it can be inferred that 1) and 3) constituted problems. In particular, with regard to 3), the expected growth rate of firms (real economic growth forecast for the next five years) fell below 2% in FY2007 and has remained low at around 1.0% since FY2015, suggesting that the absence of expectations for growth is causing firms to take a cautious stance toward investment as well as a restrained attitude toward borrowing. These figures also suggest that deflation and disinflation in Japan are not due to a lack of monetary easing by the BOJ, but to fiscal policy that was not necessarily aggressive and a failure to raise growth expectations[1].

Figure 1. G7 Central Bank Balance Sheets (Ratio to Nominal GDP)



Sources: U.S. Bureau of Economic Analysis, FRB, Cabinet Office, BOJ, Eurostat, ECB, U.K. Office for National Statistics, Bank of England, Statistics Canada, Bank of Canada
Note: The figures in parentheses in the legend are the average core inflation during the period 2010-2019 (in the case of Japan, fresh foods and energy are excluded).

Figure 2. Credit Multiplier in Japan, the U.S., and Europe (M2 / Base Money)



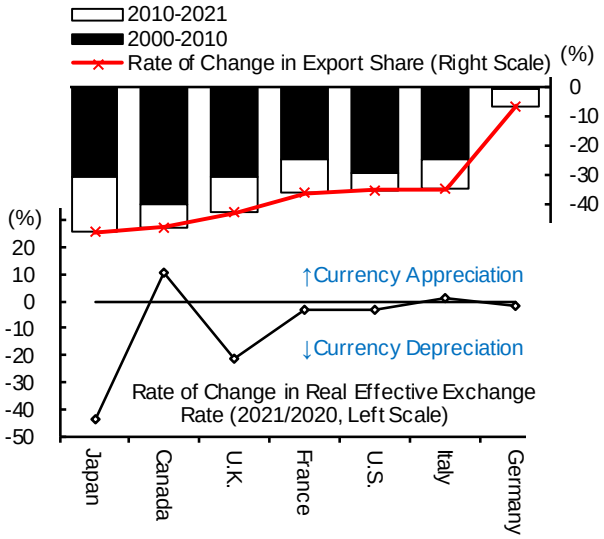
Sources: FRB, BOJ, ECB

[1] Incidentally, the velocity of money (nominal GDP / money supply) in Japan has also declined continuously since the collapse of the bubble economy, indicating that monetary easing has lost its ability to boost economic growth or inflation.

(2) Exchange rate policy

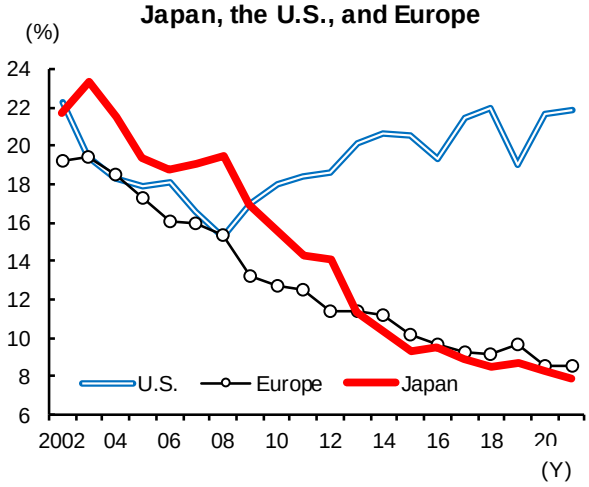
Looking at exchange rate trends, which are strongly influenced by the degree of monetary easing, the yen has fallen sharply, depreciating by more than 40% between 2000 to 2021 on a real effective exchange rate basis. On the other hand, despite this precipitous drop in the yen, Japan's share of global exports has declined the most, falling by half over the same period, so the depreciation of the yen in real terms has not led to an increase in Japanese exports or even economic growth (Figure 3). Of particular concern is the fact that during the 2000s, most developed countries, with the exception of Germany, experienced a decline in their export share as they shifted production facilities to emerging countries, but in the 2010s, the drop in Japan's share is what has stood out. The main reason for the decline in Japan's export share is the shift of production facilities overseas and the advance of "local production for local consumption" against a backdrop of shortages of electric power and rising electricity costs in the wake of the Great East Japan Earthquake, and the yen's appreciation beyond 80 yen to the dollar from the Lehman collapse to the beginning of 2012. However, a decline in the competitiveness of Japan's electrical machinery sector, including semiconductors, and the failure to create alternative export industries has also been a contributing factor. In fact, Japan's semiconductor industry, which once dominated the world, has lost ground to competition from South Korea and Taiwan, which have been aggressively investing in the sector, and has now fallen behind China's semiconductor industry. As such, Japan's share of global semiconductor shipments has dropped to around 8% (Figure 4).

Figrure 3. Share of Exports and Real Effective Exchange Rates among G7 Countries



Source: Prepared by JRI based on data from the OECD and BIS

Figure 4. Share of Semiconductor Shipments (in Monetary Terms) of Japan, the U.S., and Europe



Source: World Semiconductor Trade Statistics

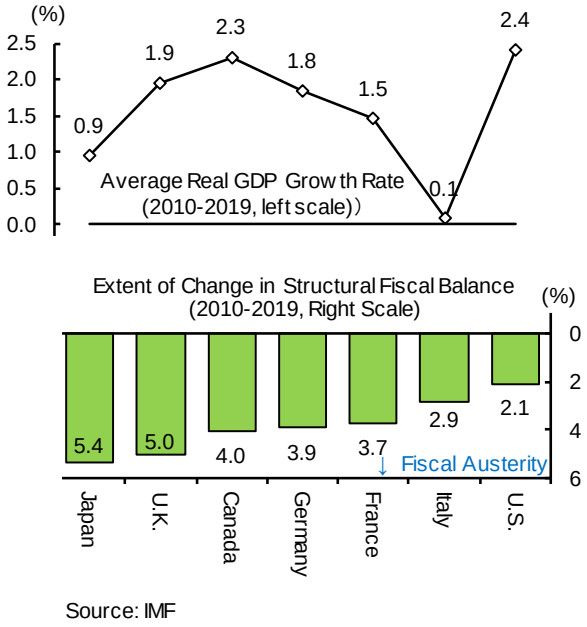
(3) Fiscal policy

In contrast, regarding fiscal policy, the degree of fiscal tightening in Japan between 2010 and 2019[2] has been the largest among major advanced countries, and this has undoubtedly been a drag on economic performance

[2] Since tax revenues increase when the economy expands and decrease when the economy worsens, the change in the ratio of structural fiscal balance to GDP adjusted for the business cycle is used here as a measure of the degree of fiscal tightening.

