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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

FOR RELEASE ON DELIVERY
EXPECTED AT 9:30 a.m.
April 11, 1983

STATEMENT OF

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BEFORE THE
HOUSE COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON TRADE

ON

JAPANESE INDUSTRIAL POLICY

Mr. Chairman and Members of the Subcommittee:

We are pleased to be with you today to discuss our reports, "Industrial Policy: Japan's Flexible Approach" (GAO/ID-82-32) and "Industrial Policy: Case Studies in the Japanese Experience" (GAO/ID-83-11). Our work focused on (1) exploring the contribution of macroeconomic policy to industrial growth, (2) determining those policies which support growing industries and (3) determining those which assist declining industries.

We examined Japan's past and present experiences with industrial policy. We reviewed the changing goals and tools of



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Japan's industrial policy to assess how and why they have changed over the postwar period. In addition, we discussed how macro-economic monetary and fiscal policies have contributed to achieving the goals of industrial policy.

In Japan, macro- and microeconomic policies have worked together to achieve governmental goals. Microeconomic industrial policies helped to achieve broad economy-wide goals through their impacts on individual industries and sectors, monetary and fiscal policies reinforced the effectiveness of industrial policy tools by creating conditions that favored investment and growth.

INDUSTRIAL POLICY AFTER WORLD WAR II

The widely accepted consensus in Japan from World War II through the early 1970s strongly supported government efforts to reconstruct the Japanese economy by rebuilding the nation's basic industries and by working to catch up with the technology of the United States and Western Europe.

Japan, in the early postwar period, marshalled a large array of industrial policy tools which enabled the government to strongly influence the rate and direction of economic growth. These tools included

- strict foreign exchange controls;
- commercial policies which gave incentives to exports and restricted imports; and
- controls over foreign investment and the acquisition of technology.

For example, foreign exchange controls were used to direct resources to targeted industries and to limit foreign competition

in the domestic market. The Foreign Exchange and Foreign Trade Control Law operated through a system consisting of a foreign exchange budget and import controls. The foreign exchange budget set the amount of foreign currency available for the year and allocated it among sectors of the economy. This enabled the government to effectively allocate foreign exchange and, thereby, to direct raw material imports and the acquisition of foreign technology to targeted sectors; for example, steel and chemicals. During this period, the government protected domestic industry by carefully restricting competition from imports and foreign industry through the use of import controls and controls over foreign investment in Japan.

Monetary and fiscal policies reinforced the effectiveness of these tools in a number of ways, primarily by

- keeping interest rates low, thereby both lowering the cost of investment and generating demand for loanable funds that exceeded supply;
- placing strict controls over domestic capital markets, which effectively prevented these markets from becoming a major source of free market capital;
- administering a tax system which favored savings and investment; and
- channeling government-controlled resources into productive investment.

By restricting capital markets and keeping interest rates artificially low, the government was able to effectively control which industries had access to Japan's limited capital. Firms were largely dependent upon Japan's 13 major city banks for financing industrial development. The city banks, in turn, were dependent

upon the Bank of Japan in order to expand their loanable funds. This interrelationship enabled monetary authorities to effectively ration credit through the city banks to targeted growth sectors. Non-targeted sectors were denied access to this cheap capital.

Fiscal authorities allocated budgetary funds to targeted industries as well. Household savings were primarily deposited in the savings system operated through the nation's post offices. These savings were channeled by the Ministry of Finance to the Fiscal Investment and Loan Program (FILP). The funds were in turn allocated to government financial institutions, such as the Japan Development Bank and Japan's Export-Import Bank, to implement government economic policy goals. Significant funds from the FILP were thus allocated to targeted industrial sectors to stimulate industrial development. The FILP account has been as large as 50 percent of Japan's general account budget and thus has accounted for significant assistance to Japanese industry.

CHANGING GOALS AND TOOLS OF INDUSTRIAL POLICY

A key feature of Japanese industrial policy has been its flexibility in responding to changes in the domestic and international economies. During the early postwar period, industrial policies were geared toward achieving rapid economic growth and establishing an industrial infrastructure. As these goals were achieved, efforts were refocused on catching up with the industrialized West and developing new technology. By the mid-1970s, Japan was giving more recognition to such concerns as the quality

of life, the environment, and other social considerations.

Furthermore, the rapid rise in the price of petroleum since 1973 had an especially strong impact on Japan. Roughly 75 percent of Japan's energy comes from oil imports, the highest of any major industrialized nation.

