



JAPAN:

MAKING THE MOST OF CURRENT TAILWINDS

How Abenomics is impacting business.

By Odd Per Brekk

Since the bursting of the asset-price bubble in the early 1990s, Japan has faced the formidable challenge of boosting growth, ending deflation, maintaining financial and exchange rate stability, and securing fiscal sustainability. Japan's rapidly ageing society, entrenched deflationary expectations and domestically-oriented economy, combined with sluggish global growth post the 2008 global financial crisis, hampered policy transmission. Against this backdrop, in late 2012, Prime Minister Shinzo Abe's newly-formed government embarked on a comprehensive strategy to revive the economy, basing it on three elements: aggressive monetary easing, flexible fiscal policy, and structural reforms to raise potential growth.

Although Abenomics, as the policies came to be called, has improved economic conditions and engendered some reform

in labour markets, financial markets, and small and medium enterprises (SMEs), it has not yet achieved a durable exit from deflation (refer to Figure 1). What do these trends mean for businesses in Japan? Let's take a closer look at some structural aspects of the Japanese economy that directly impact businesses—specifically, labour market rigidities, shortage of labour and the low productivity of SMEs.

Easing rigidities in labour markets

Labour market rigidities are a central part of the challenges faced by Japanese businesses. Unemployment has fallen to a 25-year low and the job-to-applicant ratio is at an all-time high. While labour shortages are evident in sectors like construction, accommodation, and food and beverage, wage growth remains



ABENOMICS AT WORK

Japan's economy is in a relatively good place today compared to two years ago, driven by a supportive external environment. Fiscal policy has been supportive of growth and monetary policy is now on a more sustainable footing. Despite this, wage growth has remained stubbornly low and public debt continues to be unsustainably high.

	2012	2013	2014	2015	2016	2017 (proj)	2018 (proj)
Real GDP growth (percent change)	1.5	2.0	0.3	1.1	1.0	1.3	0.6
Inflation (annual average)	-0.1	0.3	2.8	0.8	-0.1	0.7	0.6
Unemployment rate (annual average)	4.3	4.0	3.6	3.4	3.1	3.1	3.1
Population growth	-0.2	-0.2	-0.2	-0.1	-0.1	-0.3	-0.4
Old-age dependency	37.8	39.8	41.8	43.5	44.9	46.2	47.2

FIGURE 1

Source: IMF

stubbornly weak. That overall wage growth is lacklustre was underscored by the outcome of the 2017 spring wage negotiations, which showed the lowest hike in base pay in four years. A case in point is Toyota's base wage, a benchmark other Japanese companies use to gauge their pay hikes, which increased by ¥1,300 (US\$11.34) a month, below last year's ¥1,500 (US\$13.08). As a Reuter's article pointed out at the time, "For a Toyota mid-level technician earning ¥360,000 a month, the pay increase works out to 0.36 percent. It can buy one bowl of rice with pork cutlet with miso sauce on top, a specialty of Nagoya, near the Toyota headquarters."¹

Certain unique characteristics of the Japanese labour market tend to dampen wage growth even in the face of a tight labour market. One of these is the low horizontal mobility of regular workers. Under Japan's lifetime employment system, a wage increase in competitor firms may not create a wage pressure because workers are unlikely to switch jobs. By the same token, firms do not have incentives to offer higher salaries to attract workers. Furthermore, Japanese regular workers are typically hired as generalists and are expected to work in several positions and duty stations within the company. This employment model reduces incentives and the need for firms to increase wages to attract workers from outside to fill specific positions, because existing workers can be reassigned to perform other tasks.

Second, Japan's industrial relations system tends to emphasise employment stability over wage increases. Unions and workers are willing to accept wage moderation in exchange for employment stability, notably for regular workers.

Third, Japan's labour market is characterised by extreme duality when it comes to wage bargaining power. In

the past, most workers were hired under lifetime contracts. Even now, wage bargaining takes place at the firm level in coordinated industry-wide bargaining rounds, the so-called Shunto. However, with the rapid rise in the share of non-regular workers, the importance of the Shunto has waned. Unionisation rates have declined and labour conflicts have all but disappeared, suggesting a fall in the wage bargaining power of labour. As a further indication, real wages have not kept up with productivity over the past two decades, more so than in most comparable economies.

