

I ndustrial Policy in Japan 2013

— Welfare Targeting Policy —

By Naoyuki Haraoka

What Is Industrial Policy?

“Industrial policy” is a term that has various connotations depending upon the situation in which it is used. When discussing trade issues, it is often used as a synonym for protectionist policies against free trade. Protectionist policies for industrial sectors losing their competitiveness or comparative advantages against other countries through high tariffs or subsidies are aimed at helping them survive increasingly intense competition. Industrial policy in this context, according to economists, is designed to preserve such inefficient sectors and thus works as an impediment to market functions supposed to achieve optimal resource allocation. In this sense, such an industrial policy is assumed to reduce national welfare by raising prices through interventions in the market, such as setting tariffs.

In another context, however, the term industrial policy is used to refer to the encouragement of innovations. Whereas protectionist policies work to achieve a static equilibrium in the economy, innovation policies work to realize a dynamic equilibrium. In this case industrial policy is expected to raise the productivity or competitiveness of certain sectors through subsidies or other incentive policies encouraging innovation. Such sectors may be considered future leaders and thus these policies would be used to make them highly competitive and contribute to boosting national welfare.

In Japan, industrial policy is very complex and covers many other things such as regional development policies or environmental and energy policies.

It has often been mentioned as the basic policy of the Ministry of

Economy, Trade and Industry (METI) or, before 2001, the Ministry of International Trade and Industry (MITI).

No matter what METI (or MITI) may do, it is considered industrial policy. Although the industry ministry’s policy objectives varied widely and were not limited to a single goal, until the 1980s these policies were often interpreted by Japan’s trading partners as an export targeting policy. This was probably due to the fact that at that time Japan continued to maintain a large trade surplus, which had caused friction with its trading partners as a result of their mistaken interpretation of it. They believed Japan’s large surplus was the outcome of unfair practices such as export targeting or protectionist policies to preserve inefficient sectors facing serious competition from imports.

However, as globalization continues, all nations are learning that intervention in the market could be detrimental to their own economy by causing inefficiency in industrial sectors and that what will spur the competitiveness of their industries is not industrial policy but global competition itself, which will allow only industries or firms that have achieved cost effectiveness in their production to survive.

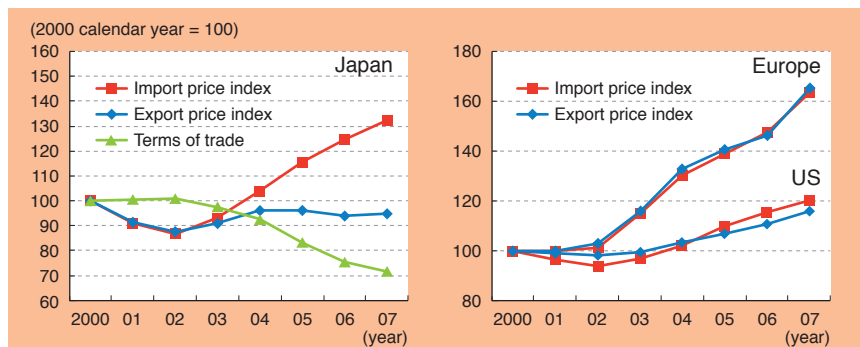
Japan is no exception. Japanese industrial policy today simply focuses on improving infrastructure for global competition, such as accommodating the rules of competition and regulatory reform.

With today’s globalization, it is business firms that choose the country they find the most attractive for their activities and not the country that chooses business firms. Having good rules for competition and good facilities for business activities, as well as good social infrastructure and taxation systems, will be key for nations to survive and attract as many companies as possible.

Many countries today are concerned about a hollowing out of their

CHART 1

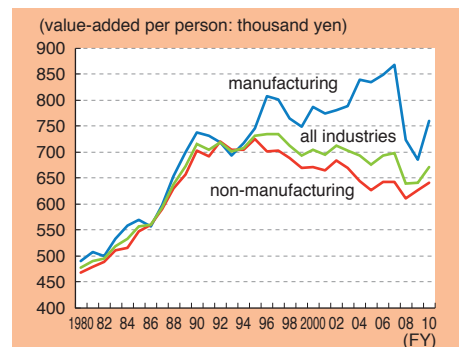
Trends in terms of trade in Japan, US & Europe



Source: IMF International Financial Statistics

CHART 2

Trend of value-added per person



Source: Ministry of Finance “Corporate Firms Statistics”

industries, which globalization by its nature encourages, in particular in nations that fail to establish a good business environment. Competition among such nations in attracting FDI is becoming serious.