In the early postwar years, policy goals were primarily sector oriented; government and business addressed themselves to rebuilding specific industries and sectors of the economy. By the mid-1960s, Japan had largely achieved its postwar development goals and began placing growing emphasis on technology and social development issues. Following the economic turbulence of the early 1970s, Japan has focused on adjusting to stable growth, supporting resource conservation, and improving the environment, while continuing to support the development of new technology.

With changes in the goals of industrial policy, tools to implement these goals also changed. Such changes are attributed to numerous factors, including

- the financial success of Japanese firms, which left them less dependent on debt financing;
- the relaxation of domestic regulation of financial markets, which opened new avenues of financing to firms;
- international pressure and obligations of Japan, such as those under the International Monetary Fund and the General Agreement on Tariffs and Trade; and
- increasing budget deficits, which placed constraints on the government's ability to finance industrial development.

Government influence over key industrial sectors began to weaken as a result of these factors.

As trade and investment laws were amended to remove controls over foreign exchange and international trade agreements provided for reductions in tariffs, quotas, and non-tariff barriers, the government lost a major source of its power to direct industry.

With increasing trade friction with developed nations, competition from newly industrializing countries, and economic hardships resulting from the oil crisis, the Japanese Government finds itself restraining competitive Japanese industries from foreign markets and assisting other industries to adjust to declining competitiveness. A rising class of structurally depressed industries, a number of which are energy-intensive, and the attendant employment problems have led to new legislation and government involvement in easing the adjustment process. In recent years, government deficits, high consumer and energy prices, and inflation have contributed to increasing difficulties in decisionmaking and in achieving consensus. As many of the postwar tools of industrial policy were lost to legislative or structural changes, administrative guidance grew in relative significance.

Today, the Ministry of International Trade and Industry continues to influence government and industry views concerning the direction of industrial development. As a result of the constraints and legislative and structural changes mentioned above, however, the Ministry has redefined the goals of industrial policy as (1) the need for Japan to move up the technological ladder in order to increase productivity and to promote conservation of resources and social goals and (2) the need to ease the

adjustment problems, particularly unemployment, of certain declining industry sectors.

CURRENT INDUSTRIAL POLICIES TOWARD
EXPANDING INDUSTRIES

The emphasis of industrial policy today has shifted from industry-specific to technology-specific targets; industries are assisted in developing and diffusing technologies throughout the economy that contribute to achieving the goals of higher value added production, greater productivity, and resource conservation. Industries such as computers, robotics, and aircraft meet these criteria and benefit from government support.

Financial support for joint government-industry research and development programs is a major tool of government assistance for technology development, while tax incentives and special leasing programs are used to promote technology diffusion. These mechanisms work through incentive rather than control and, as a result, the government has less direct influence over industrial development than it had during earlier periods. Significant obstacles hamper the success of government policies in each growth industry we reviewed. Development of leading-edge computer technologies presents new risks for the government and computer companies. Problems encountered today in developing new technologies are different than those of licensing, adapting, and commercializing foreign technologies, which were successfully overcome during the last two decades. Robotics manufacturers face an as yet undefined and undeveloped market at home and abroad. They must

develop new products as well as demonstrate applications in order to create demand for these products. The development of new aircraft and aircraft engines has become a task too costly for one company or one country to undertake, and Japanese companies, like those in other countries, need to participate in international joint ventures. It appears that the trend toward less direct government influence over industrial development may continue.

INDUSTRIAL POLICY TOWARD DECLINING INDUSTRIES

Rising labor costs, sluggish world demand, lower priced products from Southeast Asia, increased raw materials costs, and foreign market import restrictions have all contributed to severe economic disruptions for some Japanese industries. The government has attempted to assist these declining industries adjust to new circumstances by providing incentives to scrap excess production capacity. The government also assists workers in these industries through a number of unemployment and reemployment programs.

The Japanese Government has assisted troubled industries since the 1960s. The Structurally Depressed Industries Law, passed in 1978 and extended this year, addresses some generic problems of decline. Different mechanisms are used for short- and long-term problems. For example, a rationalization cartel, which permits member companies to jointly reduce output in order to stabilize prices, is used to address short-term price and production imbalances. Plant and equipment scrapping programs are aimed at long-term structural problems. The new law emphasizes the consolidation of business operations as well as disposal of

excess capacity. The thrust of the government's current financial assistance, in the form of loans and preferential financing, is directed to small- and medium-sized firms. Larger firms are expected to adjust on their own and, in the case of the ship-building industry, to assume some of the burden of assistance to small- and medium-sized firms.