(Figure 5). However, the average growth rate of the U.K, where a similar level of fiscal austerity to Japan has been pursued, was one percentage point higher than that of Japan, while Italy, where fiscal austerity has been limited, saw much slower growth than Japan, making it difficult to say that fiscal austerity alone is the decisive factor behind low growth. Rather, it could be argued that given the enormous government debt and the inability to engage in unrestrained fiscal spending, it is possible that appropriate spending in areas conducive to growth, so-called "smart spending," was not carried out.

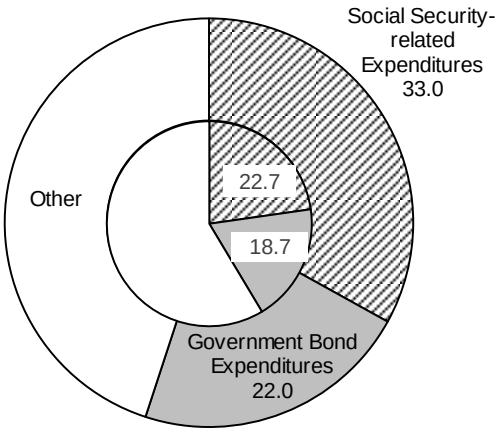
Figure 5. Real Growth Rates and Ratios of Structural Fiscal Balance to GDP among G7 Countries (2010-2019)



Source: IMF

In fact, Japan's consumption tax was increased during this period, and most of the increase was allocated to social security-related expenses. In other words, looking at the changes in revenue and expenditure from FY2001 to FY2019, we see that the consumption tax rate hike boosted revenue by 8.5 trillion yen, while other tax revenues increased by 6.4 trillion yen, but that the increase in tax revenue was used to fund the higher social security-related expenses such as pension payments, medical care, and long-term care associated with the aging of society (these climbed from 19.3 trillion yen in FY2001 to 33.5 trillion yen in FY2019). While these expenditures can contribute to a steady expansion of consumption, especially among the elderly, they are unlikely to induce innovation and promote growth. In addition, government bond expenditures increased by 6.7 trillion yen as the national debt swelled, necessitating an overall decrease in other spending. As a result, if we look at the breakdown of expenditures by category, we find that social security and government bond expenditures, which were only 40% of total expenditure in FY2001, had risen to 55% in FY2019 (Figure 6). The aging of the population and the rising debt have led to rigid spending and insufficient funding for areas essential for future growth, including digitalization and education.

Figure 6. Breakdown of Government Expenditures (Inner Circle: FY2001, Outer Circle: FY2019)



Source: Ministry of Finance
Note: All figures are from the finalized fiscal-year end accounts.

Given the macroeconomic policies and actual economic trends described above, there is no doubt that the tight fiscal policy has been a drag on the Japanese economy. However, it can be pointed out that in terms of macroeconomic policy, a major factor has been problems not only with quantity but also with quality, as the

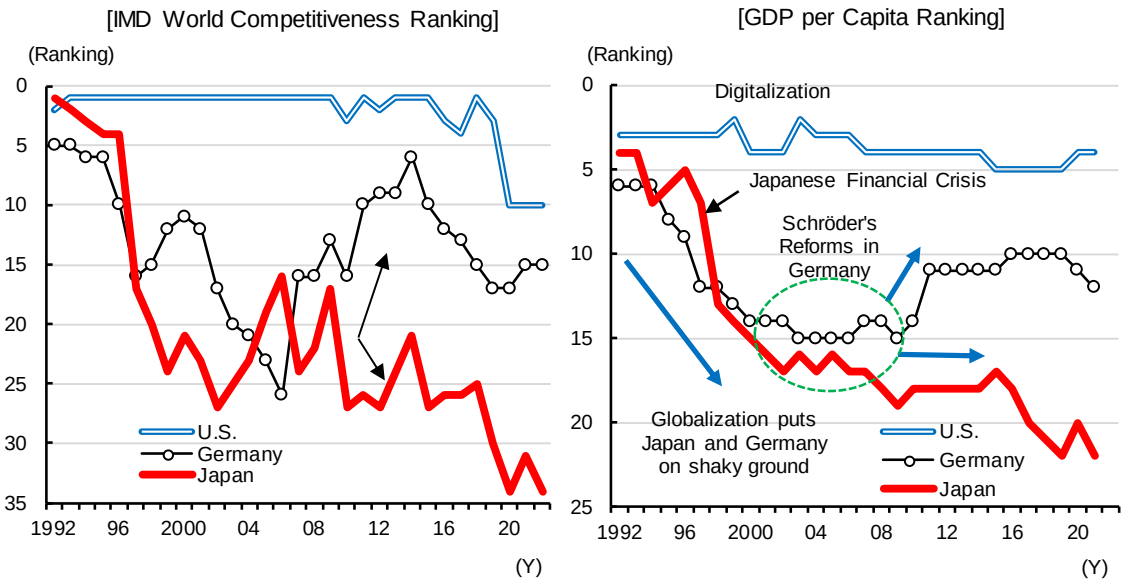
aging of the population and the fiscal rigidity caused by rising public debt prevented the government from creating truly effective policies for the economy and inducing private sector investment. Above all, it can be said that although extra-dimensional monetary easing continued to be pursued as the best recipe for economic recovery, based on the diagnosis that "deflation" was the main cause of the economic stagnation, the fact that it has been impossible to take bold measures to tackle micro issues and halt the decline in the competitiveness of Japanese firms is another factor that cannot be ignored. Such measures could have included strengthening the semiconductor industry and creating new export industries, as low growth expectations and weak exports were the real causes of sluggish investment.

