"Abenomics" & Japan's Neo-Industrial Policy Initiative

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Introduction

This paper is an overview of a Japanese phenomenon of recent years, one that can be properly called a neo-industrial policy initiative, using public-private partnership funds as a central tool for the industrial policy. It will begin with an explanation of the role of the neo-industrial policy initiative within the context of Abenomics. It will then provide a brief comparison of the initiative and the industrial policy of what was at the time the Ministry of International Trade and Industry (MITI). It will conclude with an overview of the conditions for a successful outcome to the initiative.

The Political Economy of Abenomics: Rise of the Neo-Industrial Policy Initiative

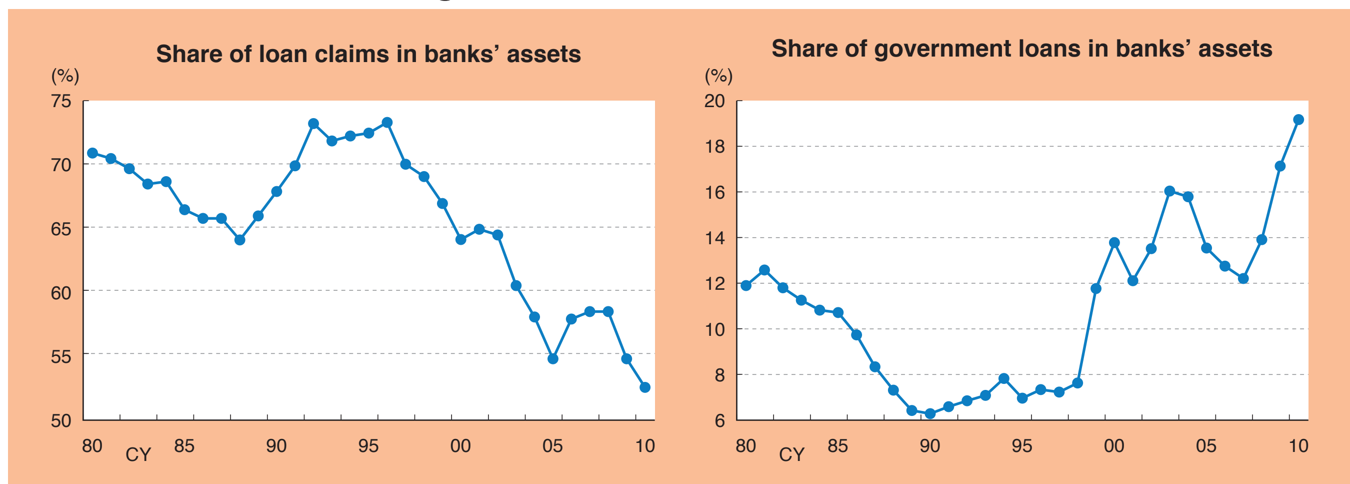
Monetary policy and fiscal policy were the first two arrows of Abenomics to be released; by contrast, the third arrow is widely considered to be slow in coming. A major reason for the delay is politics. Political opposition to expansionary monetary (arrow one) and fiscal (arrow two) policies is the exception; when it comes to the third-arrow growth strategy, powerful resistance from vested interests to deregulation and the like is the rule. Particularly with regard to the administration of Prime Minister Shinzo Abe, one of its main objectives at the beginning was to put an end to the "twisted Diet" — the administration did not have a majority in the House of Councillors — in the July upper house election. This meant that the third arrow had to be delayed in view of the expected political resistance.

However, regulatory reforms that cut into vested interests in such important areas as labor, health care and agriculture have not been making much progress even after Abe's Liberal Democratic Party (LDP) gained an upper house majority with a landslide victory. The revival of the LDP in some ways might have meant the revival of vested interests in the postwar Japanese economy.

Our experience since the 1990s, however, shows that monetary and fiscal policies — the first two arrows — are insufficient for the sustained revival of the Japanese economy. *Chart 1* shows the proportion of loans to the private sector in total Japanese bank assets and the proportion of loans to the government sector in total Japanese bank assets. *Chart 2* shows cash flow by sector since the 1980s. They demonstrate that much of the money that was pushed into the market through the expansionary monetary and fiscal policies since the latter half of the 1990s was not lent out to businesses through the banks. Instead, the money was used by the banks to purchase government bonds or remained with non-financial businesses as retained earnings. In short, since the 1990s, Japan did not see the money circulate within the private sector. Although the Japanese economy would register a modest upturn when

