Industrial Policy for Competitiveness

By Eleanor M. Hadley

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In the postwar period, Japan, by means of industrial policy, has brought a policy-variable to bear on its trade strategy little used by other industrialized countries. In addition to the customary means of international trade competition through price, quality, styling, and marketing, Japan has competed through the composition or product mix of its exports.

Japan has recognized that the sales prospects are brighter for certain industries than for other industries and has sought to recompose its industrial sector accordingly. For some goods, automobiles, for example, the demand increases with rising income, and in such circumstances market forces will do part of one's work for one. On the other hand, there are products where this does not happen, shoes for example. In the United States per-capita shoe consumption in 1978 was less than it was a decade earlier.

Japan has recognized there is GNP advantage in focusing effort on goods where the manufacturing process represents a substantial increase in value over the price of the raw materials. Cutlery, pottery, and toys represent cases where the increase in value out of manufacture is modest. Ships, cars, machine tools, and computers represent cases where there is a substantial difference. We speak of the latter as high value-added goods.

In making judgments on industries to cultivate, Japan was conscious that its prewar civilian industries—textiles, rubber-soled footwear, and so forth—would before long become subject, as the Japanese-English expression goes, to "chasing up" competition from newly industrializing countries. It was recognized that it would be more comfortable to be the "chaser" than the "chased."

