Key to Stimulating Investment Appetite Is Promoting Intangible Investment to Overcome Stagnation

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Under the Kishida administration, debate has been ignited on the topic of "new capitalism." Grasping the current situation of "capital" in Japan as the starting point for the debate is the minimum work that is necessary.

Capital stocks in the Japanese private sector have barely increased since the beginning of the 21st century. The amount of capital stocks in 2000, which was 692 trillion yen, grew to 736 trillion yen in 2019, representing an increase of only around 40 trillion yen. The stagnant growth is a stark contrast to the increase of around 60 trillion yen recorded just over the five years of the second half of the 1990s.

According to the growth accounting approach, which breaks down the economic growth rate into (i) labor force, (ii) capital, and (iii) other factors of technological progress (usually called total factor productivity), the contribution of capital was only 0.13% in the 2010s (2010-2018). This represents only 15% of the overall economic growth rate.

If we take the idea that economic growth and affluence are created through the accumulation of "capital," then it seems as if Japan has retreated to the point that it is far too premature for us to rethink capitalism. Foreign observers who have long watched Japan's prolonged economic stagnation are concerned over "Japanification," probably because they are afraid that capitalism may have lost vitality in Japan and that it might remain lost for an extended period of time.

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The Abe administration was expecting that the weak yen brought about by their unconventional monetary easing policy would trigger increases in stock prices through an increase in corporate earnings, leading to capital investment growth. Why did that scenario fail to materialize? Many economists, including those in academia, are paying attention to the fact that corporate earnings have been used to increase holdings of cash and deposits, rather than to make capital investments.

According to the Ministry of Finance's Financial Statements Statistics of Corporations by Industry, Japanese companies increased their combined amount of retained earnings over the 10-year period from the end of fiscal 2010 by around 180 trillion yen, 44% (around 80 trillion yen) of which was used to increase holdings of cash and deposits. On the other hand, the amount of tangible fixed assets increased by only 2 trillion yen. If we consider this situation from the viewpoint of portfolio selection by companies, we may interpret it to mean that companies increased their holdings of cash and deposits even at zero interest because they were fearful that the return on tangible asset investments within Japan could turn negative.

Where did the remaining 100 trillion yen go? The answer lies in the fact that the value of acquired shares and long-term loans, which come under the heading of "investments and other assets," increased by 138 trillion yen over the 10-year period. The bulk of the increase is presumed to have been used for mergers and acquisitions (M&As). According to data prepared by RECOF, an M&A advisory service firm, the number of M&As involving Japanese companies has continued to rise for the past 10 years. In particular, the value of acquisitions of foreign firms by Japanese companies surpassed 10 trillion yen in 2015.

Why do Japanese companies make investments overseas rather than at home? The obvious answer is that the return on foreign investments is higher because demand overseas can be expected to expand, but that is not the whole story. If companies intend to meet increases in foreign demand by exporting goods from Japan, they have to be prepared to constantly endure the risk of foreign exchange rate volatility. It is possible to deal with foreign exchange volatility by changing the composition of the input of factors of production in accordance with changes in exchange rates, but Japanese companies find it difficult to respond to the volatility in this way because they regard not only capital but also labor as a fixed factor of production.

An analysis by Professor Morikawa Masayuki of Hitotsubashi University showed that changes in prices and sales are regarded as uncertainty factors and that an increase in uncertainty may be a factor that causes a decrease in capital investment.

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How can the stagnant capital investment be revived in order to invigorate the Japanese economy? The key to doing that is intangible investment. Tangible investment, which has remained stagnant, refers to the construction of new buildings and the acquisition of equipment, for example. Meanwhile, intangible investment includes the accumulation of knowledge through research and development activity, the purchase of software programs, and the creation of new value in the fields of arts and entertainment.

Foreign direct investments made by Japanese companies generate income through the transfer of knowhow, specifically through exports of intangible assets, such as manufacturing knowhow cultivated by the companies within Japan. If looked at from the other side, for Japanese companies, acquiring foreign firms is the same as purchasing intangible assets which they lack, such as organizational expertise and human capital.