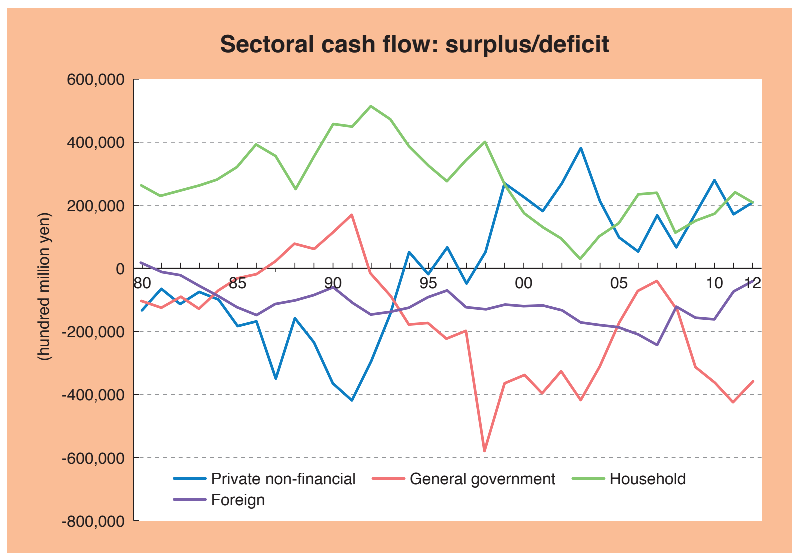
CHART 1

Shares of loan claims & government loans



Source: K. Aoki & N. Sudo, 2012. "Asset Portofolio Choice of Banks and Inflation Dynamics." Bank of Japan Working Paper No. 12-E-5.

CHART 2
Sectoral cash flow



Source: Bank of Japan

expansionary monetary and fiscal policies were implemented, it would take a turn for the worse when the effects wore off. As this cycle repeated itself, the successive waves of fiscal measures generated a massive public debt overhang that is now a major risk to the Japanese economy.

Since the 1990s, when thoroughgoing reform that cut into vested interests failed to make significant progress due to political resistance, the first microeconomic area in which the Ministry of Economy, Trade and Industry (METI) and other government agencies actively engaged was horizontal institutional reform, such as corporate law and competition law. Fundamental amendments to the Commercial Code and the Anti-monopoly Act were launched in succession with a depth and frequency that would have been unthinkable up to and during the 1980s. Policymaking processes that had not existed before emerged, such as the collaboration of the Ministry of Justice and METI to amend corporate and bankruptcy laws. This series of amendments generated such activities as efforts by Livedoor, an ambitious venture business, to acquire a major media group and the hostile takeover bids by the so-called Murakami Fund, led by Yoshiaki Murakami, a former MITI official. A widely held view, particularly in the West, is that institutional reform efforts did not make headway in Japan after the bubble-economy years. However, the institutional reforms during this period deserve respect for their depth and scope. Nevertheless, they did not immediately lead to the active recirculation of money by the private sector, and the activities of the Murakami Fund and the like brought forth a powerful, negative reaction from the business establishment.

It was when this institutional reform approach reached an impasse that the neo-industrial policy initiative, in which the state is actively engaged at the microeconomic level, began to take shape. The initiative had its beginnings in the Industrial Revitalization Corporation of Japan (IRCJ). The IRCJ was established in 2003 and went on to undertake the revitalization of Daiei, Kanebo and other firms. It turned a profit, which it delivered to the state as the investor when it was dissolved in 2007. This was one factor that propelled the neo-industrial policy initiative forward. This movement continued when the Democratic Party of Japan (DPJ) assumed power in 2009, when the Innovation Network Corporation of Japan (INCJ) was launched, originally as a state-owned venture capital operation. One of the originators of the neo-industrial policy initiative said in an interview with me at the time that “several institutional reforms were undertaken from the 1990s on but the economy was not revitalized. Now, it is our (the government’s) turn. We must take the initiative in revitalizing the economy.”

It was after the Abe administration took over, though, that the neo-industrial policy initiative, with public-private partnership funds at its core, really gathered momentum. The INCJ became a massive 3 trillion yen fund, while many other public-private partnership funds were created for purposes such as the promotion of the Cool Japan Initiative and the implementation of earthquake countermeasures. Abe has made the following bold statement:

“The state in the aftermath of the Lehman Brothers bankruptcy is forced to be actively involved on all fronts of the economy. The state needs to increase fiscal stimulus and run its own investment funds. State capitalism is emergent in the world economic system.” (Speech given at Keidanren in June 2013 — my translation.)

Abe’s statement indicates that the state-capitalistic neo-industrial policy initiative is actually moving forward as a not well-known part of Abenomics.

The economic rationale for the rash of new public-private partnership funds is that there is a lack of risk money in Japan and that innovative investments have positive externalities. Neither reason comes with clear theoretical justifications, but it is the sense of many actors in the field that there is something dysfunctional about the Japanese market when it comes to supplying risk money. That said, behind this rationale lie the various motives of several key players.