Effect of Deflation on Japan's Industrial Policy

Continuing deflation in Japan since the 1990s has lowered expectations of economic growth. In such circumstances, Japanese firms have pursued cost cutting and lowered their prices to try to win the competition in the global market. This has resulted in stagnant export prices, in contrast to increasing import prices mainly caused by a drastic rise in the cost of raw materials. *Chart 1* shows such contrasts in export and import prices, which have led to worsening terms of trade for Japan. Japanese firms' business strategy of cutting costs and trying to compete by lowering prices has also brought about a stagnant trend in value-added per person (*Chart 2*). Such stagnation means a firm can neither afford to keep employees nor pay good salaries, and then labor income declines and domestic consumption falls, which leads to further deflation. This is the vicious cycle which the Japanese economy is facing.

In addition to this vicious cycle on the demand side, the Japanese economy has another serious difficulty on its supply side, namely a significant decline in its growth potential due to depopulation and aging (*Chart 3*). Furthermore, Japan's current surplus also declined significantly in 2012 due to increased energy imports following the suspension of nuclear power stations and also a decline in value-added on exports. Once its current account falls into deficit, as many economists predict it will in the near future, Japan will face a high risk of a rapid and drastic decline of its national bonds prices unless its government debt is significantly reduced, which could lead to hyper inflation and drastic yen depreciation.

Japan has to avoid this risk and emerge from this vicious cycle and raise its growth potential. It needs an evolution in industrial policy to achieve this without increasing fiscal expenses.

Industrial Policy in Japan — Version 2

The Industrial Structure Council issued a report last June outlining a new industrial policy.

To overcome the difficulties Japan faces, it will be necessary to raise the value-added produced by firms, as well as boosting growth potential by encouraging innovation — a “structural reform” of business and the economy.

To achieve this, Japan's industrial policy for the first time will have to cover the issues of remodeling corporate business strategies and individual worker's capacity building. This work would be expected to be done by business consultants, marking a clear contrast to the old industrial policy of accommodating competition rules to improve market functions.

The report suggests a change of Japanese business strategy from one oriented toward price competition to one aimed at creating social value, recommending they sell expensive but valuable and unique goods for the increasing numbers of wealthy consumers in

Asia instead of selling cheaper goods for the masses. This could be called a welfare-targeting policy.

iPhones and iPads can attract wealthy consumers even though they are expensive. A comprehensive manufacturing process, including prior consultation with customers on

their needs, and a maintenance service after sales would be appreciated by wealthy consumers even though the product may be expensive, as it could provide solutions to actual problems that customers may encounter.

One must be creative in order to achieve such social value with products that could sell well among the wealthy in Asia today, and also to achieve supply side innovation to boost growth potential by offsetting the negative impact of aging and depopulation.

Therefore, the most important target of an industrial policy is to raise the creativity of each employee by capacity building.

How can creativity be raised effectively?

The answer in this report to this question is diversity. More women in business management could create new ideas that have never been introduced by male managers. More foreigners in business management could also encourage all board members to express views on many issues from a completely different angle. More scientists or experts on culture in the boardroom, traditionally dominated by lawyers and economists in the case of Japanese companies, could also encourage different views about management and business strategy.

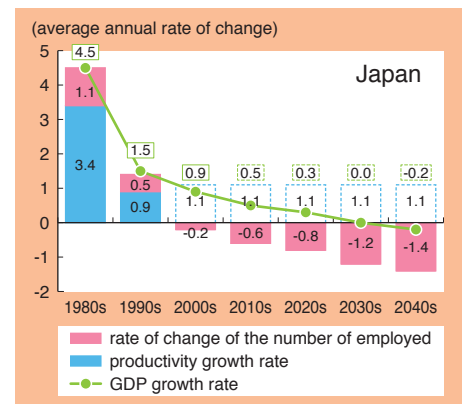
More young employees should be given opportunities to go abroad to study or work in order to broaden their minds. Many young people in Japan today find pleasure in thinking and acting on an individual basis and not in the interests of their companies, which used to be the dominant way of thinking until the 1980s. Young employees had to sacrifice their private lives even on weekends by playing golf with their superiors if they asked them to do so, even if they did not know how to play.

Capacity building for individual creativity should fit a person's character. Young people must feel happy in finding their capacity to be creative in a culture of diversity and their pleasure in such capacity building would lead to raising overall welfare in Japan. In the end Japan will emerge from deflation and avoid the nightmare of possible national bankruptcy caused by an increased current deficit.

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CHART 3

Growth potential of Japan



Source: OECD, METI