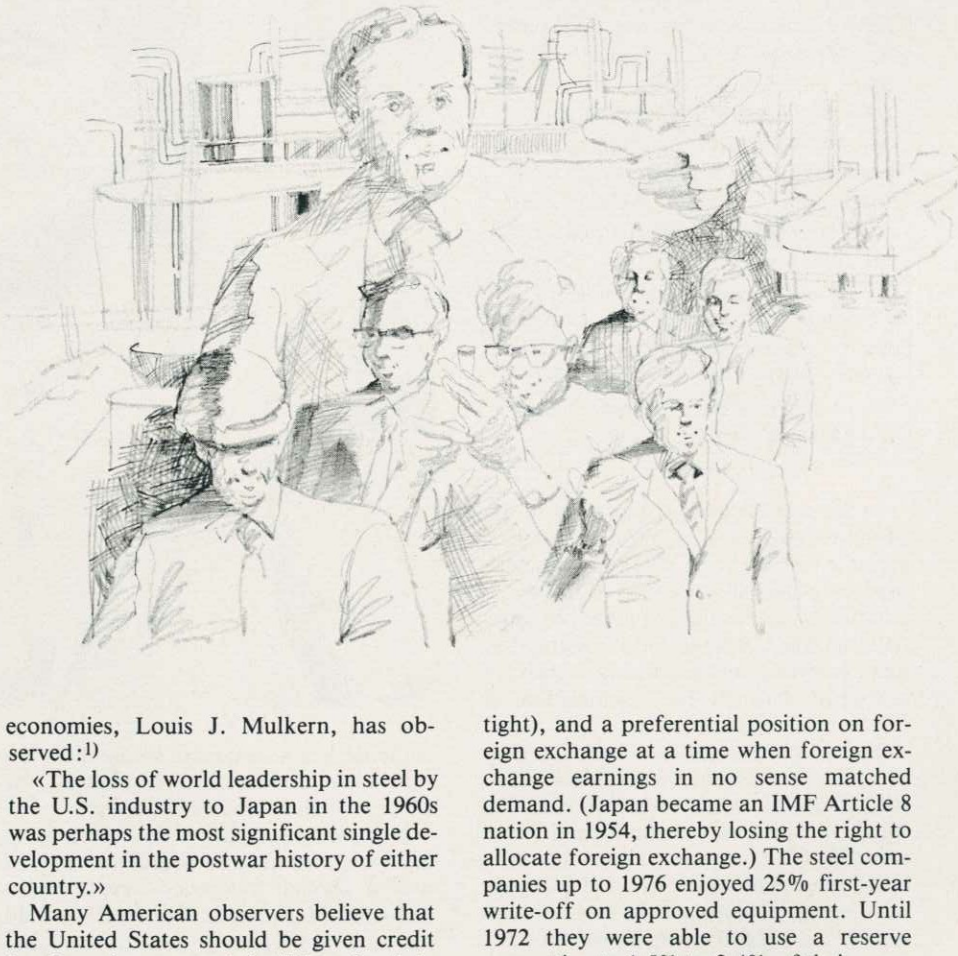
"Architecting" Key Industries

For the foregoing reasons, early in the postwar period Japan began a policy of "architecting" key industries. I emphasize "key," for in sharp contrast to centrally planned economies, at no point has Japan sought to plan the whole of its industrial sector. Further, reliance has been placed on the private sector to carry out these public policy decisions, so definitionally architecting has been a shared exercise between government and the private sector, again in contrast to the approach of centrally planned economies. Cooperation has been by inducement, not compulsion. Out of this exercise an interesting technique of public policy has emerged, one that might be described as a policy of "socializing" risk. With the government assuming a portion of the risk—oftentimes a small portion—the private sector has felt itself able to undertake challenges that otherwise would have appeared unassumable. As I see it, industrial policy has made a significant contribution to the postwar performance of the Japanese economy.

Among a good many foreign experts, however, there has been reluctance to concede industrial policy's contribution to Japan's economic performance. For example, with the exception of the late William W. Lockwood, the dominant view among American economists has been to deny industrial policy's role. Thus for example, editors Hugh Patrick and Henry Rosovsky selected Philip Trezise to write the chapter on government-business relationships for *Asia's New Giant*. Trezise staunchly believes there is no significant difference in the role of government in Japan's economy and in the U.S. economy.

American political scientists have not been as ready as American economists to argue that the Japanese Government role was undistinctive. Chalmers Johnson undertook his recently published *MITI and the Japanese Miracle* out of his frustration with the dominant economic point of view. Curiously, however, after complaining that economists told only half the story, that of the private sector, he turned around and proceeded to tell only the other half of the story himself—the government side. The private sector is scarcely mentioned in Johnson's study. In my judgment, not only has industrial policy played a critical role in Japan's postwar economic performance, but the story cannot be told without speaking of the government and private sector together.

Japan's industrial policy has had a second dimension. Not only has it led to architecting key industries but it has actively promoted the diffusion of "best manufacturing practices." Originally it may have been the intent to tie stimulation of "best practices" to target industries alone, but in the face of political pressures, the highly attractive tax feature of the Enterprise Rationalization Law (1952-1976) came to be applied by the early 1970s to virtually the breadth of the Japanese economy. This law granted a first-year depreciation write-off of 25% for "approved equipment" in "approved industries." The 25% write-off was on top of regular and incentive depreciation provisions. In other words, the Japanese Government committed itself to stimulating production under the most cost-efficient procedures available.



Beyond Winners and Losers

Speak of "industrial policy" to most Americans and the reply is likely to be "Oh, you mean picking winners and losers," which Americans typically conceive as a statistical exercise off historical growth rates. In fact, the Department of Commerce went through such an exercise a few years ago and came up with automobiles as a winner—showing the absurdity of the whole exercise.

I believe this conception of target industries quite misses the point of how Japan has selected its industries. Japanese target industries have been selected not only for their own importance but for their ramifying effect on other industries. For example, steel was chosen because, in an industrial economy, steel is the basic building block. Have cheap, good-quality steel and the products made of it will enjoy a price advantage—ships, automobiles, rails, locomotives, heavy electrical equipment, and so on. A longtime economic observer of the Japanese and American economies, Louis J. Mulkern, has observed:[1]

«The loss of world leadership in steel by the U.S. industry to Japan in the 1960s was perhaps the most significant single development in the postwar history of either country.»

Many American observers believe that the United States should be given credit for Japan's new steel facilities, for it is thought that the U.S. destroyed the prewar facilities while we "suffer" the handicap of our own facilities having come through the war intact. I recall speaking with a Japanese steel representative a few years ago about the different published figures on the proportion of Japan's steel capacity that was destroyed, seeking his judgment as to the correct figure. A smile spread across his face and he asked me what I thought Japan's prewar steel capacity had been. When I learned it was in the range of 6-7 million tons—today's capacity is 150 million—it was clearly a splendid irrelevancy what proportion came through the war intact.