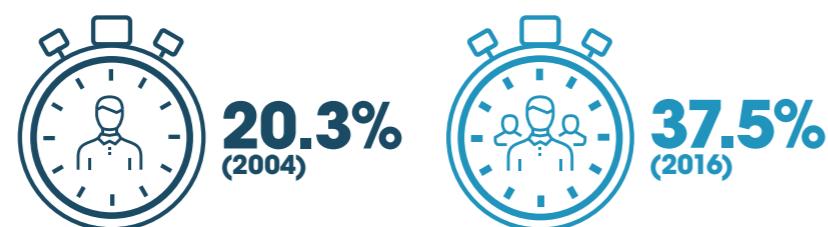
Fourth, the increasing share of part-time employment has been a structural determinant of declining average wage growth. Factors responsible for the growth in part-time employment include increased participation of women and the elderly. As life expectancy rises, many people are looking to extend their earnings period. The proportion of non-regular workers rose from 20.3 percent in 2004 to 37.5 percent in

2016. Meanwhile, part-time non-regular workers' wage (per hour) is about half that of full-time regular workers. This has suppressed the overall wage bill despite a labour shortage, putting downward pressure on wage-price dynamics.

Finally, low actual and expected inflation have contributed to stagnant nominal wages, the result of an entrenched deflationary mindset and backward-looking inflation expectations. Unions and employees look at past headline inflation in their negotiations, rather than setting wages in anticipation of higher future prices. Public wage setting takes the same approach, following developments in the private sector rather than leading in line with the authorities' inflation targets.

Despite being cash rich, Japanese companies remain cautious, given the economy's growth outlook and expectations. The sluggish wage growth, in turn, is inadequate to accelerate growth and inflation, further entrenching deflationary pressures.

The proportion of non-regular workers



In March 2017, the government unveiled the Work Style Reform (WSR), which seeks to address wage gaps between regular and non-regular workers. Among several measures, WSR envisages a cap on overtime that is expected to boost productivity and labour force participation, and provides an expansion in childcare facilities to support further integration of women in the labour market. Moreover, the minimum wage has been raised by 3 percent and tax incentives for wage increases have been enhanced. Many analysts are watching this space: How quickly will these changes reveal results? Will the tax cuts provide adequate incentive, or will they fall short?

Corporate tax rate cuts and governance reforms have yet to mobilise the large cash reserves of corporates (at almost 50 percent of GDP) for private investment and wage increases. Together with corporate governance reforms, new trade agreements, including with the remaining ten Trans-Pacific Partnership (TPP11) countries and with the EU, could encourage restructuring in the service and agriculture sectors. The IMF estimates the economic effect of TPP11 and the EU-Japan Economic Partnership Agreement would be ¥7.8 trillion (1.5 percent of GDP) and ¥5.2 trillion (1 percent of GDP), respectively and employment would increase by 460,000 and

290,000. It is also estimated that TPP11 and the EU-Japan EPA will increase farmers' income by ¥150 billion and ¥110 billion, respectively.

Diversification and enhancement of labour supply

Ongoing ageing and the decline in population size underscore the need to further raise participation rates of females and older workers, make more use of foreign labour, and raise productivity through deregulation and support for innovation.

Due to Japan's lifetime employment system, nearly 30 percent of men still work at the same firm where they started, a figure that has been virtually unchanged since 1990 (in contrast, a 2012 survey data from the U.S. Bureau of Labor Statistics indicated the share of workers in the same firm for more than 20 years was 10.6 percent). However, only 19 percent of Japanese women stay in the same firm, and this number has been declining. More than 50 percent of women in the labour force are non-regular workers, compared to 20 percent of men. Women choose non-regular work to balance the demands of childcare, elder care, and housework, given the limited availability of childcare and nursing facilities as also the frequent demands for overtime in the lifetime employment system. Though this is not a surprising trend, the disparity in

lifetime employment between men and women in Japan is much greater than that in other developed nations.

