

# Labor Market Reform under Abenomics and Productivity

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Takashi Miwa  
Chief Japan Economist  
The Nomura Securities, Co. Ltd.

## **Abstract**

Since last autumn, the Abe administration has set in train measures, centered on its *Plan to Realize the Dynamic Engagement of All Citizens*, to reform the labor market. In this article, we will try to assess the Japanese government's policies, especially its efforts to reform the labor market, from the perspective of their effectiveness in raising the potential growth of Japanese economy. As regards its policies for increasing labor inputs, we think that the government's desire to respect traditional Japanese employment practices has acted as a constraint and that it remains to be seen whether labor inputs can increase in a way that will not conflict with the efforts of Japanese companies to cut costs. As regards its policies for raising productivity, leaving aside its efforts to make production processes more efficient, a development that will inevitably accelerate because of labor shortages, we think that it still needs to do more to create demand and to increase investment in line with the growth in demand, thereby creating new job opportunities as efficiently as possible.

## **Introduction**

Since it was formed after the December 2012 general election, the Abe administration has achieved a certain degree of success in bringing about an economic recovery and raising the rate of economic growth. Although real GDP growth between 2013 Q1 and 2016 Q2 averaged 0.5% a year, less than the 0.9% average between 2010 Q1 and 2012 Q4, the Abe administration can take credit for boosting the rate of CPI inflation (headline rate, excluding fresh food) to 1.5% a year at one point and generally overcoming the deflationary trend.

However, inflation has yet to hit the 2% target set by the government and the BOJ in their joint statement of January 2013, leaving the battle to defeat deflation only half-won. Similarly, with Japan's population set to decline, the potential growth rate remains stuck around 0%.

Faced with these challenges, the Abe administration began last autumn to set in train measures, centered on its *Plan to Realize the Dynamic Engagement of All Citizens*, to reform the labor market. The aim is to create a virtuous cycle by overcoming the constraints Japan's declining population imposes on economic growth, raising the potential growth rate and thereby achieving faster economic growth, and using this to further increase the potential growth rate. These efforts would be predicated on raising the labor force participation rate of women and the elderly by improving social services such as childcare and long-term care.

In theory, an economy that is facing a decline in both its general population and its labor force but wants to raise its potential growth rate needs to adopt measures to either increase labor inputs by increasing the working population or raise productivity or both. In this regard, the *Plan to Realize the Dynamic Engagement of All Citizens* is a sensible policy.

As well as taking a fresh look at Japan's working population, labor inputs, and labor productivity, this report assesses whether the Abe administration's efforts to reform the labor market have proved effective in achieving those policy objectives and considers the challenges it is likely to face in the future.

### **1. The Japanese economy and labor market under the Abe administration: achievements of the past four years**

If we confine our assessment to the labor market when considering what has happened to the Japanese economy since the Abe administration was formed, we can say that the government's biggest achievement has been a marked increase in the number of people employed. As we can see from Figure 1, the number of people employed in Japan

increased by a cumulative total of 2.5mn between December 2012 and August 2016. As the productive-age population (defined as those aged 15 or over) declined by more than 200,000 during this period, this is a noteworthy increase.

The government has also gone some way toward halting the decline in Japan's potential growth rate, which has been falling largely as a result of labor input factors (Figure 2).

A breakdown of the increase in the number of people employed by sex and age shows a marked increase in the number of men aged 65 or over and the number of women aged 35–54. We attribute the increase in the number of men employed aged 65 or over to a deferment of retirement in response to the raising of the official retirement age and to an increase in the number of men being taken on again by their companies after they retire, while we see the increase in the number of women employed aged 35–54 as an indication of a marked increase in the labor force participation rate of women in an age group whose labor force participation rate had previously declined as a result of getting married, having children, and bringing them up. In this regard, the Abe administration's *Plan to Realize the Dynamic Engagement of All Citizens* can be said to have proved successful even before action was taken to implement it.