Was it market forces alone that raised Japan's steel making capacity from the 6-7 million range of the war years to its current 150 million tons and made it the acknowledged leader in world steel production or was it market forces plus a package of measures that "socialized" a portion of the risk? It was the latter. Government stimulus measures included Japan Development Bank loans at preferential interest rates, which loans in turn gave steel companies improved access to commercial bank credit (for most of the first 20 postwar years bank credit was tight), and a preferential position on foreign exchange at a time when foreign exchange earnings in no sense matched demand. (Japan became an IMF Article 8 nation in 1954, thereby losing the right to allocate foreign exchange.) The steel companies up to 1976 enjoyed 25% first-year write-off on approved equipment. Until 1972 they were able to use a reserve amounting to 1.5% to 2.4% of their overseas sales for market development. This latter provision, originally conceived as tax foregiveness, was transformed under GATT complaint to a 5-year tax deferral basis. The steel companies also enjoyed, with all other industries up to 1972, a few extra "brownie points" on depreciation for strong export performance. Part of the formula for determining these extra points rested on the level of exports to total sales; the other part rested on improvement in this proportion. This feature now is applicable only to medium/small enterprises.

In view of the foregoing it seems quite implausible to me to hold there was not something distinctive in the government role. However, had Japan's steel companies not enjoyed top-flight entrepreneurial direction, had the companies not been engaged for most of this period in keen rivalry with one another, the government's stimulus measures would have meant very little. Japan's steel program was a joint venture among the steel companies, MITI, and the Ministry of Finance.

Automobiles: The Way It Was

Automobiles were selected as a target industry not only because demand was expected to rise with rising incomes and because they represent a high value-added industry but for the number of industries which this industry would stimulate—glass, rubber, road-building machinery, and so forth. Japan proceeded to grow an automobile industry in much the same way it grew the world's most efficient steel industry—by a combination of government taking some of the risk in conjunction with outstanding entrepreneurial talent and fierce rivalry among the several companies.

Prewar Japan's automotive industry was overwhelmingly trucks. GM and Ford dominated the passenger car market prior to WW II. When after a lengthy debate within the government in the beginning of the 1950s Japan committed itself to growing an automobile industry, high tariff walls were created, and when some European producers got in over the 40% tariff, foreign exchange was denied Japanese wishing to purchase such cars. Competition from the second-hand car market from Occupation personnel selling cars on leaving Japan was also closed off through the control of foreign exchange. Foreign production within Japan's protected home market was stinted through the Foreign Investment Law which required government approval for investment within Japan. While the companies were left to do their own exploration of technological tie-ups, prior to the liberalization of foreign exchange in 1964 MITI was likely to enter the picture after agreement had been reached between the private parties to get better terms for Japan's weak companies. In terms of auto parts, MITI's 1952 guidelines required that on expiration of the licensing agreements, there must be local production of the parts covered by the technical agreements. The same type of credit and tax features as outlined with respect to steel applied to the automobile companies.

Reserving the home market for Japan's automobile companies enabled these initial high-cost producers to develop economies of scale and to come down the "learning curve." It was in the beginning 1960s that U.S.-Japan bilateral trade in automobiles broke even. By 1970 the Japanese surplus in this commodity line was three-quarters of a billion dollars.

There are few who would challenge the fact that infant industries need special protection. It was with the slowness that the Japanese Government reduced tariff protection and NTBs that foreign governments had a strong complaint. For example, automobile rates in the late sixties and early seventies were:

on small cars:	
as of July 1968	36%
as of January 1970	34%
as of May 1970	20%
as of April 1971	10%
on large cars:	
July 1968	28%
April 1969	17.5%
April 1971	10%

In addition, Japan imposed a 40% commodity tax on the purchase of large cars (almost all of which were foreign) and a 30% commodity tax on smaller cars. The commodity tax on imported cars was imposed "cif," the tax on domestic cars ex-factory.

Currently the Japanese Government has a keen appreciation of the place of computers in a "post-industrial" society. Just as it saw steel as the basic building block of an industrial economy, so it sees computers as the basic building block of an information processing society. Hence the emphasis given this industry since the beginning 1960s.