Women entering the workforce under regular contracts are often relegated to lower-paid jobs under the dual-track system—a fast track for management stream employees (career track) and a slow path for routine, clerical work (non-career track). Although both tracks are open to women, men dominate the former, a trend that could reflect both a lack of opportunity and a conscious choice made by women between career and childcare/elder care. While the tracks seem to be open, most employers make it technically difficult to switch from non-career track to career track by imposing high hurdles such as long tenure in the company. Companies require workers to commit to their track before hiring, and limit track switching. Some companies mandate relocation as a condition for applying for the career track, discouraging those who share family responsibilities (mostly women). Women in the non-career track are deprived of training opportunities and thus have a limited chance for promotion, further leading to lower wages compared to their male peers.

The tax system deters female labour from taking on regular positions. Many non-regular workers intentionally choose fewer hours or lower wages, as they are

exempted from income and residential tax if they earn less than ¥1.03 million (US\$9,217) per year, and from social security premiums if they earn less than ¥1.3 million (US\$11,633) per year. Household heads can also receive spousal allowance if the second-earner (typically the woman) earns less than a threshold, which is usually set below the tax or social security premium threshold. The government raised the threshold for spousal deduction from ¥1.03 million (US\$9,217 million) to ¥1.5 million (US\$13,422), effective January 2018.

Given the acute labour shortage and rapid ageing, the elderly have become increasingly important in Japan's workforce. The share of workers above 65 years old has increased to 12 percent of the total working population in 2017, compared with 9 percent in 2010. Most employers set employees' retirement age at 60 years, and rehire them under shorter working hours and lower salary (usually 50-70 percent of their pre-retirement wage level) until they reach the fully-pensionable age of 65 years. Given a more generous tax deduction for pensions compared to wage income, most older workers would accept working under the same employer with lower wages.

Due to strict immigration policies, the share of foreign workers is lower than in other advanced economies (less than 2 percent in 2016 compared with about 17 percent in the U.S.), although this number has been increasing. Employers are required to provide pay and benefits to foreign workers equal to that of Japanese citizens. Foreign workers are mostly Chinese (32 percent), Vietnamese (16 percent) and Filipinos (12 percent), and are concentrated in manufacturing and wholesale and retail activities. While the government relaxed the admission requirements for high-skilled workers

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and allowed foreign housekeeping workers in special economic zones, these policies have had limited impact in reducing labour shortages.

Boosting productivity of SMEs

Japanese conglomerates are well known globally. A lesser-known fact is the size of the SME sector, which accounts for 70 percent of total employment and 50 percent of value added in the economy. Despite their formidable size and impact, Japanese SMEs, particularly those in the retail segment, suffer from low productivity (refer to Figure 2). Retailers are highly regulated with respect to operating hours, store size, parking lot spaces to be provided for customers if the retailer exceeds a certain store size, and the inability of manufacturers and retailers to transact directly (instead having to use wholesalers, sub-wholesalers and even sub-sub-wholesalers in some cases). These regulations limit efficiency, while driving up domestic employment. Additionally, the government has a strict and explicit code that keeps international players out of these markets.

Meanwhile, export-oriented companies have been beneficiaries of cheap funds for decades. This has led to high levels of capital investment and hence limited