However, it is difficult to attribute the increase in the number of people employed to government action.

As we argued in our 3 August 2016 report [Hidden downside risk for Japan's potential growth rate](#), the increase is likely to have been in response to higher inflation expectations following the formation of the Abe administration. To put it somewhat simplistically, households expecting inflation to pick up as a result of policy changes following the formation of the new administration probably felt that they might find it difficult to maintain their standard of living if they relied solely on the earnings of the principal breadwinner and thus spouses and other family members who had previously not joined the labor force did so in order to boost their household income.

As we can see from Figure 3, the inflation expectations of households in particular have been declining as observed CPI inflation has fallen. If our hypothesis above is correct, there is a risk that the rate of increase in the labor force participation rate of women and the elderly could ease, bringing to an end the growth in the number of people employed.

## **2. Challenges**

The Abe administration can take credit for the fact that after it was formed the number of people employed increased, stemming to some extent the decline in the potential growth rate even though the labor force was shrinking. However, it still faces a number of challenges if it is to further raise the potential growth rate, enhance the impact of the

BOJ's ultralow interest rate policy by raising the natural interest rate, which is linked to the potential growth rate, boost aggregate demand, and defeat deflation once and for all. It faces the following two challenges if it is to increase labor inputs, which it will have to do in order to raise the potential growth rate.

First, it will have to maintain the increase in the labor force participation rate that occurred during its first four years in office. As we saw in section 1 above, the increase in the labor force participation rate that has occurred thus far is more likely to have been the result of a negative factor (namely the response of companies and households to the raising of the official retirement age and the prospect of higher inflation) than of government policies. In this regard, the *Plan to Realize the Dynamic Engagement of All Citizens* remains an important policy but also one that still faces some challenges.

Second, even if the plan achieves its objectives, the government will probably still have to take action to avert the risk that labor inputs may decline as a result of a further drop in the productive-age population. As most of the women and the elderly who swelled the ranks of the employed during the past four years did so as part-timers, the total number of hours worked has declined, contributing to the drop in the potential growth rate (Figure 2). One particular challenge is to make it possible for those entering the labor market to work for a specific number of hours. Also, in the longer term, Japan may have to address an absolute decline in the productive-age population by admitting immigrants and foreign workers.

Japan faces even more challenges when it comes to raising productivity, the other thing it will have to do in order to increase the potential growth rate.

Like other developed economies, the Japanese economy as a whole has faced an underlying decline in productivity (Figure 4), with no clear sign that this trend has reversed during the four years since the Abe administration was formed.

Ironically, the increase in the number of people employed that has occurred since the Abe administration was formed has had a negative impact on productivity. A breakdown of the increase in the number of people employed by industry reveals that nonmanufacturing, which by its very nature tends to have relatively low productivity, has had a disproportionate share of the increase (Figure 5). This is also a perennial problem in other countries and Japan urgently needs to take action to try to raise productivity in nonmanufacturing and service industries.

In addition to challenges such as the need to raise nonmanufacturing productivity and the decline in productivity caused by the growth in relative terms of industries with relatively low productivity, all industries face the problem that productivity has declined as a result of low corporate investment.

Since the Abe administration was formed, and particularly during its first two years, corporate earnings benefited significantly from major yen depreciation. However, very little of the resulting increase in profits and cash flow has fed through to higher capex (Figure 6).

Capital efficiency and asset efficiency, on the other hand, have seen an underlying improvement during this period (Figure 7). This suggests to us that even though companies have been reining in capex in general, they have been steadily investing in plant and equipment that will cut their costs and streamline production.

What is lacking is not capex that encourages downsizing-oriented improvement in profit margins such as through labor-saving or cost-cutting efforts, but capex that encourages expansion in the scale of business through forward-looking creation of value-added. Capex in the context of raising productivity should probably be understood as capex in the broad sense, which includes investment in human capital.