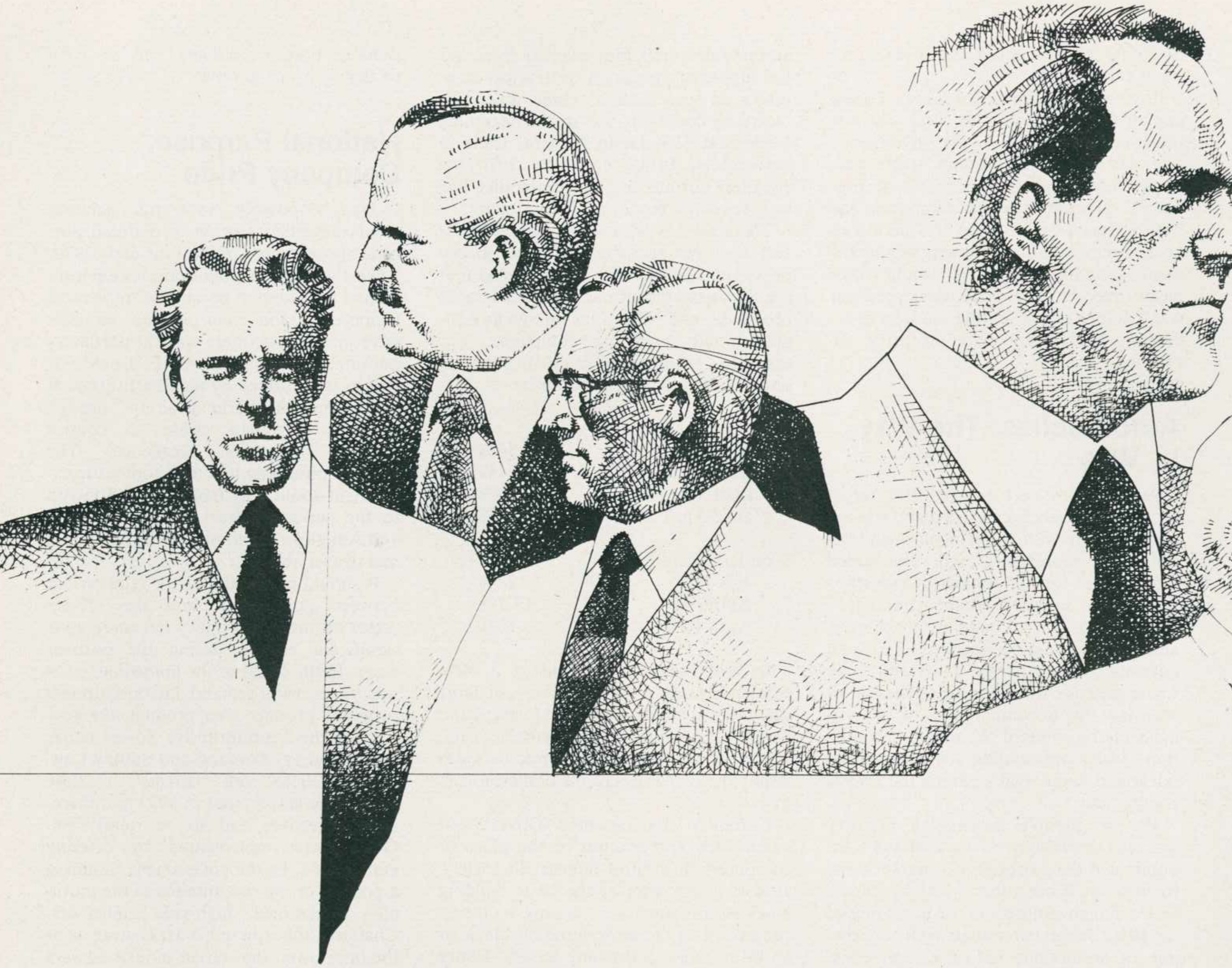
The computer industry posed a number of new problems to the architects of target industries. There was no earlier Japanese production to serve as a base on which to build. Foreign production could not be excluded from the Japanese market because IBM Japan was already here. Further, in order to get into production Japan had to have IBM licenses. Tariffs could be used to exclude foreign imports during the initial period. In this industry, in addition to the other usual stimulus measures, the government provided some R&D funds, it developed target objectives, it encouraged joint research, and it sought to expand demand for Japanese computers by developing a joint leasing arrangement to compete with IBM's leasing arrangement. However, again the point needs to be stressed that the government program was the product of government officials and the industry's leaders jointly devising strategy. The strategy would not have worked had Japan's business executives not been of top-flight quality, willing to commit their own funds to these exceptionally bold objectives, and in keen rivalry with one another.

National Purpose, Company Pride

Japan's postwar industrial achievements have had a sense of national purpose about them. Up until the early 1970s when the scale of pollution and environmental degradation became of intolerable proportions and environmental controls were introduced, there was extraordinary national consensus on GNP growth. It was as if, deprived by its Constitution of contesting for world position through armaments, Japan chose to contest through industrial excellence. The strategy obviously had more domestic excitement about it as Japan was coming up to the per-capita level of the European and American economies than after Japan had drawn abreast.

