

22nd Asian Shadow Financial Regulatory Committee

Statement: September 6th 2013 – Sapporo

Development of the venture capital markets in Japan is seen as being an important part of the Abenomics strategy to stimulate long-term growth. According to a recent survey of investment by venture capital firms as a percentage of GDP, Japan ranked 35th out of 37 countries surveyed, well below China (11th), Korea (14th) and behind many other Asian countries. (Source: VentureXpert)

Large companies are lacking investment opportunities, small companies are not emerging in significant numbers and savings are going into financial institutions which traditionally do not fund risky new business. These are among the important factors as to why Japan has been experiencing two decades of low growth. It is vital for Japan to find a path to higher sustainable growth through encouraging new start-ups.

Factors that have contributed to this situation include inflexible labour markets in which large corporations cannot afford to hire more young people, diverting many of them to work in areas such as the service industry, primarily on contract. The burst of the asset bubble at the end of the 1980's exacerbated the situation leading to a loss of appetite for risk-taking due to poor equity returns. This also resulted in the exodus of some foreign financial institutions from Japan.

Unlike in the United States where immigration policy is more friendly and there are many entrepreneurs who are recent immigrants, in Japan few foreign entrepreneurs set up business. Also the Japanese government protects ailing companies which allows them to compete at a lower cost, crowding out new business. Some sectors of the Japanese economy such as the agricultural and medical sectors are not efficient due to government regulations, barriers to entry, and subsidies. Business practices such as restrictive association membership often frustrate new entrants. These factors combined discourage enterprise and entrepreneurship leading to reluctance to take risk and an inadequate accumulation of skills to create business.

Japan continues to lose its competitive advantage in the established industries as firms in countries such as Korea and China have caught up. At the same time Japan has not been as successful as the US has been in new industries. The US has produced many world leading companies such as Apple, Google, and Amazon over the last two decades. An important driving force for the US success has been its burgeoning venture capital industry. For Japan to revive its global competitiveness, it will be important to have a vibrant VC industry.

The Venture Capital industry in Japan has been affected by both demand and supply-side issues. On the demand side issues include insufficient incentives for generating and commercializing innovative ideas; too much regulation in certain industries; over-protection of existing companies which crowds out new entrants; for-profit incorporation in certain

industries such as agriculture and medical is not permitted; strict immigration laws that discourage new immigrants to Japan.

On the supply side the major issues are as follows. Despite ample savings and financial resources, there is a lack of financial intermediaries with the VC management skills to harness these funds. This holds back the effective use of funds for investment in new ventures, especially those requiring seed capital and mezzanine investment. There is also a high level of risk aversion by financial institutions that discourages VC investment. Further, VCs prefer investing in up-the-value-chain companies in which skilled labour can be adjusted in a flexible manner.

Recommendations:

Demand side:

- 1 Encourage the growth of new ideas by encouraging interaction between academicians and industry. For example by allowing faculty members to serve on the board of private companies, particularly start-ups and inviting industry leaders to serve on the advisory boards of the university, schools and departments.
- 2 Opening up of those areas in the economy that currently face restrictions and stop protecting ailing companies and allow for-profit incorporation in all sectors, especially the agricultural and medical sectors.
- 3 Give strong incentives to encourage eventual commercialization of academic findings when reviewing applications for government funding. The funded projects will be continuously monitored by government.
- 4 Review immigration laws to encourage skilful foreign workers to move to Japan and qualified foreign students to study and work in Japan for a minimum of two years as is common practice in other countries.

Supply side:

- 1 The Japanese government should invest in foreign and local VCs operating and investing in Japan. The government should be willing to take a lower return than the VC partners.
- 2 Incentivize banks to supply funding to start-ups through investment bank arms with policies such as tax incentives.
- 3 Reform the labour market to allow more flexibility in the hiring and the laying off of staff in new start-ups.