Politically, the Abe administration needs an effective third arrow to follow the first two. Money must start circulating within the private sector on its own while monetary and fiscal policies are taking effect and market expectations are on the upswing. However, deregulation has been hard going because it is politically difficult to implement measures that cut into vested interests. The horizontal institutional reforms that took place from the 1990s on appear to have reached an impasse and in any case do not provide quick kills. By contrast, there are few if any political forces that would oppose the

government purchasing or investing in firms through public-private partnership funds. That is even truer when it comes to the acquisition of firms whose operations have become difficult to maintain such as Renesas Electronics, into which the INCJ injected 200 billion yen. It is possible to show visible results more quickly than other growth strategies. The business lobby has no reason to oppose public-private partnership funds that buy up its low-performance departments or provide massive joint investments when acquiring overseas firms.

As for bureaucratic motivation, the reason why METI, which is playing a central role in the development of Abenomics' growth strategy, is eager to set up public-private partnership funds is obvious. As I shall explain later, it had been the long-held desire of METI to have a financial tool like the public-private partnership funds to implement industrial policy.

What is unclear is where the Ministry of Finance (MOF), which is responsible for the national treasury, stands in all of this. At first glance, MOF would be expected to oppose the establishment of public-private partnership funds. If investments in public-private partnership funds do not generate profits, any losses will ultimately have to be made up with funds appropriated through the national budget. Moreover, there will be insufficient MOF oversight of investment activities by the funds using government funds during their duration.

Nevertheless, MOF is being supportive of the establishment of public-private partnership funds as reported in the *Nikkei Shimbun* (March 8, 2013). The biggest reason for this allegedly is the fact that investments by public-private partnership funds, unlike subsidies, do not have to be accounted for as losses until such losses are finalized, according to a report in the *Asahi Shimbun* (Aug. 18, 2013).

Since outstanding Japanese public debt has reached proportions unseen in world history, MOF bureaucrats wanted to avoid expanding fiscal deficits as much as possible. At the same time, there was powerful political pressure on MOF from the Abe administration to cooperate with the realization of the growth strategy. Thus, public-private partnership funds loomed as an effective tool for the growth strategy and were utilized because recognition of fiscal shortfalls could be delayed even if losses were incurred.

This convergence of the intentions of various key players in the Japanese political and economic system has led to the establishment of a string of public-private partnership funds and the emergence of a neo-industrial policy initiative. However, the divergent motives of the players pose very difficult challenges for the future management of the public-private partnership funds and for the neo-industrial policy initiative itself.

What's New? Comparison with MITI's Industrial Policy in High-Growth Era

What are the major differences between the recent neo-industrial policy initiative, with public-private partnership funds at its core, and the well-known industrial policy conducted by MITI during the high-growth era? The stark differences in the historical background and the economic and political environment make it impossible to make rigid and detailed comparisons. Here, I will highlight the critical differences.

The "developmental state model" discussed by Chalmers Johnson (*MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925-1975*, Standford University Press, 1982) is a famous depiction of the MITI industrial policy during the high-growth era. Indeed, many people hold the view that smart MITI bureaucrats exerted powerful leadership over Japanese firms during that period. However, as political economists such as Richard Samuels, Daniel Okimoto, and Kent Calder later showed, MITI was not in fact the wise and potent leader at the helm of Japan Inc. The more persuasive view today is that it was a weak coordinator standing at the center of Japan's informal and longstanding government-business network and complementing Japanese market functions, which were still under development (as I will show in my forthcoming book *"Death Valley Curve" of Institutional Change: Japanese Political Economy 1990-2005*). As a range of empirical research has shown, firms often did not follow MITI guidance, while in the few areas where MITI did exercise leadership industrial policy was not necessarily successful.

Many observers give the gradual elimination of MITI's regulatory powers as the reason for its weakness during the high-growth era. However, there was another important reason: its lack of direct control over financial policy tools. Subsidies and tax measures required the consent of MOF. Banks were under the supervision of MOF. And the foreign exchange allocation system had been abolished in the mid-1960s.

The fact that MITI did not have direct control over financial policy tools during the high-growth era must have been frustrating for the MITI officials at the time. Getting their hands on them became a long-held desire. The high-profile, early-1960s bill for an Act on Temporary Measures for the Promotion of Specified Industries was one such MITI attempt, but it failed to pass due to opposition from banks and lack of cooperation from MOF. But MITI's lack of financial policy tools worked as an external discipline on its industrial policy. Many political economists believe that this worked to the benefit of the Japanese economy as far as industrial policy was concerned.