3. Current status of Japan's competitiveness and its causes

(1) Current status of Japan's competitiveness

In fact, Japan's competitiveness has been declining rapidly since the late 1990s, and has recently fallen behind most other advanced countries. According to the World Competitiveness Ranking from the International Institute for Management Development (IMD[3]), Japan, which was in the top class in the early 1990s, slid down the ranking significantly after the financial crisis of 1997, and since the mid-2010s Japan's ranking has dropped even further, such that as of 2022 the country stands in 34th place out of 63 countries. In tandem with this, Japan's GDP per capita on a purchasing power parity basis has also dropped to 20th place among OECD member countries, which suggests that declining competitiveness is the main cause of economic stagnation (Figure 7).

Figure 7. Competitiveness Ranking and GDP Per Capita of Japan, the U.S. and Germany



Source: Prepared by JRI based on IMD, "World Competitiveness Ranking"

Source: OECD, "OECD National Accounts Statistics"
Note: Rankings are among OECD countries.

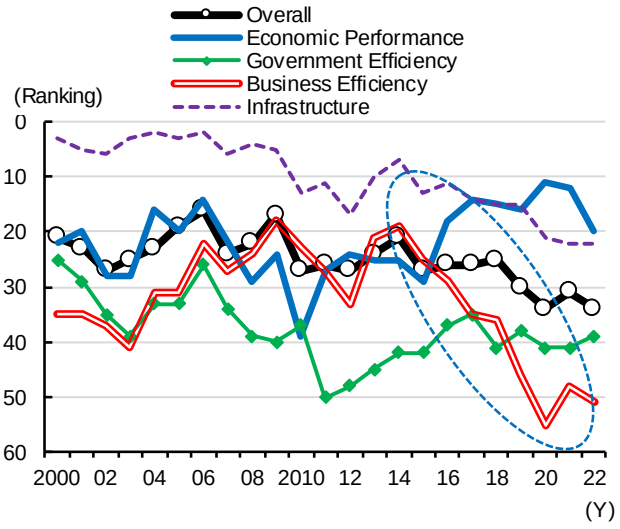
[3] Business school in Lausanne, Switzerland. The school's annual World Competitiveness Ranking, World Digital Competitiveness Ranking, and World Talent Ranking are important indicators of the competitiveness of countries and firms.

Incidentally, Germany, which had been an export-oriented country on par with Japan, also experienced a significant drop in both world competitiveness ranking and GDP per capita in the early 2000s as the end of the Cold War triggered the advance of globalization. It was even ridiculed as "the sick man of Europe" at the time. However, under the leadership of Chancellor Schröder, whose Social Democratic Party was supported by labor unions, labor market reforms aimed at increasing job mobility, including through the relaxation of restrictions on dismissals, and social security reforms (Agenda 2010) aimed at reducing the burden on firms, such as raising the age from which people could receive their pensions, were implemented. As a result, Germany's competitiveness has increased rapidly since the late 2000s, and its GDP per capita rose to second place among the G7 countries in 2011, after the U.S., and has maintained the same ranking ever since. While Japan was exposed to yen appreciation pressure after the Lehman collapse, Germany benefitted from a tailwind in the form of the introduction of the euro, which in effect abated any currency appreciation pressure. Nevertheless, the difference between Japan and Germany in the strengths of their reform drives aimed at boosting competitiveness manifested itself in this economic performance gap between the two countries from the late 2010s onwards.

(2) Background to declining competitiveness

A breakdown of IMD data provides some insight into the background to the decline in Japan's competitiveness. It shows that while the country has slipped down the rankings in terms of infrastructure, which had been a strength, it is "business efficiency" that has been dragging Japan even more. On this measure, Japan has fallen from 19th in 2014 to 55th in 2020 (Figure 8). A breakdown of "business efficiency" shows that 1) "management practices" (e.g., corporate decision-making speed), 2) "productivity and efficiency," and 3) "attitudes and values" (e.g., digitalization readiness, adaptability to change) are especially low for Japan, making them the key factors in the country's diminishing competitiveness[4] (Figure 9 on next page).

Figure 8. IMD World Competitiveness Ranking <Breakdown for Japan>



Source: Prepared by JRI based on IMD, "World Competitiveness Ranking"

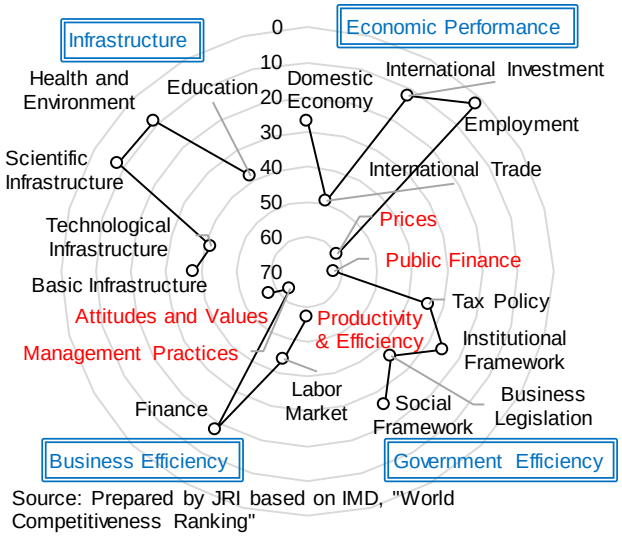
In fact, Japan's slow responses to digitalization and globalization have been exposed in many areas. In an increasing number of domains, including the entertainment sector, Japan is being forced to play second fiddle to South Korea, which moved quickly to develop overseas markets as part of its national strategy. In addition, the COVID pandemic revealed that Japan's digitalization is lagging far behind not only developed countries but

[4] Scores for these categories are based in large part on the results of questionnaire surveys of corporate managers, and as such are not necessarily objective evaluations. It is therefore possible that bias has been a factor, with Japanese managers rating their abilities lower than they actually are. Even so, the results cannot be taken lightly, because with globalization and digitalization, including digital transformation (DX), having accelerated since the mid-2010s, they reflect a growing sense of crisis on the part of managers that Japan's economy has not been able to respond appropriately and promptly to these changes.

also some emerging countries, as evidenced by the fact that at government offices in Japan various reports are still being sent by fax, and assistance for citizens in the form of targeted and rapid cash handouts has been impossible. In IMD's Global Digital Competitiveness Ranking, Japan dropped from 20th place in 2014 to 28th in 2021, mainly due to deterioration in business agility, talent, and regulatory framework (Figure 10).