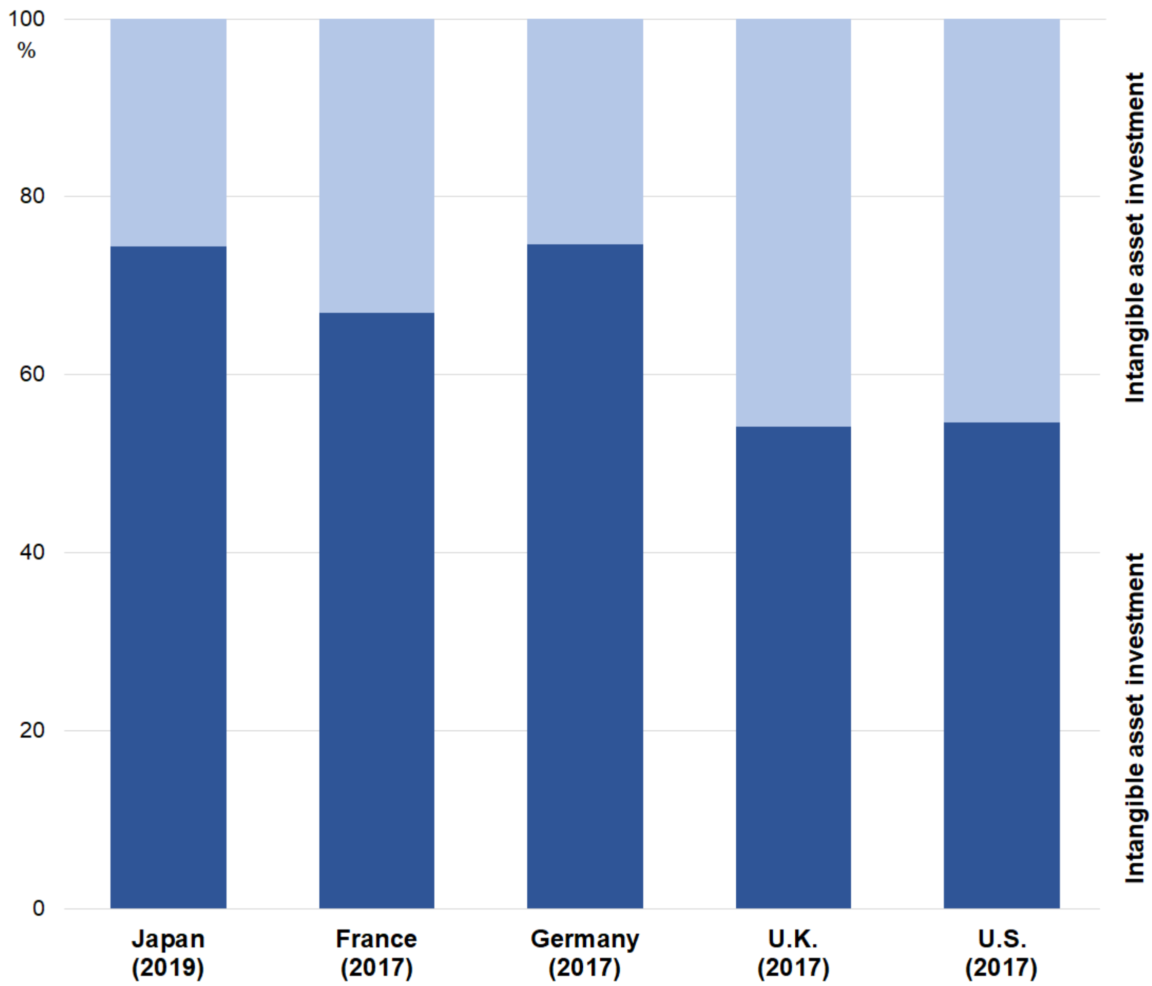
Looking at the state of intangible investment provides clues for answering the question of why tangible investment is stagnant despite the rising firm value associated with the increasing corporate earnings.