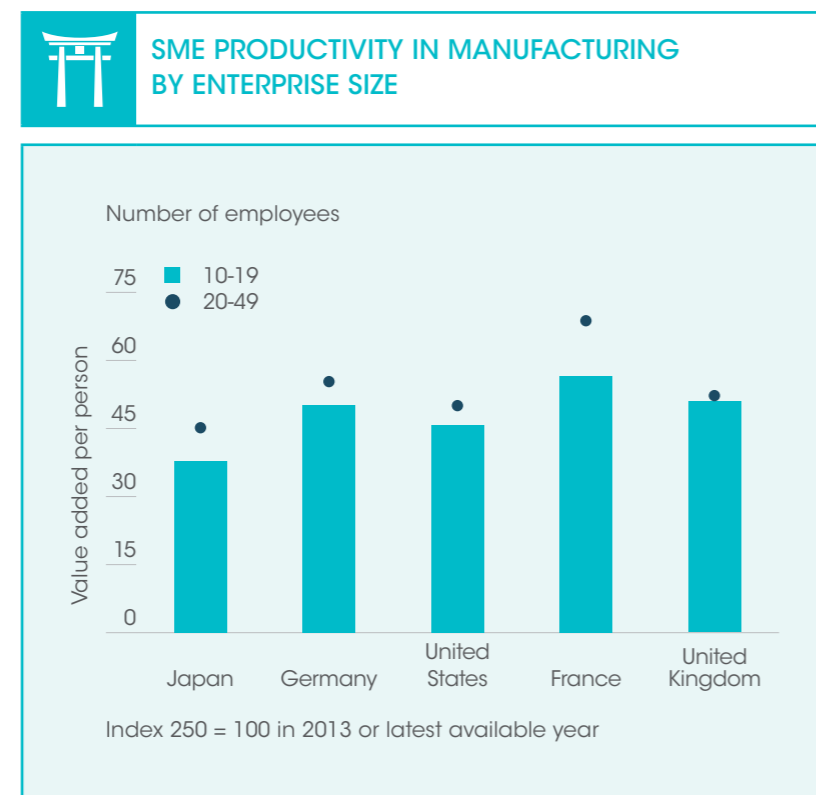


FIGURE 2

Source: OECD SDBS database

employment in this sector. On the other hand, Japanese SMEs are, by and large, not export-oriented. With SME lending based largely on fixed-asset collateral or personal guarantees, credit is not always channelled to the most productive firms.

Financial sector policies aimed at efficient credit allocation to SMEs would help to promote innovation, productivity, and investment. Bank loans are the primary source of external financing for SMEs. Although lending to SMEs has increased to pre-financial crisis levels, it is mainly concentrated in construction and real estate. Financing conditions in other key sectors such as manufacturing, IT and services remains subdued. An OECD survey also suggests that access to finance for female entrepreneurs is particularly difficult in Japan.

Policies should facilitate the move towards more risk-based lending—by upgrading banks' credit risk assessment capacity, lowering the coverage of public credit guarantees, and improving reporting standards of the SMEs. Policies could also encourage internationalisation of SMEs as part of the global supply chain, and facilitate provision of financial services towards the demands of an ageing society. Alternative forms of finance to SMEs and start-ups, such as asset-based lending and venture capital, could also be considered as long-term goals. Currently, asset-based lending based on movable assets and account receivables is less than 0.5 percent of total bank loans. Venture capital can play an important role but this requires improving the environment for angel investors who not only supply finance, but provide mentoring and networking resources (refer to Figure 3).

Structural reform priorities

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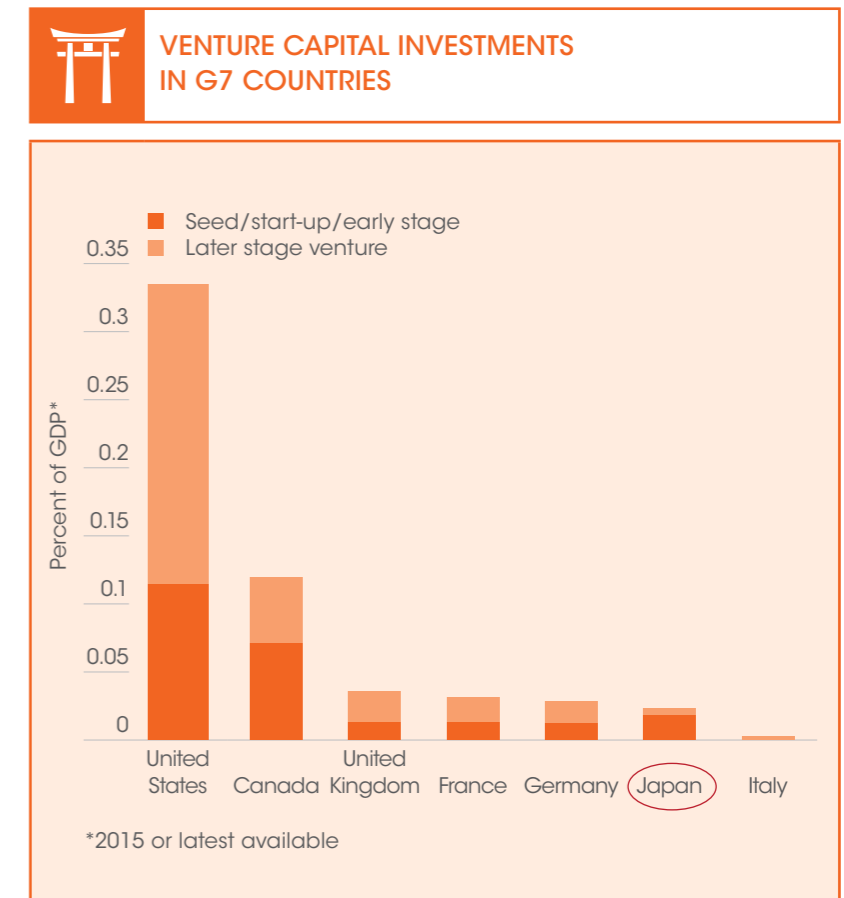