These categories have been a drag from the beginning, with Japan seeing its position fall year after year, but the reality is that the country has been slow to recognize the situation and has yet to take action to overcome its weaknesses.

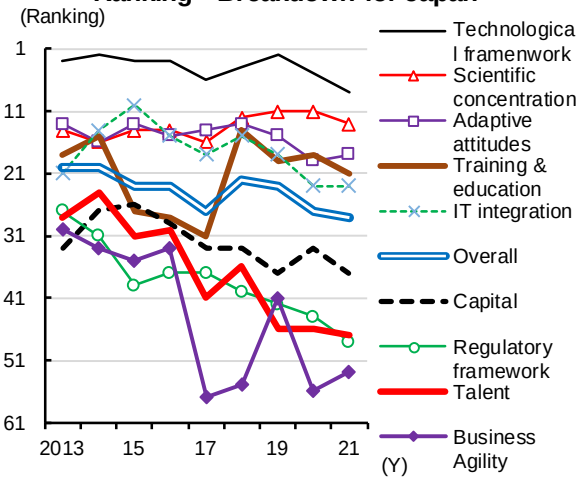
Figure 9. IMD World Competitiveness Ranking <Factors Breakdown for Japan>



Source: Prepared by JRI based on IMD, "World Competitiveness Ranking"
Note:Items in red are those ranked 50th or lower

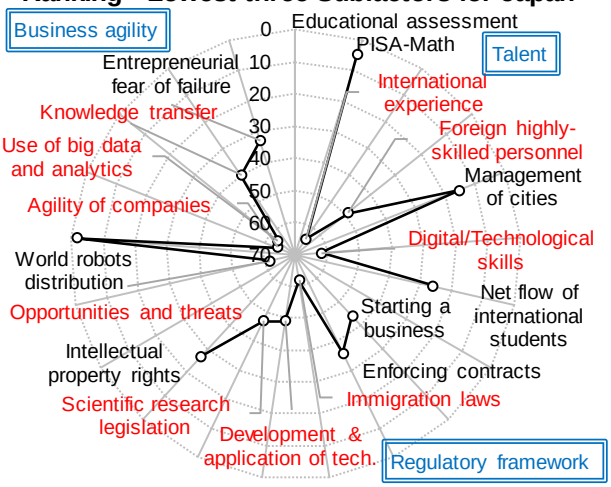
Of the three fields in which Japan ranks lowest in the digital competitiveness ranking, talent is being driven down mainly by lack of international experience, reluctance to accept highly-skilled foreign personnel, and poor digital/technological skills. As for regulatory framework, the country is hamstrung by strict immigration policies and difficulty in launching businesses (Figure 11). When viewed alongside the background to the decline in the competitiveness ranking, the fundamental factors behind Japan's declining competitiveness can be identified as 1) slow pace of business management (inability to respond quickly to "opportunities and threats," lack of flexibility and adaptability to change), 2) lack of enthusiasm for and understanding of digital technology (poor digital/technological skills, lack of ability to utilize big data), and 3) slow response to globalization (lack of international experience among firms and human resources, strict immigration policies).

Figure 10. IMD World Digital Competitiveness Ranking <Breakdown for Japan>



Source: IMD, "World Digital Competitiveness Ranking"

Figure 11. IMD World Digital Competitiveness Ranking <Lowest three Subfactors for Japan>

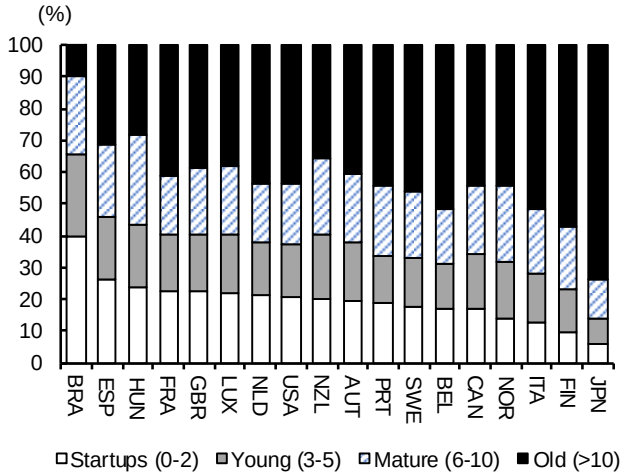


Source: Prepared by JRI based on IMD, "World Digital Competitiveness Ranking"
Note:Items in red are those ranked 40th or lower

(3) Fundamental factors behind declining competitiveness

The rigidity of Japan's economy and at the same time the lack of competition can be pointed to as the reason for the slow pace of business management. In fact, entrepreneurship is lacking in Japan, while the number of corporate bankruptcies is remarkably low by global standards, even though economic conditions are not necessarily favorable. In other words, not enough regeneration is occurring. Incidentally, an international comparison of the age of small firms between 2000 and 2010 showed that the percentage of such firms in Japan that have been in business for two years or less is extremely low, while in contrast, the percentage of those that have been in business for 10 years or more is overwhelmingly high (Figure 12). Given these circumstances, it would be assumed that many firms are unable to respond to the current fast-paced economic environment, including globalization and digitalization[5].