### **3. Assessing government policies**

How should we assess the labor market policies the Abe administration has produced to deal with these challenges? As we have done thus far, we will discuss the action it has taken to try to increase labor inputs and the action it has taken to try to raise productivity separately.

#### **A. Efforts to increase labor inputs**

As we have seen, the Abe administration's efforts to reform the labor market have mainly taken the form of its *Plan to Realize the Dynamic Engagement of All Citizens*. At the moment, these efforts appear to be break down as follows:

- (1) Efforts to adhere to the principle of "an equal wage for an equal job" by bringing the wages of nonregular employees, which compare less favorably with those of regular workers than in other countries, into line with those of regular employees, thereby removing a disincentive for them to participate in the labor force.
- (2) Efforts to reduce nonparticipation in the labor force as a result of inadequate childcare and long-term care.
- (3) Efforts as part of its "working practice reforms," particularly to reduce the long working hours of regular male employees and remove impediments to the participation of women in the labor force.
- (4) Efforts to correct any tax distortions, such as the existing married person's allowance, which act as a disincentive to women to participate in the labor force.

Mainly for the following reasons we can only be skeptical about the feasibility and likely success of the above efforts.

The Abe administration's labor market reforms are still constrained by the desire to respect traditional Japanese employment practices and the traditional family hierarchy, as a result of which its labor market reforms may end up being only half-measures. In very simplistic terms, establishing the principle of an equal wage for an equal job and starting to require companies to treat nonregular employees better will only increase Japanese companies' personnel expenses. Japanese companies, on the other hand, are said to be keen to reform their employment practices (eg, by having more precise rules for dismissing employees) to make it easier for them to dismiss regular employees and to turn the cost of full-time employees into a variable cost at the same time as they recognize the principle of an equal wage for an equal job. The government's desire to reform Japan's labor market while respecting traditional Japanese employment practices will inevitably restrict the ability of Japanese companies to make personnel expenses a variable cost and therefore make it more difficult for institutional reforms to achieve their intended aim.

The abolition of the existing married person's allowance and the introduction of a new allowance aimed at encouraging women to participate in the labor force is likely not only to be opposed by MOF, which is concerned about the loss of tax revenue, but also to face stiff resistance from conservatives within the ruling coalition who want to maintain the traditional family hierarchy.

In the longer term, it remains to be seen whether the Japanese on their own and Japan's hidden labor resources as implied by the name of the government's plan to mobilize them will be enough to offset the structural decline in Japan's labor force.

The Abe administration has begun to discuss whether to allow immigrants and foreign workers to enter the country. In other countries around the world, however, there are moves to restrict immigrant labor (eg, Brexit in the UK and Donald Trump's proposals to kick immigrants out of the US). We think it is unlikely that traditional very cautious and conservative attitudes toward immigrant workers are going to change significantly, at least in the short term.

## **B. Efforts to raise productivity**

As with the contradictions in establishing an equal wage for an equal job, the Abe administration's policies to increase labor inputs as part of its labor market reforms may not be welcomed, especially by Japanese companies, unless they are accompanied by measures to raise productivity. The government's efforts to raise productivity can be grouped into the following three categories:

- (1) Efforts (under the banner of a "fourth industrial revolution") to speed up technological innovation in the fields of IoT, big data, and artificial intelligence, thereby achieving efficiencies in production processes.
- (2) Efforts to make full use of private-sector potential by means of deregulation and institutional reform.
- (3) Policies to create bigger markets in and increase the competitiveness of individual industries such as farming, fisheries, and forestry and tourism, especially in combination with efforts to revitalize the regions.

As far as the first of these (speeding up technological innovation and achieving production efficiencies) is concerned, it is possible to accept that the Japanese economy and Japanese companies, facing structural labor shortages as a result of demographics, will have no choice but to speed up such efforts. In nonmanufacturing and service industries, which by their very nature are labor-intensive and have been characterized by low productivity, we see considerable potential for the use of the kind of technological innovation that would be employed to achieve production efficiencies and imagine that this could raise productivity significantly.