FIGURE 3

Source: Entrepreneurship at a Glance 2016, OECD 2016

exploits complementarities between macro-critical structural reforms and coordinated income and demand policies that would help lift potential growth and spur inflation. Policy frameworks should aim to boost labour market flexibility and labour supply, encourage private domestic and foreign investment, and tap into the growth and export potential of SMEs. The complex challenges facing Japan call for a multifaceted economic policy approach. Besides continued monetary accommodation and a flexible and well-anchored fiscal policy, Japan would be well advised to accelerate structural reforms along several dimensions:

FIRST PRIORITY

Labour market reforms to boost wages and increase productivity. The government's new WSR appropriately recognises the need for broad labour market reform.

Employment protection for regular workers is relatively high in Japan. Clarifying the legal framework for intermediate contracts could help promote their use, facilitate a better balance between job security and wage increases, and reduce labour market duality. Support for worker mobility across firms—including via contract reform, portability of pensions and government programmes—would improve resource allocation while increasing wages. Accelerating the ‘equal pay for equal work’ initiative, together with the introduction of job descriptions, should also help close the wage gap between regular and non-regular workers.

SECOND PRIORITY

Reforms to increase private investment and productivity. Boosting private investment is also critical to increasing potential growth and raising employment, but it has remained subdued in recent years despite favourable financing conditions, an aged capital stock, and improved profitability in the corporate sector. The restrictiveness of product and service sectors in

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Japan is high in some areas relative to its G7 peers. Deregulation, including reduced barriers to entry and removal of protections to incumbents in some industries (i.e., telecoms and gas sectors) and that of professional services, would increase productivity.

THIRD PRIORITY

There is also scope for further corporate governance reform; more ambitious requirements for outside directors, enhanced transparency of beneficial ownership, and explicit limits on cross shareholdings, which should improve monitoring of firm performance and encourage firms to invest. Providing greater clarity on macroeconomic policy frameworks to reduce policy uncertainty, promoting trade and FDI, as well as expediting deregulation in Special Economic Zones should also help boost productivity, investment, and long-term growth.

FOURTH PRIORITY

Diversification and enhancement of labour supply. Measures to boost female and older-worker labour force participation, as well as hiring more foreign workers and facilitating their integration into the economy, are crucial to compensate for a shrinking working-age population. Eliminating disincentives to full-time and regular

work stemming from the tax and social security system, and increasing the availability of childcare and nursing facilities, could help boost labour supply. Flexible employment and a wage system based on ability rather than seniority should be encouraged, and firms’ right to set a mandatory retirement age should be abolished.

All told, the success of Abenomics rests precariously on expectations. What Japan needs today is a set of mutually reinforcing policies and strategies that will stimulate growth and employment. Many of the policy measures geared to spur wages and bolster growth have already been identified in the government’s strategy. However, some gaps remain—implementation horizons could be more ambitious and clearer prioritisation is needed.

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The material in this article is derived from the International Monetary Fund’s report, “Article IV Consultation—Press Release, Staff Report and Statement by the Executive Director for Japan” published in July 2017.

Reference

- ¹ Tetsushi Kajimoto, “Workers at Japan’s Top Companies get Meager 2017 Pay Hikes in Abenomics Setback,” Reuters, March 15, 2017.