Following the study by Professor Janice Eberly of Northwestern University and others, Ishikawa Takayuki of Hitotsubashi University and I assumed that firm value reflects income generated not only by tangible assets but also by intangible assets, and arrived at the hypothesis that the gap between the rising firm value and the stagnant tangible investment is filled by intangible investment. The shortfall of the actual value of tangible investments against the estimated investment value calculated on the basis of firm value (investment gap) continued to fall deeper into negative territory after the bursting of economic bubbles, coming to minus 6.5% in 2016. If intangible asset investments are included in the actual investment value, the negative gap shrinks to a quarter of that rate, or minus 1.7%.

I presume that there is room for Japan to further increase intangible asset investments.

The figure below shows the ratios of tangible and intangible asset investments to overall investments excluding housing investments. The ratio of intangible asset investments in Japan is almost the same as the ratio in Germany. However, in the United States and the United Kingdom, the ratio of intangible asset investments is much higher, around 50%. Behind the difference is the fact that in Japan and Germany, the manufacturing sector, where the ratio of tangible asset investments is high, accounts for 20% of overall value added, whereas the manufacturing sector’s share of value added is 10% in the United States and the United Kingdom. If Japan is to strengthen the services sector and promote digitalization in the future, the country should promote intangible asset investment, which generates income more efficiently than tangible asset investment.

Ratios of tangible and intangible asset investments to capital investments



Source: Cabinet Office, System of National Accounts, and EU KLEMS Database

However, in order to ensure that intangible asset investments, including investments in research and development and in software, lead to higher productivity, it is necessary to make additional investments, including spending on nurturing and hiring highly-skilled workers and developing organizations adapted to new technology. In short, if companies are to increase intangible investments, they must be prepared to endure a temporary decline in productivity or earnings due to increases in such additional investments.

Commercial use of personal computers and the internet started in the second half of the 1980s, but it was not until the second half of the 1990s that the technological innovation bore fruit in the form of productivity growth in the United States. That time lag occurred presumably because it took some time before human capital accumulation was achieved and organizations were reformed to adapt to new technology. Japan, which is lagging behind in both digitalization and human capital development, cannot afford to wait as long as the United States did more than three decades ago for the fruits of innovation to arrive. Japan should immediately start addressing the following two challenges.

The first challenge is to make effective use of the Digital Agency, which was established in September 2021. If information infrastructure connecting government organizations and linking the government with the private sector is developed for the purpose of identifying infected people and efficiently providing benefits under the COVID-19 crisis, it may act as a catalyst for digitalization across the country.

The second challenge is to develop human capital through cooperation between the public and private sectors. The public sector should strive to improve government employees' skills while promoting digitalization. As for human capital development in the private sector, the mix of current items under consideration by the government including tax breaks for corporate wage hikes and employee training should be calibrated to place greater emphasis on human capital accumulation.

Even if wage hikes are achieved in the short term, a wage level that is decoupled from productivity will not be sustainable. To ensure a continuous rise in wages in the future, it is essential to encourage companies to allocate 1% of value added to expenditure for human capital development, which is a factor in productivity growth. If that happens, the scale of off-the-job training in Japan (relative to domestic growth product) will approach the scale in the United States and European developed countries.

What Japan should do now is to avoid merely focusing on short-term distribution policy measures. Japan must restore capitalism's inherent vitality by developing human capital with a long-term perspective and creating organizations adapted to technological innovation.

Translated by the Research Institute of Economy, Trade and Industry (RIETI).* The article first appeared in the "*Keizai kyoshitsu*" column of The Nikkei newspaper on 16 December 2021 under the title, "*Toshi iyoku hikidasuniwa (I): Datsu-teitai e mukeishisan toshi kagi* (*Key to Stimulating Investment Appetite Is Promoting Intangible Investment to Overcome Stagnation*)." *The Nikkei*, 16 December 2021. (Courtesy of the author)

*RIETI: https://www.rieti.go.jp/en/index.html

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