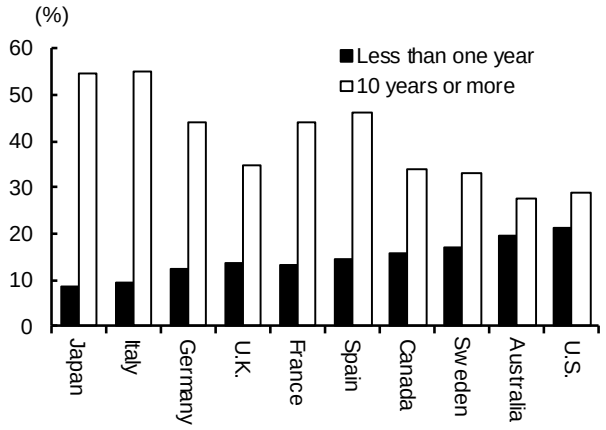
Figure 12. Share of Small Firms by Age



Source: Prepared by JRI based on OECD, "Economic Surveys: Japan 2015"
Note: Figures for Belgium, Canada, Finland, Hungary, Netherlands, U.S., and U.K. are averages for 2001-11. Figures for Austria, Brazil, Spain, Italy, Luxembourg, Norway, and Sweden are averages for 2001-10. Figures for Japan and New Zealand are averages for 2001-09. Figures for France are averages for 2001-07. Figures for Portugal are averages for 2006-11.

In the labor market, fluidity is low, and this is a factor hindering corporate regeneration. Looking at the percentages of employed people by length of service in major advanced countries, in the case of men, the number of workers with over 10 years of service is more than 50% in only Japan and Italy, which has experienced low growth (Figure 13). In addition, Japan's seniority-based personnel system has contributed to the slow responses to changes in the environment. According to the Recruit Works Institute, Japan has by far the oldest ages at promotion to section and department manager of the five countries of Japan, the U.S., China, India, and Thailand (Figure 14 on next page). In settings where long years of experience carry weight, such as in the manufacturing industry, length of service and wealth

Figure 13. Percentages of Employed People by Length of Service for Major Advanced Countries (Men, 2020)



Sources: Prepared by JRI based on OECD, "Employment by job tenure intervals: tenure composition" and U.S. Bureau of Labor Statistics, "Employee Tenure in 2020"
Note: Figures for the U.S., Japan, and Australia are for 2020 (Jan), 2017, and 2019, respectively.

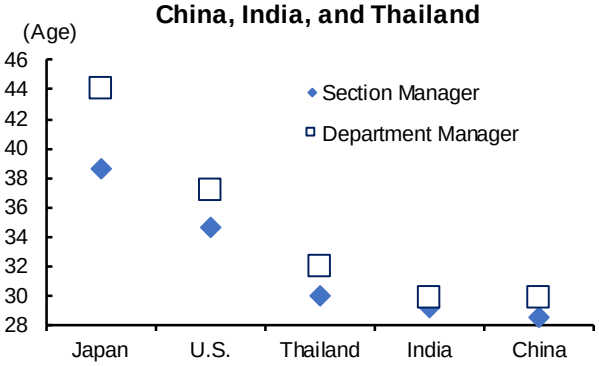
[5] The aging of firms would not necessarily lead to a decline in IMD's scores for business efficiency and management practices. In fact, Brazil, which has young firms, ranks 52nd for business efficiency, a ranking almost as low as Japan's, while Finland, with a firm age second only to Japan, ranks 5th. As for firm age, how it is perceived could differ depending on competitive conditions and other aspects of the business environment.

of experience can be an advantage. However, when it comes to recent trends such as globalization and digitalization, there is a risk that it may lead to delays in responding to major global developments.

The low level of enthusiasm for and understanding of digital technology can be attributed to the following factors, among others: 1) many firms leave information systems to IT vendors and do not have their own departments to develop and manage their own systems, which means that they are less interested in the evolution of digital technology, and 2) since the late 1990s, Japanese firms have tended to prioritize cost reduction over value-added creation, and even their ICT departments tend to view tech as a cost-cutting tool. As a result, ICT investment in Japan is underweight relative to major developed countries, amplifying the lag in ICT adoption. And in terms of the nature of investment, there is a heavy emphasis on hardware, with far less investment in software, even though the latter can improve operational efficiency and create added value. Even when ICT devices are introduced, they are unlikely to lead to transformation (Figure 15).

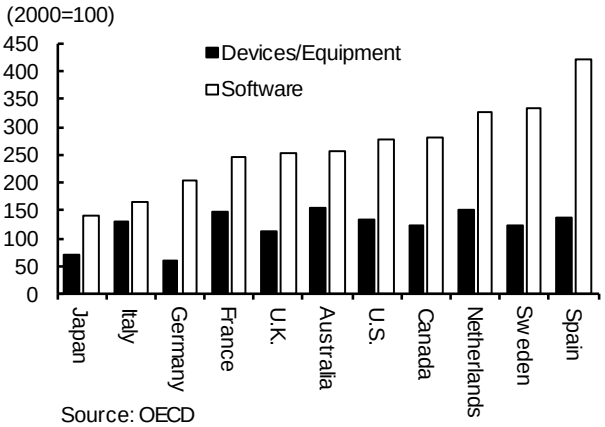
As for globalization, the fact that the Japanese market is reasonably large reduces the incentive to seek out overseas markets. Japan's goods and services export ratio was 17% in 2019, which is the third lowest among the top 15 countries in terms of the size of domestic demand, after the U.S. and Brazil. However, almost all the advanced countries except the U.S. and Japan have similar ratios to each other. These ratios are over 30%, so it seems undeniable that Japan has been complacent, and neglected to develop export markets, due to the considerable scale of domestic demand (see Figure 16). Although corporate direct investment has been expanding rapidly in recent years, it is still below

Figure 14. Age at Promotion to Management Positions in Japan, the U.S., China, India, and Thailand