However, by virtue of the fact that the use of technological innovation to raise productivity is labor-saving, we see it as an alternative to the use of higher labor inputs to raise Japan's potential growth rate. The ideal way to raise Japan's potential growth rate would be to create demand by means of efforts such as those in (2) and (3) above and to increase investment in line with the increase in demand, thereby creating new job opportunities as efficiently as possible.

In this regard, we think that the Abe administration still has some way to go to carry out the deregulation needed to create new demand and industries. As well as encouraging investment in particular industries it has identified, the government urgently needs to remove regulatory impediments (so-called bedrock regulations) to the kind of entrepreneurial innovation that creates demand.

## **Conclusion**

Since last autumn, the Abe administration has set in train measures, centered on its *Plan to Realize the Dynamic Engagement of All Citizens*, to reform the labor market. The aim is to create a virtuous cycle by raising the labor force participation rate, increasing the potential growth rate and thereby achieving faster economic growth, and using this to further raise the potential growth rate. The biggest challenge facing the government in

its efforts to "realize the dynamic engagement of all citizens" will be to reform the labor market, especially working practices.

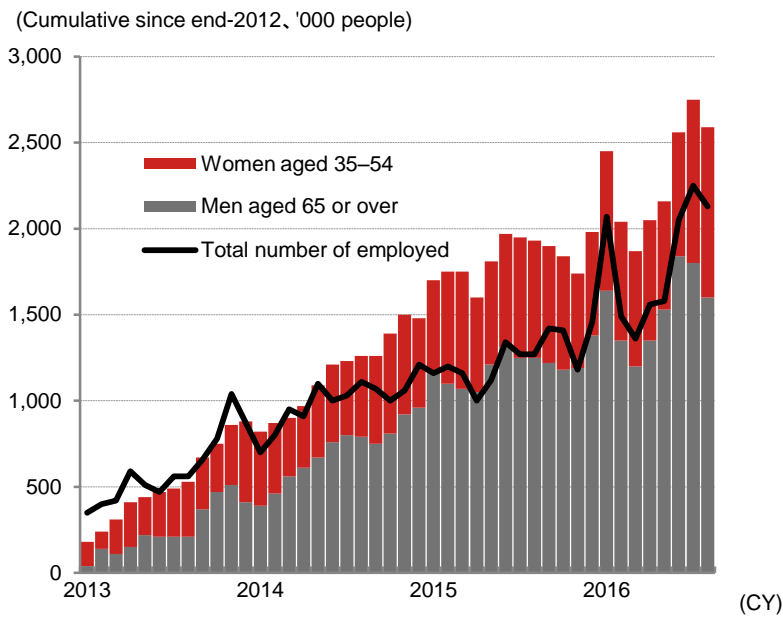
The biggest labor market success since the Abe administration was formed has been a marked increase in the number of people employed. Particularly noteworthy is the rise in the labor force participation rate of women and the elderly. The Abe administration's *Plan to Realize the Dynamic Engagement of All Citizens* can be said to have proved successful even before action was taken to implement it.

If the potential growth rate is to continue to rise, the government will have to lend a helping hand to ensure that labor inputs (above all, the number of people employed) grow steadily. In addition, action will be needed to raise productivity, although this runs counter in some ways to increasing labor inputs.

In conclusion, our assessment is that the government still faces a number of challenges in its efforts to reform the labor market. As regards its policies for increasing labor inputs, we think that its desire to respect traditional Japanese employment practices has acted as a constraint and that it remains to be seen whether it can increase labor inputs in a way that will not conflict with the efforts of Japanese companies to cut costs. As regards its policies for raising productivity, leaving aside its efforts to make production processes more efficient, a development that will inevitably accelerate because of labor shortages, we think that it still needs to do more to create demand and to increase investment in line with the growth in demand, thereby creating new job opportunities as efficiently as possible.