It should be noted that the relationship between government and the private sector on industrial policy has undergone significant change during the postwar years. In the chaos of the immediate postwar years, with demand far outstripping supply in product after product, the government held authoritative power under the Temporary Demand and Supply Law. It was "sticks" not "carrots" in those years. The law expired in 1952 and thereafter objectives had to be jointly set. Goals were implemented by offering enticements, by the government assuming a portion of the risk entailed in the mutually determined high-risk endeavors. Chalmers Johnson in his *MITI* study is of the impression that target industries were "riskless" lines of endeavor. Nothing could be further from the truth. Private business has committed huge amounts of its own money to carry out these high-risk projects. It was because of the private commitment of funds that there was no way the government could go beyond what business was willing to do.

In this regard it is noteworthy that MITI did not win all the arguments with business. For example, in the case of the automobile industry MITI, impressed with the importance of economies of scale, wanted in the mid-fifties to see the development of a single type "people's car," with MITI to select the producer out of a national competition. The industry was not interested and that was the end of the "people's car." Similarly, again motivated by a concern for economies of scale, MITI in the early sixties wanted to see the automakers—Japan had eight then and now has seven—grouped into three groupings with each grouping concentrating on a single type of car. Lacking the ability to persuade the companies through administrative guidance, MITI sought legislation giving it, among other provisions, power



to compel such steps. Three times this legislation was submitted to the Diet and three times it was unsuccessful. The Fair Trade Commission joined with the industry in vigorously opposing it.

The power of MITI and the Ministry of Finance were significantly reduced in 1964 when, in becoming an IMF Article 8 nation, Japan lost the power to allocate foreign exchange. Since the early 1970s the power of these ministries has been further reduced by industry's lessened dependence upon bank financing and the liberalization of foreign investment and the capital markets. In 1980, measured by value on a per-capita income basis, transactions on the Tokyo Stock Exchange were as large as those on the New York Exchange. The rise in the importance of equity financing reduces the role of government.

The Free Market Paradox

With all the current emotion over the imbalance in the U.S.-Japan merchandise trade, there may be a good many observers who hold that it was "unbecoming" of the Japanese Government deliberately to foster economic rationality in its economy, that this has given Japanese producers unfair advantage. With equal logic, however, the opposite conclusion might be drawn: that there would be merit in the governments of other private enterprise economies working in conjunction with their private sectors comparably to encourage economic rationality.

As market forces operate—in the American economy and elsewhere—there is striking imbalance in the position of capital and labor. Capital is free to go anywhere in the world in search of profit. In fact, most people of property doubtless regard this as a "divine right" of capital. Labor, on the other hand, is essentially bound to the nation. There have been some experiments in moving workers across national boundaries to jobs, but the record shows more liabilities than pluses.

While capital is global, knowing no national borders or national allegiance, the world consists of nation states which individually think in terms of national security, that is, in terms of national economies. While no one can have lived through the postwar period without being impressed with the rich gains that liberal trade has brought under American leadership, it is to be noted, one cannot ignore serious adjustment problems in one's own country when a major industry has lost international competitiveness.

I find it an instructive exercise to go back to the early postwar Japanese years and note the conventional wisdom of that period. Everywhere there was pessimism on Japan's future. The British were so pessimistic that they thought we Americans were seriously misguided in proposing dissolution of the *zaibatsu* for, as the British saw the matter, Japan needed every possible ounce of its resources just to survive. John Foster Dulles who negotiated the Peace Treaty for President Truman is reported, according to Orville McDiarmid, to have humorously observed "as late as 1952... that suicide was not an illogical step for anyone concerned with Japan's economic future."[2] Even in

the mid-fifties, the World Bank was doubtful of Japan's future credit-worthiness.

What did all these foreign observers (and a number of Japan's economists as well) leave out of account? What did they fail to put into the picture? Was it that they were thinking in terms of market forces alone and thus conceiving that the Japanese economy would likely be focused on textiles, apparel, cutlery, rubber-soled footwear, toys, and Japan's other prewar civilian industries? Was it that they were thinking of the prewar pattern of national income distribution with its sharply skewed curve resulting in a stunted domestic market? Was it that they failed to include the gains out of international trade that successive GATT rounds would bring? There are obviously lots of possible nominations here, but a major omission I would guess was the failure to imagine that Japan would deliberately restructure its industrial base. Changing Japan's key industries to income elastic and high value-added industries in conjunction with the democratic reforms of the Occupation brought enormous advantage to Japan and to the world.