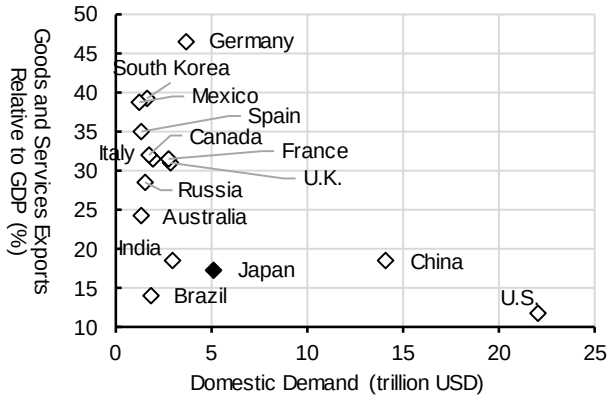
Source: Prepared by JRI based on Recruit Works Institute, "Survey of Managers in Five Countries"
Note1: Survey subjects were managers with at least one year of service working for a firm with 100 or more employees.
Note2: Survey was conducted in October 2014.

Figure 15. ICT Investment in Major Advanced Countries



Source: OECD
Note: Figures are for 2019. However, in the case of Spain, figures are for 2017.

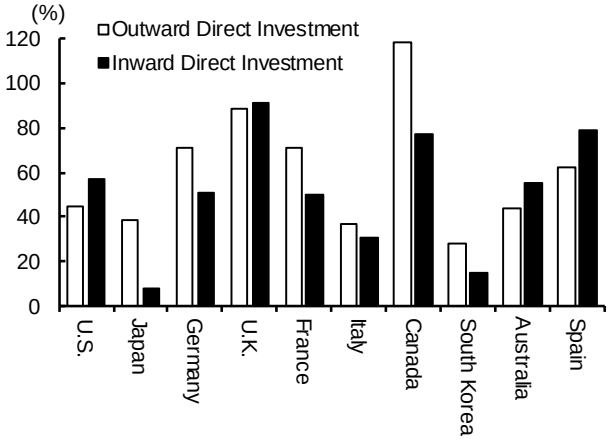
Figure 16. Domestic Demand and Export Ratio (2019)



Source: Prepared by JRI based on World Bank, "World Development Indicators"
Note1: Domestic demand = GDP less net exports
Note2: Top 15 countries for domestic demand in USD terms

average among major advanced countries, standing at 38% of GDP in 2020. Inward direct investment, meanwhile, has remained at the lowest level, 7%, due to declining growth expectations for Japan and the strong sense of caution among domestic players toward foreign firms[6] (Figure 17). The current reality is that there is an overwhelming dearth of opportunities for both firms and personnel to gain experience with import/export and investment.

Figure 17. Inward/Outward Direct Investment Relative to GDP in Major Advanced Countries (2020)



Source: Prepared by JRI based on data from the IMF

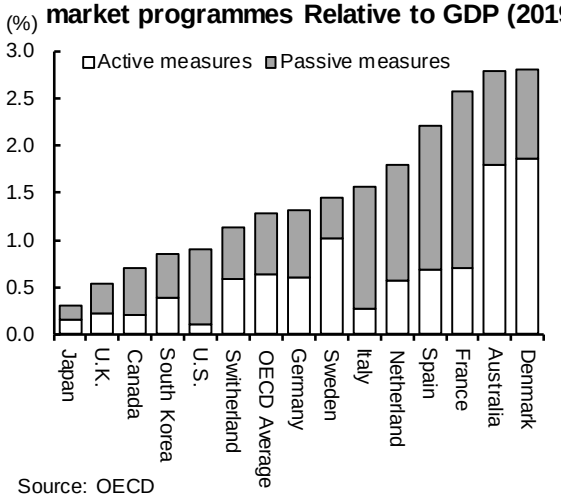
4. Restoring competitiveness

Under these circumstances, if Japan is to regain its competitiveness, it is imperative for firms and personnel to boost their regenerative capacity, while at the same time embracing digitalization and globalization to a greater degree than until now.

(1) Expand direct support to workers

To achieve this, first, the targeting of government policy support/involvement needs to be pivoted away from firms, the traditional beneficiaries, toward workers. In Japan, government support for the labor market has so far only been provided on an extremely limited scale, as support for SMEs has been strengthened to prevent unemployment, while human resource education for workers has been left up to the firms. In fact, Japan's ratio of public spending on the labor market to GDP is the lowest among major advanced countries for both active labor policies, including vocational training, and passive labor policies, of which unemployment benefits account for the bulk (Figure 18). However, the skills of Japan's human resources have deteriorated markedly from an international perspective, due to such factors as an increase in non-regular employment (for which in-house human resource education is inadequate), global environmental changes such as digitalization, and a reduction in corporate human

Figure 18. Public expenditure on Labour market programmes Relative to GDP (2019)



Source: OECD

[6] Although Japan boasts the world's largest net foreign assets, this is not necessarily something to be proud of, as its assets are on par with the global average, while its liabilities are remarkably low, meaning that in reality, it is not viewed as an investment target by foreign firms and investors.

resources investment in response to poor business performance. In addition, the number of firms that are managing to prolong their lives despite losing competitiveness has risen due to repeated support measures for SMEs, and this has inhibited regeneration. Paradoxically, these support measures, which are implemented every time a crisis occurs, have undeniably invited a weakening in Japan's national vigor.

Amid circumstances in which the functioning of the conventional enterprise-centered economic system is becoming increasingly difficult, it will be necessary[7] to gradually scale back the SME support measures, which were greatly expanded during the COVID pandemic, in order to stimulate regeneration. While this will inevitably lead to the weeding out of some firms, extending the lives of firms that have lost competitiveness will actually hinder medium- to long-term growth, because labor and other corporate resources will not be shifted to growth industries. At the same time, it will be essential to improve the skills of workers in the firms and industries that are going to be weeded out through means such as recurrent education, and to encourage a shift in the labor force to ICT and other growth fields. The government will need to fundamentally change its past approach to employment, including the entrustment of human resource education to firms, and become more actively involved in the development of workers' skills through the provision of vocational training and other programs[8]. At the same time, through the expansion of such measures as job seeker support systems, an environment must be created in which people can acquire skills without financial concerns, even if they are unemployed.