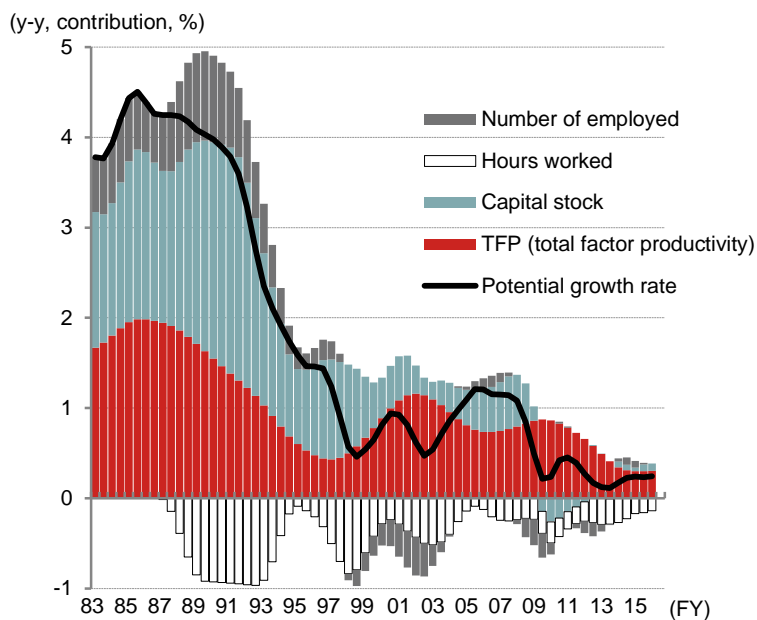


**Fig. 1: Number of people in employment since end-2012 (cumulative change)**



Source: Nomura, based on Ministry of Internal Affairs and Communications data

**Fig. 2: Japan's potential growth rate (BOJ estimate) and its contributing factors**



Source: Nomura, based on BOJ data

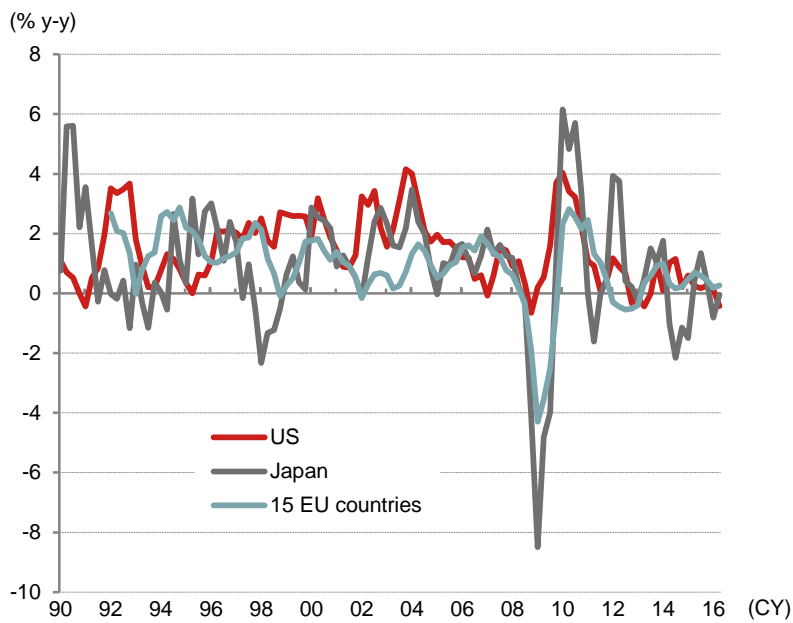
**Fig. 3: Household inflation expectations**



Note: Weighted average of *Consumer Confidence Survey* data on household inflation expectations (all-household basis)