The relationship with politics has also changed dramatically between the high-growth era and now. MITI was considered antipathetic to politics and was known for distancing itself from politics. Although the commerce and industry "tribe" was the largest contingency within the LDP, it is believed that MITI did not try to actively organize it during the high-growth era. Today, the neo-industrial policy initiative, with public-private partnership funds at its core, is being promoted hand-in-hand with the political class.

There are a variety of other differences between the industrial policy of the high-growth era and the more recent neo-industrial policy initiative, of which the most important are listed in the *Table*. There are two important points. First, now that it has secured

TABLE

Key differences from past

	Public-private funds	High-growth era industrial policy
Financial tools	**Equity funds** · 4,000 billion yen in total · 2,000 billion yen for INCJ (Total size of all private funds in Japan is 1,000 billion yen.)	Tools · Direct subsidies · **Off-budget finance (e.g. FILP)** · **Subsidized credit and R&D policy** · Tax policy Little influence on bank finance
Political involvement	**Very high**	**Weak**
MOF	**Cooperative**	**Gatekeeper**, tension with MITI
Duration	15-20 years	Yearly budget – 5-10 years R&D project
Role of government (intuitive description)	Equity **investor**? (depending on role of fund managers)	**Coordinator** with some financial and regulatory tools?

Source: Compiled by author

financial policy tools through public-private partnership funds and other means, METI in a certain sense can exercise greater influence over firms and markets than it could as MITI during the high-growth era. Beyond public-private partnership funds, the Bill for the Industrial Competitiveness Enhancement Act, which was recently passed into law at the Diet, opens the door to government engagement in business restructuring to rectify "excessive competition".

Second, MOF, financial institutions, politicians, and other forces that had mainly imposed external discipline during the high-growth era are being internalized as key players in the neo-industrial policy initiative.

Let's keep these differences in mind as we next explore what the key challenges of the neo-industrial policy initiative are.

The Challenges Ahead

In the background of the establishment of the string of public-private partnership funds are the political, bureaucratic, and economic motives of Japan's key political and economic players. Moreover, public-private partnership funds cannot make profits their sole purpose because losses would accrue to the Japanese taxpayer. That said, it is crucial that economic rationales prevail if the neo-industrial policy initiative is to succeed. The IBCJ, which ushered in the neo-industrial policy initiative, gives one reason for its success as the fact that it was able to resist excessive political and administrative intervention and make investment decisions mainly from an economic perspective.

There are several ways to prioritize economic rationale over other motives. First, it is necessary to reintroduce the variety of measures taken in the case of the IBCJ that created a barrier between business decisions and political and bureaucratic interests. Second, although the ICRJ and the like are called public-private partnership funds, in fact the public sector bears a disproportionately large share of the risk. There is a need to redistribute the risk so that the private sector shoulders more of it. Third, the incentive mechanisms for the fund managers who make the investment decisions should be as closely aligned as possible with market realities. Fourth, the duration of the public-private partnership funds are between 15 and 20 years, much longer than private-sector funds. This should be shortened. The need for a measure of independence from politics and an appropriate apportionment of risk with the private sector is a lesson that the industrial policies of the high-growth era also teaches us.

At the same time, any losses incurred by public-private partnership funds ultimately accrue to the Japanese public. Thus, democratic accountability must be secured in addition to economic rationale. The first thing necessary here is to secure transparency. Raise disclosure requirements well above those of ordinary private funds. Shorten the duration of the funds and conduct interim reviews. Of course there will be information that cannot be disclosed immediately, but there should be a mechanism in place to do so later. Ensuring transparency is also effective as a means of preventing political and bureaucratic pork-barrel manipulation.

More generally, it is important to limit the role of public-private partnership funds to a supplementary role in relation to the market, like much of MITI's industrial policy during the high-growth era. In that sense, some of the current public-private partnership funds may be too large. For example, the Cool Japan Fund reputedly is seeking 100 billion yen in investment money. This could mean that the future of this sector, where creativity is of the utmost importance, will be decided by a fund led by the government.

Finally, it is necessary to have an exit strategy in place beforehand. It is necessary to be aware that the neo-industrial policy initiative — the first and second arrows of Abenomics as well, for that matter — is merely a pump-priming measure to revitalize economic activity in the private sector. The public-private partnership funds must be prevented from becoming a new source of funding for what Takeo Hoshi and Anil Kashyap termed "zombie lending" ("Zombie Lending and Depressed Restructuring in Japan", *American Economic Review*, 98 (5), 2008) and the means to preserve firms and industrial structures whose time has passed. In that sense, the neo-industrial policy initiative forces us to reconsider the respective roles of the government and the private sector. JS

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