(2) Support firms with incentives rather than straightforward tax cuts

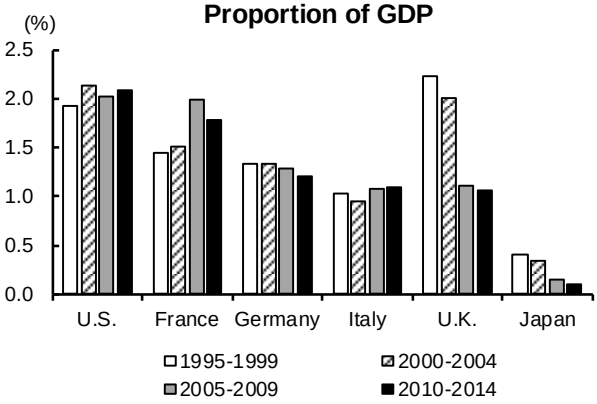
Second, the ways in which support is provided to firms must also change. Tax cuts for corporations include corporate tax cuts, investment tax cuts, and tax incentives to encourage wage increases, but to date, these have not been sufficient to boost growth. This can be attributed to the fact that many SMEs are losing money, which limits the effect of tax cuts, and to the limited willingness of firms to raise wages and make capital investments when the expected growth rate is low. Going further, a number of other factors can be pointed to as having created a background in which the effectiveness of national government policies are limited: 1) when IT-related investment stops at just deploying devices, it is unlikely to lead to sustained productivity gains, 2) while wage hikes themselves can be a starting point for the creation of virtuous economic cycle, they alone do not lead to the improvement of workers' skills and offer no guarantee of sustained productivity gains, and 3) without productivity gains, sustained wage increases cannot be expected, and the effect of stimulating consumption will be limited.

In light of this, rather than providing tax incentives to promote higher wages, it would be more effective to provide tax breaks and other government support to help firms cover human resource development costs, so as to improve workers' skills. In fact, the ratio of investment in capacity development by domestic firms to GDP is significantly lower in Japan than in other major countries (Figure 19 on next page). Even if on-the-job training

[7] In addition, it will be necessary to provide tax incentives for start-ups and the providers of funds to these firms, so as to create new start-ups and other firms and avoid triggering a downward spiral.
[8] Given that the intention is to encourage a shift in the workforce, the curricula of recurrent education should be practical, such that it can be put to use immediately. As for ICT, the latest trends need to be grasped.

is properly provided, if the skills are only applicable within the firm, their market value is not necessarily significant. As the labor market is expected to become far more fluid in the future, workers will acquire general skills through off-the-job training (OFF-JT), and as they increase their skills, they will be able to earn higher wages at their own firms. And if they cannot earn wages commensurate with their skills at their own firms, they will be able to change jobs easily. Firms can also expect to see an increase in added value if they can take advantage of their employees' improved skills, while at the same time keeping a lid on the cost of capacity development by receiving financial support from the government. On the other hand, if a firm cannot provide wages commensurate with the improved skills of its employees, it will experience an exodus of talent and ultimately be unable to stay in business. By putting firms under a certain degree of pressure, regeneration can be expected to gather pace.

Figure 19. International Comparison of Capacity Development by Firms as a Proportion of GDP



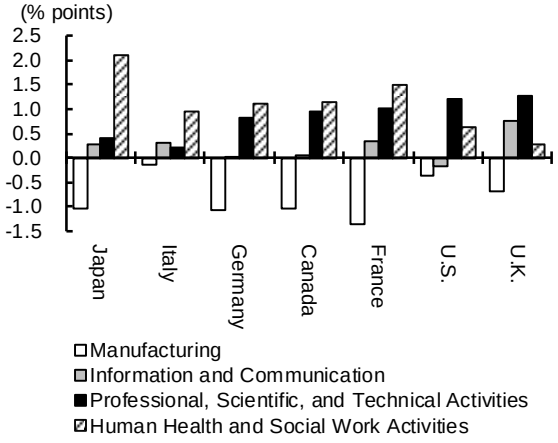
Source: Ministry of Health, Labour and Welfare, "2018 Analysis of the Labour Economy"
Note: Capacity development investment refers to off-the-job training (OFF-JT). On-the-job training is not included.

And with IT-related investment, too, given the current situation in which digitalization is not being translated into qualitative improvements in business operations and the creation of new added value, when offering tax breaks, it will be necessary to switch to tax-related incentives for business process improvement and profit expansion through digitalization. For example, if a firm allocates more money to software investments than hardware investments, it could benefit from lower tax on profits earned in the second and subsequent years.

(3) Revamp the social security system

Third, Japan's social security system needs to be revamped. Since the main cause of Japan's fiscal rigidity is rising social security-related expenses due to the aging of society, it is necessary to curtail the pace of increase in social security-related expenditures by, for example, raising the portion of medical bills paid out of pocket by the elderly, who are more affluent on average than younger people, or redesigning the current healthcare system, which does not provide incentives for medical care providers to curb medical expenses. In addition to securing stable financial resources for social security, mainly through consumption tax, securing funds that can be invested in growth areas is vital.

Figure 20. Changes in Employment Shares in G7 Countries (2010-2019)



Sources: OECD, U.S. Department of Labor
Note: Sectors are based on the International Standard Industrial Classification, Rev.4. For Canada, however, "Professional, scientific, and technical activities" includes real estate.