Source: Nomura, based on Cabinet Office data

**Fig. 4: International comparison of labor productivity (OECD basis)**



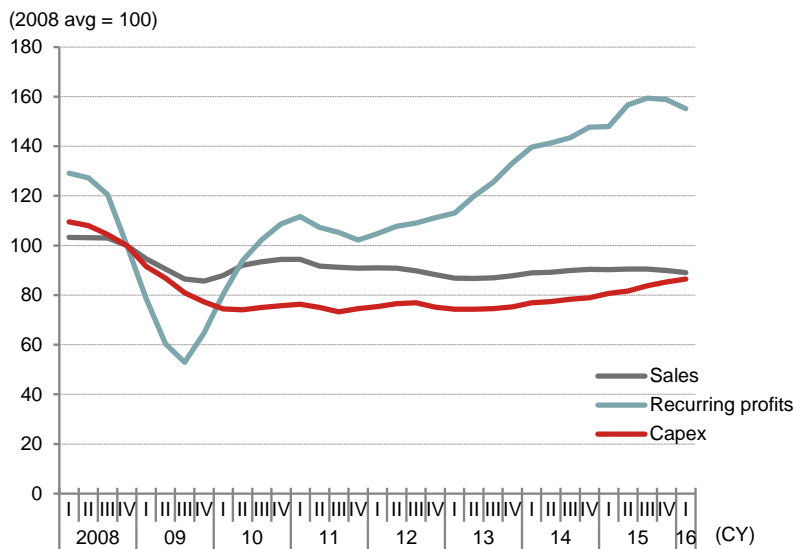
Source: Nomura, based on OECD data

**Fig. 5: Change in number of employees by industry (*Financial Statements Statistics of Corporations by Industry, companies capitalized at ¥100mn or more*)**



Source: Nomura, based on MOF data

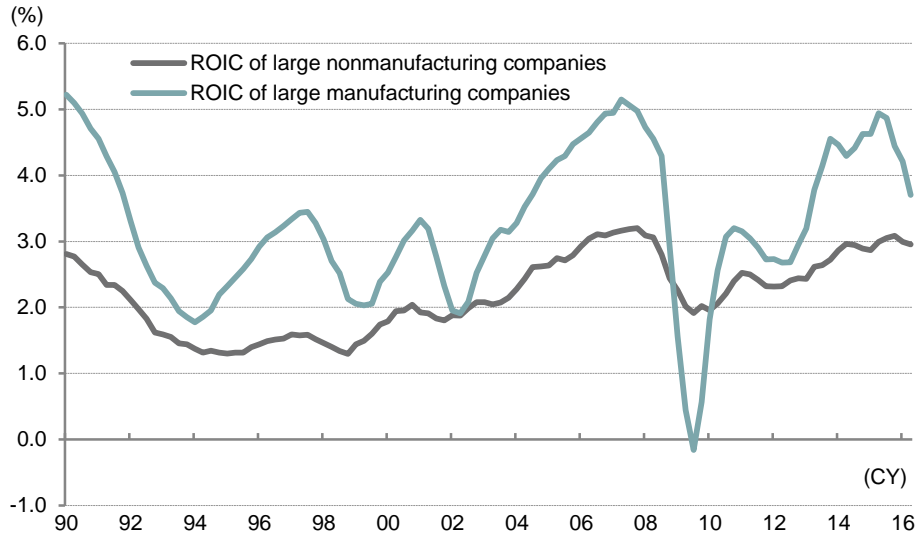
**Fig. 6: Japanese companies' sales, recurring profits, and capex (*Financial Statements Statistics of Corporations by Industry, companies of all sizes and in all industries*)**



Note: Seasonality removed by using four-quarter trailing average

Source: Nomura, based on MOF data

**Fig. 7: ROIC by sector (*Financial Statements Statistics of Corporations by Industry*, companies capitalized at ¥1.0bn or more)**



Note: ROIC = aftertax profits / (long-term liabilities + net assets)

Source: Nomura, based on MOF data