The Japanese Government, not unlike other representative democracies, has found that political reality often constrains the formation and implementation of economically rational decisions to phase industrial sectors out of the economy. Conflicts have arisen in setting priorities and implementing stabilization programs between government and industry and between firms within an industry. Nevertheless, adjustment of declining industries has occurred, although the long-term success of this adjustment process is unclear. Some effective mechanisms do exist for employment adjustment. Private industry takes the lead in retraining and outplacement. Historically, high growth rates and a variable labor force have helped to ease adjustment. In the slower growth environment, the government has become more involved in the adjustment process. Key elements of Japan's "positive adjustment" policy include (1) recognizing that emerging industries can ease the adjustment problems of declining industries and (2) coordinating programs to assist resource shifts from declining to emerging industries.

CONCLUSION

Macro- and microeconomic policies showed a high degree of complementarity during the early post-war period, which reflected

the broad consensus to reindustrialize Japan. Japanese monetary and fiscal authorities intervened directly to develop and support industrial policies during this period.

Over time, changes have occurred. A key element of Japanese industrial policy has, therefore, been the flexibility of the government and its programs in responding to the pressures and constraints of the domestic and international economies. Government credit rationing is a less effective tool for directing the private sector, because Japanese companies have become financially stronger and alternate means of financing have become available to them. Debt financing has begun to decline, although it still accounts for a large proportion of total corporate funding in Japan. The city banks' dependence on Bank of Japan funds has begun to decrease as government-set interest rates move closer to those in the free market and as financial deregulation occurs. Increased budgetary deficits, coupled with increased difficulty in financing these deficits, have placed constraints on the government's ability to finance industrial development. As mentioned earlier, industrial policy now focuses on increasing productivity and promoting resource conservation and social goals, in part through enhancing technology, as well as easing adjustment problems of certain declining industries. The government's ability to direct the course and speed of industrial growth in light of an increasing number of conflicting priorities and legislative and structural changes in industrial policy tools is unclear.

YEN-DOLLAR EXCHANGE RATE

I would also like to touch briefly at this time on our current study of the yen-dollar exchange rate. Concerns that this rate has not reflected fundamental economic factors have generated charges that Japan manipulates the exchange rate of its currency to gain an unfair trade advantage. These charges have added to the tensions with Japan over other trade issues.

This concern over the yen-dollar exchange rate also comes at a time when many observers are raising questions about how well flexible exchange rates and the current international monetary system are working. Ten years ago, when the system was adopted, two widely held beliefs were that (1) flexible exchange rates would avoid sustained inappropriate currency values and (2) domestic economic policy formulation would be freed from the burden of international payments considerations. These propositions are being questioned today.

Although our work on these issues is continuing, we have reached several preliminary conclusions.

--First, exchange rates in general cannot be adequately explained by looking only at international trade or specific bilateral relationships. Many variables, including the balance of trade, capital flows, and differences between countries' national economic policies and economic conditions, affect exchange rates. Unmeasurable factors, such as perceived political risks and expectations, also play a critical role. A consequence of these complex determinants is that foreign exchange markets can yield exchange rates that have adverse trade and employment consequences for us or for other nations at particular times.

--Second, looking particularly at the yen-dollar exchange rate, we have seen no evidence to support charges that the Japanese Government manipulated or

artificially depressed the value of the yen. On the contrary, Japanese foreign exchange intervention, together with other actions during this recent period, would tend to have strengthened rather than weakened the yen. The weakness of the yen and the strength of the dollar can be explained by a combination of variables, including high U.S. interest rates and liberalization of Japanese capital controls. The wide fluctuations in the yen and the low reached in November 1982, when the yen clearly "overshot" its equilibrium value, appear to be phenomena inherent in the nature of exchange markets.

--Third, as international trade and investment have become much more important to the United States over the past decade, domestic economic policies and exchange rates have become more dependent on each other. Domestic economic policy decisions affect exchange rates. At the same time, changes in exchange rates affect the policy's success in reaching goals, such as high employment or low inflation. Contrary to expectations, flexible exchange rates do not allow countries to pursue independent economic policies without considering the international consequences.

--Finally, although currency fluctuations have created genuine problems and some observers have called for modifying the floating exchange rate system, there is no consensus as to what changes, if any, would be desirable and no agreement on what constitutes a better system.

Where a consensus does lie is in the recognition that domestic policy options in an open economy are more constrained than in a closed economy. Implementation of domestic economic policy without explicit recognition of the international constraints and costs of policies can be very disruptive to exchange markets and, in turn, can prove costly to the economy.

Mr. Chairman, this concludes my statement. I will be happy to answer any questions you or your Subcommittee may have.