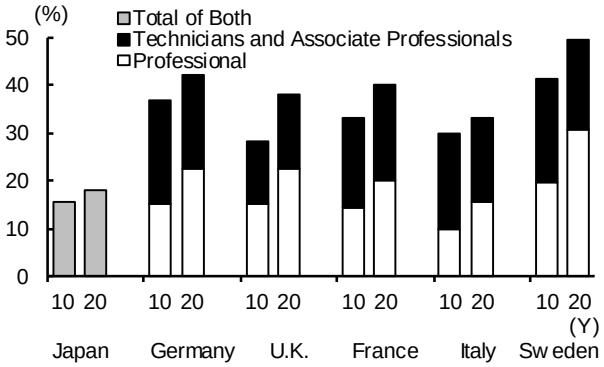
At the same time, it is essential to improve the productivity of the long-term care business. Looking at the percentage of Japan's employment by industry, between 2010 to 2019 there was a significant decline in the manufacturing employment, but a significant increase in healthcare employment, including in the long-term care field (Figure 20 on previous page). In the other G7 countries, the manufacturing sector's share of employment has been declining, but all except Japan and Italy have seen significant increases in the share of professional, scientific, and technical services for firms, and in the U.K., the share of information and communication has risen substantially. While it is inevitable that employment will shift to the long-term care sector in Japan, which has the world's oldest population, if we focus on the quantitative aspect, the more human resources are allocated to the long-term care sector, the fewer human resources will be available for other growth sectors. With the proliferation of small-scale long-term care providers, efforts are needed to increase their scale, promote ICT adoption, and otherwise increase their productivity.

(4) Revamp corporate personnel and wage systems

Fourth, organizational and institutional reform of firms is also essential. But government support measures alone will not be enough to halt the decline in competitiveness. It is the firms that actually create added value, and unless they themselves pursue reforms to create added value, the various policies will be useless. In this regard, a revamp of Japan's unique personnel and wage systems is inevitable. As mentioned above, in a rapidly changing economic environment shaped by such trends as digitalization, seniority may, depending on the nature of the work, actually be a factor in delaying adaptation to change. At the same time, if IT personnel requirements, for example, cannot be satisfied through internal training alone, and IT personnel need to be brought in from outside, it will be necessary to clearly define their duties and introduce a wage structure that is commensurate with those duties, i.e., one based on the so-called market mechanism. Otherwise, it will prove impossible to secure such personnel.

The way human resources training is conducted also needs to be reviewed. Japan has fewer professional human resources than other major countries. Looking at the composition by occupation in the major countries, the combined percentage of "professionals" and "technicians and associate professionals," who are considered highly skilled, is extremely small. [9] (Figure 21). In addition, the percentage of such personnel has increased by only 2.4 percentage points over the past decade. This is lower than Italy, which continues to experience economic stagnation. As China and other emerging countries continue to

Figure 21. Breakdown of Workers by Occupation in Major Countries



Source: Prepared by JRI based on Japan Institute for Labour Policy and Training, Databook of International Labour Statistics
Note: Based on the International Standard Classification of Occupations (ISCO-08)

[9] In Japan, job-based employment has not taken root, and there are only a small number of workers who can be clearly identified as "professionals" by international standards. Therefore, the actual number is likely to be higher, but on the whole the orientation is toward nurturing generalists, so the fact that professionals are few in number remains.

catch up in terms of technology, Japan's economy will not be able to escape from the deterioration of its competitiveness unless the entire nation mobilizes to develop professional human resources, not only in firms but also in universities and other higher education settings.

With regard to globalization, it goes without saying that it is essential to raise the level of English proficiency, the current low level of which is the biggest factor in the inward-looking orientation of the Japanese people. It is crystal clear that domestic demand alone will not be enough to deliver economic prosperity if the population continues to decline, so not only individuals but also the government and firms must focus their efforts on this issue. Also, expanding the acceptance of foreign workers is worth considering. Increasing the number of foreign workers, not only highly skilled personnel but also unskilled workers, will provide an opportunity to expand overseas networks and to highlight the inadequacies of Japan's unique customs and systems. After all, it is difficult to create innovation without exposure to different sensibilities and cultures. In addition, the increase in inbound tourism has revealed that goods, services, and events that were considered routine or normal in Japan sometimes attract the interest of foreigners to a greater extent than might be expected. Although it is necessary to carefully weigh up and consider the negative implications of accepting foreigners, such as a possible deterioration of public safety, coexistence with foreigners could be an opportunity to change the inward-looking mindset of the Japanese people and at the same time encourage innovation among the people of Japan.

5. Conclusion

As of the end of March 2022, Japan's economy is still shouldered with a GDP gap of nearly 20 trillion yen on an annualized basis, and increased fiscal spending is essential to eliminate this gap for the time being. In addition, taking into account the fact that the government has so far failed to provide sufficient fiscal support for areas conducive to growth, as growing social security-related expenditures have absorbed much of the money available, the government should not close its eyes and avoid expanding fiscal spending for the time being. However, unless the above-mentioned factors hindering growth, such as scant regeneration and the slow pace of digitalization and globalization, are fundamentally addressed, then even if the growth rate temporarily increases, the virtuous cycle mechanisms of "increase income → increase consumption" and "increase earnings → increase investment" will remain out of action, and the result will be an unnecessary buildup of public debt. In expanding fiscal spending, the government must focus on areas that will contribute to a recovery in competitiveness, such as investment tax reductions that promote digitalization, proactive labor policies such as recurrent education, and human resource investment to keep up with globalization, rather than simply shoring up demand through public works or support for SMEs, which could impede regeneration. At the same time, however, it will be necessary to implement competition policies that encourage firms that would find it difficult to strengthen their competitiveness to make their exits as soon as possible.

Compounding the declining competitiveness of Japanese firms, factors such as soaring resource prices in the wake of Russia's invasion of Ukraine have resulted in an entrenched trade deficit for Japan, and the country looks to be beginning to lose its ability to maintain the surplus on the current account that it has maintained since the 1980s. If current account surpluses cannot be maintained, Japan will be forced to rely on cash from abroad to fund its economic activities, and it will no longer be able to ease monetary policy and expand fiscal

spending without financial constraints as it has done in the past. Recognizing that this phase, in which a certain degree of freedom in terms of macroeconomic policy has been secured, is the last chance to halt the stagnation of our economy, there must be fundamental overhaul of Japan's rigid government spending structure, labor market, and extremely limited competition policies to halt the decline in competitiveness.

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