However, a bias developed in Japan's trade pattern that has come to be felt with increasing keenness as the economy has grown in size. While manufactured goods are the only goods Japan has to export, as a mature industrial power Japan has an obligation to import manufactured goods as well as agricultural products and industrial raw materials. Just as Japan sought to move into higher value-added products for the benefit of its economy, so those economies strong in high value-added goods expect to be able to enjoy sales of their wares in Japan's market. It is evident that Japan has seriously neglected this side of the coin.

Industrial Policy: Redefining Economic Rationality

However, the comfortable American assumption that the difficulty of selling in the Japanese market is entirely attributable to barriers—seen and unseen—is unpersuasive. It is abundantly evident we have difficulty competing with Japan in the American market, as orderly marketing arrangements, trigger price mechanisms, and "voluntary restraint" agreements attest. Japan does not possess tariff and nontariff barrier advantages over American goods in the American market. Further, as study of export performance in third markets shows, we are not matching Japan's performance here. (The current serious misalignment of the yen/dollar rate makes it all but impossible for American companies to compete with Japan.)

This brings us back to the issue of industrial policy. The present American administration is deeply committed to the "magic of the market." But the "magic of the market" means that American capital has no loyalty or commitment to the American market. It is after profits wherever in the world profits are to be found. Further, capital has no commitment to physical production. Paper profits are quite as satisfactory as physical production. Thus in competition with a strong industrial nation that emphasizes prowess in physical production, it is unsurprising that we find ourselves erecting a growing array of trade restraints. Financially it may have made eminent sense for U.S. Steel to commit several billions to buying an oil company, but such strategy does nothing to refurbish the ailing American steel industry. Looked at dispassionately, our American thinking has a curious dichotomy to it. On the one hand we think in terms of national security and see the nation as the relevant economic unit. On the other hand, when we focus on capital we take the world as the relevant unit with no nation-states in it at all.

Apart from the near-crisis dimensions of the current misalignment of the yen/dollar rate, if we Americans want to be competitive with Japan we need to think of the shape of our domestic economy as well as attractive investment opportunities on a global basis. We should start by taking a national economic inventory. Such an inventory should include the age of plant and equipment in our key industries and the extent to which best manufacturing practices are diffused through the industry. (While it was the United States that developed continuous casting in steel, among 10 industrialized countries for the time period 1962-78 the United States had the lowest diffusion of this efficient process, Japan the highest.) We need to note our labor force—how to add skills our industrialists will be needing, how to cope with widespread near-functional illiteracy. We need to note where our labor-management relations are strongest and where weakest and the factors accounting for the difference.

It is conventional American wisdom to assume Japan is the land of monopoly and cartels, that it is we Americans who operate under the "handicap" of competitive markets. But most of Japan's markets are characterized by powerful competition. When corporate success is defined in terms of market share, rather than return on investment, the objective has a galvanizing effect on management and labor alike—when labor can be made to feel part of the enterprise, which sometimes happens with us and oftentimes does not.

Where do I come out on the issue of industrial policy? I favor wider national adoption of its procedures. If such were to occur, additional protocols would no doubt need to be added to GATT, such as, for example, standards governing permissible depreciation limits. I have thought for some time there should be standards here. Industrial policy is designed to operate national economic policy with maximum rationality when the unit is the nation. Since we are far short of world government, it makes sense to pay attention to the state of our national economies as well as global investment opportunities. Heightened economic rationality toward domestic economies in awareness of global responsibilities should stimulate, not inhibit, world trade. ●

1) Louis J. Mulkern, "U.S.-Japan Relations: Economic and Strategic Implications," in *U.S.-Japan Economic Relations, A Symposium on Critical Issues,* Institute of East Asian Studies, (Berkeley: University of California Press, 1980), p.28.
2) Quoted in E.M. Hadley, *Antitrust in Japan* (Princeton, N.J.: Princeton University Press, 1970), p.408 where the original source is shown to be McDiarmid, "Japan and Israel," *Finance and Development,* 4:2 (June 1966), p.36.